CNB’s New Forecast (Inflation Report IV/2016)

Meeting with Analysts

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Prague, November 4, 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

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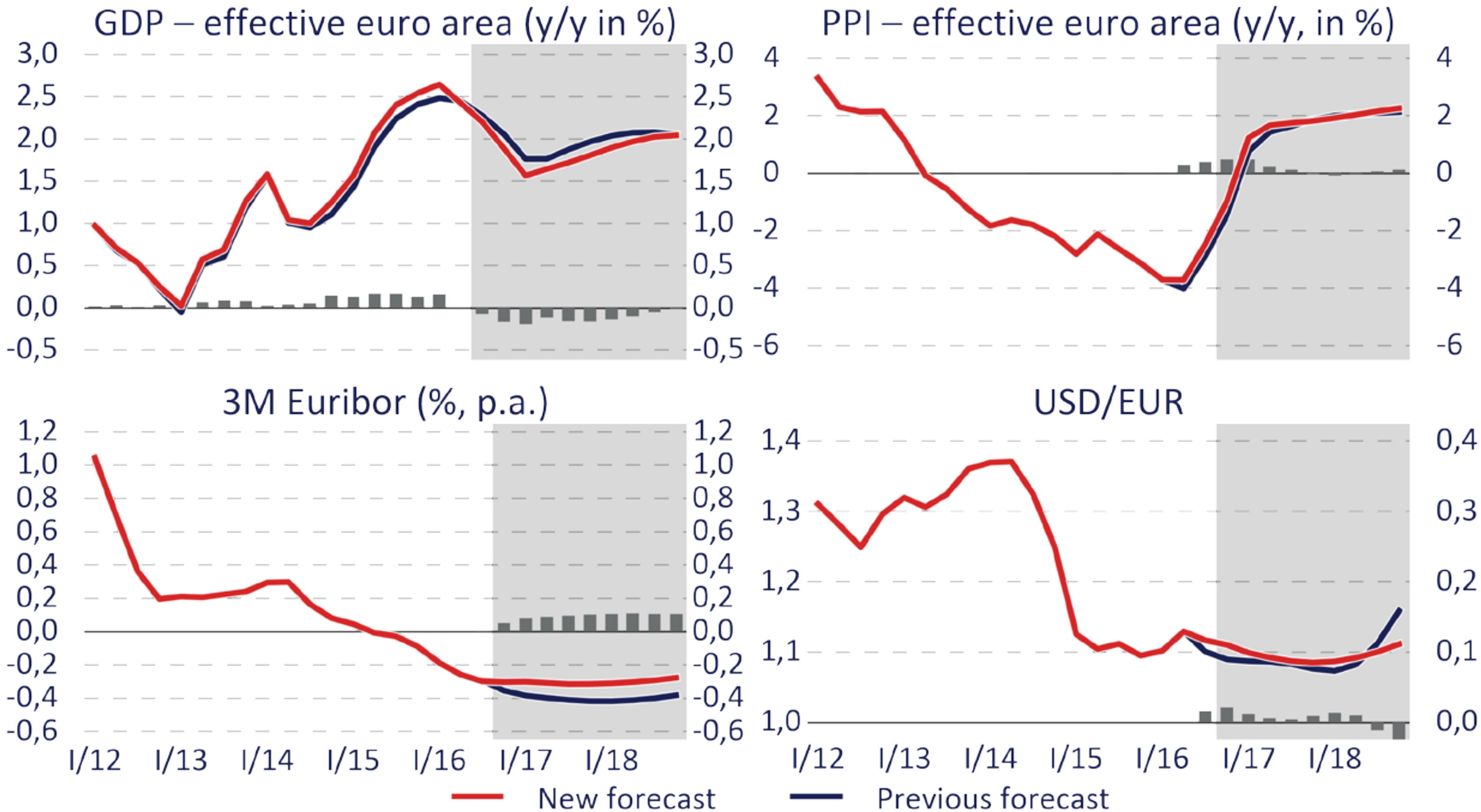
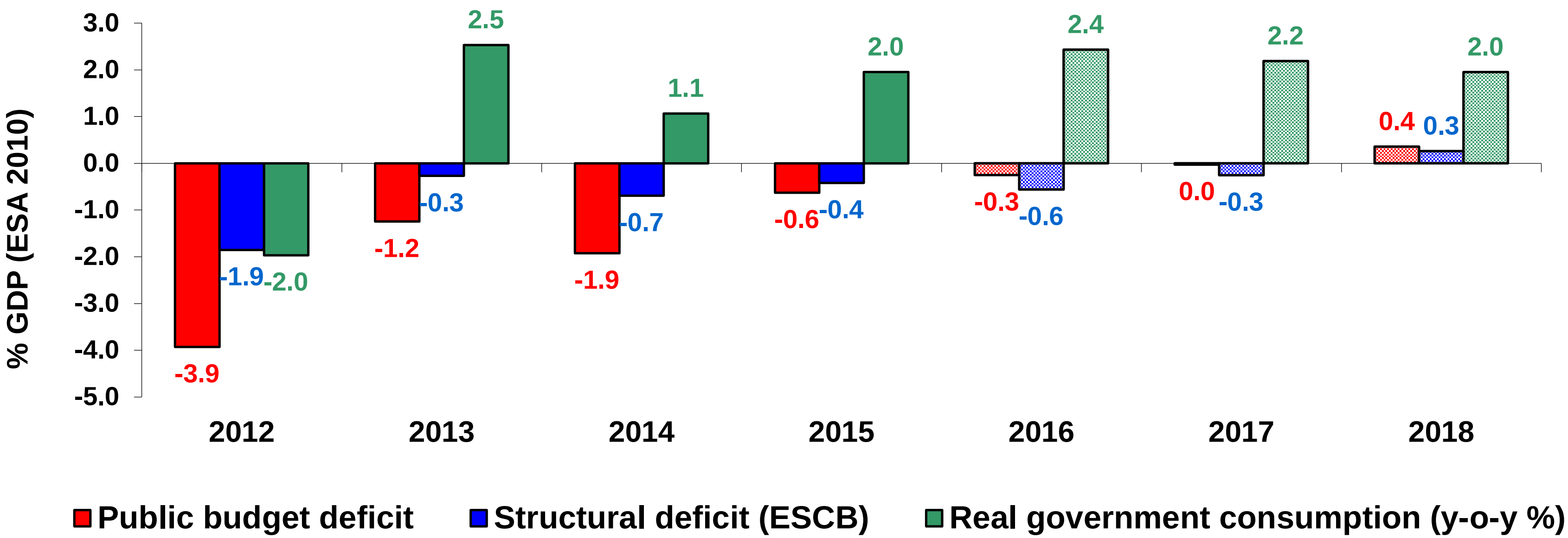


- GDP growth will slow down next year owing to the impacts of Brexit vote on sentiment. In 2018, growth in the effective euro area will return to about 2%.
- Producer prices are expected to return to annual growth at the start of next year.
- ECB's monetary policy remains easy (QE assumed till March 2017). The outlook for 3M EURIBOR is negative, the euro is expected to depreciate slightly in 2017.

Fiscal Policy



- A balanced general government budget can be expected in 2017, due mainly to continued favourable economic growth, introduction of electronic sales registration and a further increase in excise duty on tobacco products. In 2018, the general government budget will post a surplus.
- In structural terms, the budget will switch to a moderate surplus, too.
- Government consumption growth will be above 2% in 2016-2017 in real terms (and visibly more in nominal terms) due mainly to a sizeable increase in compensation of government employees and health care expenditure. In the (post-election) year 2018, it is expected to slow down slightly to 2%.

Fiscal Impulse

Contributions to GDP growth in percentage points	2015	2016	2017	2018
	actual	forecast	forecast	forecast
Fiscal impulse	0.8	-0.7	0.2	0.0
of which impact through:				
private consumption	0.2	0.0	0.0	-0.1
private investment	0.1	-0.1	-0.1	0.0
government investment, domestic	0.1	0.0	0.1	0.0
government investment, EU funded	0.4	-0.6	0.2	0.1

- Fiscal policy is having a significantly restrictive effect overall this year, making a contribution to economic growth of around -0.7 percentage point, primarily due to the decrease in government investment co-financed from EU funds.
- In 2017, the forecast assumes that the effect of fiscal policy on economic growth will be marginally positive, beyond continued growth of government consumption. This will reflect a recovery in government investment.
- In 2018, the effect of fiscal policy will be roughly neutral.

Monetary Policy

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- 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 until mid-2017.
- Sustainable fulfilment of the 2% inflation target, which is a condition for a return to conventional monetary policy, will occur from mid-2017 onwards.
- Consistent with the forecast is an increase in market interest rates thereafter.
- According to the forecast, the koruna will appreciate against the euro in the second half of 2017, and also slightly in 2018, due to:
  - a positive interest rate differential against the euro;
  - repercussions of the ECB’s quantitative easing (assumed to last until March 2017);
  - renewed – although much slower than in the pre-crisis period – real convergence of the Czech economy to the advanced euro area countries.
- But the exit should not result in the exchange rate appreciating sharply to the slightly overvalued level recorded before the CNB started intervening:
  - pass-through of the weaker exchange rate to nominal variables;
  - ”missing counterparty“ market situation and readiness of CNB to use foreign exchange interventions (not taken into account in the forecast).

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Summary of the New Forecast

- Both headline and monetary policy-relevant inflation increased slightly in 2016 Q3, but stayed well below the CNB's target. However, they will increase further and slightly exceed the 2% target at the monetary policy horizon.

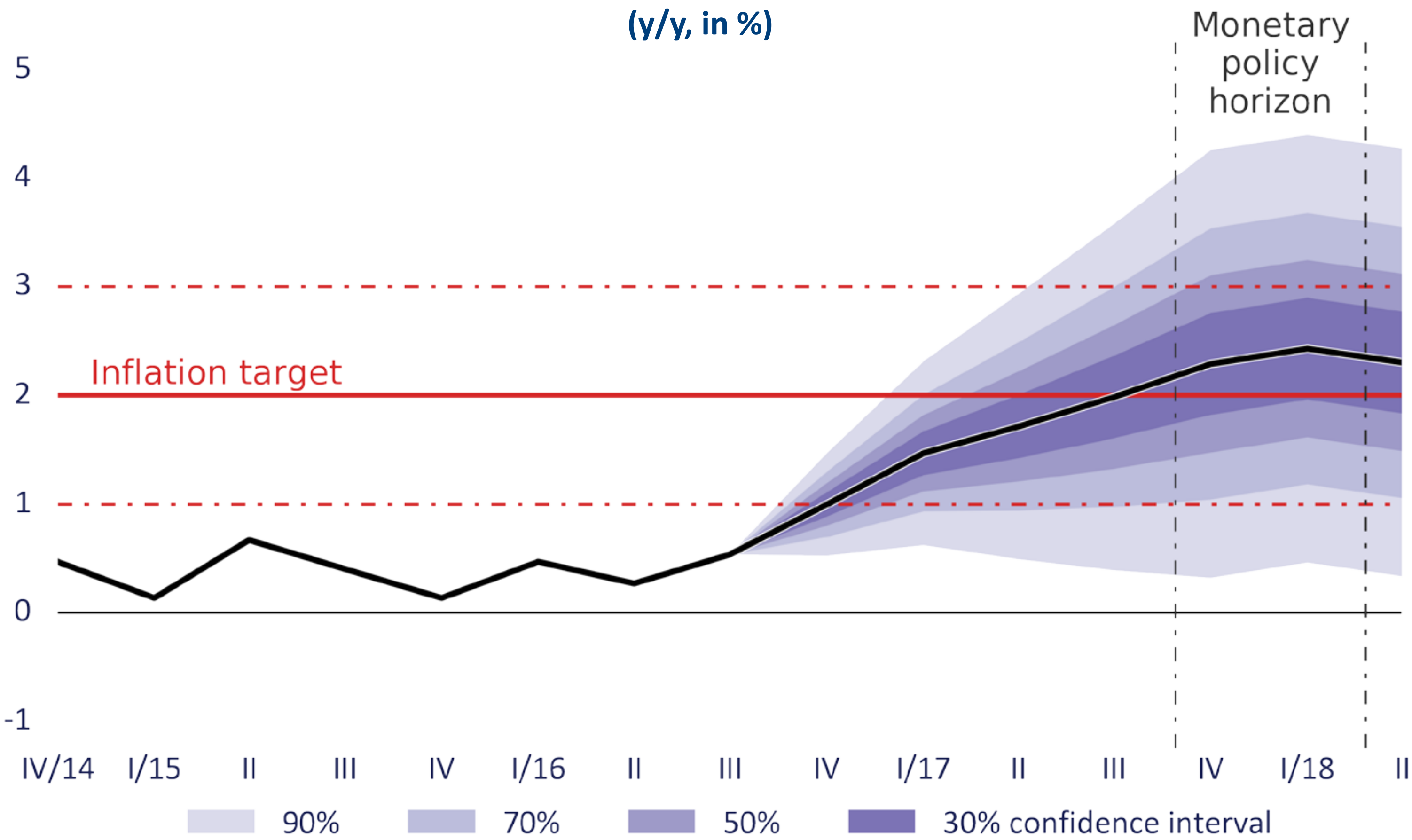
- The growth of the Czech economy has slowed as a result of a temporary drop in investment co-financed from EU funds, and will reach 2.8% in 2016 as a whole.

- GDP will continue growing at similar pace in the next two years. Growth in investment will resume, but a temporary slowdown in external demand and later also less easy monetary conditions following the discontinuation of the CNB's exchange rate commitment will act in the opposite direction.

- The continued economic growth will lead to higher wage growth amid an already only slightly decreasing unemployment rate. The domestic economy will thus continue to foster higher costs and hence also higher consumer prices.

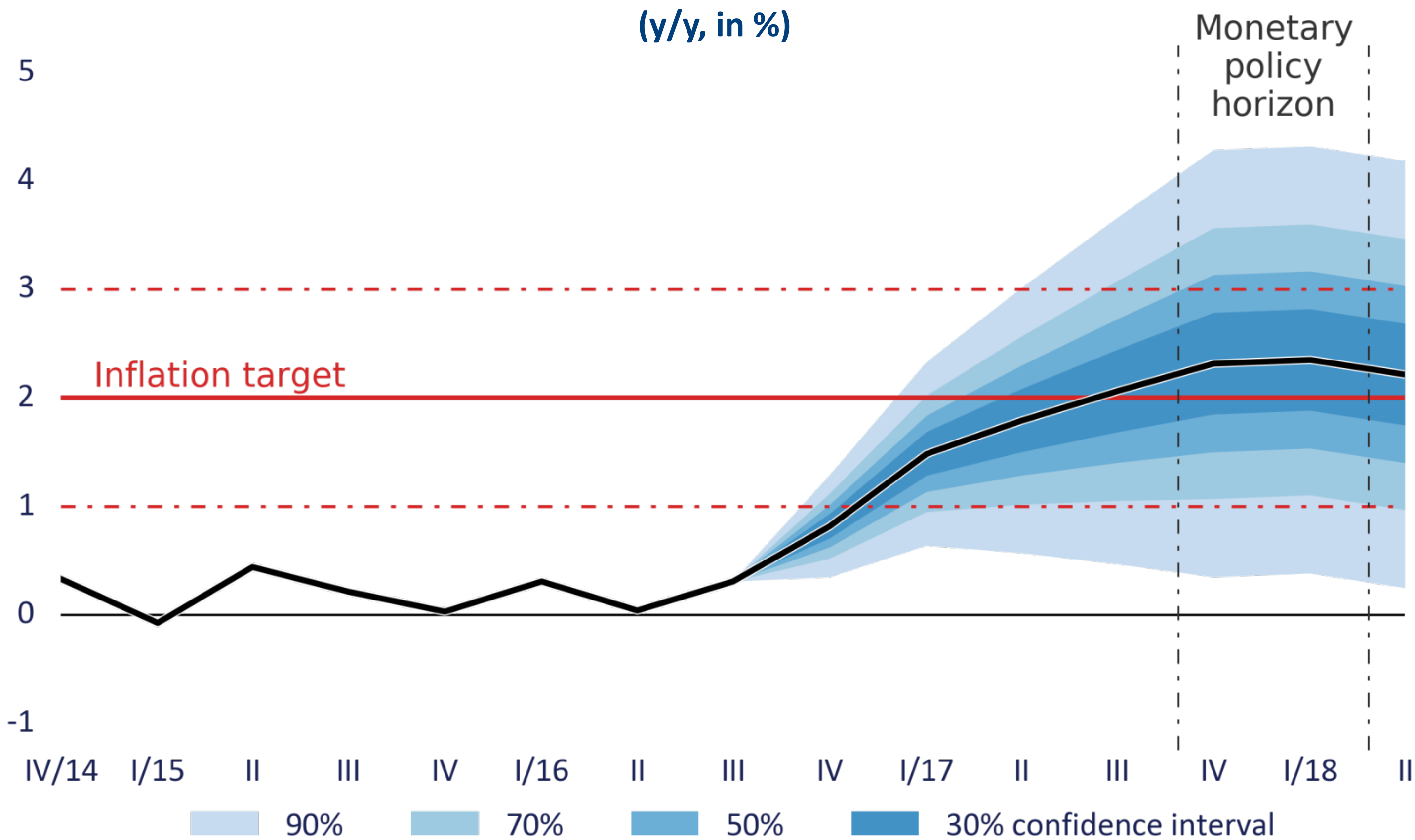
- The – already fading – anti-inflationary effect of import prices, stemming from a fall in industrial producer prices in the euro area, will fully disappear.

Headline Inflation



- Annual headline inflation accelerated slightly to 0.5% in 2016 Q3 and will continue to rise further in the period ahead.
- Inflation will exceed the 2% target at the monetary policy horizon.
- During 2018, it will return to the target from above.

Monetary Policy-Relevant Inflation



- Monetary policy-relevant inflation was 0.3% on average in 2016 Q3. It thus stayed well below the CNB's 2% target.
- Over the forecast horizon, it will differ only marginally from headline inflation. It, too, will therefore slightly exceed the target at the monetary policy horizon.

Structure of Inflation

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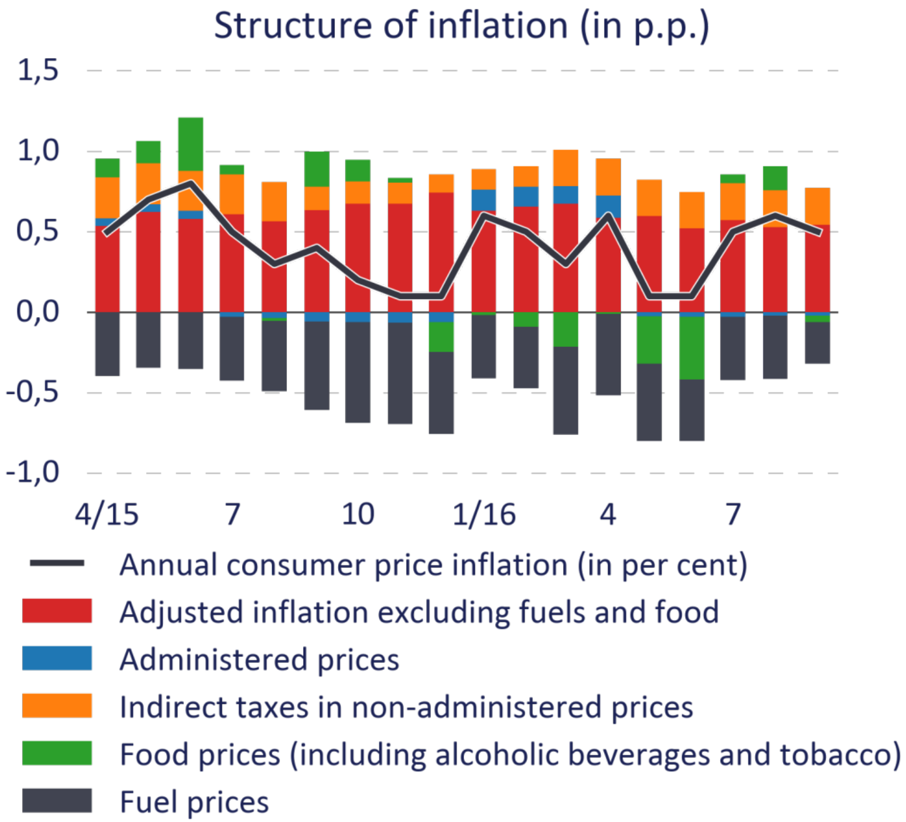
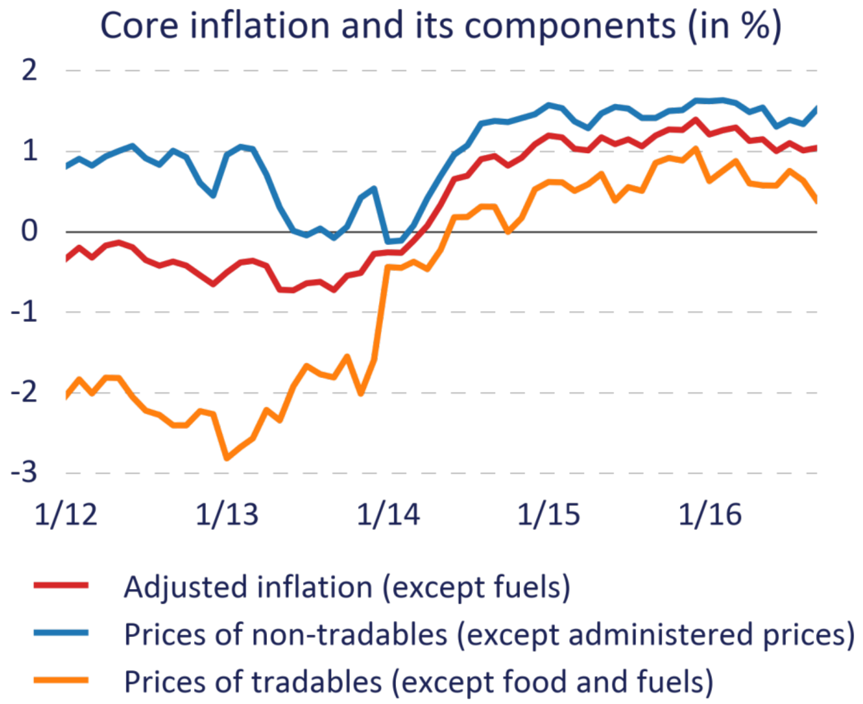
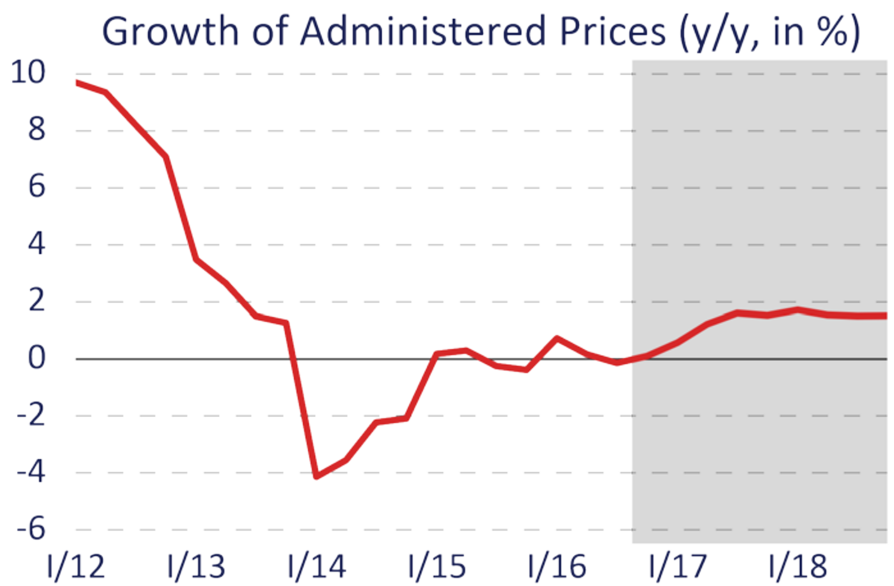
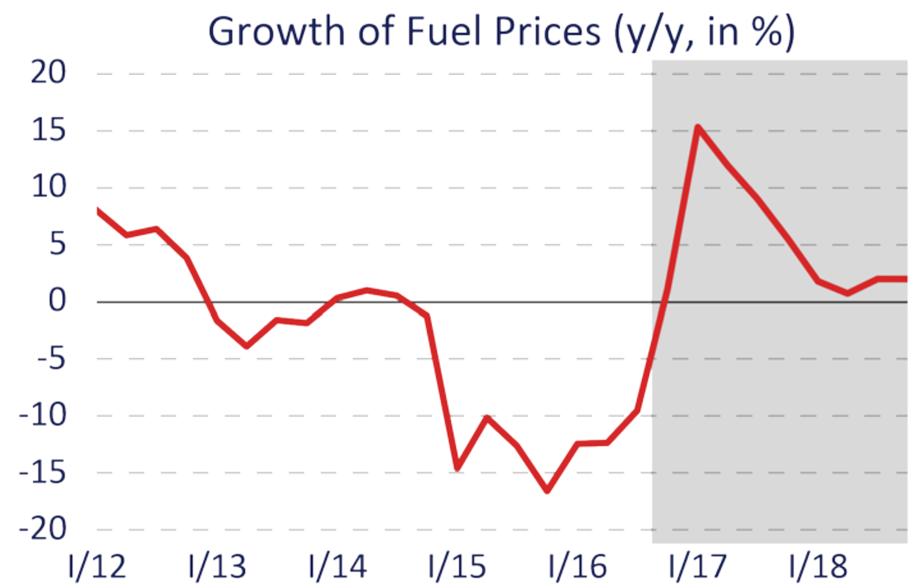




- The anti-inflationary effect of import prices, including oil, has started to unwind. The same holds for the food prices, too, although their development is not smooth.
- Core inflation remained stable in 2016 Q3, averaging 1.1%. Growth in non-tradables prices accelerated somewhat, while growth in tradables moderated.

Administered and Fuel Prices





- Administered prices fell slightly year on year in 2016 Q3 due to a decrease in gas prices for households. They will rise by 1.2% on average next year and by 1.6% in 2018. This will be due to renewed growth in natural gas prices owing to expected growth in prices on world markets amid still slightly positive contributions from all other major administered items.
- Fuel prices continued to fall year on year in 2016 Q3, although the decline gradually slowed. Their annual growth should get strongly positive at the beginning of 2017 due to annual growth in global oil and petrol prices (mainly as a result of base effects), but it will weaken later.

Adjusted Inflation Excluding Fuels and Food

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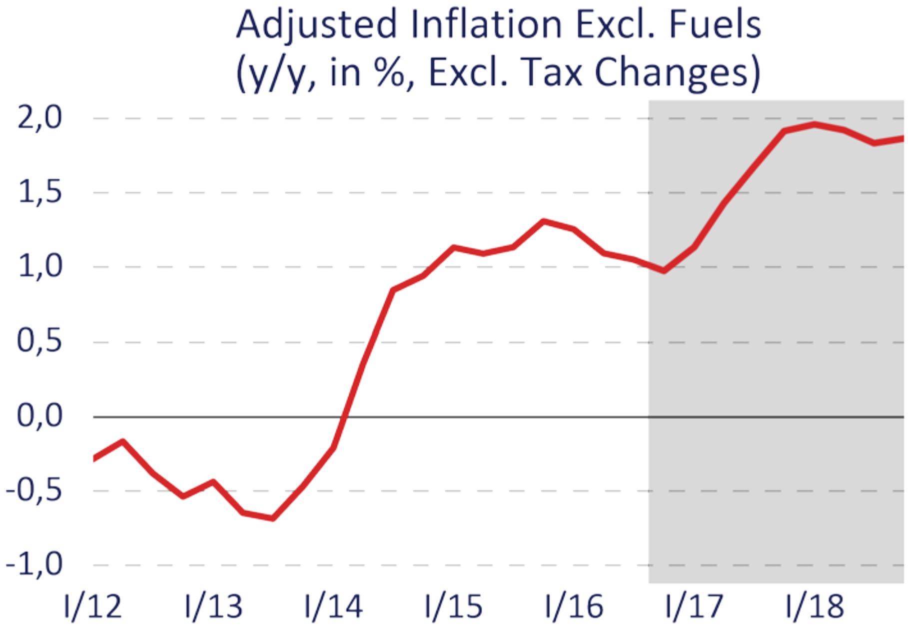
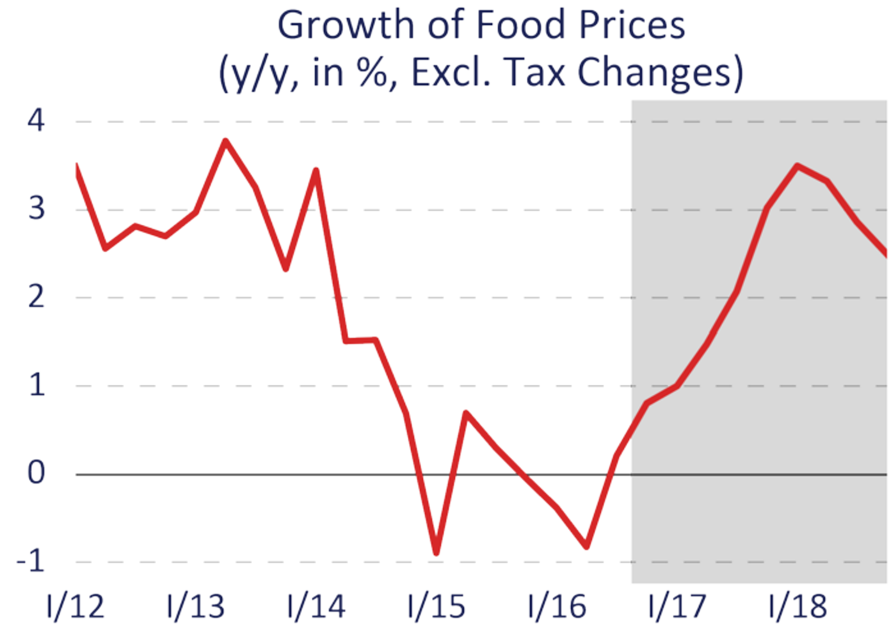
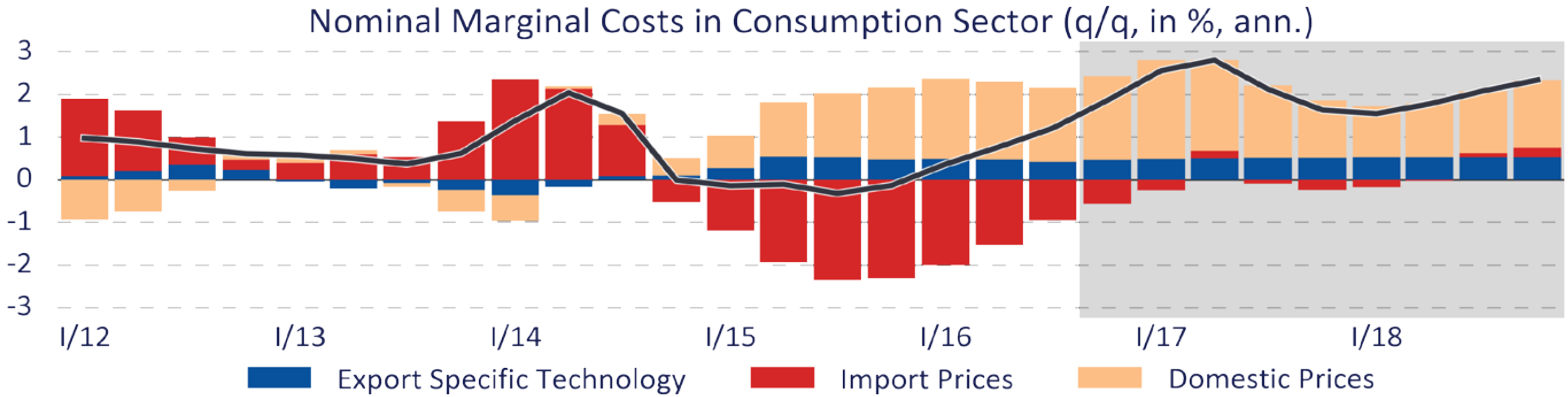
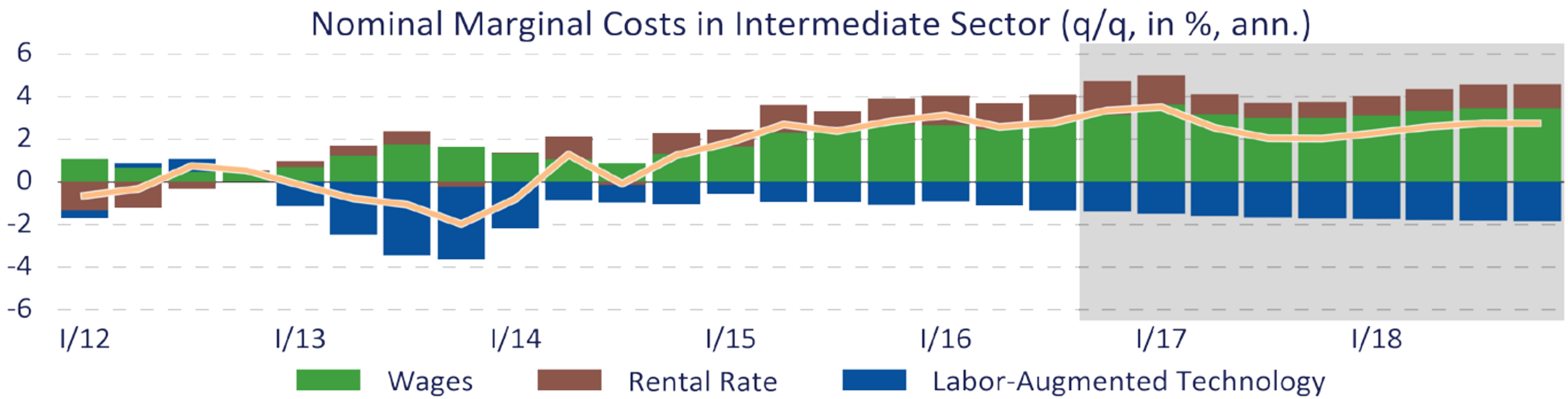




- Core inflation will remain near 1% until the end of this year, but it will start to rise gradually in 2017. In the second half of the year it will thus approach the 2% level, and will stay close to it in 2018.
- As regards food prices, the deep year-on-year declines in meat and milk product prices (caused by Russian embargo and lifting of milk quotas in the EU last year) has started to fade. These factors will disappear in the next few months and the effect of modest growth in agricultural commodity prices and the continuing inflationary effect of the domestic economy will then prevail.

Domestic Costs vs. Import Prices





- The growth of costs in the consumer goods sector has been accelerating since the start of 2016, as the deflationary effect of import prices has gradually been dissipating amid a broadly stable contribution of domestic cost pressures.
- Their growth will peak in mid-2017 due to fading out of the deflationary impact of import prices. After ”the exit“, it will slow down temporarily.

GDP Growth

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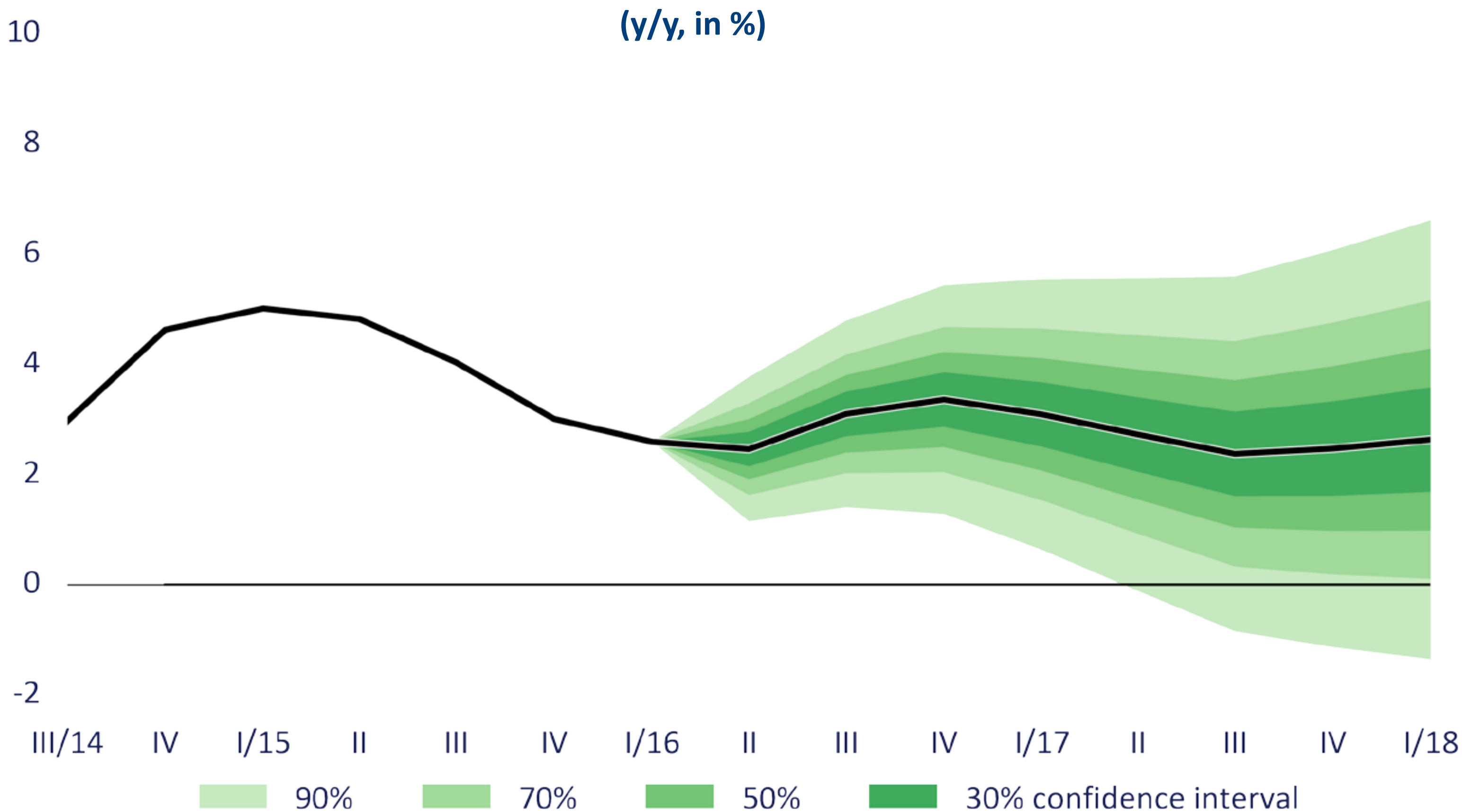
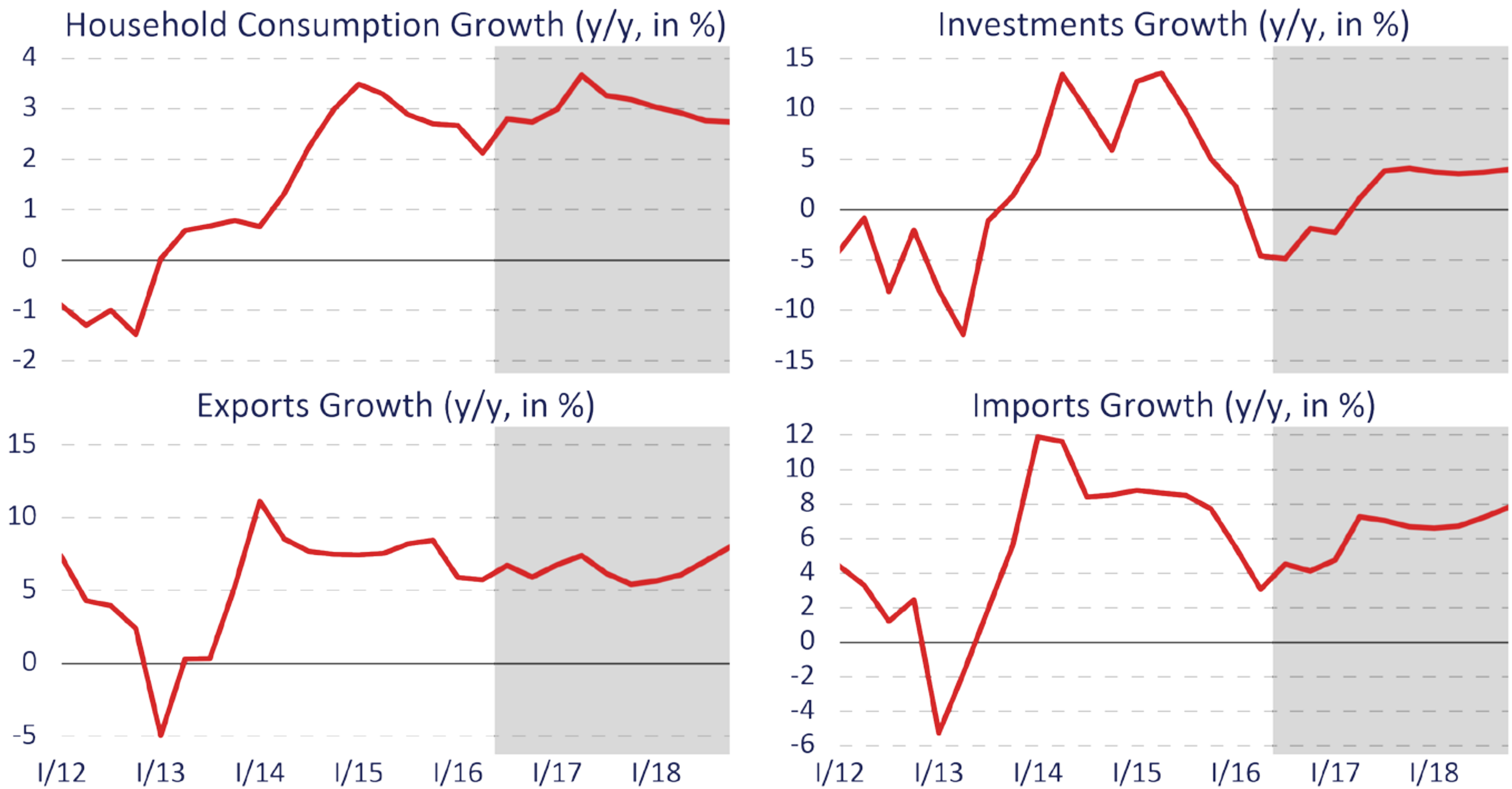


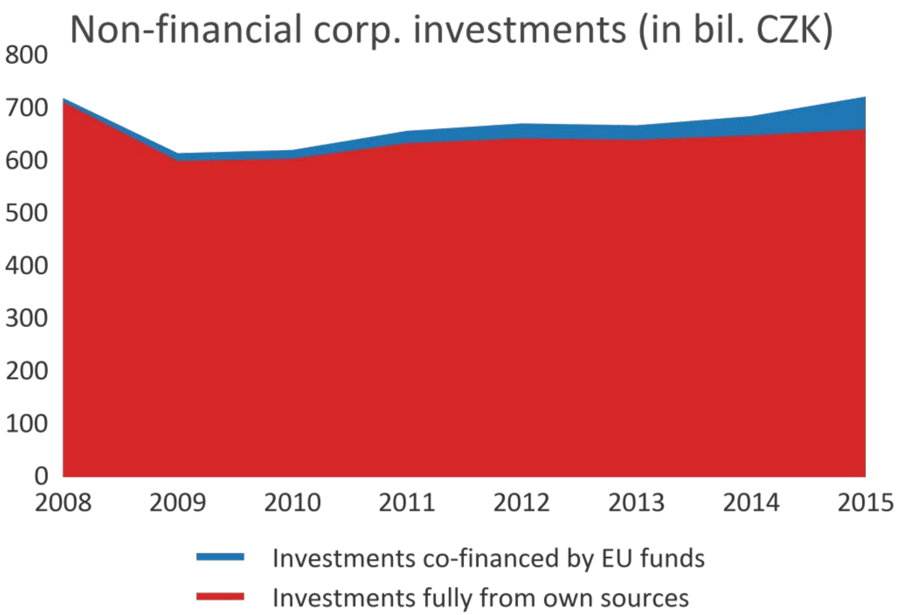
- GDP growth forecast: 2.8% in 2016; 2.9% both in 2017 and 2018.
- The slowdown this year is due to a fall in government investment and a decline in corporate investment as a result of only gradual drawdown of EU funds.
- 2017-2018: growth in investment will resume vs. a temporary slowdown in external demand and later also less easy monetary conditions after "the exit".

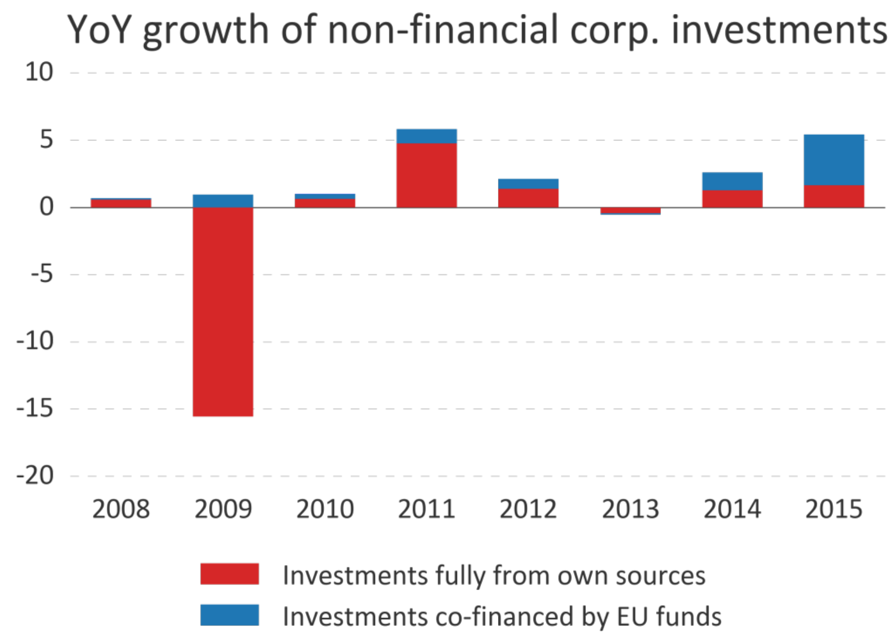
Aggregate Demand



- The slowdown of household consumption in 2Q 2016 is viewed as temporary (working day adjustment); its growth will fluctuate around 3% on average.
- Investment growth will resume in 2017 with accelerated drawdown of EU funds.
- Export growth will be relatively stable, import growth will speed up.

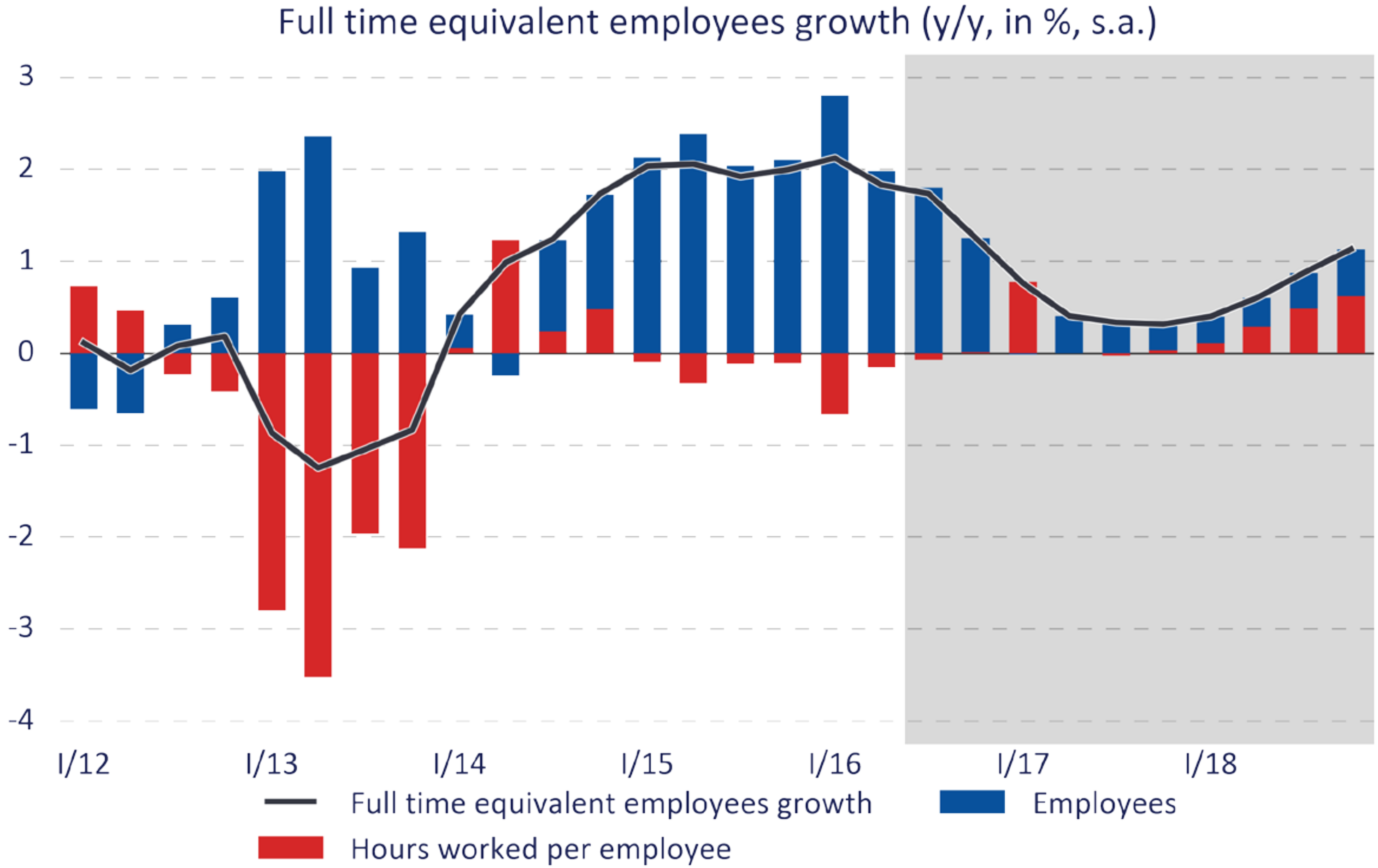
Investment of Nonfinancial Corporations





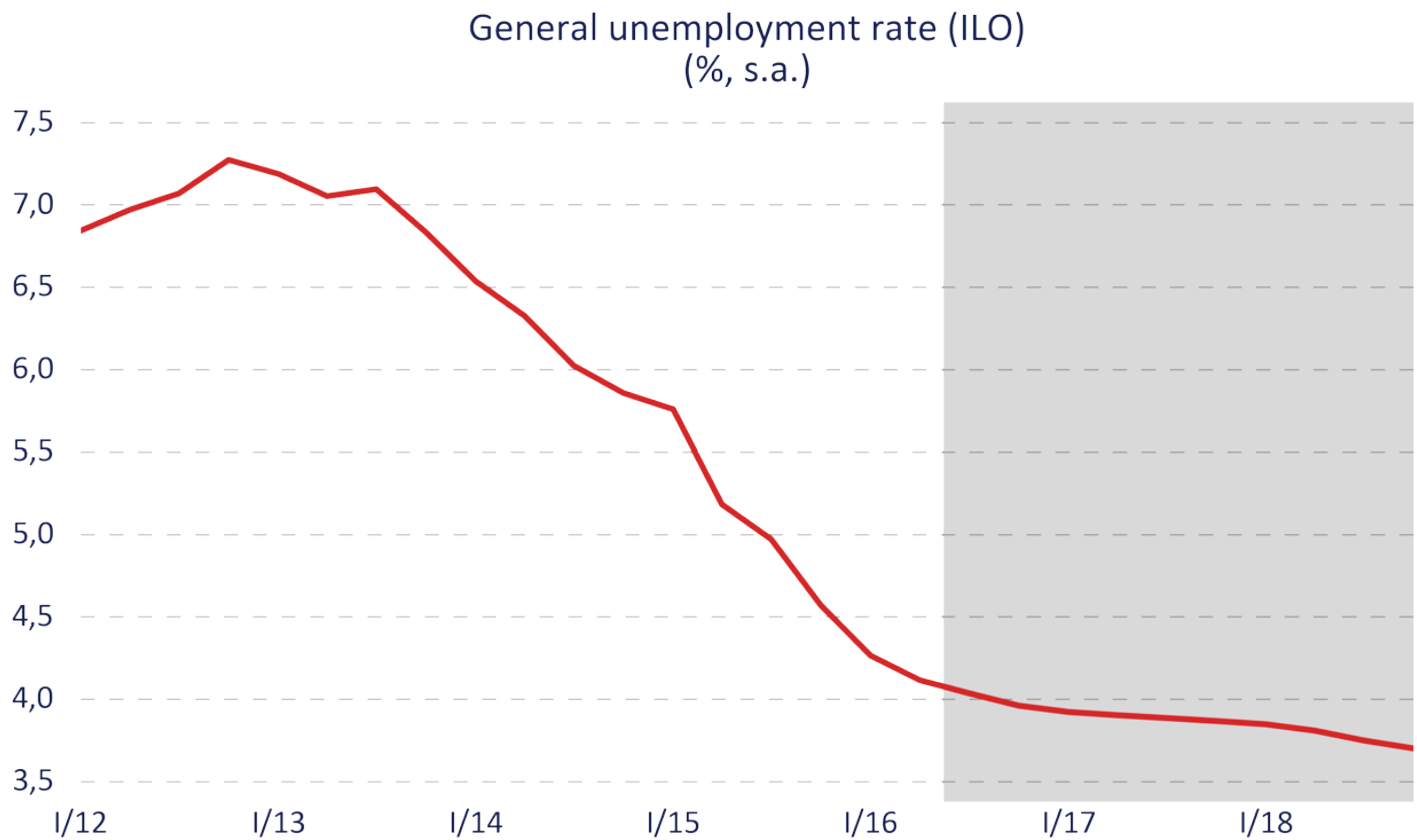
- Investment financed from firms' own resources makes up the dominant part of total investment by non-financial corporations and has been rising steadily. Recently, however, the changes in total investment have been driven to a growing extent by investment co-financed from EU structural funds.
- As regards the annual growth in investment by non-financial corporations, the contribution of investment co-financed from EU funds was particularly dominant in 2015.

Labour Market: Employment



- Year-on-year growth in the number of employees converted into full-time equivalents will gradually slacken in the coming quarters.
- This will reflect already relatively tight labour market conditions in addition to an unwinding of the effect of the employment surge observed in early 2016.

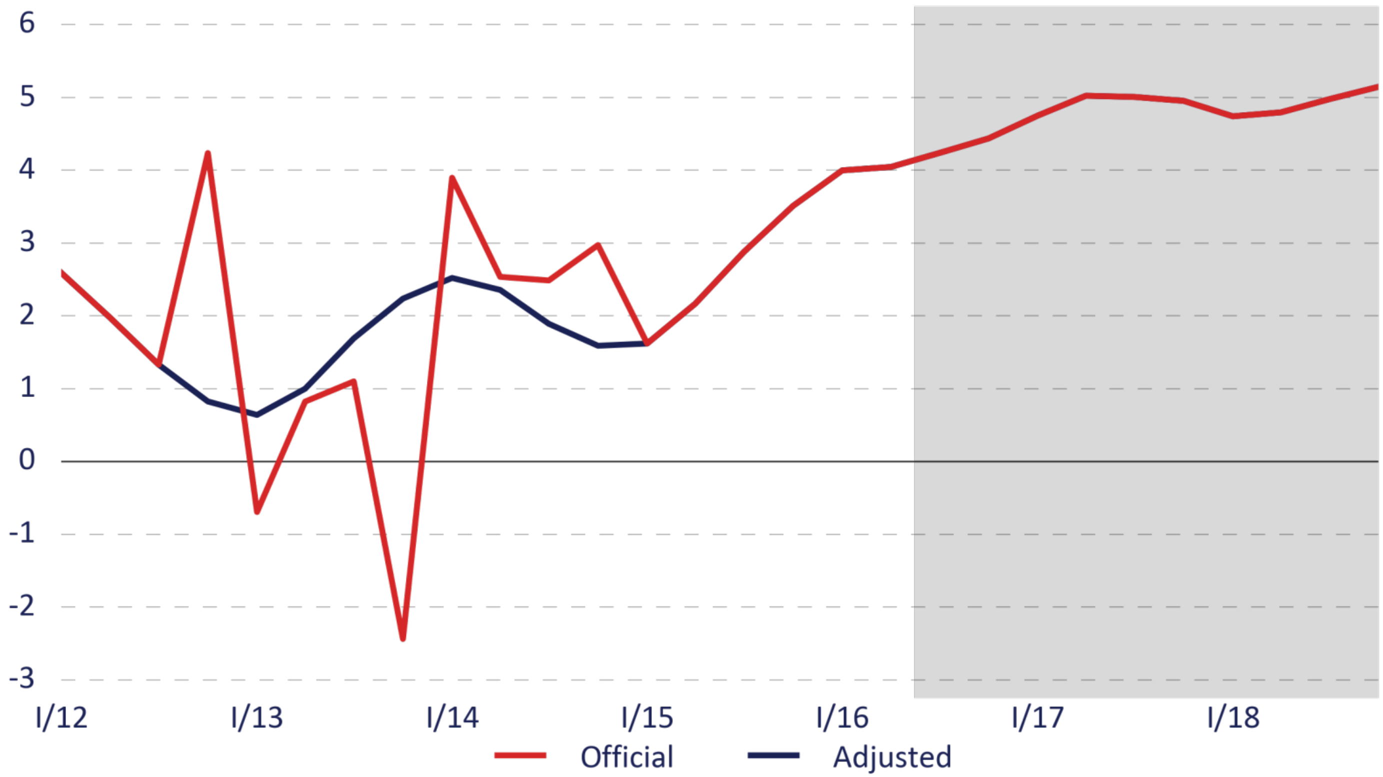
Labour Market: Unemployment



- The general unemployment rate will decrease only gradually over the rest of this year. In addition to slowing growth in employment, this reflects a further rise in the labour force. It will be slightly below 4% over the next two years.

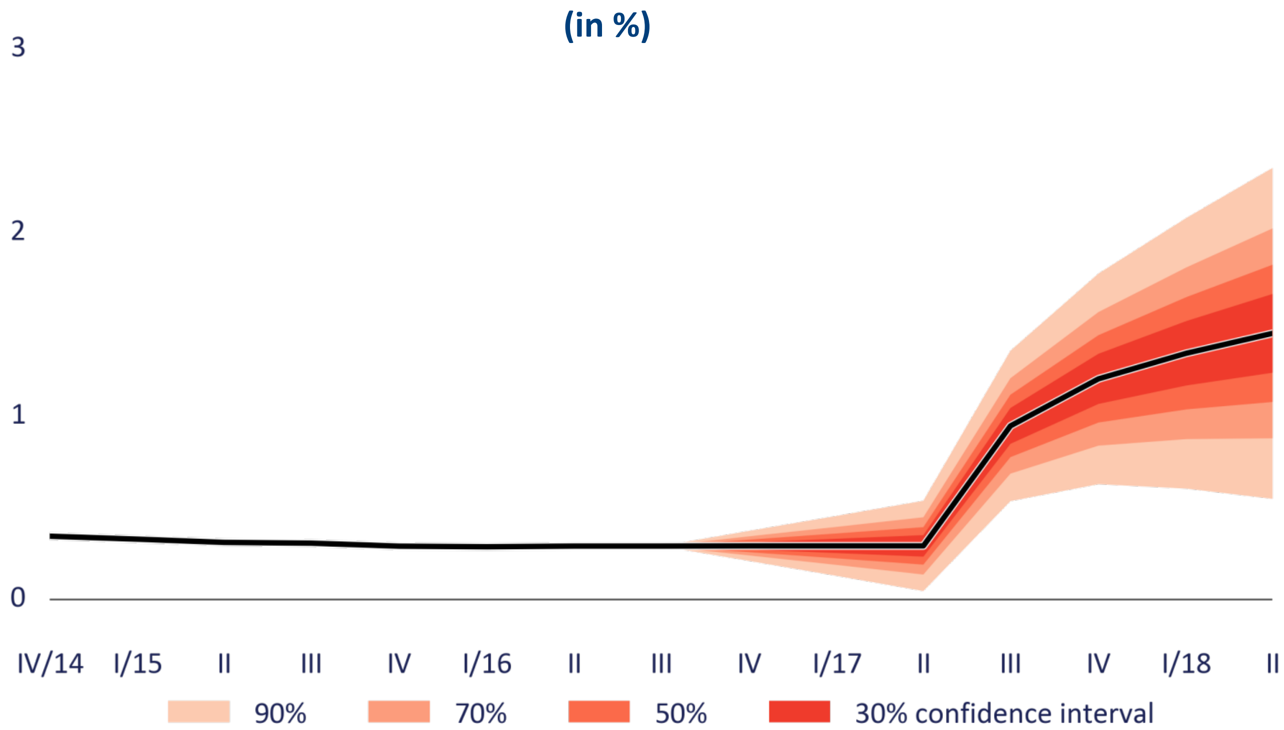
Labour Market: Wage Growth in Business Sector

Nominal wage growth in business sector (y/y, in %, s.a.)



- The forecast expects wage growth in the business sector to increase gradually in the second half of this year, and reach 4.2% in 2016 as a whole.
- Wage growth will continue to pick up to 5% in 2017 on the back of a gradual return of inflation to the target, solid economic growth, an increasing shortage of available labour force and a further increase in the minimum wage.
- Wage growth will also be close to 5% in 2018.

Interest Rate Path (3M PRIBOR)



- The forecast expects short-term market interest rates to be flat at their current very low level until mid-2017.
- 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 the second half of 2017 followed by a further modest rise in 2018.
- The speed of this rise does not reflect any additional MP considerations.

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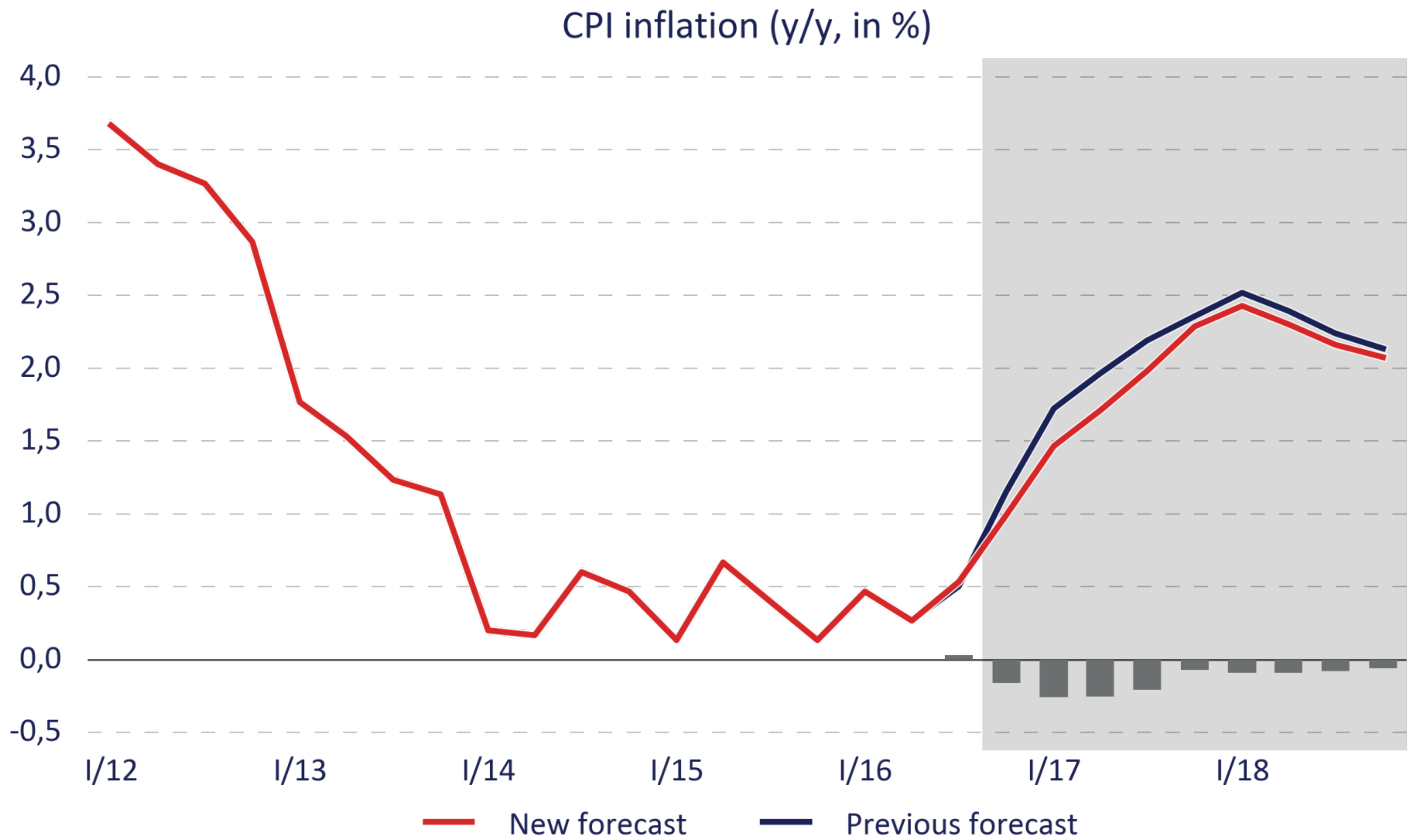
Comparison with Previous Forecast

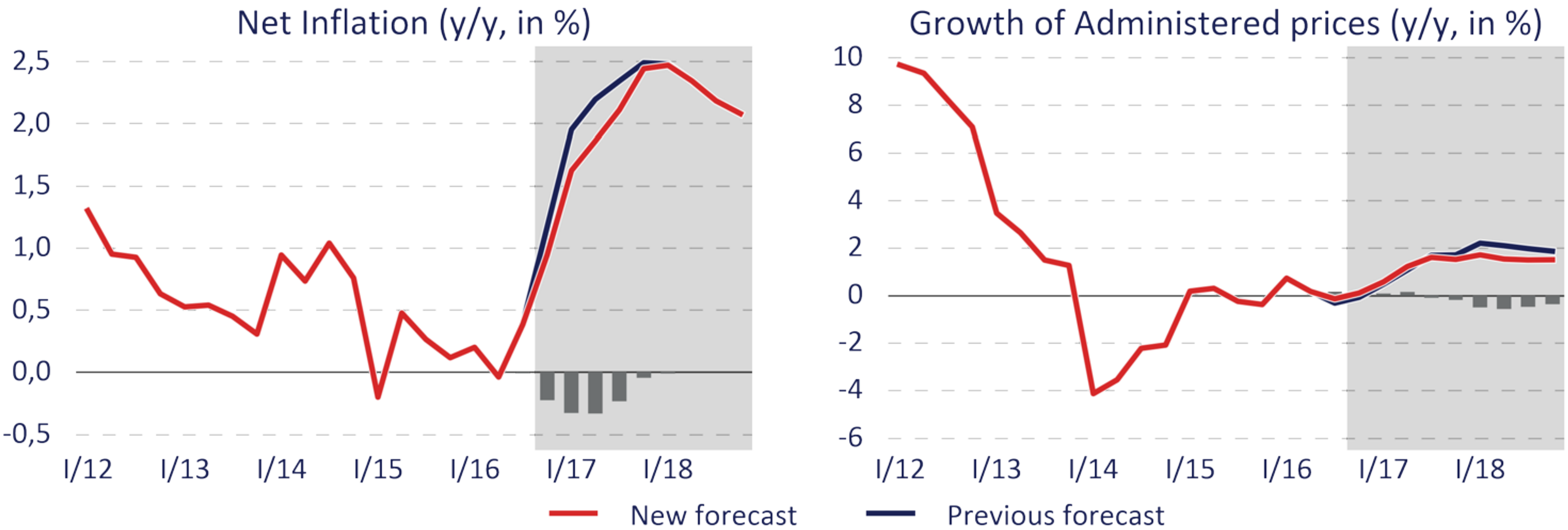
- Overall, changes in the forecast are quite small.
- The forecast for headline inflation is slightly lower. This is due to a moderately lower short-term prediction for net inflation, a lower outlook for administered prices and weaker observed and expected growth in nominal wages.
- GDP growth this year has been revised upwards amid a bigger positive contribution of net exports. By contrast, the GDP forecast for the next two years is slightly lower because of slower growth in external demand and weaker growth in domestic private investment.
- Nominal wage growth in the business sector has shifted moderately downwards until mid-2017.
- 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.

Comparison: Inflation Forecast (i)



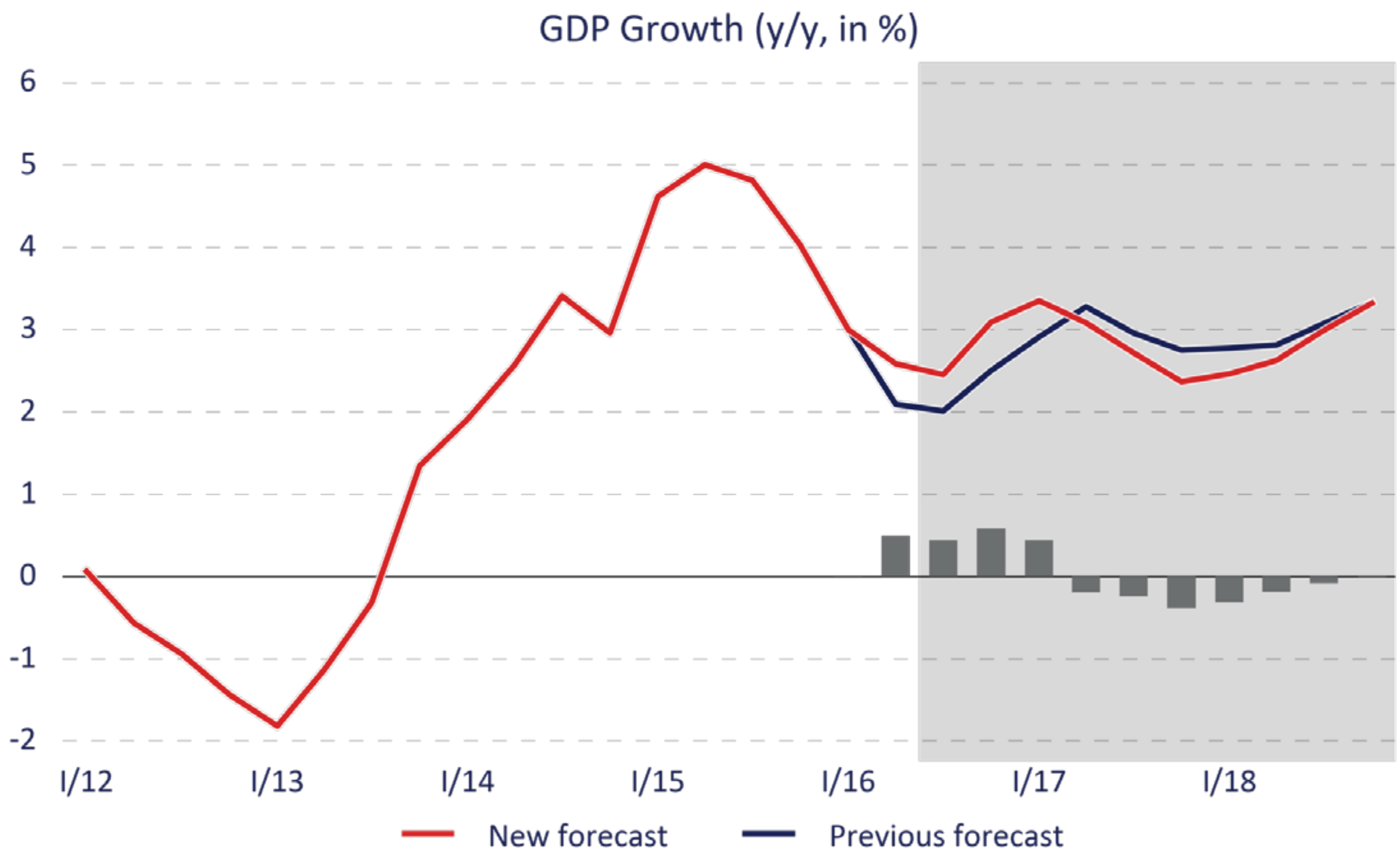
- The forecast for annual headline inflation is slightly lower than the previous one.
- This revision is due to a combination of a lower outlook for net inflation until the end of next year and a lower outlook for administered prices as from mid-2017.

Comparison: Inflation Forecast (ii)



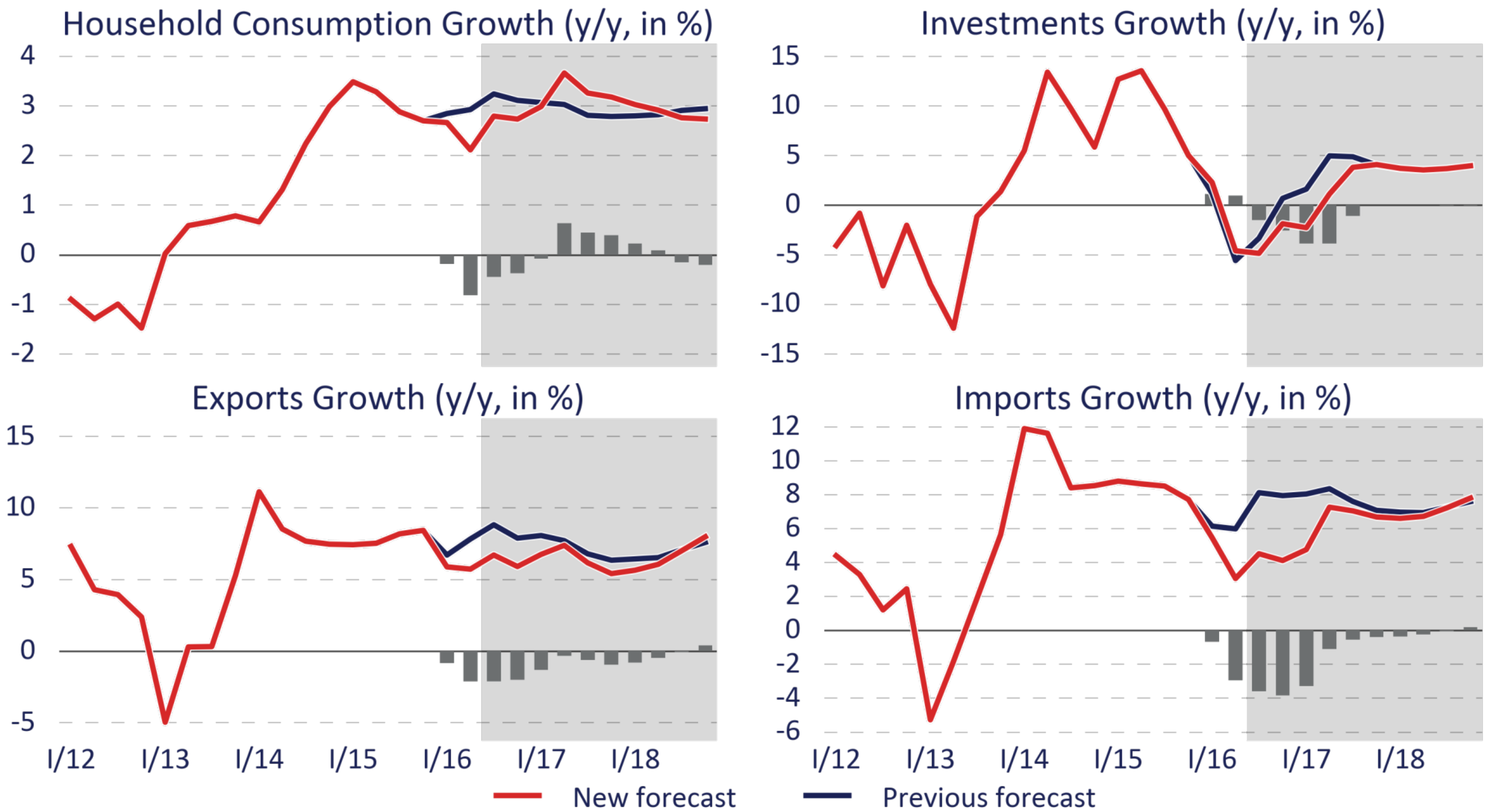
- The net inflation forecast is affected in the short run by leading indicators suggesting weaker growth in food prices. The forecast of core inflation is also lower for the next several quarters, amid less pronounced cost pressures resulting from slower wage growth in 2016.
- The outlook for administered prices in 2016 has been revised slightly upwards, mainly due to a smaller-than-expected reduction in prices of natural gas. By contrast, their outlook for the next two years has shifted downwards slightly due to a less pronounced expected increase in gas and electricity prices.

Comparison: GDP Forecast (i)



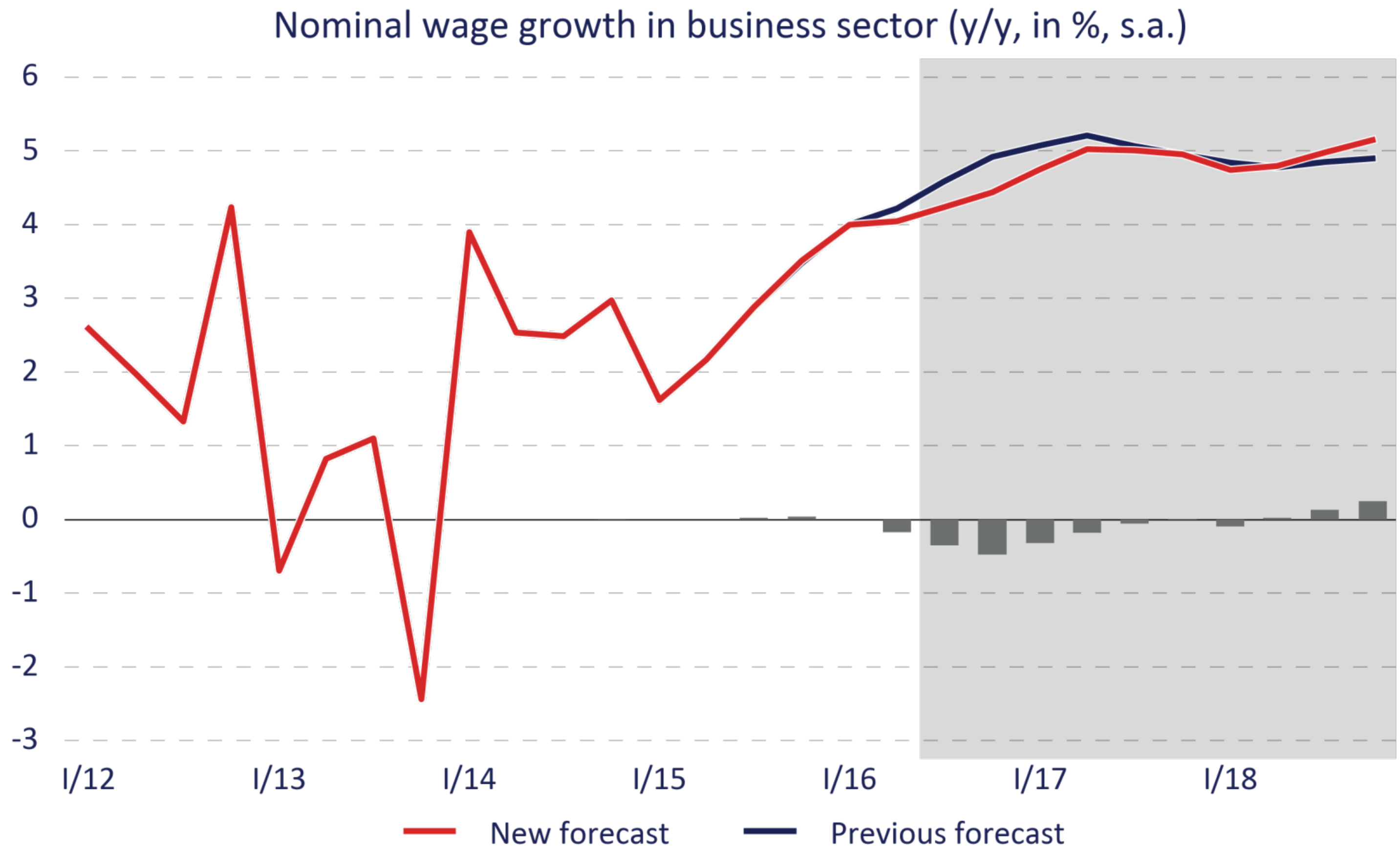
- The forecast for GDP growth this year is slightly higher owing to higher-than-expected data for 2016 Q2, in particular a stronger contribution of net exports.
- By contrast, the GDP forecast for 2017 and 2018 is slightly lower, mainly because of slightly lower external demand (the effect of the future Brexit).

Comparison: GDP Forecast (ii)



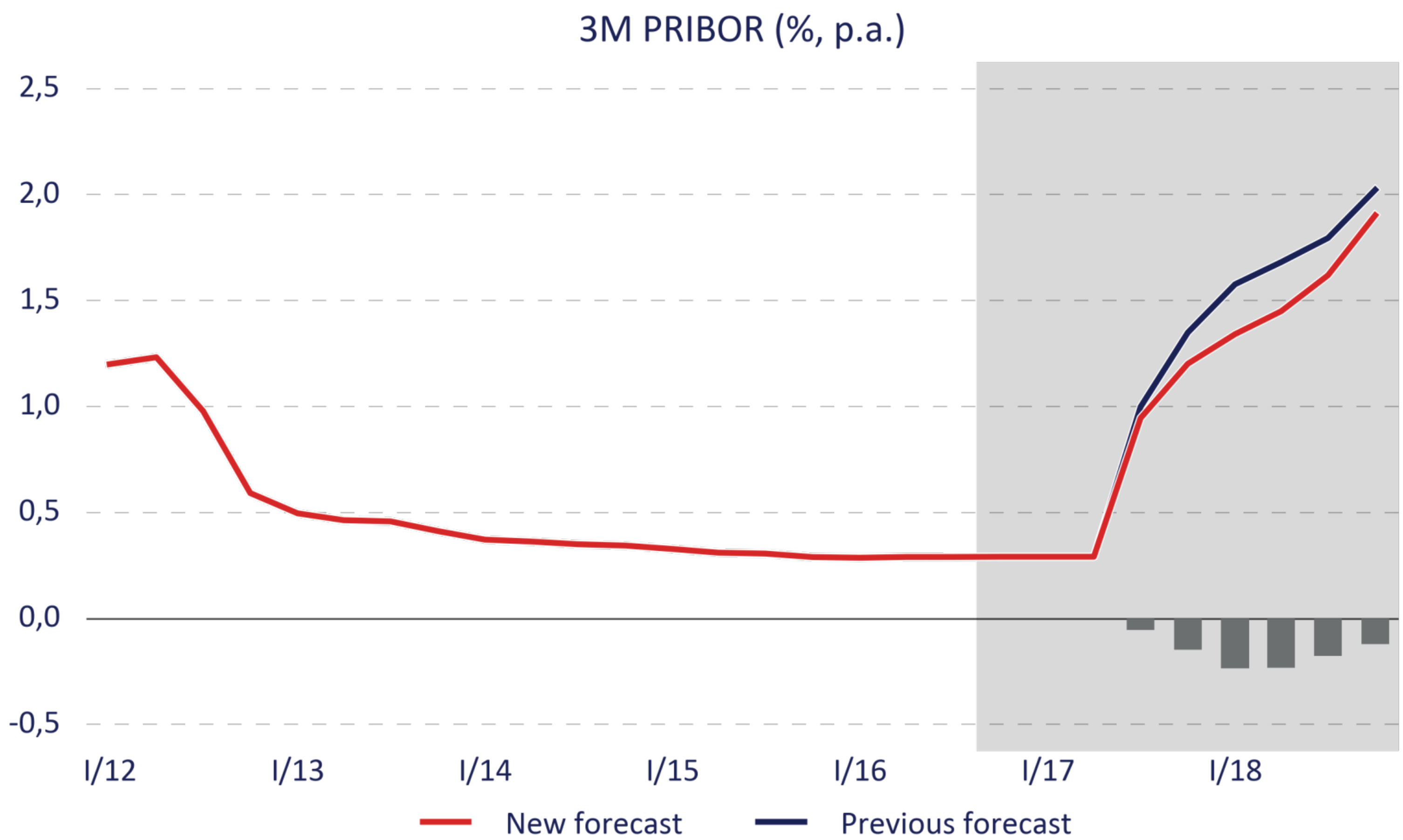
- The outlook for household consumption is lower this year owing to a short-term swing in 2016 Q2, which will be offset next year by base effects.
- It will take more time for the investment growth to recover (impact of EU funds not only on government, but also on corporate fixed investment).

Comparison: Nominal Wage Forecast



- Compared to the previous forecast, wage growth is moderately lower over the next a few quarters. This mainly reflects the less pronounced wage growth in 2016 H1.
- From the beginning of 2017, the forecast newly incorporates a government-approved hike in the minimum wage as of January 2017.

Comparison: Interest Rate Path



- As in the previous forecast, domestic market interest rates will remain stable until mid-2017.
- Their subsequent increase is slower compared to the previous prediction, reflecting a marginally stronger post-exit exchange rate and lower inflation.

Thank you for your attention!

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