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

Meeting with Analysts

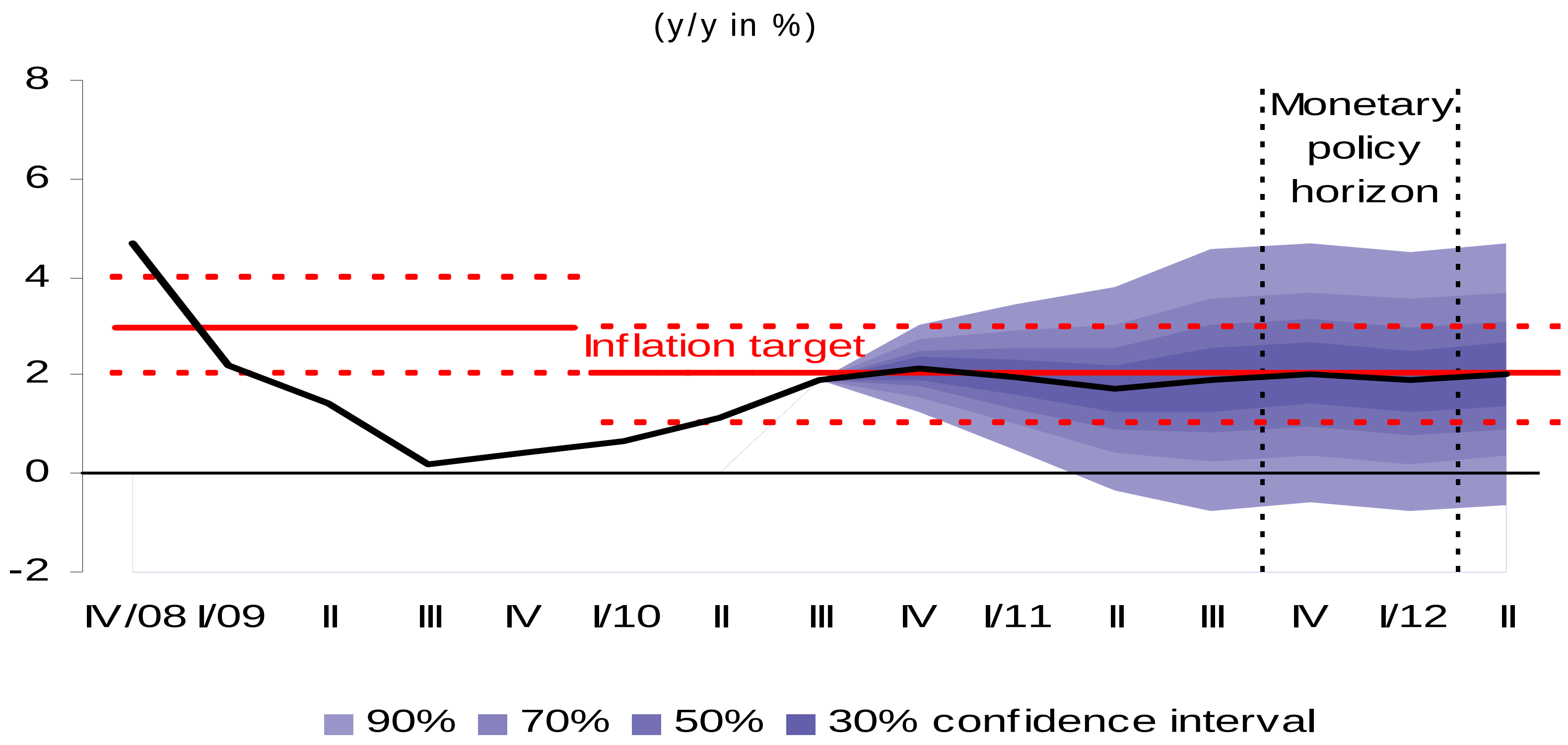
Tomáš Holub

Prague, November 12, 2010

Summary of the Inflation Forecast

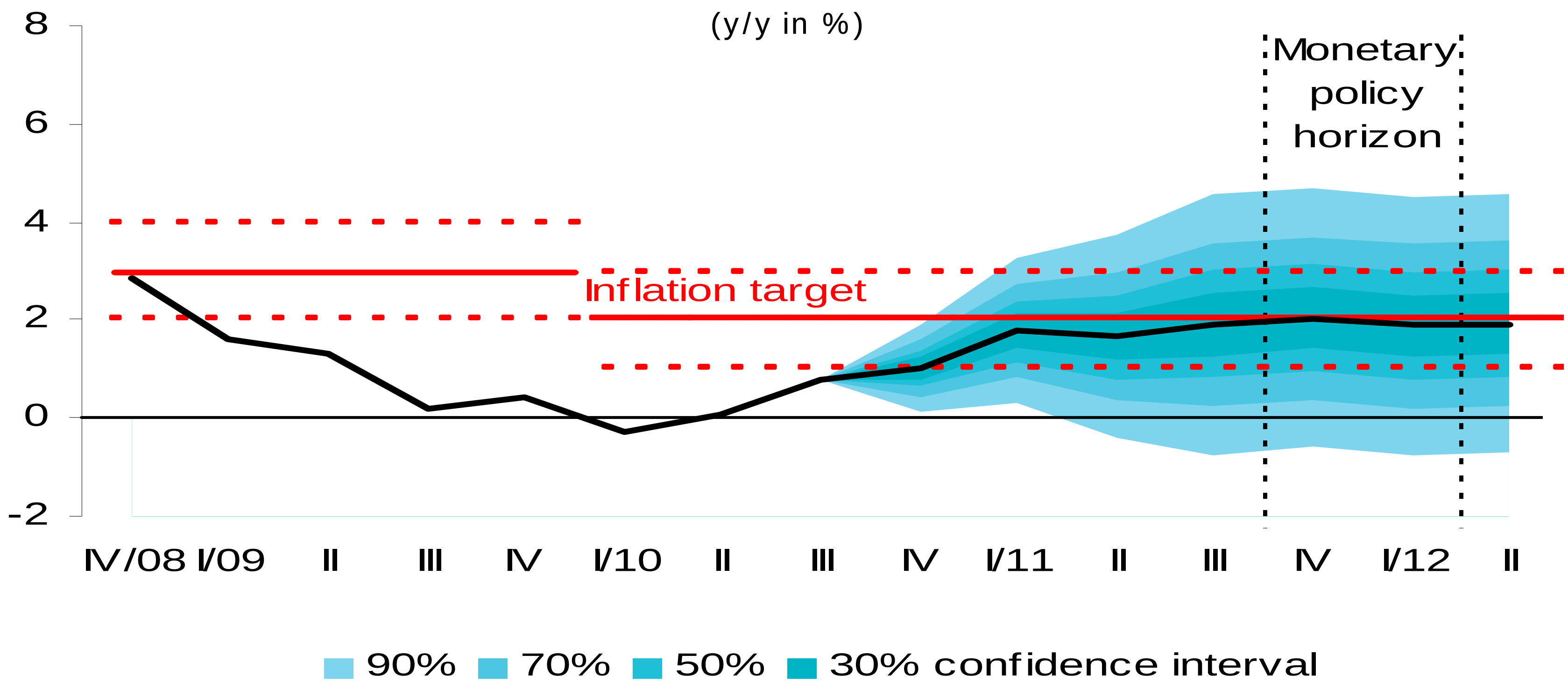
- Inflation will remain on the 2% target throughout entire forecast horizon.
- Net inflation will gradually speed up towards 2% at the end of 2012, the growth of regulated prices will accelerate temporarily (electricity).
- The growth of EA interest rates will be very gradual. Foreign demand growth will be modest, despite the positive surprise in 2.Q 2010 .
- Some inflationary pressures will start to emerge in the domestic economy in 2011-2012. Anti-inflationary effect of import prices on consumer goods has resumed temporarily due to CZK appreciation.
- Profit mark-ups are depressed, and will gradually increase in the future.
- The GDP will grow by 2.3% in 2010, 1.2% in 2011 and 2.5% in 2012. The labour market improvement comes faster than expected.

Headline Inflation Forecast



- Inflation right on the 2% target during the forecast horizon.

MP-Relevant Inflation Forecast



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

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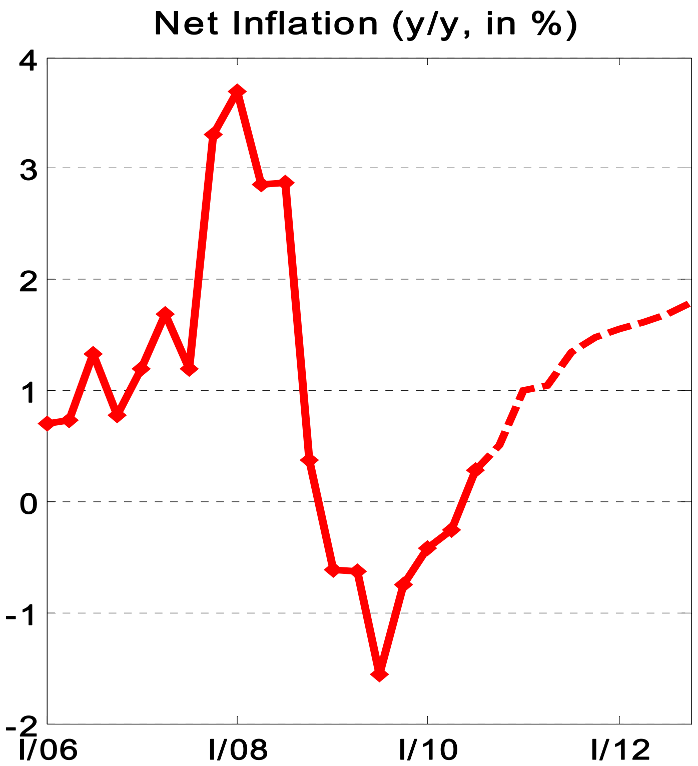
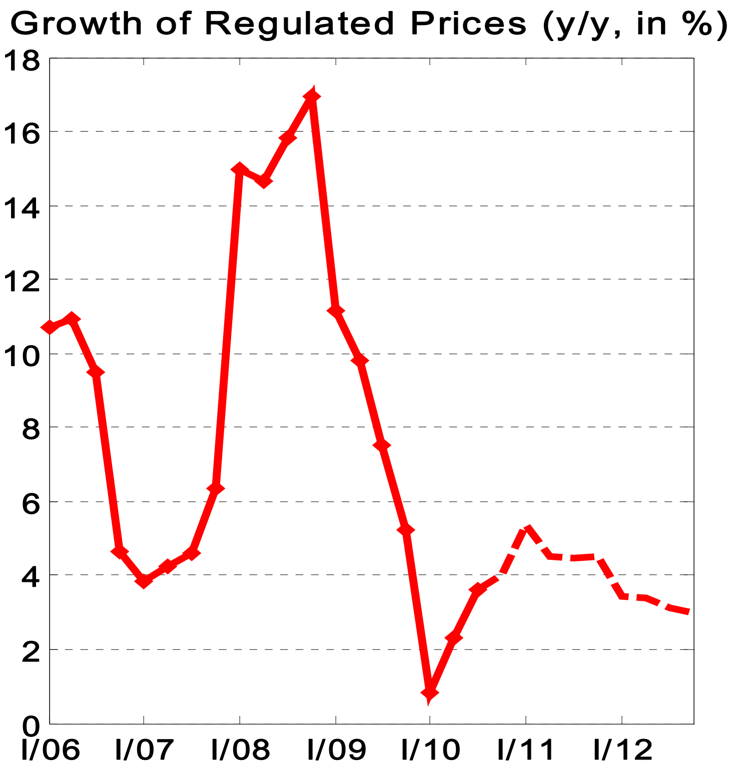
Net Inflation and Regulated Prices





- Gradual acceleration of net inflation from low levels.
- The growth of regulated prices will speed up in 2011 due to higher electricity prices.

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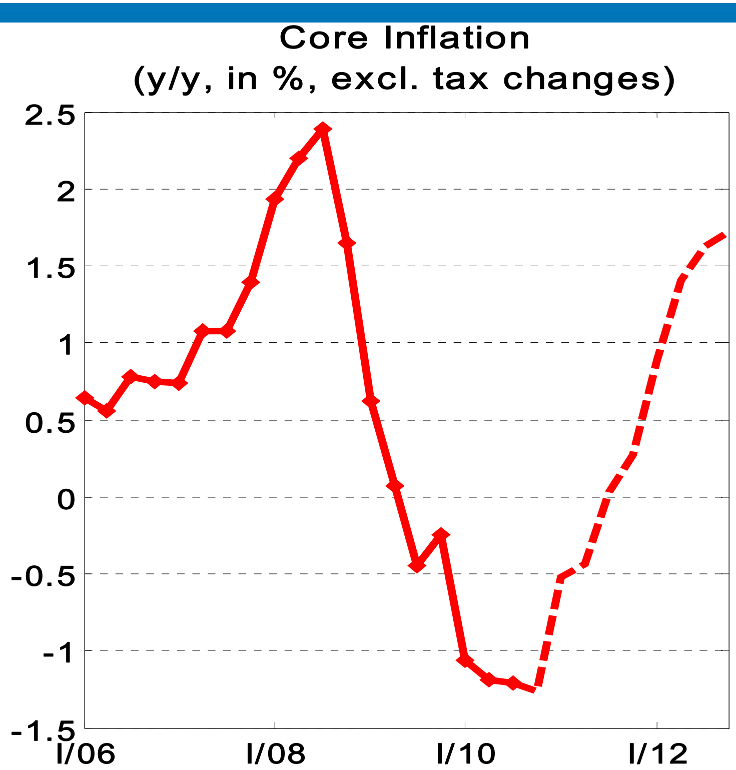
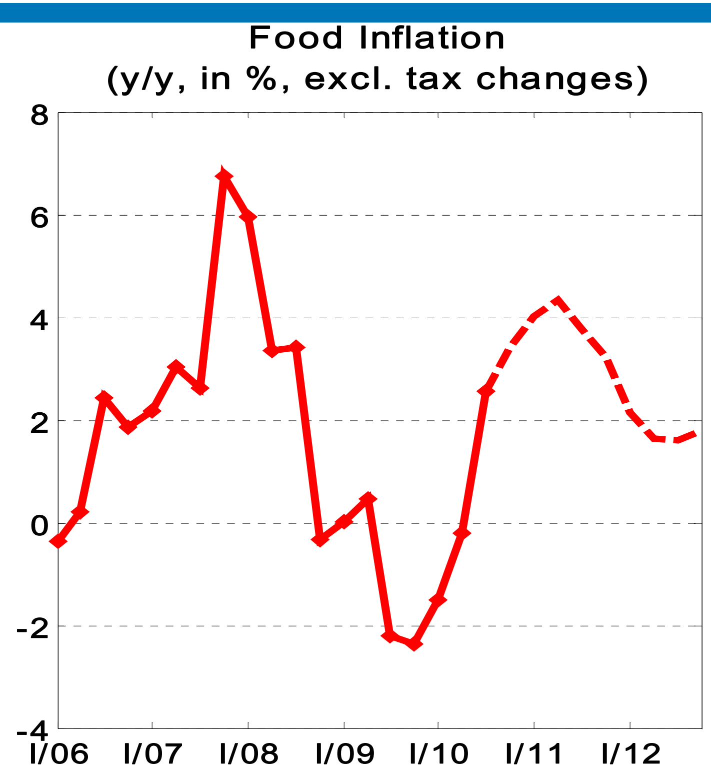
Core Inflation and Food Prices





- Increasing core inflation in 2011-2012 (from currently negative levels) together with the economic recovery.
- Higher agricultural prices ⇒ food prices.

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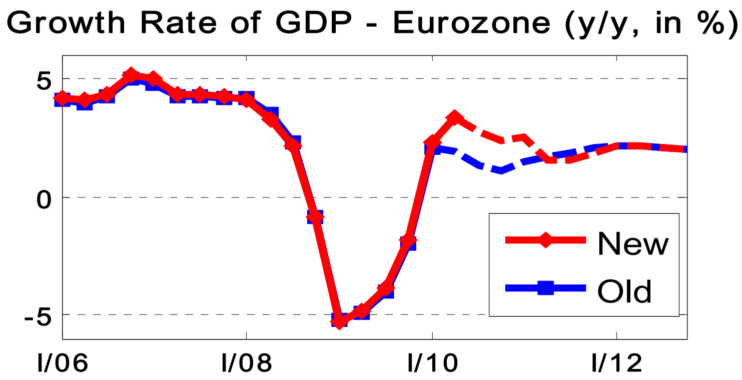
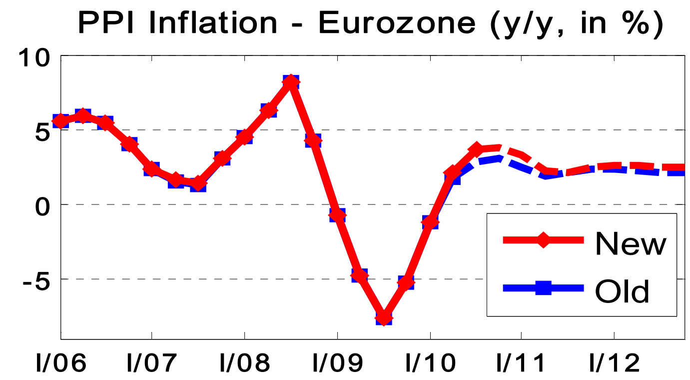
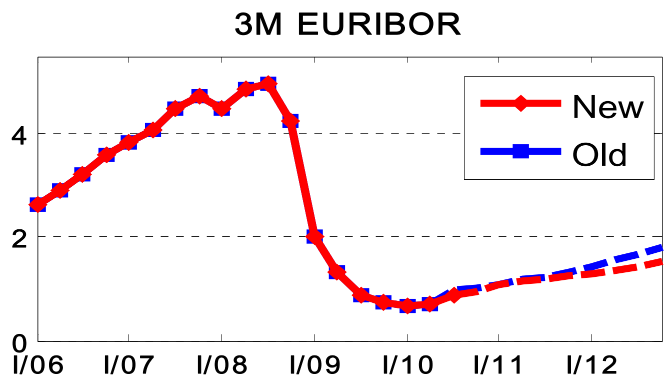
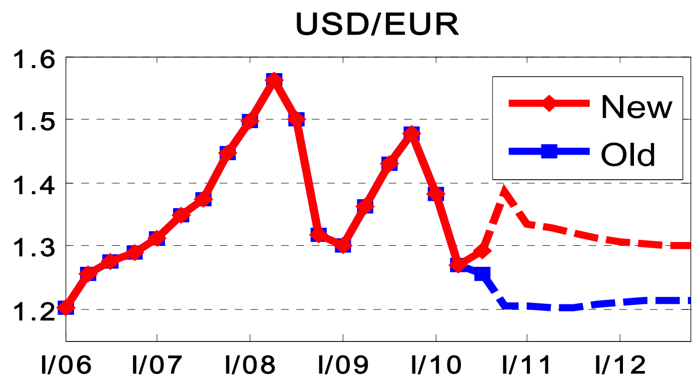
External Assumptions









- The growth of EA interest rates is postponed further.
- GDP outlook improved, but only for 2010.

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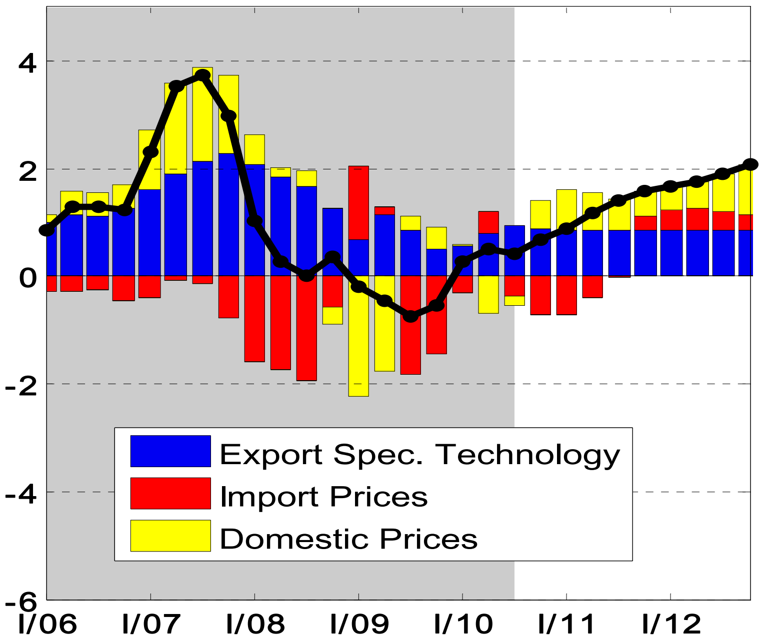
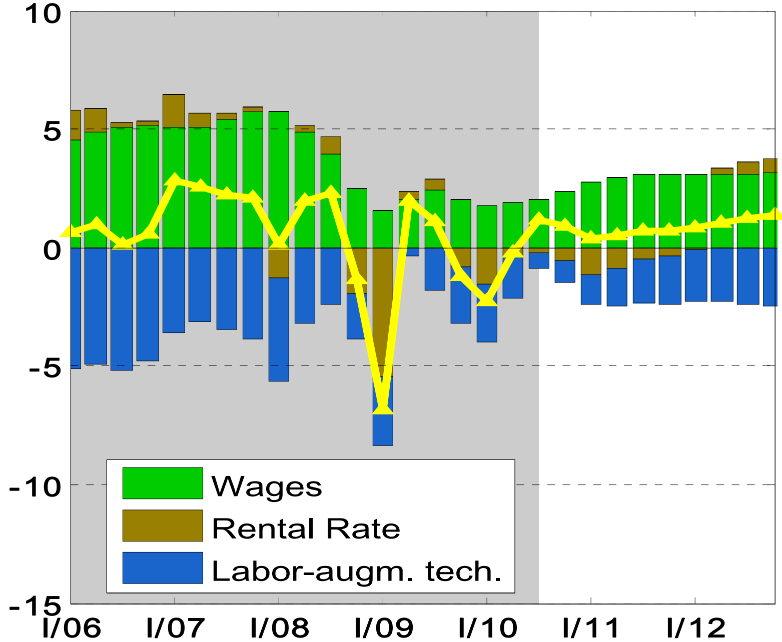
Domestic Costs vs. Import Prices

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



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



- Some domestic inflationary pressures will start to emerge, but will be offset in the near-term by strong exchange rate.
- Gradual correction of depressed margins will take place.

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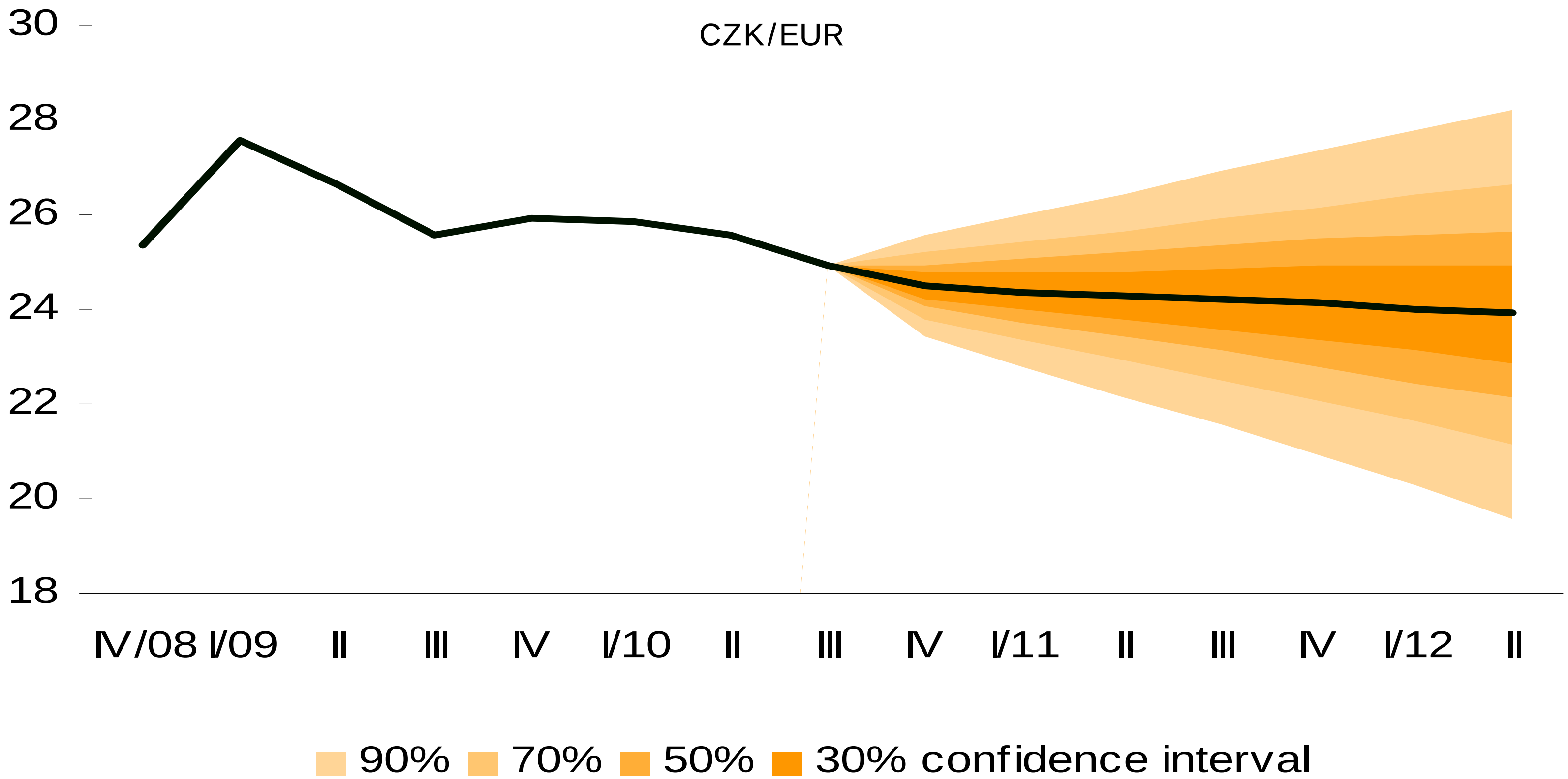
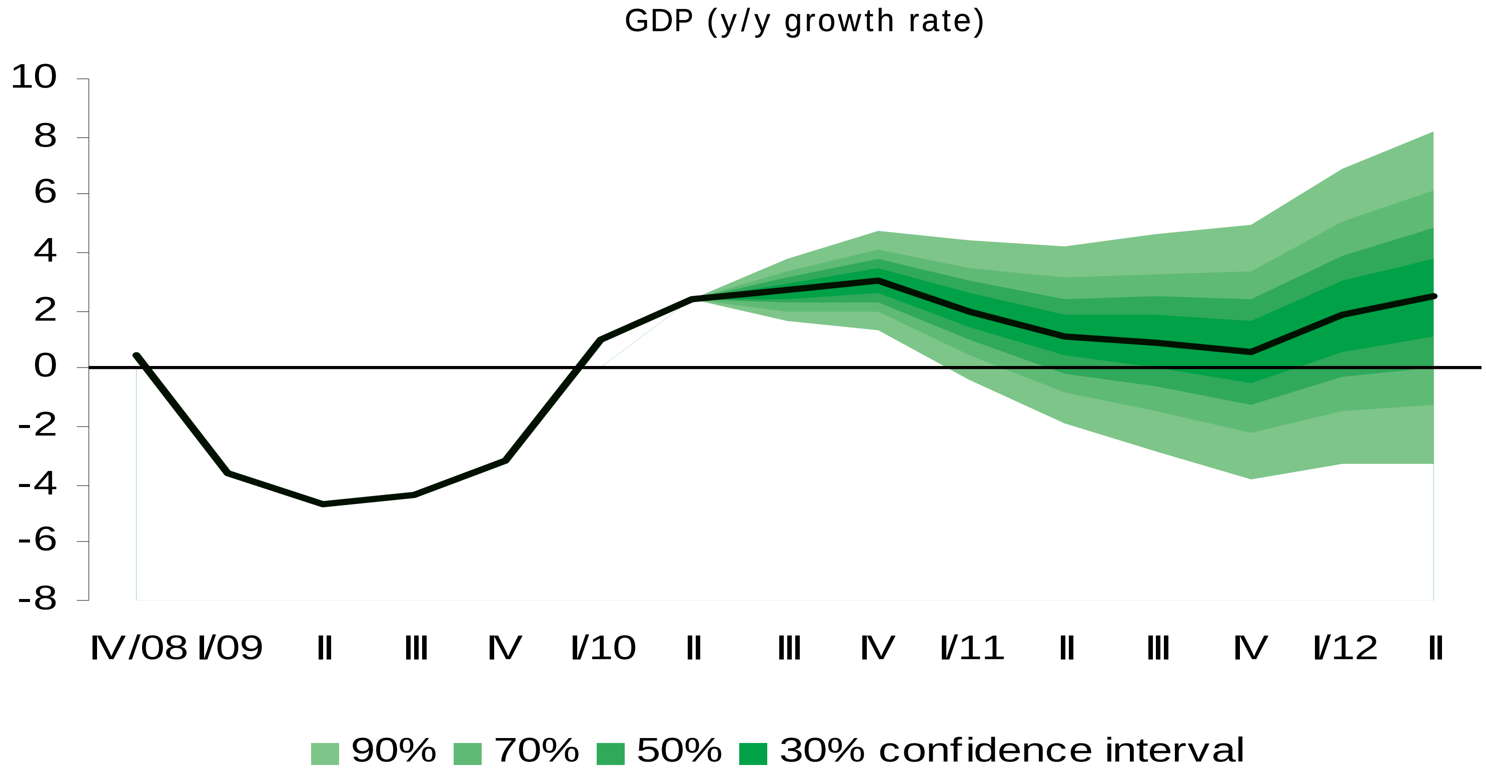
Exchange Rate Forecast



- The nominal exchange rate will gradually appreciate, reflecting low foreign interest rates, favourable BoP outlook for 2011 and resuming convergence process.

GDP Growth Forecast (i)



- The y/y GDP growth will slow down in 2011.
- Averages for 2010: 2.3%; 2011: 1.2%; 2012: 2.5%.

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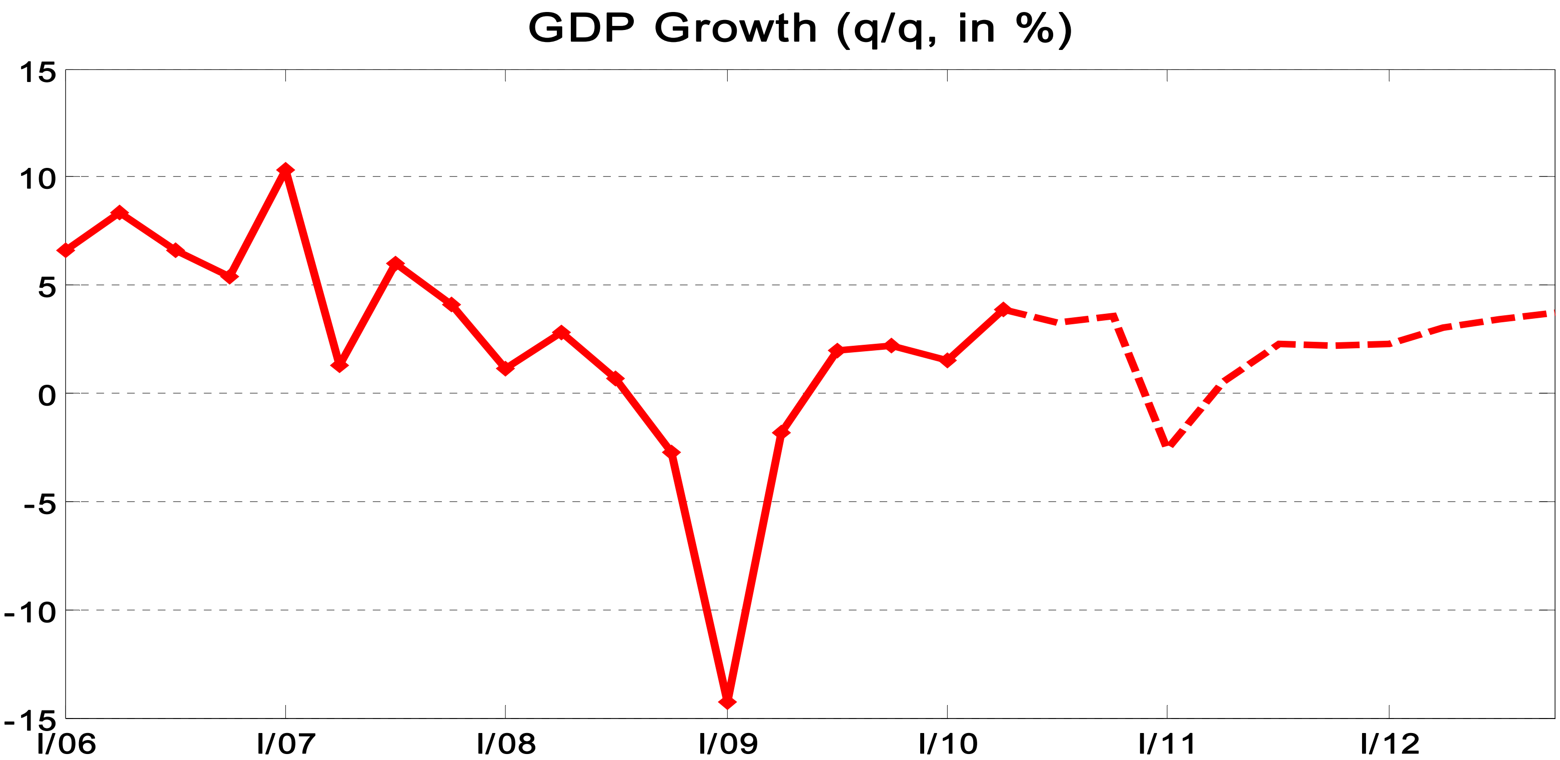
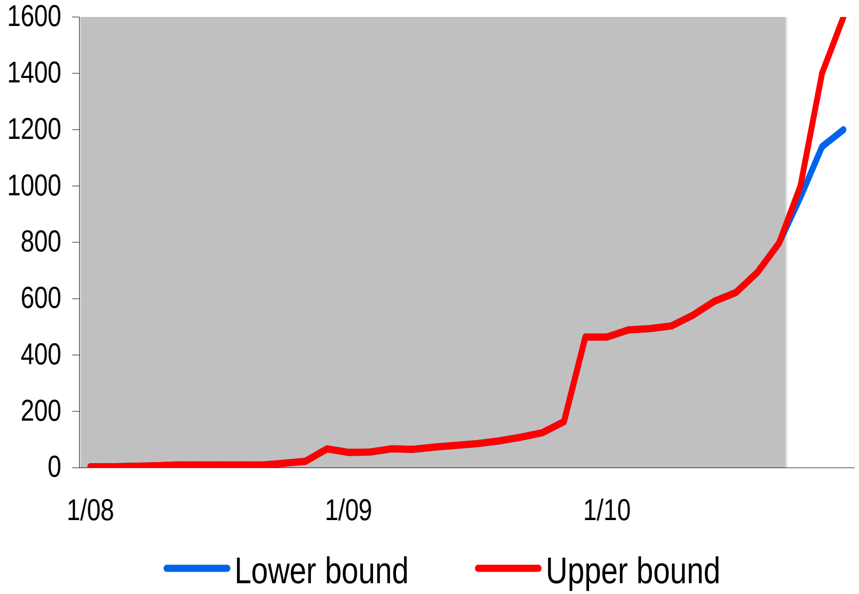
GDP Growth Forecast (ii)



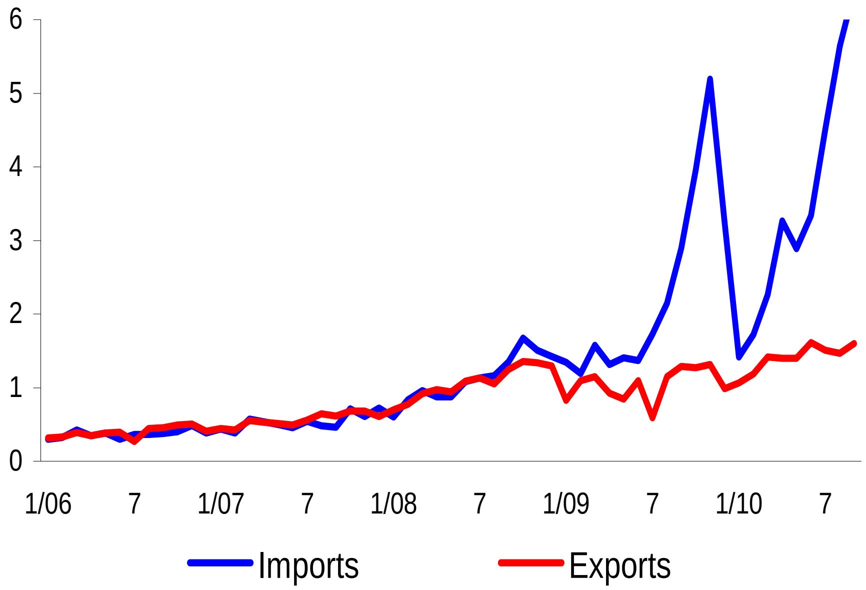
- The slowdown at the start of 2011 reflects fiscal restrictions and the end of restocking, as well as of the investment boom into solar energy plants.

Czech Solar Energy Boom

Installed capacity of solar energy plants (MW)



Imports and Exports of fotovoltaic panels (CZK bn.)



- Apart from its expected price impact, the solar boom is affecting real economy figures: net trade CZK -25 to -35 bn. in 2010; investment 40-60 bn.; nominal GDP 0.4-0.7%.

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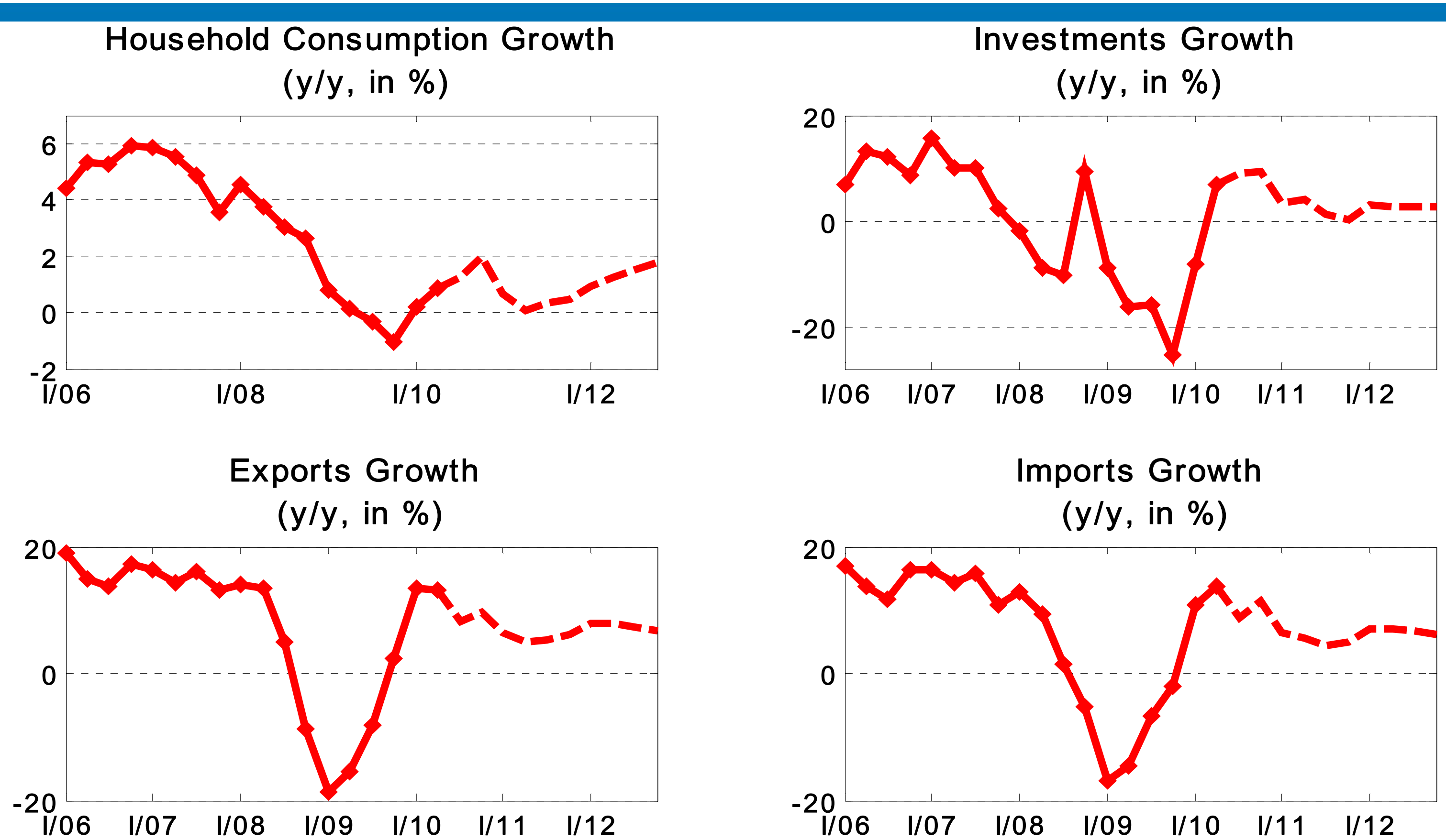
Forecast of Aggregate Demand



- Household consumption growth in 2010 is surprising, a slowdown is expected for 2011.

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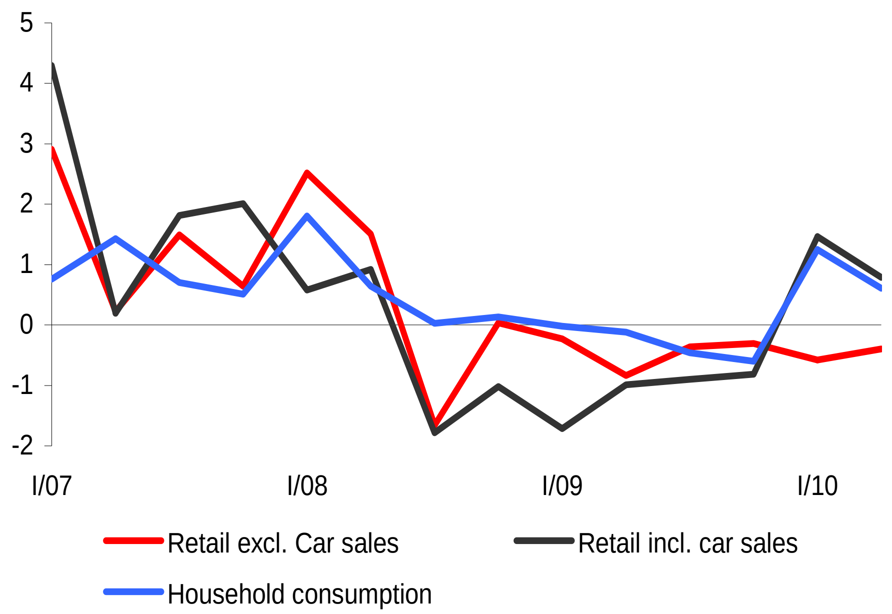
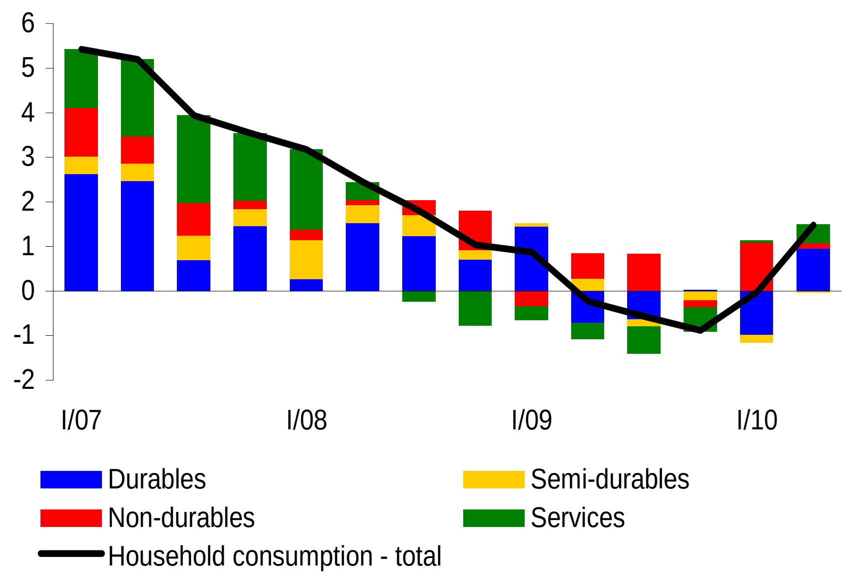
Household Consumption Growth

Real Consumption and Retail Sales Growth (q/q in %)



Structure of Consumption Growth (y/y in %)



- Households consumption q/q growth in line with retail sales including the car segment (but car sales may actually grow to firms rather than to households).

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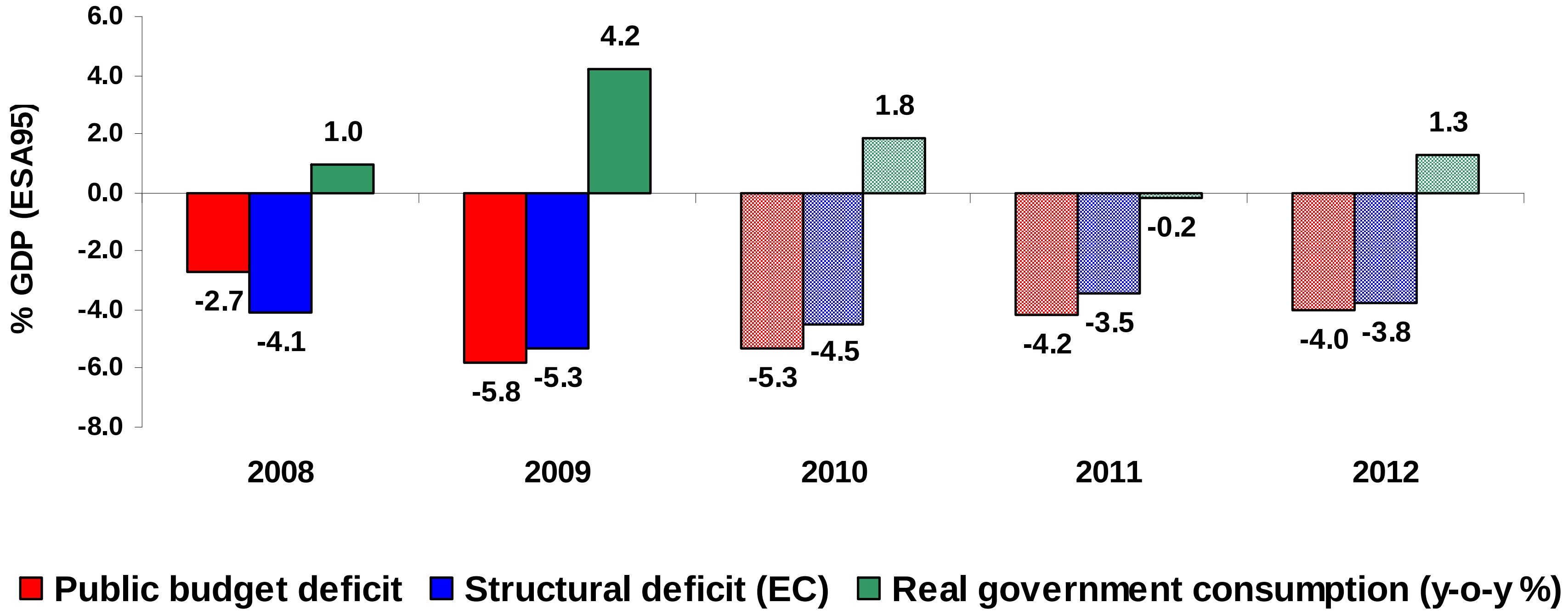
Public Budgets



- Consolidation measures for 2011 have been included in the baseline scenario (2012: no policy change).
- Impact both on gov‘t and household consumption.

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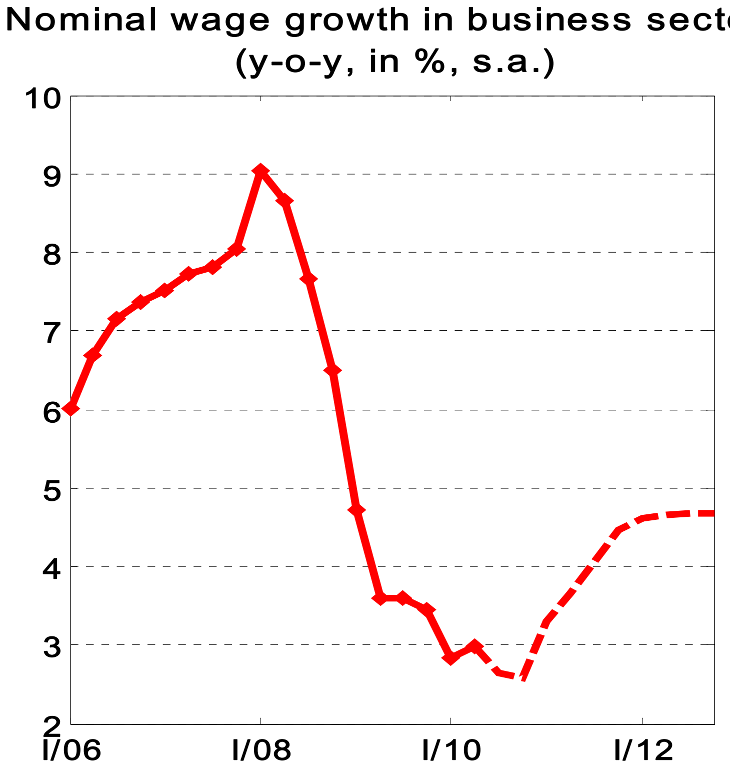
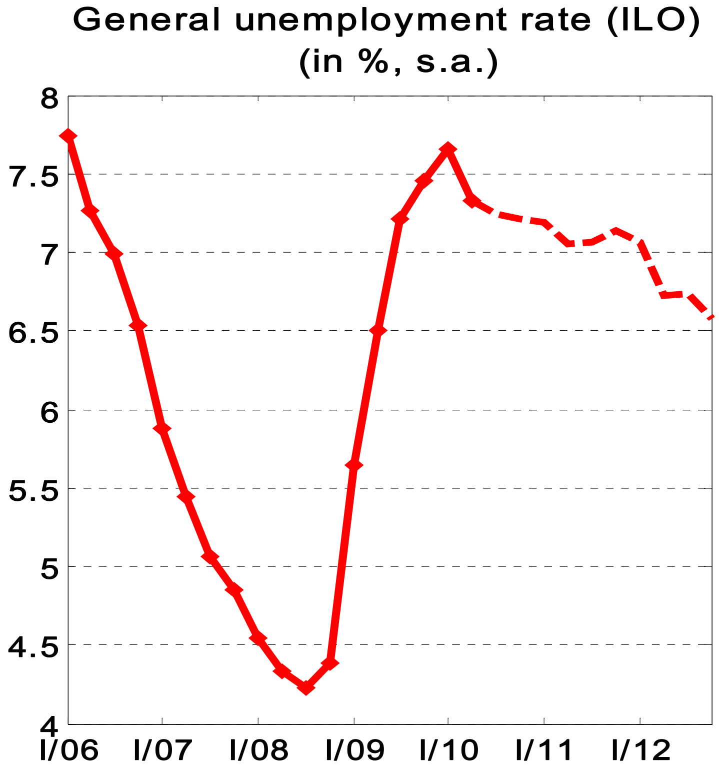
Labour Market Forecast





- The (private) wage growth will start to pick up from 2011.
- Unemployment rate will be gradually (but not smoothly) decreasing.

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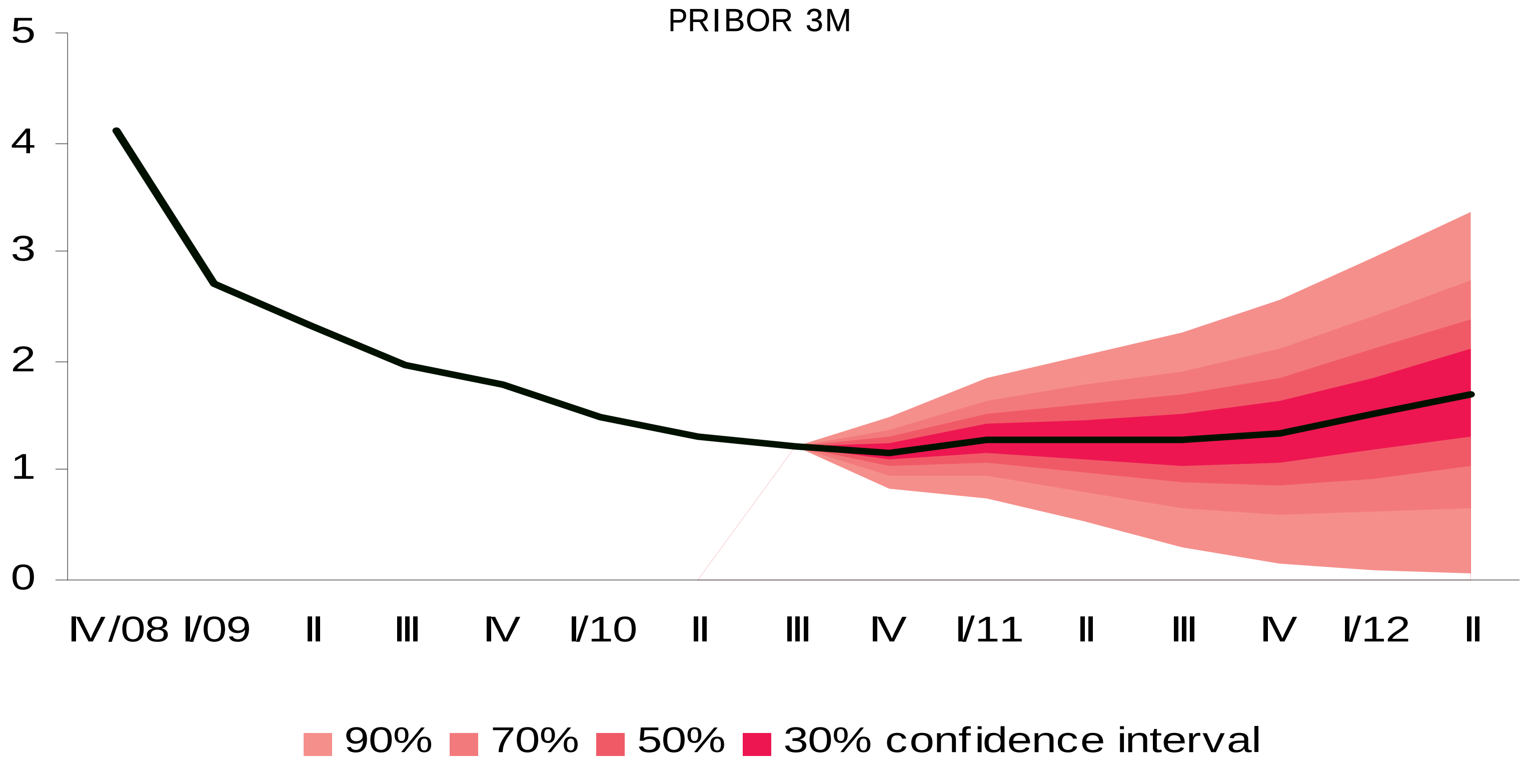
Interest Rate Forecast

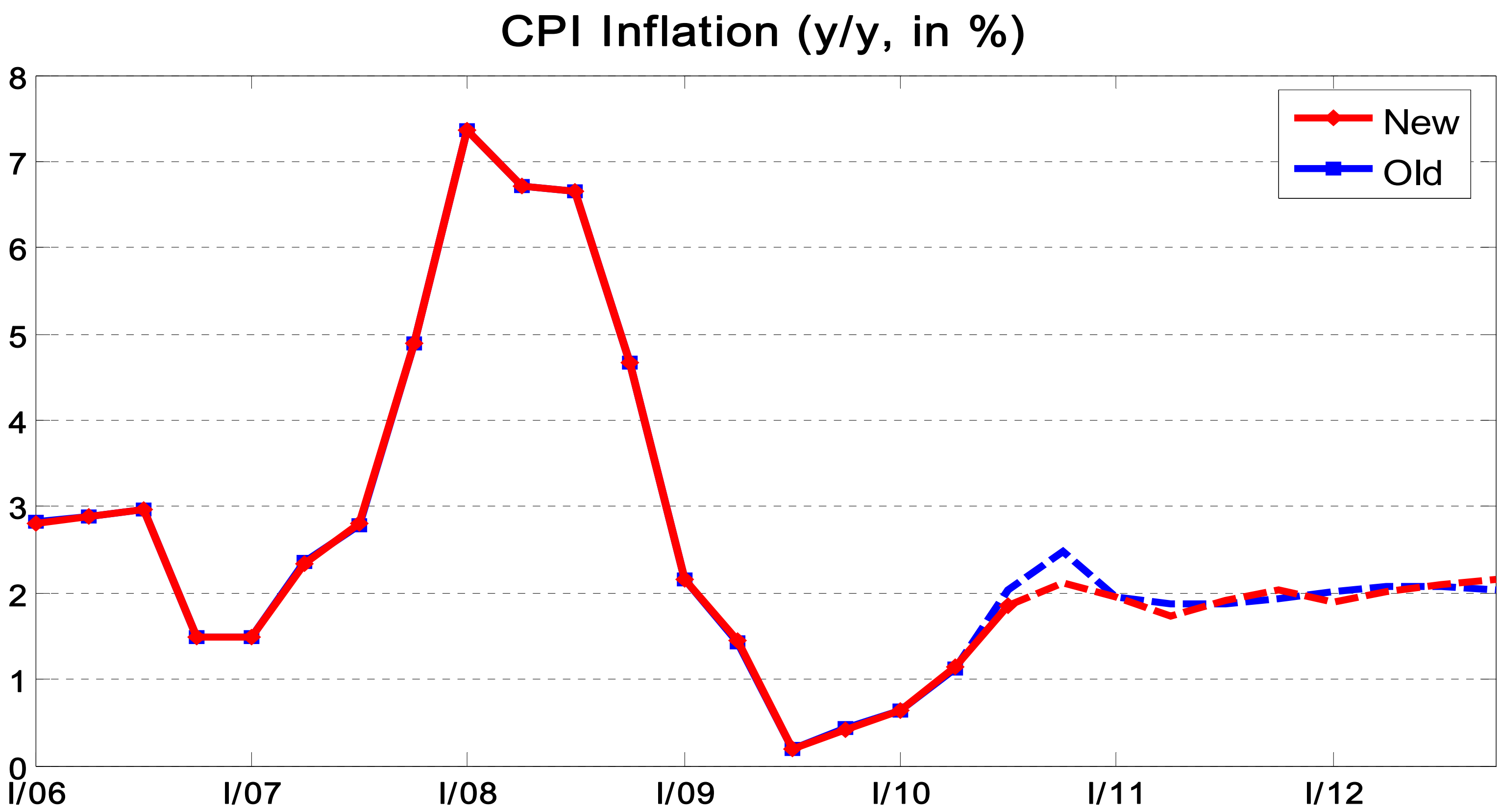


- Stability of market interest rates close to their current levels initially, followed by a gradual rise in rates at the longer end of the forecast.

Summary of the Comparison with Previous Forecast

- The overall changes in inflation forecast are small.
- Slightly higher regulated prices vs. lower net inflation.
- Higher GDP growth in 2010 vs. lower in 2011.
- The exchange rate forecast is more appreciated only in the near-term.
- Future interest rate hikes postponed further, mainly due to fiscal restrictions and new foreign outlook.

Comparison with Previous Inflation Forecast (i)



- Only slightly lower forecast for the near term.

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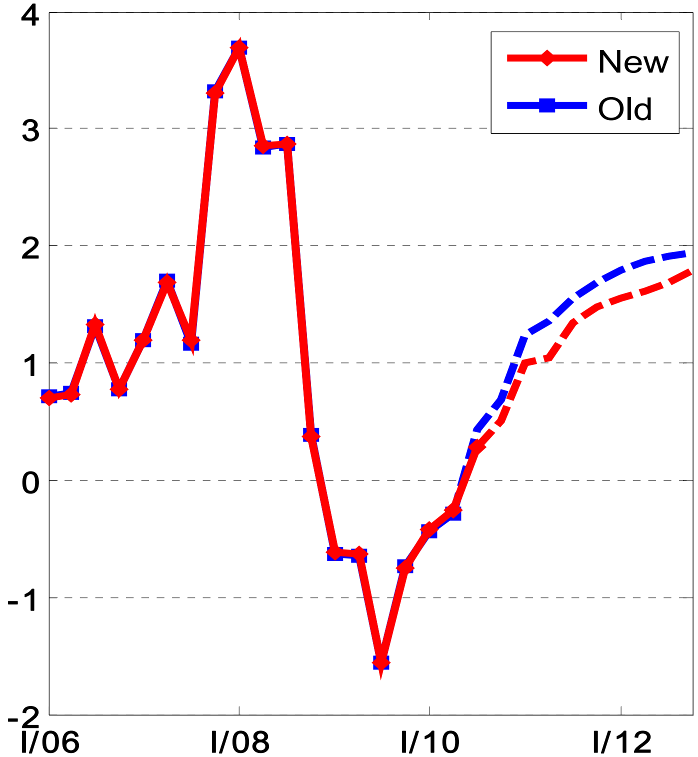
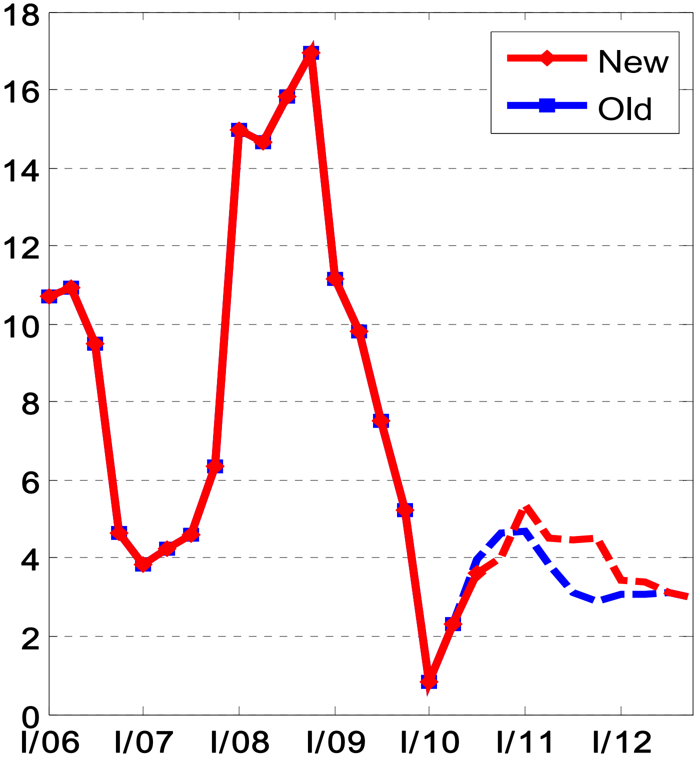
Comparison with Previous Inflation Forecast (ii)

Net Inflation (y/y, in %)



Growth of Regulated Prices (y/y, in %)



- Small reduction in net inflation forecast.
- Higher growth of regulated prices due to electricity.

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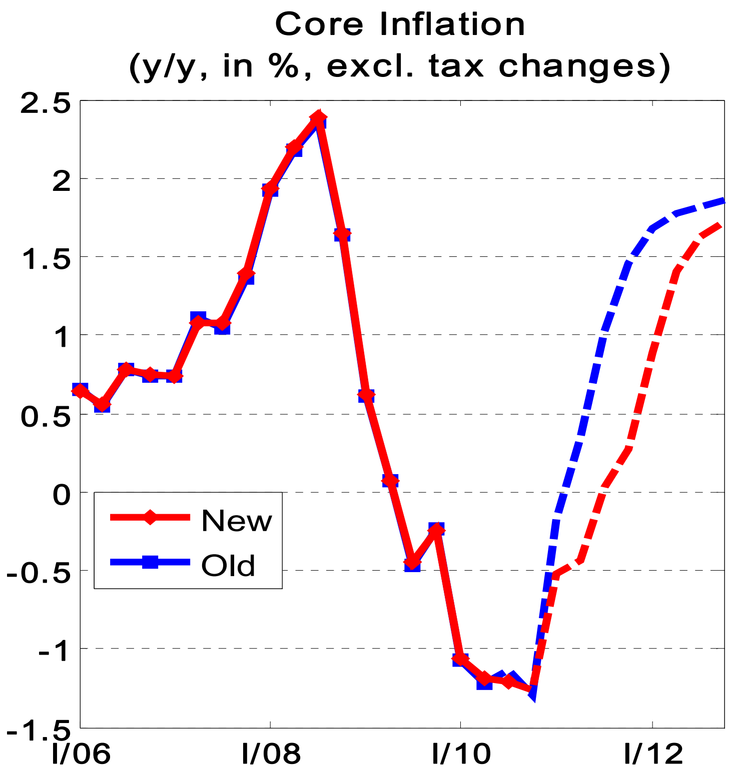
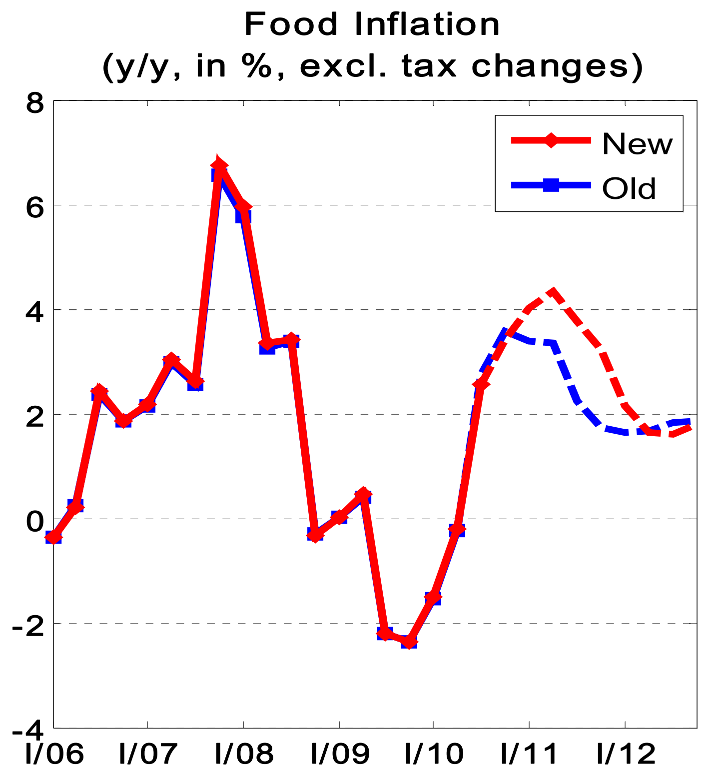
Comparison with Previous Inflation Forecast (iii)





- Lower core inflation due to CZK's appreciation and fiscal restrictions vs. higher food prices due to higher agricultural commodity prices.

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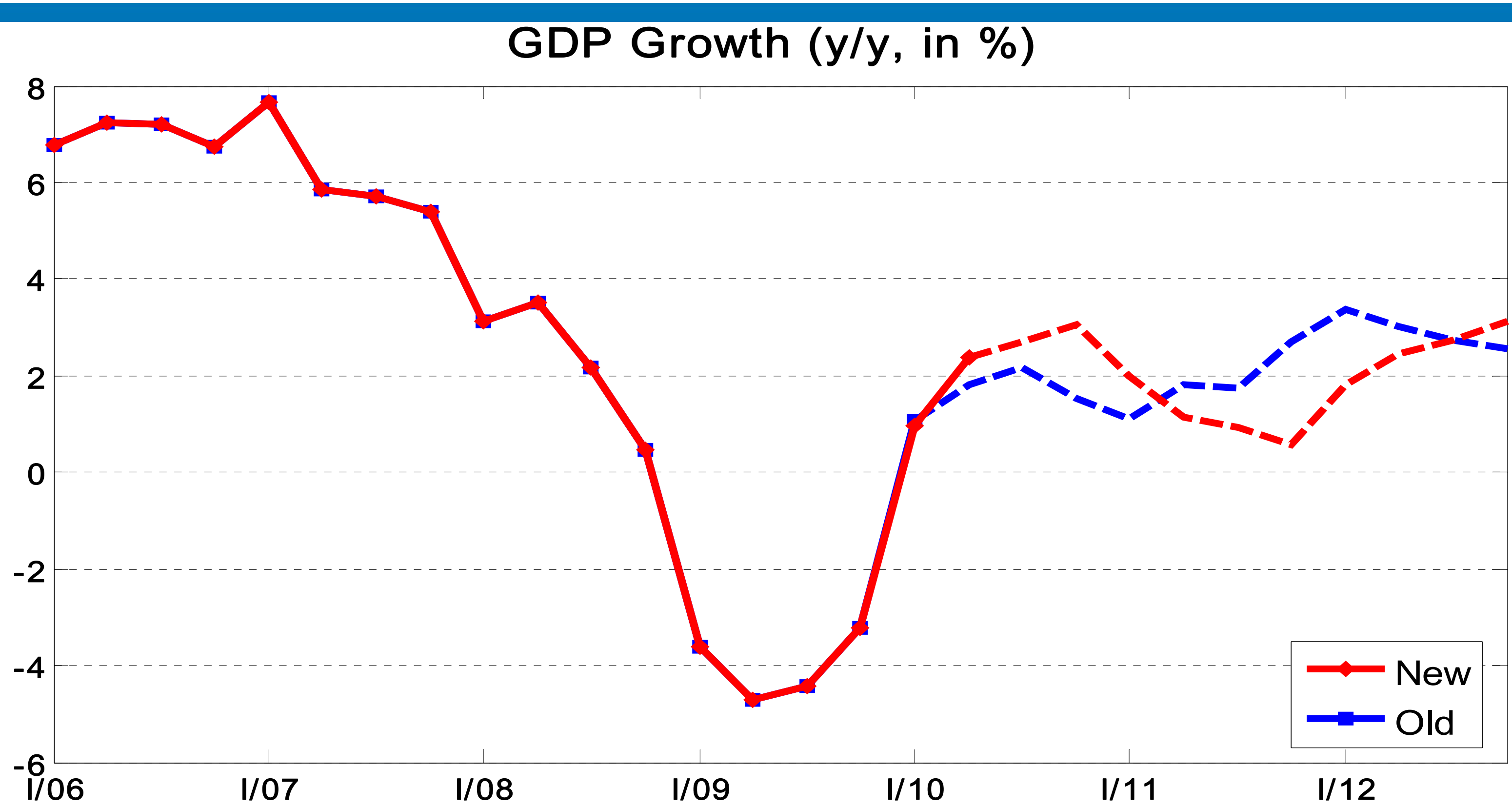
Comparison with Previous GDP Forecast (i)



- The y/y GDP outlook increases for 2010, slowdown in 2011 reflects mainly the fiscal consolidation (-0.8 p.p.).

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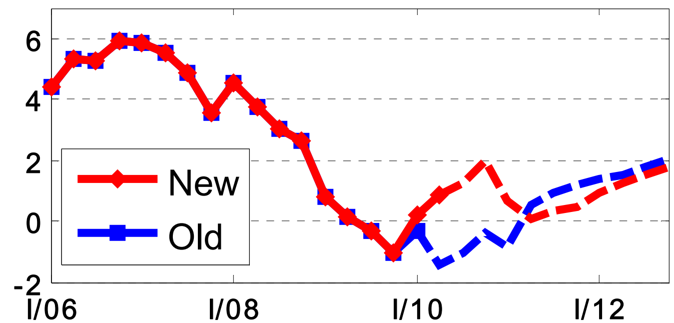
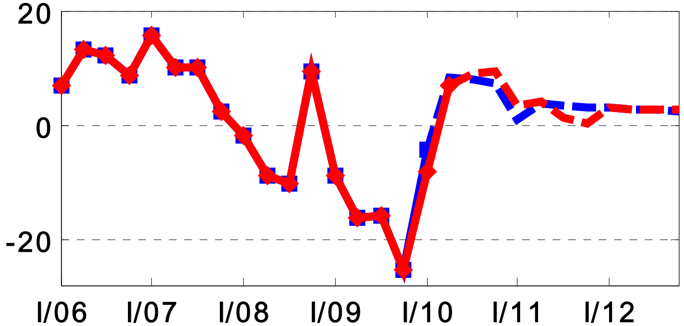
Comparison with Previous Aggregate Demand Forecast

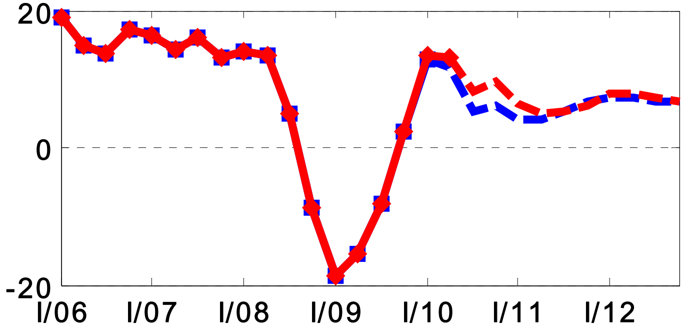
Household Consumption Growth
(y/y, in %)



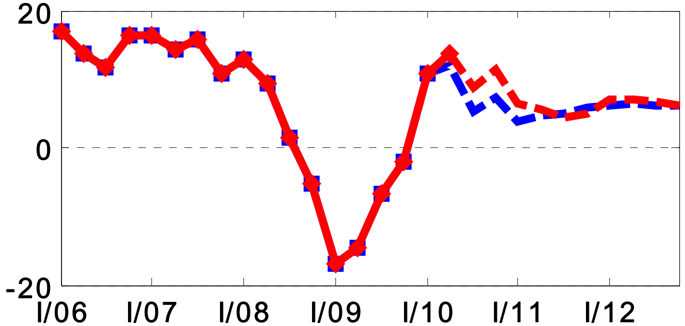
Investments Growth
(y/y, in %)



Exports Growth
(y/y, in %)



Imports Growth
(y/y, in %)



- Faster growth of consumption only in 2010.

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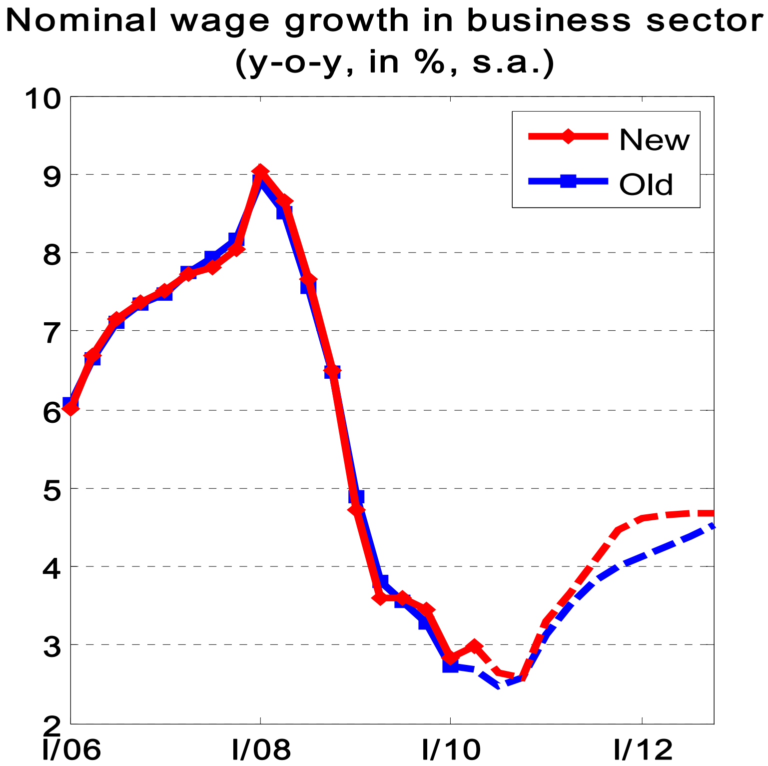
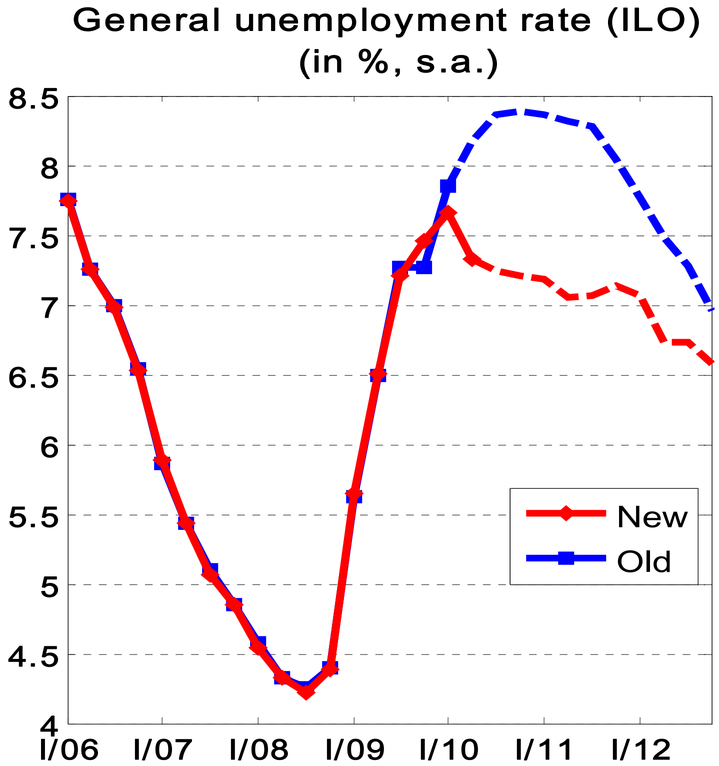
Comparison with Previous Labour Market Forecast





- The change in forecast of nominal wage growth is small and reflects positive supply-side effects of consolidation.
- The peak of unemployment rate (ILO) comes sooner.

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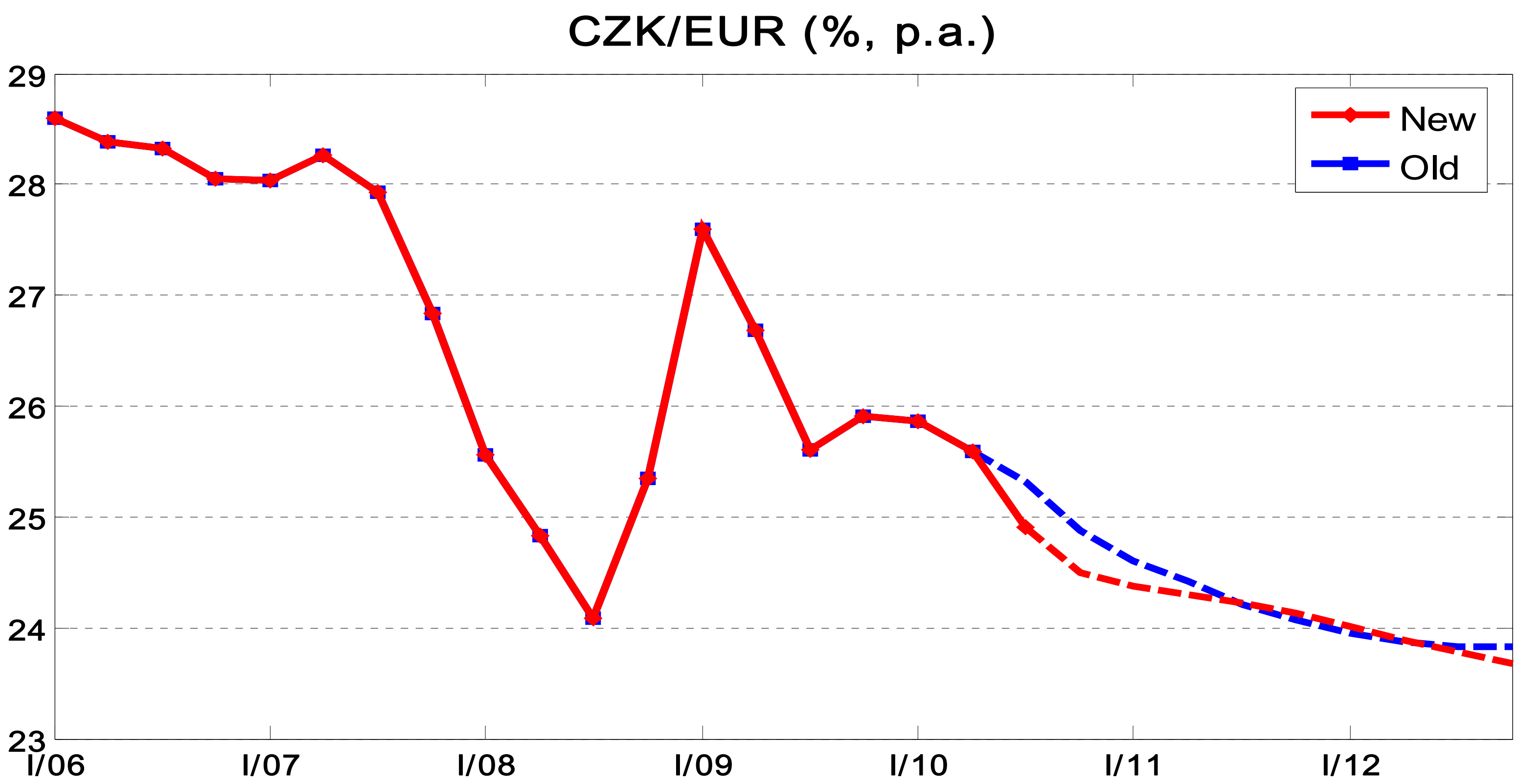
Comparison with the Previous Exchange Rate Forecast



- The exchange rate is slightly stronger initially, but then returns to the previous forecast.

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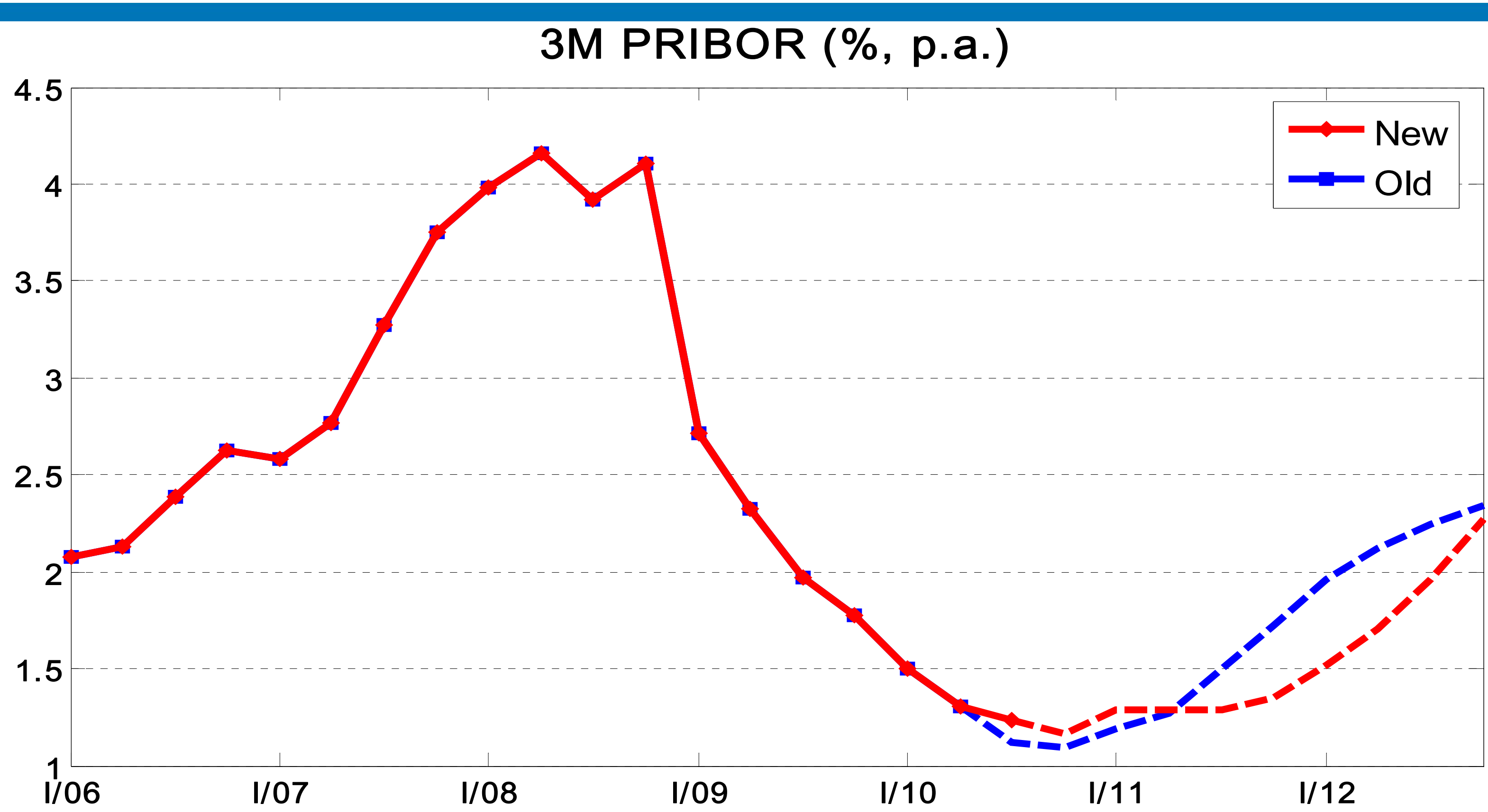
Comparison with the Previous Interest Rate Forecast



- The interest rate path implies more delayed increases compared with the previous forecast.

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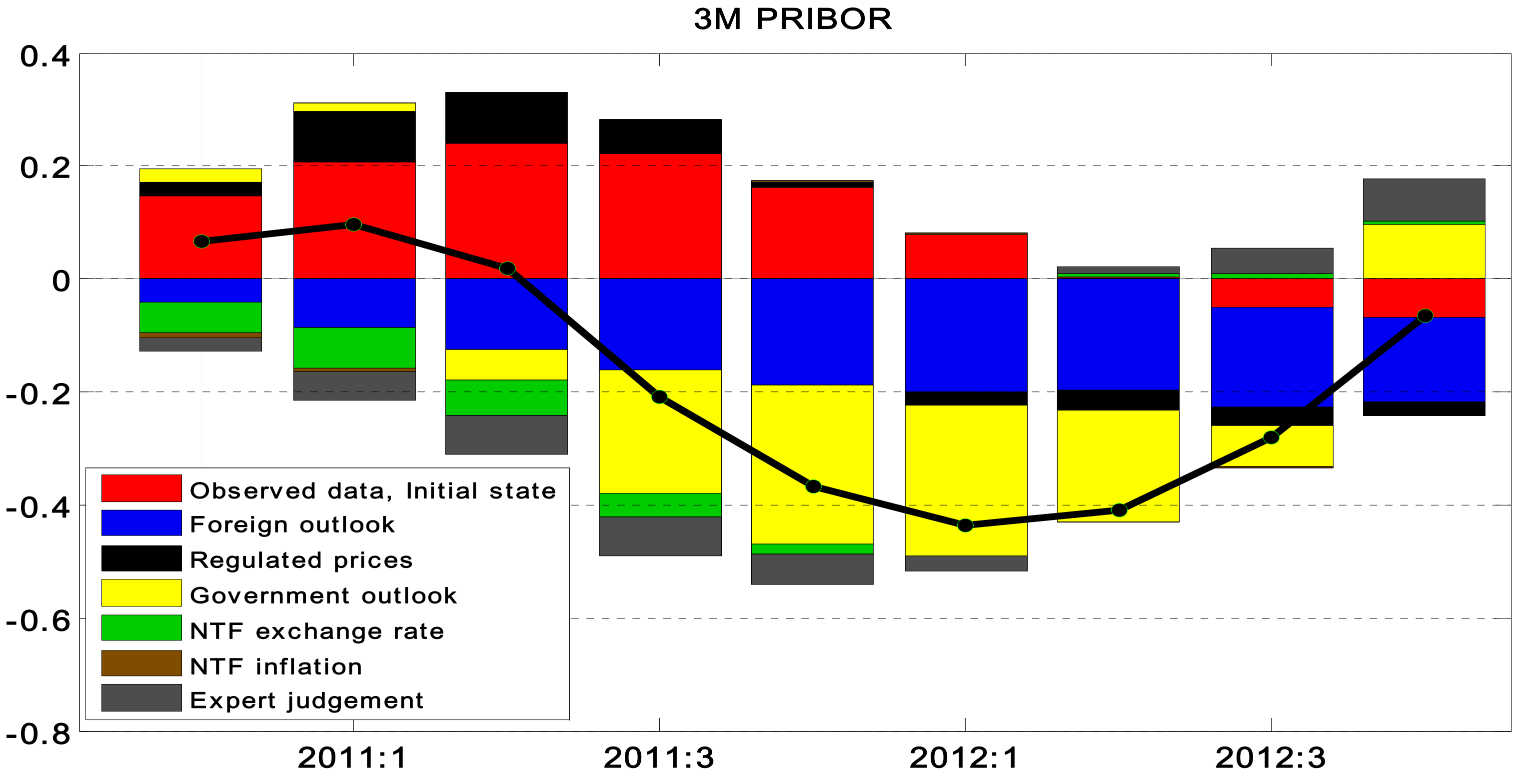
Interest Rate Forecast Change Decomposition



- The effect of initial conditions and higher regulated prices is gradually outweighed by the start of the fiscal consolidation and the new external outlook.

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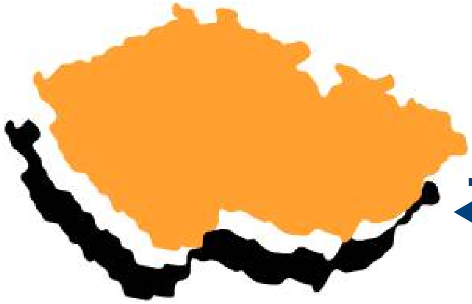
Planned Changes of Foreign Trade and BoP Data

- At the end of Sept 2010 (+18 Oct 2010), the CZSO and CNB have announced a forthcoming data revision.
- The revision is related to trade activities of foreign companies registered in CZ for VAT payments only.
- It will primarily affect the structure of the basic balance of the current account (lower trade surplus vs. more favourable balance of services).
- The overall current account deficit may nevertheless also increase, especially for 2009.
- The impact will be partly reduced by changes in the recording of foreign-trade-related services.

Illustration of the Problem (CZSO)

CZECH ECONOMY | **ABROAD**

Residents



Direct export + import

No revision planned

„Grey zone“ („VAT firms“)

Export in **BoP** = CZK 400 bn.
(change in ownership)

Export in **Trade Stat.** = CZK 420 bn.
(crossing the national border)

Import in **BoP** = CZK 350 bn.
(change in ownership)

Import in **Trade Stat.** = CZK 270 bn.
(crossing the national border)

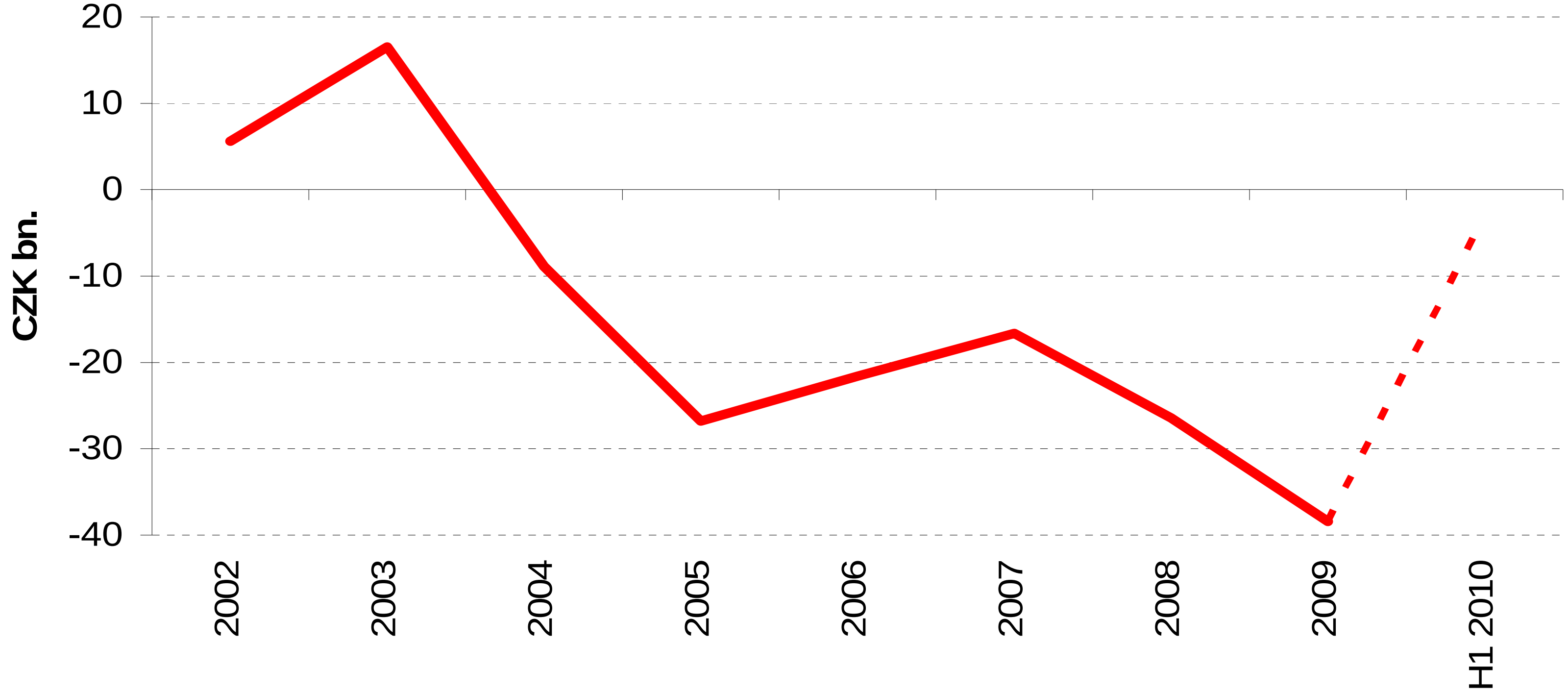
Surplus in BoP = CZK 50 bn.

Surplus of „VAT firms“ = CZK 100 bn.

Surplus in Trade Stat. = CZK 150 bn.

Errors and Omissions in BoP

Errors and omissions, exchange rate changes



- Growing trade surplus has not been matched by growing assets abroad (outflow on financial account).

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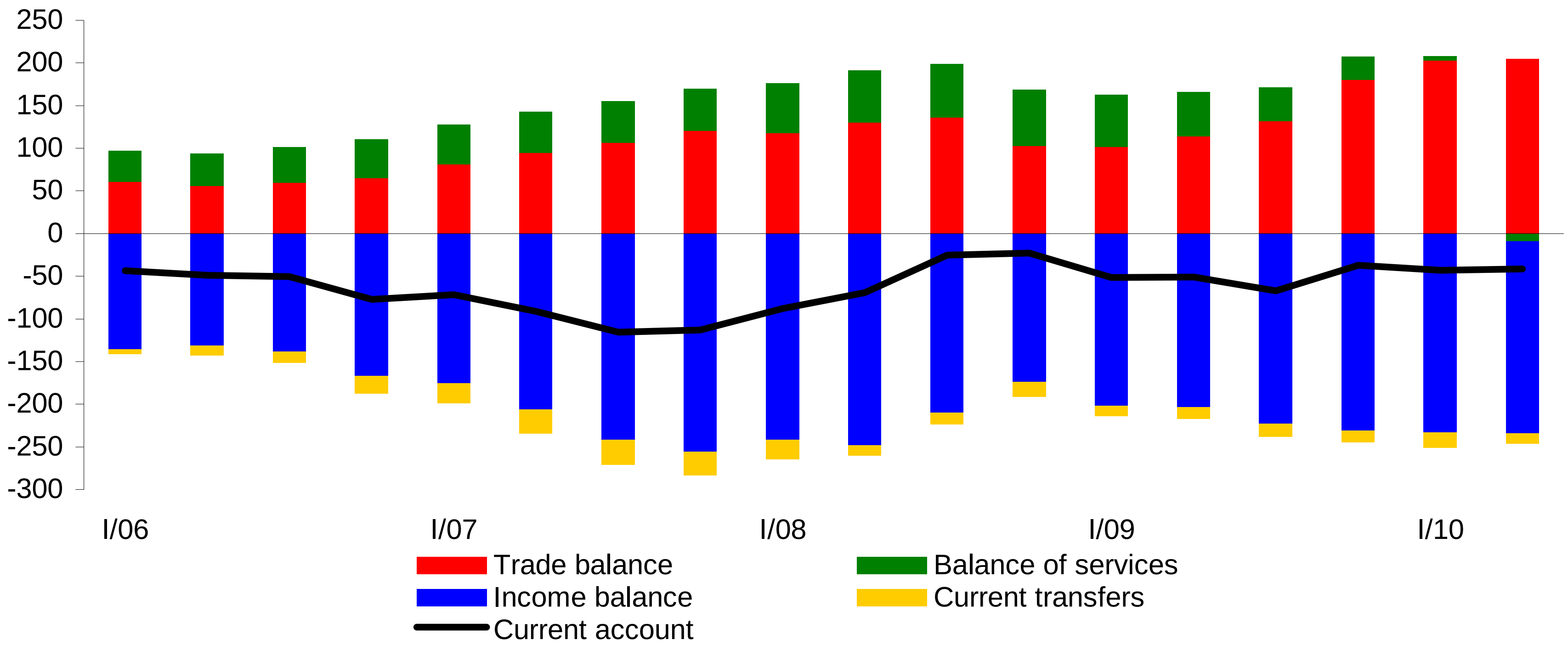
Current Account Balance

The current account (annual moving total in CZK billions)



- In 2009-2010 the problem has been partly and temporarily solved by imputing imports of ”branding“ services (≈35 bn. in 2009; 44 bn. in H1 2010).

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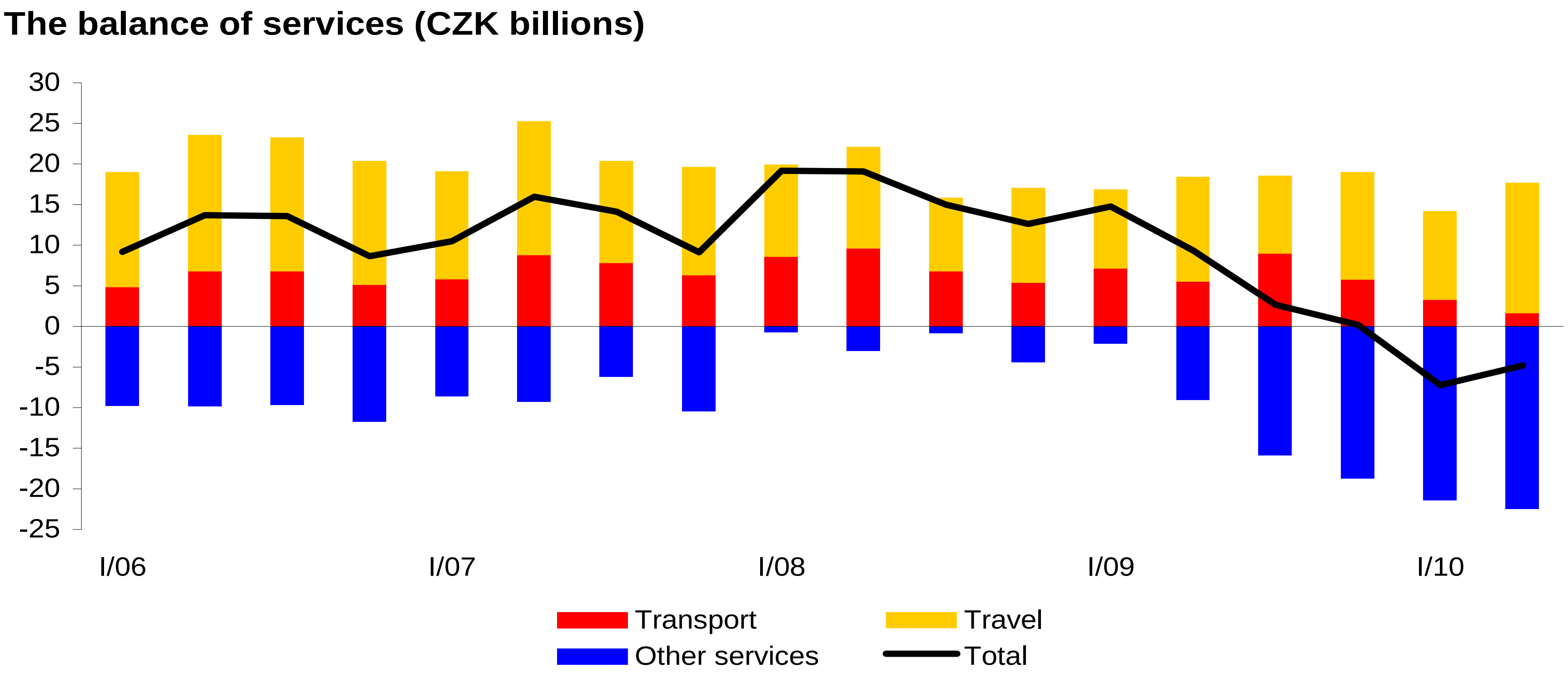
Balance of Services



- ”Branding“ is included in ”Other services“.
- It has moved the balance of services artificially into a deficit in H1 2010.

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Timetable of Data Revisions

- March 2011: the CZSO will start publishing foreign trade data in two methodologies (current + „national“), incl. the 2009-2010 time series.
- March 2011: the CNB will publish revised balance of payments for 2009-2010.
- Mid-2011: the CZSO will release 2005-2008 time series of trade in the „national“ methodology.
- September 2011: revised BoP for 2005-2008 by the CNB.
- September 2011: revised annual national accounts (CZSO; quarterly national accounts in December 2011).

Thank you for your attention

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