MNI Czech National Bank Review: February 2023

Executive Summary:

- **The Czech National Bank left interest rates and the FX stability commitment unchanged, in line with expectations**
- **The central bank's communications suggested that the exchange-rate channel is still seen as a key bulwark against inflation**
- **Governor Ales Michl explicitly pushed back against market pricing and suggested that interest rates may need to remain higher for longer**

Key Links:

- **For full statement click here**
- **For the transcript of the Q&As click here**
- **For the presentation click here**

Key Takeaways: Higher For Longer

The Czech National Bank voted 5-2 to leave the 2-week repo rate unchanged at 7.00% and maintain the existing FX regime, in line with the consensus call. The two dissenters (presumably Mora and Holub, based on past decisions) were seeking a 50bp rate hike. While the "dovish" majority outvoted them yet again, Governor Michl suggested that monetary policy settings may have to remain relatively tight for an extended period of time, with the CNB determined to get on top of inflation.

With no surprises on the main monetary policy parameters, the focus turned to the details. The outlook for 2023 consumer inflation was adjusted higher, to +10.8% Y/Y from +9.1% Y/Y, while the 2024 forecast was revised slightly lower, to +2.1% Y/Y from +2.4% Y/Y. While the central bank warned that January will likely see a notable acceleration in headline price growth, it continues to expect rapid disinflation later in the year, with inflation returning to the vicinity of the +2.0% target next year. It is worth noting that the monetary policy horizon for achieving the inflation target was reduced to the typical 12-18 months. This should imply a higher rate path, which failed to materialise in the projections. That said, Bank Board communications are more reliable as a predictor of monetary policy than staff forecasts.

The decision to reaffirm commitment to CZK stability may have disappointed a handful of participants speculating that the central bank could abandon its FX regime, after Koruna appreciation in recent months reduced the need for interventions to zero. Accordingly, short-end EUR/CZK implied volatilities (overnight & 1-week tenors) adjusted lower as headlines with the CNB's decision crossed the wires. Governor Michl reaffirmed his hawkish FX stance during the subsequent press conference, noting that a strong exchange rate helps tame inflation, which is currently a bigger problem than exports. Bank Board's Karina Kubelkova and Oldrich Dedek later echoed this view, suggesting that the central bank will stick with its FX policies for now.

While the central bank's preference for interest-rate stability remains unshaken, the Bank Board warned – in line with recent comments from some of its members – that rates may need to stay higher for longer. While staff projections continue to imply the resumption of the tightening cycle, the Bank Board this week "discussed a scenario in which the CNB's key interest rates remain at the current level for longer," noting that "in both scenarios, inflation falls close to the target in the first half of next year." Governor Michl reaffirmed this message during his press conference by suggesting that he expects Czech rate path to be higher than priced by money markets.

What had previously been perceived as the Bank Board's dovish leanings may thus be more of a tactical than strategic nature. While the proponents of immediate rate hikes are in a minority, their colleagues are in no rush to drastically loosen monetary policy. In fact, Governor Michl told reporters that interest rates may remain elevated through the remainder of his term. He noted that "over the next five and a half years we will need to be significantly stricter than the previous board." Finally, the Board keeps an official neutral to hawkish nearest-term bias, noting in the statement that next month it will decide between raising interest rates and keeping them on hold.

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Comparison of CNB Forecasts – Autumn 2022 versus Winter 2023:

Autumn 2022	2022	2023	2024
Headline inflation (%)	15.8	9.1	2.4
Monetary policy-relevant inflation (%)	15.3	8.9	2.3
Gross domestic product (annual changes in %)	2.2	-0.7	2.5
Interest rates 3M PRIBOR (%)	6.6	7.0	5.3
Exchange rate (CZK/EUR)	24.6	24.8	24.7

Winter 2023	2022	2023	2024
Headline inflation (%)	15.1	10.8	2.1
Monetary policy-relevant inflation (%)	14.6	10.6	2.1
Gross domestic product (annual changes in %)	2.5	-0.3	2.2
Interest rates 3M PRIBOR (%)	6.3	7.0	4.8
Exchange rate (CZK/EUR)	24.6	24.5	24.6

Analyst Views (Alphabetical Order)

Goldman Sachs: No Rate Change This Year But Uncertainties Are Significant

- The committee reiterated that stabilizing inflation at the 2% target will require rates to remain high for longer than usual but otherwise they see the current level of monetary tightening as sufficient. More importantly, the CNB Governor Michl added that he sees rates staying high also longer than currently priced by the market.
- Additionally, the CNB's forecast horizon for returning inflation to 2% is now back to the more 'standard' 12-18 months from an extended 18-24 months.
- The rate decision was universally expected and the market was more focused on the Bank's revised forecasts, which included a more hawkish inflationary outlook for 2023 with inflation reaching +10.8% (1.7pp higher than the autumn forecast) but minimal changes to the rate path going forward.
- Goldman think that the lack of a major revision to the rate path is likely explained by the return to a shorter forecast horizon and higher inflation canceling out the impact of a stronger Koruna.
- Their views are closer to the hawkish camp on the Board, in that we are worried by the evidence of de-anchored inflation expectations. Nevertheless, we remain comfortable with our forecast for no rate change this year, although the uncertainties around this forecast are significant.

ING: Possible Reduction In Rates Limited This Year

- The previous hiking cycle finished last June, when the hawkish bank board of CNB Governor Rusnok hiked by 125bp to 7%. Since the start of dovish Governor Michl's term, the new bank board has kept interest rates unchanged.

- The new CNB outlook forecasts inflation to pick to 17.6% in January and to decline relatively swiftly from spring towards 7.6% in the last quarter of this year. After a marked drop of headline inflation to 2.3% in the first quarter of 2024 the CNB forecast suggests it being mostly flat throughout the whole remainder of the next year.
- The forecast implies additional hikes by roughly 100bp in the first quarter followed by 200bp cuts until year-end. According to Governor Michl, however, the board preferred to keep key interest rates unchanged for longer, having regard to the sensitivity scenario presented on Friday, 3 February.
- The outcome of today's CNB board meeting is an interesting mix of dovish/hawkish stance. Refusing a rate hike suggested by the new forecast on the one hand, and a resolution to keep rates rather higher compared to forecasts on current already high levels for longer period.
- It seems the possible reduction in interest rates is limited this year, maybe 50bp or less, while the first possible cut could be delivered in August, a symbolic 25bp, while in the fourth quarter we may see another 25bp in November.

JP Morgan:

- The vote came once again with the usual 5-2 split vote, with the two dissenters (almost certainly Holub and Mora) pushing for a 50bp hike. Given that this was Marek Mora's last meeting, most likely the split will evolve to a 6-1 with just Holub in opposition.
- The staff's refreshed projections bring a more dovish reading of the outlook, with inflation firmly at target from 2Q24, stronger FX (reflecting mostly a marking to market of the starting point, since the interest rate differential with the ECB is shrinking), and lower rate path in 2024 (average 4.8%, down from 5.3%). The board also discussed an alternative scenario in which rates stay high for longer, and according to the presentation, in that scenario inflation falls to target in 2H24 (similar to the baseline).
- The forecast was even more dovish if we consider a narrowing of the policy horizon. At last August's policy meeting, the first quarterly meeting with Ales Michl as Governor, the CNB announced a six-month extension of the monetary policy horizon, from 12-18 months to 18-24 months. With CPI above target, an extension of the model horizon has the effect of lowering the endogenous rate path. Later on in November, the MPC reversed half of that decision, narrowing the horizon by three months. According to today's statement, today it undid the rest, narrowing the policy horizon back to 12-18 months.
- In the press conference, Governor Michl reiterated that the decision was still between on hold or hike. Though hawkish, this bit is not a surprise, given that two members are still voting for hikes so its almost inevitable to mention. Where Michl was really hawkish was in a clear embracing of strong FX. When asked about it, Michl said that inflation is a bigger problem than the challenges stronger CZK could pose to exporters. Moreover, Michl pushed back against market pricing of rate cuts, saying that he sees a higher rate path than what markets are pricing in.
- Between the dovish projection and the hawkish remarks, JPM are inclined to put more weight on the latter. Historically, the board has always deviated somewhat from the projection, but this is all the more true with this board, which has apparently a greater detachment from the once sacred staff projection. Their forecast is for the CNB to start cutting rates cautiously by late 3Q23, based on a sharp sequential disinflation in core CPI, meagre growth and appreciating currency (more so if the CNB stays hawkish).

NatWest: Easing In Q1 2024 At The Earliest

- The Czech National Bank kept its interest rate, and even its vote count, unchanged in line with all surveyed economists' expectations. However, higher inflation forecasts, a recognition that inflationary risks persist and an explicit statement that markets were mispricing the chances of rate cuts gave the event a clear hawkish tone.
- NatWest think the earliest the CNB will begin its easing cycle is Q1 2024 and see no near-term end to FX intervention. They remain overweight CZK on foreign capital inflows as lcy bonds offer a yield premium over the Eurozone and explicit central bank policy backstops FX depreciation risk.