CNB preview: 50bp rate cut likely while neutral real rate increases

The Czech National Bank will likely cut the key interest rate by 50bp to 5.25% as inflation has fallen towards the 2% target. Elevated price growth in services persists, limiting the likelihood of more easing. We expect a discussion on the neutral real interest rate, contributing to a higher rates outlook towards year-end

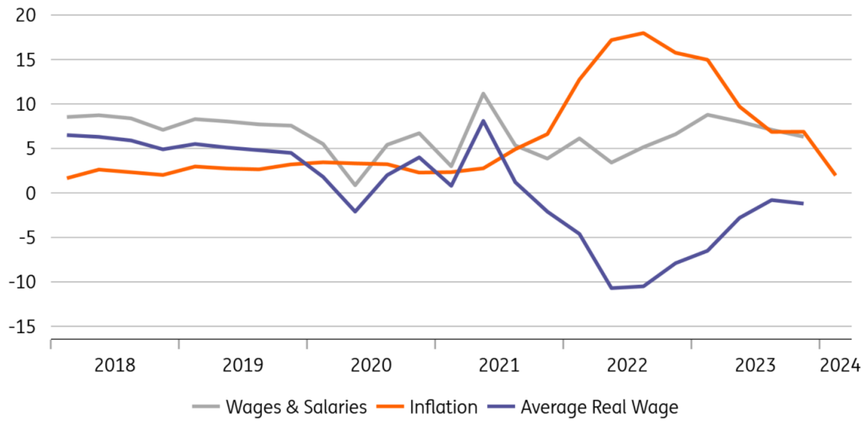
The Czech National Bank in Prague

Inflation on target and anaemic economic performance support rate cuts

The overall economic situation is ripe for further monetary easing. 2022 and 2023 had seen a surge in inflation, a fall in real wages and household budgets under pressure. This resulted in considerably underwhelming economic performance. After this extended period of elevated consumer price dynamics, overall inflation has now fallen to the 2% target. With observed inflation well below the CNB's current forecast, an undershooting of the inflation target is a viable option in the coming months unless we see a recovery in household spending with some inflationary effect. We therefore expect the CNB to cut the policy rate by another 50bp to 5.25% at Thursday's meeting.

The CNB's new forecast represents the essential input for the Board's decision-making. We will likely see an outlook for milder inflation in the May forecast, mainly due to weaker observed price growth in recent months. Both headline and core inflation came in noticeably below the current forecast from the start of the year. At the same time, we expect a positive revision in real GDP growth for this year with a pickup in household spending and investment. Firstly, consumer sentiment has been constantly improving since the beginning of the year. Secondly, real wage dynamics recovered from more than two years of declines during the first quarter. Both improvements will boost households' appetite to spend and probably tap into the high level of savings.

Rael wages have declined for more than two years (YoY%)



Macrobond, CZSO, ING

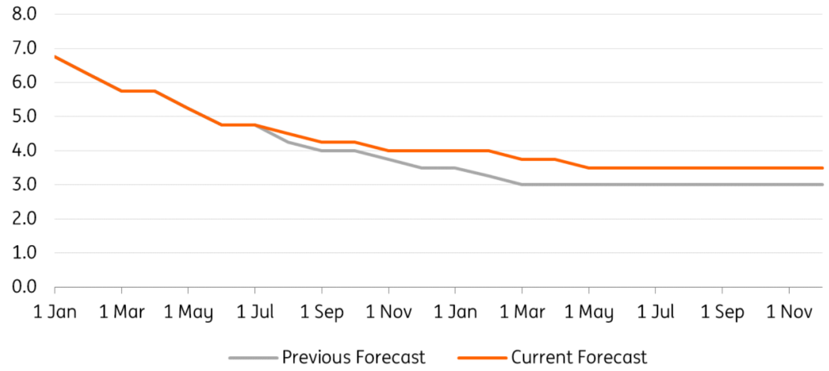
Persistent services inflation hinders more monetary easing

Elevated inflation in services persists and represents a concern for some of the board members. Positive nominal wage growth and recovering domestic demand are likely to support consumer inflation in the services sector during the second half of the year at the latest. Concerns about persistently elevated service price inflation are thus constraining any significant easing of monetary policy conditions. As the board member Jan Prochazka puts it: “I’m confident that inflation will stay within the tolerance band, but we are concerned about its structure. In services, the disinflationary process is basically not happening at all.” From this direction arise recent thoughts of a possible 25bp cut only. However, it seems the economy is ripe for a more significant easing at this point due to the well-below potential real performance with currently relatively tight monetary conditions.

The recent weakening of the koruna is another inflationary factor, with rising import prices contributing to price pressures in the months ahead. The koruna is 2.3% weaker against the euro vis-a-vis the CNB forecast, also reflecting the EURIBOR hovering above the CNB’s expectations. Brent crude oil prices have crept some 12% above the central bank’s winter forecast, adding to future price pressures. The more cautious approach of monetary institutions to rate cuts in view of possible reflation is evident on both sides of the Atlantic. After all, the European Central Bank is watching the Federal Reserve, and the CNB is watching the ECB.

As the CNB board member Tomas Holub indicates: "There is no new argument to accelerate the pace. The new (arguments) are rather for a more cautious approach, so I think keeping the pace is a good compromise for me." Overall, the emerging inflationary factors and the more cautious approach of policymakers lead us to increase the outlook of policy rates at the end of this and next year to 4.0% and 3.5%, respectively.

ING policy rate projection is revised upwards (%)



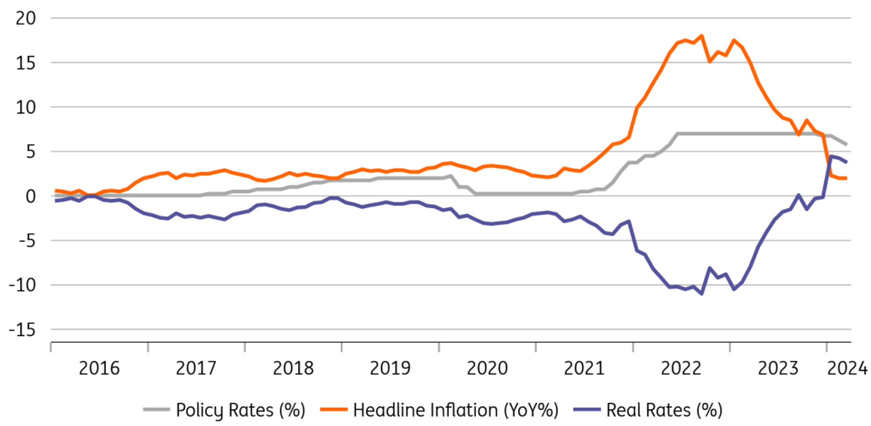
Source: Macrobond, CNB, ING

The neutral real rate has likely increased

The discussion on the neutral interest rate is developing across monetary institutions, be it the Fed, the ECB, or the CNB. The core of the concept is about setting the monetary policy rate in such a way that the economy operates close to its potential while inflation remains unchanged near the target. In short, the neutral nominal rate consists of inflation and the natural real interest rate. The latter is, however, unobserved and time-varying in the context of the evolving economic structure. Indicators such as productivity, economic potential, the real exchange rate, and demographic developments have a decisive impact.

We estimate that the real interest rate for the Czech economy is currently in the range of 1.0-1.5%. It contrasts with the very low or negative real rates of past years, which Governor Ales Michl has criticised: "This is not an anti-inflationary policy. This can hardly be made up for by sudden and rapid rate hikes when inflation has already set in."

Real interest rate has been low or negative in recent years (%)



Macrobond, CNB, CZSO, ING

Focus on the neutral real rate sets a floor to medium-term outlook

The currently elevated demand for capital and investment related to the energy transition and positive net migration to the Czech Republic could increase the real neutral rate. The CNB has indicated that it will comment on the issue at next week's meeting. However, it is uncertain whether it will proceed with any quantification. It is, after all, an unobserved variable. "The neutral interest rate should be seen as an academic concept rather than as the goal or end point of the current monetary easing process," said board member Jan Prochazka.

For reference, however, forward markets price the one-month CZK swap rate at around 3.70% in two to three years' time and any validation of our own estimates for the Czech neutral real interest rate could prevent those forwards from being priced back under 3.00% again.

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