CNB review: Easing continues at unchanged pace with potential inflationary pressures ahead

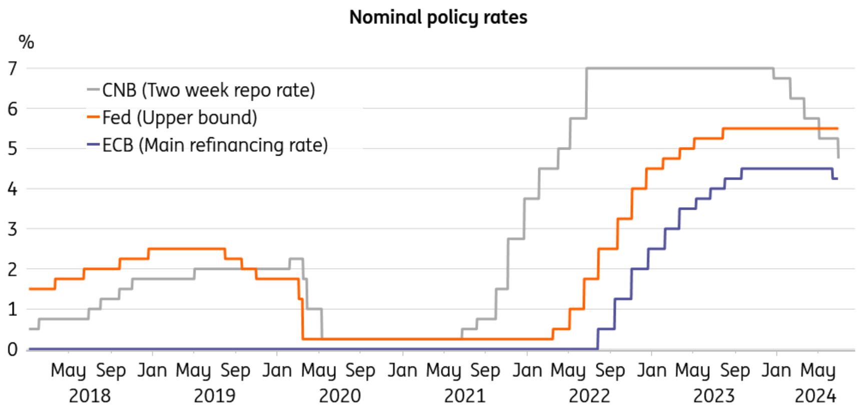
The CNB bank board has continued its series of 50bp cuts, easing the monetary policy stance beyond market expectations. A more cautious approach, including a pause, is possible at the coming meetings, as price pressures stemming from buoyant wage growth and spending represent a risk

Source: Shutterstock

Larger cut becomes weapon of choice

The Czech National Bank lowered its main interest rate by 50bp to 4.75% on Thursday, surprising market participants who expected a more modest approach. The upbeat wage growth and quickening in consumer spending are contributing to potential inflationary pressures that could drive consumer prices higher in the coming quarters. "The reason not to expect further significant interest rate cuts is that the Board sees upside risks to the outlook. Their fulfilment would mean that inflation would detach more permanently from the target towards the upper end of the tolerance band in the coming quarters," said Governor Ales Michl at the press conference.

CNB cuts in molto vivace pace



CNB, ECB, Fed, Macrobond

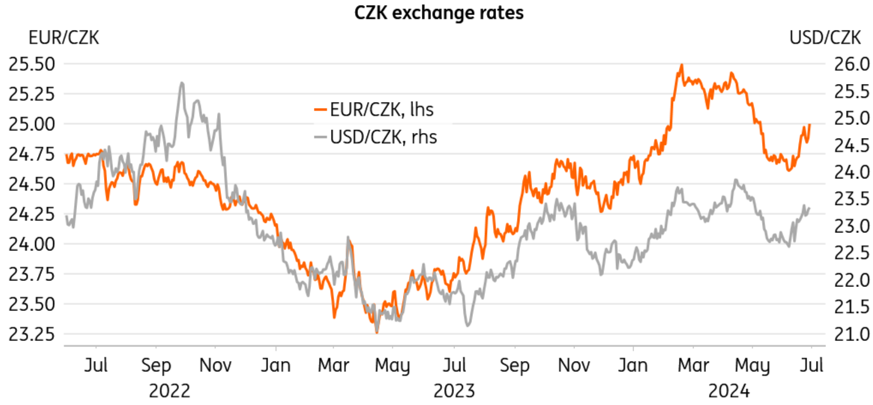
The monetary policy stance remains restrictive for the Czech economy, with the real interest rate calculated as the difference between the nominal rate and annual consumer inflation now declining to just above 2%. The Czech economic recovery remains fragile, despite a robust pickup in consumer spending, which came in stronger compared to the CNB spring forecast. However, the supply side is still waiting for a trend-based recovery, with fixed investment and industrial production remaining broadly stagnant over recent years. That a too-restrictive monetary policy could choke the renewed economic expansion was obviously a substantial worry for the bank board this time. "With rates gradually approaching neutral levels, it is likely that the board will slow down the pace of easing in monetary policy restriction at the next meetings or leave rates at the current level for some time," Michl added.

Five board members voted in favour of Thursday's decision, while the other two preferred a 25bp cut. The economy operating below its potential was likely the persuasive argument for the majority of decision makers. The CNB will publish details, including the nominal result of the vote on 8 July.

Koruna becomes less attractive

The Czech koruna weakened vis-à-vis the euro and crossed the 25 EUR/CZK threshold, still remaining below the CNB forecast for an average exchange rate of 25.2 in the second quarter and 25.1 in the third. The compressed interest rate differential toward the European Central Bank's policy rate and a more negative rate differential toward the Federal Reserve's rate reduces the attractiveness of koruna in the coming months. This would, in turn, add fuel to import prices and potentially lift consumer inflation in the near future.

Koruna weakened after the decision



Macrobond

The tight labour market and lofty wage growth represent a concern for the bank board. The governor does not see a wage-inflation spiral as evolving right now but considers it a relevant upward risk to future consumer inflation. Based on the recent decision, we lower the profile of our policy rate forecast, with a slower pace of rate cuts ahead, with 4.25% and 3.5% as terminal rates for this year and next, respectively.

Author

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