

Czech National Bank preview: We see a 25 basis point cut as likely

With inflation on target, elevated real interest rates, and mounting uncertainty around the growth outlook, the monetary policy stance seems restrictive. However, lofty wage growth and expectations, a sensitive exchange rate, and higher-than-expected rates abroad suggest that the pace of rate reduction could slow down in August



The Czech National Bank in Prague

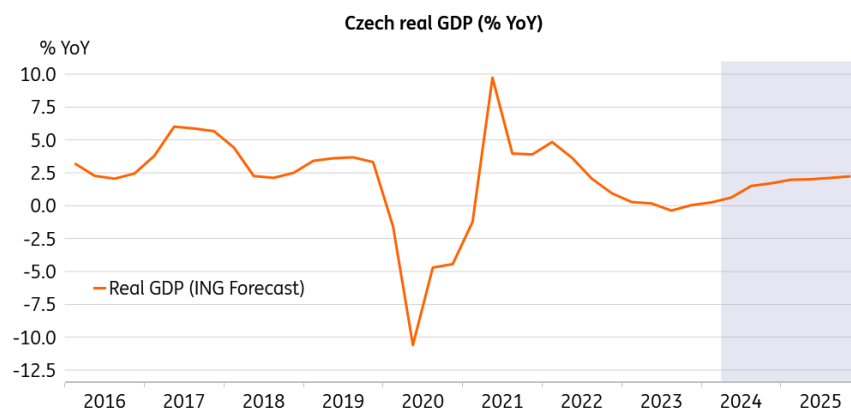
Summer forecast: ready for revision with growth taking centre stage?

We will receive the summer update on the economic outlook along with the Czech National Bank (CNB) decision on policy rates in early August. The economic story presented in the CNB Spring Forecast remains broadly intact, except the growth momentum at home and abroad is losing some steam. Hard monthly indicators such as industrial production and seasonally adjusted real retail sales point to fading momentum in domestic economic activity, while laggard new orders from abroad mirror softening in foreign demand. The leading indicators flash some worries when looking ahead, with consumer and business sentiment dropping in July. The mood of the Czech consumer has deteriorated for the third consecutive month, with worse financial conditions and with the outlook being the main drag.

The prevalence of an economic rebound is crucial to future inflation and rates path. Consumers

played their part well in the recent onset of economic recovery, demonstrated by a pickup in demand and buoyant spending. However, we would like to see the supply side lift off some two quarters after the consumer has spoken to make the rebound full-fat and sustainable, which is not exactly happening. The CNB's expectation of inflation hovering just below the target from second quarter 2025 onward is subject to conditions of 1.4% economic growth this year, followed by an acceleration to 2.7% in the next, with household consumption being the main expansion driver. Still, investments are foreseen to contribute their fair share this year, which does not seem to be the case right now.

Economic activity set to gradually rebound



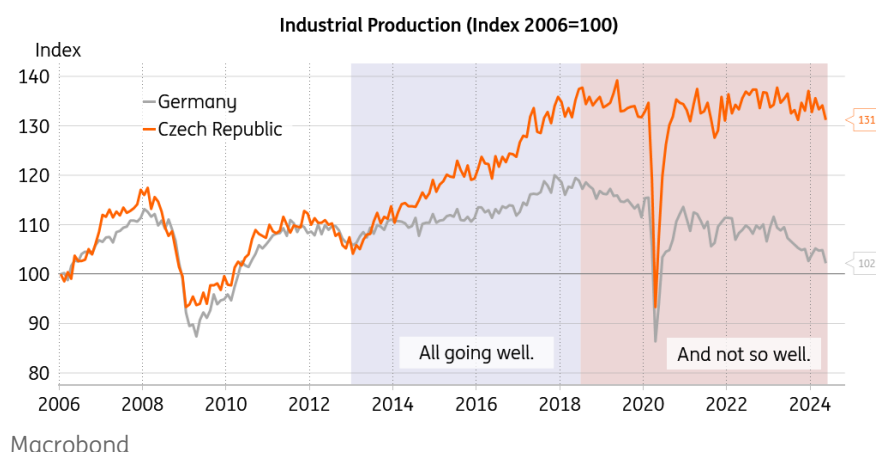
CZSO, ING, Macrobond

Our estimate of a 1% real GDP gain this year remains on the conservative side of the expectations spectre, factoring in the continued weakness in industry and investment. The question is whether the consumer can continue spending like there is no tomorrow if the industrial segment continues to suffer and businesses become more reluctant to boost wages amid palpable uncertainty. Overall, the tepid economic activity and a rather bleak outlook with consumer inflation on target make the case for further reduction in monetary policy restrictiveness down the road.

The hiccupping German engine takes a toll on the Czech industrial performance

The CNB saw a weak performance of the German economy as the main anti-inflationary risk, which seems to be unwinding right in front of our eyes. In short, the Czech main trading partner is burning more coal to deliver less industrial output. The outlook for the second half of the year does not look rosy for Czech exporters, with the [German engine](#) remaining in standby mode and the somewhat disappointing onset of the whole eurozone economy into the summer. Overall, the recent data points to mounting risks to economic activity, and we expect the CNB to somewhat lower their forecast of this year's output. We will get second-quarter GDP numbers towards the month-end, just before the CNB meeting. Nevertheless, it will hardly be fully plugged into the new CNB Summer Forecast.

Industrial production remains in limbo



The Czech industrial production seems to have set on a downward trend in recent months, which is not good news for an industrial and export-driven economy. The pricing in the manufacturing sector is also on a very soft footing, with supply-side inflationary pressures remaining at bay. Agricultural producer prices have been falling for 14 consecutive months, and prices in industry added only 1% from a year earlier in June. The service sector represents the only exception, as its inflation shows an extra portion of resilience, given that the price growth in business services remains twice as high as the 2016-2019 historical average. Still, no imminent price pressures stemming from the supply side make the direction of further rate cuts a straightforward take.

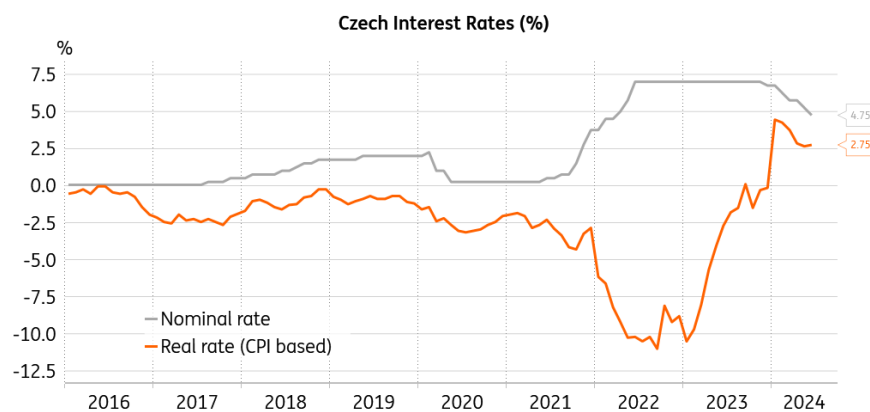
Further loosening seems the preferred way forward

We expect the CNB to lower the forecast of headline and core inflation on the year ahead horizon, reflecting the recent softness in consumer prices, but also the incorporating the reduction in energy prices for customers by some large distributors. Food prices remain a volatile item with two-way risks for near-term inflation prints, but a likely subdued dynamic reflecting the protracted and pronounced fall in prices of agricultural production. We see headline and core inflation remaining close to the target in the coming months.

According to the recent statements by the policymakers, all three dominant options are at play: (i) no rate cut followed by stability in rates for some time, accentuating the often mentioned leitmotiv of caution, (ii) a 50bp cut, focusing on the reduction of restrictiveness in the current monetary policy stance given the uncertain growth outlook amid low inflation, and (iii) a 25bp rate reduction that delivers the best of both worlds.

As the Board Member Jan Prochazka puts it: “Maybe we’ll lower rates further, or maybe we’ll take a pause.” For other policymakers, a 25bp rate reduction represents a good entry point for discussion. As Deputy Governor Jan Frait summarised: “It is clear that the main focus of the debate on 1 August will be a 25bp cut. On the other hand, the latest inflation print was very low, which is reopening the question of whether there perhaps still is room to do another 50bp. I personally will be deciding between 25 and 50 basis points”.

Real interest rate remains elevated



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Indeed, the monetary policy stance looks restrictive, with the real interest rate at 2.75%, given the headline inflation on the 2% target and uncertainty around the recovery mounting. The economy could benefit from lower rates after a year-and-a-half of stagnation, however, only to a certain extent, as issues of a structural nature are to be found behind the economic malaise. We see a rate cut as a solid way forward at the next CNB meeting, be it 25bp or 50bp, with the magnitude depending on the assessment of the domestic growth outlook on one hand and external factors such as the exchange rate and foreign monetary policy stance on the other.

Exchange rate volatility and elevated rates abroad warrant the soft approach

The 50bp rate reduction in June implied roughly a 1.5% weakening in the koruna vis-à-vis the euro, along with a boost to exchange rate volatility. The Czech policy rates also got well below the Fed base rate, and the differential toward the European Central Bank rate has been substantially suppressed. This may make holding the Czech currency seem rather unattractive and contributes to imported price pressures, which may tilt the August decision toward a 25bp rate reduction. In such a case, we expect the koruna to return to levels close to 25 EUR/CZK shortly after the decision.

Koruna depreciated after the recent cut

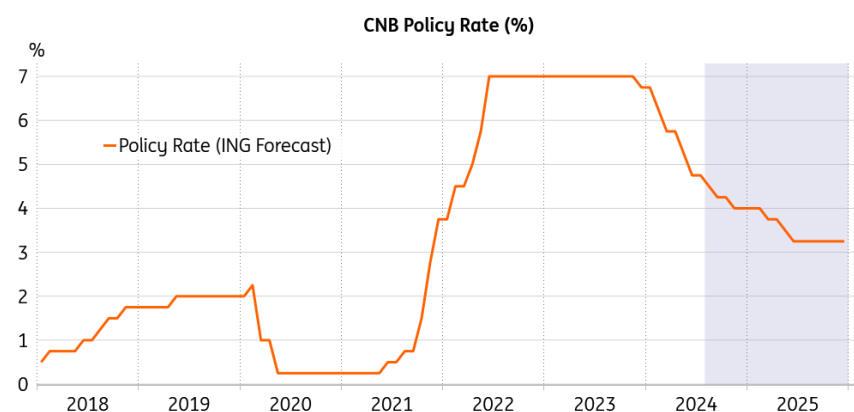


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The discussion on the long-term equilibrium real rate also goes in the direction of a softer approach to future rate cuts. More board members recently noticed that the neutral nominal interest rate is likely higher than the level currently plugged in the CNB main forecasting model. As Jan Kubicek noted: “For a long time, we have had it set at 3%. But in Europe and in the US, many economists now believe that this rate is higher than previously thought. Personally, I am of the opinion that this also applies to the Czech Republic. I would see the rate above 3%, perhaps at 3.5%”.

The overall rates trajectory would require an upward shift in the CNB new forecast, especially at the longer end. In such a case, it is a viable plan to reduce the policy rate by 25bp from August onward to close to 4% at the end of this year and further to 3.25% at the end of the next. Thus, we take this schedule into account and take the 25bp rate reduction in early August as our base case scenario.

Interest rates are expected to fall further



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Our market views

EUR/CZK has maintained a significantly strong relationship with the rate differential in recent weeks, which is basically the only driver for FX right now, isolated within the CEE peers. Surprisingly low June inflation and subsequent strong dovish pricing pushed EUR/CZK to 25.400, the highest this year, and above CNB forecasts. Having said that, if the CNB cuts rates by 25bp next week, which is our economists' base case scenario, we are very likely to see the CZK rally. However, the key here will be more central bank forward guidance. The priced terminal rate has dipped significantly on the downside in recent weeks and the new rates forecast in the context of the central bank's neutral rate discussion may have the biggest impact on EUR/CZK here. Overall, unless the CNB surprises with a bigger rate cut, we think EUR/CZK could be at its peak and a 25bp rate cut accompanied by a hawkish forecast and rhetoric may unlock a CZK rally with the potential to go below 25.00 EUR/CZK.

CZK rates and bonds have rallied strongly in recent weeks due to both the June inflation surprise but also the global rally. Just a few days ago the market was reaching for pricing in a terminal rate of 3.10%. Hawkish comments by CNB board members led to some repricing but it seems to us that the market remains more on the dovish side with heavy receiving positioning and a 25bp rate cut would thus trigger a more significant repricing of the IRS curve to the upside.

The Czech government bonds (CZGBs) market outperformed most CEE peers but still lagged behind the IRS curve move, resulting in ASWs widening. The story on the supply side remains essentially unchanged since the start of the year. The Ministry of Finance issues roughly CZK25bn each month and we don't expect much change here for the rest of the year, confirming MinFin's comfortable position relative to CEE peers. On the demand side, the latest auction showed renewed interest after previous signs of weakening demand. The current lower yields do not seem to be a problem for the market either. On the other hand, if our CNB call is correct, CZGBs may see some selling in response and offer better yields later. On the other hand, the wider ASW offers good value already ahead of CNB and the paying flow in IRS will lead to a tightening of spreads here, in our view.

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