CNB Monetary Policy on Its Way Back to Normal

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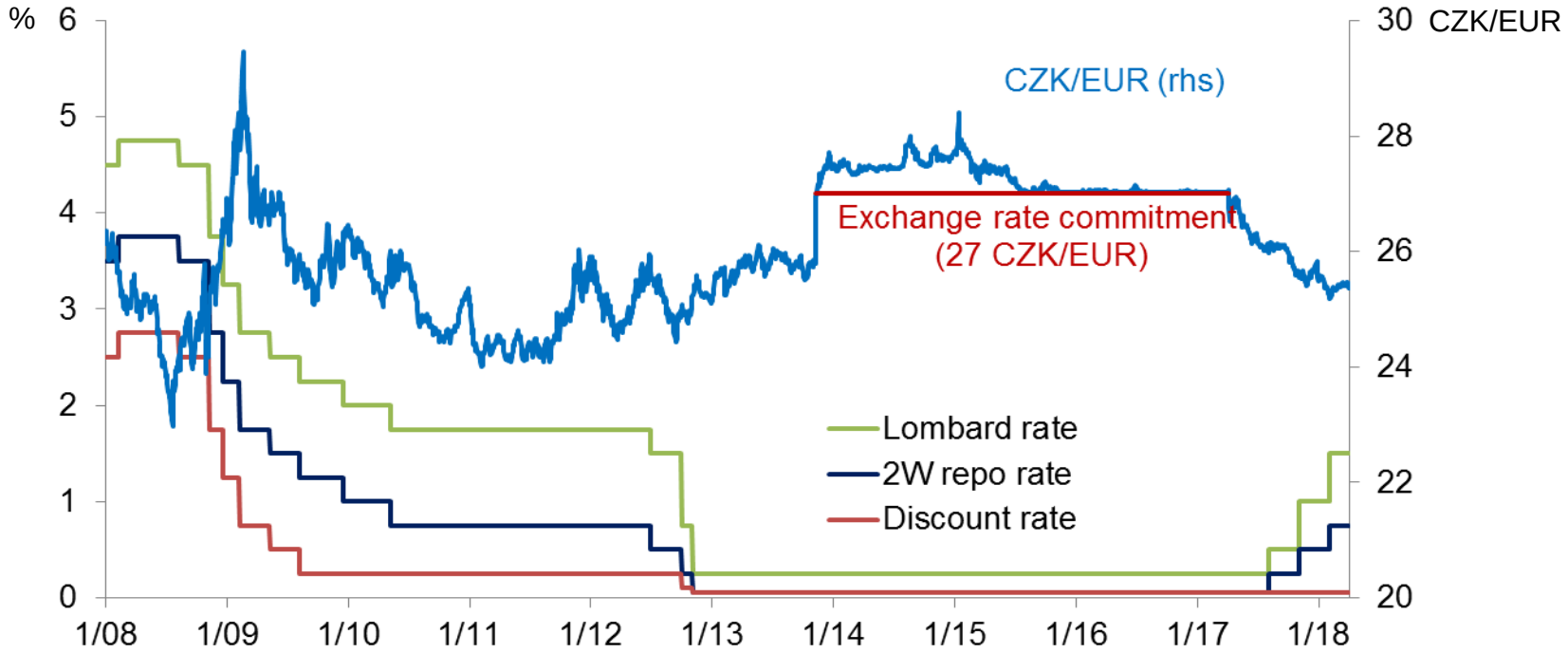
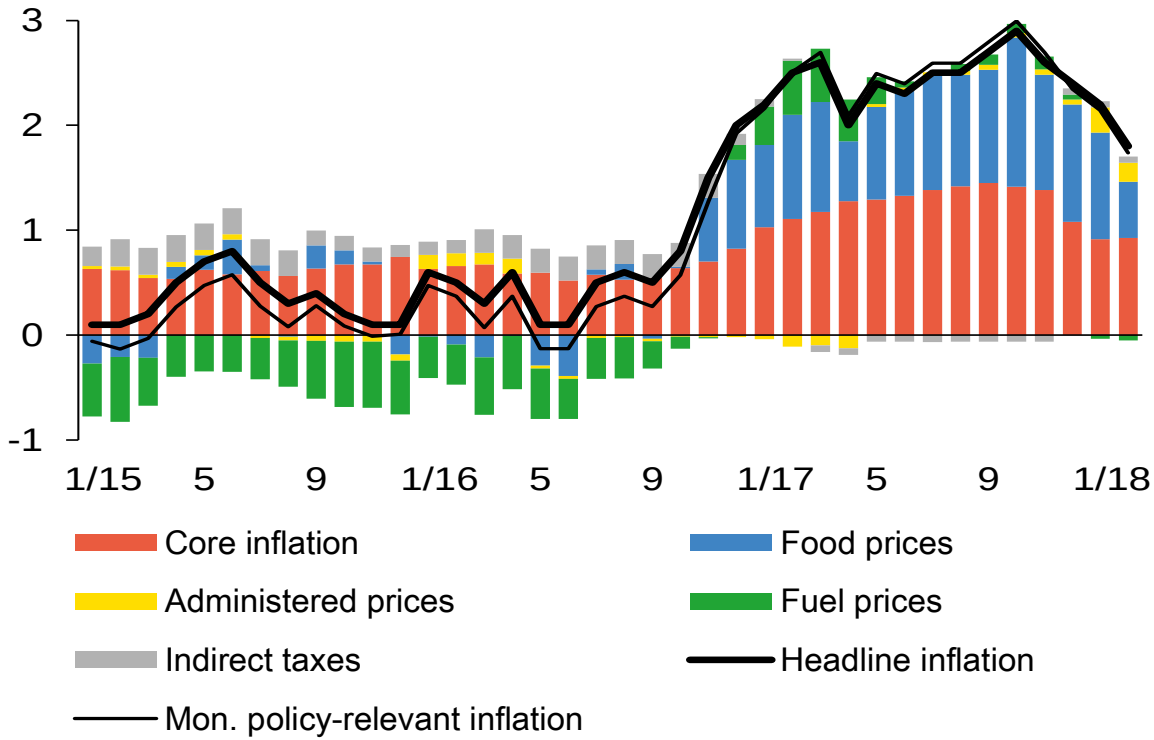
Exit from FX commitment



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

Structure of inflation

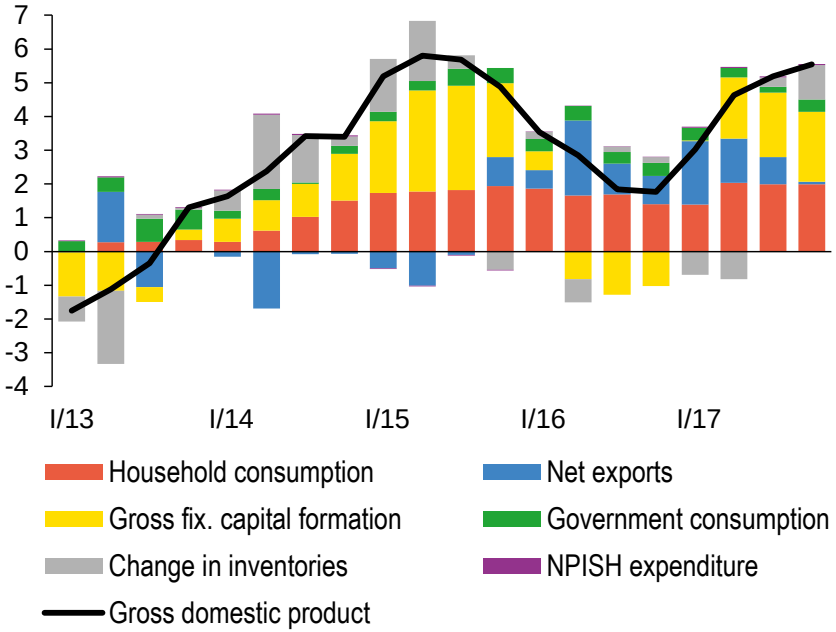
(annual percentage changes; contributions in pp)



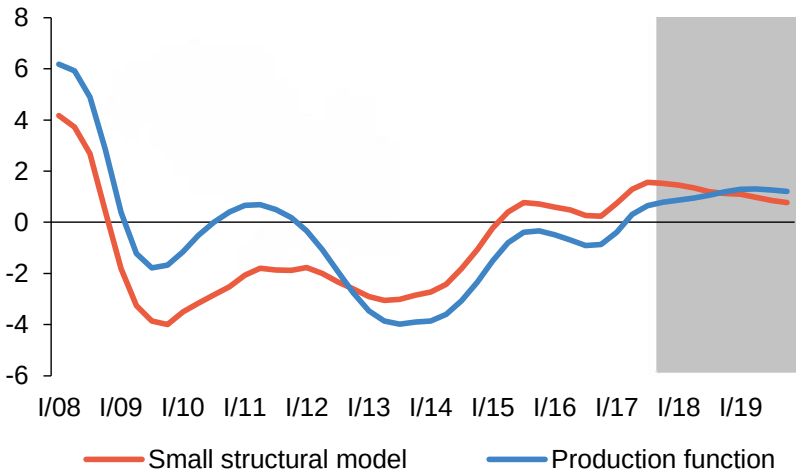
- Inflation peaked at just below 3% in 10/2017 (still within tolerance band) then declined to 1.8% in 2/2018. Strong inflationary pressures reflect faster GDP and wage growth.
  - Slowdown was driven mainly by core inflation, which declined as result of unwinding of one-off effects seen in late 2016/early 2017 (esp. pick-up in restaurant prices linked to introduction of ESR).

GDP growth and output gap

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

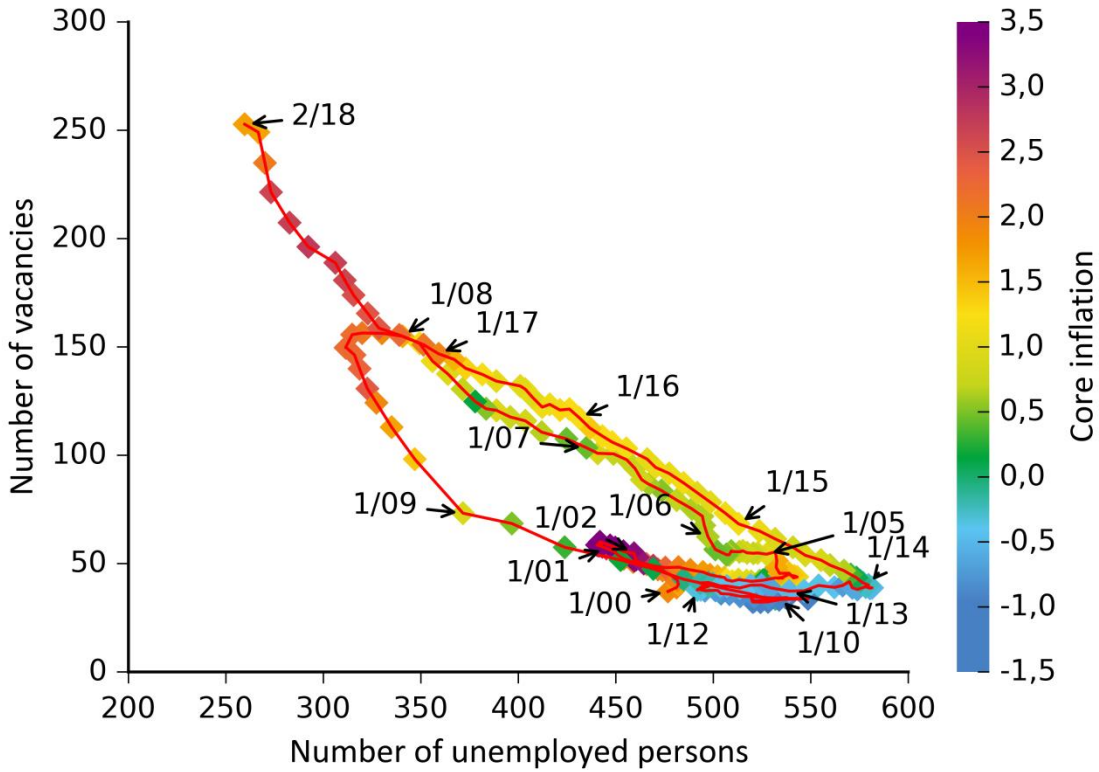


Output gap
(% of potential output)



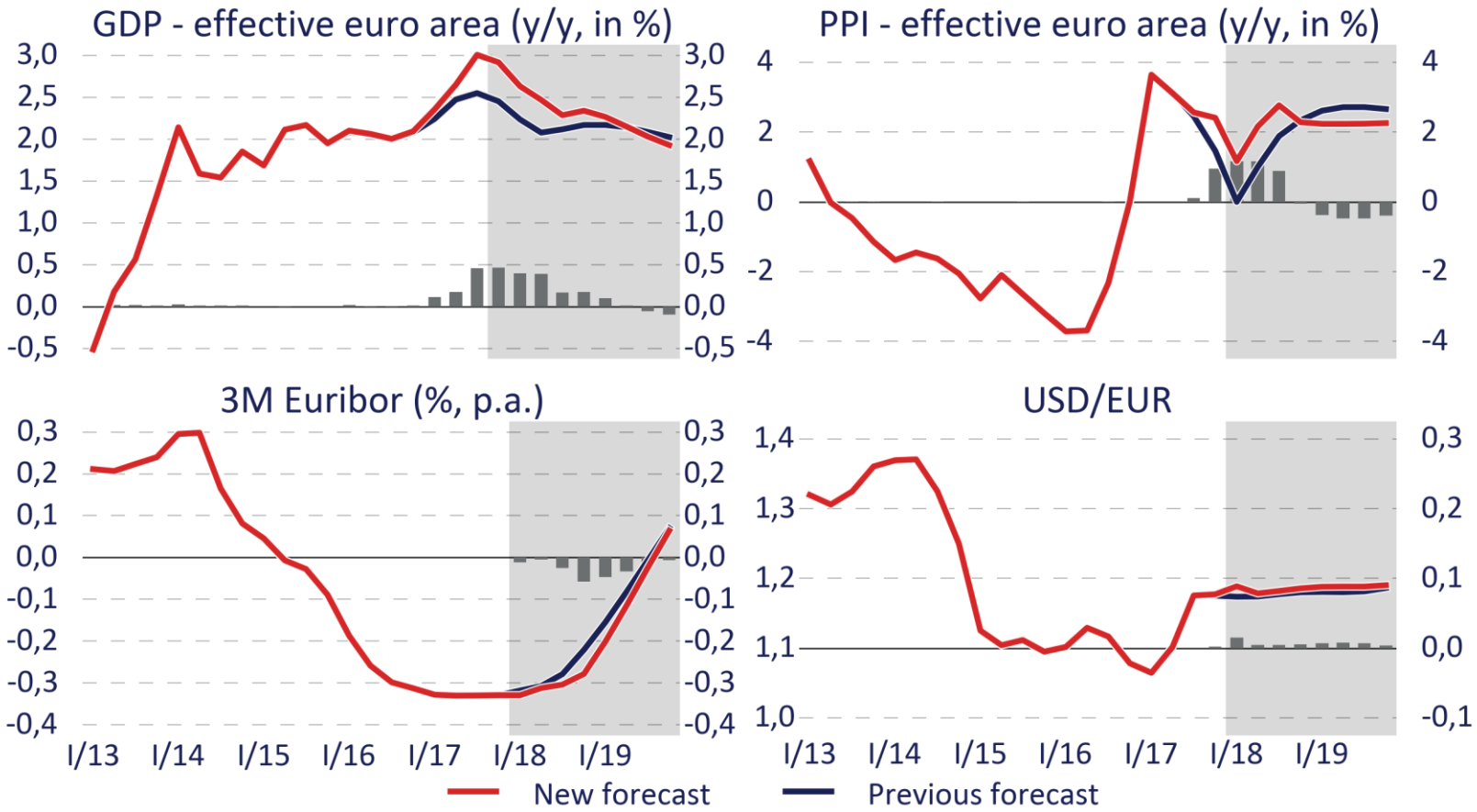
- Economic growth has accelerated significantly in recent quarters (to 5.5% in 2017 Q4) due to household consumption and investment.
  - Import intensity of investment and moderation in export growth have led to lower net exports contribution.
- Economy remains above its potential. This is reflected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

Beveridge curve



- Fall in number 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 labour force levels).
- This is being reflected in marked wage growth, which helped keep core inflation distinctly positive even after ESR effect subsided.

External environment outlook



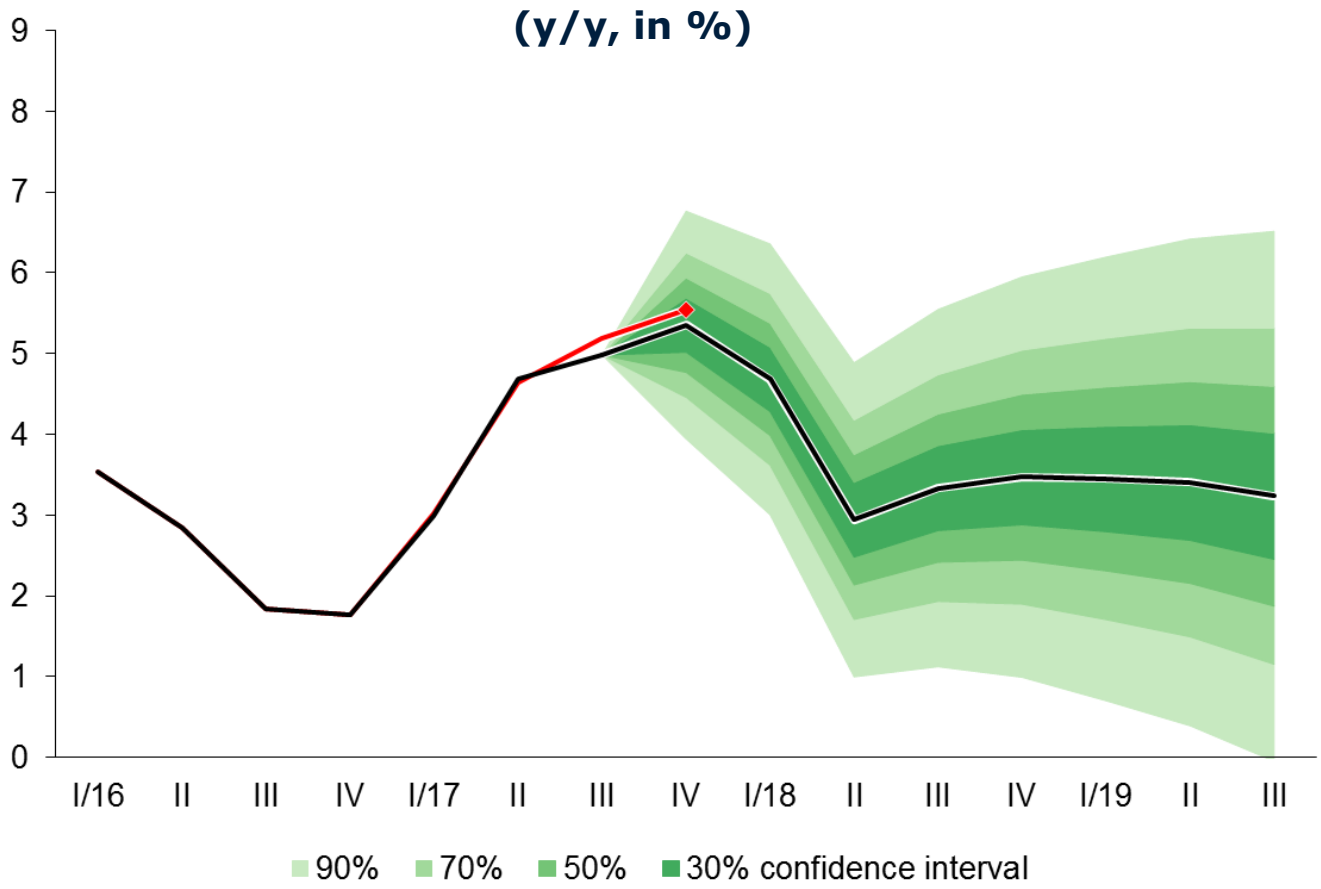
- GDP growth in effective eurozone will remain robust.
- Producer price dynamics will slow at start of 2018 but will then recover, reflecting current high oil price and increasing economic activity.
- Continued QE by ECB keeps 3M EURIBOR outlook in negative territory until mid-2019. USD/EUR outlook close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

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

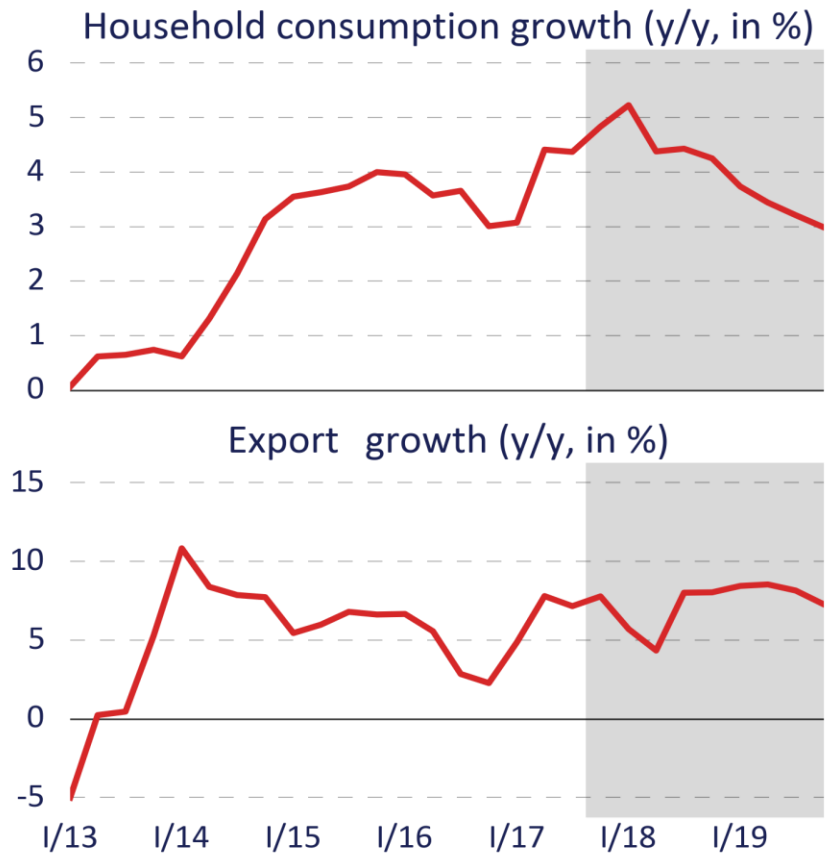
- Fiscal policy will be expansionary this year.
- Fiscal expansion will relate mainly to measures supporting household consumption, including buoyant wage growth in government sector.
- Czech economic growth will also be bolstered by faster growth in government investment in 2018 (recovery in drawdown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

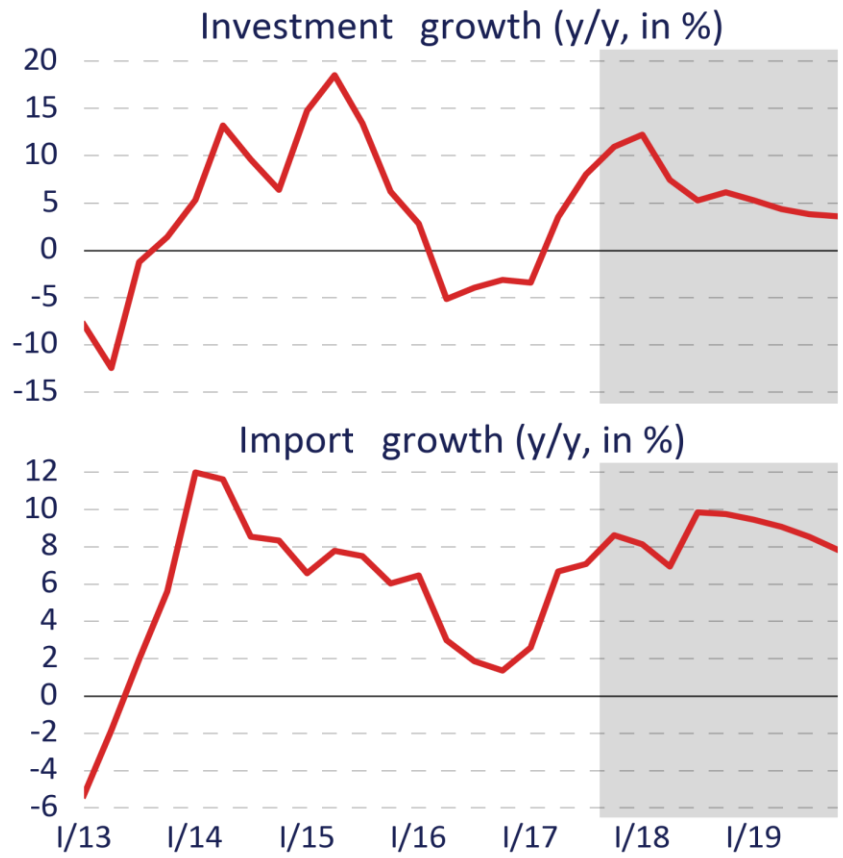
GDP growth forecast



- 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 fuelled by robust growth of 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

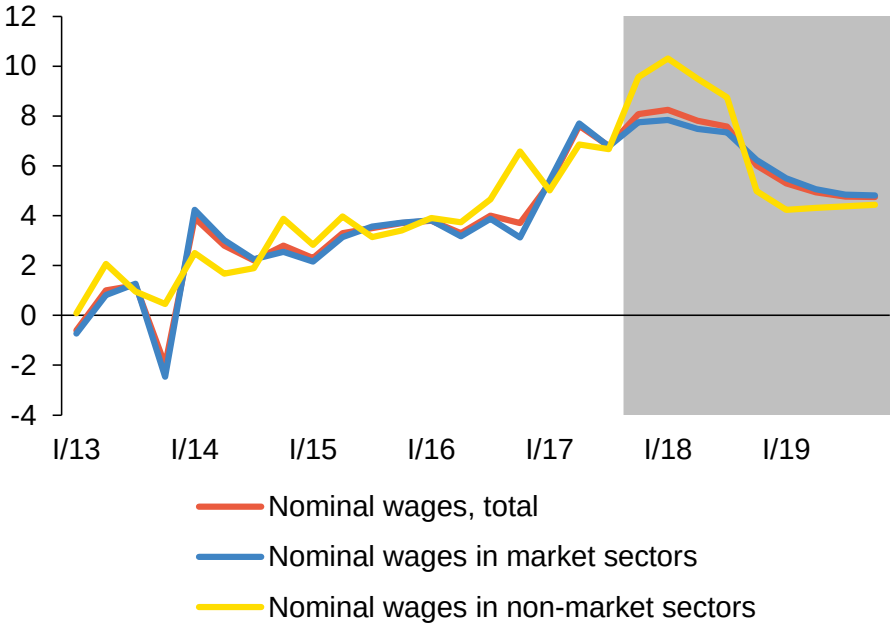




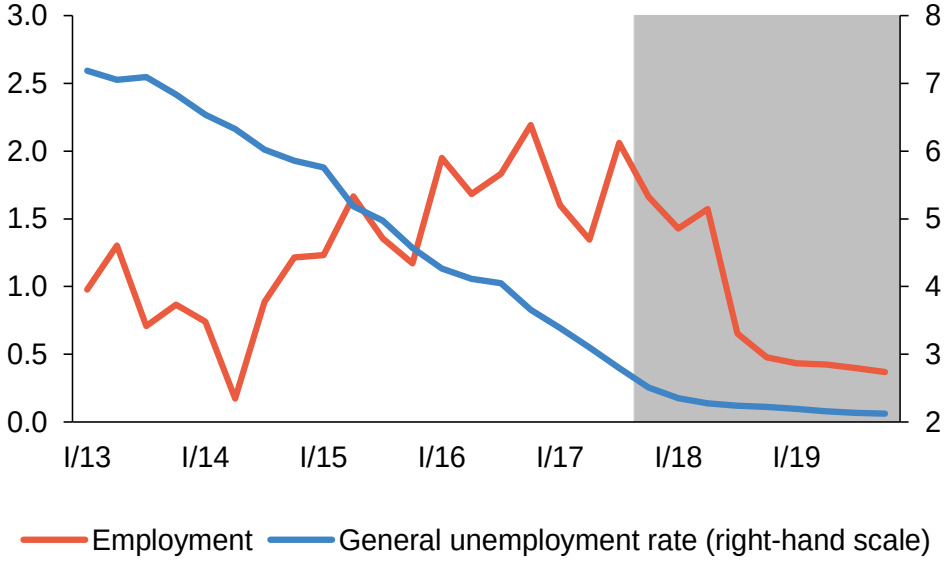
- Strong household consumption growth (peaking above 5% at start of 2018) will reflect rapid rise in wages and salaries and other income.
- Gross capital formation growth will accelerate further owing to recovery in government investment amid continued rise in private investment.
- Both export and import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

Labour market forecast

Average nominal wages
(y/y, %)

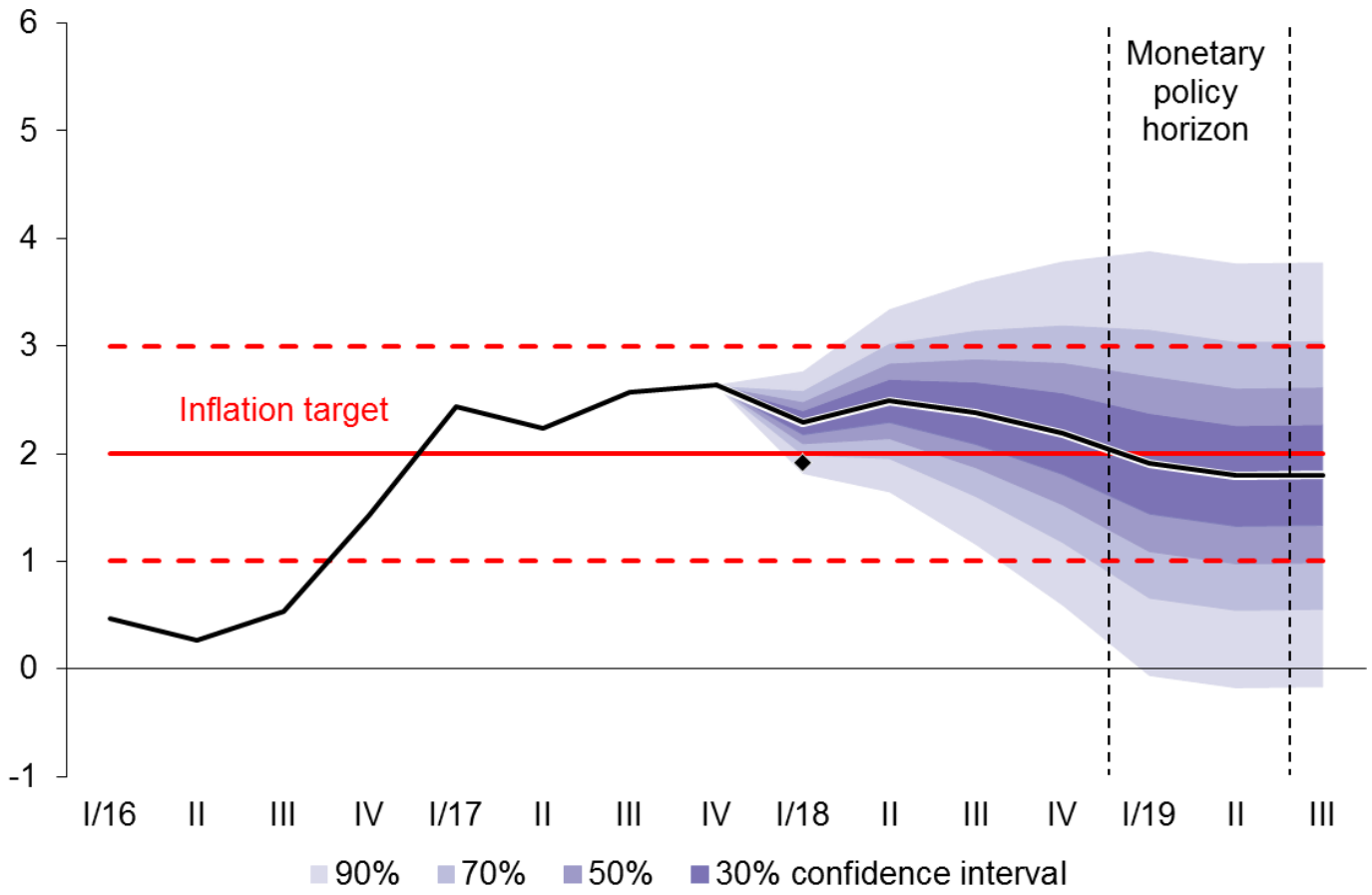


Employment and unemployment
(employment– y/y, %, unemployment %, s.a.)



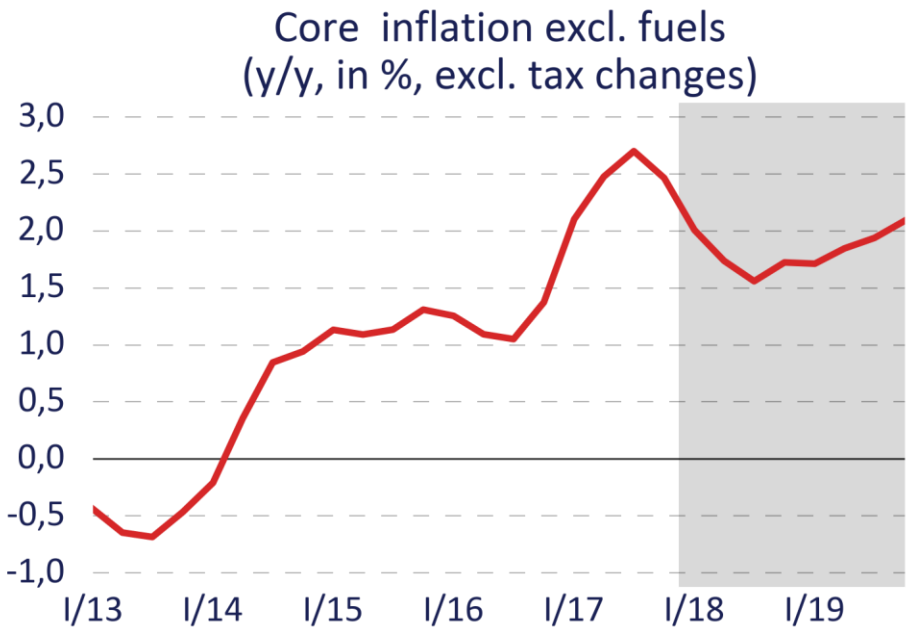
- Labour market tightness will keep wage growth in market sectors at high level (7.6 % in 2017 Q4). Further increase in minimum wage is also fostering continued fast wage growth this year.
- Wage growth will later slow gradually to close to its assumed long-term level of 5% (tightening of monetary conditions, 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.

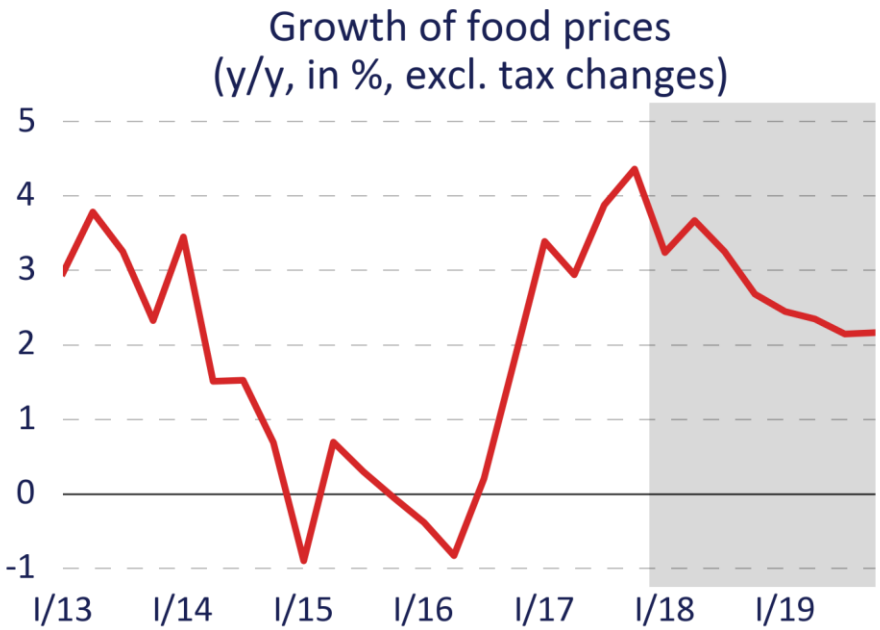
Headline inflation forecast



- Inflation will be above 2% target for rest of this year and return to it at start of next year. <u>In 2019, inflation will move just below 2%</u>.
- MP-relevant inflation will differ only marginally from headline inflation.

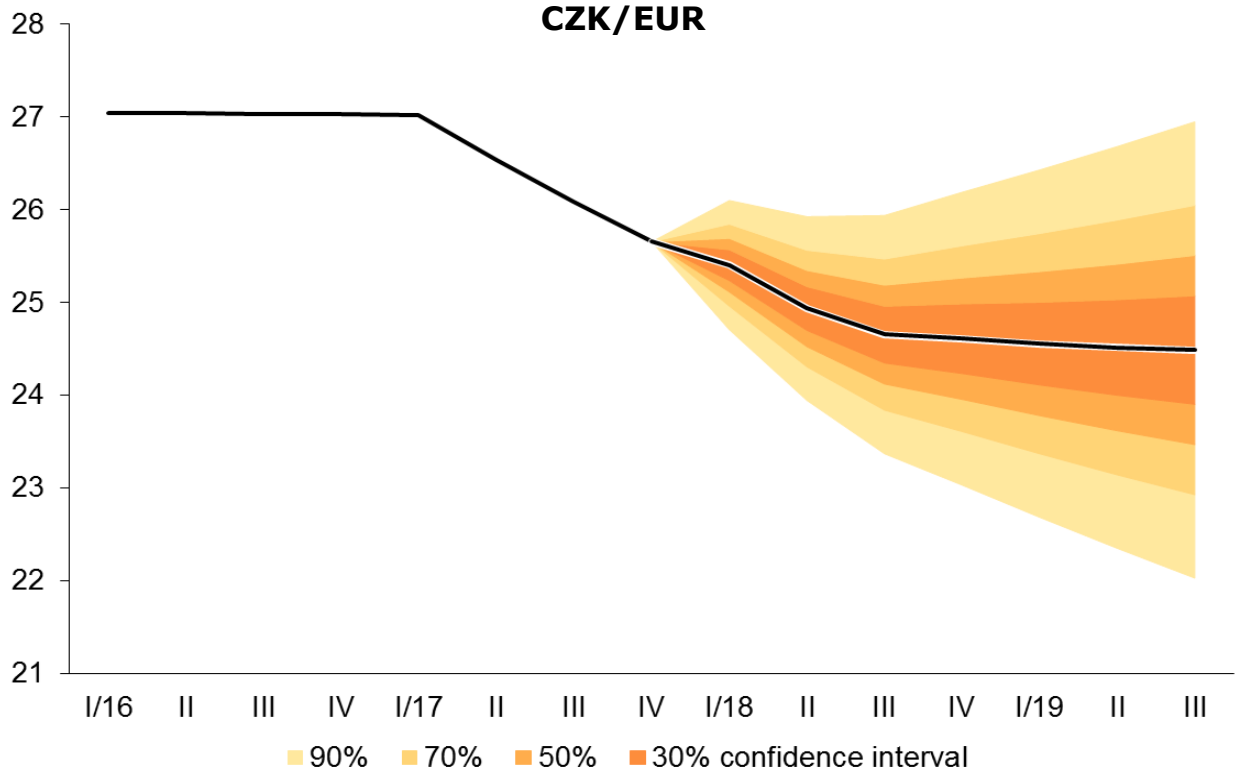
Core inflation and food prices





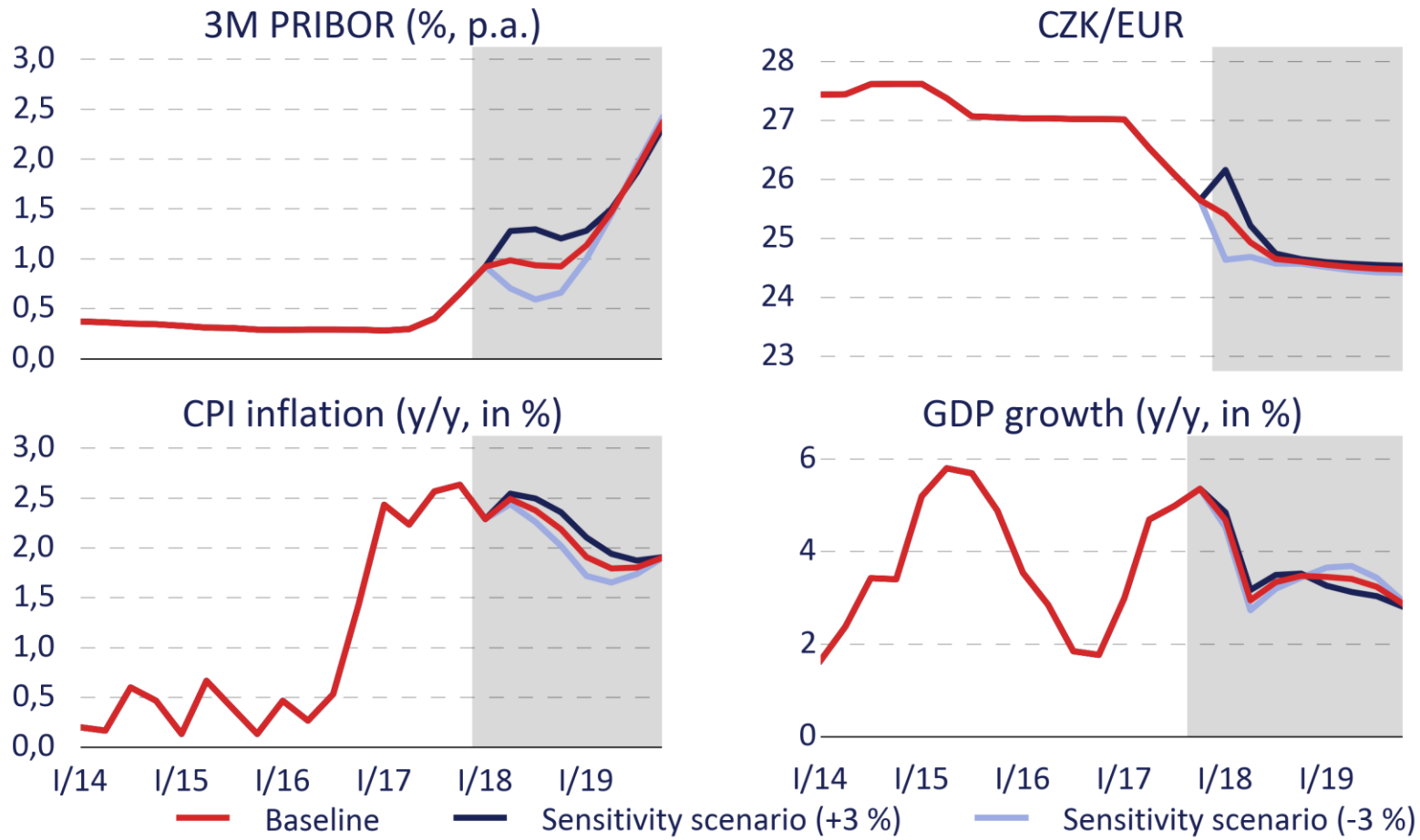
- Core inflation will slow this year owing to unwinding of one-off factors and appreciation of koruna. These anti-inflationary factors will be partly offset by impact of rising domestic demand and wages.
- During 2019, core inflation will start to rise gradually back towards 2%, reflecting renewed growth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

Exchange rate (renewed publication)



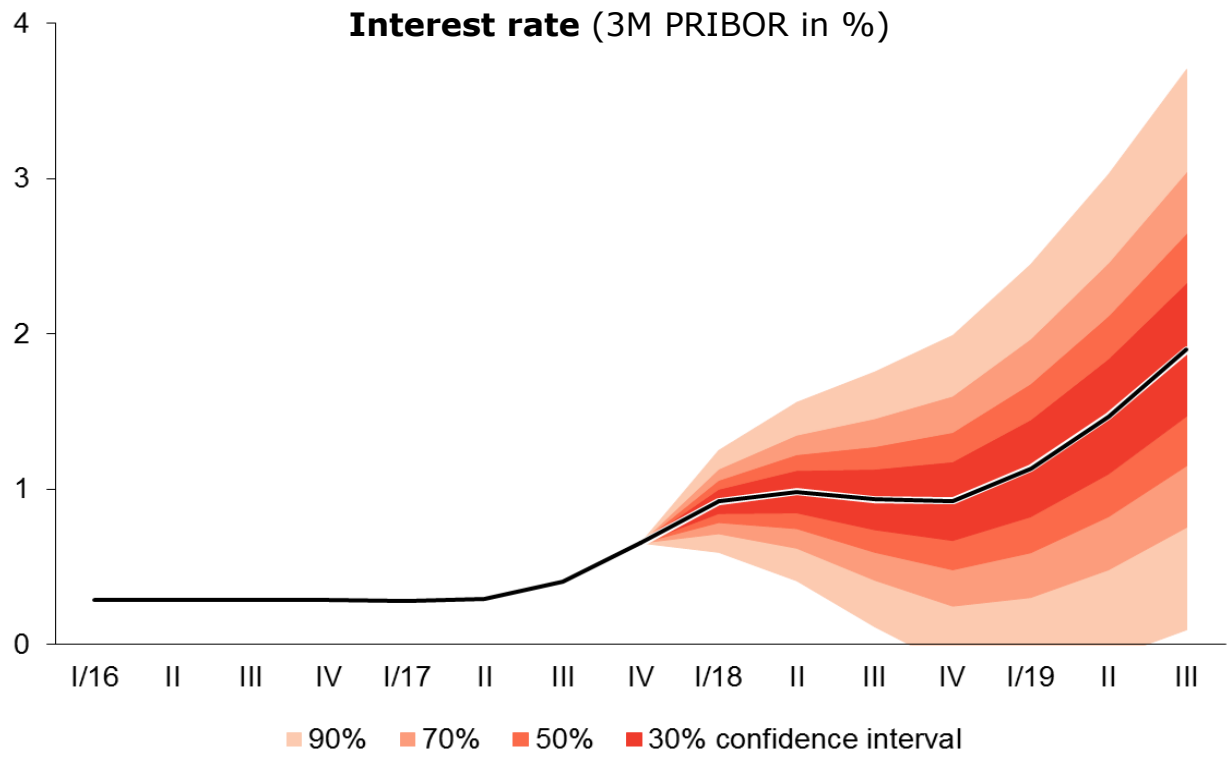
- Projected exchange rate is not commitment or preferred path!
- According to forecast, koruna will appreciate further:
  - in 2018 due to <u>increasing interest rate differential</u> vis-à-vis euro area and continued purchases of assets by ECB until 9/2018.
  - in 2019 – rather modest appreciation –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

Sensitivity scenario – exchange rate



- With resumed publication of exchange rate forecast, we also get back to this standard symmetric exchange rate sensitivity scenario.
- Temporarily weaker/stronger exchange rate in sensitivity scenario leads to higher/lower interest rate path compared to forecast.

Interest rate path



- Following interest rate increase in February (2W 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.

Thank you for your attention.

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