Monitoring Czech Republic: The inflationary tide is slowly receding

We present our latest views on the Czech economic performance and outlook. Headline inflation seems to be on a descending path but continues to weigh on consumer spending. In the first quarter, the Czech economy experienced a shallow recession which should mark the trough, but the recovery will be anaemic

Source: Shutterstock

Czech Republic: At a glance

- The Czech economy entered a mild recession and will likely remain in contraction mode in the first half of 2023. The recovery will be anaemic, given the previous hit to the export sector from high energy prices and soft recovery in the eurozone.
- Household demand remains subdued due to a decrease in purchasing power. However, rising car sales could bring a boost to the retail sector and also to the automotive industry.
- Inflation is slowly edging lower. And not only headline inflation but core inflation, too (for four consecutive months).
- A gradual decline of inflation will likely continue, which will support the stabilisation of household purchasing power and gradual recovery of depressed private consumption,

hence retail sales.

- The Czech koruna rebounded from 24.00 EUR/CZK in the post-Silcon Valley Bank period to record strong levels as we expected. For a more significant move below 23.00 EUR/CZK, however, we would need to see a big push from the global story, which is not in our outlook for now in the coming months.

Quarterly forecasts

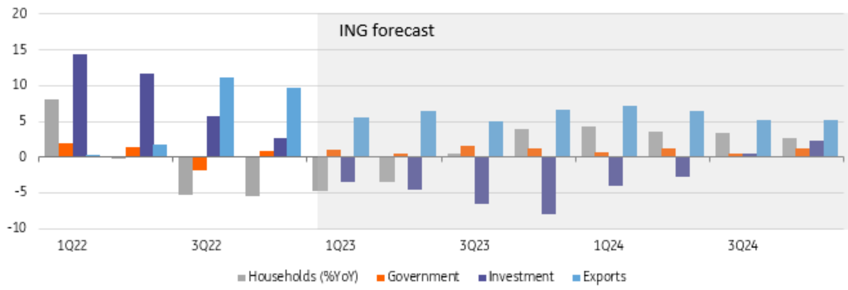
	4Q22	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F
Real GDP (%YoY)	0.3	-1.4	-1.0	0.2	1.4	2.7	2.5	2.4	2.4
CPI (eop, %YoY)	15.0	15.0	12.3	8.8	9.2	3.5	2.4	2.3	2.2
Central bank key rate (%)	7.0	7.0	7.0	6.8	6.5	5.5	5.5	5.0	4.5
3m interest rate (eop, %)	7.3	7.2	7.2	7.0	6.7	5.7	5.7	5.2	4.7
10yr yield (eop, %)	5.1	4.8	4.6	4.5	4.4	4.2	4.2	4.1	4.1
EUR/CZK exchange rate (eop)	24.1	23.5	23.5	24.3	24.2	24.2	23.8	23.7	23.6

Source: Source: national data, ING estimates

Czech GDP slipped into recession in second half 2022

Czech economic growth softened in the last quarter of 2022 to a still positive 0.3% year-on-year. The two consecutive quarterly declines in a row, however, confirmed that the Czech economy slipped into a technical recession. The main negative contribution came from household consumption, which contracted more than 5% YoY in the second half of 2022. Consumer spending has been on a descending path since the last quarter of 2021 when household purchasing power was seriously hit by rising energy prices and accelerating headline inflation. Additionally, the eurozone slowdown and the input supply problems of Czech car producers resulted in a significant slowdown of exports in the fourth quarter of the last year.

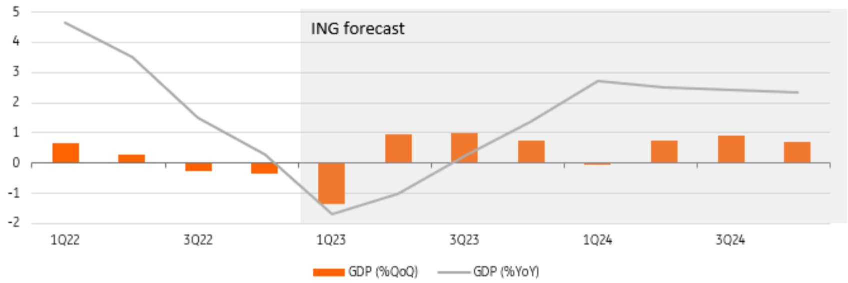
GDP components



Source: Source: CZSO, ING estimates

We expect the annual growth of GDP to turn negative in the first half of 2023 due to still declining household consumption, investment demand, and only soft growth of government spending. During the remainder of 2023, however, the economy will likely show signs of a recovery, as gradually receding inflation will weigh less on the real purchasing power of households and the gradually improving external environment will support a gradual acceleration of exports.
Yet investment demand will likely remain weak due to persistently high interest rates. Negative annual growth in the first half of 2023 and only a gradual recovery will result in an annual decline in 2023 of around -0.3%.

GDP growth

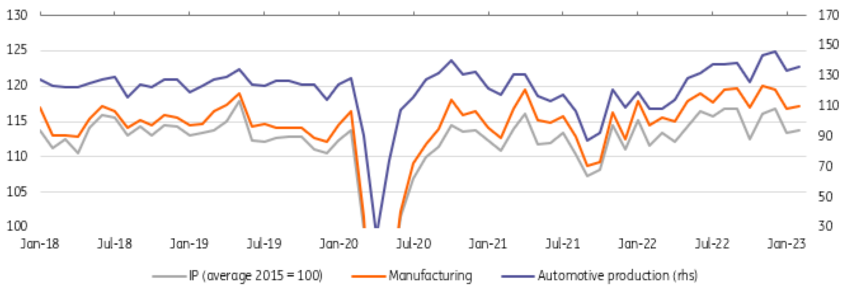


Source: Source: CZSO, ING estimates

Industry depressed by expensive sources, wages and supply problems

While the energy industry sector has been largely benefiting from the increase in energy prices, most industrial sectors are feeling the pain from the high cost of inputs and relatively robust growth of wages. In addition, Czech automotive producers have also been facing supply input problems, which have resulted in temporary outages of production at several car plants during February. While supply problems and pressure from expensive inputs are gradually fading, the stagnation of external demand will likely slow the recovery of car exports during the first half of 2023. Therefore, the growth of overall industrial output likely remained close to stagnation in the first quarter of 2023. (For example, the Industrial Production basic index was lower in February 2023 by 2.6% versus December 2022).

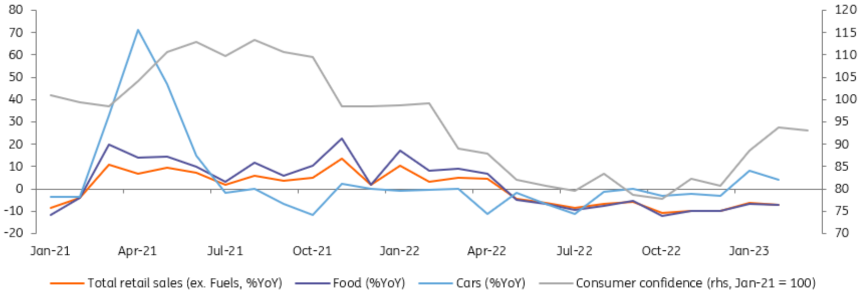
Industrial production



Car sales prevent retail sales from deeper fall

Retail trade sales decreased in real terms by 6.4% YoY in February as households were still cutting their expenditures on food. Yet sales increased in stores with products which were not so hit by a price increase, such as clothing, leather goods, and footwear. The main engine supporting retail sales has been car sales, which actually rose 4.2% YoY. It is worth mentioning that this cannot be fully attributed to rising demand but rather postponed deliveries of cars ordered earlier but held back by input supply problems. At least the good news is that demand for cars has not been affected by the adverse economic situation so far. And rising consumer sentiment looks promising for the retail sector.

Retail sales

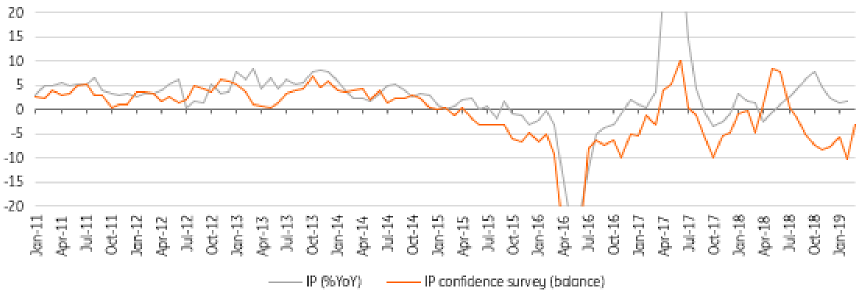


Source: Source: CZSO

Improving sentiment of industrial producers signals better times

From the second quarter onward we expect a gradual recovery of industrial output driven by improving export opportunities, a decline in energy prices, as well as fading input supply problems. The first sign of such an improvement could come with the release of the March industrial production confidence data.

IP confidence



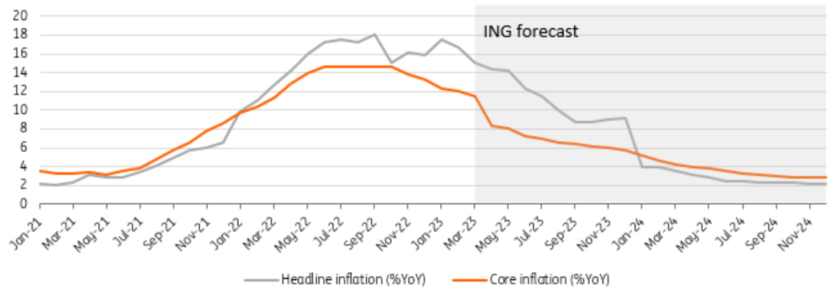
Inflation slowly moderates

It is clear the moderation of Czech headline inflation continues. In March, Czech CPI increased by 0.1% month-on-month and headline inflation moderated from 16.7% to 15%. This is the lowest YoY inflation reading since last April. The main contribution to the March decline came from base effects. Fuel prices declined 1.8% MoM which resulted in a YoY decline of almost 20%. The additional contribution to the decline of headline inflation came from gas prices, which fell 1.4% MoM, and YoY growth moderated from 74% to 60%. The positive signal is the fact that core inflation has been gradually declining for four consecutive months, while in some other EU economies, core inflation is still picking up. This suggests that domestic inflationary pressures are slightly softening, which can be partly attributed to the relatively early start of hefty rate hikes from the Czech National Bank beginning in June 2021, when the Czech economy was only emerging from the Covid lockdown. The latest inflation outlook of the Czech Finance Ministry sees headline inflation falling gradually below 10% YoY in July and further declining to 8% YoY by year-end. ING's view is a bit less optimistic, expecting headline inflation to remain a touch above

9% by the year-end.

Nevertheless, this is still unlikely to open debate about CNB rate cuts anytime soon. On the contrary, the growth of wages in industry above 10% YoY in the beginning of the year is above the CNB's comfort level.

Inflation outlook



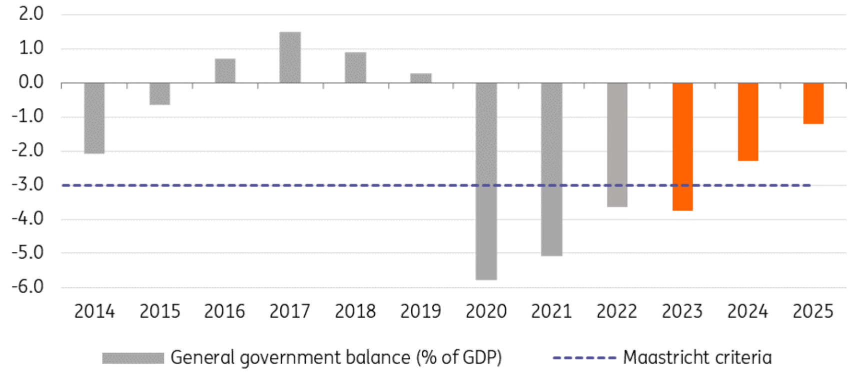
Source: Source: CZSO, CNB, ING estimates

Weak economy leads to lower tax revenues

The state budget ended March with a deficit of CZK166.2bn, the worst March result in history. The Ministry of Finance's plan for this year is a deficit of CZK295bn. The expenditure side is only slightly above plan and can be explained by frontloading some planned expenditures such as transfers to municipalities and subsidies to the private sector, as well as record strong investment activity. The main problem is on the revenue side, where roughly CZK80bn is missing. Roughly CZK50bn can be attributed to weak tax revenues and CZK30bn to non-tax revenues such as EU transfers. While we can assume that the balance of EU money inflows will improve during the year, tax revenues are not so clear. The economy is probably slowing more than MinFin expected, and tax revenues are suffering. We see a large VAT backlog for example, as well as in the case of the newly introduced windfall tax.

MinFin argues that although the collection of the windfall tax will be lower than expected this year, it will also save money on the expenditure side given the lower costs of the energy compensation programme. Moreover, in the second half of the year, MinFin will receive at least CZK40bn in dividends from the state-owned energy company. On the other hand, because of the old-age pension indexation story, there is a real risk that MinFin will have to increase spending by another CZK20bn. So overall, the whole situation is very unclear. For now, we are revising the state budget deficit forecast to CZK320bn, which translates into a general government deficit of 3.8% of GDP.

General government balance (% of GDP)



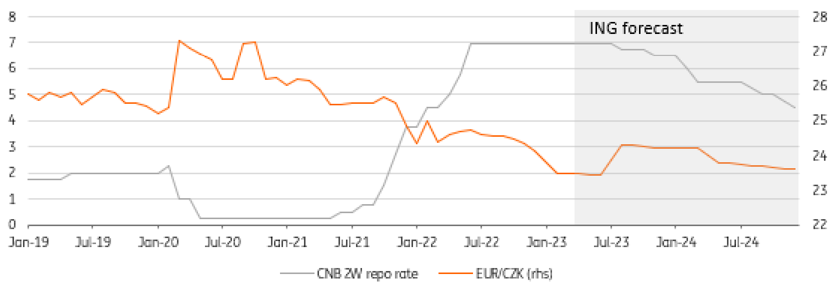
Source: MinFin, ING estimates

Softer inflation welcome, but high wages concern the CNB

The gradual decline of both headline and core inflation must make the central bank board feel more comfortable as it signals that domestic inflationary pressures are softening. What may worry the CNB board, however, is the still hefty growth of industry wages at the beginning of the year. This exceeded 10% YoY and hence remained above the critical threshold mentioned for example by Vice Governor Eva Zamrazilova. The lingering tightness of the labour market was also confirmed by the recently published decline in the unemployment rate of 0.2bp to 3.7% in March. The growth of nominal wages in the overall economy, however, remained below the 10% critical threshold (7.9% YoY in 4Q22) hence wage growth should not represent a significant risk for a rate hike debate. What will be worth following is the next labour market report for the first quarter (released 5 June), which could signal abating or rising risk for a possible rate hike.

In our view a hike is unlikely. On the contrary, we assume the CNB's current 7.00% policy rate marks the peak in the hiking cycle. Still, we see the CNB only starting the debate about the possible normalisation of monetary policy when inflation moderates close to the current levels of the policy rate. The first possibility for such a debate about a symbolic 25bp interest rate reduction could come in August when the new summer inflation outlook will be discussed. But given the prevailing risks from tightness in the Czech labour market, we do not expect more than a total of 50bp in rate cuts by the year-end. And assuming EUR/CZK has only limited scope for a possible upward correction, CNB monetary conditions should remain relatively tight for an extended period.

CNB interest rate and FX forecast



Source: Source: CNB, ING estimates

What to expect in FX and rates markets

The Czech koruna rebounded from 24.00 EUR/CZK in the post-SVB period to record strong levels as we expected. We have seen weaker levels again in recent days, but we think the market is taking some profits given the long positioning and we remain bullish on the CZK. The most hawkish central bank within the CEE region and a relatively clean risk profile compared to the forint and zloty should ensure that markets continue to support the koruna. Thus, we expect any EUR/CZK movement higher to be used to rebuild long CZK positions by the market and the koruna to remain a safe haven within the region with the best risk/reward. On the other hand, for a more significant move below 23.00 EUR/CZK, we would need to see a big push from the global story, which is not in our outlook for now in the coming months.

In the rates space, the market has reassessed its dovish expectations in recent weeks and the whole curve has moved up again. But even so, the market still remains on the dovish side with pricing of roughly 75bp of rate cuts by year-end and 165bps in the 1y horizon. The hawkish CNB meeting next week will again support paying flow, especially at the short end of the curve in our view and hence we see a case for a re-flattening of the curve. In the Czech government bond (CZGBs) space, by our calculations, MinFin has secured about 30.7% of projected CZGBs since the beginning of the year. Bonds have benefited from high demand for a long time, however, we see a slight underperformance compared to regional peers in recent weeks, which may be due to long market positioning or signs of negative sentiment stemming from the fiscal situation. For now, we do not expect a significant deterioration in the outlook for CZGBs, but we see the risk of higher supply in the coming months, which could weigh on the market's more cautious approach.

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