CNB minutes: Spending-driven inflation amid stagnant investment

The CNB board left the key rate unchanged at 4% in December due to rising inflationary risks, though two members opted for a further reduction in rates. Policymakers are now making decisions in a twofold world where robust spending is driving price increases, but the economy is struggling to gain momentum as a result of its lagging supply side

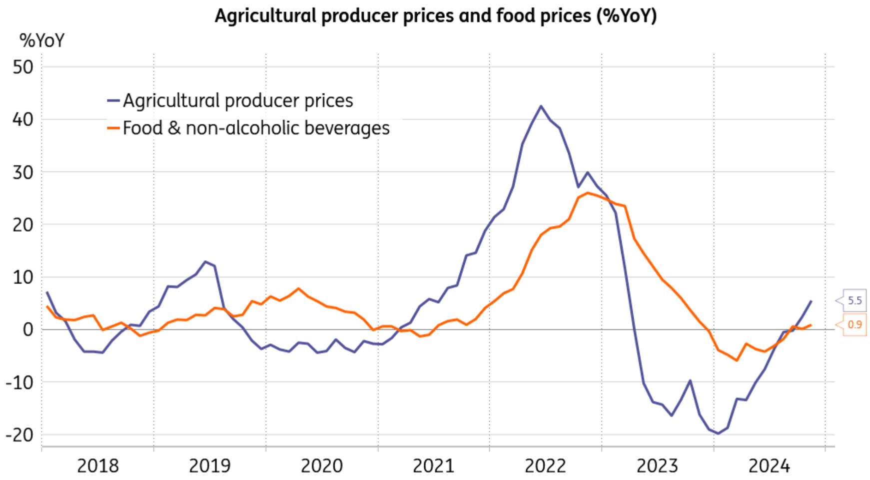
The Czech National Bank left its key rate unchanged at 4% in December

Frait and Kubelkova surprise amid piling inflation risks

The Czech National Bank's Board discussion was based on an assessment of new information obtained since the autumn forecast, which depicted a continued decline in short-term interest rates followed by a stabilisation from mid-2025. The Board saw the overall risks as moderately inflationary. CNB Governor Ales Michl pointed out that core inflation was still elevated, not breaching below 2% in the outlook, and the persistence in services inflation wasn't receding either. There was a consensus among policymakers that the current monetary policy setup still is restrictive. However, in the context of the mounting inflationary risks, the majority agreed that the decline in policy rates should be suspended for the time being. The surprise this time was that Jan Frait voted for a pause and Karina Kubelkova voted for a cut, both of which can be perceived as a change in attitude. Jakub Seidler joined the discussion and voted for the first time, making a relatively hawkish entry.

The price growth inertia in the service sector became a leitmotif of the discussion, as it is not consistent with headline inflation reaching the 2% target. Moreover, it seems that lofty wage growth can still fuel spending on services and feed the consumer price dynamic in the segment. Wage increases in the public sector and the still-tight labour market suggest continued solid wage growth throughout 2025.

Prices in agriculture will drive consumer food prices



Source: CZSO, Macrobond

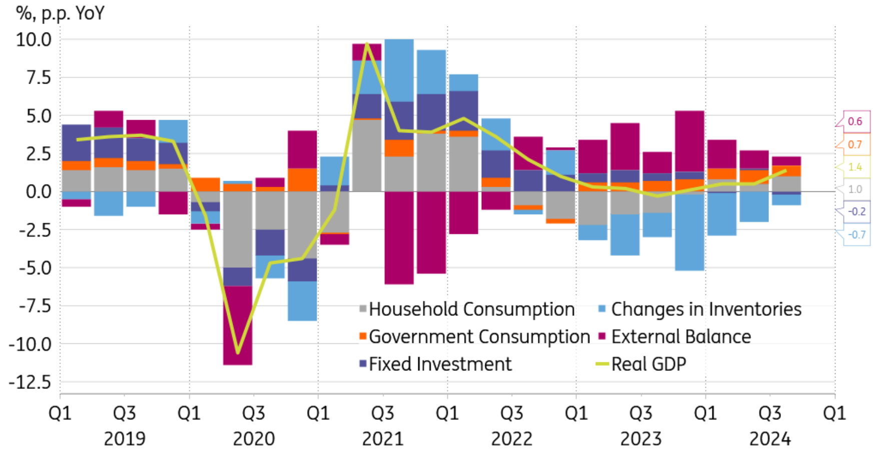
The acceleration in food prices is another concern, even though this item is considered volatile and excluded from the core inflation measure. Still, the global factors and a low comparison base will contribute to elevated food price dynamics and overall inflation. Some board members pointed out that the price growth in the residential sector is stronger than expected, and there is elevated uncertainty about where the price growth will peak. The property price index enters the computation of imputed rents, which accounts for 10.3% of the consumer basket and is an important driver of core inflation.

Stronger GDP growth but well below good times

The estimated Czech economic performance in the third quarter of 2024 was revised upwards, with real GDP gaining 0.5% quarter-on-quarter and increasing 1.4% year-on-year. The revisions in GDP components were only moderate, with a less pronounced negative contribution of changes in inventories and slightly stronger government consumption. Household spending was the main driver of overall growth, while fixed investment and inventories were the main drags.

Consumers shine

CZ - Real GDP and contributions (%, p.p. YoY)

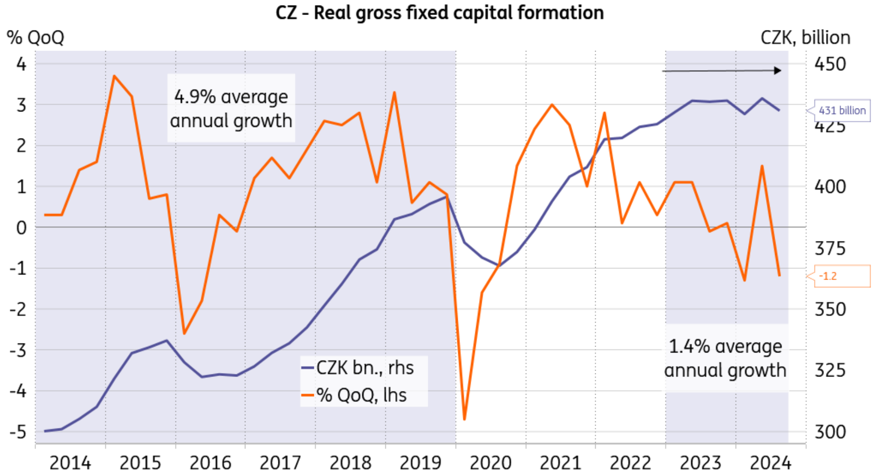


Source: CZSO, Macrobond

Real income of Czech households gained 0.3% QoQ in 2024's third quarter, while real per capita consumption added 0.7% QoQ. The saving rate eased by 0.1 percentage point to 18.8% in the same quarter. The third quarter profit margin eased to 45.9%, down 0.5ppt from the preceding quarter. Total labour costs of non-financial corporations added 6.7% YoY. The investment rate of non-financial corporations added 0.2ppt from the previous quarter to 26.6% in the third quarter of the year.

Investment progress has stalled for over a year and a half in the Czech Republic. Indeed, fixed investment increased by 4.9% annually on average between 2014 and 2019, while this statistic deteriorated to just 1.4% when measured from 2023 onward. This is less than a third of the investment expansion needed for the Czech economy to maintain its competitive edge. In any case, it is bad news for future growth performance, especially for an economy heavily skewed toward industrial manufacturing and exports. There is nothing bad per se about such characteristics until you are committed to remaining at least close to the technological frontier. And, of course, investment and innovation pave the way to remaining in that position. In a world defined by often antagonistic relations and rather tough competition, once the train is gone, it's gone.

Investment disappoints



Source: CZSO, Macrobond

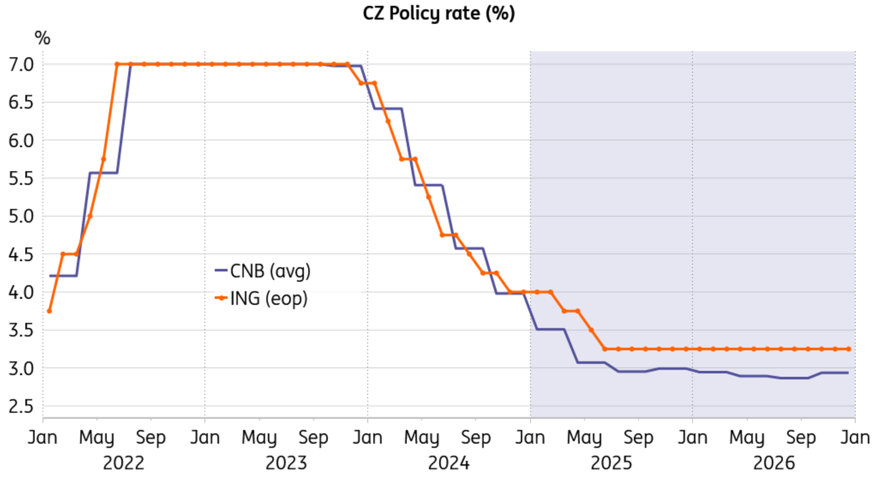
Overall, the Czech economic rebound continues, with consumers being the key driver. Meanwhile, industry is proving a laggard, with fixed investment in stagnation for a year and a half. The CNB bank board will be making its decisions a twofold world where robust spending provides fuel for price increases, but the economy struggles to gain momentum due to its underperforming supply side – and is further hampered by the lukewarm economic performance of its key EU trading partners.

Resilient inflation amid a swan song for growth prospects

The economic underperformance of the country's main European trading partners – with Germany in the lead – was perceived as a major anti-inflationary risk at the last CNB meeting. However, Eva Zamrazilova, the Deputy Governor, pointed out that the deterioration in the external environment reflects structural changes that act as negative supply factors and therefore also carry some inflationary potential. Jan Kubicek and Jakub Seidler expressed similar views, as the European economy's structural problems and stagflationary tendencies present a monetary policy dilemma.

This goes hand in hand with our opinion that Europe now faces a negative supply shock of a structural nature, which will make further decisions about propelling economic growth via lower interest rates a rather complicated venture. Indeed, it's becoming increasingly apparent that long-lasting and self-sustained economic growth is unlikely return to Europe until fundamental changes are seen in regulatory framework, investment incentives, forward-looking foreign trade policies, and overall appetite to succeed economically.

Space for easing is still available



Source: CNB, ING, Macrobond

As central banks across Europe gain a clearer understanding of these dynamics, we believe that we'll see less urgency to lower interest rates in order to compensate for structural failures and the inability to respond to obvious changes in circumstance – if the forward-looking approach is too much to ask, that is. With a constrained supply side and stagnant labour productivity, inflation will always be poised to break through the bars and escape its cage.

We see December inflation reaching well above the 3% threshold, but January's inflation data will be the pivotal point to watch for its role in determining further monetary easing. Our take is that headline inflation will soften to 2.7% in January due to reduced electricity prices, while core inflation is set to rise to 2.7%, propelled by imputed rent increases and a continuation of bold price dynamics in the services segment. These numbers aren't even close to the 2% inflation target, which we think will prompt policymakers to act more cautiously and only consider further rate reductions from March onwards.

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