

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

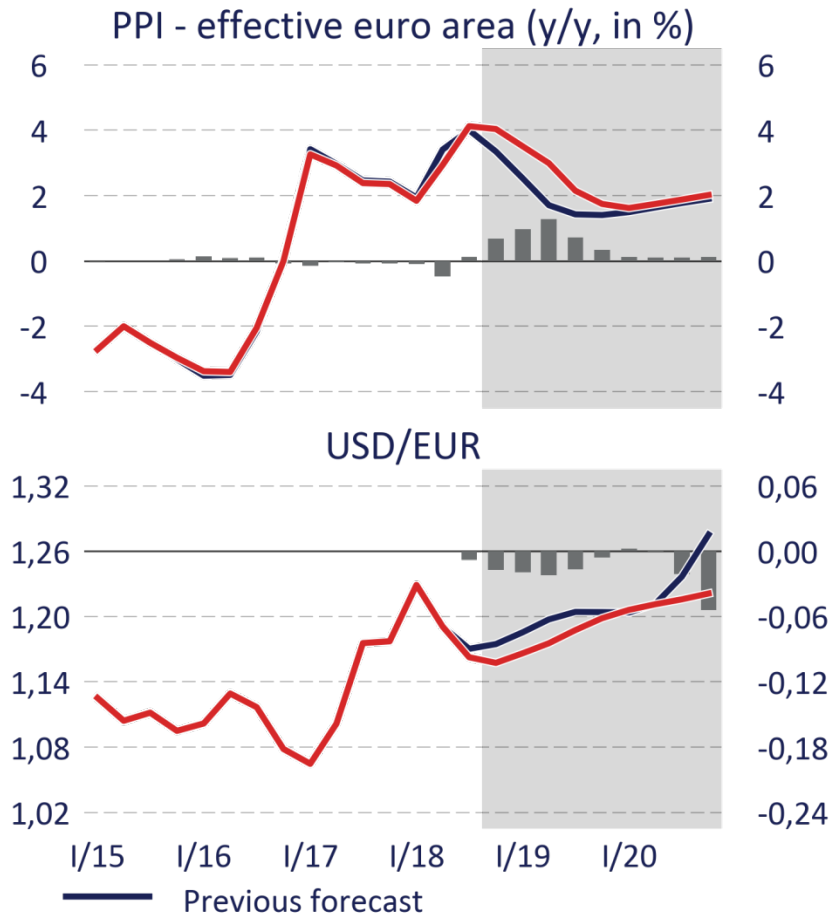
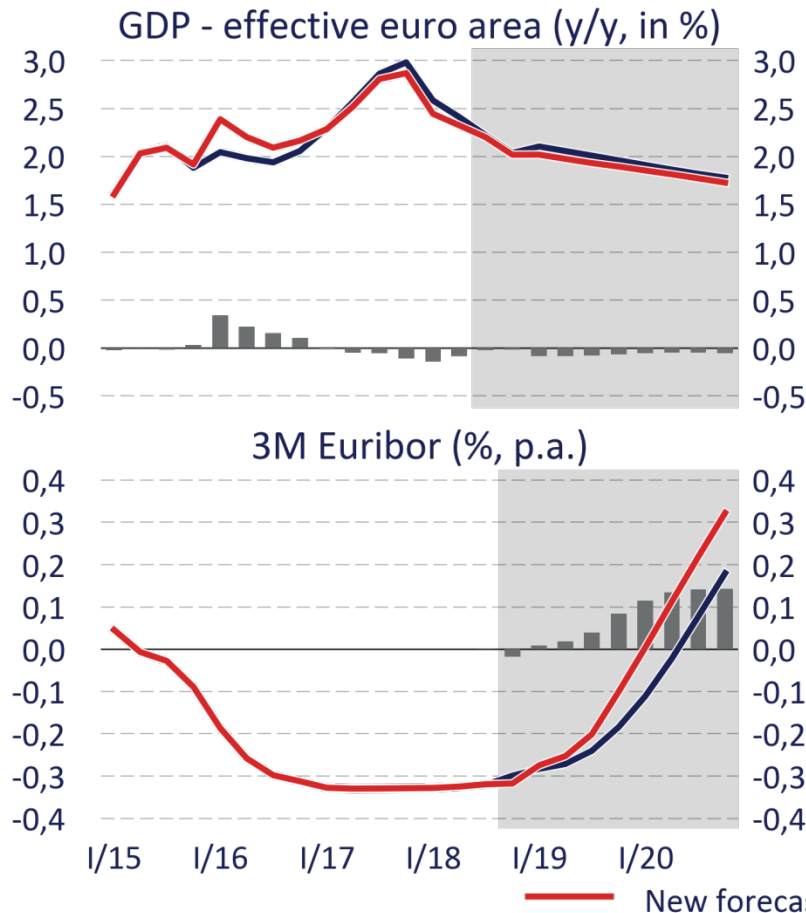
Meeting with Analysts

Tomáš Holub

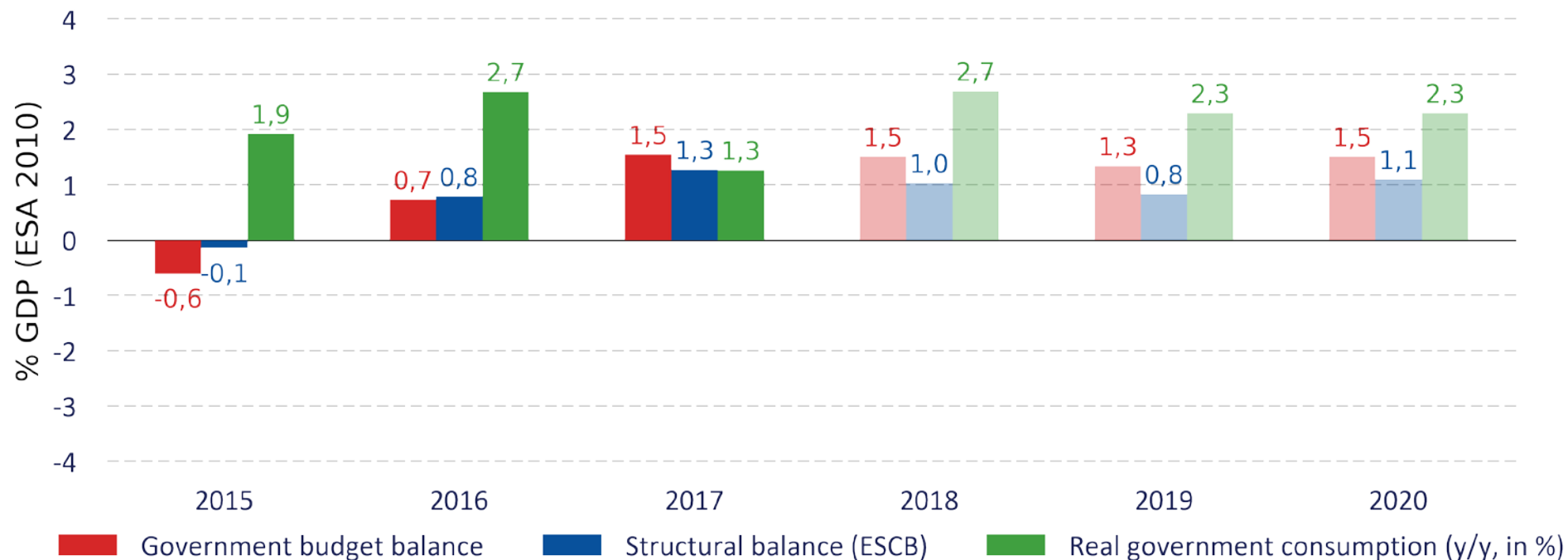
Prague, 2 November 2018

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

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- GDP growth in the effective euro area will gradually slow to 1.7% in late 2020.
- Annual producer price inflation in the euro area has reached 4% (mainly reflecting growth in oil prices), but will gradually slow to just below 2%.
- According to the market outlook, 3M EURIBOR will turn positive in early 2020.



- Government budget surpluses, reflecting increased tax revenues due to ongoing economic growth and policy measures, will persist.
- The government surplus will reach 1.5% of GDP this year and remain at a similar level in the next two years. This will translate into continued structural surpluses.
- Real government consumption will grow by 2.7% in 2018 and slow down slightly afterwards.

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	0.3	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

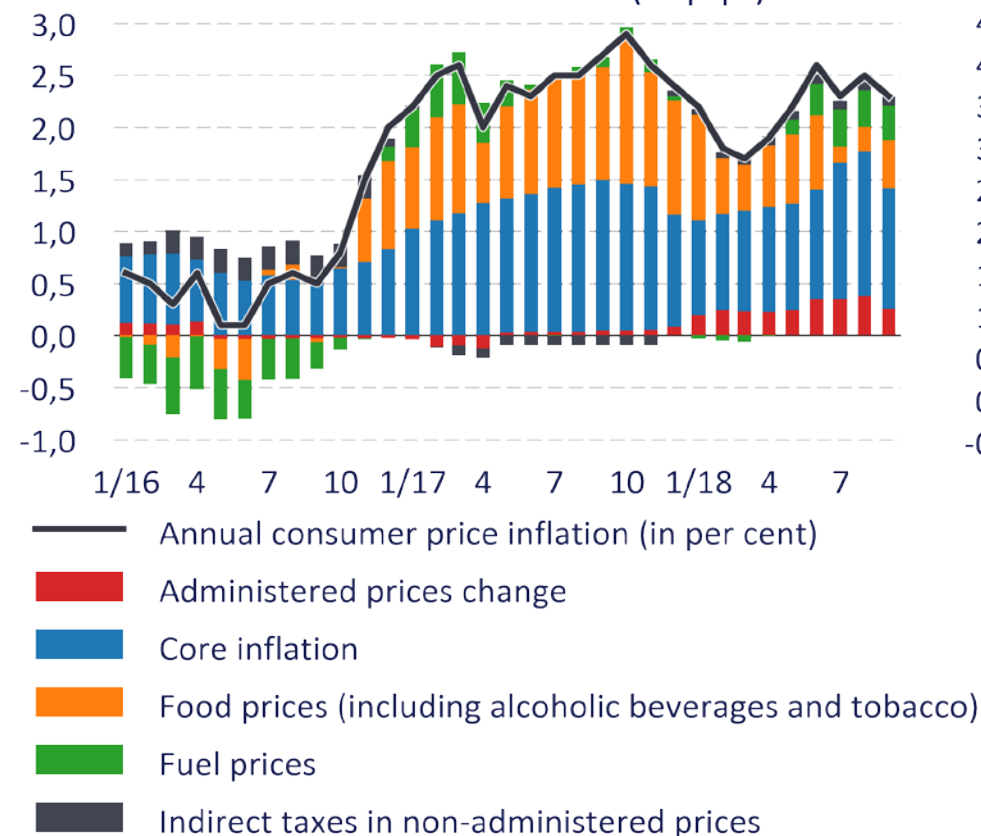
- Fiscal policy will be expansionary this year and the next, and neutral in 2020.
- The distinctly positive fiscal impulse of 0.5 p.p. this year relates mainly to measures supporting household consumption, buoyant wage growth in the government sector and faster growth in government investment.
- A positive fiscal impulse of 0.4 p.p. for the next year will reflect an extraordinary rise in old-age pensions, continued growth in government investment and strong wage growth.

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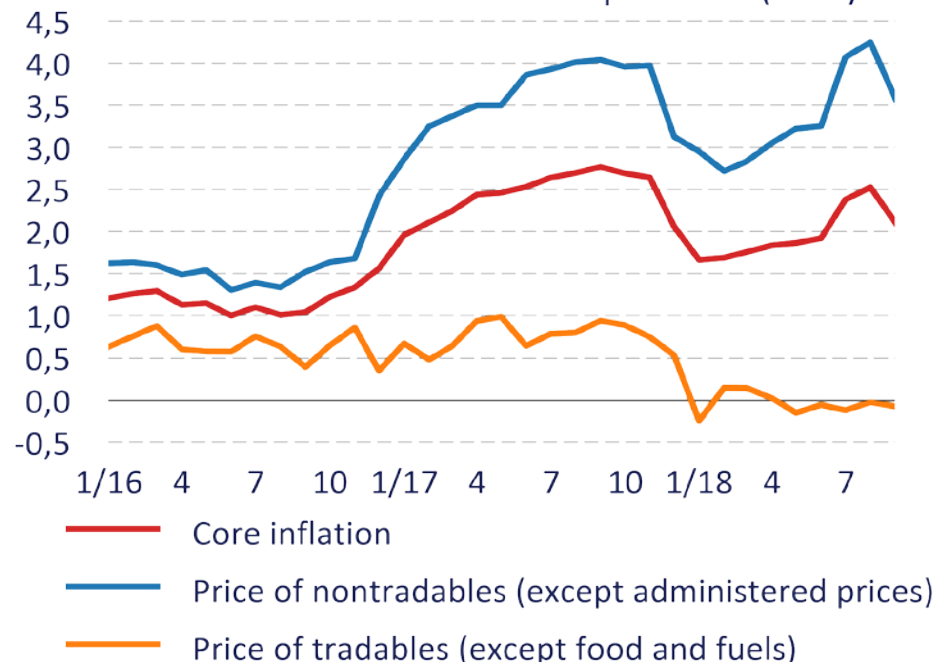
- Inflation will stay in the upper half of the tolerance band in 2019 and will approach the 2% target from above over the monetary policy horizon.
- GDP growth slowed from last year's high levels; from the whole-year perspective it will be just above 3% this year and in the years ahead. The economy will be driven mainly by growth in household consumption and by investment activity. Due to a fast growth of imports, net exports will contribute negatively in 2019.
- The continued economic growth has been reflected in a tight labour market, which will inhibit further fast employment growth. Increase in the minimum wage in 2019 will stimulate the wage growth temporarily, followed by a gradual slowdown.
- After its current weakness reflecting negative global sentiment, the koruna will return to an appreciation trend from the next year due to a distinctly positive interest rate differential vis-à-vis the euro area, 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 towards their long-run neutral level; 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

Structure of inflation (in p.p.)

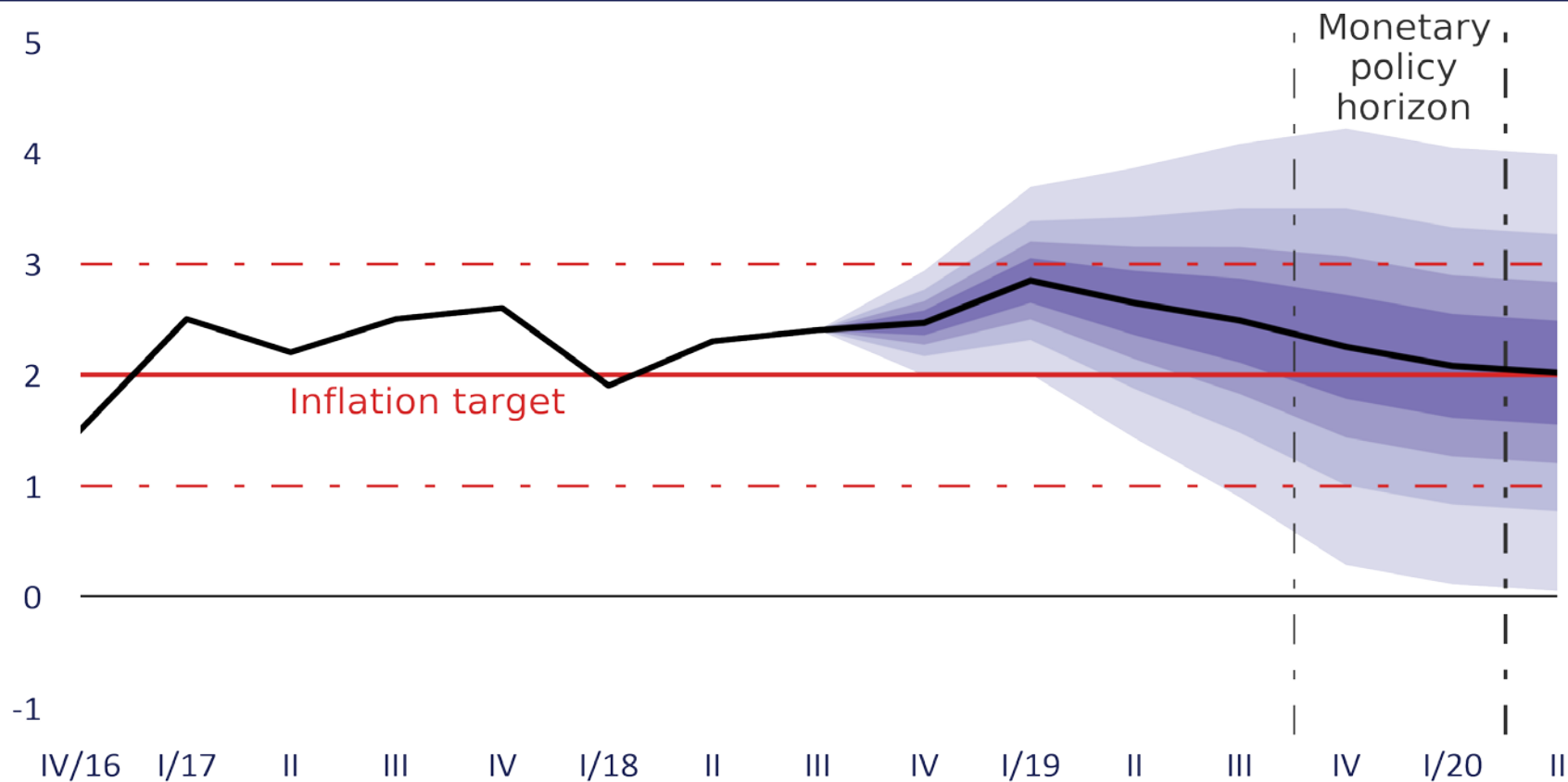


Core inflation and its components (in %)



- Inflation accelerated in 2018 Q3, which mainly reflected increasing core inflation.
- Core inflation increased due to a pick-up in the growth of nontradables prices while tradables prices recorded an ongoing negligible decline.
- The contribution of food prices to the overall inflation declined temporarily.

Headline Inflation Forecast



- Inflation will stay in the upper half of the tolerance band until the beginning of 2020, peaking in the first quarter of 2019.
- It will return close to the target at the monetary policy horizon.

- The growth of administered prices will accelerate at the beginning of 2019 due mainly to a speed-up in the growth of energy prices; in 2020 their dynamics will slow down and return below 2 %.
- The current rapid growth in fuel prices will gradually slow down and switch to a year-on-year decline at the end of next year, reflecting the assumed decline in oil price and renewed appreciation of the koruna against the dollar.

Core inflation excl. fuels
(y/y, in %, excl. tax changes)



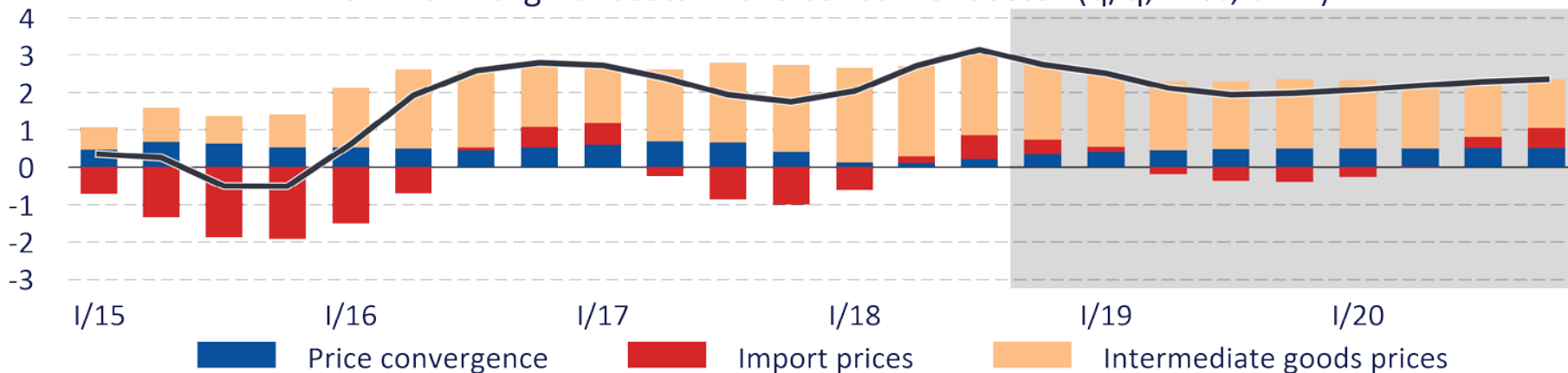
Growth of food prices
(y/y, in %, excl. tax changes)



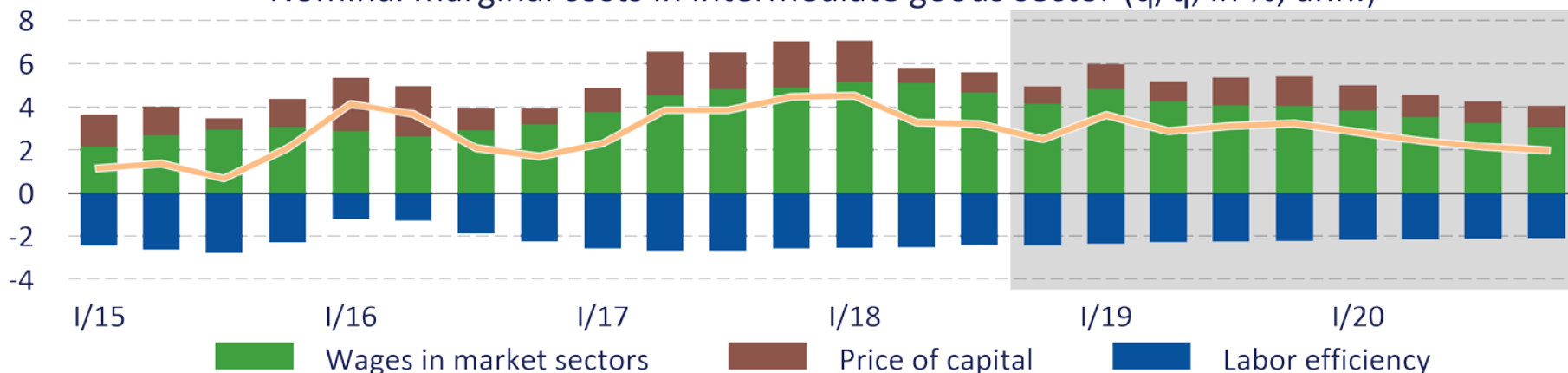
- Core inflation will rise further in the short term, as a result of recent koruna depreciation coupled with foreign producer price growth and strong domestic inflation pressures. In the second half of 2019, core inflation will return to 2% due to a moderation of the overall inflation pressures.
- Food price growth will speed up markedly on the back of an expected rise in agricultural commodity prices in the next four quarters. Reflecting subsequent stagnation of commodity prices and renewed appreciation of the koruna, food price growth will slow down somewhat by the end of next year.

Inflation pressures

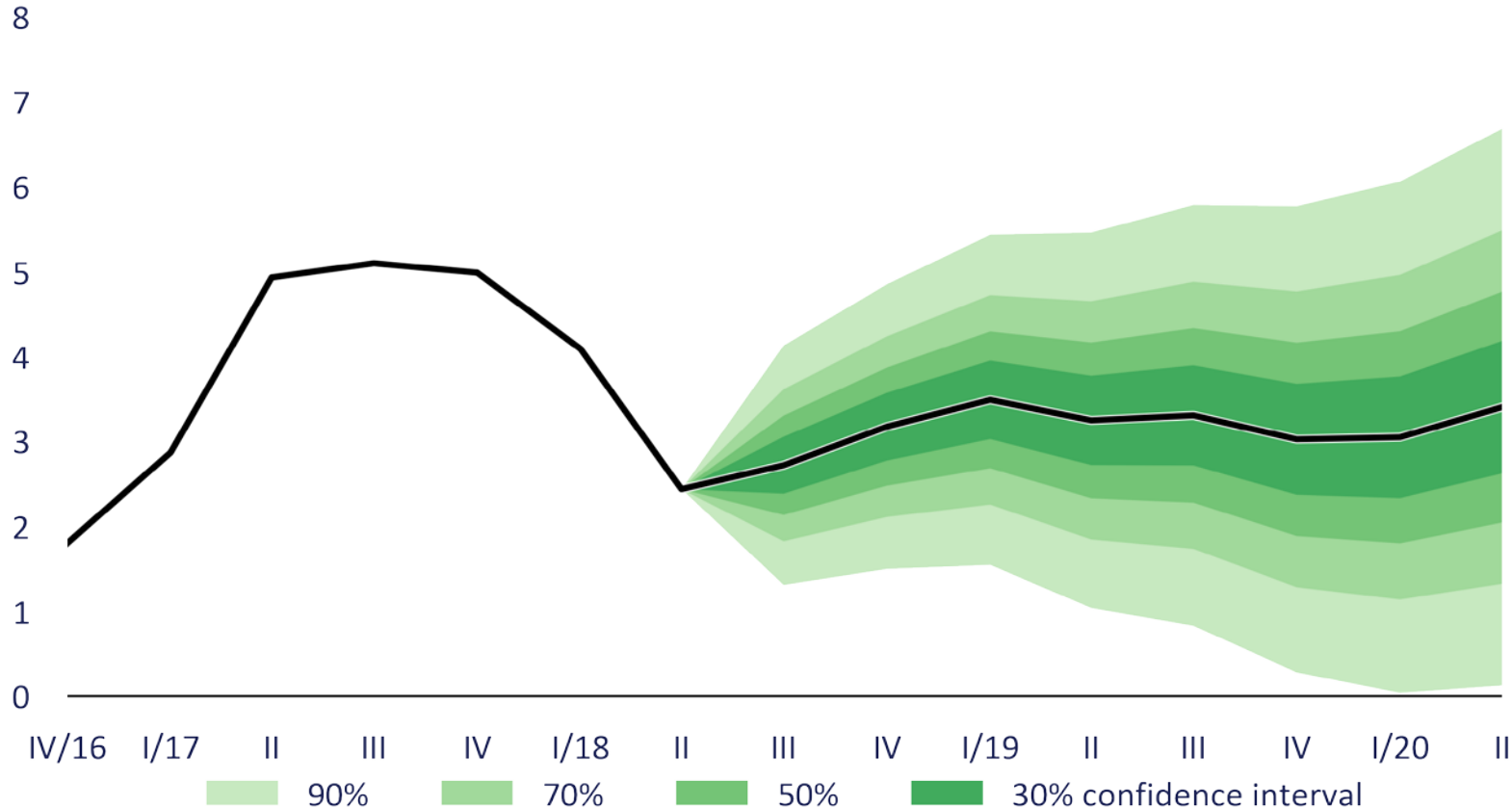
Nominal marginal costs in the consumer sector (q/q, in %, ann.)



Nominal marginal costs in intermediate goods sector (q/q, in %, ann.)



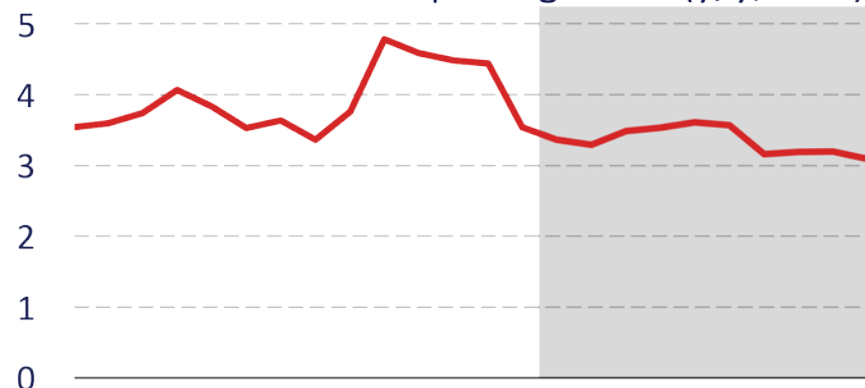
- The overall inflation pressures in the consumer sector will gradually ease in the coming year due mainly to a renewed appreciation of the koruna.
- Due to ongoing wage growth, including forthcoming minimum wage increase, domestic inflation pressures will persist in 2019 and moderate during 2020.



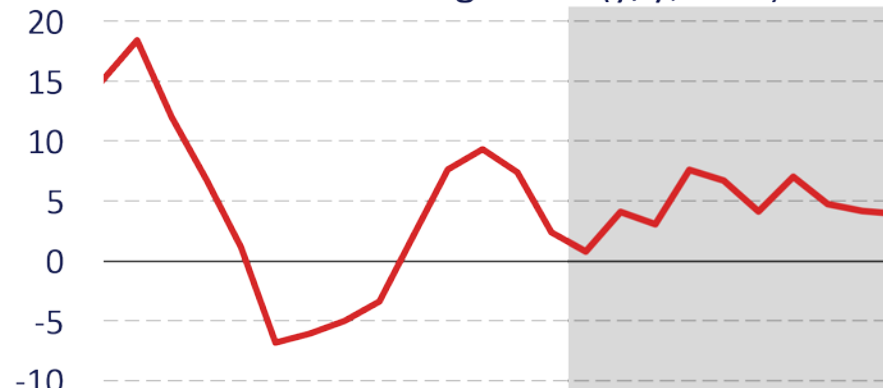
- GDP growth has slowed from last year's high levels. It will average slightly above 3% this year and in the years ahead.
- Consumption and investment will support the GDP growth over the entire forecast horizon; net exports will contribute negatively in 2019.

Aggregate Demand

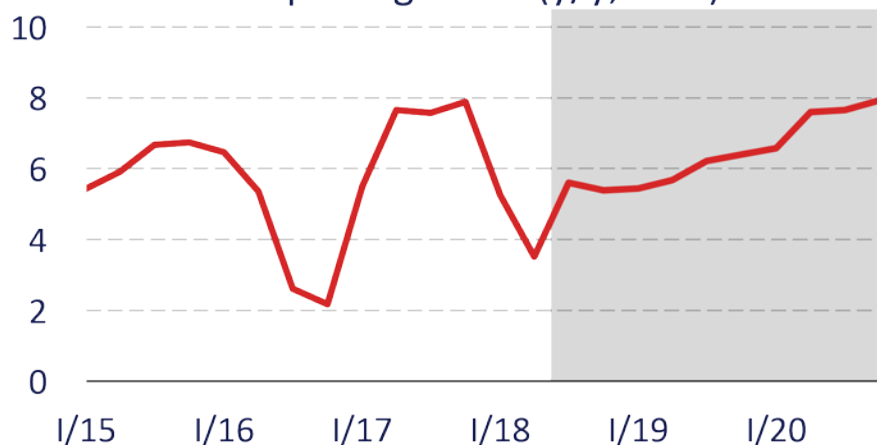
Household consumption growth (y/y, in %)



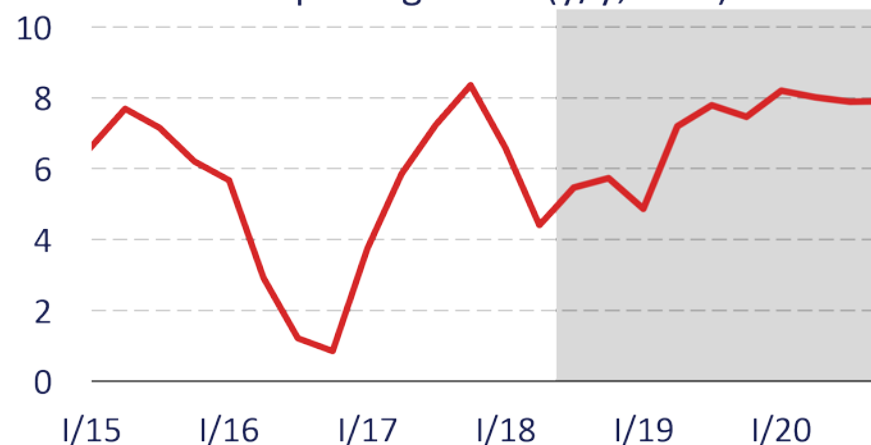
Investments growth (y/y, in %)



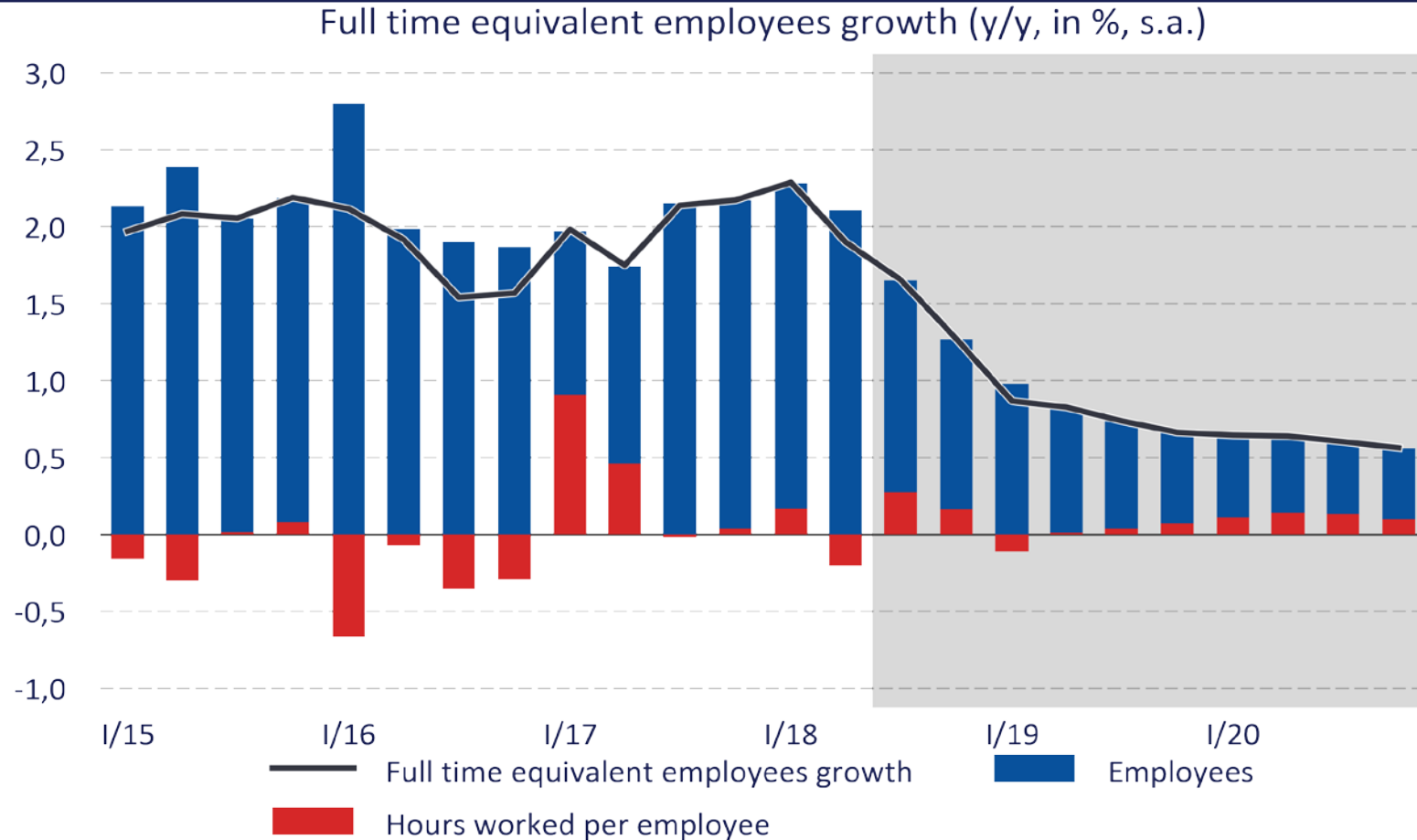
Exports growth (y/y, in %)



Imports growth (y/y, in %)



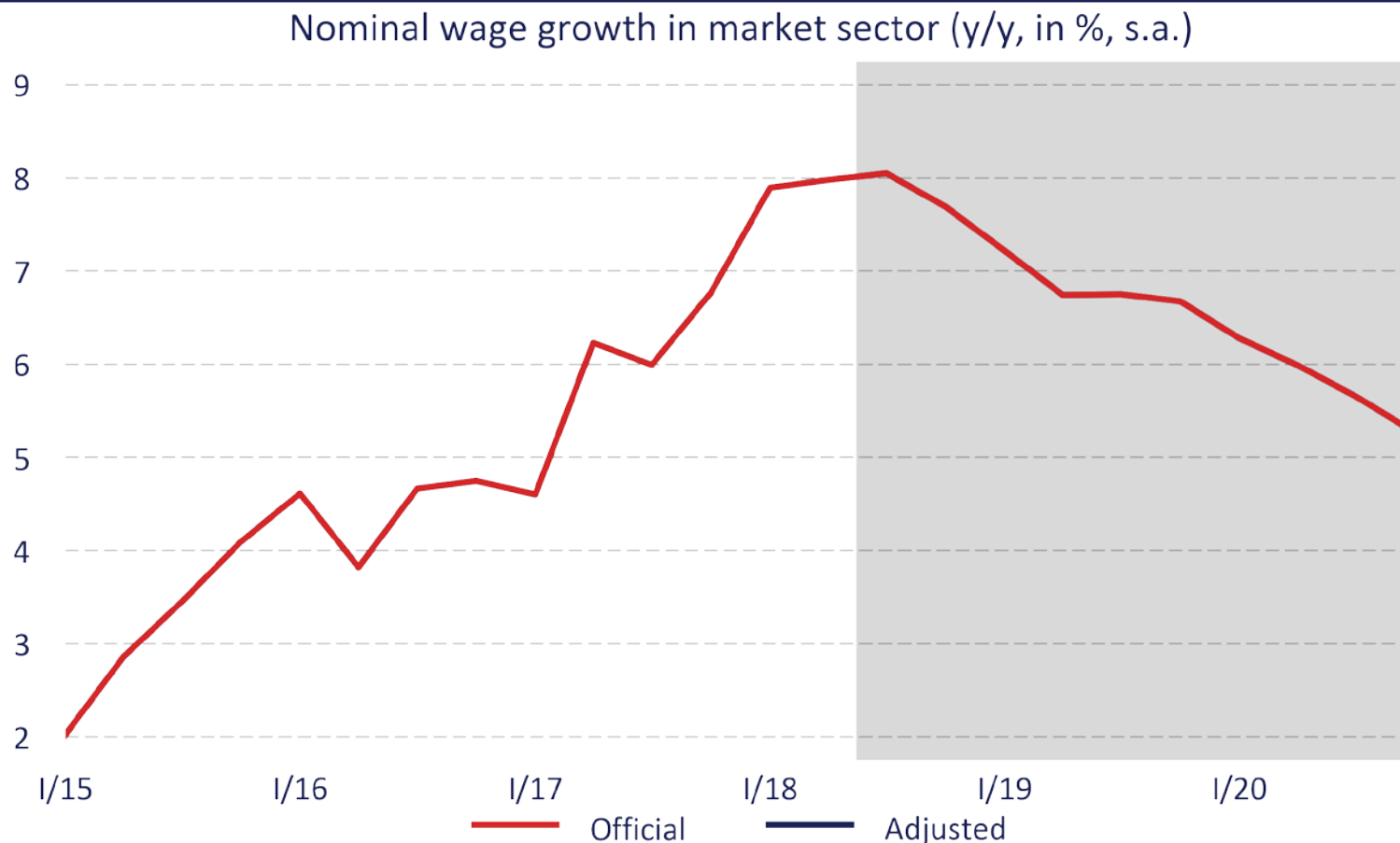
- The continued household consumption growth will reflect strong growth in wages and salaries and other income (including pensions in 2019).
- Investment growth will be driven by both private and government investment.
- The contribution of net exports to GDP growth will be negative next year due to a fast growth of imports implied by strong domestic demand.



- Employment growth will gradually slow due to labour shortages.
- With a record-low unemployment rate, employment growth will rely mainly on further increases in the labour force and in hours worked per employee.

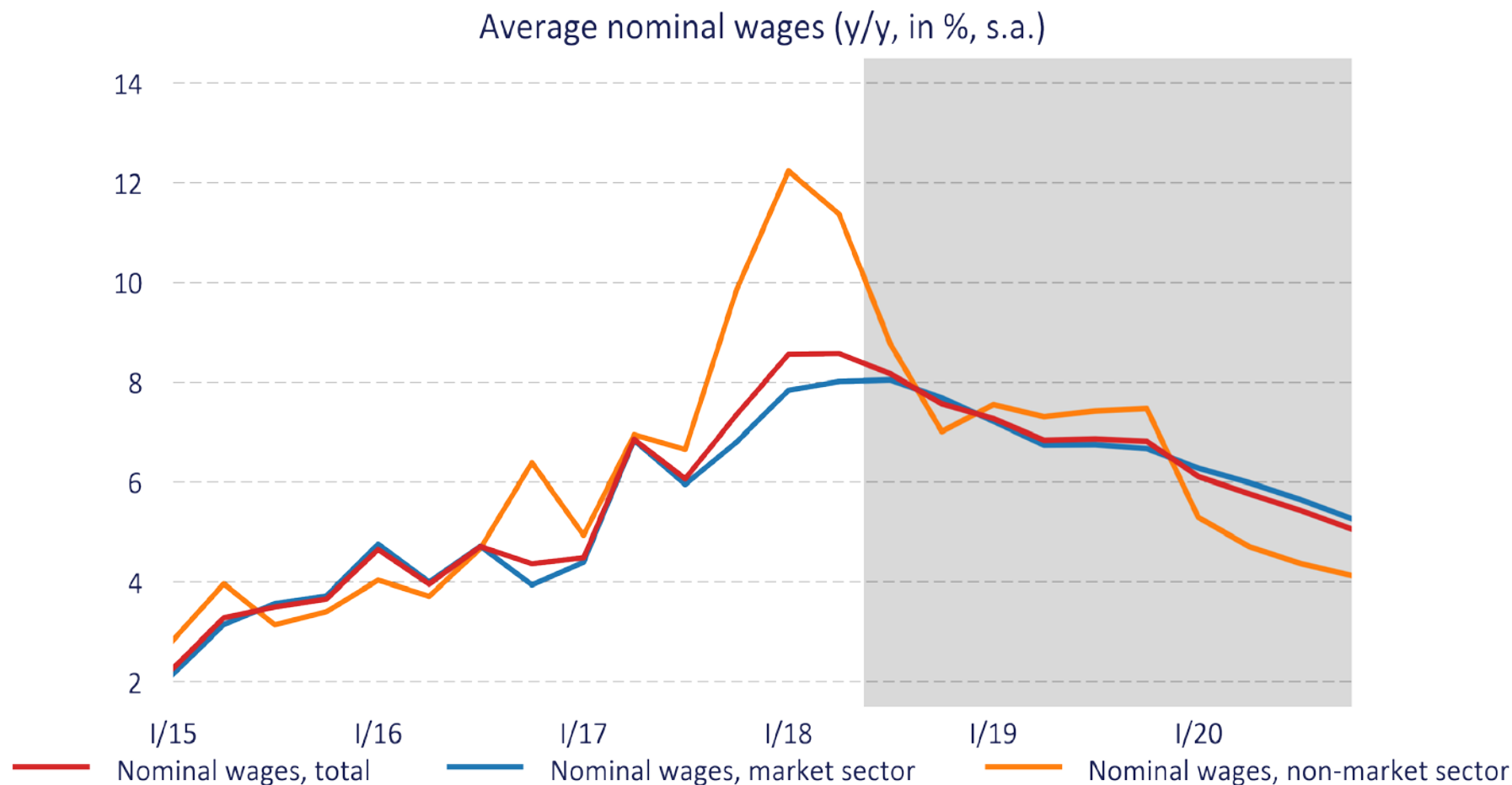


- The current very low unemployment rate will not decrease significantly further, reaching 2% by the end of 2020.

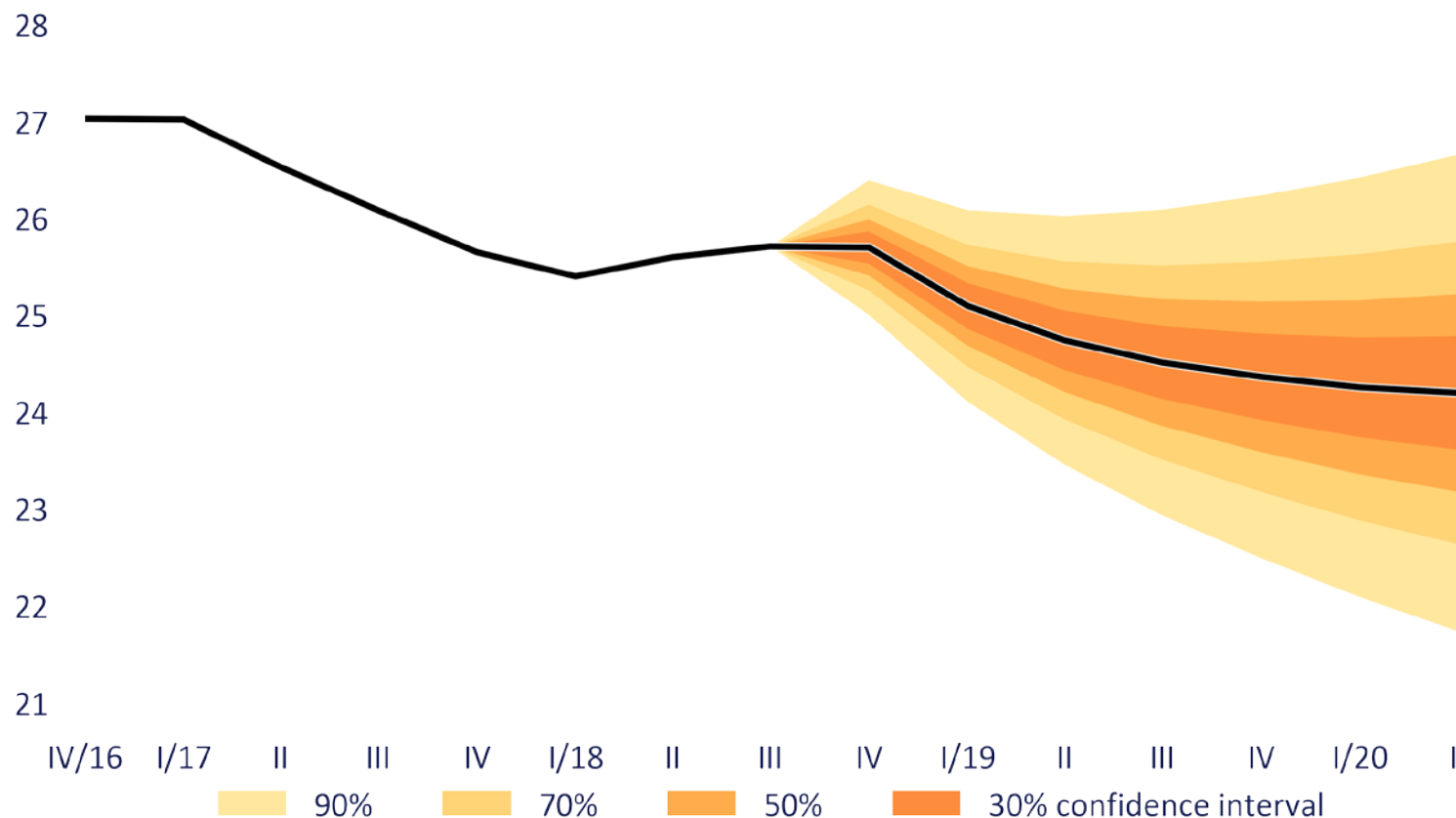


- Wage growth in the market sector is peaking at a high level in the tight labour market, but will gradually ease.
- Wage growth will start to slow at the end of 2018 due to tightening monetary conditions and firms' efforts to maintain their competitiveness and profitability.
- An increase in minimum wage in 2019 will bolster wage growth temporarily.

Comparison: Nominal Wage Growth in Non-market Sector

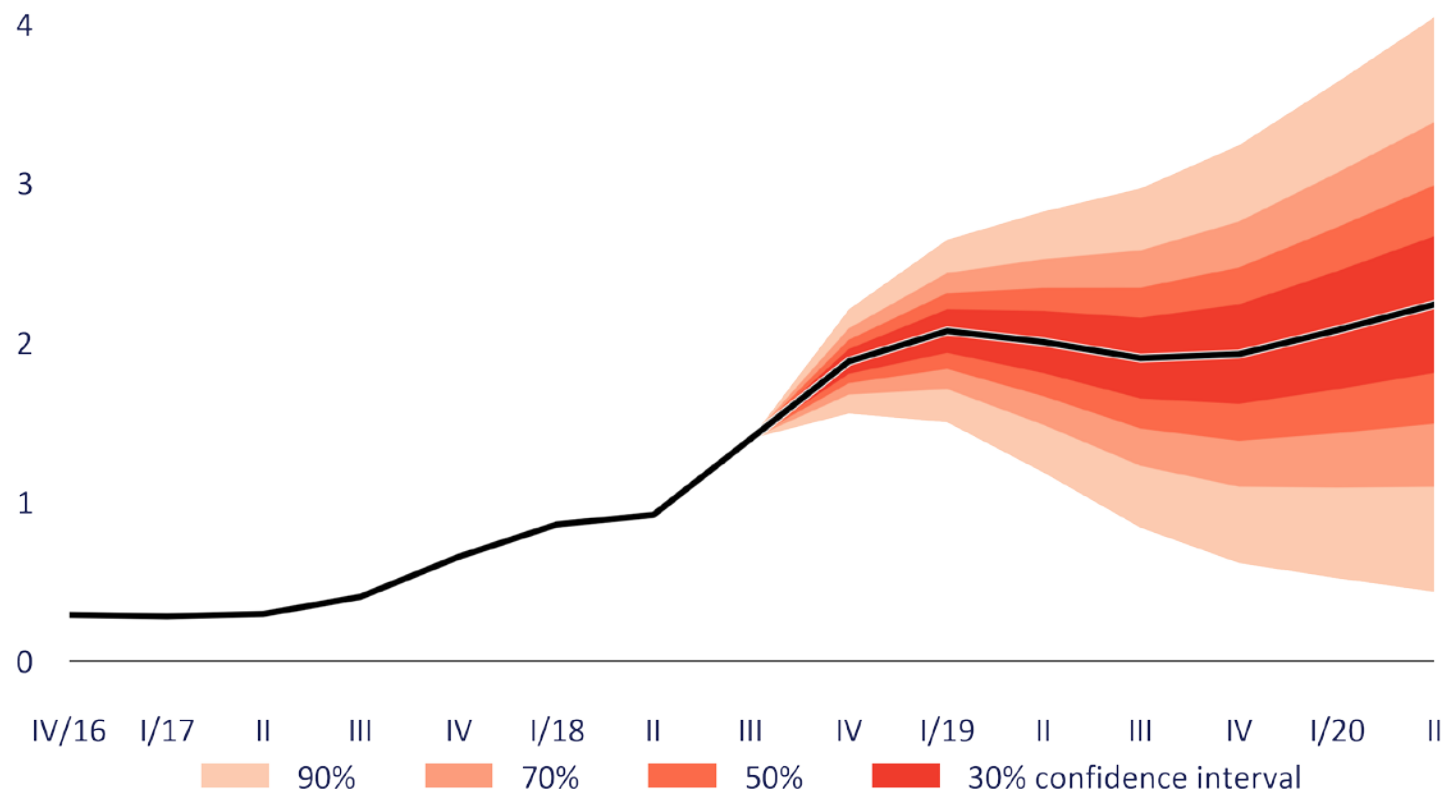


- Pronounced, albeit slowing, year-on-year wage growth will continue in the non-market sector, reflecting an increase in the wages of teachers and, to a lesser extent, other public employees.



- The exchange rate forecast for Q4 at 25.7 CZK/EUR reflects persisting negative global sentiment and an outflow of short-term capital from emerging markets to assets that investors perceive as less risky.
- Koruna will start appreciating again next year, driven by a distinctly positive interest rate differential vis-à-vis the euro area and continued real economic convergence connected with growing labour efficiency.

Interest Rate Path (3M PRIBOR)

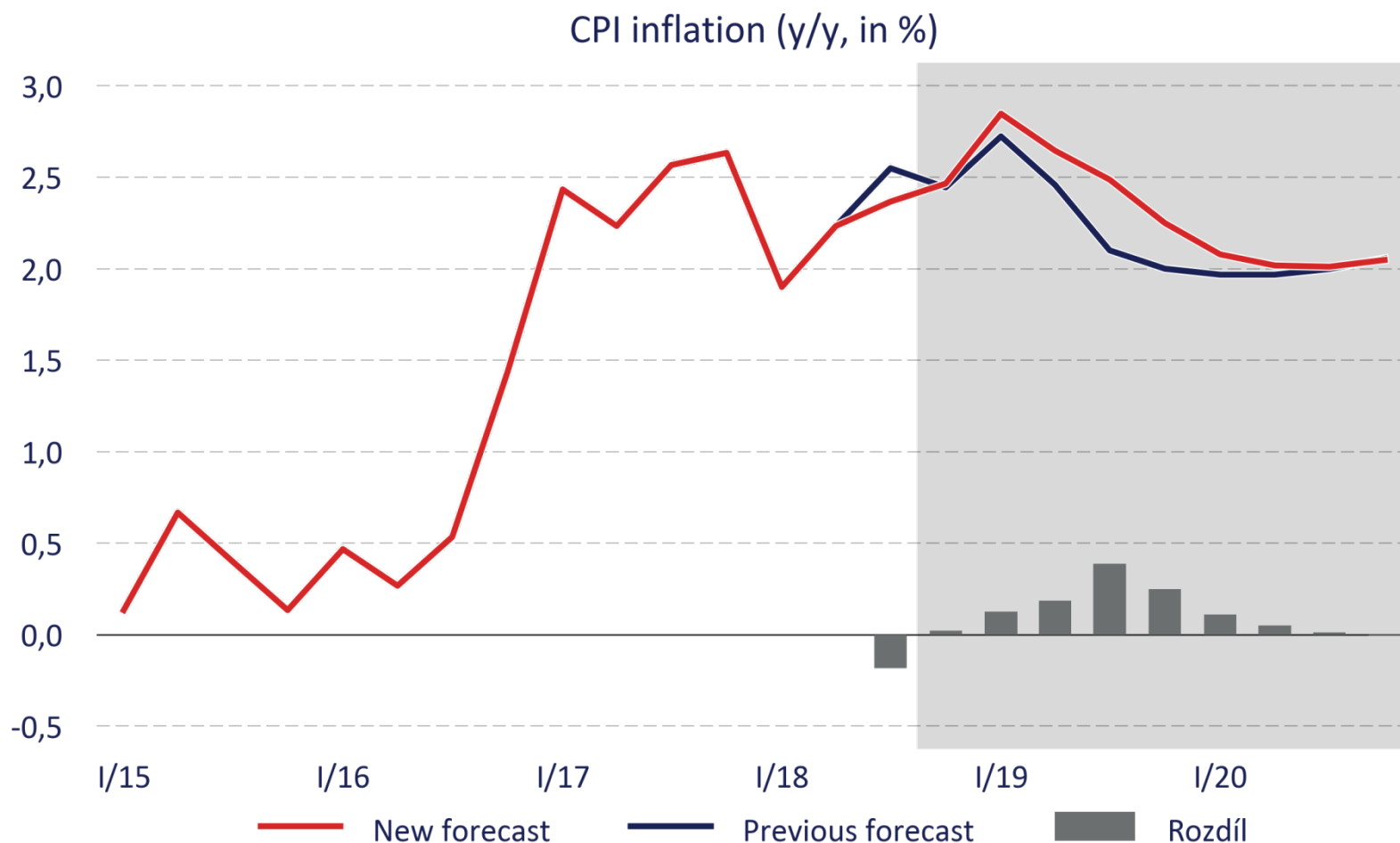


- Consistent with the forecast is a continued rise in interest rates towards their long-run neutral level.
- The rate increase at the start of the forecast is a response to the recent depreciation of the koruna, coupled with ongoing domestic inflation pressures.
- The subsequent broad stability of rates in 2019 is a result of forecasted appreciation of the koruna amid continuing very easy ECB's monetary policy.

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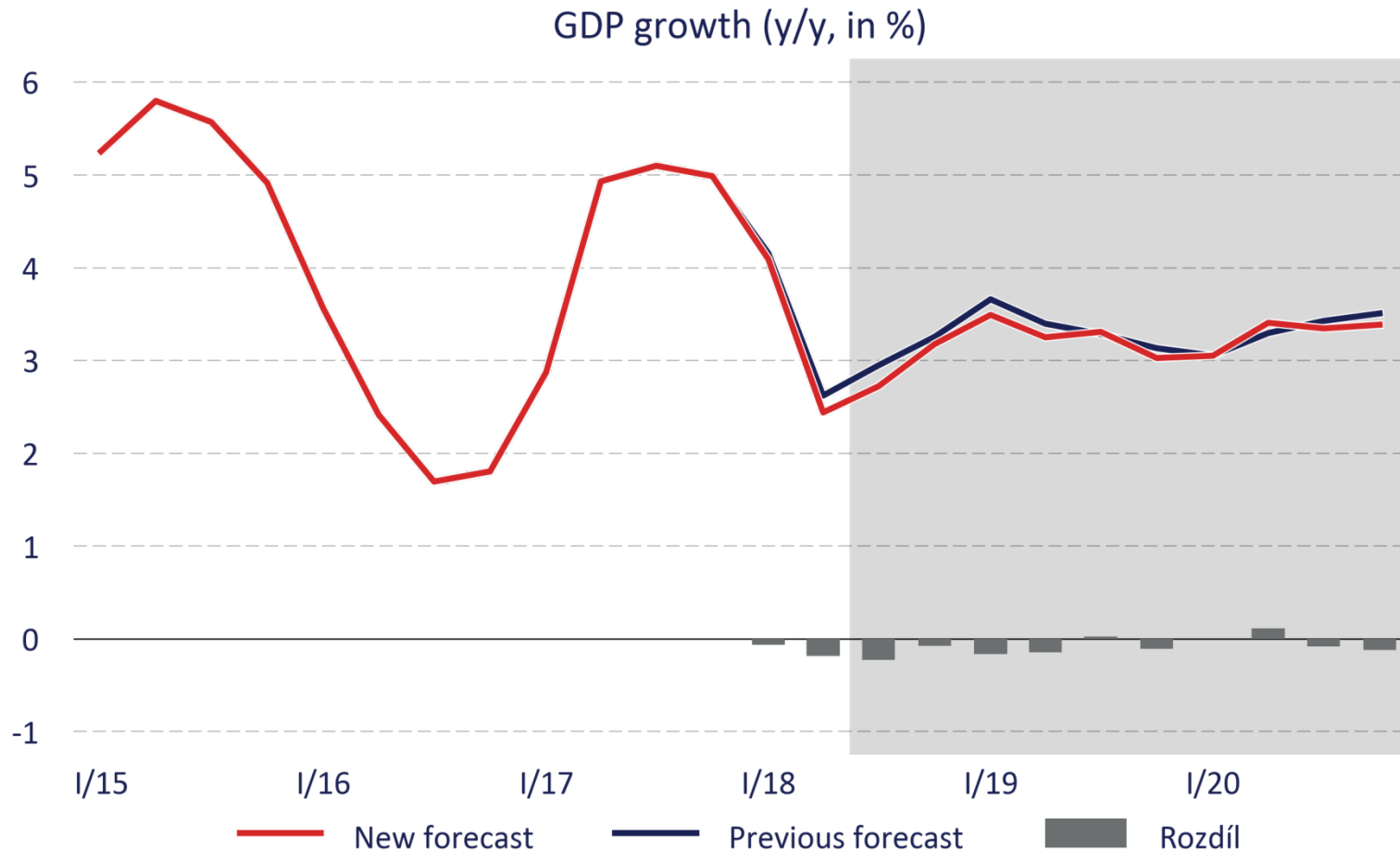
- The overall story of the forecast is essentially unchanged.
- The biggest change from the previous forecast is a later renewal of koruna's appreciation. Coupled with higher foreign producer price inflation, it leads to higher import price growth.
- By contrast, the strength of domestic inflation pressures has been revised down slightly this year due to a less pronounced wage growth. However, next year domestic inflation pressures will weaken more slowly owing to the newly incorporated minimum wage increase.
- In addition to these fundamental factors, the inflation forecast has moved upwards in the one-year horizon also due to a higher outlook for administered prices (increase in energy commodity prices).
- The outlook for domestic economic activity is virtually unchanged.
- The new forecast contains a slightly higher domestic interest rate path until the start of 2020 compared to the previous prediction.

Comparison: Inflation Forecast

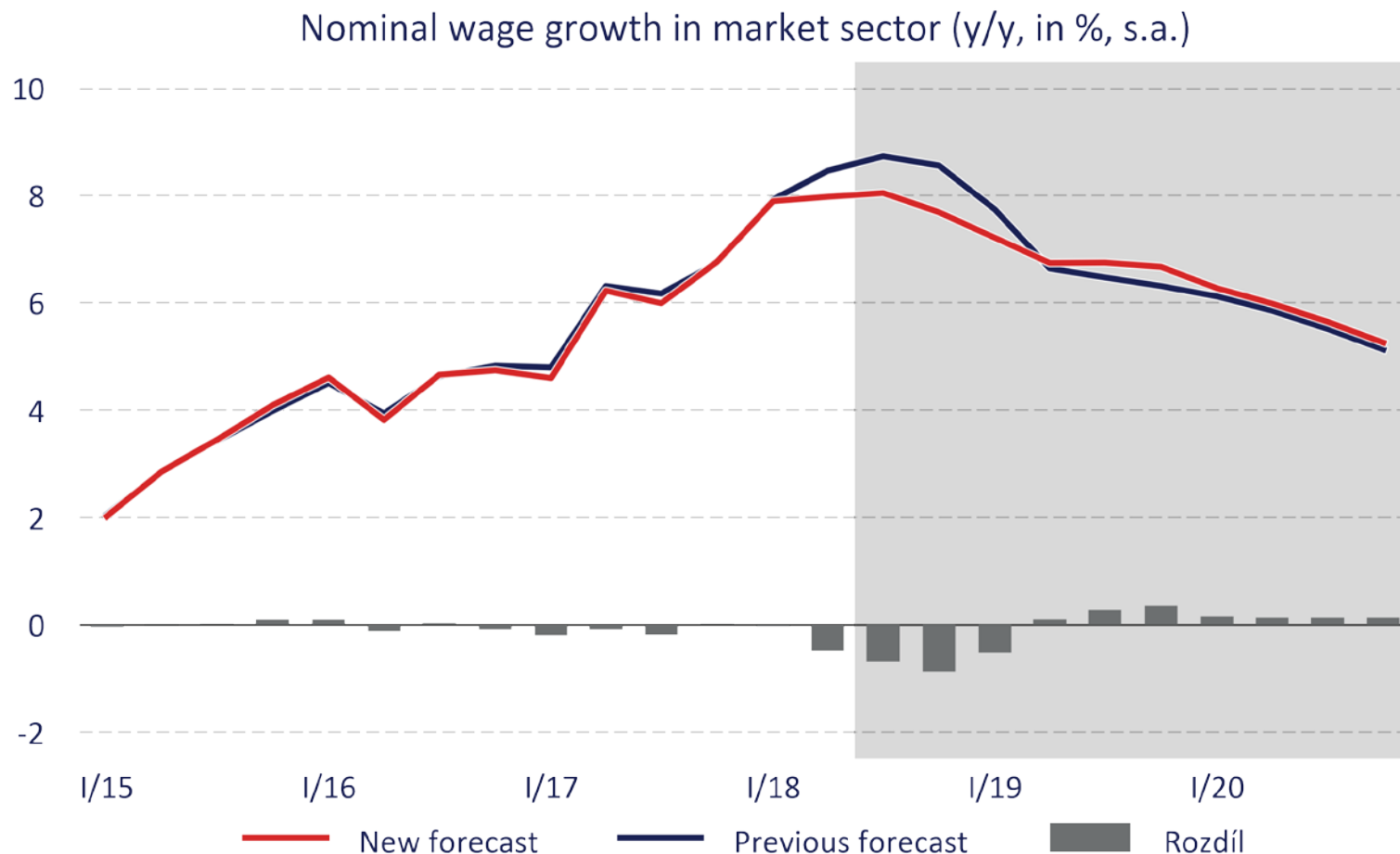


- The inflation forecast is higher for the next year, but is little changed at its longer end.
- Besides the fundamental factors (weaker koruna, higher foreign inflation), the upward near-term revision reflects the outlook of administered prices.

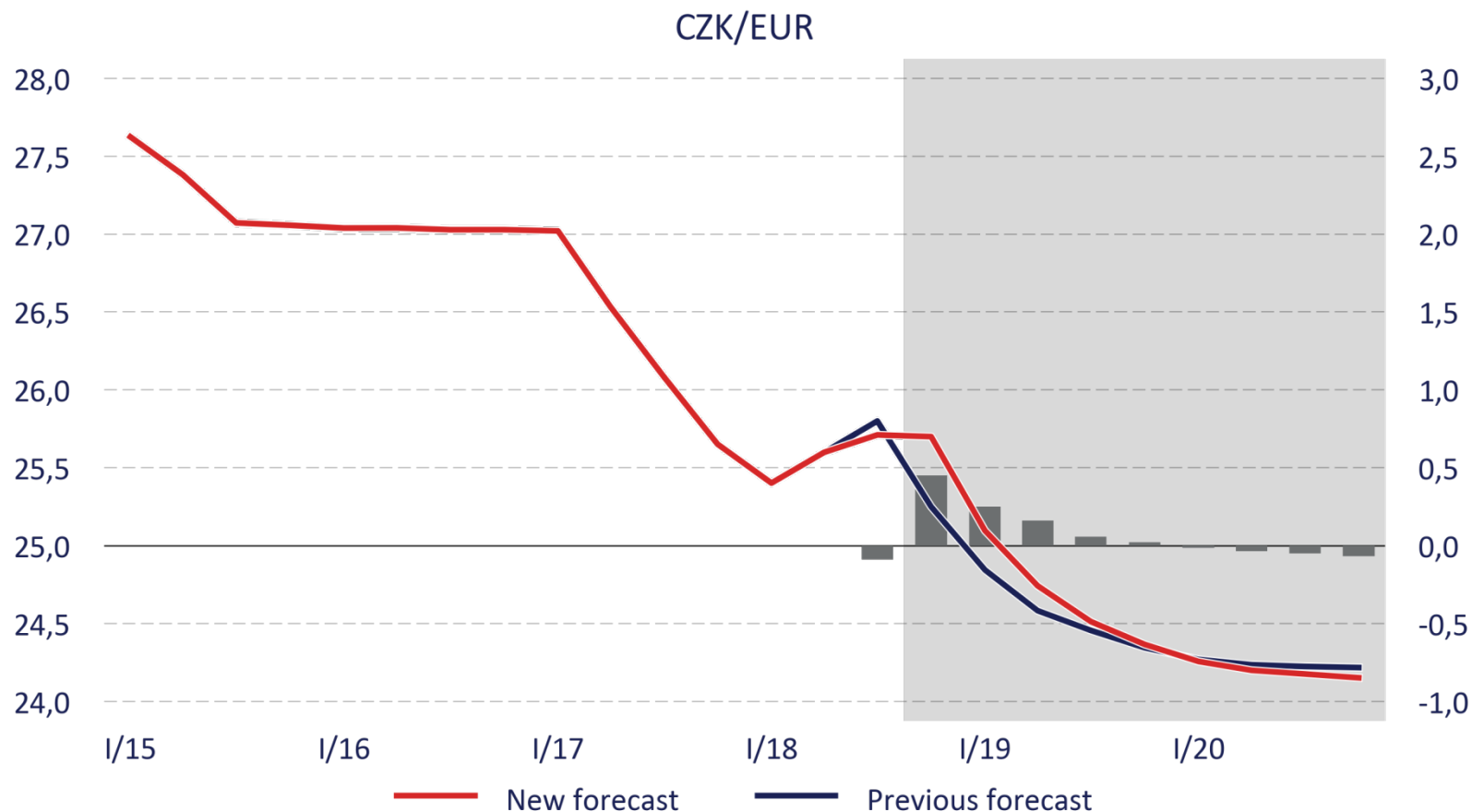
Comparison: GDP Forecast



- GDP outlook is revised only slightly downwards for this year, due to the observed slowdown in private consumption and drop in inventories.
- Real government consumption growth is also slower.
- The outlook for 2019-2020 remains almost unchanged.

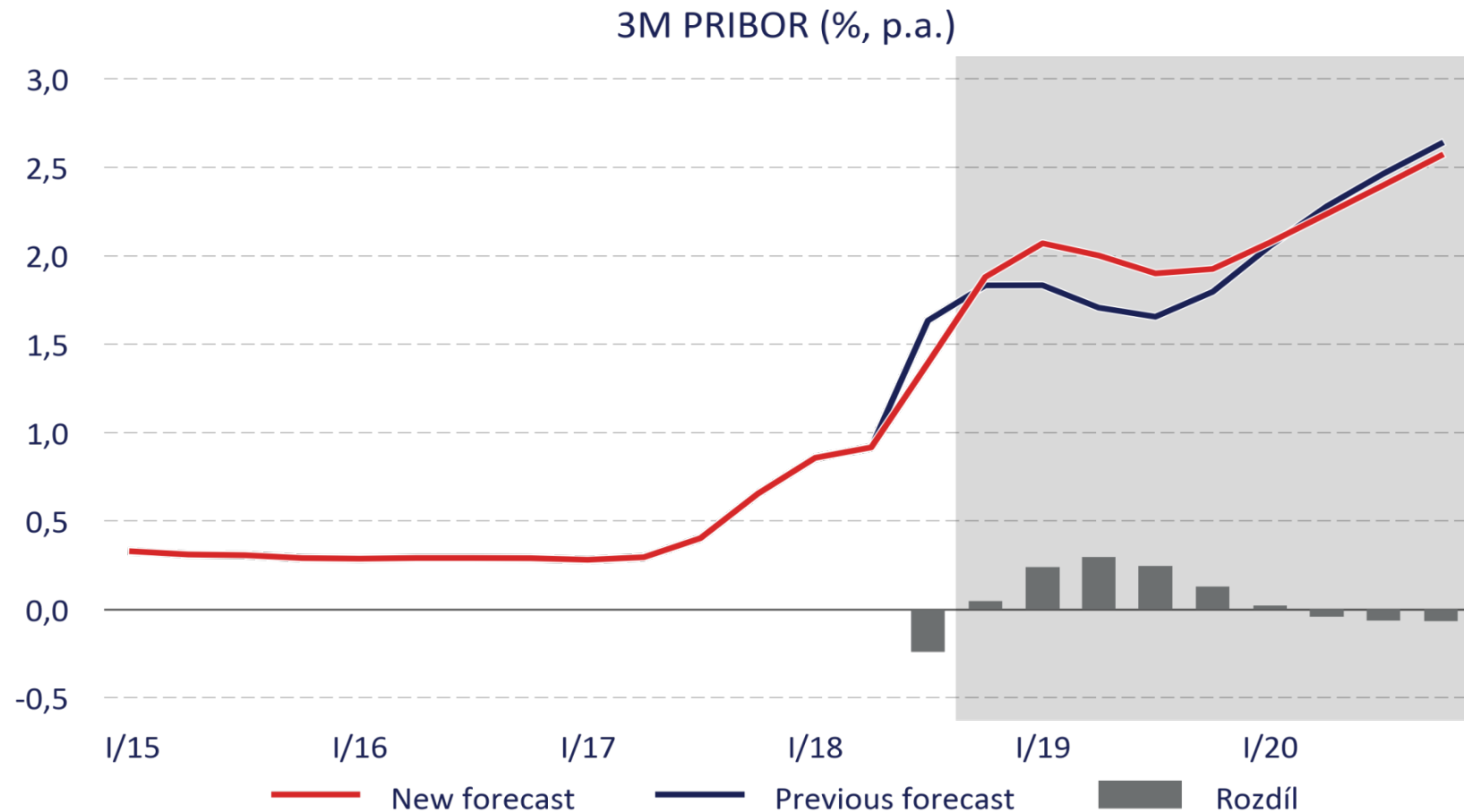


- Short-term indicators suggest that the wage growth peaked in Q3 at a lower level than expected by the previous forecast.
- But in the longer term it will decelerate at a somewhat slower pace than in the previous forecast (due to the increase in minimum wage in 2019).



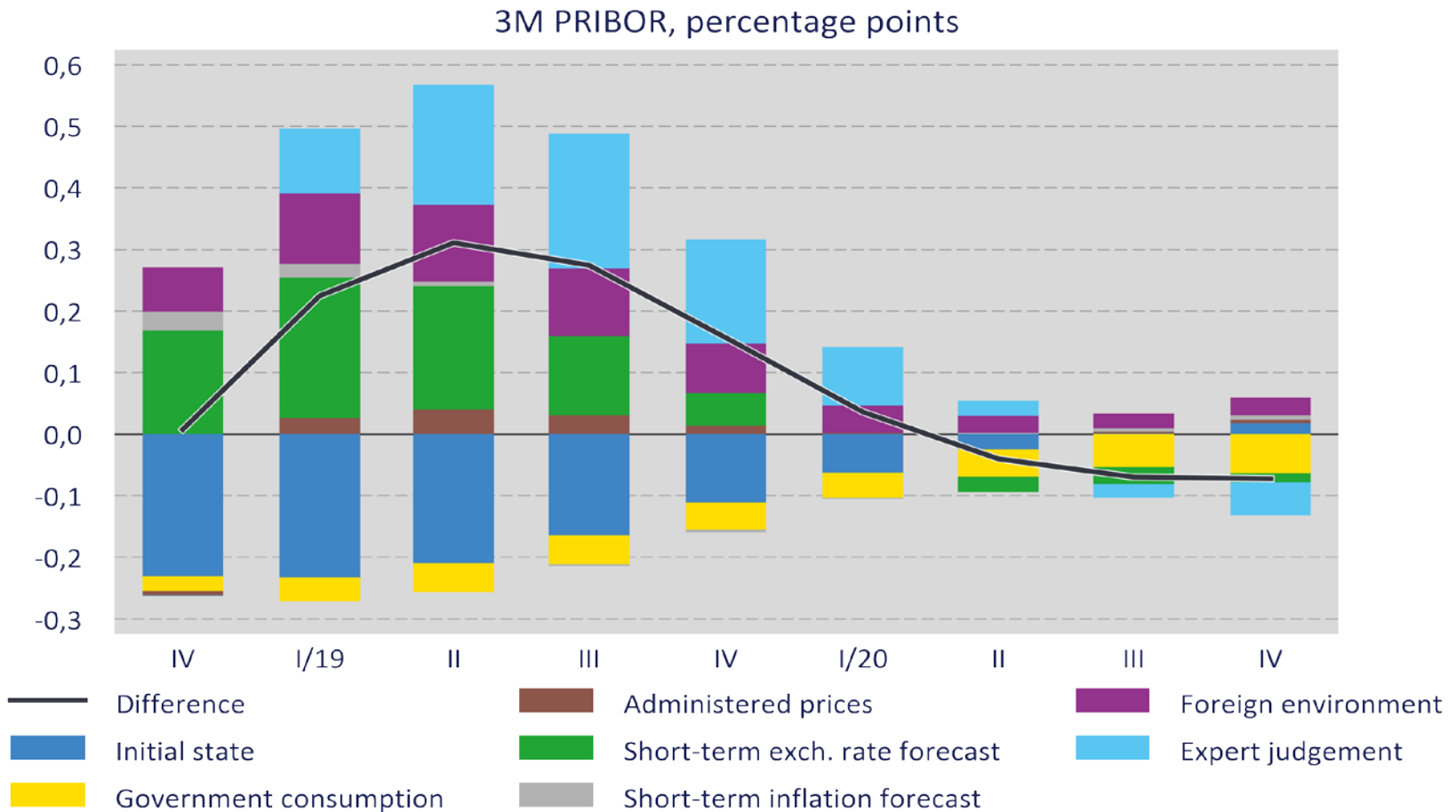
- The weaker outlook for the koruna exchange rate for the coming quarters takes into account past market developments driven by persisting global factors.
- As a result, the koruna will start to firm later than in the previous prediction.

Comparison: Interest Rate Forecast



- The interest rate path is higher until the start of 2020 compared to the previous prediction due to the weaker exchange rate, coupled with other factors (see the next slide).

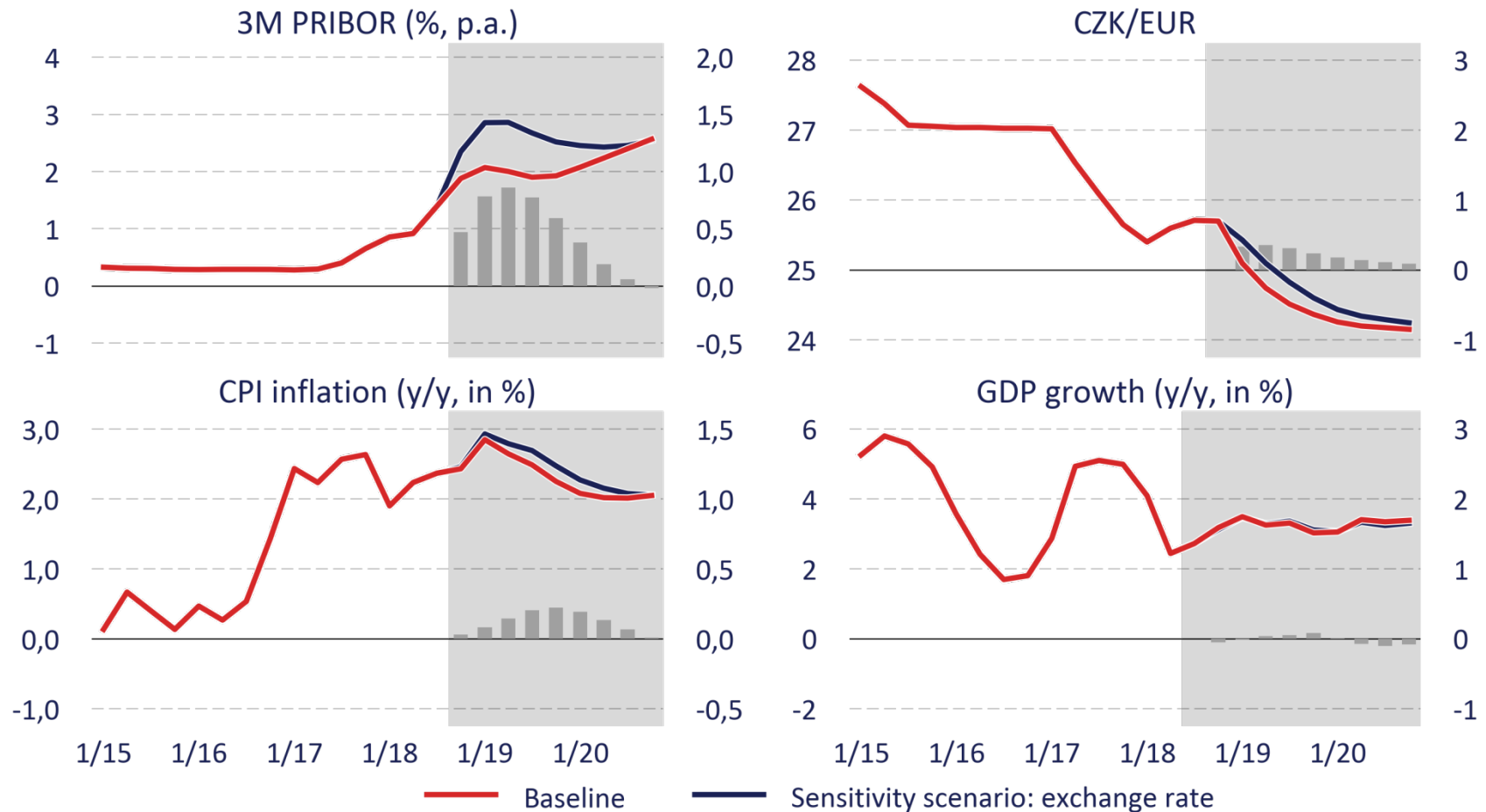
Decomposition of Changes in the Interest Rate Forecast



- Weaker exchange rate of koruna, steeper euro area interest rates trajectory and expert judgement (reflecting government policy measures, and some persistence in the negative global sentiment) push interest rates upwards.
- The initial state (wage growth, consumption growth and observed interest rate) along with lower government consumption growth act towards lower rates.

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Sensitivity Scenario – Exchange rate



- The sensitivity scenario assumes a rather strong, persistent and fully anticipated pressure for a further depreciation of the koruna.
- In order to avoid pronounced weakening of the exchange rate and long-lasting overshooting of the inflation target, interest rates have to rise much more rapidly compared to the baseline.

Thank you for your attention!

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