CNB's New Forecast (Inflation Report I/2016)

Meeting with Analysts

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Prague, 5 February 2016

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Outline

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

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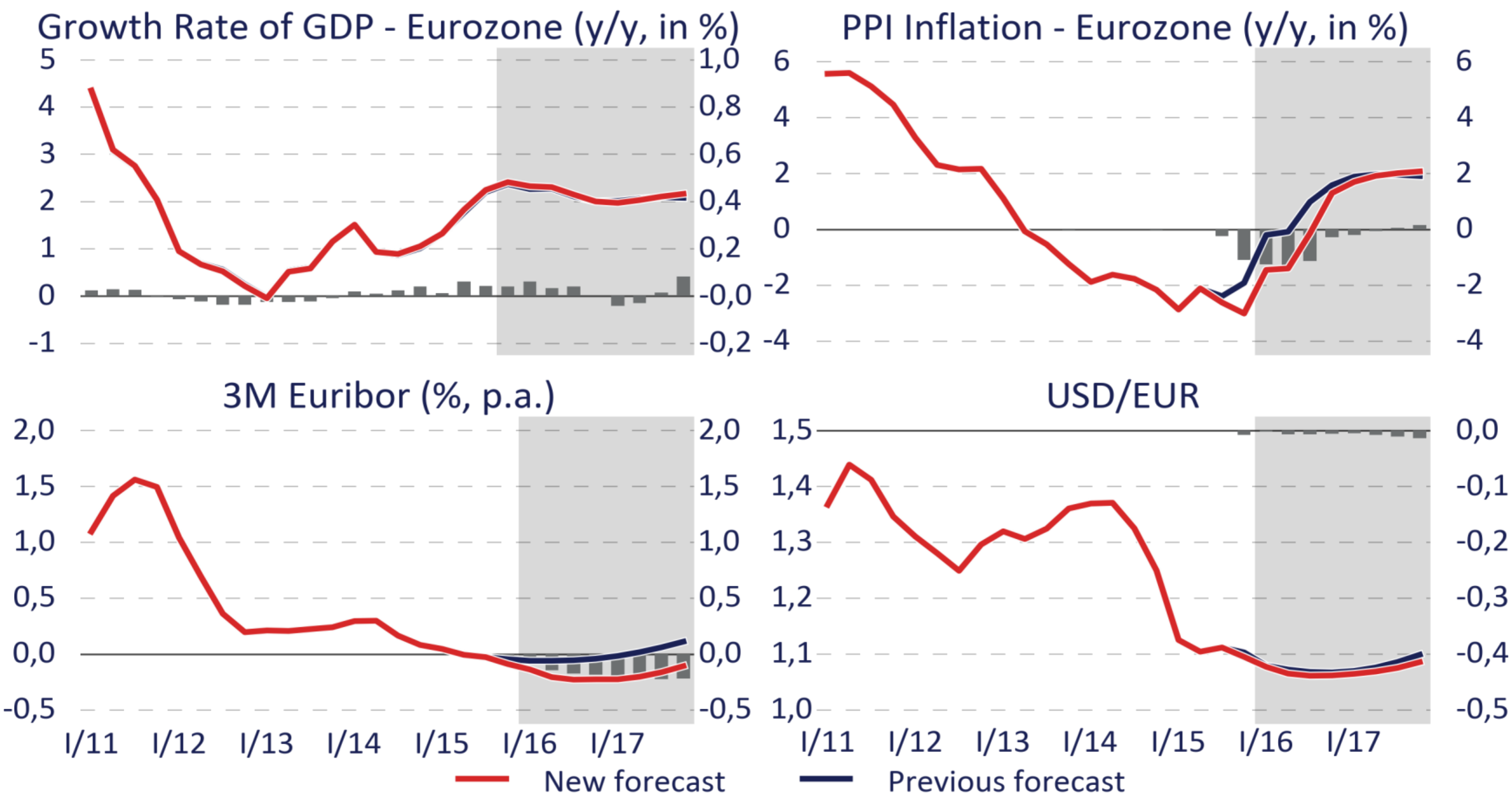
External Environment Outlook



- GDP growth will stay around 2% over the entire forecast horizon.
- Producer prices will return to annual growth at the end of this year.
- The subdued inflation is reflected in accommodative ECB monetary policy and consequently also in the outlook for 3M EURIBOR and USD/EUR.

Fiscal Policy

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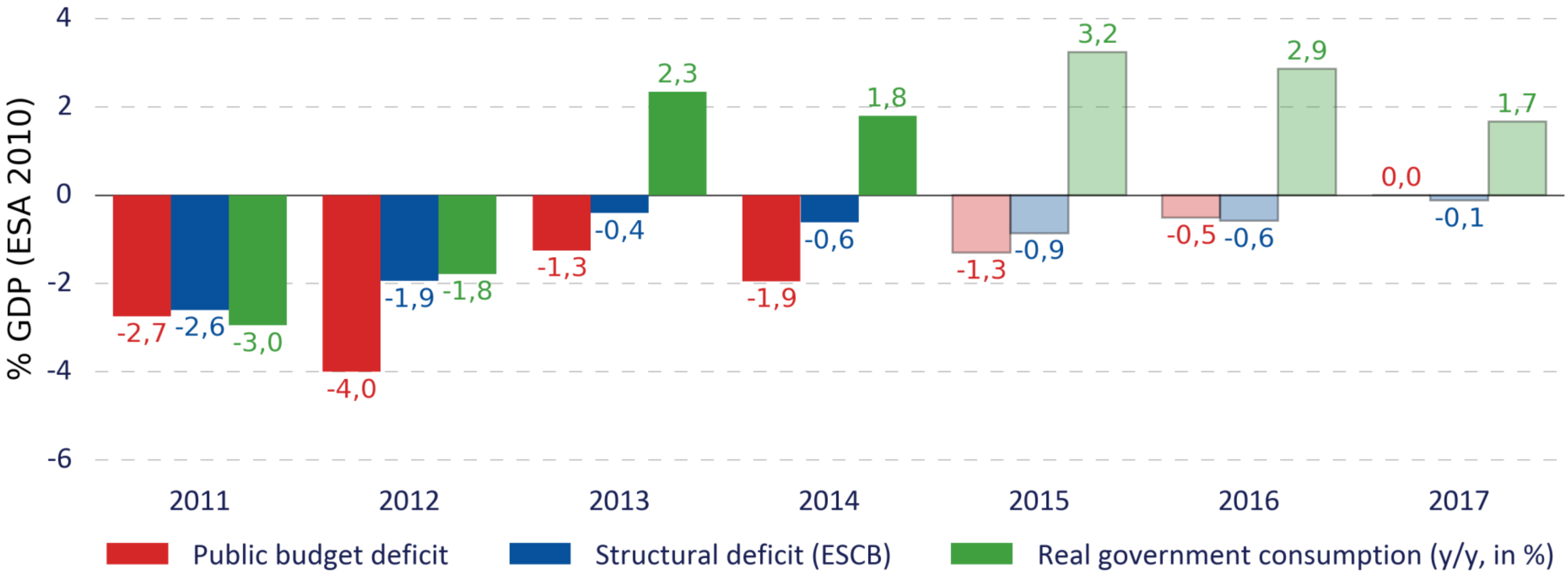


- **2015:** drop in the deficit to 1.3% of GDP due to fast economic growth coupled with dissipation of the extraordinary factors from 2014.
- **2016:** decline in the deficit to 0.5% of GDP due to a fall in co-financing of EU funds, increased tobacco excise duties (offsetting the impact of a one-off pension bonus), measures to improve VAT collection, and lower debt service costs.
- **2017:** balanced budget (ongoing economic growth, further decline in debt service costs, fading out of one-off measures from this year).

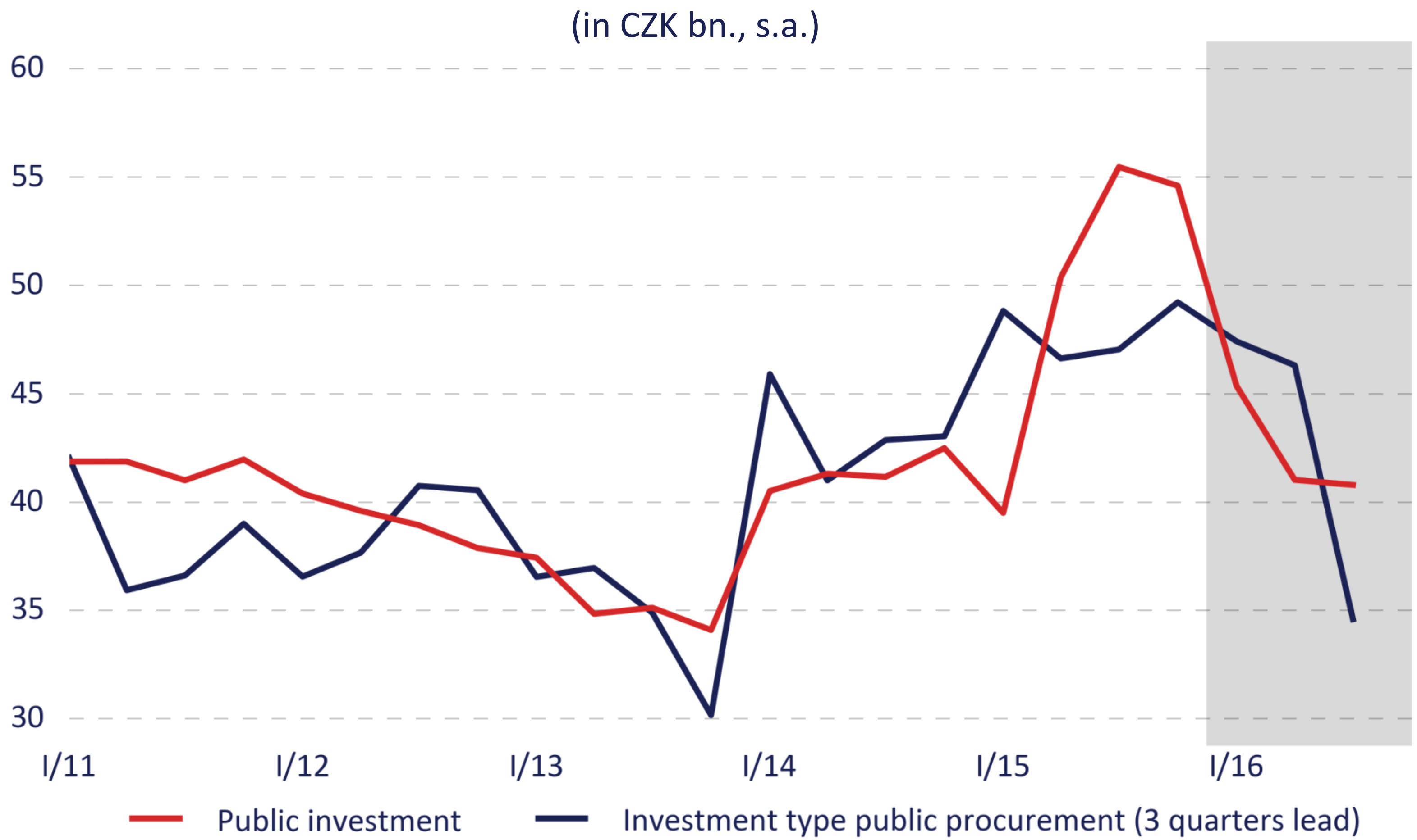
Fiscal Impulse

Contributions to GDP growth in p.p.				
	2014 actual	2015 expected	2016 forecast	2017 forecast
Fiscal impulse [a)]	0.3	0.7	-0.6	0.1
of which impact through:				
private consumption	0.1	0.1	0.0	-0.2
private investment	0.0	0.1	-0.1	0.0
government investment, domestic	0.1	0.1	0.0	0.1
government investment, EU funded	0.2	0.4	-0.4	0.2

[a)] Owing to rounding, the total sum may not equal the sum of the individual items.

- Fiscal impulse contributed significantly to the GDP growth in 2015, mainly due to the accelerated drawdown of the EU funds.
- In 2016, the impact will be significantly negative due to a drop in public investment financed by EU funds, as the new programme period has been starting only gradually.
- In 2017, the forecast assumes a marginally positive fiscal impulse.

Public Procurement and Public Investment



- Data on public procurement confirm that the drop in public investment may be really significant during 2016.

Monetary Policy

- The forecast assumes that market interest rates will be flat at their current very low level and the exchange rate will be used as a monetary policy instrument (with the exchange rate commitment set at CZK/EUR 27) until the end of 2016.
- Consistent with the forecast is an increase in market interest rates in 2017.
- The exit should not result in the exchange rate appreciating sharply to the slightly overvalued level recorded before the CNB started intervening, among other things because the weaker exchange rate of the koruna is in the meantime passing through to the price level and other nominal variables.
- Nevertheless, a positive interest rate differential, continued QE by the ECB at least until March 2017 and renewed – although much slower than in the pre-crisis period – real convergence of the Czech economy to the advanced EA countries will be apparent after the exit from the exchange rate commitment.
- The forecast does not take into account that any appreciation of the koruna following the discontinuation of the exchange rate commitment might be dampened by hedging of exchange rate risk by exporters during the existence of the commitment, by the closing of koruna positions by financial investors and by possible CNB interventions to mitigate exchange rate volatility.

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Summary of the Inflation Forecast (i)

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- Both headline and monetary policy-relevant inflation decreased towards zero in 2015 Q4, remaining well below the CNB's target. They will increase in 2016–2017, hitting the 2% target at the monetary policy horizon and then moving slightly above it.

- Growing economic activity and, this year, accelerating wage growth will continue to foster higher costs and consequently also higher consumer prices over the entire forecast horizon.

- The current strongly anti-inflationary effect of import prices will moderate.

- The growth of the Czech economy will slow from 4.7% to 2.7% this year because of a temporary decline in gross capital formation due mainly to a drop in government investment financed from EU funds. Growth will pick up to 3.0% next year.

- Employment growth will continue, albeit at a slower pace than last year. Wage growth in the business sector will record a further marked increase this year.

Headline Inflation Forecast

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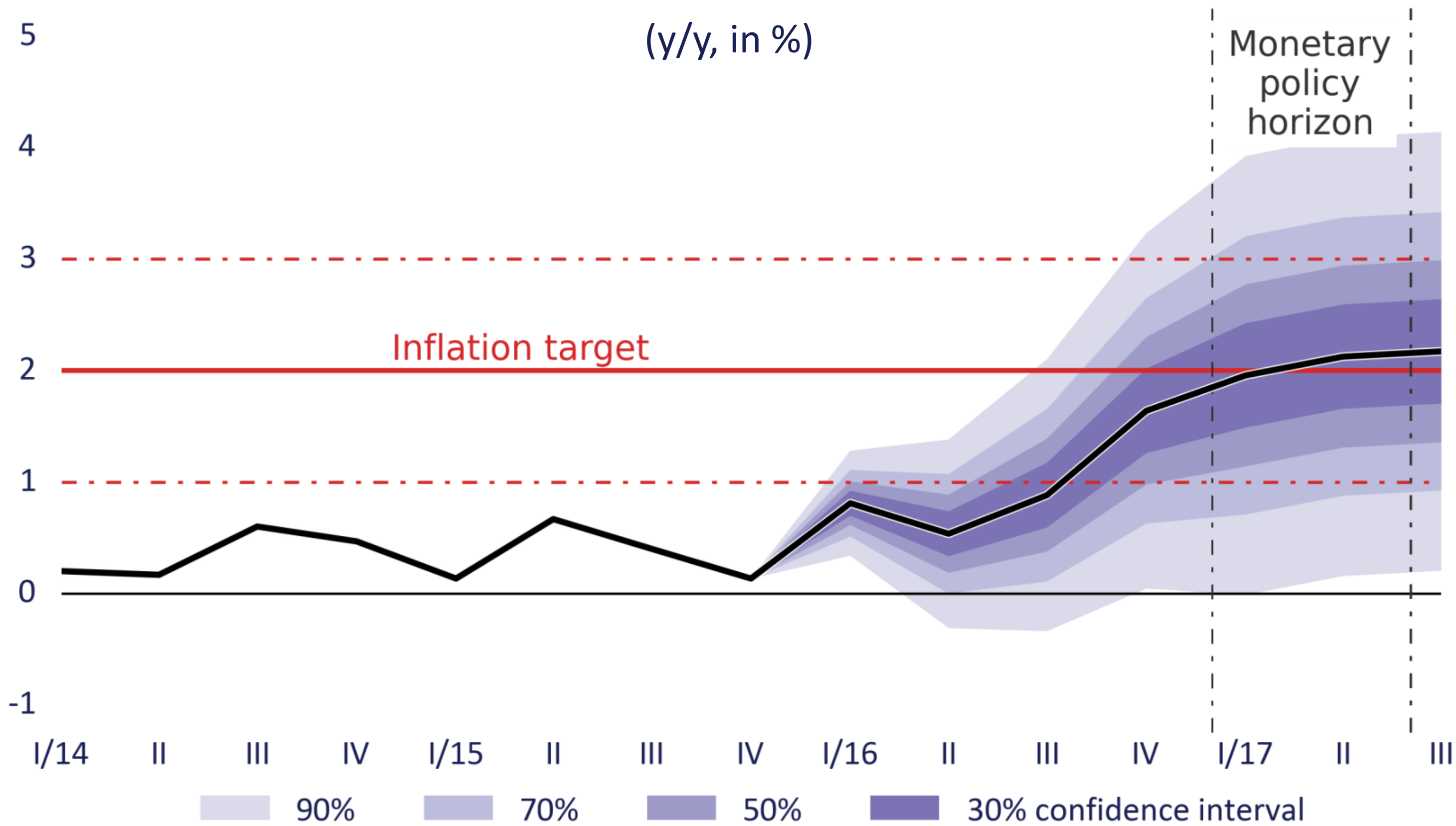
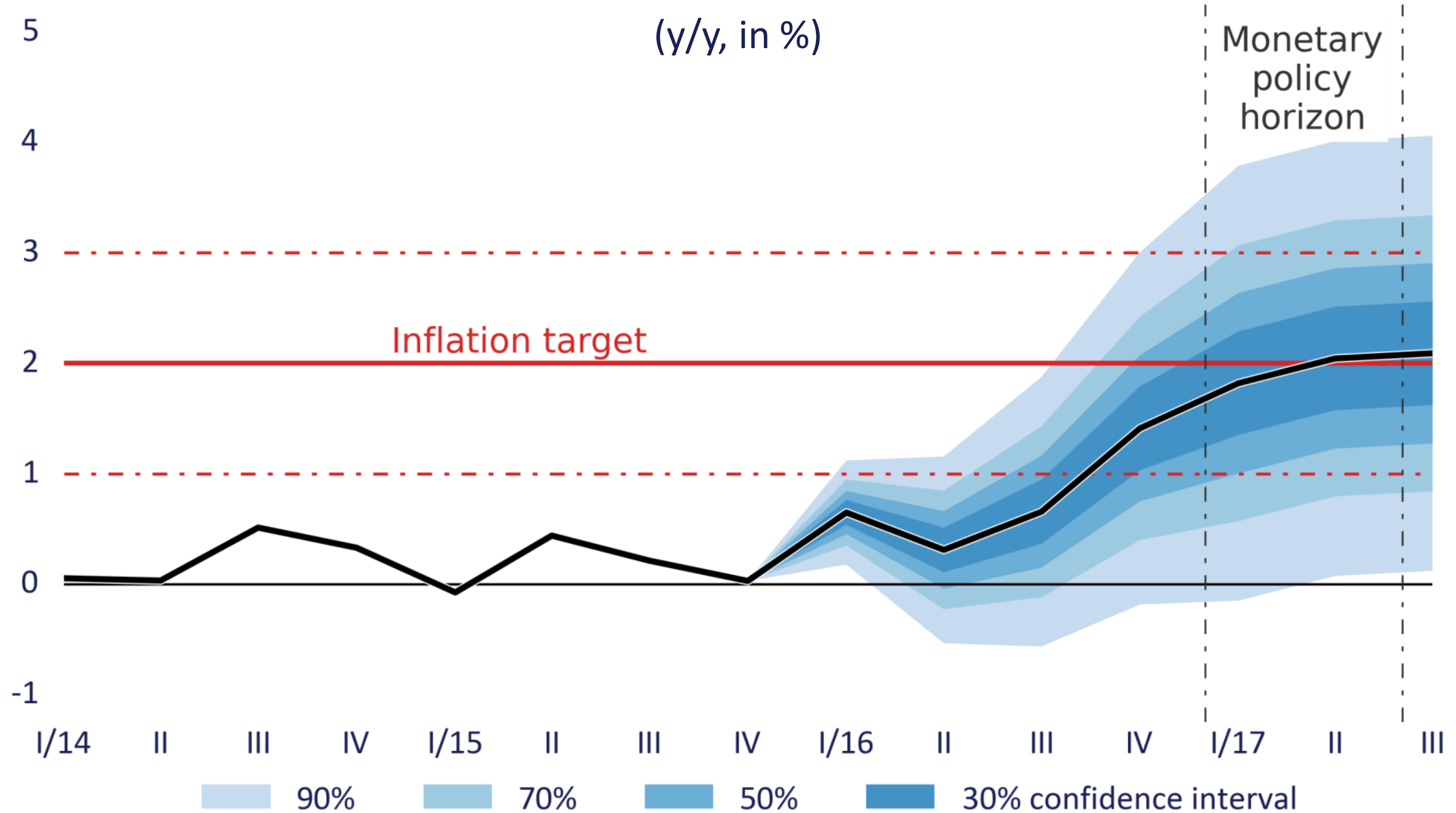


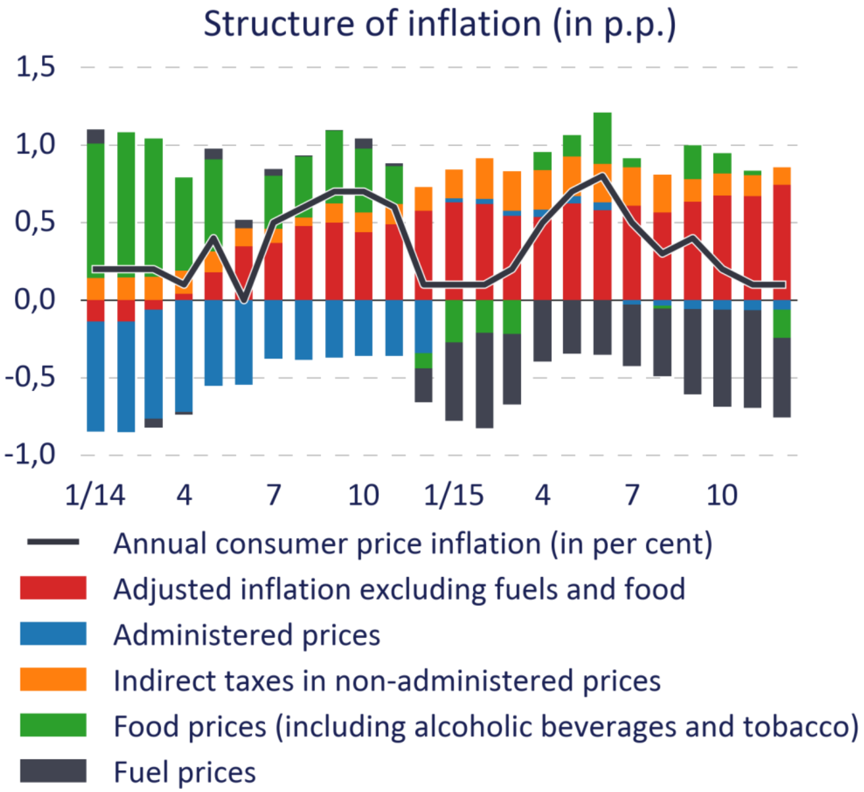
- Headline inflation dropped to 0.1% on average in 2015 Q4 (food price growth halted, the fall in fuel prices deepened further).
- Inflation will increase, hitting the 2% target at the monetary policy horizon and then moving slightly above it.

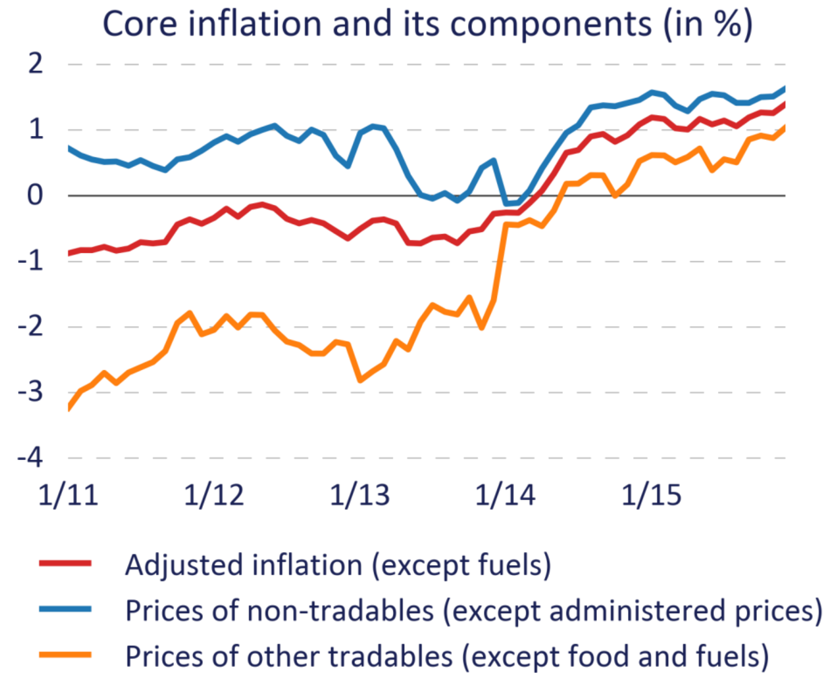
Monetary Policy-Relevant Inflation Forecast



- MP-relevant inflation slowed to zero on average in 2015 Q4. It was thus still well below the CNB's 2% target.
- Over the forecast horizon, monetary policy-relevant inflation will follow a similar path to headline inflation, although it will be slightly lower owing to increases in excise duties on tobacco.
- It will thus be close to the 2% inflation target as from mid-2017.

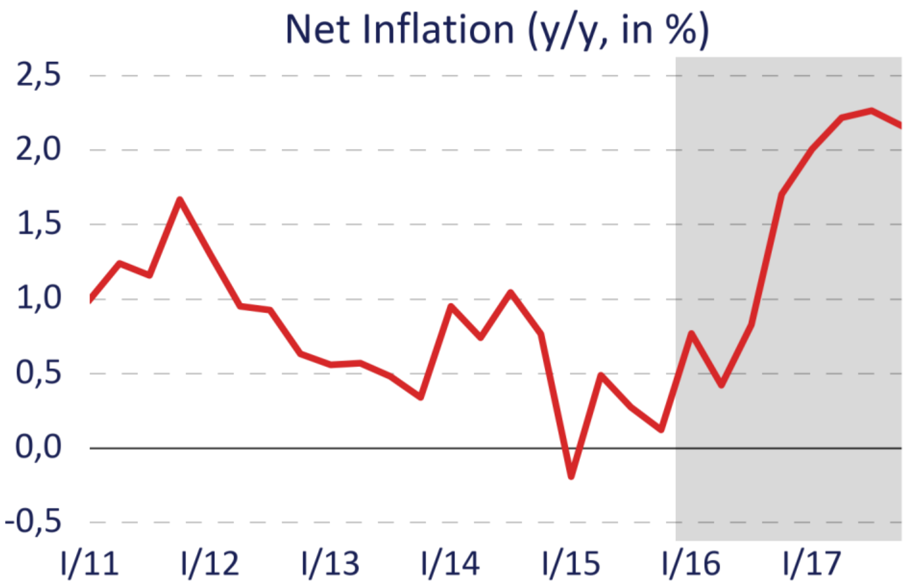
Structure of Inflation

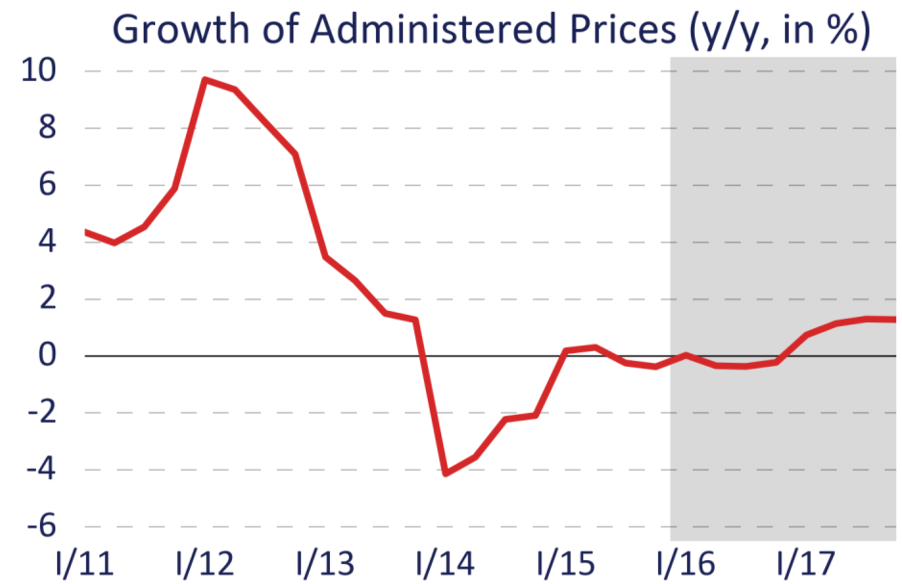




- The very low inflation reflects a drop in fuel prices, a slight decline in administered prices and in December 2015 also a renewed decline in food prices.
- Core inflation accelerated slightly during 2015 Q4 (to 1.4% in December). Growth in prices of both tradables and non-tradables picked up speed.

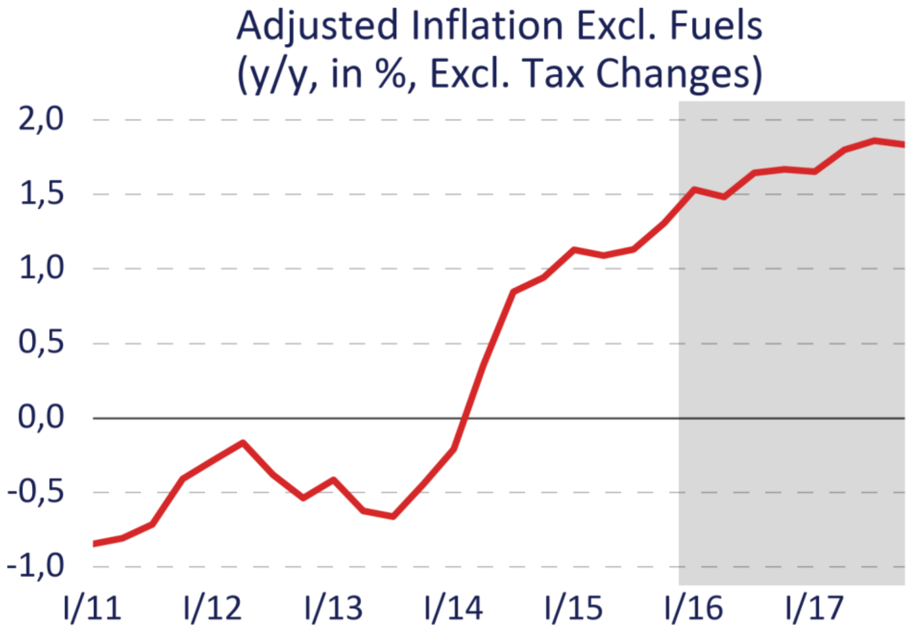
Market and Administered Prices

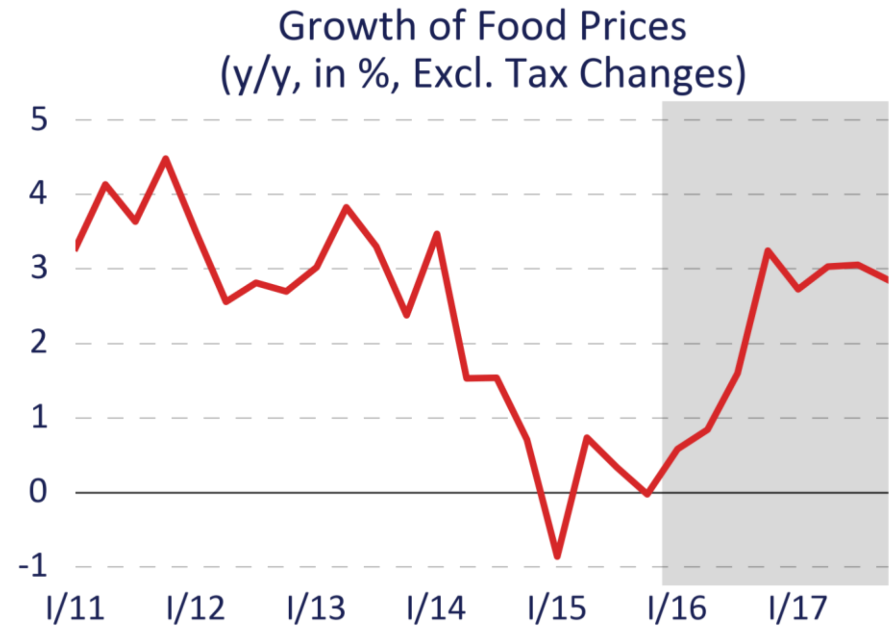




- Annual net inflation slowed further to 0.1% on average in 2015 Q4, due to a halt in food price growth and a deepening year-on-year decline in fuel prices.
- Net inflation will go up this year as a result of a further increase in core inflation, renewed growth in food prices and moderating drop in fuel prices.
- The forecast expects a continued moderate decline in administered prices this year (-0.2%), owing chiefly to a decrease in natural gas prices for households (-4.7%). In 2017, administered prices will increase by 1.1% in 2017, with positive contributions of most items except electricity.

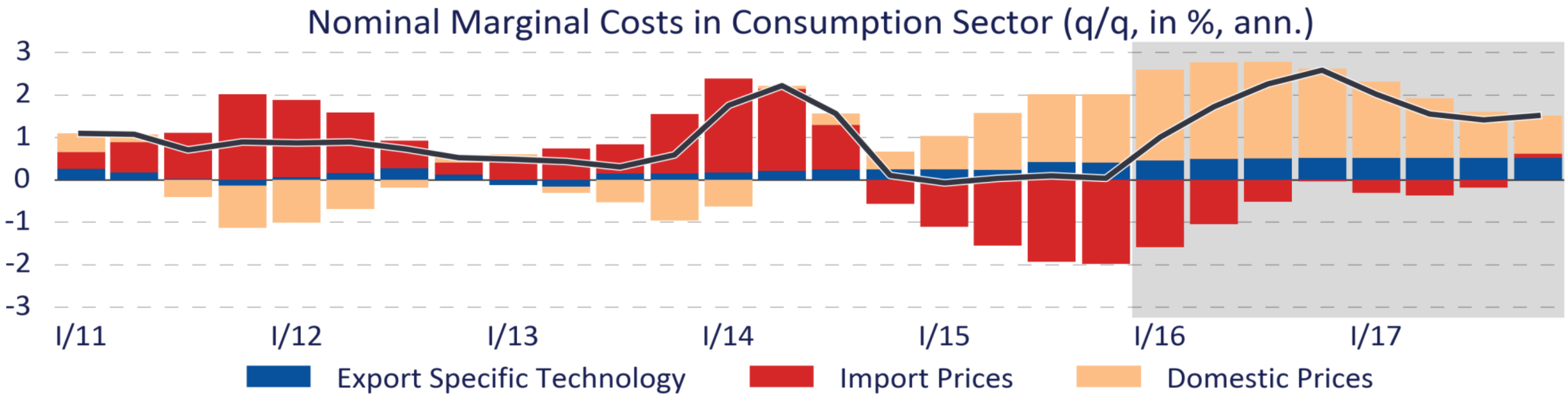
Adjusted Inflation Excluding Fuels and Food

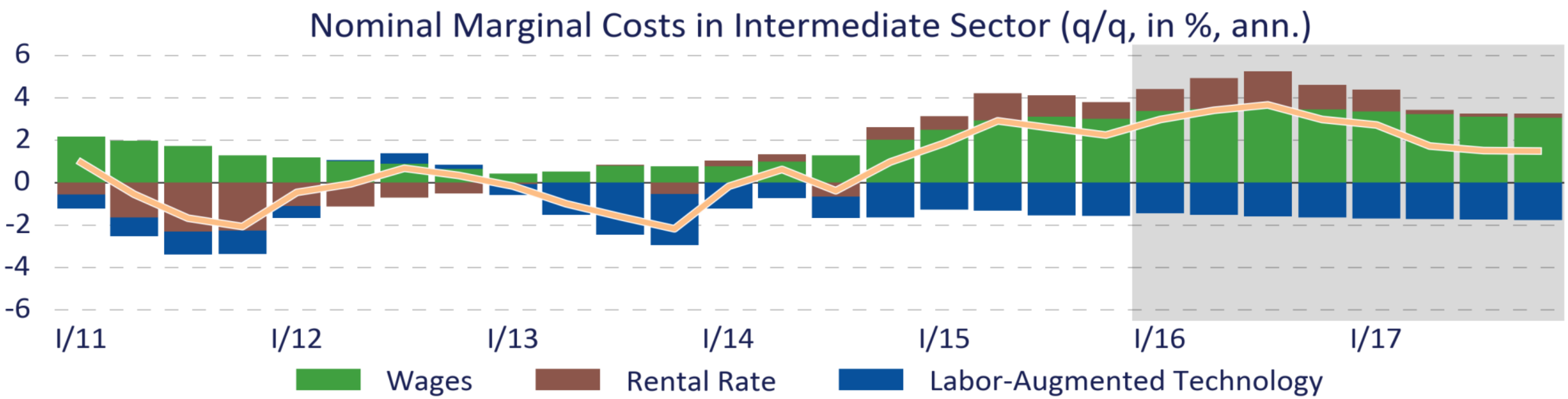




- Core inflation excluding fuels will accelerate to 1.7% by the end of this year due to the robust growth in domestic economic activity, accelerating wage dynamics and unwinding of the drop in foreign prices. In 2017, it will rise slightly further and approach 2% on account of inflation pressures from the domestic economy.
- Growth in food prices came to a halt on average in 2015 Q4. However, food prices will start rising again this year due to strengthening growth in global agricultural commodity prices, the fading of the one-off effects from 2015 and partly also a rise in inflation pressures from the domestic economy. In 2017, food price growth will rise further and fluctuate around 3%.

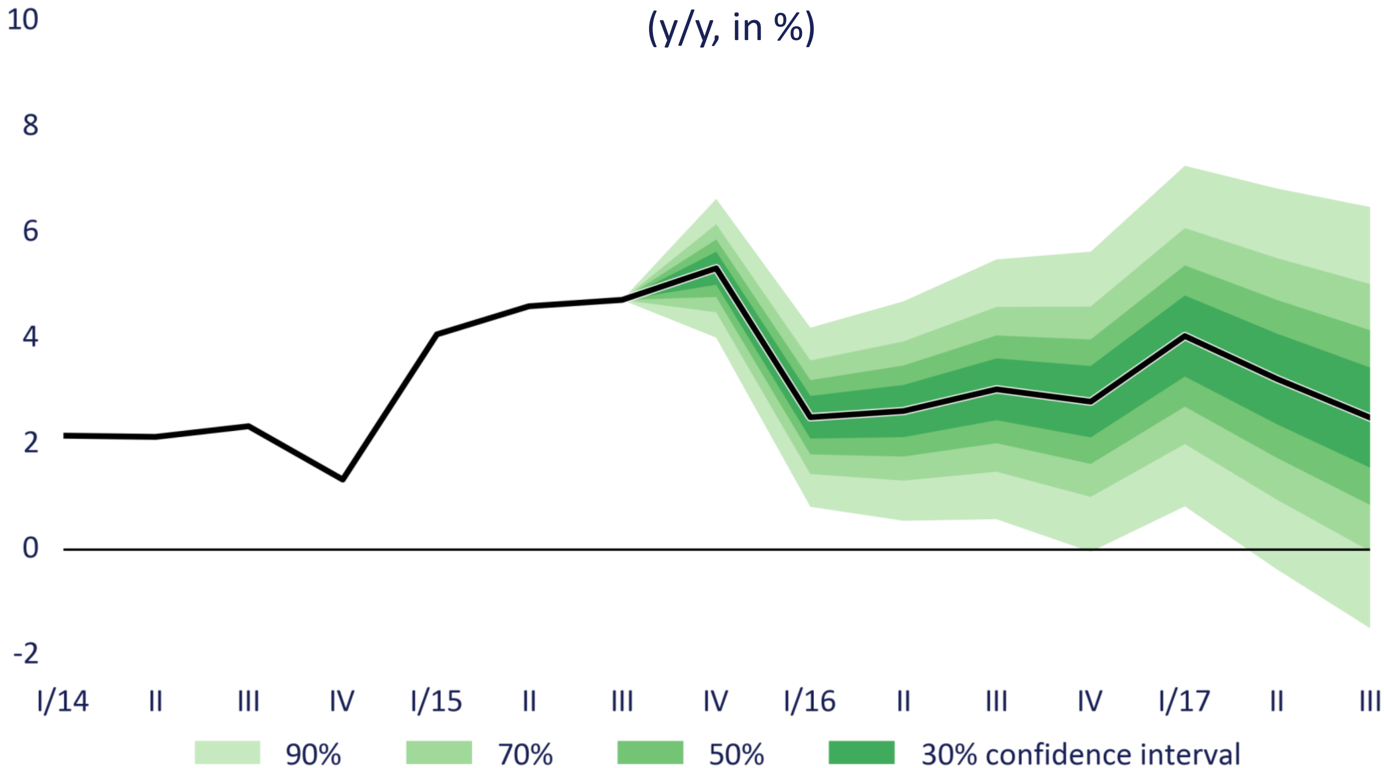
Domestic Costs vs. Import Prices





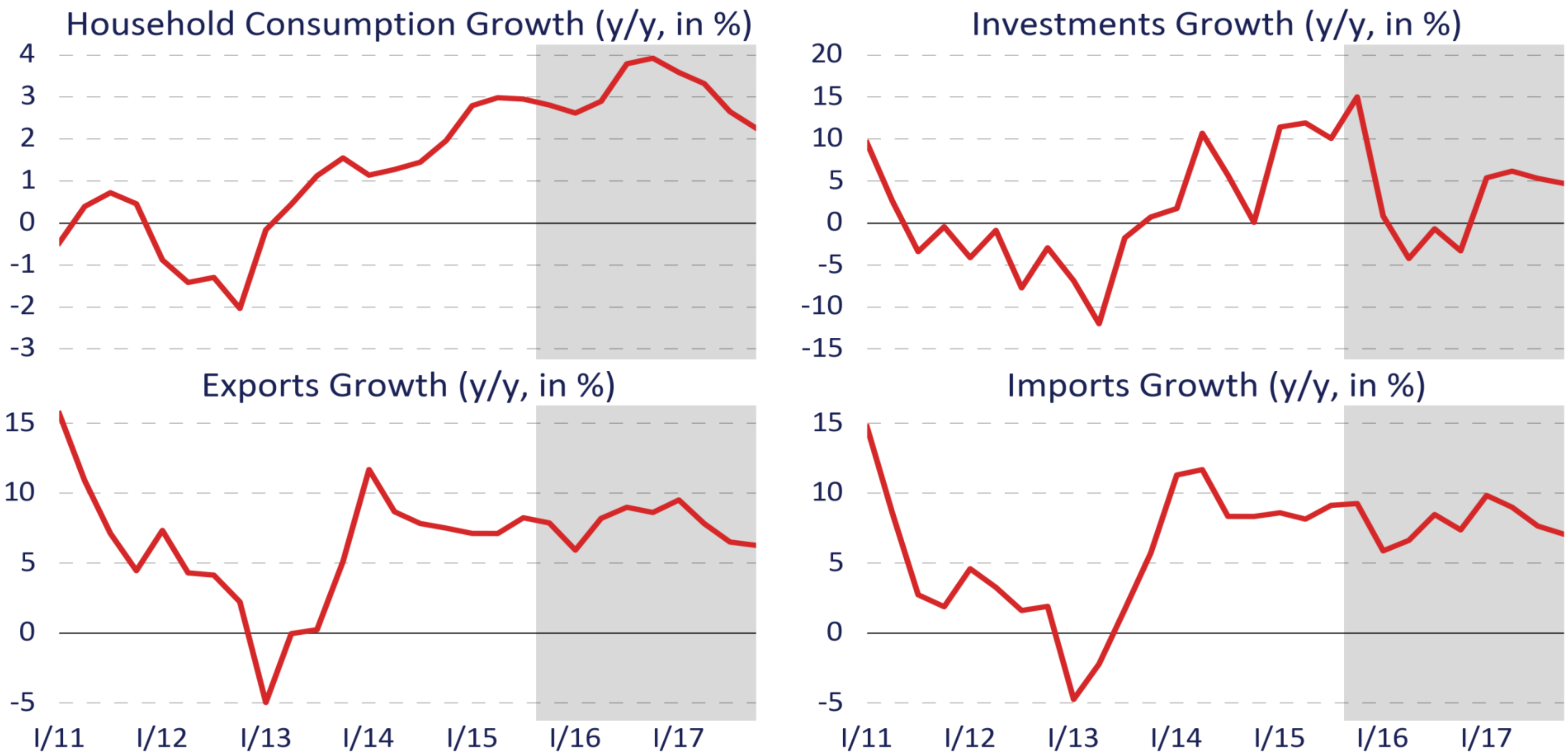
- The overall upward cost pressures on consumer prices will strengthen quickly until the end of 2016 and temporarily exceed 2%, reflecting accelerating wage growth and continued growth in both domestic and foreign demand.
- Renewed growth in producer prices abroad this year will result in a gradual moderation of the currently strong anti-inflationary effect of import prices.

GDP Growth Forecast



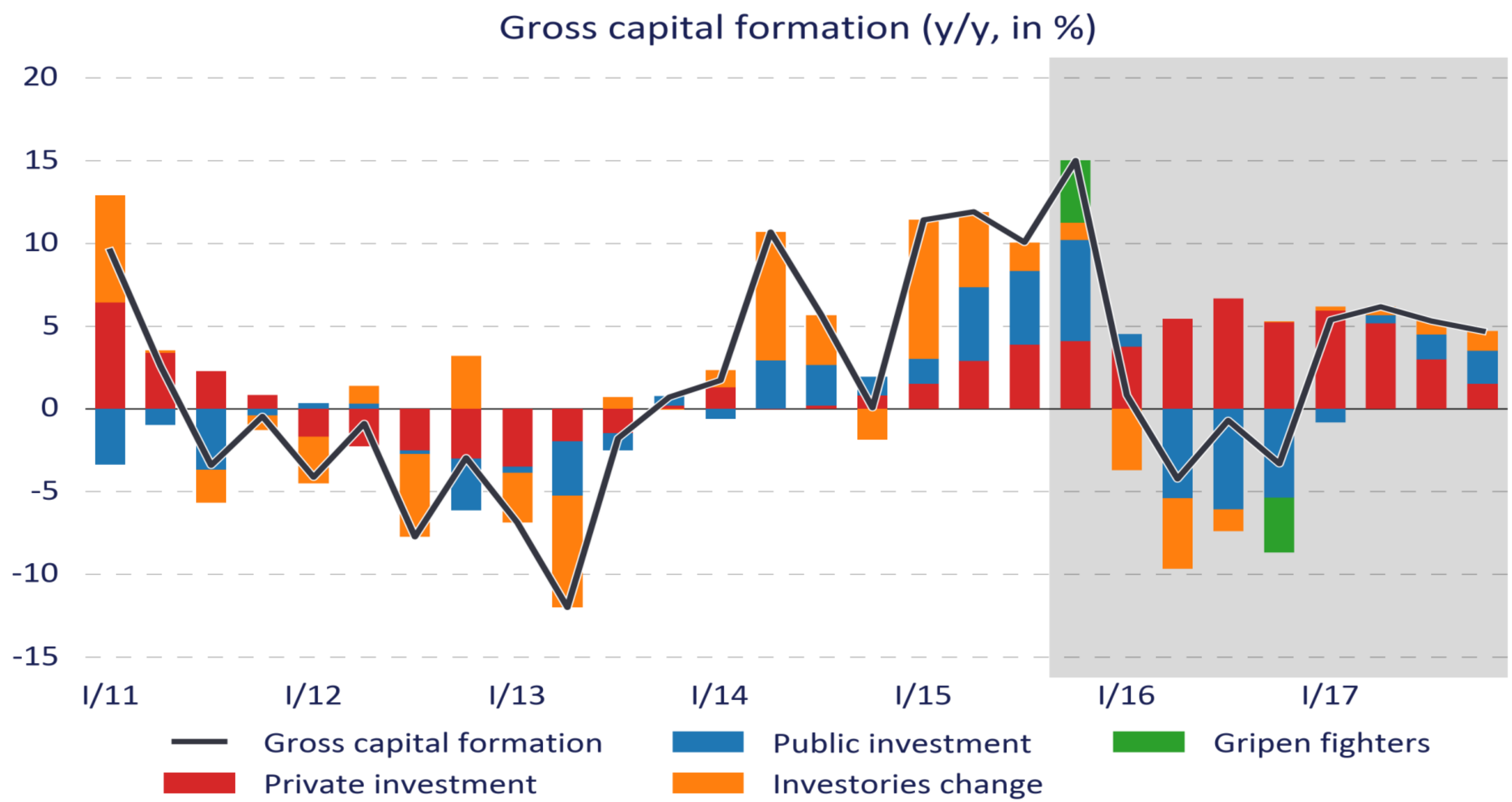
- GDP growth forecast: 4.7% in 2015, 2.7% in 2016, 3.0% in 2017.
- The Czech economy continued to grow rapidly in the second half of last year, buoyed by easy monetary conditions, a sharp rise in government investment, growth in external demand and low oil prices.
- GDP growth will slow markedly this year due to a drop in government investment financed from EU funds. Economic growth will accelerate slightly again next year.

Aggregate Demand



- GDP growth will continue to be fostered by household consumption, supported by high real wage growth including the positive effect of low commodity prices.
- Growth in exports as well as imports will be close to 7–8% in both years.
- There will be a temporary decline in gross capital formation in 2016, but investment growth will resume in 2017.

Gross Capital Formation Forecast



- Fixed investment growth will stop temporarily in 2016, when government investment will fall sharply as a result of an only gradual start to the drawdown of EU funds for the new programme period. By contrast, growth in private fixed investment will pick up further.
- The contribution of inventories to GDP growth will also be negative this year.

Labor Market: Employment

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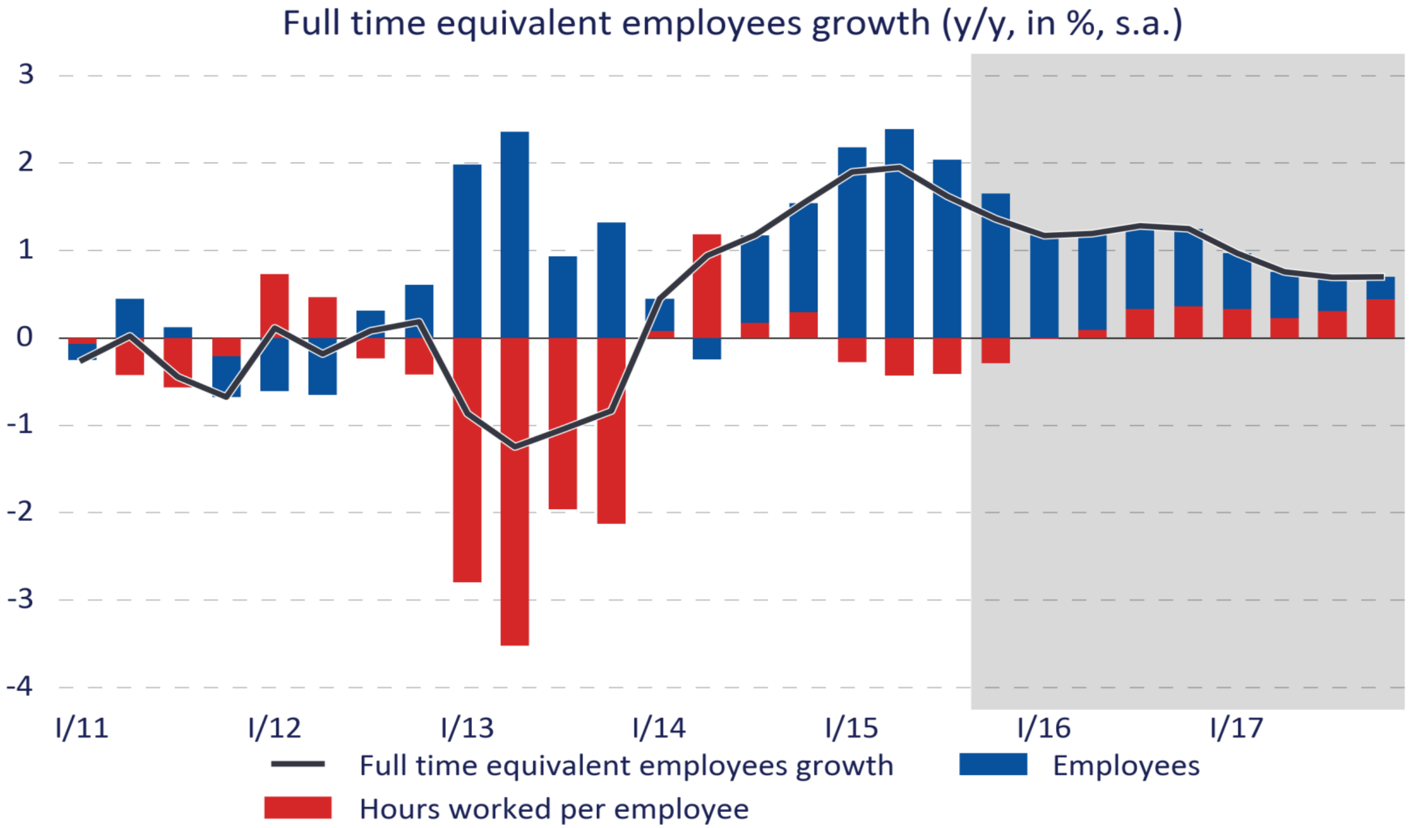
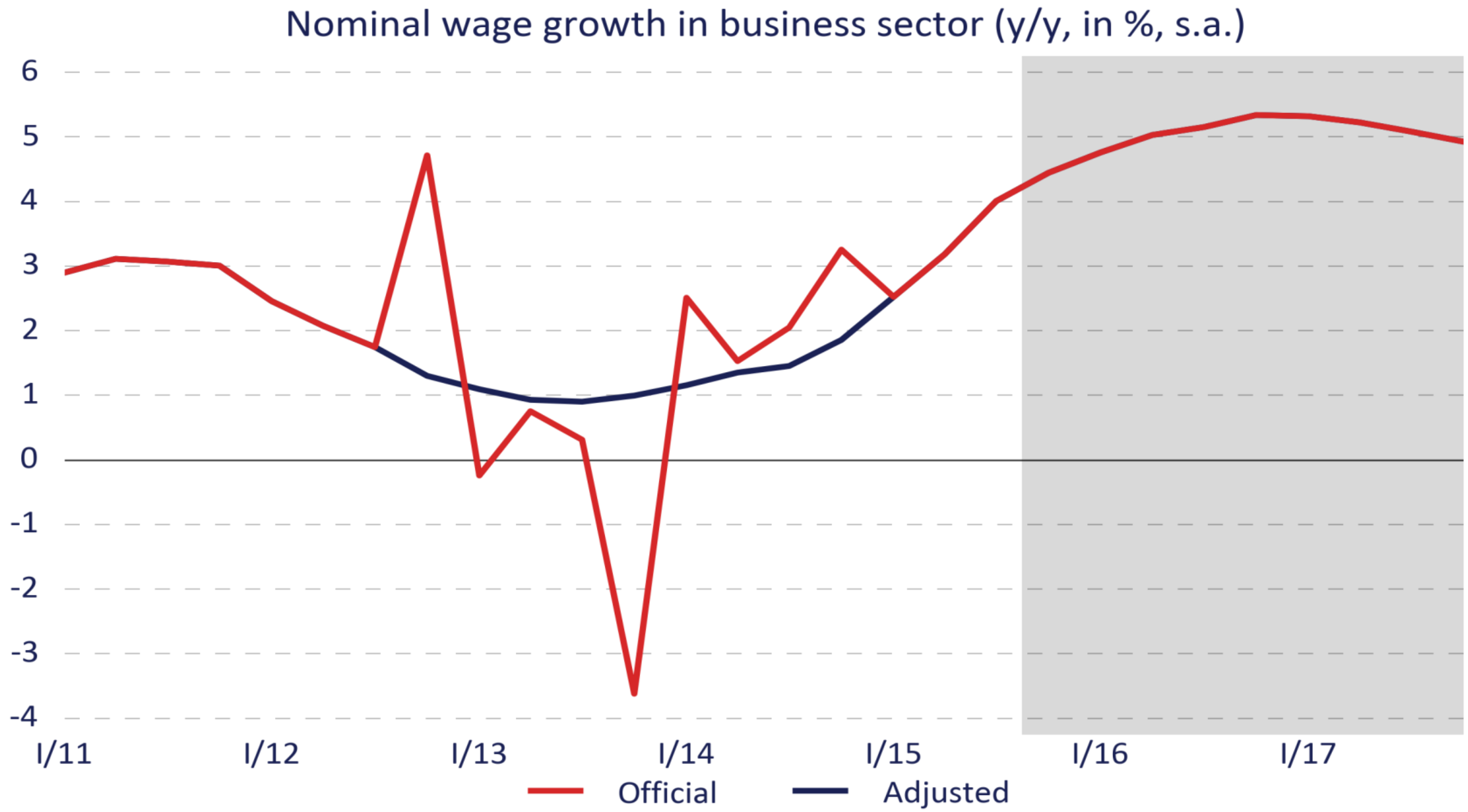


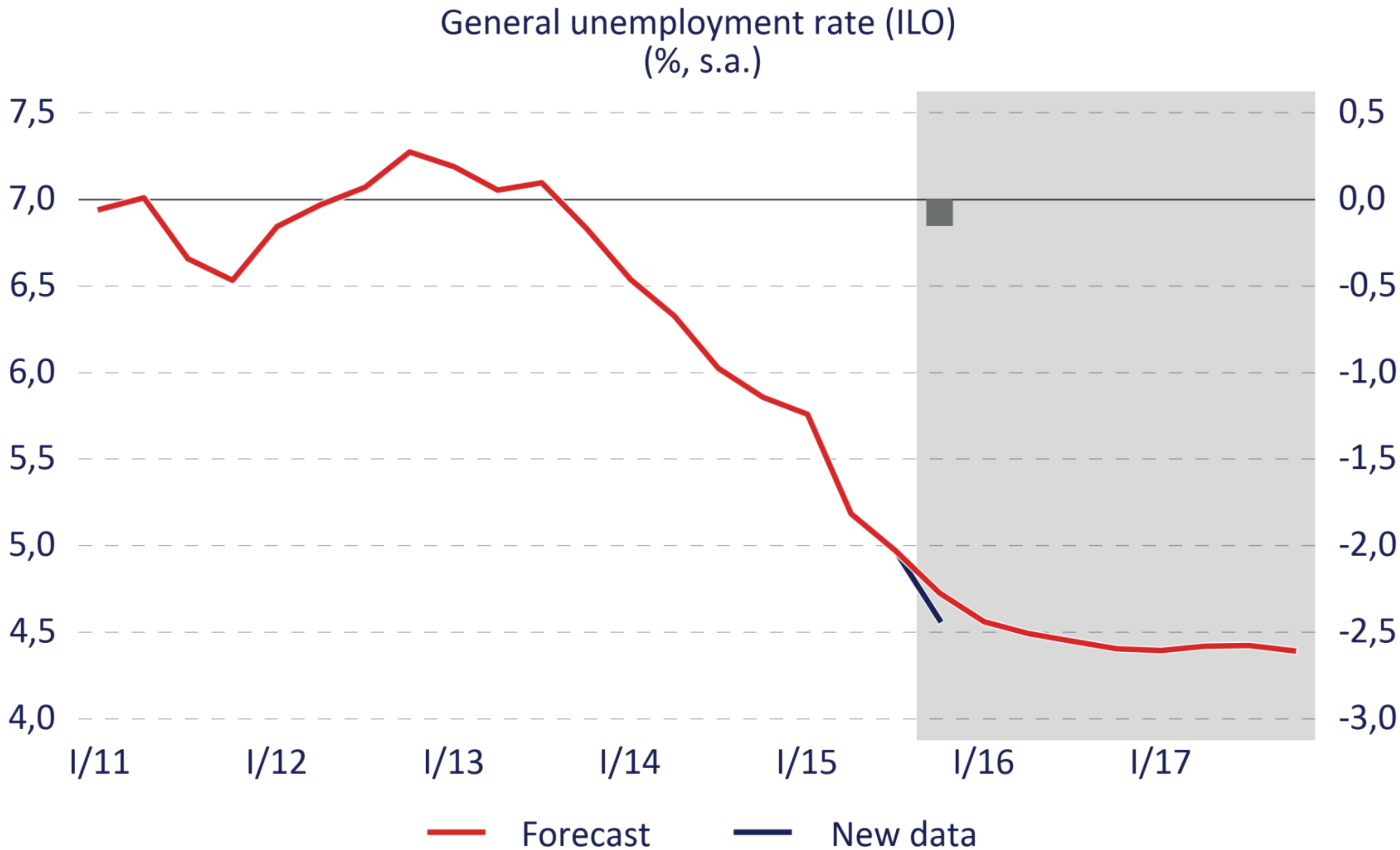
- Growth in the number of employees converted into full-time equivalents stood just above 1.5% in 2015 Q3 as a result of an increase in the number of employees coupled with slightly shorter average hours worked per employee.
- The growth will slow over the forecast horizon. It will initially be generated mainly by a further increase in the number of employees; the contribution of average hours worked will also recover during this year.

Labour Market: Wage Growth in Business Sector



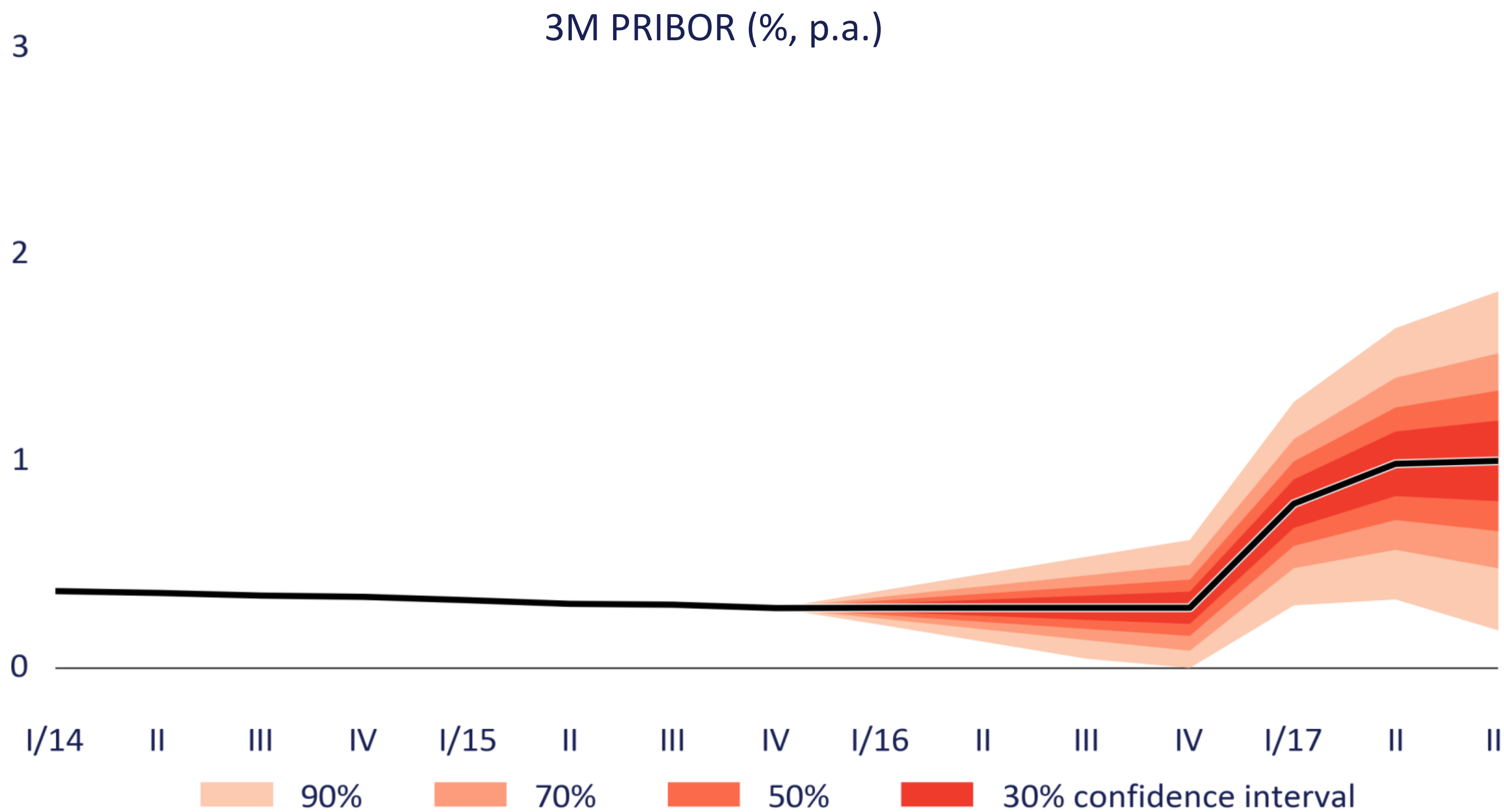
- The growth rate of the average wage will increase further this year owing to continued growth in domestic economic activity, falling unemployment and a gradual return of inflation to the target. This increase will also be fostered by a further rise in the minimum wage.
- The average wage in the business sector rose by 3.5% on average in 2015 as a whole and its growth will accelerate to 5.1% in 2016 and 2017.

Labor Market: Unemployment



- General unemployment rate decreased to 4.6% (s.a.) in 2015 Q4, and was thus 0.1 p.p. below the new forecast.
- The general unemployment rate will stabilise at 4.4% from mid-2016 due to similar quarterly growth in the labour force and employment.

Interest Rate Path



- 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 market interest rates in 2017.

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Comparison with the Previous Forecast

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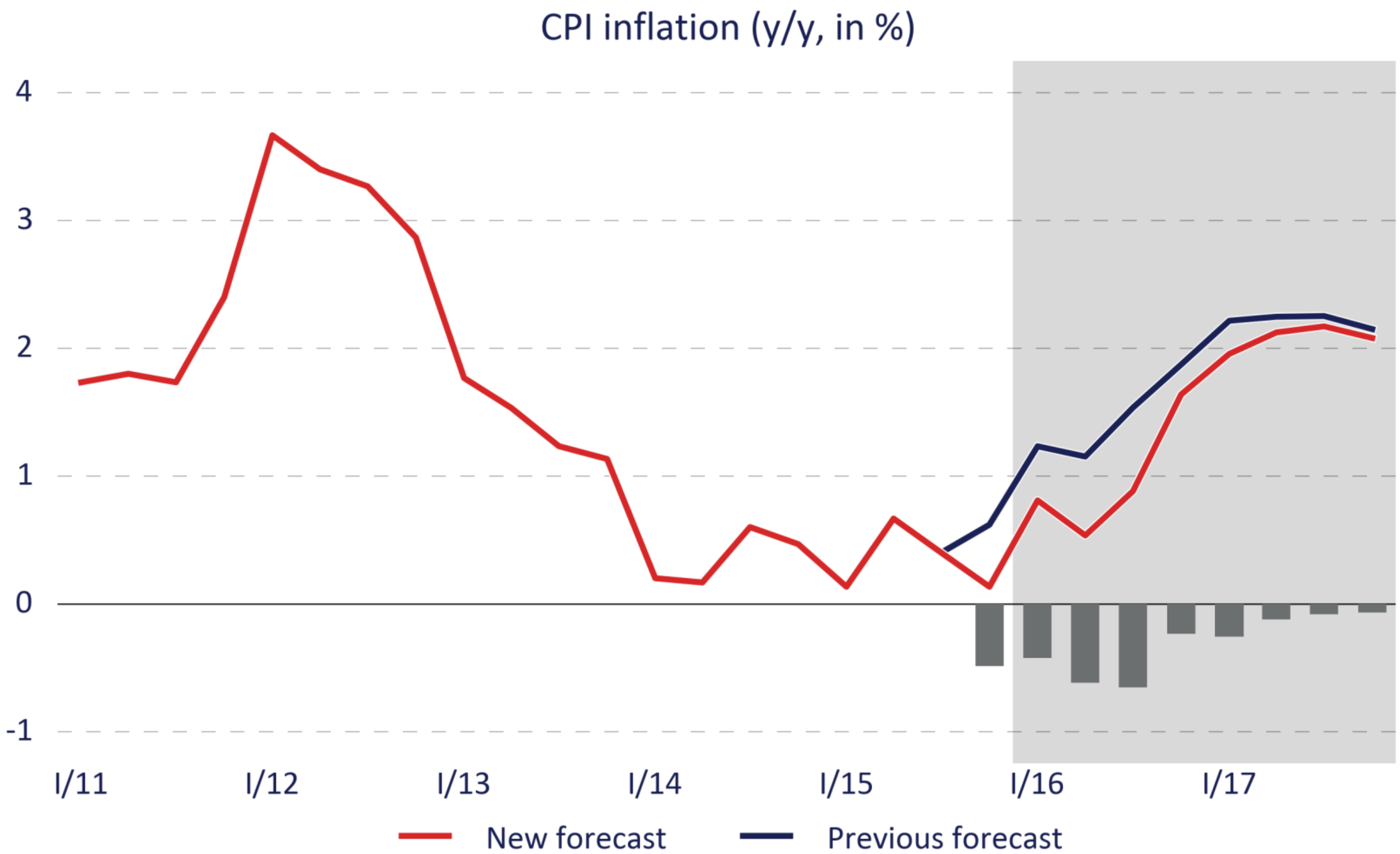
- The forecasts for headline and monetary-policy relevant inflation are lower over the entire forecast horizon, but most of all in the next three quarters, owing to lower observed net inflation, a more subdued outlook for foreign producer prices and a further drop in oil prices.
- The revision of overall GDP compared to the previous forecast is negligible.
- Nominal wage growth in the business sector has shifted upwards until mid-2017 due to the higher levels observed in the second half of last 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.
- After the exit from the exchange rate commitment in 2017, the path of market interest rates is lower primarily as a result of the extension of quantitative easing by the ECB.

Comparison: Inflation Forecast (i)



- The forecast for annual headline inflation is lower over the entire forecast horizon, but most of all in the next three quarters.
- This reflects a downward revision of the net inflation forecast, while the administered price outlook is slightly higher for both forecasted years.

Comparison: Inflation Forecast (ii)

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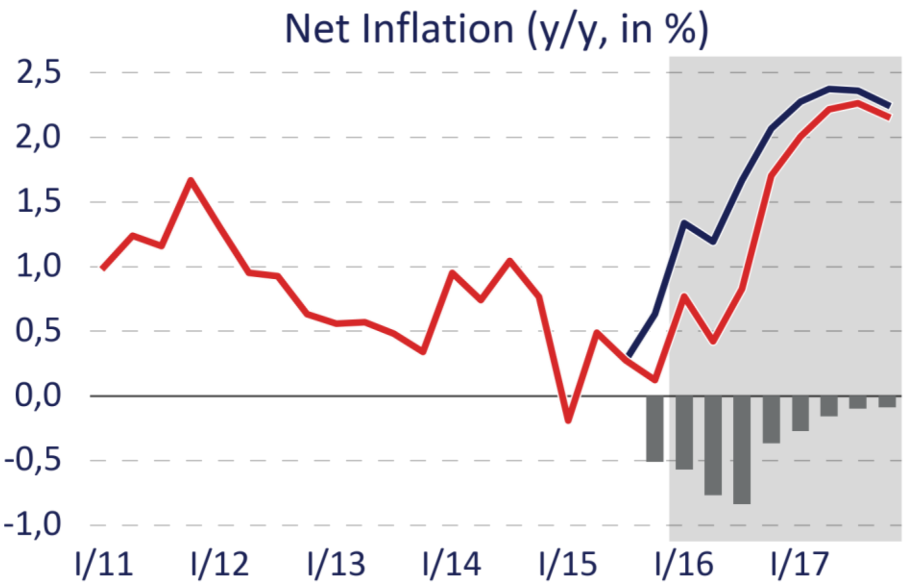
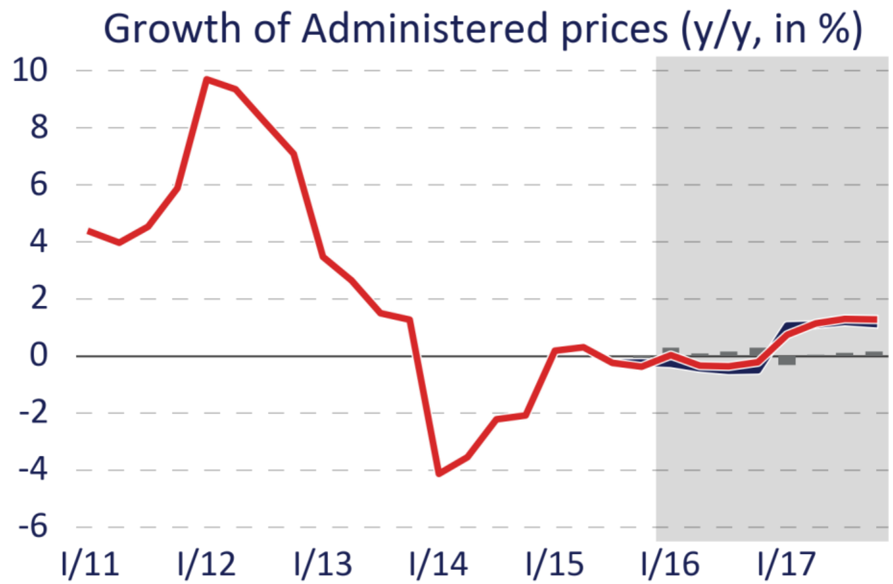
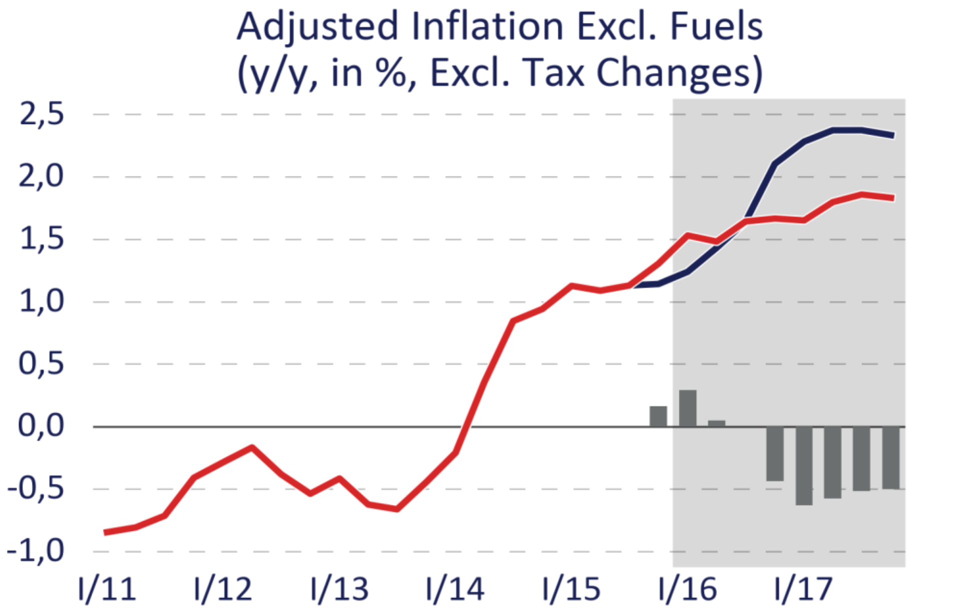


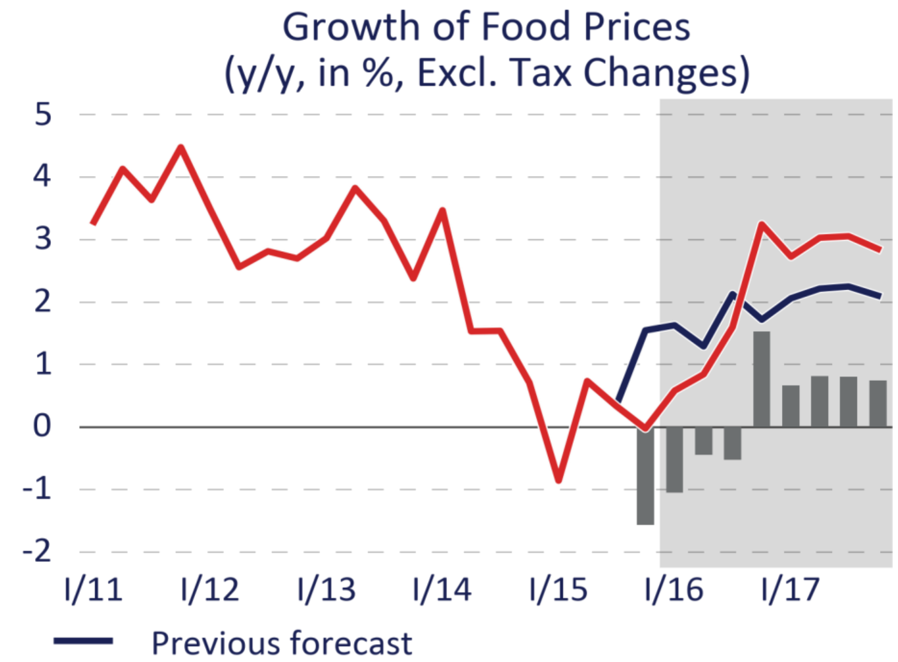


New forecast   Previous forecast

- The net inflation forecast is affected by an unexpected halt in food price growth prices at the end of 2015. It also reflects greater anti-inflationary effects of foreign producer prices and a continuing decline in oil prices.
- In 2016, the fundamental upward pressures on costs will become slightly stronger due to faster growth in both wages and the price of capital, enabling annual net inflation to gradually converge towards the previous forecast.
- The slightly higher administered price outlook reflects an increase in the distribution component of the price of natural gas for households and the fact that the assumed drop in electricity prices this year did not materialise.

Comparison: Inflation Forecast (iii)





- The outlook for core inflation is gradually moving below the previous forecast (from a higher initial level) due to the more pronounced anti-inflationary effects of import prices.
- The forecast for food prices is lower in the near term due to the observed data, reflecting stronger-than-expected one-off effects (while growth in agricultural producer prices is slightly higher). Once these fade out, food price growth will become stronger compared to the previous forecast.

Comparison: GDP Forecast (i)

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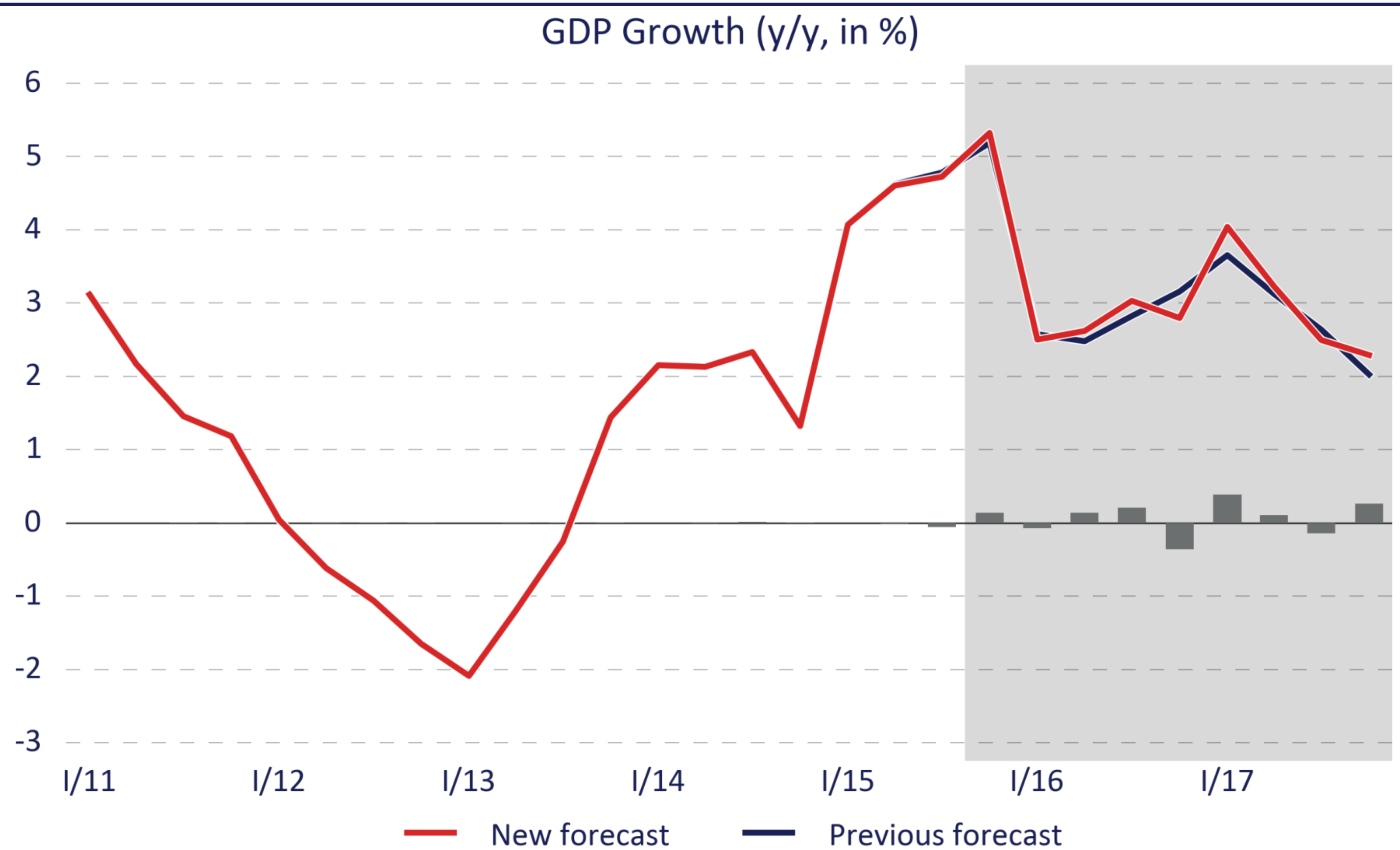
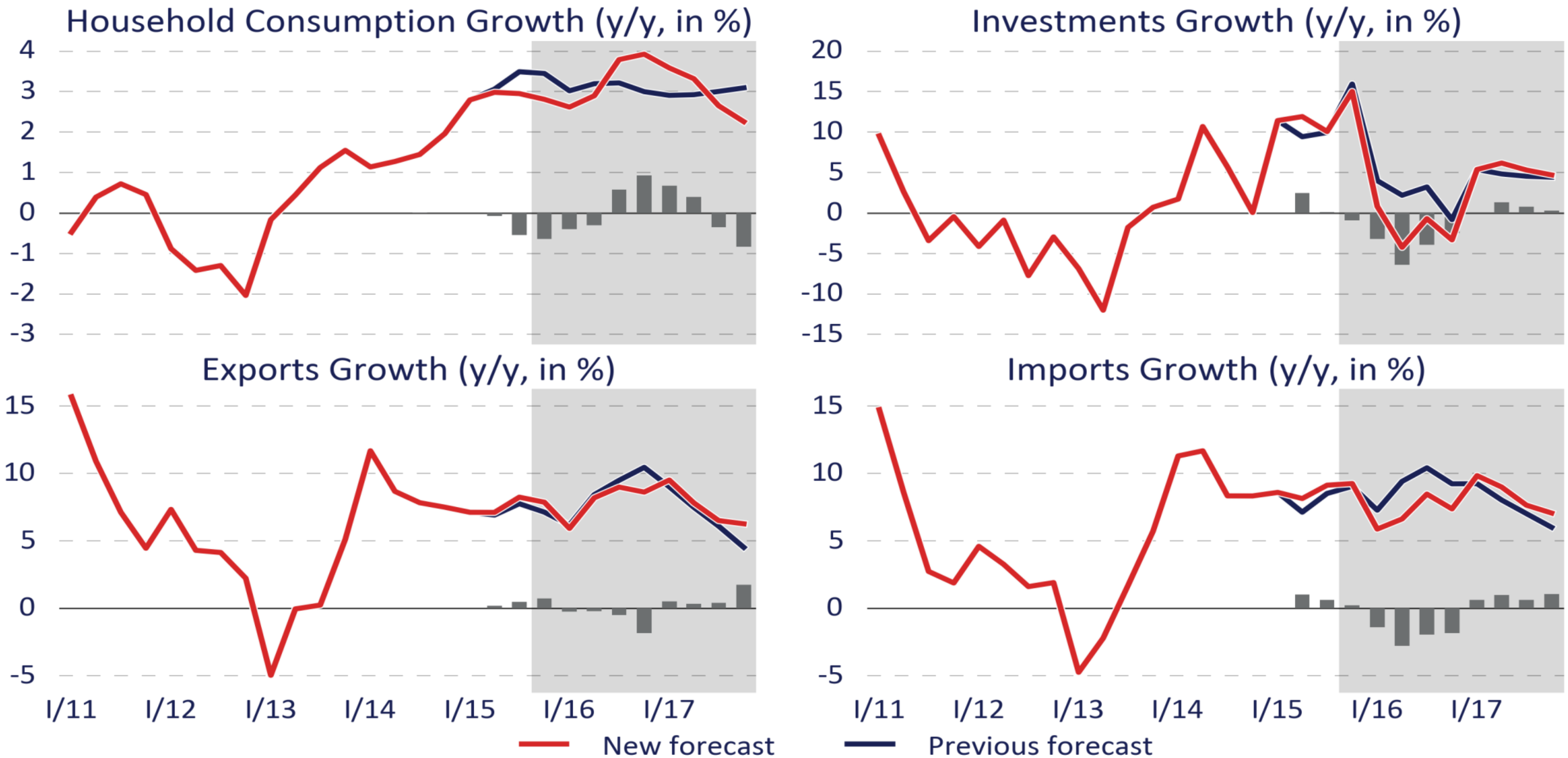


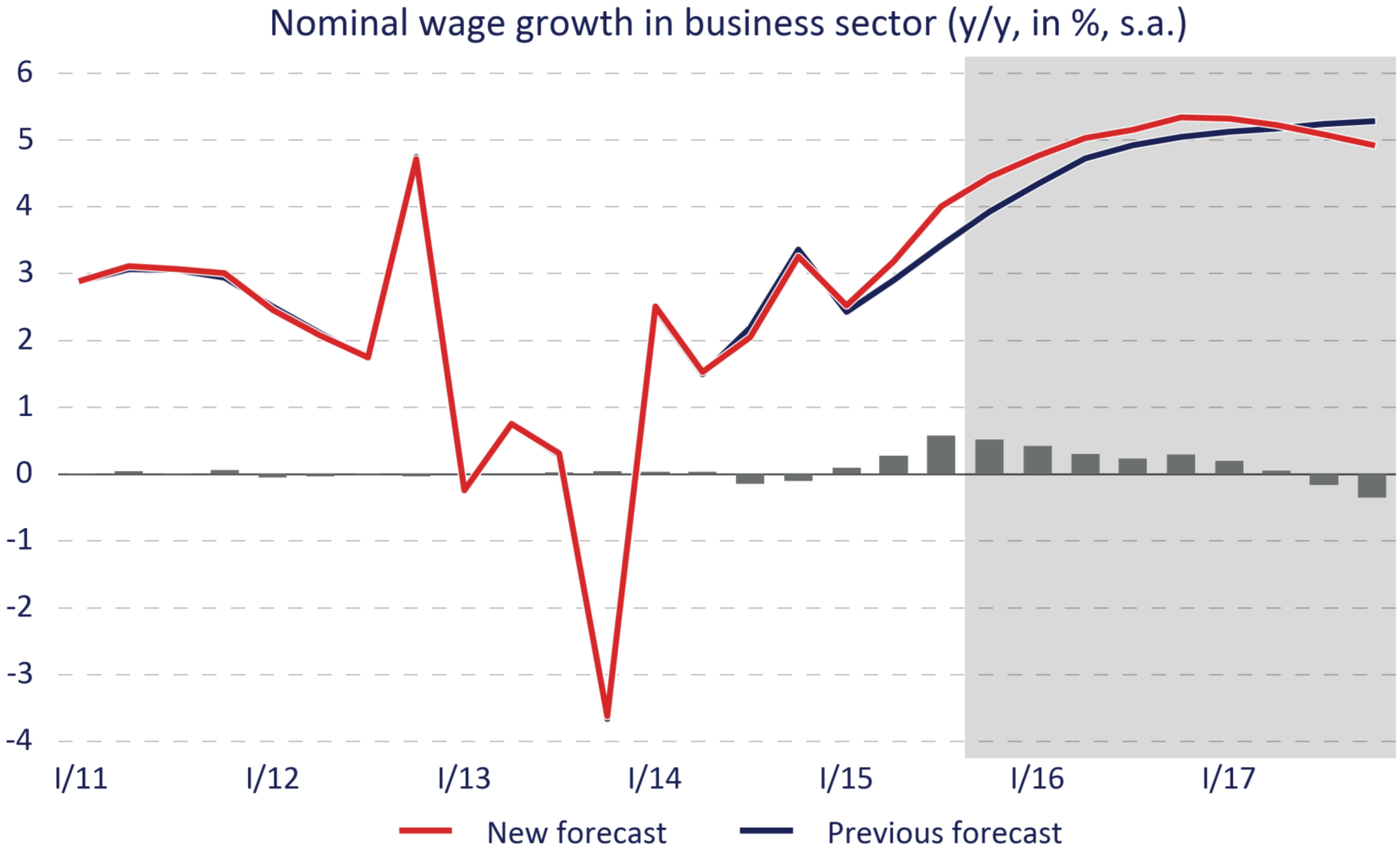
- The GDP growth outlook for this year and the next is almost unchanged overall.
- In 2016, the larger drop in government investment will be offset by a further positive supply-side effect of lower prices.

Comparison: GDP Forecast (ii)



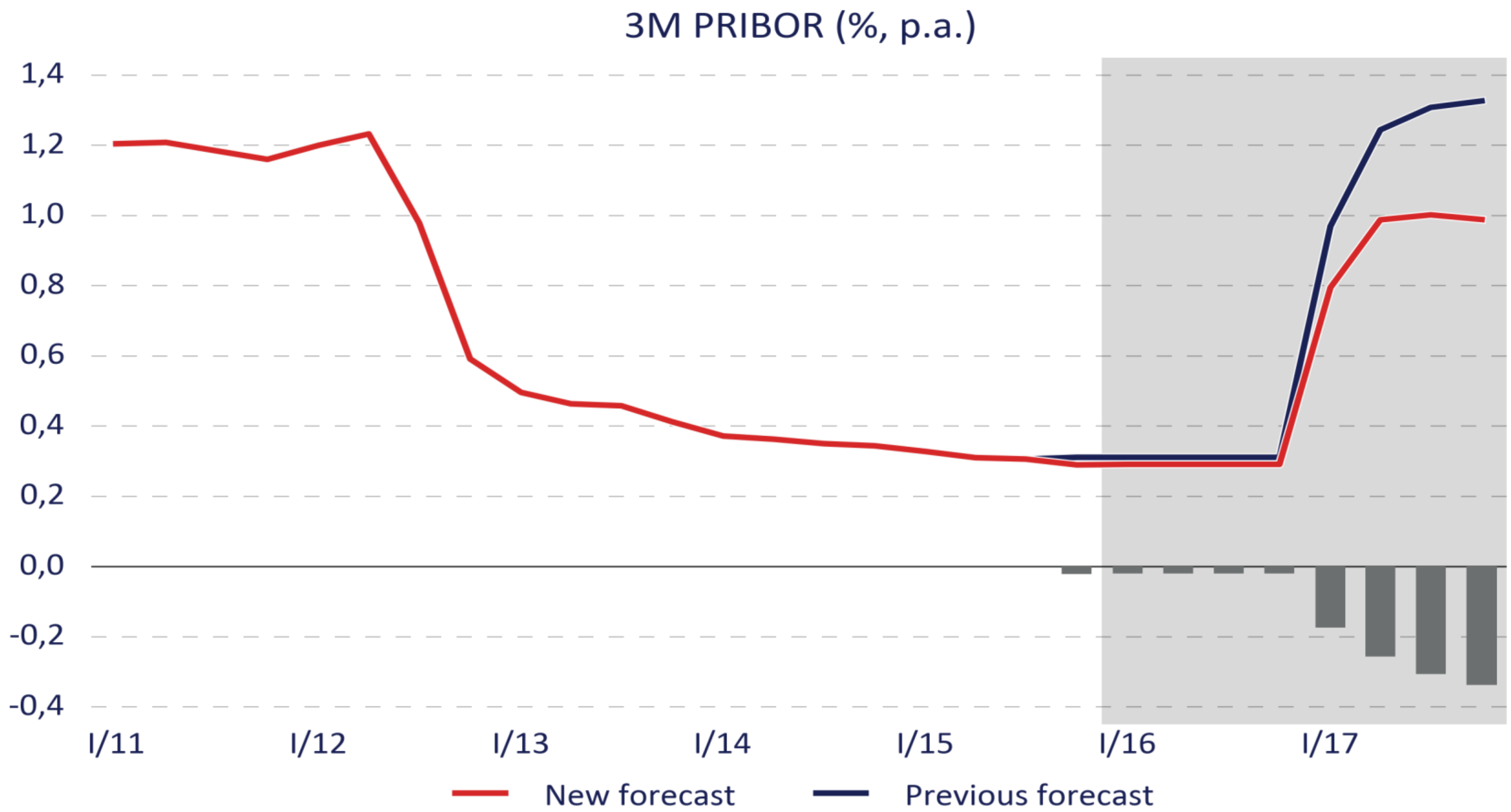
- The forecast for household consumption this year has moved upwards owing to higher real wage growth, incl. the positive supply-side effect of lower oil prices.
- Investment growth in 2016 will be affected by a slower start to the drawdown of ”new“ EU funds. Fixed investment growth will thus be more subdued despite the positive supply-side effect of low prices on private fixed investment.

Comparison: Nominal Wage Growth



- Growth in the average nominal wage in the business sector has increased compared to the previous forecast until the middle of next year. This revision primarily reflects the higher growth in wages observed last year.

Comparison: Interest Rate Path



- The path of domestic market interest rates remains unchanged until the end of this year and is lower thereafter.
- This is due mainly to easier ECB monetary policy in 2017 (lower outlook for 3M Euribor, QE at least until March 2017).

Thank you for your attention

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