CNB’s response to surging inflation

Summer 2022 forecast

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HSBC Global Emerging Market Forum

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Last monetary policy decision

6.00%	7.00%	8.00%
discount rate	2W repo rate	Lombard rate

VOTING ON 2W REPO RATE

FOR NO CHANGE **FOR INCREASE OF 100 BP**

The decision of the Board was underpinned by the CNB’s **summer 2022 forecast**.

The **monetary policy horizon** has been shifted to 18–24 months ahead in the baseline forecast. However, the scenario with the **standard CNB’s monetary policy horizon** was also presented.

The **CNB will continue to prevent excessive fluctuations of the koruna** exchange rate.

Next policy meeting in September 29, 2022.

Risk to summer forecast

The Board assessed risks and uncertainty of the baseline forecast as being significant and going in both directions.

Inflationary risks:

- further rise in commodity prices
- threat of inflation expectations becoming unanchored from the CNB’s 2% target and a related risk of a wage-inflation spiral
- easier fiscal policy

Disinflationary risks:

- growing likelihood of economic recession abroad
- stronger-than-forecasted downturn in domestic consumer and investment demand

Uncertainty:

- future course of the war in Ukraine
- availability and costs of energy
- future monetary policy stance abroad – *on the last MP meeting on Sep. 8, 2022, the ECB hiked the policy rates by 75 b.p. starting from Sep 14, 2022*
- duration of the disruptions to global value chains

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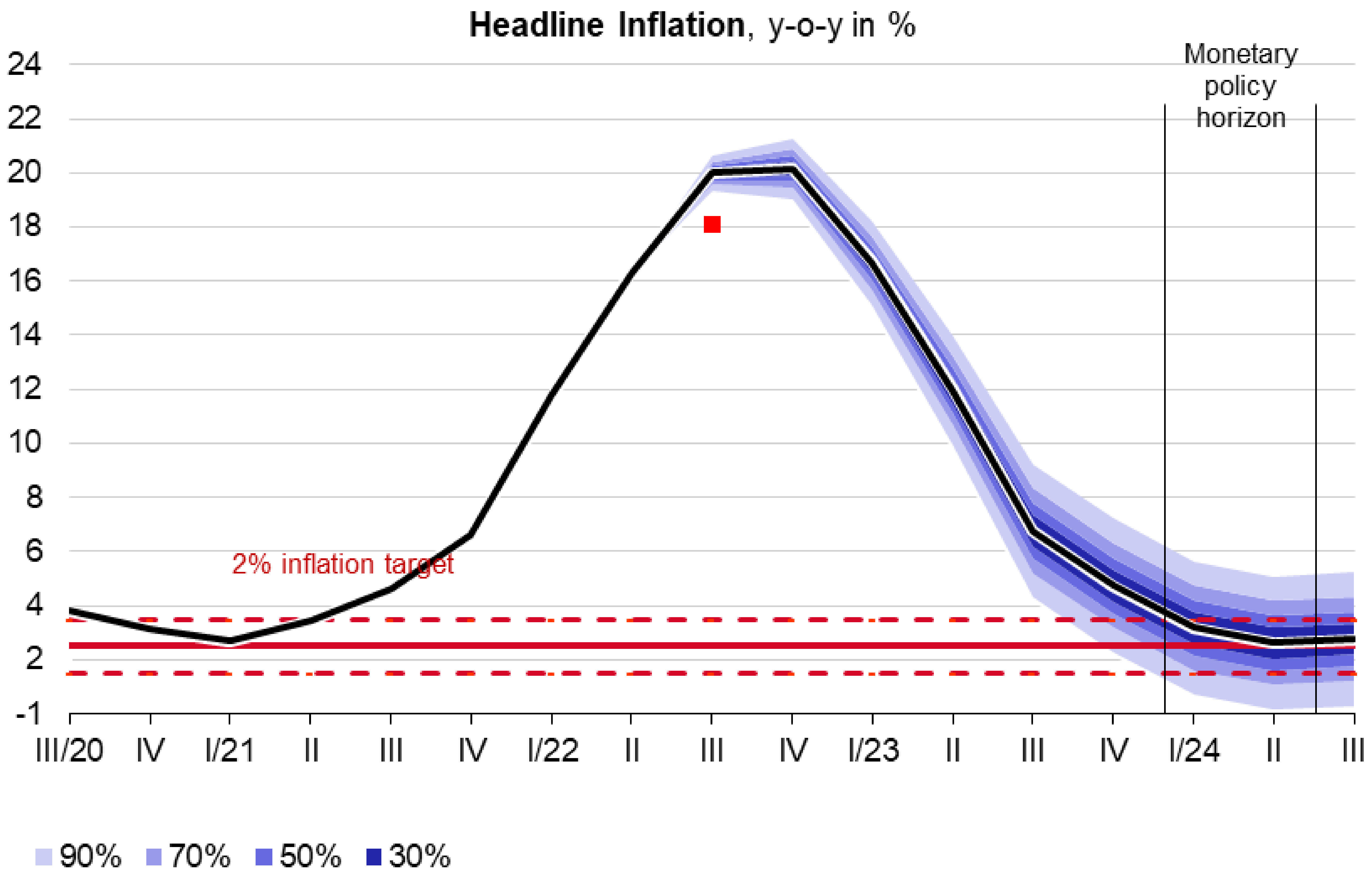
Inflation below the summer forecast in 2022Q3



Headline inflation reached 17.5% in July and 17.2% in August, which is below the forecast assuming 18.8% and 19.3%, respectively.

The summer forecast expected that **inflation would peak around 20%** in 2022H2 before starting to decline. However, actual data might suggest a somewhat **lower peak**.

Price **caps on electricity and natural gas prices** for households and small enterprises might dampen inflation further if introduced (but imply looser fiscal policy).

Inflation will return close to the target at the **prolonged monetary policy horizon** (i.e. in the first half of 2024) **reflecting the previous tightening of monetary conditions.**

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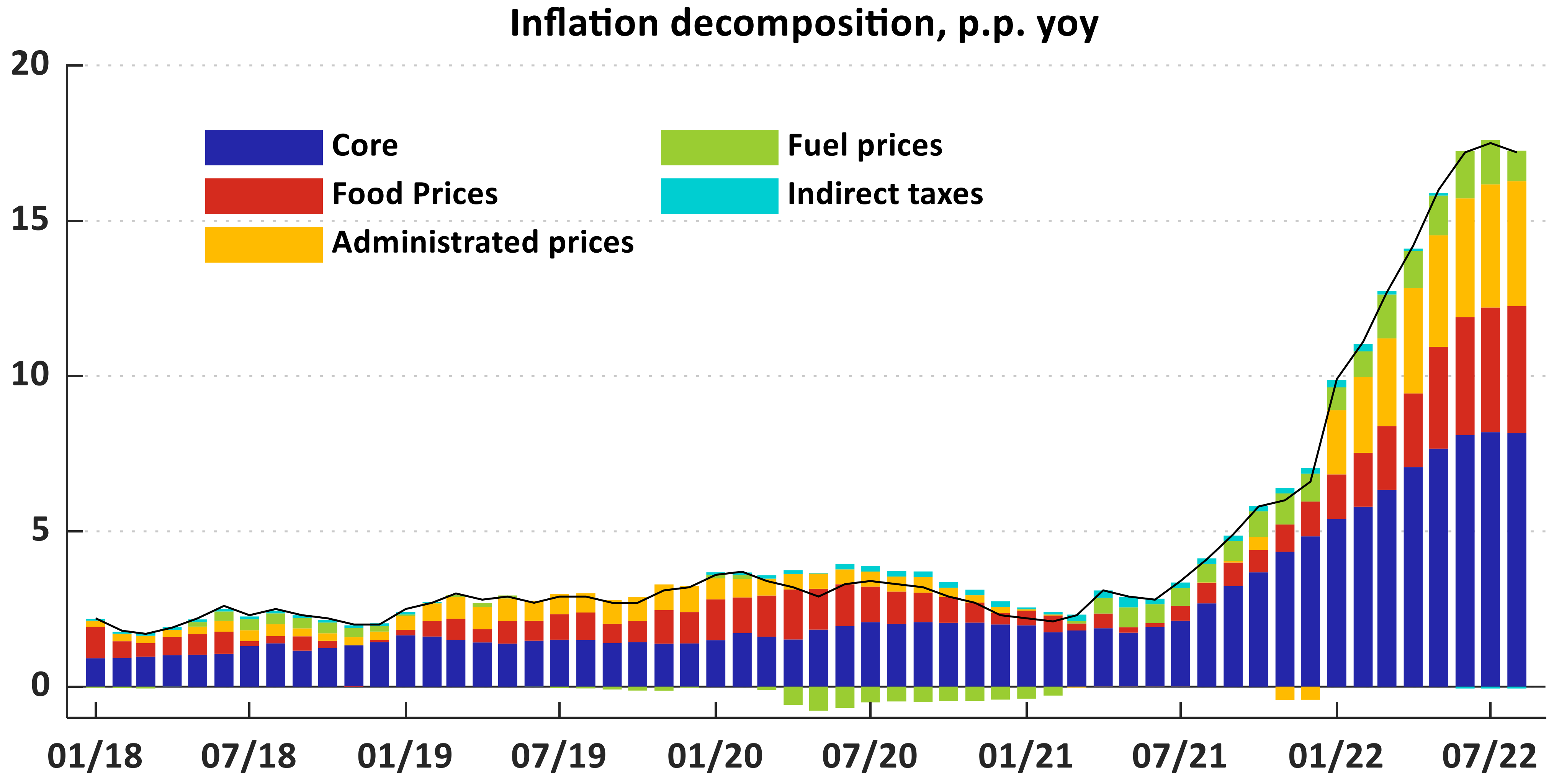
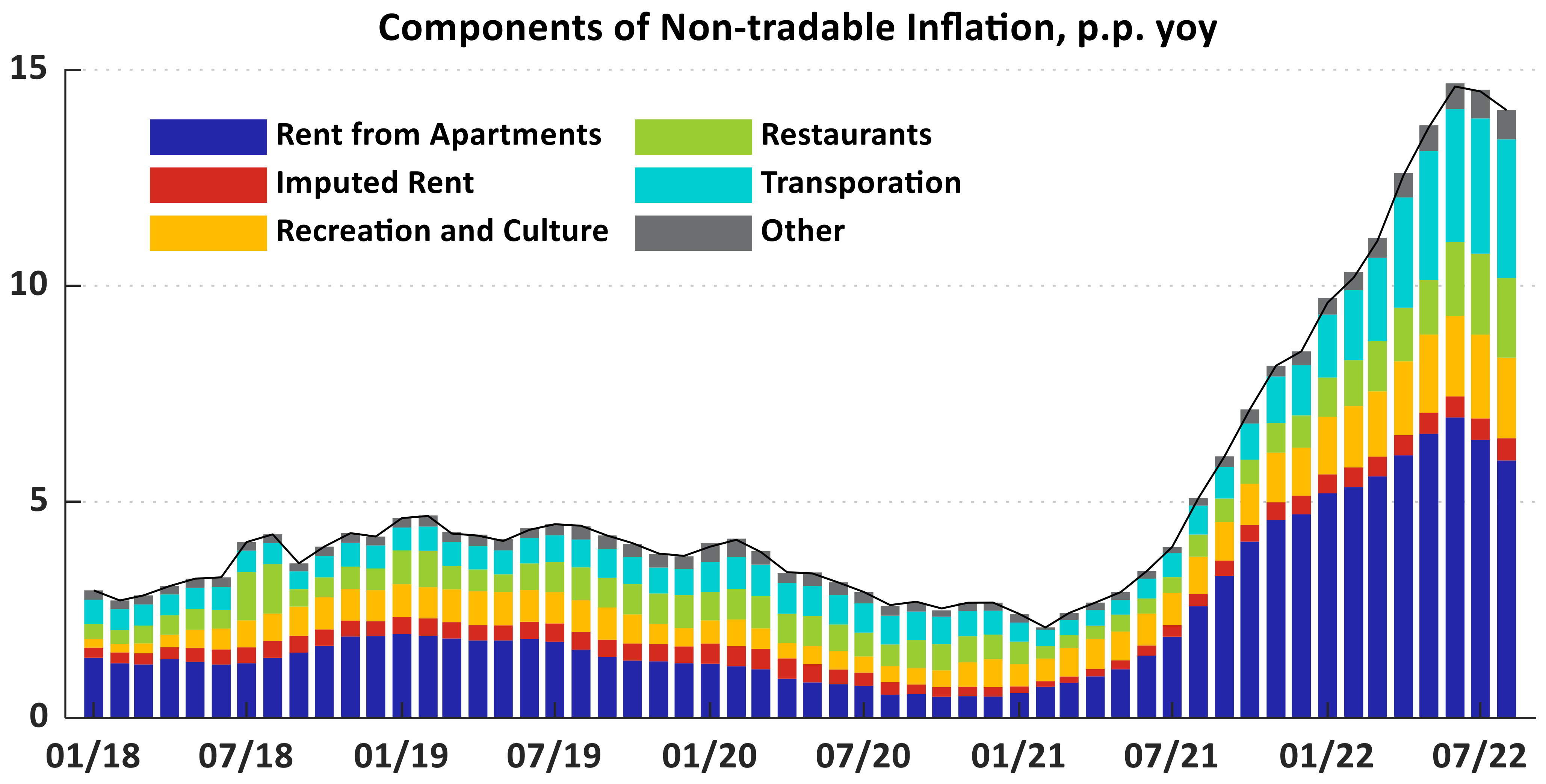
Inflation composition





Further acceleration of **core, food, and administrated prices stopped** (temporarily?) in August, but **inflation remained high**. **Fuel price inflation** even eased, given a decline in oil prices, followed by prices at filling stations.

High **core inflation** reflects a recent peak in domestic demand and continuing strong cost pressures.

While **tradable prices** inflation further accelerates, inflation of **non-tradable prices** slowed somewhat. The exceptionally high contribution of the **costs of owner-occupied housing** declined for the second time in a row in August.

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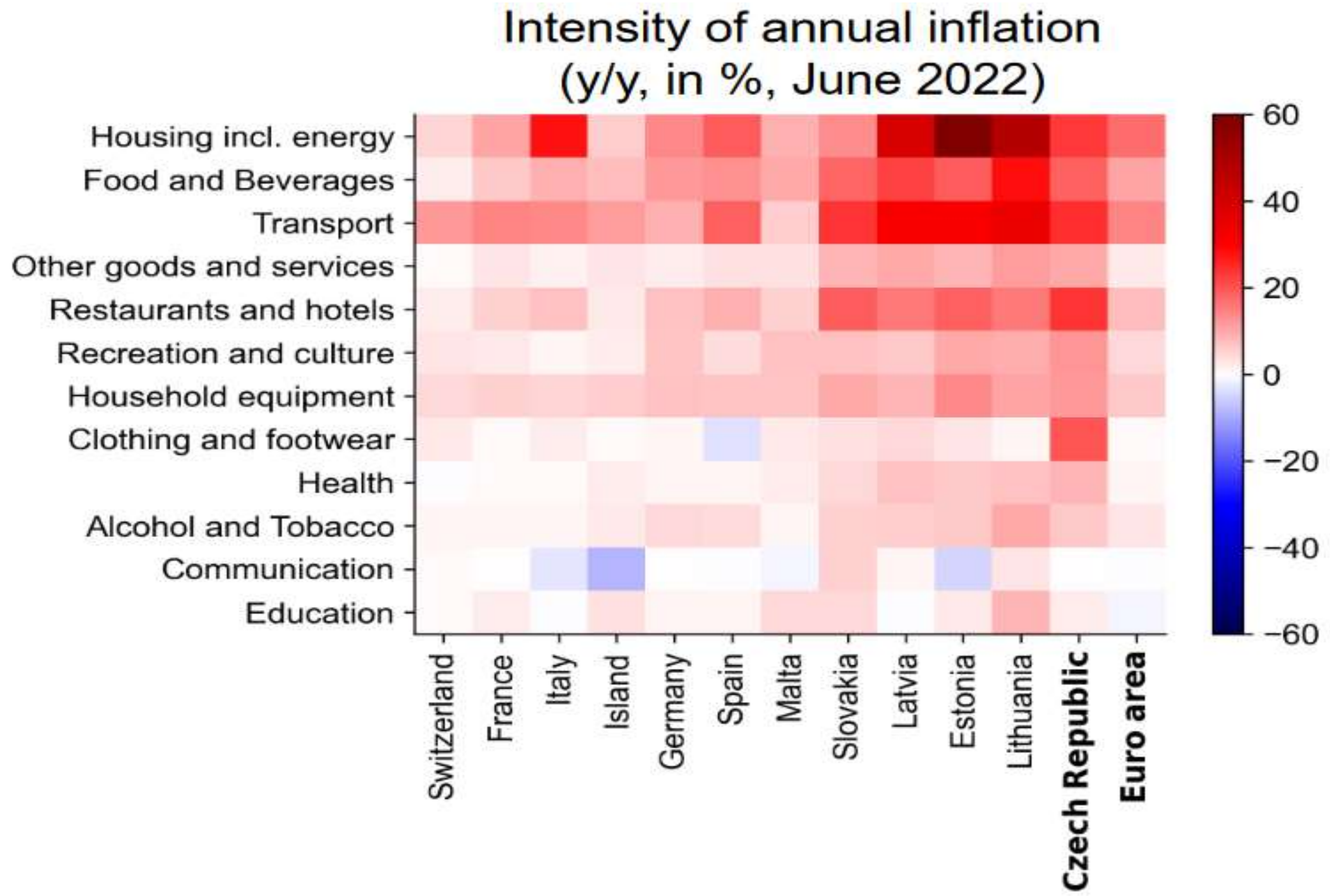
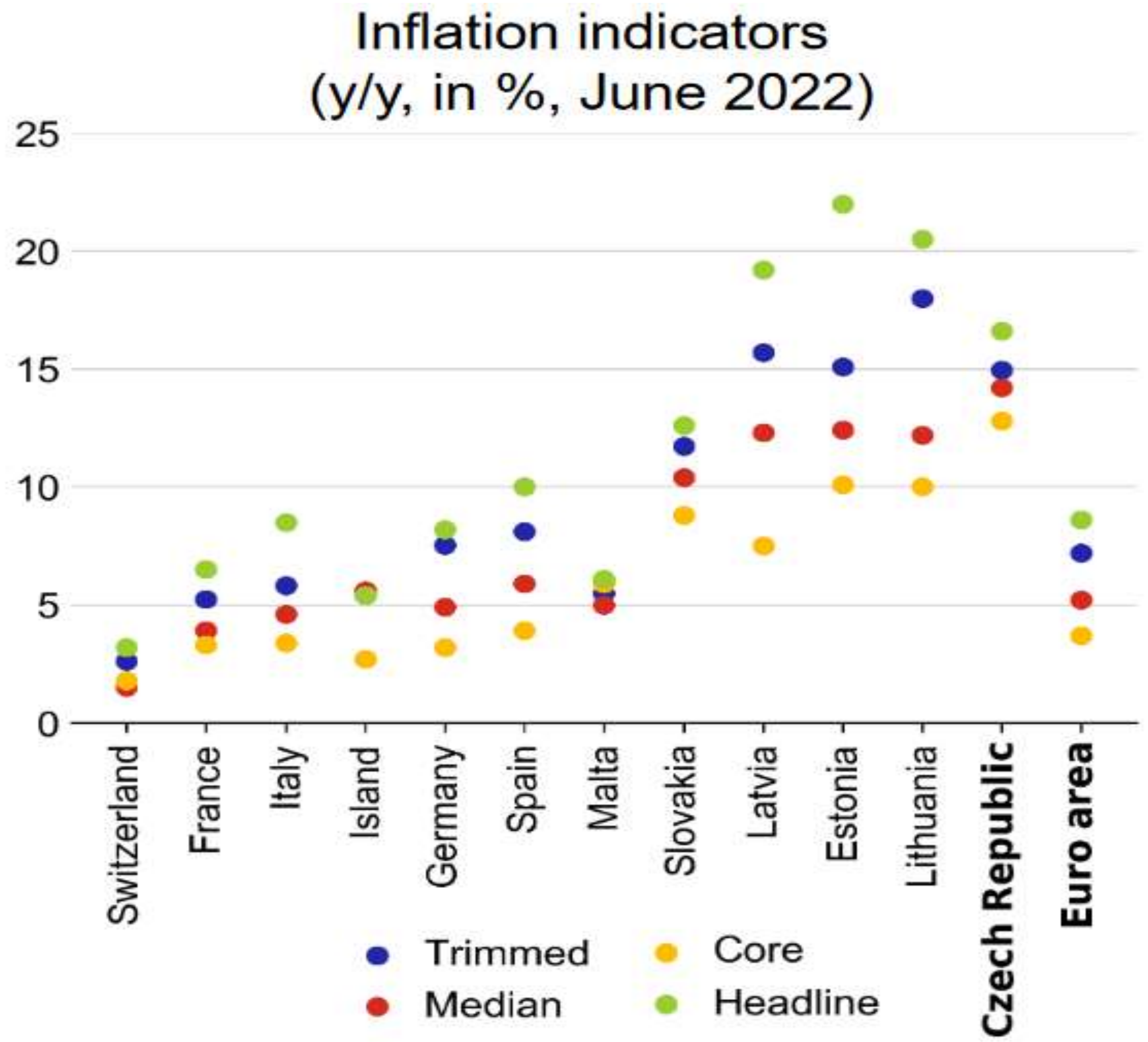
Czech Inflation in the European Context





Czech inflation has been well above the target and still **one of the highest in the EU**.

Czech inflation is high in several components which are not directly linked with external shocks (restaurants and hotels, clothing and footwear, recreation and culture), suggesting recent **demand pressures**.

Czech inflation is **broad-based** as almost two-thirds of the items have gone up in price by more than 10%.

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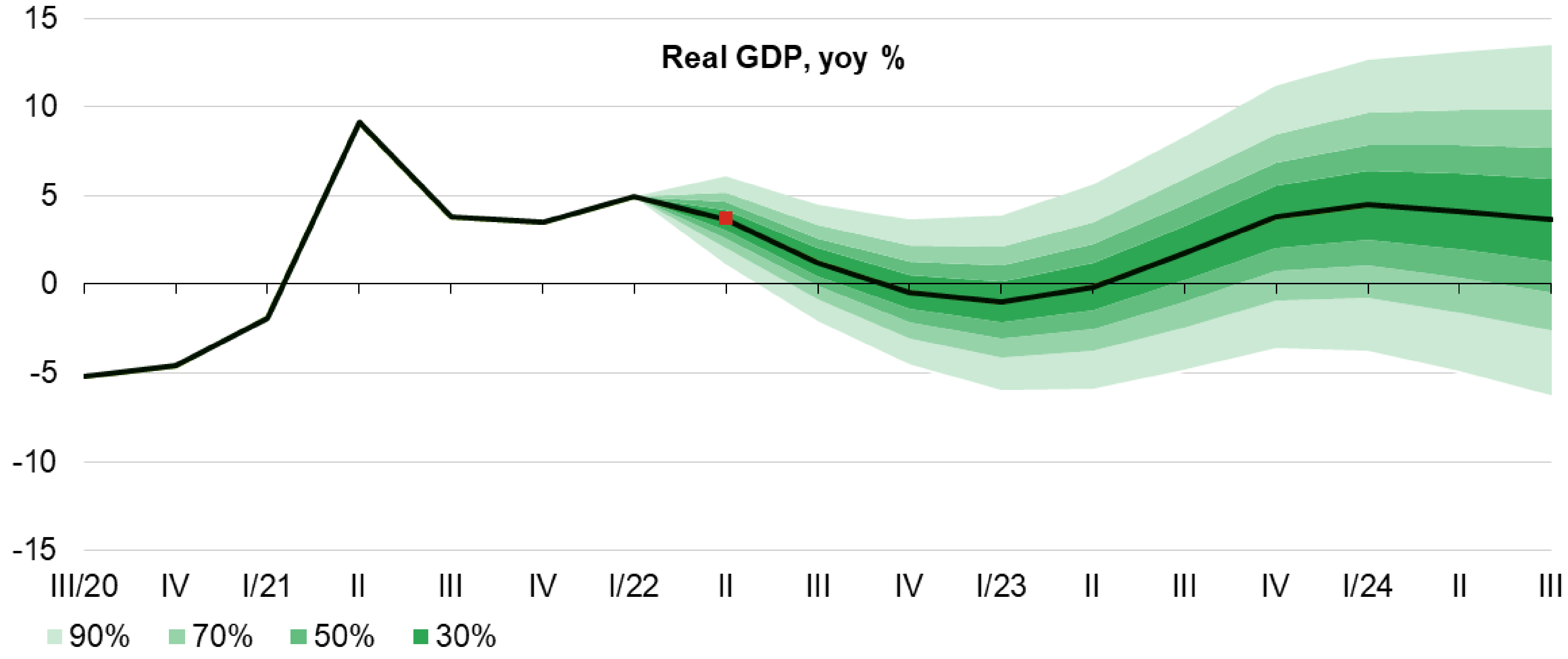
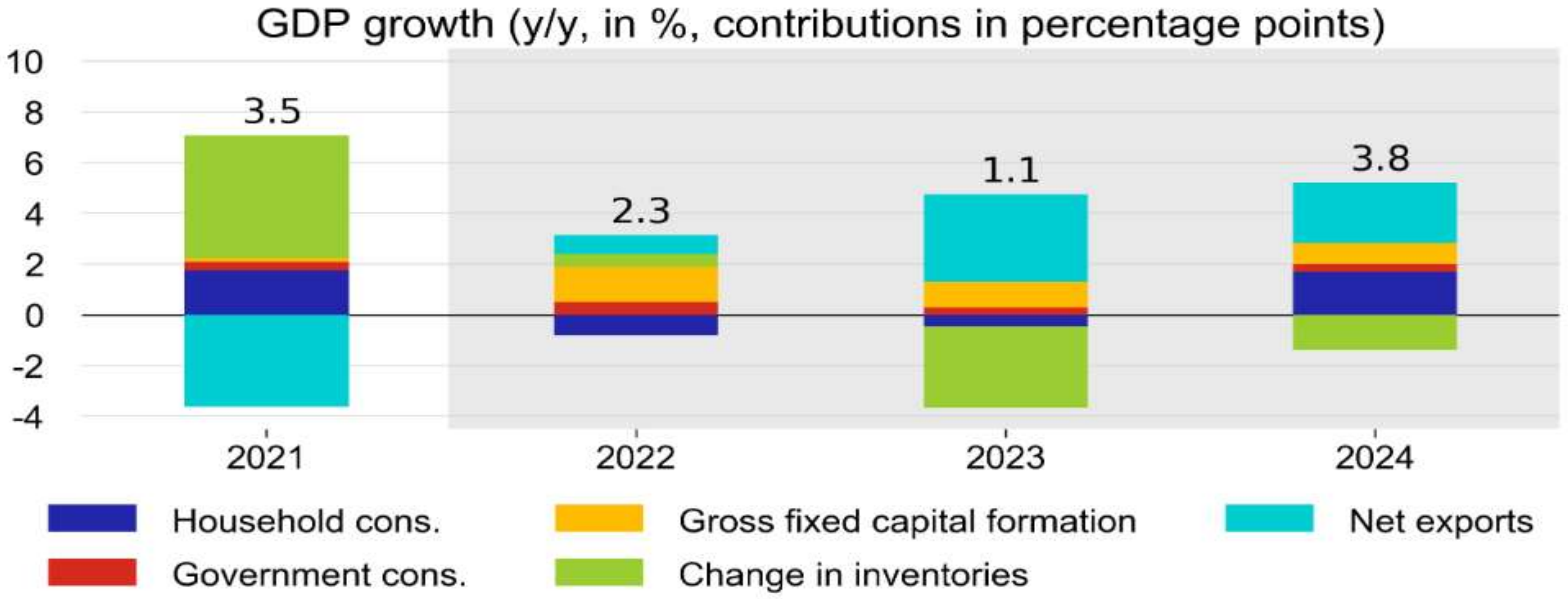
Real economy growth





The previous **overheating** of the economy **will fade out quickly** given deteriorating real income due to high inflation.

Real **GDP growth will contract** in 2022 H2, slowing down to 2.3% this year. It will decrease further to 1% in 2023 before it recovers.

New data on real GDP growth is broadly in line with the forecast. However, **household consumption** is so far more resilient than assumed. Also in contrast to the forecast, t he contribution of **net exports** dampened economic growth due to higher imports of goods and services.

2022 Q2	year-on-year in %	
	MPR Summer 2022	actual figure
Gross domestic product	3.6	3.7
Household consumption	-2.0	0.2
Government consumption	3.2	1.8
Gross capital formation	10.3	12.8
Exports of goods and services	0.9	1.8
Imports of goods and services	-0.1	2.7

constant prices, seasonally adjusted

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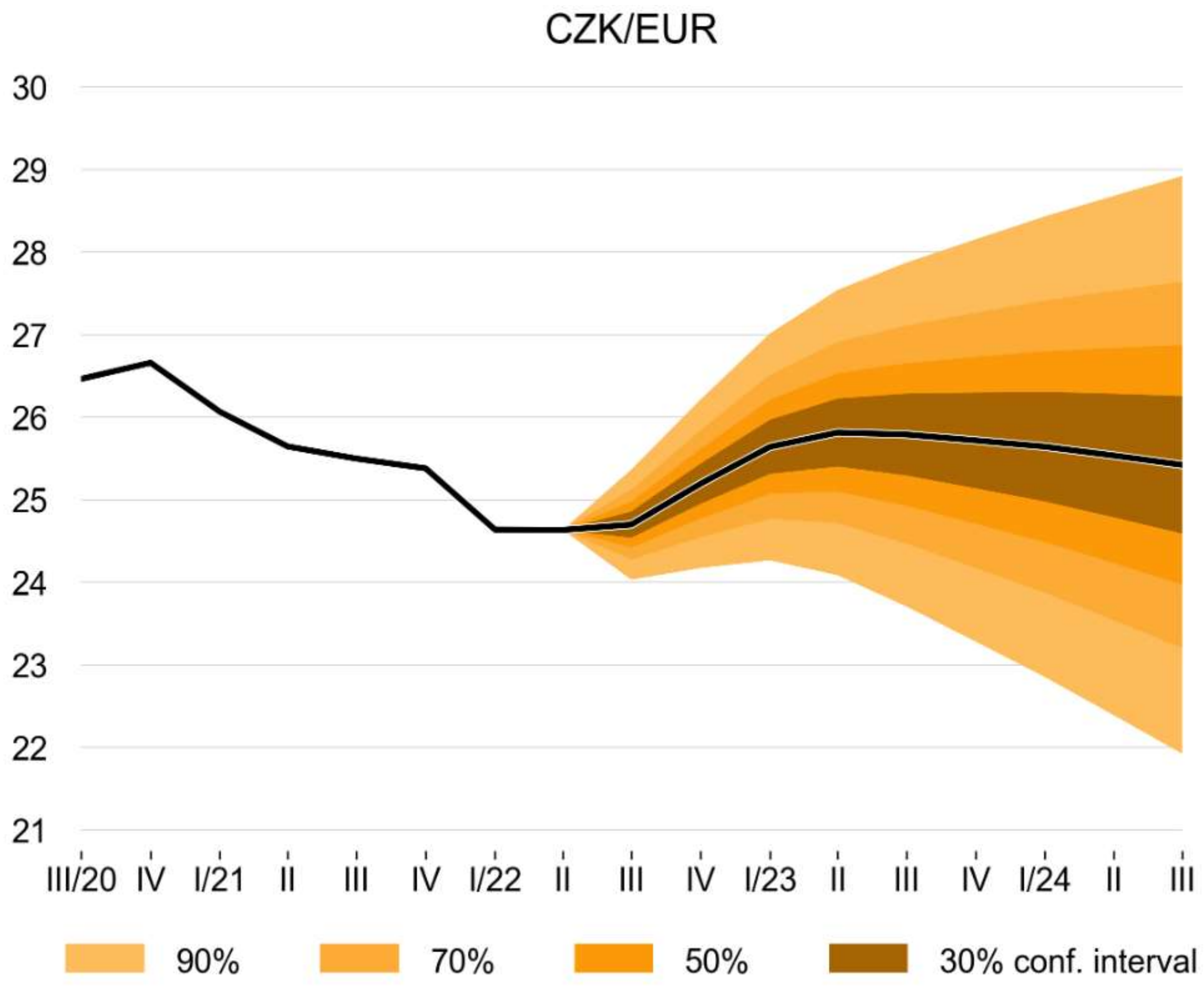
Exchange rate



The **CNB will continue to prevent excessive fluctuations of the koruna** exchange rate.

Based on the forecast, the koruna will depreciate slightly, mainly due to a **worsening trade balance** and negative sentiment in the region.

A gradually **narrowing interest rate differential** will create depreciation pressures over the entire outlook. However, a **renewed trade surplus and improved global sentiment** will result in appreciation in 2024.

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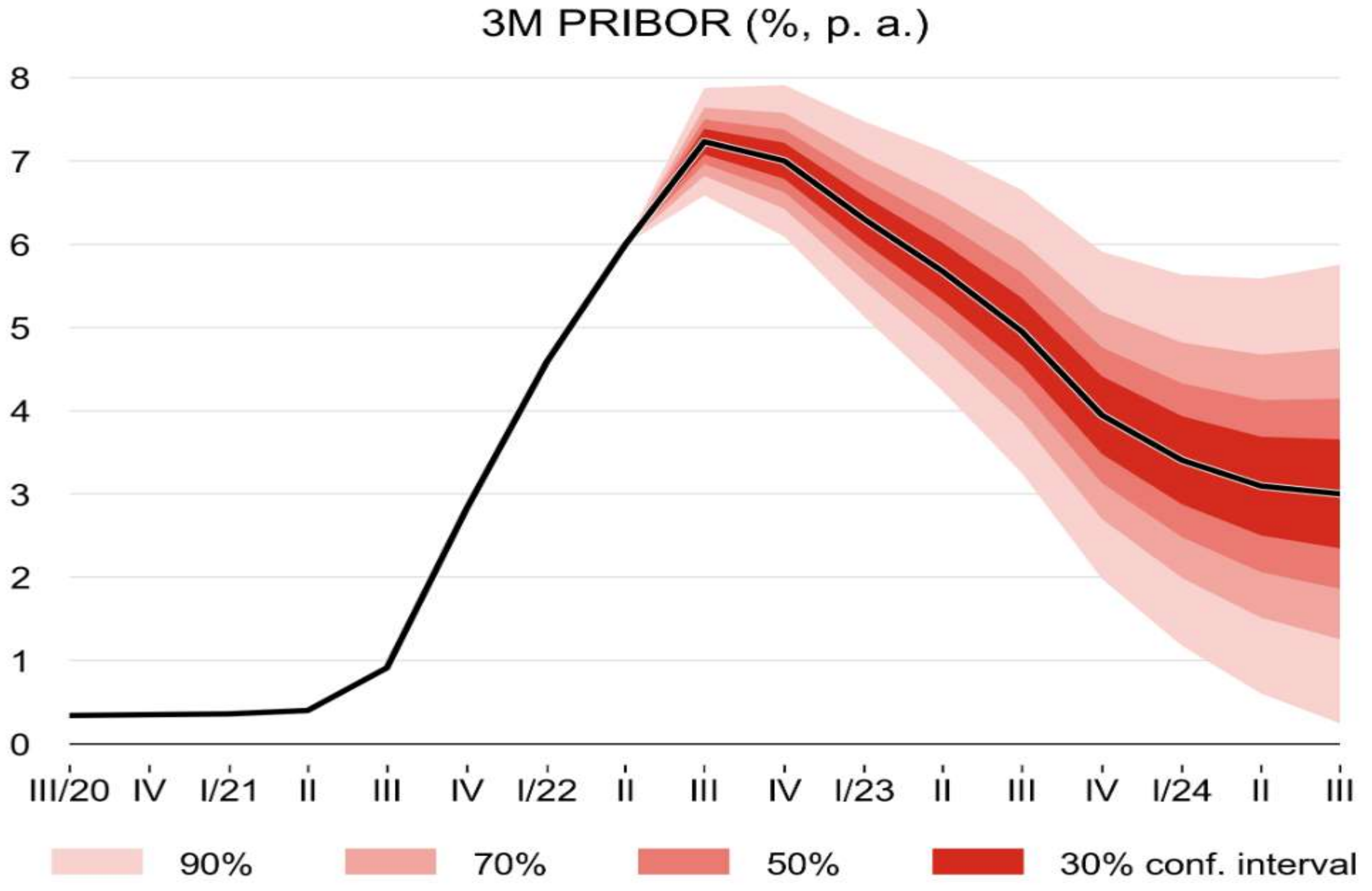
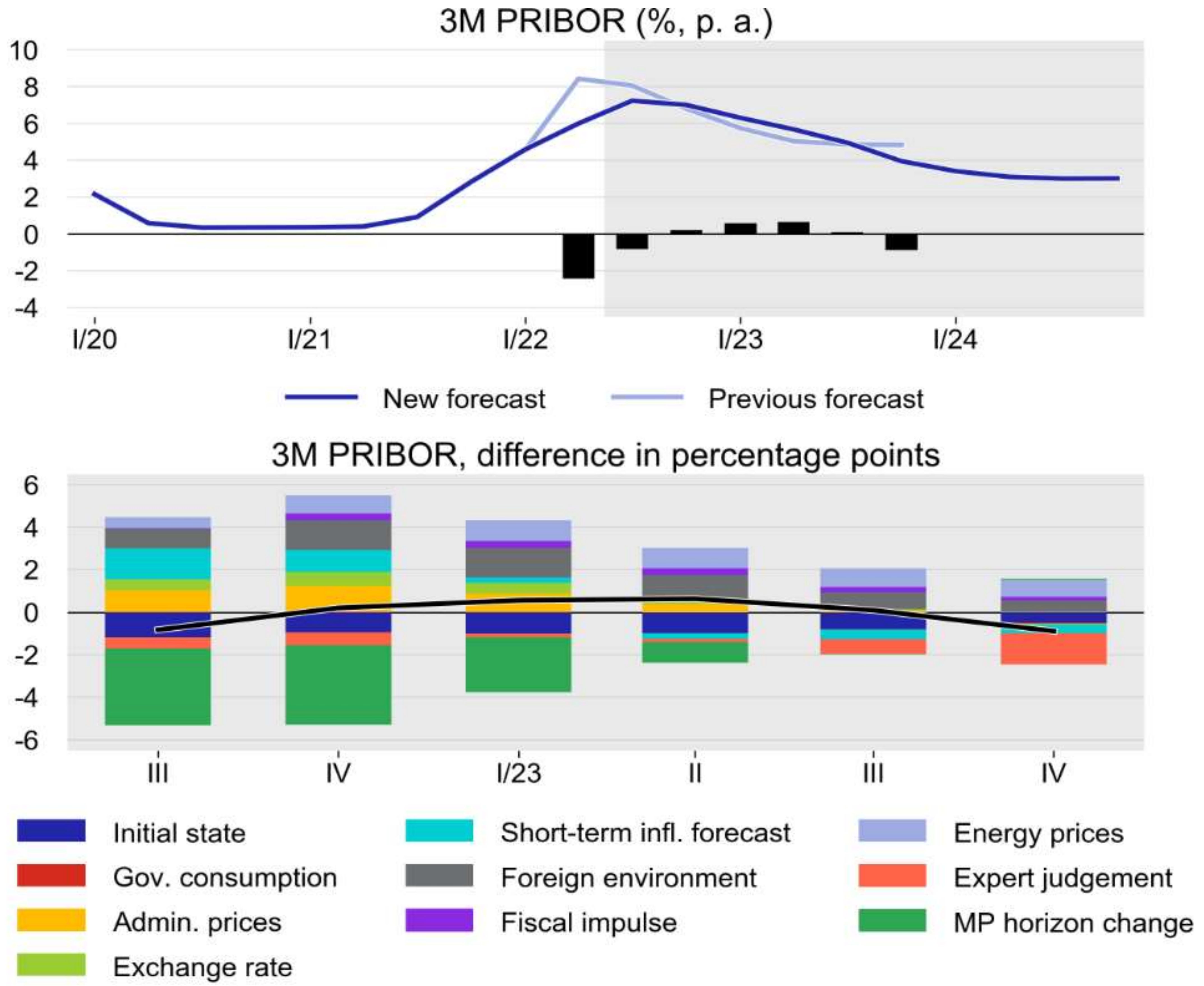
Interest rate path (3M PRIBOR)

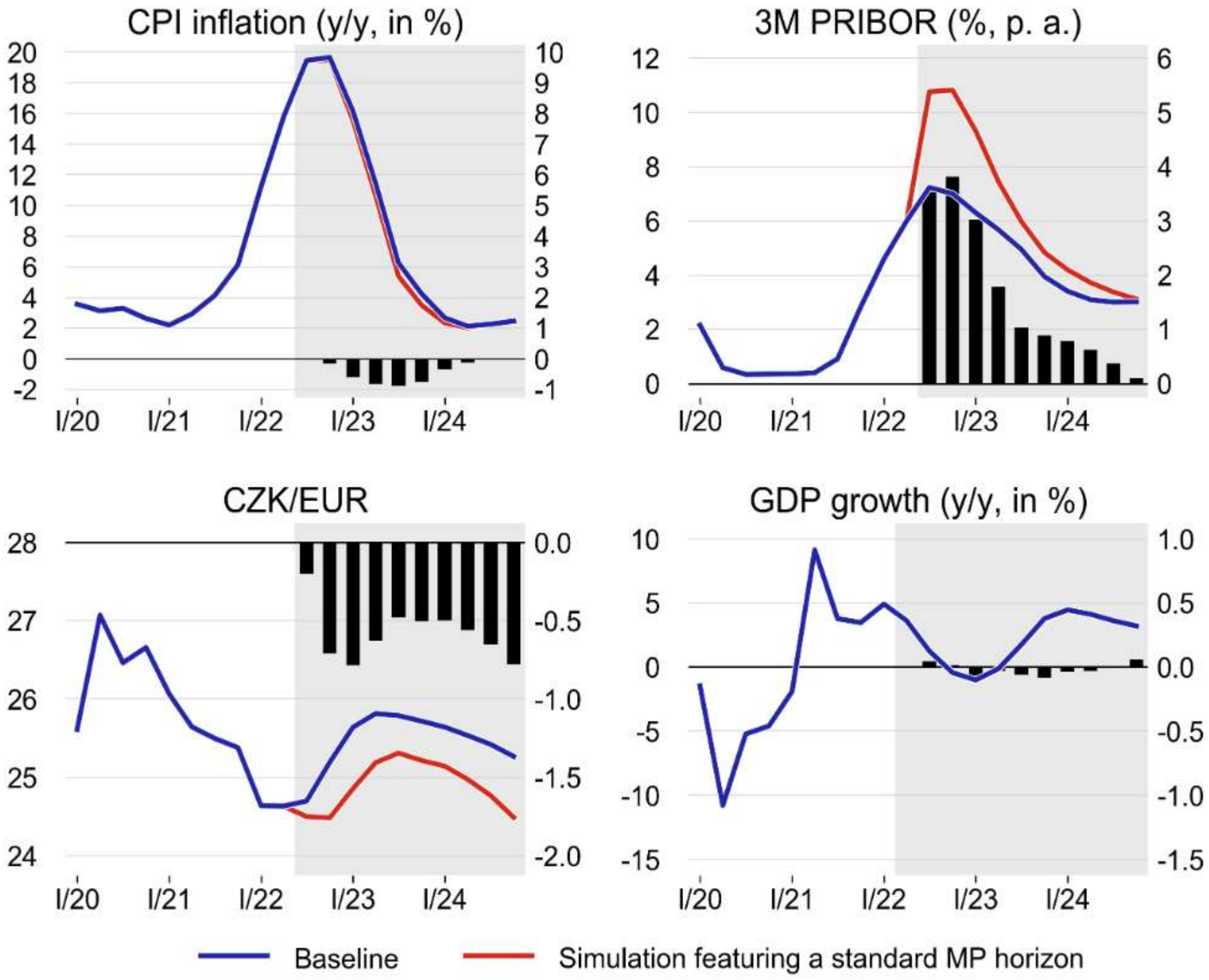




Consistent with the baseline scenario is stability of **short-term market interest rates** at their current level.

Strong **downward effects of the prolonged policy horizon** on the rate path while the **external assumptions** are suggesting a need for a higher rate compared to the previous forecast.

Scenario with the standard CNB's MP horizon



Assuming standard CNB's horizon (12-18 months ahead), the **central bank reacts strongly** with the policy instrument – **the interest rates** – to bring inflation back to the target.

Notably higher interest rates compared to the baseline bring **stronger koruna** over the whole forecast horizon and consequently lower inflation.

Tighter monetary policy helps **anchor inflation expectations** at the 2% target and **mitigate risks of an inflation-wage spiral**.

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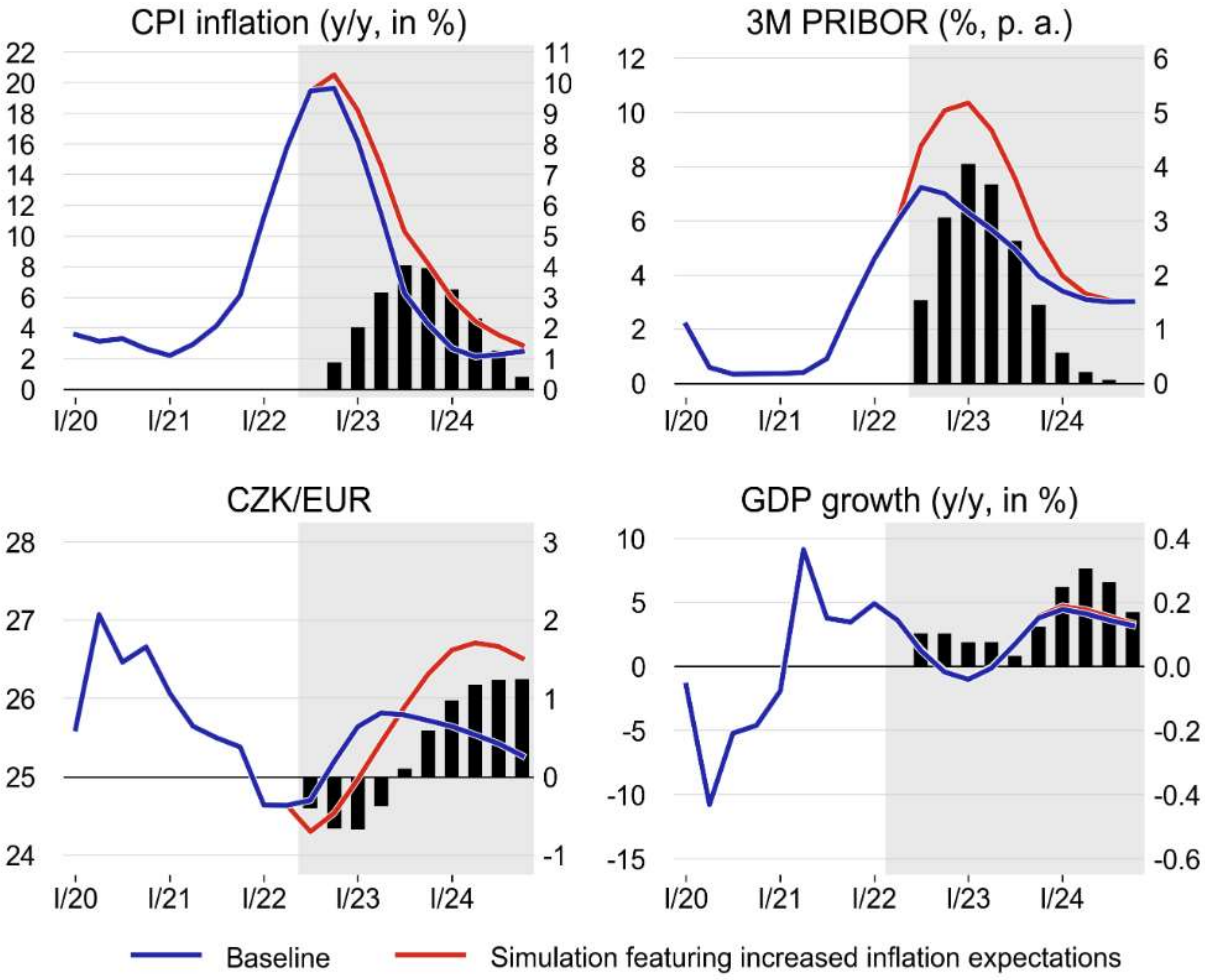
Scenario with higher inflation expectations



Prolonging the policy horizon and allowing later return of inflation back to the target poses **risks of higher inflation expectations** and threatens **the central bank credibility**.

In the scenario, economic agents **raise** their **inflation expectations** to 5% until the end of 2023. Subsequently, the expectations gradually return to 2 %.

The scenario implies **higher and more persistent inflation** and consequently **calls for tighter monetary policy**.

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Summary

Inflation will peak this year before it starts to decline given the previous monetary policy tightening.

The inflation peak might be slightly lower than assumed by the current forecast.

Prolonged policy horizon might pose risks of de-anchoring inflation expectations and threaten central bank credibility.

De-anchoring of inflation expectation would raise the costs of disinflation, worsening the policy trade-off.

The current inflation surge has been stress-testing central bank monetary policy frameworks and lessons should be learnt.

Thank you for your attention

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