Czech price pressures could make central bank more hawkish

The aggregate price level is picking up, with prices of foodstuffs, services and housing rising. The accumulated inflationary pressures will likely prevent any further easing from the Czech National Bank, with a stronger koruna hampering imported inflation. Still, the risks are tilted toward more potent and broad-based price increases

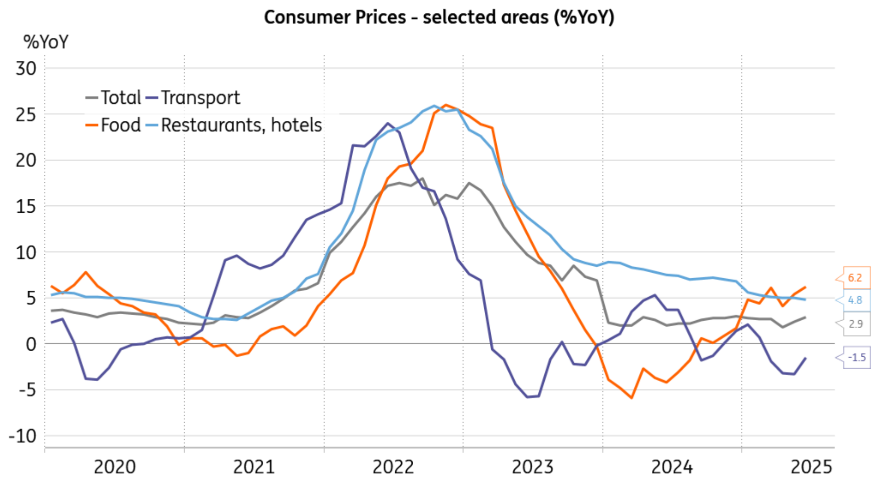
The CNB anticipates a future weakening of the koruna against the euro

Food, services, and housing drive price level higher

The prices of package holidays were up by 2.4% in June compared to May, while rental prices for dwellings rose 0.7%, and fuel prices gained 1.0%. In the food category, prices of meat increased by 2.0%, butter by 7.7%, and milk by 3.3% compared to the previous month. Meanwhile, lower prices were recorded for alcoholic beverages and fruit.

June's pickup in annual price dynamics was mainly driven by higher prices in the food section, with prices of meat adding 5.9% in June, milk prices up by 13.1%, and butter by 24.7%, with all these annual growths stronger than before. Prices of goods rose by 1.6% YoY in June, while price dynamics in the services segment picked up to 5.0% YoY. Core inflation is estimated to have increased to 3.0% in June from 2.8% previously, in line with our and the CNB's forecast.

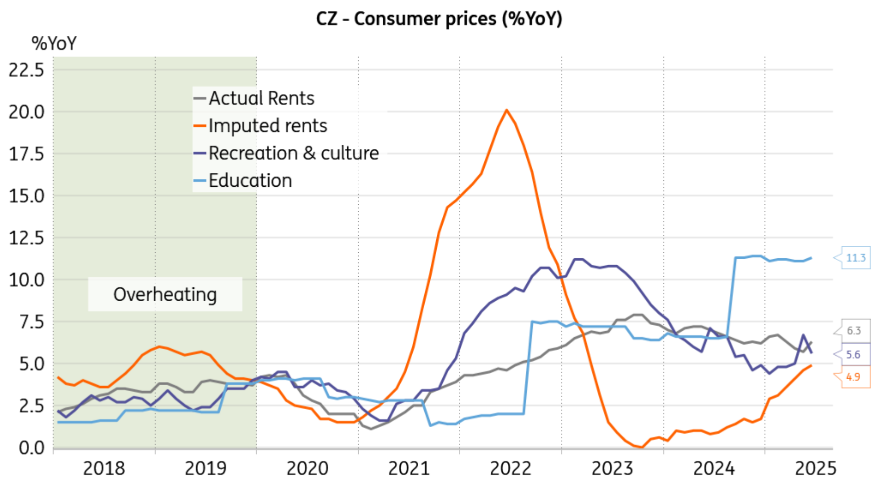
Price dynamic of foodstuffs gets punchy



Source: CZSO, Macrobond

In the housing section, market rents added 6.3% YoY in June, maintenance services gained 3.2% YoY, water charges increased by 4.2% annually, and sewerage charges by 3.7%. In contrast, electricity prices fell 4.8% and natural gas dropped 7.8% from a year earlier. Imputed rents annual dynamic quickened to 4.9% in June from 4.6% previously, yet the monthly gain of 0.5% was softer than the previous month's 0.8% increase. Still, this was the second-highest monthly increase in imputed rents since November of last year, reflecting rising property prices, along with increasing construction work costs.

Rent growth is picking up steam



Source: CZSO, Macrobond

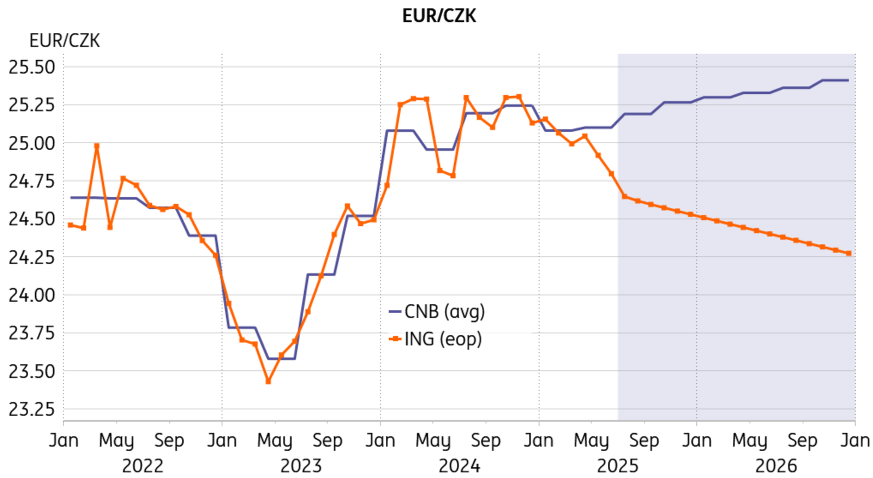
Overall, the potent price dynamic in the service segment, the quickening price growth in foodstuffs, and the robust growth in both market and imputed rents will prompt a more hawkish stance from the CNB. We currently see a stable base rate at 3.5% as the base case scenario, with average annual inflation expected to reach 2.6% this year.

However, given the continued economic rebound within a tight labour market, the overall risks are asymmetrically tilted toward higher inflation ahead, which might potentially require somewhat tighter monetary policy conditions to hold inflation in check.

Forecasts drifting apart

It has been the case for some time that our view on rates and the exchange rate outlook differs from the CNB forecast. Nevertheless, recent developments have made this difference even more pronounced, especially in two key macroeconomic variables: the exchange rate and the policy rate path.

Appreciation of the koruna to hamper imported inflation

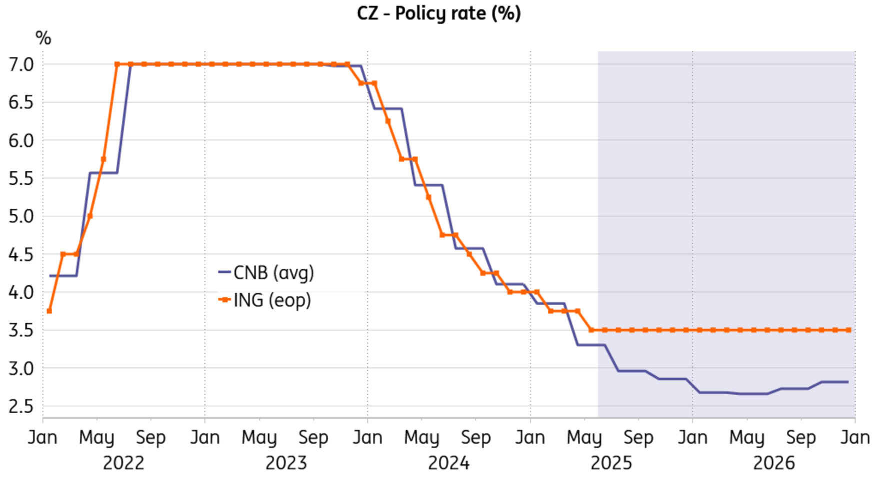


Source: CNB, ING, Macrobond

The CNB repeatedly sees a weakening koruna against the euro when looking ahead, since the potential growth for Czechia and other long-term equilibria of critical variables were lowered in the CNB's workhorse projection model. However, it takes two to tango, especially when it comes to the exchange rate.

We believe that the potential growth for the eurozone has deteriorated even more than that for the Czech economy since the onset of the pandemic. If this is the case, there is not much of a fundamental force that would drive the koruna to sustainably weaker levels, given the Czech outperformance in real economic growth and the returned convergence.

Price pressures bring easing cycle to an end



Source: CNB, ING, Macrobond

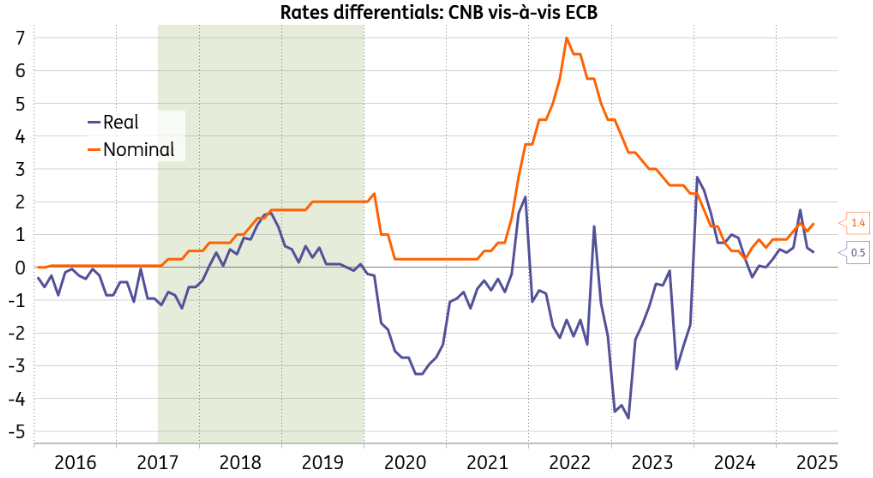
Indeed, broad monetary conditions can be tightened through various channels, such as via a lower base rate or a stronger currency. So, further appreciation of the koruna, as we see it, may help to hold imported inflation on a short lead. That said, domestic price pressures stemming from vivid household spending, the overheating housing market, and a tight labour market don't suggest further space for a rate reduction. The only remaining justification for a lower rate remains linked to the underperforming industry and stagnant fixed investment. That is, however, mostly due to broader pan-European structural issues, such as a lack of a viable strategy in the energy domain, minimal action on the topic of overregulation, or insufficient clarity about the future role of strategic industries and the objectives and means in the current reshuffle of international trade.

It is fair to say that the bank board has become increasingly less enthusiastic about the staff forecast, and the disparity between the rate-setters and the forecast has become more pronounced. So, we are looking forward to the new CNB forecast in August to see how the changed environment is reflected in the outlook.

Interest rate differential favours the koruna

The interest rate differential with the euro has widened since mid-last year in nominal terms, and it turned positive at the start of this year, even in real terms. This means that holding the koruna is now beneficial in both nominal and real metrics, providing a significant boost to the domestic currency.

Czech rate exceeds the euro rate in nominal and real terms



Source: Macrobond

Let's compare the current situation to the period from 2017 to 2019. In 2017, the Czech economy began to gradually overheat, leading to an increase in nominal rates in August. This caused the nominal rate differential with the euro to widen, and shortly thereafter, the rate differential in real terms also flipped into positive territory. As a result, the koruna appreciated by nearly 5% between mid-2017 and February 2020, until the Covid-19 pandemic abruptly ended its strong performance.

Meanwhile, despite the favourable exchange rate path that muted foreign inflationary pressures, headline inflation continued to increase, reaching 3.7% just before the pandemic. The lesson here is that a positive rate differential, coupled with economic expansion, suggests a stronger koruna that tapers imported inflation; however, that still does not mean that headline inflation cannot get out of hand.

Author

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com