Czech monetary policy: On a way to neutral interest rates

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Current economic situation
• Inflation accelerated in 2018 Q3, which mainly reflected increasing core inflation; inflation slightly slowed to 2.2% in October.
• Core inflation increased due to a pick-up in the growth of nontradables prices while tradables prices recorded an ongoing negligible decline.
• The contribution of food prices to overall inflation declined temporarily.
- GDP growth slowed to 2.4% in 2018 Q2 due to lower contributions of all components of domestic demand. The economy is driven mainly by growth in household consumption and by investment activity.

- The output gap remains positive but has narrowed somewhat.

- According to the small structural model, the positive output gap will gradually close further; according to the production function, conversely, it will gradually increase from its currently low level.
The number of unemployed persons on the labour market is currently at an all-time low and the number of vacancies at an all-time high (amid record-high employment and labour force levels). This is being reflected in marked wage growth, which helped to keep core inflation distinctly positive.
Assumptions of the forecast
• GDP growth in the effective EA will gradually slow to 1.7% in late 2020.
• Annual producer price inflation in the EA has reached 4% (mainly reflecting growth in oil prices), but will gradually slow to just below 2%.
• According to the market outlook, 3M EURIBOR will turn positive in early 2020.
Government budget surpluses, reflecting increased tax revenues due to ongoing economic growth and policy measures, will persist.

The government surplus will reach 1.5% of GDP this year and remain at a similar level in the next two years. This will translate into continued structural surpluses and decrease of debt to GDP.

Real government consumption will grow by 2.7% in 2018 and slow down slightly afterwards.
Fiscal impulse

<table>
<thead>
<tr>
<th>Contributions to GDP growth in percentage points</th>
<th>2017 actual</th>
<th>2018 forecast</th>
<th>2019 forecast</th>
<th>2020 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal impulse</td>
<td>0.2</td>
<td>0.5</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<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>0.3</td>
<td>0.2</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>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>government investment, EU funded</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
</tr>
</tbody>
</table>

- Fiscal policy will be expansionary this year and the next, and neutral in 2020.
- The distinctly positive fiscal impulse of 0.5 p.p. this year relates mainly to measures supporting household consumption, buoyant wage growth in the government sector and faster growth in government investment.
- A positive fiscal impulse of 0.4 p.p. for the next year will reflect an extraordinary rise in old-age pensions, continued growth in government investment and strong wage growth.
The macroeconomic forecast
(Inflation Report IV/2018)
Headline inflation forecast

- Inflation will stay in the upper half of the tolerance band until the beginning of 2020, peaking in the first quarter of 2019.
- It will return close to the target at the monetary policy horizon.
- October data slightly below the forecast (2.2% vs. 2.4%) due mainly to lower-than-expected annual food price inflation and, to a lesser extent, to slower growth in administered prices.
Core inflation will rise further in the short term, as a result of recent koruna depreciation coupled with foreign producer price growth and strong domestic inflation pressures. In the second half of 2019, core inflation will return to 2% due to a moderation of the overall inflation pressures.

Food price growth will speed up markedly on the back of an expected rise in agricultural commodity prices in the next four quarters. Reflecting subsequent stagnation of commodity prices and renewed appreciation of the koruna, food price growth will slow down somewhat by the end of next year.
GDP growth has slowed from last year’s high levels. It will average slightly above 3% this year and in the years ahead.

Consumption and investment will support GDP growth over the entire forecast horizon; net exports will contribute negatively in 2019.
The continued household consumption growth will reflect strong growth in wages and salaries and other income (+ pensions in 2019).

Investment growth will be driven by both private and government investment.

The contribution of net exports to GDP growth will be negative next year due to fast growth in imports implied by strong domestic demand.
• Employment growth will gradually slow due to labour shortages.
• With a record-low unemployment rate, employment growth will rely mainly on further increases in the labour force and in hours worked per employee.
Wage growth will start to slow at the end of 2018 due to tightening monetary conditions and firms’ efforts to maintain their competitiveness and profitability.

An increase in the minimum wage in 2019 will bolster wage growth temporarily.

Pronounced, albeit slowing, y/y wage growth will continue in the non-market sector, reflecting an increase in the wages of teachers and, to a lesser extent, other public employees.
The exchange rate forecast for Q4 at CZK 25.7/EUR reflects persisting negative global sentiment and an outflow of short-term capital from emerging markets to assets that investors perceive as less risky.

The koruna will start appreciating again next year, driven by a distinctly positive interest rate differential vis-à-vis the euro area and continued real economic convergence connected with growing labour efficiency.
Consistent with the forecast is a continued rise in interest rates towards their long-run neutral level.

The rate increase at the start of the forecast is a response to the recent depreciation of the koruna, coupled with ongoing domestic inflation pressures.

The subsequent broad stability of rates in 2019 is a result of forecasted appreciation of the koruna amid continuing very easy ECB monetary policy.
The sensitivity scenario assumes a rather strong, persistent and fully anticipated pressure for a further depreciation of the koruna.

In order to avoid pronounced weakening of the exchange rate and long-lasting overshooting of the inflation target, interest rates have to rise much more rapidly compared to the baseline.
Summary of the forecast

- Inflation will stay in the upper half of the tolerance band in 2019 and will approach the 2% target from above over the monetary policy horizon.

- GDP growth slowed from last year’s high levels; from the whole-year perspective it will be just above 3% this year and in the years ahead. The economy will be driven mainly by growth in household consumption and by investment activity. Due to fast growth in imports, net exports will contribute negatively in 2019.

- The continued economic growth has been reflected in a tight labour market, which will inhibit further fast employment growth. An increase in the minimum wage in 2019 will stimulate wage growth temporarily, followed by a gradual slowdown.

- After its current weakness reflecting negative global sentiment, the koruna will return to an appreciation trend from next year due to a distinctly positive interest rate differential vis-à-vis the euro area, fading effects of QE by the ECB and real convergence of the Czech economy.

- Consistent with the forecast is a continued rise in interest rates towards their long-run neutral level; the continued rise is a reaction both to marked inflation pressures from the domestic economy and to the temporary depreciation of the koruna.
Thank you for your attention

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