Snap | 27 April 2023 Czech Republic

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.

Snap | 27 April 2023

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



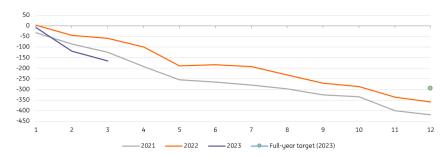
Source: Source: CZSO

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.

Snap | 27 April 2023 2

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

Snap | 27 April 2023 3

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

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.

 $Additional\ information\ is\ available\ on\ request.\ For\ more\ information\ about\ ING\ Group,\ please\ visit\ \underline{http://www.ing.com}.$

Snap | 27 April 2023 4