

Czech National Bank

CNB Focus

CNB to postpone hike amid Brexit chaos

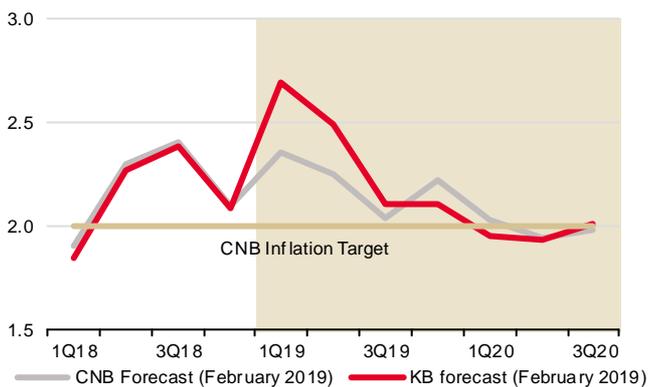


Viktor Zeisel
(420) 222 008 523
viktor_zeisel@kb.cz

While a strong domestic economic performance calls for a hike in March, the uncertainty surrounding the external environment is likely to prevail, leaving the CNB board in wait-and-see mode. We still believe the CNB will deliver two hikes this year, but we will have to wait for the Brexit situation to calm down and for stronger signals regarding a recovery in Germany.

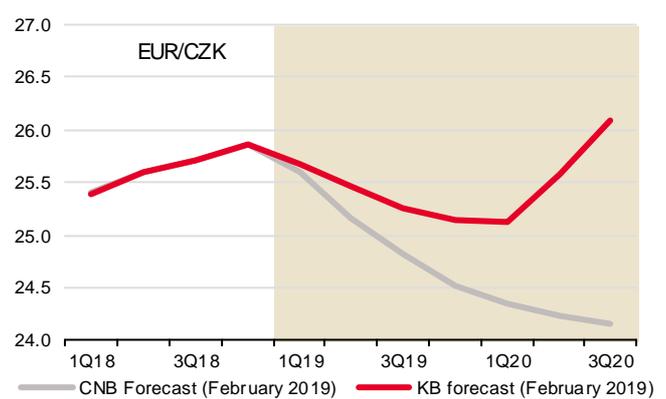
After the five hikes implemented last year, the CNB board took a breather at its December and February meetings due to uncertainty over the external environment, and in particular Brexit chaos and a weak German economy. **Thus, while the last CNB staff forecast assumed a hike in the first quarter of the year, the board decided after a lengthy discussion that another rate increase would not be appropriate.** The stream of data out of the domestic economy has been relatively pro-inflationary since the last meeting. Inflation surpassed CNB's expectations, with notably core inflation surprising on the upside, and GDP growth confirmed that the Czech economy remains resilient to the slowdown in Germany. Meanwhile, the EURCZK rate is more or less unchanged from the last meeting and is only marginally weaker than it was before the February meeting.

Inflation surprised CNB significantly on the upside



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

Koruna is still reluctant to appreciate



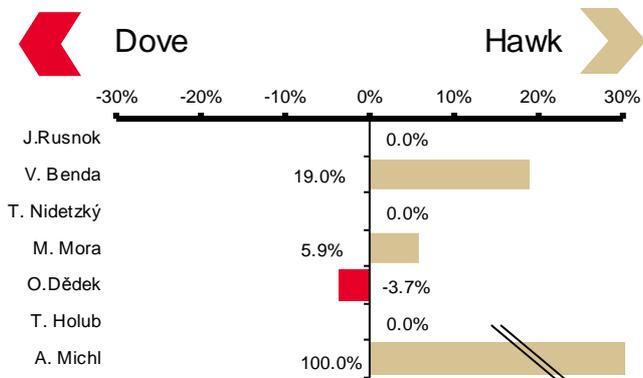
Source: CNB, Bloomberg, Economic & Strategy Research, Komerční banka

According to CNB logic last year, if CZK failed appreciate and thus help tighten monetary conditions, the central bank should step in and hike rates, potentially at the March meeting. However, there is still a lot of uncertainty. The Brexit process has turned into uncontrolled chaos and the threat of a no-deal Brexit looks stronger than ever. The recession in German industry continues and cast doubt on the notion that the problems are only temporary. The CNB board members will probably prefer to take the risk of remaining slightly behind the curve than hiking into a recession. Moreover, there is also some anti-inflationary news from the Czech economy. Wage growth fell notably behind expectations in 4Q18. We expect it to reaccelerate, but the current reading adds to the overall uncertainty.

The tug of war between domestic conditions and the external environment is also reflected in the CNB communication. Some board members (especially V. Benda and A. Michl) have tended to put more emphasis on the overheating labour market and current surging inflation – Benda even

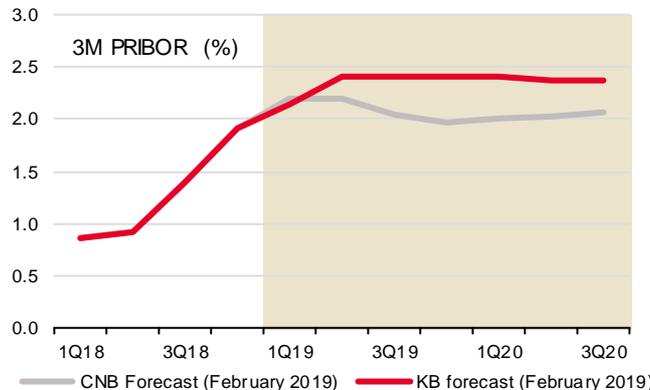
suggested that he sees up to three hikes this year if the koruna does not appreciate – while others (like M. Mora and O. Dedek) see no rush to hike rates when in view of the weak external environment.

The hawks will vote for a hike in March



Source: CNB, Economic & Strategy Research, Komerční banka

We still expect two hikes this year



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

We don't expect a hike to be announced at the March meeting, but it is a close call as domestic conditions still suggest there is room for more policy tightening as indicated by the CNB forecast model. That said, we expect the overall tone of the meeting to be relatively hawkish. We should see two more hikes this year, with the first likely to come in May. Nevertheless, if the Brexit stalemate is not resolved or postponed long term, there could be further delays. Moreover, if Germany heads into a more pronounced slowdown than we currently expect, the May hike could become less certain.

KB ECONOMIC & STRATEGY RESEARCH

Chief Economist and Head of Research



Jan Vejmelék, Ph.D., CFA
(420) 222 008 568
jan_vejmelék@kb.cz

Economists



Viktor Zeisel
(420) 222 008 523
viktor_zeisel@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

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



Evgeny Koshelev
(7) 495 725 5637
evgeny.koshelev@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 Simon, 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



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



Anatoli Annenkov
(44) 20 7762 4676
anatoli.annenkov@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



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

China



Wei Yao
(33) 1 57 29 69 60
wei.yao@sgcib.com



Japan
Takuji Aida
(81) 3-6777-8063
takuji.aida@sgcib.com



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



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

Head of Retes Strategy



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



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



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



Kevin Ferret
(44) 20 7676 7073
kevin.ferret@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



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



Kiyong Seong
(852) 2166 4658
kiyong.seong@sgcib.com



Marek Drimal
(44) 20 7550 2395
marek.drimal@sgcib.com

Régis Chatellier



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

Bertrand Delgado



+1 212 278 6918
bertrand.delgado-calderon@sgcib.com

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