CZECH NATIONAL BANK

CNB's New Forecast (Inflation Report IV/2020)

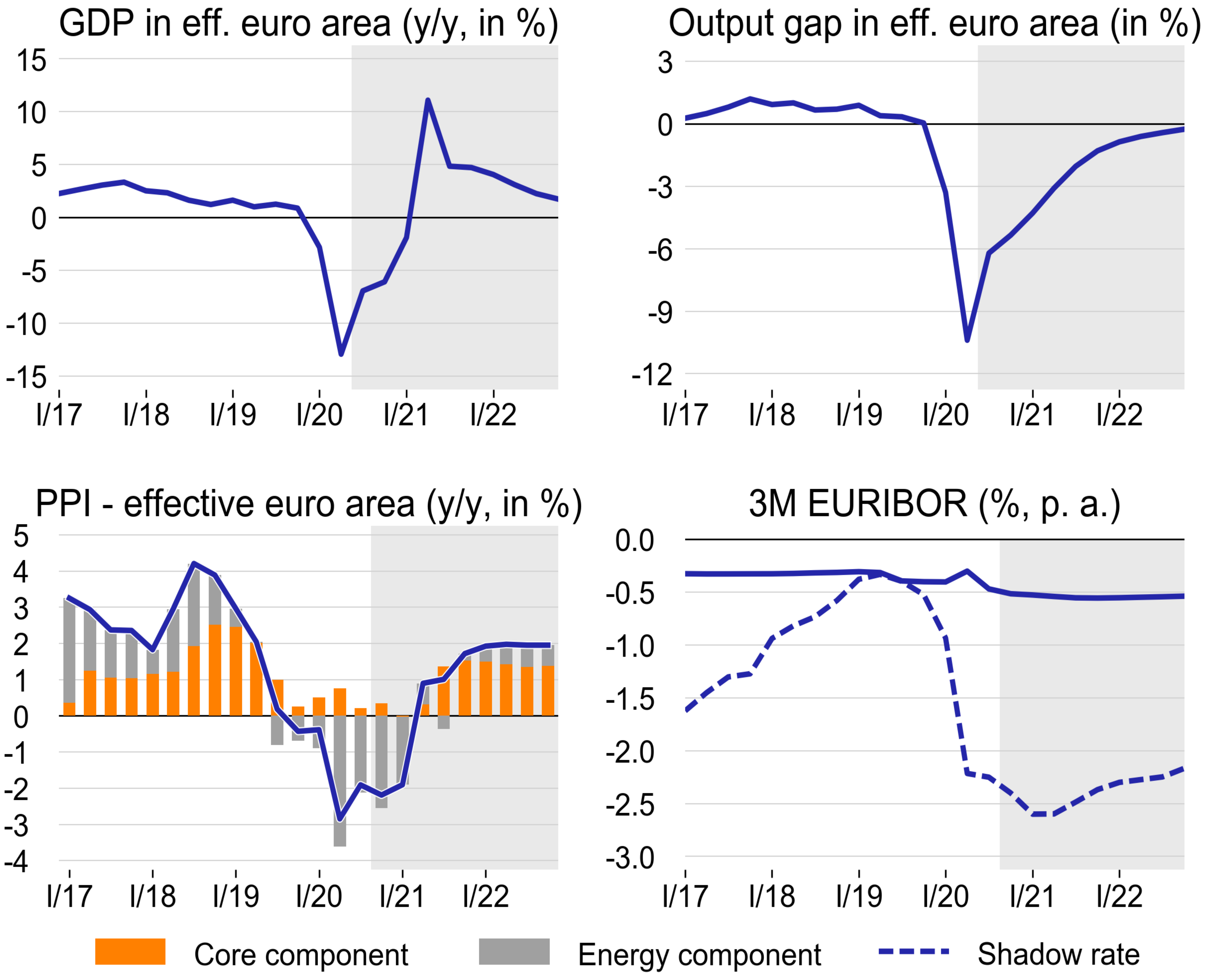
Meeting with Analysts

6 November 2020
Petr Král
(Executive Director, Monetary Department)

Presentation Outline

1. **Assumptions of the Forecast**
2. The New Macroeconomic Forecast (Baseline Scenario)
3. Comparison with the Previous Forecast
4. Worse Pandemic Scenario
5. Fiscal Scenario

External Environment Outlook



- Overall, the **effective euro area** economy will decline by more than 7% this year and grow by more than 5% next year.
- The expected recovery will not be enough for the currently still highly negative **output gap** to close before the end of the forecast horizon.
- **Industrial producer prices** will decline this year due to a negative contribution of the energy component; PPI will start rising again next year as this effect fades and growth in the currently subdued core component picks up again.
- The **3M EURIBOR** will remain negative over the entire forecast horizon. **Shadow interest rates** will lie significantly below market rates as they reflect the ECB’s asset purchase programme through which it delivers further easing of its monetary policy.

Fiscal Policy

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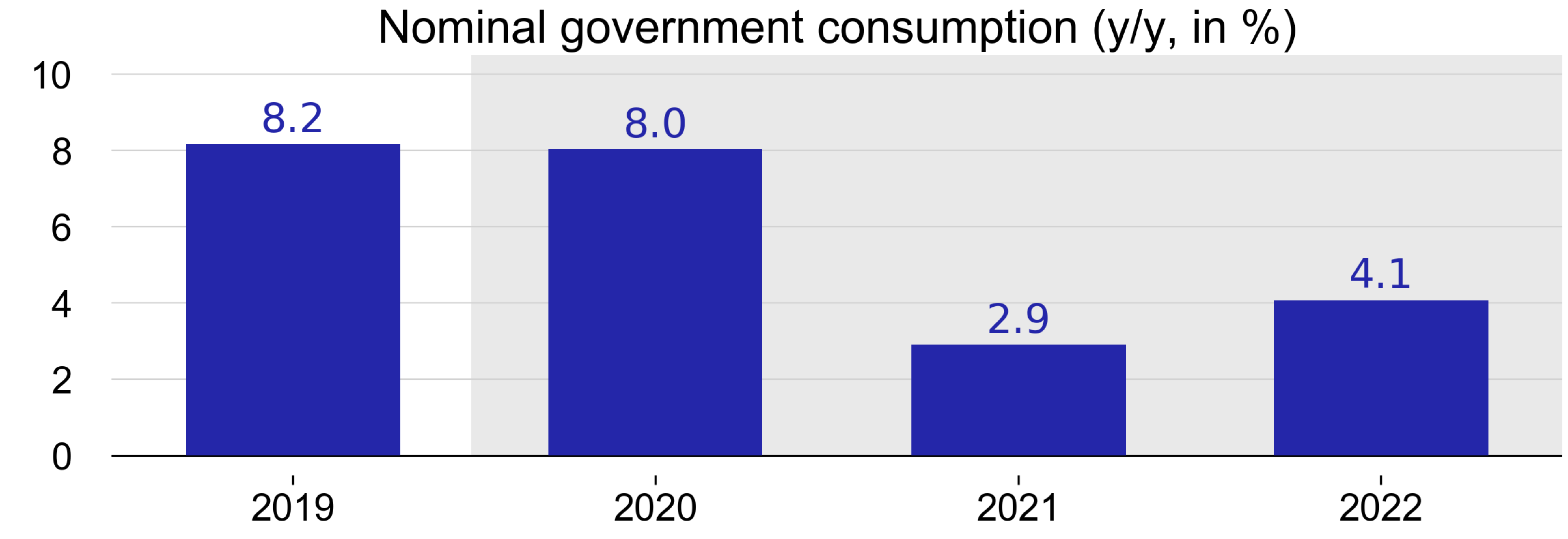

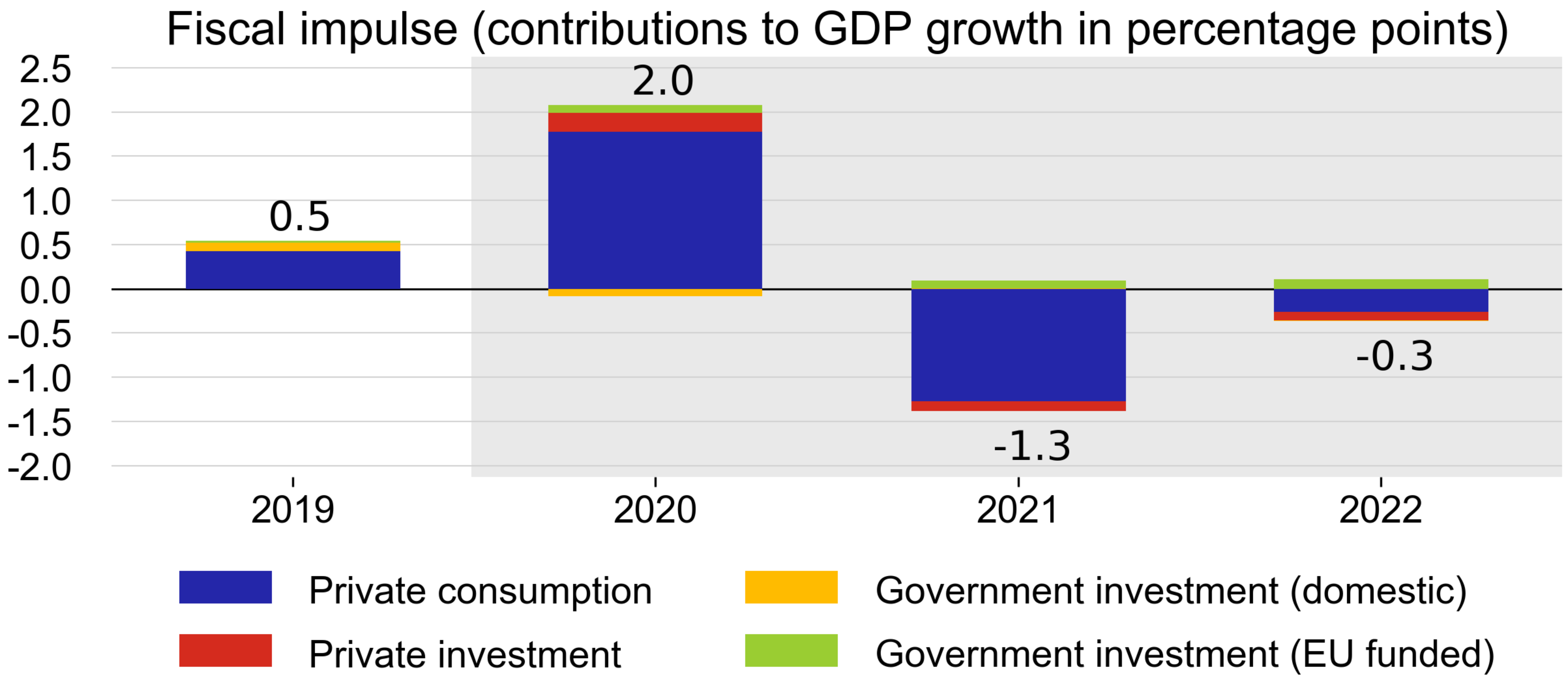

- Acceleration in **government consumption** in nominal terms will reflect a rise in expenditure on materials in health and emergency services and extraordinary compensation of employees this year.
- **Fiscal stabilisation policy** is being implemented primarily through substantial support for household consumption in 2020.
- A **positive fiscal impulse** this year is largely a result of the extraordinary measures taken to support the economy due to the pandemic (Antivirus, care allowance, tax loss carryback, one-off bonus to pensioners in December etc.).
- As most of the support measures will be temporary, the forecast expects a **negative fiscal impulse** in 2021 and 2022.

Pandemic Situation

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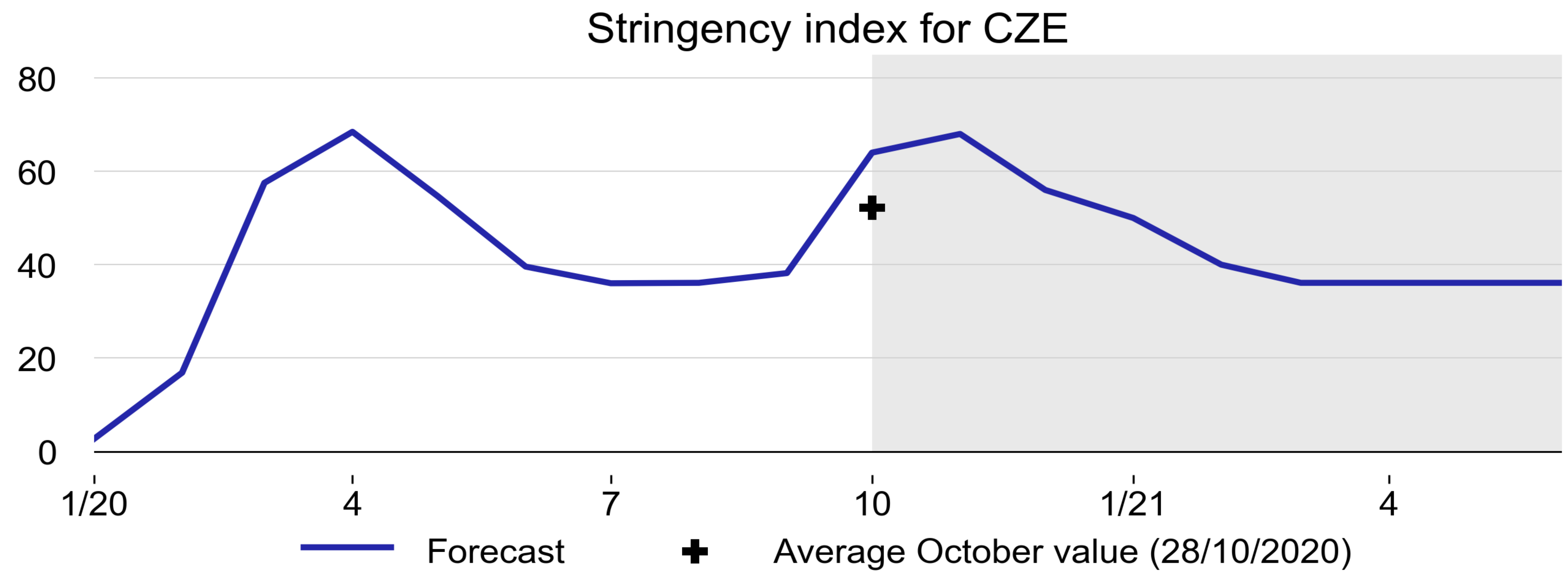

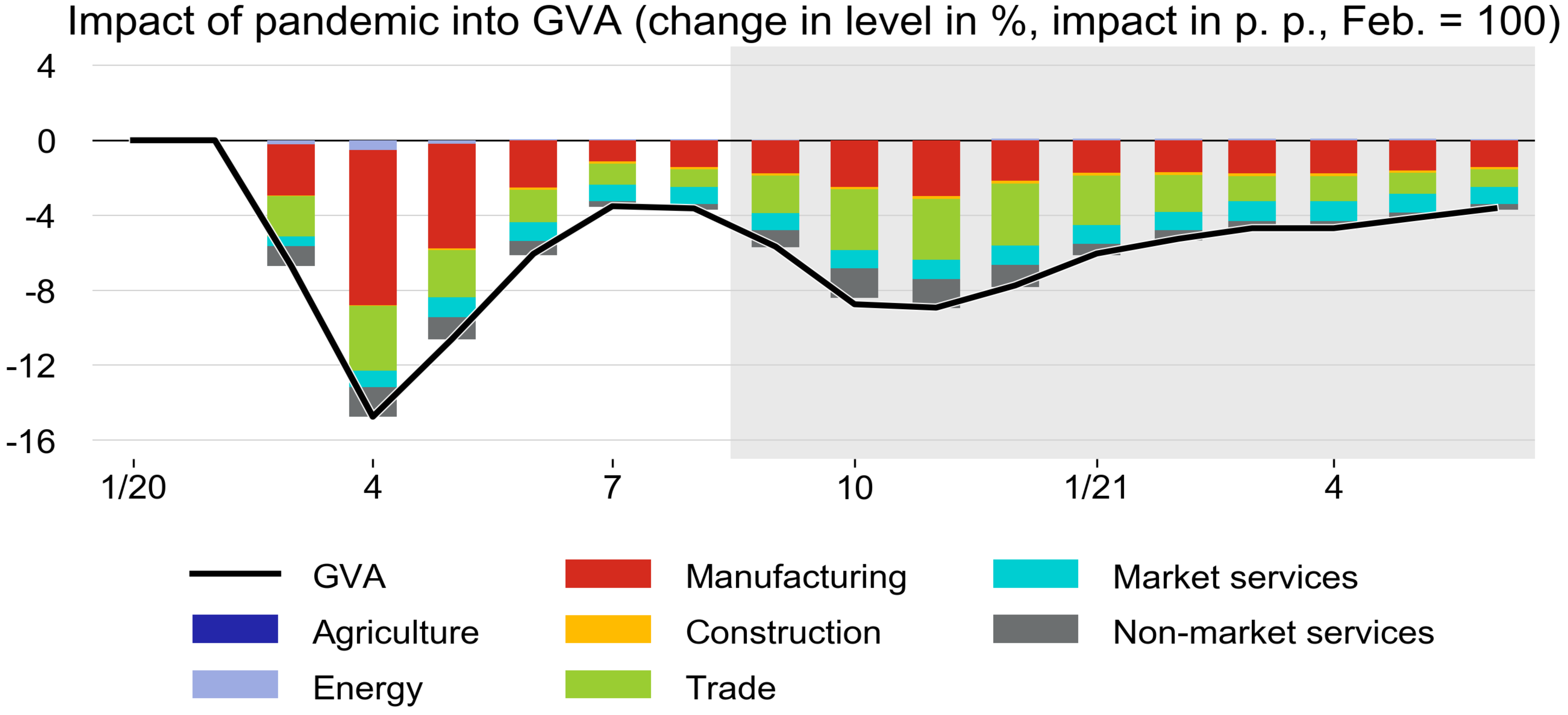

- Assumptions regarding the course of the epidemic situation are an important part of the baseline scenario of the forecast. **The adoption of a set of measures and restrictions had been anticipated** during the preparation of the forecast.
- The strength of restrictive epidemiological measures is indicated by the **Stringency Index**.
- The restrictive effect of the government's autumn measures and restrictions will peak in November 2020. The measures will be eased during the first half of next year.
- The epidemiological measures will have substantial **negative impacts on gross value added** until the end of this year (mainly through trade and services).

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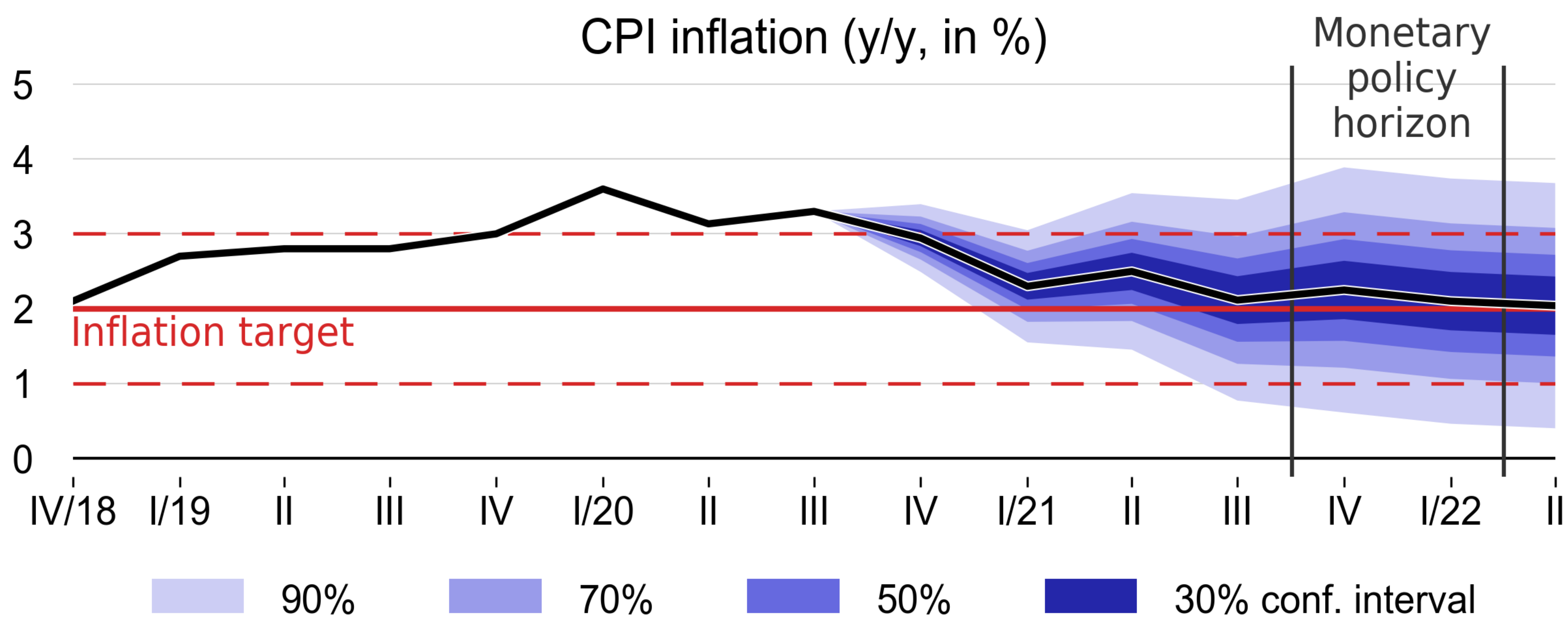
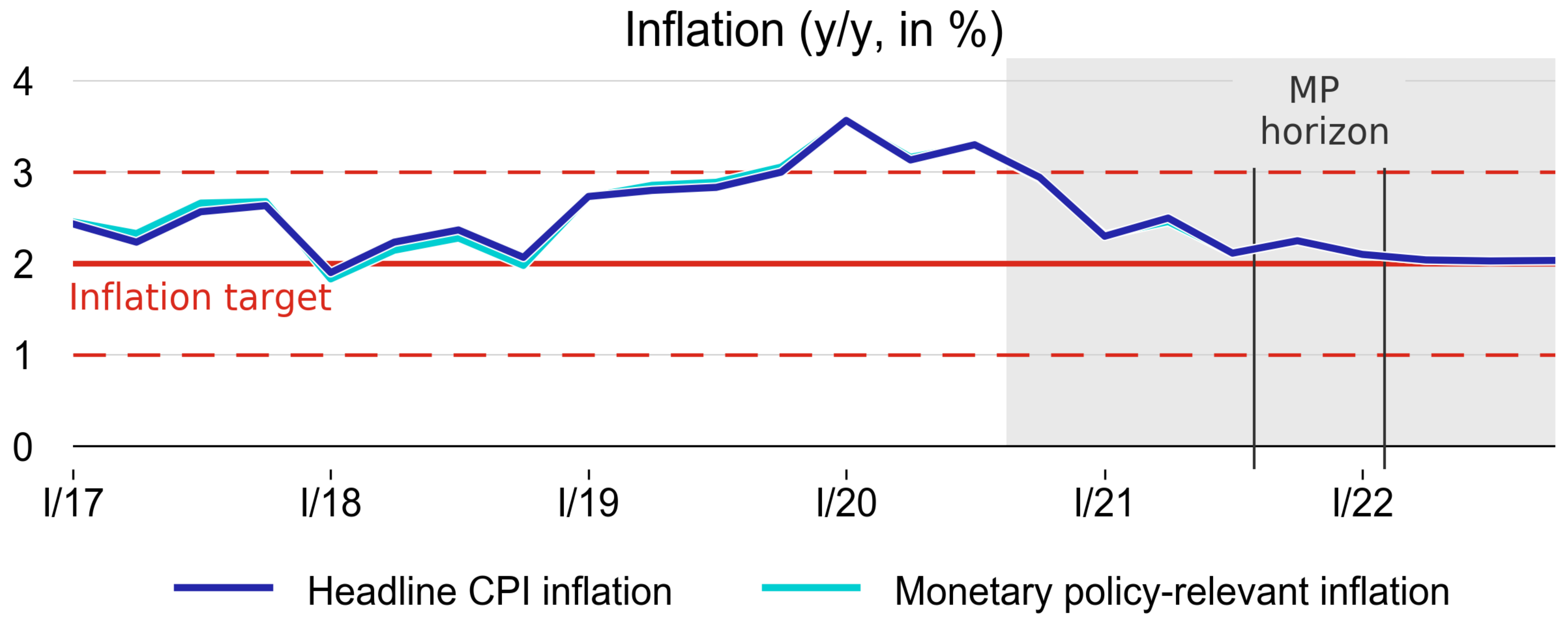
Headline and Monetary Policy-Relevant Inflation

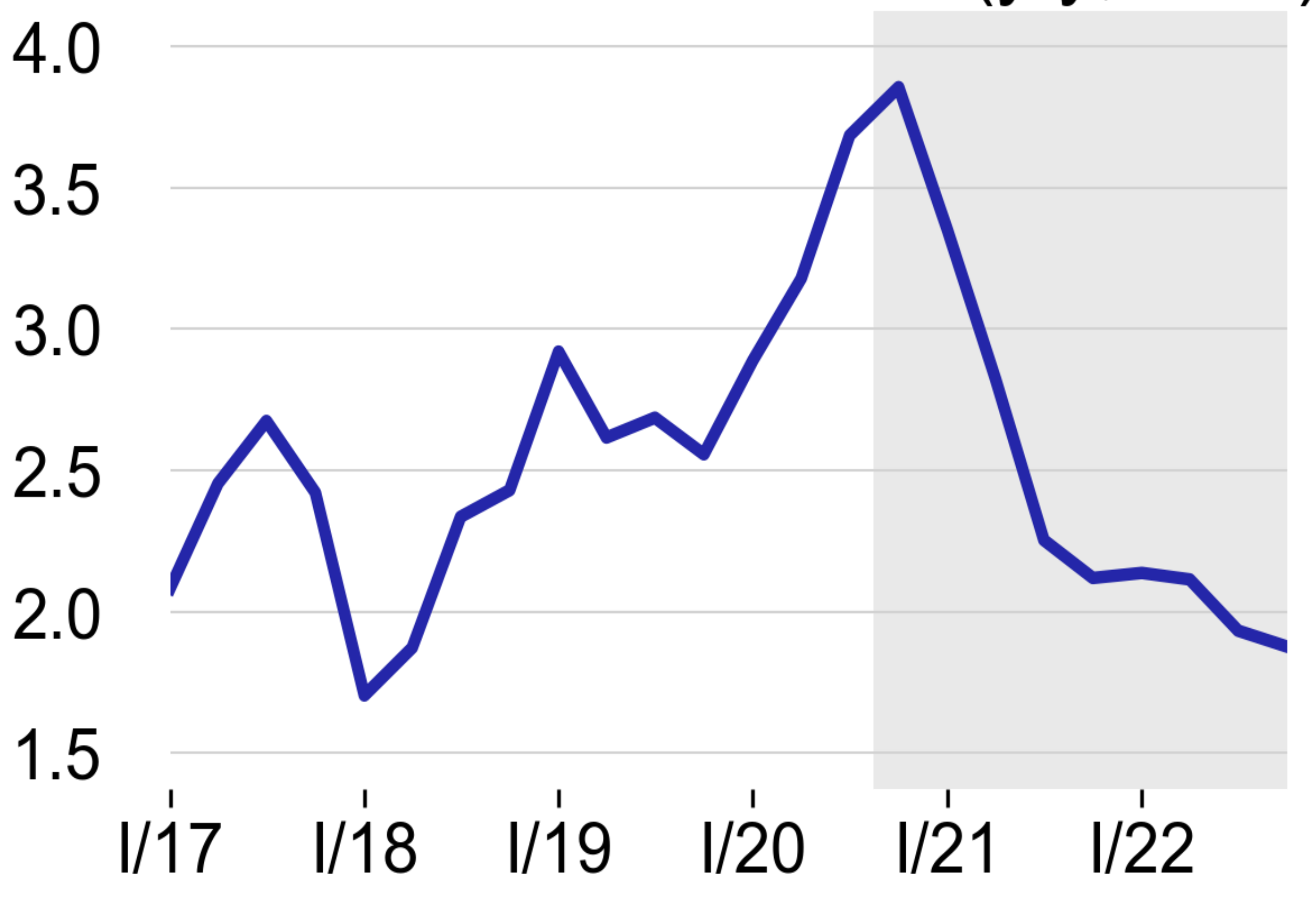




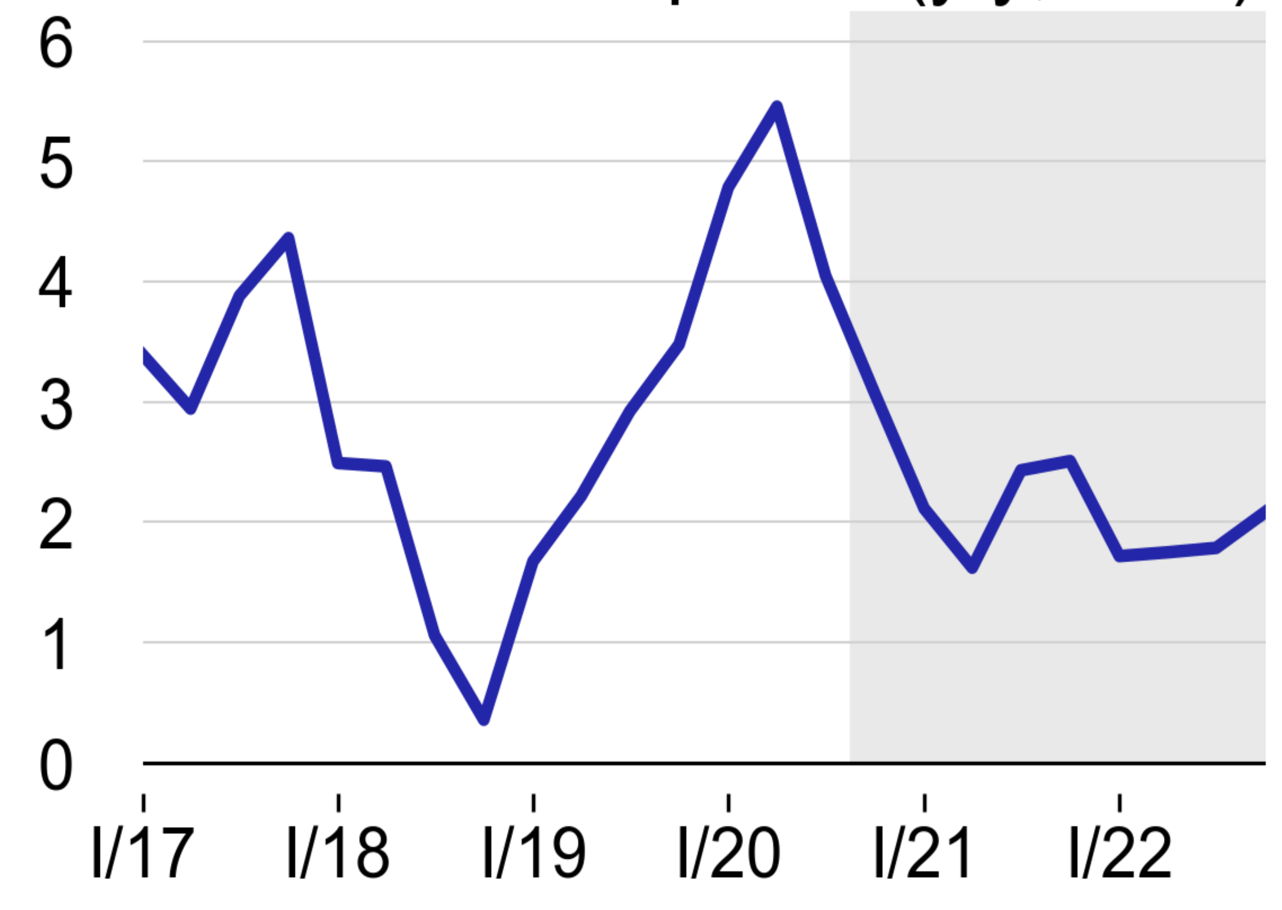
- **Headline inflation** will decrease below the upper boundary of the tolerance band in late 2020 and early 2021 partly due to a sizeable fall in administered price inflation (a decrease in gas prices for households and continued moderation of growth in electricity prices) and a slowdown in growth in food prices.
- Weaker domestic demand resulting from the adverse effects of the coronavirus pandemic, coupled with renewed exchange rate appreciation during 2021, will lead to a decline in core inflation and a return of headline inflation close to the target in 2021 H2.
- **Monetary policy-relevant inflation** will be equal to headline inflation, due to the unwinding of the positive first-round effects of this year’s changes to indirect taxes.

Inflation Components

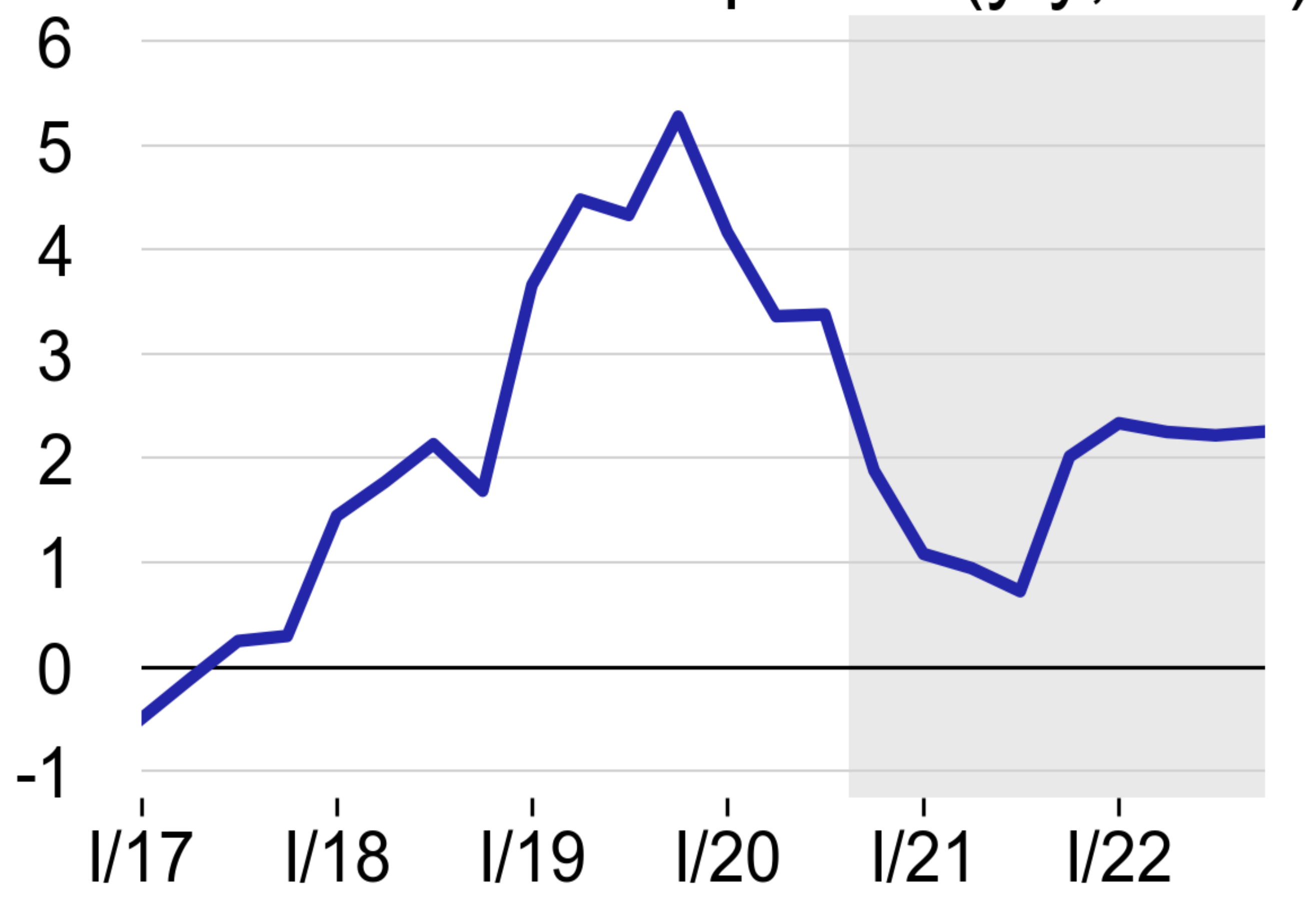
Core inflation excl. fuels (y/y, in %)*



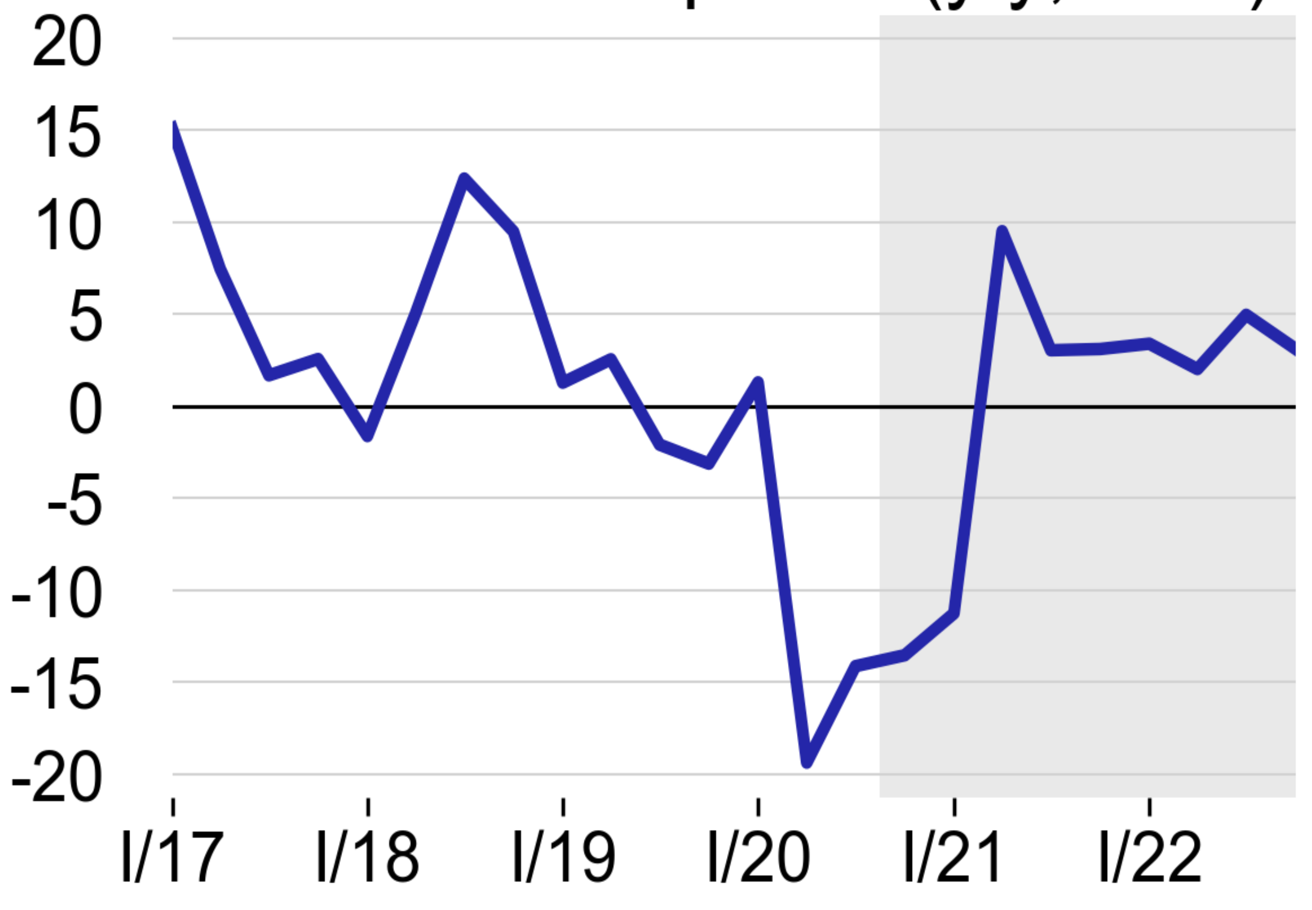
Growth of food prices (y/y, in %)*



Growth of admin. prices (y/y, in %)



Growth of fuel prices (y/y, in %)*



* excluding tax changes

- **Core inflation** will remain elevated until the end of this year reflecting the fading strong demand pressures connected with the until recently tight labour market. Core inflation will start to moderate appreciably next year (due mainly to the expected negative impacts of the autumn wave of the pandemic).
- Slowing food import prices and lower domestic demand pressures will foster a decline in **food price inflation** early next year.
- **Administered price inflation** will weaken in the near future due mainly to a decline in growth in electricity prices and a decrease in gas prices.
- The decline in **fuel prices** resulting from the previous collapse of global oil prices will fade out next year.

Inflation Pressures: Costs in Consumer Sector

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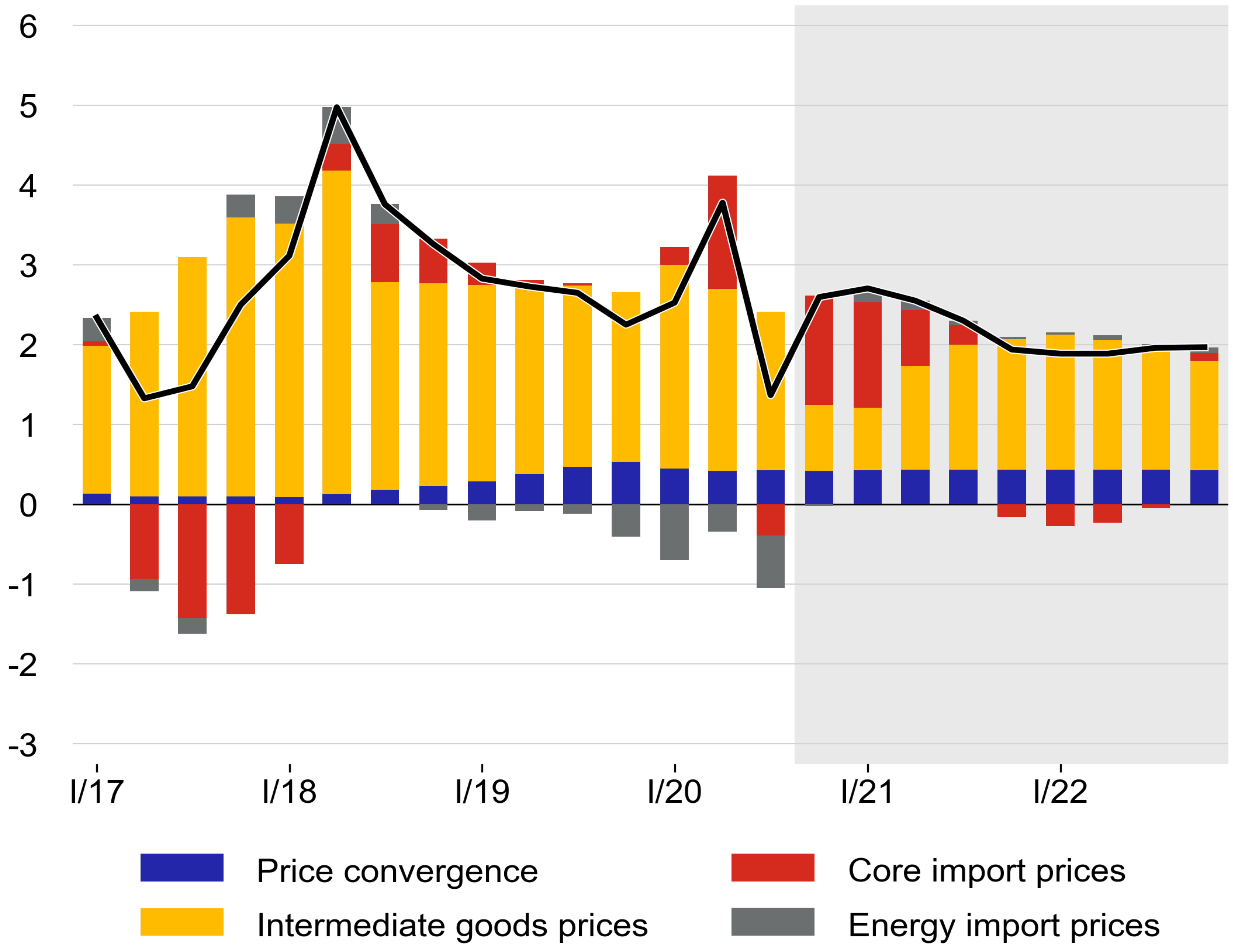
Nominal marginal costs in the consumer sector (q/q, in %, ann.)



- **Growth in total costs** will pick up temporarily due to a pronounced weakening of the exchange rate (reflected in a very positive effect of **core import prices**), then slow to its steady-state level.
- The previous negative **contribution of energy import prices** will fade out owing to an increase in oil prices.
- The **contribution of the domestic economy** to the evolution of total costs will decrease significantly in the coming quarters, owing to the negative demand impacts of the second wave of the coronavirus pandemic. Next year, the contribution of the domestic economy will increase again, due to a gradual recovery in economic activity.
- The contribution of **price convergence** will be constantly positive over the entire forecast horizon.

Inflation Pressures: Costs in Intermediate Goods Sector

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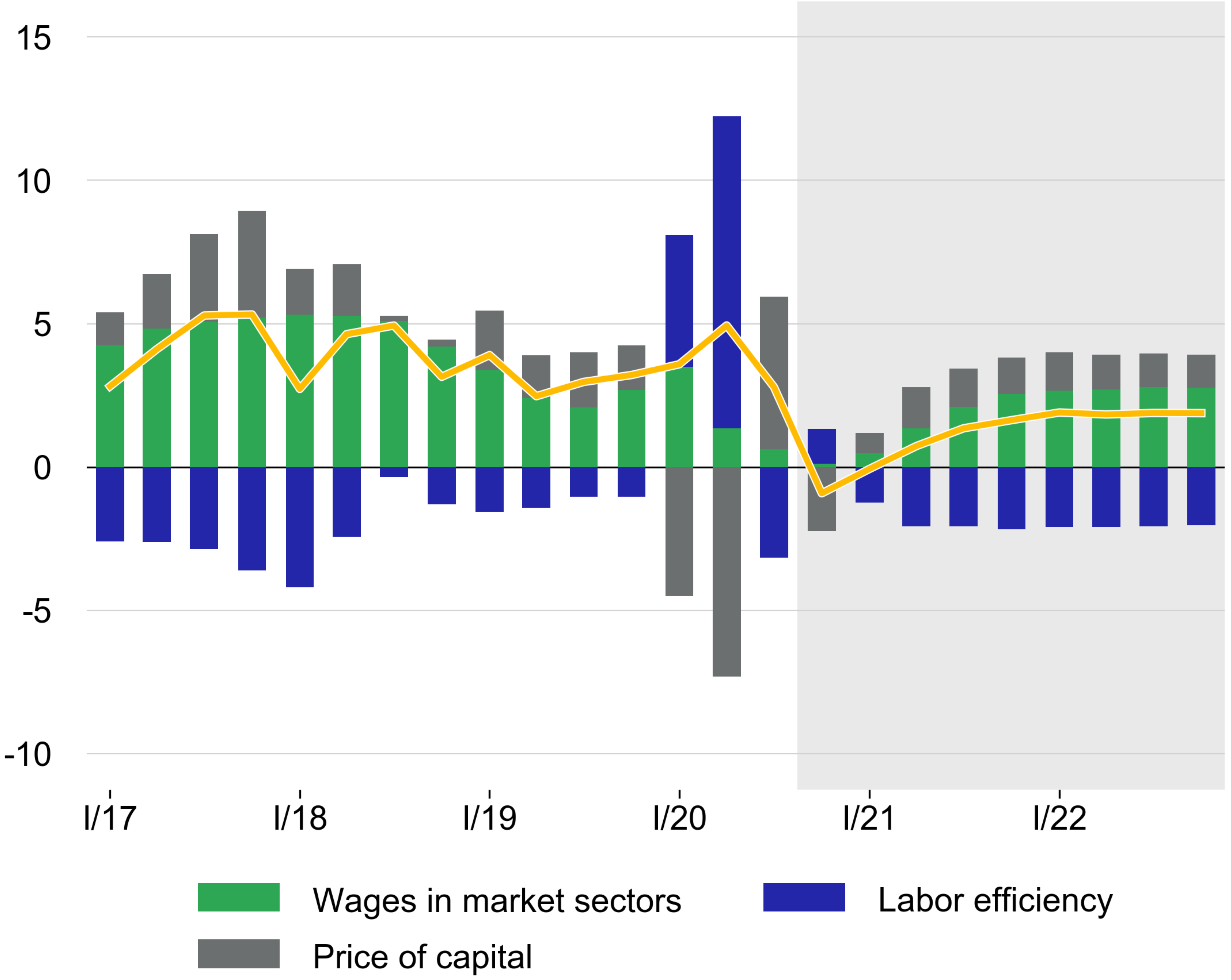
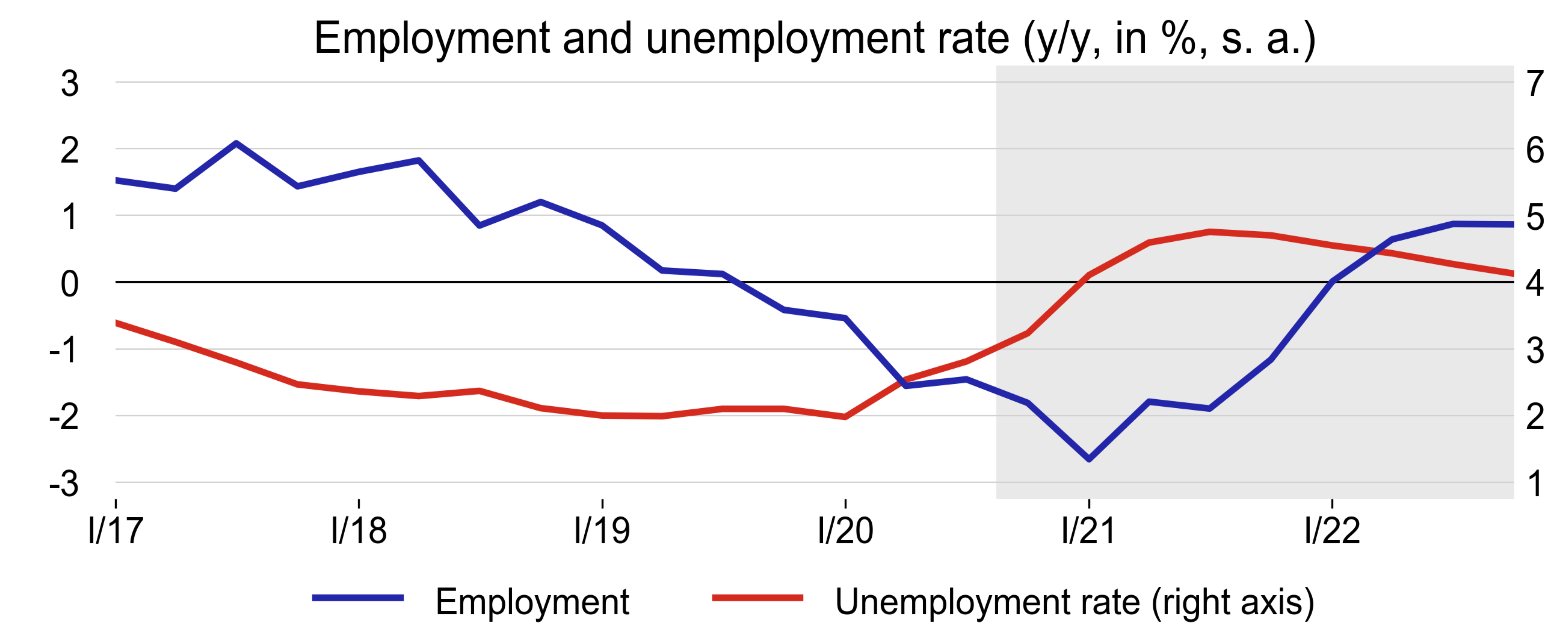
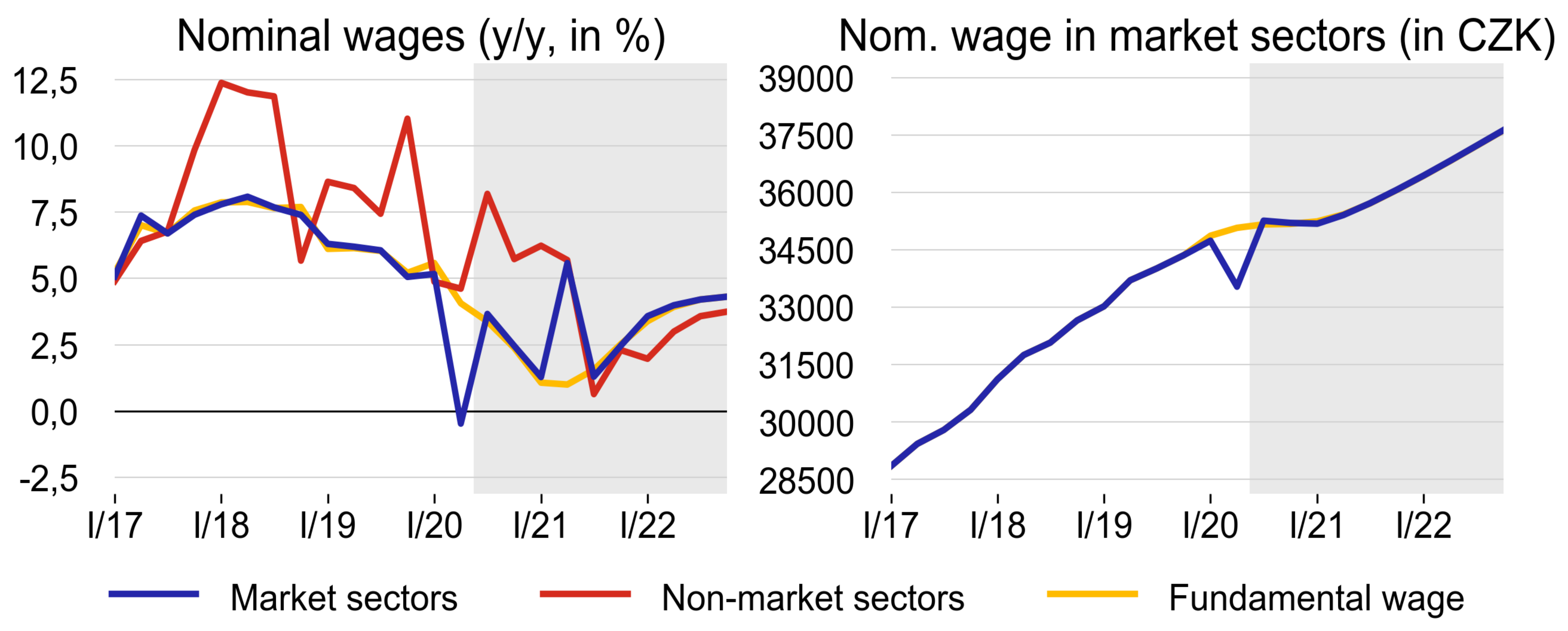
Nominal marginal costs in intermediate goods sector (q/q, in %, ann.)



- **Domestic costs** will decline temporarily at the end of this year.
- The easing of anti-epidemic measures and the reopening of the economy in the summer led to a renewal of the positive contribution of **the price of capital** and the dampening effect of **labour efficiency**. Growth in **fundamental wage costs** almost halted.
- Domestic costs will decline temporarily due to the anti-inflationary demand impacts of the second coronavirus wave. This will reflect a temporarily negative effect of the price of capital and still subdued wage growth. Labour efficiency will conversely have a slight inflationary effect.
- Their **renewed growth in 2021** will reflect a gradual recovery in domestic economic activity and growth in wages.

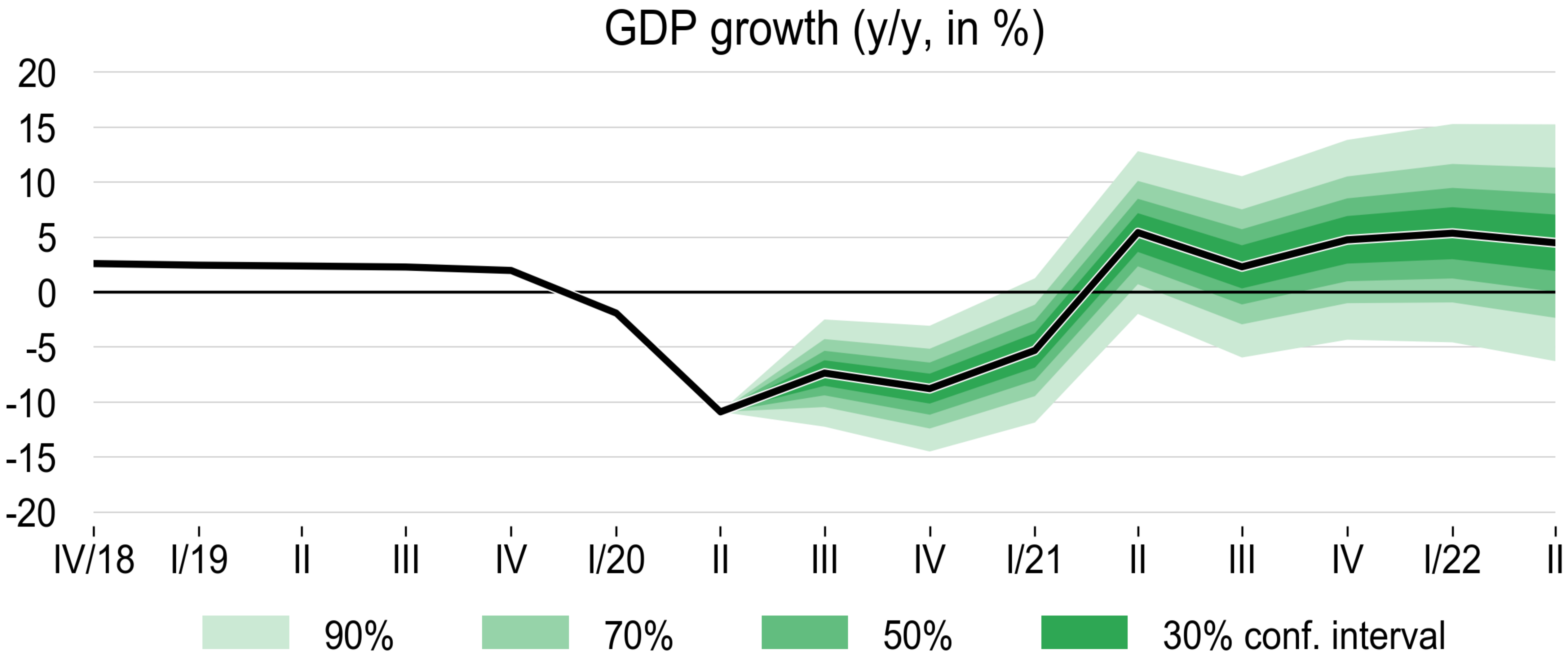
Labour Market

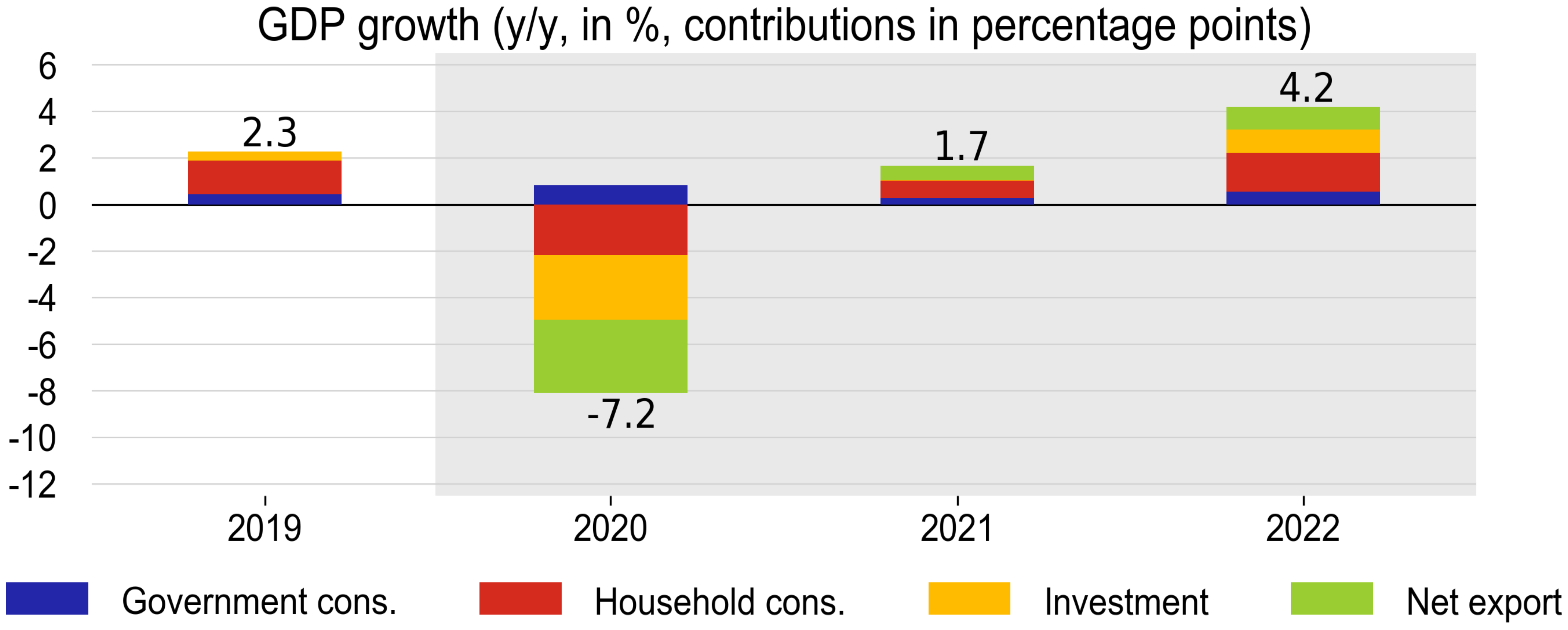




- **Employment** will decline appreciably year on year until the start of 2022 owing to this year's fall in economic activity.
- The **unemployment rate** will continue to increase substantially until 2021 H2, despite the government's employment protection measures. A high initial number of vacancies and lay-offs of foreign workers will have a dampening effect.
- **Wage growth in market sectors** will be lower on average than in previous years. **Growth in fundamental market wages** will slow until mid-2021 due to a continued cooling of the labour market.
- High wage growth will continue in **non-market sectors** this year.
- Statistical effects will cause wage growth in both sectors to fluctuate.

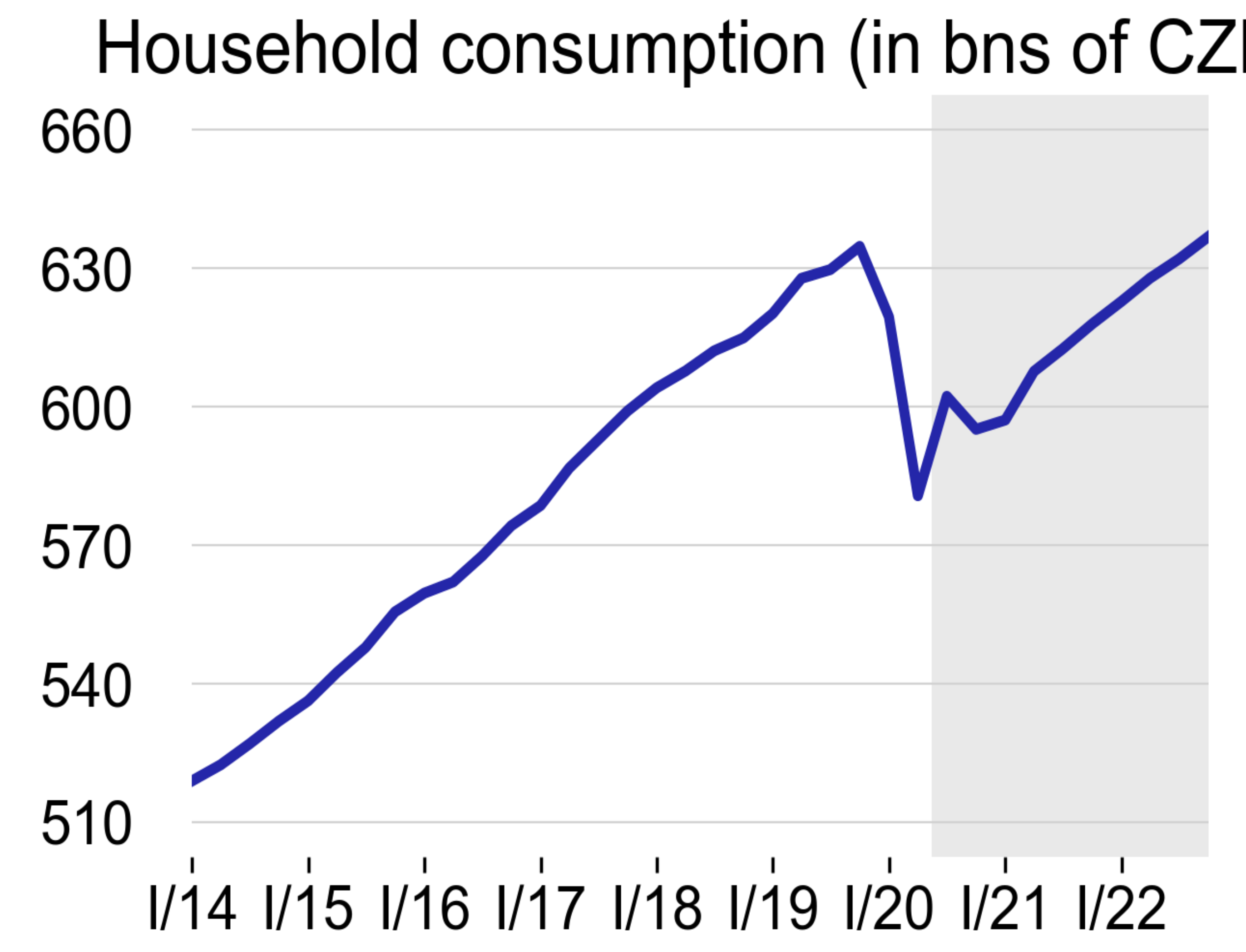
GDP Growth Forecast

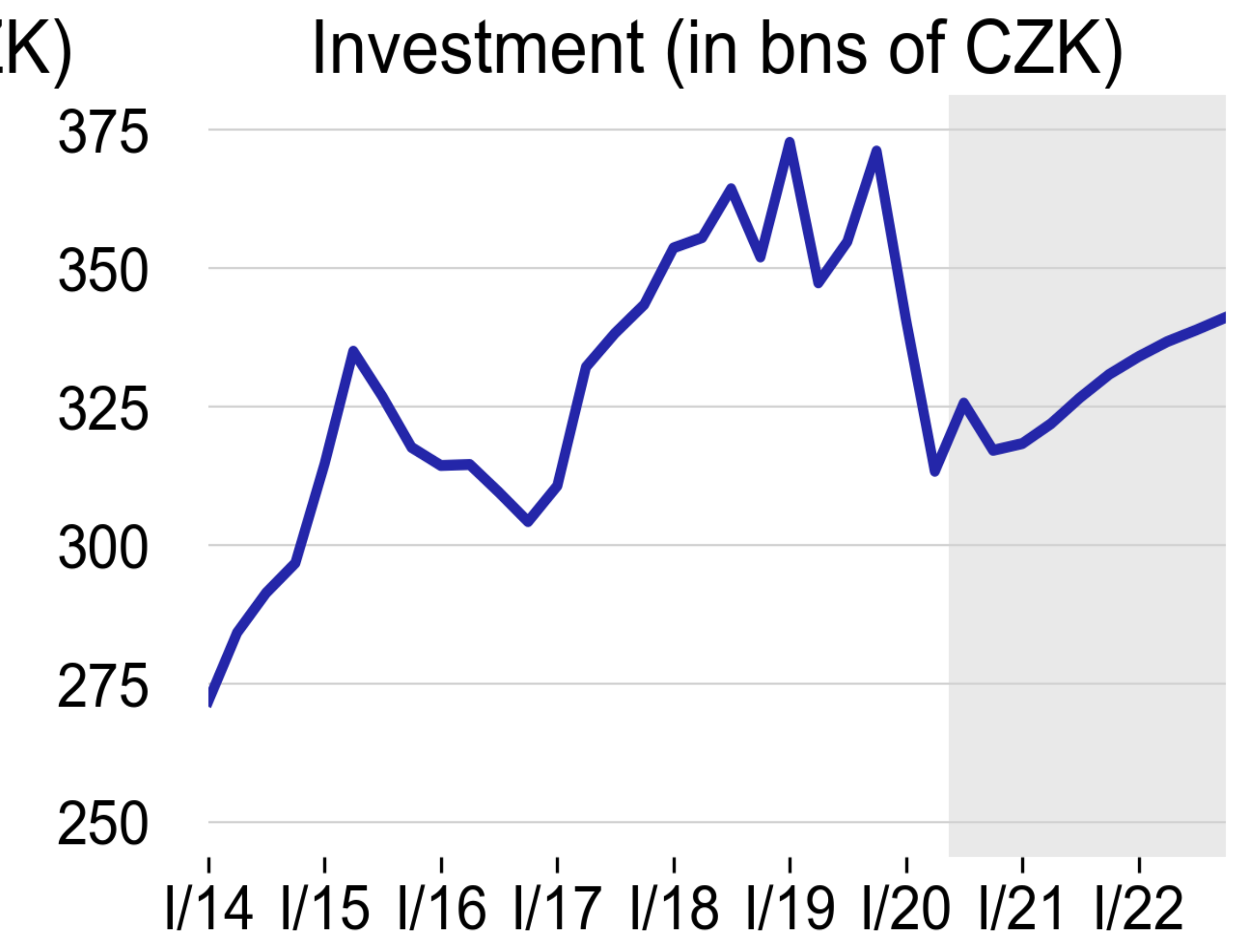


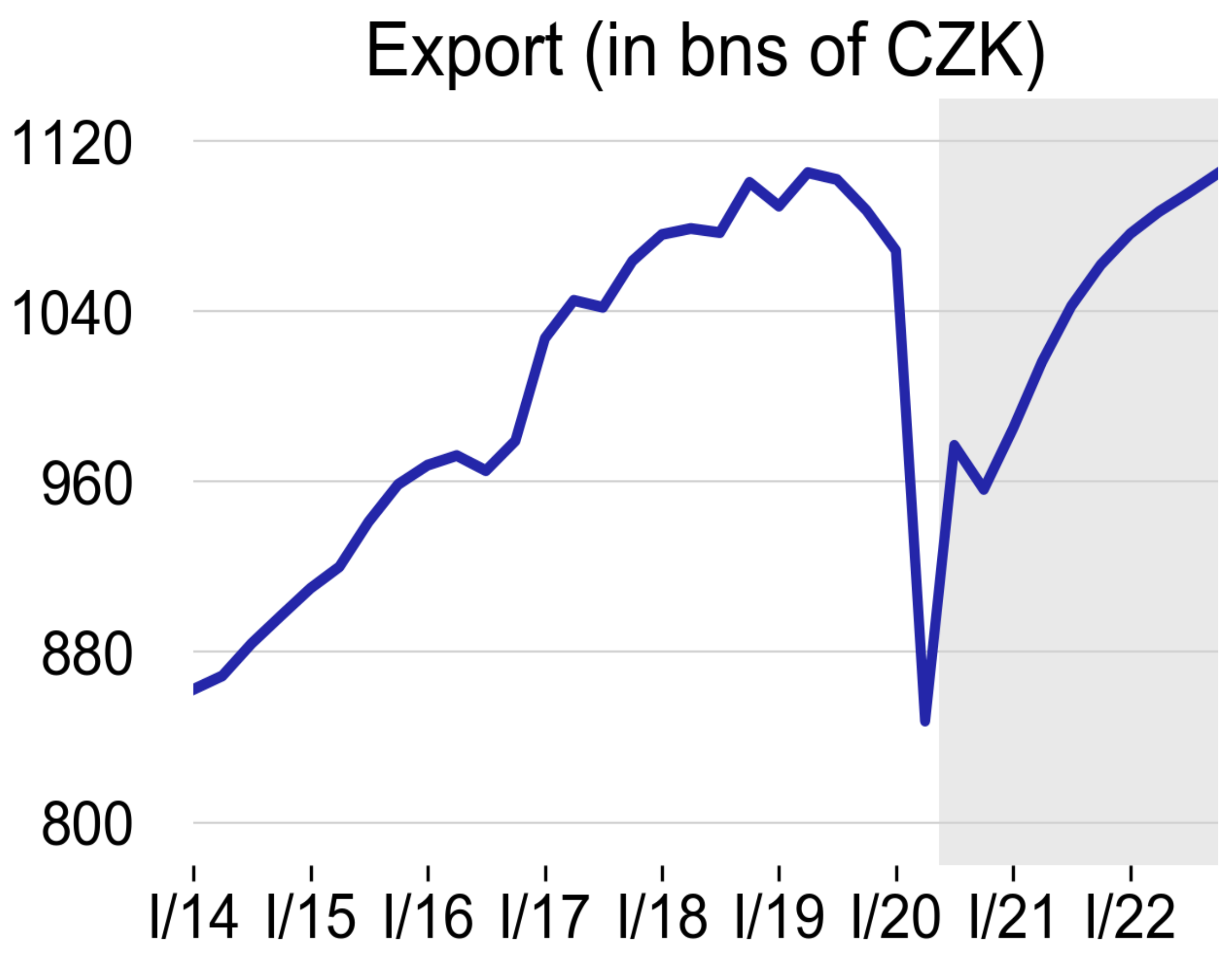


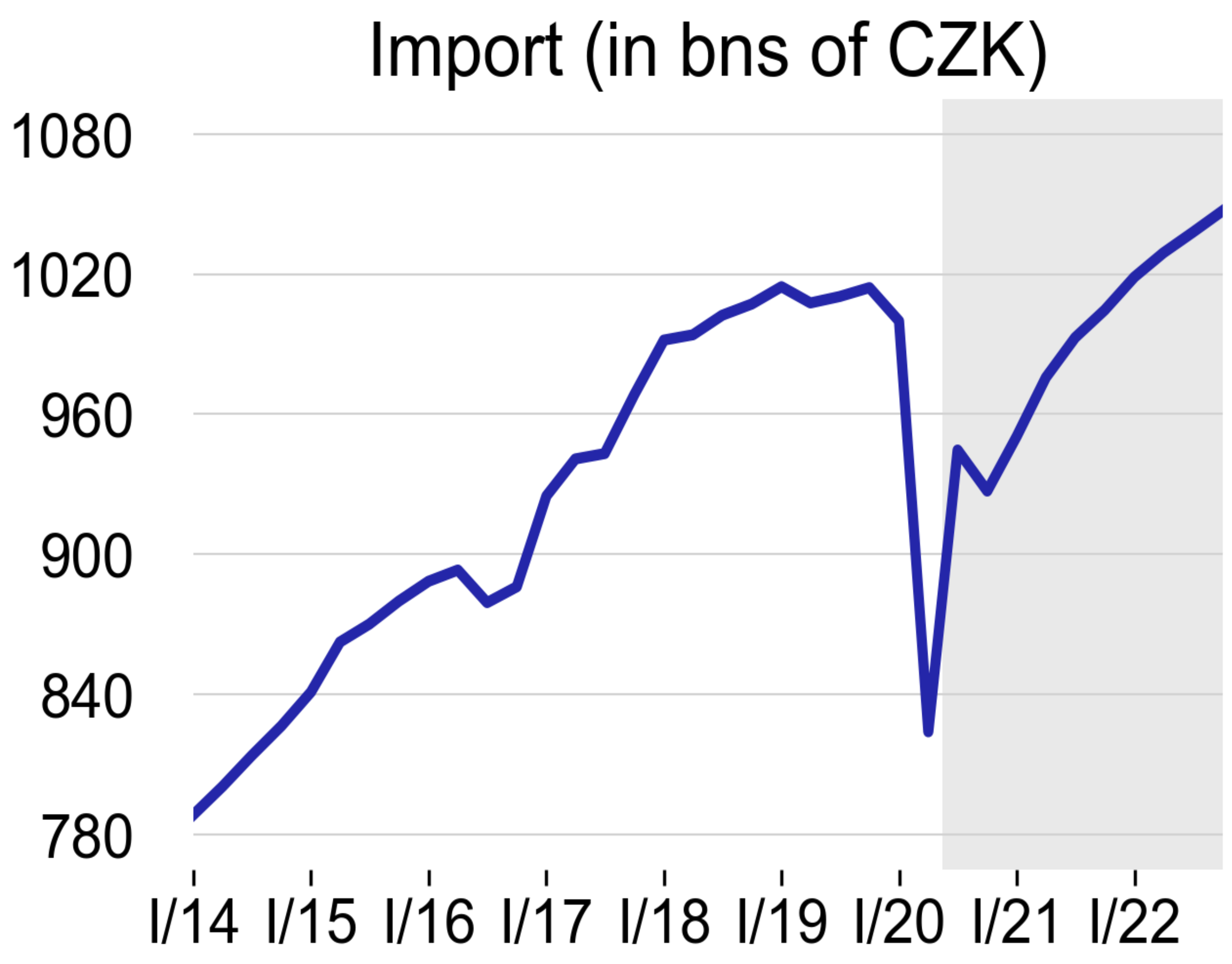
- **Domestic economic activity** will suffer a sizeable contraction this year as a result of the coronavirus pandemic.
- The drop in economic activity of more than 7% this year will be **due to all GDP components except government consumption**.
- **The negative impacts of the second wave on economic activity will fade away in mid-2021** and the domestic economy will continue to recover gradually, amid a slowly closing negative output gap.
- GDP growth of almost 2% next year will be driven mainly by household consumption and net exports.
- GDP growth will pick up further in 2022.

Aggregate Demand Components



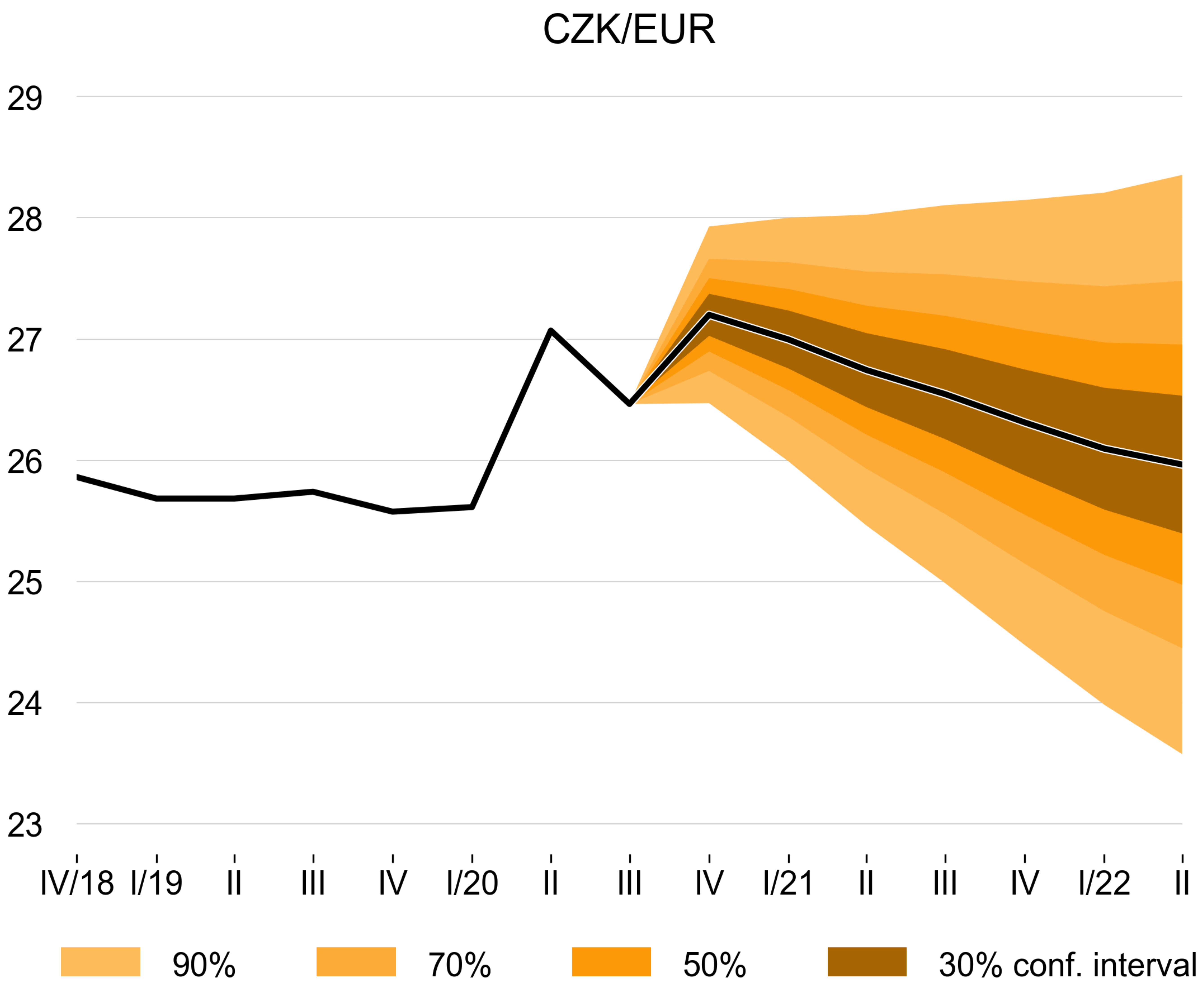






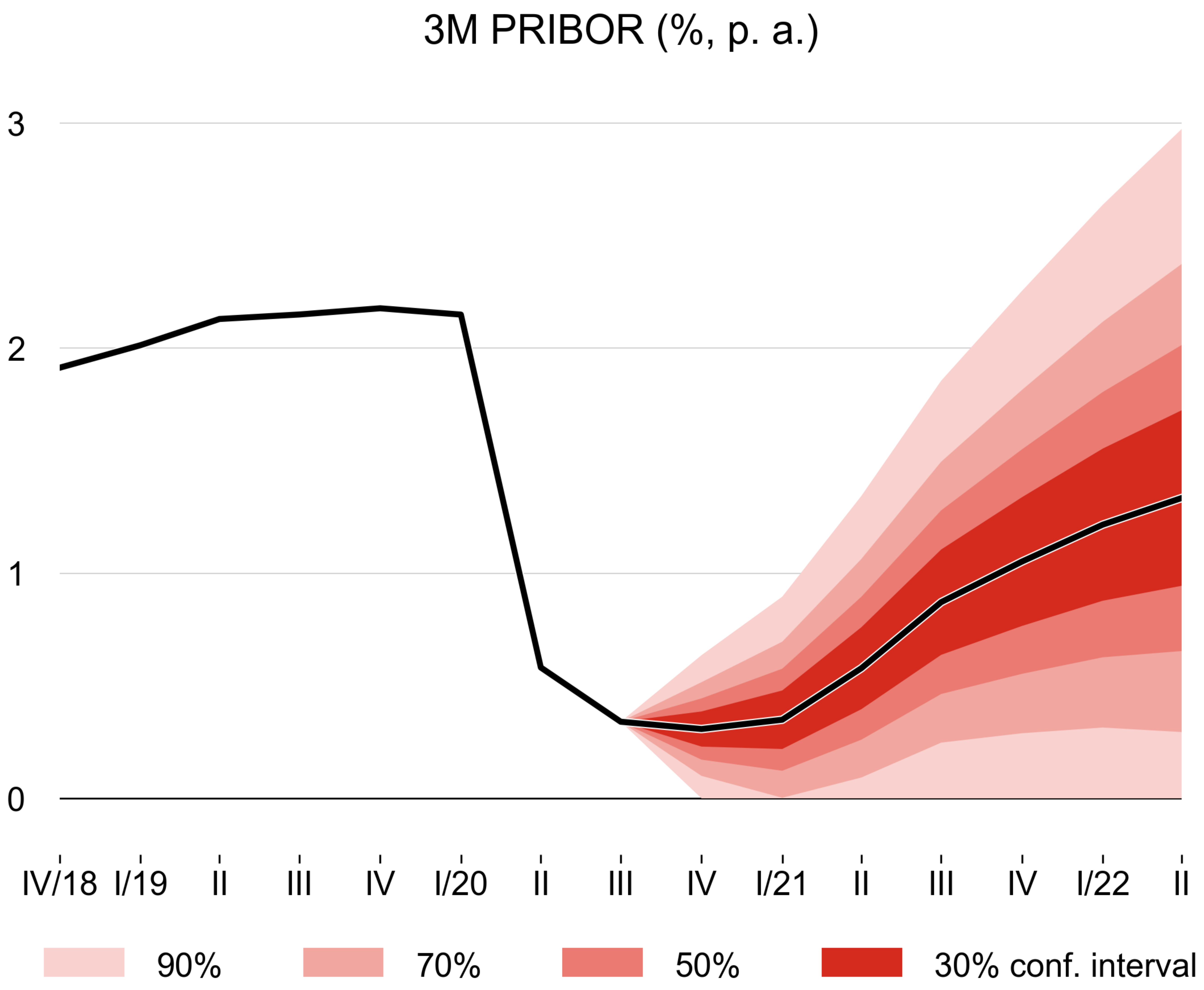
- **Household consumption** will drop this year as a result of the pandemic and a further cooling of the labour market. Household consumption will reach its pre-coronavirus level in 2022.
- **Private investment activity** will be adversely affected by the impacts of the pandemic and a repeated decline in business confidence.
- **Exports of goods and services** will drop sharply this year, but they will recover fairly fast due to a better epidemic situation abroad and expected functionality of global production chains.
- **Import growth** will fall significantly this year, due to a decrease in domestic demand and exports.

Exchange Rate CZK/EUR



- The **koruna** will start to appreciate gradually again next year.
- The exchange rate forecast for **2020 Q4** is set at **CZK 27.2 to the euro**. It thus reflects the pronounced depreciation recorded in the autumn, which was due to the reversal in global sentiment resulting from the start of the second wave of the coronavirus pandemic.
- The expected gradual calming of the epidemic situation next year will foster renewed gradual appreciation to just below CZK 26 to the euro at the end of 2022.
- This will be caused by a widening interest rate differential amid a recovery in external demand and, in turn, domestic economic activity.

Interest Rate Path (3M PRIBOR)



- Consistent with the forecast is **stability of market interest rates initially**, followed by a gradual rise in rates in 2021.
- The expected fading of the negative effects of the second wave of the pandemic in the coming quarters, inflation stabilising subsequently close to the target, and a continued return of domestic and foreign economic activity towards pre-crisis levels will then allow a gradual increase in (careful beginning of normalisation of) interest rates to start during 2021.
- This interest rate path is conditional on the assumptions about the course of the epidemic situation and the anti-pandemic measures.

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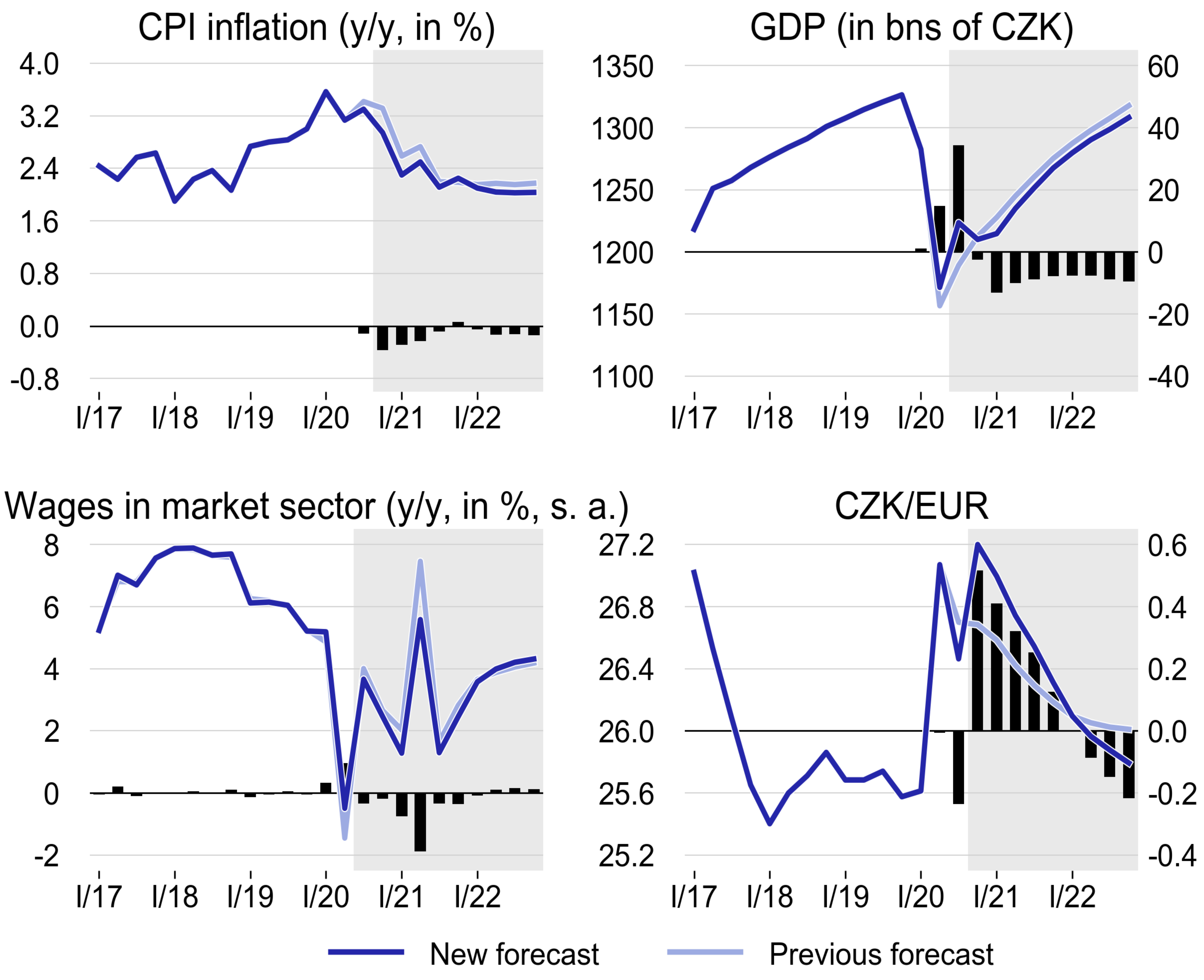
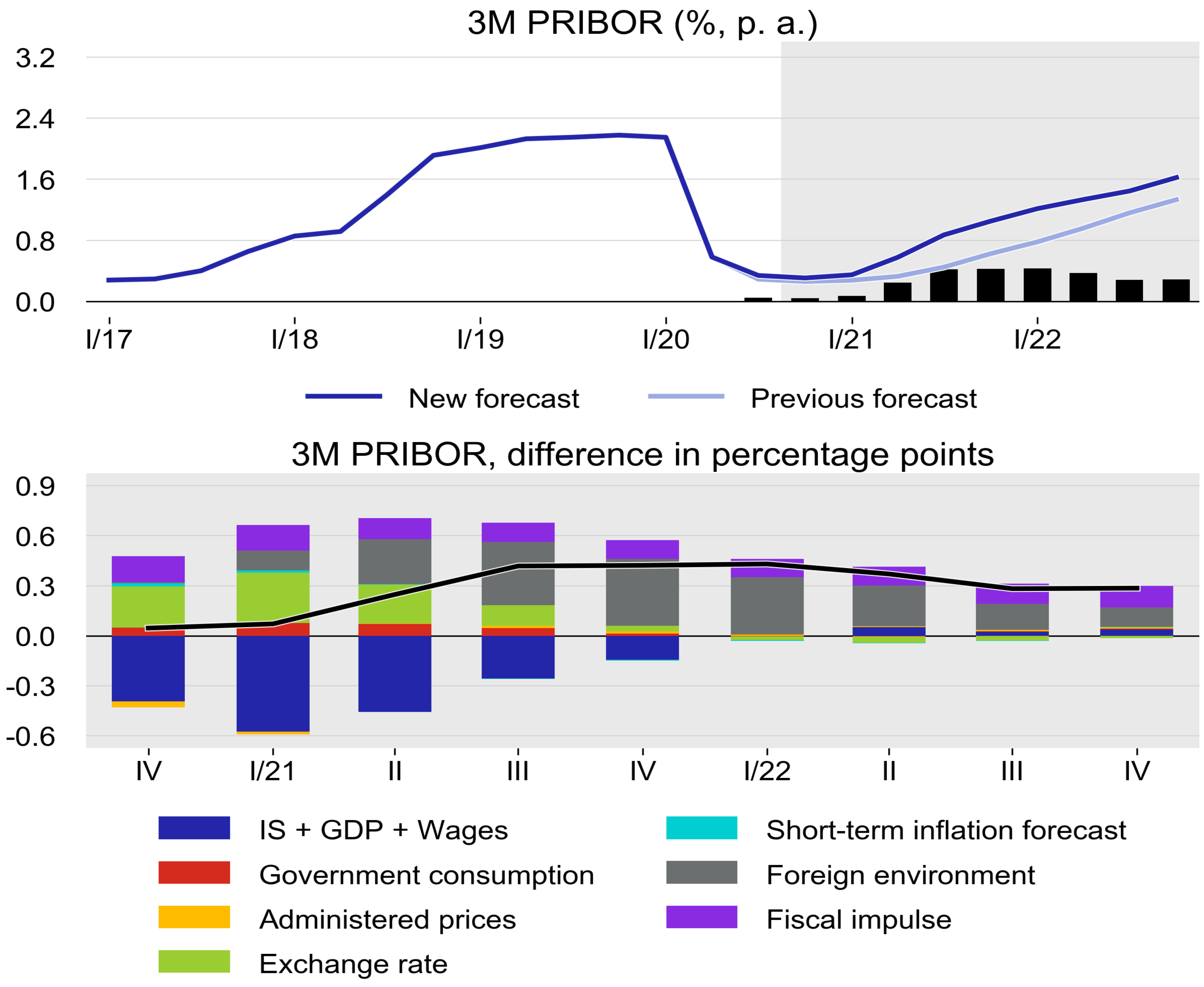
Comparison with Previous Forecast



- The **headline inflation** forecast is lower, owing initially to a decrease in the outlook for administered prices and fuel prices, and later to the decision not to increase excise duties further. The anti-inflationary demand effects of the second wave of the pandemic also contribute.
- The outlook for **domestic economic activity** is lower next year due to more subdued growth of private investment and household consumption.
- The lower **wage growth** forecast reflects milder fundamental wage pressures due to the second wave of the pandemic.
- The **exchange rate** forecast has been revised towards a weaker koruna until the end of next year, mainly due to a change in sentiment on financial markets.

Comparison: Interest Rate Forecast



- The new forecast contains a slightly higher **domestic interest rate** path from 2021 Q2 onwards than the previous one.
- The strongly anti-inflationary impacts of the second wave of the pandemic push towards lower domestic rates via domestic real economic developments in the coming quarters (contained in the aggregate category IS + GDP + Wages).
- On the contrary, a strongly inflationary effect of the initial state is the dominant factor pushing to higher rates in the next few quarters (contained also in the aggregate category IS + GDP + Wages).
- The short-term koruna outlook for 2020 Q4, a stronger positive fiscal impulse along with more expansionary domestic fiscal policy and changes in the external outlook also have an upward effect on rates.

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Worse Pandemic Scenario

- **A worse course of the second wave of the coronavirus pandemic** in the Czech Republic and especially abroad **is a major risk to the forecast**.
- The worse pandemic scenario considers a major impact (stronger than in the baseline scenario) on the global economy in late 2020 and particularly early 2021.
  - **A worse course of the second wave of the pandemic** will be characterised by **stronger and longer-lasting anti-inflationary demand effects** (reflecting a drop in private consumption and investment).
  - The scenario also assumes **a negative supply shock in the form of disruption of global supply chains**.
  - The sharp decline in economic activity will be slightly dampened by the positive effect of higher government consumption.
- For the **domestic economy**, the scenario expects the **restrictive measures to be in effect for longer and have more negative economic impacts**.
  - The scenario assumes that the **Czech government implements no further fiscal stabilisation measures** going beyond those already in place in the baseline scenario.
  - **Market services will be hit harder** than in the baseline scenario.
  - Owing to the disruption of global supply chains, **domestic manufacturing will also be affected more severely than in the baseline scenario** – to a similar extent as in the spring months.

Worse Pandemic Scenario: External Environment

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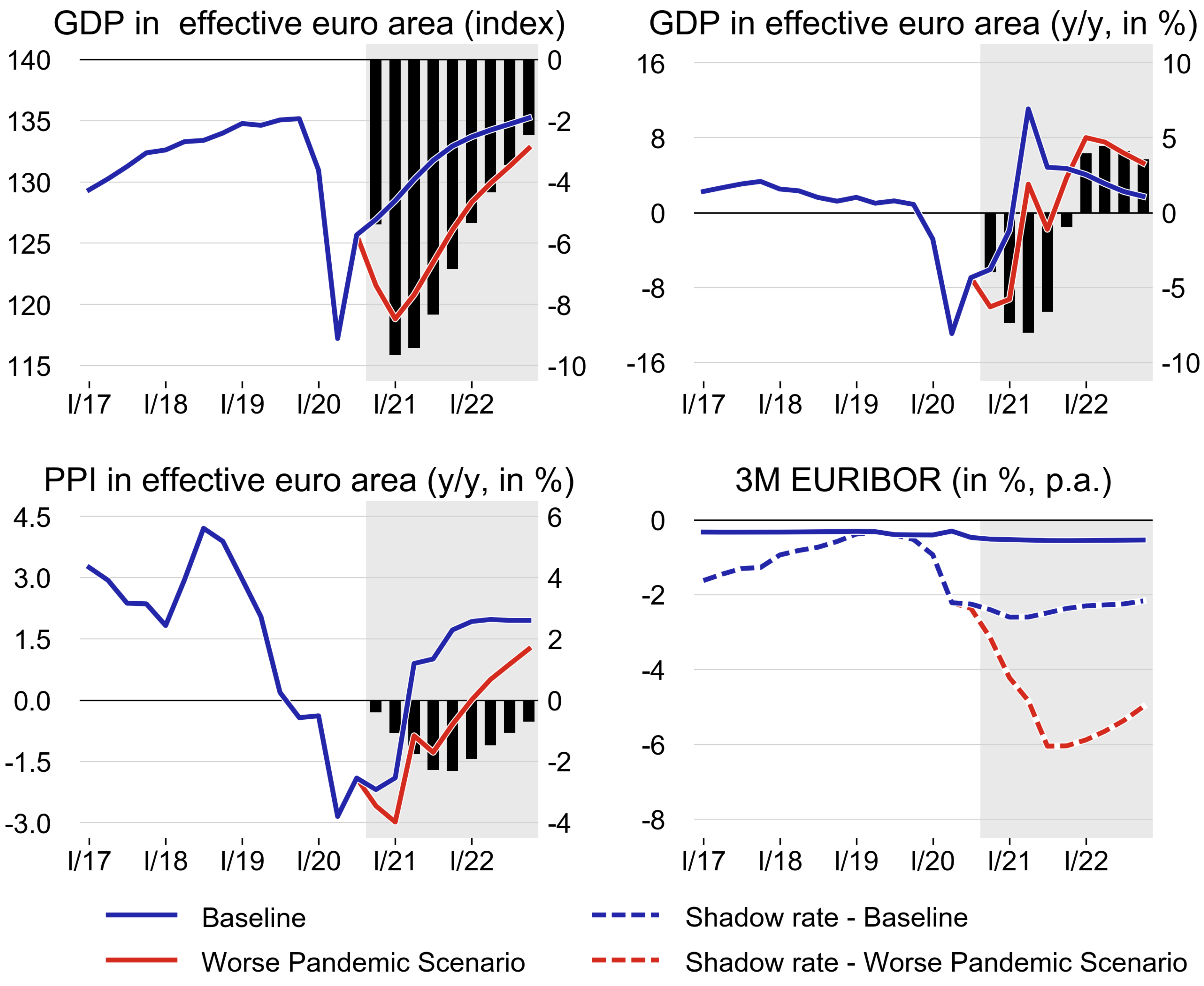
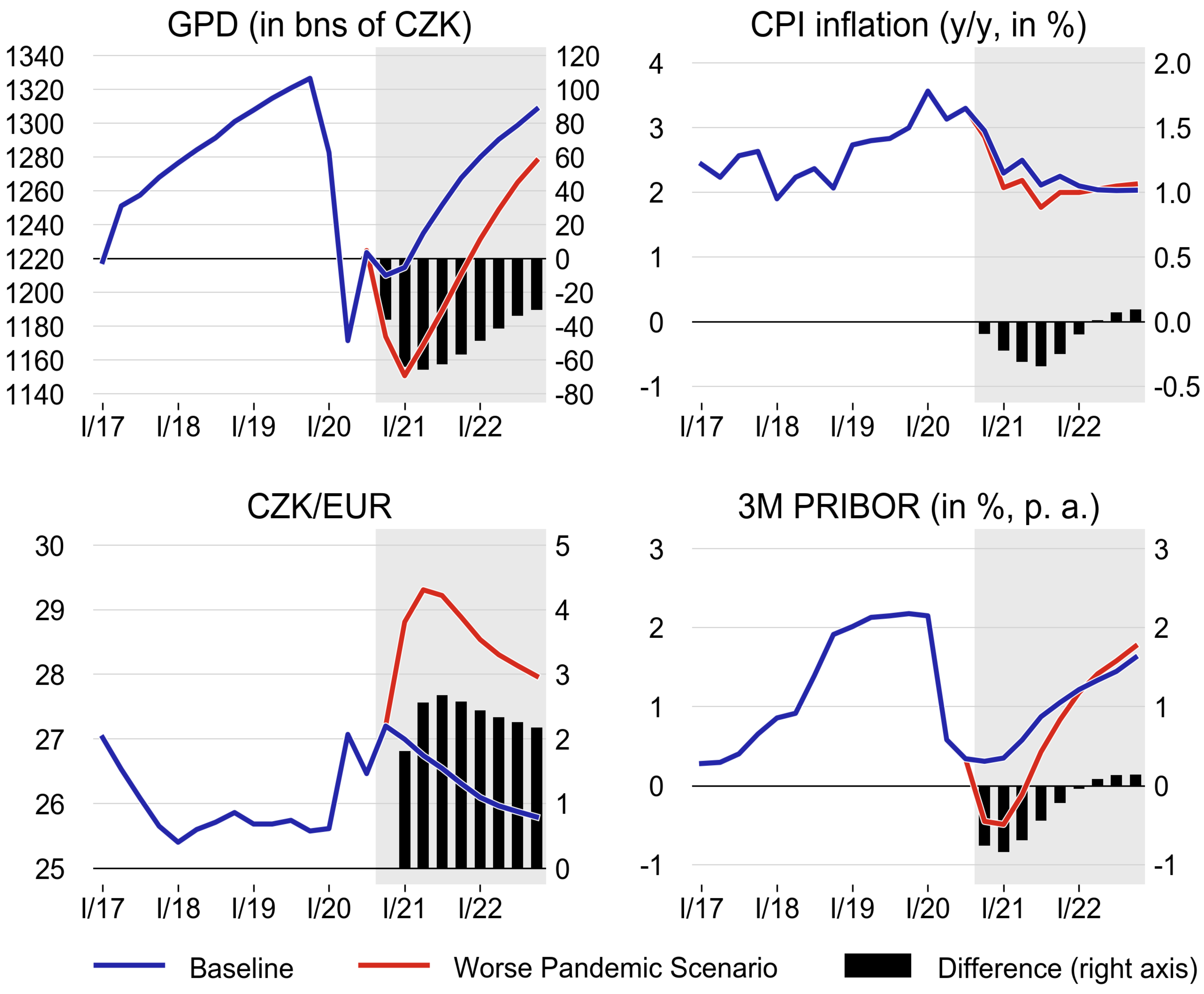


- **Economic activity** in **the effective euro area** is markedly lower in the worse pandemic scenario than in the baseline scenario.
- This will also be reflected in a deeper fall in foreign **producer prices** due to a drop in energy prices amid subdued growth in the core component.
- The ECB responds to the escalated situation by **easing monetary conditions** further using unspecified unconventional instruments. **Shadow interest rates** thus move even further into negative territory.

Worse Pandemic Scenario: Domestic Developments



- The drop in external demand will be reflected mainly in **more subdued domestic activity** (deteriorating net exports and lower private investment activity).
- The longer-lasting second wave and period of constant uncertainty will also lead to lower household consumption and to a more pronounced cooling of the labour market.
- Lower growth in domestic costs in an environment of temporarily highly subdued demand pressures will be reflected in the **inflation outlook**, which will be lower than in the baseline scenario.
- A temporary drop in **market interest rates** to slightly negative levels combined with a distinctly weaker **exchange rate** will support a gradual recovery of domestic economic activity amid a return of inflation to the target.

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Presentation outline

Fiscal Scenario

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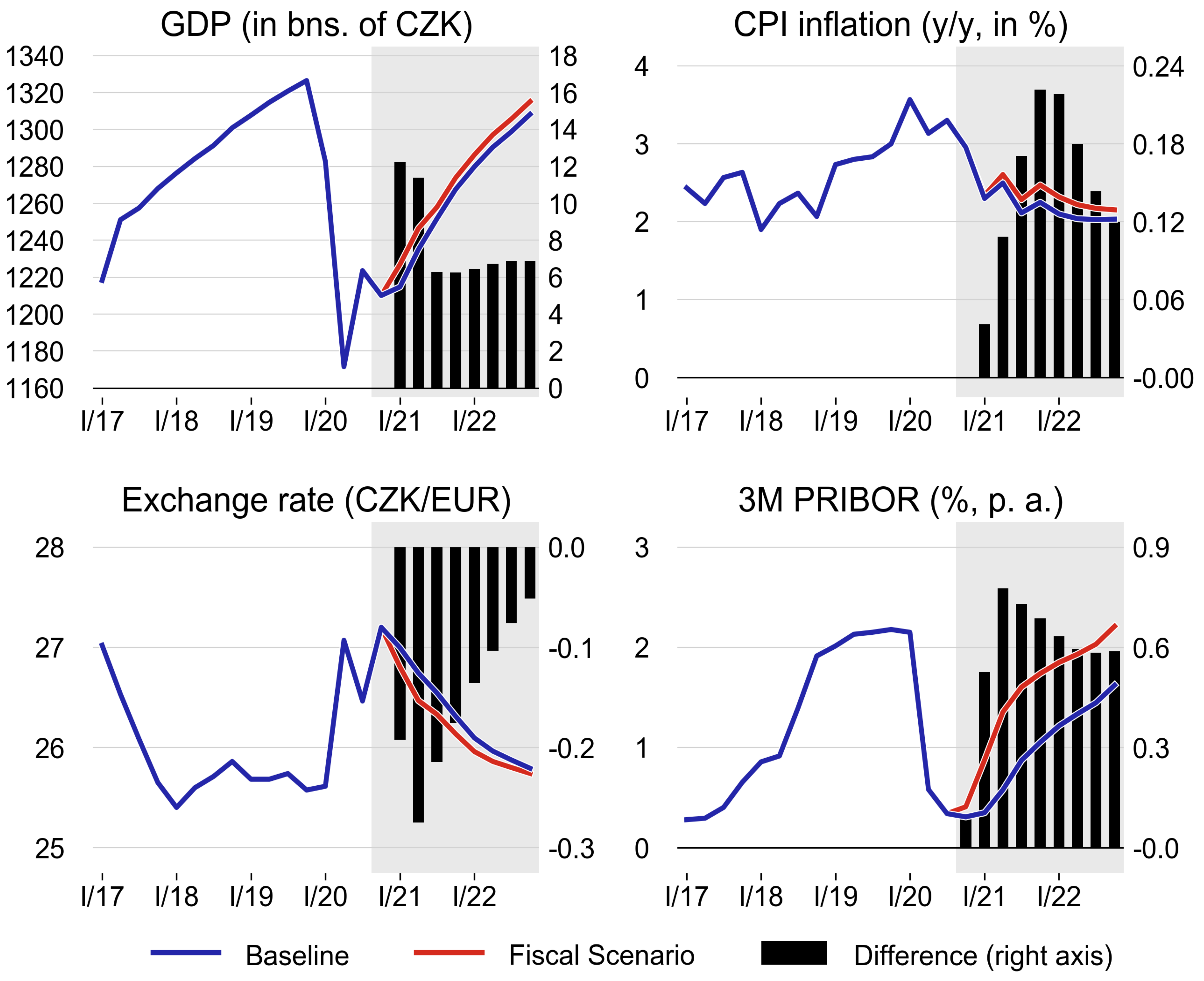
- The fiscal scenario describes the eventuality of **less restrictive or neutral fiscal policy in 2021**.
- It considers the adoption of additional budgetary measures to offset the negative fiscal impulse expected next year in the baseline scenario (additional measures amount to almost **2.2% of GDP**).
- The list and specific form of the measures is to a large extent inspired by the **proposals currently being discussed in the media and by the government**:
    - a proposal to abolish the super-gross wage while maintaining the current personal income tax rate (of 15%) for two years,
    - an increase in the minimum living level and minimum subsistence level,
    - an increase in child allowance,
    - continued support for the self-employed, employers and firms in selected sectors in 2021 H1,
    - a further cut in VAT on selected services next year.
- In addition, the scenario assumes a much faster start to the implementation of government investment projects funded from the **Recovery and Resilience Facility** (Next Generation EU).
- The most of the additional expansionary **measures considered are assumed to be temporary**, delaying the restrictive effect of fiscal policy until 2022 and 2023.
- **The assumptions regarding pandemic and foreign developments** in the fiscal scenario **are the same as in the baseline scenario of the forecast**.

Fiscal Scenario



- The expansionary budgetary measures considered will mainly affect consumption next year and, to a lesser extent, investment activity, which will be reflected in faster **economic growth**.
- The additional fiscal measures increase the **domestic inflation pressures** relative to the baseline scenario.
- The return of inflation close to the target at the monetary policy horizon will therefore require higher **market interest rates** from the start of next year.
- The earlier and larger increase in market interest rates will foster stronger appreciation of the **koruna** than in the baseline scenario.

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Thank You for Your Attention

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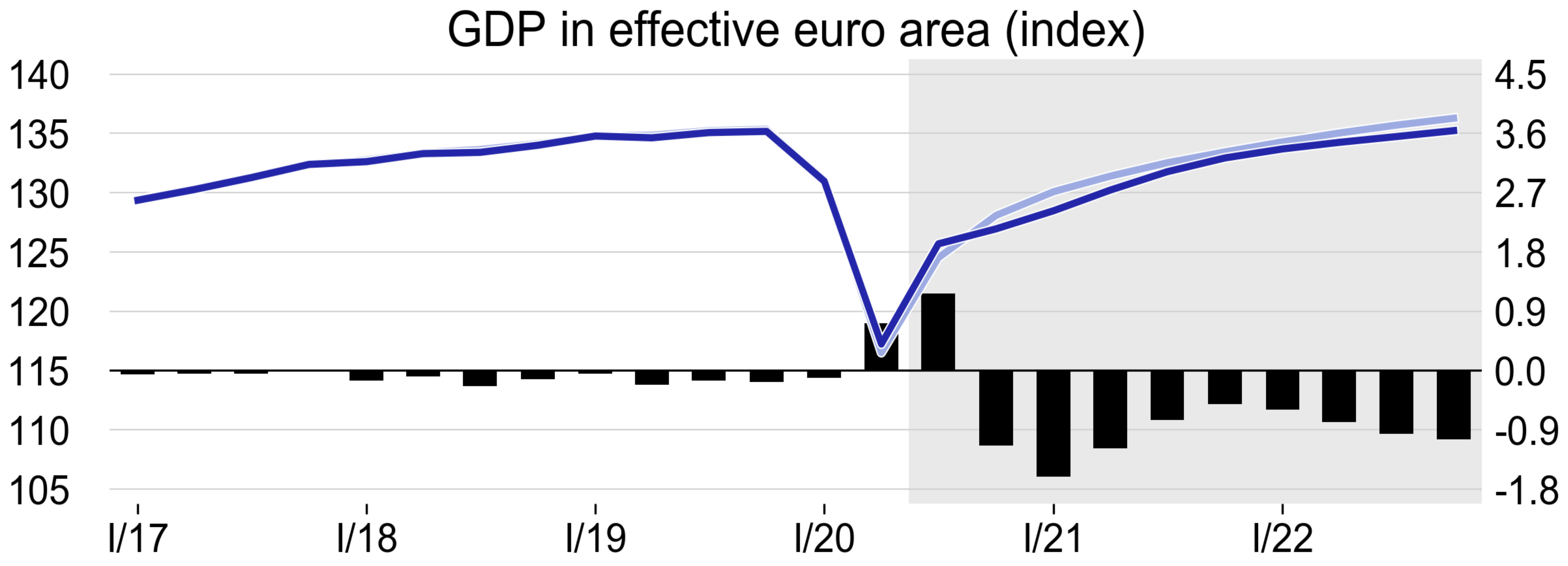
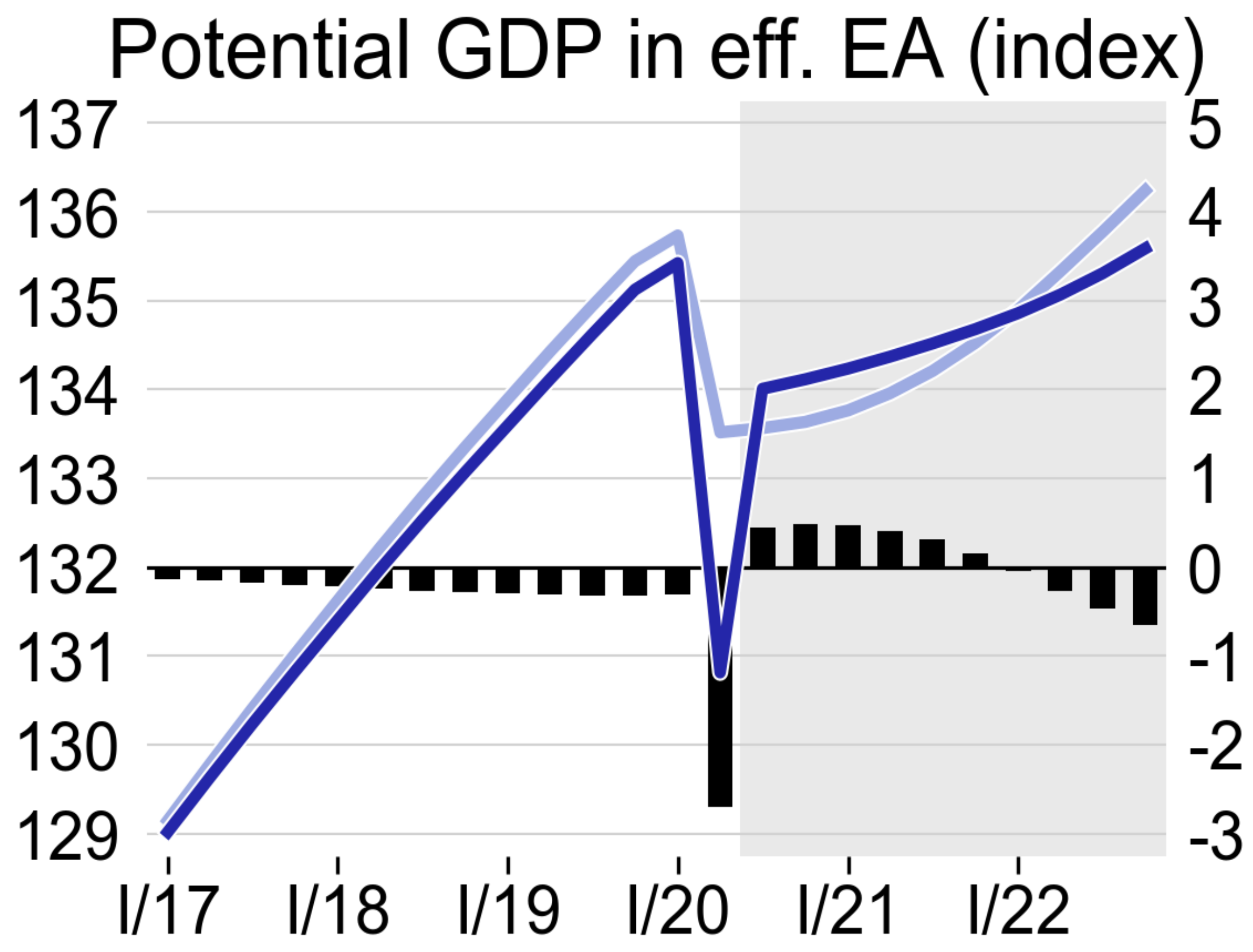
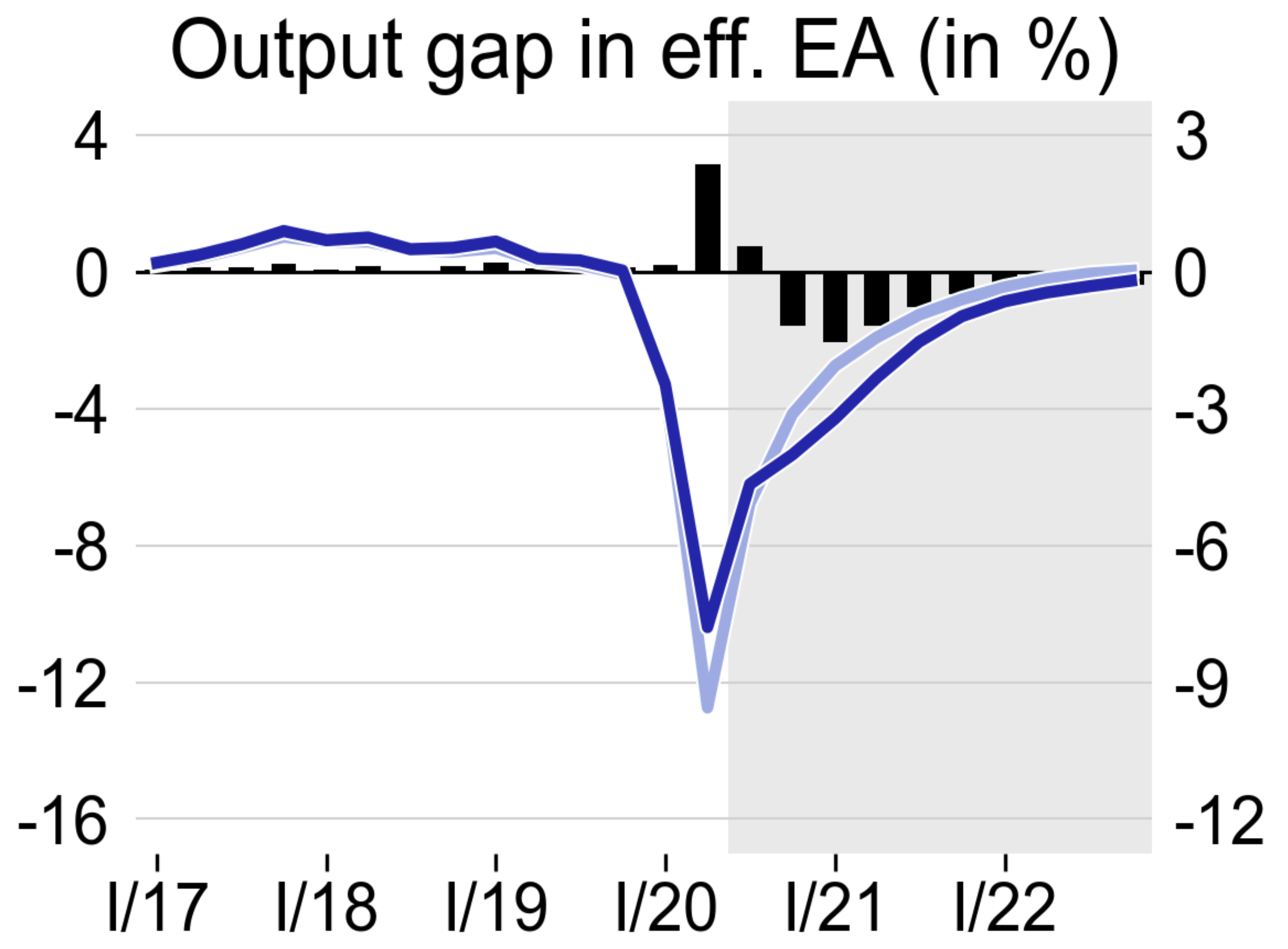
Backup

GDP in Effective Euro Area: Comparison

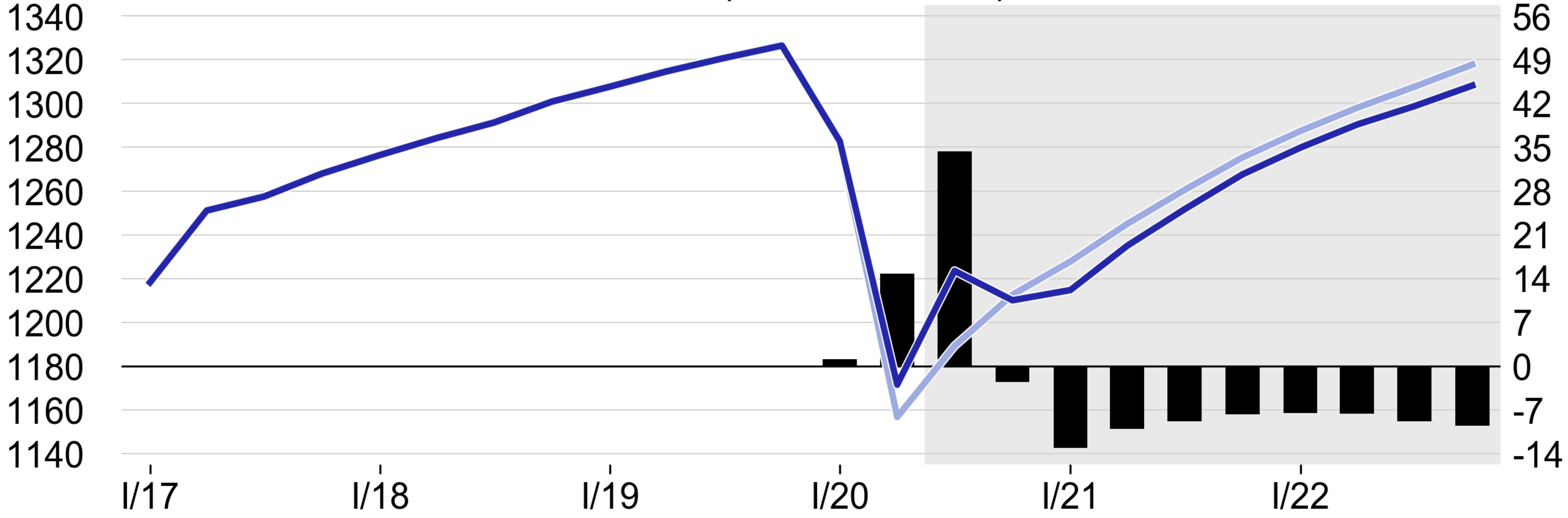




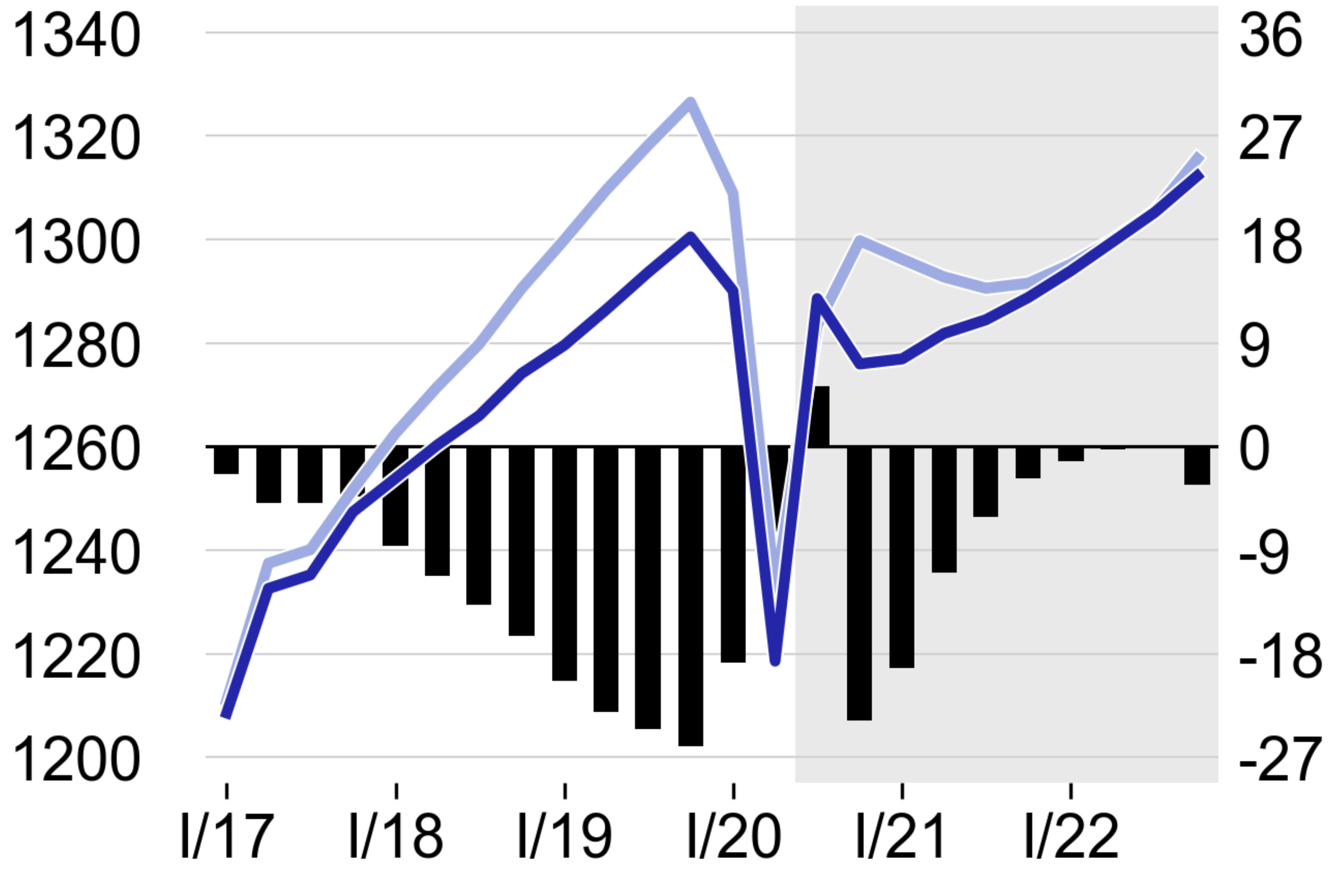


Domestic GDP: Comparison

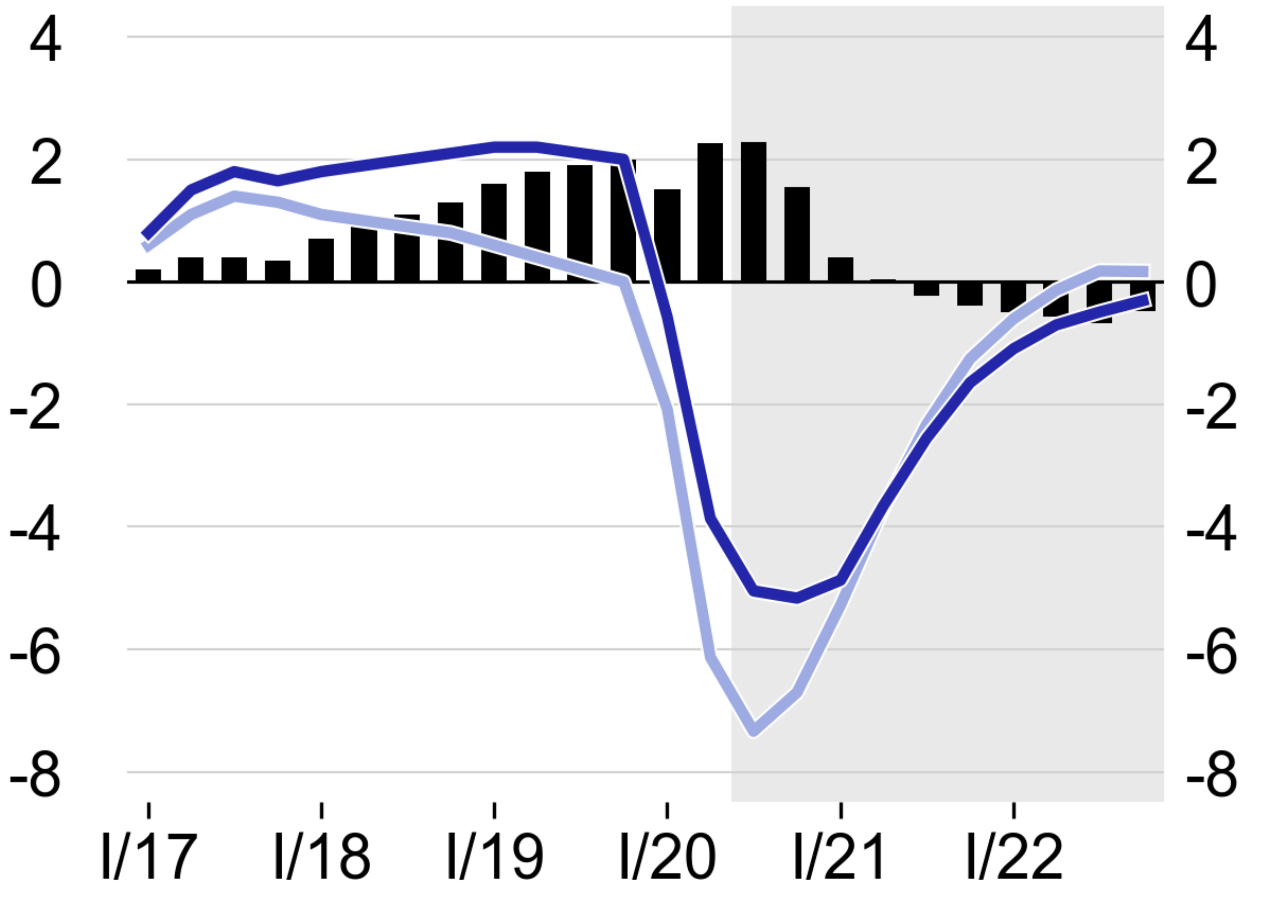
GDP (in bns of CZK)



Potential GDP (in bns of CZK)

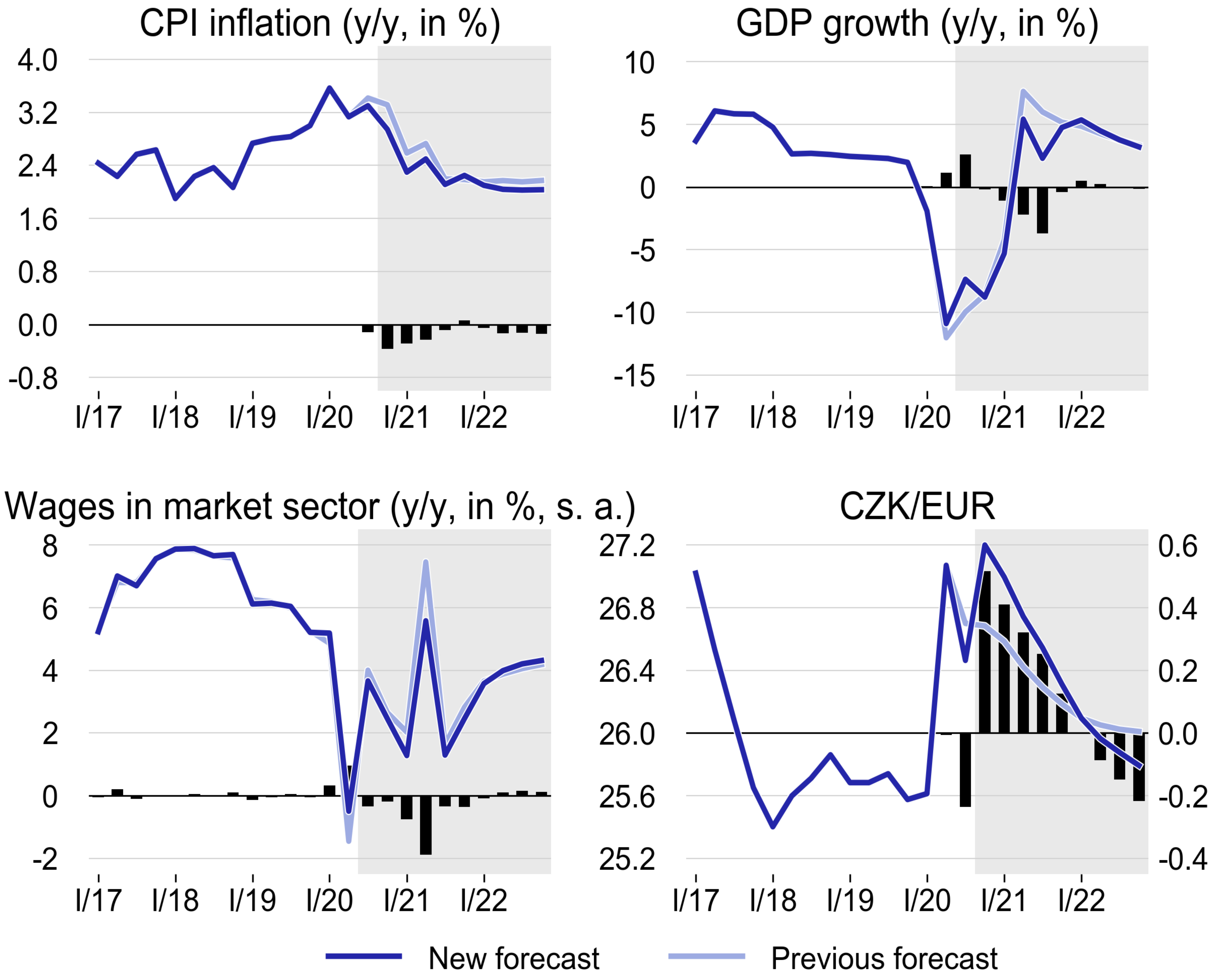


Output gap (in %)

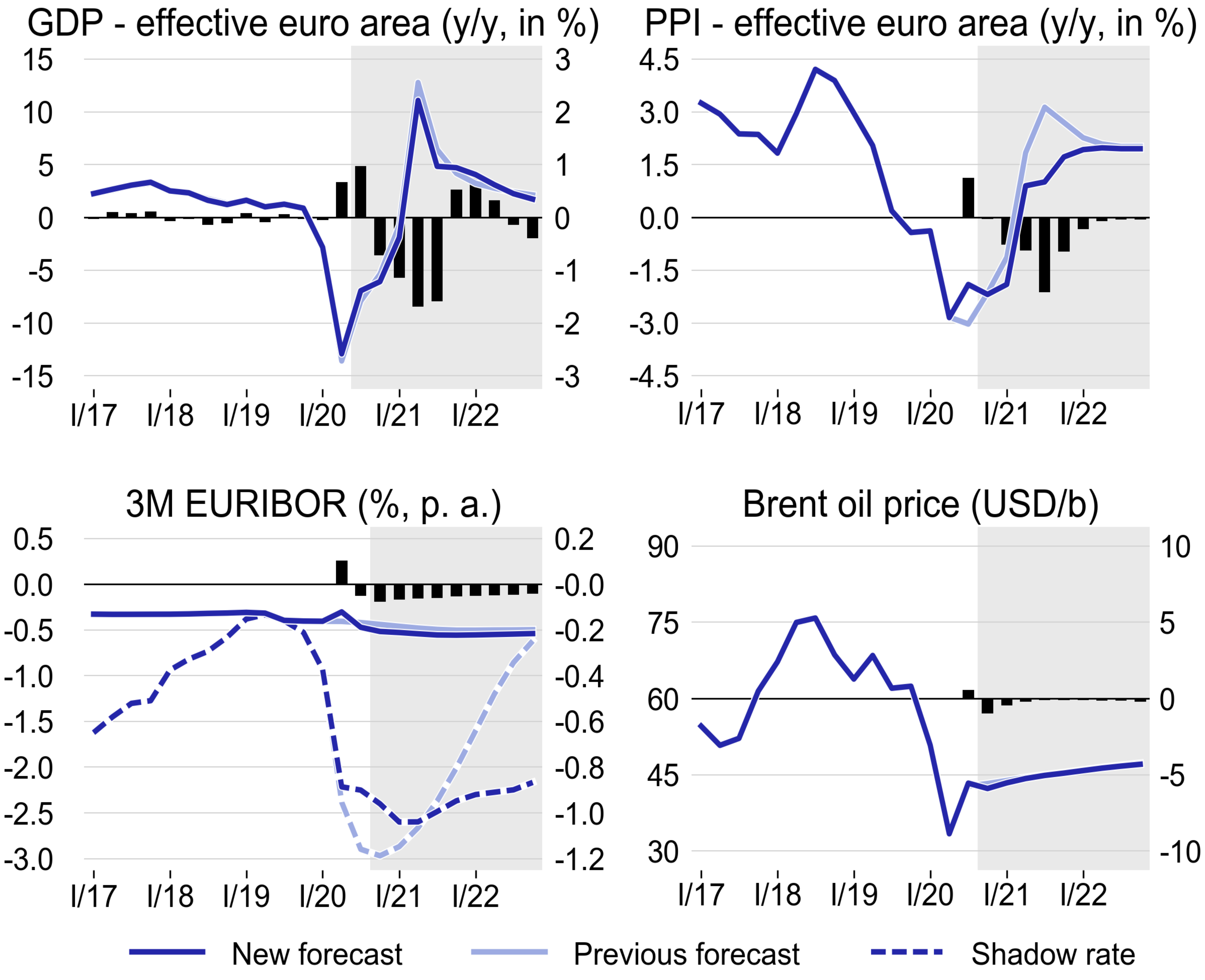


New forecast   Previous forecast

Comparison with Previous Forecast



Foreign Outlook: Comparison



PPI in Effective Euro Area: Decomposition

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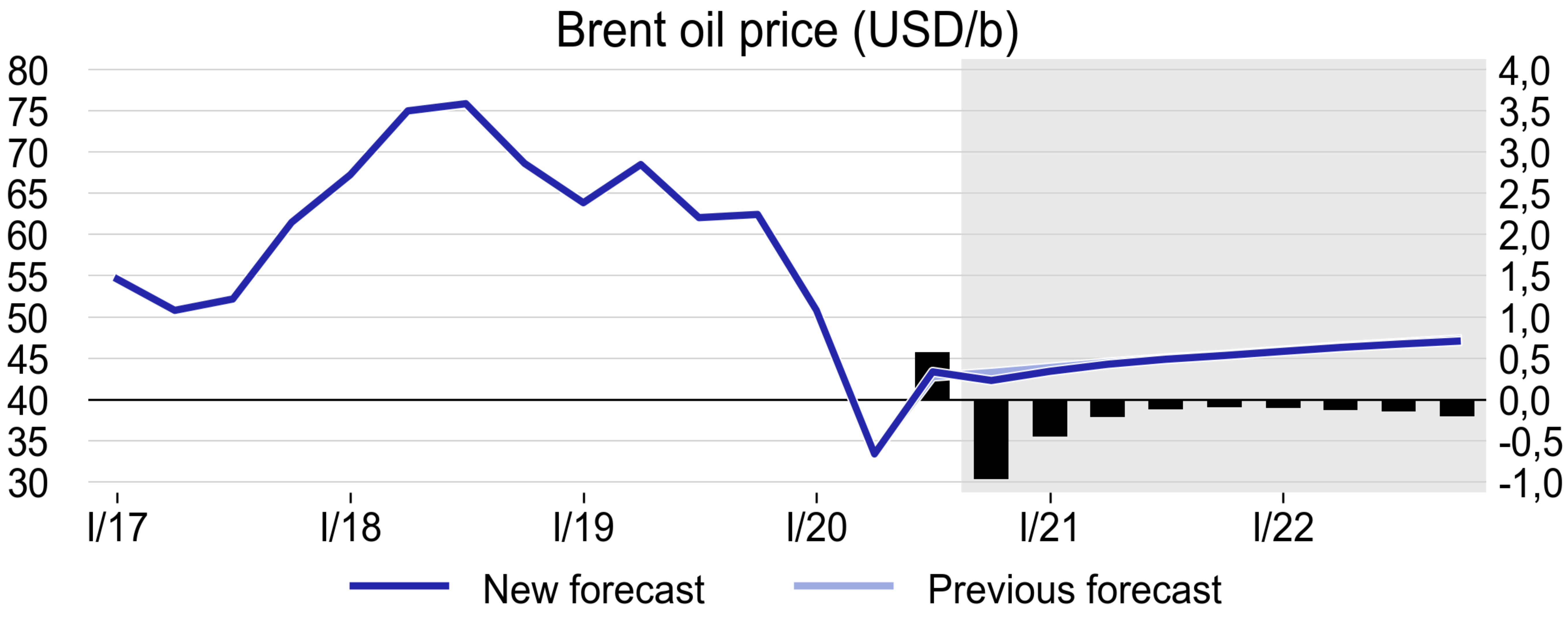

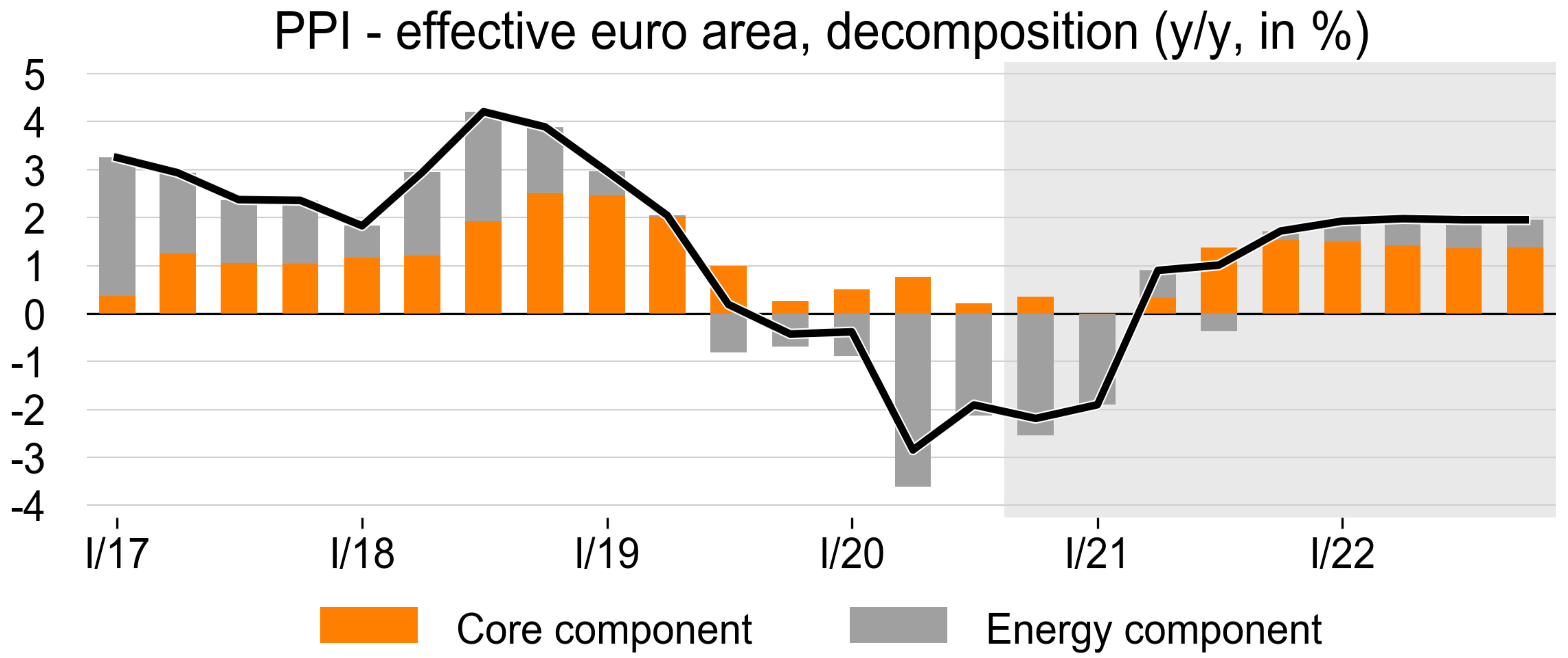

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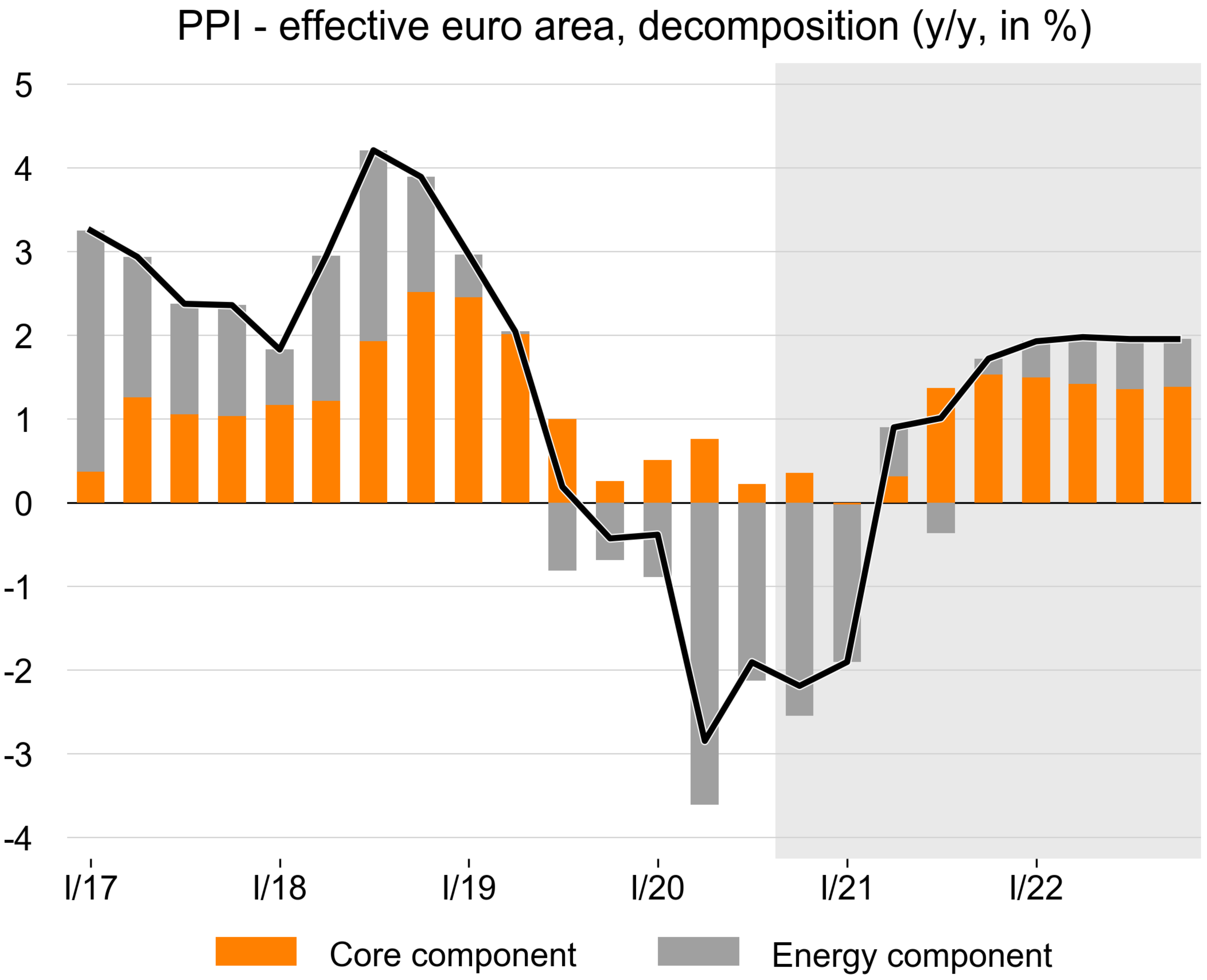
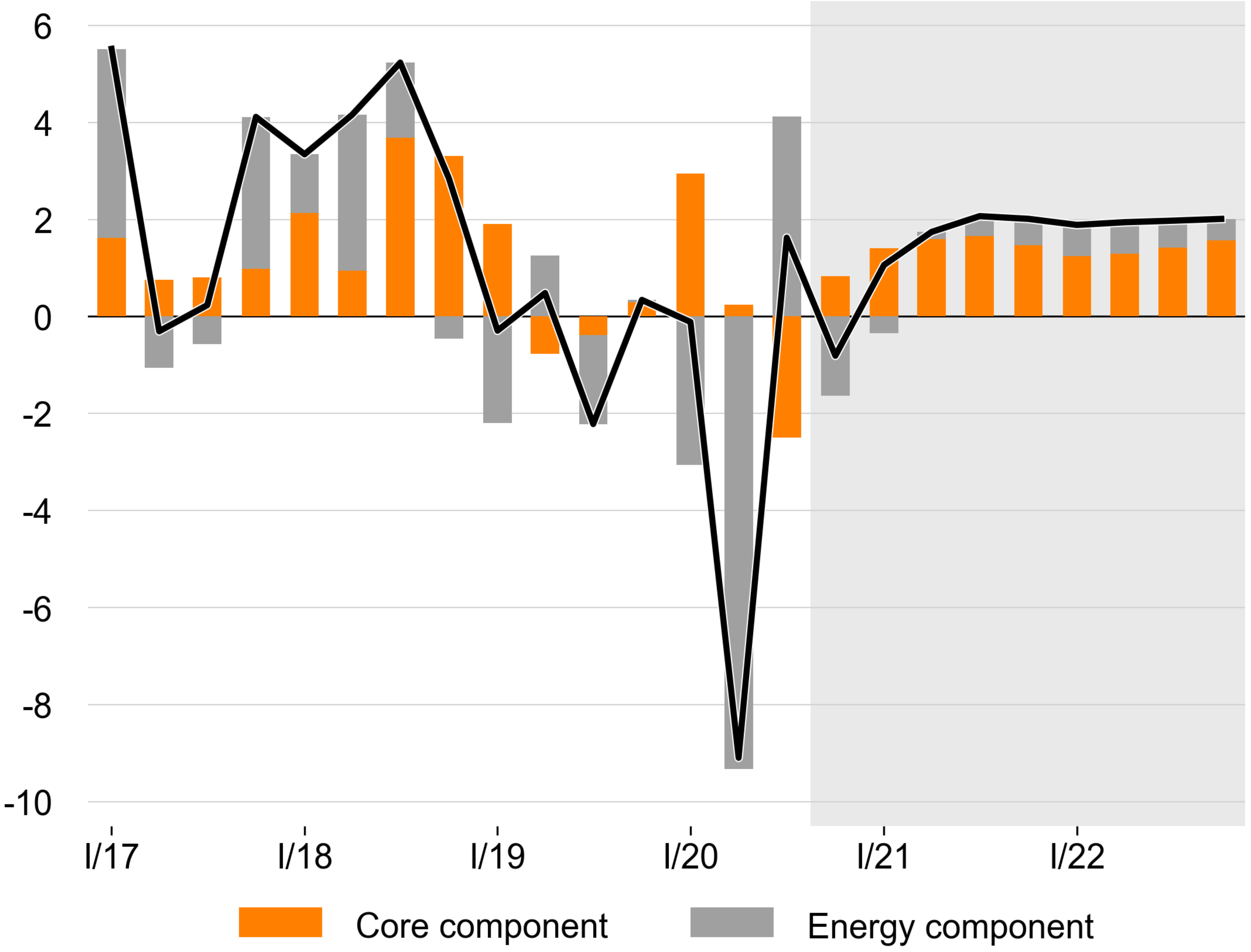
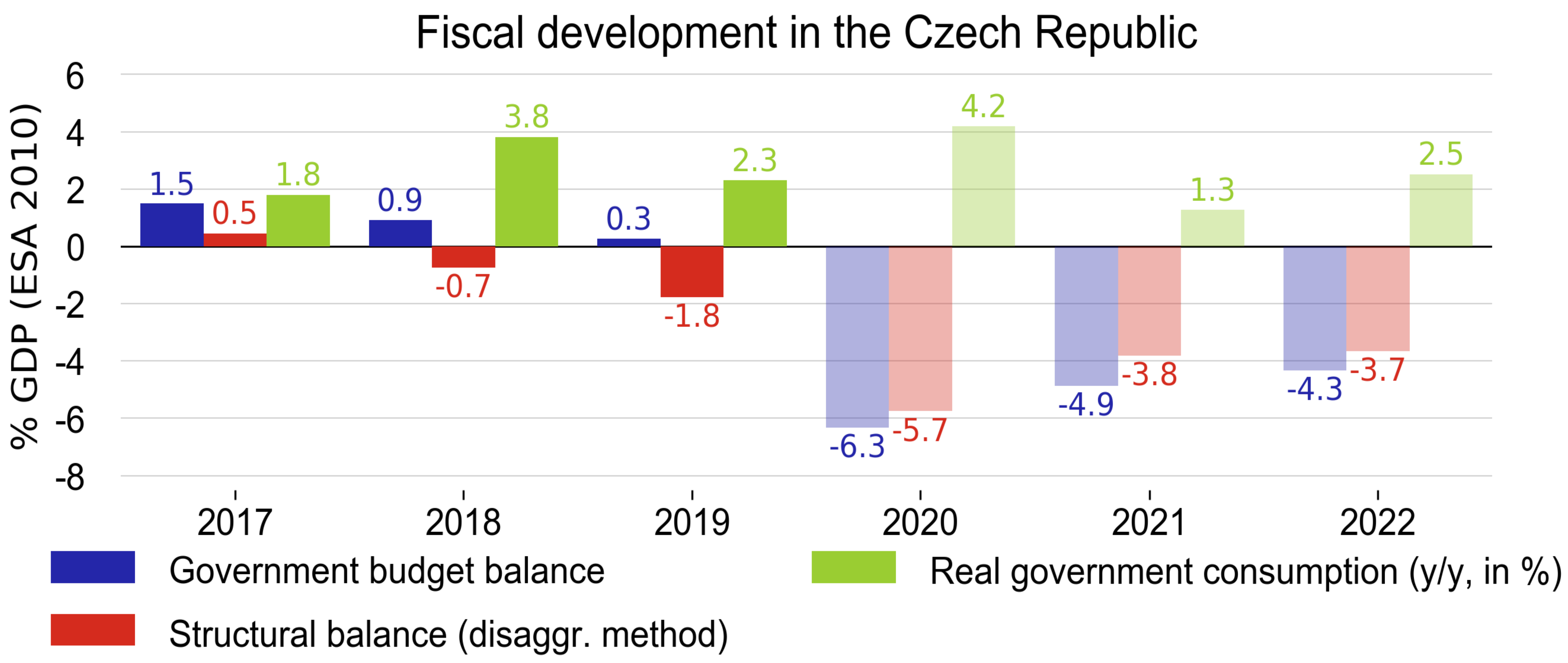


PPI in Effective Euro Area: Decomposition

PPI - effective euro area, decomposition (q/q, in %, ann.)



Fiscal Policy

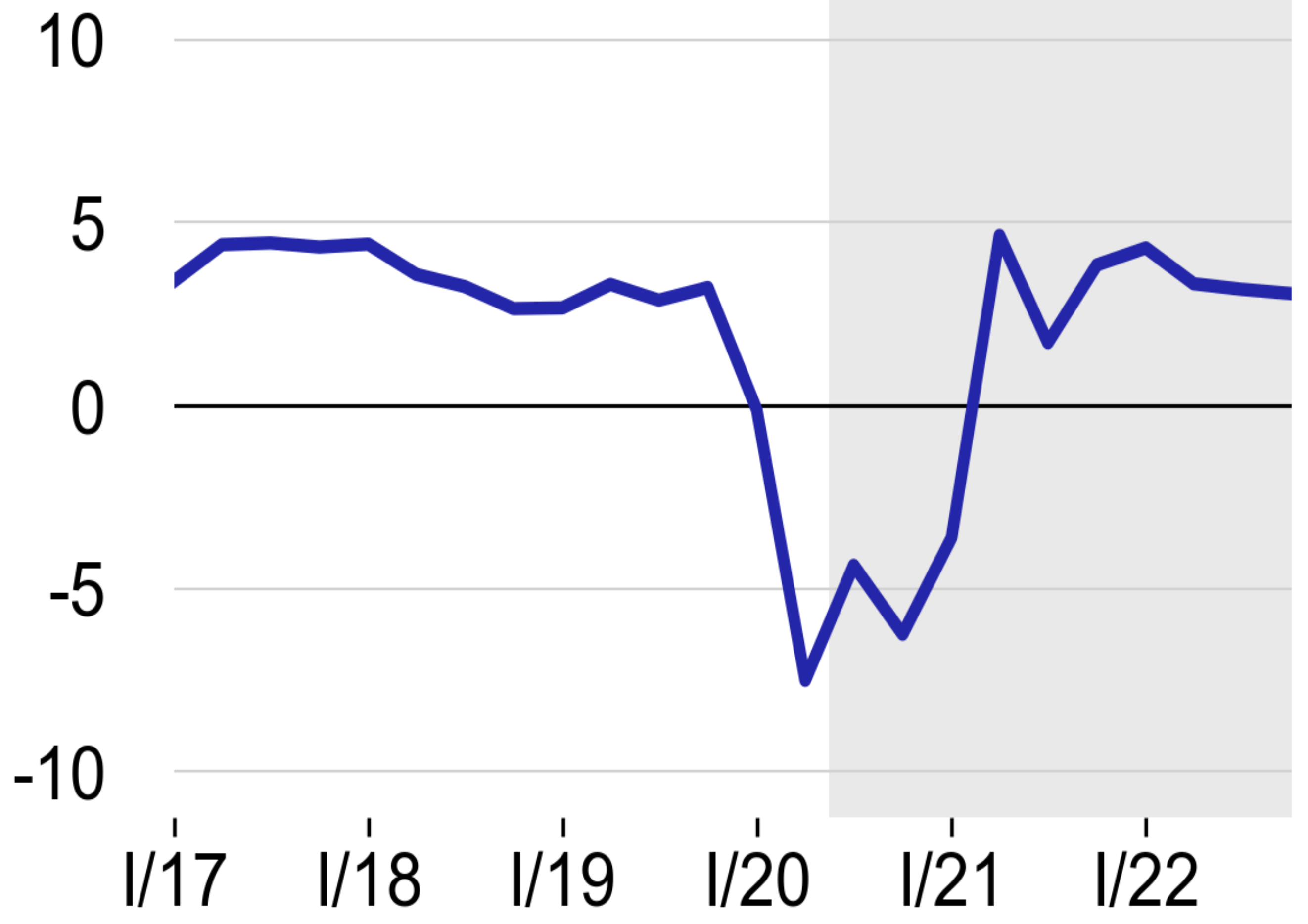


Fiscal impulse (contributions to GDP growth in percentage points)

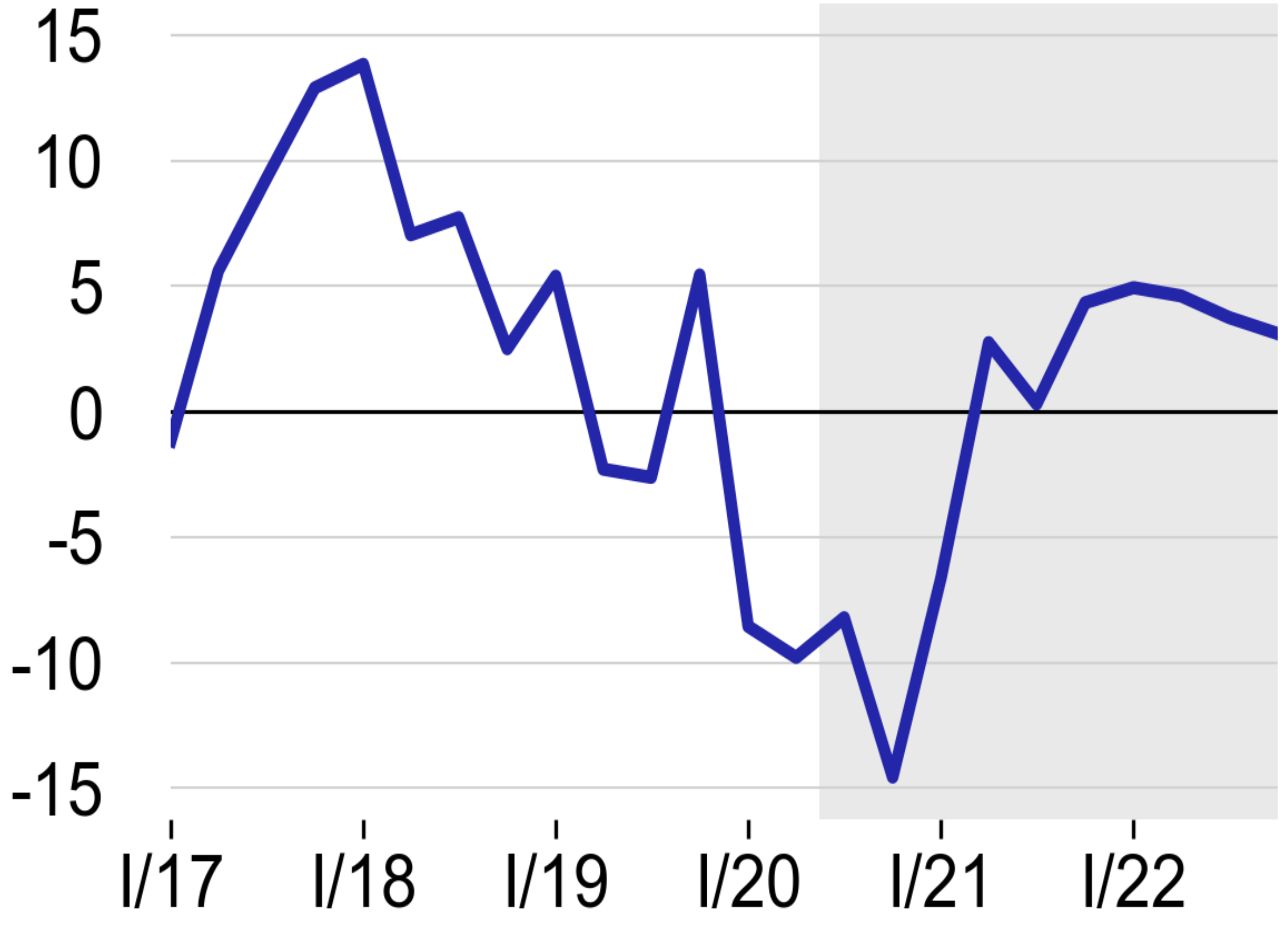
	2019	2020	2021	2022
	actual	forecast	forecast	forecast
Fiscal impulse	0.5	2.0	-1.3	-0.3
of which impact through:				
Private consumption	0.4	1.8	-1.3	-0.3
Private investment	0.0	0.2	-0.1	-0.1
Government investment, domestic	0.1	-0.1	0.0	0.0
Government investment, EU funded	0.0	0.1	0.1	0.1

Aggregate Demand

Household consumption (y/y, in %)

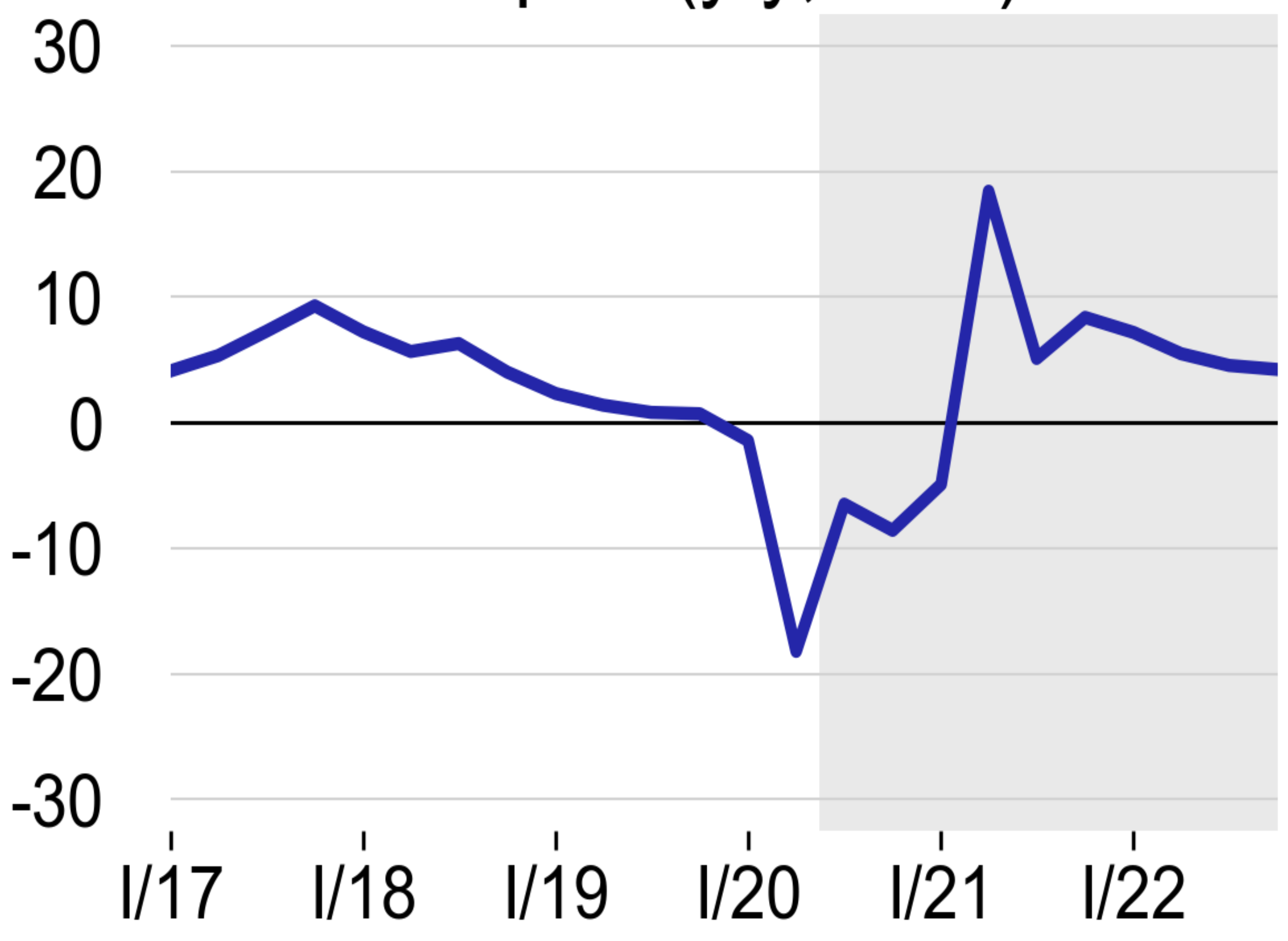


Investment (y/y, in %)

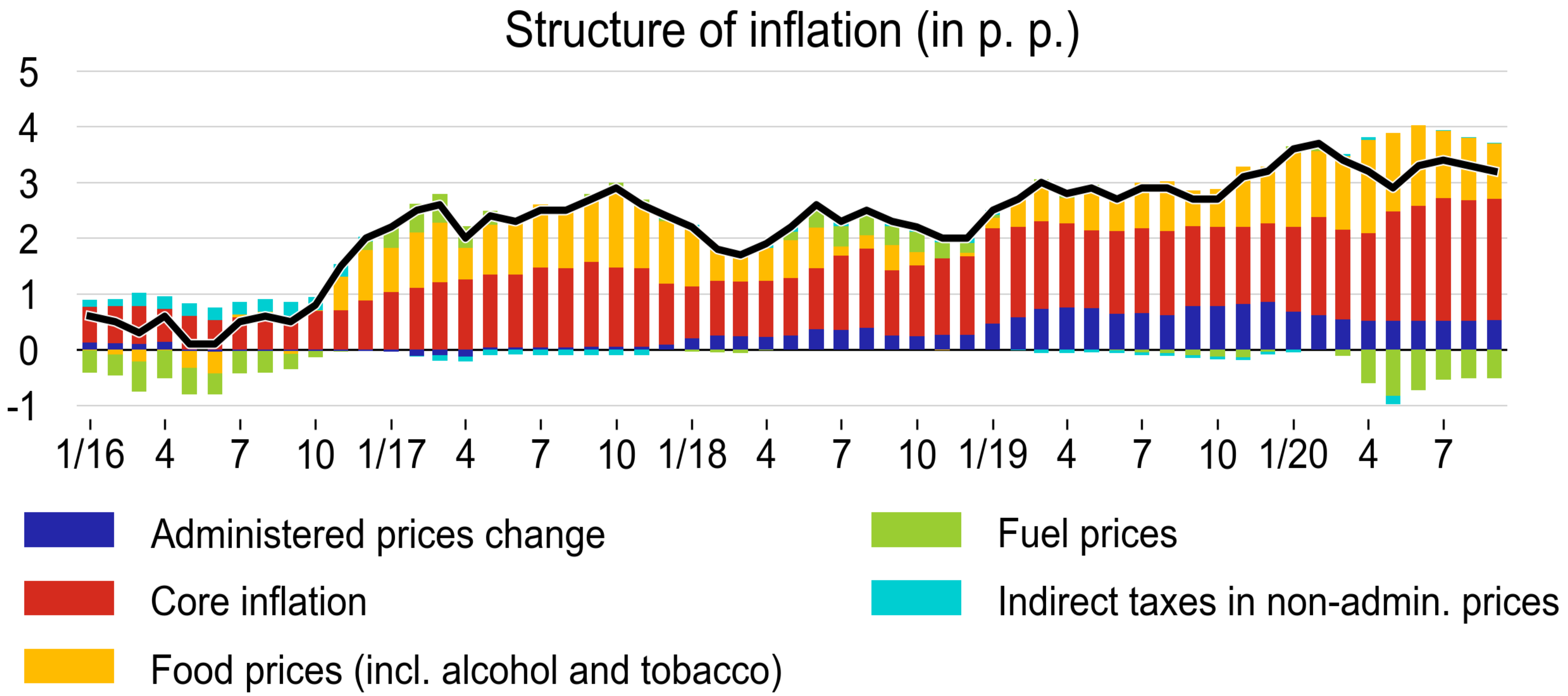


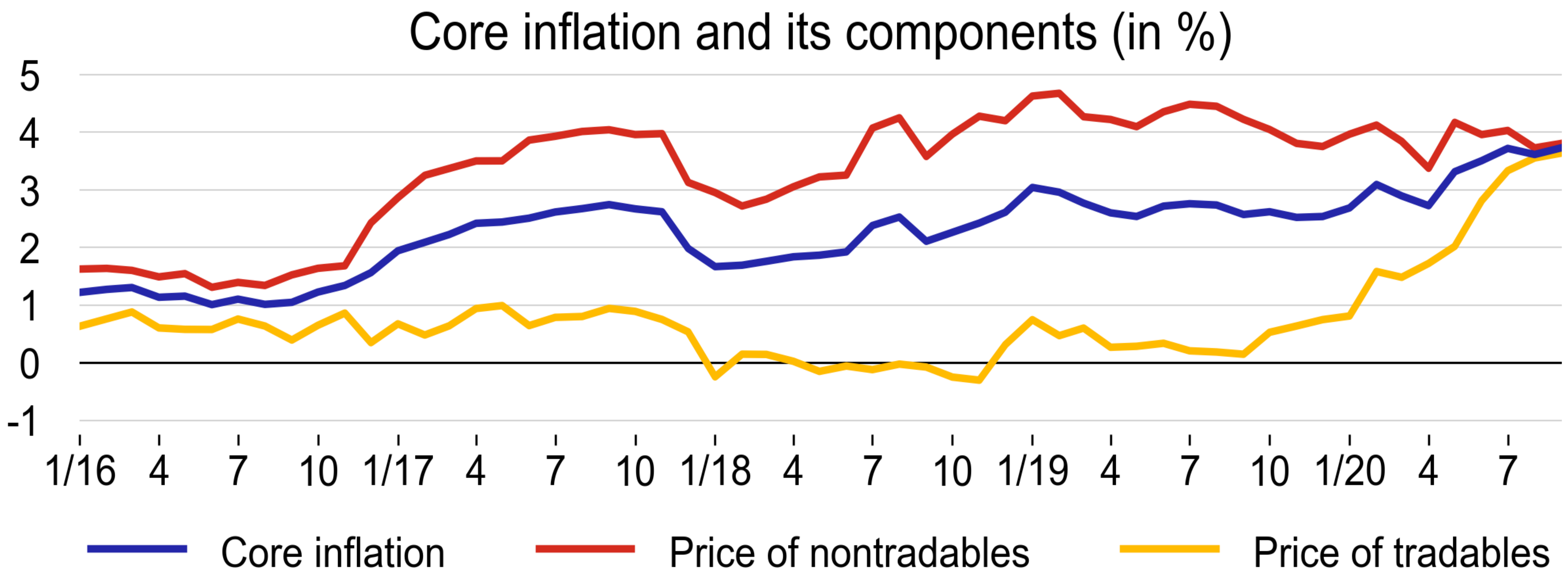
Export (y/y, in %)

Import (y/y, in %)

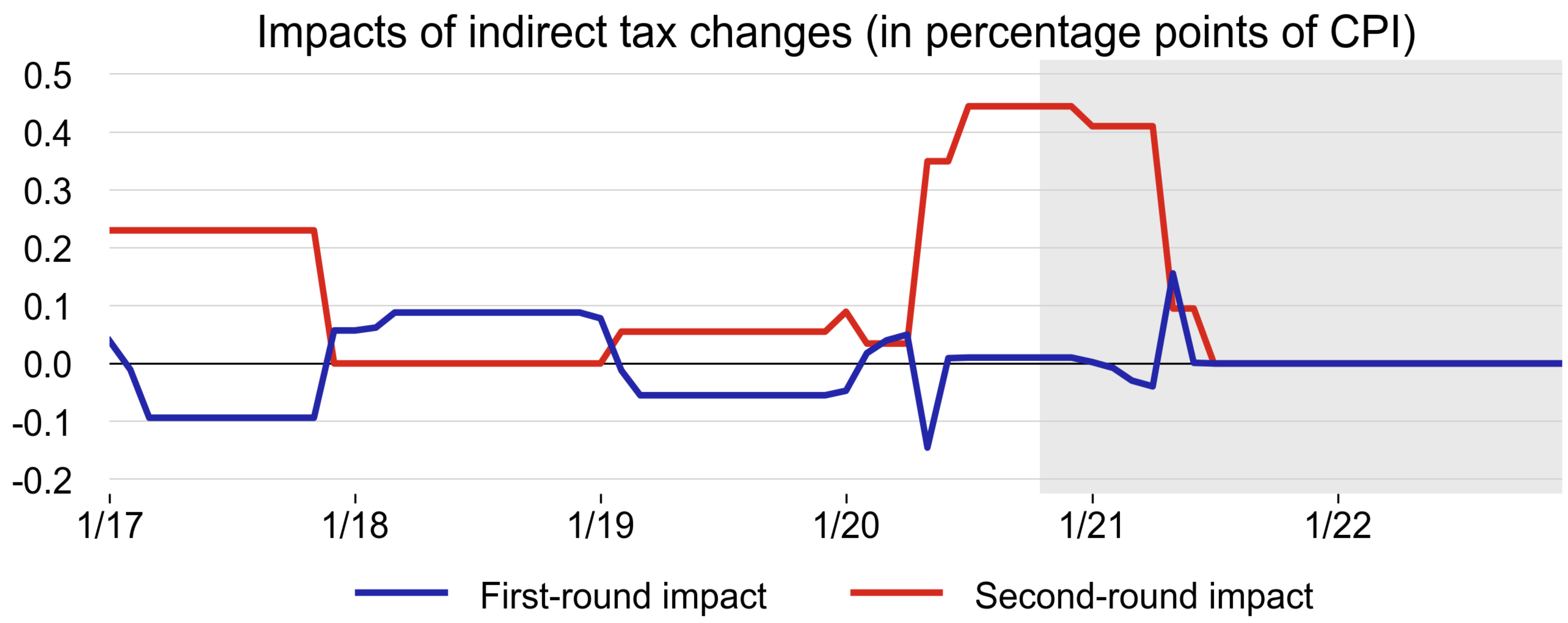


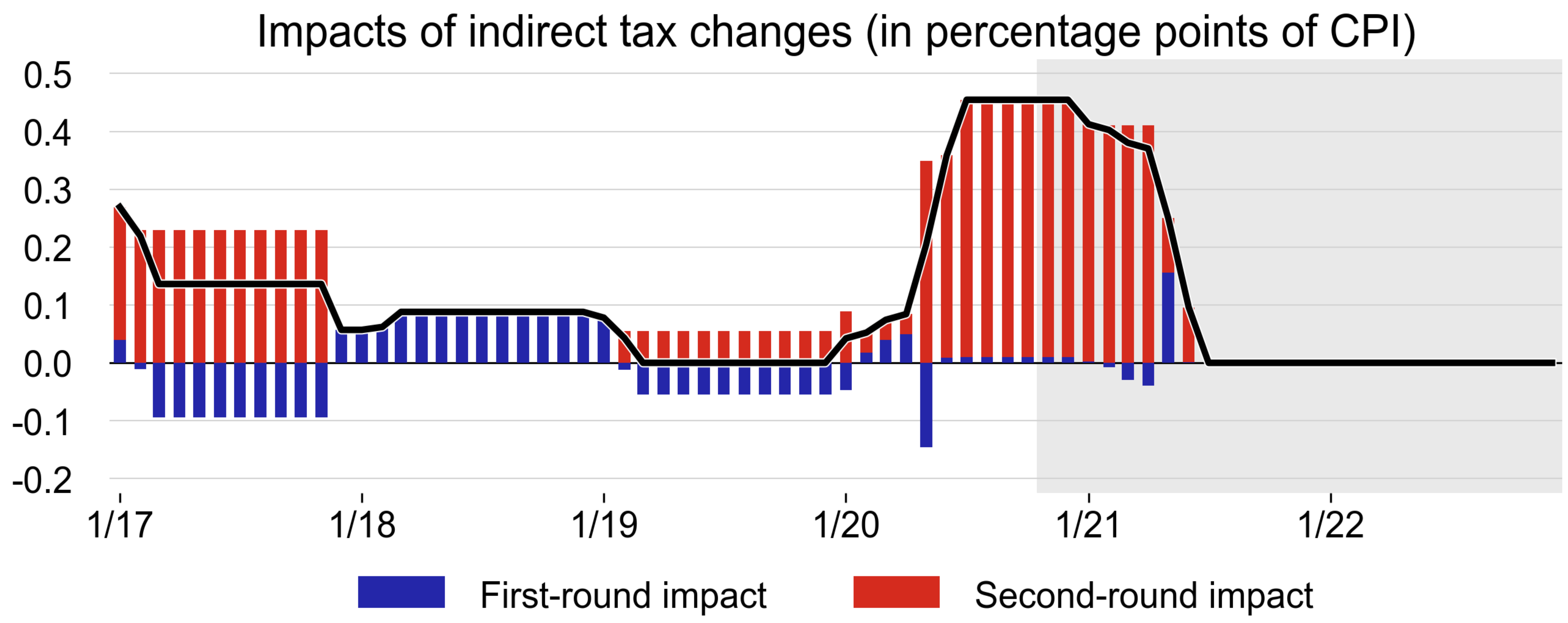
Structure of Inflation



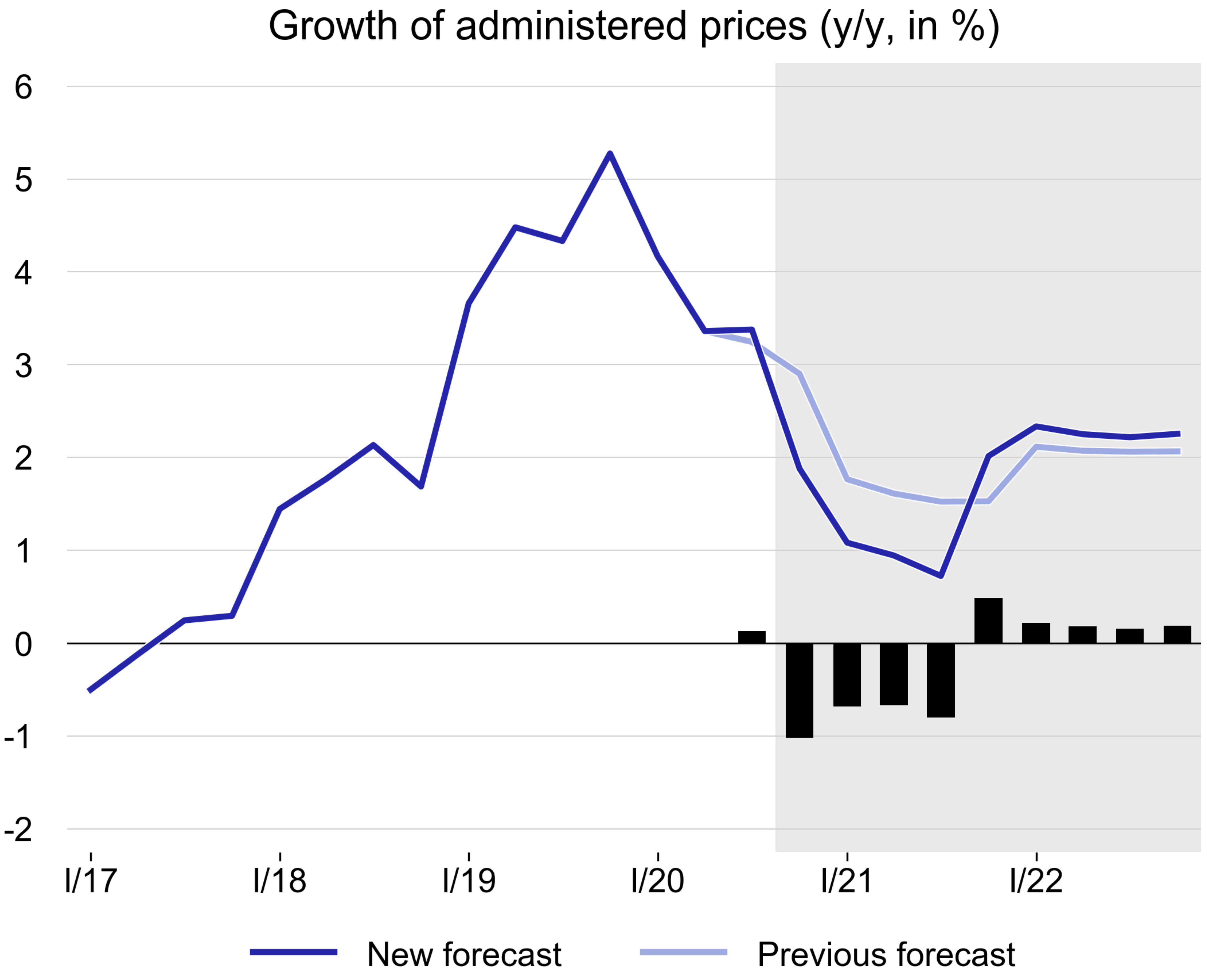


Indirect Tax Changes: Comparison

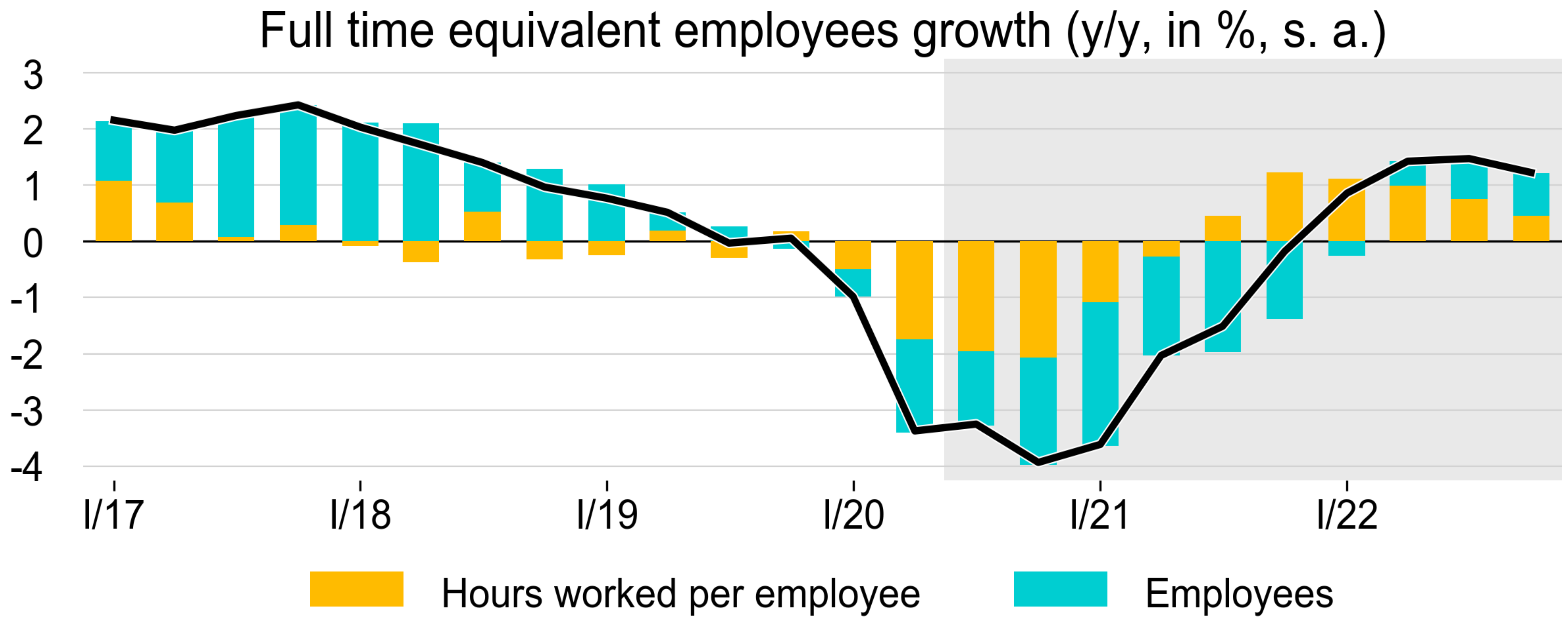


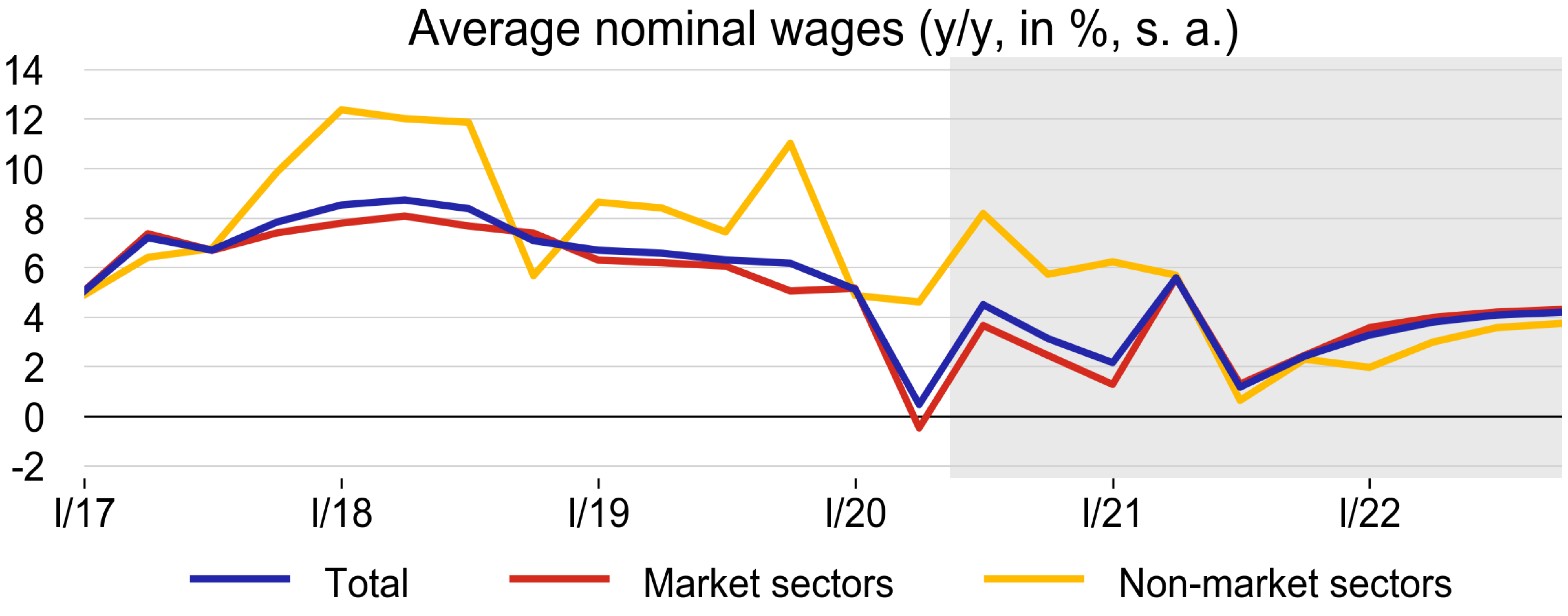


Administered Prices: Comparison

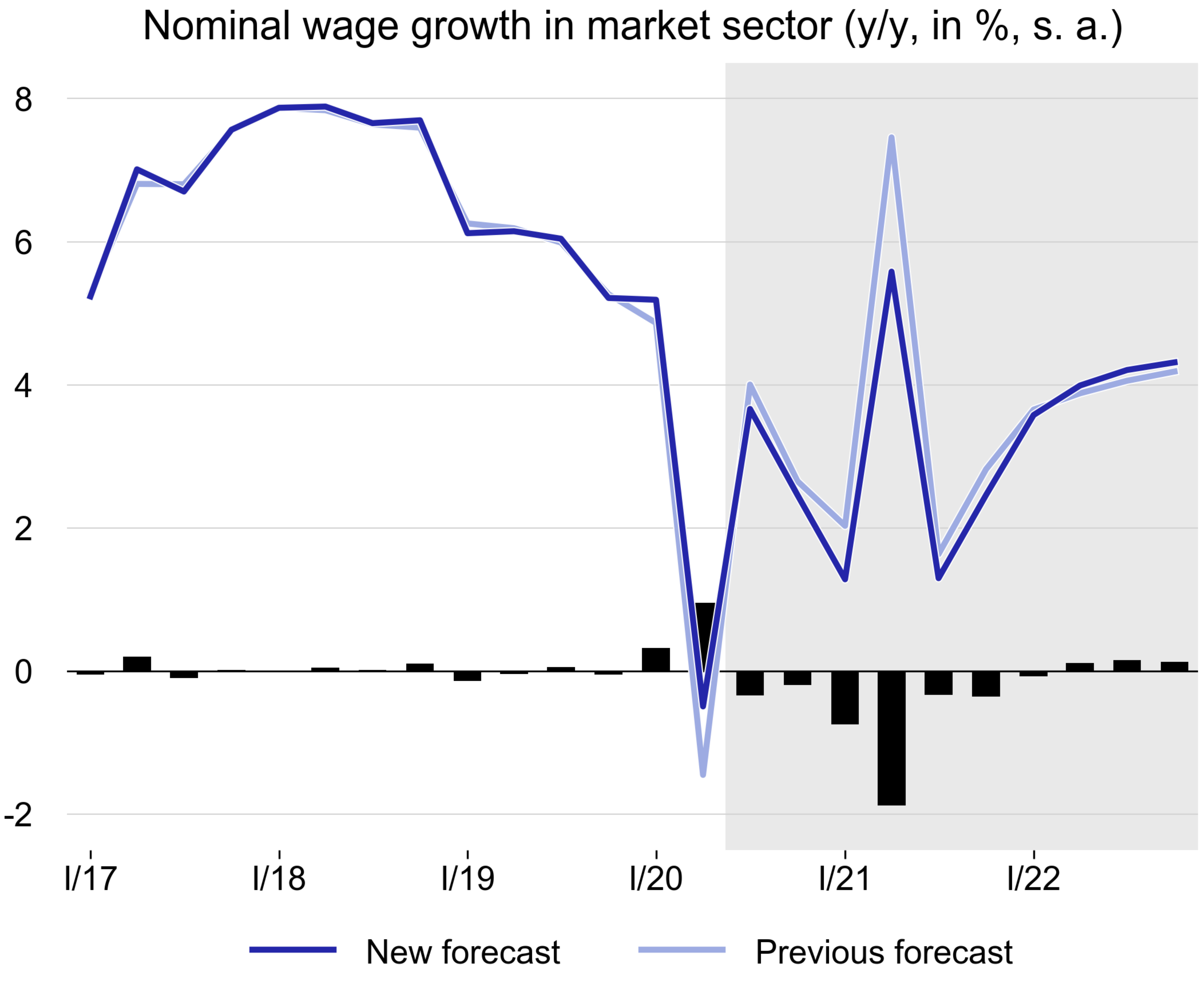


Labour Market

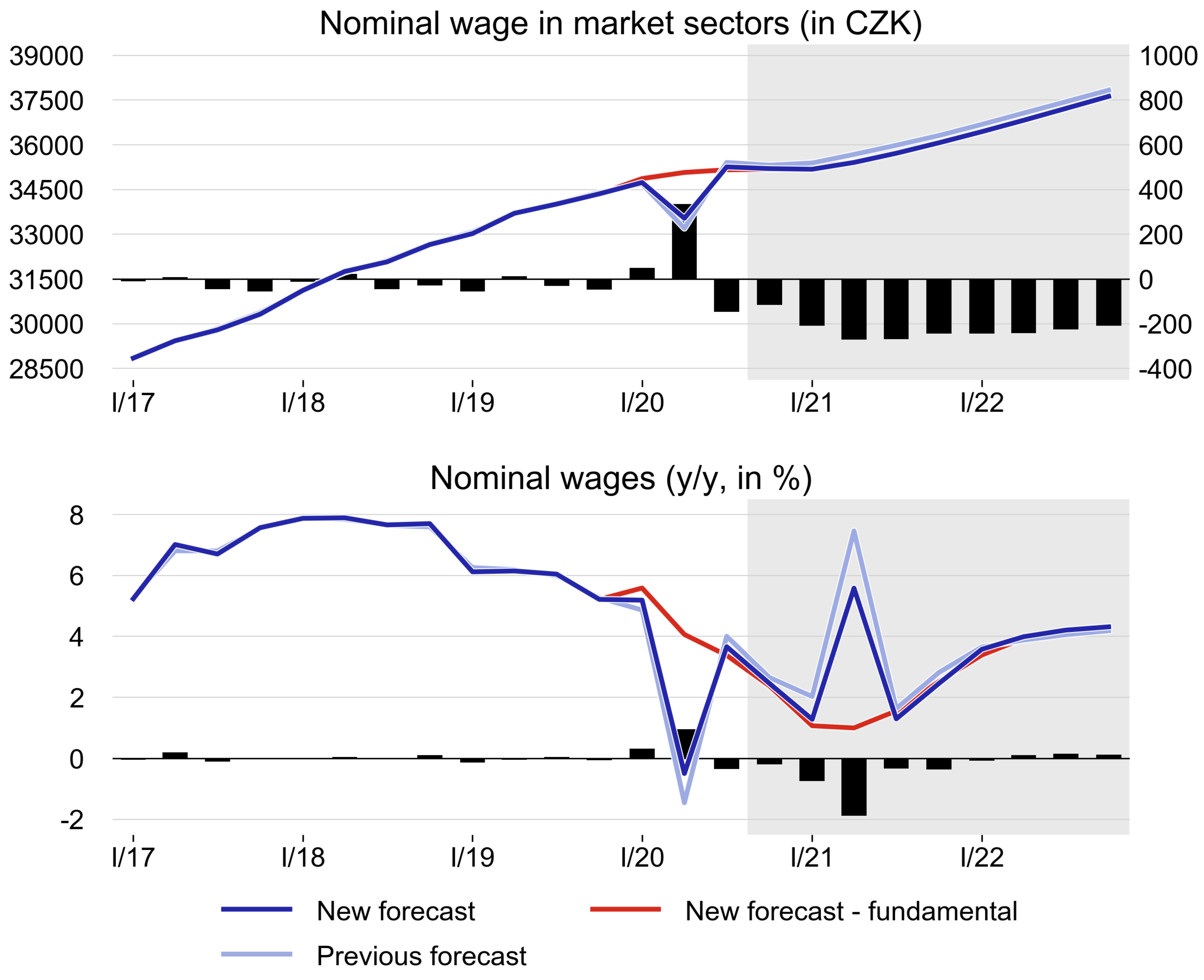




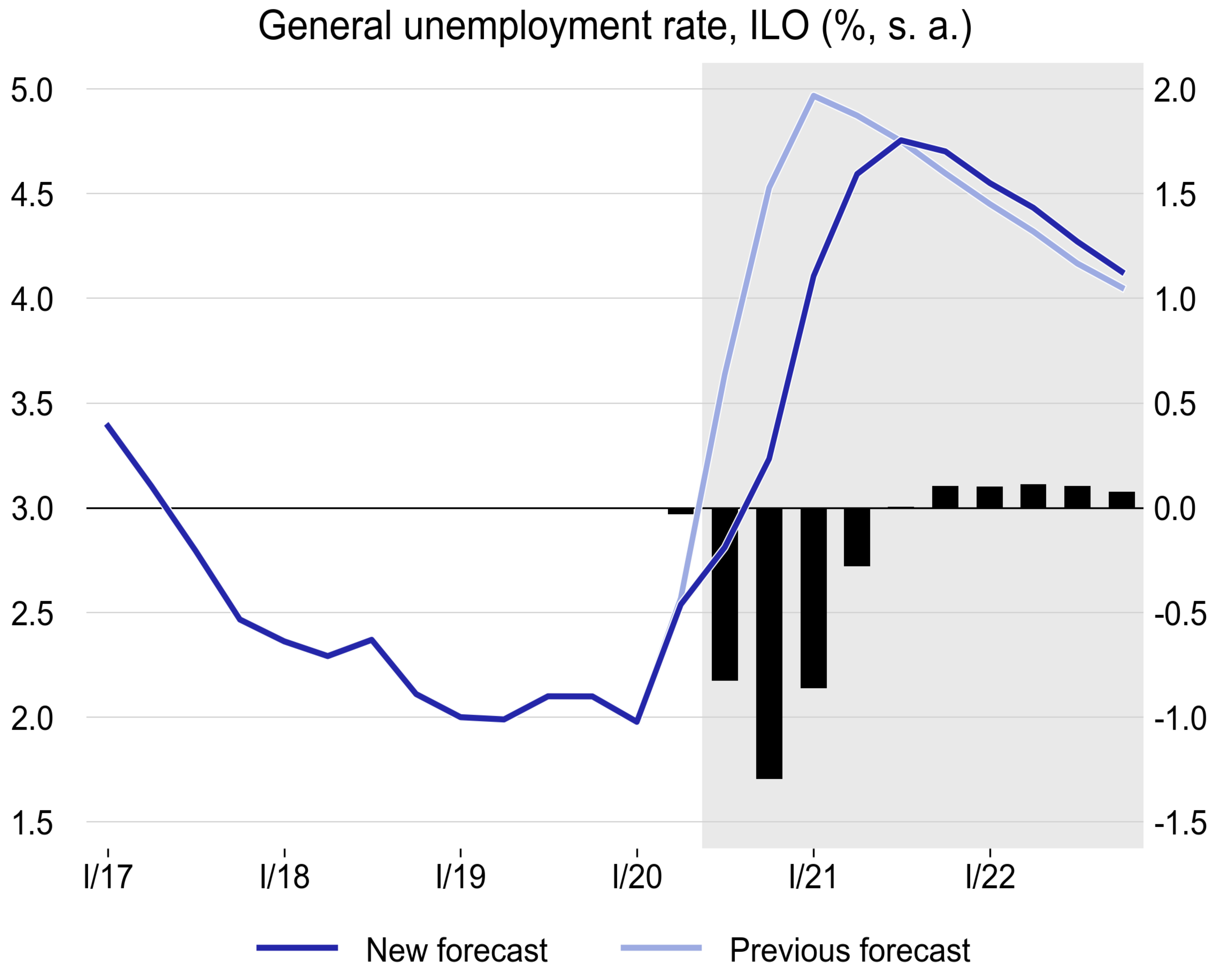
Wages in Market Sector: Comparison



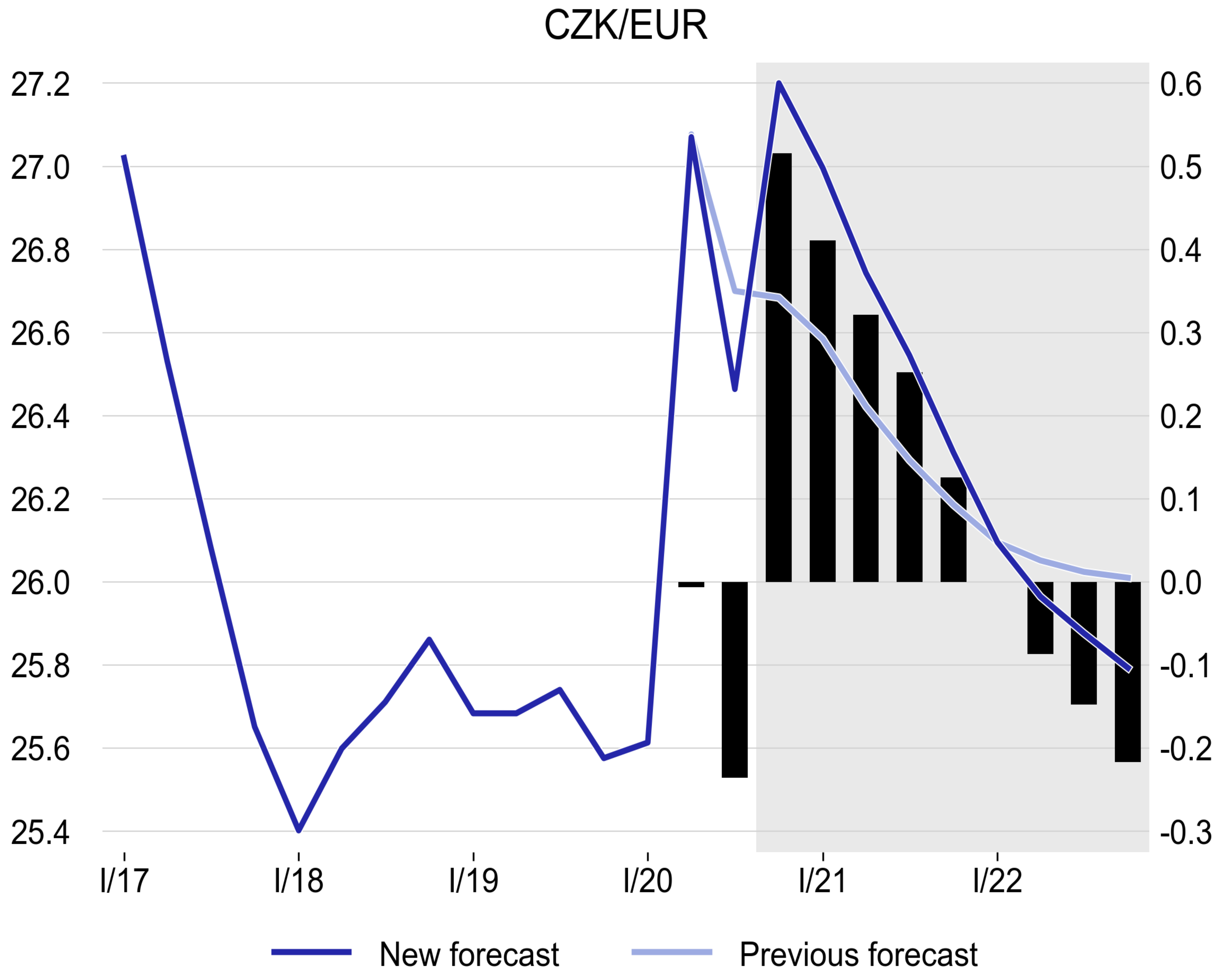
Nominal Wages: Comparison



Unemployment Rate: Comparison



Exchange Rate: Comparison



Interest Rate: Comparison