Czech National Bank Preview: Rates likely unchanged; hawks rear their heads

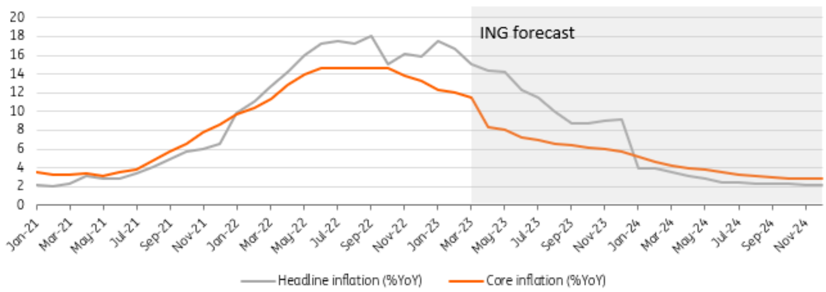
The Czech National Bank will likely keep interest rates unchanged at 7%. The future development of wages and government strategy for fiscal consolidation will play a crucial role in the possible easing of monetary policy in the future

The building of the Czech National Bank in Prague

Hawks rear their heads

Recent statements from CNB board members sounded relatively hawkish, emphasising the importance of maintaining restrictive monetary policy. On the one hand, the CNB can feel more comfortable with the gradual decline of both headline and core inflation. Core inflation declined from 14.7% in September to 11.5% in March. This confirms that the relatively early tightening of interest rates from the summer of 2021 is already bearing fruit in terms of taming inflationary pressures. We expect this trend will continue and headline inflation will fall to close to 9% by the year-end. Several board members stressed that the continuous decline of core inflation will be a crucial factor in their decision to cut interest rates at some point in the future.

Development of inflation

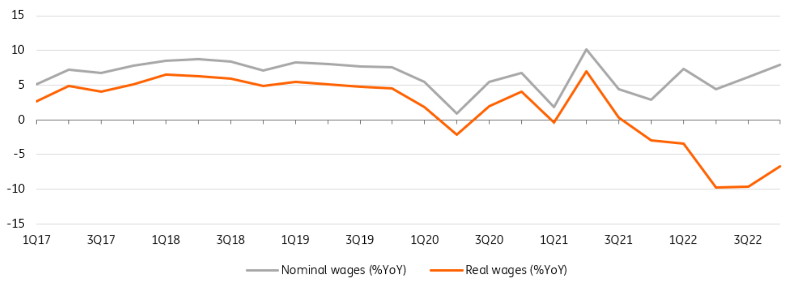


Source: Source: CNB, ING estimates

Labour market tightness represents a risk

The CNB will no doubt be worried about the still hefty growth of industry wages at the beginning of the year. This exceeded 10% year-on-year and hence remained above the critical threshold mentioned, for example, by Vice Governor Eva Zamrazilova. The lingering tightness of the labour market was also confirmed by the recently published decline in the unemployment rate of 0.2bp to 3.7% in March. The growth of nominal wages in the overall economy, however, remained below the 10% critical threshold (7.9% YoY in 4Q22) hence board members will likely wait for fresh quarterly data before they make an assessment on the risk posed by the labour market to domestic inflationary pressures. The next labour market report for the first quarter (released 5 June) will be worth following as it could signal whether the inflationary risk from the labour market is abating or increasing.

Average wage development

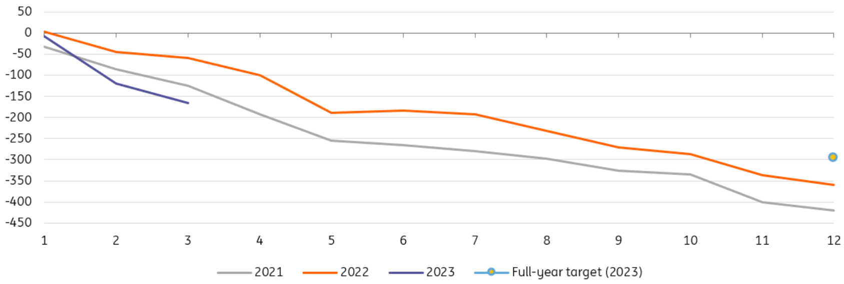


Source: Source: CZSO

The other inflationary risk is the deteriorating fiscal stance

The other issue is the adverse development of the fiscal stance. In March, the state budget recorded a deficit of CZK166.2bn, which was the worst March result on record, jeopardising the government's plan for a CZK295bn deficit this year. Board Member Jan Kubicek recently stressed that the fiscal stance will be a key element in his decision on whether to postpone the easing of interest rates or even think about an increase. He also stressed the importance of seeing core inflation on a descending path.

Czech state budget (CZKbn)

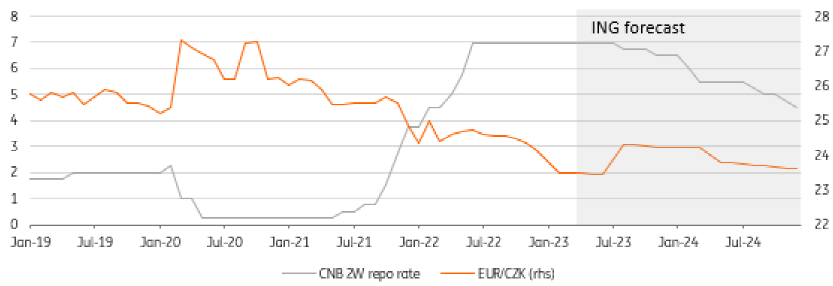


Source: Source: Ministry of Finace

Hawkish stance likely to persist until summer

In our view, a hike is unlikely. On the contrary, we assume the CNB's current 7.00% policy rate marks the peak in the hiking cycle. Still, we think the CNB will only start the debate about a possible normalisation of monetary policy when inflation moderates close to the current levels of the policy rate. The first possibility for such a debate about a symbolic 25bp interest rate reduction could come in August when the new summer inflation outlook will be discussed. But given the prevailing risks from tightness in the Czech labour market, we do not expect more than a total of 50bp of rate cuts by the year-end. And assuming EUR/CZK has only limited scope for a possible upward correction, CNB monetary conditions should remain relatively tight.

ING outlook on interest rates and CZK



What to expect in FX and rates markets

The Czech koruna settled slightly below 23.50 EUR/CZK after profit-taking and we think the hawkish CNB meeting will help it to go lower again. More balanced positioning, still decent FX carry and potential risk of FX intervention and rate hikes should help push the koruna back to 23.30 EUR/CZK, in our view. Moreover, the higher EUR/USD in recent days may unlock levels around 23.20, and if the European Central Bank delivers a hawkish message next week that supports the euro again, we do not rule out the possibility of the koruna testing 23.00 EUR/CZK as well. Given the aforementioned reasons, we see limited room for an upward correction in EUR/CZK. From this perspective, the koruna retains the best risk/reward in the CEE region, in our view.

In the rates space, the market has revised expectations upward since the last meeting, but the last few days in the core markets have again shifted the IRS curve to the dovish side. At this point, the market is expecting the first rate cut in the summer and roughly 100bp of cuts by the end of the year. We believe the CNB meeting, as in March, will move the curve up again, especially at the short end of the curve, in our view, and hence we see a case for a re-flattening of the curve. However, the paying flow will be short-lived and the next CPI print (11 May) will again be the trigger for pricing in rate cuts.

Author

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com