

Czech National Bank cuts by 25bp as cycle approaches its terminal phase

The CNB reduced its policy rate by 25bp to 3.5%, as widely expected by markets. Persistent services price growth, solid wage dynamics, and accelerating property prices may put a halt to further easing and will, in any case, foster a more hawkish tone. That said, more growth uncertainty and weak investment may require a more relaxed policy stance



The Czech National Bank cut rates by 25bp, but the end of the rate-cutting cycle is near

Rate cut when headline inflation is below target

The Czech base rate was reduced by 25bp to 3.5%, and the cutting cycle seems to be approaching its final destination in the current conditions. We saw a split vote when six members of the bank board voted for the rate reduction, while one member opted for another pause. The overall message from the Czech National Bank (CNB) was hawkish, yet less so than we had expected and than in previous press conferences. The classic concerns about sticky services inflation, robust wage increases, accelerating home prices, and government spending drove the caution. Meanwhile, new factors making the overall message less hawkish were low energy prices, a global growth outlook surrounded by the fog of the trade war, and not-so-cheerful prospects for Europe's economic performance, including expectations of lower European Central Bank (ECB) rates.

The rate cut was likely baked in the oven of the April downward inflation surprise due to falling food prices, when the 1.8% headline rate slipped below the target (CNB expected 2% in the latest forecast). Still, the Governor gave the impression that the figure itself isn't so interesting. Still, both our forecasts and the CNB's assume that headline inflation will bounce back in May, likely to 2.1% in our view (2.3% CNB forecast). Moreover, food prices are rather volatile and may revert soon, while the price dynamics of services and core inflation are set to remain relatively strong.

The new CNB forecast accommodates one more cut

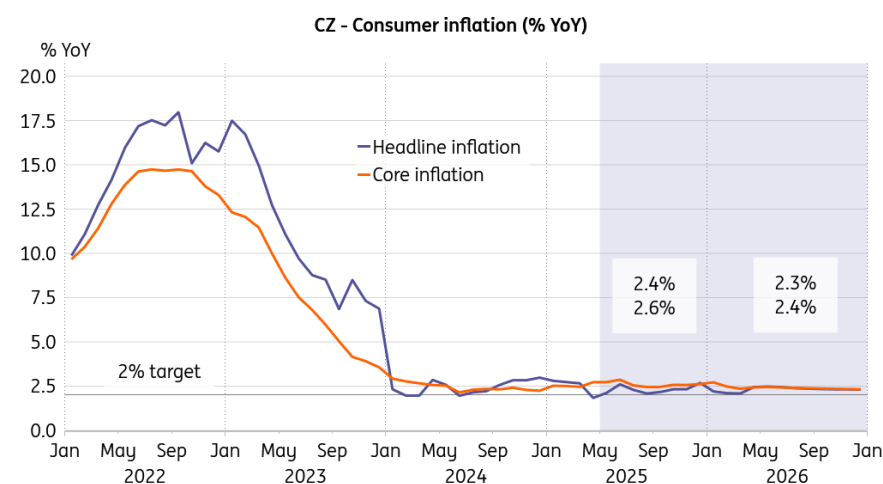
The new CNB spring forecast suggests a moderate descent in the base rate up to the third quarter this year, followed by rate stability. The economic expansion remains unchanged at 2% this year, with household consumption remaining the main engine of growth. Foreign demand acts as a drag, with European industry being suffocated by high energy prices and mounting uncertainty. The less certain global and European economic expansion is a key driver behind leaving the CNB's growth prospects for the upcoming year at 2.1% – well below the 2.4% of the previous projection, despite the planned expansion in military spending.

The CNB sees inflation remaining in the upper tier of the tolerance band around the target, averaging 2.5% this year and 2.2% next year, with both figures 0.1ppt above the previous forecast. So, we have lower real growth prospects, substantially lower global energy prices, and a stronger exchange rate, yet more potent inflation. We'd also note that the softish inflation figure for April came in just yesterday.

The risks to the inflation outlook are deemed by the board as being modestly inflationary, which is a softer gauge than during previous meetings. Indeed, the less certain global growth outlook and lower imported inflation mitigate overall inflationary risks. We see this year's inflation only 0.1ppt below the latest CNB forecast at a similar real GDP growth of 2.1%, while next year's headline rate is expected to be 0.1ppt stronger, also reflecting stronger growth prospects of 2.6% for next year.

At the same time, we continue to predict a stronger koruna, fostered by the renewed convergence toward more advanced economies and potent rates differential vis-à-vis the ECB

Headline below the core rate due to subdued energy prices



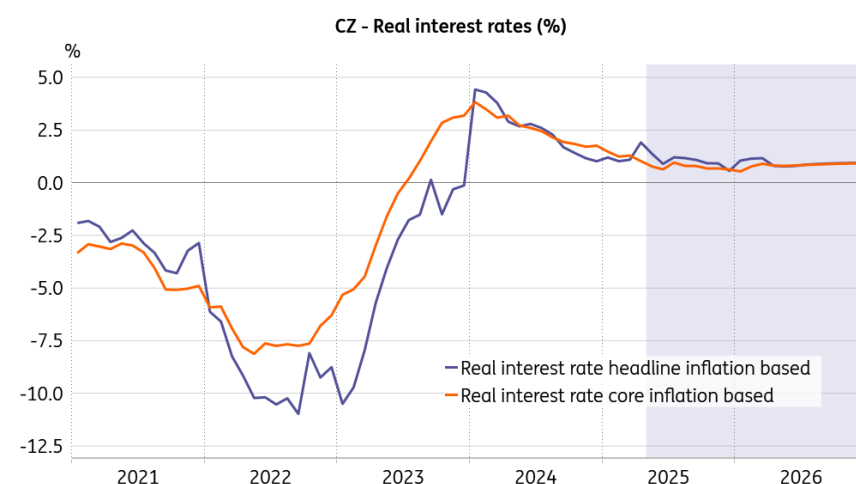
Source: CNB, ING, Macrobond

Nevertheless, stubborn price growth in the service sector, accelerating property prices, and potentially more fiscal spending on defence still remain domestic pro-inflationary factors that will drive caution among Czech policymakers. Meanwhile, declining energy prices should put a lid on price gains in the coming months, possibly trickling down to food prices and regulated prices when remaining subdued for longer. Still, positive real interest rates act restrictively, which is also the setting that enabled today's rate reduction.

Fading investments and a lack of courage threaten future growth

We perceive the overall message of the press conference as less hawkish than initially expected. Domestic inflationary pressures are still tangible, while subdued global energy prices and prospects of lower imported inflation clearly bring some relief. Further easing was not ruled out, and could be considered; our base case scenario counts on a further rate reduction in August, which is enabled by the recent soft inflation reading and persistent structural obstacles that sour the investment appetite across the whole continent. Moreover, taking our inflation forecast of 2.4% for this year and next year, along with April's low figure, the real interest rate remains comfortably positive without risking a slippage to the currently banned negative zone.

Real interest rate to remain safely in the positive zone



Source: ING, Macrobond

The door seems open to further rate reductions, largely depending on two conditions: a) an acceptably low inflation environment persists over the coming months, and b) a lack of clarity in Europe's growth strategy keeps investment at bay. Today's investment simply means future growth potential, and it will become the number one topic over the coming months unless inflation brings a nasty surprise. We think that the expectation of a less buoyant expansion next year provides some insight into the CNB's way of thinking here – including concerns about Germany not being able to come up with a viable economic revamp soon enough, with the chancellor of second choice potentially facing further dissent in government. In our view, the conditions we mentioned should hold fast, so an August rate cut remains our base case scenario.

At this point, it's impossible to disentangle exactly how much of the CNB growth reduction has been made on account of the reshuffle in the global trade landscape, and how much is a result of

a lag in initiative and a lack of courage in Europe to tackle structural issues (including high energy prices, a prohibitive regulatory burden, and reactive trade policy). Protecting European manufacturing from dumping practices will be crucial in reaffirming the importance of the region's industrial foundation and providing clear direction for its future. The Draghi report already highlighted the need to address unfair production and trade practices, though perhaps that's been largely forgotten. Meanwhile, the European competitiveness hype risks becoming nothing more than a fragile sandcastle, once again subjected to Aussitzen – a classic strategy of passive inaction. We'll wait and see whether another wake-up call for Europe's economic prosperity and growth potential simply passes quietly by again.

Our market views

Given yesterday's downside surprise in inflation, today's CNB meeting was less exciting for markets than it seemed a week ago. The central bank tried to put on its usual hawkish face, but markets are used to that tone by now, and we found them little changed after the meeting. However, we may see a different reaction in FX and rates markets. EUR/CZK broke through 24.900 after the press conference, while rates see some downside, also supported by pressure from core markets.

We believe EUR/CZK around 24.900 looks fair for now, and further downside will be limited in the days ahead, given that CNB was less hawkish than we expected. A rebound in inflation over the next two months should again show the central bank turn more hawkish again, with another pause in June while awaiting more data. We think another rate cut will only be considered in August. We therefore retain our bullish view on the Czech koruna, but it is clear that EUR/CZK has less room for downside after the CNB meeting today.

In the rate space, the entire CZK curve is down 3-8bp after the meeting, with the flattening bias coming from the core market. The rates market clearly expected a more hawkish CNB today, still pricing the terminal rate below 3%, closer to 2.75% if we assume PRIBOR is above the CNB rate at the end of the cycle. Similar to FX, paying CNB rates again may gain some momentum with higher inflation in the coming months, but for now, the story is gone, and core markets may drag CNB rates down again.

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