Czech inflation picks up amid robust private spending

Consumer prices gathered speed in June, as a continued household spending spree drove May's robust real retail sales growth and bolstered a broad-based price increase. The Czech National Bank sees the accumulated upward price pressures as a serious risk, and we're floating the possibility of an alternative scenario for core inflation and rates

The battle against inflation might not be over yet in the Czech Republic, and some risks still remain

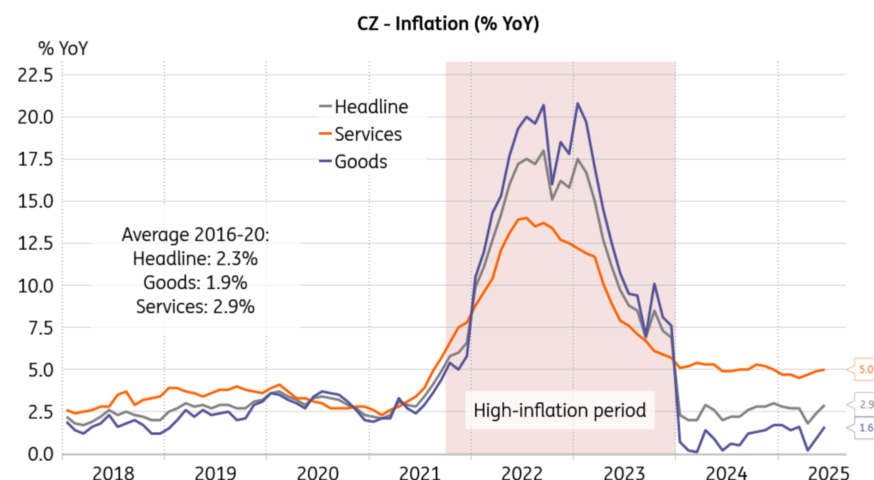
Price increases are broad-based

The preliminary estimate suggests that Czech headline inflation picked up to 2.9% annually in June, while the overall price level gained 0.3% from the previous month. The yearly figure is in line with market expectations, while the monthly increase is somewhat stronger than what analysts have predicted on average and matches the upper-bound estimates. The Czech National Bank expected annual headline inflation of 2.8% for June in its spring forecast.

While the preliminary estimate provides only a limited breakdown, it seems that the price increases were seen in most of the main groups of the consumer basket, except for energy. Price growth in services picked up to 5% annually in June (4.9% previously), suggesting that the

disinflationary process has stalled. Of course, we do not see double-digit growth rates as during the 2021-23 high-inflation period, yet annual growth rates persistently exceeding 3.5% are generally not in line with achieving price stability and having inflation sustainably at target. Meanwhile, the yearly dynamic in goods prices strengthened to 1.6% from 0.9% previously.

Price growth in the service sector does not backoff



Source: CZSO, Macrobond

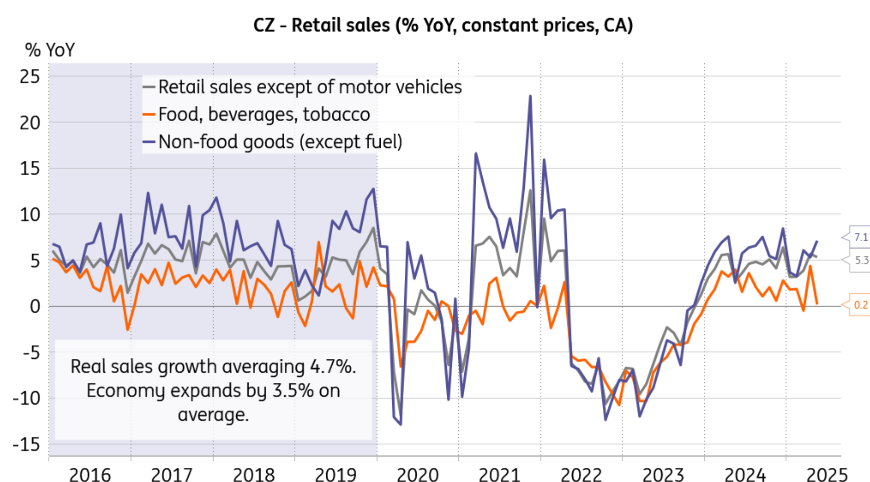
We can compare the current situation with what we have seen in the five years from 2016 to 2020: annual goods inflation averaged 1.9%, services inflation 2.9% and headline rate averaged 2.3%, hovering above the target most of the time.

Now, the period of high inflation is behind us, and the price growth of goods is dampening the headline rate, while the price dynamics of services are not willing to give in. Given the foreseen economic rebound gaining pace, a tight labour market fostering solid wage gains when looking ahead, and the boom in the property market suggesting that the economy is humming, it seems relevant to ask whether the current monetary policy setup is tight enough to hold inflation on a short leash.

Household spending to further support the rebound

Retail sales added 5.3% annually in real terms in May, with fuel sales increasing by 14.5%, non-food goods by 7.1%, and food gaining 0.2%. We see any annual gains in real retail sales of above 4% as strong enough to suggest that the economy would find itself in a solid expansionary mode. In monthly terms, May's retail sales excluding motor vehicles declined by 0.2% in real terms, with a drop in food sales of 2.0% acting as a drag. Meanwhile, sales of fuel gained 1.5% and sales of non-food 0.7% from the preceding month.

Consumers do what they do best



Source: CZSO, Macrobond

Consumer prices of processed food accelerated in May, increasing by 4.7% year-over-year. Agricultural producer prices suggest that there is little to be expected in terms of relief here. At the same time, today's preliminary harvest estimates are generally below the long-term average. Farmers expect this year's cereal harvest to be weaker than the long-term average once again, yet comparable to last year's. Yields are estimated to drop from the previous year for spring and winter barley. It seems that consumers will find no relief when it comes to food price tags and may have to swallow further price increases in basic foodstuffs.

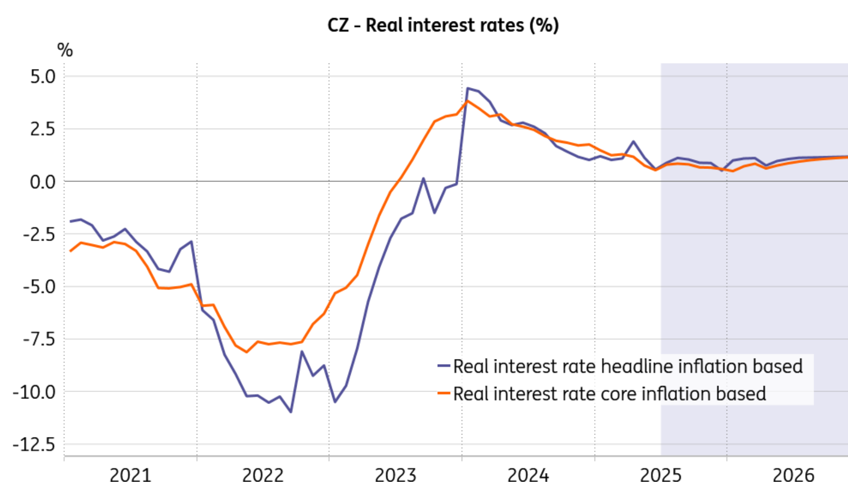
CNB is well aware of the accumulated price pressures

The Bank board unanimously decided to leave the base rate unchanged in June, with the fourth situation report providing context for evaluating new information since the spring forecast. A decline in interest rates over the second quarter was also consistent with this report. The Bank board assessed the risks to the outlook as inflationary in aggregate.

CNB Governor Ales Michl opened with a hawkish message: restrictive monetary policy should be maintained, and high inflation should not be allowed to return. Growth in the quantity of money in circulation should be hampered, attention should be devoted to the inflationary risk of a permanent public deficit, and the risk related to excessive growth in property prices should be taken seriously. *Summa summarum*, the battle against inflation isn't yet over, and risks still remain.

Real interest rates are set to remain in positive territory, exerting some restrictive pressure should the nominal rate remain at 3.5% and inflation develop in line with our base case scenario of 2.6% this year, and 2.4% the next. In such a case, the base rate of 3.5% is in many ways an optimal landing zone – and our base case scenario – though an underperforming industry might still require some relief.

Real rates remain slightly restrictive



Source: CNB, ING, Macrobond

CNB Board member Jan Kubicek mentioned that monetary conditions are still restrictive, albeit only slightly, primarily due to the exchange rate component. In contrast, Jan Frait considered the combination of interest rates and the exchange rate to be broadly neutral, with different parts of the economy likely requiring slightly different rate settings, while the overall setting remained in an adequate position. At the same time, the steps of other central banks might impact the koruna and the overall policy setup.

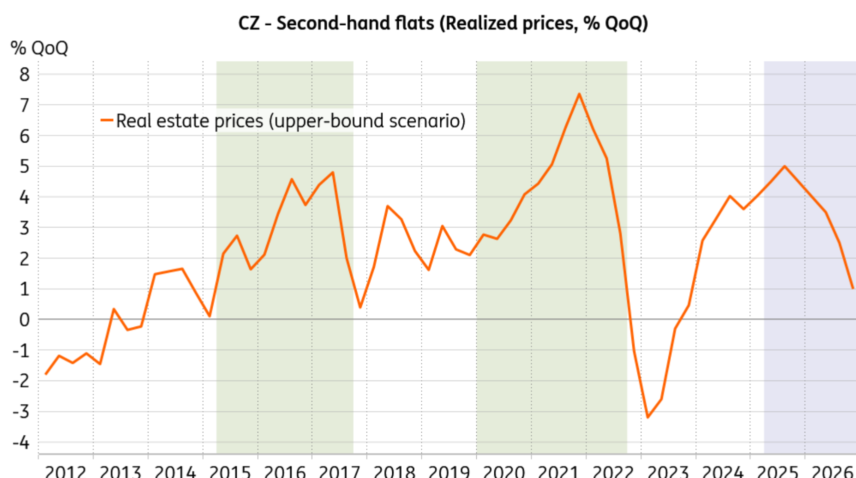
Board members Eva Zamrazilova and Jakub Seidler agree that unless the prevailing upside risks to inflation ease significantly and the risks associated with trade wars abate, there is minimal scope for a further rate reduction. Frait also added that without disinflation in services, it was challenging to consider additional monetary easing. Still, as Jan Prochazka pointed out, the subdued industrial performance, along with global cooling, could open the door to further rate cuts. Dormant investment activity worried more of the board members. We consider all the above points relevant, but inflationary risks appear to be taking the upper hand.

And yes, you guessed it: the overheating property market. The Board agreed that the rising residential prices primarily reflect structural problems that monetary policy would struggle to address, unlike the government, which has the appropriate tools to do so. Zamrazilova added that if the momentum in property prices does not abate, it will lead to a permanent impact on core inflation, which would require tighter monetary policy settings.

Our upper-bound alternative for inflation and rates

And here we reiterate our alternative upper-bound scenario, based on the heat in the Czech property market reaching up to Ray Bradbury's *Fahrenheit 451*. We base this scenario on the assumption that property prices increase by roughly 70% of the 2020-22 episode every quarter, with the final peak of the year shaved. Such a scenario means adding more fuel to the fire, but it remains in the realm of what's possible.

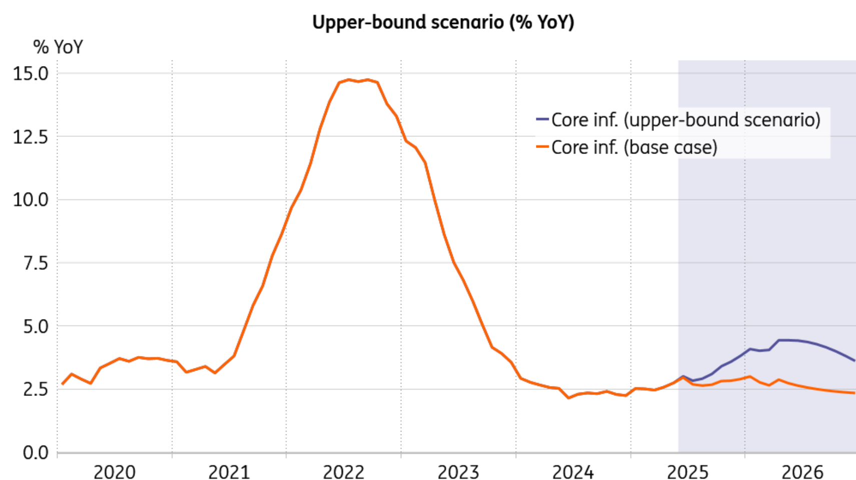
The 451 degree Fahrenheit scenario



Source: CZSO, ING, Macrobond

The final outcome will likely be something between our base case and alternative scenarios. Nevertheless, should the alternative upper bound materialise, the following would hold, as suggested by our econometric model, which includes residential prices as one of the explanatory variables. Imputed rents would gradually crawl up to reach some 8% YoY in April next year, with four more monthly increases of 0.8% as observed in May and a softening of the monthly dynamic thereafter. Meanwhile, core inflation would peak at 4.4% in the same period, well above the baseline's 2.9% annually. That's quite a difference to swallow.

Alternative core inflation gradually departs



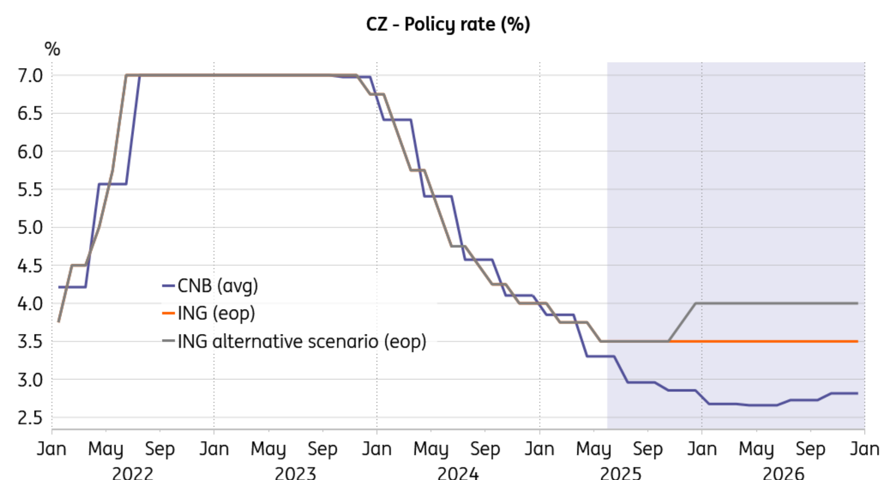
Source: CNB, ING, Macrobond

Given the only gradual decoupling of the base case and alternative paths for core inflation, the difference would become fairly obvious in this year's October inflation observation. It'd be difficult to ignore the yawning gap between core inflation, roughly intact at 2.9% (base case) and things not going in the right direction with the core rate at 3.6% in October (alternative). Then, any decent monetary institution would likely tighten monetary policy to avoid being forced to watch

core inflation flying above 4% for more than a year or so.

Ergo, it's November that presents the optimal time for a hike, should things get red hot in the residential market and core inflation presents an issue. My take is that two consecutive rate increases would do the job to cut off some part of the excessive demand on the residential market.

November would be the optimal month to go ahead



Source: CNB, ING, Macrobond

However, there are a few caveats for the alternative scenario to ultimately translate into tighter monetary policy: a) the core increase will be rather gradual, prompting a delay b) the CNB will always hope the overheating has come to an end, with statistics on the residential prices significantly delayed, c) policymakers could make it clear that sorting out property market imbalances is not their job, d) the Governor has a track record of sitting things out when the need for hikes is rather obvious. In any case, remember that it's only an upper-bound alternative scenario; it's still possible, but there's some way to go in order to get there. Stay tuned.

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