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CZECH REPUBLIC

Czech inflation sends mixed signals as upbeat core muddles rate cut outlook

Inflation decelerated significantly in January, mainly due to falling energy prices. However, core inflation picked up, and food prices recorded substantial monthly gains. The Czech National Bank will likely hold rates steady for some time, with any rate cut dependent on a potential easing of inflation in the services sector

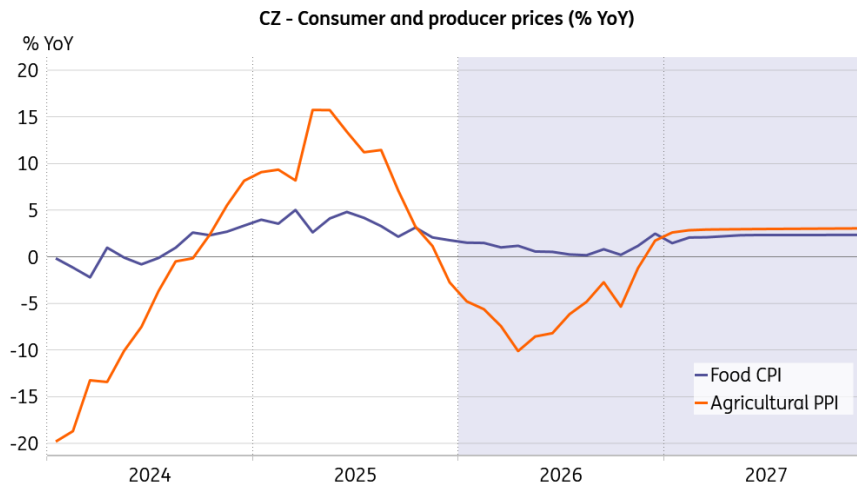


Punchy food prices and elevated core rate

Czech consumer prices increased by 1.6% year-on-year – in line with market expectations – and by 0.9% month-on-month in January, according to the preliminary estimate. Declining regulated and fuel prices brought headline inflation down. Meanwhile, annual core inflation picked up to 3% in our estimate. The notoriously volatile food prices brought yet another surprise for us: we expected a monthly increase of 1.6%, but the actual gain was much stronger, likely above 2.7%. Prices posted punchy monthly gains across food segments, whether processed or unprocessed, alcohol or tobacco. Making up roughly 26% of the consumer basket, such moves are very significant for our forecast. In turn, the strong pricing suggests an elevated spending appetite. Still, we see food prices coming under pressure over

the next few months as falling agricultural producer prices ultimately trickle down. And yes, we expect a correction in food prices to kick in in February.

Producer prices in agriculture will weigh on food CPI



Source: CZSO, ING, Macrobond

The consumer basket was adjusted so that the share of now-deflationary groups, such as energy, has been lowered. In contrast, the share of now-inflationary groups, such as services, has been increased. As usual, the basket adjustments mostly reflect the updated expense ratios of the average consumer. We estimate that the consumer basket adjustment accounts for about 0.1pp of the higher headline inflation as per our projection at the start of the year.

Now-deflationary groups lose weight

Group in the basket	2026 weight (%)	2025 weight (%)	Difference (ppt)
Unprocessed Food	4.8	4.5	0.3
Energy	11.2	12.3	-1.1
Services	41.3	38.0	3.3
Goods	58.7	62.0	-3.3

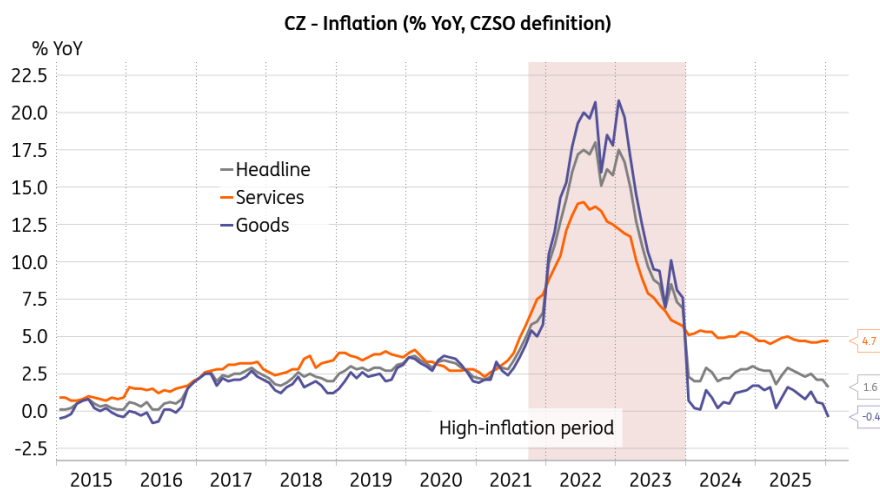
Source: CZSO, ING

Unbroken services inflation postpones potential cut

Headline inflation softened well below the target in January, while the annual core rate picked up and is set to remain elevated over the coming months. That said, January's preliminary print shows stable services price growth of 4.7%, adding 1% from the previous month. The hypothesis that restaurants might refrain from raising menu prices due to lower energy and softer food prices likely didn't materialise. In any case, strong demand will likely be further

driven by the extra resources left over from lower energy bills and lend support to core inflation. On the other hand, the lower energy prices for businesses may trickle down through all price categories and weigh on the core rate in the second half of the year. The key question is which of the two forces will prevail. Well, in a humming economy, with the output gap just about to close, much of the room created by cheaper energy may ultimately be used to prop up margins. Honestly, we only can admit that this is too close to call.

No relief for services price dynamics



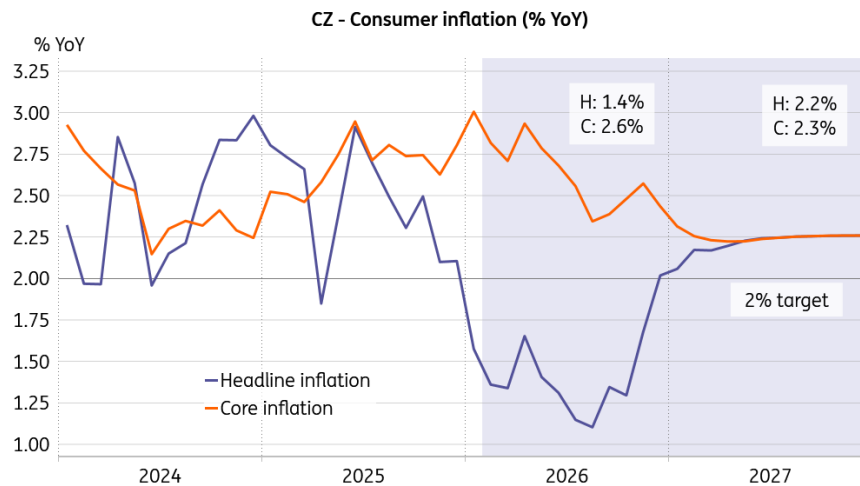
Source: CZSO, Macrobond

Meanwhile, goods prices switched to an annual decline of 0.4% at the start of the year, supported by the strong koruna. With no disinflationary process visible in the service sector, the Czech National Bank can wait it out, even if food and tradable goods prices weigh on headline inflation throughout the year. We saw goods prices drifting into annual decline over 2015-2016, yet services prices dynamics still averaged 1.2% and headline inflation was 0.5% over the period.

Kicking the can down the road with Damoclean cut

As for the CNB, the signal is that spending continues to bolster core inflation, so the likely outcome for this afternoon's meeting is to put the base rate on hold at 3.5%. As we've said beforehand, without service price dynamics decelerating below 4% annually, we're unlikely to see any monetary policy easing. We see headline inflation decelerating over the year, driven by meagre food price dynamics and a deceleration in core inflation in the second half. That said, we are pushing our call for a rate cut back to May. With core inflation at 3% in an expanding economy, the bank board is unlikely to rush into easing. Still, subdued headline inflation implies a real interest rate just below 2%, which may be considered rather restrictive – and could justify a single fine-tuning rate cut.

Hard to gauge whether core rate will decelerate



Source: CNB, ING, Macrobond

Anyway, there is a bit more clarity on one point: two cuts are off the table unless something goes wrong on the outside or the inside, such as collapsing external demand or lingering domestic investment activity. Overall, the CNB is likely to keep kicking the can down the road – holding rates steady while keeping the threat of a rate cut hanging over the outlook like the Sword of Damocles. We assign a 55% probability to a cut between May and June and a 45% probability to no change, with both outcomes defensible. Whether this toss of the coin lands on heads or tails will mostly depend on service price dynamics. But remember, coins with the same face on both sides have a way of tricking you.

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