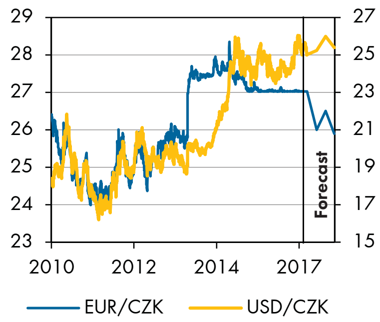
CEE Currencies
Czech Koruna
non-periodical

28 March 2017

Raiffeisen RESEARCH

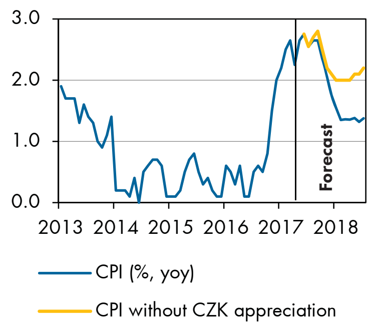
CZK special – FX regime abandoning expected for Q2 2017

CZK volatility after exit expected



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Inflation at CNB target range



Source: RBI/RaiffeisenRESEARCH, Czech Statistical Office

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On the first day of April the so called hard commitment of the CNB will vanish. Hard commitment is a verbal promise of the CNB not to scrap the FX commitment to "intervene in the foreign exchange market to weaken the koruna so as to maintain the exchange rate close to CZK 27 to the euro" before April 2017. As recently stated by the CNB governor Jiří Rusnok "anything can happen" after the first quarter.

The end of FX commitment comprises two main questions: when will it happen and what will follow?

When will the CNB let the currency appreciate to below EUR/CZK 27.0?

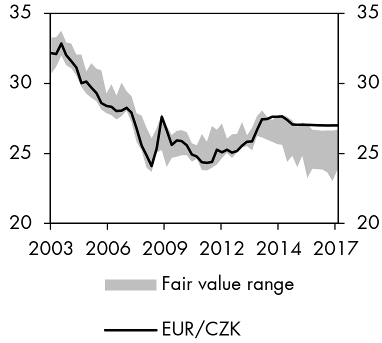
Many times over the past months the Czech National Bank board members in line with the CNB macroeconomic forecasts repeated they expected to let the CZK appreciate by mid-2017. By fulfilling that statement precisely the CNB would increase its credibility. Additionally, recent spikes in speculative inflow (in January the CNB had to intervene with EUR 14.5 bn) have increased pressure on the CNB regarding the timeframe for abandoning. Then again the CNB stated that the increase of the foreign exchange reserves is not an argument for the end of intervention. But the recent buildup of the FX reserves has been clamorous and hardly without a psychological impact on the CNB decision making. The threat of substantial future loss stemming from CZK appreciation is real. From a macroeconomic perspective there is not a huge difference if the CZK is released now or a couple of months later. The key variable for the abandoning will be the development of inflation or generally the question whether the economy seems ready for the abandoning.

Until recently we expected that the CNB would be waiting for more evidence of inflation sustainably reaching the inflation target of 2% yoy. The CPI reached 2.5% yoy in February, thus 0.4pp above the forecast of the central bank. In March inflation, which will be released on the 10 April will probably rise a bit further. Nevertheless, we continue to think that the evidence of inflation sustainably reaching the inflation target will not be sufficient already in Q2. In fact, with the abandoning of the FX regime that would have deflationary effects due to an appreciating CZK we forecast inflation to drop to below 1.5% yoy over the next 12 months. That would be within the range of the 2% +/- 1 percentage point CNB target, but there is a considerable risk that inflation might fall below this range. Despite this risk the economy looks ready to get rid of this artificial FX regulation. And from the CNB wording it seems that the CNB is expecting to be "done" in 3 – 4 months. But there are somewhat deviating views inside the monetary council as well. CNB board member Mojmir Hampl recently stated that it might be safer to exit a bit later. **However, between the two possible ways of thinking we guess that the natural wisdom (the economy does not need artificial currency depreciation) will outweigh the inflation mantra and the 7 board members will abandon the FX commitment rather sooner than later.**

The majority of the market is now expecting the CNB to abandon the FX commitment in Q2 2017. **We have also shifted our expectation of FX regime abandoning into the second quarter from previous H2 2017** despite the fact that we see a

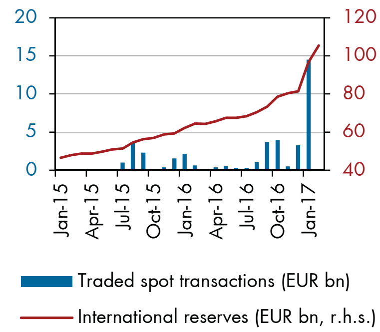
Please note the risk notifications and explanations at the end of this document

EUR/CZK fair value



Source: Macrobond, RBI/RaiffeisenRESEARCH

CNB interventions skyrocketing



Source: CNB, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	current[1]	Jun-17	Sep-17	Dec-17
EUR/CZK[2]	27.0	26.0	26.5	25.9
Bloomberg median consensus		26.9	26.3	26.2
EUR/CZK Forward		26.9	26.9	26.8
USD/CZK[2]	24.9	25.2	26.0	25.4
Bloomberg median consensus		25.5	24.9	24.6
Forward		24.8	24.6	24.5
	2015	**2016**	**2017**	**2018**
EUR/CZK, avg.	27.3	27.0	26.5	25.5
USD/CZK, avg.	24.6	24.4	25.7	24.3

1) current as of 27 March 2017; 13:21 CET
2) forecast Raiffeisen RESEARCH
Source: Bloomberg, RBI/Raiffeisen RESEARCH

risk of lower inflation within the next 12 months. The uncertainty of the exact timing within the second quarter is high. However, we guess that the CNB will be waiting at least for some new data on inflation and for at least some glimpse of the new CNB forecast which will be finished by May. Therefore the exit in May makes the most sense to us. **What is important is that the abandoning decision will not be confined to the monetary policy meeting.** Governor Rusnok stated that the decision would occur in a standard way. That means that the board members will congregate and decide. Theoretically such a meeting can happen at any time but as it should be followed by a public announcement and information to the market it makes sense to expect that it should not be during weekends or public holidays when the market could not absorb the shock.

What will happen after the exit?

Taking into account only fundamental economic variables the CZK is looking undervalued. According to our estimates of the fair-value EUR/CZK the undervaluation might be as much as 12%. On the graph we illustrate the fair value range for the CZK as a difference between several methods for calculating the equilibrium exchange rate (such as BEER or NATREX). Nevertheless, in the short-term the fundamental variables will play only a second-tier role when it comes to the FX determination. Two variables will be of most importance: a) the behavior of the biggest speculators in the CZK market and b) the behavior of the CNB.

Since the inception of the FX commitment the foreign exchange reserves increased by EUR 70 bn to EUR 105 bn by February 2017. By March the figure is estimated to be higher by some EUR 10 bn. The speculation is visible on the government bond market as well. The share of the non-residents ownership on the CZK government bonds increased to around 40%, up from 11% in 2013. That is an increase of around CZK 370 bn or EUR 14 bn. Given the increase of the bank deposits the estimated volume of the speculative hot money might be in a wide range of EUR 25 bn to EUR 45 bn. Given the fact that the real yearly demand for the CZK as represented by the current account surplus is around EUR 2 bn we see a substantial risk that speculators could have to wait an extended period of time or even several years to reach expected profit or close the position with loss or only smaller gains. **Therefore EUR/CZK volatility after the exit will probably be very high, in our view mostly within a 10% range**, but not significantly higher as otherwise the CNB would start intervening to curtail CZK volatility. That said we expect that in a very short-term horizon of several days the CNB will not be active on the market unless the appreciation or depreciation is extreme (double-digit percent). **In case of strengthening to below EUR/CZK 26.0 the appetite for closing the long CZK positions by speculators would probably get very high. Therefore we would expect EUR/CZK to have a ceiling somewhere around 26.0.**

On the other hand there could even be an unexpected effect of short-term depreciation above EUR/CZK 27.0. This could cause a sell-off, activating automatic stop-losses that could only increase the fluctuation on the market where the liquidity might get very thin unless the CNB is willing to sell part of its EUR reserves. **Shortage of liquidity and wider bid-ask spreads is an important risk for the positions in EUR/CZK.**

The above mentioned increased foreign ownership of the CZK government bonds will also lead to bigger fluctuations of the CZGB as well. We expect that the 2y CZGB yield will return to positive territory and the spread of the CZGB vis-á-vis German Bunds will slightly increase.

After a likely phase of significant short-term fluctuations the CZK should return to a longer term appreciation trend. **At the end of 2017 we expect the EUR/CZK slightly below 26.0**. The behavior of the CNB so far suggests that the risk of introduction of the negative interest rates is very low.

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