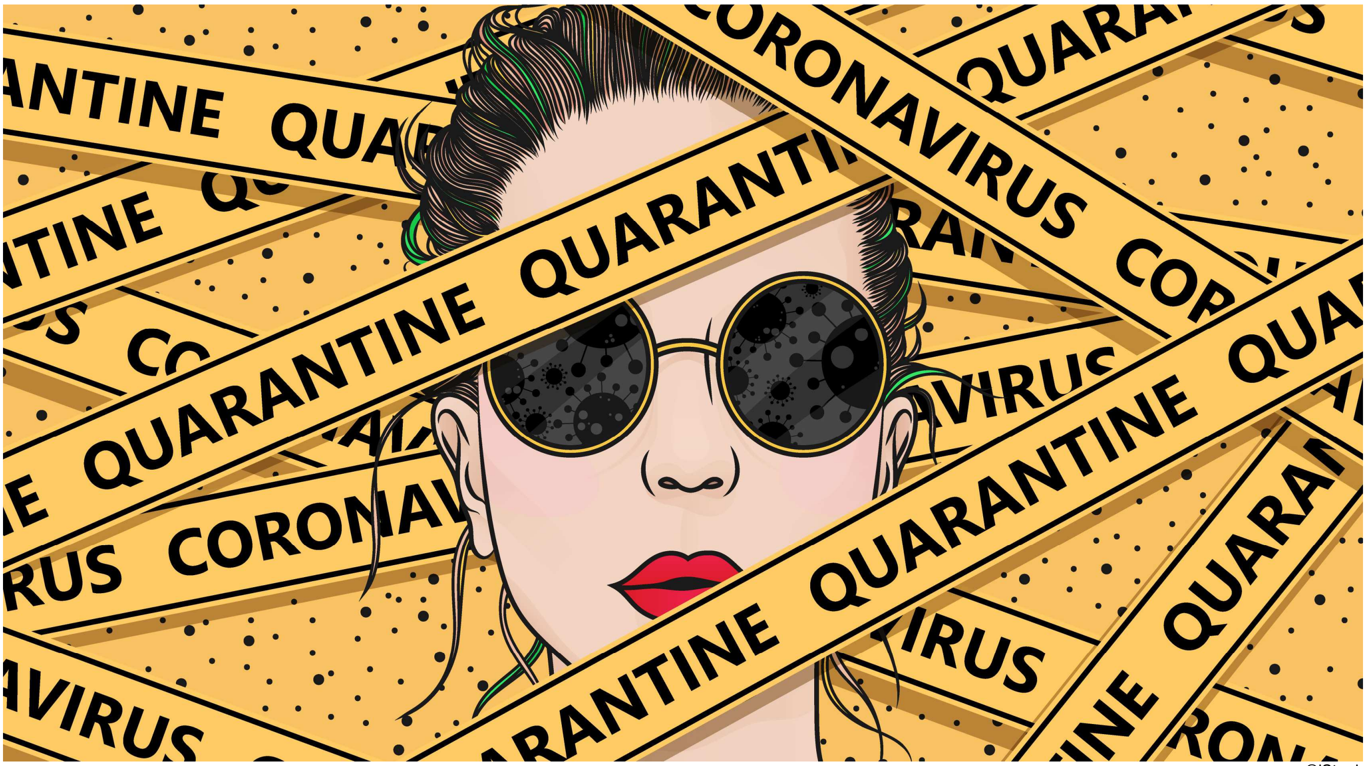
Quarterly report

Czech Economic Outlook

Lockdown version 2.0



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■ **The Czech economy declines again** The second wave will push the economy lower once again. Consequently, GDP growth will also be lower next year. Compared with our July forecast, we expect the return to pre-crisis GDP to be postponed by one year, to 2023.

■ **Inflation to decelerate** Inflation has surprised on the upside this year, but it should decelerate over the coming quarters due to the weaker economic context. Prices of food and energies should act as a disinflationary factor, but inflation is unlikely to decelerate fast due to the weaker CZK.

■ **The CNB is likely to leave rates unchanged until end-2021** According to the central bank, the current level of monetary policy easing is sufficient. The argument against further policy easing is primarily domestic inflation, which remains above the upper limit of the tolerance band and will only slowly return to the target. The economic recovery next year will be on shaky ground and the CNB is unlikely to be in any rush to tighten monetary policy. We do not expect unconventional tools to be used.

■ **Financial markets are evaluating the efforts to combat the coronavirus** For the coming weeks, we expect the koruna to reflect the domestic development and government lockdown measures. As the situation calms down, we forecast the koruna to return to stronger levels. The shift to weaker levels again opens up an opportunity for FX hedging at weaker values.

■ **The second wave has returned financial markets to spring levels** CZGB yields will likely be supported by the growth of IRS and the high supply next year. However, the short end of the curve should continue to be weighed down by pessimistic investor expectations. The drop in interest rates again opens up attractive hedging opportunities.

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COVID-19 2.0 is here

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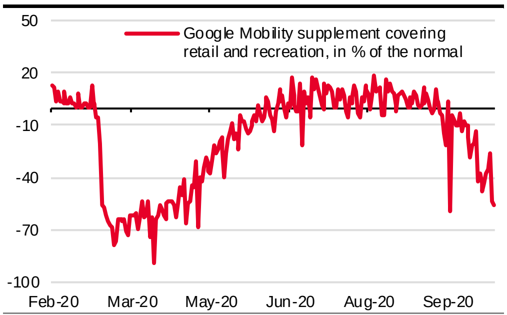
We get a strong sense of *déjà vu* while writing this editorial for the *Czech Economic Outlook.* The second wave of the coronavirus pandemic is now upon us, and this injects an enormous amount of uncertainty into macroeconomic forecasting, just as it did six months ago.

Our end-July forecast was one of the more optimistic ones in the market, and in light of the latest developments we can say that it definitely has not disappointed. The economic slump recorded in the second quarter of this year was the deepest in the history of the independent Czech Republic: compared with the first quarter, real GDP dropped by 8.7%. Nevertheless, compared with some of the catastrophic scenarios that emerged during the first wave which predicted a double-digit drop, the result is quite encouraging. What is even more encouraging is the faster-than-expected recovery in the Czech economy in the third quarter, according to the available monthly indicators. The lifting of restrictive measures spurred demand in retail and services and also in industry. The rebound in passenger car sales, so important for the Czech economy, was another positive surprise. Thus, the sharp V-shaped recovery scenario has materialised; for the third quarter we expect GDP to grow by 5.3% qoq. While the available data supports our original forecast calling for a 5% slump in the Czech economy this year, it is now clear that the slump will be much deeper due to the emergence of a second coronavirus wave.

Although shops remained open for most October, footfall started to decline in late September

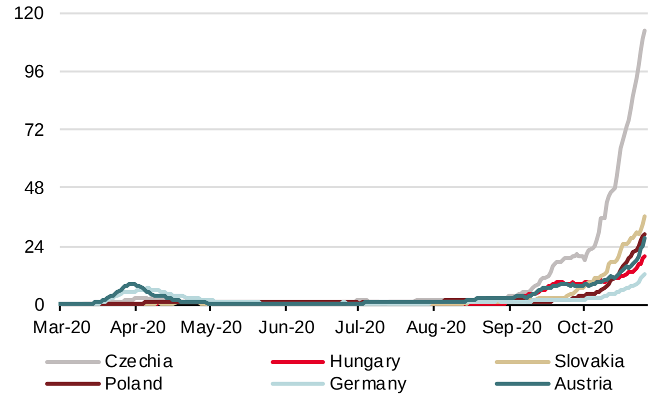


Source: Google, Macrobond, Economic and Strategic Research, Komerční banka

Our original base scenario did not factor in an autumn wave of COVID-19, so one of the most prominent risks has materialised. And unfortunately for Czech society and the economy, the second wave is turning out to be much more devastating than the first. This will have its economic impacts, regardless of whether or not the government adopts the same restrictive measures as in March. The reason is that fear of infection can result in a voluntary lockdown of a large section of the economy. In response to the deteriorating epidemiological situation, the government decided to close down all schools (with the exception of pre-school facilities), clubs, bars and restaurants (with the exception of take-aways until 20.00) as of 14 October. It has also prohibited the consumption of alcohol in public and gatherings of more than six people either indoors or out. Exactly one week later, the government further tightened the restrictive measures by closing down physical retail (except for groceries and pharmacies) and significantly restricted the movement of persons again.

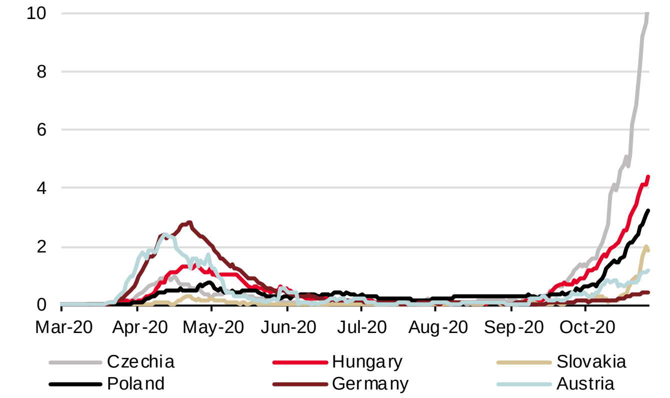
While the Czech Republic emerged as a top achiever from the spring wave, the autumn wave has swept the country into the category of worst in Europe, and worst globally in terms of number of infections and, unfortunately, deaths relative to the population. The number of people testing positive for the virus has risen dramatically, including among the most vulnerable segment of elderly citizens. The daily number of infections is growing exponentially and this trend is likely to continue in the near future because the R factor, the reproduction coefficient, is still much higher than one. The growing percentage of positive cases relative to the number of tests also indicates that the number of infections may actually be much higher than the official numbers are showing. This presents a major risk that the health system will become over-congested. So far, some reserves are still being reported, with regards to available capacities, such as beds in hospitals and intensive care units and the number of ventilators. In addition, the Czech army is currently setting up a standby field hospital with a view to expanding these capacities. However, the most formidable bottleneck in the Czech healthcare system is a shortage of personnel, and this is likely to affect some regions soon.

Daily number of infections by country, per 100,000 pop.



Source: Macrobond, Economic and Strategic Research, Komerční banka

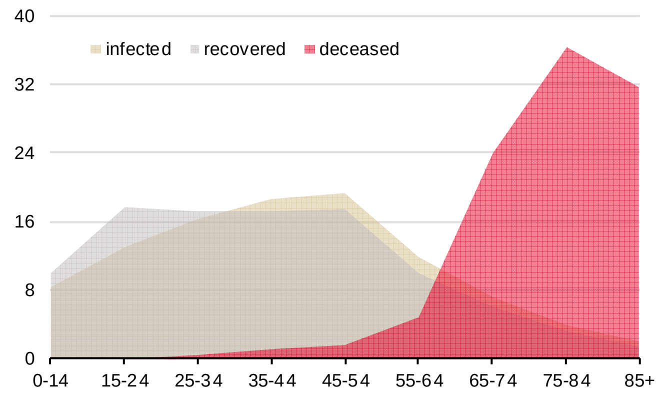
Daily number of deaths by country, per million pop.



Source: Macrobond, Economic and Strategic Research, Komerční banka

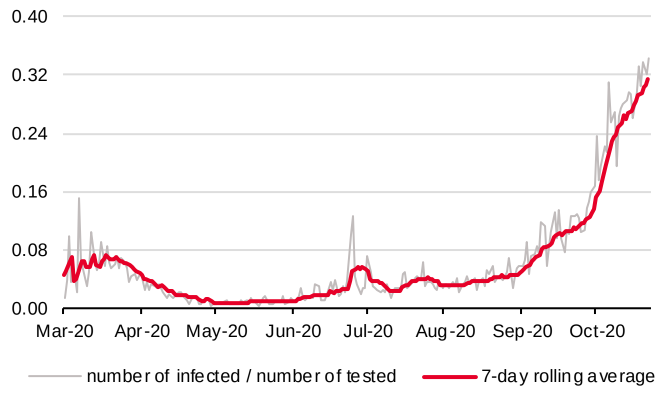
The current course of the pandemic constitutes a significant economic risk. The government measures adopted on 21 October are expected to apply for two weeks, at the end of which the state of emergency is due to expire. However, in view of the most recent developments, it seems likely that the government will request an extension to the state of emergency from the Chamber of Deputies in order to keep the current measures in place. In our base scenario we expect the state of emergency to be extended by one month. The current government measures would therefore continue to apply until the end of November, after which we expect a very cautious relaxation of the restrictions (return of primary school children to schools, reopening of some services) until the end of the year. We don't expect any significant lifting of restrictions until the first half of 2021. From the epidemiological perspective, our base scenario assumes a return to the normal in mid-2021.

Age distribution of infected, recovered and deceased people (%)



Source: Czech Ministry of Health, Economic and Strategic Research, Komerční banka

Ratio of people newly diagnosed positive vs total number of tests



Source: Czech Ministry of Health, Economic and Strategic Research, Komerční banka

The current measures are more focused than the spring measures. Our base scenario does not expect the industrial sector to be directly affected by these measures. We believe the national borders will remain open and production chains should therefore not be as disrupted as they were last spring. Thus, a second drop in demand represents the main threat to the manufacturing sector. However, we can also expect a significant negative impact again in services activities, which have been hit hardest by the latest measures. These primarily include leisure activities: sports, culture and tourism. The second wave will be a real acid test for the catering industry. Retail will also face huge problems as its peak season, the Christmas period, is now at risk.

We expect the Czech economy to decline by 4.3% in 4Q vs 3Q. We have therefore revised down our full-year economic decline from the original -5.0% to -7.6%. In view of the ongoing restrictions and uncertainties, the recovery in the first half of next year will be slower; in particular, the willingness to invest will remain weak. We therefore expect the Czech economy to grow by 3% next year, i.e. at half the rate projected in our previous forecast. Overall, this implies that the country will not return to its end-2019 level of growth until early 2023. From an economic perspective, the coronavirus pandemic will therefore have stolen at least three years of growth.

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External Environment and Assumptions

World economy shakes off first virus wave but major risks remain

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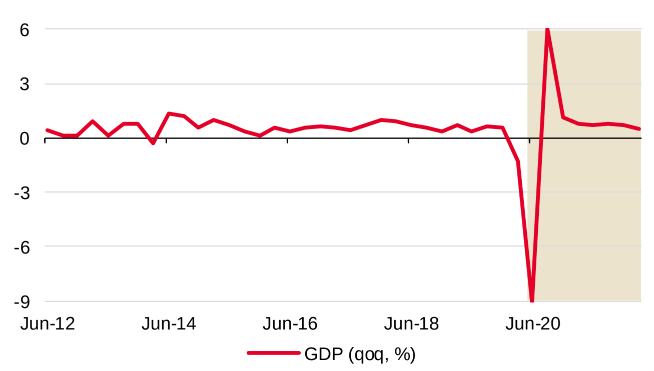
Economic activity in the US, euro area and CEE region accelerated significantly over the summer following the lifting of many lockdown measures. Households caught up with deferred consumption, and retail and industrial production returned relatively quickly to pre-crisis levels. As a result, we can look forward to high GDP growth in the third quarter. However, amid a second wave of the pandemic in some places, there are question marks over the fourth quarter. Next year, the economies of the US, euro area and CEE should post solid growth. However, inflation should remain a handicap in the US and euro area. It will likely remain below the Fed's target, with short exceptions, until 2023. We thus see room for a rate hike in the second half of 2023. The euro area should be even worse in this respect. With inflation likely to be in negative territory by the spring of next year, the ECB may extend and expand the pandemic asset purchase program at the end of this year.

US inflation set to stay below Fed target for several years

US labour market will not quickly recover from the coronavirus crisis

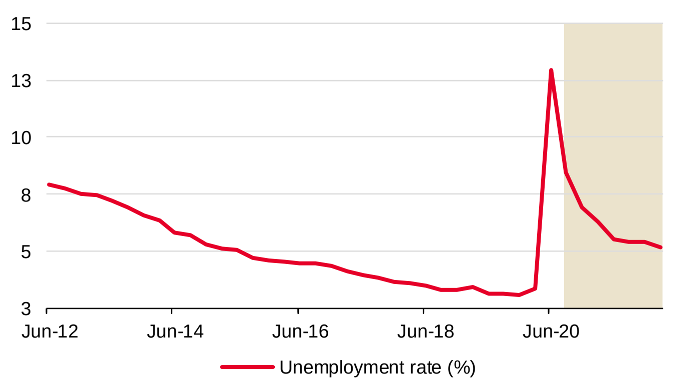
In the US, the economic recovery is on track. Retail sales grew soundly in May/July, as did industrial production. In August, the pace of growth of these indicators decelerated, but we see this as natural and part of a downshift to a more sustainable pace. In 3Q, our forecast is for 31.7% annualised q/q growth. Overall, we expect GDP growth to be down 4.2% this year and up 3.4% next year. The US labour market is likely to take a long time to recover from the coronavirus crisis. In September, the unemployment rate dropped to 7.9%, but there is limited room for further decline, in our view. Although the payrolls number is rising relatively quickly (+661,000 in September), the US labour market is still down 10 million jobs. The restaurant and accommodation sector is still being hit the most. In comparison with February, there are 2.5 million jobs missing, some of which will be lost permanently.

After a massive drop, the US economy should pick up



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment set to decelerate only slowly



Source: Macrobond, SG Cross Asset Research/Economics

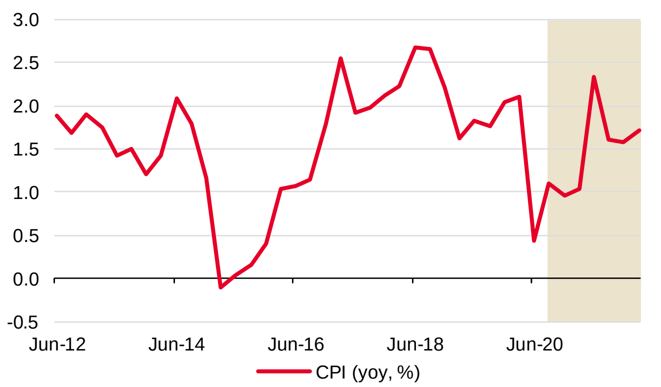
We see first rate hike in 2023

Full employment is estimated at 4.1%; however, on our estimates, the Fed will not be able to achieve this figure before 2024. Inflation will likely reach the Fed's target in 2023 at the earliest, in our view. The Fed is even more skeptical in this respect. It sees inflation staying below 2% until the end of 2022 and getting to 2% in 2023. As a result, it is not surprising that 13 of the 17 Federal Reserve bank governors do not expect any change in interest rates until the end of 2023. We see space for a first hike in 2H23.

Trump win would be a plus for growth, the dollar and equities; Biden win would be positive for corporate bonds

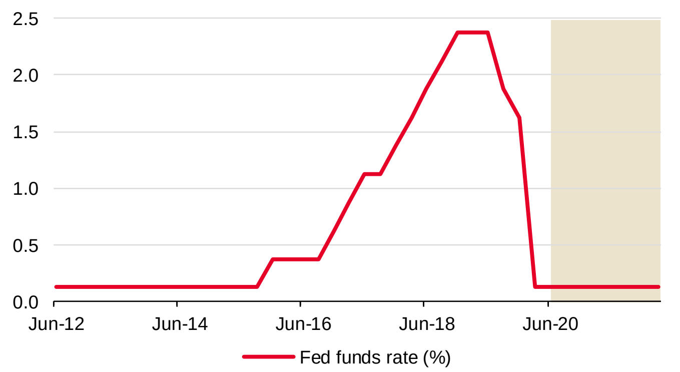
The US presidential election, scheduled for 3 November, will have an impact on the US economy too. Joe Biden is leading Donald Trump in the polls, and we give Biden a 62% chance of winning. A Trump victory is generally considered more positive for growth (given his preference for low taxes) and US risk assets. Also, the increased probability of further trade wars and the associated uncertainty would probably be better for the US dollar. The dollar thus would probably weaken less than if Biden won. On the other hand, Trump's unpredictability would mean more demand for certainty and thus more demand for gold. Biden could reduce sanctions on Iran and Venezuela, which could result in lower oil prices. We think a Trump victory would be a plus for equity markets, while a Biden win would likely be good for the corporate bond market. Generally, the elections might mean higher volatility in the markets, but this should vanish immediately after the announcement of the winner.

Inflation unlikely to stay below target for long time



Source: Macrobond, SG Cross Asset Research/Economics

Rates will likely remain at current level until 2023



Source: Macrobond, SG Cross Asset Research/Economics

Euro area: favourable prospects so far

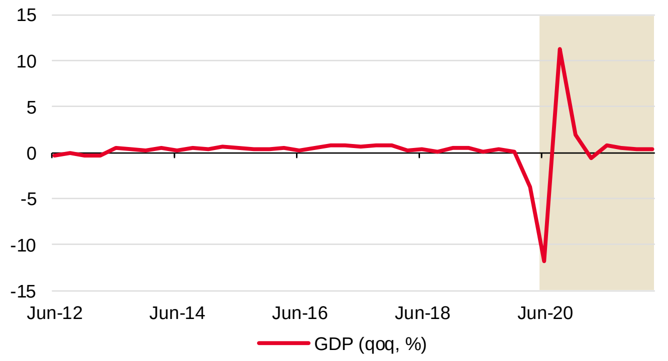
Households spending accumulated savings

Since the easing of lockdowns, the euro area economy has recovered sharply. Retail sales are enjoying a V-shaped recovery and quick growth in yoy terms. This confirms our view that households are spending their accumulated savings and releasing pent-up demand. The industrial sector is doing well too, although the August data, especially from Germany, brought some disappointment. The ratio of new orders to inventories, from which we can infer further developments in this sector, jumped 1.4 standard deviations above its historical average in September. Leading industry indicators, such as the German Ifo index, have already regained pre-crisis levels. The industry appears set to recover further unless it is significantly affected by the second wave of the pandemic, the secondary effects of the first one, or weaker foreign demand.

3Q strong, outlook uncertain

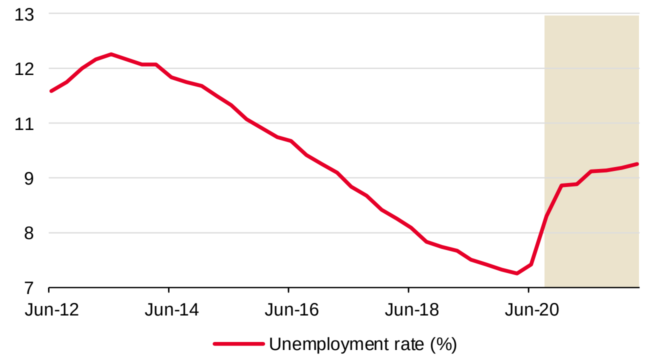
Overall, the indicators published so far point to strong growth in the euro area economy in 3Q. We estimate growth of 11.2% qoq for the quarter. For the whole year, we think GDP will fall by 6.8%, while next year it should grow by 3.9%. However, we don't think the euro area economy will reach pre-crisis levels until summer 2023. In addition, the risks are concentrated to the downside. In the medium term, we expect second-round effects of the pandemic crisis to emerge. We see unemployment rising from 7.3% in 1Q20 to 9.7% in 2021-2022, and it likely won't begin to decline until 2023. Corporate bankruptcies are likely, with investment under pressure as companies try to restore their cash buffers.

3Q looks promising (GDP, qoq, %)



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment to rise

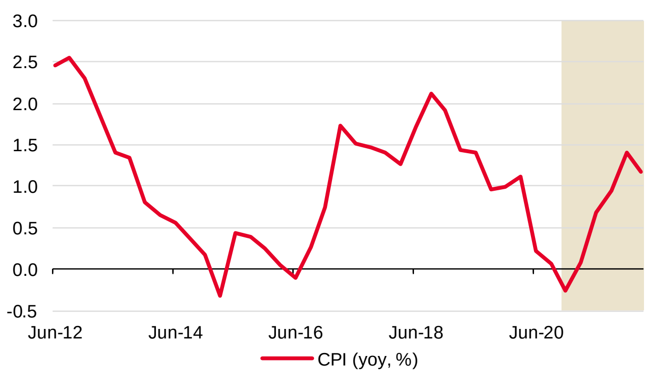


Source: Macrobond, SG Cross Asset Research/Economics

ECB will likely extend pandemic purchase programme

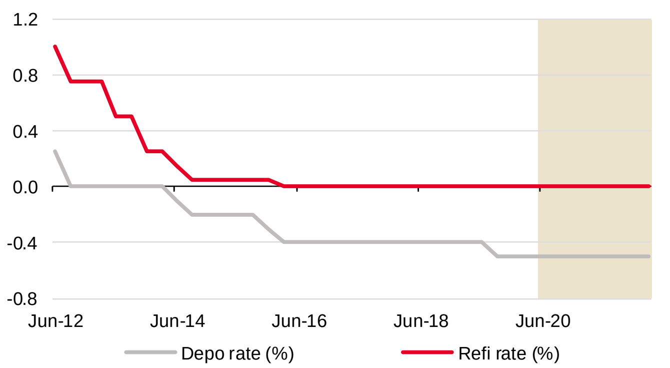
Euro area inflation was in negative territory for a second month in a row in September, with the core component falling to an all-time low of 0.2%. For the rest of this year, lower energy prices and a strong euro will likely push headline inflation further down, while rising unemployment, subdued demand and weak wage growth should dampen core inflation. We expect inflation to average 0.3% this year and 0.8% next year, with the 1.4% level not exceeded until 2024 and negative readings until spring 2021. For this reason, we expect the Pandemic Asset Purchase Program (PEPP), worth EUR1.35tn, to be expanded by another EUR500bn. We expect this decision to be taken at the December meeting. Alternatively, the Asset Purchase Program (APP), which is operating at a monthly pace of EUR20bn, could be expanded. We expect the APP to be ended at the beginning of 2023. Further ECB steps could include the inclusion of mortgage loans in the TLTRO program if household confidence and consumption fall sharply. Furthermore, an equity purchase program, could be launched if there is too much market volatility, which would jeopardise economic growth. Further interest rate cuts would be ineffective, in our view.

ECB inflation target not in sight



Source: Macrobond, SG Cross Asset Research/Economics

Interest rates likely to remain at current levels until 2023



Source: Macrobond, SG Cross Asset Research/Economics

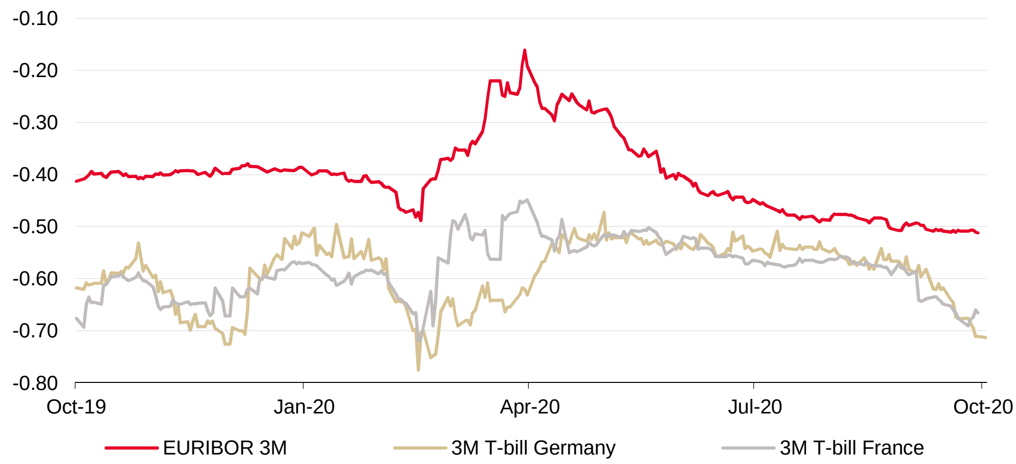
Box: The decline of Euribor – where is its bottom?

The three-month Euribor, as the main interbank rate in the euro area, serves as an indicator of the 'price' of money, i.e. as a benchmark for lending. In normal times, it is guided mainly by the ECB's monetary policy and its interest rate changes. After the outbreak of COVID-19 in spring, Euribor jumped by about 20bp. This reflected increased distrust in the interbank market, stemming mainly from fears of a dramatic increase in non-performing loans and a decline in the solvency of commercial banks. These fears were not realised, and **Euribor has**

fallen back below pre-crisis levels without the ECB contributing in any way. At present, it is at -0.51%, about 15bp below its level at the beginning of this year.

In our view, the decline has been caused by massive excess liquidity in the euro area banking sector and the end-of-year Resolution Fund effect. In recent years, the ECB has supplied huge amounts of new money to the system by buying financial assets and providing loans at negative interest rates, thus reducing banks' demand for money on the interbank market. There is nothing new about that. However, in recent months, banks have significantly reduced the maturity of their mutual loans in an effort to minimise inflated balance sheets and thus reduce their contributions to the Resolution Fund as much as possible. The contributions are derived from balance-sheet totals at the end of the year and naturally force banks to get rid of money and thus borrow more through the end of the year. A similar downward effect can be expected for interbank rates with shorter maturities as the last day of the year approaches.

France/Germany T-bills yields to limit further decline of Euribor



Source: Bloomberg, Economic and Strategy Research, Komerční banka

The question is: how far can Euribor drop over the rest of this year? By year-end, this whole story should end and things should return to normal. Until then, however, we **expect interbank rates in the euro area to fall further. In our view, their limit is the 'risk-free' T-bill yields of the main eurozone countries**, Germany and France. However, under pressure from investors fleeing to safe assets, these yields have fallen to -0.71% and -0.66% respectively in recent weeks, opening the door for Euribor to drop further. However, we do not expect its decline to go that far.

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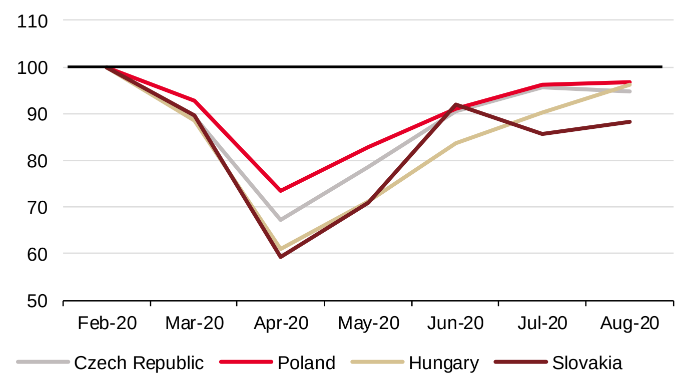
Strong 3Q in CEE, second wave to take toll from 4Q

The third quarter started very promisingly for CEE economies. Retail sales grew rapidly and almost reached pre-pandemic levels in all countries, except Slovakia. Industry, which quickly wiped out its pandemic losses, saw a similar situation. The PMI indicators showed a further recovery in this area, rising to over 50 points in all countries, indicating expansion. In Hungary, however, the five-month rally above this threshold ended in September when the index unexpectedly fell to 48.8 points. On the contrary, in the Czech Republic, the index jumped over 50 points for the first time since 2008 in September. The good news is that new orders continued to grow in all countries, and employment even returned to growth in Poland.

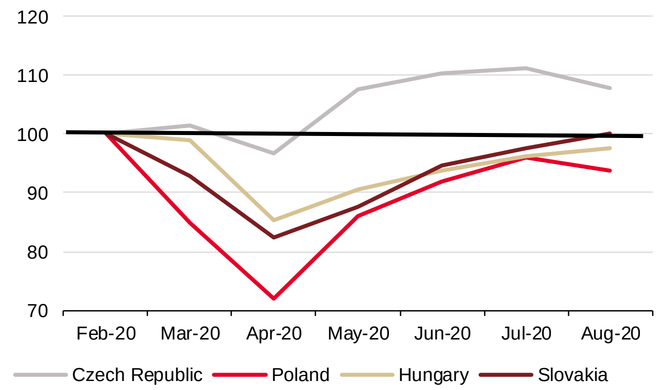
These data indicate that we can expect strong economic growth in the region in the third quarter. Our estimates see growth of 5.3% qoq in 3Q for the Czech Republic and 6.9% qoq for Slovakia. But question marks are hovering over the fourth quarter. The second wave of the pandemic has hit the Czech economy hard, and other countries in the region will not be able to avoid at least secondary effects such as deteriorating confidence and further postponement of investment or consumption. We expect Czech GDP growth to fall by 7.6% and Slovak GDP growth to drop by 8% this year. According to the Bloomberg consensus, economic growth should fall by 3.6% yoy this year in Poland and 5.3% yoy in Hungary. Next year, we expect the Czech economy to grow by 3.0%, the Slovak economy by 7.6%, while the market consensus expects the Polish economy to grow by 4.2% and the Hungarian by 4.8%.

Industry, February 2020 index = 100



Source: Macrobond, SG Cross Asset Research/Economics

Retail sales, February 2020 index = 100



Source: Macrobond, SG Cross Asset Research/Economics

Core prices surprised with a marked rise

Inflation in the region remained above central bank targets in the third quarter. Core prices rose in particular, pushed up by prices in the services sector. Service providers tried at least to partially compensate for the losses caused by the closure of economies by increasing prices. Deferred demand, with which consumers were trying to catch up, also played a role. Accommodation, recreation and entertainment prices went up the most. In September, the trend reversed (at least in the Czech Republic and Hungary) and core prices began to fall. Core inflation still surprised with unexpected growth in Poland (+4.2% yoy), but even here the deteriorating labour market situation and associated demand shock should push prices down in the coming months. CEE inflation should thus gradually return to target next year. A high base effect will also have an impact, with inflation reaching 4.7% in the first quarter of this year in Poland and Hungary and 3.7% in the Czech Republic and 3.2% in Slovakia.

Inflation will likely gradually return to target

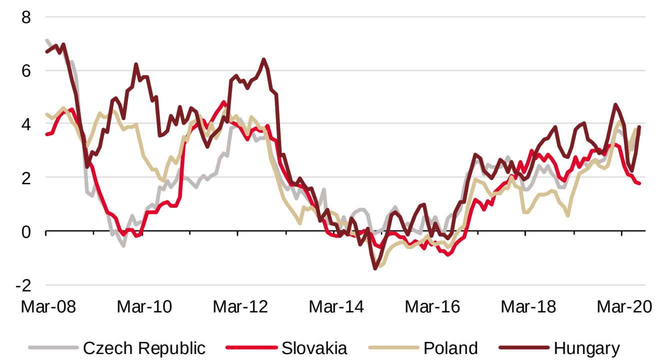
Due to the second wave of the pandemic, inflation in the region could fall faster. In the Czech Republic, inflation might fall below the 2% target of the Czech National Bank next year. A similar scenario is expected by the Polish central bank. The Hungarian central bank sees inflation returning to target. Therefore, the most likely scenario is that the regional central banks leave monetary policy unchanged in the coming quarters, except in Hungary, where we expect marginal changes.

We do not expect major changes in regional central bank policies

Czech and Polish central banks not in favour of negative interest rates. In the event of a significant deterioration of the economy, the Czech National Bank could reduce its key rate to technical zero or use alternative monetary policy instruments (FX intervention). We look more at this topic in the CNB Focus section. In our opinion, the Polish central bank will not reduce rates below the current 0.1%. We expect a first increase, of 15bp, in the final quarter of next year. The Hungarian central bank will likely increase the one-week deposit rate to 1% by the end of the year to prevent a disproportionate weakening of the domestic currency. In our opinion, it will reduce the key 3-month interest rate in 4Q by a symbolic 10bp to 0.5%. The

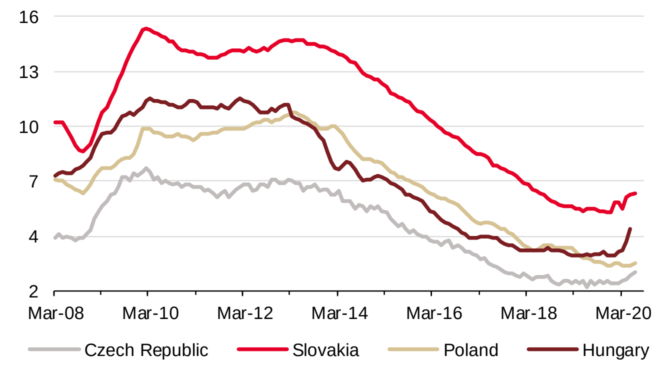
Polish and Hungarian central banks are likely to continue their quantitative easing programmes. Their balance sheets are now about 35 to 40% higher than before the crisis. As for the regional currencies, we expect the Hungarian forint to weaken to 375EUR/HUF by the end of the year but to gradually strengthen towards 365EUR/HUF in the middle of the year next year. The Polish zloty should also strengthen next year, to 4.45 EUR/PLN in 2Q21.

Inflation in CEE region will likely gradually slow down (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

Thanks to fiscal policy, unemployment rising only slowly (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

Macroeconomic outlook

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Main changes

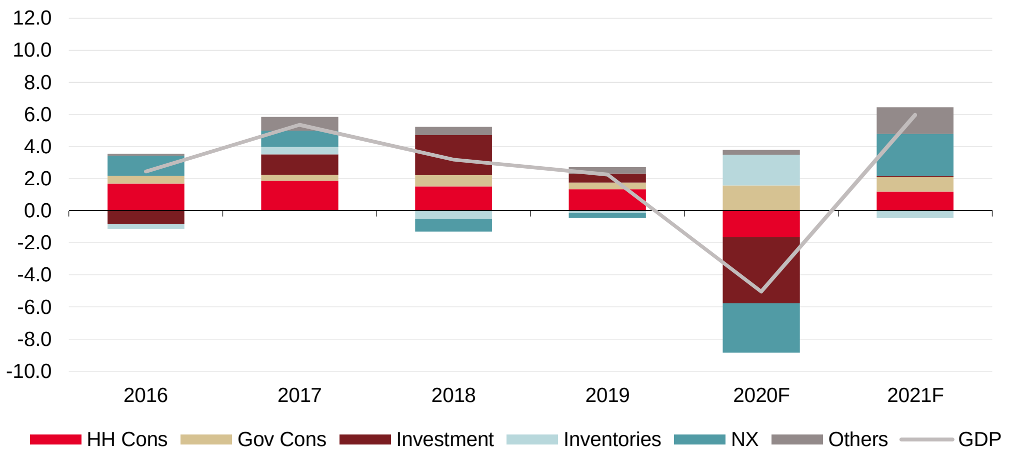
GDP:
We have lowered our 2020 forecast to -7.6% from -5.0%. For 2021, we are looking for GDP growth of 3.0%.

Inflation:
We have increased our 2020 forecast to 3.2% from 3.0% due to higher core inflation. For 2021 we increased our forecast to 2.3% from 1.7%.

Economy is experiencing a W-shaped recovery

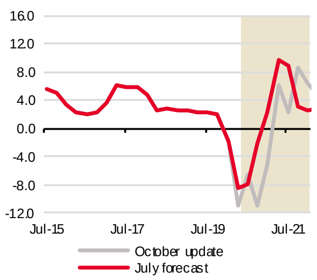
The second wave of the pandemic has probably wiped out the progress made in the recovery the previous quarter, while the shaken confidence of companies and households is likely to dent economic growth next year. Thanks to foreign demand, foreign trade should be the main driver of the recovery. Inflation will probably decelerate, however, as prices in 2020 have so far increased by more than expected, and their deceleration in the second half of this year has been driven mainly by lower food prices, not weaker demand.

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



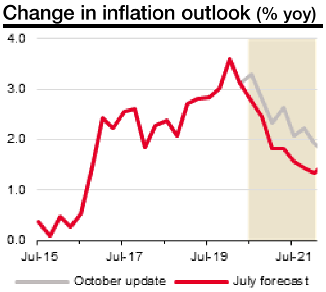
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Change to GDP outlook (% yoy)



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

Change in inflation outlook (% yoy)

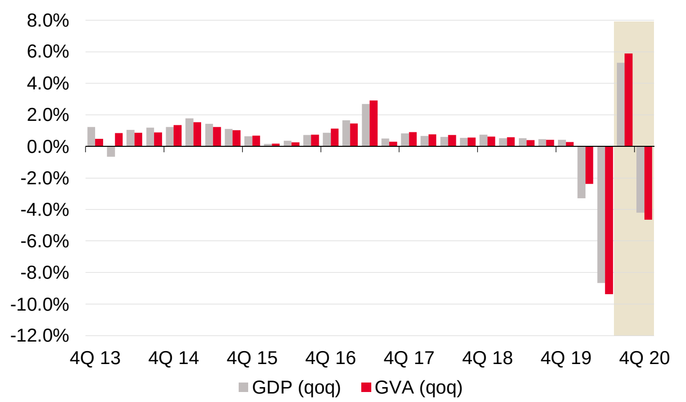


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

In the third quarter, we forecast strong GDP growth of over 5% qoq

Euphoria is replaced by disappointment

GDP bottomed in 2Q



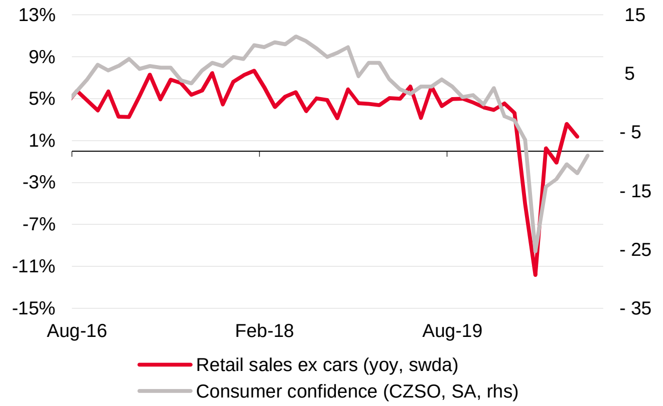
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

The situation this year has been very uncertain. However, the trends of the recent past were quite clear. By the end of 1Q, during the general lockdown, the Czech Republic experienced a strong economic decline. Already in May, and even more so in June, a strong economic upturn had got under way. Despite these gains, however, 2Q GDP was down 8.7% qoq and 10.9% yoy. That was still a (slight) positive surprise though, as consensus was calling for a quarter-on-quarter decline of 10.1%. Over the summer the economy returned to some degree of normalcy and GDP continued to increase sharply. Although the monthly data for August fell slightly short of expectations, we attribute that to the summer holidays, and we expect the September data to be more robust, as suggested by leading manufacturing indicators, i.e. new orders and purchasing managers' expectations. In contrast, services data have deteriorated, likely due to a resurgence of the pandemic, and the trend escalated further in October. New COVID-related government restrictions and a change in consumer behaviour will probably lead to another decrease in GDP. For the January 2020 to 1H21 period, we are projecting a W-shaped recovery for the Czech economy.

Retail sales quickly bounced back, but some services remain well below normal levels.

In addition to the post-lockdown reopening, the return of foreign demand played an important role in boosting the economy. That triggered an increase in the foreign trade and consequently industrial output. Yoy growth in retail sales ex auto resumed at the end of the second quarter. In contrast, segments of the economy more heavily exposed to pandemic-related risk, i.e. travel and lodging, saw their business activity levels remain far below normal. Some services related to travel and foreign clients saw sharp drops. For example, travel agency revenues reached only 10% of their prior-year levels, while lodging was only 20% and airlines just 14%. The improvement recorded by these segments in the third quarter was probably relatively small.

Retail sales are back to their prior-year levels



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

If our estimate of a 5.3% qoq GDP rise in 3Q is right, then repeated economic lockdowns would likely result in a smaller GDP decline than in the second quarter. One reason is the comparative base. Another important reason is the economic policy reaction, where the government in the second half could re-enact prior measures or simply prolong existing ones. This significantly reduces the initial uncertainty, which was enormous during the first phase of the pandemic, as we were left waiting for news regarding the fiscal policy response for weeks. In the very early stages of the pandemic it took days or rather weeks to establish that the policy would be strongly expansionary. By contrast, we are now seeing existing programmes being slightly modified or extended, which leads to less uncertainty.

We expect the COVID-19 situation to slowly improve from the end of November

We assume that the measures that limit economic activity as announced on 21 October will last until the end of November before being very slowly removed. Most importantly, we expect private services activity to decline by 7.5% qoq. Bear in mind that at c.45% of gross value-added, these services account for the largest share of the economy. Contrary to the first wave we do not expect the manufacturing sector to enter a self-imposed lockdown. But here again the output will be smaller due to natural limits stemming from the epidemic and associated shortages in the labour force. We expect industrial output to decline by 3% qoq in 4Q. While the industrial sector generates less value-added than the services sector, at 32% its share is still large. More importantly, the manufacturing sector is strongly interlinked with other sectors, including services. All in all, we expect the economy to decline by 4.3% qoq in 4Q and thus to erase most of the expansion achieved in 3Q.

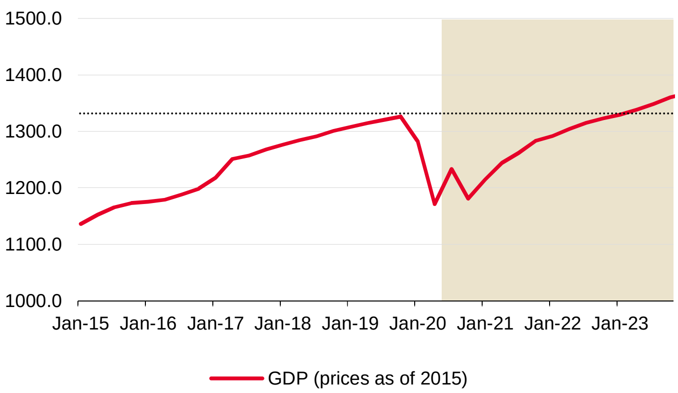
Second wave to postpone recovery by one year

In our July forecast we expected GDP to return to pre-crisis levels by the end of 2021/beginning of 2022. The progress made in the third quarter supported our expectations. However, the second wave now leads us to postpone this recovery point to 2023. In other words, the second wave erases one year of GDP.

The output gap is strongly negative

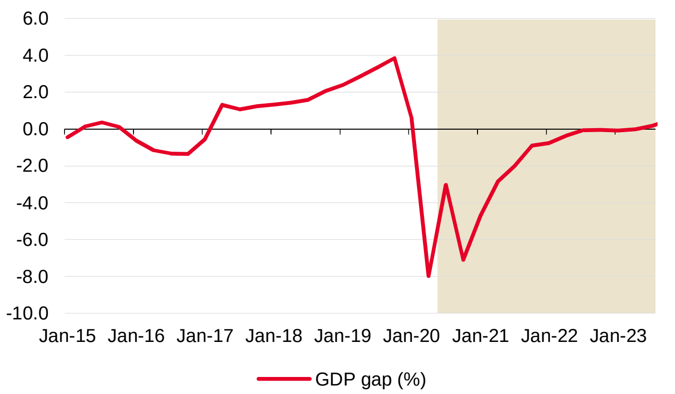
Regarding the adequacy of the economic policy reaction it is good to remember that the second wave has pushed output deeper into negative territory. The negative output gap has widened again. This huge output gap calls for expansionary economic policy, which is currently taking place (refer to monetary and fiscal policy sections). In our forecasts, we have lowered our potential output estimate as we would expect output in an economy that has been repeatedly locked down to increase only very slightly or not at all. **We expect the output gap to close at the beginning of 2023, which is similar to our July forecast, despite slower GDP growth.** Within the model we therefore see lower downward pressure on inflation than would otherwise have materialised in the scenario of rising potential growth.

Return of GDP to pre-crisis levels postponed to 2023 (quarterly CZKbn)



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

GDP strongly below potential (%)



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

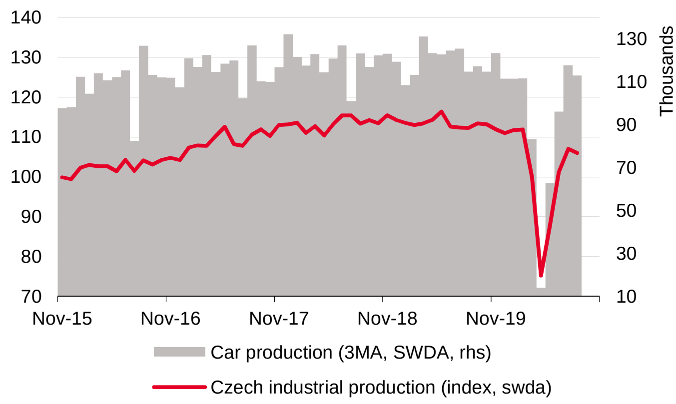
Industrial production to feel second wave but not stop functioning

Industrial output will suffer due to labour shortages

Industrial output has expanded strongly since April when it declined by more than 30% yoy. Over the summer months, car production, which almost stopped back in April, recovered to pre-crisis levels. In July, industrial output was down by just 5% yoy. The same statistics for August showed a mild deterioration but we ascribe that to the holiday season and plant-wide holidays. **Leading indicators show continuing expansion.** In September the purchasing managers index (PMI) moved above the 50-point level for the first time since the end of 2018, while the PMI sales subindex went even higher. Regarding the near-term outlook, it is positive to see an increase in new orders. The hard data still show a one-digit decline in new orders yoy. Nevertheless, the latest Markit PMI report for September showed that new orders increased for the first time in two years. Orders were purportedly supported by a recovery in exports. The ongoing recovery in foreign demand is also reflected in the PMI indices for Germany and the eurozone as a whole. The preliminary PMI manufacturing index for the eurozone rose to 54.4 points in October, its highest level since mid-2018. Meanwhile, the German PMI reached 58.0 points and showed strong manufacturing expansion. Growth in foreign demand is good news for domestic producers, as anecdotal evidence shows that companies have a sufficient amount of orders.

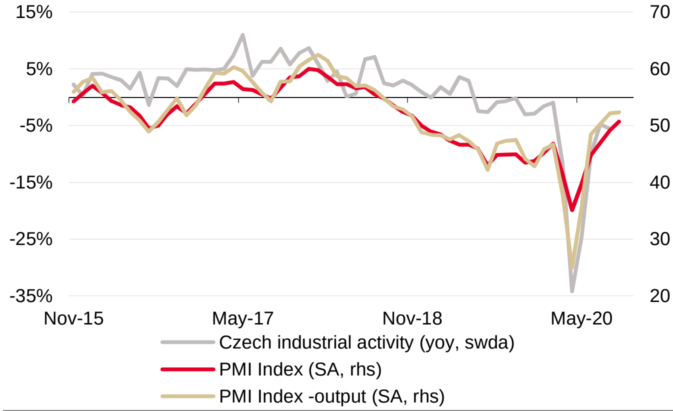
We need to remember that the closure of the industrial sector was self-imposed during the initial outbreak. Importantly, foreign demand dropped sharply over the period. By contrast, we expect the industrial sector to remain operational during the second wave. Nevertheless, capacity is likely to be affected. Capacity utilisation is still relatively low, which leaves room for expansion. But the second wave will undoubtedly lead to labour shortages and many companies will have to adopt extra safety measures. Some workers may not be able to work due to disease or quarantine. School closures will mean that some parents will have to stay at home and take holidays or use state programmes designed for the purpose. All in all, even though we expect manufacturing production to continue, we still expect the GVA of industrial output to decline by 3% qoq in 4Q, although there is significant uncertainty associated with this estimate.

Car production returned to pre-crisis levels



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

Leading indicators show continuing expansion

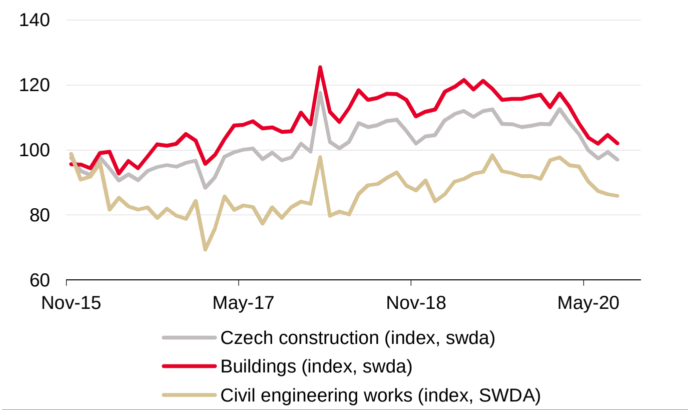


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Construction will feel the labour shortage even stronger

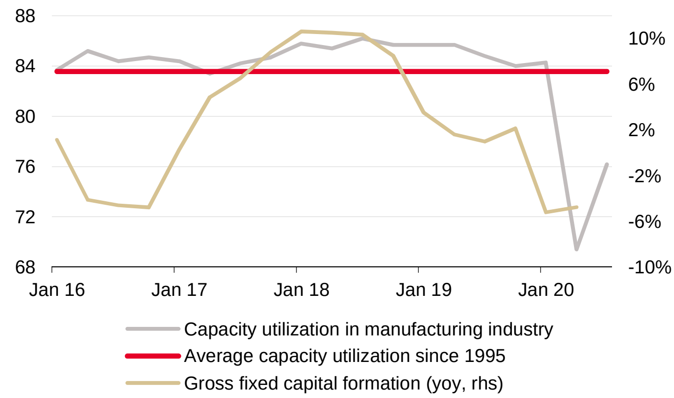
The construction sector usually lags behind other sectors in the economy. We would expect that to be the case this time as well, but for slightly different reasons. Due to weaker demand, we expect construction to be weak next year. However, capacity constraints are likely to be the main reason for the decline. Before the COVID-19 pandemic hit, shortage of labour was the biggest barrier to growth in construction while weak demand was in the second place. The departure of many foreign workers means that labour shortages will prevail for some time and the second wave is likely to enhance this trend. We expect the construction sector to decline by 7% this year and by an additional 5.8% next year. Higher uncertainty in 2020 will negatively impact investments and reduce demand next year. Over the coming years we expect there to be some room for a catch-up, and we believe infrastructure investment could grow more strongly. However, the level of uncertainty in the construction sector has also risen sharply.

Construction is trending down



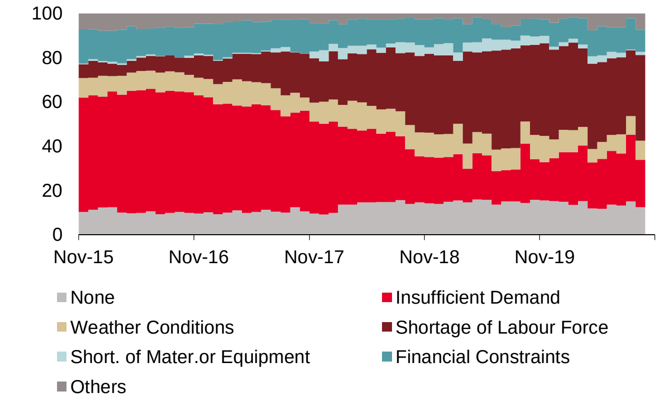
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Capacity utilisation has bottomed out in manufacturing



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

Labour shortage is the main problem in construction



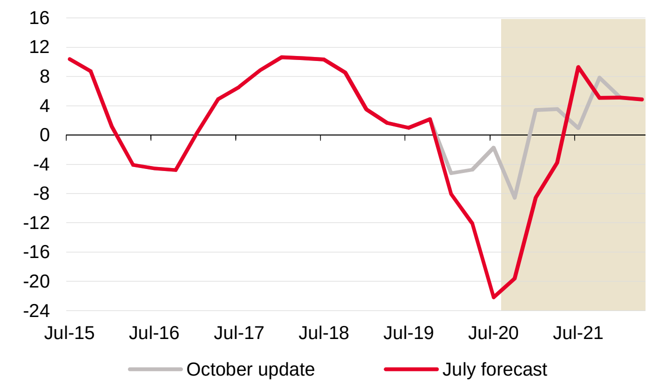
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Investment activity will remain weaker

Investment and foreign trade will be key movers on both sides

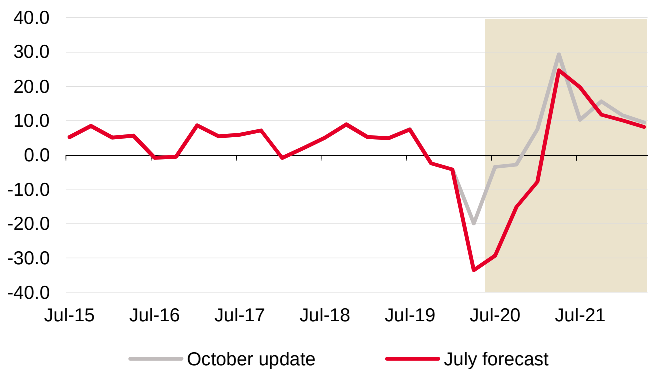
Investments react relatively quickly to economic shocks. In the first quarter of 2020 fixed capital formation dropped by 8.2% qoq. In the second quarter it started to rise again, albeit only slightly, while for the third quarter we foresee stronger growth of 4.2%. That would mean investment activity would be only 1.7% below its summer 2019 level. In the fourth quarter we will probably see growth in the manufacturing sector decline. However, the second wave could have a strong negative impact on the investment appetite of companies over the coming years. Many enterprises could naturally be afraid of further waves and are therefore likely to be more careful. On the other hand, some investments could be required to enhance safety, leading to investments in modernisation and digitalisation. However, in the current circumstances we believe companies will be more cautious, as shown by the rise in savings deposits in the non-financial sector. For FY20, we expect gross capital formation to decline by 5.1%. In 2021 we expect it to rise by 3.9% and investment activity to reach pre-pandemic levels in the first half of 2022.

Investment activity will decline further (%, yoy)



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

Exports rebounded faster than expected (%, yoy)



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

After the first wave, the economic recovery was largely driven by an improvement in foreign trade. In the cross-border methodology, exports fell by more than 80% yoy in April but had already risen back up again by over 10% yoy in July. Meanwhile, imports declined by 'only' 40% in April but the subsequent improvement was not as strong and the year-on-year comparison remained at -12%. As a result, the foreign trade balance improved strongly. The second wave is unlikely to be as detrimental as the first. We expect the foreign trade contribution to GDP to be roughly neutral in qoq terms in the 4Q. We expect foreign trade to be the main driver of the Czech economy next year.

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Fiscal policy: deep deficit expected for both 2020 and 2021

The current development of the state budget leads us to improve our forecast for this year. The shortfall in tax revenues is not as significant as expected by the Ministry of Finance and should be offset by non-tax revenues; however, the main reason for the lower state budget deficit is lower expenditures. Indeed, the government has saved on civil servant salaries, government debt service and capital expenditure. Although the investments made so far this year are at a historical high, we do not believe the government's ambitious plan will be completed. The current second wave of the pandemic, which will likely require additional expenditure of at least CZK50bn, is the biggest risk to our forecast. We now expect the 2020 state budget to print a deficit of CZK400bn. The draft state budget for 2021 is still being negotiated. However, in our opinion, the Ministry of Finance moved back to a conservative strategy of proposing higher deficits than the actual results. We thus expect a deficit of CZK320bn for 2021. We expect to see a public deficit of 7.8% of GDP for 2020, a historical high, and only a slight decrease to 5.8% of GDP for 2021. Public debt will likely increase significantly to 38.6% of GDP this year and should peak at 42.9% of GDP in 2022.

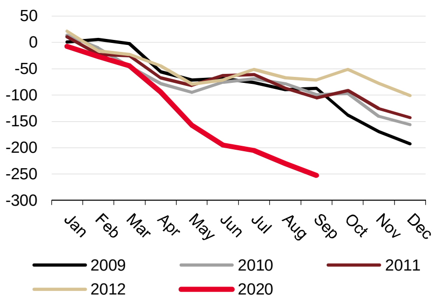
The state budget deficit is lower than we expected, but risks remain

In the first three quarters, the state budget showed a significantly better result than the government had approved at the beginning of the summer. Revenues are slightly higher than expected. However, the main reason is lower current and capital expenditures.

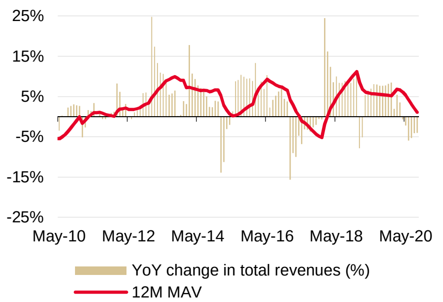
The state ran a deficit of CZK252.7bn in the first nine months of 2020. Compared to the same period last year, this is CZK231.7bn higher than in 2019. Based on September and year-round statistics, this is the deepest deficit in the country's modern history. However, the pace of its deepening is less than half that of last spring attributed to government spending for the first wave of the pandemic.

Regarding revenues, the overall situation remains the same as in previous months. Compared to the same period last year, total revenues are 4.1% lower. The largest share of this is due to the decline in corporate and personal income tax collection. However, compared with the amended state budget plan from early-July, the collection is better, and the main disappointment is VAT, which prompted a budget shortfall of CZK13.8bn. This can be attributed to the decline in retail sales and the state's optimistic expectations in the current state budget plan. Overall, tax revenues are CZK5bn higher than expected by the Ministry of Finance. In addition, as in previous months, almost CZK20bn is being added in the form of non-tax revenues on top of the state budget plan, especially from the European Union and government reserves. Overall, revenues are CZK24.9bn better than the Ministry of Finance expected.

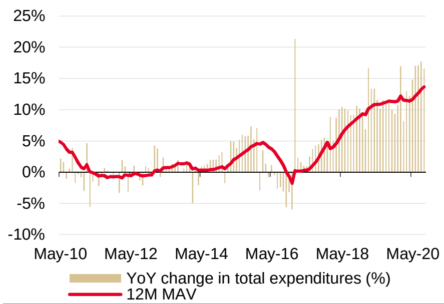
State budget in comparison with previous crises (CZKbn)



Tax collection shortfall being offset by non-tax revenues



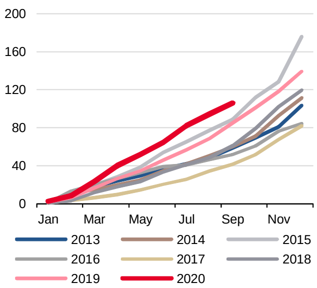
Expenditure growth is starting to slow, but the second wave remains a risk



Source: Finance Ministry, Economic & Strategy Research, KB

The main reason for the lower state budget deficit comes from expenditures. So far, the state has saved CZK76bn on current expenditures, mainly on state-employee salaries, non-investment purchases and state debt servicing. Regarding salaries, this is partly due to the seasonal payment of bonuses at the end of the year, which partly reduces these savings, whereas high demand and good conditions on the financial markets should further reduce

State investment (CZKbn)



Source: Finance Ministry, Economic & Strategy Research, KB

government debt service expenditures by the end of the year. However, higher-than-expected expenditures are associated with the support of municipalities. The lower state budget deficit is largely due to the volume of planned investments (CZK170bn, 3.0% of GDP). **The current amount of realized investments is the highest in history, however, in our opinion, the plan will not be completed this year** and unused expenditures will be transferred to 2021. This will lead to a reduction in the resulting deficits in both years.

Although the current state budget is better than we expected, the ongoing pandemic will require additional expenditures. The Ministry of Finance has already presented a number of measures that should mitigate the impact of the second wave on the economy. In our opinion, the most fundamental and most costly step will be the implementation of tax breaks and the extension of the Antivirus program. Together with other compensations, we estimate the impact on the state budget at CZK50bn. **Nevertheless, we forecast this year's deficit CZK400bn (7.2% of GDP).** This year's deficit will still be the deepest in history by far. Moreoever, a worsening of the pandemic beyond our baseline scenario would likely prompt further expenditures, which is the main risk to this year's state budget and the resulting deficit.

Surprisingly high state budget deficit for next year as well

The 2021 state budget is still being negotiated; however, it currently is proposed at a deficit of CZK320bn (5.8% of GDP), which is CZK50bn more than we expected in our last *Czech Economic Outlook*. Compared to 2020, the proposal envisages a 3.8% cut in expenditures and 7.9% increase in revenues. However, it does not envisage the tax package currently being discussed, which includes, among other things, a reduction in personal income tax. The entire package should cost the state another CZK50bn (0.9% of GDP). **We expect the current proposal to be amended in the legislative process and to include a deficit of CZK370bn (6.7% of GDP).**

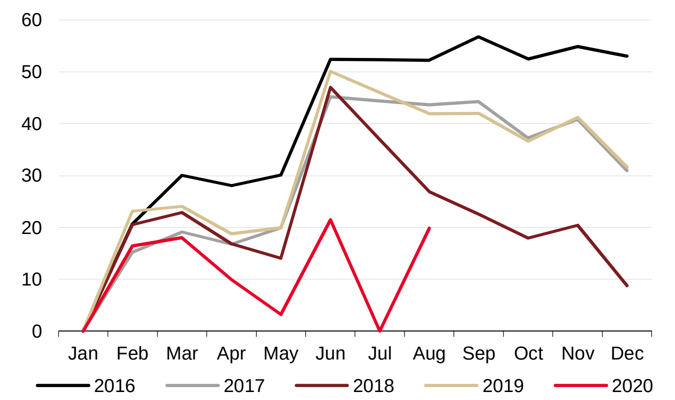
The draft budget includes a potential decrease in tax collection and insurance premiums in the amount of CZK96bn compared to the pre-pandemic budget. On our estimates, this impact should be CZK30bn lower. Capital expenditures should reach a record CZK186.9bn; however, we assume they will be difficult to implement in 2021, and even including unused expenditures from 2020, total investments will be lower. Overall, we consider the current approach of the Ministry of Finance to be a return to its previous strategy of higher proposed deficits and, consequently, better real results. **For the whole of 2021, we expect a final state budget deficit of CZK320bn (5.8% of GDP)**, which is CZK50bn more than we forecast in our previous outlook.

Public finances will not avoid the largest deficit in history

The management of municipalities is developing in line wtih our expectations, which, after several weeks of disputes, was supported by the government with additional transfers. These are intended to offset the fall in tax revenues. However, due to better corporate income tax collection, at the end of August, municipal finances had a surplus of CZK19.8bn, which is half of the same period in 2019. The good news is still the record balance of funds on current accounts in the amount of CZK230bn. **However, as municipal budgets traditionally detereiorate at the end of the year, in our opinion, they will post a roughly balanced budget for 2020.** Municipalities should return to a slight budget surplus next year.

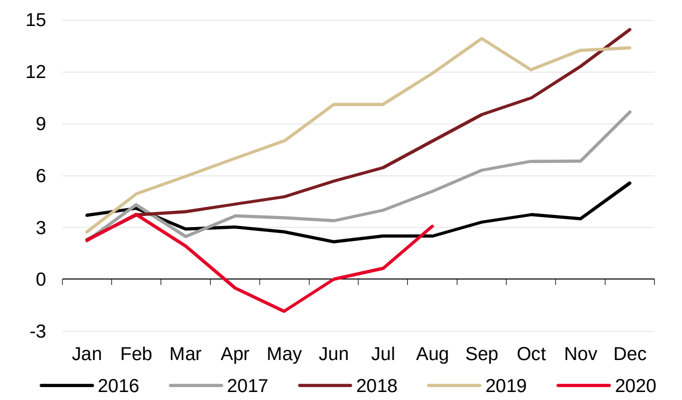
In spring, when the first wave of the pandemic culminated, the performance of health insurance companies fell into deficit for a short time. Subsequent government intervention in the form of an increase in payments for state insured persons significantly supported their management. However, the second wave of the pandemic is likely to have a devastating impact on insurance spending. Therefore, **despite better developments in previous months compared to our August forecast, we leave our deficit estimate of CZK10bn unchanged.**

Municipal finances remain in the red for the time being (CZKbn)



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

After several years, health insurance companies went into deficit



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

Public finances likely to see the worst deficit ever this year at 7.8% of GDP. Public debt should increase by 8.1pp this year to 38.6% of GDP.

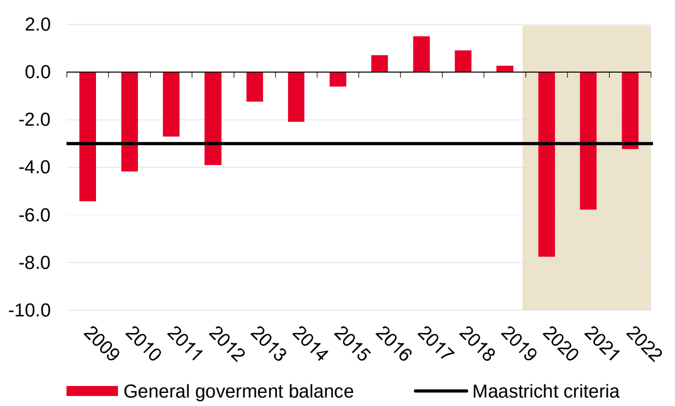
According to the ESA2010 methodology, public finances will print a deficit of 7.8% of GDP this year, a historical high, which is 0.2pp lower than we expected in our previous forecast. However, this is a year-on-year deterioration of 8.1pp and, compared with the worst year so far in 2009, the deficit would be 2.4pp higher. In 2021, the deficit should fall only slightly to 5.8% of GDP and it should decrease further in the following years. Public debt will likely increase significantly this year to 38.6% of GDP from last year's 30.2%. In 2022, on our forecast, it should reach its peak at 42.9% of GDP.

Public finance forecasts

	2019	2020f	2021f	2022f	2023f	2024f
Balance (% GDP)	0.3	-7.8	-5.8	-3.2	-1.8	-1.0
Fiscal effort (pp GDP)	-0.8	-5.4	0.9	2.6	1.4	0.8
Public debt (CZKbn)	1738.7	2138.7	2458.7	2658.7	2778.7	2848.7
Debt ratio (% GDP)	30.2	38.6	42.3	42.9	42.8	41.9

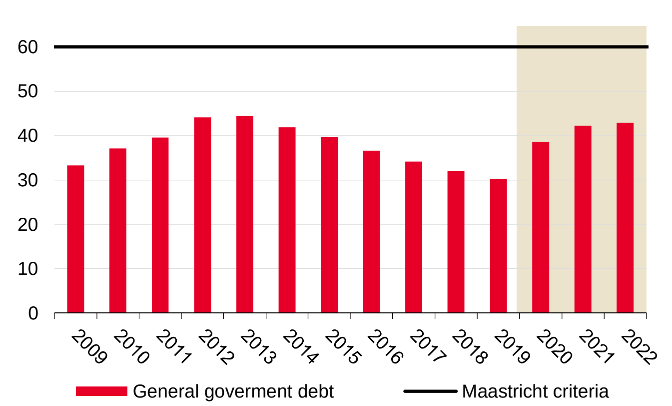
Source: CZSO, MinFin, Economic & Strategy Research, Komerční banka

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

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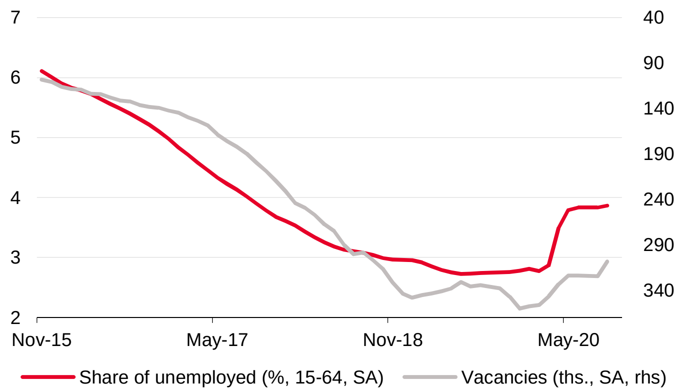
Unemployment has risen less than expected

Thanks to both government measures and a high level of vacancies, unemployment has risen only slightly. However, wage growth has decelerated significantly and has now started to decline on a yoy basis. Due to government's ongoing labour market stabilisation programmes, we expect unemployment to rise only gradually over the coming period, before starting to decline again in 2022.

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

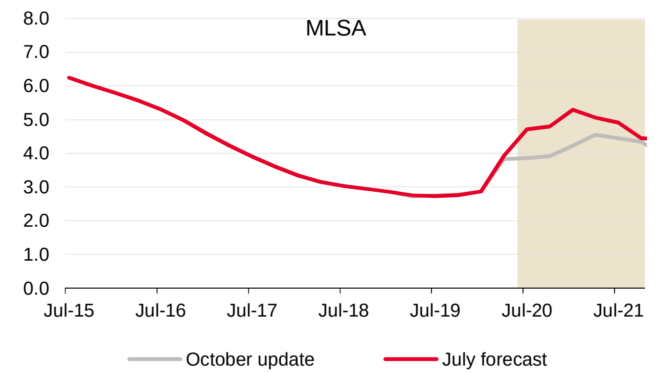
Despite the adoption of restrictive measures to halt the spread of the virus between March and September, the unemployment rate increased by only 0.8pp to 3.8%. After seasonal adjustments, the unemployment rate increased by just 1pp, which is significantly lower than we initially expected. The reality is also significantly better than was depicted by our July forecast. While we had identified factors that could ease the situation in our last forecast, their effect was stronger than we had expected. These factors were a very tight labour market before the pandemic and government measures to support the labour market. In addition to the usual inflexibilities of the Czech labour market, the so-called Antivirus programme meant that companies were not forced to dismiss any employees that they thought might be need in the future. It is also positive that usage of the Antivirus programme has declined since April, as it indicates that the need for such support has declined. **An important stabilisation variable is the tight labour market; if dismissals occur while the labour market is very tight, workers are able to find new jobs relatively easily.** Vacancies have declined by 35k since February but the overall number of vacancies is still high at around 317k, close to their September 2018 level.

High amount of vacancies provides a strong buffer



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

Unemployment rate will peak in H1 2021 (%)



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

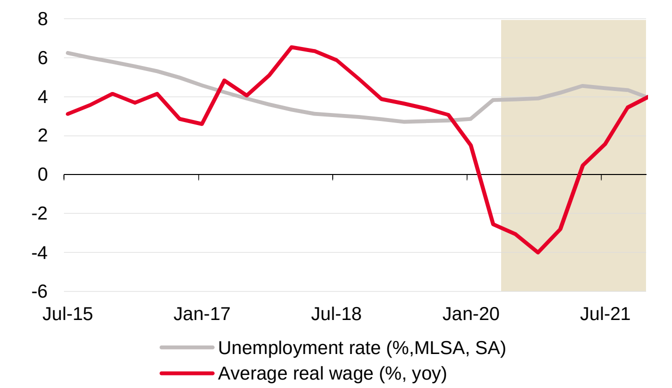
The economic decline that we expect for the fourth quarter would imply a sharp increase in unemployment, like in 2Q. The labour market deterioration can be seen, for example, in the decline in employment in the manufacturing sector, which reached 4% in 3Q. However, a faster deterioration will be prevented by the government measures aimed at stabilising the labour market, mostly via the Antivirus programme under which the government pays a portion of the wage bill to employers. This programme is expected to continue at least until the end of the year. We assume the programme will be modified for the second wave, although lower economic output will lead to a drop in new payrolls. We therefore expect the increase in unemployment to be gradual again. In our previous forecast we expected unemployment to peak at above 5% at the beginning of 2021 (MLSA methodology). We now expect it to reach only 4.4%, but the subsequent decline is likely to be slower as the economic recovery will be slower as well.

In the second quarter the average wage declined by 2.5% qoq (SA). In a year-on-year comparison that translates into a deceleration to +0.5% yoy after +5.1% yoy in 1Q. 2Q was extreme as many companies stopped paying bonuses and there was no room for higher wages. For the third quarter we expect a modest upward wage trend to compensate for the previous decline, as suggested by the almost 2% yoy growth in industrial wages in 3Q. On the whole, sentiment has improved and the forecasts indicate a possibility of faster expansion. Still we expect average wages to have stagnated yoy, mainly due to weaker output in services. The uncertain outlook for the private sector calls for caution.

Real wage growth could remain in positive territory.

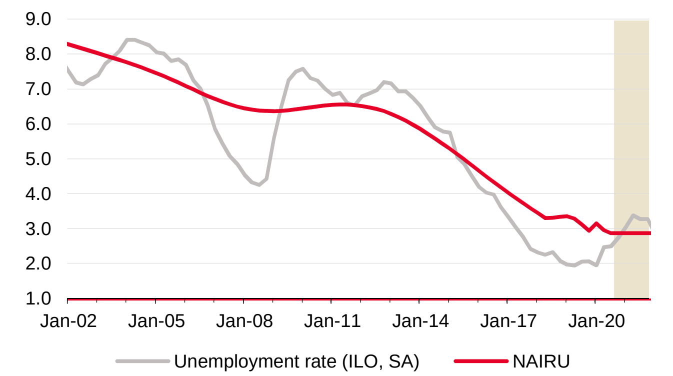
For the fourth quarter we expect another economic shock and a renewed increase in uncertainty as a result of the second wave. Similar to the second quarter we expect the average wage to decline, but at a significantly slower pace since the level of wages has already decreased and also because we do not expect such a hard lockdown in the second wave. Above all, we do not expect the industrial sector to shut down this time around. **Next year we expect mainly public wages to rise. However, given the current uncertainty, it is not easy to estimate the wage agreements for the next year.** Increasing the wage bill while facing the risk of a further wave of the pandemic could jeopardise competitiveness and increase the potential losses. The private sector will therefore act very cautiously, in our view. For next year, we have reduced our average wage growth estimate to 3.0%, vs our previous forecast of 3.8% and after only 1.1% expected for 2020. In real terms that would mean an increase of 0.7% next year after a decline of 2.0% in 2020.

Average real wage has declined (%, yoy)



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

Pressure for higher wage declines



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

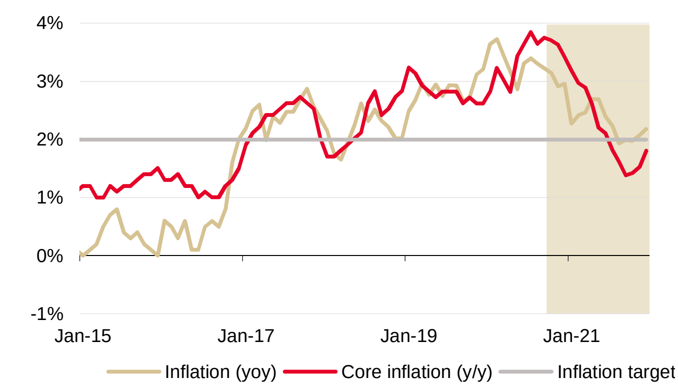
Inflation remains higher but should decelerate

In the third quarter inflation slowly decelerated on the month-on-month basis. However, the main reason for the deceleration was food prices, which decreased after a relatively significant rise in the previous period. By contrast, core inflation has showed no sign of easing. Due to the weaker economic context, we still expect inflation to decelerate until next year. Core inflation and monetary policy inflation will probably slightly undershoot the CNB's inflation target next year.

Core inflation remains elevated but should gradually decelerate

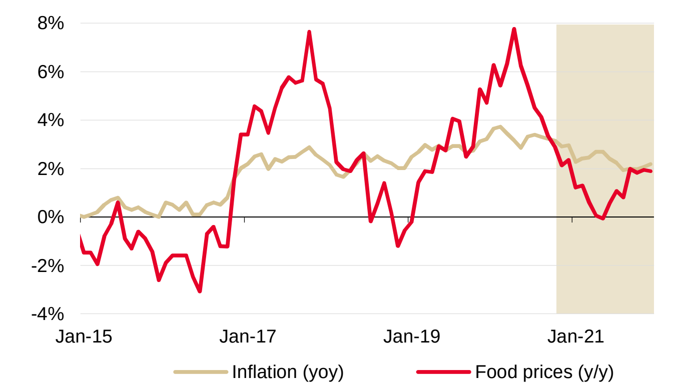
In year-on-year terms, core inflation, which does not include food, fuel, regulated prices or changes in indirect taxes, reached 3.7% in the third quarter. Given the weak economic context, we have expected inflation to slow down due to weaker demand-side pressures. However, this did not materialise as domestic demand and household consumption expanded probably slightly stronger than expected. That undoubtedly reflects the better-than-expected situation in the labour market, as described above. With regard to future price trends, the level of domestic demand remains very uncertain as it will once again be affected by the second wave in 4Q. We still expect domestic demand to act as a disinflationary factor. Lower import prices should also be disinflationary while the weaker CZK will protect against stronger disinflation. By the end of this year, we expect core inflation to work out at 3.4% yoy, but on 12-month horizon we expect it to decline below the CNB's inflation target of 2%.

Inflation will gradually decelerate towards 2%



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

Food price growth will be moderate



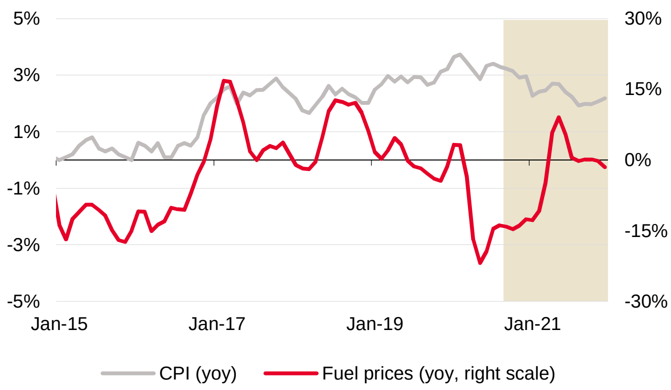
Source: CZSO, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka

Food prices have declined and any further rise should be moderate

Growth in food prices surpassed 6% yoy in the second quarter. In the third quarter food prices declined in qoq SA terms and yoy growth decelerated to 4%. Thanks to a favourable year-on-year growth outlook for crops and also given that we do not expect to see the same level of difficulties in food distribution as we saw during the first wave, we expect any food price increases over the coming quarters to be mild. The high comparison base created by 2020 will further lead to low food price inflation in yoy terms next year and act as a disinflationary factor.

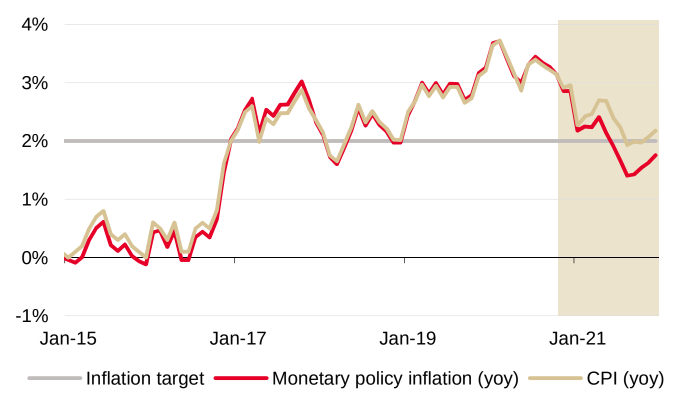
Fuel prices to remain very low. For the near term, we assume Brent oil prices will remain close to USD40/barrel, rising slightly to USD45/bbl next year. In line with the expected appreciation in the CZK vs USD, fuel prices should also act as a disinflationary factor.

Prices at petrol stations are acting as a disinflationary factor



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

Monetary policy inflation will decline below CNB target



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

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

Excise taxes on tobacco and alcohol were increased in 2020. Meanwhile, VAT on many items in the consumer basket was reduced in January, May and July. The overall impact of these changes on inflation was zero. For next year, we expect excise taxes to be raised further, although the rise should be smaller than in 2020. Overall, the administered changes should add c.0.4 pp to inflation. This year regulated prices increased inflation, mainly due to higher electricity prices. In the third quarter regulated prices increased by 3.4%. We expect them to decline in the fourth quarter, partially due to the higher comparison base from last year and also due to the announced decline in electricity and gas prices. For next year we expect regulated prices to increase more slowly as electricity prices will probably not change significantly. Going forward, we foresee a gradual pick-up in electricity prices, with green deal energy plans also contributing.

All in all, we expect inflation to decelerate in the fourth quarter and to reach 2.4% by the end of the year. For the whole year 2020, inflation should be close to 3.2%, compared with 2.8% in 2019. Next year we expect inflation to reach 2.3% on average, while monetary policy inflation, which does not include the primary impact of changes in indirect taxes, should move slightly below 2%.

Risks: pandemic still first and foremost

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

- **Second wave of the pandemic.** The impact of the second wave is very uncertain. We assume that the situation will start to improve towards the end of November although the pandemic will probably continue to affect the economy until mid-2021. We do expect the industrial sector to close down again during the second wave. However, there is a strong risk that the current restrictive measures will be insufficient and the situation will deteriorate even further. This implies a more profound economic impact and further CZK weakening if the situation were to require further fiscal and monetary policy responses.

- **Further pandemic waves.** Aside from the short-term uncertainty stemming from the second wave there is a considerable risk of further waves or COVID-19 mutations.

- **Vaccine discovery.** The announcement of a viable vaccine followed by its widespread application would pave the way to faster economic growth and a stronger CZK.

- **Impact of Brexit.** In our new forecasts we assume a hard Brexit without a deal which would have a negative impact on European and Czech economic growth. A deal would therefore imply higher GDP prospects.

- **Trade wars.** An increase of protectionism in foreign trade would further undermine the revival of the world economy as well as a Czech economic recovery. An important variable here will be the outcome of the presidential election in the US.

Key economic indicators

	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	2019	2020	2021	2022	2023	2024
GDP and its breakdown														
GDP (real, yoy)	-1.9	-10.9	-6.6	-11.0	-5.3	6.2	2.3	8.6	2.3	-7.6	3.0	4.6	2.7	2.8
Household consumption (real, yoy)	-0.2	-7.6	-3.3	-8.3	-3.5	4.5	0.4	6.3	2.9	-4.8	1.9	4.1	2.6	3.8
Government consumption (real, yoy)	4.9	1.6	-0.8	-1.8	-2.0	2.1	4.0	6.0	2.3	1.0	2.5	1.0	1.6	1.1
Fixed investments (real, yoy)	-5.2	-4.8	-1.7	-8.6	3.4	3.6	0.9	7.8	2.1	-5.1	3.9	4.6	3.5	2.8
Net exports (contribution to yoy)	-1.2	-6.0	-3.4	-1.6	-0.7	2.8	0.8	1.7	-0.3	-3.1	1.2	1.6	0.7	0.6
Inventories (contribution to yoy)	-1.1	-1.3	-0.8	-1.8	-2.6	0.1	-0.8	-0.9	-0.2	-1.3	-1.0	-0.4	-0.1	-0.2
Monthly data from the real economy														
Foreign trade (CZK bn) (**)	13	-5	50	6	41	13	31	22	143	63	107	104	119	122
Exports (nominal, yoy)	-6.0	-22.3	-3.5	-2.8	7.5	29.3	10.2	15.7	3.8	-7.6	15.7	8.9	7.5	8.4
Imports (nominal, yoy)	-4.7	-18.8	-5.1	0.2	5.2	25.5	13.8	14.3	1.8	-6.2	14.7	8.5	8.0	8.7
Industrial production (real, yoy)	-4.1	-23.5	-4.7	-8.6	-2.5	24.7	4.0	12.2	1.9	-10.2	9.6	6.8	5.4	6.0
Construction output (real, yoy)	2.7	-8.7	-10.3	-10.9	-14.6	-6.5	-4.6	2.6	0.7	-6.8	-5.8	7.0	7.8	7.6
Retail sales (real, yoy)	1.8	-3.8	2.1	-7.1	-2.0	1.7	-3.4	7.0	4.9	-1.7	0.8	4.0	2.8	5.8
Labour market														
Wages (nominal, yoy)	5.1	0.5	0.1	-1.3	-0.5	3.1	3.7	5.7	6.4	1.1	3.0	6.8	6.4	6.3
Wages (real, yoy)	1.5	-2.6	-3.1	-4.0	-2.8	0.5	1.6	3.4	3.5	-2.0	0.7	4.8	3.9	4.3
Unemployment rate (MLSA)	3.0	3.7	3.8	4.0	4.4	4.4	4.4	4.4	2.8	3.6	4.4	3.6	3.3	3.2
Unemployment rate (ILO 15+)	2.0	2.4	2.6	2.7	3.1	3.3	3.3	3.2	2.0	2.4	3.2	2.5	2.2	2.1
Employment (ILO 15+, yoy)	-0.9	-1.3	-1.6	-0.5	-0.5	-0.3	0.3	-0.6	0.2	-1.1	-0.3	0.7	0.4	0.1
Consumer and producer prices														
CPI Inflation (yoy)	3.6	3.1	3.3	2.8	2.3	2.6	2.1	2.2	2.8	3.2	2.3	1.9	2.3	1.9
Taxes (contribution to yoy inflation)	0.0	0.0	0.0	0.0	0.2	0.4	0.6	0.6	0.0	0.0	0.4	0.3	0.4	0.0
Core inflation (yoy) (*)	3.0	3.3	3.7	3.6	3.0	2.3	1.6	1.5	2.8	3.4	2.1	1.9	1.8	2.0
Food prices (yoy) (*)	6.0	6.5	4.0	2.5	1.2	0.4	1.4	1.8	2.8	4.7	1.2	1.3	1.7	1.7
Fuel prices (yoy) (*)	1.0	-19.4	-14.2	-13.9	-10.7	6.7	0.7	-0.4	-0.4	-11.6	-0.9	0.3	4.2	2.5
Regulated prices (yoy) (*)	4.2	3.4	3.4	2.6	1.5	1.6	1.5	1.9	4.5	3.4	1.6	1.4	2.0	1.8
Producer prices (yoy)	1.4	-0.6	-0.3	1.7	2.1	3.1	3.2	1.6	2.6	0.5	2.5	1.6	2.6	2.0
Financial variables														
2W Repo (%, average)	2.03	0.56	0.25	0.25	0.25	0.25	0.25	0.25	1.92	0.77	0.25	0.32	0.8	1.5
3M PRIBOR (%, average)	2.15	0.59	0.34	0.35	0.35	0.35	0.35	0.35	2.12	0.86	0.35	0.42	0.9	1.6
EUR/CZK (average)	25.6	27.1	26.5	27.3	26.8	26.3	26.2	26.1	25.7	26.6	26.3	25.5	25.2	24.7
External environment														
GDP in EMU (real, yoy)	-3.3	-14.7	-5.5	-3.7	-0.6	13.6	2.6	1.1	1.3	-6.8	3.9	1.9	1.9	1.9
GDP in Germany (real, yoy)	-2.2	-11.3	-5.5	-4.6	-2.9	8.5	2.2	1.8	0.6	-5.9	2.4	2.2	1.9	1.5
CPI in EMU (real, yoy)	1.1	0.2	0.4	0.5	0.7	1.4	1.4	1.3	1.2	0.6	1.2	1.2	1.3	1.5
Brent oil price (USD/brl, average)	54.3	27.8	40.0	40.0	45.0	45.0	45.0	45.0	64.9	40.5	45.0	50.0	58.7	61.6
EURIBOR 1Y (%, average)	-0.27	-0.11	-0.16	-0.11	-0.07	0.00	0.07	0.14	-0.22	-0.16	0.03	0.31	0.90	1.80
EUR/USD (quarter eop, year average)	1.10	1.10	1.17	1.18	1.20	1.22	1.25	1.27	1.12	1.14	1.23	1.31	1.34	1.37

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

CNB Focus

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CNB likely to keep rates unchanged for some time

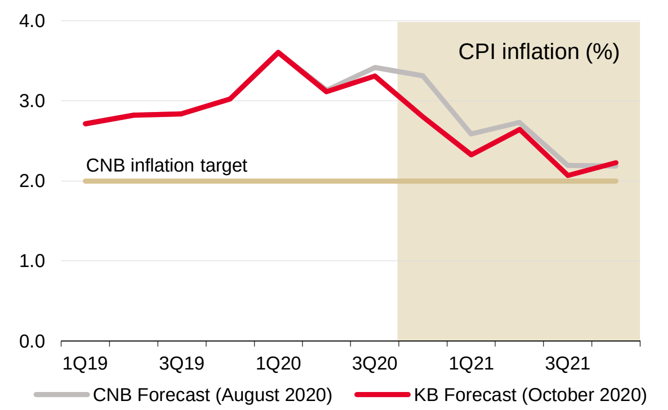
After a significant easing of monetary policy in the first half of this year, the central bank is likely to leave interest rates at the current low level at least through the end of next year. However, in our opinion, unconventional tools will not be introduced. The main argument against further easing is primarily domestic inflation, which remains above the upper limit of the CNB's tolerance band and its return to the two-percent target will likely be only gradual. The weaker koruna also contributes to price growth. The economy has been hit hard by the coronavirus pandemic and we believe a recovery next year will remain on shaky ground. Thus, central bankers are unlikely to rush to tighten monetary policy.

CNB believes monetary policy has been sufficiently eased

In addition to low interest rates, the koruna, which has lost almost 10% against the euro since February, has also helped ease monetary policy.

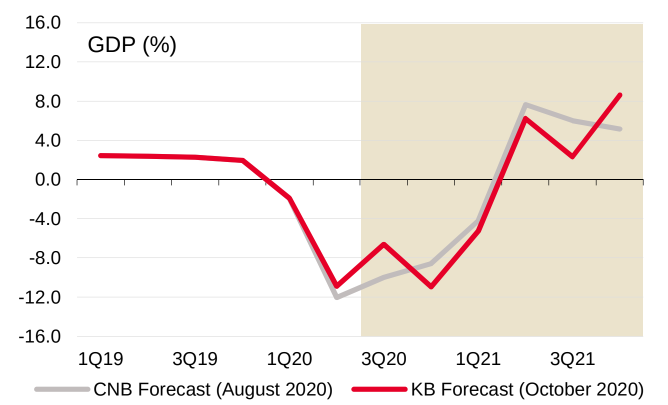
The Czech National Bank did not change interest rates during the third quarter and the key repo rate thus remains at 0.25%. After the previous cuts in the two-week repo rate by a total of two percentage points, the last of which took place in early May, monetary policy was sufficiently eased, according to central bankers. The weakening of the Czech koruna to the euro has contributed to this, as it has lost almost 10% since February and now is trading above EUR/CZK 27. In addition, the advantage for the central bank compared with previous crises is that fiscal policy is now operating in the same expansionary direction.

Inflation should subside but only slowly



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

The economic downturn is likely to deepen at end-2020



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

The main argument against further policy easing is domestic inflation

The rise in consumer prices remains above the 3%, i.e. beyond the upper end of the CNB's tolerance band; core inflation is at its highest level since 2007.

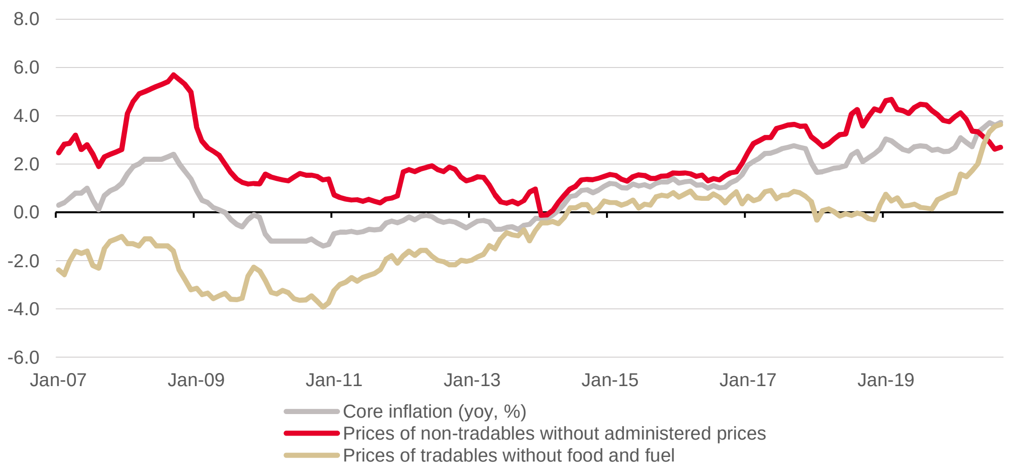
The CNB's main argument against further easing of monetary policy is primarily domestic inflation, which remains slightly above the 3% upper limit of its tolerance band. However, the central bank expected this, as the consumer price inflation in the third quarter was roughly in line with its latest forecast. Food and fuel price dynamics were lower than the CNB had forecast, while core inflation was higher. This surprisingly accelerated above 3.5% in the third quarter and was at the highest point of the time series, which starts in 2007.

According to the CNB, higher core inflation is attributable to increased costs for sellers, owing to government measures against the spread of coronavirus and the disruption of supply chains. The rise in consumer prices in the Czech economy has also been affected by the aforementioned weakening of the koruna, as evidenced by a rapid growth in the prices of tradables. This is significantly higher than for non-tradables. The weakened exchange rate is a common characteristic of central European countries, including the Czech Republic, Poland and Hungary, where stagflation prevails for the time being. Conversely, for countries in the euro area, disinflationary developments stem from weakened demand that prevailed very early on in the pandemic. In the last two months, the euro area has even seen a year-on-year decline in prices. This was also influenced by the reduction in value added tax in Germany.

Inflation will subside but only slowly, as government support programmes and the weak koruna will continue to have an effect.

Domestic inflation is, however, likely to slow in the coming months and to return to the central bank's 2% target next year. This is forecast both by us and the CNB. The prices of non-tradables, which mainly includes services, are already slowing their pace of growth. A further weakening of domestic demand, which likely has occurred as a result of the ongoing second wave of COVID-19, should accelerate this trend. However, with continued support from government programs to prevent a rise in unemployment and a decline in household incomes, there is unlikely to be a sharp decline in consumption. Moreover, the koruna could well be weak for a longer time due to the pandemic, which would therefore hinder a decline in inflation. The return to the two-percent inflation target is therefore likely to be slow.

While growth in prices of non-tradables has slowed in recent months, prices of tradables are being pushed up by the weak koruna



Source: CNB, Economic & Strategy Research, Komerční banka

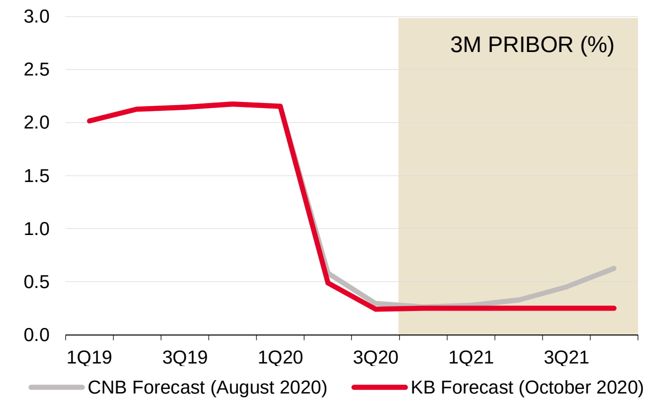
CNB's new forecast will likely indicate a deeper GDP decline

The economic downturn in the second quarter of this year was milder than the CNB expected; however, its forecast of the full-year decline is likely to be revised downward in its new forecast. Domestic GDP fell by 10.9% yoy in the second quarter, while the central bank expected a deeper decline of 12%. This was mainly due to higher-than-expected investment. For the whole of this year, the CNB's current forecast is for the economy to decline by 8.2%, and until recently it was one of the more pessimistic. It did not stand out with respect to the depth of the economic downturn in the first half of the year, but rather in the assumption of a very gradual recovery in its second half.

The CNB's new forecast, to be published in November, will probably indicate a deeper economic downturn this year than the current 8.2%.

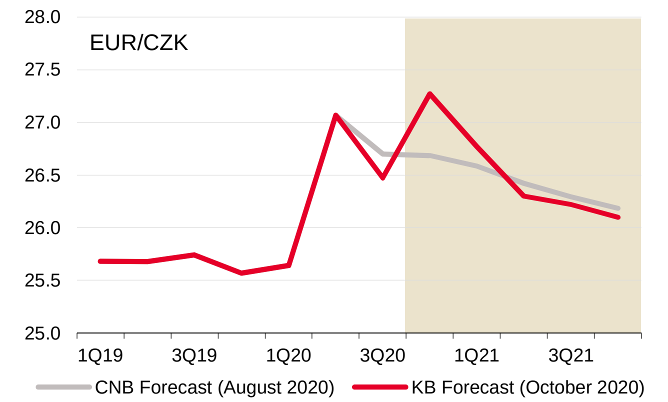
In the third quarter, the CNB expects a rise in economic activity by 2.8% qoq, which is significantly less than our forecast of 5.3% growth. However, the next CNB forecast published in early November could bring an upward revision. For 4Q20, the central bank is likely to significantly revise down. Governor J. Rusnok has already stated that the November forecast will likely include a deeper GDP decline this year than the current -8.2%. For 2021, the CNB will probably continue to forecast modest GDP growth; its latest forecast was for a 3.5% increase in 2021.

Interest rates will remain low until end-2021



Source: CNB, Economic & Strategy Research, Komerční banka

Monetary policy easing will be supported by the weak koruna



Source: CNB, Economic & Strategy Research, Komerční banka

Interest rates will remain at current levels until the end of 2021

Monetary policy interest rates likely to remain at current lows at least until the end of 2021. The inflation mentioned above speaks against further monetary easing. Its recent development is likely to force the CNB to slightly increase its inflation outlook in the new forecast, at least for the near future. Longer term, however, weak demand should outweigh this and move inflation back to target. According to the CNB, the second wave of the coronavirus does not automatically imply the need for further monetary policy easing. The CNB sees current easing as sufficient and argues for a strong expansionary fiscal policy, which in this situation has more powerful tools for emergency support of the economy. The main task of the CNB remains primarily to maintain financial stability and provide the conditions for easy access to liquidity by firms and households. We forecast that interest rates will stay at the current level through end-2021, as the economy likely will remain vulnerable and recovery will take a long time. We expect the GDP level of 2019 to be reached at the beginning of 2023.

The CNB will keep interest rates at current low levels at least until the end of 2021. However, we do not expect unconventional tools to be used.

In our baseline scenario, we do not expect the CNB to use unconventional tools. Most bank board members have already said that the introduction of unconventional instruments is unlikely. Moreover, some of them expressed this opinion when it was already clear that the situation prompted by the coronavirus was deteriorating in the Czech Republic and the introduction of further restrictive measures from the government would be inevitable. According to central bankers, the CNB continues to consider all possible alternatives, but at the moment only at a theoretical level.

Czech FX market

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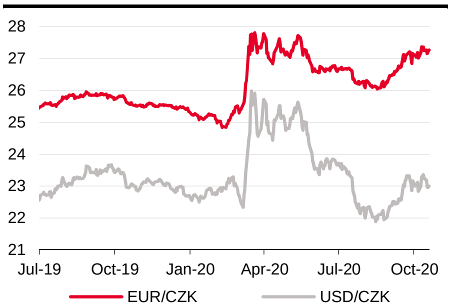
Second wave bringing koruna to its knees

In recent weeks, the koruna's exchange rate has mainly reflected the evolution of the pandemic domestically and in weakening has eased monetary conditions. In our view, the nature of the evolution of the pandemic will be key for the koruna. In our baseline scenario, we expect the pandemic to calm and government measures to be relaxed in November. This should lead to a rapid return to stronger koruna levels, especially at the beginning of next year. This is supported by the currently high risk premium and depressed financial market expectations regarding the CNB's key interest rate. A calming pandemic should lead to the normalisation of both factors and the strengthening of the koruna. The main risk to our forecast is a longer or deeper second wave of the pandemic, which would postpone our expected strengthening. The koruna's sharp reaction to the second wave and its shift to weaker levels has again opened up interesting possibilities for FX hedging at weaker values.

Markets increase risk premium for countries affected by second wave

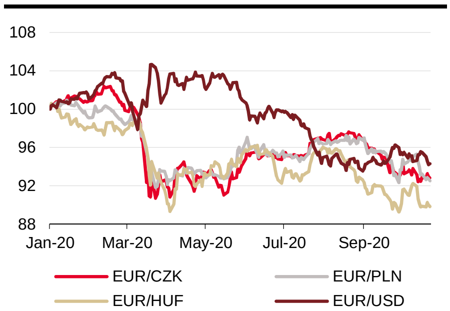
At the end of August, the koruna approached EUR/CZK26.0, surprising the market with the speed at which erased its spring losses. However, it has again returned above EUR/CZK27.0. In the first half of September the weakening was due to a correction of financial market expectations regarding the normalization of monetary policy throughout the region, while in the second half of the month the markets began anticipating a worsening pandemic. **At the beginning of October, the markets began to differentiate between individual central Europe countries and sent the koruna to its weakest level since end-May.** Since then, we have also seen a decline in the correlations between individual regional currencies, especially between the koruna and Polish zloty, which had been developed similarly.

The Koruna development



Source: Bloomberg, Economic and Strategic Research, KB

Performance of CE currencies



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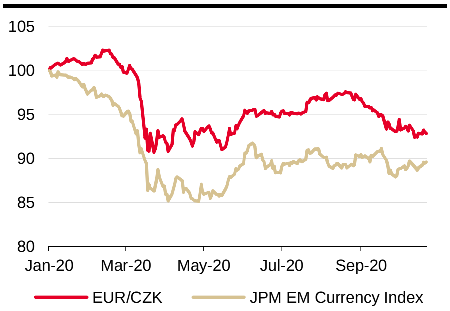
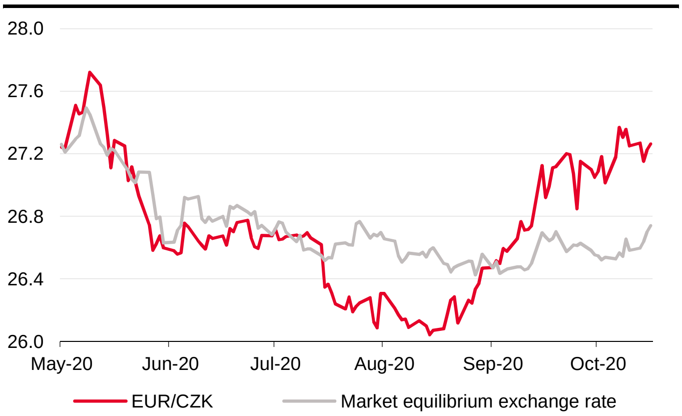
CZK lead over the market is shrinking

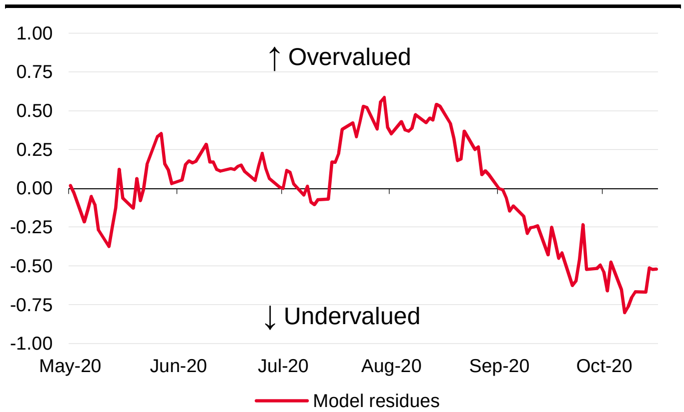


Increase in risk premium on financial markets…



Source: Bloomberg, Economic and Strategic Research, Komerční banka

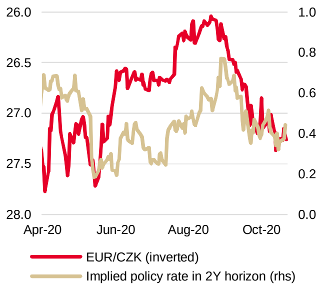
… moved the koruna to its weakest levels since end-May



Source: Bloomberg, Economic and Strategic Research, Komerční banka

In our opinion, the current weakening of the koruna goes far beyond the deterioration of its fundamentals. This is reflected in our market equilibrium model, which takes into account the evolution of global FX and stock markets and the interest rate differential between the koruna and euro rates. The unexplained part of the movement of the koruna, i.e. model residues, can be considered as a risk premium. In September, the premium began to grow to the current fifty halers, reflecting the price for the local development of the pandemic beyond global levels. At the same time, it shows the potential for the koruna to strengthen after the situation has calmed down.

With the deterioration of the pandemic domestically, the koruna has followed the decline in market expectations regarding the CNB's key interest rate



Source: Bloomberg, Economic and Strategic Research, Komerční banka

In the coming weeks, we expect the koruna to reflect domestic pandemic developments and the possible introduction of further government lockdown measures. The length and extent of the lockdown and the consequent impact on the economic recovery will be crucial for the koruna. In line with our baseline scenario, we expect the koruna to remain very volatile and weak at least until mid-November. However, as the situation calms and in advance of new government lockdown measures, it should begin to return to stronger levels. For the end of the year, we expect the koruna to be at 27.0 per euro. Although the second wave of the pandemic is likely to slow the economic recovery in the first quarter of next year, **the reduction in the current high risk premium in our view offers the potential for relatively rapid koruna strengthening.** Our outlook is also supported by depressed market expectations regarding the CNB's key interest rate. These are currently the main driver of the koruna's decline. As the situation calms down, they should help the koruna to strengthen again.

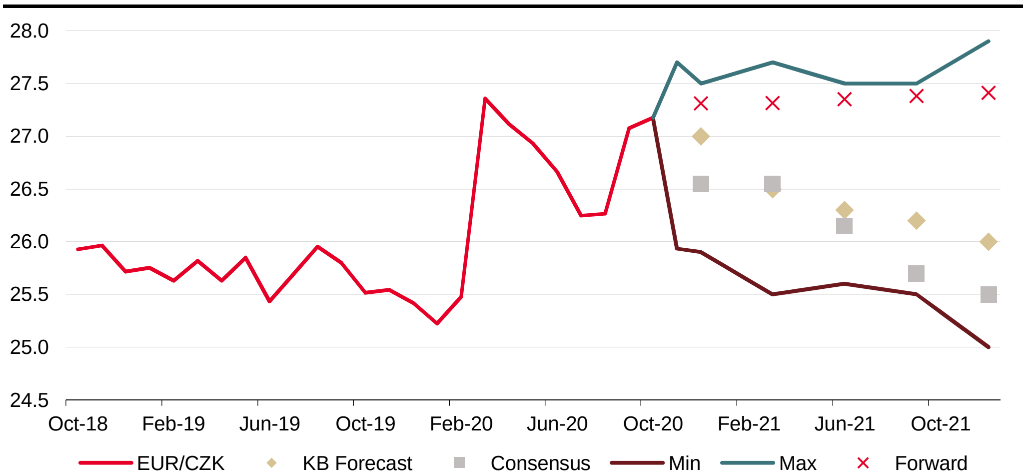
Based on the currently strong relationship between market expectations and the koruna's exchange rate, we estimate a possible weakening of the koruna by fifty halers against the euro in the event of another CNB rate cut to 0.05%.

Koruna exchange rate forecast (end of period)

	4Q20f	1Q21f	2Q21f	3Q21f
EUR/CZK	27.00	26.50	26.30	26.20
USD/CZK	22.90	22.10	21.60	21.00
EUR/CZK	1.18	1.20	1.22	1.25

Source: Economic and Strategic Research, Komerční banka

Expected EUR/CZK path, market consensus by Bloomberg (as of 27 October 2020)



Source: Bloomberg, Economic and Strategic Research, Komerční banka

The main risk to our CZK forecast is a longer or deeper second wave. We see little probability of CNB FX intervention. In the short term, the koruna may be affected by the outcome of the US presidential election.

Longer/deeper second wave and CNB intervention the main risks

The nature of the domestic evolution of the pandemic is the main risk to our forecast for the koruna exchange rate. A further escalation and new lockdown government measures beyond our baseline scenario with an impact on the economy would in all likelihood lead to further weakening of the koruna. At the same time, the length of the current measures will be crucial. A decision by the government to end them would postpone our expected return of the koruna to stronger levels.

Despite the second wave of the pandemic and its negative impact on the domestic economy, we see only a low risk of the CNB entering the FX market. The members of the CNB board unanimously state that the current situation does not require further easing of monetary conditions through unconventional instruments, including the weakening of the koruna. In addition, the CZK is responding rapidly to the deteriorating outlook for the domestic economy by easing monetary conditions in a natural way. Moreover, koruna weakness reduces the potential to ease further. Thus, in our view, FX intervention is only possible if the koruna strengthens sharply, which would hinder the economic recovery and jeopardize the CNB's target.

We see a short-term risk in the US presidential election. Should Joe Biden win (our baseline scenario), we expect emerging market currencies, including the koruna, to weaken in the short term. Should Trump win, we assume the stability of the current political line, which the markets would welcome with lower risk aversion and by strengthening emerging markets. This would also support the koruna. In the event of a disputed result or a longer counting period caused by the high number of mail votes, we expect short-term market volatility.

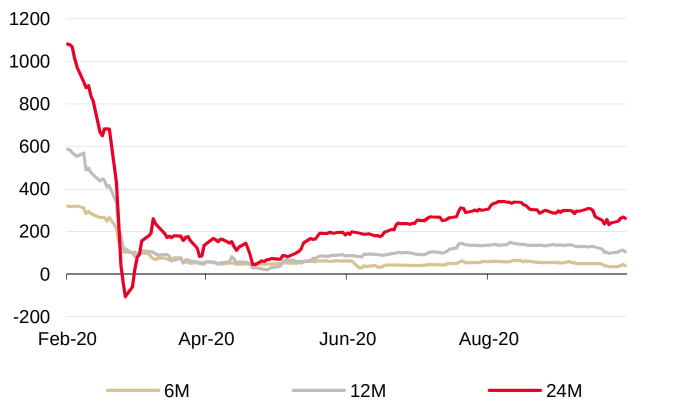
Implied EUR/CZK volatility still high

Source: Bloomberg, Economic and Strategic Research, Komerční banka

Second wave presents second opportunity for hedging

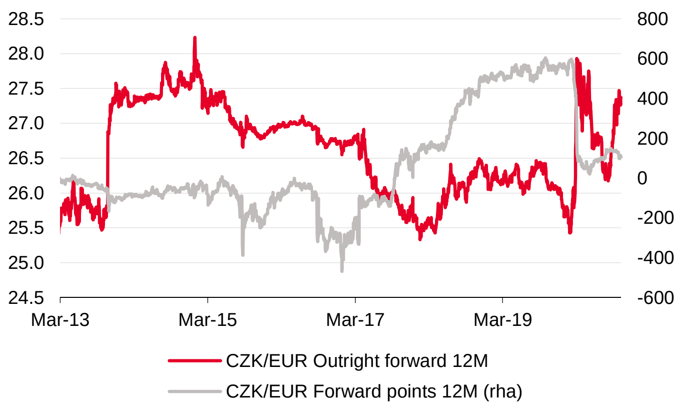
The koruna's sharp reaction to the second wave of the pandemic and its shift to weaker levels has opened up interesting possibilities for FX hedging at weaker values. The forward market could reach roughly the levels we saw at the end of April. Although forward points have bottomed out over the summer, speculation of a further decline in CNB interest rates has again pushed down market interest rates and, with that, forward points. They no longer offer as attractive a hedging option as before. Conversely, **higher volatility suggests option strategies that can improve hedging levels**. Alternatively, unlike forwards, they allow investors to participate to some extent in favourable exchange rate developments.

Forward points fell again as interest rates fell



Source: Bloomberg, Economic and Strategic Research, Komerční banka

Second wave again opens up opportunity for FX hedging



Source: Bloomberg, Economic and Strategic Research, Komerční banka

Czech government bonds and the IRS market

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The second wave has returned markets to spring levels

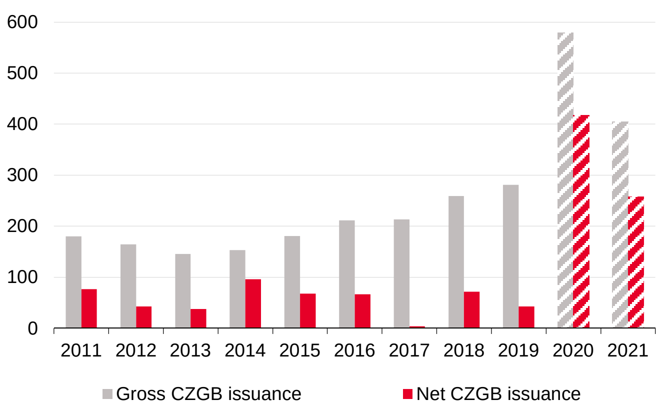
CZGB supply and the Ministry of Finance's issuance activity are currently higher due to the risk of additional expenditures associated with the second wave of the pandemic. For the markets, however, next year's supply is more crucial, which we believe will be only slightly lower than this year. The reason is the surprisingly high state budget deficit and a record redemptions calendar. This should support further growth in yields and ASW widening. The risk of a country rating downgrade persists due to the deterioration in the public finance outlook. Financial markets' pessimistic expectations are currently lowering interest rate swaps at the short end of the curve. However, the longer end is quickly returning to growth and the whole curve is becoming steeper. Swaps should trend in a similar fashion in the coming months. The current drop in IRS again opens up attractive opportunities to hedge both koruna and foreign rates.

The CZGB supply will likely remain high next year

The second wave of the pandemic will require an additional CZGB issuance. The surplus funds will likely be used to repay bonds next year.

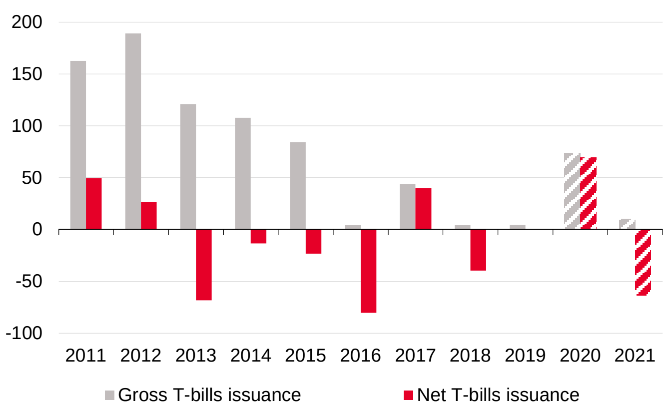
The development of the state budget over the first nine months of 2020 indicated that the current issuance will certainly cover this year's borrowing needs and part of the funds raised will go to the pre-financing of maturing government bonds next year. However, the second wave of the pandemic will require additional expenditures and will again force the Ministry of Finance to increase its activity in the primary market for the rest of the year. **According to our calculations, currently the government could cover the state budget deficit of CZK415bn.** That is CZK15bn more than we expect the final deficit to be. However, the risk of higher expenditures due to the second wave of the pandemic is high. We therefore assume that the Ministry of Finance will try to create a sufficient buffer to cover this risk, and in the event of a more favourable development, the saved funds will go to cover redemptions next year. By the end of the year, we anticipate an additional CZGB issuance in the amount of CZK30bn and T-bills in the amount of CZK5bn, maturing next year.

CZGB issuance (CZKbn)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

T-bills issuance (CZKbn)

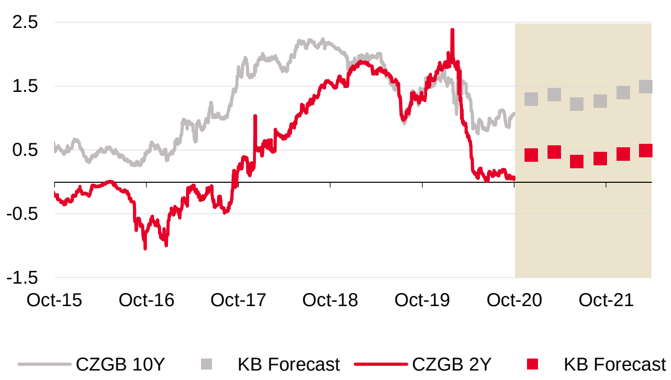


Source: Bloomberg, Economic and Strategy Research, Komerční banka

Next year, net CZGB issuance should reach CZK257.7bn, which is 38.2% less than this year.

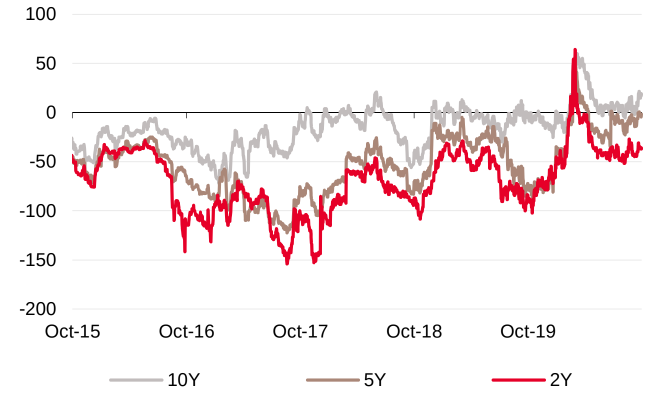
Next year, we expect redemptions of CZGB and T-bills in the amount of CZK220.2bn. In additional, CZK90bn of euro bonds and loans will mature as well. Given our forecast for a state budget deficit of CZK320bn, **we see a borrowing need next year of CZK630.1bn, which is roughly the same as we expect for this year.** The Ministry of Finance is also aware of the high borrowing needs and has increased its activity on the secondary market significantly in recent weeks. With the help of switches, it has already covered CZK36.9bn, and we expect another CZK15bn for the rest of the year. Overall, we assume that the state could cover CZK101.9bn of borrowing needs this year. We thus estimate the gross CZGB issuance for next year at CZK404.3bn (-30.2% yoy) and the net CZGB issuance at CZK257.7bn (-38.2% yoy). This would make the CZGB supply the second largest in history next year. We assume that the Ministry of Finance will be most active in the first half of the year as per the usual trend. At the same time, we expect the current strategy of longer maturities will be maintained (currently an average maturity of 5.8y).

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

ASW spreads (bp)



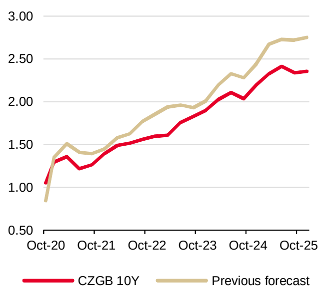
Source: Bloomberg, Economic and Strategy Research, Komerční banka

CZGB yields will likely grow more slowly due to the second wave

We expect CZGB yields to grow further, supported by the IRS growth and the high CZGB supply. Compared to the previous forecast, our expected growth is slightly slower.

Interest in domestic government bonds has broken historical records in previous months but has been steadily declining since then. Investors still prefer shorter maturities, although the Ministry of Finance has been trying in recent months to extend the average maturity and thus spread it over future redemptions. **Overall, however, demand is still sufficient** and is returning to pre-crisis levels, in a sign that Czech government bonds are not losing investor credibility.

CZGB forecast change



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

CZGB yields have been on the rise since the sharp fall in the spring months, despite higher volatility. In the coming months, their further growth should be supported by a gradual increase in IRS (more in the following paragraphs). This mechanism is driven by the development of the domestic pandemic situation and the possible reaction of the government and the CNB. In addition, the prospect of high issuance activity by the Ministry of Finance in the first half of next year will likely support CZGB yield growth, resulting in ASW widening. In the second half of the year, issuance activity is traditionally lower. This, combined with the prospect of gradual consolidation of public finances, should lead to an easing of yield and ASW tightening. **We still recommend selling CZGB 1.20% Mar-31 in ASW terms.**

Compared to our July forecast, CZGB yields will likely be affected by a slower rise in IRS and the German Bund. On the contrary, we have revised our estimate for CZGB supply next year, supporting higher yields. **In a nutshell, we expect growth in CZGB yields a few points slower across the entire curve than we expected in our previous forecast.**

CZGB yield forecast

	4Q20f	1Q21f	2Q21f	3Q21f	4Q21f
2y CZGB yield (%)	0.40	0.45	0.30	0.35	0.45
5y CZGB yield (%)	0.95	1.00	0.90	0.95	1.05
10y CZGB yield (%)	1.30	1.35	1.20	1.25	1.40
10y CZGB ASW (bp)	35	35	15	15	15

Source: Economic & Strategy Research, Komerční banka

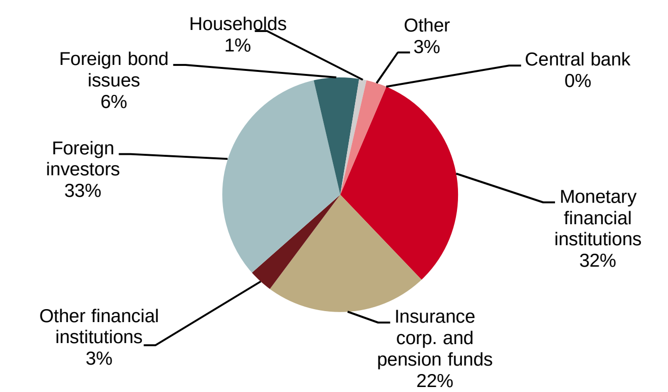
From a technical point of view, in addition to the impact of the high CZGB supply, we expect a change in the composition of the widely used GBI-EM government bond index in the coming months. According to our expectations, several CZGBs have been excluded in recent months due to their maturity, which was the result of their being sold off by funds copying the index. At present, in our opinion, one or two government bonds are missing in the index, which should be included in the coming months. Based on the index methodology and the current CZGB supply, we see CZGB 1.25% Feb-25 and CZGB 0.5% Nov-29 as the most probable candidates. Their inclusion could be announced around mid-November or mid-December with effect from the beginning of the following month. This is usually associated with higher demand and rising prices for the newly added bonds.

Government bond overview

Government bond overview								Rich-cheap analysis											
Bond	Dur.	Issued last 90D	Issuance limit	Yield	Δ1W	Δ1M	FX hedged	ASW	Δ1W	Δ1M	Min	90D	Max	Z-Score	Rank	Spline spread	Rank	Carry Roll 90D	Rank
0.75 Feb-21	0.3	0.0	38%	-0.49	5	-16	-0.97	-80	1	-20	-91		-32	-1.7	19	10.8	18	-288.5	19
3.85 Sep-21	0.9	0.0	100%	-0.20	-4	-17	-0.60	-47	1	-10	-71		-30	0.3	17	-1.3	8	-13.7	18
0.00 Feb-22	1.3	0.0	6%	0.01	0	2	-0.40	-26	4	11	-63		-26	1.7	8	-11.7	2	-1.6	17
0.10 Apr-22	1.5	1.4	101%	0.05	3	0	-0.36	-24	3	8	-47		-24	2.7	1	-12.3	1	0.1	15
4.70 Sep-22	1.8	0.0	100%	-0.06	-5	-4	-0.47	-37	1	9	-60		-34	1.6	10	8.7	17	-0.7	16
0.45 Oct-23	3.0	0.0	80%	0.30	1	6	-0.23	-9	7	17	-38		-9	2.2	3	-4.2	4	4.4	3
5.70 May-24	3.3	0.0	100%	0.21	-2	3	-0.34	-25	2	10	-52		-14	1.0	15	15.5	19	3.2	8
1.25 Feb-25	4.2	0.0	100%	0.54	3	11	-0.07	3	6	16	-27		3	1.7	7	-5.8	3	5.0	1
2.40 Sep-25	4.6	0.0	69%	0.54	1	4	-0.08	-1	5	9	-30		1	1.6	11	2.5	14	4.5	2
1.00 Jun-26	5.5	0.0	100%	0.66	2	11	0.00	6	5	13	-25		8	1.4	13	0.2	12	4.4	4
0.25 Feb-27	6.2	0.0	83%	0.77	1	12	0.08	13	5	14	-13		13	2.3	2	-4.1	5	4.3	5
2.50 Aug-28	7.2	0.0	84%	0.83	1	10	0.17	12	4	11	-12		12	2.1	4	3.5	15	3.4	7
2.75 Jul-29	7.8	0.0	67%	0.88	2	9	0.23	12	5	9	-12		14	1.7	9	3.8	16	3.1	9
0.05 Nov-29 *	9.0	13.7	57%	0.96	1	14	0.22	14	5	10	-11		14	1.8	6	-2.1	7	3.0	10
0.95 May-30	9.0	0.0	80%	0.97	1	16	0.26	14	5	14	-10		15	1.6	12	-1.0	9	2.9	11
1.20 Mar-31	9.6	3.0	69%	1.02	2	17	0.33	16	3	11	-11		16	2.0	5	-3.1	6	2.7	12
2.00 Oct-33	11.5	0.0	80%	1.07	3	11	0.44	14	4	6	-8		20	1.4	14	-0.1	11	2.2	14
4.20 Dec-36	12.3	0.0	63%	1.15	1	12	0.64	21	6	10	-6		36	0.5	16	1.1	13	2.6	13
1.50 Apr-40	16.7	8.6	63%	1.39	1	5	0.67	36	2	-2	21		56	-0.3	18	-0.3	10	3.9	6

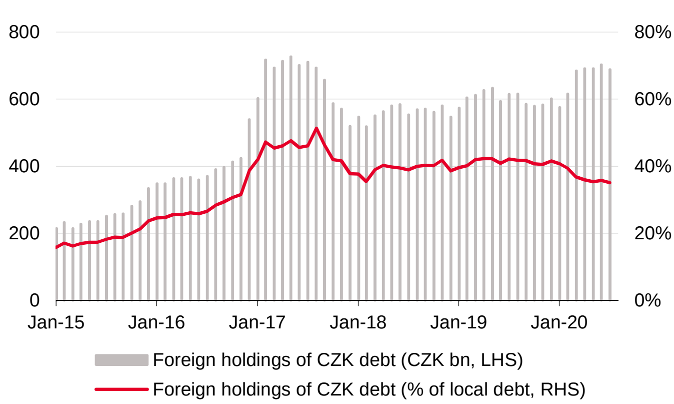
Source: Economic & Strategy Research, Komerční banka
Note: More details in CZGB Auction Alert

Holdings of CZK government debt (August 2020)



Source: MinFin, Economic & Strategy Research, Komerční banka

Share of non-resident bondholders decreased to 35.1%



Source: MinFin, Economic & Strategy Research, Komerční banka

Structure of CZGB holders: domestic banks re-establish their positions

After a sharp increase in the CZGB supply in the spring months, the share of foreign investors is steadily declining: in August, the figure was 35.1%, the lowest value since the end of 2016. At the beginning of the year, foreign entities still held up to 41.6% of all Czech government bonds. In absolute terms, however, their volume has increased since the beginning of the year. **However, most new government bonds saw demand mainly from domestic entities led by banks. In this way, the banks are gradually renewing their positions from the years before the CNB's FX commitment**, both in nominal and relative terms. In the coming months, we expect that changes in the breakdown of holders will be minimal and we consider the current situation to be a new standard.

Sovereign rating: the risk of downgrade persists

In our opinion, sovereign rating agencies do not realistically take into account the public finance outlook. For this reason, their reassessment may lead to a worse outlook or even a downgrade.

The sovereign ratings of the main agencies have remained unchanged. **The Czech Republic continues to hold the fourth-highest rating (AA-/Aa3). However, we still see a risk of a worsening outlook or a downgrade.** In our opinion, the main change in the rating reviews will be on public finance. Agencies' outlooks in this area have deteriorated dramatically over the course of this year. However, until recently, the Ministry of Finance had not published its medium-term budget outlook, making it impossible to adequately assess the further development of public finances in the coming years. Low deficits have always been the main reason for such a high rating within the region and throughout Europe. The current forecasts of rating agencies thus assumed a rapid consolidation of public finances and a return to balanced management. Compared to our forecast, they expect a 2pp improvement in the general government deficit next year on average. It is thus only a matter of time before rating agencies take into account the government's current outlook and revise their forecasts. In our view, such a shift may lead to a change in the outlook or rating. The next rating review is the S&P at the end of this week, whose current assessment of the Czech Republic we consider to be the most optimistic. The other agencies are unlikely to follow suit until next year.

Sovereign ratings overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	30.10.2020
Moody's	Aa3	STABLE	Aa3	STABLE	
Fitch	AA-	STABLE	AA-	STABLE	

Source: Bloomberg, Economic & Strategy Research, Komerční banka

Czech IRS market: the short end sinks investor expectations

The short end of the IRS curve is hampered by pessimistic investor expectations. However, the longer end continues to grow. In our view, this trend will continue in the coming months.

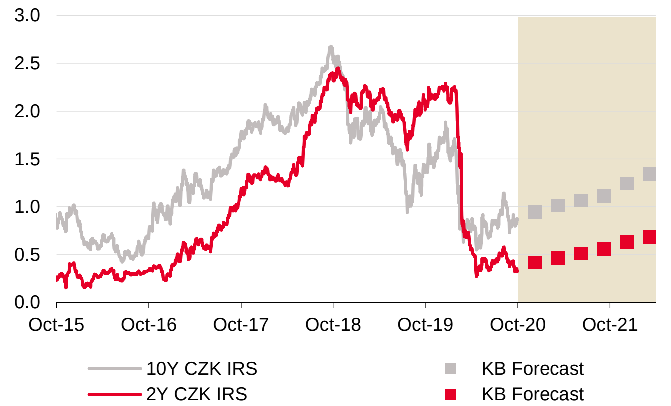
The second wave of the pandemic was mainly marked by the short end of the IRS curve, which reached its lowest values this year from mid-May. However, the long end fell only marginally and since its October lows, has risen again by almost 10bp. Currently, the steeper shape of the curve is in line with our previous forecast, although at a lower level due to the second wave of the pandemic. Our new forecast has also changed in this direction, but **we still expect a gradual rise in interest rates, especially in longer maturities.** In our view, the short end will continue to be anchored by the CNB's wait-and-see strategy. Even so, current market expectations offer room for a slight upward correction in short maturities. Currently, investors are assigning a roughly 60% probability to a CNB rate cut over a six-month horizon (assuming a technical zero of 0.05%), as the central bank's response to the second wave and its impact on the economy. However, our forecast does not assumes a rate cut (more in *CNB Focus*). Compared to the previous *Czech Economic Outlook*, we have changed our recommendation from CZK 2s5s steepener to 2s10s steepener, which we believe in the current situation offers greater potential for profit and better protection against the risk of the current crisis lasting longer.

CZK IRS outlook

	4Q20f	1Q21f	2Q21f	3Q21f	4Q21f
2Y	0.40	0.45	0.50	0.55	0.65
5Y	0.65	0.70	0.80	0.85	0.95
10Y	0.95	1.00	1.05	1.10	1.25

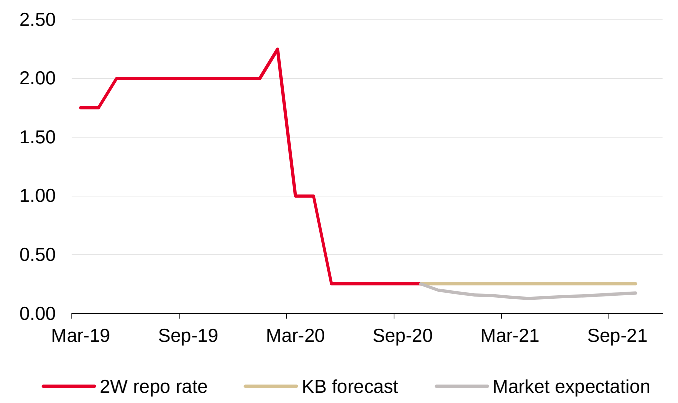
Source: Economic & Strategy Research, Komerční banka

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Part of the market is betting on another CNB rate cut

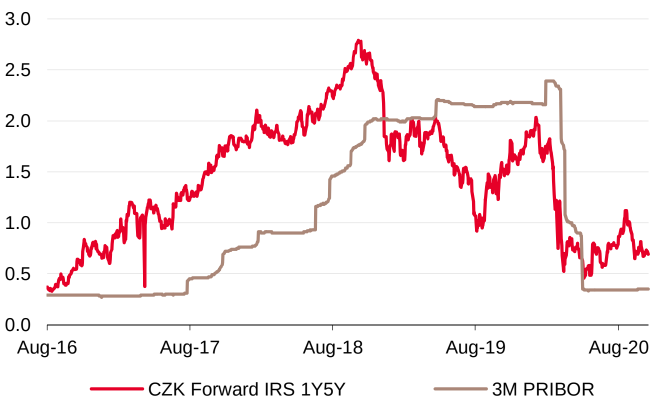


Source: Bloomberg, Economic and Strategy Research, Komerční banka

Interest rate hedging conditions have improved again

The current decline in interest rates on the market has once again opened up the possibility of attractive hedging conditions. Although the second wave did not bring rates down to the levels we saw in the spring, **market conditions are very favourable from a hedging point of view**. About half of financial market participants expect the CNB to cut interest rates to zero, which has made the current value even more attractive, and at the same time, a possible rate cut would not bring another significant decline in market rates. We can see similar developments in euro and dollar rates, which have reached historic lows, especially at shorter maturities.

The second wave opens up the possibility of IR hedging again



Source: Bloomberg, Economic & Strategy Research, Komerční banka

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

Forward	Maturita						
	6M	1Y	18M	2Y	3Y	5Y	10Y
Spot	0.36	0.26	0.30	0.30	0.41	0.58	0.85
3M	0.23	0.25	0.27	0.32	0.42	0.59	0.87
6M	0.22	0.26	0.28	0.36	0.47	0.62	0.89
9M	0.27	0.29	0.34	0.41	0.51	0.66	0.91
1Y	0.31	0.31	0.40	0.45	0.56	0.69	0.94
18M	0.31	0.45	0.50	0.57	0.66	0.76	0.98
2Y	0.59	0.60	0.66	0.69	0.75	0.84	1.03
3Y	0.78	0.78	0.82	0.83	0.86	0.94	1.11

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 27/10/2020

Banking Sector

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Further stress for the banking sector

The second wave of COVID-19 has worsened our outlook for the banking sector. Another economic downturn in 4Q20 and a slower expected recovery for next year along with elevated uncertainty will affect credit expansion, while increased propensity to save money will prevail. The six-month debt moratorium ended in October, but further postponement of payments will be possible on an individual basis. Consumer demand has not decelerated as strongly as we initially feared, as the labour market was not hit as badly as we had expected. Still, as a consequence of the second wave, we expect a further rise in unemployment and slower wage growth. This implies slower growth of consumer loans.

Real estate market is growing

Investment in housing supporting real estate market during pandemic.

Under standard conditions, the magnitude of the 2020 shock would imply a decline in housing prices. But the shock is very unique and, probably, short-lived, while households and companies will remain supported to a large extent by government programmes. In 2020, the cancellation of the real estate acquisition tax and loose monetary conditions provided additional support for the real estate market. **Therefore, we only expect a significant decline in real estate inflation, not in prices.** In 2020, demand for new housing has remained high and for that period we estimate the prices of flats to rise by 6.8%. In 2021, the prices of flats are expected to rise by modest 2.1% and to almost plateau in 2022 due to a delayed effect of the weaker economy.

Bank loans and deposits (% yoy)

	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	2019	2020	2021	2022	2023	2024
Bank loans														
Total	6.9	5.4	3.6	3.9	1.9	2.9	4.3	4.3	**4.9**	**4.9**	**3.4**	**5.0**	**6.0**	**6.0**
Households - real estate loans	7.1	7.2	6.7	6.6	5.6	4.9	4.8	3.8	**7.3**	**6.9**	**4.8**	**4.5**	**5.4**	**6.1**
Households - consumer loans	7.0	4.7	2.5	3.1	2.7	3.1	4.0	3.9	**6.7**	**4.3**	**3.4**	**5.3**	**6.9**	**7.0**
Corporate loans	6.4	4.9	1.4	1.6	0.5	2.7	5.5	6.4	**4.2**	**3.6**	**3.8**	**5.7**	**5.7**	**5.1**
Deposits														
Total	10.9	9.3	13.9	9.3	7.7	7.0	0.9	5.8	**9.6**	**10.8**	**5.4**	**4.2**	**5.5**	**5.5**
Households	8.0	10.0	9.6	8.9	6.8	4.3	3.1	3.1	**7.2**	**9.1**	**4.3**	**3.9**	**5.6**	**5.4**
Non-financial corporations	11.7	9.3	12.9	11.3	8.3	7.6	5.0	6.5	**5.1**	**11.3**	**6.8**	**5.4**	**4.3**	**5.3**
Others	15.5	8.1	21.5	8.2	8.7	11.0	-4.8	11.4	**17.9**	**13.3**	**6.6**	**3.7**	**6.1**	**5.7**
Ratios														
Loans/GDP	62.1	63.1	63.7	64.7	66.4	65.6	66.0	64.3	**60.7**	**63.4**	**65.6**	**64.1**	**64.6**	**65.3**
Deposits/GDP	91.7	95.4	101.5	93.5	103.6	103.1	101.8	94.3	**86.6**	**95.5**	**100.7**	**97.6**	**98.0**	**98.6**
Loans/deposits	67.7	66.2	62.7	69.2	64.1	63.6	64.8	68.2	**70.2**	**66.5**	**65.2**	**65.7**	**66.0**	**66.3**
Interest rates														
Real estate loans	2.6	2.4	2.3	2.2	2.0	1.8	1.9	1.9	**2.7**	**2.4**	**1.9**	**2.0**	**2.4**	**2.8**
Consumer loans	8.2	8.0	8.1	9.6	8.8	9.1	8.7	8.5	**8.4**	**8.5**	**8.8**	**8.4**	**8.7**	**9.0**
Corporate loans	3.2	2.3	1.4	2.1	1.8	2.2	2.1	2.1	**3.3**	**2.3**	**2.1**	**2.1**	**2.6**	**3.3**
Share of NPL														
Real estate loans	1.1	1.1	1.2	1.4	1.7	1.8	1.9	1.9	**1.3**	**1.2**	**1.8**	**2.0**	**2.0**	**2.0**
Consumer loans	4.1	4.3	4.3	4.9	6.0	5.8	6.3	7.0	**4.2**	**4.4**	**6.3**	**7.7**	**8.5**	**8.5**
Corporate loans	3.1	3.2	3.2	4.1	4.9	5.7	6	6.2	**3.4**	**3.4**	**5.7**	**5.7**	**5.2**	**4.9**

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

Weaker economy and projection for real estate market affect our view on mortgage market. Despite the increased uncertainty in 2020, real estate loans will probably print roughly the same expansion as in the previous year. Lower interest rates and looser conditions for mortgages (the CNB has relaxed mortgage and credit ratio limits, and lowered counter-cyclical capital buffers), combined with a possibly higher propensity to invest in housing during the pandemic, have led to higher demand. But with the economic downturn, we expect growth to decelerate over the next two years.

Credit to non-financial corporations decelerates

Corporates face increased uncertainty.

Corporate lending has been hit considerably more since the outbreak of the pandemic back in March. Government programmes have not created sufficient incentives for credit expansion. Until October, the volume of new credit within the COVID II programme was less than CZK13bn. Corporate loans declined between 1Q and 3Q in qoq terms. For the fourth quarter, we estimate a slightly better result given the recent economic recovery. **The deadline for filing applications for an extraordinary moratorium with the insolvency court has been extended to 30 June 2021. Postponements of repayments can be resolved individually.** By October, the total amount of credit under moratorium was above CZK140bn. Further government support and guarantees within COVID programmes using the state CMZRB bank and EGAP agency will remain in place and create potential for credit creation. However, the uncertain outlook will hardly lead companies to increase their investments or take larger risks. Therefore, we expect corporate loan growth to be slow until the situation brightens, which will probably be next year.

Households are hoarding deposits

As uncertainty increased during the pandemic, the pace of deposit growth accelerated to around 14% yoy. After the second wave, we expect such behaviour to prevail until at least mid-2021. Both corporate and household deposits will continue growing. But we expect a deceleration from the currently high numbers due to slower economic growth.

Non-performing loans will increase

The economic downturn will lead to a rise in non-performing loans (NPL). But the level should remain well below the highs of 2010–2016. The initial conditions are better, the shock is likely to be shorter-lived and the policy response more expansive relative to the magnitude of shock. We expect consumer NPL to peak above 8% in 2023. Corporate NPLs will probably grow faster, peaking around 6% next year. Real estate NPL should increase to only around 2%.

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2017	2018	2019	2020	2021	2022	2023	2024
GDP	real, %	5.4	3.2	2.3	-7.6	3.0	4.6	2.7	2.8
Inflation	average, %	2.5	2.1	2.8	3.2	2.3	1.9	2.3	1.9
Current account	% of GDP	1.5	0.4	-0.3	2.2	2.3	2.7	1.9	1.7
3M PRIBOR	average, %	0.4	1.3	2.1	0.9	0.4	0.4	0.9	1.6
EUR/CZK	average	26.3	25.6	25.7	26.6	26.3	25.5	25.2	24.7
USD/CZK	average	23.4	21.7	22.9	23.3	21.4	19.5	18.8	18.0

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

FX & interest-rate outlook

		26.10.2020	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
EUR/CZK	end of period	27.4	27.0	26.5	26.3	26.2	26.0
USD/EUR	end of period	1.18	1.18	1.20	1.22	1.25	1.27
CZK/USD	end of period	23.2	22.9	22.1	21.6	21.0	20.5
3M PRIBOR	end of period	0.35	0.35	0.35	0.35	0.35	0.35
10Y IRS	end of period	0.84	0.95	1.00	1.05	1.10	1.25

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

Monthly macroeconomic data

		I-20	II-20	III-20	IV-20	V-20	VI-20	VII-20	VIII-20	IX-20
Inflation (CPI)	%, mom	3.6	3.7	3.4	3.2	2.9	3.3	3.4	3.3	3.2
Inflation (CPI)	%, yoy	1.5	0.3	-0.1	-0.2	0.4	0.6	0.4	0.0	-0.6
Producer prices (PPI)	%, mom	2.4	1.4	0.4	-0.8	-0.9	-0.3	-0.1	-0.5	-0.4
Producer prices (PPI)	%, yoy	1.3	-0.7	-0.5	-0.5	0.4	-0.1	0.1	-0.3	0.2
Unemployment rate	% (MLSA)	3.1	3.0	3.0	3.4	3.6	3.7	3.8	3.8	3.8
Industrial sales	%, yoy, c.p.	-1.3	-0.3	-10.2	-35.2	-29.0	-5.6	-4.9	-8.0	n.a.
Industrial production	%, yoy, c.p.	0.5	0.6	-9.5	-36.3	-29.2	-5.5	-3.6	-7.1	n.a.
Construction output	%, yoy, c.p.	6.0	5.3	-0.3	-4.6	-7.7	-11.5	-10.4	-9.7	n.a.
Retail sales	%, yoy, c.p.	1.6	3.5	-12.0	-21.4	-12.5	-2.9	-0.9	-2.6	n.a.
External trade	CZK bn (national met.)	17.7	20.5	0.8	-24.7	-0.4	35.2	14.4	7.6	n.a.
Current account	CZK bn	24.0	37.9	17.6	-4.1	4.8	6.8	20.6	16.4	n.a.
Financial account	CZK bn	16.1	49.9	48.7	-2.3	15.5	-11.7	20.3	26.6	n.a.
M2 growth	%, yoy	8.0	7.9	9.9	9.3	9.0	9.5	10.1	9.8	n.a.
State budget	CZK bn (YTD cum.)	-8.0	-27.4	-44.7	-93.8	-157.4	-195.2	-205.1	-230.3	-252.7
PRIBOR 3M	%, average	2.17	2.34	1.95	0.96	0.46	0.34	0.34	0.34	0.34
EUR/CZK	average	25.2	25.1	26.6	27.3	27.3	26.7	26.5	26.2	26.7
USD/CZK	average	22.7	23.0	24.1	25.1	25.0	23.7	23.1	22.1	22.7

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

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