

Flash Comment

Czech Republic: A hawkish CNB might be wrong

- Recently some top Czech central bankers have indicated that interest rates are too low in the Czech Republic and that rate hikes might be needed.
- In this comment we argue that the hawks on the CNB are getting a little too much ahead of the curve, as we believe that Czech interest rates are appropriate.
- We look at five different measures of monetary policy “tightness” – they all indicate that interest rates are appropriate – or even too high.
- We continue to recommend that investors should be positioned for lower market rates and yields in the Czech Republic.

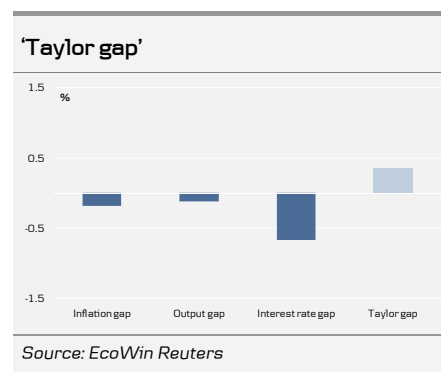
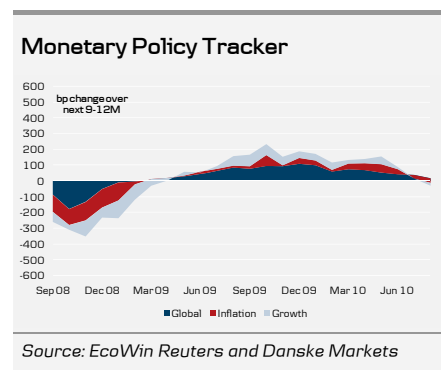
Yesterday the Bank of Japan said it would increase its loan programme, effectively expanding its quantitative easing (QE) of monetary policy and the Federal Reserve has announced that it will extend its quantitative easing measures for longer than previously planned. Even the ECB has indicated that it will extend its QE measures for longer. So there is no doubt about the global trend – the large central banks of the world are worried that growth could be easing too fast and the risk of a double-dip is increasing, along with the risk of deflation.

Contrary to what we see from the “big three” central banks is what we hear from some Czech monetary policymakers. Hence, over the past week at least three top officials from the Czech central bank (CNB) have indicated that they feel uncomfortable with the low level of interest rates in the Czech Republic. However, in this Flash Comment we argue that the hawks on the CNB board might be getting a little too much ahead of the curve.

Hence, while we agree that Czech interest rates are low by historical standard and compared with other central & eastern Europe (CEE) central banks and even to the ECB, that is not the same as saying that interest rates are *too* low. In fact we would argue that the CNB should not really be overly concerned with the level of interest rates, as most conventional measures of the “tightness” of monetary policy indicate that monetary policy is “appropriate”. There is even an argument that the CNB should ease monetary policy further going forward.

Below we take a look at the measures:

1. *Monetary Policy Tracker points to lower rates.* One of our main tools in assessing the direction and stance of monetary policy in the EMEA region is our Monetary Policy Tracker (MPT). The MPT is an indicator of monetary policy, which tracks three key components that are essential to monetary policy – inflationary pressures, growth and the expectations of global monetary policy (the Fed and the ECB). At the moment our MPT for the Czech Republic is actually pointing toward a lowering of Czech interest rates of 25-50bp over the coming nine to 12 months. This is especially due to the fact that inflationary pressures have continued to ease in the Czech Republic as the Czech koruna has strengthened – wage growth has moderated and inflation continues to be very subdued. Furthermore, it is clear from most macroeconomic indicators that the recovery in the Czech economy is losing steam, further reducing the need for monetary tightening. So while the MPT until recently indicated that the CNB should hike rates going forward, it now indicates a need for monetary easing.

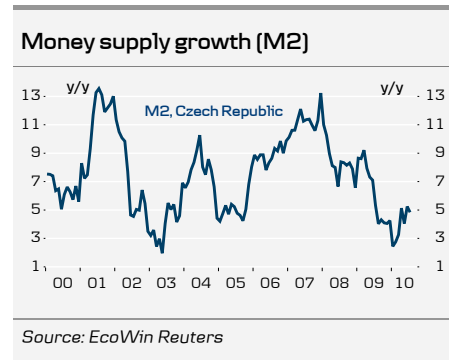


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2. *Taylor gap signals that rates are appropriate.* Another key tool in our monetary policy toolbox is what we call the ‘Taylor gap’. The Taylor gap simply measures the difference (the gap) between what the traditional ‘Taylor rule’ is saying is an appropriate level for interest rates given the ‘inflation gap’ (the difference between inflation expectations and the inflation target), the output gap and the ‘natural interest rates’ – or the equilibrium interest rates level. We calculate the Taylor gap using ‘normal’ parameters in Taylor rule, which shows that the interest rate in the Czech Republic is more or less where it should be. So while it is correct that interest rates are now below the “natural interest rate” level (of about 70bp) this is countered by the fact that both the inflation gap and the out gap remain negative. So yes, we agree that interest rates will not and should not stay this low forever, but interest rates are not too low for the moment – given the fact that inflation expectations are still well-contained close to the CNB’s inflation target and the output gap remains negative.
3. *Money supply growth indicates that medium term inflation will be below the CNB’s inflation target.* The development in money supply is a good indicator for medium- to long-term inflationary developments and it is therefore useful to take a look at the development in Czech money supply. According to the so-called quantity theory, inflation will increase (decrease) if money supply growth outpaces (grows slower) growth in (the sum of) potential GDP and the velocity of money. So what does the quantitative theory say for the Czech Republic? At the moment the broad measure of the money supply (M2) is growing by just over 5% y/y, potential GDP growth is 3-4% (in our view) and the long term trend growth in the velocity of M3 is minus 2%. This means that one can “forecast” long-term Czech inflation at 0-1%, based on the simple arithmetic of the quantity theory – below CNB’s official inflation target of 2%. Hence, money supply actually indicates that monetary policy is too tight.
4. *Fiscal reform reduces demand pressures and spurs potential growth.* The newly elected Czech government has already put forward ambitious plans for fiscal consolidation and reforms in a number of areas. In our view, this should clearly reduce the urgency of any monetary tightening as it first of all will reduce growth in domestic demand and secondly it will likely increase the potential growth rate in the Czech economy. So while there still is some uncertainty about the extent of reforms there is a good chance that at least on the margin they will reduce inflationary pressures.
5. *Long-term positive outlook for the Czech koruna reduce imported inflation.* We have for some time (correctly) been bullish on the outlook for the Czech koruna and we believe that there is clearly scope for further strengthening of the koruna going forward. The key reason for our long-term bullish call on the koruna is the favourable outlook for the Czech current account. Hence, we now expect current account surpluses in the Czech Republic in 2011 and 2012 and this should keep supporting appreciation of the koruna, which obviously would be an implicit tightening of monetary conditions, which would reduce imported inflation and hence reduce the need for monetary easing.

So why does the CNB seem so concerned that monetary policy is too loose when the measures and indicators clearly show that that is not the case? In our view, the CNB is fighting yesterday’s war – in the sense that it has (we believe rightly) concluded that an overly loose monetary policy is at the core of why we had a global credit crisis and why the global boom became unsustainable. So while we have plenty of sympathy for the CNB’s cautious approach to monetary policy and we certainly believe that the CNB should (and will) react if the above mentioned indicators indicate that inflationary pressures become excessive, we also believe that there is a risk that the CNB’s focus on “yesterday’s war” could make the CNB hike rates too early and hence risk derailing the fragile recovery in the Czech economy.

So how should investors be positioned in the present situation? It would be naïve to believe that the CNB could not hike rates given the quite hawkish comments we have received over the past week. However, if the CNB were to hike in the short-run then we would expect the actual economic development would “force” the CNB to backtrack on such monetary tightening. Hence, any rate hike should, in our view, be considered as a long-term buying opportunity for short-dated Czech bonds.



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