Inflation, house prices and the CNB's forecast

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CNB Board Member

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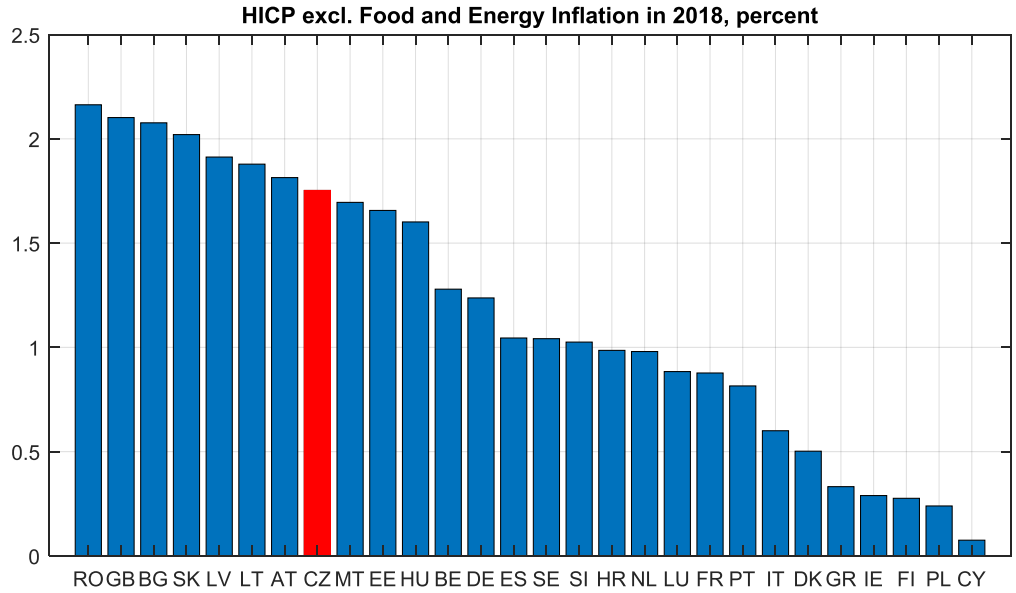
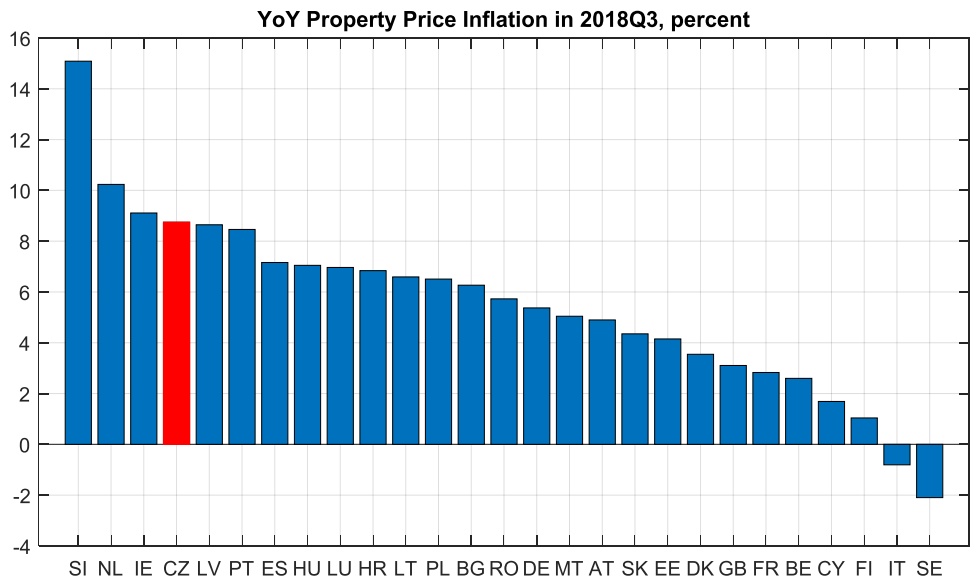
Outline

1. House prices and CPI – the Czech Republic
2. Macroeconomic outlook
3. “Hard” Brexit and its effects on the Czech economy

HOUSE PRICES AND INFLATION IN THE CZECH REPUBLIC

Inflation and House Prices – EU Countries

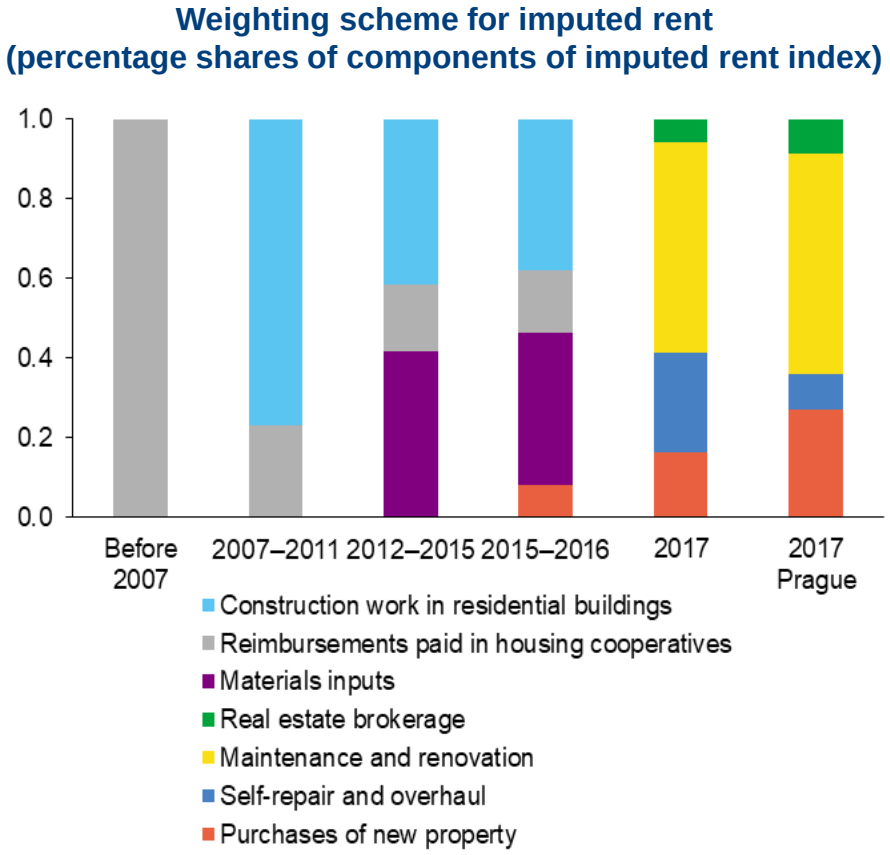




- Czech core inflation (ex food and energy) measured using HICP is in upper third of EU countries.
- Czech Republic is also among four countries with fastest house price growth.
- Since April 2017 (exit from FX commitment) seven policy rate hikes have taken place (2W repo 1.75% at present)
- Macroprudential measures: LTV, DTI and DSTI limits, counter-cyclical capital buffer.

Source: ECB Statistical Data Warehouse

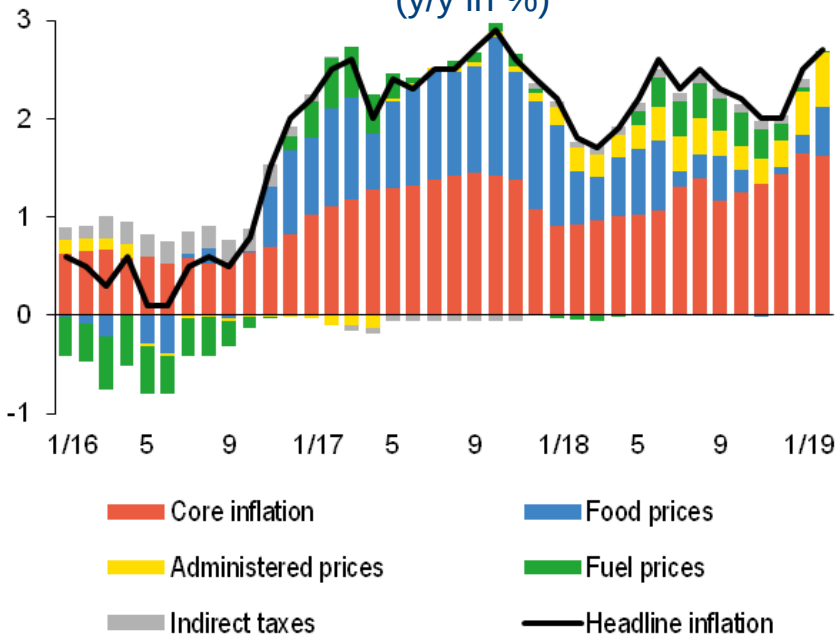
CPI and House Prices



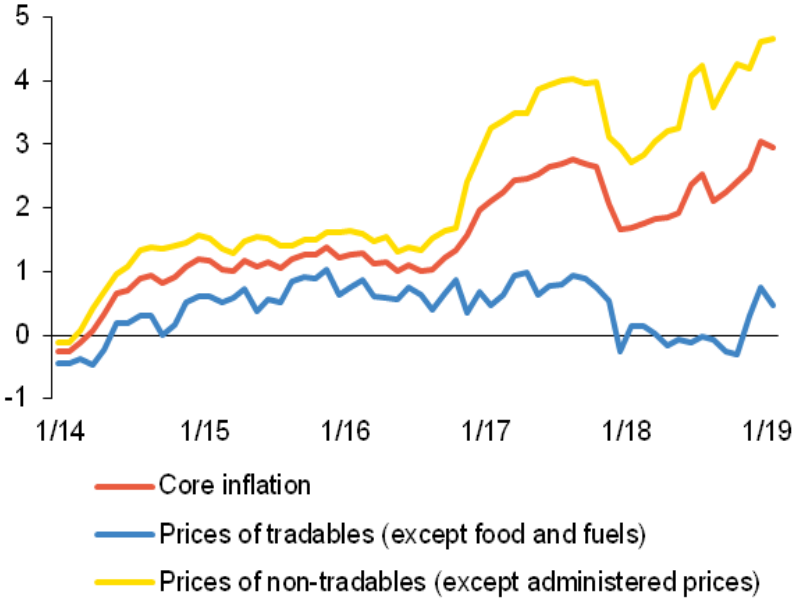
- Housing is part of Czech CPI through imputed rent.
- Weight of imputed rent in headline CPI is about 8.7%.
- Purchases of new property incorporated in 2015 using net acquisition approach (purchases from other sectors)
- Recently new property purchases with 16.3% weight (in Prague even 27%) in imputed rent.

Inflation

Headline inflation,
(y/y in %)



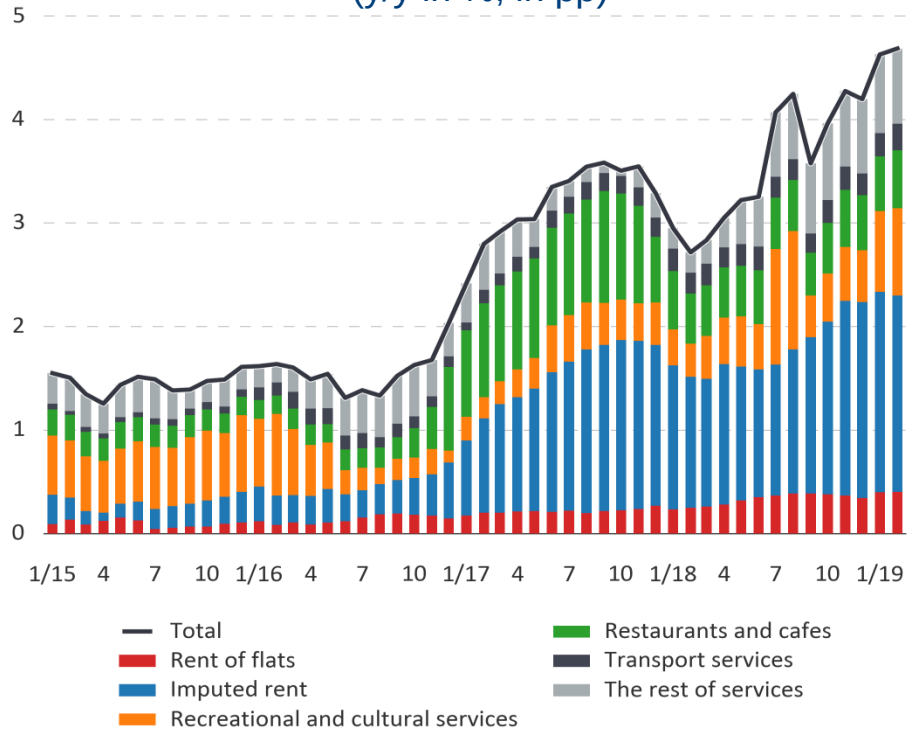
Core inflation and its components
(y/y in %)



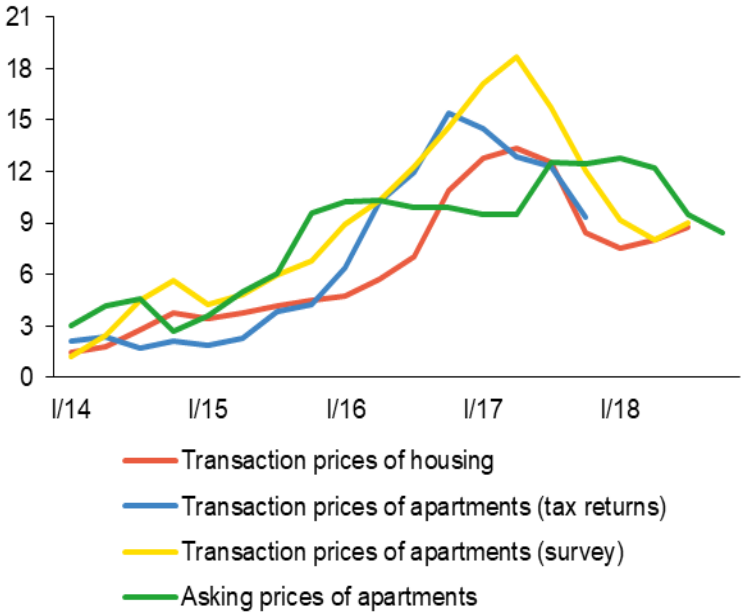
- Headline inflation declined to 2% target at end of last year before jumping to 2.7% in February 2019 (0.3 pp above CNB forecast).
- Headline inflation is being driven by core inflation. Food price inflation has started to revive, while administered prices have speeded up (electricity). Fuel price growth has faded out (due to oil prices).
- Non-tradable price growth dominates in core inflation.

Non-tradables Prices

Contributions to non-tradables price growth, (y/y in %, in pp)



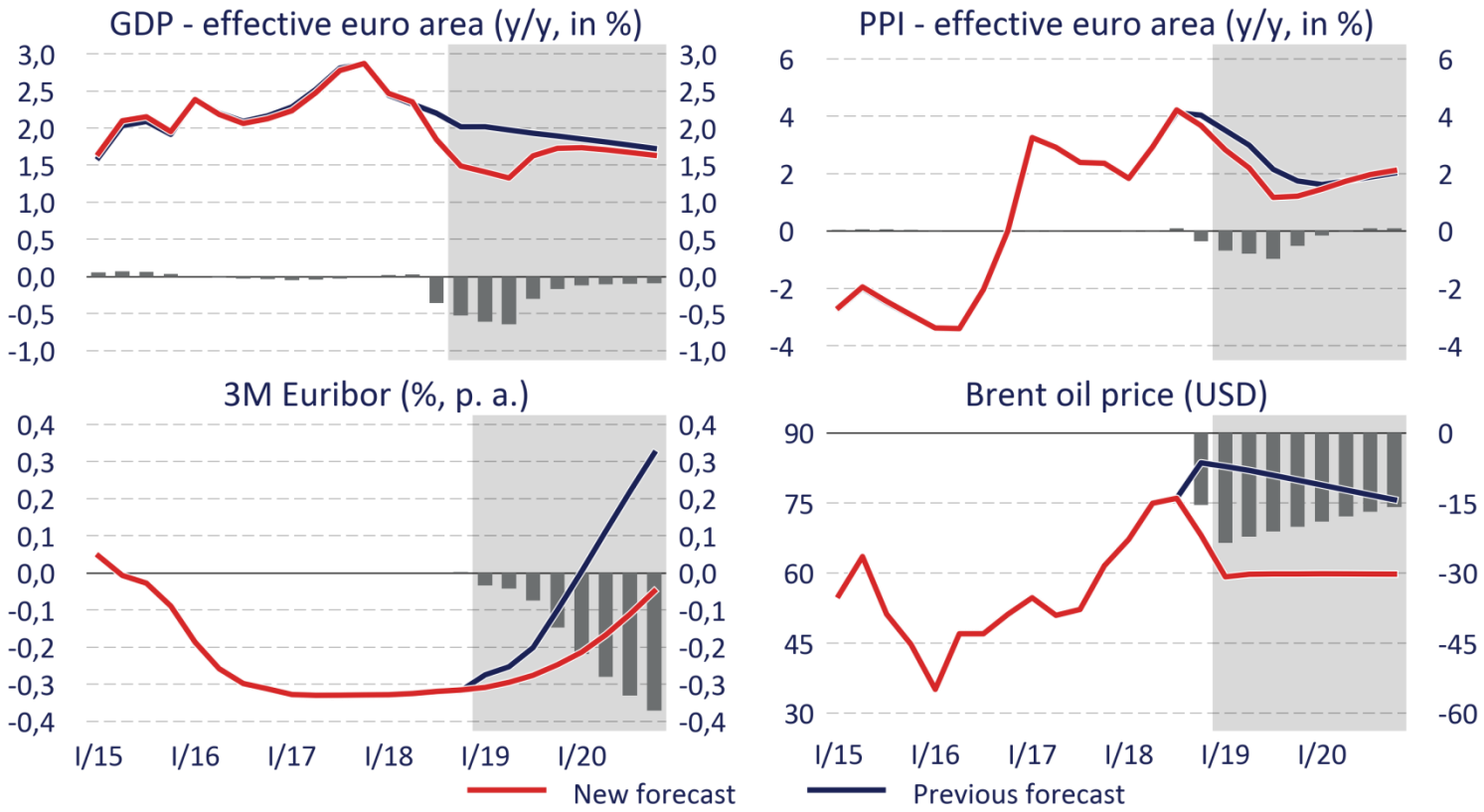
Transaction and asking prices of housing (y/y in %).



- Non-tradables price growth is fast; one half of it is due to rents (imputed, and to lesser extent actual).
- Imputed rent reflects new house purchases.
- Growth in housing prices has slowed to high single-figure levels.

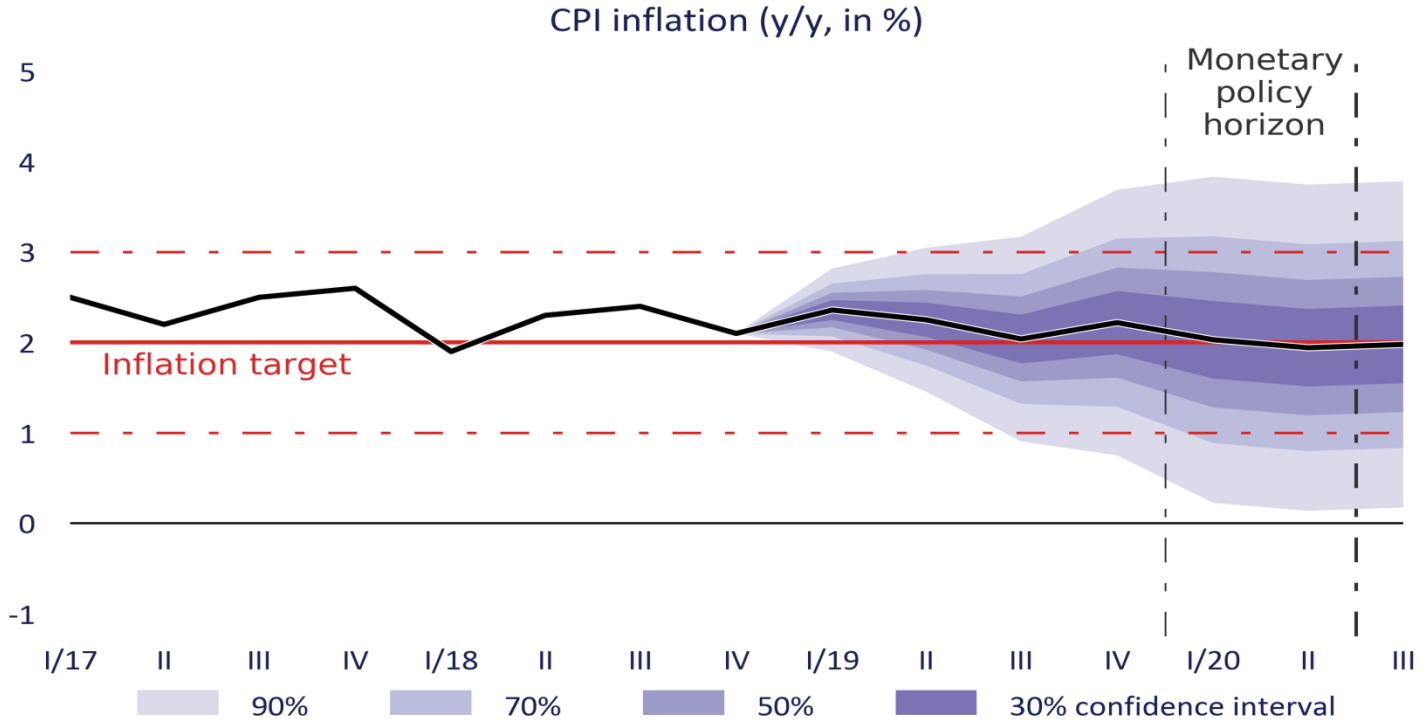
MACROECONOMIC OUTLOOK

External Forecast Assumptions



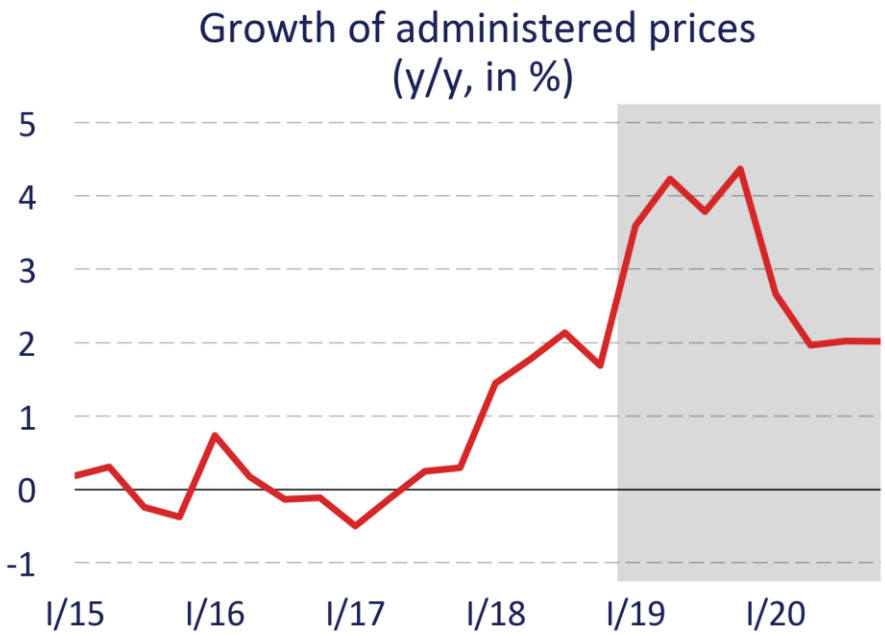
- GDP growth in effective euro area will slow to 1.5% this year and edge up to 1.7% in 2020 (with further downside risks).
- Previous decline in oil prices is reflected in slower PPI growth in euro area. Foreign PPI will return to 2% growth in late 2020.
- Euro area interest rates will remain negative over entire forecast horizon (market outlook before ECB's last decision).

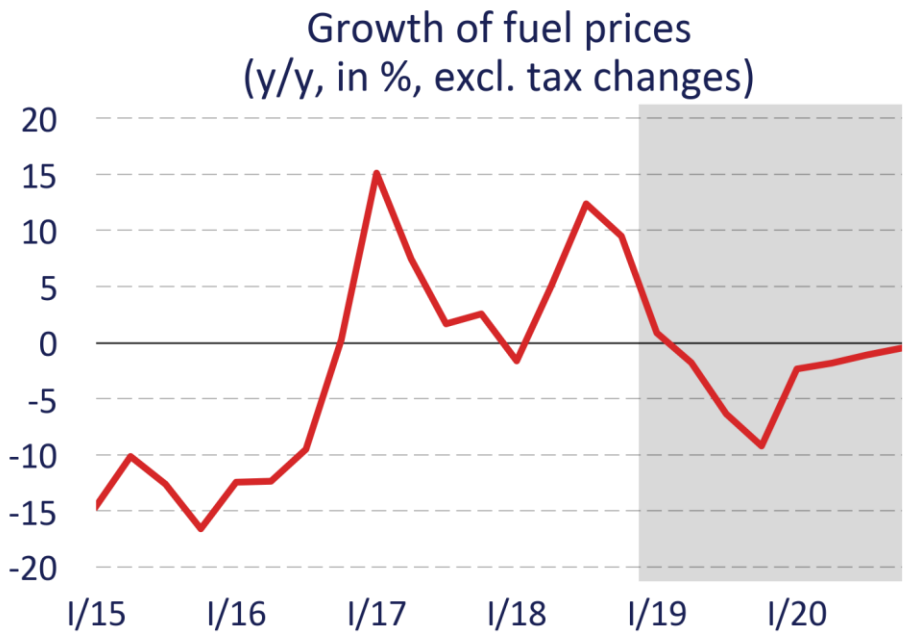
Headline Inflation Forecast



- Following temporary increase in early 2019, inflation will return to 2% target and stay very close to it at MP horizon.
- MP-relevant inflation will be very close to headline inflation.
- Strong domestic inflation pressures, reflecting rapid wage growth and low unemployment, will be partly offset by disinflationary import prices (low foreign inflation and expected renewed nominal appreciation of koruna).

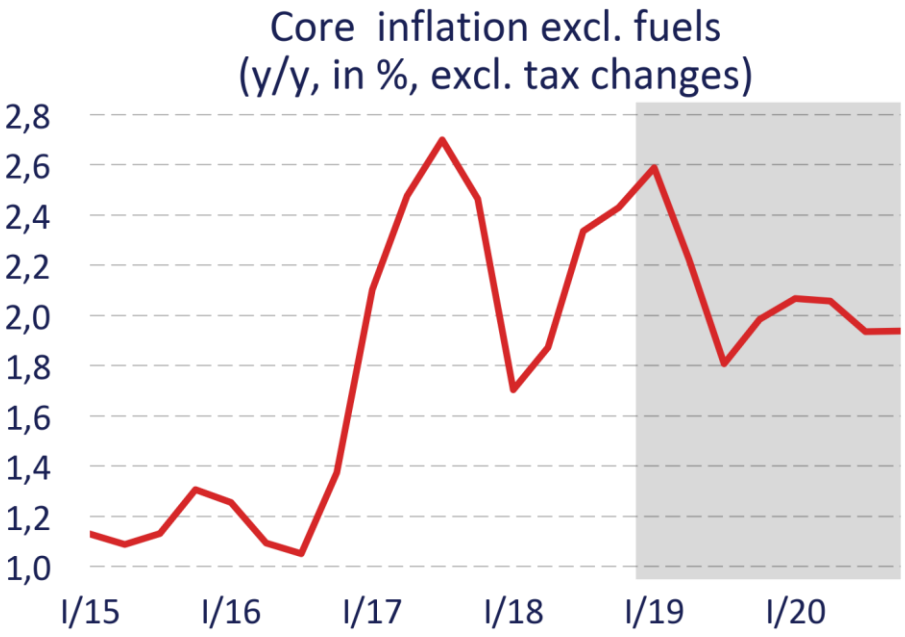
Administrative and Fuel Prices

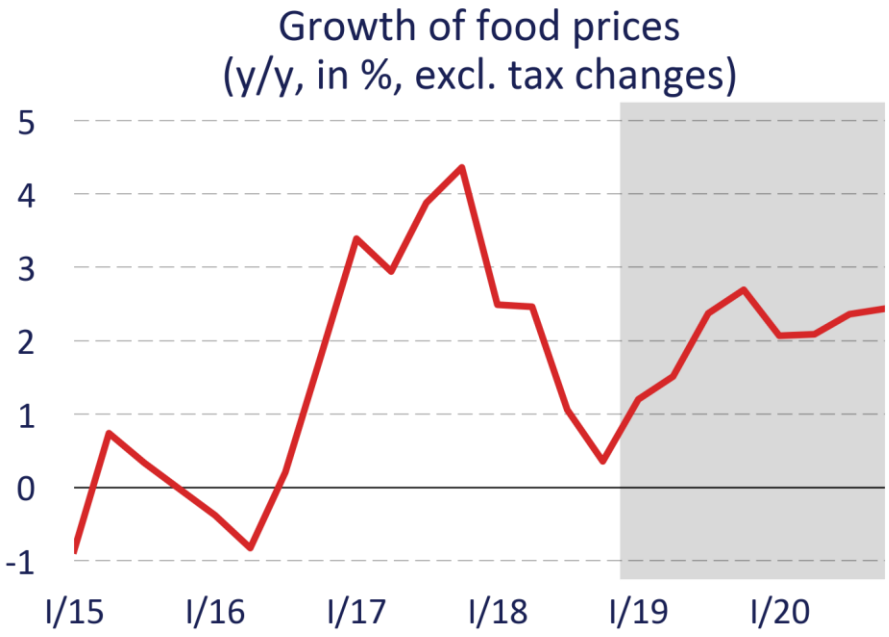




- Previous increase in world energy prices will boost growth in administered prices this year. Administered price inflation will slow to 2% in 2020.
- Fuel prices are heading towards year-on-year decline, reflecting drop in world oil prices and expected renewed appreciation of koruna.

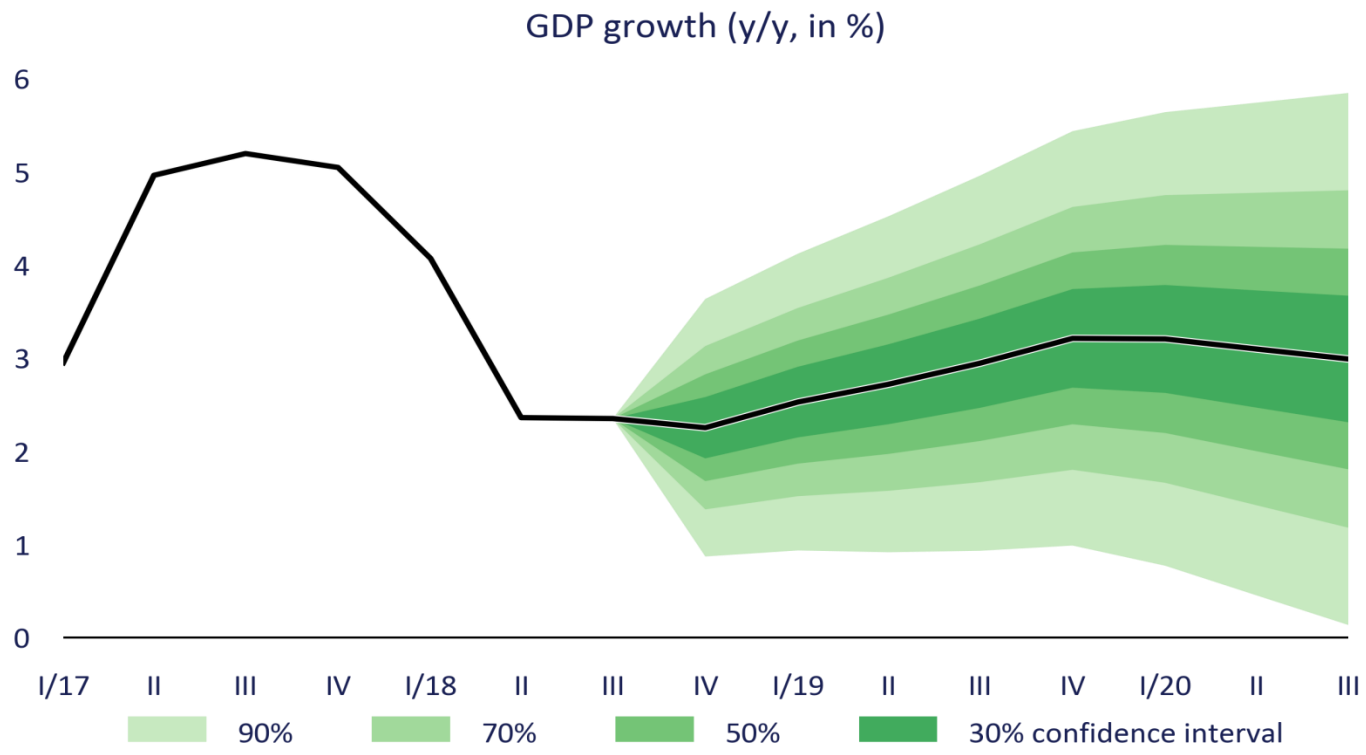
Core Inflation and Food Prices





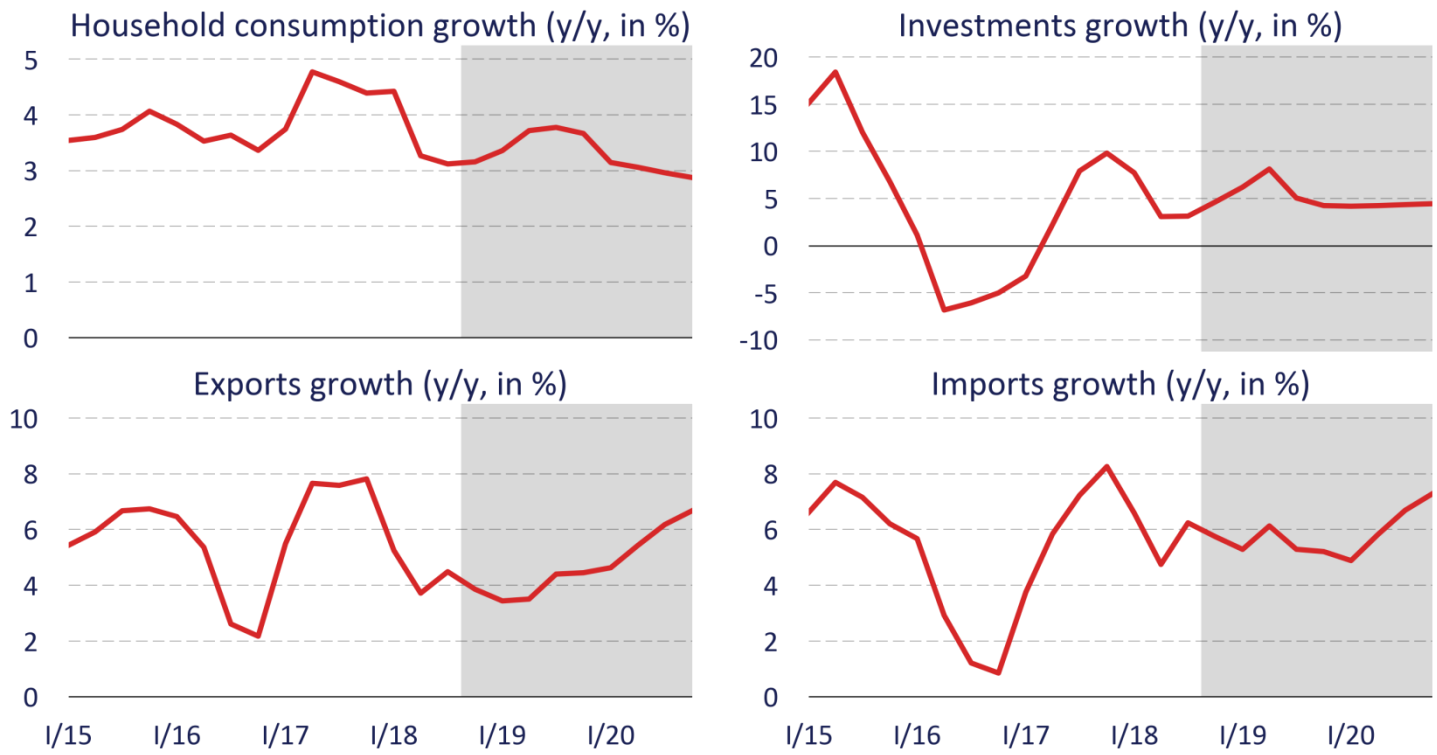
- Core inflation increased temporarily at beginning of this year (more than expected), but will go back to close to 2% afterwards as renewed appreciation of koruna along with low foreign inflation starts to pass through.
- Food price growth will increase markedly further on back of rise in food commodity prices due to poor harvest last year.

GDP Growth Forecast



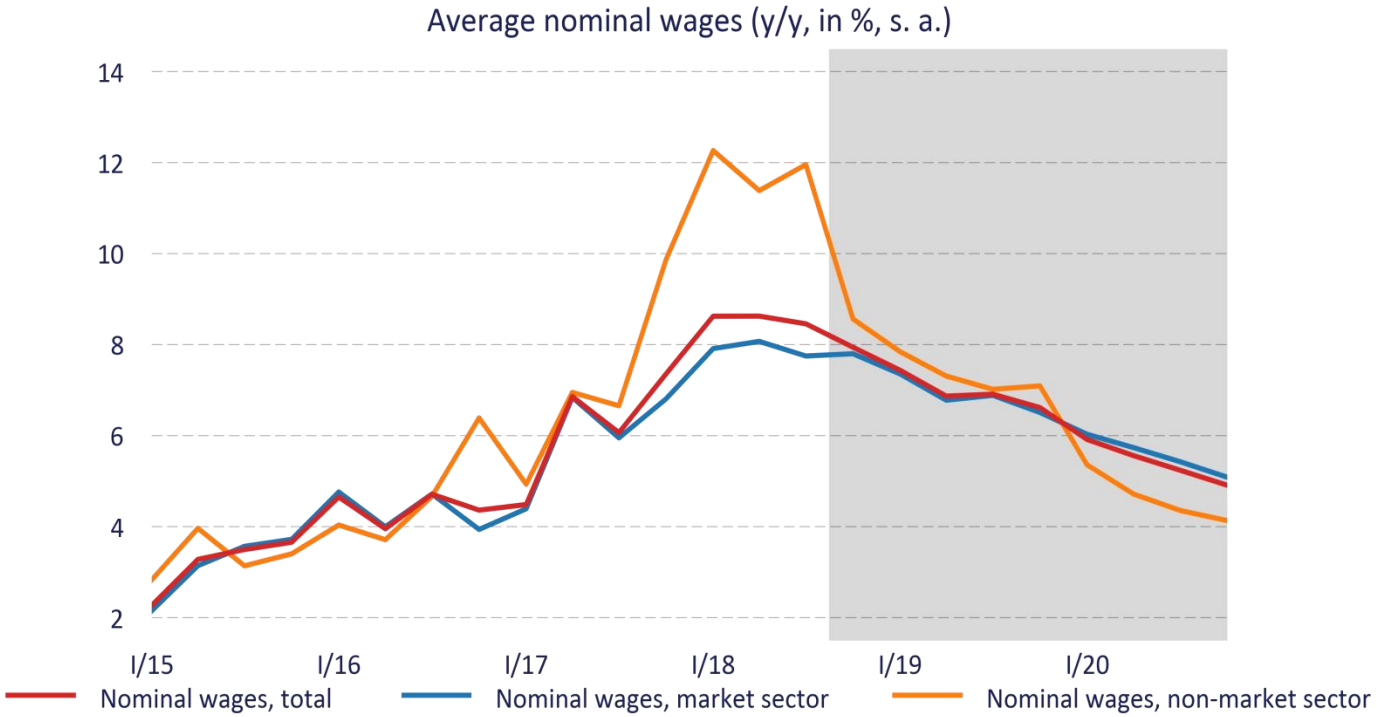
- GDP growth will remain at about 3% over next two years (2018 Q4 actually surprised on upside at 2.8% y/y).
- Household consumption and fixed investment will continue to be key drivers of growth.
- Positive fiscal impulse of 0.4% of GDP assumed this year.

Aggregate Demand



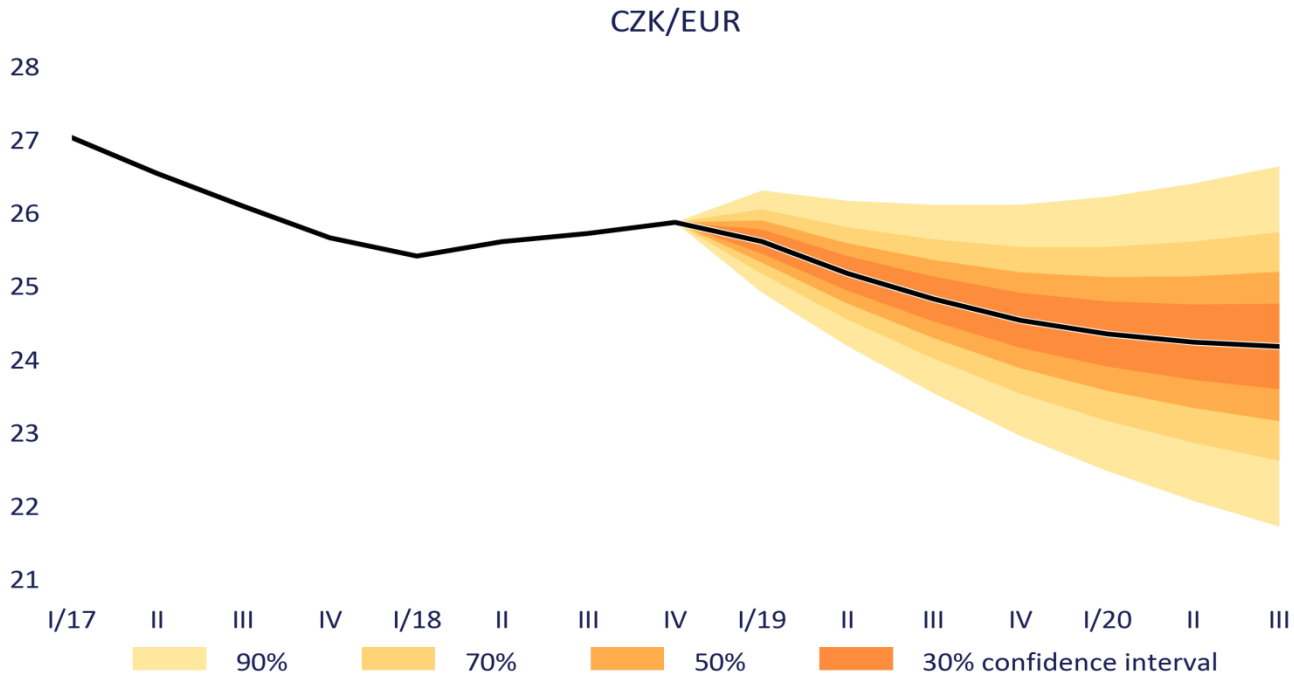
- Strong household consumption growth will reflect rapid, albeit gradually slowing, growth in wages and salaries and other income (but 2018 Q4 was weaker than predicted at 2.2% y/y).
- Investment will continue to be supported by its private and public components.
- Current muted export growth, due to both fundamental and one-off factors, will recover next year.

Nominal Wage Growth



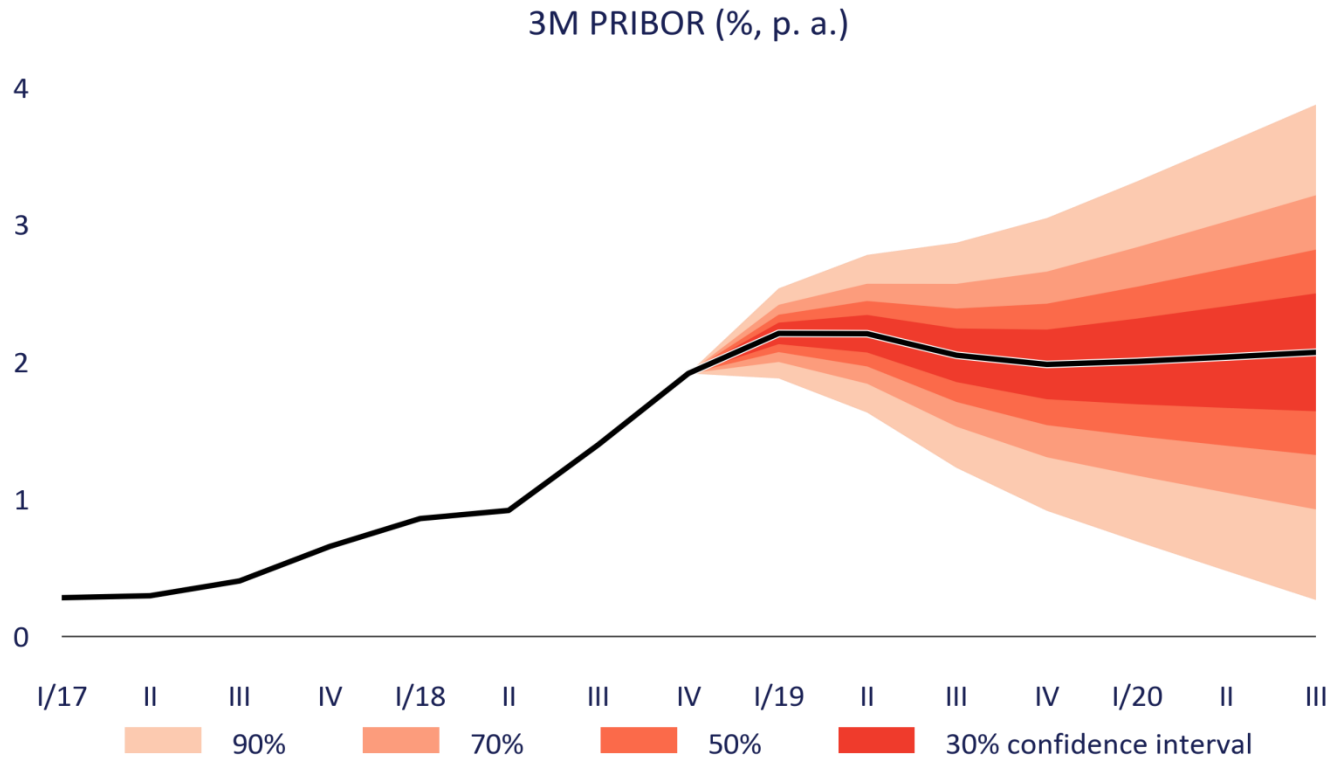
- Swift wage growth, stemming from tight labour market and increase in minimum wage, will start to slow this year (slowdown may have started already in 2018 Q4).
- Wages in market sector will (continue to) slow due to weaker economic growth, tighter monetary conditions and firms' efforts to maintain their competitiveness and profitability.
- Wages in non-market sector will continue to lose momentum, too.

CZK/EUR Exchange Rate



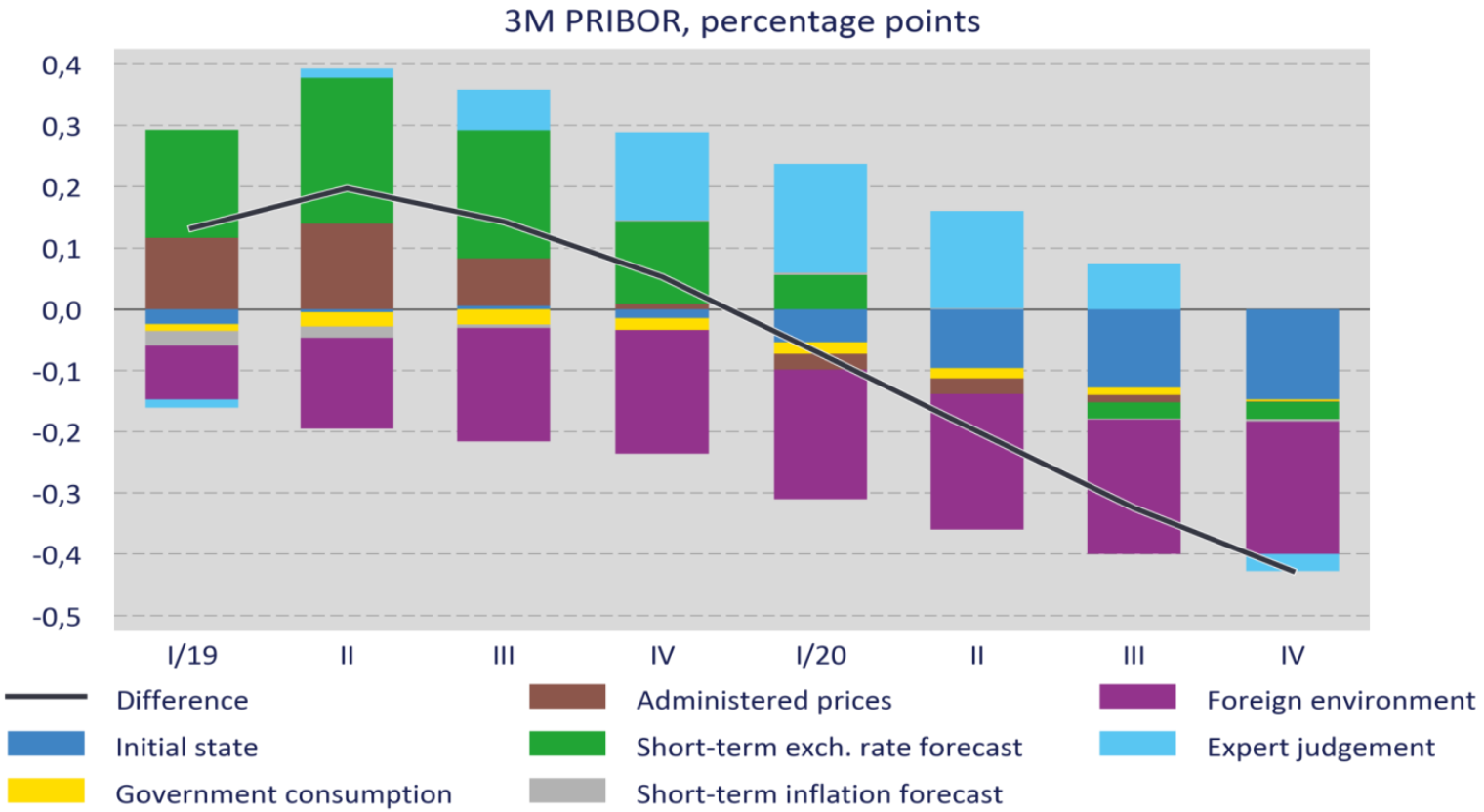
- Negative sentiment in foreign exchange markets is assumed to gradually fade out.
- Koruna is thus expected to renew its appreciation on back of positive interest rate differential vis-à-vis euro area and continuing real convergence of Czech economy.
- CNB Board sees risk of slower-than-expected appreciation.

Interest Rate Path



- Consistent with forecast is broad stability of interest rates.
- Upward pressures come primarily from koruna, strong domestic inflation pressures and administered price growth.
- Renewed koruna appreciation amid persisting negative interest rates in EA is expected to have downward effect.
- Board considers risks to forecast as slightly inflationary and tilted towards slightly higher interest rates.

Effects on CNB's Policy Outlook

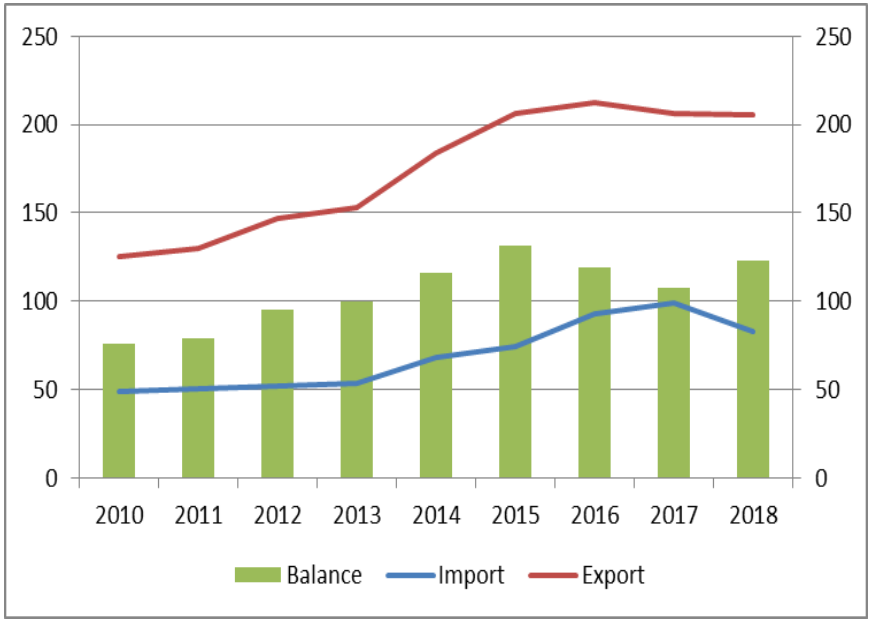


- Downward shift in euro area outlook has broadly offset weaker-than-expected exchange rate of koruna against euro in last forecast.
- Relative weight of these two factors will also play important role in risk assessment of forecast in March.

“HARD” BREXIT AND ITS EFFECTS ON THE CZECH ECONOMY

Czech Trade with UK

Trade with UK (CZK billions)

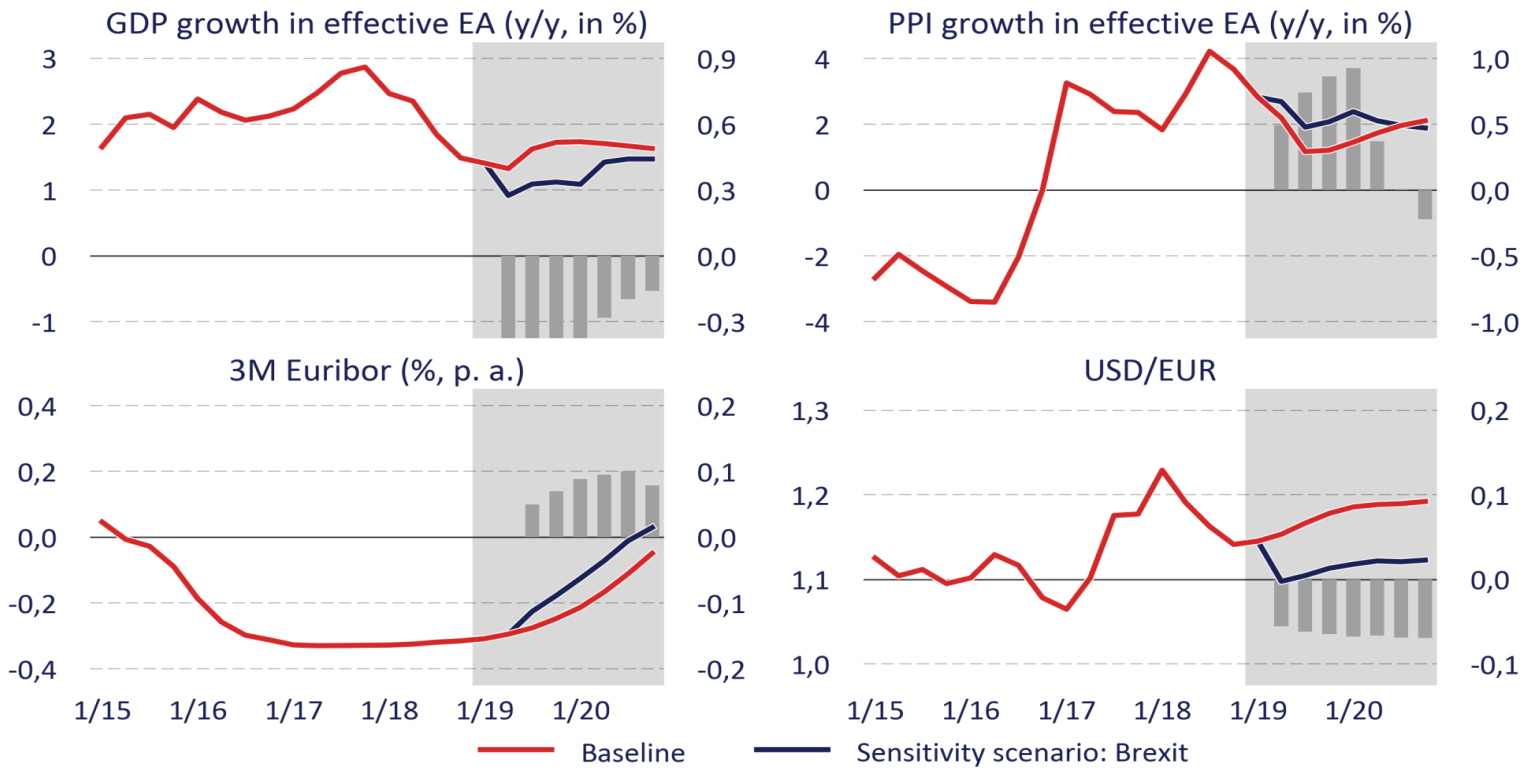


Structure of trade with UK (CZK billions, 2018)

SITC	Import	Export	Balance
Food and live animals	3.1	4.0	0.9
Beverages and tabacco	0.8	0.3	-0.5
Crude materials, inedible, except fuels	0.8	0.8	0.0
Mineral fuels, lubricants and related materials	0.4	0.6	0.2
Animal and vegetable oils, fats and waxes	0.2	0.0	-0.2
Chemicals and related products	14.9	6.3	-8.6
Manufactured goods classified chiefly by material	11.1	24.0	12.9
Machinery and transport equipment	42.6	144.2	101.6
Miscellaneous manufactured articles	8.5	25.0	16.5
Commodities and transactions not classified elsewhere in the SIT	0.2	0.2	0.0

- High trade surplus in trade with UK, but broad stagnation since 2016. Exports have also stagnated (with imports recently falling).
- UK is important market for Czech car industry.

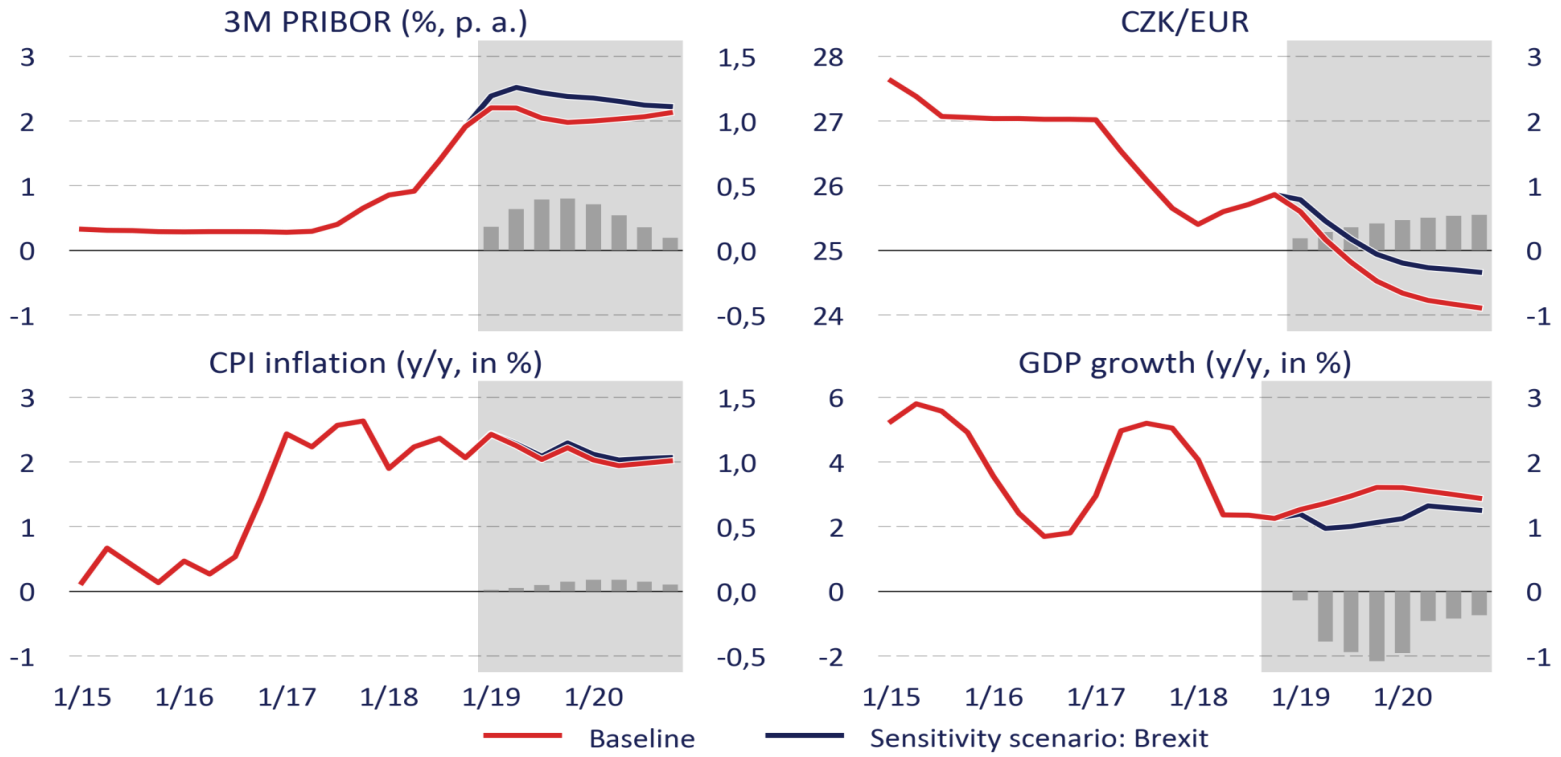
"Hard" Brexit Scenario – Effective EA



Stagflationary implications of "hard" Brexit in euro area:

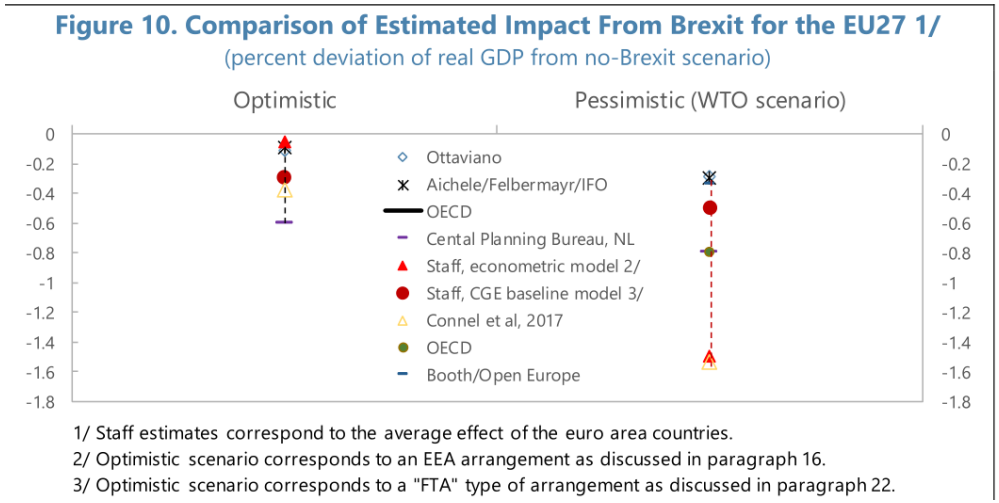
- GDP drops by about 1% due to decline in trade volumes with UK.
- Higher PPI inflation results from import tariffs and depreciation of euro against USD.

"Hard" Brexit Scenario – Czech Economy



- Indirect channel dominates, as direct channel has relatively small implications (about 5% of Czech exports)
- As a result, GDP growth slows to around 2% in 2019 due to lower net exports, and koruna weakens.
- Weaker koruna – in combination with higher foreign prices – leads to stronger import price pressures.

Comparison of "Hard" Brexit Scenarios



Source: IMF(2018)

	Impact in percent of GDP	
Institution	Eurozone/EU27	Czech Republic
IMF (2018)	-0.5	-0.9
Ministry of Finance CR	-0.3	-0.7
CNB	-0.7	-1.4

- Implications of Brexit depend heavily on its parameters ⇒ estimated adverse effects on EA/EU27 range from -0.3% to -1.5% of GDP.
- Implications for Czech economic activity arise mainly from drop in demand for exports from EA and are estimated at between -0.7% and -1.4% (in terms of level, not growth rate).

"Hard" Brexit Scenario – Monetary Policy

Inflationary pressures

- Weaker koruna
- Import tariffs
- Breakdown of some global production chains

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Disinflationary pressures

- Drop in exports and weaker domestic demand

Overall implications inflationary or disinflationary?

In my opinion, monetary policy should respond after careful evaluation of all likely implications.

Thank you for your attention

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