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Czech consumers and business more upbeat, industry remains muted

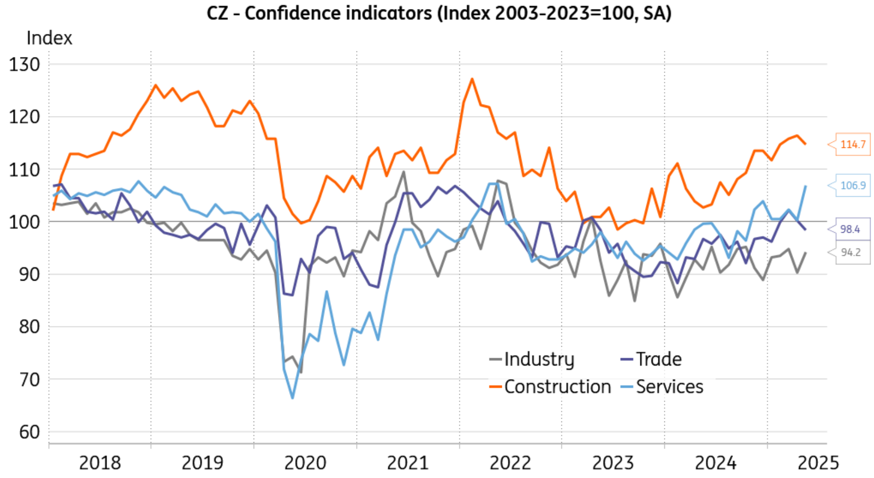
Both consumer and business confidence in Czechia have improved in May. Consumers benefit from tamed inflation and robust real wage growth, while households can channel their savings into the booming property market. Meanwhile, industry is still at a low point despite a positive correction, which will shape upcoming monetary policy decisions.

Prague, Czech Republic

Consumer and construction take the lead while industry fades

The Czech business confidence indicator rose by 4.5 points from the preceding month to 101.0 in May. The consumer confidence indicator added 3.0 points to crawl to 100.7 in May, just above the long-term average of 100. Business confidence increased in industry (+3.9 points) and in selected service sectors (+6.6 points), while dropping by 1.8 points in trade and by 1.7 points in construction. The improvement in industry sentiment mainly reflects improved expectations about manufacturing activity in the coming months but seems a correction of the preceding month's skid - the index value remaining well below its long-term average at 94.2. The continued weakness in manufacturing is outweighed by the upbeat mood in the construction and service sectors.

The industrial mood remains muted



Source: CZSO, Macrobond

Consumer confidence reached a six-month high in May, increasing to slightly above its long-term average. This was mainly due to significantly reduced concerns about the deterioration in the overall economic situation and to reduced consumer worries about the deterioration in their financial situation. The number of respondents who do not plan to make large purchases in the next twelve months remained unchanged from April.

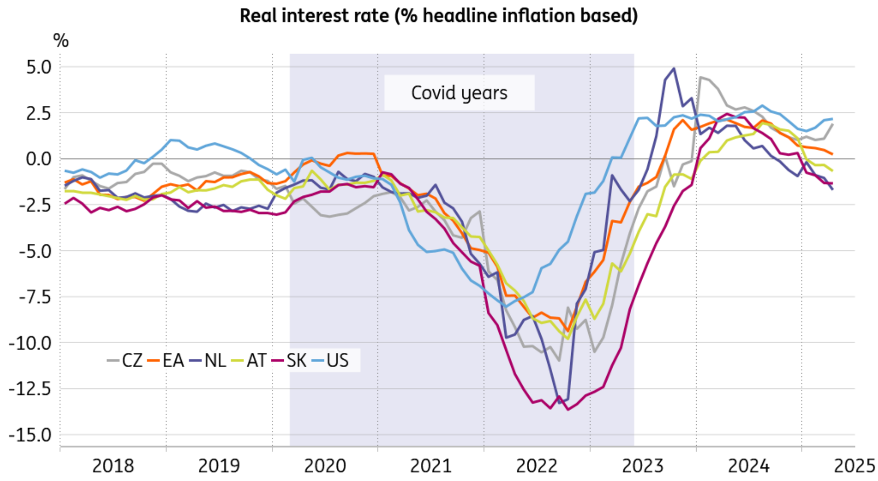
Overall, consumers' improved assessment seems justified - the fundamental driver of solid real wage growth on the back of tamed inflation and a robust labour market provides further firepower for spending. The improvement in industrial sentiment is welcome, with the caveat that the index value of 94.2 remains well below its long-term average. Still, the overall business confidence indicator exceeded its long-term average for the first time since July 2022. The CNB will be influenced by an economic environment where consumption boosts the service sector, and elevated demand for properties drives construction and residential prices. In contrast, industry is still waiting for a proper liftoff.

Czech inflation has been tamed, while real rates remain positive

Headline inflation will likely be softer than expected this year, partially due to the low April figure of 1.8% YoY and partially due to lower Brent crude oil prices. We have reduced our headline inflation forecast for the 2025 average to 2.4% from a maximum of 2.7%. Lower global energy prices will impact fuel prices very quickly. If longer lasting, these will trickle down to food and regulated prices with some lag. Meanwhile, our core inflation forecast for 2025 has been lowered only marginally to 2.5%, influenced by the extra resources stemming from lower energy bills. Still, this means that core inflation is not forecast to touch the 3% threshold over the whole period.

The domestic price risks have not fully receded but are softer than as assessed a few months before. They are mainly in imputed rents linked to the property market boom and partially in the service sector. Meanwhile, the risks of imported inflation have almost vanished due to lower global energy prices, a stronger koruna, and lukewarm growth prospects for the EU. The EU does not seem to be in a position to tackle its pressing growth hurdles decisively, so the disappointing growth performance is set to stay, posing risks to still decent Czech economic prospects.

Czech real interest rates suggest a restrictive policy stance



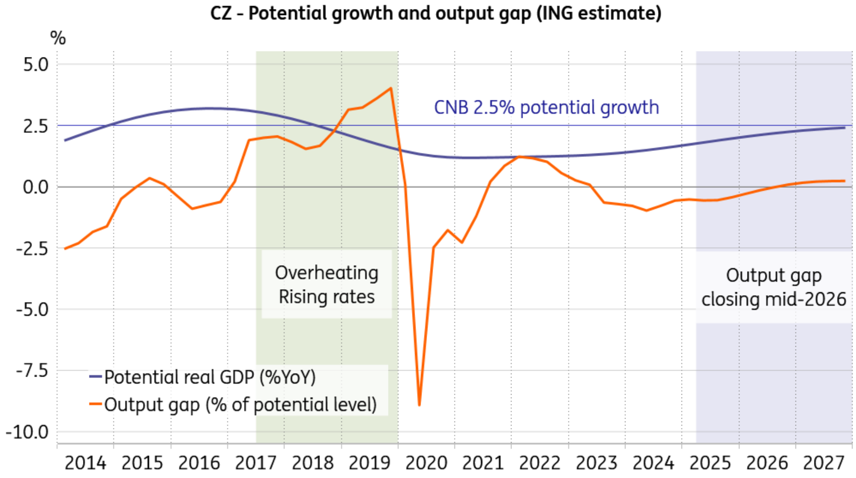
Source: Macrobond

Meanwhile, the euro real interest rate drifted toward zero in April when measured against headline inflation and slid into sub-zero territory when measured against core inflation. The potential pressure from further disappointing growth performance in the eurozone would increase the propensity of the ECB to compensate for structural growth issues via even lower interest rates, with both influencing the CNB decision function. At the same time, the ECB finds itself in a somewhat delicate position, as real interest rates have turned negative in some countries already but remain positive in others.

No investment today poses risks to growth tomorrow

Czech fixed investment has remained flat over the past three years and industry has possibly not hit bottom. Such a situation is set to be a hot topic for the CNB board over the coming months, with inflation apparently tamed. That said, even with another rate reduction, Czech real interest rates are set to remain comfortably positive, either when measured against headline or core inflation. This is key to the Governor and other rate-setters, as the monetary policy stance will, in any case, remain rather restrictive. That is in a situation when potential growth in our estimation is gradually trending back to a relatively healthy 2.5% over the next three years. The currently negative output gap is set to close only by mid-2026, leaving the economy operating below its potential and keeping overall inflationary pressures on a short leash.

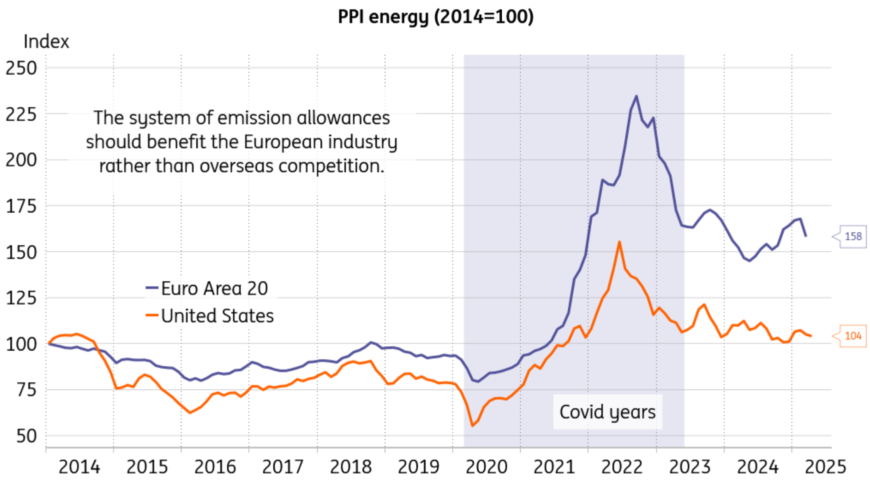
Negative output gap limits general price pressures



Source: ING, Macrobond

If there is no nasty surprise in inflation from food, services, or rents, which we do not foresee at this point, then the space for further easing looks obvious. So, one more cut in August is our baseline scenario. If things do not turn for the better in Europe by addressing the critical structural growth hurdles, then there will likely be even more space for rate reductions, even in Czechia. We reiterate whaat we see as the main obstacles to sustainable European economic performance, with the most pressing being: (i) prohibitively high energy prices, (ii) a suffocating regulatory burden, (iii) an inability to protect against unfair production and trade practices, (iv) an ideological bias in the innovation space, and (v) laggard security and economic resilience.

Energy prices remain a drag for European industry



Source: Macrobond

For all these reasons, we see potential for an abrupt change in the scenario for the Czech economy where the positive narrative flips, with all the negative implications stemming from feedback loops developing into a vicious cycle. It is like riding a bicycle: you go downhill, and everything is speedy and brisk - then the hill comes and it all changes at once. If you don't start pedalling enthusiastically, you lose momentum and ultimately fall off.

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