Meeting with Analysts

Tibor Hlédik

Prague, 7 November, 2014

Outline

- Assumptions of the forecast
- The new macroeconomic forecast
- Comparison with the previous forecast
- One year of the CNB's exchange rate commitment

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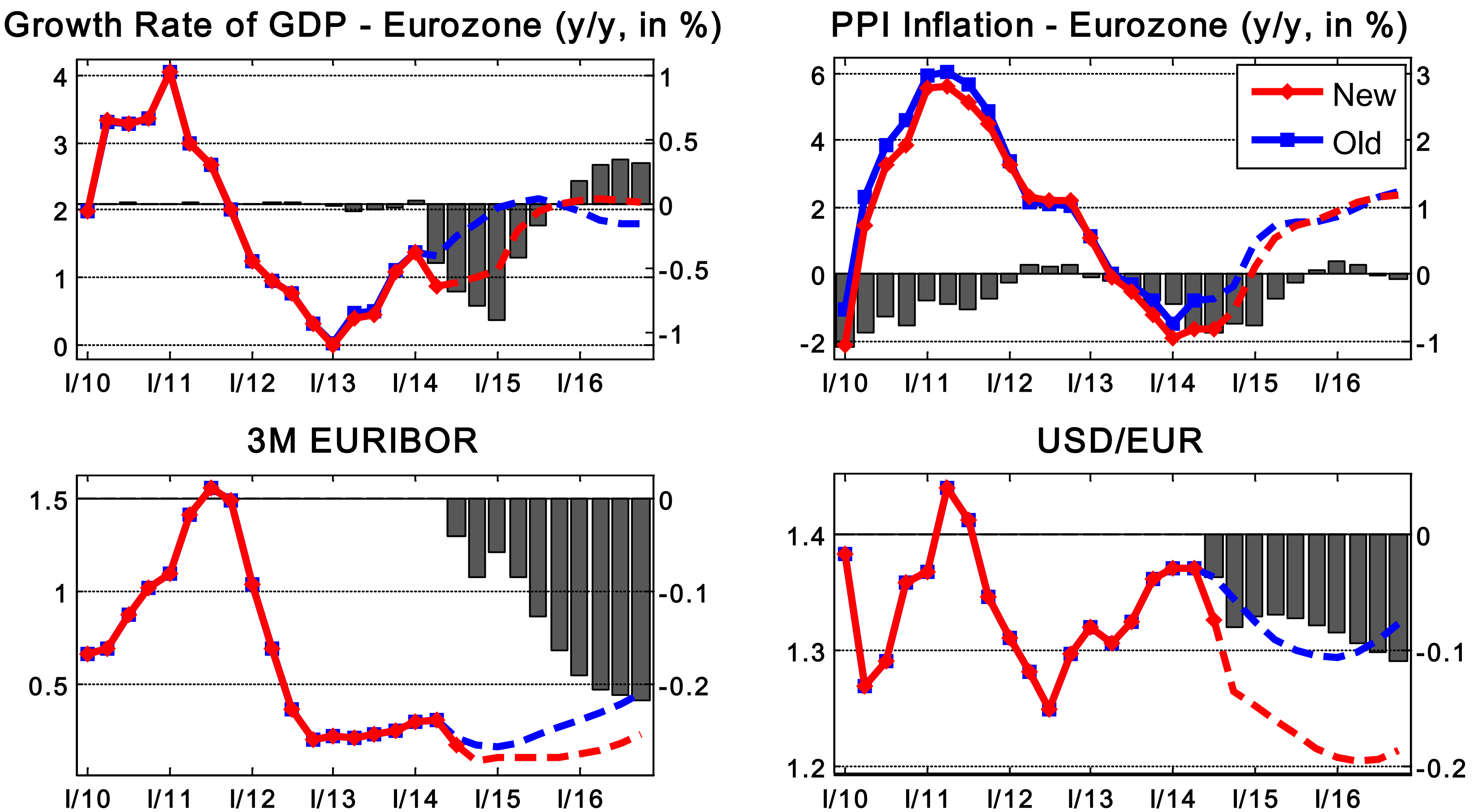
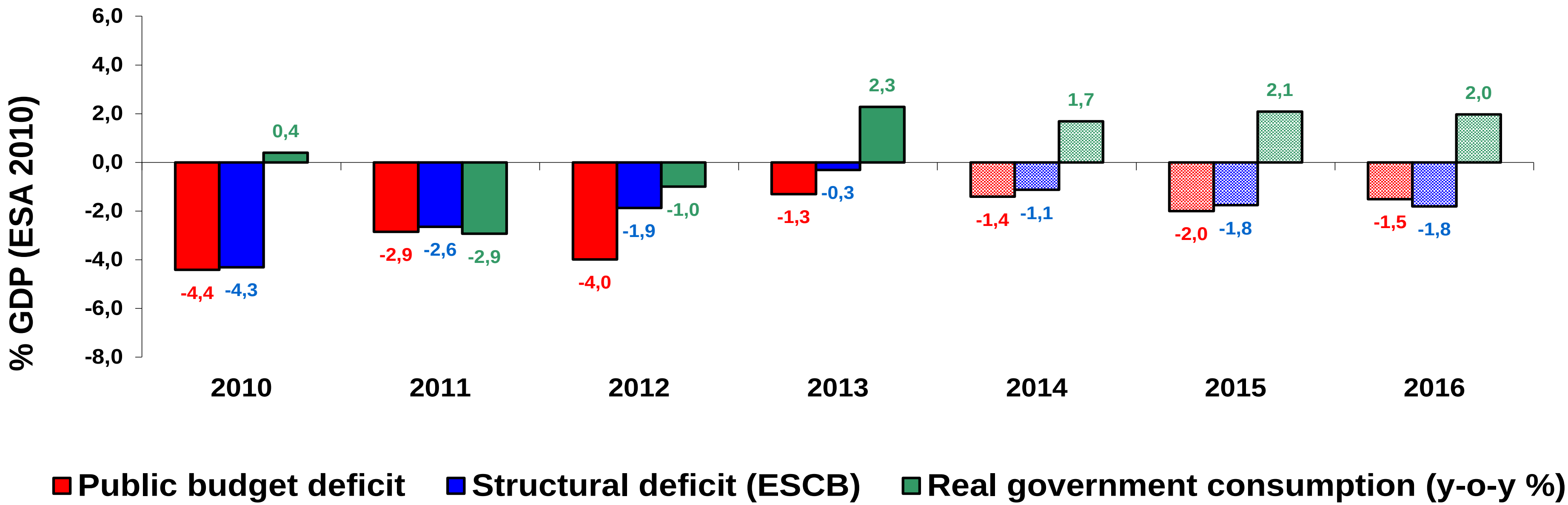
External Environment Outlook



- GDP growth in the effective EA will pick up more significantly from the 2015 Q2.
- The fall in PPI is deep and long lasting. It reflects weak economic growth in the EA and low commodity prices.
- 3M EURIBOR is expected to be low over the whole forecast horizon.
- The euro will continue to depreciate against the USD.

Fiscal Policy



- 2014: slight increase of the deficit to 1.4 % of GDP (revival of public investment and current spending vs. higher economic growth and extraordinary revenues from an auction of frequency bands to mobile operators).
- 2015: increase of the deficit to 2 % of GDP (the abolition of most fees in health care, a new 10 % reduced VAT rate, growing pensions, increase in public wages, culminating public investment financed by both EU funds and domestic sources, effect of an extension of the lease of the JAS-39 Gripen supersonic fighter aircraft).
- 2016: decline of the deficit to 1.5 % of GDP (continuing economic growth).
- Fiscal impulse: +0.3 p.p. in 2014, +0.5 p.p. in 2015 and -0.2 p.p. in 2016.

Monetary Policy

- The forecast expects market interest rates to be flat at their current very low level and the koruna exchange rate to be used as an instrument for easing monetary policy until 2016 Q1. Market interest rates are forecasted to increase by around 0.8 percentage point in 2016 Q2 and rise further afterwards.
- The forecast expects that the exchange rate of the koruna against the euro will remain close to the level of CZK 27.4 for the next a few quarters. This is a somewhat weaker level than the announced asymmetric exchange rate commitment (i.e. CZK 27 to the euro).
- The return to conventional monetary policy will not imply appreciation of the exchange rate to the level recorded before the CNB started intervening, as the weaker exchange rate of koruna will in the meantime pass through to the price level and other nominal variables.

Outline

- Assumptions of the forecast
- The new macroeconomic forecast
- Comparison with the previous forecast
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Summary of the Inflation Forecast (i)

- Both headline and monetary-policy relevant inflation remained in 2014 Q3 below the lower boundary of the tolerance band around the CNB's target. They will continue to increase towards the CNB's 2% target, at the end of the monetary policy horizont they will exceed it.

- The inflationary effect of import prices will turn to anti-inflationary at the beginning of 2015 as a result of the observed fall of foreign producer prices and stable nominal exchange rate.

- In contrast, domestic economy will start generating inflationary pressures due to continuing economic growth and accelerating nominal wage growth in the business sector.

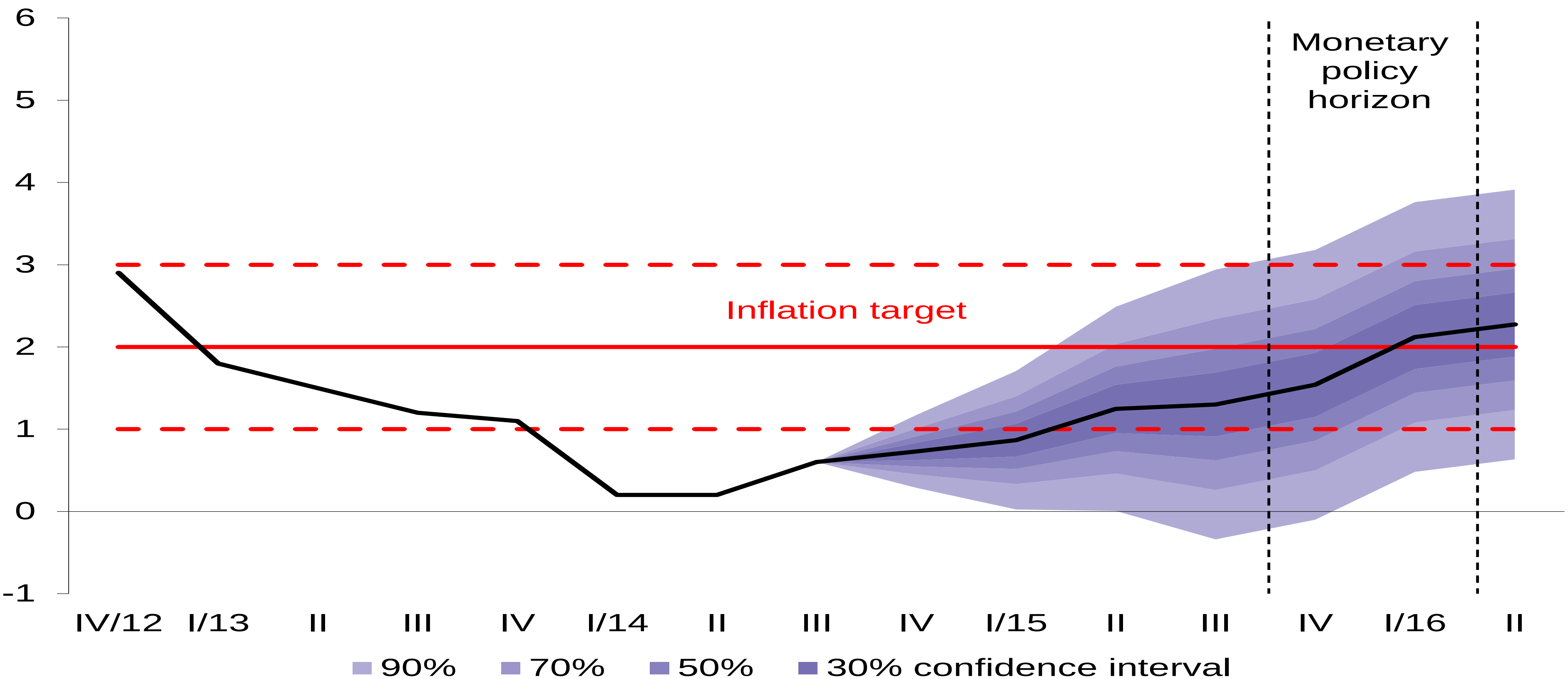
Summary of the Inflation Forecast (ii)

- Following its decline in the last year, GDP will grow by 2.5% this year, as well as in 2015. The main factors behind continuing growth will be improving external demand, relaxed domestic monetary conditions and increased government investment. The growth rate will slightly increase in 2016, despite the fall in government investment.

- The economic recovery is already manifesting itself in the labor market through renewed growth in the number of employees converted into full-time equivalents. This is expected to continue on the forecast horizon. The unemployment rate will decrease gradually. Wage growth will noticably increase in the business sector, for near-term the same holds for public sector wages.

Headline Inflation Forecast

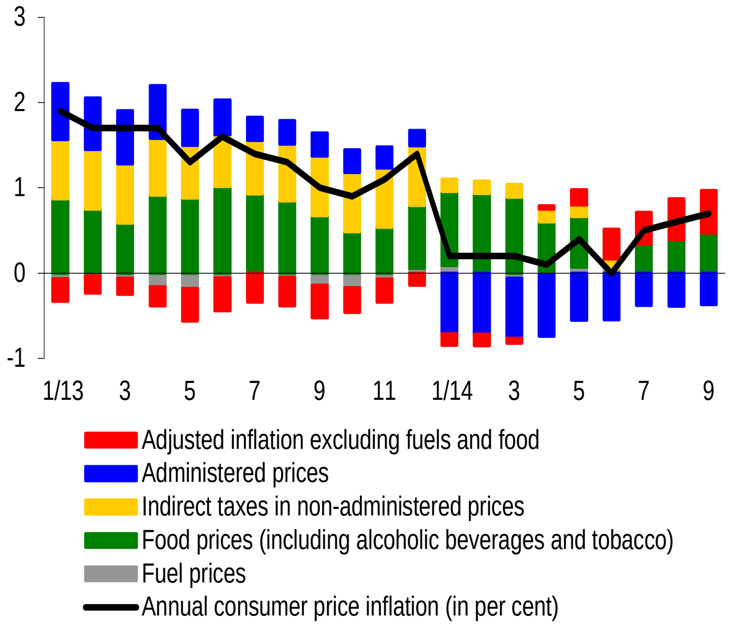
(y/y in %)



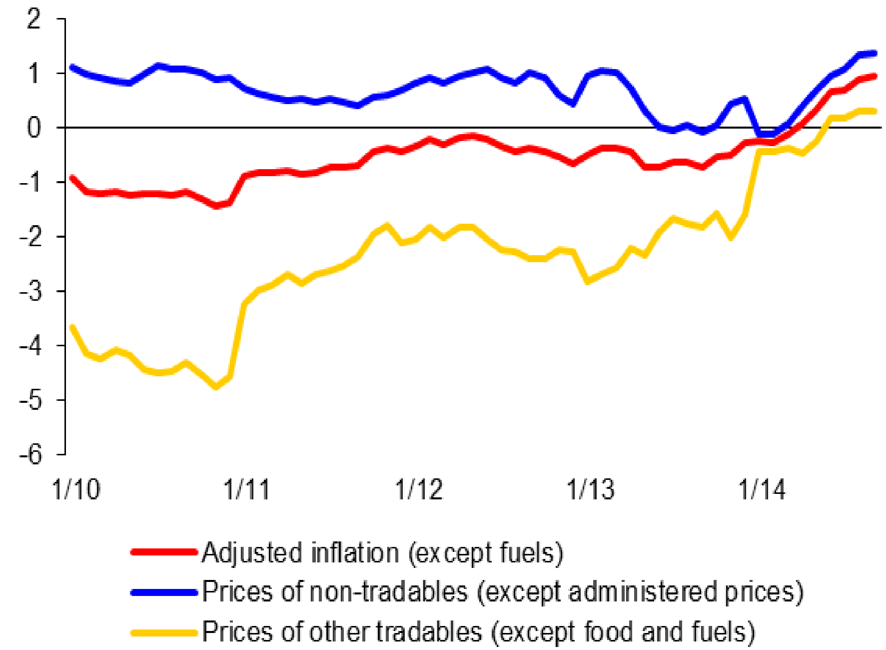
- Headline inflation remained in 2014 Q3 below the lower boundary of the tolerance band around the CNB's target.
- It will continue to increase towards the CNB's 2% target, at the end of the monetary policy horizon it will slightly exceed it.

Inflation in the 3.Q 2014

Structure of inflation



Core inflation and its components



- The y-o-y decline in administered prices in 2014 Q3 was more than offset by the increase in food prices and adjusted inflation excluding fuels.
- The change in fuel prices contributed to overall inflation only marginally.
- Adjusted inflation excluding fuels remained positive in 2014 Q3, supported by both its components.

MP-Relevant Inflation Forecast

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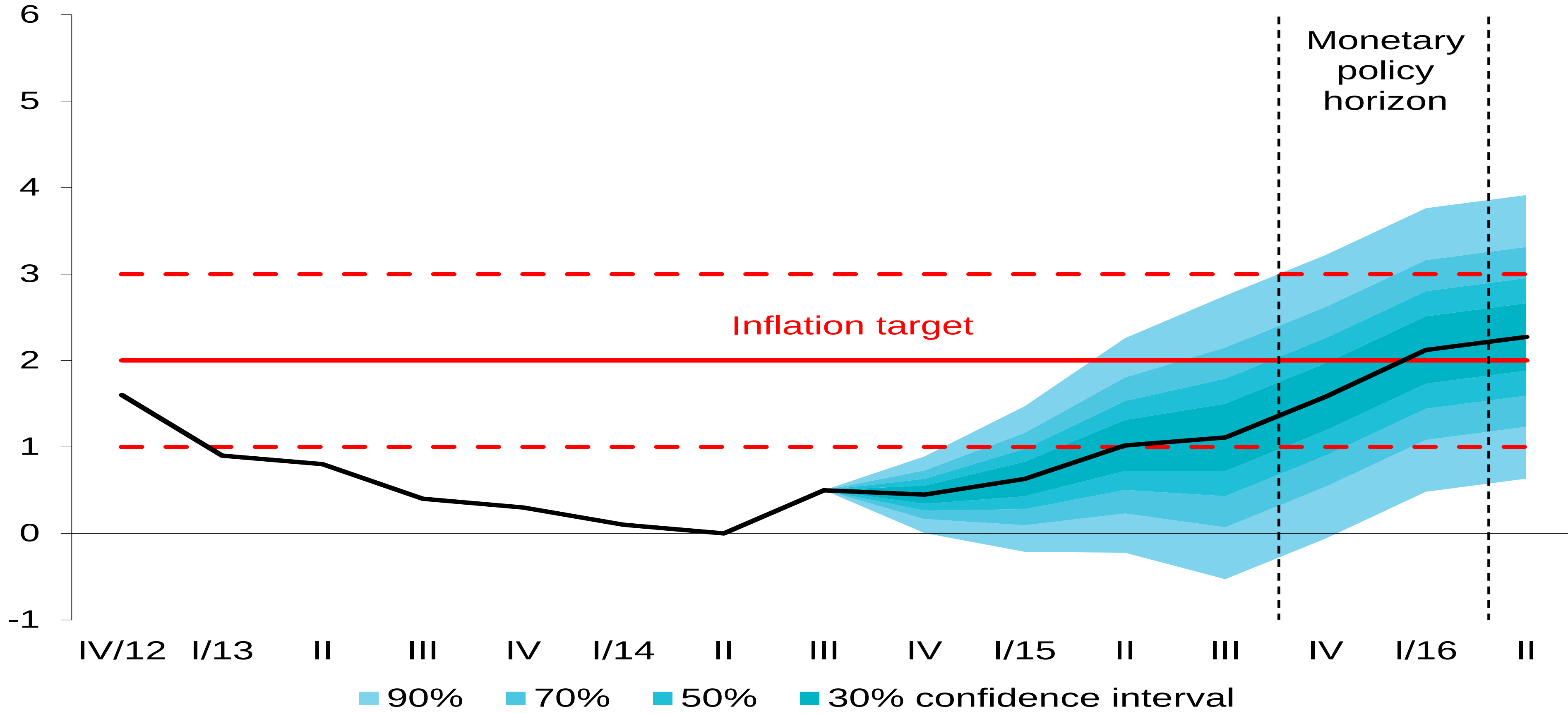
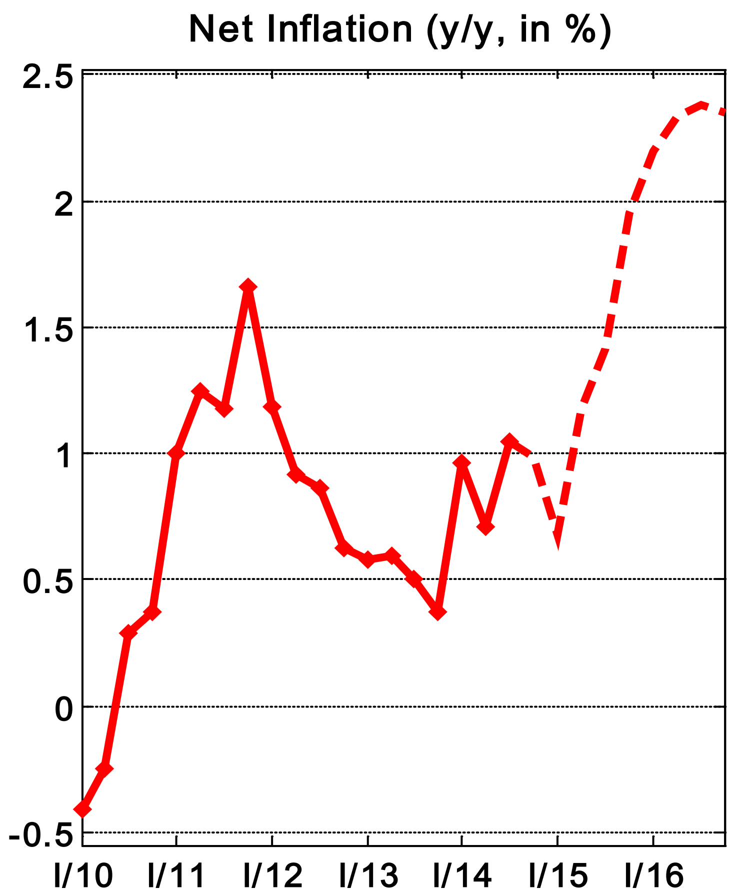
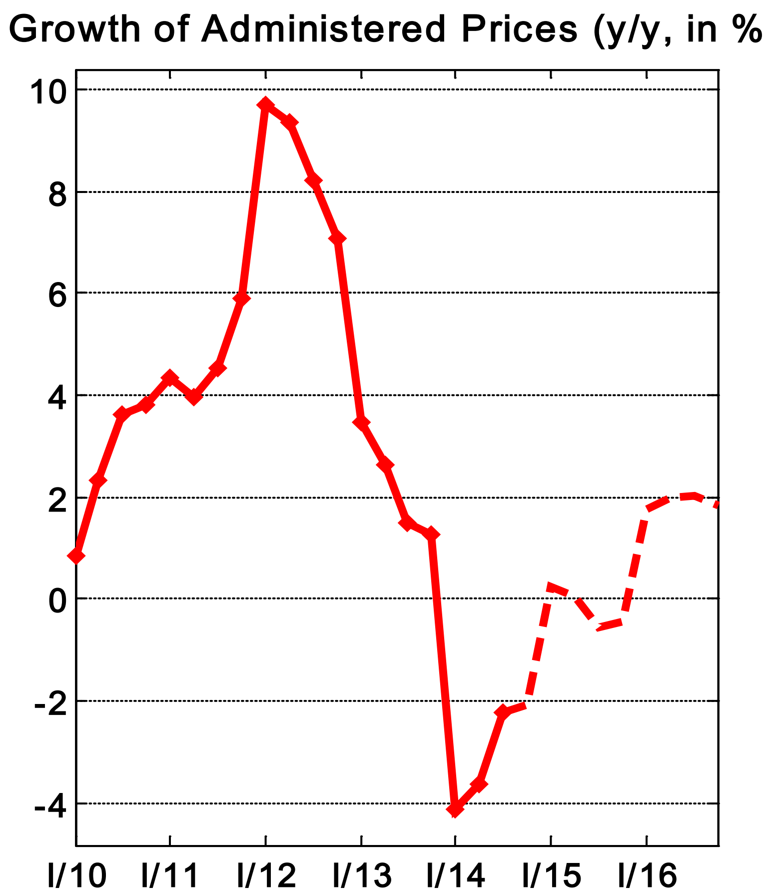
(y/y in %)



- Monetary policy-relevant inflation will increase close to the inflation target on the monetary policy horizont .
- Indirect taxation changes: increase in excise duties on cigarettes (+0.31 p.p.) and introduction of a second reduced VAT rate at 10% (-0.07 p.p., in 2015).

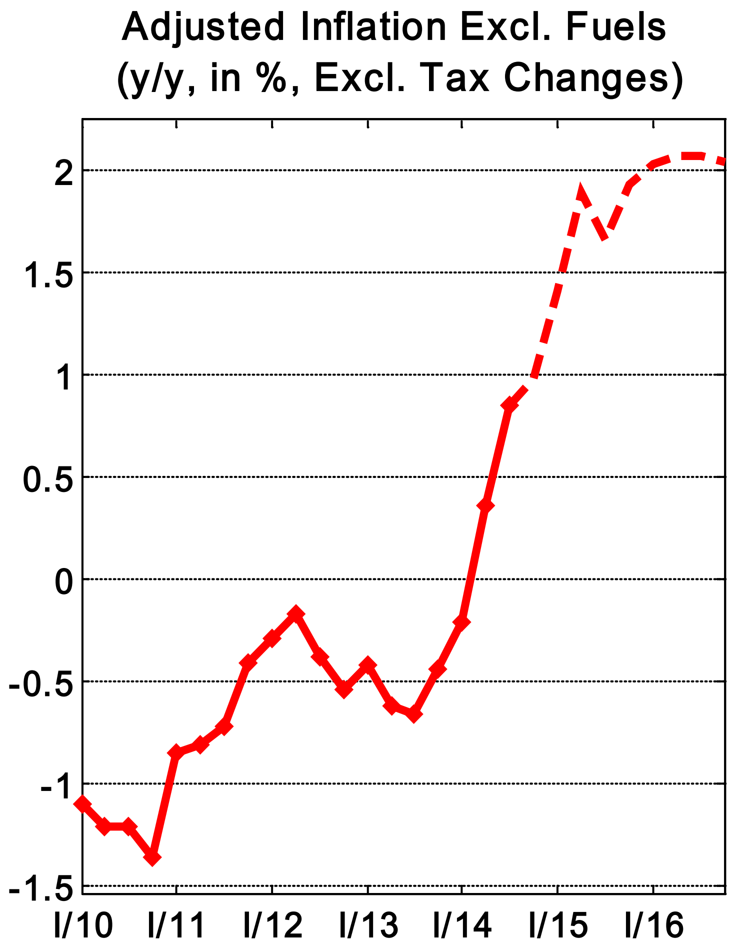
Market and Administered Prices

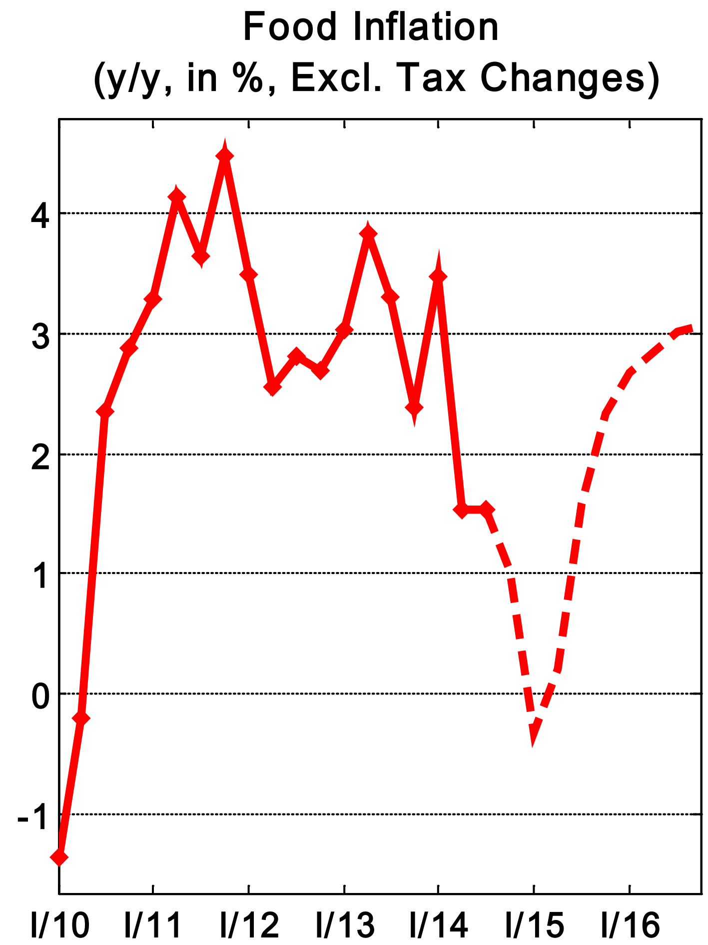




- Net inflation, after reaching 1% in 2014 Q3, will slow down due to fall in food and fuel prices. The forecast expects net inflation to start increasing again from 2015 Q2. It will exceed 2 % at the end of 2015 and remain above this level in 2016.
- Administered prices will decrease by 0.2 % in 2015 (lower energy prices and abolition of most co-payments in health care). They will grow by 2 % in 2016.

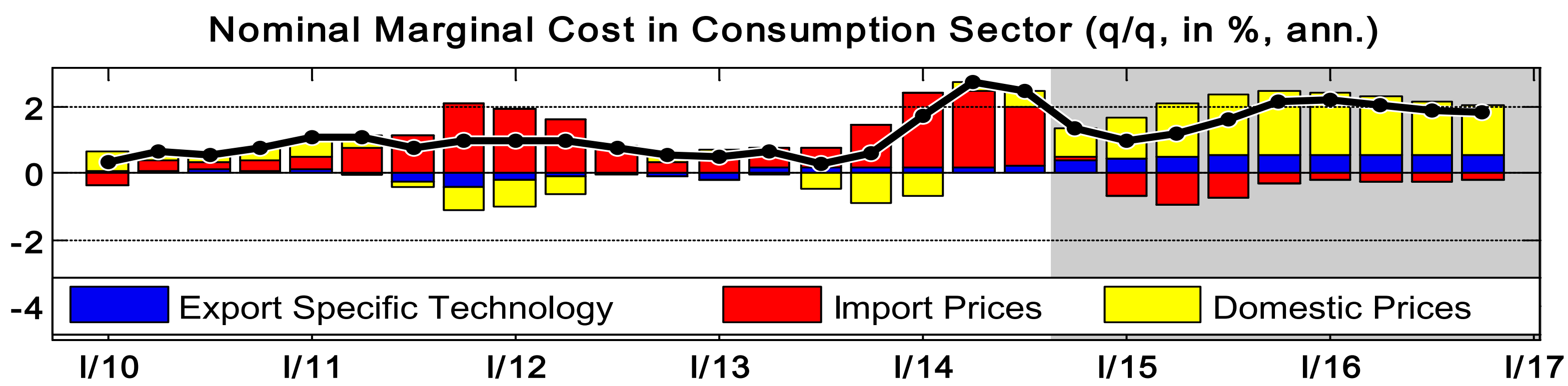
Adjusted Inflation Excluding Fuels and Food

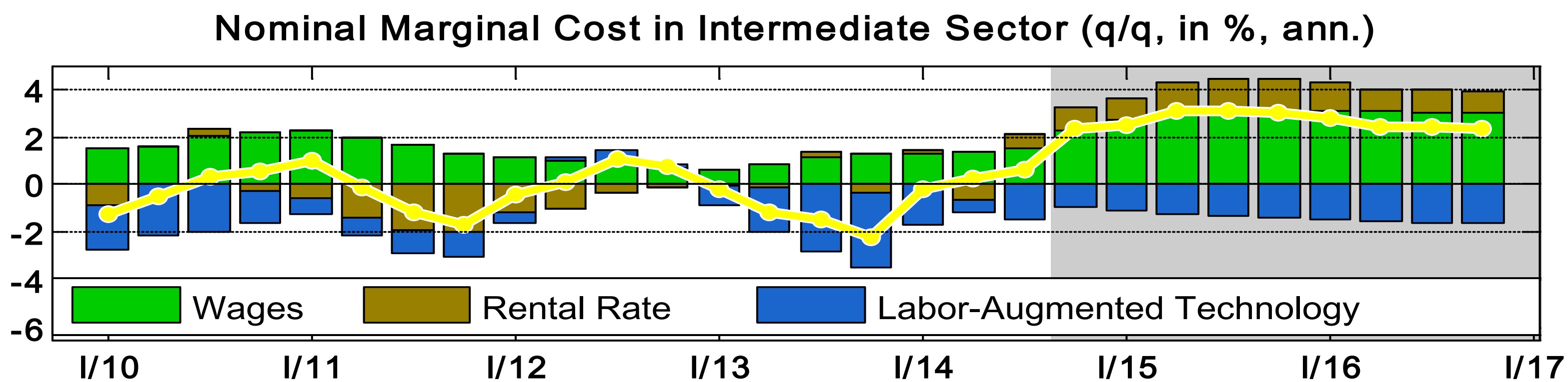




- Core inflation will speed up during 2015 in an environment of pronounced economic recovery and gradual revival of the labour market.
- Food prices are expected to decrease temporarily at the beginning of 2015 due to the fall of agricultural prices. Their growth, however, will pick up afterwards.

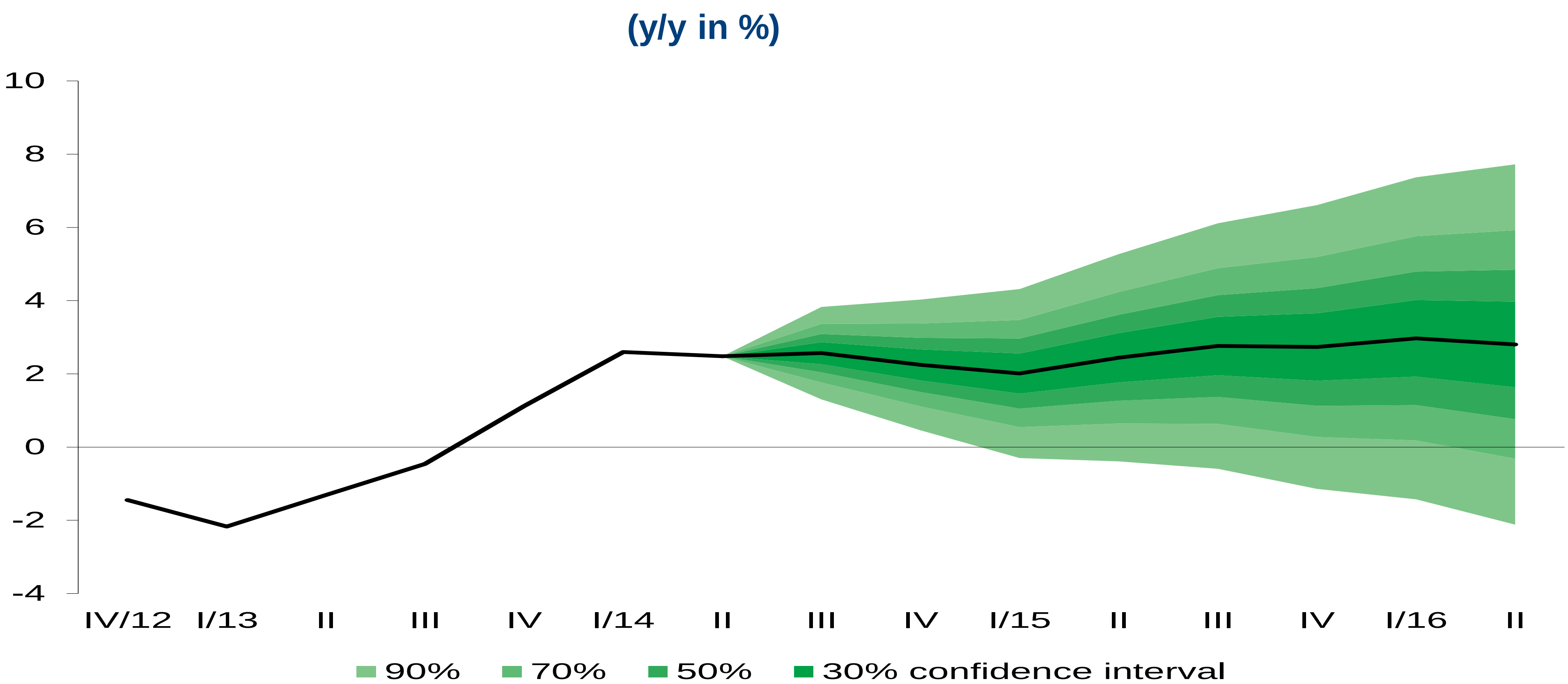
Domestic Costs vs. Import Prices





- Domestic inflationary pressures will continue to build up in coming quarters, reflecting the pronounced revival of the domestic economy.
- The marked inflationary effects of import prices will turn to slightly antiinflationary in 2015 Q1 due to the observed fall in foreign PPI and stable nominal exchange rate.
- Increasing wages and costs of capital will be driving the growth of marginal costs in the intermediate sector partly offset by curbing effects of productivity gains.

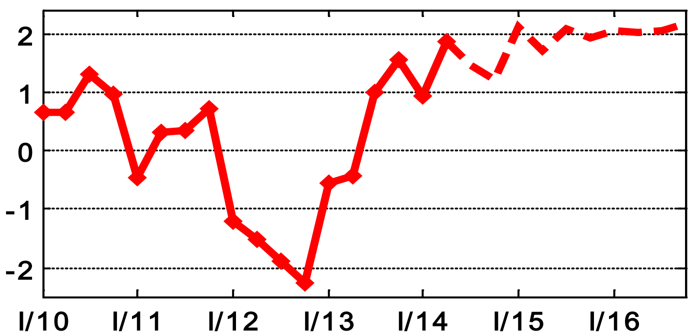
GDP Growth Forecast



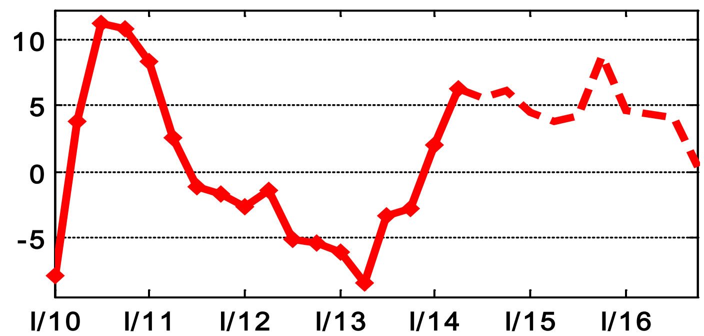
- GDP growth forecast: 2.5 % in 2014 and 2015, 2.8 % in 2016.
- The economic growth will be supported by all components of domestic demand.
- Net exports will have a positive effect on economic growth, apart from 2015, when high imports generated by a continuing growth of exports and domestic demand will result in slightly negative contribution of net exports.

Aggregate Demand

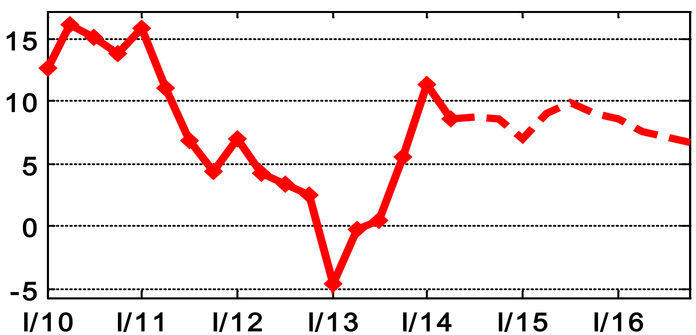
Household Consumption Growth (y/y, in %)



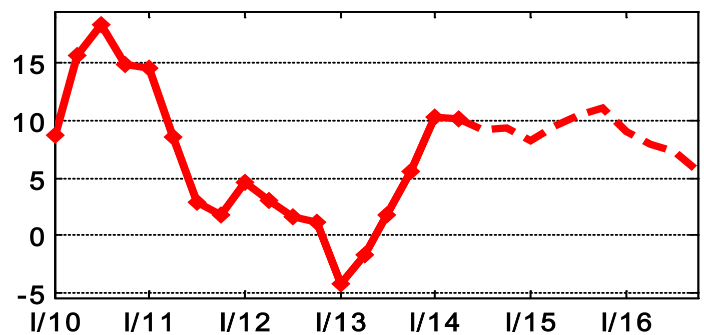
Investments Growth (y/y, in %)



Exports Growth (y/y, in %)

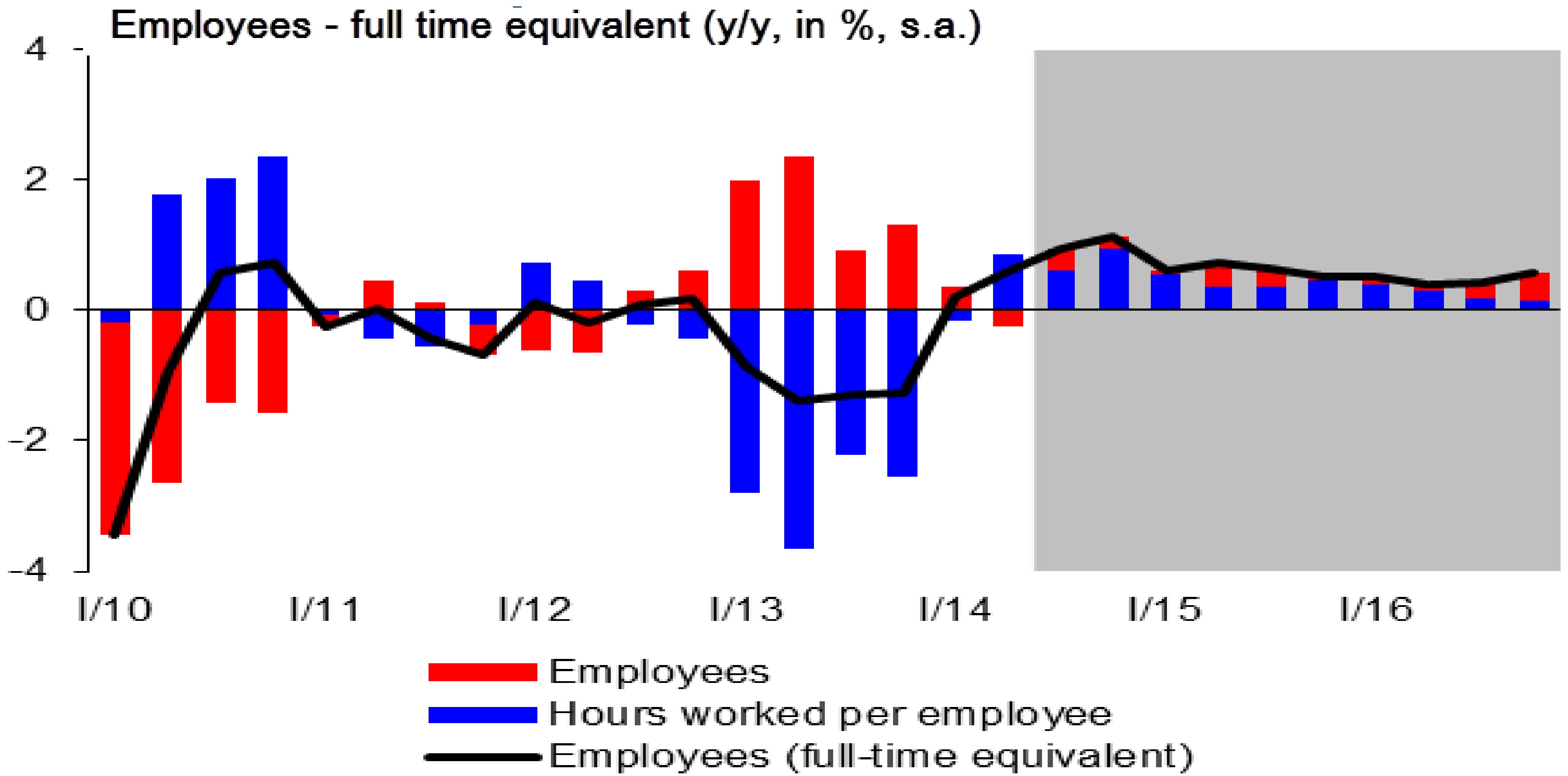


Imports Growth (y/y, in %)



- Household consumption will be growing at approx. 2 % on the whole forecast horizon, reflecting the dynamics of real disposable income of households.
- Investment recovery will be supported by continuing investment activity of the private sector and increased public investment during 2014 - 2015.
- Exports and imports will copy the temporary slowdown in foreign demand.

Labour Market Forecast (i)

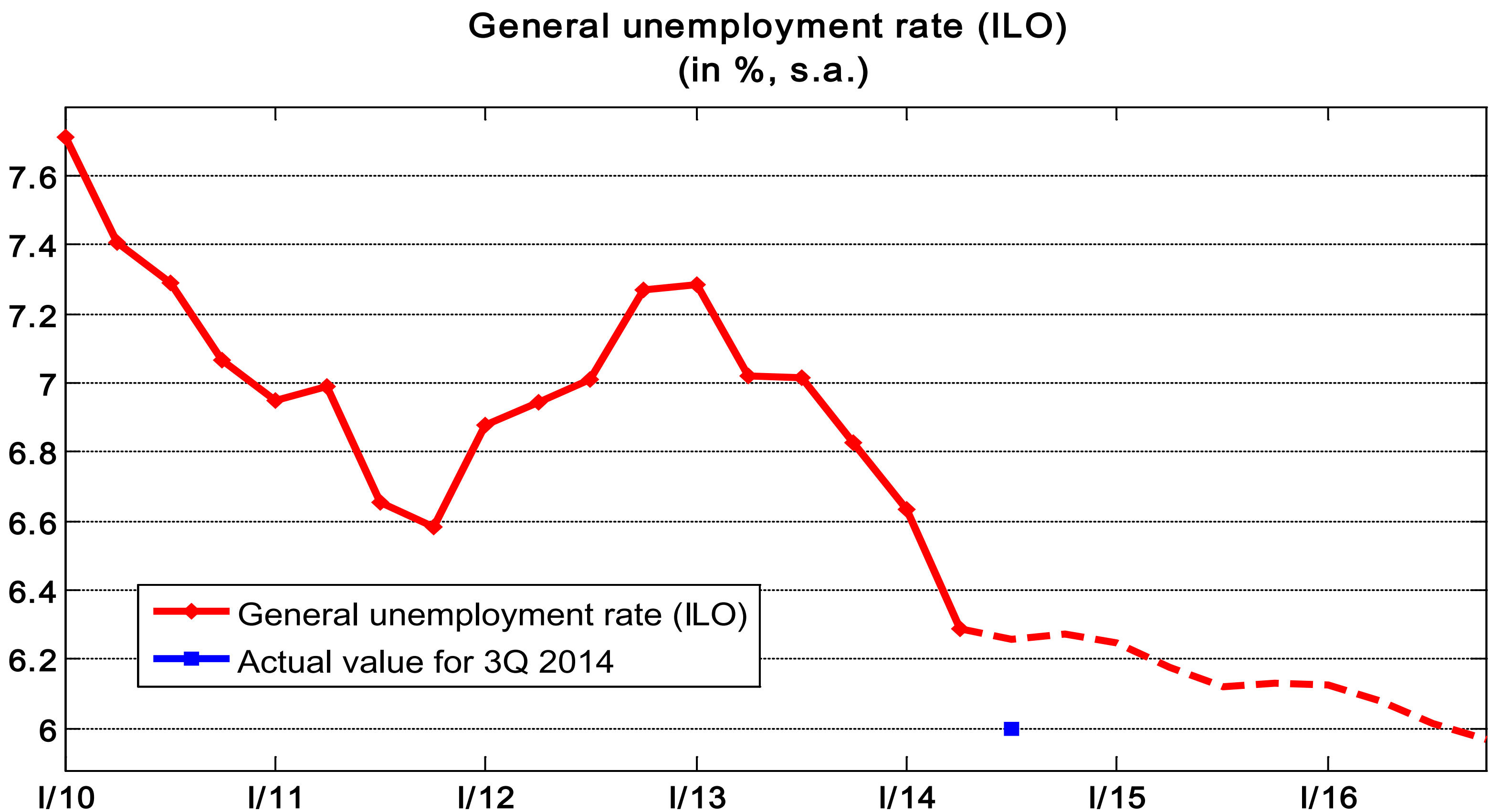


- Employment growth expressed in full-time job equivalent turned positive in 2014 Q1. Further acceleration in the rest of this year will be primarily a result of increases in hours worked per employee amid continued gradual growth in the number of employees.
- The number of employees in 2014 Q3 grew by 1 %.

Labour Market Forecast (ii)

- The observed wage data in business sector have until recently been significantly affected by tax optimization from late 2012. The adjustment of wages from the tax optimization effect was newly carried out based on detailed microdata.
- Since 2013 H2 adjusted wage growth has gradually been speeding up and this trend will continue due to growing economic activity and inflation.

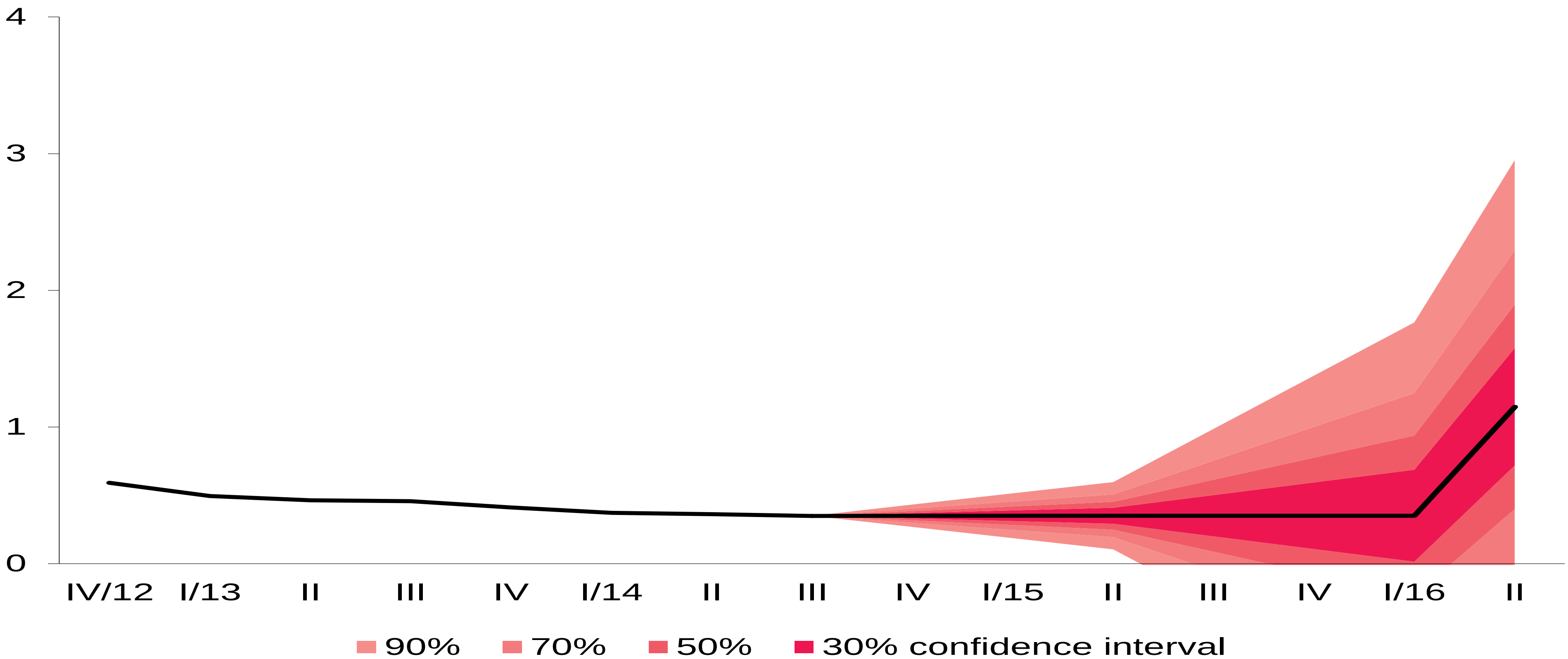
Labour Market Forecast (iii)



- The forecast expects that the s.a. level of the general unemployment rate will stay close to 6.3 % until the beginning of 2015, when a slight increase in the labor force and employment will compensate each other. Subsequently the growth of employment, supported by economic growth, will dominate.
- The value of the s.a. general unemployment rate in 2014 Q3 reached 6 %.

Interest Rate Path

PRIBOR 3M, % p.a.



- The forecast expects market interest rates to be flat at their current level until 2016 Q1, reflecting the 2W repo rate being left at technical zero over the same time frame and the assumption of an unchanged money market premium.
- Short-term market rates are forecasted to increase by around 0.8 percentage point in 2016 Q2 and then rise further.

Outline

- Assumptions of the forecast
- The new macroeconomic forecast
- Comparison with the previous forecast
- One year of the CNB's exchange rate commitment

Comparison with Previous Forecast

- The outlook for headline as well as monetary policy-relevant inflation shifted significantly downwards until the beginning of 2016 owing to a shift of net inflation in the same direction.

- GDP growth has been revised downwards for both 2014 and 2015, mainly as a result of weaker foreign demand and partially also data revisions. The GDP forecast for 2016 remains unchanged.

- The average nominal wage growth in the bussiness sector is forecasted to be lower, starting from the beginning of the next year.

- The forecast for domestic market interest rates has shifted lower in late 2015 and early 2016. This is because the new forecast expects the exchange rate to be used as a monetary policy instrument until 2016 Q1, whereas the previous forecast assumed it would be used only until 2015 Q3.

Comparison with Previous Inflation Forecast (i)

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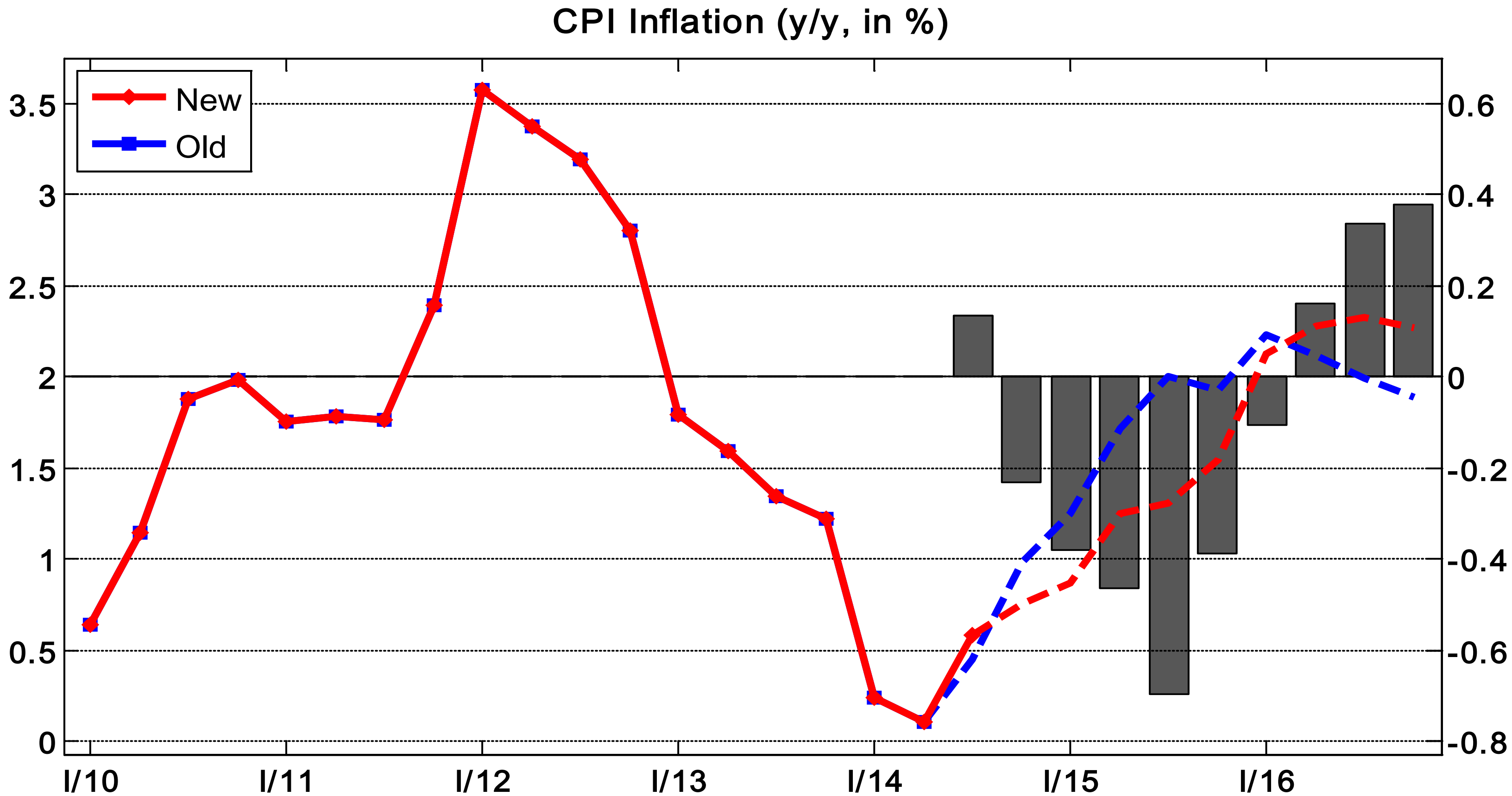

- The downward revision of the inflation forecast for the rest of 2014 and 2015 mainly reflects falling foreign PPI and lower wage growth in the business sector.
- Slightly higher growth of administered prices and food prices contributes to the higher inflation outlook in 2016.
- Similar shift in the outlook for monetary-policy relevant inflation.

Comparison with Previous Inflation Forecast (ii)

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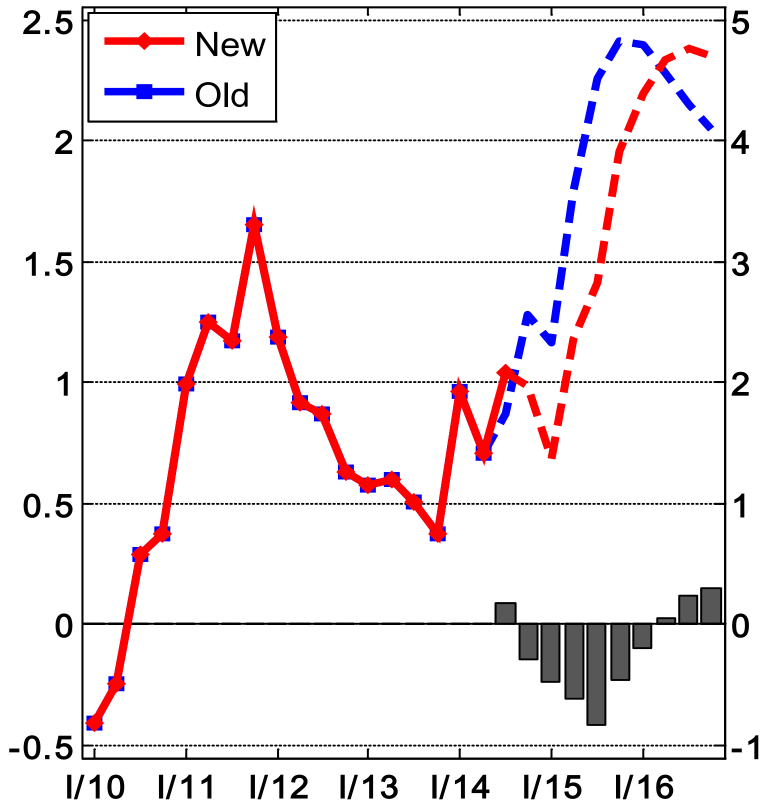
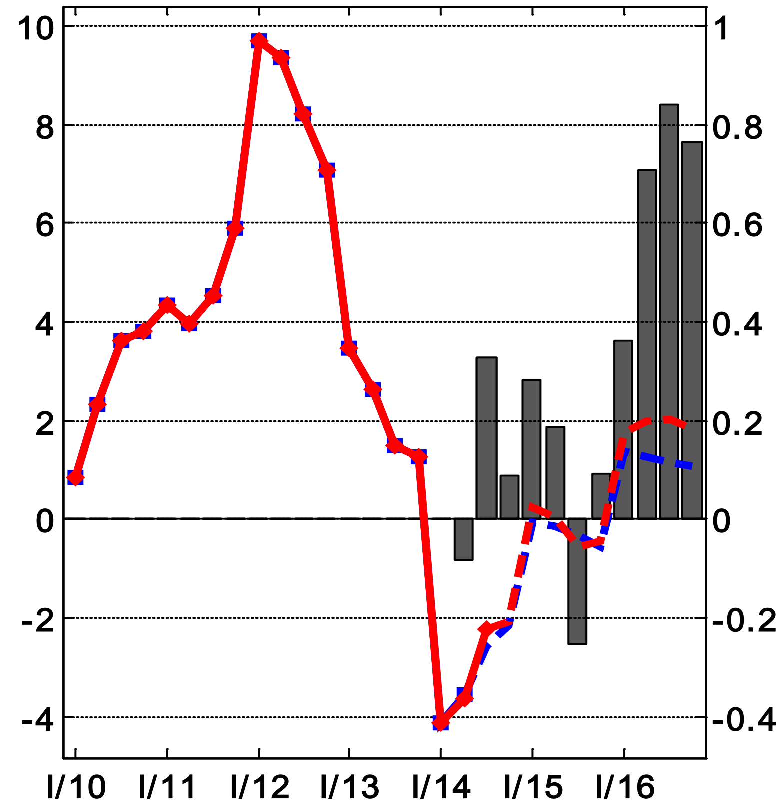
Net Inflation (y/y, in %)



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



- Net inflation: downward revision of the forecast for 2014 and 2015, since 2016 H2 somewhat higher outlook.
- Administered prices: negligible differences for 2014 and 2015, upward revision for 2016 owing to higher expected growth in gas prices linked with a rise in the market outlook for prices of its commodity component.

Comparison with Previous Inflation Forecast (iii)

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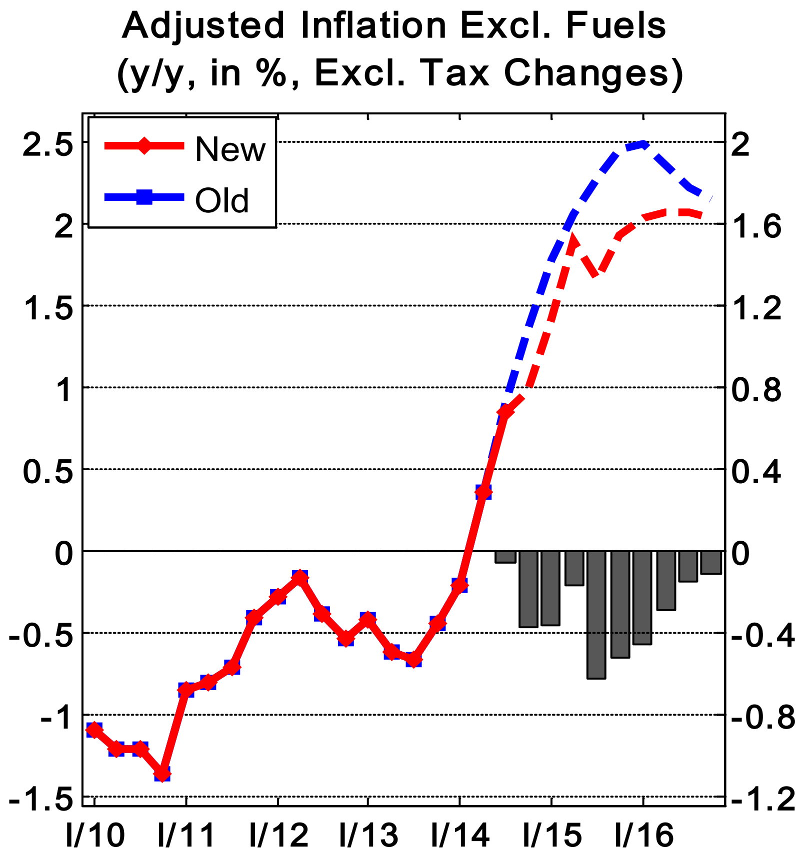
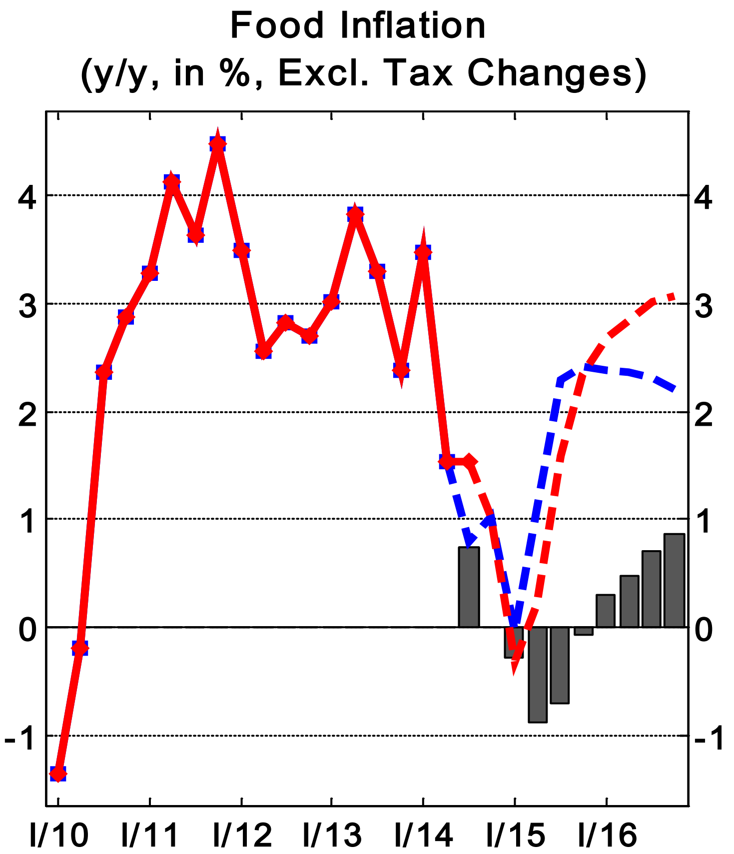
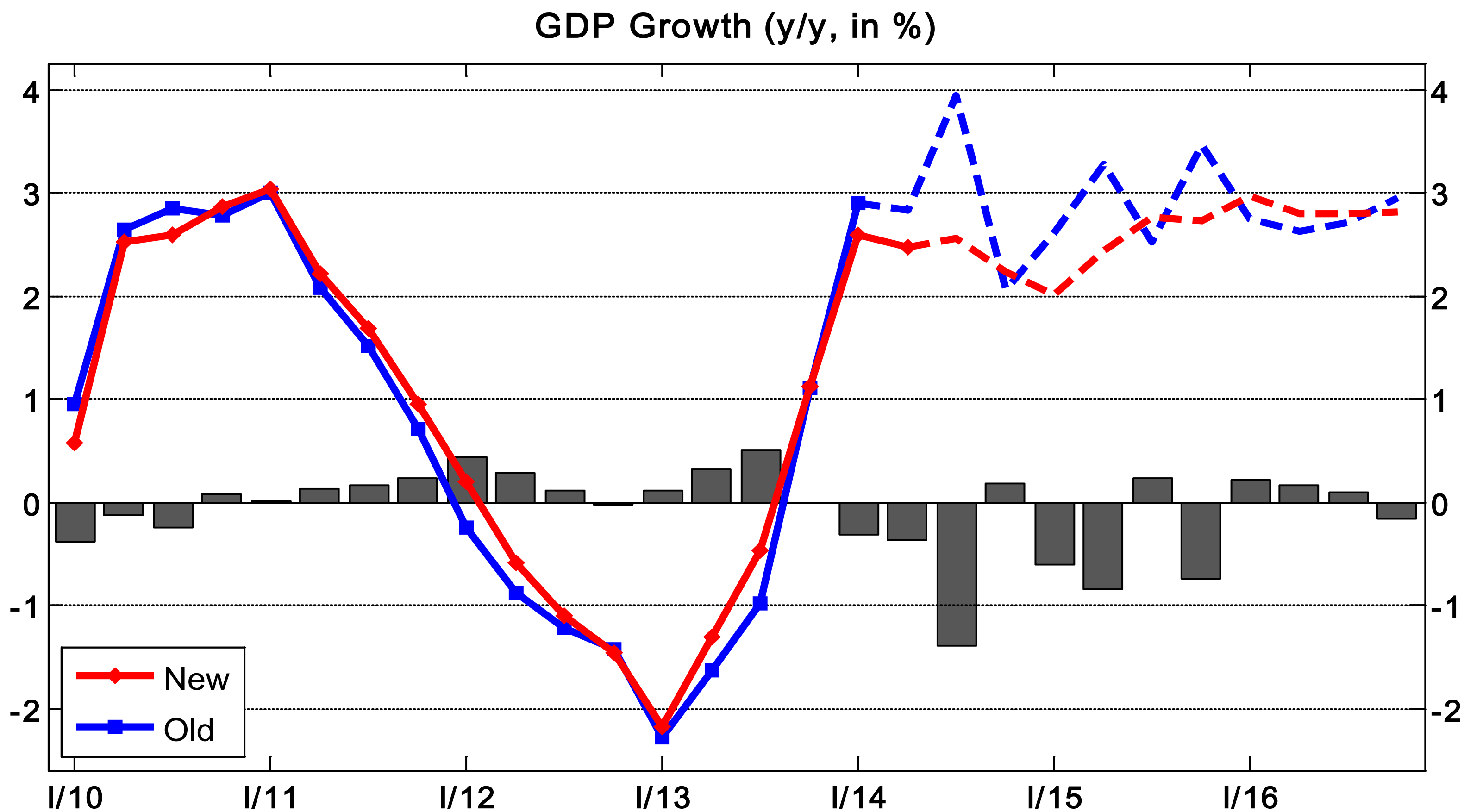




- The forecast of “core inflation“ is revised downwards due to falling PPI in the eurozone and lower wage growth in the business sector.
- The difference between the forecasts of food prices is mainly given by lower agricultural commodity prices for most of 2015.

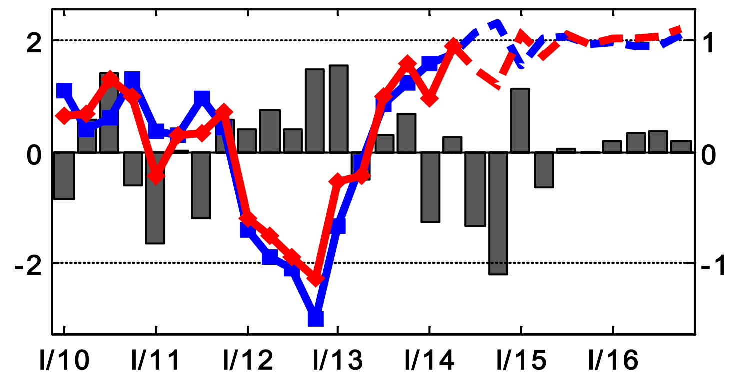
Comparison with Previous GDP Forecast (i)



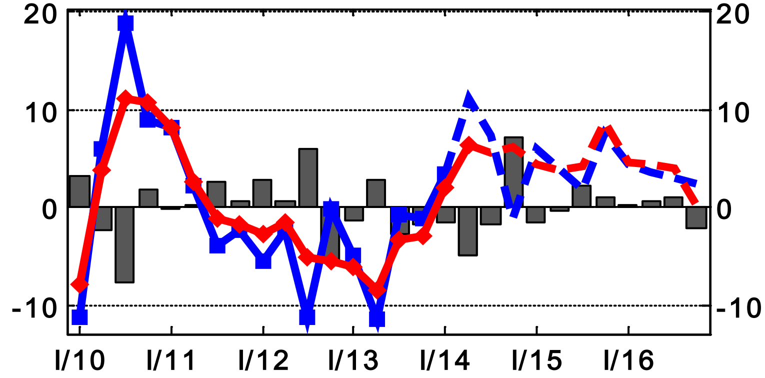
- GDP forecast has been revised downwards for 2014 and 2015, mainly as a result of weaker foreign demand. No significant change for 2016.
- The one-off effects relating to cigarette frontloading by producers and retailers ahead of excise duty increases are no longer visible in real GDP growth rates.

Comparison with Previous GDP Forecast (ii)

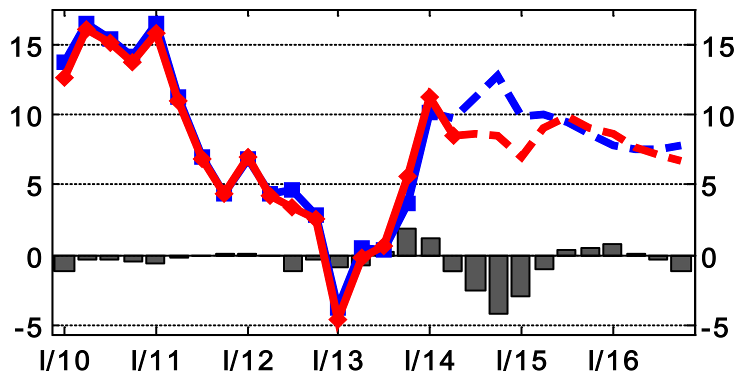
Household Consumption Growth (y/y, in %)



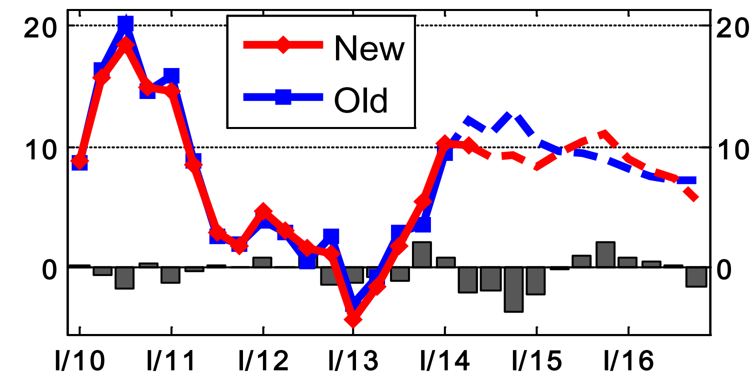
Investments Growth (y/y, in %)



Exports Growth (y/y, in %)

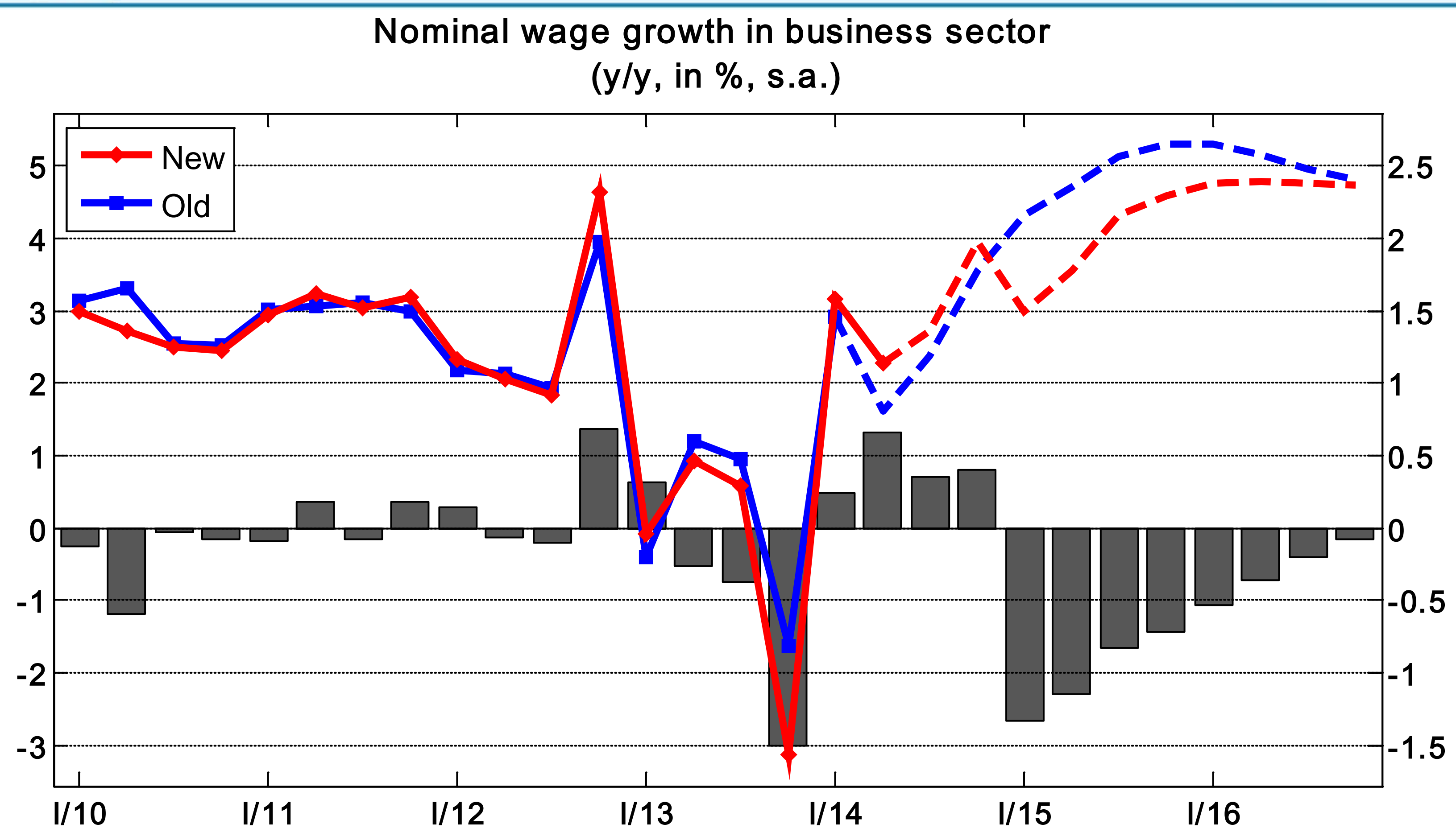


Imports Growth (y/y, in %)



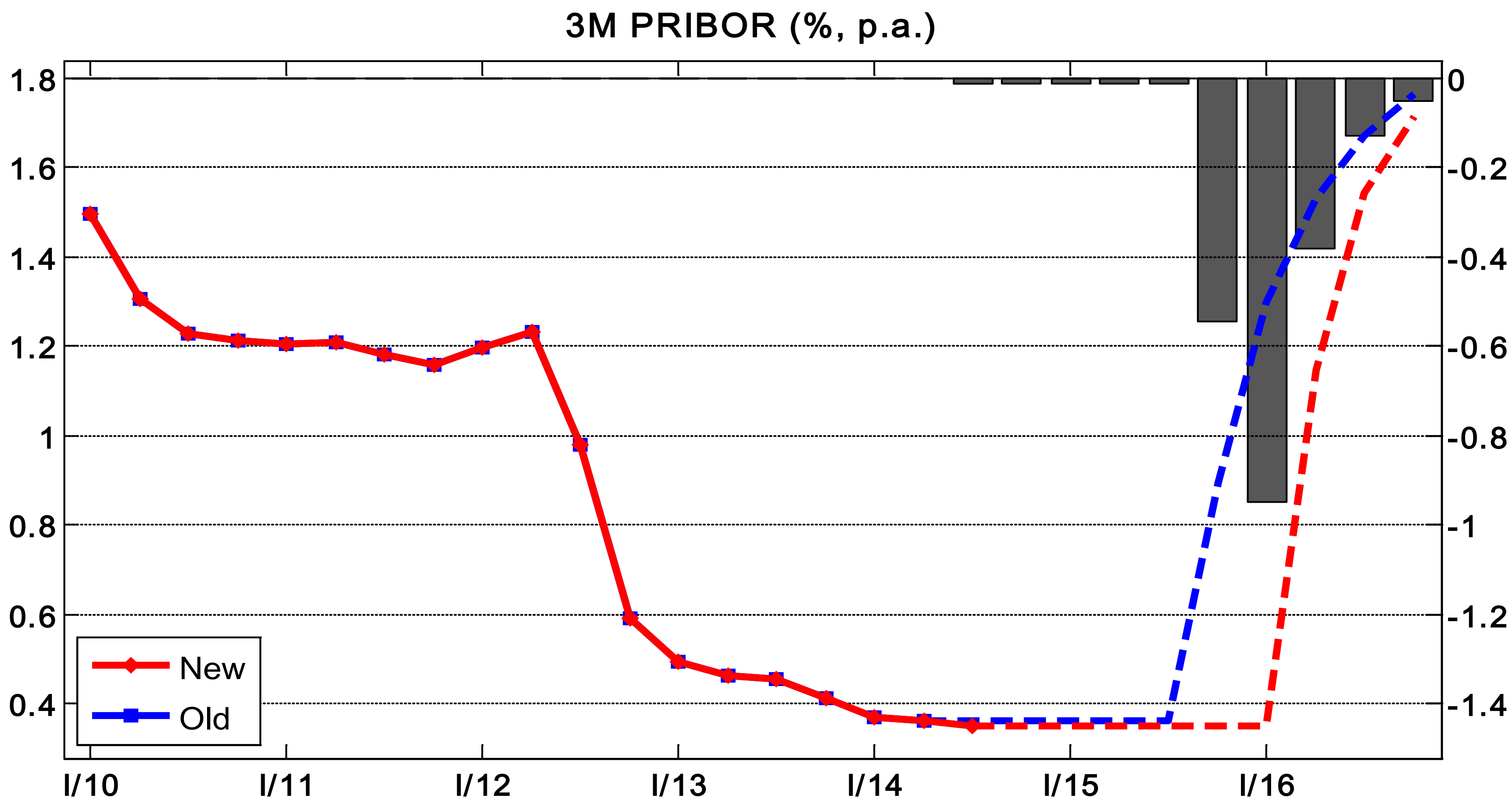
- Households‘ consumption is revised downwards mainly for the rest of 2014.
- Imports and exports for 2014 H2 and 2015 H1 are revised in the same direction, mainly due to the development of foreign demand.
- The new ESA 2010 methodology resulted in a smoother trajectory of fixed capital formation.

Changes in Labour Market Forecast



- The lower forecast of the y/y growth of average wages in the business sector from the beginning of 2015 reflects slower economic growth and inflation.

Changes in Interest Rate Forecast



- The forecast for domestic market interest rates has shifted lower in late 2015 and early 2016. This is because the new forecast expects the exchange rate to be used as a monetary policy instrument until 2016 Q1 (previously 2015 Q3).
- The need for longer-lasting easy monetary conditions is mainly due to a lower outlook for foreign producer prices and foreign interest rates.

Outline

- Assumptions of the forecast
- The new macroeconomic forecast
- Comparison with the previous forecast
- One year of the CNB’s exchange rate commitment

One year of the CNB's exchange rate commitment (i)

- In November 2013, the CNB – in line with its previous communication – started to use the exchange rate of the koruna as an additional instrument for easing monetary policy.
- It announced a one-sided exchange rate commitment at CZK 27 to the euro and expressed its readiness to prevent excessive appreciation of the koruna below this level.
- Following the announcement of the exchange rate commitment the koruna quickly depreciated beyond CZK 27 to the euro and soon stabilized without further interventions close to CZK 27.5.
- The exchange rate commitment quickly established a strong degree of credibility.
- One year on, it is appropriate to assess the effect of the CNB's new monetary policy strategy on the Czech economy.

One year of the CNB's exchange rate commitment (ii)

Table 1 Comparison of key indicators

(annual percentage changes unless otherwise indicated)

	Available on 7.11.2013		Available on 31.10.2014	
Gross domestic product (s.a.)	II/13	-1.3	II/14	2.5
Consumer price index	9/13	1	9/14	0.7
Monetary-policy relevant inflation	9/13	0.2	9/14	0.6
General unemployment rate (in %, s.a.)	9/13	7.1	9/14	5.9
Average nominal wage in business sector (in CZK, s.a.)	II/13	25 199	II/14	25 542
Average nominal wage	II/13	1.2	II/14	2.3
Number of vacancies	9/13	39 039	9/14	56 600
Composite confidence indicator (index)	10/13	88.9	10/14	94.1

- The economy - supported by a combination of recovery in the euro area, relaxed monetary conditions and increasing public investment - is growing noticeably.
- This is having a favourable effect on the labour market and household as well as business confidence.
- Headline inflation has fallen slightly compared to last year and deviated even further from the CNB's 2% target. Adjusted for the effect of tax changes, it has rebounded from the edge of deflation.

One year of the CNB's exchange rate commitment (iii)

Chart 1 Comparison of the CNB's inflation forecasts
(annual percentage changes)

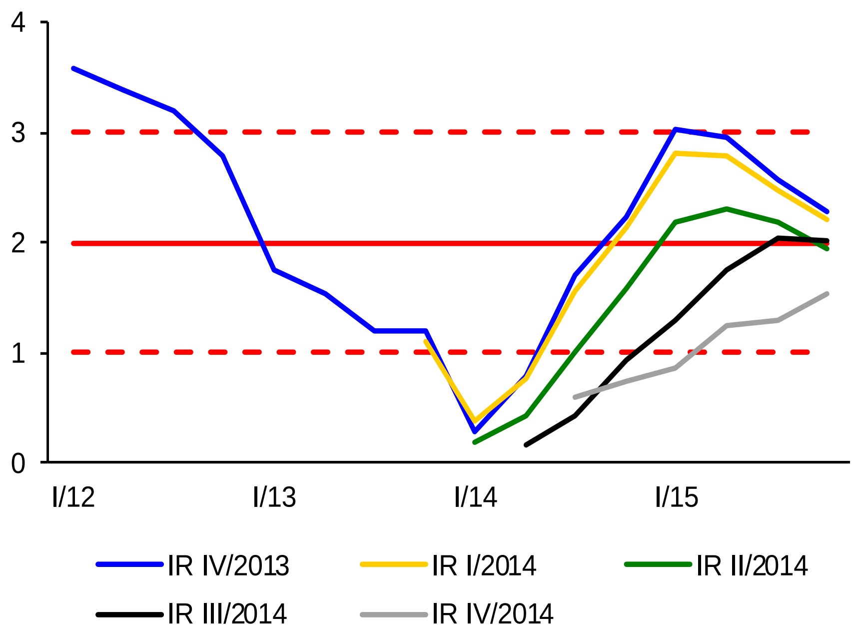
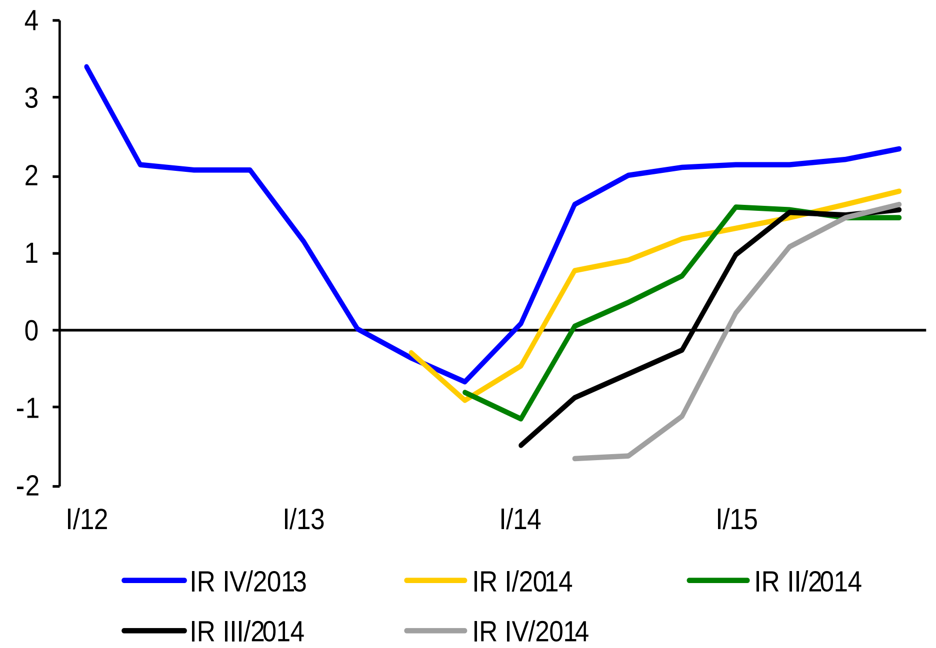
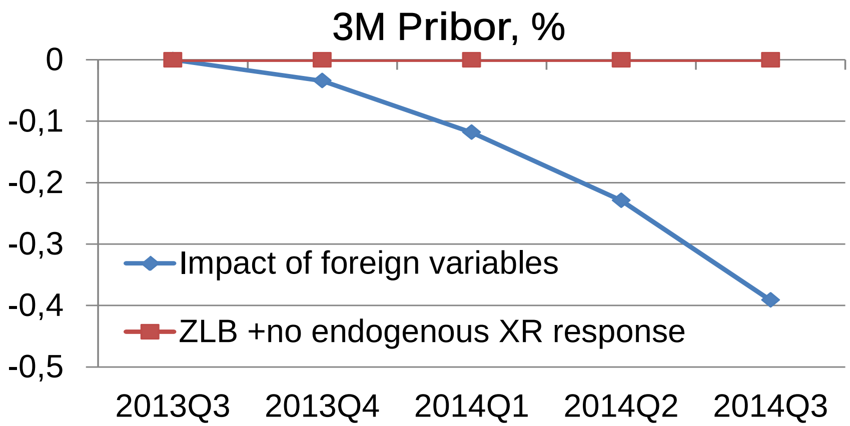


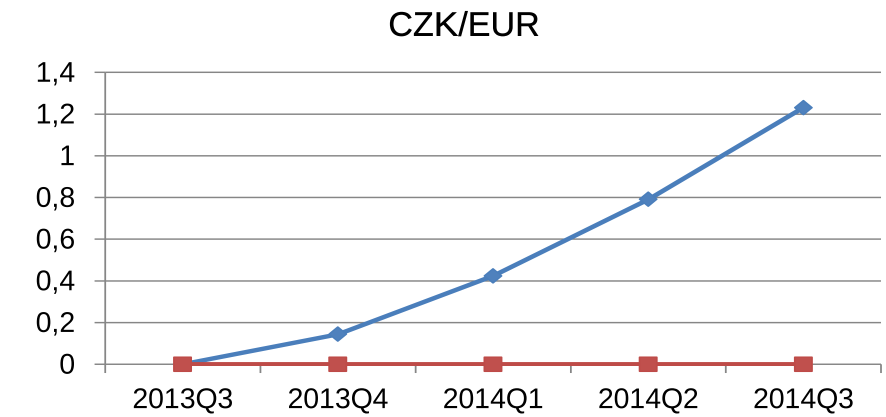
Chart 2 Shift in the outlook of effective PPI (Consensus Forecast)
(annual percentage changes; seasonally adjusted)

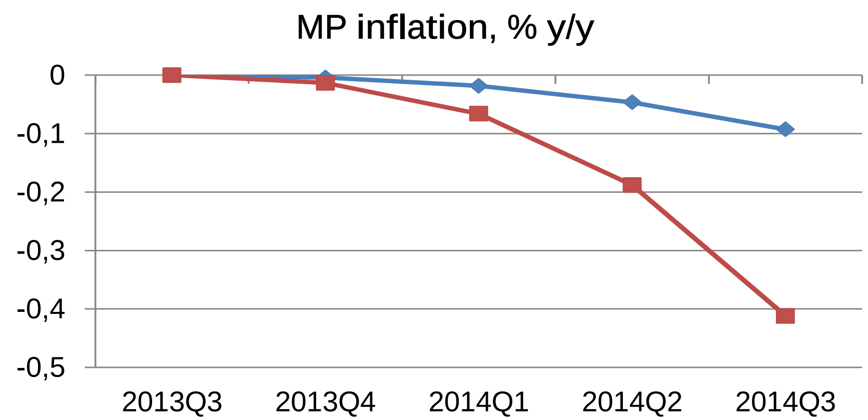


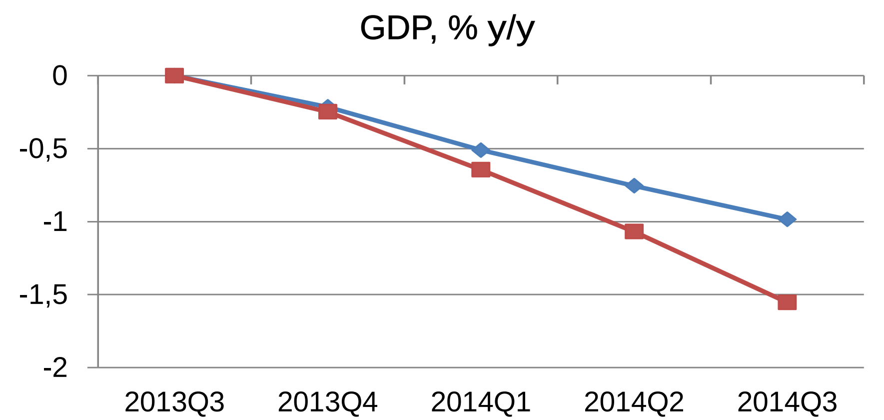
- The assessment of the impacts of the weakening of the koruna on inflation is complicated at first sight, as inflation is still very low and its outlook has shifted substantially downwards since November 2013.
- One of the key factors, explaining low inflation in the Czech Republic, is the deflationary development in the euro area. This is reflected in a decline in both observed and expected foreign producer price inflation.
- The fall in domestic admin. prices is also deeper than expected last November.

One year of the CNB's exchange rate commitment (iv)





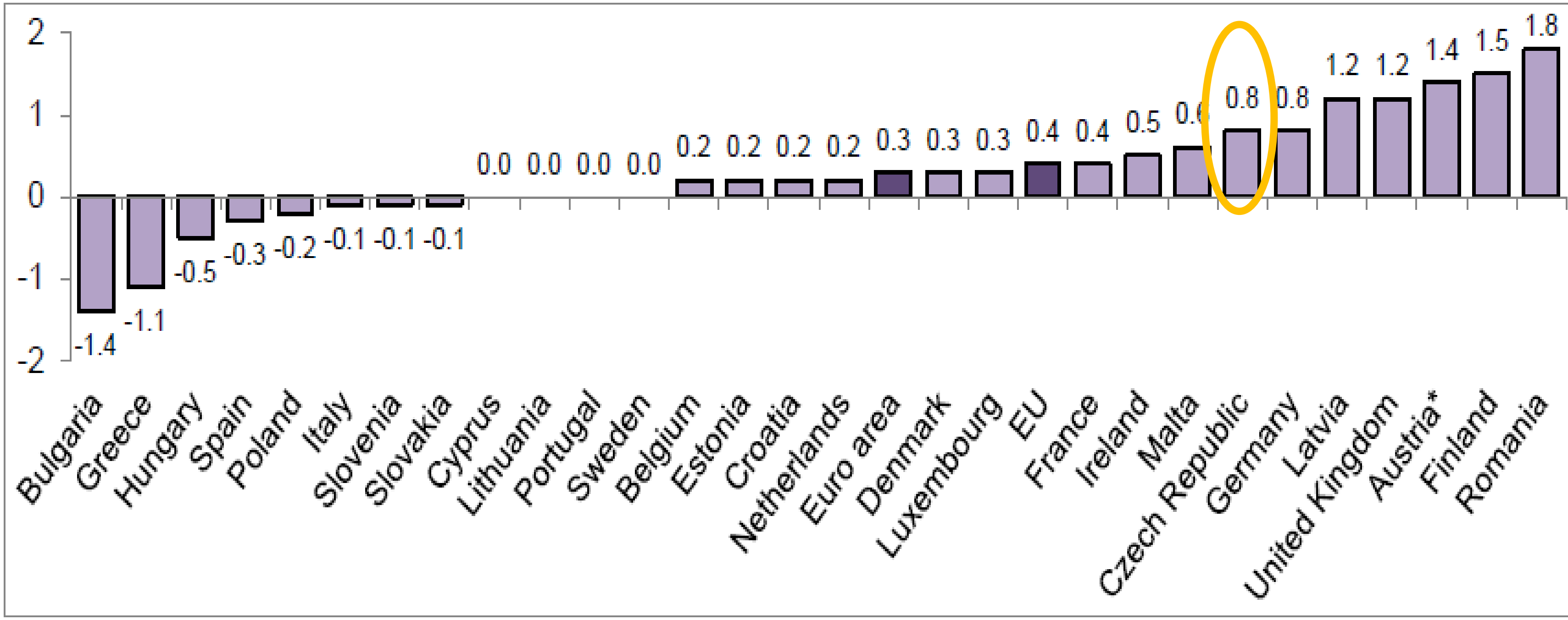




- The deflationary foreign development justifies a substantial part of the weakening of the Czech koruna's exchange rate.
- If the exchange rate had not autonomously acted as a stabilizer and interest rates would be at ZLB, the anti-inflationary foreign development would result in lower inflation and the domestic economic growth.

One year of the CNB's exchange rate commitment (v)

Annual inflation (%) in September 2014, in ascending order



* Data for Austria are provisional.

- The current inflation rate in the Czech Republic is similar to that in Germany and other European countries with relatively good economic performance.
- Without the use of the exchange rate of the koruna as instrument by the CNB in November 2013 we would probably be in the group of countries with negative inflation rates.

Thank you for your attention!

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