Czech Koruna Ready to Jump as CNB Removes Floor

The Czech koruna, the currency of an economically relatively small country, recently has gained much attention by an increasing number of speculators. They have been positioning themselves to benefit from a possible appreciation of the Czech currency. For three years, the Czech National Bank (CNB) has kept the koruna above the determined level of 27 CZK per EUR, not allowing it to appreciate further against the Euro (*Chart 1*). During this time, if necessary it intervened in the foreign exchange markets by selling koruna. Now, the question is whether the Czech National Bank (CNB) is further committed and able to defend the Czech koruna from appreciating.

The CNB's exchange rate commitment

The floor was first introduced in November 2013 in the pursuit to fight disinflation. After years of recession, this was a prime concern of the central bank. Nowadays, with inflation spiking (inflation rate from 0.5% in October 2016 to 2.5% in February 2017) and strong economic data, this threat seems to be overcome and there is pressure building up on the floor.

We remember the case of Switzerland which also had in place a floor of the Franc against the Euro. Finally, due to increasing losses, the Swiss National Bank could not sustain further interventions in the currency markets anymore. Suddenly, in January 2015 after years of keeping the exchange rate at 1.2 Francs per Euro, the Swiss National Bank surprisingly abandoned the price floor, sending foreign exchange markets around the globe into chaos.

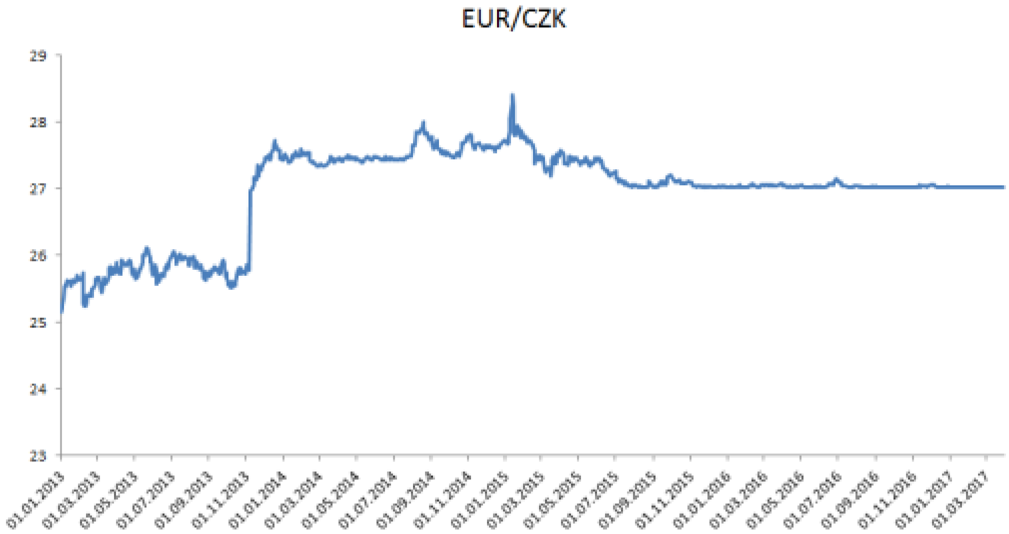

Chart 1: EUR/CZK exchange rate (source of chart data: Thomson Reuters)

Similarly, the Czech National Bank incurs increased costs defending the exchange rate. As of 28 February 2017, the foreign exchange reserves of the central bank have spiked to 105,386.8 million Euro, increasing by 7.5% from February, after the balance had already grown by 21.24% in January. It may be even appropriate to question the official numbers provided by the CNB and assume larger interventions in the foreign exchange markets. At the official levels of the end of February, the reserves amount to almost 60% of national GDP and have further increased strongly during March. As opposed to the Swiss case however, when investors were caught off-guard by the central bank´s decision, there is certainty that at some point in 2017 the CNB will abandon the currency floor. Some investors have already positioned themselves in the trade in order to profit from the possible appreciation. However, the question remains when this event will occur and how the koruna will react.

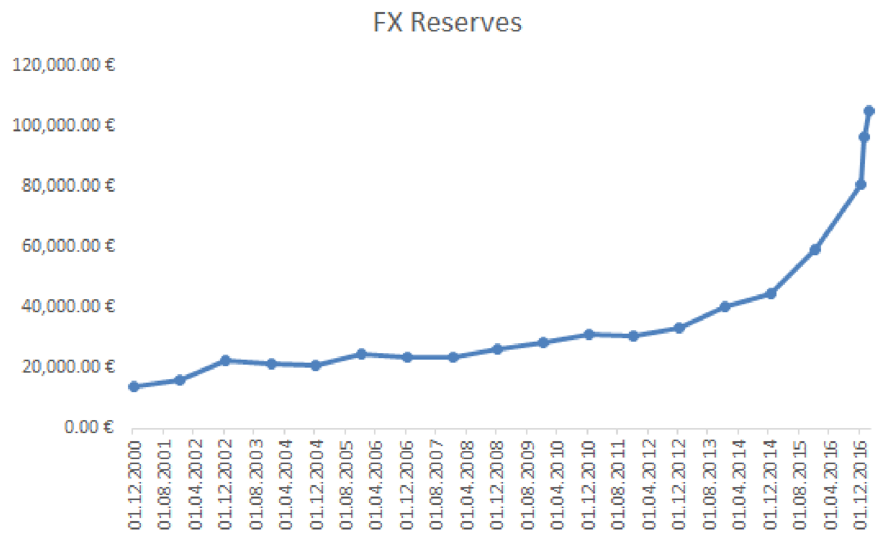

Chart 2: Foreign exchange reserves of the CNB in million € (source of chart data: Thomson Reuters)

In the face of growing inflation, strong economic data and currency speculation there was much interest about whether the CNB would announce some monetary policy measures after its meeting on 30 March 2017. However, the bank board decided to keep the two-week repo rate at 0.05%. Further, the commitment to maintain the price-floor of 27 CZK per EUR was confirmed again. Regarding the growing inflation rate the bank has argued that it is uncertain whether the current high inflation can be expected to be persistent or rather passing such as in the neighbouring Eurozone. There, inflation in March decreased to 1.5% after it had reached the 2% percent target in February. The CNB further has punctuated that there would be no intervention in the case of a possible depreciation of the koruna. In this case supply and demand would determine the currency's value.

The central bank has had a strong commitment to maintain the floor until the end of March. With the beginning of the second quarter, there is less certainty as to how long the floor can be sustained. The Czech National Bank has announced to reduce itself to a "soft guidance" from this date onward. It has already been hinted that the floor may be removed in the second half of the year or even earlier.

However, markets expect the situation to resolve itself much more quickly. By many financial analysts the next meeting on 4 May is expected to lead to the abandonment of the currency floor. May the 4th seems a likely date since it is the next regularly scheduled monetary policy meeting. The CNB most likely does not want to seem to be pressured by the markets to hold an extraordinary meeting. This makes the start of May the most probable date. But the possibility that the decision is made during an ordinary bank board meeting, of which there will be four in April, has to be considered as well. The next likely meeting will take place on 13 April and may be a plausible choice. This is because on 10 April there will be the publication of Czech CPI data for March, probably once more reporting an increase in prices. This would add further pressure on the CNB to tighten monetary policy. Additionally, given the fact that eventually the peg will be terminated, the CNB may want to abandon it sooner rather than later in order to avoid further accounting losses from its interventions in the foreign exchange market.

Macroeconomic Overview

The Czech Republic has been one of the best performers in Europe in the aftermath of the recession. Currently the GDP growth rate YoY is recorded at 1.9% and forecasts project a growth rate well above 2% for the entire year 2017. The consistent growth rate achieved after the crisis (*Chart 3*) came despite restrictive fiscal policies, that allowed to keep the public deficit under control and to make it reach a current level of -0.4%. After registering a maximum at 45.1% of GDP in 2013, the government debt is currently at 41.1%. This allowed to keep the net international investment position at levels close to those of the other small and fast growing economies of Central and Eastern Europe.

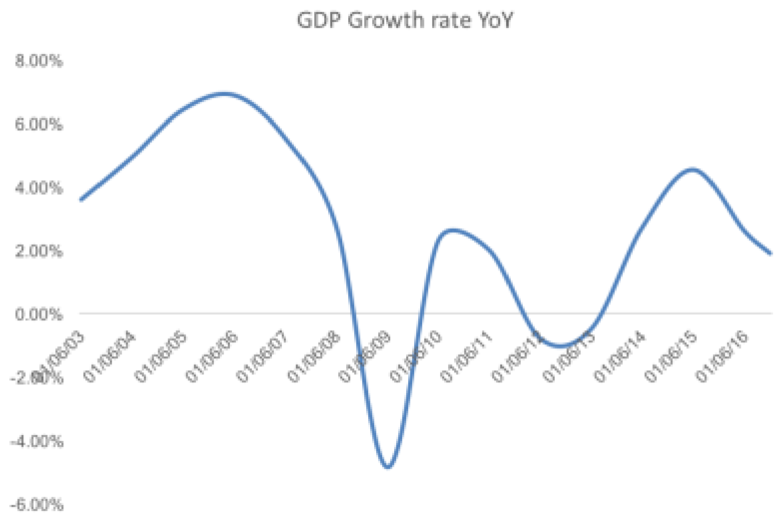

Chart 3: GDP growth rate in the Czech Republic (source of chart data: Thomson Reuters)

The economy of the Czech Republic is heavily reliant on international trade, given that exports and imports account for around 160% of its GDP (source: World Bank), among the highest levels worldwide. Germany is by far its most important trade partner, with a share of almost one third of both its exports and imports. The close trade ties with Germany have strongly propelled the recovery of the manufacturing industry and helped the economic revival after the crisis.

Until 2012, the current account had almost constantly ranged between -2% and -4% of the GDP but after the introduction of the floor and despite the inflow of capital, the Czech economy is currently showing a current account surplus of 1.2% of GDP. The sustainability of this pattern is clearly reliant on the next moves of the CNB concerning the exchange rate.

Of great interest is the recent move of the inflation rate (*Chart 4*). After sticking almost flat and never below zero for more than two years due to the strong monetary easing put in place by the CNB to defend the exchange rate floor, the inflation rate has surprised the markets and the policy makers by quickly surging to the current level of 2.5% (against expectations of 2.4%), the highest reading since 2012. This happened in a fashion very similar to many other core European countries in the last few months. Even though the central bank attributes this price increase to the rise of energy costs, also many fundamental products were affected: for instance, vegetables became 15.2% more expensive whereas the price of potatoes increased by 28.1%. The next data will be released on April the 10th, and the inflation rate is forecasted to stay consistently above 2% for at least the entire year 2017, despite the unexpected and recent easing of inflation rates in the Euro area (in particular in Germany and Spain).

Chart 4: inflation rate in the Czech Republic (source of chart data: Thomson Reuters)

The Czech macroeconomic framework has been mainly shaped by the strong monetary easing of the central bank throughout the last few years. Along with the floor on the exchange rate, the repo rate has been set at 0.05% in 2012 and never adjusted since then (*Chart 5*).

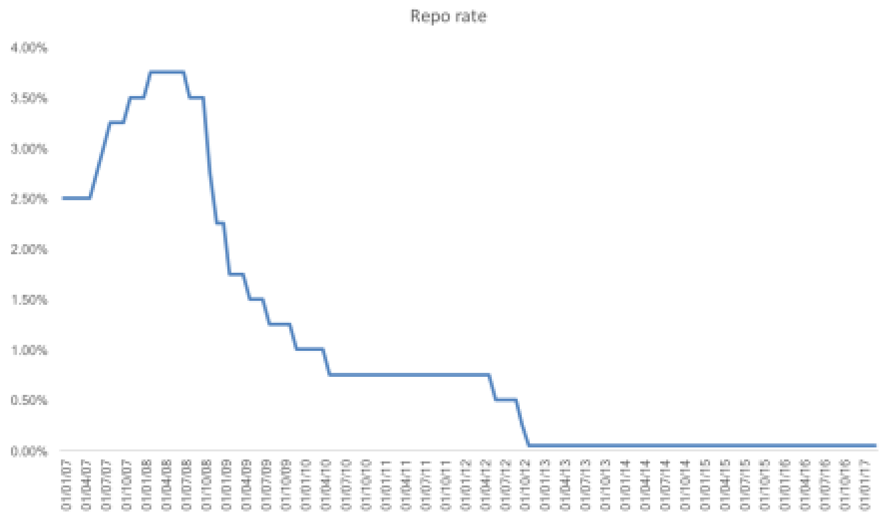

Chart 5: repo rate in the Czech Republic (source of chart data: Thomson Reuters)

This has helped the Czech economy to stick close to the lowest reading of the unemployment rate since 2008, currently at 5.1% and forecasted to keep dropping in the months to come. Moreover, the long-term unemployment rate is among the lowest in Europe (1.7%) and the youth unemployment is at 8.9% and among the best worldwide. Furthermore, even though recent data showed a wage growth rate below expectations in the last quarter of 2016, median wage growth was recorded well above the forecasted levels, signalling high wage growth for low-income workers (which have higher marginal propensity to consume). The new data on the job market coming in during the spring and in particular in June, might put more pressure on the CNB to tighten its monetary policy.

Depending on the effects that the next removal of the floor will have on the Czech koruna, the CNB might be forced to start hiking the interest rate, in order to defend its target inflation rate. In the most likely scenario, the CNB is expected to revise its repo rate upwards in the first quarter of 2018, even considering a solid upward pressure on the Czech koruna after the removal of the floor. In the bond market, positioning has already started, with 10y government bond yield up at 1.03% from 0.4% of last January.

All in all, given the inflationary pressures that will inevitably force the CNB to tighten its monetary policy, and given the much stronger shape of the Czech economy compared with 2013 (when the floor was imposed and the EUR/CZK was quoting in the market well below 26), we think that the fair value of the Czech koruna lays underneath the current imposed level of 27 CZK for one euro.

The strategy on the Czech koruna

In this clearly bullish scenario we have just described, investors have already taken their speculative positions since last January, trying to exploit the expected floor removal. Therefore, the current setting is completely different from "the Swiss Franc case" and does not allow incoming investors to profit by unexpected and huge directional squeezes on the market, as we saw in January 2015. The Czech National Bank would rather manage the transition trying to avoid the uncertainty on the exchange rate as much as possible. Consequently, before defining our investment strategy it is necessary to make a brief digression on this point.

As we can see from the chart below, pressure on the CNB to keep the exchange rate at the current level has increased significantly, inducing Czech foreign exchange reserves to raise rapidly in the last two months (January and February 2017): indeed, from official data we can observe that the CNB has purchased around 24bn EUR in

2017 (*Chart 6*), without considering March, which is more than the total amount of FX reserves purchased last year. In 24 months, reserves have more than doubled.

Chart 6: Monthly reserves increase (source of chart data: Thomson Reuters)

Considering these premises, our view on the Czech koruna remains bullish also for the following reasons: taking into account considerable speculative positions, the Czech National Bank reserves the right to intervene, if necessary, in the event of an unexpected devaluation of the koruna in order to achieve its target inflation rate. Precisely on this point, in the last January statement the executive board included the acknowledgment of an increasing likelihood of an inflationary scenario, rather than a balanced one as declared in the previous statement. This, as said before, has even opened the door to the possibility that the CNB could raise interest rates faster than what expected months ago, giving more and more bullish prospects for the Czech currency in the medium-term.

Extending this argument, as mentioned earlier we also look at the performance of the 10y government bond yields: in just two months they have literally skyrocketed, with a percentage increase of 157.5% (*Chart 7*). This movement represents the perceived likelihood of fast rate hikes given rising inflation forecasts. The scenario clearly increases pressure on the CNB to remove the fixed exchange rate.

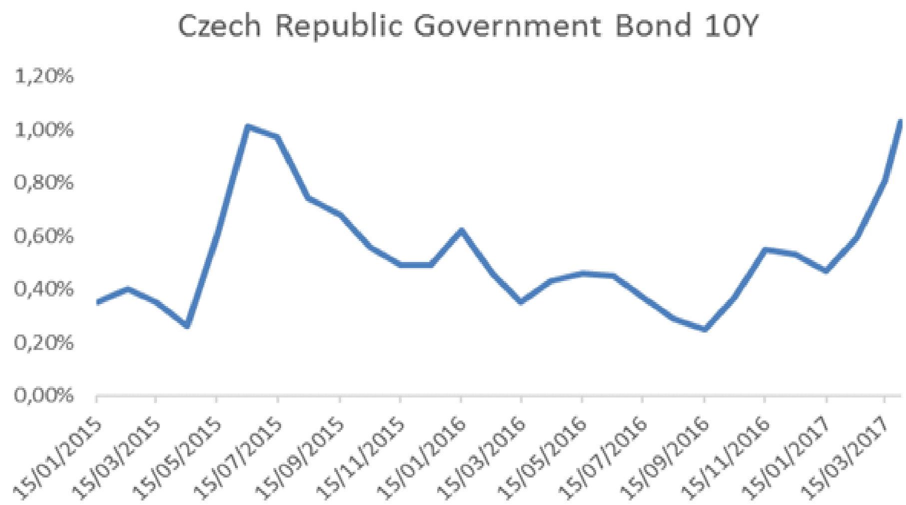

Chart 7: Czech Republic Government bond 10Y yield (source of chart data: Thomson Reuters)

We strongly believe the EUR/CZK to reach a level of 26,25-26 before the end of 2017. Investors in currency derivatives are positioned for lower appreciation, with six-month EUR/CZK forwards trading at 26.75. Following our analysis, we believe that there is still some upside in exploiting the koruna floor removal. This can be better and easily done by going short on EUR/CZK futures, mainly for two reasons: first, unlike options, these instruments do not require to pay a premium but just a margin that allow investors to leverage positions. This is very important if we consider the occurrence of the scenario expected from the market: there will be just very small variations of the exchange rate since most of the news are already priced in and investors are already holding their speculative positions. Second, despite the great potential of the leverage, the main disadvantage of the future is the potential loss the investor can sustain if he/she has the wrong view. However, in this case, even in the least likely and worse scenario, the downside of the future strategy is roughly locked due to the implicit guarantee of the CNB not to let the currency depreciate. Indeed, the effort of the former, will be focused on avoiding inflationary pressure and, therefore, intervening if the currency will eventually depreciate too much. The CNB is less likely to intervene in the opposite case, unless extreme scenarios will occur, increasing the upward perspective of the strategy. Precisely, we believe that if EUR/CZK breaks the threshold of 25.7-25.5 pressures may rise on the Central Bank executive board because the excessive appreciation of the currency could lead to an economic slowdown in the long run. This would culminate in the decision of slowing monetary tightening. Consequently, given our analysis, we think that the short EUR/CZK trading strategy offers a strong risk-reward ratio and probability of a positive payoff without the necessity to pay a premium. Therefore, we do not recommend to use option strategies, especially for the lack of interesting risk-reward conditions given the current market situation.

Nevertheless, we still expect high volatility on the exchange rate in the days immediately following the removal of the floor, in both directions, due to the speculative positions mentioned above. In the least likely scenario, EUR/CZK may also raise above 27.5-27.6 and even higher if accentuated by the trigger of stop losses or possible profit taking by bullish investors. However, we suggest to hold the position and focus on the medium-term rather than the short-term horizon as the implicit commitment of the Czech National Bank to counteract inflation and eventually backstop the market is almost certain in our opinion.

Tags: Czech Republic, Czech koruna, EUR/CZK, exchange rate floor, Czech National Bank, macroeconomics, trade idea, inflation, FX