WILL CNB HIKE AGAIN SOON?

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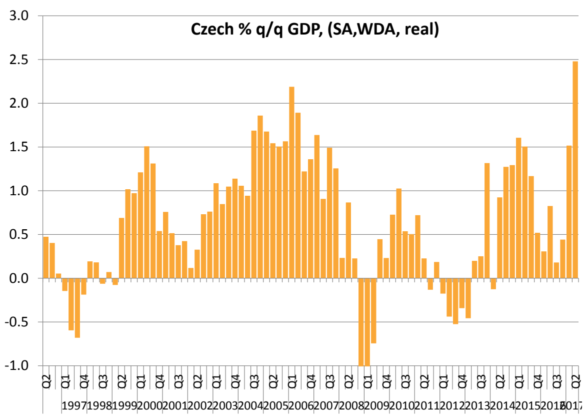
- **The CNB hike in August and strong 2Q17 GDP data revived the expectations that another hike is on cards this year**
- **Although the real estate fever and especially potential CZK weakness could bring it soon,…**
- **…non-inflationary external environment, structure of growth and inflation base effect that will come soon speak against it.**

CNB delivered a hike in August, becoming the first central bank in the region to have done so. Not only that, but it was probably the quickest turnaround of the monetary policy of any central bank previously engaged in non-standard monetary policy easing. See, FED stopped the quantitative easing in October 2014, ten months after it began the so-called tapering process. Then it took another 14 months before the FED delivered the first tightening of the policy via standard tools (i.e., via Fed funds rate). CNB, on the other hand, was busy buying euros as recently as in March 2017 (it had bought the total of EUR 42 bn. (!!) in 1Q17) in what was essentially admission that the economy still needed monetary policy assistance 6 months back, only to hike the (2-week repo) rate four months after the end of the interventions in April, essentially saying the economy was now at risk of overheating and needed tighter monetary conditions.[1]

Back in April, my forecast was that there will be no hikes this year, and obviously that wasn't the case. The question thus is this: will there be any more soon, i.e. this year? What are the arguments for and against this?

GROWTH OF THE ECONOMY AND LABOR MARKET SPEAK FOR EARLY HIKE…

The discussion about the looming hike was revived by – and this is the first argument for it to happen soon – **the strong GDP numbers for 2Q17** (or, more precisely, for the entire 1H17). According to the Czech Statistical Office, the growth in the 2nd quarter was 2,5% q/q, the strongest growth rate in the modern history of the Czech Republic, and improvement on the already strong 1Q17 (1,5% q/q). This is, on the surface, such a strong rate of growth (annualized approximately 10%) that there can be no other conclusion than that policy should be much tighter – and that indeed was the immediate impression of many observers after the preliminary 2Q17 GDP data (i.e., data without the structure) came out in the middle of August.



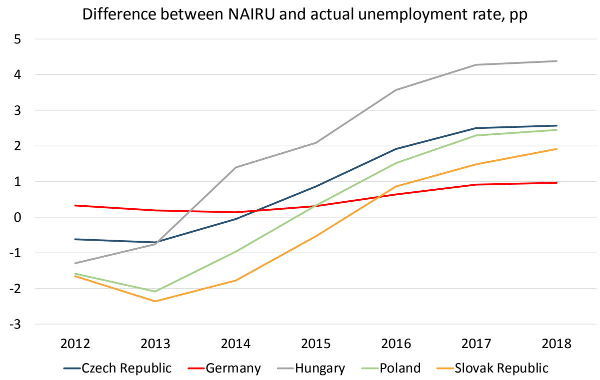
Source: www.czso.cz

On the other hand, though, the structural data that came out last Friday show that inflationary implications of the growth are not as strong as the headline number might lead one to believe.

[1] The CNB itself says that "*the appreciation of the koruna had led to a tightening of the exchange rate component of the monetary conditions equivalent to an interest rate increase of 3/4 to 1 percentage point*" ↗ Not that I believe this, but if CNB believes this it is also saying that it was - and is - behind the curve.

Although the demand of households did quicken from 0.9% q/q in the 1Q17 to 1.8% q/q in 2Q17 (fastest quarterly expansion since 2Q08), the primary reason for the record-breaking GDP growth were fixed investments. Investments rose across the board – machinery etc. – and did so at the fastest-ever rate of 6.3% q/q. Not only will this not be repeated, but it is long-term positive for the growth of potential output and thereby, cet.par., long-term negative for the demand inflation. **In other words, strong investments should lower the future demand pressures.**

What is much clearer (and of opposite sign) in its theoretical inflationary implications (and thus for monetary policy of CNB) is the state of the labor market. Czech republic's unemployment rate is lowest in the European Union and is below the natural level, as defined by NAIRU (non-accelerating inflation rate of unemployment). This is something that should be associated with the accelerating demand-driven inflationary pressures.



Source: CNB

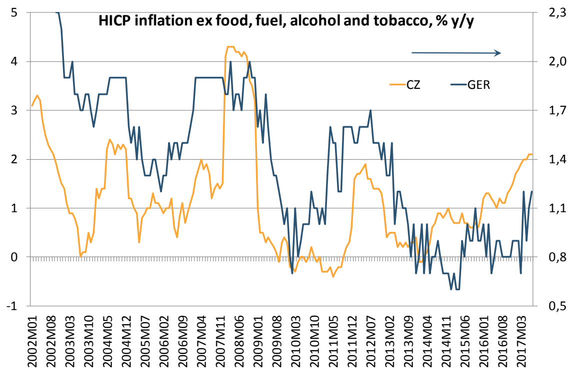
Some might say that the tightness of the labor market is visible in the wages. The nominal wages rose 5.3% y/y in the first quarter of this year. This looks like a lot, especially with the very slow wage growth in US/Eurozone, but there are two caveats:

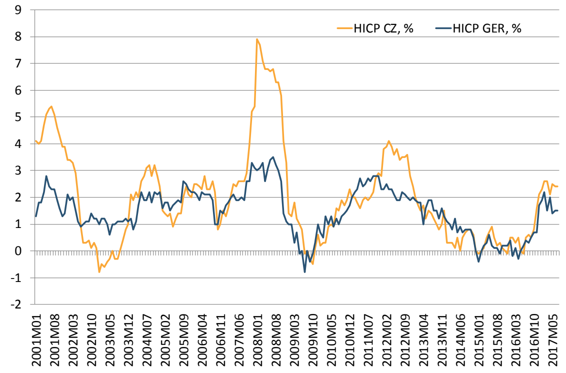
- The inflation also picked up, so real wage growth was "just"2.8% y/y, not so far from the productivity growth;

- There was an extraordinarily strong growth of wages in hospitality segment (11.8% y/y) which probably is associated not so much with the tight labor market but with the implementation of electronic-record-of-sales system. This, as I wrote before ↗, was reflected in reported volume of retail sales in the hospitality segment. Apparently, the EET led to more money being paid officially to employees in the segment as opposed to the previous widespread practice of paying them unofficially.

…WHILE ACTUAL INFLATION STRUCTURE AND EXTERNAL ENVIRONMENT SPEAK AGAINST.

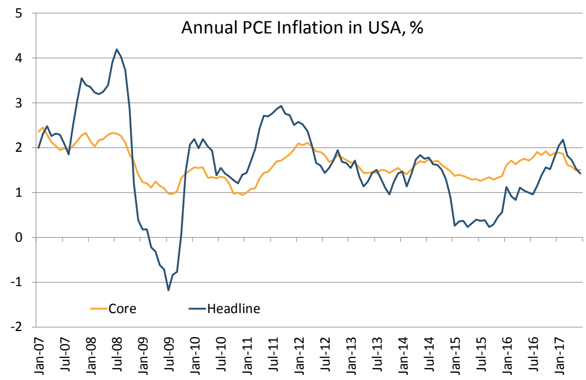
Even if the Czech wage developments could be argued to be pro-inflationary in theory, practical implications are unclear for the domestic inflation because of the nature of the Czech economy. Czech economy is very open so there historically was little correlation between the domestic inflation and domestic household demand. **Instead, the excess demand was (is?) more likely to show up in the current account than inflation, and inflation is much more closely linked to what's happening in the Eurozone, especially Germany, than what's happening inside the Czech Republic.** This is true of both headline inflation and of demand inflation, as illustrated in the pictures that follow. The only meaningful deviations from this general rule are caused by tax changes in the Czech Republic (see January 2008, for example).





Source: Eurostat

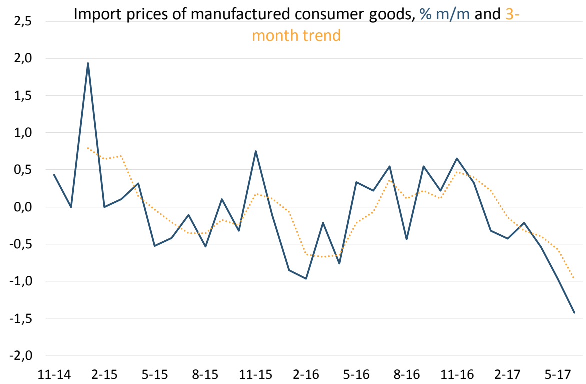
This link is important as the economies of Eurozone / Germany are still non-inflationary at the demand-inflation level. The core inflation only recently edged up above 1% in Germany and remains around 1.2% for the Eurozone as a whole. The Eurozone economy still has sizeable slack and will continue to have one in next two years. Moreover, as is seen in US, even when the labor market has improved to the point of NAIRU, it is no guarantee that the wage growth will immediately follow and that it will translate into inflation: FED has been forecasting return to 2% inflation (and hence number of hikes) for three years now, only to be proven wrong time and again: the core inflation in USD fell in August to lowest (1.4%) since December 2015 when FED hiked for the first time.

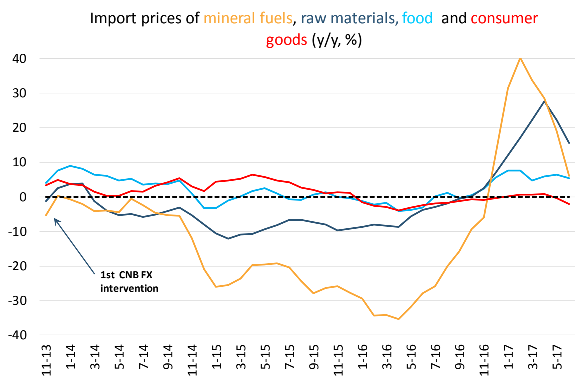


Source: St. Louis FRED

ECB is also aware of this: not only is it not predicting any fast withdrawal from the ultra-loose monetary policy (the tapering hasn't been announced and will very likely be very gradual and conditional when it is), but it also voiced concern recently (see page 6, ↗) that post-crisis structural changes may have resulted in the alteration of the wage-inflation dynamics which means the return of inflation to target may be much slower than before.

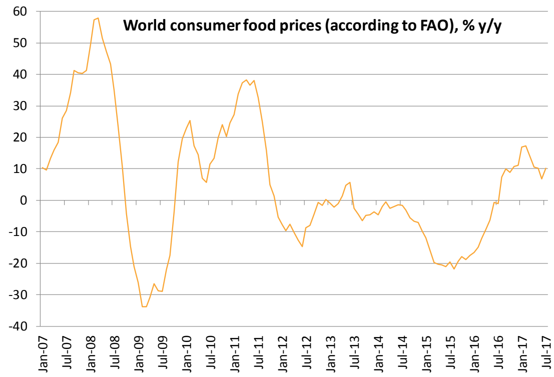
The non-inflationary external environment is reflected in Czech import prices of manufactured goods (if not just yet in consumer inflation). The import prices of consumer goods fell 4% cumulatively in the first half of the year, meaning they are again falling in annual terms: they fell 2.1% y/y in June and this can become close to 3% y/y in 2nd half of the year). Although they fell at the sharpest rate in May and June, so some effect of stronger CZK is likely reflected there, they fell in January-April as well (when EURCZK was still kept at 27), reflecting weak Eurozone inflation. Furthermore, import prices of other goods apart from manufactured ones are decelerating too, except for food prices.

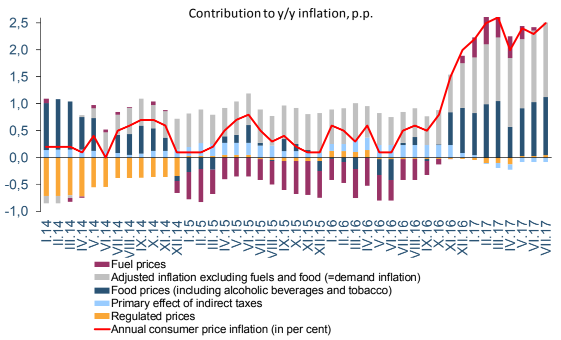




Source: www.czso.cz

Speaking of food prices, these were very important in raising – over last 9 months - the Czech inflation to current level above 2%. Reflecting the rise of global food prices over 2nd half of 2016, their contribution to annual monetary-policy relevant inflation (MPRI) climbed to 1.1 p.p. in June 2017. In other words, had the food prices not changed against last year, the MPRI that CNB targets would now be at 1.4%. And out of that, some would still be the effect of EET having influenced prices in hospitality segment.





Source: www.cnb.cz

The message this lengthy inflation discourse was meant to convey was that the inflation is less demand-driven, and hence less sustainable, than what meets the eye. If nothing surprising happens in the external environment (oil price growth, another spike in food prices), there will be noticeable inflation base effect at the end of the year and beginning of 2018 that will take Czech inflation well below 2%. Although CNB will have new forecast in early November, this should be reflected in it and thus should dissuade the Board from another hike.

REAL ESTATE CONCERNS AND POTENTIAL WEAKNESS OF CZK MAY TILT THE BALANCE IN FAVOR OF HIKE SOON

But it may not be enough. As was seen in the minutes from the August CNB meeting, the situation in the real estate sector plays a prominent role in new Board's thinking. Although Board admitted that inflation is peaking and will fall in next 6 months, it also said that "*the property market was simultaneously overheating*" and that several members mentioned that "*financial stability-related macroprudential considerations also spoke in favor of raising rates*." In other words, CNB's Board considers interest rate a reasonable tool to prick the real estate bubble when all evidence speak against this: rates are very blunt tool to do so and 25 bps. won't do anything to arrest real estate prices. But that is not important: what is important is the thinking of CNB demonstrated in August. At that time, CNB made it clear that it considers the repo rate key part of the macroprudential toolkit. And that means that it might use it again soon. **This is even more likely now that the Parliament rejected the amendment to the Law on CNB which was meant to give CNB more powers to regulate lenders (ability to set debt-to-income, debt-service-to-income restraints etc.).**

Finally, what can really bring the hikes on the table very fast is CZK. CZK has defied my expectations for post-exit weakening, having instead strengthened to 26 in three months after the floor removal on April 6. The massive "overboughtness" of the CZK, however, hasn't changed, as evidenced by the fact that the foreign holders still hold about 40% of the outstanding Czech government bonds. If CNB claims ↗ that the recent strengthening of the CZK is equivalent to 75-100 bps. in interest rate hikes and that it still had to hike – as it did - in August, then should CZK return to 27, CNB would by the same token have to tighten by similar amounts. In other words, with CZK at 27 CNB would be led by models to hike three times at least. Not that I think it would – but one hike in such a circumstance wouldn't be anything surprising. Though, from inflation perspective, hardly necessary.

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