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CZECH REPUBLIC

## Czech rate cut likely pushed back on sticky services inflation

We assume that Czech inflation will further soften throughout the year, on the back of decelerating food prices. The assumed disinflation in core inflation around the summer is a key element to a potential rate reduction. Given the solid economic performance, the Czech National Bank is in a comfortable position, and is not being pushed into action so far



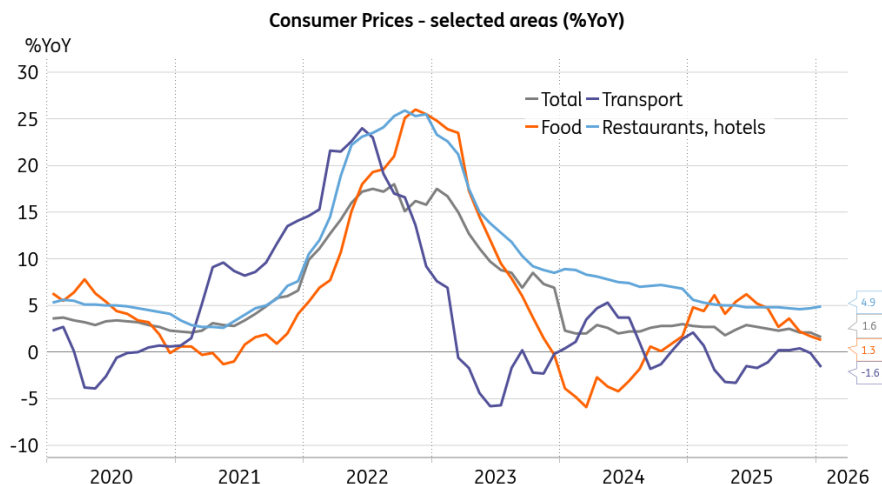
The Czech National Bank in Prague

### Herculean food prices move the headline rate once again

Czech inflation was confirmed at 1.6% year-on-year in January, with prices gaining 0.9% from the previous month. The pronounced monthly gain was mainly driven by higher prices in the food and beverage sections, as well as in alcohol and tobacco. In contrast, prices in the housing section fell 0.7% month-on-month, mostly due to 8.4% lower electricity prices, which also reflected government subsidies of electricity prices. Some prices continued to rise in the housing section, including rents, which surged 1.1% MoM, water charges rising 3.9%, and natural gas prices, which rose 1.3% from the previous month. Prices of goods increased by

0.7% MoM in January, and prices of services added 1.0% from the previous month.

## Services hold steady, the rest backs down



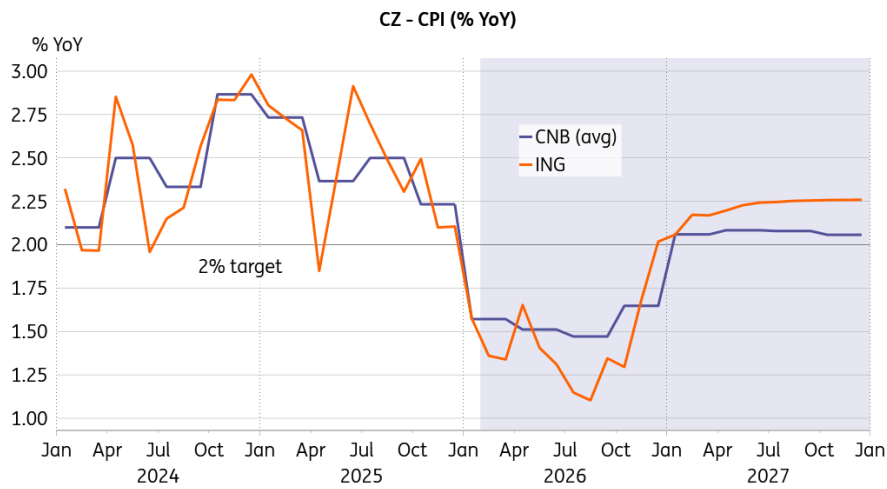
Source: CZSO, Macrobond

Core inflation picked up to 3% annually at the start of the year, according to our estimate. Annual dynamics in imputed rents marginally quickened to 5.1% YoY in January, mainly on the back of price gains for new properties. Prices of goods fell by 0.4% YoY, while prices of services gained 4.7% YoY. In any case, the absence of a deflationary process in the services segment will prevent the CNB from easing monetary policy, despite headline inflation crawling well below the target.

## Summer ease for both headline and core inflation

And here is the thing. We expect food price dynamics to gradually soften over the first half of the year, pushing headline inflation closer to 1% in the summer. Core inflation is set to remain elevated through June yet could ease in the second half of the year, depending on whether the second-round effects of lower energy prices for businesses find their way into price tags or remain hanging in the margins. We still see a case for one single rate reduction between May and August, but leaving the base rate at 3.5% is also an easily-defendable path forward.

## Headline inflation at ease

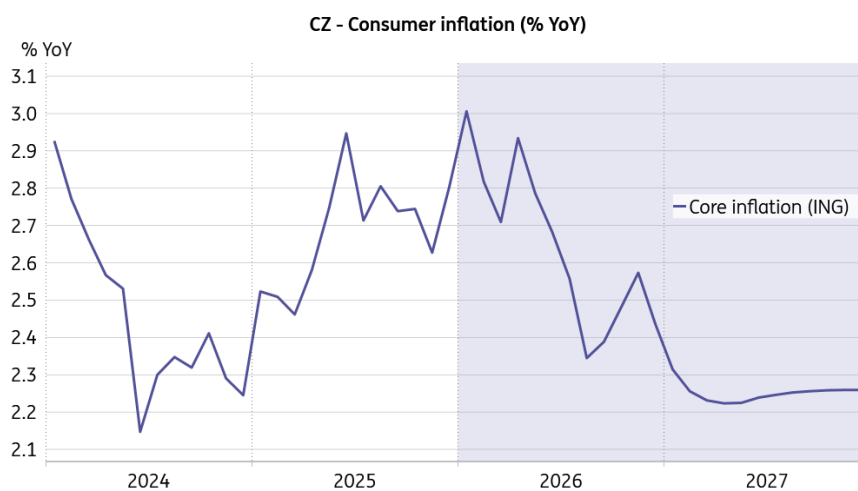


Source: CNB, ING, Macrobond

## Timing is not of the essence in a comfortable position

In our base case, we still expect services and the core rate to soften in June and July. So, when there is no sign of acceleration in services but an outlook for a slowdown, the cut will come, which is our base case. However, that outcome is only marginally different from seeing no slowdown in services at all, effectively a no-change scenario. It's roughly a 55% chance of one cut between May and August, and 45% for staying on hold.

## Core inflation is the key to a cut



Source: CNB, ING, Macrobond

So, there is already a chance of a single rate reduction in May if the Bank Board is forward-looking and our hypothesis on softening core and services inflation comes through. And yes, if

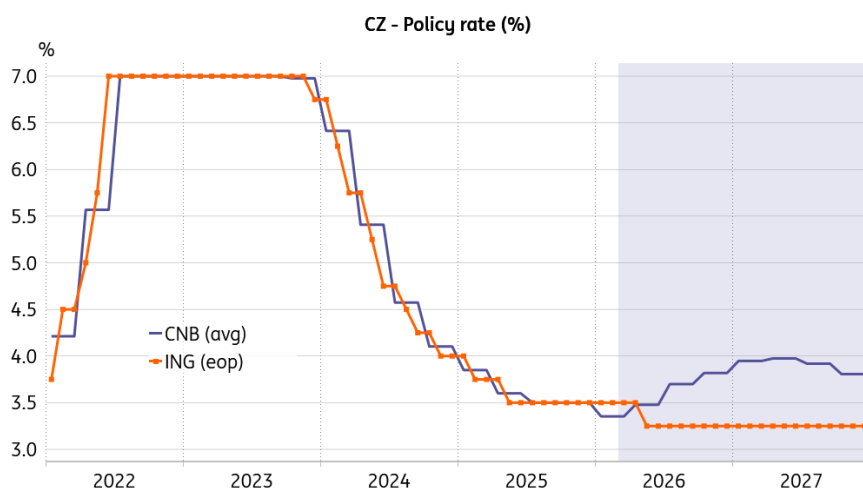
the rate-setters are about to wait for evidence in the data, then more clarity on the potential core/services price deceleration would be available by the June/July inflation print. Ergo, in the matter of timing, you can throw a dice. The CNB is in a comfortable situation, not really being pushed into action by anything. Yes, June is a good middle-ground choice. But the evidence will enter the courtroom only in early August, escorted by July's inflation print.

### **CNB bolsters rates via fiscal policy**

The Bank Board assessed the risks and uncertainties surrounding the inflation outlook as overall balanced at its last meeting, according to CNB Minutes. Meanwhile, all options for rates are still on the table when looking ahead. It was agreed that the deflationary effect of the government's subsidised electricity prices is a one-off factor, and the primary impacts should be excluded from monetary policy-relevant price developments. According to Deputy Governor Eva Zamrazilova, the primary impact of these regulatory interventions dissipates within a year and does not reduce demand-driven inflationary pressures in the economy. Of course, these administrative factors may gradually bring about anti-inflationary secondary effects, but they may be outweighed by improved disposable income and elevated spending.

According to Jan Kubicek, CNB interest rates are neither loose nor restrictive, while the development of public finances represents an expansionary risk. Jan Procházka stated that the CNB is now in a good position and, with the fading of some inflation risks, space may open for a slight decrease in interest rates. At the same time, the economy may gradually enter an overheating phase, posing an upward risk to wage dynamics, as Jan Frait and Jakub Seidler agreed. The CNB expects average wages to gain 6.1% this year. We take on board the expected 6.8% annual wage increase for the public sector from April onward but believe the private sector might be a bit reluctant to boost wages excessively in a low-inflation environment, which brings us to 5.6% wage growth for the whole economy this year. It's fair to acknowledge that this is a good candidate for an upward surprise, should Czech industry lift off properly.

## Punchy rates indeed, with inflation on target next year



Source: CNB, ING, Macrobond

One thing to mention about the projected CNB rate path is that the fiscal impulse has a significant impact on rates over the entire forecast horizon. In fact, its impact becomes even more pronounced in 2027, despite the CNB assuming a negative fiscal impulse in the final year of the projection. So, this year's positive fiscal impulse affects rates with a significant lag, and it almost seems supported by some kind of booster. We see a risk that, over time, the fiscal effect that keeps rates elevated over the forecast horizon will fade, and gradually be replaced by expert judgement, but ultimately leading to a reassessment of the whole thing toward a lower rate trajectory. And whether you consider this Friday treacherous, Philip the Fair style or otherwise, take care and have a wonderful weekend.

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