Czech Economy: Growth Without Inflation?

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Introduction: basic facts

- Czech economy: small and open
- 10.5 million of inhabitants
- GDP per capita: 15 600 EUR (PPS)
  - 85 % of EU average
  - 68 % of German level
- EU member as of 2004, non-EMU member
- Currency: CZK, Exchange rate: 27.0 CZK/EUR
- Monetary policy regime: inflation targeting
- Inflation target: 2 % (consumer price index)
Basic story of previous years

- Big slump (crisis) in 2009 followed by moderate growth 2010-2011
- Rapid growth in 2015 followed by expected moderate slowdown in 2016
- In 2015, one-off factors contributed strongly, namely the EU funds
- GDP growth expected around 2.5 % in 2016
CNB loosened its monetary policy as of October 2008 similar to other central banks.

Monetary policy rate (2 week repo rate) hit the zero lower bound in November 2012.

Inflation below target as of the beginning of 2013.

Temporary increase of CPI was caused by VAT hikes in 2012 and 2013.

The inflation forecast indicated short period of deflation in Autumn 2013.
Exchange rate commitment of CNB

- CNB started to use exchange rate as a tool of further easing of monetary policy
- ER commitment: CNB will intervene against appreciation of CZK above 27 CZK/EUR
- ER commitment was adopted in November 2013, with expected exit in Q1/2015 (when the inflation should have reached 2% according to November 2013 forecast)
- However, the fulfilment of 2% headline inflation target was not the case, so that ER commitment was prolonged
- In 2015 the average annual inflation was at 0.3%, even though GDP rose by 4.3%, y/y
- At the moment exit seems probable in mid-2017 – however it will not be a trivial task

Source: CNB
Growth above expectations, inflation below....

- The exit from FX commitment formerly expected in Q1/2015 - CPI should have reached the target and GDP growth was expected around 3%
- GDP growth under zero inflation or even mild deflation is a new macroeconomic experience (similar to Sweden, Slovakia, Poland, etc)
- The fears from deflationary spiral had been most probably overshooted
The development of price level is differentiated
Long-term desinflationary pressures (telecommunications, housing equipment, clothing and footwear)
Tobacco and alcoholic beverages, water supply, some energies
House prices are not included in CPI

Source: CZSO
Monetary indicators and bond prices

- The volume of money has been rapidly increasing in contrast to CPI
- Consumer price level rose by around 10% since 2008
- M2 volume increased by almost 40% since 2008
- State bond prices (over 10 years) rose by more than 25% since 2008
- These have been further indicators of overheating
- However, the CPI inflation remains below target. (expected to be reached in mid-2017)
• While CPI remains low, house prices have been booming in part of EU (Sweden, Denmark, Austria, Germany)
• The situation is similar to USA in 2001 – 2004...the housing bubble was downplayed by Fed –
• Reinhart and Rogoff (2009) place the HPI (house price index) to the top of the list of indicators warning about the risks of financial crises
• Czech National Bank is closely monitoring the housing market and has already introduced macroprudential measures
• However, it is a question, whether macroprudential policy may stop the housing boom if the important factor is the zero deposit interest rate....
Indicators of confidence have reached the pre-crisis levels

- Consumers have been profiting from low unemployment, increasing wages and low inflation
- Exports (mostly manufacturing industries) have been supported by solid foreign demand
- Services have been supported mostly by solid domestic demand
- Construction is the only industry performing poorly – evaporation of one-off factors (EU funds)

Source: CZSO
In June 2016, the unemployment rate in CR was the lowest in EU
Labour market figures at historical records, low unemployment, high demand for labour
Structural mismatch has started to be a barrier for higher growth
## Forecast for 2016 and 2017

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<thead>
<tr>
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<th>2016 (f)</th>
<th>2017 (f)</th>
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<tbody>
<tr>
<td><strong>GDP</strong></td>
<td>2.5</td>
<td>2.6</td>
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<tr>
<td><strong>Unemployment (domestic methodology)</strong></td>
<td>5.6</td>
<td>5.3</td>
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<tr>
<td><strong>Inflation</strong></td>
<td>0.6</td>
<td>1.8</td>
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<tr>
<td><strong>Household consumption</strong></td>
<td>3.0</td>
<td>2.7</td>
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<tr>
<td><strong>Investments</strong></td>
<td>0.5</td>
<td>3.4</td>
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<tr>
<td><strong>Eurozone GDP</strong></td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td><strong>Euro exchange rate</strong></td>
<td>27.02</td>
<td>26.80</td>
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<tr>
<td><strong>3M PRIBOR</strong></td>
<td>0.29</td>
<td>0.30</td>
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<td><strong>Balance of government institutions</strong></td>
<td>-0.7</td>
<td>-0.8</td>
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<td><strong>Government debt</strong></td>
<td>39.8</td>
<td>39.1</td>
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<td><strong>Loans to businesses</strong></td>
<td>6.0</td>
<td>5.0</td>
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<tr>
<td><strong>Loans to households</strong></td>
<td>7.2</td>
<td>5.5</td>
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</tbody>
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Risks and uncertainties

• **External**
  • Geopolitical risks...
  • Oil prices – currently expected around 50 USD/per barrel in 2017
  • Brexit – the impact is very difficult to estimate at the moment
  • Banking sector in some eurozone countries

• **Domestic**
  • The exit from FX commitment will crucially depend on external (ECB policy, eurozone growth) and domestic conditions (intensity of demand)
  • In good times shocks are better absorbed
  • Smooth exit will depend on communication and strategy of exporters – old saying: It is only when the tide goes out that you see the rocks. (Or Warren Buffet’s variant: “It is only when the tide goes out that you see who has been swimming naked.”)
Thank you for your attention