Czech inflation pickup to underpin the hawkish leitmotif

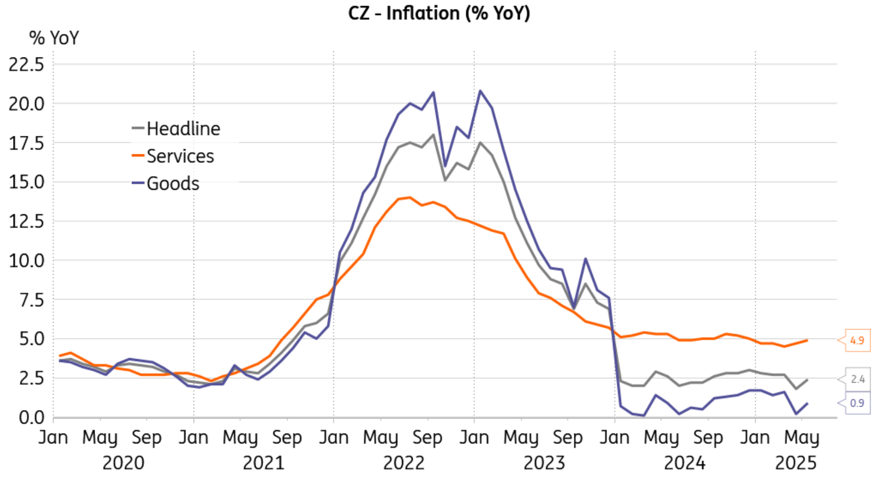
Czech inflation increased in May, driven by price gains for items within the core inflation basket and food prices. Robust real wage growth has fuelled a strong appetite for spending, with real retail sales flying high and supporting price increases in services. Three dominant factors will mostly shape the upcoming decision from the Czech National Bank

Services and food inflation hotting up

Czech headline inflation picked up to 2.4% year-on-year in May while the overall price index added 0.5% month-on-month, according to the preliminary estimate. Both inflation figures came in above what market participants had expected, with the annual rate only slightly above the latest CNB forecast.

Items related to core inflation and food prices contributed the most to the overall price increase in May. A tangible pickup in the price dynamic was observed in both services and goods prices, adding 0.5% MoM each. This brings the annual growth rate in services prices to 4.9% YoY in May from 4.7% YoY previously, suggesting that the persistence of price growth in the service sector remains intact. The annual price growth in goods jumped to 0.9% YoY in May from a subdued 0.2% YoY recorded in the previous month.

Disinflation in the service sector has stopped



Source: CZSO, Macrobond

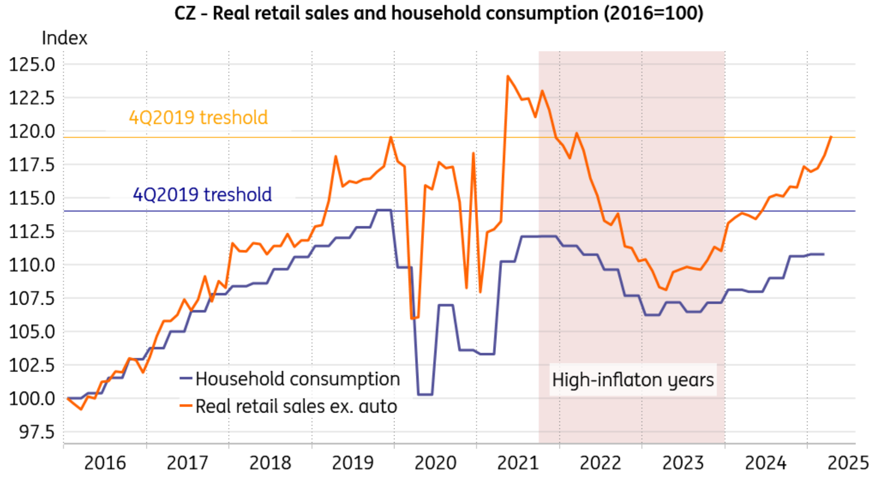
Well, for an economy in price convergence mode, the annual price dynamic in goods of around 1% is consistent with inflation hitting the target. Meanwhile, the annual price growth in services should hover around 3.5% and is currently too steep. Bringing down the price dynamic in the service sector is one of the primary concerns of the CNB board regarding price stability and well-anchored inflation expectations.

The leitmotif of this hawkish paradigm will only gain traction in the coming decisions, as the disinflation process seems to have come to a halt. Moreover, with the continued robust wage growth and still tight labour market, households have enough firepower to keep the wheels of the services sector turning, and the pressure on prices is set to prevail. That said, we have argued that the prices of services have grown substantially over the past quarters and that the space for further price hikes has become increasingly tight. However, where there is upbeat demand, there usually is also a counterpart in the propensity for price hikes. Price dynamics are notoriously persistent, and prices are indeed sticky.

Robust wage growth drives retail spending

The substantial annual increase in real retail sales of 5.8% in April also surprised to the upside, as did the annual real wage growth of 3.9% in the first quarter of the year. Retail sales have accelerated noticeably in April when adjusted for price effects, with sales gaining pace in all major store groups. Any annual growth in real retail sales that exceeds the 5% threshold can be considered robust and in line with solid economic expansion. Indeed, real retail sales have returned to pre-pandemic levels as of April. Meanwhile, the gap vis-à-vis household consumption as measured by the national accounts methodology has continuously widened since mid-2023, suggesting that one of the series may be a candidate for future revision.

The gap between retail sales and consumption has increased



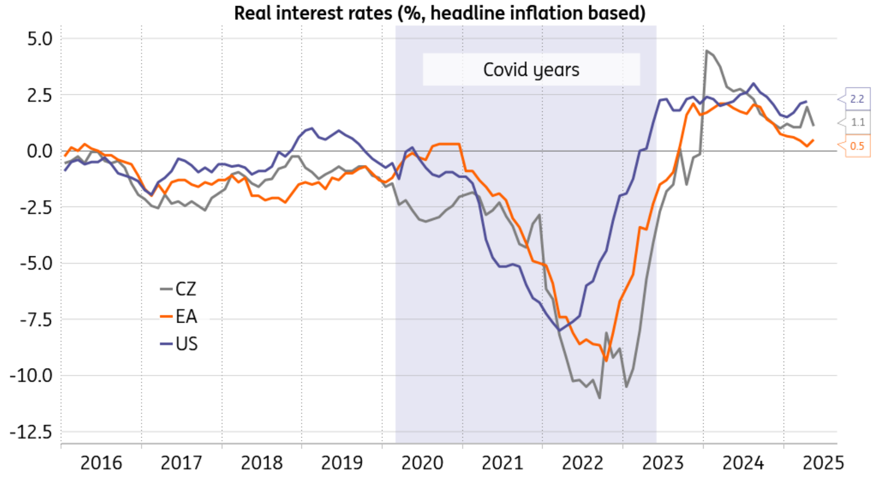
Source: CZSO, Macrobond

The average real wage gained 3.9% in the first quarter of 2025, as it increased 6.7% in nominal terms, with consumer prices adding 2.7% over the period. The nominal wage growth was only marginally lower than the latest CNB forecast. At the same time, the volume of wages increased by 7.1%, as the number of employees picked up by 0.4%. Looking at the sectoral breakdown, the most substantial gains in the average wage compared to the previous year were recorded in real estate activities (12.4%), scientific and technical activities (10.9%), and construction (10.3%). The median wage added 5.3% on an annual basis. On a quarterly basis, real average wages in 1Q25 added a solid 1.7%. This all signals that a solid economic rebound was on track at the start of the year.

Three things for the CNB to consider

The CNB will likely make its decision within a trilemma framework i) persistent price growth in the service sector, ii) lukewarm fixed investment under elevated uncertainty, and iii) further ECB rate reduction. We have addressed the first points above and now examine the interplay between the CNB and ECB situations. Annual eurozone inflation eased to 1.9% in May, while Czech inflation picked up to 2.4% in the same month. Another 25bp rate cut is broadly expected at the 5 June ECB meeting, while no change to rates is our base case scenario for the upcoming CNB decision. The Czech economy is outperforming the eurozone's, and this is likely to remain the case over the coming quarters, with the potential for inflation rates and, consequently, policy rates to drift apart even further.

Diverse real interest rate modes



Source: Macrobond

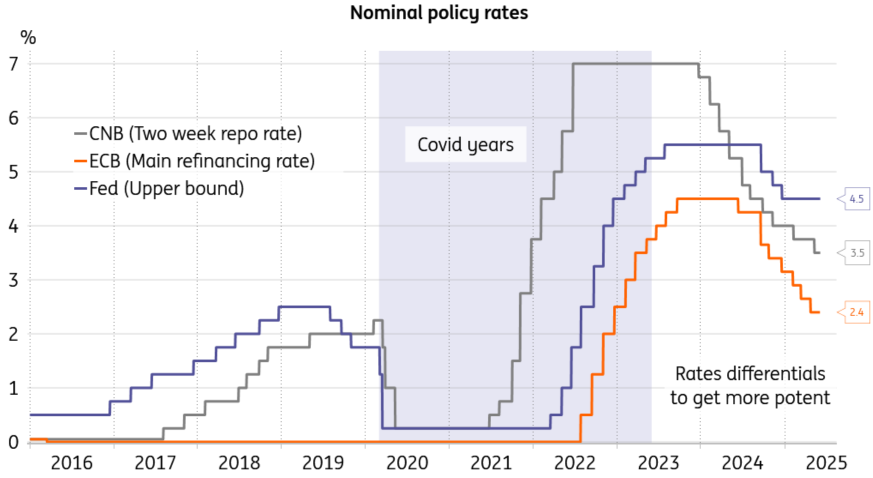
When considering real interest rates, these are decisively positive for the koruna while much lower for the euro. And here is the catch. The lower the ECB rates, the higher the incentive for Czech firms and, ultimately, households to take credit denominated in the single currency. Such a development, however, compromises the CNB's monetary policy transmission, making it potentially less efficient. Such a situation would push the euro and its rates into the position of a predator, while the koruna and its rates would find themselves in the position of the prey.

An ultra-low or negative real interest rate has its downside, which, in our view, implies a lower propensity of the economy to advance structurally. Low rates risk reinforcing existing feedback loops, potentially locking the economy into a vicious cycle: cheap credit fuels more borrowing, which drives higher consumption and, ultimately, more inflation. For some countries where inflation has remained elevated, such as the Netherlands, Austria, or Slovakia, this might become a concern should the demand eventually exceed the capacity of those economies - especially as more potent inflation means more negative real rates unless the monetary institution responds by raising nominal rates to calm the excessive demand.

Outcome of this game of chicken is hard to predict

The thing is that the landing zone for the euro rate likely remains in the realm of a game of chicken in the following setup. On the one side, there is support for eurozone economic expansion via ultra-low interest rates, represented by the ECB. On the other side, there is addressing the pressing structural issues in Europe to enable its industrial base to breathe, represented by the EC. If the eurozone's economic activity picks up and proves sustainable, the need for ultra-low borrowing costs will fade. We emphasise that the notion of how low the ECB's nominal rate may fall is a critical input into the CNB's decision function.

Nominal rate differentials becoming more potent



Source: Macrobond

Overall, the Czech economy was in a solid position in the first quarter of the year, which will pave the way for a hawkish stance by rate-setters. We expect no change to the base rate at the upcoming CNB meeting, which is scheduled for three weeks from now. That said, fixed investment remains stagnant from a medium-term perspective, and firms seem reluctant to proceed with more as industry grapples with considerable uncertainty across Europe. The interplay between services inflation driven by household spending, lukewarm investment activity in uncertain times, and the euro rate path will determine the landing runway for the Czech base rate. We currently see the terminal rate at 3.25%, which is likely to be reached at the August meeting.

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