Czech Economy and Monetary Policy

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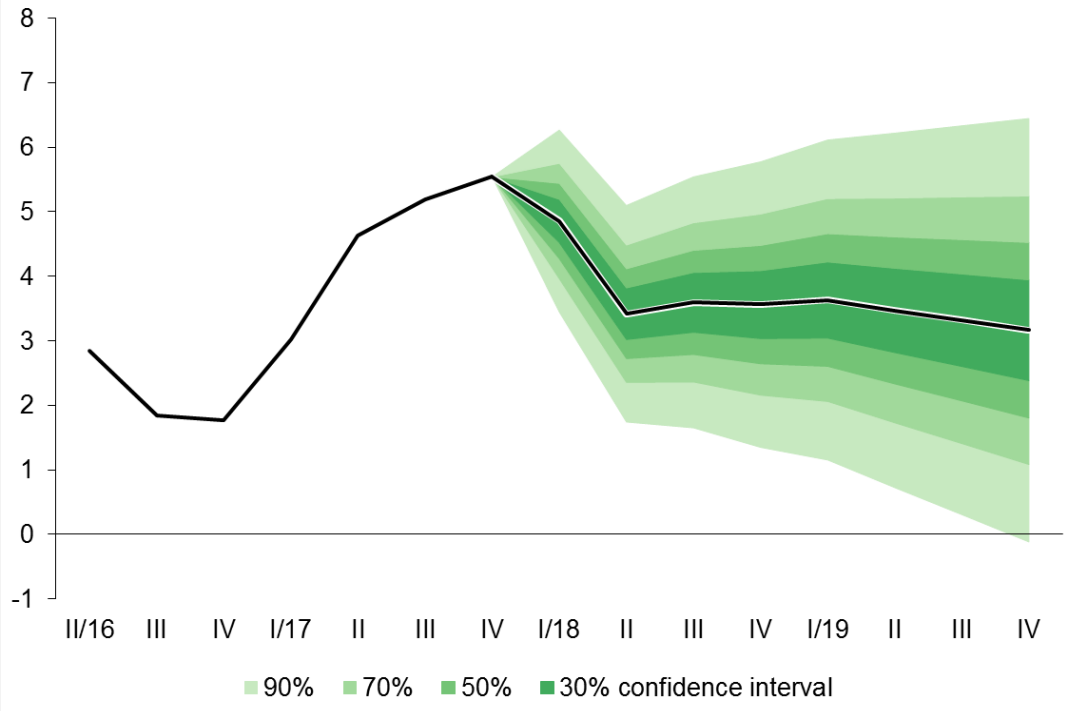
Outline and main messages

- Czech economy: robust growth, tight labour market.
- Inflation: strong domestic pressures, anti-inflationary import prices.
- Monetary policy: strengthening of monetary conditions envisaged – via both channels.
  - What will determine further steps?

Economic growth is robust

GDP growth forecast
(annual percentage changes; seasonally adjusted)



Economic growth will continue to be supported by

- robust consumption of Czech households,
- strong domestic investment activity,
- external demand (but contribution of net exports will be negative in 2018 due to stronger CZK and higher imports).

- Growth of Czech economy will slow compared to last year, but it will still exceed 3%.
- Czech economy will grow in line with its potential growth, output gap will remain slightly positive.

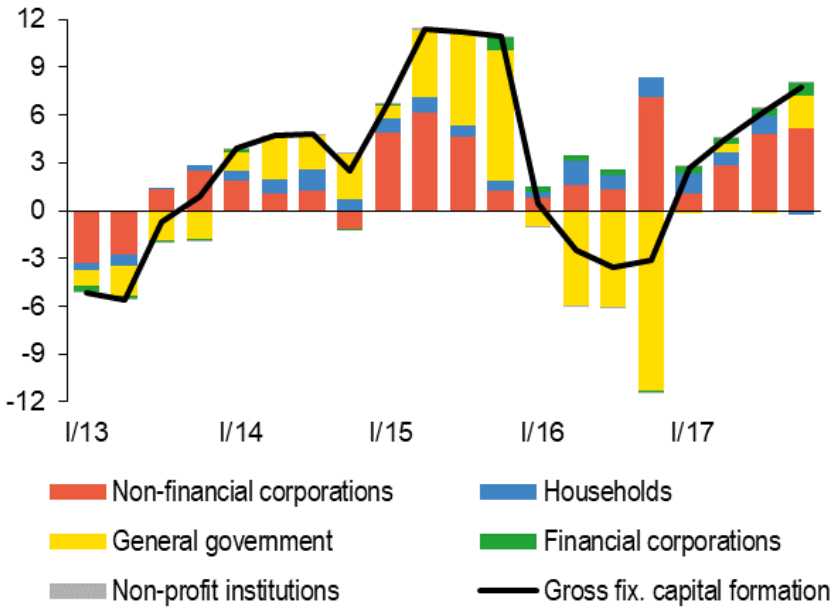
Aggregate demand growth forecast

Annual percentage changes

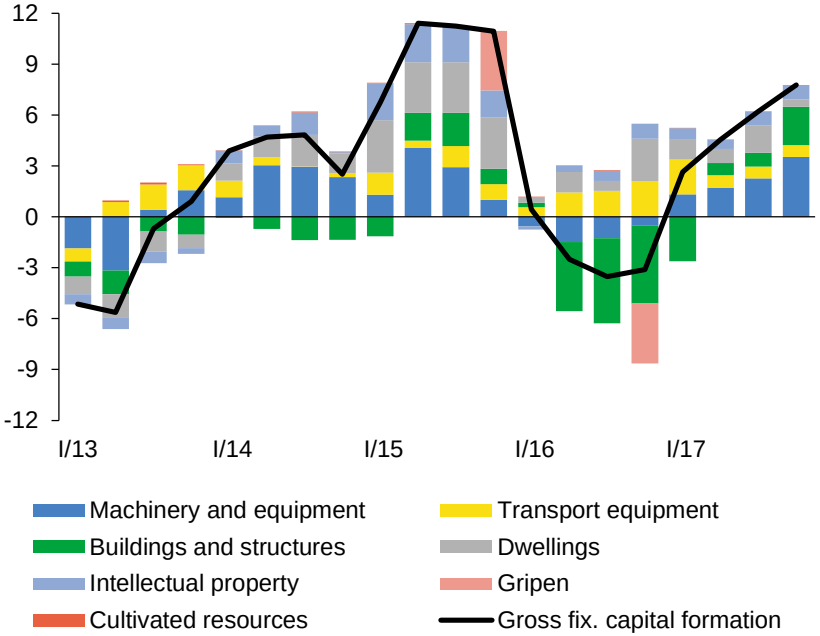
	2017	2018	2019
GDP	**4.6**	**3.9**	**3.4**
Household consumption	4.0	4.1	3.7
Government consumption	1.5	2.8	2.3
Gross capital formation	5.4	8.2	5.1
Gross fixed capital formation	5.9	8.6	7.4
Exports of goods and services	6.9	6.9	8.3
Imports of goods and services	6.2	8.7	9.3

Structure of investment

Investment by sector



Investment by type of capital

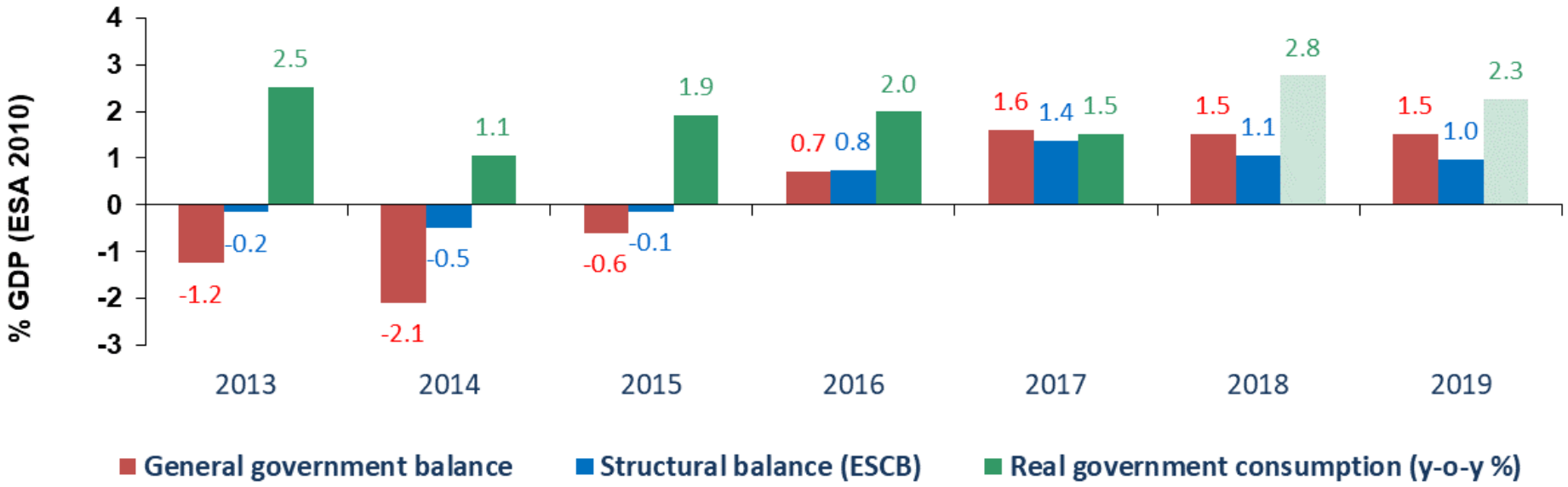


(annual percentage changes; contributions in percentage points; constant prices; seasonally unadjusted)

- Upswing in investment is fostering labour efficiency (fast investment in machinery and equipment continues).
- Investment growth is being driven by non-financial corporations; government investment also increased in Q4 2017.
- Surveys suggest continued solid growth in private investment in quarters ahead.

Fiscal policy

- Government surplus will reach 1.5% of GDP in both 2018 and 2019, along with persistent structural surpluses.
- Growth in tax revenues due to continued economic growth and policy measures are significantly contributing to increasing government budget surpluses.
- General government debt to GDP ratio is predicted to continue decreasing to 30.1% in 2019.



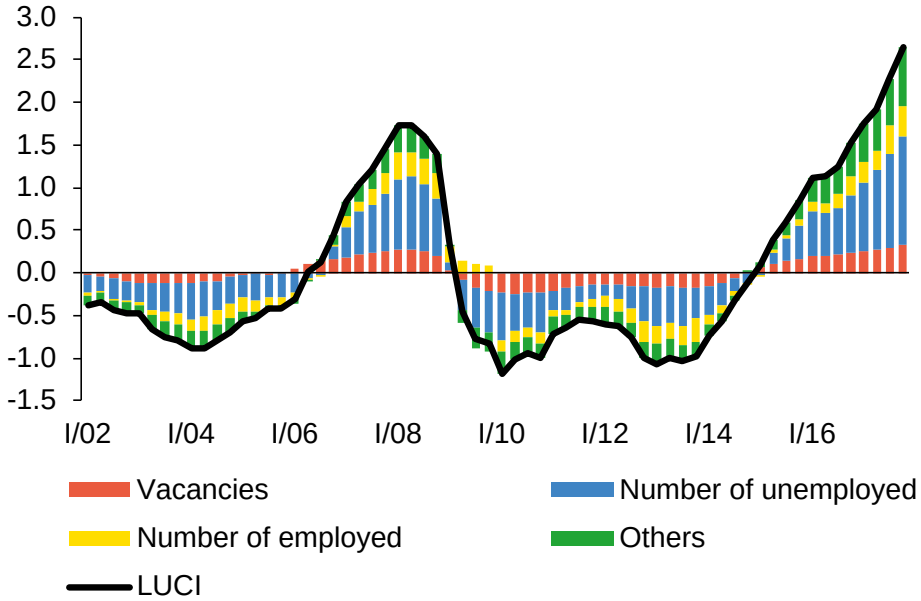
Fiscal impulse

- Fiscal policy will remain expansionary in 2018 and 2019.
  - 2018: measures supporting household consumption (including high wage growth in government sector), recovery in government investment.
  - 2019: increase in old-age pensions and continuous growth in government investment.

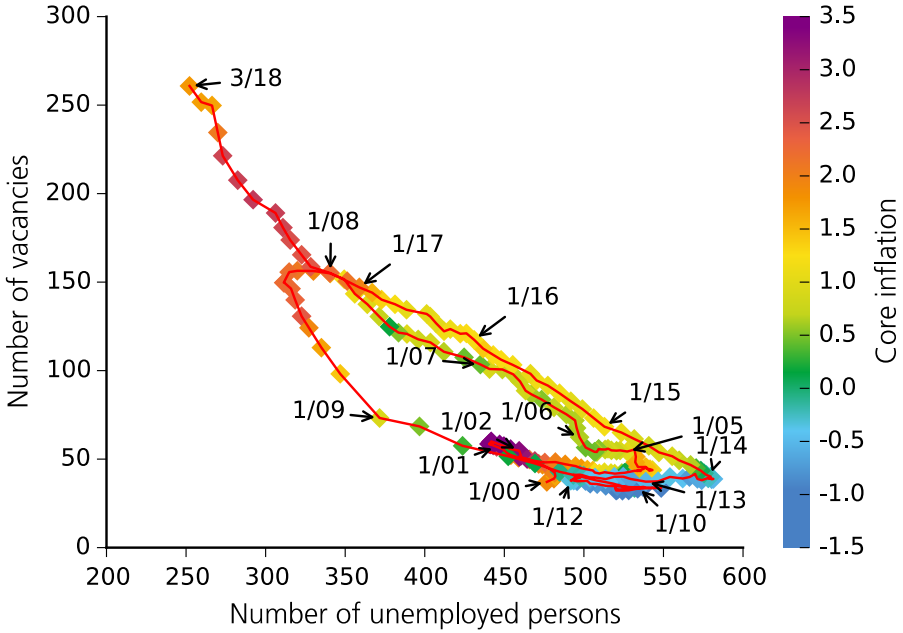
Contributions to GDP growth in percentage points	2016	2017	2018	2019
	actual	actual	forecast	forecast
Fiscal impulse	**-1.1**	**0.2**	**0.4**	**0.3**
of which impact through:				
private consumption	0.0	0.2	0.3	0.1
private investment	-0.1	-0.1	0.0	0.0
government investment, domestic	-0.2	0.0	0.1	0.0
government investment, EU funded	-0.7	0.1	0.1	0.1

Labour market is at its capacity

LUCI – labour utilisation composite index



Beveridge curve



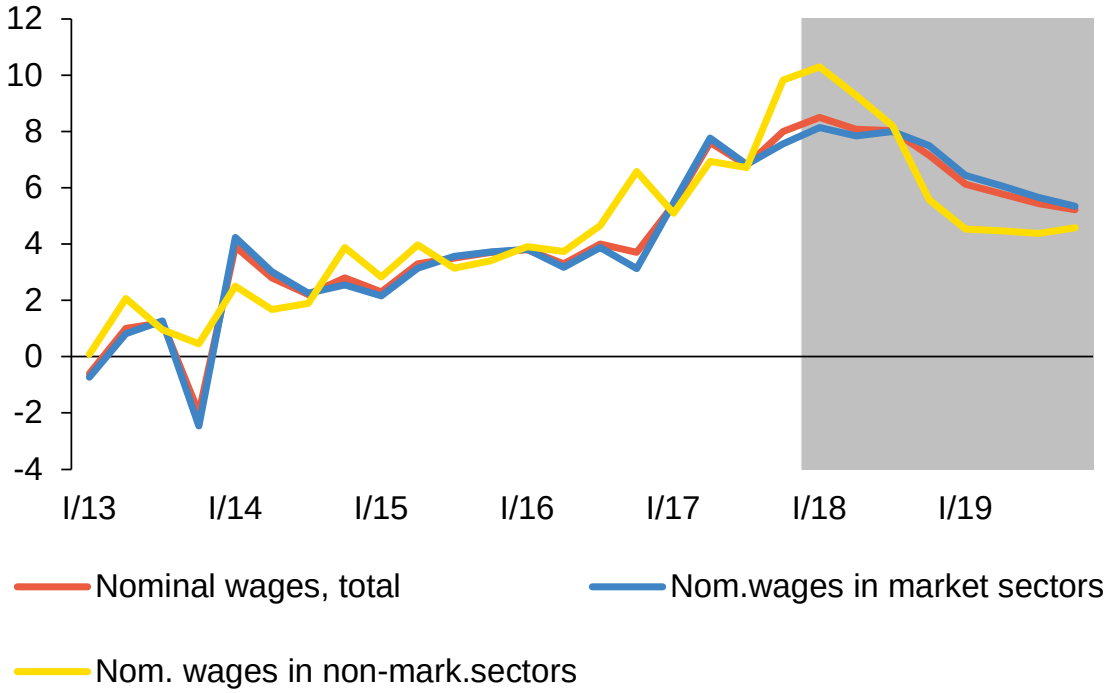
Note: Index; vertical axis shows standard deviations.

- Czech labour market is now extremely tight.
- Continued economic growth is leading to further rise in employment; unemployment rate is lowest in history.
- Firms are finding it increasingly difficult to fill vacancies.

Wage pressures have been peaking

- Tightness in labour market will keep wage growth in market sectors at high levels this year. Pay increase in government sector in November 2017 is assumed to be one-off.
- Wages will then slow, but their growth will remain above its assumed long-run equilibrium 5% level.

Average nominal wages
(annual percentage changes; total wages – source: CZSO; wages in market and non-market sectors – source: CNB calculation)

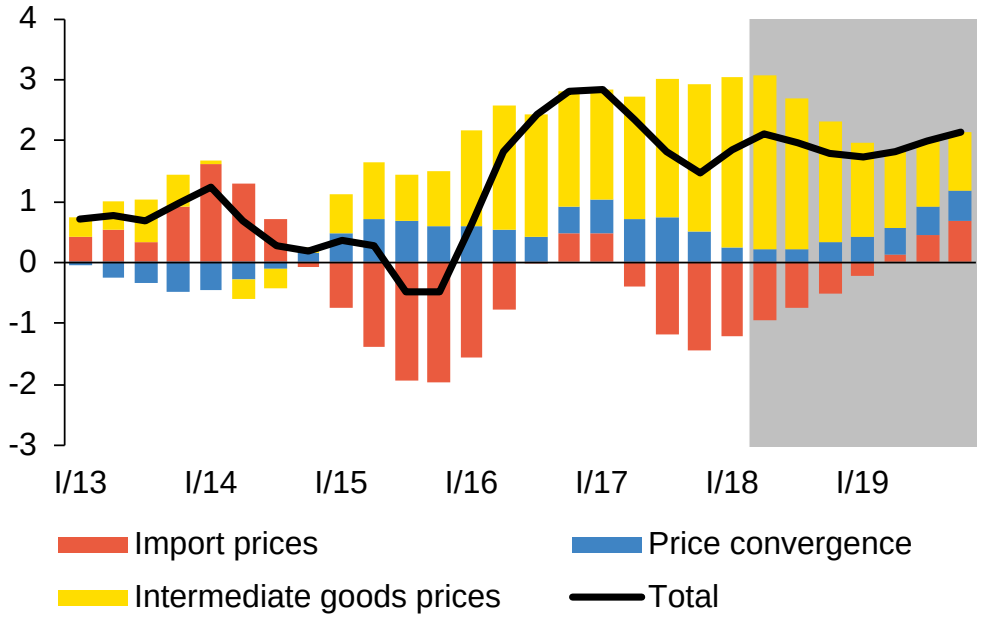


- Wage growth picked up further at start of this year (including further increase in minimum wage).
- Gradual slowdown in quarters ahead, mainly due to tightening monetary conditions and firms' efforts to maintain price competitiveness.

Inflationary pressures in economy

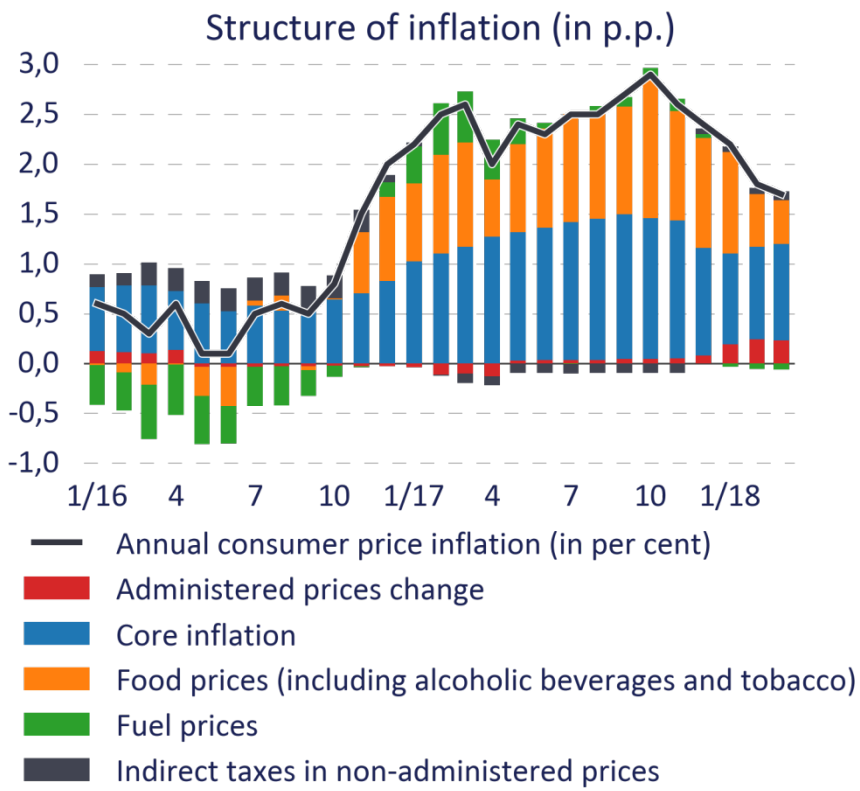
- Overall inflation pressures remain relatively strong despite anti-inflationary effect of import prices.
  - Domestic cost pressures are peaking in H1 2018, reflecting rapid growth of economy and wages. From Q3 2018 they will gradually ease.
  - Contribution of import prices will turn positive again during 2019.

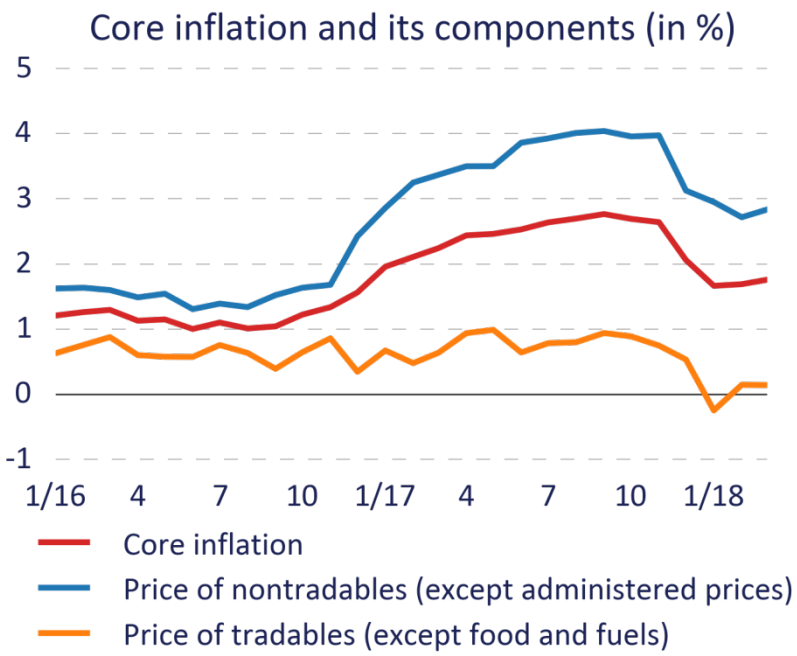
Costs in consumer sector
(nominal quarterly percentage changes; contributions in percentage points; annualised)



Inflation developments

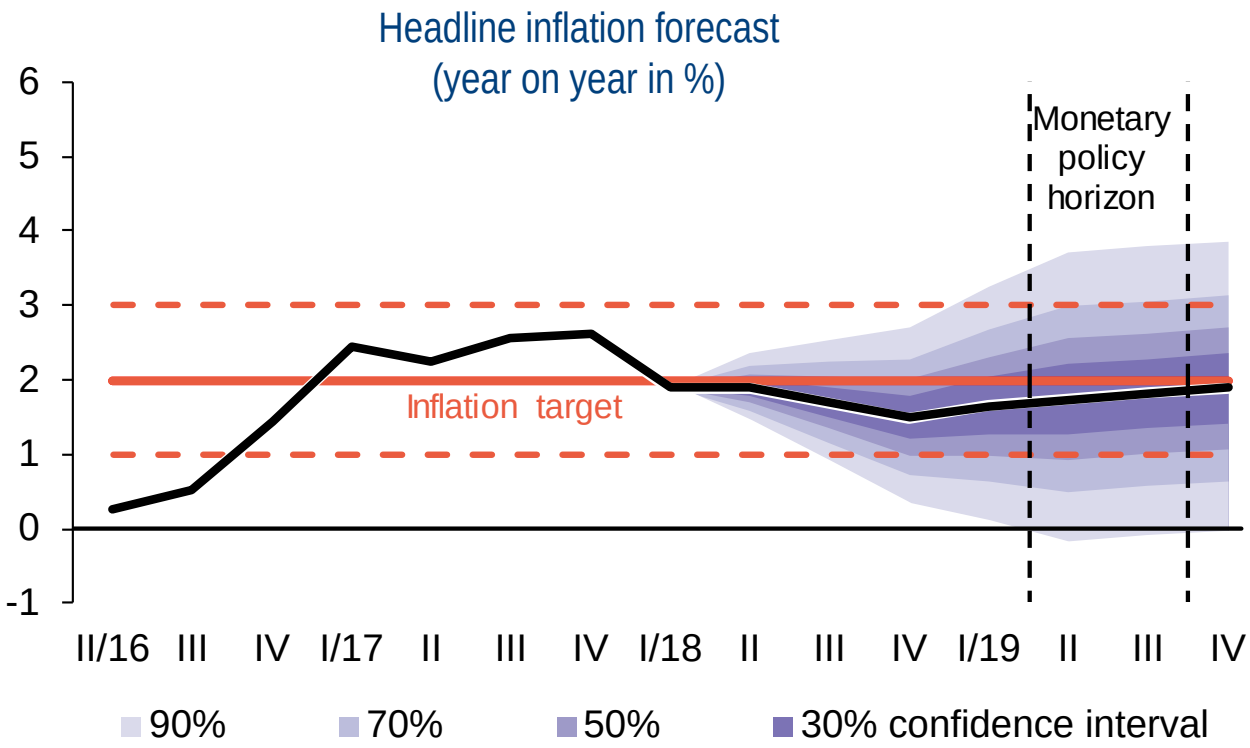
- Consumer price slowdown in early 2018 driven by markedly lower growth in food prices and decline in core inflation.
- Core inflation decline:
  - slower growth in nontradables prices (including fading out of one-off effects from 2016/2017 and slowing imputed rent dynamics),
  - tradables prices affected by import price decline.





Inflation forecast: sustainable fulfilment of target

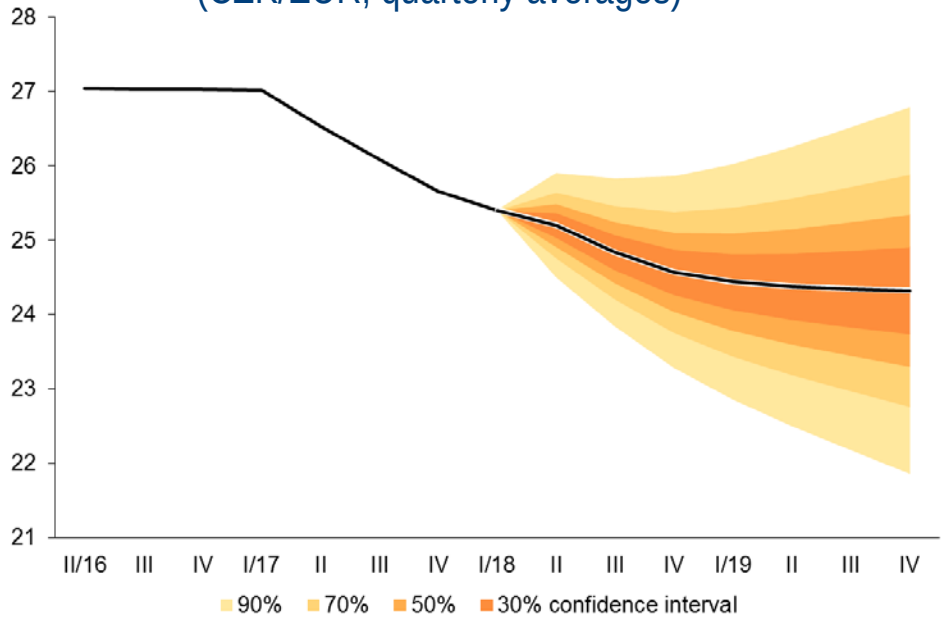
- Inflation will be in lower half of tolerance band and return to target by end of 2019.
- CZK appreciation will continue to slow down inflation in 2018.
  - In 2019, import prices will support return of inflation to target from below.
- Core inflation will remain broadly stable in near future and go up next year.



Exchange Rate

- According to forecast, koruna will appreciate further against euro, especially in 2018,
  - due to positive interest rate differential and long-term real convergence to euro area.
- In 2019, CZK will appreciate much more modestly:
  - gradually slowing growth in external demand and ECB's expected return to conventional monetary policy.

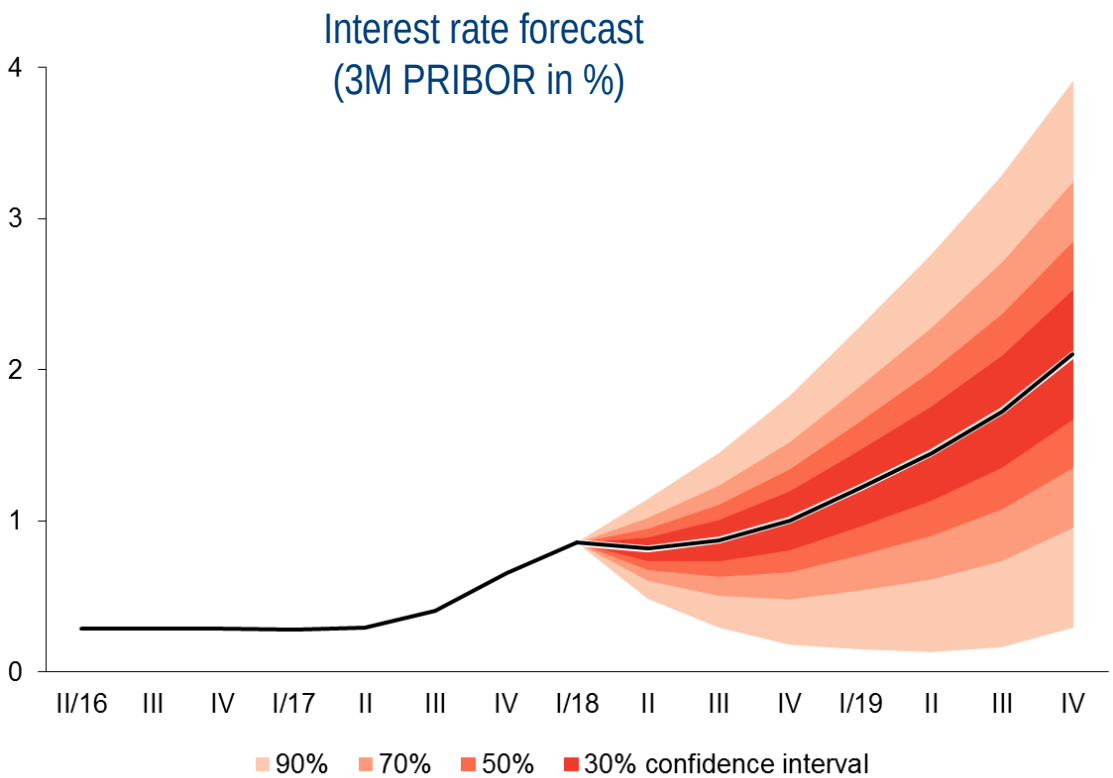
Exchange rate forecast
(CZK/EUR, quarterly averages)



- CNB renewed publication of numerical CZK/EUR forecasts.
- Fanchart form = emphasis on uncertainty and noncommittal character of trajectory.

Interest rate path

- Consistent with forecast is broad stability of market interest rates initially, followed by further growth in rates from late 2018/early 2019.
- Continued very accommodative monetary policy of ECB will remain main barrier to faster increase in domestic interest rates.

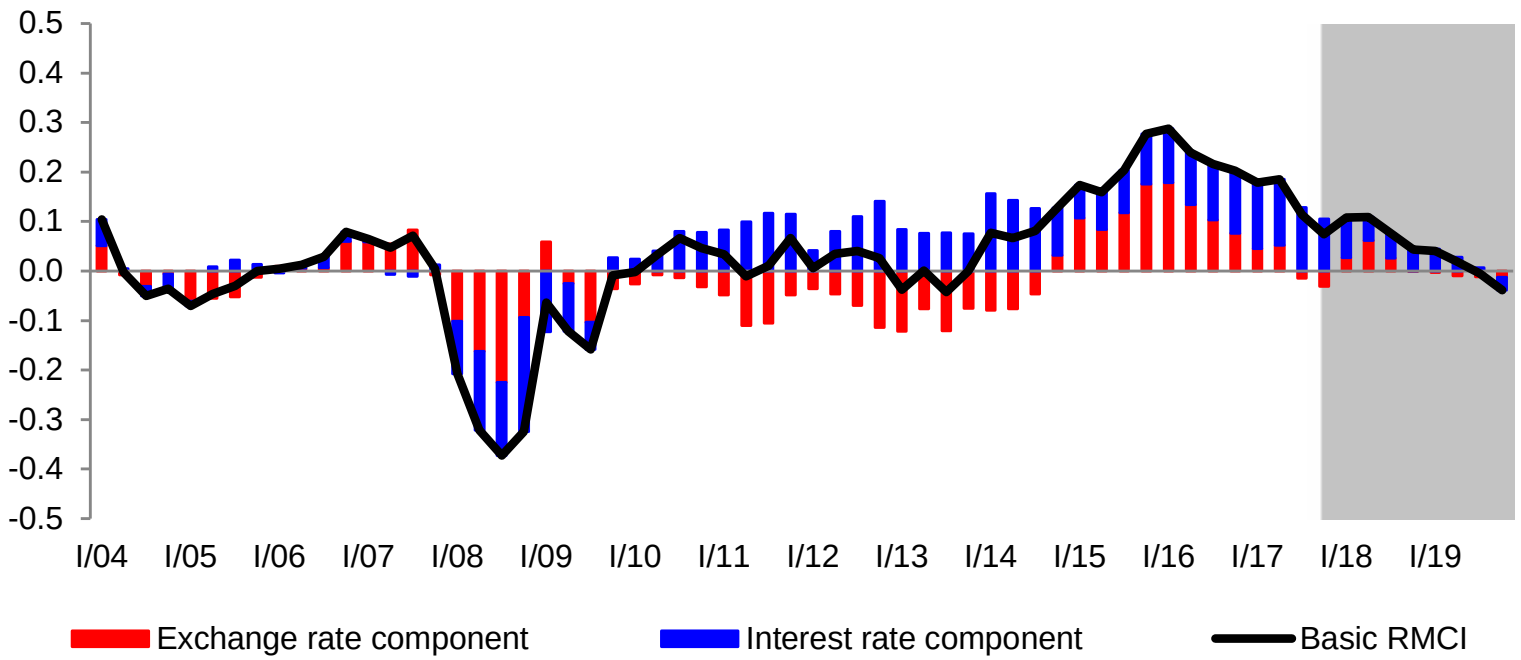


- Tendency towards rate normalisation
- vs. ECB quantitative easing.

Monetary conditions

- Monetary conditions tighten in their exchange rate component and later also in their interest rate component, thus acting against overheating of domestic economy.

Real monetary conditions index
(positive values refer to easy monetary conditions and negative values to tight monetary conditions; CNB calculation)

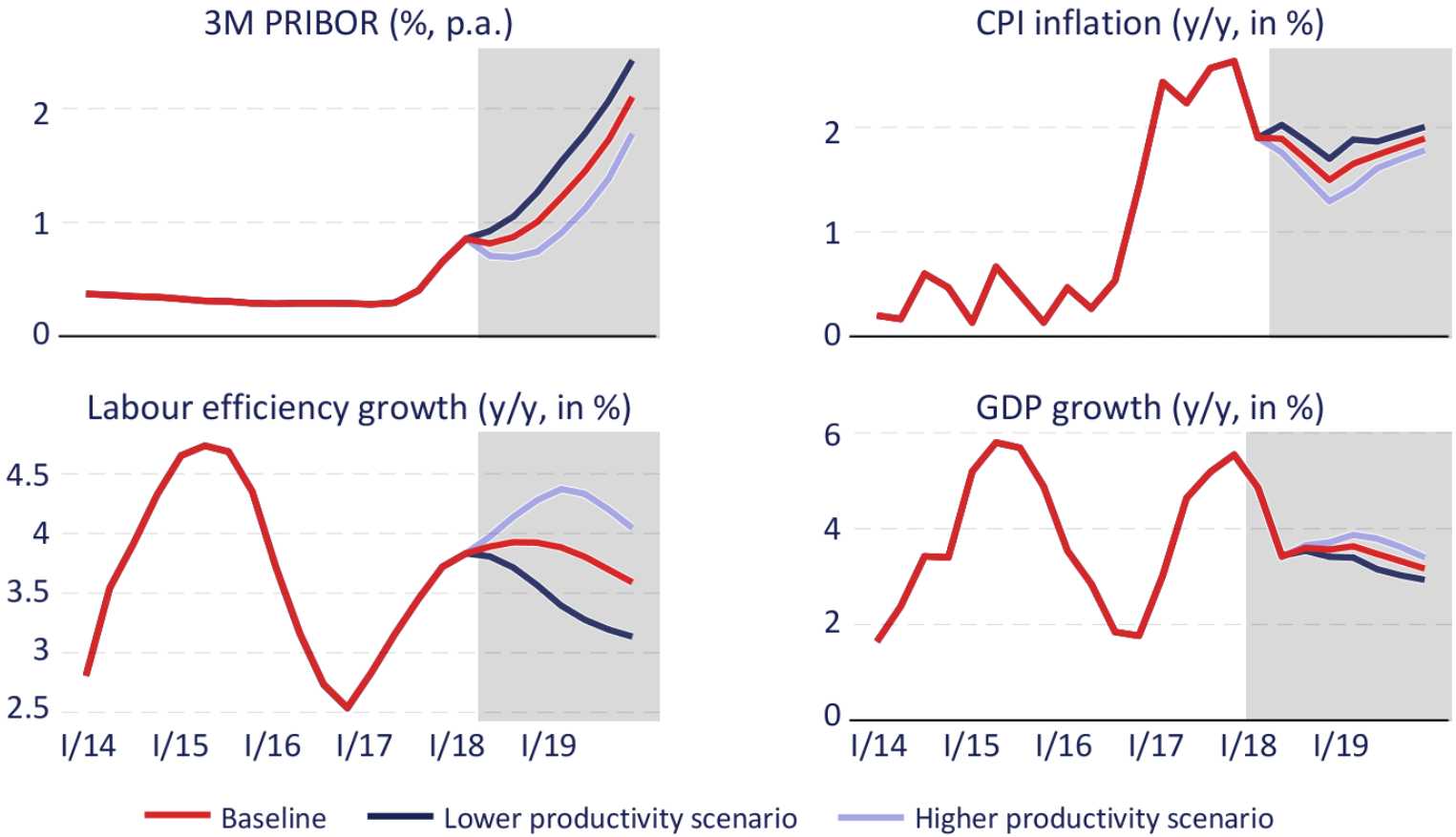


Current monetary policy setting

- CNB Bank Board monetary policy meeting on 3 May 2018:
- Bank Board assessed risks to forecast as being balanced at monetary policy horizon.
- 2W repo rate remained at 0.75%, discount rate at 0.05% and Lombard rate at 1.50%.
- Main uncertainties:
  - strength and composition of inflation pressures,
  - exchange rate developments,
  - developments abroad.

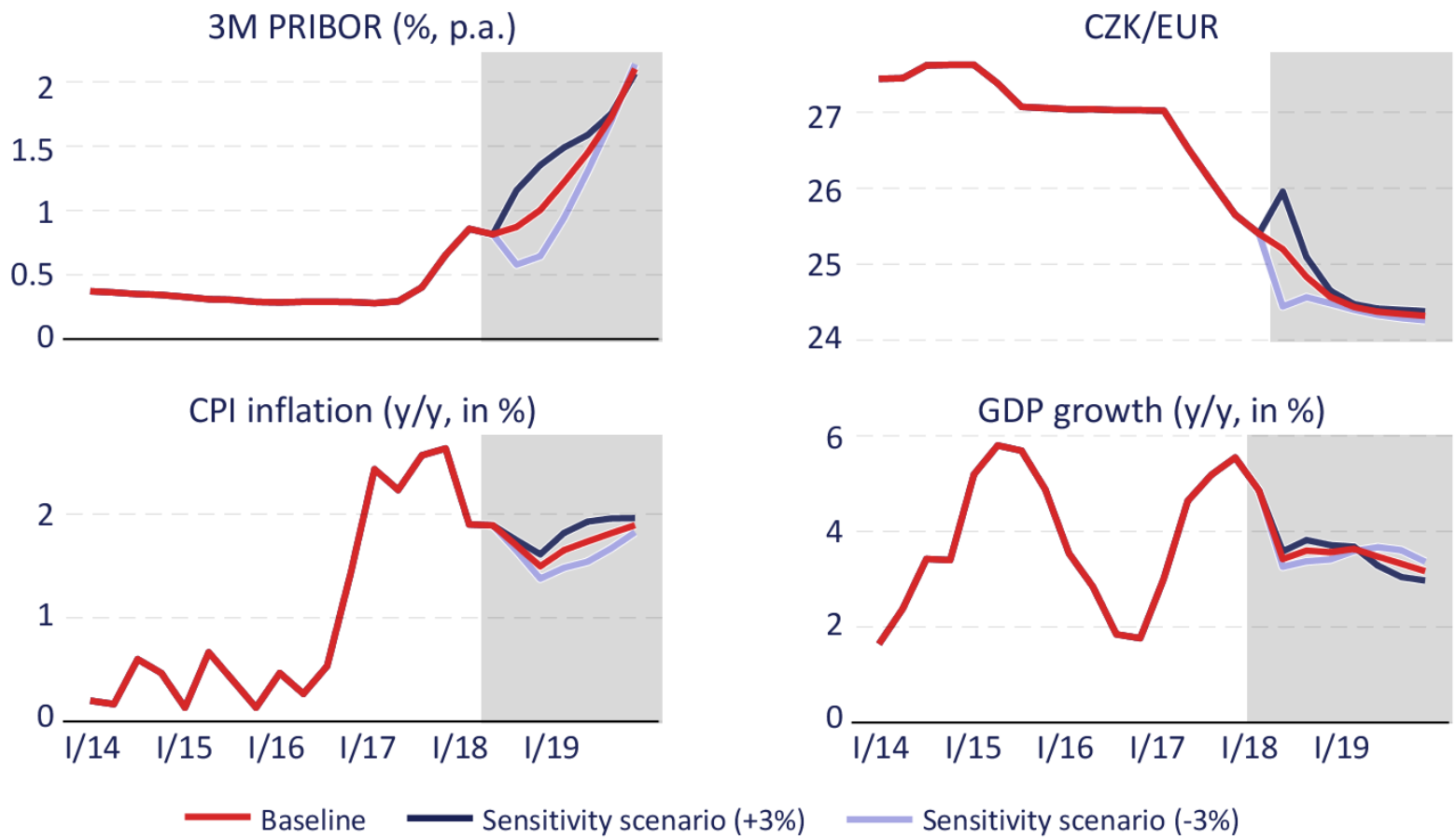
Sensitivity scenario – labour efficiency

- Scenario: current forecast for wage dynamics accompanied by lower/higher labour efficiency growth
  - slightly higher/lower inflation,
  - higher/lower trajectory of interest rates,
  - lower/higher GDP growth outlook.



Sensitivity scenario – exchange rate

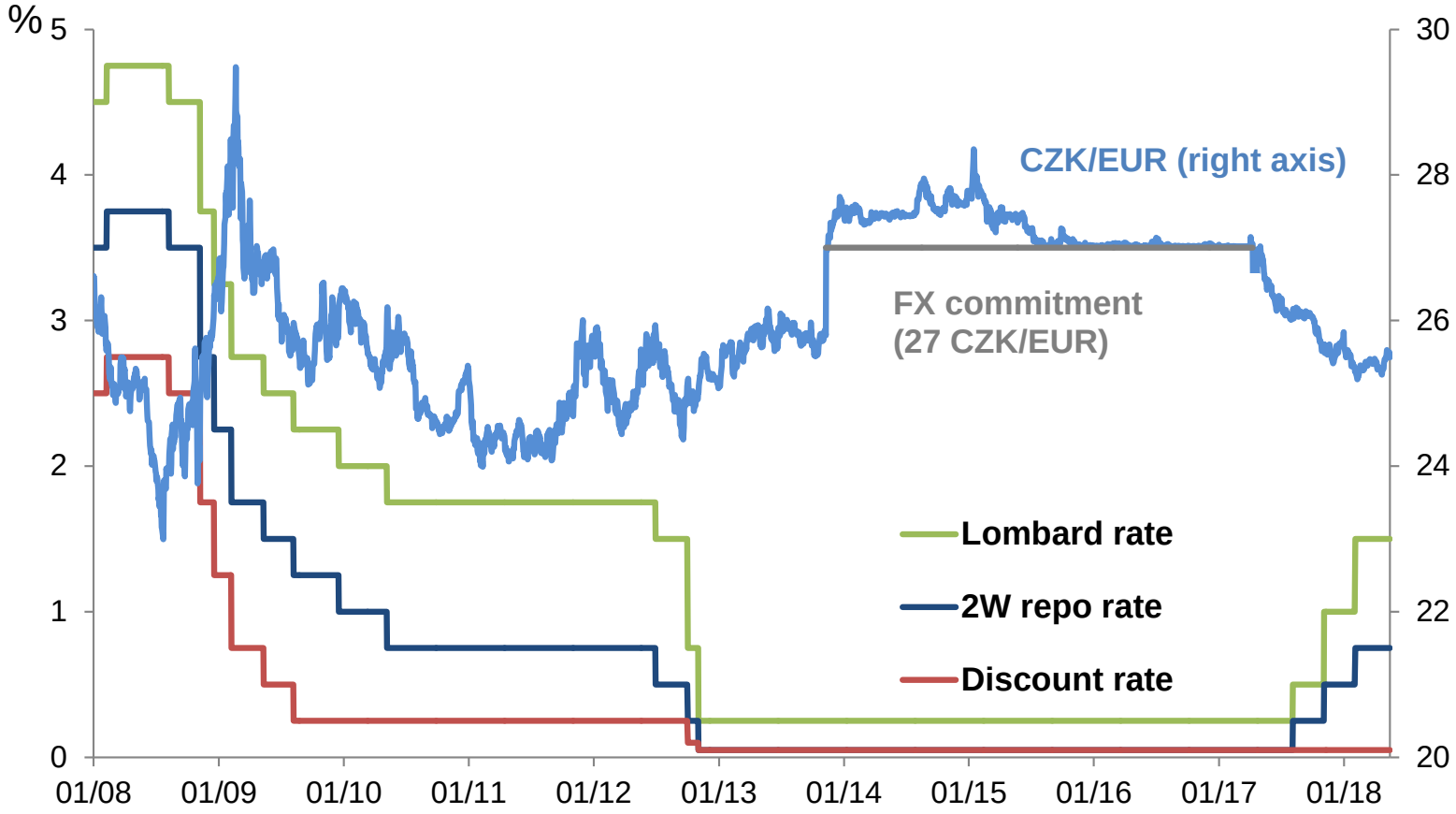
- Standard sensitivity scenario: temporarily weaker/stronger exchange rate
  - higher/lower interest rate path compared to forecast.



Monetary policy normalisation so far: four steps

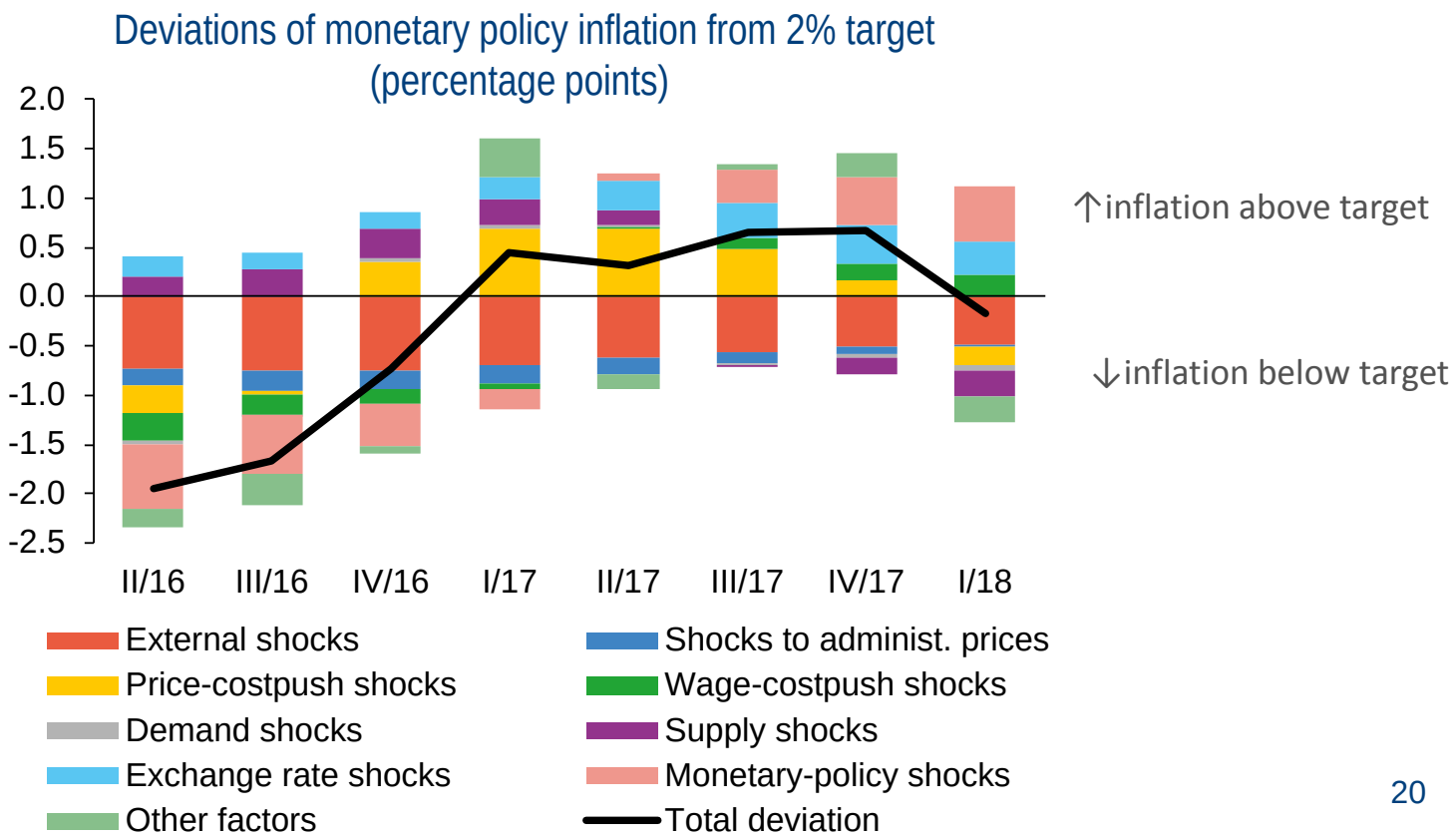
- FX commitment terminated in April 2017.
  - First step towards MP normalisation.
- Interest rate increases followed – three times so far.

CZK/EUR and monetary policy interest rates



Analysis of fulfilment of inflation target

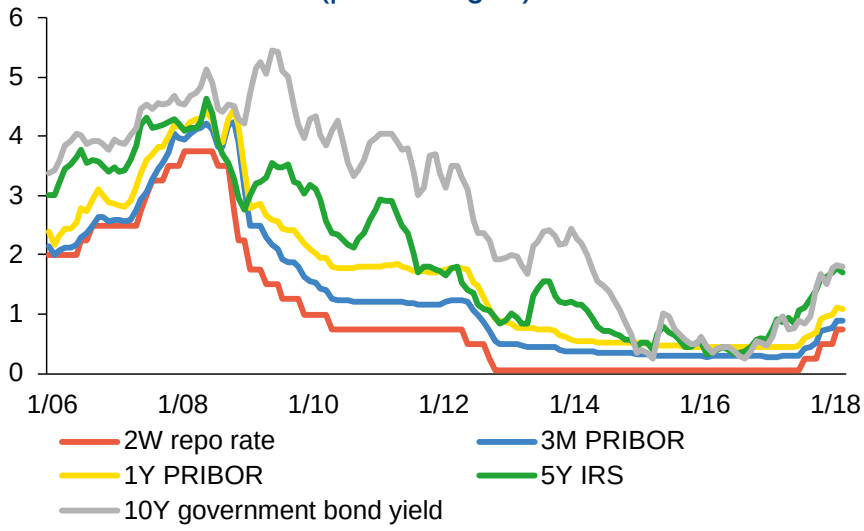
- External shocks – most important continuous source of negative deviations from target over last two years.
- Aggregate effect of domestic economy started to drive inflation above target at end-2016.
- Monetary policy and only gradual appreciation of CZK have offset anti-inflationary external pressures in recent quarters.



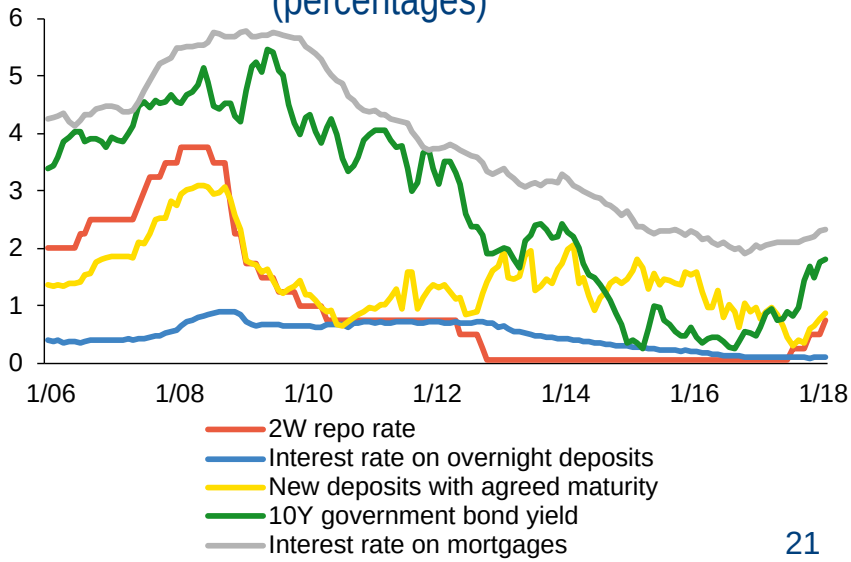
Quick analysis of MP transmission

- Monetary policy rates are passing through to financial market rates as usual.
- Growth in MP rates is also gradually passing through to client interest rates, mainly loan rates:
  - most apparent for corporate loans; transmission to house purchase loans is slower; deposit rates remain very low.
  - Banks' interest margins remain low, but margins on corporate loans and house purchase loans have risen slightly recently.

Monetary policy and financial market interest rates (percentages)



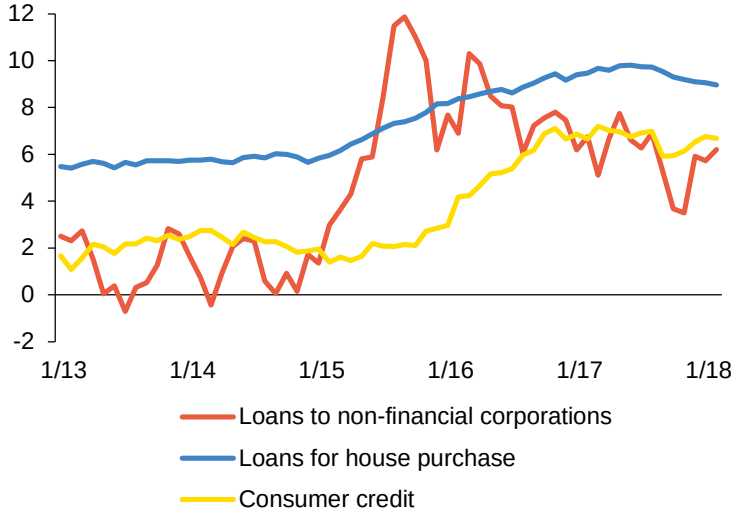
Interest rate on mortgages and household deposits (percentages)



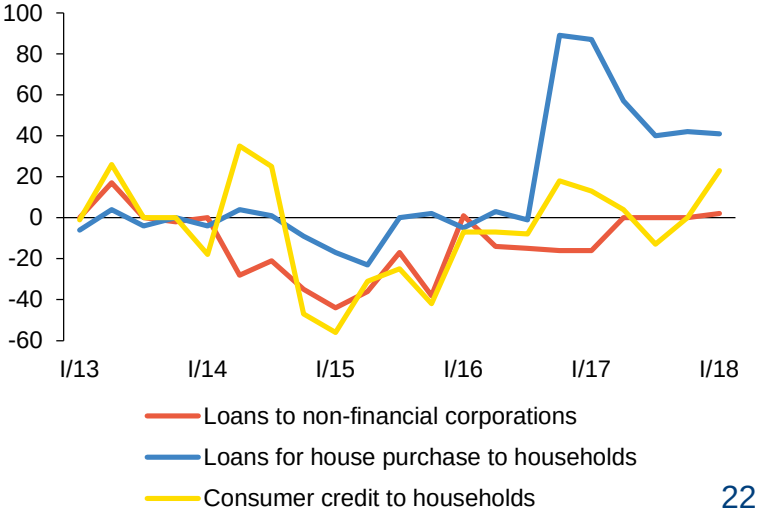
Credit market developments

- Growth in loans to private sector picked up slightly to 8% at start of this year.
  - Growth in loans to corporations rose to around 6% on back of favourable credit conditions and economic growth.
  - Growth in loans to households has recently slowed but remains buoyant – tightening of credit standards combined with high property prices is slowing down growth in loans for house purchase.

Loans to private non-financial sector
(annual percentage rates of growth)



Credit standards of banks
(net percentages of banking market;
positive value = tightening, negative value = easing)



Summary

- Czech economy is operating at its potential.
- Inflation slightly below target in 2018, will return to target during 2019.
- Monetary policy is facing strong domestic inflationary pressures, while external factors are exerting downward pressure on rates.
- Monetary strengthening is being achieved via both channels.
- Consistent with recent CNB forecast is initial broad stability of market interest rates and gradual growth in rates in the direction towards their long-run neutral level from late 2018/early 2019.

Thank you for your attention

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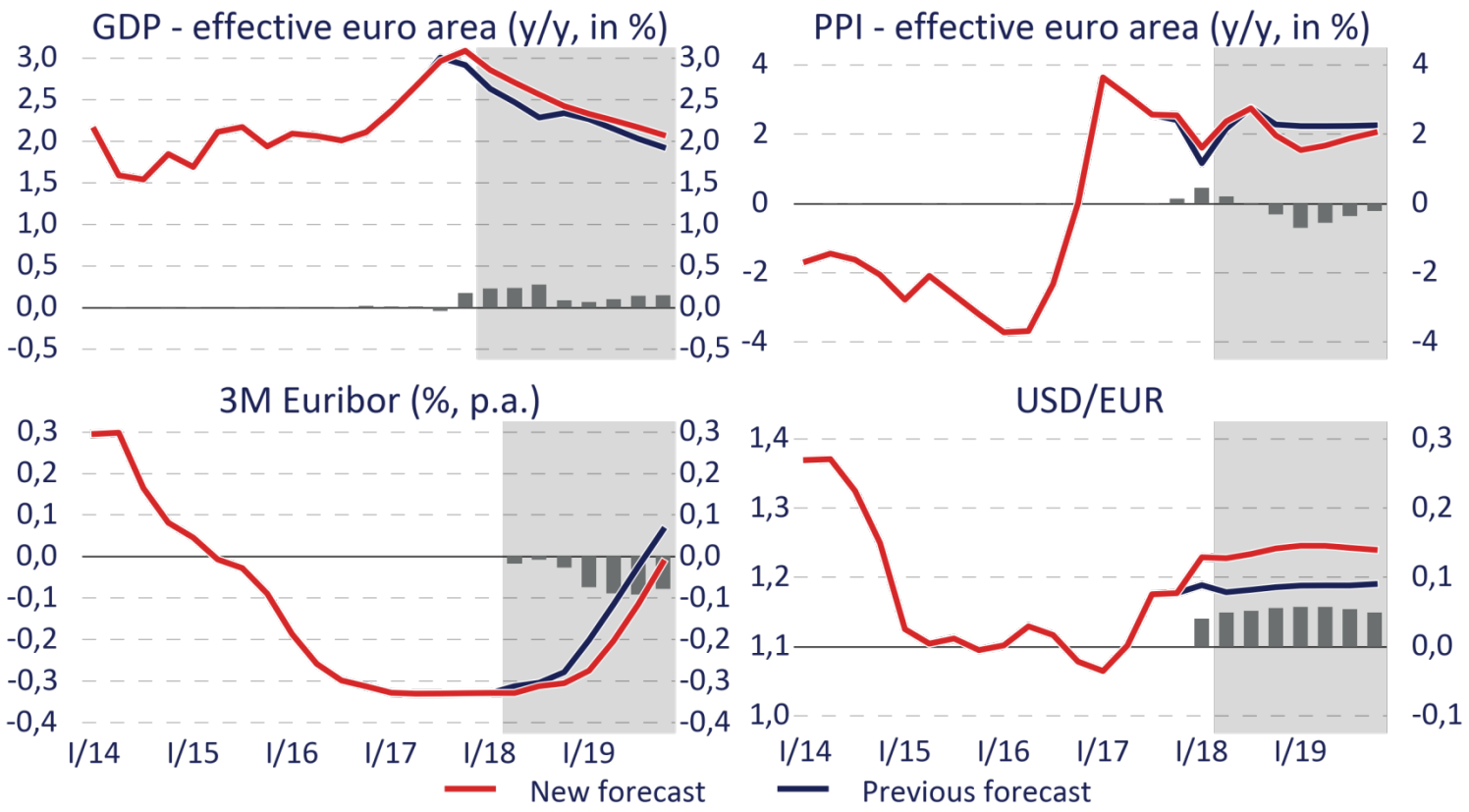
Forecasts of selected variables

	2017 actual	2018 forecast	2019 forecast
Headline inflation	2.5	1.7	1.8
GDP	4.6	3.9	3.4
Average nominal wage	7.0	7.9	5.6
Exchange rate (CZK/EUR)	26.3	25.0	24.4
3M PRIBOR (in %)	0.4	0.9	1.6

External Environment Outlook



- GDP growth in effective eurozone will remain robust and is revised upwards.
- Producer price dynamics will fluctuate around 2%.
- Continued easy monetary policy of ECB keeps outlook for 3M EURIBOR in negative territory until end of 2019.
- USD/EUR outlook is above 1.20.