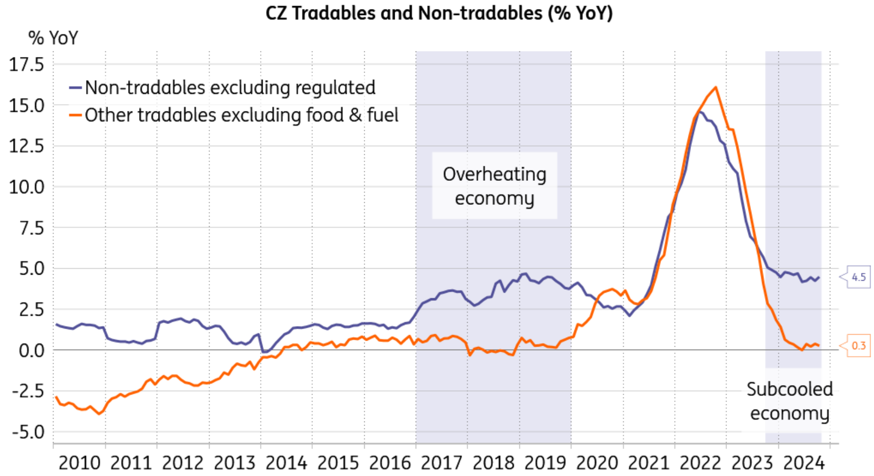
CNB minutes: Lofty services pricing in a cooling economy

Five board members voted in favour of a 25bp rate cut in the Czech National Bank's November meeting, bringing the policy rate to 4%. Meanwhile, persistent inflation in the services sector - set against the country's weak economic recovery - made two opposing alternatives stand out

Resilient prices in the service sector are a concern

The CNB Bank Board reduced the base rate by 25bp to 4.0% at its November meeting. Five board members voted in favour of this decision. Eva Zamrazilova opted for interest rate stability, while Tomas Holub voted for a 50bp rate cut. Inflation is expected to pick up to the upper bound of the target tolerance band at the end of the year and to gradually decline towards the 2% target thereafter. A continued decline in short-term market interest rates is consistent with the baseline scenario, followed by stability in the base rate from mid next year.

Non-tradables price growth is high despite below-ppotential expansion



Source: CZSO, CNB, Macrobond

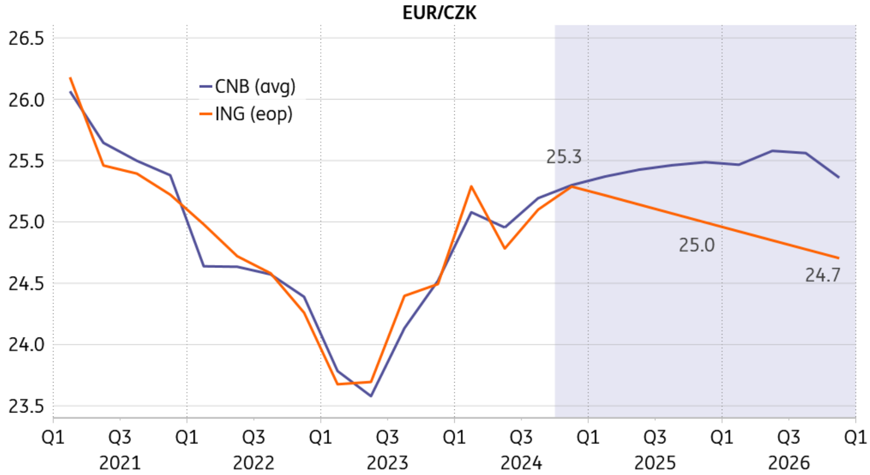
The board assessed overall risks and uncertainties as moderately inflationary. The pro-inflationary risk is mainly represented by the higher-than-expected price inertia in the service sector. Any excessive increases in total public sector expenditure would also imply inflationary risks, mostly linked to the government budget. A possible acceleration of money creation stemming from elevated credit activity, especially in the property market, is another upside risk to inflation in the medium term. In contrast, a downside risk for the overall price growth is the deterioration in global economic activity, combined with an even weaker performance of the German economy and, in turn, that of the Czech Republic.

Hawkish tone assessed as appropriate

Ales Michl stressed that the staff had increased inflation on the forecast horizon. This justifies the hawkish communication of the board so far. Overall, it seems necessary to continue the easing process in a very cautious manner or to discontinue the rate cuts. This was also supported by Zamrazilova, who mentioned that the new forecast assumes a pickup in inflation even above the upper limit of the target tolerance band, while a possible dampening effect via volatile items is nothing to rely on. Jan Frait noted that the long-term overshooting of the inflation target might result in expectations rising above 2%. Meanwhile, in Holub's view, the new forecast does not call the fulfilment of the target into question at the monetary policy horizon.

The board also discussed the exchange rate, which is projected not to appreciate any further. According to Zamrazilova, the markedly weaker koruna provides sufficient ground for suspending the interest rate cuts. Jan Kubicek pointed out that the projected exchange rate at the end of 2025 is about 6% weaker than implied by the forecast a year ago and almost 4% weaker than market expectations.

Weaker koruna adds to imported price pressures



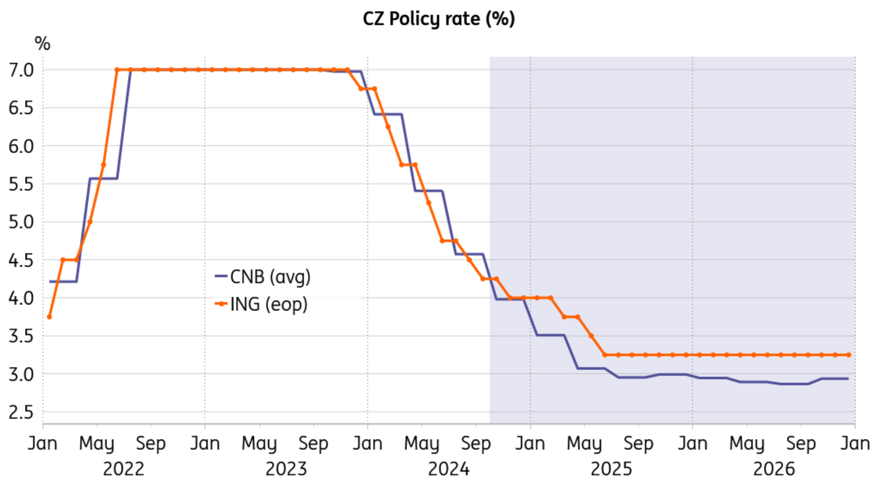
Source: CNB, ING, Macrobond

Recovery as the make-it-or-break-it for further easing

We see inflation peaking at 3.4% in December and remaining above the target over the upcoming year. The price growth in the service sector remains lofty and resistant, keeping core inflation elevated. This is set against only a gradual recovery, with the economy operating below its potential.

Meanwhile, given the tight labour market and the negative output gap starting to close over the coming quarters, we see price pressure in the non-tradable items continuing. The weaker koruna, along with renewed growth of agricultural commodities, will also foster headline inflation. We therefore see a break in the cutting cycle as the most viable option, with policymakers leaving space to evaluate January's inflation figures, which could be driven by higher rents and other one-off adjustments to price lists. Still, it will be a close call for an alternative to continued easing should the economic rebound prove even more sluggish.

Rates set to decline gradually and remain elevated



Source: CNB, ING, Macrobond

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