CNB leaves rates unchanged; oil price shock requires cool heads

Czech policymakers leave the base rate unchanged at 3.5%, which we see as the right response to the oil price shock and heightened uncertainty. Higher oil and natural gas prices will certainly push consumer inflation higher, and this will put downward pressure on economic performance. 'Wait and see' is the right approach

Aleš Michl, Governor of the Czech National Bank

Source: CNB

Czech economy at the right starting point

The current turmoil in the Middle East is sending shock waves through the markets, with energy prices being the most visible consequence. However, other factors will also resonate, including increased uncertainty, weakening confidence, and supply chain disruptions. When you get this broad global shock, the essential ingredient for resilience is each country's original fitness level. And the Czech economy is in pretty good shape, with solid growth, a favourable structure, subdued inflation, and sound fiscal policies.

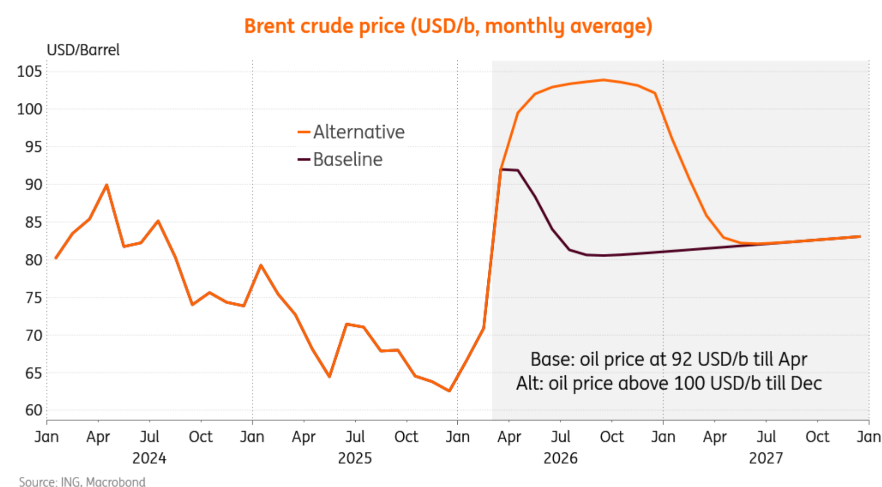
Elevated oil and natural gas prices will affect all price domains, even in Czechia, but entering the shock with headline inflation at 1.4% annually, there is quite some leeway to wait and see how it

plays out. The thing is, right now, no one really knows whether the turmoil will last a couple of weeks or drag on for months. And the trick is that negative external supply shock, be it in energy or fertilisers, has two almost simultaneous effects: increasing prices across sectors, including higher consumer inflation, and downward pressure on economic activity through tighter budgets, deteriorating confidence, hitting breaks in investment plans, and so on.

Feedback loops are hard to quantify

The tricky issue is once again linked to feedback loops that exacerbate the overall impact and often operate in a non-linear way. There are thresholds, and there is discontinuity in responses to the various impulses. Should the oil price remain, say around 100 USD/b, for two months, there would clearly be repercussions for inflation; however, only limited downward effects on growth. However, should oil prices increase further and remain elevated until year-end, the impact on global economic activity would be rather pronounced.

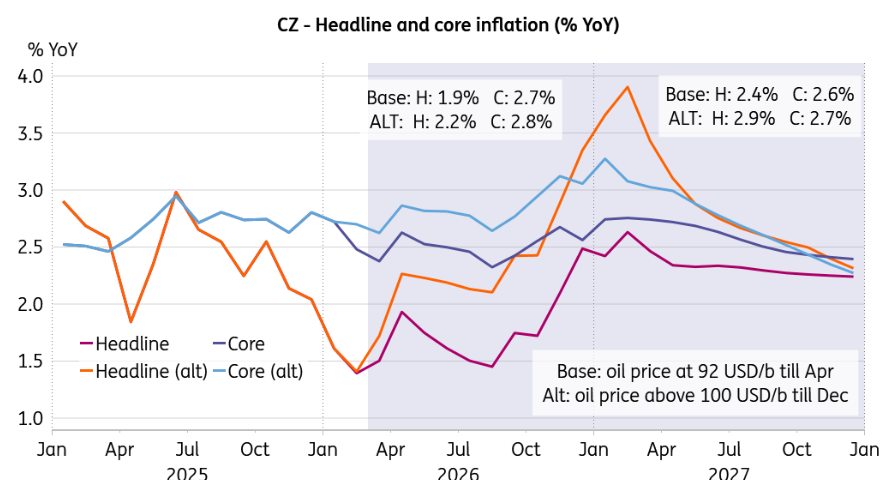
The duration of the conflict is critical to economic activity distortion



To a certain extent, inflation is about the change itself, and the increase in energy prices will be almost fully incorporated into consumer prices within a couple of months. In contrast, economic activity is more about the level of energy prices and their share of the overall budget. And here, the length of the conflict matters more. With budgets strained by higher energy bills for longer, the global economy will suffer.

Given the reasonable IMF estimate of 10% higher oil price for a year implies up to 0.2ppt weaker global expansion, and having 2025 Brent crude average at USD 69/b, the assumption of oil averaging USD 100/b or 45% increase indicates almost 1ppt weaker global growth for this year. That's quite something.

Non-linearities will drive uncertainty for monetary institutions



Source: CNB, ING, Macrobond

My experience is that global models connected mostly via trade channels usually underestimate large-scale shocks. And I would expect the impact to be a bit more severe. In any case, seeing this potentially coming, the right response for the CNB is to hold rates steady for as long as it can, before we get more clarity on the impact on global economic activity, which only gets more severe with every additional week of the Middle Eastern conflict. Potentially, should things go wrong, the CNB could even face not a world of stagflation but a world of recession with inflation.

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