

CNB review: Rate stability is the central scenario

The Czech National Bank left the policy rate unchanged at 3.5% in a unanimous vote, delivering a hawkish message while acknowledging multiple inflationary risks ahead. The new CNB forecast projects stronger economic growth, more pronounced inflation, and a higher interest rate path. We see upward risks to both inflation and rates



CNB Governor Ales Michl

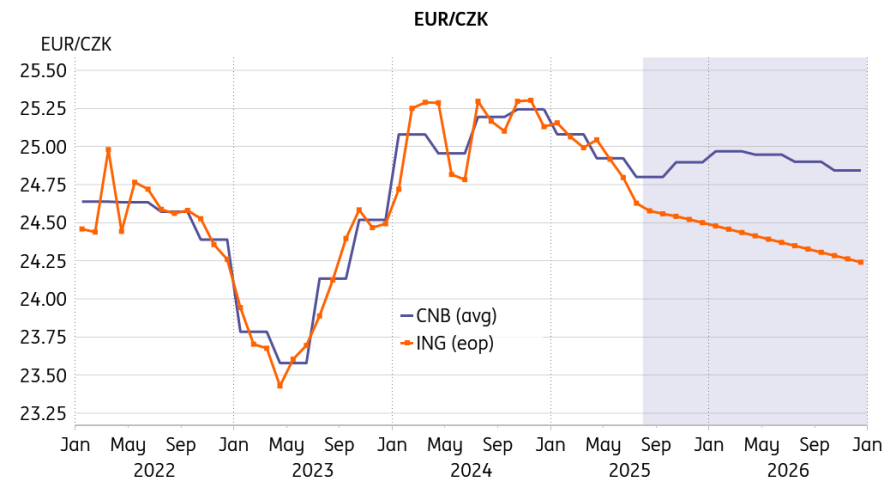
Inflationary risks do not allow for rates to go down

All members were in favour of maintaining the CNB base rate at 3.5%, while a cut was perhaps not even a point for discussion. Governor Ales Michl delivered a distinctly hawkish message at the press conference, explicitly stating his intent to be perceived that way. The reasons for such an assurance are obvious: inflation in the service sector remains stubborn, robust wage growth is driving consumption, and inflation is going to remain above the target for an extended period.

At the same time, there are clear pro-inflationary risks already brewing or appearing on the horizon, such as the overheating housing market that is driving imputed rents and core inflation, and more buoyant real growth performance, which is set to propel wage growth, support household budgets, and underscore the appetite to spend. The governor mentioned all of them, adding the risk from looser fiscal and upbeat government spending. All this means continued elevated inflation in the services sector, upbeat core inflation, and a headline rate above

the target for longer than is comfortable for any monetary institution that takes its sole mandate to maintain price stability seriously. A stronger koruna is the only disinflationary element right now, keeping imported inflation on a short leash.

Stronger koruna once again



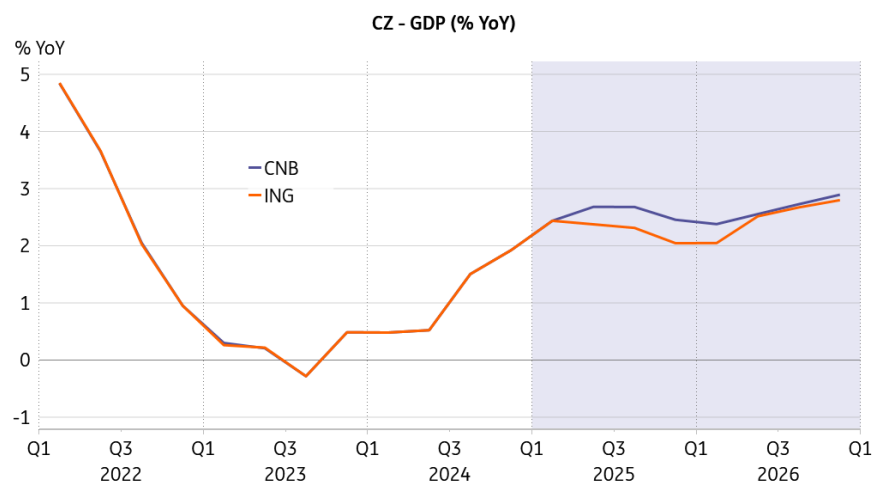
Source: CNB, ING, Macrobond

When asked about the possibility of further easing, the governor reiterated the familiar line that "all options are open" - a statement that could have quietly lingered in the background without needing to be voiced again. On the other hand, he admitted that the economy is not in a shape that would allow for further rate reductions. Well, we also don't believe that all options are on the table and would like to join Jerry Maguire in shouting at the next meeting: "Show me the cut!"

Bullish forecast revision all over the place

The CNB upgraded its outlook, projecting stronger economic growth across all key macroeconomic indicators, starting with GDP, which is expected to rise by 2.6% this year and next, with even more upbeat expectations further ahead. Such a rebound should contribute to more pronounced labour market tightness, robust wage dynamics, and more potent inflation of 2.6% this year and 2.3% the next. This is an interesting twist, as the CNB's workhorse projection model usually converges rather swiftly towards its target, suggesting that inflation expectations may actually be entering a zone of concern.

Economy expected to do well

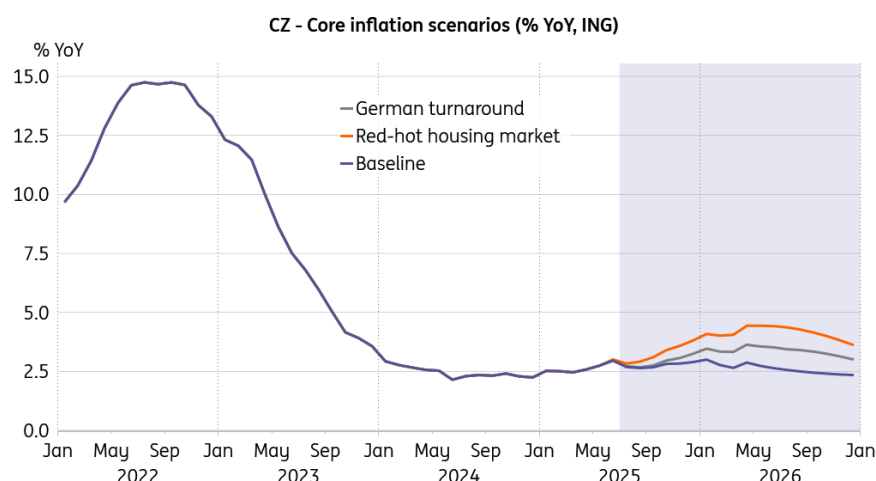


Source: CNB, ING, Macrobond

Risks that are ambiguous but could potentially drive the overall price level higher include food prices, the still-struggling German economy, and the onset of a fiscal stimulus effect, along with geopolitical risks linked to the war in Ukraine and the tense situation in the Middle East. One new but obvious risk on the forecast horizon is the difficult-to-quantify inflationary impact of the emission allowances for households or the ETS 2. The effect will be reflationary in 2027, no doubt, but the magnitude and possible front-loading into consumer prices is hard to estimate in advance. The price of emission allowances traded on futures markets is higher than expected, hitting upper bounds set by regulations.

We still have our two pro-inflationary scenarios in mind, namely the housing market running red-hot and the German package trickling down to the real economy sooner rather than later, carrying a positive spillover effect for the Czech economy. The assumption about the first alternative is based on previous property market upturns, while the German effect is based on assessing the labour market tightness and its effect on wages and core inflation. Therefore, we provide an illustrative example below of the potential scope of impact on Czech core inflation, albeit in the form of a hypothetical *what-if* scenario analysis.

Risks for core inflation are on the upside



Source: CNB, ING, Macrobond

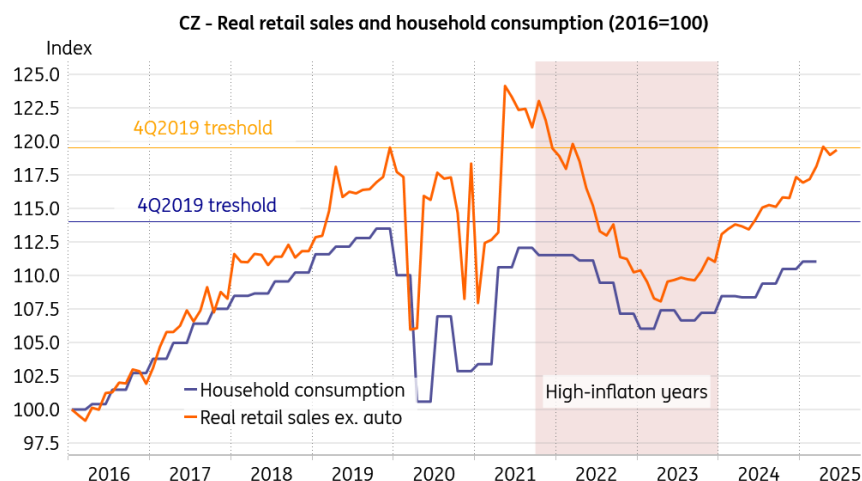
Having this in mind, we don't see any space for further rate reductions, should price stability be at the heart of your concerns. Still, the CNB summer forecast paints a picture of declining rates in 2H25, so indeed, anything can happen. When the governor was asked whether the Bank Board would smooth out the down-and-up rates trajectory, he answered that he is not there to smooth things out, but to fight inflation. His final wish for inflation to remain tamed may have had some element of a sinister prophecy. And indeed, inflationary pressures are not kept at bay by wishes, but rather by clear forward guidance and an appropriate level of monetary policy tightness.

Spending goes all well

Czech retail sales added 4.5% year-on-year in real terms and 0.3% month-on-month in June. The annual figure was softer than markets had expected, while the dynamic in the preceding month was revised downward. Sales of motor vehicles and repairs fell by 0.5% YoY and 0.3% MoM. Sales of fuel rose by 11.3% YoY; non-food goods sales gained 5.5% YoY, and food sales added 0.8% YoY.

Real retail sales have appropriately been trending upwards since October 2023. Meanwhile, the uninterrupted annual growth in real wages began right at the start of 2024, following two consecutive years of severe deterioration in real purchasing power. This rebound in real wages proved to be the game-changer that reignited consumer spending and served as the initial engine that pulled the Czech economy out of the stagnation swamp. In the second quarter of 2025, real wages gained more than 4%, further enhancing the spending capacity of Czech households throughout the year.

Sales and household consumption trend upwards



Source: CZSO, Macrobond

Overall, the Czech economy is well on track, with two engines turning the expansion propellers, namely consumption and construction. If industry fully joins the chorus, too, supported by reduced uncertainty about the EU's trade relations with the US, and aided by spillover effects from Germany's fiscal stimulus, the growth outlook becomes decidedly optimistic. However, whether welcome or not, a stronger expansion paired with only gradual improvements in production resources, particularly in skilled labour, will inevitably carry inflationary risks sooner or later. Therefore, rate-setters must be vigilant in anticipating the next wave of broad-based inflationary pressures in a timely manner.

The hawkish tone and new forecast from the central bank were very well received in the CZK market. Although we were clearly on the hawkish side in our CNB preview, the central bank managed to exceed our expectations, which gave a proper boost to the fading CZK rally. Of course, Ukrainian-Russian headlines supported the entire region today, but the CZK continues to outperform its regional peers, despite typically being the least sensitive to such geopolitical developments.

After the press conference, EUR/CZK touched 24.450 and stabilised in the 24.450-500 range, the lowest levels since the end of 2023. This aligns well with the movement in rates, and we view the market's response as justified given the CNB's messaging today. The CNB still has other opportunities to elaborate more on its hawkishness, such as tomorrow's meeting with analysts, post-meeting interviews, and next week's minutes. More details should support the hawkish case, and together with global developments, we remain bullish on the CZK as the only clear case for us in the CEE region.

The rates market initially sold off by up to 4bp at the short end of the curve in response to the press conference, but the global push lower left the CZK curve almost unchanged or only slightly higher at the end of the day. The rest of the CEE region, however, closed significantly lower, showing a hawkish effect in the CZK market. Although the FRA curve is still a few basis points below the fixing in some tenors, the short fwd-fwd in the IRS curve is already well above the fixing, indicating rate hike expectations in the future. At the same

time, we expect the hawkish CNB meeting to trigger some repricing and normalisation in the PRIBOR premium as well, and we should see some increase from the current zero bp. Similar to the FX market, we should see support for rates even after the CNB meeting. Therefore, paying any dips should continue to work, and we should see further narrowing of spreads vs. CEE peers given the unique position of the central bank in the Czech Republic in the cycle.

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

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