



Weekly Briefing

Czech Republic economy briefing:
High inflation: Recent Development & Central Bank's Response
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High inflation: Recent Development & Central Bank's Response

Summary

High inflation is a reality that will be probably present for a long period. In August, it reached 4.1 per cent according to the Consumer Price Index while being higher in fact beyond any doubt. The Czech National Bank reacted to the dynamic development by increasing the basic interest rates by 0.75 per cent to 1.5 per cent (in the case of the two-week repo rate). It was the biggest rise since 1997, moreover, a further increase is expected. It will have a serious impact on households, businesses as well as the state itself. The analysis focuses particularly on the Czech concept of the market basket and inflation index, and also on the recent central bank's policy in relation to inflation.

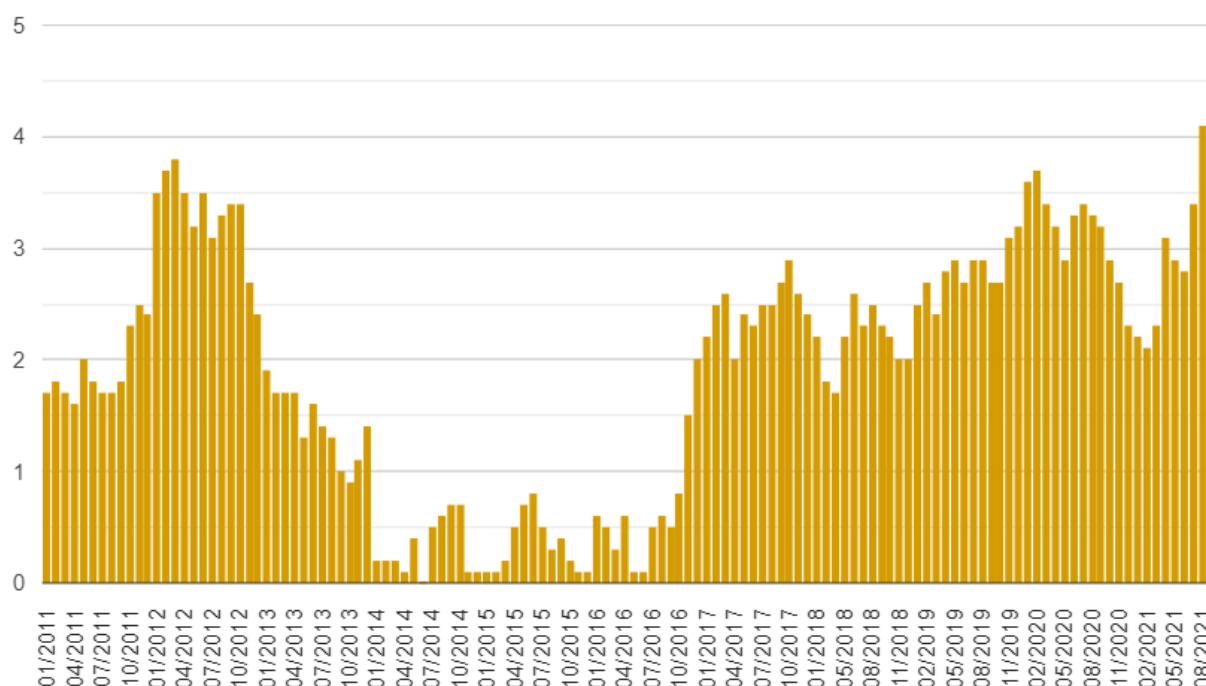
Introduction

Inflation has become one of the most relevant topics of the present day. It relates to the fact that inflation has been increasing significantly. This phenomenon has both internal and external reasons and is not typical only of the Czech Republic. Predictions vary – while some experts do not consider the current state of affairs serious, expecting a near decrease in the inflation rates, others warn against a long-term growth of prices and depreciation of money. Given the existing tendencies as well as megatrends (partial deglobalisation, green transition), it seems that pressures stimulating inflation will be strong in the long-term horizon.

Inflation and the market basket

According to the Czech Statistical Office, inflation in the Czech Republic reached 4.1 per cent in August 2021. It is higher than in 2012 when the rate was characteristic of a considerable rise (3.8 per cent in March that year). From a long-term perspective, it is comparable with a situation in 2001 when oscillated between 4.2 and 5.9 per cent. Even higher levels could be observed amidst the global economic crisis in 2008 when inflation reached 7.5 per cent in January. Generally, high inflation was a reality especially in the 1990s which was connected with the overall economic transformation, emergence and early stages of development of the market economy and integration into the global economic structures. However, one cannot

exclude that the Czech Republic will be experiencing a similar period of high inflation in the post-pandemic times. Several factors can contribute to such development.



Graph 1: Annual inflation rate in the Czech Republic since 2011

Source: kurzy.cz

The statistics elaborated by Eurostat, nevertheless, present a different picture. According to the European Statistical Office, the Czech annual inflation amounted to 3.1 per cent in August 2021.¹ Why is that? The explication lies in a different methodology. The EU authorities employ the Harmonised Index of Consumer Prices (HICP) which does not include the so-called imputed rentals. The Czech National Bank is one of the few in Europe that has introduced such an index into the inflation index since the central bankers admitted that the households' expenses on housing are important. The imputed rentals account for 10.61 per cent of the index, which is underestimated but better than nothing. It is an index of costs on acquisition, expansion and maintenance of housing stock for owner-occupied housing.² The Czech National Bank's methodology is, therefore, more accurate in comparison with many Western countries where the real inflation is much higher than indicated by the official data. Notwithstanding the progressive innovation of the Czech consumer price index (CPI) through the inclusion of the

¹ *Inflace – 2021, míra inflace a její vývoj v ČR – 10 let* (2021, September 11), kurzy.cz. Retrieved October 04, 2021, from <https://www.kurzy.cz/makroekonomika/inflace/?imakroGraphFrom=1.1.2011>.

² *Metodická poznámka k indexu spotřebitelských cen – imputované nájemné* (2021, September 10), czso.cz. Retrieved October 04, 2021, from <https://www.czso.cz/csu/czso/metodicka-poznamka-k-indexu-spotrebitelskych-cen-imputovane-najemne>.

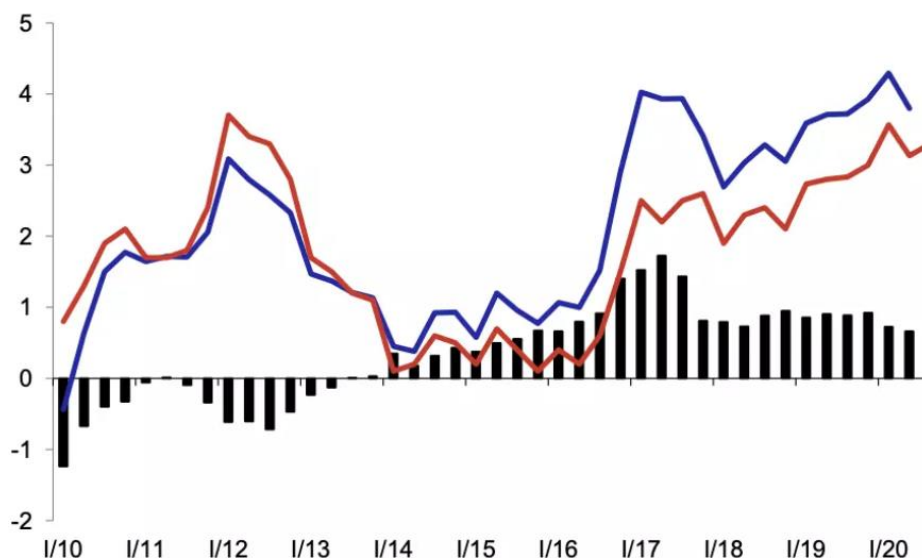
imputed rentals, the same critical remark applies to the Czech statistics as well. The problem is the very construction of the market basket. The structure of consumption has been changing. People buy different, prefer different solutions and ways of consumption products than two decades ago. This fact has been marked especially during the pandemic. Regional differentiation is another relevant issue. Some items of the basket go up in price more in major cities with Prague on the top than in remote regions. First of all, it applies to the prices of real estate. A problem typical of the pandemic period is that many services and industries were closed or restricted so measurement of the inflation is necessarily doubtful.³ From these observations follow that the official inflation index is somewhat misleading.

The risk of inflation

Apparently, the central bankers have been aware of that. Not only did they revise the CPI but also designed an alternative CPIH index („Hampl’s index“). The latter includes purchase transactions of older real estate that dominates the market. Noteworthy, the CPIH has been used predominantly internally and since the beginning of this year, it has not been presented at all. This fact was criticised by Mojmír Hampl, the former Vice-Governor of the Czech National Bank and the author of the CPIH. He estimates that the inflation rate based on the CPIH could be 5.3–5.4 per cent in August.⁴ Even though the Czech central bankers are more open and fair than their Western counterparts as far as the real inflation is concerned, the public is still deceived in a sense. People have experienced that the prices are increasing more rapidly than the official data indicate. It contributes to certain mistrust of the institution as such.

³ Stuchlík, P. *Komentář: Proč je inflace v Česku ve skutečnosti 6 % a proč to ČNB nesmí přiznat* (2021, September 14), seznamzpravy.cz. Retrieved October 04, 2021, from <https://www.seznamzpravy.cz/clanek/komentar-proc-je-inflace-v-cesku-ve-skutecnosti-6-a-proc-to-cnb-nesmi-priznat-174567>.

⁴ *Otázky Václava Moravce* (2021, October 03), ceskatelevize.cz. Retrieved October 05, 2021, from <https://www.ceskatelevize.cz/porady/1126672097-otazky-vaclava-moravce/221411030501003/>.

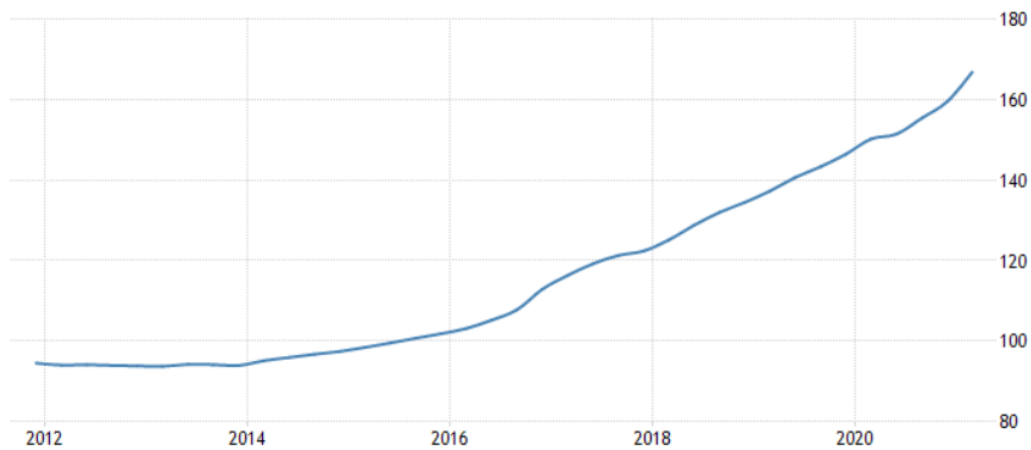


Graph 2: Comparison of the CPI (red) and CPIH (blue); black columns show monthly differences

Source: seznamzpravy.cz

The most indicative index regarding prices of real estate is the House Price Index (HPI). It presents a picture that is very different from the CPI. Naturally, it is related to the fact that the acquisition of real estate is traditionally perceived as an investment, not consumption. In reality, however, the border between these two realms is blurred in this concrete case so the development on the real estate market should be reflected by the inflation indices somehow. All the more that the housing question together with inflation itself have become the hot topic of both the public and political discourse. The sharp rise in prices of flats, houses and estates continues and this phenomenon has spilt from Prague and big cities to all regions. Bad social atmosphere, nourished by a vision of further rise in prices, has been deepened by a shortage in building materials accompanied by a substantial increase in price, and also by the rise in interest rates of commercial loans and mortgages.⁵ After some decrease in rental caused by the pandemic especially in the capital, the tendency has already turned. If the rental is supplemented by a price escalation clause, tenants could have problems with payments in the following period, particularly provided that the inflation gets out of control. Let's remind that the inflation target set by the Czech National Bank is 2 per cent. The official figure from August (4.1 per cent) is, therefore, far away from the target. And central bankers could not but admit it. Taking the present development, tendencies and risks into consideration, return to the low level of around 2 per cent seems utterly unrealistic.

⁵ For instance, the price of fuels increased by 19 per cent, timber by 160 per cent annually. It is expected that prices of power supplies will be rising in the next months by more than 20 per cent.



Graph 3: House Price Index (HPI) in the Czech Republic, 2012–2021

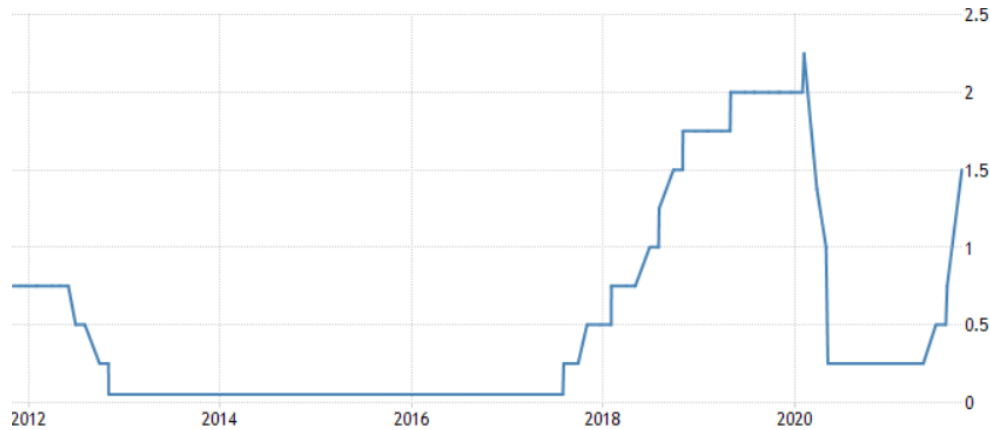
Source: tradingeconomics.com

Central bank's response

In response to the actual development of inflation, the central bankers decided to increase the basic interest rate (two-week repo rate) by 0.75 per cent to 1.5 per cent in September. The Lombard rate was increased to 2.5 per cent while the discount rate to 0.5 per cent. It was the biggest rise since 1997. Governor Jiří Rusnok has not excluded that the Czech National Bank will continue increasing the rates in the following months. The decision was not unanimous. Two out of seven members of the CNB Bank Board voted for maintenance of the former level. It shows that the supreme body of the central bank is divided as far as the monetary policy is concerned. Nevertheless, it is nothing new, since decisions taken amidst crisis periods have frequently been controversial. The two-week repo rate is the main instrument within the monetary policy, affecting short-term interest rates on the money market and consequently regulating the currency in circulation. The September actions of the central bankers will lead to a rise in interest rates for households as well as businesses and last but not least it results in higher expenses needed for the administration of the expanding state debt. This is a reason for critical remarks made by the Minister of Finance Alena Schillerová who stated that the Czech National Bank had allegedly opted for a policy typical of emerging economies. The Government accused the bankers of hampering the efforts to stimulate economic growth and improve people's living standards.⁶ A similar attitude has been adopted by the Association of Small and Medium-Sized Enterprises and Crafts, warning against damaging Czech export that

⁶ *Vyjádření Schillerové ke zvýšení sazeb ČNB je podle Rusnoka nekompetentní* (2021, September 03), [ceskenoviny.cz](https://www.ceskenoviny.cz/zpravy/vyjadreni-schillerove-ke-zvyseni-sazeb-cnb-je-podle-rusnoka-nekompetentni/2097987). Retrieved October 05, 2021, from <https://www.ceskenoviny.cz/zpravy/vyjadreni-schillerove-ke-zvyseni-sazeb-cnb-je-podle-rusnoka-nekompetentni/2097987>.

is crucial for the national economy.⁷ In any case, concrete impacts of these decisions on inflation will begin to manifest themselves no earlier than after a year. Meanwhile, inflation can surge up dramatically.



Graph 4: The Czech two-week repo rate, 2012–2021

Source: tradingeconomics.com

Conclusion

The decision took by the Czech National Bank on September 30 provoked diverse reactions. Representatives of the Government criticised it as entailing negative financial consequences to households and businesses. Even though such an assertion is right, since the increase in the basic rates will result in a rise in interest rates of loans and mortgages, thus higher expenses, it is formulated predominantly from the perspective of a debtor. Not by coincidence, the State is the principal debtor and it will be likely to expend more means on repayment of the state debt. At the same time, rising interest rates can damage domestic exporters because the Czech currency will be appreciating. The central bank's actions are controversial. But ignoring the inflation potential would be dangerous likewise.

⁷ Kratochvílová, Z. *ČNB pokutuje podnikatele za snahu odvracet následky krize* (2021, October 04), amsp.cz. Retrieved October 06, 2021, from <https://amsp.cz/cnb-pokutuje-podnikatele-za-snahu-odvracet-nasledky-krize/#>.