CNB's New Forecast (Inflation Report I/2018)

Meeting with Analysts

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Prague, 2 February 2018

CZECH NATIONAL BANK

Outline

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

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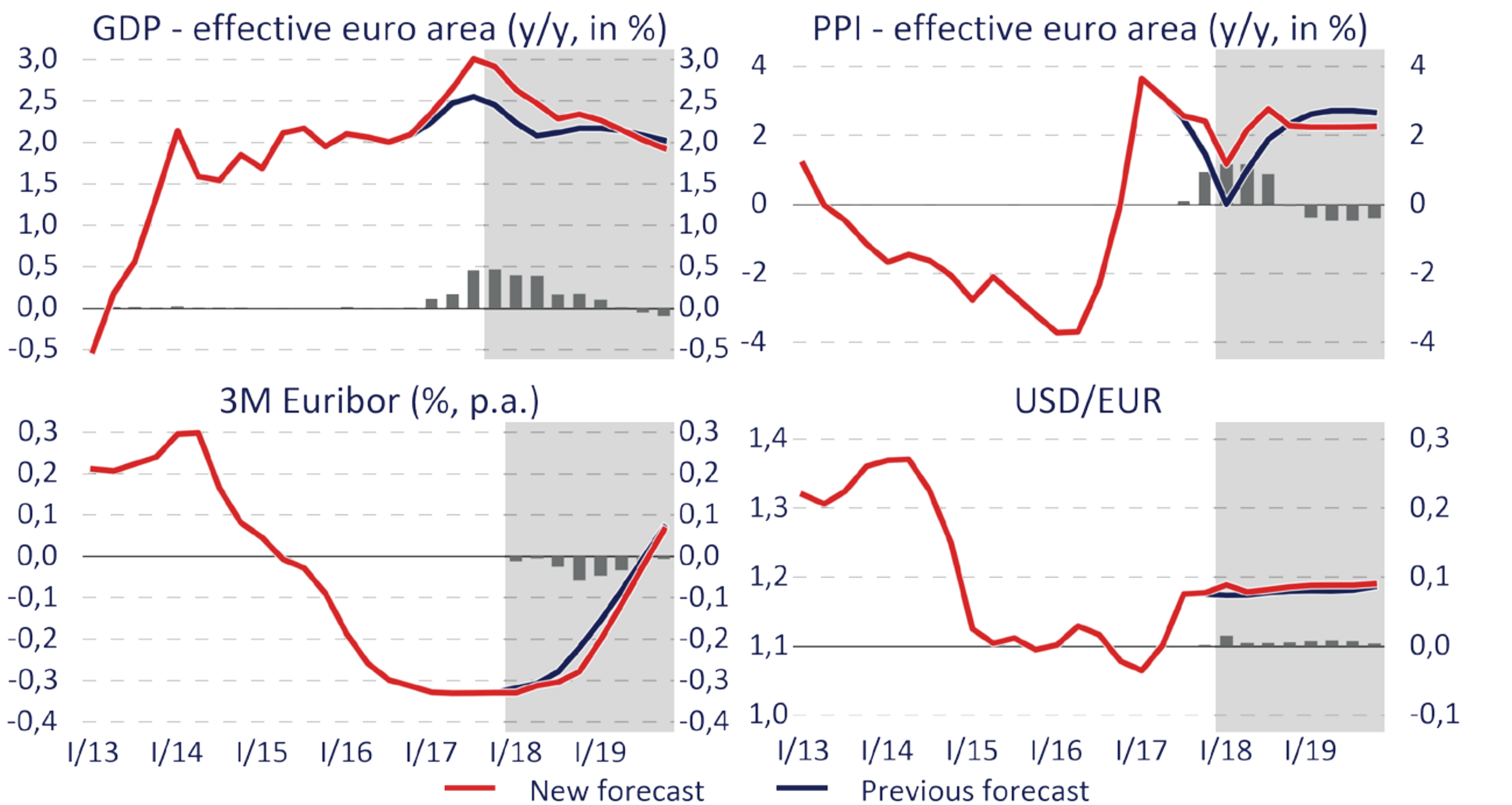
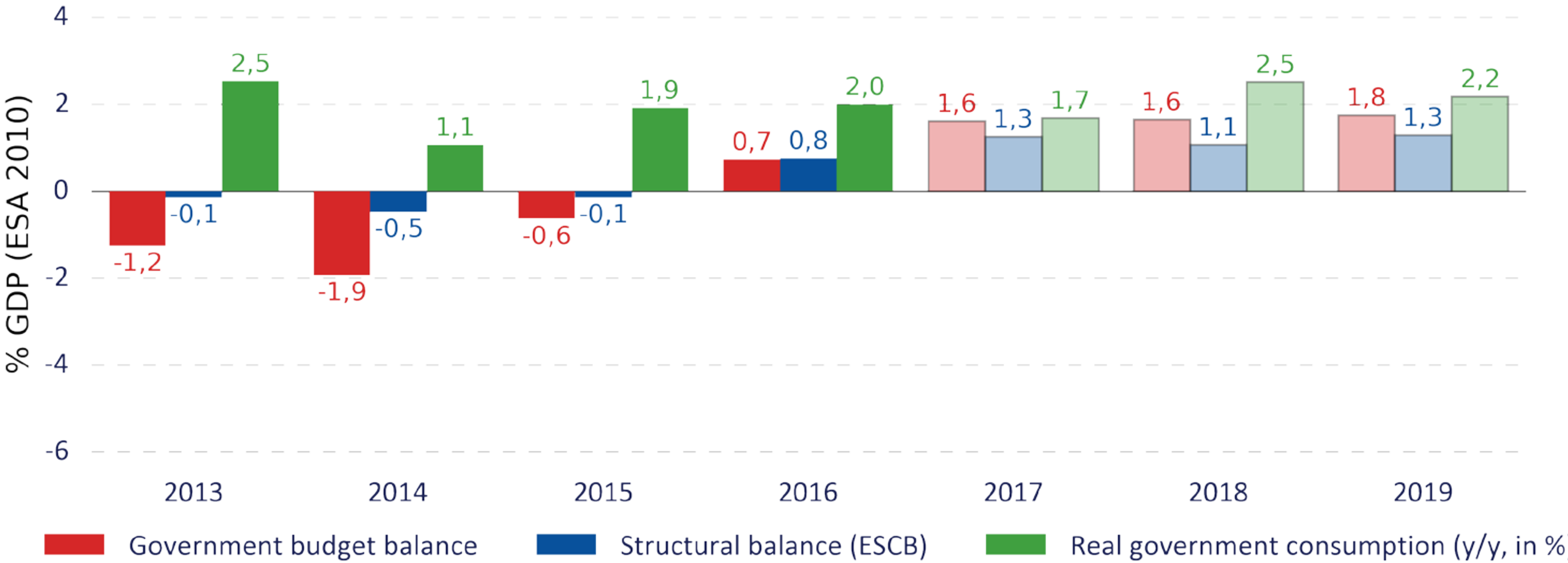
External Environment Outlook



- GDP growth in the effective eurozone will remain robust and is revised upwards.
- Producer price dynamics will slow at the start of this year, but will then recover reflecting the current high oil price and increasing economic activity.
- Continued QE of the ECB keeps the outlook for 3M EURIBOR in the negative territory untill mid-2019. The USD/EUR outlook is just below 1.20.

Fiscal Policy



- The increasing government budget surpluses primarily reflect growth in tax revenues due to continued economic growth and policy measures.
- The government surplus will reach 1.6% GDP both this year and in 2019. This will be associated with persistent structural surpluses.
- The real government consumption will grow by 2.5% in 2018 and by only slightly less in 2019.

Fiscal Impulse

Contributions to GDP growth in percentage points	2016	2017	2018	2019
	actual	forecast	forecast	forecast
Fiscal impulse	-1.1	0.2	0.5	0.0
of which impact through:				
private consumption	0.0	0.2	0.3	0.0
private investment	-0.1	-0.1	0.0	0.0
government investment, domestic	-0.2	0.0	0.1	0.0
government investment, EU funded	-0.7	0.1	0.1	0.0

- Fiscal policy will be expansionary this year and neutral in 2019.
- The fiscal expansion will relate mainly to measures supporting household consumption, including a buoyant wage growth in the government sector.
- Czech economic growth will also be bolstered by faster growth in government investment in 2018 (recovery in the drawdown of EU funds).

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Summary of the New Forecast

- Inflation will stay above the 2% target in 2018 and return to it at the start of the monetary policy horizon. In 2019, inflation will be just below the CNB's target.
- GDP growth will reach 3.6% in 2018, and will slow down slightly to 3.2% in the following year.
- The increase in domestic economic activity will be driven mainly by robust growth in household consumption and fixed investment, amid continuous growth of foreign demand.
- Growing labour demand will, in combination with the lack of available work-force, result in robust wage dynamics.
- The exchange rate will appreciate further due to a widening positive interest rate differential, ECB's QE program and long-term real convergence.
- Interest rates will rise further. This, coupled with appreciation of the koruna, will ensure that inflation returns to the target.

Structure of Inflation

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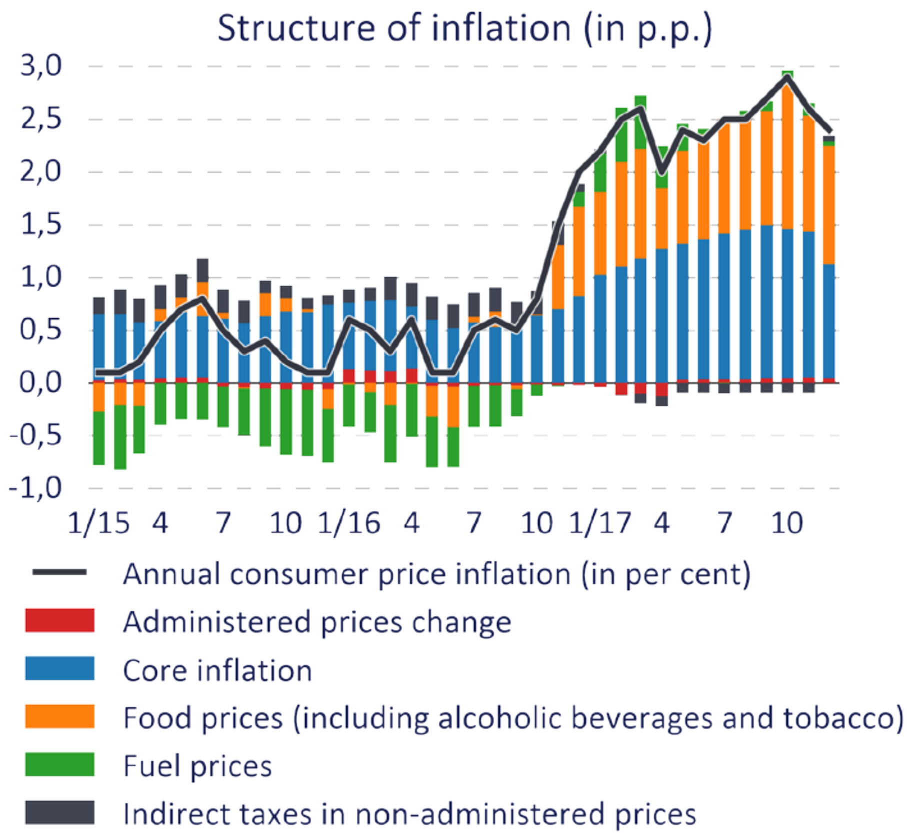
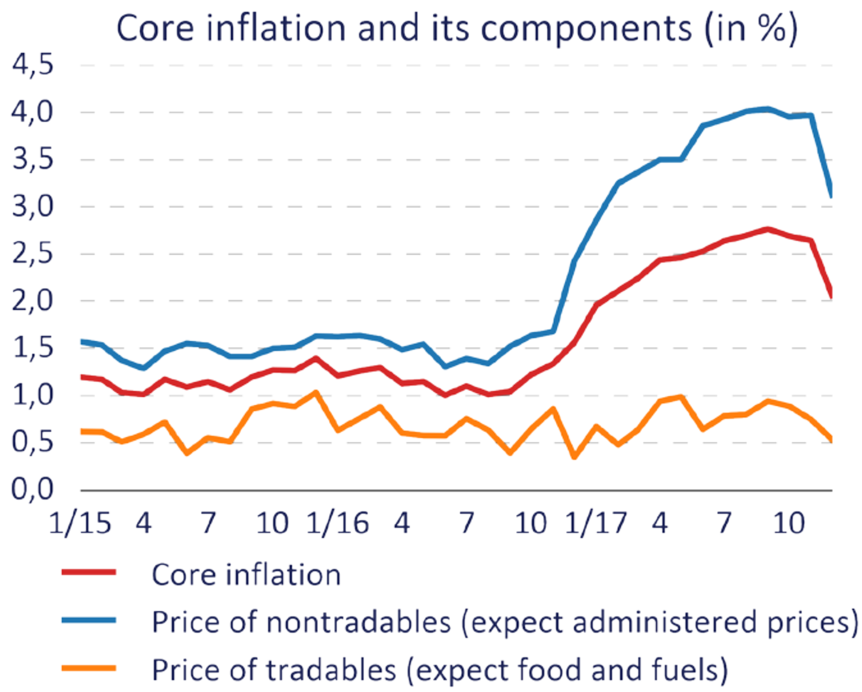
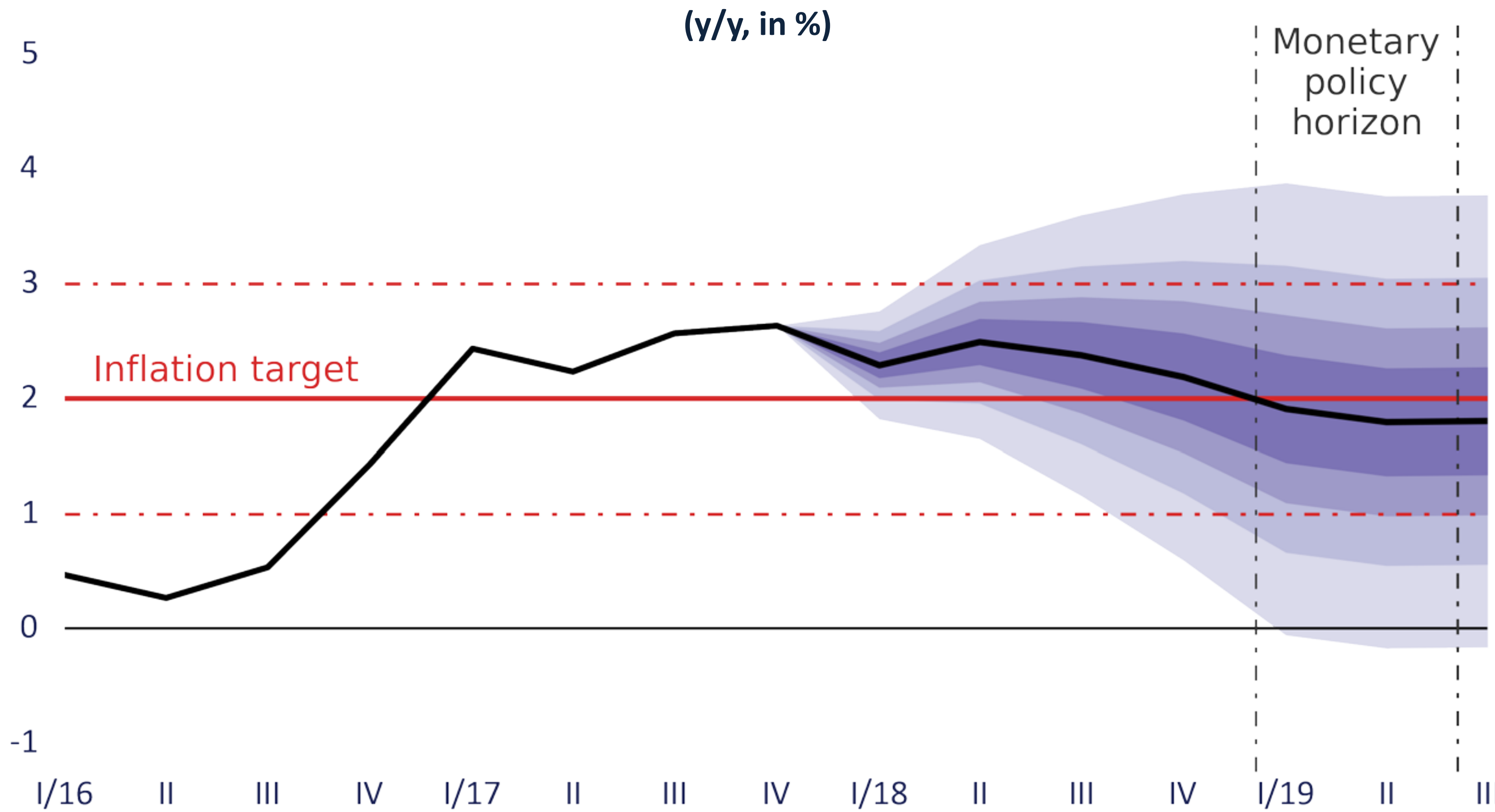




- The growth in consumer prices has been driven by core inflation and fast growth in food prices.
- Core inflation declined in December owing to slower growth in the prices of nontradables, mainly due to slowing dynamics of prices in restaurants (fading out of one-off effects from 2016/2017) and imputed rents.

Headline Inflation Forecast



- Inflation will stay above the 2% target this year and return to it at the start of the monetary policy horizon. In 2019, inflation will move just below 2%.
- MP-relevant inflation will differ only marginally from headline inflation.

Administered and Fuel Prices

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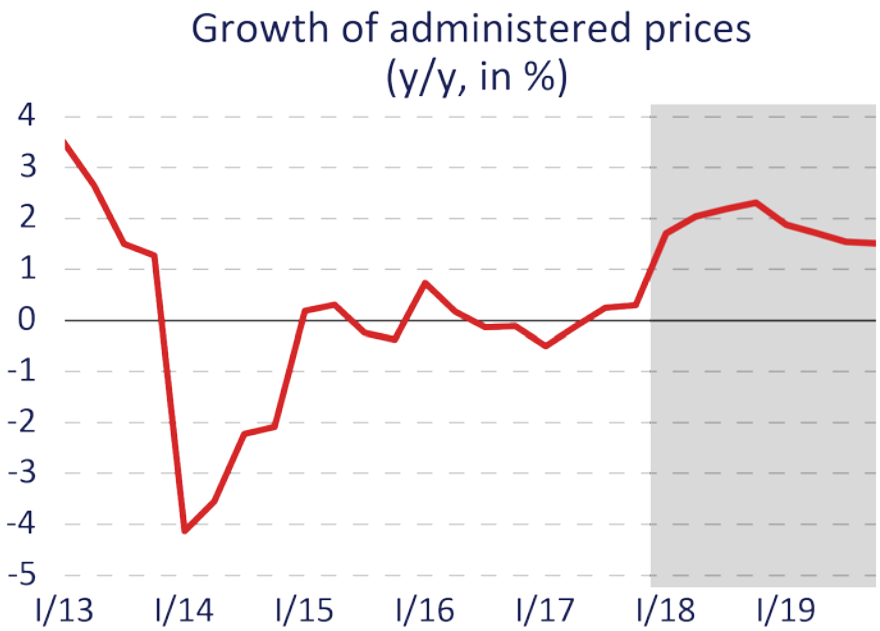
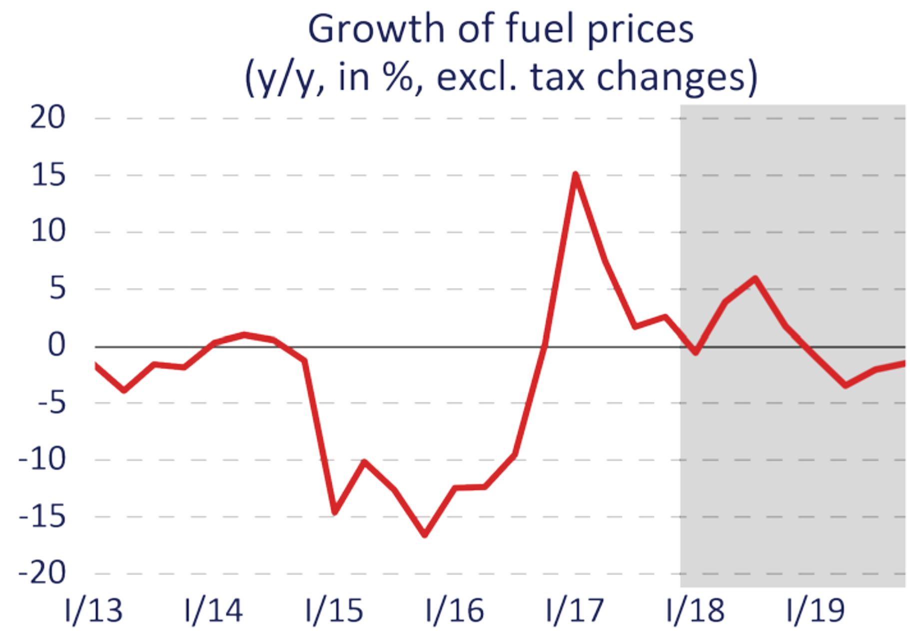
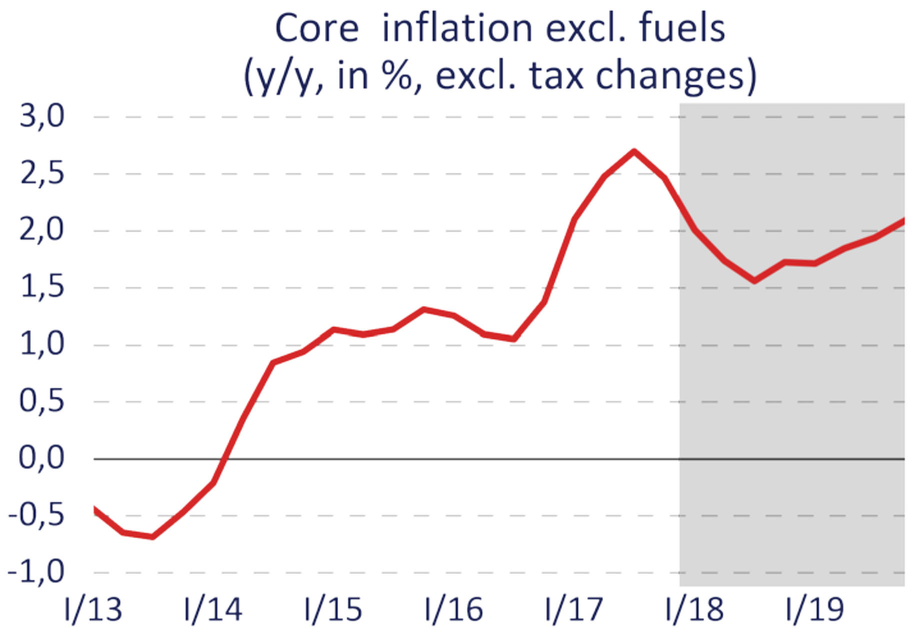
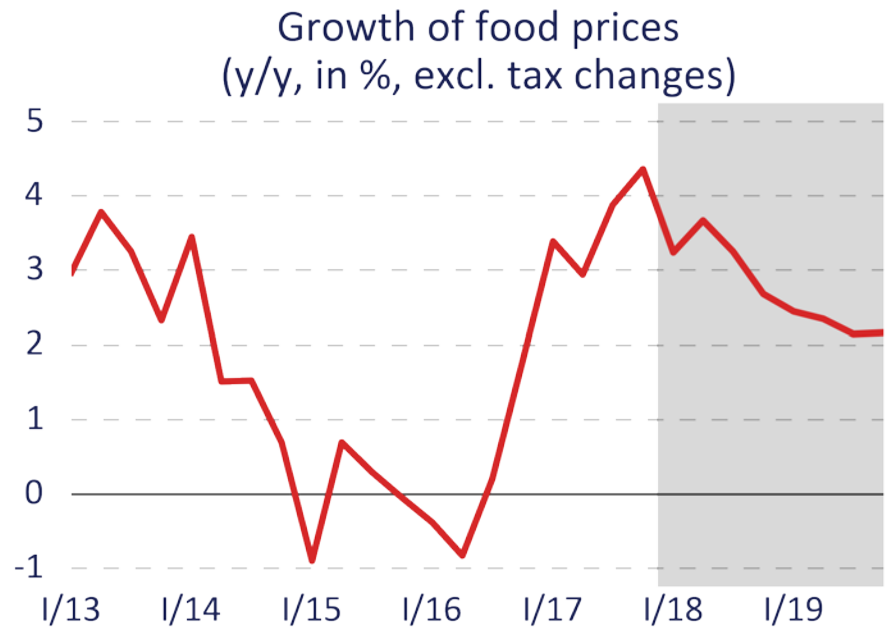




- Administered prices will start rising again this year, owing mainly to an increase in electricity prices. The negative contributions of gas and heat prices to administered price inflation will fully disappear during 2018 Q1.
- In 2019, administered price will slow somewhat due to more muted increases of electricity and fuel prices. This will contribute to headline inflation being marginally (and temporarily) below target in 2019.
- Fuel prices will see renewed growth this year, but will decline slightly in 2019.

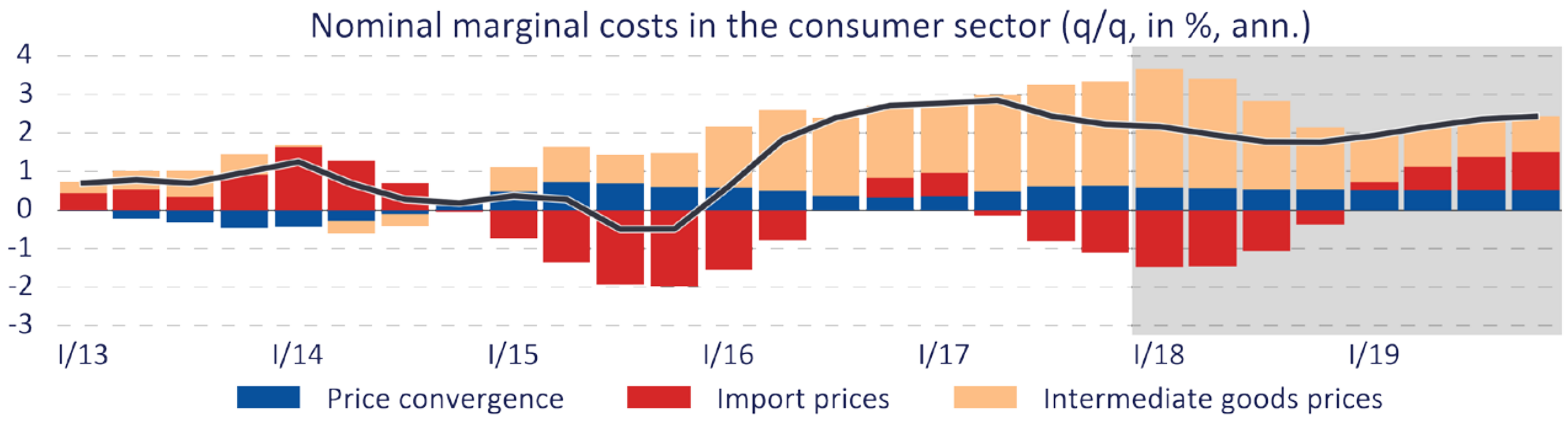
Core Inflation and Food Prices

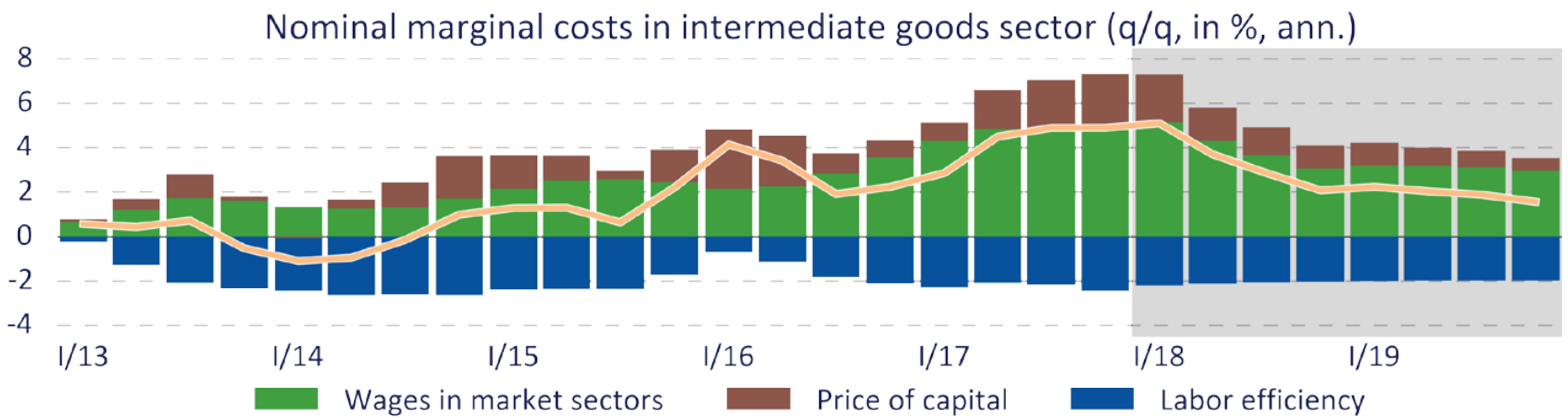




- Core inflation will slow this year owing to an unwinding of one-off factors and appreciation of the koruna. These anti-inflationary factors will be partly offset by the impact of rising domestic demand and wages.
- During 2019, core inflation will start to rise gradually back towards 2%, reflecting renewed growth in import prices.
- The recently high food price inflation will moderate owing to an expected slowdown in the rapid growth in agricultural commodity prices. Appreciation of the koruna will act in the same direction this year.

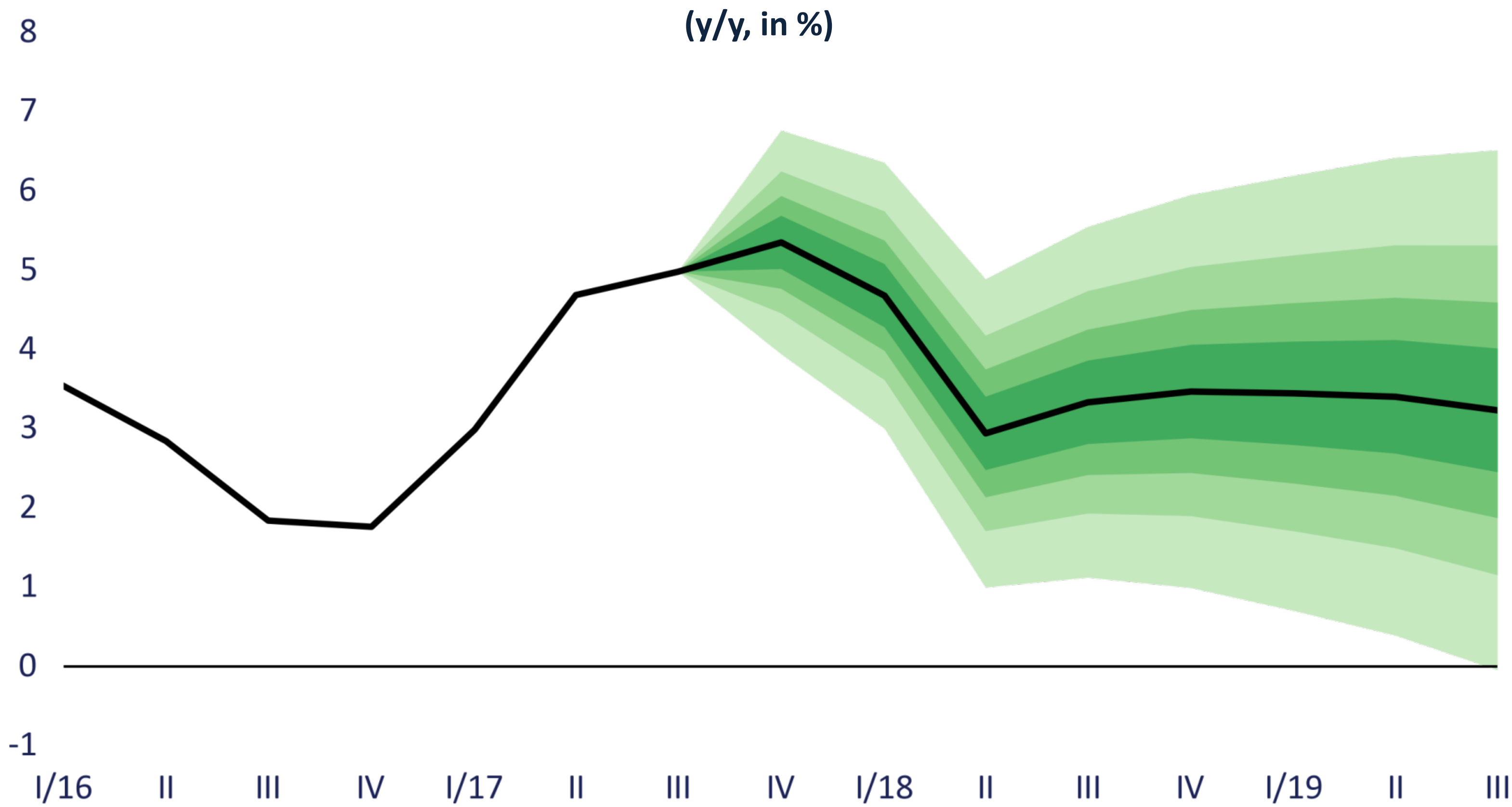
Inflation pressures





- The currently strong inflation pressures, stemming from accelerating growth of the domestic economy and wages, will ease gradually. In 2018, this will be due mainly to an anti-inflationary effect of import prices.
- Later on, the domestic inflation pressures will easy (less pronounced growth of wages, smaller contribution of the price of capital).

GDP Growth Forecast



- GDP growth reached 4.5% last year and will slow down to slightly above 3% on average in the next two years.
- The dynamics of GDP will be fuelled by robust growth of domestic demand.
- Foreign demand will be supportive, too, but the contribution of net exports to GDP growth will turn negative in 2019 (stronger CZK, speed up in imports).

Aggregate Demand

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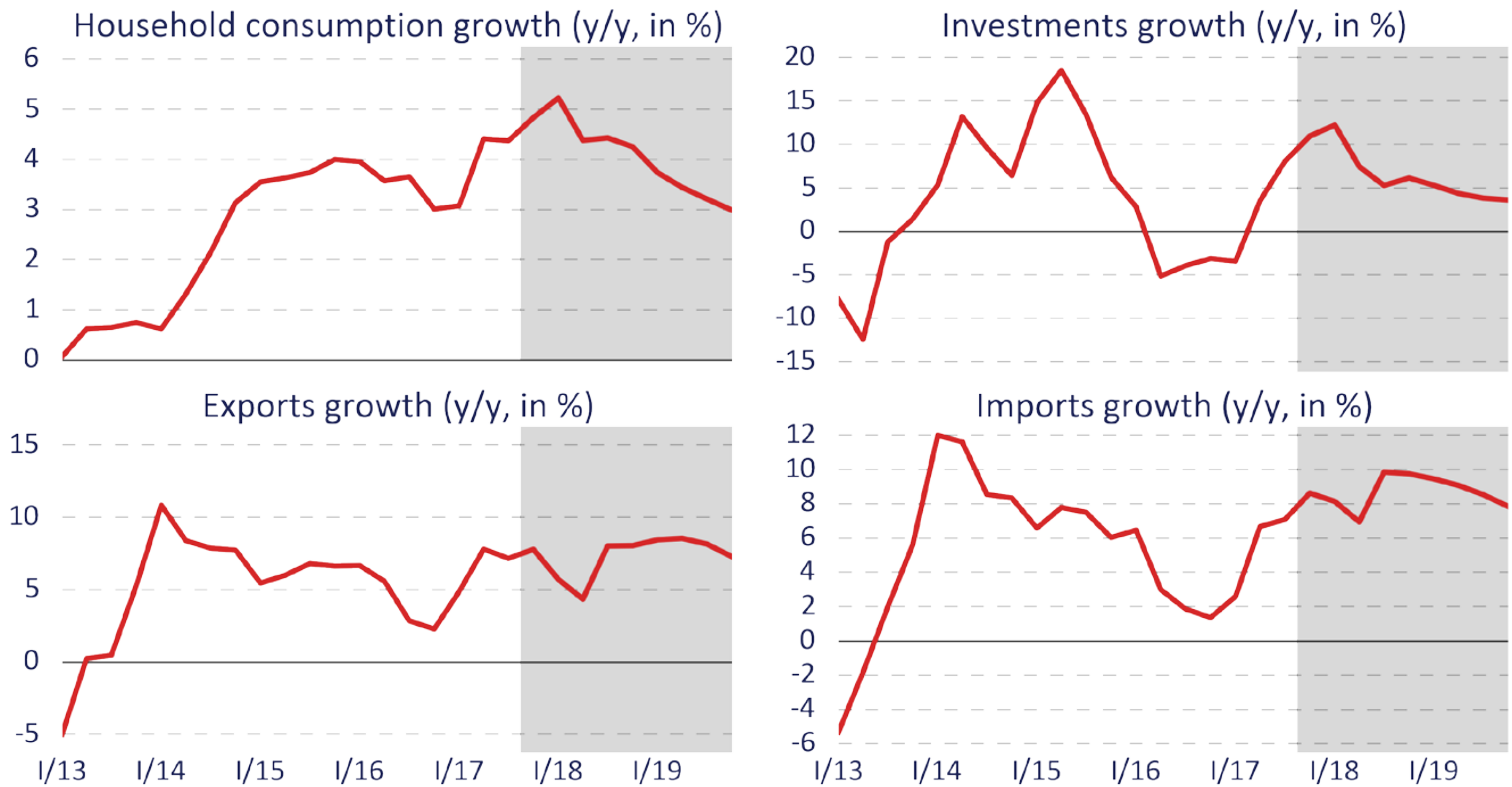
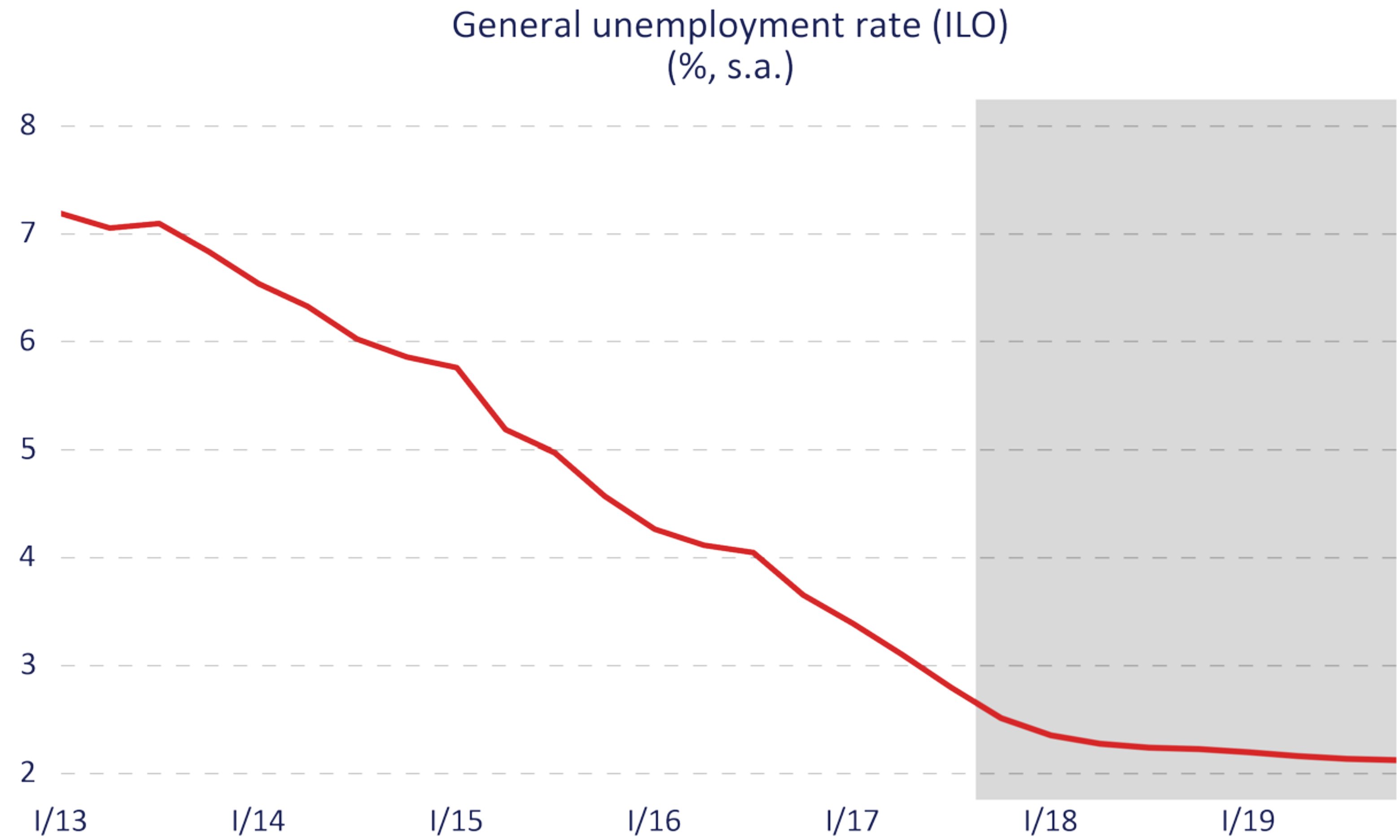


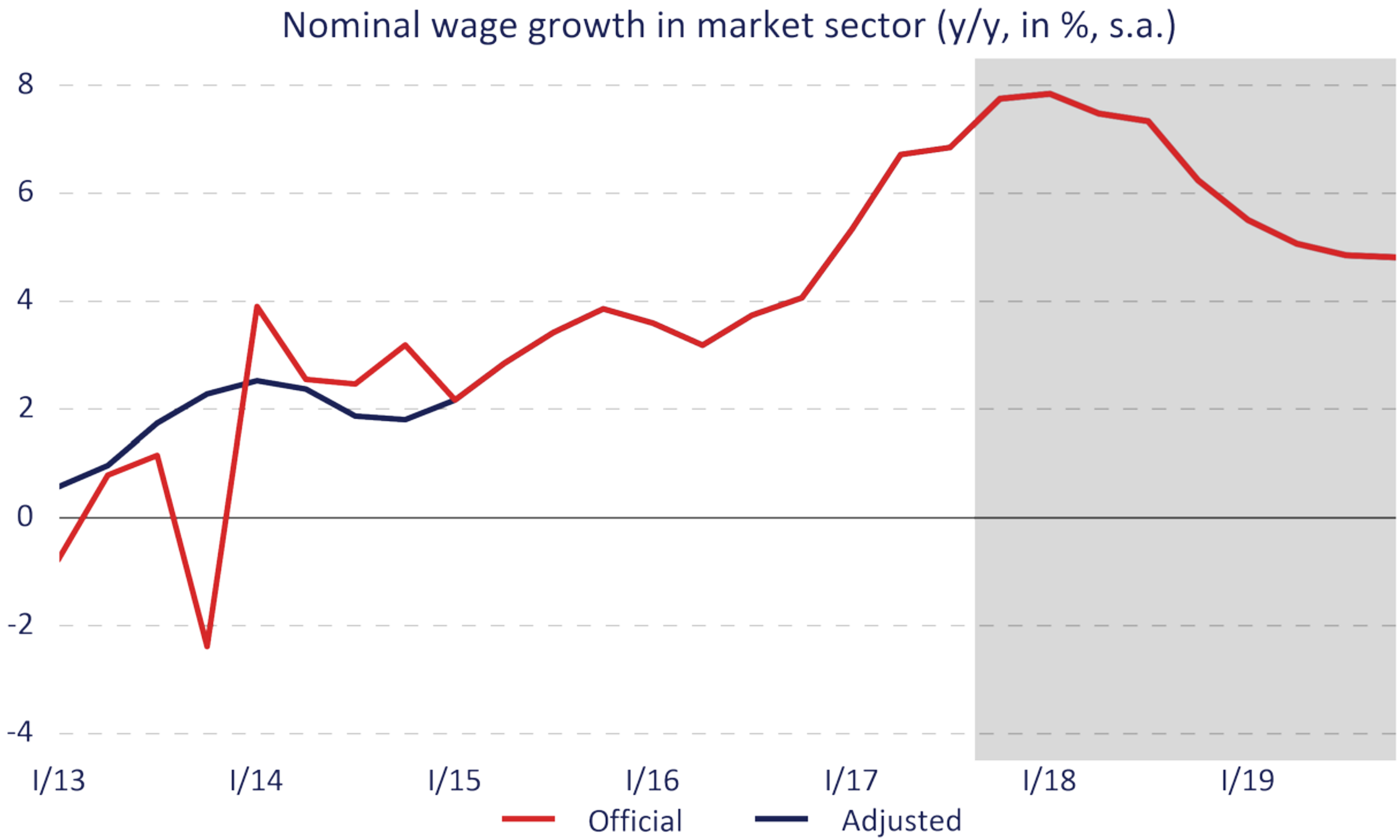
- The strong household consumption growth (with a peak above 5% at the start of 2018) will reflect a rapid rise in wages and salaries and other income.
- Growth in gross capital formation will accelerate further owing to a recovery in government investment amid a continued rise in private investment.
- Both export and import dynamics will slow down only temporarily.

Labour Market: Unemployment



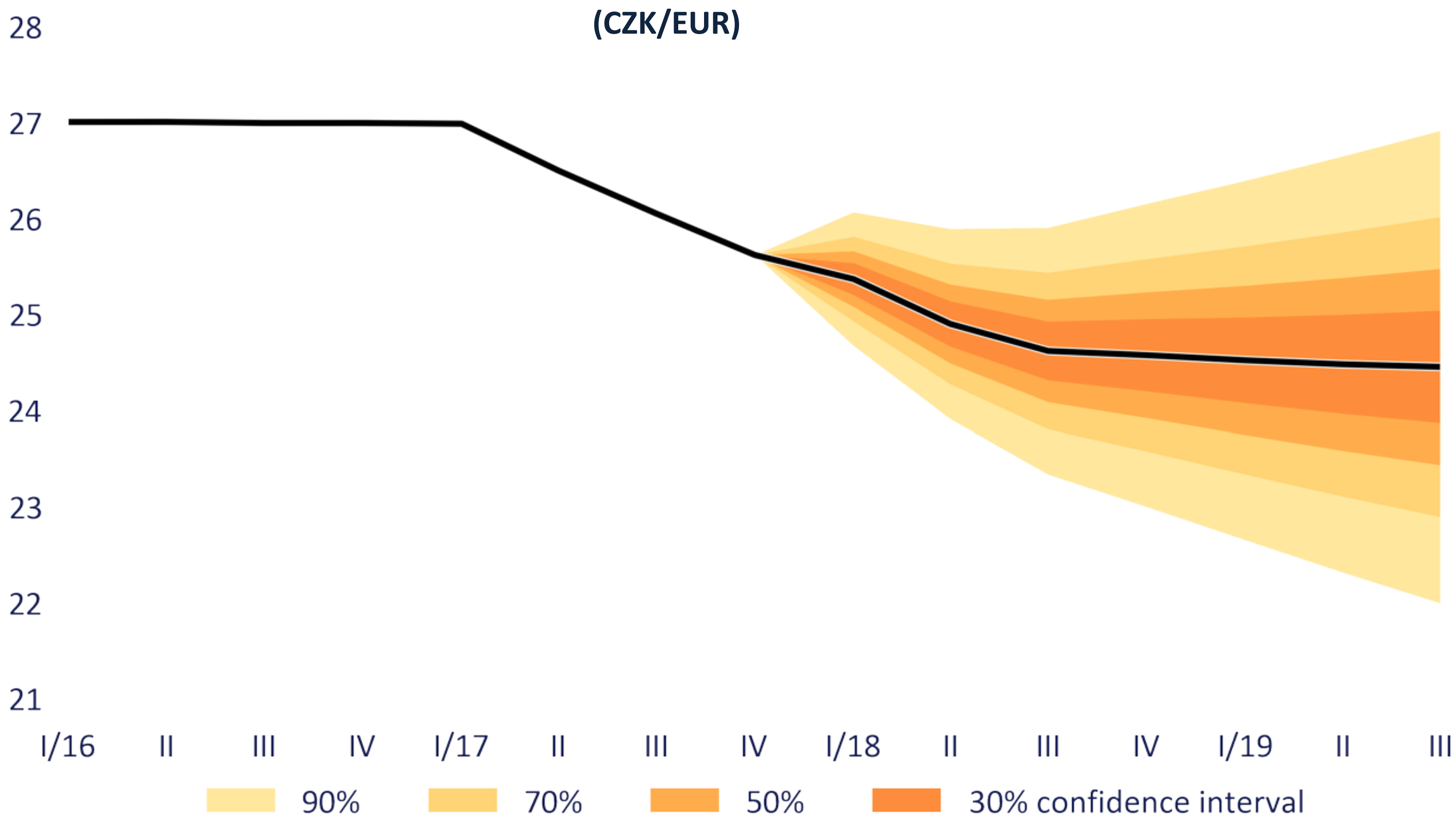
- The now very low unemployment rate is preventing unemployment from falling significantly further.
- Growth in the number of employees will slow down.

Labour Market: Wage Growth in Market Sectors



- The tightness in the labour market will keep wage growth in market sectors at a high level. A further increase in the minimum wage will also foster continued fast wage growth at the beginning of this year.
- Later, it will slow gradually to close to its assumed long-term level of 5%.

Exchange Rate



- The CNB has resumed publishing a numerical exchange rate forecast.
- Beware: the projected exchange rate is not a commitment or preferred path!
- According to the forecast, the koruna will appreciate further (due to monetary policy divergence this year between the Czech Republic and euro area, and ongoing long-term real convergence).

Interest Rate Path

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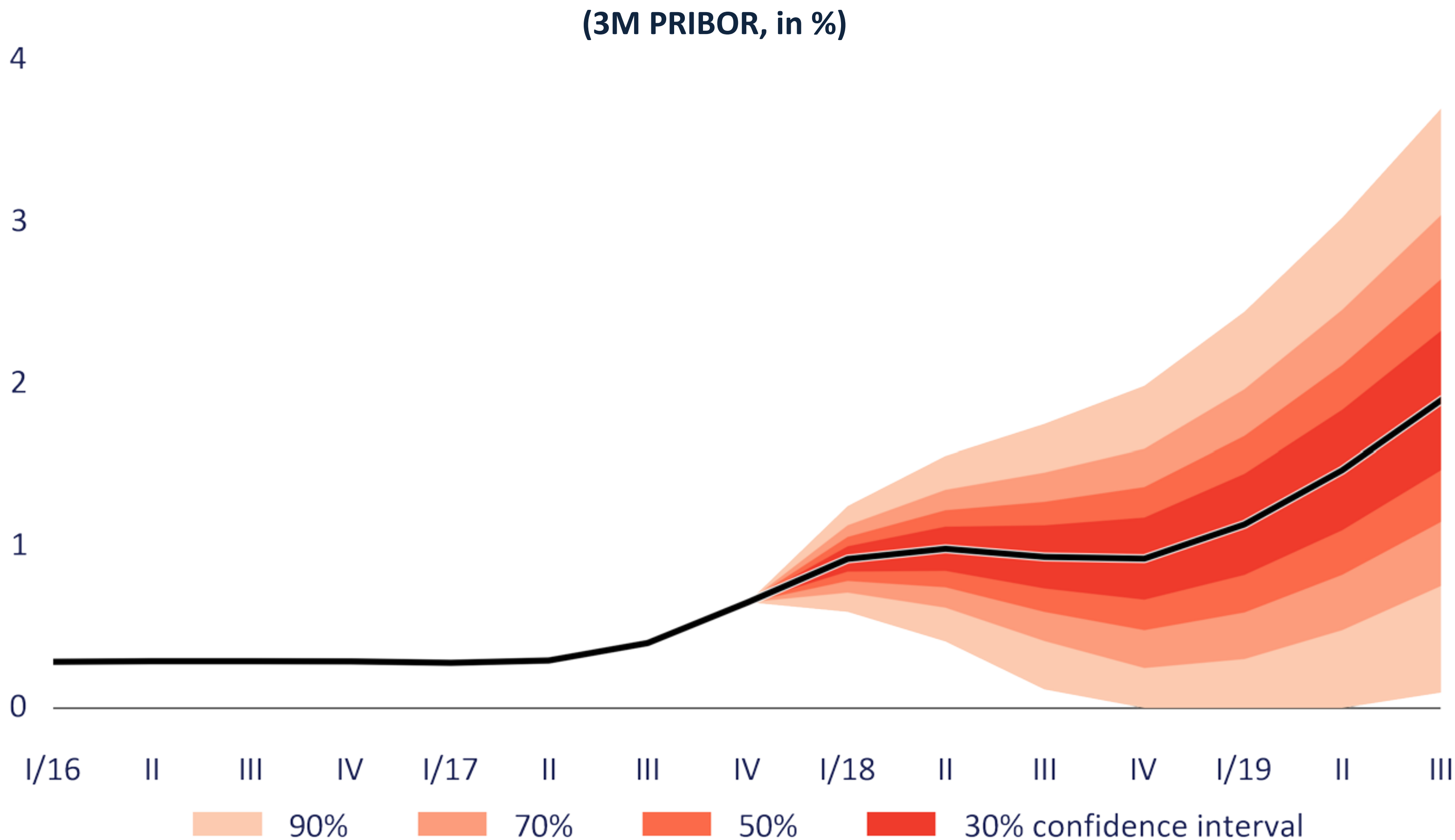

- Consistent with the forecast is a further rise in domestic market interest rates this year and especially next year (i.e. once the ECB‘s QE is over and euro area market rates move back to the positive range).

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Comparison with Previous Forecast

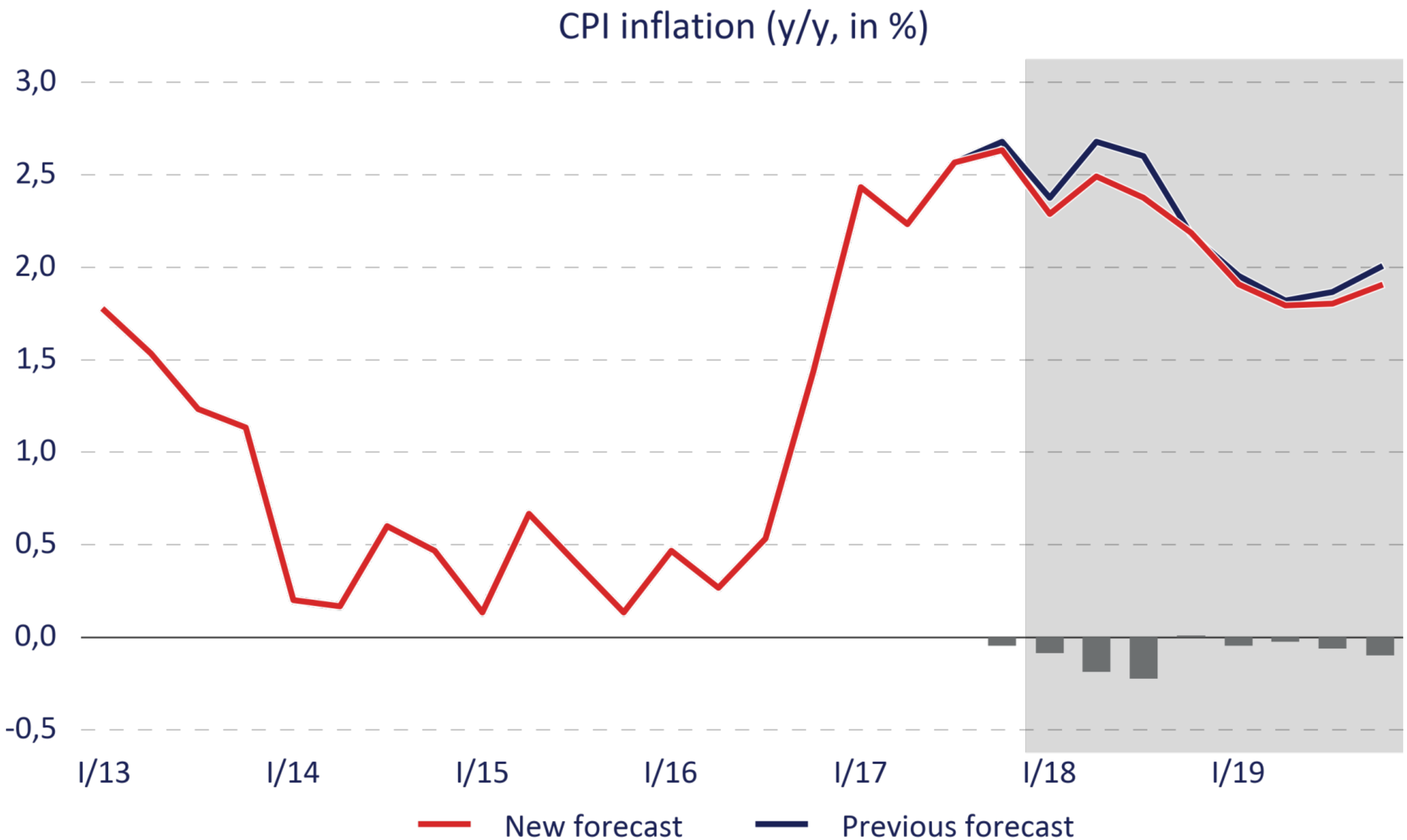
- The new inflation forecast for this year has shifted downward slightly despite moderately higher overall inflation pressures.

- Forecasts of GDP growth and the growth of nominal wages have been moderately increased for both 2018 and 2019.

- The exchange rate of the koruna against the euro will appreciate slightly more in the longer term by comparison with the previous forecast.

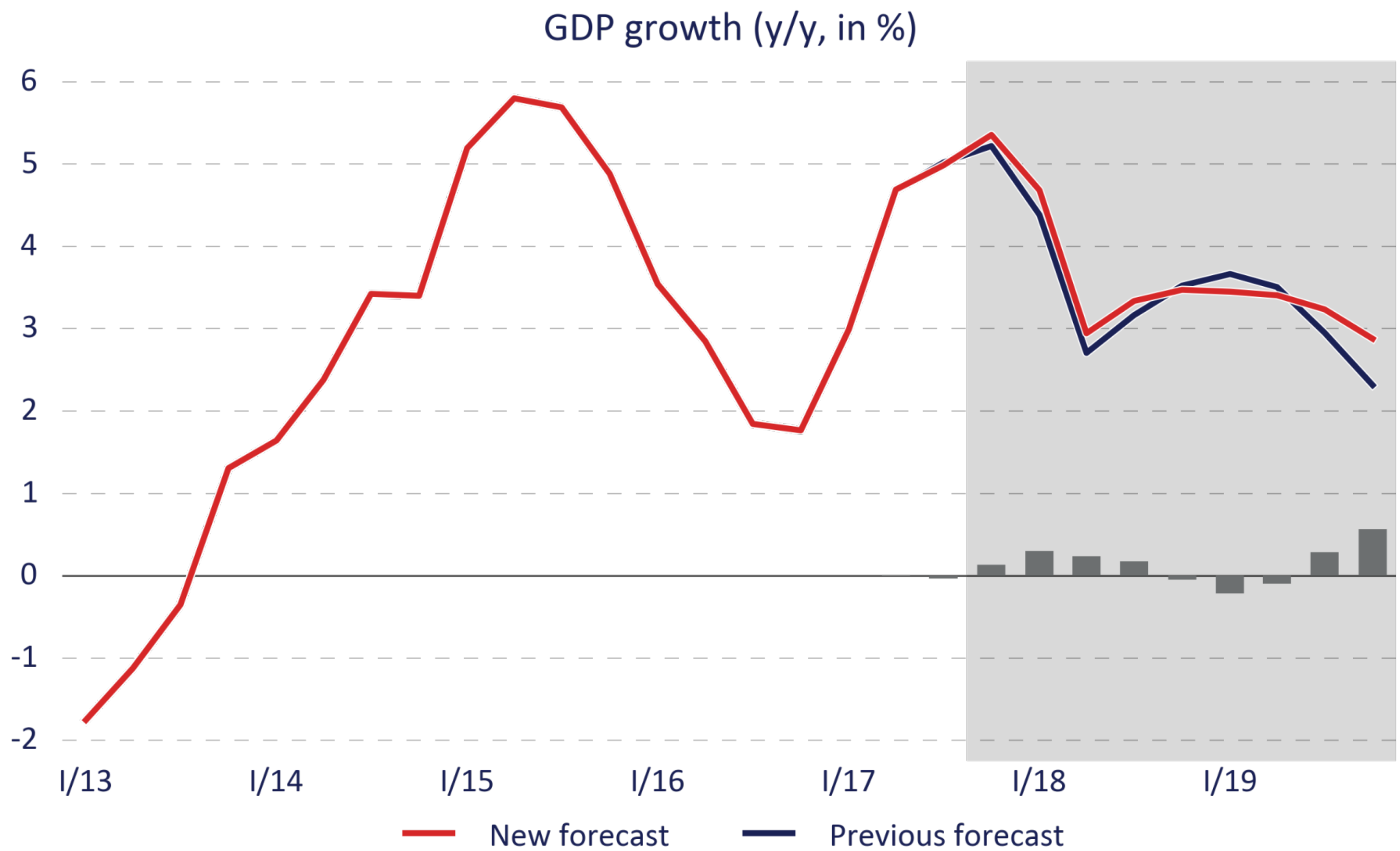
- The forecast is leading to slightly higher interest rates in the near future compared to the previous one. By contrast, the pace of growth in interest rates in the longer term is more gradual.

Comparison: Inflation Forecast



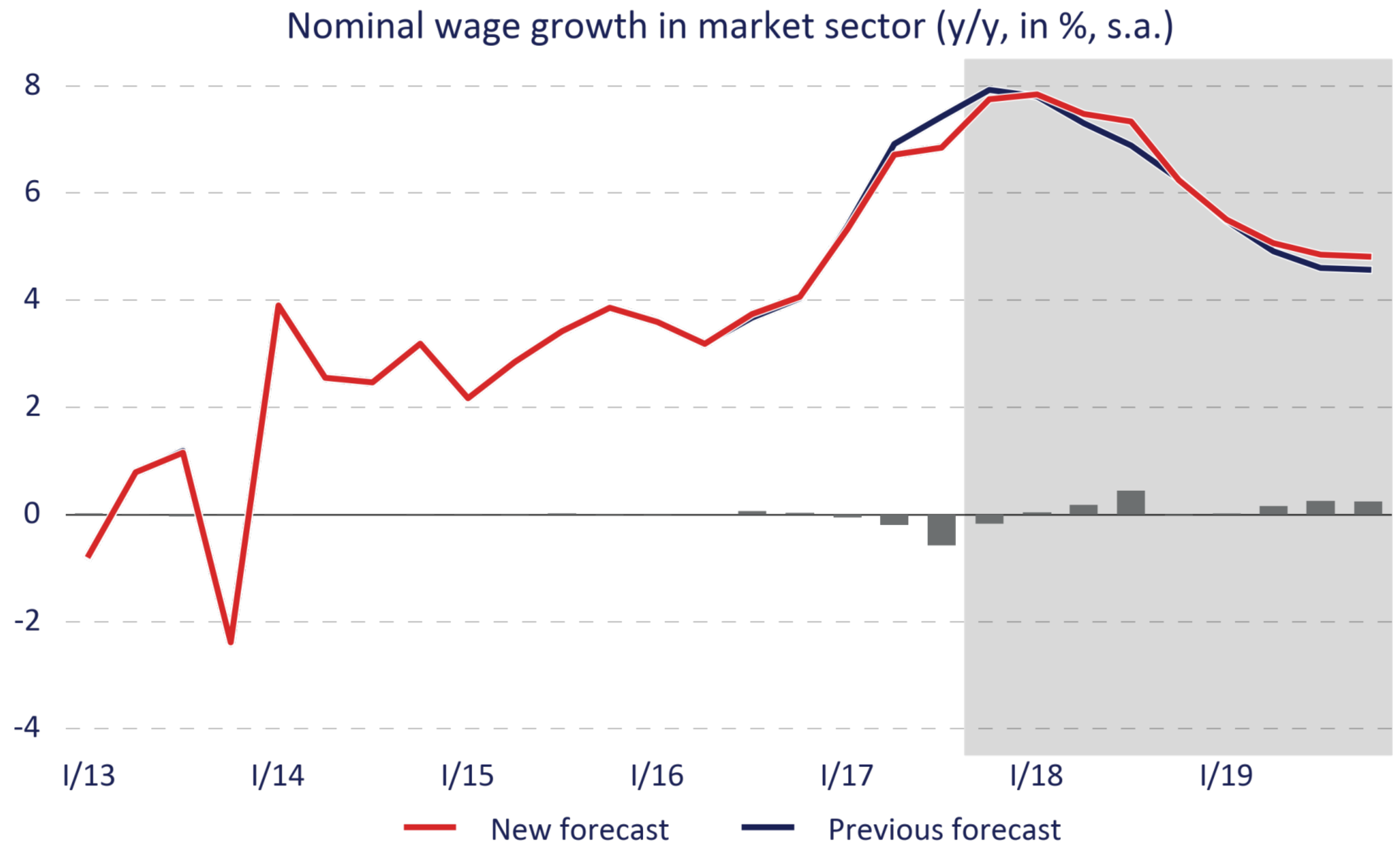
- The headline inflation forecast for this year is lower due mainly to the slightly lower core inflation observed at the end of 2017 and a postponement of the next phases of electronic sales registration.

Comparison: GDP Forecast



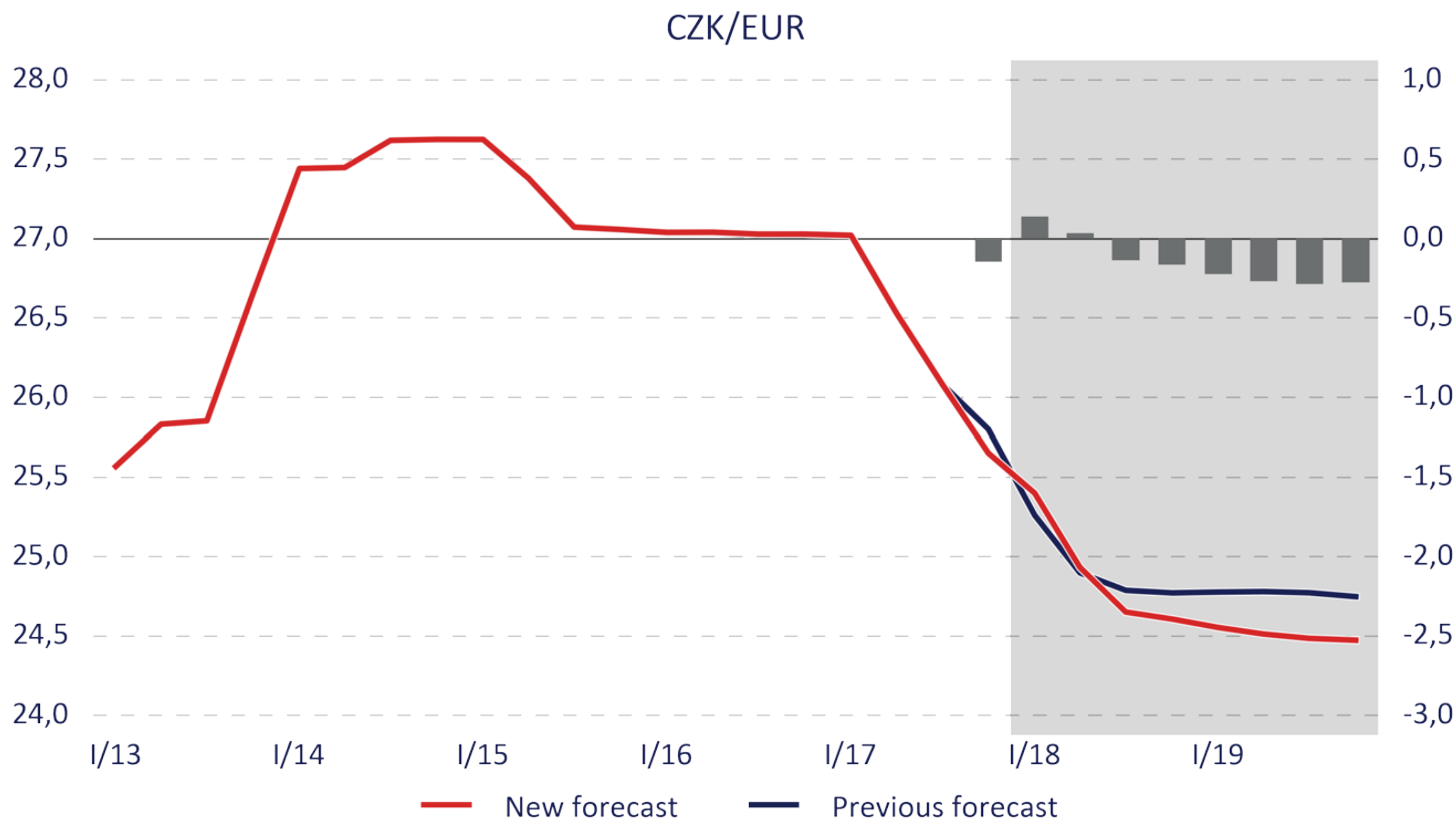
- Faster growth in external demand and a stronger fiscal impulse will foster slightly more rapid economic growth this year.

Comparison: Nominal Wage



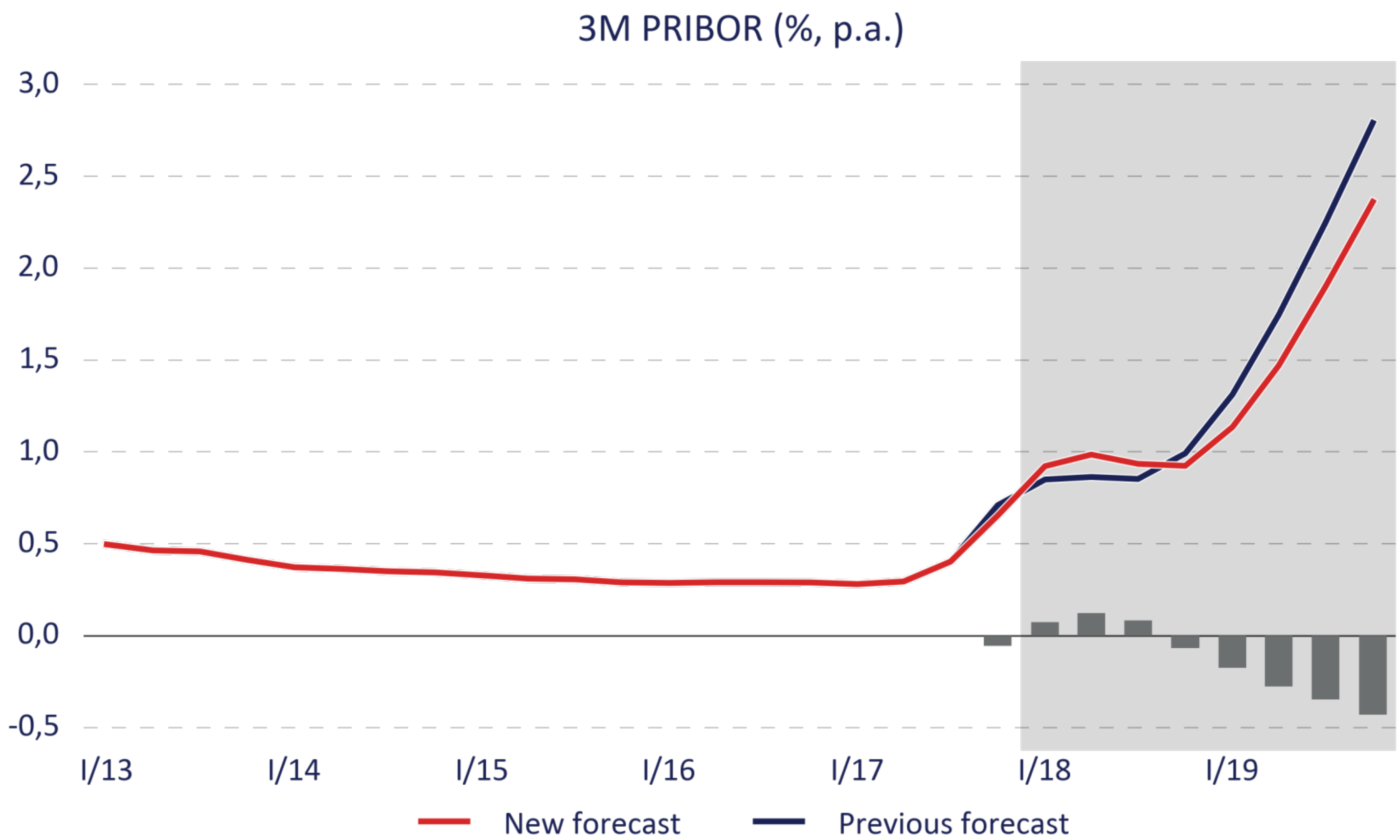
- Wage growth will be slightly faster compared to the previous forecast, supported by more robust economic growth, faster labour efficiency dynamics and a higher external demand outlook.

Comparison: Exchange Rate



- In the longer term, a stronger exchange rate forecast is fostered by more robust domestic and external economic activity coupled with higher growth in labour efficiency, and also by more accommodative ECB's monetary policy.

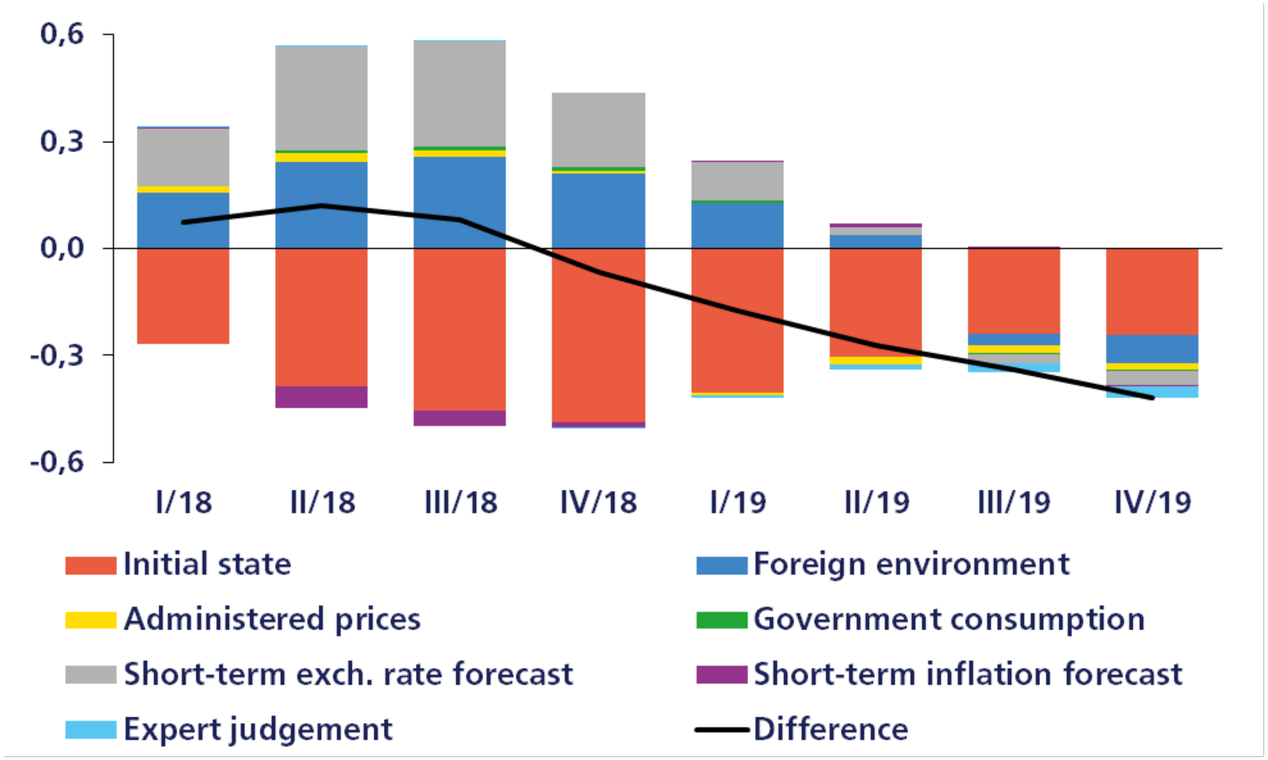
Comparison: Interest Rate Forecast



- The path of market interest rates in the coming quarters has shifted upwards slightly compared to the previous forecast.
- By contrast, the pace of interest rates hikes in the longer term is more gradual.

Decomposition of Changes in the Interest Rate Forecast

(3M PRIBOR, percentage points)



- The slightly faster rise in interest rates in early 2018 compared to the previous forecast is due to greater inflation pressures from abroad and the short-term exchange rate forecast.
- The downward effect of the initial state on rates is due mainly to an upward revision of labour efficiency growth as a result of faster increases in private investment.

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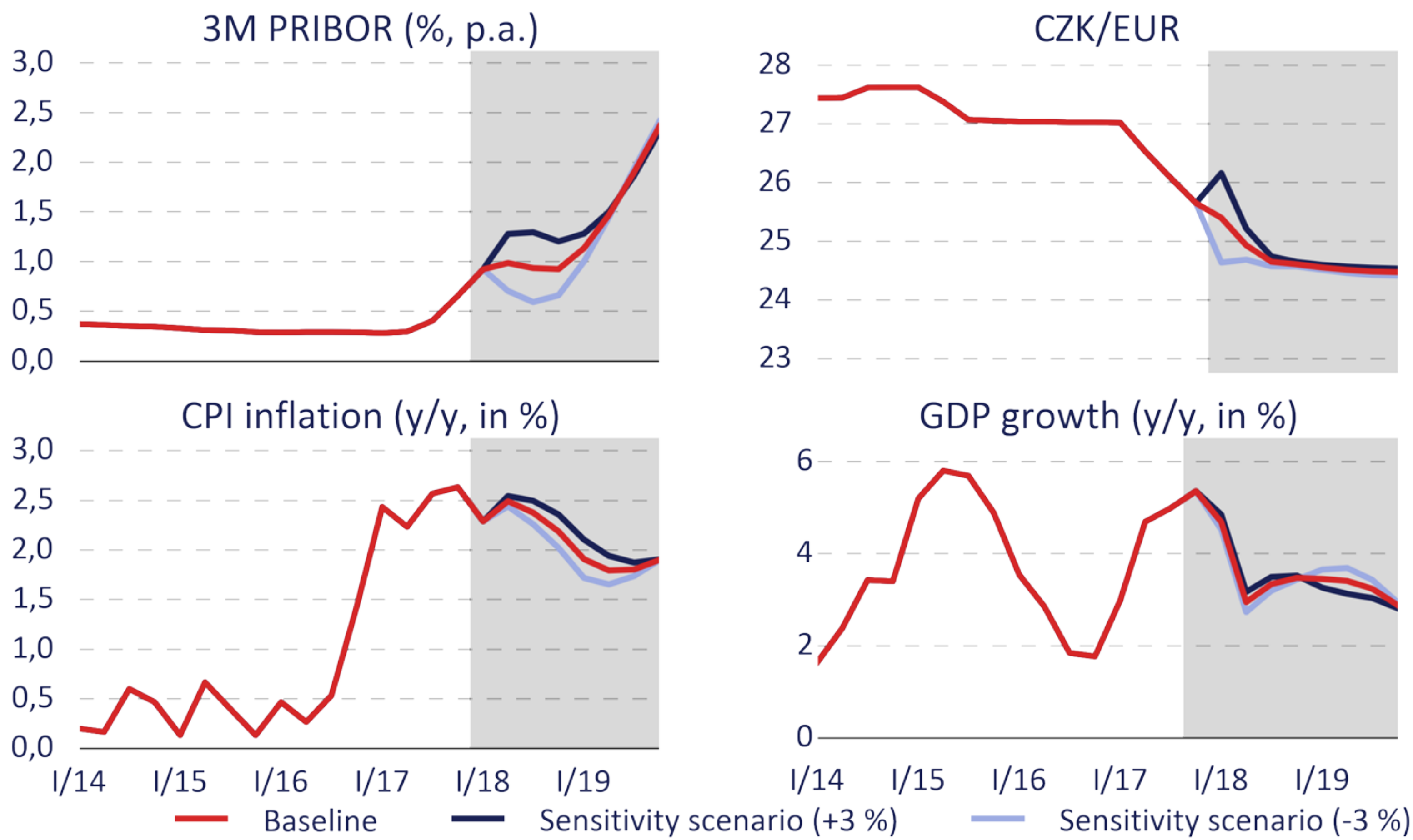
Sensitivity Scenario – Exchange Rate



- With resumed publication of the exchange rate forecast, we also get back to this standard symmetric exchange rate sensitivity scenario.
- The temporarily weaker/stronger exchange rate in the sensitivity scenario leads to a higher/lower interest rate path compared to the forecast.

Thank you for your attention!

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