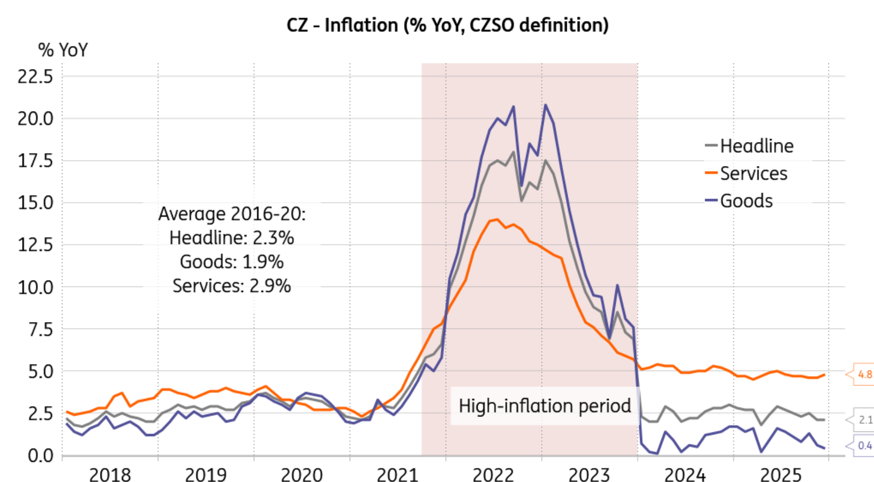
Soft Czech inflation brings rate cuts closer

Headline inflation remained close to the target in December, representing a downward surprise to both market participants and the Czech National Bank. Another monthly decline in food and energy prices contrasts with upbeat price growth in services. In any case, below-target inflation throughout this year makes a rate reduction likely

Subdued food prices contrast with upbeat service prices

Inflation came in below expectations at 2.1% in December, mainly driven by another sharp drop in food prices. Additionally, there was likely another weak figure in regulated prices, as the smaller distributors perhaps followed suit and lowered their energy end-prices. Goods prices dropped noticeably over the month, bringing their yearly inflation to 0.4% in December from 0.6% previously. In contrast, prices in the service sector recorded a monthly gain and the annual rate picked up to 4.8% in December from 4.6% previously. We estimate core inflation increased marginally to 2.7% on an annual basis.

Service price growth remains upbeat



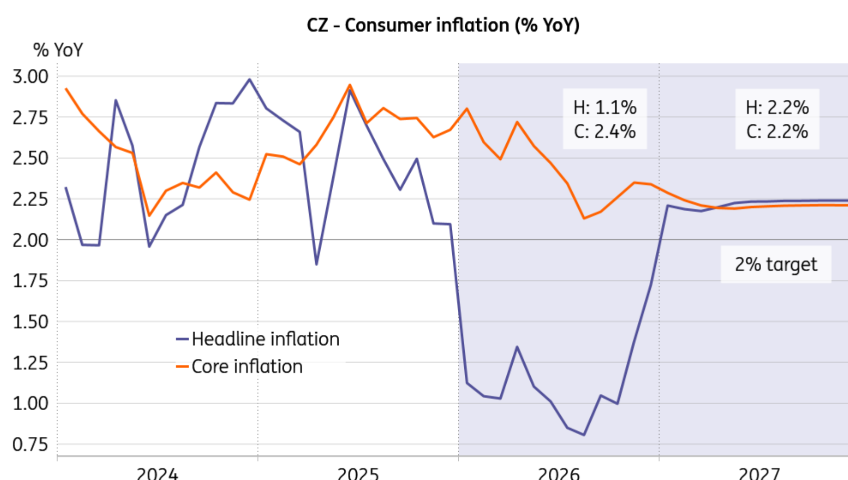
Source: CZSO, Macrobond

We're already seeing a twofold dynamic: subdued energy and food prices are keeping headline inflation in check while core inflation remains buoyant, driven by persistent price pressures in the services sector. Declining energy bills have eased household budget constraints, leaving more room for discretionary spending - primarily on services and other items that drive core inflation. That said, gains in goods prices are being kept at bay by a stronger koruna, making all imports cheaper. We expect this modus operandi to only strengthen throughout this year, as more energy price cuts are coming in January, along with government electricity subsidies.

Lower energy prices set to push headline and core inflation down

Energy prices are set to decline across all business sectors, which we view as a positive supply shock that supports higher output at softer prices. Overall, the downward second-round effects across various price categories should ultimately prevail, translating into disinflationary pressures on core inflation over time, despite more buoyant spending. At this stage, the key question is whether lower energy prices will be the decisive factor that enables Czech industry to achieve a more sustainable lift-off – a question that also looms large for Germany. If this scenario materialises, labour could once again become a scarce resource, particularly as manufacturing shows early signs of renewed hiring after three years of stagnation.

Headline inflation set to drift below the target



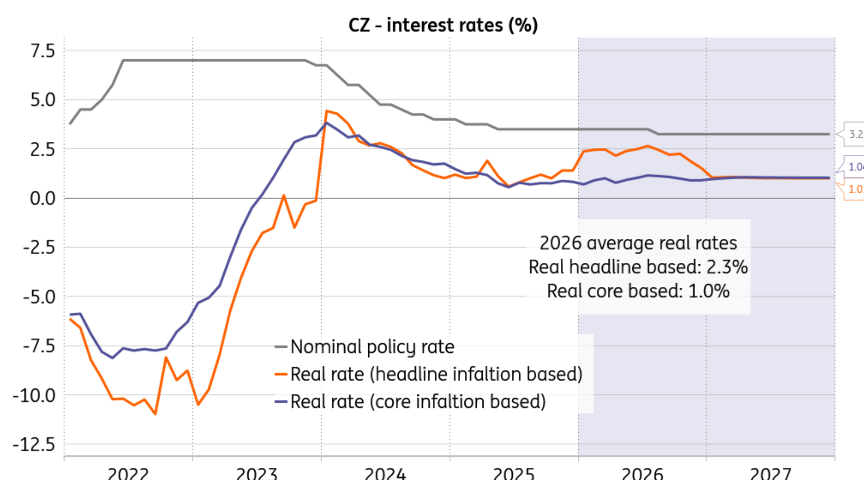
Source: CNB, ING, Macrobond

When taking the latest surprise on board, we see headline inflation dropping to 1.1% on average this year, pushed down by declining energy prices. The major energy distributors are about to slash end-prices of electricity and natural gas, the government will subsidise the regulated part of the electricity price, and fuel prices reflect subdued global energy prices and a strong koruna. Voilà! Here we stand in a situation with decent economic expansion and subdued inflation: Who wouldn't want that?

One summer cut and done vs. March and August one-two punch

Still, with headline inflation well below the target from January onwards, core inflation likely drifting lower throughout the year, and both close to 2% in 2027, we see monetary conditions easing as the most likely outcome. We see two ways forward now: i) The CNB could wait, with no immediate pressures, and opt for a single cut around summer – positioning 3.25% as a sound long-term equilibrium rate, especially with inflation projected near 2% by 2027. ii) Alternatively, with the real interest rate above 2% from January, the CNB might proceed with a cut in March, followed by another in August as core inflation decelerates - ultimately calling 3% the appropriate terminal rate. Stay tuned, we'll see how the bets evolve.

Punchy real interest rate facilitates easing



Source: CNB, ING, Macrobond

It's hard to draw intuitive and personal odds for the two paths. The real interest rate, as measured against headline inflation, seems a bit too high, indeed, as it hovers around 2.5%. At the same time, when measured against core inflation, 1% seems rather bearable, especially as Governor Ales Michl pledges real positive rates ahead, for all the right reasons, in our view. And you can always argue that, as a forward-looking institution, you should focus on inflation nearing the target beyond this temporary low-inflation phase, which was largely a one-off driven by government measures.

Moreover, inflation undershooting the target a bit is not a big deal after the serious inflationary wave between 4Q 2021 and 2023, and after inflation was somewhat above the target in the last two years. Any harmful deflation is not really in sight with the economy humming at around a 2.7% growth rate. Summa summarum, we tilt a bit more towards the one summer cut and done option for now, with 3.25% providing a decent base for an expanding economy in 2027, and we maintain this as our base case scenario. As always, the timing is key, and we agree that the March and August one-two-punch is also an appealing option.

Author

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

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss

arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.