CNB policy set to remain restrictive despite near-target inflation

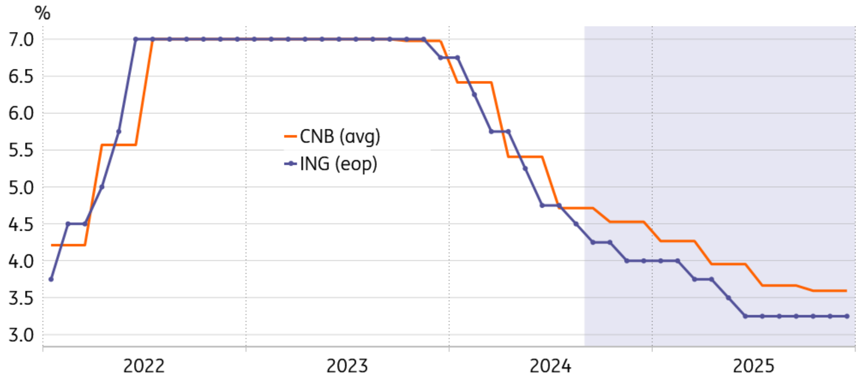
Czech policymakers unanimously opted for a softer approach to monetary policy easing in early August. Meanwhile, a cautious approach is set to remain the preferred path forward, with the elevated rate path to be taken seriously even amid a lukewarm recovery and low inflation

We think the CNB could be set to cut rates once more before pausing to assess incoming data

The elevated rate path is to be taken seriously

The Bank Board of the Czech National Bank reduced the policy rate by 25bp to 4.50% at its August meeting, with all seven members voting in favour. Inflation is set to remain close to the 2% target for the rest of this year and over the monetary policy horizon, according to the CNB's summer forecast. A slight decline in market interest rates is consistent with the baseline scenario.

CNB set to reduce rates only gradually

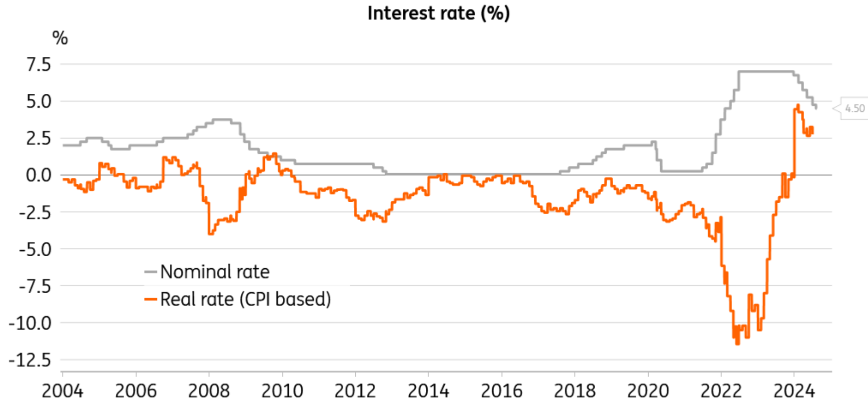


Source: CNB, ING, Macrobond

The Bank Board sees the risks of the forecast as broadly balanced. The upside risk to inflation is higher wage demands in the private and public sectors, along with potentially excessive growth in public sector spending. Higher-than-expected inertia in service prices and buoyant money creation due to accelerating credit activity are also considered pro-inflationary. Conversely, a possible deterioration in global economic activity and a weak German economy pose a significant risk to the Czech recovery, suggesting lower inflation.

Continued cautious interest rate cuts are the right way forward according to the Bank's governor, with a need for continued tightness in monetary policy the core inflation is fully under control. A softer approach overall to rate reductions will eventually make it possible to interrupt the easing with a restrictive stance. Three board members pointed out that there had recently been some autonomous easing of monetary conditions through the exchange rate weakness and a decline in longer-term interest rates.

Real rates are high compared to historical standards



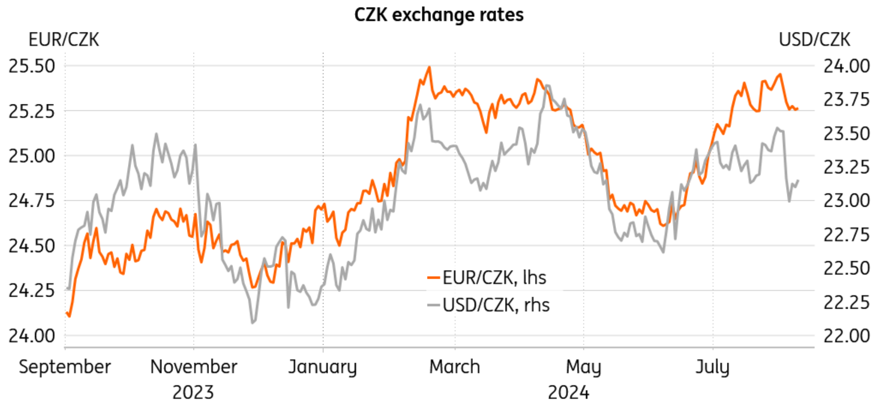
Source: CNB, Macrobond

As Deputy Governor Jan Frait noted, the CNB is aware that markets do not fully buy the outlook of elevated rates, which mirrors efforts to keep monetary policy much tighter than in the previous decade. However, policymakers intend to stick to the higher rate level, as it would prevent the excessive creation of new money and drive savings and investment rather than borrowing.

Weak exchange rate and a tight labour market warrant restrictive MP

Most of the policymakers agreed that the current weakness in the Czech koruna favours a cautious stance, also as a result of the softer approach from monetary institutions in the US and the eurozone. With Czech rates below those of the Federal Reserve and the rates differential toward the European Central Bank suppressed, the attractiveness of the koruna is undermined. A more significant rates reduction could – in the context of the CNB's communication to date – further weaken the currency and create new inflationary pressures, which should be avoided.

The koruna partially recovered after the soft cut



Source: Macrobond

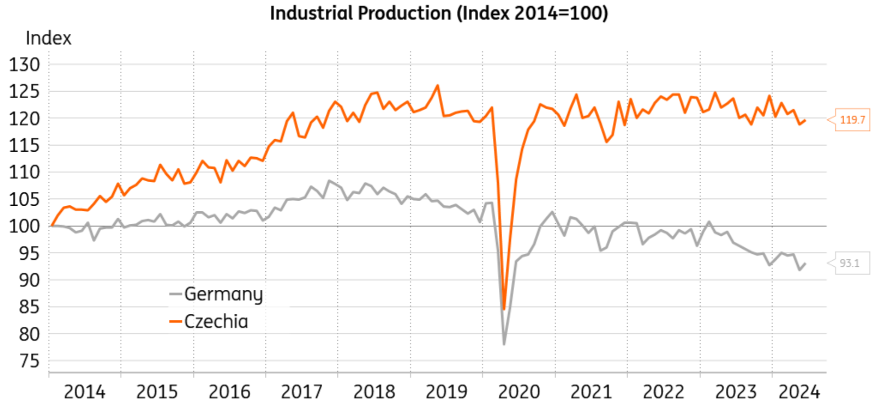
A restrictive monetary policy stance is also desirable in the context of continuously tight labour market conditions. Tight monetary policy will further contribute to companies covering increasing wage costs from their margins and not passing those on to final price tags.

Inflation below target due to a lukewarm recovery and can be tolerated

The board members agreed that the downside risk to inflation had increased significantly due to a hesitant economic recovery. Recent data on both the domestic and foreign economic environment signals more uncertainty surrounding a future expansion; the subdued indicators from Germany in particular represent a concern about the demand outlook.

At the same time, a slight undershooting of the inflation target in the coming months is not seen as an issue. Deputy Governor Eva Zamrazilova pointed out that the price level is 30% higher than three years ago. It seems that offsetting such a huge increase in consumer price level is a viable option.

Czech and German industries do not propel recovery

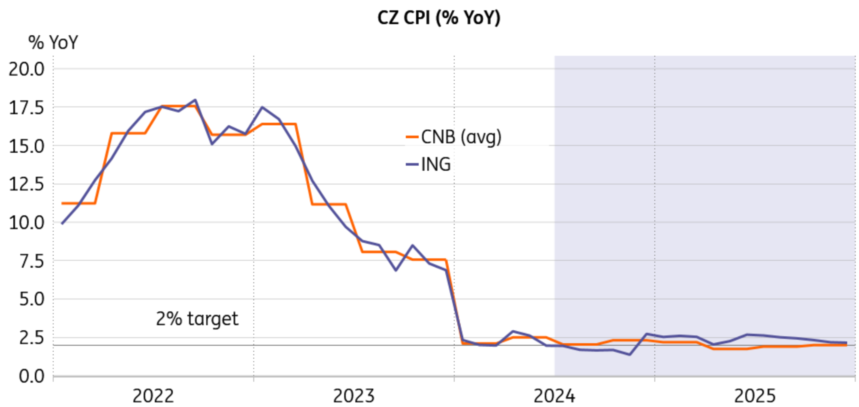


Source: Macrobond

We see the Czech economic recovery coming in at a softer pace than the CNB's summer forecast projects, as real interest rates above 2% for an extended period represent a considerable drag on economic activity. Unless the recovery proves robust throughout the year, our base case scenario still sees the rates path somewhat below the CNB's projections, with this year's terminal rate at 4% and 3.25% the following year. At the same time, policymakers confirmed that they intended to keep monetary conditions tight and would not compensate for structural weaknesses in the economy.

It seems, however, that the nonperforming manufacturing sector will eventually be reflected in a declaration of wage increases, which would also put a lid on disposable income and affect consumers' appetite for spending. Such a combination would likely result in continued stagnation, but this time with downward pressure on consumer prices. That said, we expect headline inflation to slide below target for a couple of months from August onward.

Czech inflation likely to remain subdued



Source: CNB, ING, Macrobond

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