Expect a Czech rate rise in November

The Czech National Bank holds, but we worry the transmission mechanism is broken

The CNB meeting

In line with our expectations and in a split decision (3 votes for a hike), the CNB stays on hold but sends a strong signal for a 25bp hike in the upcoming November meeting, when the new inflation report is released.

A November hike's a 'done deal'

The CNB decision to hold off on a rate hike until the November meeting does not make a material difference, given the strong pre-commitment for the hike. The CNB very much acknowledged that the economy is ready for tighter monetary conditions. Also, due to strong wage dynamics in the second quarter, approval for a salary increase in state administration and the stronger union pressure, wages may accelerate by more than 8% next year, compared with 6.2% expected in the last CNB forecast.

Wage growth is a significant pro-inflationary factor, which could lead to a faster tightening of monetary policy, especially in a situation where the exchange rate is not appreciating (due to the koruna's 'over-boughtness') and doesn't bring monetary tightening. As such, in addition to a November hike, which is a done deal in our view, we see a further three hikes being delivered by the CNB in 2018 (with two in 1H18). It was also mentioned today:

• Czech GDP growth accelerated above the CNB's expectations due to strong household consumption, a recovery in investment activity and strong foreign trade. Wage growth soared in 2Q17, both in the market and non-market sectors. As such, labour market tensions are strong.

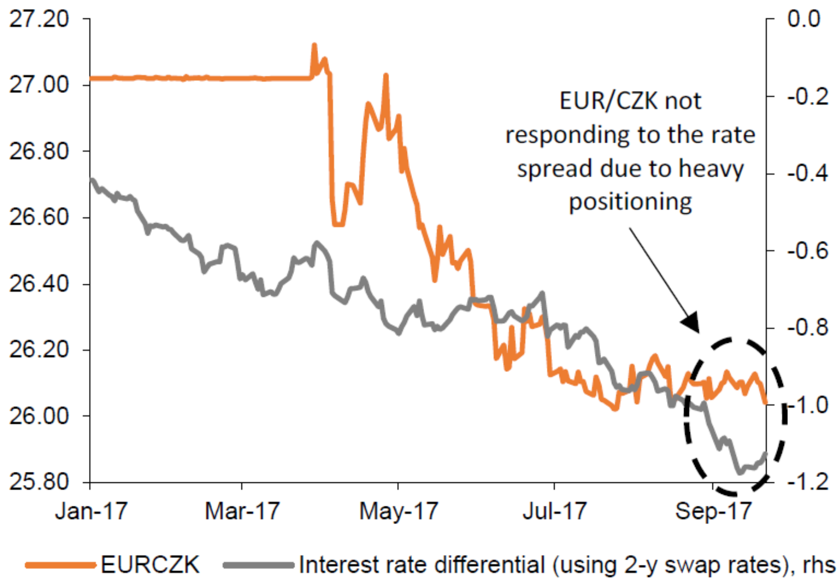
• The CNB board assessed the risk versus its previous (August) forecast as slightly pro-inflationary due to more solid domestic activity and accelerating wages. In the opposite direction is the outlook for lower producers' prices.

• The CNB's hiking trajectory will depend on the development of all macroeconomic variables, including the EUR/CZK. The CNB is aware, however, that the EUR/CZK channel is somewhat broken due to CZK "over-boughtness".

• Governor J Rusnok confirmed that postponement of the hike was mainly driven by the desire to wait for the new set of forecasts, and he did not see the need for a hike as acute. The ECB's policy was also discussed by board members, but this factor is now perceived as less important because the FX-channel is not functional.

• J Rusnok can imagine that rates might increase by more than 25bp within six months.

Figure 1: CZK not reacting to the rising CZK swap rates



Source: ING, Bloomberg

FX and rates

With the 25bp hike in November priced in by the market with 90% certainty, the actual delivery should not change current EUR/CZK trading patterns. There is limited scope for the overbought koruna to persistently push below the 26.00 level.

Regarding rates, with a CNB hike at the November meeting seemingly a done deal, we expect the market to focus on the path of the hiking cycle beyond that. Given the broken transmission mechanism from interest rates into EUR/CZK (Figure 1), we expect the CNB to deliver an additional two hikes in 1H18 during the inflation report meetings (likely February and May). This should be indicated in the new CNB interest rate forecast, which should be more “linearised”.

This is not priced into the market yet, with only 50bp of hikes priced in over the 9m period (vs our call for 75bp). Note the broken transmission mechanism from interest rates into FX and hence the lower need to wait for the ECB meeting next month was one of the arguments of the three dissenting board members for a hike today.