Quo Vadis 2019: Czech economic perspectives and CNB policy

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CNB Board Member

Prague, 20 Feb 2019
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 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

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>2.8</td>
<td>2.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Household consumption</td>
<td>3.5</td>
<td>3.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Government consumption</td>
<td>3.5</td>
<td>2.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Gross capital formation</td>
<td>4.6</td>
<td>5.9</td>
<td>4.3</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>9.4</td>
<td>4.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>4.3</td>
<td>3.9</td>
<td>5.7</td>
</tr>
<tr>
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<td>5.8</td>
<td>5.5</td>
<td>6.2</td>
</tr>
</tbody>
</table>
Structure of growth

Contributions to growth – demand side

• 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.
Both private and public consumption to stay solid

- 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

Disposable income keeps growing, supporting demand

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

<table>
<thead>
<tr>
<th>FISCAL IMPULSE</th>
<th>2017 actual</th>
<th>2018 exp. outcome</th>
<th>2019 forecast</th>
<th>2020 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>of which impact through:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>private consumption</td>
<td>0.2</td>
<td>0.4</td>
<td>0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>private investment</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>government investment, domestic</td>
<td>0.0</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>government investment, EU funded</td>
<td>0.0</td>
<td>0.2</td>
<td>0.1</td>
<td>0.0</td>
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</tbody>
</table>
Output gap and 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.

(percentage deviations from potential output)  (contributions in p.p. to q/q increase in domestic price pressures)
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

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
- 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 diminished.
  - 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
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

Structure of inflation – forecast
(year on year in %)

- Core inflation
- Administered prices
- Food prices
- Fuel prices
- Indirect taxes
- Headline inflation
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 (%)
• 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.
• 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.

Risk of more gradual appreciation due to excessive CZK liquidity:

<table>
<thead>
<tr>
<th></th>
<th>CPI inflation (in pp)</th>
<th>3M PRIBOR (in pp)</th>
<th>GDP growth (in pp)</th>
<th>Nominal exchange rate (CZK/EUR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I/19</td>
<td>0.0</td>
<td>0.3</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>II/19</td>
<td>0.1</td>
<td>0.4</td>
<td>0.1</td>
<td>0.4</td>
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<tr>
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<td>0.1</td>
<td>0.4</td>
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<td>0.3</td>
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<tr>
<td>IV/19</td>
<td>0.2</td>
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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.

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

<table>
<thead>
<tr>
<th></th>
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<th>3M EURIBOR</th>
<th>Effective GDP growth</th>
<th>Exchange rate USD/EUR</th>
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<tbody>
<tr>
<td>I/19</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>II/19</td>
<td>0.5</td>
<td>0.0</td>
<td>-0.4</td>
<td>-4.8</td>
</tr>
<tr>
<td>III/19</td>
<td>0.7</td>
<td>0.1</td>
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<tr>
<td>IV/19</td>
<td>0.9</td>
<td>0.1</td>
<td>-0.6</td>
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<tr>
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<td>0.9</td>
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Sensitivity scenario – hard Brexit

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

<table>
<thead>
<tr>
<th>(deviations from baseline scenario paths)</th>
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<td></td>
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<tr>
<td><strong>CPI inflation (in pp)</strong></td>
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</tbody>
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Czech GDP forecast and hard Brexit scenario (% y/y growth)

Koruna FX forecast and hard Brexit scenario (CZK/EUR)
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 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 (\%)](chart1.png)

![Credit standards tighten (% of the market, positive = tighter standards)](chart2.png)
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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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.