CZECH INFLATION: IN DEFIANCE OF CNB

WHAT WILL CZECH INFLATION MAKE CNB DO THIS YEAR?

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- **Czech inflation fell at the beginning of 2018, defying the CNB's forecast that it'd rise**
- **Although regulated prices and fuel prices will add to price level growth this year,…**
- **…food prices will offset that.**
- **Core inflation will remain unchanged on 1Q18 and may decline if house prices moderate further**

There was a time in Czech Republic – and it was not so long time ago – when consensus was that Czech rates would rise quickly, much more quickly than in the Eurozone. This view was the major driving force behind the weakening of the EURCZK that we witnessed in the twelve months since the end of interventions in early April 2017.

The hawkish case for Czech rates was based on the expectation that Czech inflation will continue to rise and that both stronger CZK and higher rates (the former to a good extent consequence of the latter) will be needed to contain the allegedly high demand pressures. CNB, with arguably the largest analytical team in the Czech Republic, studded with PhDs, came up, in early February of 2018, with the following forecast: the CPI will average 2.2% in 1Q18, and will move up to 2.4%, 2.3% and 2.1%, respectively, in each of the remaining three quarters of this year following the 1Q18. Considering that the actual 1Q18 inflation was 1.9% and the March one merely 1.6%, i.e. 0.6 pp below what CNB expected for that particular month, this alone would be enough to call February forecast of CNB an inaccurate one.

What makes it a remarkably bad one is the fact that **CNB also expected the CZK to start strengthening in 2Q18**. One needs to keep in mind that the forecasts of inflation and EURCZK aren't independent. Just the contrary, they are closely intertwined – the stronger expected CZK (i.e., lower EURCZK exchange rate), the weaker, *cet.par.*, expected inflation, and vice versa. CNB said in February that for average inflation to be 2.4% in 2Q18 the EURCZK would have to, *at the same time*, be 24.90. It thus implicitly said that if EURCZK were to stay at 25.40, as it did in April, the inflation would be higher than 2.4%. Now, with March 2018 inflation at 1.6%, it is next to impossible to have 2Q18 inflation average 2.4%, let alone more. In other words, 2Q18 inflation will certainly be much lower than 2.4% even though the EURCZK will be higher than 24.90…

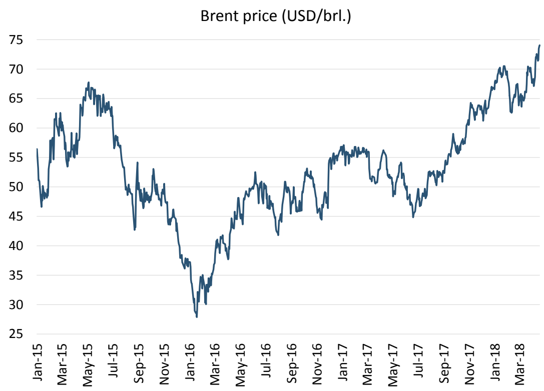
CNB thus clearly massively overestimated the domestic inflation and the demand pressures emanating from the economy (or their impact on Czech price level). The majority of that overestimation was due to lower actual food prices, but a non-negligible 1/3 of the difference between the actual and expected inflation was due to lower actual core (demand) inflation. In other words, not only has CNB overestimated the overall inflation, it also overestimated the intensity of the domestic inflation pressures. Not to brag (but one needs to commend oneself as nobody else does that… ☺), but I did not: in the December 12, 2017 Special report ↗ I wrote that "*looking forward, the strong disinflation is what lies ahead, disinflation that will bring Czech inflation below 2% soon, and possibly lower (depending on house prices, mainly)*."

Enough of the CNB-bashing. Let us look at the outlook for inflation for the remainder of this year as it will also inform us about what to expect from CNB.

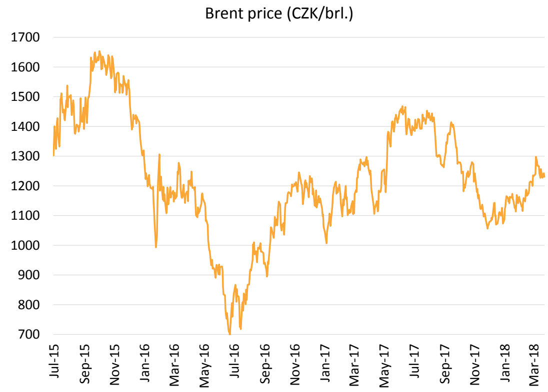
Czech headline (total, overall) inflation is composed of four main components: regulated prices, prices of fuels, prices of food and core inflation, with the weights approximately 15%, 5%, 25% and 55%[1]. Monetary-policy relevant inflation (MPRI) in which the CNB's target is set is defined as headline inflation less primary effect of indirect taxes. Core inflation is then defined as MPRI less fuel and food prices. Let us look at the outlook of each of these categories in a hope to arrive at the outlook for the MPRI this year.

Regulated prices are the prices of electricity, energy, sewage, garbage removal, healthcare etc. After last four years (2014-2017) in which regulated prices fell or stagnated, 2018 and 2019 will see their growth. This is due primarily to rebound in oil prices, impacting first the prices of electricity, natural gas and then, second, filtering into other segments (such as garbage removal). **Both 2018 and 2019 should see regulated prices grow at 1.5-2% y/y.**

Fuel prices are also going to add to the inflation this year, but only at its end. Brent price, in dollars/barrel, rose by about 2/3 from the summer low of last year and although the momentum of global economic growth seems to have peaked, it is unlikely that oil prices will return to strongly disinflationary levels of, say, early 2016 – OPEC guards the lower bound and global recession is very unlikely in next two years.

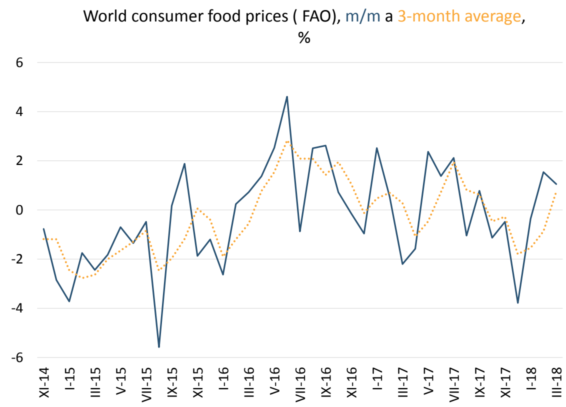


What is more important is that CZK-denominated price, having fallen by about 11% since the end of intervention in early April 2017, began rising in early March of 2018 and is now about 9% higher than at the beginning of previous month. If CZK doesn't strengthen this year and if oil prices stay the same as now, or fall marginally, this will translate into about 0.2-0.3 pp addition to headline inflation starting in last quarter of 2018.

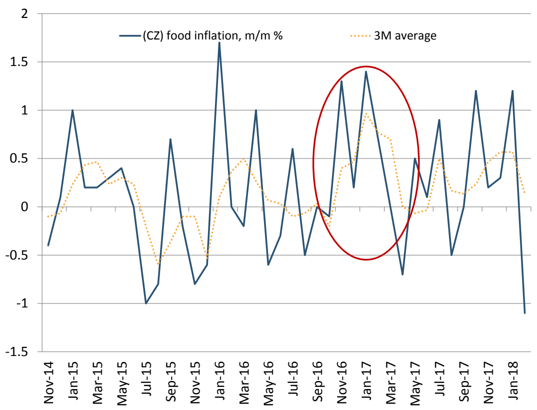


SOURCE: 42FS

Food prices had a major impact on the growth of inflation at the end of 2016 and the beginning of 2017, and were one of the three main reasons behind the growth of Czech inflation in 2017 which enabled CNB to tighten policy (the other two having been the implementation of the electronic record of sales system and rising prices of real estate). Global growth of food prices which was fast in the 2H16 couldn't but impact, with a lag of few months, naturally, the very open Czech economy.



[1] There is also the effect of indirect taxes here, but this is unlikely to be high in the coming years as indirect taxes won't change much.



SOURCE: FAO / CNB

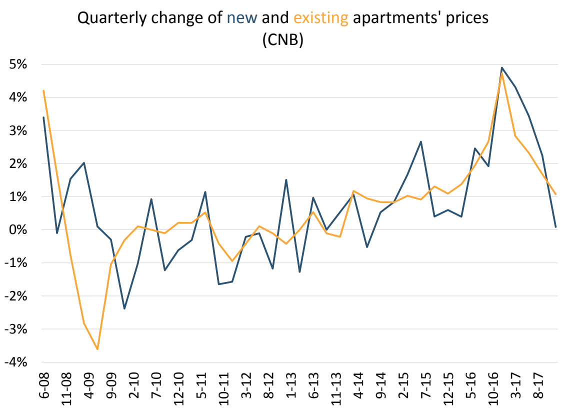
Now, food prices are notoriously hard to predict, being influenced by essentially unpredictable factors such as weather and harvests. But from the evolution of global food prices in the 1Q18 it seems reasonable to surmise that food inflation will be positive this year, though certainly not as high a contributor as in 4Q16-1Q17. I expect 2018 growth of food prices to be about 2%, i.e. less than what was seen in 1Q18 (2.5%) and certainly less than 3.6% growth recorded in 2017. In other words, **food prices will be a drag on annual CPI in the remainder of this year.** The effect on inflation in the rest of the year will be about -0.4 pp from the MPRI level seen at the end of March (1.6%), i.e. first offsetting the effect of higher regulated prices (in 2Q18-3Q18) and the offsetting the effect of higher fuel prices (in 4Q18).

Which means that the major determinant of the 2018 – early 2019 Czech inflation will be the core (demand) inflation. As an aside, core inflation should, in my view, be what the target of every central bank should really be specified in. Core inflation alone is the reflection of the sustainable domestic inflationary pressures and the only component of inflation that can be influenced by monetary policy. Food and fuel prices lie outside the purview of the monetary policy and should therefore be taken into account only insofar as they influence core inflation (i.e., only their secondary effects should be monitored, just like CNB does with the indirect taxes).

Looking at the core (demand) inflation, it rose noticeably last year, with annual dynamics of core inflation peaking at 2.8% in September 2017; this was notably faster than 1% y/y rise seen year before in September of 2016. As I explained in the above-mentioned Special report of December 2017, this rise was predominantly due to two things: EET and prices of real estate (with the latter effect reinforced by the change to the structure of the consumer basket which saw the weight of new house prices in imputed rents, a component of demand inflation, increase substantially).

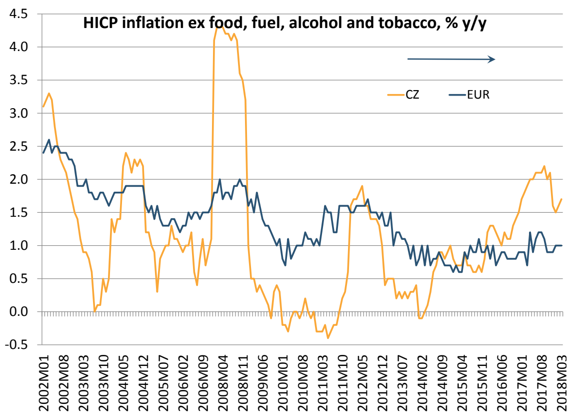
Looking forward, EET is now out of the base of the index and was one reason why MPRI fell at the end of 2017 and at the beginning of 2018. Although there are expectations for broadening of the activities subject to EET, the Constitutional Court Decision 26/16 of December 12, 2017 struck down some provisions of the EET law, and thus what was supposed to start in March 2018 (third phase of EET covering transportation, freelancing etc.) and in June 2018 (selected production activities, trade) was now postponed indefinitely. Therefore, I don't expect EET to influence price level this year – or next.

House price growth, another culprit behind 2017 rise of demand inflation, **also appear to be cooling off.** According to CNB data, the quarterly change of prices of new apartments fell to zero at the end of last year, and that of existing ones slowed to 1%. The growth of the new apartments' prices is thus slowest since 2Q14, that of existing apartments' prices slowest since 2Q15. Since, as indicated above, the prices of new apartments are now important component (approx. 30%) in the calculation of imputed rents and since imputed rents are important component of CPI consumer basket (10% of consumer basket as of January 2018), the loss of dynamics, if it continues into 1H18, **will have a tangible negative effect on Czech core inflation.**

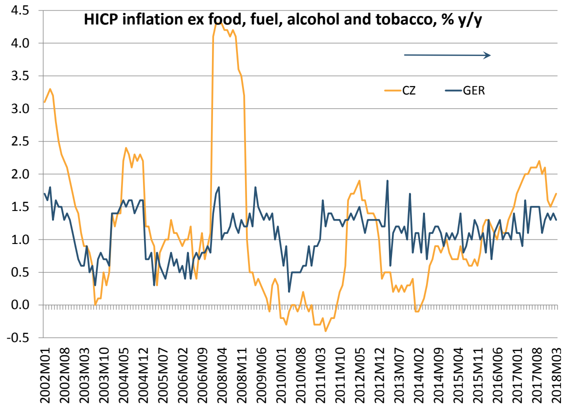


SOURCE: CNB (ARAD)

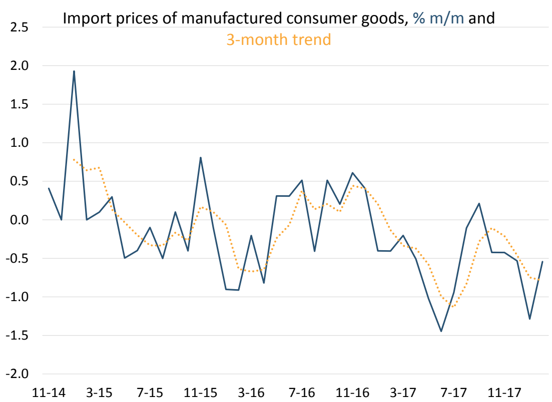
Third, there is still low inflation in Eurozone. And since Eurozone inflation has historically been the most potent determinant of the inflation in the small & open Czech economy, this is important information in the Czech inflation riddle. See, very seldom did it happen in last 15+ years that Czech core inflation[2] would deviate long-term and to the upside from that of Eurozone, and especially of Germany. With German inflation being kept down due to combination of factors likely to persist in next 12 months (loose labor market in Eurozone, sharp decline of structural unemployment to under 4% after the crises of both 2008-9 and 2010-12 etc.), I expect German core inflation to remain between 1 and 1.5% in next 12 months.

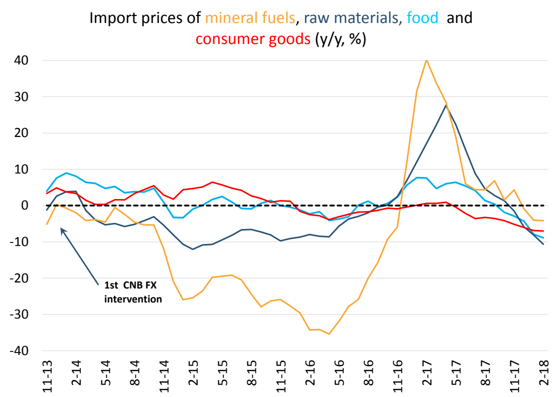


[2] Defined in the pictures below as harmonized index of consumer prices, or HICP, less food, fuel, alcohol and tobacco; HICP index used to enable cross-country comparisons by making inflation comparable across different jurisdictions.

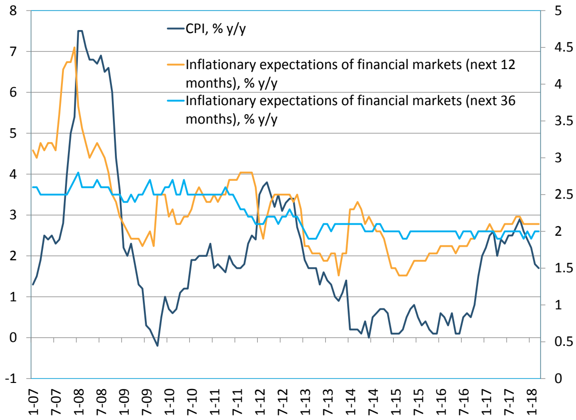


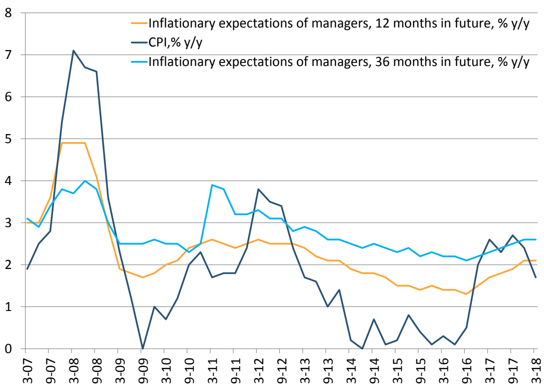
This will thus exert downward pressure on Czech core inflation even without CZK strengthening any further. Even though I think the import prices are done falling (having fallen in almost all months since January 2017), they will continue to be a drag on annual inflation throughout this year and will not return to annual growth before 2Q19. Of course, massive weakening of the CZK would lift inflation and - although long overdue - I am unable to say whether it will indeed happen in next twelve months. And thus unwilling to bet on it in my inflation thinking.





Fourth, Czech inflation expectations have been stable, especially on the longer horizons, making expectations-driven increase of inflation in the coming 6 quarters unlikely.





SOURCE: CNB (ARAD)

Finally, the business cycle also speaks in favor of cooling off of domestic inflation pressures. With expansion in Eurozone well into its 6th year, the probability that meaningful slowdown comes in the next two years is high and increasing. The recent slowdown in leading indicators from Germany (IFO) and Eurozone as a whole (PMI) supports my conviction that the growth momentum has already peaked. With that comes less of a pressure on excessive wage growth and thus on truly demand inflation.

This means that the core inflation will not grow this year and, if house prices moderate further, may decline further. **Czech monetary-policy relevant inflation will thus stay under or at most at 2% this year** and, if economy indeed slows as I expect, in 2019 as well. And, crucially, it will be so without stronger CZK or higher CNB rates. Should CZK strengthen– and it will require something else than the expectation that Czech rates will soar because nobody of the sane mind can now expect that – it would depress the inflation even lower.

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