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Article

Czech National Bank preview: Rate cuts coming into focus

We expect the CNB to raise its key rate by 50bp next week, but the latest GDP data raises the odds of a 75bp hike. The new forecast will show significant rate cuts in 2H22, which will be challenging for the Board's communication. Although we do not expect the first cut until the middle of next year at the earliest, it will be the main story for the market this year

Source: Shutterstock

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Change in the key rate

ING forecast

Board balancing between stagflation risk and staff recommendation

The Czech National Bank will hold its monetary policy meeting on Thursday next week. In addition to the decision to raise interest rates, it will bring a new forecast - the first since the start of the Ukrainian conflict. It will see a massive revision in all directions. The CNB will basically have to halve growth projections for the external environment and double external price pressures compared to the February forecast. So, on the domestic front, we think GDP growth will be cut in half, implying about 1.5% for this year and a peak in inflation of just below 15% in May or June, which is in line with our view. So overall, we expect a massive upward revision to the interest rate forecast just on the merits of the CNB's macro model. According to our simulations, the peak in the key rate envisioned by the CNB could get as high as 7% in the second quarter with the aim of getting inflation to the 2% target by the middle of next year, which we think is unrealistic. We can also expect the model to inherently show rate cuts starting in the third quarter of this year, with a trajectory heading to the 3-4% range at the end of the forecast horizon, which will be difficult for the Board to communicate.

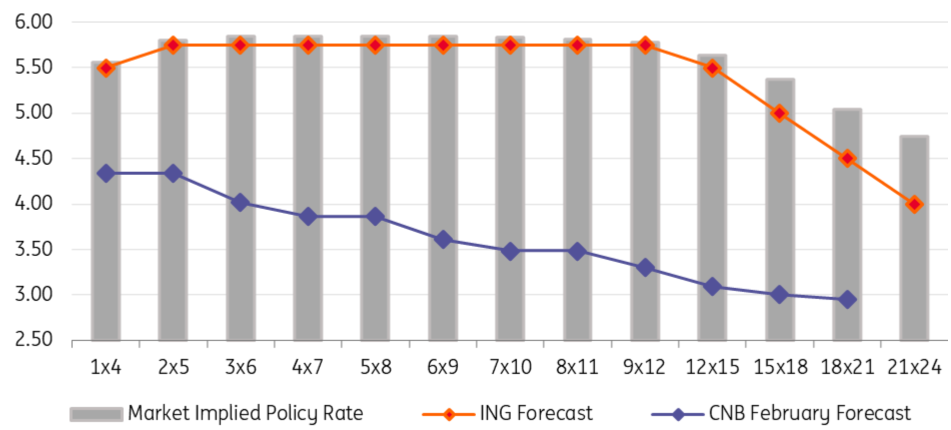
> "The peak in the key rate envisioned by the CNB could get as high as 7%"

Rate cuts will be the main story of the May meeting

Almost nothing has changed in our view since the March meeting. The Board will remain more cautious relative to the staff's recommendations, which we believe will again recommend a 100bp hike or even more. However, we think the Board will find the best compromise to a 50bp hike, balancing the risk of stagflation and further inflation. However, we see a 75bp hike as an alternative scenario, especially after Friday's 1Q GDP release, which mitigates the risk of stagflation for the coming quarter. In our view, a 50bp hike next week would open the door to a further 25bp tightening in June and a terminal rate of 5.75%. In the case of a larger move, this could be enough for the Board to deliver the last hike in this hiking cycle next week.

However, we think the interpretation of the new forecast and communication of the next rate path will be the key story of this meeting. Given the massive rate hikes now and the early rate cut, we think the Board will take a smoothing approach, meaning smaller rate hikes now but a rate cut later versus the forecast, depending on the incoming data. We believe the Board will be reluctant to cut rates until the spot inflation rate falls visibly into the single-digit range, and given the potential upside surprises in inflation, we expect the Board to further delay rate cuts until at least the middle of next year.

Czech FRA curve expectations



Source: Refinitiv, ING

What to expect in FX and rates markets

It may be difficult for the market to find a clear path through the CNB's new forecast indicating rate hikes now and cuts later, while at the same time looking for a compromise in the Board's communication. The market is currently expecting about a 50bp hike in May and another 25bp in June with slight upside risk, which is in line with our expectations. However, we think the new forecast and possible larger move will push short-term expectations up for the next few months, though down in the longer term. At this point, markets are expecting the first 25bp rate cut in the one-year horizon, but further cuts are very gradual and even at the two-year horizon, implied rates are not returning below 4%. As we've mentioned since the March meeting, we think the May meeting will be a turning point in the market's view and the first opportunity for longer-term rates receiving. On the other hand, given the inflation trajectory and CNB communication, it is likely to be a bumpy road down in the coming months. For this meeting, the market will focus on the 2-4y segment, which we think currently most underestimates the CNB's willingness to cut rates in the future. The extent of the market move will depend, in our view, on the Governor's success in communicating the new forecast and the Board's divergent view.

In the FX market, the koruna has been in a range of 24.30-24.50 or just slightly above this level for the past few weeks given the Poland-Russia gas conflict, in line with our expectations. As the koruna has recently re-established its relationship with the interest rate differential, next week's CNB meeting may bring high volatility as the market looks for a way out. However, we do not expect a major move out of the current range. A reassessment of market expectations for faster rate cuts will be negative news for the koruna, though on the other hand, it may be supported by questions about possible central bank intervention and FX reserve sales.

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