

Czech National Bank Preview: The governor strikes back

We expect no change in CNB interest rates next week. However, we see a risk that sooner or later the central bank may be pushed to hike rates by the koruna. Forward guidance should be dovish, however, its presentation may be tricky for markets. We expect a steeper curve as a result of the dovish shift



We think the CNB could be set to cut rates once more before pausing to assess incoming data

Finding arguments on why not to raise interest rates

On Thursday, 4 August, the CNB will hold its first monetary policy meeting under the leadership of a new governor and with a new composition of the board, including the presentation of the central bank's new forecast. Not much has changed in our view since [the last meeting](#) at the end of June. We believe the new governor will deliver what he promised when he was [appointed](#), and interest rates will remain unchanged for the first time since the first post-Covid rate hike in May last year.

The new forecast will, in our view, deliver a less hawkish outlook than we have been used to in the past, but should still point to further rate hikes. The main reason for this should be a shift in the peak of inflation from the summer to the autumn months at 20% year-on-year and a higher trajectory for the rest of the year. In addition, the upward revision to the GDP growth forecast

should be in place. The first quarter was a significant positive surprise, and the second quarter does not suggest numbers as bad as the CNB expected in its May forecast. We can also probably expect several alternative scenarios, as in the May meeting, including a scenario with a more distant monetary policy horizon, which should support the Board's decision not to hike rates and to tolerate inflation for a longer period of time.

However, similar to May meeting, communicating more views and making decisions based on alternative scenarios may be confusing for the market, and in addition, compared to May, the factor of a new governor and board members with unanchored views will also play role. Thus, we expect a dovish outcome of the press conference highlighting geopolitical and economic risks, including the reasons we have heard from new board members in recent weeks such as slowing or falling credit activity in some segments or a drop in retail sales.

7.00% CNB's key policy rate
We expect no change next week

The next two months of a staring contest

The CNB continues to intervene in the FX market to [defend the koruna](#), which we estimate has cost it about 11% of FX reserves since mid-May. Although pressure on the weaker koruna has eased in the past two weeks, we expect confirmation of the CNB's dovish transformation and stable rates to revive pressure on the depreciation.

On the domestic front, this will be compounded a week later by the release of July inflation, which we believe will show the full force of the summer's household energy repricing. We could very easily see an upside surprise, which could soon give the Board a hard time. However, we think the pressure on the koruna and the associated cost of FX intervention will be key. In this case, however, the geopolitical risks are not playing into the CNB hands, which could very quickly trigger another EM currency sell-off as we saw in early July. Thus, a rapid rise in the cost of interventions could ultimately drive the CNB to hike rates and end or change its approach to FX intervention from the current commitment-style to a more flexible approach. For now, however, we see this as an alternative scenario albeit with a high probability. The baseline scenario assumes rates remain stable for the rest of this year. However, next week the CNB should show us more on how serious it is about its dovish stance.

What to expect in rates and FX markets

Financial markets have significantly lowered hawkish expectations in recent weeks, but still give a 25bp rate hike a better chance than stability (80:20). As mentioned earlier, we believe the market is still underestimating the CNB's transformation from the region's most hawkish central bank to the most dovish. Thus, next week will be the first opportunity for the CNB to show its new face. We expect the market to reassess current expectations downward at the short end of the curve under the pressure of a dovish outcome. On the other hand, persistent inflation and renewed depreciation pressure on FX will keep long-term expectations elevated. Therefore, with a steepener we could see an attractive risk-reward with limited potential loss due to current market expectations and near record curve

inversion.

On the bond side, market repricing should drive Czech government bond yields lower, plus recent weeks have shown a return of buyers and strong demand at auctions. This is countered by historically record August supply volume in primary auctions, which could break the traditional seasonal pattern of ASW tightening in the second half of the year.

The koruna gave the CNB a little bit of peace over the past two weeks, but this week has shown that the central bank needs to be on guard. Overall, however, the 24.60 EUR/CZK level seems unbreakable and if the market would allow it for a small price, it cannot be ruled out that the CNB would push the level a bit lower. Nevertheless, we expect the market to start testing the central bank's resolve strongly again after next week's meeting, which, in concert with global geopolitical risks, could lead to an early end to FX interventions. Until then, however, we expect the koruna to remain just below 24.60 going forward.

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