CNB IN 2019

IS 2019 GOING TO BE JUST A SLIGHTLY SLOWER 2018?

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The pause in its tightening campaign that CNB took in December prompted speculations,…

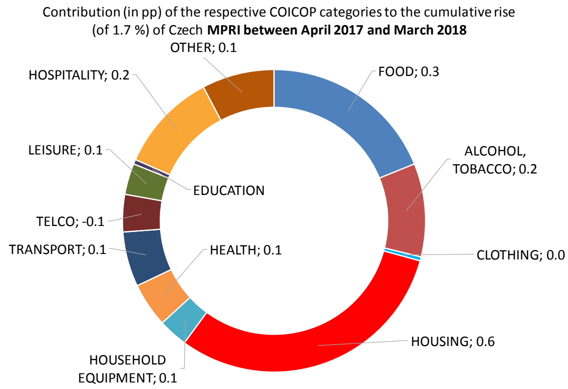
…whether it is just the time-out, or a possible end of the tightening cycle.

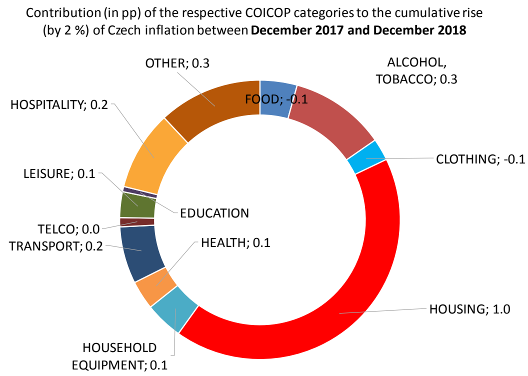
I think the latter is much more probable.

After what was, from a monetary policy perspective, a very eventful year, the last meeting of CNB shortly before last Christmas was a non-event. Having increased its key (two-week repo) rate five times over previous eleven months, CNB, with two new members of Banking Board (Tomas Holub, Ales Michl) for the first time, decided to stay put in December. Although the decision was not unanimous (two members, Ales Michl and Vojtech Benda, having voted for what would have been the 6th increase in 2018), the two-week repo rate stayed at 1.75%. The question that immediately arose was thus this: **is this the end of tightening cycle, or just a time-out pause?**

Analysts, at least those quoted by local daily Hospodarske noviny ↗, are confident that latter is the case: at least one, but more likely three more hikes are to be expected in 2019, they say. Central bank, on the other hand, is significantly more cautious: its own forecast calls from November 2018 calls for no tightening whatsoever in 2019, for instance, leaving further hikes only for 2020, four new CNB forecasts away (and hence of little predictive value). So, who'll have been closer to truth once we assess 2019 this time next year?

First, let us look back at 2018. As mentioned above, CNB hiked five times in 2018. But I continue to claim that it was not necessary from the inflationary perspective, i.e. because of broad demand inflationary pressures. Look at the following pictures:

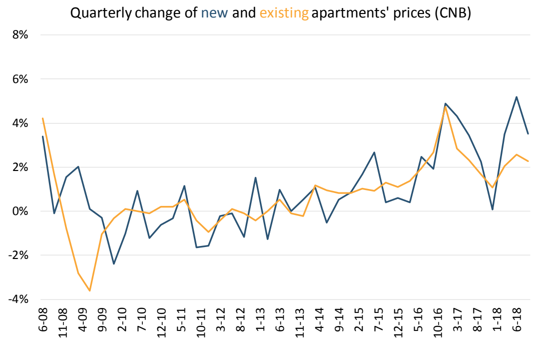




SOURCE: WWW.CZSO.CZ ↗

What do we see, you ask? Well, that **most of the inflation in 12 months following the end of interventions in April 2017, as well as in twelve months of 2018, was due to housing**. This reflects both the housing price increases (which are reflected in the consumer price inflation index via imputed rent subindex) as well as other costs associated with housing (electricity, natural gas, other utilities). **Without the housing** component, the inflation would've been a full percentage point lower at the end of last year than it was, i.e. **inflation would've been around 1%**! In other words, the "threat of inflation" that CNB was responding to last year via tighter policy would not have existed without the housing – and, by the way, it was CNB's previous policy (interventions, lowest mortgage rates ever) that contributed to the housing increases essentially. In all other sectors, the price increases were small, which comes as no surprise as Eurozone, our biggest partner, has been decisively anti-inflationary in last years. To respond to one sector's overheating via tighter policy for everyone is probably not the smartest monetary policy, but hey, CNB had been intervening in the FX market for 3+ years against a non-existent deflationary threat, so it is not all that surprising, I guess.

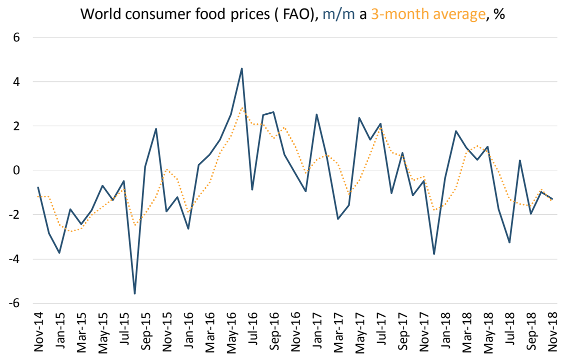
Anyway, the primacy of the housing in the inflation means that the inflation is likely to head lower in 2019. First, the house prices should stop growing as tighter monetary policy (higher mortgage rates ↗) and new limits, as of October 1, 2018 ↗, on debt-to-income & debt-service-to-income, in addition to previously existing limits on loan-to-value, will make mortgages noticeably harder to get than previously. Last year, we didn't see that as borrowers were scrambling to get mortgage before new recommendations of CNB kicked in and banks were trying to get as many clients as possible ↗, choosing not to pass higher borrowing costs onto borrowers. This is now over: mortgage rates will continue to rise and banks will conform to the recommendations of CNB: the result will be a fall in mortgages.

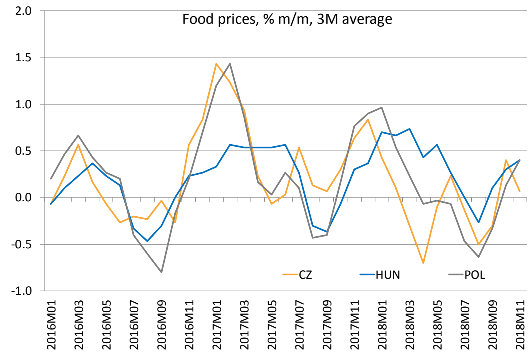


SOURCE: CNB ARAD Database ↗

Secondly, **other costs associated with housing are also likely to dampen the price level increases in 2019.** The fall of CZK Brent oil and natural gas prices by 25% since their peaks in October, if sustained, will be reflected in prices of some utilities in 2019 (electricity will probably not be among them as it proved impervious to previous gas and oil price slides). This will not only show in the housing segment of the CPI, but, subsequently, though to a lesser degree, in other segments.

***Third*, food prices.** These were expected to push the price level up following the subpar drought-affected harvest of 2018, but just the contrary happened. World food prices fell almost 9% in the 2nd half of 2018, and Czech (and regional) food prices followed.

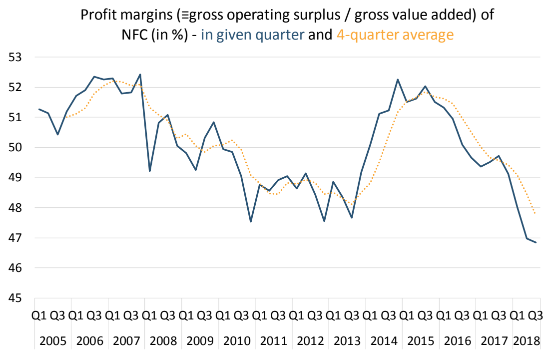


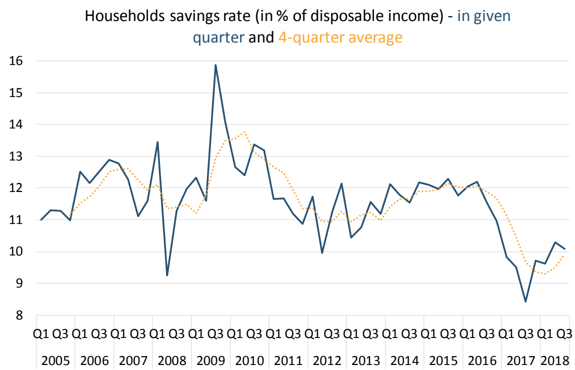


SOURCE: Eurostat

Food prices shouldn't, in my view, influence the monetary policy, but since they're included in the monetary-policy relevant inflation index, they, in Czech Republic, do.

***Fourth*, the cold from the Eurozone is beginning to be felt in the Czech economy.** Germany was likely in recession in 2nd half of 2018 (q/q growth in 3Q18 was negative, what monthly data we have for 4Q18 suggests it was in that quarter as well) or pretty close to it. The weakness of Czech soft / leading indicators at the end of the year (see, for example, latest confidence indicators ↗ or latest manufacturing PMI , which fell below 50) makes the slowdown in industry in 2019 a foregone conclusion. But the weakening is not restricted to just the industry. Lower consumer confidence, reflecting heightened concerns about the future and thus higher intention to save (that is, higher savings rate) coupled with lowest profitability of non-financial corporations in at least a decade (limiting further wage increases, at least in the private sector) mean that the household demand growth will be slower in 2019 than in 2018. This will be so despite the fact that interest rates on new consumer loans have been falling continuously even as CNB (picture on p.5 here ↗) tightened.





SOURCE: CZSO, Table 3 here ↗

Fifth, risks. Brexit remains as unsolved as on the day of the referendum ↗ and the chances of no-deal exit increased recently. The budgetary conflict between Rome and Brussels has not been solved and is ready to resurface at any moment, as is the Trump's trade war. Even if none of these risks materialize to the point of massive escalation, their combined effects on economic decisions will be felt.

Finally, even CNB alone is rather non-committal when it comes to further future hikes. This is seen in the last statement (from the December 20, 2018 meeting ↗). Although the risks of the November forecast were in the end seen as '*being broadly balanced*', the text of the statement read like anything but. While the only pro-inflationary factors mentioned were, obviously, (by 1%) weaker CZK and somewhat higher-than-expected wage growth (with CNB itself adding that this was due to higher-than-forecast growth in public sector), the list of anti-inflationary factors was much longer. It included "*outlook for foreign variables having been revised downward*", "*market outlook for Brent crude oil price being markedly lower over the next two years*", "*domestic inflation declining and being lower than forecast*", "*household consumption slightly lower than predicted*", "*employment growth recording a more pronounced slowdown than predicted*".

Even the press after December meeting was pretty cautious when it came to interest rate increases next year ↗ - one could sense much less conviction that economy will do so well that tighter policy will be needed. In governor's words: "*If the economy develops favorably, which we continue to expect – the Czech economy could grow by around 3% next year – a further interest rate increase will probably be necessary. But it will certainly be much more gradual than this year.*" The only thing that Board sees as something that may require a tighter policy is CZK, again with the turn towards dovishness due to range of anti-inflationary factors mentioned above: "*…that means that even in the potentially materializing sensitivity scenario of weaker koruna*[1] *rates may need to be raised less than we assumed in the original and still valid November forecast.*"

To sum: CNB's most recent forecast (i.e., no tightening in 2019) is in my eyes much closer to what the reality of 2019 will be than the analysts' mechanical extrapolation of last year's housing-driven tightening. And, if some risks outlined above materialize, I would not be surprised to see a debate, this time next year, whether the next move in rates should not actually be *down*.

[1] In November forecast, this alternative scenario called for 80-90 bps. more hikes in 2019 as against baseline.

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