# FX Special Czech Koruna

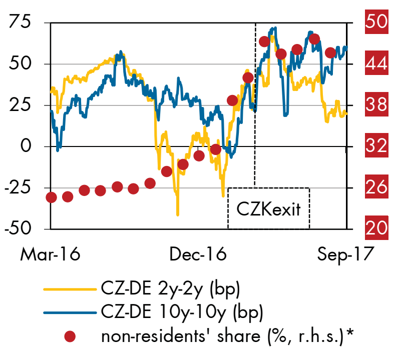
non-periodical

11 September 2017

Raiffeisen RESEARCH

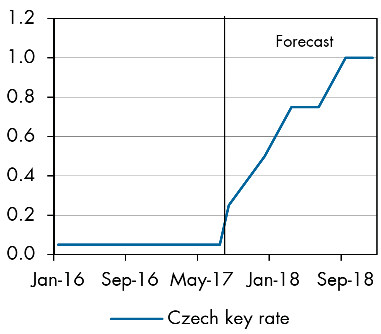
## CZK appreciation to persist – main risk from speculative capital

**CZGB spreads vs. Bunds and NRH***




** % share of non-resident holdings (NRH) in total CZK government bonds (CZGBs) outstanding*
*2y-2y: 5y high 70;5y low -42*
*10y-10y: 5y high 92;5y low -23*
*Source: Bloomberg, Czech MinFin, RBI/Raiffeisen RESEARCH*

**CZK key rate outlook**




*Source: Bloomberg, RBI/Raiffeisen RESEARCH*

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In the timeframe from November 2013 to April 2017 the Czech Central Bank (CNB) used its currency as a monetary tool to fight deflationary fears, introducing an FX regime that initially caused EUR/CZK depreciation from 25.8 to above 27.0. During this FX regime increasing (non-resident) speculative capital inflows were observed, betting on CZK appreciation after the regime abandoning. In March 2017 alone the CNB was forced to intervene with more than EUR 20 bn (buying EUR against CZK) to defend its currency regime; altogether the CNB increased its FX reserves by roughly EUR 90 bn in its sucessful attempt to prevent CZK appreciation.

With the CNB ending its FX-regime on 6 April 2017, the koruna witnessed an appreciation trend of roughly 3.7% against the euro until July. This appreciation was predominantly driven by a mere normalization from artificially weakened koruna levels. Following this appreciation from EUR/CZK 27.0 (the FX regime intervention level) to roughly 26.0 in July, the koruna has seen a rather sideways movement during August, but noteworthy setbacks were also not observable. It has to be kept in mind that EUR/CZK stood at roughly 25.8 before the FX regime introduction with the Czech Republic outpacing the growth in the Euro area during the FX regime late 2013 to early 2017 (i.e. positive growth differential versus euro area). This would indicate additional CZK appreciation potential as the koruna is projected to be fundamentally undervalued.

With the initial normalizing impact of the CZK seemingly fading (with the movement from 27 to 26 against the euro) we would now expect the fundamental view to gain more relevance for further CZK appreciation:

From the economic side CZK should remain well supported with GDP figures showing 2.5% qoq and 4.7% yoy growth for the second quarter 2017, thereby surpassing all previous market estimates. This strong economic picture is expected to remain throughout Q4 2017 with our estimate for full-year GDP growth likely getting a significant upward revision. Fitch recently responded with a rating outlook upgrade for the Czech Republic given the strong fundamental developments. For 2018 we would currently only expect a minor GDP slowdown compared to 2017, still remaining at a level that would outperform the euro area. At the same time consumer price inflation has likewise seen a pick-up to 2.5% yoy in August.

The CNB thereby seems to follow a rather hawkish strategy, ending the FX regime basically at the earliest data following the so called "hard commitment" and being the first European central bank to raise interest rates in July. Given this approach by the CNB we would estimate one more 25bp rate hike in Q4 2017 and two more 25bp rate hikes in 2018 (Q1 and Q3) – well before the ECB. Thus, albeit we are talking about a mini hiking cycle, this should likewise support ongoing CZK appreciation throughout 2018.

### Economics Czech Republic

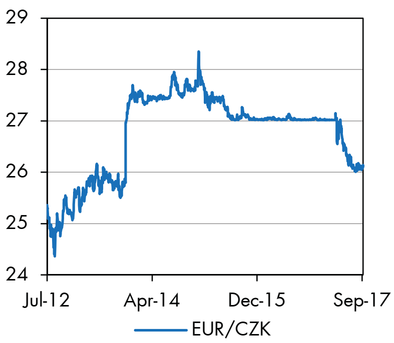
| | 2017e | 2018f |
|---|---|---|
| Real GDP (% yoy)** | 2.7 | 2.5 |
| Consumer prices (avg, % yoy)** | 2.3 | 2.1 |
| Current account balance (% of GDP)** | 1.1 | 1.2 |
| Key rate (% eop) | 0.5 | 1.0 |
| 3m historical perform. vs EUR* | 0.4% | |
| 5y carry over German Bunds* | 0.4% | |

** current value as of 8 Sep 2017; ** under revision*
*Source: Bloomberg, RBI/Raiffeisen RESEARCH*

**EUR/CZK one-year development**

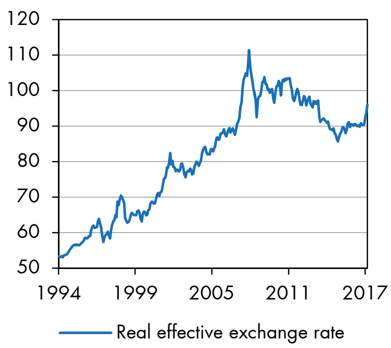

*Source: Thomson Reuters, RBI/Raiffeisen RESEARCH*

**EUR/CZK 5-year development**




*Source: Thomson Reuters, RBI/Raiffeisen RESEARCH*

**CZK Index***




** Real effective exchange rate (CPI based); monthly average; 2010 = 100*
*Source: BIS, RBI/Raiffeisen RESEARCH*

But despite this expectation of overall CZK appreciation over the coming months, we could be in for short-term setbacks. With the maturing of CZK denominated bonds and bills in September (roughly CZK 200 bn) – amidst zero T-bill supply in September – some foreign investors could decide not to reinvest in Czech bonds. According to latest MinFin data (as of end-July) foreign investors are holding around 45% of CZK den. government bonds due to the large inflow of speculative capital, with the level not decreasing since CZKexit (see chart 1 on page 1).

This brings us to one relevant unknown going forward, however, the future dynamics of the high stock of speculative money in the system. Whereas up until now most investors remained reluctant to take (FX) profits, likely given the expectation of additional CZK strengthening over the coming months, any larger scale withdrawal could cause significant setbacks. To put it into perspective, estimated real yearly FX demand of the economy with a C/A surplus of about EUR 2 bn has to be compared with the speculative capital outflow of EUR 50-65 bn.

On the one side any stronger CZK setback due to the pulling out of speculative capital would likely have repercussions via CNB response (faster rate hikes) and a weaker CZK would again attract investors in the hope for FX gains given the fundamental undervaluation. On the other side the extreme high stock of speculative capital bears significant risks especially when markets regard the CZK appreciation potential as exhausted (in our view below 25.0). In combination with a global change in risk perception this could lead to a more pronounced setback in CZK. That said the high level of speculative capital remains the main source of uncertainty in our view.

Regarding the upcoming legislative elections on 20-21 October we, on the other hand, would not expect too much effect on CZK from this side. The opinion polls suggest the populist ANO party is the leader (preferred by 27% voters) followed by CSSD (15%). Currently, these two parties form a coalition. However due to different topics the remaining parties take distance from ANO. Thus, depending on the outcome, difficulty of forming a coalition might create a phase of political uncertainty that could have minor negative implications for the koruna.

**Bottom line:**
The CZK is currently still fundamentally undervalued despite the already seen appreciation following the FX regime abandoning. Then again the initial stronger appreciation following the abandoning seems to have stalled somewhat in the past two months. This could indicate that for the coming months fundamental factors will more and more take over as main drivers for appreciation. Thereby the supportive economic conditions and the hawkish approach of the CNB should contribute to ongoing appreciation. In our view the biggest risk for more pronounced CZK setbacks is currently stemming from the still very high stock of speculative foreign capital. This, however, should only happen once appreciation expectations are diminishing, a point that could be reached at more neutral EUR/CZK levels of 25.0. Until then setbacks could occur from time to time, but these should be short-lived. Our main scenario remains ongoing CZK appreciation versus the euro towards a fundamentally neutral level near 25.0 until end 2018.

### EUR/CZK – Quarterly forecasts

| | current* | Q4 2017 | Q1 2018 | Q2 2018 | Q3 2018 |
|---|---|---|---|---|---|
| Raiffeisen RESEARCH | 26.10 | 25.7 | 25.3 | 25.4 | 25.1 |
| Bloomberg median consensus | | 26.0 | 25.8 | 25.6 | 25.4 |
| Forward | | 26.0 | 26.0 | 26.0 | 26.0 |

** closing price as of 8 September 2017*
*Source: Bloomberg, Consensus Forecasts, RBI/Raiffeisen RESEARCH*

### EUR/CZK – Annual averages

| | 2015 | 2016 | 2017e | 2018f |
|---|---|---|---|---|
| Raiffeisen RESEARCH | 27.28 | 27.03 | 26.40 | 25.29 |
| Consensus estimates* | | | 26.45 | 25.79 |

** Consensus Forecasts August 2017*
*Source: Bloomberg, Consensus Forecasts, RBI/Raiffeisen RESEARCH*

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