

Czech Republic Macro View

CNB Dilemma: Agreement on Diagnosis, Not On Treatment

- **Our key takeaways¹** — While we think that CNB's Bank Board members mostly agree on the source of current weakness in the economy, their suggested therapies differ – in some case marginally, in some cases markedly. Despite this, given our more negative outlook on the foreign demand, more accommodative ECB and weaker Czech economy outlook, we think that there is still a room for cuts in the policy rate, starting with 25bps on 27 September (these cuts can be however less than 25bp) and with the policy rate at 0.05% by this year-end from current 0.5%. However, as we expect the koruna to ease monetary conditions we think that non-standard measures are less likely unless we see larger disinflationary pressures and a drop in economic activity.
- **Our scale of monetary policy measures** — First, we expect the Bank Board to utilise the policy rate tools accompanied with commitments (the CNB's forecasts of 3M PRIBOR and EURCZK are not a commitment now). This could be followed by FX intervention if we see a stronger koruna (to limit strengthening rather than to weaken it), less withdrawal of liquidity by the central bank or negative interest rates.
- **CNB's Vice Governor Mojmir Hampl made rather hawkish comments yesterday** (Reuters) compared to what we understand from Governor Miroslav Singer on Tuesday. While, Mr. Hampl is undecided on the interest rate vote on 27 September, he is, in our view, less hawkish than Mrs. Eva Zamrazilova has been in her statements. We understand from his comments that he does not rule out a cut in the policy rate. However, he has concerns about a negative impact of a further fall in policy rate on a poor sentiment of consumers and firms as this step could strengthen their concerns despite central bankers seeing a fundamentally sound economy.
- **While we expect Mr. Hampl to vote for a cut in September (although we were surprised by the hawkishness of his comments), his position against non-standard measures is clear** and is closer to another CNB Board member Lubomir Lizal. Both believe that such measures, particularly some form of QE, should be used to address non-standard events in the financial system, which obviously is not the case in the Czech Republic. Hampl's view is not surprising, as he is known to be a libertarian rather than a mainstream economist. However, after his public statements, Mr. Lizal sounds less convinced and more open to non-standard measures in some form, such as a negative interest rate, if necessary. Vice Governor Vladimir Tomsik as well as Governor Singer are also open to non-standard measures, if necessary, we think.
- **Our assessment of non-standard measures and Bank Board members' views is presented inside.**

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¹ In this note we reflect on recent comments of Czech National Bank policy makers and our meetings with CNB's policymakers in Prague on 18 September 2012.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Overview of potential non-standard measures

Figure 1. Non-exhaustive list of potential non-standard measures

Type of measure	Used in the past?	Our view	Our comment
Zero bound policy rate	No	Very likely	We expect the CNB to cut the policy rate to 0.05% by end of this year.
Commitments	No	Very likely	We see a possibility of some form of commitments being introduced in September (to keep the policy rate low unless the monetary policy relevant inflation touch the upper bound of the inflation target).
Stop of daily EUR selling	Set up in 2007 (2004)	Quite likely	While €4mn per day is small amount compared to the daily turnover (though it is around 0.6% of GDP annually), it could provide a signal regarding the FX intervention.
FX intervention	2001-2002	Likely	If we see a further appreciation of koruna likely below 24 against the euro. But probably lower in the near-term as our forecast of foreign demand is lower compared to the consensus.
Fine tuning of withdrawal the liquidity	No	Possible	The tighter rules on withdrawing the liquidity could reduce the surplus of liquidity with less potential negative impact compared to the negative interest rate (see below) we think.
Easing of collateral	No	Possible	This can provide some liquidity for banks that are short of it, but there is plenty of liquidity in the system. There is a possibility to get liquidity from the CNB against government bonds and these two-week and three-months windows are used rarely (there is also two-week FX swap window with central bank).
Negative policy rate	No	Possible	<p>Not ruled out by Gov. Miroslav Singer, Lubomir Lizal or by Vice Gov. Vladimír Tomsík, we think. But, Gov. Singer does not see room for "too negative" interest rates. Moreover, he mentioned legal constraints that we believe could be resolved, if necessary. There should also be a change in communication to teach the public to think in real rather than in nominal terms. It could be also a tool regarding FX intervention, but maybe limited as it would attract foreign investors due to a likely rally in T-bills and government bonds.</p> <p>We see two main risks: i) Negative impact on households deposits due to possible flight for higher interest rate at union saving banks. However, there is still a room for a cut as the average deposit overnight rate was 0.7% in July 2012 and with agreed maturity up to two years close to 1.5%. This measure would be less painful, we think, if it were accompanied by a new lower inflation target that would lead to higher ex-ante interest rate on deposits. ii) A negative repo rate could result in a larger decrease in liquidity that is sterilized by the central bank from commercial banks. This could transform into holdings of t-bills, bonds and it is not certain, if it will return to the previous stage once a positive interest rate is established. In other words, the "cyclical" tool could result in a structural risk. We discussed our concerns with CNB's policymakers and found these were not shared. But we understand from our meetings at the central bank that it has not yet run the scenario of negative rates regarding the banking sector stability.</p>
Communicate the PRIBOR spread	No	Possible	Despite the surplus of the liquidity in the banking sector and the opportunity to ask the CNB for the liquidity, the spread between 3M PRIBOR and the policy rate has remained elevated at 40-50bp recently. Hence, we suggest the CNB to start to publish the forecast of CNB's policy rate instead of 3M PRIBOR. Although the CNB does not see problems in the transmission mechanism now, a reduced 3M PRIBOR spread is the alternative way to effectively avoid "zero bound" as many of banks' loans are linked to artificial 3M PRIBOR (artificial means that there is actually no inter-bank market at this tenor).
Buying gov't bonds and other forms of Quantitative and Qualitative Easing	No	Not likely	Czech government bonds yields have been at historical lows, hence, we do not think this is a necessary option for the central bank, a view similar to that of Governor Singer. There is the possibility of buying corporate or "MBS" bonds, but the secondary market is not liquid enough, we think. We also do not expect the CNB to support the qualitative easing as the banking sector is healthy, with high CAR and profitability. We also do not think it needs any non-standard subsidy from the central bank. Additionally, the CNB Board as well as public opinion is too conservative, in our view, for these options.
Change of policy regime – FX targeting or lower inflation target	1998	Less possible	The CNB started to target inflation in 1998. It was also a non-standard change in policy regime for emerging markets. While we would expect inflation targeting to remain in place, it can be accompanied by FX rate targeting. But, we do not see yet any large structural disinflationary pressures and our forecast of "Grexit" points to weaker koruna in mid-term. However, if we see a combination of larger recession and a koruna appreciation, we could well imagine this change in policy regime. There is also the possibility of a lower inflation target if there is a strategy to use a negative policy rate as part of the FX interventions against a stronger currency. This could limit potential outflow from deposits regarding the negative policy rate due to higher ex-ante interest rates. But this is unlikely to be an option for the board now as it wants households to consume more and firms to invest more. Also it would raise the expectations of higher policy rate due to a lower inflation target. But this is not necessary as we expect a milder convergence process ahead (real and nominal) that could allow this step. This is unlikely to find CNB support. Though if successful it could have a pro-growth impact as there are more savers than debtors that could result in a higher real disposable income, particularly if demand for credit remains structurally weak in future.

Source: Citi Research

A member, a different opinion

While we think the central bank's Bank Board members are mostly agreed on the source of the current weakness in the economy, their suggested treatments differ. We think that views of Vice Governor Vladimir Tomsik and Governor Miroslav Singer have the most support, although Mr. Singer seems as yet undecided over which option to use. We think that Board member Lubomir Lizal still believes in pursuing orthodox policy measures, but he appears to be open to more aggressive methods if necessary. While Professor Kamil Janacek has said he doubts the impact of non-standard measures (including a zero policy rate (Dow Jones, 18 July), Mr. Pavel Rezabek has not yet communicated his view. This group is accompanied by Mrs. Eva Zamrazilova, who is concerned about inflationary pressures particularly after the Fed introduced QE3. Finally, we think Vice-Governor Mojmir Hampl more or less agrees with this group's position. All in all, we believe that this heterogeneous group's (Hampl, Zamrazilova, Rezabek and Janacek) view is in opposition to the more aggressive group (Tomsik, Singer, Lizal) who believe that words must be supported by actions (non-standard measures) at some point.

Figure 2. Our assessment of CNB's central bankers' positions on non-standard measures

CNB's Bank Board	Our assessment of their views on non-standard measures
Vice-Governor: Vladimir Tomsik	"I am personally ready to take all necessary steps to achieve our inflation target and help stabilize inflation expectations.... I can personally imagine making a commitment to do everything that is needed to return inflation expectations toward the inflation target" (Bloomberg, 16 August 2012)
Governor: Miroslav Singer	Supporter, but likely not decided which to use
Board member: Lubomir Lizal	For the time being against, but open to think about negative interest rate if necessary
Board member: Pavel Rezabek	Not sure, but likely a possible supporter, if it is necessary, but seems to be conservative now
Board member: Kamil Janacek	He doubts the impact of non-standard measures (including a further cut in the policy rate) on the real economy.
Vice-Governor: Mojmir Hampl	Against
Board member: Eva Zamrazilova	Against
Source: Citi Research	

Our recent comments on CNB's Bank Board

CNB Governor Miroslav Singer talked about non-standard measures in an interview yesterday (MF Dnes, 18 September). As the central bank policy rate is just 50bp above zero, he said that the Bank's board cannot avoid a discussion about non-standard measures - likely at the forthcoming meeting on 27 September, we think. Governor Singer highlighted that he does not see a possibility of some significant negative interest rates and besides, there are legal constraints, which we however think could be resolved. Second, the possibility of buying government bonds was also mentioned, however, Governor Singer noticed that the 10Y yield is at 2.4%, so he is not persuaded that this is the right option. Third, CNB could ease the collateral rules, but there is plenty of liquidity in the system and moreover, there has not been a show of interest to ask liquidity from the central bank.

CNB's hawkish Zamrazilova said inflationary risks prevail and further cuts in Czech policy rate should be approved with caution despite the Fed's QE3. Judging by her comments (Reuters, 17 September) we think she is likely to vote for an unchanged policy rate on September 27.

CNB's Bank Board member Lubomir Lizal said that the CNB should not intervene in the foreign exchange market; while Reuters said (3 September) that this differs from

dovish comments of CNB's Vice Governor Vladimir Tomsik. We actually do not see too much difference as Mr. Lizal said he does not expect a significant appreciation of the koruna (Hospodarske Noviny, 3 September), while we think that Professor Tomsik talked about additional measures if there are further disinflationary risks. Also Mr. Lizal mentioned some unconventional measures in case the CNB cuts its policy rate to zero. Both members voted for the non-realised 25bp cut in August (Governor Singer missed the meeting). We expect these two, and Governor Miroslav Singer and Vice Governor Hampl, to vote for a 25bp cut on 27 September. Rezabek has voted for unchanged policy rates since Sep 2009 (meanwhile the policy rate was cut by 75bp) and Professor Janacek since Sep 2011.

Q&A with analysts from 10 August 2012 on "zero bound" and "wait-and-see" – Vice Governor Vladimir Tomsik and Board member Eva Zamrazilova answered questions: Vice Governor Tomsik stressed that the CNB still has a 50bp buffer to cut its policy rate and even after that there are several tools of monetary policy, including a commitment of central bank. He mentioned that the tools that seem to be "non-conventional" today could be conventional in future. Moreover, he said that the CNB's goal is price stability and not the stability of a (positive) interest rate. Mrs. Zamrazilova said that she is ready to cut the policy rate, if there is a threat of deflation. We think that CNB is likely to use its 50bp buffer first including the "commitment policy of low interest rate for prolonged period", followed by FX interventions, before it starts with other measures, e.g. negative policy rate or change in the FX regime. Both Board members have not suggested any measures to narrow the spread between 3M PRIBOR and CNB's policy rate in the environment of liquidity surplus.

Selected charts

Figure 3. Czech Republic – selected nominal interest rates

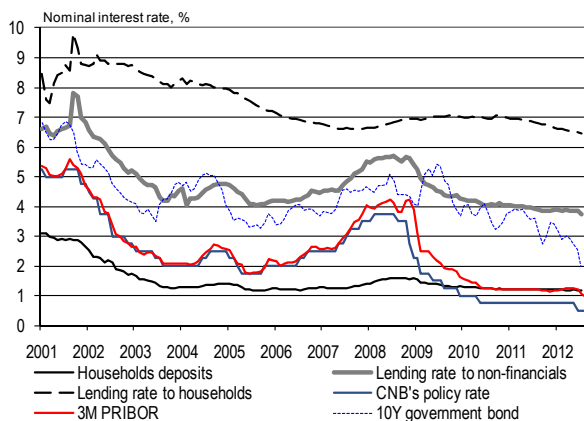


Figure 4. Real interest rate: Illusion of positive interest rates

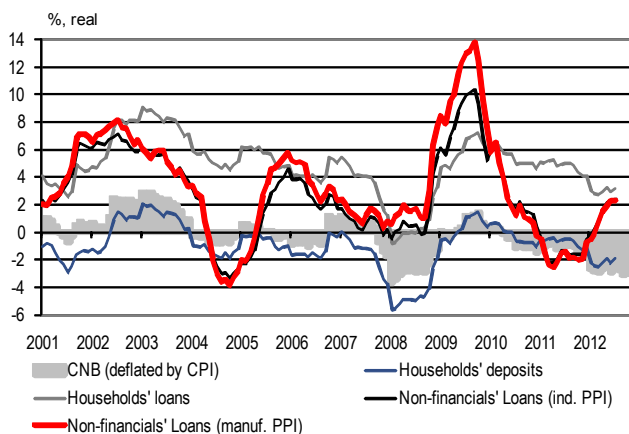


Figure 5. CNB's intervention against the strong CZK in 2001-2002, followed by irregular sale of EUR in 2004-2006, followed by regular daily sale since mid 2007

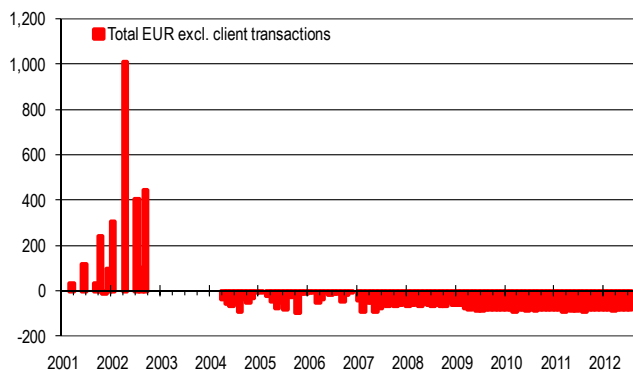


Figure 7. There has been a milder appreciation trend of koruna

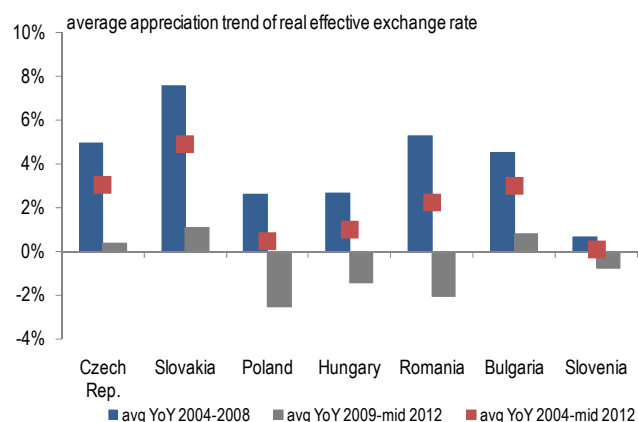


Figure 9. Sterilized liquidity amounts 8% of banks' balance sheet

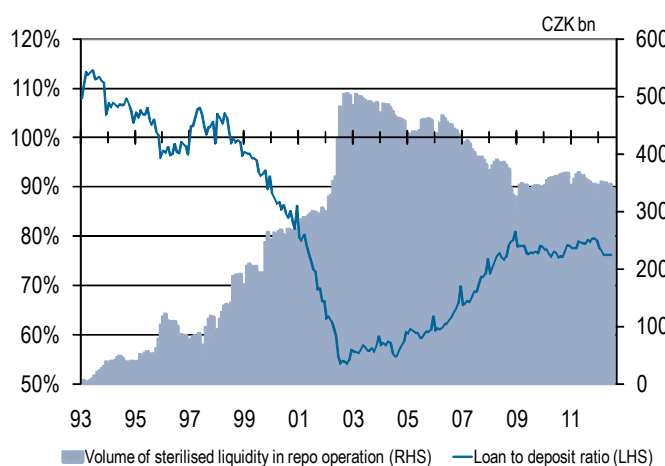


Figure 6. EURCZK – CNB vs. Citi forecast. The quarter-to-date average is 25 and most recent spot 24.8

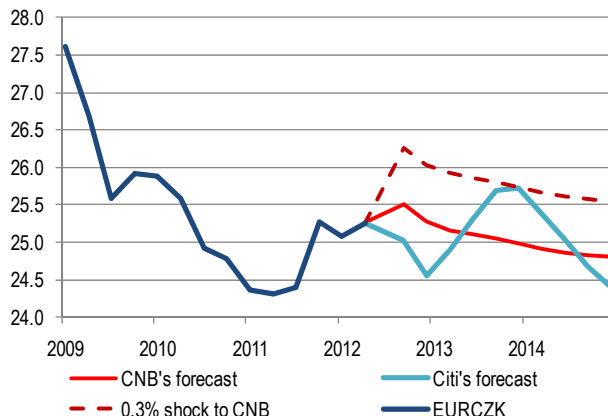


Figure 8. Koruna has not usually strengthened greatly after QE announcement

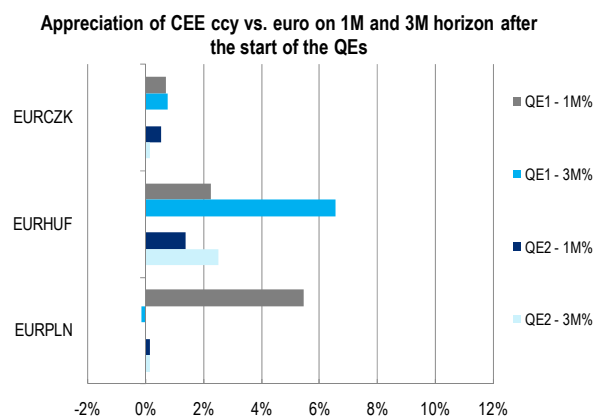
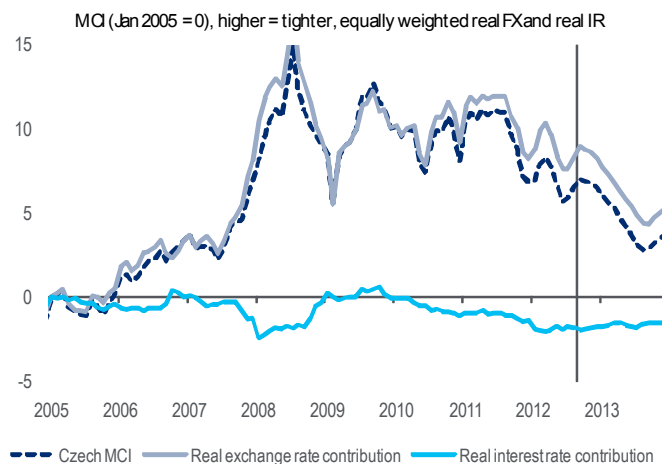


Figure 10. Our view on simple Czech monetary condition index influenced by "Grexit"



Source: CNB, CZSO, Haver Analytics, Citi Research

Appendix A-1

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