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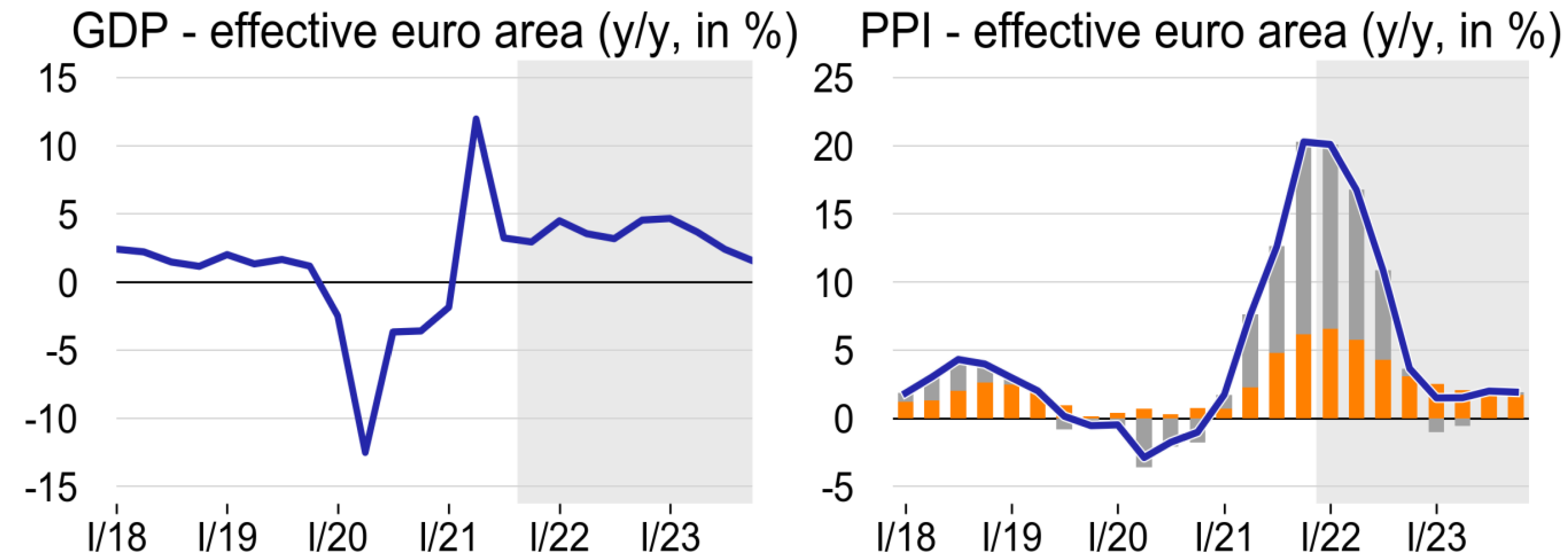
Perspectives of the Czech Economy and CNB Monetary Policy

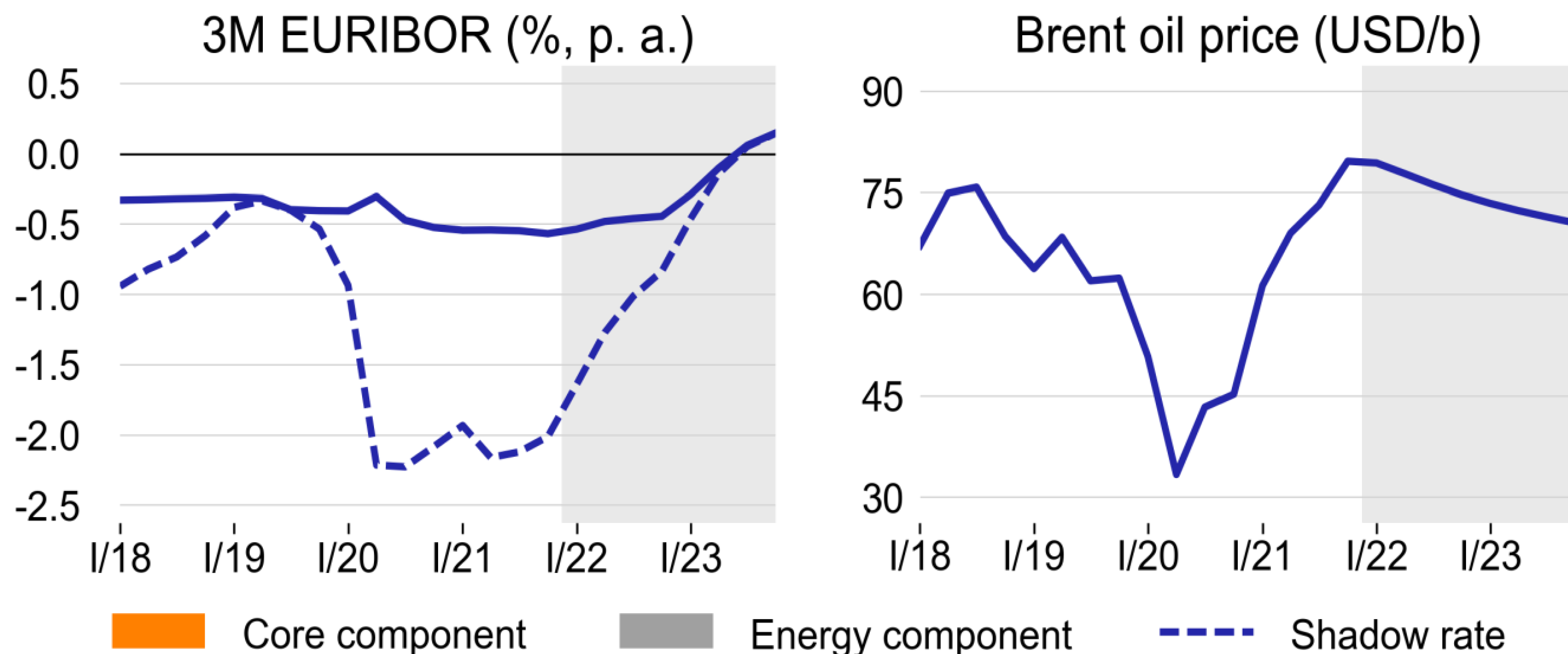
JCCI CZ Monthly Meeting

18 February 2022

Vojtěch Benda (CNB Board Member)

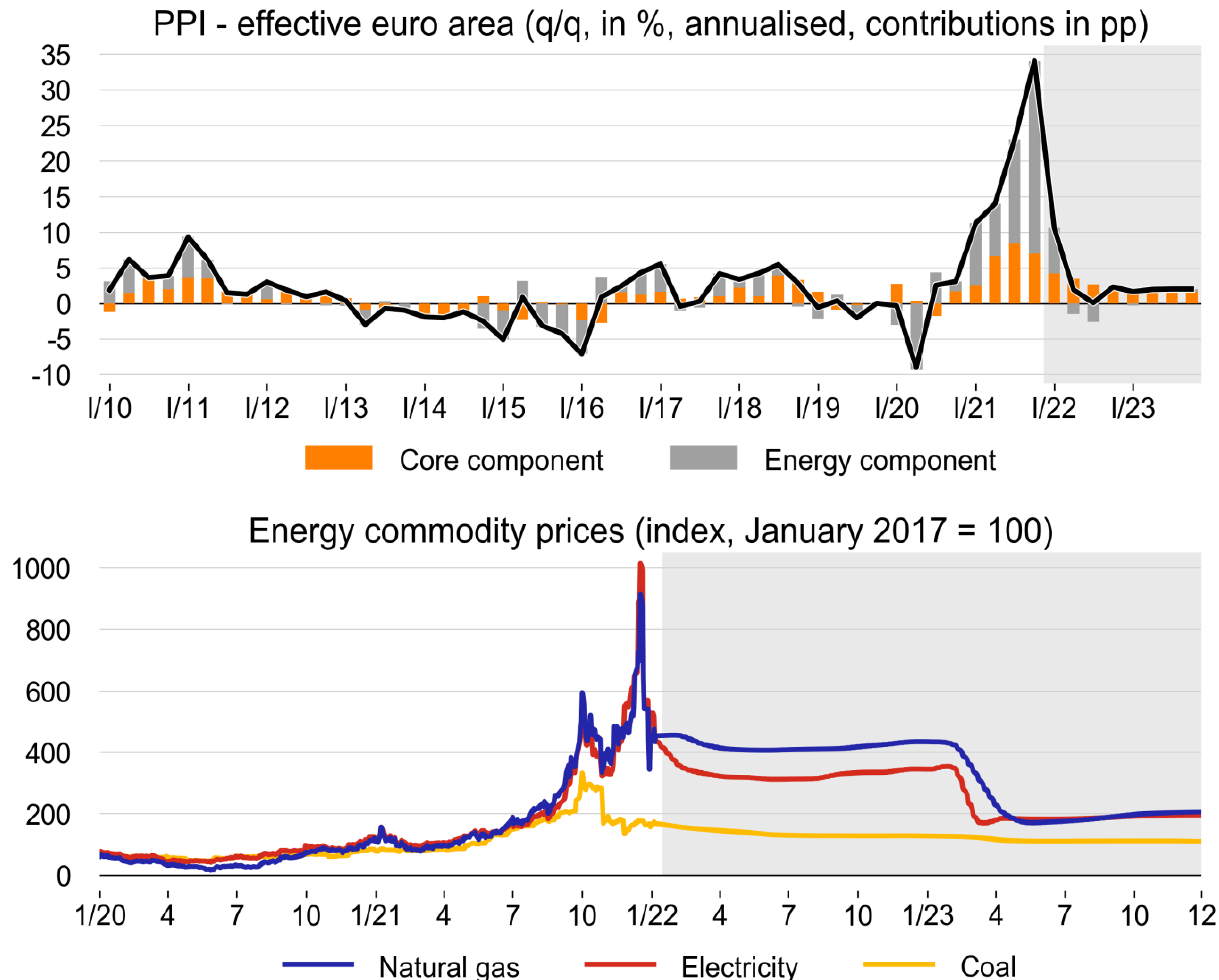
External Environment Outlook – the Euro Area





- The stress in global chains shall ease in mid-2022. Coupled with improving epidemic situation and spending under national recovery and resilience plans, this will give the EA economy a growth impulse.
- Overall, **GDP growth in the effective EA** will reach 4% this year and slow slightly next year.
- The **inflation pressures in the production sector** hit a historical high at the end of 2021. The price growth abroad is driven by energy prices.
- **Oil prices** will edge down in the next two years from the currently elevated levels.
- **The ECB** confirmed the expected reduction in asset purchases; first hikes expected by markets in 2022. The US Fed is expected to tighten monetary policy relatively quickly, too.

Producer Prices in Effective EA and Commodity Prices



- The **inflation pressures in industrial production** strengthened exceptionally in 2021 Q4, mainly due to record-high prices of natural gas and electricity (captured by the **energy component**).
- Robust demand for industrial goods is being reflected in producer price inflation via its **core component.**
- In the longer run, falling prices of energy commodities will reduce the inflation pressures. However, according to market expectations, these commodities cannot be expected to become significantly cheaper until 2023.

Growth of Administered Prices

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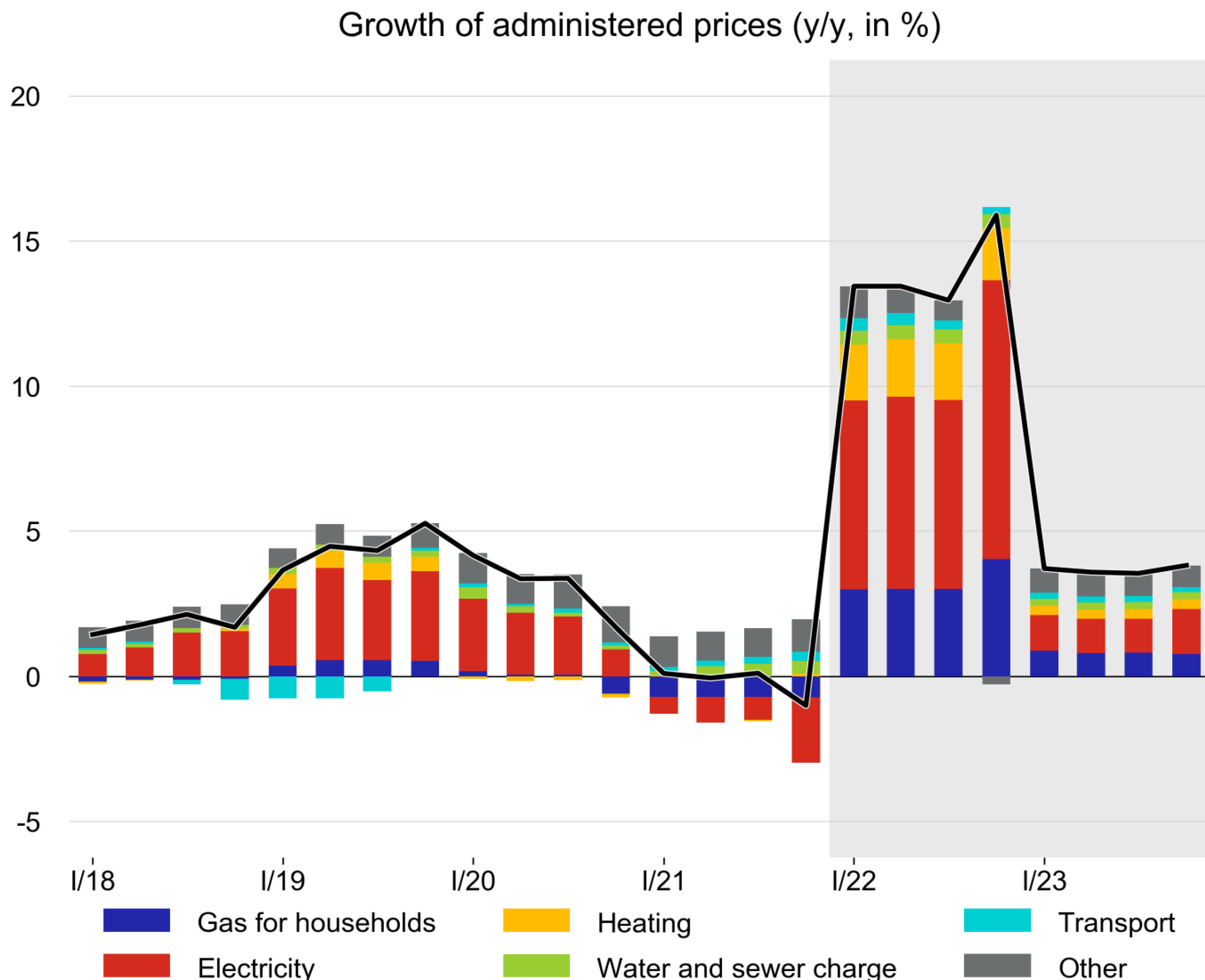

- Following a temporary drop in 2021 Q4 caused by VAT waiver, **administered prices** rised sharply at the start of this year, due to the surge in energy prices.
- This reflects high energy commodity prices. Housing-related energy (electricity, natural gas, heating) will thus become significantly more expensive in the domestic administered price segment.
- Overall, administered price inflation will fluctuate around 13% during most of this year. In 2023, it will slow but will still be close to 4%, due to the pass-thourgh of the high prices on commodity exchanges.

Fiscal Policy

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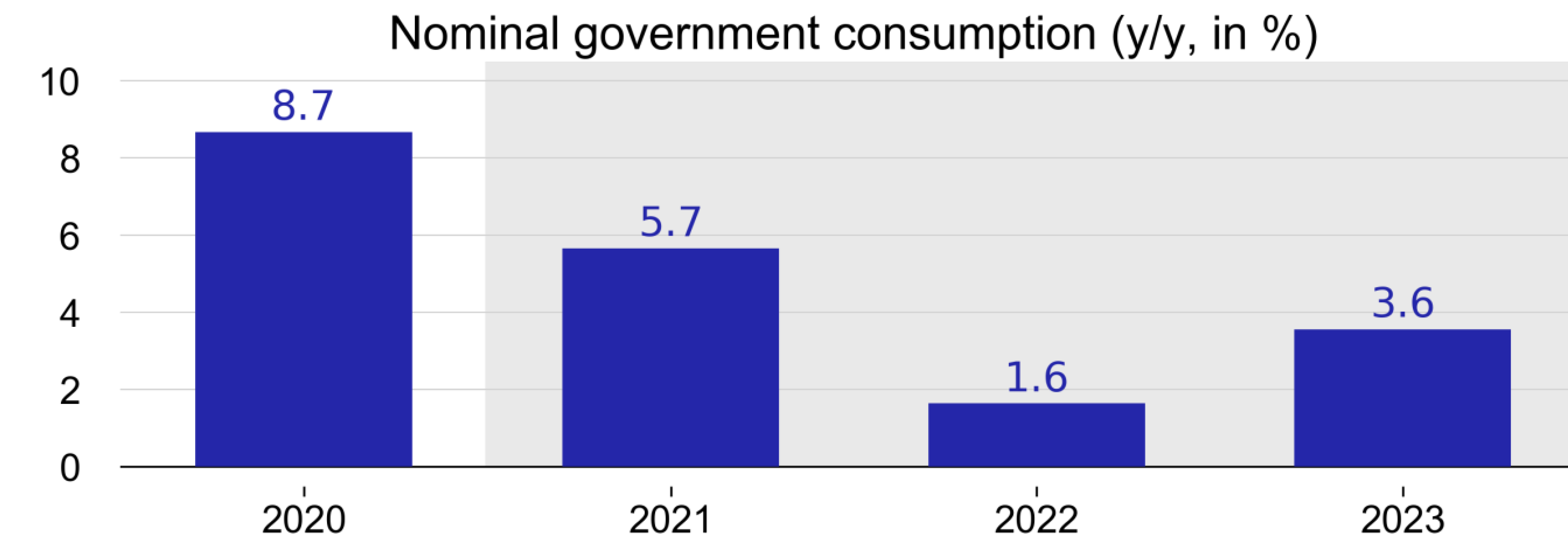

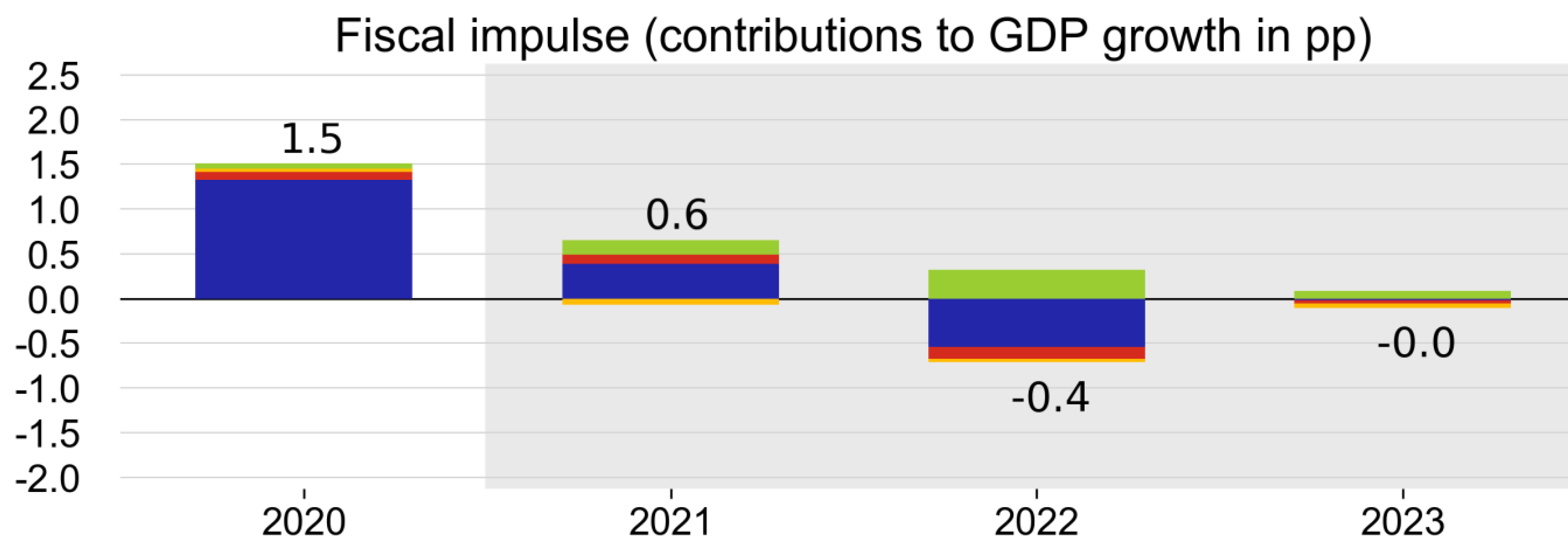

- **Nominal government consumption** growth slowed last year due to base effects, despite continued high pandemic-related spending, especially in health care. A large part of pandemic expenditure should fade out this year, leading to another slowdown in government consumption.
- As a result, the **fiscal impulse on GDP** will turn negative this year.
- However, the restrictive effect associated with the phasing out of stabilisation measures this year will be partly offset by an increase in pensions (covering for higher living costs) and faster absorption of EU funds.

Headline and Monetary Policy-Relevant Inflation

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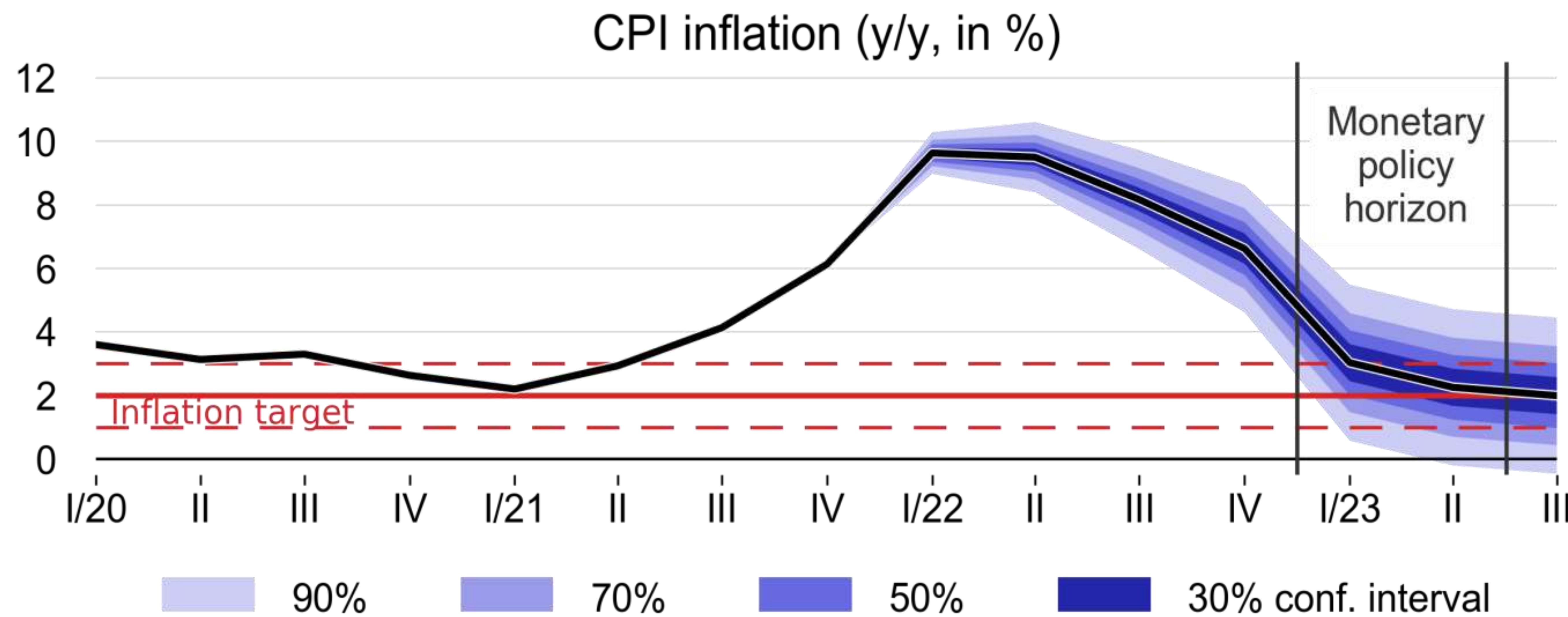

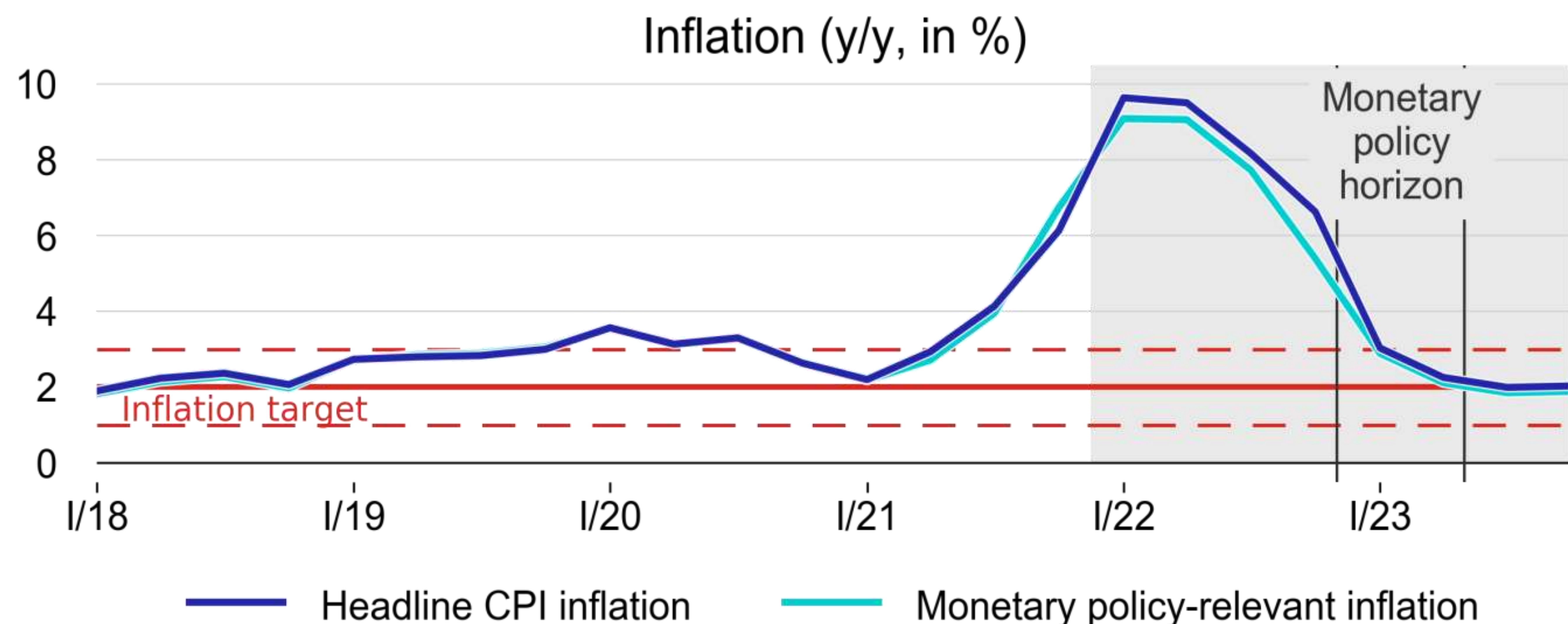

- **CPI inflation** rised to almost 10% at the start of 2022 but will start to fall rapidly in 2022 H2 and decline close to 2% over the monetary policy horizon.
- **Domestic demand pressures** will push prices up further until mid-2022.
- The inflationary effect of excessive domestic demand will fade out at the end of this year, due to the previous monetary policy tightening.
- **Monetary policy-relevant inflation** will be below headline inflation over the entire forecast horizon, reflecting the increase in excise duty on tobacco and base effects of waiver of VAT on energy at the end of 2021.

Inflation Structure

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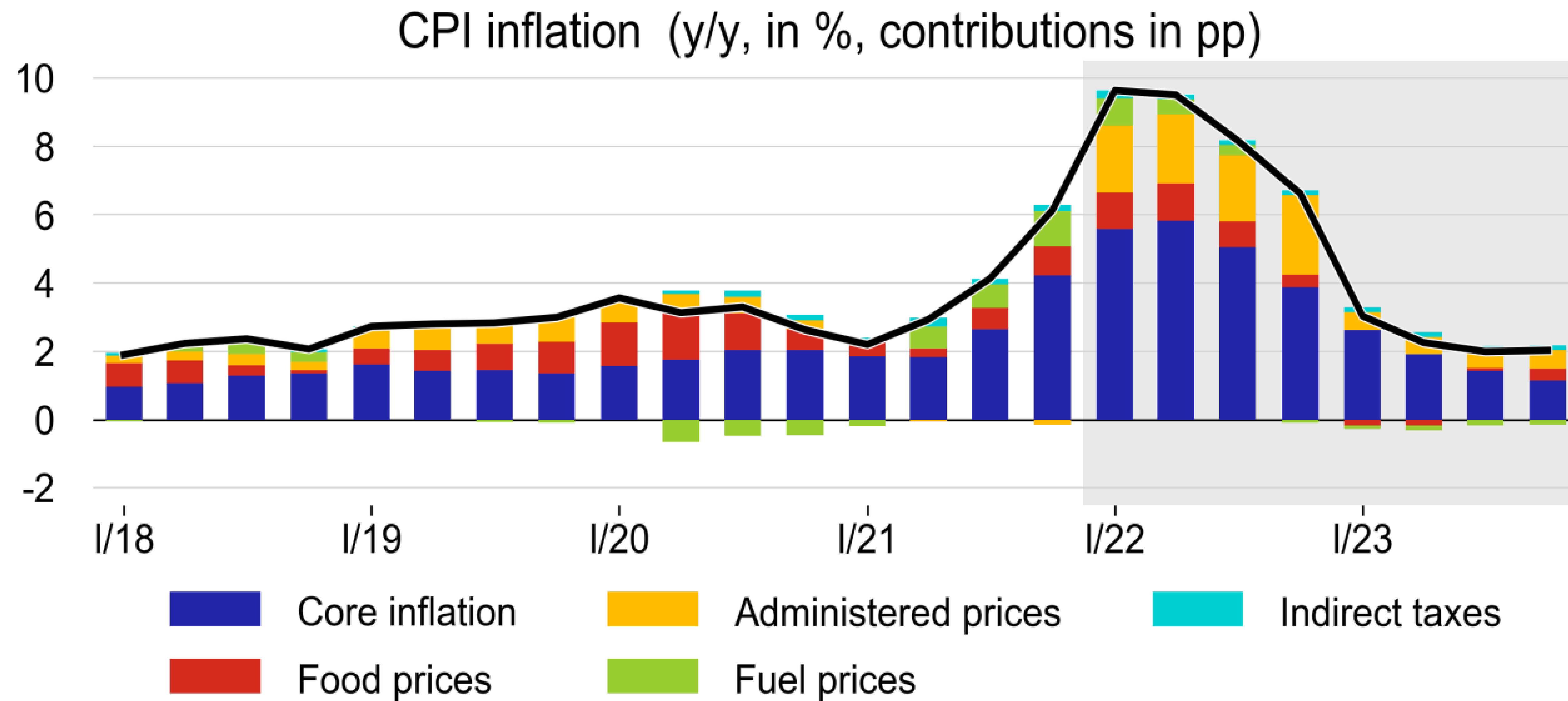
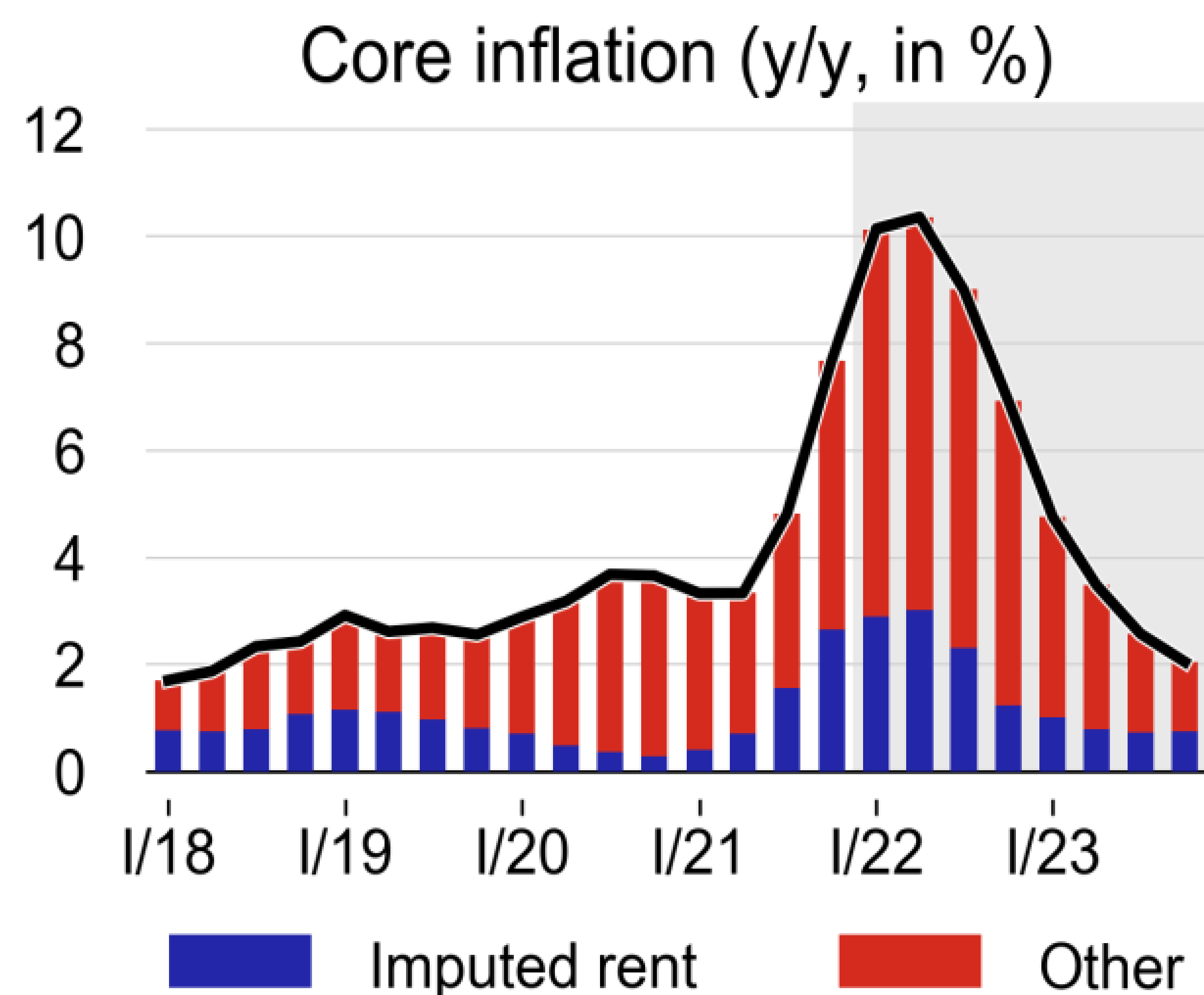
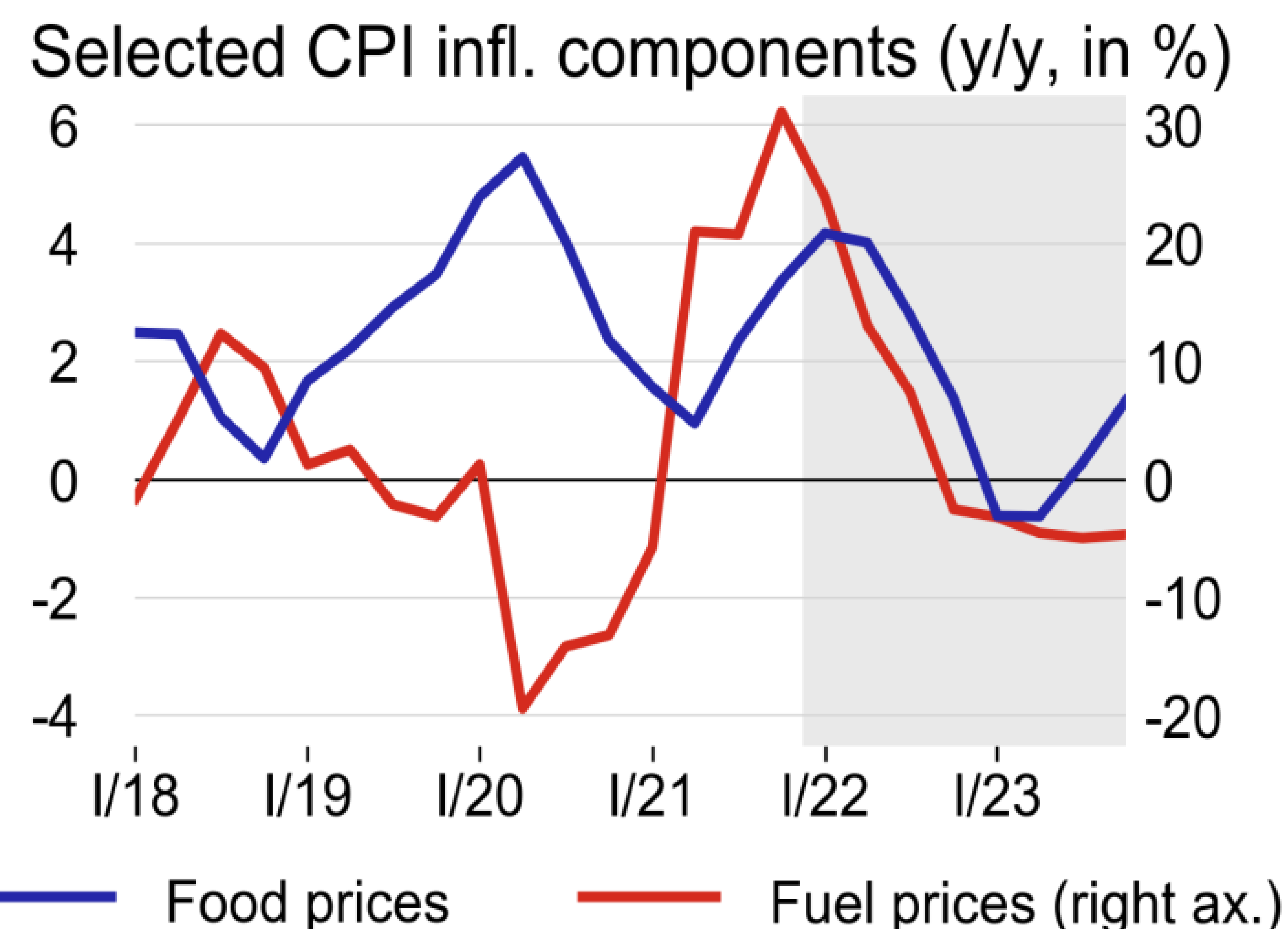
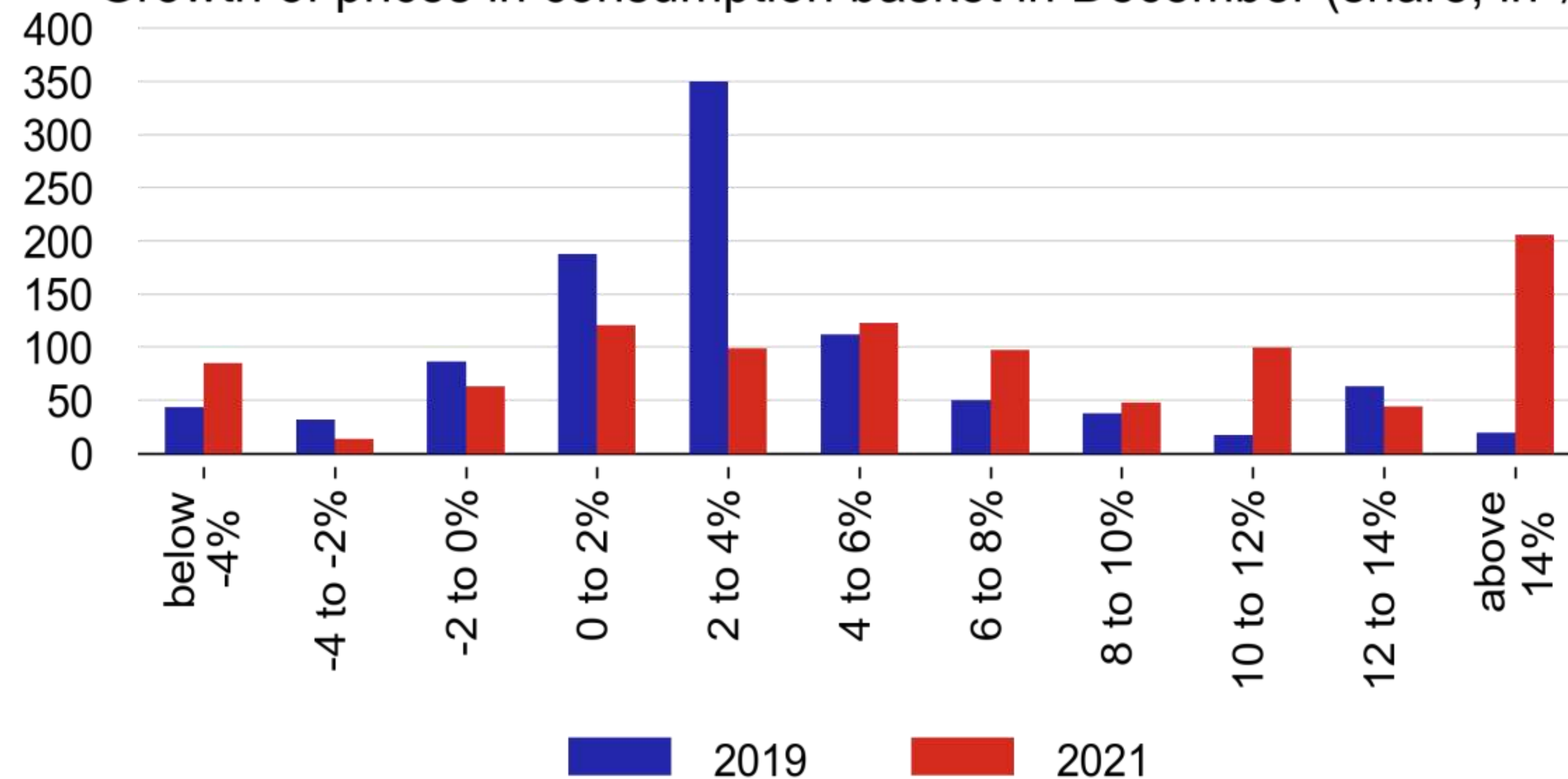


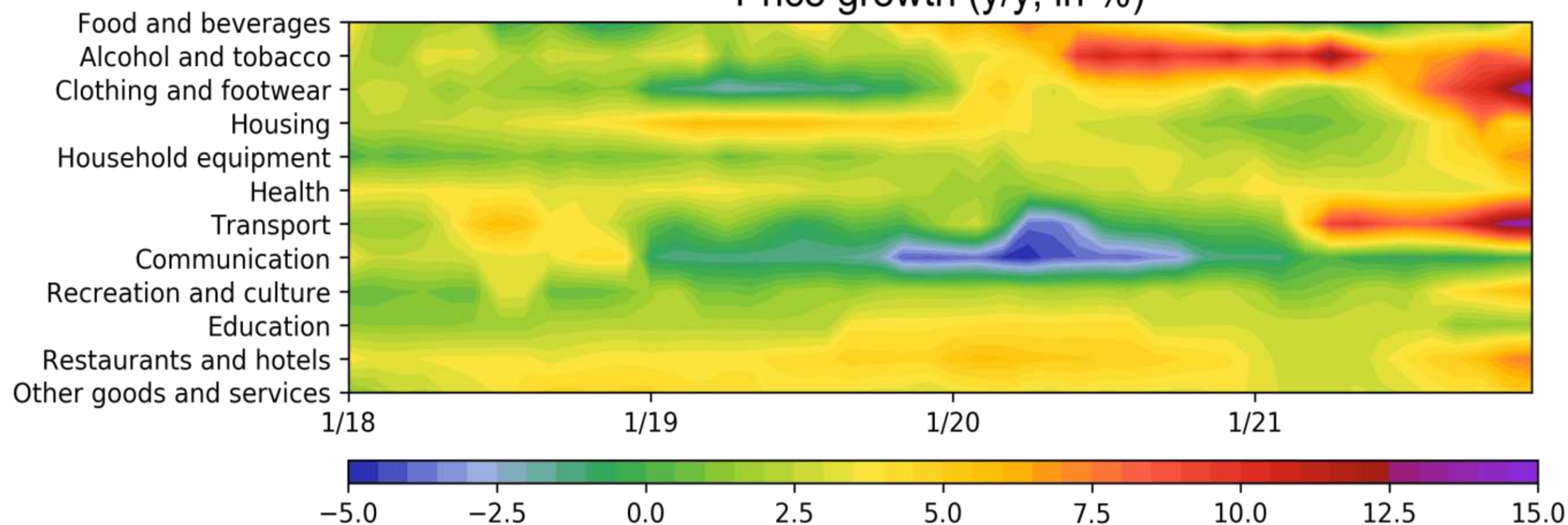




- Besides further growth in **core inflation**, a surge in **administered price inflation** is driving the headline number. Rising **food and fuel prices** also contribute to inflation.
- **Core inflation** will continue to rise at the start of this year, caused by the traditional January adjustments to prices after the substantial increase in costs including prices of energies seen in the second half of last year. Within core inflation, **imputed rent** plays a major role.
- The surging **food price inflation**, mostly reflecting strong demand pressures and growth in global agricultural commodity prices, will peak in the first half of this year.
- **Fuel price inflation** will go down in 2022 H2, due to the FX strengthening and stabilisation of global oil prices.

Broad-Based Price Growth





- The current **exceptionally high and still rising inflation** can be characterised by two phenomena:
  - **the intensity of the growth**,
  - **the broad nature of the rise in prices** across the items of the consumer basket.
- At the end of 2021, most of the consumer basket has grown at a higher pace than in 2019. The current elevated inflation is therefore not the result of significant growth in the prices of only a few items, but is broad-based.
- After a peak in this quarter, inflation should ease, helped by restrictive monetary policy, stronger FX and easing supply disruptions.

Labour Market

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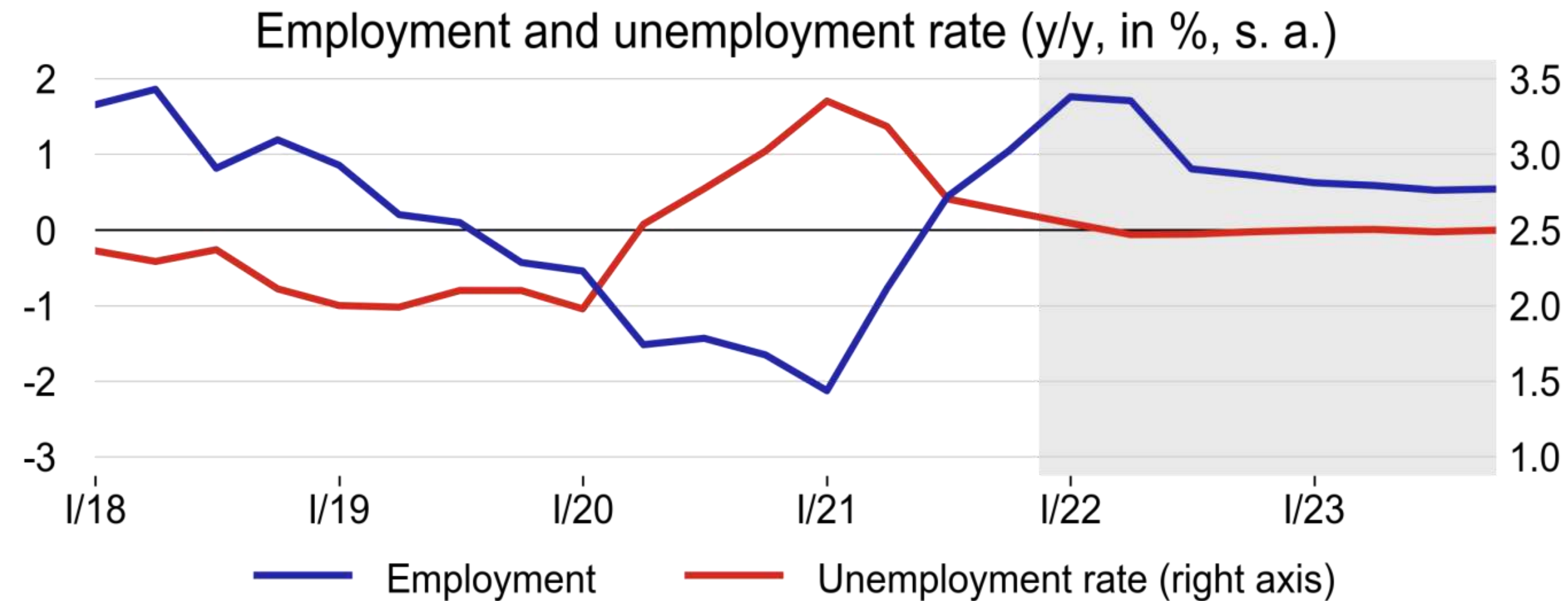
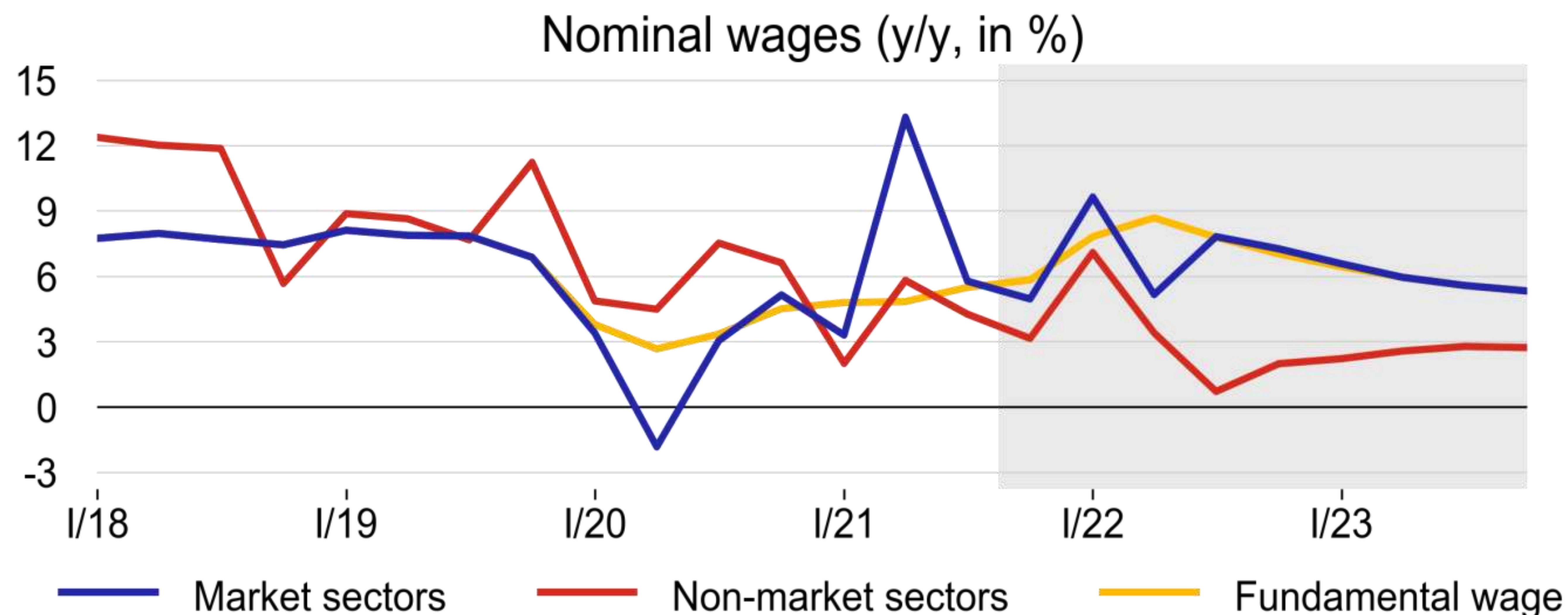
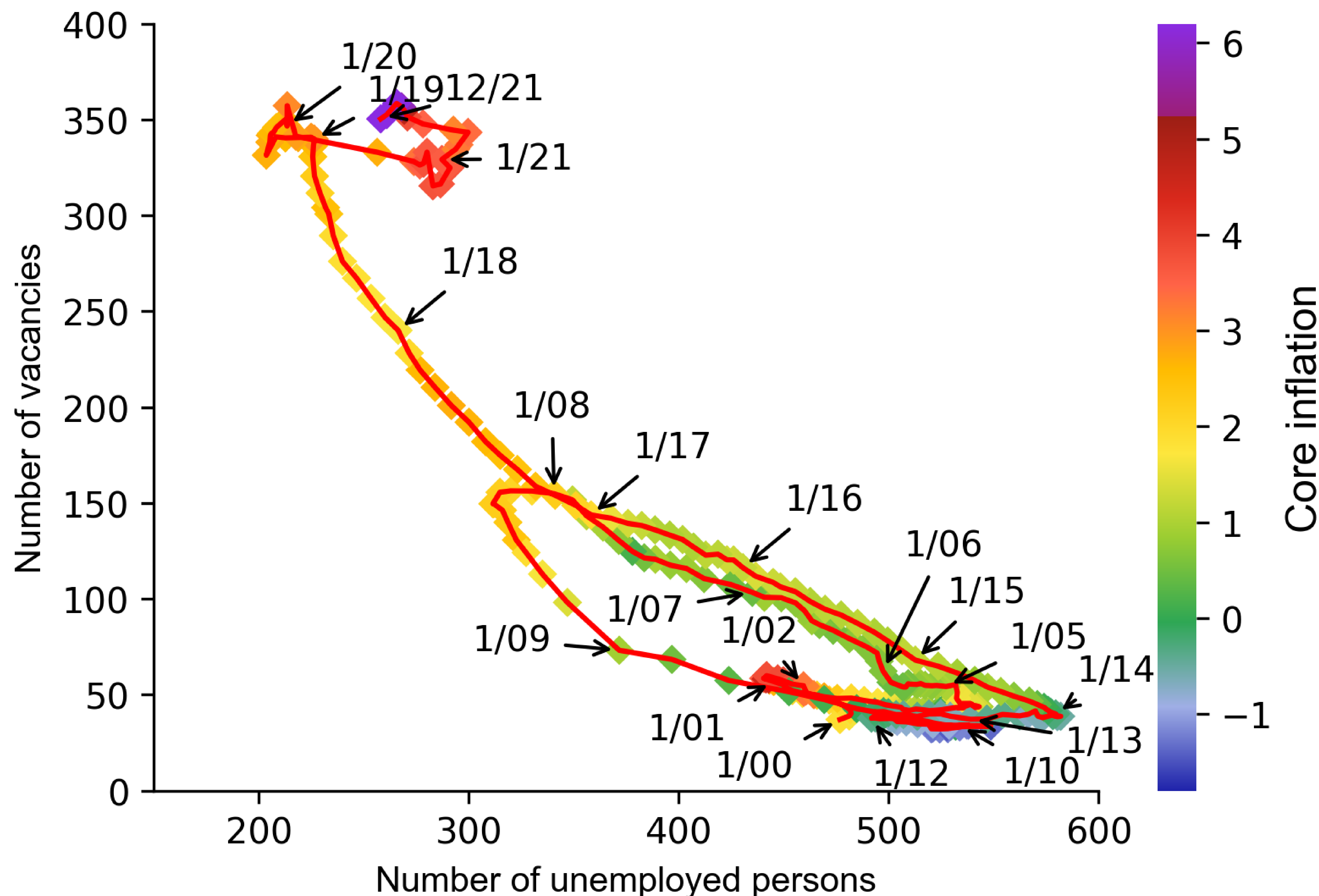




- **Employment** will continue to rise on the back of strong demand for labour. This is indicated by persisting elevated expected recruitment by employers and a high number of job vacancies.
- The decline in the **unemployment rate** has slowed. The room for a more substantial decline is, however, limited.
- **Fundamental wage growth in market sector** will accelerate this year in an environment of an overheated labour market and as a result of efforts to keep up with inflation. Further, wage growth will be supported by marked increase in the minimum wage in January 2022.
- **Nominal wages in market sectors** will continue to be affected this year by one-off factors and base effects.

Labour Market



- **Number of vacancies** continues to dominate the **number of unemployed persons**, pointing to a tight labor market.
- Labor market tightness is historically correlated with periods of **high core inflation**.
- That seems to manifest also in the current situation. Pandemic-related **slowdown did not create broader unemployment**, with the help of government furlough schemes.
- **Insufficient labor supply** continues to be a substantial growth obstacle for many businesses.

GDP Growth Forecast

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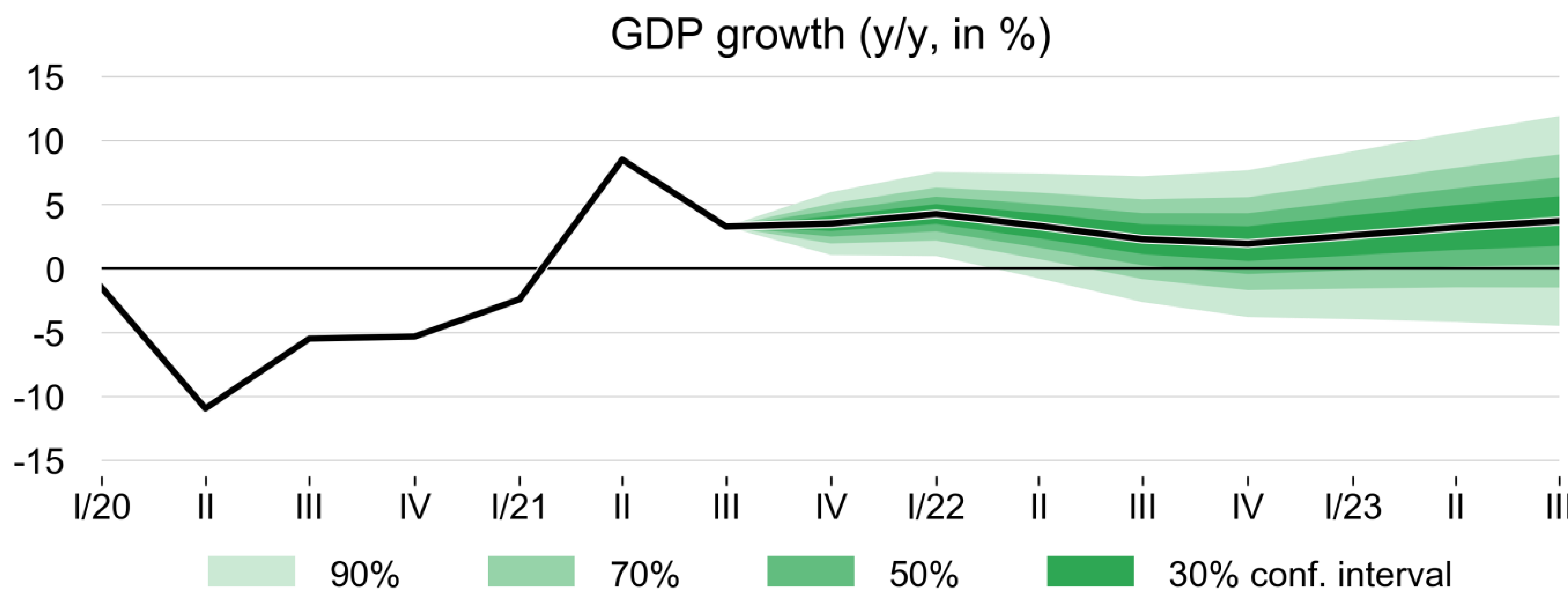

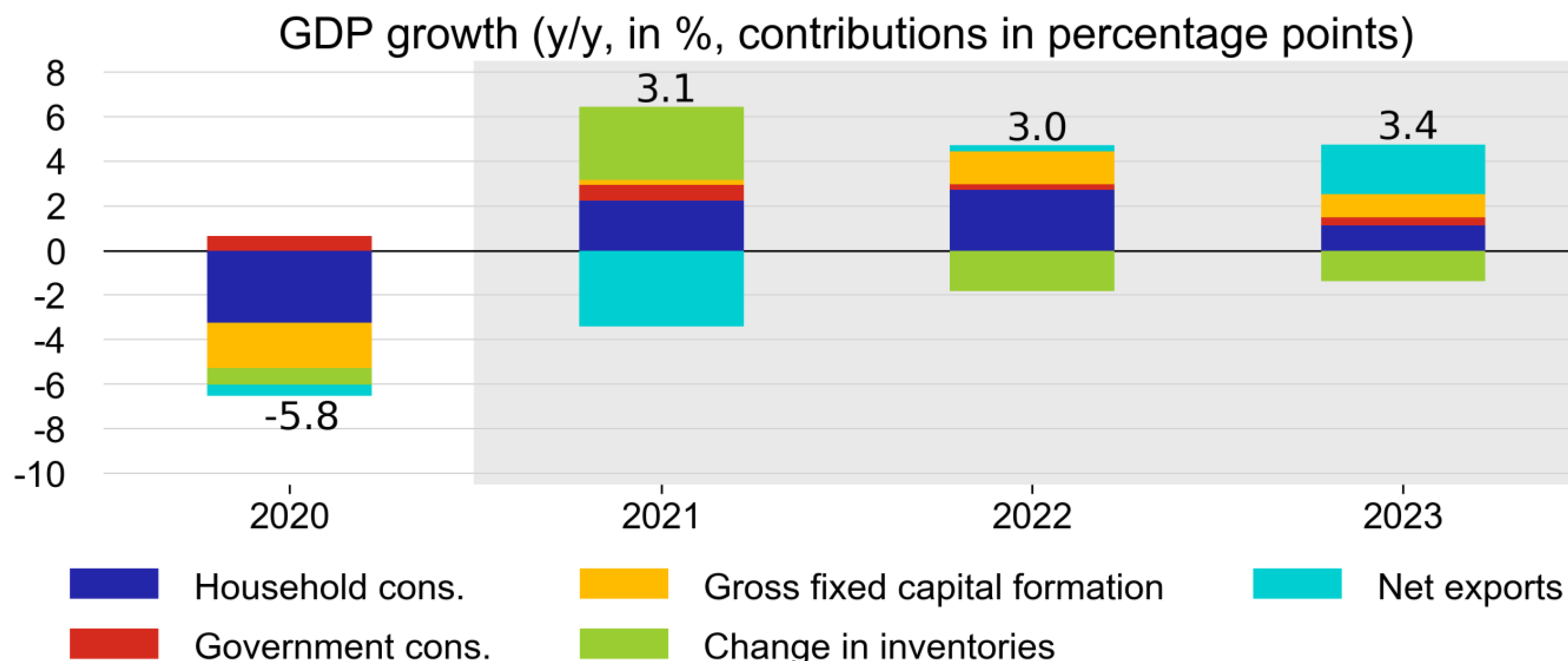

- The **economic activity will continue to recover from the pandemic** this year despite persisting issues in global production and supply chains. The issues will start to ease gradually in the second half of the year and virtually disappear by the year-end.
- **Annual GDP growth** will be driven this year by household consumption, initially aided by last year's low base. Next year, the recovery of net exports will play the major role.
- Similarly to last year, **GDP growth** will average around 3% in 2022 as a whole. In 2023, it will edge up to around 3.5%.
- The Czech economy is estimated to be overheating somewhat, but will return to its potential in 2023.

Household Consumption

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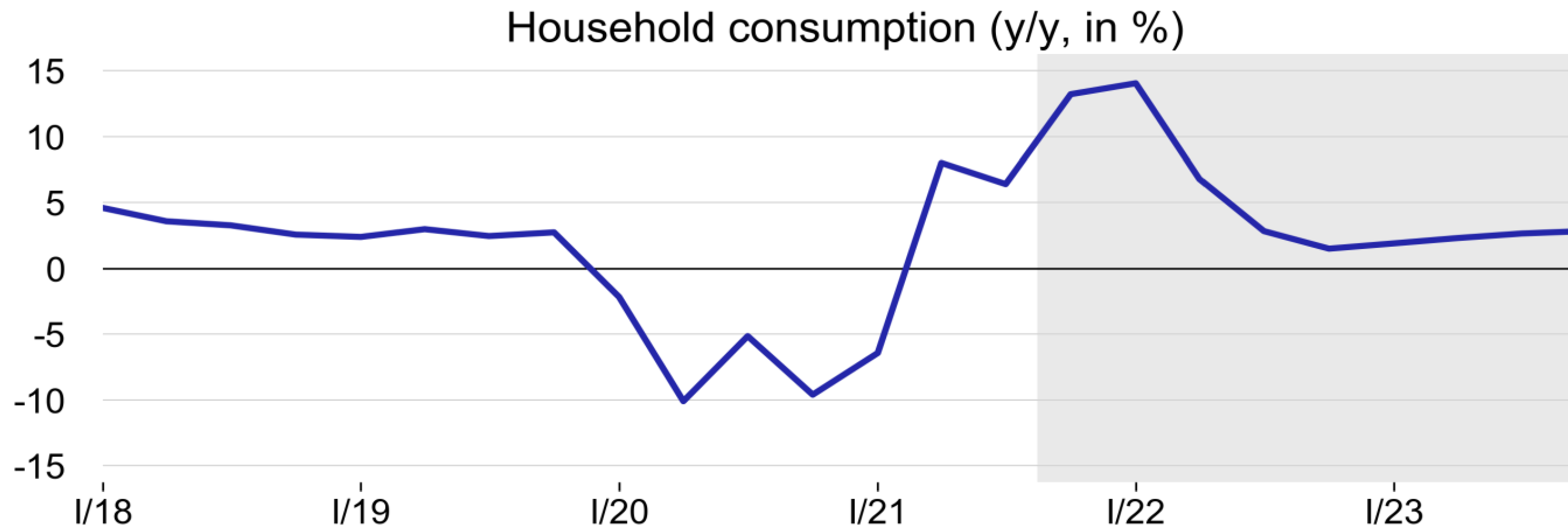

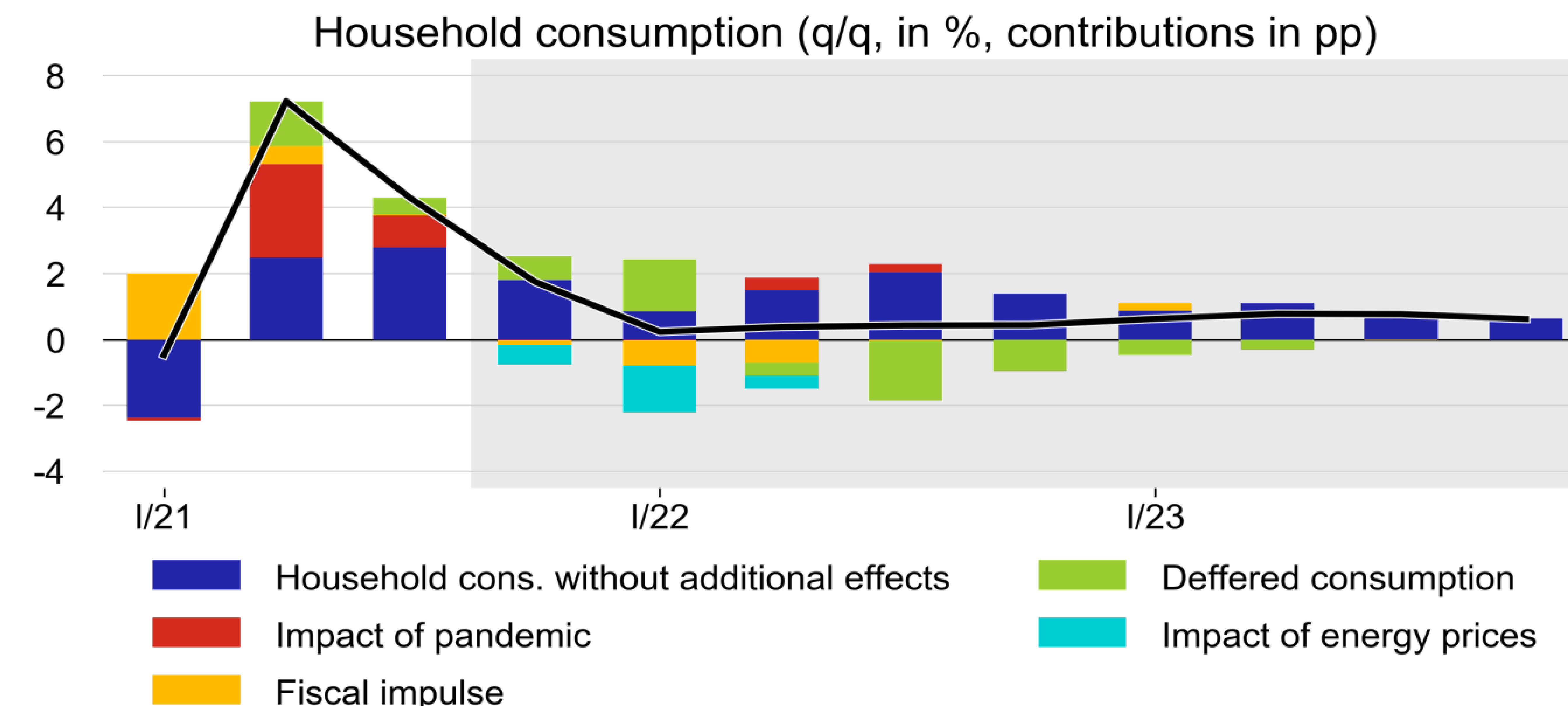

- **Household consumption growth** will initially be very strong this year due to base effects and will then ease off.
- Household consumption started to be **negatively affected last autumn by a surge in inflation**, which slowed the growth in the purchasing power. This was counteracted by renewed growth in labour market tightness, and by partial spending of savings accumulated during the pandemic.
- The **q-o-q growth in household consumption** will slow sharply, due mainly to high inflation, fading fiscal support and elevated interest rates. The rise in energy prices will drain large part of the savings.

Gross Capital Formation

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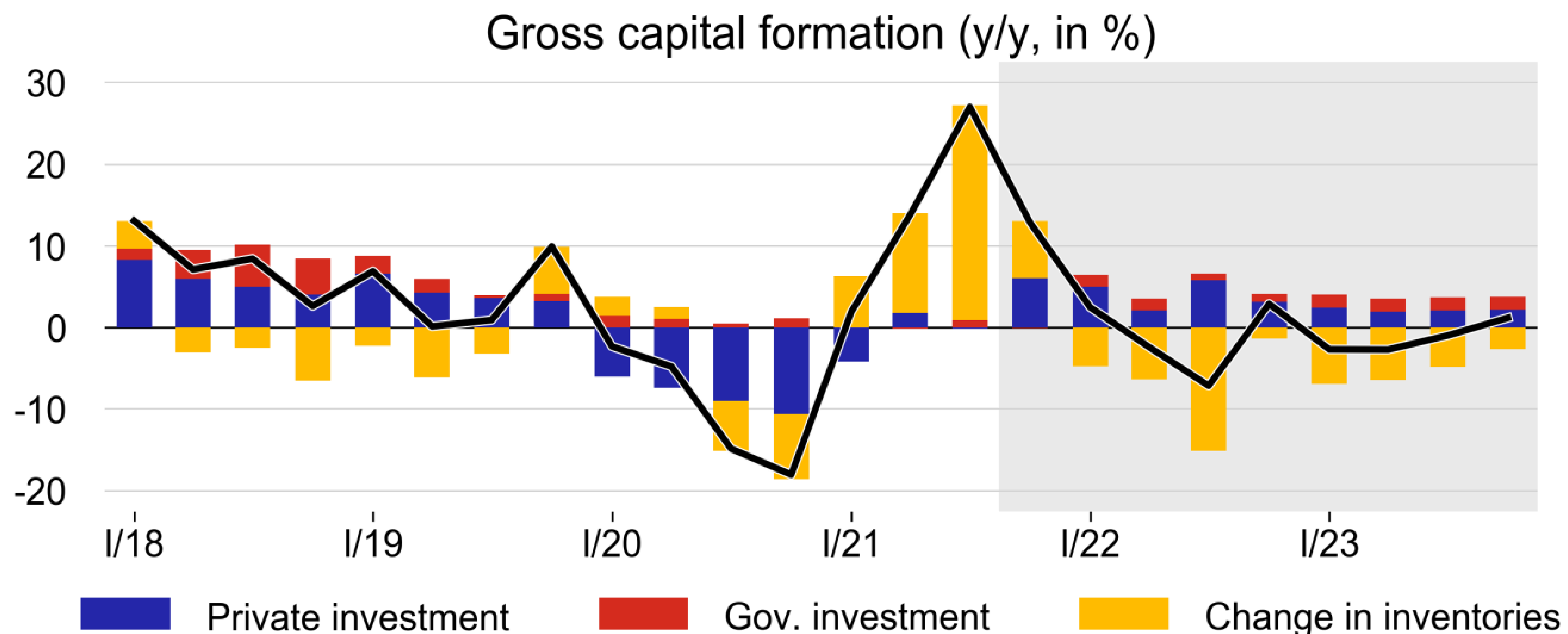

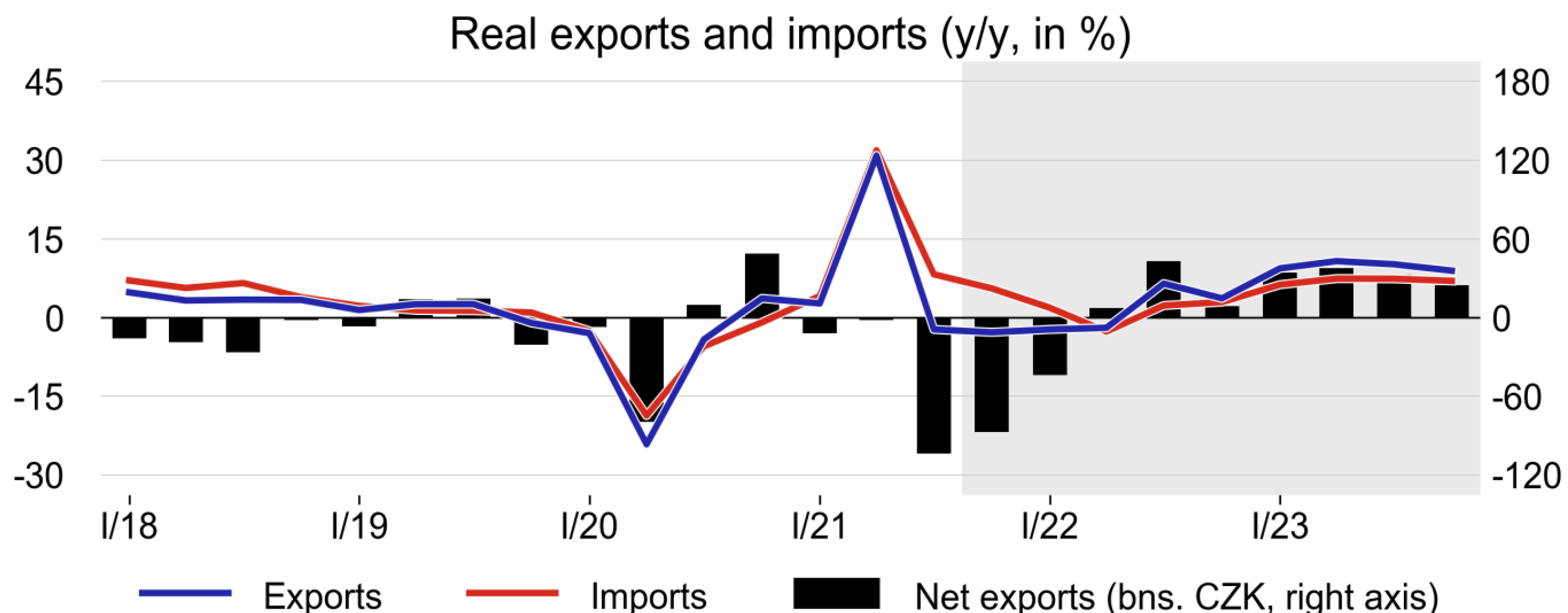

- **Growth in total investment** will be volatile mainly due to the dynamics of inventories. The investment boom will be held back by production and supply chain disruptions, as their negative effect will gradually fade during the year.
- **Private investment activity** will be motivated this year by firms trying to automate production. Fixed investment will also be supported by recovering external demand.
- **Government investment** will increase and will be supported by EU funds.
- **Exports** will initially be muted this year by continued disruptions to material and component supplies and will start growing again as these issues fade out, leading to positive contributions of net exports.

Exchange Rate CZK/EUR

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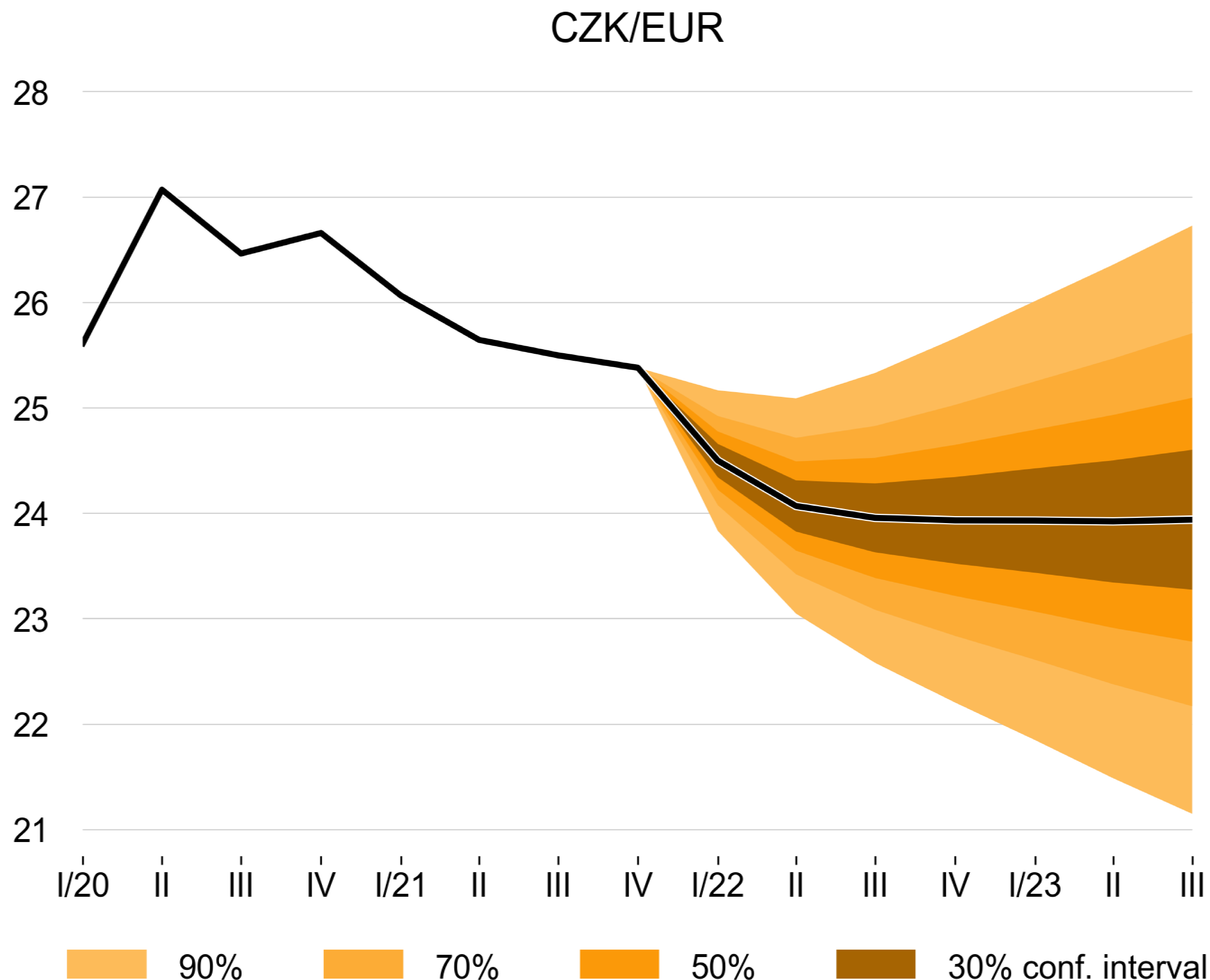

- We expect the **exchange rate** to stay around 24.5 EURCZK on average in 2022 Q1.
- The koruna will strengthen significantly in the first half of the year, due to a further pronounced **widening of the interest rate differential** vis-à-vis the euro area.
- The gradual decline in domestic interest rates towards their long-run neutral level in the second half of this year onwards, coupled with monetary policy abroad gradually becoming less accommodative, will imply a depreciation pressure. A gradual recovery in exports in the second half of this year and continued real equilibrium appreciation will have a compensating effect.
- These opposing forces will ultimately lead to a **stable koruna around CZK 24** to the euro.

Interest Rate Path (3M PRIBOR)

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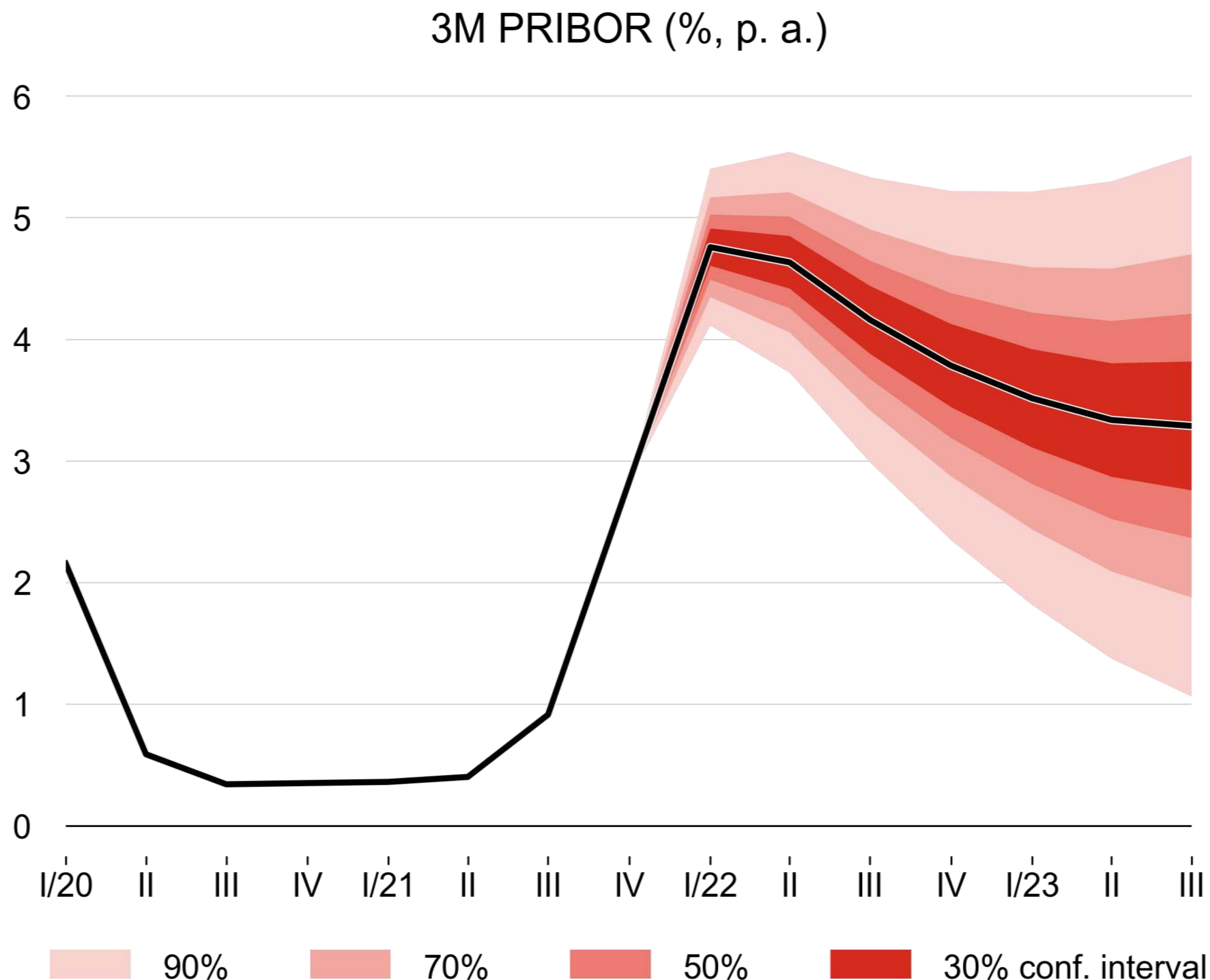
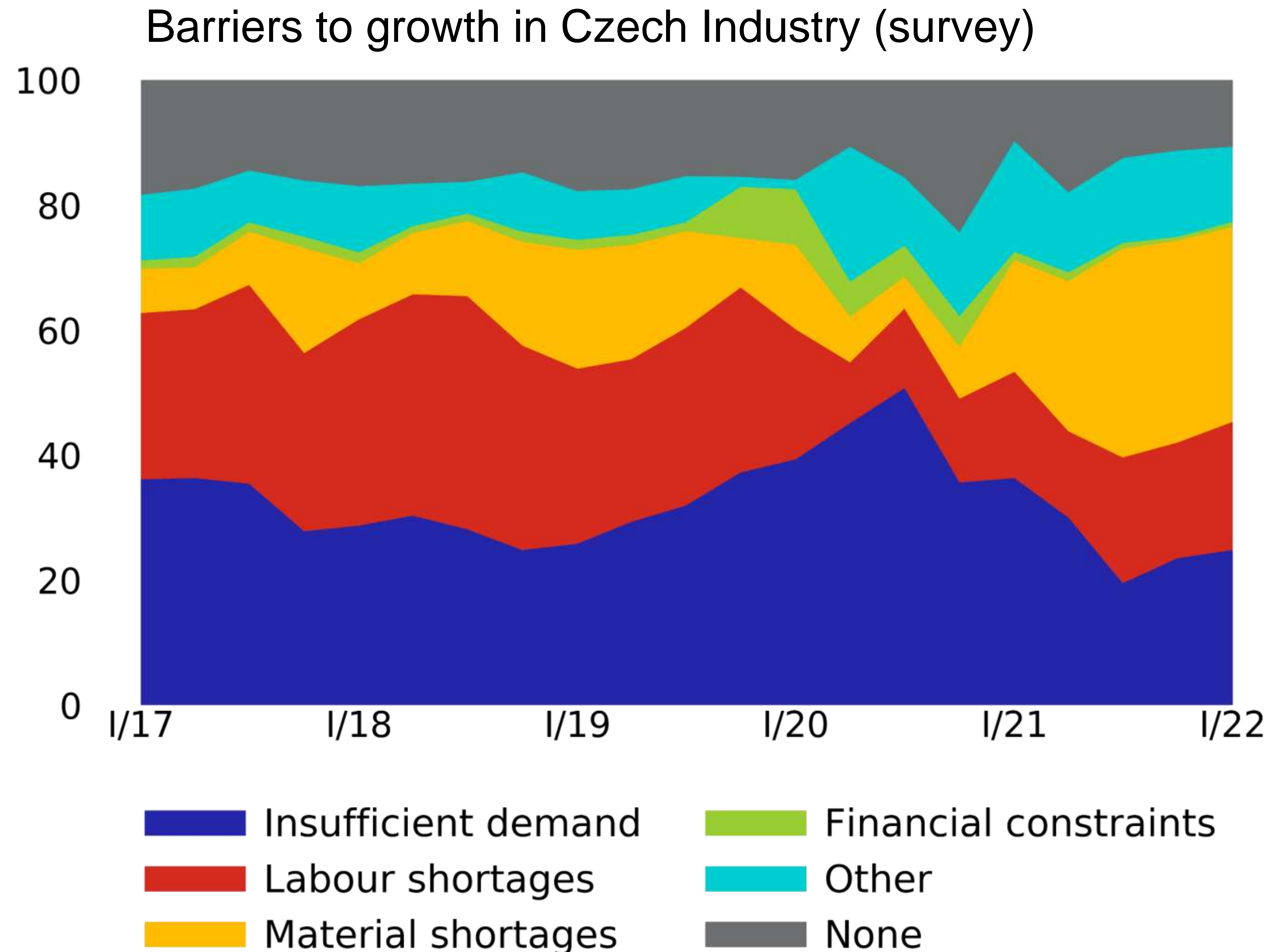


- Consistent with the forecast is a substantial rise in **market interest rates**, followed by a gradual decline from the second half of this year onwards.
- The initial increase in rates reflects a need to react to the combination of **extraordinarily strong price pressures** from the domestic and foreign economies, which are reflected in high and broad-based domestic price growth.
- **Tighter monetary policy will dampen excessive demand and import price growth**, limit the pass-through of the current price pressures to inflation in the longer term, and help anchor inflation expectations.
- If inflation pressures ease, interest rates will be able to start decreasing gradually towards the end of the year and in 2023.

Challenges and Risks for the Future



- Many risks to the current forecast are becoming apparent
- **Price pressures** seem to be stronger, and potentially more persistent (January 2022 inflation release, German producer prices, oil price developments).
- ***Faster tightening of the Fed and the ECB*** is a risk for our rates forecast – it will be difficult to cut rates when the big central banks will be hiking.
- Material shortages do not seem to be fading, neither are labor shortages, due to the industry survey.
- Further ***escalation of Russia-Ukraine tensions*** seems to be an inflationary risk due to potential surges in energy prices.

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Thank You for Your Attention