Quarterly report

Czech Economic Outlook

Making progress…but at a snail's pace

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- **Slow economic recovery** After last year's stagnation, we expect GDP growth of just 0.7% this year and an acceleration to 1.9% next year. This is a worse outlook than our previous forecast, but we still expect stronger household consumption to contribute to the economic recovery, supported by continued real wage growth. We see industrial activity remaining weak this year.

- **Inflation to fall below target by 2025** We estimate that inflation will average 2.3% this year and decline to 1.7% next year. We expect it to be pushed below the 2% target mainly by lower growth in core and regulated prices, reflecting an excessively tight monetary policy, still-weak demand and falling energy prices.

- **CNB to cut interest rates further** While central bankers have pointed to a slowdown in the pace of rate cuts, recent data support further significant monetary easing. We expect the key repo rate to end the year at 3.75% and to reach its terminal level of 3.5% in February next year.

- **The decline in market interest rates may be over** A resumption in the positive slope of the koruna curve next year may be supported by a rise in longer-term foreign interest rates, reflecting concerns about the deteriorating fiscal situation in the major economies.

- **Better times ahead for the koruna** The koruna should be supported by the CNB's only gradual easing of monetary policy and improving domestic economic fundamentals, as well as by the unwinding of long dollar positions in connection with the start of the Fed's rate-cutting cycle.

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Revisions change the story, but how much?

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In the last four years, the Czech economy has had to cope with several major shocks that were not primarily economic in origin but that did have fundamental macroeconomic consequences. First, came the pandemic in 2020, and then Russia's invasion of Ukraine in late February 2022, which, among other things, fuelled the energy crisis. The deterioration in the geopolitical situation was a major contributor to the global production and supply chain paralysis, now, **2024 looks set to be the first relatively normal year. Nevertheless, the work on our new macroeconomic forecast is not much easier, as considerable uncertainty remains in a number of areas.** We address the most significant areas in the Special Boxes of this summer's edition of Komerční banka's *Czech Economic Outlook*.

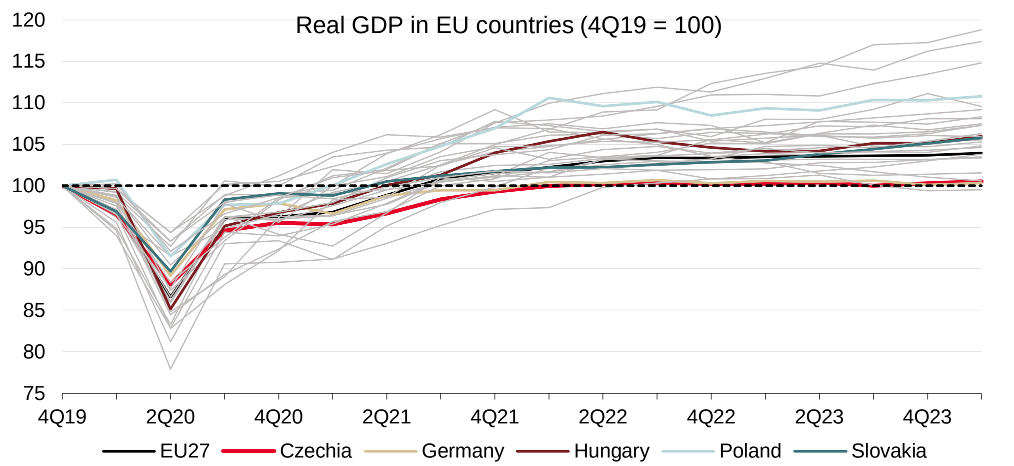
National accounts data revised by the CZSO adjusts the history of the Czech economy's development to date.

Shortly before the summer holidays, the Czech Statistical Office (CZSO) released revisions to the data in the national accounts. It published extraordinary adjustments to the 1990 to 2020 data and a definitive data set for 2021 and 2022 and including preliminary data for 2023. The CZSO's extraordinary review of the data for the past three decades has led to only negligible changes in qualitative terms. However, the adjustments to the initial years of the current third decade have resulted in a more accurate economic history for those years, by helping to eliminate some trends that were hard to explain, and generally improving the coherence of the various indicators. **In quantitative terms, the extent of the revisions was not unusual in any way, but in qualitative terms the story has changed – but to what extent?**

Pre-pandemic production levels was restored more than two years ago.

The Czech economy had already returned to pre-pandemic production levels in the first months of 2022. In our previous editions of the *Czech Economic Outlook,* we had wondered why the country had not exceeded that level, ranking last in the EU. But the country has been above that milestone for more than two years. The revised data suggests that in the end, it did not experience the technical recession in the second half of 2022 due to soaring energy commodities. Most of the upward revision in GDP concerned household consumption, which is still the main reason for the Czech economy's weak growth. However, although household spending slumped last year almost hitting the pandemic lows, this weakness is now much less pronounced. This is also partly related to the change in the status of many Ukrainian refugees, who are now classified as 'Czech residents'.

Czech GDP has been at pre-pandemic levels since 2022 but unable to rebound from it



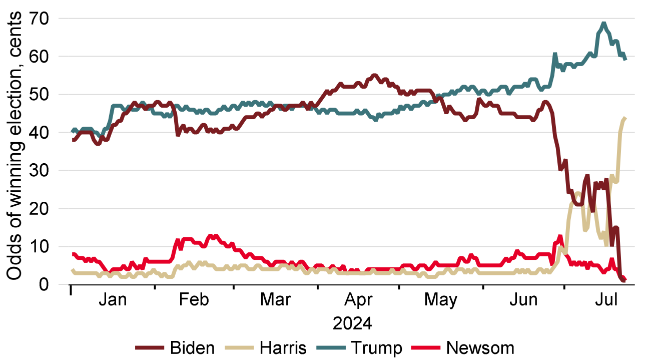
Source: Eurostat, Economic and Strategy Research, Komerční banka

However, the economy has been contending with anaemic growth for the last two years, while the current growth momentum is weakening.

However, the current growth momentum is not very encouraging. Yes, the pre-pandemic level was reached at the beginning of 2022. But as KB's economist Martin Gürtler mentions in *Box 2*, this was due to the downward revision of the end of 2019, which is our comparison base, rather than thanks to stronger growth dynamics in 2020 and 2021. However, achieving the pre-pandemic level of real production basically now appears to be the ceiling; the reason being that the Czech economy has been unable to rebound from that level for more than two years now. The revised data for the last quarter indicate a loss of growth momentum, as qoq growth, seasonally and workday number adjusted, has slowed (from +0.3% in 4Q23 to +0.2% in 1Q24; and for 2Q24 our estimate is +0.1%). No wonder, given the continuing industrial crisis in Germany.

There is a risk that the presidential elections in the US may have an adverse impact on emerging economies and their currencies.

According to PredictIt[1] Trump is headed towards victory (%)



Source: PredictIt, Macrobond, Economic and Strategy Research , Komerční banka
Note: PredictIt also took into account that Joe Biden would give up the race in the end and be replaced with current Vice-President Kamala Harris or California Governor Gavin Newsom

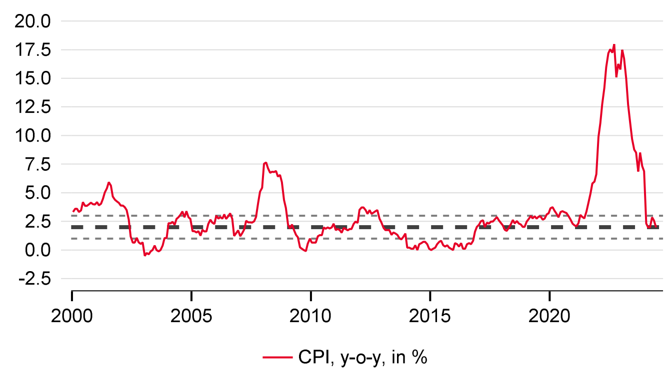
The geopolitical backdrop is a major source of uncertainty at the global level. We saw how the traditionally rather less important elections to the European Parliament drastically impacted the French political scene. And we are apparently in for a hot autumn. First, the new European Commission will convene, and secondly, the US presidential elections will take place. From the perspective of the incumbent, Joe Biden, the first disappointing debate with the former president Donald Trump, triggered speculation on whether he will be able to continue to run for the White House. In the end, it turned out that he would not. Donald Trump is the favourite, according to both polls and financial markets. In *Box 1*, KB economist, Jana Steckerová, summarises the economic impact of either candidate's victory. She notes that a Trump victory could put pressure on public finances and result in relatively higher inflation and thus higher interest rates too. Trump would probably pick up where he left off in his first-term efforts to repatriate manufacturing to the US, although it is more expensive there.

Food prices are volatile, core inflation is under control.

Inflation in the Czech Republic is at its 2% target. It was there at the end of 1Q24 and following its increase to 2.9% yoy in April, it returned to its target in June. The main culprit of the temporarily spike in inflation was food prices, which have been particularly volatile and difficult to forecast of late, together with higher motor fuel prices than in 2Q23. KB economist, Kevin Tran Nguyen, focuses on this issue in *Box 3*, primarily through the lens of prices across the food production chain. He concludes that before the end of 2024, we should see disinflationary or even deflationary food-price trends. However, risks of foodstuff becoming more expensive are accumulating for 2025.

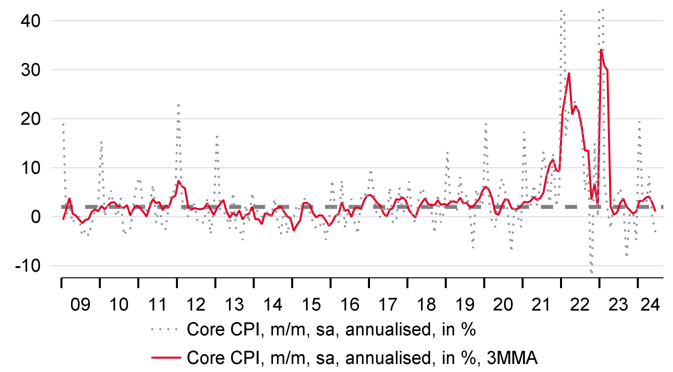
[1] PredictIt is a New Zealand-based online prediction market that offers instruments tied to political and financial events. PredictIt is owned and operated by Victoria University of Wellington with support from Aristotle, Inc. PredictIt uses a continuous double auction to sell shares for each event in its market, meaning that for every person who predicts that an event will take place, there must be another person who predicts that it will not.

Czech inflation at its target



Source: CSO, CNB, Macrobond, Economic and Strategy Research, Komerční banka

Current core inflation dynamics also at its target



Source: CSO, CNB, Macrobond, Economic and Strategy Research, Komerční banka
Note: Month-on-month annualised change, seasonally adjusted (Census X-13), 3M moving average

The key feature of the current inflation constellation in this country is that **the development of core inflation is basically consistent with the 2% target**. Prices in services, which have long been resilient, also appear to have peaked. And since our forecast also shows that average inflation will even be slightly lower than the target for next year, the CNB can continue to cut its rates. In view of the hitherto cautious rhetoric and communication indicating a return to the standard 25bp changes in monetary-policy rates, we expect that this will be the pace at which rates will gradually approach the neutral level at each subsequent CNB monetary policy meeting, which we see at 3.50% and which we expect to be achieved in 1Q25.

Despite the still only anaemic growth in the economy as a whole, the labour market is likely to stay tight. In addition, following the revision of the national accounts data, it seems that real wages have plunged further than productivity. Therefore real wages have some room to grow in the coming quarters without generating inflation pressures. We expect wage growth to be the main driver of household consumption as the key factor of this year's growth in the Czech economy. We believe that the Czech election cycle will be positively reflected in public sector wage growth as early as this autumn. However, from the perspective of long-term or potential growth and keeping the economy competitive, we believe investment activity must be increased. The easing of monetary restrictions and the return of interest rates to a neutral level in the initial months of 2025 would help in this respect.

We wish you a beautiful summer, starting with Komerční banka's *Czech Economic Outlook*!

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External environment and assumptions

Inflation on the wane on both sides of the Atlantic

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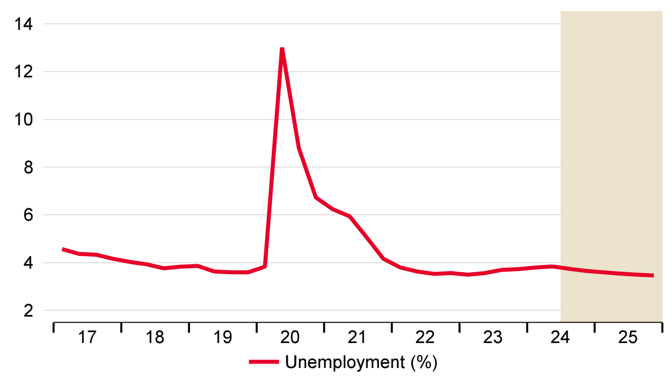
Inflation is slowing in the US and euro area. Thus, in the euro area, we are reasonably certain that we will see a further easing of monetary conditions in September. In the US, because of the June inflation surprise, we have brought forward our expectation for a first rate cut to September here, as well. Furthermore, rates should be cut by a quarter percentage point every quarter until they reach a neutral level, which we see at 3.25-3.50%. In contrast, in the euro area, monetary policy developments may not be as straightforward after the expected September rate cut. Given relatively robust wage growth and high core inflation, the ECB may opt to take a pass on cutting interest rates in December. However, our baseline scenario so far sees a quarter-percentage point cut every quarter, down to 2.5% in the case of the deposit rate, which we consider to be its neutral level. Household consumption should remain the main driver of economic growth in both the US and the euro area. We do not expect a recession in either case.

US inflation slows, bringing Fed rate cut closer

June inflation surprised to the downside, boosting bets of a Fed rate cut.

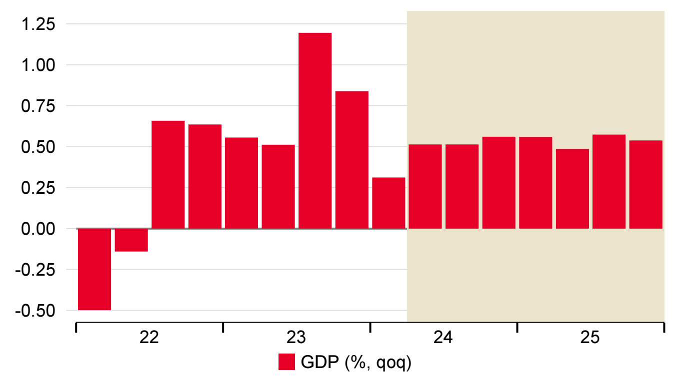
Price pressures in the US are gradually starting to ease. Inflation in June had surprised with a lower-than-expected level of 3.0%. Core prices rose 0.1% mom (SA), the slowest pace since 2021. On an annual basis, core inflation fell to 3.3% from 3.4% in May, the lowest in three years. At the same time, price growth of rents, which makes up a third of the US consumer basket and is key to the sustainable achievement of the inflation target, is starting to slow (+0.2% mom in June). For these reasons, we have brought forward the first interest rate cut of 25bp from March next year to September this year. After the Fed's first rate cut, our forecast is that it should continue to cut every quarter (-25bp) until the key interest rate reaches its neutral level. We now estimate this at 3.25-3.50%. At the same time, we think the market expectation for an 70bp rate cut by January are overdone. Data from the real economy have surprised to the upside recently, with inflation risks skewed in the same direction, in our view.

The US labour market remains tight



Source: Macrobond, SG Cross Asset Research/Economics

No recession in the US economy



Source: Macrobond, SG Cross Asset Research/Economics

The US economy is still in relatively good shape.

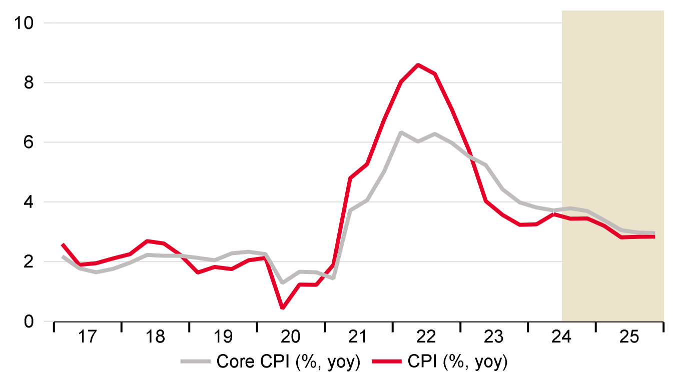
The tight labour market and firms' reluctance to lay off workers is a good sign that the US economy is still in good shape. Job creation numbers have surprised on the upside since the beginning of the year (except for April). The Nonfarm Payrolls have consistently exceeded 150,000 (excluding April), which is a level below which job creation would have to slow for the labor market to begin to ease, in our view. Large sectors such as health care, education, and government are still hiring. Rising labour costs are already eating into corporate profit margins, but these remain high and do not signal the onset of a recession.

Households are benefiting from low unemployment and high asset returns. Retail sales surprised with a strong growth in June (+0.9% m/m in the control group, which is important for the GDP calculation), while industrial production also posted a strong result. Thus, for this year as a whole, we expect the US economy to grow by 2.5%, as it did last year, with GDP growth expected to reach 2.2% next year.

China will also benefit from the improved US performance.

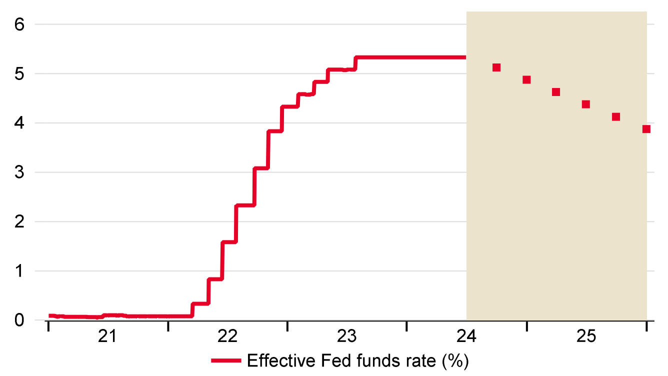
The Chinese economy should also benefit from a strong US economy through higher goods exports. The former should achieve its 5% growth target this year, although the risks are concentrated in the direction of lower dynamics in light of the latest data. In addition to exports, increased Chinese government investment in infrastructure should also contribute to growth. However, a more balanced growth scenario would require the stabilisation of the property market. This is still being negatively affected by the lack of confidence in local developers and their ability to complete projects. We expect the property market, which accounts for around a fifth of the Chinese economy, to continue to decline in the second half of this year. We do not expect it to stabilise until the turn of the year. The decision by local governments to buy up unsold properties and convert them into social housing should contribute to this. Property purchases are not helped by weak wage growth, which is the result of efforts to deleverage the public sector. Thus, without further support measures, household consumption is likely to remain subdued. Overall, our estimate is for Chinese GDP growth of 5% this year and 4.5% next year.

Inflationary pressures in the US economy are easing



Source: Macrobond, SG Cross Asset Research/Economics

Fed rates are set to go down in September for the first time (%)



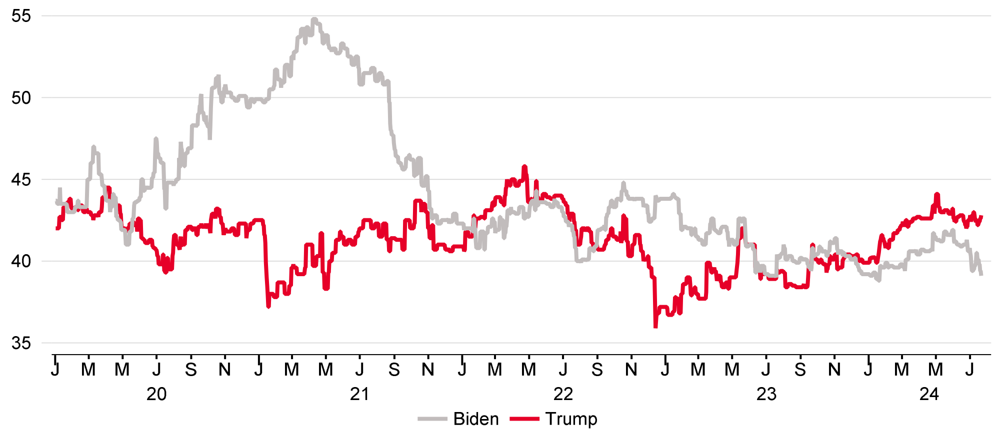
Source: Macrobond, SG Cross Asset Research/Economics

Box 1: US election means higher volatility, emerging markets may suffer

The US presidential election is scheduled for early November this year. Joe Biden's poor performance in the first televised debate and the subsequent increasing pressure from some of his fellow party members to withdraw led him to abandon his candidacy. At the same time, he has encouraged Vice President Kamala Harris to run for the post. Although the Democrats will not make a final decision on their nominee until August, we will try to outline, based on past experience, what impact the election results might have on economic policy and the financial markets.

The impact on the federal budget deficit of victory for Donald Trump or any potential Democratic candidate will be similar - in both cases it will rise. In the case of Trump, it will be due to tax cuts, while with Democrats' nominee, it will be due to higher spending. The tax cuts introduced by Trump are still in place and are due to expire in 2025. If extended, they would cost an additional $4.6tn over the next ten years, according to the Congressional Budget Office. This, together with corporate tax cuts, could mean stronger economic growth but also deeper government budget deficits. The country's higher debt would then put upward pressure on longer-maturity bond yields. These rose by 50bp in the two weeks following the election of Trump and the Republican Congress in November 2016. At the same time, the curve's slope increased, as the Fed kept rates near zero at the time. However, the election of Biden in 2021 had a similar effect. The prospect of deeper deficits, combined with accelerating inflation, led to a 50bp widening of the spread between the 2y and 10y bonds. Thus, either a Republican or Democratic victory is likely to put upward pressure on longer US interest rates. European and hence Czech rates will likely see similar moves.

Voting polls before Biden's withdrawal (%)



Source: Bloomberg, Real Clear Politics

Short interest rates will be determined by Fed monetary policy. The Fed has long been politically neutral, and this will be not change ahead of the presidential election. There is greater uncertainty around the appointment of new FOMC members after the election. Trump has already indicated that he would let Chair Powell complete his term (to May 2026). At the same time, the president can only appoint seven FOMC members. The remaining five, who have voting power, are the governors of the Federal Reserve banks, over whom the president has no authority.

Regardless of which party wins, volatility in the financial markets will rise ahead of the elections. According to the options market, EUR/USD volatility will be about four times higher than usual the day after the election.

A Trump administration would likely lead to higher inflation and thus possibly slower Fed rate cuts. One channel for price rises could be the introduction of further tariffs or increases in current ones. The tariffs Trump introduced in his term (aluminium, steel, washing machines, dryers or solar panels) are still in force. Under the Biden administration, tariffs on imports of electric cars from China have been added and tariffs on some other goods have been hiked further. In general, the imposition of tariffs has led to a one-off increase in the price level rather than a more permanent rise. This tended to reflect the shifting of production back to the US, where it is more costly. Moreover, the introduction of them has not been fully reflected in final prices. At the same time, as the tariffs were being introduced, the Fed curtailed raising rates and instead unexpectedly cut them.

Another potential channel for price rises after the election is migration policy. If Trump pushes for the deportation of large numbers of illegal immigrants, this could further tighten the labour market and thus put upward pressure on wages and hence the price level.

We do not expect any significant impact on equity markets. The S&P 500 has seen an average annual return of around 10% since inception in 1957, i.e. under both Democratic and Republican administrations. Stock market returns have only been negative when the country was in a financial crisis (2008) or experiencing a stagflationary spiral (1973), which is incomparable to the current situation.

In addition to the fiscal aspect, or rather its impact on interest rates, geopolitical risk may also have an impact on Czech government bonds and the koruna. Any weakening of support for Ukraine would likely put pressure on emerging market assets and could trigger a wave of sell-offs. In this sense, the riskier candidate is Trump, who has been critical of the North Atlantic Alliance and is not a supporter of funding Ukraine.

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Euro area: another rate cut in September this year

Household consumption will fuel euro area growth.

We expect the eurozone economy to continue to grow moderately this year and next year. Household consumption should be the main driver, supported by robust wage growth, low inflation and higher net interest income. Moreover, the savings rate is still around 1.5pp higher than it was on average between 2013 and 2019, with excess savings reaching more than 7% of GDP. Fiscal policy remains a risk, and could be more restrictive than we have assumed so far.

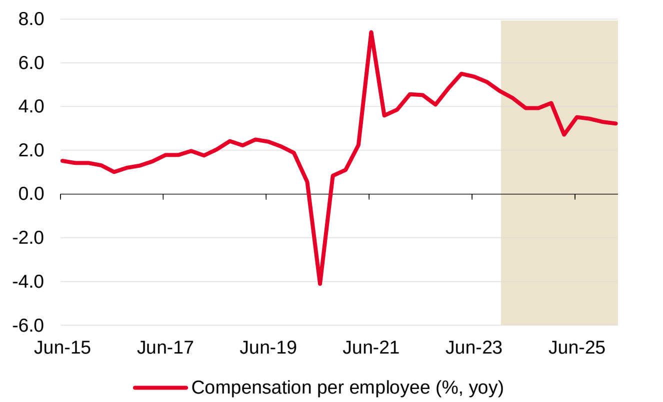
The labour market is tight, with wages growing briskly.

The euro area labour market remains tight. The unemployment rate remained at an all-time low of 6.4% in May. There were 2.2 unemployed people per job vacancy, compared with 6.7 in 2015. Wages rose by 4.4% yoy in the first quarter of this year. We expect them to grow by 4.1% in 2024 as a whole and by 3.2% in 2025. We estimate that rising wage costs will already translate into a decline in companies' profit margins this year, which will lead to a reduction in investment activity. At the same time, the tight labour market is the reason why demand for goods and services is still outstripping supply in some sectors. Overall, we expect the euro area economy to grow by 0.9% this year, after 0.6% last year, and by a solid 1.4% next year.

Germany should have put the worst behind it, the risk is the development in the industrial sector.

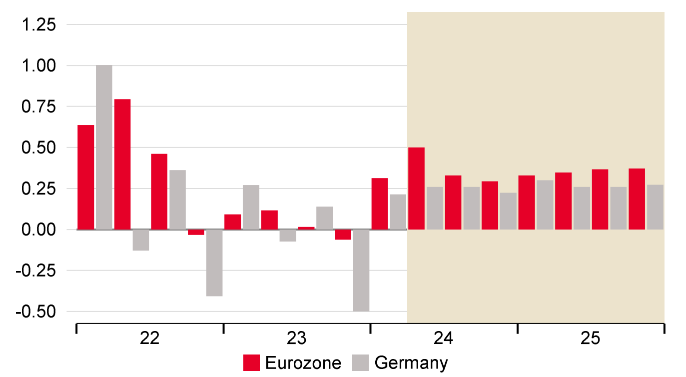
After last year's stagnation, the German economy started this year on a positive note, with GDP growth of 0.2% qoq. This was due to the exceptionally good performance of the construction sector and net exports, which is unlikely to be repeated in the coming quarters. However, given solid wage growth (4.7% estimate for this year, 3.5% for next year) and falling inflation, we expect consumers to start using some of their savings, leading household consumption to rise. Net exports are likely to be negatively impacted by firms' efforts to rebuild reduced inventories, and given the debt brake in place, fiscal policy will also need to be tightened next year. At the same time, however, there have also been discussions about tax cuts that would further boost household consumption. GDP growth is expected to come in at around 0.2-0.3% qoq in the coming quarters. For the whole of this year, the German economy is expected to add 0.3%, followed by 1.1% yoy next year. However, the Achilles' heel of the German economy remains its strong industrial orientation and the weak performance of this segment in previous months. The risks to our forecast are thus skewed towards lower growth.

Wage growth is currently strong by European standards in EA



Source: Macrobond, SG Cross Asset Research/Economics

Household consumption should fuel the GDP growth (%, qoq)

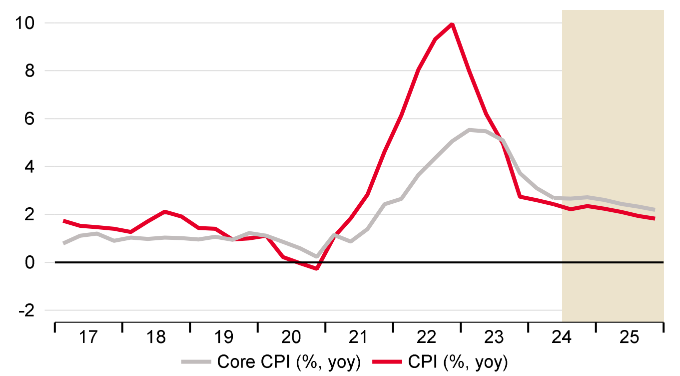


Source: Macrobond, SG Cross Asset Research/Economics

Eurozone inflation falls below 2%, but core inflation remains higher.

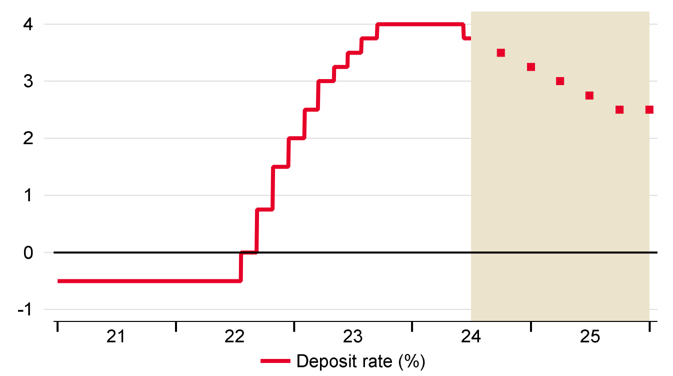
Eurozone inflation slowed to 2.5% yoy in June from 2.6% in May. However, its core component remained at a still high 2.9% yoy. As a result of the impact of the high comparison base and developments in wholesale gas and electricity prices, headline inflation should fall below 2% yoy in the autumn, but its core component is forecast to remain around 2.7% yoy throughout the rest of this year. In our view, the ECB will use the fall in inflation to make the case for a further 25bp interest rate cut at its September meeting. However, the further cut that our forecasts envisage for December may be postponed due to inflation risks. The decline in interest rates should stop at 2.5% (for the deposit rate) in 2H25, which we see as the neutral level.

Inflation in the euro area should fall below 2% in the autumn



Source: Macrobond, SG Cross Asset Research/Economics

ECB: another rate cut in September



Source: Macrobond, SG Cross Asset Research/Economics

CEE: regional central banks to be cautious in easing monetary conditions

Polish interest rates will remain at current levels for an extended period.

Poland's central bank has left interest rates unchanged since last October, when it cut them by 25bp to 5.75%. Moreover, Governor Glapinski significantly stepped up the hawkish rhetoric after the last meeting, saying that a rate cut could not be expected until 2026. Until recently, he had suggested that such a move could come in 2025. The reason for the caution, he said, is still high core inflation, which stems from rapid wage growth. The central bank has revised this upwards significantly, expecting 12.9% for this year instead of the 11.5% predicted in March, and 8.6% instead of 7.1% for next year. Core inflation is forecasted to remain at current levels until the end of this year (3.8% yoy) and to slow slightly next year (3.3% yoy). Headline inflation will jump from current levels (2.6% yoy in June) to above 6% in the second half of this year, due to the easing of support measures linked to the energy crisis (lower value added tax on food and energy prices). According to the central bank's forecast, inflation will not return to target until 4Q26. Our estimate assumes that the central bank will cut rates in July next year. However, in a dovish context it could come even earlier, in our view, especially if the zloty continues to deepen its gains. The zloty reached levels as high as EURPLN 4.25 following Governor Glapinski's comments, but we expect it to weaken during the autumn months due to increased geopolitical uncertainty related to the outcome of the US presidential election (EURPLN 4.5 at the end of the year).

The Hungarian central bank will leave rates unchanged.

The Hungarian central bank continued to ease monetary conditions in the second quarter of this year. However, the pace of interest rate cuts has already slowed down, with the NBH cutting the key three-month deposit rate by only 25bp in June and July to 6,75%. We assume interest rate stability for the rest of this year. Overall, we see inflation accelerating from the current 4% to 4.6% at the end of this year, with other upside risks stemming from price developments in services. We therefore expect monetary conditions to be eased by 25bp in the first quarter of next year. We forecast the Hungarian forint to depreciate in the final third of this year. The forint is thus forecast to weaken towards EURHUF 400 in 4Q.

Macroeconomic forecast

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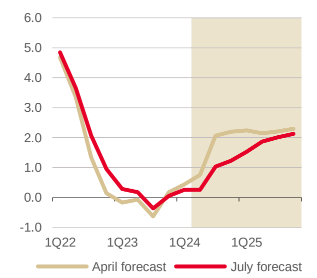
Major changes

GDP:
After stagnating last year, we expect the economy to grow by just 0.7% this year and accelerate to 1.9% next year. Compared with our previous forecast, GDP growth is lower in both years, as we expected 1.4% and 2.2% respectively. The revision is related to the weak data so far. However, we still expect rising household consumption to be the main driver of the economic recovery, supported by renewed increases in real wages.

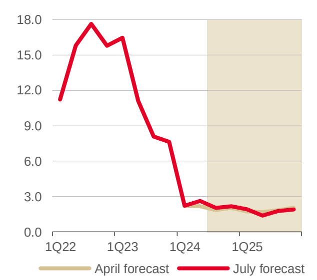
Inflation:
Inflation is set to remain close to the 2% target until the end of the year, averaging at 2.3% in 2024. We then expect it to decline to 1.7% in 2025. Excessively tight monetary policy, subdued demand and falling energy prices should keep inflation below target. Compared with the April forecast, the estimate for this year is slightly higher, while that for next year is slightly lower (we previously had 2.1% and 1.8% respectively).

Changes to GDP forecast (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

Changes to CPI forecast (%, yoy)

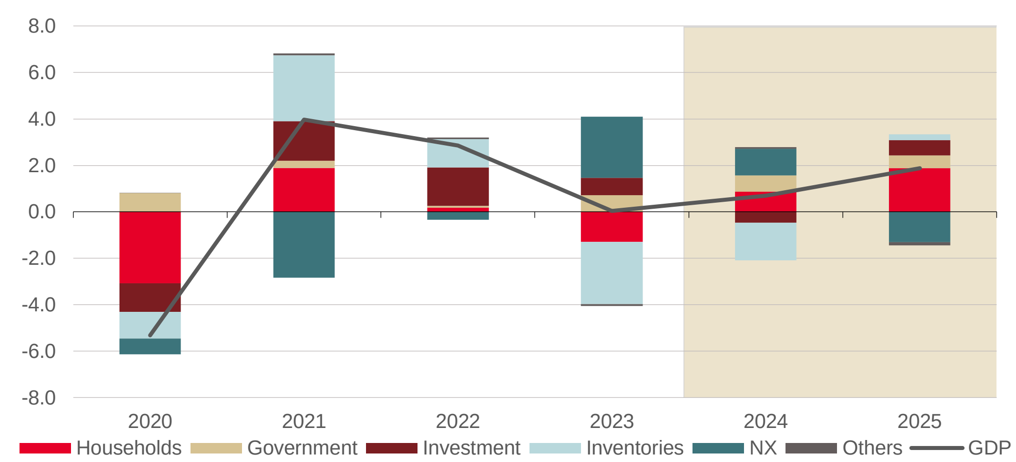


Source: CZSO, Economic & Strategy Research, Komerční banka

Sluggish economic recovery and below-target inflation

According to the revised data, the Czech economy reached its pre-pandemic level more than two years ago, but is unable to grow significantly further. Moreover, its growth momentum weakened in 1H24. Domestic industrial production continued to decline due to weak demand for industrial goods and problems with the supply of parts for car production. Consumer demand has also disappointed, recovering more slowly than we had expected. Nevertheless, household consumption should continue to rise and be the main source of the economy's modest growth this year. A resumption of real wage growth, which is likely to be faster than we originally thought, should help. However, this will not necessarily lead to higher inflationary pressures, as real wages lag behind labour productivity. We expect inflation to reach 2.3% this year and decline to 1.7% next year. This should be driven by excessively tight monetary policy, still weak demand and falling energy prices.

We expect the economy to grow by 0.7% this year and accelerate to 1.9% next year (%, yoy)



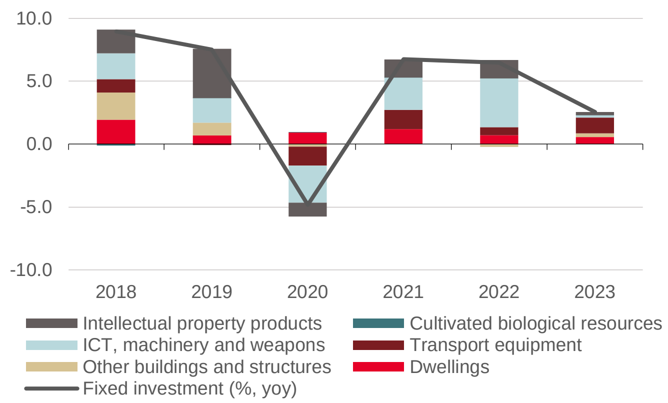
Source: CZSO, Economic & Strategy Research, Komerční banka

Czech economic growth slower than expected

The economy has been stagnating for about a year and a half, mainly due to subdued consumer demand. The revised national accounts data, which we discuss in more detail in *Box 2*, show that the economy grew by 0.3% qoq in 4Q23 and then slowed to 0.2% qoq in 1Q24. However, this essentially offset the 0.4% qoq contraction in 3Q23, which was caused by problems with the supply of parts to the automotive industry. Moreover, qoq GDP growth was not significantly different to zero in 1H23 and 4Q22. As a result, we estimate that the economy has been operating below potential since around the middle of last year, with potential output growth remaining subdued and well below pre-pandemic levels. Household consumption began to pick up gradually at around the turn of the year. This was supported by the rapid decline in inflation, which contributed to improved household sentiment and a resumption of real wage growth. After the previous sharp contraction, real household spending in 1Q24 was still 5.5% below the pre-pandemic level of 4Q19. Subdued consumer demand thus remains a major drag on economic growth.

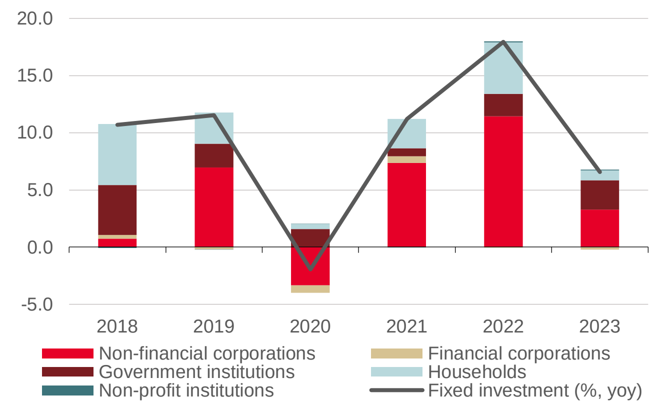
Fixed investment has followed the opposite trend, growing strongly over the past three years. In 1Q24 it exceeded the pre-pandemic level by a significant 7.8%. The biggest boom in fixed investment was in the category of ICT, other machinery and equipment, and weapons systems, especially in 2021 and 2022. Last year, when investment growth had already slowed significantly compared with the previous two years, it was dominated by purchases of transport equipment. The sector accounts, which are only available in nominal terms, then show that non-financial corporations accounted for more than half of the growth in fixed investment. Household investment in dwellings also made a significant contribution in 2021 and 2022. By contrast, the share of government institutions in total investment was relatively small over the period and only increased in the last year. This is also confirmed by the subdued trend in investment in other buildings and structures, where large government investment in infrastructure has traditionally been a significant item. However, some government investment, notably in defence, is included in the former category. Overall, the favourable trend in business investment is good news for the economy's potential output in the coming years. Nevertheless, investment growth may be exhausted for some time. Indeed, fixed investment was flat qoq in 2H23 and even fell by a significant 1.8% qoq in 1Q24. This decline was broad-based. This may be due to below-average business confidence and the weak performance of both manufacturing and construction, as both sectors are plagued by insufficient demand.

Investment was mainly in machinery and equipment in 2021-2022 and in transport equipment in 2023 (stable prices)



Source: CZSO, Economic & Strategy Research, Komerční banka

Non-financial corporations have contributed the most to rapid investment growth in the past three years (current prices)



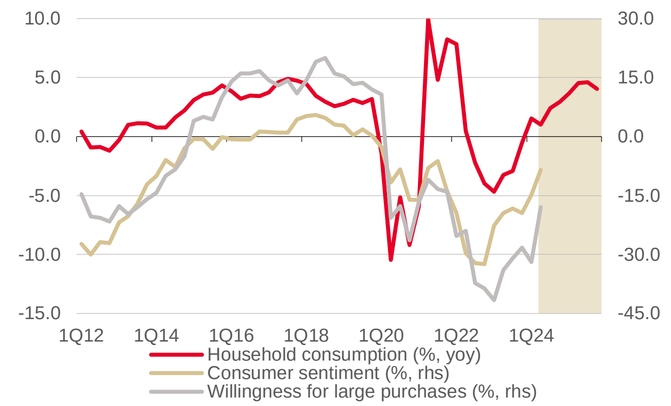
Source: CZSO, Economic & Strategy Research, Komerční banka

Improved fundamentals point to further growth in household consumption, but we do not expect it to return to pre-pandemic levels before 2H25.

GDP growth in 2Q24 is likely to have disappointed, as we estimate it at only 0.1% qoq. This would be the third consecutive quarter of declining growth momentum. The situation in industry has not improved, as we expect another significant qoq fall in output. This is due to persistently weak global demand for industrial goods and continuing problems with the supply of selected components for domestic car production. Foreign trade surpluses remain more than solid, but this is likely to be a temporary effect of exports of previously unfinished production. A turnaround in industry was unlikely, however, as industrial production in neighbouring Germany, a key market for many Czech companies, also remained depressed. The weakness of consumer demand was more surprising. While household consumption grew relatively strongly at the turn of the year, by 0.6% qoq in 4Q23 and 0.7% in 1Q24, we estimate a slowdown to 0.4% qoq in 2Q24. Available data for April and May show that retail and services sales were roughly flat in real terms. Thus, our expectation of an increase in household consumption for 2Q24 as a whole is mainly the effect of the rapid growth in spending at the end of 1Q24.

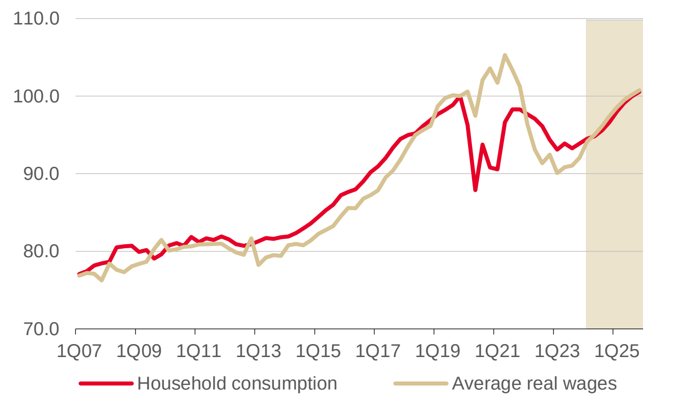
We are lowering our GDP growth estimates for both this year and next. While we expect an increase of only 0.7% this year, growth should accelerate to 1.9% next year, compared with 1.4% and 2.2% in our previous forecast. The revision is mainly due to the recent weakness. However, the economic recovery should continue in the coming quarters. The fundamentals of household consumption support further growth. Consumer sentiment has improved markedly and is even above its long-term average. In 2Q24 it was at its highest level for more than two years. On a positive note, real wage growth has continued and is likely to be faster than we had expected. In addition, savings remain high and household credit is rising rapidly. However, as recent data suggest, the recovery in household consumption is likely to be gradual. We do not expect a return to pre-pandemic levels until 2H25. Government consumption continues to increase rapidly. In contrast, we expect fixed investment to fall by 1.7% this year due to a high comparison base and the ongoing downturn in industry. We expect industrial production to fall by around 1%, as in the previous year. The contribution of net exports to GDP growth should remain strongly positive this year, but will be offset by a negative contribution from the change in inventories. This reflects the effect of destocking and the subsequent export of previously unfinished production, which will gradually fade.

Household consumption to be the main driver of economic growth, supported by improved consumer sentiment



Source: CZSO, Economic & Strategy Research, Komerční banka

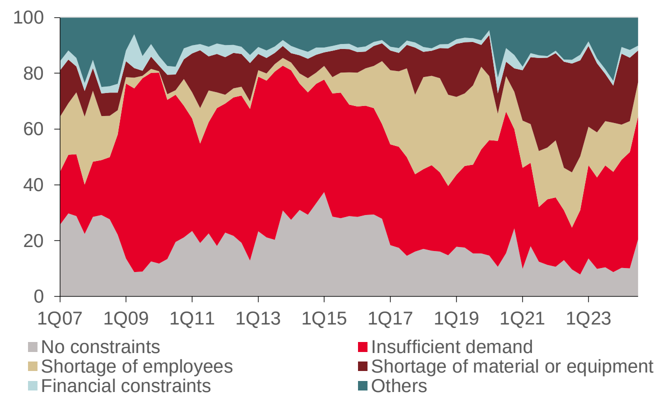
Real wages on the rise again, helping household consumption to gradually recover (4Q19=100)



Source: CZSO, Economic & Strategy Research, Komerční banka

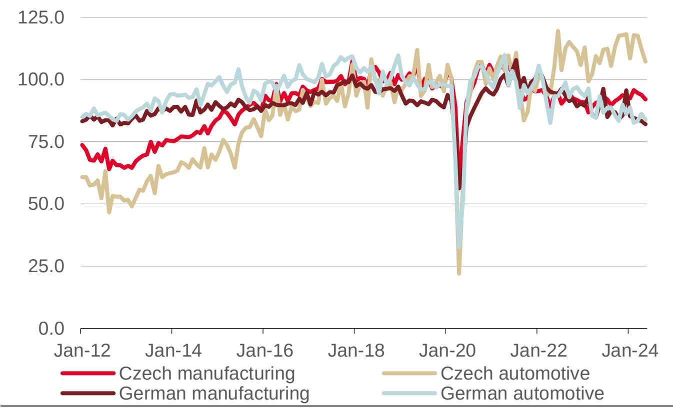
The risks to our GDP forecast are mainly related to the pace of recovery in consumer demand and developments in industry. As household consumption is likely to be the main source of GDP growth this year, we believe that the strength of its recovery will determine the outcome for the economy as a whole. The pace of wage growth will be an important factor. There is now considerable pessimism about future developments in industry, as most leading indicators have turned down again. This applies to both the Czech Republic and Germany. However, the development of domestic industrial orders is not bad.

Insufficient demand is currently the main constraint on industrial production growth (%)



Source: CZSO, Economic & Strategy Research, Komerční banka

Czech carmakers outperform the rest of the industry and German peers in terms of new orders (real, SA, 2021=100)

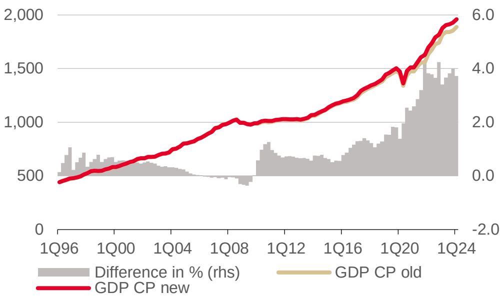


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: The relevant producer price index (PPI) was used as a deflator for Czech industrial new orders data, which are only available in nominal terms.

Box 2: Revision of national accounts: impact on evaluating the economy

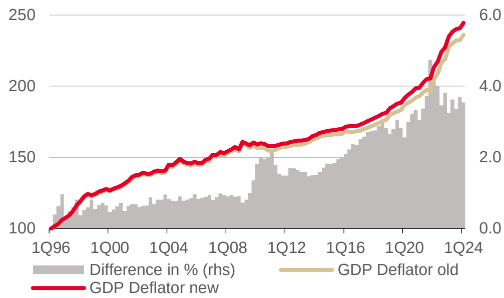
At the end of June, along with the GDP data for 1Q24, the Czech Statistical Office (CZSO) published a set of revisions to the national accounts, which are reflected in changes in the assessment of the economy's performance. Each year, the CZSO publishes regular revisions of historical data, which provide a more precise view of economic development over the last few years. This time, it also provided an extraordinary revision of the national accounts. This mainly includes the refinement of data resulting from the last population census of the Czech Republic in 2021, and integrates the methodological recommendations of Eurostat. These recommendations should contribute to a higher degree of comparability of statistical data across individual EU states. The result is changes along the entire length of the time series, for the most frequently used seasonally adjusted quarterly national accounts data at constant prices, i.e. since the beginning of 1996.

Nominal GDP (CZKbn)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: CP = current prices

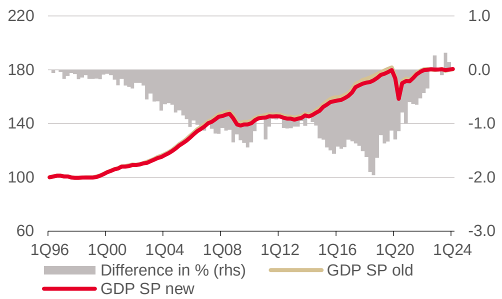
GDP deflator (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: GDP deflator as a ratio of nominal to real GDP

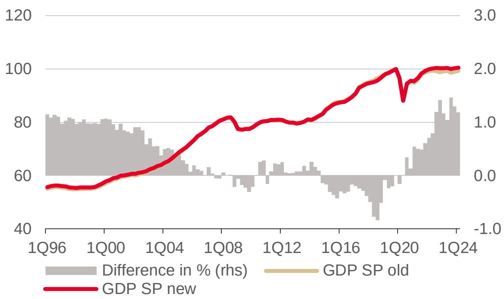
At the aggregate level, the changes mainly concern nominal GDP, which was increased primarily due to a higher price index. Apart from the years 2006-2009, the upward revision can be seen over the entire length of the GDP time series at current prices. However, it is most visible in the years 2021-2023, when there was an average increase of 3-4%. From the point of view of evaluating the state of the economy, nominal GDP is significant primarily in relational indicators. The most notable of these is probably the ratio of public debt to nominal GDP, which will naturally decrease because of a higher denominator. The main reason for the upward revision of GDP in current prices is a higher price index, or GDP deflator. The level of the deflator was revised higher over the entire time series, but its yoy dynamics did not change fundamentally.

Real GDP (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: SP = stable prices

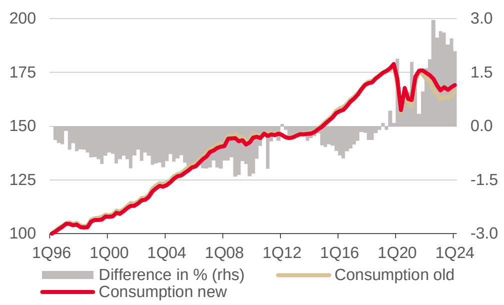
Real GDP (4Q19 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: SP = stable prices

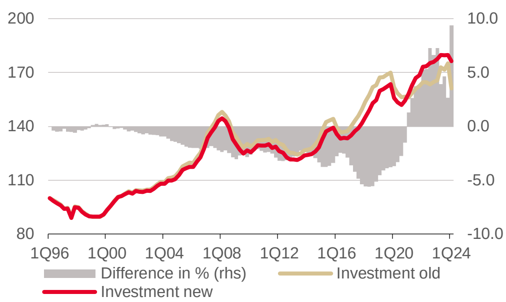
The earlier return of real GDP to the pre-pandemic level under the revised numbers is more of a statistical illusion, in our view. The evaluation of real GDP revisions is complicated by the change in the reference year of stable prices. While real GDP was originally calculated in stable prices based on 2015, prices are now related to the year 2020. To better compare the new and the original times series, we have recalculated both to the beginning of the time series, i.e. to 1Q96 (the same also applies to the GDP deflator). This also makes it possible to evaluate the ongoing impact of revisions. These have a downward impact until approximately the end of 2018, over which period the negative difference between the new and original time series of real GDP increases from quarter to quarter until it reaches -2%. Thereafter, the negative difference between the new and the original time series of real GDP gradually diminishes due to the upward nature of the revisions, until, in essence, it is complete eliminated. In other words, the level of economic activity at the turn of last year and this year, measured by the ratio to 1Q96, remained unchanged after the revision. The original time series of real GDP showed that the economy had still not returned to the pre-pandemic level of 4Q19. However, according to the revised time series, this level was already reached in 1Q22. Real GDP in 2019 was reduced by roughly 1%, which is about the gap that the economy needed before the data revision to reach pre-pandemic levels. According to the new time series, real GDP in 1Q24 was 0.5% above this reduced level in 4Q19.

Household consumption (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Household consumption in stable prices

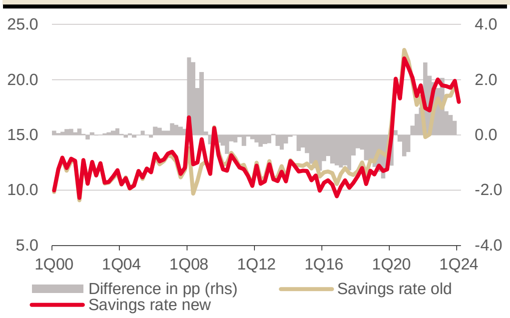
Fixed investment (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Fixed investment (gross fixed capital formation) in stable prices

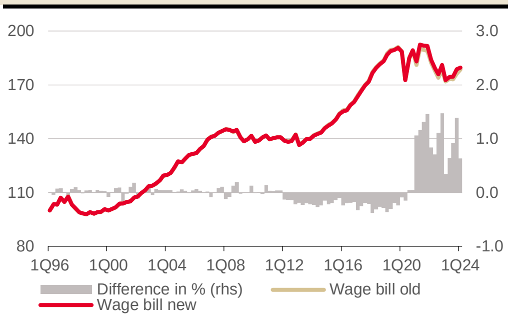
According to the revised data, domestic demand has recovered more, but household consumption is still significantly behind pre-pandemic levels. Before the revision, real household consumption in 1Q24 was lower by 7.3% compared to 4Q19. The revised data shows that it was behind the pre-pandemic level by a more modest 5.5% in 1Q24. The comparison is not, as in the case of the entire GDP, distorted by a lower comparative base. Household consumption in 4Q19 compared to 1Q96 remained almost unchanged after the revisions. Its post-COVID recovery was indeed stronger than the data originally showed. To a certain extent, however, this is the effect of the change in the capture of data on Ukrainian refugees from 2022. The CZSO originally considered them non-residents and their consumption was therefore captured as an export of services. However, according to the new methodology, Ukrainian refugees are considered residents from the moment they arrive in the Czech Republic, and their expenses thus fall under the household consumption item. Among other things, this was also reflected in the revisions of net exports, the contribution of which to the annual dynamics of real GDP was reduced by 1.3pp in 2022 and by 0.4pp in 2023 (in 2021, in contrast, the contribution increased by 1.5pp). In the period 2021-2023, fixed investments were revised upwards, by an average of 4.5%.

Savings rate (SA, in % of disposable income)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Ratio of gross savings to gross disposable income of households

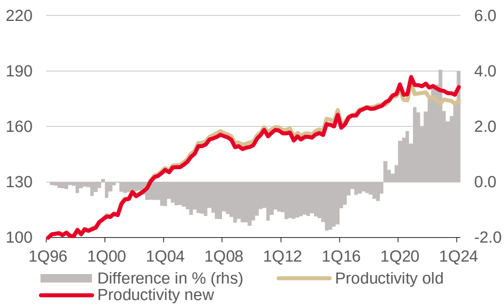
Real wage bill (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Nominal volume of wages and salaries deflated by CPI index

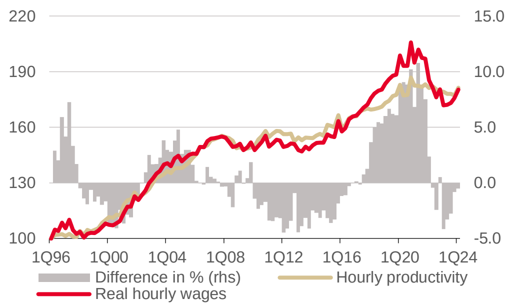
For the post-COVID period, data revisions brought an increase in the household savings rate and an increase in labour productivity, which even slightly outpaced the development of real wages. In the years 2021-2023, due to the revision, the savings rate increased by approximately 1pp, but the figures for previous years were revised downwards. The rate of savings is normally subject to revisions, and their magnitude this year does not deviate in any way from a historical viewpoint. However, the development remains the same on a qualitative basis. After the outbreak of the pandemic, the savings rate rose by leaps and bounds to an elevated level. The average savings rate for the years 2020-2023 was 19.1% compared to 11.7% during the pre-pandemic years 1999-2019. And, even under the revised data, households still have a high level of accumulated savings. The development of the household income of employees captured by the volume of wages and salaries in the national accounts has changed only slightly. During the years 2021-2023, the revisions increase the wage bill by an average of 1%, which does not change the fact that its real value, after the previous decrease, now only corresponds to the middle of 2018. As a result of the decrease in the level of employment and the number of hours worked, there were 2021-2023 increases in hourly labour productivity of an average of roughly 3%. From 2018, labour productivity significantly lagged behind real wages, but then from about the middle of 2022, it slightly overtook it. From 2Q22 to 1Q24, real hourly wages compared to hourly labour productivity were lower on average by 1.7%, but in 1Q24 alone they lagged behind by only 0.5%.

Hourly labour productivity (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Real GDP to hours worked

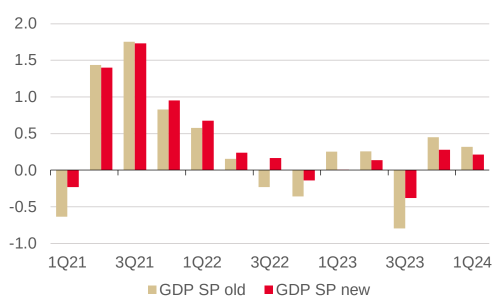
Productivity vs real wages (1Q96 = 100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Revised time series; real hourly wage as ratio of real wage bill to hours worked

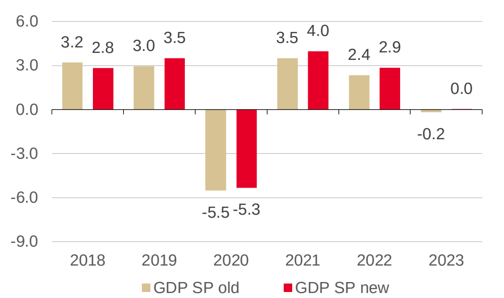
The revised data show that the economy did not go through a recession in the last three years, and that last year it stagnated instead of declining slightly. Prior to the revisions, the data indicated a technical recession in 2H22, i.e. two consecutive qoq declines in real GDP. Post-revision, however, the decline only occurred in 4Q22, and the last recession the economy recorded was the one in 1H20, when there was a sharp decline as a result of widespread closures during the first wave of the pandemic. It does not bode well for the development in subsequent quarters that, according to the revised data, the qoq dynamics of the economy was weaker at the turn of last year and this year.

Quarterly GDP growth (%, qoq)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: SP = stable prices

Annual GDP growth (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: SP = stable prices

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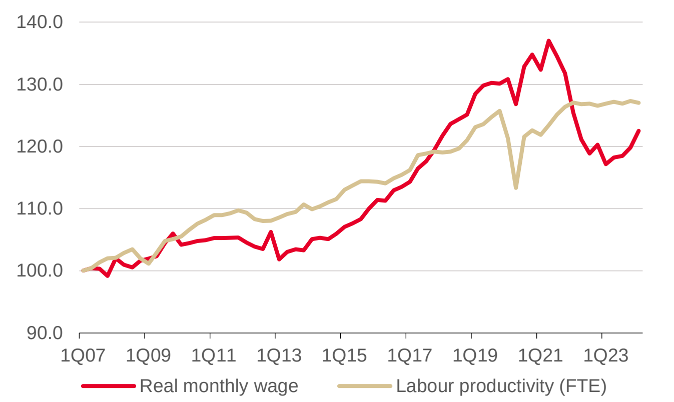
The fall in real wages has been so deep that they now even lag behind labour productivity.

Real wages set to rise as workers try to recoup earlier losses

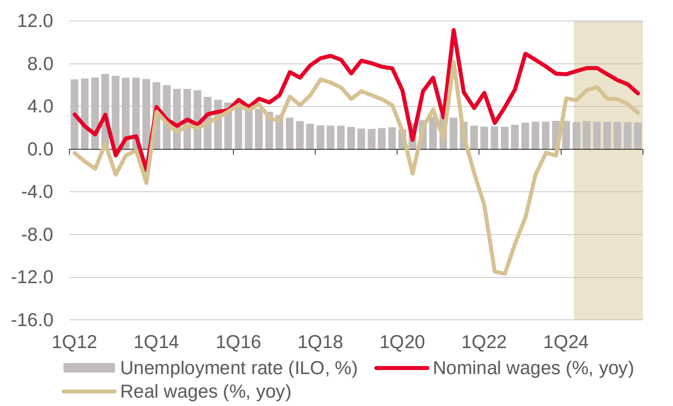
After 8.0% growth last year, we expect average nominal wages to grow by 7.4% this year and 6.2% next year. In both years, this is significantly higher than we expected in our April forecast, which predicted growth of 6.2% in 2024 and 5.4% in 2025. The revision is heavily influenced by developments in 1Q24, when wages surprised to the upside, with an overall increase of 7.0% yoy. Moreover, leading indicators suggest that annual wage growth should accelerate further in the coming quarters. Wages are likely to rise in both the private and public sectors. This is due to increasing pressure from employees and trade unions to at least partially offset the previous decline in purchasing power. Indeed, real wages have fallen by almost 12% over the past two years. Despite the resumption of qoq growth since 2Q23, the level of real wages in 1Q24 was only about the same as in mid-2018. We expect real wages to rise by 5.2% this year and 4.3% next year. Accordingly, we do not expect them to reach their pre-pandemic level until the end of 2025. This is one of the factors that will restrain growth in household consumption. It is also important to note that the decline in real wages has been so pronounced that their level now even lags behind labour productivity. The gap is larger in the official wage statistics than in the hourly national accounts indicators mentioned in *Box 2*. This is also likely to have an impact on further wage increases, which may not be inflationary, at least for some time. Labour shortages and a very low unemployment rate are likely to remain the main stylised facts of the Czech labour market. Employment will increase significantly this year as a result of the inclusion of Ukrainian refugees in the labour market statistics. We expect more modest increases in the coming years, as the influx of foreign workers is likely to continue.

Real wages are now lagging labour productivity, so their further growth may not be inflationary (1Q07=100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Labour productivity as a ratio of real GDP to full-time equivalent employment

Nominal wage growth is likely to remain high this year, pushing up real wages after two years of decline



Source: CZSO, Economic & Strategy Research, Komerční banka

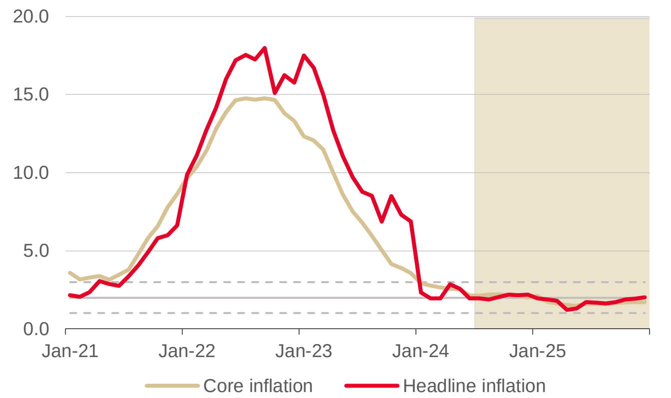
Core inflation momentum is currently subdued and below 2% on an annualised basis.

Chances of inflation falling below 2% next year rise

Inflation has returned to the central bank's 2% target. After a temporary increase in annual inflation in April and May, it returned to 2% in June. Inflation was also broadly in line with the target in 1Q24. The temporary increase was mainly due to the normally volatile food and fuel items. Core inflation declined from 2.9% yoy in January to 2.2% yoy in June. However, price developments for goods and services remained very different. In June, goods prices rose by only 0.2% yoy, while services prices increased by 4.9%. Although annual growth in services prices remained high, it moderated somewhat compared with previous months. A particularly positive element in the development of core inflation is the seasonally adjusted mom dynamic. Indeed, it fell significantly in May and June, even below 2% on an annualised basis. In our view, this may reflect the lagged effects of tight monetary policy and subdued consumer demand.

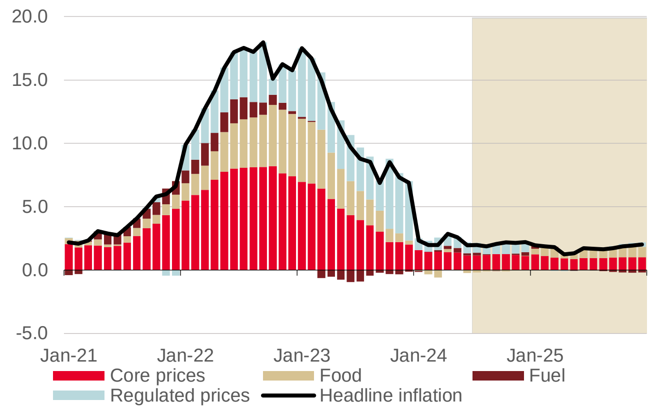
We estimate inflation at 2.3% this year and expect it to fall to 1.7% next year. Our previous forecasts were for 2.1% and 1.8% respectively. The reason for the higher estimate this year is a potentially milder decline in food prices and a faster rise in fuel prices than we expected in April. Food prices are currently very volatile, but we expect them to fall overall in 2024. As we show in *Box 3*, there is still room for consumer food prices to fall in the short term. In the medium term, however, we are concerned about the adverse effects of climate change and its impact on the global agricultural harvest. We therefore expect food price growth to exceed 2% next year. We expect regulated prices to rise by 5.8% this year, mainly due to the jump in regulated energy prices at the beginning of the year. However, the non-energy part of regulated prices, which includes health services and public transport, is also likely to grow rapidly in 2024. Annual growth in regulated prices is set to accelerate towards the end of the year due to the lower comparison base, which we expect to contribute to a slight increase in headline inflation to 2.2% yoy. However, household electricity and gas prices have been gradually declining in recent months, with a time lag reflecting favourable developments in wholesale energy markets. This should continue. We therefore expect regulated prices to rise by only 0.6% next year. Lower market prices for energy are unlikely to put upward pressure on their regulated components. The general election next autumn is also likely to hamper any potential increases. We therefore do not expect a significant increase in the regulated energy component next year.

Headline and core inflation to remain close to 2% until end-2024, with the possibility of falling below target in 2025 (%, yoy)



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

Lower growth in core and regulated prices should keep headline inflation below 2% in 2025 (%, yoy)



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

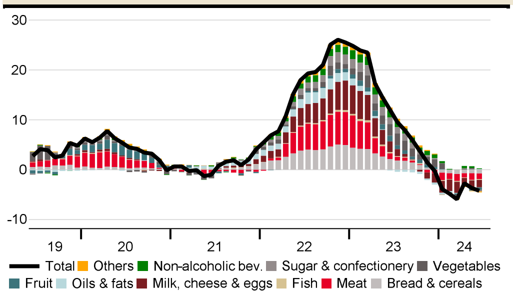
Core inflation should continue to decline and fall below the CNB's 2% target next year. We estimate that it will reach 2.4% this year and 1.7% next year. This is lower than our April forecast (2.6% and 1.9%) for both years. Monetary policy was probably too tight in 2H23 and 1H24. Current consumer price developments support this view, with headline and core inflation already close to the 2% target. Given the traditional lag of around one year in the effects of monetary policy, we therefore expect core price dynamics to be subdued in 2H24 and 1H25.

The risk we see for higher inflation next year is a possible significant acceleration in house price growth. The housing market is now showing signs of recovery, even though interest rates are still high. The high level of household savings may support this upward trend. However, the pass-through to inflation via imputed rents has not been straightforward in the past, both in terms of time lags and intensity.

Box 3: Food disinflation impulse may be slowly drawing its last breath

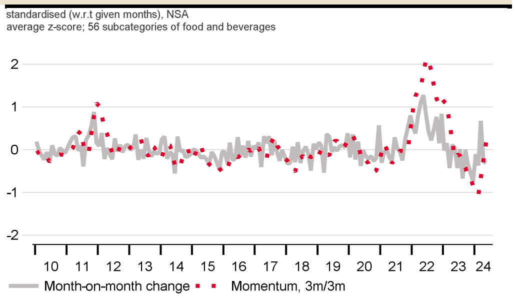
Food inflation, which make up a large part of the consumer basket, have contributed significantly to the rise in the price level by more than a third since January 2020. The current slight downward trend in food prices is in turn helping to keep inflation within the CNB's tolerance band. Notably, the reduction in the VAT rate from 15% to 12% has also played a part. While food prices are volatile and are removed from the core inflation – as they do not necessarily reflect underlying price pressures – they have a major impact on household spending power, and this is compounded by the low elasticity of food demand. Combined with energy, rising food prices are the key reason why the burden of high inflation has been borne disproportionately by low-income households. In this *Box*, we assess the evolution of food prices and the key drivers, which we believe still indicate the exhaustion of this inflationary impulse. Hence, we think food inflation should remain subdued this year and that food prices should fall overall. Looking ahead, however, the risks are beginning to tilt towards stronger price growth.

Food and non-alcoholic beverages (%, yoy, pp)



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

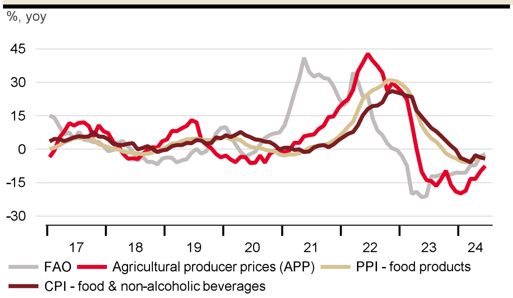
Subdued growth of food prices (%, mom)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Mom growth is standardised always with respect to mom growth in the given month over the course of the time series.

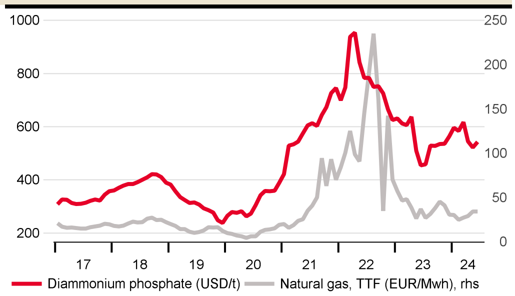
The broad-based increase in food prices since 2021 reflects the surge in prices of agricultural commodities and other agricultural inputs. Furthermore, the steep increase in energy prices coupled with supply chain issues affected fertiliser prices, which contributed to escalating inflationary pressures. While energy prices are well below their peaks, they remain above their pre-2021 levels, as do fertiliser prices. Agricultural producer prices (APP) have been declining rapidly since about mid-2023, continuously lagging global food commodity prices. However, the significant decline has not yet been fully reflected in shop prices, although this is probably due to other costs in the food production chain, as well as the time lag with which developments in the production chain are usually reflected in final prices.

End-to-end production chain price pressures



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

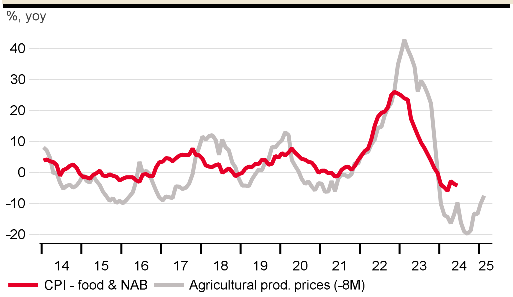
Fertiliser and energy prices remain elevated



Source: Bloomberg, World Bank, Macrobond, Economic & Strategy Research, Komerční banka

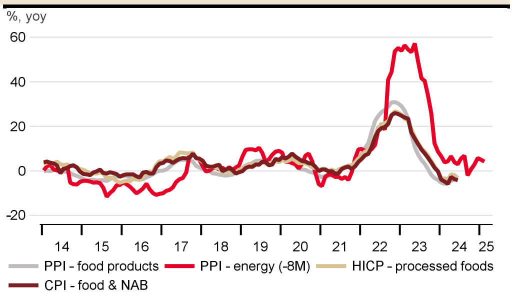
Historical evidence suggests that agricultural input prices are reflected in final consumer prices with a significant lag of around 6-18 months, depending on the intensity.[2] Over the past two years, the link between consumer and agricultural producer prices has strengthened, while the time lag between their movements has leaned toward the shorter side. Thus, spillovers from developments at the very start of the food production chain have accelerated and the rapid increase in APP has been strongly reflected in final prices. On the same note, their rapid decline is likely to continue to contribute anti-inflationary pressure, as it seemingly does not yet appear to be fully reflected in consumer prices.

APP signal room for a further fall in food prices



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: (-8M) denotes time lag of eight months. NAB = non-alcoholic beverages

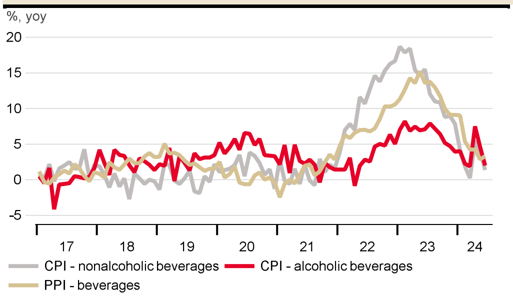
Prices are also falling in the food industry



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

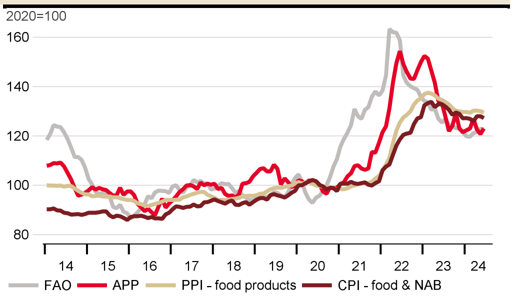
Further up the production vertical, inflationary pressures were amplified by input price increases in food manufacturing itself. We note that the time lag on this effect is generally shorter than in the agricultural sector, although the overall decline in manufacturing producer prices is much tamer by comparison. This partly reflects the direct impact of energy prices, which, unlike wholesale energy commodities, have not yet become significantly cheaper. Food manufacturing PPI and consumer prices are closely linked. Store prices have so far generally reflected a slight decline in the PPI, but we are already seeing signs of a slowdown in the transmission between food manufacturing and consumer prices. The disinflationary impulse from the manufacturing sector is thus becoming increasingly limited. This is especially true for the beverage sector, which is less exposed to commodity prices.

Inflationary pressures still strong in beverages



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

Food price correction has been tame so far

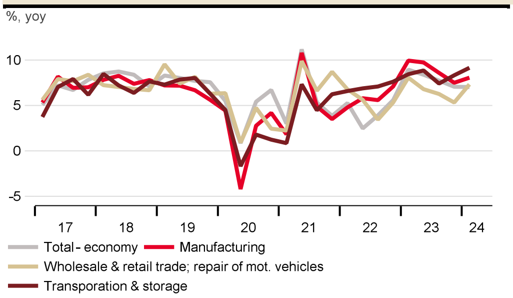


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

[2] The result is based on the *wavelet analysis or wavelet* coherence between inputs in the food production chain and consumer prices. The procedure allows, in principle, to investigate the relationship between two variables in both time and frequency domains. For the sake of brevity, we do not present the analysis here, but derive from its results here. For more see Torrence, C., & Compo, G. P. (1998). A Practical Guide to Wavelet Analysis. *Bulletin of the American Meteorological Society*, 79(1), 61-78.https://doi.org/10.1175/1520-0477(1998)079<0061:APGTWA>2.0.CO;2.

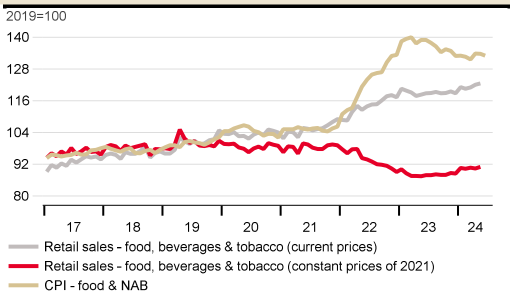
Wages and product margins also deserve a mention in the context of cost pressures. Brisk wage growth in manufacturing (8.1% yoy in 1Q) is likely to be one of the factors limiting the transmission of lower input prices to consumer prices. Increasing wage costs in the transport and storage sector – an important link in the food retail chain – as well as in the stores themselves, are also likely to affect the ability of firms to pass on cheaper inputs to final consumer prices. Data on the profitability of the food industry and stores are limited. But given that retail sales of food (incl. beverages and tobacco) have dropped sharply and were down 9% this May compared to the 2019 average, while their prices have risen by more than a third since then, low demand coupled with higher costs is likely to be squeezing retail margins. But probably from elevated levels.

Wages limit spillover from lower input prices



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

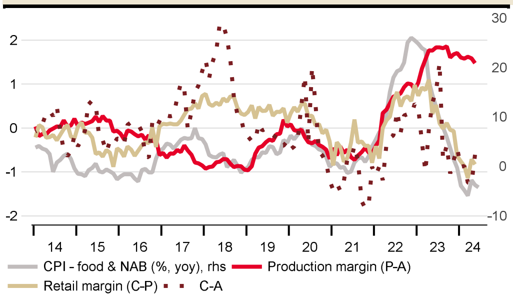
Weak demand squeezes retail profit margins



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

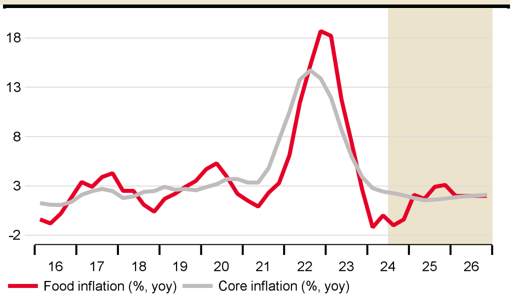
Lower food prices since 1H23 have been largely attributable to retail stores, while gross margins in the manufacturing sector remain high. Using CZSO data from price surveys of selected agricultural, industrial and consumer food products, we analyse the evolution of price margins across the production vertical.[3] The narrowing gap between producer and consumer prices (retail margins; RM) is the primary source of the current decline in food prices (of selected products), while the margin between producers and agricultural producers (producer margins; PM) has not yet been squeezed. While the RM is near historical lows, the PM remains at the other end of the spectrum. This may be partly justified by other cost factors in the industry pipeline. Nonetheless, as lower input prices gradually trickle down and the PM eventually declines, there is still some scope for food prices to cheapen further. Meanwhile, weak consumer demand may continue to keep retailers' margins at lower levels.

Cost margins remain elevated in the industry



Source: CZSO, CNB, Macrobond, Economic & Strategy Research, Komerční banka
Note: For the respective price margins, this is the average of the standardised margins of the surveyed food products. (C) indicates final consumer prices, (P) producer prices and (A) agricultural producer prices.

Food and core inflation forecast (%, yoy)

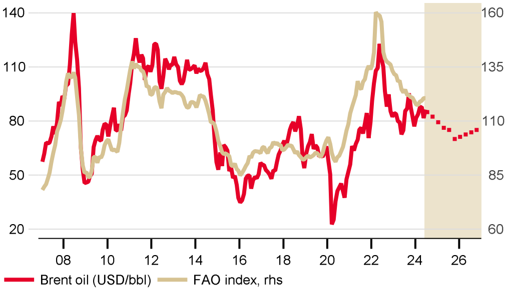


Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

[3] The CNB has conducted a similar analysis. For example, here: https://www.cnb.cz/cs/o_cnb/cnblog/Odkud-se-bere-zdrazovani-potravin-a-je-Cesko-opravdu-tak-vyjimecne/; or also here: https://www.cnb.cz/en/monetary-policy/inflation-reports/boxes-and-annexes-contained-in-inflation-reports/What-drives-food-prices/.

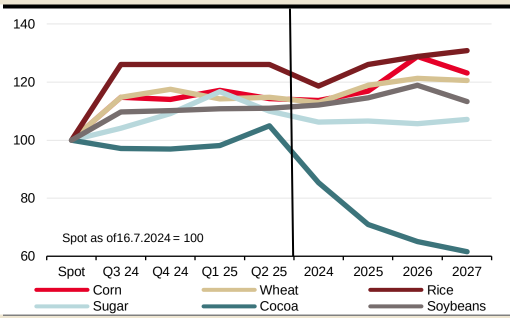
In the short term, food prices should thus continue to have an anti-inflationary or even deflationary impact. However, the likelihood of a significant and prolonged price correction is low. This reflects, among other things, climate change, which increases the likelihood of adverse weather events leading to crop damage. Last year's extreme droughts, which have placed sustained inflationary pressure on some agricultural commodities this year, are a case in point. Another example is the El Niño phenomenon, or rather its transition from a normal phase to a strong phase, which, according to the ECB's calculations, can lead to a 9% increase in global food commodity prices, albeit with a significant delay.[4] The recent El Niño was one of the strongest on record and could thus herald inflationary pressures. Domestically, lower estimated crop yields, which according to the CZSO are below the level of the past five years, are also likely to have a negative impact in the direction of higher food prices.[5]

FAO index and SG forecast for Brent crude



Source: Macrobond, SG Cross Asset Research/Economics

Median estimates of agricultural commodities



Source: Bloomberg, Economic and Strategic Research, Komerční banka
Note: Median estimates from Bloomberg. The x-axis is not proportional to time but corresponds to different time periods

All in all, the impact of disinflationary pressures across the food production vertical may gradually be wane. However, the pass-through is already quite limited given other cost factors (energy prices, wages, or margins). An investigation of selected food products shows that the primary source of lower food prices has been retailer margin squeeze, while production margins in the manufacturing sector have remained largely untouched. Their eventual decline could help keep food prices lower for longer. But although we expect the anti-inflationary impact to persist in the short term, we do not see scope for a major price correction. In the longer term we see the risks intensifying, yielding faster food price growth. This is largely due to the adverse impact of unpredictable weather conditions on crop yields.

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[4] Adolfsen, J. F., & Lappe, M. (28 September 2023). Risks to global food prices from El Niño. European Central Bank. https://www.ecb.europa.eu/press/economic-bulletin/focus/2023/html/ecb.ebbox202306_01~36e78cc75e.en.html.

[5] CZSO (2024, July), Harvest estimates– June 2024, CZSO, https://csu.gov.cz/rychle-informace/harvest-estimates-june-2024.

Monetary policy

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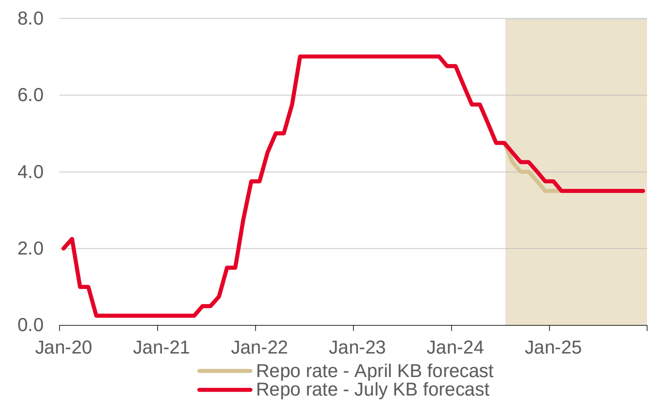
CNB to slow pace of rate cuts despite weak data

At the June meeting, the central bank cut interest rates by a further 50bp, bringing the key repo rate to 4.75%. The bank board's communication remains hawkish, suggesting a slowdown in the pace of rate cuts to 25bp at the August meeting, despite weak economic data and a return of inflation to the 2% target. We therefore expect the repo rate to be cut by 25bp in August and at each of the remaining meetings this year, bringing it down to 3.75% by the end of the year. We continue to see its terminal level in the current monetary policy cycle at 3.5%, which we expect to be reached in February next year. However, the risks to our forecast are tilted towards a faster decline and a lower terminal level.

The latest economic data point to the need for another more significant rate cut, but statements from the CNB board indicate a slowdown in the pace of monetary easing.

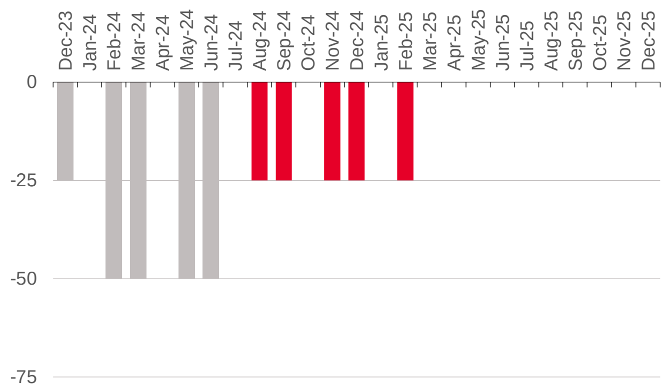
The Czech National Bank cut interest rates by a further 50bp in June, but is indicating a slowdown in the pace of monetary easing at its August meeting. The size of the June cut was the same as at the previous three meetings, bringing the repo rate to the current 4.75%. As in previous quarters, rate cuts were slower than the CNB staff forecast. According to the CNB forecast, the repo rate should have averaged 5.1% in 2Q24, but in reality it was 5.4%. The stronger koruna also contributed to tighter monetary conditions than in the CNB forecast. The koruna strengthened from EURCZK 25.1 in 1Q24 to EURCZK 25.0 in 2Q24, while the central bank had expected a weakening to EURCZK 25.2. The average exchange rate was therefore 0.8% stronger. Economic growth was weaker. The central bank had expected it to reach 0.4% qoq in 1Q24, but it was only 0.2% qoq. Although average annual inflation was higher in 2Q24 (2.6% vs 2.4% in the CNB forecast), this was mainly due to higher food prices and partly also to regulated prices. In contrast, for monetary policy more important core inflation came in below the CNB forecast (2.4% yoy in 2Q24 vs 2.6%). Moreover, the gap widened during the quarter, with core inflation falling sharply to 2.2% yoy in June vs the CNB forecast of 2.6% yoy. Therefore, the only variable that deviated from the CNB's May forecast in the inflationary direction was in fact faster nominal wage growth. The CNB had estimated it at 6.4% yoy in 1Q24, but it actually reached 7.0%.

Compared to our April forecast, we expect a slower reduction in the repo rate, but maintain its terminal level at 3.5%



Source: CNB, Economic & Strategy Research, Komerční banka

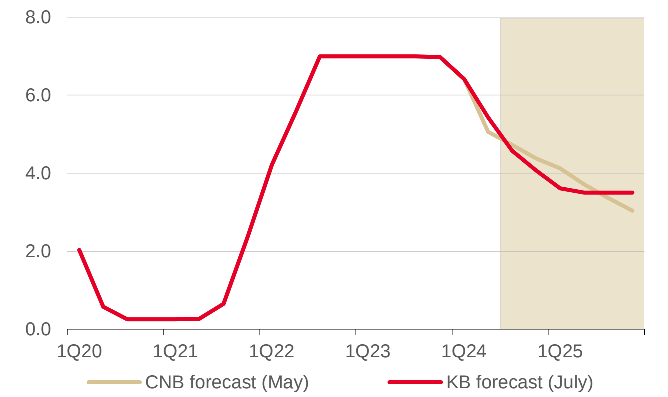
The pace of interest rate cuts to slow in August (repo rate changes in bp)



Source: Economic & Strategy Research, Komerční banka

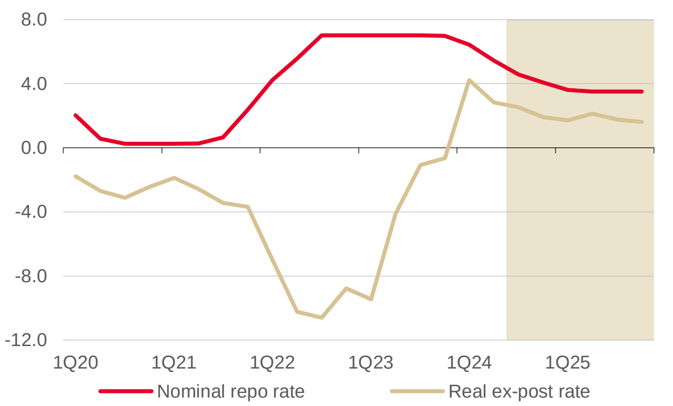
From August, we expect the pace of interest rate cuts to slow to 25bp at each meeting this year, bringing the repo rate to 3.75% by the end of the year. However, our forecast is subject to a high degree of uncertainty. Our expectation of a 25bp cut in August is largely based on comments from central bankers, some of whom have described a further 50bp cut as unlikely even with knowledge of the latest inflation data. According to recent statements, the CNB board does not want to overstate the favourable inflation developments of recent months. This is in line with the board's hawkish communication so far, which emphasises higher rates for a longer period. The main reasons given are the risks associated with still-high annual inflation in services and developments in wages and the koruna exchange rate. However, the words of central bankers have not always been entirely reliable in predicting interest rate developments. In our view, therefore, the probability of a 50bp cut in August is almost as high as the 25bp cut we expect. Indeed, we believe that the macroeconomic data argue strongly in favour of another more significant rate cut. However, our baseline scenario is for a 25bp cut in August and we expect monetary policy to remain excessively tight, slowing the economic recovery and eventually leading to inflation falling below 2%. Looking further ahead, the CNB board statements still point to a repo rate of around 4% at the end of this year. This would be roughly in line with our estimate of 3.75%. What is starting to change is the indicated level of the neutral rate. Originally, the board was talking about 3.5-4.0%, but now the statements are more in the range of 3.0-3.5%. It is therefore possible that the neutral rate will eventually return to where the CNB's monetary department has long estimated it to be, i.e. at 3%. In our forecast, we continue to use 3.5% as the terminal repo rate level for the current monetary policy cycle and expect it to be reached in February next year.

Weakness in the economy and inflation at the 2% target to push the repo rate further down (%)



Source: CNB, Economic & Strategy Research, Komerční banka

Monetary tightening is likely to be excessive this year, with interest rates still high and inflation on target (%)



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

Fiscal policy

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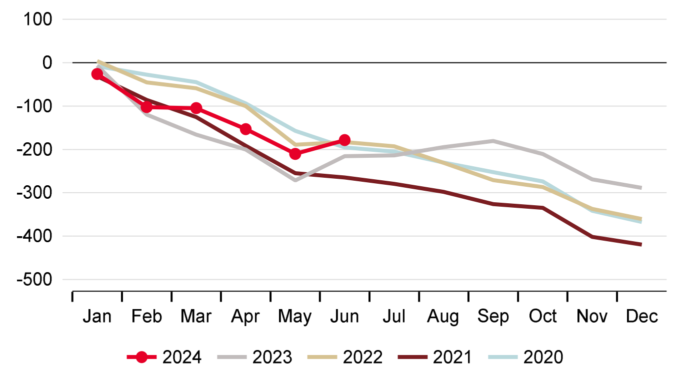
Gradual steps on the road to consolidation

Although this year's state budget did not develop very favourably in first half of the year, in our baseline scenario we still expect the deficit to end the year at CZK250bn, roughly in line with the MinFin's plan. Next year, the deficit should narrow to CZK235bn, but the general election skews the risk towards a slightly deeper deficit. As a share of GDP, the negative general government balance should be within sight of 2% this year and next, helped by an upward revision of nominal GDP. Total public debt relative to nominal GDP will rise slightly in the coming years, but will gradually stabilise, in our view. In fact, the current legal framework requires the consolidation of public finances to continue.

Developments so far this year give hope of meeting the planned deficit

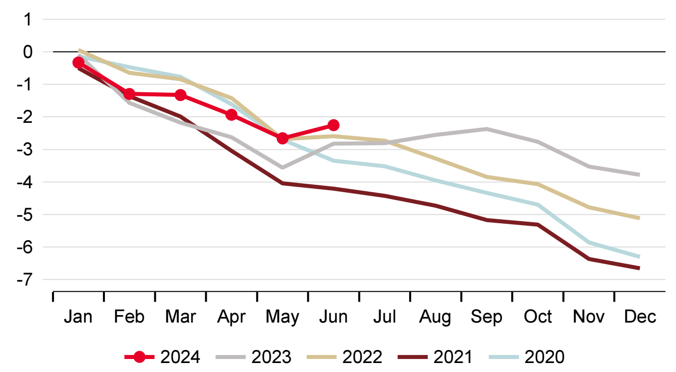
At the end of June, the state budget was running a deficit of CZK178.6bn. Compared to CZK210.4bn in May, it therefore narrowed by more than CZK30bn month-on-month. June is traditionally a month when the deficit does not worsen much or even improves, due to, among other things, seasonal collections of advance payments for corporate income tax. In a year-on-year comparison, the deficit for the first half of the year was CZK36.7bn shallower, which is related to higher revenues. Relative to nominal GDP, the state budget deficit in the first six months reached its lowest level since 2019, helped by the significant previous increase in the price level.

State budget balance (CZKbn, ytd cumulative)



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

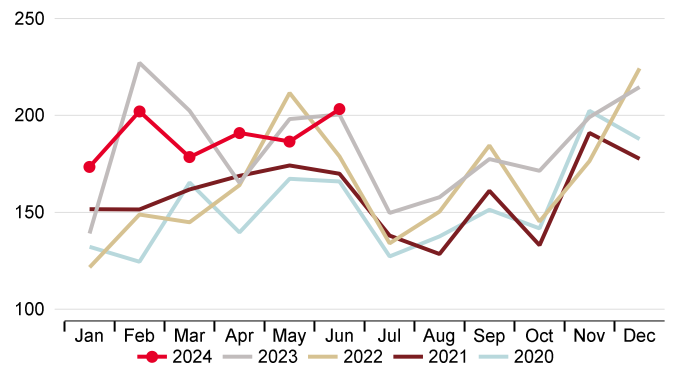
State budget balance (% GDP, ytd cumulative)



Source: Ministry of Finance, CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: Nominal GDP in 2024 according to the KB forecast.

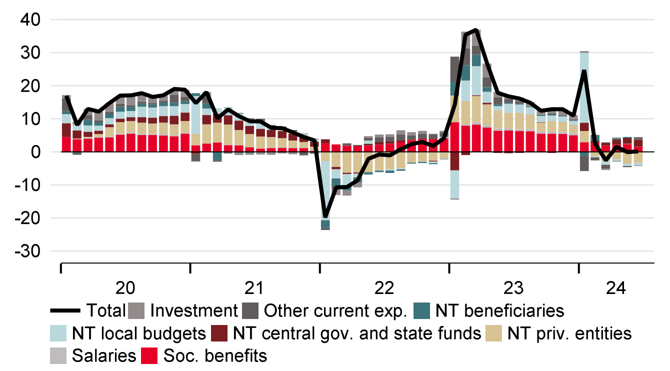
Expenditures were CZK2.2bn (0.2%) higher yoy at the end of June ytd. Compared to last year, social benefit spending rose (CZK17.2bn), reflecting the indexation of old-age pensions. Expenditure in the chapters of non-investment transfers to state funds (CZK17.3bn) or public health insurance funds was also visibly higher year-on-year due to an increase in state insured persons' contributions. Expenditure on servicing the national debt also increased by around 14% (CZK5.3bn) year-on-year. By contrast, non-investment transfers to businesses fell (by CZK37.2bn) as a result of last year's compensation for high energy prices.

State budget expenditure (CZKbn, non-cumulative)



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

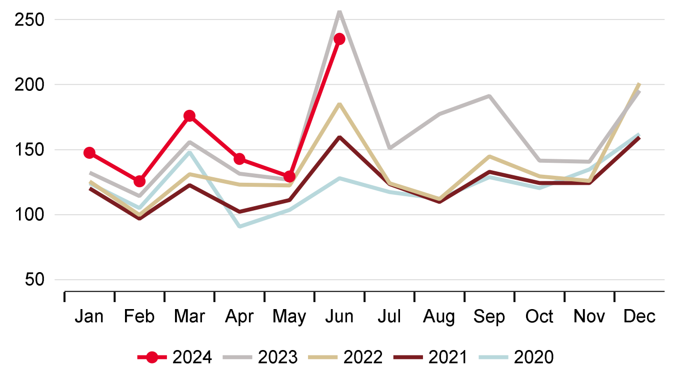
State budget expenditure (%, pp, yoy, ytd cumulative)



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

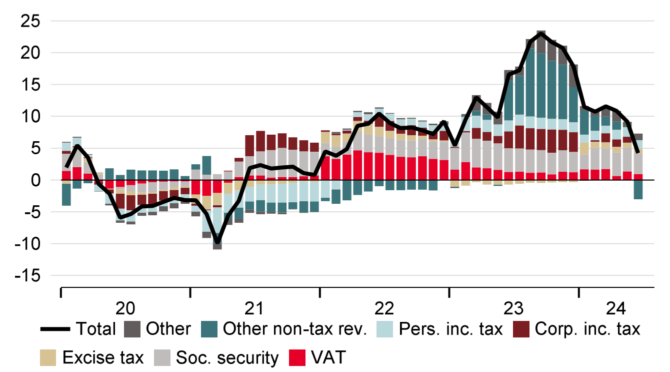
Revenues increased by CZK38.9bn (+4.2%) year-on-year in the first six months. The largest contributions were from social security contribution (CZK30.4bn), windfall profits tax (CZK18.2bn), personal income tax (CZK12.0bn) and VAT (CZK8.3bn). The positive development of the most significant social security contribution collection (+9% yoy) probably reflects both solid wage growth and tax changes effective from the beginning of this year (reintroduction of employee sickness insurance, increase in the minimum assessment base for self-employed persons). However, even this has not been enough to cover the costs of old-age pensions within the pension system. In fact, since the beginning of the year, these have been more than CZK30bn higher than the income from pension insurance premiums.

State budget revenue (CZKbn, non-cumulative)



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

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

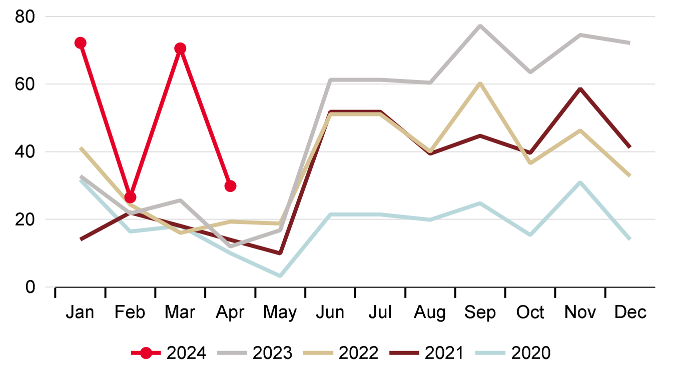


Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka
Note: other revenue includes EU funds for example

Despite the relatively high deficit reported for the first half of this year, we believe that the full-year state budget deficit of CZK250bn is still achievable. The consolidation package and the cancellation of measures related to high energy prices are contributing to its mitigation this year. However, the gradual growth of the domestic economy will also play a role, although it is likely to be much slower than the 2.3% envisaged by the Ministry of Finance when the budget was drawn up last August. In our view, the balance of risks is skewed more towards a deeper deficit, both in view of the aforementioned risk of lower economic growth and the discussed proposals to increase civil servants' salaries this year beyond the approved budget.

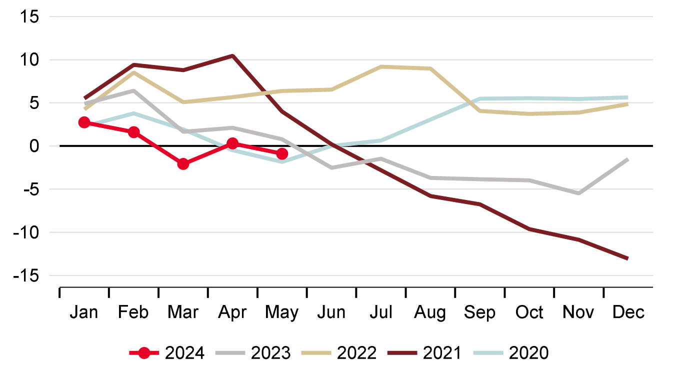
By the end of April, the municipal budgets were running a ytd surplus of CZK29.8bn. Year-on-year higher revenues (by CZK19.8bn, +8%) combined with only a slight increase in expenditure (by CZK1.9bn, 0.8%) resulted in a year-on-year increase in the positive balance by CZK17.9bn. The increase in revenue was related to an increase in own non-tax revenue. However, tax revenues also increased year-on-year, mainly due to a higher collection of corporate and individual income taxes in line with wage growth, as well as an increase in VAT collection reflecting increased household demand. The accumulation of municipalities' funds in bank accounts also continued this year. At the end of March, according to data from the Ministry of Finance, municipalities and regions had a total of CZK523.3bn in their current accounts, while their debt amounted to CZK88.5bn.

Municipal finances (CZKbn, ytd cumulative)



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

Health insurers' finances (CZKbn, ytd cumulative)



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

State budget deficit to fall to CZK235bn next year

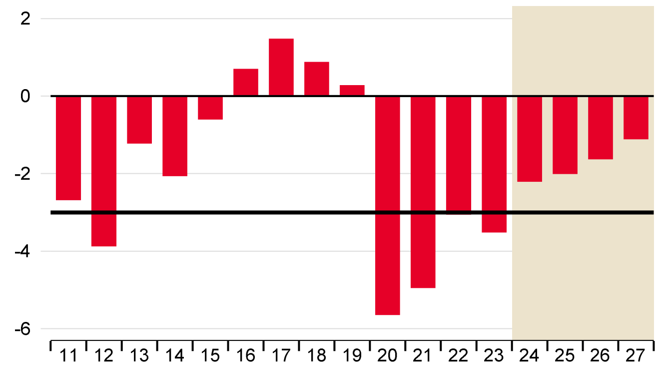
We expect the state budget deficit to decline moderately in 2025, in line with the MinFin's medium-term outlook. According to our estimates, the deficit should reach CZK235bn in 2025 and CZK210bn in 2026. However, the risk towards a deeper deficit next year is linked to the political cycle and the parliamentary elections.

Public finance forecasts

	2022	2023	2024f	2025f	2026f	2027f
Balance (% GDP)	-3.1	-3.5	-2.2	-2.0	-1.6	-1.1
Fiscal effort* (pp GDP)	0.9	-0.3	0.4	0.1	0.3	0.5
Public debt (CZKbn)	2 997.6	3 228.4	3 478.4	3 713.4	3 923.4	4 083.4
Debt ratio (% GDP)	42.5	42.3	44.0	45.3	45.8	45.6

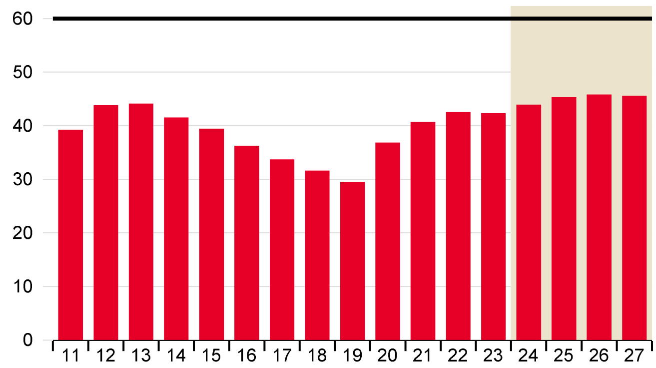
Source: CZSO, Macrobond, Ministry of Finance for published data, Economic & Strategy Research, Komerční banka
Note: fiscal effort is measured as the year-on-year change in the public finance balance, adjusted for the economic cycle and one-off operations on GDP in pp.

Public finance balance (% of nominal GDP)



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

Public debt (% of nominal GDP)



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

Public finance deficit safely below 3% of GDP

In our view, this year's public finances will end with a significantly lower deficit of 2.2% of GDP vs 3.5% of GDP last year. This is partly supported by the upward revision of nominal GDP.

This year, we expect the public finance deficit to ease significantly to 2.2% of GDP. The general government deficit as a whole should be lower again compared to the government budget. However, the traditionally surplus performance of municipalities will be partly offset by the deficit performance of the State Transport Infrastructure Fund. As a share of GDP, the deficit is expected to return below 3% of GDP for the first time since 2019. Next year, the public finance deficit will moderate to 2% of GDP, on our estimate. Public debt relative to GDP will grow by an average of 0.8pp per year over the 2024-2027 period to reach 45.6% of GDP in 2027, on our estimate. Compared our previous forecast, we expect both public deficits and public debt to be lower, driven mainly by the upward revision in the level of nominal GDP, which has been as high as +4% of GDP in recent history (see *Box 2* for details on the national accounts revision).

Structural imbalances in public finances persist, the law obliges the next government to consolidate. Although the consolidation package has reduced the mismatch between government revenues and expenditures, the general government structural deficit remains at around 2% of GDP. However, the statutory limits[6] on structural balances tighten by 0.5pp per year in the following years, from a baseline of 2.75% in 2024-2027[7]. The next government will therefore be required to continue consolidating public finances under the current version of the law.

[6] Act No. 23/2017 Coll. on the Rules of Budgetary Responsibility

[7] The limit is 2.25% of GDP in 2025, 1.75% in 2026 and 1.25% in 2027. From 2028 onwards, it is 1% of GDP.

Summary forecast table

	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	Q2 25	Q3 25	2023	2024	2025	2026	2027	2028
GDP and its breakdown														
GDP (real, yoy, %)	0.0	0.3	0.3	1.0	1.2	1.5	1.9	2.0	0.0	0.7	1.9	2.3	2.4	2.3
Household consumption (real, yoy, %)	-0.5	1.5	1.0	2.4	2.9	3.7	4.5	4.6	-2.9	2.0	4.2	2.7	2.2	2.2
Government consumption (real, yoy, %)	3.9	3.5	3.5	3.0	3.3	3.0	3.0	2.5	3.5	3.3	2.6	1.4	1.7	1.8
Fixed investments (real, yoy, %)	2.2	-0.7	-2.6	-1.9	-1.5	1.1	2.7	2.8	2.7	-1.7	2.4	3.0	2.7	2.5
Net exports (contribution to yoy)	3.9	2.3	1.9	1.3	-1.0	-1.6	-1.8	-1.3	2.6	1.1	-1.3	0.1	0.2	0.2
Inventories (contribution to yoy)	-5.0	-3.2	-2.0	-1.6	0.4	0.3	0.4	0.2	-2.7	-1.6	0.2	-0.1	0.1	0.2
Monthly data from the real economy														
Foreign trade (CZKbn)	48.3	83.6	69.8	14.2	15.3	68.7	38.1	-1.5	123.4	182.9	122.1	143.2	178.9	218.2
Exports (nominal, yoy, %)	-0.8	0.5	7.3	8.6	5.0	5.8	0.2	6.2	1.0	5.2	3.8	5.3	6.0	5.7
Imports (nominal, yoy, %)	-9.4	-3.4	4.5	7.1	8.3	7.6	3.0	7.8	-6.2	4.0	5.3	5.0	5.5	5.2
Industrial production (real, yoy, %)	-0.6	-1.0	-2.2	0.9	-0.6	0.7	2.1	2.1	-0.8	-0.7	1.8	2.7	2.6	2.2
Construction output (real, yoy, %)	-2.7	-6.4	0.5	0.8	-0.4	0.8	3.8	2.8	-2.6	-1.4	2.8	3.4	3.3	2.2
Retail sales (real, yoy, %)	0.1	3.4	4.8	4.7	4.6	3.8	3.9	3.9	-4.4	4.4	3.7	2.5	1.9	1.8
Labour market														
Wages (nominal, yoy, %)	7.1	7.0	7.3	7.6	7.6	7.0	6.5	6.1	8.0	7.4	6.2	4.7	4.3	4.4
Wages (real, yoy, %)	-0.6	4.8	4.6	5.5	5.8	4.7	4.7	4.2	-2.4	5.2	4.3	2.7	2.0	2.3
Unemployment rate (MLSA, %)	3.6	3.9	3.7	3.8	3.8	4.1	3.7	3.8	3.6	3.8	3.8	3.8	3.8	4.0
Unemployment rate (ILO 15+, %)	2.6	2.8	2.5	2.6	2.5	2.7	2.5	2.5	2.6	2.6	2.5	2.5	2.5	2.7
Employment (ILO 15+, yoy, %)	1.6	3.8	3.1	3.1	3.1	0.2	0.3	0.6	1.5	3.3	0.4	0.5	0.3	0.1
Consumer and producer prices														
CPI Inflation (yoy, %)	7.6	2.2	2.6	2.0	2.2	1.9	1.4	1.7	10.7	2.3	1.7	2.0	2.2	2.1
Taxes (contribution to yoy inflation)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Core inflation (yoy, %) (*)	3.9	2.8	2.4	2.2	2.1	1.8	1.5	1.6	7.6	2.4	1.7	2.0	2.1	2.0
Food prices (yoy, %) (*)	2.6	-1.2	0.0	-1.0	-0.4	2.1	1.7	2.9	10.0	-0.6	2.4	2.0	1.9	1.9
Fuel prices (yoy, %) (*)	-7.6	0.4	7.3	3.4	4.3	5.1	0.5	-3.5	-12.4	3.8	-1.3	-2.1	3.5	4.4
Regulated prices (yoy, %)	33.2	6.2	5.9	5.3	6.0	-0.1	-0.3	0.9	27.8	5.8	0.6	2.2	2.1	2.0
Producer prices (yoy, %)	0.8	-0.9	1.1	1.0	0.7	0.1	0.7	0.4	5.3	0.5	0.3	0.9	1.7	1.8
Financial variables														
2W Repo (%, average)	7.0	6.4	5.4	4.6	4.1	3.6	3.5	3.5	7.0	5.1	3.5	3.5	3.5	3.5
3M PRIBOR (%, average)	7.0	6.2	5.3	4.8	4.3	3.9	3.8	3.8	7.1	5.2	3.8	3.8	3.8	3.8
EUR/CZK (average)	24.5	25.1	25.0	25.2	24.9	24.7	24.6	24.5	24.0	25.1	24.6	24.3	24.1	23.9
External environment														
GDP in EMU (real, yoy, %)	0.2	0.4	0.8	1.1	1.4	1.5	1.3	1.3	0.6	0.9	1.4	1.3	1.1	1.1
GDP in Germany (real, yoy, %)	-0.2	-0.2	0.1	0.2	1.0	1.1	1.1	1.1	0.0	0.3	1.1	1.0	1.0	1.0
CPI in EMU (yoy, %)	2.7	2.6	2.5	2.2	2.3	2.3	2.1	1.9	5.5	2.4	2.0	1.8	1.8	2.0
Brent oil price (USD/bbl, average)	86.0	82.7	85.6	85.0	82.5	79.4	76.3	75.0	82.5	84.0	75.2	73.1	75.0	75.9
EUR/USD (quarter eop, year average)	1.08	1.09	1.08	1.09	1.11	1.12	1.14	1.14	1.09	1.09	1.14	1.17	1.18	1.18

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

Czech IRS market and government bonds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Decline in market interest rates may be over

Koruna market interest rates have declined notably since the beginning of June, supported by domestic factors and developments abroad. Overall, however, we believe that there are forces in place to prevent them falling further. Across the curve, we may get a partial correction of the recent decline in the near term, followed by only a slight decline at the shorter end of the curve. At longer maturities, the higher CNB terminal rate and, especially next year, concerns about the deteriorating fiscal positions of major economies should contribute to a slight rise in koruna market interest rates. Czech government bonds could, however, hold up relatively well in this unfavourable environment. A larger rise in their yields should be prevented by the ongoing consolidation of public budgets, which is also enshrined in future legislation. We estimate that gross CZGB issuance will remain close to current levels for the rest of the year. Next year, it will increase slightly as a result of higher maturing debt repayments but in net terms should remain similar to this year.

Czech IRS market: Gradual normalisation of koruna curve

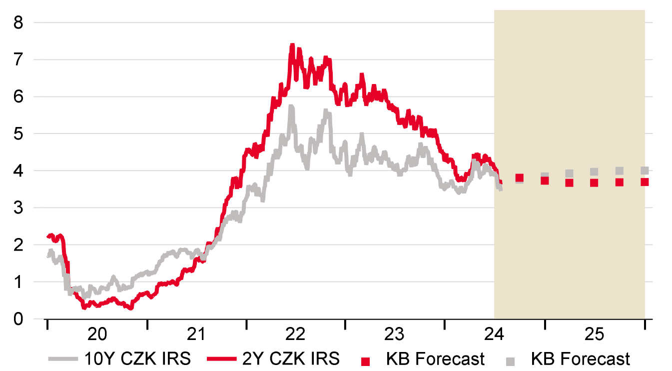
In our view, there is only very limited scope for further reductions in koruna market interest rates. After an initial correction, shorter-maturity rates could fall slightly. Conversely, the longer end of the curve could rise somewhat, prompted by foreign developments.

The koruna market interest rate curve has fallen significantly since the beginning of June, while the inversion of the curve has continued to ease. Global developments, including the renewed disinflationary trend in the US, and domestic factors both played a role. Among the domestic factors, the CNB's June meeting, which saw a 50bp cut in the repo rate, was not fully priced in by the financial markets. CZK rates were pushed even lower by a surprisingly sharp drop in domestic yoy inflation in June to the central bank's 2% target as well as a shift in the CNB board members' communication regarding the neutral repo rate. Prior to the May meeting, CNB officials had suggested that the neutral rate could be in the range of 3.5-4%, but according to recent statements they now see it more at 3-3.5%.

Despite the CNB's continued rate cuts, we do not think shorter koruna market interest rates will fall much further. On the contrary, they could soon reverse part of their recent decline. For the CNB's August meeting, we are leaning more towards a slowdown in the pace of rate cuts to 25bp given board members' statements, while market contracts price in a 25-50bp cut. The new CNB forecast (published at the August meeting) might also provide an upward impulse to the koruna curve, as the CNB's staff economists signalled at the June meeting that the new information generally pointed to a slightly higher interest rate path than the spring forecast. As in our April *Czech Economic Outlook* report, we still see the terminal repo rate at 3.5%, higher than the market, which currently sees it near 3%. In the US, the rise in the Fed's key long-run median dot-plot rate has also been evident recently.

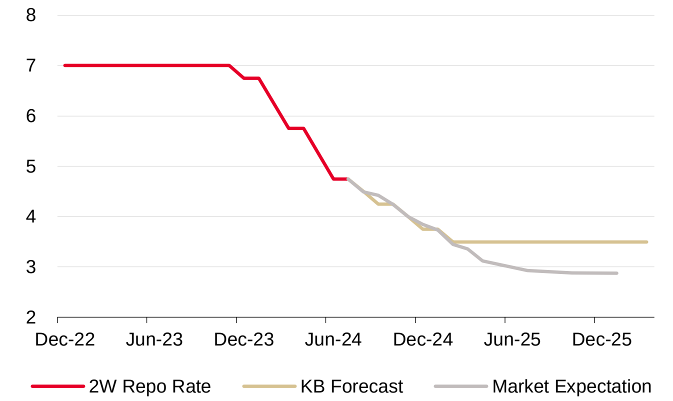
For longer maturities, we expect koruna market interest rates to stabilise slightly above current levels. This should mainly be the result of a higher CNB terminal rate, combined with global factors that argue for a slight increase in longer-term interest rates, especially next year, in connection with a rise in the term premium. In our view, this will only be partly offset by subdued domestic inflation, which we expect to fall below the central bank's target next year. The less predictable and inflationary effects of the policies announced by Donald Trump, the current favourite to be the next US president according to polls and the market, could contribute to a rise in longer-dated dollar rates and an increase in the slope of the curve. Longer-term global interest rates in the euro area and US may not show a clear direction until year-end but should tend to rise next year as political uncertainty fades (post US presidential election, formation of government in France) and, especially in the case of bonds, as attention returns to fiscal policy, high deficits, rising debt and the cost of servicing it.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 24 July 2024 (%)



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

In our view, the key risk to koruna rates is the level of the CNB terminal rate. The expected neutral rate is largely reflected along the entire curve, and the increased uncertainty about its level may itself cause, in addition to higher volatility, an increase in risk premia for longer-maturity rates. We expect the repo rate to reach an assumed equilibrium level of 3.5% in 1Q25. The koruna curve should thus already have a positive slope next year.

CZK IRS outlook (end of period, %)

	3Q24f	4Q24f	1Q25f	2Q25f
2y	3.80	3.75	3.65	3.65
5y	3.65	3.70	3.80	3.85
10y	3.75	3.85	3.90	3.95

Source: Economic & Strategy Research, Komerční banka

Euro market still offers lower interest rates, CZK forwards look attractive

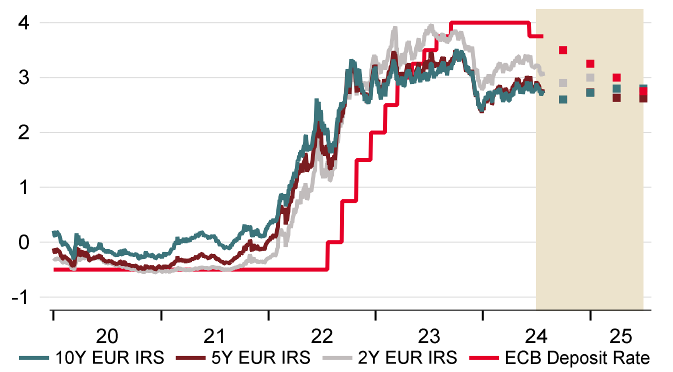
Interest rate hedging conditions in the koruna market have improved notably of late across maturities. Moreover, even lower rates can be achieved in the forward market compared to spot IRS, which makes them attractive from our perspective given that we see relatively limited potential for further declines. **Visibly lower interest rates compared to the koruna still prevail in the euro area.** While we expect euro market interest rates to fall slightly temporarily, we also perceive a risk that the ECB will eventually cut rates this year by less than additional 50bp that we (like the market) assume in our baseline scenario. Moreover, we expect euro swaps to increase next year.

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

Forward	Maturity 1Y	2Y	3Y	5Y	10Y
Spot	3.98	3.61	3.45	3.34	3.45
3M	3.69	3.41	3.31	3.26	3.40
6M	3.42	3.24	3.20	3.20	3.37
1Y	3.07	3.09	3.11	3.16	3.35
2Y	3.11	3.13	3.15	3.25	3.42
3Y	3.15	3.16	3.21	3.35	3.48

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 24 July 2024

Euro area rates (%)



Source: Bloomberg, SG Cross Asset Research/Economics

Gross CZGB issuance likely to rise next year, and net to remain roughly flat

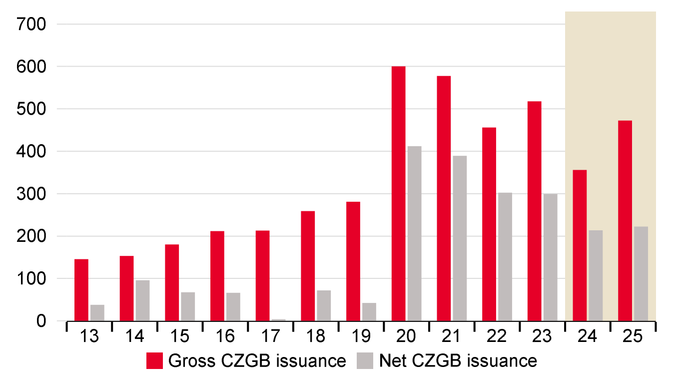
Lower debt repayments and the easing of the state budget deficit are contributing to significantly lower year-on-year issuance activity this year. We expect the state budget deficit to head towards CZK250bn this year after last year's CZK288.5bn. Combined with other financing needs, especially maturing bond repayments, we estimate gross issuance of CZK355.8bn this year. CZGB supply would thus fall by CZK162.2bn yoy this year, in our view. For 3Q24, the Ministry of Finance has kept the indicative volume of CZGB offered in primary auctions at CZK75bn, like in 1Q and 2Q, and for 2H24 as a whole it indicates CZK150-250bn. Thus, we assume that CZGB supply will not decrease significantly over the rest of this year and could on the contrary increase slightly given that about half of our estimated full-year volume was covered as of 20 July. According to the MinFin, issuance of a euro-denominated bond is also still in play this year, with the MinFin preferring to use domestic issuance to cover foreign currency financing needs. Next year, assuming the state budget deficit eases to CZK235bn, gross issuance should rise to CZK472.3bn, mainly due to higher repayments, according to our estimates. In net terms, however, it should increase only slightly.

Funding programme and issuance activity (CZKbn)

	2024		2025	
	MinFin	KB	MinFin	KB
State budget deficit	252.0	250.0	235.0	235.0
Transfers and other operations of state financial assets	4.4	4.4	1.9	1.9
T-bonds denominated in local currency redemptions	142.0	142.0	250.0	250.0
T-bonds denominated in foreign currency redemptions	25.2	25.2	0.0	0.0
Redemptions and early redemptions on savings bonds	7.5	7.5	11.2	11.2
Money market instrument redemptions	44.8	44.8	0.0	20.0
Redemption of T-bills		9.3		20.0
Redemption of other money market instruments		35.5		0.0
Repayments on credits and loans	0.6	0.6	0.6	0.6
Total financing needs	**476.5**	**474.5**	**498.6**	**518.7**
Money market instruments		50.0		20.0
T-bills		20.0		20.0
Other money market instruments		30.0		0.0
Gross issuance of CZK T-bonds on domestic market		355.8		472.3
Gross issuance of EUR T-bonds on domestic market/eurobond		25.2		0.0
Gross issuance of government savings bonds		5.0		1.4
Received credits and loans		23.5		10.0
Financial asset and liquidity management		15.0		15.0
Total financing sources		**474.5**		**518.7**
Gross borrowing requirement		**459.5**		**503.7**
Net CZGB issuance		**213.8**		**222.3**

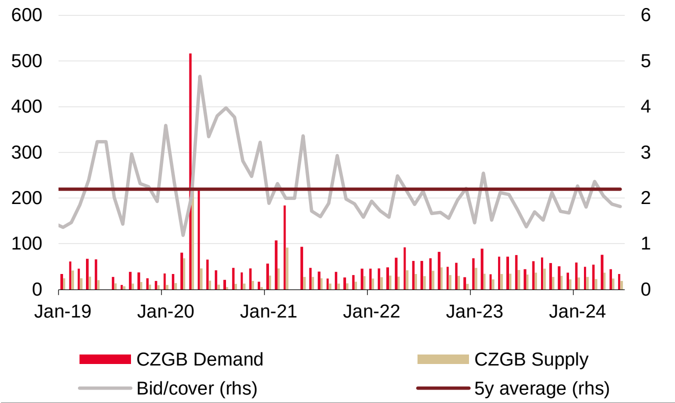
Source: MinFin, Economic and Strategy Research, Komerční banka

CZGB issuance (CZKbn)



Source: MinFin, Economic and Strategy Research, Komerční banka

CZGB primary market (CZKbn)



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

CZGB yield forecast (end of period)

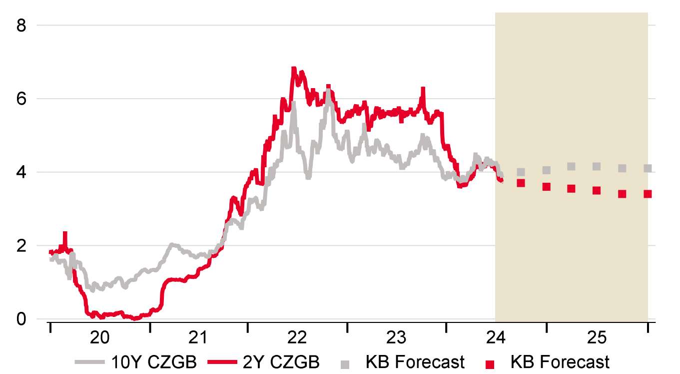
	3Q24f	4Q24f	1Q25f	2Q25f
2y CZGB yield (%)	3.70	3.60	3.55	3.50
5y CZGB yield (%)	3.85	3.85	3.85	3.85
10y CZGB yield (%)	4.00	4.05	4.15	4.15
10y CZGB ASW (bp)	25	20	20	20

Source: Economic & Strategy Research, Komerční banka

Fiscal consolidation keeps bond yields at bay

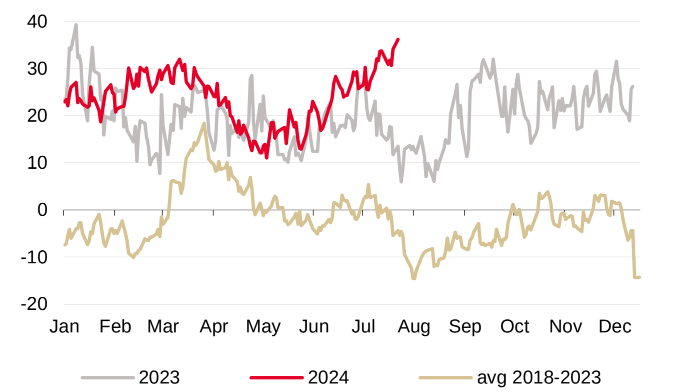
Like the CZK IRS, the CZGB yield curve has fallen sharply since the beginning of June. Again, this probably reflects the disinflationary tendencies in the domestic economy and the CNB's more dovish policy than expected, as well as developments in global bond markets. Meanwhile, the ongoing implementation of the domestic state budget did not look very positive until June, when favourable seasonality helped. However, given that we still expect this year's planned deficit to be met and that the law requires further consolidation in the coming years so that the structural deficit of public finances reaches 1% of GDP in 2028, we believe that spreads between market interest rates and bonds could gradually narrow. Overall, as in the case of market interest rates, yields at the shorter end of the yield curve should tend to fall slightly, while the longer end of the yield curve could move up somewhat as foreign yields gradually rise. In our view, the CNB's higher terminal policy rate compared with the past and market expectations should also contribute to this.

CZGB yield forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

10y CZGB ASW (bp)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

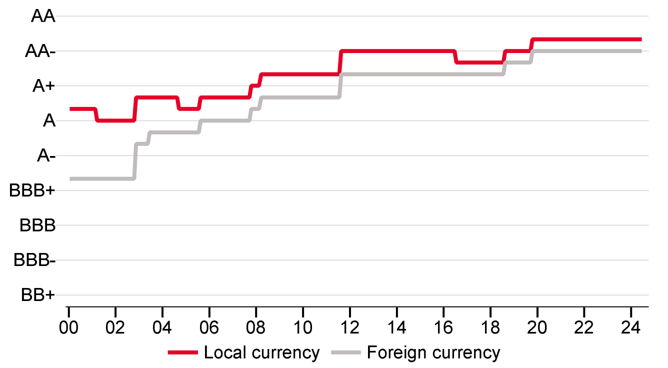
The Czech Republic's rating remains unchanged, with stable outlooks from all major agencies. The latest change came in February, when Fitch, like Moody's last November, upgraded the outlook from negative to stable. Last year's outlook downgrade was mainly related to the energy crisis and deteriorating public finances. Both Fitch and Moody's praised the Czech government's consolidation efforts and the reduced Russia energy dependence in their latest assessments. Fitch also cited as positive the moderation of inflation and the lack of impact of the pandemic and energy shock on the long-term growth prospects of the domestic economy. The Czech Republic still has the best credit rating of any CEE country.

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	11.10.2024
Moody's	Aa3	STABLE	Aa3	STABLE	26.07.2024
Fitch	AA-	STABLE	AA-	STABLE	16.08.2024

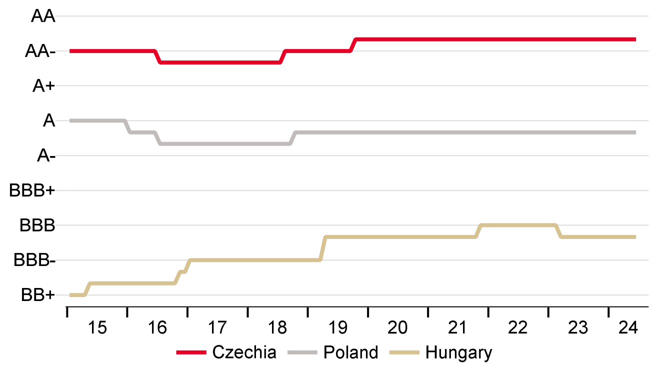
Source: Bloomberg , Economic and Strategy Research, Komerční banka

Czech Republic's rating (average of Fitch, S&P and Moody's)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Rating in CE3 – local currency (avg. of Fitch, S&P and Moody's)



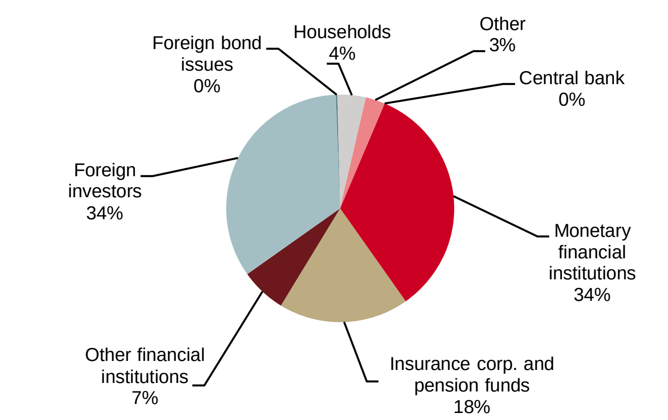
Source: Bloomberg, Economic and Strategy Research, Komerční banka

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
0.00	Dec-24	0.4	0.0	34%	4.31	11	-22	3.87	-34	8	-26	-85		-28	1.9	21	-17.2	1	-74.6	24
1.25	Feb-25	0.5	0.0	100%	4.13	-8	-7	3.83	-24	4	34	-85		-24	3.2	1	-4.2	5	-53.7	23
2.40	Sep-25	1.1	0.0	85%	3.78	-5	-45	3.45	-34	6	7	-57		-33	1.6	24	13.9	23	-33.1	22
6.00	Feb-26	1.5	0.0	71%	3.62	0	-44	3.39	-19	7	16	-55		-19	2.7	2	19.7	24	-26.4	21
1.00	Jun-26	1.8	0.0	100%	3.76	-6	-43	3.52	0	6	11	-37		4	1.7	22	-0.2	13	-18.8	20
0.25	Feb-27	2.4	0.0	104%	3.68	-7	-47	3.46	9	5	15	-27		10	2.1	18	-1.5	10	-14.7	19
2.50	Aug-28	3.7	0.0	94%	3.57	-11	-53	3.34	13	5	9	-11		13	2.2	13	-2.1	8	-8.9	18
5.50	Dec-28	3.8	0.0	70%	3.53	-12	-53	3.35	11	5	6	-15		11	2.3	11	0.7	18	-8.5	17
5.75	Mar-29	4.0	0.0	121%	3.56	-12	-51	3.39	16	4	10	-6		16	2.6	5	-2.7	7	-7.3	16
2.75	Jul-29	4.6	0.0	100%	3.58	-12	-51	3.36	19	2	10	-9		19	2.4	9	-4.7	3	-6.0	15
0.05	Nov-29	5.2	0.0	58%	3.56	-12	-51	3.26	11	4	6	-5		17	1.7	23	-1.9	9	-5.0	14
0.95	May-30	5.5	0.0	100%	3.61	-12	-50	3.27	16	4	7	-1		18	2.1	17	-4.7	4	-4.1	12
5.00	Sep-30	5.1	0.0	101%	3.57	-13	-53	3.30	17	4	6	-4		18	2.4	10	0.5	17	-4.3	13
1.20	Mar-31	6.1	0.0	100%	3.63	-13	-48	3.25	16	3	9	-4		18	2.0	20	-2.7	6	-2.8	8
6.20	Jun-31	5.7	0.0	72%	3.62	-14	-47	3.37	22	2	10	-4		22	2.6	7	0.1	15	-3.1	9
1.75	Jun-32	7.1	0.0	100%	3.69	-12	-43	3.25	19	4	9	0		20	2.1	19	0.4	16	-1.6	6
4.50	Nov-32	6.6	15.0	62%	3.73	-12	-43	3.37	27	3	11	1		27	2.6	4	-0.3	12	-1.8	7
3.00	Mar-33	7.3	10.9	36%	3.76	-11	-43	3.33	26	3	10	3		27	2.1	15	-0.5	11	-1.3	3
2.00	Oct-33	8.0	0.0	100%	3.76	-11	-41	3.27	21	3	11	1		22	2.2	14	4.2	22	-1.1	2
4.90	Apr-34	7.7	8.3	58%	3.80	-12	-41	3.42	32	4	13	4		32	2.5	8	3.1	21	-1.3	4
3.50	May-35	8.8	11.4	74%	3.86	-10	-35	3.42	32	6	14	3		32	2.6	6	2.4	19	-1.5	5
4.20	Dec-36	9.3	0.0	100%	3.85	-10	-35	3.47	32	7	16	3		32	2.6	3	3.1	20	-3.2	10
1.95	Jul-37	11.0	4.6	40%	3.90	-11	-37	3.40	30	5	14	5		32	2.1	16	-5.6	2	-3.6	11
1.50	Apr-40	13.2	2.2	55%	3.98	-11	-32	3.45	31	6	16	5		34	2.3	12	0.0	14	0.0	1

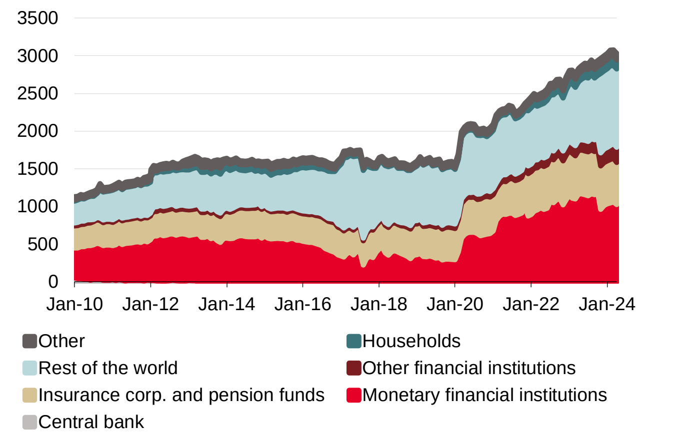
Source: Economic & Strategy Research, Komerční banka; Note: more details in CZGB Auction Alerts

Holdings of CZK government debt (May 2024)



Source: MinFin, Economic & Strategy Research, Komerční banka

Holdings of CZK government debt



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech FX market

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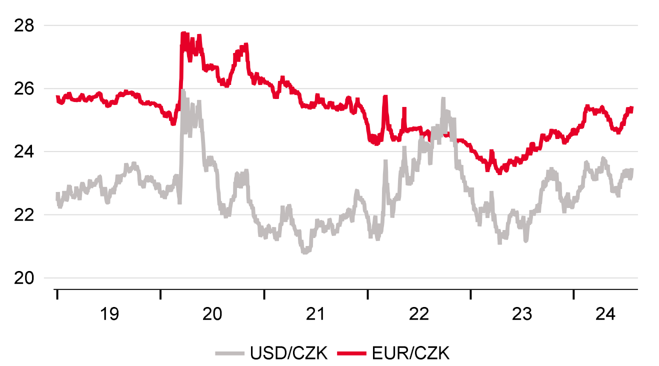
The koruna is looking towards better times

The weakening of the koruna against the euro since roughly the beginning of June is probably coming to an end. We expect the gradual recovery of the Czech economy, together with a slowdown in the pace of domestic monetary easing and a higher CNB terminal rate, to favour the koruna's appreciation by the end of the year. Emerging market currencies should also generally benefit from the start of interest rate cuts in the US this year, which we believe will be accompanied by significant US dollar outflows. We therefore expect the koruna to return to below EURCZK 25 vs the euro later this year and continue to strengthen next year. Overall, however, the risks to our forecast are concentrated more towards a weaker koruna.

The koruna is close to its weakest level since the beginning of the year in July

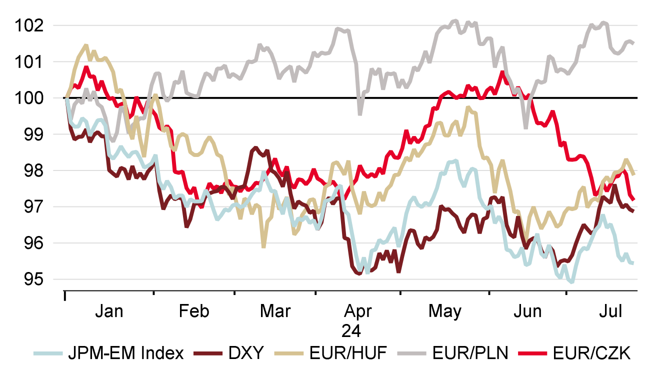
After the latest bout of depreciation, the ytd performance of the koruna has moved closer to other emerging market (EM) currencies. The Czech currency has already essentially erased the gains it made vs the euro in April and May, despite the recent spillover of investors from the US dollar into EM currencies. This development in global FX markets probably reflected the renewed disinflationary trend in the US and renewed confidence in Fed interest rate cuts beginning this year. Faster economic growth in the US and higher dollar interest rates, which have so far been a major attraction for investors, will in our view begin to fade, leading to a significant unwinding of long dollar positions. The catalyst for a change in sentiment in the global FX markets should be the start of monetary easing by the Fed in September. Following this, we expect the US dollar to depreciate by around 2% by the end of this year, both in effective terms through the lens of the DXY index and vs the euro (to EURUSD 1.11). The greenback should then weaken further next year, supporting the appreciation of EM currencies.

CZK exchange rates



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Performance of CE currencies (1. 1. 2024 = 100)



Source: Bloomberg, Economic and Strategy Research, Komerční banka
Note: a value above 100 indicates an appreciation of the CZK, PLN or HUF against the EUR or the Emerging Market Currency Index (JPM-EM), or a weakening of the Dollar Index (DXY) from 1 January 2024.

We have revised our EURCZK forecast to slightly higher levels in the near term. This was due to both the weaker performance of the Czech economy and a narrower interest rate differential. By contrast, we expect the koruna to be slightly stronger from the end of this year, mainly due to the anticipated US dollar depreciation.

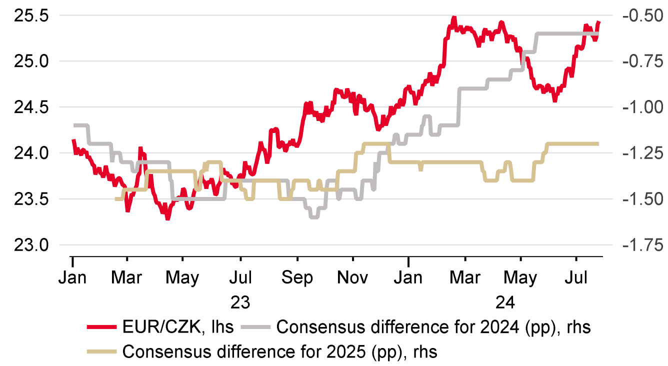
Interest rate differential as a key factor

The temporary decoupling of the koruna from the interest rate differential related to positive market sentiment is over. The strengthening of the koruna to EURCZK 24.55 in early June was not supported by the widening of the koruna-euro market interest rate differential, which we believe subsequently contributed to the correction back to EURCZK 25. This was then compounded by a 50bp cut in monetary policy rates at the June CNB meeting, which was not fully priced in by the markets. The June inflation print, which surprisingly showed inflation slowing down to the CNB's 2% target, also contributed to a further narrowing of the interest rate differential, and thus to koruna depreciation in July. In our view, however, the depreciation pressures related to the interest rate differential should not escalate any further. In fact, the interest rate differential has the potential to widen in conjunction with a fall in euro rates and a rise in CZK IRS if the CNB slows down the pace of interest rate cuts at its August meeting. From this perspective, the fact that the financial markets are already pricing the CNB's terminal rate at around 3%, while we (as we described in our April *Czech Economic Outlook*) are leaning more towards 3.5%, could work in the koruna's favour.

EUR/CZK and interest rate differential

Source: Bloomberg, Economic and Strategy Research, Komerční banka

EUR/CZK and GDP growth differential between the euro area and the Czech Republic



Source: Bloomberg, Economic and Strategy Research, Komerční banka
Note: Bloomberg consensus difference: euro area-Czech Republic.

Growth in the domestic economy should significantly outperform the euro area. According to the market consensus, this gap should widen over time, with euro area GDP expected to grow 1.2pp slower than the Czech economy next year in full-year terms. We also expect higher growth in the domestic economy, although in our baseline scenario the growth differential is more modest next year (c.0.5pp). The equilibrium exchange rate was slightly above EURCZK 25 in 2Q24, according to our model. As the Czech economy resumes convergence, we expect it to gradually decline. A possible increase in the volume of sales from the CNB's foreign exchange reserves, which has been close to EUR300m per month since last September, could also have a stabilising effect on the koruna exchange rate. The central bank's foreign exchange reserves stood at EUR136.9bn at the end of June this year. Relative to the size of the economy, the Czech Republic's foreign exchange reserves amount to more than 40% of annual nominal GDP, which is among the highest levels in the world on this basis.

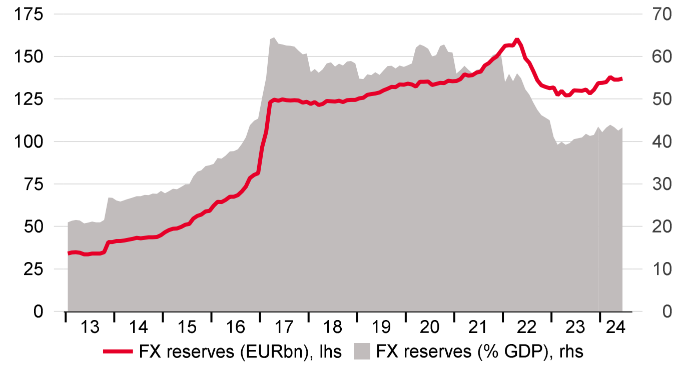
Overall, therefore, we do not see much room for the koruna to weaken further against the euro. In our view, both improving domestic economic fundamentals, accompanied by the CNB's only gradual monetary easing, and developments on the global FX markets should in fact contribute to its gradual appreciation.

Koruna exchange rate forecast (end of period)

	3Q24f	4Q24f	1Q25f	2Q25f
EUR/CZK	25.10	24.85	24.65	24.55
USD/CZK	23.05	22.40	22.00	21.50
EUR/USD	1.09	1.11	1.12	1.14

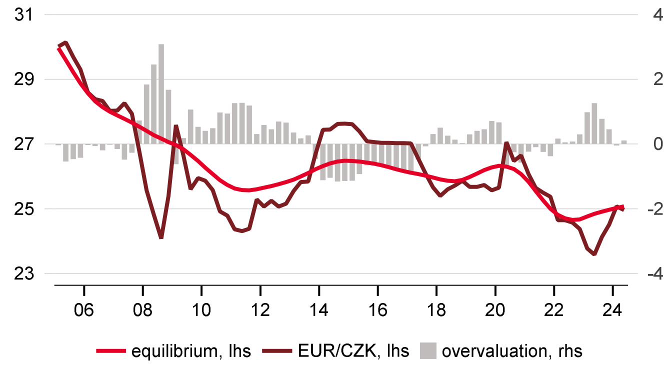
Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

CNB's FX reserves



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

Equilibrium EUR/CZK exchange rate

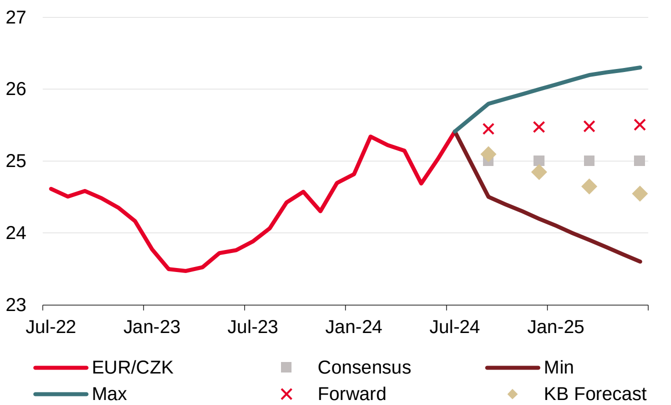


Source: Macrobond, Economic and Strategy Research, Komerční banka
Note: the estimated equilibrium exchange rate is based on a model of the economy's internal (output gap) and external (net export-to-GDP gap) equilibrium.

Balance of risks is tilted towards a weaker koruna

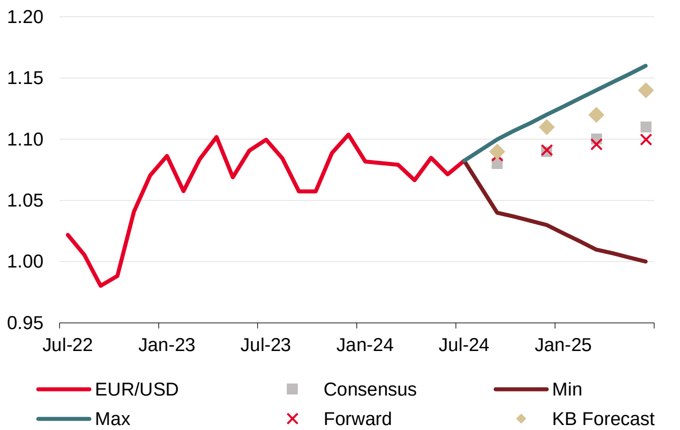
The risks to the interest rate differential are skewed towards a weaker koruna compared to our baseline scenario. In our outlook for ECB monetary policy rates, where we expect two more rate cuts this year (in line with the market), we perceive a risk of less monetary easing, with a possible pause in December. On koruna market interest rates, in the short term, we identify the possibility of a 50bp cut in CNB rates in August (vs 25bp in our baseline scenario) and, in the medium term, also a lower-than-our-forecast terminal repo rate (3.5%). **In the same direction, there is also a risk that the US dollar will be stronger than we forecast, which could put pressure on EM currencies.** The general uncertainty remains the speed of the domestic economic recovery amid the continued lacklustre performance of the German economy and the geopolitical situation (see *Box 1*).

Expected EUR/CZK path, Bloomberg consensus (as of 24 July 2024)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

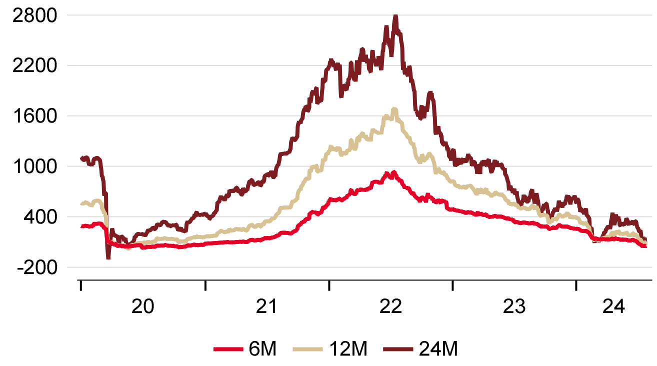
Expected EUR/USD path, Bloomberg consensus (as of 24 July 2024)



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

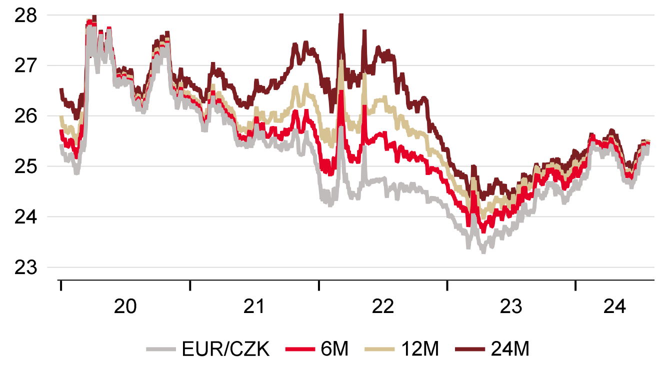
The weaker koruna has improved hedging conditions for exporters. As mentioned above, although the interest rate differential may widen slightly, the spot exchange rate should not weaken any further. On the contrary, we expect the koruna spot to strengthen gradually against the euro. From the perspective of exporters, we therefore see the current forward exchange rate levels as relatively attractive for potential hedging against exchange rate risk.

Forward points



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Forward vs spot exchange rate: EUR/CZK



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Banking sector

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Mild credit uplift of meagre economic growth

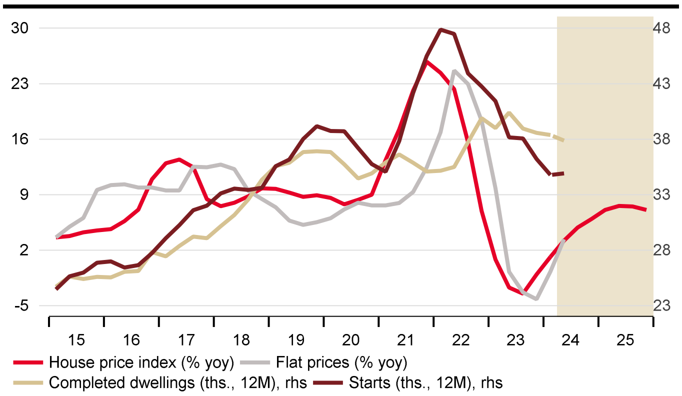
The credit impulse continues to increase significantly for households, while corporate lending remains weaker. It should be further bolstered by the continued decline in interest rates, significantly looser financial conditions and renewed business and household confidence. However, it is likely to still be hampered by tight monetary policy and the high level of own funds. Mortgage activity should continue to pick up as the slight decline in mortgage rates provides a mild boost. This is likely to underpin the acceleration of house price growth, helped by pent-up demand and weak construction. Corporate investment appetite remains weak, but it should see some improvement in 2H24 thanks to looser financial conditions and further monetary easing. Lower interest rates are set to contribute to slowing deposit growth, which may fail to outpace credit growth this year. Prevailing low credit default rates demonstrate robust private sector financial health, which should help to accelerate economic growth, once business confidence is regained more firmly.

Mortgage lending and real estate prices poised for strong growth

Falling interest rates, bolstered mortgage activity and the release of pent-up demand should contribute to accelerating house price growth.

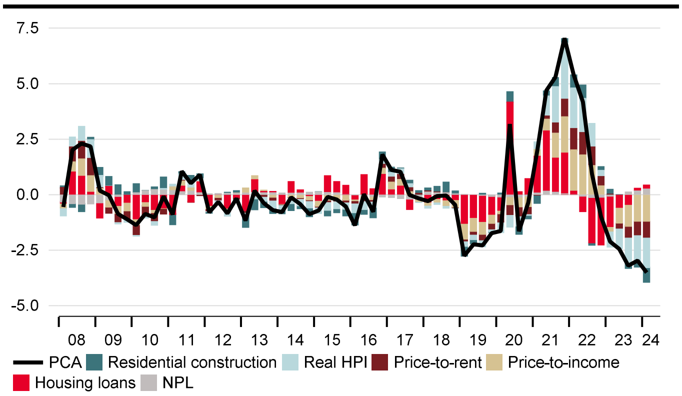
The renewed growth in real estate prices is set to strengthen further this year. Following a slight cooling last year, house prices are already rising at a fairly strong pace. The house price index (HPI) rose 0.9% qoq in 1Q24, the same as in 4Q23, and we expect growth to have accelerated to 1.3% qoq in 2Q, bringing the yoy gain to 3.2%. We expect growth to strengthen further in the rest of the year, boosted by falling interest rates, the release of pent-up demand and renewed household confidence. By year-end, we expect house prices to rise by 5.9% yoy. On average, we estimate a rise of 3.8% this year and 7.3% next year. The pick-up in pace this year is also indicated by the 2.2% qoq increase in asking prices for flats in 2Q (+3.4% yoy). The release of pent-up demand is likely to be aided not only by improved financing conditions, but also by the high level of excess household savings, which do not represent a boost solely to consumption. Strong demand, paired with limited residential construction over the past two years, is likely to underpin strong house price growth in the future. Despite a slight improvement over the past two years, housing affordability – measured by the house price-to-income ratio – remains markedly deteriorated. This, in turn, may put a brake on price growth. Moreover, our combined expectations for house price growth and wage growth suggest no further improvement. Alas, fundamentally strong domestic demand for own housing and insufficient residential construction will likely instead push towards a further decline in housing affordability.

House price growth set to accelerate up to 6% yoy



Source: CZSO, Macrobond. Economic & Strategy Research, Komerční banka
Note: data on dwelling completions and starts (as of May 2024) is extrapolated and only indicative for 2Q24. 12M denotes 12-month trailing sum.

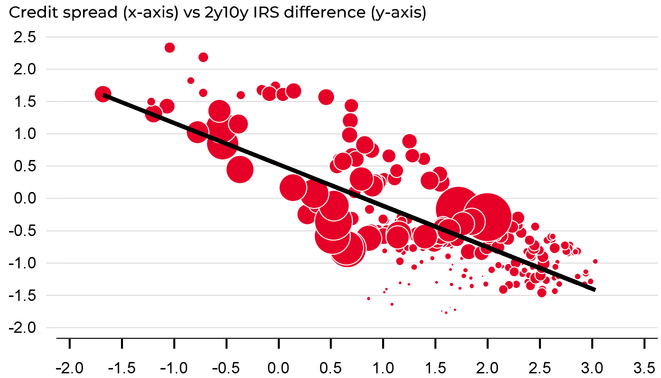
Composite housing index shows signs of stabilisation



Source: Economic & Strategy Research, Komerční banka
Note: own calculations; PCA = principal component analysis vector. The composite index is the result of Principal Component Analysis (PCA). Construed as per Cár, M., & Vrbovský, R. (2019, March). *Composite index to assess housing price development in Slovakia.* https://www.nbs.sk/_img/documents/_publik_nbs_fsr/biatec/rok2019/03-2019/05_biatec19-3_car.pdf.

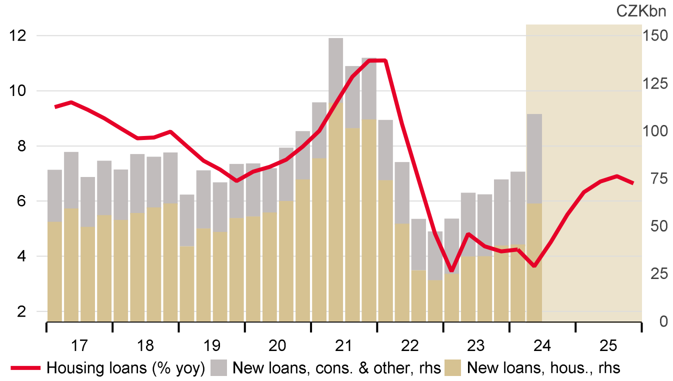
Mortgage lending continues to gain strong momentum. The volume of new loans for housing has increased 73% ytd, helped by last year's low comparison base. Still, on a qoq basis, mortgage lending is clearly strengthening, despite a limited interest rate decline amid fairly volatile fluctuations in market interest rate swaps (IRS). Mortgage rates have yet to reflect the recent sharp decline in IRS, similar to the period at the start of this year, which was followed by a steep rise. Mortgage credit spreads have widened amid the drop in IRS. Given our view on the gradual rise of IRS from its current low levels and the prevailing inversion of the curve and its slow reversal, we see limited scope for a reduction in mortgage rates.

Mortgage credit spreads over IRS and 2y10y yield spread (pp)



Source: CNB, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka
Note: The size of the bubbles represents the volume of new loans. Credit spread is computed as the difference between the realised interest rate on housing loans and the weighted average of corresponding market IRS (only an approximation).

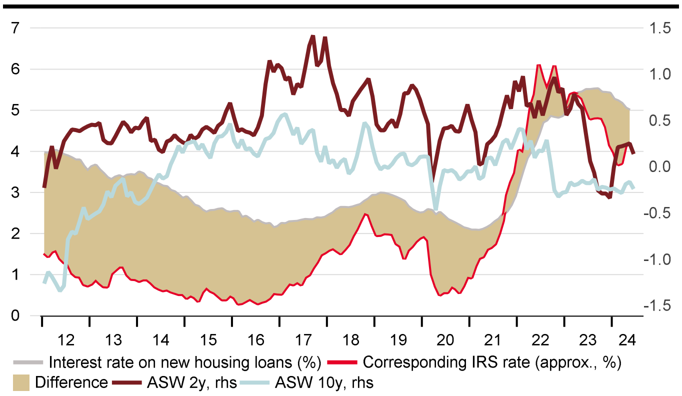
Mortgage lending on track to accelerate further



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

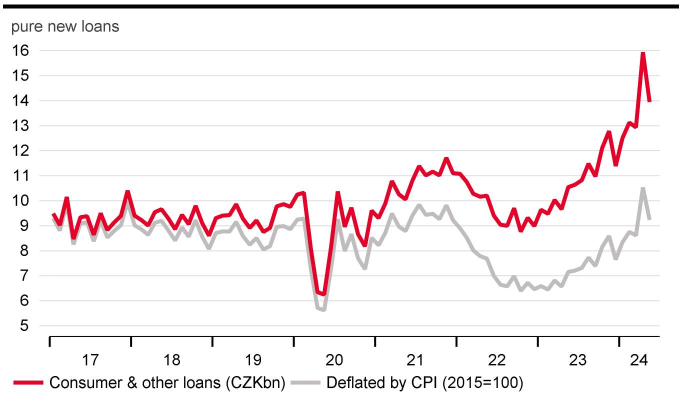
Nonetheless, we still foresee a slight decline in mortgage rates, which should strengthen activity in 2H24. The Consumer Credit Act amendment, effective from September and which will introduce penalties for early repayment, is unlikely to further affect credit supply. Strong 1H23 activity could partly reflect frontloading before the introduction of sanctions. Longer fixed-terms rates are likely to remain elevated due to refinancing concerns. The bulk of mortgage activity should permanently shift to the front-end of the curve, vs the longer-end preference in the past. We estimate the mortgage market to grow 5.5% in 2024 and even faster in 2025 at 6.6%.[8] The volume of new loans should exceed CZK200bn this year, with CZK81bn already closed in the first five months.

Normalisation of mortgage rate spreads over IRS (%, pp)



Source: CNB, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka
Note: ASW of corresponding CZGBs.

Consumer lending has significantly strengthened in real terms



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

[8] Unless otherwise stated, values refer to the end of the period.

Consumer financing set to grow strongly on the back of increased mortgage activity.

Consumer financing strengthens on the tail of higher mortgage activity

The increase in consumer finance this year is primarily driven by higher activity in the mortgage and real estate markets. Household consumption is recovering, albeit very slowly, while consumer credit is growing rapidly. In real terms, it is reaching 2019 levels, and in nominal terms, thanks to the elevated price level, it is at all-time highs. Having declined in recent years, the household debt-to-GDI remains low. This year, however, it should rise slightly. We expect the consumer credit-to-GDP ratio to rise to 4.5% (+0.2pp vs last year). The household credit impulse continues to improve, indicating an acceleration in consumption, which is not materialising. Gradually, however, paired with wage growth and high excess savings it should eventually fuel a more tangible recovery in consumption. We estimate growth in consumer credit to accelerate to 9.0% in 2024 (vs 7.9% last year) and to slow to 7.8% in 2025, given lower inflation.

Bank loans and deposits (%, yoy)

	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	Q2 25	Q3 25	2023	2024	2025	2026	2027	2028
Bank loans														
Total	7.0	7.5	5.8	5.9	5.4	5.7	6.6	6.7	5.9	6.1	6.3	5.9	5.8	5.5
Households - real estate loans	4.2	4.2	3.6	4.5	5.5	6.3	6.7	6.9	4.2	4.5	6.6	5.6	5.0	5.0
Households - consumer loans	7.9	8.5	8.0	8.3	9.0	8.2	8.0	7.9	8.7	8.4	8.0	6.6	6.0	5.8
Corporate loans	9.8	10.7	7.3	7.5	5.7	5.5	6.3	6.8	6.0	7.8	6.3	6.2	6.2	5.7
Deposits														
Total	14.4	8.6	5.7	5.3	5.1	5.9	7.1	6.3	9.4	6.2	6.3	4.7	4.6	4.6
Households	7.6	8.6	8.7	8.3	8.1	8.0	7.7	7.3	6.6	8.4	7.4	4.8	4.3	4.3
Non-financial corporations	7.5	5.4	2.3	8.3	6.8	5.1	5.7	5.8	8.1	5.7	5.6	4.4	4.1	4.5
Others	37.8	11.2	3.4	-1.5	-2.0	3.2	7.1	5.1	16.8	2.8	4.8	4.9	5.6	5.4
Ratios														
Loans/GDP	57.1	57.5	57.2	58.0	58.0	58.7	58.9	59.7	57.0	57.7	59.2	60.2	60.9	61.6
Deposits/GDP	87.9	93.4	92.9	93.2	89.0	95.6	96.1	95.6	91.0	92.1	94.5	95.0	95.0	95.3
Loans/deposits	65.0	61.5	61.6	62.2	65.2	61.4	61.3	62.5	62.6	62.6	62.7	63.4	64.1	64.6
Interest rates														
Real estate loans	5.4	5.2	5.0	4.9	4.8	4.6	4.5	4.5	5.4	5.0	4.5	4.5	4.5	4.6
Consumer loans	9.3	8.8	8.8	8.4	8.2	7.9	7.7	7.7	9.4	8.6	7.8	7.8	8.0	8.4
Corporate loans	8.2	7.4	6.7	6.3	5.8	5.3	5.2	5.2	8.6	6.6	5.3	5.2	5.2	5.3
Share of NPL														
Real estate loans	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.7	0.8	0.8	0.9	1.2	1.4
Consumer loans	3.9	4.1	4.2	4.8	5.1	5.3	5.6	5.6	3.9	4.5	5.6	6.4	6.9	7.5
Corporate loans	2.5	2.6	2.6	2.7	2.9	3.0	3.2	3.3	2.9	2.7	3.2	3.3	3.8	4.6

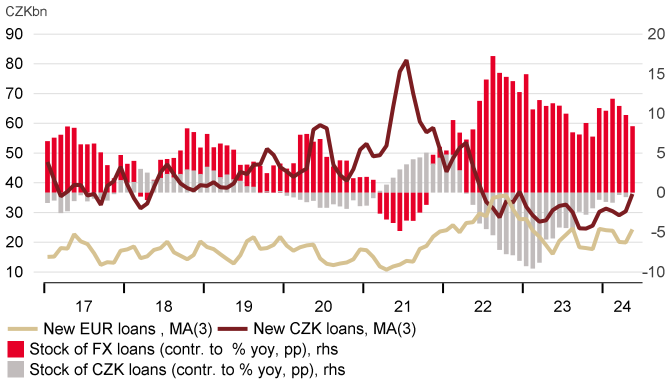
Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: quarterly values are end of period. Full-year values are averages.

Corporate demand for credit is set to benefit from lower interest rates and a more stable environment for investment.

Investment appetite remains weak, awaiting a more tangible boost

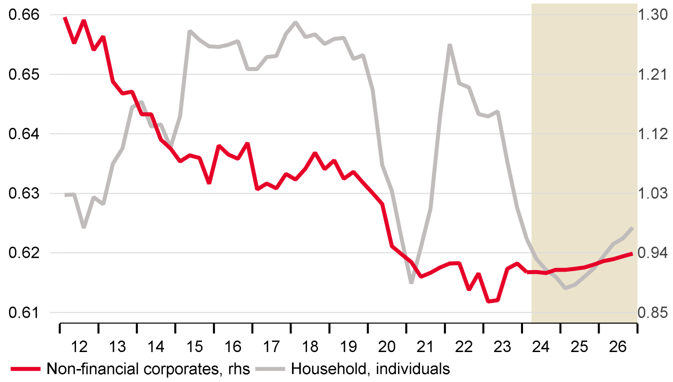
Credit to non-financial corporations (NFCs) remains dampened by tight monetary policy. However, the continued decline in interest rates and renewed business confidence should help boost investment appetite in 2H24. But overall, it should remain limited, in part due to subdued and struggling manufacturing activity. On the other hand, the recovery in the real estate sector provides a boost, although likely to a lesser extent given the growing share of financing flowing through domestic real estate investment funds. In general, non-bank funding is likely to reduce lending. According to Bloomberg data, non-bank corporate bond issuance in 1H24 alone surpassed last year's entire issuance volume. Notably, this primarily concerns large corporates, while credit demand should be significantly sparked by SMEs, which the tight monetary policy strangles the most. The volumes of new koruna- and euro-denominated loans remain neck and neck, growing by an identical 18% ytd by May. Nevertheless, real investment activity actually decreased in 1H24.

Credit to NFCs is not reflecting much of the financial easing yet



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

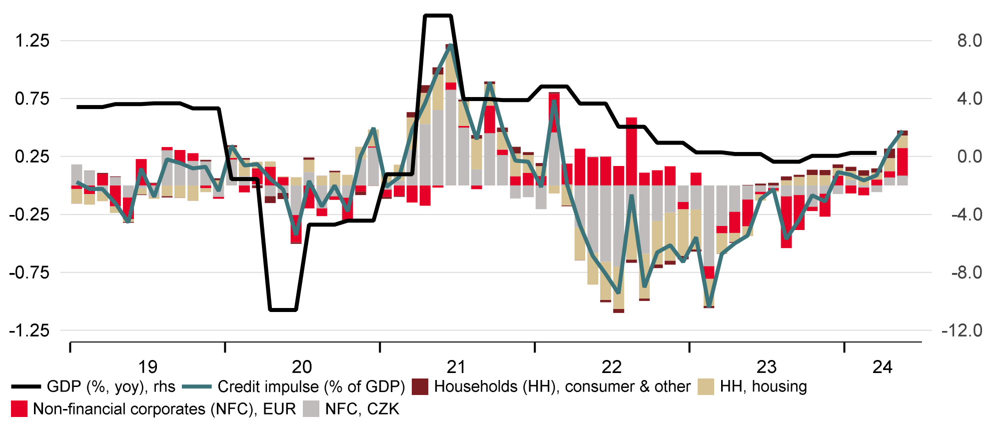
Loan-to-deposit ratios



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

Financial conditions have largely improved owing to the sharp decline in IRS and their easing, and despite our expectation for a gradual correction, should support credit activity. Meanwhile, euro loans retain their relative advantage through the lens of the CNB and ECB rate differential. However, this should reduce from 100bp to 50bp by year end, in our view. In contrast to household credit, we have lowered our NFC credit growth estimate in view of weaker economic growth and lower investment. We estimate credit to NFCs to grow by 5.7% in 2024 and accelerate to 6.5% next year.

The credit impulse is poised to provide a stronger uplift to the economic growth in 2H24



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: credit impulse is defined as the change in the volume of new borrowing, often given as a % of annual GDP. The presented credit impulse represents the yoy change in new borrowing of the non-financial private sector to trailing 12m nominal GDP. It is further broken down according to the use of the loan for households and the currency denomination for firms. As opposed to monthly credit indicators (as of May 2024), GDP (as of 1Q24) is a quarterly indicator.

Deposit growth to slow markedly and fail to outpace loan growth in 2024

Lower interest rates on deposits and increased credit activity should prevent a further fall in the loan-to-deposit ratios.

Growth in deposits is set to slow this year and likely to lag loan growth. Nonetheless, higher lending activity should be reflected in higher deposit volumes. After the liquidity hoarding on bank accounts over the past two years, the household and corporate loan-to-deposit ratios are set to gradually increase. The prevailing deposits overhang over loans reflects the reduction in household consumption and lower credit activity combined with the high level of corporate liquidity, reflecting solid profitability. The gradual fall in interest rates has stepped up deposit outflows, especially by more interest rate-sensitive subjects such as FIs. While household deposits continue to grow at a solid pace, this is likely reflecting the tie-up in savings products and the linked interest income. We estimate total deposits to grow by 5.1% this year, which should slightly lag the 5.4% credit growth.

Tight monetary policy failed to trigger a wave of credit defaults

Credit default rates for households and corporates remain very low, reflecting good financial health despite adverse economic growth.

Default rates continue to hover near all-time lows and thus reflect the fundamentally robust household and corporate balance sheets. Tight financial conditions have yet to trigger a tangible increase in corporate default rates. Although some segments see the volume of non-performing loans (NPL) increasing (FIs, consumer and housing loans), their ratio to total loans remains low. The only mention worthy is the rise in the NPL share in consumer loans, although the situation in the much larger mortgage segment remains stable. Tight monetary policy should, however, be reflected in a slight and gradual rise in the NPL share across sectors. Still, this is not likely to pose a material increase in risk on domestic bank portfolios.

Key economic indicators

Macroeconomic indicators – long-term outlook

		2021	2022	2023	2024	2025	2026	2027	2028
GDP	real, %	4.0	2.9	0.0	0.7	1.9	2.3	2.4	2.3
Inflation	average, %	3.8	15.1	10.8	2.3	1.7	2.0	2.2	2.1
Current account	% of GDP	-2.7	-4.7	0.4	0.6	0.2	0.3	0.5	0.8
3M PRIBOR	average, %	1.1	6.3	7.1	5.2	3.8	3.8	3.8	3.8
EUR/CZK	average	25.6	24.6	24.0	25.1	24.6	24.4	24.2	23.9
USD/CZK	average	21.7	23.4	22.2	23.1	21.7	21.0	20.5	20.3

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

FX & interest-rate outlook

		23-07-2024	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
EUR/CZK	end of period	25.4	25.10	24.85	24.65	24.55	24.50
USD/EUR	end of period	1.09	1.09	1.11	1.12	1.14	1.14
USD/CZK	end of period	23.4	23.05	22.40	22.00	21.50	21.50
3M PRIBOR	end of period, %	4.57	4.35	3.95	3.70	3.70	3.70
10Y IRS	end of period, %	3.48	3.75	3.85	3.90	3.95	4.00

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

Monthly macroeconomic data

		X-23	XI-23	XII-23	I-24	II-24	III-24	IV-24	V-24	VI-24
Inflation (CPI)	%, yoy	8.5	7.3	6.9	2.3	2.0	2.0	2.9	2.6	2.0
Inflation (CPI)	%, mom	0.1	0.1	-0.4	1.5	0.3	0.1	0.7	0.0	-0.3
Producer prices (PPI)	%, yoy	0.2	0.8	1.4	-1.8	-0.9	0.0	1.4	1.0	1.0
Producer prices (PPI)	%, mom	-0.1	-0.4	-0.5	2.5	0.5	-0.1	0.2	-1.2	-0.3
Unemployment rate	% (MLSA)	3.5	3.5	3.7	4.0	4.0	3.9	3.7	3.6	3.6
Industrial production	%, yoy, c.p.	7.3	-2.8	-5.8	-0.3	1.6	-11.2	9.0	-3.2	n.a.
Industrial sales	%, yoy, c.p.	9.8	-4.2	3.6	3.2	6.0	-9.6	11.9	-2.7	n.a.
Construction output	%, yoy, c.p.	-0.3	-5.1	-3.3	-6.4	2.9	-8.4	-0.2	-6.8	n.a.
External trade	CZKbn (national met.)	13.9	29.5	4.9	6.4	36.3	40.8	32.9	13.6	n.a.
Current account	CZKbn	2.3	15.5	-5.8	9.1	36.7	58.9	28.0	-14.7	n.a.
Financial account	CZKbn	-5.6	32.7	20.1	-10.2	15.9	82.7	9.8	-33.4	n.a.
M2 growth	%, yoy	8.0	7.9	8.3	8.4	8.0	6.9	7.0	6.7	n.a.
State budget	CZKbn (YTD cum.)	-210.7	-269.1	-288.5	-26.0	-102.5	-105.0	-153.1	-210.4	-178.6
PRIBOR 3M	%, average	7.05	7.06	6.97	6.63	6.20	5.83	5.55	5.17	5.03
EUR/CZK	average	24.6	24.5	24.5	24.7	25.2	25.3	25.3	24.8	24.8
USD/CZK	average	23.3	22.6	22.4	22.7	23.4	23.3	23.6	23.0	23.0

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

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