CNB Monetary Policy on its Way Back to Normal

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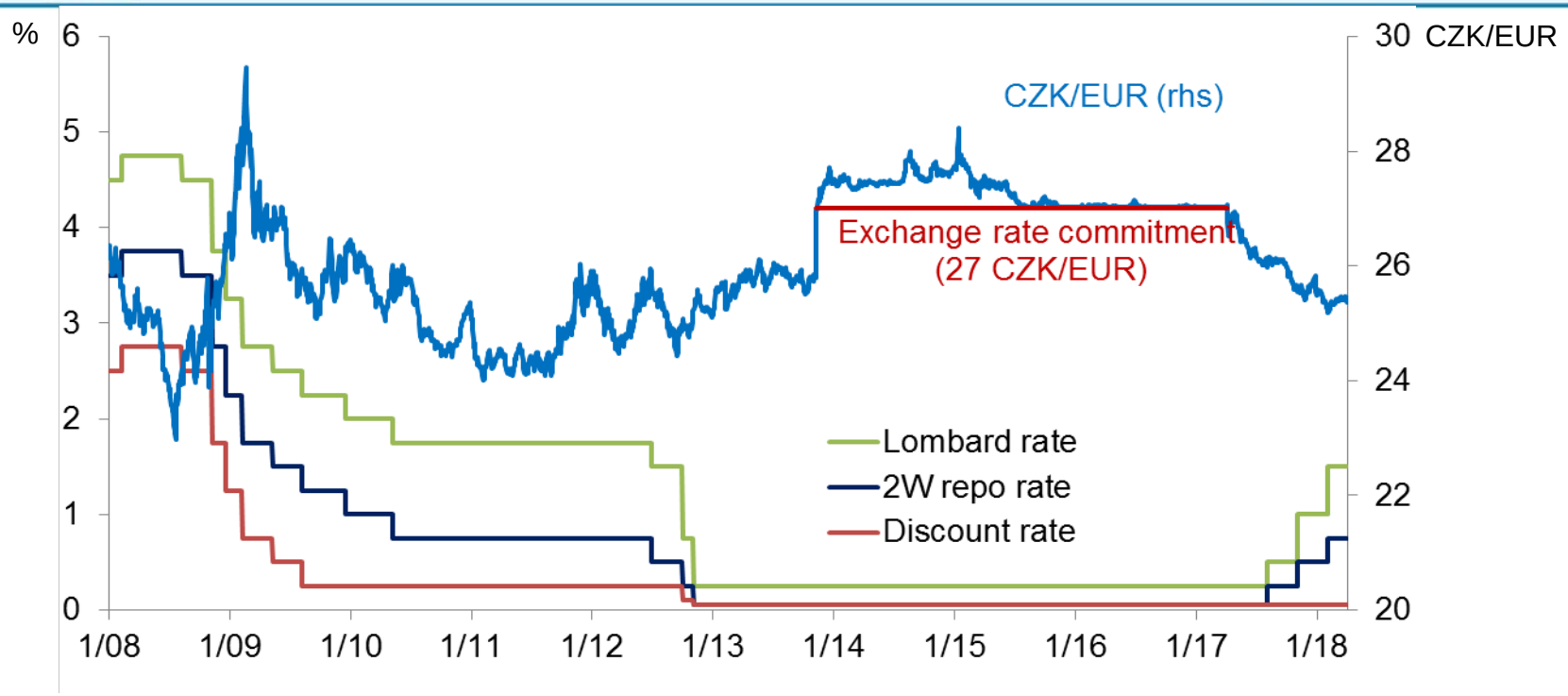
Czech National Bank

Spring Meetings 2018
Washington, D.C.

Exit from FX commitment



- FX commitment was abandoned on 6 April 2017 as conditions for sustainable fulfilment of the 2% inflation target had been met.
- Exit from the commitment was smooth. Czech koruna has appreciated gradually and moderately since then.
- Exit was first step towards normalizing monetary conditions and was followed by increases in the CNB's interest rates in 8/2017, 11/2018 and 2/2018.

Outline

I. External environment outlook

II. Inflation

III. GDP growth

IV. Labor market

V. Fiscal policy

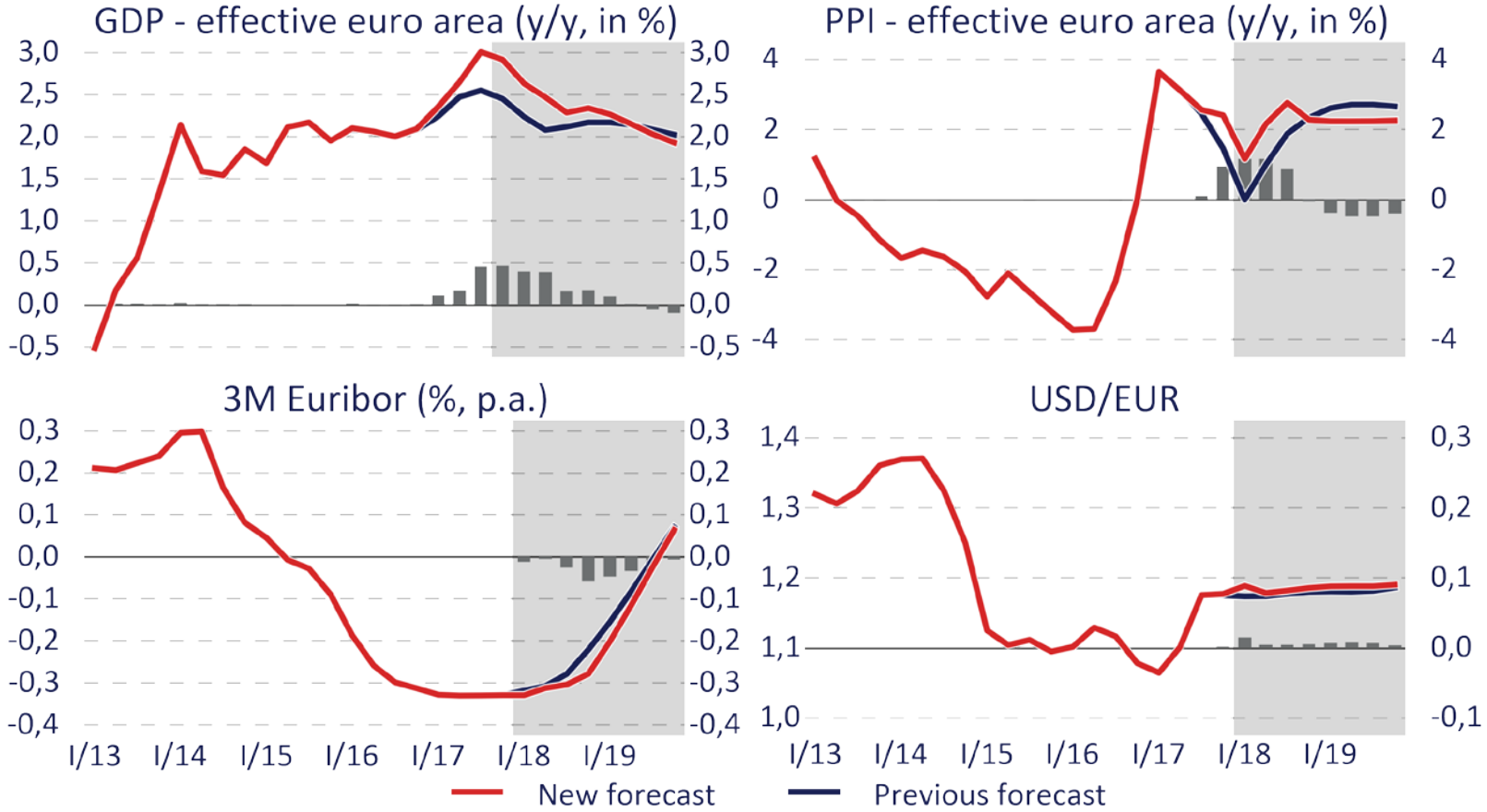
VI. Exchange rate

VII. Interests rates

VIII. GRIP

I. External environment outlook

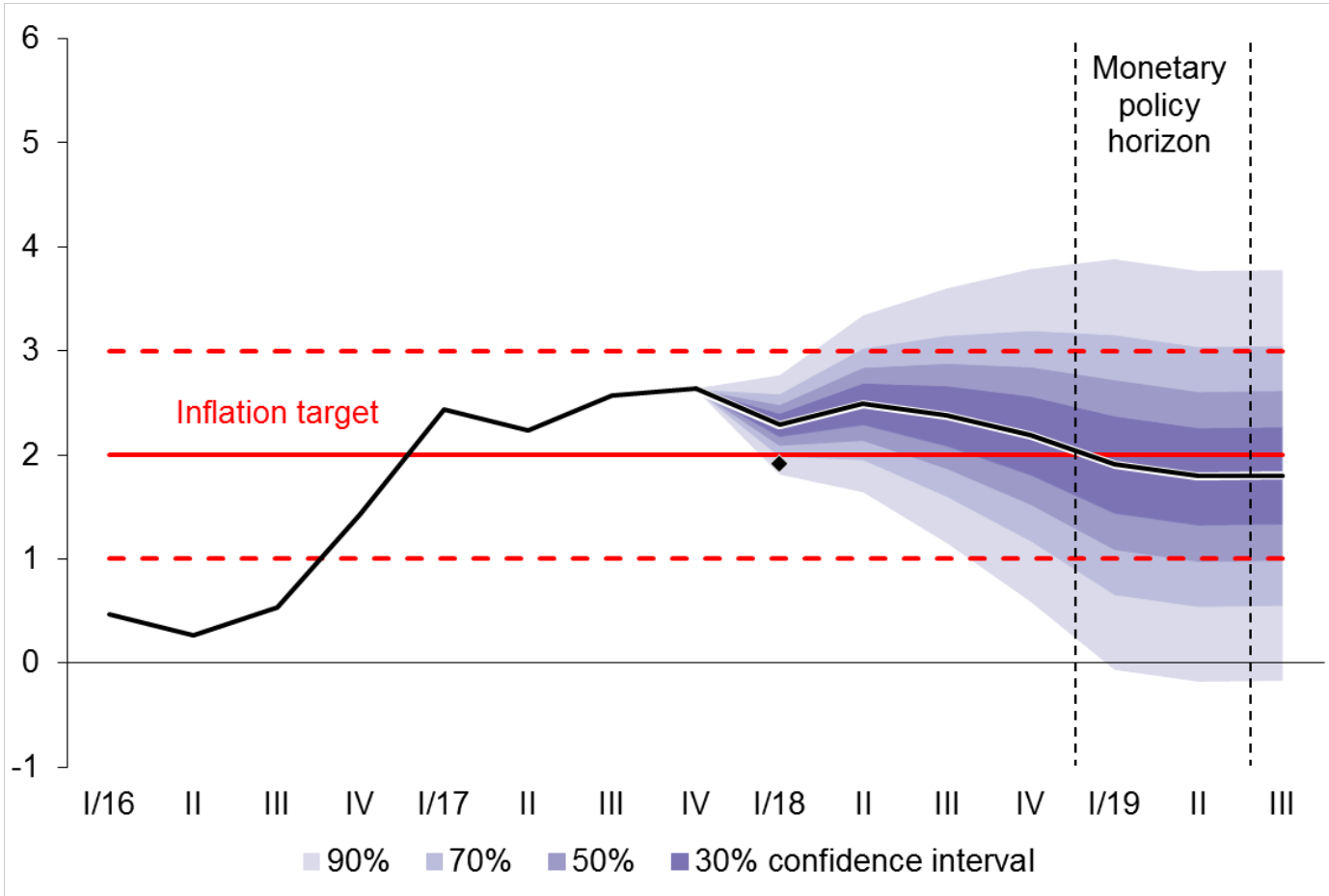
External environment outlook



- GDP growth in effective eurozone will remain robust (according to January 2018 assessment).
- Producer price dynamics will slow in early 2018 but will then recover, reflecting current high oil price and increasing economic activity.
- Continued QE by ECB keeps 3M EURIBOR outlook in negative territory until mid-2019. USD/EUR outlook close to 1.20.

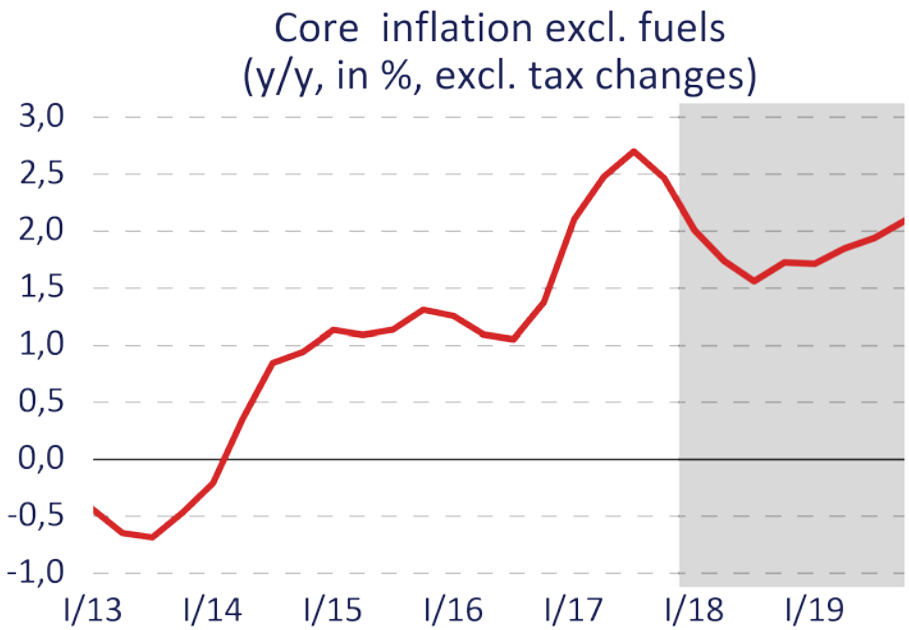
II. Inflation

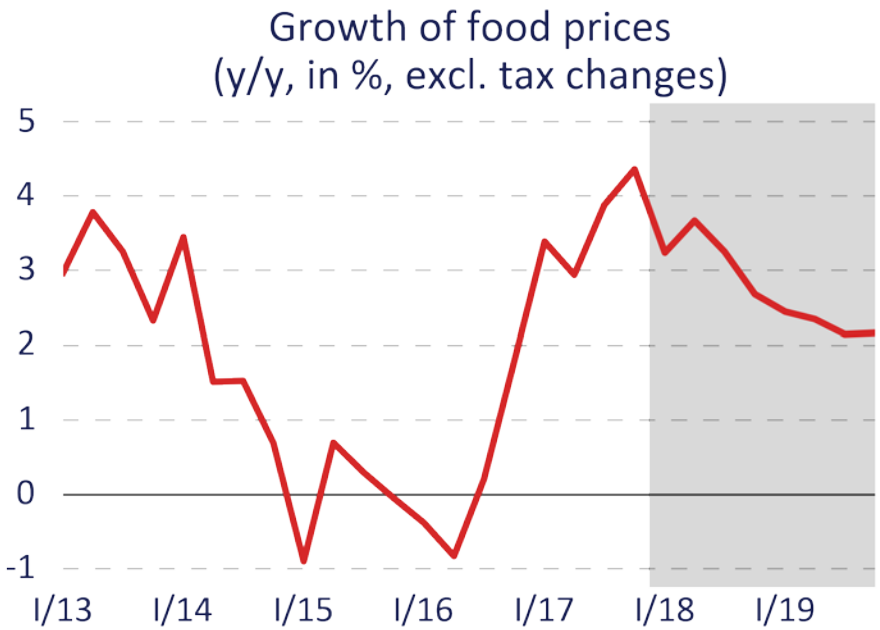
Headline inflation forecast



- Inflation will be above 2% target for rest of this year and return to it at start of next year (January 2018 assumption). In 2019, inflation will move just below 2%.
- MP-relevant inflation will differ only marginally from headline inflation.

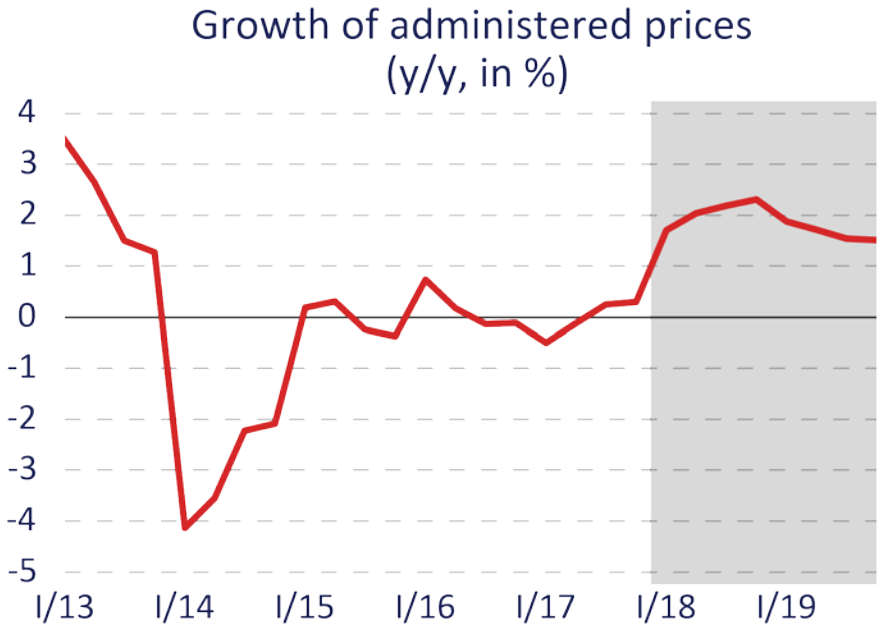
Core inflation and food prices

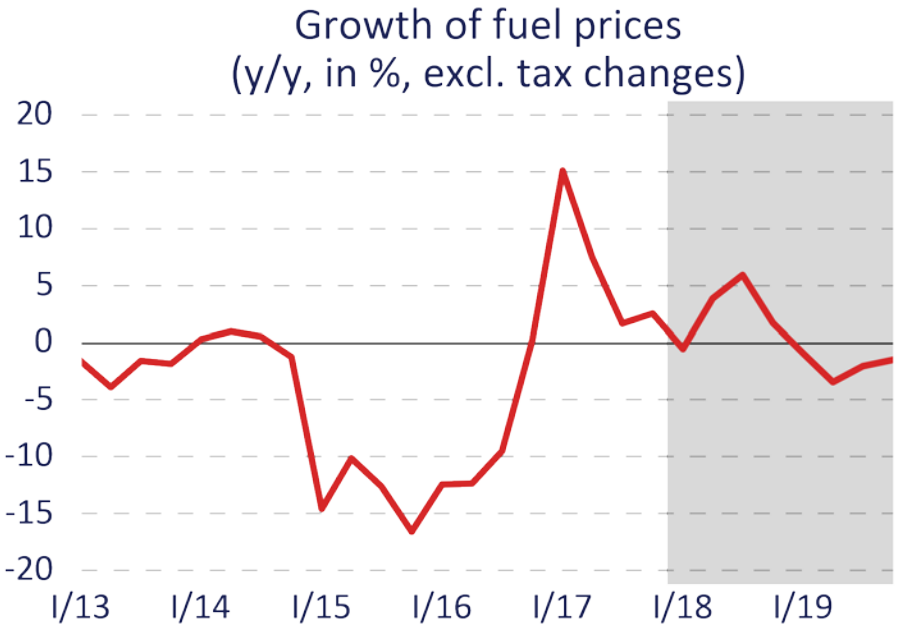




- Core inflation will slow this year owing to unwinding of one-off factors and appreciation of koruna. These anti-inflationary factors will be partly offset by impact of rising domestic demand and wages.
- During 2019, core inflation will start to rise gradually back towards 2%, reflecting renewed growth in import prices.
- Recently high food price inflation will moderate owing to expected slowdown in growth in agricultural commodity prices. Appreciation of koruna this year will reinforce this trend.

Administered and fuel prices

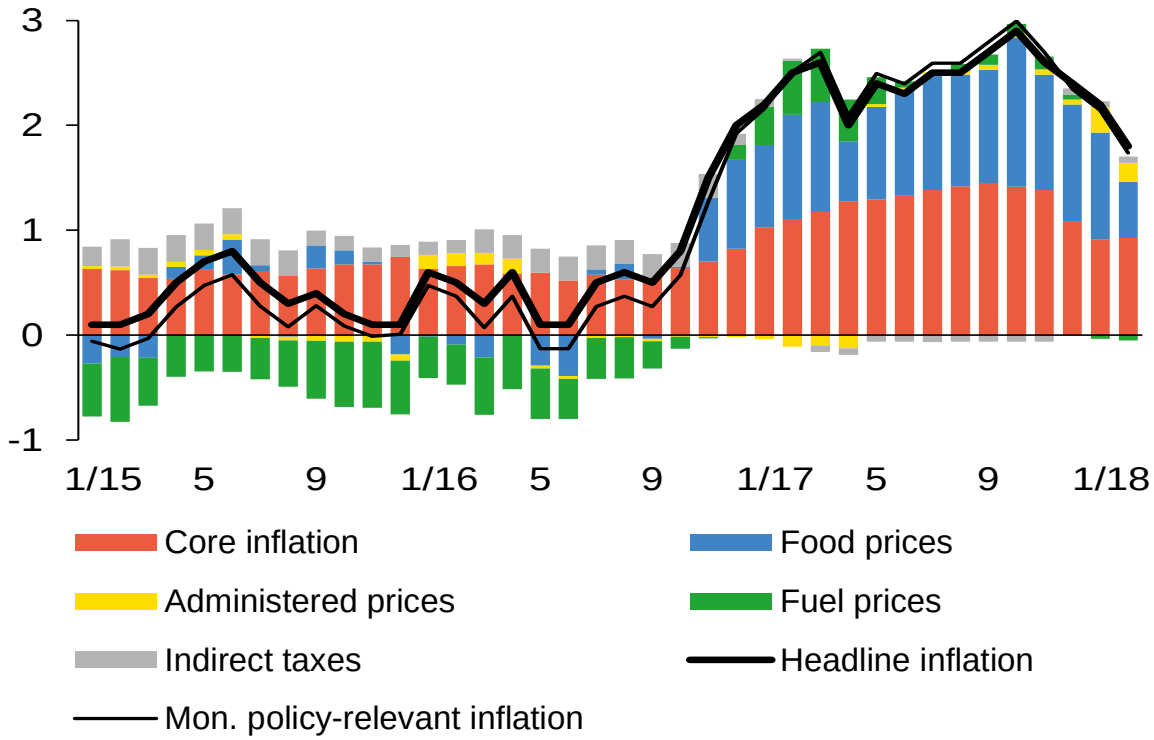




- Administered prices will start rising again this year, owing mainly to increase in electricity prices. Negative contributions of gas and heat prices to administered price inflation will fully disappear during 2018 Q1.
- In 2019, administered prices will slow somewhat due to more muted increases in electricity and fuel prices. This will contribute to headline inflation being marginally (and temporarily) below target in 2019.
- Fuel prices will see renewed growth this year but will decline slightly in 2019.

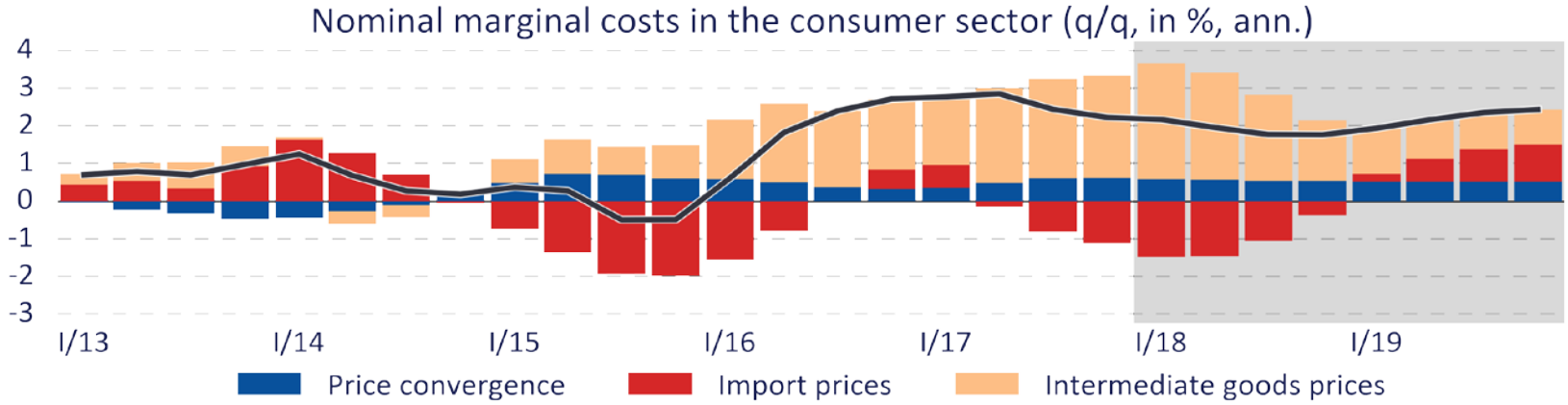
Structure of inflation

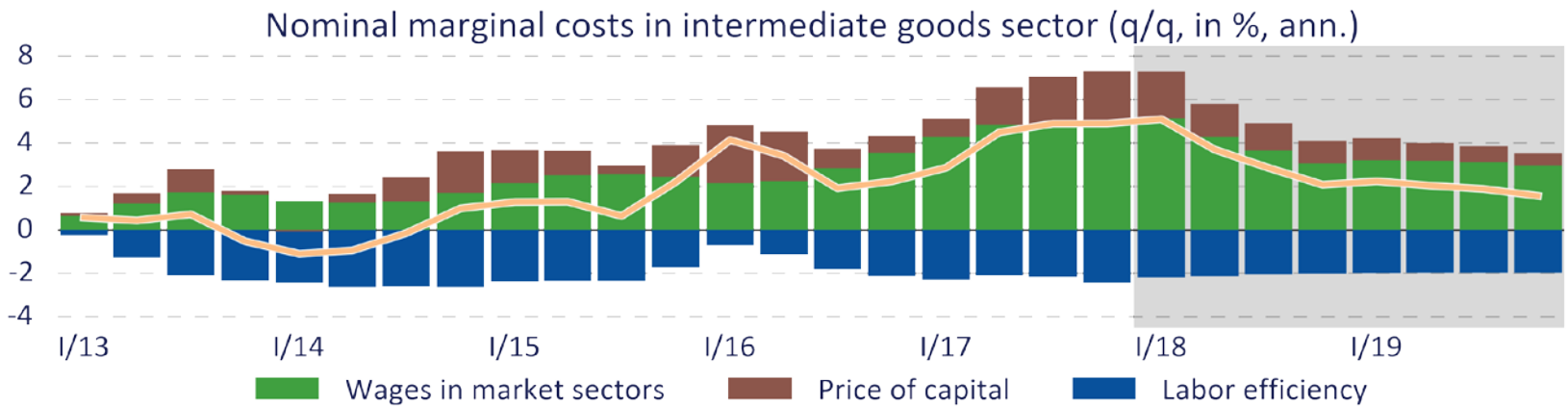
(annual percentage changes; contributions in p.p.)



- Inflation peaked at just below 3% in 10/2017 (still within tolerance band), then declined to 1.7% in 3/2018.
- Slowdown was driven mainly by core inflation, which declined as result of unwinding of one-off effects seen in late 2016/early 2017 (esp. pick-up in restaurant prices linked to introduction of ESR).

Inflation pressures

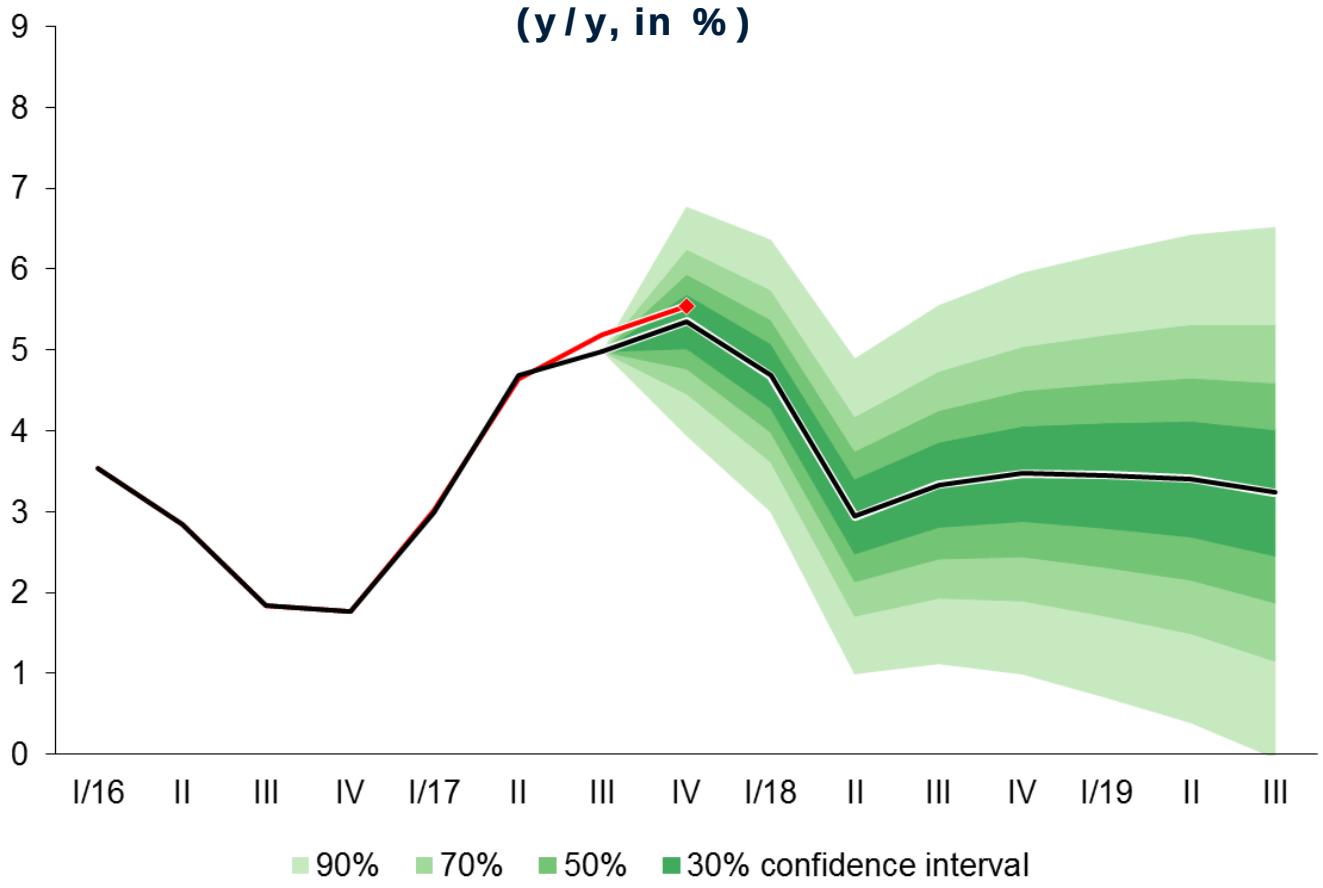




- Currently strong inflation pressures, stemming from accelerating growth of domestic economy and wages, will ease gradually.
- In 2018, this will be due mainly to anti-inflationary effect of import prices.

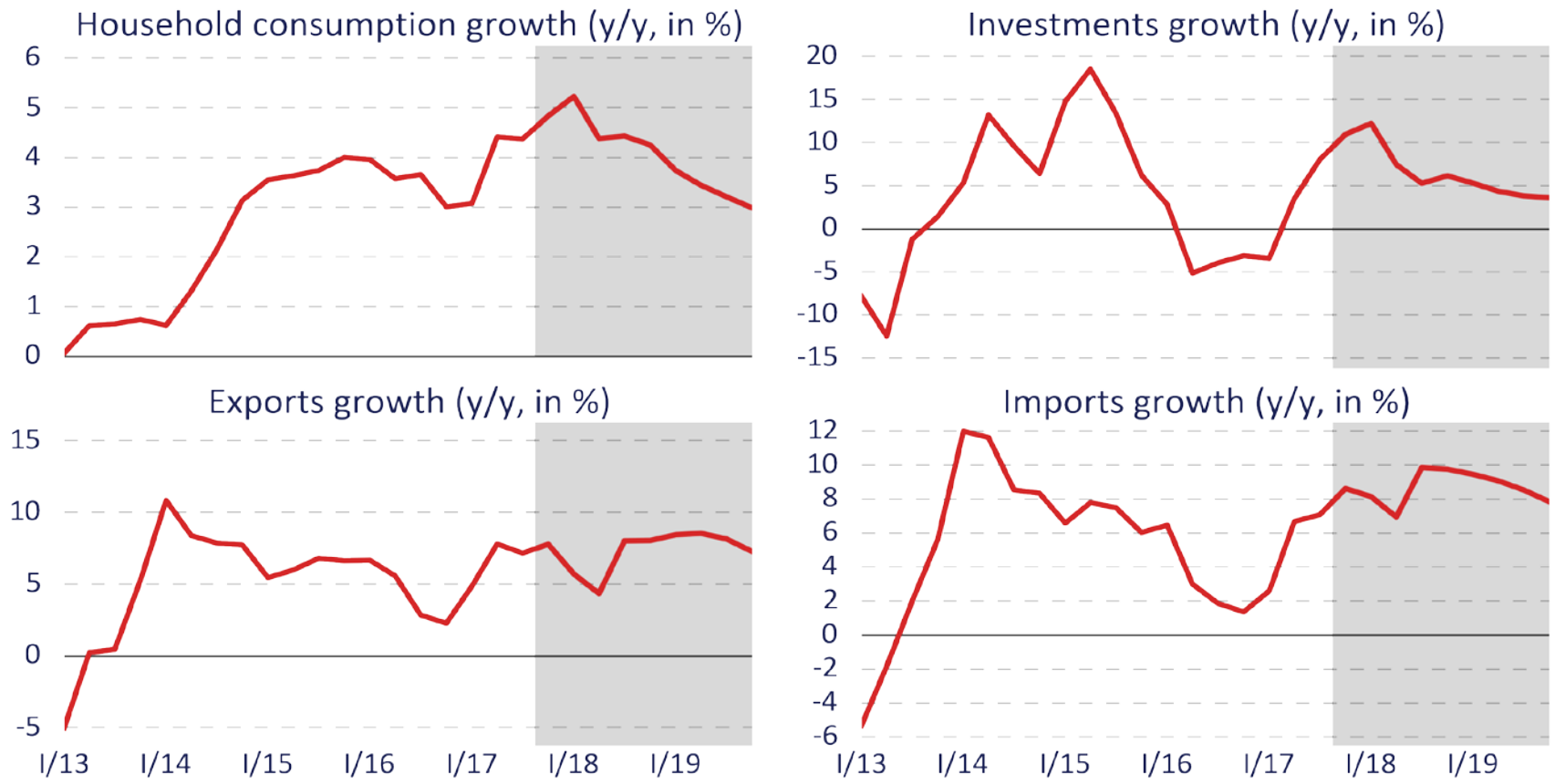
III. GDP growth

GDP growth forecast



- GDP growth reached 4.6% last year (5.5% in Q4) and will slow to just above 3% on average in next two years.
- Dynamics of GDP will be fueled by robust domestic demand.
- External demand will be supportive too, but contribution of net exports to GDP growth will turn negative in 2019 (stronger CZK, upswing in imports).

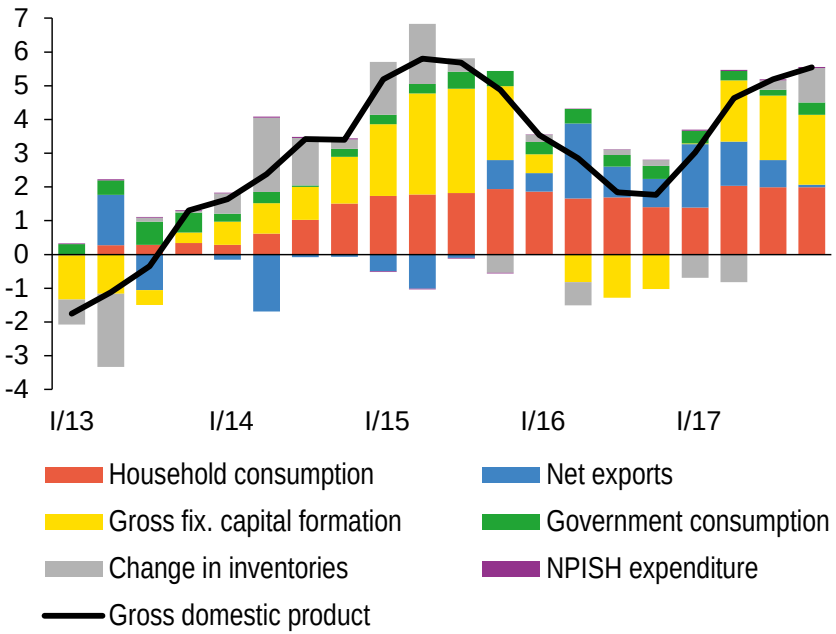
Aggregate demand



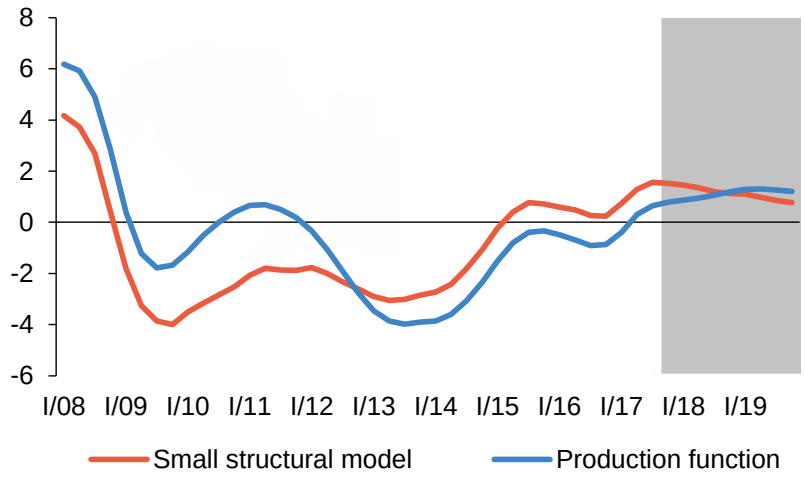
- Strong household consumption growth (peaking above 5% at start of 2018) will reflect rapid rise in wages, salaries and other income.
- Gross capital formation growth will accelerate further owing to recovery in government investment amid continued rise in private investment.
- Both export and import dynamics will slow only temporarily.

GDP growth and output gap

Structure of GDP growth
(contributions in p.p. to annual change in %; s. a.)



Output gap
(% of potential output)

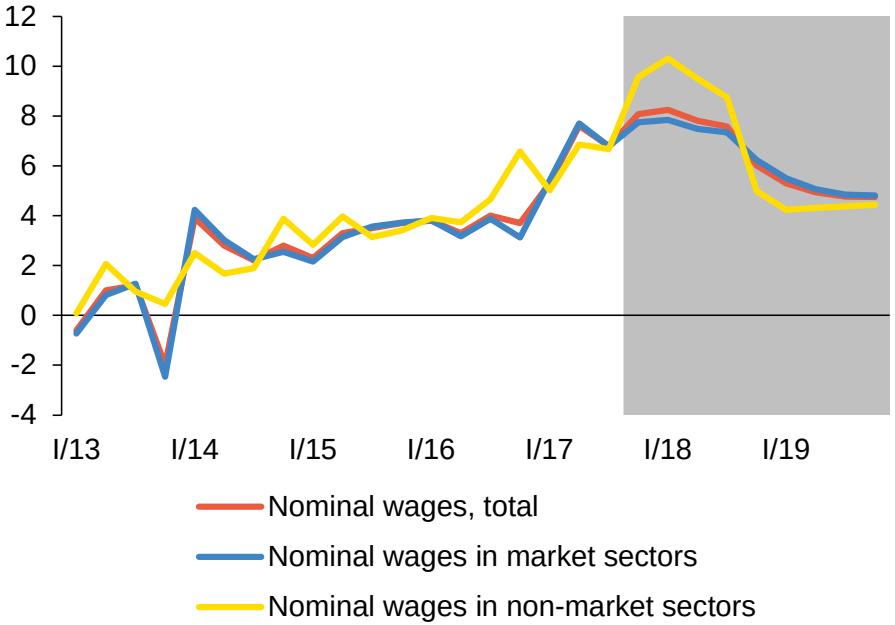


- Economic growth has accelerated significantly in recent quarters (to 5.5% in 2017 Q4) due to increasing household consumption and investment.
  - Strength of imports (reflecting investment) and moderation in export growth led to lower net export contribution.
- Economy remains above its potential. This is reflected in increasingly distinct shortage of available labor.

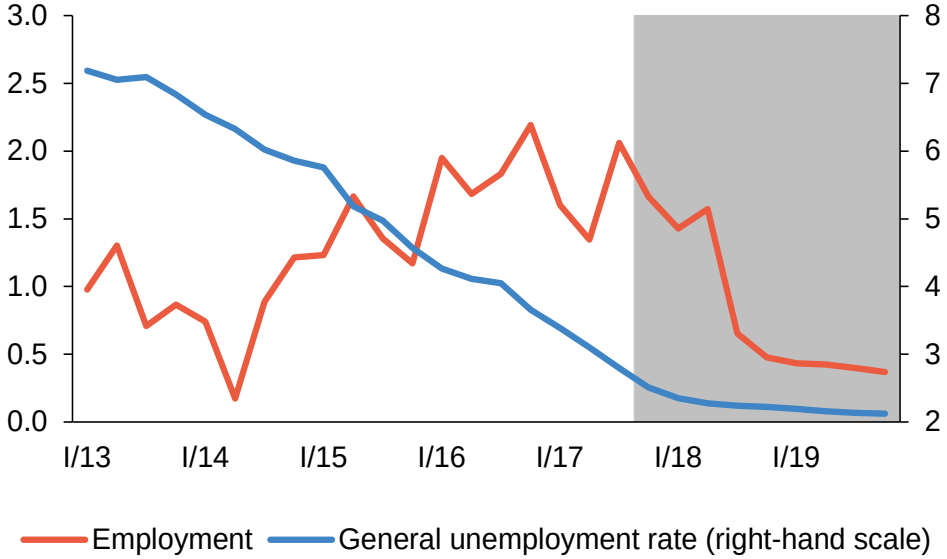
IV. Labor market

Labor market forecast

Average nominal wages
(y/y, %)

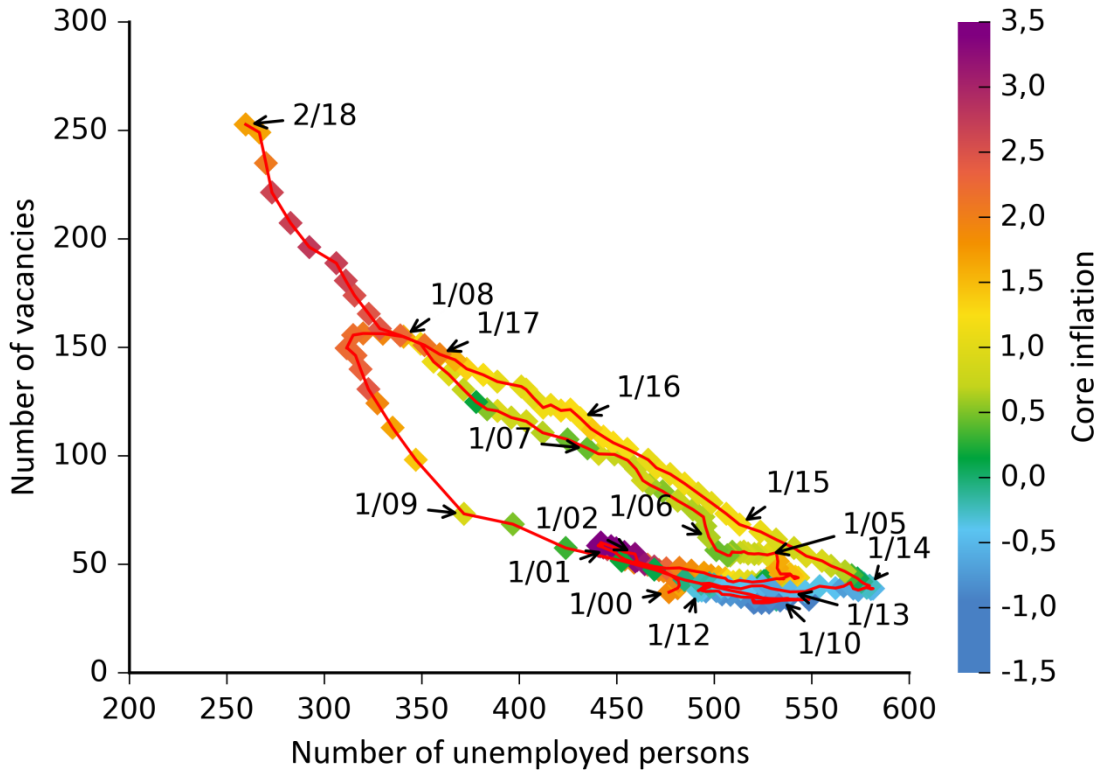


Employment and unemployment
(employment y/y, %, unemployment %, s.a.)



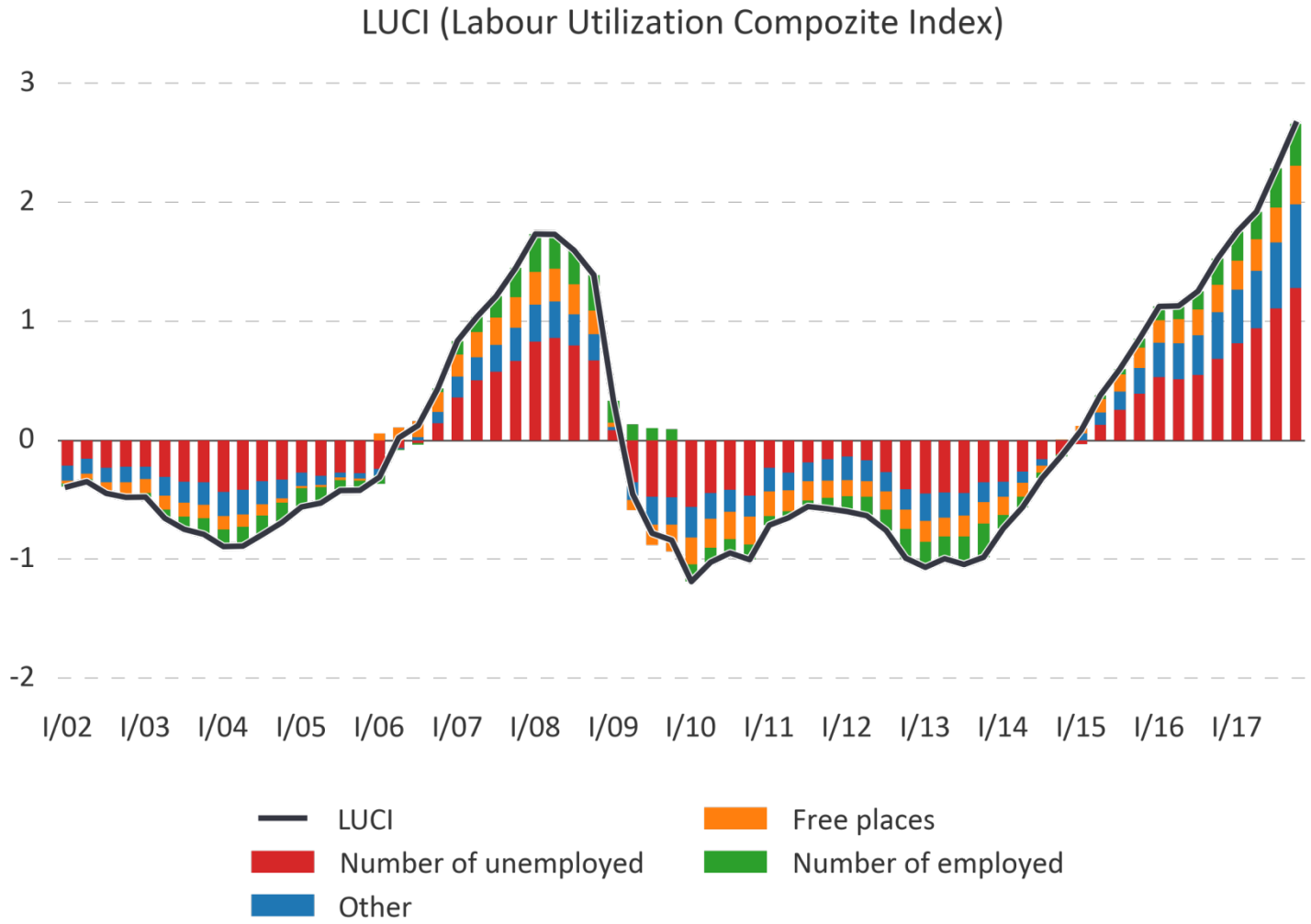
- Labor market tightness will keep wage growth in market sectors at high level (7.6% in 2017 Q4). Further increase in minimum wage is also fostering continued fast wage growth this year.
- Wage growth will later slow gradually to close to its assumed long-term level of 5% (owing to tightening of monetary conditions, efforts by firms to maintain price competitiveness).
- Unemployment rate remains lowest in EU, and scope for further reduction is low. Employment growth will therefore slow.

Beveridge curve



- Fall in numbers of unemployed persons has gradually been slowing, while number of vacancies has reached record highs.
- Number of unemployed persons is currently lowest since start of century and number of vacancies is at all-time high (amid record-high employment and labor force levels).
- This is being reflected in marked wage growth, which helped keep core inflation distinctly positive even after ESR effect subsided.

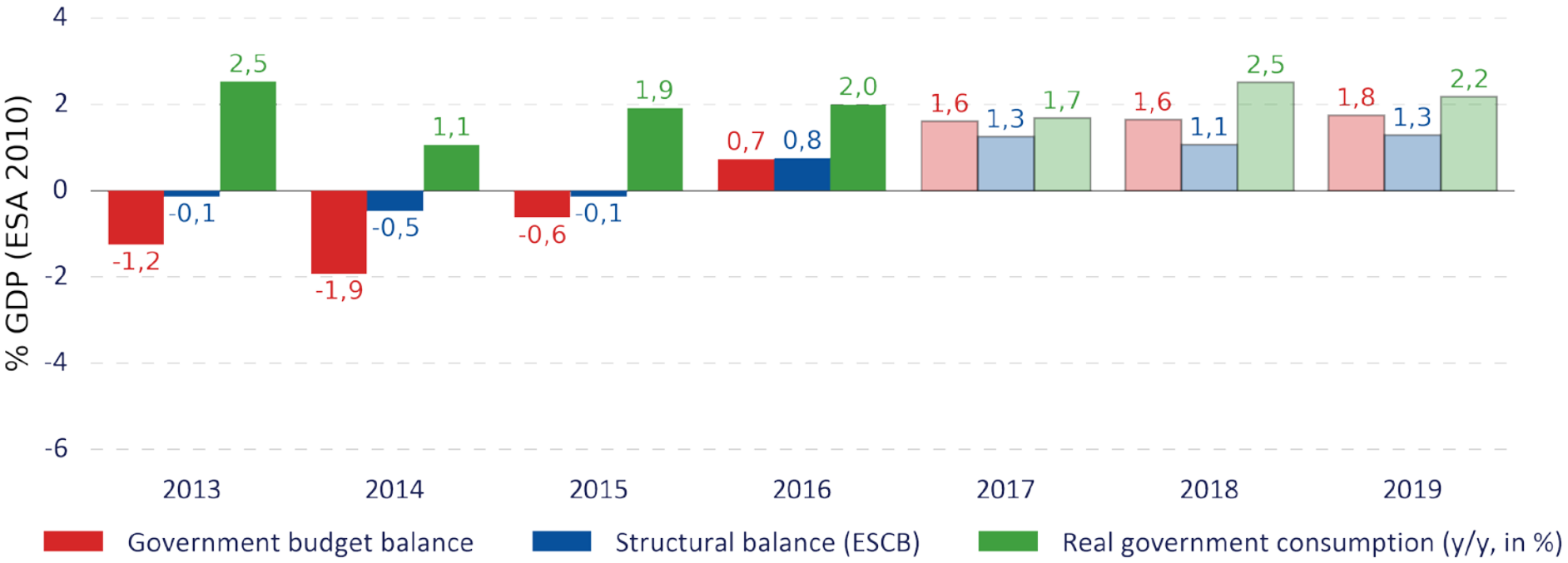
LUCI



- LUCI points to significantly pressurized labor market; from long-term point of view (since 2002), this pressure has historically reached highest values.

V. Fiscal policy

Fiscal policy



- Increasing government budget surpluses primarily reflect growth in tax revenues due to continued economic growth and policy measures.
- Government surplus will reach 1.6% of GDP both this year and in 2019. This will be associated with persistent structural surpluses.
- Real government consumption will grow by 2.5% in 2018 and by only slightly less in 2019.

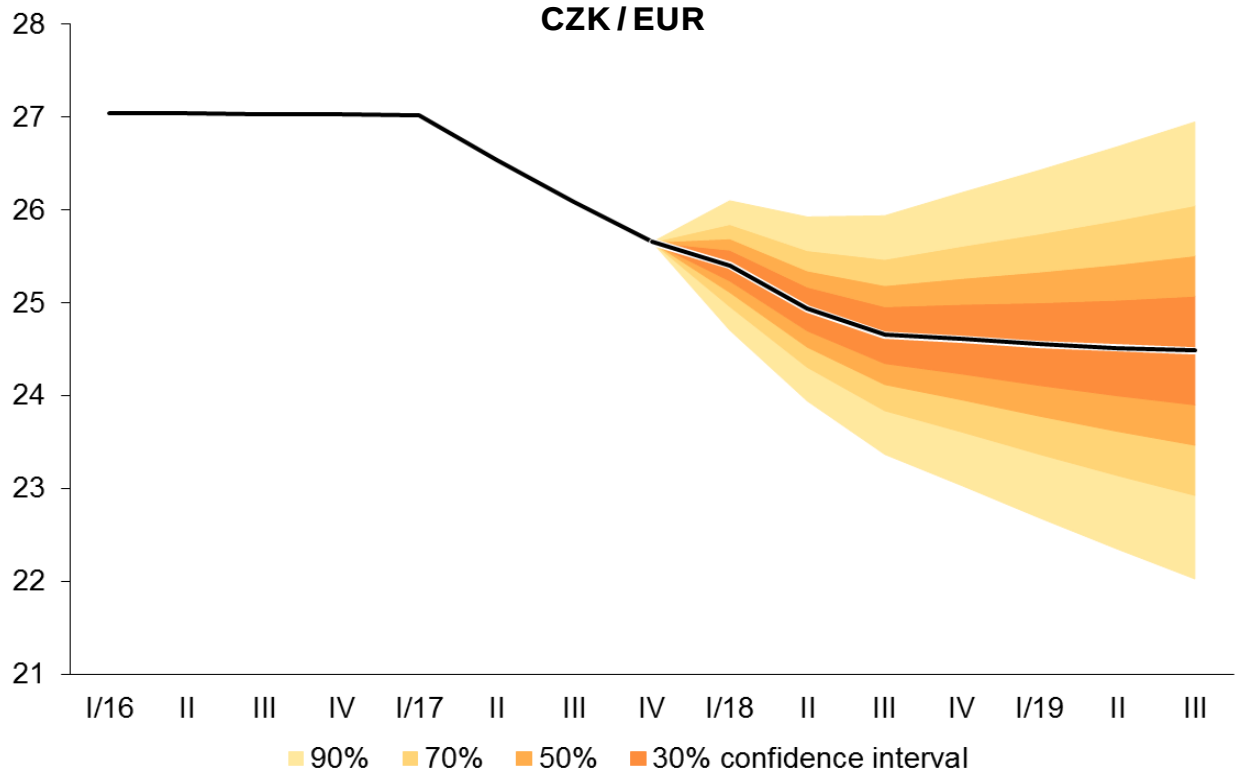
Fiscal impulse

Contributions to GDP growth in pp	2016	2017	2018	2019
	actual	forecast	forecast	forecast
Fiscal impulse	-1.1	0.2	0.5	0.0
of which impact through:				
private consumption	0.0	0.2	0.3	0.0
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	0.0

- Fiscal policy will be expansionary this year.
- Fiscal expansion will relate mainly to measures supporting household consumption, including buoyant wage growth in government sector.
- Czech economic growth will also be bolstered by faster growth in government investment in 2018 (recovery in drawdown of EU funds).

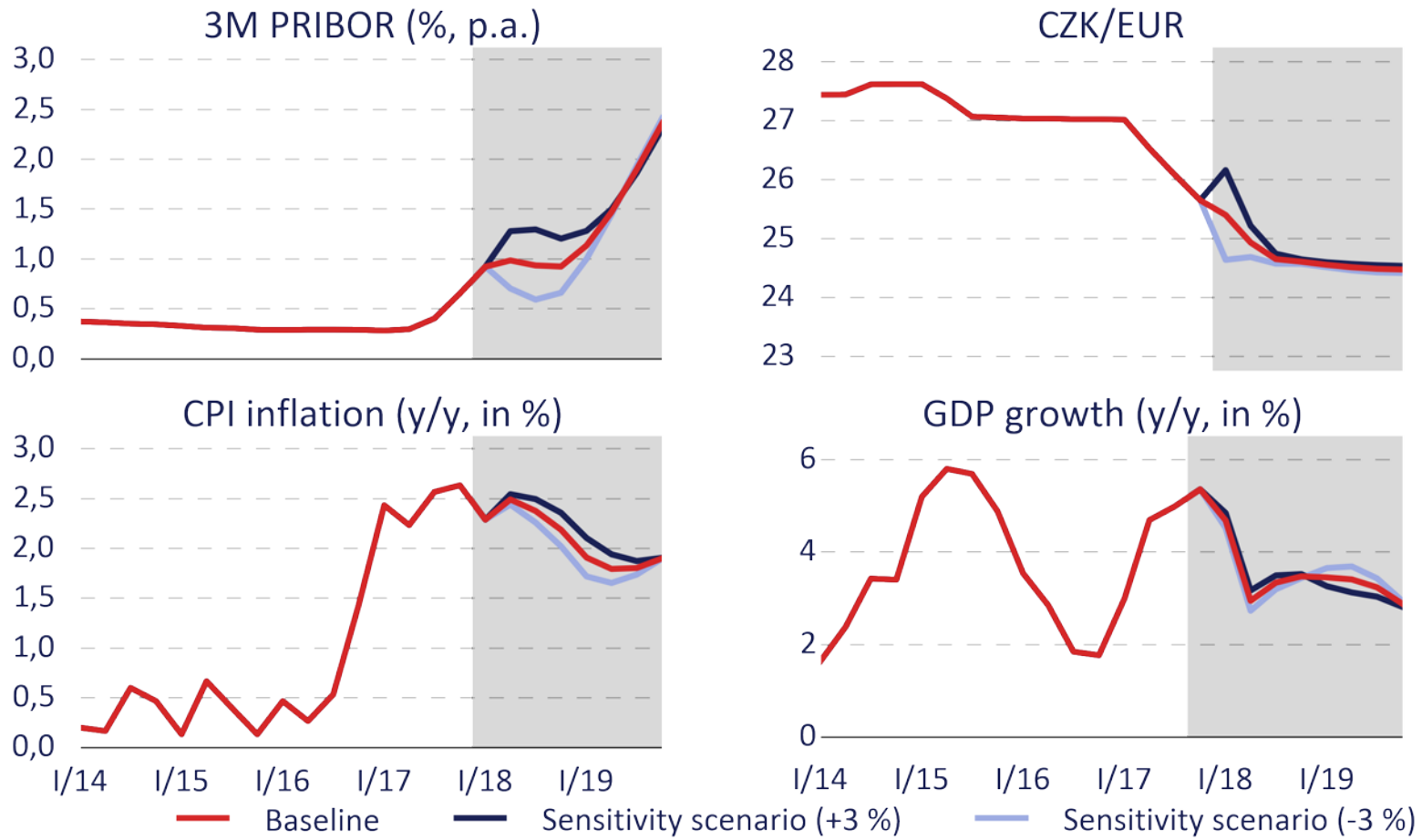
VI. Exchange rate

Exchange rate (renewed publication)



- Projected exchange rate is not commitment or preferred path!
- According to forecast, koruna will appreciate further:
  - in 2018 due to increasing interest rate differential vis-à-vis euro area and continued purchases of assets by ECB until 9/2018.
  - in 2019 – rather modest appreciation – due to ongoing long-term real convergence and ECB monetary policy normalization.

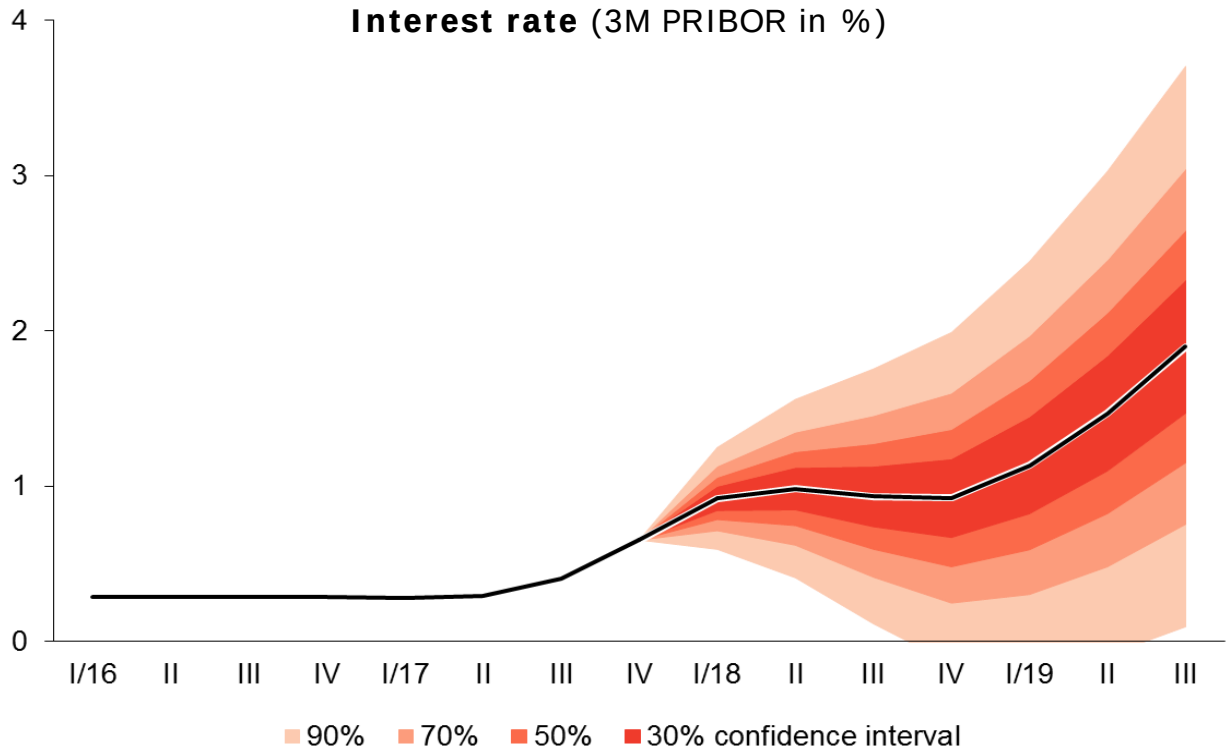
Sensitivity scenario – exchange rate



- With resumed publication of the exchange rate forecast, we also return to the standard symmetric exchange rate sensitivity scenario.
- Temporarily weaker/stronger exchange rates in the sensitivity scenario will lead to a higher/lower interest rate path compared to the forecast.

VII. Interest rates

Interest rate path



- Following interest rate increase in February (2T repo rate to 0.75%), further rise in rates at close of this year at earliest and especially next year is consistent with forecast.
  - In 2018, rise in interest rates will be slowed by continued accommodative ECB monetary policy, which will add to appreciation pressures on CZK.
  - During 2019, domestic interest rates will converge smoothly to their assumed long-run neutral level (i.e. 3% for 3M PRIBOR), owing, among other things, to foreign rates turning positive again.

Latest MP meeting

- 29 March 2018 MP meeting outcome: **2W repo rate maintained at 0.75%**, discount rate at 0.05% and Lombard rate at 1.50%.

- Bank Board assessed risks to existing inflation forecast at monetary policy horizon as being **slightly anti-inflationary**.

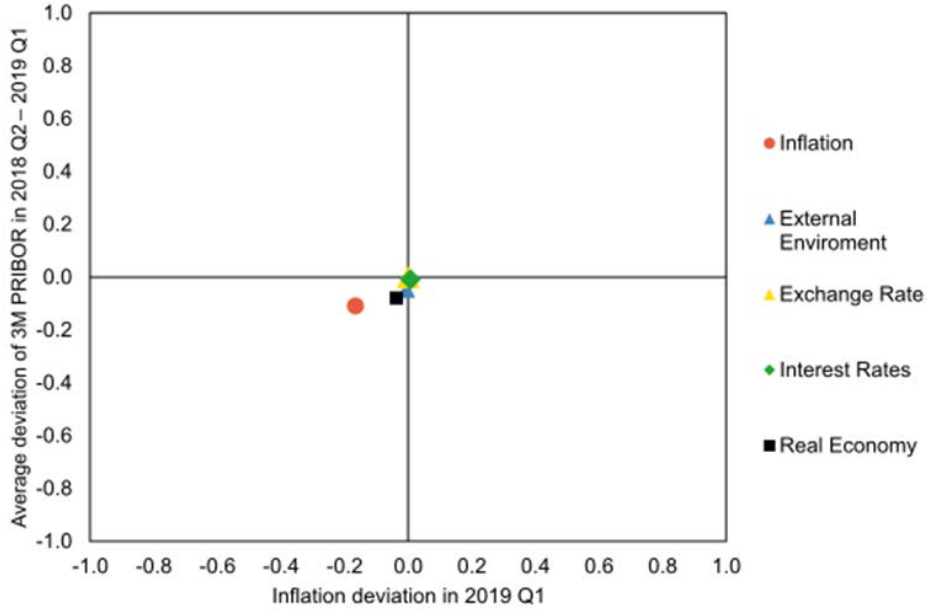
- Risks in this direction stem mainly from inflation, which decreased faster at start of this year than CNB had expected.

- However, more gradual appreciation of koruna compared to forecast may act in opposite direction in quarters ahead.

- CNB has renewed publication of Graph of Risk to Inflation Projection (GRIP). GRIP assists Board in its decision-making between two forecasts. It uses deviations to capture, in simplified way, effect of new information on current outlook for inflation and interest rates.

VIII. GRIP – Graph of Risks to Inflation Projection

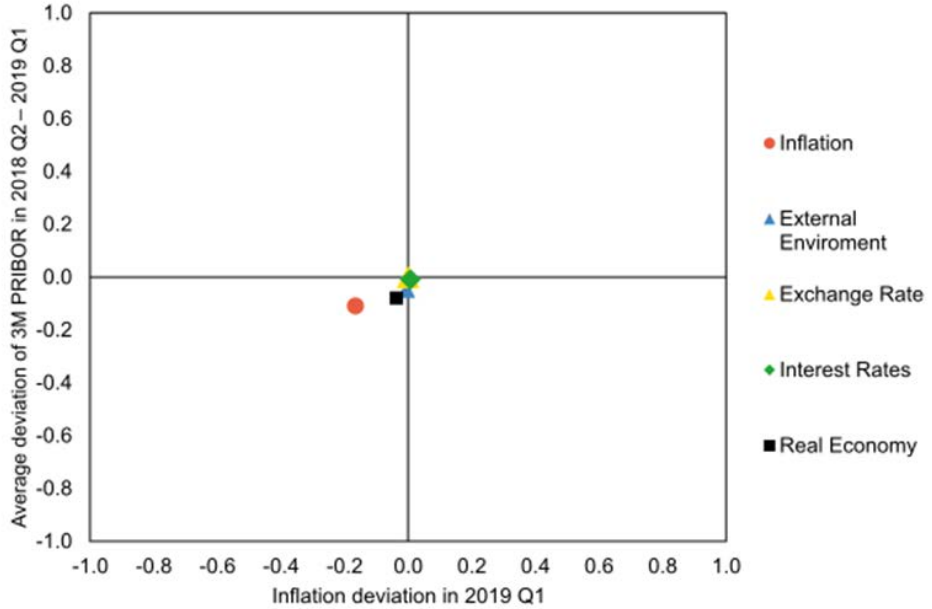
GRIP (Graph of Risks to Inflation Projection)



- GRIP is visual aid capturing risks to latest macroeconomic forecast by means of assessment of effect of new information on outlook for headline inflation and interest rates.

- GRIP is based on two-dimensional coordinate system.
  - On horizontal axis, distance from intersection point shows deviation of simulation from current headline inflation forecast at beginning of monetary policy horizon (t+4 quarters).
  - Vertical axis indicates effect of new information on average deviation of interest rates (3M PRIBOR) at horizon of t+1 to t+4 quarters, where t is current quarter (quarter of preparation of “small” situation report).

GRIP (Graph of Risks to Inflation Projection)



- **"External Environment"** point on GRIP indicates direction and size of shift in forecast with knowledge of new data on evolution of key foreign variables and changes in their outlook (mainly from CF and market outlooks).
- Effect of new data on GDP, structure of GDP and on wages in market sectors is reflected in **"Real Economy"** point.
- **"Exchange Rate"** point on GRIP illustrates shift of forecast in response to new short-term prediction for CZK/EUR exchange rate in current quarter.
- Similarly, **"Interest Rates"** point describes effect of potential deviation of average 3M PRIBOR market rates in given quarter from forecast.
- **"Inflation"** point indicates shift of current forecast using revised version of short-term inflation prediction. When simulating effect of new domestic inflation data, two new monthly inflation observations are usually available in current quarter.

Thank you for your attention

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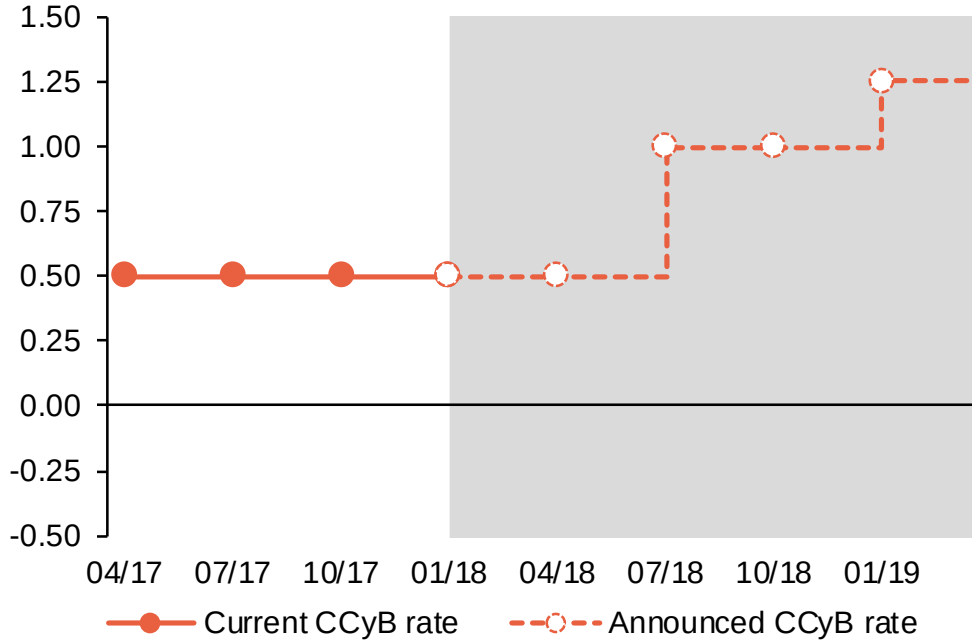
IX. Financial stability

CCyB rate setting

- CNB set CCyB rate at <u>above-zero level for first time</u> in 12/2015 (rate of 0.5%)
  - CCyB rate was subsequently raised twice to currently announced 1.25%.

Current and announced CCyB rate in Czech Republic
(% of total risk exposure)

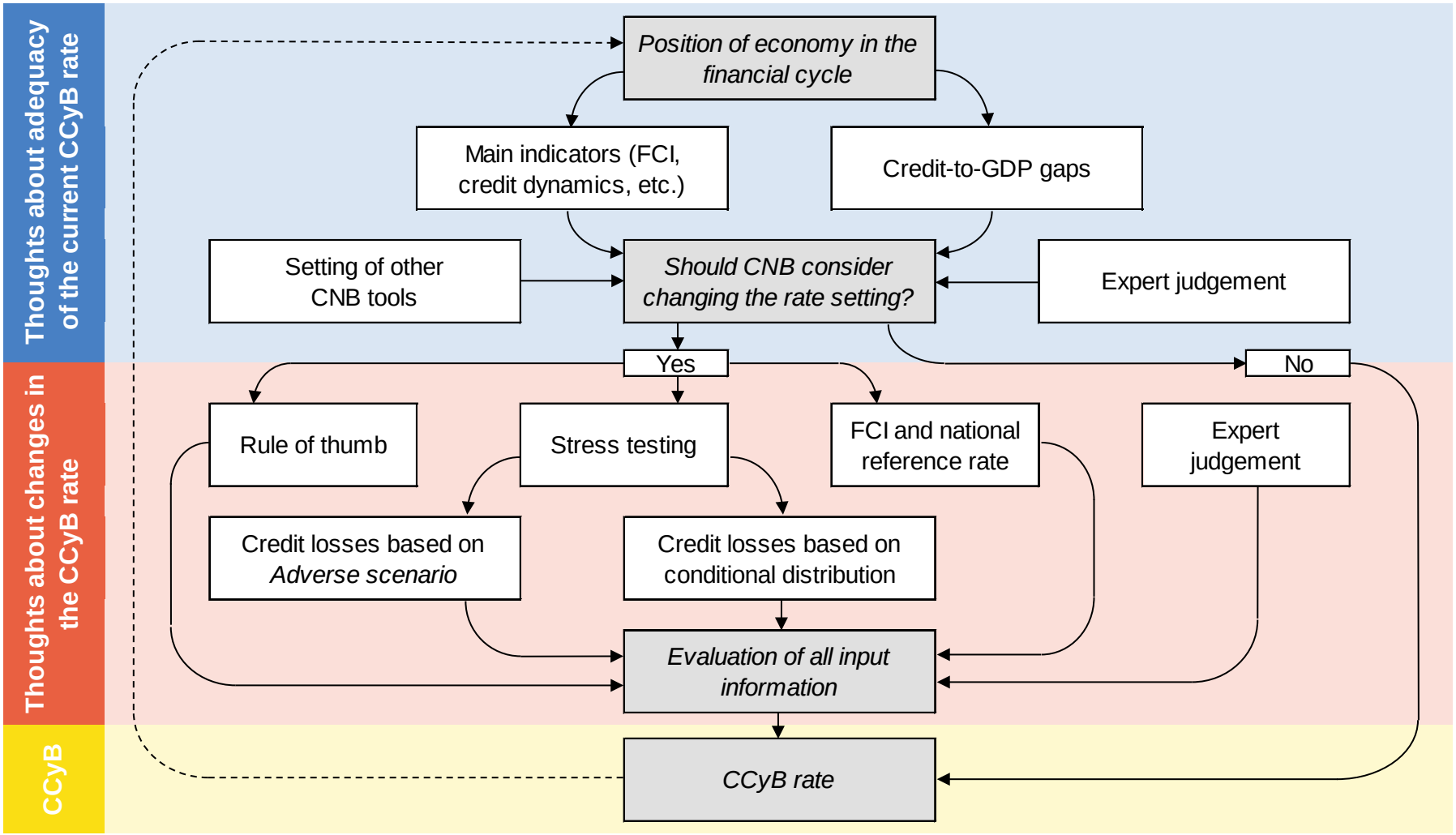


Source: CNB

Philosophy behind setting CCyB rate

- CCyB is not tool for curbing rapid credit growth, it just creates buffer for coping with its aftereffects.
- Potential for higher credit losses associated with growing optimism in good times should be reflected in higher CCyB to absorb them.
- Part of risks associated with fast credit growth should be preempted through targeted tools such as LTV limits.
  - Such tools can moderate policy response through CCyB, not eliminate it.
  - Should targeted tools fail to work, CCyB and other capital tools would have to be applied.
- CNB agrees with view that CCyB rate in normal times should exceed zero.

CNB's approach to setting CCyB: overall picture



Source: CNB