

CNB preview: Easing story comes to an end

An improved outlook for economic growth, driven by an expected boost to defence spending, will influence the tightness in the labour market, robust wage gains, and upbeat inflation pressures. The renewed convergence requires relatively tight monetary policy so that inflation does not get out of hand. Just finish this easing act and move on

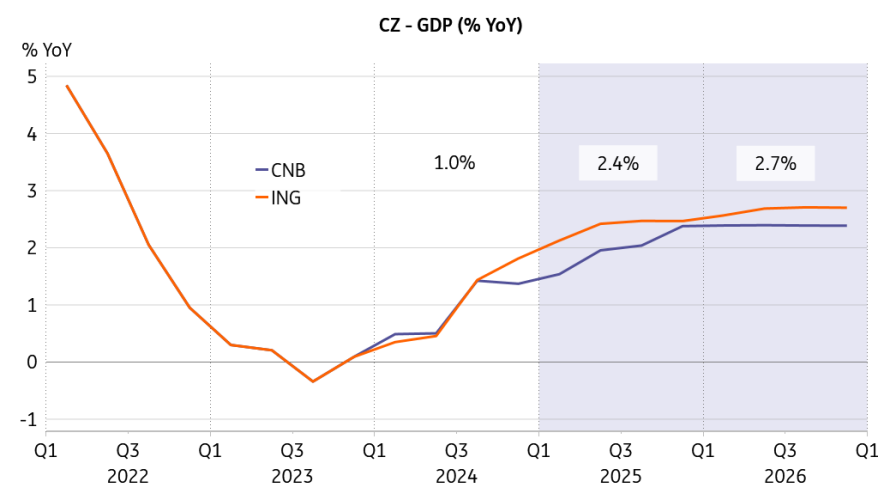


Czech National Bank headquarters in Prague

Punchy economic performance can feed inflation

Our outlook for Czechia's economic performance received a non-negligible boost recently, with real GDP growth lifted to 2.4% for this year (from 2.1%) and to 2.7% for next year (from 2.5%). This year's change is mainly driven by the revision in 2024, carrying a more upbeat performance towards the year-end. The change for next year reflects discussions and plans for additional defence spending, which will benefit Czech industry and the economic performance. Our current growth forecast is thus 0.4 and 0.3 percentage points above the latest Czech National Bank Winter projection for this year and next. Two pistons are driving the recovery right now: robust consumer performance and a revitalised construction sector.

Economic expansion set to lift off



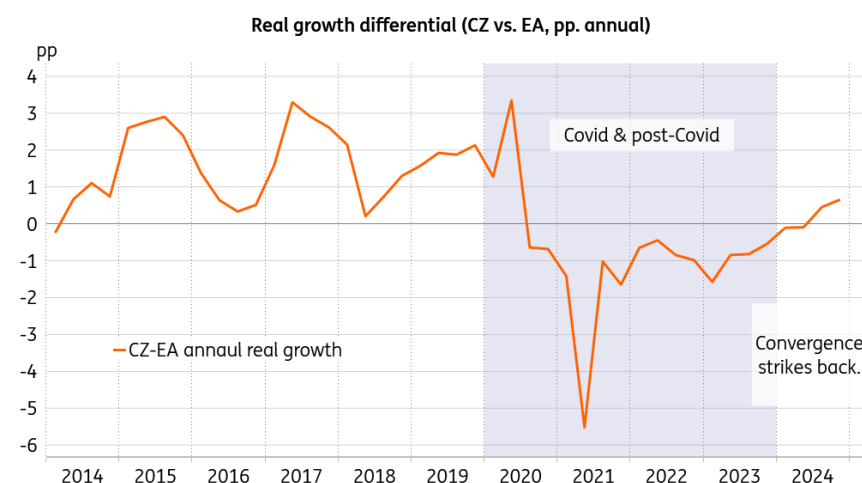
The annual wage growth of a robust 7.2% at year-end came in above the CNB's expectations of 7%, while real wage gains were higher than market participants had foreseen. Annual real retail trade was softer than expected at the beginning of the year. However, this is largely due to base effects, as the pattern was exactly the opposite in December and January in previous readings. We don't think the retail sales deceleration is particularly noteworthy, as the yearly growth rate is influenced by distortions. We conclude that Czech households have enough financial muscle to support the economy with their spending.

The labour market has softened somewhat as layoffs in industry kick in, but this has not yet significantly impacted the strong wage growth. Moreover, the construction sector has partially compensated for these job losses, and should industry hit bottom in the near future, as we believe, the scarcity of labour could again become one of the main bottlenecks for further economic expansion, without generating inflationary pressures.

Inflation to remain elevated with more risks in the pipeline

And here we approach the soft spot of any central banker's heart: inflation will likely not drift back to the target. It will likely hover in the upper tier of the tolerance band, hitting the limit here and there over the course of this year, and will remain above the target well beyond. We see inflation averaging at 2.7% this year and remaining at 2.4% next, which is 0.3 percentage points above the latest CNB forecast. When plugging in all the available predictors, our best guess about the nearest headline inflation reading in March is a stable 2.7% annually, with a marginally softer core rate and more potent food price growth.

Real growth outperforms eurozone once again

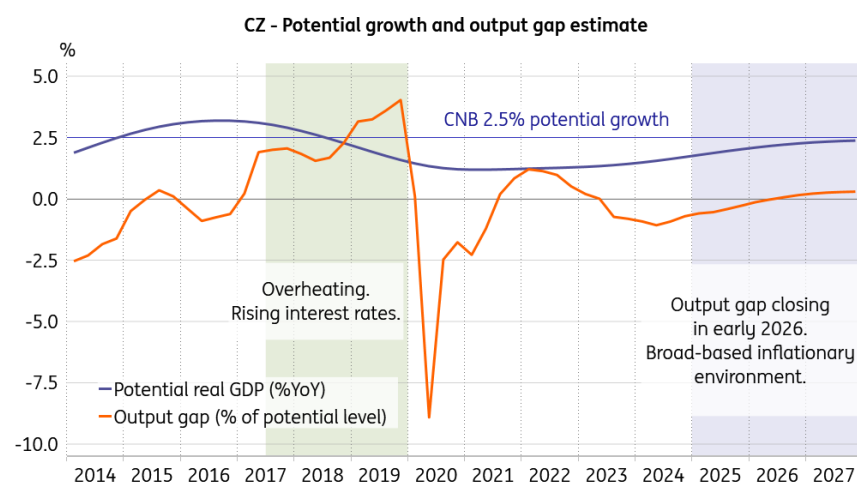


That said, we see a punchier inflation outlook even in conditions of a stronger koruna against the euro compared to the latest CNB projection, as the robust spending fosters persistence in consumer price dynamics. Indeed, the Czech economy is positioned for an accelerating expansion, supported by consumer spending, a rebound in construction, and likely the bottoming out of manufacturing. Such growth will likely halt the recent easing in the labour market and add heat to broad-based inflationary pressures over the coming quarters. These jigsaw pieces compound the story of renewed convergence to the more advanced eurozone economies regarding prices, wages, and real growth performance. In turn, the growth outperformance vis-a-vis the eurozone will support the koruna against the euro over the coming quarters.

Finish the job and look ahead

With the Czech economic rebound gaining traction, the current leitmotif of monetary policy easing comes to an end. We believe the bank board is in a general position to get the easing job done, proclaiming an agreed nominal rate as an equilibrium or natural rate, and looking ahead to what comes next. Our output gap estimate suggests that it would come into a neutral position early next year, along with a gradual recovery of the potential growth. Once the output gap turns positive, the economy should start to see general shortages in production inputs for the given output level, resulting in a situation much more favourable to broad-based price pressures across economic segments than seen before. We see a parallel situation in 2017, as the economy decisively entered a phase of overheating, and interest rate hikes followed suit in August.

Output gap is gradually closing while potential growth increases



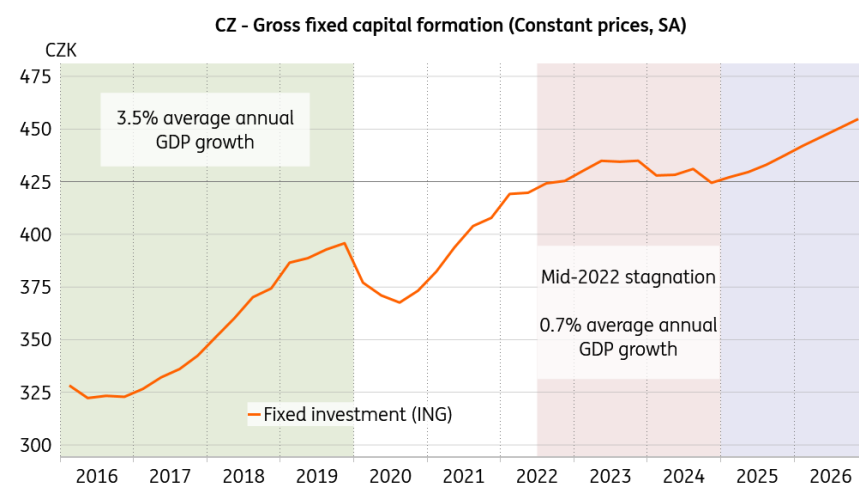
Should the base case of an economic rebound prove right, we expect broad inflationary pressures to intensify from mid-2026 onward. There are other supporting elements for this outcome stemming from the political domain, such as the EUR 500bn defence and infrastructure fund agreed in Germany, including some relaxation of the debt brake. There is also a critical consensus across the Czech political spectrum that defence spending should be increased, perhaps to some 3% of GDP. The CNB has indicated that it sees extra fiscal expansion as a clear risk to consumer price growth.

The Czech industrial base has a lot on offer in the arms industry, so the overall Europe-wide propensity to spend more on defence would provide an additional boost to the Czech economic performance, which is already, to some extent, reflected in our more upbeat projection. The shift from manufacturing cars to producing weapons, following Europe's awakening after three years of intense conflict, is likely to benefit Czech economic performance in the coming years.

Investment and productivity are flashing red

Manufacturing, the backbone of the Czech economy, has not been doing well for a long time, which manifests itself in stagnant industrial production from 2018 onwards, and flat investment activity for the last two-and-a-half years. This situation may change soon, as we believe that Czech industry has overcome the worst of its challenges, which is confirmed by the latest confidence survey. Business confidence in the economy increased in March across all sectors, with industry picking up to 94.8 points, the highest level observed since last October.

Investment has suffered but the future looks way better



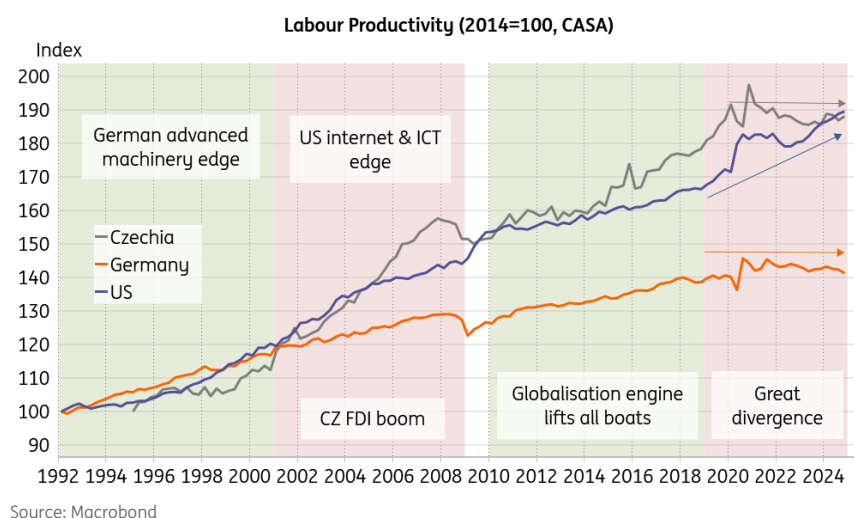
However, there is a serious threat of a vicious cycle when an economy fails to attract investment, struggles to retain it, and ultimately faces disinvestment. Such is the case with Germany, Czechia's most important trading partner, where fixed investment has been trending downwards since 2019 and is now at roughly the same level as in 2016. To enhance labour productivity, all the extra fiscal spending planned across Europe must be used efficiently and directed towards fruitful sectors.

Nevertheless, this is not guaranteed and must be realised in practice, as labour productivity has long been overlooked in European efforts. However, we see a viable path for the Czech economy to thrive, driven by four key factors: sustained household consumption, a rebounding construction sector, a bottoming out of industry and investment, and the resurgence of strong export performance.

Why landing lower might be strategically benign

The labour productivity quandary remains an open wound. When taking a broad perspective and some degree of simplification, we see that Czech and German productivity amelioration has broadly kept pace with the US for a long time. We see periods when one had outperformed the other, benefitting from the German advanced machinery edge or driven by the intensive internet and ICT development in the US. However, something obviously changed around 2019, when the labour productivity gains stalled in Germany and were wiped out for the Czech economy only two years later.

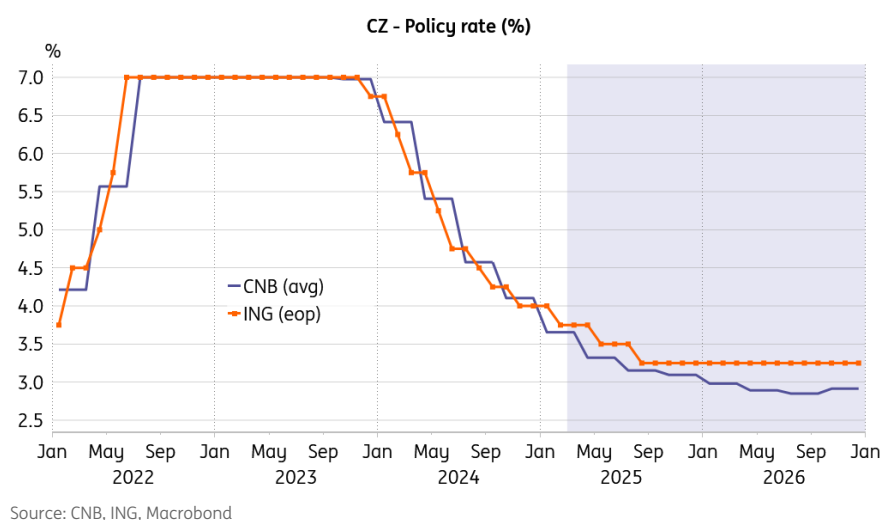
Czechia and Germany do not necessarily lose out to the US



Also, things still can go wrong for industry, as there are many structural hurdles on the European scale, such as the high price of the emission allowances resulting in prohibitively high energy prices. Mounting administrative costs and regulatory red tape that firms in Europe face are also not helping in the context of fierce global competition, with European competitiveness under pressure for a long time. One also has to admit that there is quite some uncertainty about dealing with such difficulties when looking ahead.

The hurdles to investment appetite and improved productivity represent a key issue for European economies, as labour productivity gains allow for higher consumption of better-quality goods and services at a manageable increase in the overall price level. This is a crucial element when determining where the CNB should set the policy rate for the next year or so. The stronger the economic expansion, the higher the likelihood of additional price pressures. Given the persistent tightness in the labour market, a policy rate of 3.5% is worth considering.

Eagle has landed: soon enough



From a strategic standpoint regarding future communication, it is essential to demonstrate that every effort was made to help the economy reach its potential after several wasted years. Hence, we echo Cato the Elder: *Ceterum censeo Carthaginem esse delendam*. Setting the base rate at 3.25% this summer is the preferred option, providing a more favourable starting position for the next phase. This target is likely to be achieved through rate reductions in May and August, when a comprehensive CNB forecast is available.

Our market views

The Czech koruna does not seem very interested in local or global events in recent weeks. Although EUR/CZK is gradually trending lower, it still seems locked in a range of 24.950-25.150, significantly less volatile than its CEE peers. However, the picture for the CZK is positive for the coming weeks in our view and we are reasonably bullish. On the local side, we can expect support from a hawkish CNB and possibly some repricing next week. On the global side, we see three main stories at the moment. While the German fiscal expansion and a possible ceasefire in Ukraine is positive for the CZK, incoming US tariffs on 2 April pose downside risks. In particular, for the German fiscal story, the CZK seems to be the clearest trade within the CEE region due to its links with Germany, proximity and the size of the Czech military industry. Thus, in our view, EUR/CZK has a good chance to retest levels below 25.00 and potentially new lows this year below 24.900 in the coming weeks.

The rates market adjusted its expectations for next week's CNB meeting following comments from board members ahead of the blackout period. It now sees a minimal chance of a rate cut at the March meeting. Looking ahead, the market is quite confident about a rate cut in May when the CNB publishes a new forecast but the next outlook is rather unclear. Although the market is still pricing in a roughly 3.25% terminal rate this cycle, assuming a return of 3M PRIBOR above the base rate, the timing is roughly evenly spread over the second half of the year with no clear preference. As we see increasing chances that the May rate cut may be the last, while the entire IRS curve rallied in the final days following core markets, the CNB meeting may be a good opportunity to see some upward repricing and pay rates at the short end of the curve. On the other hand, the long end of the IRS and CZGBs curve still looks cheap following the move in the German Bund after the fiscal expansion announcement. In the CZGBs market, we see particular value at the long end of the curve in both the outright and ASW vs IRS curve.

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