

REGULARITY AND TRENDS OF CNB MONETARY POLICY IN THE CONTEXT OF EXPLOSIVE INFLATION IN THE CZECH REPUBLIC

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Abstract. At present against the background of the expectation of a recession in the world economy, inflation has also covered the whole world. The Czech Republic is also experiencing an inflation that at least one generation does not remember. Today, the Czech National Bank (CNB) is fully aware of its role as a monetary institution. It now bears the main burden in fighting inflation and supporting the economy.

Keywords: recession, stagnation, inflation, economic recession, standard of living, monetary policy.

First of all, let us note that according to the IMF (and a number of famous economists) the prospects of the world economy remain gloomy [1]. The Fund believes that more than one-third of the world economy will shrink in 2022 and 2023, and stagnation will continue in the three largest economies (the United States, the European Union and China).

Moreover, and this is no longer a refutable fact, inflation has hit the entire world. And the Czech Republic, like the rest of the world, is experiencing inflation that at least one generation does not remember [2].



Figure 1. - Dynamics of inflation changes in the Czech Republic [3]

So who is to blame for the fact that the Czech Republic now has such high inflation (See Figure 1)?

Here we emphasize that even before the pandemic the Czech government's fiscal policy had been greatly relaxed. And during the pandemic, any fiscal restrictions simply disappeared. So, according to the public sector budget strategy approved in May 2022, nothing will change significantly in the coming years either: in 2023, 2024 and 2025 the state budget deficit should be between 300 and 360 billion crowns (each year) [4].

Second, not only fiscal policy but also monetary policy was too soft even before the pandemic. The fall of rates to zero in the spring of 2020, and their more substantial increase only in the fall of 2022 - all steadily negative real rates in the economy and without unemployment, which eventually caused just a rush of borrowing and a credit boom on almost everything (See Figure 2) [5].



Figure 2. – Dynamics of CNB discount rate [5]

Third, partly as a result of the previous two points, there was an excessive increase in wages relative to labor productivity. And this whole process was also triggered by the government, which since 2017 has been massively raising salaries in the public sector: the growth of salaries in health care and education over the past five years has reached 45%. And the private sector could not help but respond. Every year since 2017, wage growth throughout the economy has significantly outpaced productivity growth, by the way, precisely at the expense of corporate profitability.

In short, we must now look for the original and main (though certainly no longer the only) reason why the Czech Republic now has the highest inflation in the European Union after the Baltic countries. What will help now is wage growth in line with productivity and a significant reduction in the state budget deficit. Unfortunately neither one nor the other can do without a recession and without a share of interest rates in the economy.

As for the possible correction of monetary policy carried out against this background by the CNB, at its meeting on November 3, 2022, the CNB Banking Council left interest rates at the current level (See Figure 2).

Thus, the main rate remains at the level of 7% for the time being. However, the CNB downgraded its assessment of economic development for this year and next. Opponents of further increases, who are in the majority on the CNB's banking council, still believe that interest rates are high enough to keep inflation in check. Thus, as of June 22, 2022, the benchmark interest rate remains at 7%, the highest level since 1999.

At the same time, the CNB has worsened its estimate of economic development for this year and next 2023. Czech GDP is expected to grow by 2.2 percent this year and decline by 0.7 percent next year. In its previous August forecast, the CNB expected growth of 2.3% this year and growth of 1.1% next year (last year's 2021 economy grew by 3.3%).

CNB also lowered its estimate of inflation, which, according to him, will average 15.8% at the end of 2022. In August he estimated its growth at 16.5%. CNB expects consumer prices to fall to 9.1% next year in 2023, while in August it projected a decline to 9.5%.

Still, according to a number of experts, the Czech economy now faces inflationary pressure from external costs. Household consumption is already constrained by high energy and food prices, as well as higher interest rates. According to the CNB governor the impact of fiscal policy on economic activity is still neutral, but with an inflation risk in the future [6]. The CNB's latest forecast suggests that inflation will peak in the last quarter of this 2022 and decline thereafter. And it will have to reach the 2% target only in the middle of 2024.

CNB also left the lombard rate at 8% (the lombard rate is the interest rate at which commercial banks can borrow money from CNB against securities). And the discount rate, which, for example, is associated with penalties for non-payment of loans, remained at 6%.

And so against this background let's try to analyze the situation of the Czech krone, which is pressured on the one hand by inflation (CNB is fully aware of its role and it carries the main burden in the fight against inflation), and on the other hand - by speculators.

It should especially be noted that the state of the Czech krone in this year 2022 depended on several events that shook up its exchange rate. Back in early February 2022, one euro was selling for about 24.20 crowns, but soon after Russian troop's invasion to Ukraine, the Czech currency weakened above 25.80 Czech crowns per euro. The CNB then intervened in the foreign exchange market in early March, and for the first time since 2000 it intervened to strengthen the krone. It was the simplest intervention, i.e. the usual sale of CNB reserves in euros, which it had accumulated during the artificial weakening of the krone from November 2013 to April 2017.

According to analysts, since March, the CNB has sold about 23.2 billion euros on the market (at the exchange rate it is about 570 billion crowns). Thus, the CNB's total reserves have fallen to €139 billion (3.42 trillion Czech crowns), which is still more than three times higher than, for example, the Hungarian central bank (See Figure 3, 4).

Note here that the krone strengthened most strongly against the single European currency in April, when one euro was worth approximately 24.30 kronor. And in the first half of 2022, the "hawkish" monetary policy of the CNB (then still led by Governor Jiří Rusnok) played into the hands of the krone. As part of the fight against high inflation, the CNB then quickly raised interest rates, making the krona more attractive to foreign investors.

However, there was another development in May - markets were spooked by the news of the appointment of Ales Michl as the new CNB governor and the Czech currency exchange rate quickly fell to above 25.40 against the euro. A. Michl is considered rather an opponent of higher interest rates, and investors began to sell off the krone. Also in May, the CNB stepped in and once again saved the exchange rate of the krone.

Since May, the CNB began to intervene regularly and continues to do so today. Without CNB interventions, the krona would be weaker today (See Figure 4).



Figure 3. – Dynamics of gold and currency reserves in the Czech Republic [7]

By selling its foreign exchange reserves, that is, foreign exchange reserves, the CNB strengthens the krona and reduces inflation because it makes imports cheaper, especially energy traded in euros or dollars (a weak krona would increase the price of imported goods, which include, for example, oil and natural gas).

Thanks to CNB interventions, the exchange rate of the krona has more or less stagnated in a narrow range without significant fluctuations around the level of 24.50-24.60 Czech crowns per euro. However, experts note that had the CNB not intervened in the foreign exchange market, the krona would have been much weaker.

Now it's hard to say how much weaker it would have been, because if the CNB hadn't sold foreign exchange reserves, it probably would have raised interest rates to account for the rate of inflation. So far, this combination still makes the Czech currency more attractive (See Figure 4).

And if the CNB had done nothing at all and kept interest rates at the level set by the previous CNB bank board, the exchange rate could have fluctuated somewhere around CZK 25.50 per euro," believes Tomáš Kudla, commercial director at SK Ebery [9]. Viktor Valent of SAB Finance believes the same. And, according to him, the current forecasting model has changed significantly due to recent events.



Figure 4. – Dynamics of change in the exchange rate of the krona to the euro [8]

CNB itself now expects the average exchange rate next year to be around CZK 25.70 per euro (the spring forecast was CZK 24.30 per euro). (See Figure 4, 5).

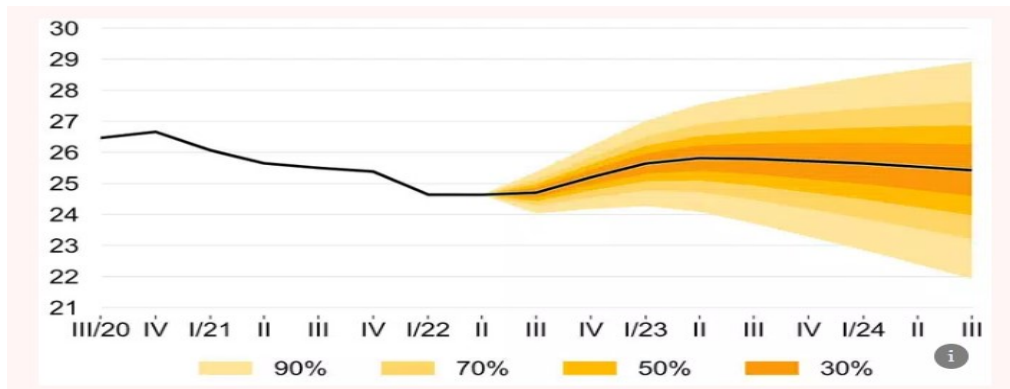


Figure 4. – CNB Forecast Estimates in the exchange rate of the krone to the euro [8].

From the point of view of Czech economists, the krone will still not weaken as much as the Hungarian forint or, as of late, the Polish zloty. Nevertheless, the CNB still intervenes and can keep the exchange rate at current levels for quite a long time.

At the same time, according to many economists, this could be a relatively risky approach [9]. The more the domestic economy and exports deteriorate, the stronger the pressure to weaken the Czech currency could be. The CNB would then have to intervene in a much larger volume of its interventions in order to keep the exchange rate of the krone under control.

Also Czech currency may still be under pressure from sellers (speculators) due to lack of further interest rate hikes. While the current CNB leadership has so far refrained from tightening monetary policy, major central banks such as the US Fed or the European ECB, on the contrary, have started to raise rates very quickly (See Figure 5).

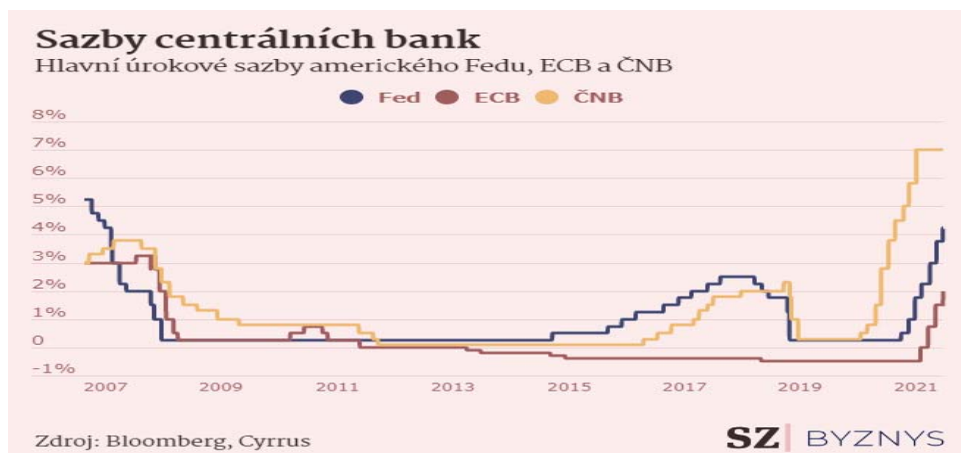


Figure 5. – Raising rates by central banks [10].

At its fall meeting in 2022, the U.S. Federal Reserve raised the rates to the range of 3.0 to 3.25 percent and said it would continue to raise them further (the last regular Fed meetings in 2022 will be held on 11/02 and 12/14, with the end of the year rate projected in the range: 4.25 to 4.5 percent), while noting that the Fed plans to lower them only in September 2024 [11].

And if this is justified, then already in the spring of 2023, CNB will begin to raise rates much faster than its other “colleagues” in order to increase the attractiveness of the crown in the eyes of investors. Otherwise, investors will prefer to get rid of the krona and choose the US dollar or euro as a safe haven, even if they do not earn much. And it will lead to a weakening of the Czech currency.

So far, the behavior of the krona in the last months of 2022 shows that the CNB has not allowed the exchange rate to weaken above the area of 24.70-24.75, although the CNB has not named the exact area publicly. And according to many experts, it is mainly speculators who are behind the fluctuations of the krone, which we have seen since around the end of May 2022.

And the analysis of liquidity in the Czech banking system shows that the CNB continues to significantly intervene in the market and thus keeps the crown below 24.50 CZK per euro. It will continue as long as it makes some sense. If speculators know that the CNB will protect the krone at a predetermined level and beyond, then this information in itself does not provoke speculative attacks, especially if the difference in interest rates against the dollar and the euro decreases.

Although under certain circumstances the course of the krone may "shoot", but this will further depend on the pressure under which the krone will be. And according to the statement of CNB Governor A. Michl after the last meeting on monetary policy, CNB will continue to protect the Czech crown from significant fluctuations. At the same time, if the krone is under strong pressure for some period, the CNB will also have the opportunity to raise interest rates. There is no other option. The market can "force" the CNB to retreat only if its foreign exchange reserves are gradually reduced to a sensitive level. But the debate about a specific level of foreign exchange reserves, below which gold reserves should not fall, is currently not on the agenda in the Czech Republic. Thus, and this is seen by both investors and specialists, CNB is fully aware of its role as a monetary regulator in the Czech economy.

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