Czech National Bank

CNB Focus

Not enough hands for a June hike, but August looks very possible

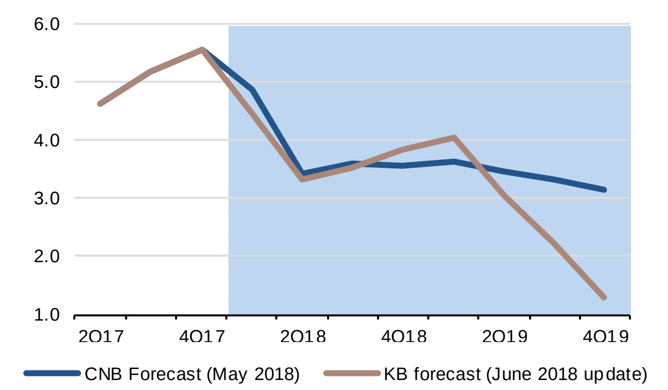
Viktor Zeisel
(420) 222 008 523
viktor_zeisel@kb.cz

Strong wage growth has finally begun to pass through into inflation, while the exchange rate has depreciated on the back of the EM sell-off triggered by political turmoil in Italy and the initial trade skirmishes. The resurgence of inflation has induced hawkish talk from some board members. The common message is that CNB is likely to hike earlier than is indicated by the current forecast. This makes the upcoming June meeting much more interesting than we had previously thought. While we do not believe in a rate hike, we expect lively discussion and a hawkish outcome to the meeting. That said, the rate hike now looks closer than we previously expected. We expect the bank to increase rates as early as its August meeting.

Inflation reviving while EUR/CZK depreciates

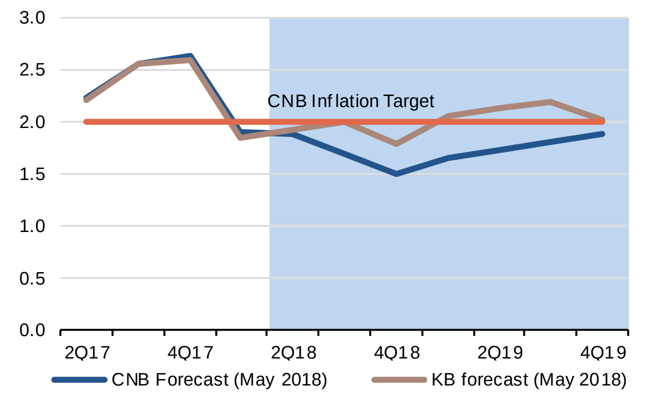
When inflation turned down at the beginning of the year, CNB aggressively played down market expectations of a hike this summer. Yet, very strong wage growth, currency depreciation and, most importantly, the revival of inflation has resurrected chances of a summer rate hike. Wages increased by a strong 8.6% yoy in nominal terms in the first quarter which, together with muted inflation, resulted in real wage growth of 6.6%, fully in line with the CNB's May forecast. By contrast, productivity growth disappointed in the first quarter and printed at below 3%. Moreover, the situation on the labour market is extremely tight, suggesting that wage growth is unlikely to lose momentum any time soon. While at the beginning of the year, we did not see wage pressures passing through into inflation, the second quarter showed that businesses had started transferring higher wages partly onto consumers. That said, the labour market should continue to propel core inflation.

GDP and productivity slowing down (%, yoy)



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

Inflation to remain close to target

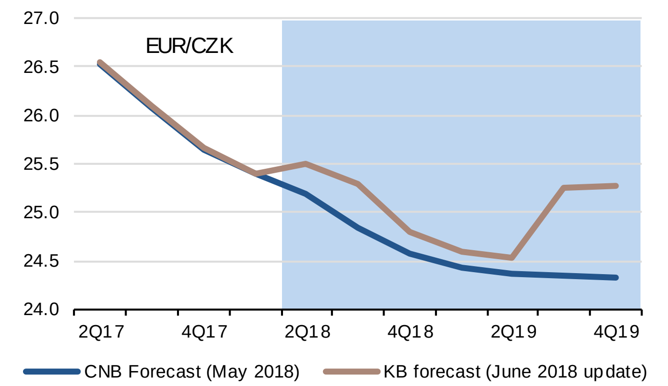


Source: CNB, Macrobond, Economic & Strategy Research, Komerční banka

The exchange rate has also been pro-inflationary in recent months. The risk-off mood triggered by the Italian political crisis and the simultaneous trade skirmishes took their toll on the EUR/CZK exchange rate. From mid-April to the end of May, the koruna lost more than

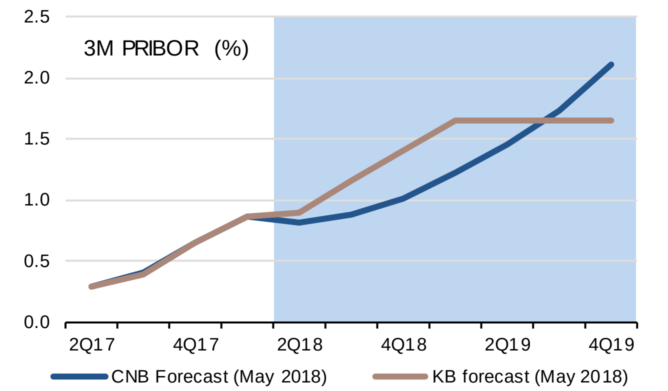
2.5% against the euro. However, although the Italian crisis has calmed down and the CNB board has turned more hawkish, the koruna remains at weaker levels of around EUR/CZK25.80.

Koruna appreciation trend marks a pause



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

Hike to come earlier than CNB expected in its May forecast



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

The external environment could weigh against immediate monetary policy tightening. Current political uncertainty and talks about trade barriers could make central bankers more reticent with regards to rate hikes. Moreover, after the disappointing 1Q figures from EMU countries, the data for 2Q looks unlikely to provide much reassurance. Thus, the external demand risks for the Czech economy are tilted to the downside.

The CZK depreciation and wage pressures driving inflation have woken up the hawks in the bank board. Since the last meeting, vice-governor Hampl and one other board member have spoken up in favour of hiking earlier than the current forecast suggests. These figures were then joined by more moderate members of the board, followed by governor Rusnok and T. Nidetzky who also suggested that a hike could come earlier this year.

We believe the central bank will get back to the tightening trajectory sooner than the turn of 2018/2019 assumed by the current CNB forecast. Given the weak koruna and inflationary pressures stemming from the labour market, we believe CNB will resume its hiking cycle in August and continue in November, delivering two more hikes this year. We see a modest risk (25% vs 50% priced in by markets) that CNB will hike as early at the upcoming June meeting, but given the external risks, we feel the board is likely to wait for the new forecast in August. Moreover, the most hawkish member of the board, M. Hampl, will not be attending the June meeting. Thus, in our view a June hike would only be possible if it were backed by Governor Rusnok.

KB ECONOMIC & STRATEGY RESEARCH

Chief Economist and Head of Research
Jan Vejmělek, Ph.D., CFA
(420) 222 008 568
jan_vejmelek@kb.cz

Economists
Viktor Zeisel
(420) 222 008 523
viktor_zeisel@kb.cz

Marek Dřímal
(420) 222 008 598
marek_drimal@kb.cz

Monika Junicke
(420) 222 008 509
monika_junicke@kb.cz

Jana Steckerová
(420) 222 008 524
jana_steckerova@kb.cz

Equity Analysts
Miroslav Frayer
(420) 222 008 567
miroslav_frayer@kb.cz

Jiří Kostka
(420) 222 008 560
jiri_kostka@kb.cz

Sectors
David Kocourek
(420) 222 008 569
david_kocourek@kb.cz

SG IN CENTRAL AND EASTERN EUROPE

Chief Economist of SG Poland
Jaroslaw Janecki
(48) 225 284 162
jaroslaw.janecki@sgcib.com

Head of Research of Rosbank
Yury Tulinov, CFA
(7) 495 662 13 00 (ext. 14836)
yury.tulinov@rosbank.ru

Chief Economist of BRD-GSG
Florian Libocor
(40) 213 016 869
florian.libocor@brd.ro

Head of Fin. Markets Research BRD-GSG
Carmen Lipara
(40) 213 014 370
carmen.lipara@brd.ro

Economist
Ioan Mincu
(40) 213 014 472
george.mincu-radulescu@brd.ro

Equity Analyst
Laura Simion, CFA
(40) 213 014 370
laura.simon@brd.ro

SG GLOBAL ECONOMICS RESEARCH

Head of Global Economics
Klaus Baader
(852) 2166 4095
klaus.baader@sgcib.com

Euro area
Anatoli Annenkov
(44) 20 7762 4676
anatoli.annenkov@sgcib.com

Michel Martinez
(33) 1 4213 3421
michel.martinez@sgcib.com

Yvan Mamalet
(44) 20 7762 5665
yvan.mamalet@sgcib.com

United Kingdom
Brian Hilliard
(44) 20 7676 7165
brian.hilliard@sgcib.com

North America
Stephen Gallagher
(212) 278 4496
stephen.gallagher@sgcib.com

Omair Sharif
(1) 212 278 48 29
omair.sharif@sgcib.com

Latin America
Dev Ashish
(91) 80 2802 4381
dev.ashish@socgen.com

Ankur Shukla
(91) 80 6731 4432
ankur.shukla@sgcib.com

China
Wei Yao
(852) 2166 5437
wei.yao@sgcib.com

Japan
Takuji Aida
(81) 3 5549 5187
takuji.aida@sgcib.com

Kiyoko Katahira
(81) 3 5549 5190
kiyoko.katahira@sgcib.com

Arata Oto
(81) 3 6777 8064
arata.oto@sgcib.com

Korea
Suktae Oh
(82) 2195 7430
suktae.oh@sgcib.com

India
Kunal Kumar Kundu
(91) 80 6716 8266
kunal.kundu@sgcib.cz

Inflation
Vaibhav Tandon
(91) 80 6731 9449
vaibhav.tandon@sgcib.com

SG CROSS ASSET RESEARCH - FIXED INCOME & FOREX GROUPS

Global Head of Research
Brigitte Richard-Hidden
(33) 1 42 13 78 46
brigitte.richard-hidden@sgcib.com

Head of Fixed Income & Forex Strategy
Guy Stear
(33) 1 41 13 63 99
guy.stear@sgcib.com

Fixed Income
Bruno Braizinha
(1) 212 278 5296
bruno.braizinha@sgcib.com

Jean-David Cirotteau
(33) 1 42 13 72 52
jean-david.cirotteau@sgcib.com

Cristina Costa
(33) 1 58 98 51 71
cristina.costa@sgcib.com

Jorge Garayo
(44) 20 7676 7404
jorge.garayo@sgcib.com

Head of Euro Area Rates Strategy
Ciaran O'Hagan
(33) 1 42 13 58 60
ciaran.ohagan@sgcib.com

Shakeeb Hulikatti
(91) 80 2802 4380
shakeeb.hulikatti@sgcib.com

Rates Derivative Strategy
Adam Kurpiel
(33) 1 42 13 63 42
adam.kurpiel@sgcib.com

Head of US Rates Strategy
Subadra Rajappa
(1) 212 278 5241
subadra.rajappa@sgcib.com

Jason Simpson
(44) 20 7676 7580
jason.simpson@sgcib.com

Marc-Henri Thoumin
(44) 20 7676 7770
marc-henri.thoumin@sgcib.com

Foreign Exchange
Kit Juckes
(44) 20 7676 7972
Kit.juckes@sgcib.com

FX Derivatives Strategy
Olivier Korber
(33) 1 42 13 32 88
olivier.korber@sgcib.com

Alvin T. Tan
(44) 20 7676 7971
alvin-t.tan@sgcib.com

Head of Emerging Markets Strategy
Jason Daw
(65) 6326 7890
jason.daw@sgcib.com

Amit Agrawal
(91) 80 6758 4096
amit.agrawal@sgcib.com

Régis Chatellier
(44) 20 7676 7354
regis.chatellier@sgcib.com

Phoenix Kalen
(44) 20 7676 7305
phoenix.kalen@sgcib.com

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