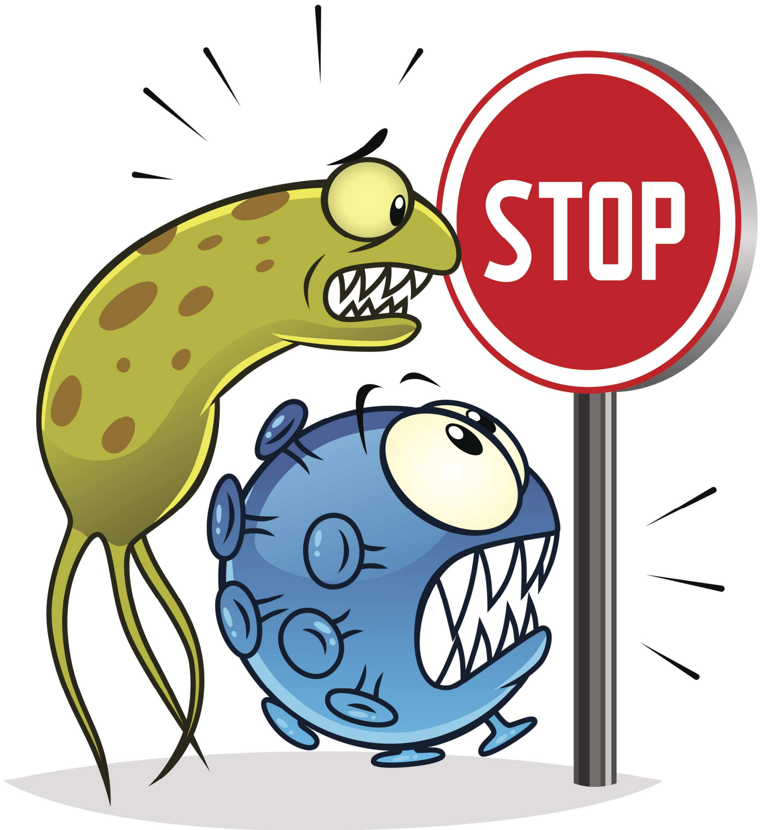
Quarterly report

Czech Economic Outlook

Stop to the Virus, Back to the Normal



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■ **Czech economy recovers** With the end of lockdown, the economy has quickly started to reopen. In majority of cases, activity will try to return to pre-crisis levels, but that will not be possible in all areas. We do not expect GDP to return to the pre-COVID-19 level until 2022. The forecasts remain strongly uncertain and the coming months will unveil how much damage has been done.

■ **The inflation will decelerate** Consumer prices will be elevated with the weaker CZK and more expansive food. According to our estimates these will be outweighed by the impact of weak demand and lower oil prices and the inflation will decelerate below the 2% CNB inflation target.

■ **The restart of the economy will return the koruna to stronger value** Low interest rates make the koruna less attractive and prevent it from appreciation. In the second half of the year, however, there should be an economic recovery and, with it, a belief in monetary policy normalization.

■ **High demand pushes CZGBs yields down** Despite the unprecedented issuance of government bonds and the worsening outlook for public finances, investor interest is not waning. The wave of monetary condition easing has pushed market interest rates to their cyclical bottom. In the second half of the year, we expect them to rise gradually.

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Economy waking up with a COVID headache

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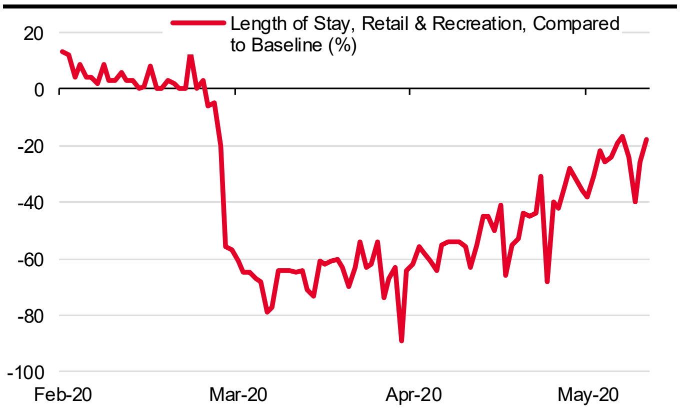
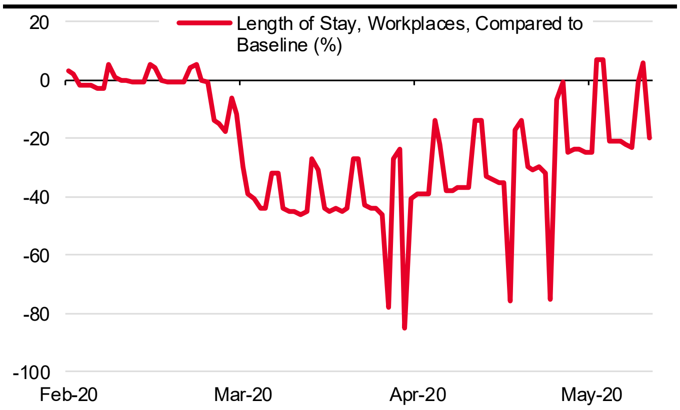
The worst is over for the Czech economy. Between mid-March and end-April, the Czech economy was paralysed by the impact of the government's measures to combat COVID-19. All the country's automobile works were closed down, and the service sector all but suffocated because the government's restrictions basically anaesthetised tourism, catering, culture, and sports. The Czech Republic's key trading partners were in a similar situation. In addition, the governments of European countries decided to do something almost unimaginable – national borders within the EU were closed down. Gradual relaxation of the restrictions started in May. In the last week of May, indoor catering operations were opened – albeit in a restricted mode. It was the closure of restaurants that had been the main symbol of the lockdown.

Activity in retail and tourism recovering only slowly



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

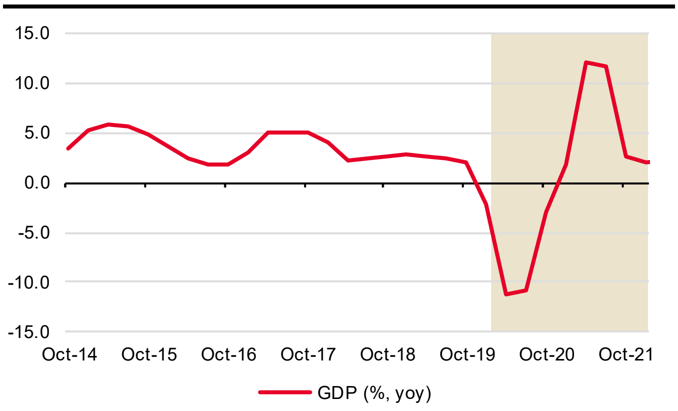
Return to workplaces almost complete at the end of May



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

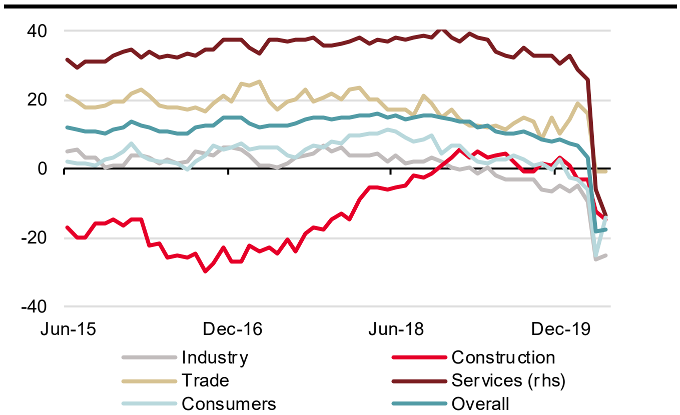
The economy is growing already, but it will be a long time before this is reflected in data on the real economy. The government's measures only had an impact on the Czech economy from the second half of March. Despite that, according to the CSO's preliminary estimate, GDP dropped by a significant 3.6% in real terms compared with the last quarter of 2019. This is the worst result in the time series since 1996. And it is obvious that 2Q20 will be much worse (we expect -8.6% qoq).

Economy slumped in 1Q20, but likely to have hit bottom in April, or 2Q20



Source: CSO, Economic and Strategy Research, Komerční banka

Sentiment indicators have bounced off the bottom (p.)

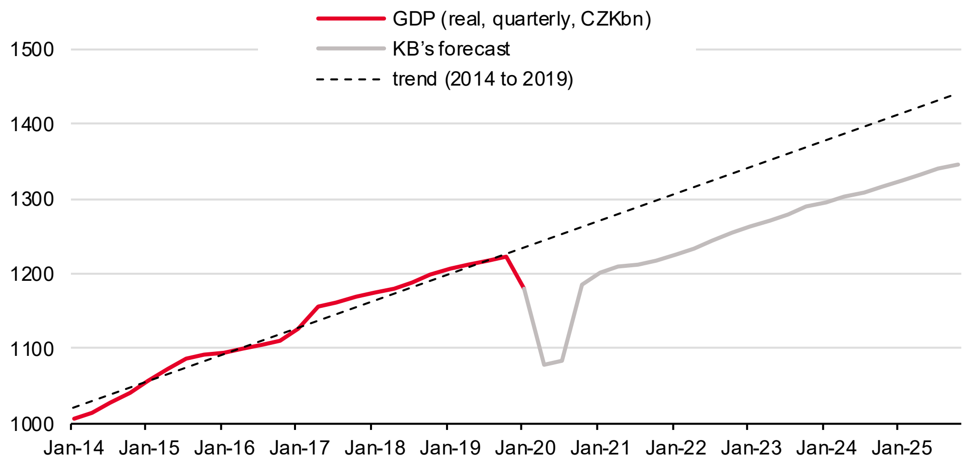


Source: CSO, Economic and Strategy Research, Komerční banka

But the CSO is not due to publish the first preliminary estimate of the result for 2Q until 31 July, and we will only receive the final figures for the national accounts, including sectoral ones, on 2 October. We think that economic activity hit bottom in April and we expect this to be confirmed by the May data from the real economy, although this will not be published until the first half of July.

The shock that (not only) the Czech economy has suffered has not made economic forecasters' (already difficult) life any easier. The standard macroeconomic models employed for forecasting are not designed for the current type of shock. The reason is that they assume that economic relationships do not change over time. But this is not the case for the current situation; during the coronavirus, the world, including the economic world, is simply different. Our forecasting has therefore required a number of expert adjustments, which only highlight the great uncertainty surrounding the forecast that we are offering you in this issue of the *Czech Economic Outlook*. No less importantly, it should be noted that every forecast is based on a certain status, on the current situation. But as noted above the status of the Czech economy during 2Q20 is surrounded by enormous uncertainty and we will only be wiser in a few months.

We expect the economy to return to the pre-crisis level in two years at the earliest



Source: Economic and Strategy Research, Komerční banka

One of the few certainties is that the Czech economy fell into recession in March. The central bank dramatically relaxed the currency conditions and we expect it to cut rates to a technical zero in June. The government has promised, in the international context, extensive help amounting to more than 15% of the GDP. However, the delivery is lagging behind. Once the economic situation stabilises in 3Q20 we expect the end of the year to see the economy start growing again. In any case, the coronavirus measures will cost the Czech Republic more than two years: it will only return to the end-2019 level in 2022, in our view. But later winners are born in crises. Through investments in the infrastructure in the broadest sense (transport, communication, IT, education, etc.) the government's economic policy now also has the chance to underpin private sector investment activity and push the Czech economy up by a level towards the new economy.

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External Environment and Assumptions

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Coronavirus sets its teeth into the world's economies

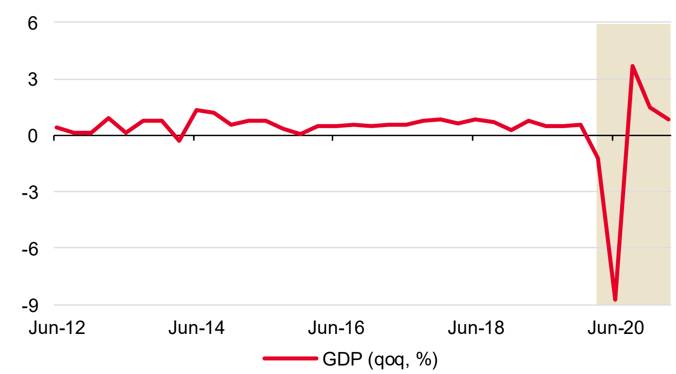
The 1Q20 results have already demonstrated how COVID-19 is eating into growth of the world's economies. And the second quarter will be even worse in this respect. However, the US and euro area economies should show significant growth in the third quarter, although GDP is not expected to return to pre-coronavirus levels immediately. The impacts on the labour market and consumer prices will also be significant. Interest rates should therefore remain at the current extremely low levels for a long time to come.

US: substantial decline to be followed by significant growth

GDP growth will not return to pre-COVID-19 levels immediately.

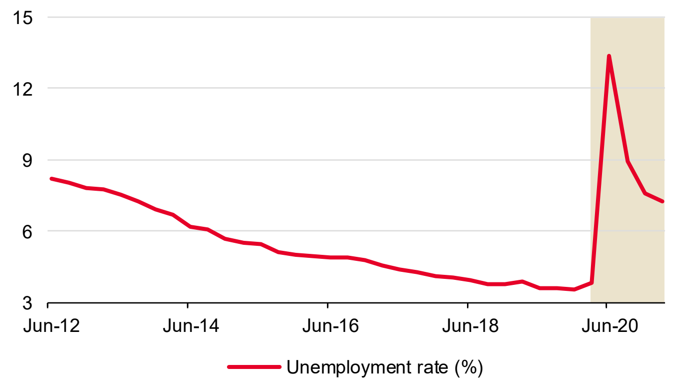
The GDP growth decline in the US in 1Q20 was more pronounced than we expected (-5.0% qoq annualised) and the breakdown was also surprising. Expenditure on services fell the most, as their contribution to GDP was negative at 5.0pp. Expenditure on travel, recreation and leisure fell dramatically, which was to be expected. The surprise came from healthcare spending, which is usually stable. The outage of routine healthcare, preventive examinations and preventive interventions cut 2.3pp from GDP. Expenditure on durable goods, especially cars, declined as well, which is a typical sign of a recession. By contrast, expenditure on consumer goods grew. We expect the GDP decline to be even more significant in 2Q. Our forecast assumes an annualised drop of more than 30% qoq. In 3Q and 4Q, however, the economy should start to pick up at a very fast rate. Overall, we expect GDP growth to be down by 4.9% this year. Next year, growth should return to normal levels. However, it is unlikely to reach pre-coronavirus levels until 2022. Potential output has so far been estimated at 2%. However, due to coronavirus, it is likely to decrease to about 1.5-1.7%.

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



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment rate to reach double digits



Source: Macrobond, SG Cross Asset Research/Economics

The US labour market is seeing its worst conditions in 30 years.

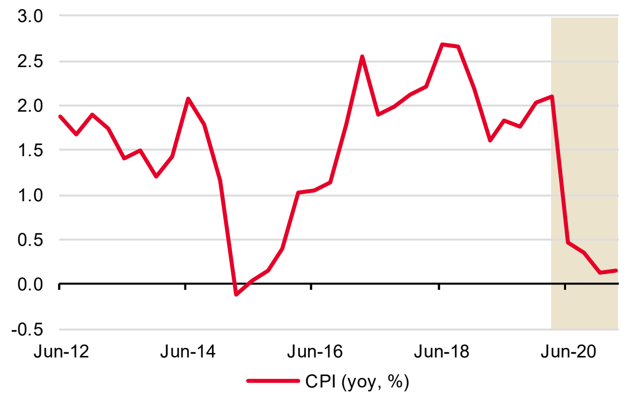
The US labour market could take a long time to recover from the coronavirus crisis. The unemployment rate reached 14.7% in April, vs 4.4% in March, its highest level since the 1930s. April saw 20.5 million people lose their jobs in the US. Nevertheless, according to our estimates, the unemployment rate should fall back below 10% by the end of this year. That being said, the room for any further decline is limited, in our view. We forecast the unemployment rate to come in at 6.5-7.0% at the end of 2022. Given the Fed's mandate to achieve full employment, we can say goodbye to interest rate hikes for several years, in our view.

It might take several years for inflation to get back to the Fed's target.

High unemployment will not be the only reason why the Fed will not raise rates immediately. Another factor will be inflation, which in April fell to its lowest level since 2015

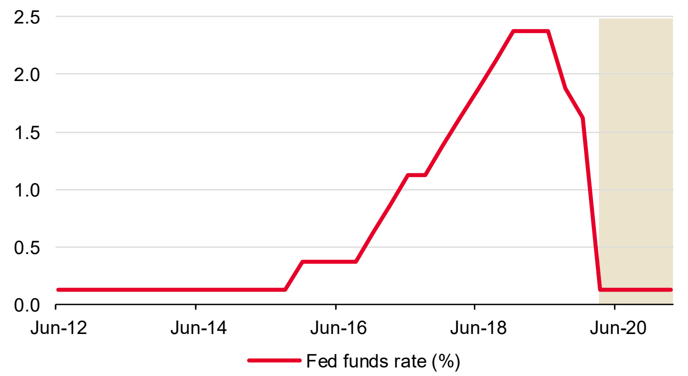
(0.3% yoy). Fuel prices, the main reason for the decline, should rise again over the coming months, but traders' efforts to lure customers back into stores will push prices down. In our opinion, inflation won't reach the 2% inflation target until 2022-2023 at the earliest. Until then, the Fed will try to support the economy with the available tools. In addition to the unlimited purchase of government bonds, there will also be purchases of corporate bonds, which the Fed entered into for the first time in mid-May. While it is not yet buying them directly on the primary market but through publicly-traded funds (ETFs), in time it would also like to make direct purchases. The corporate bond purchase programme was approved at the end of March. The Fed also announced that it is planning to buy bonds with a non-investment speculative rating (high-yield). While the Fed has only now made its first purchases, the corporate bond market has revived significantly. The highest number of corporate bonds ever sold in a single month in the history of the US were sold in April. And the volume of newly issued corporate bonds is likely to reach record levels as well. The government is not far behind either with support for the economy. With spending already approved, the deficit is set to reach $4tn this year.

Inflation will not reach Fed's target any time soon



Source: Macrobond, SG Cross Asset Research/Economics

Rates will remain at current level until 2022



Source: Macrobond, SG Cross Asset Research/Economics

Euro area: service-oriented economies hit hardest

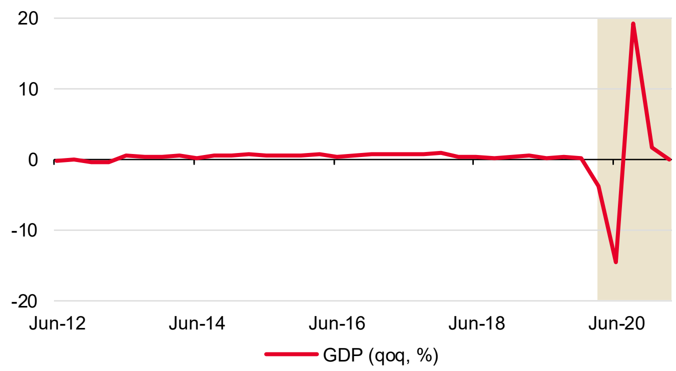
Massive drop in activity will be followed by sharp rise.

The euro area economy registered its strongest contraction ever in 1Q (-3.8% qoq). The surprise was not so much the extent of the decline but the breakdown between the individual countries. GDP did not fall most in Italy (-4.7% qoq), but in France (-5.8% qoq) and Spain (-5.2% qoq). In the end, the German economy was the least affected by the coronavirus pandemic, with GDP falling by 2.2% qoq and -1.9%. yoy (NSA). This confirmed our view that the service-oriented economies would be harder hit by the current crisis than the industrial ones. The closure of a large part of the economy in the second quarter will result in a sharp decline in GDP growth during this period. The PMI decreased to historically low levels (April composite PMI 13.5 points), which is consistent with a 2Q GDP decline of 10-15% qoq. According to SG economists, each day of lockdown corresponds to a 25-35% reduction in economic activity, or a 0.07-0.10pp decline in GDP growth. According to our assumptions, GDP will contract by 14.3% qoq in 2Q. The recovery is likely to be gradual and incomplete. It will take some time for consumers and businesses to return to their normal behaviour. Even so, we expect strong GDP growth of 20% qoq in 3Q20. Euro area GDP for the whole of this year should be down by 5.4%, but we expect 6.0% growth for next year.

The QE programme will be extended.

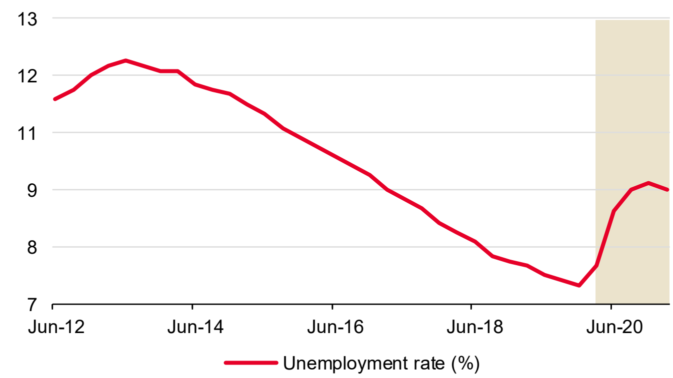
Like the US, the euro area will not be able to avoid the secondary effects of the coronavirus pandemic either. We expect the unemployment rate to increase by at least 1pp by 2021, corporate profits to be lower, some corporations to record losses or declare bankruptcy and corporate debt to increase. This will subsequently lead companies to be less willing to invest or hire new employees. Thus, GDP will not return to its pre-coronavirus level before 1Q22, in our view. Overall, however, the consequences of this crisis will be much smaller than those of the great financial crisis in 2009. This is due to the type of crisis and the massive response from governments and the European Central Bank. In our opinion, the ECB reacted in time and sufficiently aggressively. Further steps by the ECB could include the inclusion of mortgages in the TLTRO programme if household confidence and consumption were to fall sharply. Furthermore, an equity purchase programme, or ETF, could be launched, if there were excessive volatility in the market, which would jeopardise economic growth. We currently think further interest rate cuts would be ineffective. By contrast, we expect the current QE programme to be extended for another year in January and extended by €500bn.

We expect a V-shaped recovery in the euro area



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment will rise

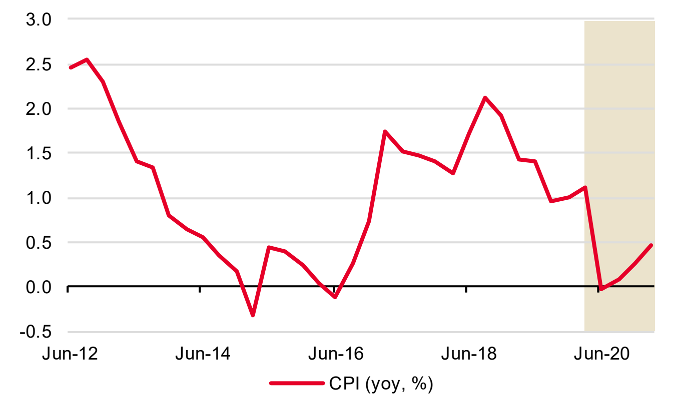


Source: Macrobond, SG Cross Asset Research/Economics

Inflation will fall into negative territory in the euro area

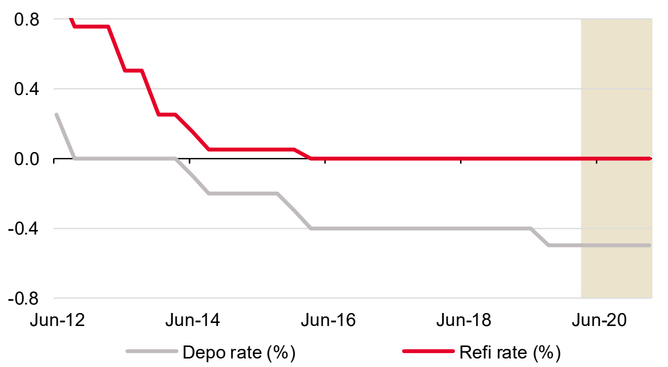
The ECB will likely be pressured into keeping rates at current levels and further expanding its asset purchase programme, not only due to concerns about economic growth but also about inflation. In our view, inflation will fall into negative territory due to the drop in fuel prices and lower prices in the accommodation, catering and recreation segments. By contrast, food prices and prices of healthcare services should rise. As with economic growth, we expect consumer prices to show a V-shaped recovery – after a significant decline, prices should start to rise again, according to our forecast. However, we do not expect inflation to return to the ECB's inflation target over the coming years.

Inflation at freezing point



Source: Macrobond, SG Cross Asset Research/Economics

Interest rates will remain at current levels for a long time



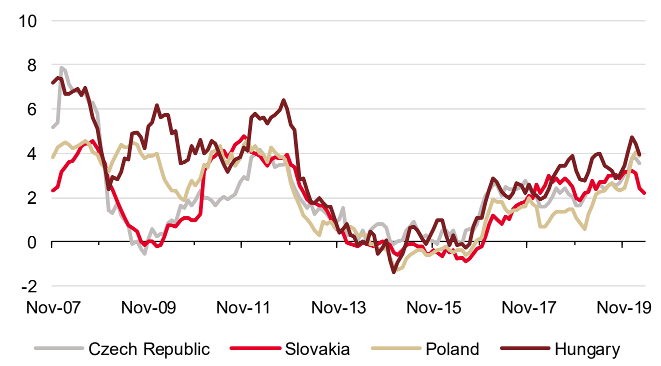
Source: Macrobond, SG Cross Asset Research/Economics

CEE countries are holding up relatively well so far

The Polish central bank cut rates to 0.1%

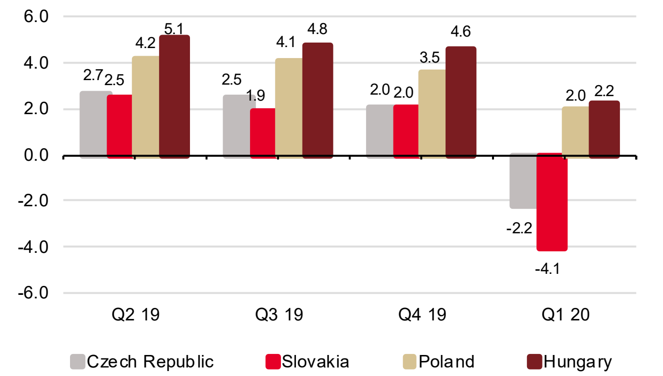
In the end, the first quarter of this year was not as bad as had been widely expected for the CEE countries. The best performers were Hungary and Poland, both of which maintained positive GDP growth year-on-year, while Slovakia performed worst. The Polish economy contracted by 0.5% in 1Q compared with the previous quarter, while GDP grew by 2.0% year on year. The coronavirus pandemic hit Poland a little later than its regional neighbours, and in addition, Poland is not dependent on the car industry as much as Slovakia for example. The Polish government and the central bank rushed to help the economy. The government has designed a programme dubbed the Anti-Crisis Shield, which should release up to PLN212bn to help the economy. In addition, a public investment fund worth PLN30bn was set up. Overall, government help should reach around 10% of GDP. The economy is also being supported by the Polish central bank. It reduced interest rates to 0.1% and launched a quantitative easing program. Even so, Poland will not avoid a slump in economic growth. According to the International Monetary Fund's forecast, GDP growth should fall by 5% this year. The market consensus measured by Bloomberg is more optimistic in this respect, expecting a GDP decline of 3.5%. Similar to other economies, the largest decline in Poland can be expected in 2Q, by 8.4% (Bloomberg consensus). As a result, we expect the Polish zloty to weaken. According to our forecast, it should reach the low point in 3Q20 (4.68 PLN/EUR).

Inflation in CEE region decelerated (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

The region can expect a further decline ahead (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

The Hungarian forint is likely to weaken further

Hungary's GDP fell by 0.4% quarter on quarter in 1Q, while the yoy dynamic remained positive, with GDP growing by 2.2%. According to preliminary data, both the services sector and industry made a positive contribution to the result. However, the second quarter will be a different matter. Industrial production fell by 10% year on year in March, the highest drop since 2009, and an even more significant decline can be expected in April. Confidence in the Hungarian economy has fallen by the largest amount in the last 11 years (-33 points), which will have a negative impact on investment activity and domestic demand. According to analysts interviewed by Bloomberg, the Hungarian economy will fall by 2.1% for the whole of this year. The local government is also taking huge steps to prop up the economy and the overall support should reach 14% of GDP. Like Poland's central bank, the Hungarian CB has launched a QE program and it is quite aggressive in nature. Each week, the central bank can buy HUF100bn, in an attempt to push the long end of the yield curve down. The program should be revised when purchased volumes reach HUF1tn. We expect no change in the key interest rate in the coming months. The Hungarian forint is, however, likely to weaken together with other EM currencies. Our forecast for the end of this year is 375EUR/HUF.

Macroeconomic outlook

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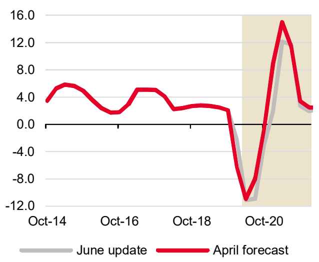
Main changes

GDP:
For 2020, we have revised down our forecast slightly to -6.8% from -6.5%. For 2021, we expect economic growth to accelerate to 7.1%.

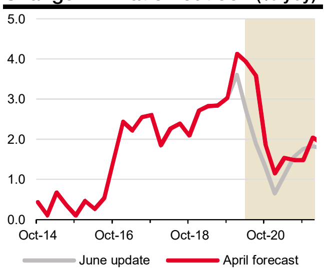
Inflation:
After inflation rose to 2.8% last year, we have decreased our forecast for 2020 to 2.4% from 3.0% due to drop in the demand and lower oil prices.

Change to GDP outlook (% yoy)



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

Change in inflation outlook (% yoy)

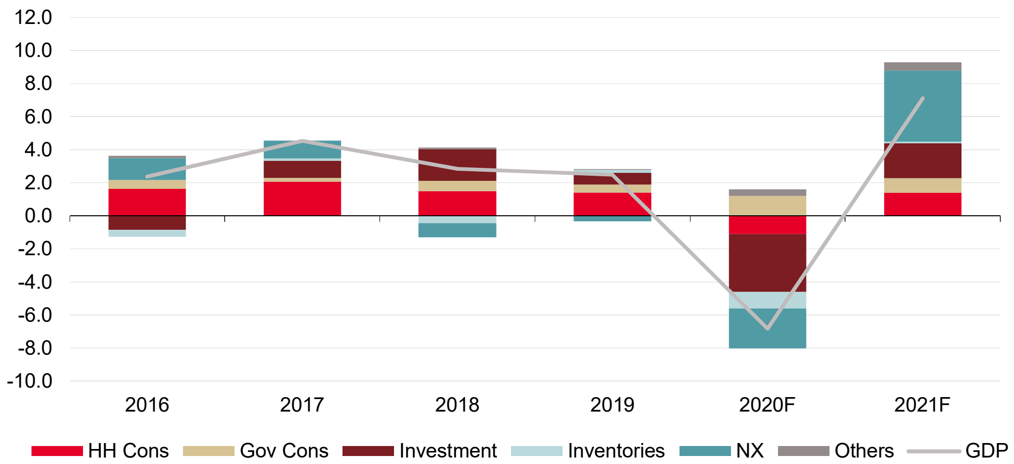


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

On the road again

The economic outlook remains highly uncertain. Compared to our -6.5% forecast from April, we now expect the economic decline this year to be only slightly deeper at -6.8%. The recovery should be quite strong but not as strong as we expected due to the slower-than-expected fiscal policy response and slower recovery abroad. The economy could return to pre-pandemic levels in 2022. The negative shock to demand will probably outweigh pro-inflationary factors such as a weaker CZK and disruption to supply chains, and inflation will likely decelerate below the CNB target.

Decline in investment and exports will likely be the main drag on the economy in 2020 (%, yoy)

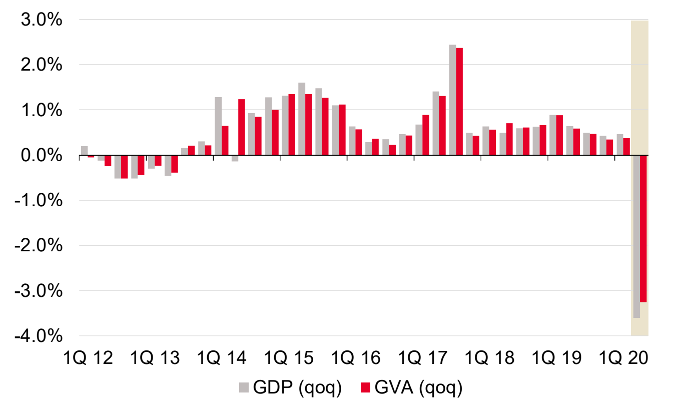


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Economy declined

According to the flash estimate, Czech GDP growth declined by 3.6% qoq in 1Q20. The statistical office said the decline was mainly driven by decreasing external demand and lower capital formation, offset somewhat by government expenditure. Doubts around the accuracy of the statistics have increased, and therefore bigger revisions are more likely than usual. **We expect that the services sector also contributed strongly to the decline. On the expenditure side, we expect a negative contribution from household consumption.** However, the first-quarter average masks the fact that the pandemic shock escalated as late as the second half of March. The economy started to unlock in late-April/May, so economic growth probably bottomed in April. As the economy is still operating well below pre-pandemic levels, we should see another strong GDP decline in 2Q. We expect

GDP decline since March dragging down quarterly average



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

-8.6% qoq, which translates into a 11.1% yoy decline. **While the initial post-lockdown recovery will be fast, we think it will take around two years to reach pre-crisis levels.**

Economic policy is expansionary, but fiscal support is milder than we had expected

It is important to state that the forecasts remain highly uncertain, as the damage to the economy is unknown. The shape of the recovery will be strongly influenced by developments abroad, where we expect something in between an L-shaped and U-shaped recovery. Importantly, with regard to the domestic economic policy response, both monetary and fiscal policy have been expansionary since the removal of the economic restrictions. **However, the fiscal policy reaction has been slower and milder than we initially expected.** This, together with the deteriorating GDP outlook for economies abroad, was why we revised down our GDP outlook. As we noted in our Czech economic outlook in April, the government has taken action to support businesses and protect families. The effectiveness of these measures will be crucial for the speed of recovery. The recovery may be slow if the government tries to push the burden of financing these measures onto the private sector. Unfortunately, this has to some extent materialised.

Initial economic and financial conditions were favourable

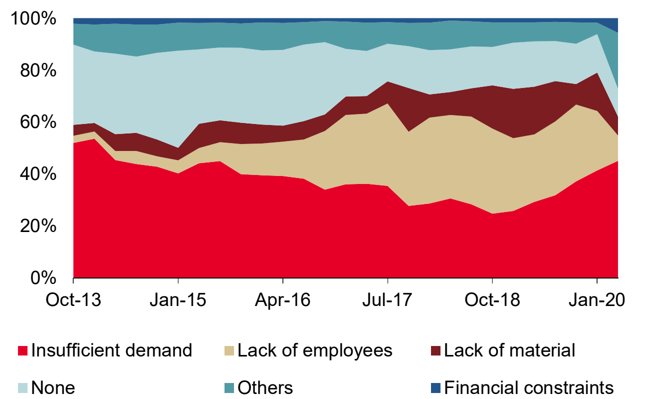
The direction of the policy reaction was correct, i.e. it was not restrictive. Accompanied by natural automatic stabilisers, a significant portion of the shock was absorbed. Moreover, the pre-existing economic conditions – extremely low unemployment, healthy household finances, a sound and stable banking system, a narrowing but probably positive output gap, and relatively solid room for manoeuvre in terms of monetary and fiscal policy – prevented the economy from more serious consequences and a deeper decline.

Industrial producers take another hit

The car production outlook remains very uncertain, but compared to foreign producers the Czech carmakers were doing relatively well before the pandemic

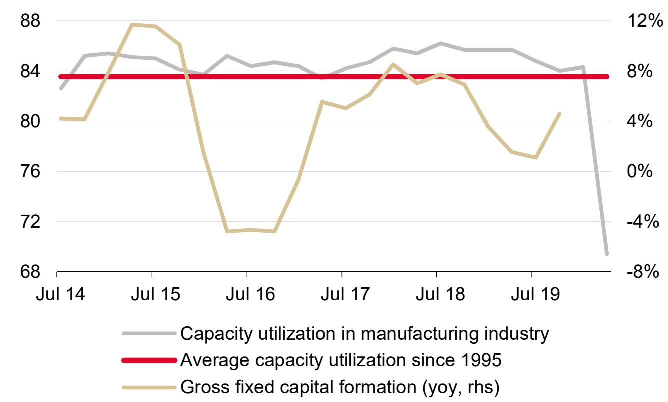
The manufacturing sector had significant problems even before the pandemic. After stagnating last year and before the lockdown, we saw a chance of industrial output recovering later this year. But that would have been only weak uncertain growth amid uncertainty for the automotive sector and its suppliers. **The pandemic has increased this uncertainty. Given the external demand drop, we see a large industrial output decline this year of 14%.**

Insufficient demand the main barrier to industrial expansion



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

Capacity utilization well below long-term average



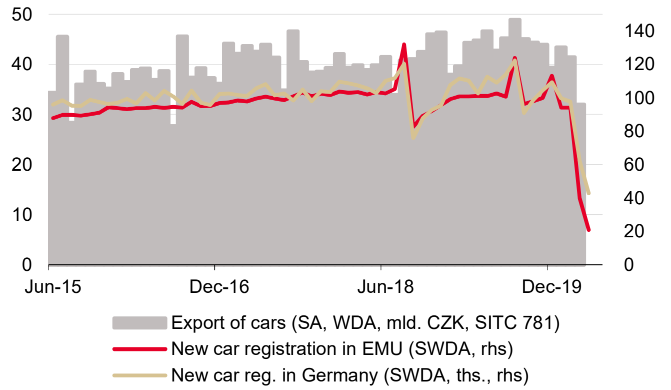
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

In our base-case scenario, we assume no further lockdown caused by another pandemic wave. In that case, industrial output should return to growth at an extremely low level in 2Q20. The general trend uncertainty surrounding carmakers is a major risk. However, before the pandemic, compared to carmakers elsewhere, Czech carmakers performed very well and even increased production. We believe that after the lockdown a substantial portion of the demand for cheaper, quality Czech cars will return. Still, industrial output will probably not return to pre-pandemic levels before 2022.

Construction likely to decline due to limited capacity and lower demand

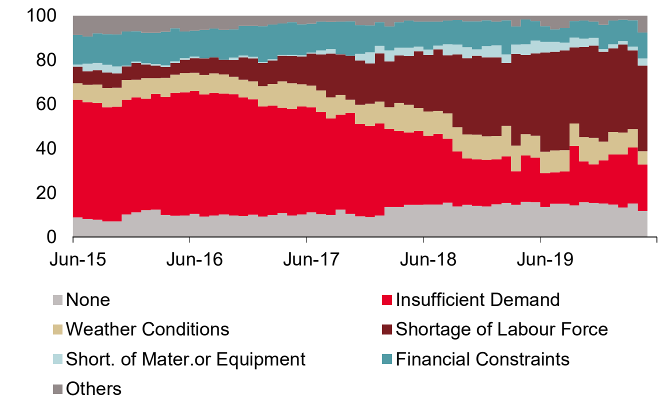
Construction hit less than other sectors. The impact of the pandemic on demand within the construction sector has a significant natural lag. Furthermore, construction work did not require as strong epidemic safety measures, i.e. there was no lockdown. Still, the sector faces an even more pronounced shortage of employees than before the pandemic. Moreover, it has been hit by supply chain disruptions. Therefore, construction started to decline from March as well. We expect the sector to decline amid lower demand, with some investments cancelled or delayed. On the other hand, public sector investment will offset this somewhat. Altogether, the decline this and next year should be in the low single digits.

Automotive industry hit hard



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

Lack of capacity still main obstacle to growth in construction (%)



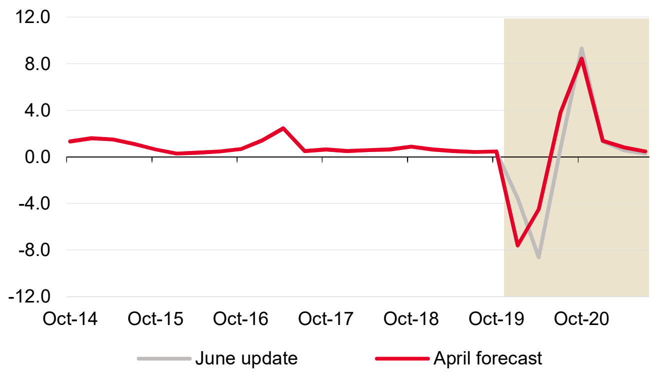
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Drop of investment activity and in foreign trade

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

At the beginning of this year, we expected a small increase in investment activity in 2020 and no improvement in foreign trade. Due to the pandemic shock, these two variables will be the main drags on the economy this year. Dropping foreign demand should decrease foreign trade activity, while the rise in risk aversion and uncertain outlook should lead to a drop in investment. Similarly, when the expected recovery happens, these two GDP components should become the main GDP growth drivers.

GDP growth will recover (%, qoq)



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

Fiscal policy: the deepest public finance deficit in history

The current economic crisis has completely overwritten the public finance picture. The previous four years of surplus have been replaced by a slump to the worst result in the country's modern history. As a result of the deep decline in the domestic economy, we expect a revenue shortfall of CZK180bn this year. On the expenditure side, we see risks in both directions compared to the updated version of the budget, depending on the course of the fiscal stimulus for the rest of the year and the implementation of investments. In our view, the state budget should end this year with a record deficit of CZK340bn. Municipalities and health insurance companies should benefit from the reserves created in previous years and an increase in payments for state insured persons. Public finances should end in a deficit of 6.7% of GDP this year.

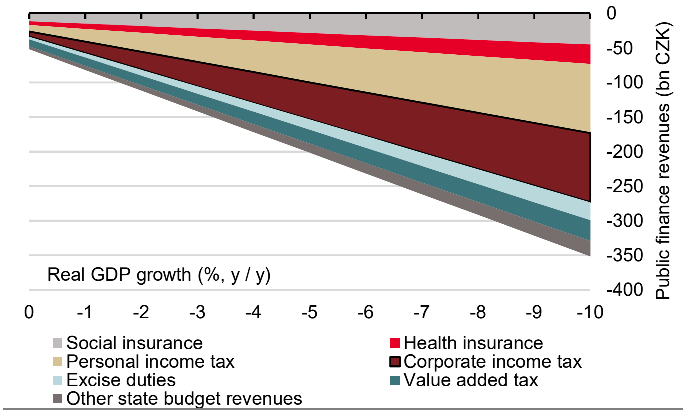
The state budget should end this year with a deficit of CZK340bn

We estimate this year's shortfall in state budget revenues at CZK180bn. On the expenditure side, final support for the economy and the investments made will determine the deficit level.

In the first four months, the state deficit was CZK93.8bn. This is CZK64.1bn worse than for the same period last year. From the point of view of the April results, this is clearly the worst result in history. For the time being, the impact of the current crisis on the revenue side of the budget is most noticeable, while the increase in expenditures does not deviate significantly from the trend seen previous months. The most visible decline can be observed in pesonal income tax and VAT. But we will only see the main decline in revenues in the coming months. In June, the forgiven advance on corporate income tax, which we estimate at CZK40bn, will be dropped from the state budget, and the lockdown from April to May will be fully reflected.

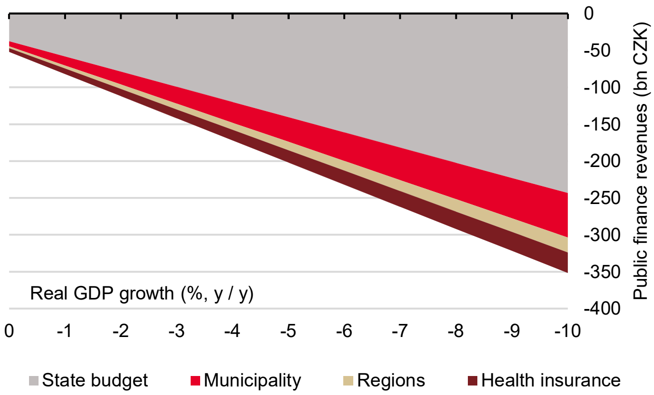
Due to significant uncertainty surrounding this year's growth in the domestic economy, **we have simulated individual GDP development scenarios based on the estimated elasticity of public finance's main revenue groups.** Subsequently, we assigned individual revenues to specific beneficiaries according to the current budget allocation of taxes and the structure of public finances. The resulting graphs thus show a shortfall in revenues compared to the Ministry of Finance's original budget. The latter expected growth in the domestic economy of 2.2% and a state budget deficit of CZK40bn.

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



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

Public finance revenue scenarios according to recipients compared to the MinFin's original budget (CZKbn)



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

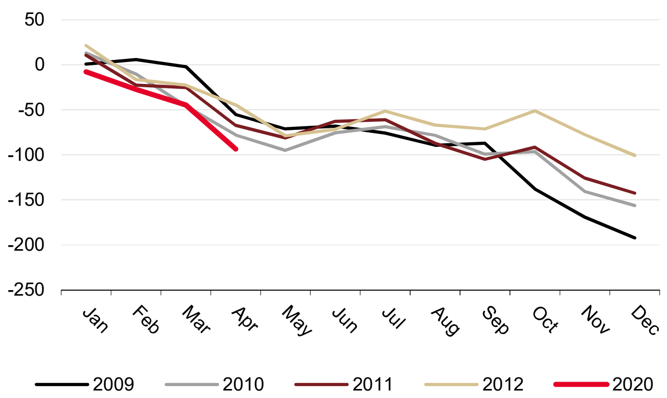
The model used works with several assumptions that are difficult to predict in reality. The main shortcoming is the linear relationship between economic development and public finance revenues. Especially in the case of a deeper decline in GDP, it can be assumed that the more volatile tax items (e.g. corporate income tax) will see a more significant shortfall than predicted in the model. At the same time, the government's discretionary measures, such as the waiver of some tax advances, etc., cannot be taken into account. Our new macroeconomic forecast assumes a 6.8% decrease in this year's domestic economy. **This would imply a shortfall in**

public budget revenues of CZK180bn compared to the Ministry of Finance's original CZK32bn budget, with the biggest drop expected in direct taxes.

At the moment, the expenditure side of the state budget is most influenced by the government's discretionary measures and the actual implementation of those measures, which is difficult to estimate. The updated version of the state budget envisages a 7% increase in expenditures compared to the original budget, i.e. +CZK112bn to CZK1,730bn. **Contrary to the Ministry of Finance's forecast, we expect a higher unemployment rate this year. This should lead to an increase in spending on social benefits (by approximately CZK15bn), which accounts for more than one-third of the state budget.** We consider the rest of the expenditures to be adequate given the government's published plans and the risks on both sides. In the case of persistent problems with the use of state programmes, we see the risk of lower state expenditures compared to the current budget. In addition, there is a relatively ambitious volume of investment planned this year, which will be difficult to implement due to the economic recession. Most military contracts (CZK75bn this year) are likely to be completed despite the current crisis, but their completion may take until next year. Related to this is the risk of distortion of GDP statistics, depending on cash payments (see the previous *Economic Outlook*). However, lower state budget expenditures to support the economy this year, in our opinion, would imply lower tax revenues and a higher deficit next year. On the other hand, we also see the risk of higher expenditures in the event of a deeper decline in the domestic economy or greater political will for fiscal stimulus, also due to the political cycle.

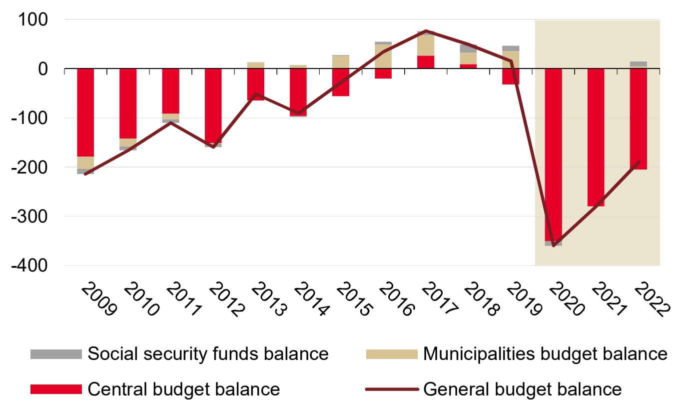
Overall, we expect this year's state budget to end up in a deficit of CZK340bn, i.e. almost CZK150bn more compared to the worst economic result in 2009. In relative terms, this is on a slightly less demanding (by 1.4pp GDP growth) comparison base. The outlines of the state budget for next year are even less certain due to this year's risks. According to previous statements by the Ministry of Finance, however, the deficit is projected to be in line with this year. The whole process of new budget preparations should take a month more compared to the standard legislative procedure. The proposed budget should not be delivered to the Chamber of Deputies until the end of October. **Due to a more optimistic forecast of next year's domestic economic growth, we expect a deficit of CZK270bn.**

State budget in comparison with the previous crisis (CZKbn)



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

Breakdown of general government balance (ESA2010, CZKbn)



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

Total public finances should end the year with a record deficit of 6.7% of GDP

Municipalities should lose CZK60bn this year. However, the reserves created in recent years should keep the economy roughly balanced. Health insurance companies' loss of income will be reimbursed by the state.

We see a significantly more optimistic picture in other sectors of public finance. Although in their case we have data available on their performance for March only, we believe that their previous budgetary responsibility and the reserves created will withstand the current revenue shortfall. **In the first three months, municipalities had a surplus of CZK18bn and a current**

account surplus of CZK200bn. In our opinion, this should cover our tax revenue shortfall estimate of less than CZK60bn this year. For this and next year, we expect a balanced budget. Health insurance companies should be a little worse off. **However, our CZK20bn shortfall estimate for health insurance should be offset by the recent increase in payments for state insured persons.** For this year, we assume an overall deficit of CZK10bn, which is comparable to 2009 but is only half of GDP. Health insurance companies should return to a balanced budget next year.

Public finances should experience the worst deficit in history this year at 6.7% of GDP. Public debt should increase by 7.7pp this year to 38.4% of GDP.

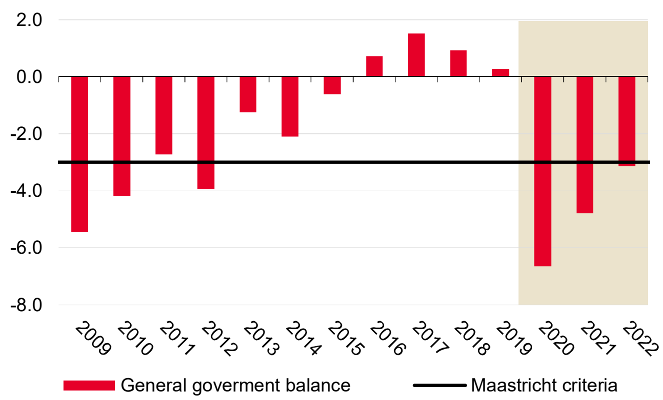
Public finance forecasts

	2019	2020f	2021f	2022f	2023f	2024f
Balance (% GDP)	0.3	-6.7	-4.8	-3.1	-1.3	-0.5
Fiscal effort (pp GDP)	-0.5	-6.5	2.0	1.7	1.8	0.9
Public debt (CZKbn)	1738.7	2078.7	2348.7	2548.7	2648.7	2698.7
Debt ratio (% GDP)	30.7	38.4	40.1	42.0	41.7	40.9

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

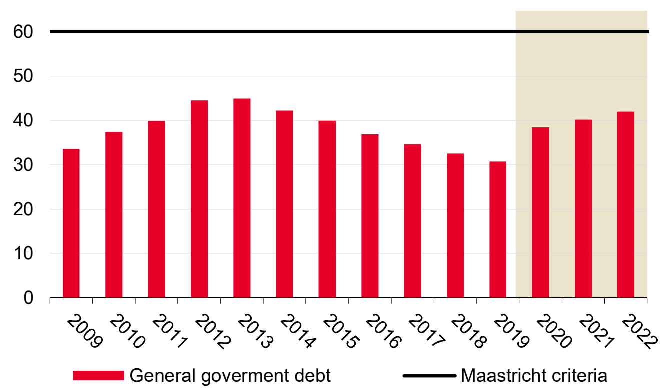
According to the ESA2010 methodology, total public finances should end this year with a deficit of 6.7% of GDP, which would mean 1.3pp worse than the worst year so far (2009). Next year, the deficit should fall to 4.8% of GDP, mainly due to what we expect to be an economic recovery. **Public finance debt should increase significantly this year from last year's 30.7% to 38.4% of GDP.** In the next two years, it should climb to 42% of GDP and then start to decline slightly.

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

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Unemployment rate on the way up

Unemployment will rise, but vacancies provide some cushion

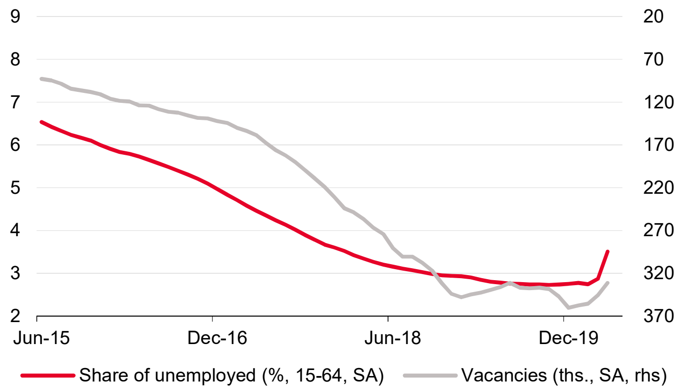
From the inception of restrictions to end-April, the unemployment rate increased by less than a percentage point. We were afraid of a somewhat sharper increase, and part of the explanation might be the relatively low flexibility of the Czech labour market. But there are other reasons. First, as schools closed, many parents stayed home with their children, with 80% of their wages being substituted with state healthcare payments. Large amounts of foreign workers left the market. By Czech law, it usually takes two months minimum for an employer to dismiss employees. Importantly, the government introduced a so-called kurzarbeit scheme in which the state financed 30-80% of wages, aiming to prevent a rapid increase in unemployment. These factors prevented the labour market from worsening quickly. **But the unemployment rate will likely rise, as companies are facing a drop in demand. However, the labour market was extremely tight before the pandemic. Even in**

April, the number of vacancies was more than 330,000. This is a substantial cushion for the labour market.

Unemployment rate rise could be relatively short-lived

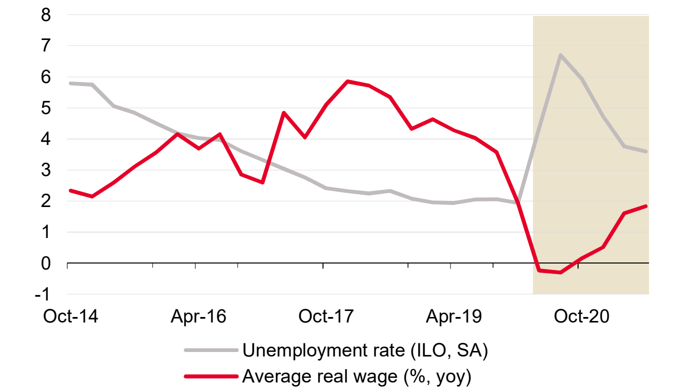
The pandemic shock is unique and could have many unique consequences. The shock to the economy has been very fast and deep, but we think it could be also relatively short. **We expect the unemployment rate to peak this year at 7-8%.** Most of the jobs losses will probably be in the services sector. Given the recovery we expect, there could be a relatively quick improvement next year, with the unemployment rate declining to below 5%.

Unemployment rate to rise, vacancies provide significant buffer



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

Wage growth to decelerate significantly (%)



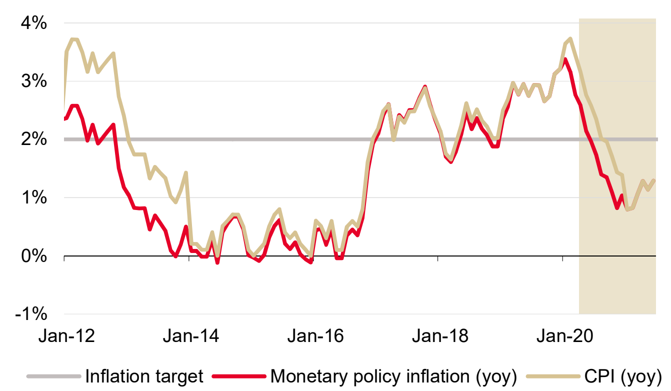
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Public sector wages will be the main driver of wages this year. Private companies will likely cut wage costs and investment. **With inflation expected at 2.4% this year and nominal wage growth at 2.8%, average real wages are close to stagnation.** That, together with the expected rise of unemployment, corresponds with our expectation for household consumption to decline by 3.5% this year. Nevertheless, like GDP growth, household consumption should have bottomed in 2Q20.

Inflation likely to undershoot 2% target

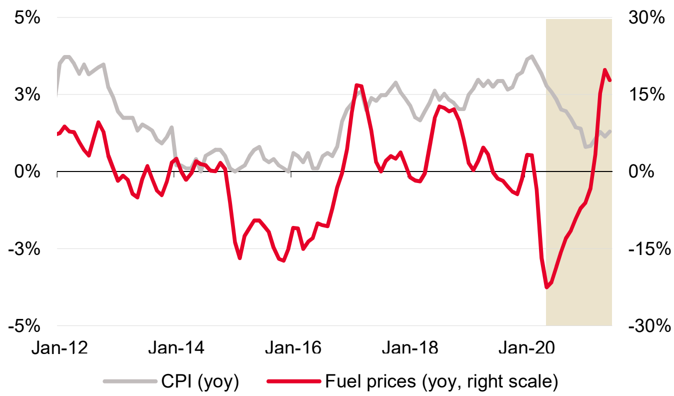
The COVID-19 shock to domestic demand will push consumer prices down, as will low oil prices. A weaker CZK and higher food prices will prevent a deeper decline. After bottoming below 1% yoy in Q1 2021 the inflation will start increasing.

In H2 2020, inflation will likely undershoot CNB target



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

Fuel prices likely to keep inflation low until 2021



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

We expect a gradual oil price rebound

While at the beginning of the year the Czech National Bank was facing inflation significantly overshooting the 2% target, it seems that the situation has turned upside

down. Initially, huge oil price declines brought prices down. Assuming only a gradual oil price rebound toward USD40/bbl this year, oil prices will keep inflation lower until early 2021. **Second, we expect core inflation to decelerate rapidly due to the shock to domestic demand, rising unemployment and decelerating wage growth.**

Weaker CZK, higher food prices and disruption to supply chains will push prices up

On the other hand, prices will see upward pressure due to the much weaker CZK. Excise tax hikes should further increase tobacco and alcohol prices this year. **Moreover, the disruption to global supply chains could bring higher prices.** We perceive this as a significant upward risk to our CPI forecast. Similarly, difficulties with the supply of food, especially fruit and vegetables amid potential difficulties with crop collection, might lead to higher food prices. We believe that food prices will keep inflation up, but we see significant upward risks – for example drought and environmental issues – that could lead to even higher prices. And we fear that the overall negative shock to demand has been so strong that there has not been enough monetary policy easing and that inflation will undershoot the target in the next 12 months. While we expect only small energy price increases in 2021, we think that from 2022 energy prices will contribute more positively to inflation as the economy returns to normal and European green energy plans push energy prices higher.

Even given the expected recovery, we see a negative output gap and inflation below 2% until 2022. As with the GDP estimate, the projections are more uncertain than usual.

Risks: Epidemiology first and foremost

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

- **Second pandemic wave.** Although we think that in this event the lockdown would not have as destructive an impact as in March–April, GDP growth this and next year would be significantly lower (in an alternative scenario we expect a GDP decline by 10% this year and a rise by only 3.5% in 2021). Inflation would stay lower for longer, as would interest rates.
- **Vaccine discovered.** This is a strong upside risk for GDP and inflation. However, we see this risk as smaller compared to the downside risk in the above mentioned second pandemic wave, as the positive shock from the vaccine has tighter limits.
- **Fiscal policy reaction.** The Czech government has promised strong fiscal support, and our forecasts assumes that fiscal policy will play a strong role. However, the implementation of the announced measures has been rather complicated, and their future is unclear. There has been a tendency to shift the burden of financing fiscal expansion to non-government entities such as banks, municipalities and landlords. If this tendency proves strong, the recovery would be slower.
- **Disruption to global supply chains.** The risk of a no-deal Brexit has significantly decreased since the last election in Britain. Nevertheless, a deal has to be negotiated this year, and given how the negotiations have gone so far, Brexit remains on our list of significant risks.
- **Brexit.** Unresolved issue that could have a major negative influence the European trade.
- **Trade wars.** With Donald Trump as the president of US, the risk of renewed foreign trade tension remains and could jeopardise the recovery at any time.

Key economic indicators

	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	2019	2020	2021	2022	2023	2024
GDP and its breakdown														
GDP (real, yoy)	2.0	-2.3	-11.1	-10.9	-3.1	1.9	12.1	11.7	**2.5**	**-6.8**	**7.1**	**2.4**	**3.0**	**2.4**
Household consumption (real, yoy)	3.2	-1.2	-4.2	-4.4	-4.3	0.1	3.3	3.8	**3.0**	**-3.5**	**2.8**	**4.7**	**3.8**	**2.2**
Government consumption (real, yoy)	1.7	2.0	2.5	4.4	10.3	8.5	2.5	1.0	**2.6**	**4.8**	**2.1**	**0.0**	**0.8**	**1.4**
Fixed investments (real, yoy)	4.6	2.7	-4.2	-14.3	-12.0	-7.6	1.3	13.7	**2.7**	**-6.9**	**3.7**	**2.7**	**1.1**	**2.2**
Net exports (contribution to yoy)	-2.4	-2.2	-5.9	-1.0	-0.5	1.5	4.0	0.4	**-0.3**	**-2.4**	**4.3**	**0.5**	**0.0**	**0.2**
Inventories (contribution to yoy)	1.2	-0.6	-5.6	1.5	0.1	0.0	7.6	-1.6	**0.2**	**-1.0**	**0.1**	**-0.4**	**0.1**	**0.0**
Monthly data from the real economy														
Foreign trade (CZK bn) (**)	10	41	38	43	32	54	54	40	**142**	**123**	**153**	**172**	**167**	**170**
Exports (nominal, yoy)	-3.7	-5.1	-33.6	-29.3	-15.1	-7.7	24.7	19.7	**3.8**	**-20.6**	**12.1**	**7.6**	**4.0**	**4.7**
Imports (nominal, yoy)	-3.5	-4.5	-35.0	-33.0	-16.1	-11.4	24.8	23.1	**1.3**	**-22.0**	**11.8**	**8.1**	**4.7**	**5.0**
Industrial production (real, yoy)	-3.3	-3.7	-23.8	-18.1	-10.6	-6.6	21.9	14.6	**2.1**	**-14.0**	**9.8**	**6.7**	**2.6**	**2.8**
Construction output (real, yoy)	2.7	2.9	-11.9	-3.8	-1.9	-9.4	-5.2	5.0	**0.9**	**-3.7**	**-1.3**	**11.9**	**5.5**	**5.3**
Retail sales (real, yoy)	3.9	0.6	-6.2	-10.8	-9.6	-4.4	2.2	7.4	**4.9**	**-6.5**	**3.4**	**7.8**	**5.2**	**2.5**
Labour market														
Wages (nominal, yoy)	6.7	5.6	2.5	1.6	1.5	1.2	2.7	3.4	**7.1**	**2.8**	**3.0**	**7.7**	**6.0**	**3.9**
Wages (real, yoy)	3.6	1.9	-0.2	-0.3	0.2	0.5	1.6	1.8	**4.1**	**0.4**	**1.7**	**5.8**	**3.8**	**1.9**
Unemployment rate (MLSA)	2.9	3.0	5.1	7.6	7.0	5.8	4.5	4.5	**2.8**	**5.7**	**4.7**	**3.9**	**3.7**	**3.7**
Unemployment rate (ILO 15+)	2.0	2.0	4.3	6.8	5.9	4.8	3.7	3.7	**2.0**	**4.7**	**3.7**	**2.7**	**2.5**	**2.5**
Employment (ILO 15+, yoy)	-0.4	-0.6	-2.4	-4.8	-3.9	-2.5	0.5	3.3	**0.2**	**-2.9**	**1.1**	**1.0**	**0.3**	**0.0**
Consumer and producer prices														
CPI Inflation (yoy)	3.0	3.6	2.7	1.9	1.3	0.7	1.1	1.6	**2.8**	**2.4**	**1.3**	**1.8**	**2.1**	**2.0**
Taxes (contribution to yoy inflation)	-0.1	0.1	0.3	0.0	0.0	-0.1	0.0	0.0	**0.0**	**0.4**	**0.0**	**0.0**	**0.0**	**0.0**
Core inflation (yoy) (*)	2.5	2.9	2.4	1.4	0.8	0.3	0.7	1.3	**2.6**	**1.9**	**1.0**	**1.5**	**1.8**	**1.7**
Food prices (yoy) (*)	4.3	6.0	6.4	5.3	4.4	3.0	1.7	1.8	**2.8**	**5.5**	**2.1**	**2.1**	**2.5**	**2.7**
Fuel prices (yoy) (*)	-3.3	1.0	-10.5	-9.5	-7.8	-3.6	6.9	6.5	**-0.4**	**-6.7**	**3.3**	**2.9**	**3.5**	**3.1**
Regulated prices (yoy) (*)	5.3	4.2	3.0	2.6	2.1	0.5	1.0	1.5	**4.5**	**3.0**	**1.3**	**2.6**	**2.3**	**2.0**
Producer prices (yoy)	1.3	1.4	-1.7	-1.7	-0.6	0.2	2.6	2.9	**2.6**	**-0.7**	**1.9**	**1.4**	**3.9**	**2.9**
Financial variables														
2W Repo (%, average)	2.00	2.03	0.10	0.05	0.05	0.05	0.05	0.05	**1.92**	**0.56**	**0.05**	**0.65**	**1.50**	**1.80**
3M PRIBOR (%, average)	2.18	2.15	0.30	0.25	0.25	0.25	0.25	0.25	**2.12**	**0.74**	**0.25**	**0.82**	**1.70**	**2.00**
EUR/CZK (average)	25.6	25.6	27.2	27.0	26.8	26.7	26.6	26.2	**25.7**	**26.7**	**26.3**	**25.4**	**25.0**	**24.9**
USD/CZK (average)	23.1	23.3	24.5	23.9	23.5	23.2	22.8	22.0	**22.9**	**23.8**	**22.3**	**20.5**	**19.4**	**19.0**
External environment														
GDP in EMU (real, yoy)	1.0	-3.3	-17.5	-2.0	-0.5	3.4	21.0	1.5	**1.2**	**-5.8**	**6.5**	**1.1**	**1.7**	**1.7**
GDP in Germany (real, yoy)	0.4	-2.3	-12.0	-4.2	-3.2	-0.4	11.3	2.6	**0.6**	**-5.4**	**3.9**	**1.8**	**1.4**	**1.3**
CPI in EMU (real, yoy)	1.0	1.1	0.0	0.1	0.3	0.5	1.4	1.4	**1.2**	**0.4**	**1.1**	**1.4**	**1.4**	**1.6**
Brent oil price (USD/brl, average)	62.9	54.3	30.0	35.0	40.0	45.0	45.0	45.0	**64.9**	**39.8**	**45.0**	**50.0**	**58.7**	**61.7**
EURIBOR 1Y (%, average)	-0.28	-0.27	-0.29	-0.29	-0.24	-0.20	-0.13	-0.06	**-0.22**	**-0.27**	**-0.10**	**0.18**	**0.80**	**1.70**
EUR/USD (average)	1.11	1.10	1.11	1.13	1.14	1.15	1.17	1.19	**1.12**	**1.12**	**1.18**	**1.24**	**1.30**	**1.30**

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 cut repo rate to technical zero in June

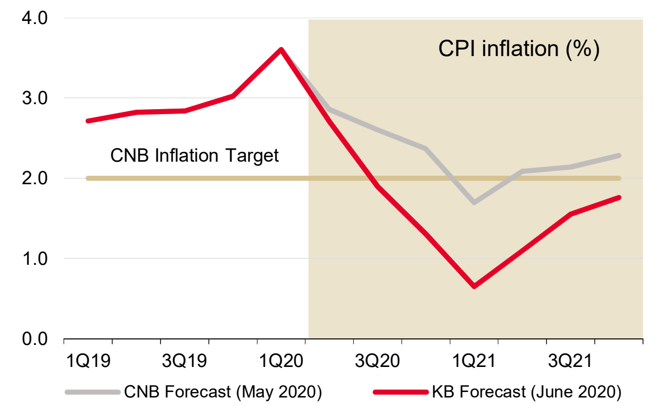
The Czech National Bank is likely to use its remaining policy room and cut the key repo rate to 0.05% at the June meeting. The foreign demand outlook, which now corresponds with the CNB's alternative scenario, will likely be the main reason. We expect the two-week repo rate to remain at technical zero over the next year. A necessary condition for monetary policy normalisation is inflation reaching the CNB's 2% target, but this probably will not happen over the next year due to weak demand. In the event of a long economic downturn, or if the pandemic returns, the CNB would need to use unconventional measures. We see FX intervention as the most likely tool, as the CNB has experience using it.

Foreign demand outlook will be crucial

As a result of COVID-19, the central bank has cut the two-week repo rate by a large 200bp to 0.25%; consequently, the Czech koruna has weakened by 8%.

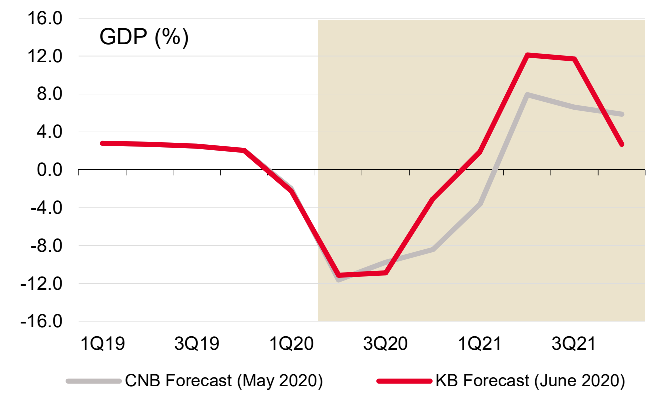
In reaction to the impact of COVID-19 on the Czech economy, the Czech National Bank (CNB) has cut its key repo rate by a total of 200bp since March to 0.25%. Two of the cuts came in the second half of March shortly after the coronavirus became a global issue as the central bank showed willingness to ease monetary conditions to try to ensure the smooth functioning of financial markets and eventual revival of the Czech economy. As a result, the Czech koruna weakened by c.8% to above 27 versus the EUR, and it has remained there. The expected impact of the pandemic grew as the period of government measures was extended, as was the case in other economies. The CNB therefore cut interest rates for a third time in early May. This decision was related to ongoing developments and the CNB's pessimistic outlook on foreign demand – if external economies require more time to recover, domestic inflation could go below the CNB's 2% target.

Inflation is going to slow …



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

… as a result of depressed demand



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

Czech interest rates will likely go to technical zero in June, as external developments proved worse in 1Q than assumed by the CNB forecast.

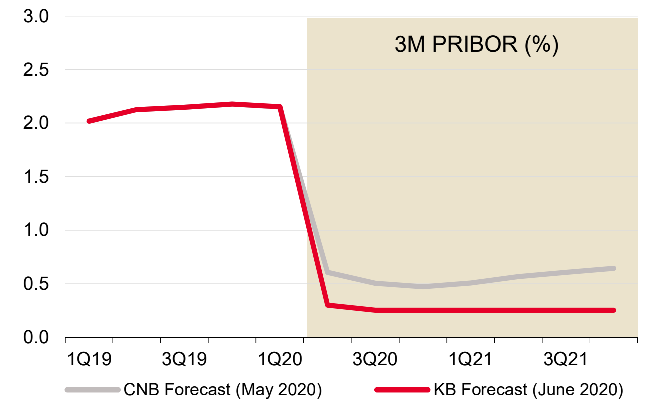
We expect the central bank to use its remaining room for manoeuvre to decrease the two-week repo rate to technical zero (0.05%) at its June meeting. The main reason will be external developments. According to Eurostat advance estimates, the decrease in eurozone economic activity in 1Q was greater than assumed in the last CNB forecast. Moreover, the refined estimates could show an even deeper decline. The current state of foreign demand corresponds with the CNB's alternative scenario, which sees the key repo rate decreasing to technical zero and remaining there through the end of next year. Based on this alternative scenario, weak foreign and domestic demand will be disinflationary and push inflation below the CNB's 2% target in 2021. We also expect below-target inflation in 2021, even under the more optimistic scenario of a Czech economic recovery. We don't know what form the expected economic rebound will take in the second half of this year, but the risks are toward lower growth. The CNB's board is therefore likely to assess its baseline scenario as optimistic at the June meeting. We expect the CNB to cut the key repo rate to technical zero at this meeting, in line with its alternative scenario, and to keep it there through end-2021. If rates are cut to technical zero, we could expect a supplementary statement that rates will not change until inflation reaches the 2% target.

Unconventional monetary policy on the horizon

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

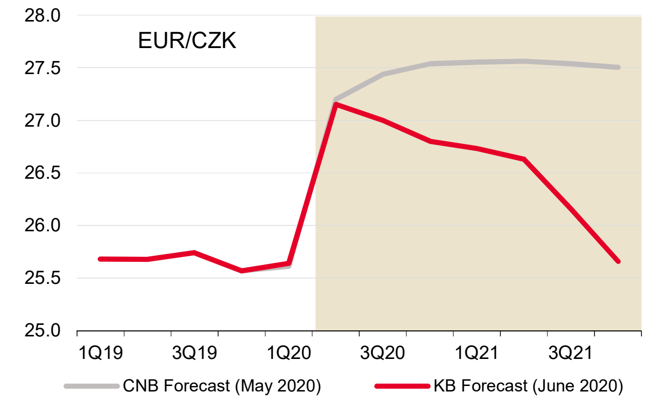
There would then be almost no room for more rate cuts, so any further easing of monetary policy would have to be done via unconventional tools. The need could arise if the impact of the pandemic proved more severe or in the event of a second wave. The CNB estimates the impact of a second wave on the Czech economy in its second alternative scenario. According to this scenario, the return of coronavirus would require monetary policy easing, which could not be realized by conventional tools. Consequently, the CNB would need to use unconventional measures. We see FX intervention as the most likely tool, as the central bank experienced its use in 2013-2017. However, the CNB has been rather quiet about the usage of unconventional measures, and so the parameters of potential FX intervention are unclear. We view other tools of unconventional monetary policy, namely quantitative easing and negative interest rates, as less likely.

We expect low interest rates until end-2021



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

Czech koruna has remained weaker this year



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

Czech FX market

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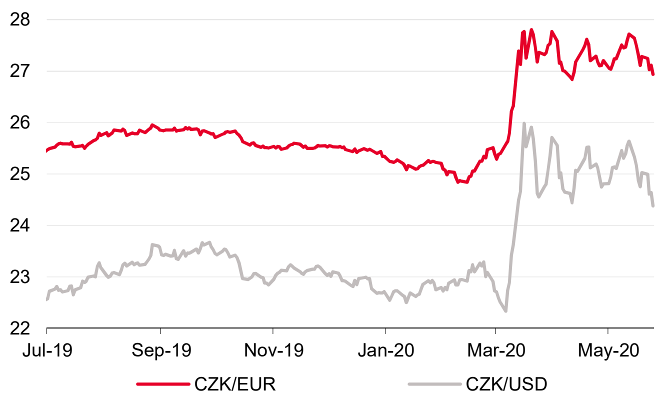
The restart of the economy will return koruna to stronger value

After a record weakening at the end of March, the koruna stabilised in the 27-28 EUR/CZK range, where, in our opinion, it will remain for a few more weeks. The main factors remain low market interest rates, which reduces its attractiveness and the development of the coronavirus pandemic abroad. In the second half of the year, however, we expect the koruna to stabilise and gradually begin to strengthen. However, short-term fluctuations in both directions caused by variable sentiment in global markets cannot be ruled out. The second wave of the pandemic, which would disrupt the recovery of the domestic economy and the CNB's entry into the foreign exchange market, remains a risk to our forecast. We continue to recommend use short-term fluctuations in the koruna to weaker values to hedge FX risk.

The stabilisation of global financial markets has brought peace to the koruna

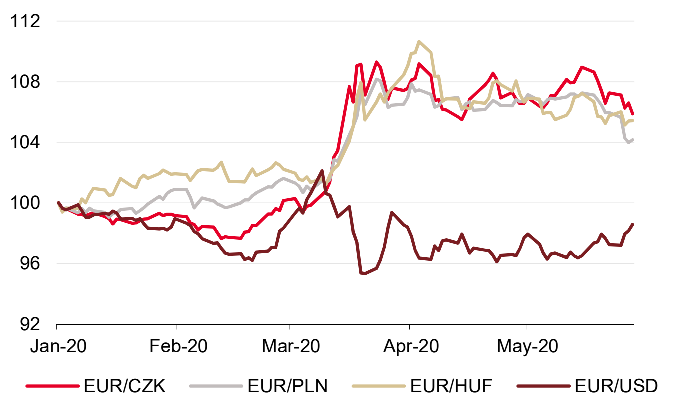
The koruna has been moving in the range of 27-28 per euro since the end of March, when it jumped sharply. In our opinion, this is where it will remain for a few more weeks. The financial markets were calmed by an unprecedented wave of economic policy easing across continents, which absorbed the initial shock of the COVID-19 pandemic and allowed markets to stabilise. Gradual calming is also evident in the domestic market (see weekly data on the movement of ETFs with koruna assets). However, it can be assumed that in the coming weeks we will still see several waves of repeated weakening of the koruna as information comes from abroad about the real effects of the pandemic on the economy. Developments abroad is currently the main factor influencing the koruna's exchange rate.

Development of the koruna exchange rate over the past 12 months



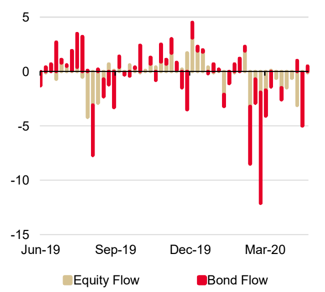
Source: Bloomberg, Economic and Strategic Research, Komerční banka

Performance of Central European currencies (1.1.2020 = 100)



Source: Bloomberg, Economic and Strategic Research, Komerční banka

ETF flows with CZK assets (USDbn)



Source: Bloomberg, Economic and Strategic Research, Komerční banka

However, **by the end of the first half of the year, we expect the koruna to stabilise at the 27 EUR/CZK** level as financial markets see the light at the end of the tunnel and begin to expect an economic recovery and rising interest rates. Until then, it will be the record low interest rate differential against euro rates that will prevent the koruna from strengthening. A further reduction in the CNB's interest rates and the threat of using unconventional instruments will not allow it to remain at stronger levels for most of the rest of this year. However, short-term fluctuations in both directions caused by variable sentiment in global markets cannot be ruled out.

Koruna exchange rate forecast (end of period)

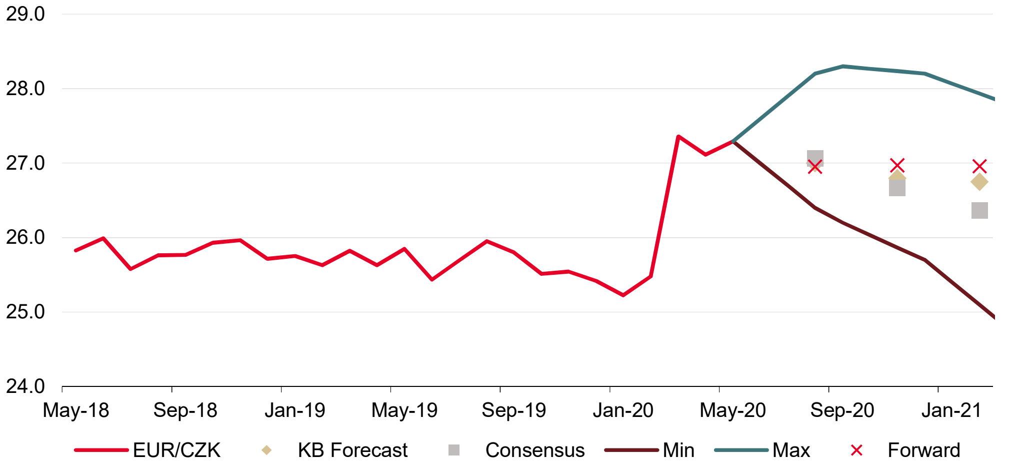
	Q2 20f	Q3 20f	Q4 20f	Q1 21f	Q2 21f
EUR/CZK	27.0	27.0	26.8	26.7	26.6
USD/CZK	24.8	24.8	24.4	23.8	23.3
EUR/CZK	1.09	1.09	1.10	1.12	1.14

Source: Economic and Strategic Research, Komerční banka

The main risk for the koruna is a protracted recession and CNB intervention

A significant risk to our forecast is the CNB's possible entry into the FX market. The Board has repeatedly declared its readiness to intervene against "excessive movements of the koruna" and thus prevent it from further weakening. We still consider the key level to be 28 per euro. However, we assume that the koruna would have to be above this level for a longer period of time or show a tendency to further weaken in order for the central bank to need to start intervening. Although the CNB has recent experience with the FX floor, the current composition of the Board has a more restrained approach to this instrument.

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



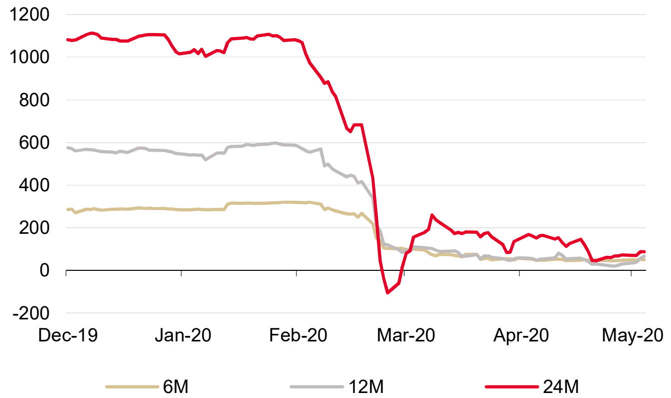
Source: Bloomberg, Economic and Strategic Research, Komerční banka

In the longer term, however, the CNB may, paradoxically, find itself in the opposite situation, considering interventions in favour of a weaker koruna. Our expected interest rates cut to a technical zero will intensify the current discussion within the Board on how to further loosen monetary conditions if necessary. As already mentioned in the *CNB Focus* chapter, we consider the FX commitment to be the most probable variant of the central bank's menu of unconventional instruments. The pessimistic scenario would repeat the story of 2013, when the CNB sought to support economic growth by artificially weakening the koruna, preventing the risk of deflation and returning inflation to the 2% target through higher import prices. Such a scenario may occur if a second wave of the pandemic hits and the economic recovery we expect does not materialise. On the contrary, in the optimistic scenario, which we give a significantly lower probability to, a rapid economic recovery could be accompanied by a too rapid strengthening of the koruna, which would tighten domestic monetary conditions and reduce export price competitiveness more than the CNB would be willing to tolerate.

Window of opportunity to hedge the weak CZK level is closing

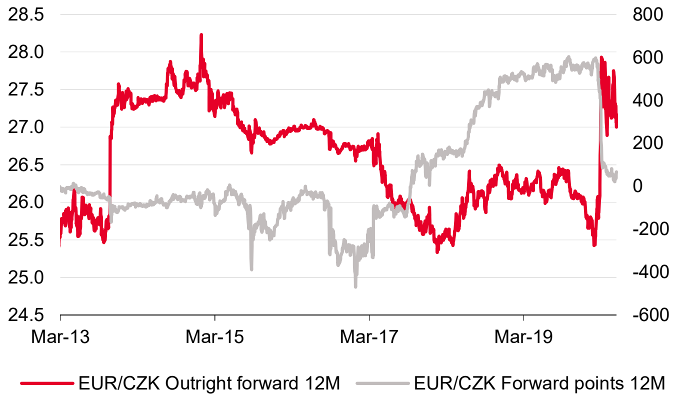
We do not consider the current shifts of the koruna to stronger values to be sustainable, but in the longer term we expect the koruna to start strengthening. Although forward points have fallen sharply with the collapse of interest rates, the level of the koruna still offers interesting hedging options against its future strengthening. Therefore, **we continue to recommend using the koruna's returns to weaker values in order to hedge FX risk.** In addition, current market conditions have opened up advantageous options for more comprehensive hedging solutions, such as some cost-free option strategies. The shift in the reversal risk (the difference between implied volatility between a call and put option with the same exercise price) together with increased volatility creates an opportunity for advantageous hedging against the koruna's strengthening and at the same time brings the opportunity to benefit from its possible weakening.

Forward points follow a collapse in interest rates



Source: Bloomberg, Economic and Strategic Research, Komerční banka

The weaker level still offers interesting hedging options



Source: Bloomberg, Economic and Strategic Research, Komerční banka

Czech government bonds and the IRS market

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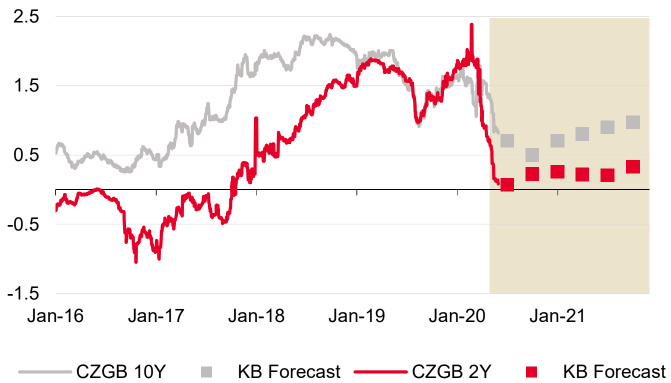
High demand will keep government bond yields low

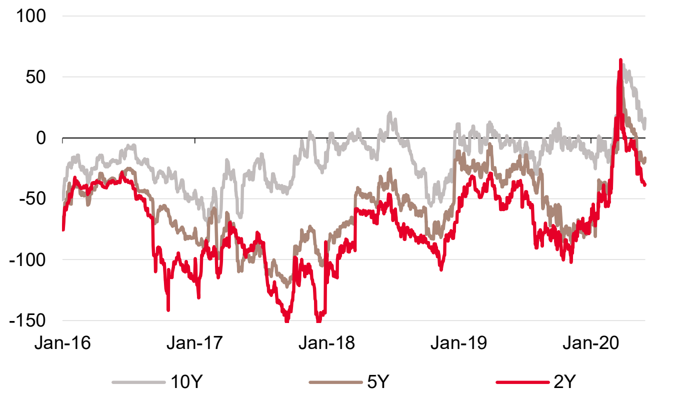
The prospect of a record state budget deficit forced the Ministry of Finance to issue more government bonds in two months than it did all of last year. However, high supply is being met with external demand in the market. For next year, we expect the borrowing needs of the state to increase even more. Although demand may no longer be as strong, we assume that the market will easily absorb such supply. High demand will thus continue to push government bond yields down. Especially at the longer end of the curve, we still see room for decline. Right now, financial markets slightly underestimate the chances of the CNB cutting interest rates to zero. This should lead to a slight decline in rates at the short end of the curve. In general, however, we consider current rate levels to be a cyclical bottom, which we recommend using to hedge interest rate risk.

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

ASW spreads (bp)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

The borrowing needs of the state will break this year's records next year

The Ministry of Finance has issued more government bonds in the last two months than in the record year of 2018 so far. However, next year the government's borrowing needs will increase.

In view of the growing planned state budget deficit, the Ministry of Finance had to issue a record amount of government bonds in a short time. **In April and May alone, it issued government bonds in the amount of CZK300bn, thus breaking the record year of 2018 (CZK250bn).** Together with treasury bills and operations on the secondary market, the Ministry of Finance thus secured 92% of CZK550.3bn of borrowing needs to cover the assumed state budget deficit of CZK340bn, repayments of previously issued bonds, and other government liabilities. The ministry has already done most of the work.

On the other hand, we still perceive a high risk of significantly higher borrowing needs this year. (1) In our opinion, the Ministry will want to take advantage of favourable conditions on the financial markets and pre-finance some instalments of government bonds maturing at the beginning of next year. (2) In addition, the actual deficit of this year's state budget may be significantly higher than what the government currently expects, which should be revealed by the interim results of the budget in the coming months (more in the *Fiscal Policy* chapter). In addition, thanks to the rich calendar of maturing government bonds and the high state budget deficit, borrowing needs will exceed this year's by approximately CZK100bn.

However, we assume that demand for CZGBs will continue next year. The domestic financial market continues to overflow with liquidity, and the CNB's readiness to buy government bonds in the event of problems will also support demand from abroad. However, we perceive the risk that demand in primary auctions and in the secondary market may no longer be as high as this year.

In recent weeks, CZGBs yields have fallen sharply under the pressure of high demand. The short end of the curve approached the zero limit and, in our opinion, hit its bottom. With less attractive shorter maturities, investor interest has shifted to the longer end, where we still see room for declining yields. At these levels, the entire curve will be maintained for at least the rest of this year, and only next year will the longer end of the curve be taken for gradual growth.

CZGB yield forecast

	1Q20f	2Q20f	3Q20f	4Q20f	1Q21f
2y CZGB yield (%)	0.05	0.20	0.25	0.20	0.20
5y CZGB yield (%)	0.45	0.40	0.50	0.60	0.60
10y CZGB yield (%)	0.70	0.50	0.70	0.80	0.90
10y CZGB ASW (bp)	-0.05	-0.25	-0.10	-0.25	-0.20

Source: Economic & Strategy Research, Komerční banka

Sovereign rating: deterioration of public finances as a risk to the future

Several regional peers have received a worse rating in the last two months, or at least their outlook has deteriorated. In the case of the Czech Republic, we have so far only seen confirmation of the current status from two of the three major agencies. **We do not expect a downgrade in the near future, but there is a risk of a negative outlook.** The Ministry of Finance expects a significant and, above all, long-term deterioration in the structural deficit of public finances, which, in our opinion, may lead to a stricter view of rating agencies. The recent relaxation of budgetary responsibility has not contributed to the situation either. At the same time, the good state of domestic public finances was the main reason for such a high rating compared to other peers in the region. We see the greatest risk of a change in the outlook at Moody's.

Sovereign ratings overview

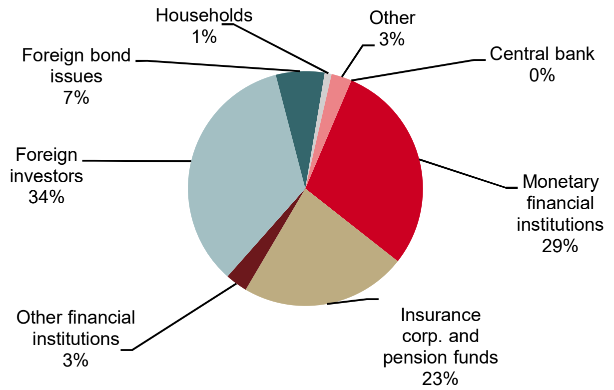
	Local Currency	Outlook	Foreign Currency	Outlook	Next Rating Review
S&P	AA	STABLE	AA-	STABLE	30.10.2020
Moody's	Aa3	STABLE	Aa3	STABLE	07.08.2020
Fitch	AA-	STABLE	AA-	STABLE	24.07.2020

Source: Bloomberg, Economic & Strategy Research, Komerční banka

Structure of CZGB holders: the share of foreign holders decreased

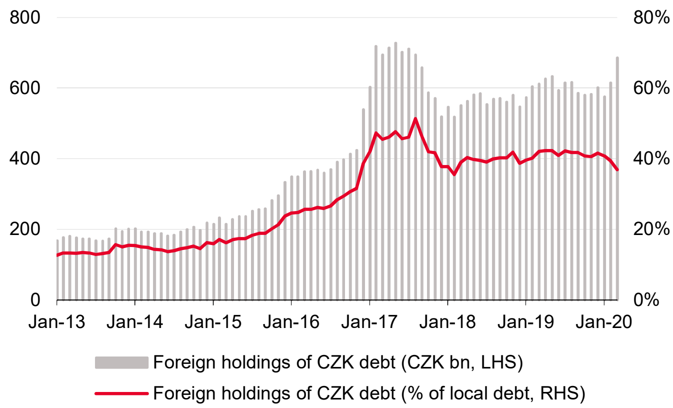
The share of non-residents holders of CZGBs fell to 36.9% in April from 39.4% in March. In relative terms, this is the lowest value since March 2018. In nominal terms, however, their holdings increased by approximately CZK70bn. However, in the flood of newly issued government bonds, domestic entities demanded more, increasing their holdings by almost CZK230bn in April. This trend probably continued in May. In the coming months, however, the issuance activity of the Ministry of Finance will decline, which should stabilize the structure of CZGBs holders, unless there is further turbulence in the financial markets.

Holdings of CZK government debt (April 2020)



Source: MinFin, Economic & Strategy Research, Komerční banka

Share of non-resident bondholders decreased to 36.9%



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech IRS market: rates hit their bottom

In our opinion, the financial market slightly underestimates the possibility of a CNB rate cut, which should slightly deepen their lows at the short end of the curve. In the second half of the year, however, we will see them grow.

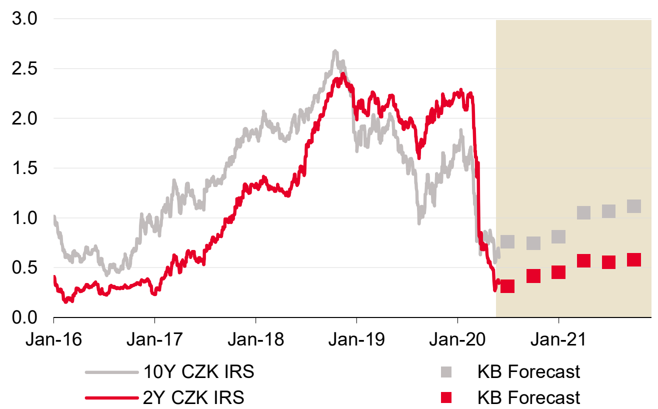
At this point we think financial markets slightly underestimate the probability of the CNB cutting rates to zero. The actual cut at the end of June should thus slightly shift the short end of the curve downwards. However, the Board strongly rejects the possibility of negative interest rates, which is also perceived by financial markets in their prices. In our view, IRS are currently at their lowest level or only slightly above. In the second half of the year, we expect that along with the economic recovery, financial markets will also begin to perceive the possibility of policy rates returning to normal levels, which will cause IRS to rise along their entire curve. At the longer end, an increase in euro and dollar rates will also contribute to this. However, we expect a more significant increase in the slope of the curve at the turn of the year.

CZK IRS outlook

	1Q20f	2Q20f	3Q20f	4Q20f	1Q21f
2y	0.30	0.40	0.45	0.55	0.55
5y	0.60	0.60	0.65	0.85	0.85
10y	0.75	0.75	0.80	1.05	1.05

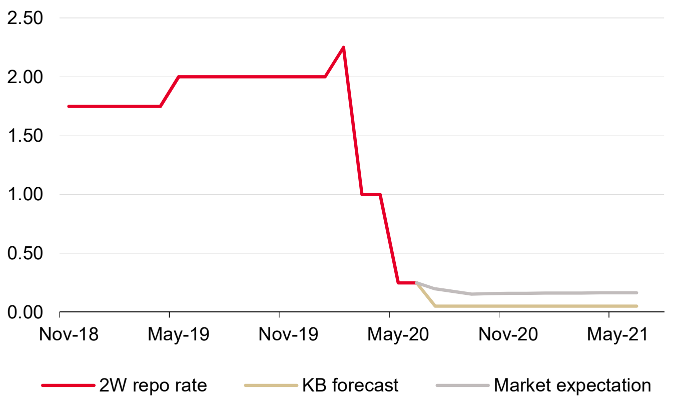
Source: Economic & Strategy Research, Komerční banka

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Financial markets slightly underestimate the probability of the CNB cutting rates to zero (%)

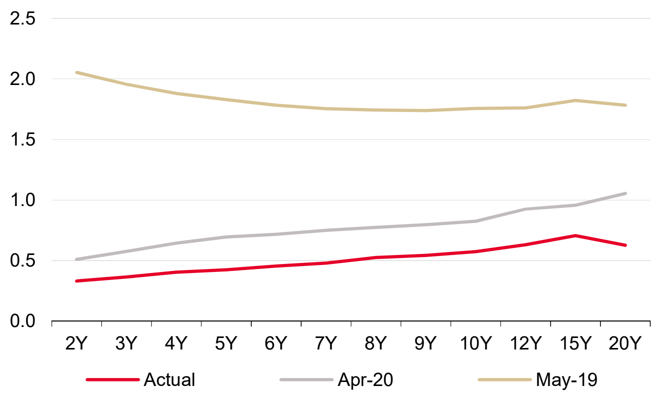


Source: Bloomberg, Economic and Strategy Research, Komerční banka

Record low rates offer attractive hedging options

We consider the current levels of IRS to be a cyclical bottom, which we recommend using to hedge interest rate risk. Although we do not expect the CNB to begin raising interest rates until 2022, the financial markets will start pricing in this option this year, which will lift the entire IRS curve. We see similar opportunities abroad. Throughout its length, the euro curve has turned negative and dollar rates have fallen to historically low levels. In both cases, however, we expect them to gradually increase in the second half of the year.

The slope of the IRS curve still offers favourable hedging



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	0.27	0.32	0.33	0.37	0.44	0.57
3M	0.23	0.27	0.30	0.32	0.36	0.44	0.58
6M	0.24	0.30	0.32	0.35	0.39	0.45	0.60
9M	0.30	0.33	0.35	0.37	0.41	0.46	0.62
1Y	0.36	0.36	0.39	0.40	0.43	0.48	0.64
18M	0.36	0.40	0.41	0.43	0.47	0.51	0.67
2Y	0.44	0.44	0.45	0.46	0.51	0.55	0.70
3Y	0.48	0.48	0.52	0.54	0.53	0.60	0.75

Source: Bloomberg, Economic & Strategy Research, Komerční banka¨, as of 29. 5. 2020

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2017	2018	2019	2020	2021	2022	2023	2024
GDP	real, %	4.5	2.8	2.5	-6.8	7.1	2.4	3.0	2.4
Inflation	average, %	2.5	2.1	2.8	2.4	1.3	1.8	2.1	2.0
Current account	% of GDP	1.7	0.4	-0.4	-1.6	1.4	0.6	0.0	-0.1
3M PRIBOR	average, %	0.4	1.3	2.1	0.7	0.3	0.8	1.7	2.0
EUR/CZK	average	26.3	25.6	25.7	26.6	26.3	25.4	25.0	24.9
USD/CZK	average	23.4	21.7	22.9	23.8	22.3	20.5	19.4	19.0

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

FX & interest-rate outlook

		29-May-2020	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
EUR/CZK	end of period	27.0	27.0	27.0	26.8	26.7	26.6
USD/EUR	end of period	1.11	1.09	1.09	1.10	1.12	1.14
CZK/USD	end of period	24.2	24.8	24.8	24.4	23.8	23.3
3M PRIBOR	end of period	0.34	0.15	0.15	0.15	0.15	0.15
10Y IRS	end of period	0.61	0.75	0.75	0.80	1.05	1.05

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

Monthly macroeconomic data

		IX-19	X-19	XI-19	XII-19	I-20	II-20	III-20	IV-20	V-20
Inflation (CPI)	%, mom	2.7	2.7	3.1	3.2	3.6	3.7	3.4	3.2	n.a.
Inflation (CPI)	%, yoy	-0.6	0.5	0.3	0.2	1.5	0.3	-0.1	-0.2	n.a.
Producer prices (PPI)	%, mom	1.9	0.9	0.9	2.1	2.4	1.4	0.4	-0.8	n.a.
Producer prices (PPI)	%, yoy	0.1	-0.3	-0.1	0.1	1.3	-0.7	-0.5	-0.5	n.a.
Unemployment rate	% (MLSA)	2.7	2.6	2.6	2.9	3.1	3.0	3.0	3.4	n.a.
Industrial sales	%, yoy, c.p.	4.5	-2.9	-5.5	-0.9	-1.2	-0.9	-10.8	n.a.	n.a.
Industrial production	%, yoy, c.p.	5.7	-2.9	-6.5	-0.7	0.5	0.5	-9.4	n.a.	n.a.
Construction output	%, yoy, c.p.	-0.3	-0.3	4.5	4.5	6.0	5.3	-2.3	n.a.	n.a.
Retail sales	%, yoy, c.p.	8.6	2.6	3.0	4.4	1.8	3.5	-15.5	n.a.	n.a.
External trade	CZK bn (national met.)	20.7	7.1	12.0	-9.5	16.7	20.8	3.1	n.a.	n.a.
Current account	CZK bn	-9.4	-9.0	-3.5	-10.6	18.5	29.9	-0.5	n.a.	n.a.
Financial account	CZK bn	28.1	3.5	-17.5	12.2	12.8	45.1	46.4	n.a.	n.a.
M2 growth	%, yoy	7.9	8.1	7.6	7.1	8.0	7.9	9.9	9.3	n.a.
State budget	CZK bn (YTD cum.)	-21.0	-19.6	-38.6	-28.5	-8.0	-27.4	-44.7	-93.8	n.a.
PRIBOR 3M	%, average	2.14	2.17	2.18	2.18	2.17	2.34	1.95	0.96	n.a.
EUR/CZK	average	25.9	25.7	25.5	25.5	25.2	25.1	26.6	27.3	27.3
USD/CZK	average	23.5	23.2	23.1	22.9	22.7	23.0	24.1	25.1	25.0

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

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