CNB review: On hold to safeguard credibility in an above-target inflation world

The Czech National Bank opted for a pause in its cutting cycle due to higher inflation seen at the end of the year. But the February meeting appears to be live and the Board is open to discussing a rate cut again. The focus now will be on the January inflation number. The market is on the hawkish side of pricing, but we see higher chances of more rate cuts

Czech National Bank building in Prague

4.00%

CNB 2W repo rate

No change

As expected

Inflation risks warranted a pause

The Czech National Bank paused at 4.00% in its current monetary easing cycle, as expected by most market participants recently. The inflationary pressures such as lofty nominal and real wage growth, increasing household spending, and a pickup in residential property prices seem too high a risk for ending up with inflation above the target over the next year. The stubborn price inertia in the service sector and the elevated potential for rent hikes over the coming year warranted a pause if you take the price stability mandate seriously. Moreover, the expected decline in household electricity prices can be partially compensated by increases in the price lists for housing services such as heat and water, so the decline in regulated prices is not a fait accompli.

Dovish pause in the cutting cycle

During the press conference, the governor did not want to be too specific about what was behind the pause in the cutting cycle, but the rise in inflation in December above 3% due to the comparative base from last year and the rise in food prices was mentioned several times. The governor also reiterated that the CNB expects inflation to fall again in January. In the governor's words, February is therefore an open meeting and the Board is open to both options - cut or pause.

The dovish tilt was given by two board members who voted for the rate cut today. Our best guess is that they are Frait and Prochazka. The minutes will be released in early January to show us the details of the meeting. At the same time (as in November) global developments, which are currently the main downside risk to the central bank, were discussed more during the press conferences.

Questions and answers

A few key questions will come next: a) at what level of January's inflation will the easing continue? b) will the flash estimate provide enough structure for the central bank to move forward with a decision? c) do you want to enter a shoot/don't shoot modus operandi?

Our answers are as follows. We believe that inflation below 2.8% in January amid a lukewarm economic performance is good enough to carry on with rate reductions. The complete inflation structure is warranted if the headline number is close to the 2.8% border case. The bank board is not willing to enter a stop-and-go-and-stop-again dance. For the above reasons, any further action or inaction is likely to be expected at the March meeting.

There is also the element of the M2 monetary aggregate gaining slightly too much strength for headline inflation to return to target in a reliable manner and for the core rate to decelerate below 2%. Inflation expectations are also formed by the central bank's determination to maintain price stability, and that likely goes hand in hand with the willingness for bold action – but also with some consistency and calm to outweigh the often over-excited market approach.

Our market views

The market is pricing in roughly one cut by the May meeting and a terminal rate of 3.50% at this time. While this scenario cannot be ruled out if January inflation surprises with a level above 3%, it seems more of an alternative scenario at the moment. In contrast, today's meeting showed that the Board is still in a cutting mood and February should be a lively meeting. January inflation sets the level for the full year given the high seasonality in the

Czech Republic, and 2.7-2.8% could be enough for a rate cut. We see the CNB as more dovish on this than our economists and market pricing.

We therefore prefer to be on the dovish side in the interim, which is the market's assessment after today's press conference. Therefore, we expect a return of pressure on the CZK to 25.30 levels as a first stop as the market reassesses rate pricing.

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