

CNB Minutes: Inflationary risks soften while industry stagnates

Six out of seven CNB board members voted for a rate cut amid uncertainty over the industrial sector's recovery. While domestic price pressures remain persistent, lower imported inflation, lower ECB rates, and lower eurozone growth prospects are creating space for further easing. Europe's structural issues, meanwhile, remain a drag

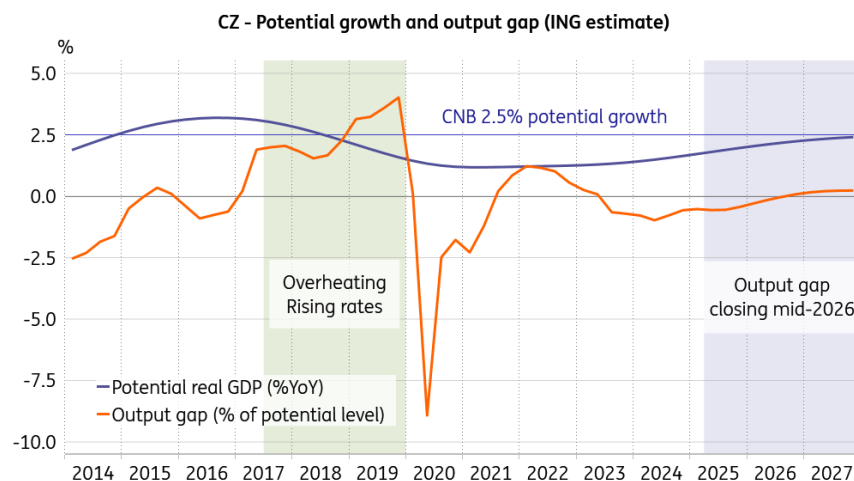


Bifurcated economy stuck below potential

The Czech National Bank's board reduced the base rate by 25bp to 3.5% at its last meeting, coinciding with the release of a new economic forecast. Inflation will likely float in the upper tier of the tolerance band for the rest of the year and is set to drift close to the target in 2026. Consistent with the baseline scenario is a gradual decline in short-term market rates in the second quarter of this year. The Board assessed the overall risks to the outlook as moderately inflationary, mainly stemming from domestic factors, while the risk of potent imported inflation has mostly receded. A restrictive policy stance is still warranted with core inflation hovering above the target for some time. The rate setters shared the need for caution when easing monetary conditions.

Deputy Governor Eva Zamrazilova underscored the dual-track dynamics in the Czech economy, where strong consumer demand—driven by relatively fast wage growth—contrasts with weak business investment, which has yet to bottom out. Jan Frait similarly characterised the economy as split, noting that still-high interest rates on loans to non-financial corporations justify a lower base rate, while other credit segments show no clear need for monetary easing. Meanwhile, Jan Kucek pointed to the incomplete disinflation process within the core of the consumer basket, where price dynamics have gained momentum this year.

Potential is slowly recovering, output gap remains negative



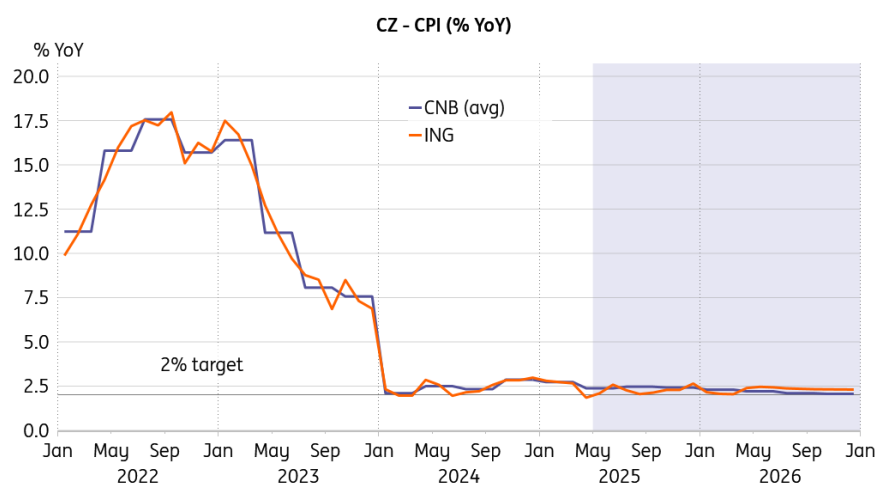
Source: ING, Macrobond

Jan Prochazka stated that the economy was likely still below its potential, while real household consumption remains weaker than before the pandemic, despite the ongoing rebound. Jakub Seidler highlighted that wage growth might be slower than expected, although even the softer wage growth could have pro-inflationary effects due to stagnant and noticeably lower productivity gains. We assess the above-mentioned points as relevant and note that these were brought up in our economic assessment previously.

Projection and hard-to-believe scenarios

The surprisingly soft inflation figure for April of 1.8% is likely a temporary anomaly, influenced by this year’s different Easter timing compared to last year. Likewise, a single spike in core inflation expected in June should not be overinterpreted. The new CNB forecast pencils in a rather strong core inflation rate of 2.7% this year, which is 0.2pp above our own outlook. The headline rate projection of 2.5% this year is only a tick stronger than our expectations, yet the CNB cut-off date was before the weak April reading had arrived. The real GDP growth outlook has remained unchanged at 2% this year but was revised downward by 0.3pp to 2.2% for the following year.

Headline inflation remains tame



The rapid growth in property prices and its impact on imputed rents was one of the hot topics at the meeting. Zamrazilova holds the view that the high savings rate in recent years represents deferred demand for property rather than consumption, with savings being put to work right now. For her, this is a reason to hold rates slightly higher. At the same time, some members pointed out that it was not the role of central banks to solve the structural and institutional problems of the property market. That said, a significant proportion of new loans is related to real estate, so it is necessary to take the real estate market into account. The CNB policies currently have a rather neutral effect on the property market, while factors outside the CNB's remit continue to drive high housing costs.

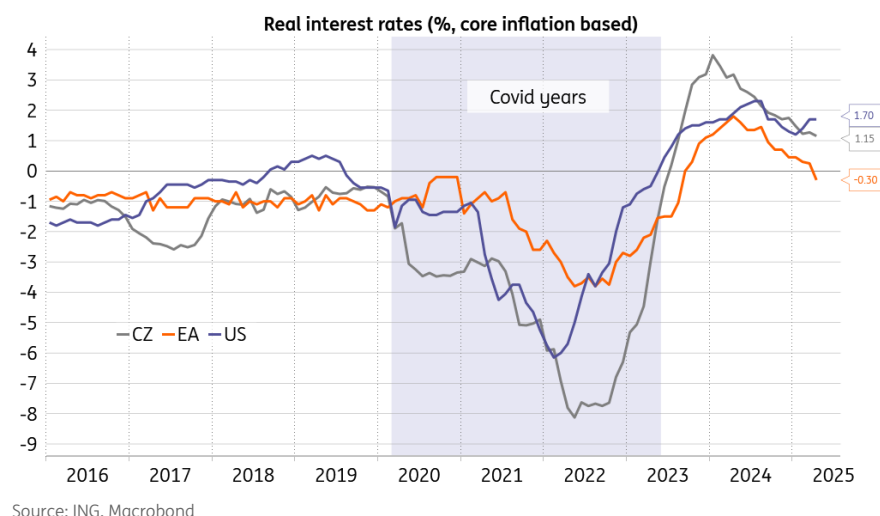
The impact of the current geopolitical tensions and trade wars was deemed very hard to quantify, as various counter-directional effects are in place, including uncertainty about their timing. A possible weakening of global demand would have an anti-inflationary effect, while some inflationary impact could also occur from restricted supply. Given the high uncertainty about the developments and effects in this area, its weighting was rather discounted in the decision. The CNB presented two scenarios linked to the reshuffling of the global trade landscape: i) the anti-inflationary downturn in global demand and ii) the pro-inflationary disruptions to global value chains. The muted response of Czech inflation, compared to the pronounced price increases abroad, represents a notable setback, despite the generally proportional adjustments in foreign and domestic policy rates. Moreover, the outcome contrasts with similar dynamics observed during the pandemic, where inflationary reactions played out differently in several key aspects.

The unenviable eurozone positioning

Foreign interest rates matter for any central bank as they do not operate in a vacuum. For the CNB, the moves of the two heavyweights - the Federal Reserve and the European Central Bank - are an essential variable entering its reaction function. The ECB has continuously reduced its policy rates as headline inflation has been drifting lower since the start of the year. However, core inflation in the eurozone picked up significantly in April. Looking at the ECB real interest rate, it has declined to 0.2% when measured against headline inflation, but turned negative when measured against core inflation. In contrast, real interest rates in the US and Czechia remained positive,

whether measured against headline or core inflation.

Real interest rates take different directions



In our view, the real rate is the decisive monetary variable that modifies the speed of structural adjustment in the economy, as it influences the survival and adaptation of enterprises and sectors. Similar to inflation and wage growth in certain aspects, the interest rate ultimately reflects the price of money. Generating economic growth through negative interest rates is not beneficial to the future structural advances of the economy, as too many unproductive enterprises and potentially sectors are allowed to carry on in a zombie mode, nurtured by the negative cost of credit. The ECB is simply trying to overcompensate for structural weaknesses of the European economy, but such an endeavour has its future cost in the form of reduced propensity to adapt. That is not good news for the European economy, and yes, there is no such thing as a free lunch. Channelling Paul McCartney's "Live and Let Die" philosophy, this approach holds significance even in economics, as struggling enterprises set precious production factors free after fading into obscurity. Meanwhile, we view the negative real euro rate as a weak spot for the single currency.

On the other side of the coin, savings held in euros have lost real purchasing power compared to a year ago, whereas those preserved in the koruna or dollar have gained in what they can buy. We are eager to see how central banks navigate the almost-tamed inflation within the realm of real interest rates. And like it or not, an unspoken challenge looms among monetary institutions—who will be able to 'walk the line' like Johnny Cash, setting real rates at levels that foster economic growth without propping up stagnant enterprises or eroding household savings?

An operation or an autopsy?

We wonder whether they are following various measures of real interest rates at the ECB, with the presumption that it is generally a good idea to do so. The CNB Governor Ales Michl stated repeatedly that negative real rates are not an option, for a good reason, we believe. Of course, there are always exceptions, such as the Swiss National Bank in this area, which opposes a too-strong franc. Nevertheless, this is far from an attempt to stimulate growth in an economy structurally weakened, stagnant, and teetering like a house of cards.

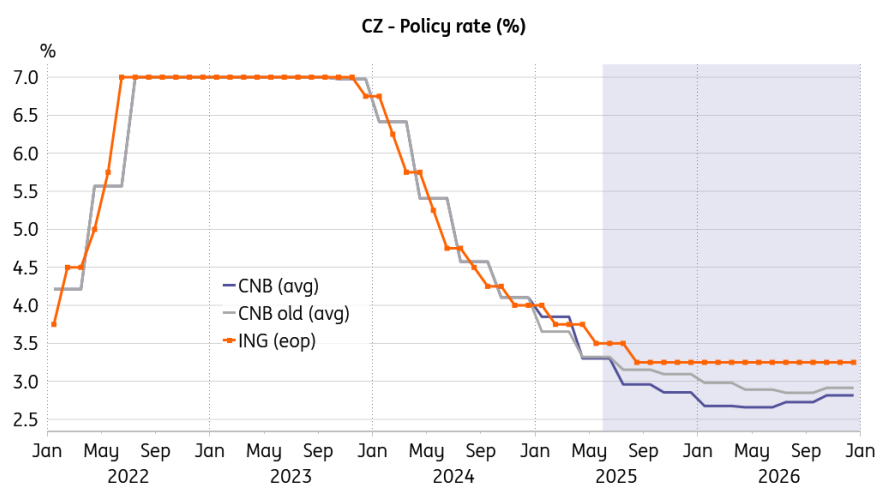
Jan Frait also stressed that it is necessary to closely follow the actions of the new German

government. And here we stand. Europe has tried to create an environment that is so safe and predictable that it eventually regulated itself out of decent economic expansion. The regulatory web is so dense that the economy can move neither forward nor backward, and polite emails by the German chancellor to the European Commission seem not to have had the desired effect. The situation does not seem ripe for a scalpel, but rather for a sledgehammer, unless we have an autopsy on our minds already. If the current setup is not altered decisively and promptly, sustainable growth and economic prosperity will not return to Europe in the foreseeable future. The sluggish growth of the three largest economies—despite negative borrowing costs—remains a persistent and troubling reality rather than a fresh concern. Yet they have negative repercussions for many other economies across the continent.

Forecast pencils in further easing while board calls for caution

Jan Prochazka expressed his conviction that keeping rates unchanged for longer would not be consistent with the state of the Czech economy, even considering the upside risks to inflation, with a 25bp cut still reflecting a cautious stance. Zamrazilova pointed out that she did not see the space for a further rate reduction as large as the forecast; if the upside risks to inflation were to materialise her vote for a rate cut could be the last this year. Other members agreed that a slightly restrictive monetary policy remains the appropriate positioning.

The staff forecast suggests quite some scope for further easing



Source: CNB, ING, Macrobond

When looking at the CNB base rate forecast, we actually come to two to three rate cuts until mid-next year. Since the CNB's inflation outlook is rate-dependent, keeping rates unchanged could bring inflation closer to target more quickly, but at the expense of slower economic growth. Obviously, the gap between the more cautious bank board and the staff forecast has only widened from the winter forecast. Our view remains the same, that the economy is still ripe for slightly lower borrowing costs, as fixed investment has remained stagnant for almost three years in a row, and industry has not hit bottom. There is actually a shift to consider: the potential for significantly lower imported inflation coupled with increased uncertainty surrounding the European economic rebound. Should core inflation remain contained, we would consider room for more than one cut this year.

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