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

Meeting with Analysts

Tibor Hlédik

Prague, August 5, 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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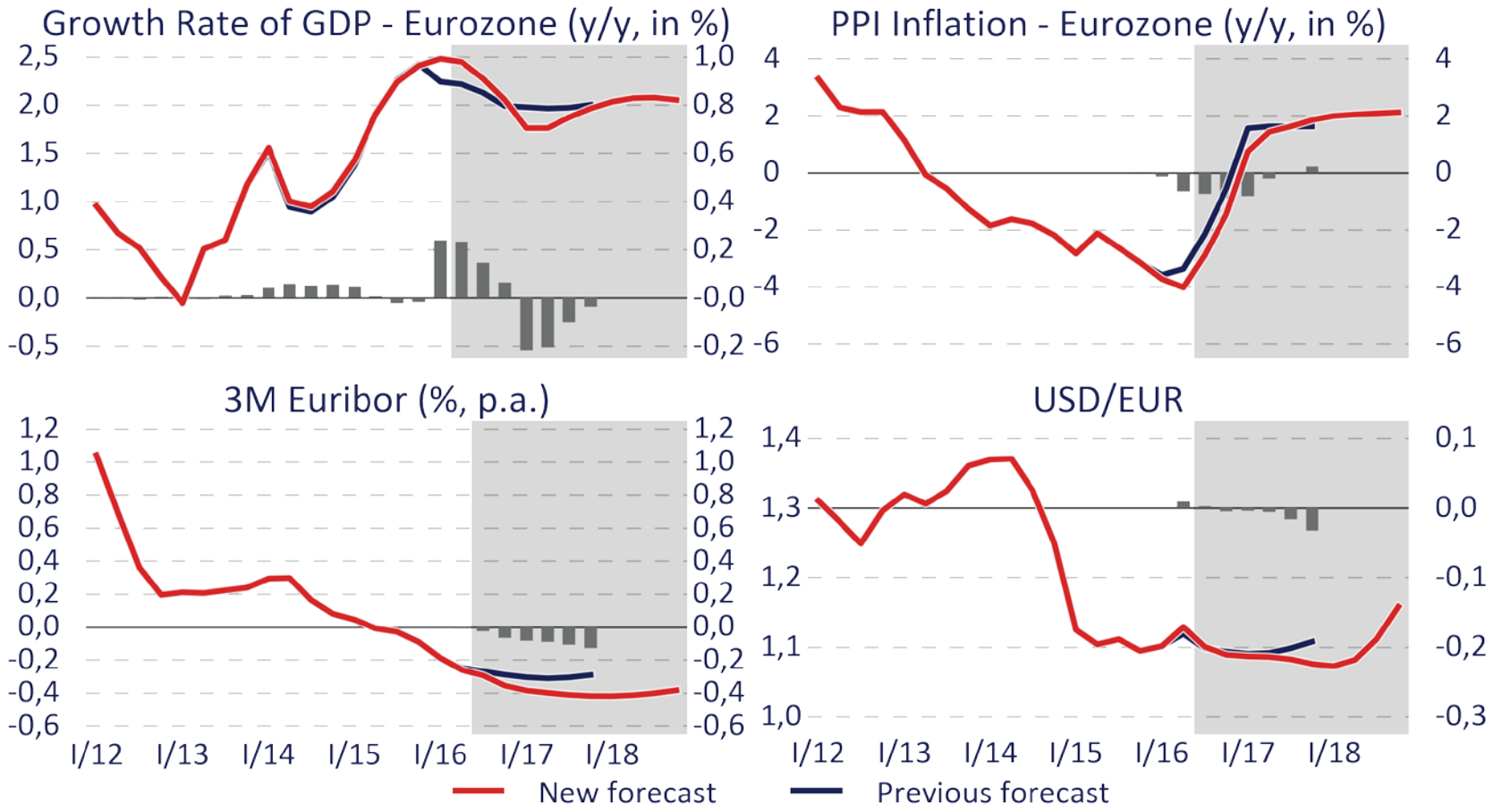
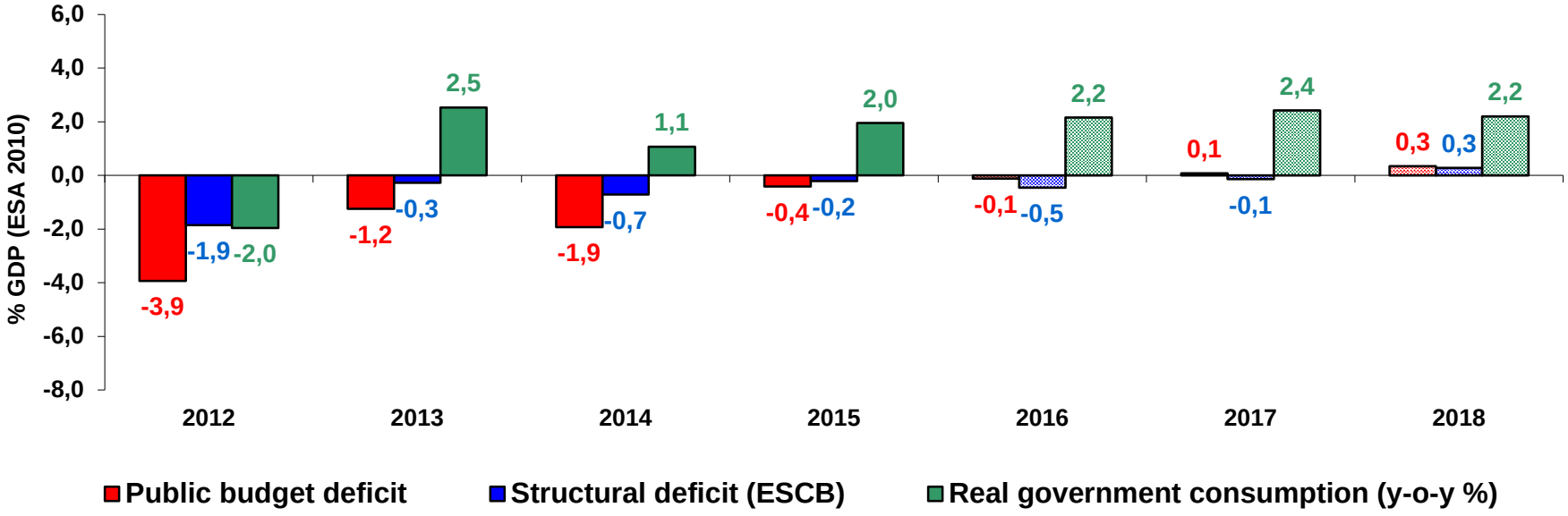
External Environment Outlook



- GDP growth will slow down throughout 2017 and will slightly pick up afterwards.
- The decline in the industrial producer prices will fade out in 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



- **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 of 0.1% 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 programme period, acceleration of wages and other current government expenditures).
- **2018:** a slight increase of the public budget surplus to 0.3% of GDP .

Fiscal Impulse

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Contributions to GDP growth in percentage points				
	2015	2016	2017	2018
	actual	forecast	forecast	forecast
Fiscal impulse[a)]	0.8	-0.7	0.1	0.1
of which impact through:				
private consumption	0.2	0.0	-0.1	-0.1
private investment	0.1	-0.1	0.0	0.0
government investment, domestic	0.0	0.1	0.1	0.0
government investment, EU funded	0.5	-0.7	0.1	0.1

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

- In 2016, the fiscal impulse will be significantly negative due to a temporary drop in public investment financed by EU funds, as the new programme period has been starting only gradually.
- In 2017 and 2018, the forecast assumes that the effect of fiscal policy on economic growth will be marginally positive, beyond continued growth of government consumption.
- A risk to the fiscal forecast is a potentially larger drop in government investment than expected by the forecast, due in part to the need to reassess the environmental effects of certain infrastructure projects (EIA).

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.

- Thus, after the exit from the exchange rate commitment, the koruna will appreciate due to:
  - the positive interest rate differential against the euro;
  - the repercussions of the ECB's quantitative easing, which the forecast assumes will last until March 2017;
  - 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 a sharp exchange rate appreciation, 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

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- Both headline and MP-relevant inflation decreased slightly in 2016 Q2 and stayed well below the lower boundary of the tolerance band around the CNB's target. However, they will start to rise in the near future and slightly exceed the 2% target at the MP horizon. During 2018, inflation will return to the target from above.

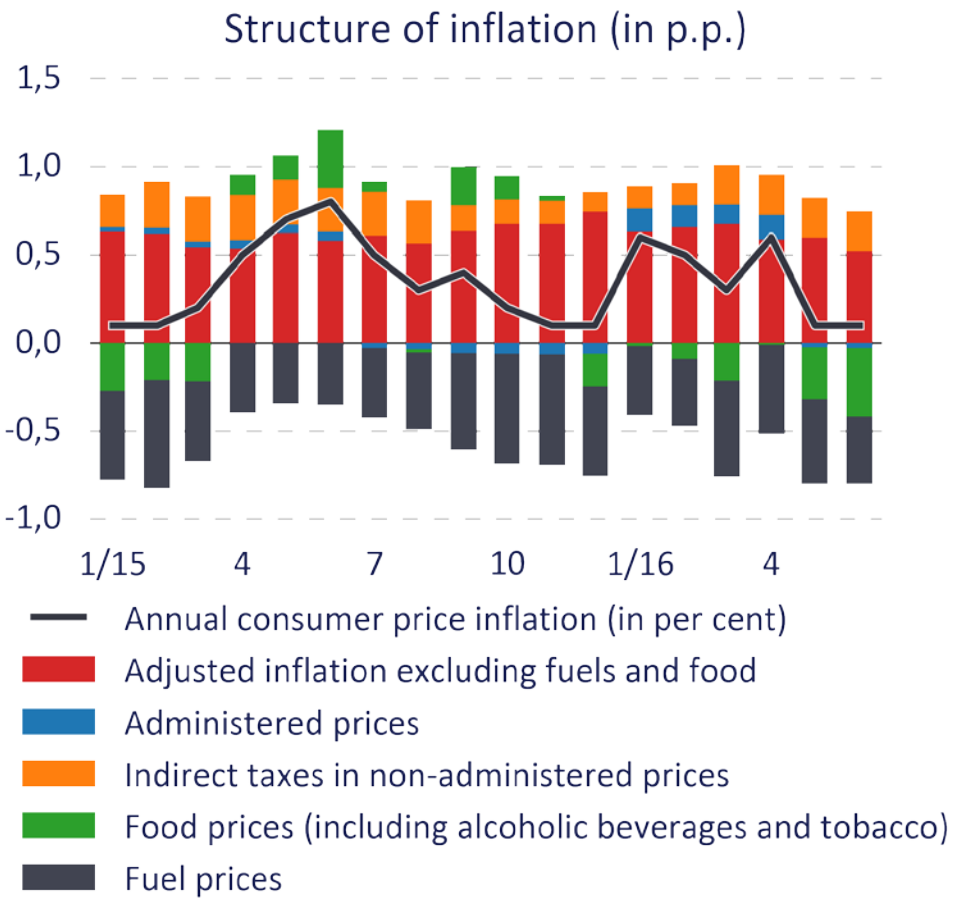
- Real GDP growth will slow markedly to 2.4% this year, due mainly to a fall in government investment from EU funds.

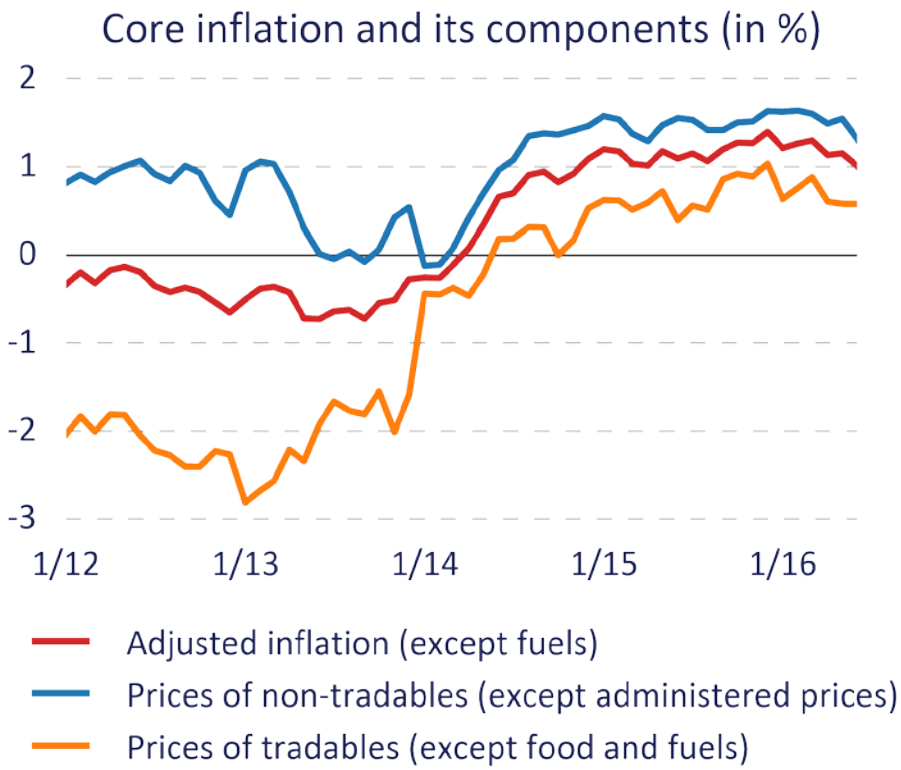
- On the other hand, the economy continues to be supported by still easy monetary conditions, low commodity prices and external demand. GDP is expected to grow by 3% in the following two years.

- The already fading anti-inflationary effect of import prices will gradually disappear.

- The economic growth will be reflected in a further improvement in the labour market situation, including faster wage growth.

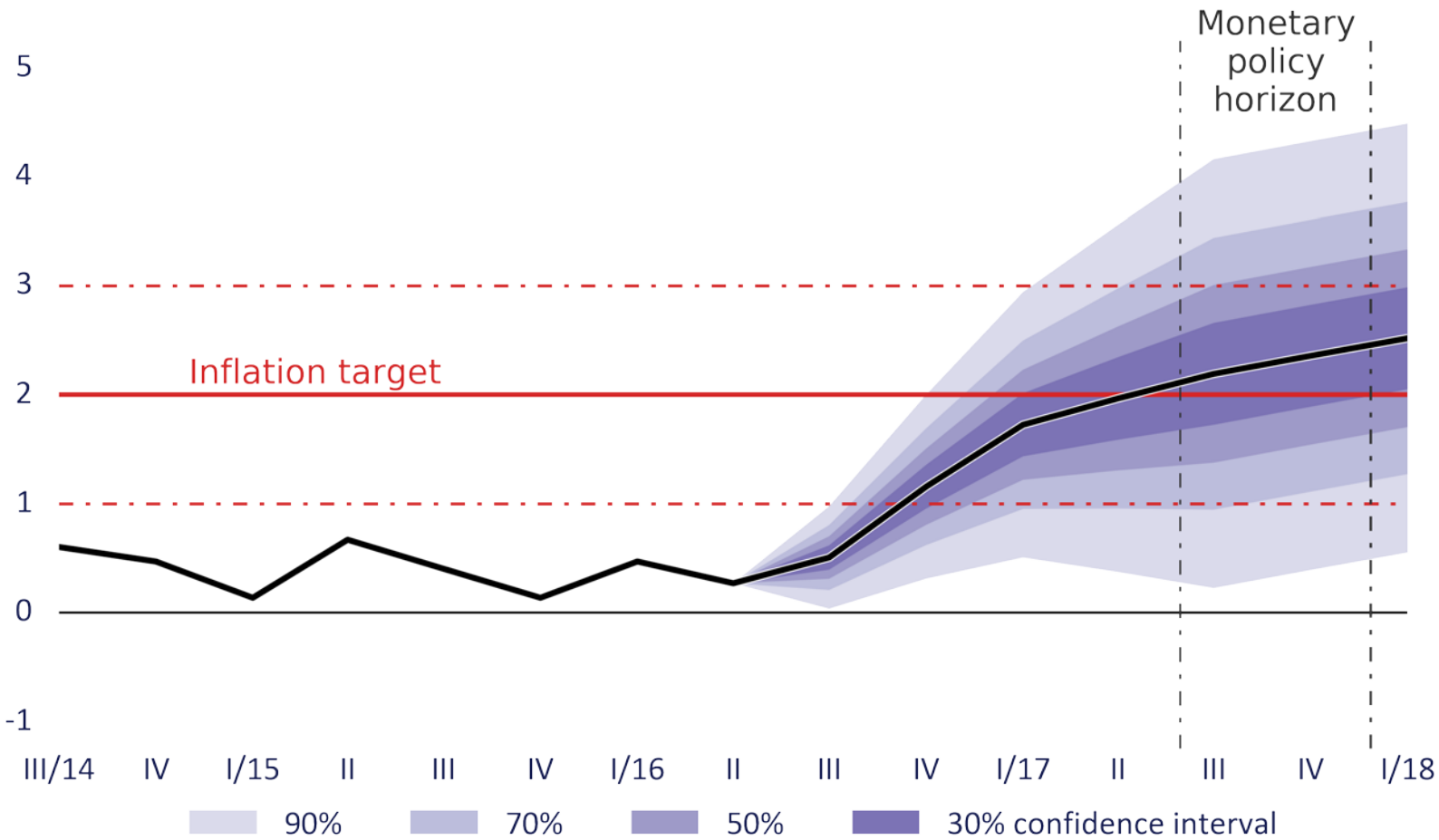
Structure of Inflation





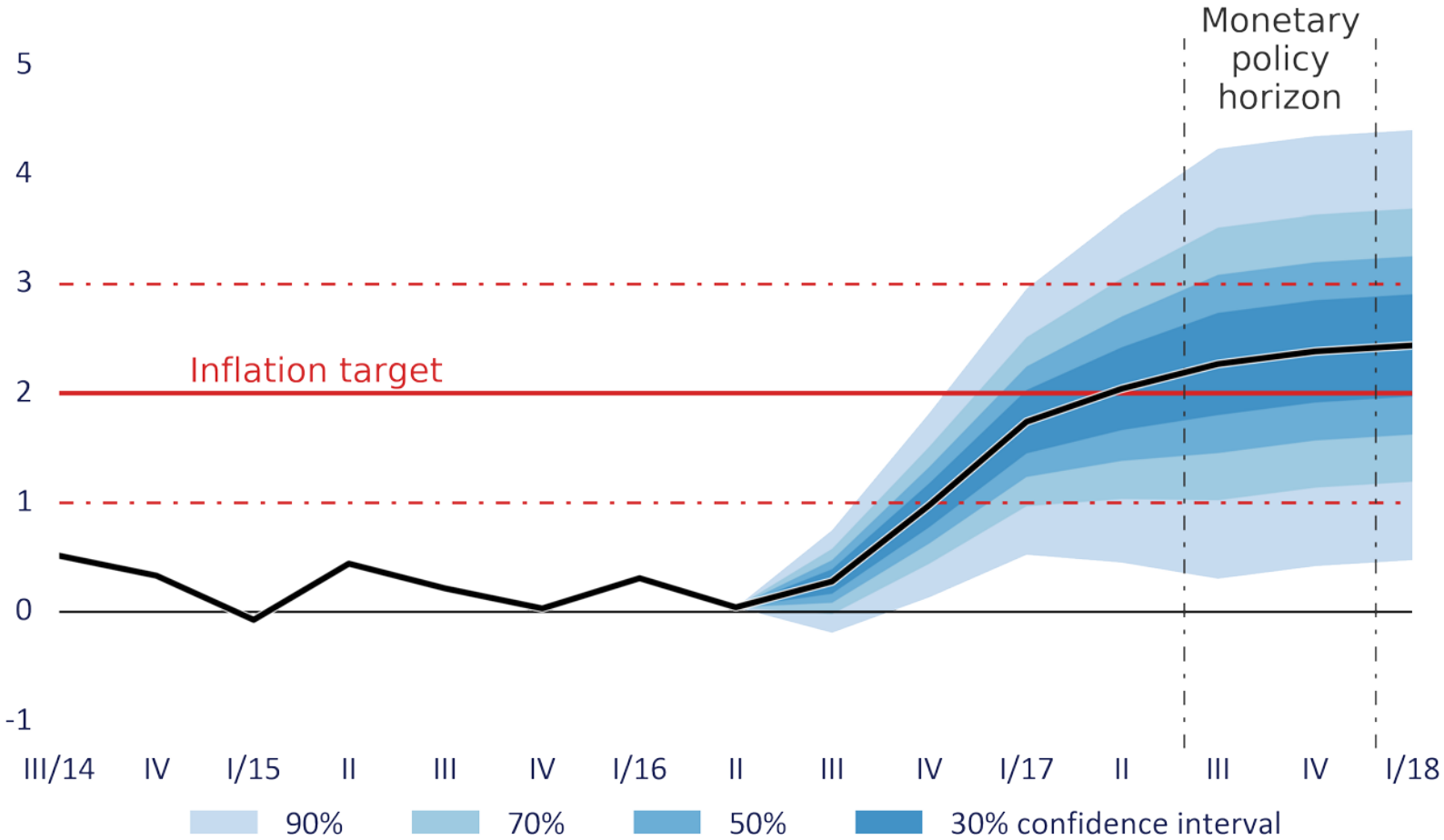
- The decline of headline inflation throughout May and June was mainly brought about by the renewed fall in food prices.
- Core inflation moderated slightly (to 1% in June), owing to a modest slowdown in growth in non-tradable prices.

Headline Inflation Forecast



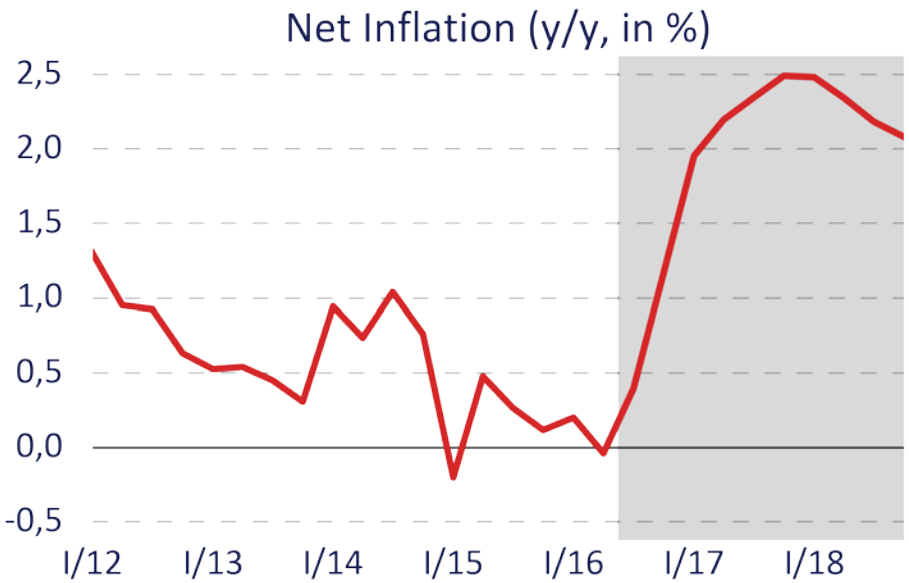
- Annual headline inflation slowed somewhat in 2016 Q2, however, it should start to rise in the period ahead despite a continued moderate decrease in administered prices and subdued food price inflation.
- At the MP horizon headline inflation will slightly exceed the 2% inflation target, in 2018 inflation will return to the target from above.

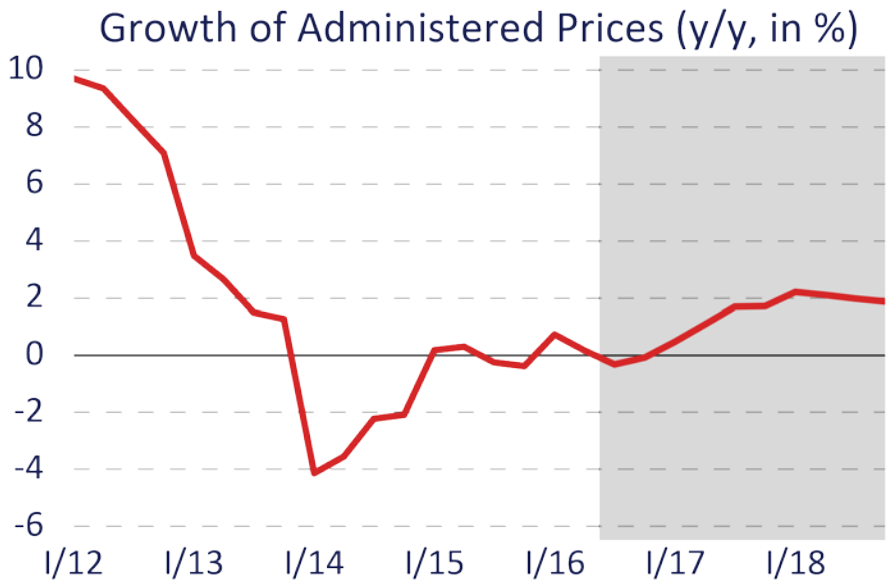
Monetary Policy-Relevant Inflation Forecast



- MP-relevant inflation was zero on average in 2016 Q2, still well below the CNB's 2% target.
- Over the forecast horizon, MP-relevant inflation will follow a similar path to headline inflation.

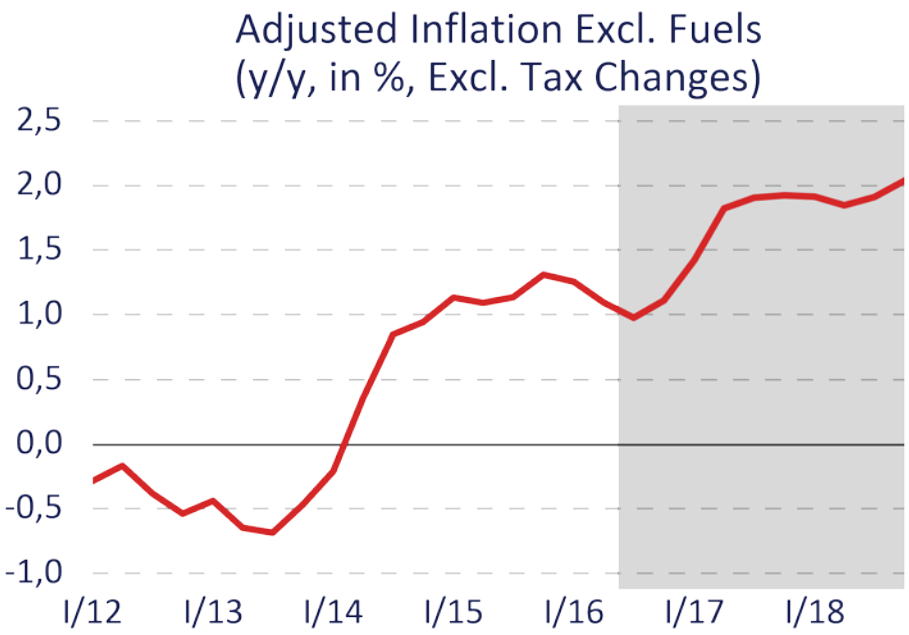
Market and Administered Prices

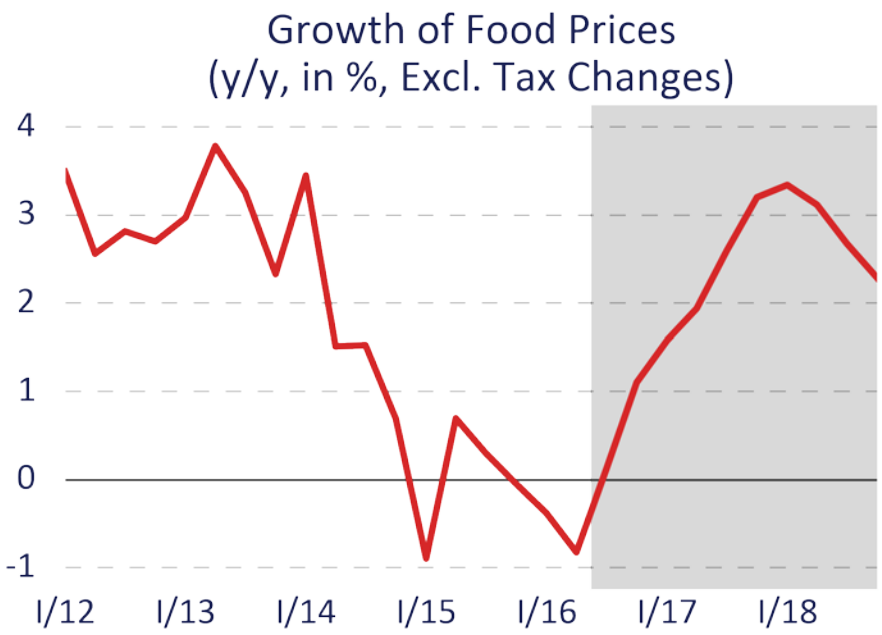




- Net inflation was slightly negative on average in Q2. However, it will increase quickly in the period ahead amid continued growth of the domestic economy and strengthening cost pressures stemming from the labour market. As from 2017 Q2, net inflation will fluctuate above 2%.
- Administered prices will remain broadly unchanged this year, as the declining gas prices will be offset by growth in electricity prices, health care prices and water supply and sewerage collection charges. Next year, they will rise by 1.2% on average and by 2% in 2018.

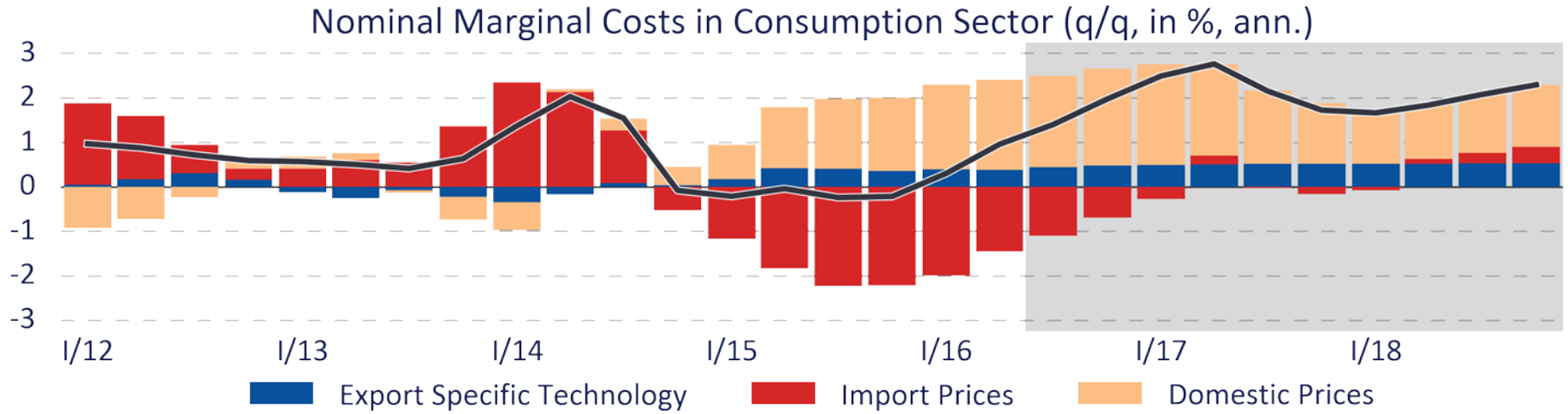
Core Inflation and Food Prices

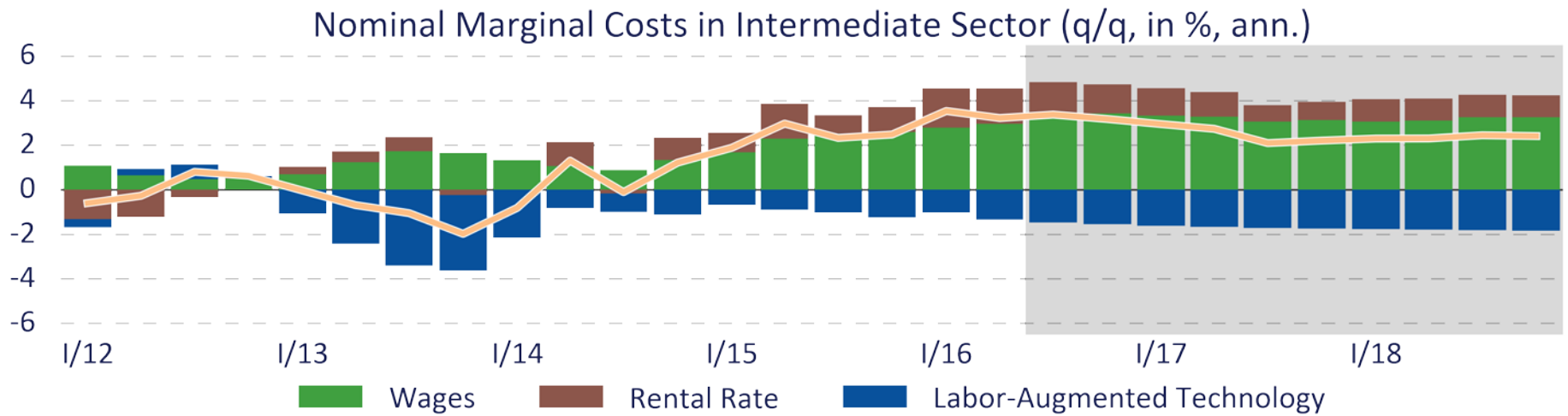




- Core inflation slowed slightly in 2016 Q2. Its pick-up on the forecast horizon will be due to inflationary pressures from the domestic economy amid rapid wage growth and to a renewed increase in PPI in the euro area (partly offset by the expected appreciation of the CZK following the exit).
- The decline in food prices deepened during 2016 Q2 (lagged effects of a Russian embargo on imports of selected foodstuffs and lifting of milk quotas in the EU). Food price growth will rise above 3% at the end of 2017 and slow slightly in 2018 (fading of the above one-off effects and renewed growth in APP).

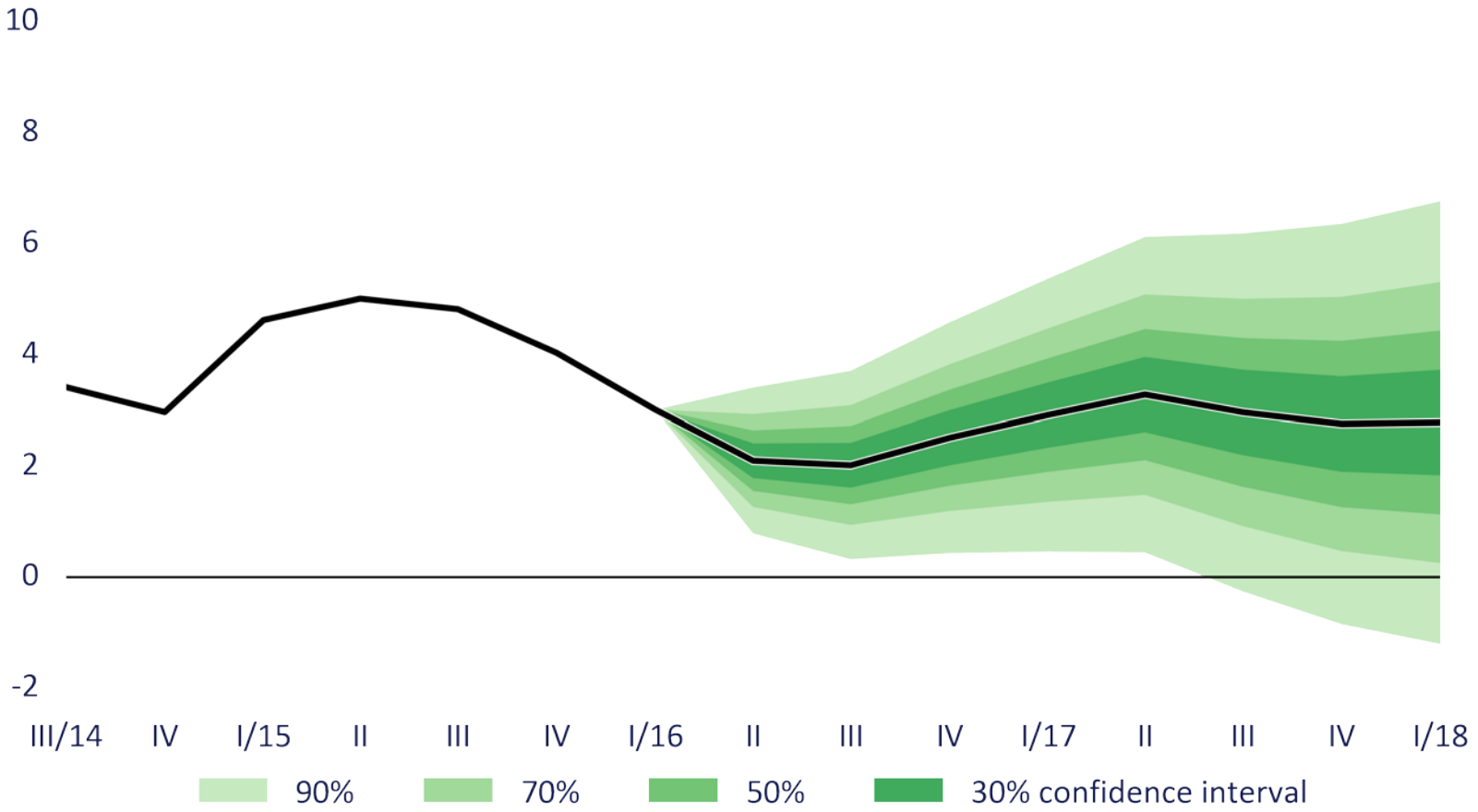
Domestic Costs vs. Import Prices





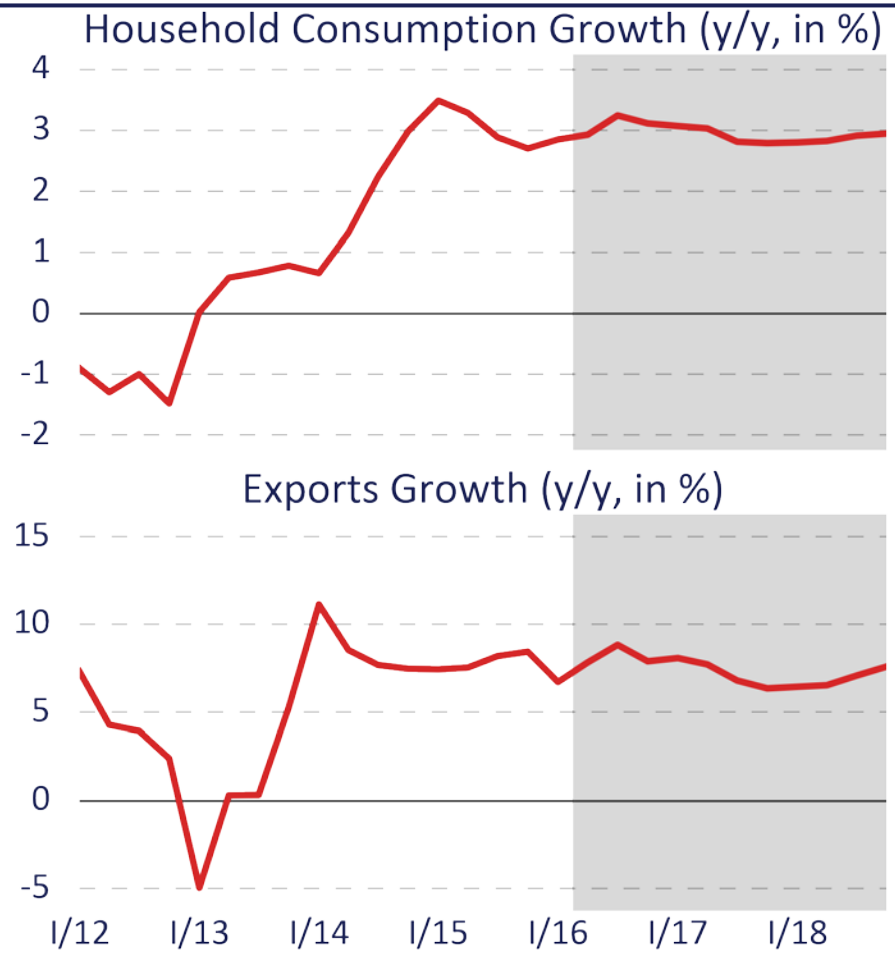
- Recovering growth of costs in the consumption sector will reflect persistent domestic cost pressures, as well as fading negative contribution of import prices.
- Domestic costs will rise on the back of continued wage growth and a rising price of capital.

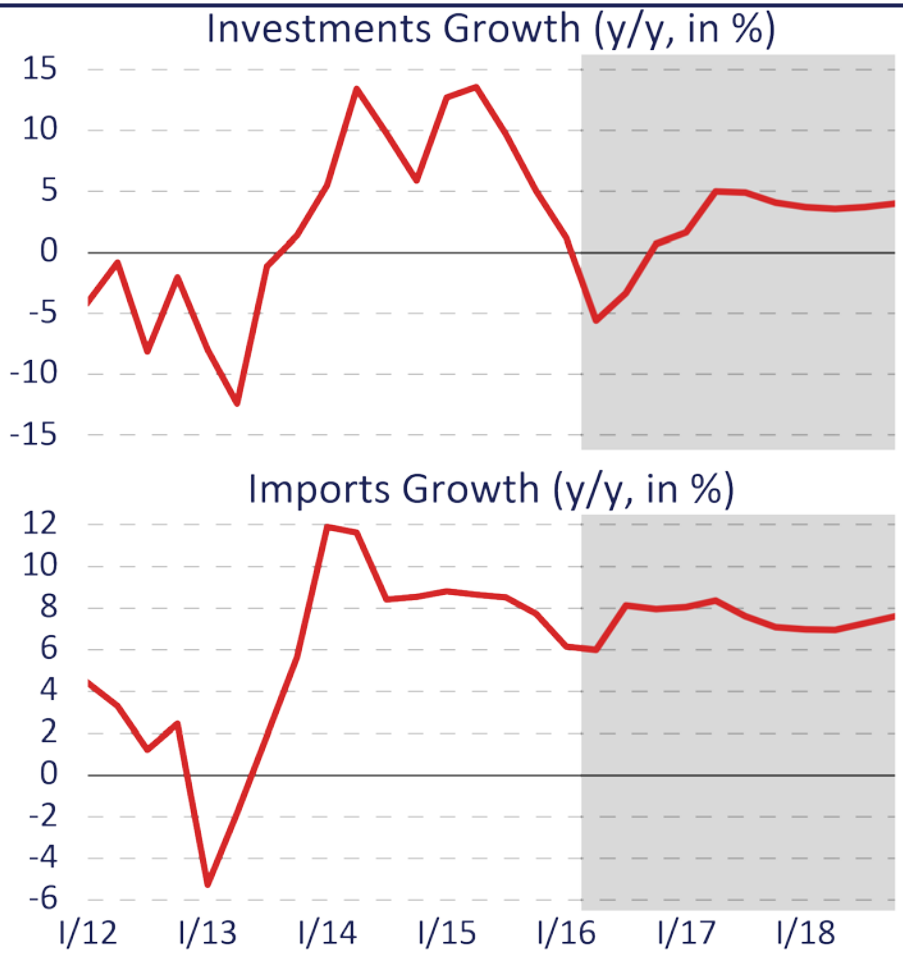
GDP Growth Forecast



- GDP growth forecast: 2.4% in 2016, 3.0% in both 2017 and 1018.
- Economic growth will slow down this year due to a temporary decline in gross capital formation (government investment financed from EU funds).
- The Czech economy will still be supported by easy monetary conditions, low oil prices and ongoing growth of external demand.

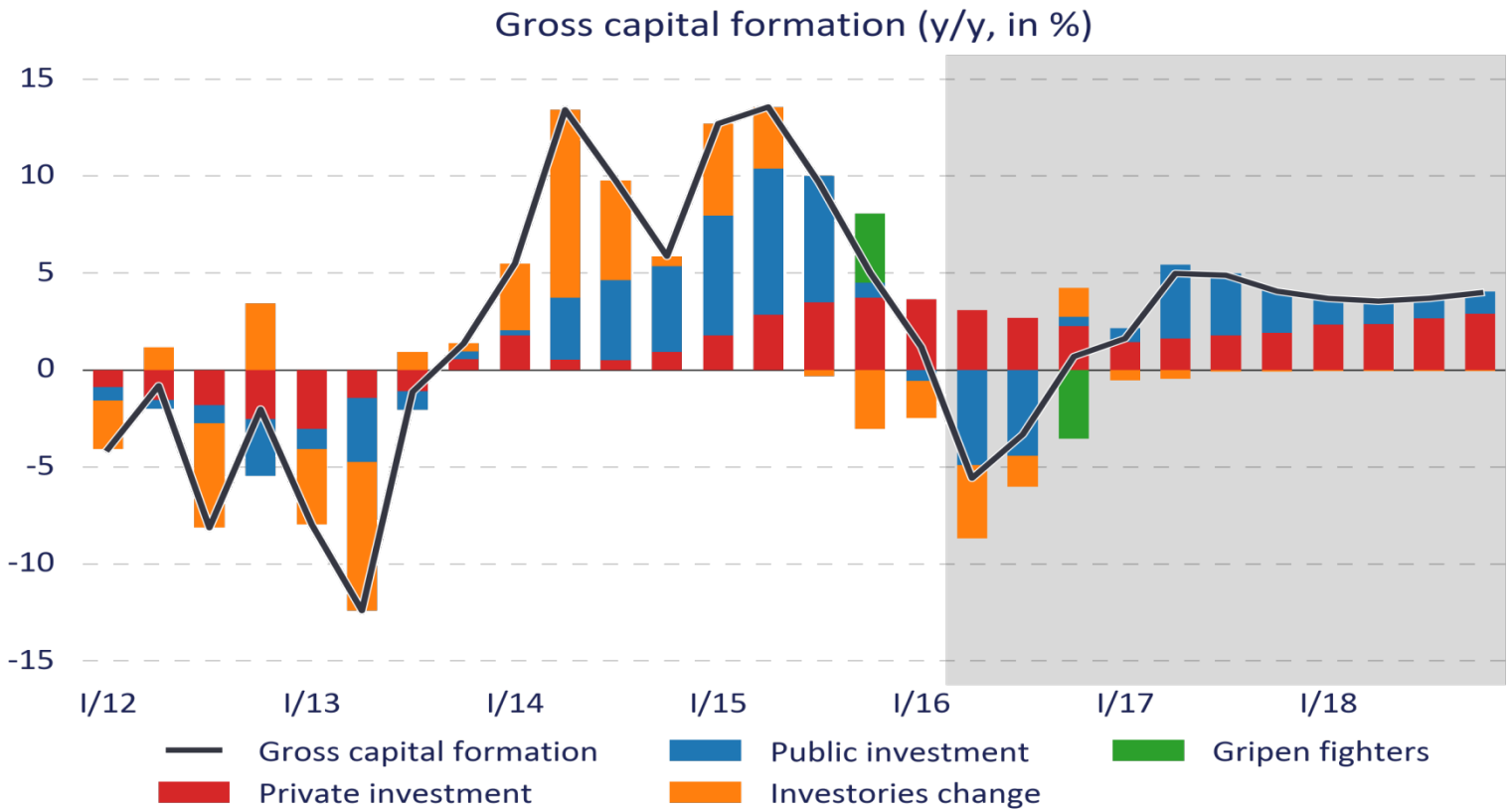
Aggregate Demand





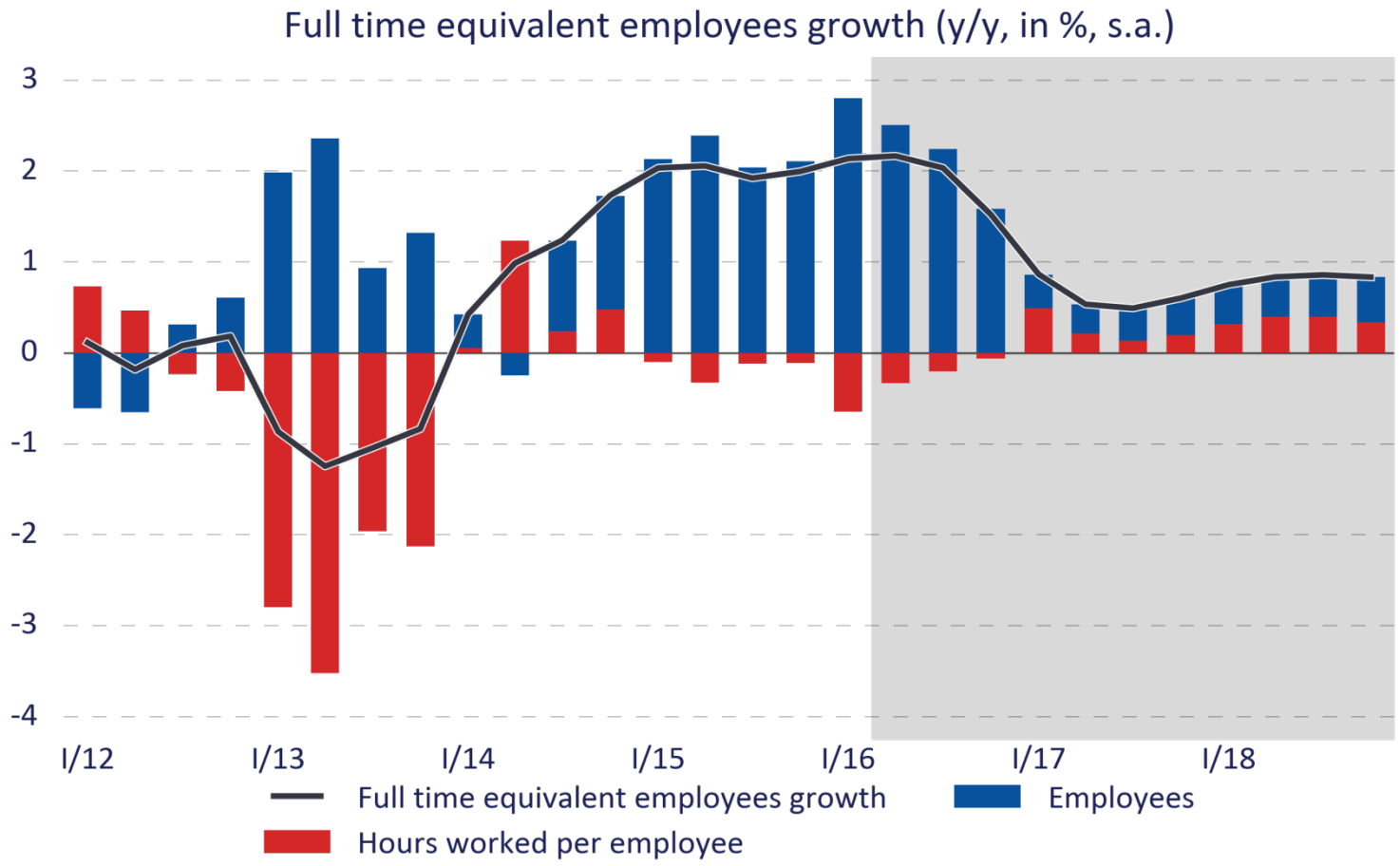
- Household consumption growth will be supported by increase in wages and salaries, consistent with growth in retail sales and recovered credit growth.
- Decline in investment in this year is driven primarily by a drop of public investment.
- Contribution of net exports: 1.1 p.p. in 2016, 0.1 p.p. in 2017, 0.3 p.p. in 2018 .

Gross Capital Formation Forecast



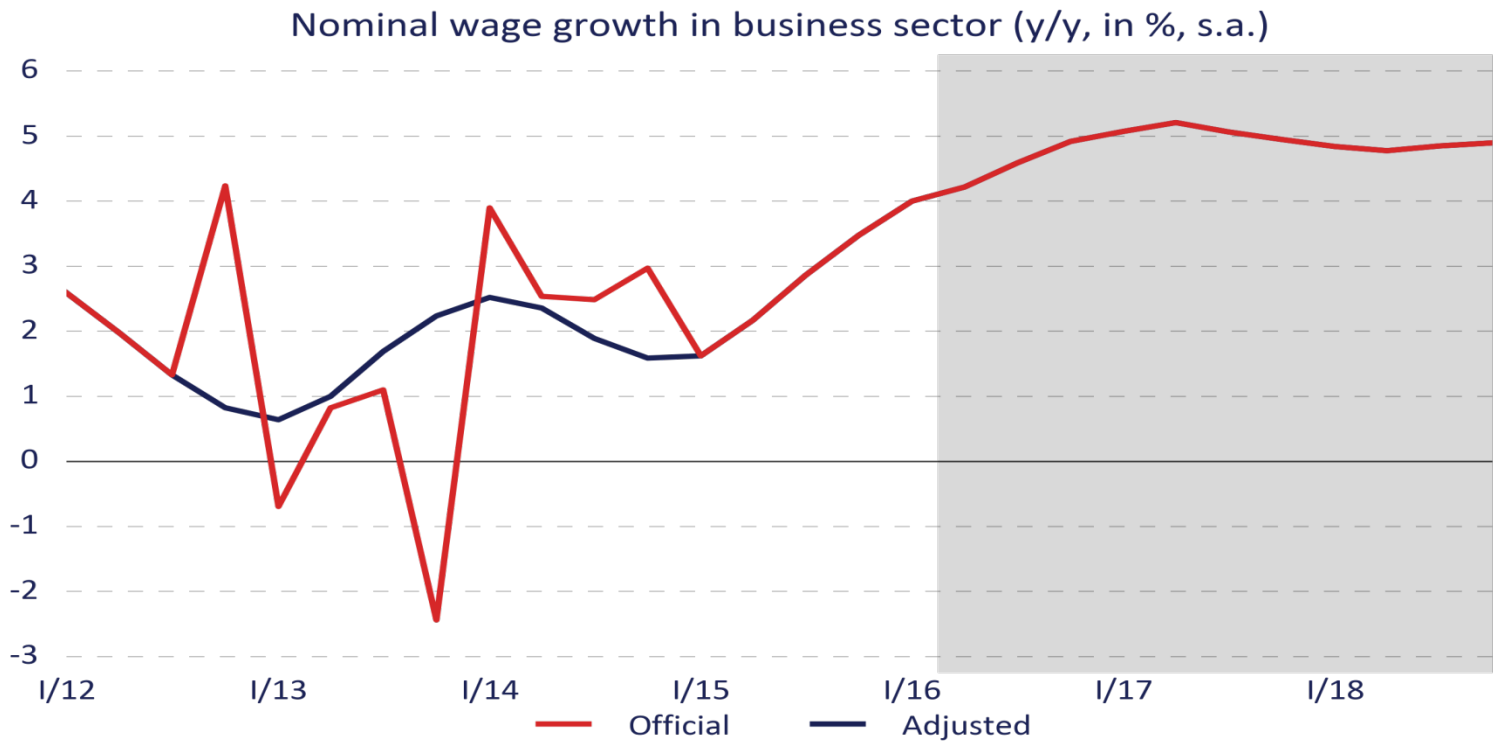
- Fixed investment will decrease throughout 2016, mainly as a result of slowdown in drawing from EU funds in the new programme period and need for reassessment of environmental effects of projects under the new EIA legislation.
- Continued growth of private investments (positive effect of external demand,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

Labour Market: Employment



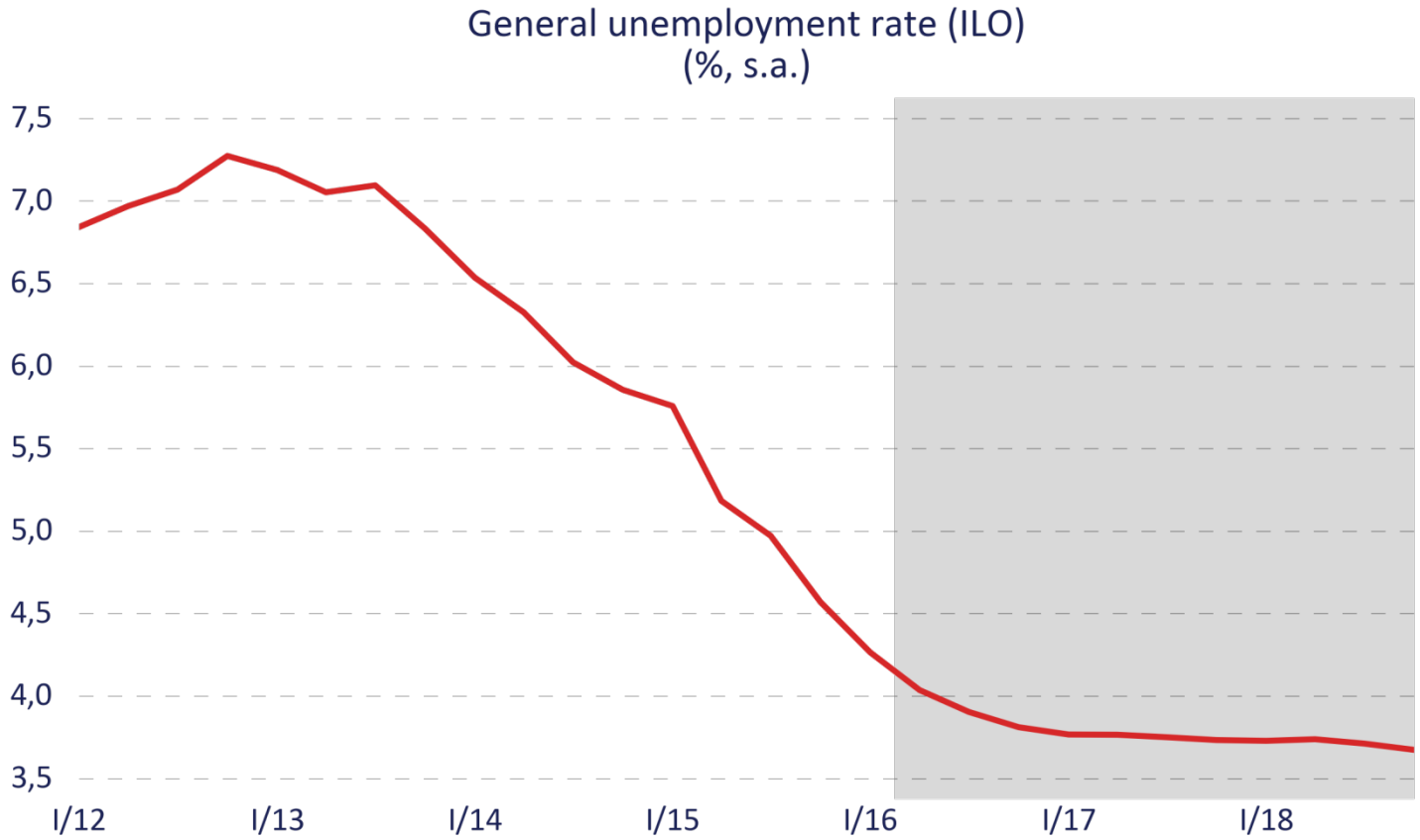
- The number of employees converted into full-time equivalents will continue to rise, although the growth will gradually ease in the coming quarters.
- The converted number of employees will rise this year exclusively through a further increase in the number of employees, while the contribution of average hours worked will turn positive in early 2017 .

Labour Market: Wage Growth in Business Sector



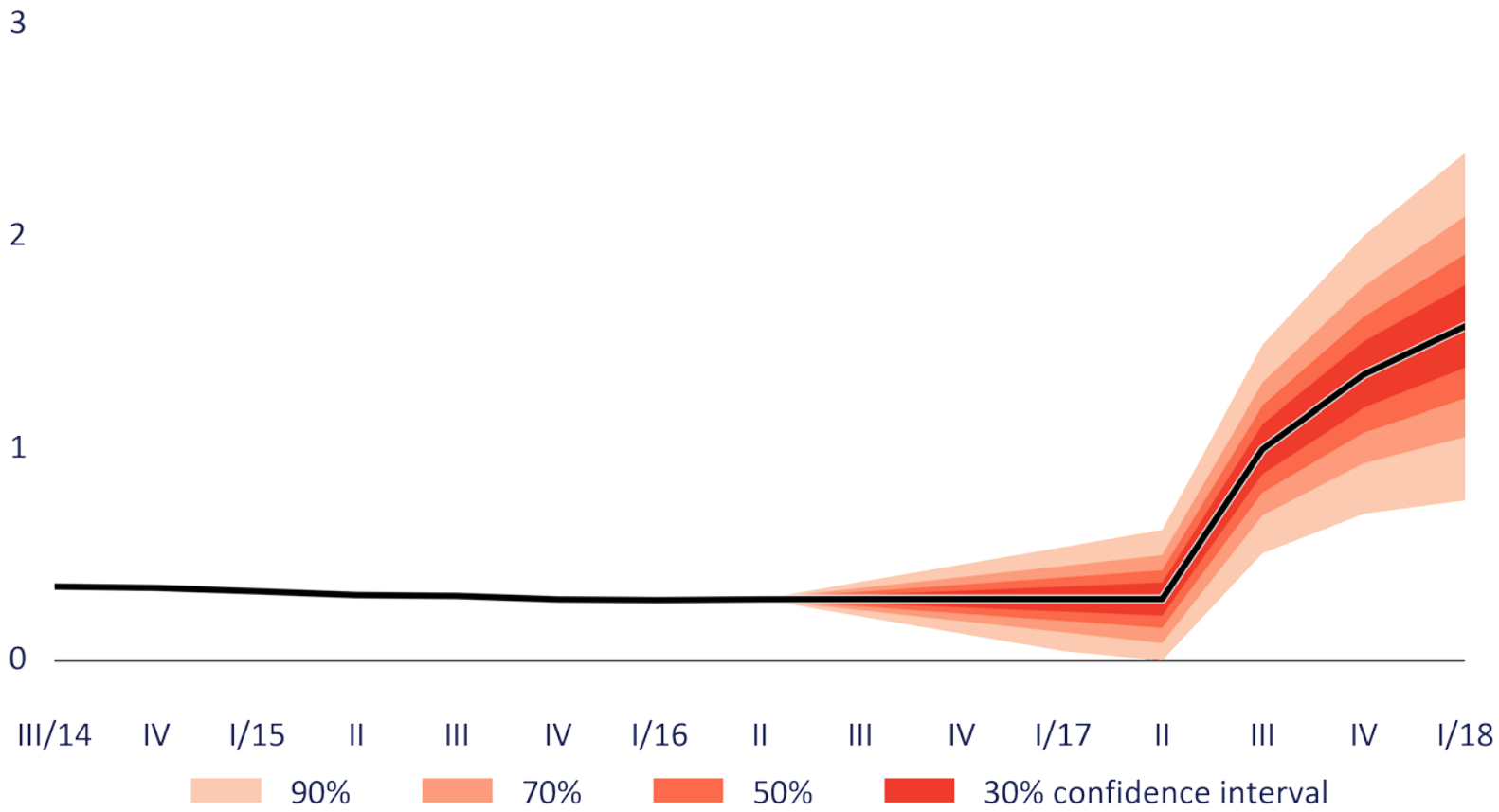
- Average nominal wage growth in the business sector rose further to 4% in 2016 Q1 (s.a.). The gradual pick-up in wage growth will continue this year, reflecting still high demand for new labour amid a low unemployment rate.
- The return of inflation to the target, a renewed pick-up in economic activity and an increasing shortage of available labour will result in a wage growth close to 5% thorough 2017 and 2018.
- Wage dynamics in the non-business sector in 2016: 4% 2017: 5% 2018: 4.5%.

Labour Market: Unemployment



- The previous sharp decrease in the seasonally adjusted general unemployment rate will slow significantly this year.
- The unemployment rate is expected to stay slightly below 4% over the next two years amid identical quarterly growth in the labour force and employment.

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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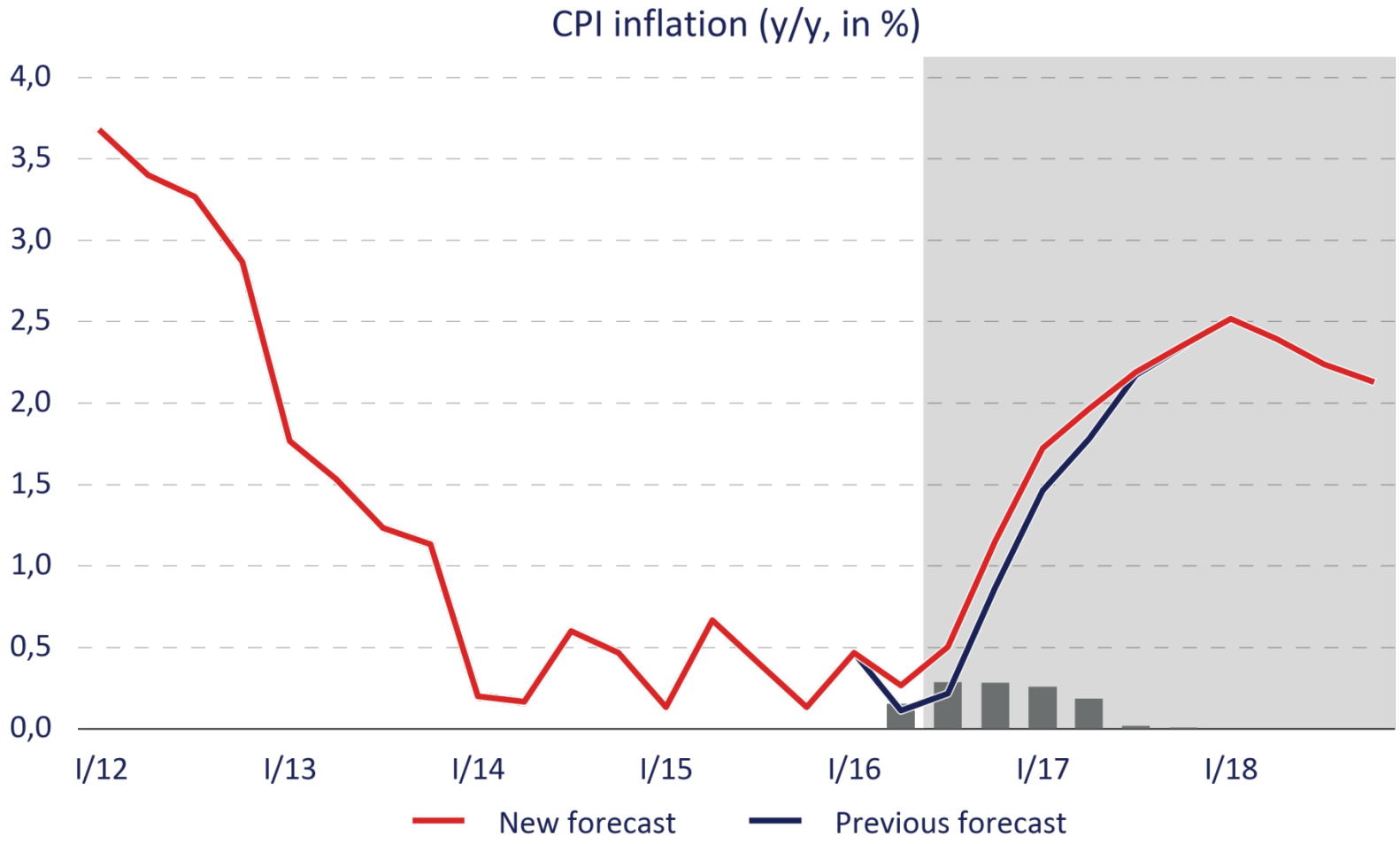
- In the new forecast, the assumption of flat market interest rates at their current very low level and the use of the exchange rate as a monetary policy instrument until mid-2017 has been left unchanged.

- The predictions for headline and MP-relevant inflation are moderately higher until mid-2017. This is due to a slightly higher short-term prediction for net inflation, a higher outlook for administered prices and faster observed and expected growth in nominal wages.

- Overall GDP growth this year has been revised slightly upwards, mainly as a result of a more modest fall in gross capital formation. By contrast, the GDP forecast for 2017 is lower owing to slower growth in external demand, due in part to the outcome of the Brexit referendum.

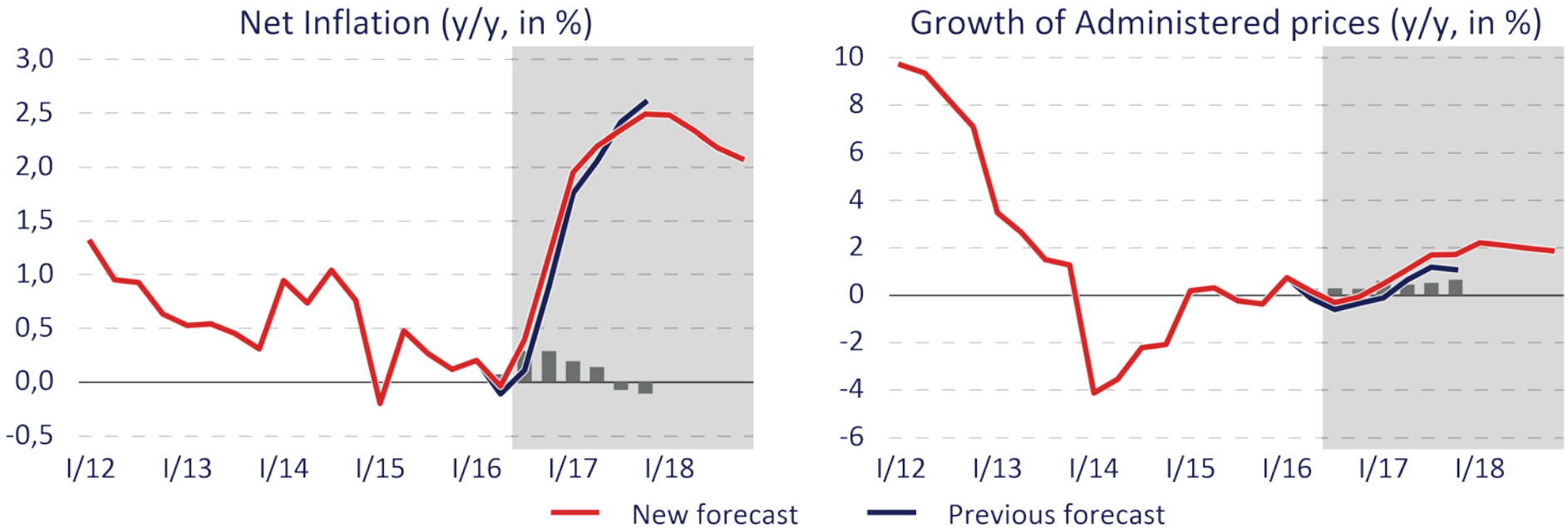
- Nominal wage growth in the business sector has shifted upwards until mid-2017. This mainly reflects the higher wage growth observed early this year and higher expected GDP growth and inflation this year. From mid-2017, by contrast, nominal wage growth will be slower due to slower growth in domestic economic activity.

Comparison: Inflation Forecast (i)



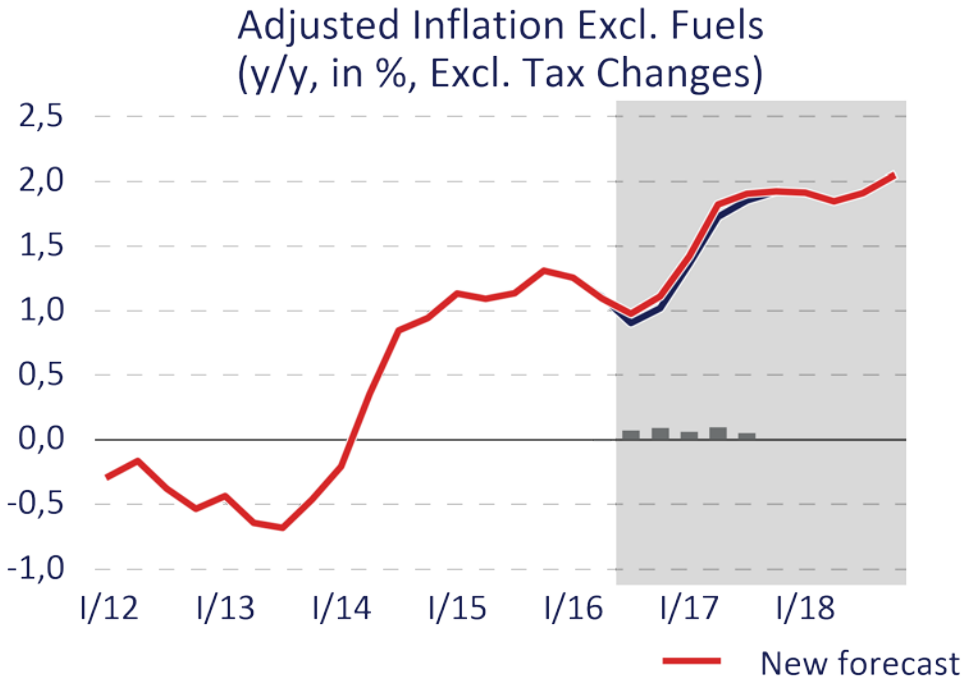
- The forecast for annual headline inflation is slightly higher for the next four quarters.
- The change is due to higher expected net inflation and the outlook for administered prices.

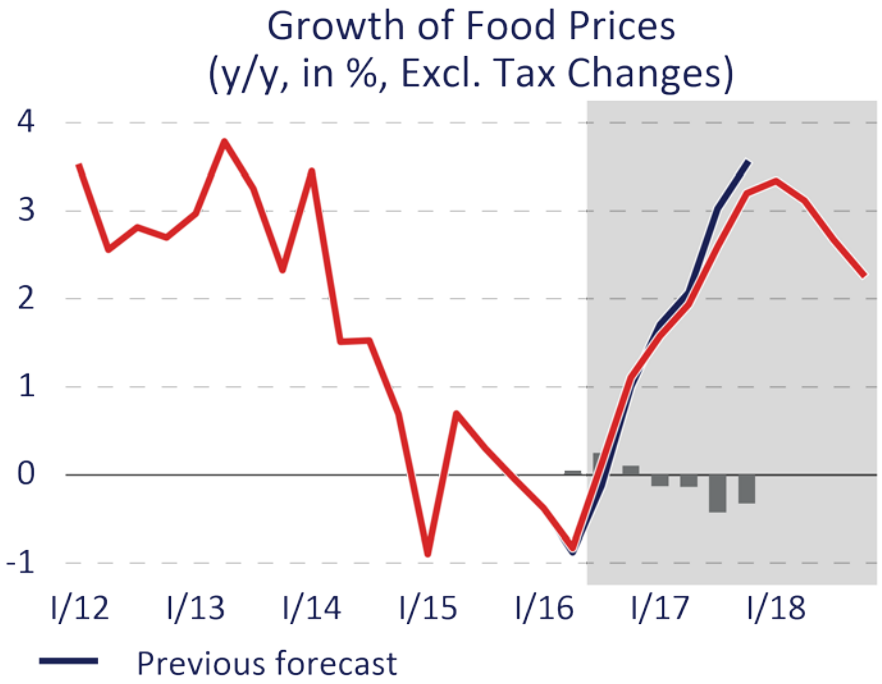
Comparison: Inflation Forecast (ii)



- The forecast of net inflation is affected in the short run by higher food prices and a smaller drop in fuel prices. The prediction also reflects cost pressures resulting from faster wage growth, which offset a later renewal of growth in foreign prices. Compared to the previous forecast, domestic cost pressures will thus rise more quickly in the short run and will then be roughly the same.
- The outlook for administered prices has been revised upwards, mainly due to a smaller-than-predicted reduction in prices of gas for households and faster growth in heat and electricity prices and water supply and sewerage collection charges.

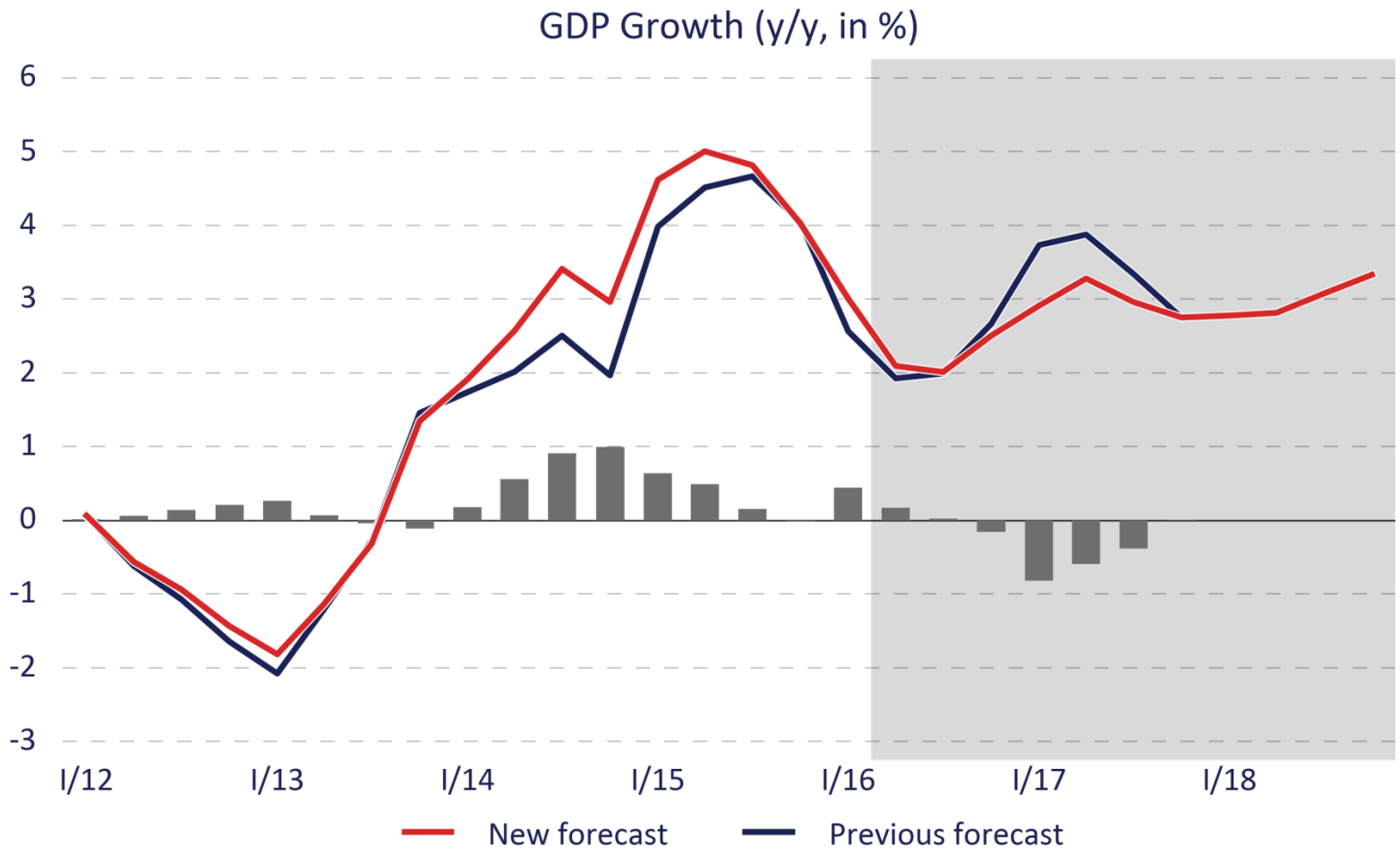
Comparison: Inflation Forecast (iii)





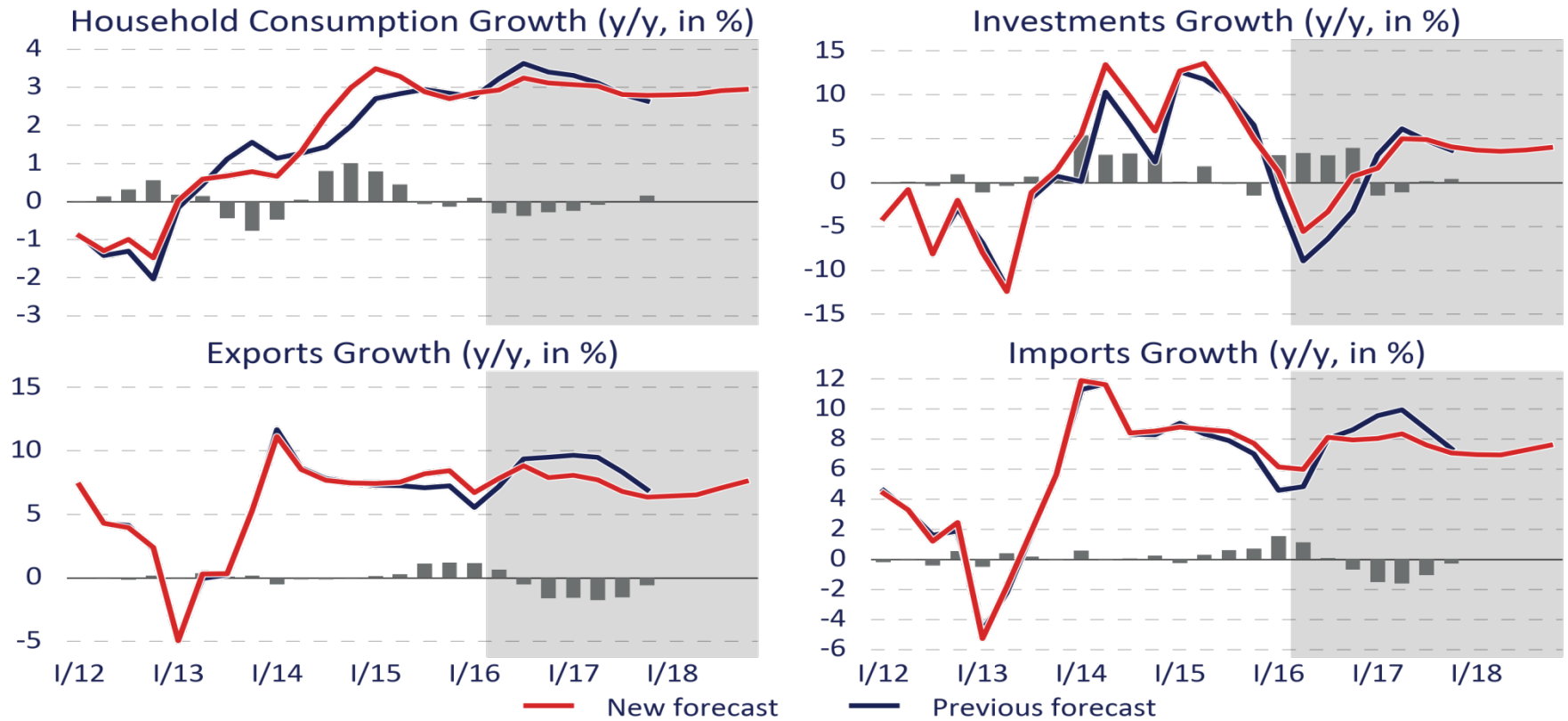
- The forecast of core inflation is almost the same as in the previous forecast.
- The outlook for food prices in 2017 is revised slightly downwards due to deeper drop of agricultural prices in 2016 and their slower pick-up from early 2017.

Comparison: GDP Forecast (i)



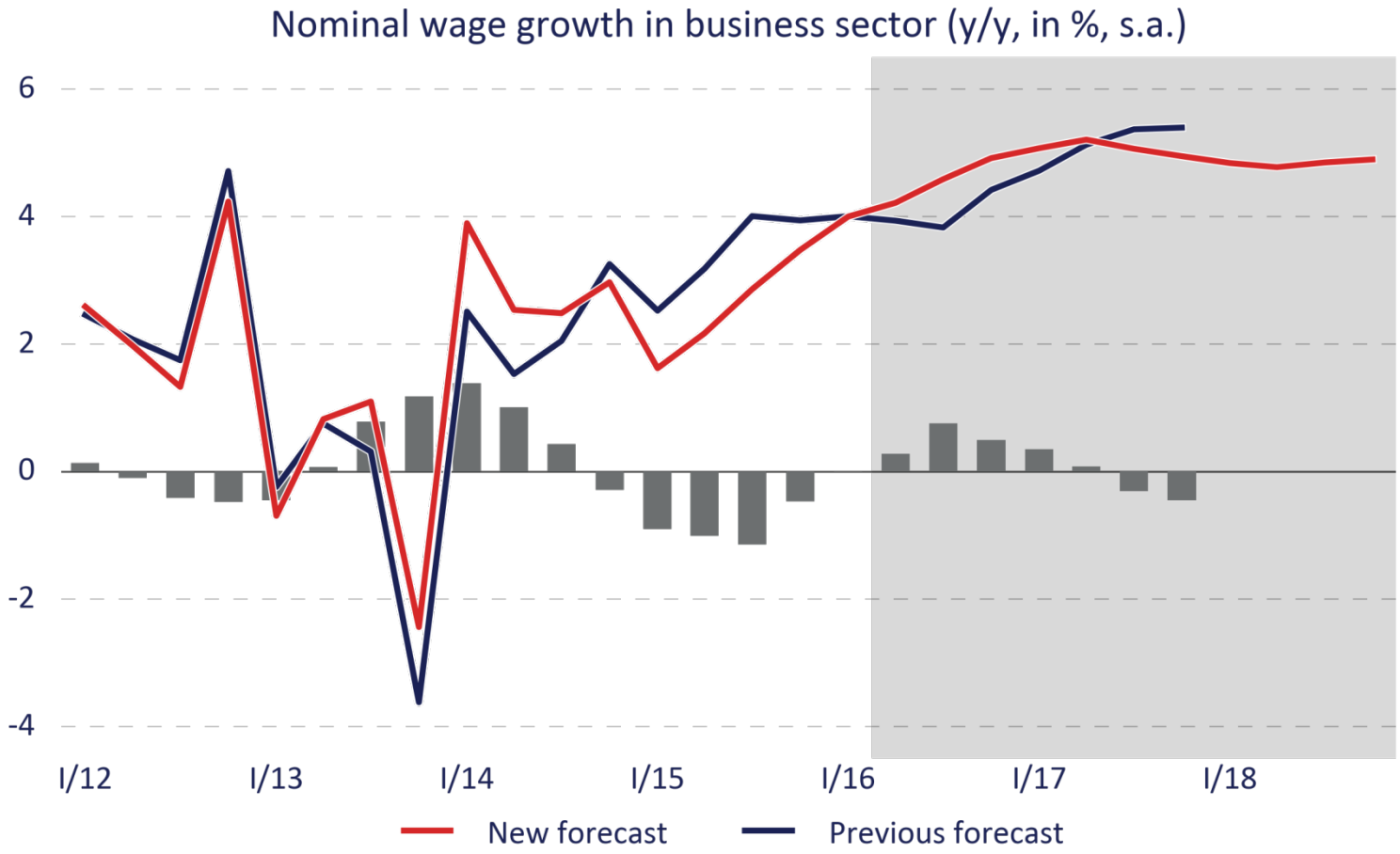
- The forecast for annual GDP growth is slightly higher this year owing to a more moderate decline in gross capital formation.
- In 2017, by contrast, it is lower, primarily because of slightly lower external demand (the Brexit effect).

Comparison: GDP Forecast (ii)



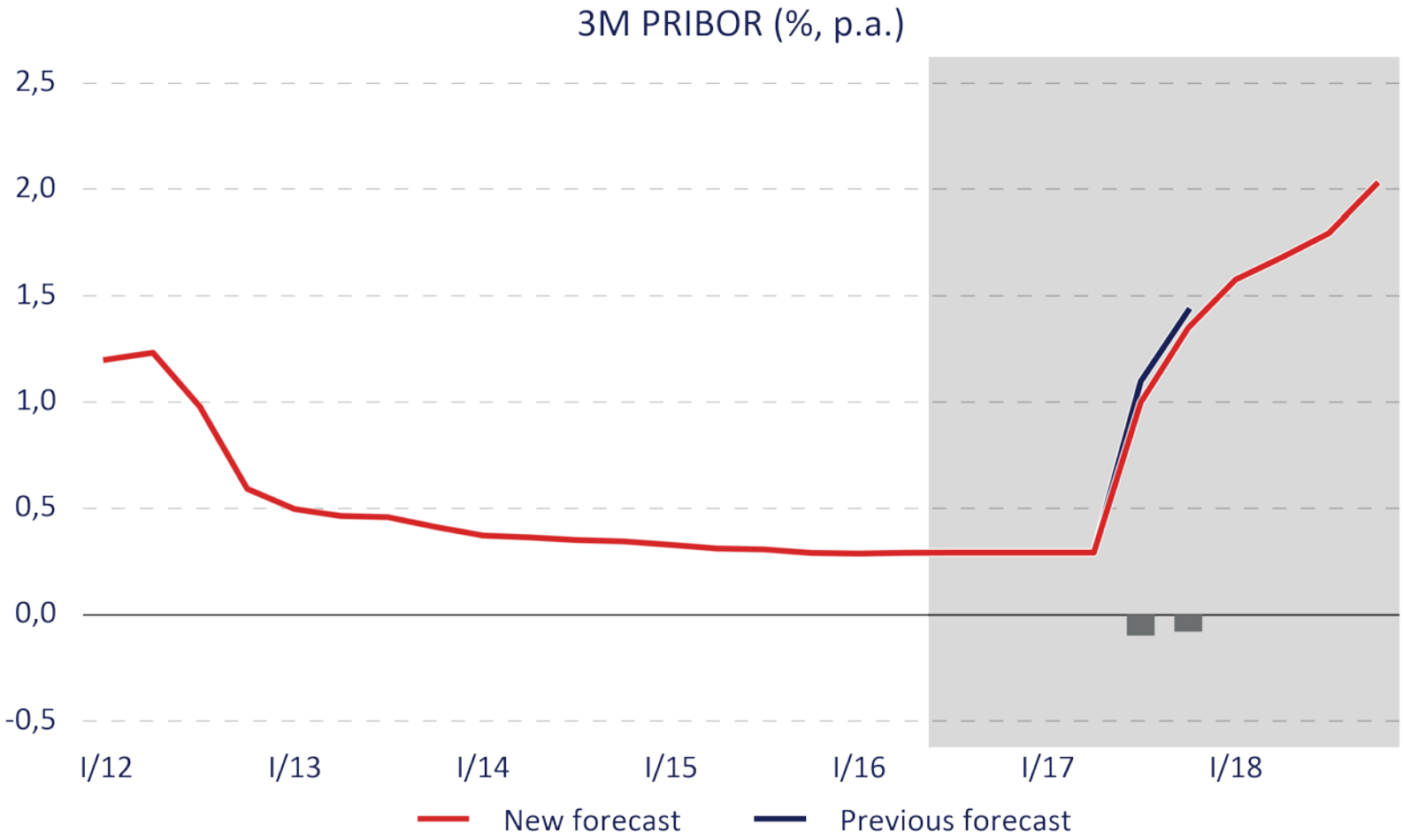
- Despite continued robust growth in wages and salaries, the outlook for household consumption is slightly lower for this year and the next due to higher predicted inflation.
- Investment growth is significantly affected by government investment, which has been revised towards a more moderate decline in 2016.
- The contribution of net exports to GDP growth in 2016 will be less positive, in 2017 the contribution of net exports is smaller (external demand).

Comparison: Nominal Wage



- The growth in wages in the business sector is higher until mid-2017, mainly due to higher wage growth observed early this year. At the same time, it is consistent with the slightly higher expected GDP growth and inflation this year.
- From mid-2017, by contrast, nominal wage growth will be slower due to slower growth in domestic economic activity.

Comparison: Interest Rate Forecast



- As in the previous forecast, domestic market interest rates will be stable until mid-2017.
- Their subsequent increase does not differ much from the previous forecast either.

Thank you for your attention!

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