

## CZK meltdown: Is the past catching up?

Given the global backdrop, EUR/CZK is set to head higher, with EUR/CZK 26.50 being the next realistic target. With the koruna under heavy pressure, potential aggressive rate cuts could make things even worse and generate a CZK meltdown. We thus refrain from a call for meaningful CNB rate cuts, though a modest signalling rate cut seems more likely for now



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### CZK under pressure

The Czech koruna is sharply down and EUR/CZK is above 26.00. What used to be the safe harbour in times of stress within the CEE region has turned into an underperformer.

The problem for the koruna is that positioning is finally catching up. Foreign holdings of Czech government bonds - behind 40% clearly shows that the koruna has been persistently and chronically overbought, making it vulnerable in times of stress. While the CZK weathered the 2019 global trade war storm relatively well (EUR/CZK did not move above the 26.00 level), current market jitters are taking a heavy toll.

This is due to:

(a) Across the board deleveraging, which has made overbought currencies particularly vulnerable (CZK in the CEE, RUB in the wider EMEA space or MXN in the LatAm region),

(b) Markets aggressively pricing in Czech central bank rate cuts, with the central bank being one of the few with ample room to ease monetary policy.

## Potential rate cuts will affect CZK

While there isn't much the Czech authorities can do about the positioning, they have power over rate cuts. Although from a bird's eye view, the case for central bank rate cuts is rising, from an idiosyncratic point of view, any larger scale easing cycle would in our view lead to a CZK meltdown.

The currency is already very vulnerable due to the positioning and should the central bank take away the key anchor behind CZK (the yield advantage), the exodus from Czech asset markets could be rather pronounced. Indeed, based on our conversation with investors last year, the yield advantage was the key reason why investors remained invested in CZK during the 2019 global trade war.

## Signalling CNB cut more likely

Bar the implications for the currency, we also don't see rate cuts as the best remedy for the current Czech economic situation.

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As Governor Jiří Rusnok mentioned this week, rate cuts might not help the economy much as a small deceleration in lending costs won't be a game-changer for companies, which mainly need to have access to credit. Credit availability will be considered as more crucial than lending costs itself.

A small rate cut would aim to signal coordination between the central bank and the government (as was the case in the UK), but a more effective measure would be a lower counter-cyclical capital buffer to support credit availability.

Hence, we are biased not to call for aggressive easing from the central bank given the currency consideration. Of course, with the central bank having ample FX reserves (60% of GDP), it is well equipped to deal with the currency free-falling, if the situation were to arise and defend the koruna.

*We think FX interventions below EUR/CZK 27.00 are unlikely*

But we think FX interventions below EUR/CZK 27.00 are unlikely. To be clear, the current CZK fall is primarily a function of the global environment and pressure on risk assets (including EM FX) and the central bank cannot do much about it, but there are idiosyncratic reasons

why the CZK declining more than its CEE peers and here the CNB has the power to influence the scale of the koruna downside.

It's worth noting that the CZK weakness has already delivered three implicit rate cuts, while the koruna is still not undervalued after the recent fall.