CNB's New Forecast (Inflation Report IV/2019)

Meeting with Analysts

8 November 2019

CNB CZECH NATIONAL BANK

Outline

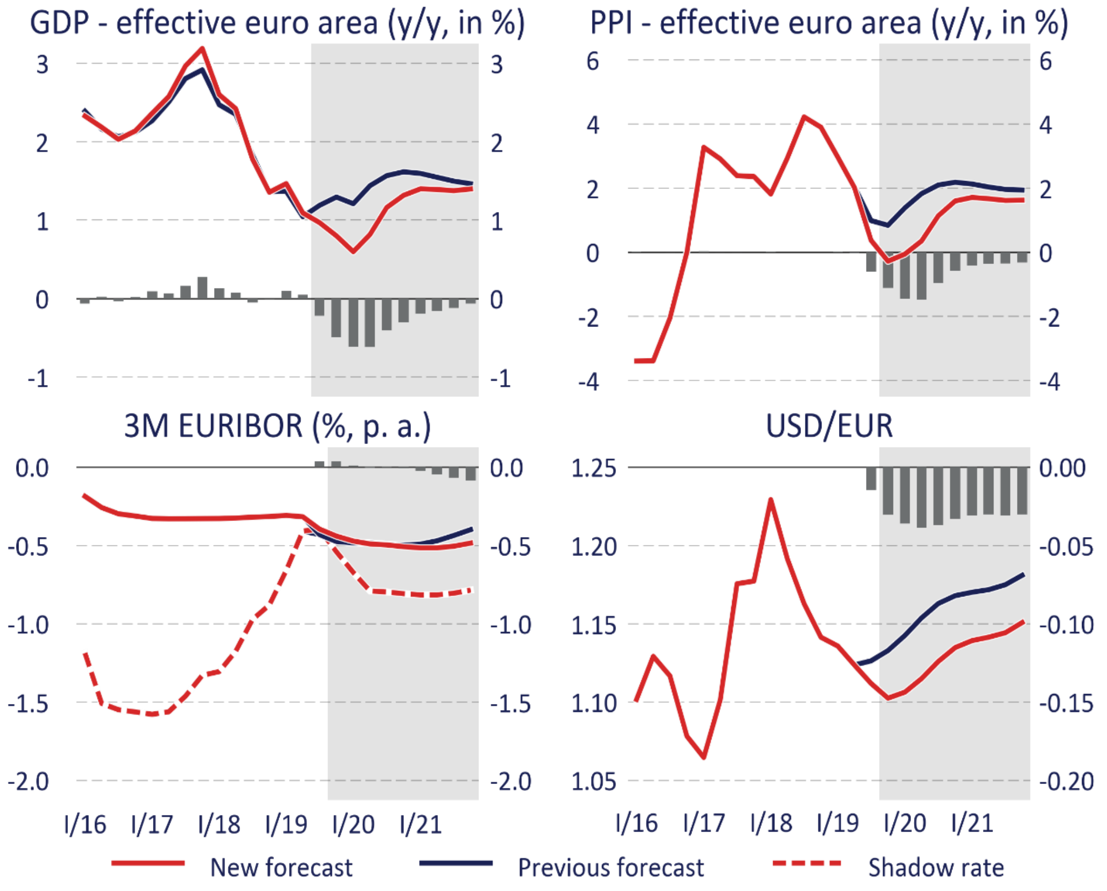
1. **Assumptions of the forecast**

2. The new macroeconomic forecast

3. Comparison with the previous forecast

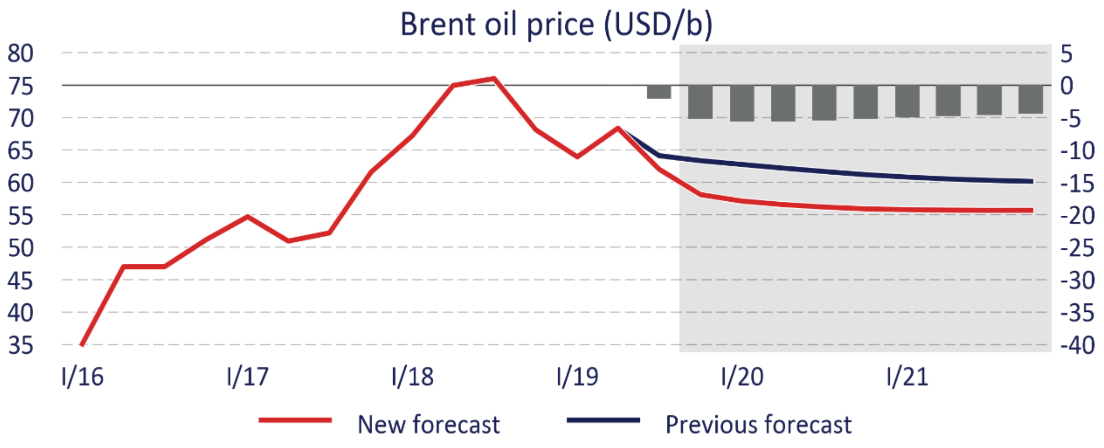
4. Disorderly Brexit scenario

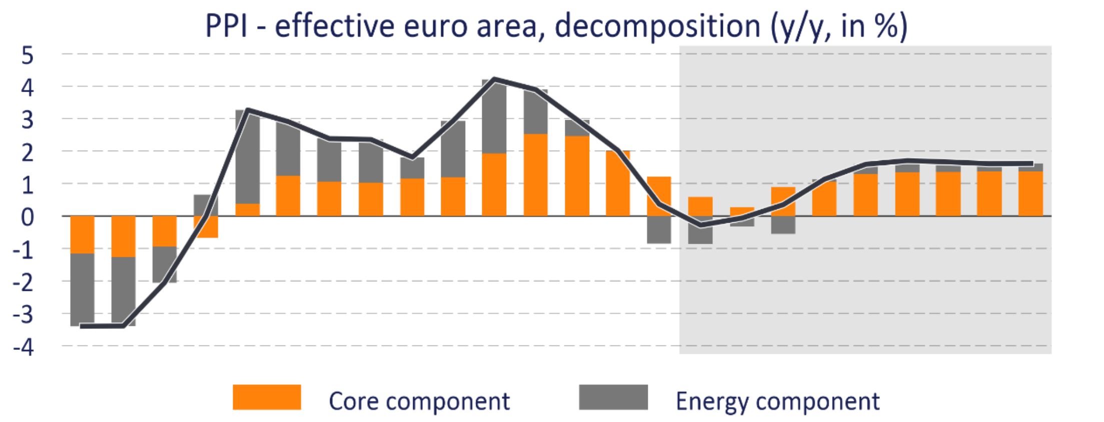
External Environment Outlook



- GDP growth in the effective euro area is slowing this year, due to global trade slowdown, but will start to accelerate gradually next year.
- Producer price inflation in the effective euro area will start to go up gradually next year, reflecting the upturn in the economic growth.
- According to the market outlook, the 3M EURIBOR will remain at -0.5% until the end of 2021. A renewal of ECB's APP as of November 2019 is reflected in the shadow rate outlook.
- The October CF outlook expects the euro to strengthen only slightly against the dollar.

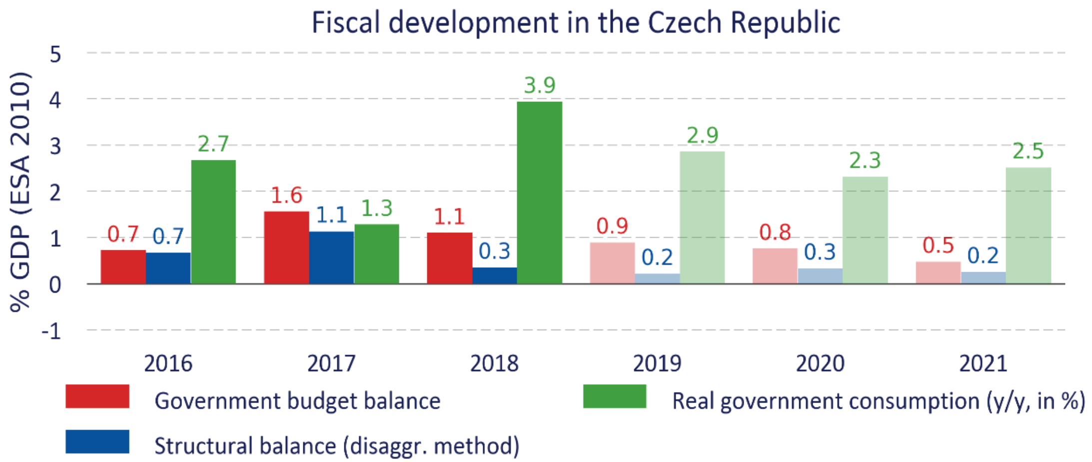
PPI in Effective Euro Area: Decomposition





- The price of oil, including its falling outlook, reflects the worsening forecast for the global economy.
- The overall inflation pressures from the production sector will weaken further at the end of this year, mainly due to a slowdown in the core component.
- The contribution of the energy component to industrial producer price inflation will be temporarily negative owing to the year-on-year decline in oil prices.

Fiscal Policy



Fiscal impulse (contributions to GDP growth in percentage points)

	2018	2019	2020	2021
	actual	forecast	forecast	forecast
Fiscal impulse	0.7	0.5	0.0	0.0
of which impact through:				
Private consumption	0.4	0.3	0.0	0.0
Private investment	0.0	0.0	0.0	0.0
Government investment, domestic	0.2	0.1	0.0	0.0
Government investment, EU funded	0.2	0.1	0.0	0.0

- The government budget surpluses will gradually decrease.
- The government consumption growth will slow down, but it will stay close to 2.5%.
- The expansionary effect of fiscal policy this year is linked with extraordinary valorisation of pensions, rapid wage growth in the government sector and continued growth in government investment.
- The neutral effect of fiscal policy in 2020 reflects the fact that the impacts of the discretionary fiscal measures offset each other overall.
- No further discretionary measures have been announced for 2021.

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Summary of the New Forecast

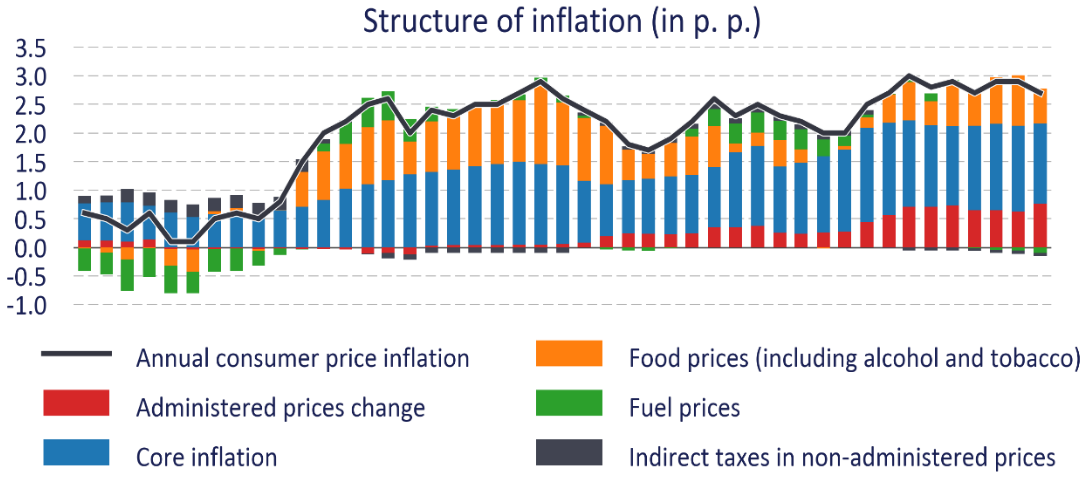
Inflation

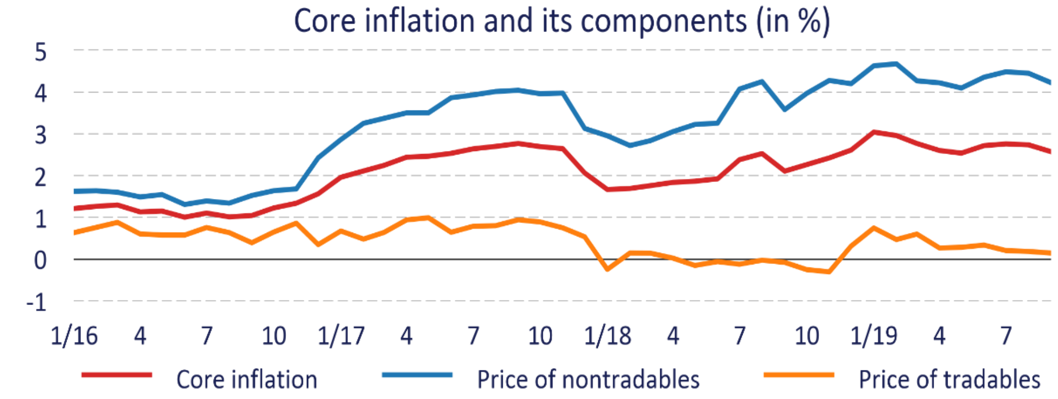
Economic activity and labour market

Exchange rate and interest rate

- **Inflation** will stay in the upper half of the tolerance band in the coming quarters and return to the target in early 2021.
- The decrease in inflation in 2020 will be slowed by the impacts of expected **changes to indirect taxes**.

Structure of Inflation





- Consumer price inflation remained at 2.8% in Q3. Core inflation was still the biggest contributor together with administered and food prices growth. Conversely, the contribution of fuel prices remained insignificant.
- Growth in administered prices remained high due mainly to increasing electricity prices and to a lesser extent to rising gas and heat prices.
- Persisting strong inflation pressures from the domestic economy are keeping core inflation at high levels. Its slight rise at the start of Q3 was caused by accelerated price growth of non-tradable goods.

Headline Inflation Forecast

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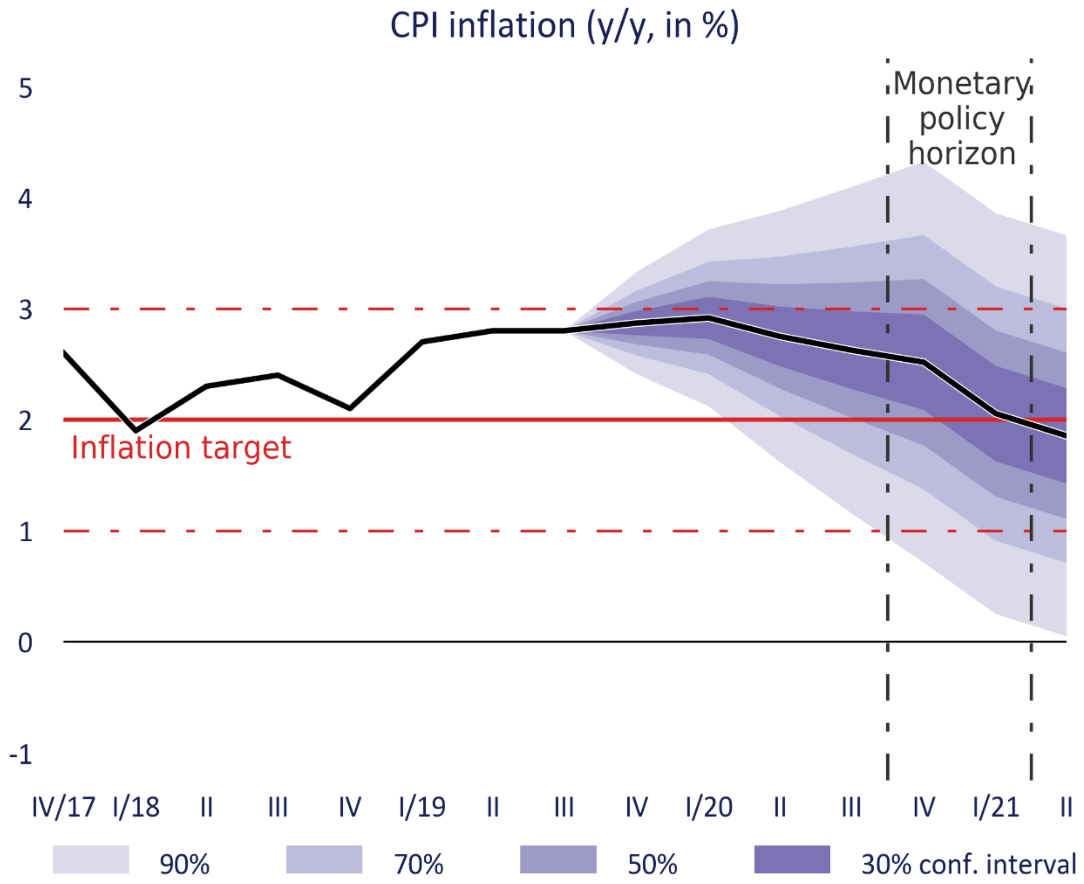
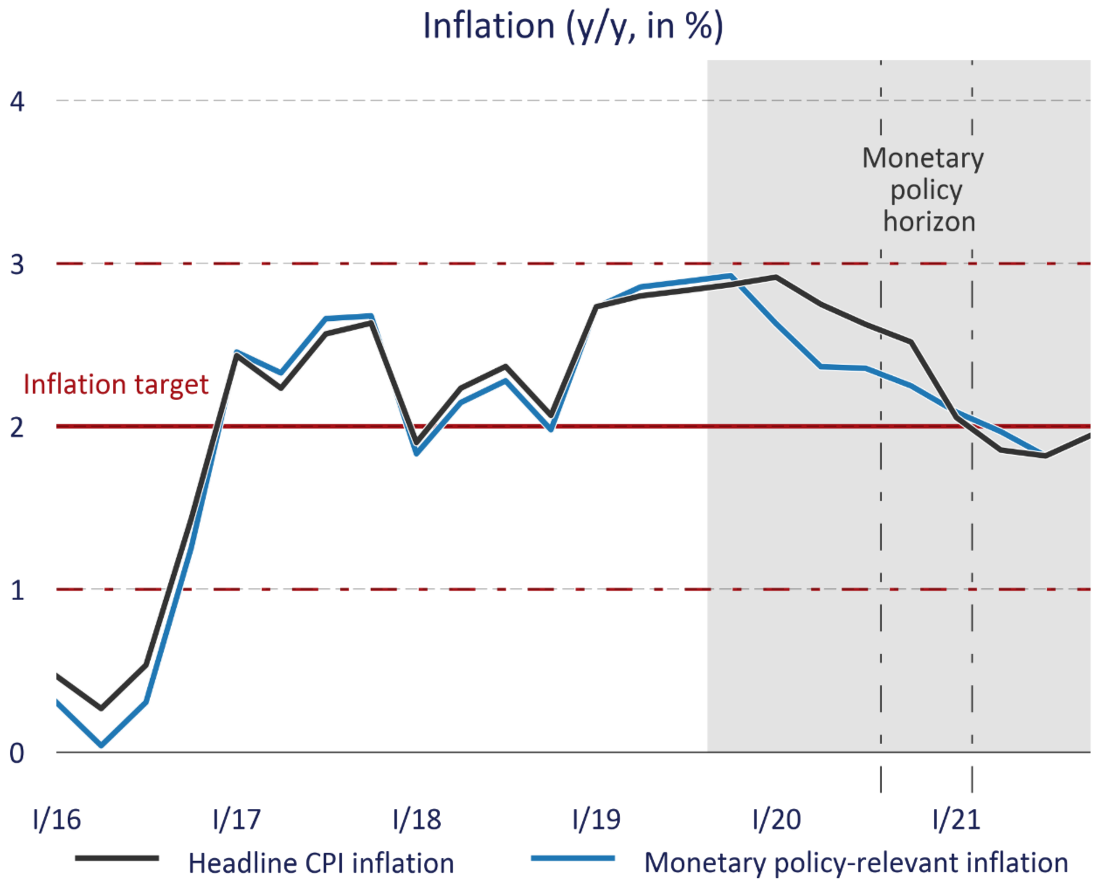


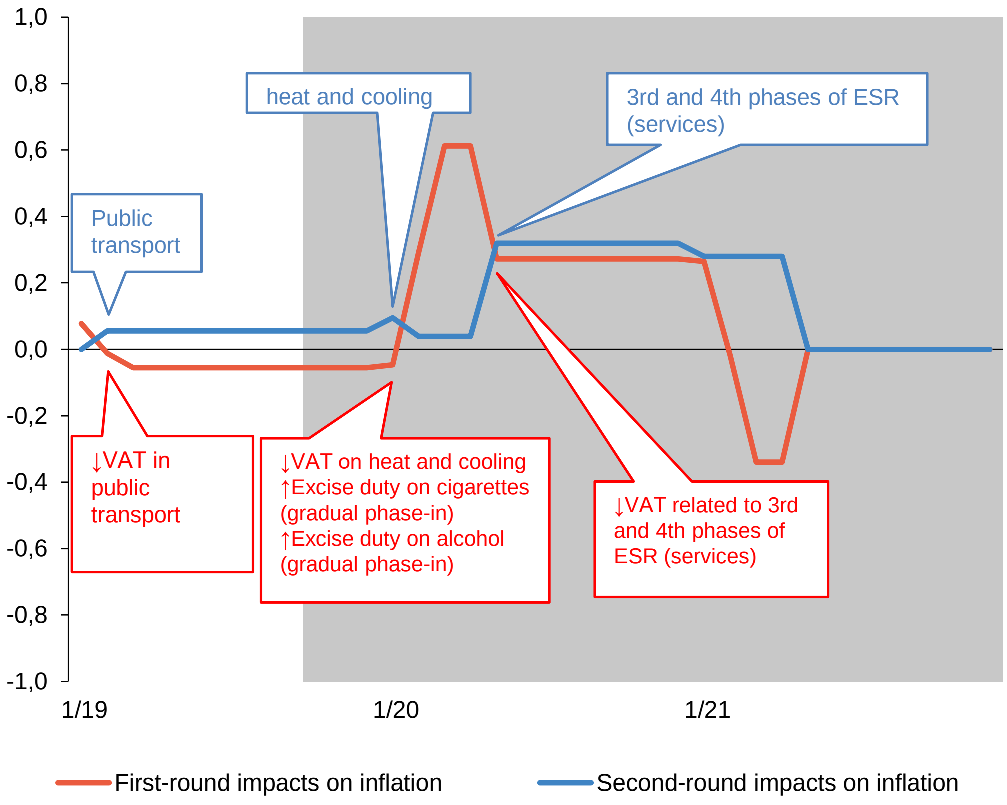
- Headline inflation will stay in the upper half of the tolerance band in the coming quarters and return to the target in early 2021.

Headline and Monetary Policy-Relevant Inflation



- Monetary policy-relevant inflation will be below headline inflation in 2020 and close to it in 2021 due to the impacts of indirect tax changes.

Effects of Changes to Indirect Taxes on Inflation Forecast



- The forecast assumes that excise duty on cigarettes and alcohol will be increased significantly in January 2020.
- The third and fourth phases of ESR will be launched in May 2020. This will be associated with a decline in the VAT rate on certain consumer basket items.
- The first-round impacts of changes to indirect taxes are distinctly positive in 2020 and close to zero in 2021.
- The forecast assumes only limited pass-through of the VAT rate cut to consumer prices. The (immediate) second-round effects of these changes are therefore positive.

Changes to Indirect Taxes

(impacts on CPI in percentage points)

Item	Tax	First-round impacts	Second-round impacts
Administered prices:			
Heat and cooling	↓ VAT	-0.08	0.04
Other[a)]	↓ VAT	-0.10	0.05
Market prices:			
Core inflation			
Books	↓ VAT	-0.01	0.00
Other services[b)]	↓ VAT	-0.23	0.23
Food prices			
Alcohol[c)]	↑ Excise	0.09	0.00
Cigarettes[c) d)]	↑ Excise	0.60	0.00
Cumulative impact as of 5/2020		0.27	0.32
Average impact in 2020 Q1		0.30	0.04
Average impact in 2020 Q2		0.39	0.23

[a)] e.g. water supply and sewerage collection charges

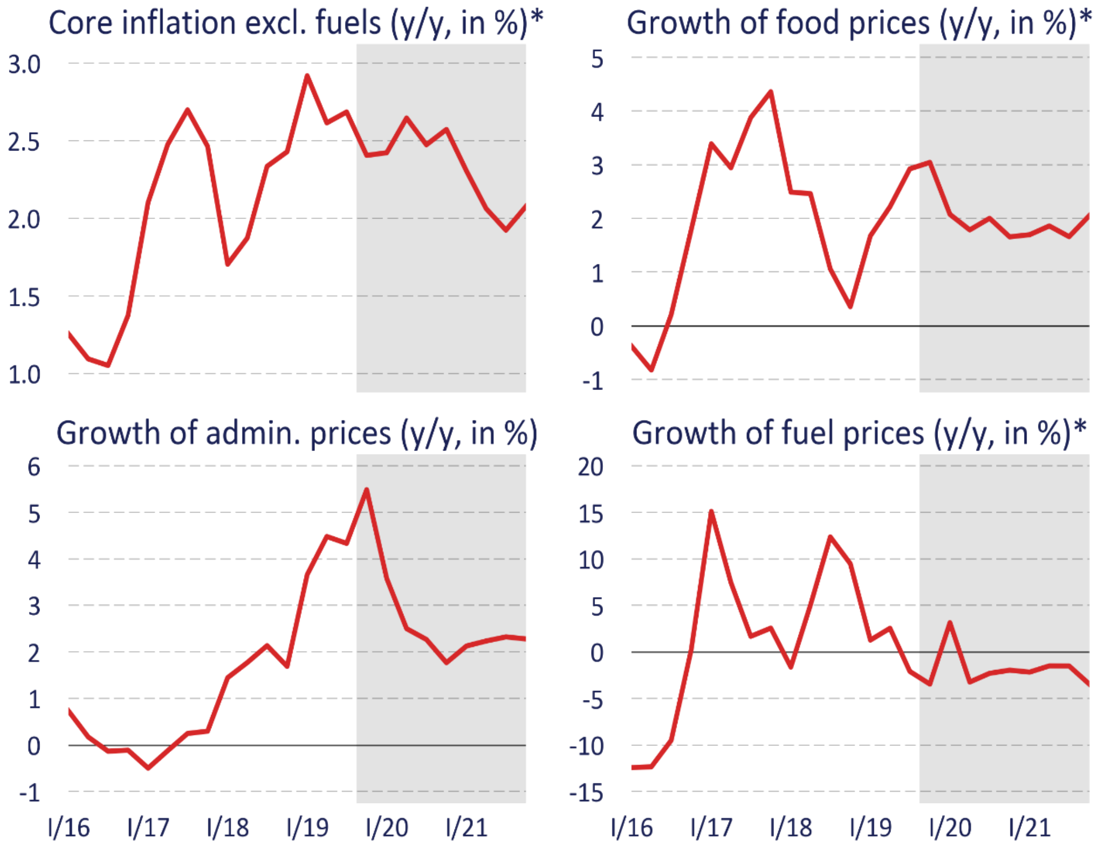
[b)] e.g. hairdressing services and restaurants

[c)] The impacts will appear gradually in the first three months of the year.

[d)] harmonisation change

- Monetary policy does not react to the first-round effects of the indirect tax changes, it reacts on their second-round impacts only.

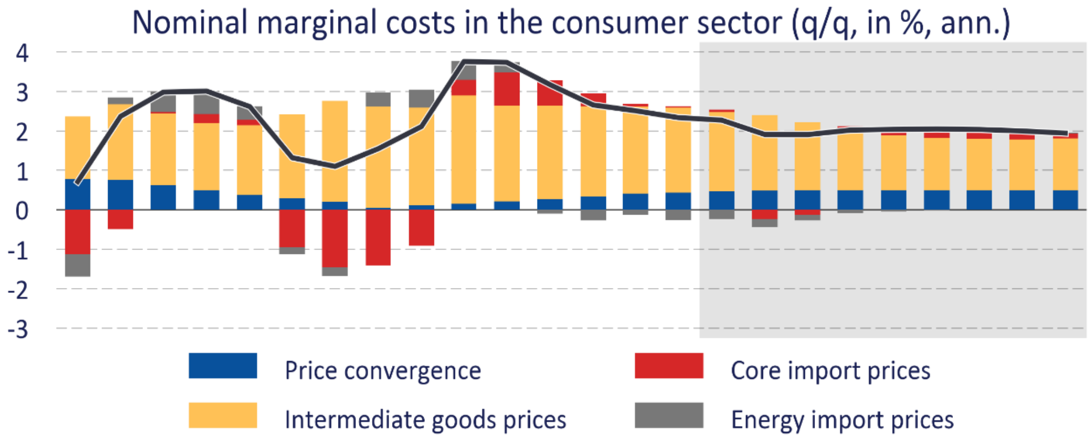
Inflation Components

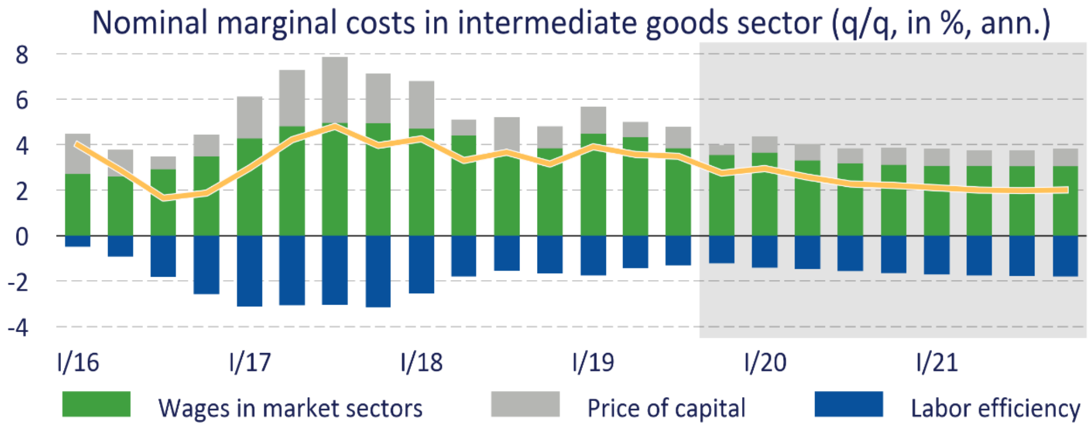


* excluding tax changes

- Core inflation will fluctuate around 2.5% in the quarters ahead and moderate during next year.
- Food price inflation will remain elevated at the end of this year and slow next year, reflecting a temporary decline of agricultural producer prices and prices of imported food.
- The already high growth in administered prices will temporarily pick up further and then slow next year.
- The year-on-year decline in fuel prices will deepen at the end of this year.

Inflation Pressures





- Growth in total nominal costs will slow further at the start of next year and stabilise around 2% later on.
- The core import prices will have a modest anti-inflationary effect in the next few quarters due to a slight appreciation of koruna. It will then turn positive mainly due to an acceleration of foreign PPI inflation.
- The domestic cost pressures will gradually ease due to slowing wage growth and an increasing contribution of labour efficiency.
- The contribution of the price of capital will remain positive, reflecting continued growth in domestic demand.

Summary of the New Forecast

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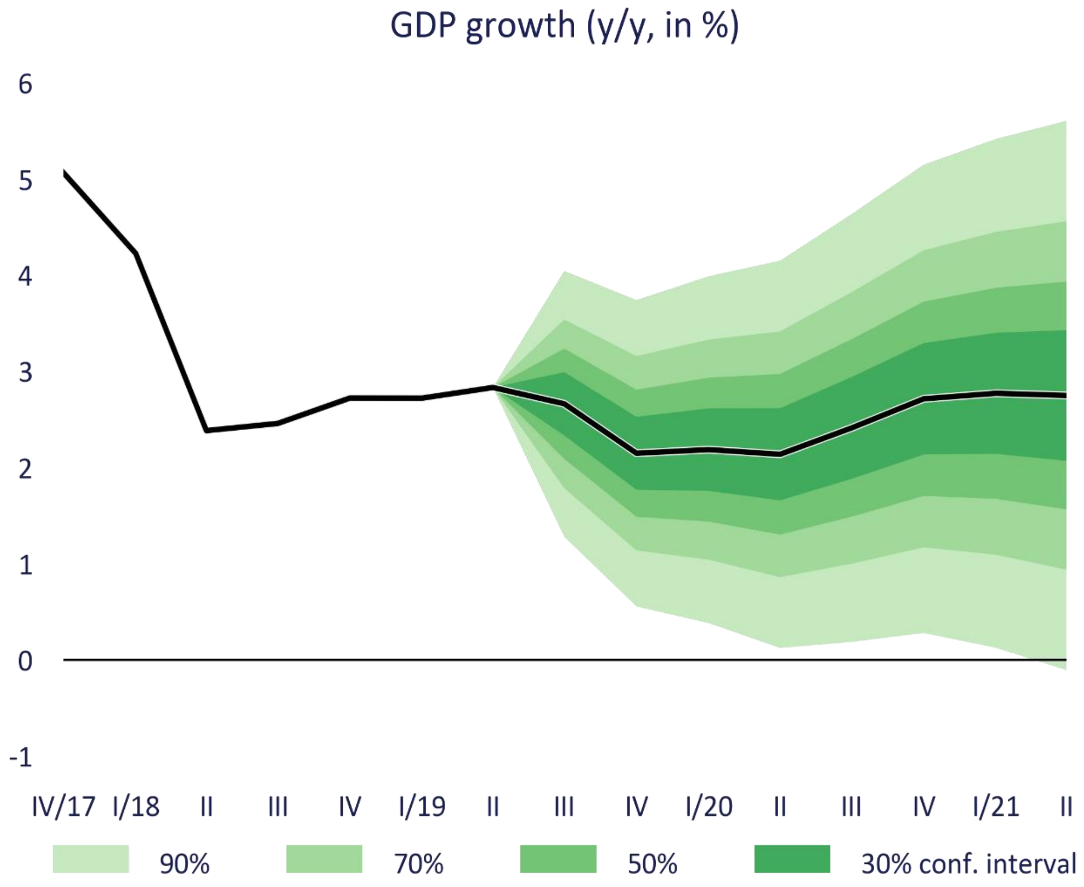
Inflation

Economic activity and labour market

Exchange rate and interest rate

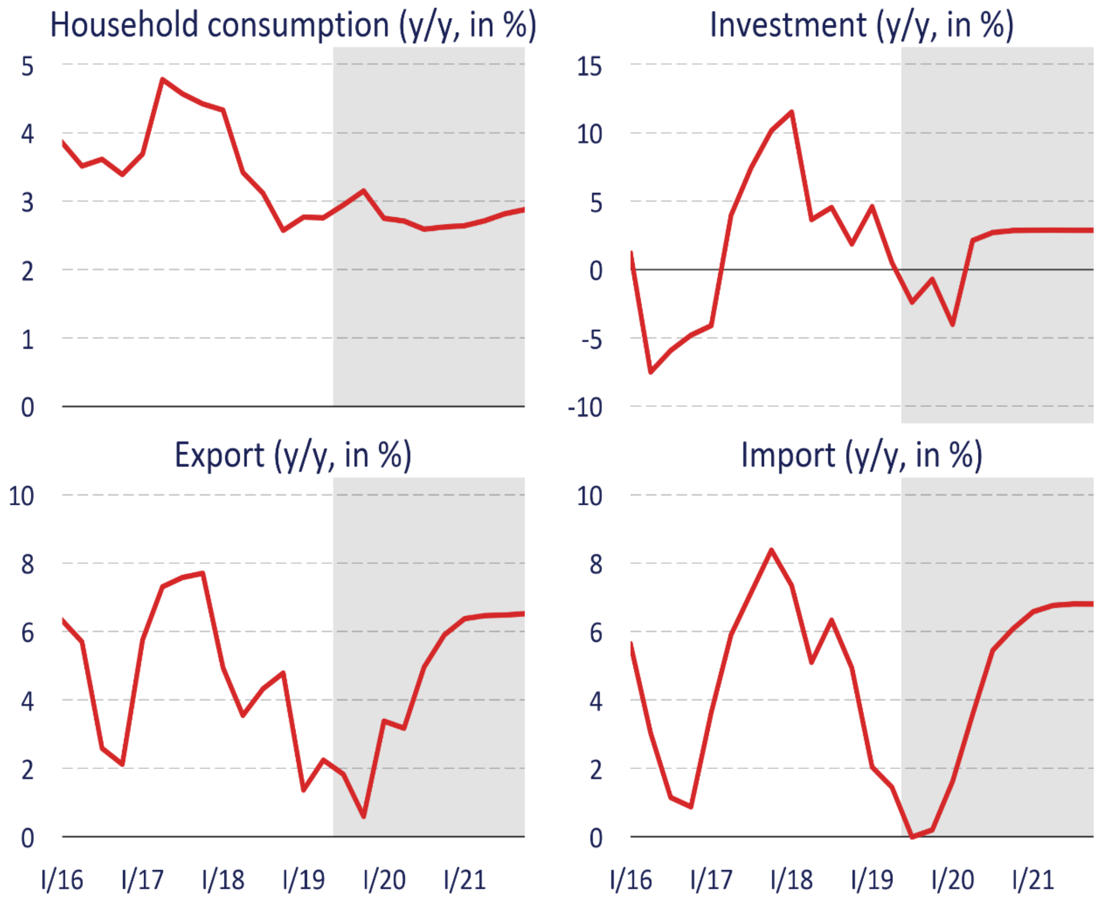
- **GDP** will grow by 2.6% this year. Growth will slow in the quarters ahead due to weakening external demand and accelerate towards its long-term rate at the end of next year.
- The current record-low **unemployment rate** is no longer creating room for unemployment to fall any further.
- **Wage growth** will start to slow next year due to gradually easing labour market tightness.

GDP Growth Forecast



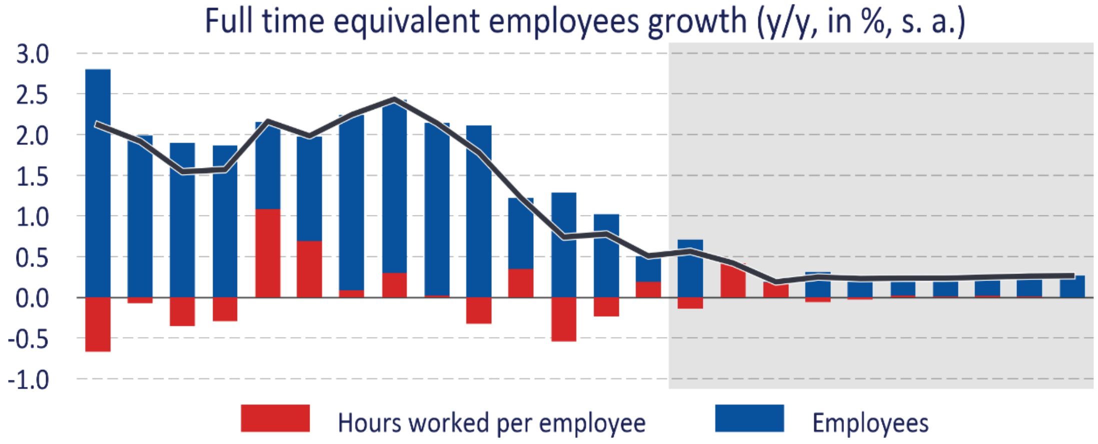
- Growth in economic activity of 2.6% this year will be driven mainly by solid growth rates of household and government consumption.
- The positive contribution of net exports to GDP growth, due to the current investment downturn, will temporarily disappear next year. It will return as growth in external demand picks up.
- Together with the contribution of investment, this will cause economic growth to accelerate at the end of next year.

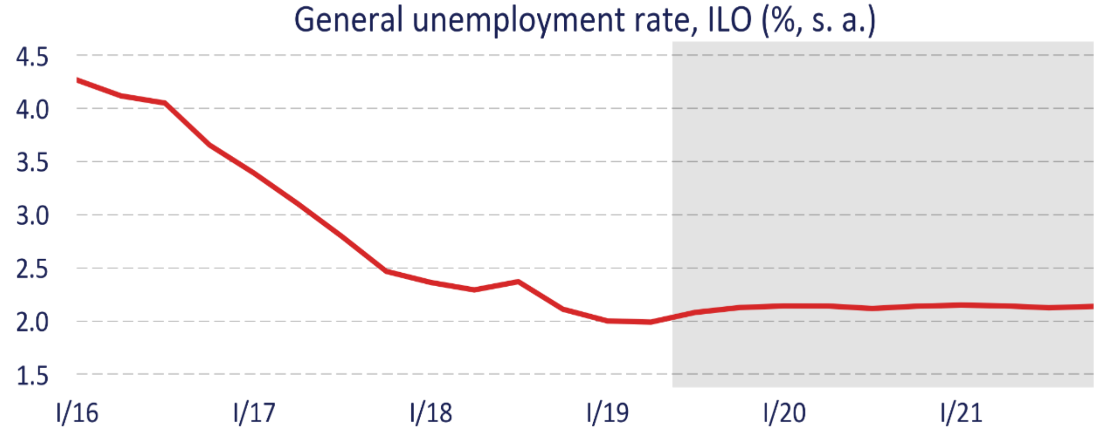
Aggregate Demand



- The continued household consumption growth will reflect rapid, albeit gradually slowing, growth in wages, salaries and other income.
- Gross capital formation will decrease over the next few quarters. This will be due in particular to private investment, which reflects the slowdown in external demand.
- The currently subdued export growth will recover next year as external demand picks up.
- Import growth will mainly reflect domestic investment activity and export growth.

Labour Market: Employment and Unemployment





- Employment growth will remain muted due to persisting labour shortages amid weakening demand for labour.
- The tightness in the labour market, linked with a record-low unemployment rate, will continue to be reduced slightly by growth in the labour force.
- The general unemployment rate will be close to its current level despite slightly weakening – yet still relatively strong – demand for labour.

Labour Market: Nominal Wage Growth

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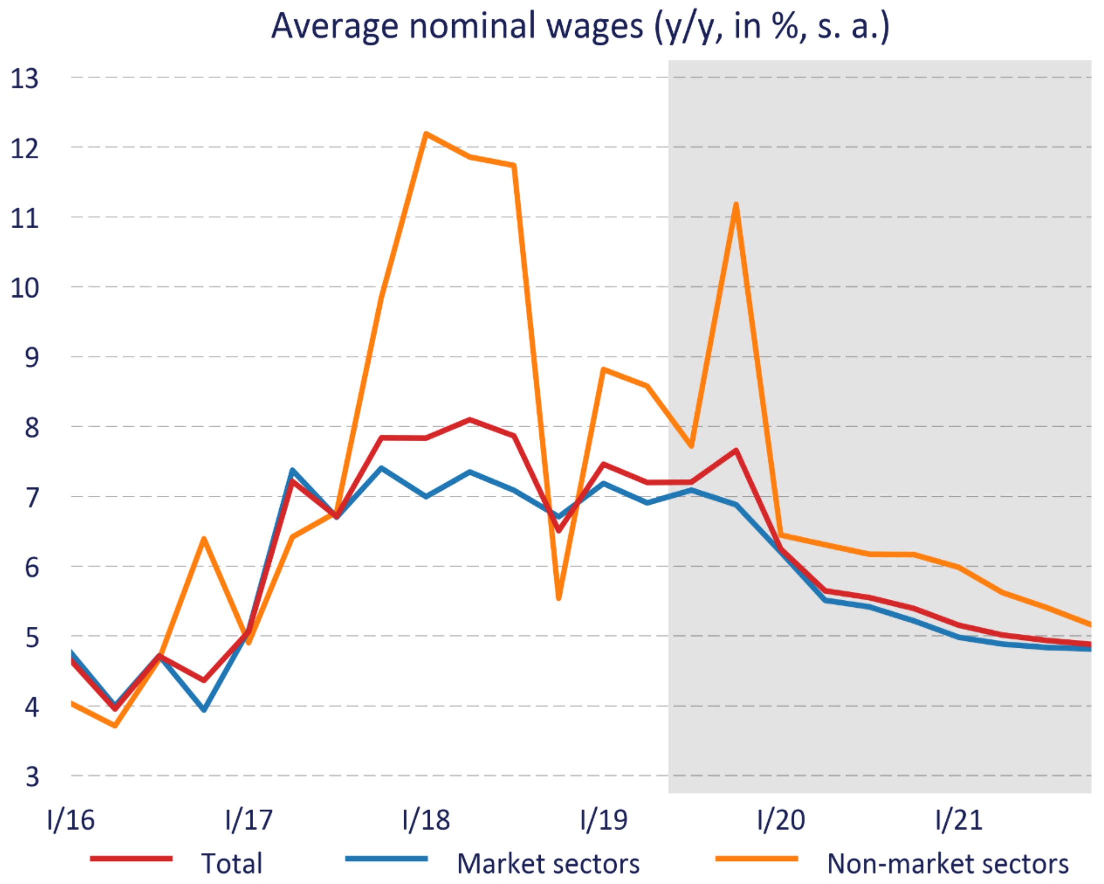

- Annual market wage growth will stay close to 7% for 2019. It will gradually converge to its steady-state level at the end of next year and fluctuate around it in 2021.
- Wage growth will be affected by a further increase in the minimum wage in January 2020. However, firms' efforts to maintain their competitiveness and profitability will lead to a slowing wage growth.
- Pronounced wage growth, albeit lower than last year, will continue in non-market sectors. It will mainly reflect an increase in the wages of teachers and other public employees over the entire forecast horizon.

Summary of the New Forecast

Inflation

Economic activity and labour market

Exchange rate and interest rate

- The **koruna** will appreciate only slightly over the forecast horizon.
- Consistent with the forecast is a rise in **domestic market interest rates** in this quarter and the next, followed by a decline as from mid-2020.

Exchange Rate CZK/EUR

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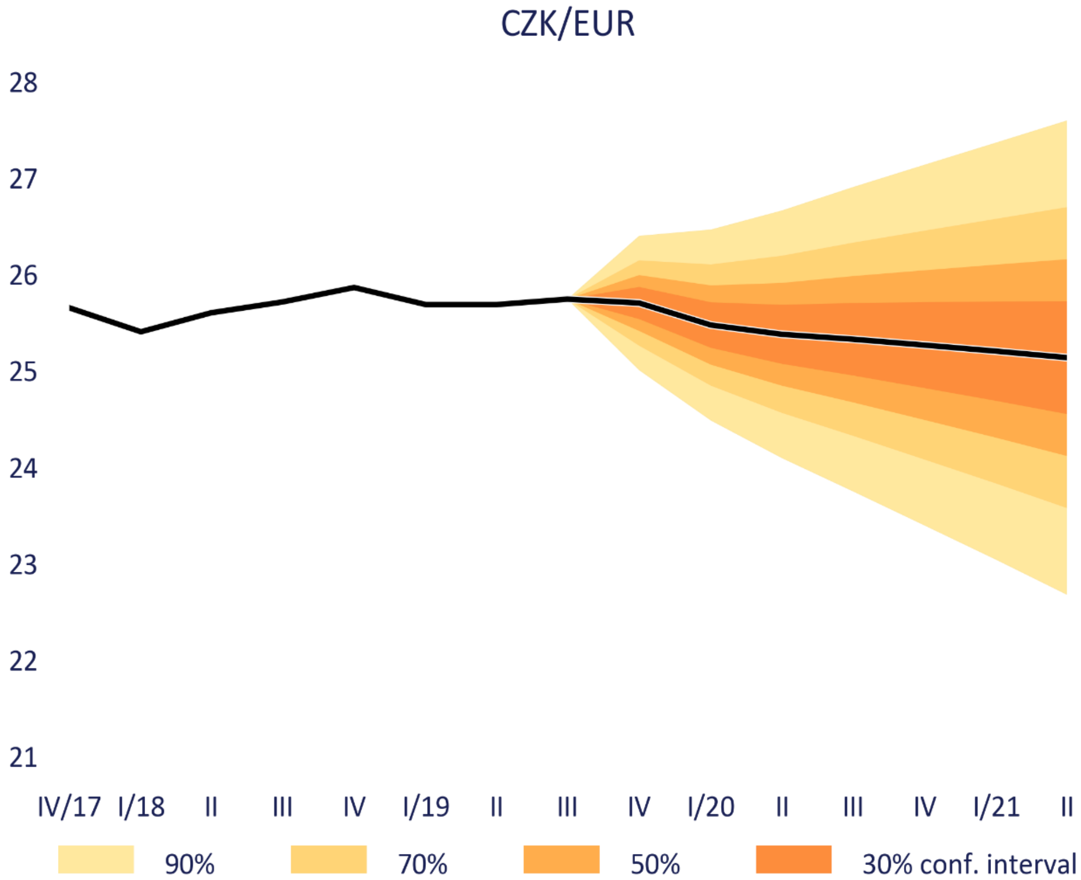
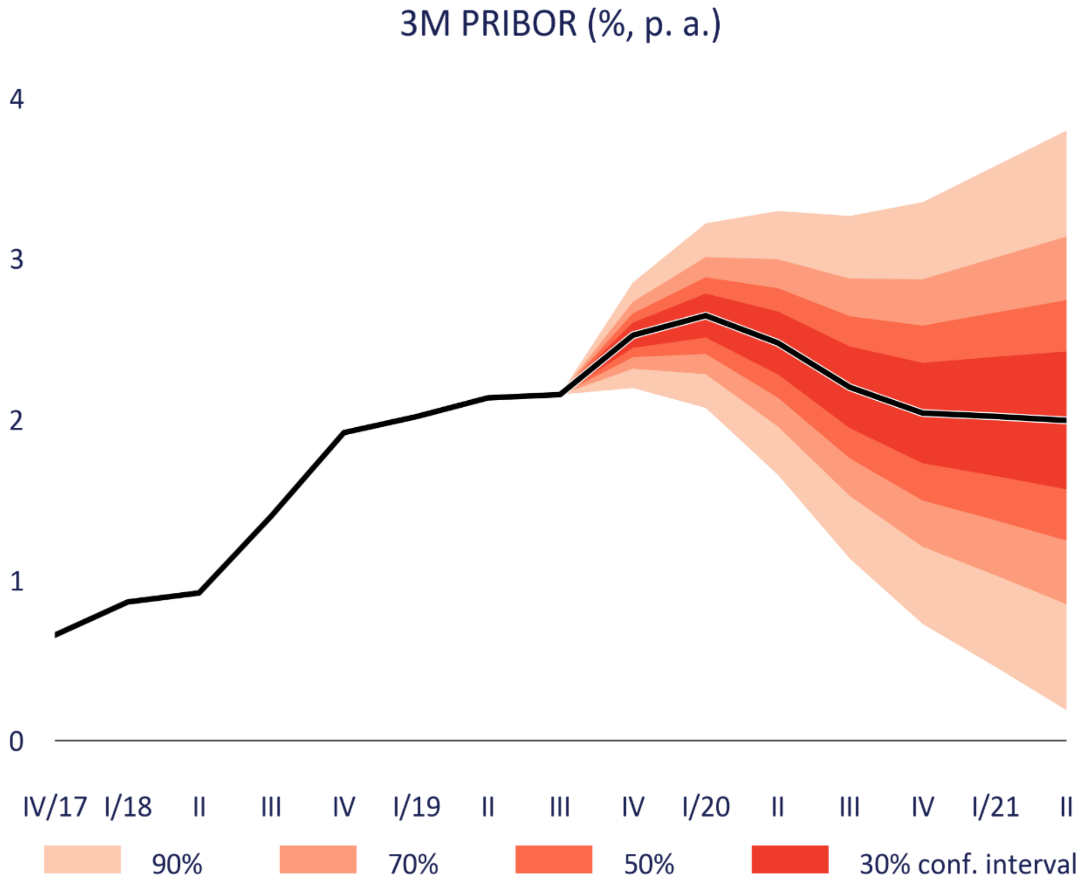


- The exchange rate forecast expects the koruna to remain close to CZK 25.7 against the euro in 2019 Q4.
- The subsequent slight appreciation will reflect continued real convergence of the Czech economy and a further widening of the interest rate differential, which will partly reflect the renewed unconventional monetary policy of the ECB.
- However, these factors will be dampened by the reaction of the koruna to deteriorating foreign economic and price developments.
- The exchange rate will thus gradually appreciate to CZK 25 to the euro at the end of 2021.

Interest Rate Path (3M PRIBOR)



- Consistent with the forecast is a rise in domestic market interest in this quarter and the next, followed by a decline as from mid-2020.
- The rise in domestic rates primarily reflects persisting domestic cost pressures (slowdown in labour efficiency growth and only gradually decreasing wage growth). To a lesser extent, the increase in rates is a forward-looking reaction to the second-round effects of tax changes.
- The subsequent decline in domestic rates from mid-2020 will be due mainly to persisting deeply negative interest rates and continued quantitative easing in the euro area.

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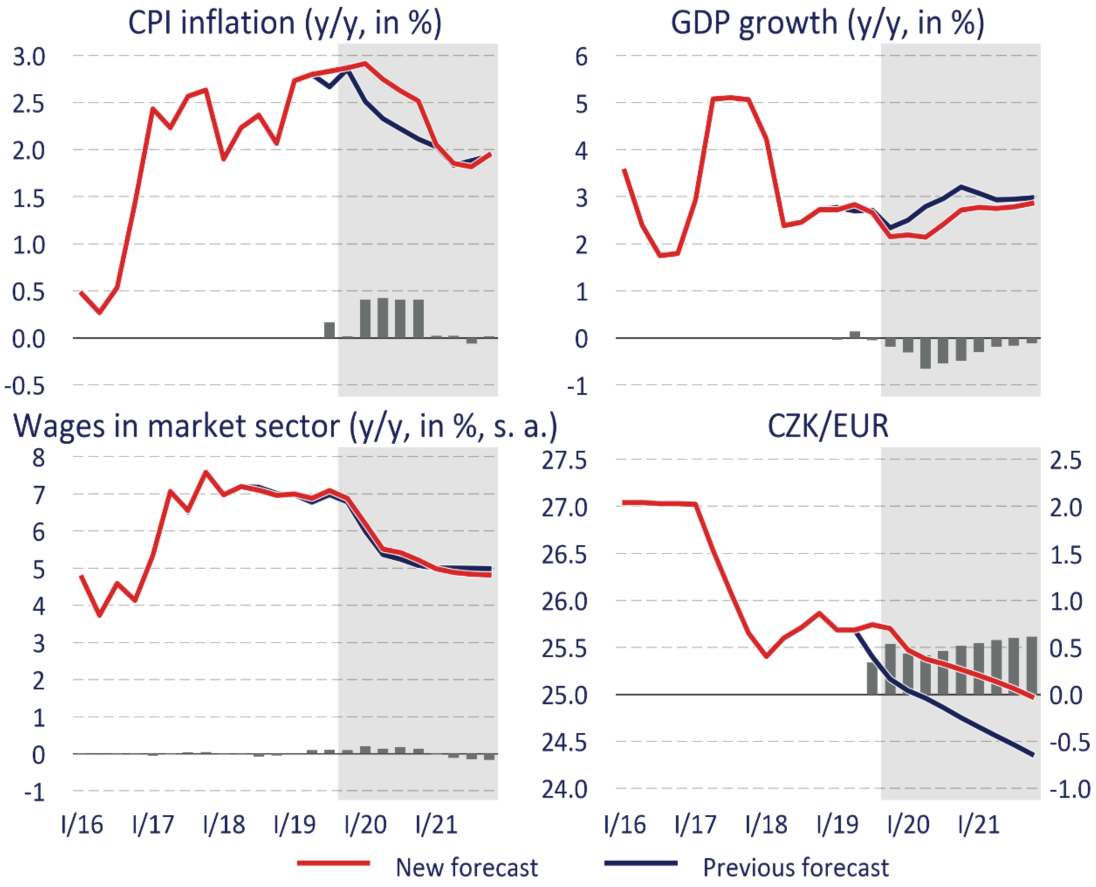
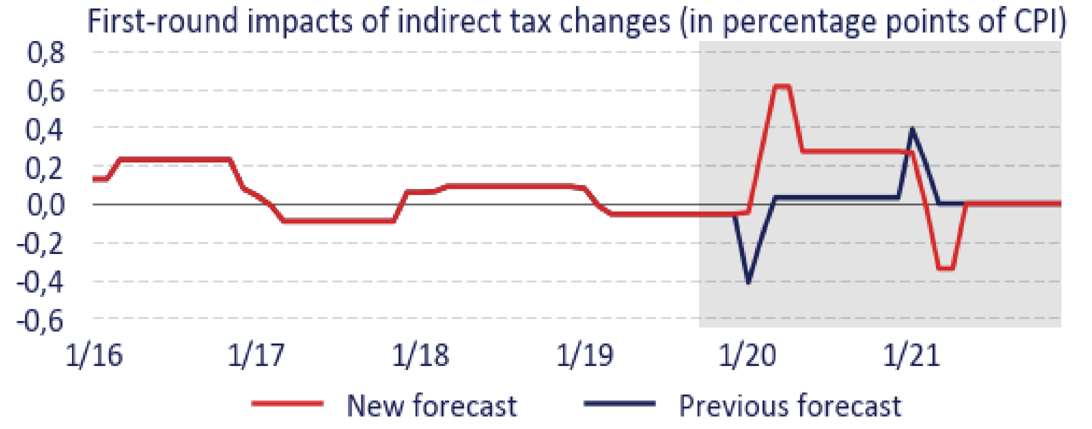
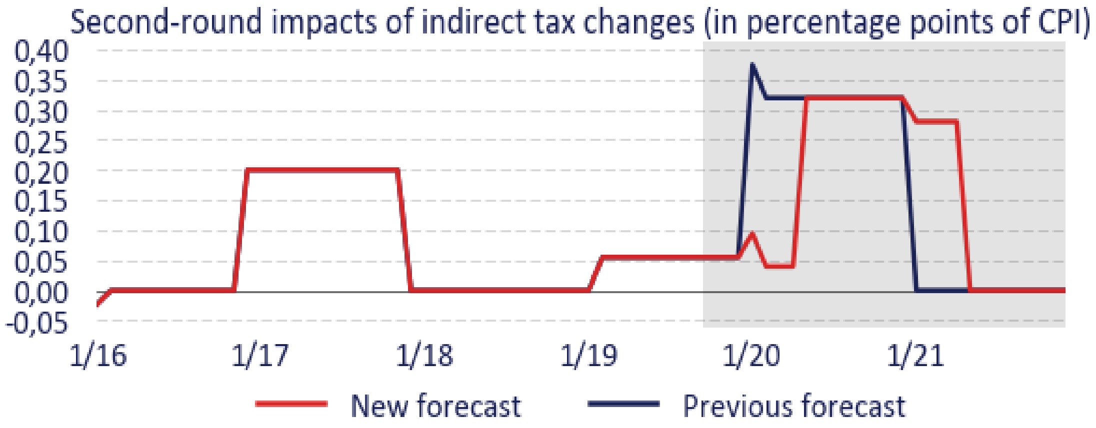
Comparison with Previous Forecast



- The inflation forecast for next year is higher due to stronger domestic pressures, a weaker exchange rate and larger effects of tax changes.
- The forecast for domestic economic growth has been revised downwards mainly as a result of the worsened external outlook.
- Wage growth will be slightly higher in 2019 and 2020 than in the previous forecast, fostered mainly by further increase of minimum wage in 2020.
- The koruna will appreciate noticeably more gradually than in the previous forecast due to the worse external outlook.

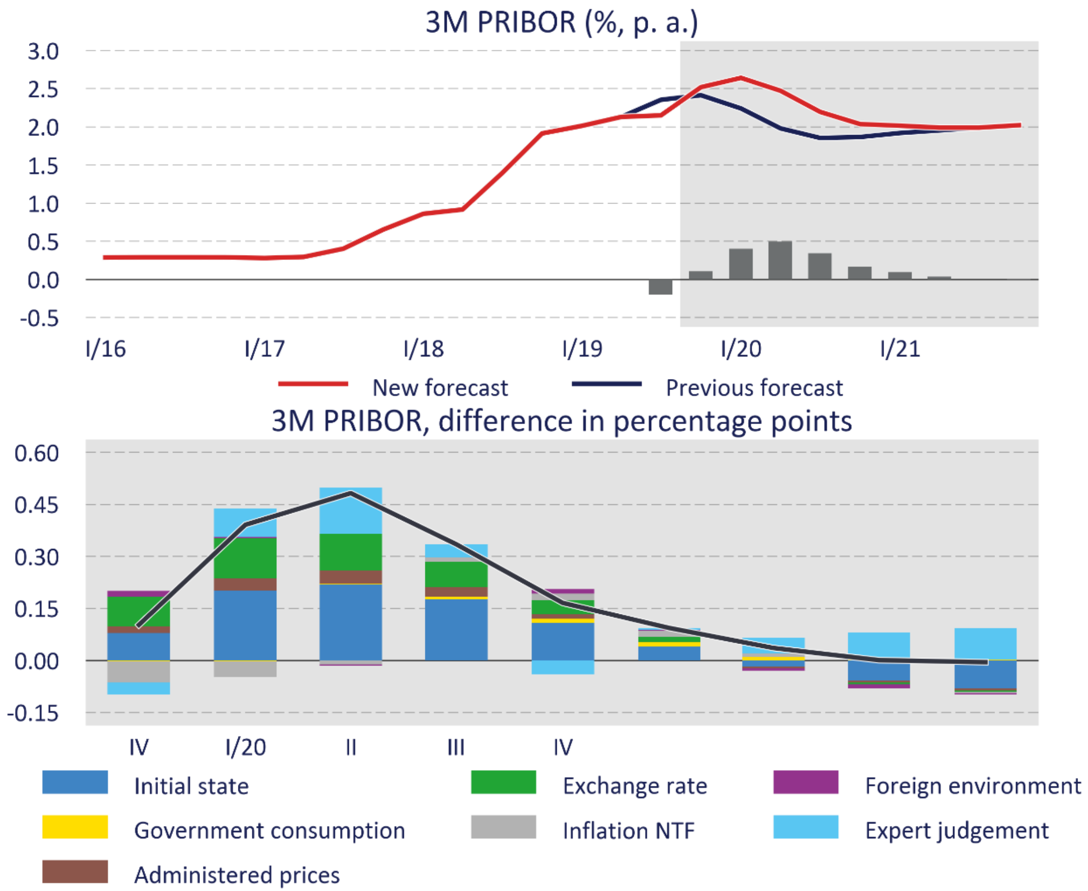
Comparison with Previous Forecast





- The estimated impact of the increase in excise duty on cigarettes on headline inflation next year has been revised. Current estimate is 0.24 percentage point higher compared with the previous forecast.
- The launch of the third and fourth phases of ESR and the related cut in the VAT rate on selected items of the consumer basket has been postponed from January to May 2020, which also delays the second-round impacts of these changes.
- These changes are reflected in the forecast for headline as well as monetary policy-relevant inflation.

Comparison: Interest Rate Forecast



- The new forecast implies a higher domestic interest rate path, especially in 2020.
- A more inflationary initial state has the dominant upward effect on rates (lower growth of labour efficiency and the structure of wage growth in market industries in 2Q 2019).
- A shift of the short-term koruna exchange rate forecast to a weaker level and the overall impact of expert adjustments (postponement of the ESR, minimum wage increase in 2020, volatility of package holiday prices, wage rigidity in 2021) also foster an upward revision of the interest rate path in the new forecast.

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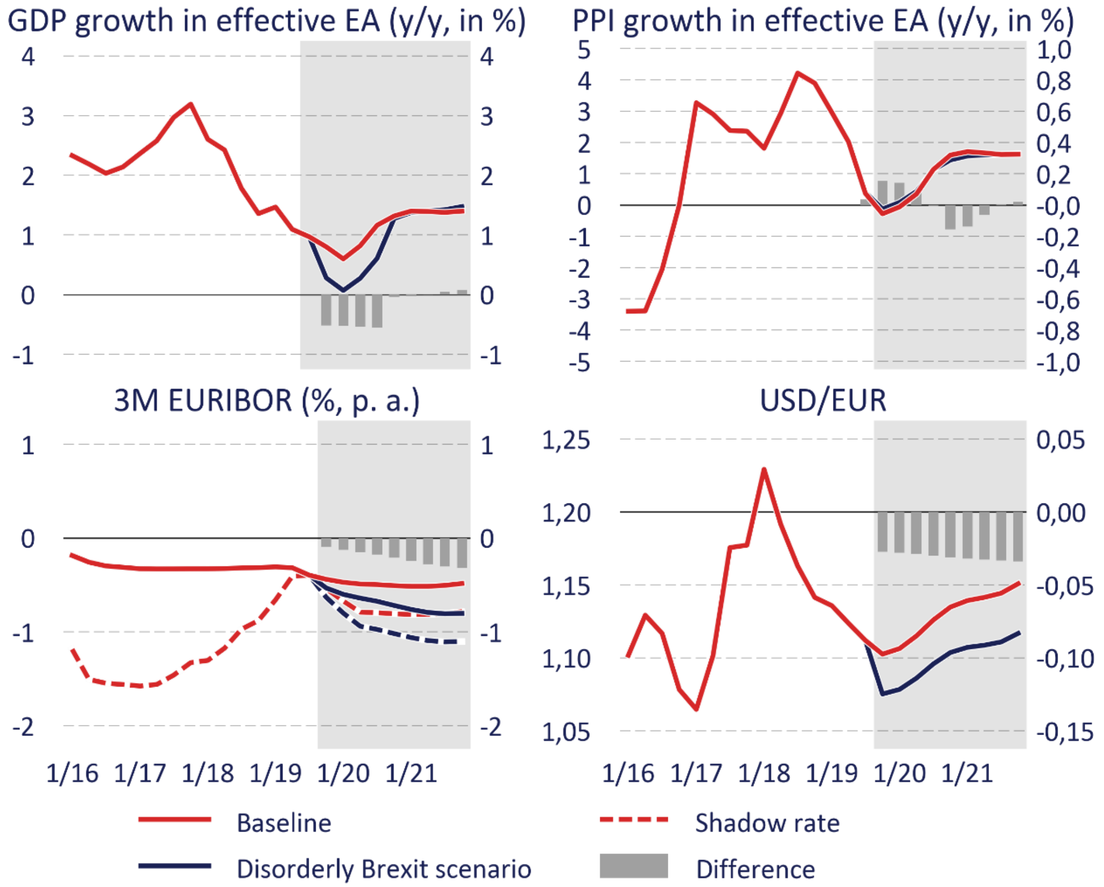
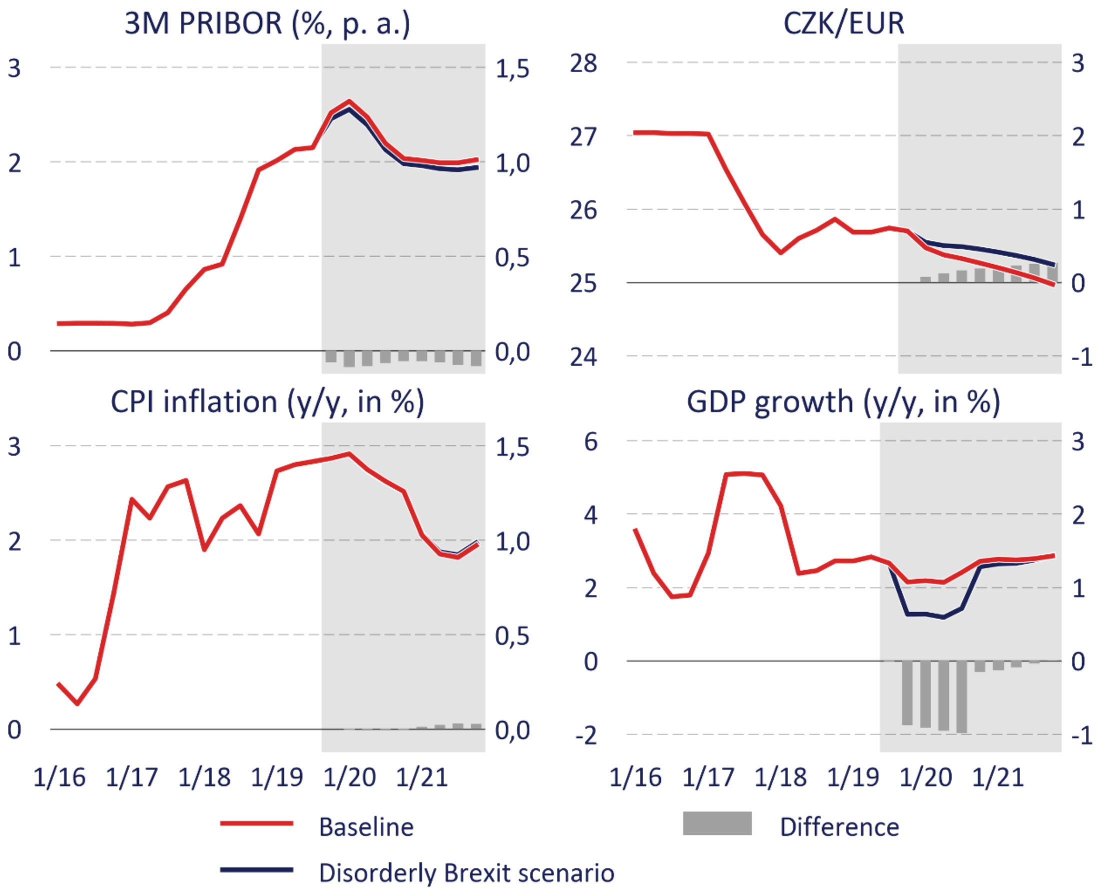
Disorderly Brexit Scenario: External Environment



- This updated version of the disorderly Brexit scenario (IR I/2019) captures in greater detail the economic links between the UK the EA.
- The disorderly Brexit would be reflected not only in a fall in trade between the UK and the euro area, but also in a deterioration in sentiment.
- This disorderly Brexit would lead to slower economic growth and slightly higher producer price inflation in the effective euro area.
- The ECB responds to the lower demand with easier monetary policy.
- The euro depreciates slightly against the dollar.

Disorderly Brexit Scenario: Domestic Economy



- The disorderly Brexit would lead to slower growth of the Czech economy, mainly through a downturn in exports to the EA but also to the UK directly.
- The drop in external demand is reflected in a slightly weaker koruna, which increases the inflation pressures from import prices.
- The interest rate path is slightly lower than in the baseline scenario, as the impacts of the weaker koruna are outweighed by lower domestic inflation pressures and easier monetary policy abroad.
- The deviation of the inflation forecast from the baseline scenario is therefore ultimately insignificant.

Thank you for your attention

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