

# CNB's New Forecast (Inflation Report II/2019)

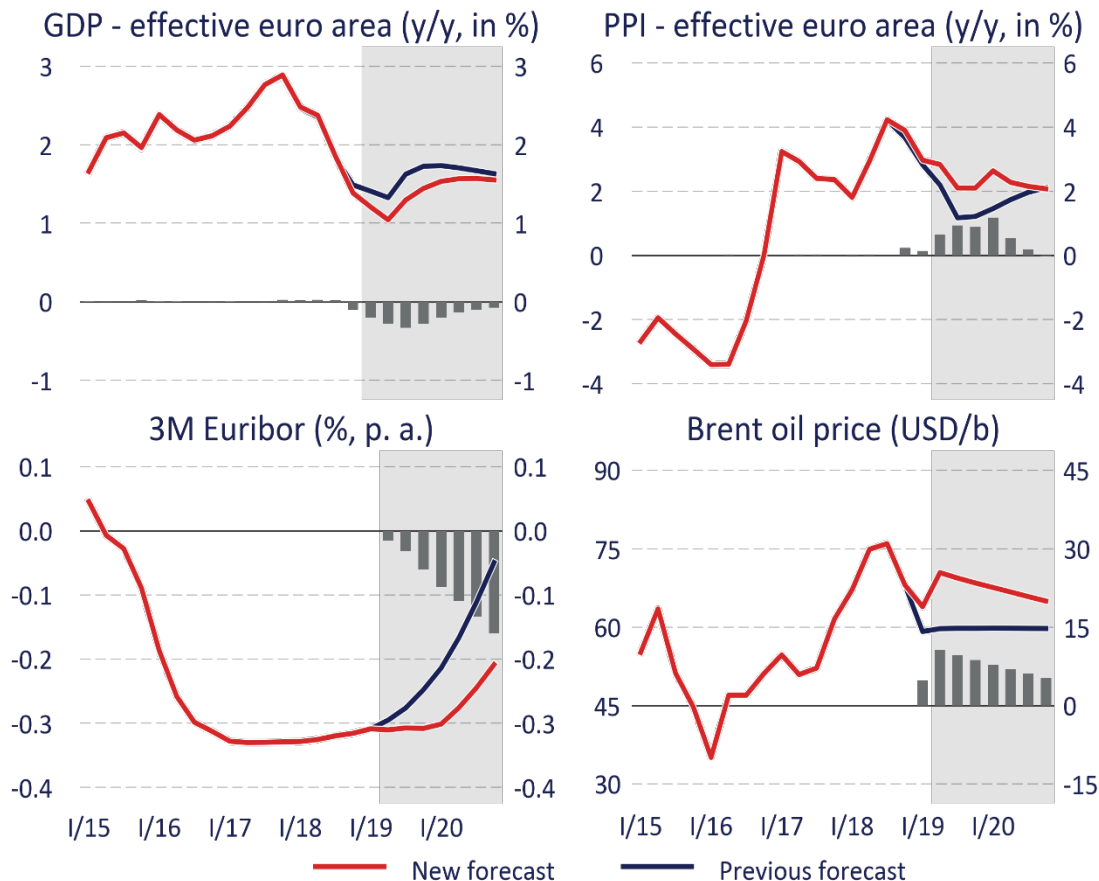
---

## Meeting with Analysts

Luboš Komárek

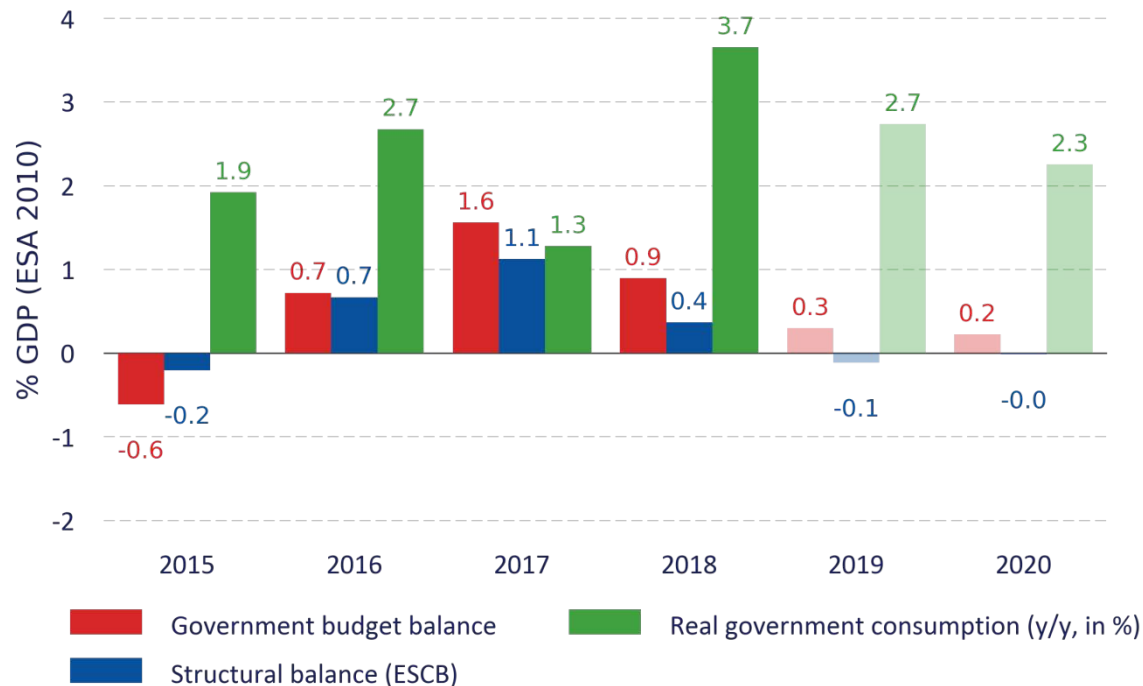
Prague, 3 May 2019

- 1. Assumptions of the forecast**
2. The new macroeconomic forecast
3. Comparison with the previous forecast
4. Alternative scenario: g3+ model forecast



- **GDP growth** in the effective euro area will slow to **1.2%** this year, due to deteriorating sentiment, and accelerate to **1.6%** in 2020, reflecting global demand growth.
- The growth in **crude oil prices** observed in early 2019 will temporarily slow the decline in euro area **producer price inflation**, which will subsequently stabilise above 2%.
- Following a weak foreign demand and inflation outlook, the ECB rates and **3M Euribor** will remain negative over the entire forecast horizon.

Fiscal development in the Czech Republic



- **Government budget surpluses will decrease significantly over the forecast horizon.**
  - A slowdown in private consumption and wage growth and newly introduced VAT changes will be reflected in slower revenue growth.
  - Continued wage and investment growth in the public sector, the increase in old age pensions, and fare discounts, will increase government spending.
- **Government finances in structural terms will be broadly balanced.**
- **Government consumption growth will gradually slow, but it will stay above 2%.**

Fiscal impulse (contributions to GDP growth in percentage points)

	2018	2019	2020
	actual	forecast	forecast
Fiscal impulse	0.8	0.4	0.0
of which impact through:			
Private consumption	0.4	0.3	0.0
Private investment	0.0	0.0	0.0
Government investment, domestic	0.2	0.0	0.0
Government investment, EU funded	0.2	0.1	0.0

- **Fiscal policy** will again be expansionary this year.
  - It is linked mainly with the higher-than-usual increase in old-age pensions, continued growth in government investment (EU funds) and rapid wage growth in the government sector.
- **The fiscal impulse** will be neutral in 2020.
  - proposals to increase mandatory expenditures (e.g. higher indexation of pensions and an increase in parental allowance);
  - this might be partially reduced by the proposed increases in some taxes;

1. Assumptions of the forecast
- 2. The new macroeconomic forecast**
3. Comparison with the previous forecast
4. Alternative scenario: g3+ model forecast

## Inflation

Economic activity

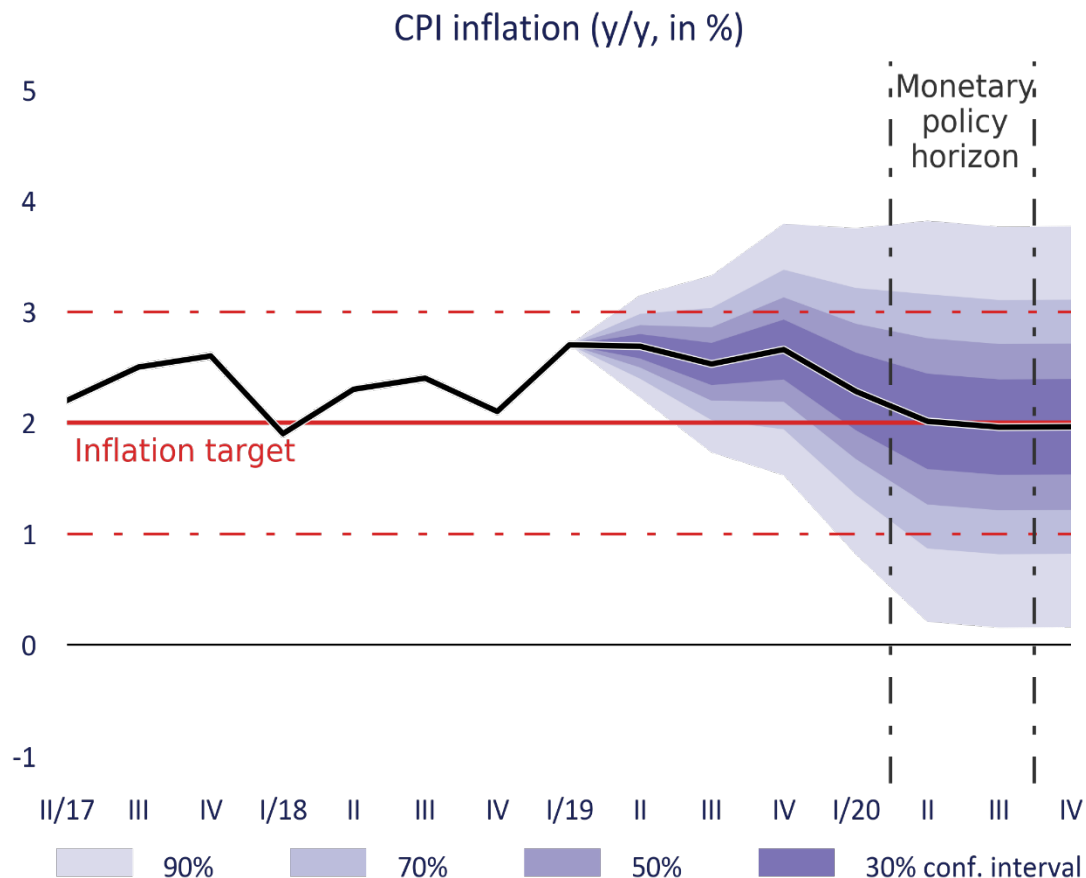
Labour market

Exchange rate

Interest rate

- **Inflation** will be in the upper half of the tolerance band this year and will return to the CNB's 2% target over the monetary policy horizon.
- Although gradually easing, **domestic inflationary pressures** will remain the dominant factor of total inflationary pressures, which will remain steady throughout the forecast horizon.

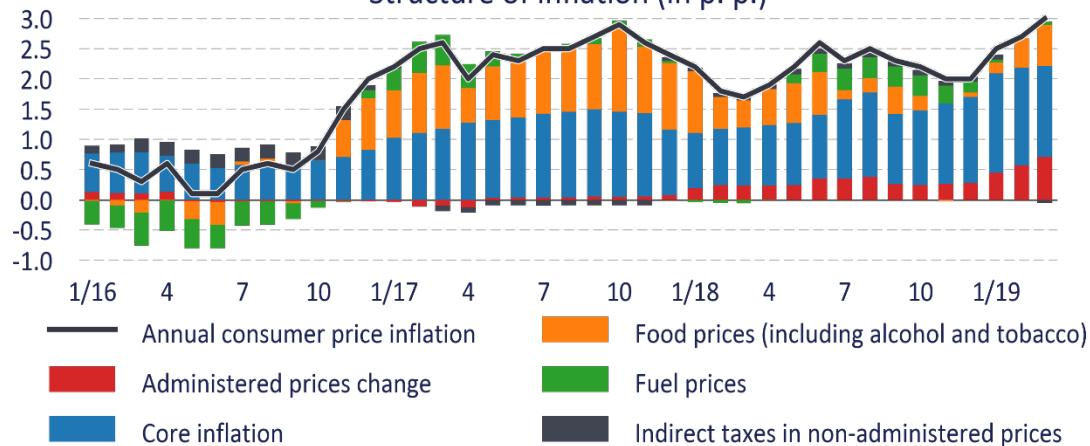
# Headline Inflation Forecast



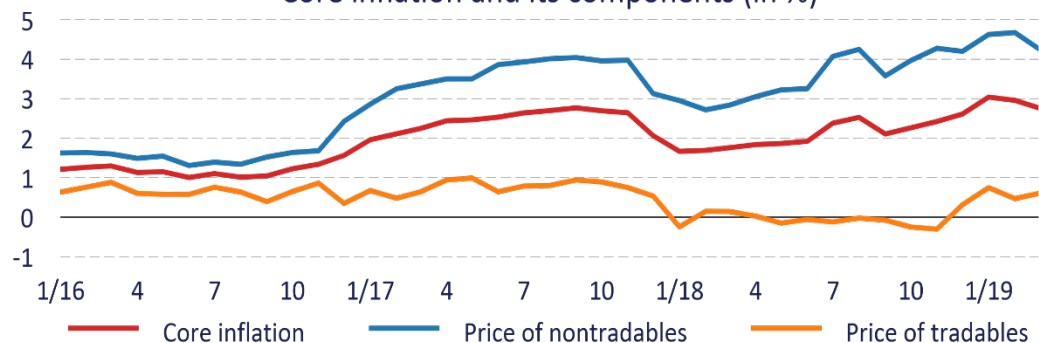
- **CPI inflation** will stay in the upper half of the tolerance band this year and return to the CNB's 2% target over the monetary policy horizon.
- **Monetary policy-relevant inflation** will be only marginally higher than headline inflation over the entire forecast horizon (due to decreased VAT in public transport this year and the decreased VAT rate on heat in next year).



Structure of inflation (in p. p.)

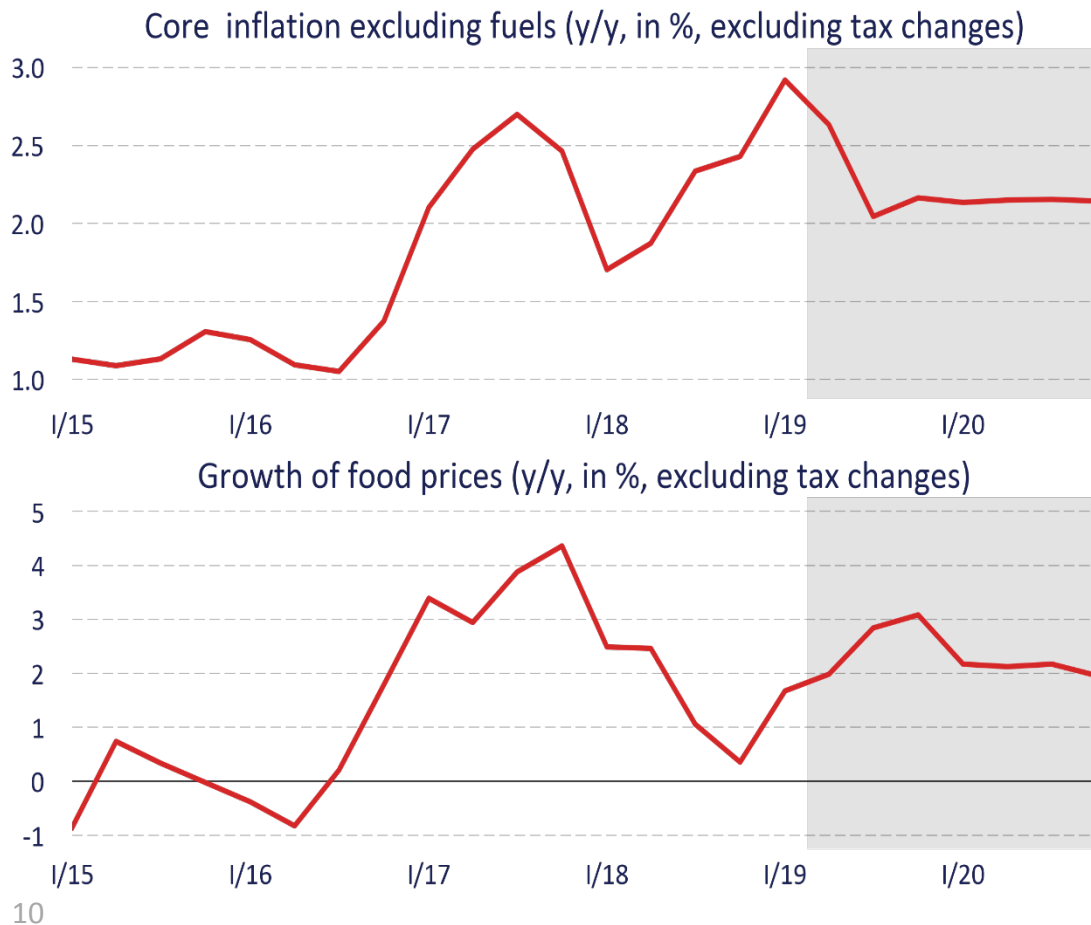


Core inflation and its components (in %)



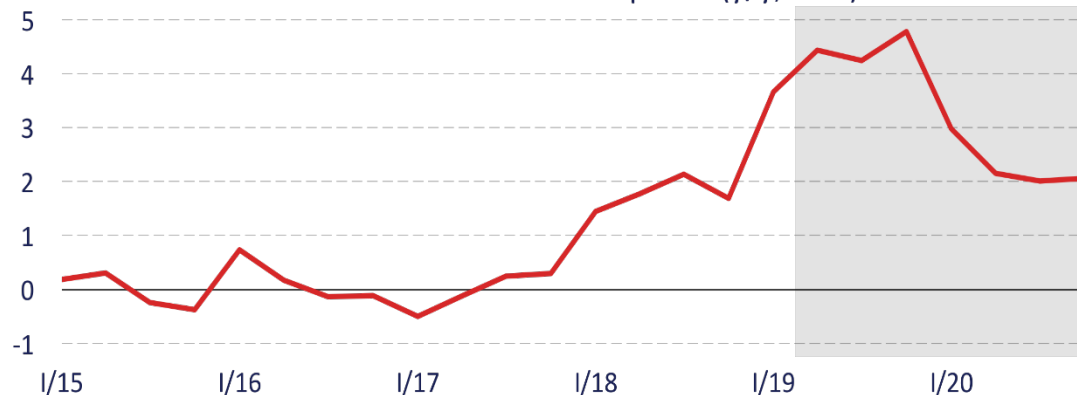
- **CPI Inflation** rose to 2.7% in 2019 Q1, reaching 3% in March.
- **Core inflation** again made the largest contribution, reflecting continued growth in consumer demand and buoyant wage growth.
- The rise in administered price inflation and renewed growth in food prices also played an important role.
  - Growth in administered prices was driven mainly by a sizeable increase in electricity prices, but the prices of heat and gas increased as well.
  - The increase in core inflation was due to both non-tradables and tradables prices.

# Core Inflation and Food Prices

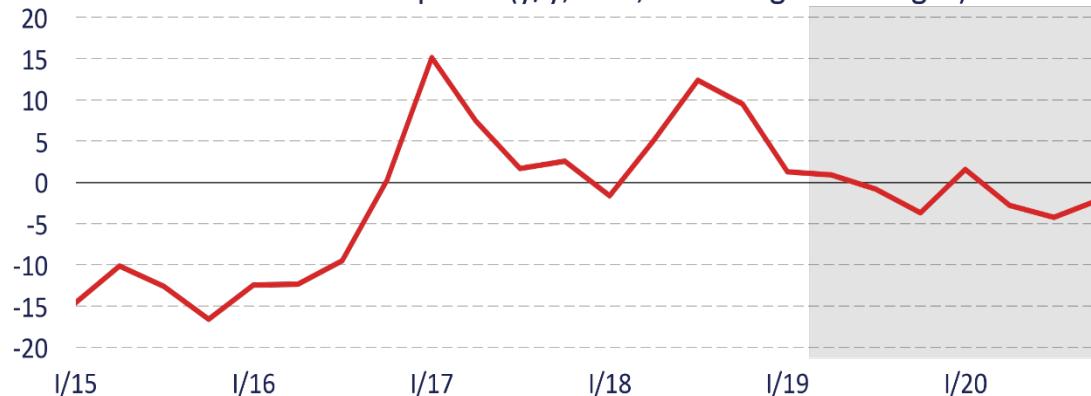


- **Core inflation excluding fuels will remain elevated in 2019 Q2 but it will then decline close to 2%.**
  - High core inflation will be a result of strong domestic inflation pressures, especially in the services sector.
  - It will then ease towards 2%, mainly due to gradually diminishing domestic inflation pressures. (The previous temporary decrease in import prices will act in the same direction).
- **Food price inflation will continue to increase markedly on the back of a rise in agricultural producer prices.**

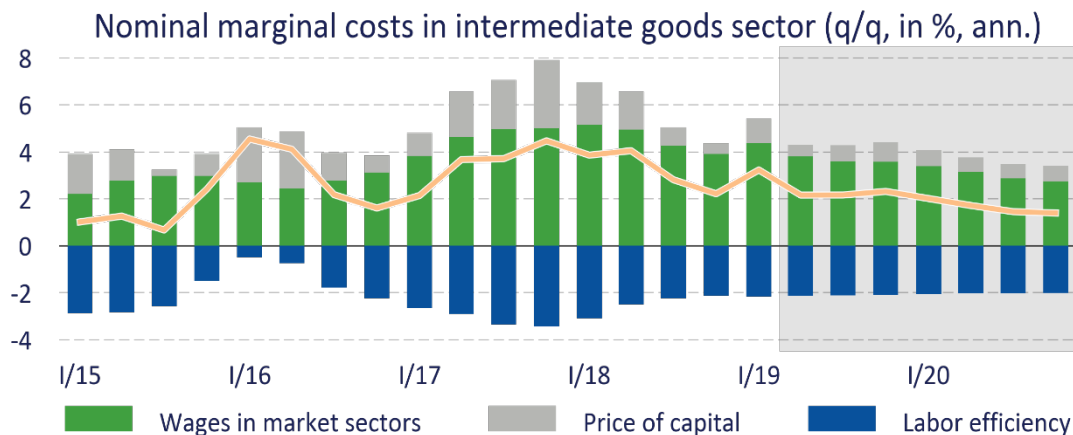
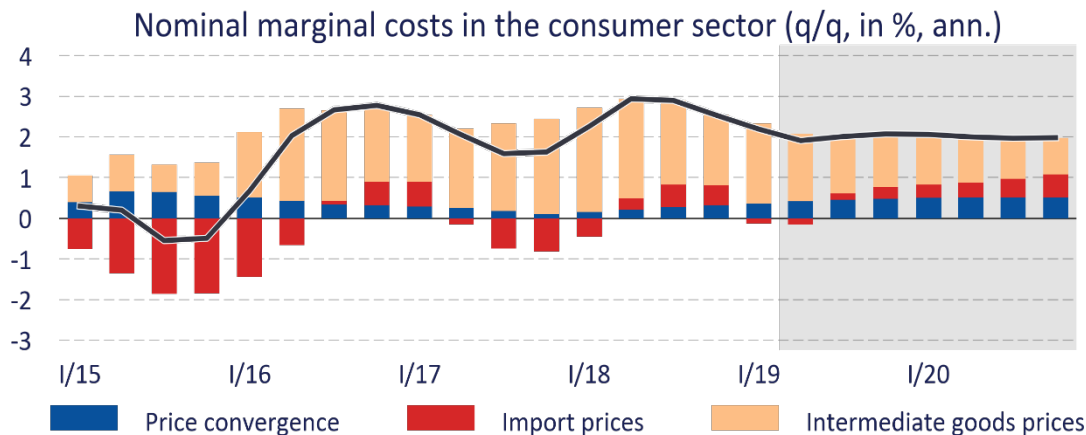
Growth of administered prices (y/y, in %)



Growth of fuel prices (y/y, in %, excluding tax changes)



- The already substantial growth in administered prices will accelerate even further in the quarters ahead.
  - The growth will be driven by ongoing increases in electricity, gas and heat prices.
  - The previous decrease in public transport prices for students and pensioners will act against the further growth in administered prices.
- Fuel prices will start falling year on year in mid-2019, reflecting the dynamics of oil prices and renewed appreciation of the koruna against the dollar.



- **Total nominal costs** will increase at a stable pace of around 2% over the entire forecast horizon. Following a temporary anti-inflationary effect, the contribution of import prices will turn positive again in the second half of this year, mainly on the back of renewed growth in foreign producer prices.
- After a temporary pick-up due to an increase in the minimum wage and old age pensions, **domestic cost pressures** will gradually ease, reflecting a slowly cooling labour market.

Inflation

**Economic activity**

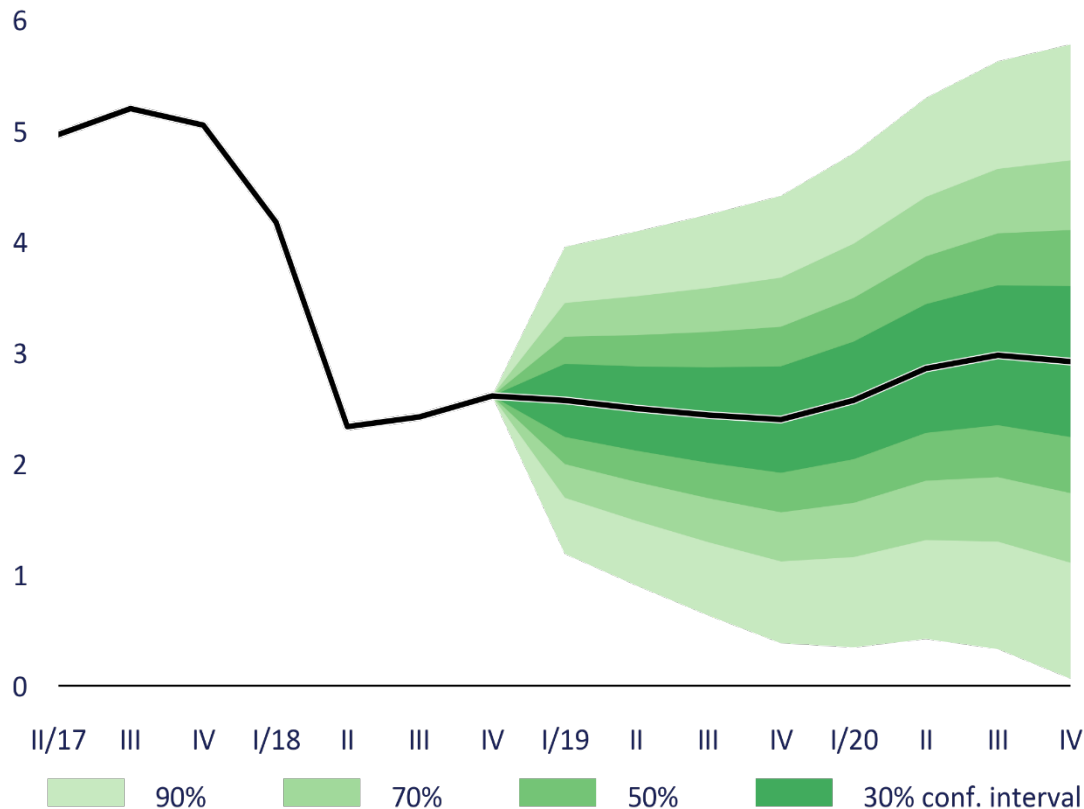
Labour market

Exchange rate

Interest rate

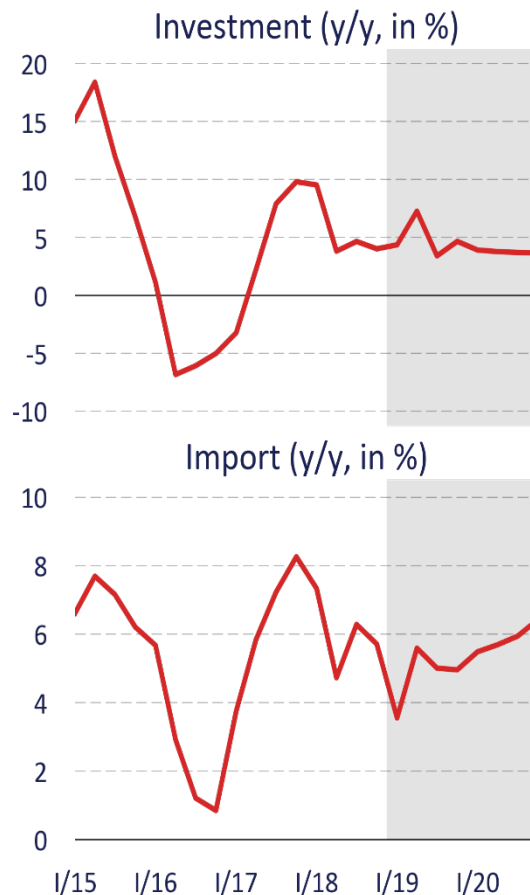
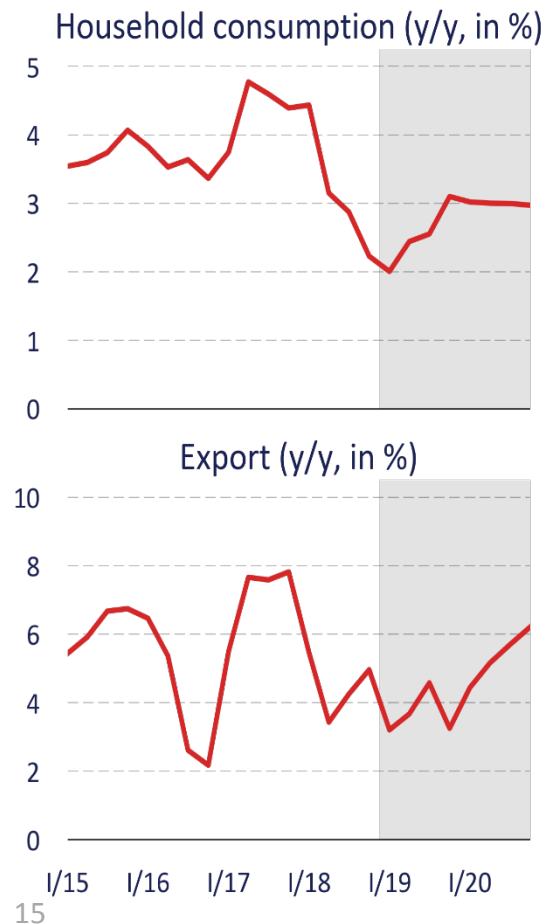
- Having slowed in the second half of last year, **GDP** will grow at a stable pace of around 2.5% this year and pick up slightly in 2020.

GDP growth (y/y, in %)



- **Growth in economic activity** of around 2.5% this year will be driven by all components of domestic demand amid continued, though slower, growth in external demand.
  - **Household consumption** and **investment activity** will be the main drivers of economic growth, and government consumption will stimulate growth as well.
  - **Net exports** will make a negative contribution to economic growth.
- **GDP growth** will accelerate slightly in the next year due to higher foreign demand, which will cause the negative contribution of net exports to fade.

# Aggregate Demand



- **Household consumption** growth will accelerate this year as the slowdown in 2018 Q4 gradually fades, and will be supported by solid, albeit gradually slowing, growth in wages and salaries.
- **Gross capital formation** will continue to be supported by both private and government investment (mainly from EU funds).
- **Export growth** reflects the development of foreign demand and the gradual appreciation of the koruna, which affects competitiveness.
- **Growth in imports** is in line with export growth. The temporary slowdown in 2019 Q1 reflected weak consumption and export dynamics.

Inflation

Economic activity

**Labour market**

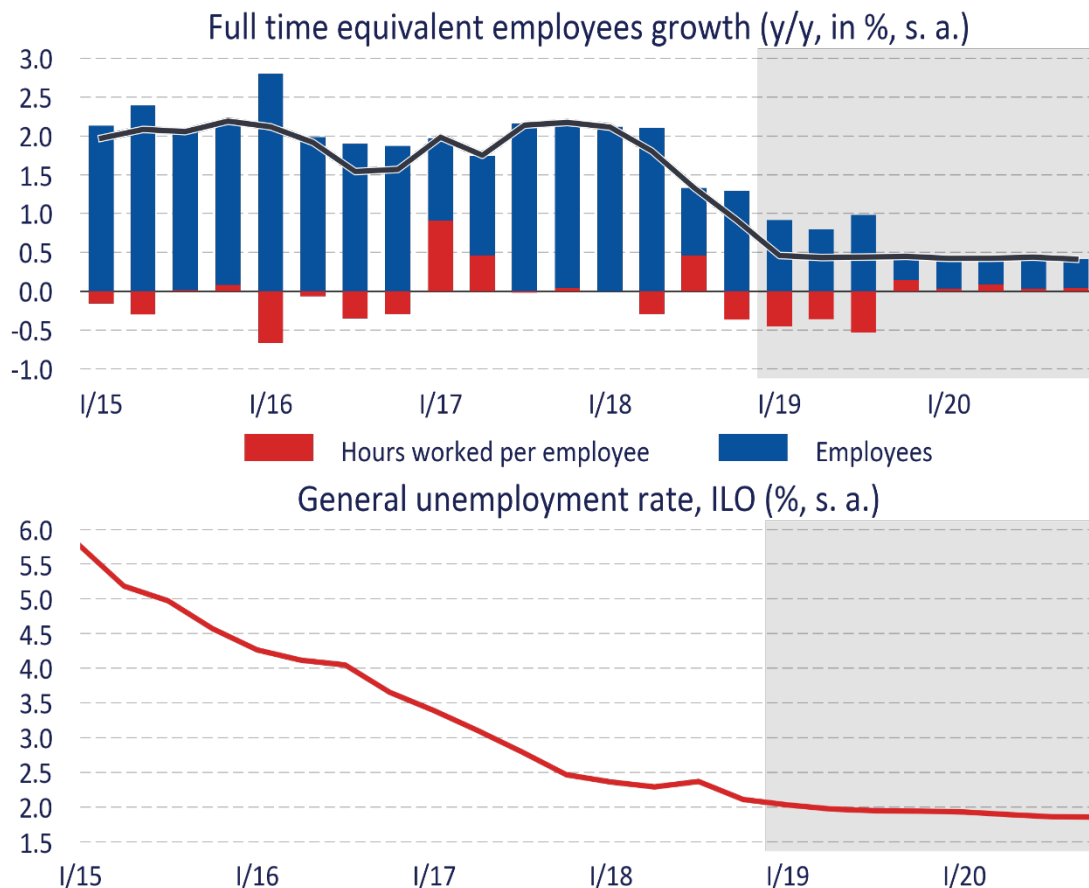
Exchange rate

Interest rate

- **Employment growth** will slow due to labour shortages and lower growth in economic activity.
- The record-low **unemployment rate continues** and unemployment has no room to fall further.
- **The labour market** remains tight, but wage growth has already peaked.



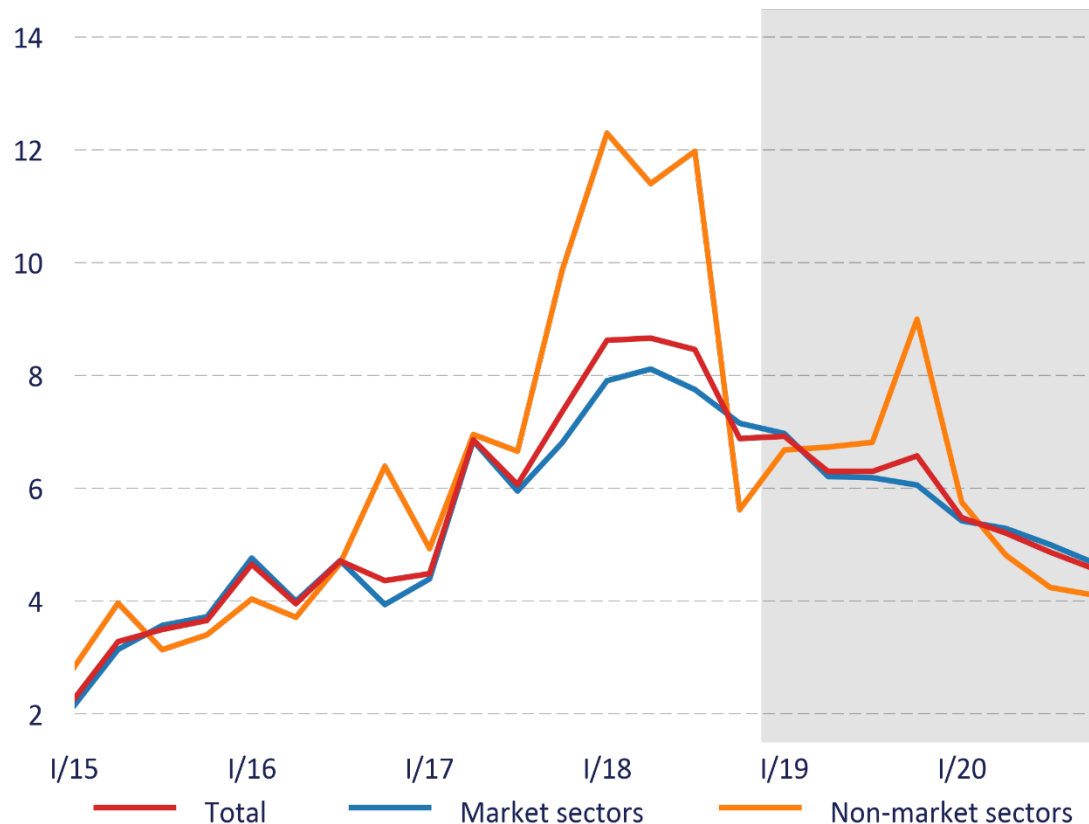
# Labour Market: Employment and Unemployment



- **Employment growth** will slow further due to labour shortages.
- Therefore, the tightness in the labour market, linked with a record-low **unemployment rate**, will be reduced only partially by growth in the labour force.
- The general unemployment rate will go down only slightly, stabilising just below to 2% next year.

# Labour Market: Nominal Wage Growth

Average nominal wages (y/y, in %, s. a.)



- **Wage growth in market sectors will:**
  - continue to gradually slow and it will near its long-run equilibrium level in the next year;
  - decrease due to a slowdown of economic growth and firms' efforts to maintain their competitiveness and profitability;
  - however, average nominal wage grow remains solid (6,9%).
- Although considerably lower than last year, the pronounced **wage growth in non-market sectors will continue this year, reflecting an increase in the wages of teachers and other public employees.** In 2020, the wage growth in non-market sectors will slow to below 5%.

Inflation

Economic activity

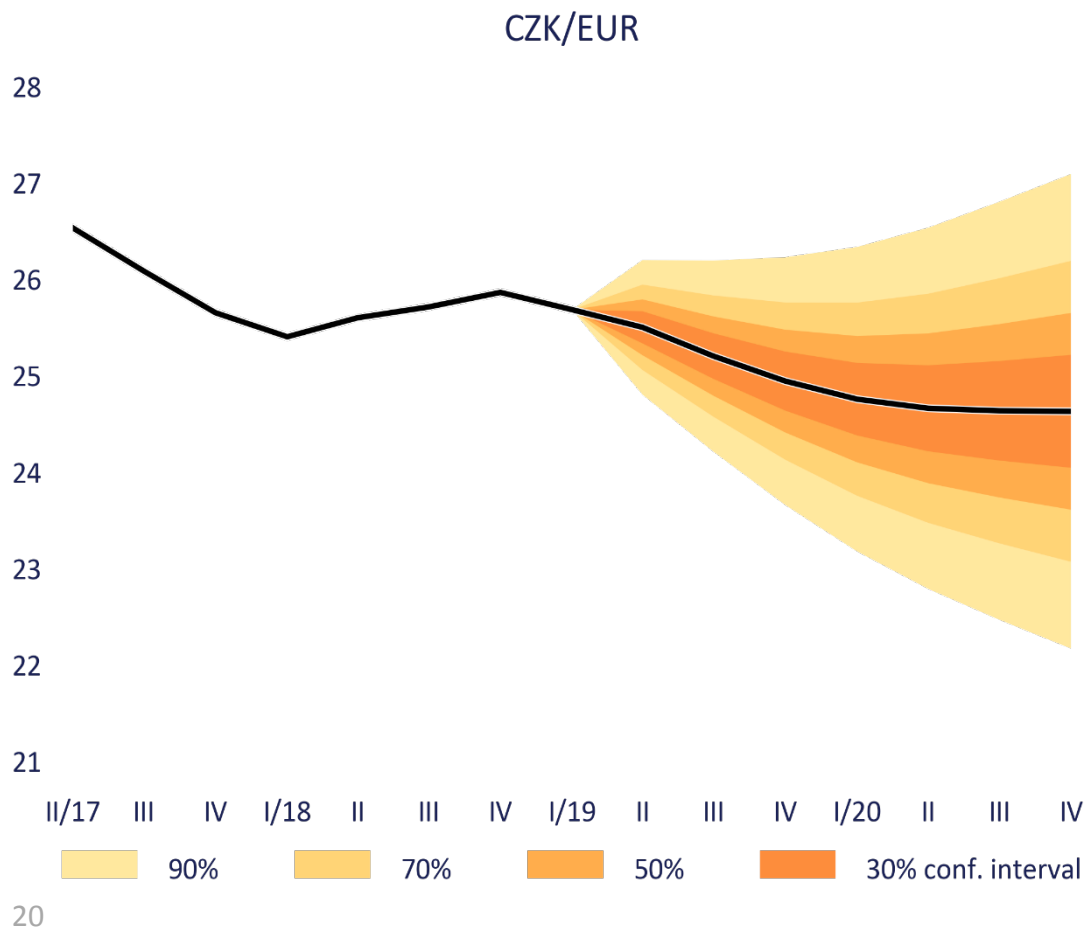
Labour market

**Exchange rate**

Interest rate

- **The koruna will gradually appreciate over the forecast horizon.**

# Exchange Rate CZK/EUR



- **The exchange rate CZK/EUR forecast expects the koruna to appreciate to CZK 25.5 against the euro in 2019 Q2.**
- The initial condition and the forecasted path of the exchange rate takes into account the broad stability since 2018 Q2.
- **The appreciation of the koruna will be driven by a markedly positive interest rate differential vis-à-vis the euro area and continued convergence of the Czech economy.**
- **The exchange rate will thus gradually appreciate to just below CZK 25 to the euro at the end of this year, and CZK 24.6 to the euro by the end of 2020.**

Inflation

Economic activity

Labour market

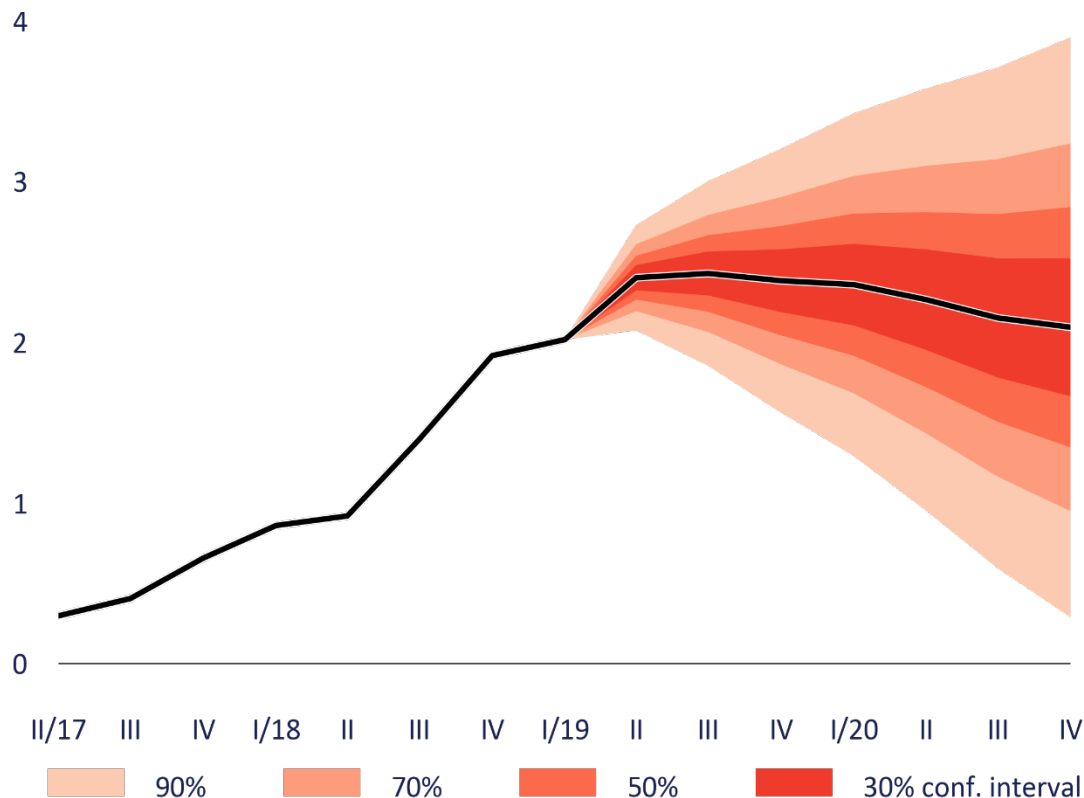
Exchange rate

**Interest rate**

- Consistent with the forecast is a initial rise in **domestic interest rates** followed by broad interest rate stability until mid-2020.
- The rise in rates at the start of the forecast is a reaction above all to persisting domestic inflation pressures and growth in import prices.

# Interest Rate Path (3M PRIBOR)

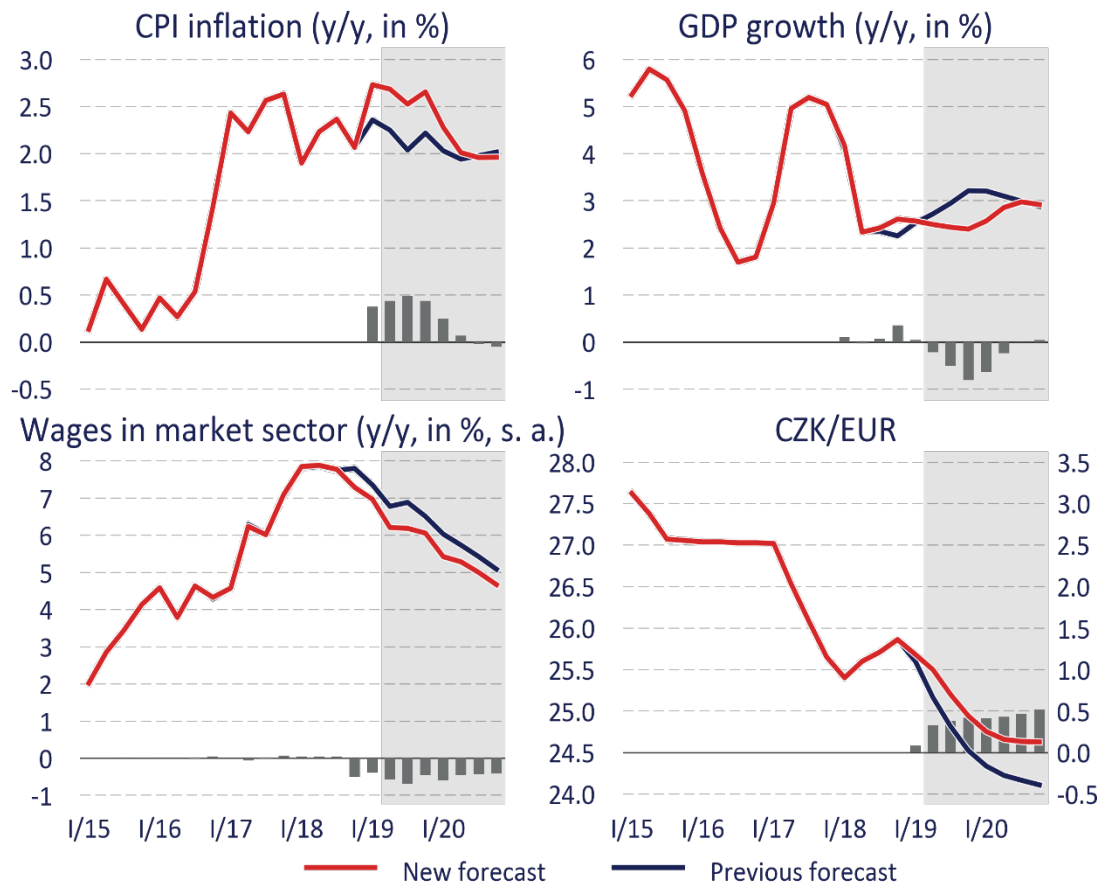
3M PRIBOR (% , p. a.)



- Consistent with the forecast is an initial increase of **domestic interest rates** and followed by broad stability until the mid-2020.
- The increase in rates at the start of the forecast is a reaction primarily to persisting domestic inflation pressures and growth in import prices.
- The subsequent broad stability of rates until mid-2020 mainly reflects persisting negative interest rates in the euro area.

1. Assumptions of the forecast
2. The new macroeconomic forecast
- 3. Comparison with the previous forecast**
4. Alternative scenario: g3+ model forecast

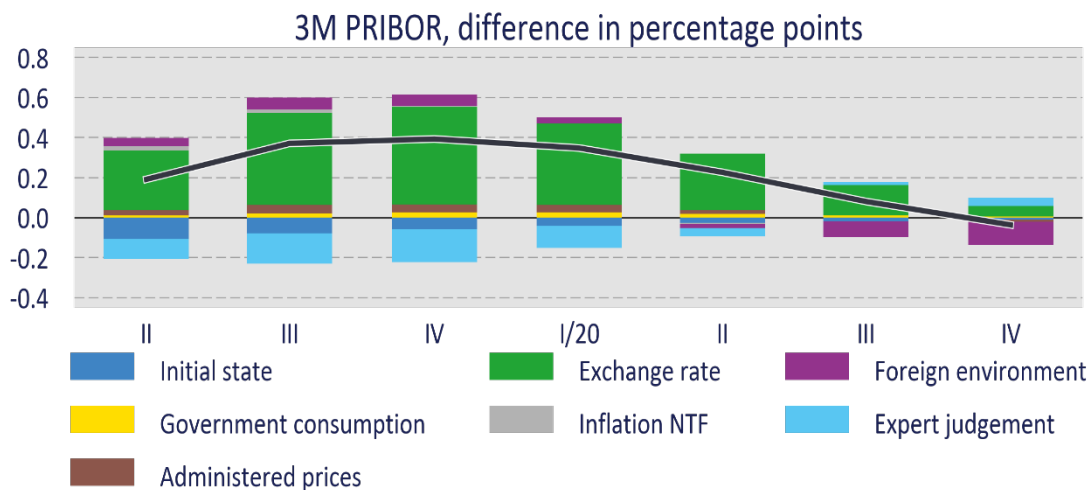
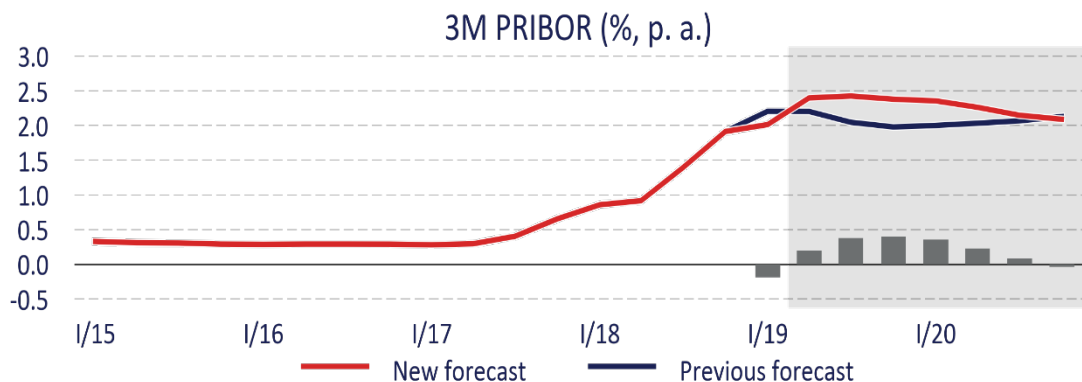
# Comparison with Previous Forecast



- **The inflation forecast is higher for this year due to higher observed core inflation**, which reflects higher growth in the prices of some non-tradables.
- **The GDP growth forecast is slightly lower due to a worse external demand outlook.**
- **Wage growth is slower due to lower levels observed in 2018 Q4**, leading indicators for 2019 Q1 and **weaker forecasted economic growth.**
- The more gradual **appreciation of the koruna** mainly reflects its weaker levels observed last year and the worse outlook for external demand.



# Comparison: Interest Rate Forecast



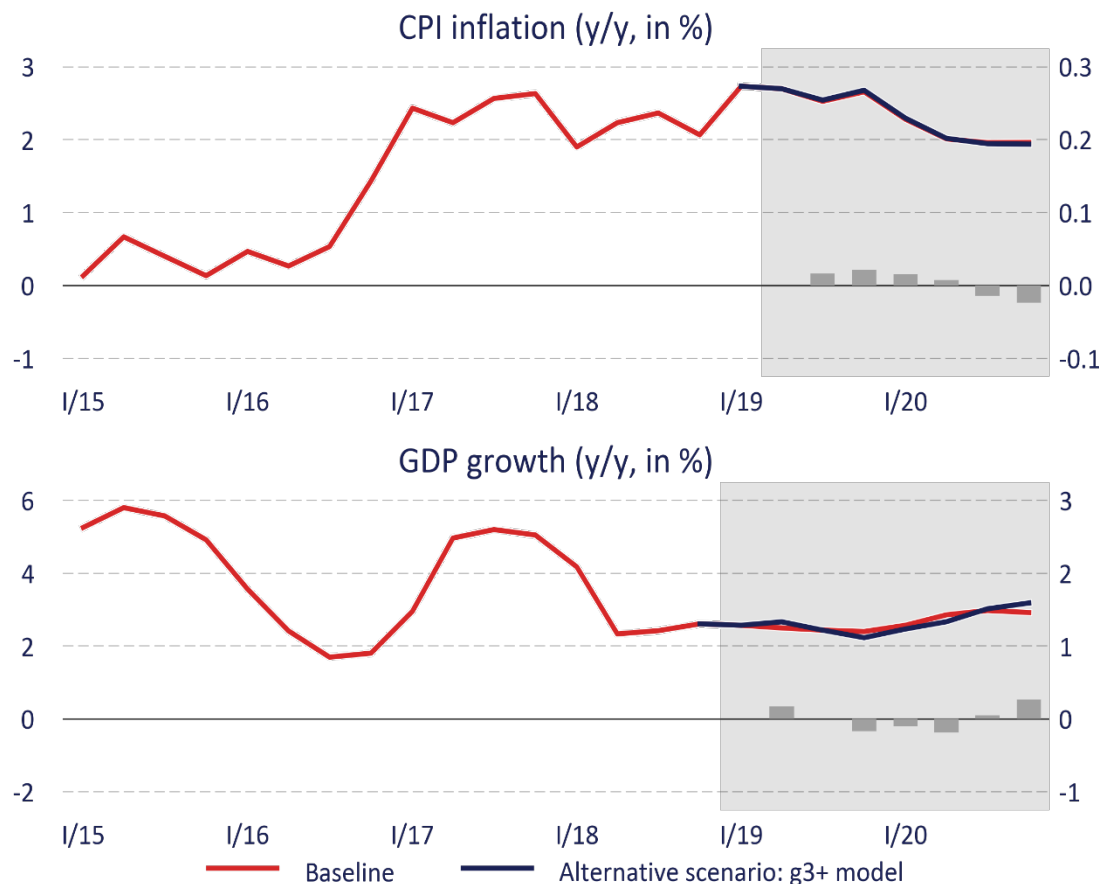
- The new forecast implies a higher domestic interest rate path over almost the entire horizon.
- The higher rates will be due mainly to a weaker koruna, including the related model adjustment.
- **The initial state** – in particular the observed wage and consumption levels – will exert pressure downwards.
- **The expert judgement**, mainly reflecting the slower observed growth in consumption, will act towards lower rates until mid-2020.
- The lower path of **foreign interest rates** will foster reduced domestic rates in the course of next year.

1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast
- 4. Alternative scenario: g3+ model forecast**

- **The alternative scenario:**
  - was prepared using model g3+, an extended version of the CNB's existing core prediction model;
  - briefly presents the g3+ model and the forecast created using this model;
  - is based on the same assumptions and outlooks as the baseline and it does not capture any specific risk or uncertainty in the baseline scenario prepared by using g3 model;
  - starting with the next Inflation Report, this model (g3+) will become the CNB's main prediction tool.
- **The introduced changes to the CNB's existing core prediction model (g3):**
  - bring the model structure closer to the true situation in the domestic and foreign economy, enabling us to capture economic phenomena more accurately;
  - describe the model structure in more detail in our forecasts;
  - ultimately improves the model's predictive properties;
  - will be described in more detail in the next Inflation Report.

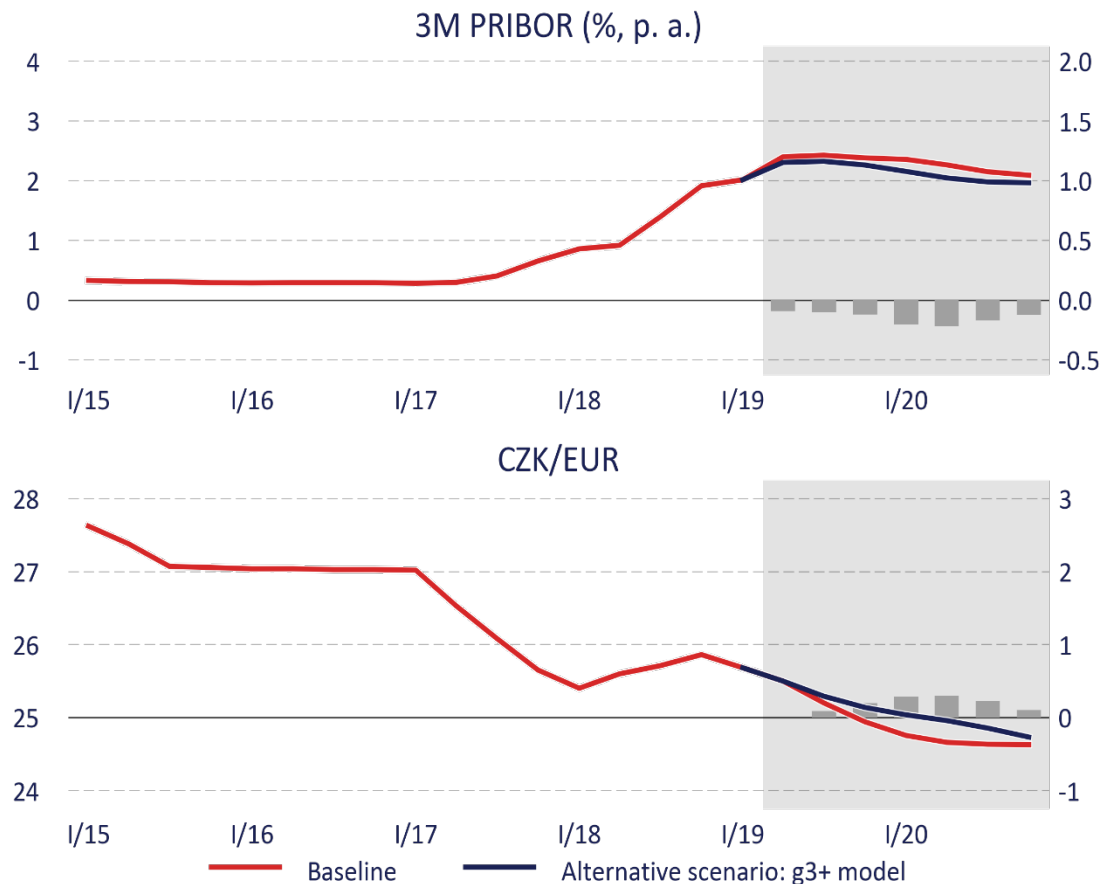
- **The g3+ model** reflects the CNB's previous experience and trends in macroeconomic modelling for monetary policy purposes. The main extensions include:
  - a more detailed and interconnected structure of a **foreign block**;
  - division of **foreign prices** into energy and fundamental (non-energy) components;
  - more realistic coverage of the **consumption behaviour of households**;
  - a new way of processing **exogenous outlooks**;
  - recalibration of selected model parameters and long-term equilibrium levels.

# Alternative Scenario: g3+ Model – Forecast Comparison



- As in the baseline scenario, **consumer price inflation** returns to the 2% inflation target over the monetary policy horizon.
- **Foreign PPI** is decomposed into its energy and fundamental component in the g3+ model. Compared to the baseline scenario, the growth of the fundamental component is somewhat subdued. This is reflected in a negative contribution of import prices in total costs growth in 2019, while domestic inflation pressures are slightly higher.
- **The growth of the Czech economy** will be roughly stable this year and pick up slightly next year (faster export growth, weaker koruna) according to both scenarios.

# Alternative Scenario: g3+ Model – Forecast Comparison



- The forecasted interest rate path in 2019 is broadly in line with the baseline scenario. The trajectory is slightly lower due to a more anti-inflationary effect of import prices.
- The nominal exchange rate appreciates rather more slowly than in the baseline scenario. This is due to slower growth in the fundamental (non-energy) component of external producer prices at the start of the forecast, which makes Czech exporters less competitive and thus puts pressure on the koruna to appreciate more gradually.

# Thank you for your attention

[www.cnb.cz](http://www.cnb.cz)

**Luboš Komárek**

Monetary Department

Lubos.Komarek@cnb.cz