

**Overview:** In this week's showCASE, our experts discuss the decision of the Czech National Bank to increase the interest rate, and whether or not other central banks across Europe will follow suit.

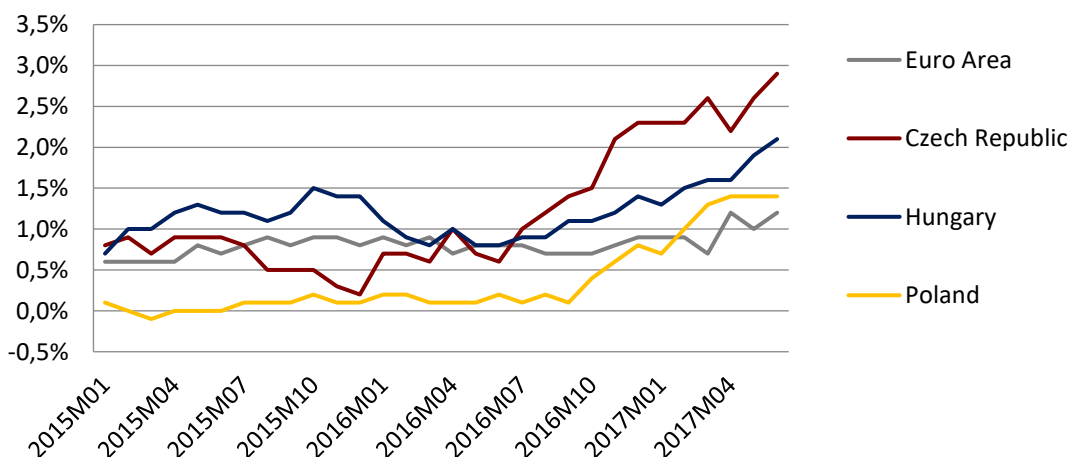
## The Czech National Bank: (not) a bellwether for policy reform in the continent

By: [Iakov Frizis](#), CASE Economist

Last week, the Czech National Bank (CNB) decided to increase its base policy interest rate to 0.25%, becoming the first European central bank to move away from prolonged monetary easing. However, one instance of tightening in the Czech Republic is not a bellwether for monetary policy reforms across the continent, as core inflation (as measured by consumer prices) across both the Euro Area and the neighboring Visegrad countries remains far from its target rate.

After close to five years of monetary easing (0.05% base rate and a commitment to defend the 27 EUR/CZK exchange rate parity), the Czech Republic has [avoided deflation](#). However, the country has yet to leave its monetary travails behind, and indeed, the Czech Republic is facing higher-than-targeted inflation,<sup>1</sup> with core inflation currently at 2.9% (from a mere 0.6% in June 2016). Meanwhile, local industries have been facing mounting [challenges](#) in meeting the demand for exports, as [labor shortages](#) underscore the unsustainability of the country consistently producing above its current potential.

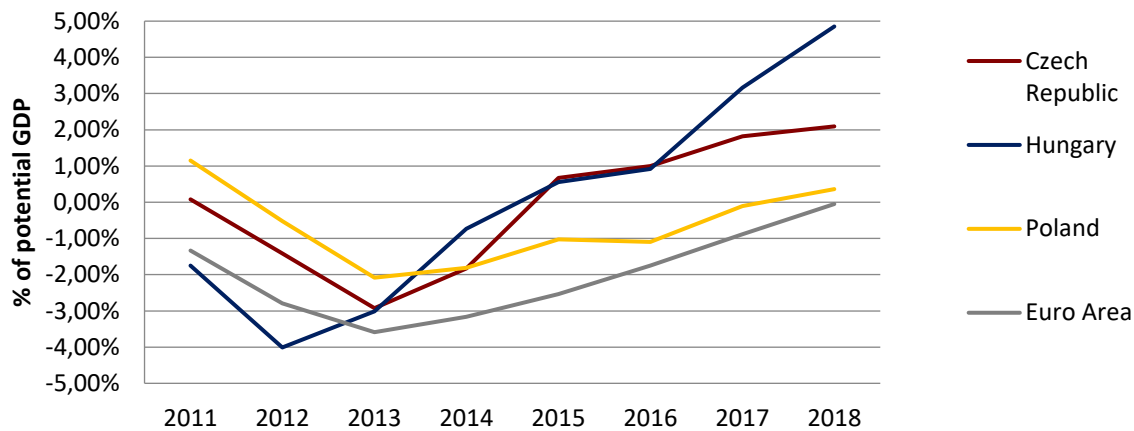
**HICP - excluding season food and energy**



Source: Eurostat

<sup>1</sup>The inflation rate for the Czech Republic currently remains above the target rate irrespective of the method that one employs to observe inflation in the country. In particular, CASE has taken under consideration the following three rates provided by the EUROSTAT: HICP – All items, HICP – All items excluding energy, food, alcohol and tobacco and HICP – All items excluding energy and seasonal food. Moreover, CASE also considered the CPI measurement that the CNB offers via <https://www.cnb.cz/en/statistics/inflation/>.

### Output gap of the total economy



Source: OECD Economic Outlook No 101 – June 2017. The efficient level of production for a country is at 0% (potential output = actual output). For positive values of the output gap actual output is above potential. For negative values of the output gap the economy is underutilizing the currently available factors of production.

The interest rate hike was not the first step taken by the CNB to get a grip on increasing inflation, as, in April 2017, the Bank allowed the koruna to float. This resulted to an immediate appreciation of the currency against the euro, from the 27 EUR/CZK fixed rate down to 26.12 EUR/CZK by August 2. This 3.4% exchange rate appreciation already qualifies as a form of monetary tightening ([according to the CNB](#), 1% of interest rate appreciation equals 0.25 increase in the base rate).

But it is the rate hike that has garnered the attention of markets, as the CNB's increase made it the first central bank in the Eurosystem to break away from quantitative easing. While the Czech Republic's base rate is still a far cry from the rates of neighboring (non-Euro) countries, with Hungary at 0.9% and Poland at 1.5%, by opting for a 20 basis-point rise, the CNB has set the scene for further small hikes. This approach is hoped to allow the Bank to maintain a watchful eye over the Czech price level and its exchange rate, as well as to preserve a substantial amount of flexibility in reacting to the still-unclear tapering plans of the ECB.



Sculpture on the roof of the headquarters of the Czech National Bank in Prague.

Source: [Aqwis](#), Wikimedia Commons, CC 3.0

Nevertheless, despite the CNB having just signaled the first departure from zero rates on the continent, there is room for caution before proclaiming the end of the monetary easing era. While most countries in the

European Union present a small indication of economic recovery, core inflation growth across most of the continent remains sluggish and even Poland and Hungary (exhibiting some of the strongest rates of GDP growth in the EU at 4.16% and 3.79% y/y during the first quarter of 2017 respectively) have rates under 2%. It is highly unlikely that the ECB will break its addiction to easy money in the short-term, given the fragility of the economic recovery in the Eurozone. It appears that, as with so many other policies, the non-Eurozone members are once again marching to the beat of a different drummer.



**This week:** President Andrzej Duda submitted a draft of the so-called “Swiss-franc bill” aimed at bailing out Polish holders of Swiss-franc mortgages. The presidential project envisages that banks with foreign currency loan portfolios would have to contribute up to PLN 3.2 billion to a “restructuring fund.” For some banks, it could result in a drop in profits of up to 30-40%. The project’s announcement triggered a quick reaction from investors, with bank shares plummeting between 3.4 and 4.3%.

**GDP (Q1 2017)**

↑ **4.2% y/y (est.)**

Up from 2.9% in Q4

**Inflation (June 2017)**

↓ **1.5% y/y**

Down from 1.9% in May

**Unemployment (Jun 2017)**

↓ **7.1%**

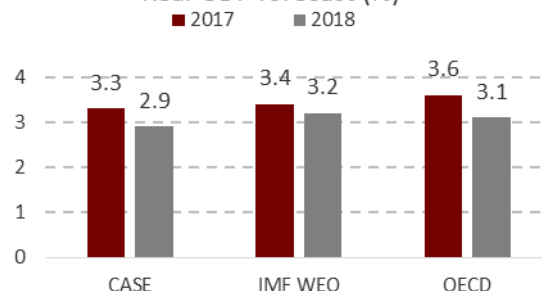
Down from 7.4% in May

**NBP Base rate**

**1.5%**

From 2% Mar 2015

Real GDP forecast (%)



**This Week:** Russian Prime Minister Dmitry Medvedev compared new U.S. sanctions to a “full-fledged economic war” on Russia, criticizing President Trump’s decision to uphold the decision made by the Congress. The sanctions are likely to hurt the Russian energy sector and could provoke counter-measures from the Russians.

**GDP (Q2 2017)**

↑ **2.7% y/y (est.)**

Up from 0.5% in Q1

**Inflation (July 2017)**

↓ **3.9% y/y**

Down from 4.4% in June

**Unemployment (Jun 2017)**

↓ **5.1%**

Down from 5.2% in May 2017

**CBR Base rate**

**9%**

Down from 9.25%

Real GDP forecast (%)



**This week:** The Federal Statistical Office announced that, during the past year, German public debt fell by EUR 15.1 billion (a 0.7% decrease compared to 2015) accompanied by a decline in the debt owned by the public budget to the non-public sector. Debt per capita diminished by more than EUR 400, reaching a level of EUR 24,407 in 2016.

**GDP (Q1 2017)**

↓ **1.7% y/y**

Down from 1.8% in Q4

**Inflation (July 2017)**

**1.5% y/y (est.)**

Unchanged from June

**Unemployment (June 2017)**

↓ **3.6%**

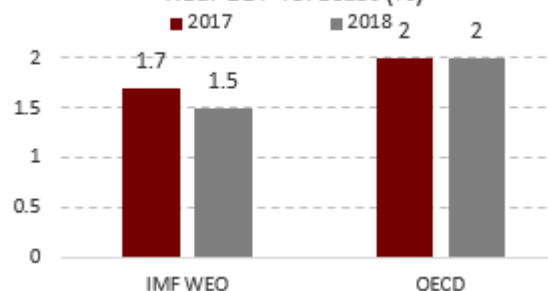
Down from 3.7% in May

**ECB Deposit rate**

**-0.4%**

From -0.3% Dec 2015

Real GDP forecast (%)





**This week:** After inflation spiked in July to 15.6% y-o-y, far overshooting the National Bank's of Ukraine (NBU) forecasts, the NBU held its base rate at 12.5%. The unexpected growth of inflation was caused by a rapid increase in raw food prices. The NBU expects a gradual decline of inflation from August onwards, bringing the level near the Bank's projection.

**GDP (H1 2017)**

**2.5% y/y (est.)**

From 2.5% in Q1

**Inflation (June 2017)**

**↑ 15.6% y/y**

Up from 13.5% in May

**Unemployment (Q1 2017)**

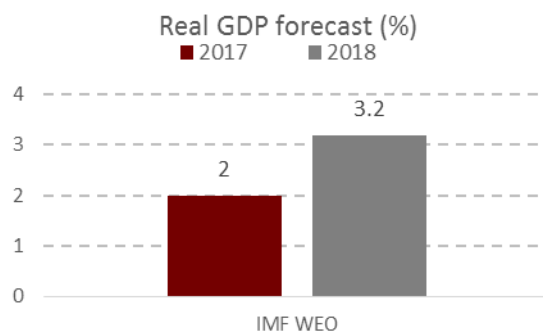
**↑ 10.5%**

Up from 10.0% in Q4

**NBU Base rate**

**12.5%**

From 13.0% in May



**This week:** As noted above, the Czech National Bank (CNB) increased the two-week repo rate by 20 basis points to 0.25% on August 3. It also increased the lombard rate by 25 basis points to 0.50%. The discount rate stayed at 0.05%. New interest rates are in effect from August 4, 2017. The CNB is the first central bank in the EU to change the interest rates in this economic cycle.

**GDP (Q1 2017)**

**↑ 3.0% y/y**

Up from 1.9% in Q4 2016

**Inflation (June 2017)**

**↓ 2.3% y/y**

Down from 2.4% in May

**Unemployment (Q2 2017)**

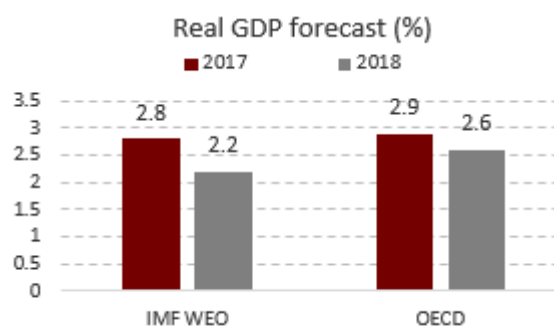
**↓ 3.0% (est.)**

Down from 3.4% in Q1

**CNB Base rate**

**0.25%**

From 0.05% (4 August 2017)



**This week:** The business confidence index composed by of the Institute for Economic and Enterprise Research (GVI) of the Hungarian Chamber of Commerce and Industry (MKIK) increased from 21 points in April to 32 points in July. The increase is attributed to businesses' optimism about expected profitability and order stock based on a survey with 400 corporate managers.

**GDP (Q1 2017)**

**↑ 4.2% y/y (est.)**

Up from 1.6% in Q4

**Inflation (June 2017)**

**↓ 1.9% y/y**

Down from 2.1% in May

**Unemployment (Q1 2017)**

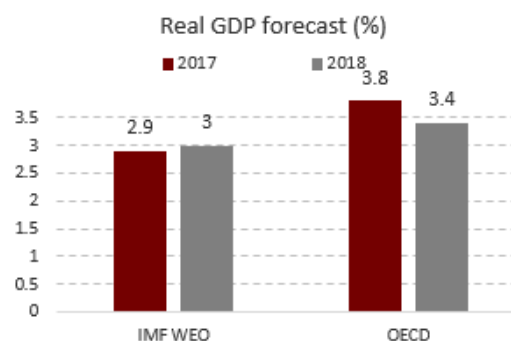
**↓ 4.3%**

Down from 4.6% in Q4

**MNB Base rate**

**0.9%**

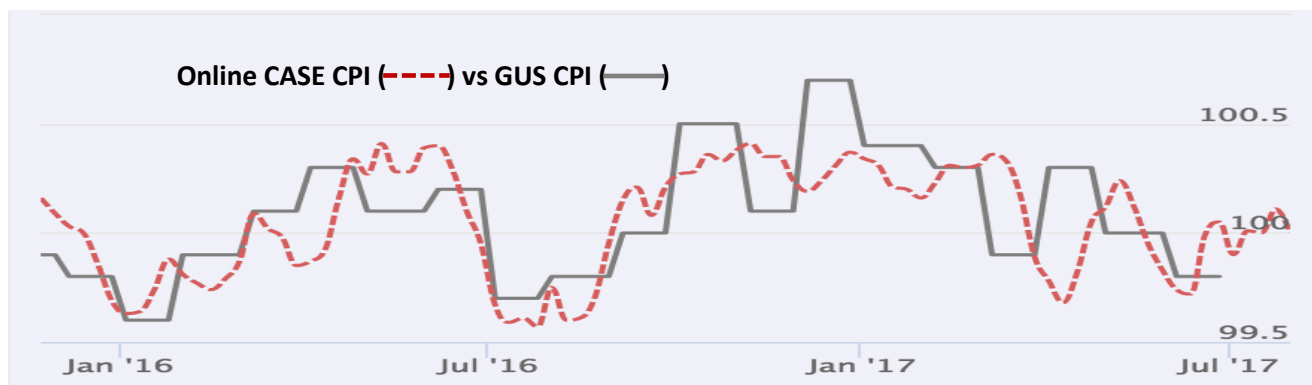
From 1.05% May 2016



### The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

### Our weekly online CASE CPI



### Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, and the CPI.

#### **CASE economic forecasts for the Polish economy** *(average % change on previous calendar year, unless otherwise indicated)*

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
<b>2017</b>	3.3	3.5	2.9	3.8	1.9
<b>2018</b>	2.9	3.0	2.7	3.7	2.0
	Nominal monthly wages	Merchandise exports (USD, bn)	Merchandise imports (USD, bn)	Merchandise trade balance (USD, bn)	CA balance (USD, bn)
<b>2017</b>	4.7	201.6	201.8	-0.2	-4.7
<b>2018</b>	3.5	211.3	213.1	-1.8	-5.9

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