

CNB review: Continued absence of forward guidance amid a soft cut

We got another 25bp rate cut from Czech policymakers - in line with market expectations - with the monetary policy stance remaining in the restrictive zone. However, real interest rates will likely get below 1.5% over the coming months, as inflation remains above the target and the reduction in rates is set to continue in November



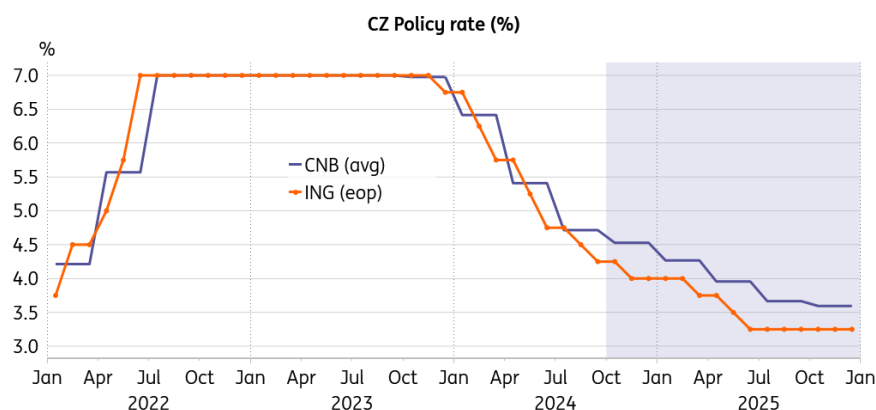
Czech National Bank headquarters in Prague

Easing of monetary policy conditions set to carry on

Czech policymakers reduced the base rate by another 25bp, bringing it to 4.25% at the late-September meeting. We see the Czech National Bank press conference message as neutral, with the governor citing many reasons for a cautious approach during his speech, as mentioned in our [CNB preview](#). What we perceive as new was the firmer stance that has somewhat discounted the imminent impact of changes in foreign conditions on Czech monetary policy, be it the market view or rate reductions by foreign banks. Ales Michl stressed that things could move in any direction every half-year in financial markets while the CNB rhetoric remains unchanged and focuses on maintaining price stability. The need for a more relaxed monetary policy was also addressed, mainly due to the soft economic recovery and inflationary risks assessed as balanced when

looking ahead.

Policy rate has already moved below the CNB outlook



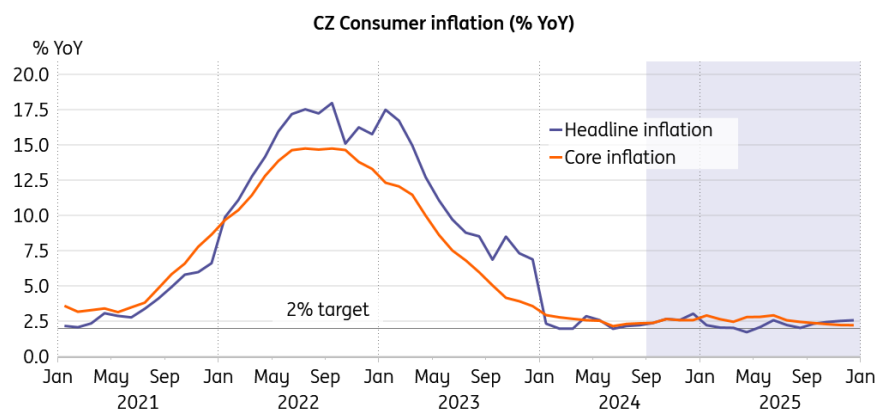
Source: CNB, ING, Macrobond

We maintain our view of another 25bp rate cut in November, followed by a pause in December. The December pause-or-not-to-raise dilemma must be perceived as a close call, given that any forward guidance is absent. That is except for the somewhat outdated summer forecast, with the CNB just getting below their outlook when it comes to the policy rate. The easing cycle could carry on in early spring, bringing the rate to 3.25% by mid-next year, unless there are upward surprises in January's core inflation, such as a spike in the market and imputed rents, reflecting the renewed growth in residential property prices. A downward risk to the Czech base rate is represented by the potential adverse scenario of a synchronous global economic slowdown that would bring the Czech economic rebound to a halt, and likely result in policy rates falling elsewhere.

Services and core inflation do not back off

With headline inflation just above the target and inflationary risks perceived as balanced, policymakers have turned their attention to more support for the lukewarm recovery and the never-ending underperformance of industry. However, price growth in the services sector remains elevated and persistent, resulting in core inflation remaining above CNB expectations. We see core inflation remaining elevated until mid-next year ceteris paribus, i.e. in conditions of continued gradual recovery amid softly declining policy rates.

Headline inflation could increase to 3% in December



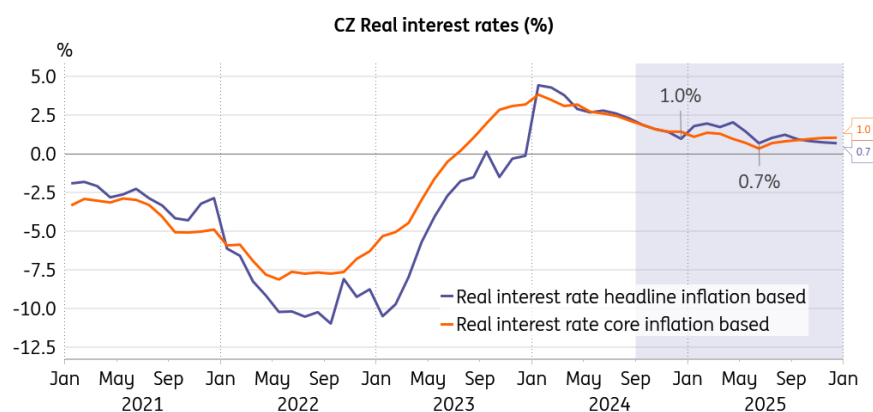
Source: CNB, ING, Macrobond

Headline inflation is set to reach 3% in December, partially due to a low comparison base of the preceding year. At the same time, the announced reduction in end prices of electricity and natural gas announced for September and December by major energy distributors could hold headline inflation in check, with either of these price reductions resulting in a 0.2pp downward effect on the overall dynamic of consumer prices. Still, there is quite some uncertainty about how pronounced those price reductions will be and how they will be recorded by the statistical office regarding the impact and timing.

Level of policy restrictiveness set to decline further

Headline inflation potentially at 3% in December and the base rate at 4% implies a real interest rate of 1%, which is still restrictive as compared with the historical standard of sub-zero real rates. The question is whether the real rates below 1.5% as measured by core inflation are enough to hold core inflation on a short leash, break the stubborn price growth in the service segment, and temper the accelerating credit growth.

Real interest rates close to 1% as measured by core inflation



Source: ING, Macrobond

No forward guidance was provided at all, except that the easing could stop at any time. It is

interesting that simultaneously the governor proclaimed that they are looking more ahead. Providing adequate guidance to the markets is one of the key instruments for any central bank, as both sides can benefit from a well-defined symbiosis. We must conclude that the CNB is not particularly strong in this fine but powerful discipline, to put it mildly. This is not an emergency situation when conditions could change on a weekly or even daily basis. Inflation is close to the target, the economy is gradually expanding, so there are not many reasons to be overly reticent.

The fine art of forward guidance has been lost

To be fair, the CNB is not alone. It seems that many other central bankers have lost their telescopes to watch the horizon and be able to call: "Land!" Instead, the new normal is mostly represented by bouncing from one meeting to another, repeating that they are data-dependent. I mean, who is not? Consider the uninspiring European Central Bank communication. Yet there are exceptions, such as the Swedish Riksbank with clear statements and transparent commitments. Indeed: *ars longa, vita brevis*. Information is appreciated in communication, carrying the potency to form either views or expectations, which contrasts with simple data description. Advisors of the policymakers should perhaps consider obtaining a powerful stereo for the next meeting to play Led Zeppelin's song Communication Breakdown with the volume knob turned to the right.

Our market view

EUR/CZK remains basically unchanged at around 25.150 after the CNB meeting. Although we still see market pricing on the dovish side and potential repricing should support the koruna, the market doesn't seem to see any reason to change anything right now. However, we remain positive on the CZK for this reason. Two weeks from now, the inflation reading should point to some rebound in inflation which may open a discussion on a pause in the cutting cycle in December or February as our economists forecast, and the market may switch to a more hawkish stance given the heavy dovish positioning in the FX and rates market. Thus, we continue to see EUR/CZK testing 25.00.

The market is essentially pricing in full 25bp rate cuts for the next two meetings this year and 2.75% as the terminal rate next year. While this scenario is realistic given the weak numbers from the economy, we think it could be a bumpy road with CNB hawkishness on board. Still, the CNB is indicating higher rates next year and it is hard to see a visible change in communication until at least the end of this year. So on paper, we think the front of the curve is more pay than receive, but of course, the global dovish story complicates this view. Therefore, we continue to see an easier play to this view through FX. On the other hand, the CNB's hawkishness and weak economy should be supportive of the long end of the curve, which, after the rally in USD rates, remains above the USD curve, indicating there is more room to the downside. We have a similarly positive view for CZGBs, which remain cheap relative to the IRS curve, while the supply side remains low without much change, and primary and secondary market demand is strong despite the rally in August.

Frantisek Taborsky

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

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.