CNB Monetary Policy

November 2019

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Hungary & Czech Republic Investor Seminar

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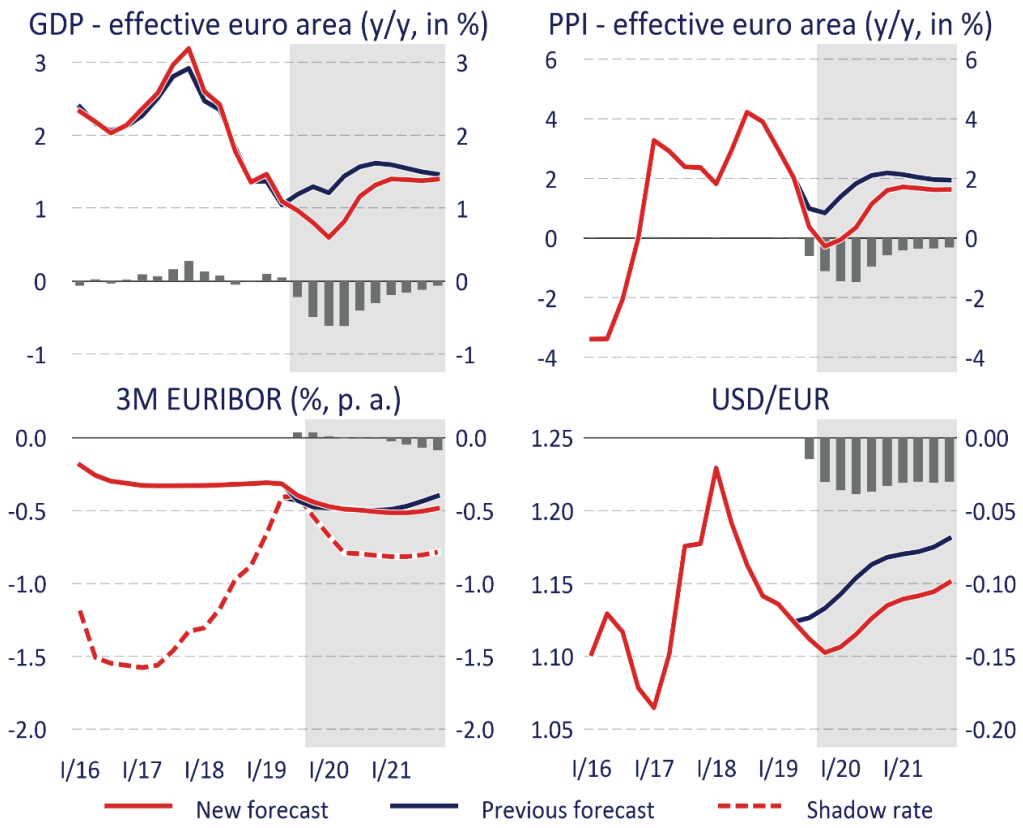
Outline

- CNB's November 2019 forecast
- The forecast's assumptions and implications
- CNB's Board Decision

NOVEMBER 2019 FORECAST
INFLATION REPORT IV/2019

Worsening of the external outlook



- **GDP growth in the effective euro area will remain subdued** next year, starting to accelerate in 2021.
- The slowdown in economic activity and a fall of world oil prices will translate into **low producer and consumer price inflation** in the effective euro area.
- **ECB's monetary policy will remain easy**, but the room for further easing through interest rates might be already quite limited.

Neutral fiscal stimulus over the forecast horizon

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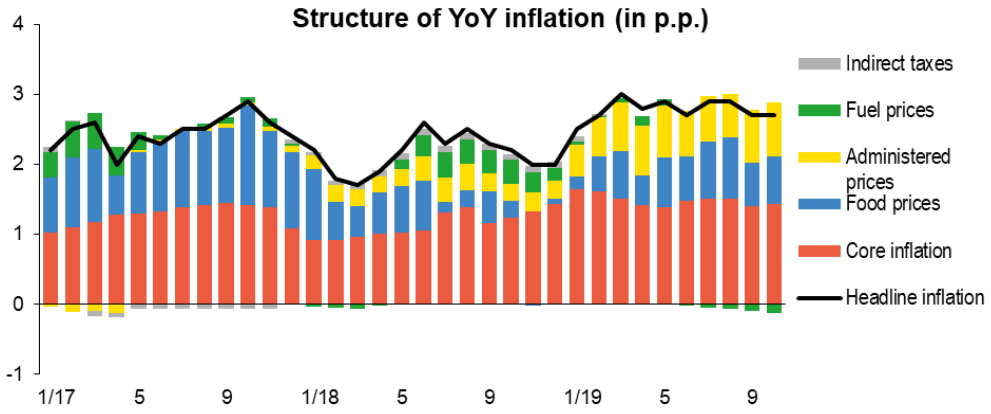
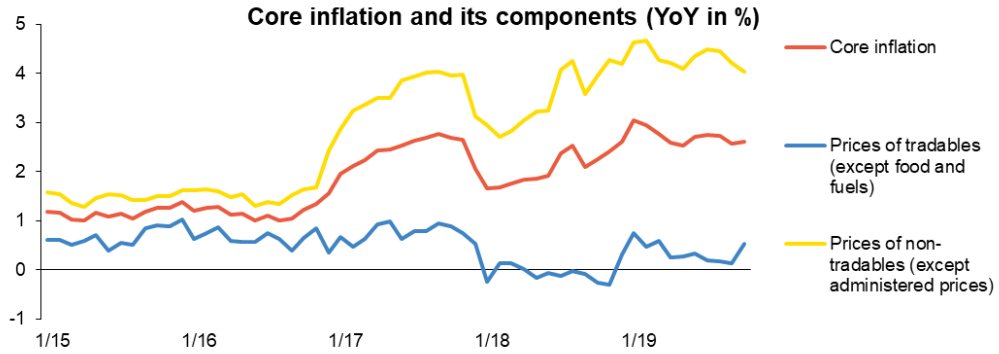
Fiscal impulse (contributions to GDP growth in percentage points)

	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 positive fiscal impulse this year is linked to the **extraordinary valorisation of pensions, rapid wage growth** in the government sector and continuing growth of government **investment**.
- The **neutral effect** of fiscal policy in 2020 reflects:
  - **Expenditure:** increase of parental allowances and public sector wages and pensions.
  - **Income:** increase of excise duty on cigarettes and alcohol, increase in lottery and gambling taxes, removing income tax exemptions on gambling revenues, the 3rd and 4th wave ESR and related VAT changes.
- No further discretionary measures have been announced for 2021.

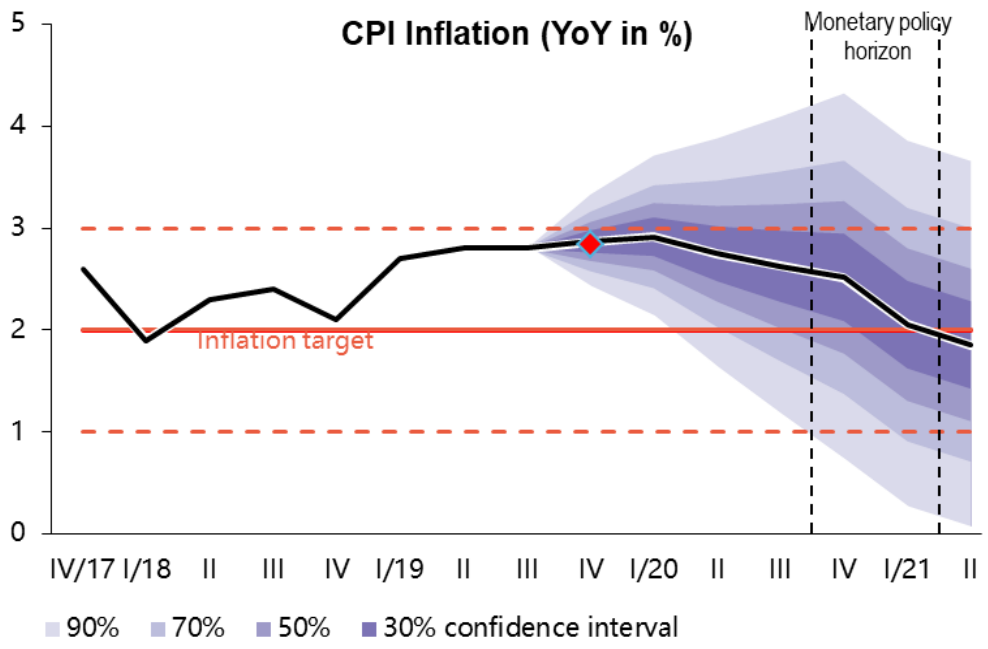
Inflation still close to 3%





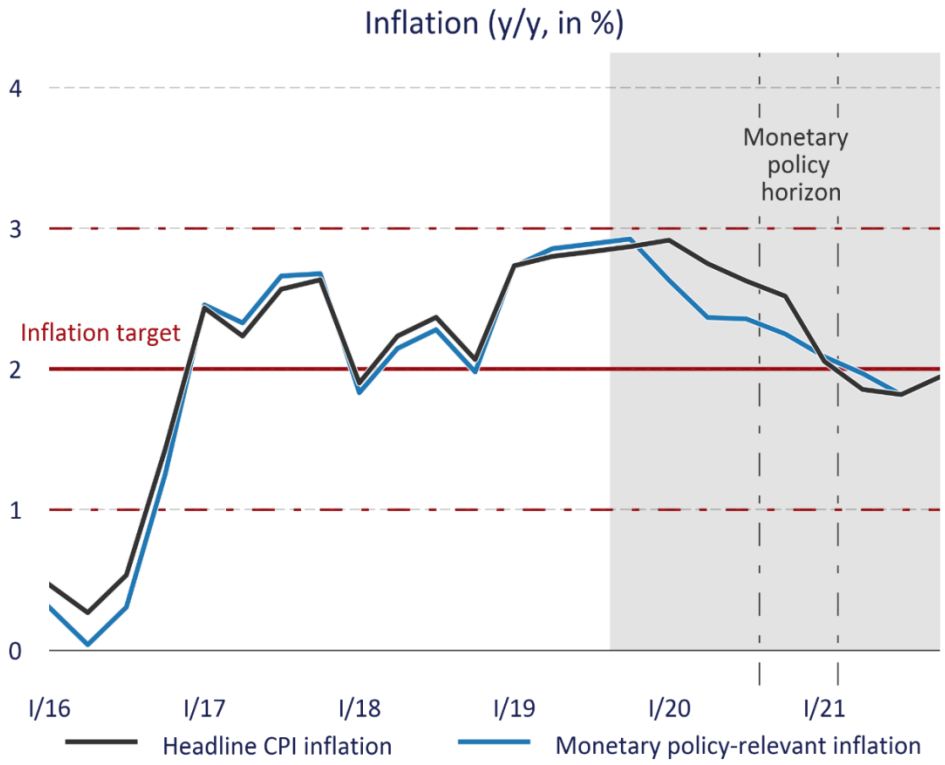
- Headline inflation reached 2.8% in 2019Q3 (2.7% in October), driven mainly by **core inflation**.
- **Food price inflation** and **administered price inflation** also contributed to high inflation. On the other hand, **fuel prices** declined.
- Regulated price inflation is driven by rising **electricity prices** and, to a lesser extent, by rising **gas and heat prices**.
- The persisting strong inflationary pressures from the domestic economy have kept core inflation, **non-tradable price inflation** in particular, at high levels.

Inflation back to the target in early 2021



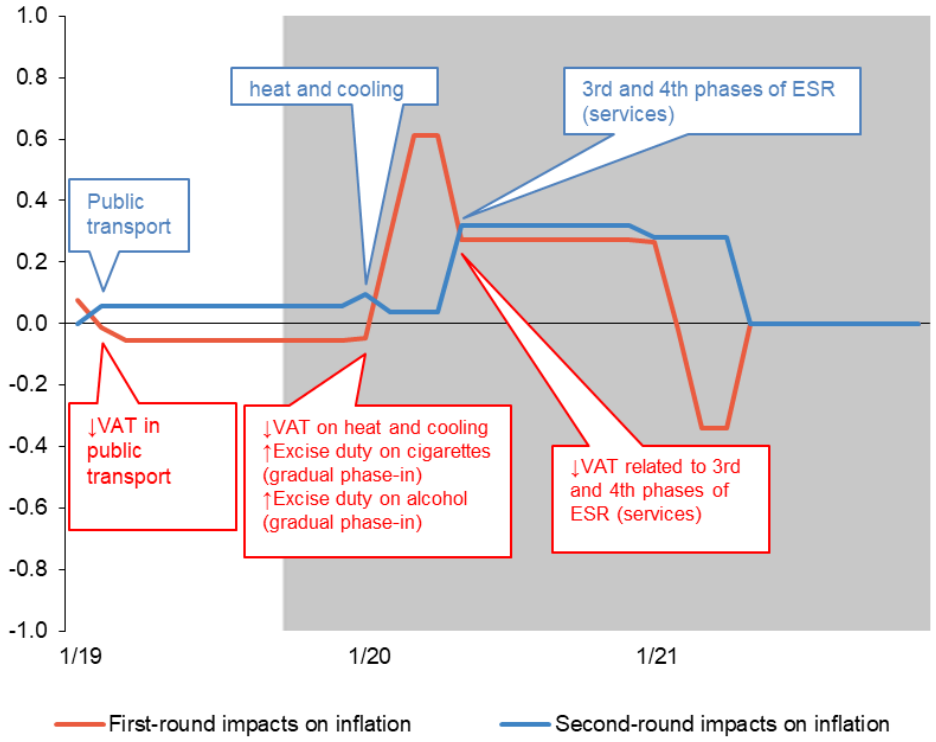
- **Headline inflation** will remain close to the upper boundary of the tolerance band this year, before returning to the target within the monetary policy horizon.
- The inflation forecast reflects only gradually unwinding strong domestic **inflationary pressures.**
- To return inflation back to the target within the monetary policy horizon requires additional, although moderate, **tightening of monetary policy**.
- **Headline inflation reached 2.7% in October**, thus only slightly below the current forecast.

Headline inflation affected by tax changes



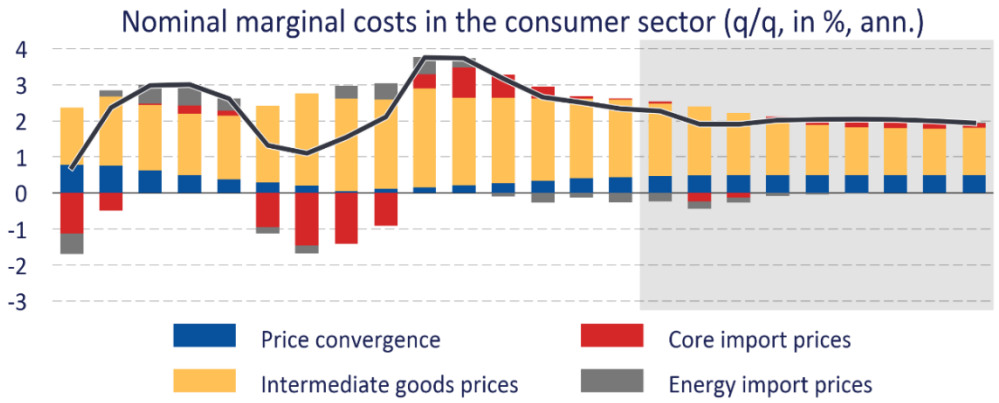
- Monetary policy responds to **monetary policy-relevant inflation**, i.e. headline inflation adjusted for the first-round effects of indirect tax changes:
  - Changes in the level and structure of indirect tax rates are a specific type of exogenous shock, to which the CNB applies escape clauses.
  - Monetary policy responds only to the secondary effects of indirect tax changes.
- Monetary policy-relevant inflation will be below headline inflation in 2020 as a result of the **positive first-round effects of indirect tax changes**.

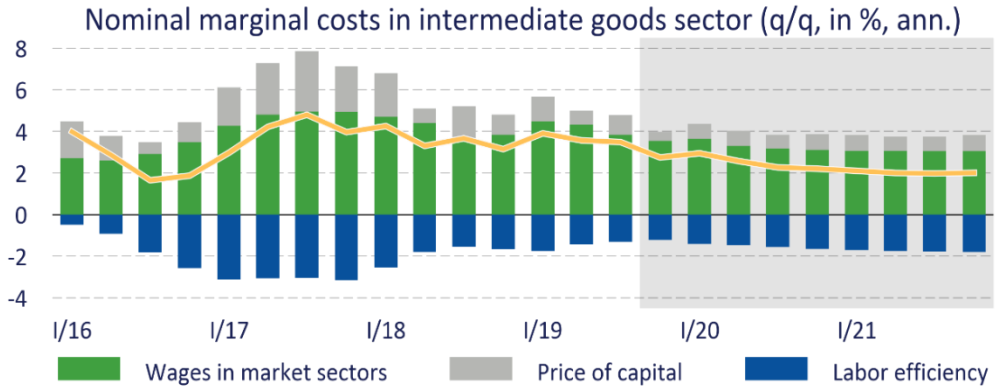
Unchanged price of services despite lower VAT



- **Higher excise duties on cigarettes and alcohol** starting from January 2020.
- **The 3d and 4th phase of ESR** will launch in May 2020, accompanied by VAT cuts on hairdressing and barbers' services, bicycle repair, footwear, clothing and draft beer.
- Only limited passing on of the VAT cuts to price of services => **positive** (immediate) **second-round effects.**
- The **second-round effects** will increase monetary-policy relevant and headline inflation in the next 2 years.

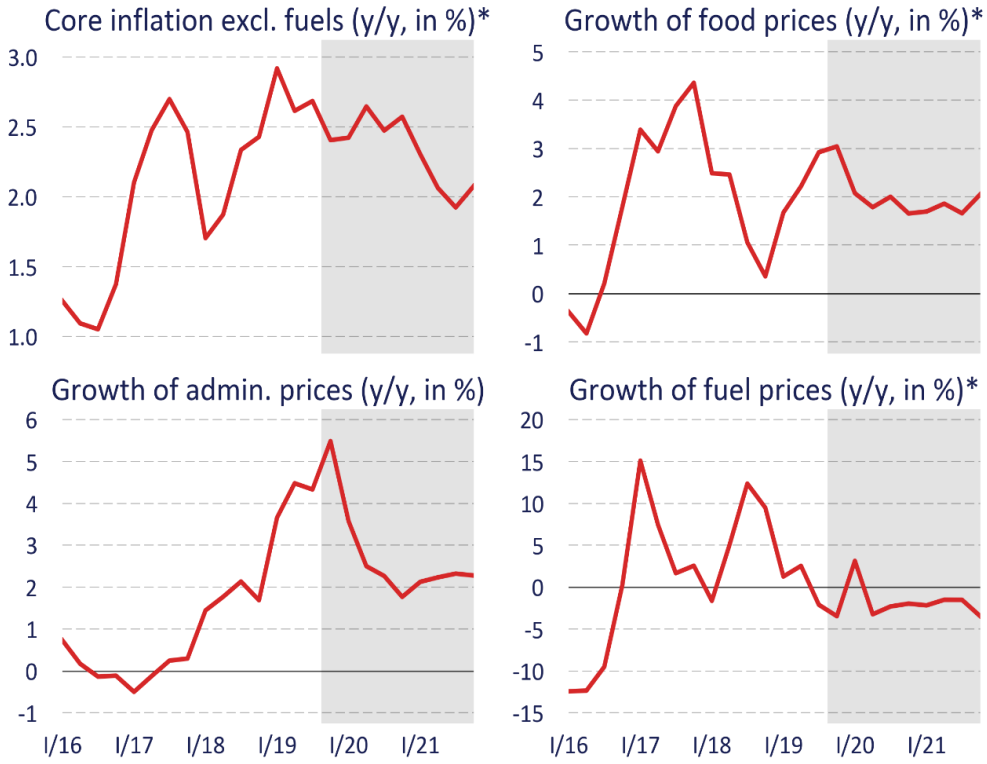
Cost-push inflation pressures will ease gradually





- **Growth in total nominal costs** will slow further at the start of next year and stabilise around 2% later on.
- **Domestic cost pressures** will gradually decline due to **slowing wage growth and improving labour efficiency.**
- Core (non-energy) **import prices** will have a modest anti-inflationary effect early next year before renewing their inflationary contributions starting from the second half of 2020.
- The contribution of the **price of capital** will remain positive, reflecting continued growth in domestic demand.

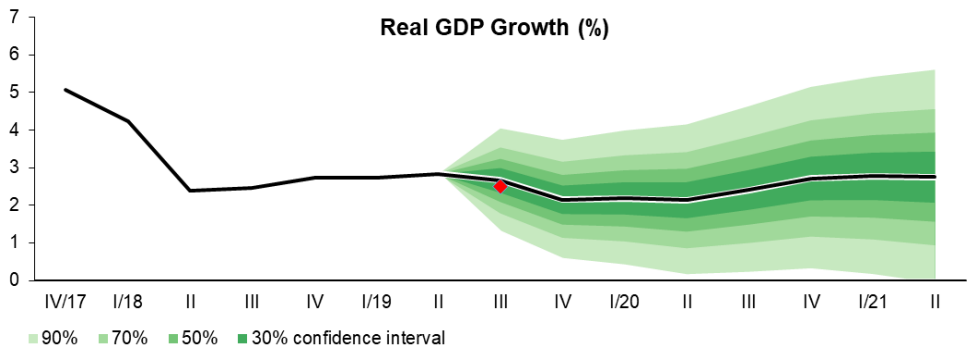
High inflation of core and administrated prices

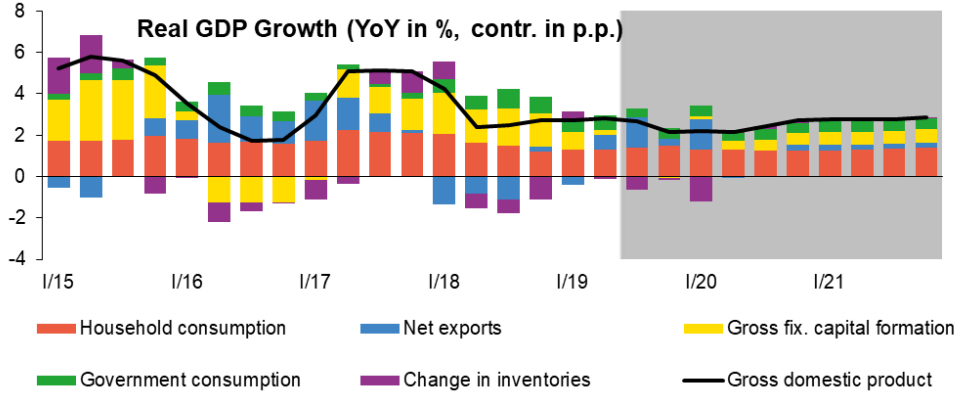


* excluding tax changes

- **Core inflation** will be pushed by strong **domestic inflationary pressures** and, from May 2020, by **positive second-round** effects of VAT cuts in services. The **tightening of monetary conditions** will be disinflationary.
- **Food price inflation** will remain at elevated levels at the end of this year before slowing down next year.
- **Fuel prices** will continue to decline reflecting a slight year-on-year decline in oil prices and a gradual appreciation of the koruna-dollar exchange rate.
- Significant acceleration of **administrated prices** is related mainly to rising electricity prices.

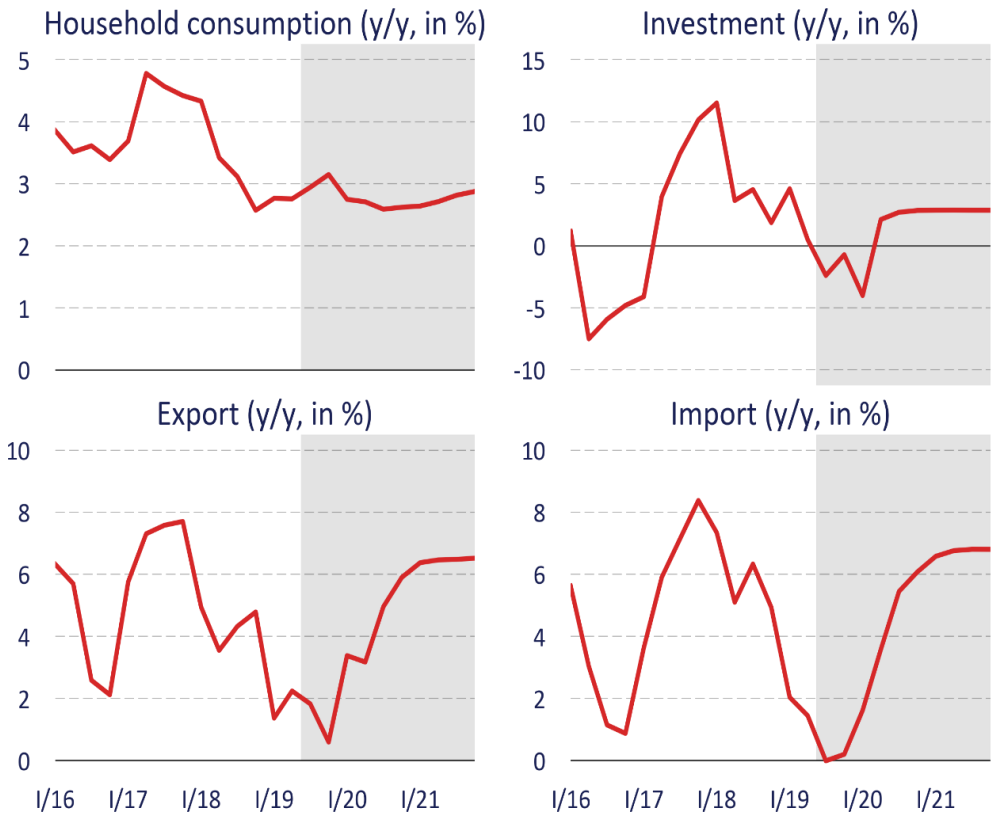
Private and public consumption boost growth





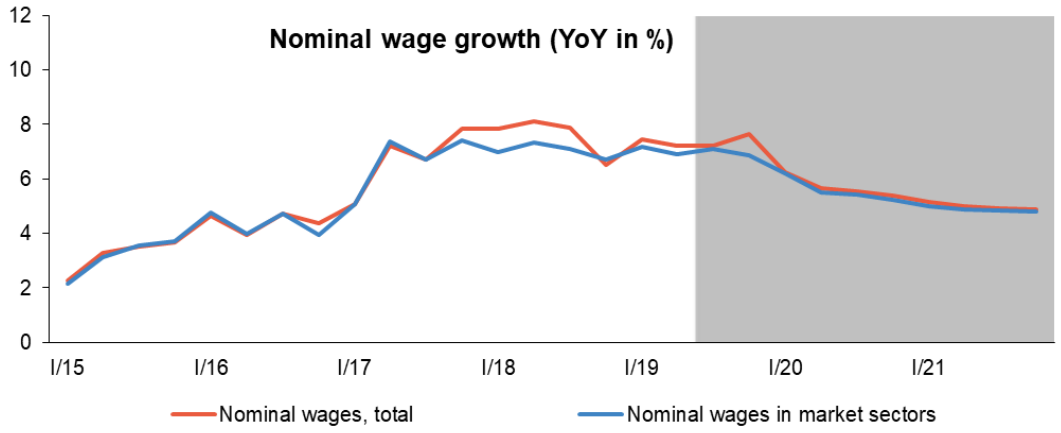
- Real growth this year will reach 2.6%, driven mainly by **household and government consumption** (a positive fiscal impulse).
- Starting in the last quarter of this year, **growth will slow down** as foreign demand weakens.
  - Investment slump will persist until mid-2020.
  - The positive contribution of net exports will temporarily fade next year and resume only with accelerated growth in external demand.
- Growth will **slow down** to 2.4% **next year**. It will return gradually to its long-term level during 2021.
- Flash estimate reached **2.5% in 2019Q3**, slightly below the forecast.

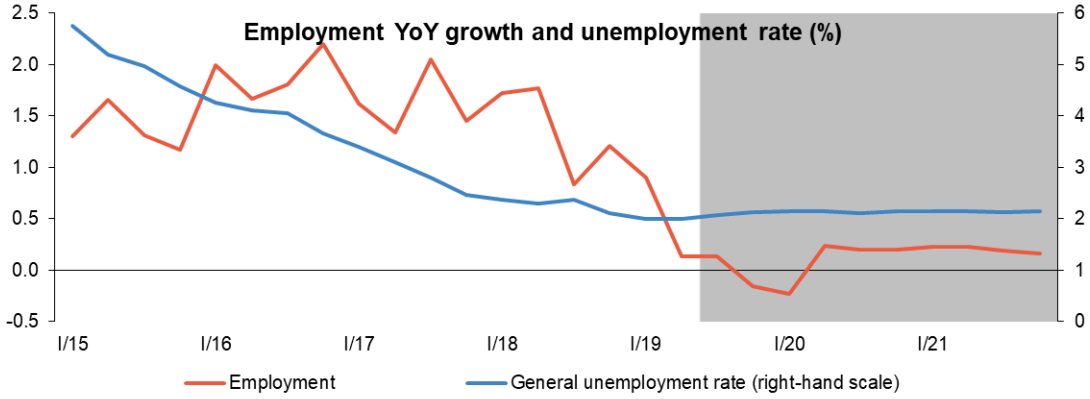
Household consumption will remain robust



- Robust growth of **household consumption** will continue on the back of swift, albeit gradually decelerating, wage and income dynamics.
- **Private investment** will decline over the 1-year horizon, reflecting a slowdown of external demand. **Government's investment** will be positive throughout the forecast horizon.
- The currently subdued **export dynamics** will increase next year along with accelerating external demand.
- **Import growth** will mirror domestic investment and export dynamics.

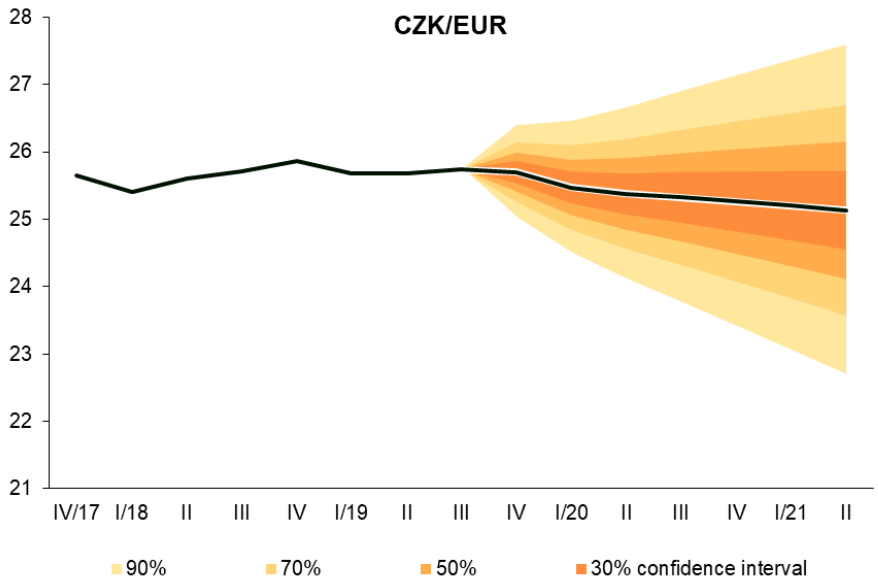
Nominal wage growth will slow down





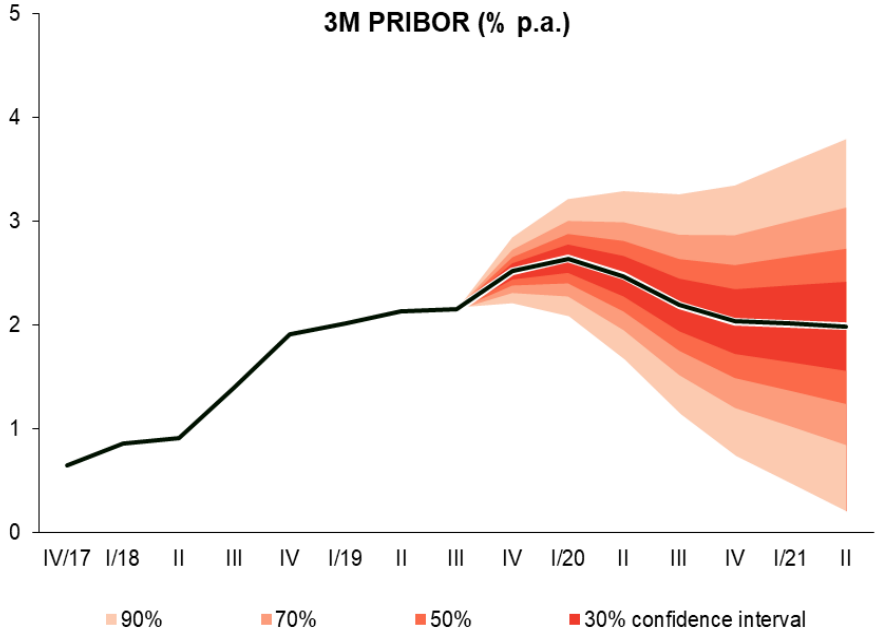
- **Wage growth** will start to slow down next year:
  - Declining economic growth and firms struggling to preserve profitability and price competitiveness.
  - A further increase in the minimum wage will act in the opposite direction.
- **Employment** growth will remain subdued due to a persisting lack of available labor, amid declining labor demand.
- The **unemployment rate** will stay close to its current record low levels.

Gradual appreciation of the koruna



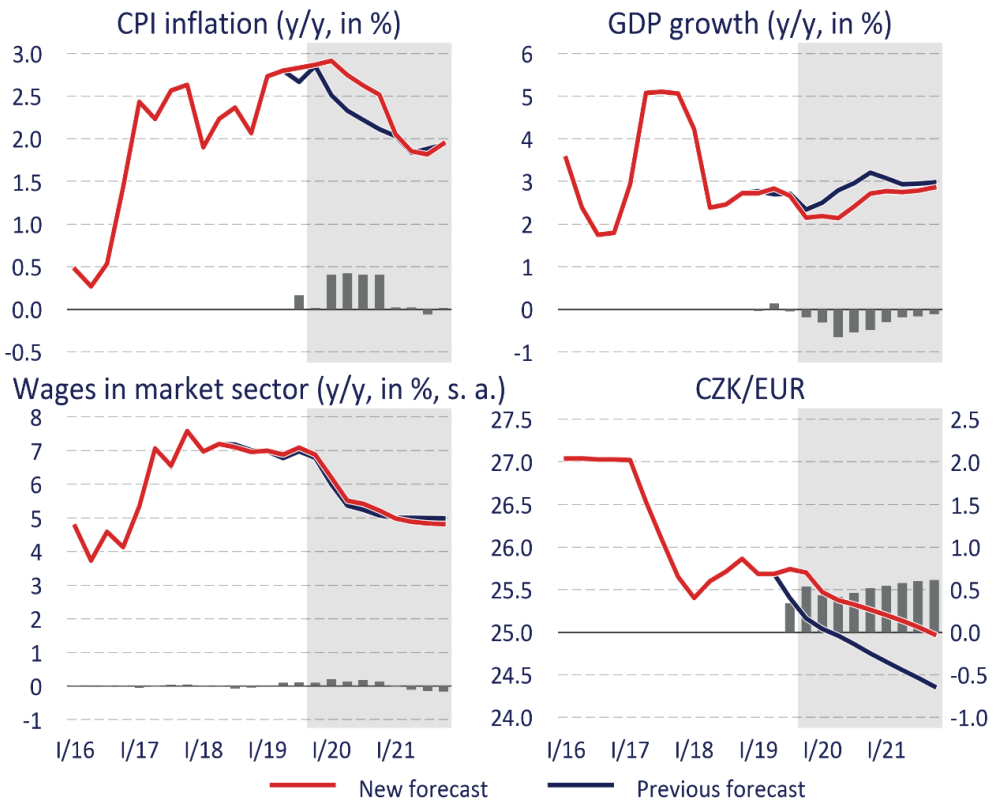
- **Mild strengthening of the koruna** will reflect the continuing real convergence of the Czech economy on the back of productivity growth.
- Koruna appreciation will be temporarily supported by further **widening of the interest rate differential**, which will partly reflect the renewed unconventional monetary policy of the ECB.
- However, these factors will be dampened by **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 consistent with the forecast



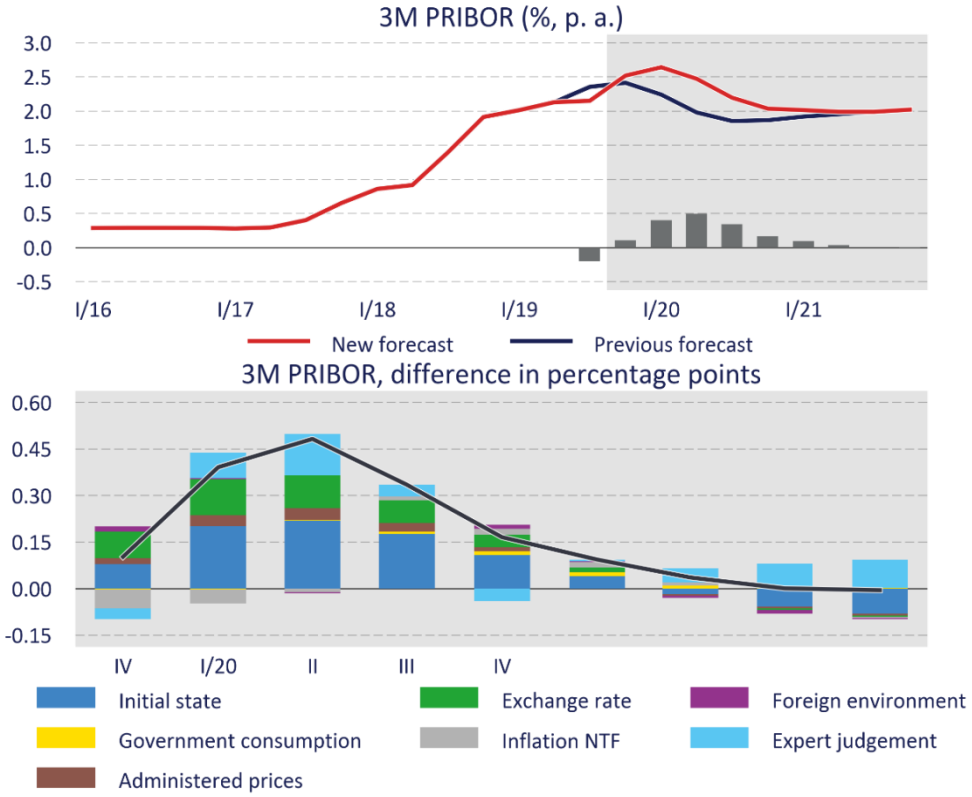
- Consistent with the forecast is an increase in **domestic market interest rates** in this and the next quarter, followed by a decline of interest rates.
- The hikes primarily reflect persisting **domestic cost pressures** (slowdown in labour efficiency growth and only gradually decreasing wage growth).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

"Stagflation" – forecast revision



- The **inflation forecast** for next year is higher due to (i) stronger domestic pressures, (ii) a weaker exchange rate and (iii) 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 more gradually than in the previous forecast due to the worse external outlook.

Factors behind interest rate path revision



- The new forecast implies a **higher domestic interest rate** path, especially in 2020:
  - A more **inflationary initial state** (lower growth of labour efficiency and more tariff based wage growth in market industries in 2Q 2019).
  - **Weaker** short-term **exchange rate** forecast.
  - **Inflationary effects of expert judgments**, including (i) VAT changes, (ii) higher minimum wage, and (iii) a more persistent wage growth.
- The worsening outlook for external GDP and PPIs is offset by the weaker exchange rate (built-in stabilizer of net trade) and thus the effects of the **foreign environment** are **neutral**.

MONETARY POLICY DECISION

NOVEMBER 7, 2019

Monetary policy decision

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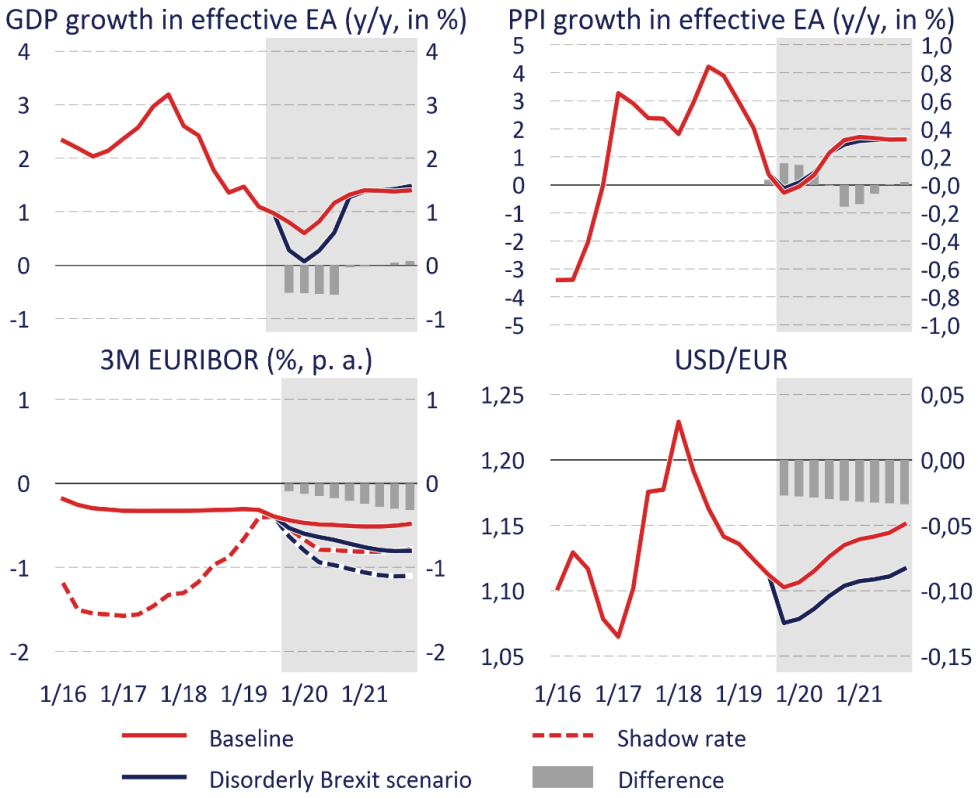
The Board of the Czech National Bank decided to keep interest rates unchanged. The two-week repo rate thus remains at 2%, the discount rate at 1% and the Lombard rate at 3%.

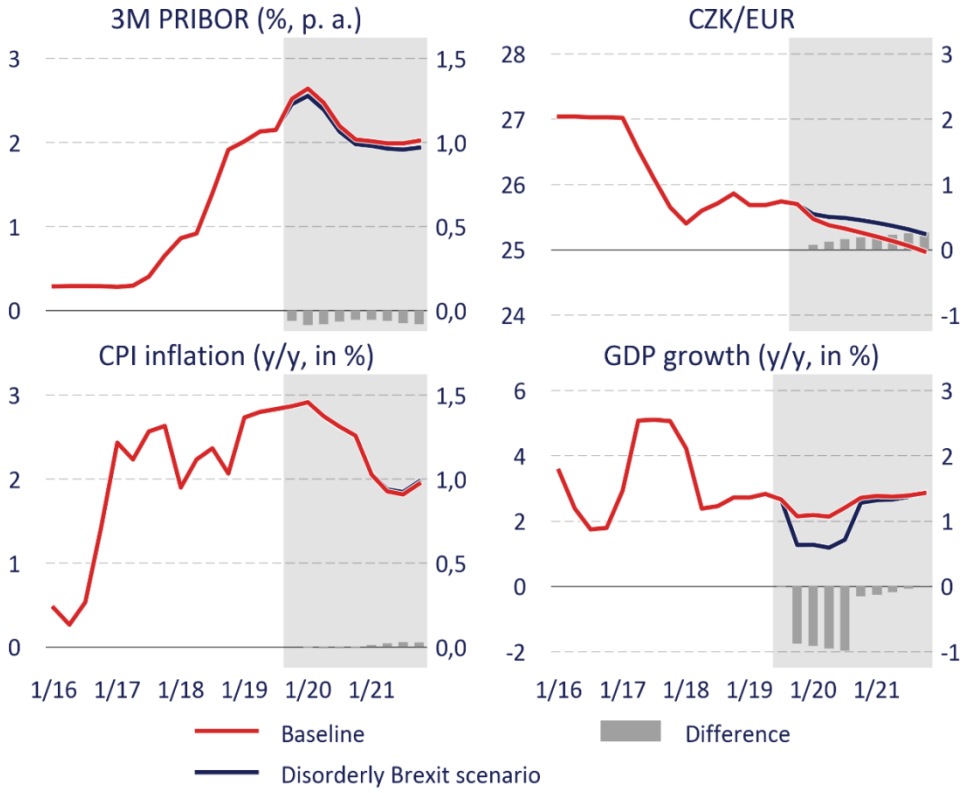
- Five members voted in favour of this decision, and two members voted for increasing rates by 25 basis points.
- Consistent with the forecast is a rise in domestic market interest rates in this quarter and the next, followed by a decline from mid-2020.
- The Bank Board assessed the balance of risks to the inflation forecast at the monetary policy horizon as being anti-inflationary.
  - The risks stem primarily from the situation abroad, which may be negatively reflected in the open Czech economy with a lag.
- The communicated sensitivity scenario of "Disorderly Brexit" did not play a significant role as Brexit has been postponed and the probability of a hard exit declined.

Disorderly Brexit Scenario: External Environment



- Updated version of the disorderly Brexit scenario (IR I/2019) captures in greater detail the economic links between the UK the EA.
- A 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 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 via 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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