Czech National Bank Minutes: Pace of cuts to slow amid inflationary risks

The CNB Bank Board reduced the policy rate by 50bp to 4.75% at its June meeting, with five decision makers voting in favour, while Eva Zamrazilova and Karina Kubelkova opted for a 25bp cut. Monetary conditions remain restrictive, but inflation risks warrant some caution

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Monetary conditions remain restrictive but inflationary pressures are tangible

The Bank Board assessed the risks and uncertainties in the outlook as moderately inflationary. However, the monetary policy setting was deemed sufficiently restrictive, so the main question is how quickly this restriction can be eased. The risks to higher future inflation are the following:

- Elevated wage demands in both the private and public sectors.
- Inflationary impact of the state budget due to excessive public wage bill.
- Higher-than-expected persistency in prices of services.
- Fade-out of disinflation in tradable goods.
- Accelerated money creation resulting from a potentially strong recovery in credit.

Governor Ales Michl stressed that the fight against inflation was not over. Even if the Bank Board cuts interest rates further, they will remain positive in real terms and will dampen inflation. At the same time, he added that the Board should discuss the possibility of slowing down the pace of rate cuts or stabilising rates for some time at its coming meetings.

In contrast, the downside risk to inflation is considered a sharper-than-expected deterioration in global economic activity and a weaker performance of the German economy. The development of foreign monetary policy also remains uncertain.

Exchange rate weakening in the spotlight

The recent weakening in the exchange rate was a point of discussion, as the EUR/CZK has hovered around 25.1 since the decision, adding heat to the renewed growth in import prices. Deputy Governor Jan Frait sees the koruna as undervalued, given the favourable developments in the current account and a tight labour market. Therefore, the exchange rate component of the monetary conditions might be looser than desirable. Karina Kubelkova expressed concern that domestic interest rates getting below the Federal Reserve's base rate would lead to a more pronounced and prolonged koruna depreciation. Deputy Governor Eva Zamrazilova stressed the importance of the exchange rate for current decision making, seeing a risk of further depreciation and higher volatility.

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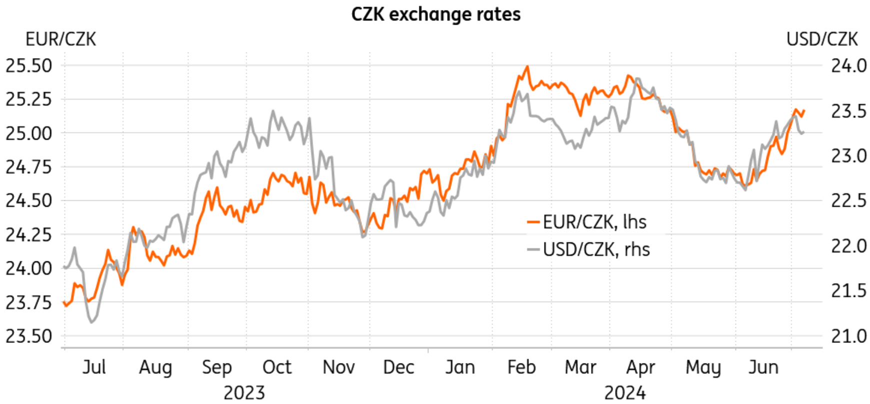

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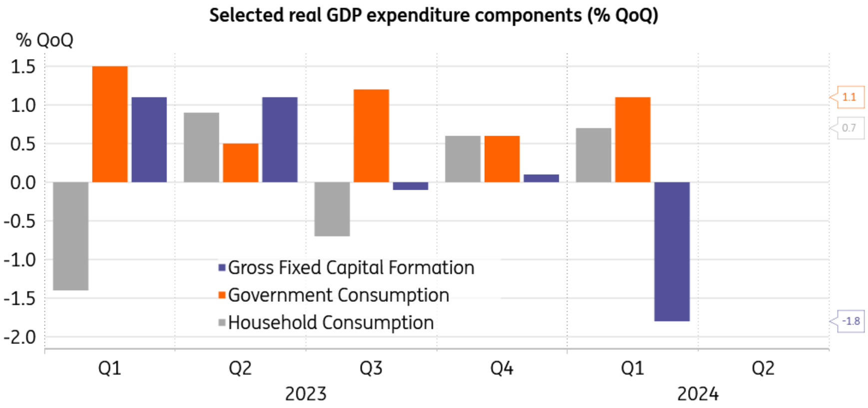
Four Board members preferred to ignore short-term fluctuations in the market outlook and to focus on the medium-term and forward-looking basis of monetary policy. Jan Frait pointed out that the effects of stricter monetary policy may take effect later than in the past due to fiscal spending or implicit guarantees for financial stability and public debt by key central banks.

Further easing on the horizon amid weak investment activity

Board Member Jan Prochazka noted that households' inflation expectations were gradually falling as inflation had returned to close to the target. Although a rise in headline inflation to 3% at the end of the year cannot be ruled out due to base effects, this should not represent an obstacle to further interest rate cuts.

The Board also discussed negative surprises in fixed investment. Tomas Holub highlighted that the overall impact on inflation needed to be clarified. Mediocre investment could have an anti-inflationary effect through weaker domestic demand in the short term. Still, its dampening effect on the supply side could outweigh this, and the overall impact could turn inflationary in the medium term.

Fixed investment struggles for three quarters



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We expect the CNB to slow the pace of rate cuts, with the policy rate coming down to 4.25% at the end of this year and further to 3.5% in the next. The next meeting will likely see a discussion about a 25bp cut or a pause. We expect both headline and core inflation to have softened further in June, so a 25bp rate cut is our base case scenario for the August CNB meeting. We assess the inflation pressures that the Bank Board discussed as relevant enough to keep the policy rate at elevated levels, especially compared to historical standards. At the same time, the risk that subdued demand from the main trading partners undermines the domestic recovery looks more likely than a quarter ago.

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