24 March 2023

Snap

Czech National Bank preview: No action, with a preference for stability

The Czech National Bank (CNB) will likely keep interest rates at the current level of 7%. The decision will likely be accompanied by a statement that any rate cuts depend on inflation showing a clear trend towards the 2% inflation target

The Czech National Bank headquarters in Prague, Czech Republic

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No change

CNB's key rate

CNB likely to keep interest rates unchanged at 7%

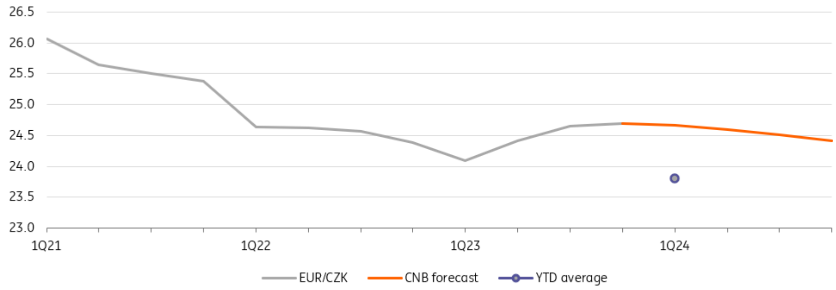
The Czech National Bank's monetary policy meeting next week is unlikely to bring a change in the interest rate. We expect the CNB 2-week repo rate will remain flat at 7%, where it has remained since the last hike in June 2022.

CNB board members recently reiterated their mantra that the current setting of monetary policy instruments is sufficient to return inflation back to the 2% target at the beginning of 2024. While the CNB forecast suggests the need to hike rates in the first quarter of 2023 by around 100bp, followed by relatively hefty rate cuts during the remainder of this year, CNB board members advocate rate stability at the current level until there is a visible and significant decline in CPI below the nominal interest rate.

One of the reasons the CNB mentions is the rising appetite from the corporate sector for EUR-denominated loans, which provide lower financing costs compared to Czech koruna (CZK) loans. The CNB officials assume that if CZK interest rates increase further, the demand from the corporate sector for FX loans will strengthen too, making the transmission of CNB monetary policy less effective. This is the reason why the CNB board in the new composition is betting more on the effect of a strong currency, which should likely tame the imported inflation from higher commodity prices.

The outperformance of the Czech koruna since the beginning of the year, compared to the CNB's forecast, is clearly welcome by the CNB as it lowers the need to tighten the monetary policy mix via interest rates. So far koruna remains stronger, compared to the CNB forecast, by 3.5% in the first quarter, which is roughly the equivalent of a 75-100bp hike in interest rate. Therefore, the CNB feels no need to track its winter forecast suggestion to deliver an additional sizable hike any time soon.

CNB winter forecast of EUR/CZK vs. actual development

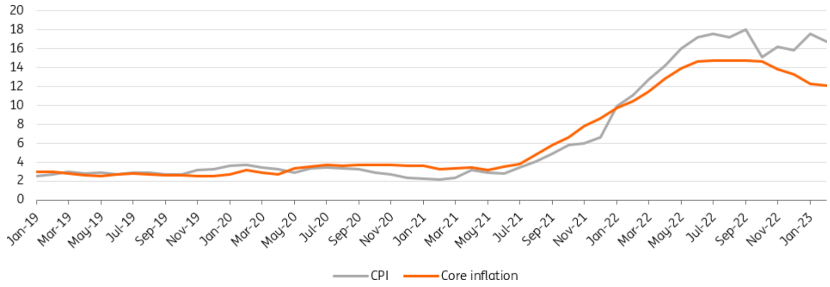


Source: CNB, ING

CNB officials have stressed several times that they prefer a prudent approach in the sense that interest rates should remain at their current level for an extended period, until there is a visible and sizable decline in inflation back towards the 2% inflation target. In addition, Vice-Governor Eva Zamrazilova previously mentioned that she assumes a broader definition of price stability, i.e. embracing not only consumer prices but also real estate prices.

The Czech economy experienced several years of double-digit growth of dwellings prices which were – to some extent – also fuelled by cheap mortgages. Despite the previous tightening of macroprudential tools, only the sharp increase in interest rates stopped the hefty real estate price spiral. Therefore, it seems more likely the CNB will keep the interest rate at the current level until it sees that the risk of real estate price inflation has disappeared. The CNB can also feel more comfort with core inflation gradually declining for the past five months, as the result of relatively early monetary policy tightening.

Core inflation gradually declining



Source: CNB, ING

Our FX and rates call

The Czech koruna was the second-most affected currency after the Hungarian forint during the recent financial market turmoil due to its previously very heavy long positioning and sensitivity to energy prices. However, we believe that the factors pushing the koruna to stronger levels still remain. Moreover, potential losses are limited by the central bank's readiness to intervene in the FX market. Thus, in our view, current market conditions, i.e. higher EUR/USD, lowering risk aversion, falling gas prices and decent stable carry is the ideal combination for the koruna to return to its earlier record strong levels. Although the forint is probably juicier from this perspective, we believe the koruna offers the best risk/reward within the CEE region at the moment.

In the rates space, the drop in core rates led to a significant dovish shift in the CZK market. At this point, the market has fully priced in the first rate cut in the middle of the year and roughly 130bps by the end of this year. This is far from our forecast or the CNB's alternative scenario, which is the board's preferred scenario at the moment. The latter assumes the first rate cut only in the fourth quarter of this year. Thus, overall, we see the largest market mispricing in the CZK curve within the CEE region and we believe the CNB meeting will be the catalyst to correct these expectations.

In the Czech government bonds space (CZGBs), first-quarter financing points to a very comfortable situation for MinFin with 28% coverage of issuance needs, which should limit the potential sell-off after the current rally. On the other hand, we see risks on the fiscal policy side in weaker tax revenues and potential additional costs stemming from the indexation of old-age pensions. Overall, however, we see a sound story of CZGBs, but also not much potential to rally from current levels compare to other peers within the CEE region, making CZGBs a safe haven if risks materialise at the global level.

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