

| Czech National Bank |

CNB Focus

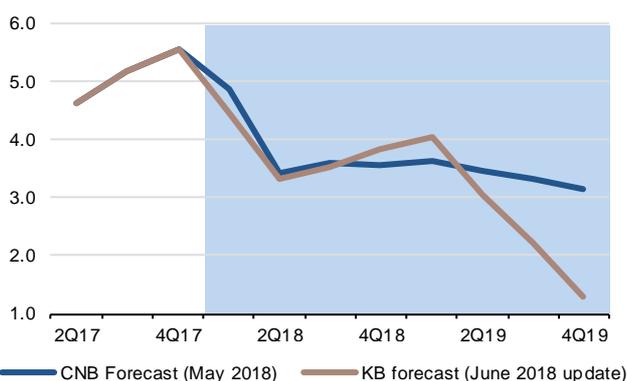
Not enough hands for a June hike, but August looks very possible


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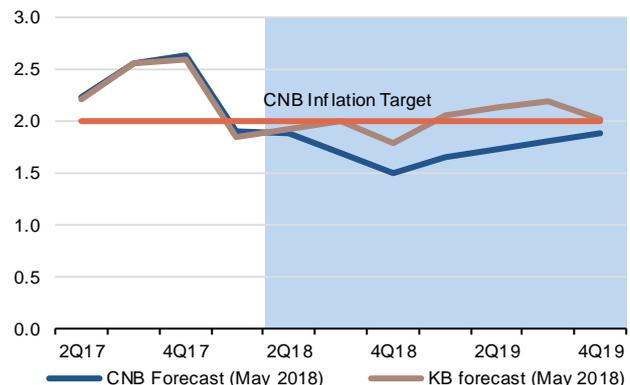
Strong wage growth has finally begun to pass through into inflation, while the exchange rate has depreciated on the back of the EM sell-off triggered by political turmoil in Italy and the initial trade skirmishes. The resurgence of inflation has induced hawkish talk from some board members. The common 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

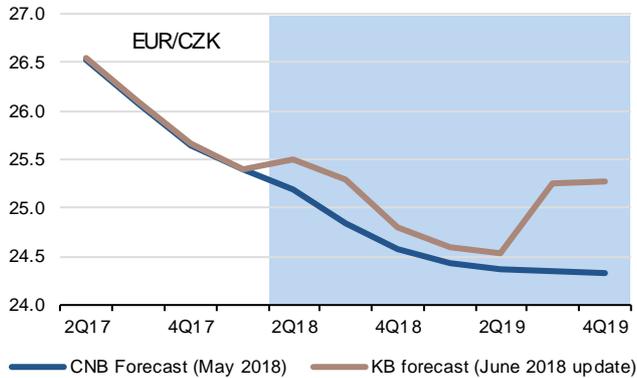
Inflation to remain close to target


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

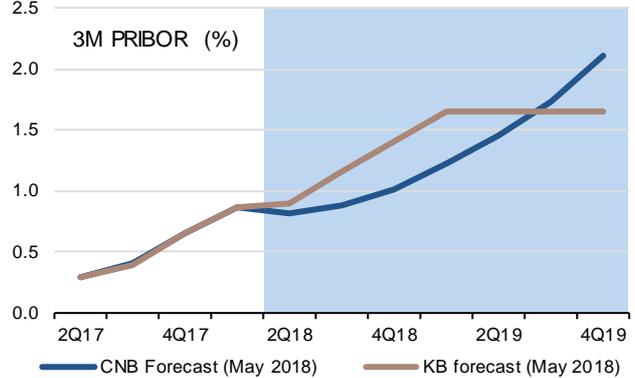
2.5% against the euro. However, although the Italian crisis has calmed down and the CNB board has turned more hawkish, the koruna remains at weaker levels of around EUR/CZK25.80.

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.

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