Quo Vadis 2019: Czech economic perspectives and CNB policy

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CNB Board Member

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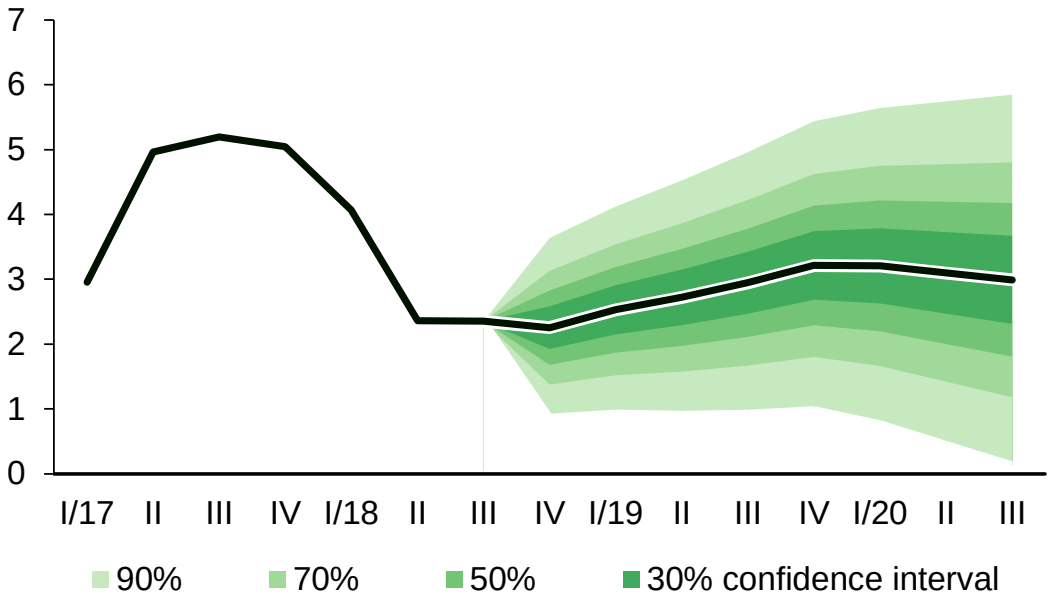
The Czech economy: A stable island in a storm?

Outline and main messages

- GDP: robust growth, has shown resilience to foreign slowdown
- Labour market: extremely tight, constraining businesses but supporting demand
- Inflation: strong domestic pressures, anti-inflationary risks from foreign prices
- Monetary policy: outlook of broad stability
  - Potential need for higher rates if koruna fails to strengthen

Economic growth looks set to continue

GDP growth forecast
(annual percentage changes; seasonally adjusted)



Economic growth will continue to be supported by

- robust consumption by Czech households…
- …on the back of strong household income
- and strong domestic investment activity…
- …prompted by need to raise labour productivity

- Growth of Czech economy will accelerate slightly in 2019 (2.9% on average) after temporary slowdown towards end of 2018.
- Potential output growth is catching up and will lead to currently positive output gap closing.

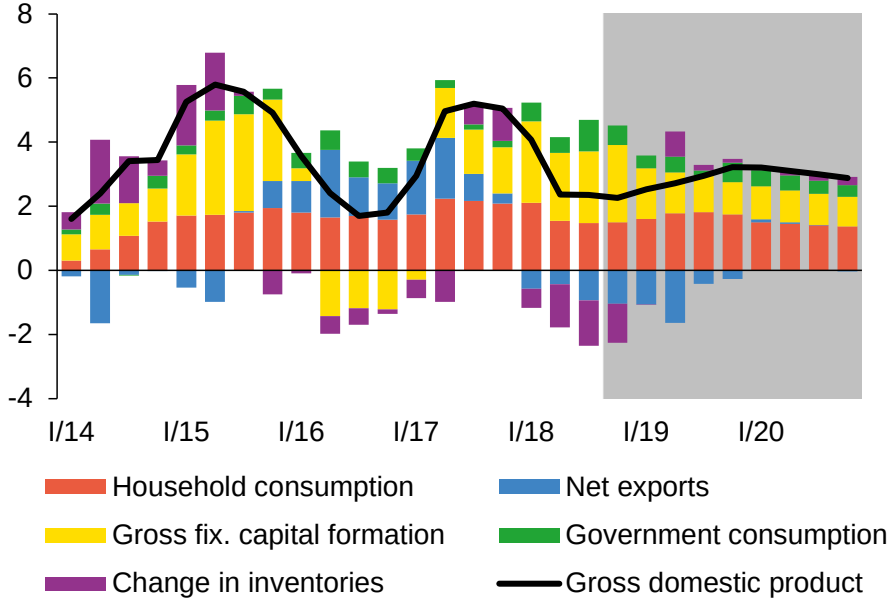
GDP components forecast

Annual percentage changes

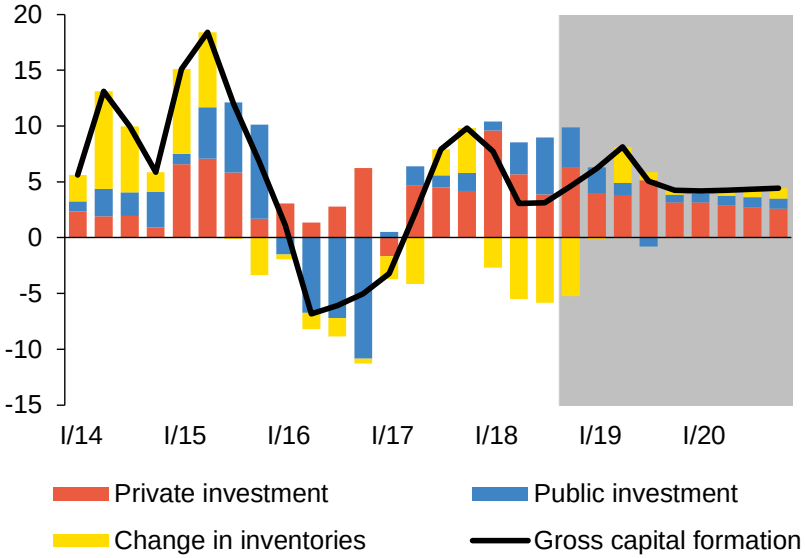
	2018	2019	2020
GDP	2.8	2.9	3.0
Household consumption	3.5	3.6	3.0
Government consumption	3.5	2.1	2.2
Gross capital formation	4.6	5.9	4.3
Gross fixed capital formation	9.4	4.8	3.7
Exports of goods and services	4.3	3.9	5.7
Imports of goods and services	5.8	5.5	6.2

Structure of growth

Contributions to growth – demand side



Investment decomposition

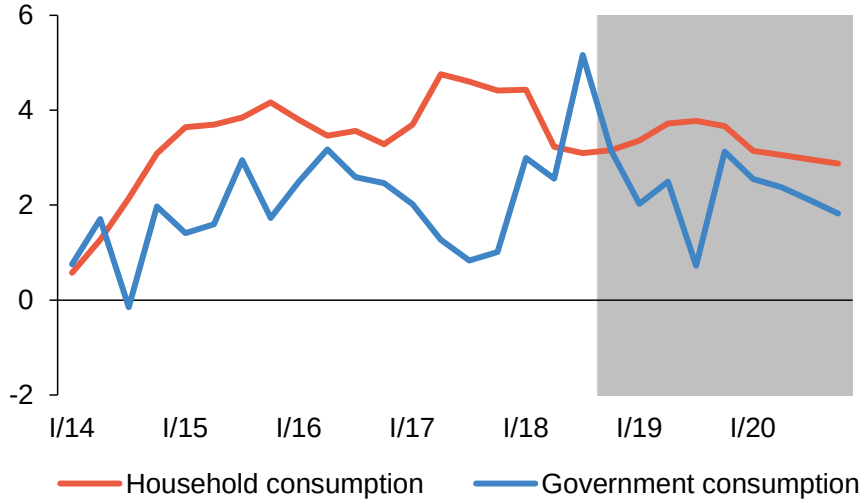


(annual percentage changes; contributions in percentage points; constant prices; seasonally adjusted)

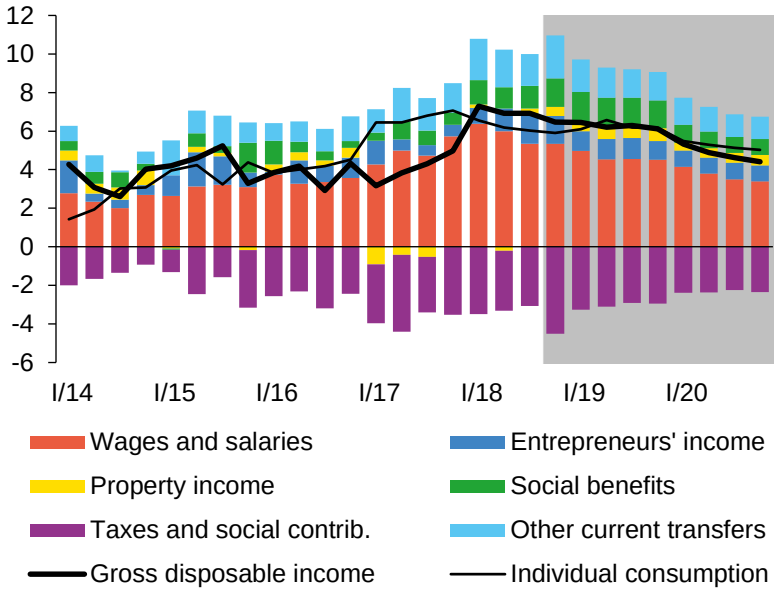
- Domestic demand to remain major driver of growth
- Strong investment reflecting need to boost productivity
  - Investment has recently made even bigger growth contribution than private consumption
- Rapid growth of private investment has been joined by public investment activity this year
  - EU fund drawdown acceleration has contributed. Even public investment might increase productivity if targeted at infrastructure development.

Private and public consumption

Both private and public consumption to stay solid



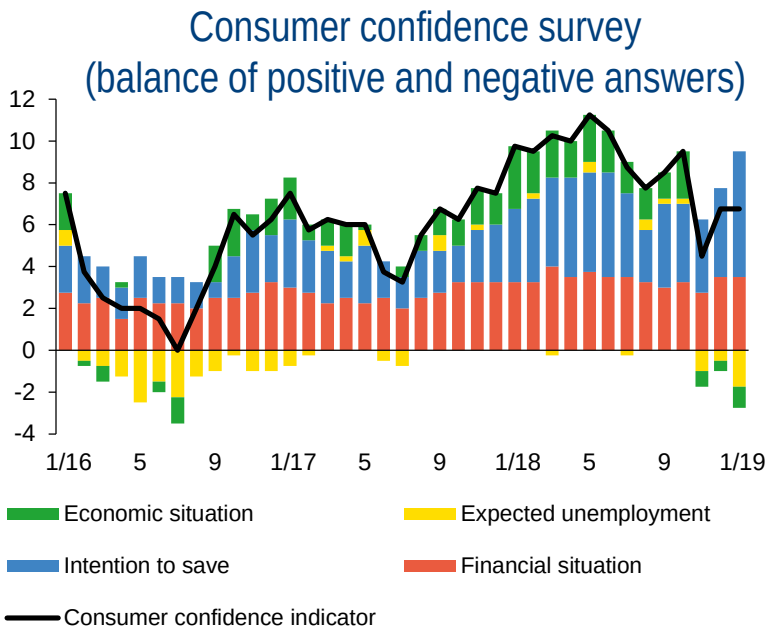
Disposable income keeps growing, supporting demand

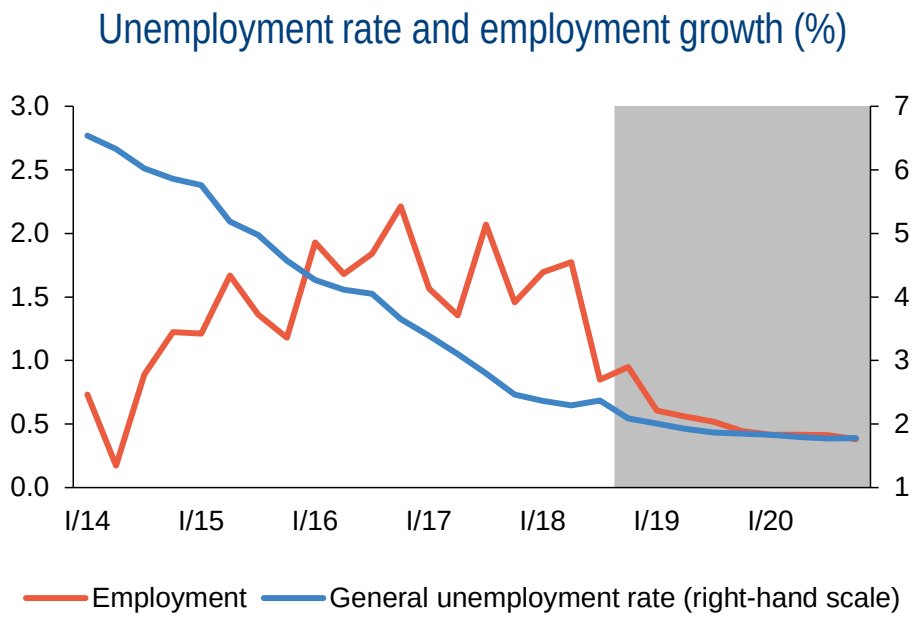


(annual percentage changes; contributions in percentage points; constant prices; seasonally unadjusted)

- Surge in government consumption driven largely by public workers' pay
  - Feeding into households' disposable income
- Private consumption driven by solid income growth
  - Nominal disposable income growing at rates exceeding 6%, expected to stay strong

Consumer confidence shaken a bit

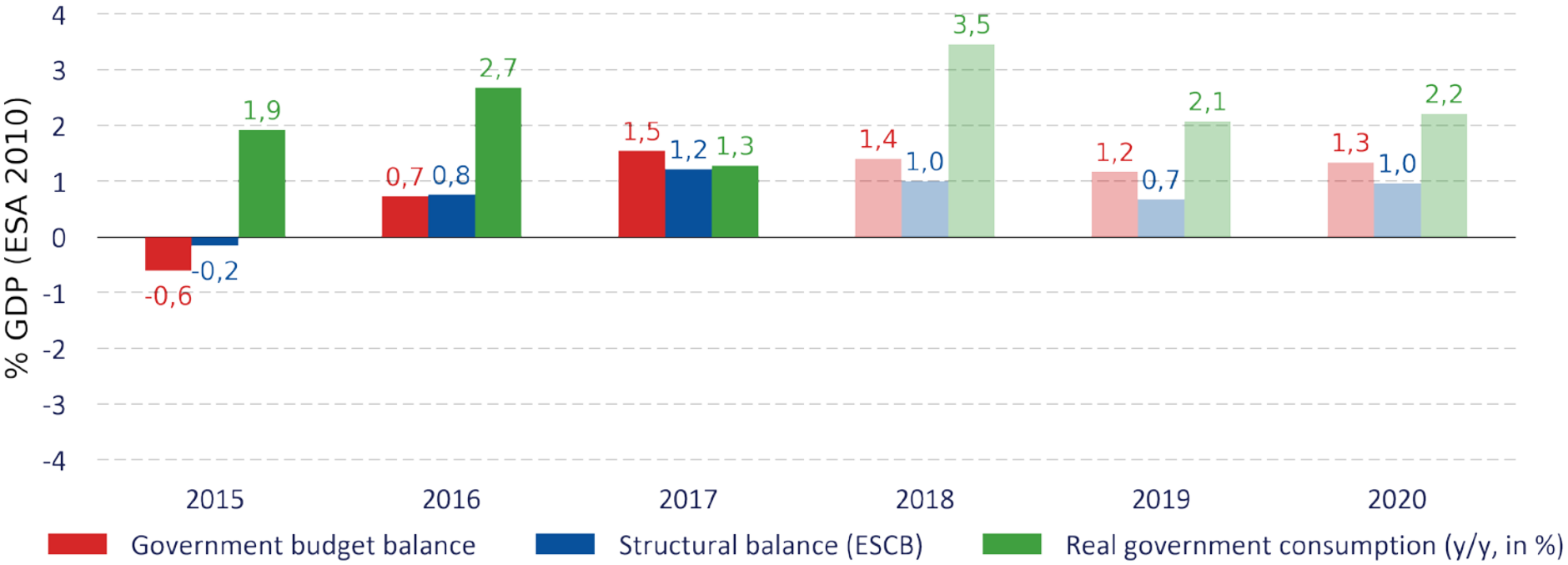




- Perceived economic situation has deteriorated, dragging down consumer confidence
  - Joined by unemployment expectations
  - While financial situation remains solid
- Data still show unemployment close to record lows with no sign of trend reversal in near future
  - Additionally employment keeps growing

Budget balance remains positive

- Both general government and structural balance positive recently
  - According to ESCB methodology, structural balance remains at around 1% of GDP
  - Strong income growth, driven mainly by VAT and social contributions
  - On expenditure side, public investment growing fast (on both central and municipal level), with help of EU funding
- Balance to stay positive in years to come, general govt. debt to decline



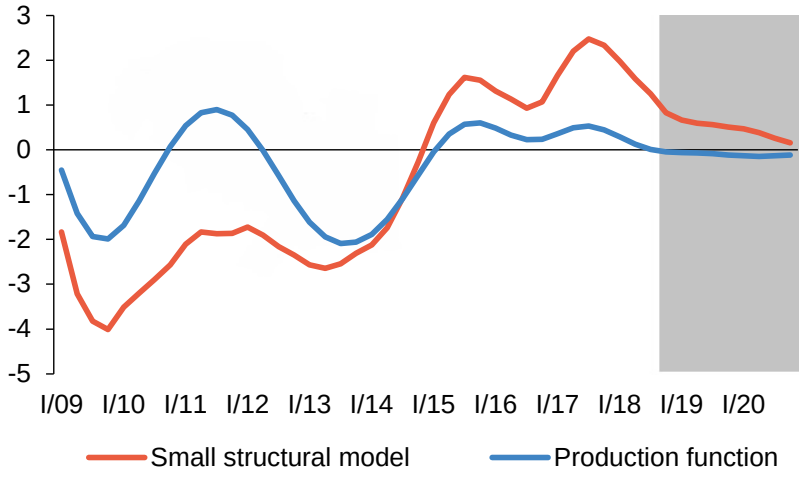
Fiscal impulse supportive to growth in 2019

- Fiscal policy will remain expansionary in 2019
  - Increase in public sector wages and retirement pensions supporting private consumption
  - Investment co-funded by EU continues to support growth
- Fiscal impulse turns neutral in 2020
  - No new expansionary measures announced, recent announcements on the contrary point to risk of tighter fiscal policy

	2017 actual	2018 exp. outcome	2019 forecast	2020 forecast
FISCAL IMPULSE	0.2	0.8	0.4	0.0
of which impact through:				
private consumption	0.2	0.4	0.3	0.0
private investment	-0.1	0.0	0.0	0.0
government investment, domestic	0.0	0.2	0.0	0.0
government investment, EU funded	0.0	0.2	0.1	0.0

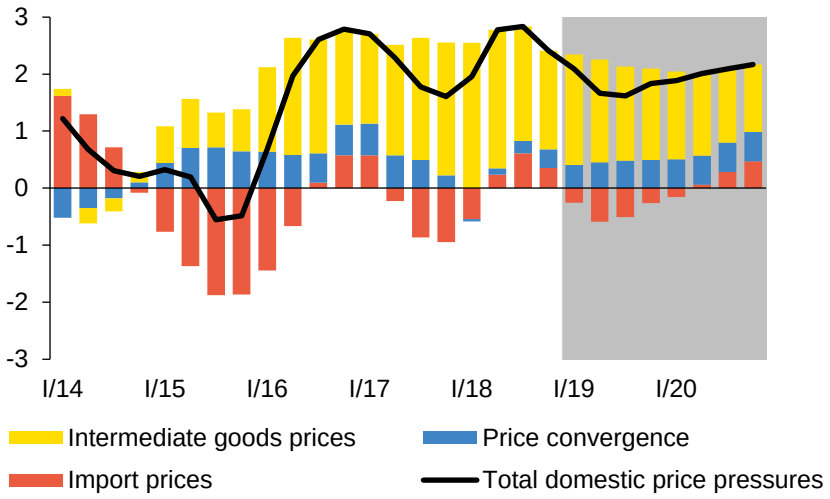
Output gap and price pressures

Output gap to close from above



(percentage deviations from potential output)

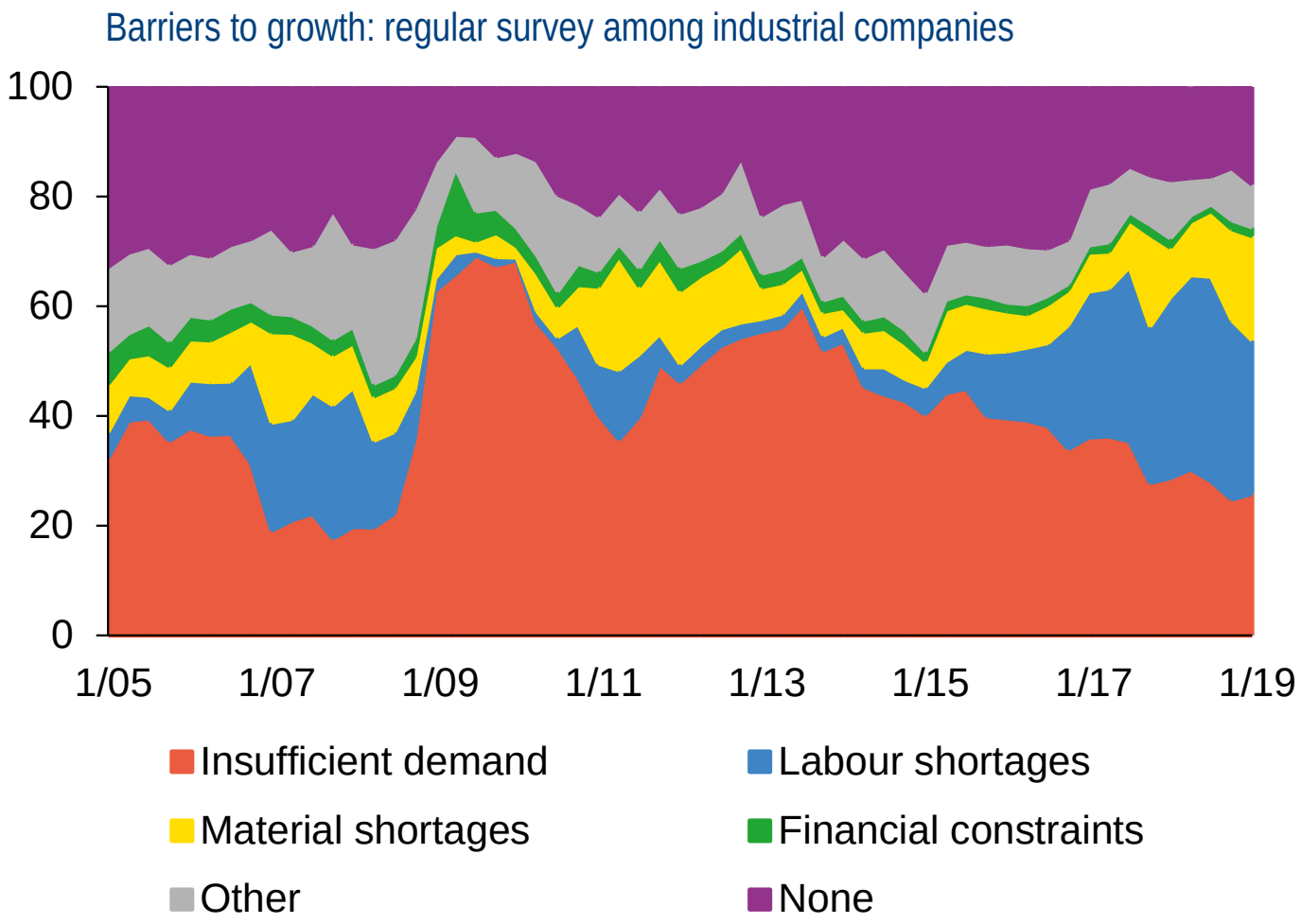
Price pressures from domestic economy remain high



(contributions in p.p. to q/q increase in domestic price pressures)

- Domestic economy creating robust price pressures.
- Output gap estimates suggest that currently positive gap would close from above in near future
  - Driven both by mild slowdown in growth and by potential growth catching up as businesses invest to boost productivity
- Price pressures from domestic economy currently driven by increasing wage costs
  - Price of capital contributing positively, too. Rising rates and capacity constraints making investment costly.

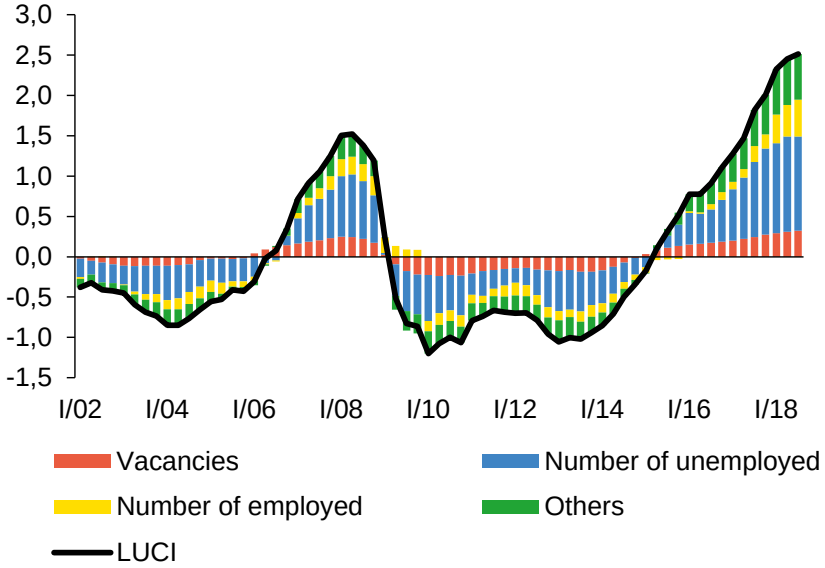
Main constraint? Lack of workforce.



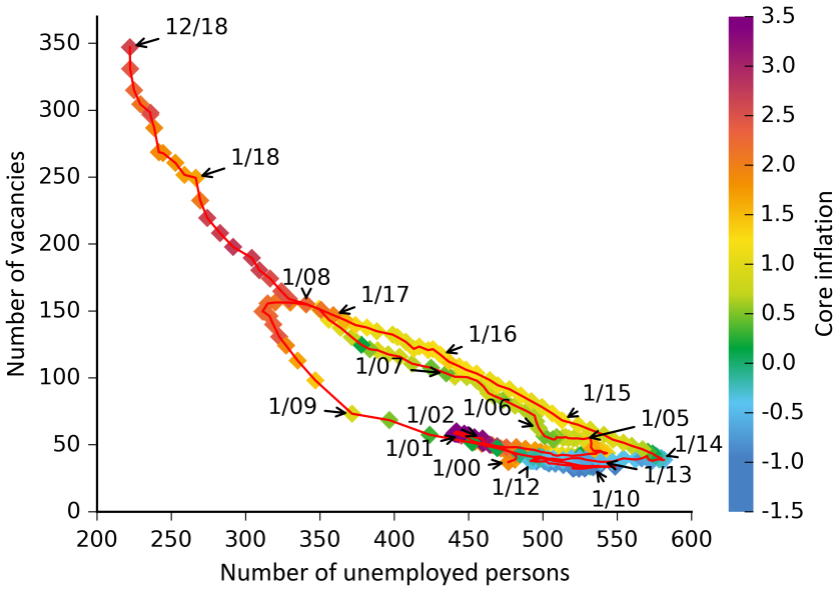
- Labour shortages are increasing concern since 2015
- Material shortages have also started to disturb industrial producers recently

Labour market: main constraint

LUCI – labour utilisation composite index
…reaching new highs



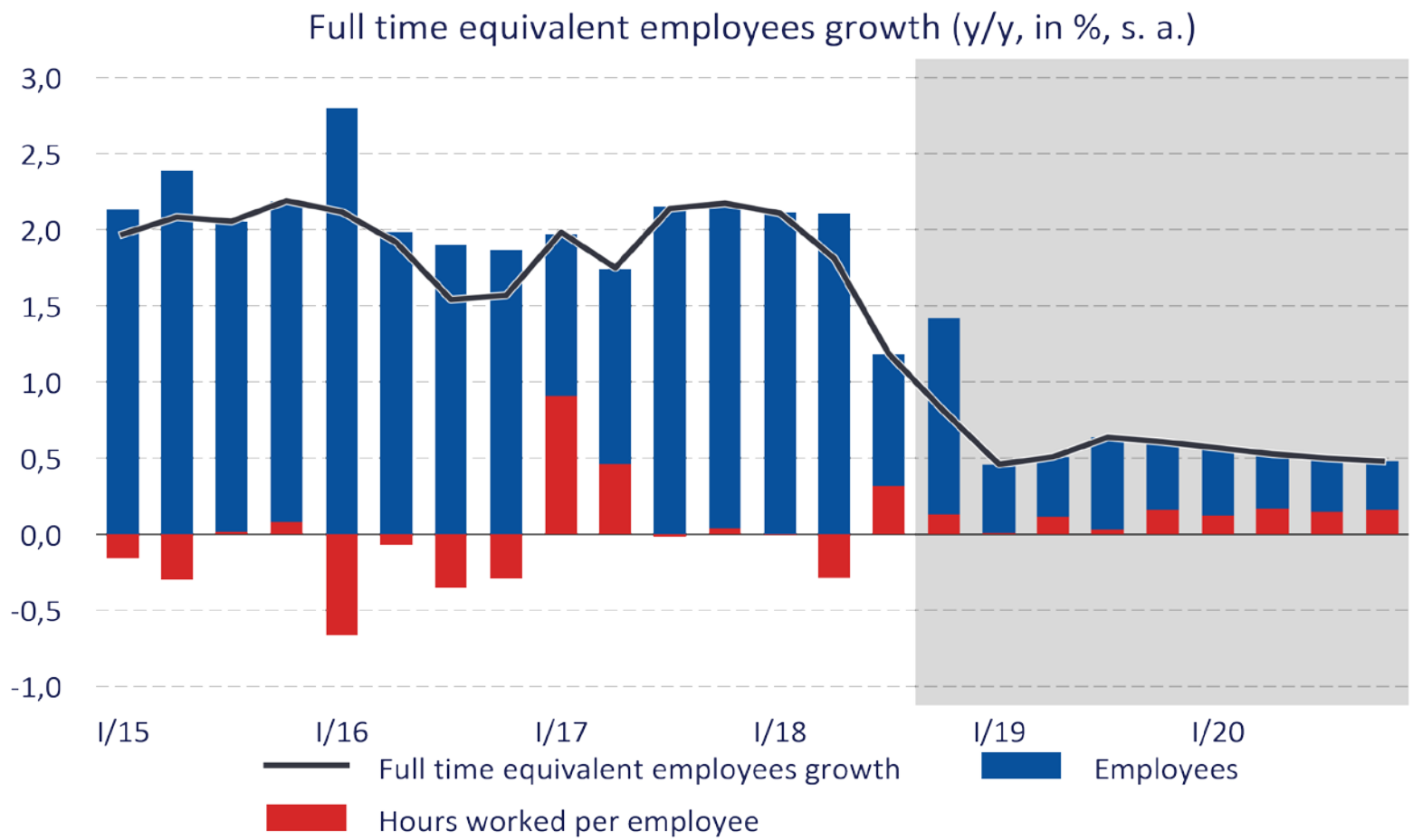
Beveridge curve exploring uncharted territory



Note: Index; vertical axis shows standard deviations.

- Czech labour market heated far beyond 2008 levels
- Number of unemployed pushing record lows. Exceeded by vacancies in mid-2018 and diverging further.
- Tapping workers outside current labour force (women, elderly) and importing workforce remain the ways to go

New workers or more hours per head?

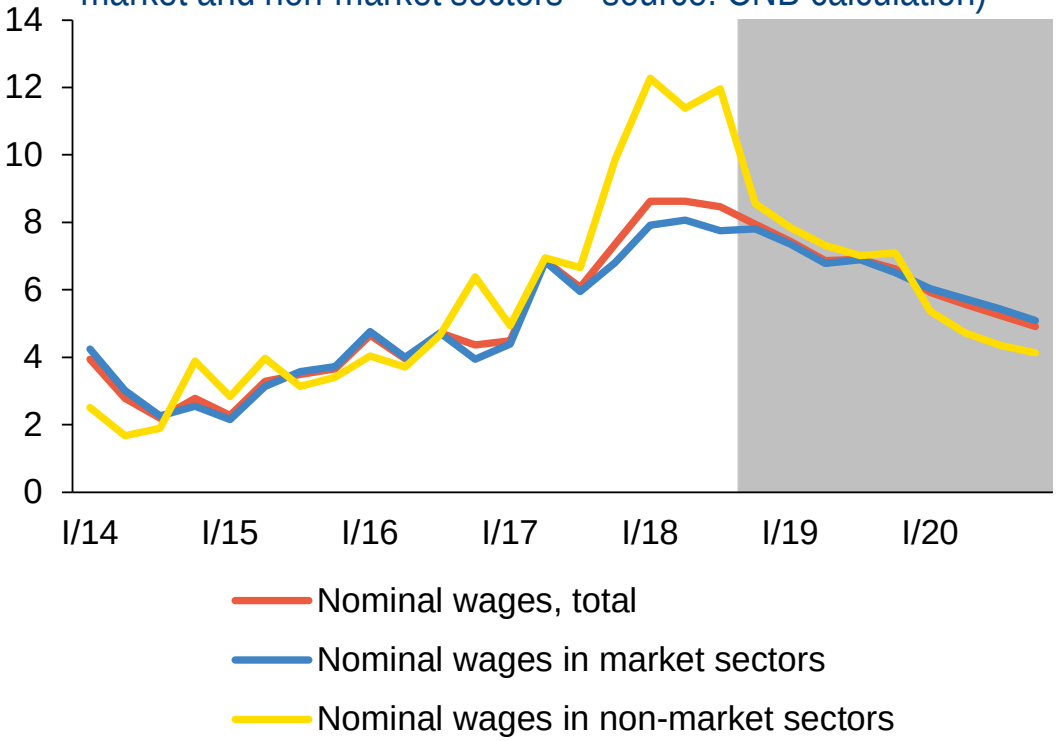


- FTE growth recently driven by headcounts
  - Employing previously discouraged workers leading to increasing number of part-timers. Most significant in age group 60+, but also young workers

Wage pressures easing only gradually

- Tight labour market would again drive wage growth in 2019
- Slowdown in 2019 mainly due to public sector wages, which continue to grow, but at slower pace than in 2018
  - Teachers' wages rose by 15%, other public servants on average by 6%, according to plan

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

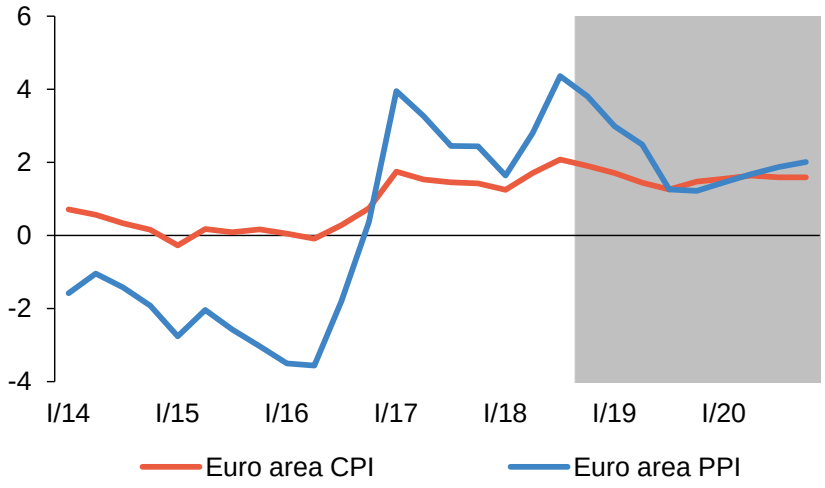


- Total wage growth easing below 7% this year
- Low unemployment continues to support wage demands of workers and unions
- In 2020, wage dynamics would adjust towards long-term equilibrium of around 5%

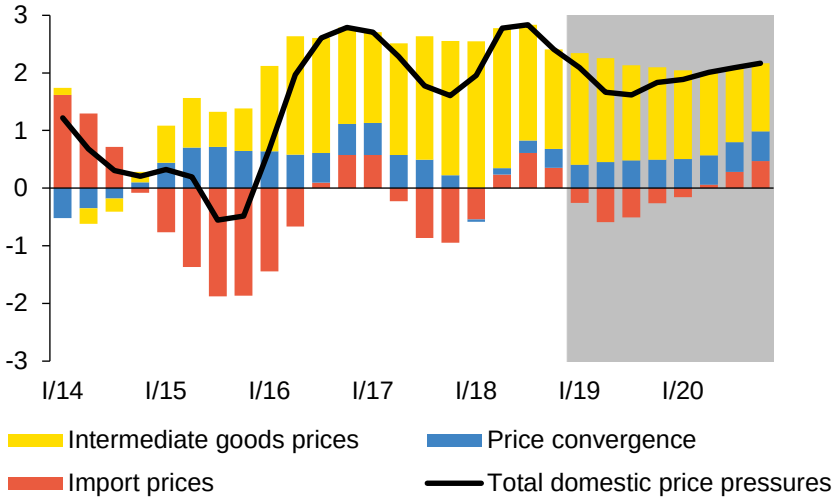
Lack of foreign price pressures

- Following oil price fall and demand weakness, contribution of foreign prices to domestic inflation has diminshed.
  - Despite koruna weakness
- With renewed koruna appreciation, imports would become cheaper and contribute negatively to domestic inflation
  - Import prices would start exerting price pressures again in 2020

Foreign price growth slowing
(y/y increase in euro area price levels)

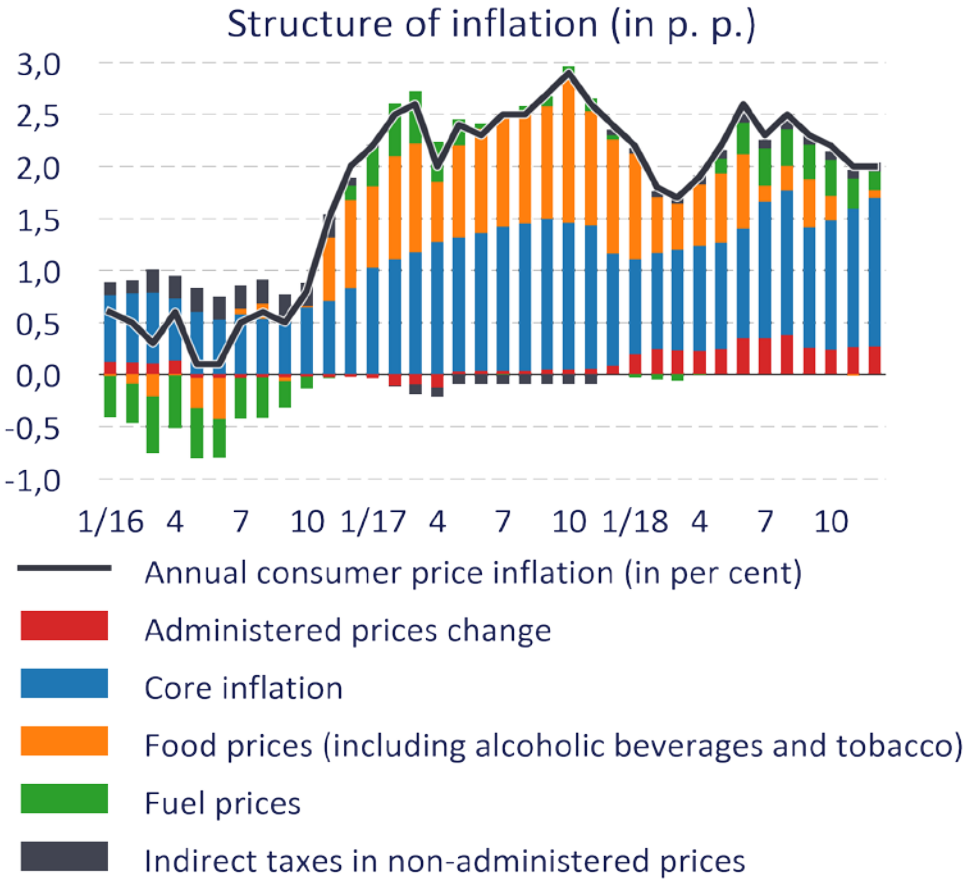


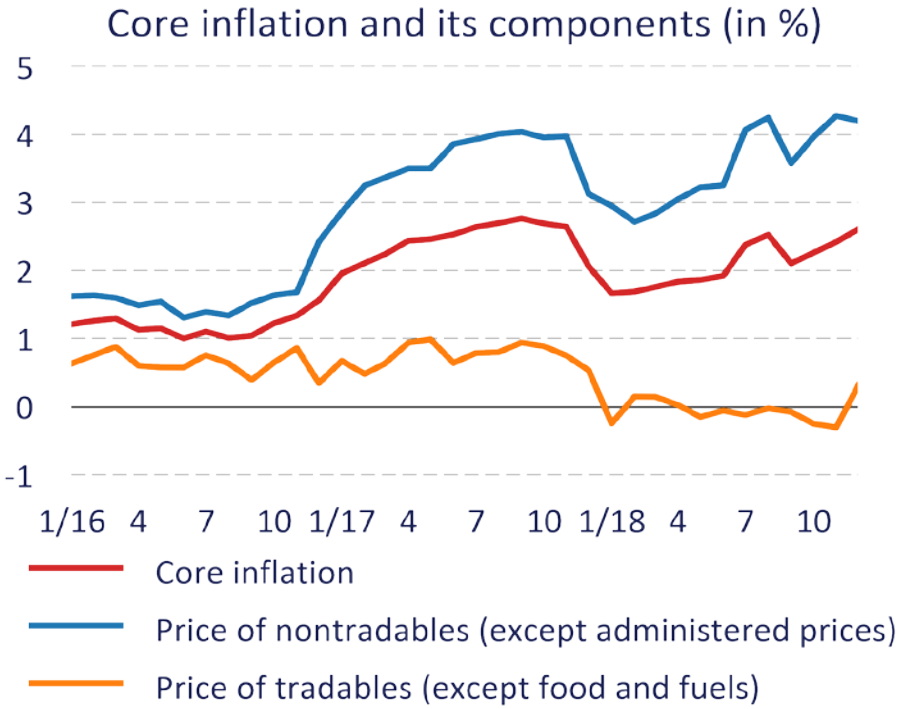
Costs in consumer sector
(contributions in p.p. to q/q increase in overall price pressures)



Inflation developments

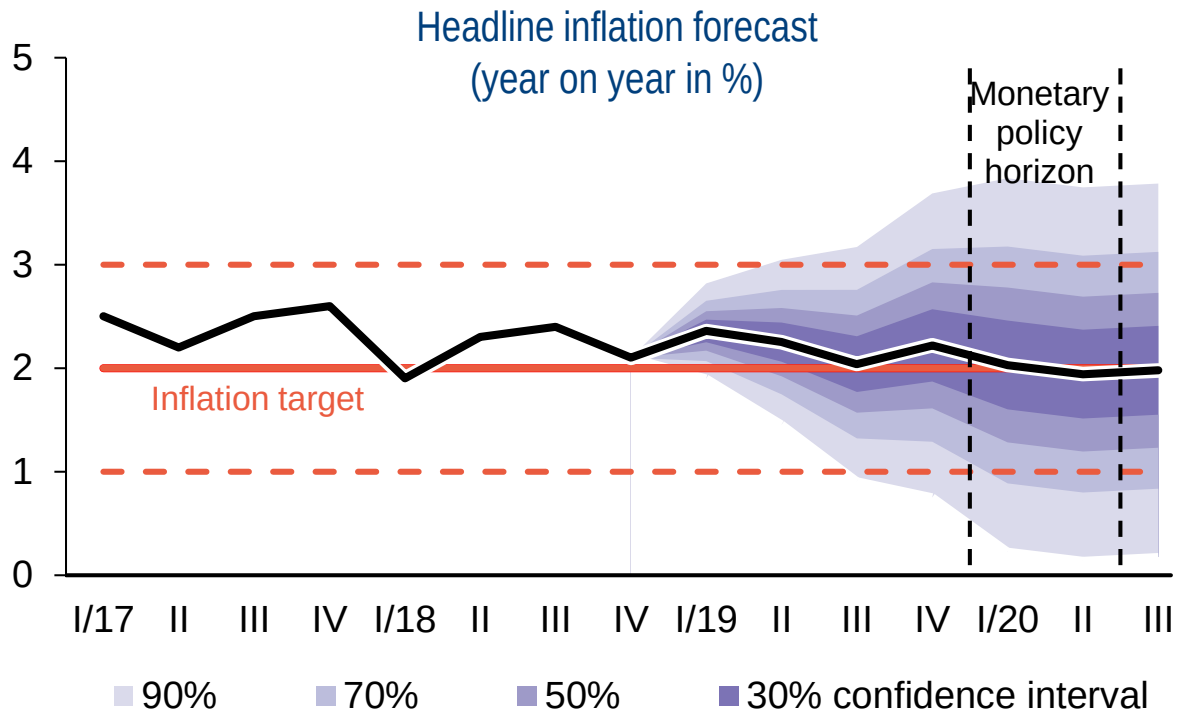
- Core inflation has remained main driver of price growth
  - With substantial contribution from imputed rent
  - Still, nontradables price growth illustrates domestic price pressures
- Food price growth has disappeared despite weak harvest





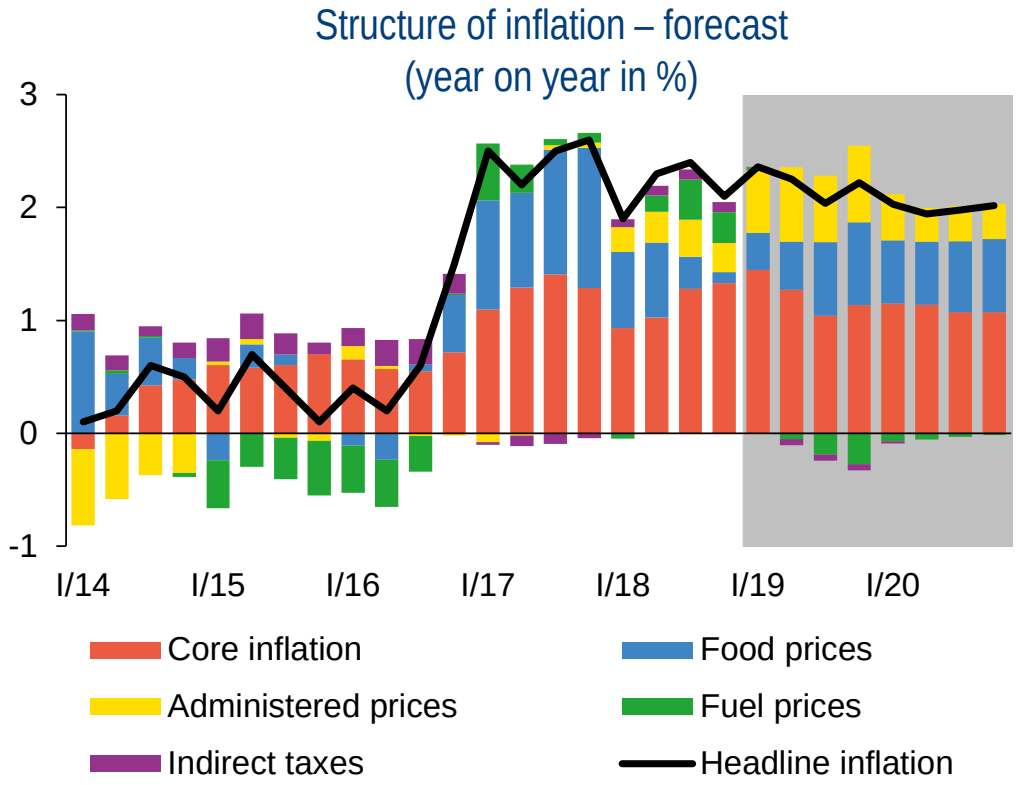
Inflation to stay close to the target

- Inflation to stay above target during 1H19 then converge to 2% from above.
- CZK appreciation would tame import price growth and limit growth of tradable goods prices.
- This would compensate strong domestic inflation pressures, resulting in inflation staying close to target.



Structure of inflation – core is driver

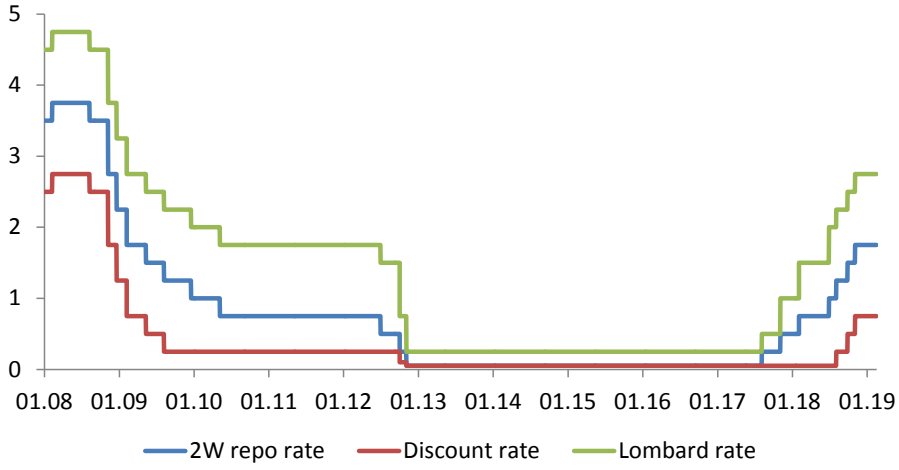
- Core inflation would remain main contributor
- Food price would accelerate as higher food commodity prices feed through to consumers
- Administered prices have jumped at start of 2019 due to energy (mainly electricity) repricing
- Fuel prices to ease off as a result of oil price correction



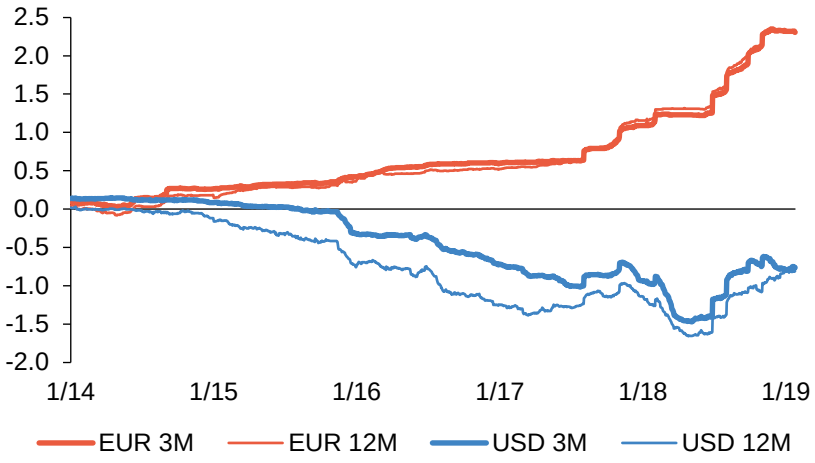
Monetary policy normalisation in progress

- Seven hikes since FX floor was ended in April 2017.
  - Ahead of regional peers and major trading partners in hiking cycle
  - But EUR-CZK rate differential not sufficient to ease pressures on koruna in 2018
  - Emerging market currencies suffered from USD rate hikes

Interest rate path towards neutral rates
(%)

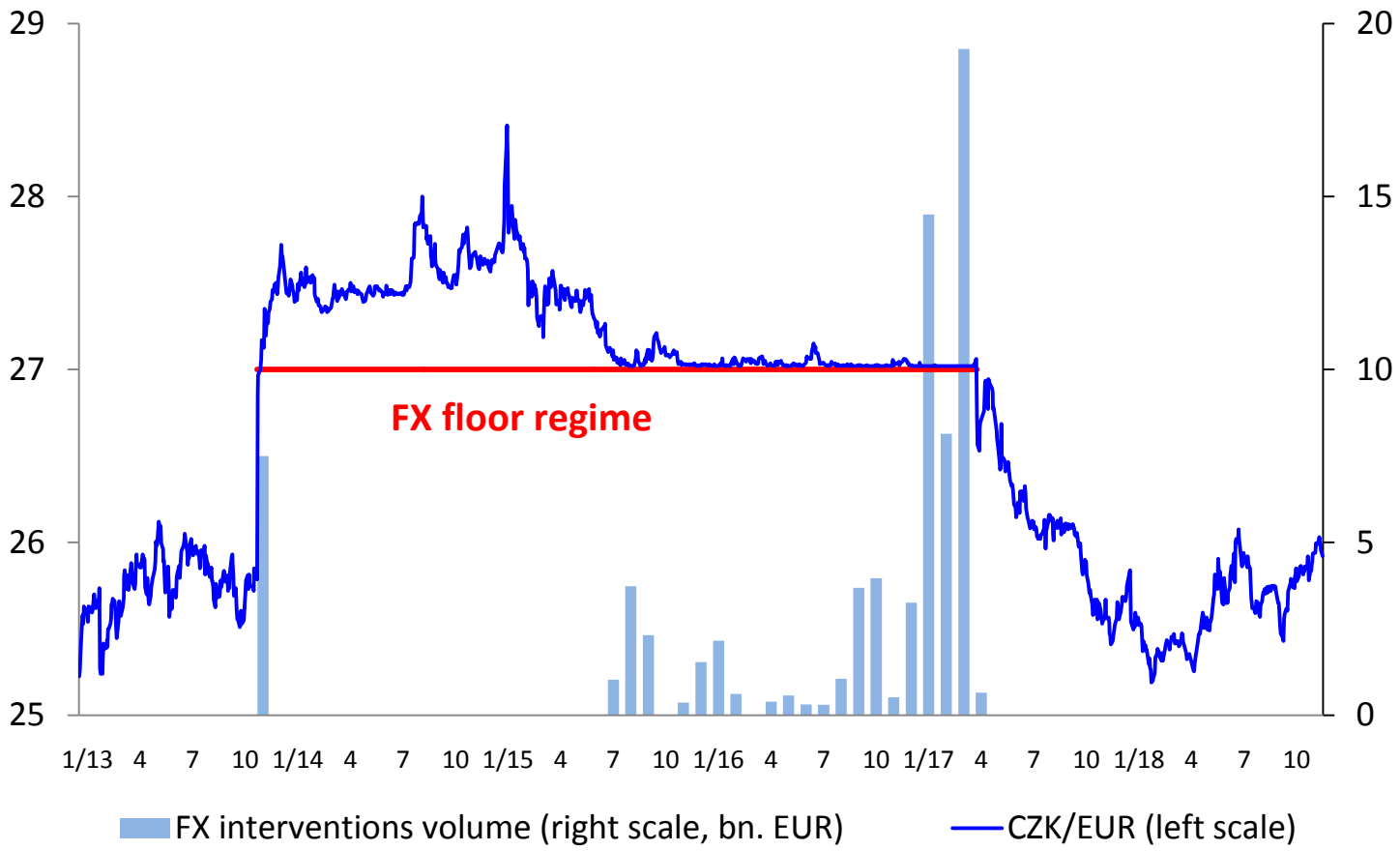


Differentials of CZK interest rates against EUR and USD
(%)



Koruna after FX floor

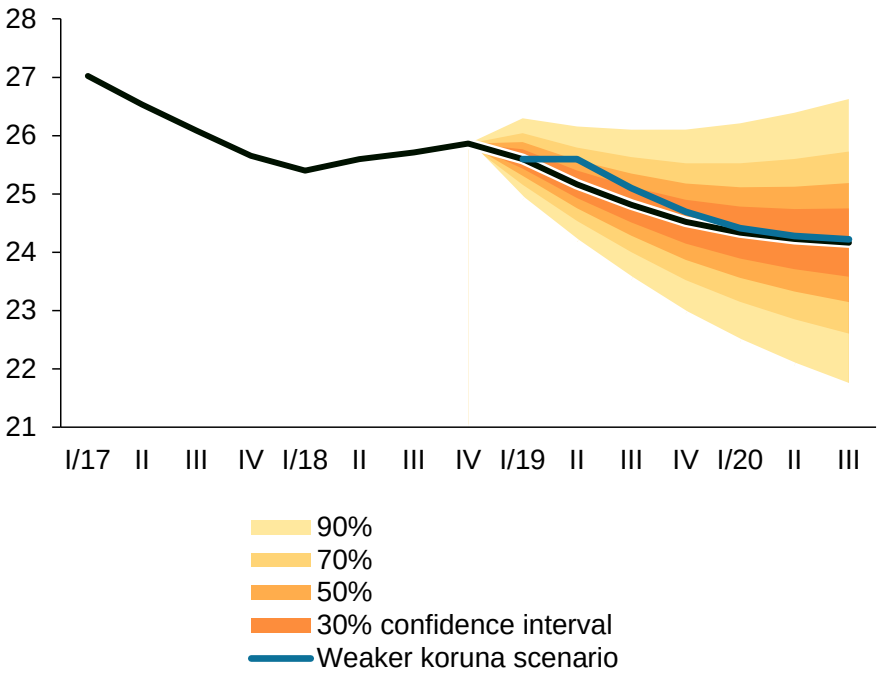
- Last months of FX commitment saw large volumes of newly accumulated reserves due to interventions
- Koruna gained in 2017 but appreciation halted in 2018. Emerging markets sell-off partially to blame.



Exchange rate forecast

- The forecast sees koruna getting below 25 CZK/EUR during 2019
  - Koruna will be supported by positive interest rate differential. Current account surpluses contributing to demand for CZK. Trend real appreciation is additional factor.

Exchange rate forecast
(CZK/EUR, quarterly averages)



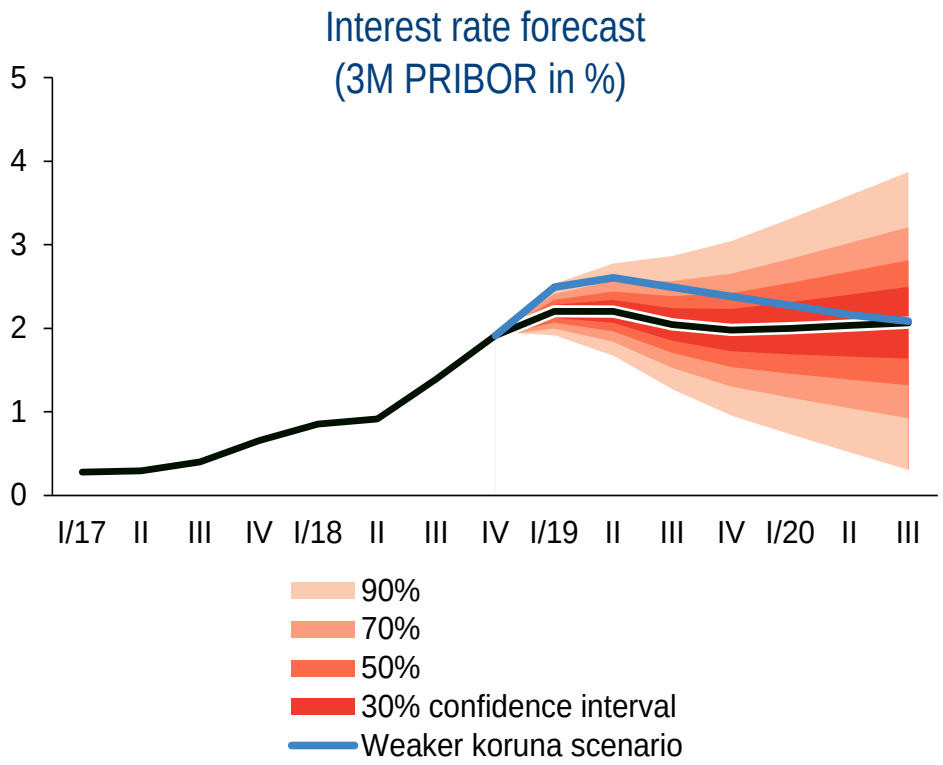
- Risk of more gradual appreciation due to excessive CZK liquidity:

	CPI inflation (in pp)	3M PRIBOR (in pp)	GDP growth (in pp)	Nominal exchange rate (CZK/EUR)
I/19	0.0	0.3	0.0	0.0
II/19	0.1	0.4	0.1	0.4
III/19	0.1	0.4	0.1	0.3
IV/19	0.2	0.4	0.1	0.2
I/20	0.2	0.3	0.0	0.1
II/20	0.1	0.1	-0.1	0.1
III/20	0.1	0.0	-0.2	0.1
IV/20	0.0	0.0	-0.1	0.1

(differences from baseline)

Interest rate path

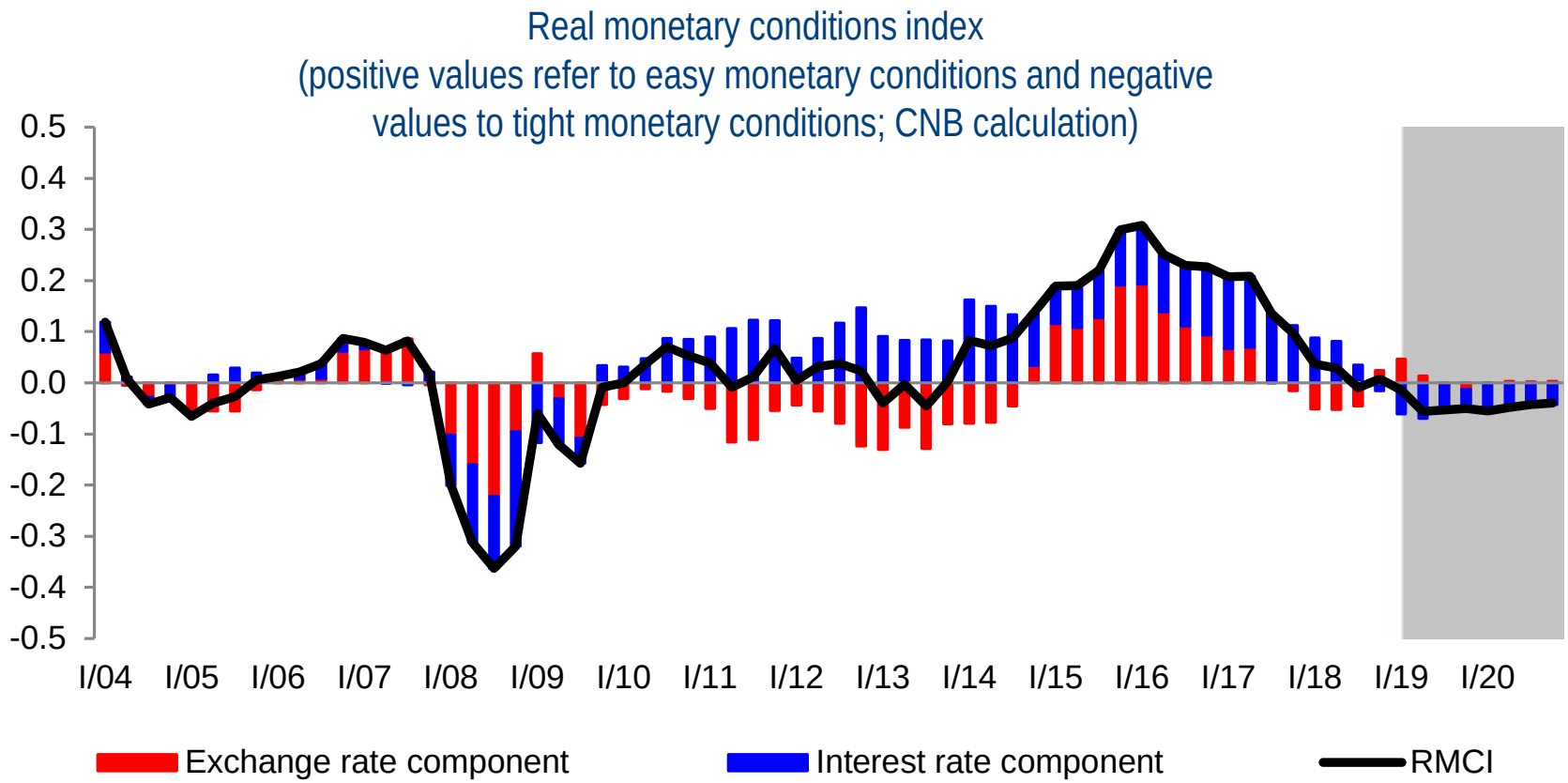
- Forecast implies broad stability of market interest rates at forecast horizon.
  - Rates are kept stable by outlook of postponed ECB hikes and expected koruna appreciation
- 3M PRIBOR expected to stay close to 2%



- Temporary lack of koruna strengthening would imply higher rates
- Beyond horizon of projection, rates would return towards neutral levels

Monetary conditions

- Monetary conditions have turned slightly restrictive as a result of interest rate hikes
- Exchange rate component was recently expansionary with koruna staying weak. This is about to correct.

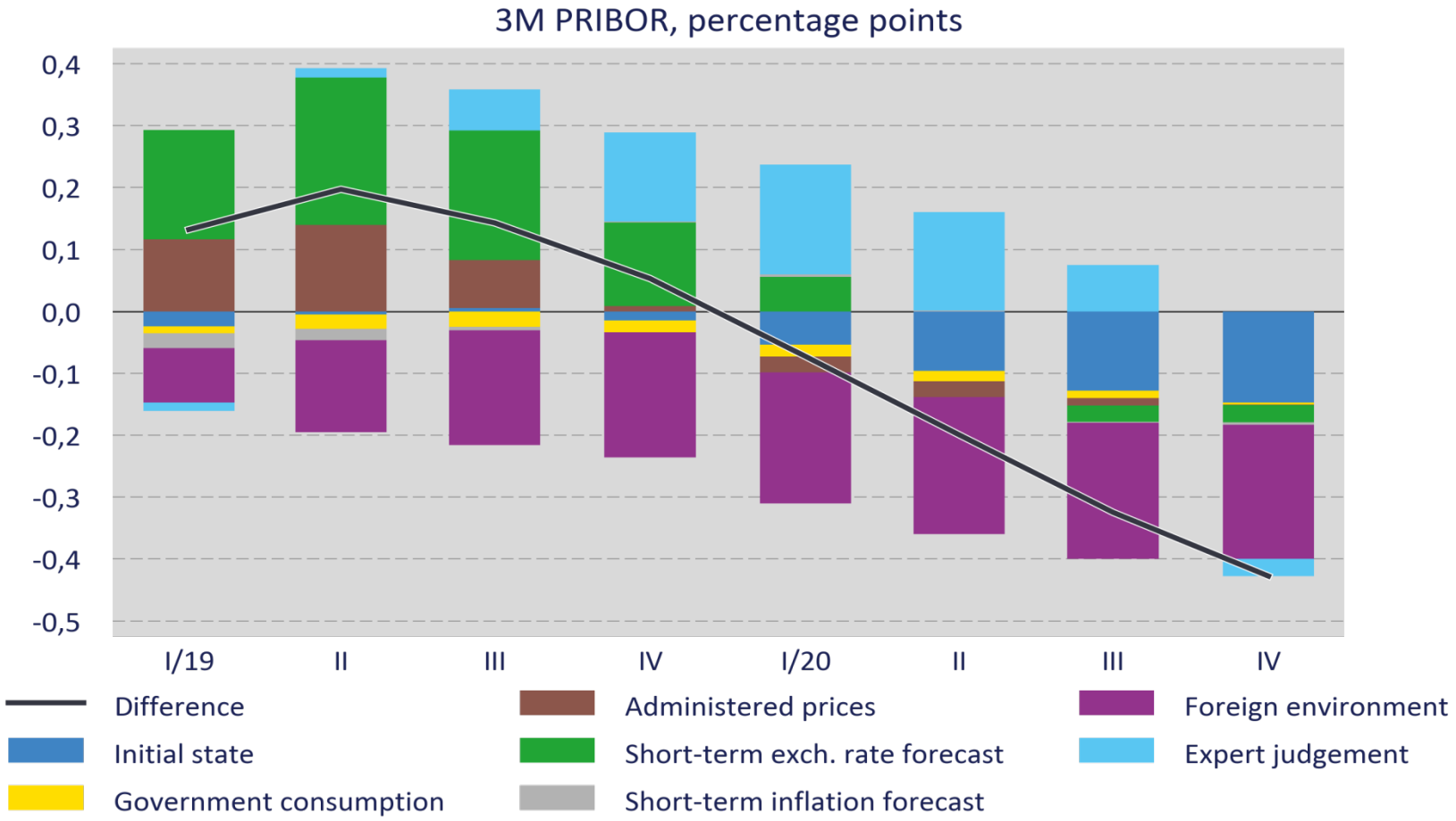


Current monetary policy setting

- Outcome of CNB Bank Board monetary policy meeting on 7 Feb 2019:
  - Bank Board assessed risks to forecast as being slightly inflationary.
  - Potential slower appreciation of koruna seen as risk for higher inflation and rates
  - Disorderly Brexit would slow domestic growth and further weaken koruna
  - Protectionist measures in international trade remain source of external uncertainty
- 2W repo rate remained at 1.75%, discount rate at 0.75% and Lombard rate at 2.75%.

Rate setting: what has changed?

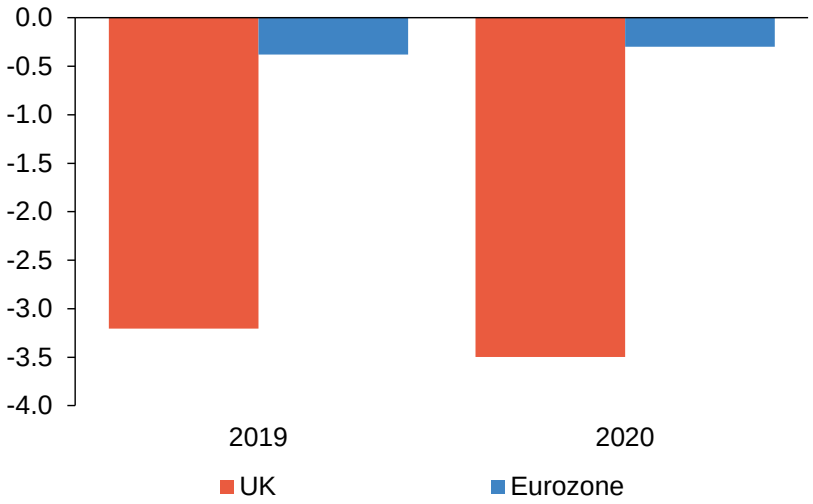
- Weaker koruna, including short-term forecast, suggesting higher rates
- Foreign environment (prices: EA PPI, rates: 3M EURIBOR) dragging domestic rate outlook down



Sensitivity scenario – hard Brexit

- Impact on external environment:
  - Direct impact on exports from CZ to UK (small)
  - Indirect impact through fall in euro area demand (large)
  - Includes significant EUR depreciation effect (against USD)

Impact of hard Brexit on GDP growth in UK and EA
(percentage points deviation from baseline)



(deviations from baseline scenario paths)

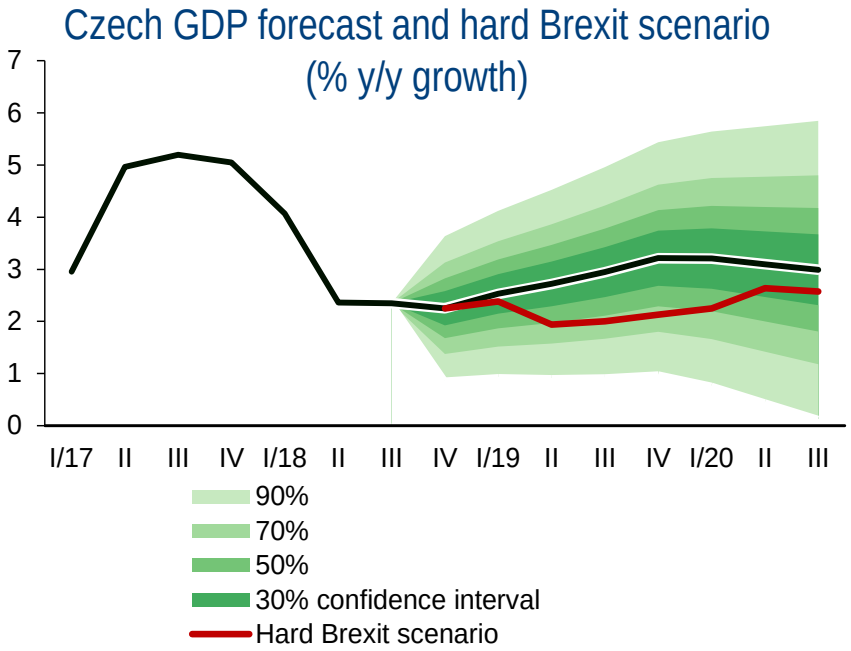
	Effective PPI inflation (in pp)	3M EURIBOR (in pp)	Effective GDP growth (in pp)	Exchange rate USD/EUR (in %)
I/19	0.0	0.0	0.0	0.0
II/19	0.5	0.0	-0.4	-4.8
III/19	0.7	0.1	-0.5	-5.3
IV/19	0.9	0.1	-0.6	-5.5
I/20	0.9	0.1	-0.6	-5.7
II/20	0.4	0.1	-0.3	-5.6
III/20	0.0	0.1	-0.2	-5.8
IV/20	-0.2	0.1	-0.1	-5.8

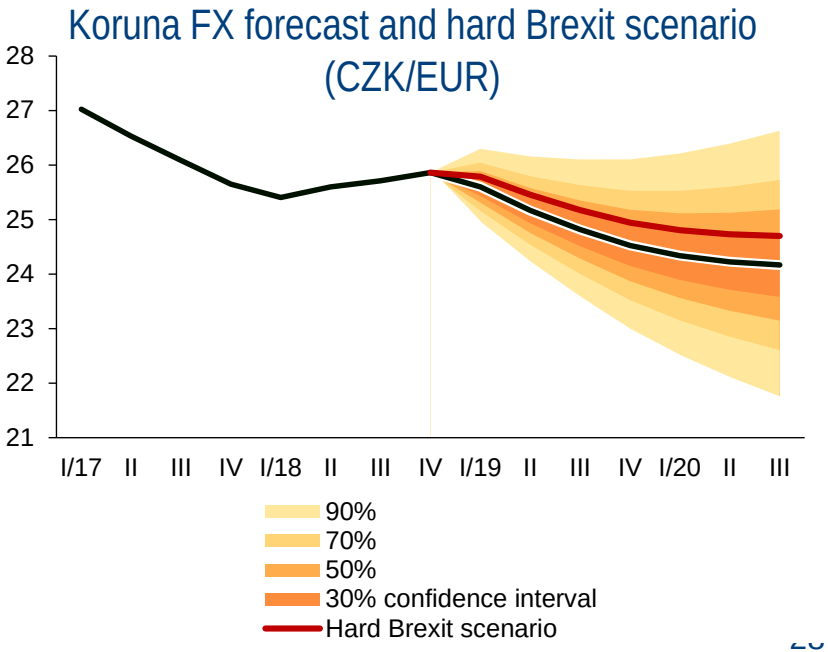
Sensitivity scenario – hard Brexit

- Domestic economy:
  - Lower growth (-1.1 p.p.)
  - Weaker koruna…
  - …implying higher inflation pressures…
  - …and higher rates.

(deviations from baseline scenario paths)

	CPI inflation (in pp)	3M PRIBOR (in pp)	GDP growth (in pp)	Nominal exchange rate (CZK/EUR)
I/19	0.0	0.2	-0.1	0.2
II/19	0.0	0.3	-0.8	0.3
III/19	0.0	0.4	-0.9	0.4
IV/19	0.1	0.4	-1.1	0.4
I/20	0.1	0.4	-1.0	0.5
II/20	0.1	0.3	-0.5	0.5
III/20	0.1	0.2	-0.4	0.5
IV/20	0.1	0.1	-0.4	0.6

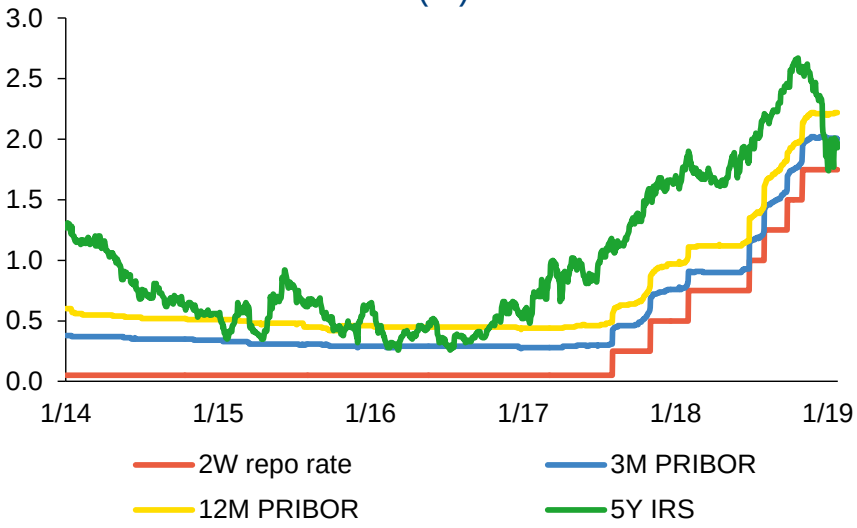




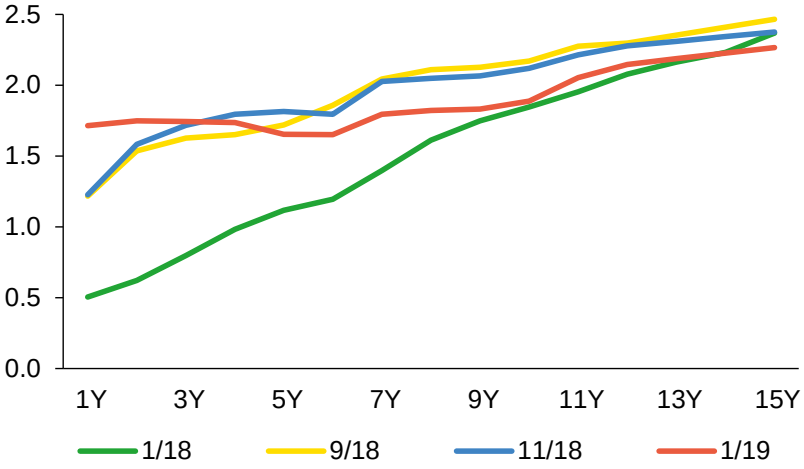
Monetary policy transmission: market

- Monetary policy rates passing through to money market rates up to 1–2 years.
- Longer end of yield curve has dropped
  - Both on IRS and govt. bond market
  - Global uncertainty about growth and price developments (and monetary policy reaction) has pushed longer yields down

Monetary policy and financial market interest rates
(%)



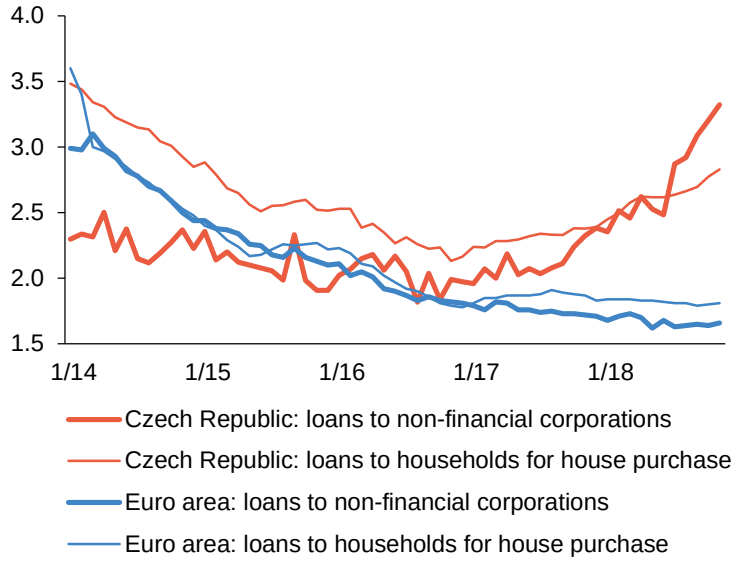
Govt. bond yield curve has flattened
(%)



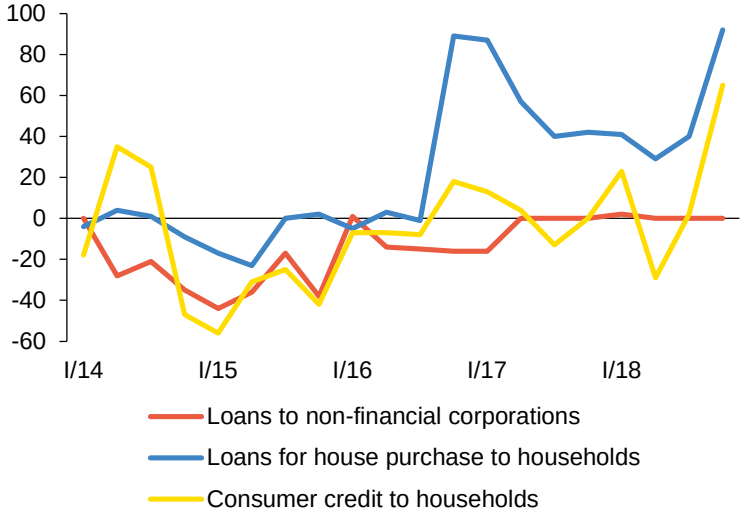
Monetary policy transmission: clients

- Client rates have increased too
  - Rates on loans to non-financial corporations exceeded 3% in 2H18
  - Rates on mortgage loans to households at 2.8% at end of previous year
- Credit standards have tightened mainly for household sector
  - Reflecting new CNB recommendations on DTI, DSTI

Transmission to client rates (%)



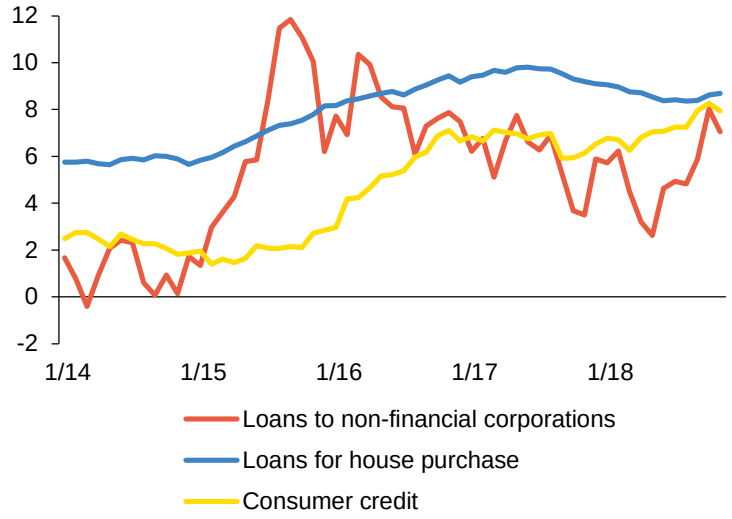
Credit standards tighten
(% of the market, positive = tighter standards)



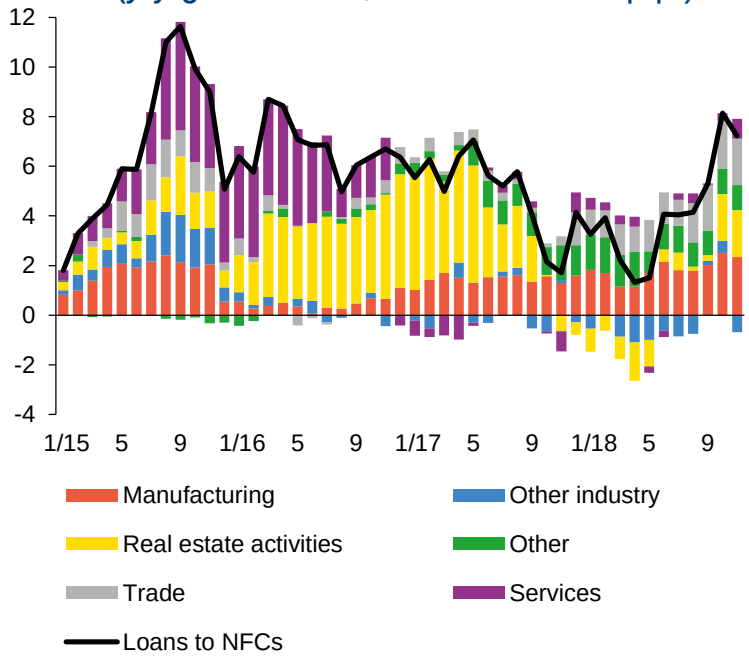
Credit market developments

- Growth in loans to private sector picked up slightly to 7.5% towards end of 2018
  - Loans to NFC peaked at 8% in Oct, steady dynamics in household loans
- Among NFCs, it was mainly tertiary sector that contributed to acceleration of borrowing

Loans to private non-financial sector
(y/y growth in %)



Structure of loans to non-financial corporations
(y/y growth in %, contributions in p.p.)



Summary

- Despite foreign weakness, Czech economy has shown resilience
- Labour market remains extremely tight, supporting wage growth and demand (both consumption and investment)
- Domestic price pressures counteracted by foreign anti-inflationary factors, fostered by expected koruna exchange rate appreciation
- Consistent with recent CNB forecast is broad stability of market interest rates
- Risks of slower koruna appreciation and foreign trade disruptions would suggest need to increase rates

Thank you for your attention

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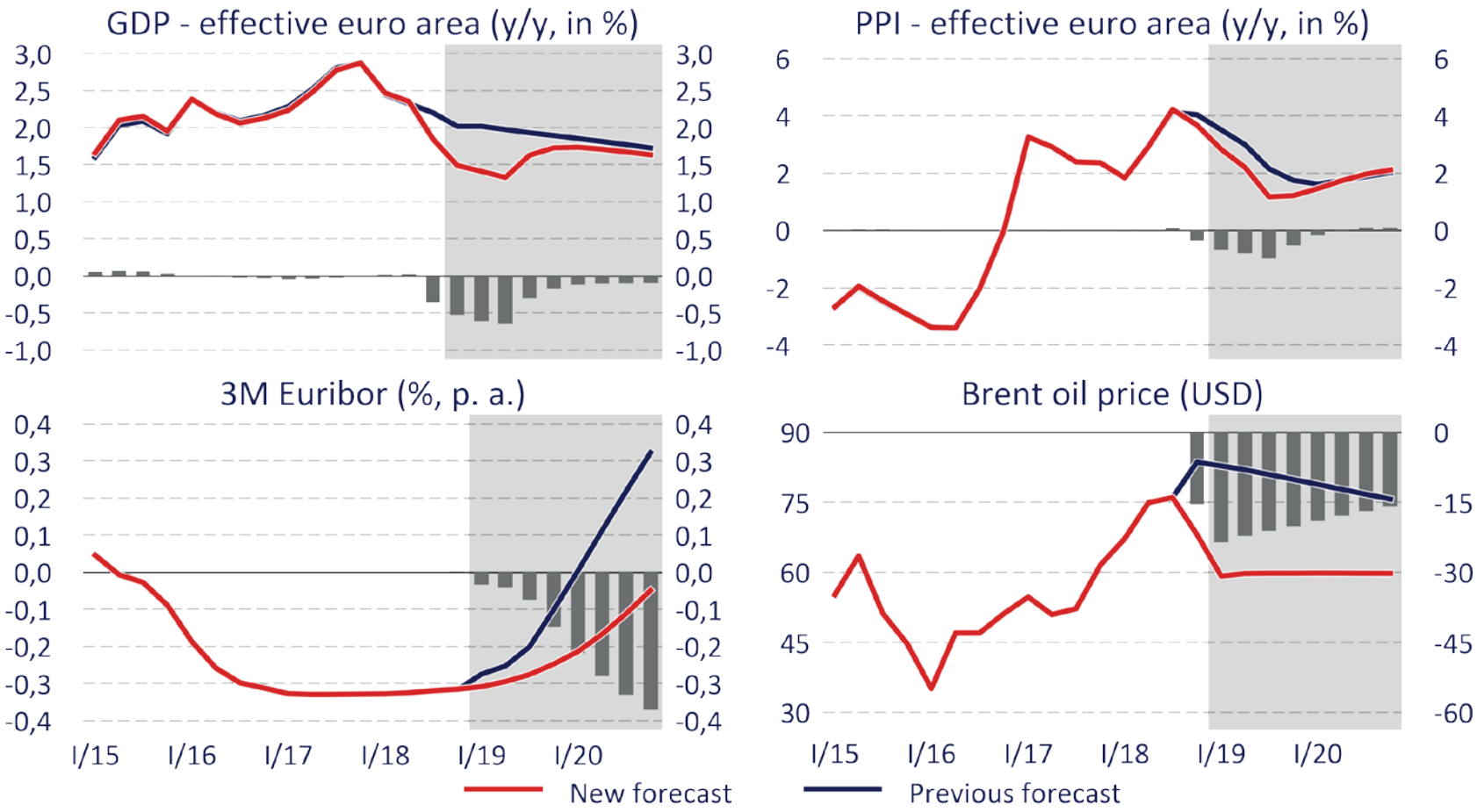
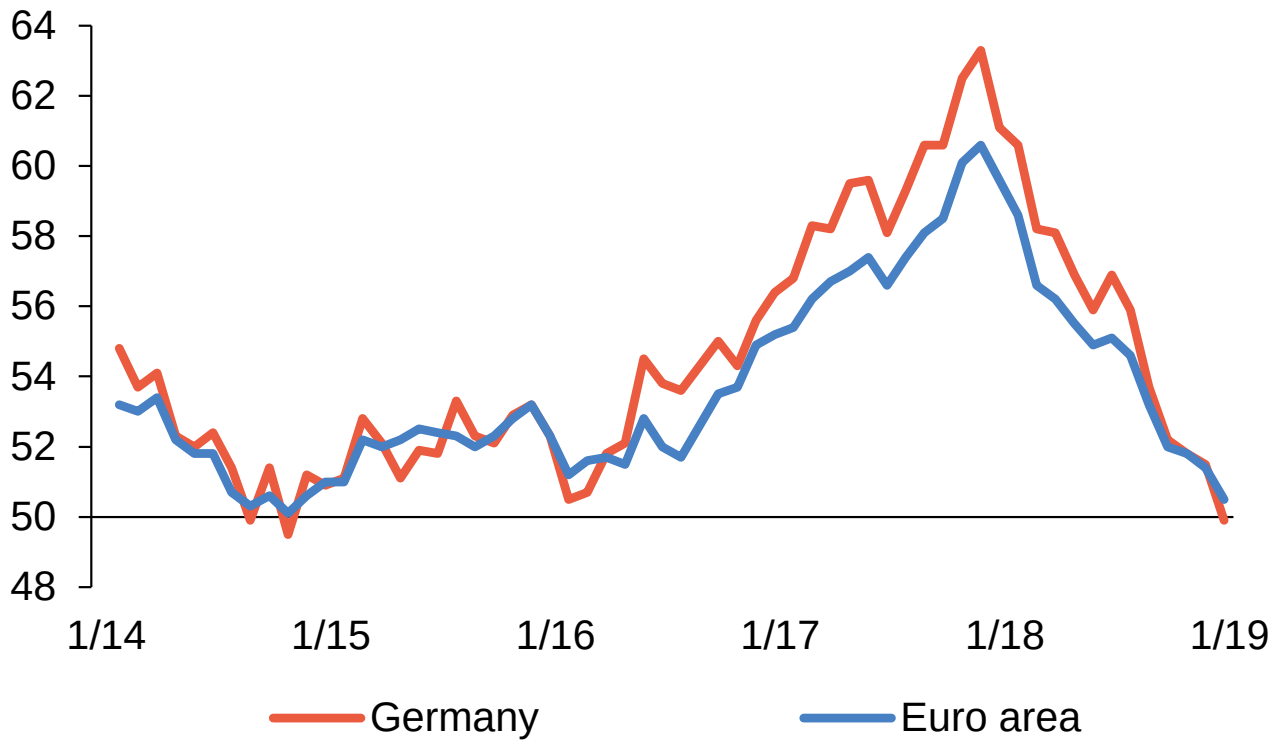
External environment outlook: all down



- GDP growth in effective eurozone revised down.
- Producer price dynamics too.
- 3M EURIBOR outlook fell by a few decimal points.
- Brent oil price sharply down.

PMIs: close to signalling recession in EA



- Purchasing managers' index in manufacturing
- >50: growth, <50: recession
- In Germany, PMI is indicating recession. Is this only temporary stumble caused by one-off factors?
- New emission standards, low waterline in Rhine, chemical industry disruptions.