CNB review: Resumed easing despite punchy inflation in January

The Czech National Bank eased monetary policy conditions via a 25bp cut despite headline inflation remaining above the target in January. We see a push to get the base rate to the terminal destination to unlock the Czech economy's potential. Let's see whether inflation behaves over the year

Czech National Bank headquarters in Prague

Get it done and wait for a proper recovery

The CNB reduced the monetary policy rate by 25bp to 3.75%, in line with expectations of market participants. All members voted in favour, which may be perceived as somewhat surprising given today's rather punchy headline inflation print of 2.8% for January. It seems to us that the Bank board is keen to ease monetary policy conditions as much as possible to help the underperforming manufacturing segment and stagnant investment. We anticipate the final rate to settle at 3.25%, with the Bank keeping some powder dry in case the economic performance in Europe and Czechia deteriorates further, particularly in the industrial sector. The government mentioned, however, that the growth impediments seem to be of a structural nature, including elevated energy prices.

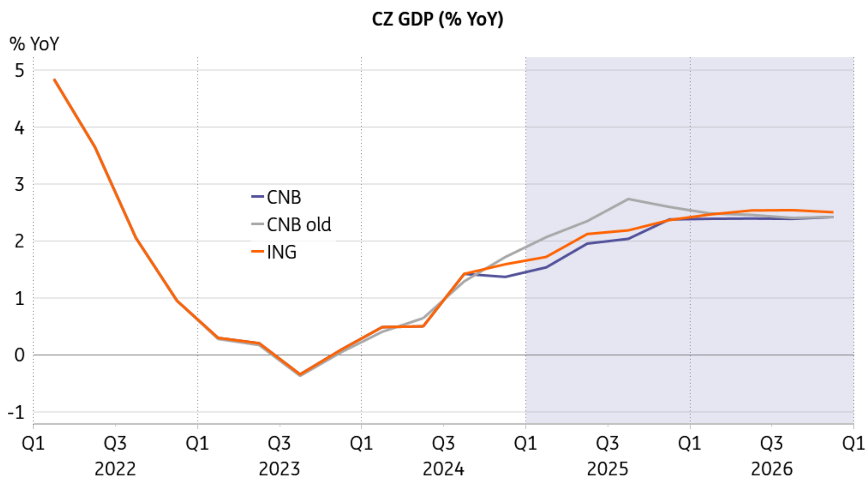
With January's headline inflation rate being much closer to the 3% upper bound than to the 2% target, it appears that hopes for inflation to fall below the target for an extended period are unlikely. Indeed, the governor emphasised that achieving the inflation target remains the ultimate goal.

The new CNB forecast implies only a modest decrease in the base rate from now on and approximate stability from the mid-year onward. The restrictiveness of monetary policy has eased in the meantime, while some inflationary pressures clearly remain convincing. Still, real interest rates remain in positive territory, helping to prevent excessive credit growth. Meanwhile, money growth in the economy remains elevated.

More pro-inflation risks than vice versa

The economic rebound is set to gain pace in the new CNB outlook yet at 2%, the foreseen expansion remains below potential. The main drag is seen in lukewarm foreign demand and the continued underperformance of European industry. Meanwhile, wage growth remains elevated compared to the historical standard, which will allow the consumer to drive the economy this year. Such a situation carries pro-inflationary risks, according to the governor, especially in the form of stronger food prices, solid public sector spending, and lofty wage demands in the private sector. The typical anti-inflationary risk is evident in the underperformance of the German economy, while a new risk may arise from actions taken by the US administration in trade policy.

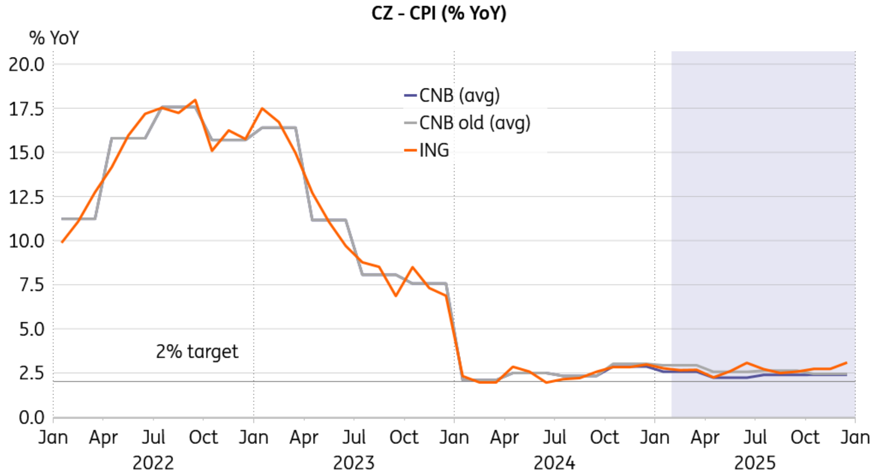
Gradual rebound this year



Source: CNB, ING, Macrobond

Growth expectations have been lowered to 2% for this year, further driven predominantly by households and government spending. This may carry inflationary potential, which is reflected in the overall trajectory of higher rates. Meanwhile, the performance of net exports is expected to be rather muted, due to the continuously weak demand from Europe's main trading partners. Negative real interest rates are to be avoided. Risks stemming from the potential for food price growth, a property market boom, and persistence in services price growth, resulted in a hawkish cut. Inflation is about to reach 2.4% this year and 2.1% next year, nevertheless today's inflation number shows an upside risk to the forecast.

Inflation within the tolerance band



Source: CNB, ING, Macrobond

Overall, we interpret today's developments as follows: January's higher-than-expected inflation is a given, and the promised rate cut to support growth was delivered, albeit with a hawkish tone. This is evident in (i) the higher projected rate path despite lower forecast real growth, and (ii) the governor's indication that rates could exceed the current projections. Indeed, January's strong inflation figure poses a clear upward risk to the CNB's softer inflation forecast for this year. The koruna was given more trust this time compared to the previous projection, also reflecting a lower outlook for Euribor and thus a more favourable interest rate differential

Bitcoin - central bank relationship to be studied

Everyone anticipated it, and now the question about potential cryptocurrency reserves has finally arrived. The Bank board is determined to take a transparent approach and to communicate their thinking about this sound topic with the public. The governor expects an analysis to be prepared to assess the possibility of investing in another asset class. The majority of the Bank's board wants to see a thorough analysis before coming to any conclusions, while a time horizon for the analysis has not yet been set. However, the discussion is gaining traction, and it seems the time is right to gain a more comprehensive understanding of a potential relationship between central banks and the crypto world. After all, as the saying goes: *fortes fortuna adiuvat.*

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