Czech National Bank Review: Restoring price stability is an absolute priority

The central bank raised rates by 50bp and disappointed the market, but at the same time sent a hawkish message that it is ready to tighten monetary policy further. We continue to expect another rate hike in May. However, with the CNB's May forecast, we expect increasing discussion about possible rate cuts

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5.0% CNB's key rate

+50bp

CNB is ready to raise interest rates further

The CNB decided to hike the key rate by 50 basis points to 5.0%, the highest level since 2001. However, the decision was 25bp below our expectations and led to market disappointment. On the other hand, the press conference delivered a hawkish message and a commitment to raise interest rates further. Unsurprisingly, five board members voted for a rate hike and two for stability. However, more interesting were the details revealed by Governor Rusnok. The staff recommendation was a 75bp hike (which was the ING call) and according to the governor, several board members were willing to vote for this proposal. In the end, however, the prevailing view was to wait for the new forecast at the May meeting and to be more cautious until then. At the same time, the governor said that the CNB's internal forecast suggests GDP growth would be roughly half of the February forecast, implying growth of around 1.5%. However, he later said in a TV interview that he is more sceptical than central bank analysts and personally expects growth to be only slightly above zero for this year. In terms of inflation, nothing in the CNB's outlook has changed from statements made in recent weeks, implying a peak in inflation of around 13% in the spring months and a gradual slowdown in the second half of the year. The governor did not provide more detailed forward guidance regarding future interest rate path, but the Board's statement was very clear.

> *"Restoring price stability soon is now the CNB’s absolute priority"*
>
> Statement of the CNB Board

FX interventions are not on the table, but remain a backup solution

The governor also sent a clear message on speculation about whether the central bank would intervene in favour of a stronger koruna. In his words, FX as a monetary policy tool has been discussed, but the activity so far in early March has been judged successful and no further action is needed. Of course, the governor reiterated that the CNB is always ready to react to a sharp depreciation of the koruna or high volatility. He also said that the central bank has resumed the FX reserves yield sales programme that was launched in January.

More rate hikes this year, but rate cuts will become a main theme

Today's meeting brought no change in our call. We expect inflation to peak in May/June at around 14% year-on-year. Thus, on this assumption, we expect another 50bp rate hike at the May meeting and stability in interest rates for the rest of the year. In our view, March inflation (published on 11 April) will show more, fully revealing the impact of the Ukraine conflict on inflationary pressures in the Czech Republic, which may open the door for more rate hikes this year. Although a possible rate cut was not discussed today, we think it will be the main story for the May meeting with the CNB forecast pointing to a 3-4% range at the end of the horizon.

What to expect in FX and rates markets

Despite the wild moves during the day and especially after the CNB decision, we found market rates roughly 5-10bp higher on the short end and more or less unchanged on the long end after the press conference. Financial markets are currently expecting a 25-50bp hike at the May meeting and a terminal rate in the 5.50-5.75% range, which is very close to our forecast. On the other hand, the market is expecting a rate cut in a one year horizon, a bit earlier than we expect. Overall, however, we see that inflation still has room to surprise to the upside, so we would not completely close the door to payers for the coming weeks. On the other hand, we expect the May CNB forecast will show relatively quick cuts in interest rates, which will be a new main theme for the markets. Of course, it depends where the market pricing will be at that time, but it will likely be the first opportunity for longer-term receivers.

On the FX front, the CNB decision hasn't changed the recent rate correction, leaving the market interest rate differential roughly 30bp below its peak and the CZK vulnerable to any shock from global headlines. On the other hand, we know that the CNB will not allow the CZK to weaken significantly. Thus, we continue to expect a gradual appreciation to pre-Ukrainian conflict levels, but with temporary swings to weaker levels.

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