Czech economic perspectives and CNB monetary policy

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CNB Board Member

London, 9 Sep 2019

The Czech economy: an island of stability?

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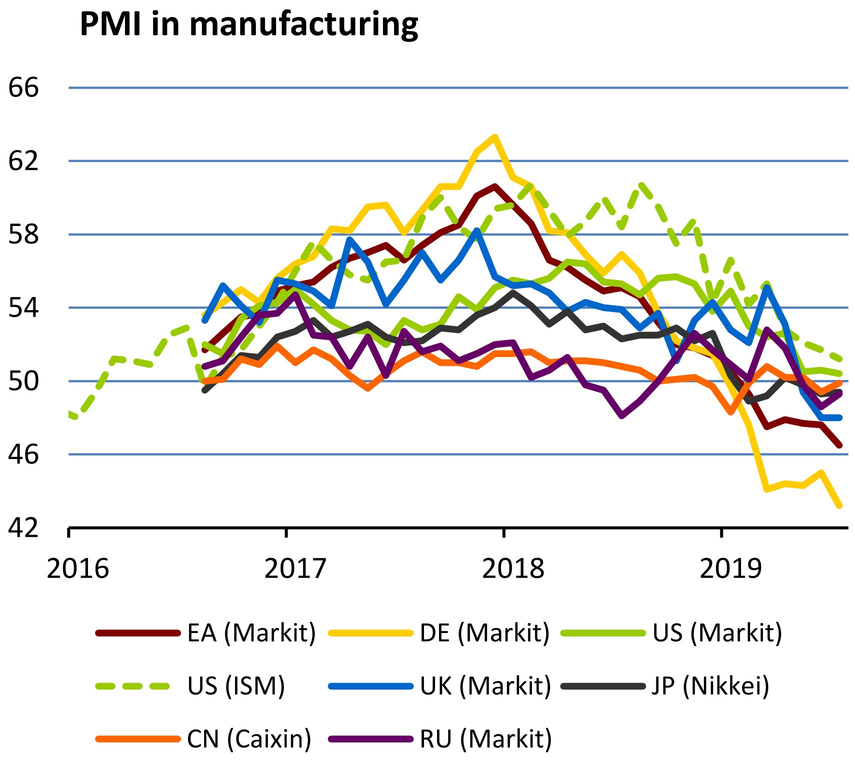
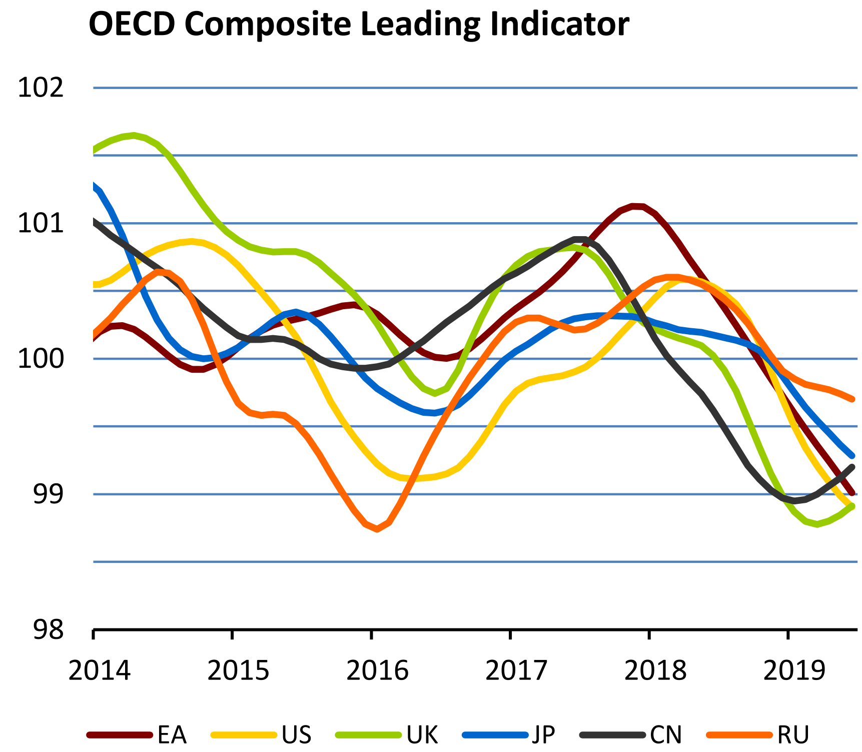
The storm outside…

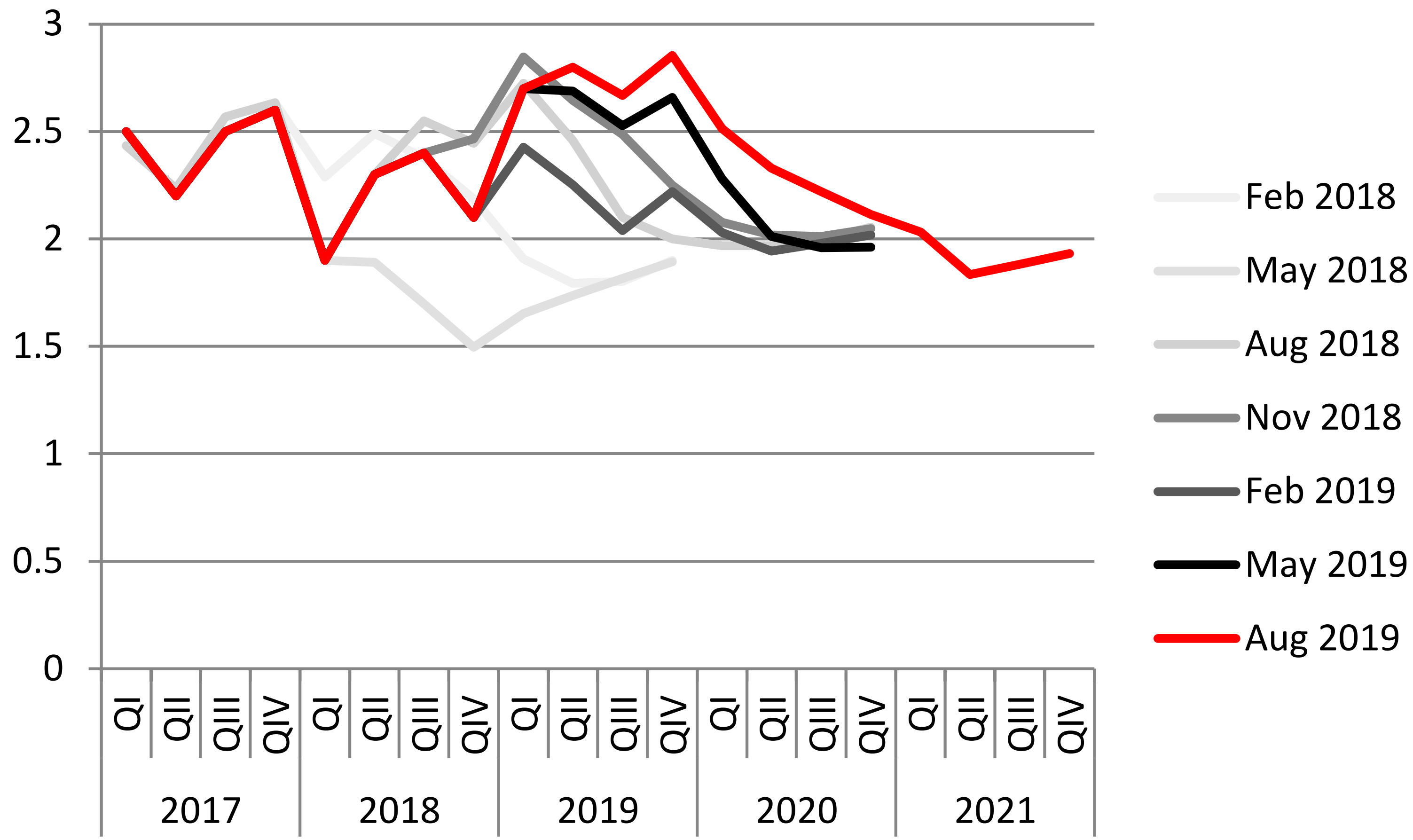




- …plus German GDP stagnation and industrial production decline
- Fellow central banks have turned to easing mode

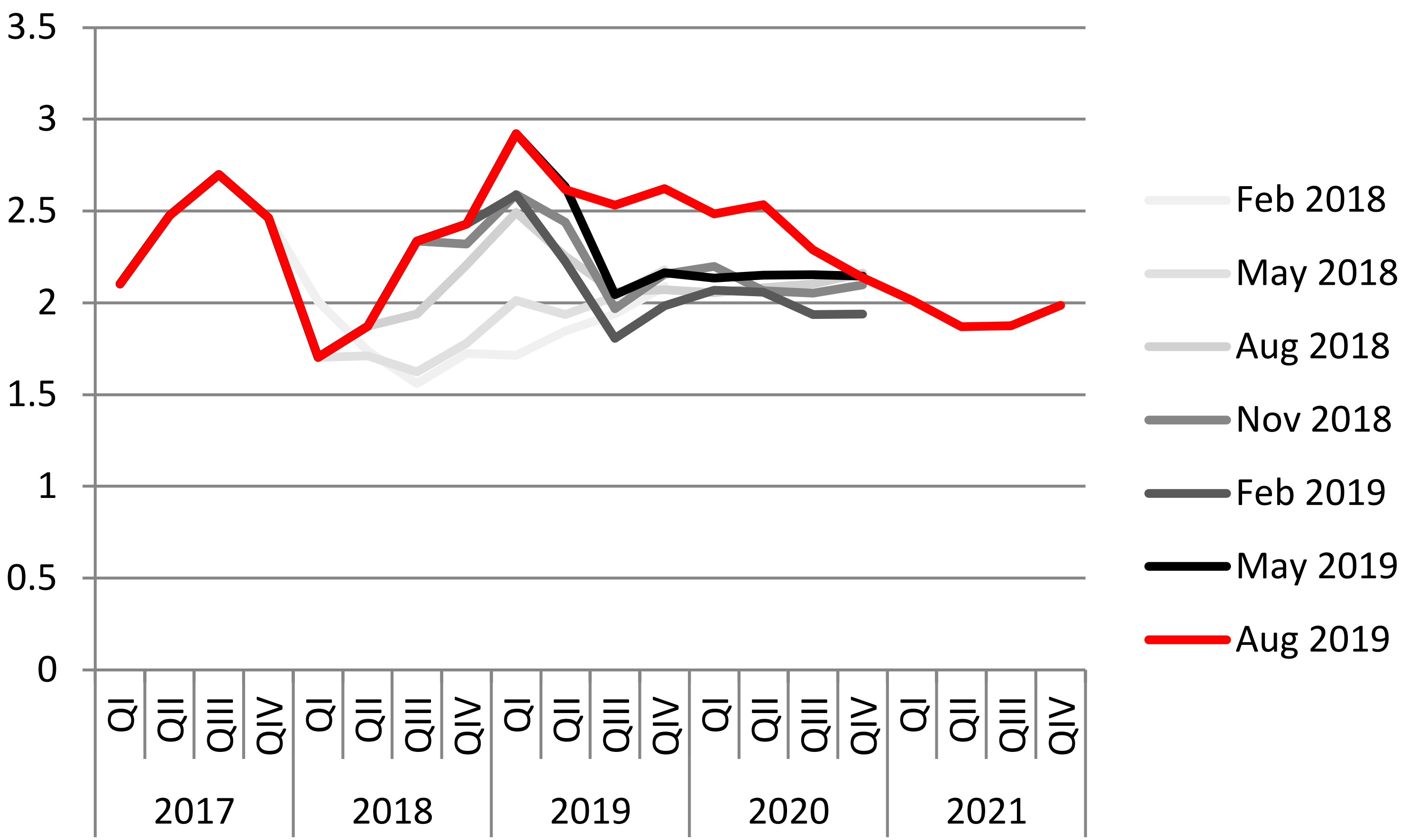
But the world we live in…

- Inflation outlook being repeatedly revised upwards



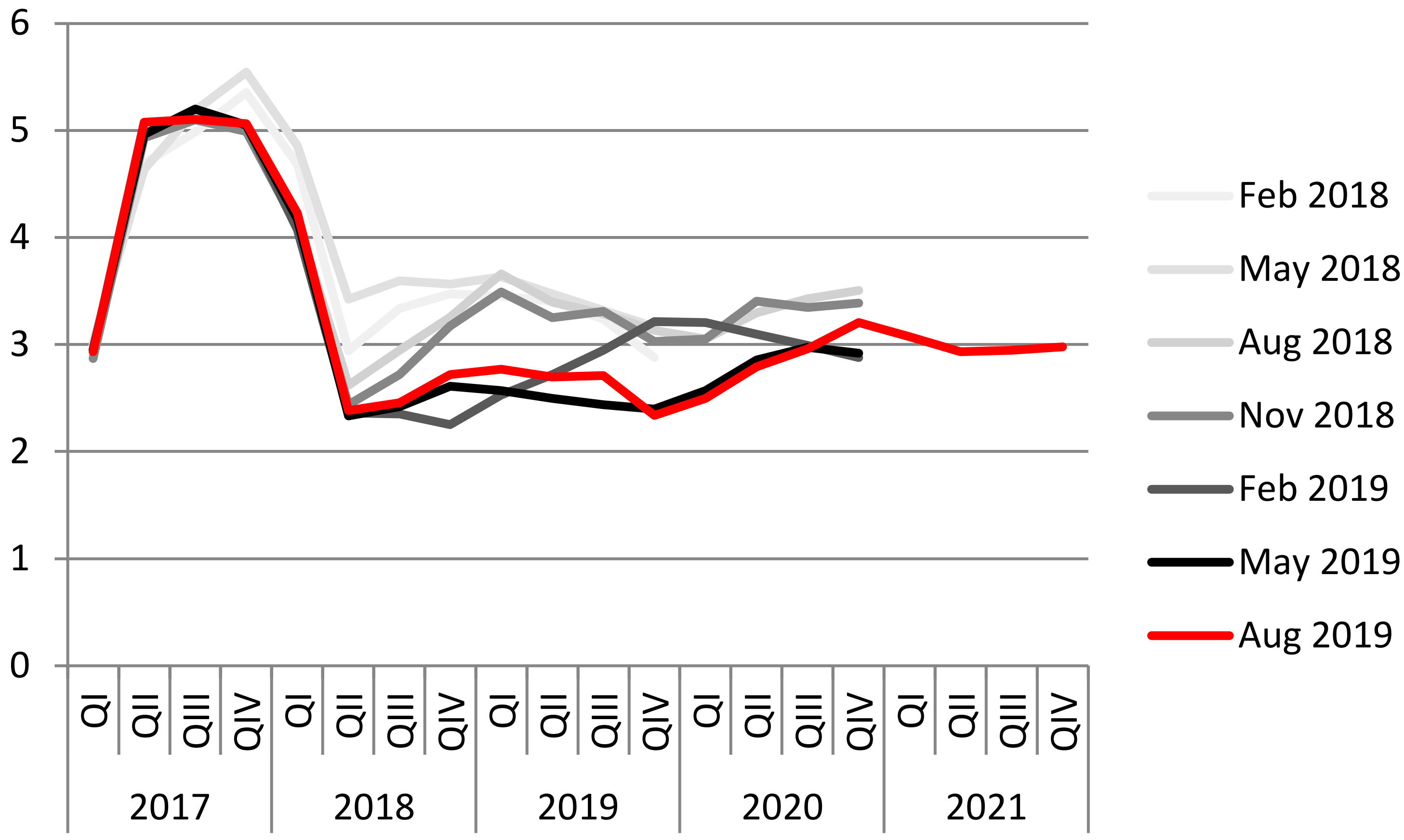
The world we live in (continued)

- …and core inflation!

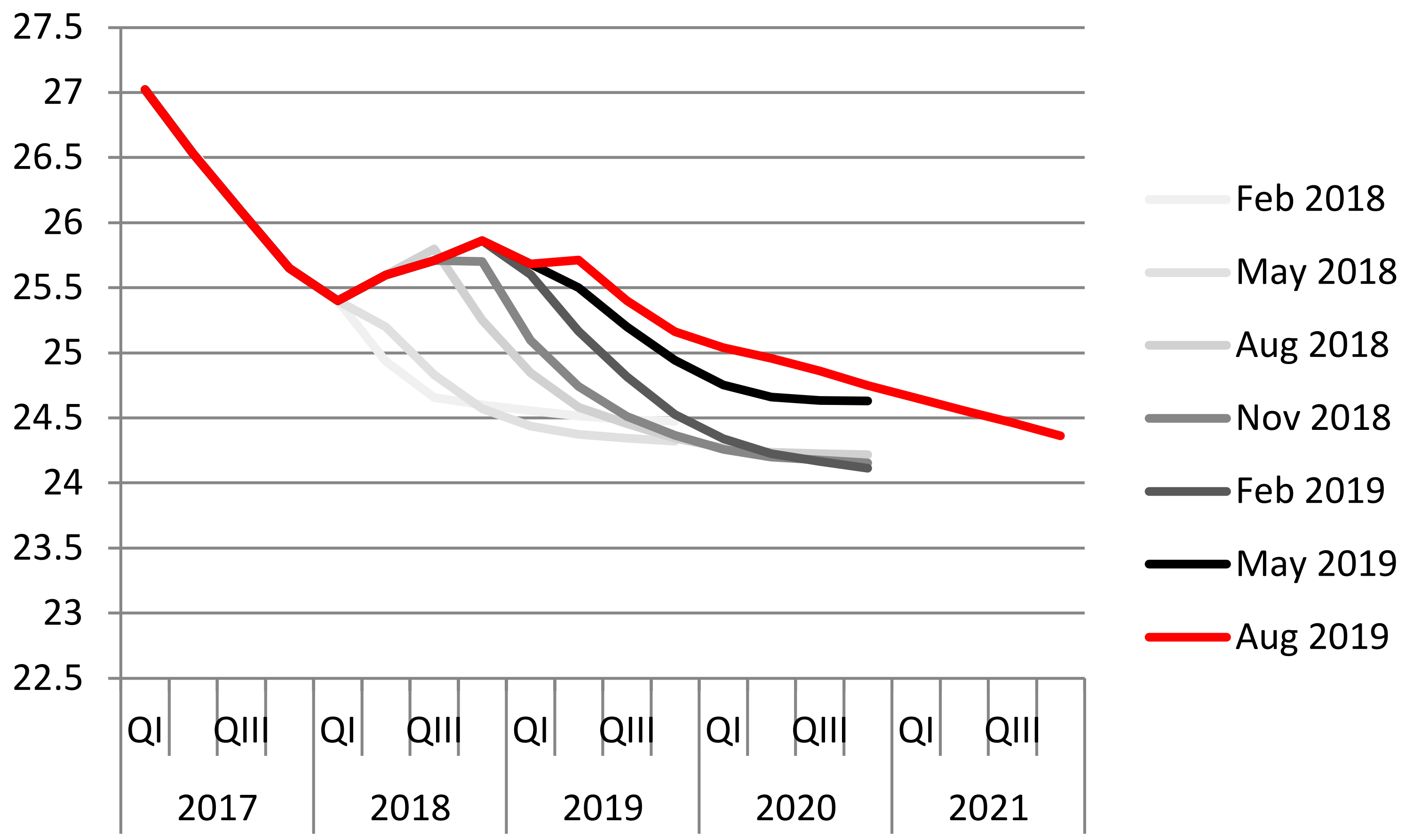


The world we live in (continued)

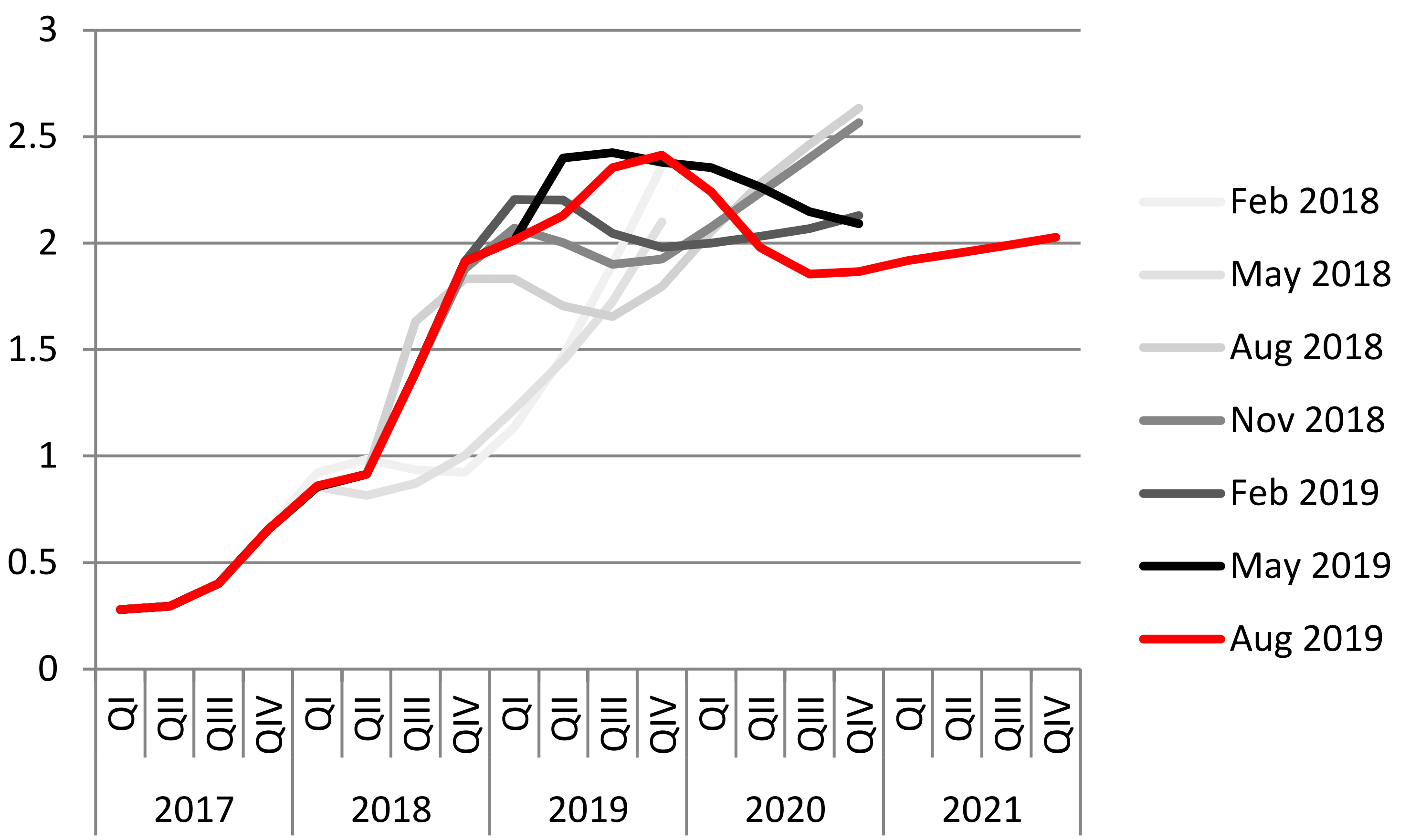
- GDP somewhat weaker but broadly on track



- We have been revising CZK outlook…



- …which has contributed to faster hiking



Revamp of CNB forecasting model: G3+

- The CNB’s new core projection model enables us to capture economic phenomena more accurately and improves the model’s predictive properties.

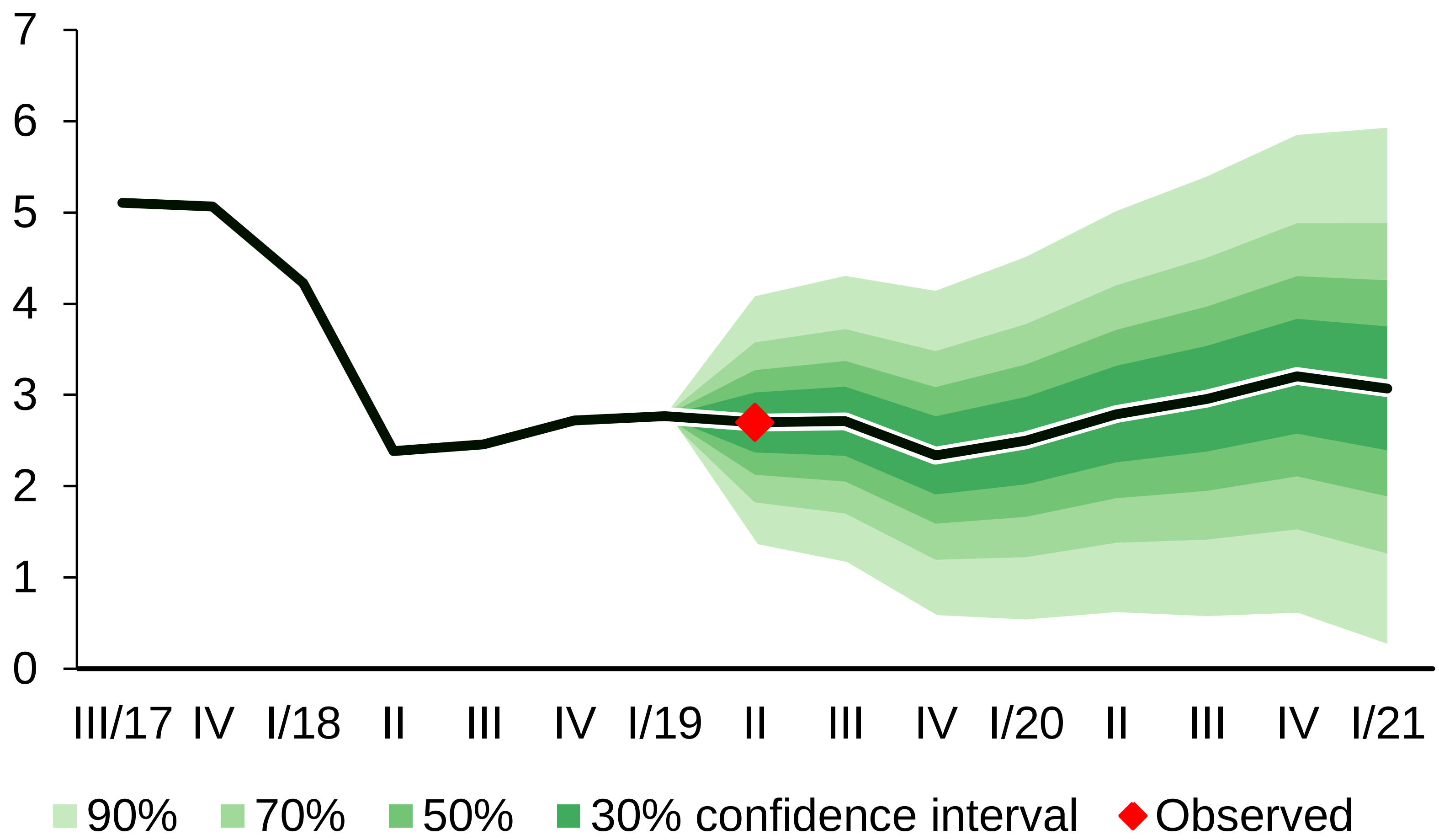
- The main extensions of g3+ include:
  - external block richer in structure and more internally consistent
  - division of foreign producer prices into their energy and core components
  - inclusion of energy in factors of domestic production;
  - introduction of “hand-to-mouth” households
  - new way of working with exogenous outlooks
  - recalibration of selected model parameters and long-term equilibrium levels

Story of the August 2019 CNB forecast

- 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

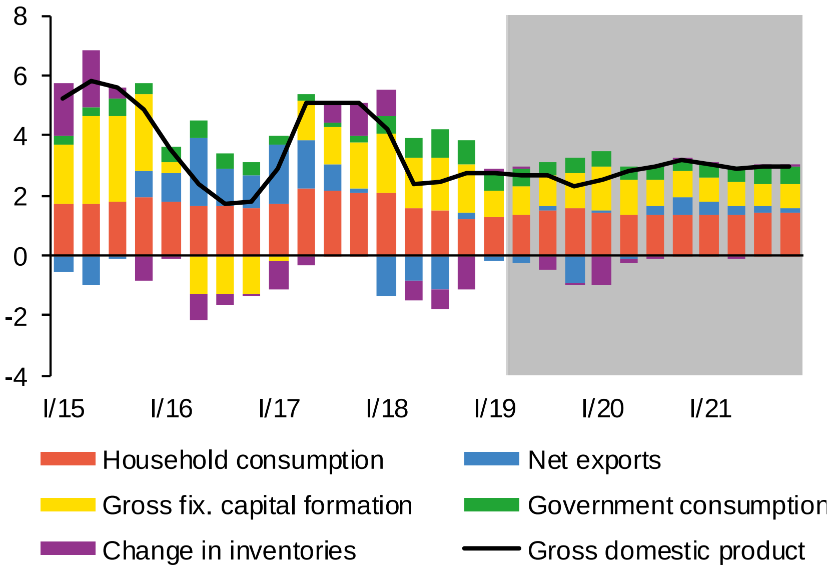
A soft patch, not a recession

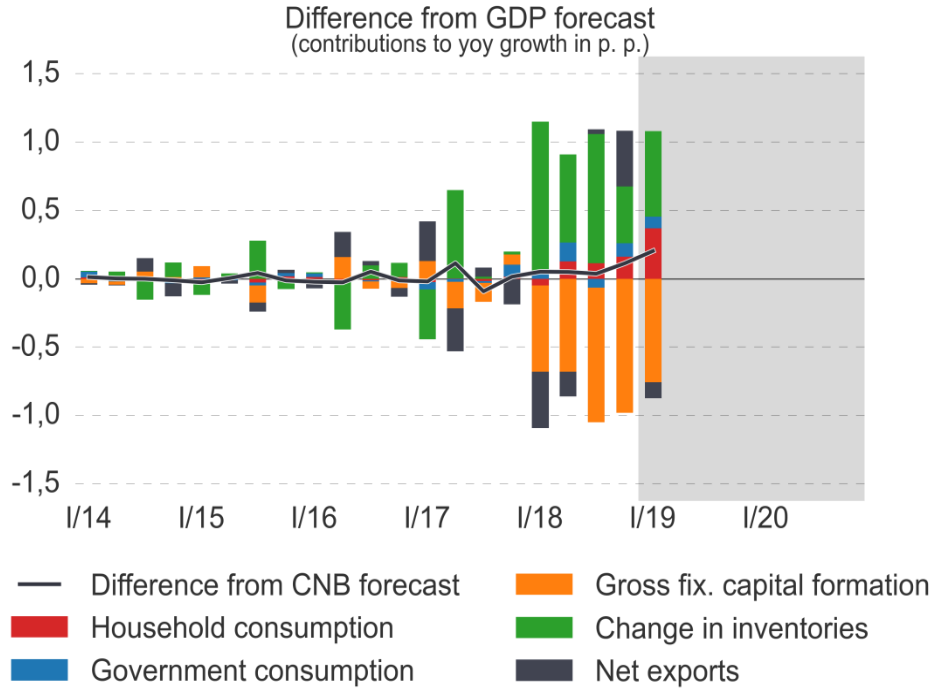
GDP forecast (% yoy growth)



GDP structure, investment revision

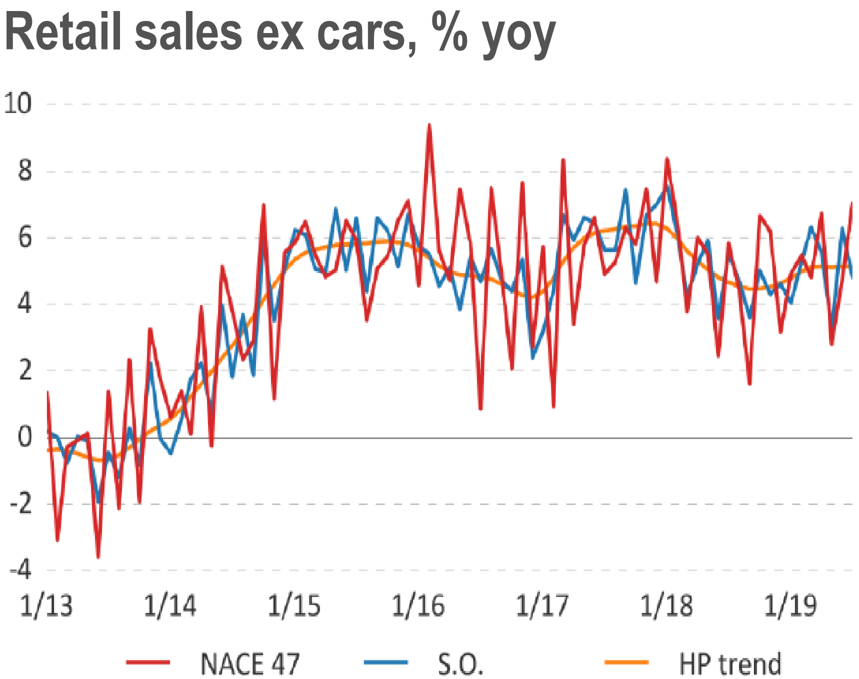
Annual GDP growth structure
(annual percentage changes; contributions in percentage points; seasonally adjusted)

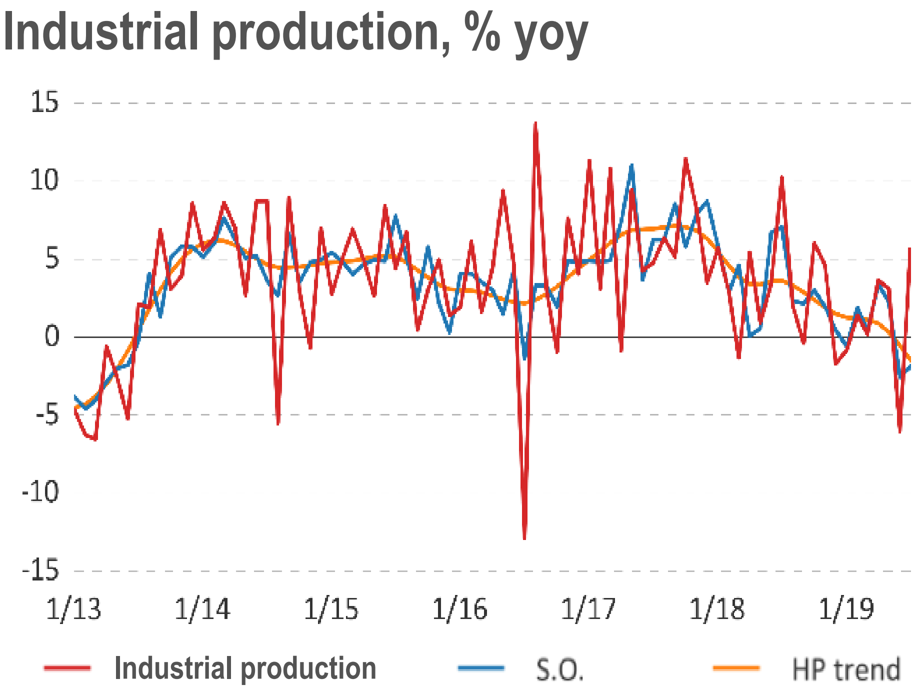




- Less investment than we had expected, domestic economy more proinflationary
- Fixed investment growth stopped in 2019 Q2 according to first estimate

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

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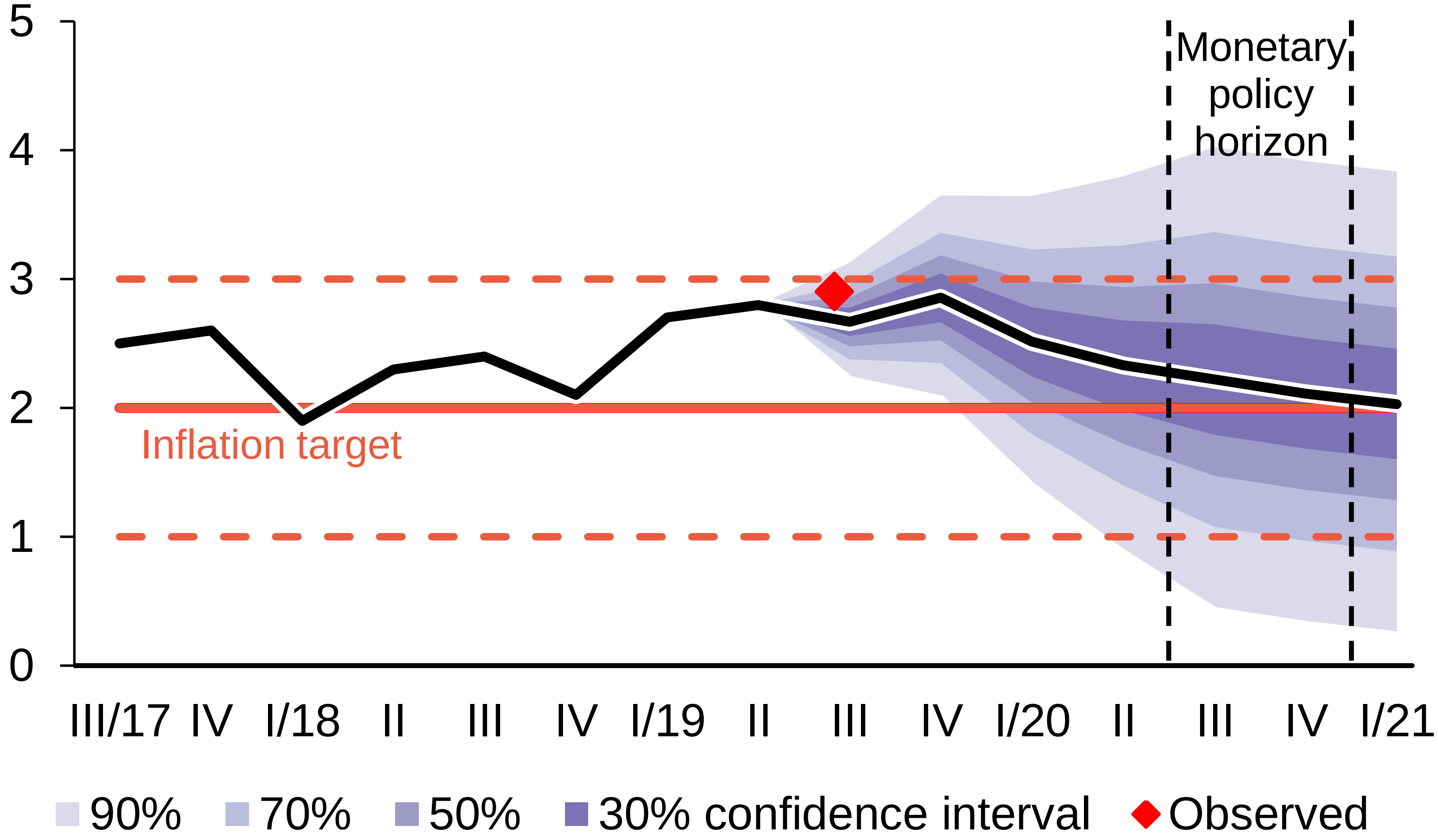
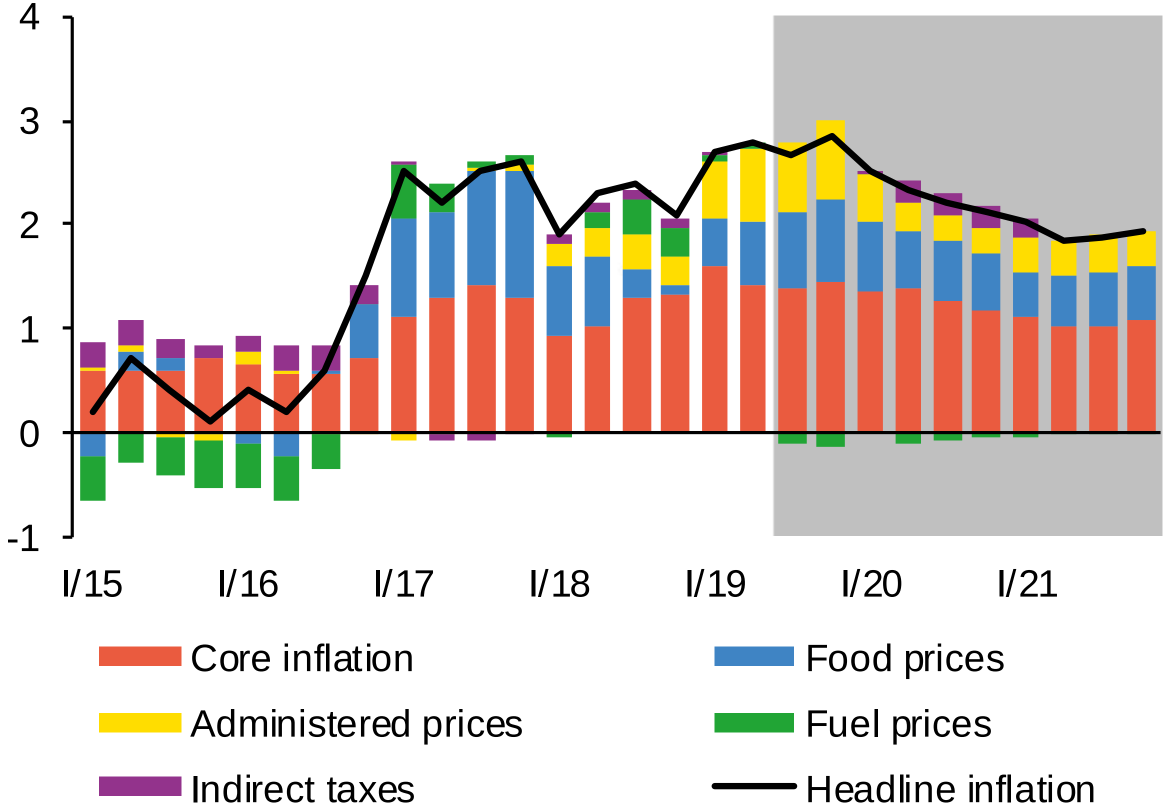
CPI inflation forecast (% yoy growth)



Inflation structure: core inflation

Structure of inflation and the inflation forecast
(annual percentage changes; contributions in percentage points)



- Also, core inflation has been source of recent inflationary surprises

Wage growth to ease next year

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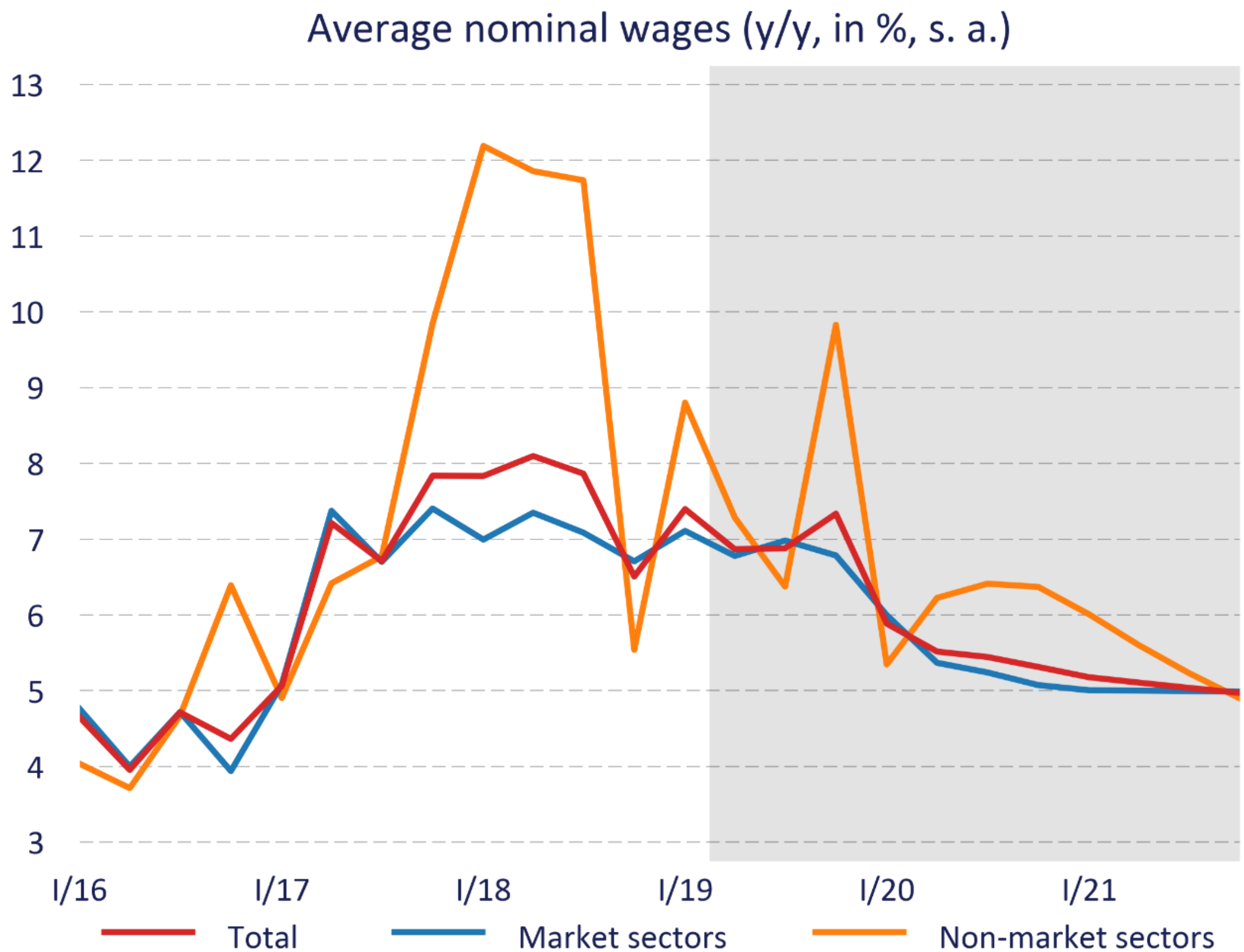
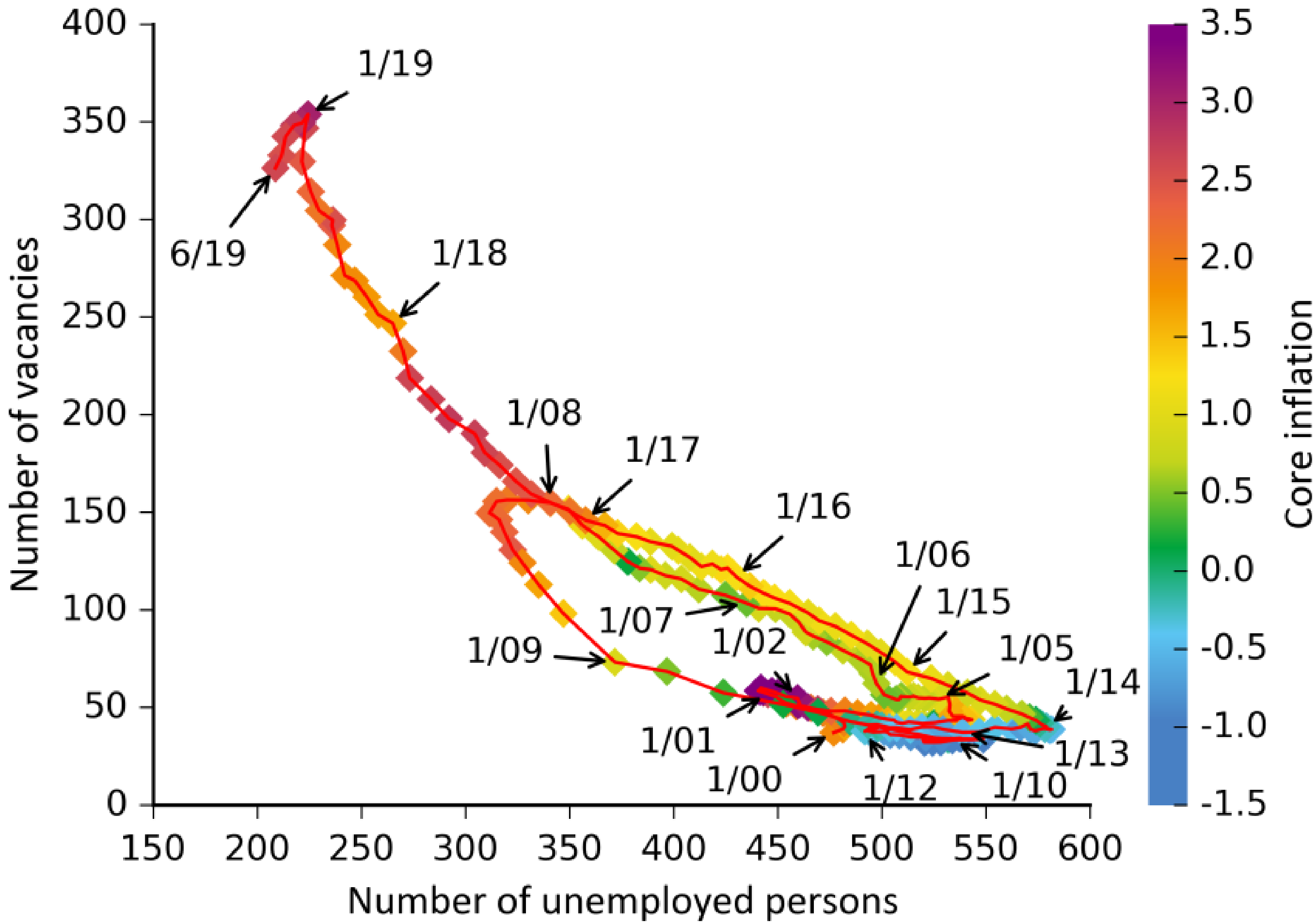


- This year, labour unions still had enough bargaining power amid record-low unemployment and full order books
- We don’t expect optimism to prevail at such a level in 2020

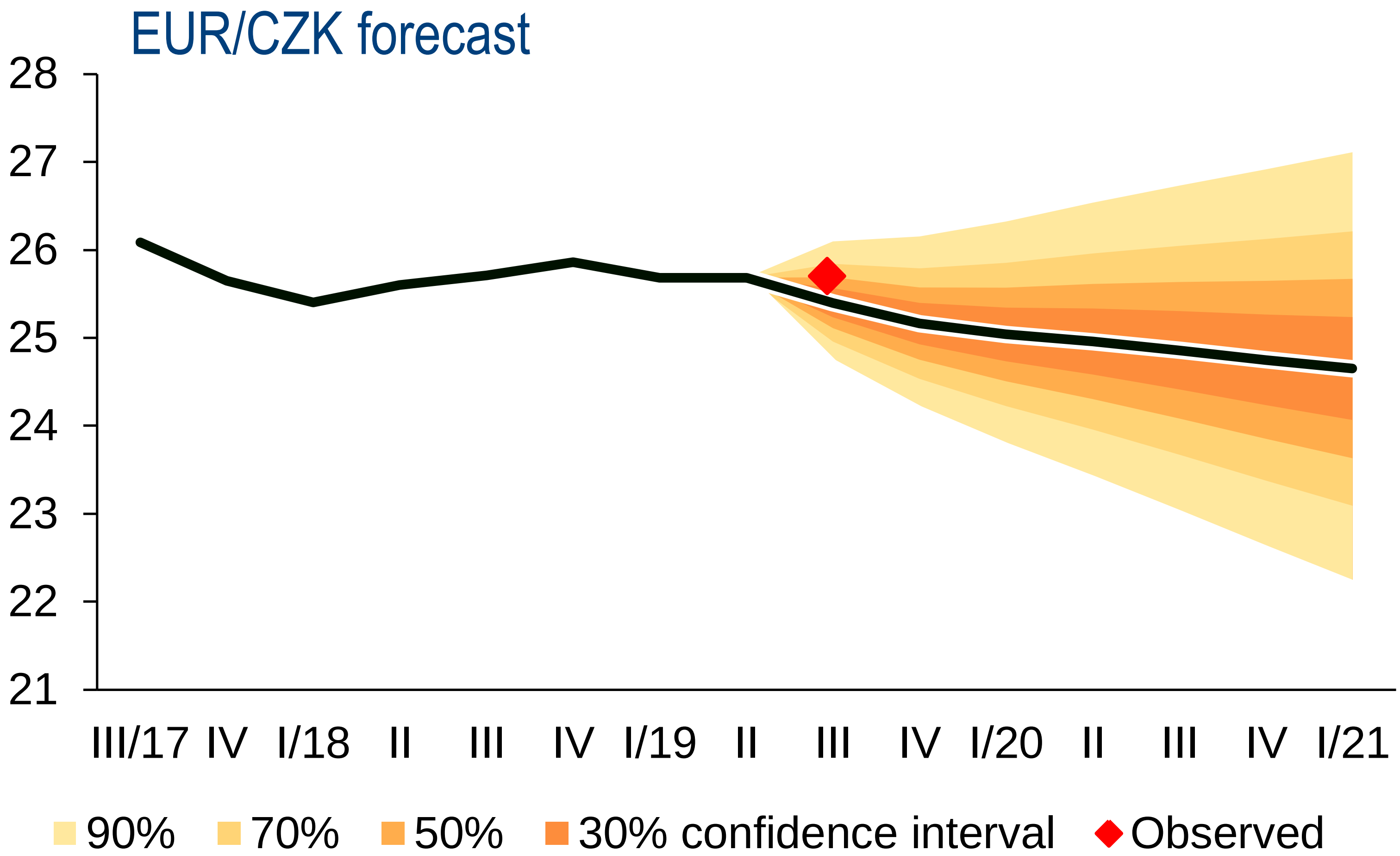
Beveridge curve: beyond a turning point

Beveridge curve

(numbers in thousands; seasonally adjusted; annual percentage changes for core inflation; source: MLSA, CZSO)



Koruna FX rate: cautious appreciation



- 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

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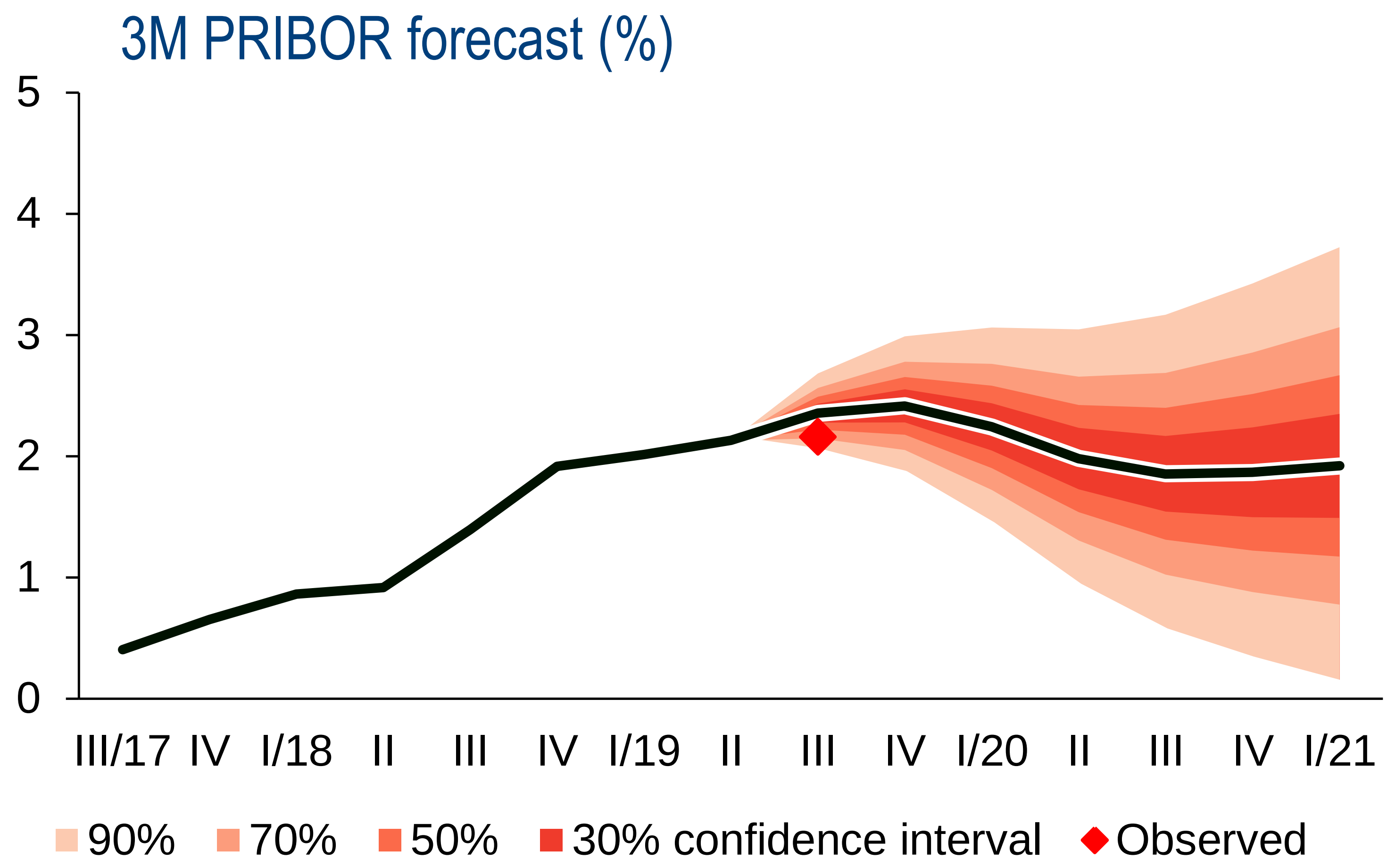
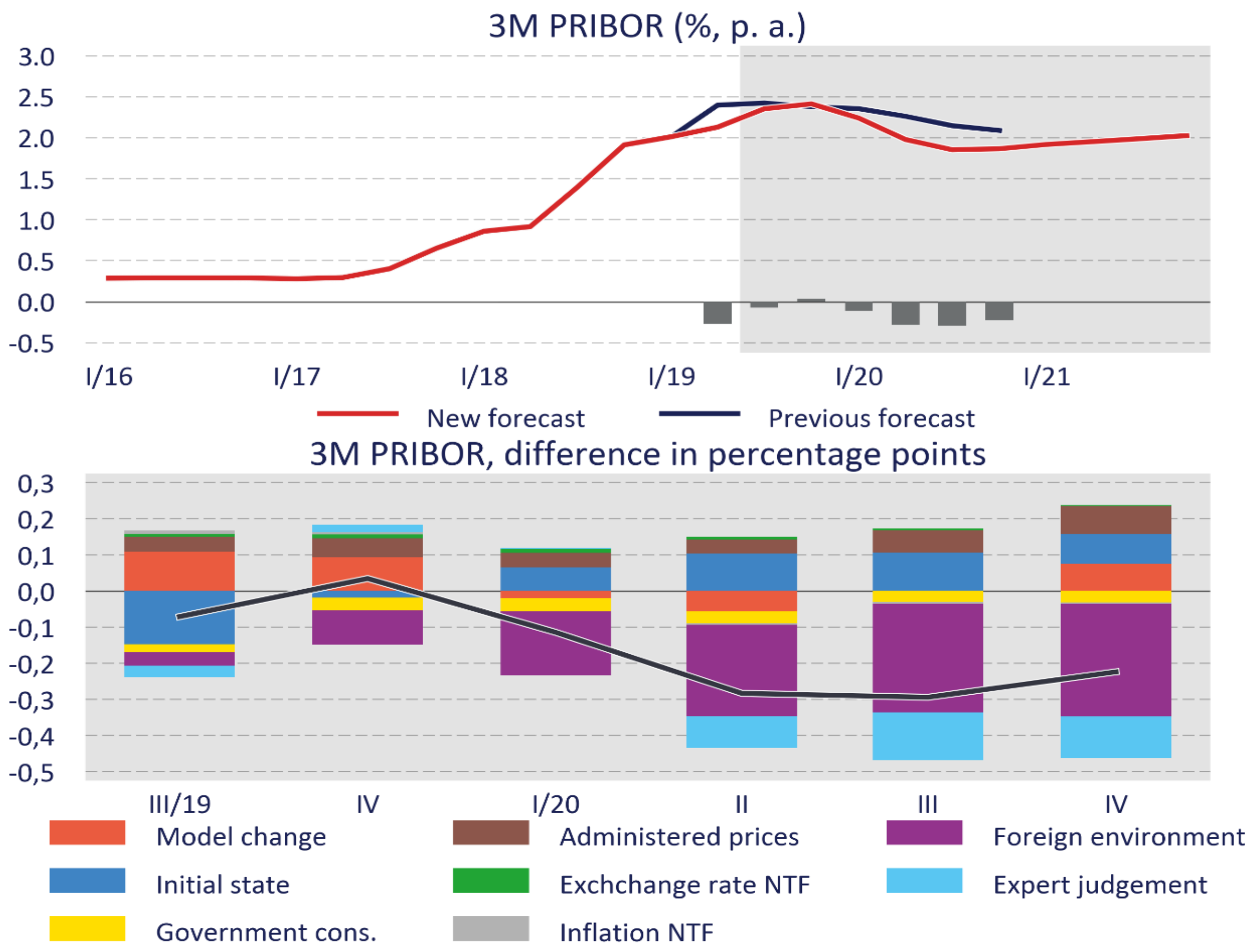


- “Consistent with the forecast is a modest rise in domestic market interest rates initially followed by a decline in 2020.”
- As you know, no change was made in early August

Interest rates: sources of revision



- 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

We should have tightened faster in 2018

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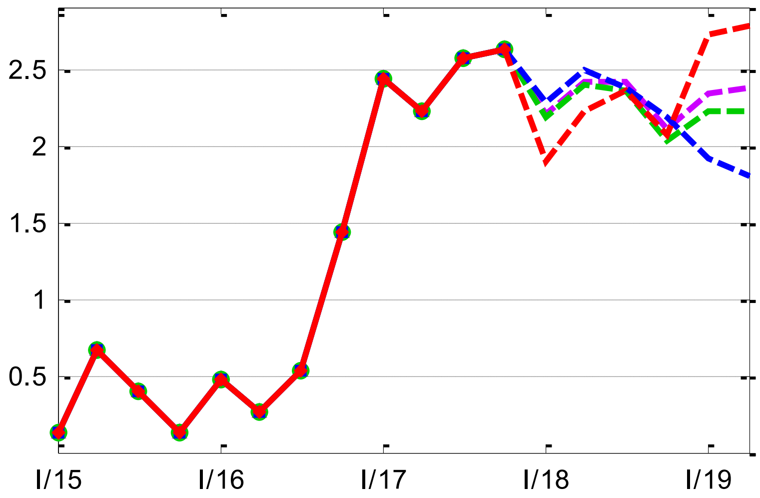
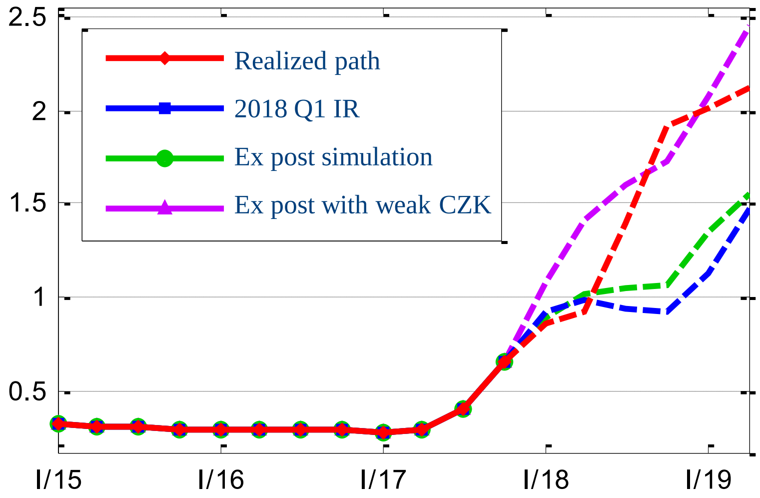
Inflation, % yoy



3M PRIBOR, % .



- 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

Discussion points

- 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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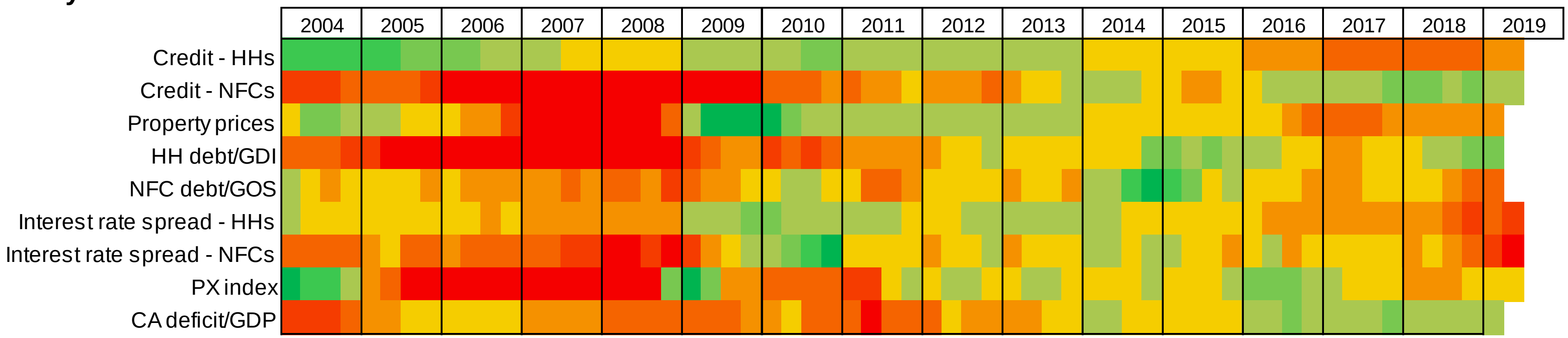
Financial cycle indicators

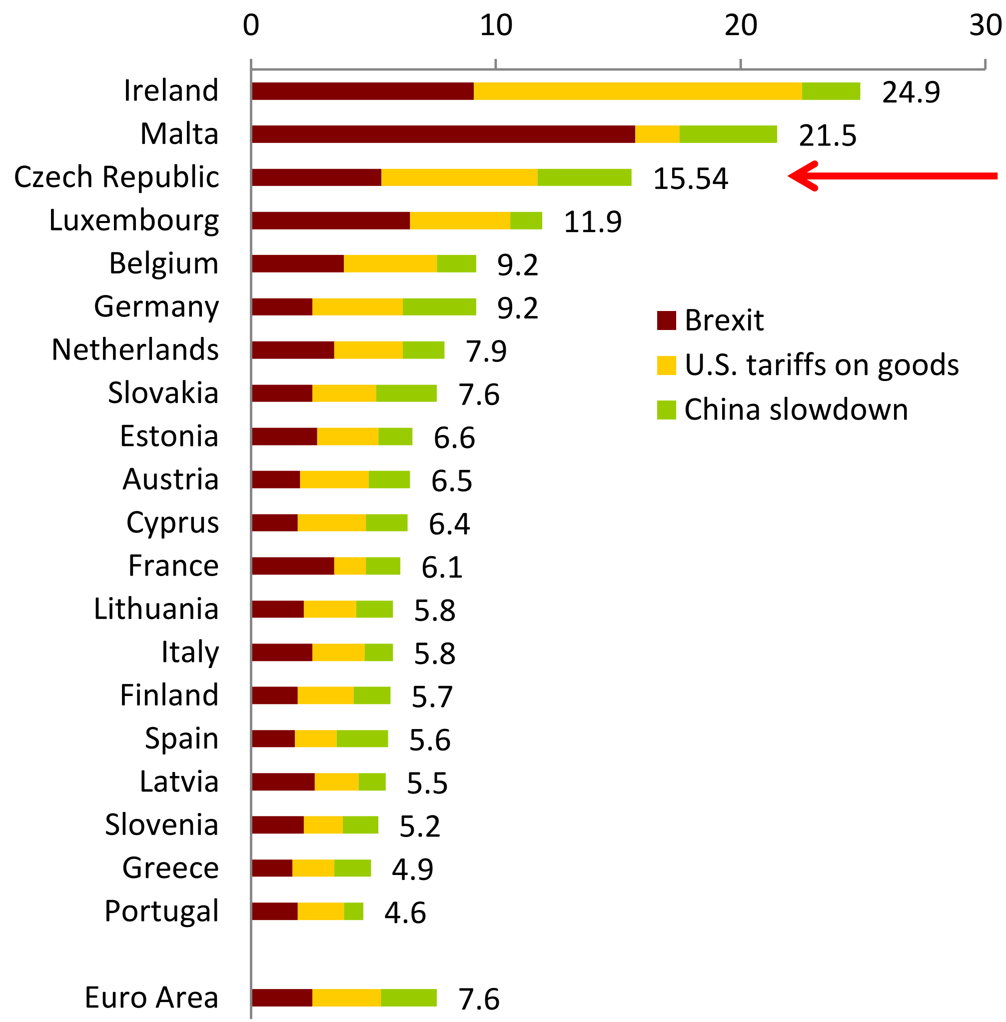
Financial cycle indicators



Source: CNB

- 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

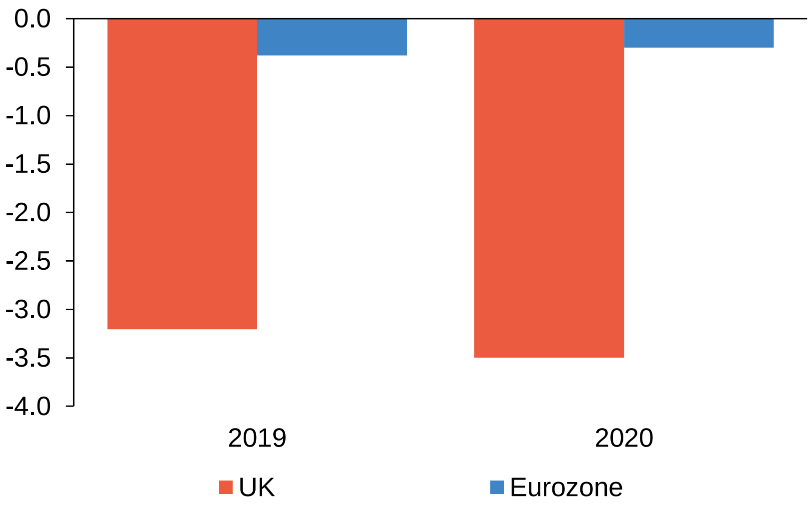


- % of value added at risk according to OECD TiVA tables (Bloomberg Economics and CNB)

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
(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