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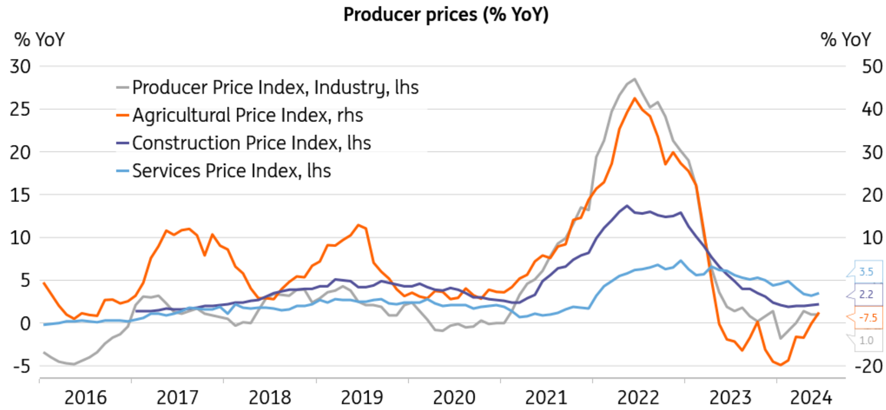
Muted producer prices make the next Czech rate cut easier

Czech producer price dynamics are muted across sectors, suggesting no inflationary pressures are coming from the supply side. And, when looking at the economy as a whole, the case for more rate cuts is perhaps becoming more straightforward

Subdued producer prices but stubbornly elevated services numbers

Agricultural producer prices dropped by 7.5% from a year earlier in June, falling 14 months in a row. Prices in industry increased by 1.0% YoY, the same as in May and marginally below market expectations. Prices for construction work added 2.2% from a year earlier, driven by revived activity in the residential market. A quickening in the growth pace was seen in prices for business services, recording a 3.5% annual increase in June, with price dynamics in the service sector still drawing the attention of Czech central bank policymakers

Persistent growth in business services prices



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The dynamic in business services shows approximately a one-year lag compared to prices in industry and agriculture. However, the annual growth in services prices remains well above the historical average of 1.4% recorded between 2016 and 2019, when the economy expanded by 3.5% on average. Industry price dynamics got pretty close to historical standards, with prices in agriculture remaining in a protracted decline. To sum up, there is some extra stickiness in business service prices, which is not attributed to a simple time lag needed for the cost pressures to trickle down to end prices.

The tight labour market, even amid tepid economic growth, is the likely source of the price stubbornness in the service sector, which would become a potential source of inflationary pressures should the rebound turn more robust.

Looking at the monthly comparisons, agricultural producer prices added 1.9% in June, mainly due to a seasonal increase in vegetable prices. Food prices tend to be rather volatile due to the vagaries of seasonal effects. Industrial producer prices were 0.3% lower on a monthly basis, reflecting falling prices in the coke and refined petroleum products sectors.

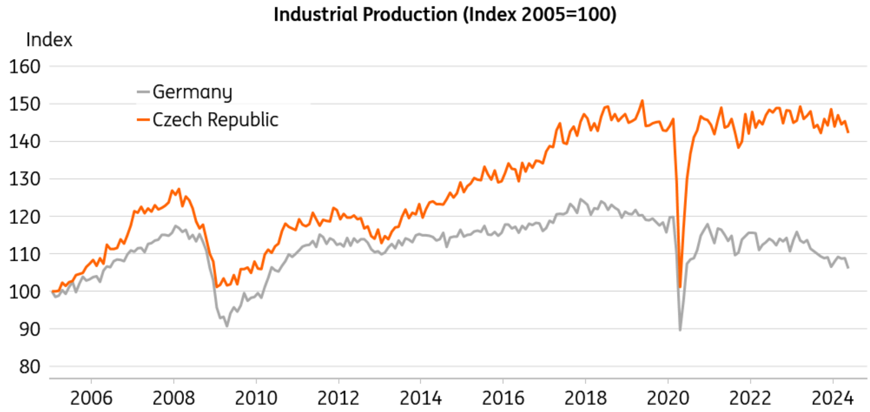
Placid pricing confirms the supply side is limping behind demand

The industrial production data and surveys suggest that Czech industry isn't exactly flourishing. Today, we have another piece of the jigsaw, with lower prices perhaps reflecting overall industrial weakness. Reported malaise in foreign demand and low levels of new orders aren't exactly contributing to the positive outlook of the industrial performance in the near term.

In contrast, household spending is still riding the wave of elevated nominal and real wage growth after years of austerity imposed by crumbling purchasing power amid high inflation.

The second quarter's real GDP figure will likely show a positive development in Czech economic activity, driven by household demand and still the positive contibution of next exports.

The German engine of Czech exports is not helping



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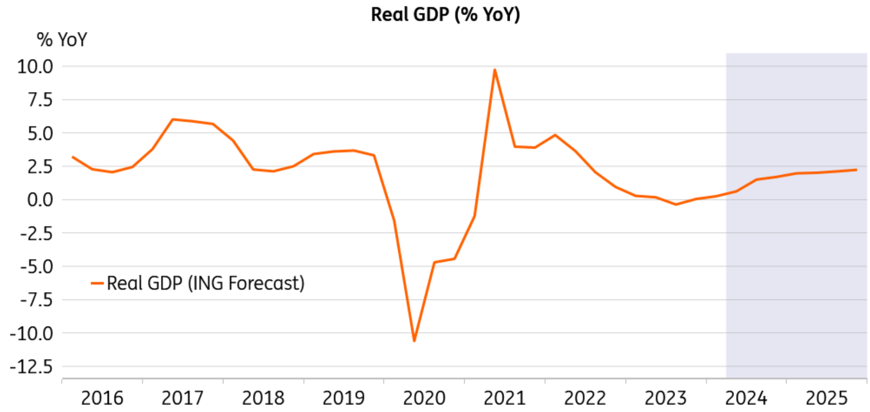
The question is, for how long can the consumer spending bonanza keep going if the economy's industrial base is not doing well? In a fully-fledged economic recovery, we would like to see the supply side take off toward expansion in employment and investment some two quarters after the demand side has played its part. However, this is not the case, as the disappointing Czech industrial production data shows which looks to be embarking on a downward trend. This has been happening for quite some time in Germany, which has traditionally been one of the essential engines for Czech export performance; the export leg is so crucial for the Czech Republic's overall economic performance. However, new orders and the general mood in industry signal that a fundamental improvement is not yet in sight.

More rate cuts to come amid fragile outlook

The latest subdued producer price numbers make a further reduction in monetary policy restrictiveness more straightforward. We're counting on a 25bp cut in the early August meeting and further 25bp cuts that will bring the policy rate down to 4% by the end of the year. We'll likely then pause due to risks related to traditionally more substantial price changes in January.

Real GDP is set to pick up only gradually



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We see the policy rate be reduced further from March next year to a terminal of 3.25%. However, the continued economic recovery is vital to this scenario. The weak investment and lingering industry amid hesitant foreign demand highlight the fragility of the outlook. We see a relatively conservative growth outlook of 1% this year and a gradual expansion in the next, factoring in the uncertain ground for investment and industrial performance. Meanwhile, the CNB sees a solid rebound in economic activity for this year of 1.4% and an acceleration to 2.7% in the next, holding the view that household demand will be the main driver of the rebound.

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