Czech National Bank

CNB Focus

June rate hike likely to signal CNB's readiness to fight inflation

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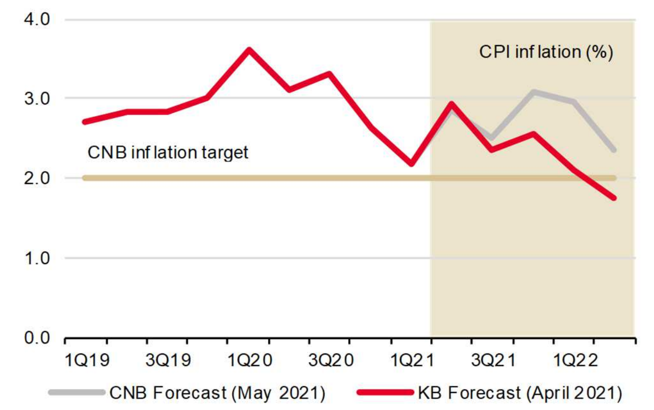
The Czech National Bank (CNB) is likely to raise interest rates next Wednesday. This follows on from statements made by the bank board, indicating that five of the seven board members voted for a rate hike in June. According to the central bankers, inflation remaining above the two-percent target for more than two years is the main reason for early policy tightening. They especially mention a possible adverse impact on inflation expectations. A 25bp increase in June should therefore signal that the CNB is ready to fight higher inflation. However, we do not expect the repo rate to move above 1% at the end 2021.

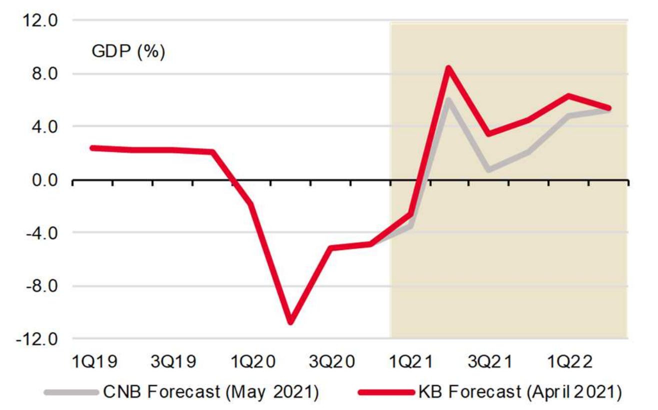
The latest statements released by the CNB's board signal its readiness to raise interest rates at its meeting next Wednesday. They flag inflation of 3% as being the main argument in favour of the early tightening of monetary policy. Inflation has remained close to the upper limit of the central bank's tolerance band and above the 2% target for more than two years. Moreover, the pandemic has hit the supply side of the economy hard and put further upward pressure on prices. Rapid growth in industrial prices due to shortages of certain production inputs and higher commodity prices is now very evident. The May increase in Czech producer prices crossed the 5% yoy level.

Inflation is forecast to remain above the CNB target all year



Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

The second half is likely to bring a strong economic rebound



Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

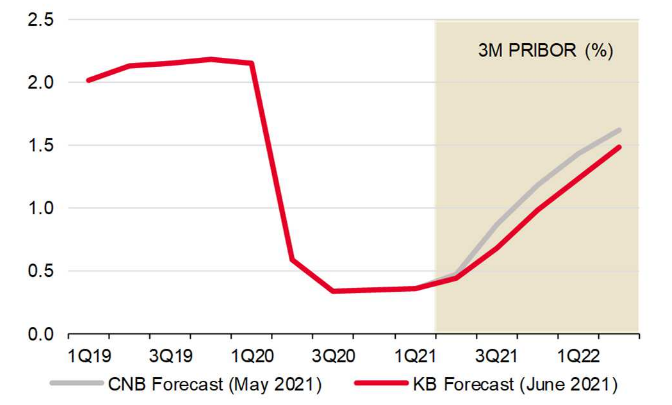
The income of most households continued to increase during the pandemic due to strong fiscal support. The reduction of personal income taxes by the Czech government also had an effect. Furthermore, we have not seen any significant increase in unemployment and some employers are already reporting problems hiring new workers, in both the unskilled and skilled categories. With the labour market now almost as tight as it was prior to the pandemic and likely to remain so, wage growth looks set to accelerate. This, together with a gradual spending of excess savings built up during the pandemic, should support consumer demand and likely put greater pressure on prices.

The central bankers are thus worried that inflation hovering above their target for longer could jeopardise the anchoring of inflation expectations. Indeed, a prolonged rise in consumer prices of around 3% could confirm that sellers of goods and services should increase their prices by more than the 2% targeted by the central bank. In each of its communications, the CNB has emphasised that its principal and legal mandate is to ensure price stability. It is therefore likely that the primary objective of the June interest rate hike will be to send a signal that the bank is prepared to supplement its current hawkish rhetoric with real action and that it is determined to get inflation back to 2%. While consumer price developments over the coming months look uncertain, the risk is that higher inflation will persist.

Based on the above, we are adjusting our forecast for the first rate hike and now expect it to be announced at the CNB's June meeting next week. The economic arguments favouring gradual policy tightening this year remain the same – see our previous research here https://bit.ly/2TwfNfj. The shift in the first hike from August to June is thus solely based on the board's statements declaring the necessity of acting quickly to send a signal of its readiness to fight higher inflation. However, we still think the first increase in the key repo rate will be of 25bp. The fact that this is likely to occur about a month earlier than we previously expected should not significantly affect our economic scenario. This underlines the signalling role of the June hike.

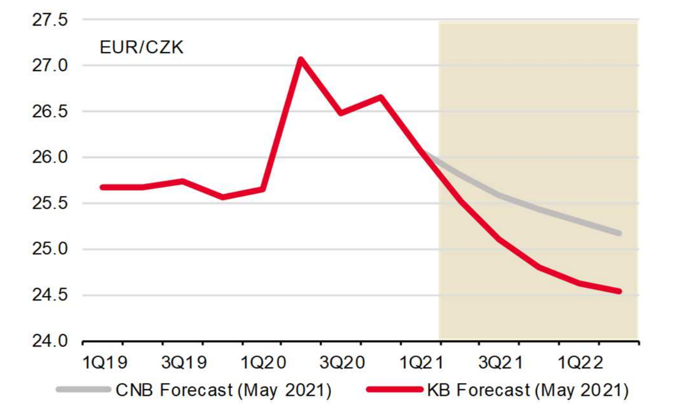
The difference between raising interest rates for the first time in June or August remains very subtle. There is therefore a large risk to our rate forecast. Given the available statements from the board members, we expect five of the seven board members to vote for a rate hike in June, namely Governor Rusnok, Vice-Governors Mora and Nidetzký, and Board Members Benda and Holub are likely to prefer higher interest rates. On the other hand, Board Members Dědek and Michl are likely to vote for ongoing rate stability.

We expect interest rates to increase by 50-75bp this year



Source: CNB, Economic & Strategy Research, Komerční banka

Koruna should be stronger than the CNB expects



Source: CNB, Economic & Strategy Research, Komerční banka

We do not think the June rate hike will significantly accelerate the pace of policy tightening over the rest of the year. We expect one or two further hikes in 2H21 which still means the key repo rate should not exceed 1% at the end of the year. The continued strengthening of the Czech koruna, which we expect to be below EUR/CZK25 at end-2021, should remove some pressure on interest rates. Rate increases are also likely to be held back by the risk of the emergence of new COVID variants that could be more resistant to the available vaccines.

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