Polish Economic Institute

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CEE POLICIES AGAINST THE SLOWDOWN

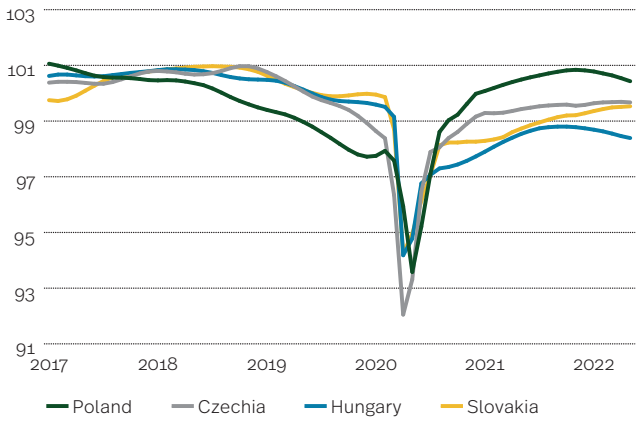
→ Activity in the CEE economies is starting to slow down, even though inflation is still rising. Managing an effective policy mix is very demanding task in these conditions. We therefore expect to see diverse approaches to stimulating the economy and combating inflation. In this issue of the CEE Monthly Monitor, we describe recent policy developments in Hungary, Poland, and Czechia.

→ Hungary has capped prices for basic goods, such as food, energy and fuel. Its expansive fiscal policy is leading to a larger fiscal deficit. The government is currently planning to offset additional spending with a windfall tax. The largest share of the tax burden will fall on the banking and energy sector. The taxes will also affect retail companies and airlines. The government plans to collect HUF 800 billion (1.3% of GDP) in 2022 and 2023. The tax could backfire, with an increase in inflation and weak investments. We describe the Hungarian proposition in the section *The windfall tax in Hungary*.

→ Polish data shows a strong increase in SMEs' profit margins. The companies have been blamed for exacerbating inflation. However, general operating surpluses and mixed incomes in the economy have not increased significantly since 2021. We analysed the factors that accounted for the higher profit margins. The situation should become less pronounced in the coming quarters due to the weaker economic activity. The heightened inflation is therefore unlikely to spiral due to companies' growing margins. We present a detailed outlook in the section *The myth of the price-margin spiral*.

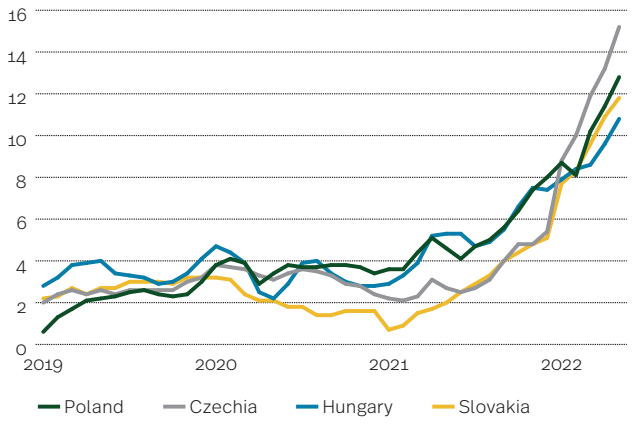
→ The Czech monetary authorities suggest that the tightening cycle is nearing its end. The Czech National Bank (CNB) raised interest rates by 125 basis points in June, to 7%. This decision is likely to conclude the tightening cycle, given the change in bank governor and board members. The new members are much more dovish than the outgoing ones. The change in composition suggests that the CNB will start rate cuts relatively soon – the recent consensus points to a first decision in mid-2023. For a detailed outlook, see the section *The revolution on the CNB board*.

OECD common leading indicators for the CEE economies



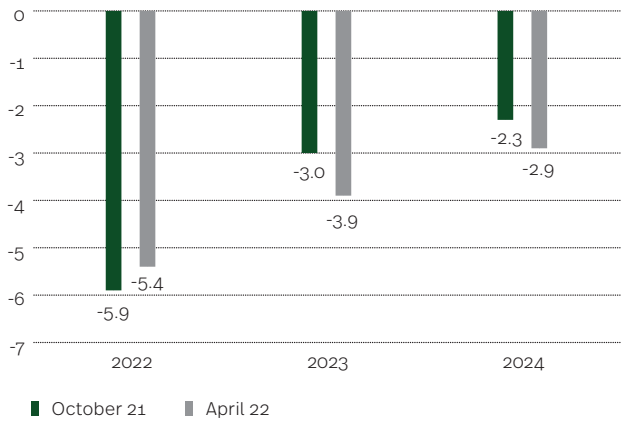
Source: OECD.

Inflation in the CEE countries (%)



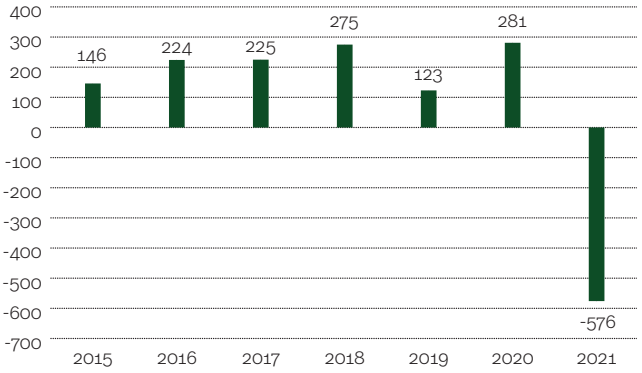
Source: Eurostat.

General government net lending in Hungary (% of GDP)



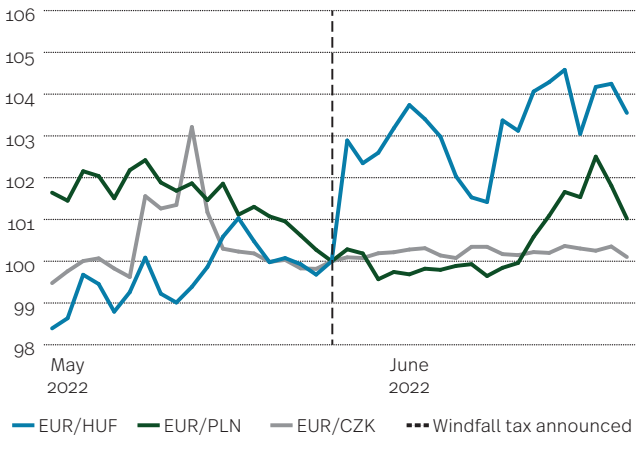
Source: IMF WEO.

WizzAir's net profits (millions of EUR)



Source: Wizz Air.

FX rates in CEE (25 May = 100)



Source: Macrobond.

The recent crisis is taking a toll on the Hungarian budget. The IMF expects a larger deficit to continue in both 2023 and 2024. The higher deficit partly results from policies enacted to shield consumer from inflation – mainly a price cap on food, energy, fuel and mortgages.

Hungary is planning to offset additional spending with a windfall tax. This is a tax on the extra profits of companies that benefit excessively from the economic situation. The government expects to collect around HUF 800 billion (EUR 2 billion, up to 1.3% of GDP) per year in taxes in 2022 and 2023.

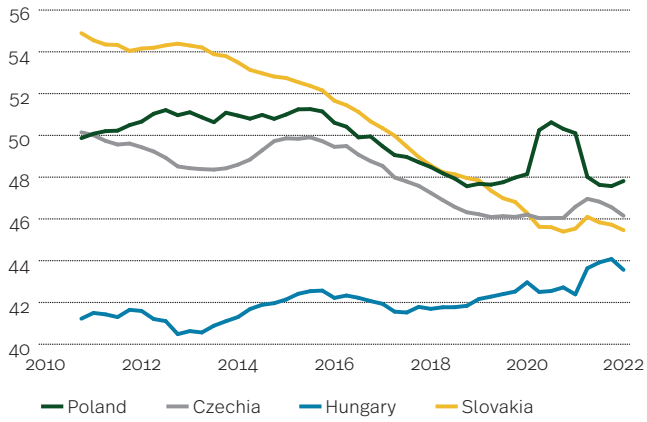
The largest share of the tax burden will fall on the banking (HUF 300 billion) and energy sectors (HUF 300 billion). The remaining HUF 200 billion will be collected from retail companies and airlines. The money will be allocated to special funds for consumer-shielding policies.

The profits' excessive nature is debatable. Many airlines and retail companies have faced a signifficant economic downturn during the COVID-19 recession. The current surpluses serve to partially make up for past losses.

Some of the tax is likely to be passed on to consumers. Budget airlines have already annouced an additonal fee making up for tax losses. Hungarian media outlets indicate that a similar move has been made by commercial banks. **The windfall tax in Hungary is likely to increase tensions between the businesses affected and the government.** Windfall taxes are supossed to be one-offs, yet some of them could remain in place for longer. The immediate market reaction was a swift depreciation of the Hungarian Forint.

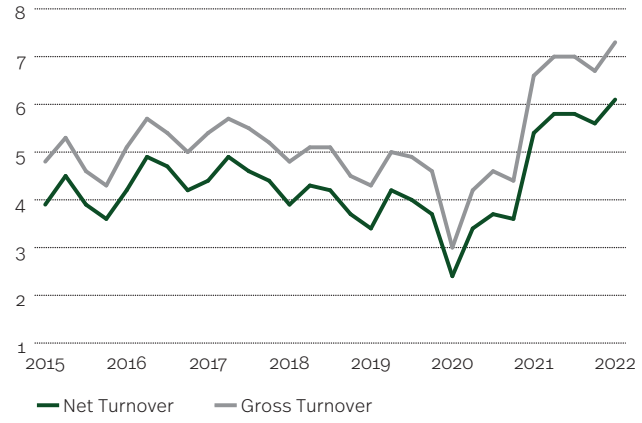
The windfall tax might decrease investment. The energy sector accounts for almost 40% of the tax set to be collected. This branch of the economy will need to increase green investment heavily. Taxing companies' profits will naturally affect their capability to invest – this might be further reinforced by introducing additional uncertainty about future tax rates (see Bloom, Bond and van Reenen, 2007). However, EU policies strongly incentivise green investments. Hence **the tax's overall impact on investment decisions is unknown.**

Gross operating surplus as a share of GDP (%)



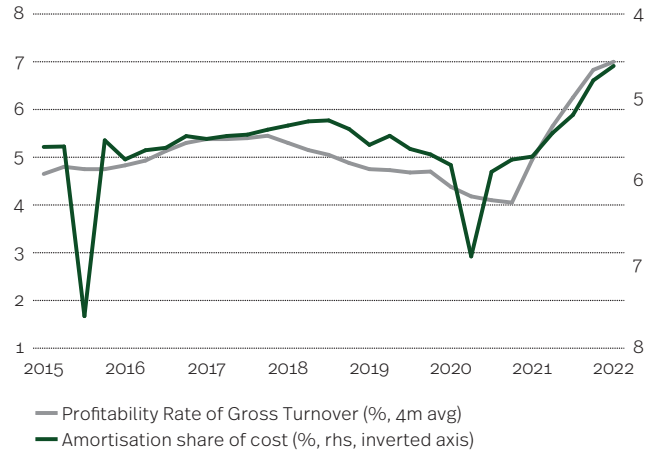
Source: OECD.

Poland: Profitability rates in the enterprise sector (firms with 50+ employees)



Source: GUS.

Lower amortisation-related costs increase margins



Source: GUS.

Operating surpluses and mixed incomes in the CEE economies did not increase significantly in 2021 and have deteriorated since the start of the war in the Ukraine. The phenomenon suggests that the increase in profit margins should decrease along with weaker economic activity. **The high inflation is therefore unlikely to spiral due to companies' rising margins.** Weak operating surpluses also limit the efficiency of windfall taxes.

The gross operating surplus describes the proportion of income in national accounts derived from capital. It is equal to economic value added, minus employees' compensation (salaries and non-monetary benefits). It includes not only corporate profits, but also costs related to capital depreciation. Subtracting fixed capital consumed leads to a derivation of net operating surplus, a better measure of actual capital income. However, these statistics are not available in all the CEE countries.

The share of both the net and gross operating surplus in the economy have been declining since 2016 in every Visegrad country except Hungary (Figure 1). This is an aftermath of the rapid wage growth. The COVID-19 pandemic temporarily increased the distribution of income towards enterprises in Poland in 2020. However, this effect vanished the following year as the support schemes ended. However, operating surpluses increased in Czechia, Slovakia, and Hungary in H2 2021. We expect slowing activity to reduce companies' profitability.

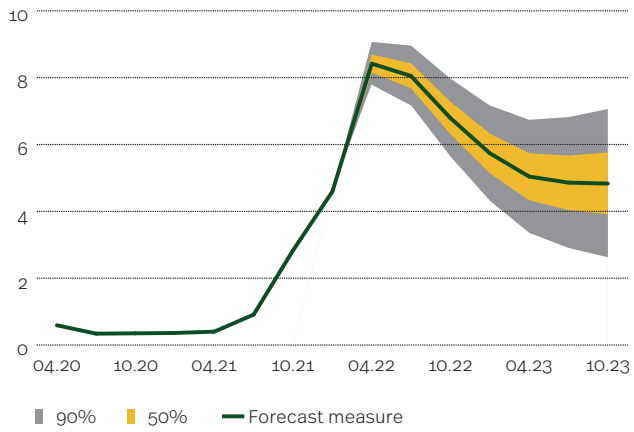
Nevertheless, companies' profit margins became a topic in the Polish public debate due to the rapid growth in SMEs'. **The increase in companies' revenue margins has been bolstered by two accounting issues.** Firstly, the value of financial losses in 2020 was the highest ever. The Polish taxation system allows losses to be deducted. This decreases the corporate income tax and improves financial results. As a result, we see a widening of the spread between the net turnover margin (after tax) and the more frequently-cited gross turnover margin (Figure 2). It currently amounts 1.3 point, twice its standard value.

The higher profit margins are also linked to the lower fixed investments during the COVID-19 crisis. The limited spending has also had an impact on the amortisation. Typically, these kinds of expenses amount 5.5-6% of total costs, but they have collapsed to 4.5%. The situation should stabilise in the coming quarters, as investment recovered in 2021.

Finally, companies' pricing power should deteriorate due to the slowdown in economic activity. The continuation of the price-margin spiral is therefore a myth, without a solid basis.

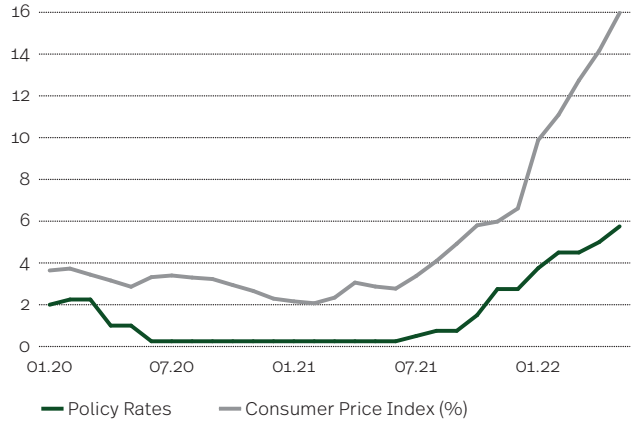
THE REVOLUTION ON THE CNB BOARD

CNB projection: 3M PRIBOR (%)



Source: CNB.

Interest rates and inflation in Czechia



Source: Macrobond.

CNB Hawkometer

Eva Zamrazilová	Dovish	Incoming
Jan Frait	Dovish	Incoming
Karina Kubelková	Neutral	Incoming
Oldřich Dědek	Dovish	
Aleš Michl	Dovish	
Tomáš Nidetzký	Neutral	Outgoing
Jiří Rusnok	Hawkish	Outgoing
Vojtěch Benda	Hawkish	Outgoing
Marek Mora	Hawkish	
Tomáš Holub	Hawkish	

Source: CNB.

The Czech National Bank (CNB) board raised interest rates by 125 basis points in June, slightly surprising the markets. The two-week repo rate is 7%, the highest in the region. **This decision is likely to conclude the tightening cycle,** given the change in bank governor and board members. The new members are much more dovish than the outgoing ones. The board will therefore not raise rates to the level in the latest projection (8.5%). **The CNB is also likely to start rate cuts relatively soon** – the recent consensus suggested that the first decision could be made in mid-2023.

The change in governor should make policy dovish. Outgoing governor Jiří Rusnok had a rather hawkish stance – he started the tightening cycle earlier than the developed market. The choice of successor points to a strong shift in policy. The new governor, Aleš Michl, has served as a member of the CNB board since 2018. He is extremely dovish – he has proposed to stop the cycle of rate hikes. At the May meeting, he was one of two members to vote against the rate hike.

The CNB board will also reach a comprise with its more dovish members. In July, three new members will join the board: Eva Zamrazilová, Jan Frait and Karina Kubelková. They will replace deputy governor Tomáš Nidetzký and Vojtěch Benda. Both outgoing members supported tightening; the latter stressed the importance of a strong koruna and was determined to combat inflation at the cost of a recession. The new members are between the outgoing hawks and the new governor; each has a neutral or moderate dovish stance on restrictive monetary policy.

Jan Frait was a member of the CNB board from 2000 to 2006. During his first term, he was perceived as a dove. Later, though, as a director of the CNB's Financial Stability Department, he opposed zero interest rate policies and supported tightening.

Eva Zamrazilová was also a member of the CNB board in 2008-2014. She opposed a FX floor policy in 2013 and is rather critical of the tightening cycle.

Karina Kubelková has served as a commercial economist at the Chamber of Commerce. She has advised on fiscal policy, rather than monetary policy.

There will be further changes to the CNB board in February 2023. The terms of two members will end: Marek Mora (strongly hawkish) and Oldřich Dědek (strongly dovish). Their successors are still unknowns, yet recent decisions suggest that more moderate doves will be appointed.

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The Polish Economic Institute

The Polish Economic Institute is a public economic think tank dating back to 1928. Its research primarily spans macroeconomics, energy and climate, foreign trade, economic foresight, the digital economy and behavioural economics. The Institute provides reports, analyses and recommendations for key areas of the economy and social life in Poland, taking into account the international situation.

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