CNB CZECH NATIONAL BANK

Macroeconomic Forecast for the Czech Republic

Inflation Report II/2020

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Monetary Policy Decision

The CNB Board cut the 2W repo rate by 75 basis points to 0.25% at its meeting on May 7, 2020. At the same time, the Board decided to cut the Lombard rate to 1.00%. The discount rate remained unchanged at 0.05%.

Five members of the Board voted in favor of this decision and two members voted for reducing the 2W repo rate by 50 basis points.

The decision taken by the Board is based on the **CNB's new macroeconomic forecast.**

The uncertainty about the external and domestic assumptions of the current forecast, including their description by the forecasting apparatus, **is extremely high.**

0.25%
2W repo rate

0.05%
discount rate

1.00%
Lombard rate

FOR CUT OF 75 BP

FOR CUT OF 50 BP

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Current Macroeconomic Forecast

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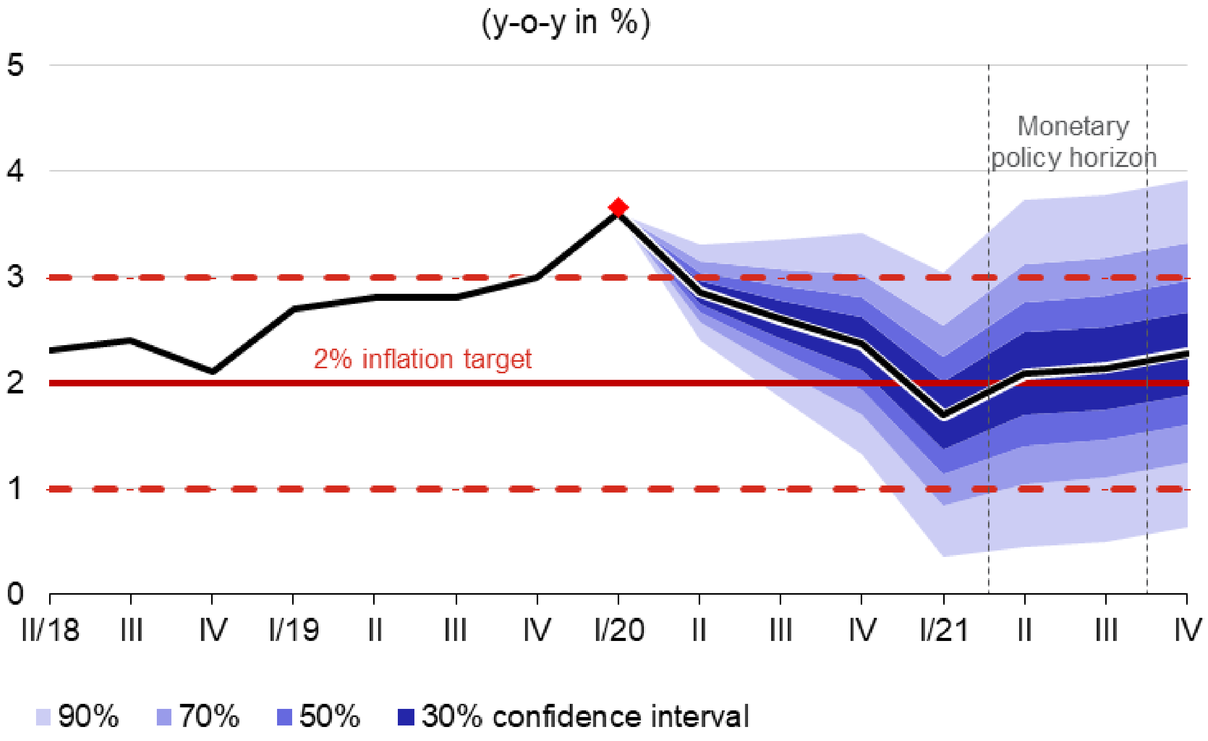
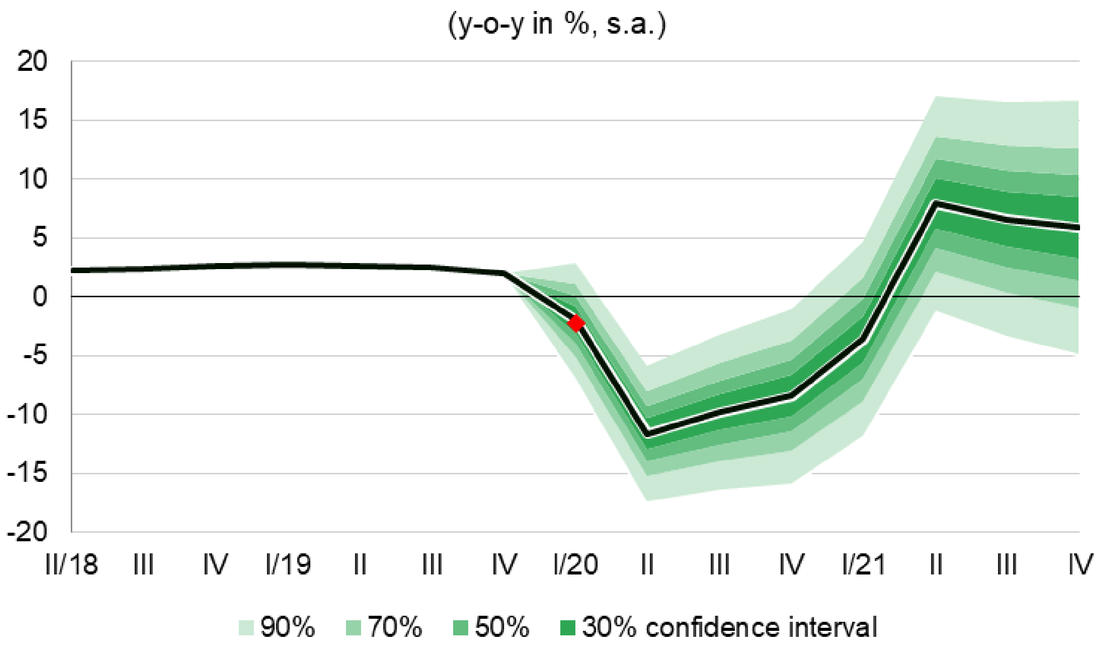
Headline Inflation Forecast



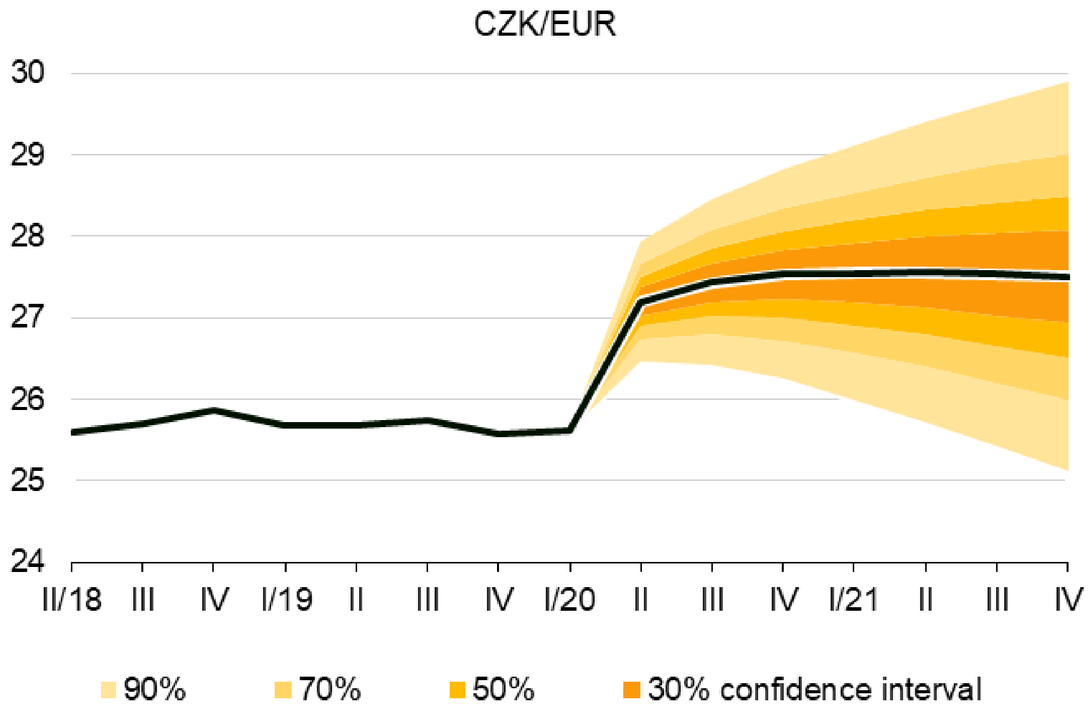
- **Headline inflation will drop sharply** back into the tolerance band, dragged by the overall anti-inflationary effects of the pandemic. It will remain close to the target next year on the back of markedly easy monetary conditions.
- **Core inflation will decelerate** following the easing of domestic price pressures and in line with the gradually deteriorating situation on the labor market.
- **Food price inflation will remain high** this year given limited supply and higher production costs.
- In response to the world oil price collapse, domestic **fuel prices** will fall sharply and the high growth in **regulated prices** will slow further.
- In April 2020, inflation reached 3.2% y-o-y, 0.2 pp above the CNB's current forecast.

Real GDP Forecast



- The Czech economy **has been hit hard by the quarantine measures** and GDP will **fall by 8%** this year.
- **All expenditure components except government consumption** will contribute to the fall in GDP.
- The loosening of government restrictive measures will revive **economic activity**, but it will **not reach the 2019 level** even by the end of next year.
- **Real GDP fell by 2.2% y-o-y in 2020 Q1** (current CNB forecast 2%), but **the easing of restrictive measures is faster** than assumed in the baseline scenario.

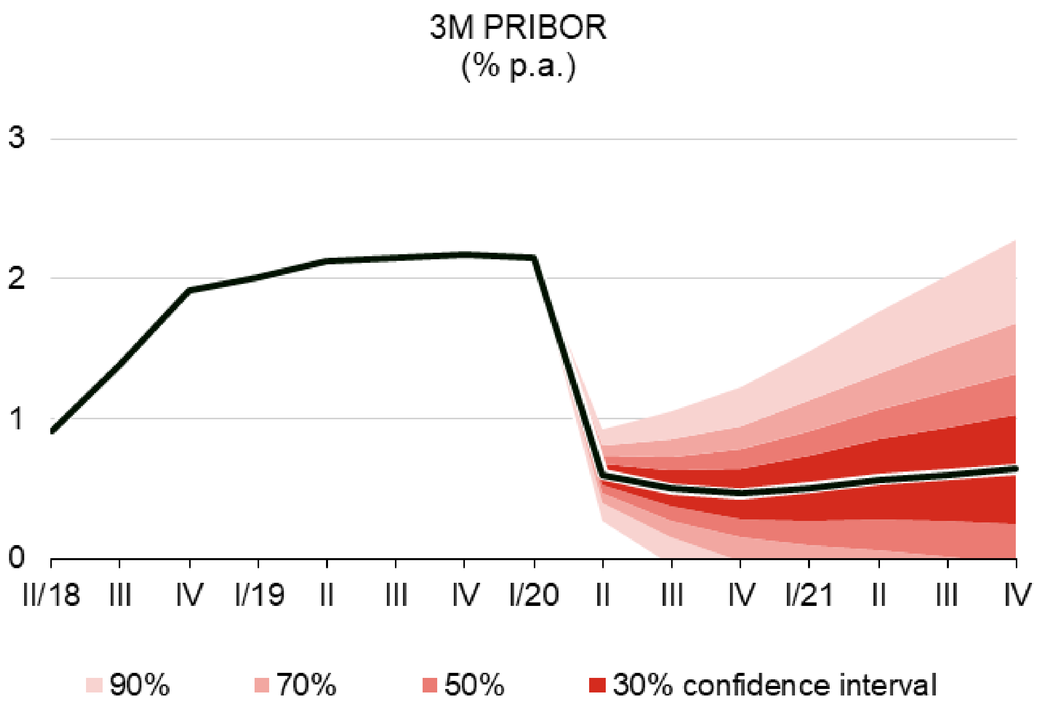
Koruna Forecast



- The koruna will **remain close to its current weakened values**, mainly due to unfavorable economic developments at home and abroad. A significant reduction in the positive interest rate differential vis-à-vis the euro area will also affect the exchange rate of the koruna.

- The forecast assumes 27.2 CZK/EUR in 2020 Q2.

Interest Rate Forecast



- After a sharp reduction in in March, **a further decline domestic market interest rates in 2020 Q2, followed by approximate stability, is consistent with the current forecast**.

- **The Board reduced the 2W repo rate more than suggested by the baseline scenario**, assessing the risks to the forecast as unprecedentedly high and **requiring even stronger easing of monetary conditions**.

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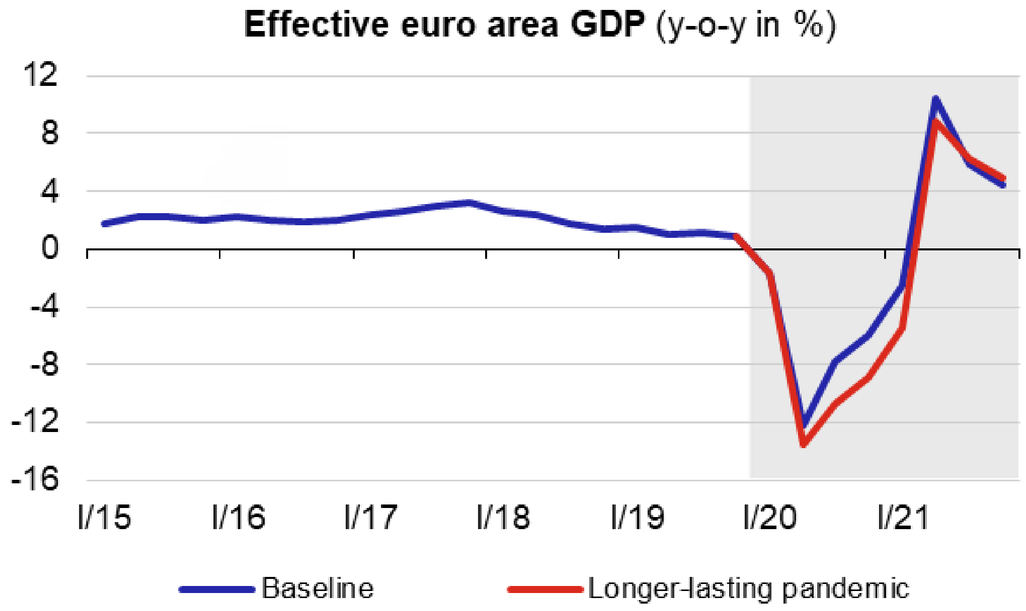
Forecast Risks and Uncertainty

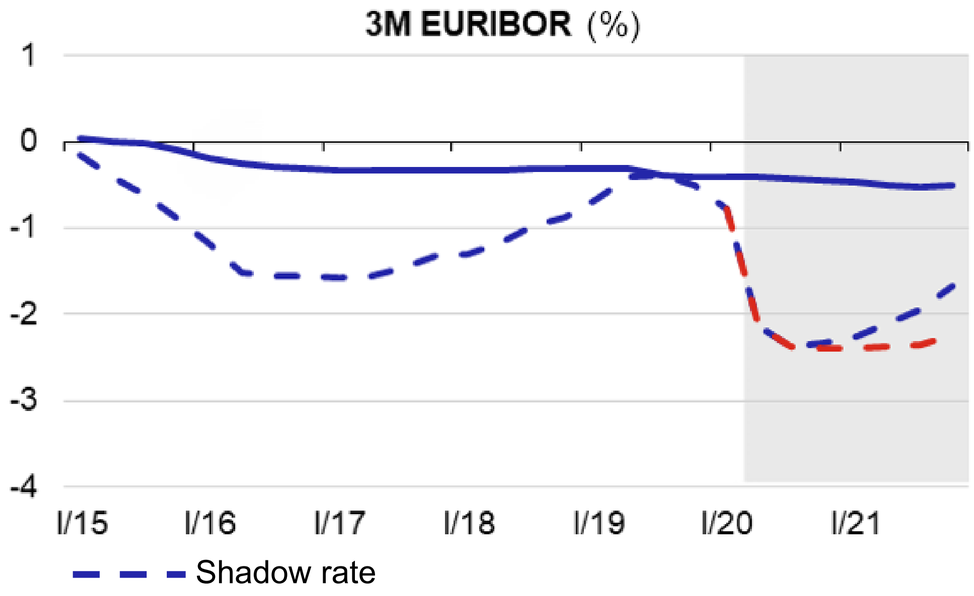
- **The extraordinary risks of the forecast** with regard to the pandemic are described in two alternative scenarios:
  - **Longer-lasting pandemic scenario**
  - **Pandemic resurgence scenario**

Longer-lasting pandemic

Foreign economy

- Government measures extended by 2 to 3 weeks.
- The slower return of economic activity to growth and deteriorating corporate sentiment and consumer confidence imply lower inflationary pressures in the effective euro area. Consequently, there is a need to keep monetary policy looser for longer.

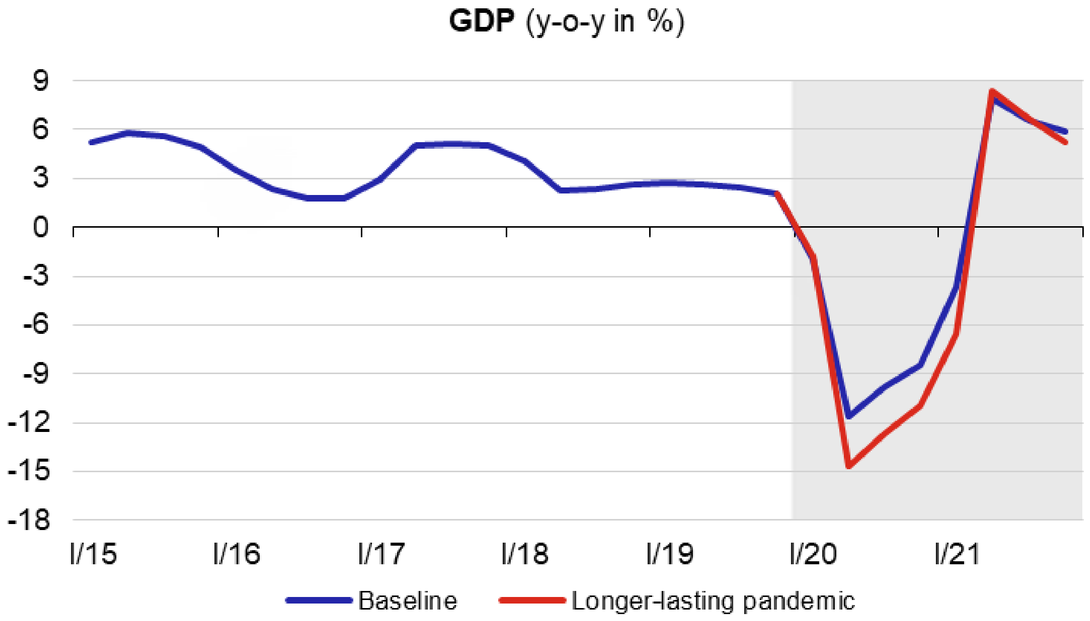


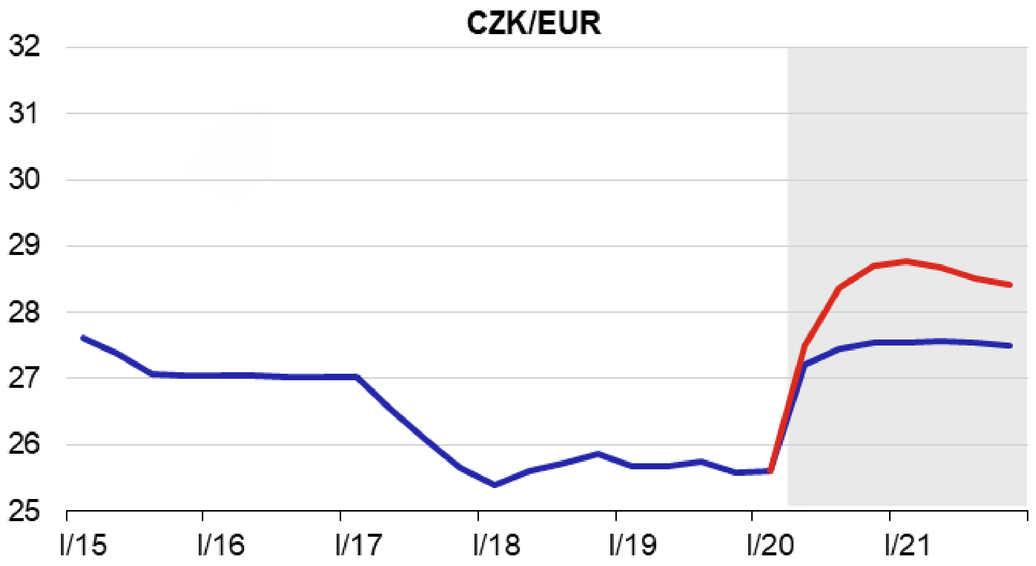


Longer-lasting pandemic

Domestic economy

- Compared to the baseline scenario, the pandemic **measures are lifted a month later** (tourism limited until the end of August), which further worsens the sentiment of households and companies.
- The scenario implies a **sharper decline in domestic economic activity, a worsening of the labor market** (higher unemployment and lower wage growth), and **a weaker koruna** (a result of the common market reaction).

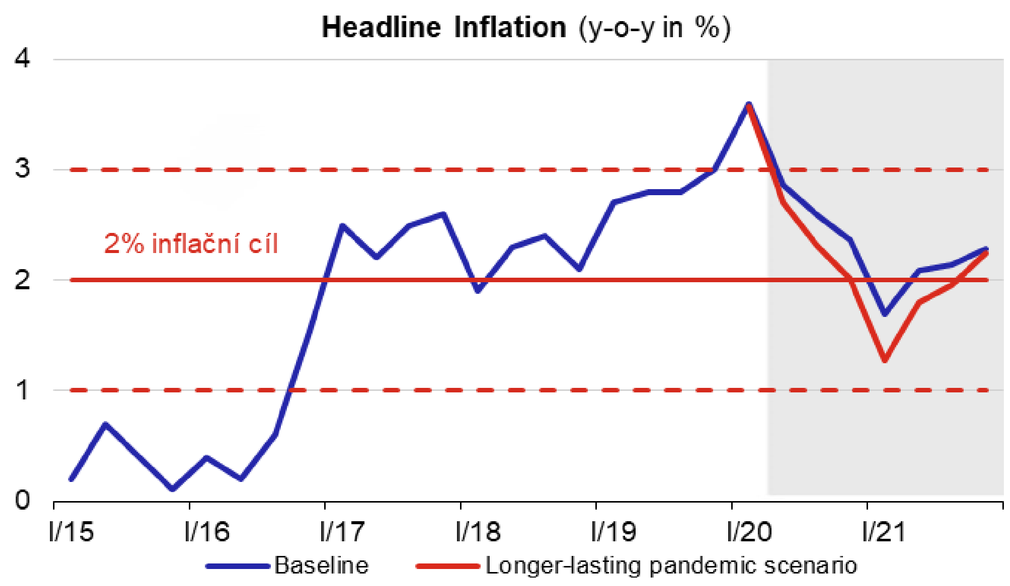


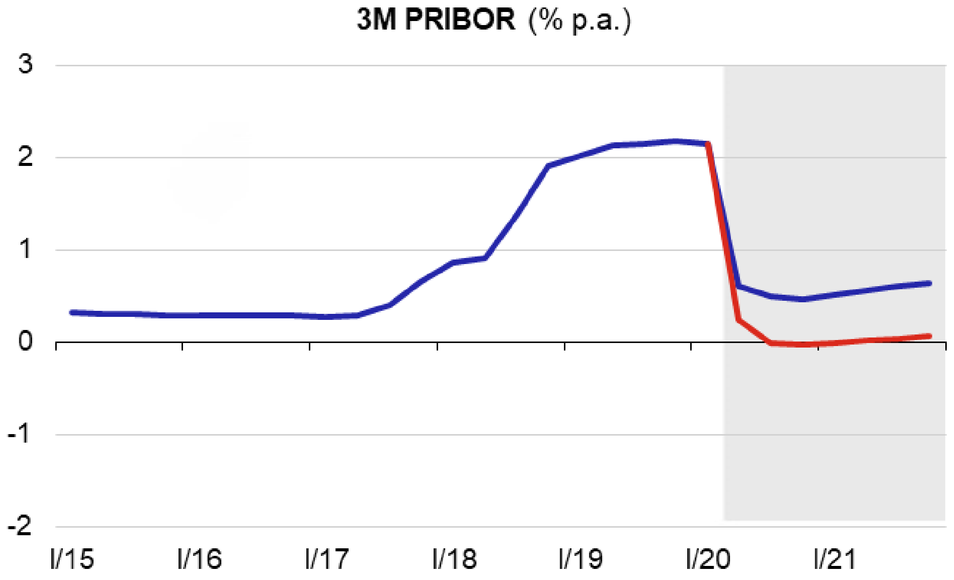


Longer-lasting pandemic

Inflation and Monetary Policy

- The deterioration of the labor market will lead to **lower inflationary pressures** (despite the weaker koruna) and call for a **stronger easing of monetary policy, using all the remaining space in nominal interest rates**.
- The measures are currently being lifted faster, but the depth of the negative effects (on sentiment, balance sheets, loans, etc.) is uncertain.



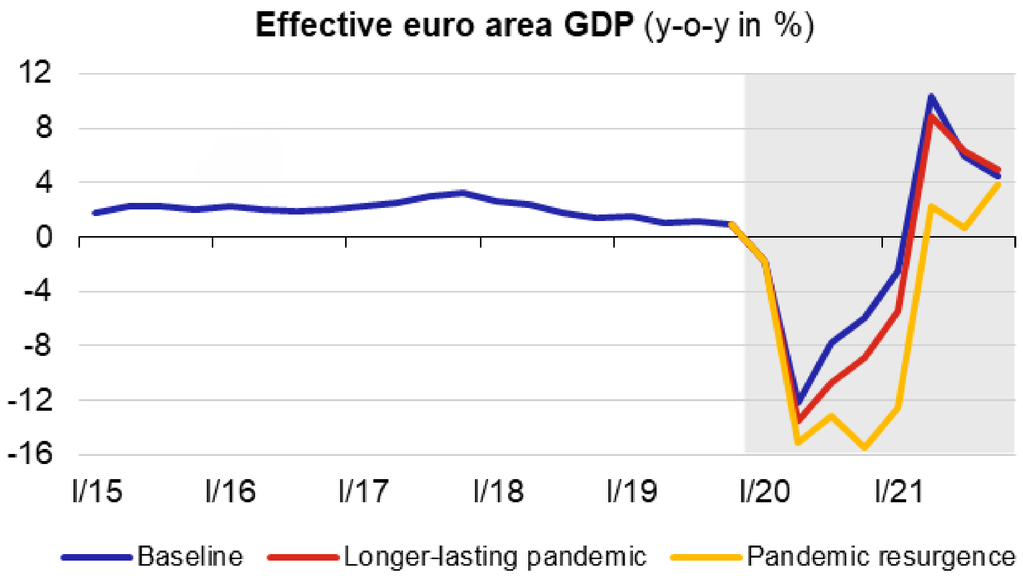


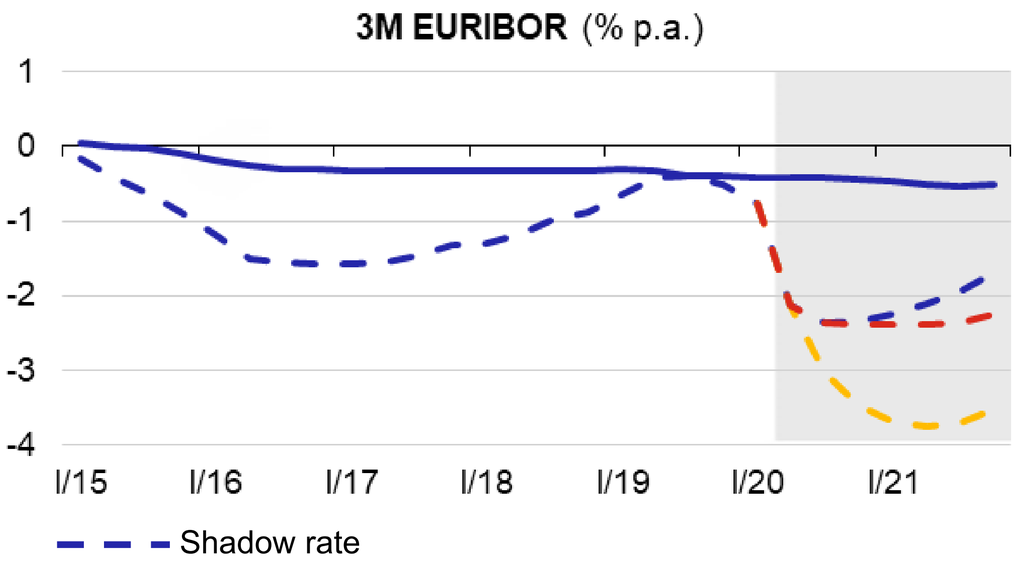
Pandemic resurgence

The same assumptions as the previous scenario **plus a resurgence of the pandemic at the end of this year.**

Foreign economy

- The second wave of the pandemic leads to the **reintroduction of restrictive measures for 2 months starting in October**, albeit on a smaller scale than during the first wave.
- The scenario implies **deglobalization** of the world economy, slower real GDP growth, and faster price growth.

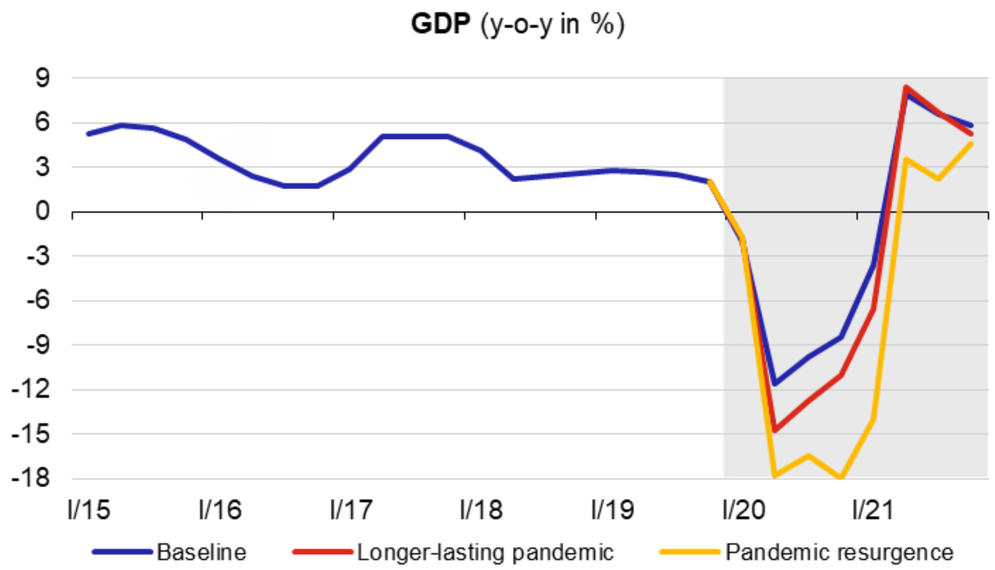


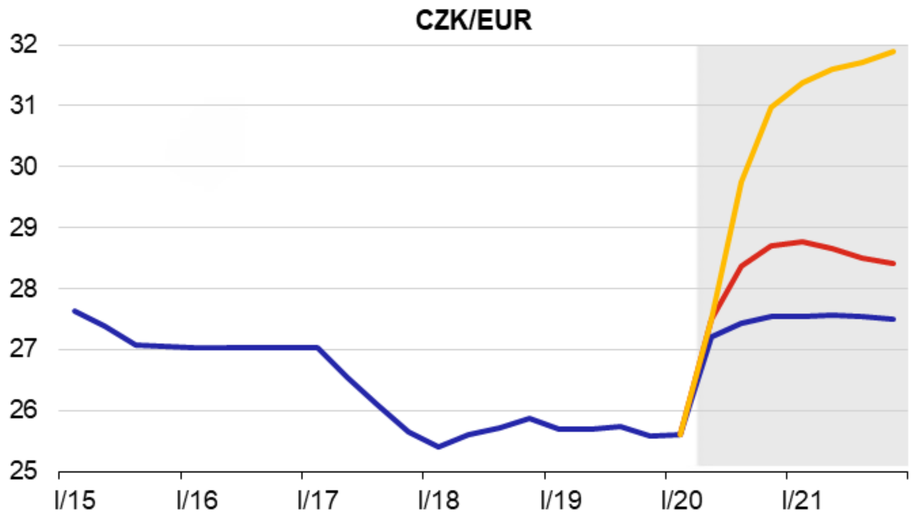


Pandemic resurgence

Domestic economy

- Resumption of government quarantine measures from October to the end of this year, albeit to a lesser extent due to higher preparedness.
- A significant **drop in economic activity, a worsening of the labor market, and a weaker koruna** compared to the baseline and the previous alternative scenario (again, this is a spontaneous market reaction without CNB intervention; negative domestic rates also play a role - only hypothetically!).

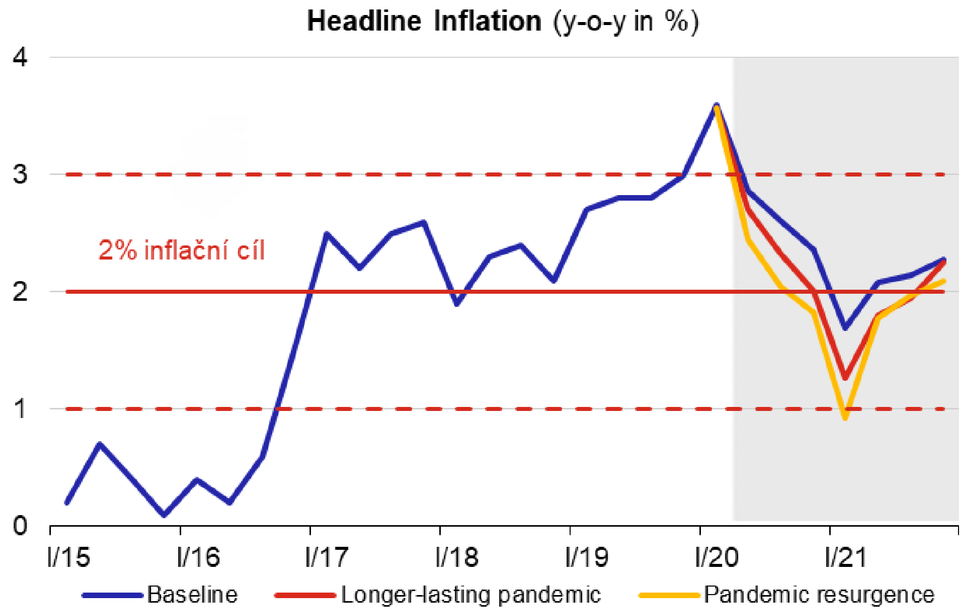


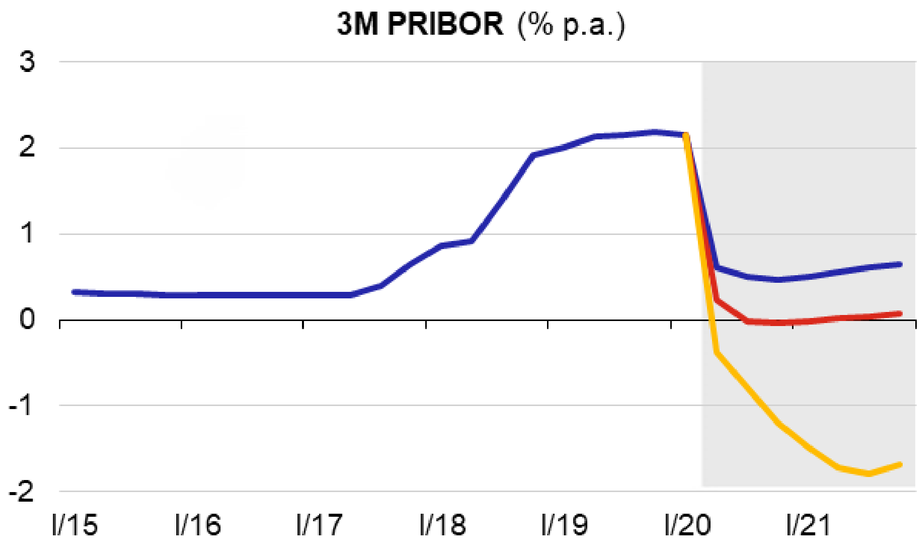


Pandemic resurgence

Inflation and Monetary Policy

- Low demand is mirrored in inflation falling to the lower bound of the tolerance band (despite the monetary policy response).
- A need for a **significant easing of monetary policy**, which cannot be achieved using interest rates.
- The scenario implies **a need for unconventional tools**. **Any debate on unconventional tools is only hypothetical** at this moment, reflecting the "precautionary principle." **The Board has not yet discussed the preferred order of potential unconventional tools.**





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Thank you for your attention

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