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

Meeting with Analysts

Petr Král

Prague, 6 May, 2016

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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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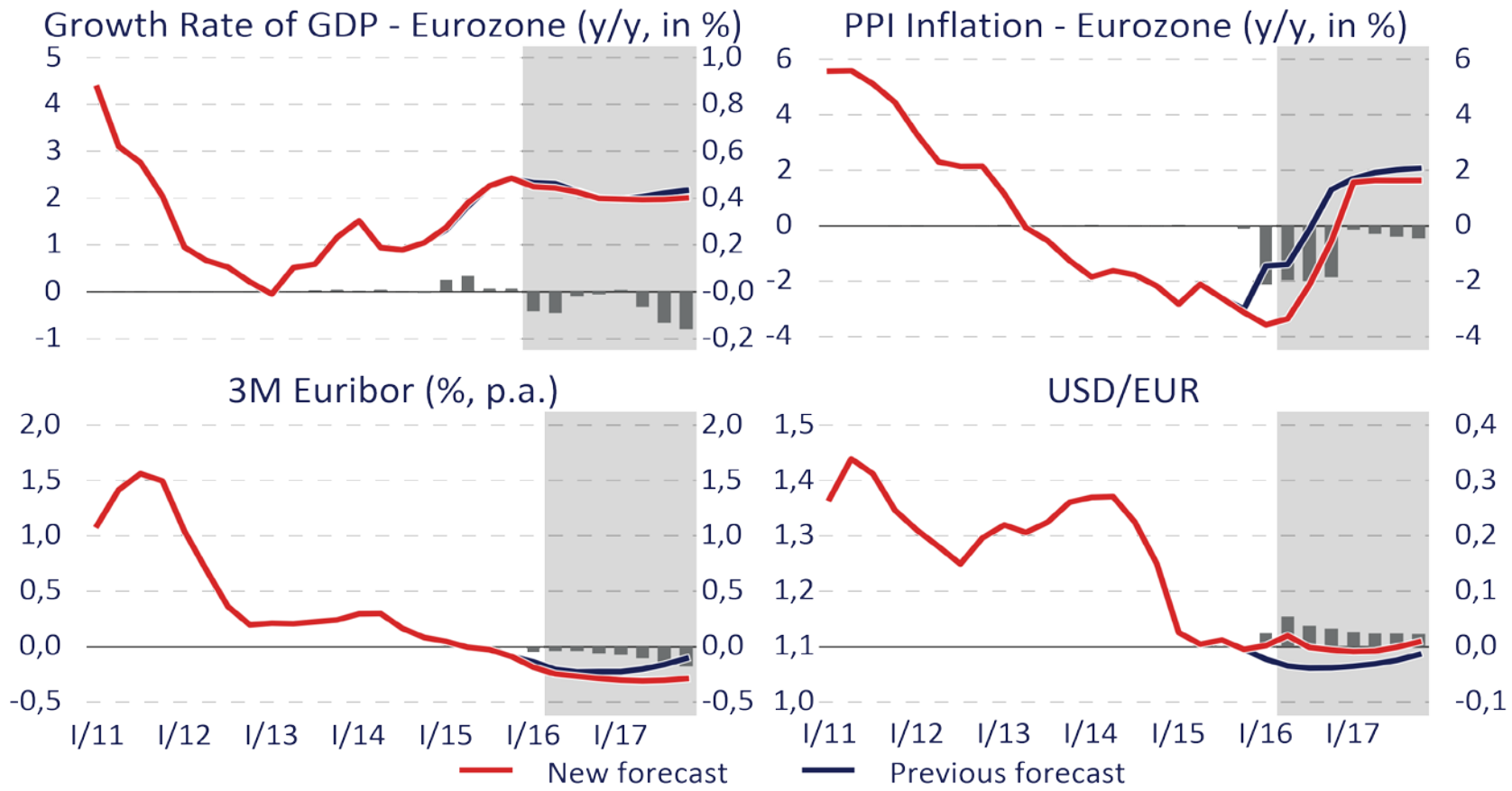
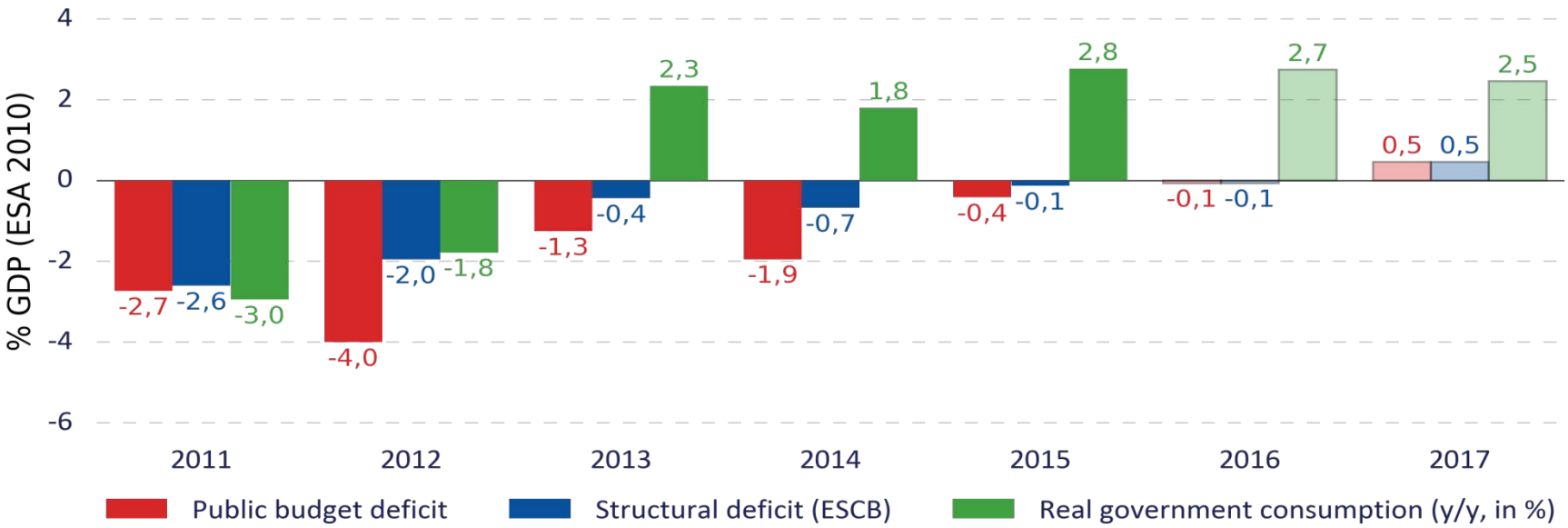
External Environment Outlook



- The GDP growth will be around 2% over the entire forecast horizon.
- The decline in the industrial producer prices will not fade out until early 2017.
- 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 0.4% of GDP due to accelerating economic growth, with highly expansionary fiscal impulse due to public investment boom.
- **2016 :** further decline of the deficit to 0.1% (smaller drawdown of EU funds, additional revenues from introduction of VAT control statements, increase in tobacco excise duties, and rise in the taxation of lotteries and similar games).
- **2017:** public budget surplus 0.5% of GDP (continued economic growth, introduction of electronic sales registration and increased tobacco excise tax, vs. re-accelerated drawdown of EU funds within the new programming period, acceleration of wages and other current government expenditures).

Fiscal Impulse

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Contributions to GDP growth in p.p.			
	2015 actual	2016 expected	2017 expected
Fiscal impulse	0.8	-0.8	0.0
Of which impact through			
private consumption	0.2	0.0	-0.2
private investment	0.1	-0.1	0.0
government investment, domestic	0.0	0.0	0.1
government investment, EU funded	0.5	-0.8	0.1

- Fiscal impulse contributed significantly to the GDP growth in 2015, due mainly 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 that the effect of fiscal policy on economic growth will be roughly neutral, beyond continued growth of government consumption.

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 mid-2017. Consistent with the forecast is an increase in interest rates in the second half of 2017.

- A positive interest rate differential against the euro and the repercussions of the ECB's quantitative easing, which the forecast assumes will last until March 2017, will manifest themselves after the exit from the exchange rate commitment.

- Thus, 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.

- 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.

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Summary of the Inflation Forecast (i)

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- Inflation increased slightly at the start of this year, but remained well below the CNB's target. In the near term, inflation will temporary decrease close to zero. Afterwards it will start to grow again, hitting the 2% target at the monetary policy horizon and then moving slightly above it.

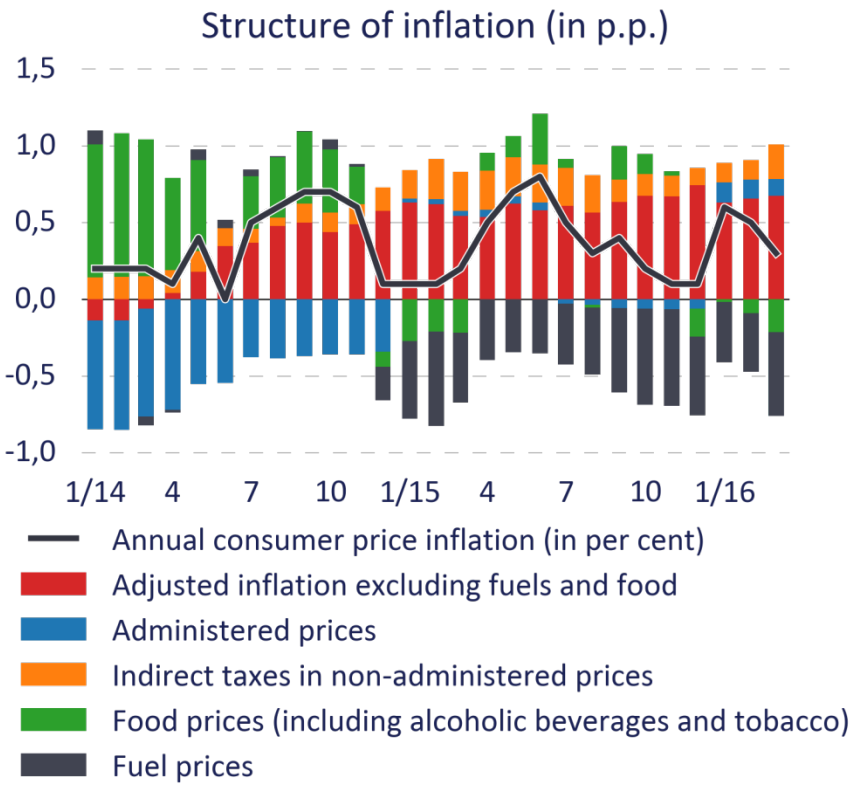
- The growth of the Czech economy slowed somewhat at the end of last year. It will continue to follow this trend this year, with GDP growth decelerating to 2.3% because of a drop in government investment.

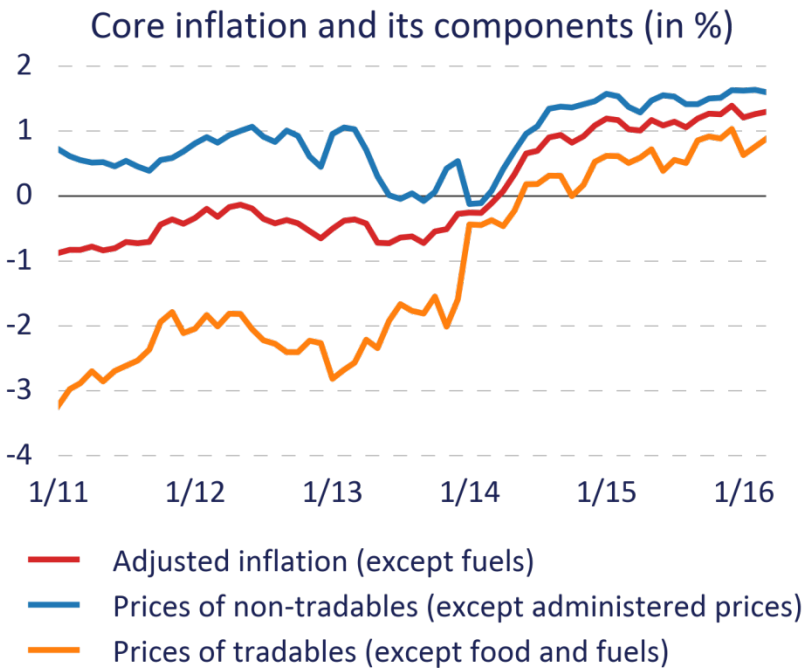
- On the other hand, economic activity will be further supported by easy monetary conditions, growth in external demand and low oil prices. GDP growth will pick up again next year.

- The current strongly anti-inflationary effect of import prices will subside amid persistent domestic inflationary pressures.

- In the context of continued economic growth, the labour market situation will improve further.

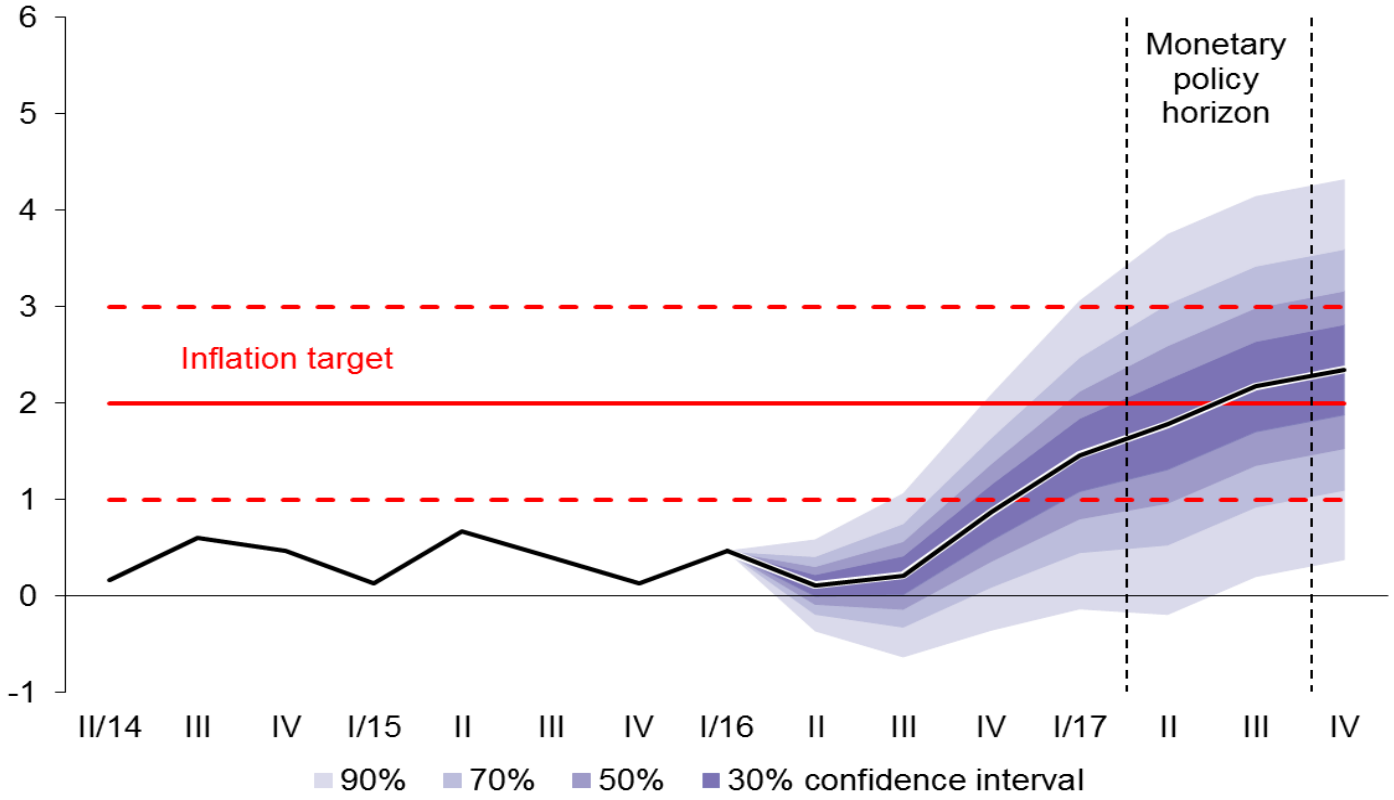
Structure of Inflation





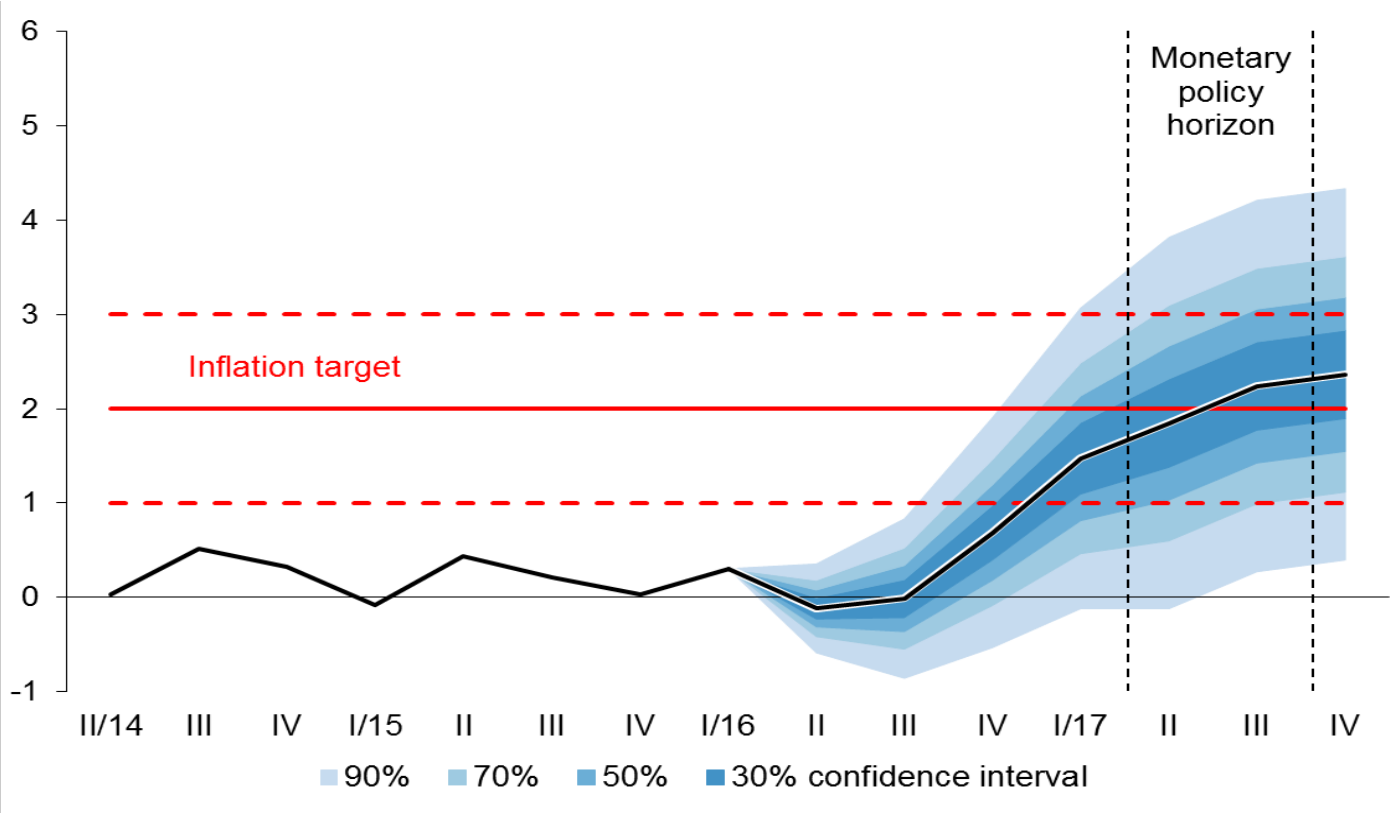
- Headline inflation rose slightly to 0.5% on average in 2016 Q1, as the decline in fuel and food prices was outweighted by the renewed growth of administered prices amid roughly stable core inflation.
- Core inflation was moderately above 1% with both its sub-components moving in the positive range.

Headline Inflation Forecast



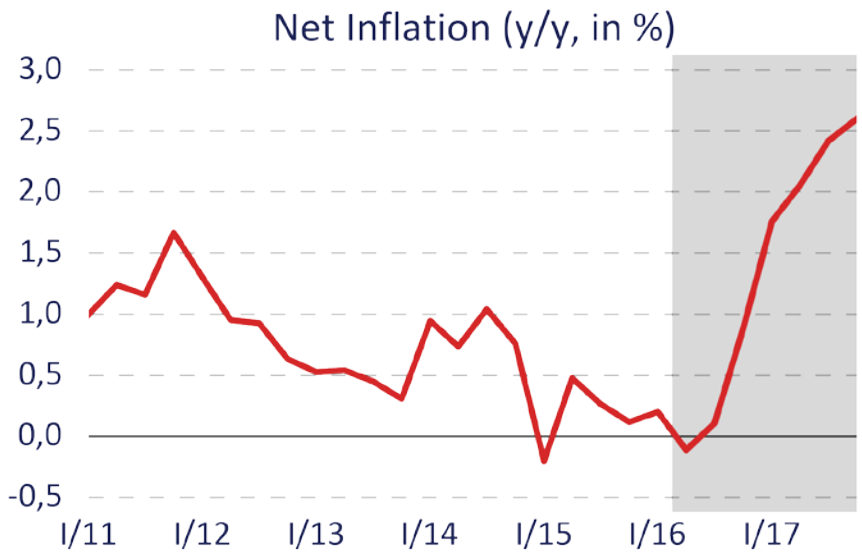
- In the next two quarters inflation will temporary decline close to zero.
- At the end of 2016 it will start rising again, reaching the 2% target at the monetary policy horizon, and then being slightly above it.

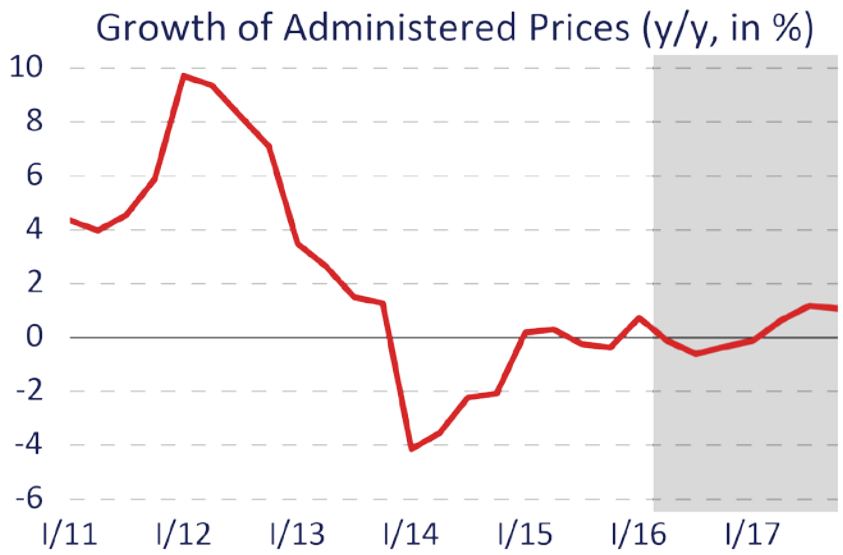
Monetary Policy-Relevant Inflation Forecast



- MP-relevant inflation rose to 0.3% on average in 2016 Q1, still well below the CNB's 2% target.
- Over the forecast horizon, MP-relevant inflation will follow a similar path to headline inflation.

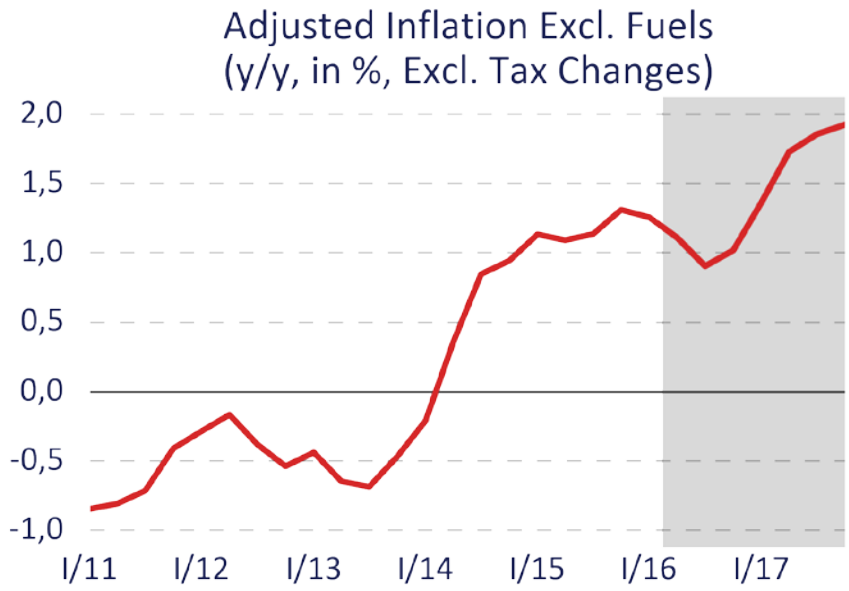
Market and Administered Prices

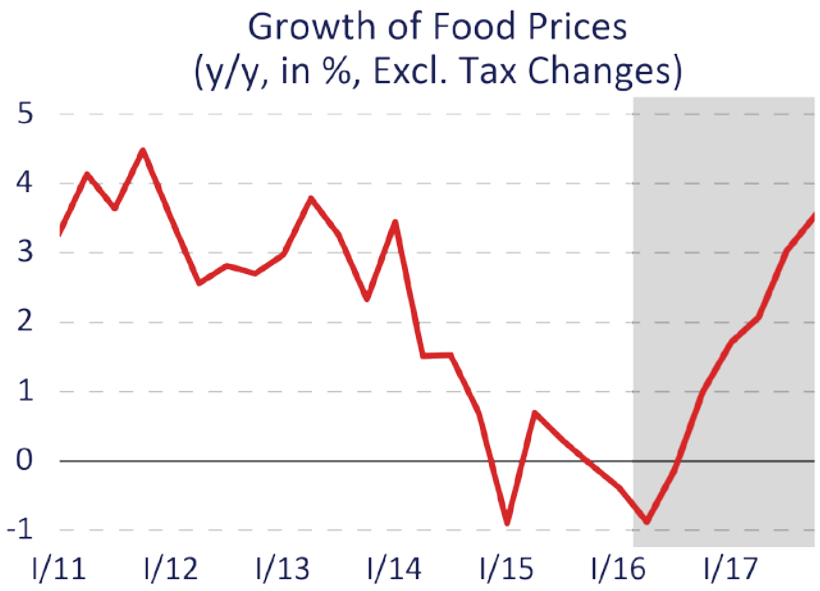




- After a temporary decline in the next quarter, net inflation will rise markedly in the second half of the year amid continued growth of the domestic economy, strengthening cost pressures from the labour market and subsiding anti-inflationary effects of external environment.
- Administered prices will decrease slightly this year due to the decline in the gas prices. They will renew their growth in the next year.

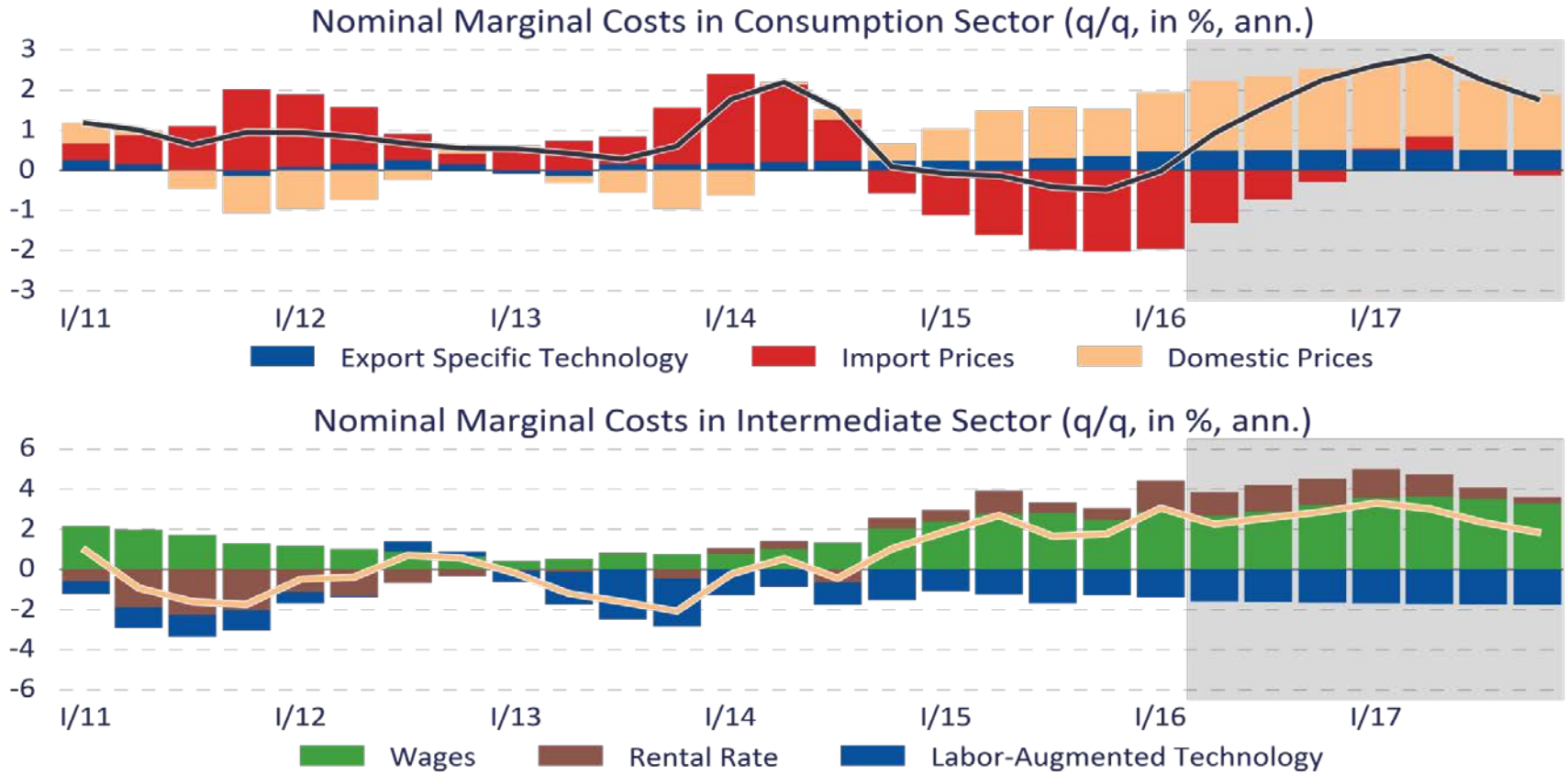
Core Inflation and Food Prices





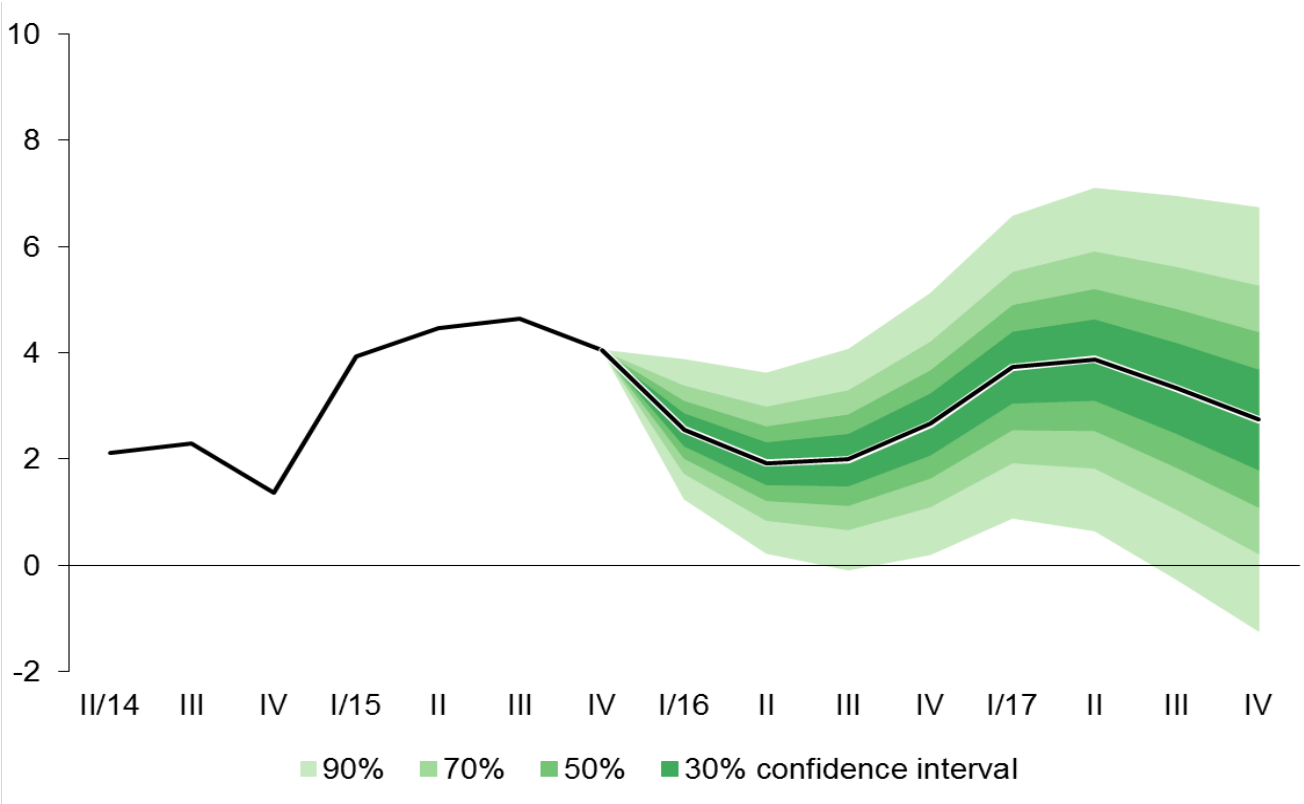
- In the rest of this year core inflation will slow down to 1% (decline in import prices and stagnant growth in wages), and gradually rise up to 2% next year (inflationary pressures from both domestic and foreign economy).
- Food price growth will recover starting the beginning of the next year, after dissipation of one-off effects, amid gradual rise of inflationary pressures from domestic economy and next year also increase in agricultural commodity prices.

Domestic Costs vs. Import Prices



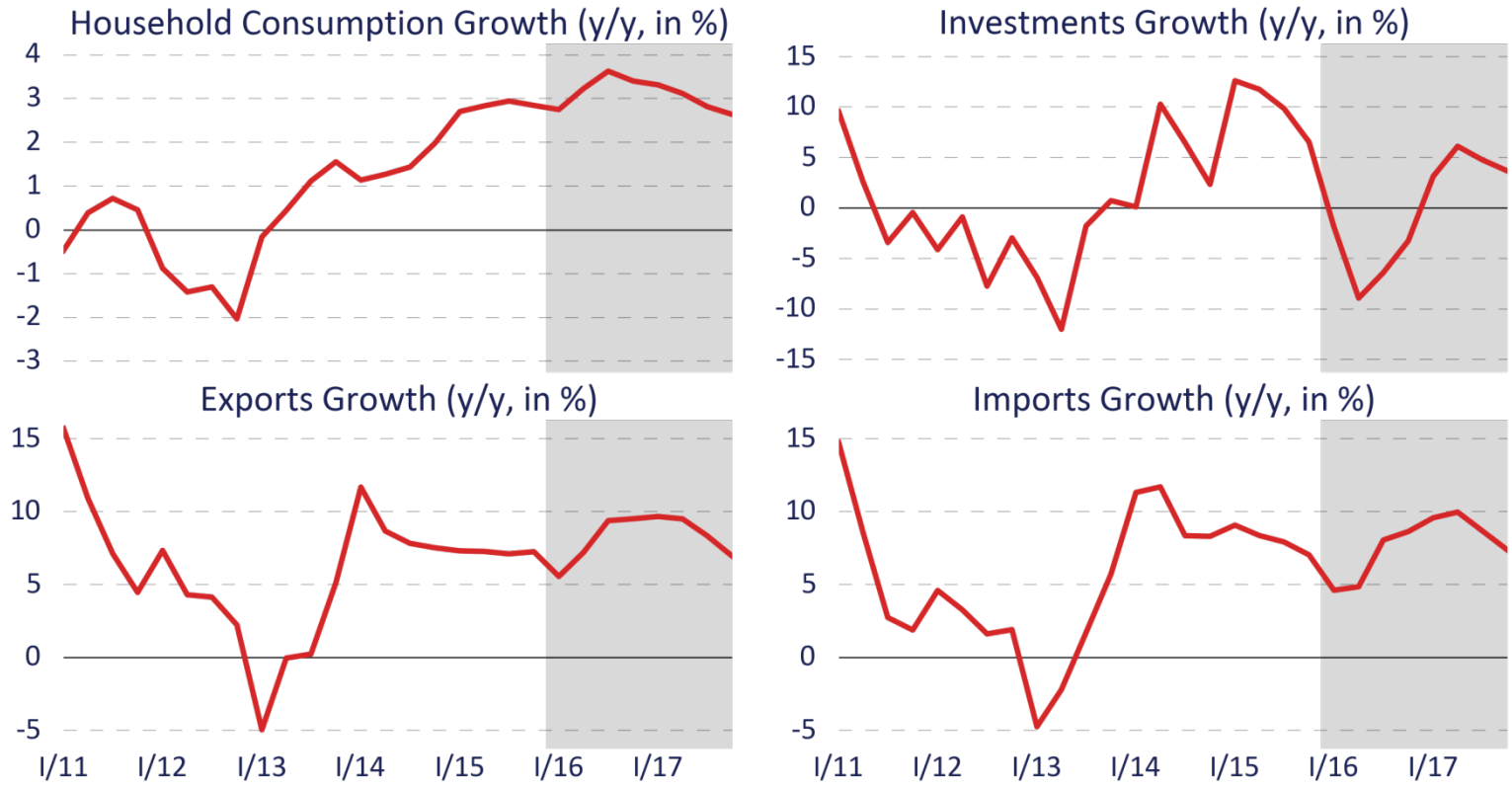
- Recovering growth of costs in consumption sector will reflect growing domestic cost pressures, as well as fading negative contribution of import prices.
- Domestic costs will rise on the back of continued wage growth and a rising price of capital.

GDP Growth Forecast



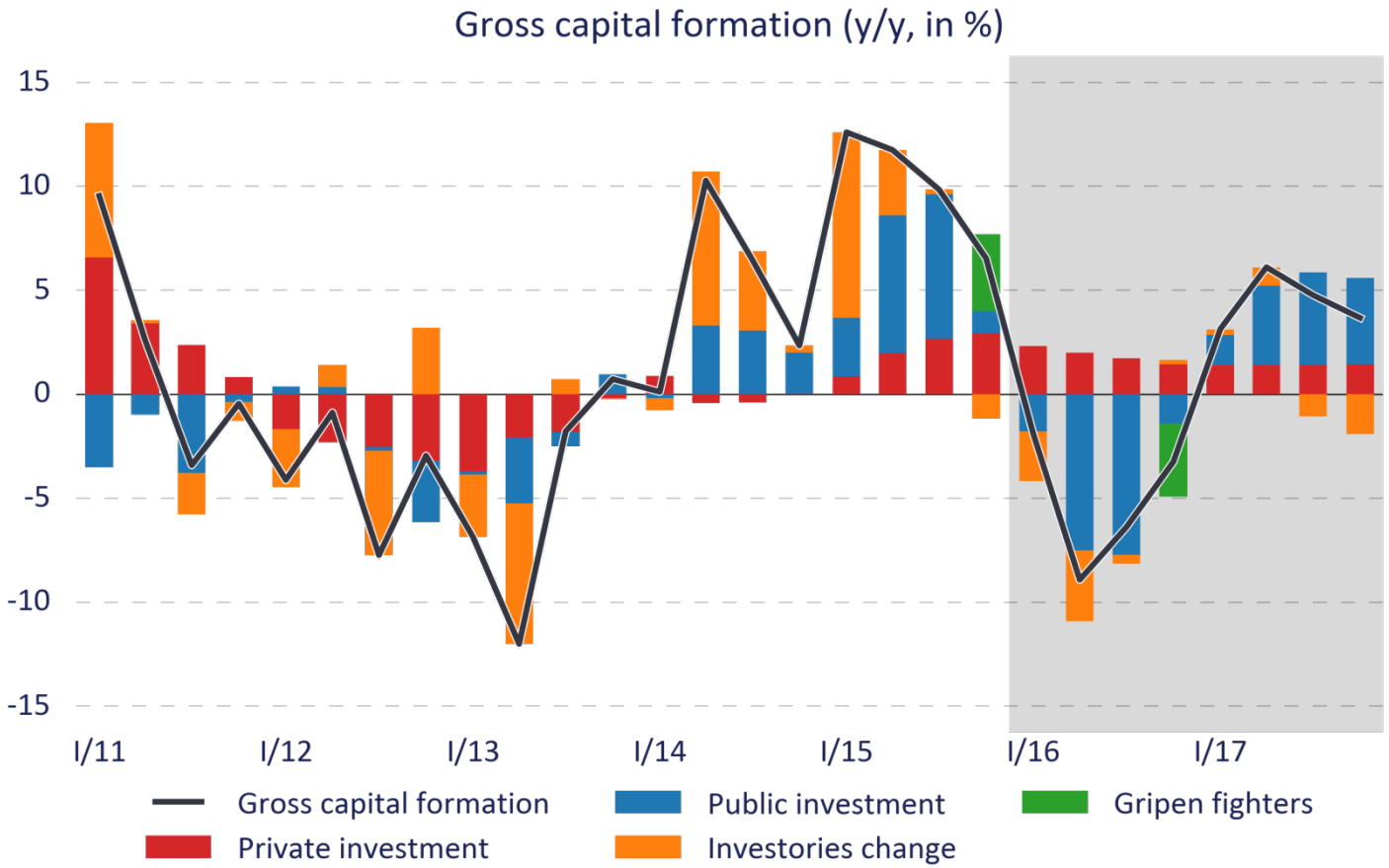
- GDP growth forecast: 2.3% in 2016, 3.4% in 2017.
- GDP growth will slow down this year due to a temporary decline in gross capital formation (government investment financed from EU funds).
- Economy will still be supported by easy monetary conditions, low oil prices and stable growth in external demand.

Aggregate Demand



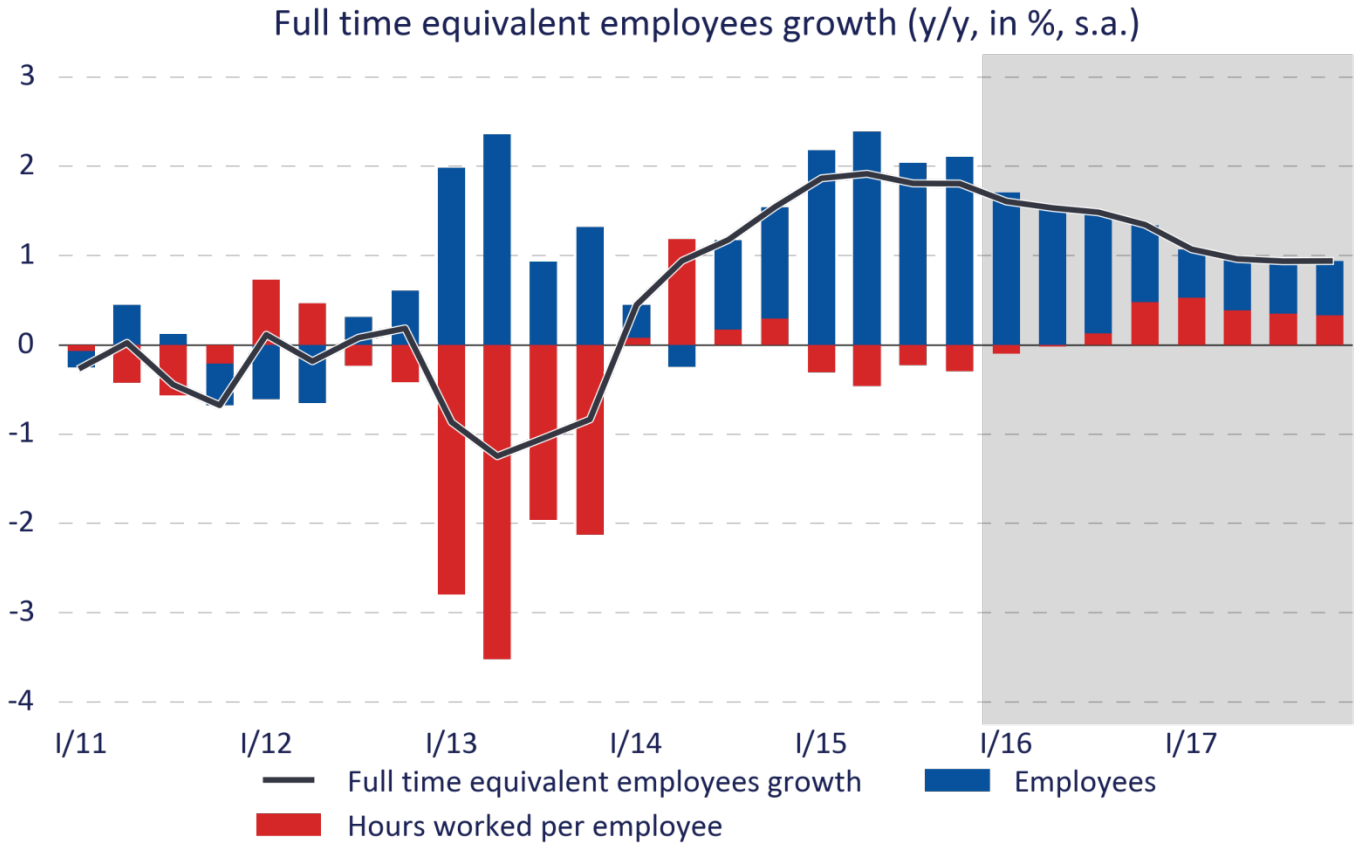
- Household consumption growth will be supported by increase in wages and salaries, consistent with growth in retail sales and recovered credit growth.
- Significant drop of investment growth in this year is driven primarily by slowdown of public investment.
- Net exports contribution will be positive.

Gross Capital Formation Forecast



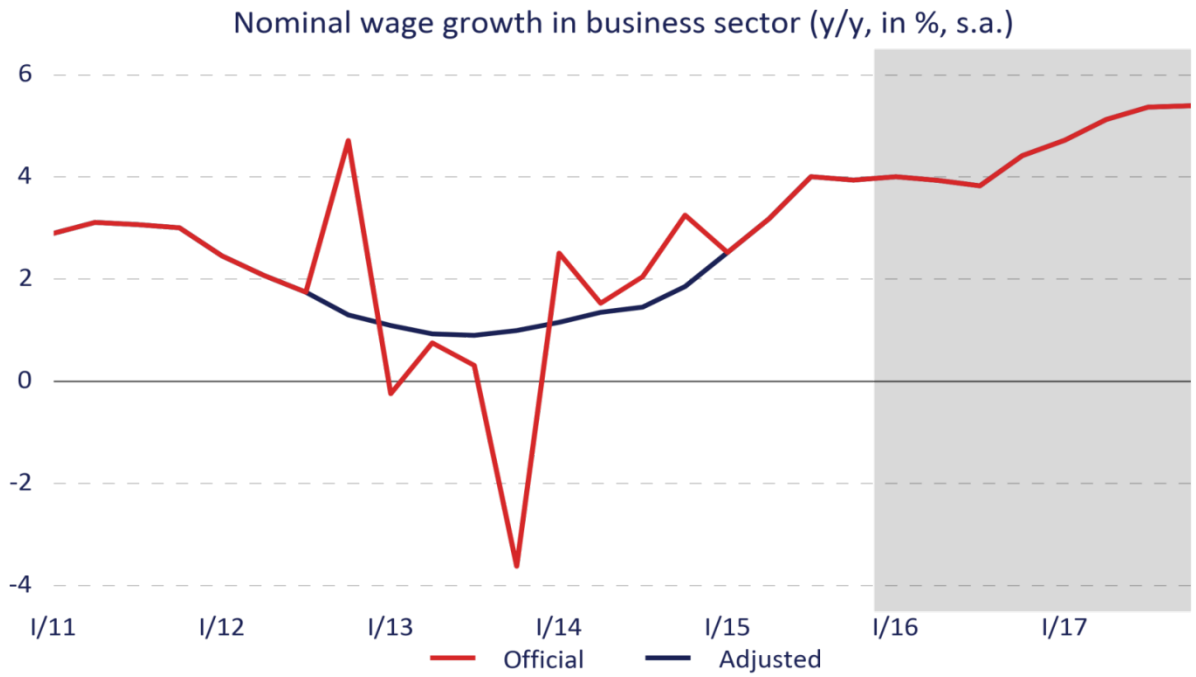
- Fixed investment will decrease throughout 2016, mainly as a result of expected slowdown in drawing from EU funds in the new programming period and need for reassessment of environmental effects of projects under new EIA legislation.
- Continued growth of private investments (positive effect of external demand, low oil prices) will only partially offset these factors.

Labour Market: Employment



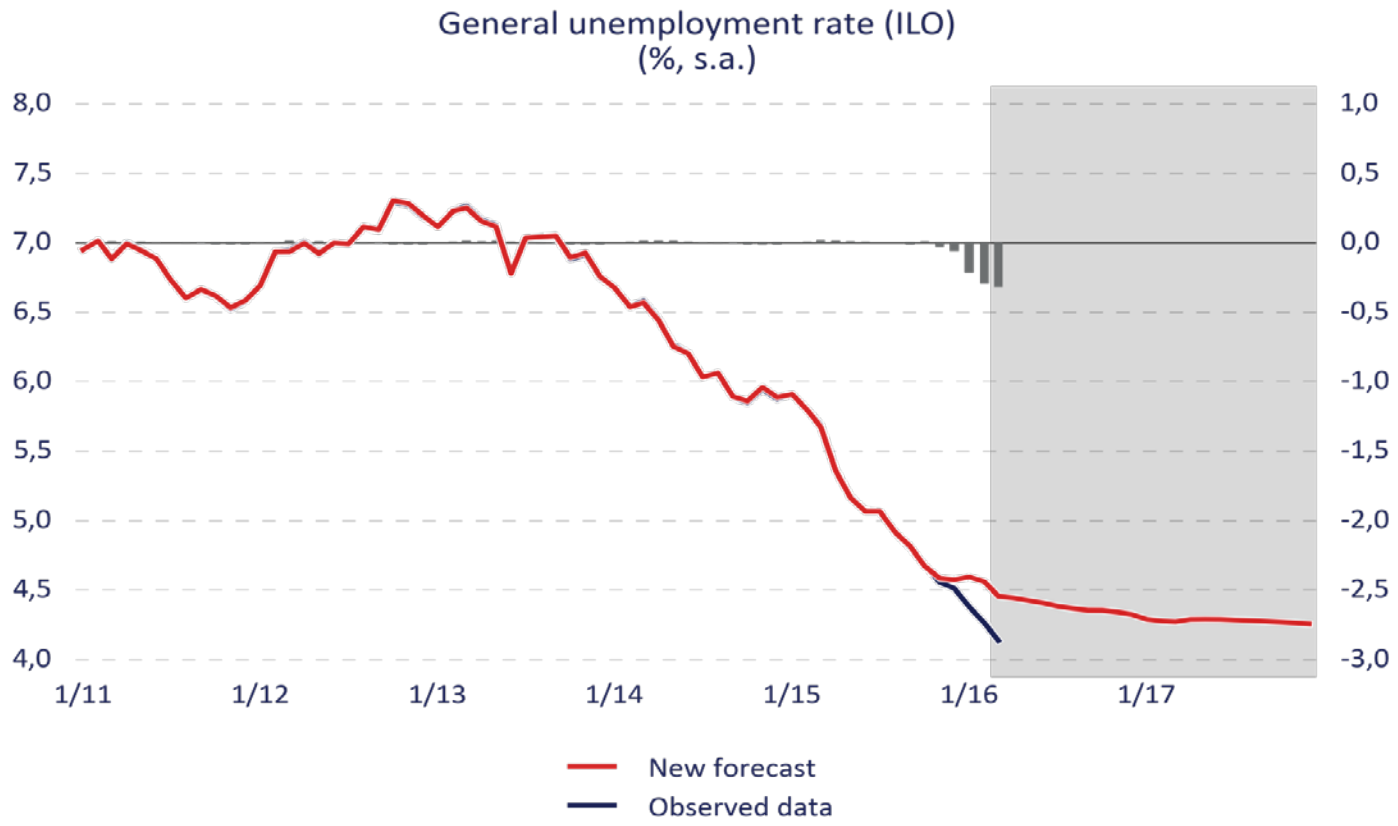
- Number of employees converted into full-time equivalents (FTE) will continue to grow, but at a decelerating pace.
- Increase in FTE will be initially generated by a further growth in the number of employees, while contribution of average hours worked will turn positive in the second half of this year.

Labour Market: Wage Growth in Business Sector



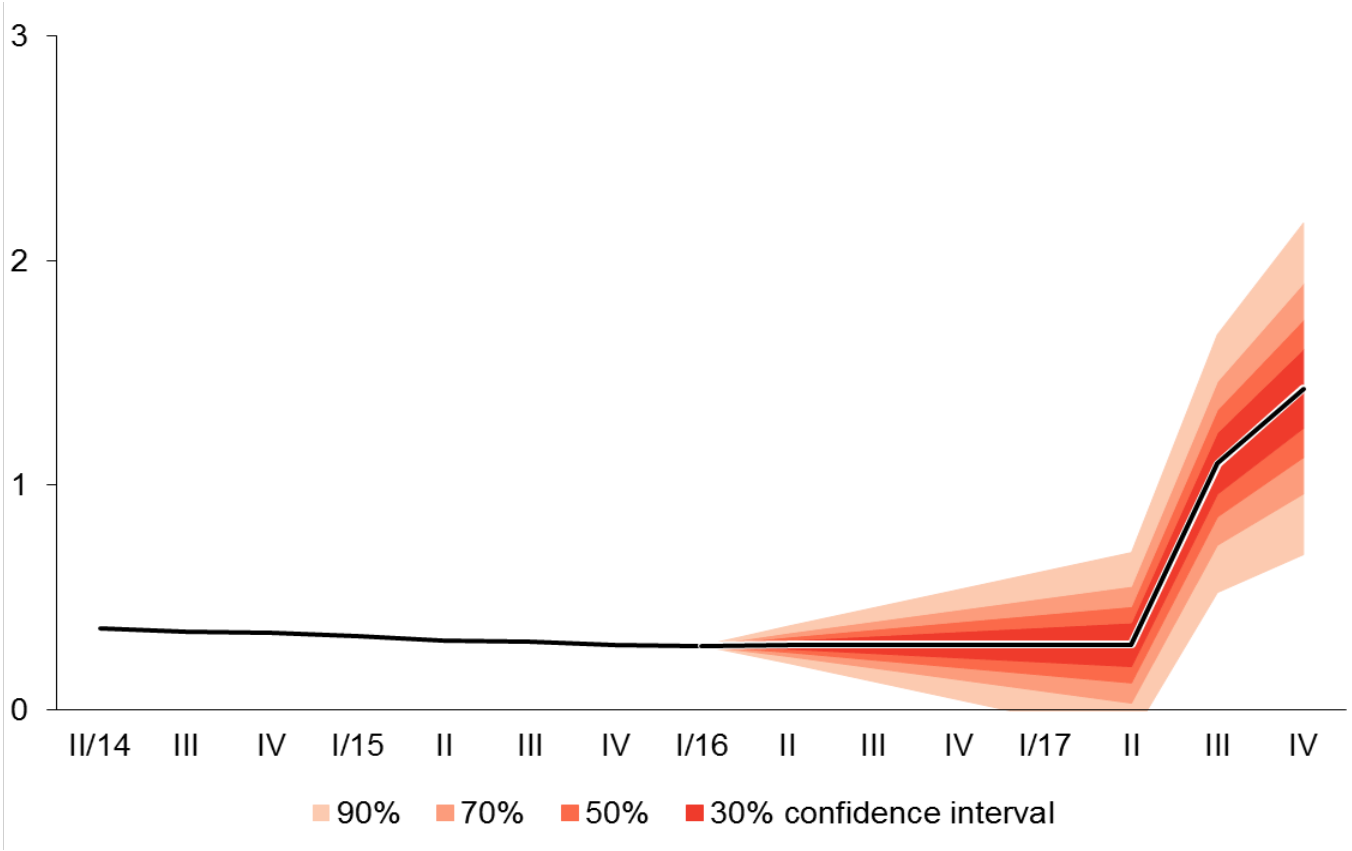
- Acceleration of growth of average wage in business sector has been halted in the last quarter of 2015. Similar rate of growth will persist in the rest of this year.
- The average wage in the business sector will accelerate by 4% on average in 2016 and accelerate to 5.2% in 2017, due to gradual return of inflation to the target, renewed pick-up in economic growth and generally tight labour market.
- Annual wage growth in non-business sector will be 3.1% this year, and in 2017 it will accelerate to 4.7%.

Labour Market: Unemployment



- The previous sharp decrease in the seasonally adjusted general unemployment rate will moderate significantly this year.
- In 2017, it will remain at 4.3% amid similar quarterly dynamics of labour force and employment.
- According to new monthly data, unemployment rate at present is already down to 4.1%, mainly due to a revision of historical data.

Interest Rate Path (3M PRIBOR)



- The forecast assumes market interest rates to be flat at their current very low level and exchange rate to be used as a monetary policy instrument until mid-2017.
- Consistent with the forecast is an increase in interest rates in the second half of 2017.

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Comparison with Previous Forecast

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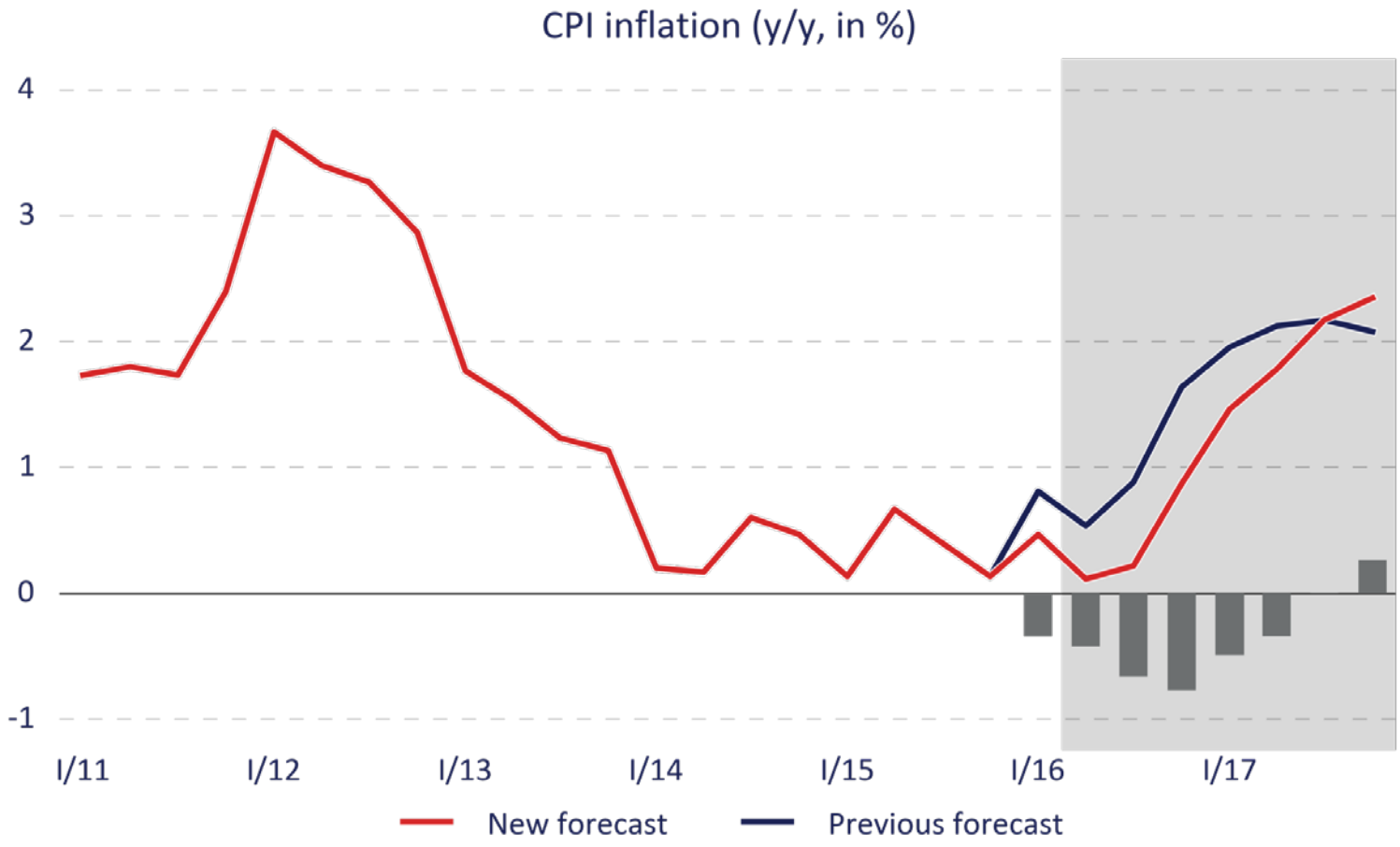
- In the new forecast, the assumption of flat market interest rates at their current very low level and the use of the exchange rate as a monetary policy instrument has moved two quarters further into future, i.e. to mid-2017.

- The predictions for inflation is markedly lower until the mid-2017 owing to lower observed net inflation, lower outlook for foreign producer prices and lower growth in domestic nominal wages.

- Deeper fall in government investment and more gradual growth in private investment have led to a downward revision of annual GDP growth outlook this year. The prediction for the following year is revised upwards, partially because of an extension of the assumed length of the exchange rate commitment.

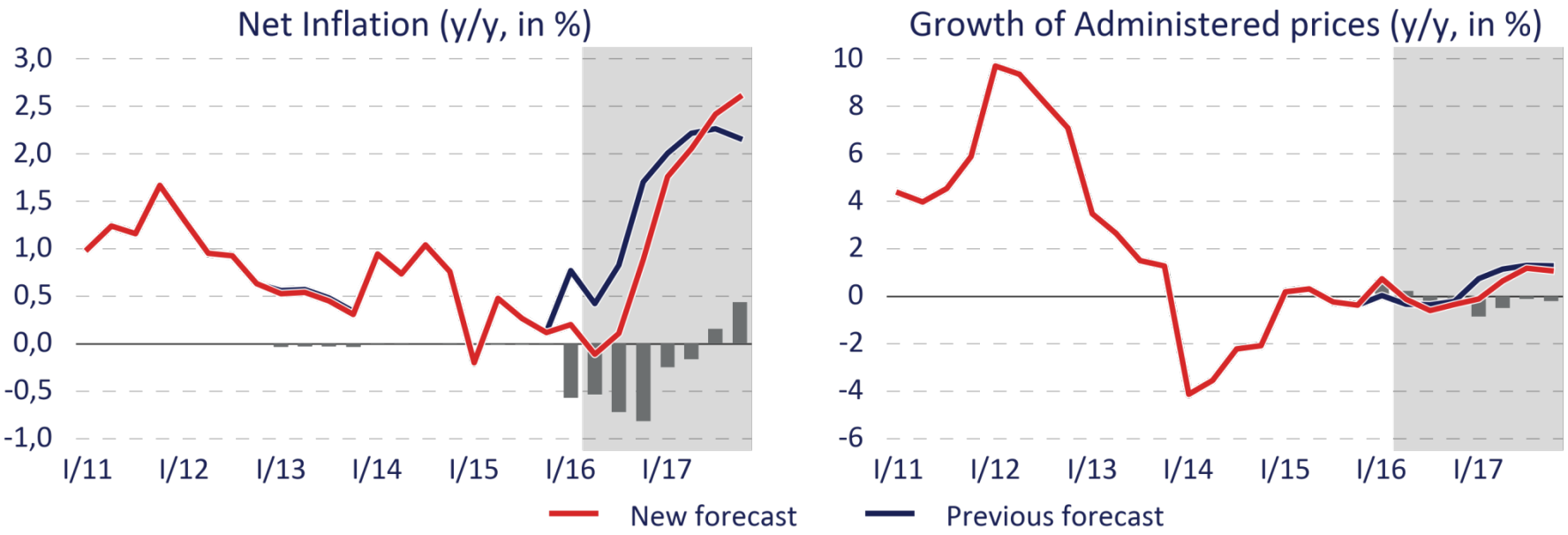
- Outlook for nominal wage growth in the business sector has shifted downwards until mid-2017 due to the lower pace observed last year. Simultaneously, it corresponds to more subdued inflation outlook and a slower expected increase in economic activity.

Comparison: Inflation Forecast (i)



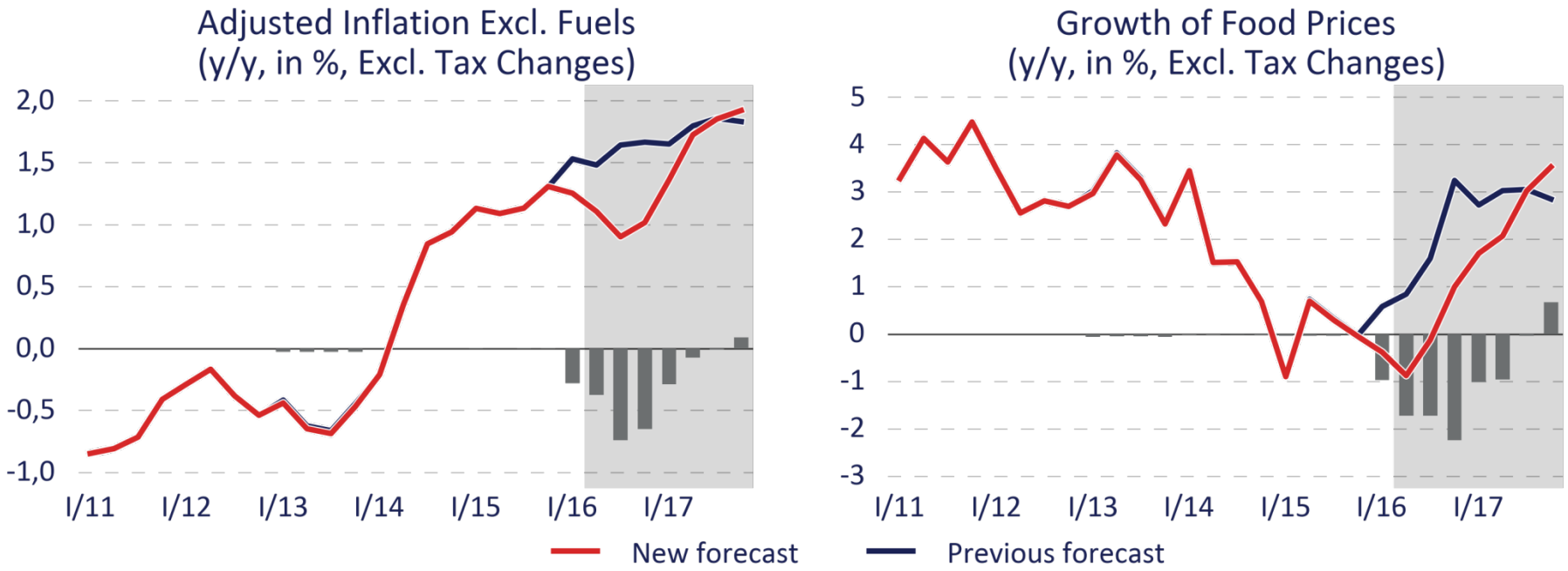
- The forecast for annual headline inflation is lower than in the previous forecast until mid-2017 due to lower observed net inflation, lower outlook for foreign producer prices and weaker growth in domestic nominal wages.

Comparison: Inflation Forecast (ii)



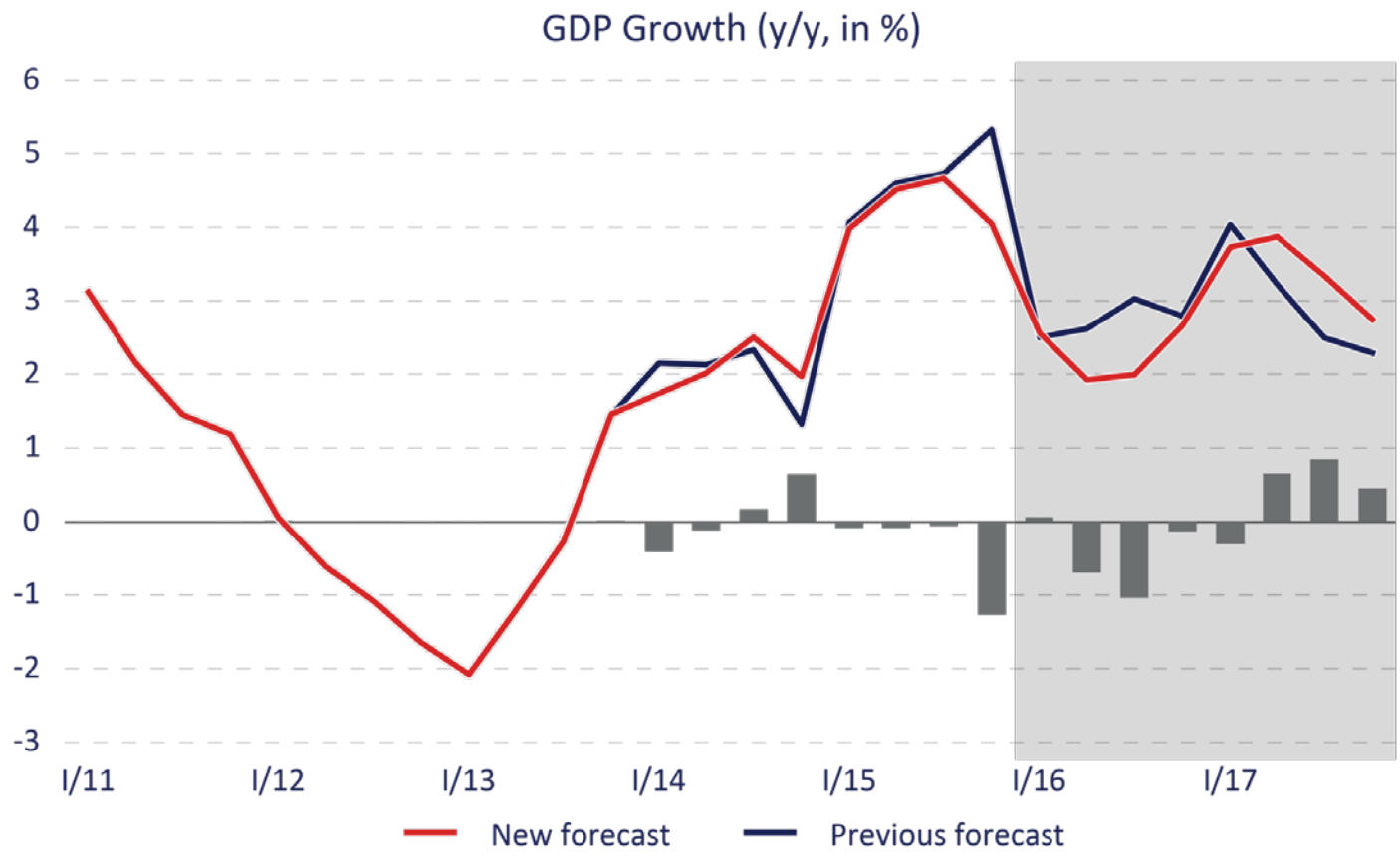
- As regards net inflation, it has been revised similarly as headline inflation, owing to lower recently observed data, as well as weaker cost pressures due to a further sharper drop in import prices and lowered wage growth forecast.
- Cost pressures will become stronger during 2017 as a consequence of the inflationary effect of the extension of the assumed length of the exchange rate commitment on import prices and domestic costs.
- The administered price outlook is lower compared with the previous forecast due to lowered gas price outlook.

Comparison: Inflation Forecast (iii)



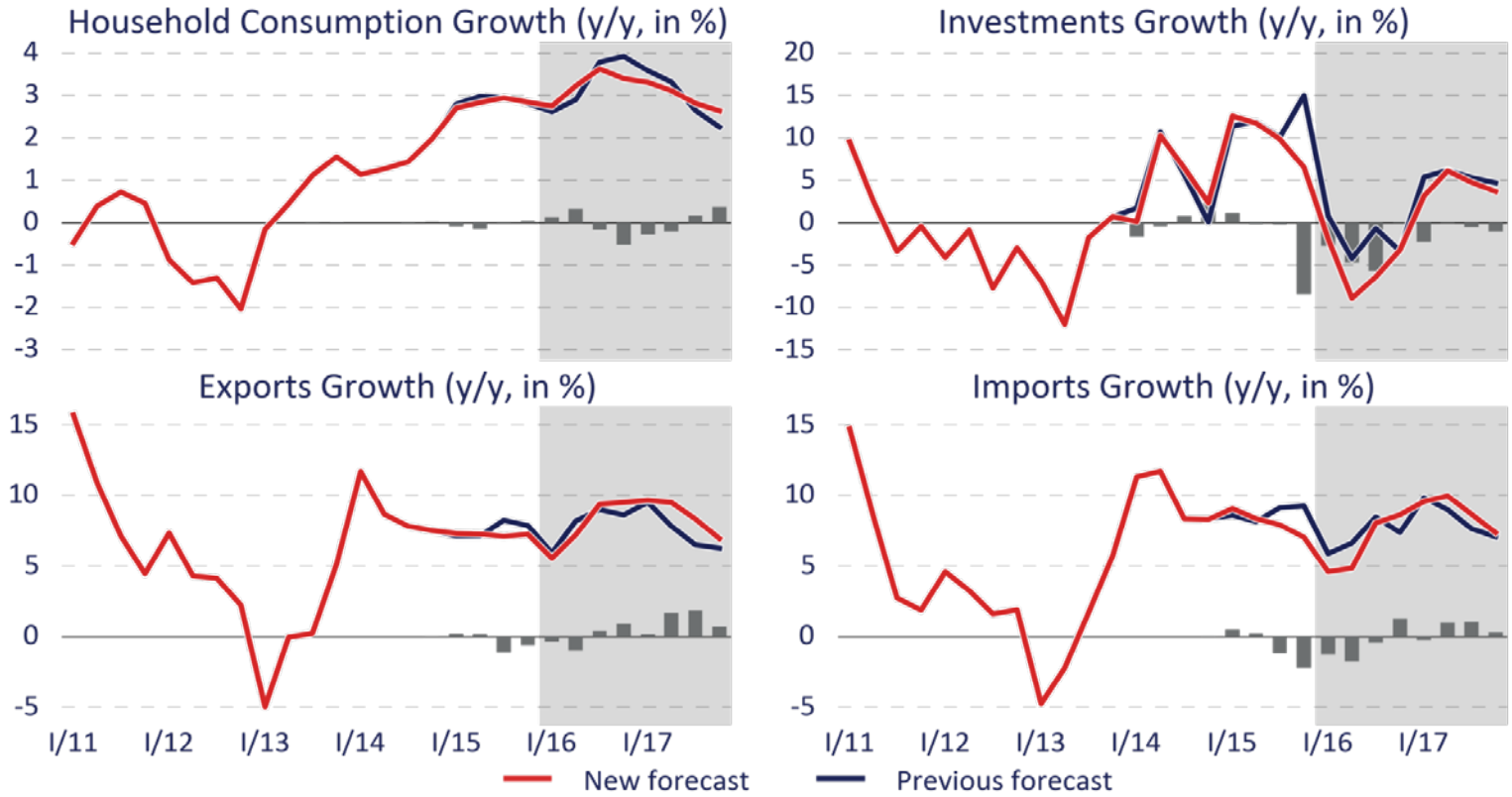
- The significantly lower outlook for core inflation in the short term reflects more subdued price developments abroad and expected less pronounced growth in wages.
- The forecast of food prices is lower in the near term due to the observed data, as well as due to a lower outlook for the agricultural commodity and producer prices.

Comparison: GDP Forecast (i)



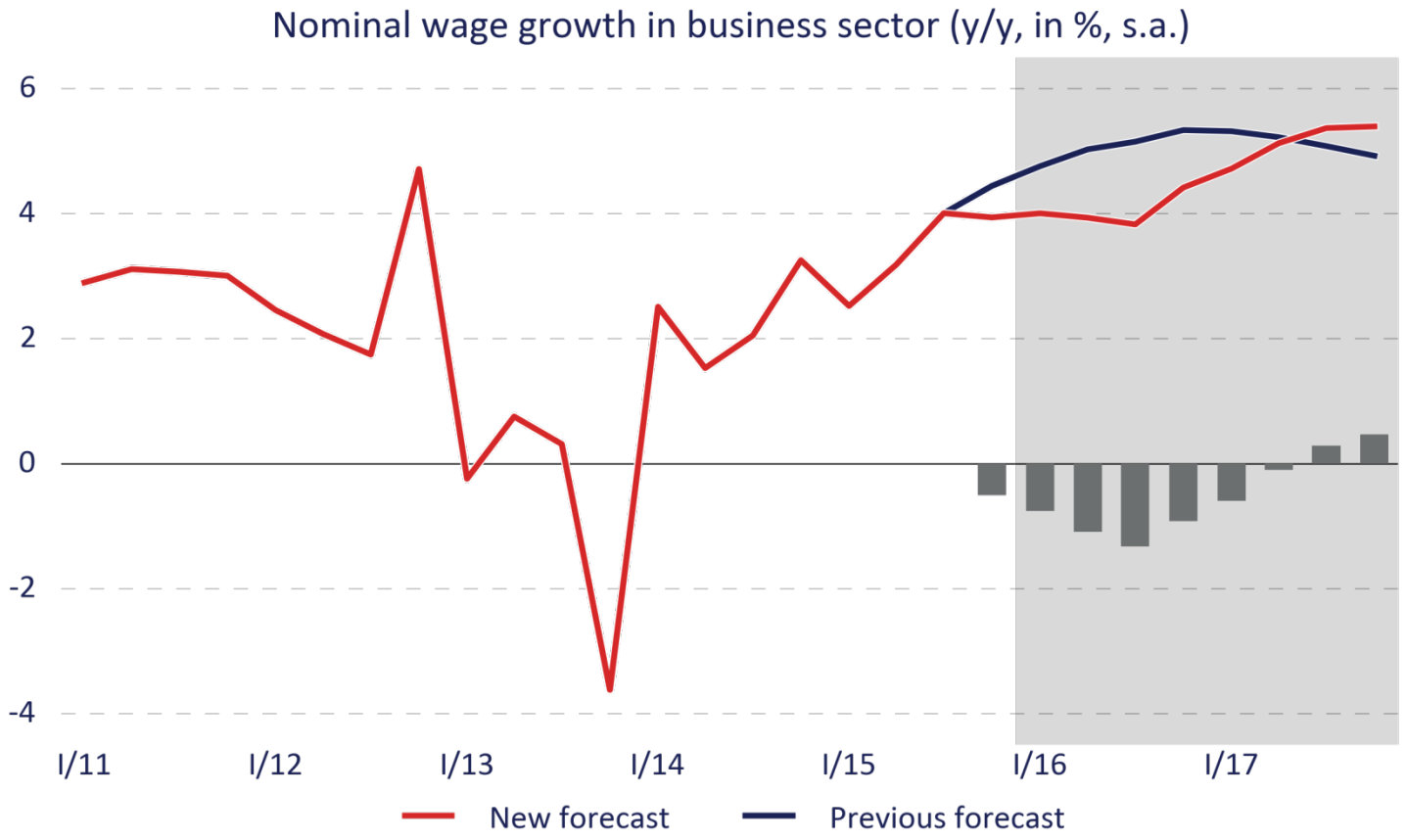
- The forecast for annual GDP growth is being lowered this year, reflecting the more subdued fixed investment growth than in the previous prediction.
- From mid-2017, by contrast, GDP growth will be faster than in the previous forecast, as the assumed extension of the exchange rate commitment will support domestic economic activity.

Comparison: GDP Forecast (ii)



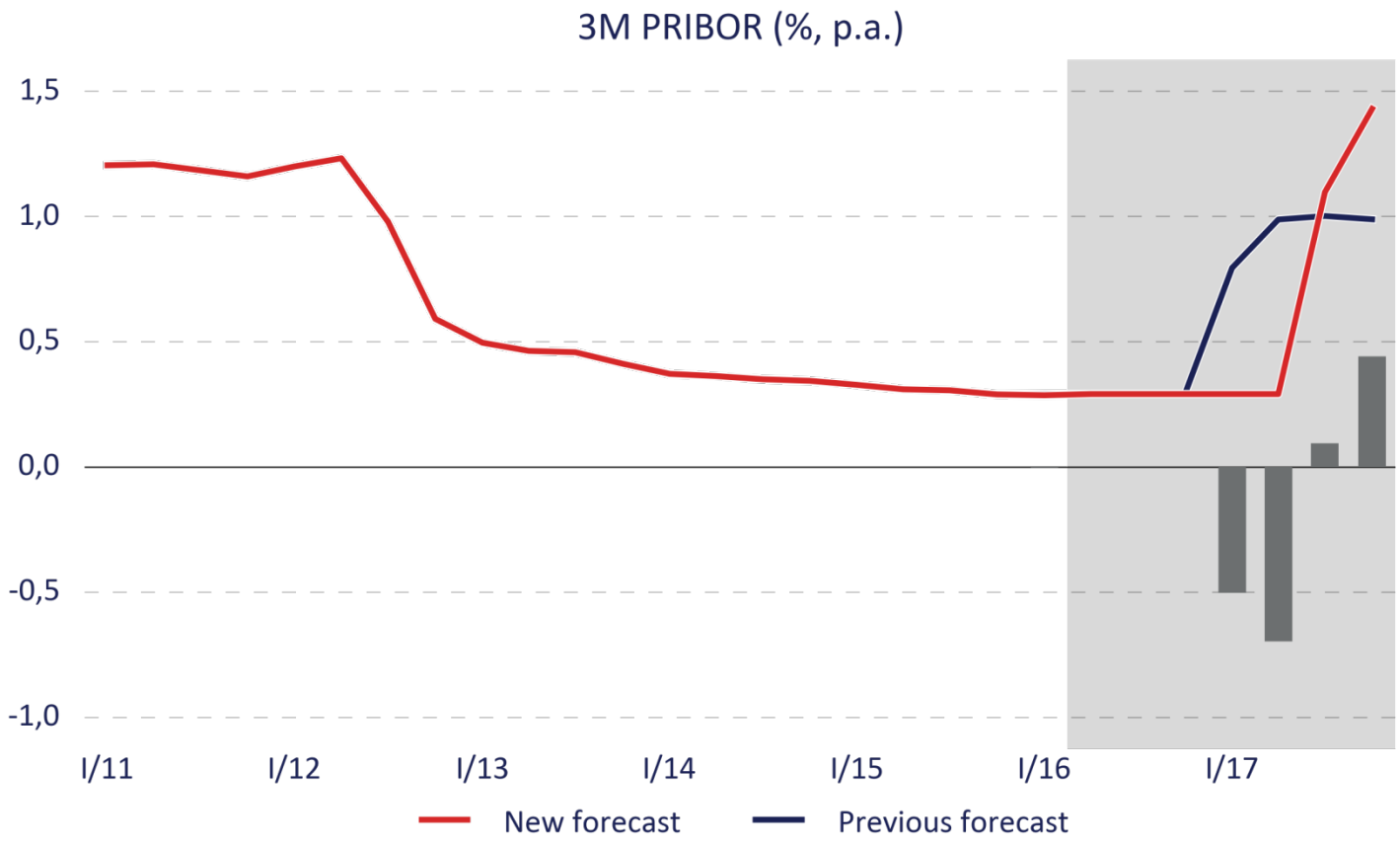
- The forecast of household consumption for next two years has not changed much.
- Dynamics of fixed investment will be more subdued compared to previous forecast, as government investment drop will be more pronounced and private investment will grow slower than previously predicted.
- New forecast shows positive contribution of net exports to GDP in both years.

Comparison: Nominal Wage



- Forecast of the nominal wage growth in the business sector has been markedly decreased compared to the previous forecast until mid-2017.
- This revision primarily reflects lower dynamics of wages observed in the end of last year. Simultaneously, it corresponds to more subdued outlook for inflation and expected slower economic growth in 2016.

Comparison: Interest Rate Forecast



- Domestic market interest rates remain flat until mid-2017; thereafter, their path is higher than in the previous forecast.
- This reflects the extension of assumed length of exchange rate commitment in the new forecast.

Thank you for your attention!

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Petr Král
Monetary Department

Petr.Kral@cnb.cz