Czech economic perspectives and CNB monetary policy

Vojtěch Benda
CNB Board Member

London, 9 Sep 2019
The Czech economy: an island of stability?
The storm outside...

• ...plus German GDP stagnation and industrial production decline
• Fellow central banks have turned to easing mode
But the world we live in...

- Inflation outlook being repeatedly revised upwards
• ...and core inflation!
• GDP somewhat weaker but broadly on track
• We have been revising CZK outlook...
...which has contributed to faster hiking
The CNB’s new core projection model enables us to capture economic phenomena more accurately and improves the model’s predictive properties.

The main extensions of g3+ include:

- external block richer in structure and more internally consistent
- division of foreign producer prices into their energy and core components
- inclusion of energy in factors of domestic production;
- introduction of “hand-to-mouth” households
- new way of working with exogenous outlooks
- recalibration of selected model parameters and long-term equilibrium levels
• The economy is slowing from its peak
• We expect a “soft patch” rather than a recession
• The economy is still grappling with inflationary pressures stemming from the recent growth episode
• The labour market remains tight and wages are continuing to grow rapidly; mild signs of a turnaround are visible
• The risk of a deeper foreign slowdown is offset by higher observed inflation and weaker CZK
A soft patch, not a recession

GDP forecast (% yoy growth)

90% 70% 50% 30% confidence interval  Observed
• Less investment than we had expected, domestic economy more proinflationary
• Fixed investment growth stopped in 2019 Q2 according to first estimate
Since then: retail solid, industry dropping

- Divergence between solid retail sales, driven by domestic demand, and drop in industrial production, driven by weak foreign demand
- Retail ex cars showed solid 4.8%, while industry dropped by 1.9% (yoy, swda)
- Employment in industry fell by 0.9%, while wages kept growing by 6.9%
Inflation to gradually return to the target

CPI inflation forecast (% yoy growth)

Monetary policy horizon

Inflation target

90% 70% 50% 30% confidence interval Observed
• Also, core inflation has been source of recent inflationary surprises
This year, labour unions still had enough bargaining power amid record-low unemployment and full order books.

We don’t expect optimism to prevail at such a level in 2020.
Beveridge curve: beyond a turning point

Beveridge curve
(numbers in thousands; seasonally adjusted; annual percentage changes for core inflation; source: MLSA, CZSO)
We still expect the koruna to gain, but much less than in our previous forecasts. The risks are clearly tilted towards a weaker FX rate, as also indicated by the observed path to date.
Interest rates: tighten and ease again

- "Consistent with the forecast is a modest rise in domestic market interest rates initially followed by a decline in 2020."
- As you know, no change was made in early August
The foreign environment (esp. rates) is pushing our trajectory down.

A more pro-inflationary state of the domestic economy would be a reason for revising up.
• Inflation has surprised on the upside recently and is touching the upper limit of our target tolerance band
• From our ex-post evaluation of the forecast and policy, it is apparent that...
  • With knowledge of the global factors adversely affecting CZK, our monetary policy should have been tighter and hiking faster
  • That policy would have led to inflation being closer to the target now
After the German stagnation, even the domestic data are starting to look worrisome.

The labour market is beyond a turning point.

Wages and prices are still marching ahead.

But we should not fight the battles of yesterday.

How long can domestic demand substitute for the foreign weakness?

Weaker CZK might warrant higher rates.

But monthly activity indicators suggest lower inflation pressures in the pipeline.
Thank you for your attention

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We are in a late phase of the financial cycle, with credit to HHs and property prices showing some cyclical overheating.

Interest rate spreads have become very low on the back of MP tightening.

NFCs’ indebtedness (relative to operating surplus) is also high.
Brexit + trade wars vulnerability

- % of value added at risk according to OECD TiVA tables (Bloomberg Economics and CNB)
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

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<tr>
<th>(deviations from baseline scenario paths)</th>
<th>Effective PPI inflation (in pp)</th>
<th>3M EURIBOR (in pp)</th>
<th>Effective GDP growth (in pp)</th>
<th>Exchange rate USD/EUR (in %)</th>
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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

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**Czech GDP forecast and Hard Brexit scenario** (% yoy growth, May forecast)

**Koruna ER forecast and Hard Brexit scenario** (CZK/EUR, May forecast)