CNB's New Forecast (Inflation Report I/2017)

Meeting with Analysts

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Prague, 3 February 2017

CZECH NATIONAL BANK

Outline

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

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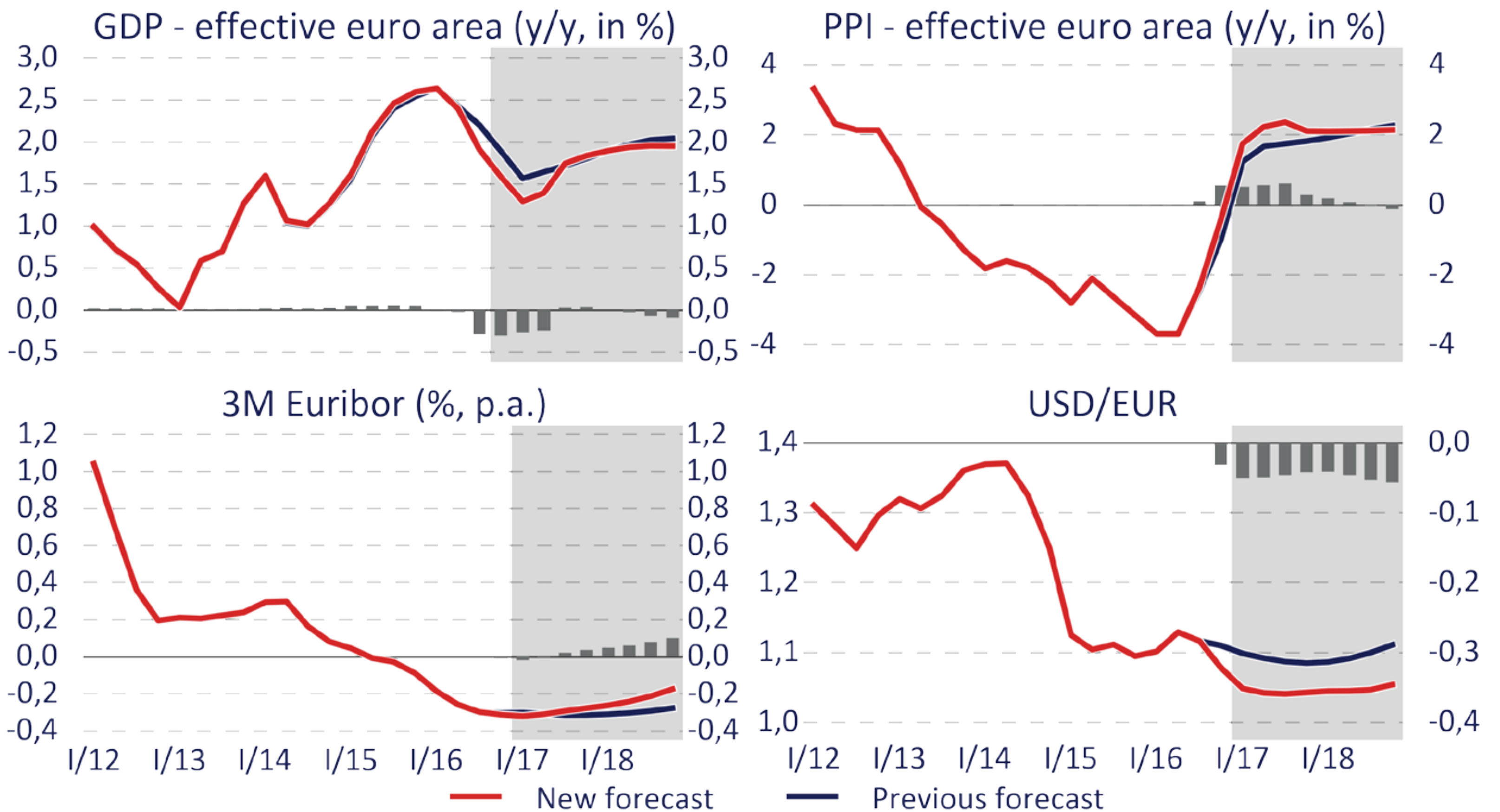
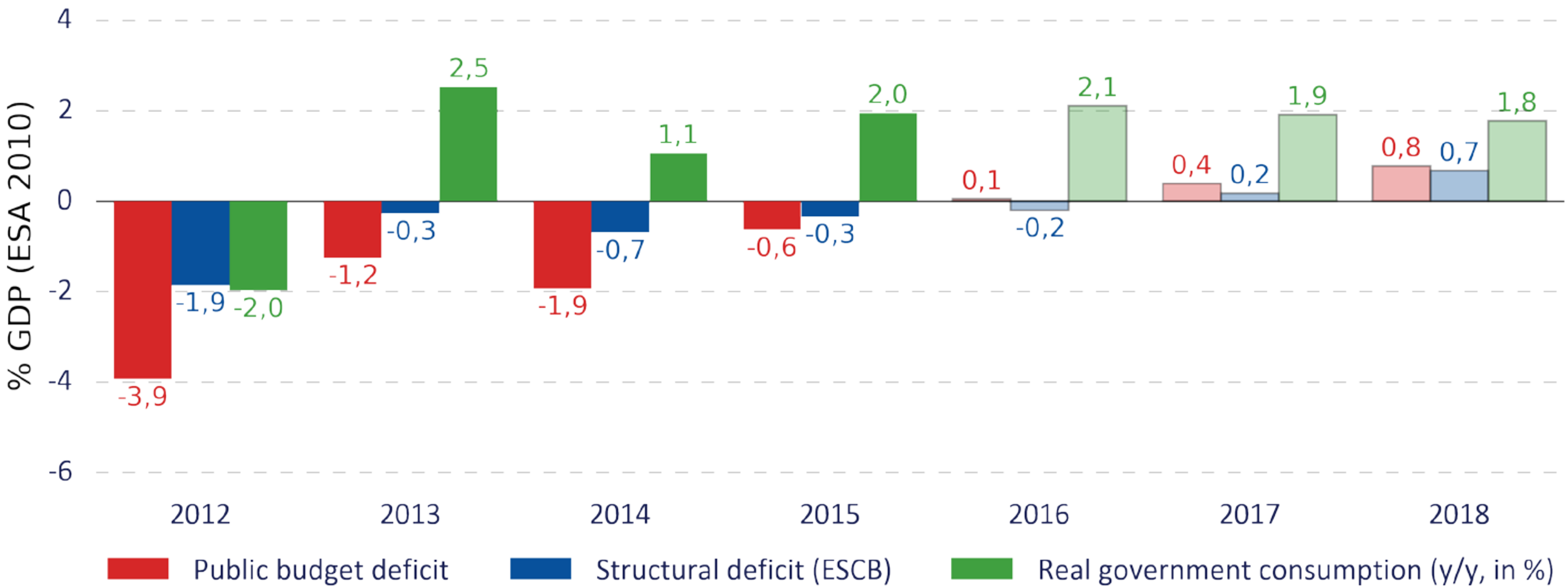
External Environment Outlook



- The growth of external economic activity will slow further at the start of this year and will then return gradually to around 2%.
- The decline in industrial producer prices fades away in early 2017. These prices will then rise at a pace of just over 2%.
- The outlook for 3M EURIBOR and USD/EUR reflects continued easy monetary policy of the ECB.

Fiscal Policy



- The favourable economic developments in 2016 led to a slight general government surplus of 0.1% of GDP according to the CNB‘s estimate.
- The surplus will increase further in the coming two years, mainly due to growing structural balance.
- The government consumption grew by 2.1% in 2016. The forecast expects slightly lower, but still clearly positive, growth in 2017-2018.
- Fiscal impulse will be slightly positive at 0.3% of GDP in 2017, due to a recovery in government investment (mainly co-financed by the EU), and neutral in 2018.

Monetary Policy

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- The forecast assumes that interest rates will be flat at their current very low level and the exchange rate will be used as a policy instrument until mid-2017.

- The conditions for sustainable fulfilment of the 2% inflation target in the future, after the return to conventional MP, will be met from around 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;
  - the effect of the ECB’s quantitative easing;
  - renewed – although much slower than in the pre-crisis period – real convergence of the Czech economy to the advanced euro area countries.

- However, the forecast does not take into account that the appreciation of the koruna may be dampened by:
  - ”missing counterparty“ market situation;
  - possible CNB‘s interventions in the FX market.

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Summary of the New Forecast

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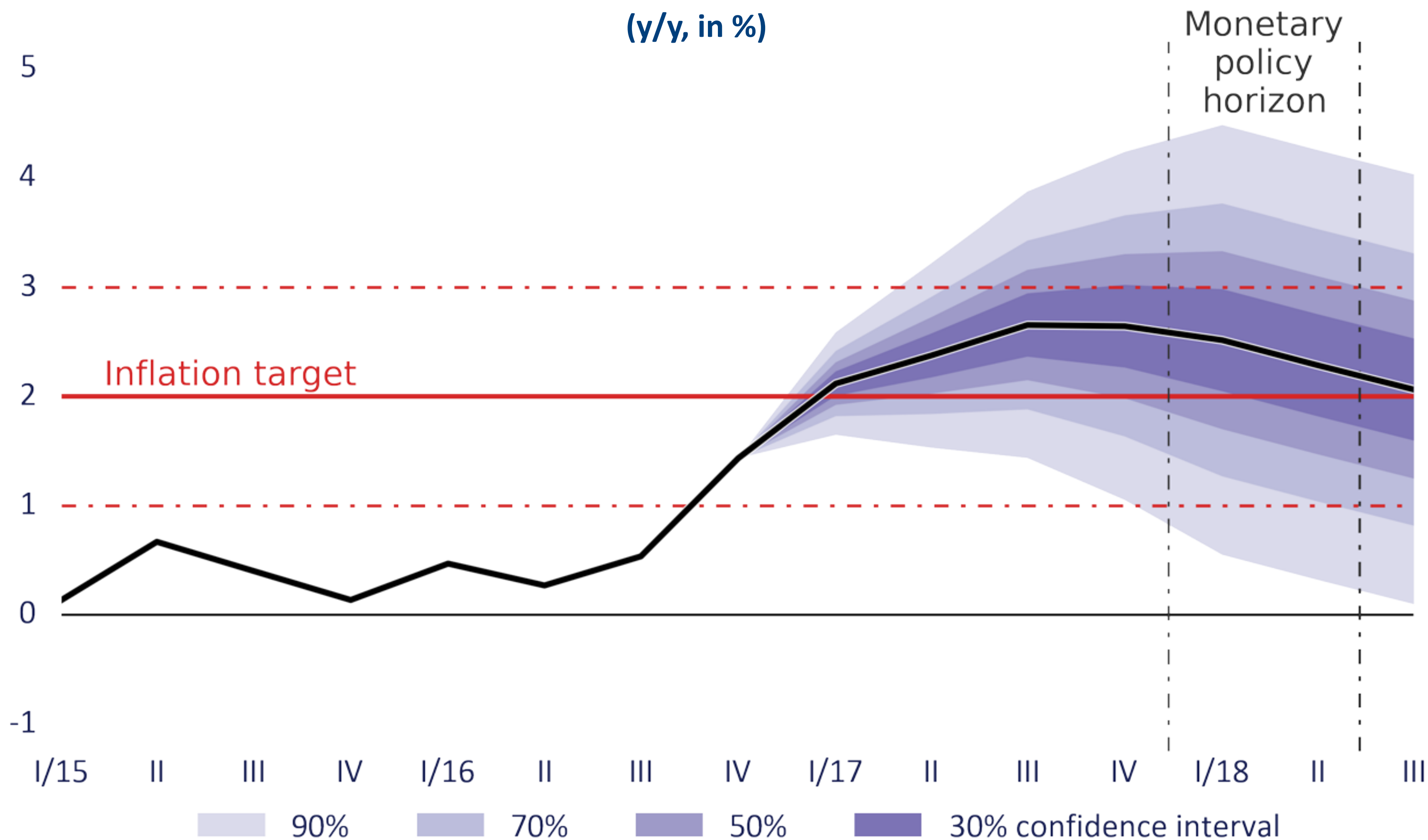
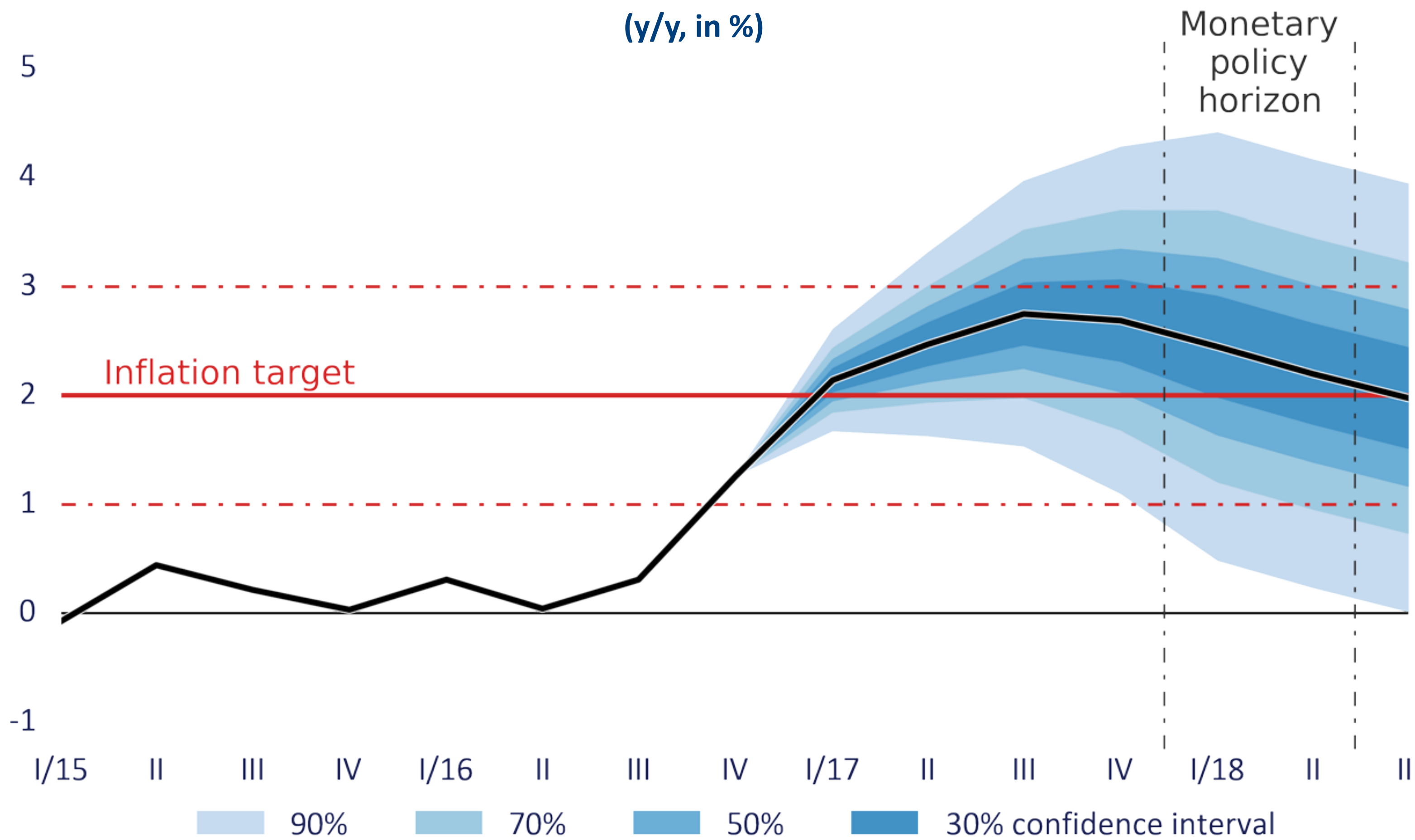
- At the close of 2016, inflation rose sharply and returned to the CNB’s 2% target.
- Both headline and monetary policy-relevant inflation will increase further into the upper half of the tolerance band around the CNB’s target. They will return to the 2% target from above at the monetary policy horizon.
- Growth in consumer prices will be fostered by renewed growth in foreign producer prices and by ongoing growth of the domestic economy and wages.
- Following a temporary slowdown last year, GDP will increase by 2.8% both this year and the next.
- The economy will be supported by renewed growth in government investment co-financed from EU funds, and an acceleration in export growth from its current subdued pace, amid steady growth in household consumption.
- The monetary conditions remain easy and will start to shift towards a neutral effect following the discontinuation of the CNB’s exchange rate commitment.
- The continued economic growth will lead to a further increase in wage growth amid an only slight decrease in the unemployment rate.

Headline Inflation



- In 2016 Q4, inflation rose sharply and returned to the tolerance band around the CNB's target. In December, headline inflation hit the 2% target.
- Inflation will increase further into the upper half of the tolerance band around the CNB's target. It will return to the 2% target from above at the monetary policy horizon.

Monetary Policy-Relevant Inflation



- MP-relevant inflation will differ only marginally from headline inflation.

Structure of Inflation

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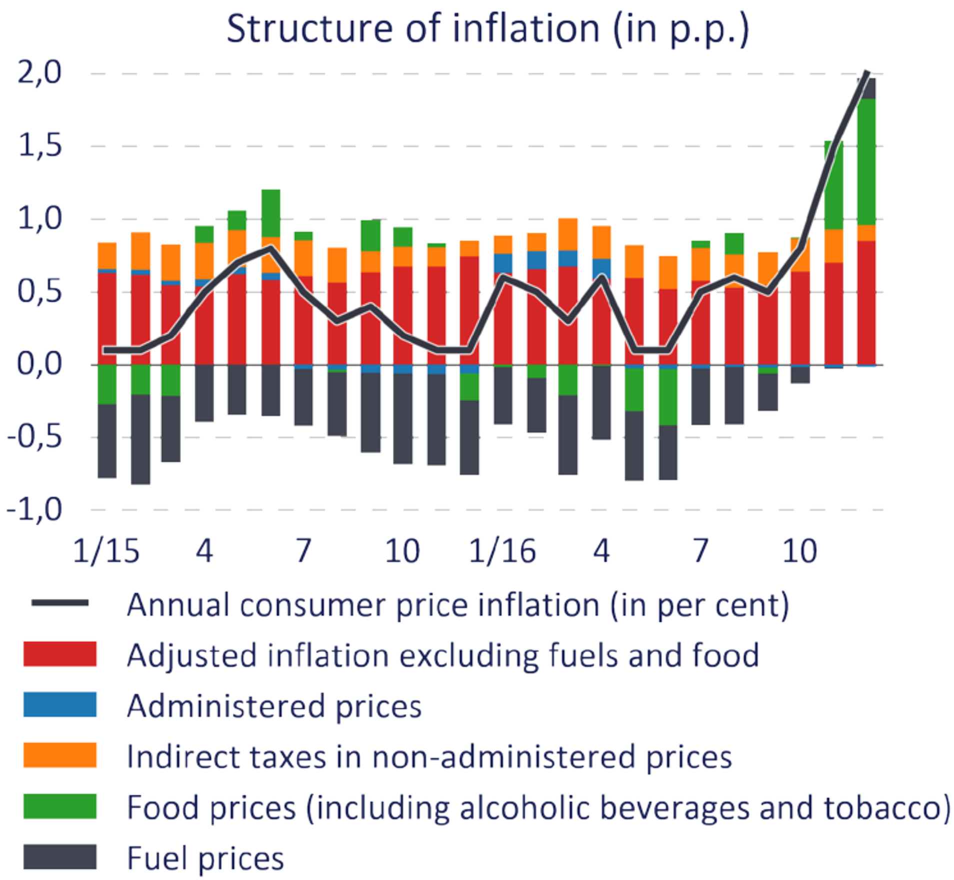
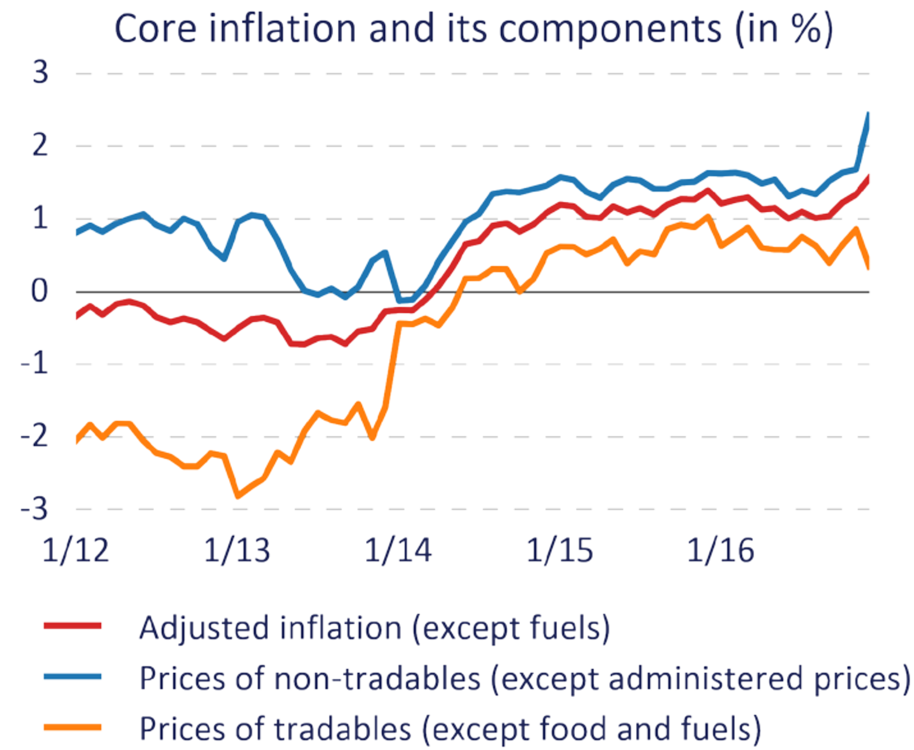
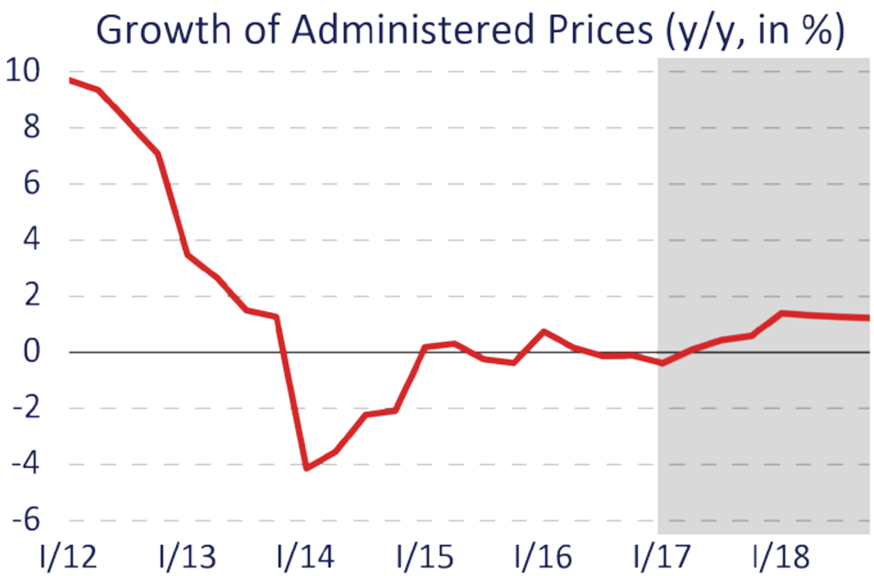
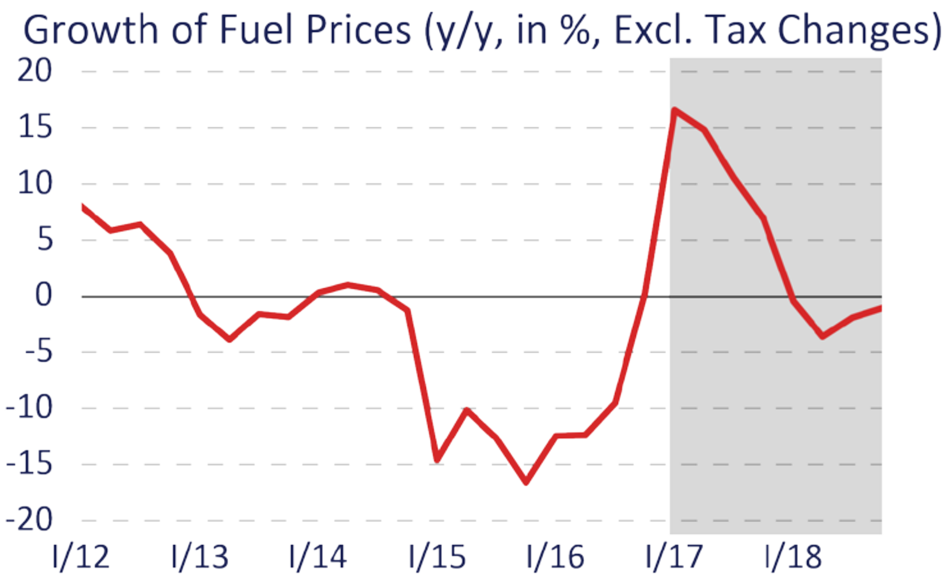




- The increase in inflation was due to a marked increase in food price growth and to a lesser extent to a rise in core inflation and renewed growth in fuel prices.
- The rise in core inflation reflected an ongoing growth in domestic economic activity, faster growth in wages, and in December also a surge in restaurant prices linked with the introduction of electronic sales registration.

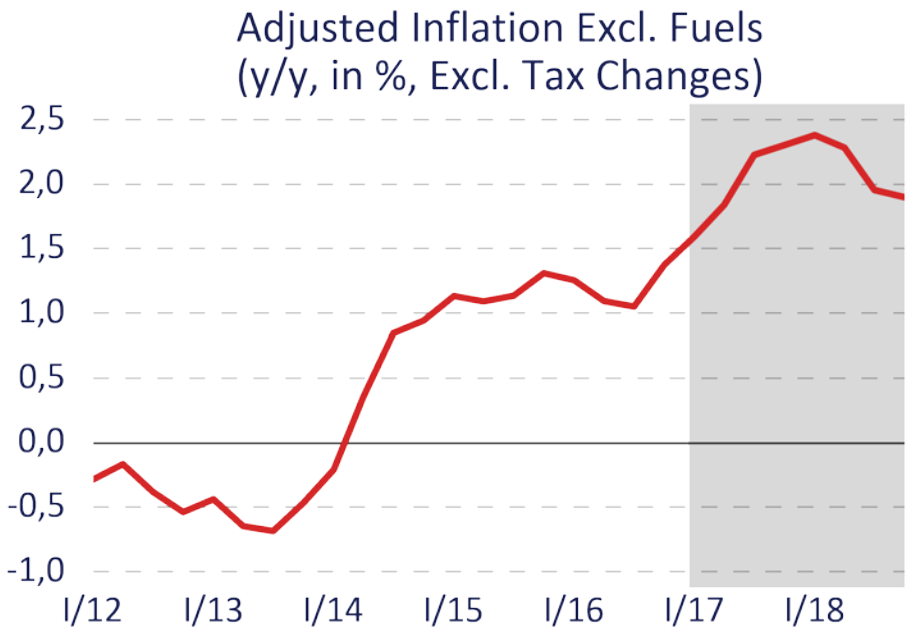
Administered and Fuel Prices

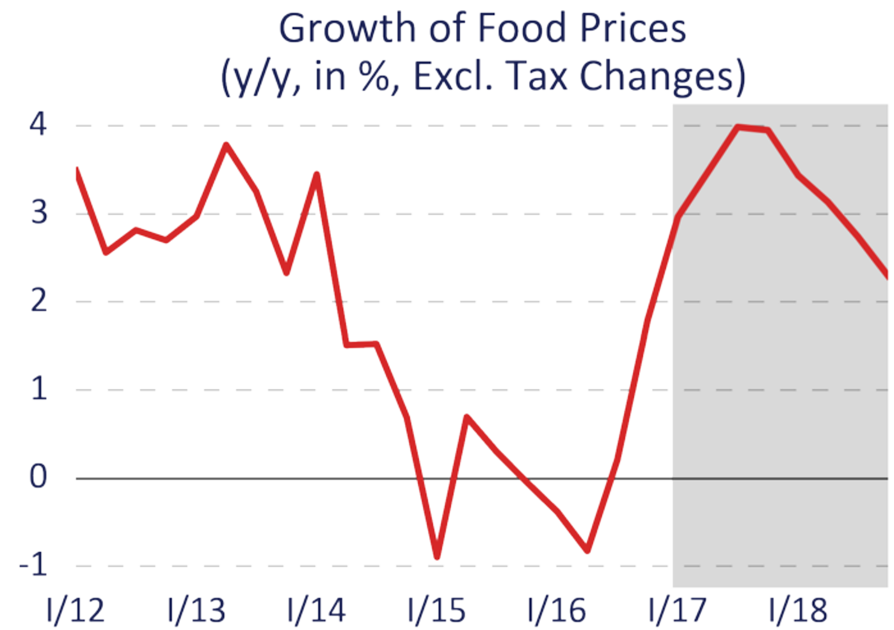




- Administered prices fell slightly year on year in 2016 Q4. This was due mainly to a decrease in gas prices for households. The forecast expects the decline in gas prices to deepen further at the start of this year. Overall, administered prices are expected to rise by just 0.2% this year, and then by 1.3% on average in 2018.
- The decline in fuel prices gradually slowed in 2016 Q4, switching to a growth in December. Annual fuel price growth is expected to keep rising owing to year-on-year growth in global oil and petrol prices. However, it will subsequently go down in 2017 H2. Fuel prices are expected to decline again slightly in 2018.

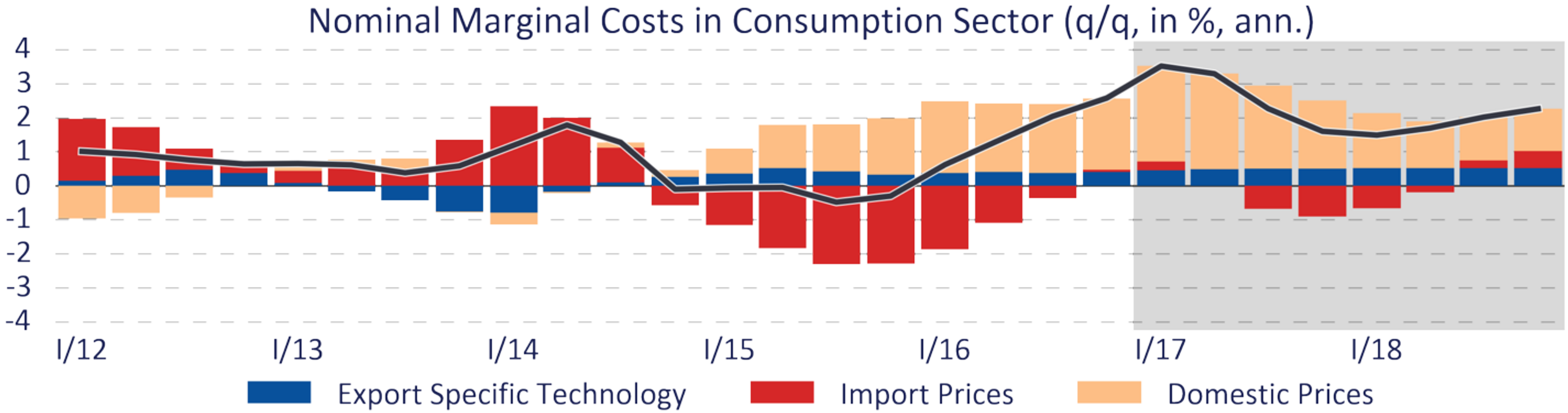
Adjusted Inflation Excluding Fuels and Food

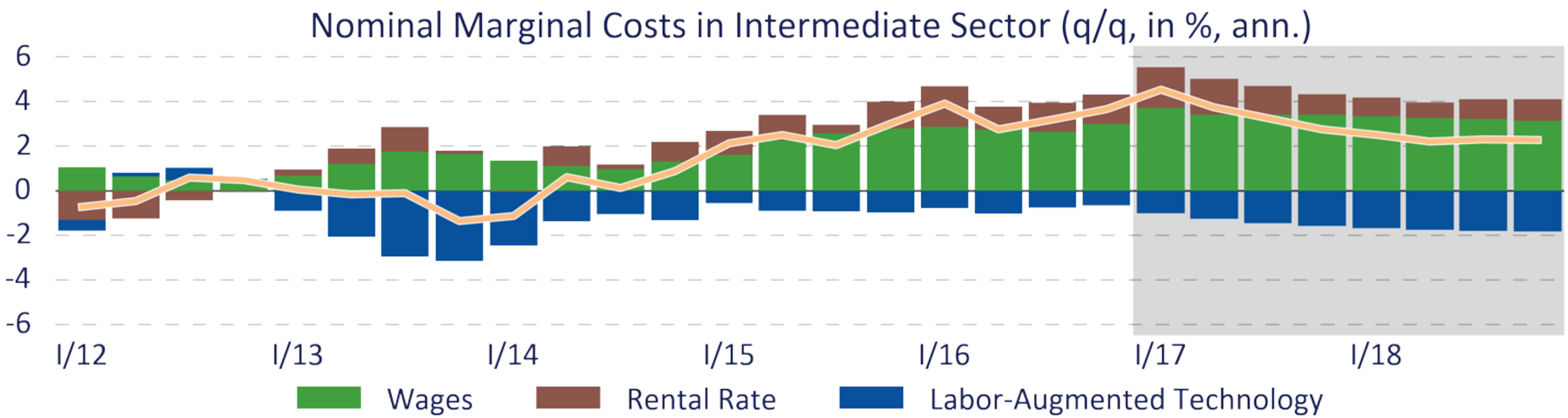




- Core inflation increased in 2016 Q4 due to faster growth in non-tradables prices. It will increase further to 2.3% at the end of 2017, owing to continued cost pressures from the domestic economy coupled with renewed growth in producer prices in the euro area. In 2018, core will gradually slow to just below 2%, mainly as a result of the koruna‘s appreciation following the ”exit“.
- Food prices increased in 2016 Q4 due to a rapid unwinding of previous extraordinary factors. Their growth will continue to rise this year owing to increases in agricultural commodity prices and domestic cost pressures, but it will go down gradually in 2018.

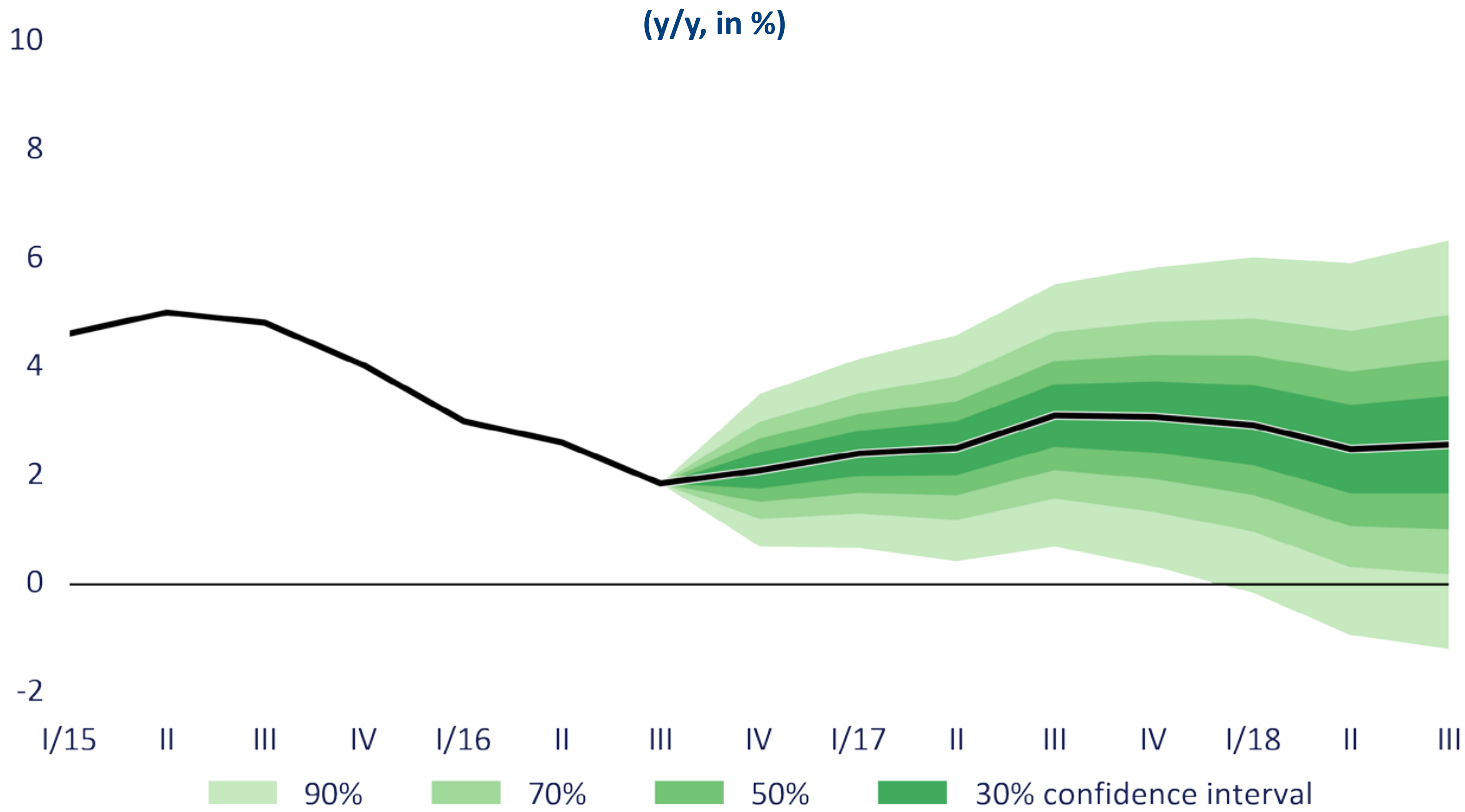
Domestic Costs vs. Import Prices





- Growth in total costs will peak at the start of 2017. This will reflect higher growth in domestic wages, supported by an increase in the minimum wage in January 2017, and renewed growth in foreign producer prices.
- The growth in costs will moderate after the "exit".

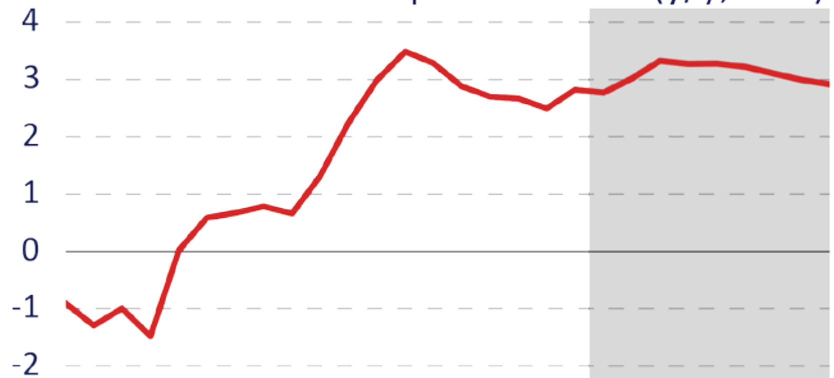
GDP Growth



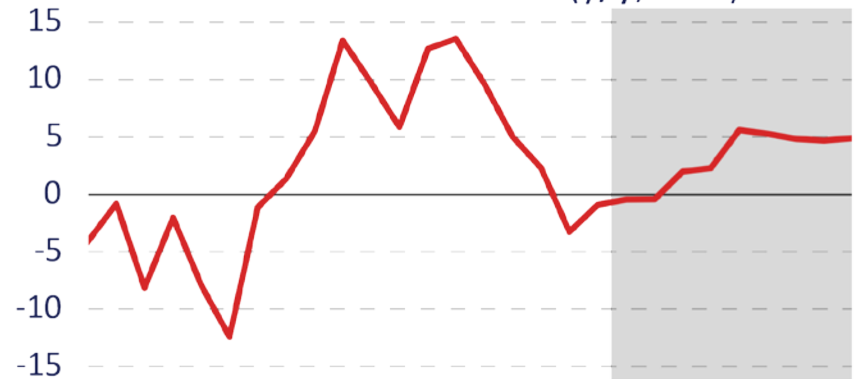
- GDP growth forecast: 2.4% in 2016; 2.8% both in 2017 and 2018.
- GDP growth will accelerate mainly because of renewed growth in government investment. Slower growth in external demand in 2017 H1 and later on less easy monetary conditions after the assumed exit from the CNB’s exchange rate commitment will act in the opposite direction.

Aggregate Demand

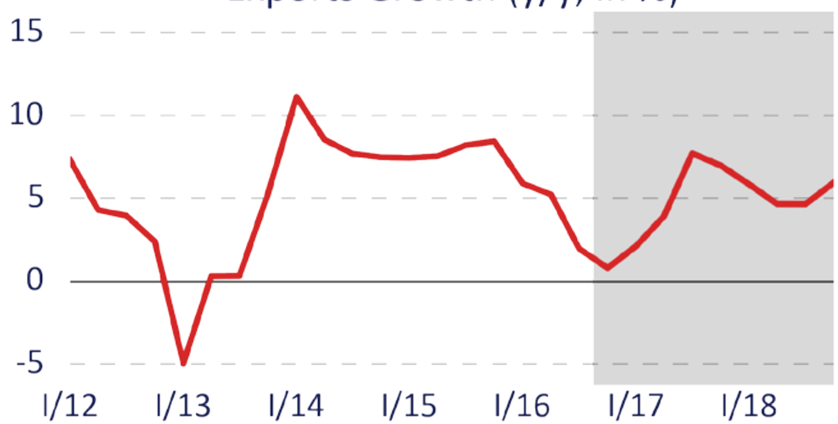
Household Consumption Growth (y/y, in %)



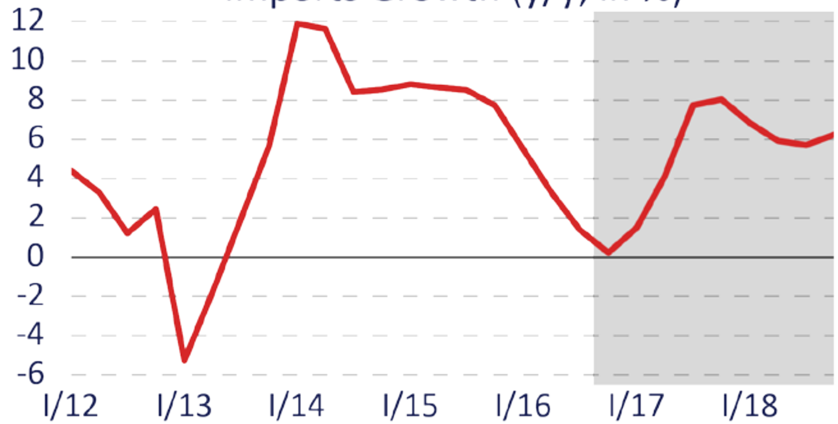
Investments Growth (y/y, in %)



Exports Growth (y/y, in %)

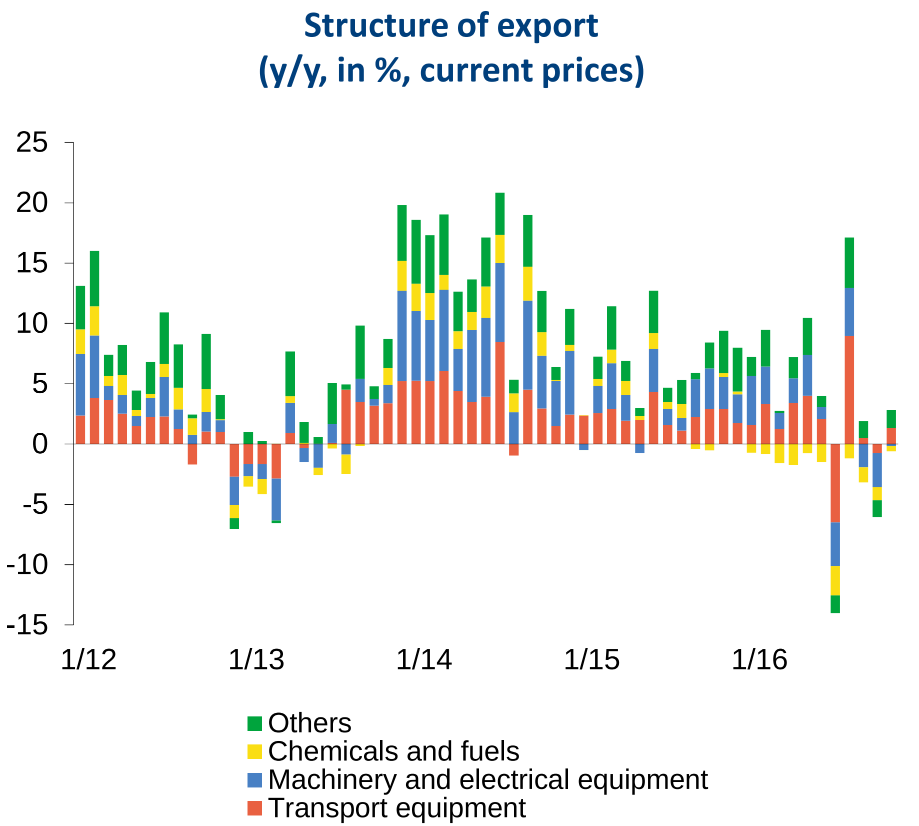


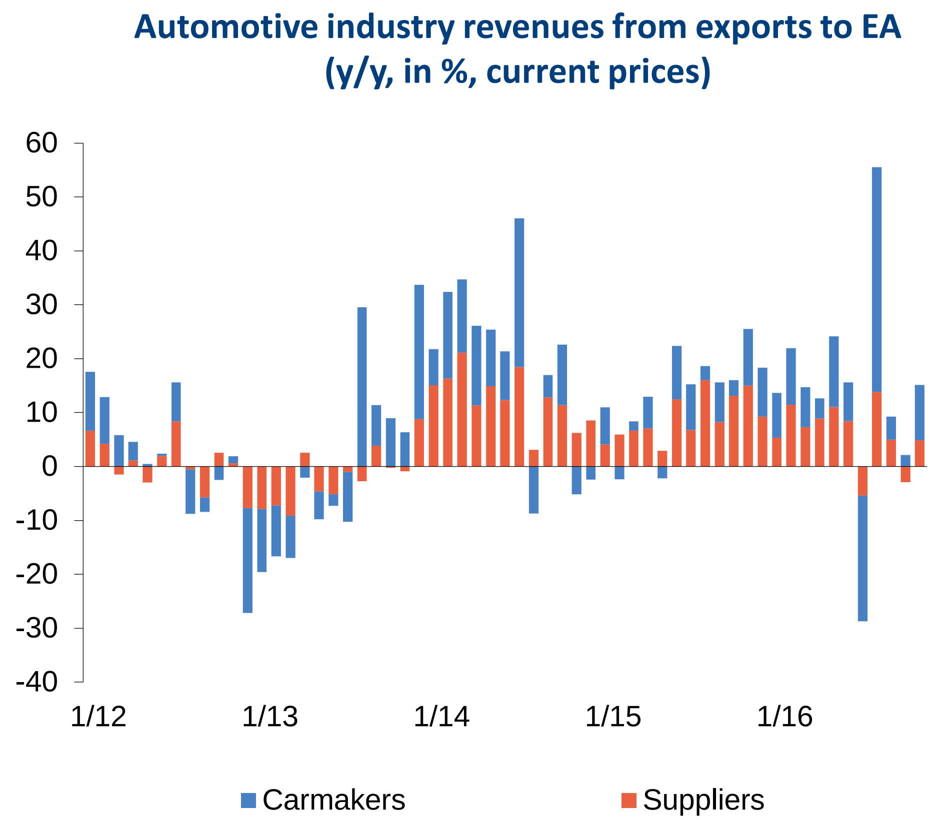
Imports Growth (y/y, in %)



- Household consumption increased by 2.7% in 2016. Its growth will speed up further in 2017 and 2018 and slightly exceed 3% in both years.
- Investment growth will turn positive at the start of 2017.
- Export growth slowed to 3.4% in 2016 as a whole. However, it will start to pick up gradually to more than 5% on average both in 2017 and 2018.

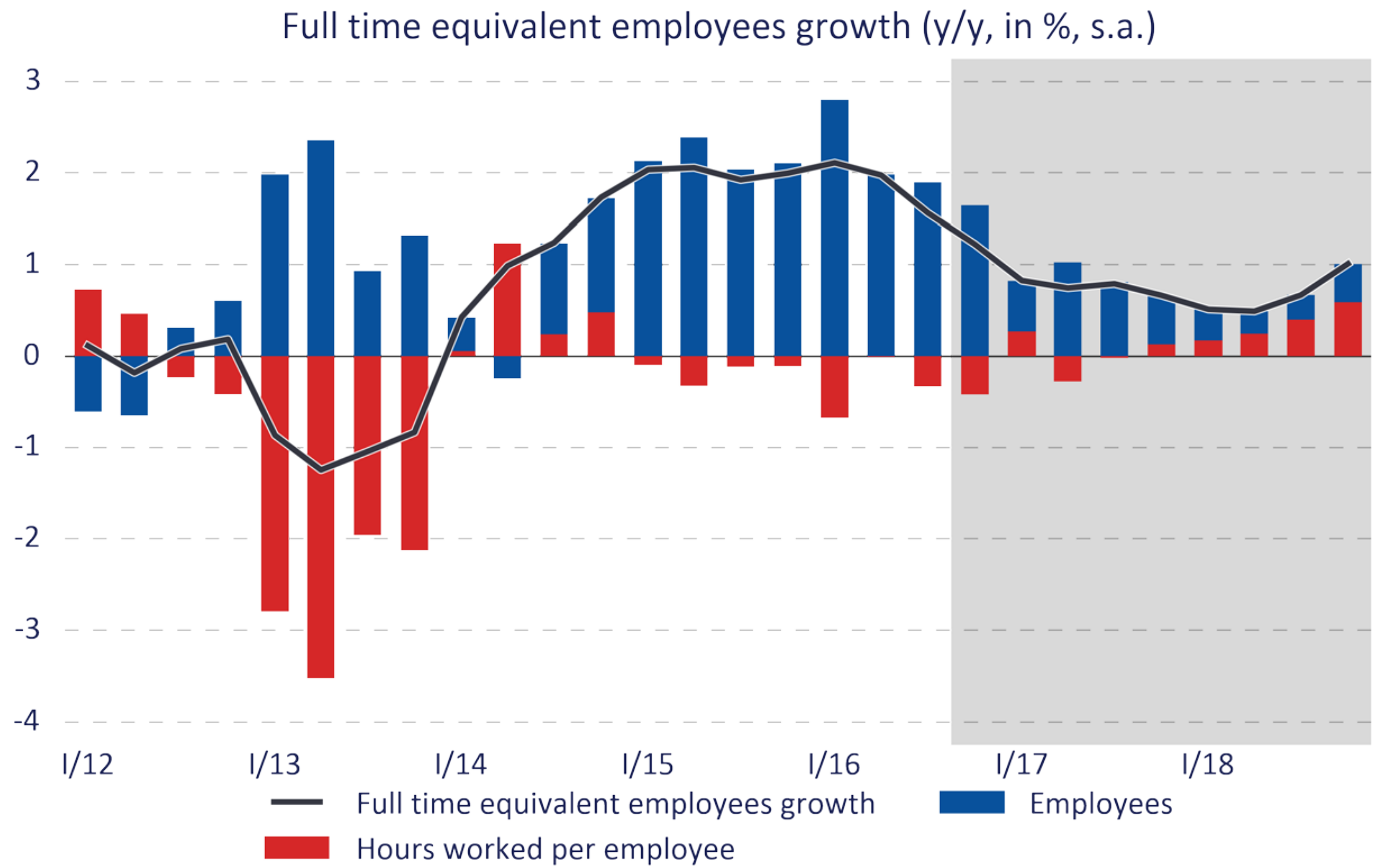
The Causes of Observed Slowdown in Export Growth





- The marked slowdown in exports in 2016 Q3 was due to the automotive industry. Domestic car production then recovered quickly, but exports of parts for the automotive industry remained subdued in the first two months of Q4.
- Unlike in H1, the automotive industry was therefore unable to outweigh as strongly the persisting fall in exports of chemical products, fuels and electricity caused by shortfalls in domestic production last year.

Labour Market: Employment



- The growth rate of the number of employees converted into FTE will slacken further in the coming quarters.
- Slowing employment growth will reflect tight labour market conditions (an increasing barrier of a shortage of available labour force).

Labour Market: Wage Growth in Business Sector

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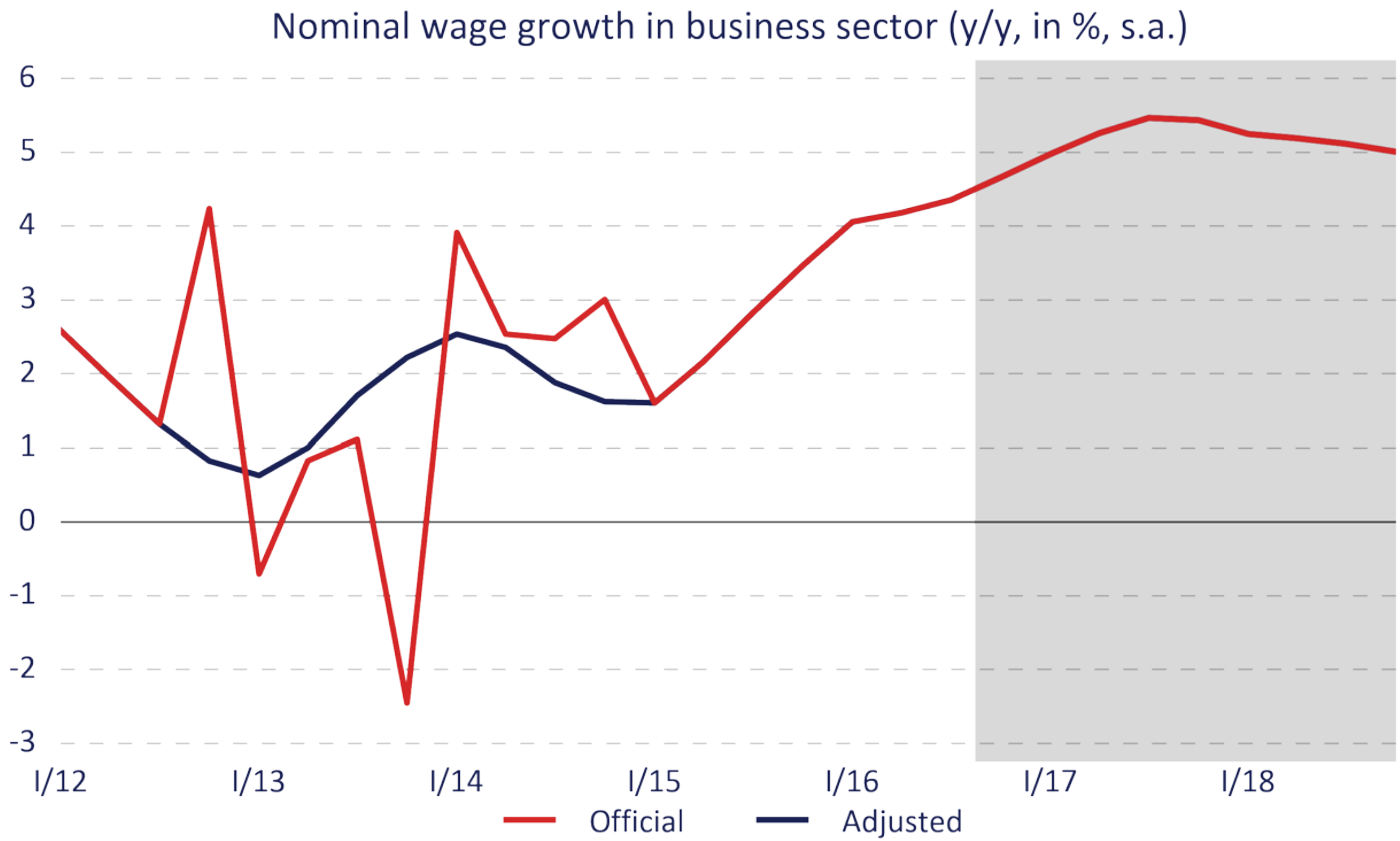
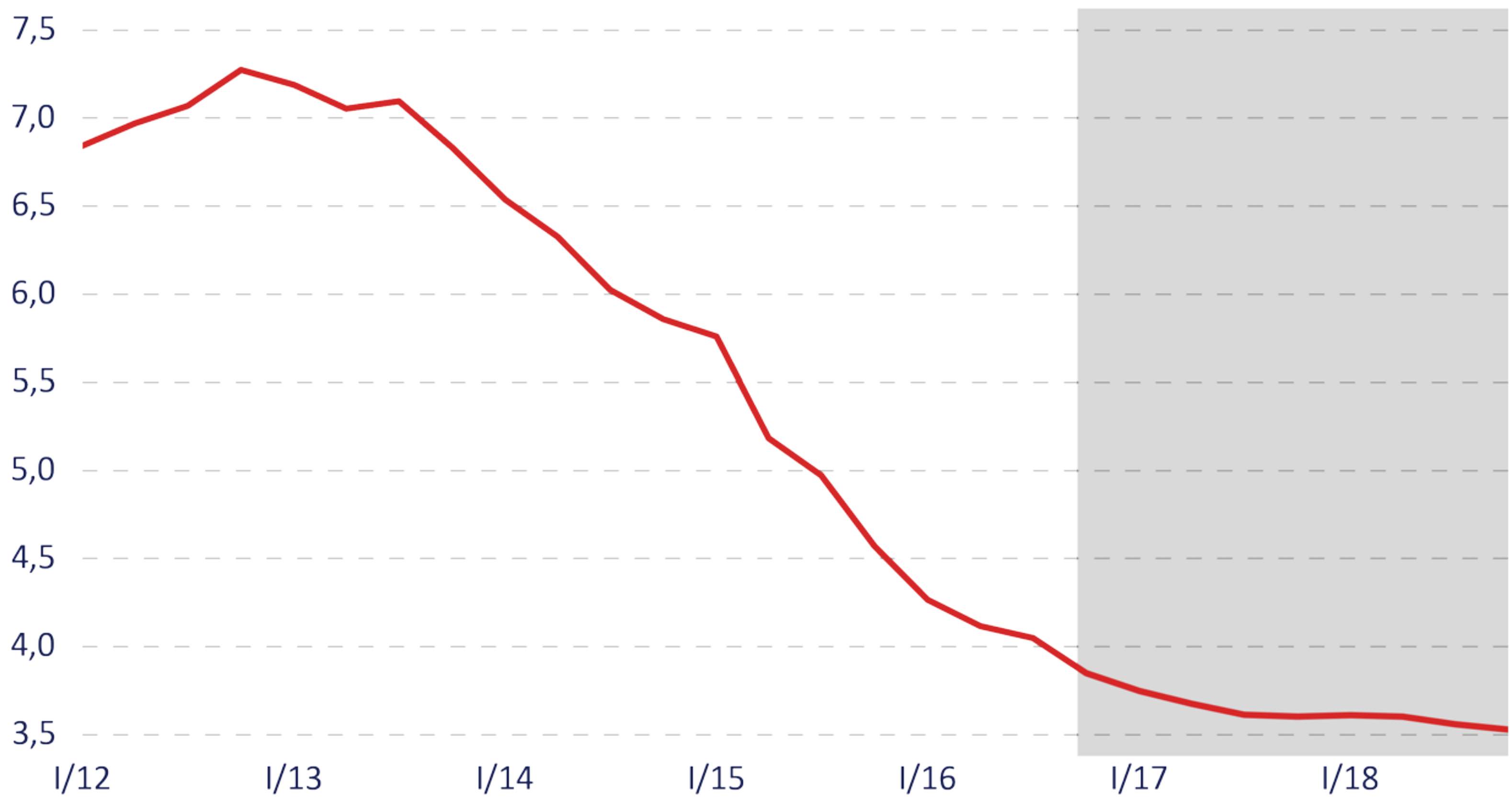


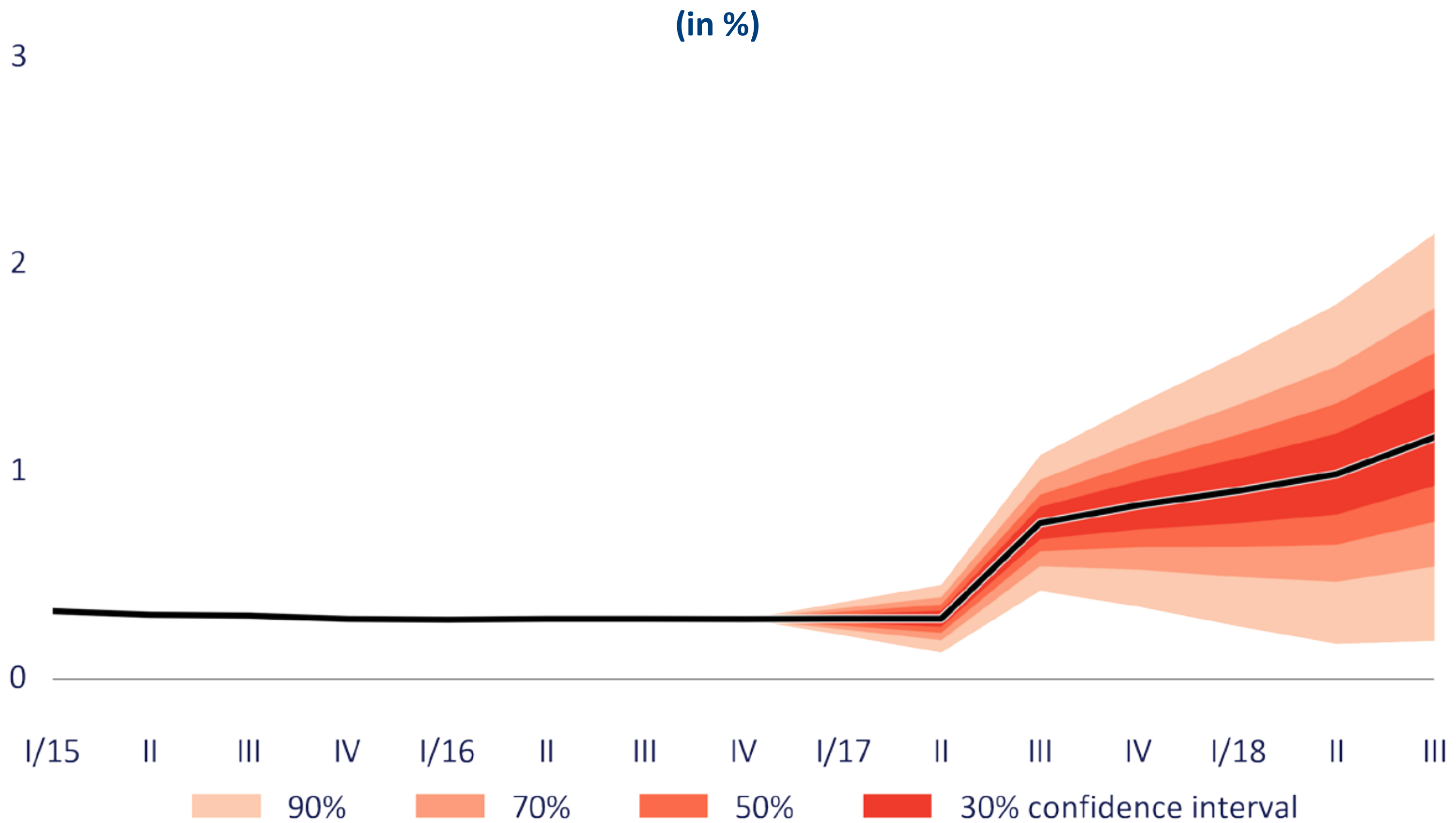
- The average nominal wage in the business sector rose by 4.4 % in 2016 Q3. The wage growth will increase gradually in the coming quarters as well.
- In addition to solid economic growth, rising consumer prices and continued strong demand for labour, this will be fostered by a further rise in the minimum wage in January 2017.

Labour Market: Unemployment



- General unemployment rate dropped below 4% in 2016 Q4.
- It will decrease only gradually in the period ahead. With growth in employment slowing, this will reflect a further rise in the labour force.

Interest Rate Path (3M PRIBOR)



- The forecast expects 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.

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Comparison with Previous Forecast

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- The forecast for annual headline inflation in 2017 is higher than the previous one. In 2018, the change is negligible.
- GDP growth has been revised downwards at the shorter horizon amid a lower contribution of net exports. However, the GDP forecast for this year and the next from the whole-year perspective is only slightly lower.
- Nominal wage growth in the business sector has shifted upwards over almost the entire forecast horizon.
- 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 path of market interest rates after the exit shifted towards their slower growth (prolonged QE by the ECB).

Comparison: Inflation Forecast (i)

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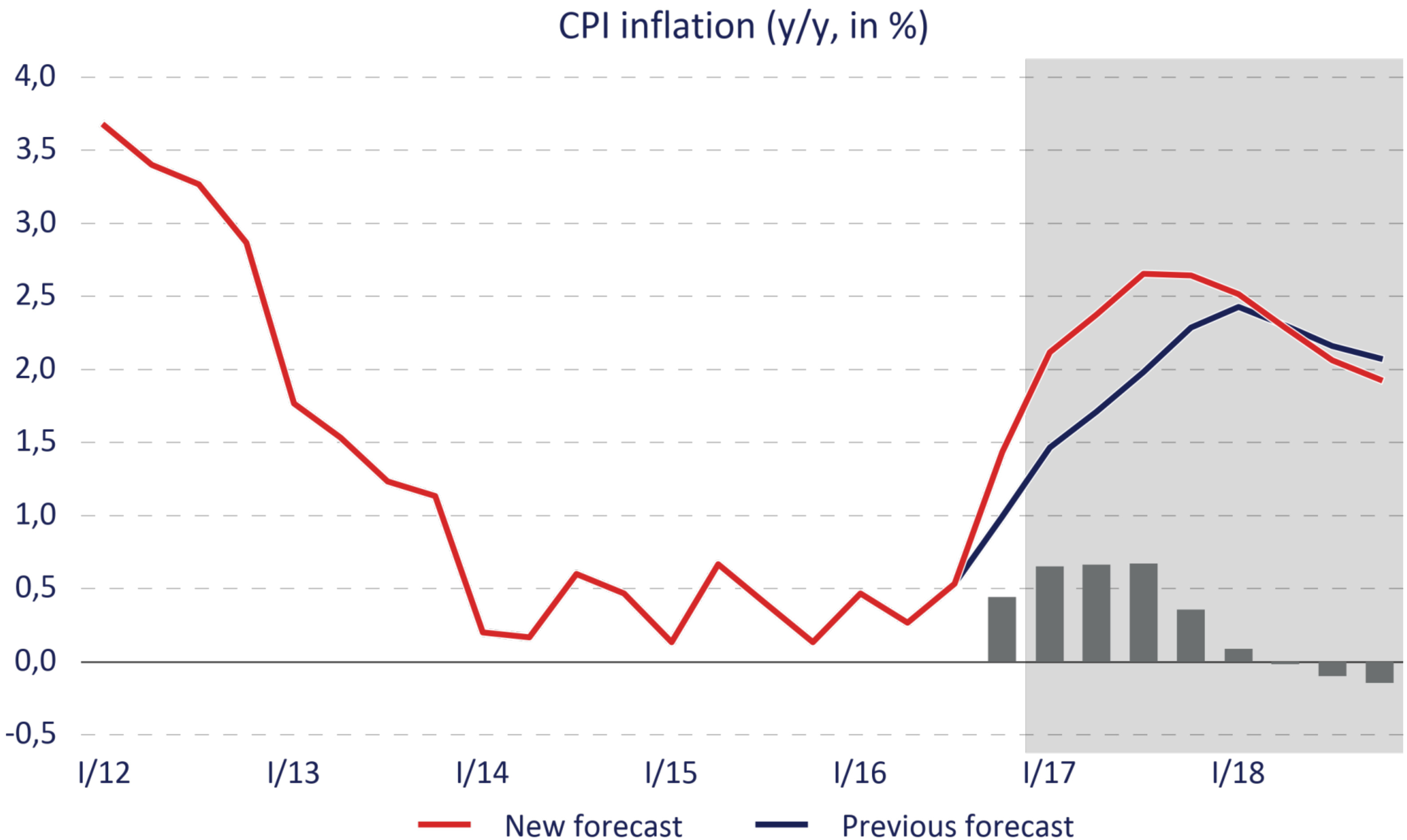
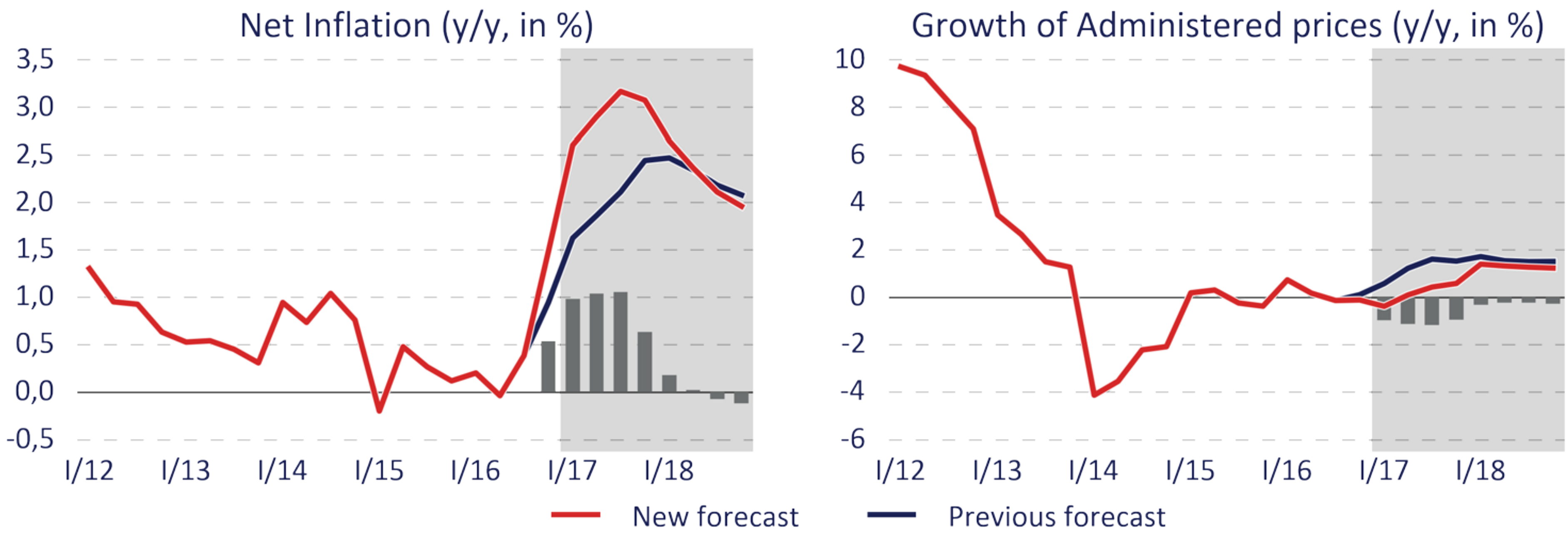


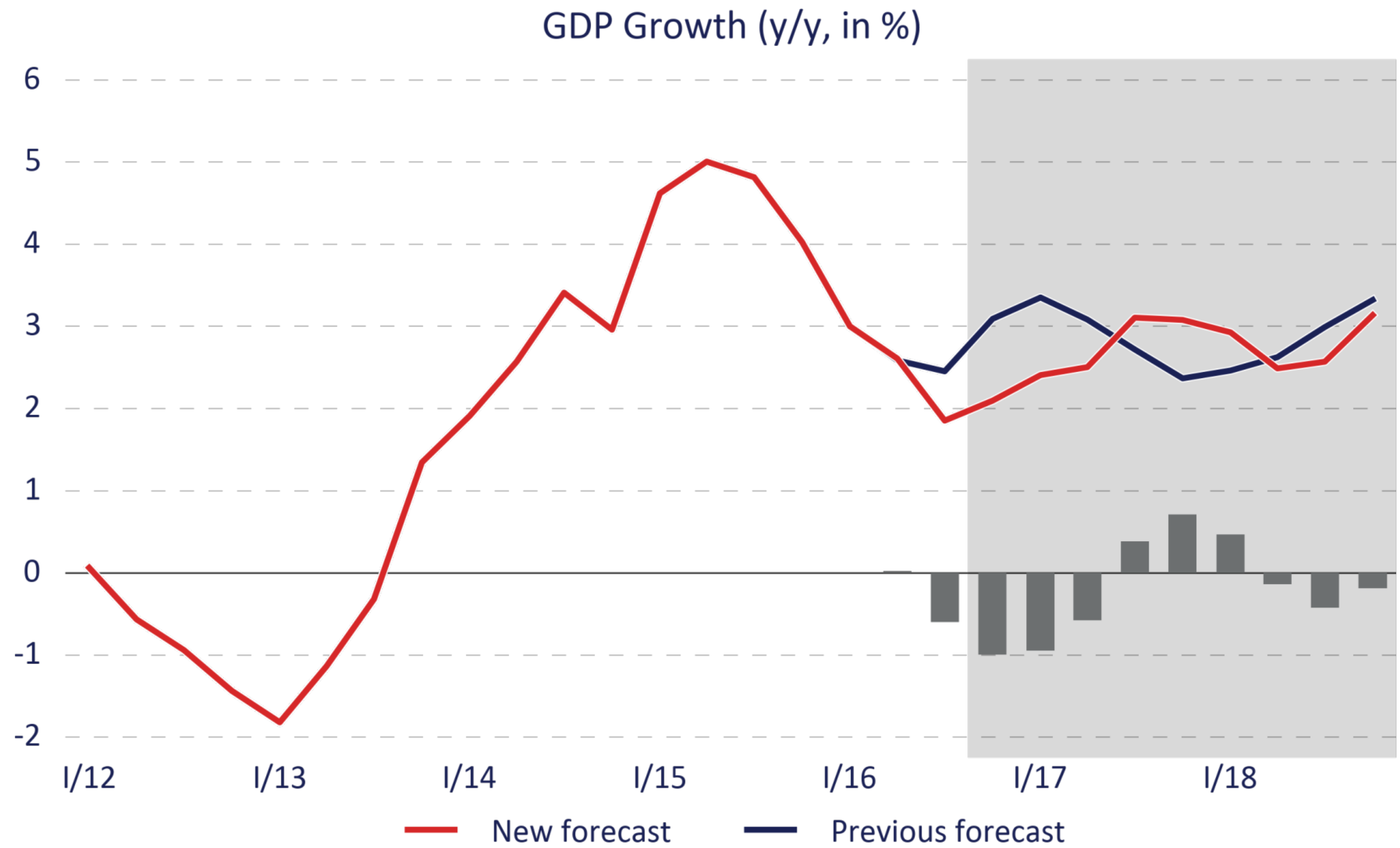
- The forecast for headline inflation in 2017 is higher than the previous one.
- This revision is due to a markedly higher outlook for net inflation for the next year, whereas a slightly lower outlook for administered prices acts in the opposite direction.

Comparison: Inflation Forecast (ii)



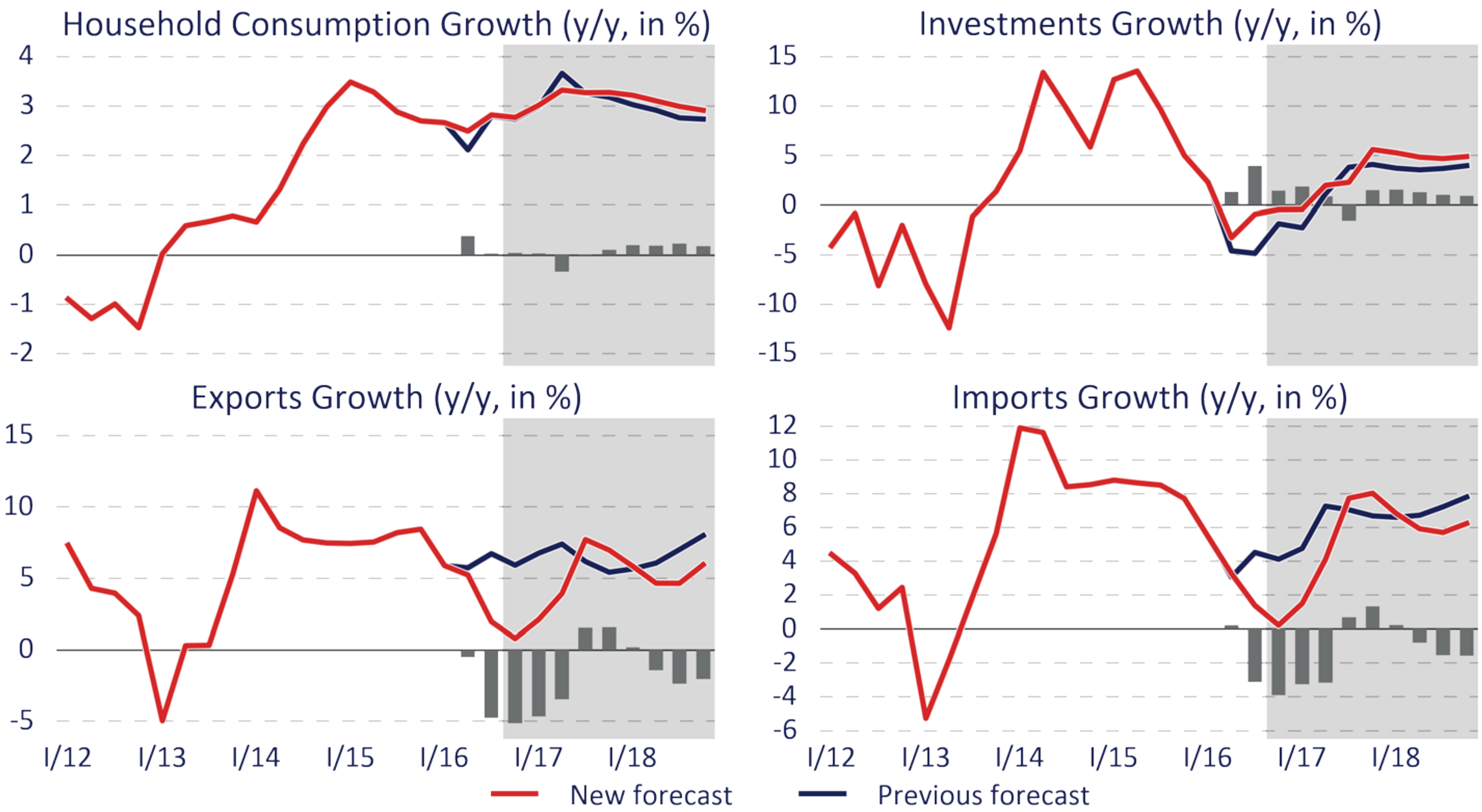
- The change in the net inflation forecast is due to faster growth in food prices and adjusted inflation excluding fuels at the end of last year. The revision also reflects higher overall cost pressures at the start of this year, which, however, will then return to the levels of the previous forecast.
- The outlook for growth in administered prices for the next two years has been revised downwards due to an expected further drop in prices of gas for households and a less pronounced increase in electricity prices.

Comparison: GDP Forecast (i)



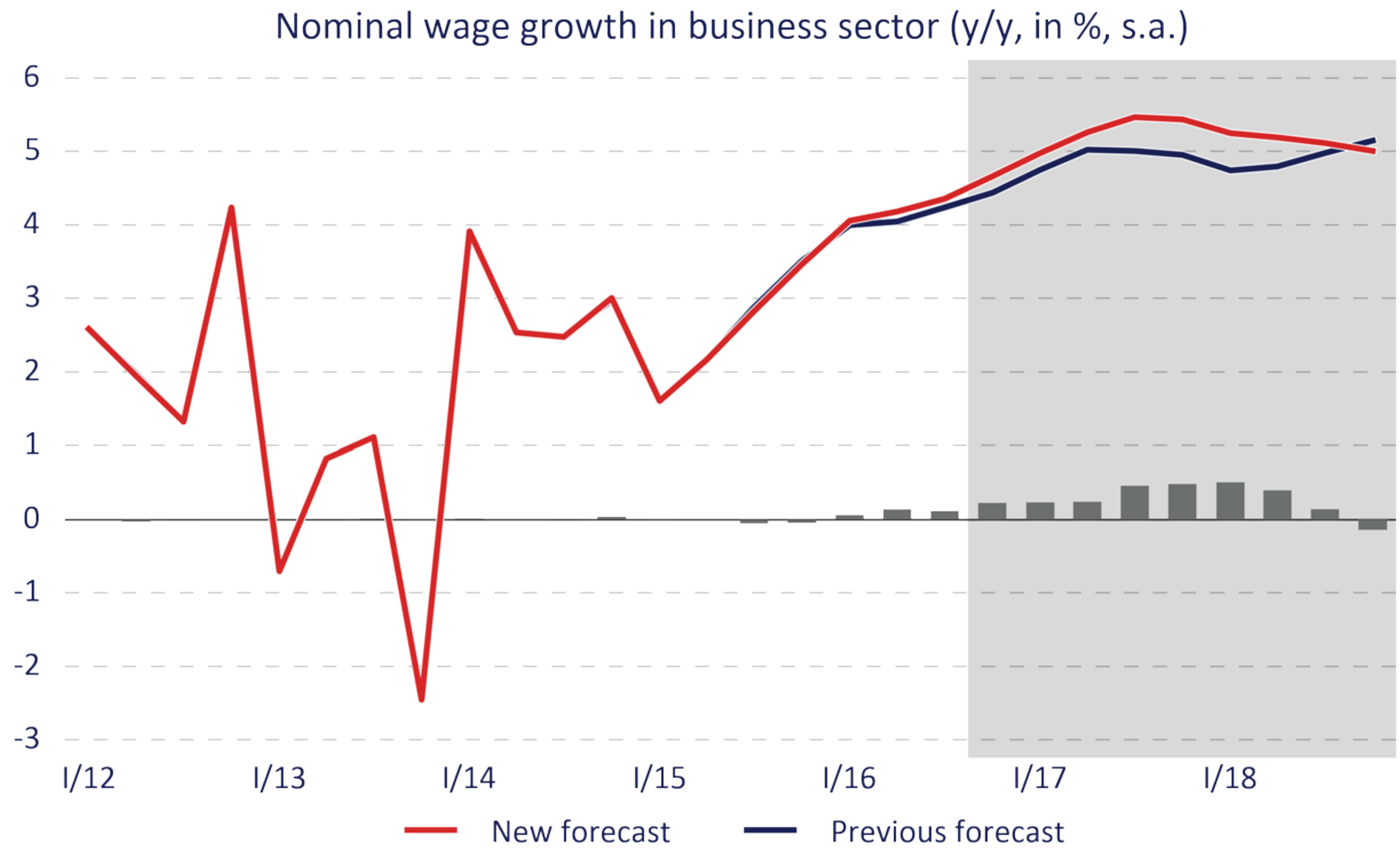
- The forecast for annual GDP growth this year is lower at the start of 2017 owing to lower-than-expected data for 2016 H2, when the contribution of net exports recorded an unexpected sharp fall.
- Overall, the forecast for GDP growth in 2017 and 2018 is only slightly lower.

Comparison: GDP Forecast (ii)



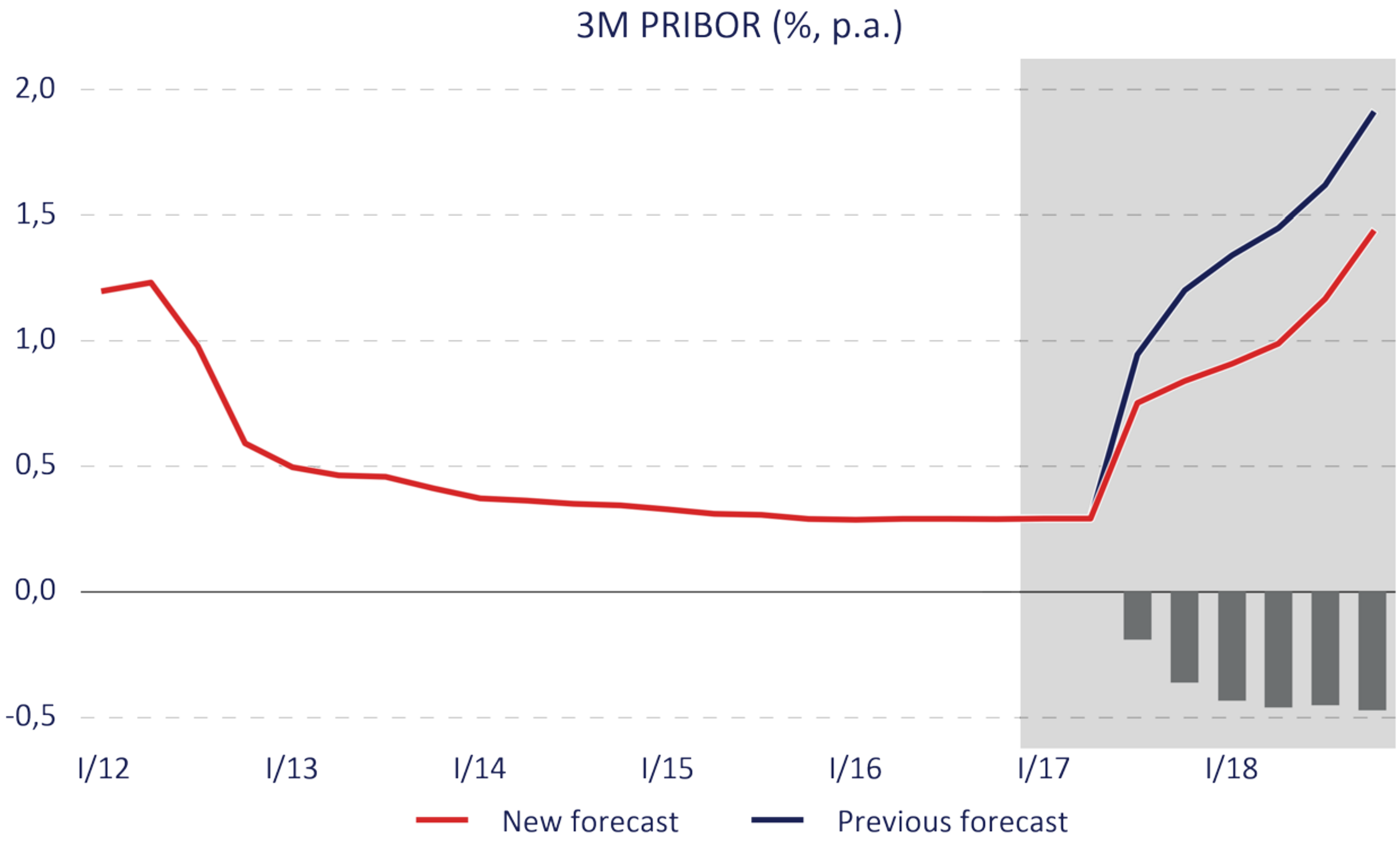
- The outlook for growth in household consumption is close to previous forecast.
- Gross capital formation growth is higher this year and the next.
- Export and import growth starts from a much more subdued pace.

Comparison: Nominal Wage



- Compared to the previous forecast, growth in the average nominal wage in the business sector is slightly higher over the entire horizon.
- This mainly reflects the stronger wage growth observed at the end of 2016 (and partly also higher observed and predicted inflation).

Comparison: Interest Rate Forecast



- The assumption of flat interest rates and the use of the exchange rate as an additional monetary policy instrument until mid-2017 remains unchanged.
- The extension of the ECB's asset purchase programme is reflected in slower growth in domestic market interest rates after the exit.

Thank you for your attention!

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