# CNB’s New Forecast (Inflation Report IV/2015)

# Meeting with Analysts

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Prague, 6 November, 2015

CZECH
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# Outline

1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast

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# External Environment Outlook

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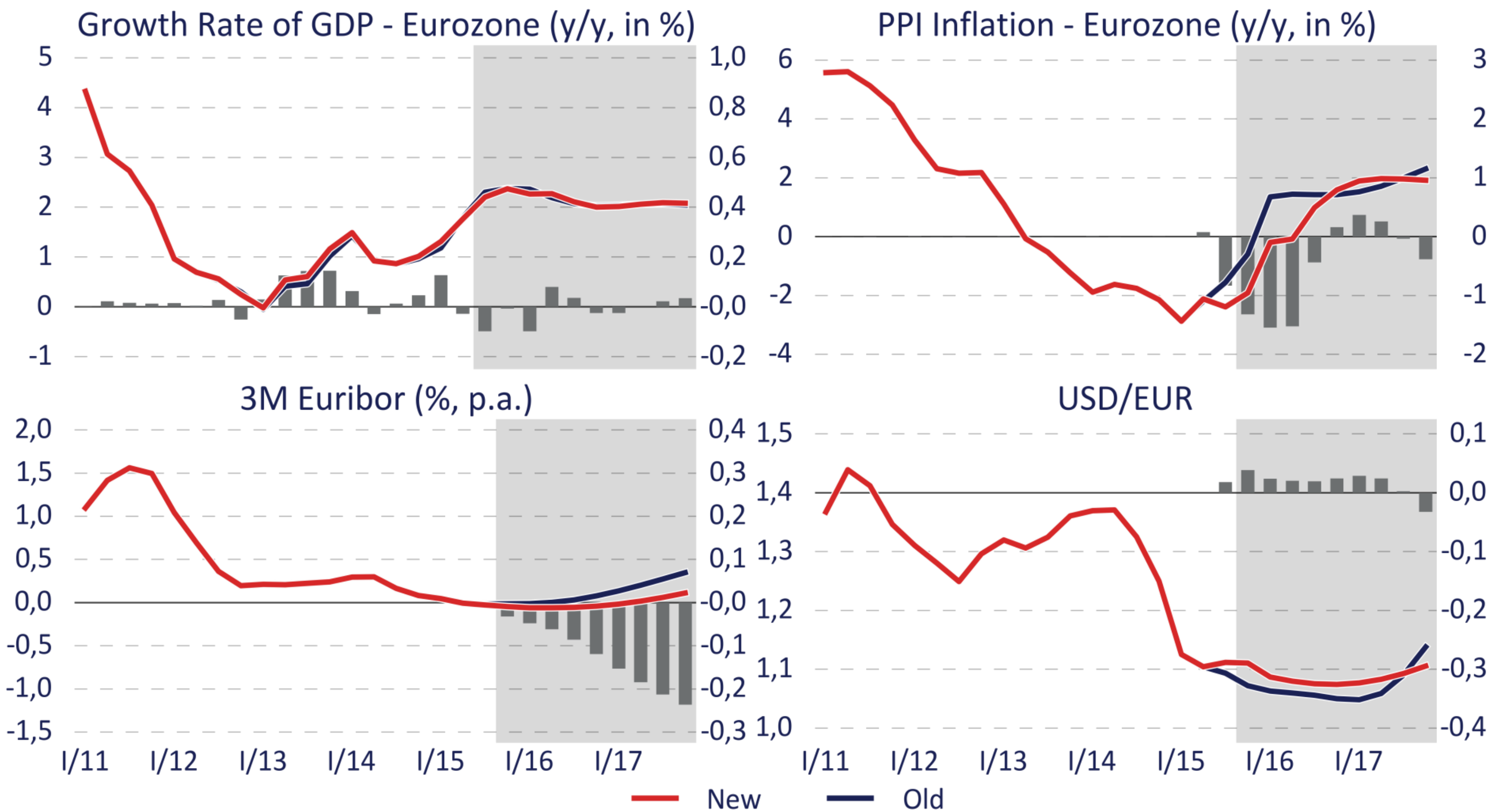
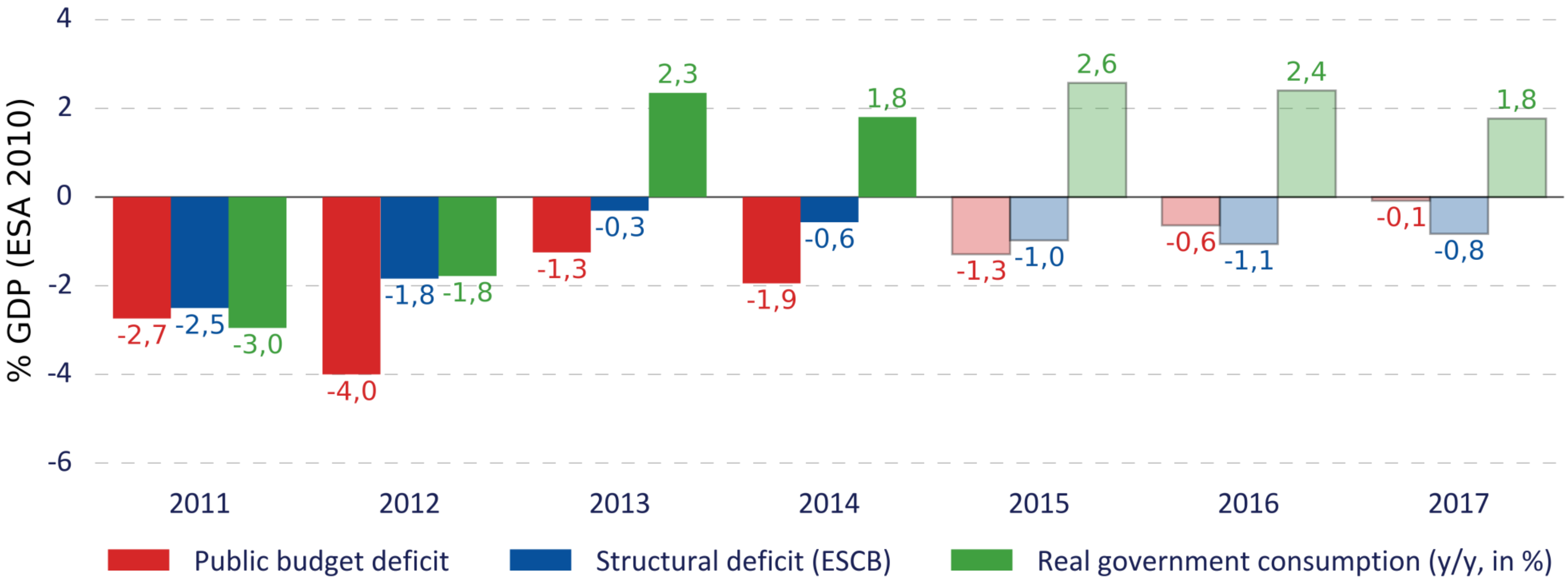



- The GDP growth will fluctuate around 2% over the entire forecast horizon.
- Producer prices are not expected to return to annual growth until the second half of next year.
- The subdued inflation is reflected in accommodative ECB's monetary policy and consequently also in the outlook for 3M EURIBOR and USD/EUR.

# Fiscal Policy




- **2015:** drop of the deficit to 1.3% of GDP due to accelerating economic growth coupled with dissipation of the extraordinary factors from 2014.
- **2016 :** further decline of the deficit to 0.6%  (fall in public investment due to a smaller drawdown of EU funds, additional revenues from tobacco excise duties).
- **2017:** further drop of the deficit to 0.1% of GDP (ongoing economic growth and higher revenues from sales of emission permits, vs. re-accelerated drawdown of EU funds within the new programming period).
- Fiscal impulse: +0.6 p.p. in 2015,  -0.3 p.p. in 2016  and +0.1 p.p. in 2017 (mainly related to the EU funds cycle).

# Monetary Policy

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- The forecast assumes market interest rates to be flat at their current very low level and the exchange rate to be used as a monetary policy instrument until the end of 2016. Consistent with the forecast is an increase in interest rates in 2017.
- The exchange rate of the koruna against the euro appreciated slightly in 2015 Q3 to CZK 27.1 on average. The forecast expects it to remain at similar levels in the quarters ahead.
- After the exit from the exchange rate commitment the koruna will moderately appreciate due to the positive interest rate differential and renewed – though compared with the pre-crises period less pronounced – real convergence of the Czech economy to its advanced counterparts in the euro area.

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# Summary of the Inflation Forecast (i)

- Both headline and monetary policy-relevant inflation decreased slightly in 2015 Q3, remaining well below the CNB's target. Both these measures of inflation will increase and hit the 2% target at the monetary policy horizon. In 2017, they will be slightly above the target.

- The growing economic activity and accelerating wage growth will continue to foster higher costs and consequently also a higher price level.

- On the other hand, import prices will continue to dampen inflation until mid-2016.

- GDP will grow by 4.7% this year, boosted by easy monetary conditions, accelerating growth in external demand, low oil prices and rising government investment. Economic growth will then slow just below 3% in the next two years as extraordinary factors (i.e. EU funds, drop in oil prices) dissipate.

- Nominal wage growth will accelerate, the employment growth will continue.

# Headline Inflation Forecast

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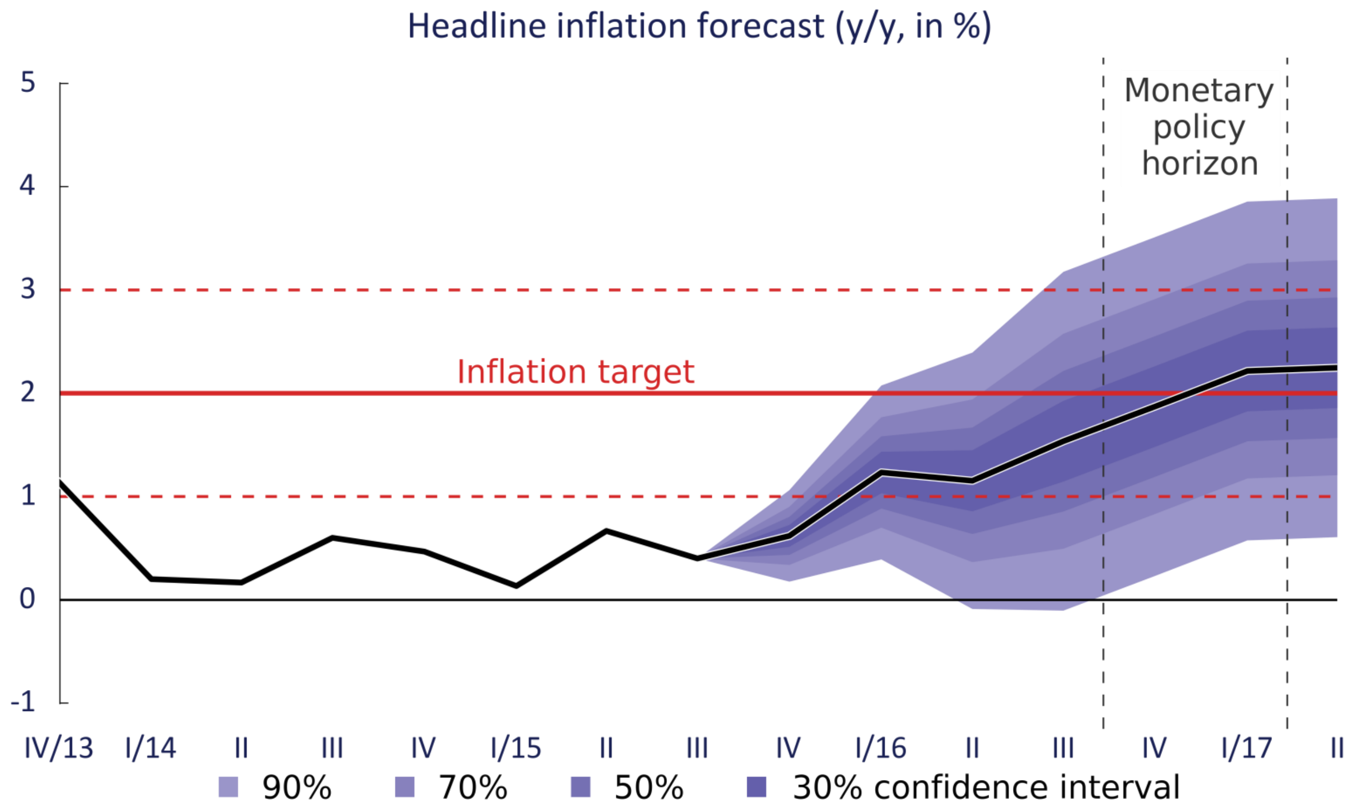
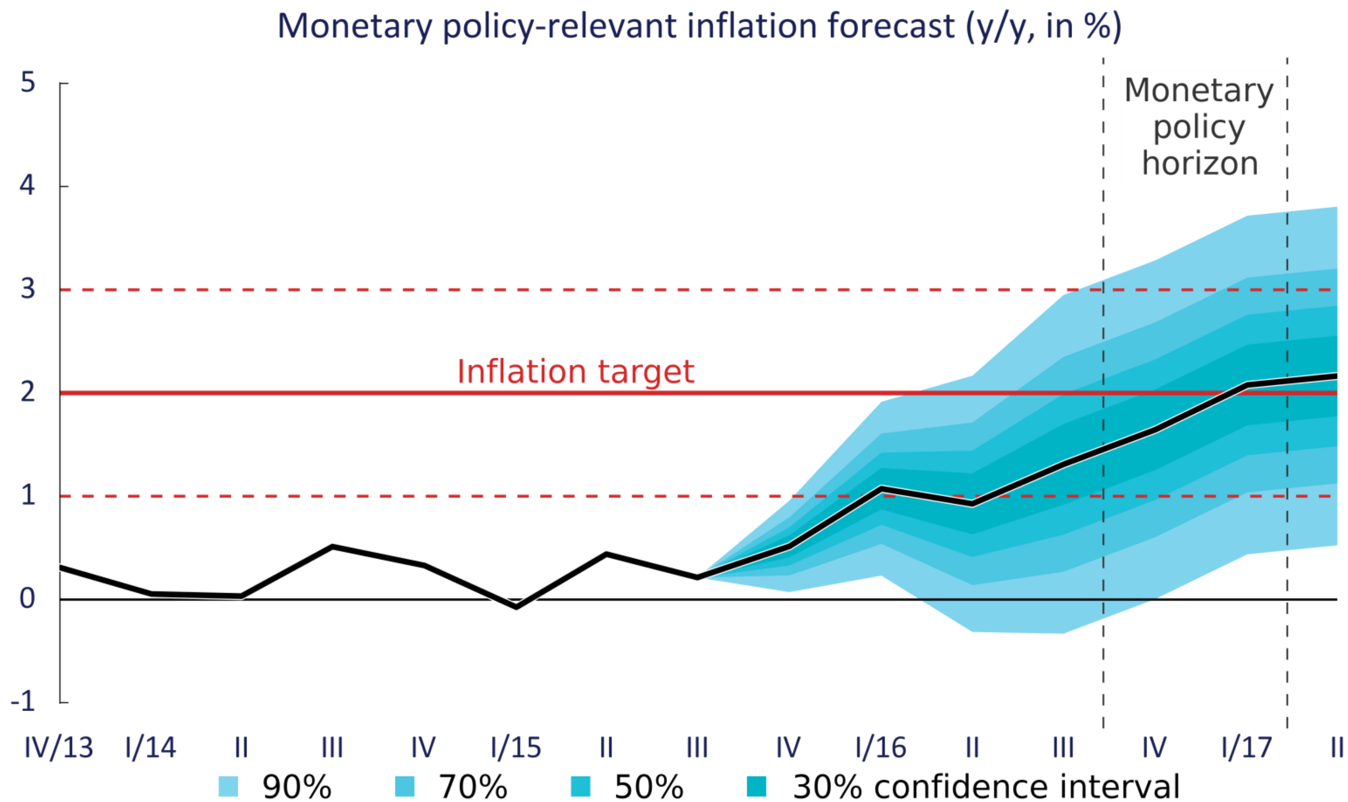



- Headline inflation dropped to 0.4% on average in 2015 Q3 (food price growth slowed down, the fall of fuel prices deepened again).
- Inflation will start increasing again in 2015 Q4. It will reach the 2% target at the monetary policy horizon and then fluctuate slightly above it until the end of 2017.

# Monetary Policy-Relevant Inflation Forecast




- MP-relevant inflation slowed to 0.2% on average in 2015 Q3. It was thus still well below the CNB's 2% target.
- Over the forecast horizon, MP-relevant inflation will follow a similar path to headline inflation, although it will be slightly lower owing to slightly positive contributions from changes to indirect taxes.
- It will be slightly above the 2% target as from the start of 2017.

# Structure of Inflation

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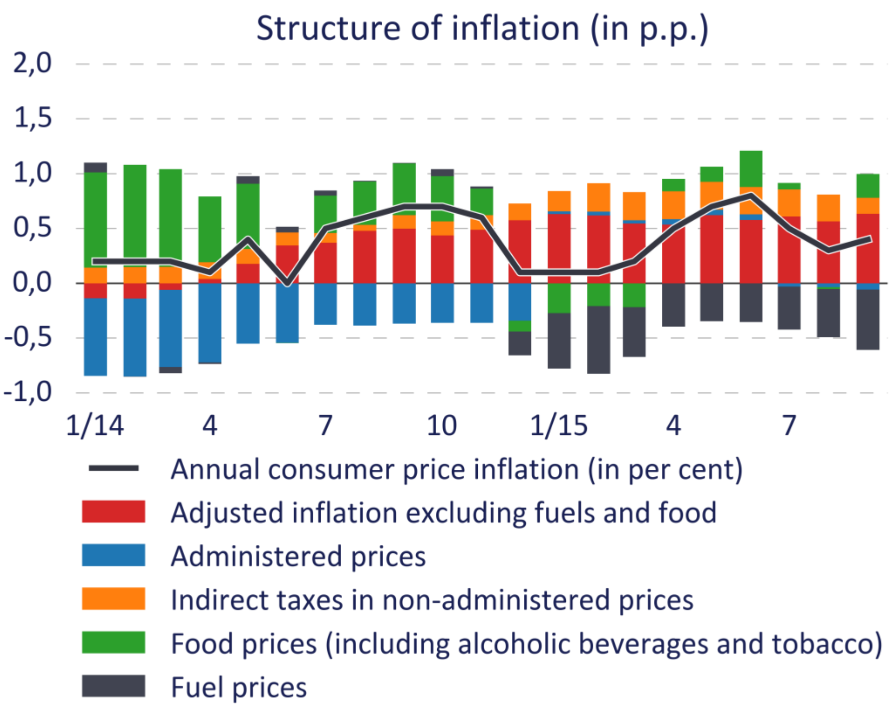
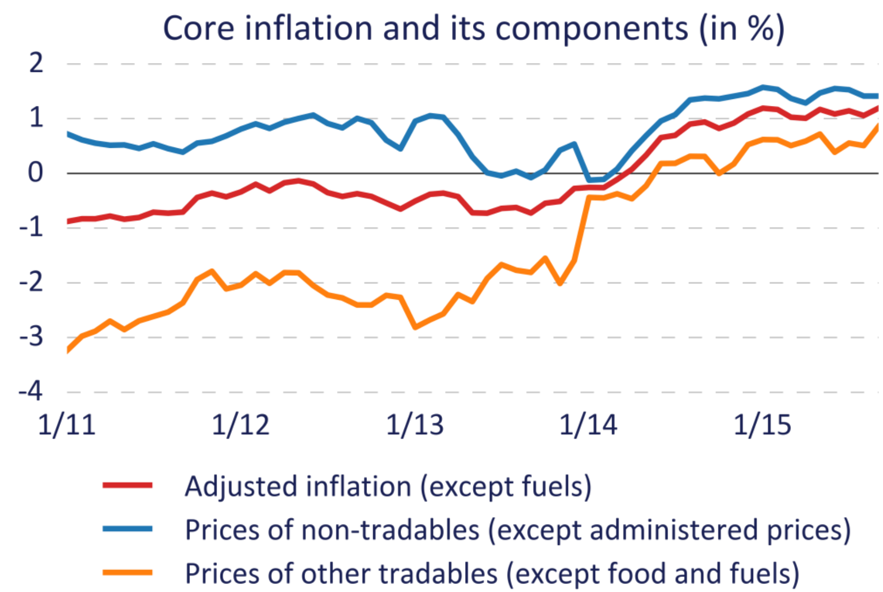
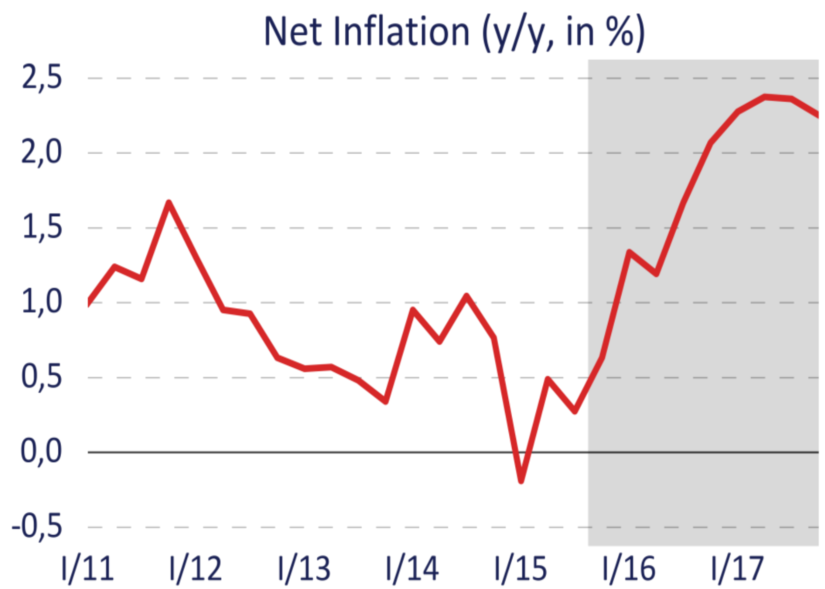
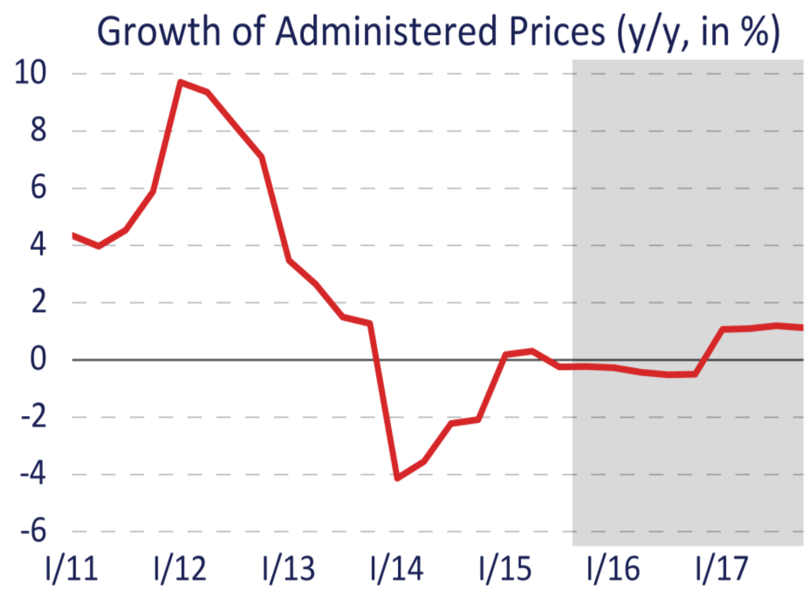



- The still very low inflation reflects a sizeable decline in fuel prices and recently also a slight decline in administered prices, while core inflation has got a stable positive contribution. Food prices returned to a slightly positive annual growth in September 2015.
- Core inflation edged up to 1.2%. Both its sub-components move in the positive range.

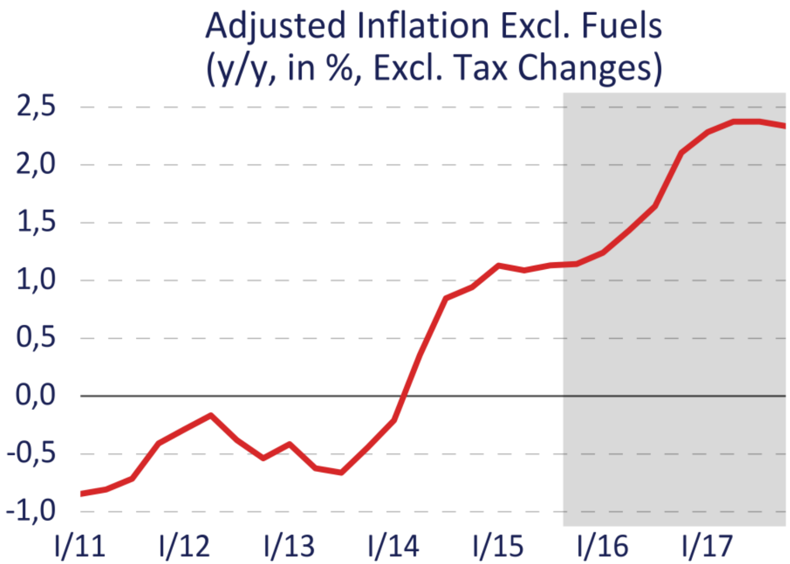
# Market and Administered Prices

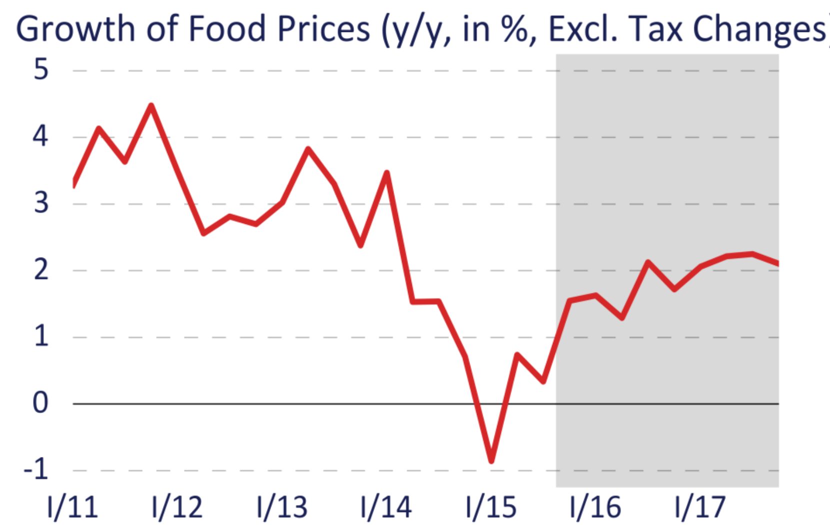



- Net inflation slowed slightly to 0.3% on average in 2015 Q3 due mainly to a temporary moderation of growth in food prices and a deepening of the year-on-year decline in fuel prices.
- Net inflation will rise markedly in the period ahead owing to an increase in all its components (i.e. core inflation, food price growth, fuel prices).
- Administered prices started falling slightly year on year in 2015 Q3. The forecast expects the moderate decrease in administered prices to continue for the rest of this year and next year due to a further decline in energy prices (mainly gas prices in 2016 and the price of electricity in 2017).

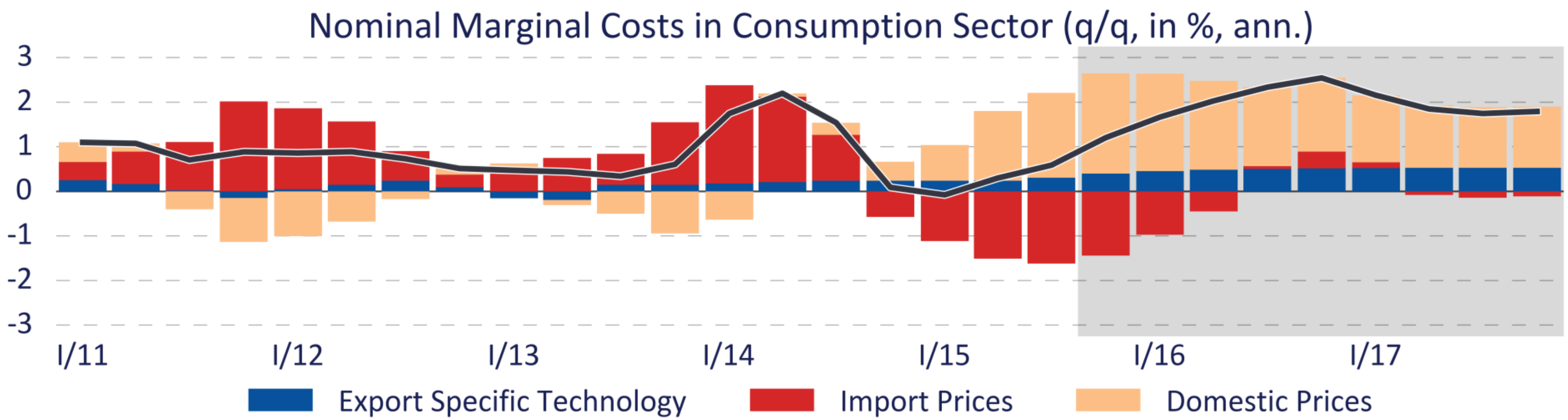
# Adjusted Inflation Excluding Fuels and Food

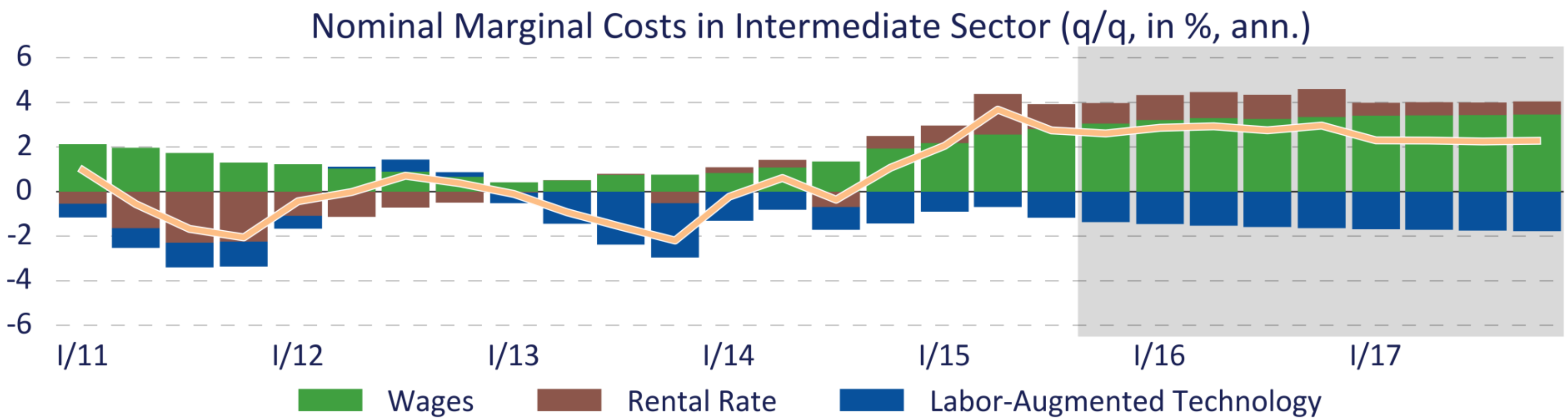



- Core inflation was unchanged in 2015 Q3, averaging 1.1%. It will stay at its current level for the rest of this year and rise next year (growing economy and wages, dissipating fall in import prices). In 2017, it will remain above 2%.
- Growth in food prices slowed substantially in 2015 Q3, averaging 0.3%. However, the forecast expects food price growth to increase by the end of 2015 due to this year’s drought, causing prices of vegetables, fruit etc. to rise.
- In the longer term, an expected gradual rise in world agricultural commodity prices coupled with an increase in inflationary pressures from the domestic economy will foster an increase in food price growth.

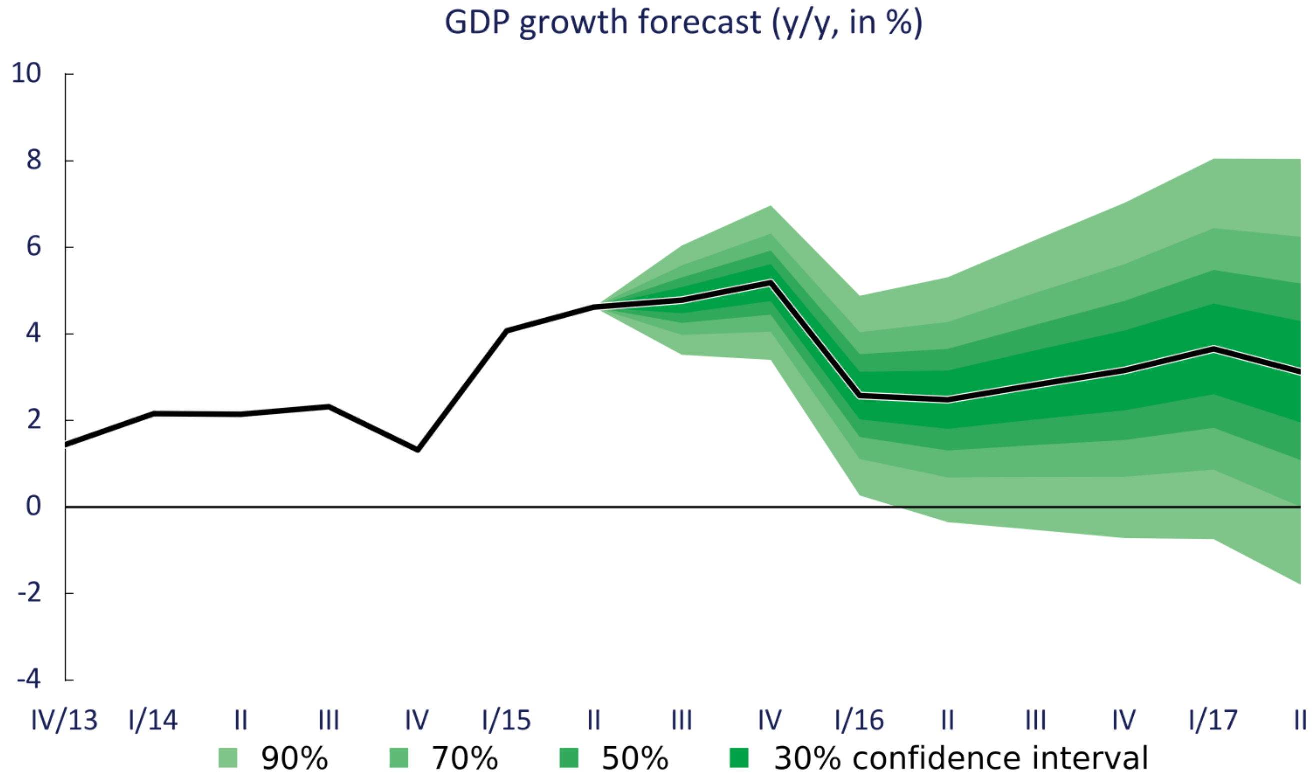
# Domestic Costs vs. Import Prices



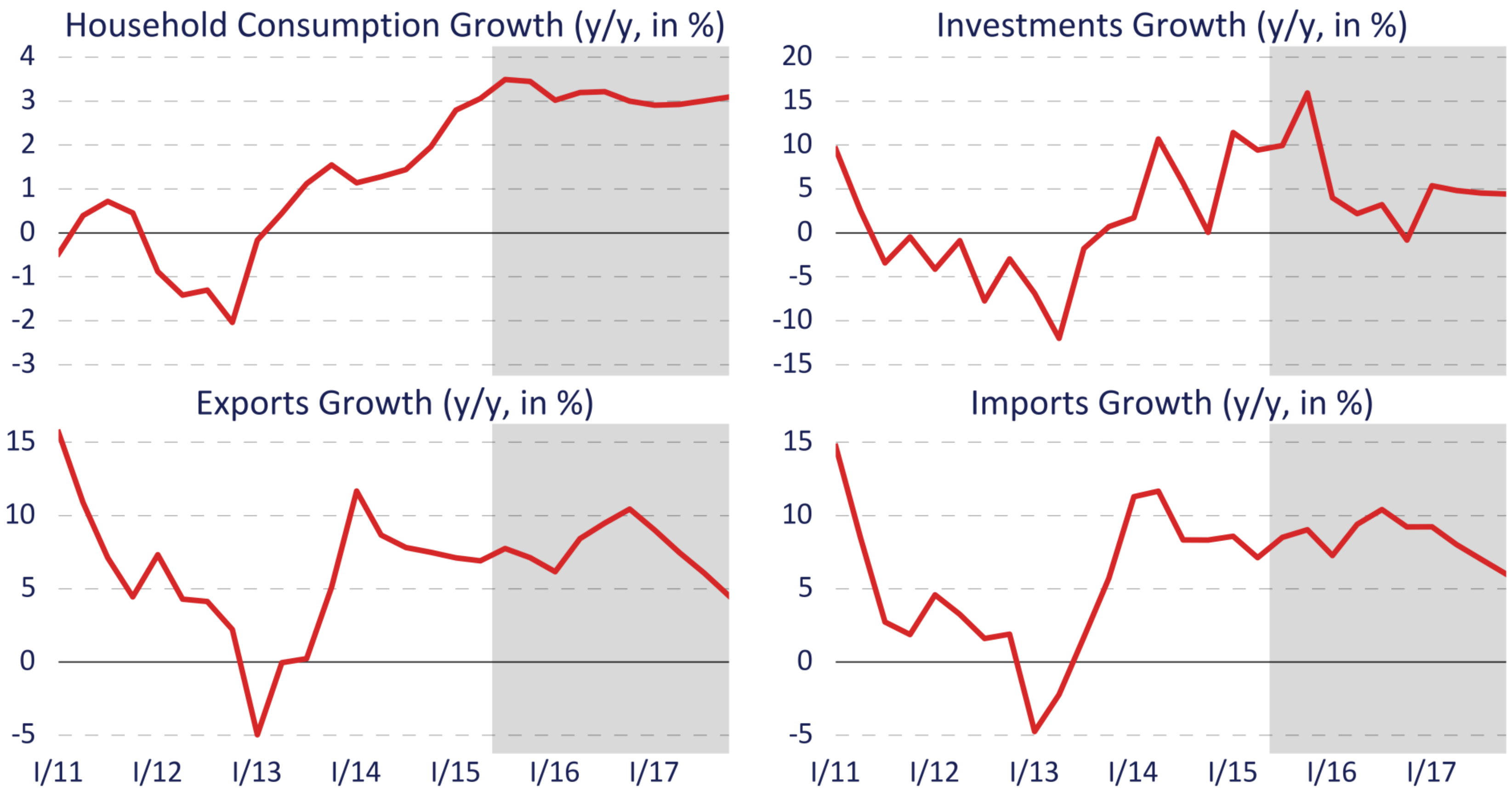

- The overall upward cost pressures on consumer prices will strengthen gradually until the end of 2016, reflecting accelerating wage growth and continued growth in economic activity. At the same time, the return to growth in foreign producer prices will gradually moderate the anti-inflationary effect of import prices, and from mid-2016 they will have a slight upward effect on costs.

# GDP Growth Forecast




- GDP growth forecast: 4.7% in 2015; 2.8% in 2016, 2.9% in 2017.
- The economy has been boosted by a pickup in external demand, easy monetary conditions, low oil prices and increasing public investment due to EU funds.
- The slowdown in 2016 will reflect a fall in government investment due to the end of possible drawdown of EU funds from the previous programme period, as well as unwinding of the effect of an increase in inventories at the start of this year and of the fall in oil prices.

# Aggregate Demand




- Household consumption will increase by 3.2% in 2015. Its growth will remain close to 3% in 2016 and 2017, driven by continued real income growth.
- Investment growth will be high this year (EU funds), and slow down in 2016.
- Exports will continue increasing, reflecting growing foreign demand. Imports will be boosted by growing exports as well as domestic demand.

# Fixed Investment Forecast

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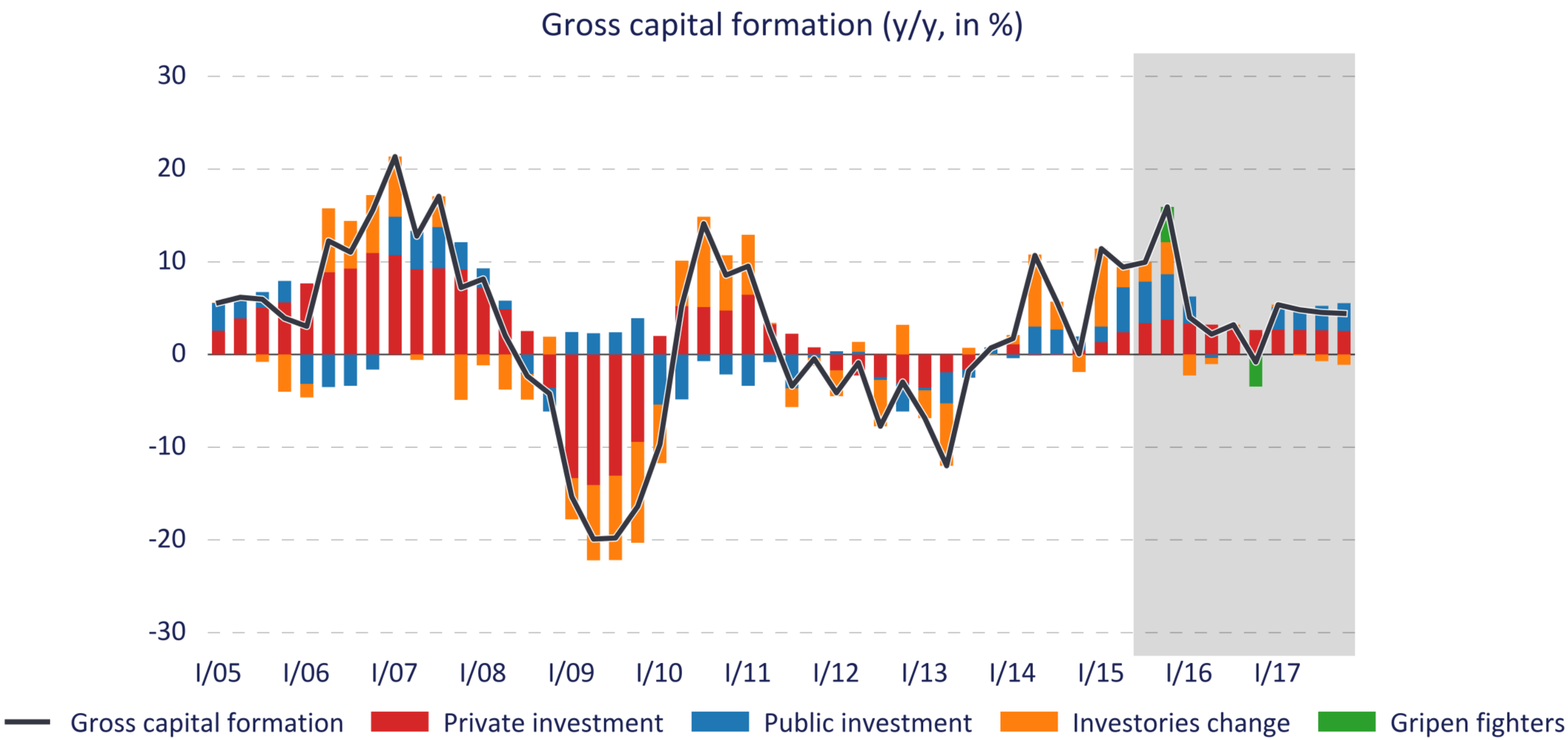
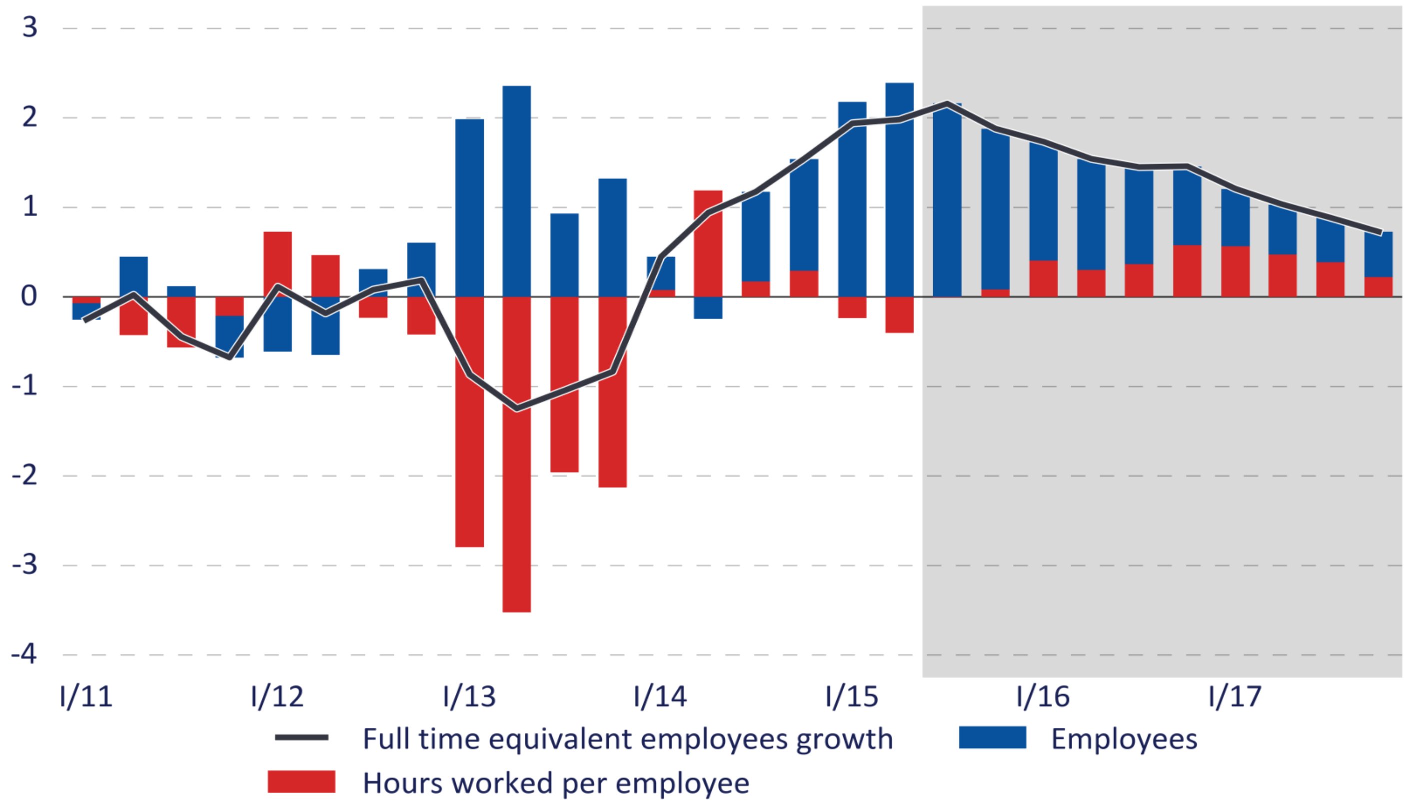



- Fixed investment will increase further in 2015 H2, mainly as a result of expected growth in public investment connected with the drawdown of EU funds.
- The investment growth will slow down in 2016, when EU-financed government investment will decline. By contrast, private fixed investment will continue to rise.

# Labor Market: Employment

Full time equivalent employees growth (y/y, in %, s.a.)




- Growth in the number of employees converted into full-time equivalents (FTE) was close to 2% in 2015 Q2.
- The rate of growth of FTE will gradually decrease together with the expected GDP growth slowdown, and as labour will become scarcer due to the already low unemployment rate.

# Labor Market: Wage Growth in Business Sector

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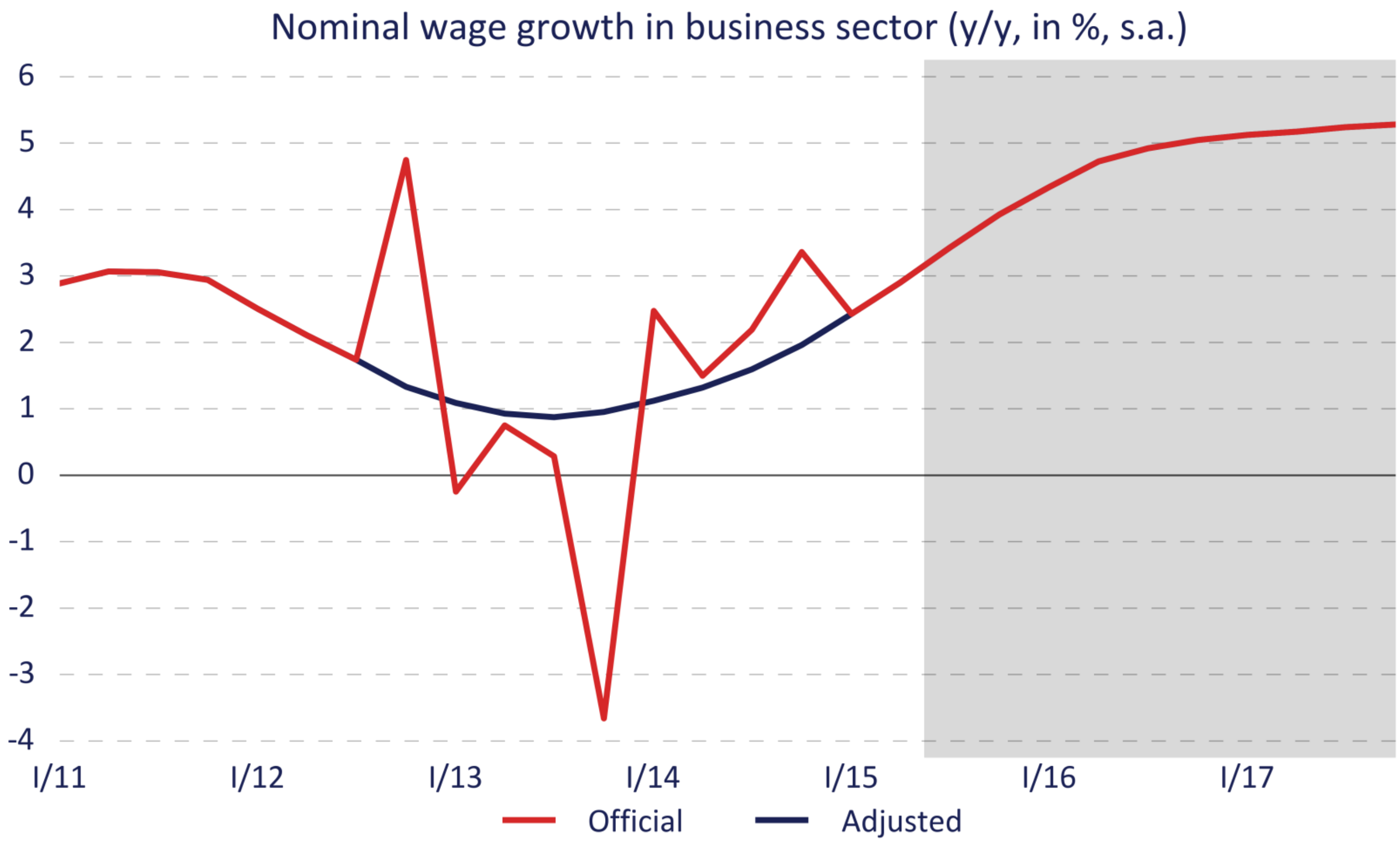
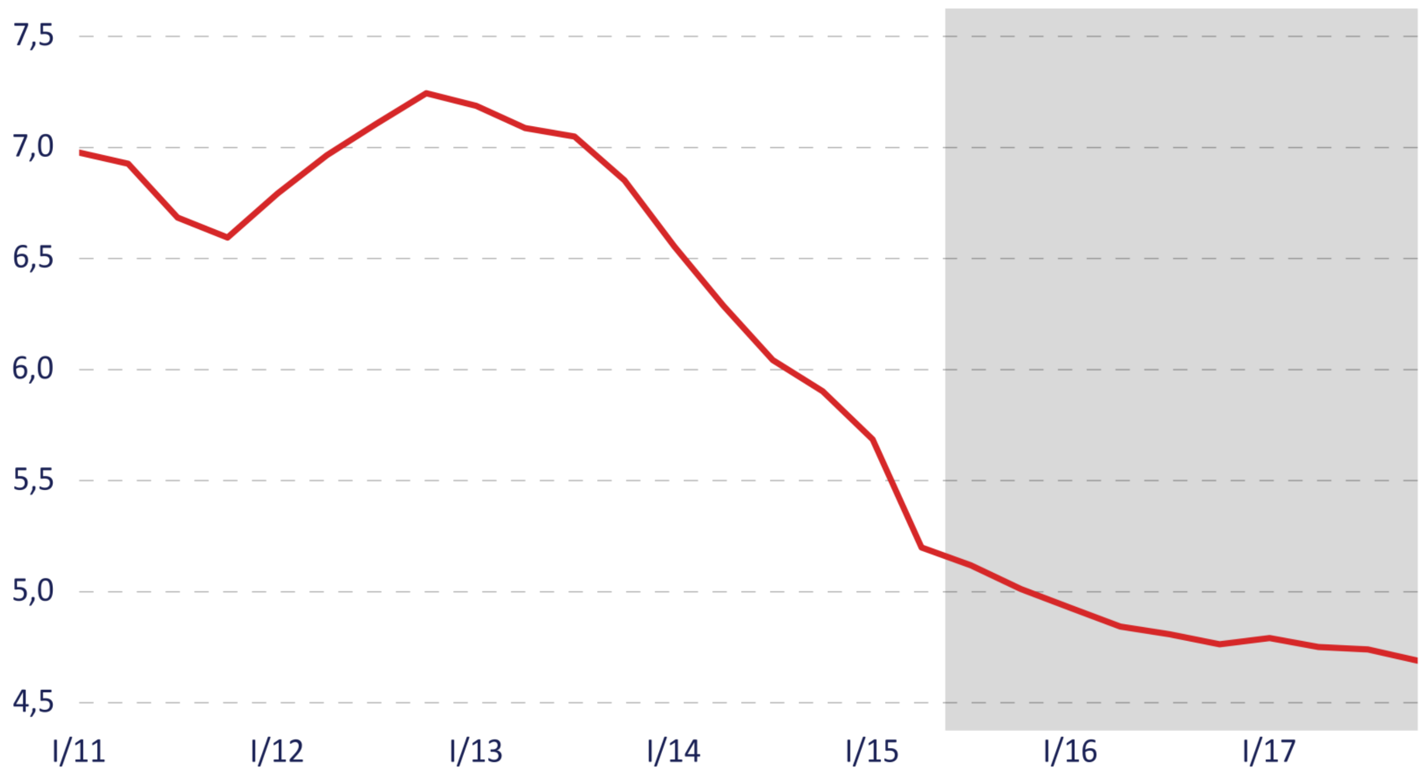



- Continued growth in domestic economic activity, falling unemployment and a gradual return of inflation to the target will result in faster growth in the average wage in the period ahead.
- The average wage in the business sector will increase by 3.2% on average in 2015 and accelerate to 4.8% and 5.2% in 2016 and 2017 respectively.

# Labor Market: Unemployment

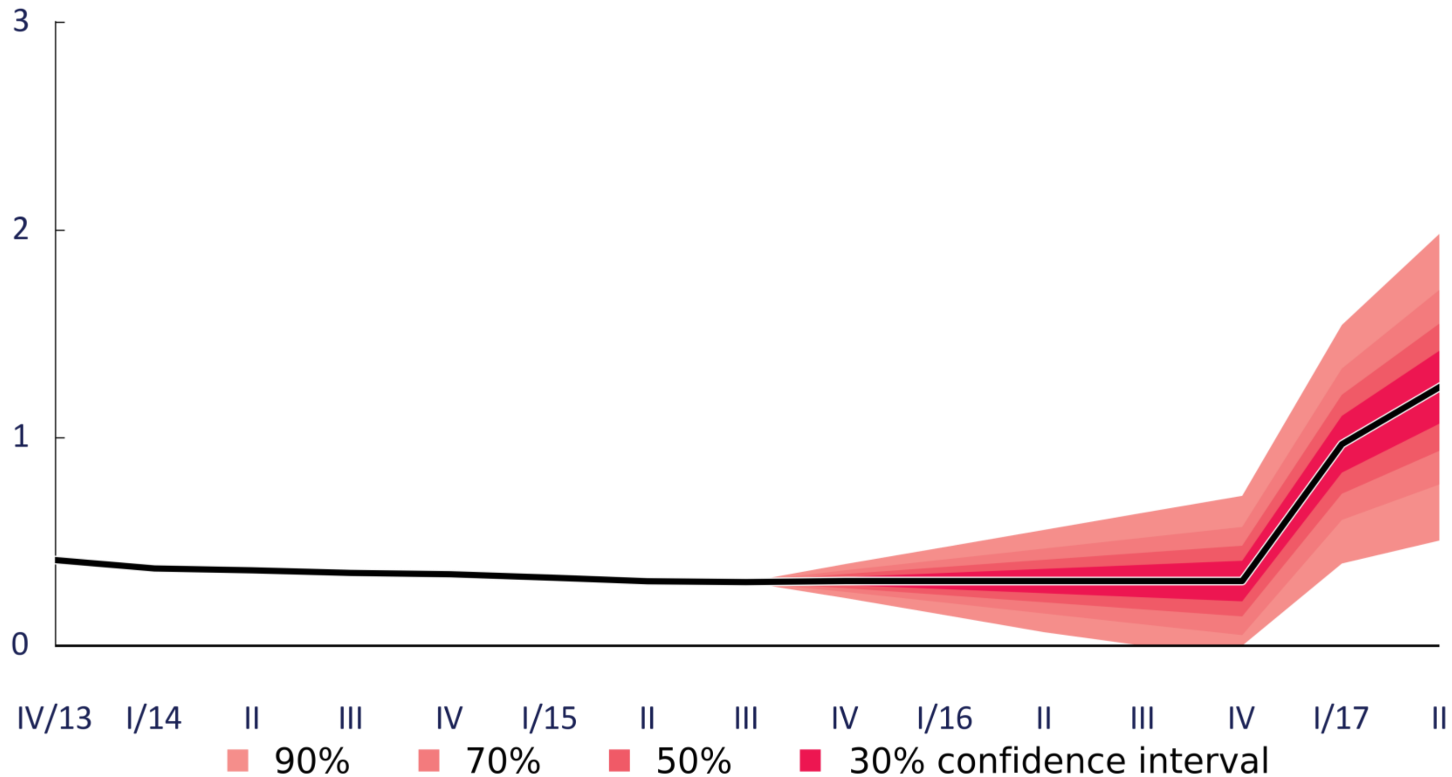
General unemployment rate (ILO)
(%, s.a.)




- General unemployment rate decreased to 5.1% in 2015 Q3. It will continue to come down gradually in the period ahead as a result of growth in employment and a simultaneous slight increase in the labour force.

# Interest Rate Path (3M PRIBOR)

Interest rate forecast (y/y, in %)




- The forecast expects market interest rates to be flat at their current very low level until the end of 2016.
- This reflects an assumption that the 2W repo rate will be left at technical zero and the money market premium will remain unchanged in the same period.
- Consistent with the forecast is an increase in interest rates in 2017.

# Outline

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# Comparison with Previous Forecast

- The predictions for headline and monetary policy-relevant inflation are lower until 2016 Q3 owing to lower observed net inflation and a lower outlook for foreign producer prices and domestic administered prices. Thereafter, forecasted inflation levels are slightly higher, due to better performance of the domestic economy.

- Stronger growth of the economy in 2015 Q2 and a faster labour market recovery have led to a marked upward revision of annual GDP growth this year. The prediction for the following two years is virtually unchanged.

- Growth in nominal wages in the business sector has shifted upwards over the entire forecast horizon as a result of a higher observed level in 2015 Q2 and the faster growth of the domestic economy this year.

- The assumption of flat market interest rates at their current very low level and the use of the exchange rate as a monetary policy instrument until the end of 2016 is unchanged.

# Comparison: Inflation Forecast (i)

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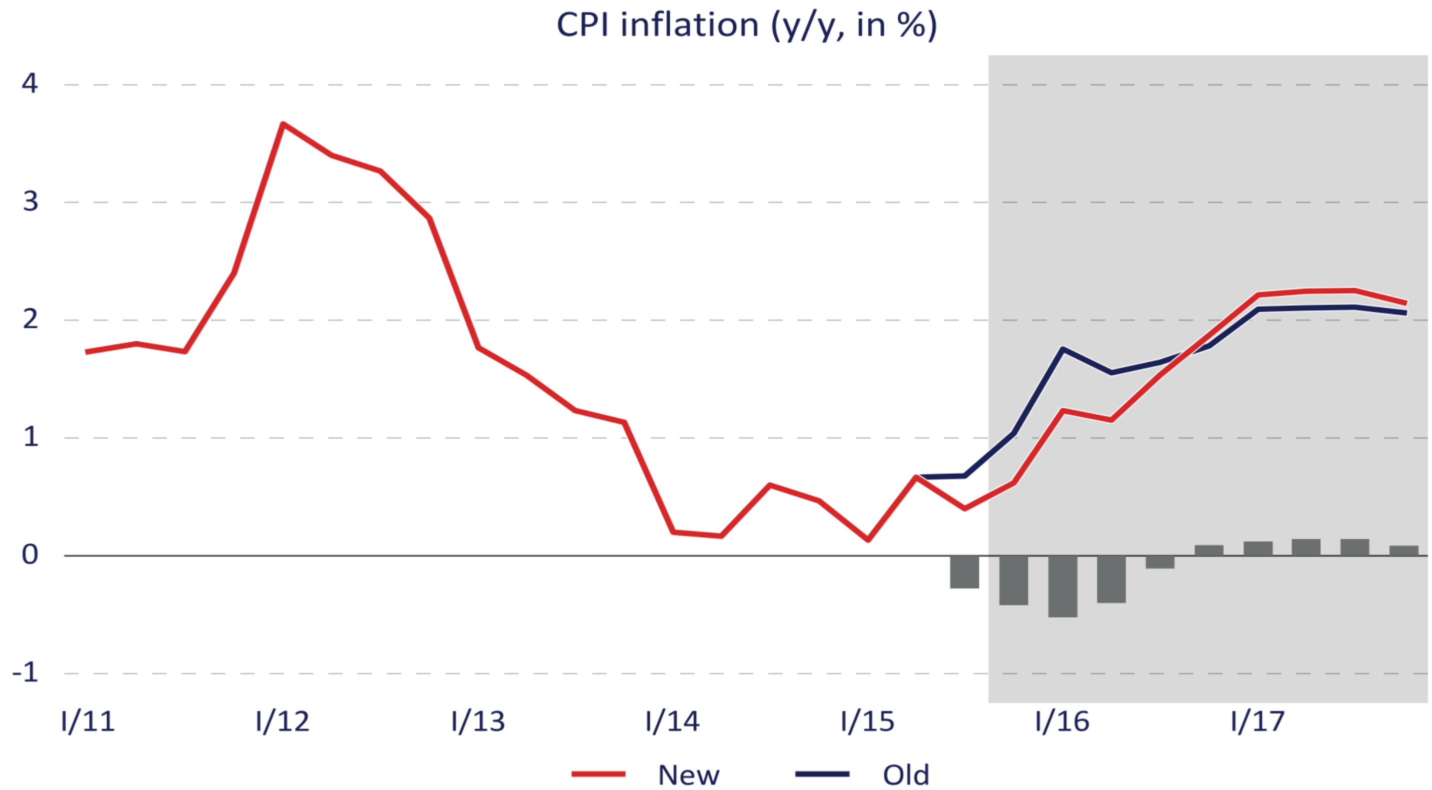
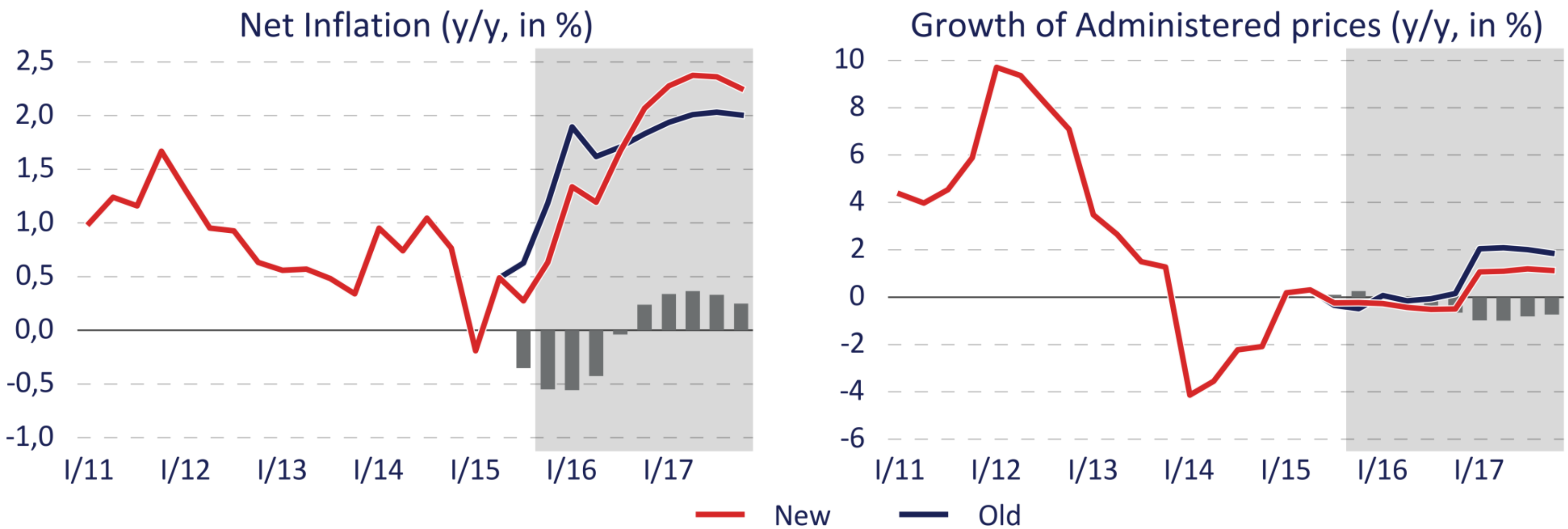


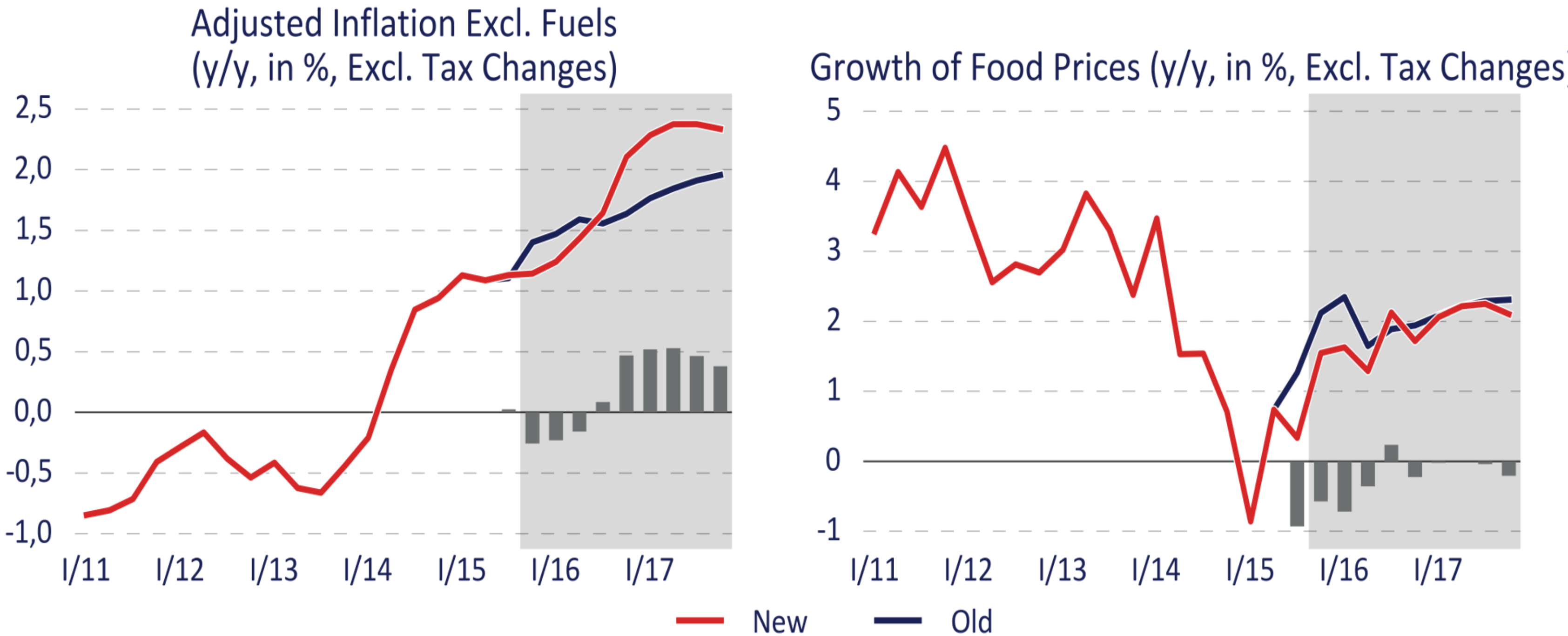

- The forecast for annual headline inflation is lower than in the previous forecast until 2016 Q3, but slightly higher thereafter.
- At the shorter end of the forecast it is affected by the lower inflation observed in recent months (lower food price growth and a larger-than-forecasted decrease in fuel prices). The more robust growth of the domestic economy and wages has an offsetting effect in the longer term.

# Comparison: Inflation Forecast (ii)



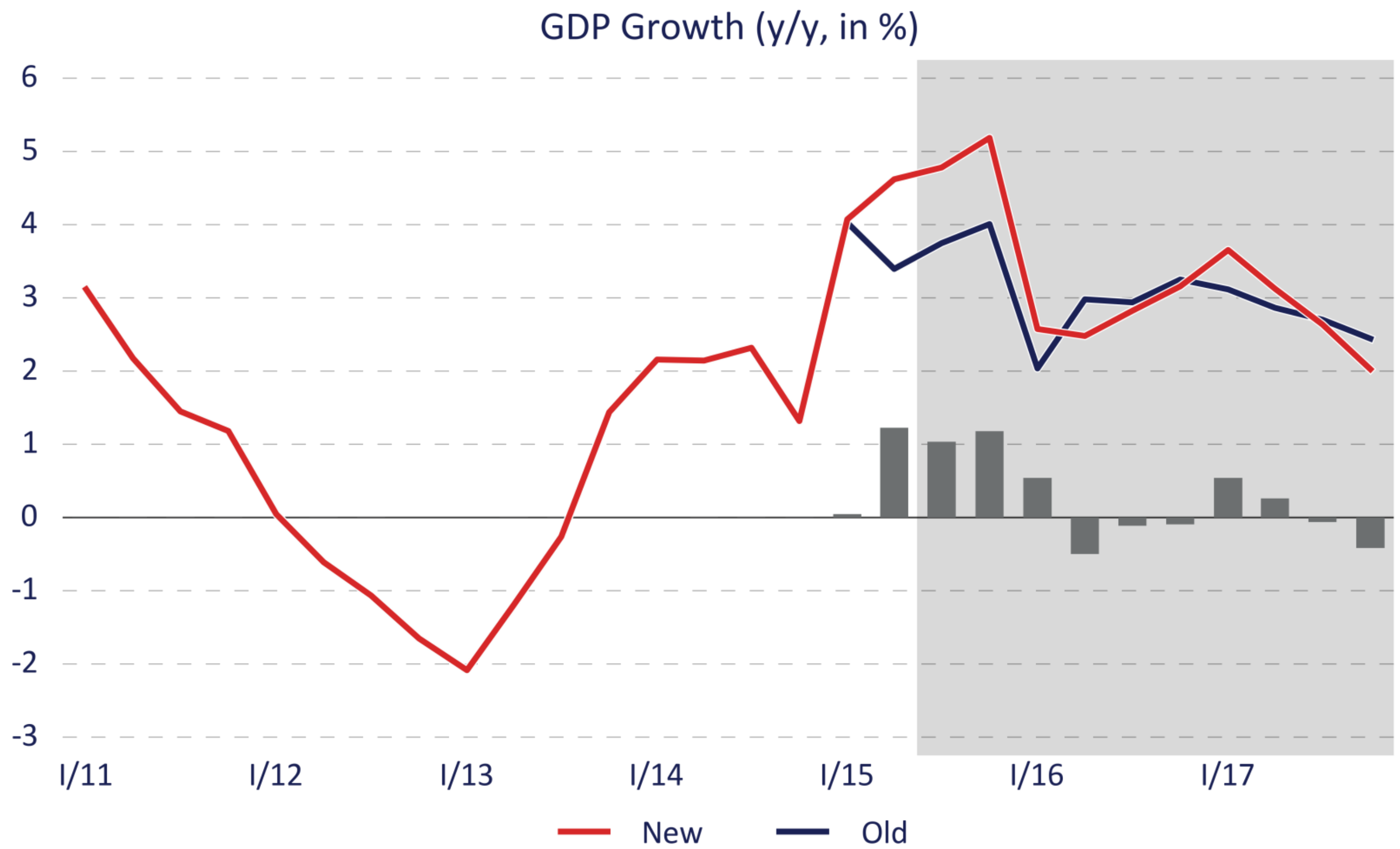

- As regards net inflation, the situation this year is characterised by slightly weaker cost pressures compared to the previous forecast, mainly reflecting a more anti-inflationary effect of external prices (and food prices).
- By contrast, in 2016 the fundamental upward pressures on costs are slightly higher due to the domestic economy, pushing net inflation higher as from the end of next year.
- The administered price outlook is lower compared with the previous forecast. The revision of the forecast for next year mainly reflects a lower energy price outlook. In 2017, the expected growth in water supply and sewage collection charges and heat and electricity prices is smaller in 2017.

# Comparison: Inflation Forecast (iii)




- The lower outlook for core inflation in the coming quarters reflects more subdued price developments abroad. At the longer end, the forecast is higher due to more robust domestic cost increases (wages and prices of capital).
- The forecast of food prices is lower in the near term due to the observed data, as well as due to a lower outlook for the agricultural commodity and producer prices.

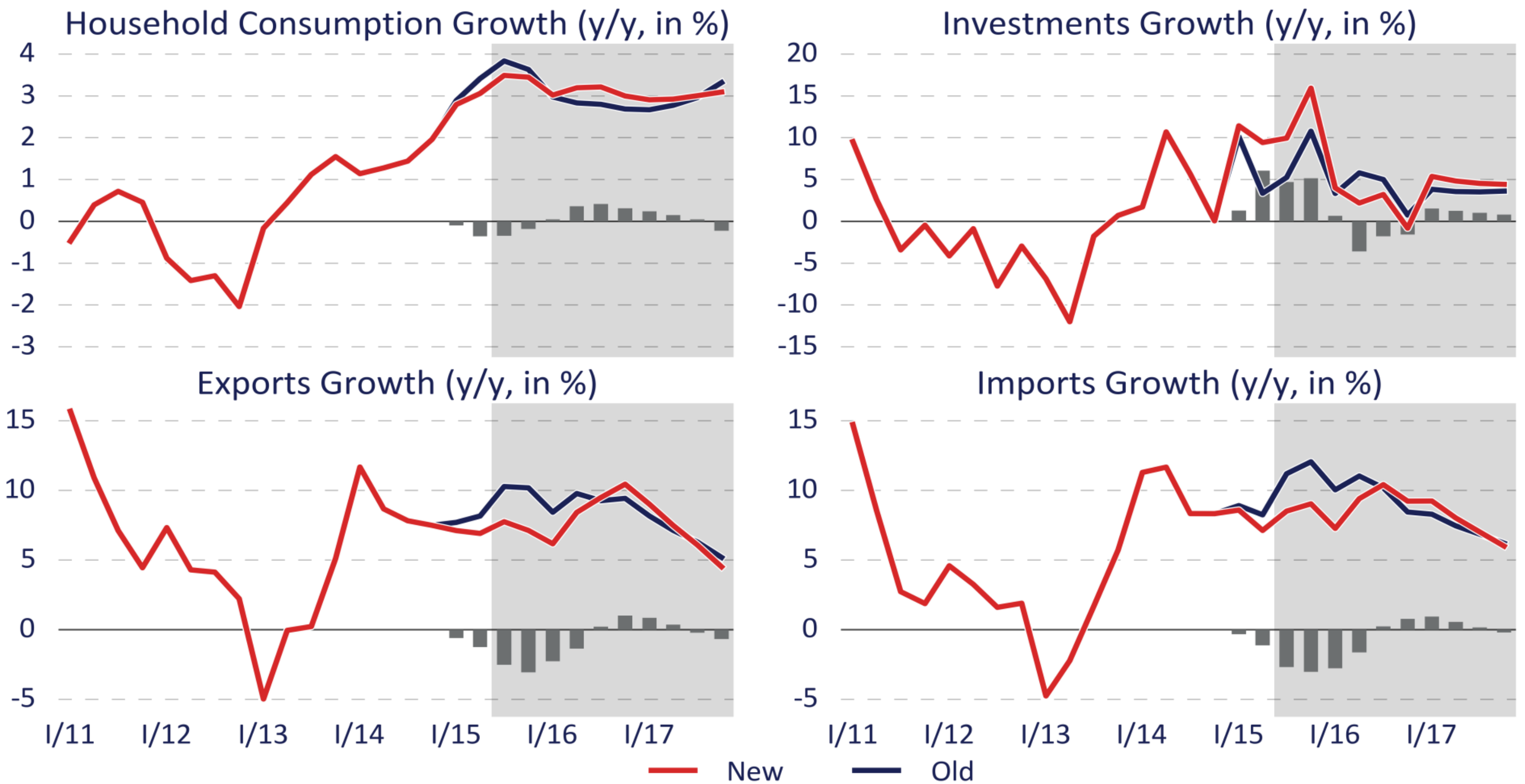
# Comparison: GDP Forecast (i)




- The forecast for annual GDP growth in 2015 is significantly above the previous prediction. The revision is due mainly to considerably stronger GDP growth in 2015 Q2, primarily reflecting stronger growth in gross capital formation.
- The GDP growth outlook for the following years is almost unchanged overall.

# Comparison: GDP Forecast (ii)






- The forecast for household consumption this year has moved downwards slightly owing to the observed data. For 2016 and 2017, it is revised slightly upwards owing to faster growth in wages and employment.
- Higher economic activity will also lead to stronger growth in fixed investment and inventories this year; but government investment will fall more next year.
- The forecast reflects observed lower growth in exports and imports.

# Comparison: Nominal Wage

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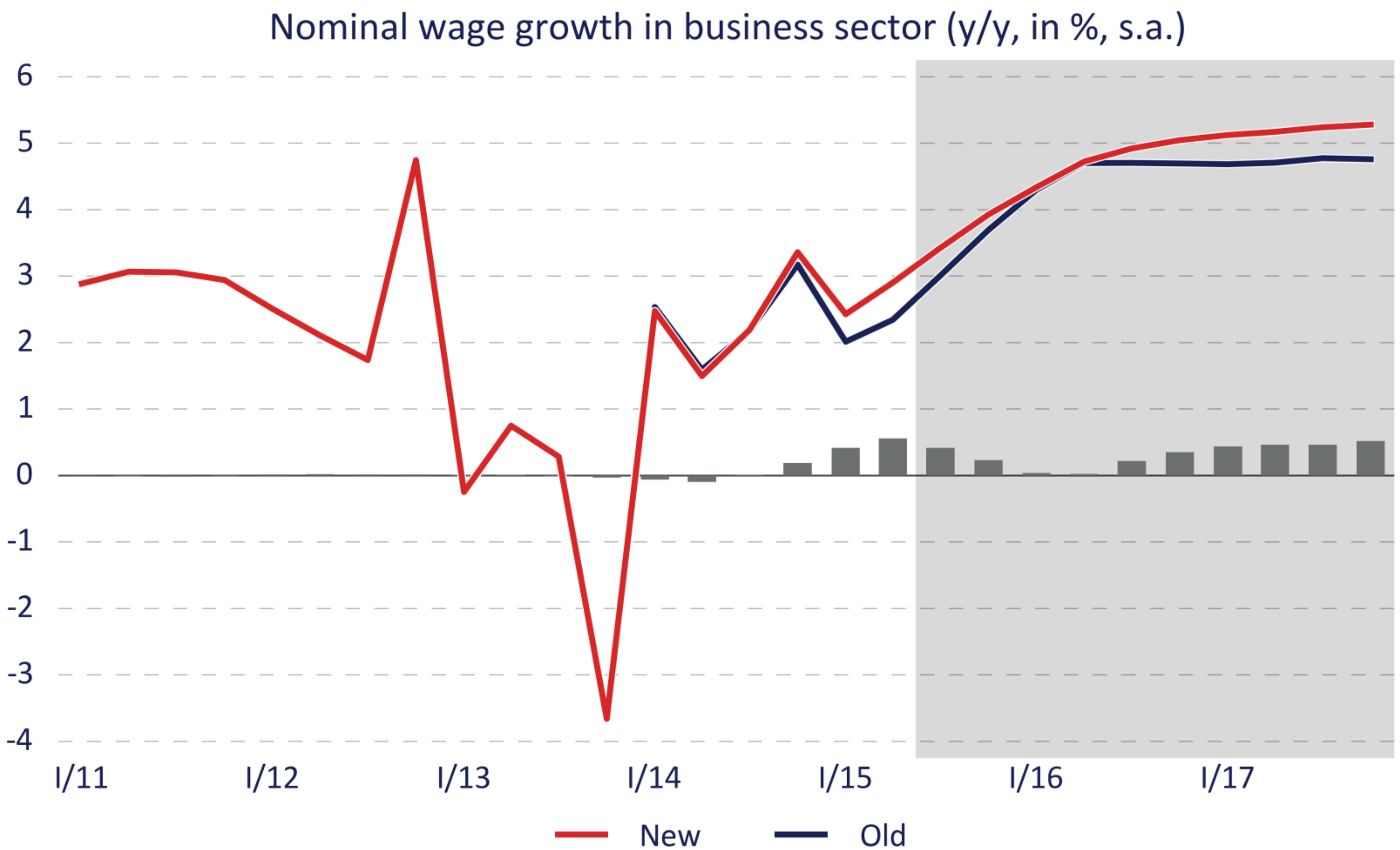
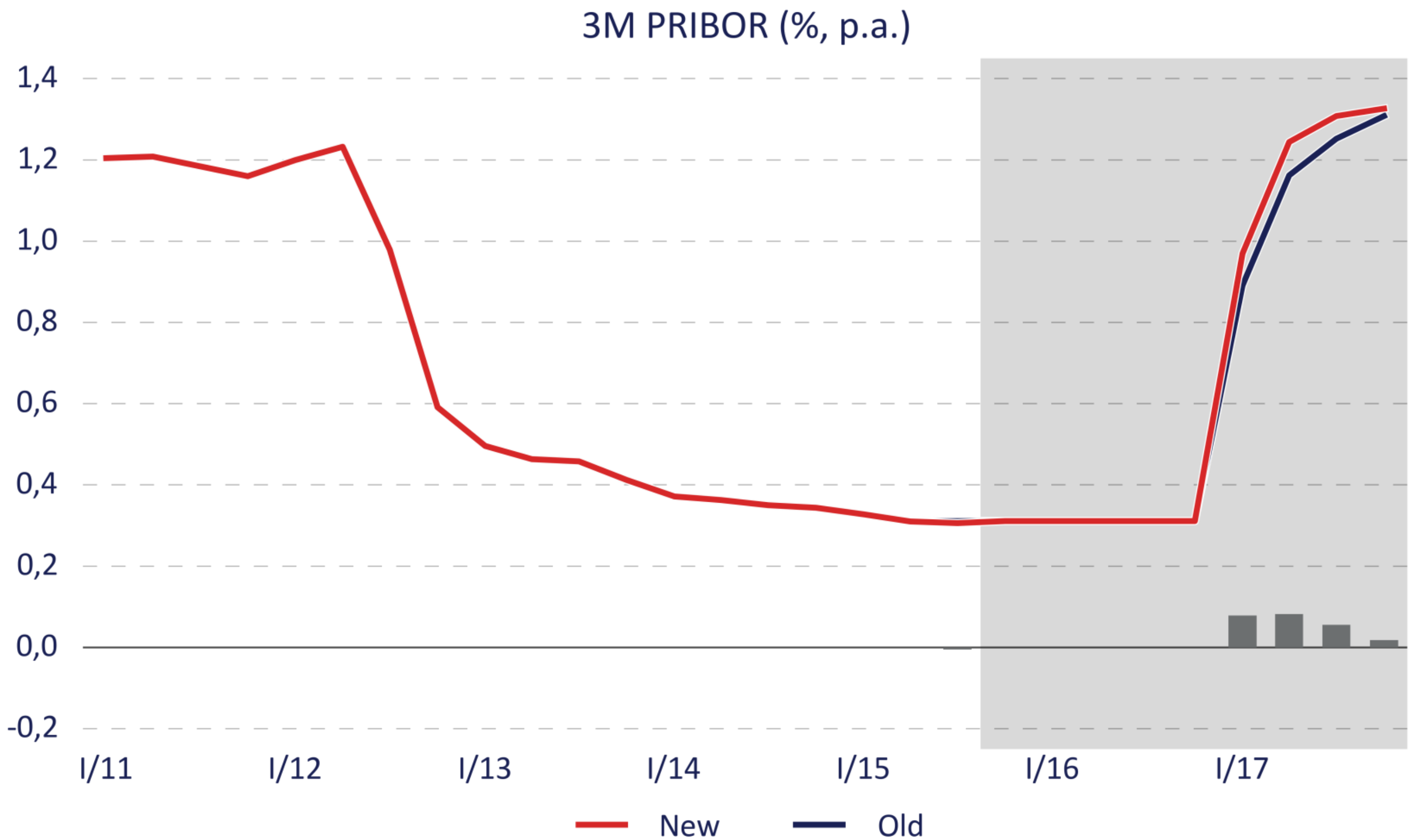



- Growth in the average nominal wage in the business sector has increased compared to the previous forecast over the entire forecast horizon.
- This revision primarily reflects the observed higher growth in wages and faster growth in domestic economic activity this year.

# Comparison: Interest Rate Forecast




- The path of domestic market interest rates remains unchanged until the end of next year and is slightly higher thereafter.
- This is due to higher upward cost pressures from the domestic economy, counteracting lower outlook for 3M EURIBOR rates.

# Thank you for your attention!

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