Quarterly report

Czech Economic Outlook

Emerging from the vale of tears

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- **Waiting for vaccine** The economy should return to growth this year with the help of widespread vaccination and economic policy stimulus. The pre-crisis GDP level will likely be reached again as we approach 2022.

- **Inflation to slow** This year, the average inflation rate should fall below 2% due to cheaper food, weaker demand and lower import prices.

- **The CNB to remain in wait-and-see mode until fourth quarter** We expect the central bank to implement a first rate hike in 4Q21. This should mark the start of a gradual normalisation of monetary policy over 2022.

- **The economic recovery will support the koruna back to stronger values** Positive sentiment on an earlier increase in the CNB's interest rates in combination with vaccinations and improving financial market prospects will lead to a rapid strengthening of the koruna's exchange rate. At the end of this year, the EURCZK should almost reach pre-pandemic levels.

- **Monetary and fiscal policy will push yields and rates up** The prospect of gradual vaccinations and the return of the economy to normal are accelerating the start of monetary policy normalisation. In conjunction with the expansionary fiscal policy and the record supply of government bonds, we expect continued growth in CZGB yields and market interest rates.

Jan Vejmělek
(420) 222 008 568
jan_vejmelek@kb.cz

Michal Brožka
(420) 222 008 569
michal_brozka@kb.cz

František Táborský
(420) 222 008 598
frantisek_taborsky@kb.cz

Martin Gürtler
(420) 222 008 509
martin_gurtler@kb.cz

Jana Steckerová
(420) 222 008 524
jana_steckerova@kb.cz

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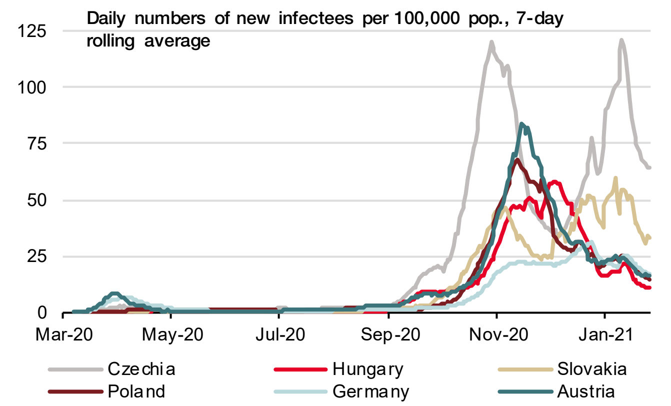
Economy to grow slightly this year thanks to policy relaxation

Jan Vejmělek
(420) 222 008 568
jan_vejmelek@kb.cz

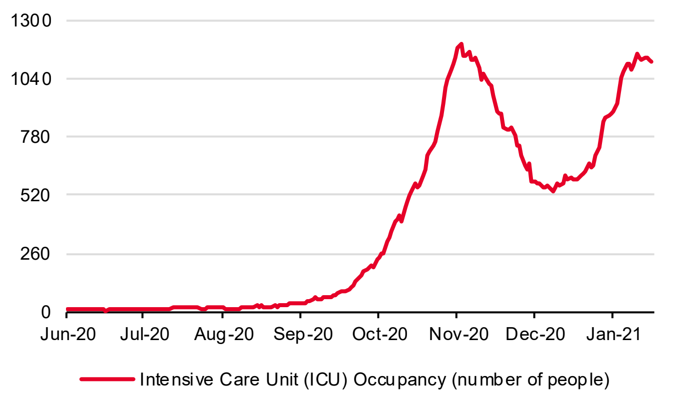
Czechia has experienced one of the worst years in recent history, at least from an economic perspective. The restrictive measures imposed by various governments with a view to containing the pandemic have affected the entire global economy. Thus, 2020 will clearly be associated with a global recession caused primarily by a non-economic factor.

While Czechia managed the spring wave excellently, the autumn and winter waves rank it among the worst in the world



Source: Macrobond, Economic and Strategy Research, Komerční banka

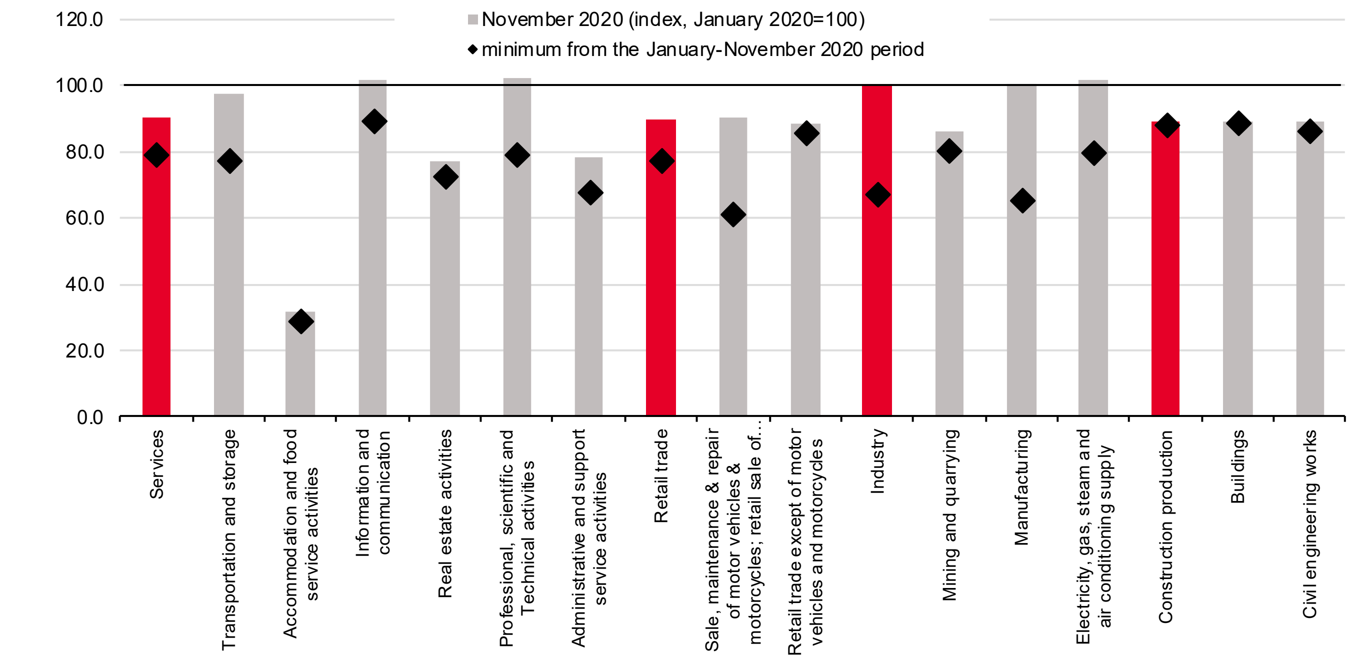
The restrictive measures have remained in place for a long time mainly due to concerns that the health system could collapse



Source: Macrobond, Economic and Strategy Research, Komerční banka

Nevertheless, we witnessed a high level of flexibility and adaptability last year, particularly in the private sector. While in pandemic terms, Czechia was one of the hardest hit countries at the end of last year, the economy did not collapse. Indeed, quite the opposite occurred, as it turned out that the sectors that the government had let breathe, mainly industry, were returning towards pre-pandemic levels at the end of the year. The Czech export-oriented industry clearly profited from strong external demand and, unlike during the spring months, also from open national borders.

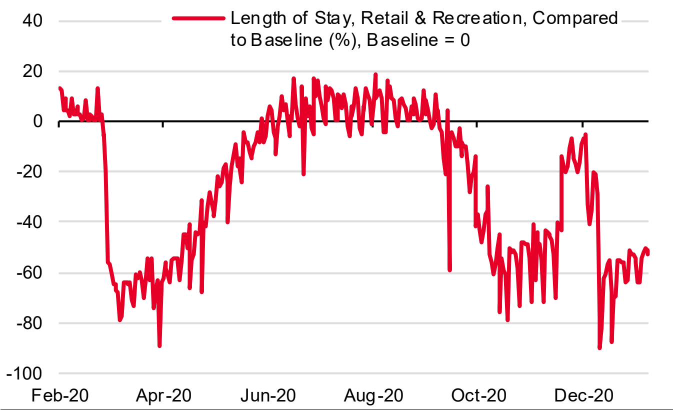
Industry has come back into its own while other sectors are much worse off (HoReCa most notably)



Source: CZSO, Economic and Strategy Research, Komerční banka

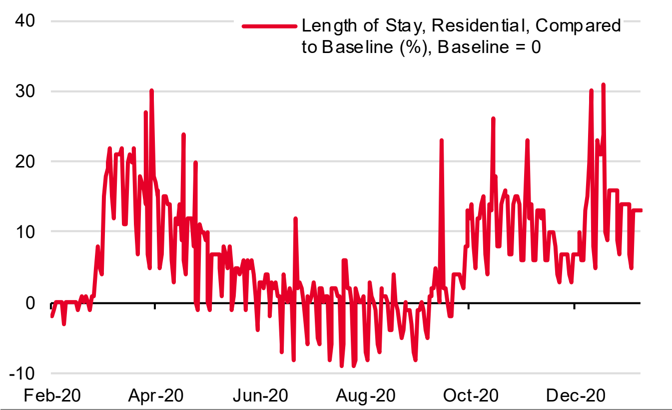
The Czech economy recorded its deepest decline ever last year – we estimate it at 6%. Thus, the catastrophic scenarios presented by the media last spring/summer, warning of a double-digit drop, did not materialise. In addition, none of these forecasts incorporated such a terrible pandemic scenario for the end of the year. Proactive economic policy played an important role, notably the marked easing of monetary policy including support for maintaining financial stability on the one hand, and the effect of the automatic stabilisers of fiscal policy on the other, combined with proactive tools for supporting the corporate sector (such as governmental guarantees for loans through COVID schemes) and households (primarily the various versions of the Antivirus scheme, which helped to slow down the rise of unemployment significantly).

The current wave of restrictions is crushing tourism&retail again



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

Households are staying at home, as they did in the spring



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

A large part of the Czech economy remains under lockdown at the beginning of 2021, including notably services and retail. In our macroeconomic forecasts we expect the pandemic situation to allow only a cautious lifting of measures during the first quarter; we expect the measures to stay in place until mid-2021 to some extent. As a result, quarter-on-quarter growth will remain subdued. Nevertheless, thanks to the low comparison basis from last year, the first half of this year should already be marked by a strong GDP growth. If the vaccinations are successful, we should be able to look forward to a more visible recovery in the Czech economy in the second half of this year.

Economic policies and primarily fiscal policy will play an important role again this year. As of the beginning of the year, personal income taxes have been significantly reduced and 'super gross wages' have been abolished. In combination with one-off increases in all types of pensions in December, we expect this to have an appreciable positive impact on household consumption this year. For a more detailed quantification of the impacts on growth, please see box 1. However, the downside of the income tax reduction is its drastic impact on public finance. The general election in the autumn will show whether this reduction will be made permanent or last for only two years as proclaimed. In just three years, the public debt-to-GDP ratio could climb to 45%; as late as 2019, it was under 30%. On the other hand, the first effects of the recovery plan and the beginning of the new programming period for the EU's budgetary funds should have a positive impact on the investment side, mainly in the second half of this year. More details on this issue and its impact on the economy can be found in box 3.

On the whole, the Czech Republic is expected to grow at a rate of 2.6% this year, according to the current forecast. However, as highlighted at various points in this issue of the *Czech Economic Outlook*, last year's non-economic shock has disrupted settled economic ties and led to much greater forecasting uncertainty. The quickly changing pandemic situation, leading governments to abruptly impose or relax restrictions – slam on the brakes and then the accelerator – also play a role. The FY numbers are not capable of describing these dynamics in full, but the quarterly data will be significantly affected by the volatile statistical base.

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External Environment and Assumptions

Jana Steckerová
(420) 222 008 524
jana_steckerova@kb.cz

The world economy has learned to live with COVID-19

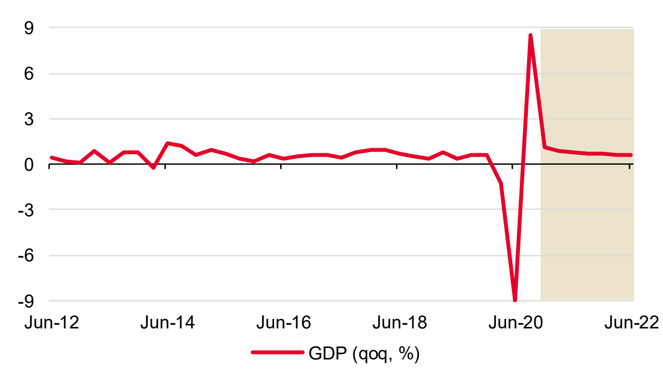
The United States, the euro area and the CEE region were hit by another wave of the coronavirus pandemic in the fourth quarter of last year. Nevertheless, global economies coped with it much better than during the first wave. Above all, the industrial sector proved to be surprisingly resilient against the pandemic, but losses were smaller in the service sector as well. In 4Q20, GDP in the euro area and in CEE region is likely to see a drop. However, it will be significantly milder compared with 2Q20. Even the beginning of this year will probably be rather embarrassing due to continuing economic restrictions, while Brexit will play its part too. During the year, however, we expect economic activity to pick up. An accommodative monetary policy and an expansionary fiscal policy, as well as the flow of EU funds, will support the recovery. Vaccination should also facilitate a return to normal economic functioning.

US: Industrial sector is doing very well but services is suffering

The US labour market will not recover quickly from the coronavirus crisis

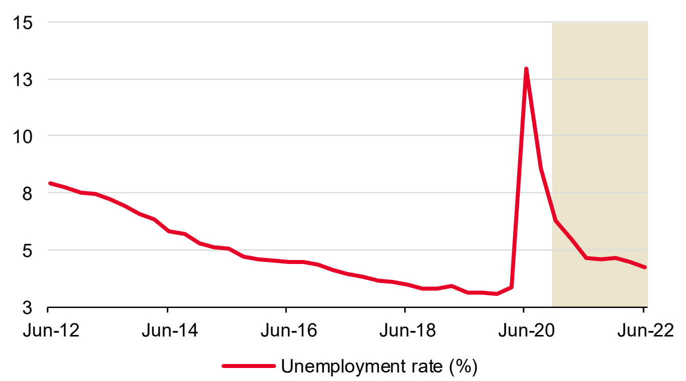
The impact of the pandemic crisis is still evident in the United States economy. Although some sectors have surprised with very good results, the performance of others has suffered due to restrictive measures. However, the industrial sector is doing very well. Production in December surprised with month-on-month growth of 1.6%, while leading indicators were strong as well. In December, the industrial ISM jumped to its highest level since 2018. New orders, production volume and even employment grew rapidly. Developments in other economic sectors also correspond with developments in the labour market. While job creation is accelerating in industries like construction, the situation in the restaurants sector remains poor. In December alone, almost half a million jobs were lost in this sector. Overall, unemployment finally stagnated at 6.7% in December. This is significantly lower than in April, when it stood at 14.8%, but there are still almost 10 million jobs missing compared to the pre-pandemic period. According to our forecast, unemployment will not return to pre-crisis levels until 2024. This year, it should reach 5.2% on average.

The US economy will grow, even in 4Q20 (GDP, qoq, %)



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment set to decelerate further



Source: Macrobond, SG Cross Asset Research/Economics

Developments within the labour market are uneven.

Despite the complicated situation in the labour market, wages saw solid growth in December (5.1%, yoy), while household disposable income was raised further by fiscal measures and rising equity prices. Even so, household consumption disappointed at the end of last year. In December, retail sales fell by 0.7% month-on-month, and after adjusting for car and energy sales they dropped by 2.1%. Our estimate of GDP growth for 4Q20 of between 4-5% quarter-on-quarter annualised thus approached its lower end. In the first quarter of this year, we expect GDP growth of 2.5% qoq annualised. It should gradually increase to 3% in the final quarter of this year. For the whole of this year, we expect the US economy to grow by 3.6%.

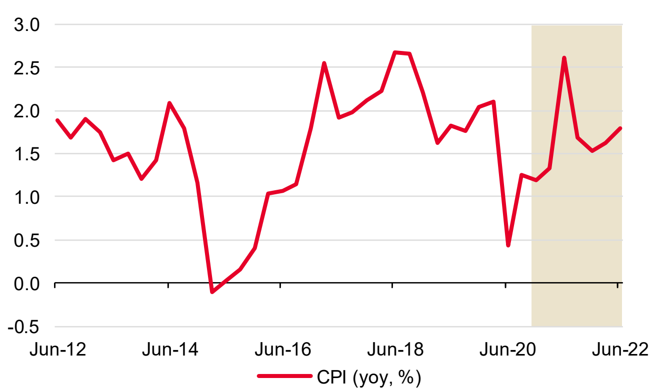
We expect the first rate hike in 2H23.

At its December meeting, the Fed left rates unchanged at the current level of 0.00-0.25%. At the same time, it announced that it would continue to purchase assets at the current rate (USD120bn per month), at least until substantial progress was made towards meeting full employment and the inflation target. What exactly this progress means has not been explicitly stated yet. What is certain, however, is that rates will stay at current levels for a long time. Meanwhile, 12 of the 17 federal bank governors saw interest rates unchanged in December until the end of 2023. The remaining five would be in favour of raising them. The number of these votes is gradually growing, so we assume that over time it will converge on our forecast, i.e. the growth of interest rates in the second half of 2023.

Inflation will jump above 2.5%, but then slow down again.

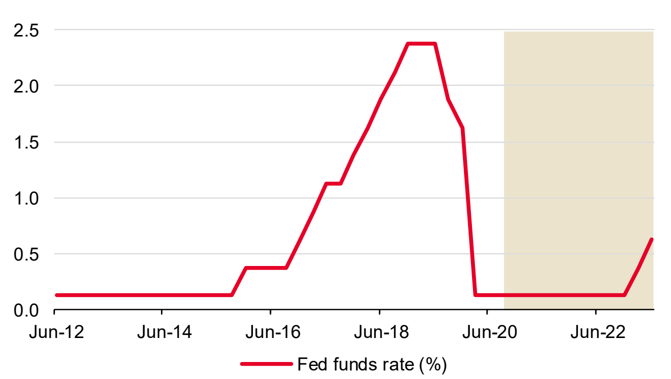
In our opinion, the Fed could start reducing asset purchases in the second half of this year, when vaccination is more widespread and it is certain that the economy is recovering quickly from the crisis. Massive fiscal aid should also help. President Joe Biden has already introduced a fiscal package totalling USD1.9tn. Of this, about USD1tn should go to directly support households, USD440bn to help small businesses affected by the crisis and USD415bn to fight the pandemic crisis more internally. The fiscal package also contributes to rising inflation expectations. According to our forecast, inflation will rise above 2.5% in the first half of this year, but then fall again and will not start hovering above 2% until the end of next year. In addition, given the Fed's average 2% inflation target, it will have to remain above this level for some time in order for the US Federal Reserve to take action.

Inflation will briefly increase above 2% (%, yoy)



Source: Macrobond, SG Cross Asset Research/Economics

Rates will remain at current levels until 2023



Source: Macrobond, SG Cross Asset Research/Economics

Euro area: COVID-19 and Brexit will shave off GDP in 1Q

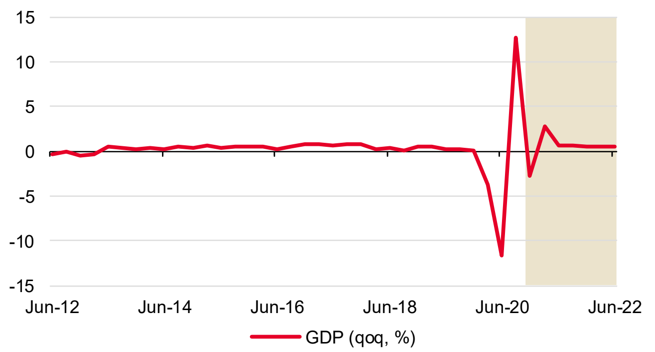
Industry and construction are doing well despite the pandemic crisis.

Data coming from the euro area in the fourth quarter was rather surprising on the upside. Industry and construction performed well. The industrial PMI remained safely above the 50 points threhold, with restrictive measures affecting the services sector. Overall, it has been seen that companies and consumers have already learned to live with the pandemic and are coping with the second wave significantly better than with the first one. This was also evident in the result of German GDP for 4Q20, which surprised favourably with quarter-on-quarter stagnation. According to our estimate, the euro area economy as a whole should show a decline of 2.7% in 4Q, but the risks are now concentrated in the direction of a better result.

Restrictive measures and Brexit will hit GDP in the first quarter.

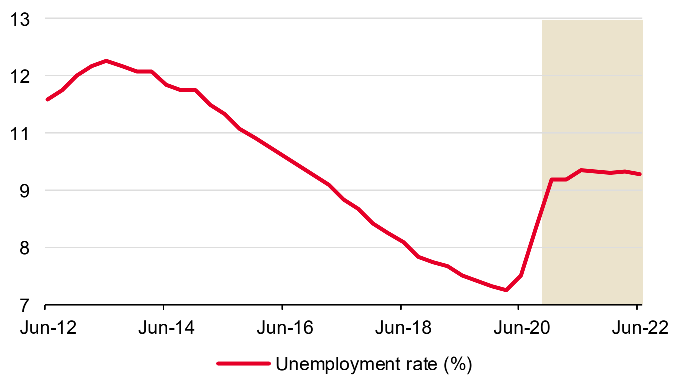
Questions remain about the further development of the euro area economy as restrictive measures remain in force in most countries. Another wave of the pandemic cannot be ruled out and Brexit will not be free of charge either. According to estimates by the International Monetary Fund, it will cost the British economy 1-2% of GDP this year. The impact on the euro area should then be about a quarter to a fifth. In addition, the UK appears to have pre-stocked in 4Q20 due to concerns about Brexit, which will have a negative impact on EU industry in 1Q21. Lending activity is likely to be lower. It peaked in May (7.3% yoy) and has been gradually declining since then. The situation in the labour market will also be worse. While unemployment has gradually fallen from its July peak (8.7%) to the current 8.3% in the past four months, according to our forecast it will rise to 9.7% this year. Overall, we expect the euro area economy to grow by 4.3% this year after last year's decline of 7.4%. According to our forecast, the impact of vaccinations will start to manifest itself first in 2H21, while GDP will not reach pre-crisis levels again until 2023.

Euro area economy down again in 4Q20 (GDP, qoq, %)



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment to rise (%)



Source: Macrobond, SG Cross Asset Research/Economics

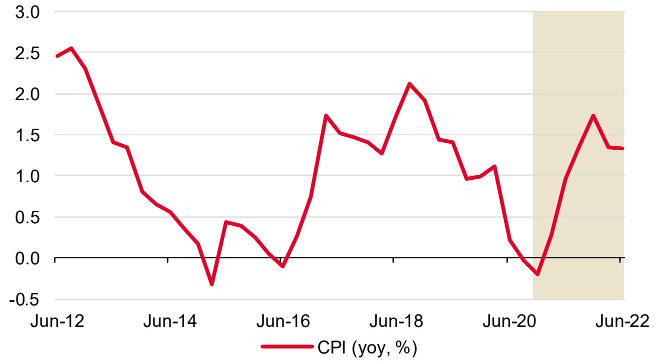
The ECB will focus on maintaining favourable financing conditions rather than on achieving the inflation target.

We do not expect much from the European Central Bank this year. Attention will be focused on the revision of its monetary policy strategy, which is likely to result in the change of the inflation target to a symmetrical one. However, from the point of view of the market or in terms of inflationary expectations, this will probably not be a fundamental change. Fiscal policy should help the ECB with the rise of inflationary expectations, as we have seen in the United States. Over the next two years, the ECB will focus on maintaining favourable financing conditions in the market rather than on achieving the inflation target. More interesting will be how the ECB will deal with ending its Pandemic Emergency Purchase Programme (PEPP) without increasing volatility in financial markets. This should take place in March 2022. The ECB could start preparing markets for this step as early as the second half of this year, by sharply reducing purchases and declaring that current market interest conditions are more important to the ECB than the balance sheet volume. We do not see the first rate hike sooner than 2024 however.

Inflation will return to positive territory, but the core component may raise fears of deflation.

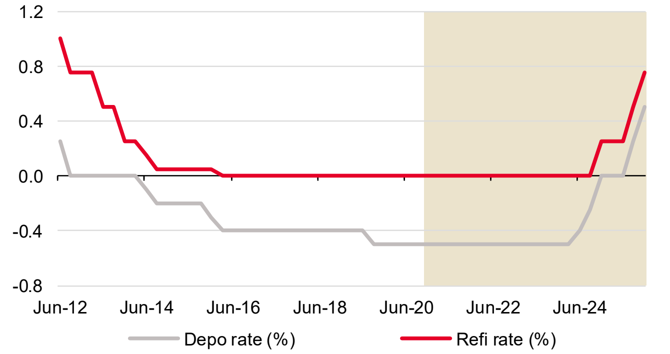
Inflation will remain the euro area's Achilles heel. In December, its core component stagnated for the fourth month in a row at 0.2%, while headline inflation remained unchanged at -0.3% yoy. Core inflation is likely to stay below 0.5% throughout the first half of this year. It will take several years to exceed the 1.5% level, in our view. Headline inflation should return to positive territory at the beginning of this year. Even so, fears of deflation may appear on the scene in the first half of this year.

ECB inflation target not in sight



Source: Macrobond, SG Cross Asset Research/Economics

ECB nterest rates likely to remain at current levels until 2023

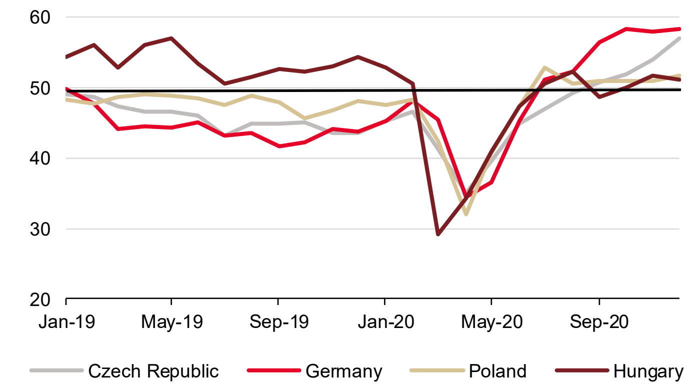


Source: Macrobond, SG Cross Asset Research/Economics

CEE: industrial sector is doing surprisingly well

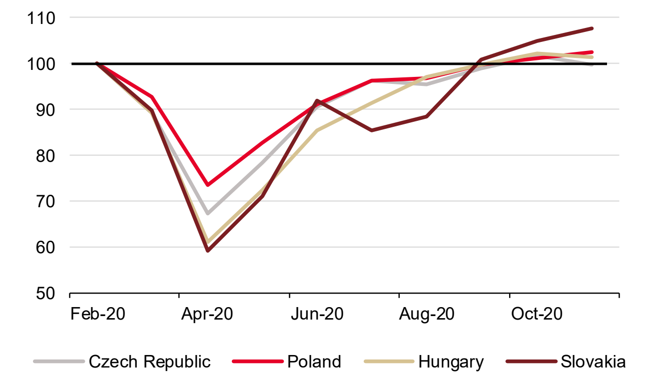
Even the CEE region did not avoid the second wave of the pandemic. However, the data shows that it dealt with it relatively well from an economic standpoint. Above all, the industrial sector surprised with solid results, benefiting from relatively strong foreign demand and supply chains being in better conditions than during the first wave. Despite the pandemic crisis, the leading PMI indicator in the Czech Republic, Poland and Hungary remained above the 50-point threshold in December. The industrial production output jumped above pre-crisis levels in October and stayed there in November too. In 1Q21, restrictive measures and Brexit may affect the sector's results negativelly, but overall, should do well. A relaxed monetary policy by regional central banks, a generous fiscal policy and the absorption of EU funds should contribute to the rapid recovery. After last year's decline of 6%, the Czech economy should add 2.6% this year. According to the market consensus, the Hungarian economy should increase by 4.1% after last year's decline of -6.0%, while Polish GDP is expected to rise by 3.7% after last year's decline of 3.4%.

The PMI in the region remains above the 50-point threshold



Source: Macrobond, SG Cross Asset Research/Economics

Industrial sector, February 2020 index = 100

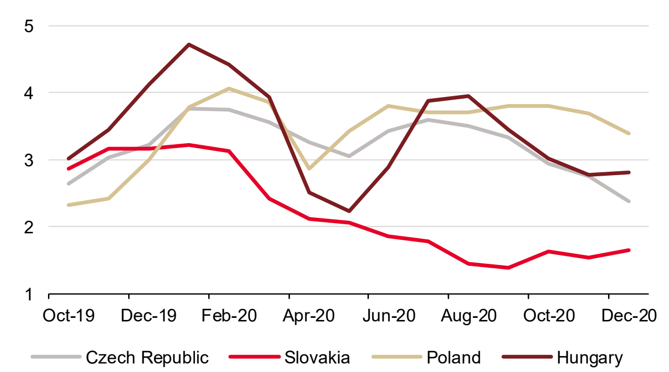


Source: Macrobond, SG Cross Asset Research/Economics

Inflation in the CE region decelerated.

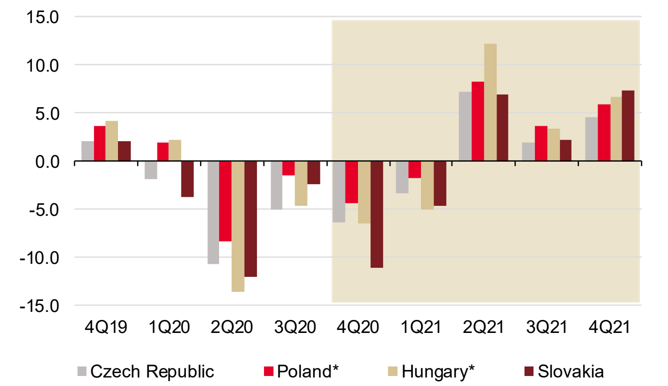
Inflation in the region slowed markedly in December. In the Czech Republic it fell from 2.7% in November to 2.3% in December, in Poland from 3.0% to 2.3%. In Hungary meanwhile it fell from around 4% in recent months to 2.7%, whereas in Decmeber stagnated for the second month in a row. Consumer prices were affected by a significant drop in food prices. However, another story depicts core inflation. It is still at high levels throughout the region. In Poland it was 3.7% in December, 3.6% in the Czech Republic, and in Hungary it even rose to 4%. The discrepancy between the development of headline inflation and its core component will also be what will keep the policy of regional banks in check. The Polish central bank responded to the second wave of the pandemic in December by intervening against the Polish zloty. It thus sought to support the export activity of the domestic economy and economic growth. At its January meeting, the bank indicated that it could continue to take such steps. We believe that this would be the case if the Polish zloty strengthened significantly below the level of EUR/PLN4.50. In our opinion, it will not move with rates (0.1%) of course, unless another significant shock hits the economy. We do not expect a change in interest rates in Hungary either. Although inflation has fallen below the central bank's inflation target in the past two months, it will shoot back to 4% in the first half of this year, according to its forecast. On average, it will remain slightly above the inflation target both during this year and next. We expect that the first central bank to change interest rates will be the Czech one, a topic which we examine in the *CNB Focus* section.

Inflation in CEE region decelerates (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

GDP in the region (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka
*Bloomberg consensus

Macroeconomic outlook

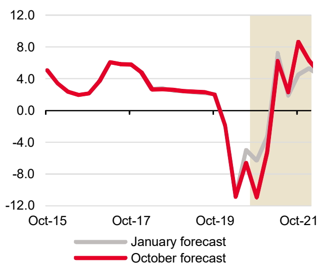
Michal Brožka
(420) 222 008 569
michal_brozka@kb.cz

Main changes

GDP:
For 2020, we have increased our GDP estimate to -6.0% from -7.6% previously. For 2021, we expect the economy to grow by 2.6%.

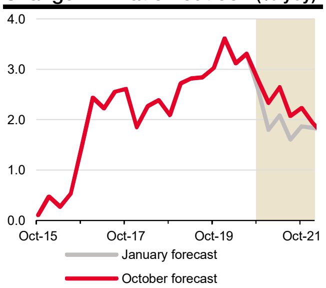
Inflation:
For 2021, we have reduced our inflation estimate to 1.8% from the 2.3% previously, mainly due to lower food prices.

Change to GDP outlook (% yoy)



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

Change in inflation outlook (% yoy)

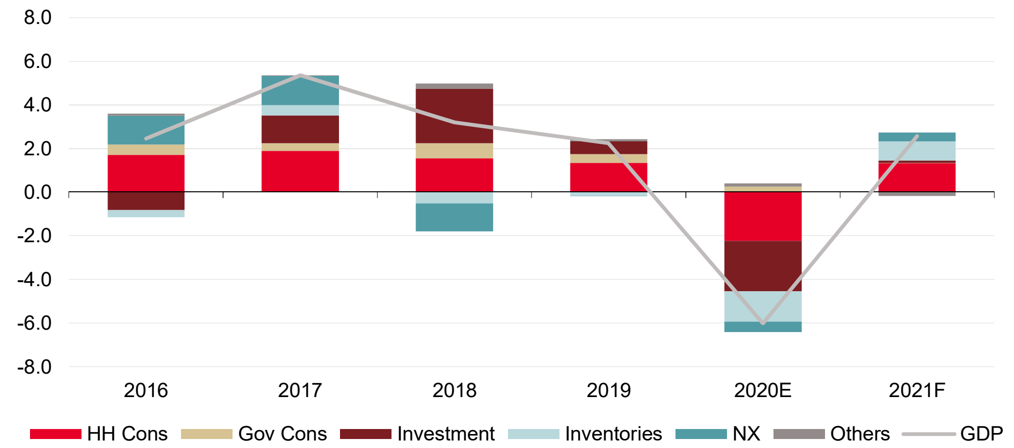


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Production is growing; services pending end of the pandemic

On our estimates, the Czech economy shrunk again at the end of 2020 and the downturn continued into the beginning of 2021. In the first quarter, we expect a gradual lifting of the measures designed to stop the virus' spread, with a resumption of economic growth. In the second half of the year, vaccinations should lead to a significant reduction in pressure on the economy, which should in turn drive more rapid growth, while loose fiscal and monetary policy should give the economy another significant boost. We expect inflation to be just under 2% this year.

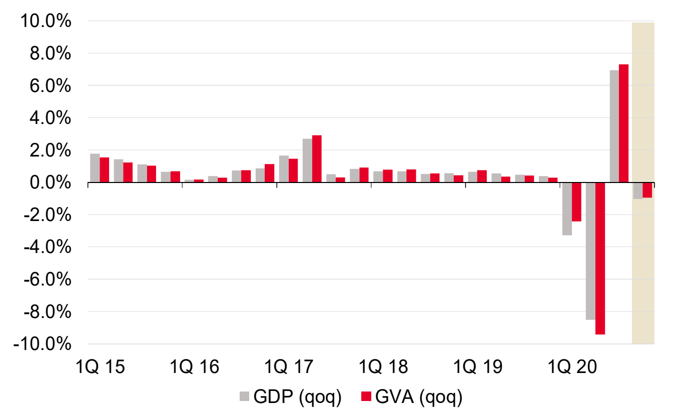
Household consumption should be the main driver of GDP in 2021 (% yoy)



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

The economy remains in decline

GDP probably fell slightly again in the fourth quarter



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

As the pandemic ramped up again, the Czech government locked down a large part of the economy at the end of October 2020. This led to a significant reduction in trade, services and cultural events, where social contact takes place. Schools were also closed. After a brief reopening in early December, the government tightened restrictions again when it became clear that growing numbers of infected patients were at risk of flooding the healthcare system. **In our previous forecast, we correctly assumed that the second wave of the pandemic would not have as overwhelming of an impact on the economy as the first one did, mainly because there were no full-on closures.** Companies could continue to produce and export abroad, as demand grew solidly. We therefore estimate that industrial production increased by 2.3% qoq in the last quarter of 2020. In contrast, the private services sector, which accounts for less than half of the Czech economy's value add, probably pulled GDP down throughout the pandemic. Here we estimate a decline of 3.5% qoq in the fourth quarter.

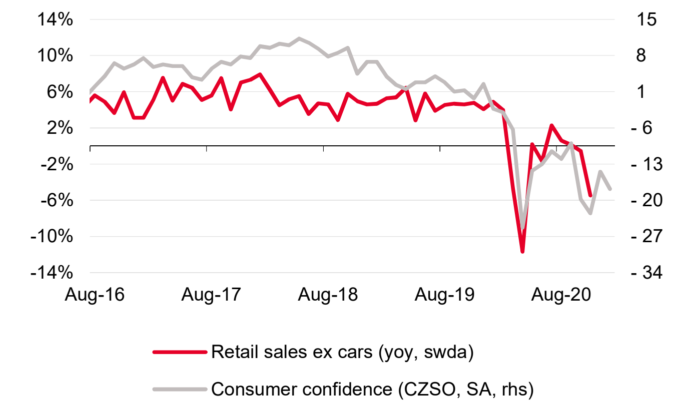
The economy showed strong growth in the third quarter of last year, and we expect a smaller decline in the fourth quarter.

Compared to the second quarter, when services fell by more than 10%, this would be a significantly smaller decrease. However, that would mainly be due to the fact that services are now declining from a lower level, as even a significant 5.2% recovery for services in the third quarter failed to offset the previous decline. **Less uncertainty compared to the first wave was also likely to have contributed to the smaller slump,** as was the faster economic policy response, as the government was no longer treading completely unknown waters. Let us recall that in the first wave of the pandemic, it took several weeks for it to become clear that the government would have to embark on an expansionary policy path. This time around, the government's approach was more readable. We observed less uncertainty, for example, in consumer confidence trends. While confidence started to decrease in October, the decline was not as steep as in the first wave, and by December, it had already increased to levels comparable to June 2020. One could conclude that people have, to some extent, become accustomed to the situation. Our estimate of the 4Q services trend is based on monthly data trends. When the Czech Republic entered the second pandemic wave, we feared a larger decline, even though the situation had been ongoing for some time already and despite the bankruptcies that had already taken place. In this respect, the situation seems to be more stable than we feared.

Germany's preliminary 4Q GDP data also points to more favorable economic trends, with a flat quarter-on-quarter GDP likely. In the Czech Republic, however, we expect a slightly worse result, as the second wave probably had a bigger impact there. Here the second wave was preceded by a more pronounced loosening in the third quarter, so we will probably see a poorer quarter-on-quarter performance.

In summary, we expect the Czech economy to have declined by 1.0% qoq in 4Q20, which would deepen the year-on-year drop in GDP to 6.3% yoy from the previous decline of 5.0% yoy. Although this development can still be described as very unfavourable, it is worth recalling that estimates for the economic outlook at the start of the second wave of the pandemic were significantly more pessimistic. The economic recovery during the third quarter was also stronger than expected. **In summary, we expect the economy to decline by 6.0% in GDP terms for the whole of 2020, which is a significant improvement compared to our previous estimate, where we expected a 7.6% decline.** It can be said that the manufacturing segment in particular was a positive surprise, as was household consumption, which was favourably affected by the stable labor market.

Consumer confidence fell less in the second pandemic wave



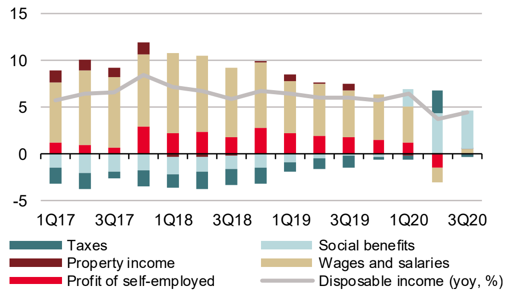
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Box 1: Higher pensions and lower taxes to boost consumption

The coronavirus pandemic and the associated closure of the economy have significantly affected households and businesses. Together with restrictive measures, the Czech government has introduced a number of support programmes to mitigate these effects. This analysis focuses on those directed to households. The Antivirus programme in particular has a significant impact in this regard, whereby the state compensates affected companies for a portion of – or in the case of a complete closure of operations – all labour costs. **As a result,**

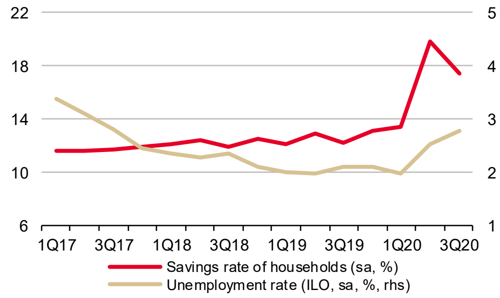
there has been no significant increase in unemployment or a decline in household income so far. This reflects the trend in gross household disposable income, which, despite the deep economic downturn, continued to grow year-on-year in the first three quarters of last year. As the chart below shows, lower wages and salaries were offset by payments from the state in the form of social benefits. These include, among other things, both the payment of nursing and sickness benefits, as well as compensatory bonuses to self-employed persons, who are also statistically classified as households.

Wage shortfalls were offset by income from social benefits



Source: CZSO, Economic & Strategy Research, Komerční banka

Savings rate increased more than unemployment rate



Source: CZSO, Economic & Strategy Research, Komerční banka

At the turn of the year, two other government measures came into force to support household consumption. However, in contrast to the above-mentioned Antivirus programme, the measures were designed to provide direct support to affected entities as well as to boost the income of most households. This is a one-off financial payment to all persons receiving a retirement, disability or survivor's pension, with the elimination of the super-gross wage, together with an implicit reduction in the personal income tax rate and an increase in the basic taxpayer rebate (collectively referred to as the tax package). All these measures have led or will lead to a significant increase in income and, due to their already mentioned widespread effect, have the potential to significantly influence household consumption and the economy as a whole.

The government made a one-time CZK5,000 payment in the first half of December last year to all persons receiving one of the above types of pensions. The payment was the same for all pensioners regardless of the pension they normally receive. Taking into account the weight of each group of pensioners, pensioners' quarterly income increased by an average of 13% in the last quarter of last year. The volume of paid pensions thus increased by almost CZK15bn in the fourth quarter, which is also the impact that the measure had on the state budget last year. Pensioner households generally have a high propensity to consume and, according to the latest CZSO data for 2018, spent 82% of their income on consumption. They had the same propensity to spend in previous years as well. **According to our estimates, pensioners spent CZK12bn of a total of CZK15bn, which is almost 2% of total household consumption in the third quarter of last year.** If we relate this volume to total GDP last year (assuming a full-year decline of 6%), the CZK12bn is about 0.2%.

While payments to pensioners present only a temporary increase in income, elimination of super-gross wage and related tax adjustments will lead to a sustainable increase for a large portion of Czech households. According to the government's plan, the lower tax burden should apply at least this year and next. With average growth in net wages and salaries of 7.7% from 1 January, total disposable household income should rise by nearly CZK30bn year-on-year thanks to tax adjustments every quarter this year. According to the latest CZSO data for 2018, employee households' propensity to consume is 77%. **If the average propensity to consume remains 77% this year, the government's tax**

adjustments should lead to an increase in household consumption of approximately CZK23bn each quarter. Relating this amount to total household consumption in the third quarter of last year, the increase is considerable at 3.4%. In comparison with our GDP forecast for the whole this year (assuming a 6% decrease in 2020 and a roughly 3% increase in 2021), the increase in consumption resulting from lower income taxes (about CZK90bn for the full year) accounts for 1.6% of GDP. The willingness of households to spend additional money should also be supported by the above-mentioned fact that the current crisis has not yet led to a decline in disposable income.

The present situation, however, is still highly uncertain on the economic growth front, which may in turn be reflected in a partial preference for savings over consumption. We witnessed this last year, when the savings rate of Czech households rose to a record level of almost 20% in the second quarter. After the pandemic restrictions ended, the savings rate declined slightly in the third quarter, as shown in the chart on the previous page, but still remained above normal values. Table 1 therefore includes alternative calculations of the impact of tax changes that allow for a lower propensity to consume.

Even if a lower propensity to consume of only 60%, or even 50%, is taken into account, the increase in overall household consumption is still significant at 2.6% or 2.2%, respectively. The impact on annual GDP (using the same economic assumptions as above) is summarised in Table 1. The spillover of higher household income to consumption may be hindered by the continuing closure of the economy, and so the positive effects may occur with a delay (the same holds true for the one-off pension payment mentioned above).

Table 1 – Impact of lower taxes on household consumption by propensity to consume

Propensity to consume	77%	60%	50%
Increase in household expenditure – quarterly	CZK23bn	CZK18bn	CZK15bn
Increase in total household consumption – quarterly	3.4%	2.6%	2.2%
Impact on full-year GDP in 2021e	1.6%	1.3%	1.1%

Source: Economic & Strategy Research, Komerční banka

We write more on this topic in our Special Report, which is available here http://bit.ly/FiscalJan21EN.

Martin Gürtler
+420 222 008 509
martin_gurtler@kb.cz

Return of GDP to its pre-crisis level in 2022

We expect a gradual improvement of the epidemic situation in the Czech Republic starting in February.

We assume that anti-epidemic measures will gradually weaken from February as the epidemic situation improves. It is possible that the growth of the economy in the second quarter of this year will be relatively fast. However, we expect the second half of the year to be much calmer when a significant part of the population could be vaccinated or reach herd immunity. Vaccination is a significant hope for the future, which is reflected in a better outlook for the economy and has contributed to less uncertainty about future estimates. **However, it should be emphasised that the uncertainty still remains high for this year** (see the list of risks at the end of the chapter). Compared to the previous forecast, a more relaxed fiscal policy – especially the personal income tax cuts adopted and effective since December of last year – is also contributing to a better outlook for the domestic economy.

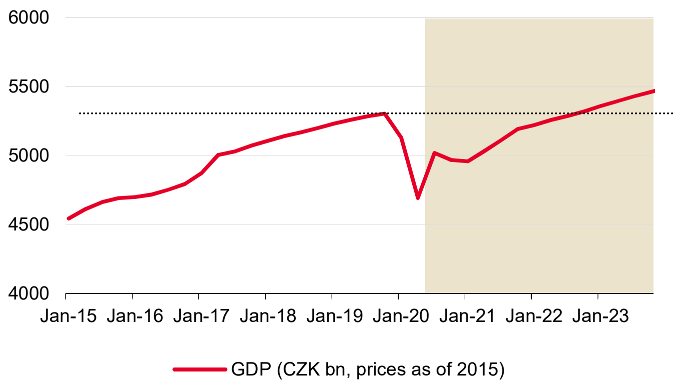
Despite the above-mentioned improved outlook for the economy due to vaccinations, we have reduced the estimated GDP growth rate for this year to 2.6% from the original

3.0%. The reduction is to some extent due to the third wave of the pandemic, however, the estimate of lower growth for this year is mainly due to the assumption of better economic development in the second half of last year and thus a higher base effect. With the economy declining by 6.0% in 2020 and subsequently growing by 2.6%, **the level of real GDP would return above the pre-crisis level in the third quarter of 2022.** In the previous forecast, we expected the pre-crisis level not to be reached until the beginning of 2023.

The output gap will probably close faster than we had expected.

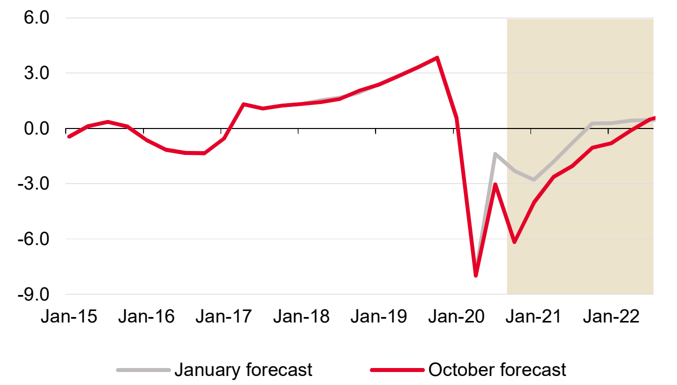
In our forecast, better economic development also means a faster closing of the output gap. In terms of structure, the main driver of the economy will be household consumption (household consumption gap is closing faster). We expect consumption to grow by an average of 2.8% this year, with a reduction in income taxes (we conservatively assume a marginal propensity to consume at 60%) and a one-off contribution to old-age pensions (with an assumed marginal propensity to consume 80%) gradually starting in the first quarter (See Box No. 1). **This, in summary, represents a declining risk of disinflation pressures**, which is also essential for estimating inflation and thus the expected monetary policy response.

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



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

GDP gap will be closing faster (%)



Source: Economic & Strategy Research, Komerční banka

Industrial sector is driving the economy in the second wave of the pandemic

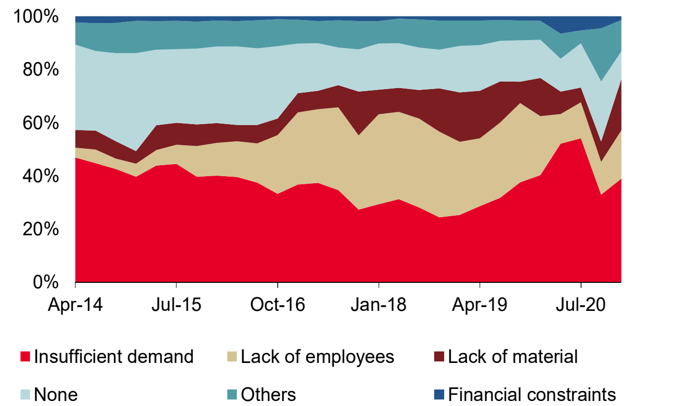
Industrial output will suffer due to labour shortages.

As we expected during the second wave of the pandemic, industrial producers were not forced to close down. On the contrary, the demand for the production of Czech producers expanded. We feared that because of the pandemic, manufacturers would face greater labour problems and supplies of components for production and industrial production would decline slightly. These fears were only partially fulfilled. Industrial production grew rapidly from July to October, with the strong support of car production. In year-on-year terms, industrial production managed to return to positive numbers, specifically in October when it reached a rate of 1.4%. Although the industry declined month-on-month in November, it still remained positive year-on-year.

The development of leading indicators, such as purchasing managers' indices or confidence indices, is encouraging for developments in the coming months. The previously mentioned PMI index continues to be a positive surprise, rising to 57.0 points in December. It indicates an acceleration of production growth in the near future. The growth of the index is due to a better evaluation of the already mentioned production, as well as orders and employment. At the same time, however, the index was artificially increased by difficulties and delays in supply and transport. However, that does not mean that the producers are that busy. In fact supply limits are a problem for the supply side, which increases the index but leads to a lower level of production. In summary, we anticipate that given the growing demand, which is also indicated by the development of leading indicators abroad, the manufacturing sector should develop relatively favourably during the year.

Nevertheless, we believe that several factors will accumulate that will cause a weaker overall performance, especially in the first quarter of this year. On the one hand, we believe that part of the higher car production in the second half of last year was related to efforts to pre-supply and pre-register due to the approaching Brexit (see the External Environment and Assumptions chapter) and also due to higher emission standards from this year (see Box 2). This may reduce the production and exports of the automotive industry in the first quarter. Furthermore, there is a growing problem with supplies, where carmakers are waiting longer due to the worsening global pandemic situation.

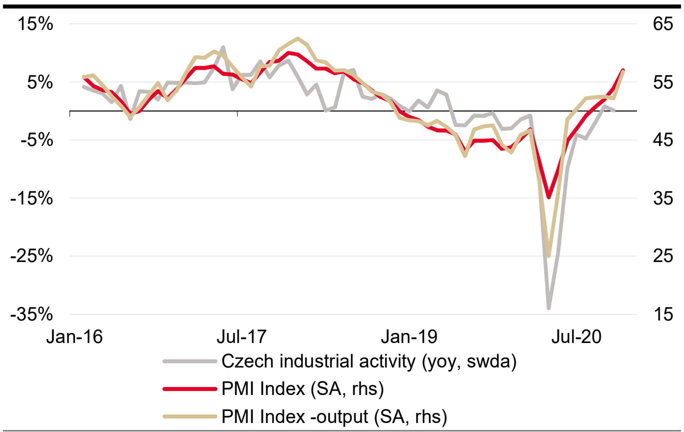
Barriers to industrial output growth



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

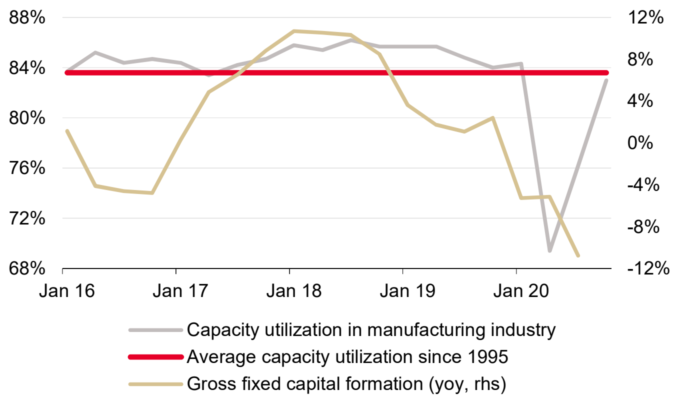
Another significant barrier to production growth is the persistent shortage of labour. The current state of the labour market is largely being preserved by government measures, so the shift of labour from the affected sectors to other sectors is slow. In addition, the industrial sector cannot easily absorb these workers due to many of them having different qualifications. Some employees in the sector are limited due to quarantine or the need to stay at home with children. From the point of view of car production, we expect further expansion, albeit at a slow pace, as carmakers have to cope with regulations and technological change. At the very beginning of this year, we estimate a quarter-on-quarter decline in industrial production of 0.3%, followed by gradual growth in the coming quarters. Nevertheless, due to last year's low base effect, we expect year-on-year growth in industrial production of 9.8% this year, after a decline last year that was 7.5% according to our estimates.

Leading indicators show the expansion of manufacturing



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

Capacity utilisation back to its pre-crisis level

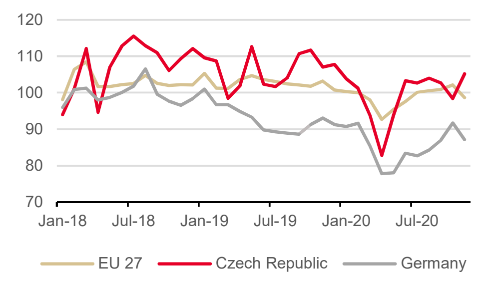


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Box 2: Car production in the Czech Republic should grow

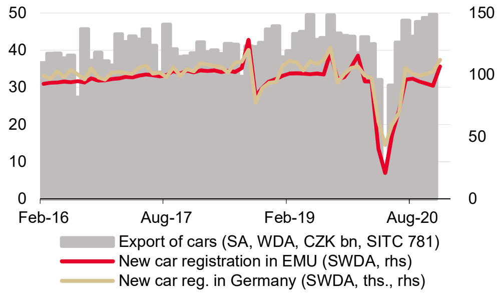
It is well known that the Czech Republic is a significant car producer, being second in the world for car production per capita after Slovakia and first in the world for buses. Car production in the Czech Republic accounts for approximately 4.7% of GDP, and together with subcontractors, the share of GDP is estimated at around 9%. In addition, a number of services are linked to the automotive industry. And while in 2005-2018, growth in the automotive industry was a major driver of the economy with average annual production growth of close to 9%, the situation has changed since 2019 (when motor vehicle production fell by about 1% annually). The DieselGate affair, which culminated in 2015-2016, resulted in a gradual shift away from diesel cars and also contributed to the newly adopted emission regulations. **From September 2018, newly registered cars must meet new emissions standards of WLTP (replacing the former NEDC).** Consequently, there was an increase in registrations before this date and a subsequent decline, which was then followed by a decline in motor vehicle production in Europe and especially in Germany in 2019. In the chart below, we see that Czech motor vehicle manufacturers were still relatively successful, although there was a decline at the turn of 2019-2020. In 2019, Czech carmakers benefited from higher demand for cheaper higher quality cars with conventional engines. After a slump during March-May 2020, when carmakers shut down due to the pandemic, they recovered rapidly in the summer months. **The production of motor vehicles last year reached approximately 1,159,000. In 2019 it was 1,428ths and the year before 1,437ths.**

Car production (2015 = 100, SA)



Source: Eurostat, Economic & Strategy Research, Komerční banka

Demand for cars in Europe has risen again after the spring slump

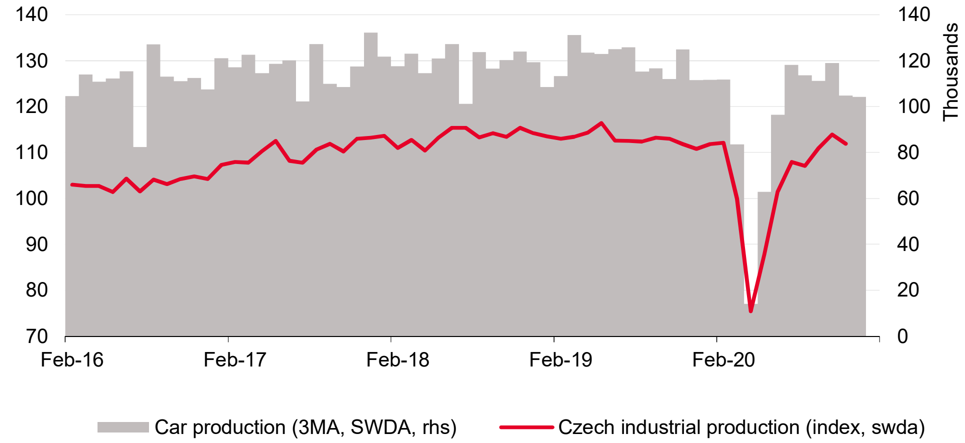


Source: Macrobond, Economic & Strategy Research, Komerční banka

In 2020, the 95 g/km CO2 limit for a car weighing 1380kg came into force for 95% of the car fleet. From 2021, these limits apply to 100% of the fleet. Cars with emissions below 50g were counted as 2 cars in 2020, as 1.66 cars in 2021 and as 1.33 in 2022, which will slightly reduce the requirements for the entire fleet. Car manufacturers should do their best to comply with the new regulations and invest in technological changes related to alternative and hybrid drive systems. This will negatively affect car profitability, but still leaves room for growth in production in the medium term. **The view beyond 2025, when emission limits should be tightened further, is unfortunately very uncertain from the point of view of car manufacturers, and our forecast does not take it into account. In terms of developments in the coming years, a key issue will be whether Czech car production will meet demand.**

Although Skoda belongs to the Volkswagen Group, which has lagged behind in new technologies, its portfolio has been relatively competitive in the past two years. Demand for the manufacturer's cheaper conventional cars has been solid, and it has significantly reduced emissions in conventional engines. At present, in addition to conventional models, Skoda is also launching hybrid and electric cars. It is possible that cautious attitudes about buying a car (which might be cheaper during the current high uncertainty) will stick around, as uncertainty is still high despite the vaccine. Skoda could continue to benefit relatively. Trying to buy "normal" cars while there is still time could also help. Toyota, one of the leaders especially in the case of hybrids, has taken over TPCA, and in addition to conventional small cars, is preparing to start production of a small hybrid model for this year. As a result, the manufacturer is planning a three-shift operation from February this year and intends to hire new workers, which indicates higher production. In our opinion, production at domestic carmaker Hyundai also does not indicate that there might be a reduction in production. In the coming years, on the contrary, there will be an increase in hybrid cars. The share of low-emissions cars in Europe should increase in the coming years with significant state support.

After the spring slump, monthly car production quickly returned to close to previous levels



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

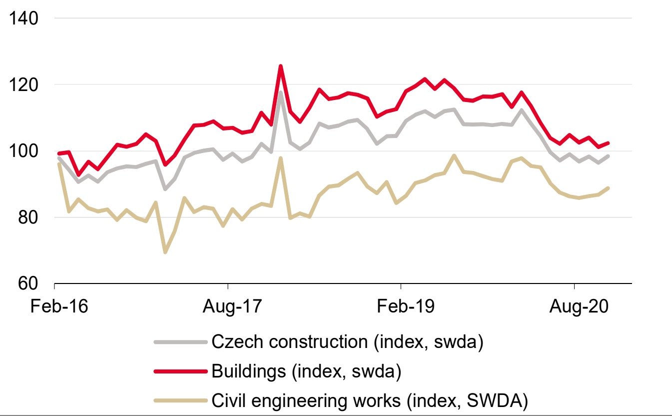
Regulatory requirements are a significant complication for the sector, but automakers seem able to cope with this at least until 2025e. From the point of view of production, however, car manufacturers are having a hard time supplying the necessary components (for example, Skoda cites a lack of chips) and are suffering from a lack of manpower, which will limit this year's production. However, growth in demand will still be crucial. After a sharp decline in demand for motor vehicles in the second quarter of 2020, demand rose sharply in the second half of last year, and car registrations in Europe made up for the previous decline. Programmes to support "green" cars in some European economies have also helped boost demand. **Exports to the EU should increasingly meet growing demand for low-emission cars.** For this year, we expect a gradual resumption of economic growth, which should increase demand for cars. For the first quarter itself, however, we expect a slight decline in car production due to the previous increase that was driven by efforts to pre-register manufactured cars in 2020 owing to emission limits and a desire to reduce fines. We also expect a reduction in exports to the UK in the first quarter. Note that there was an effort to pre-supply in 2020 due to uncertainties arising from Brexit (see the chapter on the external environment and forecasts). Given last year's low base effect, this year's full-year growth in car production could reach a double-digit rate. **Even so, we do not expect year-round production to return to 2019 levels until 2022.**

Michal Brožka
+420 222 008 569
michal_brozka@kb.cz

The construction industry will feel the labour shortage even more strongly this year.

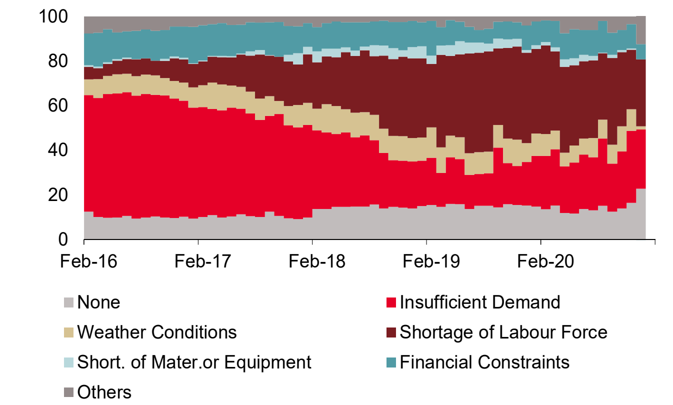
The construction industry showed a decline mainly in the first half of last year, and since then its performance has remained at approximately the same level. We estimate that for the whole of 2020, the decline in construction output reached 6.4%. Developments in the construction industry usually lag behind that of the manufacturing sector, as projects here have a longer-term duration. **For this reason, we believe that the previous economic downturn will continue to be reflected by weak developments in the construction industry in 2021 due to the cautious investment behaviour of companies.** In addition to weaker demand, the construction industry also continues to face labour shortages, and this problem is unlikely to go away in the near future. On the contrary, construction should be supported by infrastructure investments, where the EU Recovery Plan will play a positive role (see Box 3). In summary, we expect a decline in construction of about 4% this year. The permanent improvement of the pandemic situation should subsequently bring solid increases in construction production, and in the coming years we expect its expansion to be around 6% per year.

The construction industry is trending down



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

A shortage of employees is the main problem seen in construction



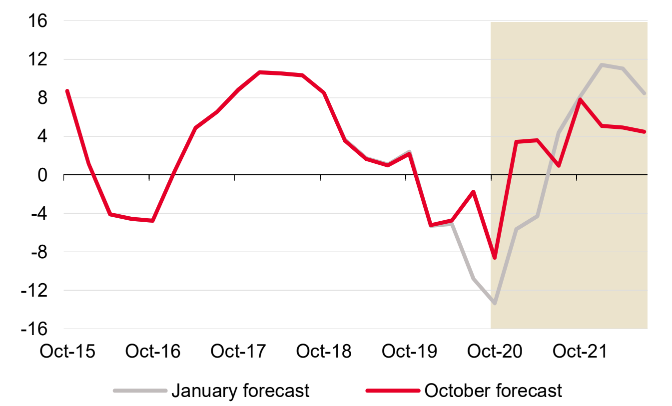
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Investment activity will remain weak

Investment activity should grow cautiously this year.

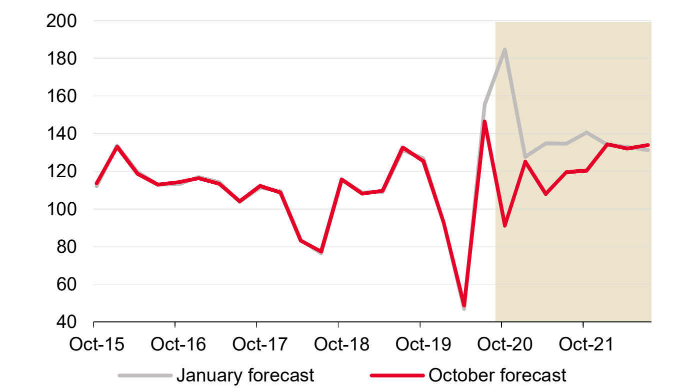
After the growth of investments was the main driver of the economy in 2018, it slowed down already in 2019. In 2020, the fall in investment activity together with household consumption, became the main source of the decline in GDP. While the fall in investment was not so strong during the first wave of the pandemic (it even increased by 0.6% qoq in the entire first quarter), the decline in the summer months reached a significant 5.0% qoq. The foresight indicators have shown an increase in optimism thanks to the vaccines since the autumn. However, uncertainty for the near future remains high despite this positive factor. Persistent concerns are reflected in the rapid increase in deposits of non-financial corporations. We expect a further slight decline in fixed capital investment in the last quarter of last year and at the beginning of this year. However, we have been counting on their growth since the second quarter, which corresponds to improving confidence about the economy and growing demand for domestic industrial production. **For the whole of 2021, we expect a slight increase in investment in fixed capital by 0.6%, as well as a positive contribution from investment in the recovery of inventories.**

The decline in investment in 3Q was deeper than we expected (%, yoy)



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

Net exports rose at a record high (CZKbn)



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

Foreign trade in 2020 surprised positively.

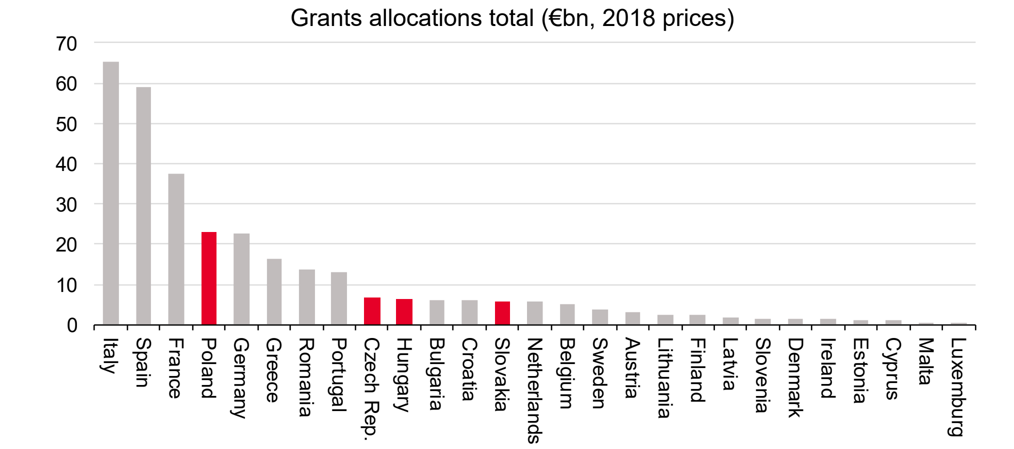
We expected a boom in foreign trade in 2021. It was to become the main driver of the economy. However, this improvement took place as early as the second half of 2020. The trade balance reached record surpluses, largely due to declining investment activity and thus weaker imports, but also to growth in exports following its slump during the first wave of the pandemic. For the whole of 2020, we estimate the trade balance surplus in the national methodology to be close to CZK180bn, which would mean a year-on-year increase of approximately CZK30bn. In the previous forecast, we anticipated that the effect of the trade balance on the economy would be roughly neutral in 4Q20. Instead, we now expect it to have had a significant positive boost. We expect that foreign trade will continue to prosper this year as well, however, due to renewed investment activity, the foreign trade surplus is likely to fall to CZK153bn this year (national methodology).

Box 3: A recovery plan will help kick start investment

In response to the pandemic situation, the European Union has come to the aid of Member States with a €750bn recovery plan (NextGenerationEU). The centrepiece of the instrument is the Recovery and Resilience Facility (RRF), which makes up 90% of the recovery plan. Of this, money can be provided in the form of grants (€312.5bn) and loans (€360bn). The recovery plan also includes the REACT-EU programme (€47.5bn) and the Just Transition Funds (€10bn). The remaining €20bn is distributed between the Horizon Europe, Rural Development, RescEU and InvestEU funds.

EU Member States can allocate REACT-EU funds as needed. In the Czech Republic, these funds were allocated to the Integrated Regional Operational Program 2014-2020 (approximately CZK30bn). According to the government resolution, half of the funds should go to healthcare and the remaining funds to the integrated rescue system for the construction of homes for the elderly and equipment for athletes. All REACT-EU projects must be implemented and reimbursed by the end of 2023.

Grants awarded to individual countries under the Recovery and Resilience Facility



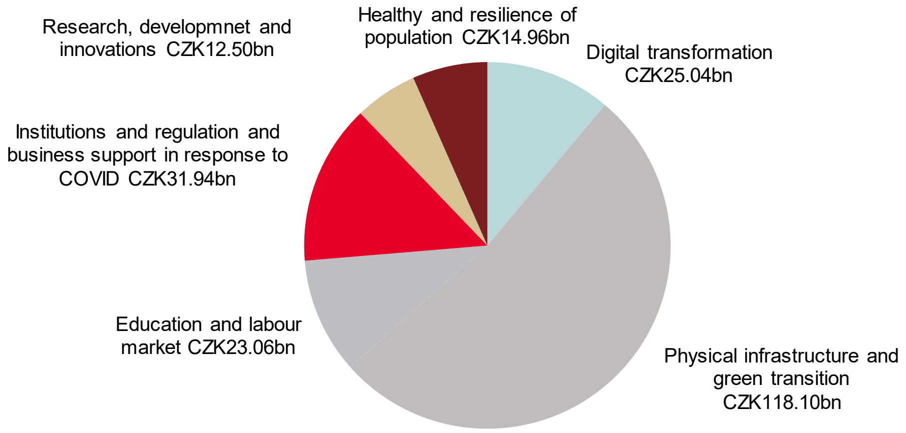
Source: European Commisstion, Economic & Strategy Research, Komerční banka

As part of the Recovery and Resilience Facility, the Czech Republic received approximately CZK172bn in the form of grants (at constant 2018 prices), while the amount of loans provided could reach up to CZK405bn. Loans must be complementary to approved grants. Of the total amount of grants allocated, the European Commission will provide 10% for the pre-financing of projects already this year. In terms of time, EU conditions are relatively strict this time around. 70% of grants must be committed by the end of 2022, the remaining 30% by the end of 2023. A request for payment from the EU can be submitted no later than in August 2026. A retroactive clause allows for applications for reimbursements of investments made from 1 February 2020.

The condition for drawing funds from the recovery plan is the creation and submission of the National Recovery Plan to the European Commission, no later than the end of April this year. These plans must be prepared for the period 2021-2023, and they will be able to be updated in 2022, when the exact amount that the country will be able to draw in 2023, is announced. The Czech government has already prepared such a plan. It contains six basic pillars, within which the funds will be drawn. However, when using the funds, the Czech Republic must comply with the rules set by the EC, i.e. that 37% of expenditures will go to support the climate transition and another 20% to digital transformation.

Surprisingly, out of the total volume of funds in the recovery plan, i.e. CZK226bn, only CZK27bn is likely to be used as compensation for the sectors most affected by the pandemic. The support is part of the Institution and Regulation and Business Support pillar in response to COVID-19, where a total of CZK31.9bn (14% of the total package) was allocated. The support is likely to consist of the introduction of a tax institute for the retroactive application of the tax loss. The largest amount of funds is likely to be drawn under the Physical Infrastructure and Green Transition pillar (52% of the total volume of funds in the recovery plan). Thus, most of the money is intended for strategic, longer-term investments, rather than for acute assistance to companies affected by the COVID-19 pandemic.

Czech Republic: recovery plan, distribution of funds into individual pillars (CZKbn)



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

The recovery plan comes at the same time as the new 2021-2027 programming period for drawing on EU funds starts. The Czech Republic is set to receive €21bn, i.e. €3bn less than in the 2014-2020 programming period. At the same time, the national co-financing rate has been increased (for more developed regions from 50% to 60%, for transition regions to 30%, for less developed regions it remains unchanged at 15%). The rule for drawing has been changed from n+3 to n+2. Without the Recovery Plan, the Czech Republic would be worse off than in the previous programming period. However, thanks to the plan, the Czech Republic will now be able to draw 23% more than in the previous period. However, the risk is that while it will focus intensively on project preparation under the recovery plan, the start-up of the new programming period will be very slow, as the time required for the preparation of projects will be missing. From the point of view of investment activity, 2023 could be very interesting. The Czech Republic will be pushed by the n+2 rule to draw funds from the new 2021-2027 programming period. At the same time, all funds from the current programming period will have to be used according to the n+3 rule. All CZK30bn from the REACT-EU programme will have to be pumped by 2023, while the drawing of funds under the recovery plan will already be in full swing (70% of projects must be committed by the end of 2022). If the Czech Republic wants to avoid the risk of losing EU funds, investment activity should run strongly as early as 2022. 2021 will be more a year of project preparation, and we expect their launch in the second half of the year. In 2023, the massive drawdown of EU funds could take place, as was the case in 2016. Overall, according to our estimates, the annual contribution of the Recovery Fund to investment growth is likely to be around 0.4pp over the next three years. As a share of GDP, it is likely to reach its highest level in 2023 (1.1%), after which it will gradually decline.

Jana Steckerová
+420 222 008 524
Jana_Steckerova@kb.cz

Fiscal policy: economic recovery and record deficit

František Táborský
(420) 222 008 598
frantisek_taborsky@kb.cz

Last year, the government ran a record deficit of CZK367.5bn that was nonetheless much lower than foreseen by the Ministry of Finance in its budget plan. This was due to lower expenditure and, in particular, higher tax collection. A positive surprise was the fulfilment of the ambitious government investment plan. In relative terms, however, investment still lagged record years. A budget with a deficit of CZK320bn was approved for this year. However, it does not incorporate the tax changes approved at the very end of last year, which will have a negative effect on state revenues. In the coming months, the government will amend the state budget law, which we assume will lead it to foresee a deficit in excess of CZK400bn. In our view, however, the deficit should stop at this amount only. Last year, other public finance sectors proved surprisingly resilient, helped by increased transfers from the central government. Like last year, these sectors should help achieve a lower public finance deficit this year. According to our estimates, the deficit ended last year at a record 6.1% of GDP. This year, we expect this figure to increase by 0.4pp. At the end of last year, public debt increased to 38.2% of GDP, the highest level since 2015. Over the next three years, we expect further increases to above 46% of GDP.

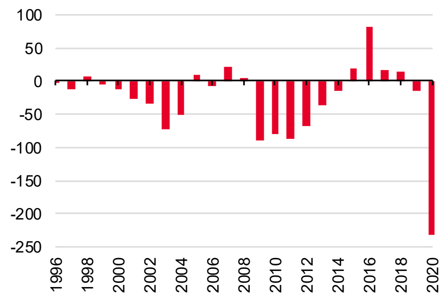
Record deficit but better than planned due to higher tax collection

Last year, the state budget saw a record deficit. But lower expenditure and higher tax revenues in particular helped achieve a better result than planned.

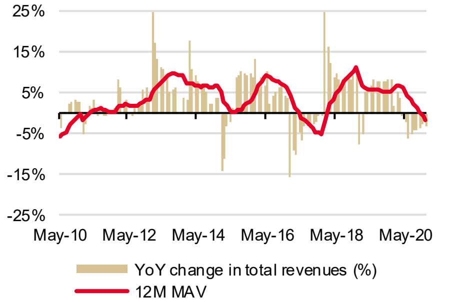
Last year saw a record budget deficit of CZK367.5bn (6.5% of GDP). However, the budget law had penciled in a much bigger deficit of CZK500bn. Higher revenues in particular contributed to the better result. **The Ministry of Finance collected CZK55.1bn more** than anticipated in the approved plan. This was mainly due to a better economic peformance than expected amid resilience of domestic companies to the pandemic and government support measures. This was reflected in corporate income tax collection, which decreased most of all major tax items (-12.2% yoy) but was CZK30.6bn higher than expected despite the government repeatedly approving tax advance waivers over the year.

The Ministry received another CZK36.4bn in non-tax revenues, mainly due to the drawing of budget reserves and slightly higher revenues from the European Union. In addition, lower government expenditure contributed to the more favourable deficit. Compared to its assumptions, **the government saved CZK41.1bn,** mainly due to lower transfers to business entities, lower costs of servicing state debt and slightly lower capital expenditures. However, **government investment, at CZK172.7bn, almost met the ambitious target** and was comparable to the record year of 2015, which was affected by the drawdown of EU funds. However, in relative terms (3.1% of GDP), government investment still lagged the record year of 2009 (3.4% of GDP).

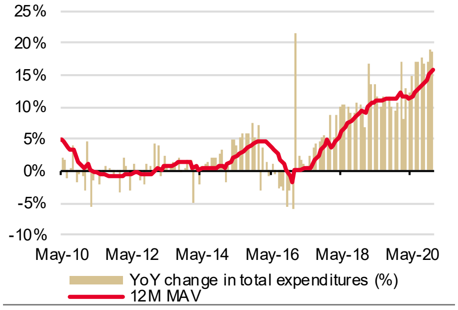
2020 state budget in comparison with previous years (CZKbn)



Despite the yoy decline, tax collection surprised positively



Spending continued to rise but was lower than what budget anticipated

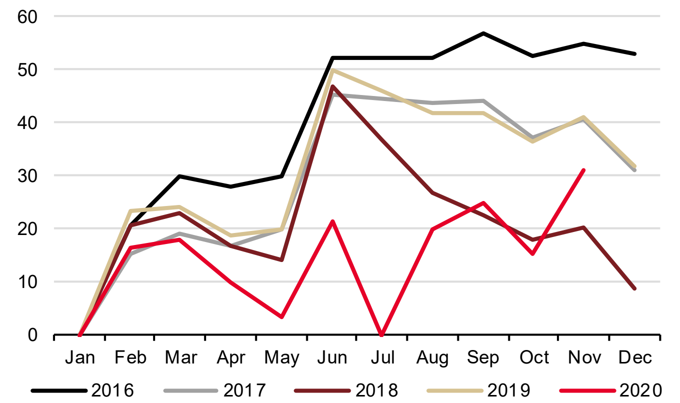


Source: Finance Ministry, Economic & Strategy Research, KB

This year's state budget deficit will likely exceed last year's

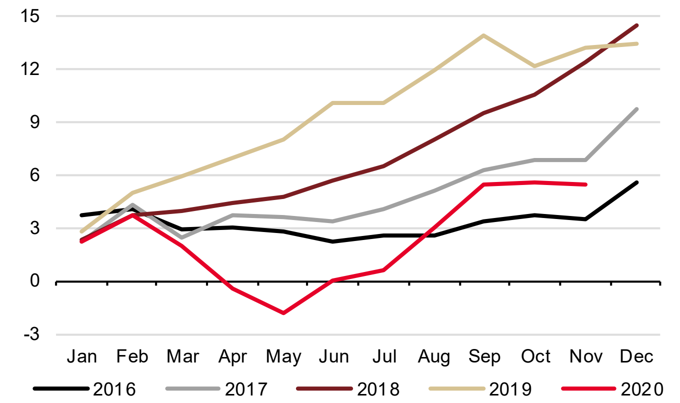
The Chamber of Deputies approved the 2021 state budget in December with a deficit of CZK320bn. However, it did not account for recently approved tax changes, including a reduction in the personal income tax rate. According to Ministry of Finance estimates, this should increase the total public finance deficit by c.CZK100bn in gross terms. According to government statements, the impact on municipalities of the budgetary determination of taxes should be offset by the state budget. **We expect that the planned amendment to the law will see the government revise the deficit up to over CZK400bn.** Although this year still brings a large amount of uncertainty, we assume that the state budget will end 2021 at CZK400bn and no more. The shortfall in tax revenues should be offset by the higher collection of VAT associated with increased household consumption. In addition, the Ministry of Finance has likely again adopted a conservative approach to estimating tax revenues, which has become a political strategy. For nine years in a row, the state budget has ended up better than foreseen in the approved law. In our opinion, this year should not be an exception.

The management of municipalities was a positive surprise (CZKbn)



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

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



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

Other sectors helping reduce general government deficit

Regarding last year's public finance account, we still lack the December data for municipalities and health insurance companies. In both cases, however, the second half of the year saw strength, supported by extraordinary state subsidies and an increase in payments for state-insured persons. While we expected an improvement in the second half of the year, we were surprised by the degree of it. **We have thus slightly raised our surplus forecast for municipalities and health insurance companies to CZK15bn and CZK5bn respectively.** We expect the performance of both sectors to improve again thanks to the return of the economy to growth and higher central government transfers. Together, these sectors should reduce the general government deficit by 0.5pp last and this year.

Public finance forecasts

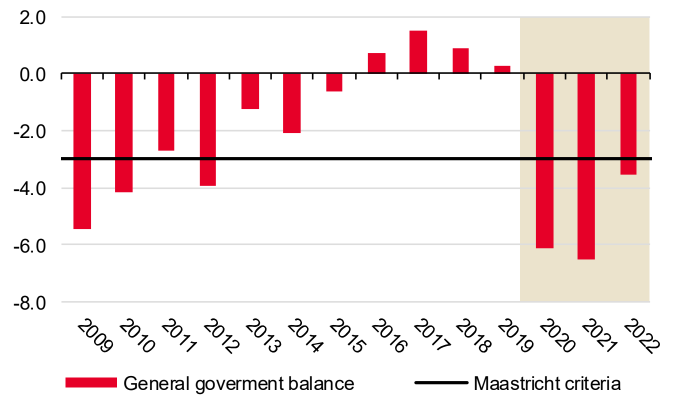
	2019	2020f	2021f	2022f	2023f	2024f
Balance (% GDP)	0.3	-6.1	-6.5	-3.6	-2.6	-1.0
Fiscal effort (pp GDP)	-0.8	-3.8	-1.5	3.0	0.9	1.6
Public debt (CZKbn)	1 738.7	2 146.2	2 546.2	2 796.2	2 996.2	3 096.2
Debt ratio (% GDP)	30.2	38.2	43.5	45.1	46.3	45.8

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

Public finances ended last year with a record deficit. We expect a further increase in the deficit this year. Public debt has reached its highest level since 2015 and will likely continue to grow.

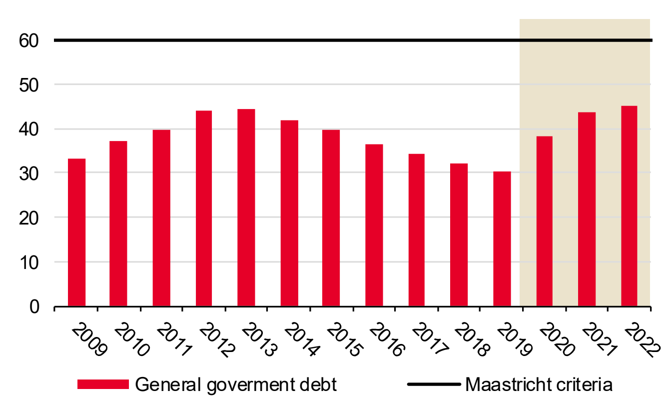
According to the ESA2010 methodology and our calculations, public finances saw a deficit of 6.1% of GDP last year, a historical high that was 6.4pp more than in 2019. Compared to our October forecast, however, the result was 1.1pp better, mainly due to a weaker-than-expected economic downturn last year and better management of municipalities and health insurance companies. **For this year, we expect the general government deficit to reach an even higher 6.5% of GDP.** The main reason is our expected higher state budget deficit compared to last year and renewed economic growth. For 2022, we expect a return to a lower deficit of 3.6% of GDP. According to our calculations, general government debt rose to 38% of GDP at the end of last year, slightly less than we expected in our October forecast. In year-on-year terms, however, indebtedness increased by 7.9pp to the highest level since 2015. We expect debt to continue to grow in the next three years, reaching a record high of 46.3% of GDP in 2023. Subsequently, the figure should gradually begin to decline.

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Michal Brožka
(420) 222 008 569
michal_brozka@kb.cz

The labour market is incredibly stable

The unemployment rate remains low and the number of job vacancies remains high. Government measures and the favourable period before the economy entered the recession created a thick cushion to prevent a deterioration in the labour market. We anticipate that the government support will continue to operate as amended this year. Some companies will likely make further layoffs, given the duration of the recession and a still not entirely certain outlook. We expect only a small increase in unemployment this year and a further decline in 2022.

Unemployment is set to continue to rise, but government programs and high job vacancies should continue to offset this considerably.

At the end of 2020, unemployment stood at 4.0%, according to the methodology of the Ministry of Labor and Social Affairs. Compared to December 2019, this means an increase of only 1.1pp. Unemployment increased after seasonal effects, especially in April and May. In the following months, the increase in unemployment was practically negligible. In December alone, we even saw a slight decline in seasonally adjusted unemployment, but we cannot talk about a trend. **In absolute terms, the number of unemployed aged 15-64 increased by**

78,000 last year. In this age group, about 27k people left the labour market during the year, which visually reduces the reported unemployment rate slightly by less than half a percentage point but does not fundamentally change the overall story. Statistics on the development of employment in the ILO methodology show a decrease between the first and third quarters by about 64k (SA), which would correspond to a decrease in the average employment rate by less than a percentage point to 58.2%. In terms of how the statistics are trending, there is only a slight deterioration in the labour market. **Companies in the manufacturing sector are still talking about labour shortages.** In manufacturing, employment fell by as much as 4.1% yoy during last year, but this decline stopped and fell to 3.8% yoy in November. The number of vacancies registered at labour offices was still 318,000 at the end of December. It is important to note here, however, that many of these vacancies may in fact no longer exist. Even so, it is a very high number, which indicates a similar tightness of the labour market as there was in the previous year.

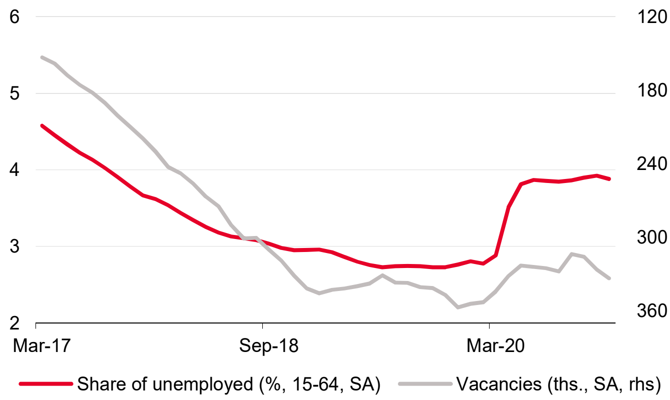
Weekly data from the Ministry of Labor and Social Affairs from the beginning of this year show a slight increase in the unemployment rate to 4.36% (as of Jan 22). After the first wave of the pandemic under existing programs and prevailing uncertainty, companies were able to delay layoffs. However, the second wave may have forced companies to go ahead with layoffs despite their hope of a future recovery after the first wave. In addition to government support, companies' earlier difficulty in finding employees probably also played a significant role in their reluctance to lay off workers. From this point of view, the Czech economy had a great advantage in terms of its stage of advancement within the economic cycle, i.e. absorbing short-term shocks is much easier when they are preceded by a period of prosperity. The arrival of the second wave was another shock that some companies had to respond to by using savings. **If the decision to dismiss employees was made during the second wave of the pandemic by many companies, we could expect an increase in unemployment from the beginning of this year, given the length of the notice periods.**

The current program (Antivirus) of providing wage cost compensation to companies due to COVID has been extended until February. The future of the program is not clear at the moment, however, given the still unfavourable pandemic situation and the upcoming elections to the Czech Parliament in the autumn. That said, we expect that government support for the labour market will continue (regime Kurzarbeit). Some companies may have decided to lay off employees, but the still tight labour market should be able to absorb some of them. Overall, therefore, we still expect the unemployment rate to rise to 4.5% (excluding seasonal effects) in the second quarter of this year, followed by a very gradual decline from the third quarter. Without seasonal adjustment, this would mean that the unemployment rate would be 4.3% in the middle of the year, which is a year-on-year growth of 0.6pp. The labour market reacts with a lag to developments in economic activity. Next year, with regard to the expected economic expansion, we expect a gradual improvement in the labour market.

After a quarter-on-quarter decline in the average wage level of 3% (SA) and a slowdown in its growth to 0.6% yoy in the second quarter 2020, a turnaround took place in the third quarter. The average wage rose by 5.8% quarter on quarter and year-on-year growth accelerated back to 5.1%, the same rate as in the first quarter. Wage growth thus largely offset the decline in the previous quarter. With the advent of the second wave of the pandemic, we expect the rate of wage growth to weaken again. However, developments will be very differentiated at the sector level. In the affected services, wages are unlikely to increase at all in the near future. There could be an increase in the case of production or services not affected by pandemics (e.g. IT). A tight labour market is still evident in these sectors. For example, in the case of industrial producers, employment fell by less than 4% yoy in November, but the year-on-year growth rate of the average wage accelerated to 4.5% over that time. In the case of construction, the year-on-year decline in employment was 1.9% in

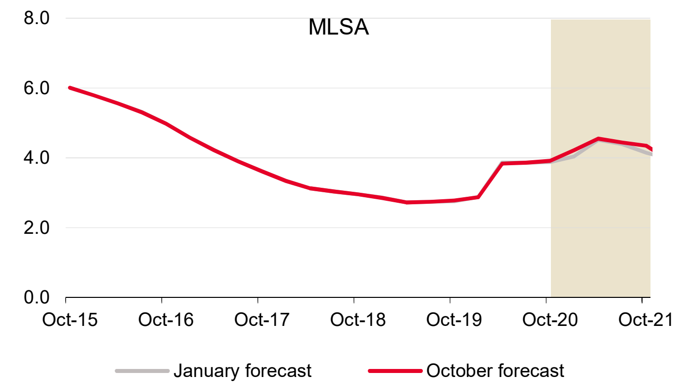
November, but growth in the average nominal wage was 6.6%. Only to a certain extent is this probably the effect of the dismissal of lower income groups.

The number of vacancies has decreased only a little last year



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

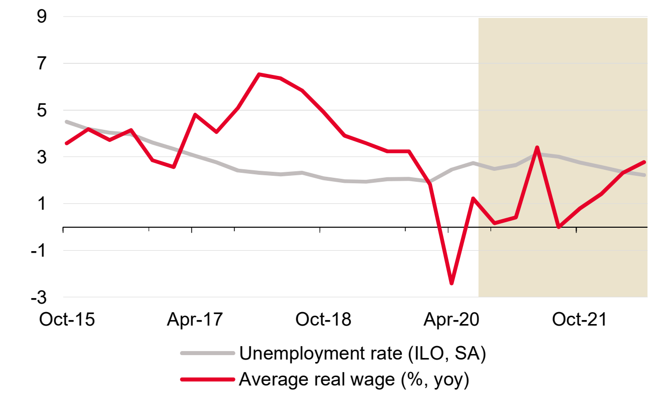
Unemployment will likely peak in the middle of this year (%, SA)



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

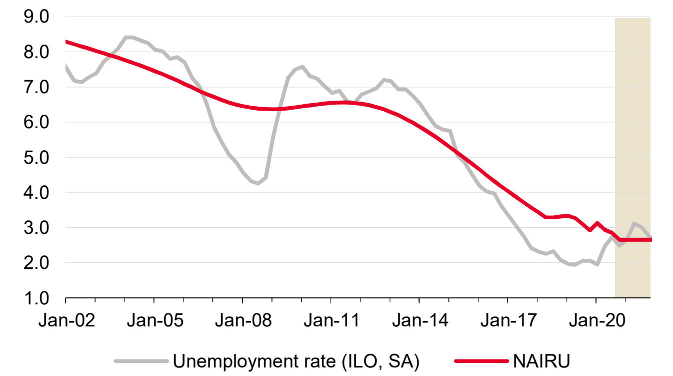
For the fourth quarter, we expect the year-on-year growth of the average wage to decelerate to 2.8%, which in real terms, means almost stagnation. The still uncertain outlook for the private sector indicates a low willingness to raise wages, with the exception of sectors that are facing severe job shortages and are expanding. In the public sector, we expect wage increases of 10% for social and health workers, and teachers' salaries to rise by around 9%. We also expect the minimum wage to increase by 4%. **We estimate an average wage growth of 3.4% in 2020 and 3.0% next this year. If inflation slows down as we expect, this would mean an increase in the average real wage of 1.1% this year after last year's 0.2%.**

Average real wage had been falling (%, yoy)



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

The pressure for higher wages has declined (%)



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

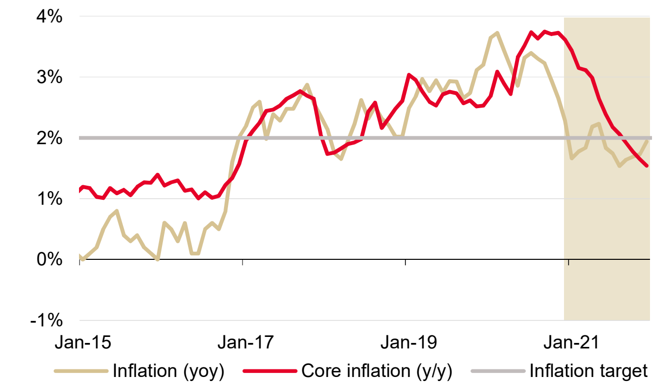
Inflation should continue to slow down

We expect inflation to slow slightly below the CNB's 2% inflation target in 2021, mainly due to cheaper food, weakened domestic demand and lower import prices. In the coming years, inflation should remain close to 2%. A rise in core inflation remains a risk, which has so far slowed down more gradually than the growth in the economy would imply.

We expect core inflation to bottom out in the middle of this year

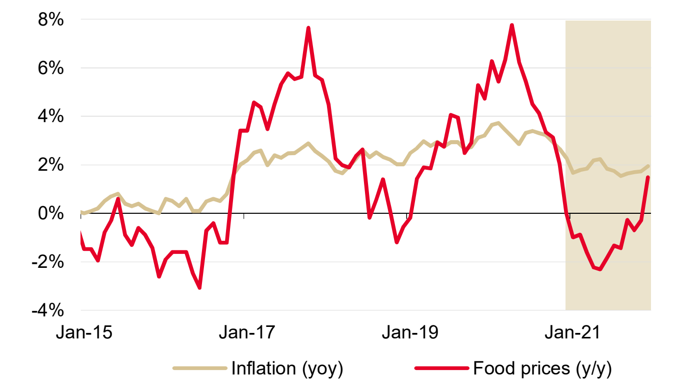
Growth in consumer prices slowed markedly in the second half of last year. Year-on-year inflation slowed to 2.3% yoy at the end of 2020, after peaking at 3.4% yoy in July. The main reason for the slowdown in inflation was, after a previous sharp rise, a fall in food prices, which exceeded our expectations. Conversely, in the case of core inflation, which does not include food, energy and tax changes, and which thus better reflects the impact of the economy on consumer prices, the slowdown was weaker. In year-on-year terms, core inflation was 3.7% in the middle of the year and was still at 3.6% yoy in December. In terms of month on month moving averages (3M) annualized rate, core inflation peaked at 4.6% in July, and has slowed to 3.1% since then - which, of course, is still a relatively high pace. **However, we believe that the economy is still acting in a disinflationary manner and that core inflation will slow down in the coming months.** In terms of month-on-month changes in our forecast, core inflation is bottoming out in the middle of this year and has been slowly accelerating since then. Year-on-year, core inflation should fall to 2.4% yoy in the middle of 2021 and reach its low of 1.6% yoy by the end of 2021. Then we expect it to increase again. The development of inflation in a given year, especially its core component, is usually suggested by its value at the beginning of the year, when many companies regularly revalue their products and services. Here, however, there is a significant risk of a surprise this time, in both directions, due to the closed part of the economy and due to the pandemic. Above all, it is possible that many companies will postpone revaluation until the outlook for the economy is clearer. **From the result of inflation in January, it will not be possible to read whether and how many companies revalued, and whether or not to expect price adjustments in the coming months.**

Inflation should gradually decelerate below 2%



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

Food price growth should continue to be a disinflationary factor



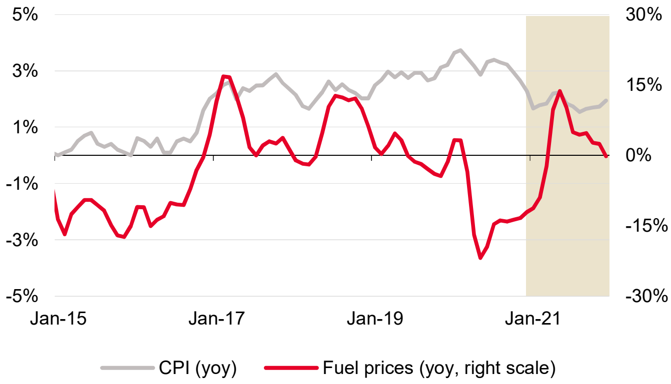
Source: CZSO, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka

Food prices declined in H2 2020, but we expect the trend to stop this year.

The rise in food prices peaked in the first half of last year, when difficulties with seasonal food supplies were added to the previous rise due to higher import prices and strong demand. Food prices rose by a high 7.8% yoy in April. From June onwards, food prices began to fall so sharply that by the end of the year, their impact on year-on-year consumer price inflation was completely zero. In the coming months, we expect a slight rise in food prices given rising commodity prices on world markets. On the contrary, domestic factors such as last year's favourable harvest and generally weakened demand should counteract the rise in prices. However, last year's high base effect will mean that food prices will fall year-on-year and thus have a disinflationary effect.

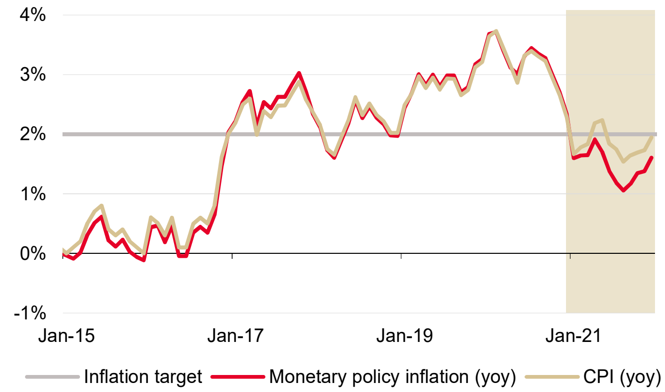
The fall in oil prices and consequently lower fuel prices significantly dampened inflation last year. In the middle of the year, the year-on-year decline in diesel and petrol prices averaged about 20%. Since then, prices at petrol stations have risen slightly. In 2021, we expect a slight increase in oil prices to a still relatively low level of USD49 / barrel. However, this is an increase from a low base and fuel prices will thus have a pro-inflationary effect.

Prices at gas stations will rise this year



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

Monetary policy inflation may drop below 2%



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

Higher excise taxes will lead to an increase in inflation.

Last year saw an increase in excise duties on tobacco and alcohol and, conversely, a reduction in VAT rates on some items in the consumer basket. Overall, the price impact of the tax change on headline inflation was approximately zero. For this year, we expect a further increase in the excise tax on tobacco by about 10% and an increase of about half the rate in the next two consecutive years. Against that, the excise duty on diesel has been reduced since January this year, which has a minimal impact on headline inflation. The overall effect of administrative changes should thus add about 0.4pp to inflation this year. Electricity prices fell in the fourth quarter of last year. For the beginning of this year, the Energy Regulatory Office announced a reduction in the prices of the regulated part of electricity. In contrast electricity prices in the energy exchange have increased. It is possible that during this year, if the economy prospers, energy prices will rise again, but we expect stable prices for the first half of the year. For the whole of last year, regulated prices increased by 3.2% and for this year, we expect a slightly lower growth of 1.0%.

All in all, we expect inflation to slow now and reach a year-on-year rate of 1.8% at the beginning of the year. For the whole of 2020, consumer prices increased by 3.2%. We expect inflation to slow to 1.8% on average this year, with monetary policy inflation, which does not include the primary effects of changes in indirect taxes, expected to average 1.4%.

Risks: COVID-19 still first and foremost

We still consider the risks associated with the development of the pandemic to be the most significant in terms of short- and medium-term forecasts. The main risks include:

- **Vaccination campaign will not have a sufficient effect.** In our baseline scenario, we expect the positive impact of the vaccination campaign to allow the economy to operate with minimal restrictions on social contact in the second half of this year. Failure to meet this assumption would fundamentally affect our forecast for economic development.

- **Another pandemic wave.** We expect the gradual opening up of the economy from February. In the second quarter, we still expect some restrictions for the economy, but not another pandemic wave and the associated tighter measures. Failure to meet this assumption may again significantly affect the forecast of development, especially downwards.

- **Fiscal policy.** When calculating the effect of the reduction in personal income taxes, we assume a marginal propensity to consume at 0.6 and in case of the one-off contribution to all pensions at 0.8. However, depending on the behaviour of the population, the total impulse may be weaker or stronger or otherwise distributed in time. In addition, the fact that 2021 is an election year increases the chances of additional fiscal “gifts” to voters.

- **Price development during a pandemic.** This revolves around how companies in the current situation approach their pricing. The estimated development of prices in closed services may be different in reality. Inflation in January will largely set the level for the whole year, but in the current situation, it will not be clear whether companies have postponed price adjustments to later months.

- **External environment.** We expect a recovery in the external economy, which is, however, also strongly influenced by the pandemic and hopes for vaccination. A further recession in the euro area would mean the risk of another decline for the Czech economy as well.

Key economic indicators

	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	2019	2020	2021	2022	2023	2024
GDP and its breakdown														
GDP (real, yoy)	-1.9	-10.8	-5.0	-6.3	-3.3	7.2	1.9	4.5	2.2	-6.0	2.6	3.9	2.6	2.6
Household consumption (real, yoy)	-0.2	-8.3	-3.9	-6.7	-2.7	6.0	2.2	5.7	2.9	-4.8	2.8	3.5	2.8	2.5
Government consumption (real, yoy)	4.6	1.6	0.1	-0.8	-2.0	-0.1	1.3	1.1	2.2	1.4	0.1	-0.4	1.1	1.8
Fixed investments (real, yoy)	-5.3	-5.1	-10.8	-13.3	-5.7	-4.3	4.4	8.1	2.2	-8.6	0.6	9.4	4.3	4.3
Net exports (contribution to yoy)	-0.2	-5.7	1.3	2.7	0.7	4.5	-1.8	-1.8	0.0	-0.5	0.4	0.3	0.4	0.3
Inventories (contribution to yoy)	-1.2	-0.7	-1.6	-2.1	-0.6	1.2	1.4	1.5	-0.2	-1.4	0.9	-0.1	-0.4	-0.3
Monthly data from the real economy														
Foreign trade (CZK bn)	39	10	59	72	51	40	34	28	146	180	153	154	146	138
Exports (nominal, yoy)	-4.1	-22.5	-0.9	10.6	11.2	34.1	10.9	6.6	2.2	-4.3	15.7	7.4	6.0	5.9
Imports (nominal, yoy)	-3.4	-18.7	-4.5	4.2	10.3	30.4	14.6	11.8	0.9	-5.6	16.8	8.4	6.8	6.4
Industrial production (real, yoy)	-4.1	-23.5	-4.4	2.2	3.1	29.0	3.8	3.3	-0.1	-7.5	9.8	6.0	5.3	6.0
Construction output (real, yoy)	2.7	-8.7	-9.7	-9.7	-12.3	-3.1	-2.1	0.7	0.9	-6.4	-4.2	5.9	6.6	7.1
Retail sales (real, yoy)	1.8	-3.8	1.0	-2.7	-1.7	2.1	-1.0	5.4	4.9	-0.9	1.2	5.4	5.7	4.0
Labour market														
Wages (nominal, yoy)	5.1	0.6	5.1	2.8	2.2	5.5	1.6	2.7	6.4	3.4	3.0	4.5	6.4	5.3
Wages (real, yoy)	1.8	-2.4	1.2	0.2	0.4	3.4	0.0	0.8	3.5	0.2	1.1	2.6	4.3	3.2
Unemployment rate (MLSA)	3.0	3.7	3.8	4.0	4.2	4.3	4.3	4.3	2.8	3.6	4.3	3.7	3.4	3.4
Unemployment rate (ILO 15+)	2.0	2.4	2.9	2.4	2.7	3.0	3.1	2.7	2.0	2.4	2.9	2.3	2.0	2.0
Employment (ILO 15+, yoy)	-0.9	-1.3	-1.4	-1.5	-0.1	-0.1	0.3	1.0	0.2	-1.3	0.3	0.6	0.4	0.1
Consumer and producer prices														
CPI Inflation (yoy)	3.6	3.1	3.3	2.6	1.8	2.1	1.6	1.9	2.8	3.2	1.8	1.9	2.1	2.0
Taxes (contribution to yoy inflation)	0.0	0.0	0.0	0.0	0.1	0.4	0.5	0.5	0.0	0.0	0.4	0.2	0.2	0.1
Core inflation (yoy) (*)	2.9	3.2	3.7	3.7	3.2	2.6	2.0	1.7	2.7	3.4	2.3	1.9	2.0	2.0
Food prices (yoy) (*)	6.0	6.5	4.0	1.7	-1.1	-2.2	-1.0	0.2	2.8	4.5	-1.0	1.6	1.4	1.9
Fuel prices (yoy) (*)	1.0	-19.4	-14.2	-13.1	-7.7	11.3	4.7	1.7	-0.4	-11.4	2.5	-1.8	3.3	1.4
Regulated prices (yoy) (*)	4.2	3.4	3.4	1.8	0.4	0.4	0.6	2.4	4.5	3.2	1.0	2.3	2.0	2.0
Producer prices (yoy)	1.4	-0.6	-0.3	0.1	0.4	1.5	1.7	1.7	2.6	0.1	1.3	1.6	2.2	1.9
Financial variables														
2W Repo (%, average)	2.0	0.6	0.3	0.3	0.3	0.3	0.3	0.3	1.9	0.8	0.3	0.8	1.5	2.1
3M PRIBOR (%, average)	2.2	0.6	0.3	0.4	0.4	0.4	0.4	0.4	2.1	0.9	0.4	0.9	1.6	2.2
EUR/CZK (average)	25.6	27.1	26.5	26.7	26.0	25.7	25.5	25.3	25.7	26.5	25.6	25.0	24.4	24.0
External environment														
GDP in EMU (real, yoy)	-3.2	-14.7	-4.3	-7.1	-0.8	13.1	1.2	4.7	1.3	-7.3	4.6	2.2	1.9	1.8
GDP in Germany (real, yoy)	-2.1	-11.3	-4.2	-5.8	-2.7	8.9	1.8	4.6	0.6	-5.9	3.1	3.4	2.0	1.6
CPI in EMU (real, yoy)	1.1	0.2	0.0	-0.2	0.3	0.9	1.4	1.7	1.2	0.3	1.1	1.2	1.2	1.5
Brent oil price (USD/brl, average)	54.3	27.8	43.2	44.3	49.0	49.0	49.0	49.0	64.9	42.4	49.0	53.0	61.7	64.7
EURIBOR 1Y (%, average)	-0.3	-0.1	-0.4	-0.5	-0.5	-0.4	-0.3	-0.3	-0.2	-0.3	-0.4	-0.1	0.2	1.2
EUR/USD (quarter eop, year average)	1.10	1.10	1.17	1.19	1.20	1.23	1.25	1.27	1.12	1.14	1.24	1.32	1.34	1.36

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

CNB Focus

Martin Gürtler
(420) 222 008 509
martin_gurtler@kb.cz

Monetary policy tightening is on the horizon

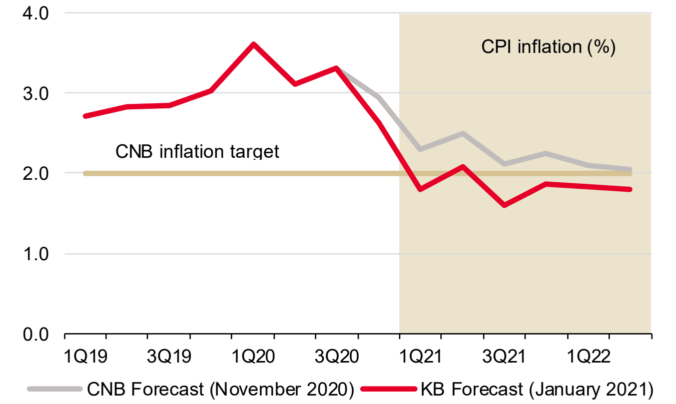
The Czech National Bank (CNB) is likely to remain in wait-and-see mode, for some time, given uncertainty on the development of the pandemic and on the consumer price trend. Furthermore, premature rate hikes could jeopardise financial stability. In the CNB's new forecast, the effect of expansionary fiscal policy should be more than offset by a stronger Czech koruna. The early part of this year will be marked by continuing restrictions, but with the COVID-19 vaccination roll-out now underway, there is hope for a better economic performance in the second half of the year. We expect the CNB to make a first increase in key repo rate, of 25bp, at its November meeting. By that time, most of the uncertainties should have cleared. A November hike would therefore, in our view, start a gradual normalisation of monetary policy, which would continue over 2022. According to our forecast, the repo rate should be close to 1% at the end of the next year. While the Lombard rate should, in our view, increase alongside the repo rate, the discount rate is likely to remain at its current level until the end-2022.

Pandemic is still the reason for loose monetary policy

After being cut by a total of 200bp in 1H20, the two-week repo rate remained unchanged in 2H20.

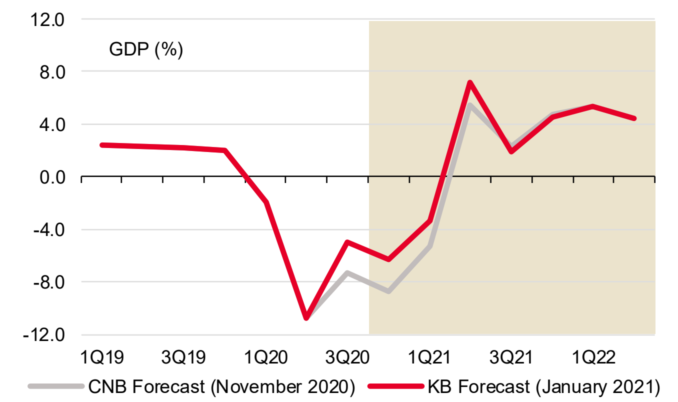
As expected, the CNB's monetary policy remained unchanged in 4Q20. The key repo rate is therefore at 0.25%, the Lombard rate at 1.00% and the discount rate at 0.05%. **The main reason for the stability of interest rates was the continuing impact of the coronavirus pandemic**, the second wave of which led to the re-closure of a large part of the Czech economy in the autumn, and so probably resulted in a further decline in output. Similar developments can also be noted in other European countries. Moreover, the restrictive measures were not lifted at the end of last year and their effects are likely to be reflected in poor results in 1Q21.

Inflation outlook is largely uncertain due to the pandemic



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

Stronger economic rebound likely only in 2H21



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

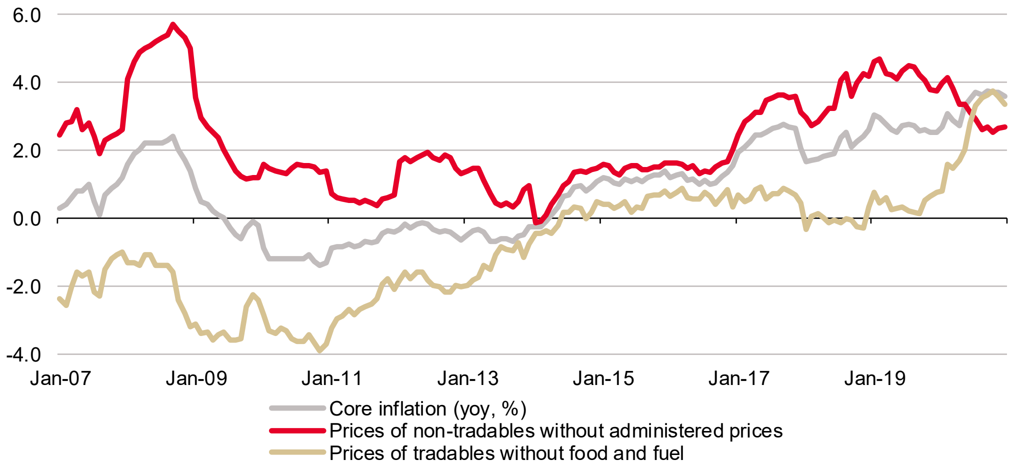
Inflation below and GDP above the CNB forecasts

Inflation slowed markedly and was below the CNB forecast in 4Q20. This was mainly due to volatile food prices, while core inflation remained above 3.5%.

Consumer price inflation was lower in 4Q20 than the central bank expected. While the CNB had forecast inflation of around 3% yoy, the average for the last three months of 2020 was only 2.6%. This represents a significant decline, with a particularly pronounced drop in December to 2.3%. The decline was mainly caused by volatile food prices, which surprised with a significantly lower growth. **On the other hand, core inflation developed broadly in line with the CNB forecast, hovering at just above 3.5% throughout 4Q20.** The core component thus remains the main source of total inflation, with the prices of both tradables and non-tradables contributing to its dynamics. Tradable goods prices were rising at a rate of around 3.5% and probably reflect the previous weakening of the koruna. After slowing in 3Q20, growth in prices of non-tradable services was close to 2.5%.

The economic recovery in 3Q20 was stronger than the CNB had forecast. The central bank expected Czech GDP to grow 4.4% qoq, while the economy actually grew by 6.9%. In particular, net exports were significantly higher and household consumption surprised on the upside as well. On the other hand, investments were lower than in the CNB forecast. For 4Q20, the CNB expects a decline in the domestic economy of around 1% qoq, which is in line with our forecast. **Faster GDP growth in 3Q20 was also reflected in higher growth of average nominal wages**, which rose by 5.1% yoy, while the central bank had forecast an increase of 4.5%. For 4Q, the CNB expects average wage growth of 3.1%.

Core inflation remains above 3% and the prices of both tradables and non-tradables are contributing to its dynamics



Source: CNB, Economic & Strategy Research, Komerční banka

A stronger koruna vs expansionary fiscal policy

The koruna's current level is the level the CNB had forecast for end-2021.

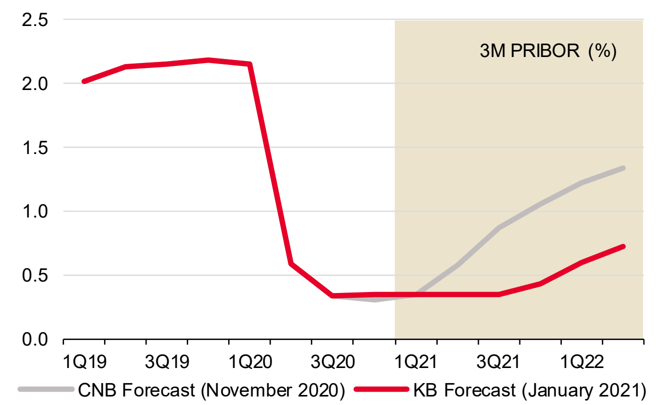
Compared with the CNB forecast, the Czech koruna was stronger vs the euro by about 2% on average in 4Q20. The firmer koruna was fostered not only by the positive news on the start of vaccination, but also by the central bank having three rate hikes for 2021 in its latest forecast. Market interest rates immediately reacted to this, shifting the entire yield curve up. The koruna remains stronger at the beginning of this year, trading slightly above EUR/CZK26. CNB did not expect this level until end-2021. **The new CNB forecast, to be published in early February, should therefore contain a stronger koruna for most of the forecast horizon.** This, together with slower growth in consumer prices in 4Q20, is likely to push inflation lower over the forecast horizon.

The economy is likely to grow faster this year than the central bank forecasts. The CNB expects Czech GDP to grow by 1.7% over 2021, making its forecast one of the most pessimistic on the market. For comparison, we expect an increase of 2.6%, even with a significantly lower economic downturn last year. However, the CNB's new forecast is likely to come with higher growth for this year, as already suggested by some Bank Board members. Although the first few months of the year are likely to be marked by continuing restrictions, the promise of a gradually increasing proportion of the population being vaccinated gives hope that **the second half could return the economy to a free-functioning state and so accelerate its recovery**.

The impact of fiscal policy will likely be stronger this year than in the CNB's baseline scenario. Both extension of most government support programmes and lower personal income taxes will have an effect.

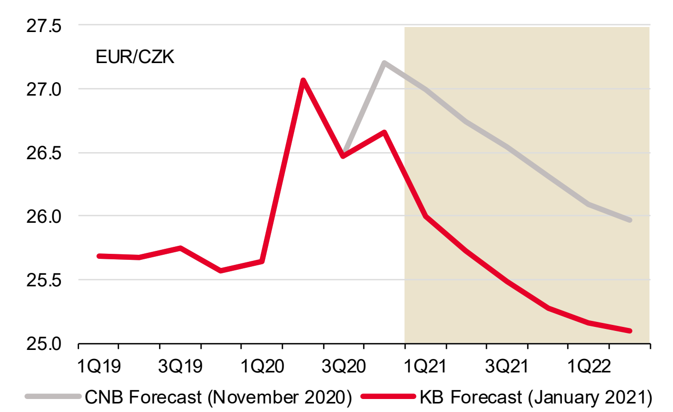
Domestic demand will be significantly supported by expansionary fiscal policy this year. The turn of the year saw most government support programmes extended and also brought one-off increases across the board for pensions and a significant reduction in personal income tax. This, together with a favourable trend in household disposable income so far, should support private consumption and, after the easing of restrictions, provide the economy with strong impetus for a rapid recovery. **The baseline scenario of the CNB's current forecast includes a markedly negative fiscal impulse this year**, which is based on the assumption that most of last year's support programmes will end at the beginning of this year. Moreover, the scenario only includes the above-mentioned effect of higher pensions but does not include the effect of lower taxes. This is included in the alternative scenario, which already contains a neutral effect of fiscal policy (compared to its impact last year), and thus also a slightly higher pace of inflation and faster growth in interest rates.

Interest rates likely to rise slightly at end-2021



Source: CNB, Economic & Strategy Research, Komerční banka

Stronger koruna has partly tightened monetary conditions



Source: CNB, Economic & Strategy Research, Komerční banka

Year-end 2021 likely to bring slightly higher rates

The CNB Board is likely to continue in wait-and-see mode for some time, and interest rates should remain at the current low levels for much of this year. Uncertainty about the pandemic's development is still high, not only in the Czech Republic but also abroad. Although the COVID-19 vaccine roll-out is now underway, it will be some time before we see the real effects on the economy. In addition, a premature rise in interest rates could jeopardise the already tested financial stability. Although the expansionary effect of fiscal policy is likely to be reflected in higher demand pressures this year, we think that this will be more than offset by a stronger koruna. **As a result, the inflation outlook in the central bank's new forecast may be slightly lower. However, further developments in consumer prices are associated with an unusually high degree of uncertainty.** Given the ongoing closure of the economy, the question is when will sellers raise prices, which they usually do at the beginning of the year, or even whether they might decrease them. This uncertainty will probably be resolved only in the course of 1H21.

According to our forecast, the key repo rate will remain at the current low level until November, when we expect it to increase by 25bp. We expect normalisation of monetary policy to then continue in 2022, at the end of which the repo rate should be close to 1%.

We expect a first 25bp increase in the key repo rate at the November meeting, which should start a gradual process of monetary policy normalisation. By 2H21, we should already see the results of the improving economic situation. At the November meeting, the central bank will be able to provide forecasts based on a complete set of data on economic developments in 2Q21. The above-mentioned uncertainties should also have been resolved, and the CNB's forecast should thus provide the Bank Board with a more certain anchoring of their expectations regarding the development of the economy. Another important factor is that, in our opinion, **the central bank will raise interest rates only when it is sure that it can continue to do so in subsequent meetings**. This is also the reason why we think that the November increase in interest rates will start the process of gradual monetary policy tightening, which should continue throughout next year. At the end of 2022, our forecast assumes a two-week repo rate of close to 1%. **While the Lombard rate will, in our opinion, rise alongside the key repo rate; i.e. from November, the discount rate should remain at the current level until the end-2022.** As in the previous cycle of tightening monetary policy (from April 2017 to February 2020), the central bank is likely to want to restore the standard symmetric band around a repo rate of 1%.

The central bank's February forecast is likely to include a faster rise in rates than we model. This will probably apply also for this year, when the first increase in interest rates is planned for 2Q in the CNB's current forecast. The reason is the highly forward-looking CNB's prediction model, in which this year's rates respond to the economic situation next year. However, in our opinion, the Bank Board will remain restrained and, as after the last meeting, express its preference for interest rate stability for a longer time period. However, **its communication could already carry a slightly hawkish tone**, and indicate possible outlines on the expected normalisation of monetary policy.

Czech FX market

František Táborský
(420) 222 008 598
frantisek_taborsky@kb.cz

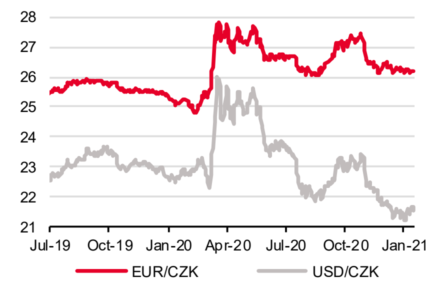
Recovery should push koruna back to stronger levels

At the end of last year, the koruna was strongly supported by the CNB's surprisingly bold forecast. In our view, CNB behaviour will be a key factor this year as well. The growing probability of the first rate hike at the end of this year should support the koruna in advance in a further shift to stronger levels. We expect most of the strengthening in the first half of the year, which we see the koruna ending at 25.65 per euro. We see a 4% strengthening over the entire year, putting the currency at around EUR/CZK 25.20 at end-2021. This is well above the market expectation. Pandemic/vaccine developments remain a risk, and there is uncertainty around CNB monetary policy linked to this. The rise in market interest rates is reflected in higher forward points, which thus offer full coverage of our expected koruna strengthening.

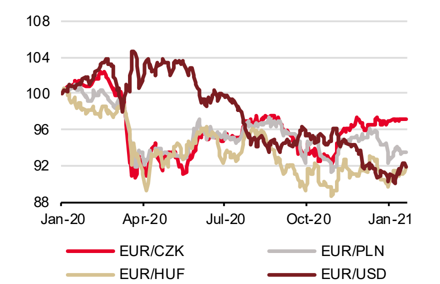
Expectations of earlier interest rate increases already supporting koruna

The koruna ended last year near 26.20 per euro, more than 70 halers weaker than at the start of 2020. **Within Central Europe, however, it saw the smallest loss, of 3%, over the year.** The Polish zloty moved similarly for most of last the year, but in recent weeks it has been hurt by central bank intervention. For most of last year, we saw a similar story in case of the weaker Hungarian forint. The first weeks of January were for PLN and HUF marked by catching up with the losses, while the CZK stagnated. However, if the Polish zloty had not weakened amid central bank intervention, the koruna would have been the leading performer in the region for this year with our expected profit of 4%. At this rate, after two years, it will return to roughly the same level at which it started last year.

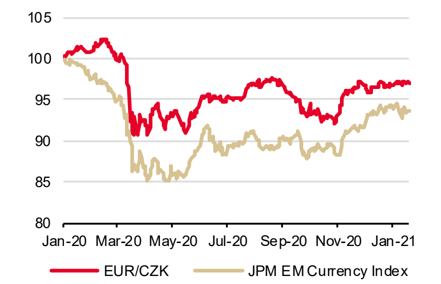
CZK development



Performance of CE currencies



CZK lead over the market is shrinking



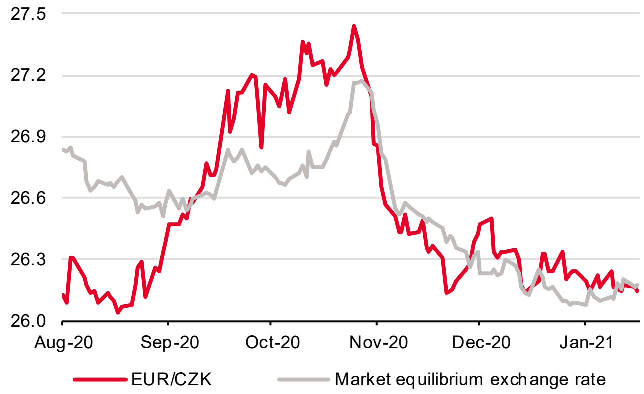
Source: Bloomberg, Economic and Strategic Research, KB

1.1.2020 = 100

After a surprising 0.4pp slowdown in consumer inflation to 2.3% yoy in December, the financial markets have corrected their expectations for a first CNB rate hike. This is reflected in short-term market interest rates and the decline in the potential of the koruna to further strengthen. From this point of view, the new central bank forecast and its interpretation by the CNB board will be crucial in the coming days. It was the CNB's November forecast that started the koruna's sharp strengthening. Despite the recent correction, financial markets still see a first rate hike this year, in line with our forecast. In our view, this should be confirmed by the CNB board, thus likely unleashing the koruna’s potential to strengthen this year.

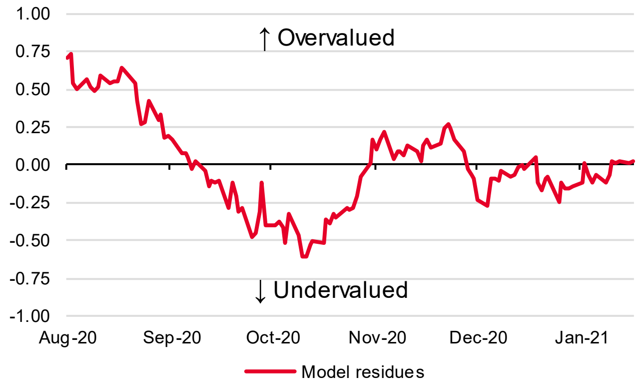
Although we expect a first CNB rate hike only in November (more on our monetary policy forecast in the *CNB Focus* chapter), market expectations, i.e. market interest rates, should rise in advance and gradually take into account further monetary policy tightening next year. Combined with vaccination, economic re-opening and improving sentiment in global markets, **we expect most of the strengthening in the first half of the year, with the koruna ending the half at 25.65 per euro.** In the second half of the year, the strengthening should slow slightly, with the koruna ending the year at EUR/CZK25.20.

Koruna has returned to equilibrium…



Source: Bloomberg, Economic and Strategic Research, Komerční banka

… with movements in the financial markets



Source: Bloomberg, Economic and Strategic Research, Komerční banka

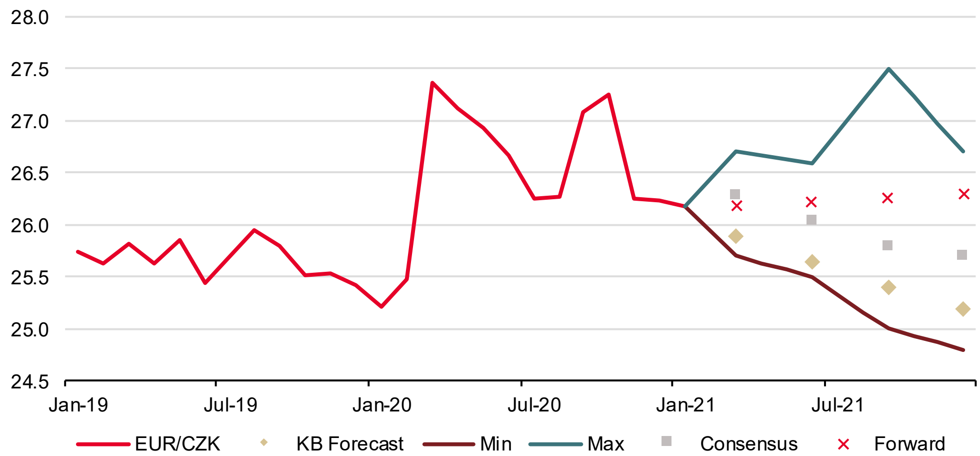
Compared to our last forecast (see https://bit.ly/2LJteFv), we see the koruna 10 to 30 halers stronger due to **a faster economic recovery, earlier coronavirus vaccination and a bolder central bank approach to tightening monetary policy.** On average, financial markets currently expect the koruna at 25.70 per euro at the end of this year, i.e. 50 halers weaker than in our forecast.

Koruna exchange rate forecast (end of period)

	1Q21f	2Q21f	3Q21f	4Q21f
EUR/CZK	25.90	25.65	25.40	25.20
USD/CZK	21.60	20.85	20.30	19.85
EUR/CZK	1.20	1.23	1.25	1.27

Source: Economic and Strategic Research, Komerční banka

Expected EUR/CZK path, market consensus by Bloomberg (as of 27 January 2021)



Source: Bloomberg, Economic and Strategic Research, Komerční banka

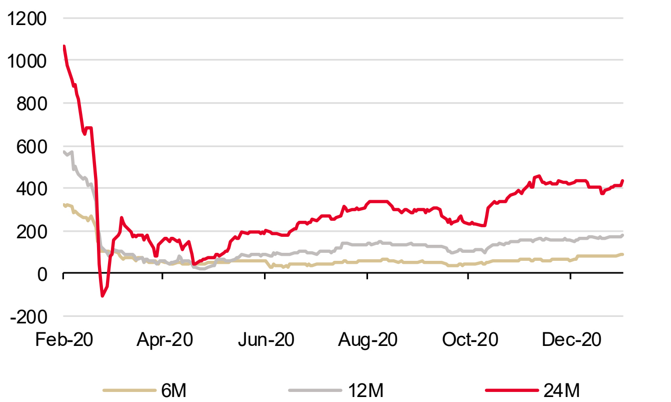
Pandemic and slower or ineffective vaccination the main risks

The pandemic remains a major risk to our forecast. However, given the current situation and market perceptions, we see this risk as skewed in the direction of a weaker exchange rate compared to our forecast. We see a risk of vaccination being slow or ineffective. In terms of vaccination, the financial markets may begin to distinguish between successful and unsuccessful countries, and any vaccine failure would likely to lead to global stress in the markets. In either case, however, the result would be a weaker koruna than we forecast. On the other hand, **CNB monetary policy remains a symmetrical risk**. Faster economic recovery and persistent inflationary pressures would likely lead to an earlier rise in interest rates and, in advance, a stronger koruna. On the contrary, the delayed effect of the second and third waves of the pandemic and government measures could reveal a moribund economy, including a more pronounced undershooting of the inflation target, which would likely delay monetary policy tightening until next year and result in a weaker koruna than we forecast.

Forwards offer full coverage of expected CZK strengthening

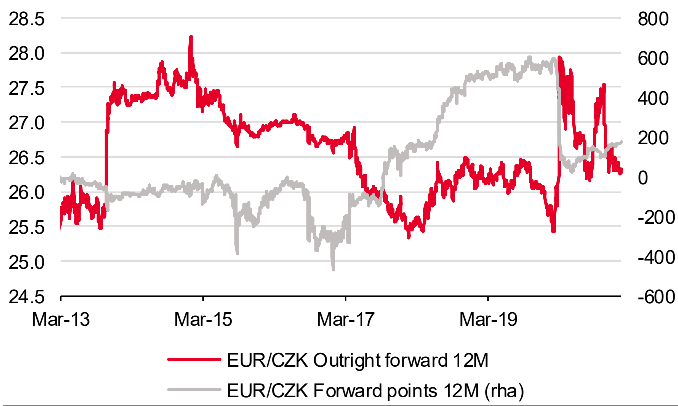
Our new forecast assumes a rapid strengthening of the koruna, by 4%, this year. Although the conditions for hedging currency risk no longer allow for as attractive levels as last year, recent interest rate developments have pushed forward points to their highest levels since the market slump in March. In the one-year horizon, the current conditions offer full coverage of our expected koruna strengthening, i.e there is a **difference of more than one koruna between the forward rate and our forecast.**

Rising rates increase the attractiveness of forward points



Source: Bloomberg, Economic and Strategic Research, Komerční banka

However, a stronger koruna worsens hedging conditions



Source: Bloomberg, Economic and Strategic Research, Komerční banka

Czech government bonds and the IRS market

František Táborský
(420) 222 008 598
frantisek_taborsky@kb.cz

Monetary and fiscal policy will push yields and rates up

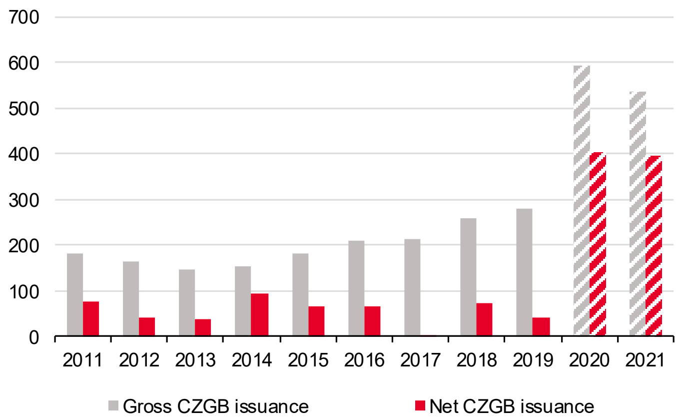
The prospect of gradual vaccinations and the return of the economy to normal are accelerating the imminent start of monetary policy normalisation. In conjunction with the expansionary fiscal policy and the record supply of government bonds, we expect continued growth in CZGB's yields and market interest rates. Government bonds should thus become cheaper during the year, both nominally and in relative terms to the IRS. Compared to last year, we expect a larger supply of euro bonds. The risk of rating downgrades continues to decline but is still not negligible. Next year, the Czech Republic could see a return among developed economies in the JPM methodology. That would mean a significant outflow of capital. Financial markets currently underestimate the pace of normalisation of the CNB's monetary policy and the associated rise in interest rates over the longer term. As a result, we believe that there are opportunities to hedge interest rate risks on the market. However, last year's hedging levels are no longer achievable.

The CZGB supply will likely remain high this year

The CZGB supply will be similar to last year. In addition, we expect a higher issuance of euro bonds.

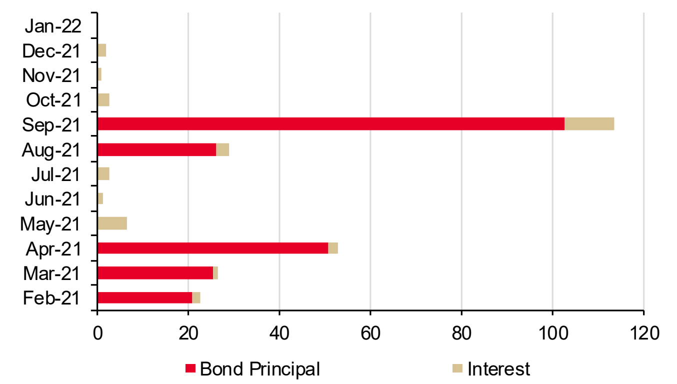
According to our calculations, the lower-than-planned state budget deficit in 2020 and increased MinFin activity in the secondary market last year made it possible to keep this year's borrowing needs under control. On the other hand, the current official MinFin debt management strategy for 2021 will have to be revised in mid-2021 due to the higher state budget deficit after tax cuts are taken into account (for more details see the *Fiscal policy* chapter). **We estimate that this year's borrowing needs will be only slightly lower than last year's (CZK628.3bn vs CZK646.3bn; 10.7% of GDP vs 11.1%). The net CZGB issuance will be roughly the same at CZK395.7bn.** Compared to 2020, we expect higher EUR borrowing needs. In our view, these will be covered by the issuance of euro-denominated CZGBs under Czech law, which the MinFin introduced two years ago. These should become eligible as collateral with the ECB this year, which should increase their attractiveness to foreign investors. However, the specific form will depend on the current market conditions.

CZGB issuance (CZKbn)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

CZGB and T-bill redemptions calendar (CZKbn)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Due to the heavy redemption calendar in the coming months, we expect that the MinFin will issue the vast majority of CZGBs in 1H21. The MinFin has a medium-term target of an average CZGB maturity of 6y (currently 5.6y). However, last year it issued more shorter maturities than planned in an effort to meet stronger demand for that part of the curve. In our view, it will try to compensate this year if demand for the longer sections of the curve allows it. In the 6y+

bucket, the MinFin currently has room for issuance of c.CZK250bn, which **implies the need for several new issues this year.**

Funding programme and issuance activity for 2021 (CZKbn)

	MinFin	KB
State budget deficit	320.0	400.0
Transfers and other operations of state financial assets	0.0	0.0
T-Bonds denominated in local currency redemptions	141.4	141.2
T-Bonds denominated in foreign currency redemptions	56.0	51.6
Redemptions and early redemptions on savings bonds	0.0	0.0
Money market instruments redemptions	25.4	25.4
Redemption of T-bills		25.4
Redemption of other money market instruments		0.0
Repayments on credits and loans	3.5	3.5
Total financing needs	**546.3**	**647.1**
Money market instruments		20.0
T-bills		20.0
Other money market instruments		0.0
Gross issuance of CZK-denominated T-bonds on domestic market	Min. 400	536.9
Gross issuance of EUR-denominated T-bonds on domestic market		51.4
Gross issuance of T-bonds on foreign market		0.0
Gross issuance of savings government bonds		15.0
Received credits and loans		5.0
Financial asset and liquidity management		18.8
Total financing sources		**647.1**
Gross borrowing requirement		**628.3**
Net CZGB issuance		**395.7**

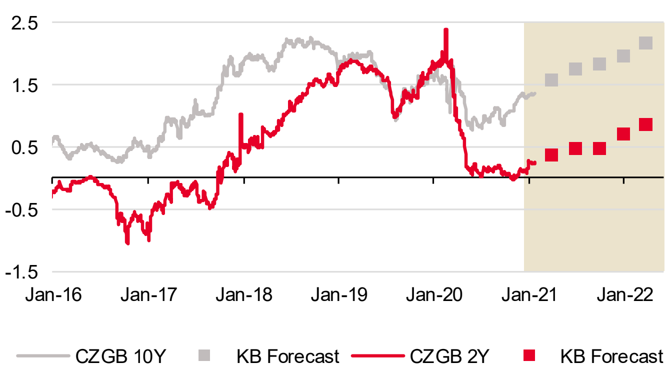
Source: MinFin, Economic and Strategy Research, Komerční banka

Further growth in yields, CZGB cheapening in ASW terms

We expect further growth in CZGB's yields, mainly due to their high supply and better economic outlook. The issuance will be concentrated in the first half of the year, resulting in CZGB cheapening in ASW terms.

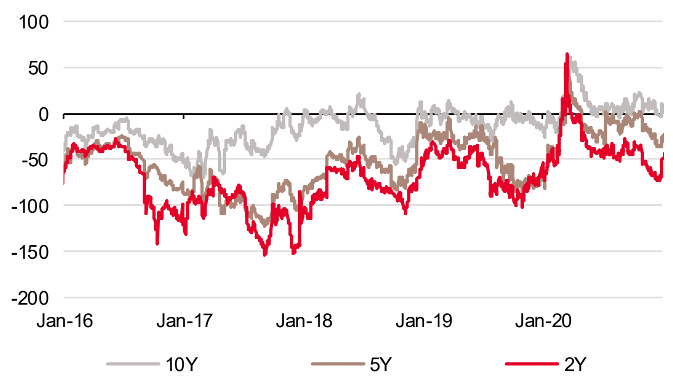
We expect further growth in CZGB yields this year, supported by growing expectations of CNB rate hikes, strong bond supply, and pressure from rising yields in developed markets. The CNB's current forecast envisages a swift rise in interest rates this year. Our November forecast assumes the first rate hike at the beginning of next year due to a stronger koruna and lower inflation compared to the CNB view. But the latest economic data have generated the possibility that interest rates may be hiked earlier, but probably not before 4Q21. However, market expectations will likely support CZGB yields in 1H21 already.

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

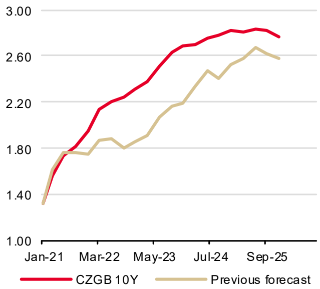
ASW spreads (bp)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

The MinFin usually delivers most of its CZGB supply in the first half of the year, creating ASW seasonality. In our view, this year will see record bond supply, which will likely be even more concentrated in the first half of the year than usual due to the redemptions calendar.

CZGB forecast change



Source: Economic & Strategy Research, Komerční banka

Compared to last year, however, the market will likely have a free hand due to the absence of CNB verbal intervention, like we saw last May. At that time, the central bank gained new tools approved by Parliament and mentioned the possibility of CZGB purchases to support demand and mitigate a possible sell-off. However, this year, the CNB's unconventional instruments are most likely off the table. We still recommend *Sell CZGB 1.2% Mar-31 in ASW.*

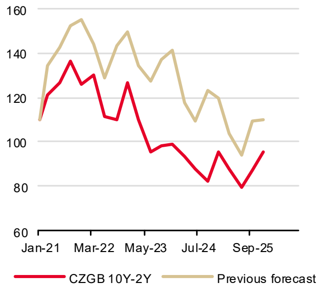
Compared to the previous forecast, we expect significantly faster yield growth, especially in the longer forecast horizon. The main reason is a better outlook for the domestic economy and thus a faster pace of monetary policy normalisation. Related to this, we will see the steepest point of the curve earlier, before it begins to flatten again.

CZGB yield forecast (end of period)

	1Q21f	2Q21f	3Q21f	4Q21f	1Q22f
2y CZGB yield (%)	0.35	0.45	0.45	0.70	0.85
5y CZGB yield (%)	1.00	1.10	1.10	1.25	1.40
10y CZGB yield (%)	1.55	1.75	1.80	1.95	2.15
10y CZGB ASW (bp)	20	20	20	15	15

Source: Economic & Strategy Research, Komerční banka

Change in the curve forecast



Source: Economic & Strategy Research, Komerční banka

Despite the relatively stable development of government bond yields in recent weeks, shorter maturities cheapen the most. At the same time, they became the cheapest in ASW terms. From this point of view, on the other hand, the belly of the curve remains the most expensive, which also offers the highest carry-roll.

CZGB bondholder structure: domestic banks re-establish their positions

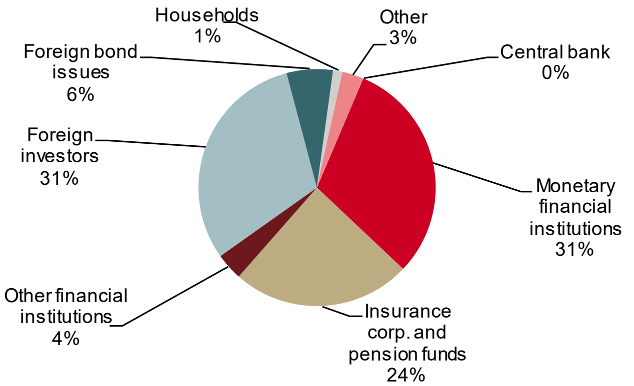
After a sharp increase in the CZGB supply last spring, the share of foreign investors has been steadily declining. In November, the figure was 32.7%, the lowest level since the end of 2016. At the beginning of 2020, foreign entities still held up to 41.6% of all Czech government bonds. In absolute terms, however, their volume has increased since the beginning of last year. **Most new government bonds saw demand mainly from domestic entities, led by banks. In this way, the banks are gradually rebuilding their positions from the years before the CNB's FX floor,** both in nominal and relative terms. In the coming months, we expect this trend to continue given the high CZGB supply planned for this year, the still-high volume of free liquidity in the domestic banking sector, and the low CNB repo rate.

Government bond overview

Government bond overview								Rich-cheap analysis												
Bond	Dur.	Issued last 90D	Issuance limit	Yield	Δ1W	Δ1M	FX hedged	ASW	Δ1W	Δ1M	Min	90D	Max	Z-Score	Rank	Spline spread	Rank	Carry Roll 90D	Rank
3.85 Sep-21	0.7	0.0	100%	-0.15	1	37	-0.77	-54	-8	33	-106		-30	0.4	2	4.1	17	-28.3	18
0.00 Feb-22	1.1	0.0	6%	0.03	0	12	-0.62	-43	-2	14	-59		-27	0.0	4	-3.0	5	-3.4	17
0.10 Apr-22	1.2	0.0	100%	0.15	1	11	-0.52	-34	-3	13	-50		-24	0.7	1	-11.2	1	-0.3	16
4.70 Sep-22	1.6	0.0	100%	0.10	-2	12	-0.63	-49	-5	17	-69		-36	0.2	3	3.3	14	1.2	15
0.45 Oct-23	2.7	0.0	80%	0.38	0	2	-0.50	-39	-5	6	-48		-7	-0.6	7	0.8	12	4.2	7
5.70 May-24	3.0	0.0	100%	0.30	0	2	-0.67	-60	-4	9	-72		-23	-0.7	8	19.7	18	3.2	12
1.25 Feb-25	4.0	0.0	100%	0.69	-2	1	-0.34	-27	-7	4	-34		4	-0.8	10	-6.1	2	5.1	4
2.40 Sep-25	4.4	0.0	69%	0.73	-1	-2	-0.32	-29	-6	1	-35		-1	-1.1	16	-0.7	11	5.5	2
1.00 Jun-26	5.2	0.0	104%	0.88	-1	3	-0.21	-20	-6	4	-28		7	-0.8	12	-4.7	4	5.2	3
0.25 Feb-27	5.9	0.0	83%	0.97	-1	3	-0.14	-15	-5	4	-25		14	-0.9	13	-5.5	3	5.5	1
2.50 Aug-28	6.9	0.0	84%	1.03	-1	-1	-0.04	-15	-4	-3	-20		13	-1.1	17	3.7	15	4.6	5
2.75 Jul-29	7.6	0.0	67%	1.11	-2	-1	0.07	-9	-5	-3	-14		14	-1.2	18	3.2	13	4.3	6
0.05 Nov-29	8.7	11.1	91%	1.18	-2	1	0.08	-4	-2	1	-9		16	-1.0	15	-1.2	9	4.0	8
0.95 May-30	8.8	4.5	87%	1.22	-2	2	0.14	-1	-2	1	-5		17	-1.0	14	-1.9	6	3.8	9
1.20 Mar-31	9.4	0.0	67%	1.27	-2	3	0.21	0	-1	1	-6		16	-0.8	11	-1.7	7	3.5	10
2.00 Oct-33	11.2	0.0	80%	1.38	-1	4	0.36	3	-1	2	-6		20	-0.4	5	-1.1	10	3.1	14
4.20 Dec-36	12.3	0.0	63%	1.43	-1	4	0.47	1	-1	1	-7		26	-0.7	9	3.9	16	3.1	13
1.50 Apr-40	16.4	4.1	75%	1.64	0	7	0.52	17	0	4	7		43	-0.5	6	-1.5	8	3.4	11

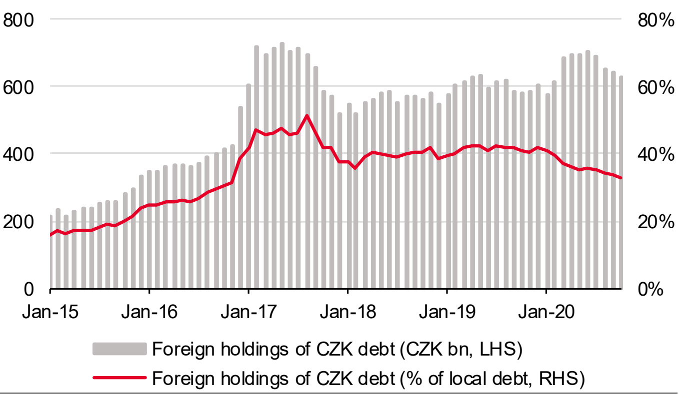
Source: Economic & Strategy Research, Komerční banka
Note: More details in CZGB Auction Alert

Holdings of CZK government debt (November 2020)



Source: MinFin, Economic & Strategy Research, Komerční banka

Share of non-resident bondholders decreased to 32.7%



Source: MinFin, Economic & Strategy Research, Komerční banka

Sovereign rating: the risk of downgrade gradually decreases

Last year, all major rating agencies confirmed the current fourth-highest rating to the Czech Republic. In many cases, we see room for revisions in the forecasts of individual agencies, which creates a risk of a deterioration in the rating, especially its outlook on the "negative". Besides, Fitch and Moody's issued a negative report at the end of last year about the government tax cuts proposal, which will significantly affect state budget revenues. On the other hand, the economic downturn last year was less pronounced and public finances ended in a lower-than-expected deficit. Public debt should thus remain below the median of the countries the Czech Republic is being compared with. In this evaluation, it will continue to be the public finances that provide the Czech Republic such a high assessment within the region and the European Union. In addition, the current rating was confirmed by the Fitch agency a few days ago, which we think adopted the most pessimistic view during the coronavirus crisis last year. **Since our previous forecast, the risk of a downgrade has decreased, but it still cannot be ruled out.**

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	30-Apr
Moody's	Aa3	STABLE	Aa3	STABLE	22-Feb
Fitch	AA-	STABLE	AA-	STABLE	25-Jun

Source: Bloomberg, Economic & Strategy Research, Komerční banka

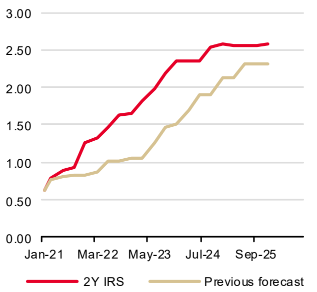
The Czech Republic is soon to return to a place among the developed economies

In 2017, the Czech Republic was moved from the developed to the emerging economies of the JPM bond index family after its GNI per capita in USD terms fell below the threshold due to the CNB's FX floor. However, the Czech Republic has returned above this level, and it is thus only a matter of time before it will be excluded from the GBI-EM index and moved to the developed index again. In our view, this will cause a significant outflow from the CZGB market due to the much lower weight of the country among developed economies than among emerging economies. **We expect the Czech Republic to be excluded from the GBI-EM index and included in the GBI index at the beginning of 2022.** However, the data available to confirm this step will be published in the middle of this year.

Until then, **we expect new CZGB issues to be included in the GBI-EM index** due to the recent maturity of previously included bonds. In addition, the Czech Republic has much fewer bonds in the index than regional peers. Index rebalancing is usually announced in the middle of the month, and the inclusion of a bond is usually associated with a strong inflow. Our best guess for inclusion is the CZGB 1.25% Feb-25 or CZGB 0.5% Nov-29.

Czech IRS market: rapid growth supported by a bold monetary policy

IRS forecast change



Source: Economic & Strategy Research, Komerční banka

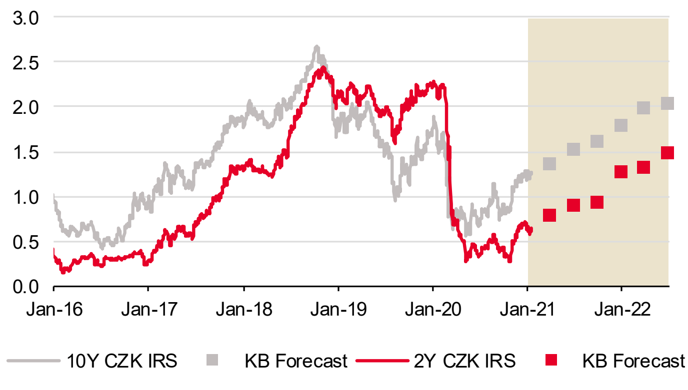
The bold November forecast of the central bank started the return of market interest rates back to higher levels. Since then, the financial markets have been raising their bets on the early start of monetary policy normalisation with a few breaks. The last time the correction of expectations was led by the publication of December inflation, which slowed down surprisingly quickly from 2.7% to 2.3%. However, it took ten days for financial markets to return market rates to their original levels. We expect a similar development for the coming months, i.e. **an increase in rates with several pauses, depending on vaccination development, uncertain price developments and the resulting rhetoric of the CNB**. Financial market expectations at the one-year horizon are currently in line with our forecast. However, they still do not anticipate such a rapid pace of interest rate increases for the coming years. That is why we see significant room for IRS growth here. Compared to the previous forecast, we now expect a sharp rise in interest rates even at the short end of the curve due to the earlier increase in central bank interest rates. Related to this, we expect even lower steepening of the entire curve. In this context, we recommend *Pay CZK 10y IRS* and *Pay CZK 2y IRS vs Receive HUF 2y IRS*.

CZK IRS outlook (end of period, %)

	1Q21f	2Q21f	3Q21f	4Q21f	1Q22f
2Y	0.80	0.90	0.95	1.25	1.35
5Y	1.20	1.30	1.35	1.60	1.75
10Y	1.35	1.50	1.60	1.80	2.00

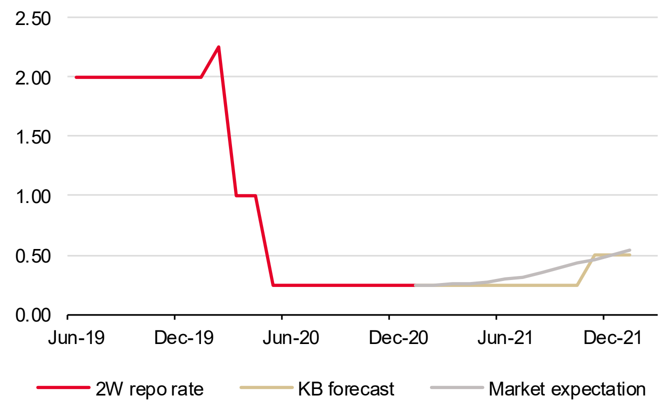
Source: Economic & Strategy Research, Komerční banka

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Market expectations in line with our forecast

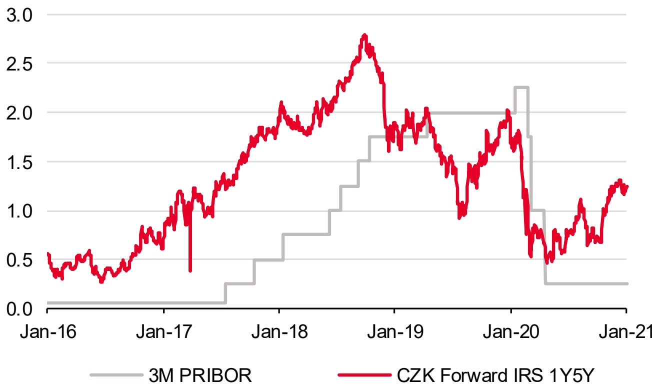


Source: Bloomberg, Economic and Strategy Research, Komerční banka

Hedging conditions remain advantageous, especially in the longer term

The onset of vaccinations and the economy's adaptation to the coronavirus have significantly erased the uncertainty associated with further developments. The central bank is also responding to this, signalling the possibility of raising interest rates already this year. This is reflected by the financial market participants, the IRS has safely detached from the bottom and, in our view, rates will have rapid growth this year. At the one-year horizon, the markets expect the first increase in CNB rates in line with our forecast. **For the coming years, however, they still underestimate the normalisation of monetary policy, which still maintains favourable opportunities for interest rate risk hedging.** However, market conditions have been deteriorating for several months and we do not expect anything to change in this trend. Previous levels of hedging are thus no longer achievable.

Interest rate hedging conditions are deteriorating



Source: Bloomberg, Economic & Strategy Research, Komerční banka

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

Forward \ Maturity	6M	1Y	18M	2Y	3Y	5Y	10Y
Spot	0.40	0.42	0.57	0.65	0.81	1.04	1.25
3M	0.40	0.54	0.64	0.73	0.88	1.09	1.28
6M	0.48	0.66	0.72	0.83	0.97	1.14	1.31
9M	0.69	0.77	0.84	0.92	1.04	1.19	1.34
1Y	0.84	0.84	0.94	0.99	1.11	1.24	1.37
18M	0.84	0.99	1.04	1.12	1.21	1.29	1.41
2Y	1.14	1.14	1.21	1.25	1.31	1.35	1.45
3Y	1.35	1.36	1.38	1.40	1.41	1.43	1.53

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 25/1/2021

Banking Sector

Michal Brožka
(420) 222 008 569
michal_brozka@kb.cz

In anticipation of an improving economy

Despite the latest wave of the pandemic, economic development is slightly more favourable than we expected. This should also have a positive impact on the development of the banking sector. Housing loans will continue to expand, albeit at a slower pace. Loans to corporations should not start to rise until the second quarter when companies should gain more confidence in the future. Consumer credit should accelerate as the pandemic subsides. The high growth in deposit prices should gradually slow down. The number of non-performing loans is developing very favourably in view of the economic downturn.

Real estate market is growing

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

For 2020, we estimate apartment prices rose 7.2%. Price growth was supported by the behaviour of the population, who preferred real estate investments during the pandemic. The abolition of the real estate transfer tax, low interest rates and looser conditions for the provision of mortgages were other supports for demand for residential real estate. Together with our improved outlook for the economy, to which lower income taxes will also contribute, we expect real estate price growth to continue this year as well, albeit at a slightly slower pace of around 6.6%. **The higher outlook for real estate prices is also connected to the improved outlook for housing loans.** According to our estimates, average housing loan growth in 2020 was close to 7.4%, which is practically the same rate as in the previous year. A higher propensity to invest in housing due to the pandemic is likely to play a role. Interest rates will remain low for most of the year, and will gradually be expected to rise. The weakened economy should work in favour of lower mortgage growth. **In summary, we estimate a slowdown in the growth rate of mortgage loans to a still solid rate of 6.7% this year.**

Bank loans and deposits (% yoy)

	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	2019	2020	2021	2022	2023	2024
Bank loans														
Total	6.9	5.4	4.5	4.2	2.3	3.2	3.7	4.8	**4.9**	**5.2**	**3.5**	**5.3**	**5.5**	**5.6**
Households - real estate loans	7.1	7.2	7.5	7.7	7.5	7.0	6.5	5.7	**7.3**	**7.4**	**6.7**	**4.8**	**4.8**	**5.4**
Households - consumer loans	7.0	4.7	2.7	1.0	2.1	3.3	3.8	5.6	**6.7**	**3.8**	**3.7**	**6.5**	**6.9**	**6.5**
Corporate loans	6.4	4.9	2.3	0.9	-2.0	-0.1	2.0	4.9	**4.2**	**3.6**	**1.2**	**7.0**	**5.4**	**5.1**
Deposits														
Total	10.9	9.3	10.4	12.6	10.5	12.3	7.5	7.0	**9.6**	**10.8**	**9.3**	**3.9**	**5.2**	**5.3**
Households	8.0	10.0	10.5	11.4	11.2	9.2	7.3	5.6	**7.2**	**10.0**	**8.3**	**3.6**	**5.3**	**5.6**
Non-financial corporations	11.7	9.3	14.6	12.9	8.7	10.9	7.4	8.1	**5.1**	**12.1**	**8.8**	**5.0**	**4.4**	**4.5**
Others	15.5	8.1	7.5	14.8	10.7	18.5	8.1	9.0	**17.9**	**11.5**	**11.6**	**3.5**	**5.7**	**5.6**
Ratios														
Loans/GDP	62.1	63.1	63.9	63.9	65.5	64.5	65.1	64.3	**60.7**	**63.3**	**64.8**	**64.5**	**65.0**	**65.7**
Deposits/GDP	91.7	95.4	98.0	94.8	104.4	106.1	103.5	97.5	**86.6**	**95.0**	**102.9**	**100.8**	**101.3**	**102.2**
Loans/deposits	67.7	66.2	65.2	67.4	62.7	60.8	62.9	66.0	**70.2**	**66.6**	**63.1**	**64.0**	**64.2**	**64.3**
Interest rates														
Real estate loans	2.6	2.4	2.2	2.1	2.0	2.0	1.9	1.9	**2.7**	**2.3**	**2.0**	**2.1**	**2.5**	**2.8**
Consumer loans	8.2	8.0	8.0	7.9	6.8	7.1	7.1	7.0	**8.4**	**8.0**	**7.0**	**7.0**	**7.4**	**7.8**
Corporate loans	3.2	2.3	1.4	2.0	1.7	1.8	1.8	1.9	**3.3**	**2.3**	**1.8**	**2.2**	**3.0**	**3.6**
Share of NPL														
Real estate loans	1.1	1.1	1.0	1.1	1.2	1.4	1.5	1.4	**1.3**	**1.1**	**1.4**	**1.5**	**1.5**	**1.5**
Consumer loans	4.1	4.3	4.1	4.9	5.5	5.8	6.3	6.6	**4.2**	**4.3**	**6.0**	**7.0**	**7.6**	**7.8**
Corporate loans	3.1	3.2	3.3	3.9	3.9	4.2	4.4	4.4	**3.4**	**3.4**	**4.2**	**4.6**	**4.6**	**4.7**

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

Growth in consumer credit weakened last year

Consumer credit should return to expansion as economic growth returns.

The first and subsequent waves of the pandemic led to a decline in household consumption and to a lower demand for consumer credit. In a quarter-on-quarter comparison, loans declined in the second and probably fourth quarters of 2020. As the economy and household consumption returns to growth this year, supported by lower income taxes, we also expect higher demand for consumer credit. On average, we expect a slight increase of 3.7% this year, similar to last year.

Loans to non-financial corporations should decline in the first half of this year

Consumer credit should return to expansion as economic growth returns.

The low investment activity of companies led to a decline in lending in the second quarter of 2020, and this weakness prevailed in the rest of the year. At the beginning of last year, the year on year growth in loans to non-financial corporations was 6.4% and, according to our estimates, was 0.9% in the last quarter of 2020. A better outlook for the economy in our forecast leads to a resumption of credit growth on a quarter-on-quarter basis from the second quarter and especially in the second half of 2021. In a year-on-year comparison, however, the first half of the year will show negative growth rates. For the whole year 2021, we expect an average growth of loans to non-financial corporations of 1.2%.

Households are still accumulating deposits

Deposit volumes increased sharply.

Increased uncertainty led to an increase in deposits last year. In the case of companies, we estimate their year-on-year pace in the last quarter of 2020 at 12.9% and for individuals at 11.4%. We expect this development to continue in the first quarter of 2021. In the next quarters, we expect a slowdown in deposit growth as the outlook for the economy improves, albeit with the current low level of economic activity. For 2021 as a whole, we expect a slowdown in the growth rate of deposits with households and companies to a still high 8-9%.

Bad loans are not growing significantly yet

The share of non-performing loans is likely to increase, but so far, their development is favorable.

We continue to expect that the economic downturn will lead to an increase in the volume of non-performing loans (NPLs). However, so far this increase has been relatively very weak, even after the end of the six-month moratorium on debt repayments. Although it is still likely that there will be a gradual increase in NPLs, the current development and improved outlook for the economy gives hope that it should be a rather modest increase. In the case of NPLs in consumer loans, we expect a gradual increase in growth this year and a further increase in the share to 7.0% next year. In the case of NPLs for non-financial corporations, we expect an increase to 4.4% this year and further to 4.6% in 2022. For mortgages, we forecast an increase to 1.5% in the NPL this year and to remain close to this level in the coming years.

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2017	2018	2019	2020	2021	2022	2023	2024
GDP	real, %	5.4	3.2	2.2	-6.0	2.6	3.9	2.6	2.6
Inflation	average, %	2.5	2.1	2.8	3.2	1.8	1.9	2.1	2.0
Current account	% of GDP	1.5	0.4	-0.3	3.3	3.3	2.1	2.0	2.0
3M PRIBOR	average, %	0.4	1.3	2.1	0.9	0.4	0.9	1.6	2.2
EUR/CZK	average	26.3	25.6	25.7	26.5	25.6	25.0	24.4	24.0
USD/CZK	average	23.4	21.7	22.9	23.2	20.8	19.0	18.2	17.6

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

FX & interest-rate outlook

		26-01-2021	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
EUR/CZK	end of period	26.0	25.9	25.7	25.4	25.2	25.1
USD/EUR	end of period	1.21	1.20	1.23	1.25	1.27	1.30
CZK/USD	end of period	21.4	21.6	20.9	20.3	19.8	19.3
3M PRIBOR	end of period, %	0.36	0.35	0.35	0.35	0.60	0.60
10Y IRS	end of period, %	1.25	1.35	1.50	1.60	1.80	2.00

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

Monthly macroeconomic data

		IV-20	V-20	VI-20	VII-20	VIII-20	IX-20	X-20	XI-20	XII-20
Inflation (CPI)	%, mom	3.2	2.9	3.3	3.4	3.3	3.2	2.9	2.7	2.3
Inflation (CPI)	%, yoy	-0.2	0.4	0.6	0.4	0.0	-0.6	0.2	0.0	-0.2
Producer prices (PPI)	%, mom	-0.8	-0.9	-0.3	-0.1	-0.5	-0.4	0.3	-0.1	0.0
Producer prices (PPI)	%, yoy	-0.5	0.4	-0.1	0.1	-0.3	0.2	0.4	-0.5	0.2
Unemployment rate	% (MLSA)	3.4	3.6	3.7	3.8	3.8	3.8	3.7	3.8	4.0
Industrial sales	%, yoy, c.p.	-35.2	-29.0	-5.6	-4.4	-7.3	-1.9	-1.3	-2.2	n.a.
Industrial production	%, yoy, c.p.	-36.3	-29.2	-5.5	-3.6	-7.2	0.0	2.3	1.1	n.a.
Construction output	%, yoy, c.p.	-4.6	-7.7	-11.5	-10.4	-9.7	-7.9	-10.5	-8.4	n.a.
Retail sales	%, yoy, c.p.	-21.4	-12.5	-2.9	-0.9	-2.9	-2.5	-3.7	-9.2	n.a.
External trade	CZKbn (national met.)	-24.3	-0.5	34.4	15.2	8.4	35.1	32.2	32.2	n.a.
Current account	CZKbn	-2.1	5.6	4.7	19.8	17.9	32.8	7.8	18.3	n.a.
Financial account	CZKbn	1.8	19.0	-15.1	15.2	24.1	66.5	-5.8	-6.9	n.a.
M2 growth	%, yoy	9.3	9.0	9.5	10.1	9.8	11.2	10.8	10.7	n.a.
State budget	CZKbn (YTD cum.)	-93.8	-157.4	-195.2	-205.1	-230.3	-252.7	-274.0	-341.5	-367.4
PRIBOR 3M	%, average	0.96	0.46	0.34	0.34	0.34	0.34	0.35	0.35	0.35
EUR/CZK	average	27.3	27.3	26.7	26.5	26.2	26.7	27.2	26.5	26.3
USD/CZK	average	25.1	25.0	23.7	23.1	22.1	22.7	23.1	22.3	21.6

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

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KB ECONOMIC & STRATEGY RESEARCH

Chief Economist and Head of Research
Jan Vejmělek, Ph.D., CFA
(420) 222 008 568
jan_vejmelek@kb.cz

Economists
Michal Brožka
(420) 222 008 569
michal_brozka@kb.cz

Jana Steckerová
(420) 222 008 524
jana_steckerova@kb.cz

Martin Gürtler
(420) 222 008 509
martin_gurtler@kb.cz

Strategist
František Táborský
(420) 222 008 598
frantisek_taborsky@kb.cz

Equity Analyst
Bohumil Trampota
(420) 222 008 560
bohumil_trampota@kb.cz

SG IN CENTRAL AND EASTERN EUROPE

Head of Research of Rosbank
Evgeny Koshelev
(7) 495 725 5637
evgeny.Koshelev@rosbank.ru

Economist Rosbank
Yury Tulinov, CFA
(7) 495 662 1300 (ext. 14-836)
yury.tulinov@rosbank.ru

Economist Rosbank
Anna Zaigrina
(7) 495 662 1300
anna.zaigrina@rosbank.ru

Economist Rosbank
Evgeniy Vertiporokh
(7) 495 662 1300 (ext. 14-263)
evgeniy.vertiporokh@rosbank.ru

Romania
Ioan Mincu
(40) 21 301 4472
george.mincu-radulescu@brd.ro

SG GLOBAL ECONOMICS RESEARCH

Head of Global Economics
Klaus Baader
(44) 20 7762 4714
klaus.baader@sgcib.com

Euro area
Michel Martinez
(33) 1 4213 3421
michel.martinez@sgcib.com

Anatoli Annenkov
(44) 20 7762 4676
anatoli.annenkov@sgcib.com

Yvan Mamalet
(44) 20 7762 5665
yvan.mamalet@sgcib.com

United Kingdom
Brian Hilliard
(44) 20 7676 7165
brian.hilliard@sgcib.com

North America
Stephen Gallagher
(1) 212 278 4496
stephen.gallagher@sgcib.com

Latin America
Dev Ashish
(91) 80 2802 4381
dev.ashish@socgen.com

India
Kunal Kumar Kundu
(91) 80 6716 8266
kunal.kundu@sgcib.cz

Korea
Suktae Oh
(82) 2195 7430
suktae.oh@sgcib.com

China
Wei Yao
(33) 1 57 29 69 60
wei.yao@sgcib.com

Greater China
Michelle Lam
(85) 2 21 66 57 21
michelle.lam@sgcib.com

Japan
Takuji Aida
(81) 3-6777-8063
takuji.aida@sgcib.com

Japan Rates Strategist
Tomoya Narita
(81) 3 6777 8065
tomoya.narita@sgcib.com

SG CROSS ASSET RESEARCH – FIXED INCOME & FOREX GROUPS

Global Head of Economics,
Cross-Asset & Quant Research
Kokou Agbo Bloua
(44) 20 7762 5433
kokou.agbo-bloua@sgcib.com

Head of Fixed Income & Forex Strategy
Guy Stear
(33) 1 41 13 63 99
guy.stear@sgcib.com

Head of Rates Strategy
Adam Kurpiel
(33) 1 42 13 63 42
adam.kurpiel@sgcib.com

Covered Bonds & SSA
Cristina Costa
(33) 1 58 98 51 71
cristina.costa@sgcib.com

Head of US Rates Strategy
Subadra Rajappa
(1) 212 278 5241
subadra.rajappa@sgcib.com

Jorge Garayo
(44) 20 7676 7404
jorge.garayo@sgcib.com

Jean-David Cirotteau
(33) 1 42 13 72 52
jean-david.cirotteau@sgcib.com

Shakeeb Hulikatti
(91) 80 2802 4380
shakeeb.hulikatti@sgcib.com

Kevin Ferret
(44) 20 7676 7073
kevin.ferret@sgcib.com

Rohit Gaurav
(91) 8067318958
rohit.gaurav@sgcib.com

Chief Global FX Strategy
Kit Juckes
(44) 20 7676 7972
Kit.juckes@sgcib.com

FX Derivatives Strategy
Olivier Korber
(33) 1 42 13 32 88
olivier.korber@sgcib.com

Head of Emerging Markets Strategy
Jason Daw
(65) 6326 7890
jason.daw@sgcib.com

Bertrand Delgado
(1) 212 278 6918
bertrand.delgado-calderon@sgcib.com

Phoenix Kalen
(44) 20 7676 7305
phoenix.kalen@sgcib.com

Kiyong Seong
(852) 2166 4658
kiyong.seong@sgcib.com

Marek Dřímal
(44) 20 7550 2395
marek.drimal@sgcib.com

Vijay Kannan
(91) 7010445705
Vijay.kannan@sgcib.com