Forecast Update

Special Report

Consuming stagflationary shock

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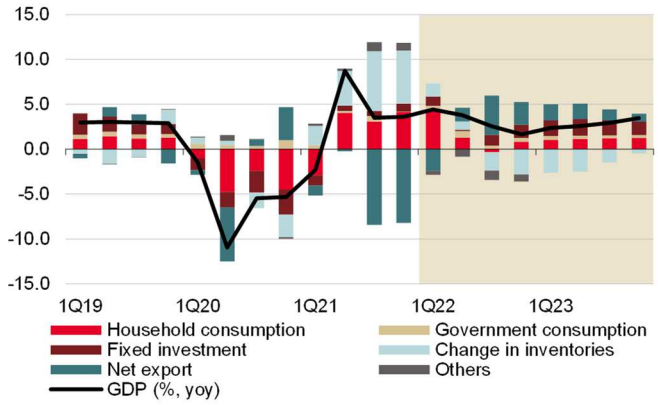
The war in Ukraine has affected the global economic outlook. The fears of potential disruption to Russian energy imports have pushed commodity prices up, which is likely to further exacerbate the already severe inflationary pressures. A shortage of Russian energy would also lower GDP growth, especially in highly dependent Europe. Moreover, the war is likely to hinder the expected easing of supply-chain issues. Given this, we have decided to revise our forecasts for Czech key macro and financial variables ahead of the regular quarterly update. We have increased our inflation forecast from 8.8% to 11.5% for this year. In addition, we have lowered our estimate for GDP growth from 4.9% to 3.1%. In our view, the CNB is likely to continue raising interest rates. Previously, we had expected rates to reach a peak of 5%, but now we see them peaking at 5.5%. Bringing interest rates back to policy-neutral level is likely to be postponed until next year.

This-year GDP growth to be significantly slower than previously expected

The economy faced a severe shortage of production inputs in the second half of last year, and pandemic fears did not completely disappear. Nevertheless, GDP growth remained solid. This year, economic growth should be boosted by easing supply-chain issues, the first signs of which were visible in recent months. However, war in Ukraine and new COVID outbreak in China are likely to hamper this. Moreover, we expect household consumption to be dampened by double-digit inflation: private spending already decreased 1.8% qoq in 4Q. We have therefore significantly lowered our 2022 GDP growth forecast from 4.9% to 3.1%. In terms of the economy's position within the cycle, we expect the negative output gap to gradually close during this year and the next. Pre-pandemic GDP levels are likely to be reached in 1Q23. Given the Czech Republic's high dependence on Russian energy imports, we see downside risks to our GDP growth outlook.

GDP to grow around 3% this year and next (%, contributions in pp)



Source: CZSO, Economic & Strategy Research, Komerční banka

Negative output gap to close in 2023 (% of potential GDP)

Source: CZSO, Economic & Strategy Research, Komerční banka

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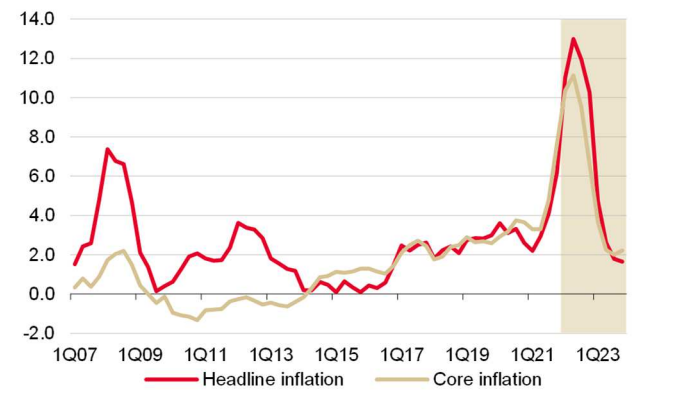
Real wage growth curbed by inflation, despite a very tight labour market

The rebound in the Czech economy has reduced the unemployment rate to near its pre-crisis levels and pushed the number of vacancies to record highs. In our view, the unemployment rate is already below its equilibrium and we expect it to decline a bit further this year. The overheating labour market will probably put upward pressure on average nominal wages this year. We expect them to rise by a solid 7.5%, but due to high inflation, this would represent a decline on a real basis. Next year, however, real wages should rise again. We think that employees will insist more strongly on being at least partly compensated for high inflation, and companies could be less reluctant due to more favourable economic conditions.

Inflation heading towards 13%

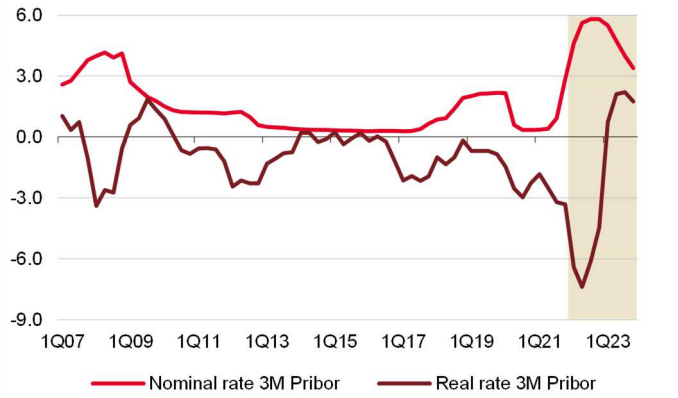
CPI inflation accelerated at the beginning of 2022. In February, inflation reached 11.1% yoy. The main driver was housing costs, mainly from rising energy prices driving up utilities, but also from higher imputed rents. Growth in food prices also accelerated. Fuel prices pushed consumer prices higher. Core inflation reached 10.4% yoy in February. We believe the month-on-month headline and core inflation rates are peaking in 1Q22. Nevertheless, compared to our expectation from January, inflation was faster at the beginning of 2022 and, importantly, the war in Ukraine led to CZK depreciation and higher oil and gas prices. We have therefore increased our inflation forecast to 11.5% for this year, with the yoy rate peaking slightly above 13% in May. However, we expect inflation to decelerate significantly in 2H22. The reasons are tight monetary policy, no further rises in oil and gas prices, an expected deceleration of real estate prices and, importantly, an easing of supply chain disruptions. Our assumption regarding the material easing of supply side inflationary pressures is strong, and considering the possible consequences of the war in Ukraine, we see the risks to our inflation forecast as tilted to the upside.

Inflation should peak above 13% in May (%, yoy)



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

In May, we also expect the CNB interest rates to peak at 5.5%



Source: CNB, Economic & Strategy Research, Komerční banka

CNB rates likely to cross 5%, larger increase prevented by FX intervention

The Czech National Bank raised the repo rate from 3.75% to 4.50% at its February meeting. Inflation is well above the central bank's 2% target, which remains the reason for further monetary policy tightening. Given the increased inflation outlook, we have had to revise our call for the CNB. While we had forecast interest rates peaking at 5% in May, we now expect them to peak at 5.5%. We see the CNB hiking the repo rate by 50bp at each of the next two meetings, in March and May. Due to continued strong inflationary pressures, the gradual reduction of interest rates back to policy neutral levels is likely to be postponed until next year. Once the easing is complete at end-2023, we envisage interest rates at the 3% neutral level. On 4 March, the CNB entered the FX market to prevent the Czech koruna from weakening excessively. We see two reasons for this decision. One is the stabilisation of the koruna, which was under selling

pressure amid global risk-off sentiment in financial markets. The second reason is further strong inflationary pressure, which the weakening koruna, combined with rising energy prices, is creating. The CNB has not announced the intervention level, and we do not expect it to do so. Interest rates remain the main monetary policy instrument. However, with the FX intervention, the CNB can avoid raising interest rates to well above 5%. The CNB has enough room to defend the koruna against excessive weakening, as its FX reserves account for 60% of Czech GDP, which is the second highest percentage of GDP in the world.

Fiscal policy: the beginning of gradual consolidation

The new budget for this year, with a planned deficit of CZK280bn, was approved last week by the Czech Parliament, which introduced an additional CZK80bn of savings compared to the initial proposal. For the time being, we are sticking to our previous forecast for this year's deficit at CZK270bn, seeing potential for slightly higher incomes than MinFin predicts due to more pronounced inflation. Combined with a continuing surplus at the municipality level overall, we expect the public finance deficit to be reduced to 3.4% of GDP this year, and the improvement looks set to continue over the coming years. We expect public debt to peak in 2023 at 42.0% of GDP. However, if the geopolitical situation escalates further, there is a significant risk of higher fiscal deficit amid higher energy costs, incoming refugees and lower economic growth.

CZK will appreciate as the CNB continues raising rates

We expect the CZK to remain strong on the back of improved sentiment towards the region and additional rate hikes by the CNB in the near term. The wide interest rate differential should then support the currency on the remainder of our forecast horizon as well. Overall, we expect the koruna to appreciate to EURCZK24.40 at end-2022.

Czech Republic	1Q21	2Q21	3Q21	4Q21	1Q22f	2Q22f	3Q22f	4Q22f	1Q23f	2019	2020	2021	2022f	2023f	2024f	2025f	2026f
GDP (% qoq)	-0.3	1.4	1.6	0.9	0.5	0.7	0.4	0.1	1.2	3.0	-5.8	3.3	3.1	2.8	3.4	3.1	2.7
Consumer expenditure	-0.2	7.3	3.9	-1.8	0.2	0.4	0.5	0.6	0.6	2.6	-6.8	4.3	3.2	2.4	3.1	2.9	2.7
Government expenditure	-1.6	-0.9	2.4	0.2	0.4	0.8	0.6	0.4	0.4	2.5	3.4	1.6	2.6	1.8	2.0	1.7	1.8
Investment	0.4	4.8	-2.1	0.5	0.8	1.4	1.7	1.7	1.7	5.9	-7.5	0.9	3.7	6.3	4.8	4.5	3.0
Exports	-2.7	0.8	-5.8	2.2	1.9	1.5	3.0	2.1	1.9	1.4	-7.0	5.0	3.9	7.3	6.5	6.5	6.7
Imports	2.6	5.1	-3.2	-0.4	0.3	1.0	2.4	1.9	1.3	1.5	-6.9	11.4	2.1	5.8	6.7	6.7	6.9
Net trade*	-4.5	-3.5	-2.3	2.1	1.3	0.4	0.6	0.2	0.6	0.0	-0.5	-4.6	1.5	1.4	0.2	0.1	0.2
Inventories*	4.0	0.2	1.9	-0.2	-0.4	-0.4	-1.0	-1.0	-0.3	-0.3	-0.8	4.6	-0.7	-1.8	0.1	0.0	0.1
Nominal GDP (% yoy)	1.6	13.7	8.3	7.0	13.9	15.2	12.7	10.0	7.2	7.0	-1.7	7.5	12.9	5.6	5.6	5.0	4.8
CPI headline (% yoy)	2.2	2.9	4.1	6.2	11.0	13.0	11.9	10.2	4.8	2.8	3.1	3.9	11.5	2.7	2.1	1.9	2.0
CPI core (% yoy)	3.3	3.3	4.8	7.7	10.3	11.1	9.5	6.6	3.7	2.7	3.4	4.8	9.4	2.5	2.0	1.9	2.0
Unemployment rate (%)	3.3	3.1	2.6	2.4	2.3	2.3	2.2	2.2	2.2	2.0	2.5	2.8	2.2	2.2	2.2	2.2	2.2
Employment (% yoy)	-2.1	-0.8	0.5	0.8	0.9	1.1	0.4	1.3	1.0	0.2	-1.3	-0.4	0.9	0.5	0.1	0.0	-0.2
Productivity (% yoy)	-1.3	7.5	1.8	1.3	3.5	2.7	2.1	0.4	1.3	2.4	-4.2	2.2	2.1	2.3	3.3	3.1	2.9
Compensation per employee (% yoy)	3.4	11.5	5.7	4.0	8.4	2.0	9.5	10.0	9.4	7.9	3.2	6.1	7.5	8.8	5.2	4.6	4.7
Fiscal stance (% of GDP)										-0.8	-3.8	-0.9	2.2	0.6	1.0	0.8	0.6
Output gap (% of GDP)										3.7	-3.7	-1.9	-0.7	-0.4	0.3	0.5	0.4
Budget balance (% of GDP)										0.3	-6.1	-6.4	-3.4	-2.5	-1.4	-0.7	-0.1
Public debt (% of GDP)										30.0	37.8	42.0	41.1	42.0	41.7	41.0	39.7
Main central bank rate (%)	0.3	0.5	1.5	3.8	5.0	5.5	5.5	5.5	4.8	1.9	0.6	1.2	5.2	4.0	3.0	3.0	3.0

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

* Net contribution to GDP growth

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