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Czech Republic: green light to start the process of monetary policy normalisation

Development

The Czech National Bank (CNB) kept its policy rate unchanged at 0.25%, in line with our (and consensus) expectations at its meeting today. Reflecting the combination of COVID-19 apprehensions, weaker-than-expected inflation and a stronger-than-expected exchange rate, the CNB set out a more dovish rate path than the November inflation report – which had forecast 3 rate hikes by end-2021 – to now 2, and slightly lowering the rate to 1.25-1.50% at end-2022 (compared with 1.25-1.50% in the November report). With the CNB's revised economic growth forecasts pointing to a stronger than previously expected recovery in 2021 (from 1.7% to 2.2%), this meeting marked the turning point where the green light was given to start the process of monetary policy normalisation.

Key data

Two-week repo rate: unchanged at 0.25% (MUFG 0.25%; consensus 0.25%)

Lombard rate: unchanged at 1.00% (MUFG 1.00%; consensus 1.00%)

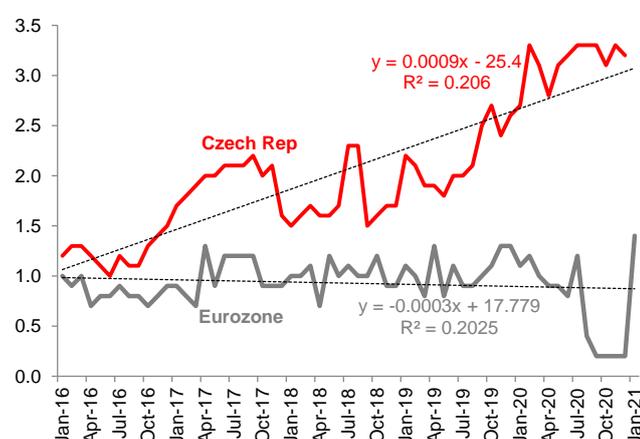
Discount rate: unchanged at 0.05% (MUFG 0.05%; consensus 0.05%)

Macro

Up until recently, the CNB had been cognisant to relax any hawkish implications from the November inflation report forecasts – qualitatively softening the quantitative

STARK SPREAD BETWEEN CZECH AND EUROZONE INFLATION IN RECENT YEARS

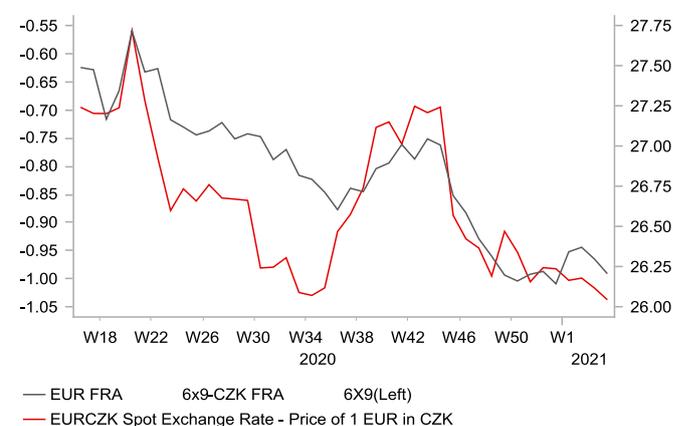
CZECH REP. AND EUROZONE CORE CPI (% Y/Y)



Source: Bloomberg, CNB, Eurostat, MUFG Research

CZK BOOSTED BY HAWKISH CNB POLICY STANCE

EUR/CZK VS SHORT-TERM RATE SPREAD



Source: Bloomberg, Macrobond & MUFG Research

output – though developments since the November publication have been dovish. First, inflation was 0.7pp below the CNB's forecast in December (2.3% y/y vs 3.0% y/y), a large surprise in the space of 2-3 months, and we believe that it will continue to fall, temporarily undershooting the 2.0% target through 2021. Second, the Czech Koruna (CZK) is currently trading at ~25.9 against the Euro, that is, respectively, 4.8% and 4.1% stronger than CNB's Q4 2020 (EUR/CZK = 27.2) and Q1 2021 (EUR/CZK = 27.0) forecasts. Meanwhile, the outturns on real activity have been somewhat mixed, with relatively resilient activity in Q3 and Q4 but negative news on COVID developments.

Putting this into perspective, today marks the inflection point where the green light was given to start the process of normalisation. With the intention to begin all but confirmed by Governor Rusnok last week, noting that the CNB is mulling up to two rate hikes in 2021, attention has shifted from the start of the cycle to the size and speed. Rusnok has highlighted subdued unemployment (the EU's lowest) as an inflationary pressure while growth is due to pick up in H2 2021. The Czech Republic still has more available jobs than people seeking work and the labour shortage will likely continue to pressure wages. This is partly due to the starting position of the economy, entering the crisis showing initial signs of overheating. Rusnok has also articulated that the inflation potential is incomparably higher than that of the euro area, which looking at the past few years the deviation has been marked.

On net, our forecast is for the CNB to start normalising policy rates before year-end with one 25bp hike in Q4 2021 and 75bp of cumulative hikes in 2022, with the risks skewed towards more tightening and an earlier start to the tightening cycle, especially if inflation does not moderate over the first months of 2021 as we expect.

FX

We expect the CZK to continue to benefit from the CNB's relatively hawkish policy stance. Today's policy update signals that the CNB remains comfortable to begin raising rates well ahead of other regional central banks and the ECB. The NBP is still talking up the possibility of further rates cuts in Q1, and leaving rates on hold until 2022 at the earliest. At the same time there is little to no chance of ECB rate hikes in the coming years. It stands in contrast to the CNB's plans to begin gradually raising rates from "roughly the middle of this year onwards". The widening policy divergence will continue to encourage a stronger CZK. We recently recommended a short EUR/CZK trade idea ([click here](#)). Downward momentum for the pair could accelerate after key support at the 26.000-level was broken over the past week, and open the door to a return to pre-pandemic levels below 25.500. Even though the CNB has scaled back the number of planned rate hikes for this year from 3 to 2, it still suggests that the CNB is not overly concerned by the potential for the CZK to strengthen further going forward. The CNB is much more relaxed over CZK strength than the NBP who have intervened to keep the PLN weak at the end of last year and have warned they are prepared to cut rates as well if needed.

Trading

Today's meeting had around 1.5 price hikes for the rest of the year. We felt this is about right and expected the CB to push back on their previous forecast of 3 for this year especially given currency strength. While CNB will be wary of CZK appreciating too much too quickly relative to other CBs in the region it is very hands off currently. We like RV longs in CZK vs PLN.

Czech Koruna Forecasts

Quarter End	Spot close 03.02.21	Q1 2021	Q2 2021	Q3 2021	Q4 2021
EUR/CZK	25.884	25.900	25.750	25.600	25.400
USD/CZK	21.507	21.060	20.770	20.320	19.840
CZK/JPY	4.882	4.8920	4.9120	4.9710	4.9890
		Range	Range	Range	Range
EUR/CZK		25.400-26.500	25.200-26.300	25.100-26.200	24.900-26.000

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