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CZECH REPUBLIC

Punchier inflation outlook opens door for Czech tightening

Czech inflation matched market expectations of 1.9% in August. However, we continue to see a stubborn core rate, which is driving our inflation outlook higher. Persistently elevated oil prices also reshape the narrative, while November brings tighter monetary policy into focus. Nobody likes real rates too close to the zero bound

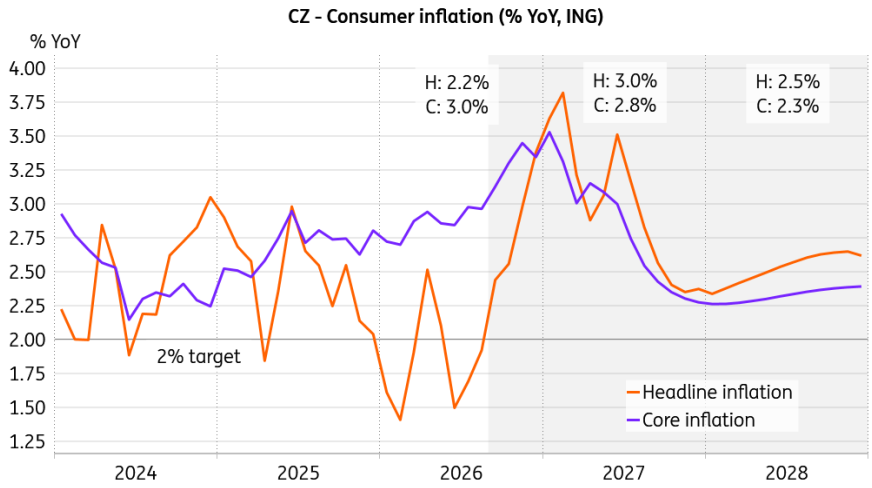
We increase our headline inflation forecast to 2.2% this year and 3% next, while the core rate is set to average 3% this year

Sticky core inflation alters our forecast

Czech headline inflation picked up slightly to 1.9% year-on-year in August and gained 0.3% month-on-month, which is in line with market expectations. Fuel prices were the main driver of the gain, while food prices continued to dampen the headline figure. Prices of both processed and unprocessed foodstuffs recorded monthly declines in August, while alcohol and tobacco were more expensive than the previous month. When looking at the limited breakdown provided by the preliminary estimate, we believe that the regulated price segment is starting to lift off, as distributors begin to pass persistently elevated oil and natural gas prices on to customers.

Annual growth of services prices softened to 4.5% in August (from 4.7% previously), while overall price growth in the goods segment flipped to a 0.2% annual increase. That said, the 4.5% pace of services prices remains in territory that is not compatible with medium-term price stability, which is some 1ppt below that figure. We estimate that annual core inflation has landed at 3% in August, thus above our original assumption, with imputed rents being the main culprit of this intransigence.

Prices tend to be order two integrated



Source: CZSO, CNB, ING, Macrobond

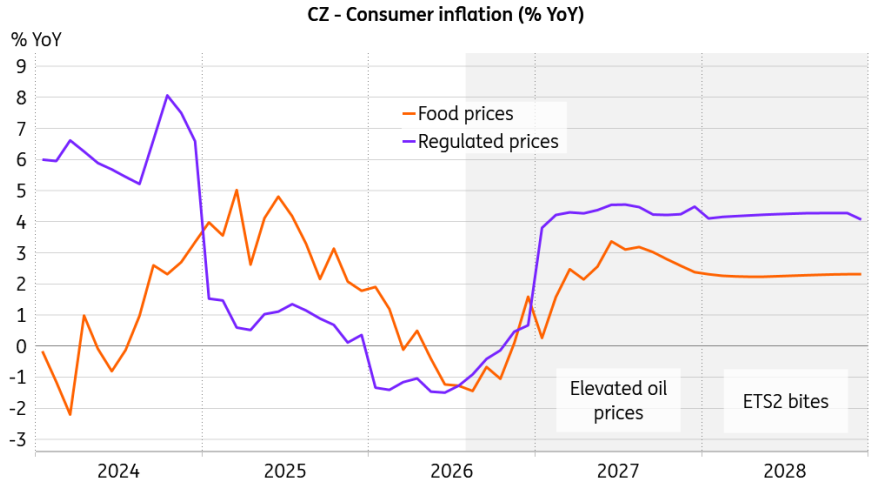
And that is a problem, as core inflation tends to be rather stubborn. Indeed, a price time series is often a process that shows the second order of integration, meaning that the price level, and also its first difference, is non-stationary. Such properties imply ample stickiness and persistence. I have been surprised on the upside by core inflation prints over the recent months, and I don't like it. If you know how not to take it personally, please let me know. As a remedy, I have simply increased the long-term equilibrium for core inflation to 2.4% in our econometric model. Fundamental reasons are at hand, including i) the rising population driven by immigration, ii) a shift in Czech consumption towards services as society gets richer, iii) a shrinking pool of experienced labour due to ageing, and iv) stagnant productivity at best.

Persistently elevated oil price changes the story

With continued robust growth in real retail sales of 4.8% in July, supported by solid annual real wage gains of 4.3% in 2Q26, we see both headline and core inflation steadily increasing up to early next year. This is partially on account of a low comparison base in 1Q26, but persistently upbeat oil and gas prices will take a pro-inflationary toll. We face a classic situation when gradual quantitative adjustments result in a change in quality itself, such as adding one grain of sand to another – and suddenly you get a pile. It's hard to identify the single grain when it has happened, yet – voilà – you have it. And, instead of having a significant drop in oil and gas

prices by the end of this year, as was assumed from the onset of the Hormuz turmoil, we get still-elevated energy costs with the effect of kicking the can down the road.

Regulated and food prices set to dent real purchasing power

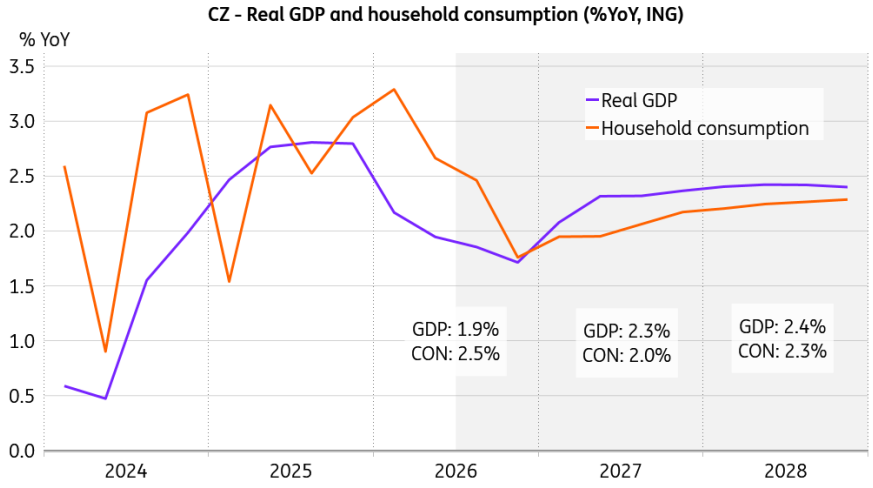


Source: CNB, ING, Macrobond

For all the above-mentioned reasons, we increase our headline inflation forecast to 2.2% this year and 3% next, while the core rate is set to average 3% this year and to recede only gradually over the next year to 2.8% on average. With headline inflation expected to peak at 3.8% in February, also driven by a rebound in regulated and food prices, we must shift our expectations about the monetary policy response. The situation is rather complex though, as we are dealing with a negative supply shock after all, with the general price level largely propelled by energy prices. Yet, as we all know, a negative supply shock – like it or not – brings pressure to economic activity.

Summa summarum, the forces of potentially stronger-than-expected wage and rent growth on the one hand, and the possibly disappointing overall economic performance on the other, will shape the Czech National Bank's reaction. We take the position that none of these opposing drivers would take the upper hand soon and opt for policy rate stability as the likely outcome for now. However, we see the case for tighter monetary policy as strengthening. The CNB's traditional scepticism towards expansionary fiscal policy could further support such an outcome, while the budget draft will be shaped by negotiations over the coming weeks. There is still a chance that the deficit-to-GDP ratio will not exceed the 3% threshold substantially.

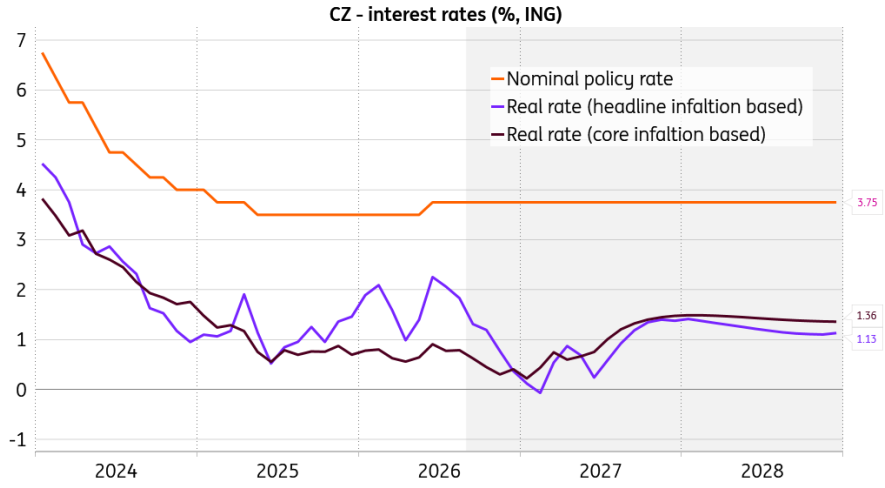
Real economic growth is softening



Source: CZSO, ING, Macrobond

We still see CNB as being on hold at its next meeting in September. But we deem November's meeting as a live one, with a 35% chance for a rate hike. For sure, this figure is set to evolve subject to the essential macro data and policymakers' forward guidance. And as experience suggests, another hike is potentially just one biker-jacket interview with the governor and a couple of hawkish comments from fellow board members away.

Real interest rates set to drop



Source: CNB, ING, Macrobond

The question remains the same. Would the supposed 4% base rate be a fait accompli, or could we see a genuine hiking cycle creeping in, grain after grain, if the economy lifts off forcefully? In our reading, this mostly depends on whether the economy gets into full swing in the near future. If yes, a genuine hiking cycle could be in the making, if not, then 3.75% or 4.00% is

good enough. By the way, should our inflation forecast be correct, real interest rates would touch the zero bound in February, and I heard on the radio a couple of times that the governor is not a fan of negative real interest rates.

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