

# **Inflation and Energy Crisis in Czech Republic: Temporal or Long-Term Phenomenon?**

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## **Introduction**

The situation in Europe due to the conflict in Ukraine is reflected in the economic situation in the Czech Republic (CR). After the stage of social changes following 1989, monetary and banking crisis (1997-1998) and after the period of economic turbulence (2008–2009), the economy was gradually stabilized. Only a Covid-19 pandemic has weakened the domestic economy, which was reflected in the decline in the dynamics of GDP growth and the growth of the state budget deficit. This trend continued with the conflict in Ukraine, which disrupted the supply of raw materials and energy and was reflected in a price increase. Now the economy is experiencing a period of double-digit inflation and the energy crisis persists by limiting the supply of gas and oil from the Russia. The lack of alternative sources caused temporary reduction in the availability of energy sources and caused an increase in their prices from new suppliers. Despite these negative aspects, the country's indebtedness remained low, although the dynamics of debt increased. The remedy is difficult due to the impact of the conflict-related sanctions, inflation, and energy prices.

The inflation rate in the European Union (EU) in January 2023 continued to decline from the previous two months and decreased to 10%. In contrast, in the CR inflation after December decline accelerated again. With the value of 19.1% (Eurostat data) was the third highest in the whole EU-27 countries. Only Hungary (26.2%) and Latvia (21.4%) had a higher level of inflation. Compared to December 2022, year-on-year (y-o-y) inflation decreased in 18 EU members.

## **Inflation and Energy Crisis in Czech Republic: Causes and Analysis**

As in 1990s, when the Czech economy experienced a period of high inflation, the current situation is not optimal. High inflation is accompanied by a rapid pace of state debt. Nevertheless, the CR is one of the least indebted countries in the EU. In 2021, however, the Czech debt increased from 37.7% (2020) to 41.9% of GDP and the rate of debt increase was the worst in the whole EU. In IIIQ 2021 state debt exceeded 2.43 trillion CZK (40.4% of GDP). A year later (IIIQ 2022) debt exceeded 2.98 trillion CZK (43.8%). Since 1993, the lowest state debt has been between 1996 and 1998 (9% of GDP). In the period 1999-2013, the debt increased steadily, from 10% to 41% of GDP. State debt has begun to decline since 2014, when it was 38% of GDP, and decreased until 2019, when it reached 29% of GDP. In 2020, the debt was 36% due to the cost of pandemic and increased to 40% of GDP in 2021. The macroeconomic weaknesses of the CR now are:

- (1) High inflation;
- (2) High prices of fuels and energy;
- (3) Growing state budget deficit);
- (4) Negative foreign trade balance.

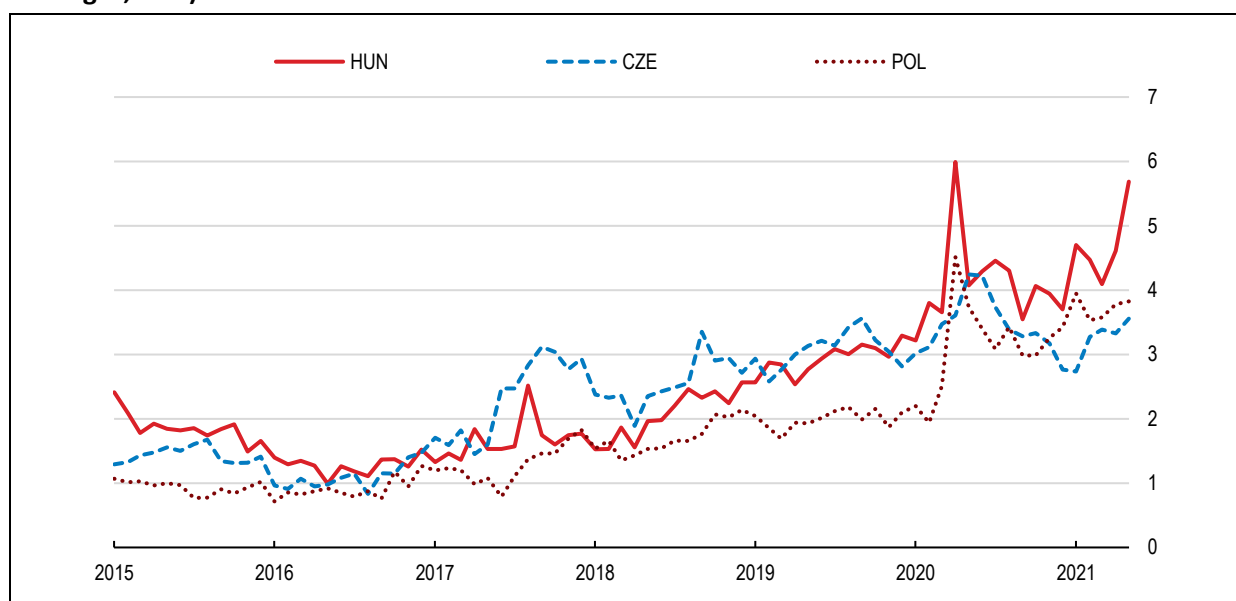
In the pre-pandemic period, there should have been stricter monetary and budget policy. The pandemic period was marked by a generous subsidies. The new government abolished electronic sales records (EET) to ease the situation to entrepreneurs, but deprived of part of the tax revenue. Opponents critically look at the abolition of the “super-gross” wage and outflow of money through companies registered in tax havens.

The current high inflation rate is caused by various factors: growing global demand for products (e.g., microchips); increasing household demand; energy crisis - problems with Russian oil and gas supply, and conflict in Ukraine. After a period of forced savings people began to buy again. Due to the limitation of production during the pandemic and for delay in transport, lack of workers and key inputs (due to lack of chips, car production was interrupted) the goods supply was partly limited. Inflation is also driven by the rise in energy prices - electricity, natural gas, and oil, which is reflected in the prices of other goods and services.

Partial compensatory measures for Czech investors were the purchase of government bonds in recent years. The issue of six-year bonds “Dluhopisy republiky” (DRs) was a new attractive product. The 13th issue of DRs, issued in January 2022, has recorded purchases of 41bn CZK. This kind of bonds could buy only citizens.

Consumer prices increased y-o-y by 15.8 %, which was 0.4 p.p. less than in November 2022. The data is again influenced by the imposed energy price limits. The measure reduces the inflation value by about two percentage points. For 2022, the average inflation was 15.1% and is the highest since 1993. While in the period 2009-2021 the price level increased by 27.9%, only in 2022 the average inflation rate was 15.1%. Prices of goods in 2022 increased in total by 16.8% and the prices of services by 12.3%. If one compares the situation in 2015-2021 (Figure 1) with the present situation (Figure 2), the dynamics of inflation growth is visible.

**Figure 1: Inflation development before conflict in Ukraine - the CR, Hungary and Poland (y-o-y changes, in %)**

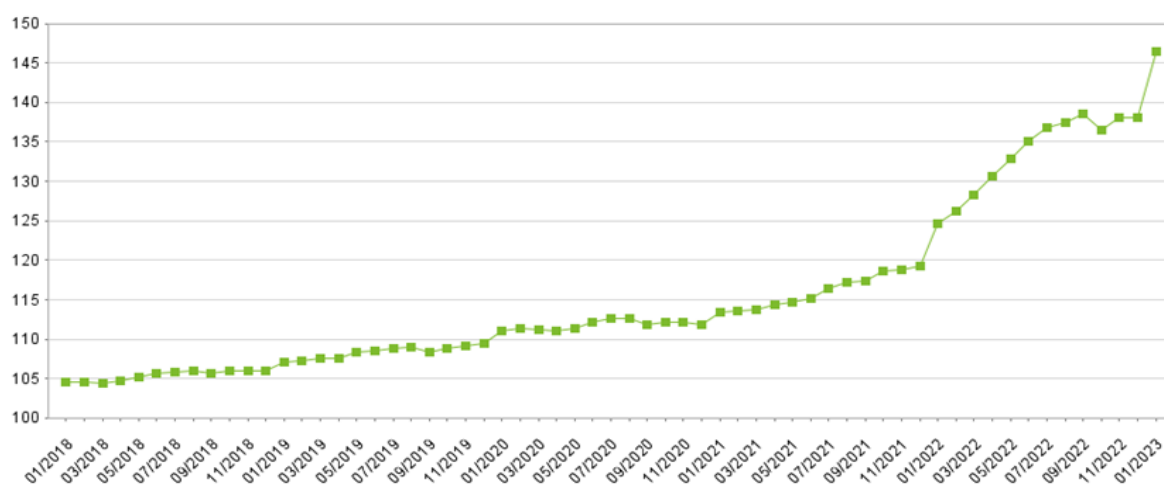


Source: OECD data, 2022

Consumer prices in the CR increased by 15.8% y-o-y in December 2022. This was 0.4 p.p. less than in November. This deceleration of y-o-y price growth was mainly affected by alleviating the rise in car prices and a decrease in fuel and oil prices to 4.4% in December of 14.5% in November. Food prices and the cost of housing had the greatest influence on the y-o-y growth of price levels in December 2022. The higher price of natural gas (+140.2%) is significantly reflected in the cost of housing. While inflation in the last months of 2022 was moderated by the state administrative interventions, in January 2023 they were terminated. The end of the economical household tariff led to an increase in prices. The main impact on inflation level had price growth of energy, heat, food, water, and sewage. The Czech National Bank (CNB) should respond more to price development by growing interest rates earlier, which is not doing now. Although the CNB seeks to avoid permanent wage growth, there is a risk of permanent price growth. To suppress rapid price increases can be expensive in the future and may lead to recession and unemployment.

In the next period, the rate of price growth should be slowed and in the second half of 2023 it should fall below ten percent. Consumer prices increased y-o-y by 17.5% (Eurostat = 19.1%) in January 2023, while in December 2022 it was 15.8%. Inflation growth continues to be supported primarily by energy and food prices as well as the amendments to the price lists early 2023. The price of electricity changed - from a 21.2% decline in December 2022 it jumped by 36.4%. On the other hand, natural gas prices alleviated their growth to 87% (140.2% in December). The acceleration of inflation was also influenced by more expensive foods.

**Figure 2: Consumer price indices in the CR (ECOICOP classification, basic index) (average 2015=100)**



An amount of CZK 100 bn CZK is set aside for 2023 for compensations. For companies in energy-intensive sectors, the aid so far has reached 2.9 bn CZK.

The current period represents one of the two periods, when the economy has evidenced a y-o-y decrease in monetary stock. However, the decrease in the currency supply M1 (liquid money) is not yet reflected in the decline in inflation. According to P. Kohout, four factors are possible reasons:

- Considerable growth in energy prices;
- Monetary policy works with delay;
- The influence of deficient state budgets manifests;
- The importance of foreign currencies in the economy increases.

The CNB also changes the strategy of its policy. It has decided to leave interest rates and thus help the corporate sector. According to the CNB, it is necessary to reach the balanced budget despite the relatively difficult economic situation. The strong Czech crown (CZK) currently helps the economy to alleviate inflationary development. For some businesses, however, trading in Eurocurrency is more advantageous.

The state allocates considerable resources (4% of GDP) to assist households and companies due to rising energy prices. The deepening deficit of the state budget (-360.4 bn CZK in 2022) is the result of pandemic and energy crises. Table 1 shows the situation regarding the state budget deficit.

**Table 1: Development of the deficit of the state budget of the CR (in bn of CZK)**

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 (proposal)
Revenues	1133.8	1234.5	1281.6	1273.6	1403.9	1523.2	1475.5	1487.2	1624.4	1928.0
Expenditures	1211.6	1297.3	1219.8	1279.8	1401.0	1551.7	1842.9	1906.9	1984.8	2223.0
Balance	-77.8	-62.8	61.8	-6.2	2.9	-28.5	-367.4	-419.7	-360.4	-295.0

Source: Ministry of Finance CR

The efforts of the government to improve the situation regarding the increasing state budget deficit are still at the stage of considering what measures to adopt so that the public finance system is sustainable for a long time. The National Government Advisory Body (NERV) submitted a set of measures saving public expenditure. On the income side, it is, e.g., an increase in personal income tax and real estate taxes. The expenditure side includes, e.g., shortening the period of receiving parental allowance, reducing unemployment benefits, reducing fare discounts, reducing subsidies in agriculture or canceling state support for building savings. If the government manages to enforce the change in valorization of pensions for 2.4 mil. old-age pensioners, then the state will save about 20 bn CZK. However, opposition parties are against this change.

The CR is the only EU country that has increased state debt in IIIQ 2022 (45.2% of GDP). In that period, the whole EU debt decreased to 85.1% of GDP and fell to 93% of GDP in the euro area. Household debt increased by 6.1% y-o-y and reached CZK 3.15 bn.

Table 2 presents the situation in foreign trade. High trade deficit in 2022 is evident, which is a bad sign for small highly export-oriented economy.

**Table 2: Foreign Trade in goods (in mn of CZK, current prices)**

Year	Turnover goods	Export goods	Import goods	Balance goods
2014	6152387	3149198	3003189	146009
2015	6394966	3262971	3131994	130977
2016	6434558	3299106	3135452	163654
2017	6862328	3512897	3349431	163466
2018	7134014	3616240	3517774	98466
2019	7237832	3691763	3546068	145695
2020	6786220	3483076	3303145	179931
2021	7907205	3949118	3958087	-8970
2022	9145951	4473906	4672045	-198139

Source: Czech Statistical Office, 2023

### Future Expectations and Implication

What can be expected in the medium-term is difficult to predict regarding the uncertain situation in Ukraine. In the coming months the situation in the energy sector will be stabilized, although at a higher price level of supplies. However, global demand for raw materials/energies cannot only cause further increase in their prices, but also cut-offs as companies face increasing production and transport costs. But a possible global recession can lead to a decline in prices.

Compared to the current price list, E.ON, an energy company, reduces the price of gas for permanent customers by 13% and the price of electricity by 18%. For most permanent clients (one million households) the new lower prices will be valid from mid-February 2023.

The CNB expects a reduction in inflation since spring 2023. Inflation in January 2023 increased to 17.5% (Eurostat data = 19.1%), when the effect of an economical tariff subsided, and the January repricing of traders was reflected. From February 2023, inflation should slow down and return to the inflation target in 2024. Macroeconomic forecasts show that higher inflation will be manifested in the economy longer than expected. The CNB in its forecast has deteriorated the view of this year's average inflation from 9.1% to 10.8%. Therefore, there has been a tendency for companies to realize business in Eurocurrency. This reduces the risk of a rapidly changing exchange rate. The willingness of companies to obtain loans in crowns has declined (-102 bn CZK in 2022) and increased interest in taking loans in the Eurocurrency (+150 bn CZK).

The CNB expects a significant reduction in inflation since spring 2023. The CNB's basic scenario is that in 2024 the economy should have inflation at 2%. The CNB's concern is that the policy of the government could still speed up the inflation. The CNB wants to solve the problem with inflation in the next two years. There are not many loans provided and the mortgage market has also stopped, which is important for control of inflation. According to the two former CNB governors, the central bank has recently been to continue the trend of gradual increase in interest rates. Maintaining the current level represents the risk of continuing the high level of inflation.

According to the CNB, 2023 inflation will still be about 20%. From February 2023, inflation should slow down and return to the inflation target in 2024. Food prices will probably rise even further in February. The possible continuation of financial assistance provided to the population may only accelerate inflation. According to a PwC survey 53% of Czech companies, the average annual

inflation rate will be double-digit in 2023. The government admits an increase in real estate tax because it refuses to increase direct taxes.

Therefore, in the budget for 2023, the government is looking for new revenue and savings to get state expenses under control. The aim is to reduce the planned deficit of 295 bn CZK by about 70 bn CZK. The government plans to develop its own reform package whose specific measures are being prepared at the coalition level. The package aims to reduce the structural deficit by at least one percent. In 2024, according to the MF CR, the state budget deficit should get below three percent of GDP.

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