



CNB's New Forecast (Inflation Report III/2010)

Meeting with Analysts

Tomáš Holub

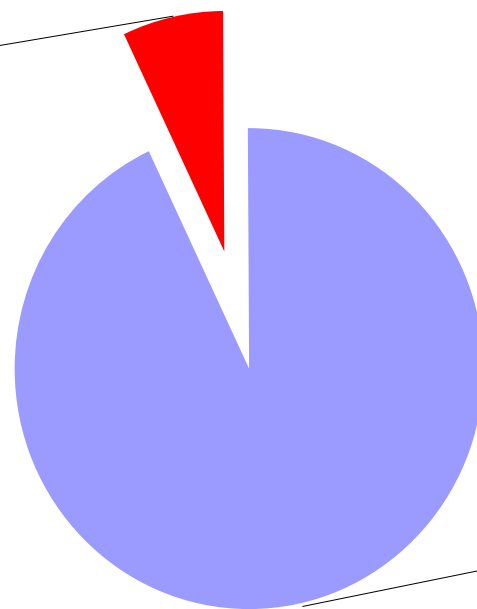
Prague, August 13, 2010

New Form of Inflation Report (i)

- Situation Report and Inflation Report were traditionally prepared as two separate documents.
- Now these documents have been merged into one, with the Inflation Report being a subset of the Situation Report.
- This change increases transparency of monetary policy by:
 - Providing much more information on the forecast
 - Publishing sensitivity scenarios
 - Providing explicit comparison with the previous forecast, etc.

New Form of Inflation Report (ii)

**Situational
report -
internal
part; 7%**



**Inflation
report -
published
part; 93%**

- A dominant part of the Board's information set is now being revealed (almost) immediately.
- The excluded parts are mostly technical, too detailed, etc.
- The full Report will continue to be published after 6 years

New Form of Inflation Report (iii)

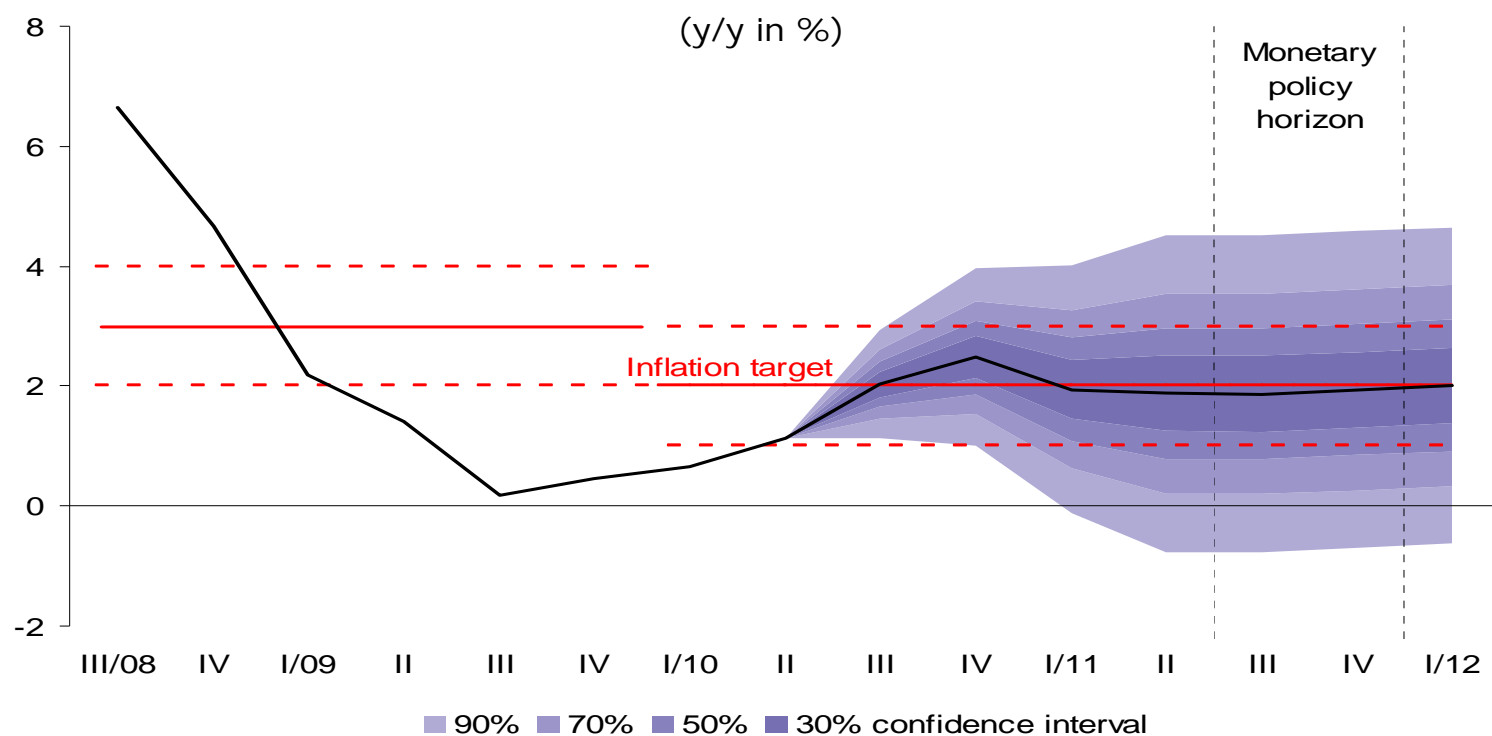
- New ordering of the chapters (top-down approach).
- Broader analytical coverage not just in forward-looking, but also in backward-looking parts.
- Minutes of the Board meeting no longer enclosed to the Inflation Report – available on the website.
- Statistical annex eliminated (except the Key Macroeconomic Indicators) – data available in ARAD, e.g.

http://www.cnb.cz/cnb/STAT.ARADY_PKG.STROM_SESTAVY?p_strid=GB&p_sestuid=&p_lang=EN.

Summary of the Inflation Forecast

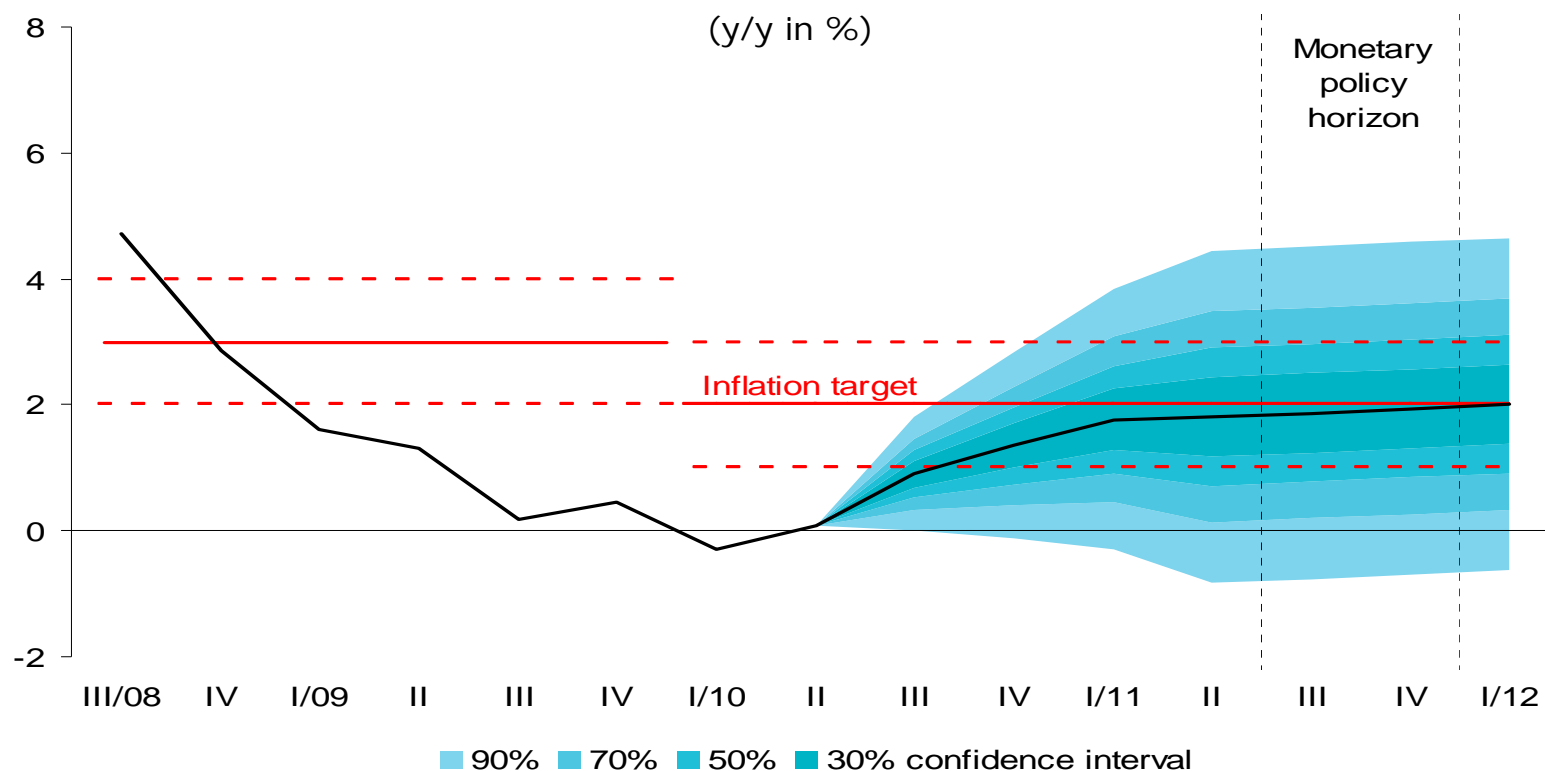
- Inflation will slightly exceed the 2% target in late 2010 due to past tax changes, but will return back to target on the MP horizon.
- Net inflation will turn positive and gradually speed up towards 2% at the end of 2012, growth in regulated prices will remain moderate.
- Growth in EA interest rates will be very gradual. Foreign demand growth will be modest, but the 'W-shape' almost fades away.
- Some inflationary pressures will start to emerge in the domestic economy in 2011-2012. The anti-inflationary effect of import prices will resume due to CZK appreciation.
- Profit mark-ups are depressed and will gradually increase in the future.
- GDP will grow by 1.6% in 2010, 1.8% in 2011 and 2.9% in 2012 (but fiscal consolidation is not included in the baseline scenario). The labour market improvement is coming faster than expected.

Headline Inflation Forecast



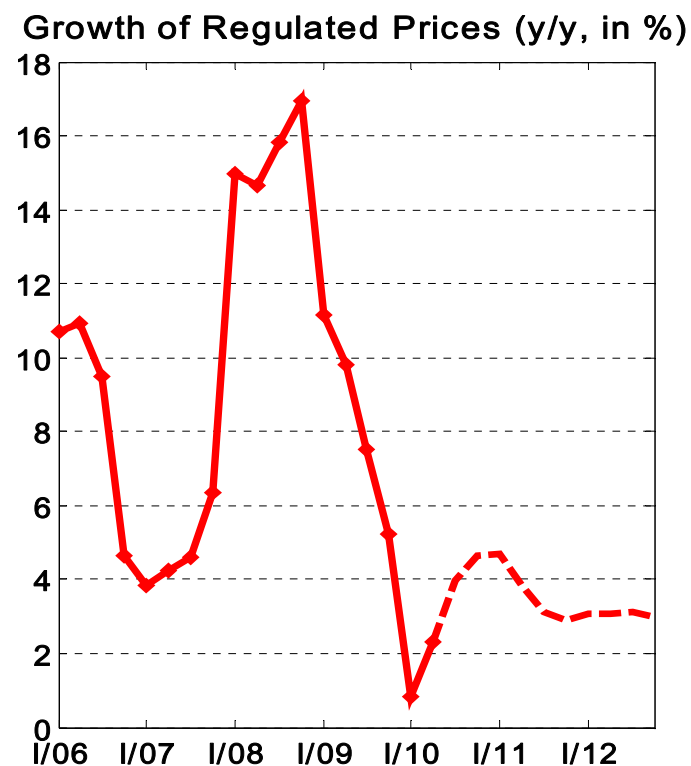
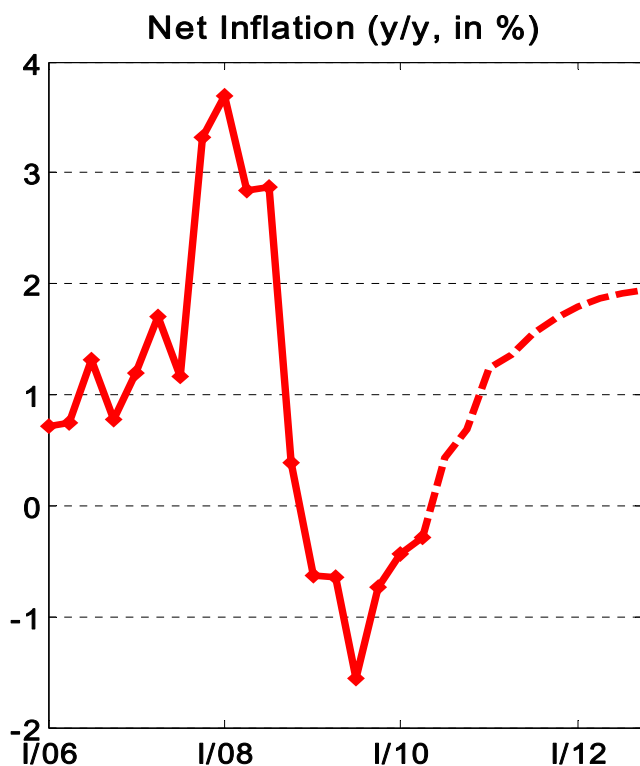
- Forecast slightly above the 2% target in late 2010 (taxes).
- The July 2010 figure (1.9% y/y) was only slightly below the forecast, mainly due to lower regulated prices.

MP-Relevant Inflation Forecast



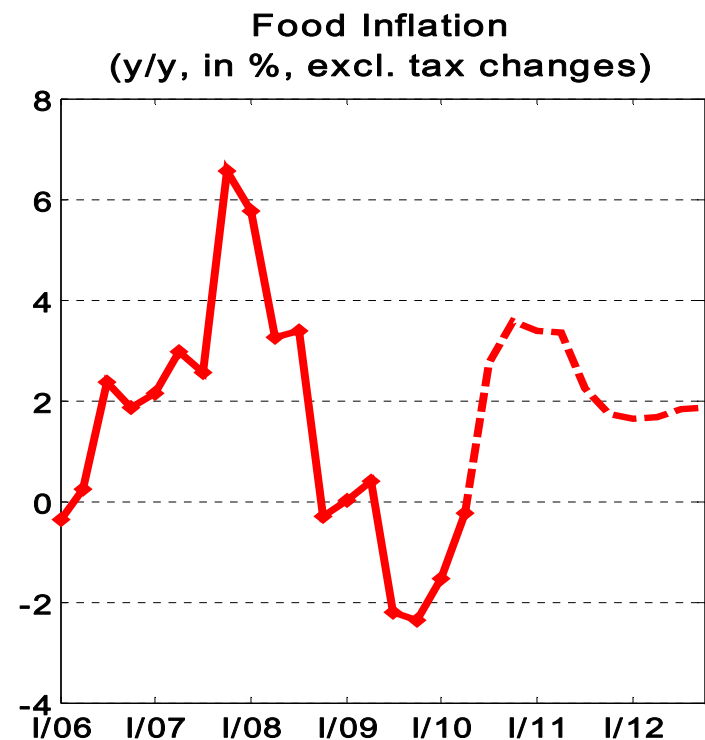
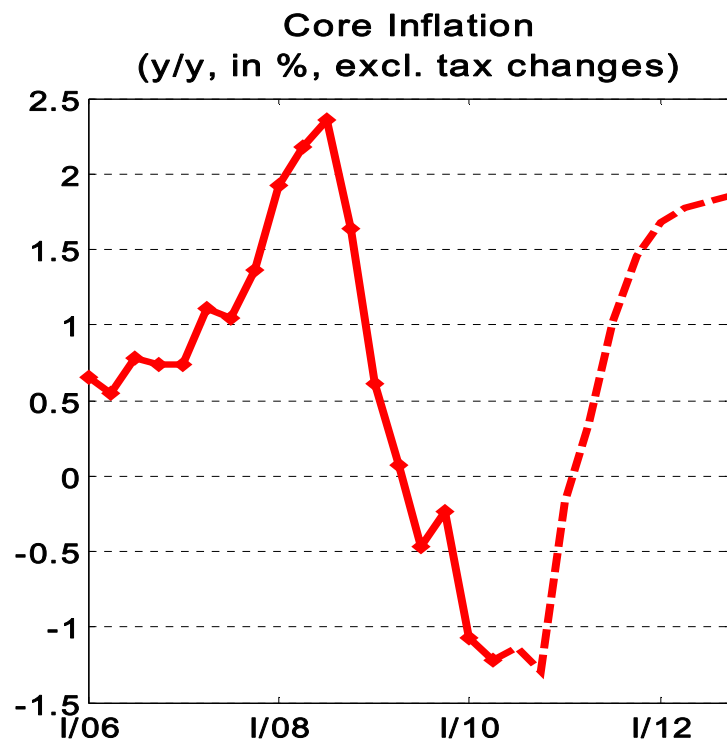
- MP-relevant inflation forecast is temporarily below the headline inflation (due to tax changes in 2010).
- Returning back to the target at the MP horizon.

Net Inflation and Regulated Prices



- Gradual acceleration of net inflation from low levels.
- Growth of regulated prices will speed up but remain relatively moderate.

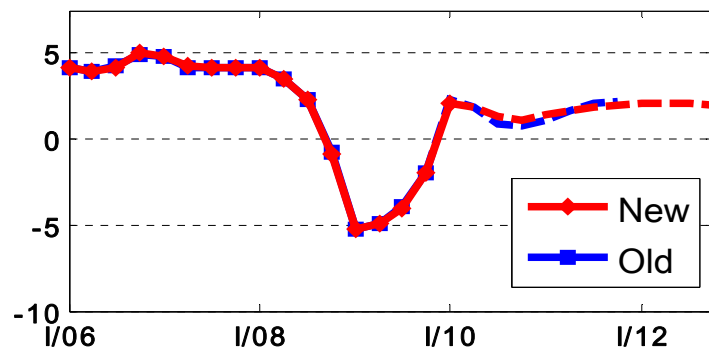
Core Inflation and Food Prices



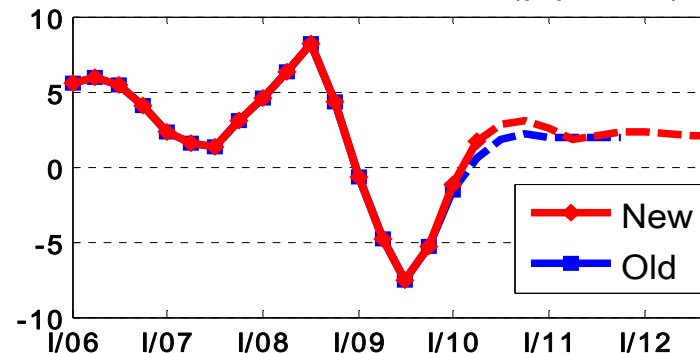
- Increasing core inflation in 2011-2012 together with the economic recovery and accelerating wage growth.
- Higher agricultural prices \Rightarrow food prices.

External Assumptions

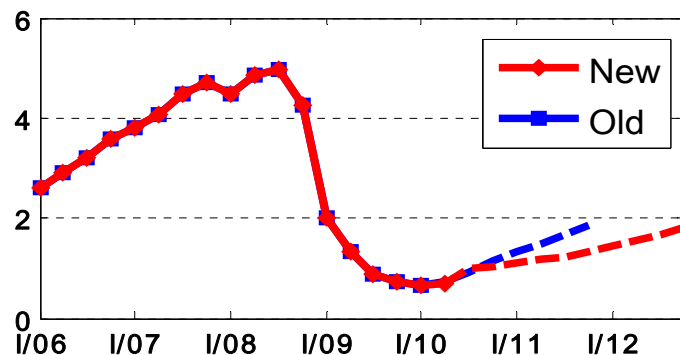
Growth Rate of GDP - Eurozone (y/y, in %)



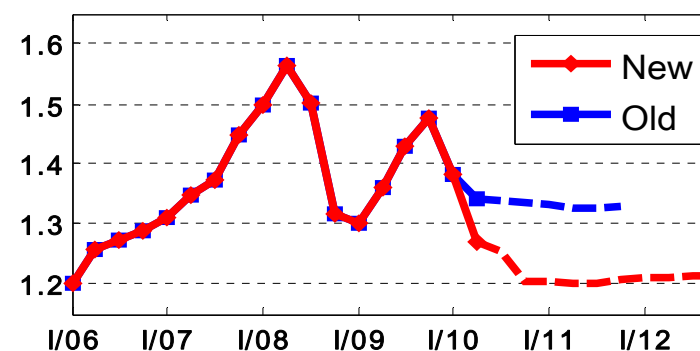
PPI Inflation - Eurozone (y/y, in %)



3M EURIBOR



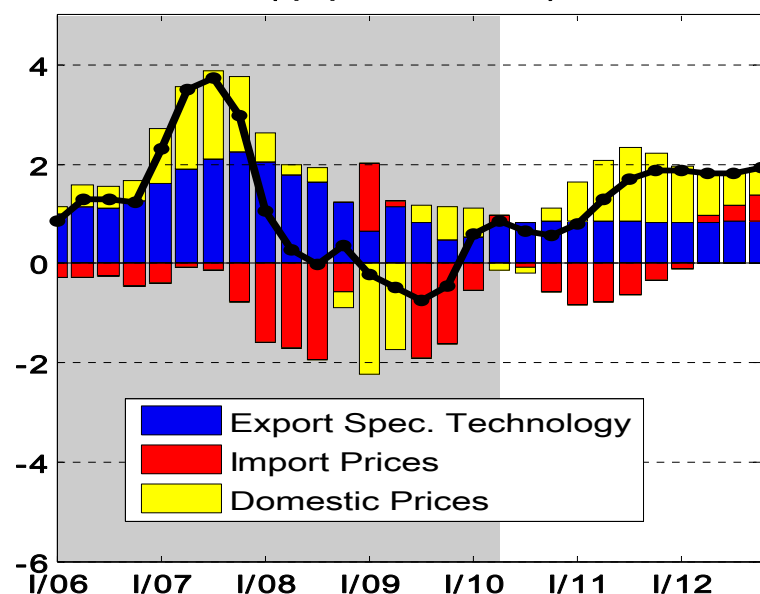
USD/EUR



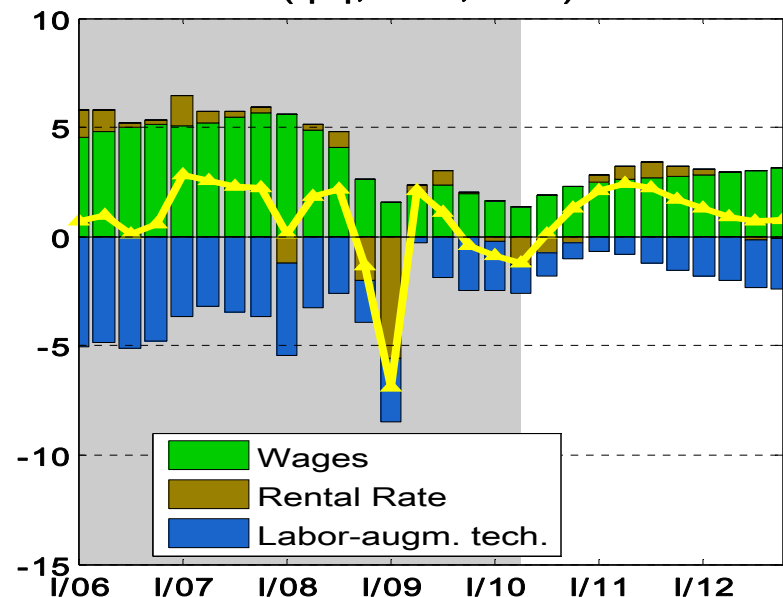
- Growth in EA interest rates will be very gradual.
- GDP outlook improved in the key export markets.

Domestic Costs vs. Import Prices

Nominal Marginal Cost in Consumption Sector
(q/q, in %, ann.)

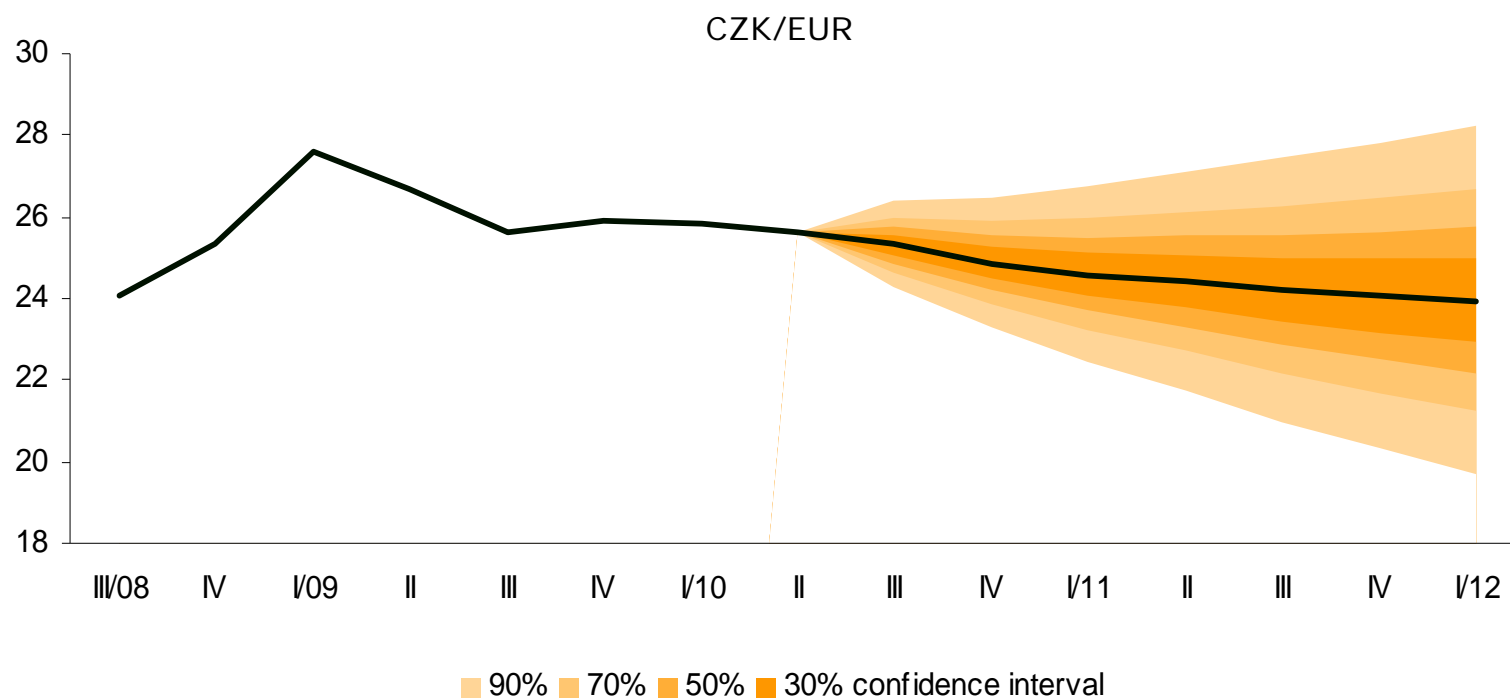


Nominal Marginal Cost in Domestic Sector
(q/q, in %, ann.)



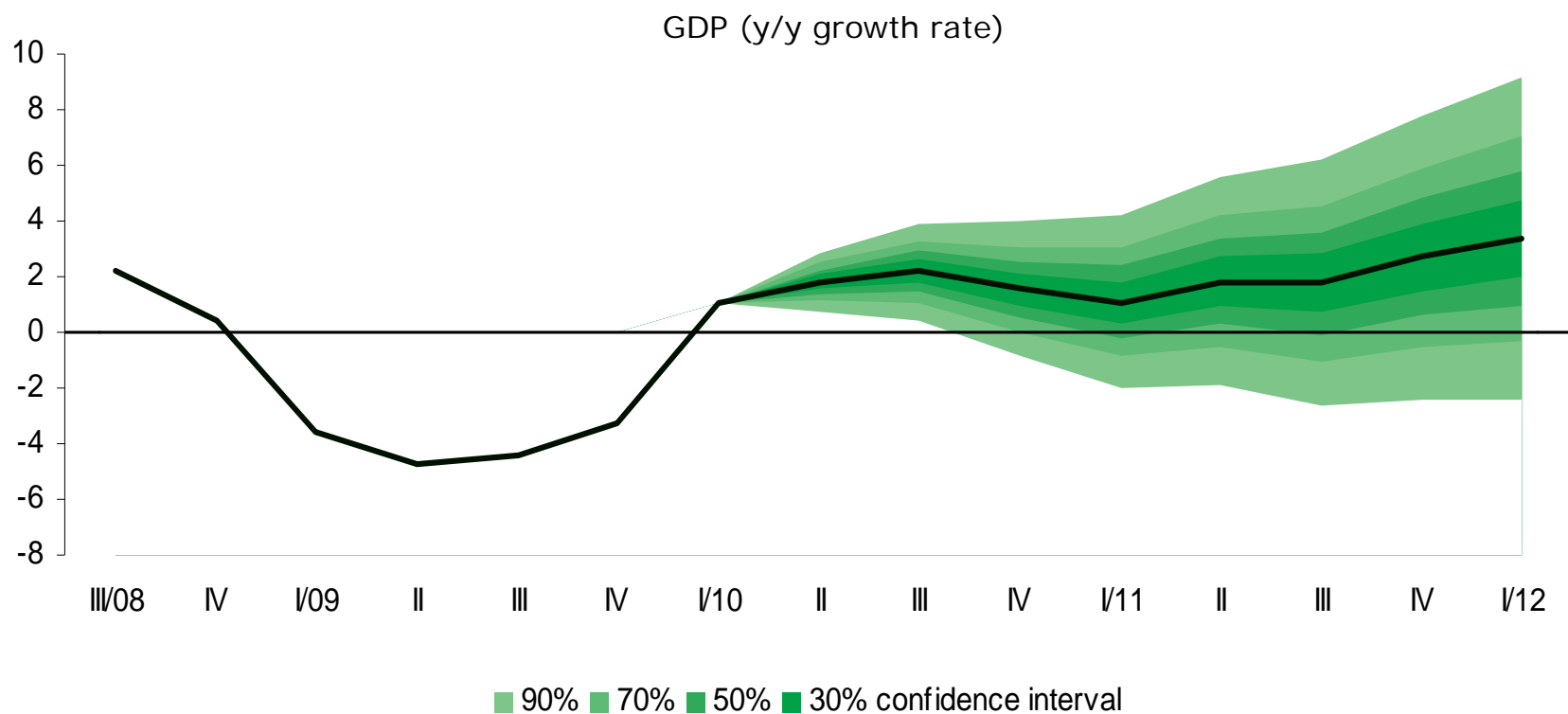
- The effect of falling import prices has stopped temporarily.
- Some domestic cost pressures will emerge in 2011-2012.
- Gradual correction of depressed margins will take place.

Exchange Rate Forecast



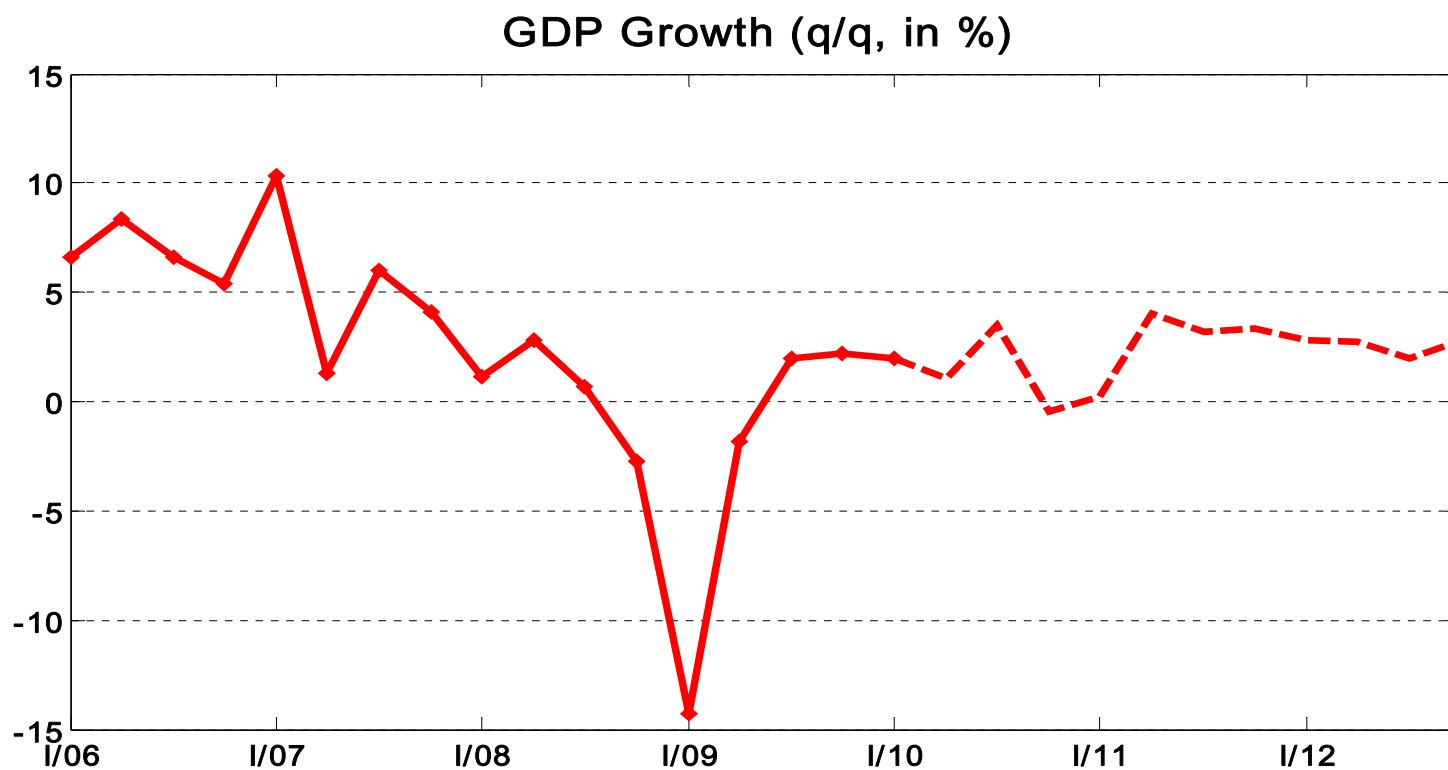
- The nominal exchange rate will be gradually appreciating.
- The appreciation will more than offset the impact of growing foreign prices.

GDP Growth Forecast (i)



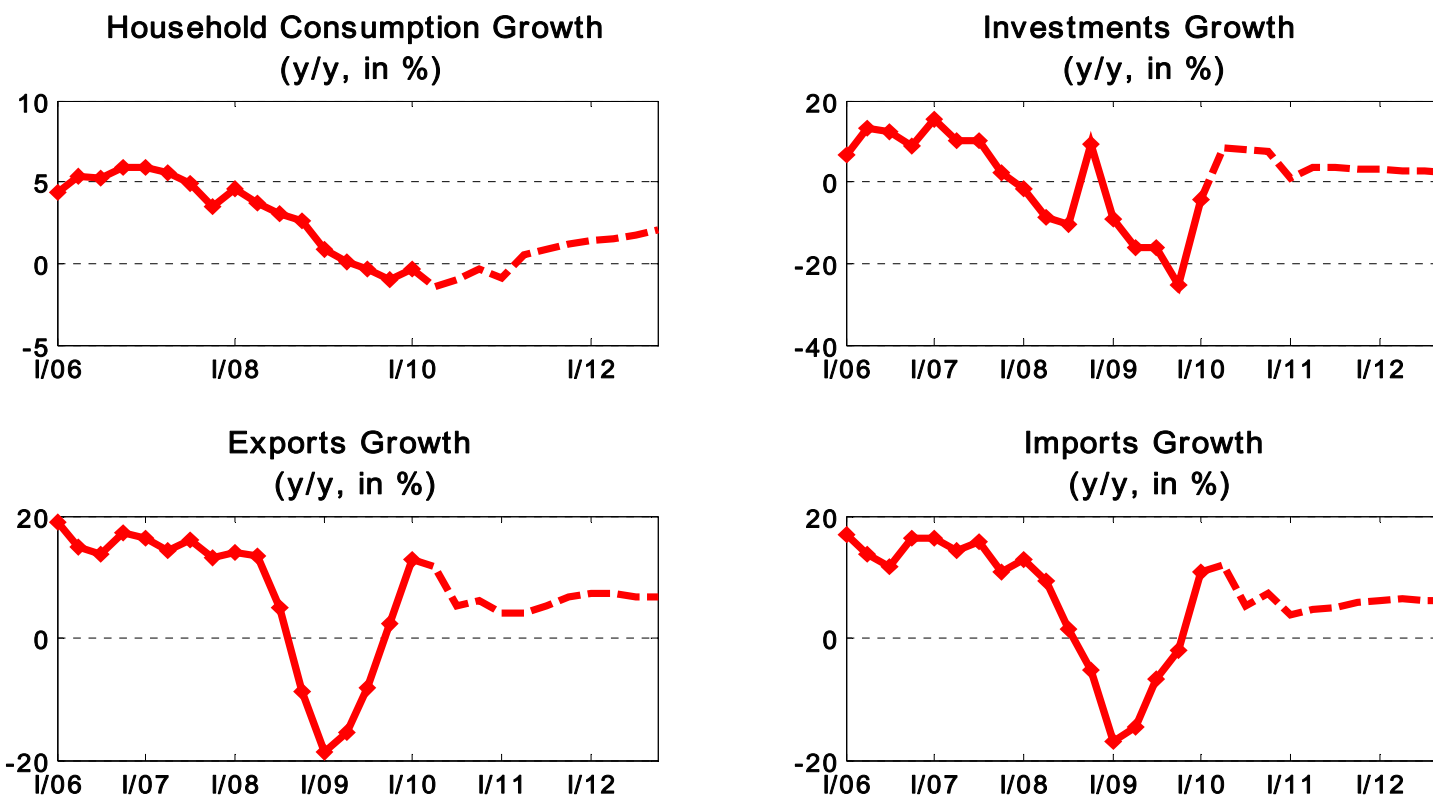
- Y/y GDP growth will be moderate and uneven.
- Averages for 2010: 1.6%; 2011: 1.8%; 2012: 2.9%.

GDP Growth Forecast (ii)



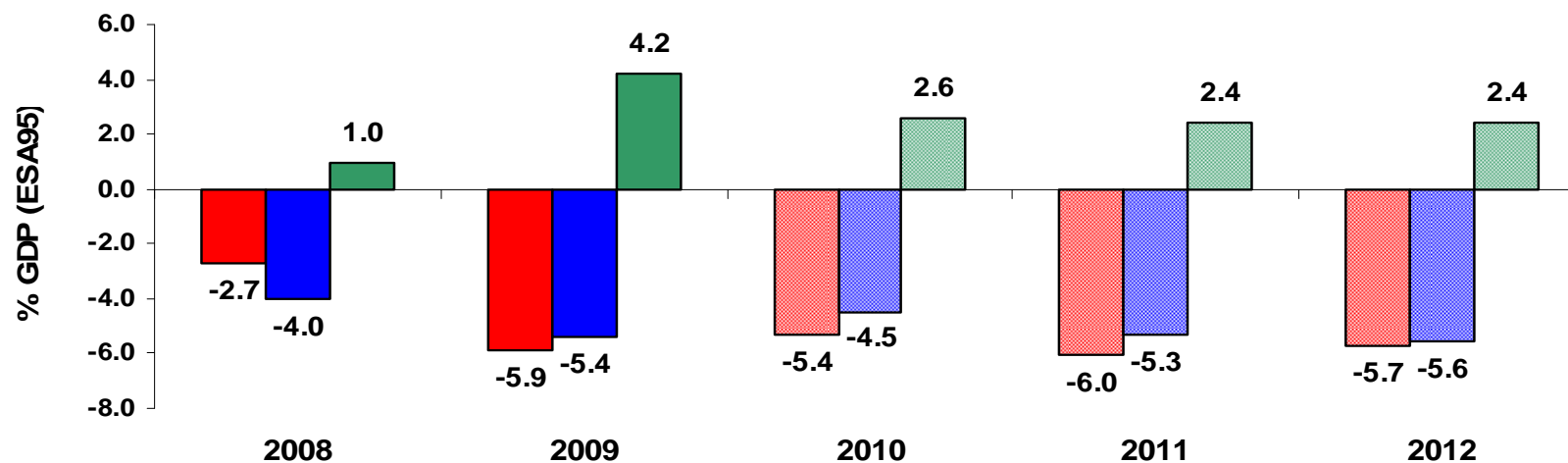
- In q/q terms, the forecast still predicts a temporary stagnation in late 2010 / early 2011.

Forecast of Aggregate Demand



- Growth will be driven by inventories and net exports.
- Household consumption will recover in 2011-2012.

Public Budgets

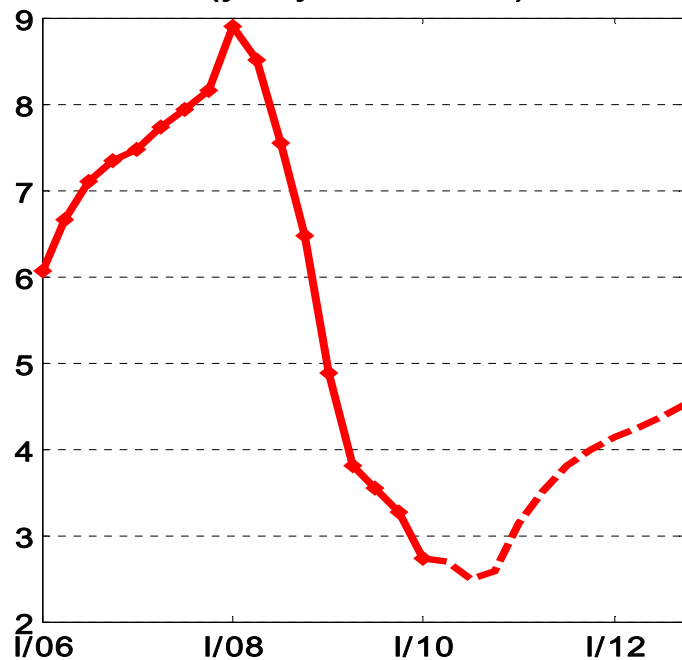


■ Public budget deficit ■ Structural deficit (EC) ■ Real government consumption (y-o-y %)

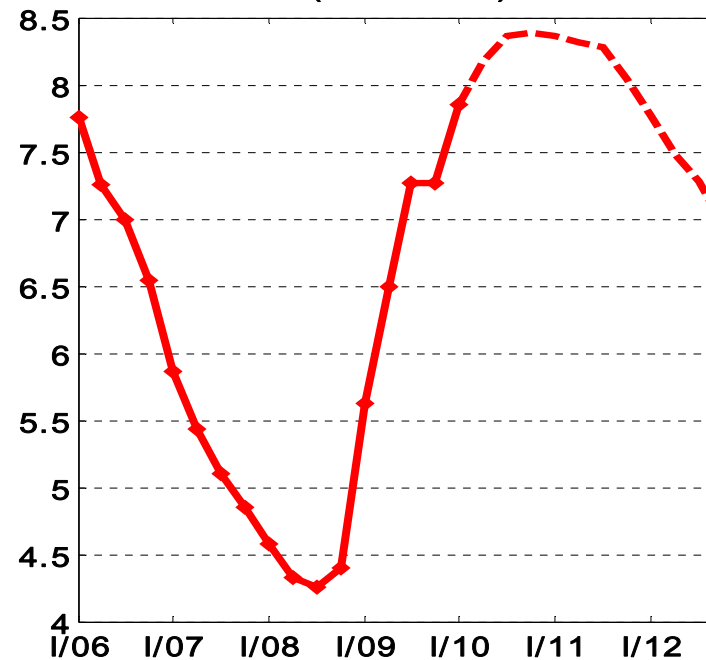
- The baseline scenario is based on the standard no-policy-change assumption.
- The planned consolidation in a sensitivity scenario.

Labour Market Forecast

Nominal wage growth in business sector
(y-o-y, in %, s.a.)

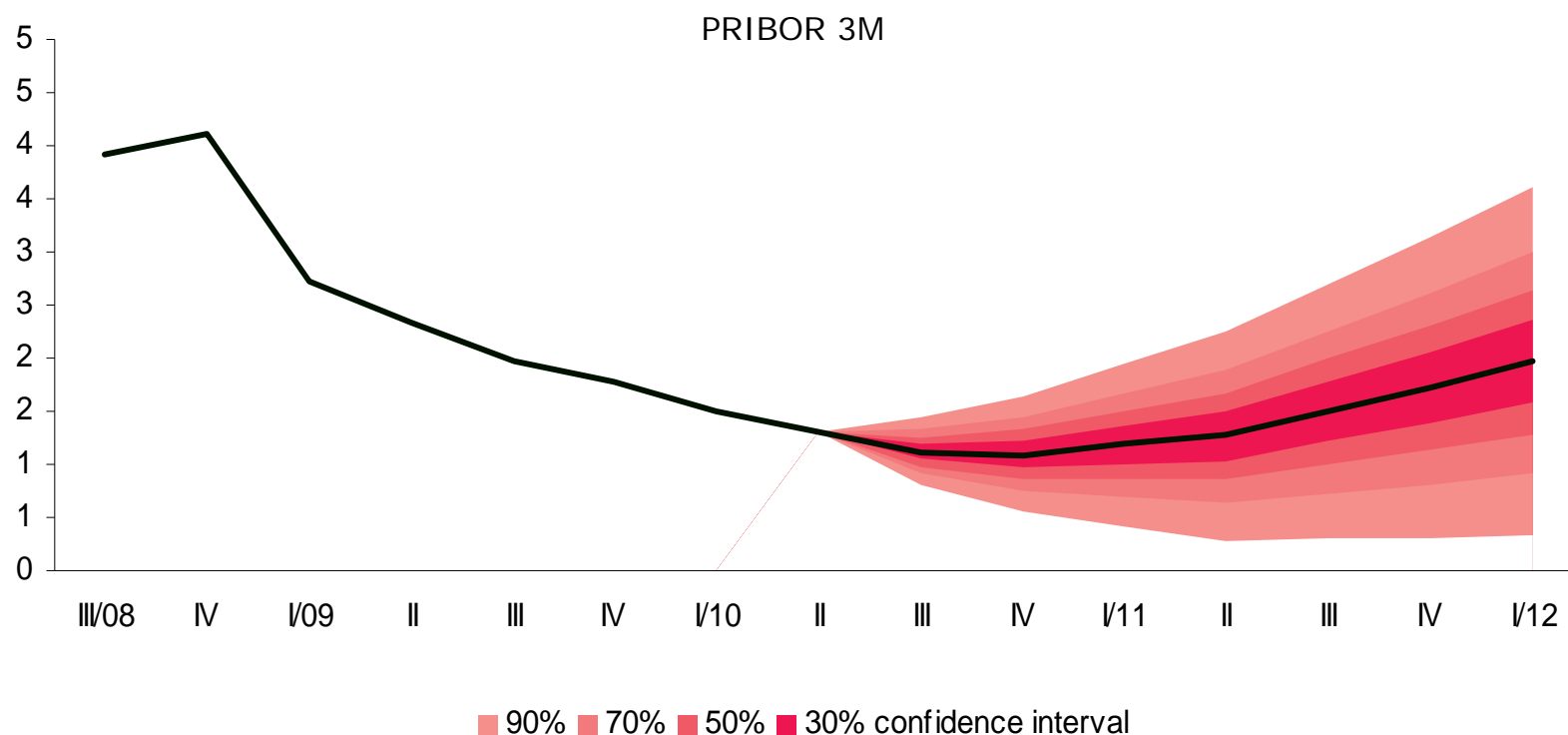


General unemployment rate (ILO)
(in %, s.a.)



- Wage growth will start to pick up pace from 2011.
- The unemployment rate will peak in the coming quarters (2010 Q2 was below the forecast).

Interest Rate Forecast

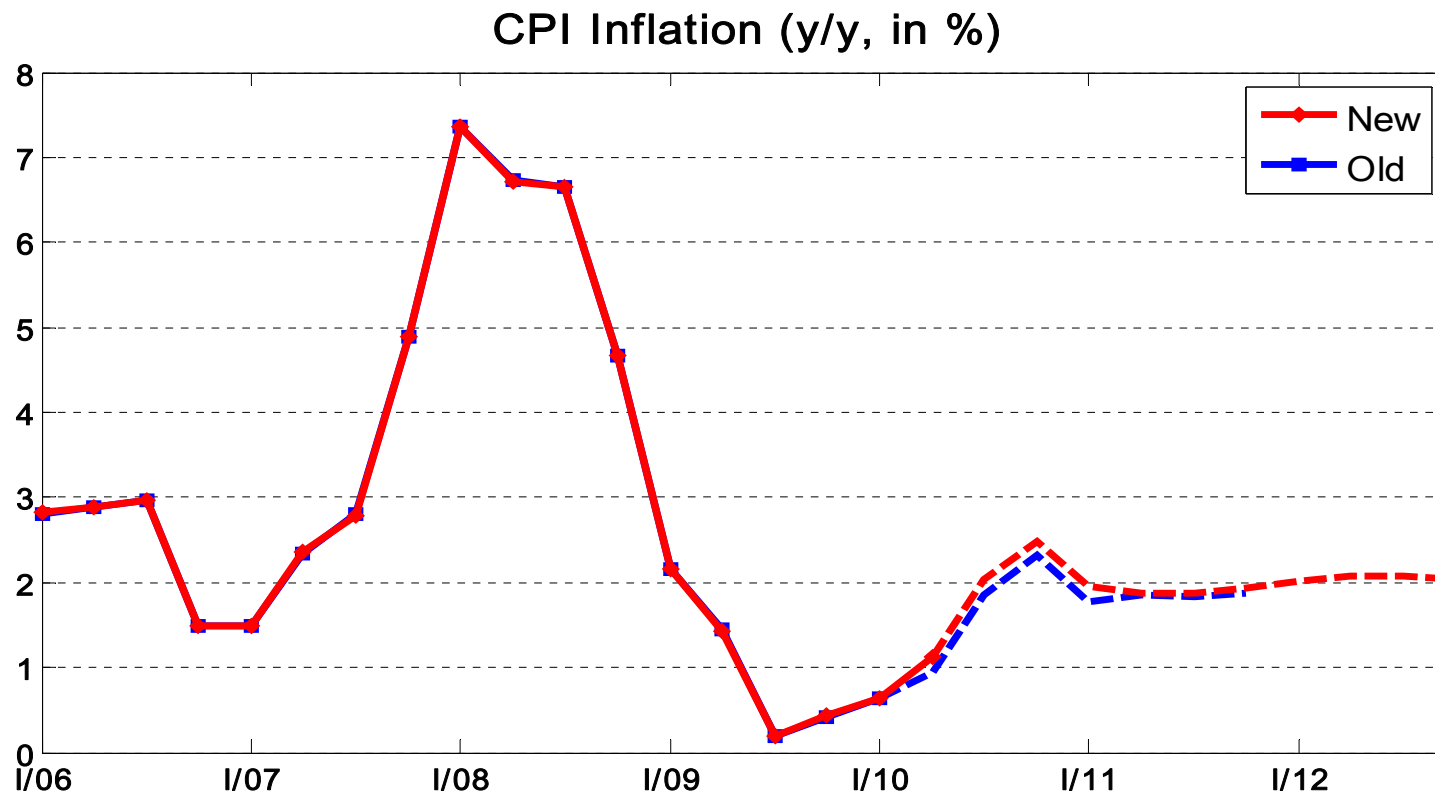


- Consistent with the forecast is stability of market interest rates close to their current levels initially, followed by a gradual rise in rates as from 2011 H2.

Summary of the Comparison with Previous Forecast

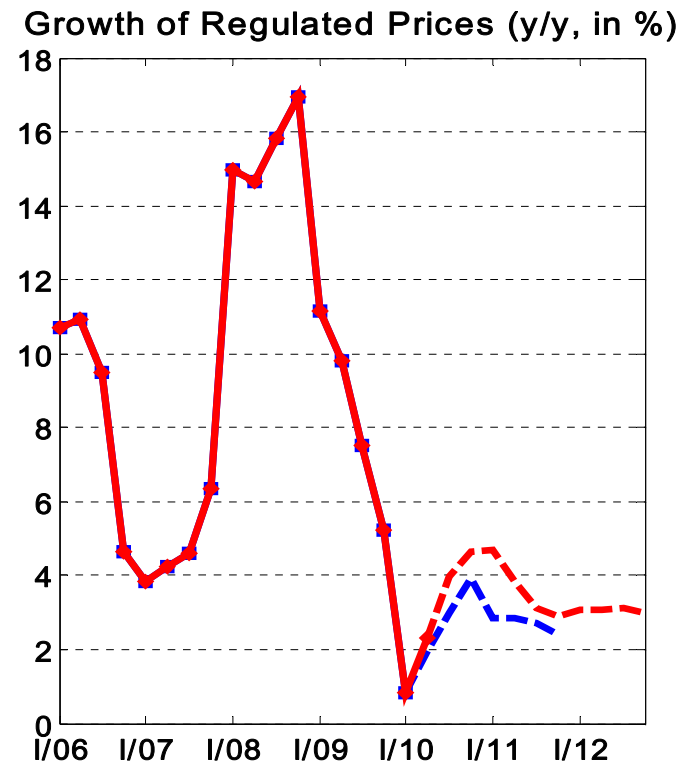
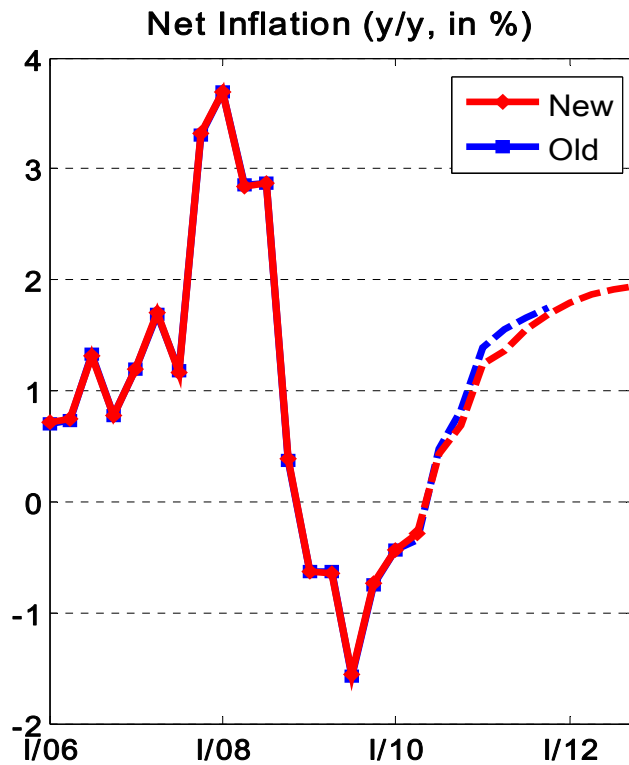
- The overall changes in the inflation and GDP forecasts are small, somewhat bigger differences are in their structure.
- For inflation: lower core inflation vs. higher food prices and regulated price growth.
- For GDP growth: smaller contribution of net exports and higher contribution of domestic demand.
- The expected exchange rate appreciation is faster.
- Lower domestic interest rates in the medium term, mainly due to the lower outlook for rates in the EA.

Comparison with Previous Inflation Forecast (i)



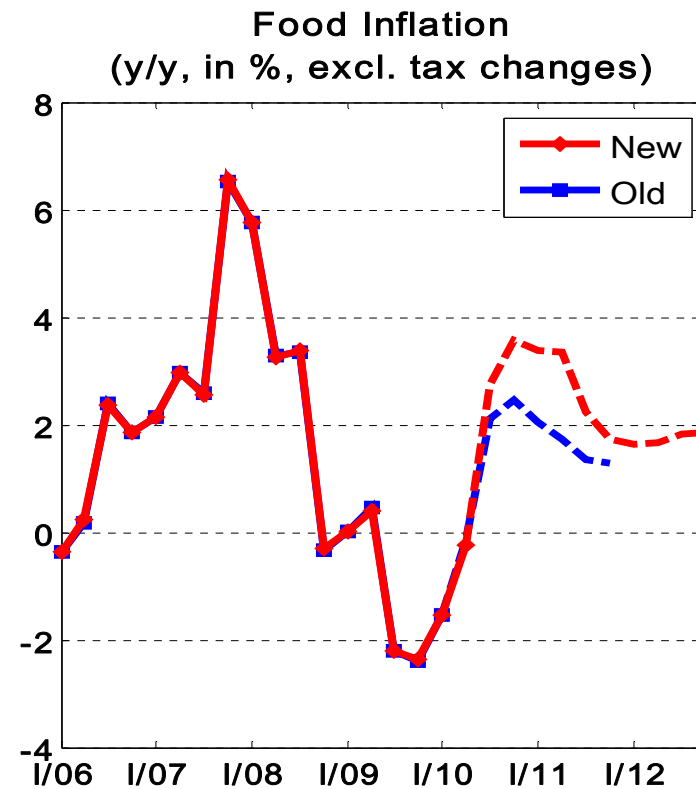
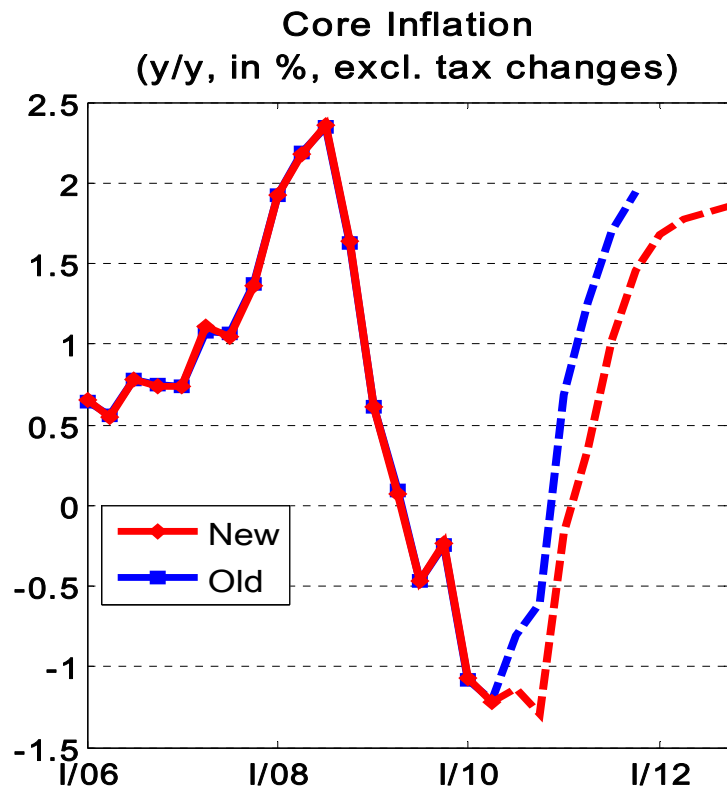
- The forecast has been increased, but only marginally.

Comparison with Previous Inflation Forecast (ii)



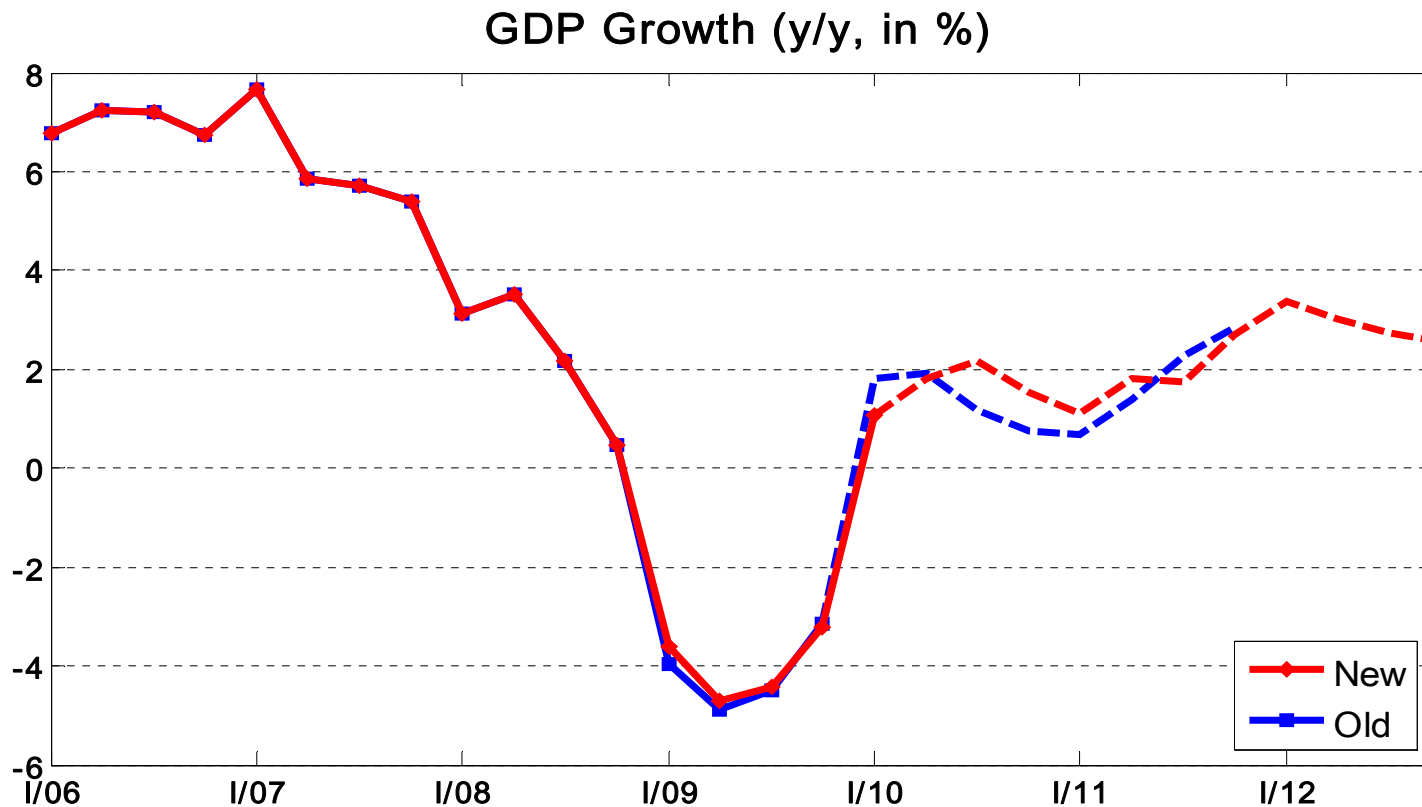
- Very small reduction in net inflation forecast.
- Higher growth of regulated prices due to gas prices.

Comparison with Previous Inflation Forecast (iii)



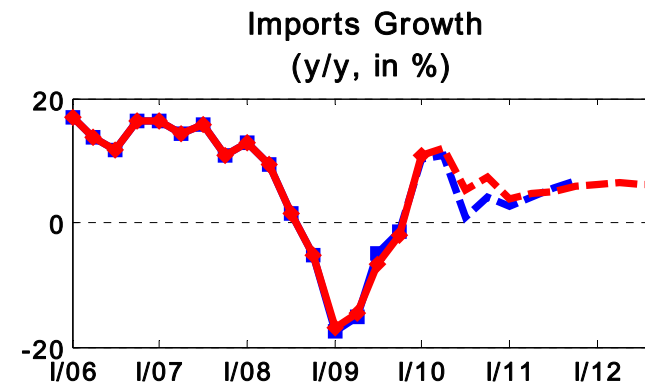
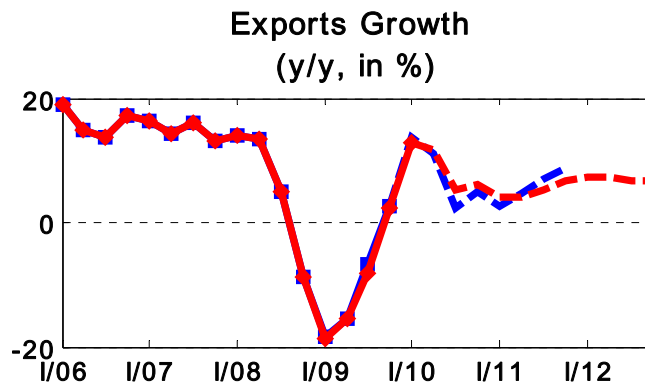
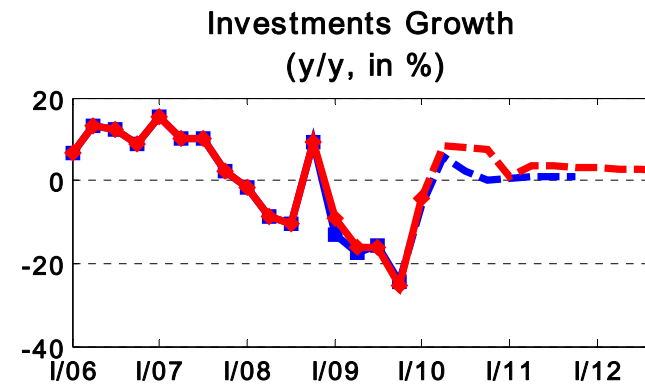
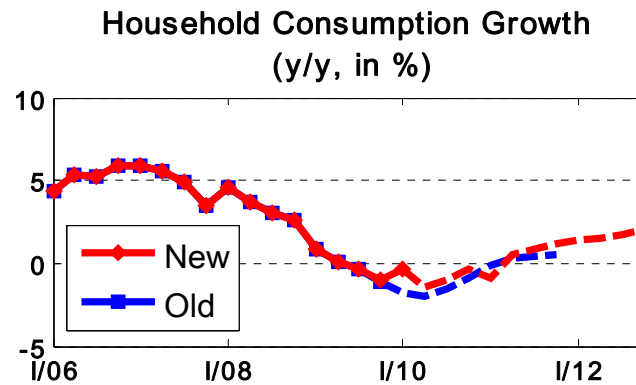
- Lower near-term forecast of core inflation.
- Higher food prices due to higher agricultural prices.

Comparison with Previous GDP Forecast (i)



- The y/y GDP outlook remains broadly similar (but the 'W shape' is less apparent) .

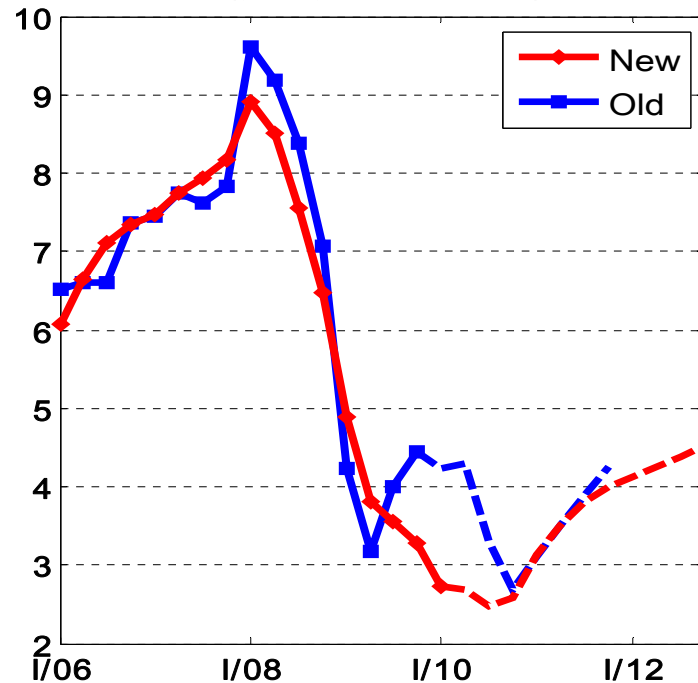
Comparison with Previous Aggregate Demand Forecast



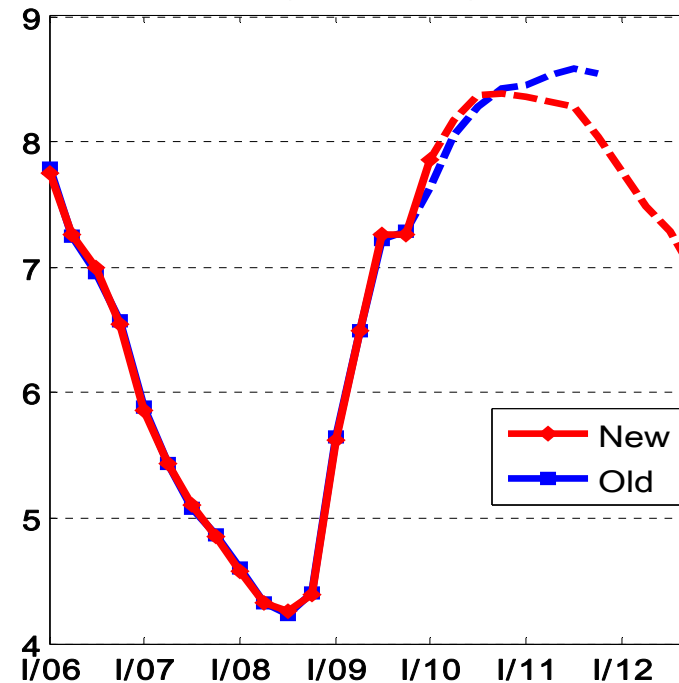
- Faster growth in inventories and smaller decline in households consumption vs. weaker net exports.

Comparison with Previous Labour Market Forecast

Nominal wage growth in business sector
(y-o-y, in %, s.a.)

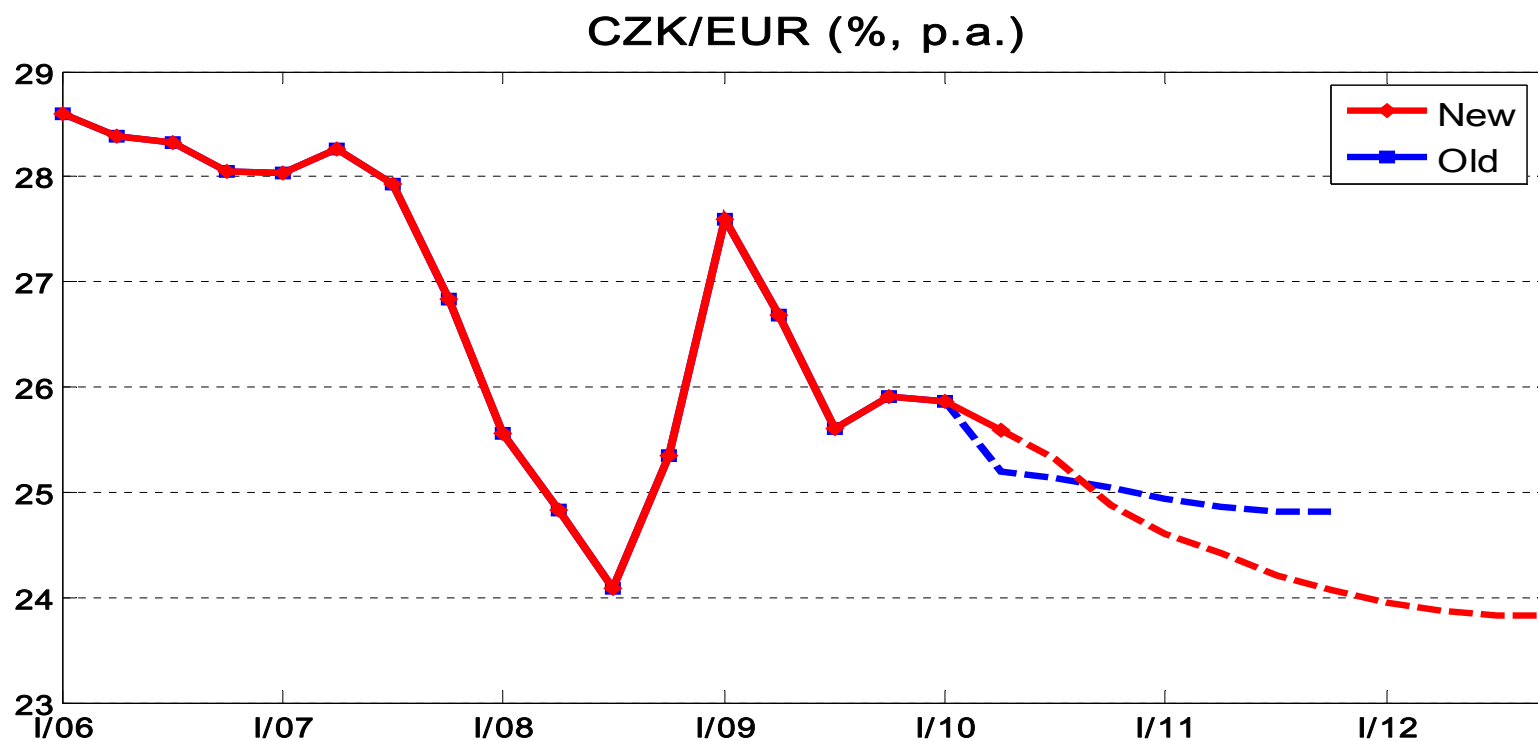


General unemployment rate (ILO)
(in %, s.a.)



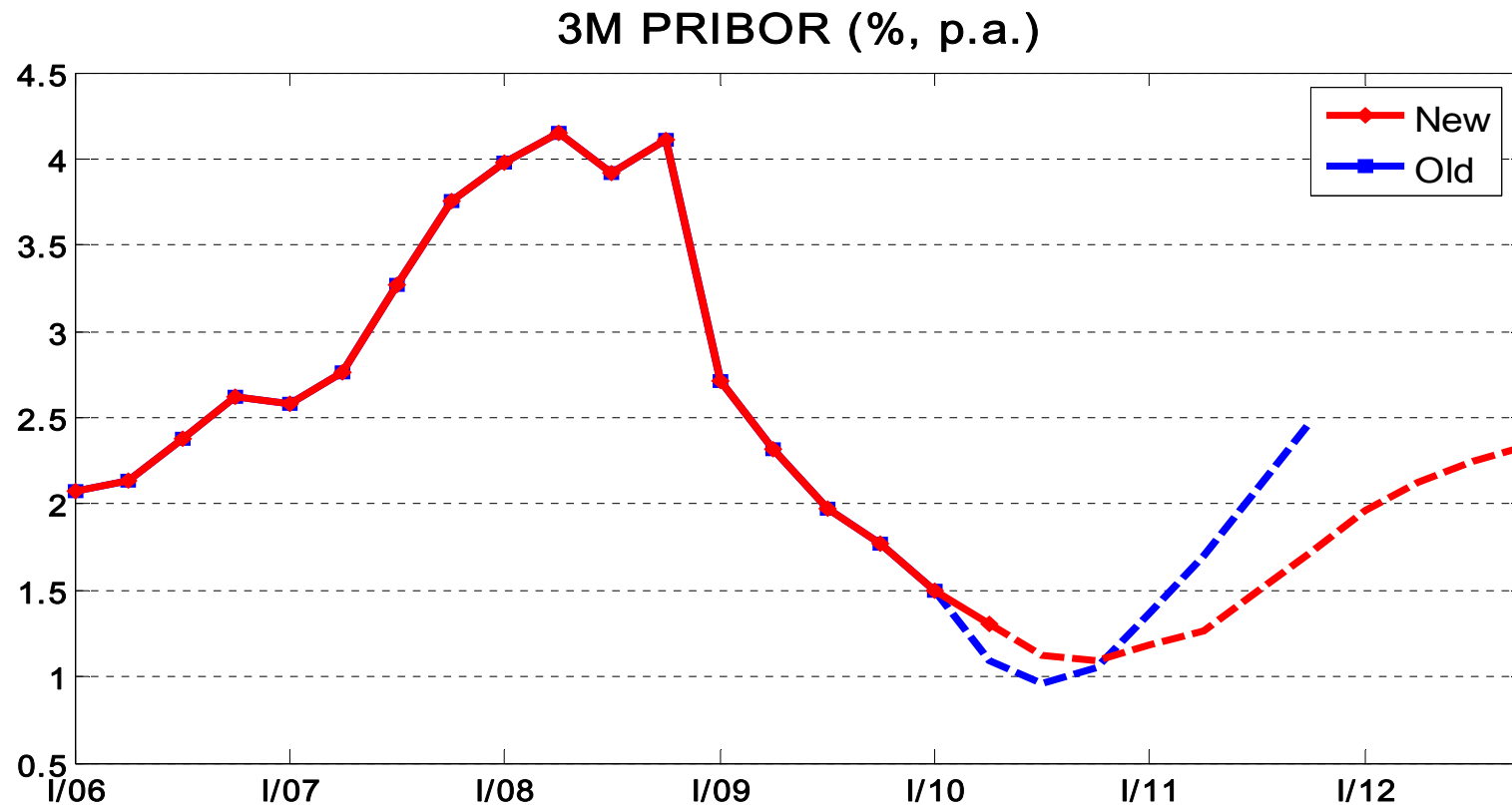
- The forecast of nominal wage growth has changed only for the near term (new seasonal adjustment).
- The unemployment rate (ILO) will peak sooner.

Comparison with the Previous Exchange Rate Forecast



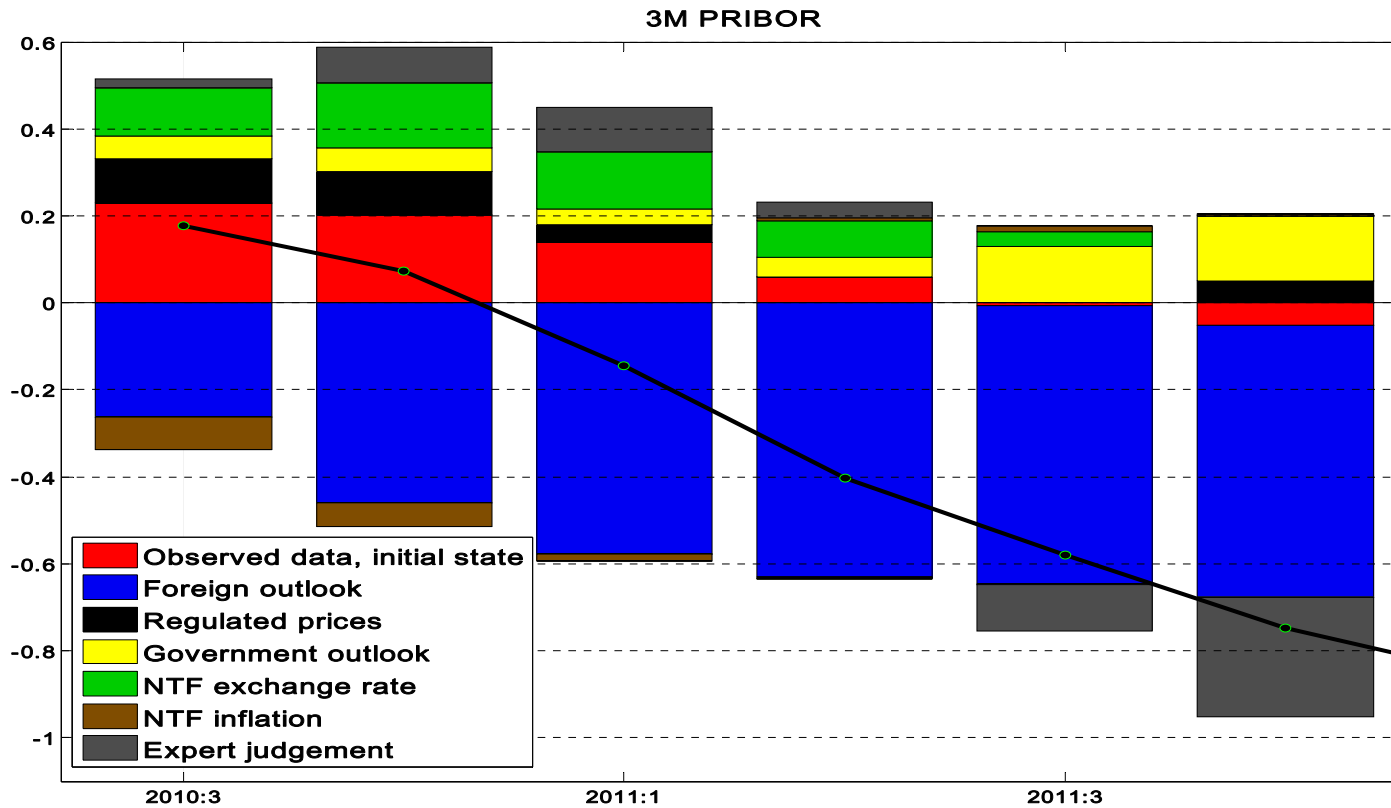
- The exchange rate is slightly weaker initially, but appreciates faster than in the previous forecast.
- Current exchange rate stronger than the forecast.

Comparison with the Previous Interest Rate Forecast



- The interest rate path is slightly higher for the near term and significantly lower for the medium term.

Interest Rate Forecast Change Decomposition

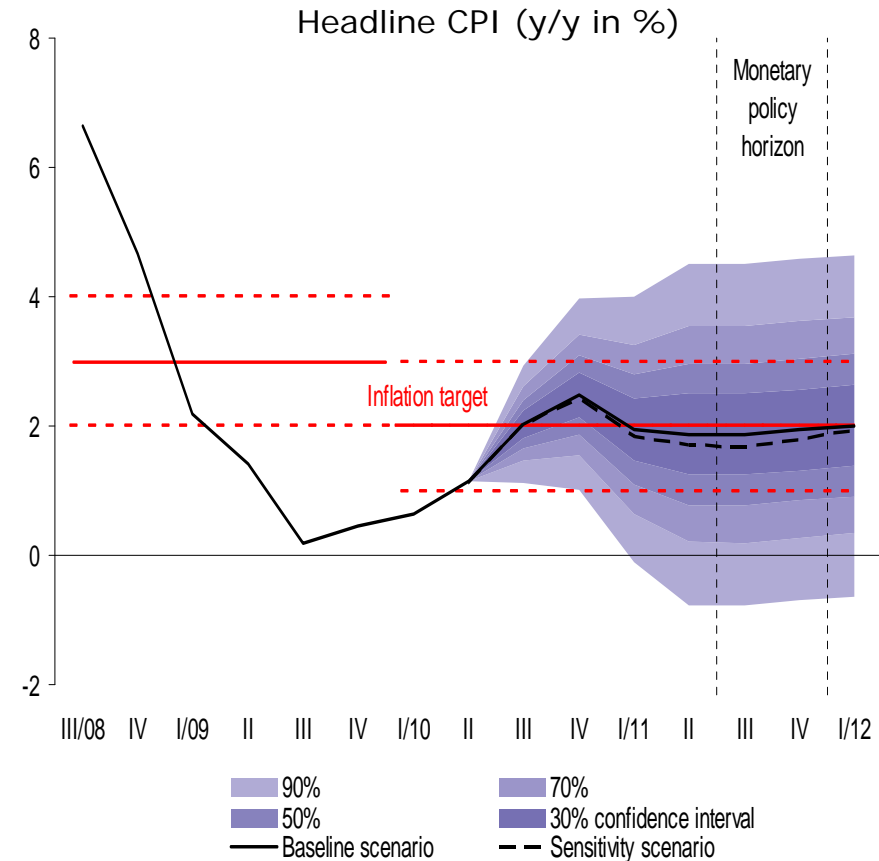
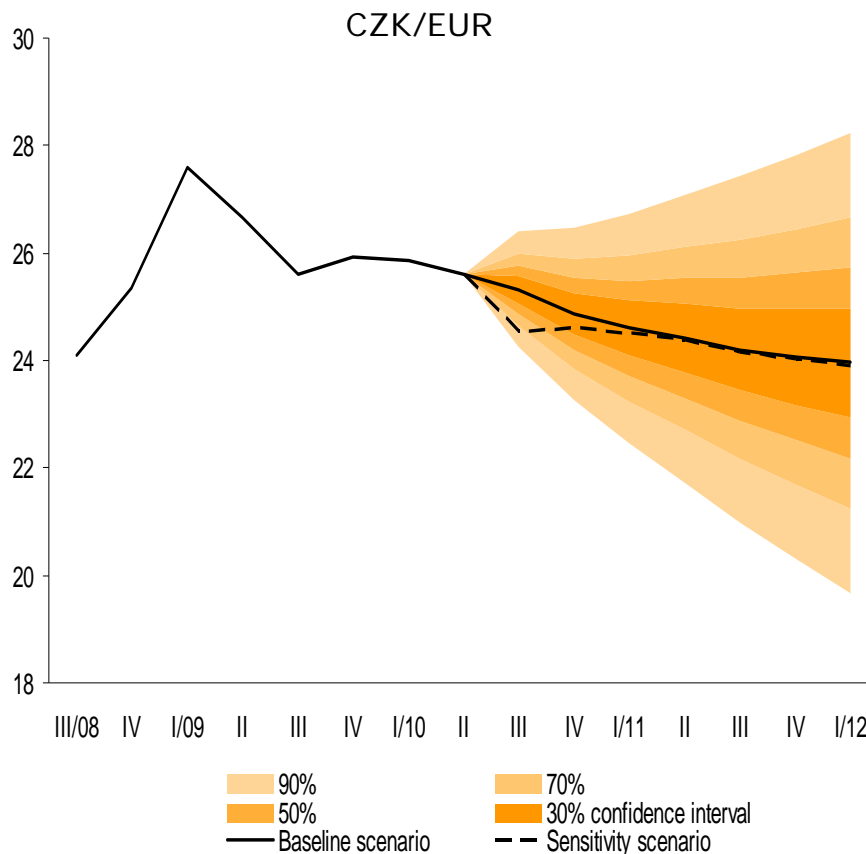


- Downward impact of foreign interest rates.
- Initially offset by new data and near-term forecast.

Sensitivity Analyses

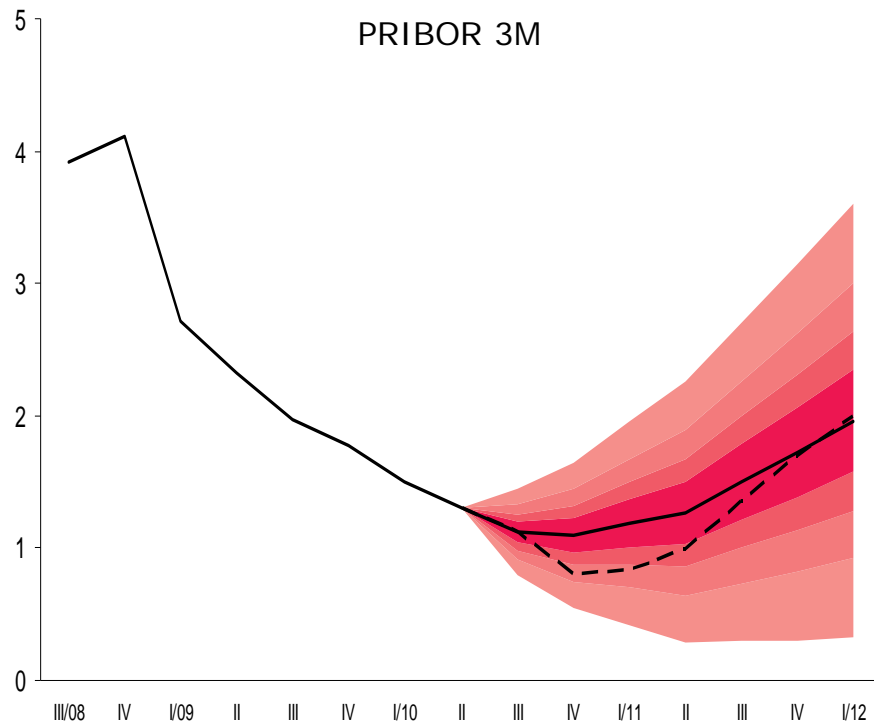
- Sensitivity scenarios do not provide a full-fledged alternative, but quantify some elements of uncertainty.
- Exchange rate sensitivity scenario (regular): a one-off CZK/EUR shock of $\pm 3\%$ with a delayed MP response.
- Foreign interest rate sensitivity scenario: potentially faster return of EURIBOR to neutral levels from 2011 H2 onwards.
- Fiscal policy sensitivity scenario: fiscal consolidation with budget deficits of 4.8% for 2011 and 4.2% for 2012, focused on expenditure cuts (+ \uparrow tax on cigarettes).

Exchange Rate Sensitivity Scenario: CZK/EUR and Inflation

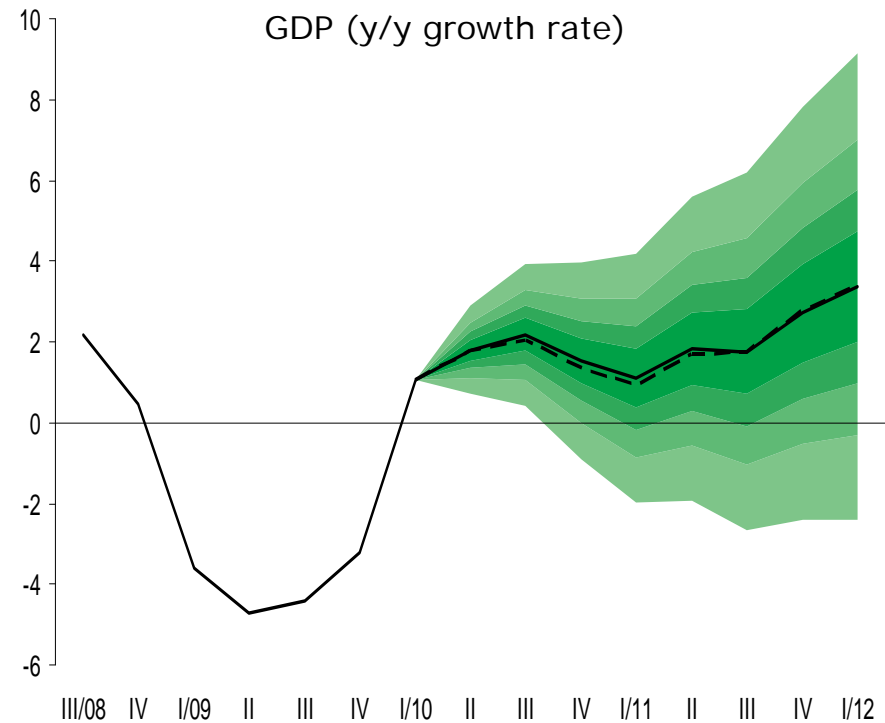


- Exchange rate shock simulated as temporary.
- Inflation outlook slightly lower due to import prices.

Exchange Rate Sensitivity Scenario: 3M PRIBOR and GDP



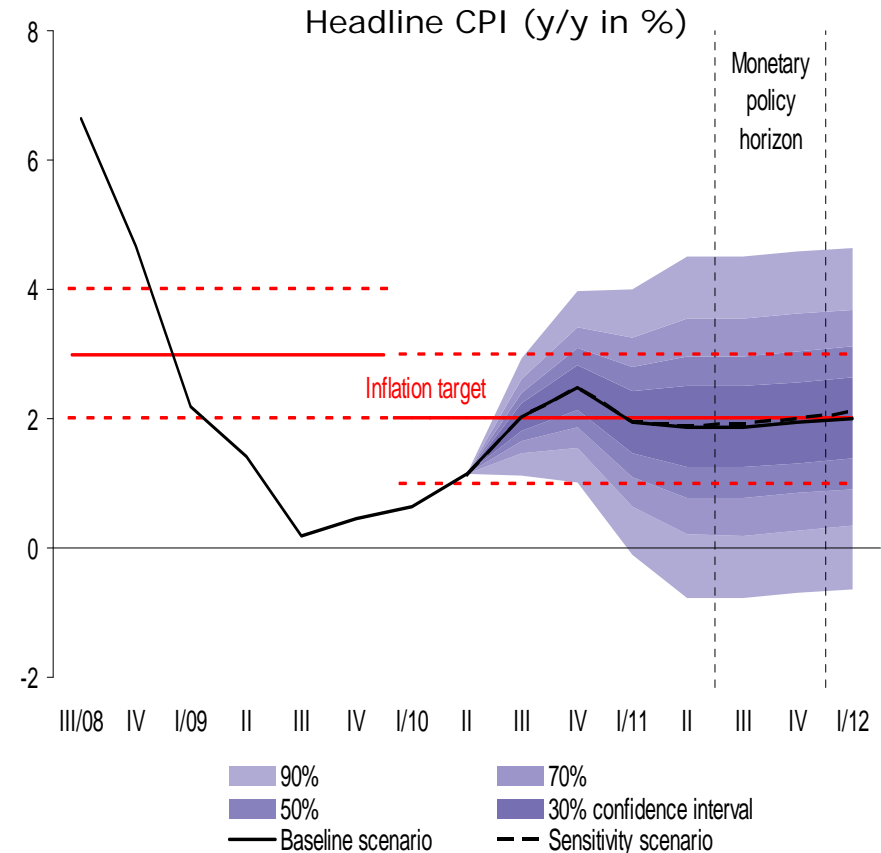
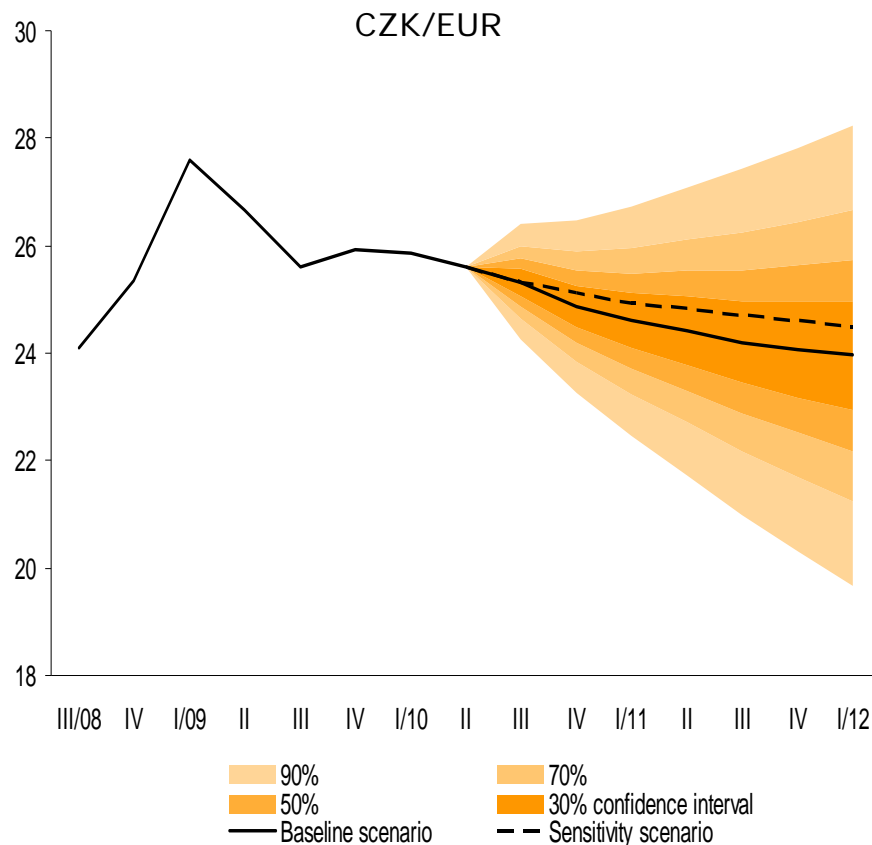
■ 90%
■ 50%
■ 30% confidence interval
— Baseline scenario
- - Sensitivity scenario



■ 90%
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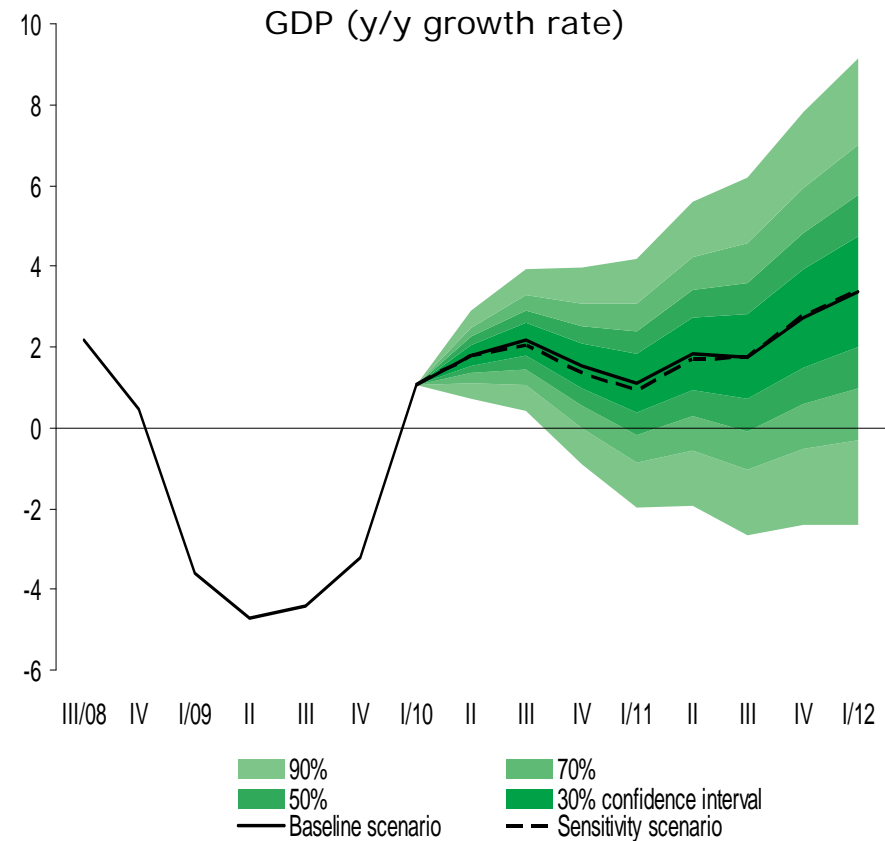
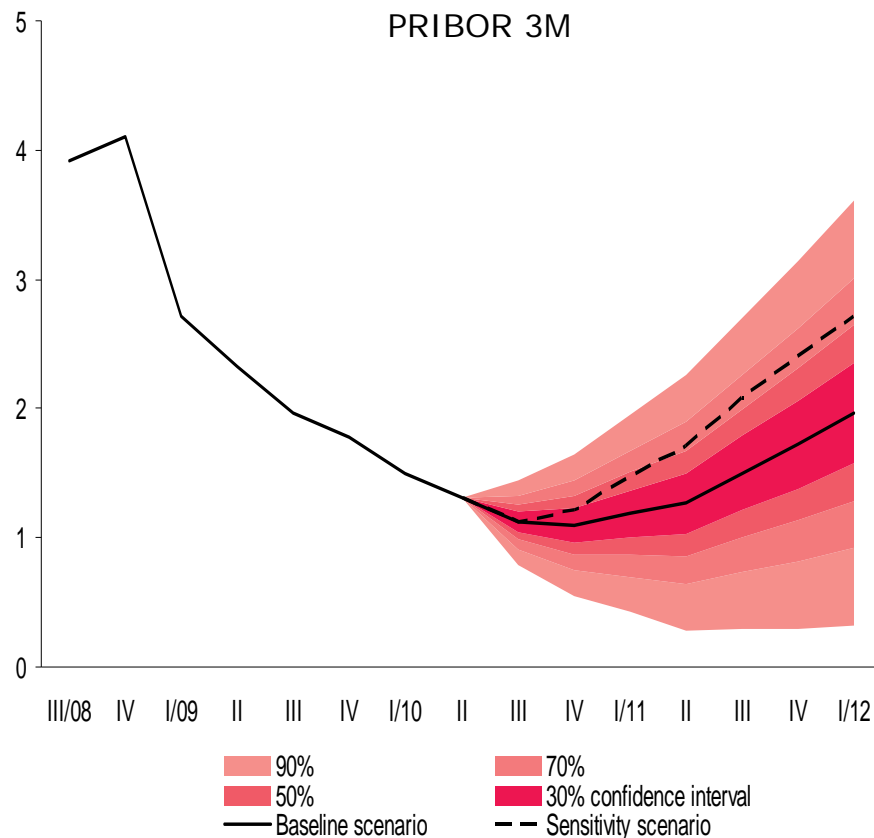
- Lower domestic interest rates.
- GDP growth only slightly weaker due to MP response. ³¹

Foreign Interest Rate Sensitivity Scenario: CZK/EUR and Inflation



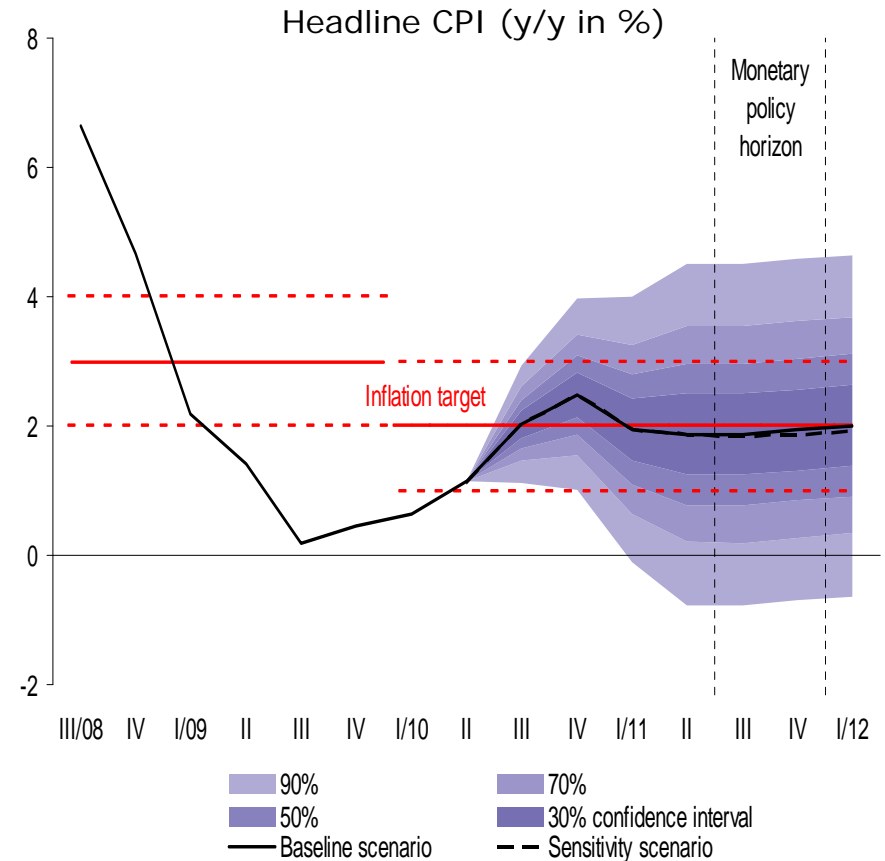
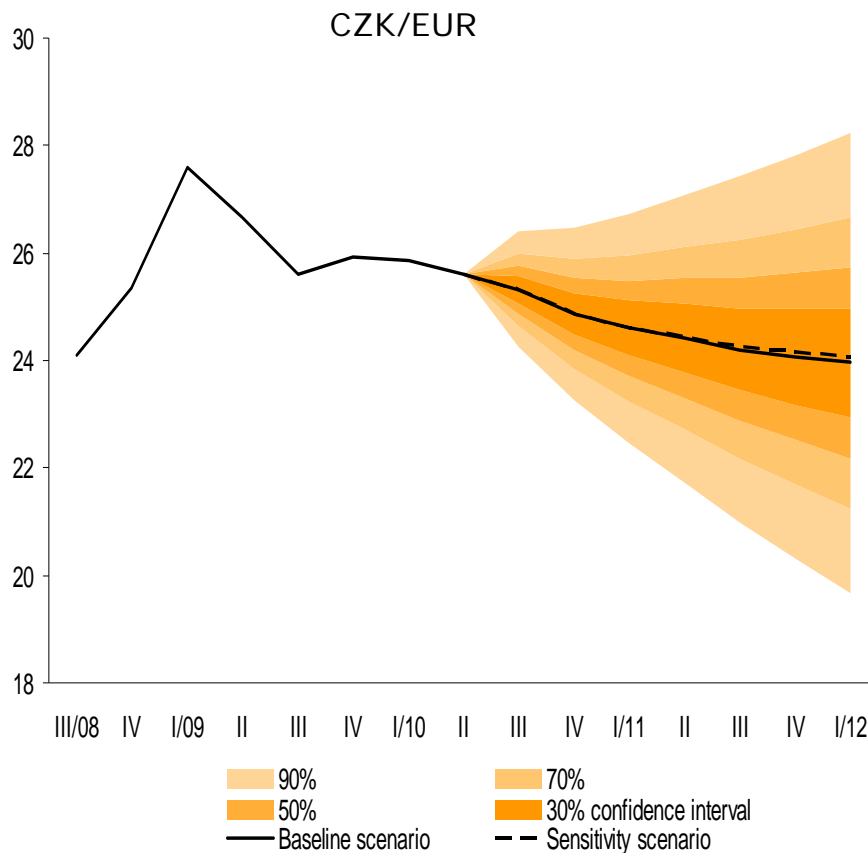
- Higher foreign interest rates weakening the CZK.
- Small upward impact on inflation.

Foreign Interest Rate Sensitivity Scenario: 3M PRIBOR and GDP



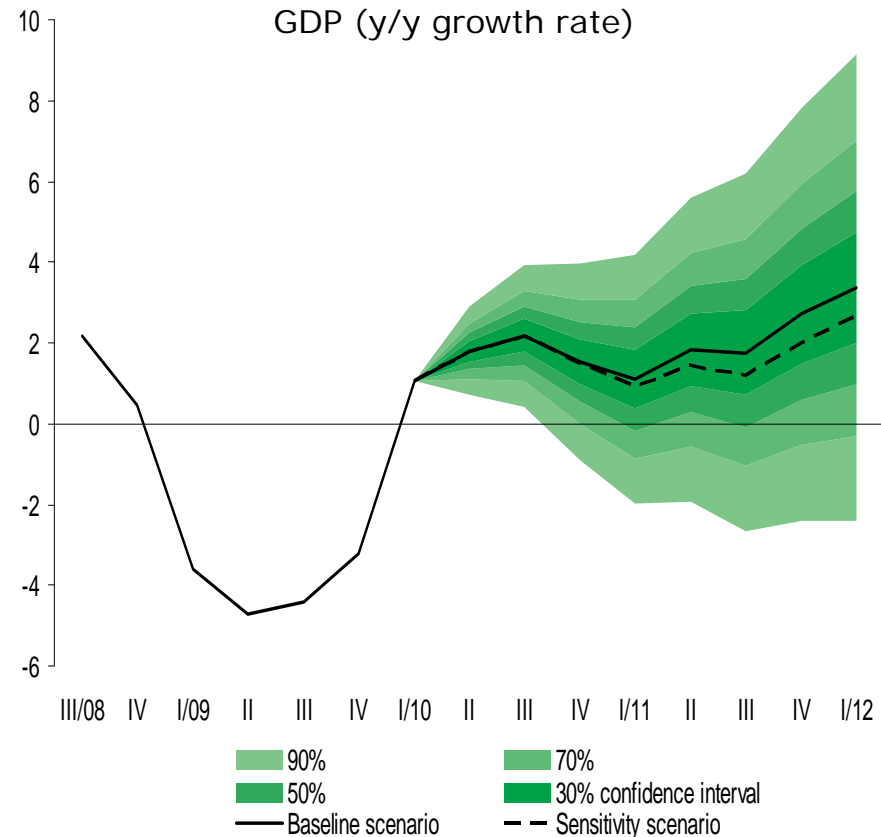
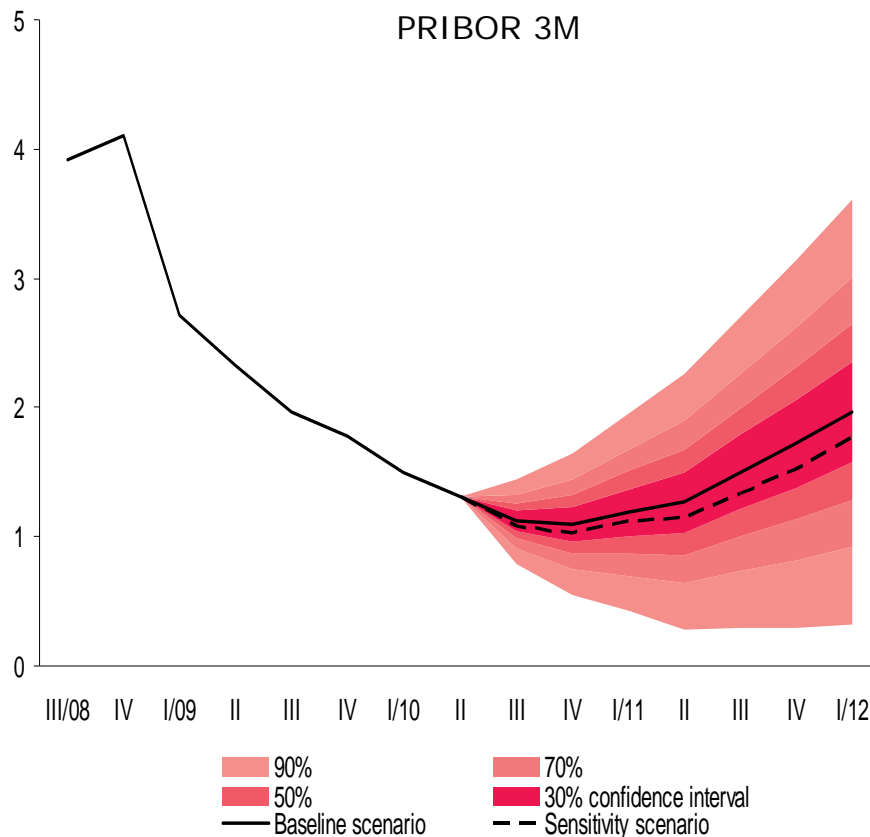
- The higher outlook for foreign rates is simulated as expected \Rightarrow forward-looking response of PRIBOR.

Fiscal Policy Sensitivity Scenario: CZK/EUR and Inflation



- No confidence-enhancing effect on CZK included.
- Inflation very similar (lower GDP vs. taxes + CZK).

Fiscal Policy Sensitivity Scenario: 3M PRIBOR and GDP



- GDP growth weaker (by about 0.5 p.p. in 2011).
- Future interest rate increase more gradual.



Thank you for your attention

www.cnb.cz

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