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CZECH REPUBLIC

Different scenarios for the Czech economy due to the Middle East conflict

With the escalation of the Middle Eastern turmoil, Czech inflation is set to crawl up, and economic growth will soften. An alternative scenario sketches the option of a rate hike. This, however, is at the cost of slower economic expansion and the potential for a monetary policy mistake, with no easy solution at hand

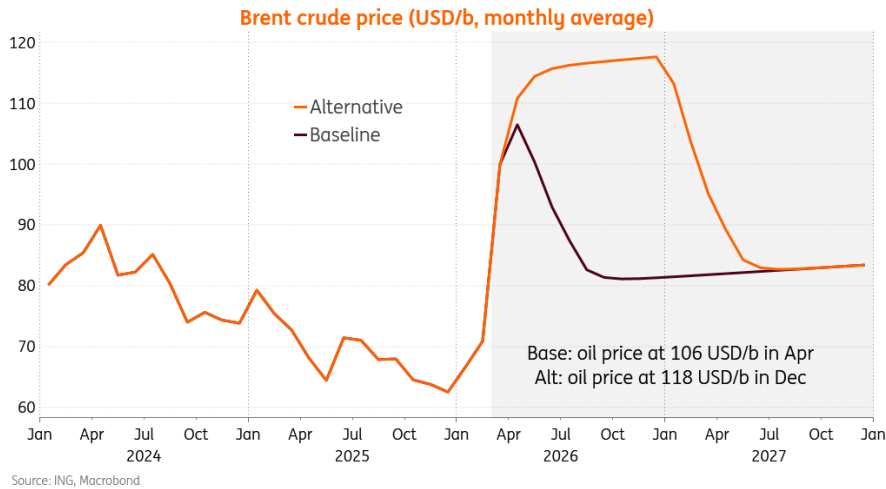


Inflation is set to go up and economic growth down due to the ongoing conflict in the Middle East

Inflation set to cross the 3% threshold in any case

With the Middle Eastern conflict soon entering its second month, and piling repercussions for supply chains, confidence, and global growth outlook, we start to enter the territory when quantitative adjustments start to imply a change in quality.

Quo vadis oil price?

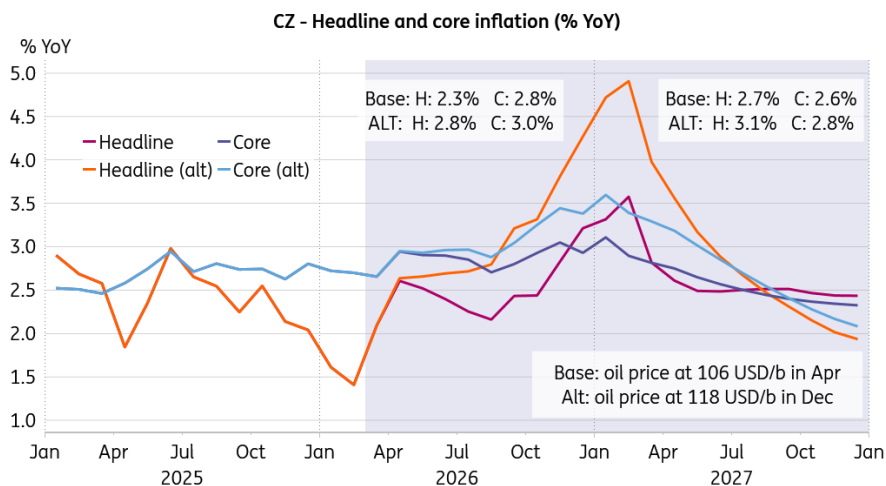


Source: ING, Macrobond

Our baseline scenario assumes Brent crude averaging US\$106/bbl in April and then gradually receding to US\$80/bbl in September, while our alternative scenario builds on a protracted conflict outlook, with Brent crude price crawling to US\$118/bbl in December.

Under a new assumption of Brent crude price averaging US\$106/bbl in April and then gradually receding, Czech headline inflation would average 2.3% this year and 2.7% next year. Core inflation is expected to average 2.8% this year and 2.6% next year. Meanwhile, GDP is revised downwards to 2.2% this year.

Two different worlds for inflation



Source: CNB, ING, Macrobond

In the alternative scenario with Brent crude average crawling up to US\$118/bbl in December,

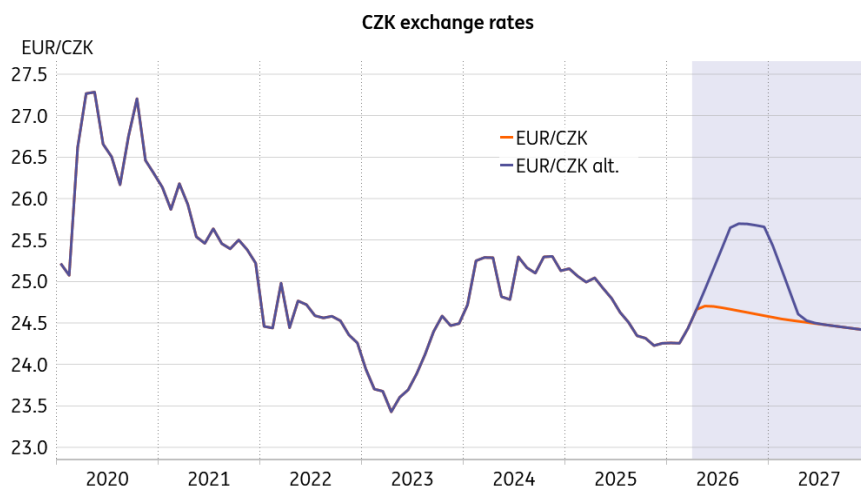
headline inflation would average 2.8% this year and 3.1% next year. Core inflation is expected to average 3.0% this year and 2.8% next year. In such dismal conditions for energy prices, supply chains, and global growth, Czech economic performance softens to 1.6% this year. That said, a lot goes down to the response of the outer world, the intensity and timing of negative feedback loops, etc., with quite some potential for even more subdued economic activity.

ECB moves are not binding for the CNB

A negative external supply shock, including an oil price shock, has two clear responses: i) higher inflation and ii) lower economic performance. The right response of a monetary institution is not to react – if conditions allow – to see the proportions of the two effects. And yes, the initial conditions matter for how each economy can withstand the shock. Czechia enters the shock with inflation at 1.4% and growth at 2.6%, the eurozone with inflation at 1.9%, and growth at 1.2%, Germany with inflation at 1.9%, and growth at 0.4%.

We were inspired by our clients asking about how the Czech National Bank would react should the European Central Bank proceed with two hikes before the end of the year. Should the ECB react to the initial upward price effect and refrain from waiting for the downward growth effect, the CNB does not have to follow suit. Sure, the ECB's interest rates are an important factor for the Czech exchange rate, imported inflation, and monetary policy setup. However, we have seen before that the CNB does not follow the ECB when it's not appropriate.

Koruna can withstand the shock with honour



Source: ING, Macrobond

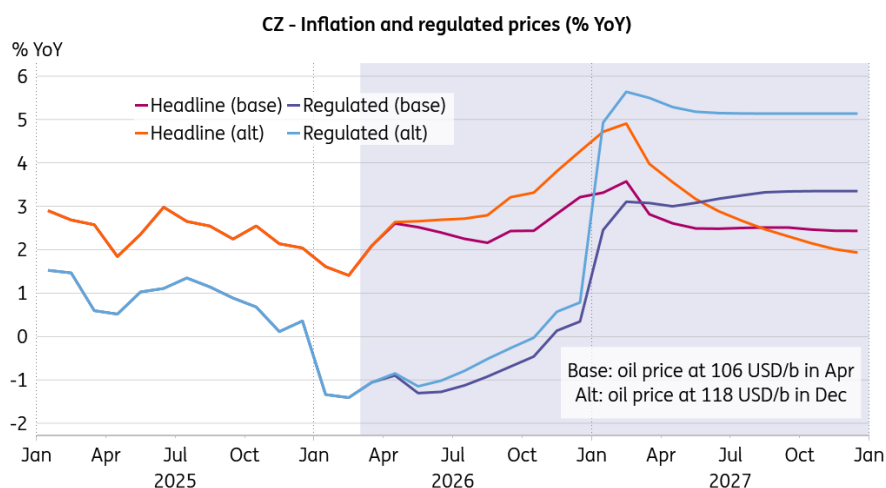
Should the ECB proceed with two hikes, the CNB vis-à-vis the ECB interest rate differential would remain positive in both nominal and real terms, so we are not too worried about the koruna. Even in the severe scenario, the koruna would be some 4% weaker as compared to the baseline, which is not a big deal given the size and duration of the adverse supply shock.

Moreover, the likelihood of a monetary policy mistake would increase for the ECB, especially should we see some eurozone economies, such as Germany's, flipping into contraction once again. Summa summarum, in this situation and setup, the ECB's moves are far from binding for the CNB.

Maintaining discipline will be hard

Any monetary institution knows the basics, so let's see about their discipline. In our base case scenario, we think the CNB will likely do the right thing and hold policy rates unchanged, waiting out the severity of the implications for economic activity. However, in the alternative scenario, when headline inflation would crawl up close to 5% and core inflation would hover around 3.5% at the beginning of the next year, the desire to challenge inflation at the cost of low economic growth could take the upper hand. After all, the CNB is a single mandate institution.

Regulated prices will make the difference in 2027



Source: CNB, ING, Macrobond

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