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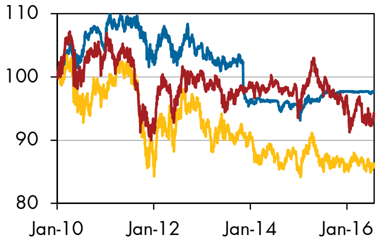
Main findings

After having previously projected the end to the FX regime for H1 2017 we have seen more and more indications that would speak in favor of further postponement into H2 2017. The Brexit vote with the likely effect of prolonged accommodative monetary policy especially by the ECB and diminishing inflation expectations are the main drivers behind this. That said, we have adjusted our projection of the FX regime abandoning into H2 2017 and here rather towards the fourth quarter. The situation regarding the strategy of exiting, however, has not altered as much. With the CNB according to its own statements not yet having worked out any procedure for scrapping the currency regime we continue to see high unpredictability for this point. While we project the abandoning to occur with prolonged FX interventions without making public a new FX target, negative deposit rates or even a readjustment to the FX cap could occur in case of significant increase in speculative pressure combined with heavy FX intervention needs.
Until H2 2017 we project EUR/CZK to remain close to the cap at near 27.0, with rising inflation rates spurring speculative pressure on CZK over the coming quarters. This should cause a rise in intervention amounts necessary to prevent additional CZK appreciation, albeit remaining below levels of roughly EUR 5 bn monthly intervention that would endanger the feasibility and make additional measures (negative deposit rates, changes to FX cap) necessary. In this context it has to be stressed that the CNB had initially introduced the FX regime in order not to use negative deposit rates, and new CNB governor Rusnok has indicated he would not want negative deposit rates. Only with ECB indicating an end to the accommodative monetary policy and inflation rates back near the 2% target range on a sustainable basis do we expect abandoning of the FX regime with continued interventions to prevent too fast and too strong appreciation.

CZK in peer comparison*

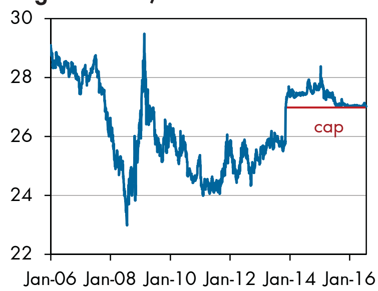


** Indexed chart: January 2010 = 100*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

New central bank governor, old monetary policy

With the term of the CNB governor Singer ending his successor Jiri Rusnok took over as CNB governor in July 2016. Rusnok thereby endorses the course of Singer regarding the FX regime and is expected to continue with the FX regime in the current form. Additionally he has emphasized that he does not want negative deposit rates, thus making such a move rather unlikely unless we see significant worsening of conditions. Rusnok is definitely taking over the governor post in a time of elevated uncertainty, especially given the Brexit votum that has certainly increased chances for prolongation of the accommodative monetary policy of the ECB. Additionally inflation expectations are diminishing, thus not only making inflation projections less reliable, but possibly indicating prolonged environment of below target inflation rates. That said it will remain a tough task to time the end of the FX regime and (depending on speculative pressure prior to the decision) how to structure the FX abandoning. In his first briefing after taking office Rusnok gave some insight into his views. He mentioned that in case of extreme worsening of conditions further monetary loosening could be necessary. Such a monetary loosening would then likely occur on the FX side (adjusting the FX cap) instead of negative deposit rates as he regards them as less efficient. Then again he mentioned the possibility of selective negative rates on new capital inflow to support the FX cap while stressing his view that such steps would be unlikely given current conditions. With respect to the FX cap regime abandoning he also stressed that the CNB has not worked out any procedure for scrapping the currency ceiling.

Long-term EUR/CZK movement



Source: Bloomberg, RBI/Raiffeisen RESEARCH

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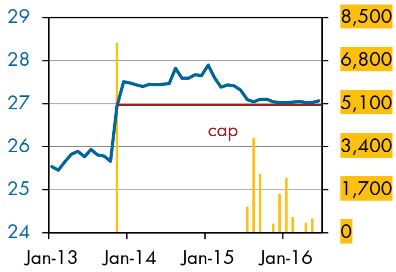
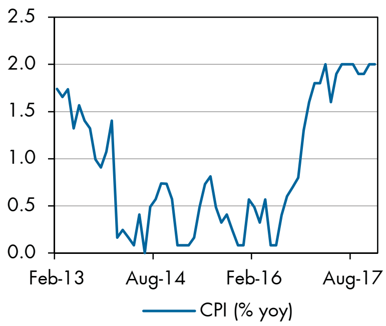
Interventions remain moderate



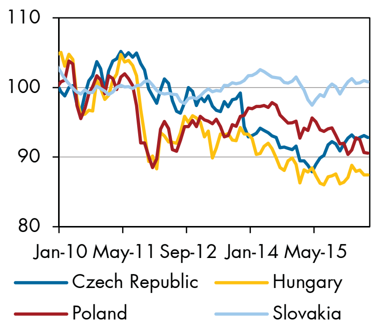
Souce: CNB, Thomson Reuters, RBI/Raiffeisen RESEARCH

Inflation at target range in early 2017*



** CPI forecasts under new assumption of FX regime abandoning in H2 2017*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Real effective exchange rate



Source: BIS, RBI/Raiffeisen RESEARCH

Inflation main component for CNB

The initial reason for the introduction of the FX regime in November 2013 was the threat of a deflationary market environment. Thereby the CNB decided to use the exchange rate as its monetary tool instead of cutting the interest rates below zero. Recall that the CNB had already cut its interest rate towards basically zero (0.05%) in autumn 2012. The CNB has repeated that it aims for a 2% inflation target while in its May forecast expecting this to be reached in the course of H1 2017. That said the key variable for the Czech National Bank is inflation. We expect that due to base effects continued rise of commodity prices and rising domestic inflationary pressures the Czech inflation will reach the 2 % CNB target in the first quarter of 2017. From today's perspective we do not see enough evidence that the inflation should thereafter strongly deviate from the target in any direction. Therefore, if the CNB sticks to its FX commitment the inflation will stay close to the 2% target until the end of 2017. In case the FX commitment is abandoned already in H1 2017 the inflation would decelerate in H2 to around 1.5% - 1.7% depending on the magnitude of the following appreciation.

In addition to the inflation target the CNB will, however, also have to look at global monetary policy developments before abandoning the FX regime. In case we see prolonged ECB accommodative monetary policy throughout 2017 it should be comparably more difficult to start with the monetary policy tightening (via abandoning of the FX regime) prior to this.

Possible scenarios to FX regime abandoning

For the time being we expect the CNB to continue with its current FX strategy - that means intervening to prevent appreciation below 27.0. Then, depending on the domestic as well as external market environment, the CNB will be confronted with the task of evolving an exit strategy where we would currently see three scenarios as the most likely ones.

Scenario with gradual appreciation after FX regime abandoning:

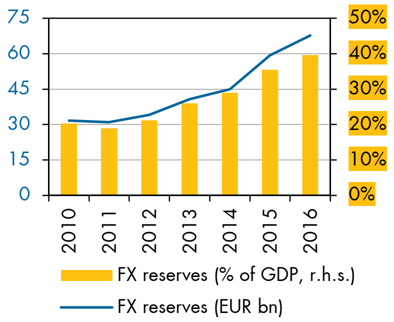
This currently remains our baseline scenario and the preferred approach by the CNB, with projection of continued moderate (albeit increasing) interventions. Under this scenario we would expect a rise in inflation together with a moderate rise in speculative pressure that can be handled by the CNB via continued interventions. Then with the abandoning of the FX regime we would expect the CNB to end the FX regime without introducing a new cap for EUR/CZK. At the same time the CNB would continue intervening while allowing for some appreciation below EUR/CZK 27.0. Whereas the CNB in this scenario would have to continue intervening (with likely heavy interventions at first), it would do so without giving a certain FX target, thus leaving markets with uncertainty regarding the targeted CZK rate. The CNB would likely have to continue with interventions for the following months, but as CZK finds its new equilibrium the speculative pressure and thus the intervention amounts would decline.

The success of such a strategy would largely depend on the speculative pressure and the intervention commitment of the CNB. The interventions necessary prior to the FX regime abandoning should already indicate if such a strategy could work out. In case intervention necessity prior to the abandoning is already at very high levels the risks to this scenario could turn out to be too high, making this strategy difficult to implement.

Scenario with negative deposit rates:

This scenario would additionally lead to continued interventions by the CNB to prevent CZK appreciation below EUR/CZK 27.0. But in case speculative pressure would increase significantly and intervention amounts would reach values in the region of EUR 5 bn (or more) on a monthly basis the CNB would have to rethink its exiting strategy going forward. Under such circumstances the continuation of the FX regime possibly into H2 2017 could become a topic regarding stretching of its balance sheet, making an ordered exit of the regime only with continued interventions difficult if not even impossible. This would then call for alternative measures by the CNB. Even though up until now it was indicated that negative deposit rates would not be desired they could then reappear as a possible alternative. To make this work the CNB could introduce negative deposit rates also to fight speculative pressure, something that would have to be done well before the FX regime abandoning in our view.

FX reserves rising*



** Data as of year end, 2016 FX reserves as of 30 June 2016*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Scenario with changed FX cap:
Should inflation projections prove to be too optimistic currently and should the deflationary environment prevail well into 2017, then the CNB could opt to use either negative deposit rates and/or shift the FX intervention border higher (e.g. taking the intervention level up towards EUR/CZK 28 or higher). Whereas given our inflation expectations we would see the chances for this scenario as slim, it should be mentioned that the overall changes to basic market assumptions have somewhat turned more towards a scenario of continued accommodative monetary policy and prolongation of the current deflationary environment.

Appreciation potential after FX regime

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Timing of abandoning the FX regime

Apart from the possible approach of the CNB regarding the exiting strategy the timing of the abandoning will be a key driver. This should be seen in the context of significant delays ever since the introduction. With the recent Brexit vote and the probability of prolonged accommodative ECB monetary policy the timetable for a possible abandoning is again tilted rather towards a later abandoning, thus triggering our call to postpone the abandoning into H2 2017. Whereas the main driver for an abandoning of the FX regime will remain to be the inflation rate with the inflation target of 2%, the CNB will likewise have to include external developments into the decision. In the case of prolonged accommodative global monetary policy, especially of course by the ECB, it will be more difficult for the CNB to abandon the FX regime in this scenario. Otherwise the appreciation pressure on the crown could get too strong, demanding prolonged massive FX interventions. We currently estimate the inflation rate to reach the 2% target range in early 2017 and with our assumption of continuation of the FX regime into H2 2017 would expect it to remain near 2%. What would in our view make an abandoning in early 2017 unlikely is the fact that the inflation target would then not be met on a sustainable basis as the appreciation in CZK would lead to a fall in inflation back below the 2% target in the following months.

Exchange rate forecasts

	current*	Sep-16	Dec-16	Jun-17	Dec-17
EUR/CZK	27.02				
Raiffeisen RESEARCH		27.0	27.0	27.0	25.9
Consensus Economics		27.1	27.0	27.0	n.a.
Foreward		27.0	27.0	27.0	n.a.
USD/CZK	24.57				
Raiffeisen RESEARCH		24.6	25.7	27.3	25.4
Consensus Economics		24.8	25.0	25.2	n.a.
Foreward		24.6	24.4	24.2	n.a.
	2014	**2015**	**2016e**	**2017f**	**2018f**
EUR/CZK avg.	27.5	27.3	27.0	26.9	25.5
USD/CZK, avg.	20.8	24.6	24.6	26.6	24.1

Data as of 26 July 2016, 09:39 CET
Source: Bloomberg, RBI/Raiffeisen RESEARCH

The second main factor that could influence timing of the FX regime abandoning could be interventions necessity, especially as soon as rising inflation rates indicate that we are getting nearer to the FX regime end. In case the intervention amounts used to keep EUR/CZK near 27.0 remain low, the CNB will have little reason to deviate from the inflation targeting. Then again growing interventions (monthly interventions of roughly EUR 5 bn or more) could increase the pressure

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CZK comparison to peers

	EUR/CZK	EUR/PLN	EUR/HUF
Performance 3m	0.05%	0.73%	-0.41%
Performance 6m	-0.01%	2.01%	0.19%
Performance 12m	0.02%	-5.64%	-0.93%
Key rate	0.05%	1.50%	0.90%
5-year yield*	0.35%	2.77%	2.46%

** differential to Bund*
Data as of 26 July 2016; 10:53 CET
Source: Bloomberg, RBI/Raiffeisen RESEARCH

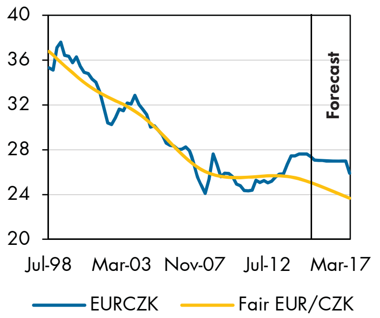
on the CNB, forcing it to alter its strategy or end the regime early. As a proxy one could take a comparable look at the situation in Switzerland until early 2015 when the Swiss central bank was confronted with a significant rise in its FX reserves towards 70-90% of GDP. The CNB currently (data as of June 2016) has FX reserves amounting to EUR 67.7 bn, thus roughly at 40% of GDP. Taking about 12-18 months until the abandoning of the regime and additionally estimating continuous intervention necessity by the CNB we would have to see monthly intervention amounts of roughly EUR 3-5 bn to reach levels of FX reserves of 70% of GDP. Given the thus far seen intervention amounts of EUR 1.2 bn on average since July 2015 (when EUR/CZK closed in on the 27.0 cap rate), we are well off any excessive levels in our view. Then again it has to be expected that with a continuous rise in inflation rate back towards the CNB target the speculation pressure is bound to rise, thus possibly calling for stronger interventions. Nevertheless, even in such a scenario we would regard the policy of the CNB as feasible until H2 2017

What could happen after the exit

Our calculation for a EUR/CZK fair value which is derived from productivity and price differential development shows that without intervention the EUR/CZK would currently be slightly below 25.00. There are many other similar calculations within other institutions, mostly showing such a stronger "fair value" of the CZK compared to current levels. Nevertheless, EUR/CZK will remain deviated from the fair value probably for a longer time even after the end of the FX commitment. Firstly because of the intervention that was already done and will be done before and after the exit. Secondly due to the assumption that in case there are stronger CZK appreciation pressures after the exit the CNB will intervene even more. Since setting of the FX commitment foreign investors were piling up more and more CZK denominated assets. For example, since the beginning of the intervention the holdings of Czech government bonds by non-residents more than doubled to above CZK 364 bn in May 2016. Part of that demand has been driven by expectation for future CZK appreciation and thus potential FX profit. That said investors will be eager to close their positions after the exit, thereby limiting room for stronger appreciation. In fact we might even see brief depreciation. This could be amplified if there is a strong hedging activity of Czech exporters before the exit. Nevertheless, even in case of low hedging activity, comparing the Czech foreign trade surplus at around CZK 160 bn as expected in 2016 with the above mentioned foreign holdings of government bonds, it should be seen that the development of the EUR/CZK exchange rate after the exit does not have a straight answer.

Low appreciating pressure after the exit would be definitely very comfortable for the CNB. Therefore the CNB will support such views and could try to convince the market that there will not be a strong appreciation. In case of stronger CZK depreciation the CNB would probably start selling accumulated FX reserves i.e. intervening against CZK depreciation. In general we think that the Swiss-style way of FX floor exit is rather unlikely in the case of CZK. All in all we would warn of a high EUR/CZK volatility after the exit.

EUR/CZK equilibrium exchange rate

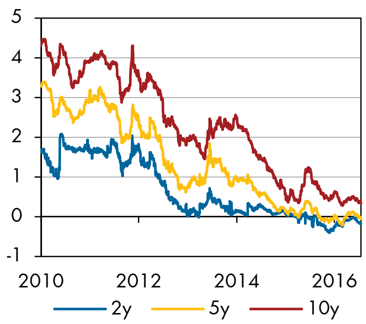


Fair EUR/CZK according to Raiffeisen RESEARCH calculations
Source: RBI/Raiffeisen RESEARCH

Risks to our base-case scenario

The main risk to our new baseline scenario of renewed postponement of the FX regime abandoning into H2 2017 lies in the inflation trajectory as well as central bank monetary policy. In case of stronger inflation trajectory central banks could end their accommodative monetary policy earlier throughout 2017, thus likely also causing a faster end to the FX regime (possibly with less speculative pressure on CZK appreciation). Then again there likewise is the risk of a slower inflation trajectory which in return would lead to prolonged accommodative monetary policy and even further postponement of the FX regime abandoning.

Czech LCY yield development (%)



Source: Bloomberg, RBI/Raiffeisen RESEARCH

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Buy recommendations	42.4	59.4
Hold recommendations	29.6	3.1
Sell recommendations	28.0	37.5

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