# CNB's New Forecast (Inflation Report II/2017)

# Meeting with Analysts

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Prague, 5 May 2017

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# Outline

1. Exit from the FX commitment
2. Assumptions of the forecast
3. The new macroeconomic forecast
4. Comparison with the previous forecast

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# Background of FX Commitment Decision and its Effects (i)

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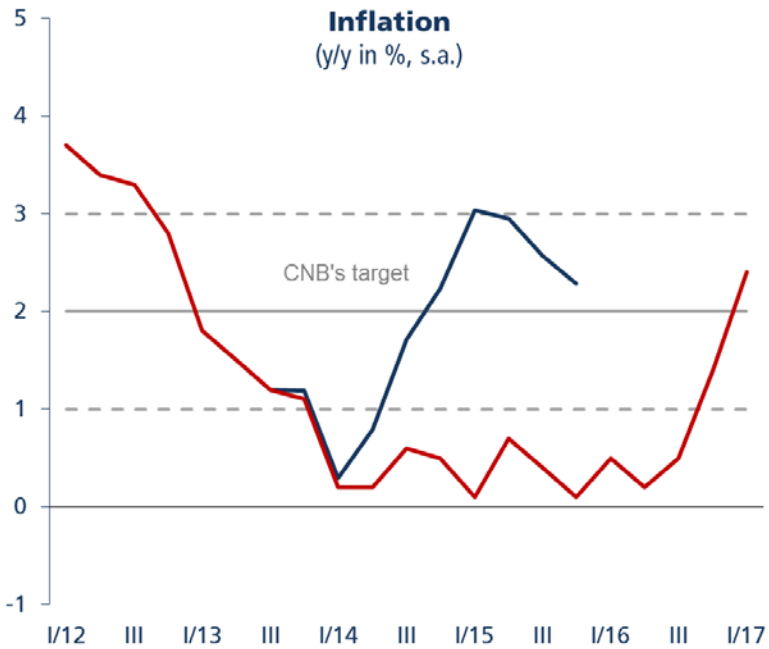
- In 2013, the Czech economy was going through the longest recession in its history, with decreasing household consumption, low investment, and inflation falling towards zero. CNB's forecasts indicated possibility of deflation-recession spiral in case that monetary conditions would not be eased further.

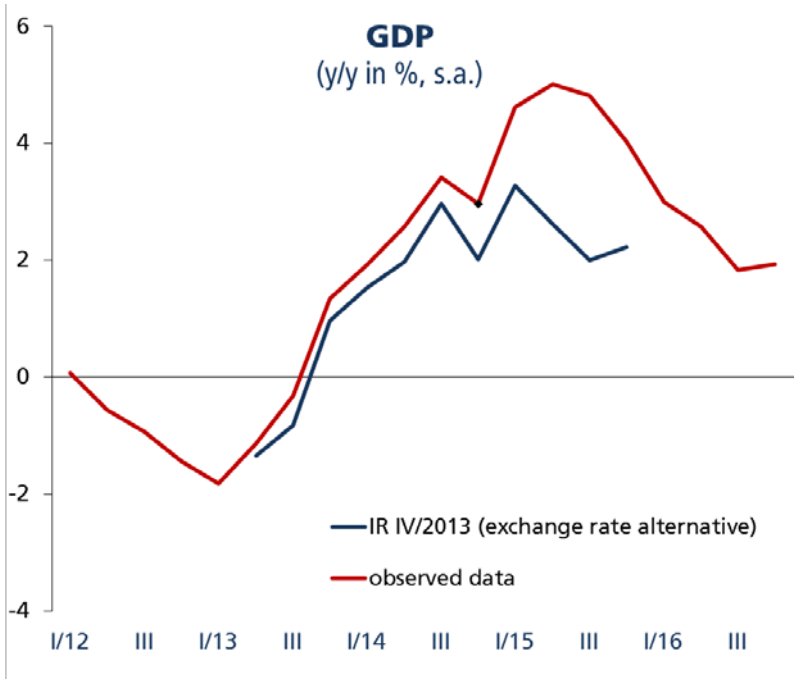
- The standard monetary policy tool, however, reached its limits, as the CNB had already kept interest rates at technical zero for a year. In the second half of 2013 it communicated that it was ready to use the exchange rate if a further monetary policy easing became necessary.

- On 7 November 2013, the Bank Board adopted an one-sided exchange rate commitment (a "floor" set at CZK 27 to the euro).

- The weakened exchange rate contributed significantly to the economic recovery that occurred in 2014 (together with recovery in external demand and the end of restrictive domestic fiscal policy).

# Background of FX Commitment Decision and its Effects (ii)




- The revival of economic activity has been even faster than predicted in November 2013 (in 2015 fostered by EU funds and positive supply-side effect of the oil price drop). Together with an improvement in the labour market it led to a quick rise in core inflation to more than 1%.
- However, headline inflation reached the upper half of the tolerance band around the CNB's 2% target two years later than originally envisaged due to imported deflationary pressures.

# Smooth Entry and Even Smoother Exit

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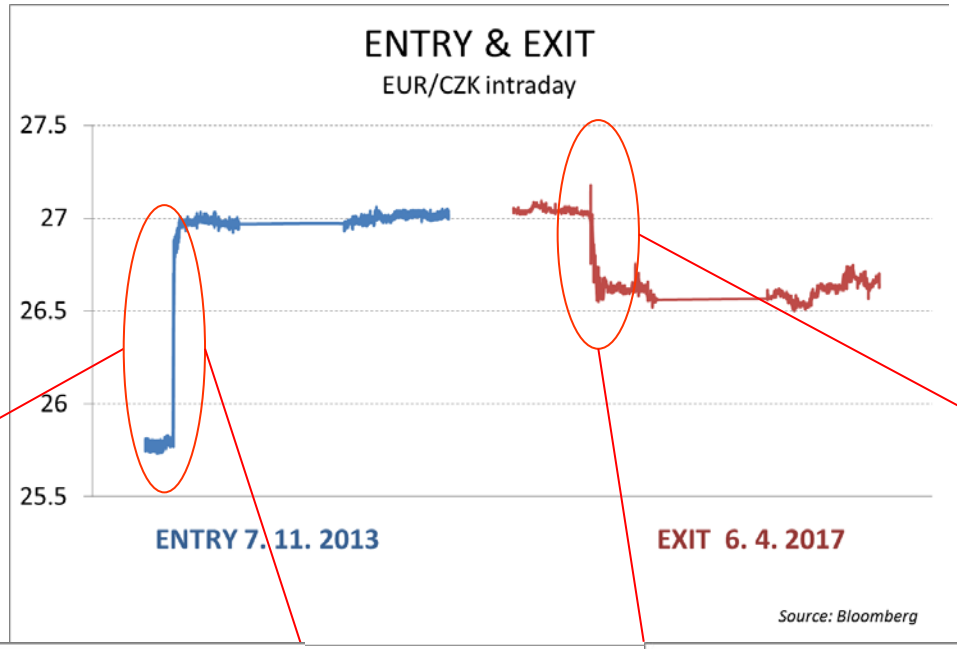
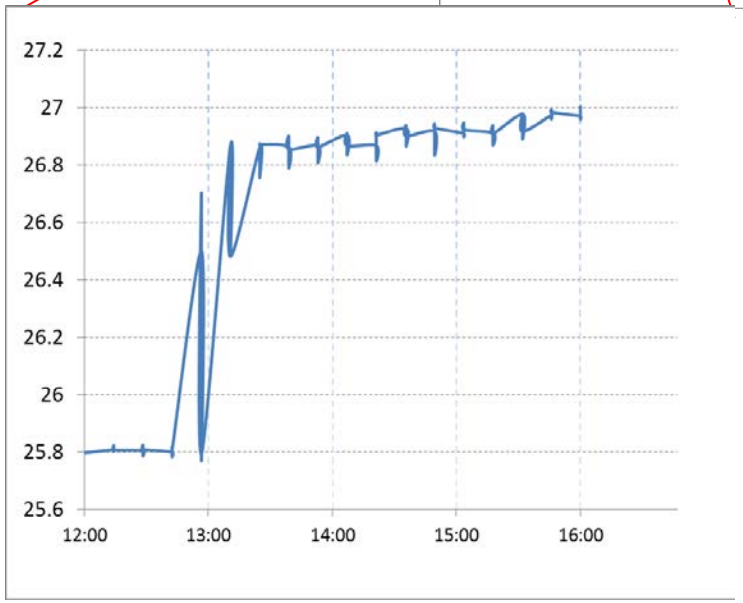
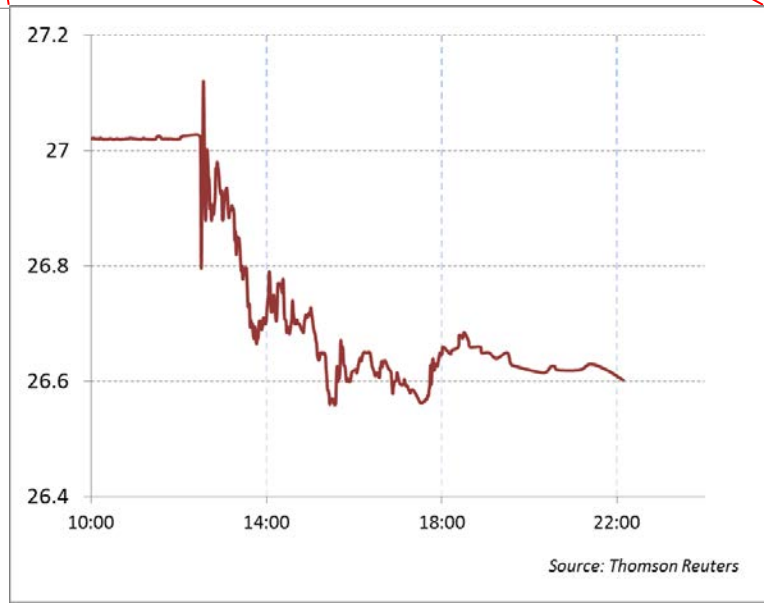
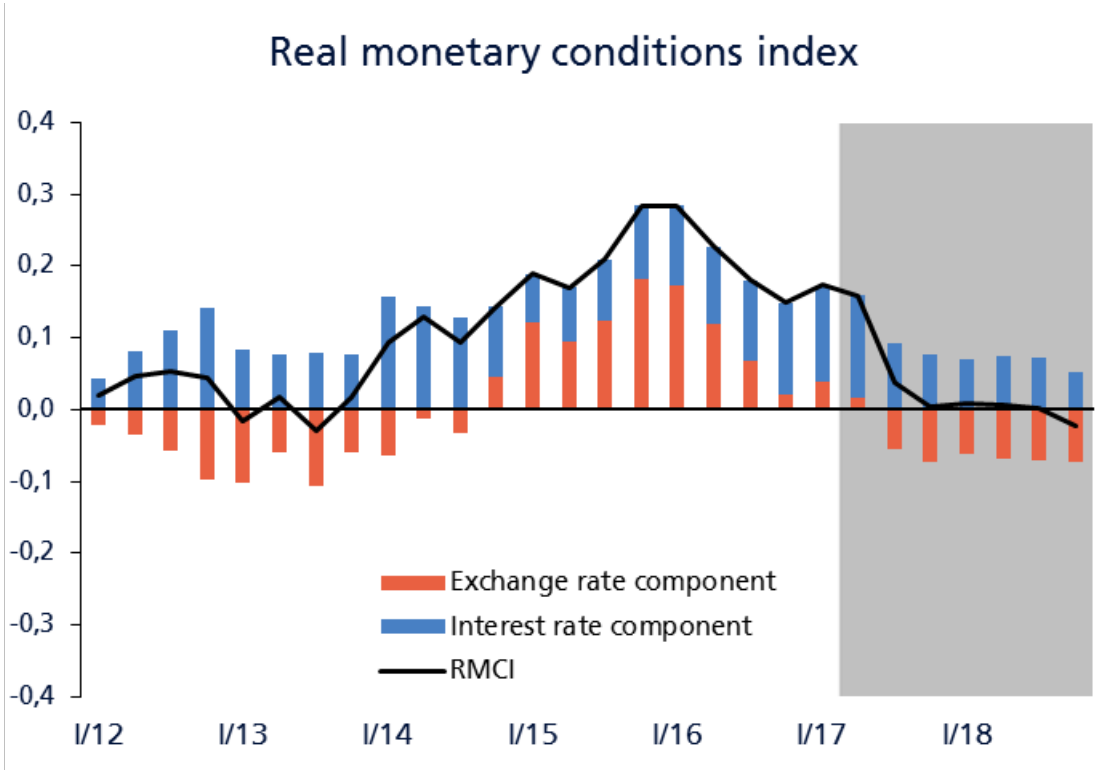


# Exit as a First Step of Monetary Policy Normalisation




- Persisting domestic cost pressures coupled with an unwinding of foreign anti-inflationary effects are generating need for a return to neutral monetary stance.
- A majority of this shift is expected to be delivered by forecasted appreciation of the koruna, while a smaller part will reflect an increase in interest rates as from the second half of this year.
- There is significant uncertainty about the evolution of these two components of overall monetary conditions.

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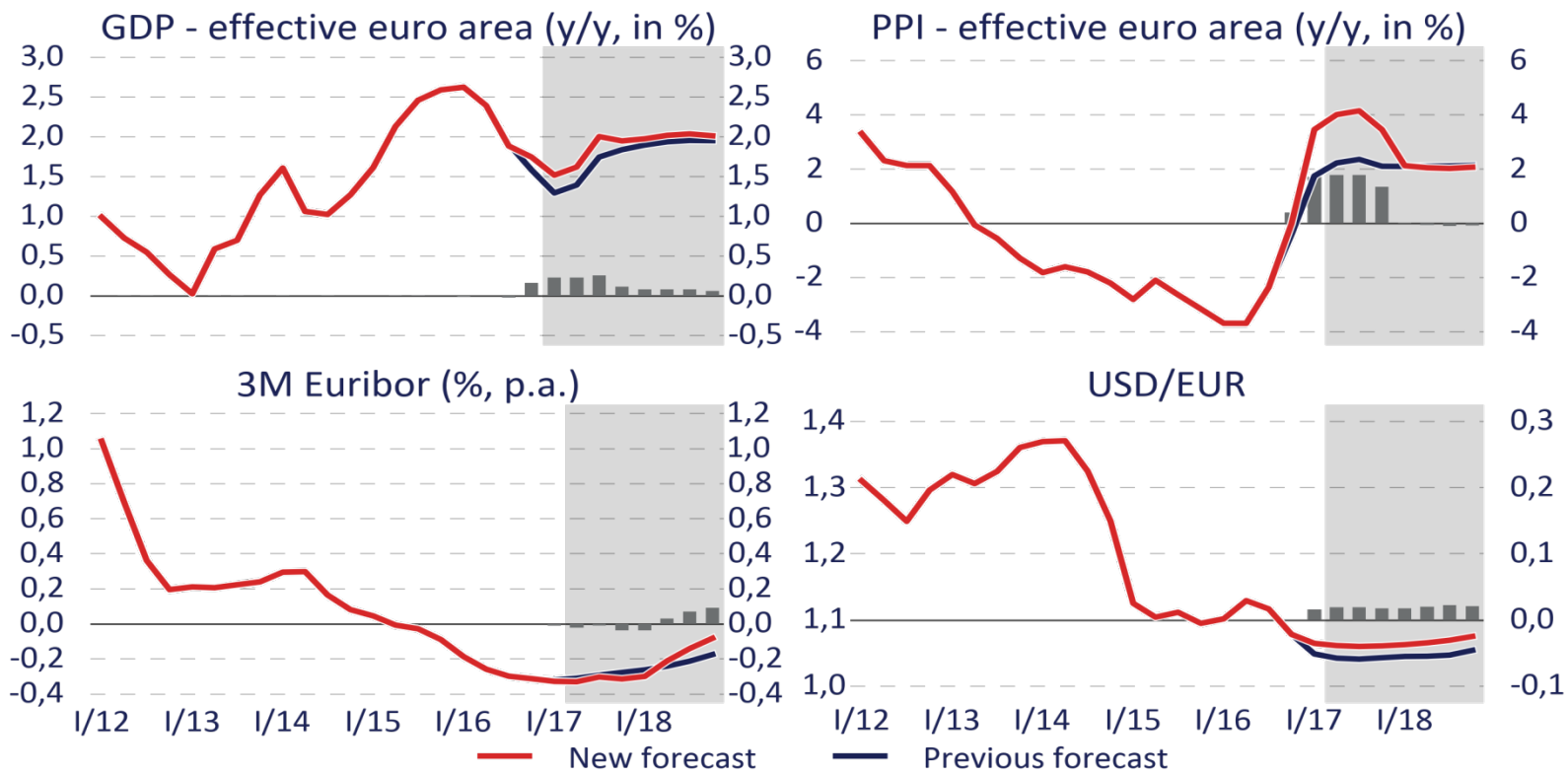
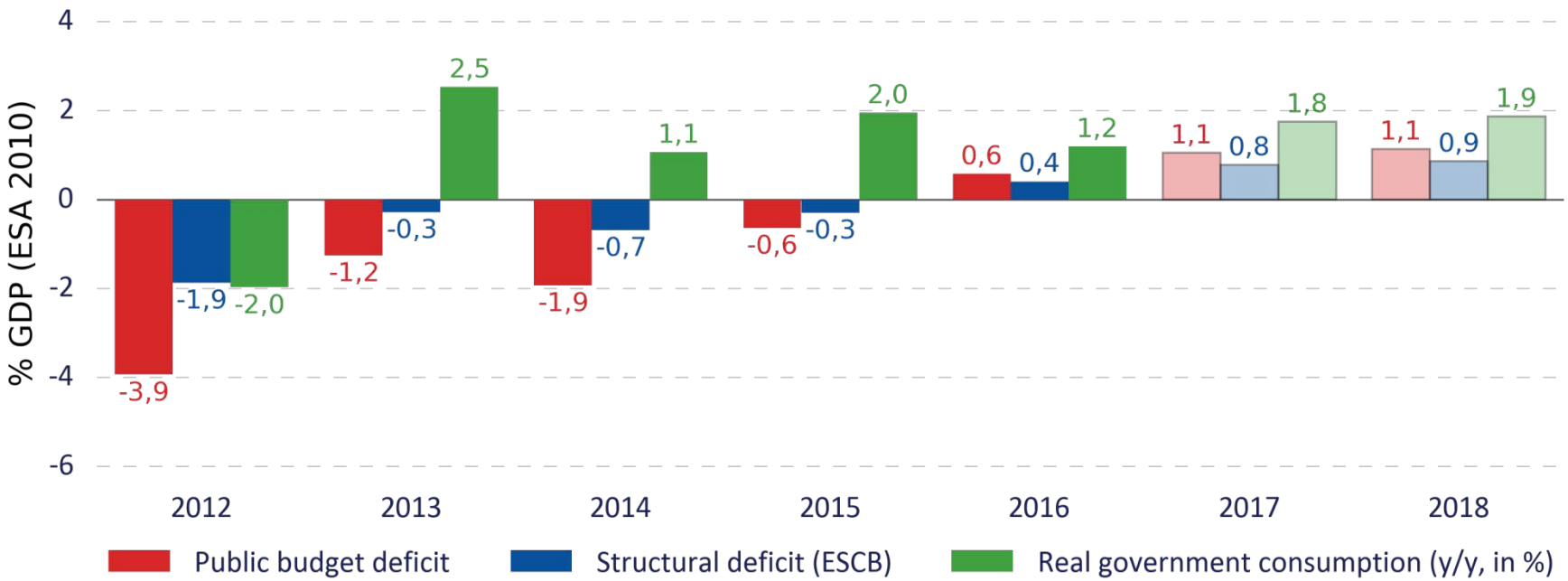
# External Environment Outlook




- The growth in the effective euro area will gradually accelerate towards 2%, supported by easy monetary conditions, good labour market conditions and strong economic confidence.
- Surge in foreign industrial producer prices from early 2017 will slacken.
- The outlook for 3M EURIBOR and USD/EUR reflects continued easy monetary policy of the ECB and expectations of further hikes by the Fed, respectively.

# Fiscal Policy




- The favourable economic developments and increase in tax revenues in 2016 led to a general government surplus of 0.6% of GDP.
- The surplus will increase further in the coming two years, due mainly to growing structural surplus.
- The government consumption grew by 1.2% in 2016. The forecast expects slightly higher growth in 2017-2018 owing to vivid wage growth in public sector.
- Fiscal impulse will be positive at 0.3% of GDP in both years, due to a recovery in government investment in 2017 and new social benefits measures in 2018.

# Monetary Policy

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- Forecast assumes that after the exit from the exchange rate commitment carried out in April 2017 the koruna will appreciate against the euro in the rest of forecast horizon, due to
  - a positive money market interest rate differential against the euro;
  - effects of the ECB's quantitative easing;
  - continued – 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 continue to be dampened by "missing counterparty" market situation.

- The forecast assumes that the interest rates will remain at the current level in 2017 Q2.

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# Summary of the New Forecast

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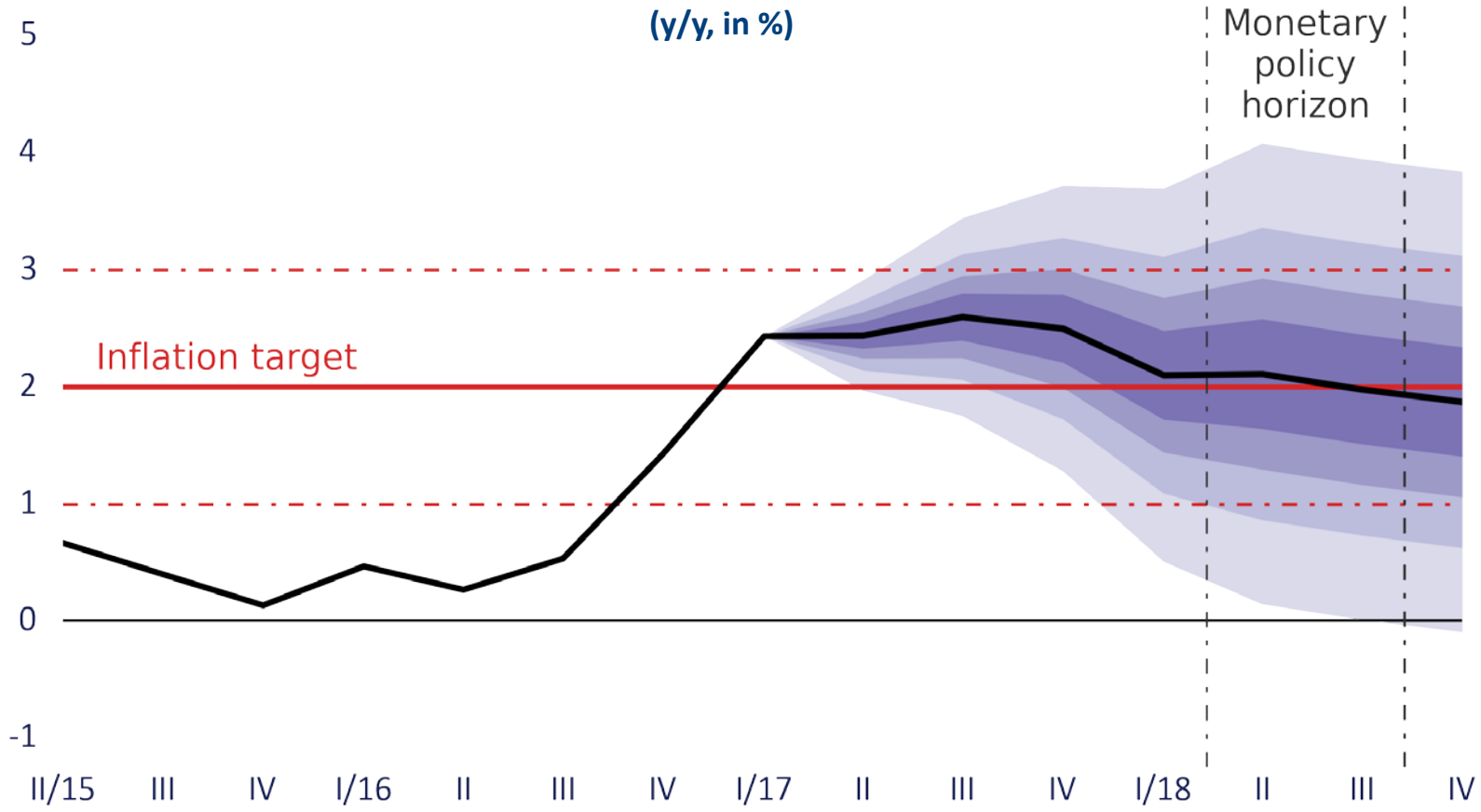
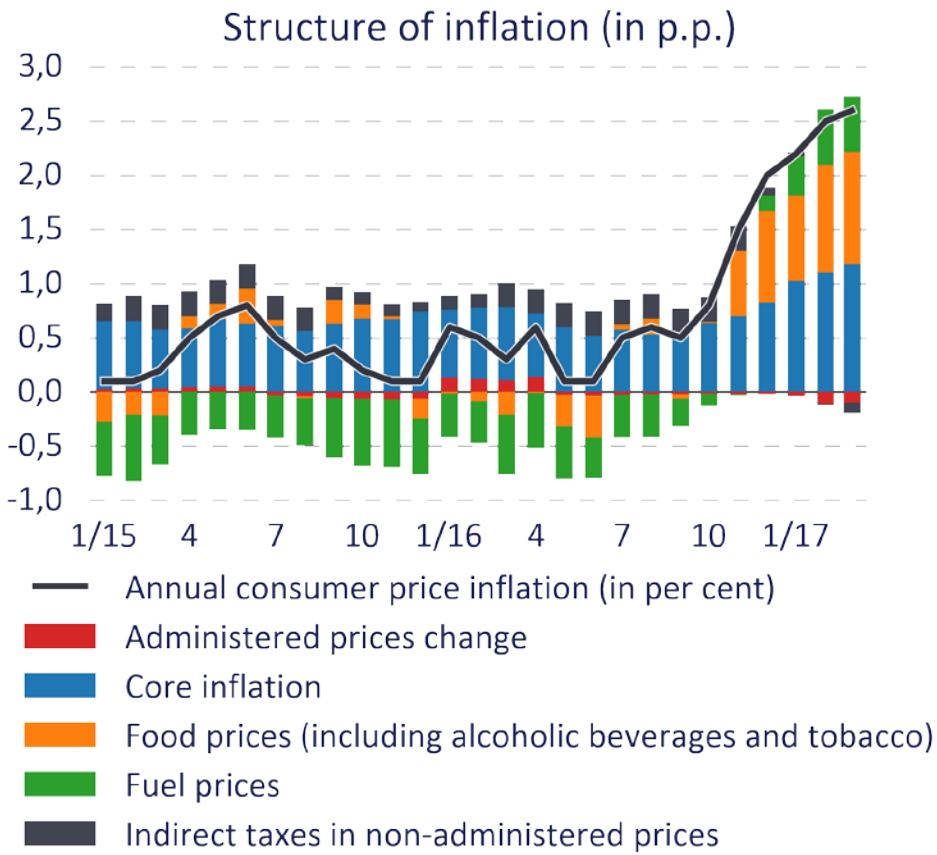
- In 2017, inflation will stay in the upper half of the tolerance band around the CNB's target and return to the target early next year. It will remain close to the 2% target at the monetary policy horizon.
- GDP growth will increase to almost 3% in 2017 and remain at this level in 2018.
- The economy will be supported by continuous growth of foreign demand and gradual renewal of government investment co-financed from EU funds.
- Growing labour demand will, in combination with the lack of available work-force, result in further wage growth acceleration.
- Consistent with the forecast is an increase in domestic market interest rates in the 2017 Q3 and later also in 2018.

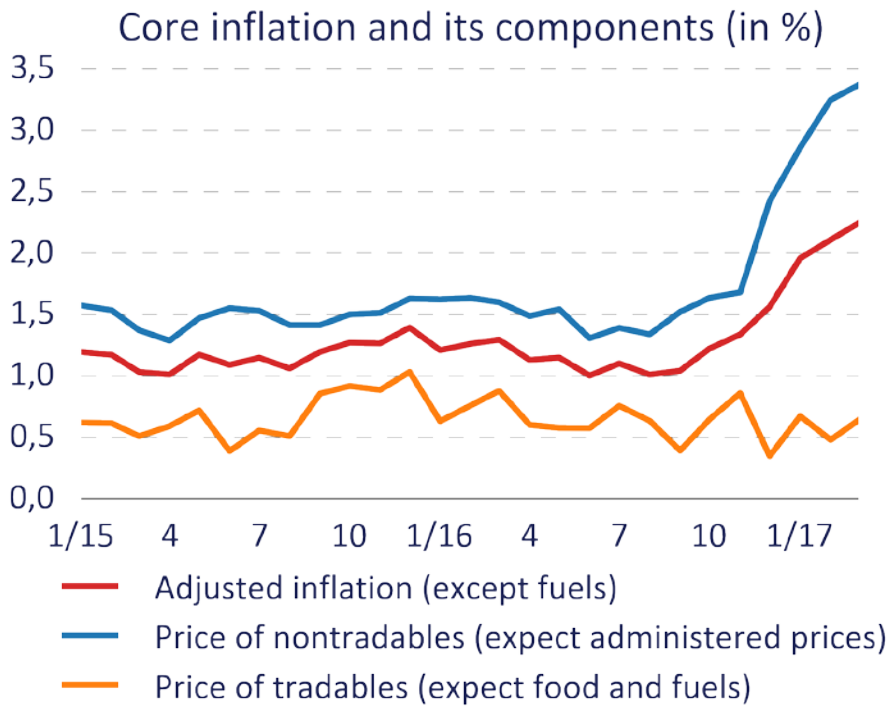
# Headline Inflation




- Headline inflation will decline at the start of 2018 and will be very close to the 2% target at the monetary policy horizon.
- MP-relevant inflation will differ only marginally from headline inflation.

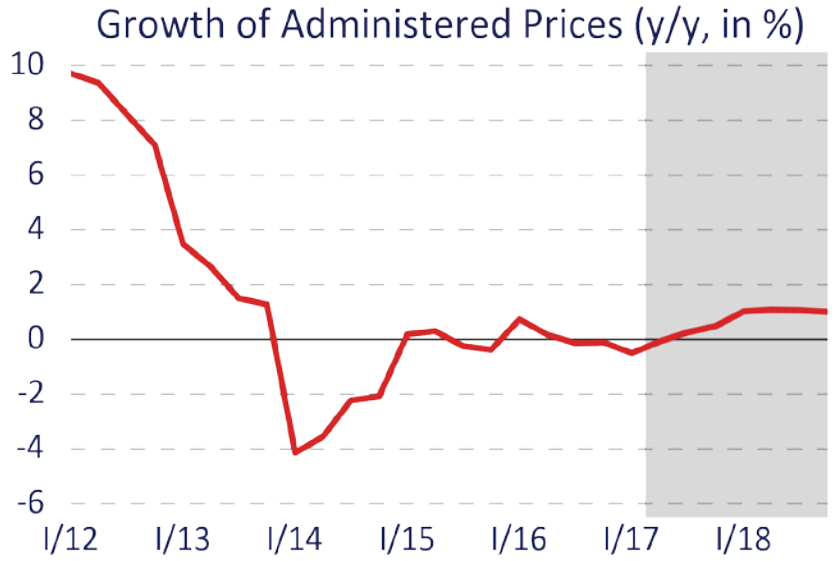
# Structure of Inflation

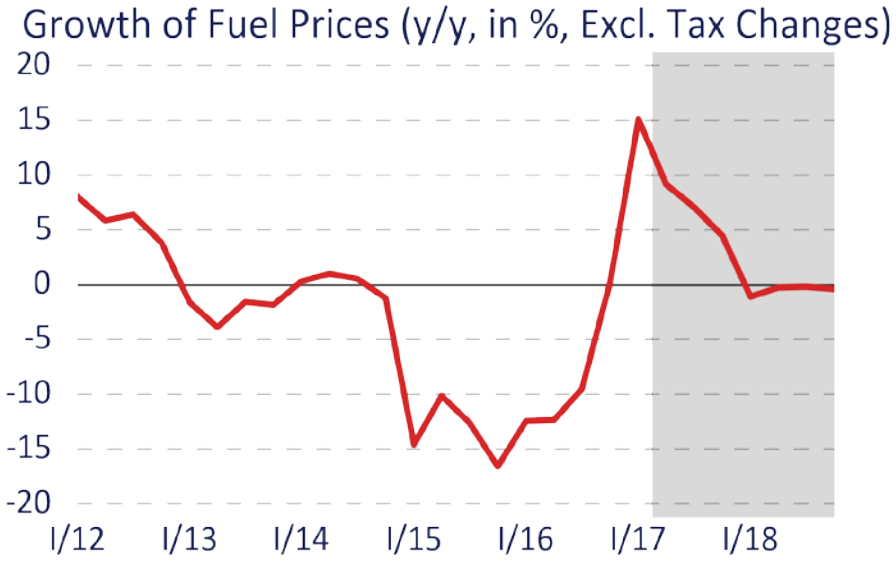



- The observed marked increase in inflation was primarily due to a rise in core inflation and increase in food price growth, accompanied by renewed growth in fuel prices.
- The rise in core inflation above 2% reflected a fast speed-up in the non-tradable goods prices.

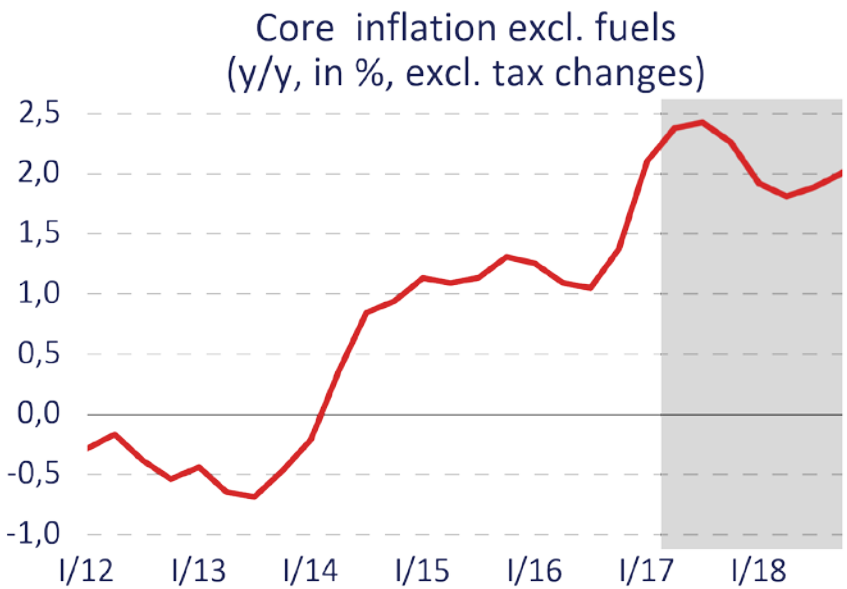
# Administered and Fuel Prices

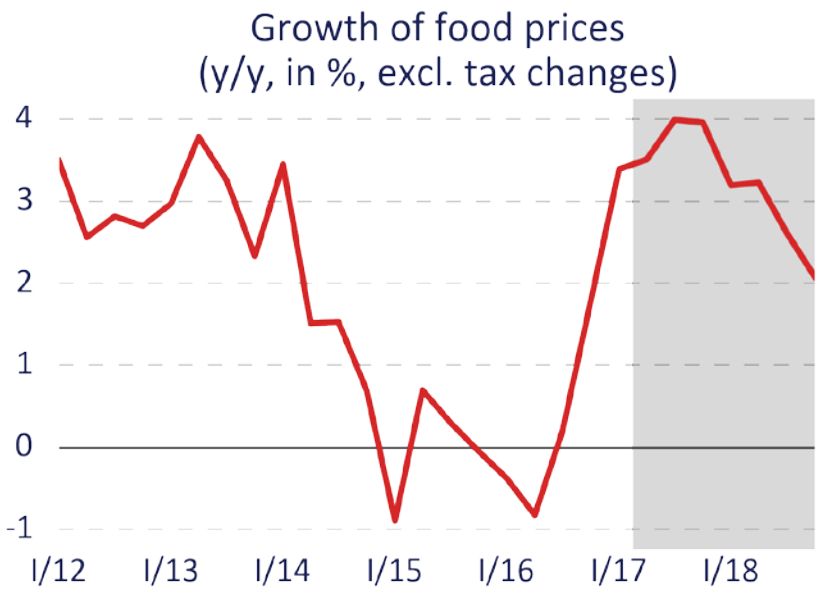



- Growth in administered prices will resume as the current decrease in gas prices fades away. While the price of heat will also decline this year, other items of administered prices will grow, thus leaving the total unchanged for the rest of 2017. In 2018, the administered prices will grow on average by 1 %.
- Currently strong growth of fuel prices will gradually decrease in relation to stable outlook of oil price.

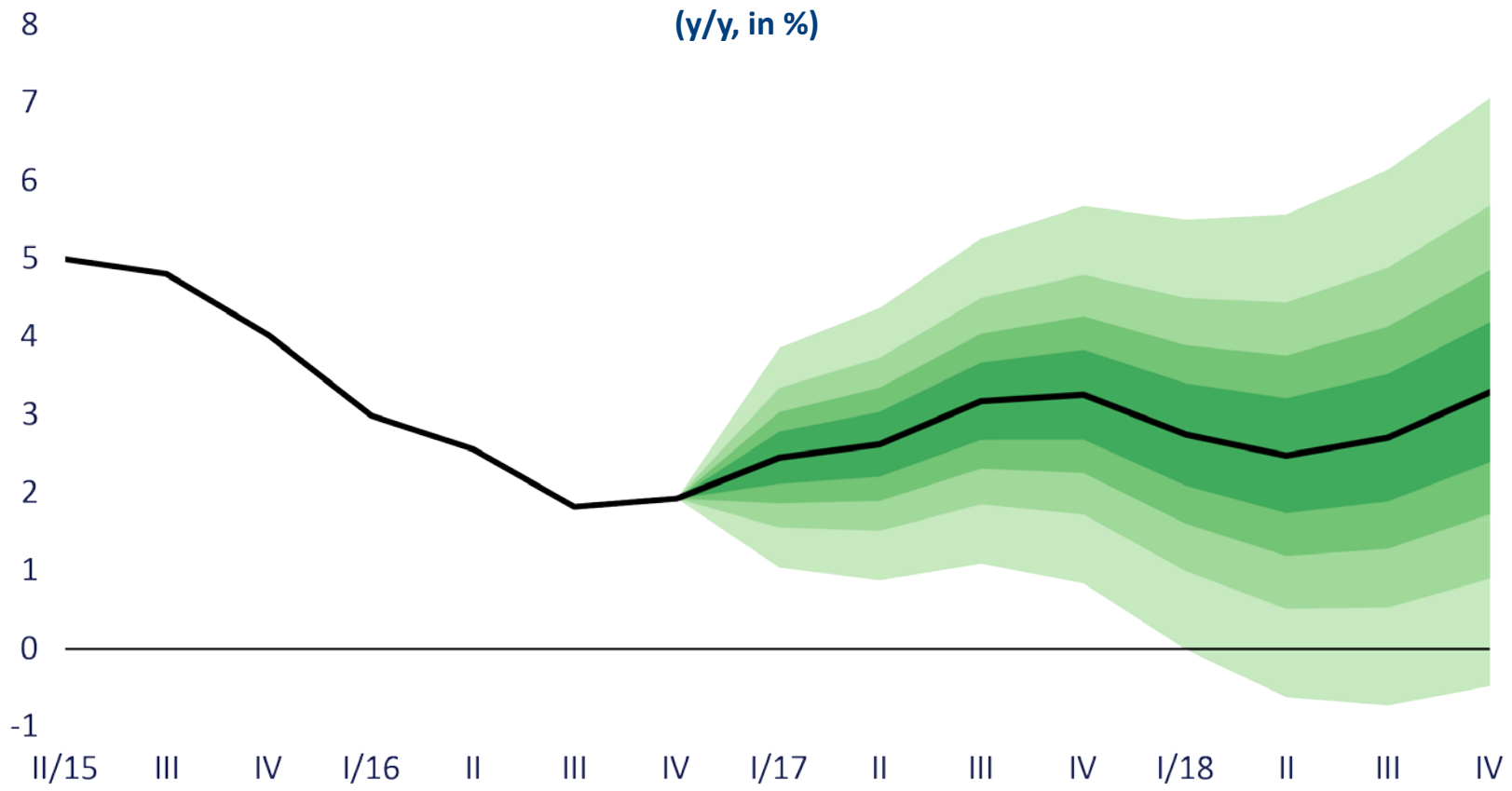
# Core Inflation and Food Prices



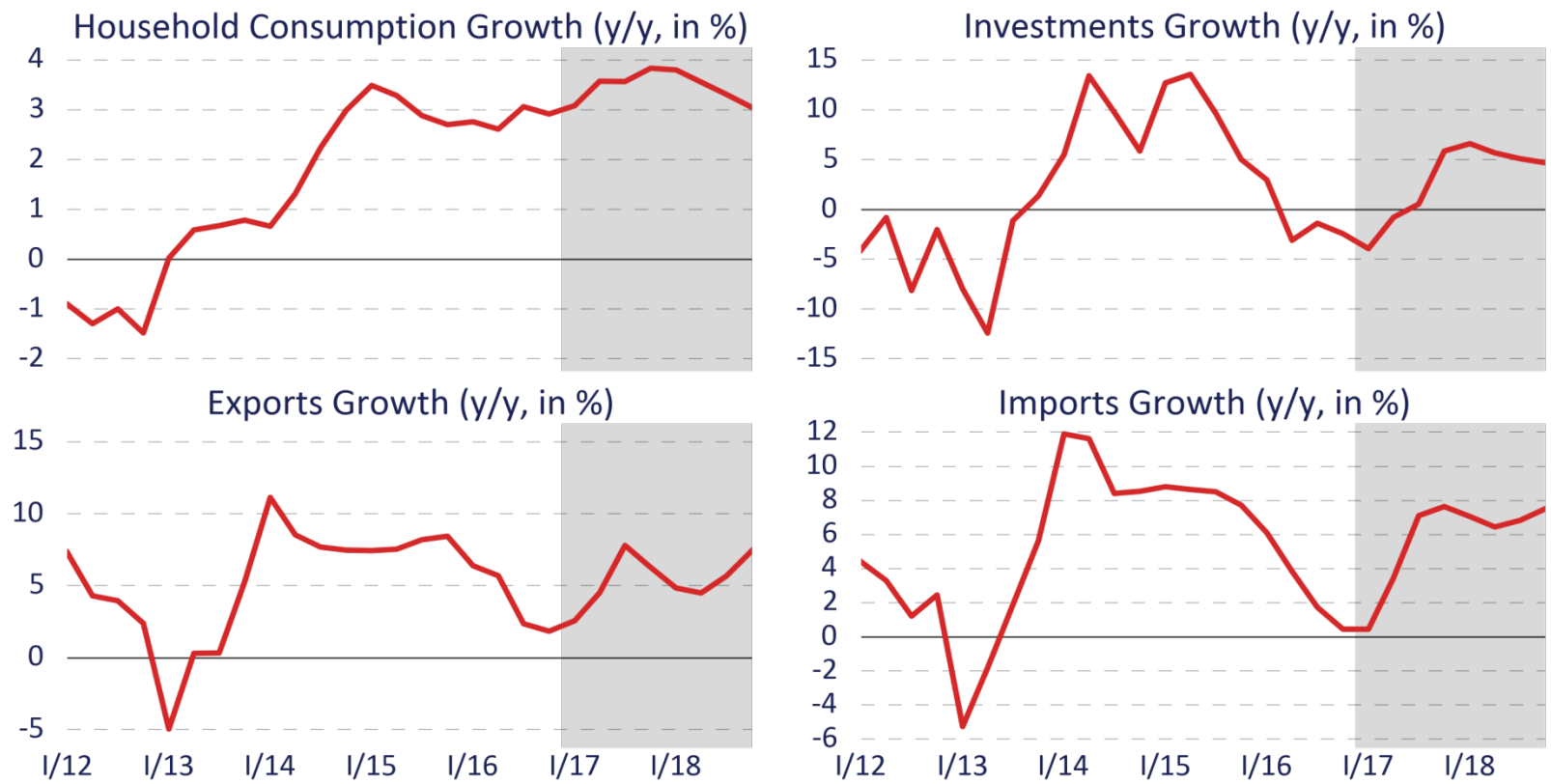

- Core inflation will remain at currently elevated values in 2017 due to previous accumulation of cost pressures from the domestic economy amid continuous wage growth. In 2018, core inflation will gradually slow to just below 2% reflecting the renewed decrease in import prices and the fading out of the one-off effect of EET introduction.
- Growth of food prices will speed up in the next two quarters due to revival of agricultural commodities prices growth, reaching approximately 4% at the end of year. In 2018, the food price growth will slow down gradually.

# GDP Growth



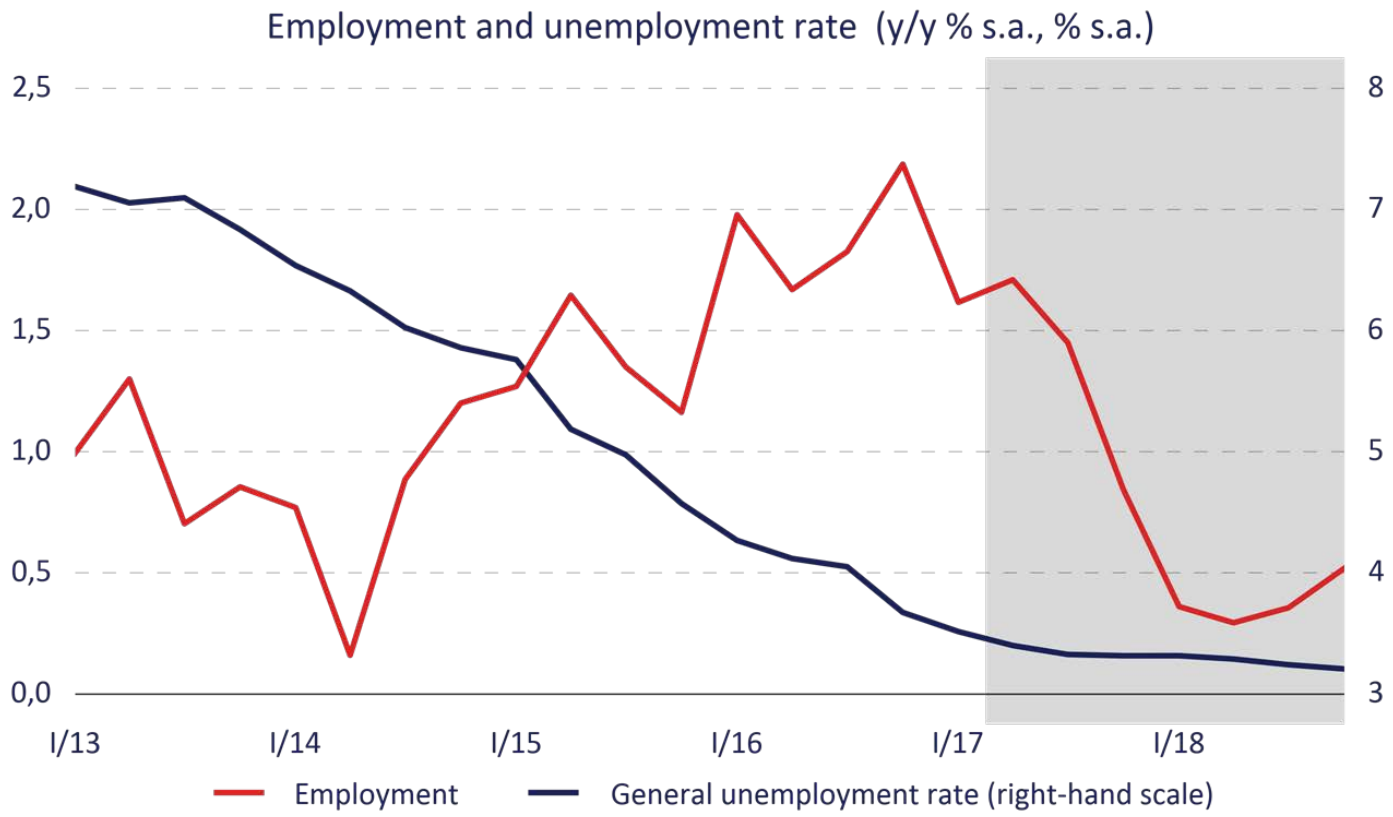

- GDP growth forecast: 2.9% in 2017; 2.8% in 2018.
- The economy will benefit from a positive fiscal impulse and ongoing foreign demand growth.

# Aggregate Demand



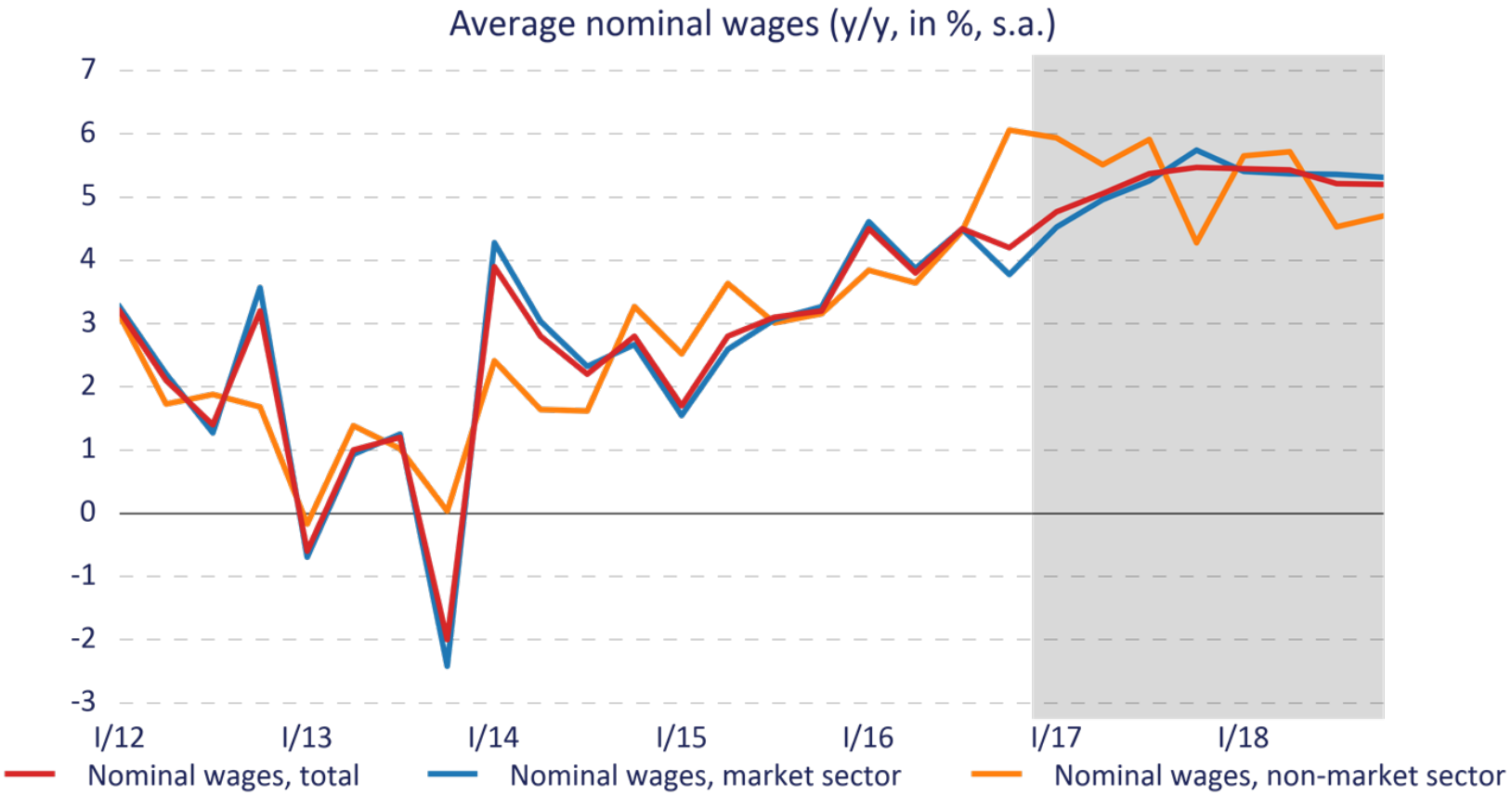

- Household consumption growth will accelerate up to almost 4 % by the end of the year. Main driving force will be the high growth of disposable income.
- Investment growth will turn positive at the end of 2017 (EU funds cycle).
- Both export and import will grow faster, due to positive outlook of both foreign and domestic demand. Net exports will thus contribute positively to GDP in this year, but negative in 2018 due to renewed investment and CZK appreciation.

# Labour Market: Unemployment



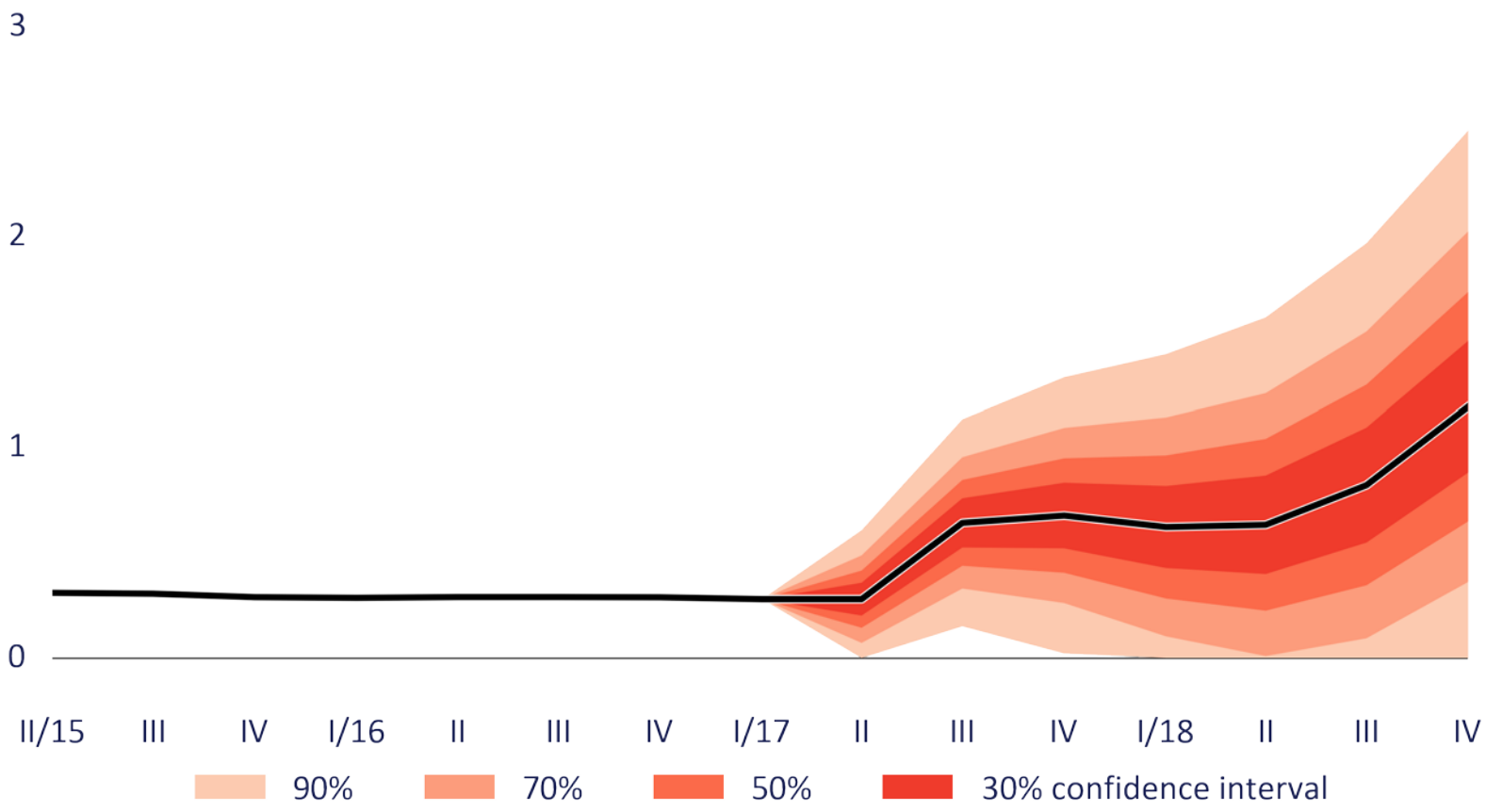

- The previously strong growth in employment will slow due to an increasing shortage of labour.
- Previous long-term decline in general unemployment rate to its current very low levels limits any further significant drop. Therefore, it will decrease only slowly to 3.2% in 2018.

# Labour Market: Wage Growth in Business Sector




- Growing tension on the labour market will push towards higher wage dynamics in the business sector. Starting mid-2017, wage growth will be above 5%.
- Similar trend is expected for wages in public sector, with stronger growth in 2017 implied by recently approved or envisaged nominal wage increases.

# Interest Rate Path (3M PRIBOR)




- Consistent with the forecast is an increase in domestic market interest rates in the 2017 Q3 and later also in 2018.
- However, the rate increase will be strongly dampened until around mid-2018 by the ECB's currently ongoing quantitative easing.

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# Comparison with Previous Forecast

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- The forecast of inflation is slightly lower at the monetary policy horizon, despite currently stronger inflationary pressures which are expected to gradually fade away. These pressures reflect faster than expected growth of foreign producer prices, and higher domestic inflation owing partly to the one-off effects.

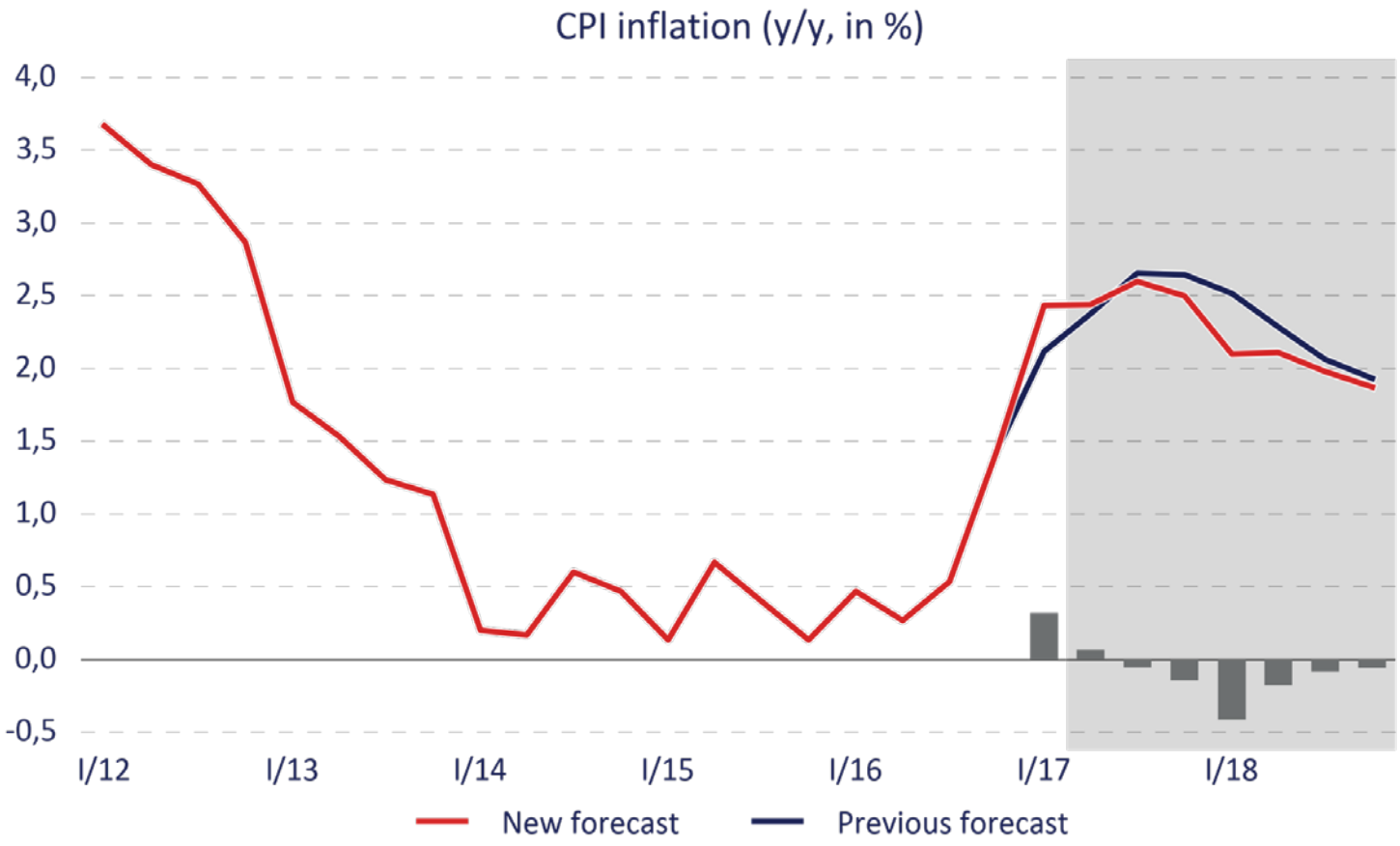
- The GDP outlook has not changed significantly.

- Lower than predicted growth of nominal wages in the business sector in the end of the last year is considered to be only temporary deviation from the trend.

- Compared to assumptions of previous forecast, exit from the exchange rate commitment has happened earlier. This implies – according to the forecast – an earlier than previously predicted appreciation of koruna, reflected in more anti-inflationary effect of import prices.

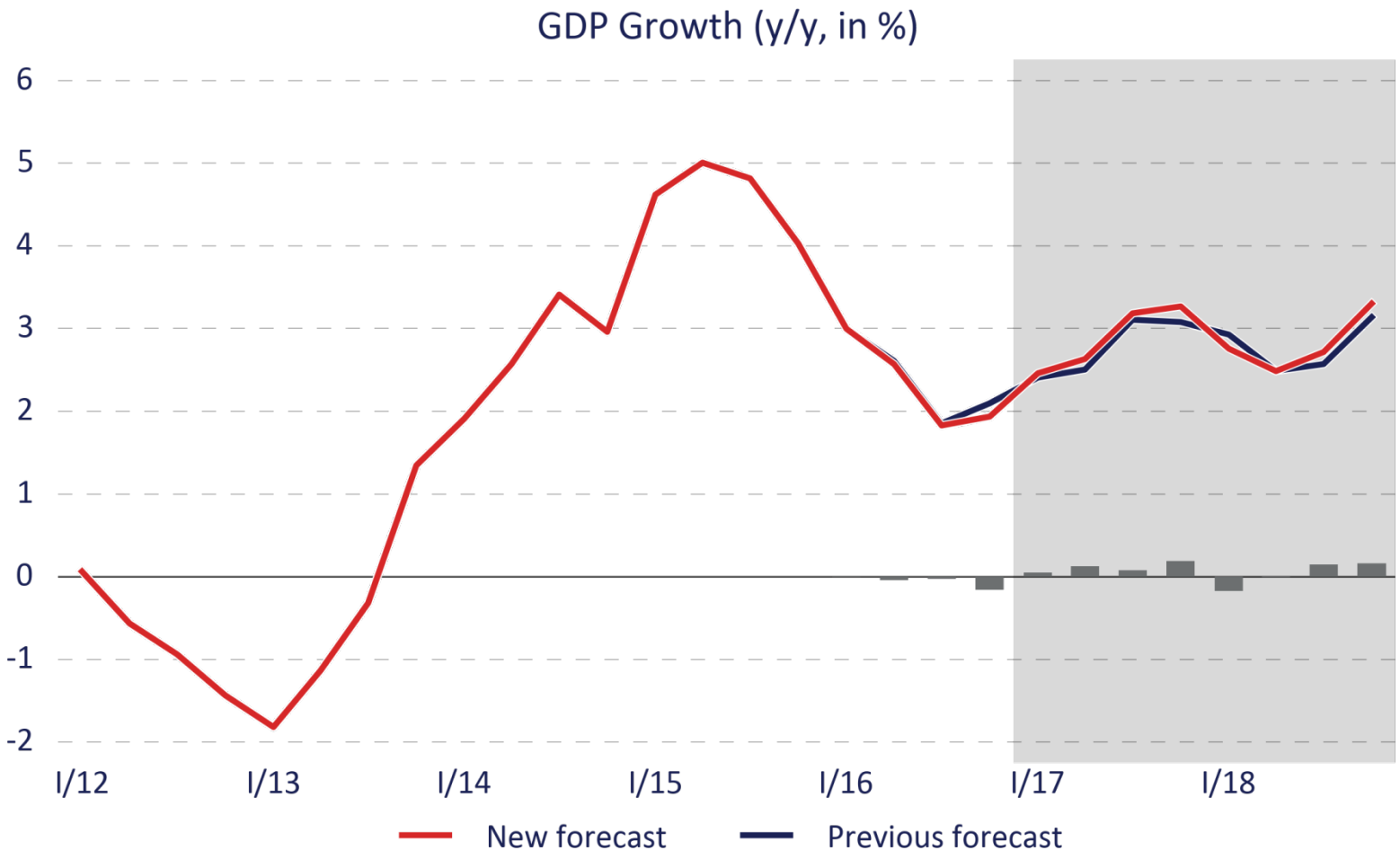
- Trajectory of market interest rates shifts in the direction of their slower increase.

# Comparison: Inflation Forecast



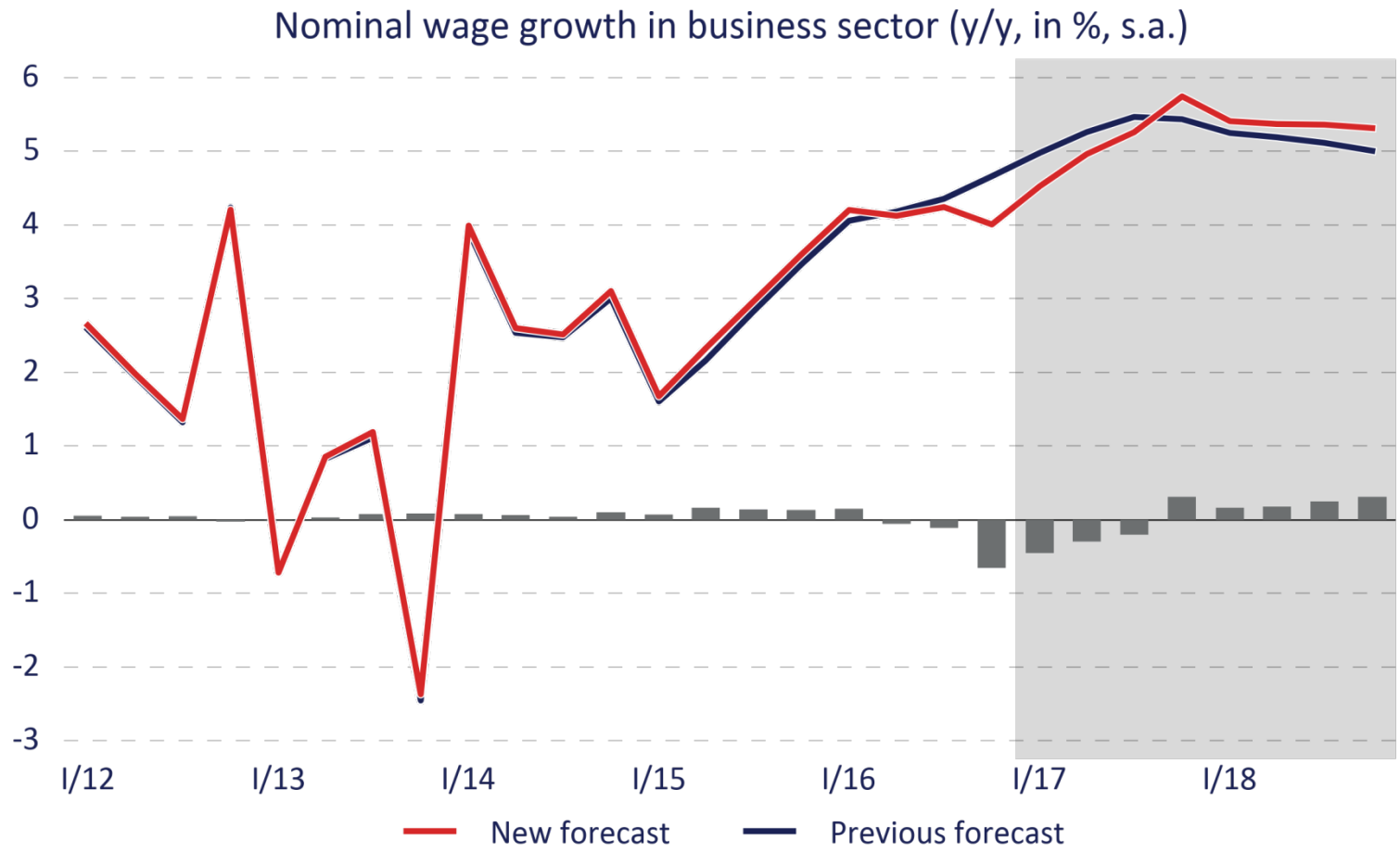

- Overall inflationary pressures are higher than previously forecasted, due to observed faster growth in domestic prices, as well as foreign producer prices.
- Slightly lower inflation forecast at the monetary policy horizon is driven mainly by stronger koruna, and unwinding of the current one-off inflationary factors.

# Comparison: GDP Forecast (i)



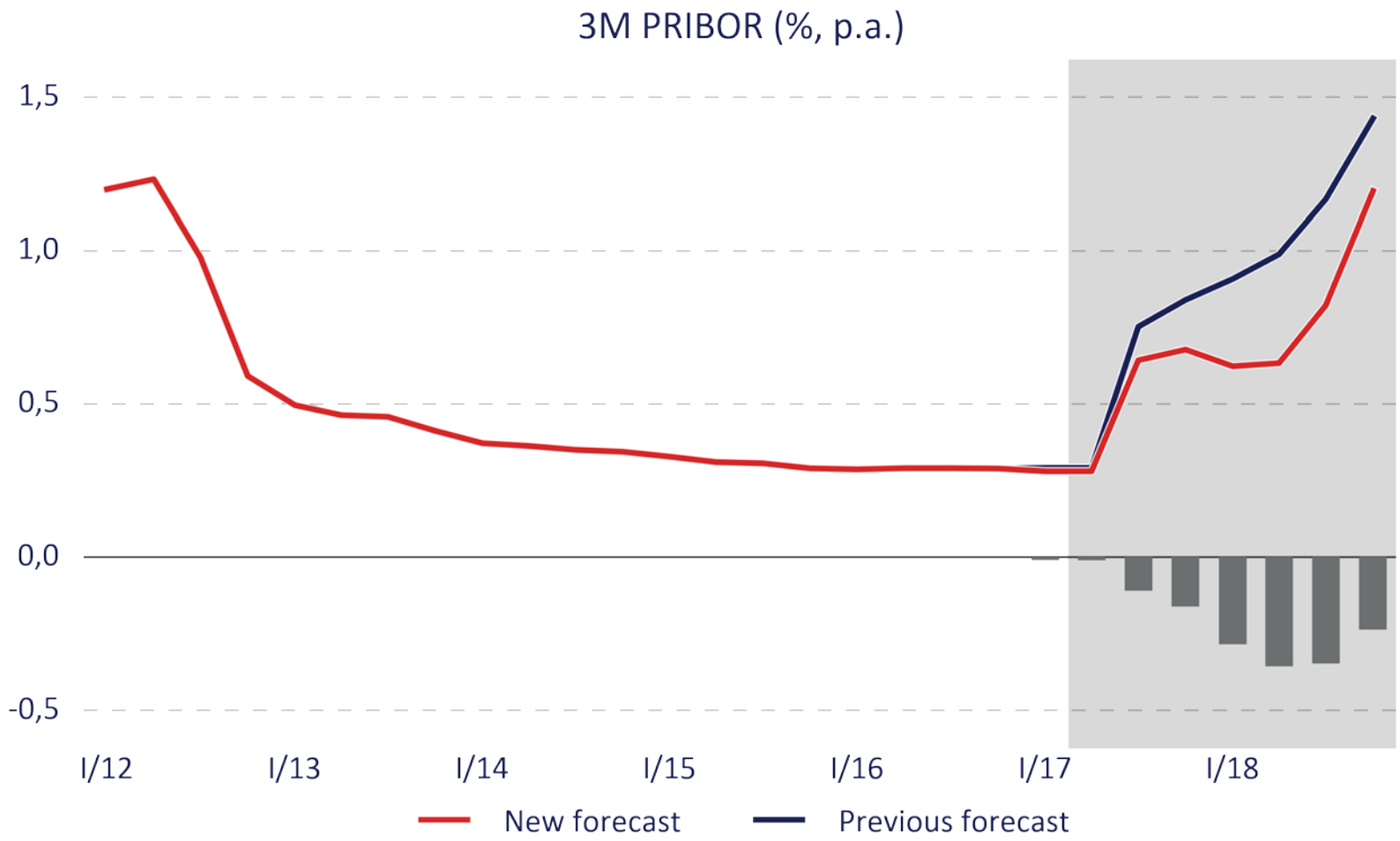

- The GDP growth outlook for the following years is almost unchanged overall; there are, however, slight shifts within its structure (higher consumption, delayed revival of investment growth and higher contribution of net exports).

# Comparison: Nominal Wage




- Lower observed growth of nominal wage in the business sector at the end of last year is considered to be only a temporary deviation from the upward trend.
- Dynamics of wages will then converge to the previous forecast, and shift a little higher in 2018.

# Comparison: Interest Rate Forecast




- The path of domestic market interest rates shifts towards slower increases due mainly to earlier discontinuation of exchange rate commitment and related slightly lower inflation forecast at the monetary policy horizon.

# Thank you for your attention!

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