CNB’s New Forecast (Inflation Report III/2018)

Meeting with Analysts

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Outline

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

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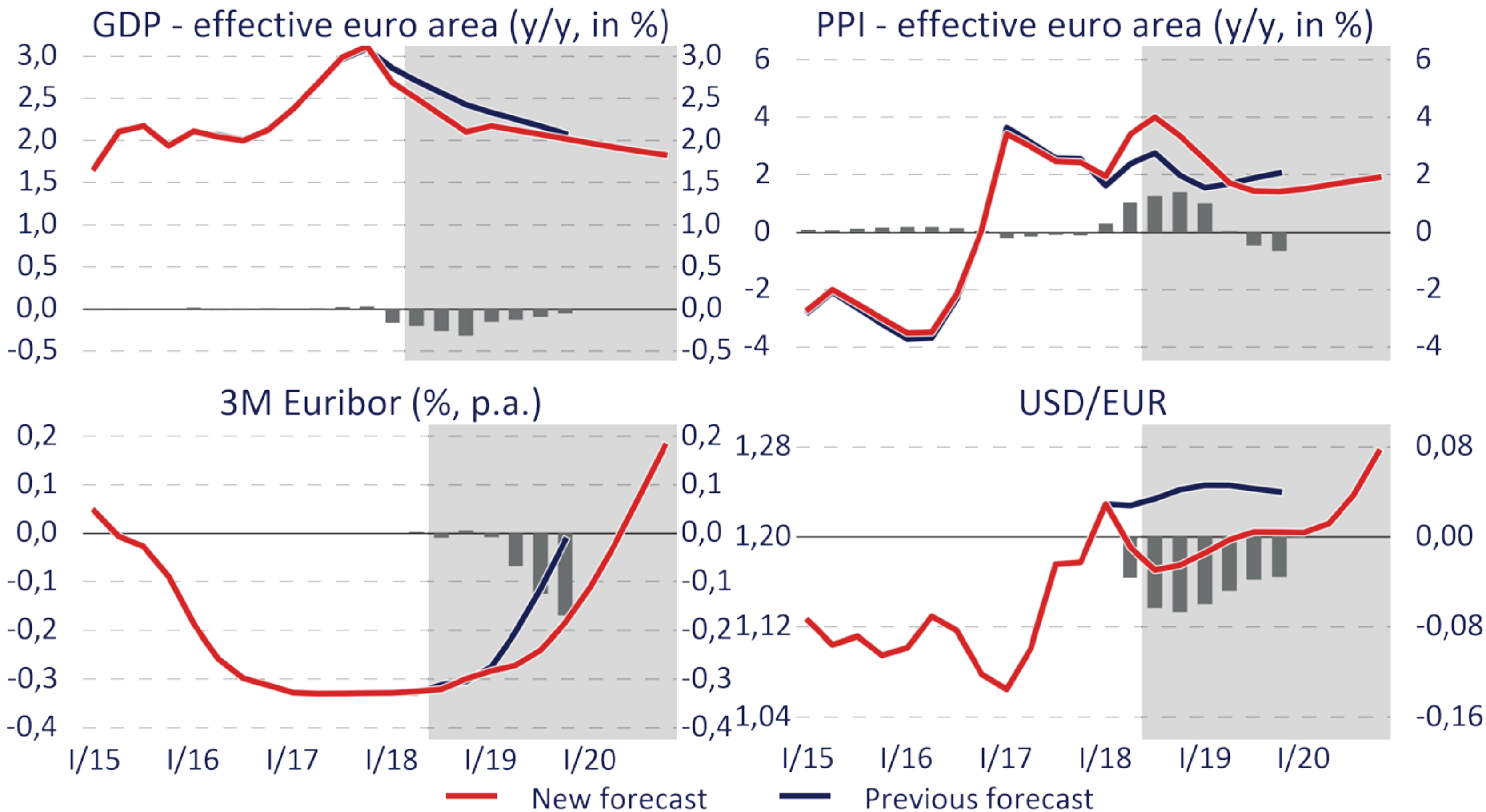
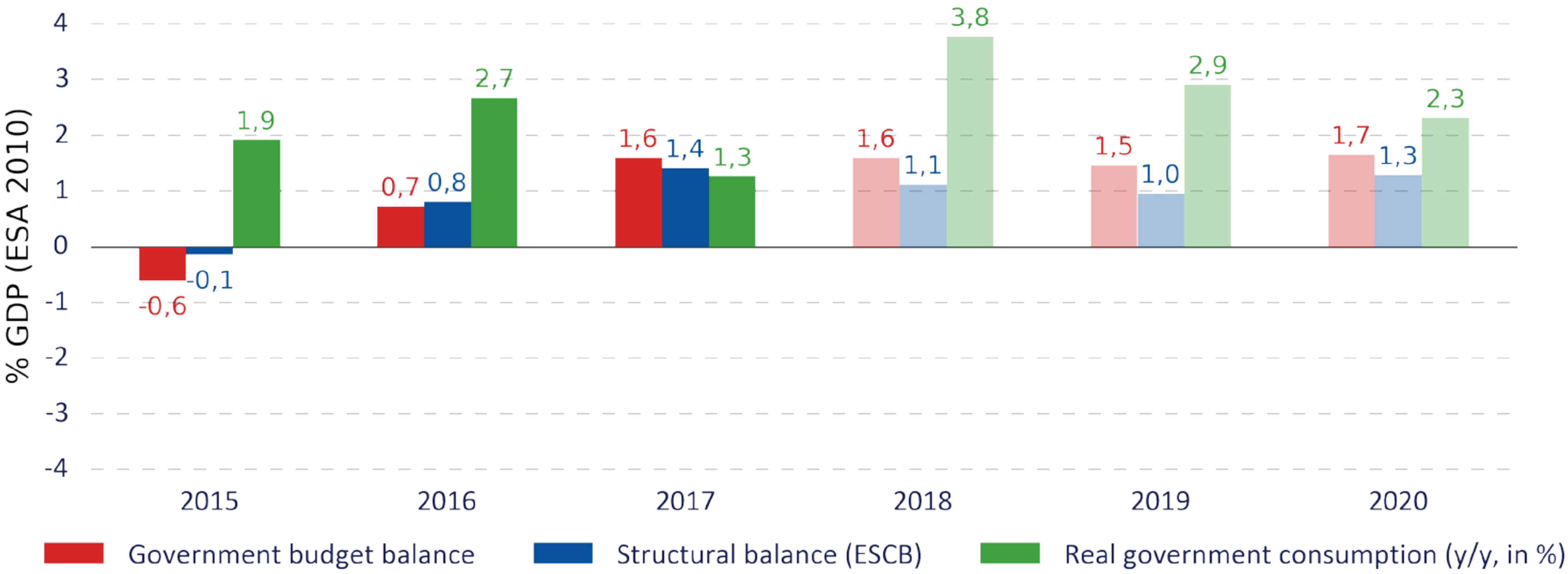
External Environment Outlook



- GDP growth in the effective eurozone will gradually slow to 1.8% in late 2020.
- Annual producer price inflation in the euro area will peak in 2018 Q3 (mainly reflecting growth in oil prices) and gradually slow to just below 2% in 2019.
- In line with the continued QE of the ECB and according to the market outlook, the return of the 3M EURIBOR from negative levels to zero will be gradual.

Fiscal Policy



- Positive government budget surpluses, reflecting increased tax revenues due to continued economic growth and policy measures, will persist.
- The government surplus will reach 1.6% GDP in this year and remain at a similar level in the next two years. This will translate into continued structural surplus.
- The government consumption will grow by 3.8% in 2018 and slightly slow down afterwards.

Fiscal Impulse

Contributions to GDP growth in percentage points	2017	2018	2019	2020
	actual	forecast	forecast	forecast
Fiscal impulse	**0.2**	**0.5**	**0.4**	**0.0**
of which impact through:				
private consumption	0.2	0.4	0.2	0.0
private investment	-0.1	0.0	0.0	0.0
government investment, domestic	0.1	0.1	0.0	0.0
government investment, EU funded	0.0	0.1	0.1	0.0

- Fiscal policy will be expansionary this year and in 2019, and neutral in 2020.
- Fiscal expansion will increase this year, materializing to a greater extent through household consumption. This will be driven by a package of new social measures, faster growth of pensions, and continued sound growth in public sector pay.
- A positive fiscal impulse of 0.4 p.p. for the next year reflects an above-average rise in old-age pensions, continued growth in government investment and strong wage growth.

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Summary of the New Forecast

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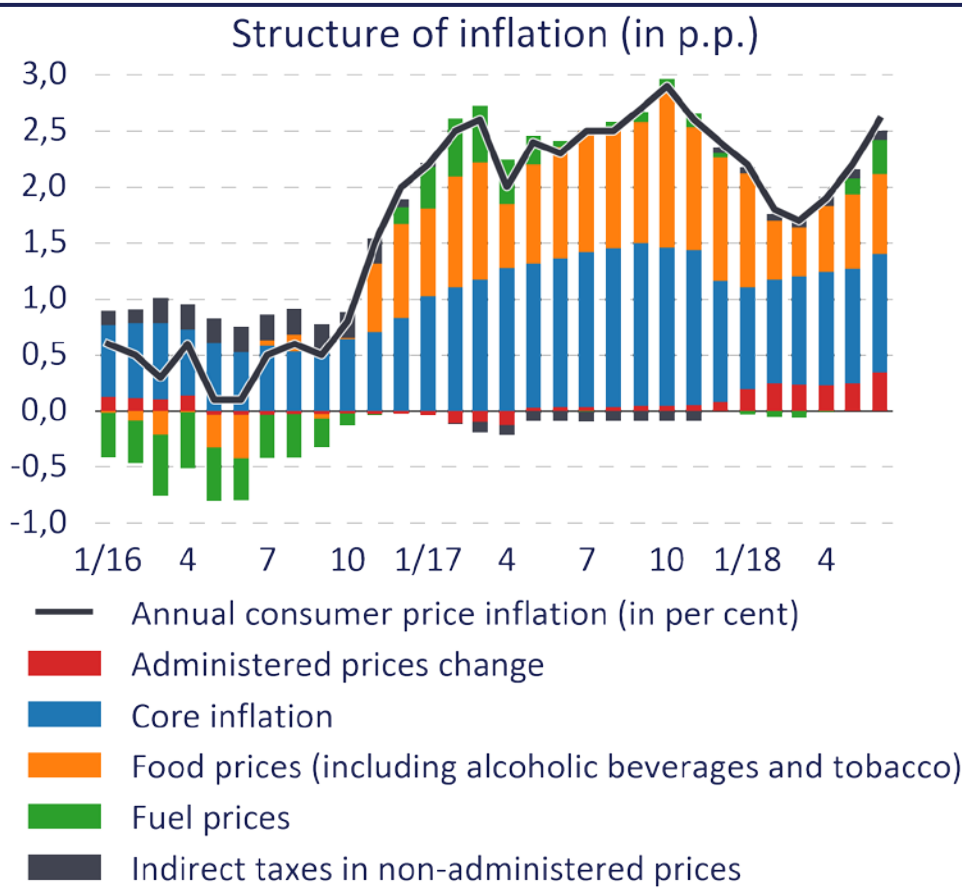
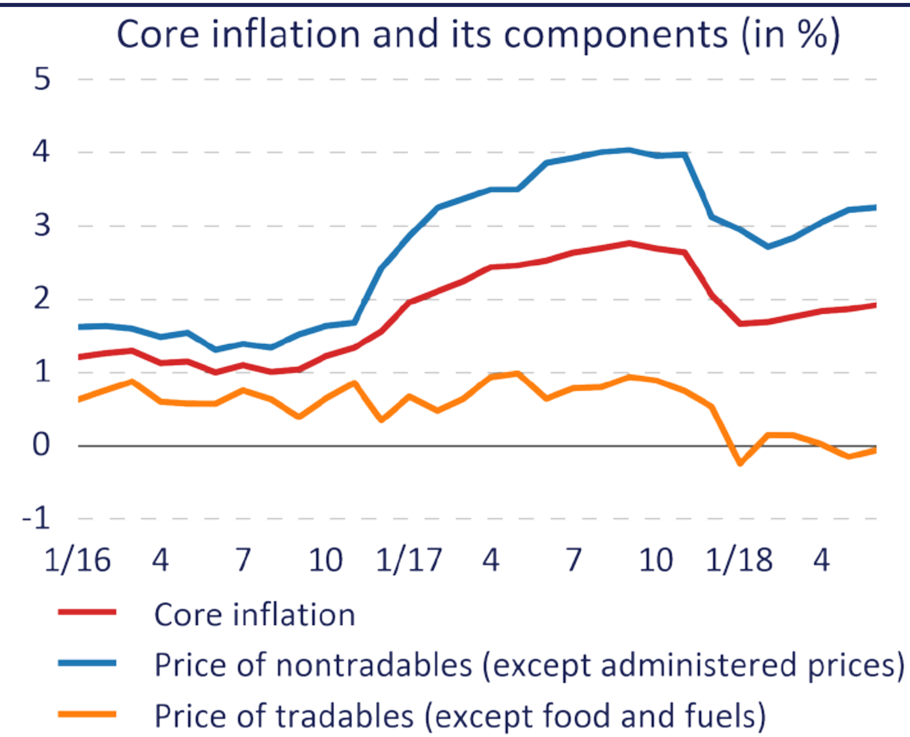
- Both headline and monetary policy-relevant inflation will stay in the upper half of the tolerance band until mid-2019 and return to the 2% target at the monetary policy horizon.
- The growth of the Czech economy will slow from last year's high pace this year, but will remain above 3% in the following years: the economy will be driven mainly by robust growth in household consumption, continuing investment activity and briskly rising foreign demand.
- The strong economic growth is reflected in a very tight labour market, which will lead to slower employment growth and continued high wage growth.
- After weakening temporarily (related to a change in sentiment on foreign exchange markets), the koruna will return to an appreciation trend in end-2018 due to a distinctly positive interest rate differential vis-à-vis the euro area, the fading effects of the QE by the ECB and real convergence of the Czech economy.
- Consistent with the forecast is a continued rise in interest rates; continued rise is a reaction both to marked inflation pressures from the domestic economy and to the temporary depreciation of the koruna.

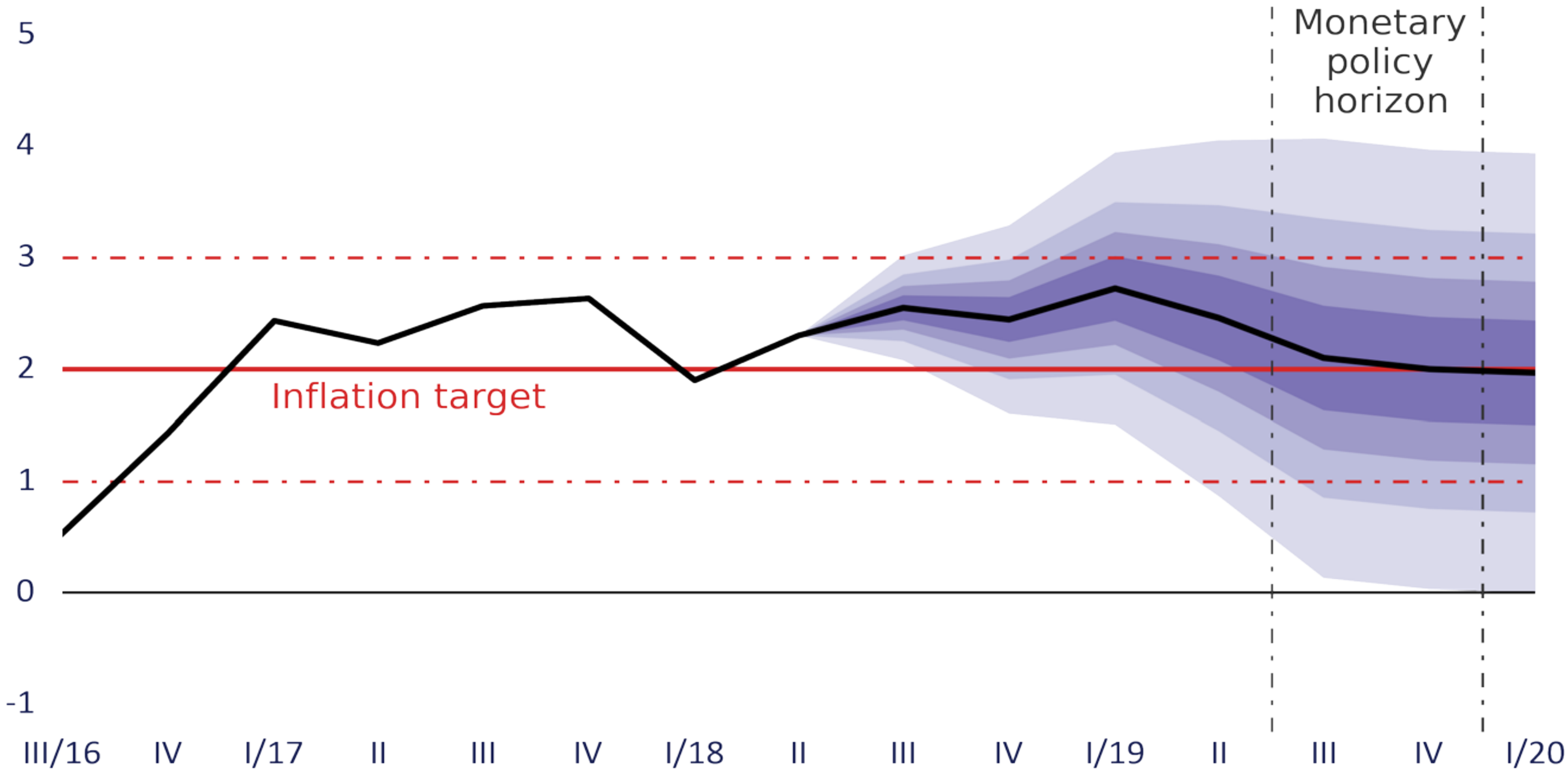
Structure of Inflation





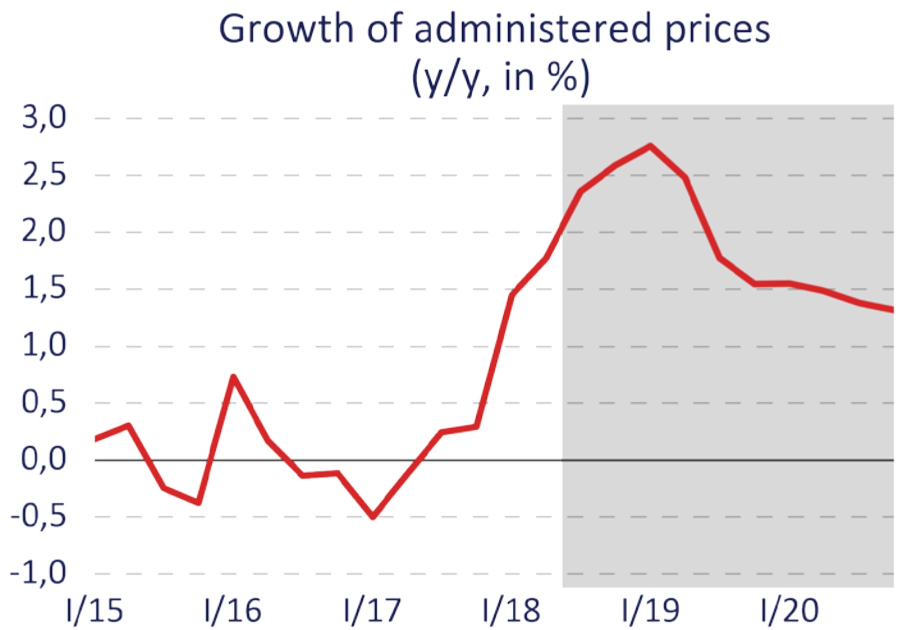
- Inflation accelerated in 2018 Q2, which mainly reflected movements in traditionally volatile items: a substantial increase in growth of fuel prices (reflecting higher oil price), together with a pick-up in food price growth.
- Administered price inflation also increased due to a rise in electricity prices.
- The slight increase in core inflation was due to renewed faster growth in non-tradables prices while tradables prices recorded a slight decline.

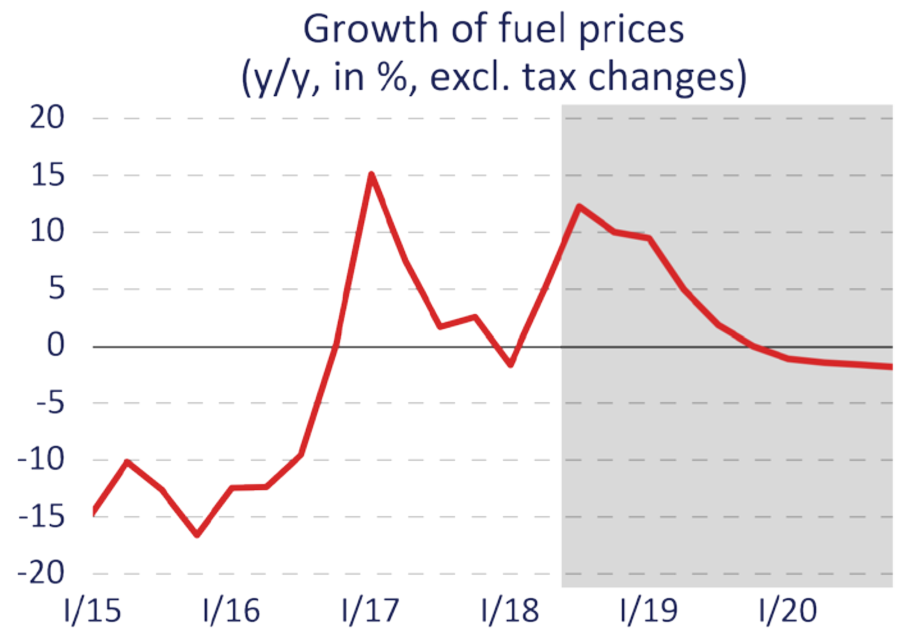
Headline Inflation Forecast



- Inflation will be above the 2% target until mid-2019, but stay in the upper half of the tolerance band, which reflects both fundamental factors and the evolution of more volatile price categories.
- It will return to the target at the monetary policy horizon.
- Monetary policy-relevant inflation will be very close to headline inflation.

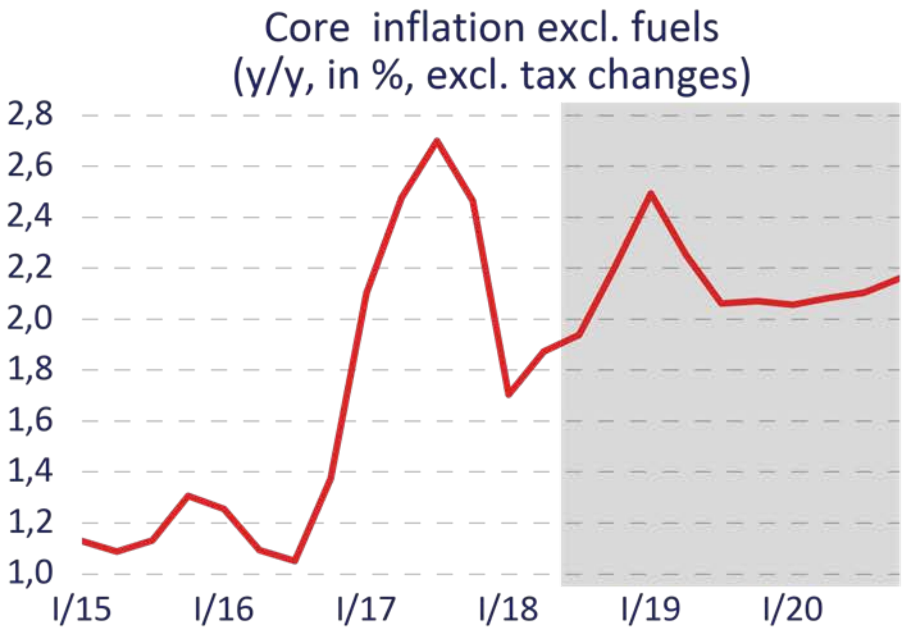
Administered and Fuel Prices

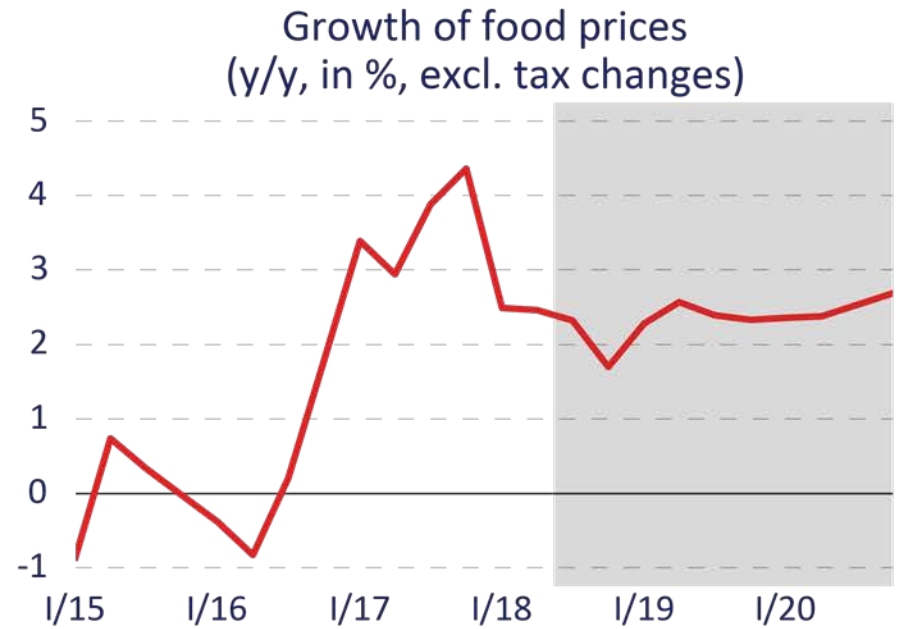




- Growth in administered prices will be driven by electricity prices, which rose sharply in June; after 2019 Q1 their dynamics will slow down and return back bellow 2 %.
- The current rapid growth in fuel prices will gradually slowdown and switch to a year-on-year decline at the end of next year, reflecting the dynamics of oil price and renewed appreciation of the koruna against the dollar.

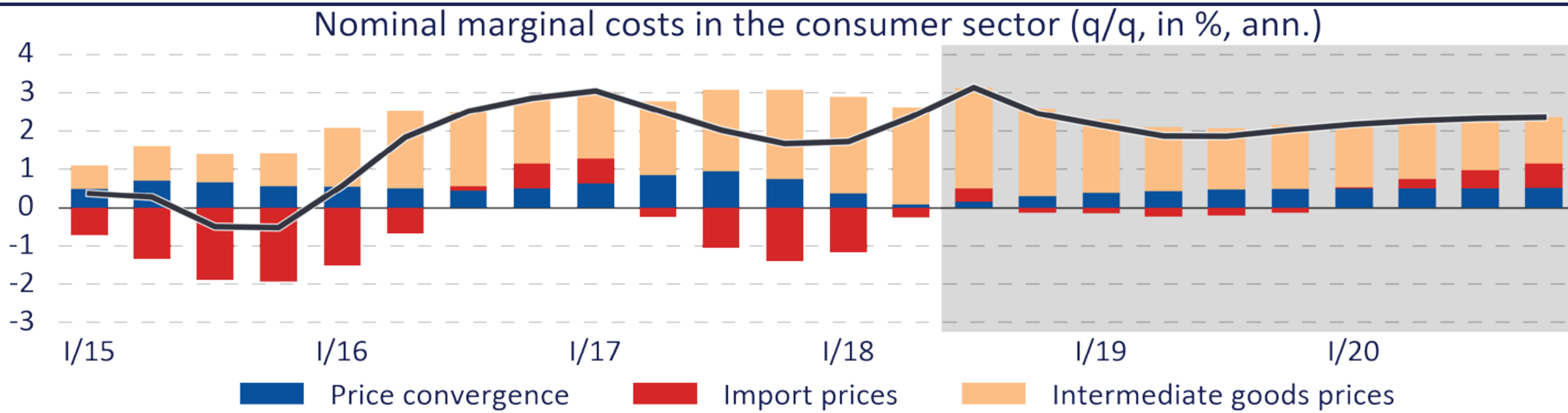
Core Inflation and Food Prices

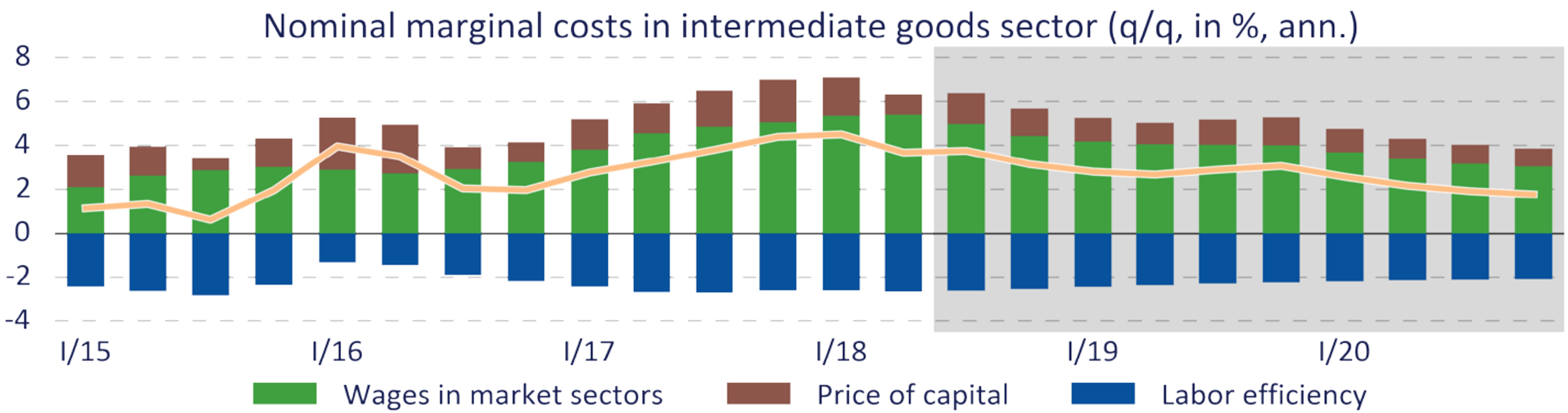




- Core inflation will accelerate to 2.5% in 2019 Q1 due to an increase in imported prices, resulting mainly from the recent koruna depreciation coupled with rising foreign producer price inflation in the effective euro area. At the same time, strong inflation pressures from the domestic economy will drive up prices in non-tradable sector.
- Food price growth will moderate in the rest of this year due to falling agricultural commodity prices. The monthly food price survey for July indicates that the downward correction could take place sooner and to a larger extent.

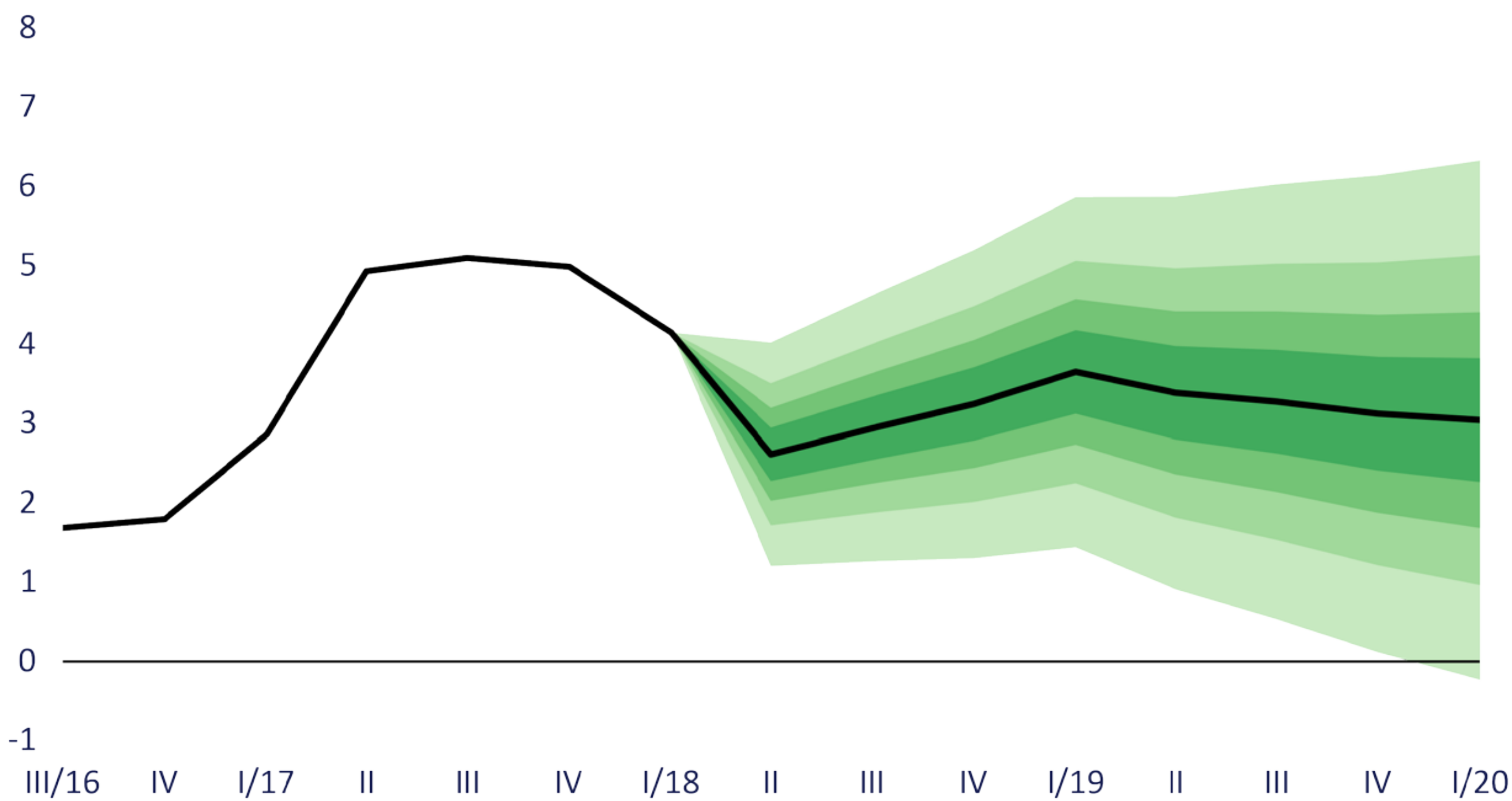
Inflation pressures





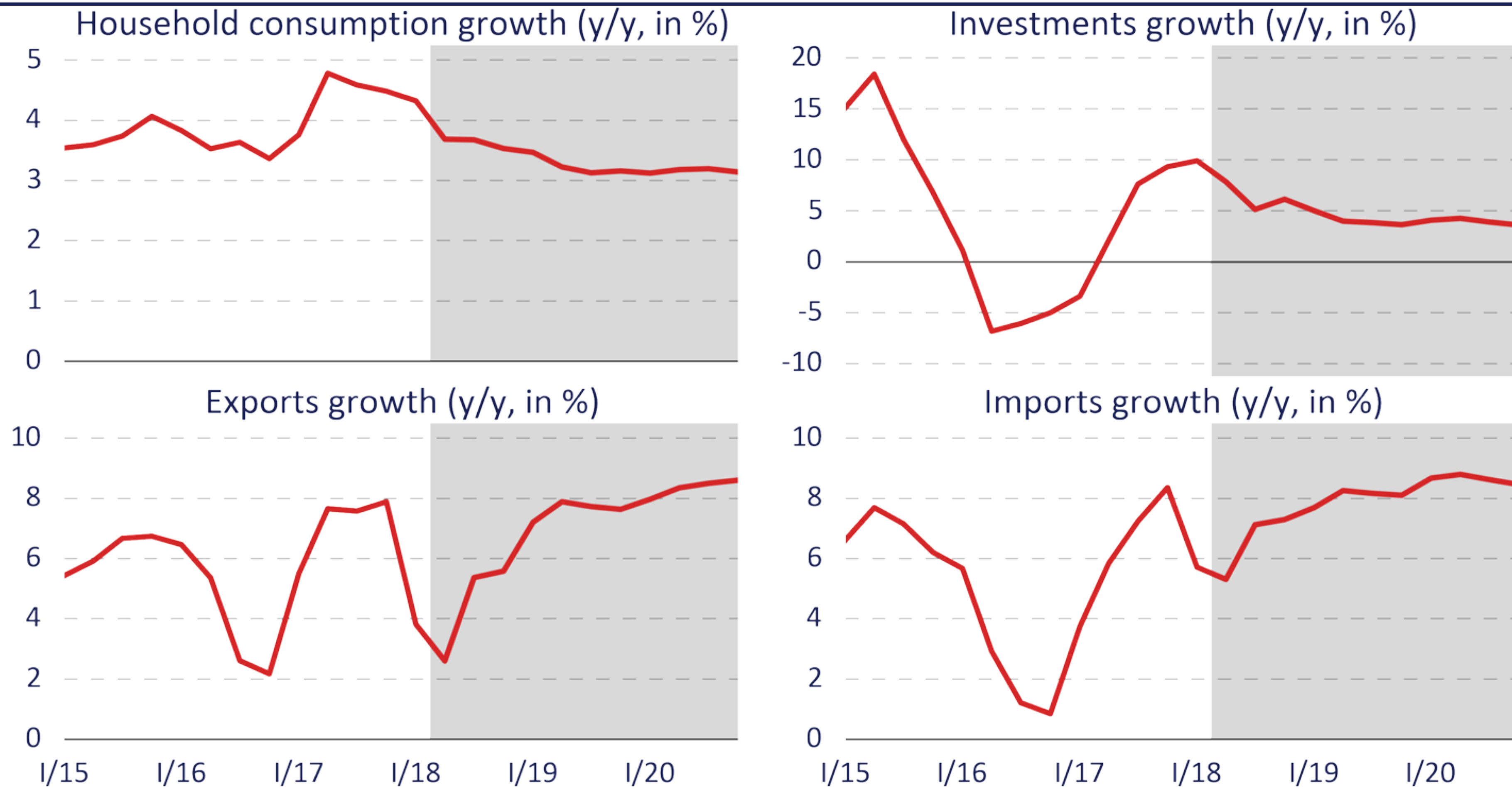
- The overall inflation pressures in the consumer sector will strengthen further in the short term, reflecting a temporary weakening of the koruna and persistent domestic pressures (driven mainly by continued wage growth).
- It will then ease towards 2 % due to renewed exchange rate appreciation and a gradual moderation of domestic inflation pressures.

GDP Growth Forecast



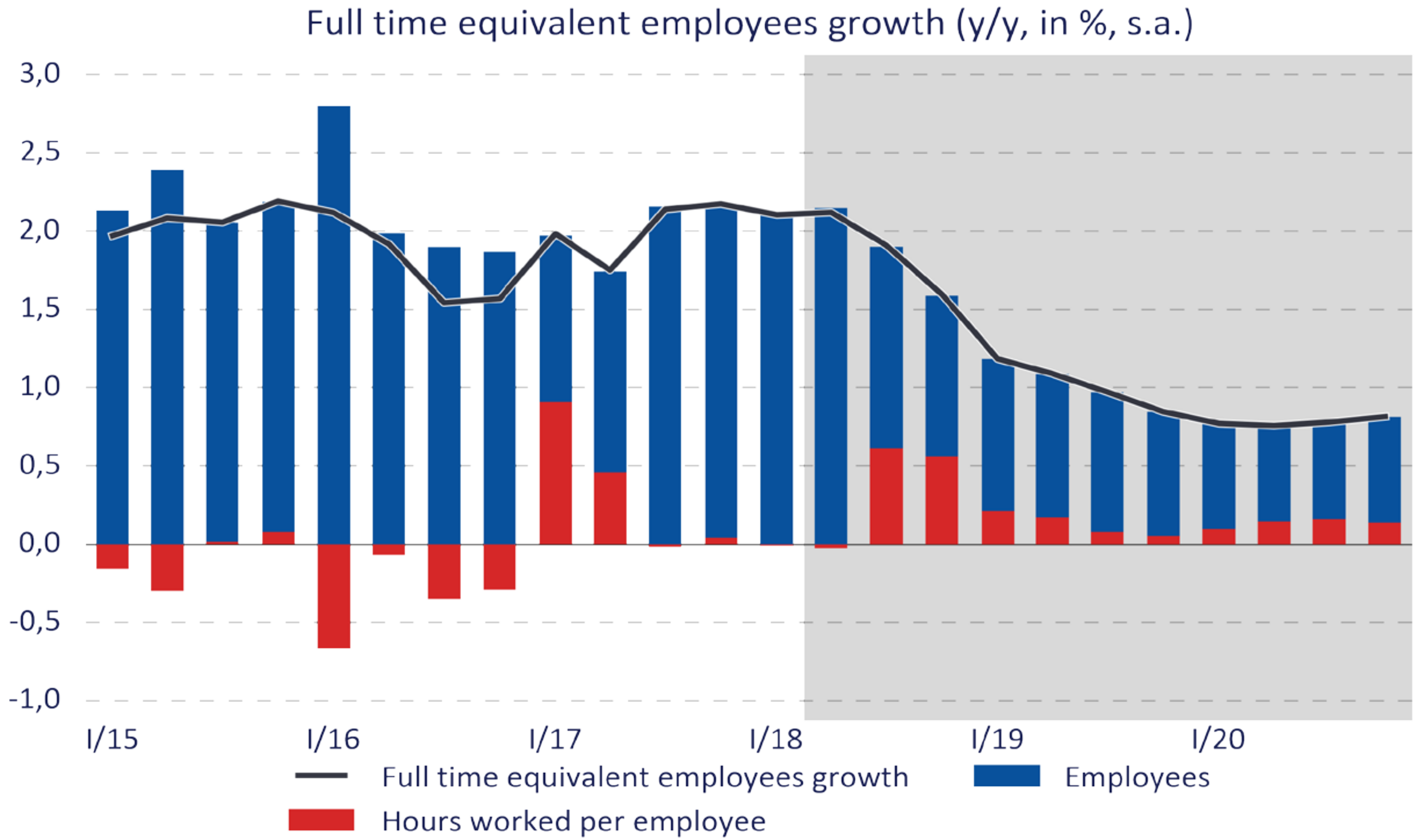
- GDP growth will slow from last year's high levels, averaging just above 3% in the years ahead.
- Consumption and investment will contribute to GDP growth over the entire forecast horizon; the contribution of net exports will temporarily be negative this year.

Aggregate Demand



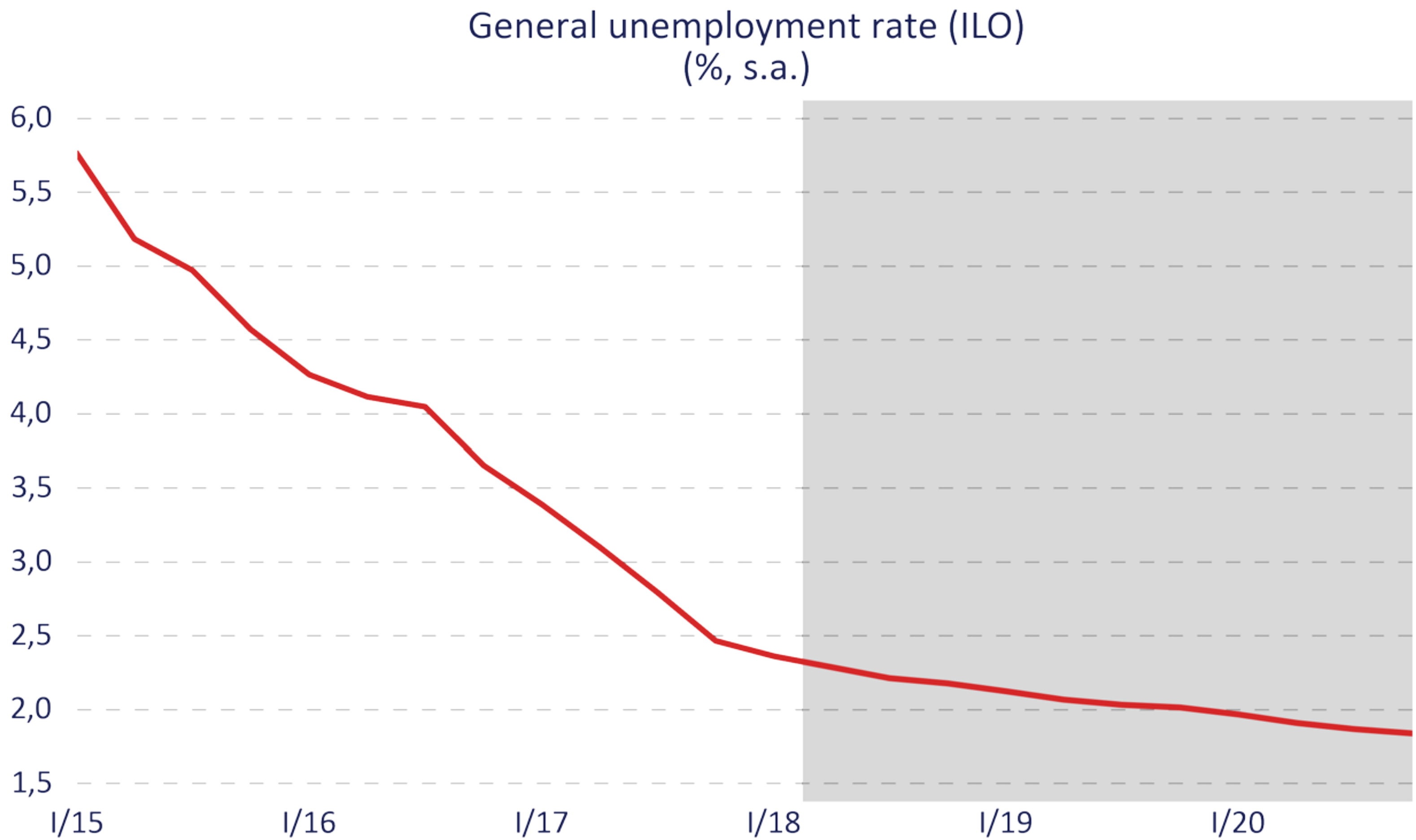
- Household consumption growth will remain robust reflecting continued growth of total disposable income.
- Investment growth will be driven by both private and government investment.
- The contribution of net exports to GDP growth will be negative this year due mainly to a short-lived slowdown in export growth.

Labour Market: Employment



- Employment growth will slow this year due to labour shortages.
- Growing tightness in the labour market, linked with a record-low unemployment rate, will be reduced only partially by growth in the labour force.

Labour Market: Unemployment



- The current very low unemployment rate will not decrease significantly further and will be just below 2% by the end of 2020.

Labour Market: Wage Growth in Market Sectors

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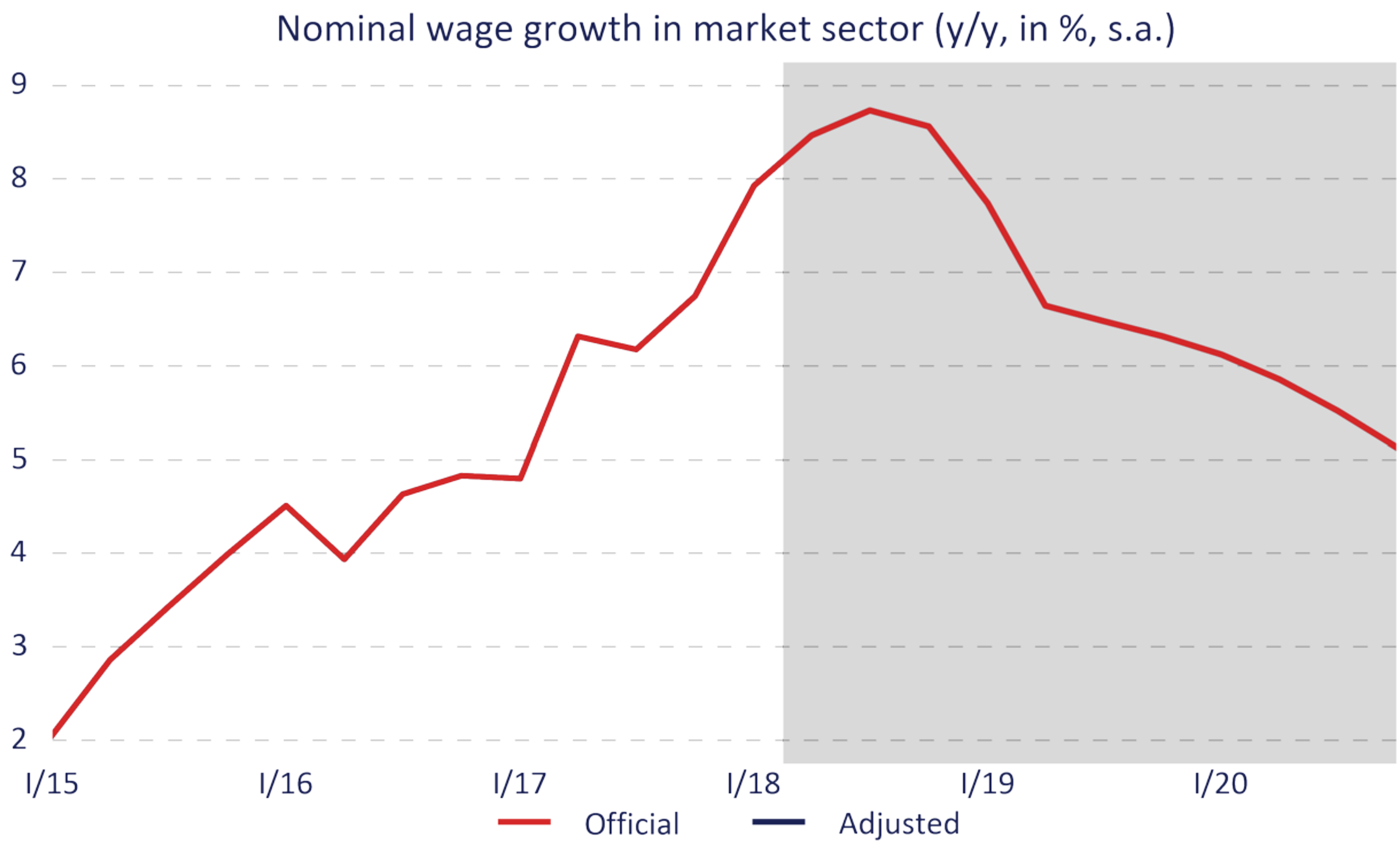
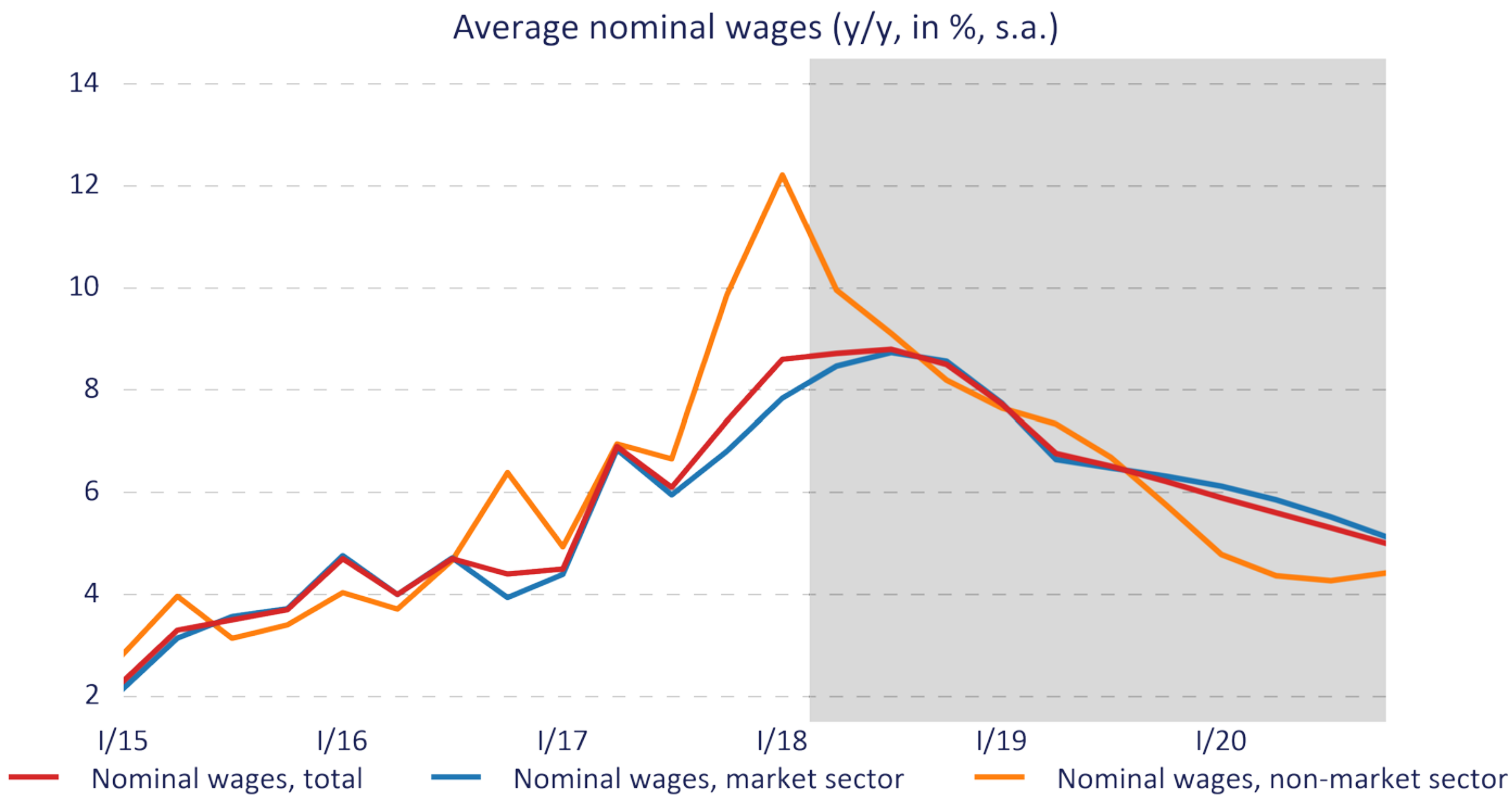


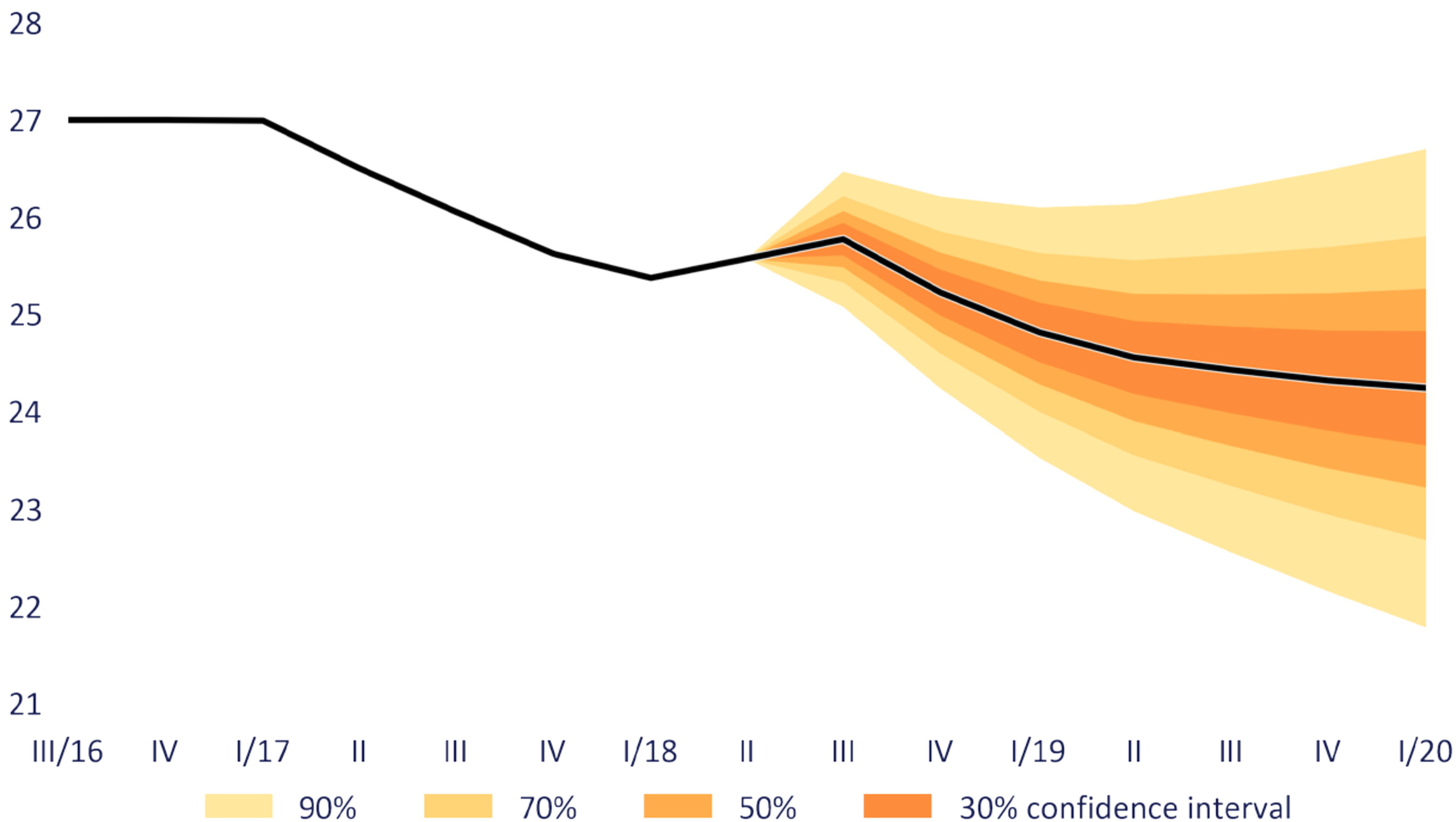
- Tightness in the labour market will keep wage growth in market sectors at a high – albeit gradually decreasing – level.
- Wage growth will start to slow at the end of 2018 due to tightening monetary conditions and firms' efforts to maintain their price competitiveness and profitability.

Comparison: Nominal Wage Growth in Non-market Sectors



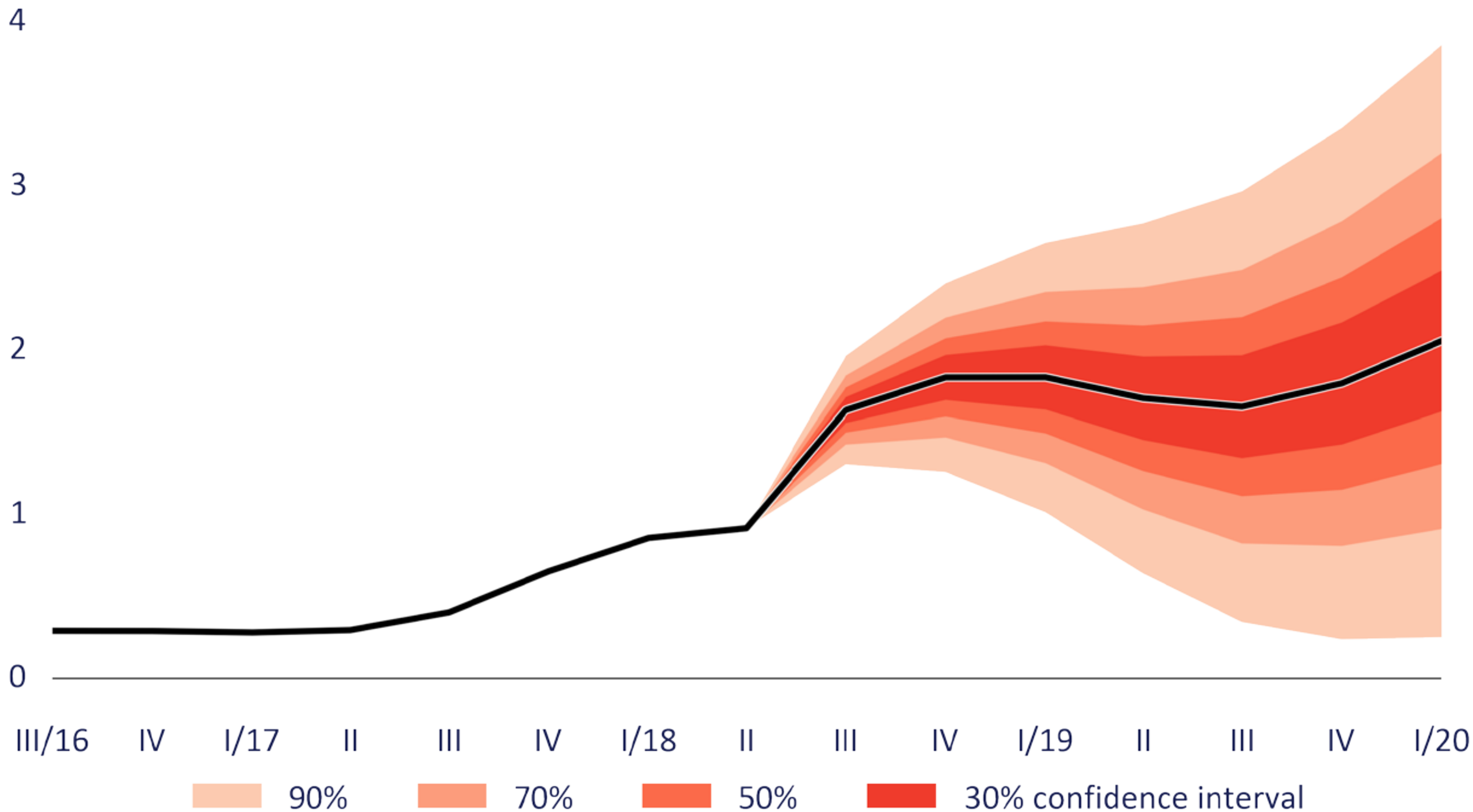
- Strong annual wage growth will continue also in non-market sectors owing to a pronounced increase in wages and salaries of state employees.

Exchange Rate CZK/EUR



- The exchange rate forecast for Q3 reflects a change in sentiment and an outflow of short-term capital from emerging markets to assets perceived as less risky.
- The renewed appreciation of the koruna will be driven by a distinctly positive interest rate differential vis-à-vis the euro area, the fading effects of asset purchases by the ECB and real convergence of the Czech economy.

Interest Rate Path (3M PRIBOR)



- Consistent with the forecast is a continued rise in interest rates towards their long-run neutral level.
- The rise in interest rates is a reaction both to domestic inflation pressures and to the temporary depreciation of the koruna.

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Comparison with Previous Forecast

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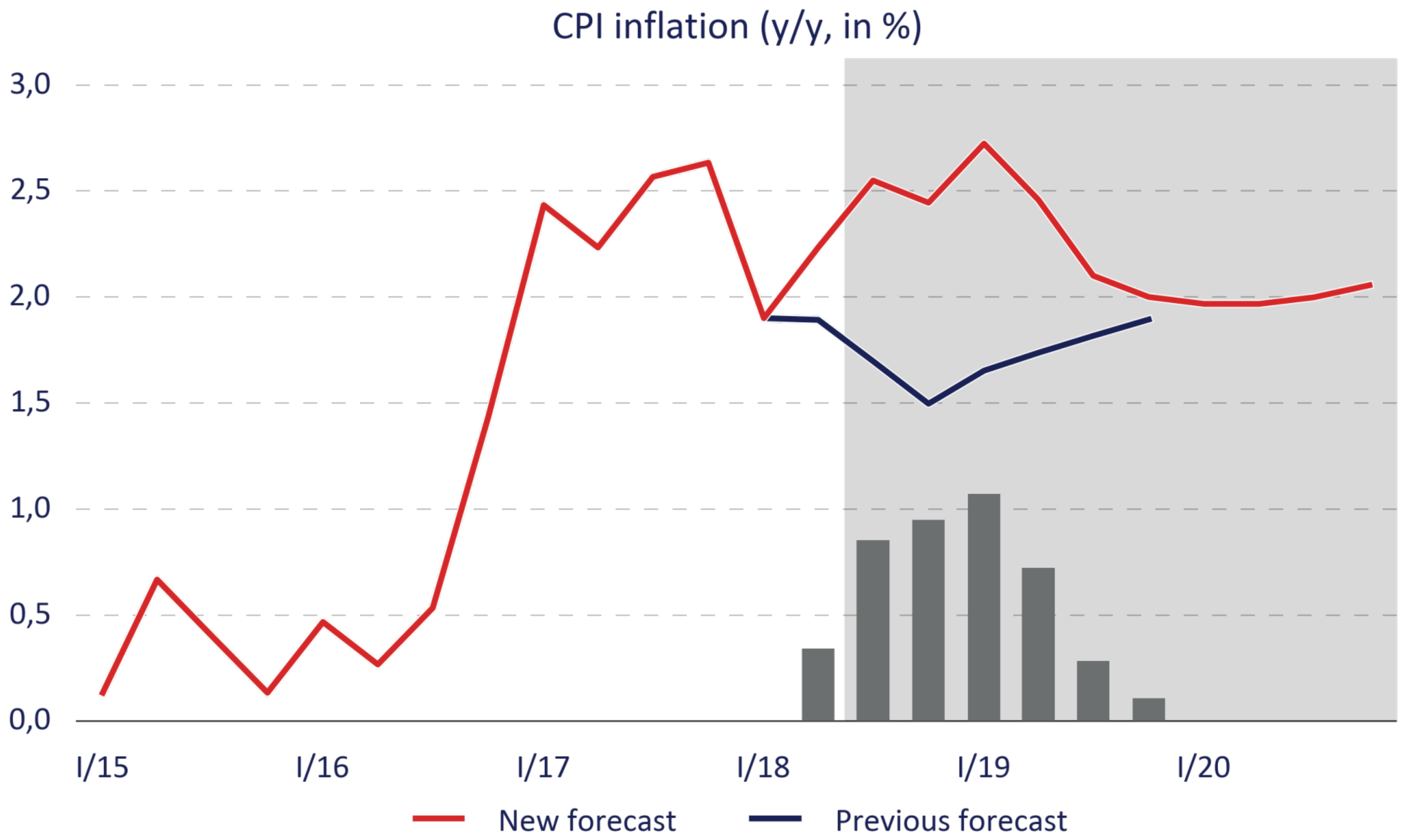
- The biggest change compared to the previous forecast pertains to the exchange rate of the koruna, which weakened in Q2 as a result of an unexpected and significant change in sentiment on financial markets.
- Stronger inflation pressures both from abroad (weaker koruna coupled with faster growth in foreign producer prices) and from the domestic economy (faster wage growth) are acting in parallel at the shorter end of the forecast.
- In addition to these fundamental factors, the inflation forecast has moved higher due to an increased outlook for administered prices and traditionally volatile items, i.e. fuel and food prices.
- The new forecast thus indicates a need for a faster increase in interest rates until mid-2019. This revision reflects the path of the exchange rate most of all.
- The decrease in the prediction for domestic economic activity this year mainly reflects data revisions and a slightly lower external demand outlook.

Comparison: Inflation Forecast



- The inflation forecast is higher at the horizon of up to one year due to a combination of factors, but is little changed at the monetary policy horizon.
- Besides the fundamental factors (weaker koruna, higher foreign inflation, faster wage growth), the revision reflects higher observed values and admin. prices.

Comparison: GDP Forecast

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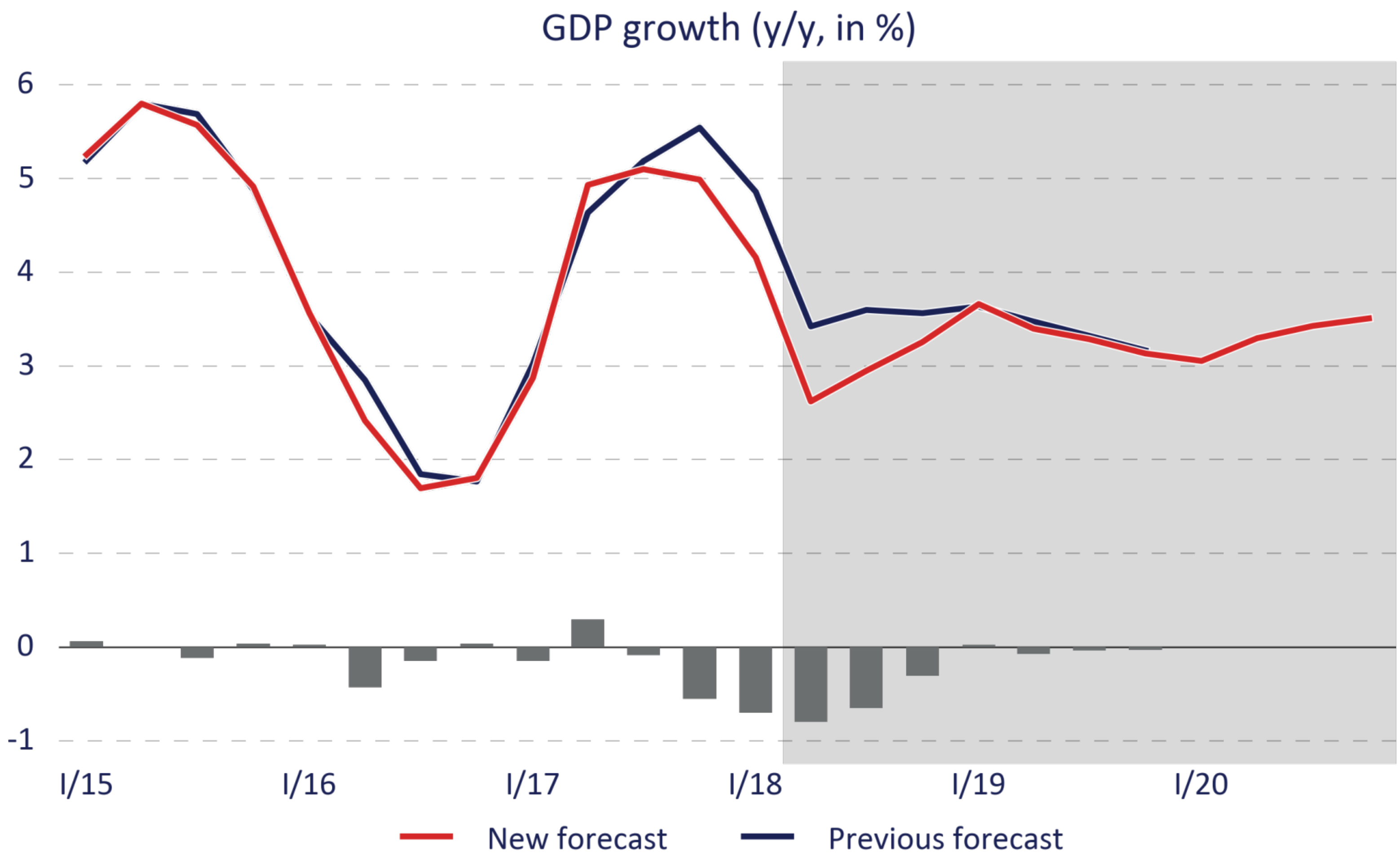
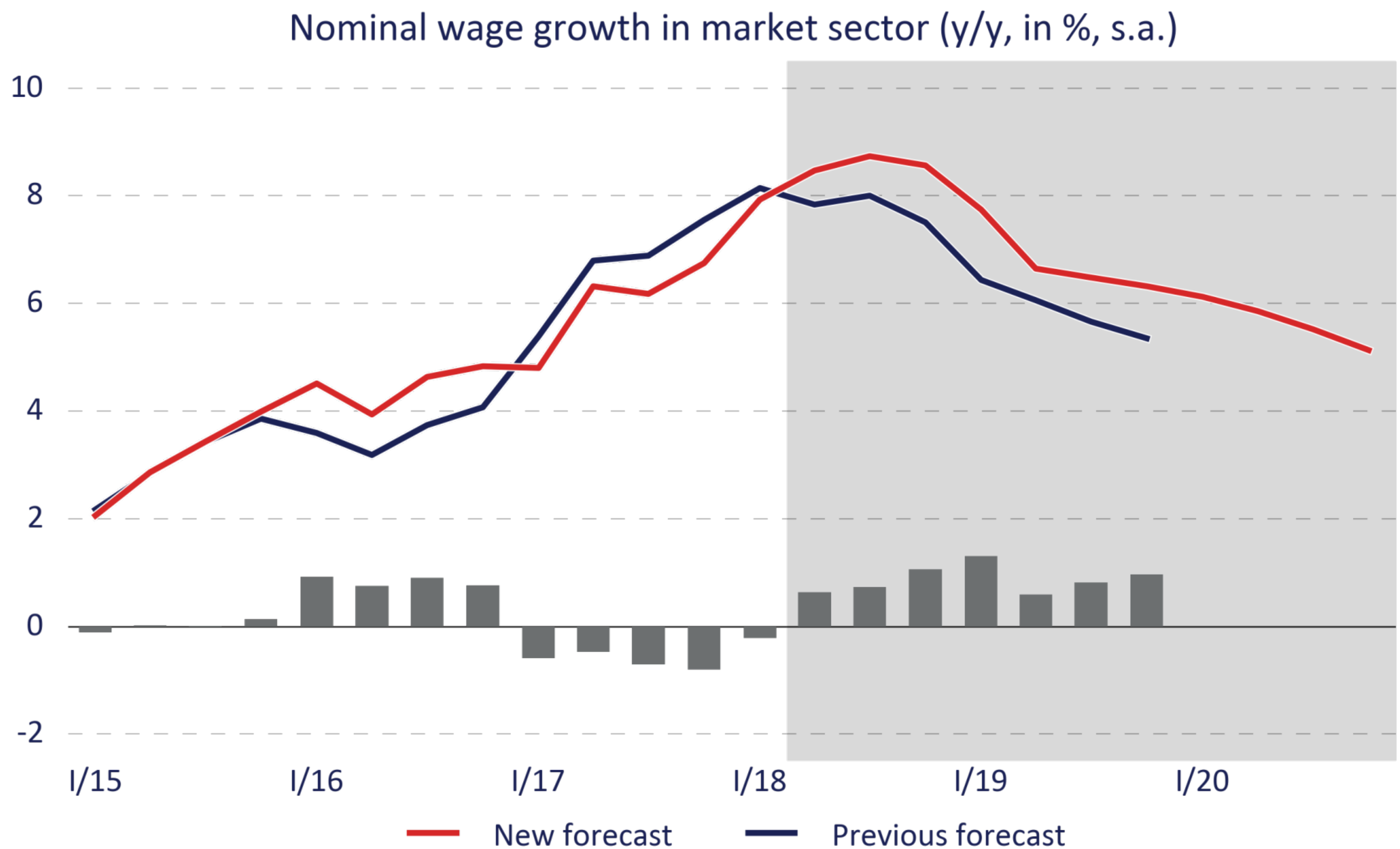


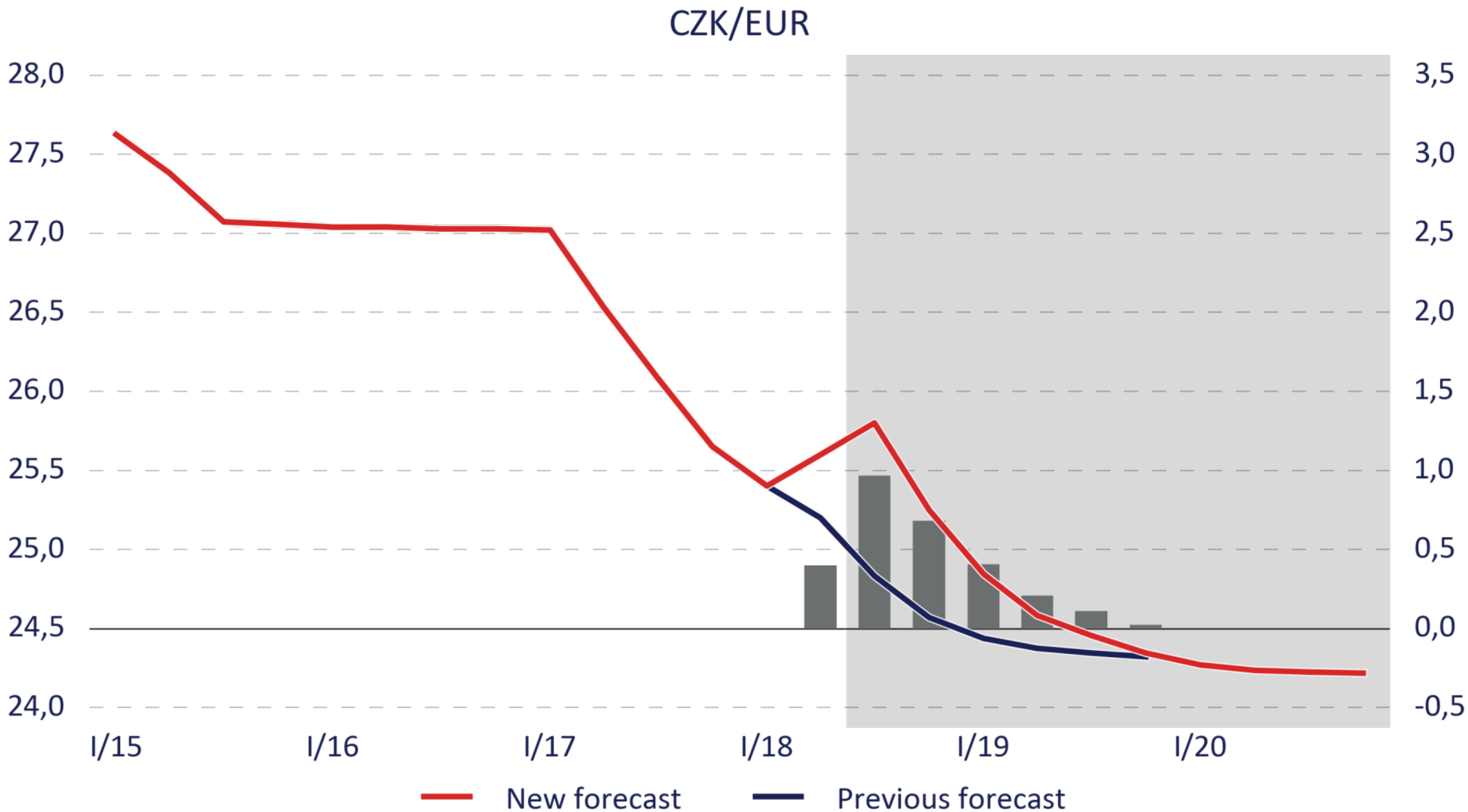
- The forecast for domestic growth this year is lower due to a revision of the national accounts for 2016 and 2017 and a more negative contribution of net exports.
- The outlook for next year remains unchanged.

Comparison: Nominal Wage



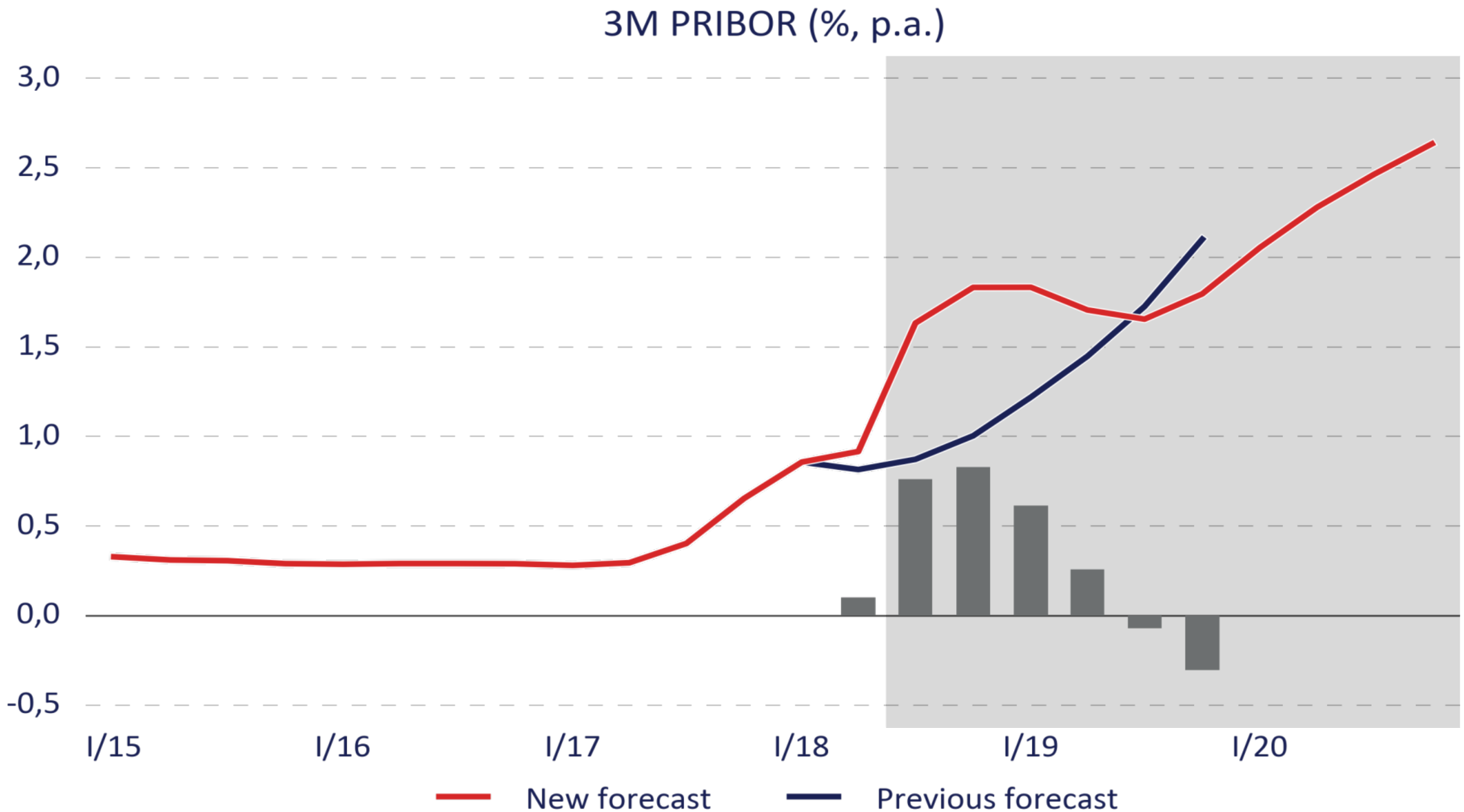
- Wage growth will be faster than in the previous forecast reflecting a weaker koruna and higher expected inflation and expectations of higher figures for 2018 Q2 based on short-term indicators.
- The forecast also expects more gradual slowdown in wage growth during 2019.

Comparison: Exchange Rate Forecast



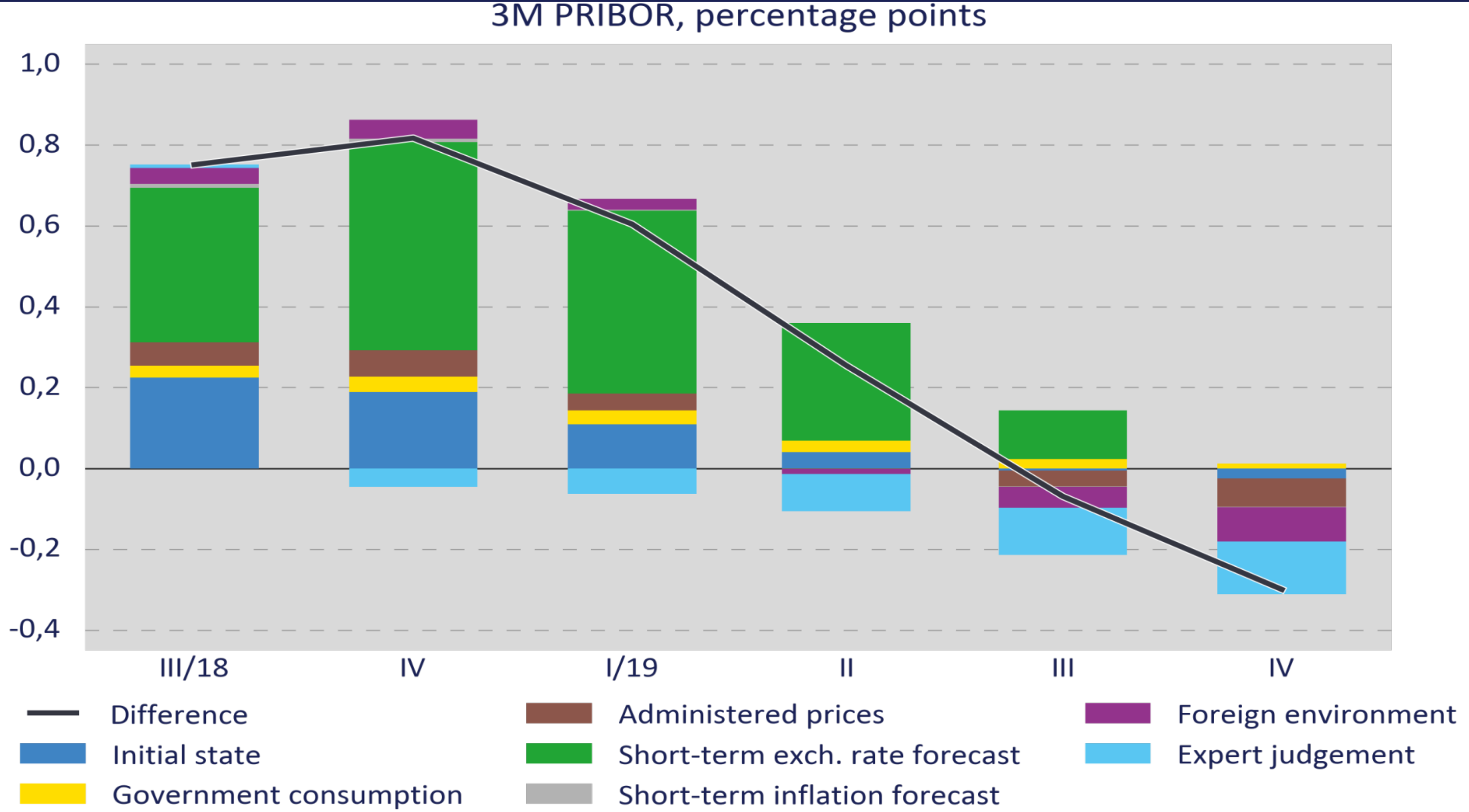
- The change in the outlook for the koruna for the coming quarters takes into account past market developments driven by global factors.
- The forecast assumes that the negative effect of global sentiment will partly persist in the next two quarters.

Comparison: Interest Rate Forecast



- The forecast indicates a need for a faster increase in domestic interest rates until mid-2019.
- This is due mainly to the currently significantly weaker koruna and its subsequent only gradual correction, and due partly to higher inflationary pressures.

Decomposition of Changes in the Interest Rate Forecast



- The higher interest rate outlook at the horizon of up to one year is due to several factors, dominated by a weaker koruna.
- The initial state (wage growth, import prices and observed inflation), the outlook for administered prices and government consumption are acting towards higher rates this year, too. However, the aggregate contribution of these factors is only about a third of the revision of the exchange rate path.

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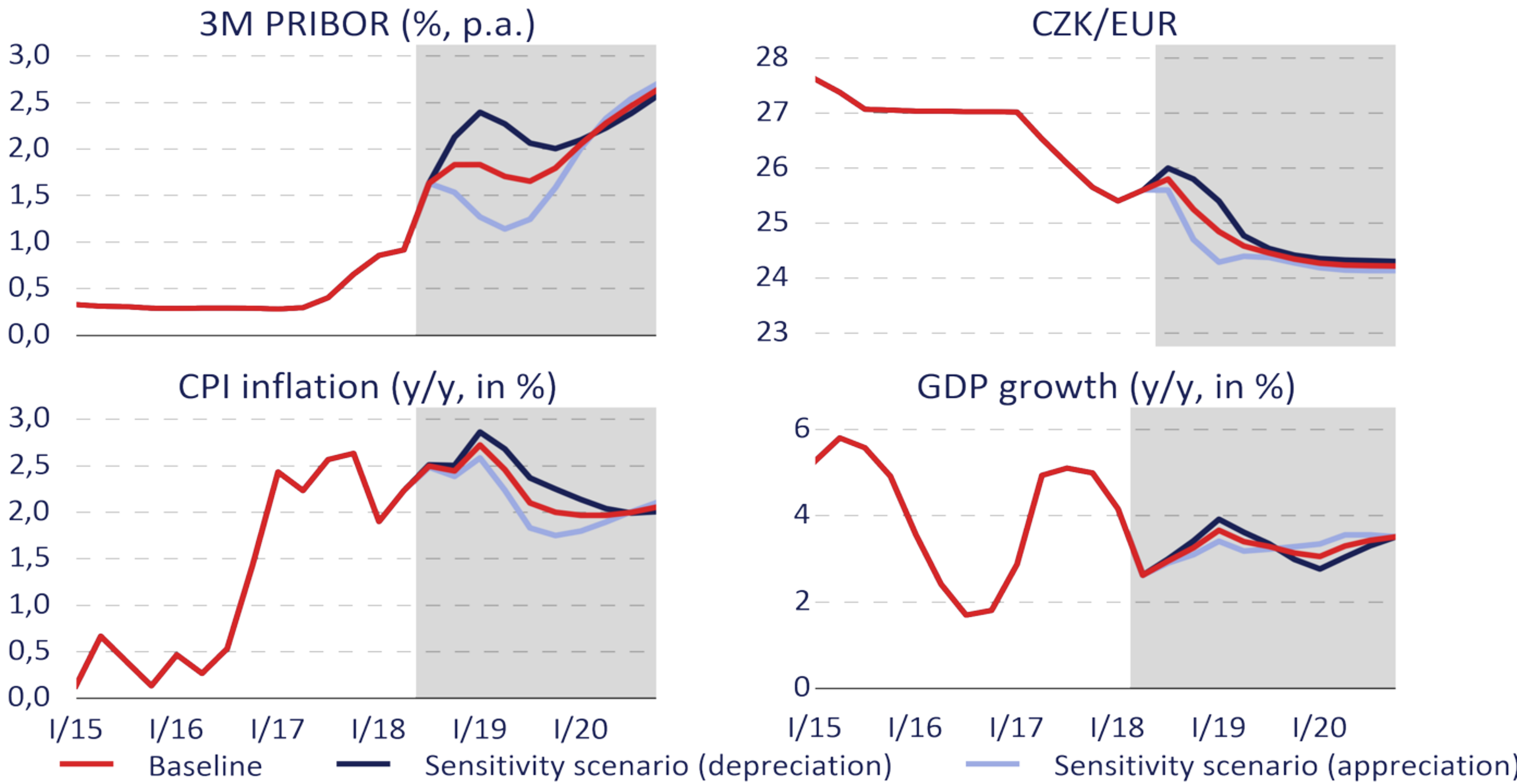
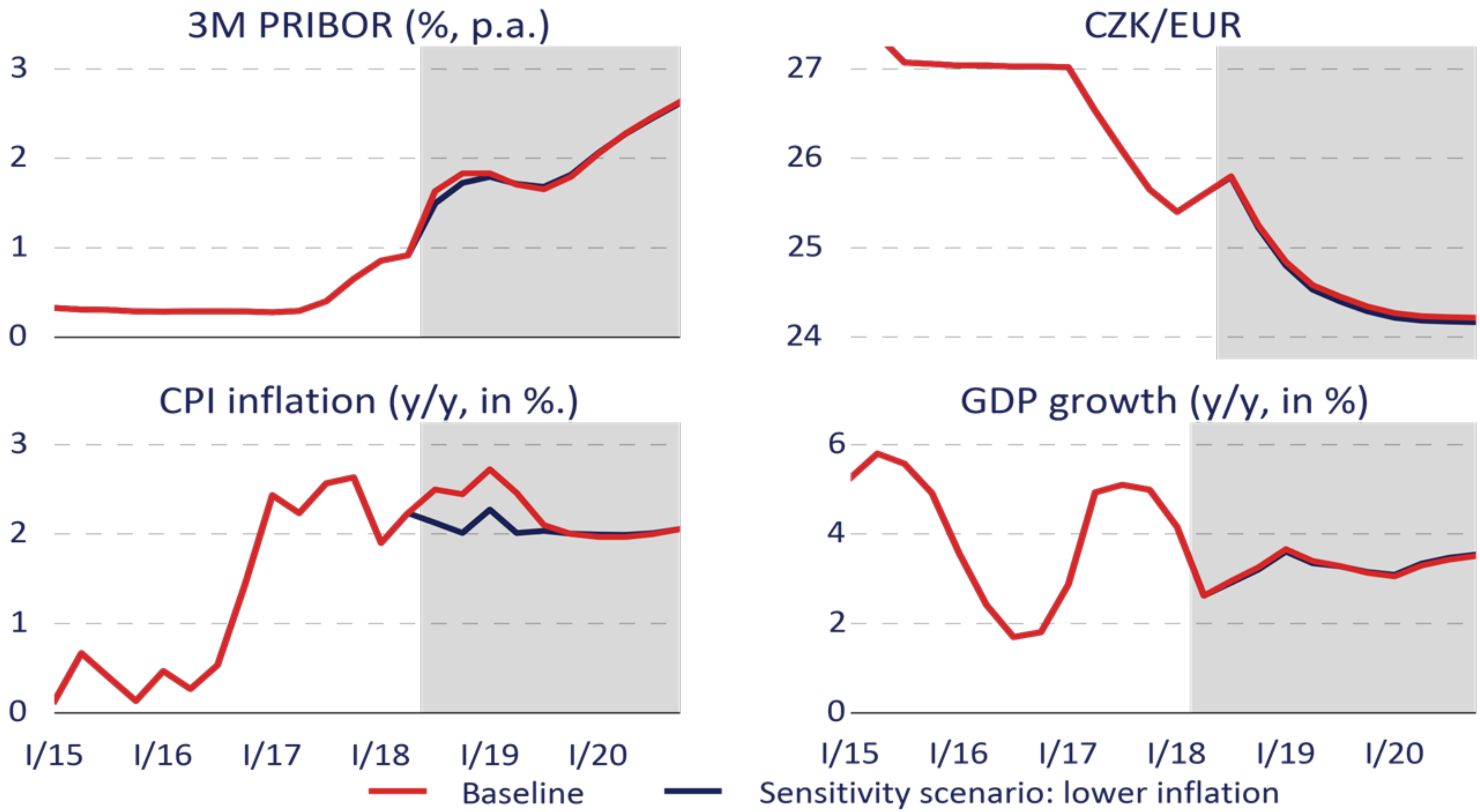
Sensitivity Scenario – Exchange rate



- The main uncertainty is the duration of the global factors associated with the change in sentiment on global markets which caused the koruna to depreciate.
- The depreciated koruna in the upside version of this scenario vis-à-vis the baseline leads to temporarily higher inflation and faster GDP growth.
- Interest rates are also higher in the short run and thus have a stabilising effect.

Sensitivity Scenario – Lower inflation



- The short-term risk of lower inflation is described by a scenario, in which the recent growth in volatile prices fades out more quickly than in the forecast.
- Inflation is closer to the target and the deviations of the other variables are insignificant as forward-looking monetary policy has no reason to respond strongly to this type of shock, i.e. to a negative one-off shock to traditionally volatile inflation components.

Thank you for your attention!

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