CNB preview: Above-target inflation amid below-potential expansion

The CNB will decide between a pause and a 25bp rate cut this week depending on whether elevated inflation or subdued economic growth amid stagnant investment is a bigger concern. The comfort of seeing January's inflation breakdown, along with a recently more cautious approach from the ECB, will likely foster a more hawkish tone

Czech National Bank building in Prague

Money supply matters for all prices

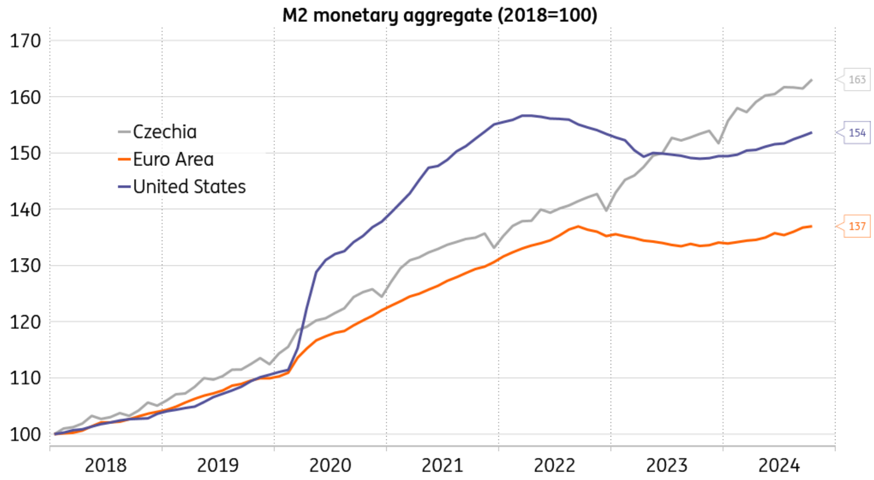
Czech National Bank Governor Ales Michl favours below-target core inflation as desirable for the fulfilment of the CNB's price stability mandate, stating that the central bank "will choose stability of interest rates for some time, and assess the new forecast with a goal of bringing core inflation slightly below 2% and the overall inflation to the target."

This is a clear commitment, and suggests that past mistakes should not be repeated – even with respect to taming the amount of money in circulation, which is crucial for taming inflation. Indeed, inflation is largely a monetary phenomenon, as too much money in the economic system lifts all price tags.

However, when looking at the Czech M2 monetary aggregate, its annual dynamic has hardly decelerated below 5% since the fight against high inflation started in 2021. It has recently accelerated to 6.3% when compared to the previous year's October. Meanwhile, comparable monetary aggregates declined in the US and the eurozone when the battle against high price growth became most intense, remaining still below or close to the 2022 record height.

Of course, a converging economy like the Czech Republic's can see robust growth in the money supply – however, after a year of stagnation and only a mild recovery, this may seem on the strong side.

The Czech money supply increases steadily

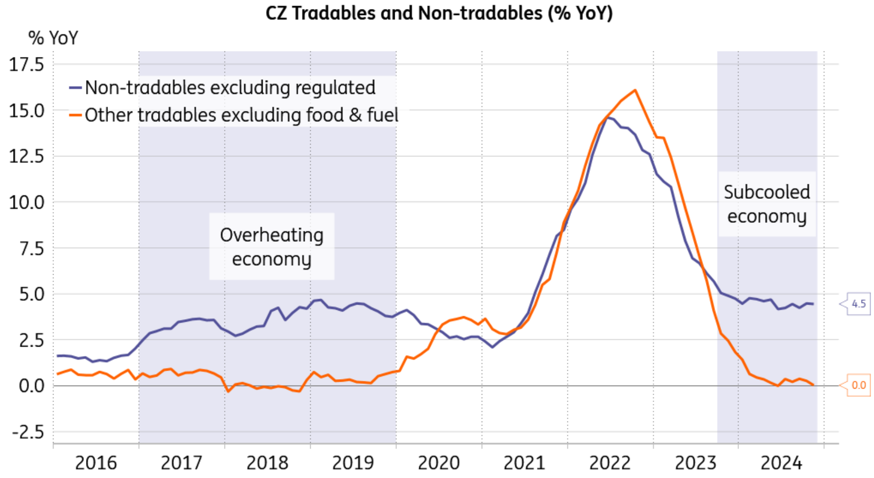


Source: Macrobond

The inflation structure remains worrying for Eva Zamrazilova, the CNB's Deputy Governor, with prices of services still growing more than 5%. This is above the desirable dynamic for the central bank, which is closer to some 3.5% for an economy in a price convergence mode. She voted for a pause during the previous meeting and incoming data is likely not about to alter her views.

Indeed, the price dynamics of non-tradables – a good proxy for services prices – hasn't cooled off, still flying at 4.5% annually in November. Even driven by this inertia, our own forecast sees headline inflation peaking at 3.4% in December and remaining above the target through the next year.

Non-tradables inflation is persistent



Source: CZSO, CNB, Macrobond

Still, the appetite for further rate cuts has likely not entirely vanished in the bank board, as the lingering rebound amid weak investment activity is asking for a boost. The recent koruna appreciation and softer-than-expected headline and core inflation in November also bring some relief.

However, the strengthening exchange rate is solely driven by markets tilting toward the pause option and a more hawkish setup on the outlook. Still, with year-end inflation above target, along with some upward risks for January's reading, we see the December pause as a safer bet for the upcoming vote.

Price stability is closer to Czech policymakers' hearts as the economic recovery continues, albeit at a moderate pace. With stronger-than-expected household spending along with upbeat nominal and real wage growth, it makes more sense to wait and see how January's inflation breakdown looks before moving ahead with further rate cuts.

Inflation in January is key to further easing

Price moves in January tend to be rather pronounced as the annual or semi-annual adjustment of the price lists takes place. In our view, January's CPI will be largely driven by a monthly increase in food and fuel prices.

This will be partially compensated for by reduced electricity end prices, which will drag regulated prices into a monthly decline. Higher imputed rents and persistent price growth in the service sector will drive core inflation. Such monthly moves will translate into annual headline and core inflation at 2.7% at the beginning of the year, allowing for further easing of monetary policy should the economic rebound remain rather mild.

However, if there is a spike in food prices or rents, with more potent headline and core rates, the bank board might have second thoughts about further rate cuts down the road. Especially as real interest rates hover below 1%, the monetary policy stance does not seem restrictive enough to break the price inertia in the service sector under conditions of robust household spending.

Inflation to remain above the target

Dec-24	% YoY	% MoM
Headline	3.4	0.1
Core	2.3	0.1
Food	4.4	0.2
Regulated	7.1	0.2
Fuels	-2.3	0.9

Jan-25	% YoY	% MoM
Headline	2.7	0.8
Core	2.7	0.6
Food	3.9	2.0
Regulated	0.8	-0.4
Fuels	-1.3	0.5

Source: ING

Annual wage growth will be another concern from the inflationary perspective, as it came in stronger than the CNB has previously expected. Nominal wages added 7% in the third quarter, while annual wage dynamics picked up to a robust 4.6% when adjusted for inflation.

Moreover, nominal wages in the industry accelerated to 7.2% at the beginning of the year's last quarter and to 10.1% in the construction sector. With construction activity likely gaining steam after the winter season, labour market tightness is about to prevail throughout the next year, driving solid wage increases, relaxing household budget constraints, and providing enough firepower to spenders.

Something is rotten in the state of Denmark

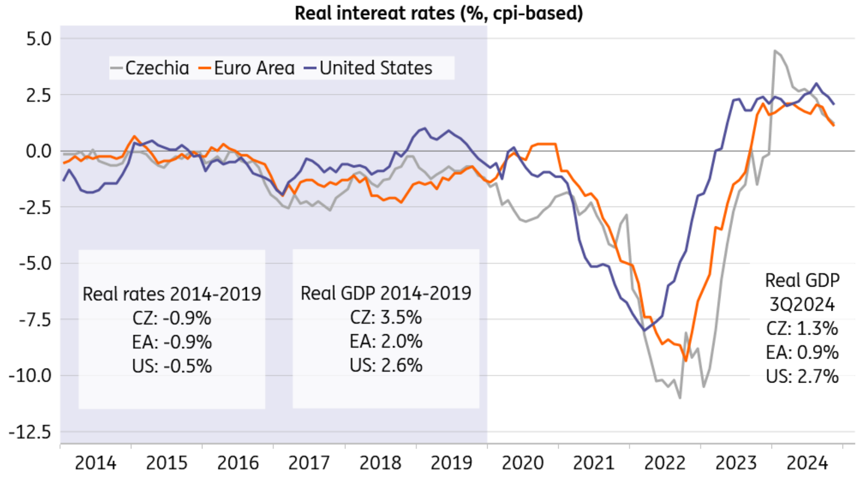
Consumers are driving the Czech recovery while investment remains dormant, which will be another topic to consider for the bank board. To a certain extent, the degree of adjustment in an economy can be measured by the investment activity, which also reflects the propensity for innovation. Czech fixed capital formation has stagnated for over a year but is at least some 9% above its 2019 peak.

Meanwhile, fixed investment in Germany has been trending downward for four years in a row, now more than 7% lower than their pre-pandemic level. In contrast, the US fixed investment is almost 19% above its 2019 peak. Indeed, expecting decent economic growth in economies with undermined investment ethos and fading investment activity is foolish.

At the same time, elevated interest rates don't seem to be the main reason for the disappointing investment in the Czech economy. Real borrowing costs over the upbeat growth period between 2014 and 2019 were negative on average for Czechia and the eurozone, yet less so for the US. This period of ultra-low rates was, however, followed by a devastating inflationary tsunami that brought real rates to extremely negative levels, with household real savings and purchasing power suffering.

Central banks will therefore likely be reluctant to return to a sub-zero real rates world. Fast forward to 2024: real borrowing costs for Czechia and the eurozone are again somewhat lower than across the Atlantic, but economic growth is hardly half as strong. Well, it must be something other than interest rates being too high that's hampering European economic performance.

Real borrowing costs decline while Czech growth remains tepid



Source: Macrobond

Support for economic growth with lower interest rates has limited effects if the economy's structure is wrecked and the investment incentives are undermined. On the other hand, the first rule of any organism is to adapt, because the world is not standing by – it's moving along.

Suppose Europe cannot adjust to the changing global landscape when it comes to friends and foes, throat-cutting competition, growth-fostering policies, and retention of research and development. In that case, its economy is heading to oblivion. Two ingredients are needed to move ahead: ability and willingness. Should Europe be unwilling to introduce changes that would propel its economic prospects and investment appetite, it will sooner rather than later lose even the ability to expand, regardless of any wishes.

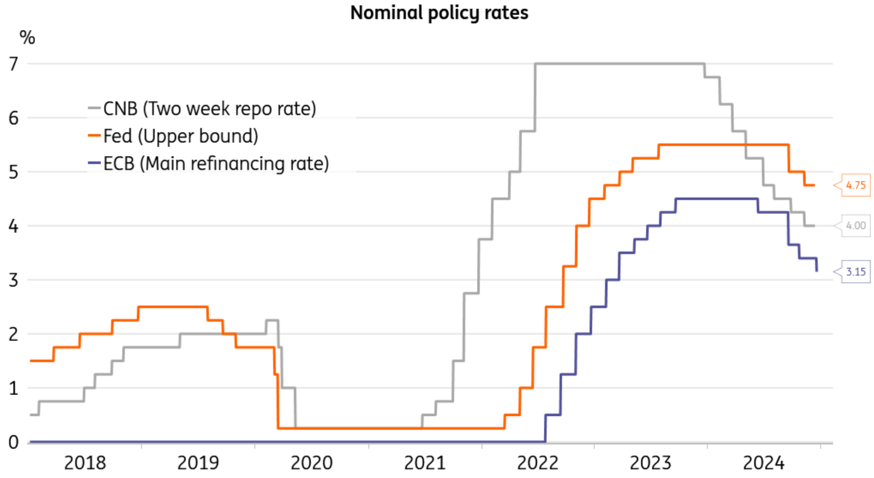
Between Scylla and Charybdis

Two major European countries, Germany and France, now face political instability that will likely be anything but good for Europe's economic performance. As we know, the economy is an adventurous field because of the rich feedback loops. We also know that things can quickly turn nasty in financial markets. So, let's hope we won't face another whatever-it-takes moment soon. In such an adverse scenario, worries about price stability would likely become a second-tier consideration.

In any case, if the very recent concepts of no-growth become a reality in Europe, even unintentionally, the price to be paid will be measured in currencies of wealth, well-being, social peace, and political stability. It's not rocket science to understand that better economic performance is needed to safeguard the *In varietate concordia* for future generations. Sub-zero real rates do not offer a proper solution, for a number of reasons.

If general uncertainty is too high and a viable plan to get out of the misery is not at hand, it can be hard to make firms borrow even in conditions of sub-zero nominal rates and even if non-standard monetary policy measures (such as quantitative easing) are being carried out. The European Central Bank chose a cautious approach with its recent 25bp rate cut, which will make a more hawkish attitude from the CNB somewhat easier.

Cautious ECB approach will foster CNB hawkish tone



Source: Macrobond

The European economic malaise and the ECB's compulsion to compensate for structural weaknesses will also impact the CNB's decision function. It will continue to navigate between Scylla and Charybdis for some time ahead: the economy not being able to lift off properly on the one hand, with Czech inflation flying above the target on the other. How to prioritise and whether to cut rates will remain a key dilemma.

Our market view

The hawkish CNB board turn and a possible pause in the cutting cycle has visibly supported the koruna, which has only strengthened since the US election result despite a significant EUR/USD move lower. Since the US election, we've seen a strong reconnection with the rates differential, which has become the only driver in recent weeks. This leaves EUR/CZK at its lowest level since the surprise 50bp cut from the CNB in June, which triggered the EUR/CZK spike.

At the same time, the koruna is roughly 1% stronger than the CNB expected in its November forecast. Yet the CNB board saw the weaker CZK in the new forecast as one of the reasons to be hawkish. EUR/CZK is probably not a topic for the December decision at the moment, but should push the needle in the direction of more cuts in the general discussion going forward. The market is pricing in a pause in December pretty much fully, so the question is more about the vote split and the governor's rhetoric during the press conference. If we see some votes for cuts, given the hawkish pricing, this could signal a weaker CZK.

The market is pricing in only 12bp of rate cuts for the next three months, which we think is too hawkish. However, the situation is heading into a binary scenario depending on January inflation. If the number is low enough, the CNB may continue with rate cuts in February, while otherwise we may find ourselves in a situation where the November rate cut was the last in this cycle (in an extreme case). Market pricing in our view now underestimates the chance of a February meeting at this point, although our economists expect a pause as well.

Author

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Disclaimer