

Article | 2 March 2026

CZECH REPUBLIC

Czech PMI in no man's land

Czech manufacturing PMI picked up marginally last month, only to land at the 50 point line between contraction and expansion. This suggests that the worst is behind us. However, fierce global competition makes the outlook anything but rosy. The central bank must now consider both risks to inflation and growth

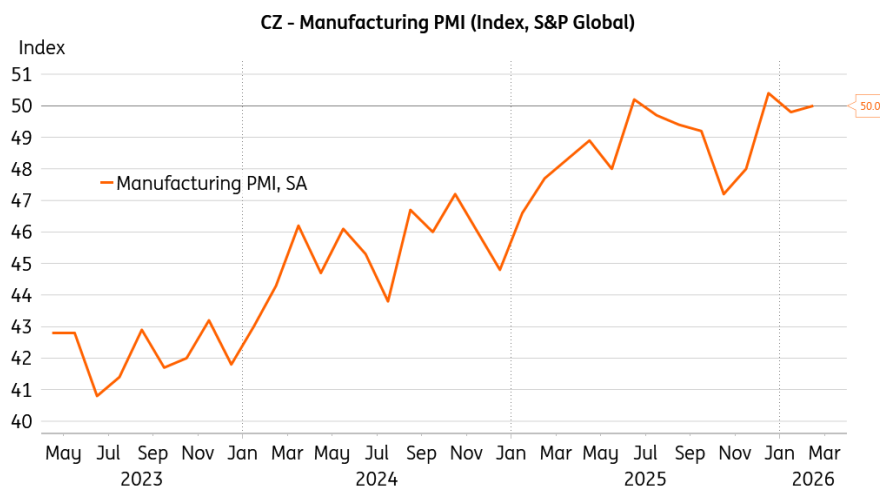


Out of a dark and cold place

Czech manufacturing PMI rose to 50 in February, signalling early signs of stabilisation supported by stronger output. Production increased at its fastest rate in four years, though the survey still points to weak demand and a continued focus on cost control.

Challenging business conditions and strong competition led to a second consecutive monthly drop in new orders, prompting firms to cut staff and scale back input purchases. Even so, optimism about output performance over the next year climbed to a four-year high. Input prices kept rising, and higher operating costs pushed companies to raise selling prices more quickly, despite tough global competition.

PMI between expansion and contraction



Source: S&P Global, Macrobond

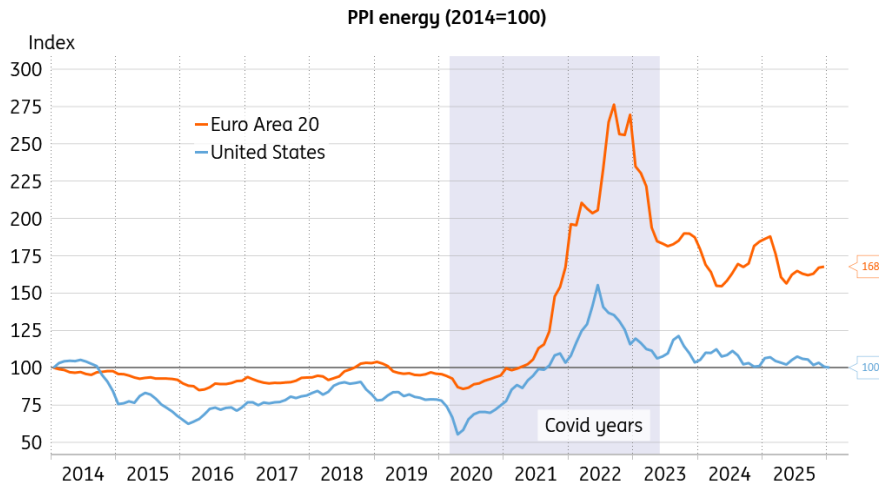
Production volumes rose for the third consecutive month in February, but new orders waned for two months in a row. Two major factors underpinned the decline in new export orders: sluggish demand in Europe and Asian competitors winning bids due to lower prices.

Employment fell at the fastest pace in three months, as workers who left voluntarily were not replaced. Shortages of essential materials, including metals, implied the second-strongest deterioration in supplier performance since the end of 2024. Rising operating costs were associated with higher supplier prices, especially for inputs such as metals, wood, and foodstuffs. Despite fierce competition, pressure on margins has forced companies to raise selling prices at the fastest pace in three years. Czech companies are planning to invest in new technologies, expand production capacity, and acquire new clients.

Expensive energy and overregulation drag on

Overall, Czech manufacturing is starting to see the light ahead. At the same time, fierce competition from Asia, mostly driven by China's production overcapacity, is about to make the path forward anything but easy. We still see high energy prices on the back of ETS1 as one of the major setbacks for European competitiveness, along with the never-ending regulatory barrage from the EC. That said, more pressure is emerging from EU member states in both domains.

European industry faces ample energy costs

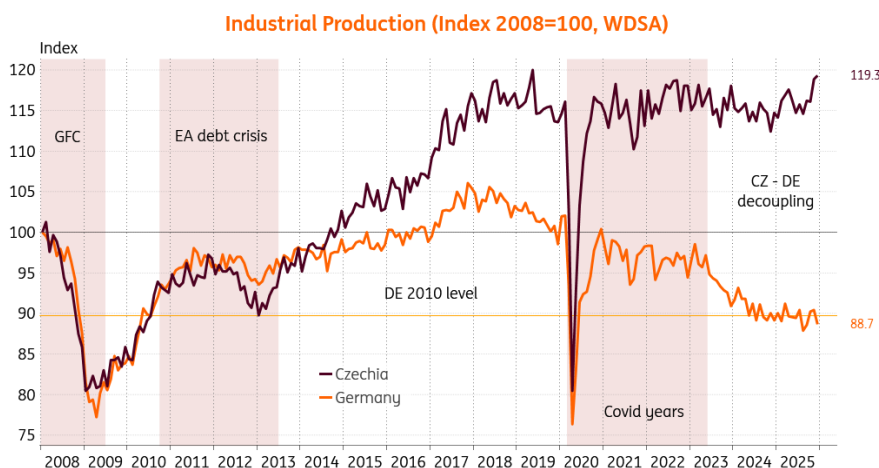


Source: Macrobond

For example, Czech Prime Minister Andrej Babiš has been actively pushing to revise the current emissions allowance system and delay the introduction of ETS2. In Germany, Federal Minister for Economic Affairs Katherina Reiche has criticised the European Commission for burdening legislation with so many rules that developing industrial policy becomes increasingly difficult.

For European industry, it's becoming a race against time – and the clock is not in its favour. Without tackling high energy costs and excessive regulatory pressure, discussions about competitiveness risk sounding hollow. In such a delicate environment, Franz Kafka's remark feels apt: *In the struggle between you and the world, be a second to the world.*

Quo vadis, industry?



Source: Macrobond

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That said, the Czech economy has managed to expand for eight consecutive quarters, despite the fact that industrial production has been broadly stagnant. At the same time, the protracted layoffs in manufacturing were to a large extent absorbed by the expanding services sector. However, the recent gains in the unemployment rate suggest that the services sector might be getting saturated, implying that further solid economic growth might be at risk, unless industrial production starts to play its part properly.

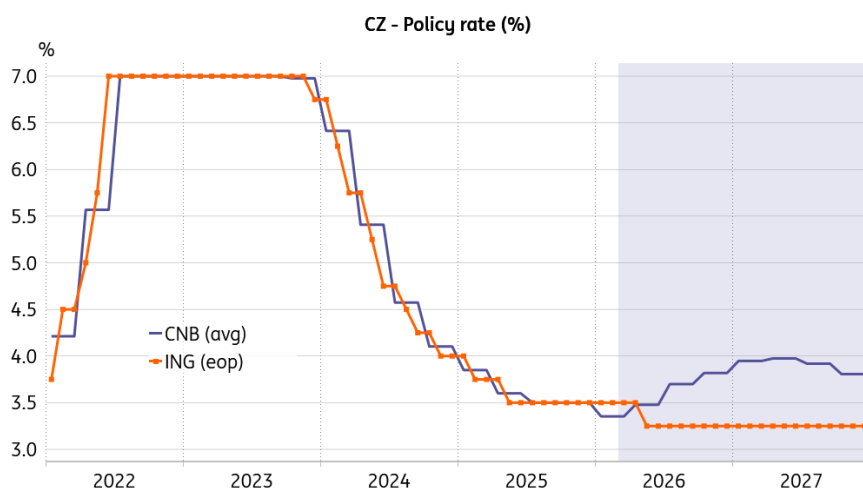
CNB to balance risks for inflation and growth

We wonder how the Czech National Bank (CNB) will comment on the recent events in the Middle East, which represent upward risks to inflation. Fuel prices will respond to higher oil prices almost immediately, while it takes around three months for the second-round effects to be tangible in core inflation, with the full pass-through taking seven months. Beyond the direct impact on energy and transport costs, the broader challenge is that the economy may be leaving behind the period of low oil prices for some time.

Having the headline inflation below the target, we believe that the interest rate trajectory is currently about two things: the core inflation and the real economic performance. And voilà, conflicts are not good news for external demand and Czech exporters. Together with the recent uptick in the unemployment rate, and the services segment perhaps not able to absorb any further layoffs in manufacturing, we have a potential risk to the economic growth outlook, notwithstanding the dampening effect of more uncertainty on households' appetite to go ahead with some extra spending.

So, we believe that our rates trajectory is still at a good place, as the CNB will have to balance the upward risks of inflation stemming from higher energy and transportation costs on the one hand, with risks to growth and demand on the other hand.

A potential rate cut is hard to time



Source: CNB, ING, Macrobond

The CNB may voice a more hawkish rhetoric in the coming days, giving way to fears about the inflationary pressures. However, given the risks to external demand and economic performance, we don't see the nominal interest rate drifting toward 4% as painted in the CNB forecast. We still see the case for one rate cut for now, but of course, we have to see when the dust has settled. As it goes with G. W. F. Hegel: *The owl of Minerva spreads its wings only with the falling of the dusk.*

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