

## Czech National Bank to stay on hold this week

We expect the Czech National Bank to stay on hold this Thursday, not least due to recent comments from CNB Board members. New forecasts will fine-tune some variables, bringing perhaps a higher inflationary outlook or a revised CZK path, but the big-picture should remain the same



The headquarters of the Czech Central Bank (CNB) in Prague

### Inflation above expectations in recent months

The Czech average inflation rate in the second quarter of this year reached 3.1% and was above the CNB's estimate from May's forecast of 2.9%. Moreover, the CNB-defined core inflation number reached 3.2% on average in 2Q while the Bank estimated an average of 2.2%. It was partially due to a VAT decline in May which has yet to be seen in final prices and that pushed the core measure higher.

Despite some uncertainty as to what extent prices are correctly measured during these extraordinary times in 2Q, domestic inflation remains somewhat elevated and above the upper limit of the central bank's tolerance band. As such, the risk of deflation seems to be relatively distant which, at least for now, would limit any need for the Czech central bank to introduce unconventional monetary steps as interest rates are close to zero-lower bound.

## Inflation should moderate in the coming months

On the other hand, the CNB is not concerned about inflation being above the upper tolerance band as this is most likely a temporary effect; that's suggested by decelerating producer prices which came in below the CNB forecast in 2Q (industrial producers -0.6% YoY vs +0.6% YoY, agricultural prices -3.2% YoY vs. -1.8% YoY expected in the forecast).

Also, households' worries about inflation somewhat eased in recent months after its peak in May, though they remain close to historical highs. As such, some easing of inflation is likely and, as Board Member Tomas Holub put it in an interview for Bloomberg, *'the stagflation trend is temporary and inflation may land quite softly on target in the medium-term'*.

# 0.25%

## The main CNB interest rate

We're expecting no change on Thursday

## Stronger CZK not a problem for the CNB right now

The Czech koruna appreciated below 26.3 EUR/CZK at the end of July, being broadly 4% stronger compared to the CNB 3Q average forecast of 27.4. Still, the average July rate was at 26.5, around 3% stronger compared to the CNB 3Q expectations. Though FX delivered some monetary tightening, given the recent CPI numbers being above the CNB tolerance band, some FX-tightening which could gradually tame above-target inflation might be considered as the CNB is a particularly strict inflation targeter.

## New forecast keeping the same big picture

The CNB will also publish a new macroeconomic forecast and some changes are likely, for instance on the higher inflationary outlook (from 2.8% in 2020) given higher-than-expected numbers in the previous months. There will also be a EUR/CZK trajectory change, which was assumed to remain above the 27 EUR/CZK target until the end of the year and even into 2021. But from the big-picture perspective, the direction of the Czech economy should remain similar in the new forecast, with a contraction being in-between current analysts' estimates ranging from 5 to 10 %. The latest 2Q flash GDP number which showed a 10.7% YoY decline was very close to the CNB forecast from May (-11.6).

## Longer term stability of rates most likely

As the current situation remains highly uncertain due to the global Covid-19 developments, the CNB does not want to officially exclude any possible unconventional monetary tools in case of any emergency need. But we believe the CNB will try to avoid these measures. This was also suggested by the vice-governor Tomáš Nidetzký in an interview for Reuters when he inferred that possible unconventional tools will remain only part of "academic" debate. All in all, unless the Czech economy deteriorates more significantly (contraction above 10 %) and deflationary risks become more tangible, unconventional measures will not be delivered by the CNB, in our view. For now, the longer-term stability of rates seems the most likely scenario.