CNB minutes: Pro-inflationary risks warrant restrictive stance

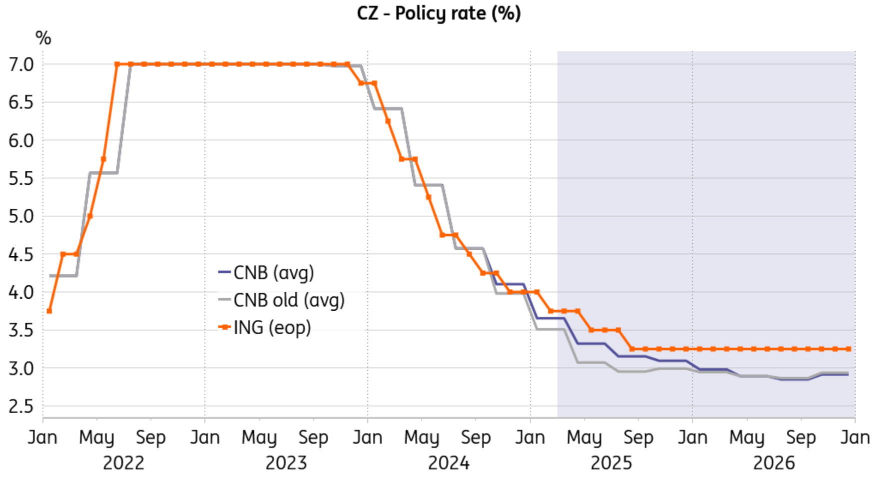
Czech policymakers decided to reduce the base rate by 25bp to 3.75% at the last meeting, with all seven members of the board voting in favour of this decision. Meanwhile, the bank board perceives overall risks as pro-inflationary, which will contribute to a hawkish bias along with declining real rates

Czech National Bank building in Prague

Restrictiveness of the policy is a priority

The decision was based on the first situation report for this year and the new macroeconomic forecast, which assumes inflation remains above the 2% target this year and slowing down close to the target at the monetary policy horizon. The baseline scenario depicts a continued decline in policy interest rates followed by approximate stability from the middle of the year.

The space for further cuts is limited

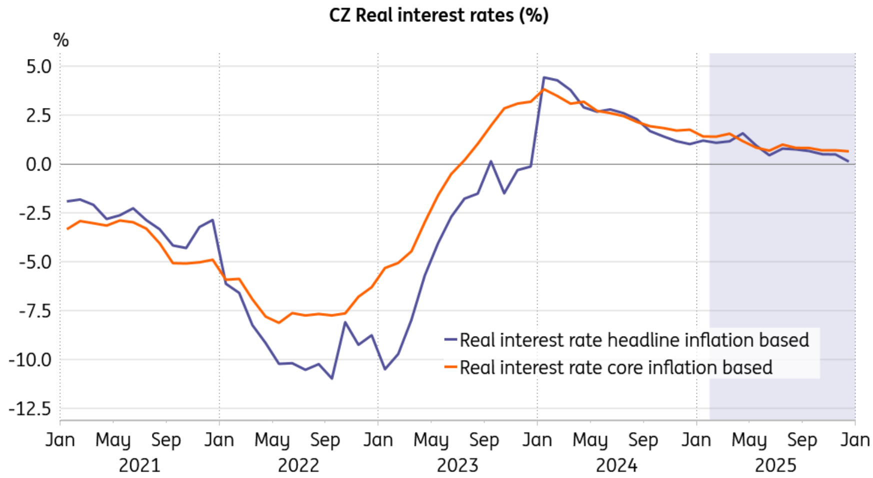


Source: CNB, ING, Macrobond

At the same time, the board assessed the risks to the inflation outlook as overall moderately pro-inflationary. Governor Ales Michl said that the government's deficit and the growth in the amount of money circulating in the economy suggest a preference for a hawkish bias in the long run. Any further possible monetary easing is to be carried out very cautiously to maintain a restrictive monetary policy stance.

Eva Zamrazilova and Jan Frait also advocated for caution regarding a further reduction in interest rates. Frait added that interest rates were no longer restrictive in certain areas, which can be observed in the property market. It is, therefore, important to keep rates higher in the long term than the neutral level assumed by the markets. This would also make it easier to counter any depreciation pressures on the koruna resulting from the strengthening of the US dollar due to capital flows to the US. In contrast, Jan Kubicek pointed out that long rates were at similar levels to a year ago, showing almost no easing. The relative stability of longer rates seems to create room for further reductions in short-term interest rates.

Sub-zero real interest rates to be avoided



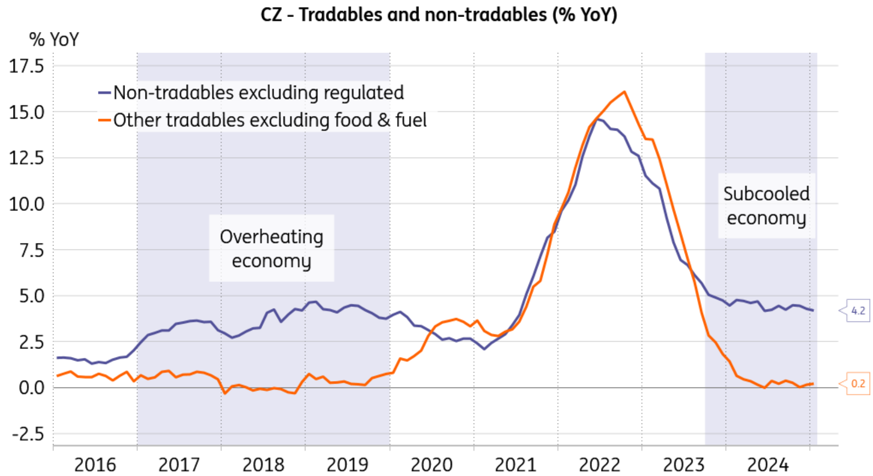
Source: ING, Macrobond

We see this year's inflation at 2.7%, which is stronger than the CNB forecast, bringing real interest rates close to the zero-bound at year-end. Therefore, we don't see the base rate drifting towards 3%, as suggested by the CNB outlook, but to be parked at 3.25% from August onward. That said, the last CNB forecast does not account for the punchy January inflation reading and less buoyant household spending expected towards year-end. Should the wage growth prove more persistent, driving price stagnation in the service sector, and should the cost pressures in the agriculture segment be fully transposed to consumer price tags, we would also consider a 3.50% terminal rate as an option. The governor made it clear that negative real rates are to be avoided, while the risk of getting uncomfortably close to the zero threshold is not negligible.

Labour market tightness matters

The bank board perceives the labour market as tight despite a slight rise in unemployment recently. According to Jan Frait, low inflation is generally seen in countries where the unemployment rate has risen noticeably. So, until there is a significant easing in the domestic labour market, wage pressures can be expected to remain strong and foster inflation. The better-than-expected performance of the Czech economy in the fourth quarter was highlighted, driven mainly by household consumption and continuously strong retail sales. According to Jakub Seidler, this represented an additional inflationary factor not yet captured in the forecast.

Inflation of non-tradables remains elevated



Source: CZSO, Macrobond

The inertia in services and food price inflation is also perceived as an upward risk to the inflation outlook despite some relief in the services price dynamics. Food prices will likely drive consumer prices this year, not only because of rising commodity agricultural commodity prices on world markets but also because of the low comparative base from last year. At the same time, food price dynamics play a significant role in households' perception of inflation. Jan Kubicek mentioned the rather fundamental difference between December's core inflation within CPI (2.3% YoY) and the HICP methodology (3.8% YoY), which take into account a higher weighting of services, which he considered to be rather far from the requirement of price stability.

ECB, Germany, and tariffs as potential risks for lower rates

According to Karina Kubelkova, the ECB's monetary policy would create downward pressure on domestic rates, as it would cut rates more quickly in the wake of a more pronounced downturn in the eurozone's economic activity. The continuation of German economic underperformance represents a clear risk to Czech growth remaining below its potential for longer than desired, which could restrain consumer price growth. In contrast, Jan Kubicek suggested that the weaker German economy was not yet providing a significant impetus to cut domestic interest rates beyond the forecast trajectory.

In the context of the uncertainty of the impact of the possible introduction of trade tariffs between the US and Europe, both Jan Frait and Jakub Seidler see the risk in the European context as being more in the direction of lower inflation, not only because of potentially weaker economic activity but also because of efforts to place goods affected by the tariffs from the respective territories on the European market.

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