

| Czech National Bank |

CNB Focus

Growing uncertainty to delay first hike implied in CNB forecasts



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Following the last CNB meeting on 4 May, the koruna began an appreciation rally, in our view, prompting many CNB board members to rethink their intention (implied by the latest CNB staff forecasts) to implement a rate hike as early as 3Q. This came as no surprise to us. We have already stressed that FX developments would be critical, while we have also observed the emergence of several anti-inflationary risks since the last meeting. The board members have stated that they would rather have a loose monetary policy for longer than implement a hike prematurely. Hence we still think the bank board is unlikely to implement a hike in 3Q, and that it will wait until the last quarter to do so.

Current CNB forecast imply two rate hikes in the third quarter, but the central bankers have stressed that they will be watching developments on the FX market closely. The koruna has appreciated roughly 2.8% vs the euro since early April when the FX floor was scrapped, which is equivalent to a hike of roughly 70bp. This is unlikely to be a source of major concern for the

Bank's board members. While the central bank has not released its latest EUR/CZK forecast, based on its previous forecast and CNB's Chief Economist's comments that the outlook has not materially changed, we deduce that it expects a stronger CZK appreciation. The board evaluated the risk to its forecast as pro-inflationary due to the uncertainty stemming from speculative positions. Since the last meeting, however, we have identified several other factors that could affect the balance of risks to inflationary forecasts:

Pro-inflationary risks

- Wage growth has surprised on the upside, with nominal wages increasing 5.1% in the first quarter, vs the CNB's expectation of only a 4.8% increase.
- Economic dynamics have surprised on the upside (+1.3% qoq) buoyed by renewed investment activity. In yoy terms, GDP growth was 2.9% in the first quarter vs 2.5% expected by the CNB and investment printing at -0.6% vs the CNB's forecast of -2.1%.
- Although food prices have eased slightly, agricultural prices have been accelerating. Their yoy double-digit growth suggests that there are still upward pressures on food prices.

The CNB to start its hiking cycle in 4Q17



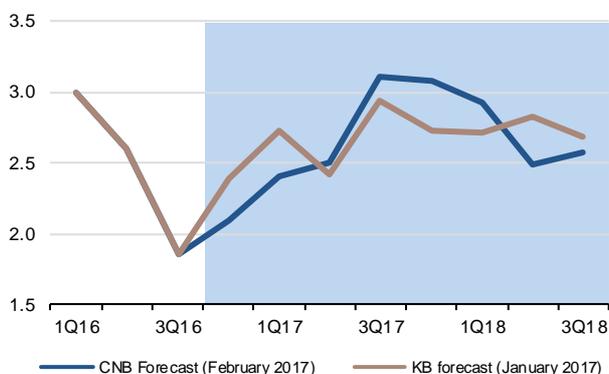
Source: CNB, Bloomberg, Macrobond, Economic & Strategy Research/Economics, Komerční banka

Anti-inflationary risk

- Headline inflation lags the CNB’s forecast. However, this is only a minor risk as the difference lies mainly in food and fuel prices.
- Despite accelerating wage growth, we see only moderate growth in household consumption. While the CNB had forecast an acceleration to 3.1% growth yoy, the released figure for 1Q17 was only 2.8%. Hence, in our view, there is a danger that conservative Czechs could, rather than increase spending, save from their growing wages.
- If the recent slump in the global oil price persists over the summer high season, this may have a longer-term effect not only on fuel prices, but also on other price components. While we expect the oil price to pick up, there is a significant risk that they may not.
- The ECB keeps its dovish tone and our in-house forecast of a tapering in its asset purchasing programme has been further postponed. The ECB’s loose monetary policy will exercise further pressure on EUR/CZK appreciation and thus on lower import prices.

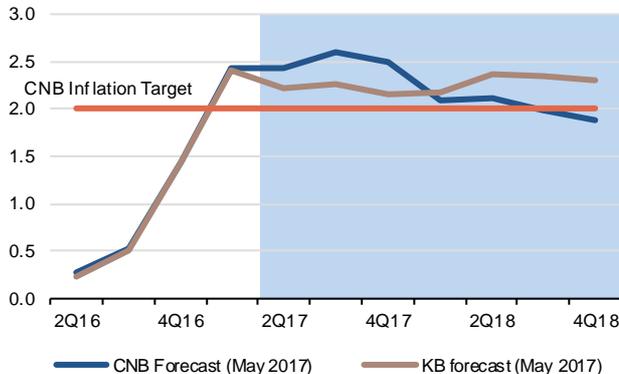
We see plenty risk on both sides. We believe that the overall picture will remain pro-inflationary with the biggest risk likely to remain FX development, while uncertainty on the ECB’s steps is also of growing importance. Nevertheless, uncertainty is growing and CNB board members have stated that they would rather wait than have to reverse hikes at a later date. We expect this to be the CNB’s message at Thursday’s meeting when the board once again defines its stance compared to the current forecasts that imply two hikes in 3Q. On the other hand, we still expect the central bank to reiterate once again that it is ready to raise the rates this year. This notwithstanding, the upcoming meeting should corroborate our view that the CNB will begin the hiking cycle in 4Q17.

Accelerating GDP growth set to (% , yoy) ...



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

... buoy inflation above the 2% target



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

We believe that the Czech economy is operating above its potential. This view is supported by a super-low unemployment rate and accelerating wage growth. The normalisation in rates should continue next year too on the back of the widening output gap. We expect four more hikes in 2018. Yet, our view is based on the assumption that the ECB will announce a tapering in its asset purchase programme in September. If the ECB does not proceed with a tightening, the CNB may be more cautious in its hiking path.

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