CNB's New Forecast

Monetary Policy Report – Summer 2022

Meeting with Analysts

5 August 2022

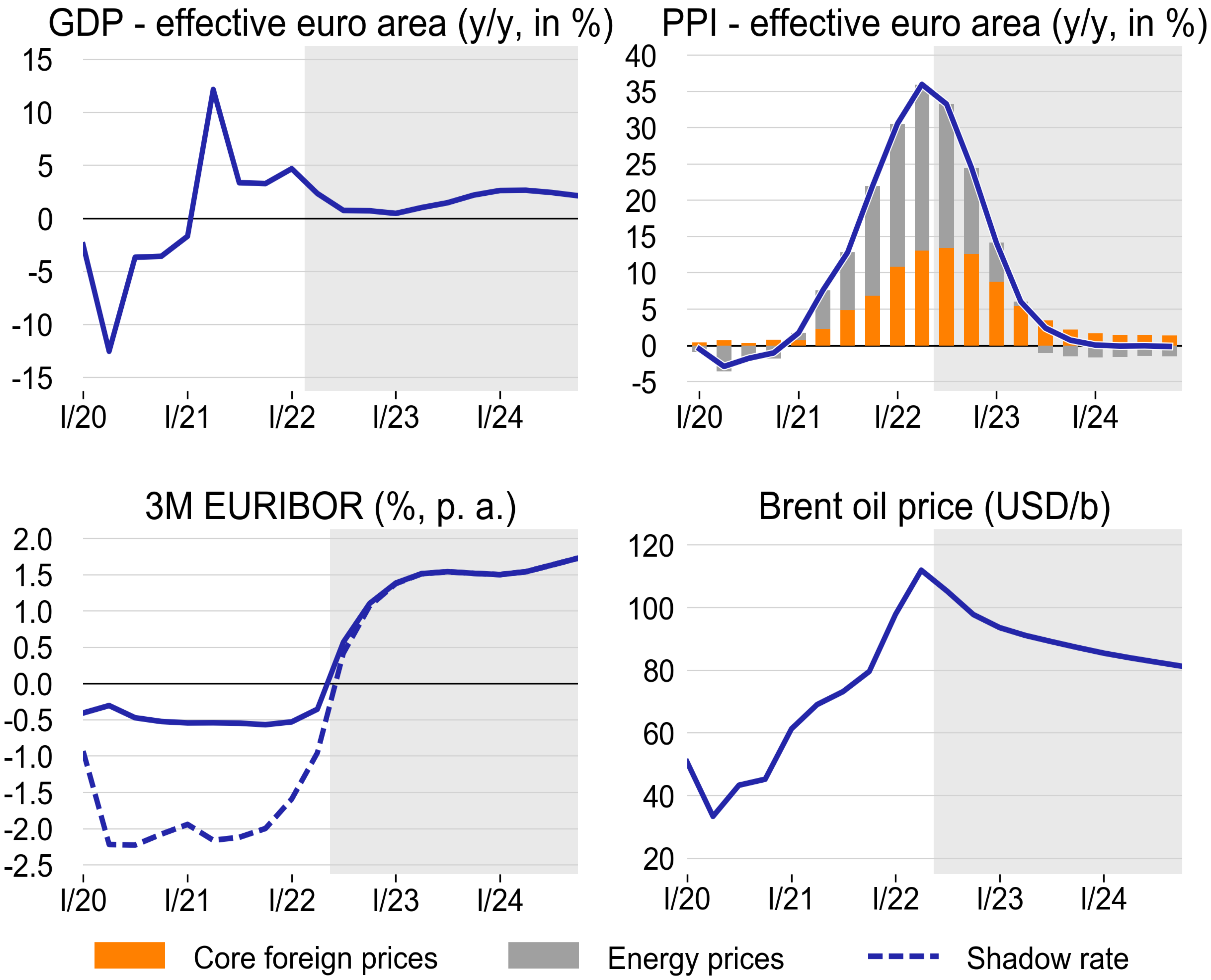
Karel Musil (Monetary Department)

CNB CZECH NATIONAL BANK

Presentation Outline

1. **Assumptions of the Forecast**
2. The New Macroeconomic Forecast
3. Comparison with the Previous Forecast
4. Monetary Policy Simulations

External Environment Outlook



- **Effective euro area GDP** will grow by just above 2% overall this year, slowing markedly in the second half of the year due to high inflation and the war in Ukraine. The economy will recover in 2023 as supply chain disruptions ease and international trade recovers.
- The current extraordinary **price growth in industry abroad** is driven mainly by the energy component (rising prices of gas and electricity), but the contribution of the core component is also increasing. It will slow markedly next year due to an expected decline in commodity prices and easing of supply chain stress.
- The market outlook for rising interest rates reflects the **ECB's** expected reaction to the increasing inflation pressures.

Fiscal Policy

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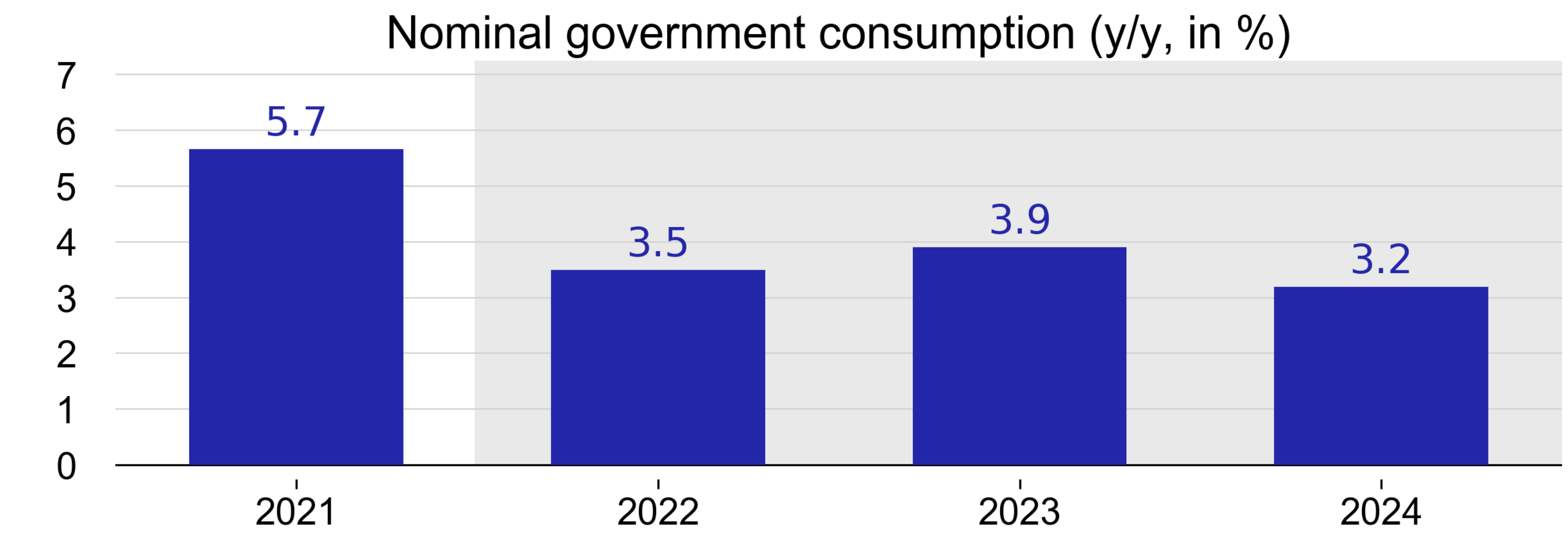

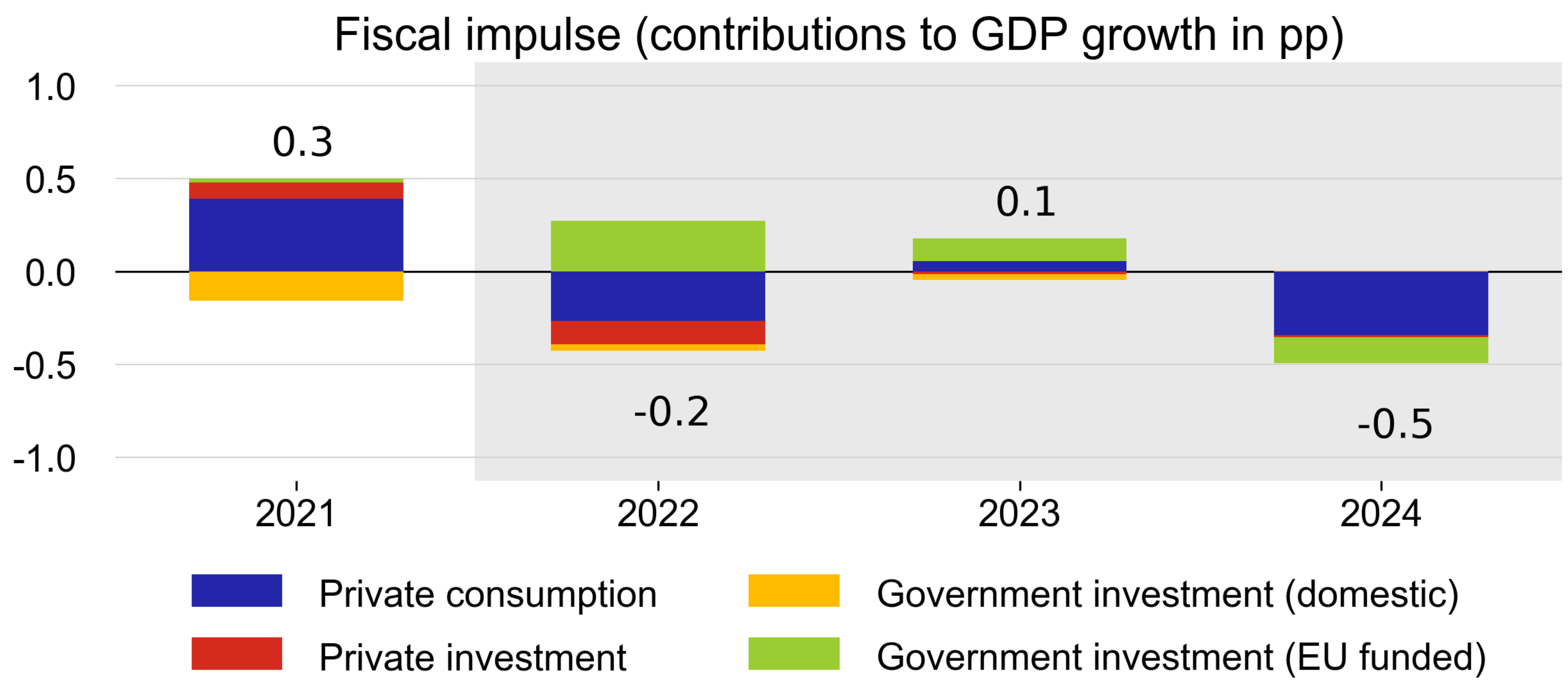

- A large part of previously high pandemic-related spending will be ended this year. Together with a wage freeze or only a moderate wage growth for government employees, this will lead to a slowdown in **nominal government consumption**.
- Its continued growth will be fostered by an increase in health and education expenditure linked with the arrival of Ukrainian refugees.
- Despite extraordinary refugee and energy crisis related expenditure, **fiscal impulse** will dampen GDP growth slightly this year due to the phasing out of Covid support programmes.
- Measures connected with the surge in energy prices will be in place until the next year, when the fiscal impulse will turn slightly positive.

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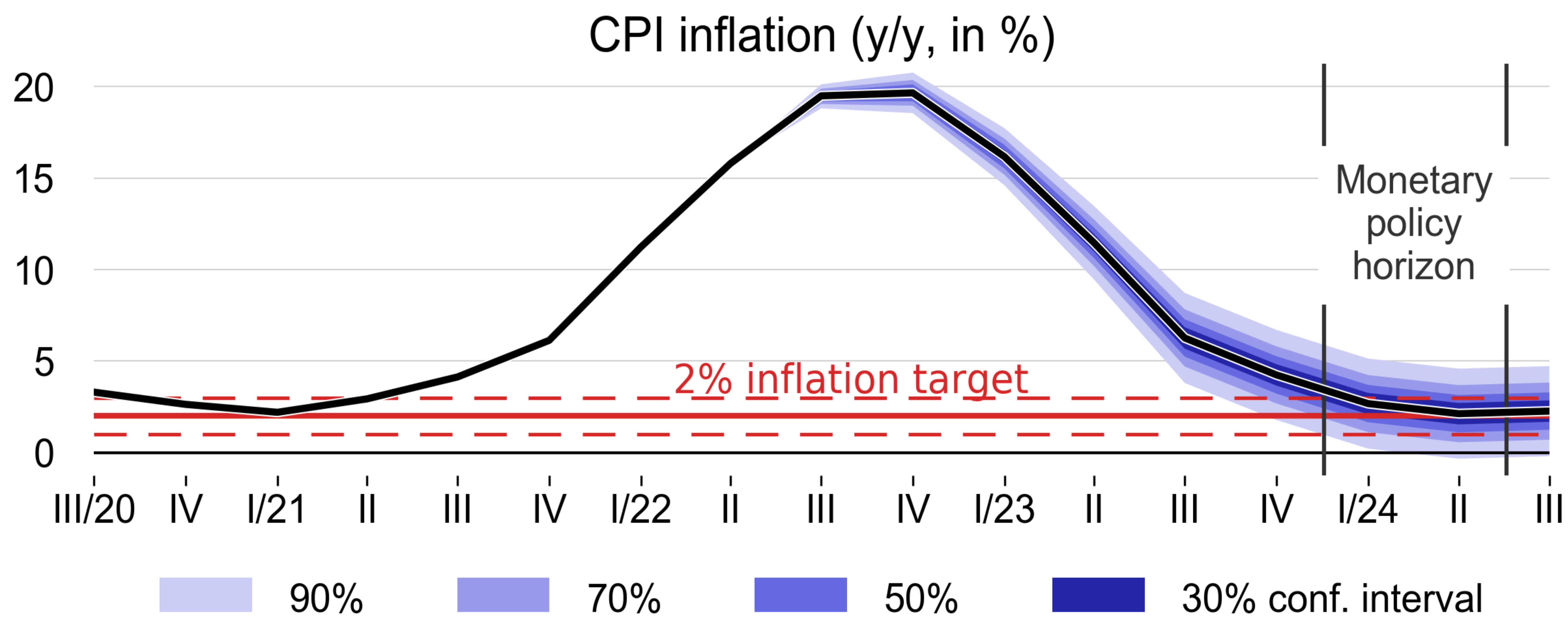
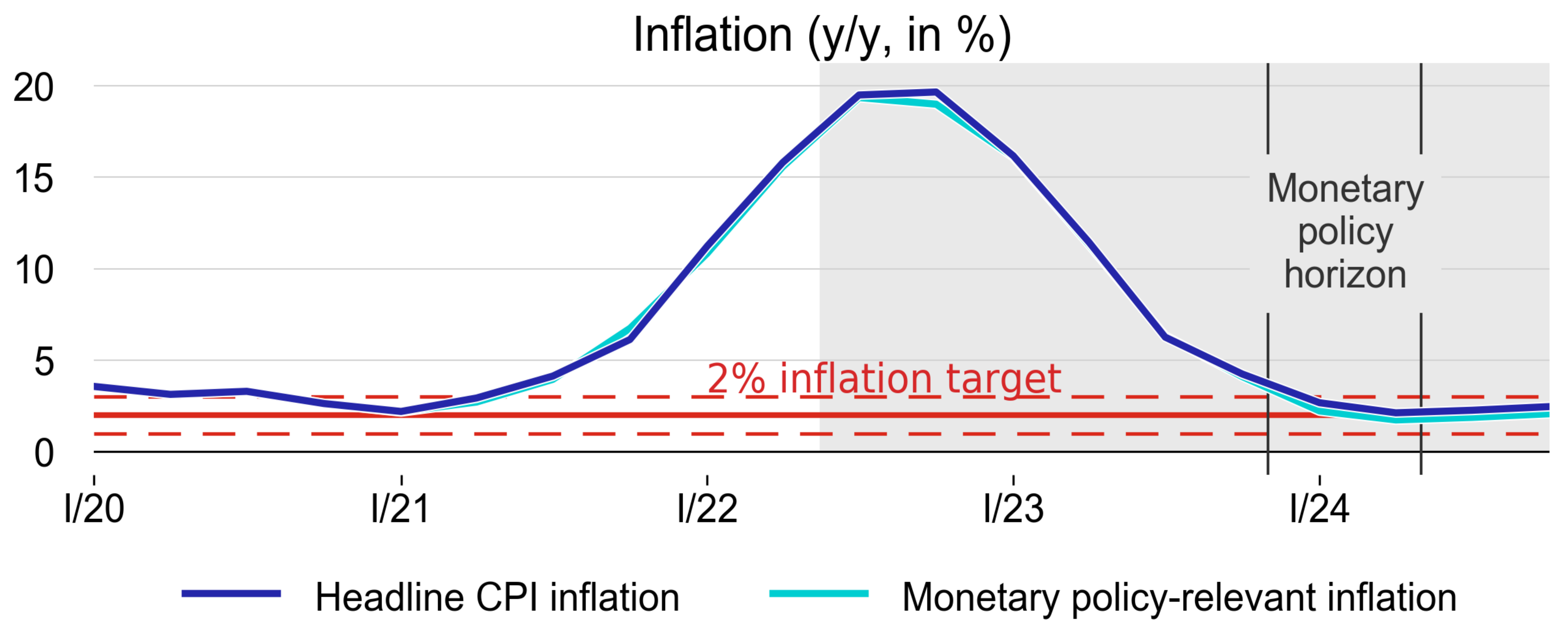
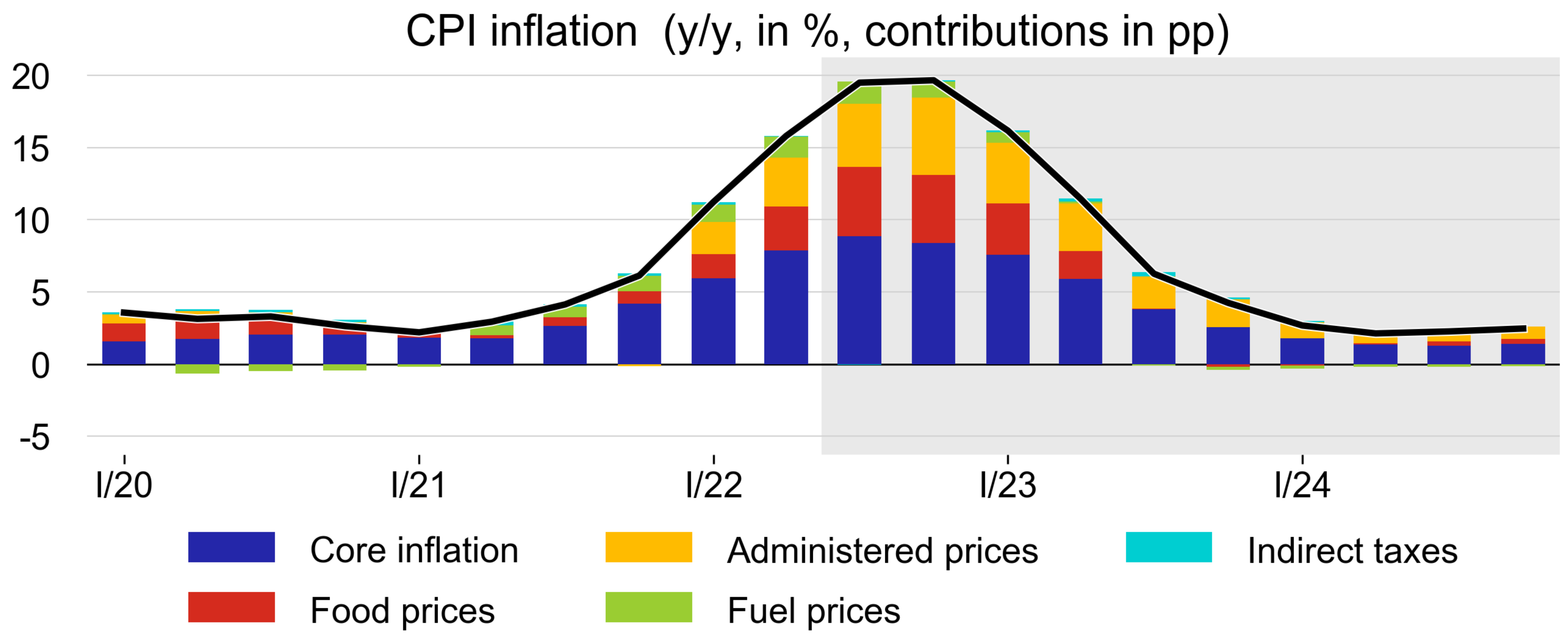
Inflation

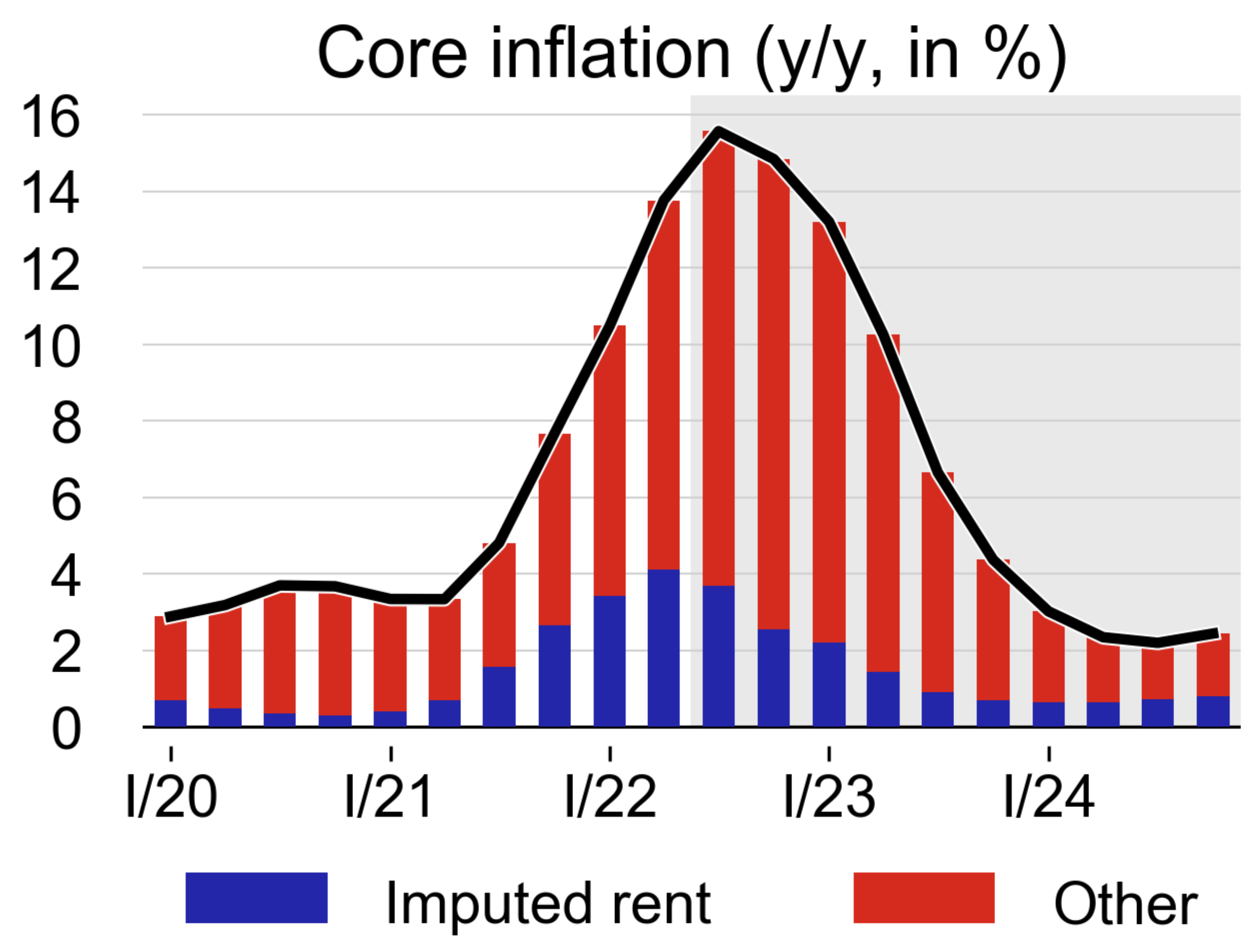


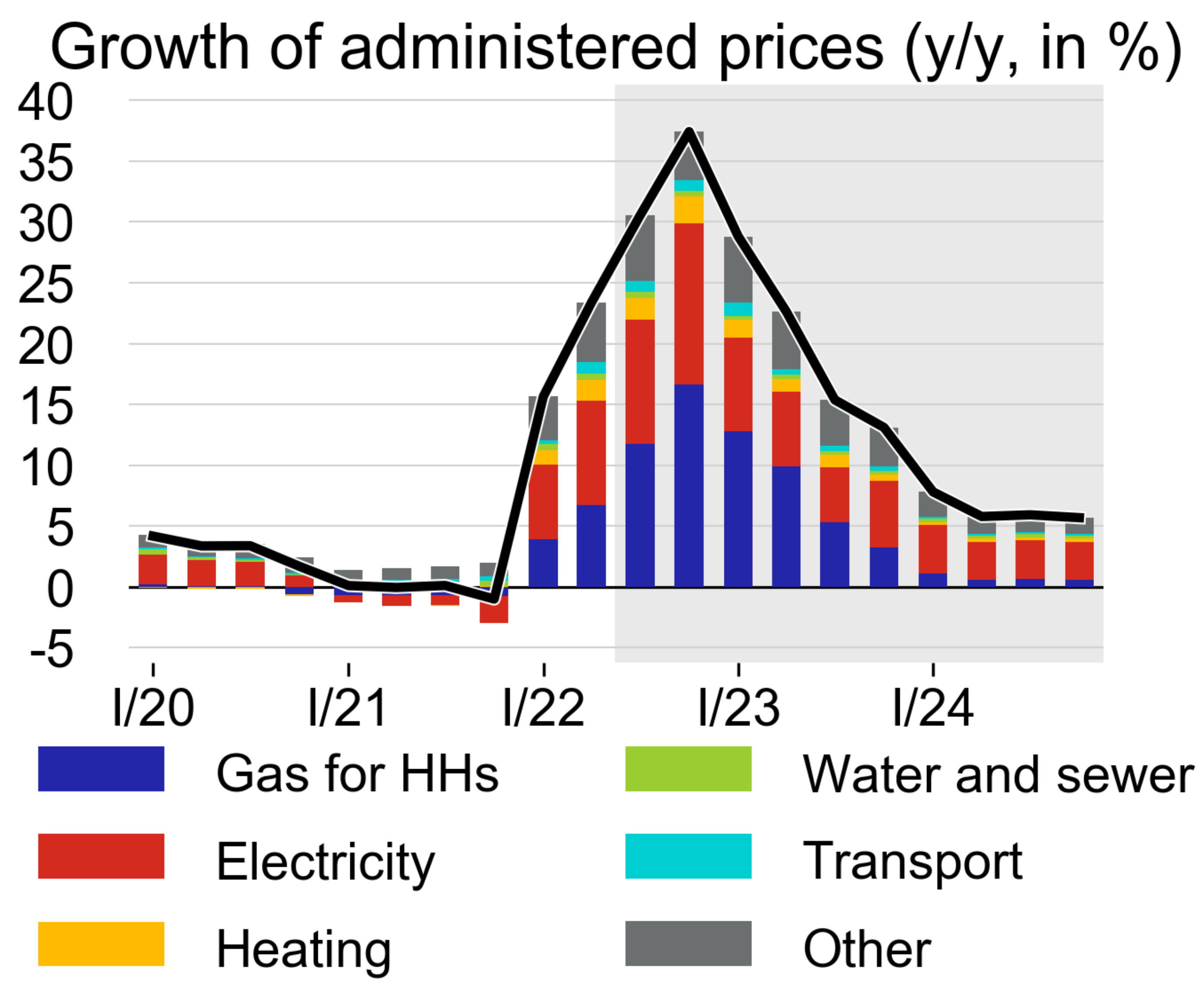


- **CPI inflation** will approach 20% in 2022 Q3 and Q4 and then start to fall.
- It will decrease close to the inflation target at the monetary policy horizon (18–24 months ahead, i.e. in the first half of 2024) due in part to the previous tightening of monetary conditions.
- Changes to indirect taxes will affect CPI inflation in both directions.
- Temporary waiver of VAT on electricity and gas in the last two months of 2021 will slightly widen the gap between headline and **monetary policy-relevant inflation** for a short time at the end of this year, due to base effects.

Inflation Components

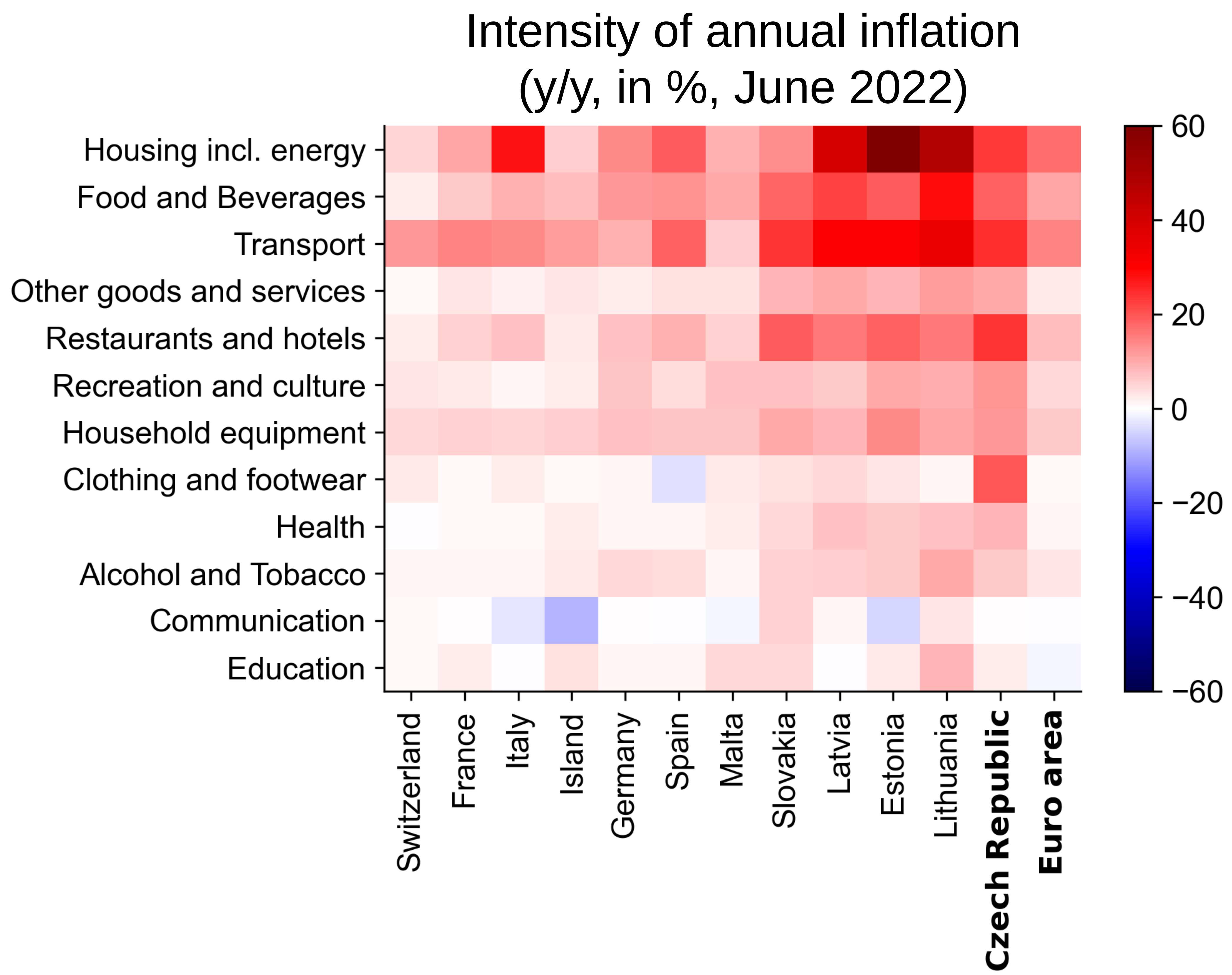


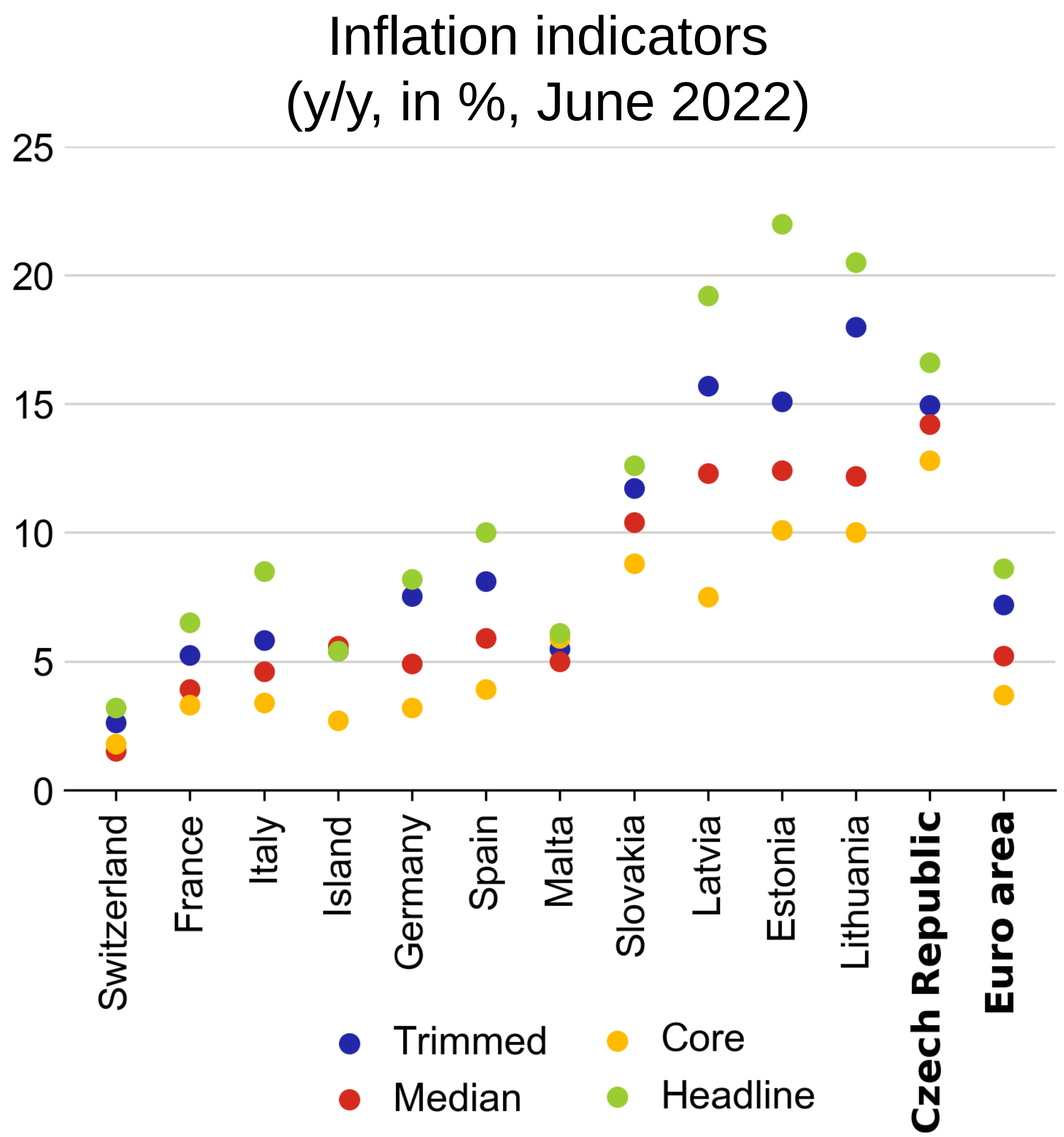




- The escalating **price growth** will continue to be dominated by core inflation, but growing contributions of administered prices and sharply rising food prices will also play a significant role.
- Within **core inflation**, there is significant growth in prices of tradables and especially nontradables, in which imputed rent still plays a big role.
- The strong contribution of **imputed rent** will start to decrease gradually in the second half of this year due to base effects and the previous interest rate increases.
- **Administered price inflation** will rise further due to continued growth in energy prices. In 2023, it will slow but remain high due to the gradual pass-through of the previous growth in energy prices.

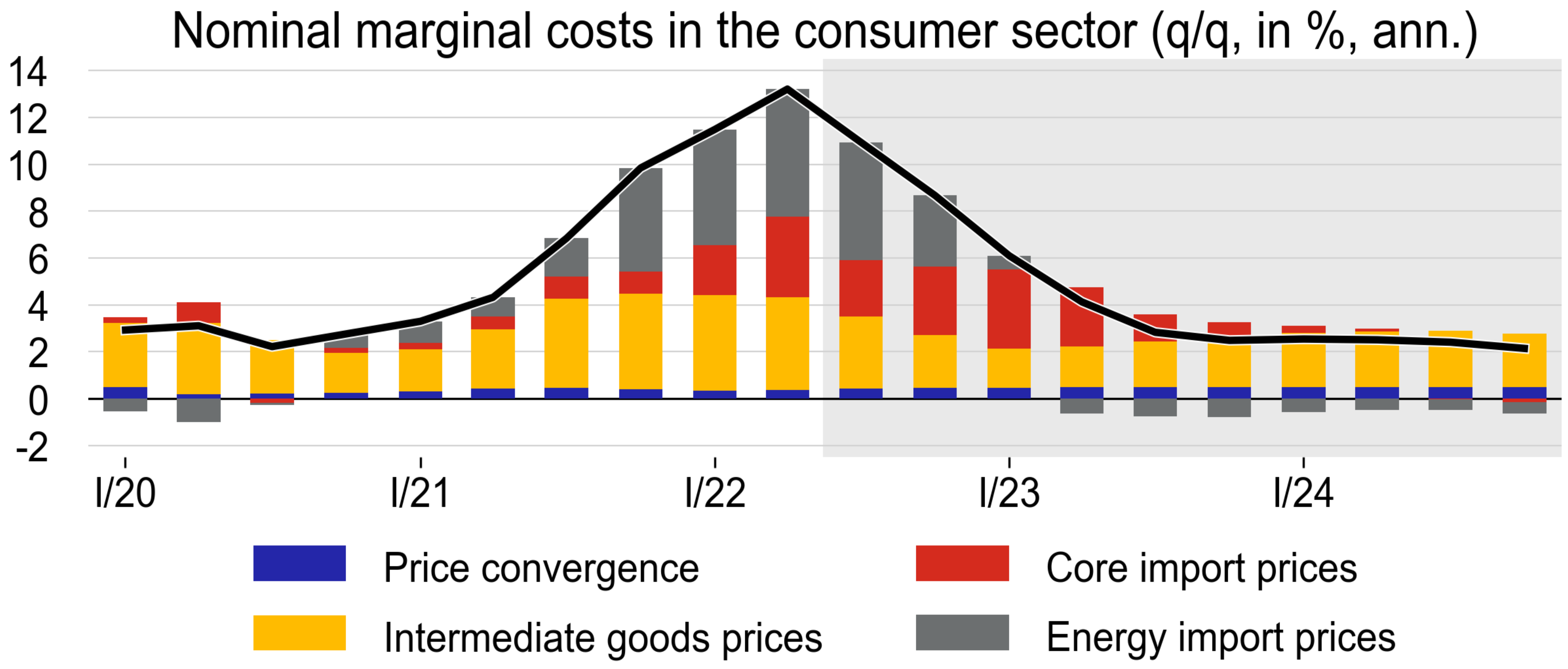
Czech Inflation in the European Context

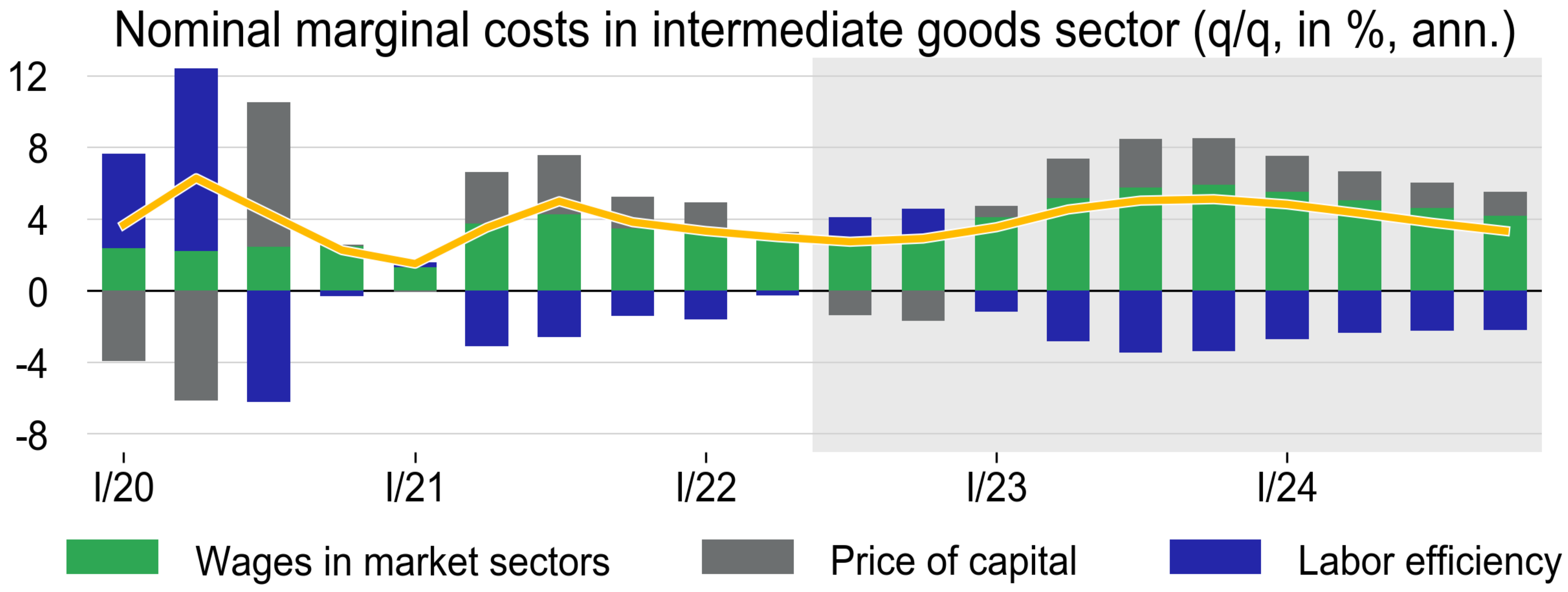




- The price growth in the main **consumer basket categories** shows that inflation in the countries under review was driven up mainly by growth in housing (including energy and fuel), transport and food prices. The Czech Republic holds "first places" in several categories, that are not directly associated with external shocks (restaurants and hotels, clothing and footwear, recreation and culture).
- The indicators of **underlying inflation** show that price pressures in the Czech Republic are broad-based. Almost two-thirds of the items have gone up in price by more than 10%.

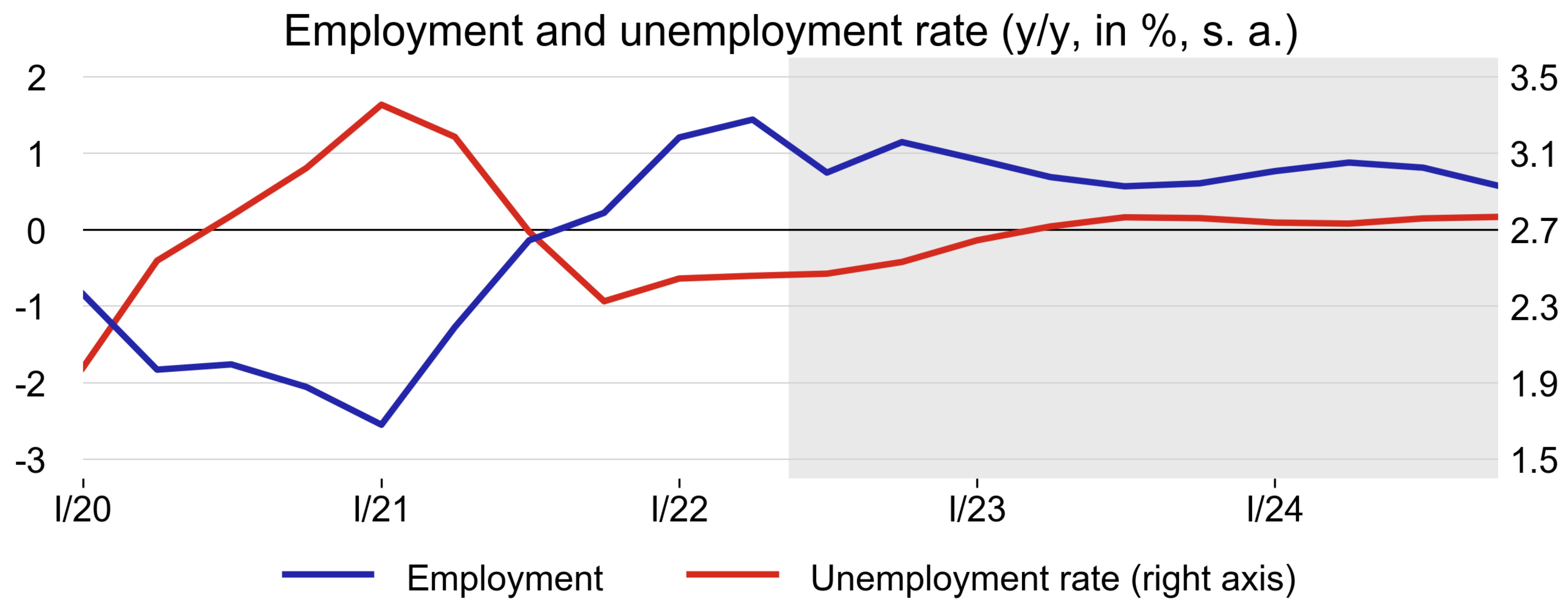
Cost Pressures

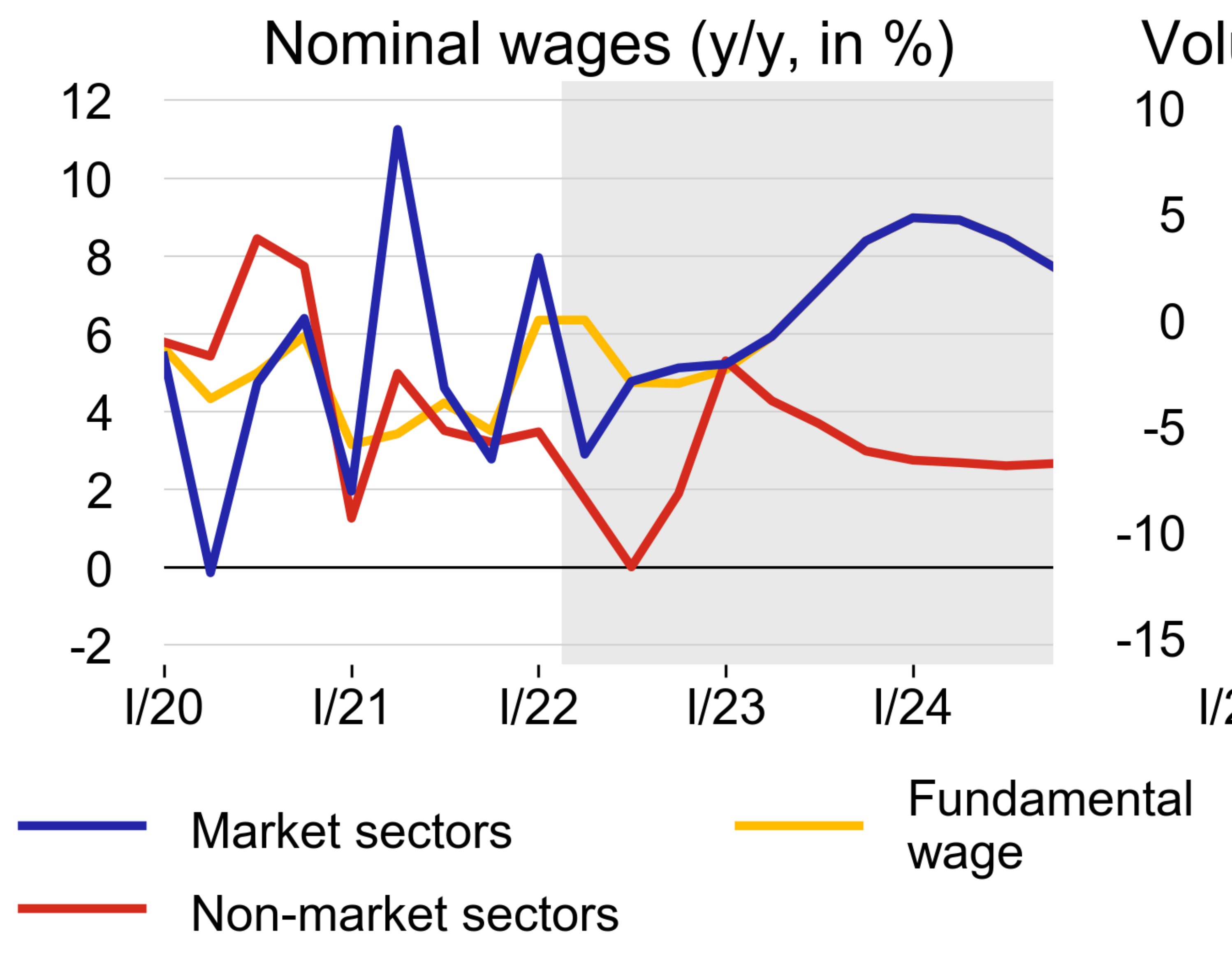


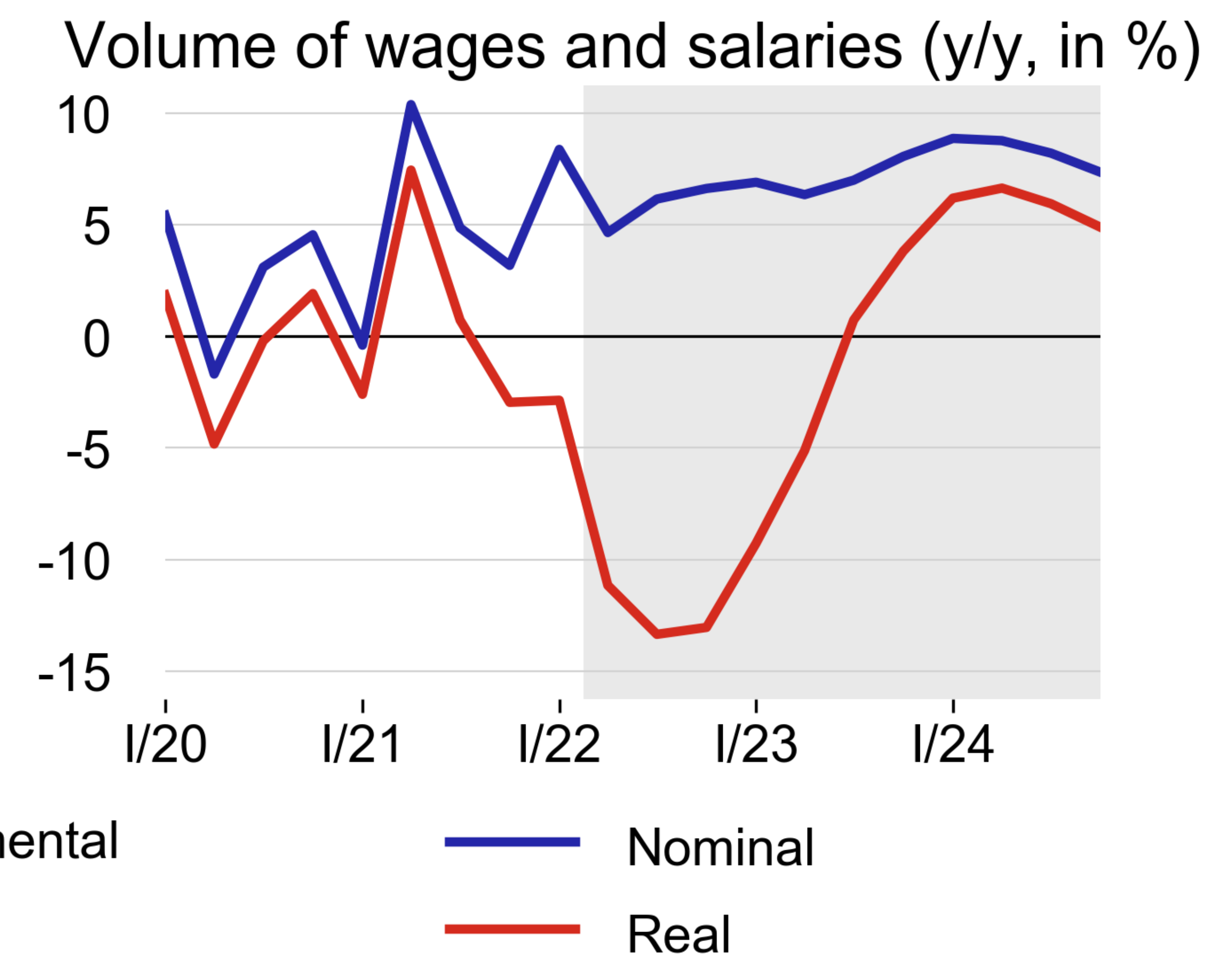


- Growth of **total costs in the consumer sector** rose significantly in 2022 Q2, due to a further pickup in growth in import prices. This primarily reflected a further rise in international gas and electricity prices and rising growth in core foreign producer prices.
- The exceptionally strong cost pressures will start to ease in 2022 H2, due to lower growth in import prices and prices of domestic intermediate goods.
- **Domestic cost pressures** eased but will start to strengthen next year.
- The gradual slowdown in growth in domestic costs was due in part to a temporary drop in wage growth. However, the contribution of wages to growth in domestic costs will strengthen gradually in 2023 due to efforts to make up at least partly for this year's drop in real income.

Labour Market

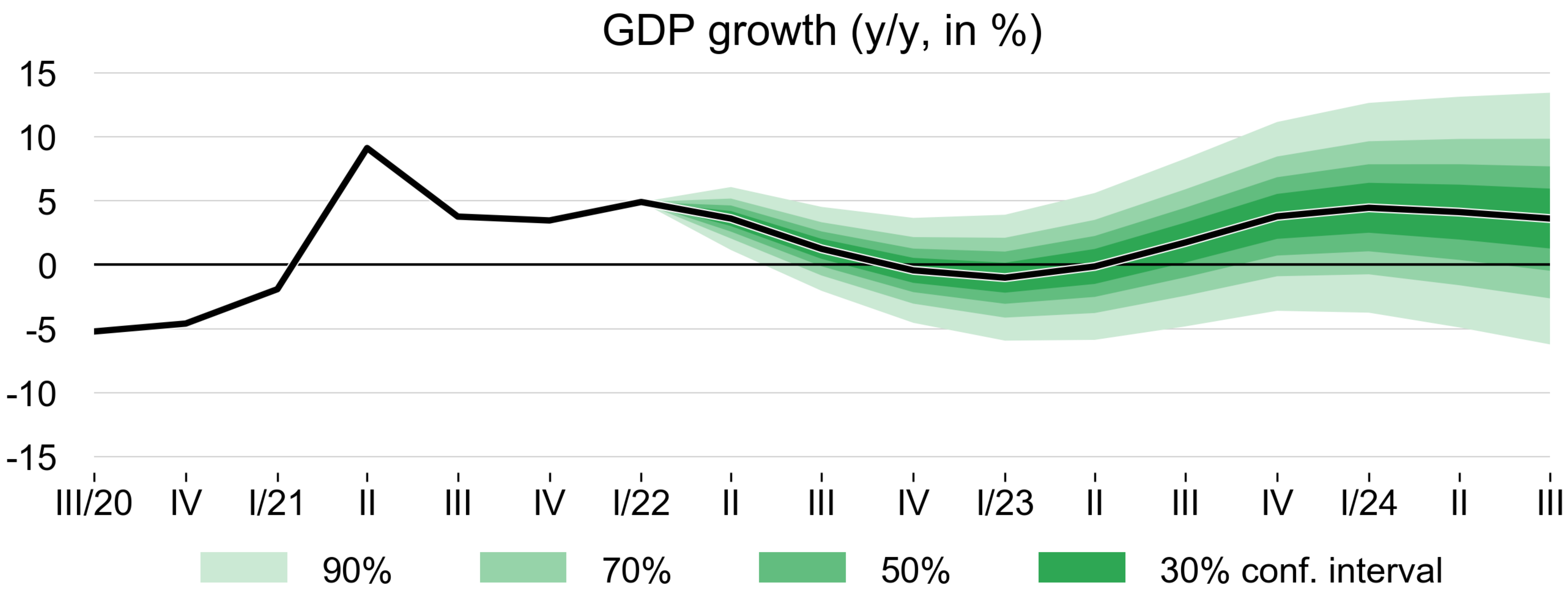


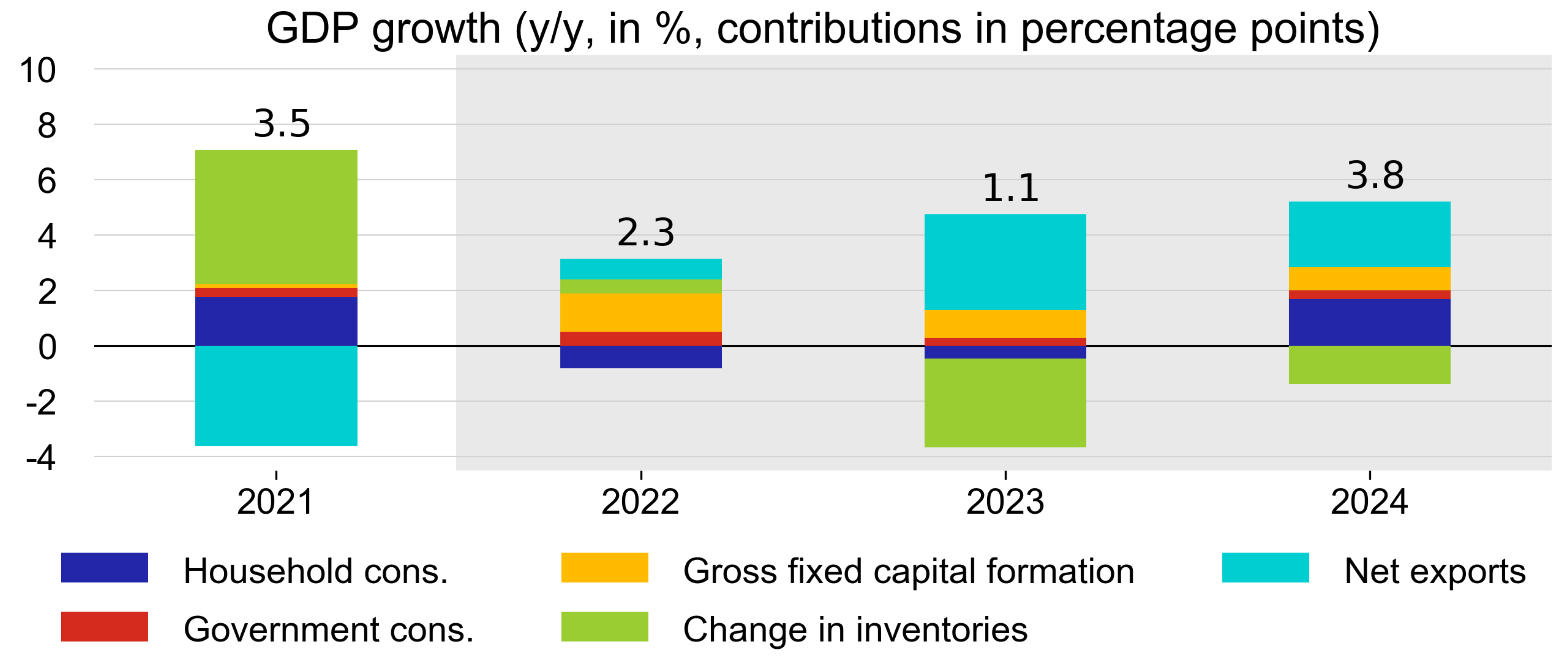




- **Employment** will continue to rise, with the growth decreasing only slightly owing to subdued economic activity. **The unemployment rate** will grow only marginally (migration from Ukraine will not be reflected in the statistics).
- Inflation will not be significantly reflected in **wage growth** this year, despite still solid demand for labour in the first half of the year. Firms are facing high energy prices and also problems in global value chains, which have been exacerbated by the war in Ukraine. This is reducing the room for growth in wages. The arrival of a large number of war refugees is fostering subdued wage growth.
- Growth in **the real volume of wages and salaries** will be deeply negative in the coming quarters due to high inflation.

GDP Growth Forecast

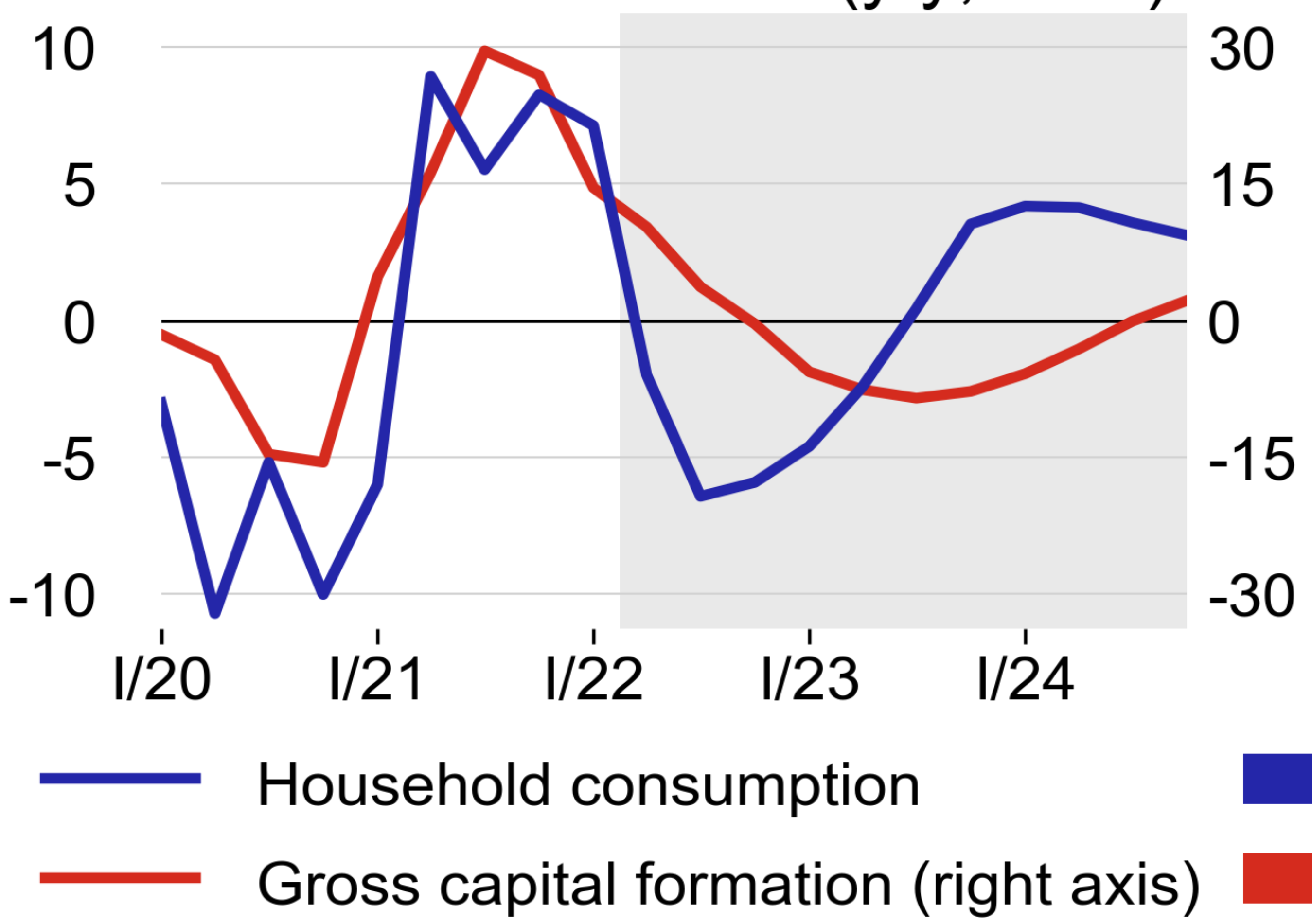




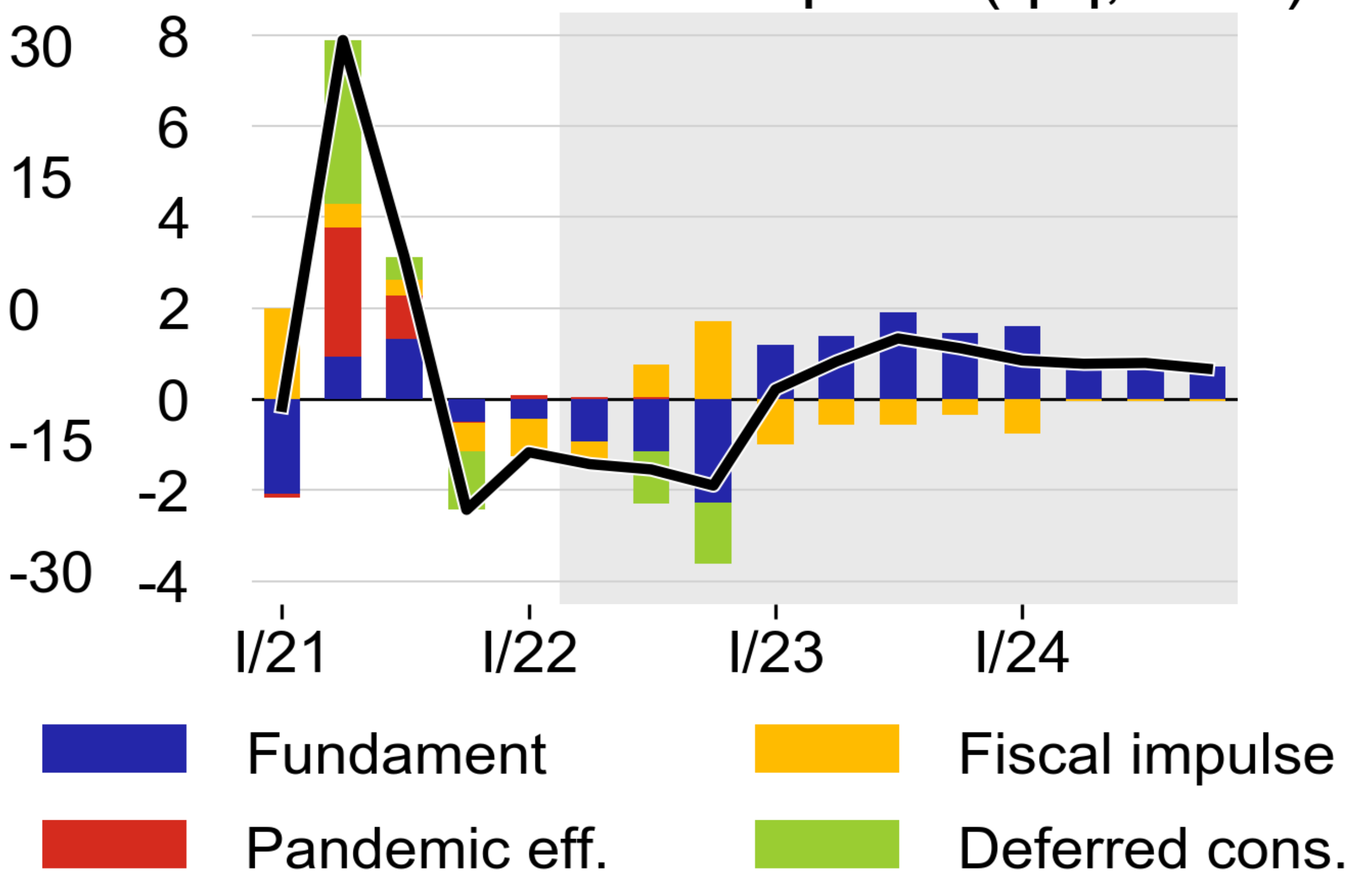
- **Economic growth** will be dampened in the coming quarters by a deterioration in the sentiment and financial situation of Czech firms and households along with persisting problems in global value chains exacerbated by the war in Ukraine.
- The economy will contract in 2022 H2 and start to grow again next year.
- GDP growth will slow to **2.3%** this year in **whole-year terms**. In 2023, it will decrease further to around **1%**, and it will pick up to **4%** in 2024.
- According to a **preliminary CZSO estimate**, Czech GDP increased by **3.6%** year on year in 2022 Q2, which is in line with the CNB forecast.
- The previous overheating of the economy will fade away quickly in the rest of this year and the economy will be below its **potential** temporarily.

GDP Components

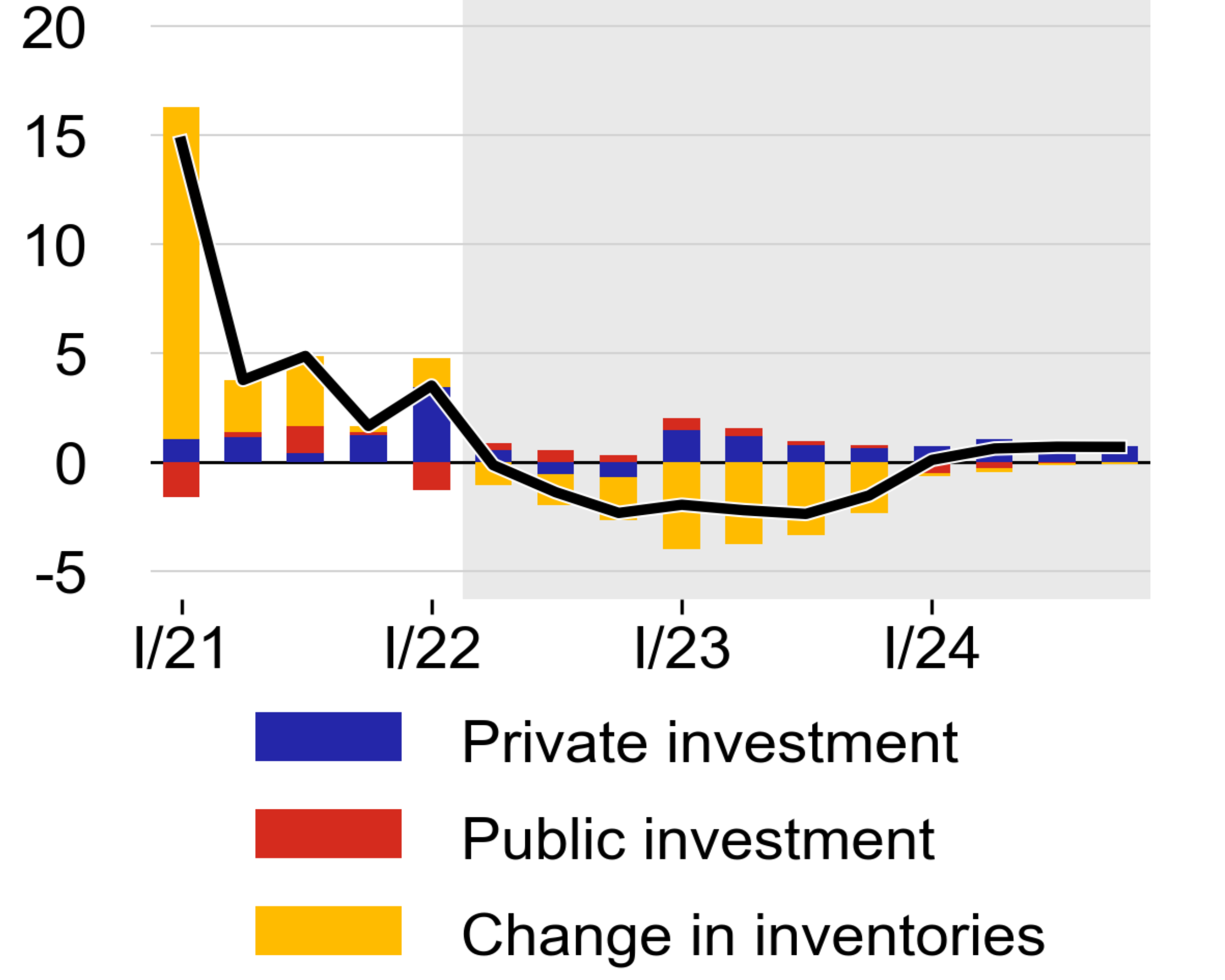
HH cons. and GCF (y/y, in %)



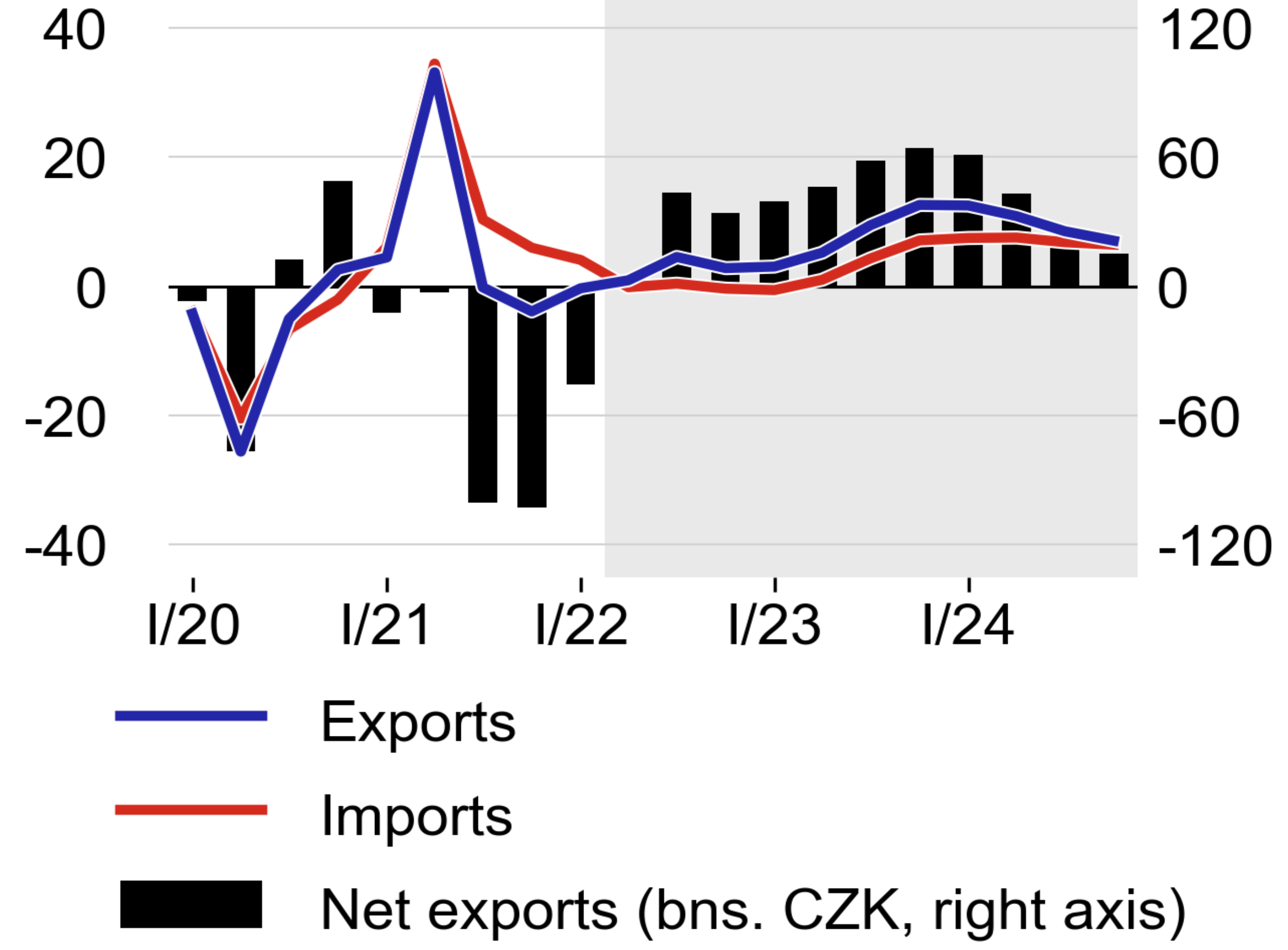
Household consumption (q/q, in %)



Gross capital formation (q/q, in %)

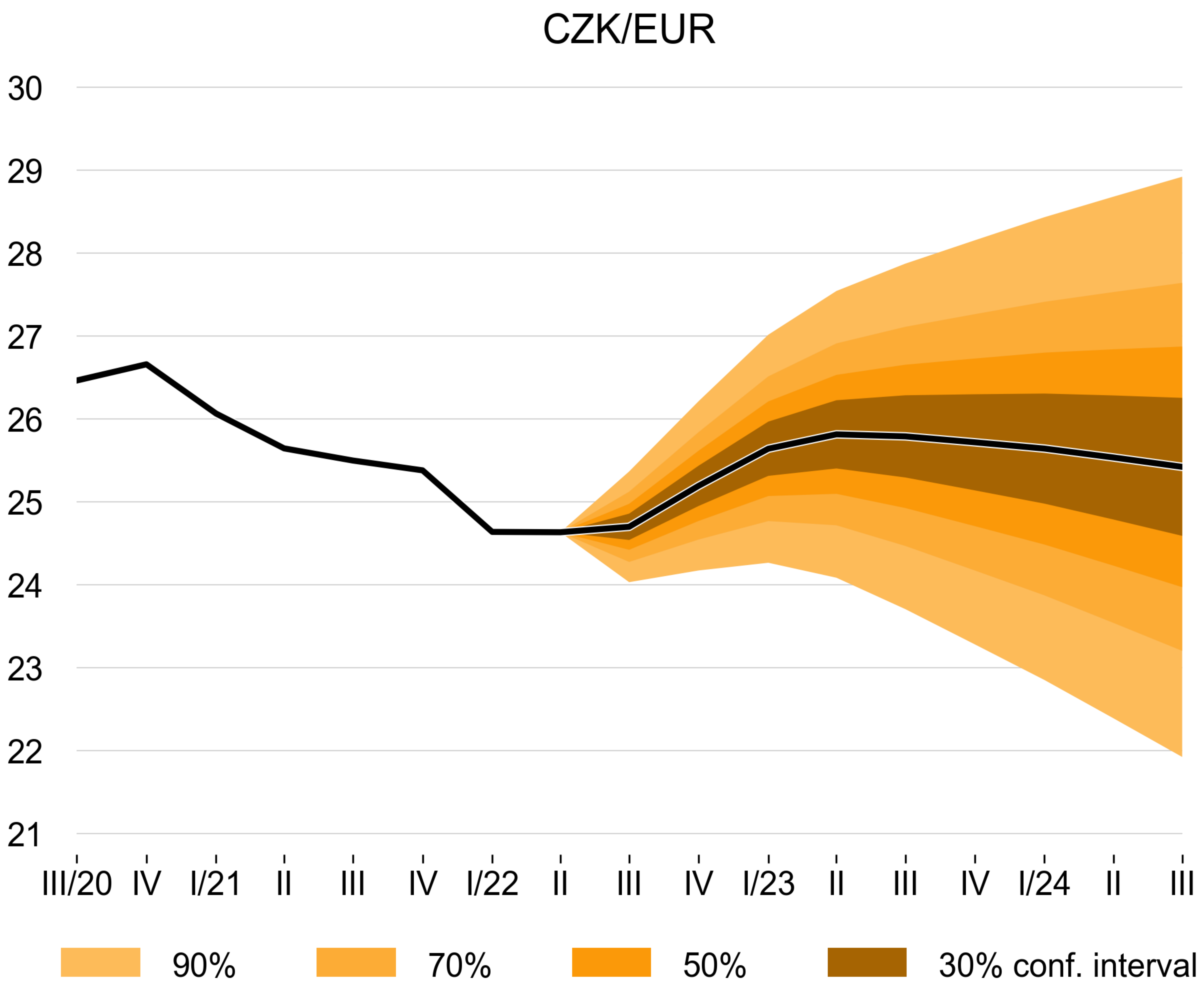


Real exports and imports (y/y, in %)



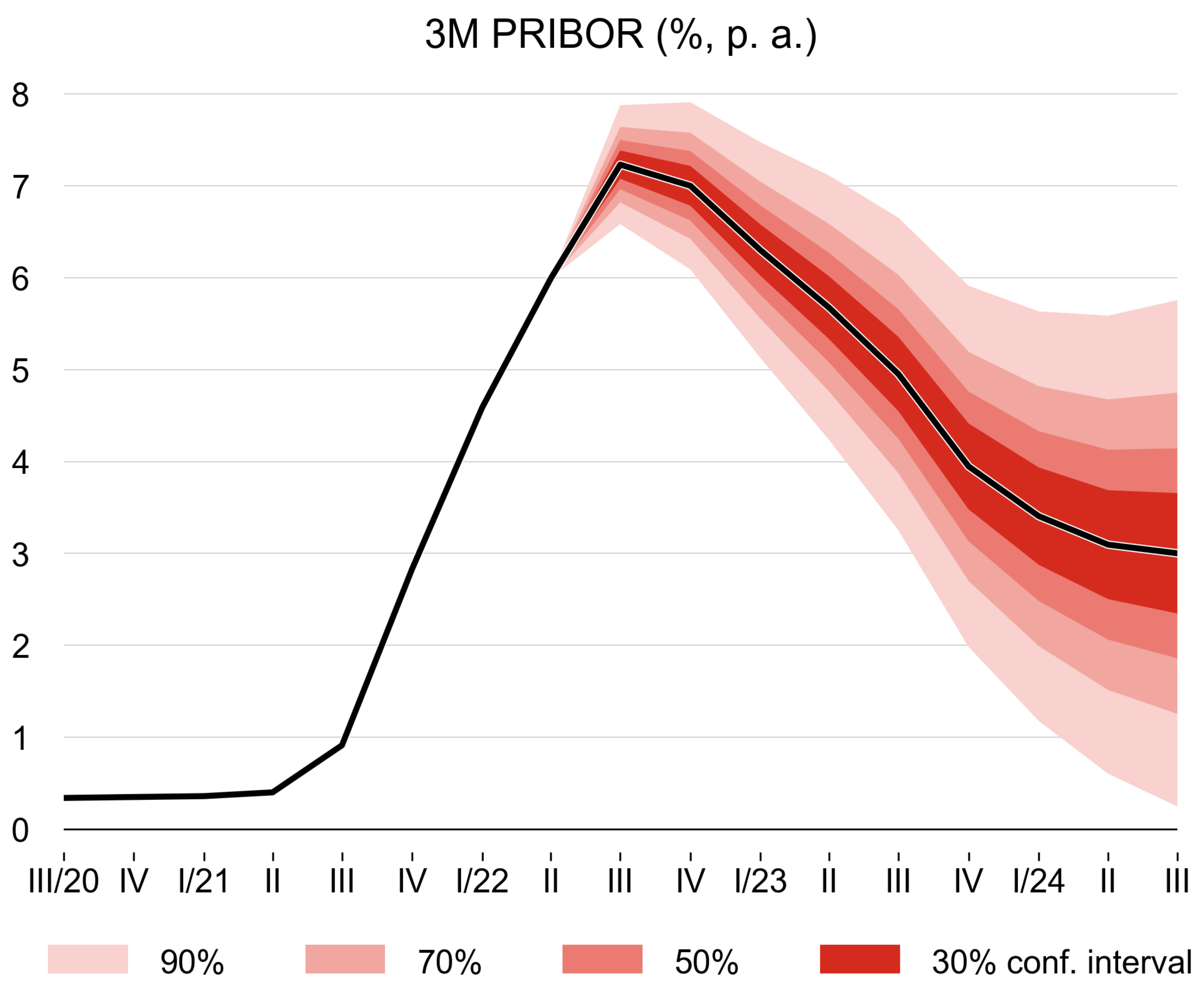
- **Household consumption** will decrease this year due to a sharp decline in households' real income and sentiment, with higher interest rates and forced savings depletion also contributing.
- The financial situation of households will improve in 2023 as inflation drops significantly and wage growth picks up.
- Growth in **fixed investment** was solid at the start of this year but will slow due to a cooling of external demand and a deterioration in firms' financial situation. **Government investment** will be volatile.
- A slowdown in external demand and persisting, war-exacerbated shortages of components and materials will be reflected in subdued **export and import growth** and high **additions to inventories** this year.

Exchange Rate CZK/EUR



- The forecast expects the **koruna** to average CZK 24.7 to the euro in 2022 Q3.
- In the coming quarters, the koruna will depreciate slightly, reaching just below CZK 26 to the euro in mid-2023.
- This will be due mainly to a worsening trade balance and negative sentiment in the region, factors caused primarily by the current geopolitical situation and high energy prices. A gradually narrowing interest rate differential will act in the same direction over the entire outlook.
- The impacts of disrupted global supply chains and the direct impacts of the war in Ukraine will gradually fade next year.
- A renewed trade surplus and improved global sentiment will be reflected in appreciation pressure on the koruna, which will prevail in 2024.

Interest Rate Path (3M PRIBOR)



- Consistent with the baseline scenario is a stability of **short-term market interest rates** at their current level initially.
- This rate stability represents the monetary policy response consistent with the central bank endeavouring to fulfil the 2% target in the first half of 2024.
- The central bank thus abstracts from the unprecedented effect of the strong exogenous cost factors and focuses on stabilising inflation at the horizon immediately after they diminish.
- The gradual fading of the current extreme foreign price pressures, combined with the previous monetary policy tightening, will result in inflation falling close to the target in the first half of 2024.
- Interest rates will thus be able to start decreasing gradually at the start of 2023.

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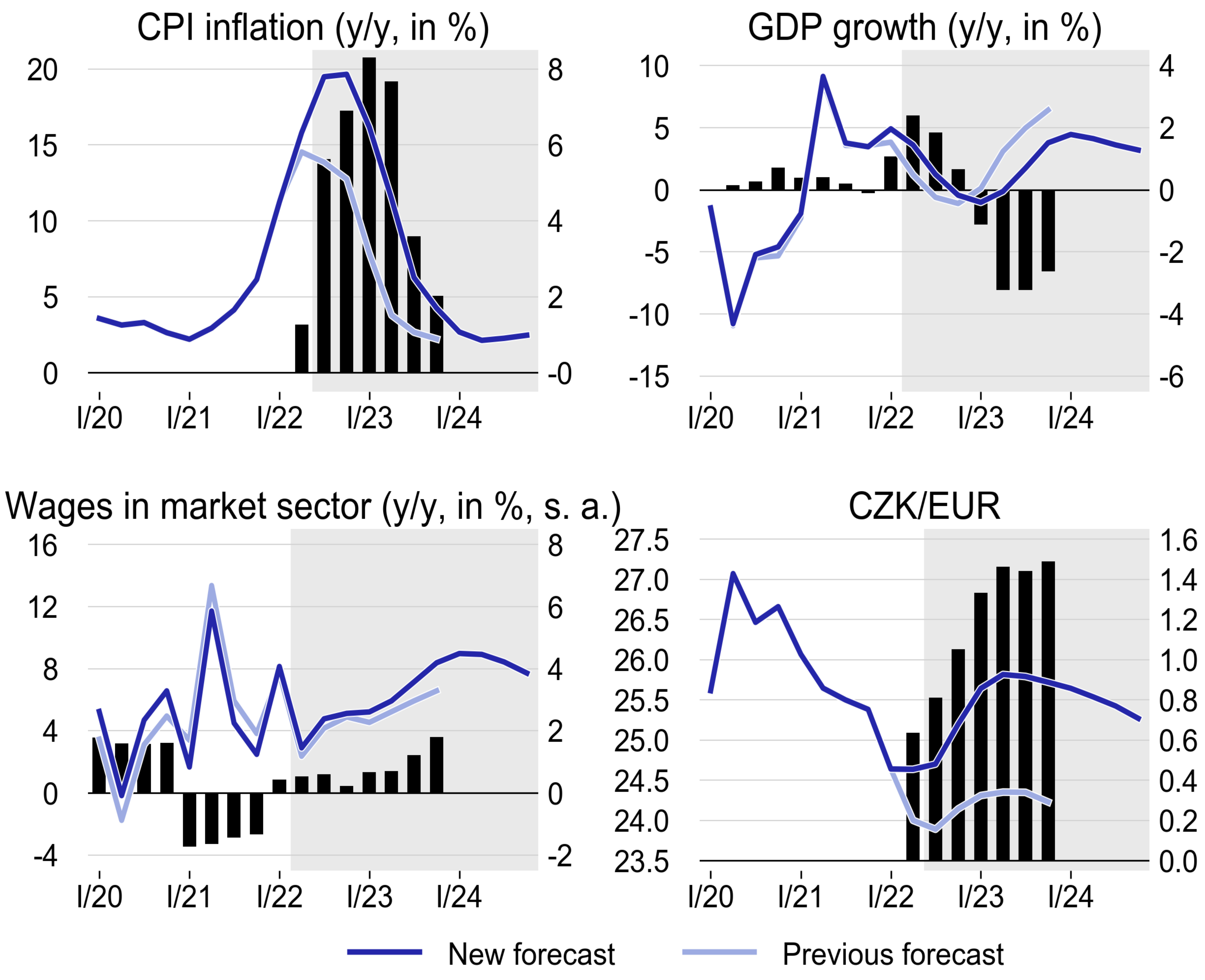
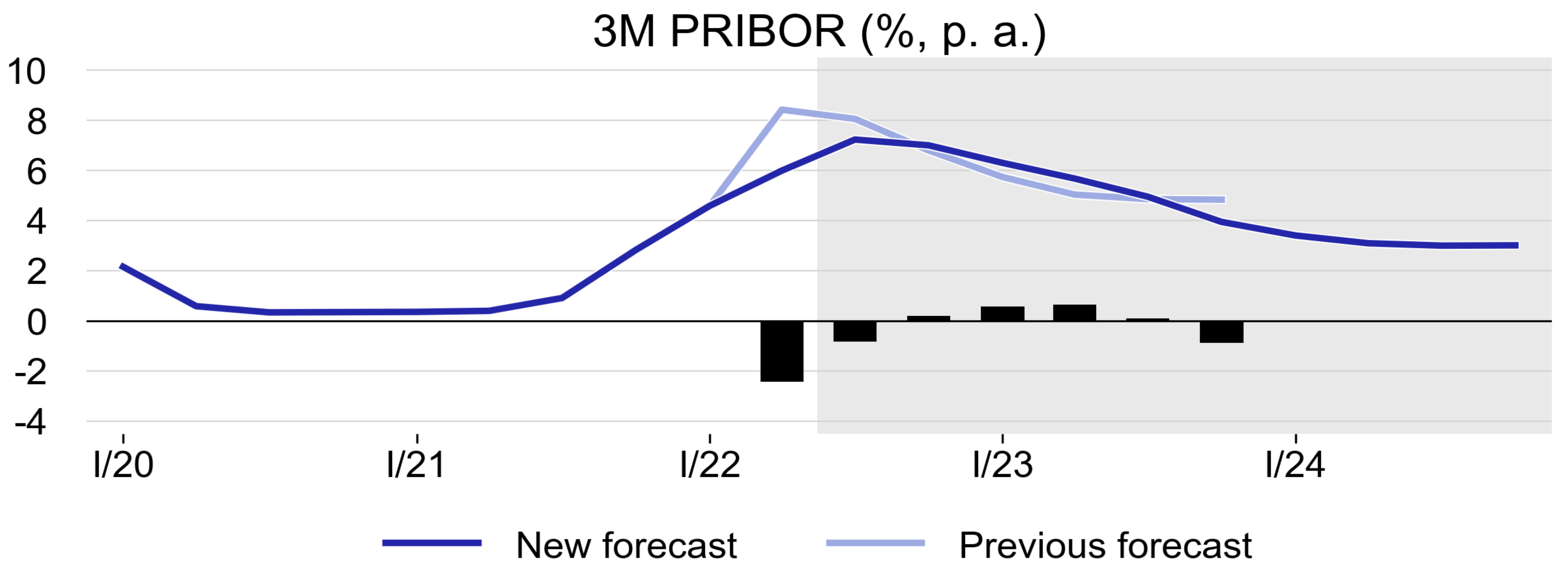
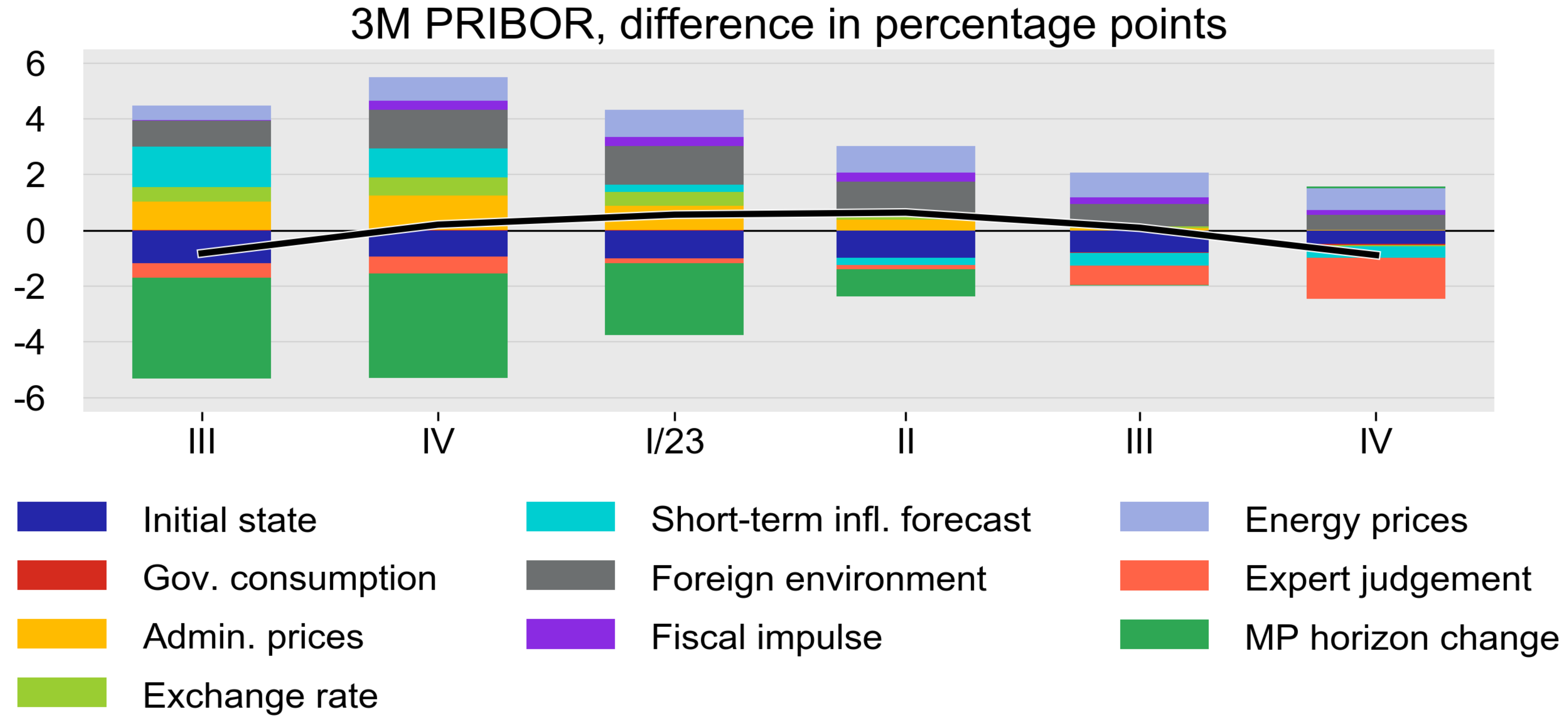
Comparison with Previous Forecast



- The upward revision of the **inflation** forecast is due to all its components.
- The **GDP growth** outlook is higher for this year, due to better-than expected figures at the start of the year, and significantly lower next year, due to a greater cooling of domestic demand.
- The higher **wage growth** in 2023 reflects greater compensation for the drop in real income this year caused by higher and more persistent inflation compared with the spring forecast.
- The **koruna** is weaker over the entire forecast horizon. Initially, this reflects its previous observed path. Later, it is due to a smaller trade surplus and faster decreasing interest rate differential vis-à-vis the euro area compared with the previous forecast.

Comparison with Previous Forecast: 3M PRIBOR





- **Interest rates** are lower initially and slightly higher in 2023 H1.
- **The initial state** fosters lower rates due to their lower initial level and higher labour efficiency.
- **The foreign outlook** fosters higher rates reflecting less accommodative ECB policy and a faster core foreign PPI growth.
- The **energy** component of import prices reflects a higher outlook for prices of oil, gas and electricity on commodity exchanges.
- The higher rates are also due to the **short-term inflation** and **exchange rate** forecast and the outlook for **administered prices**.
- **Expert adjustments foster** lower rates as they capture the stronger expected decline in household consumption this year and the dampening of wage growth next year.
- **The shift of the monetary policy horizon** has a downward effect on the rate path.

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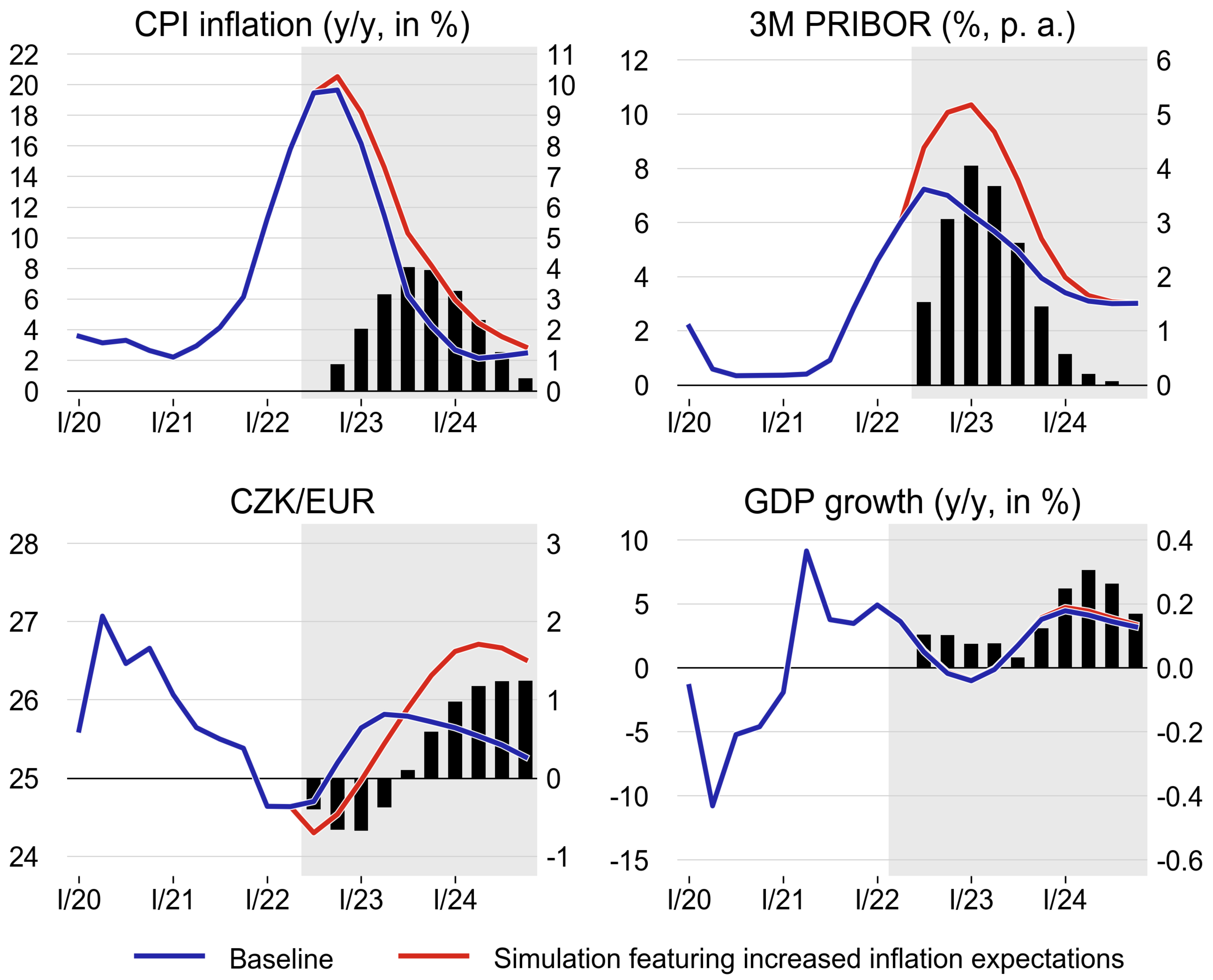
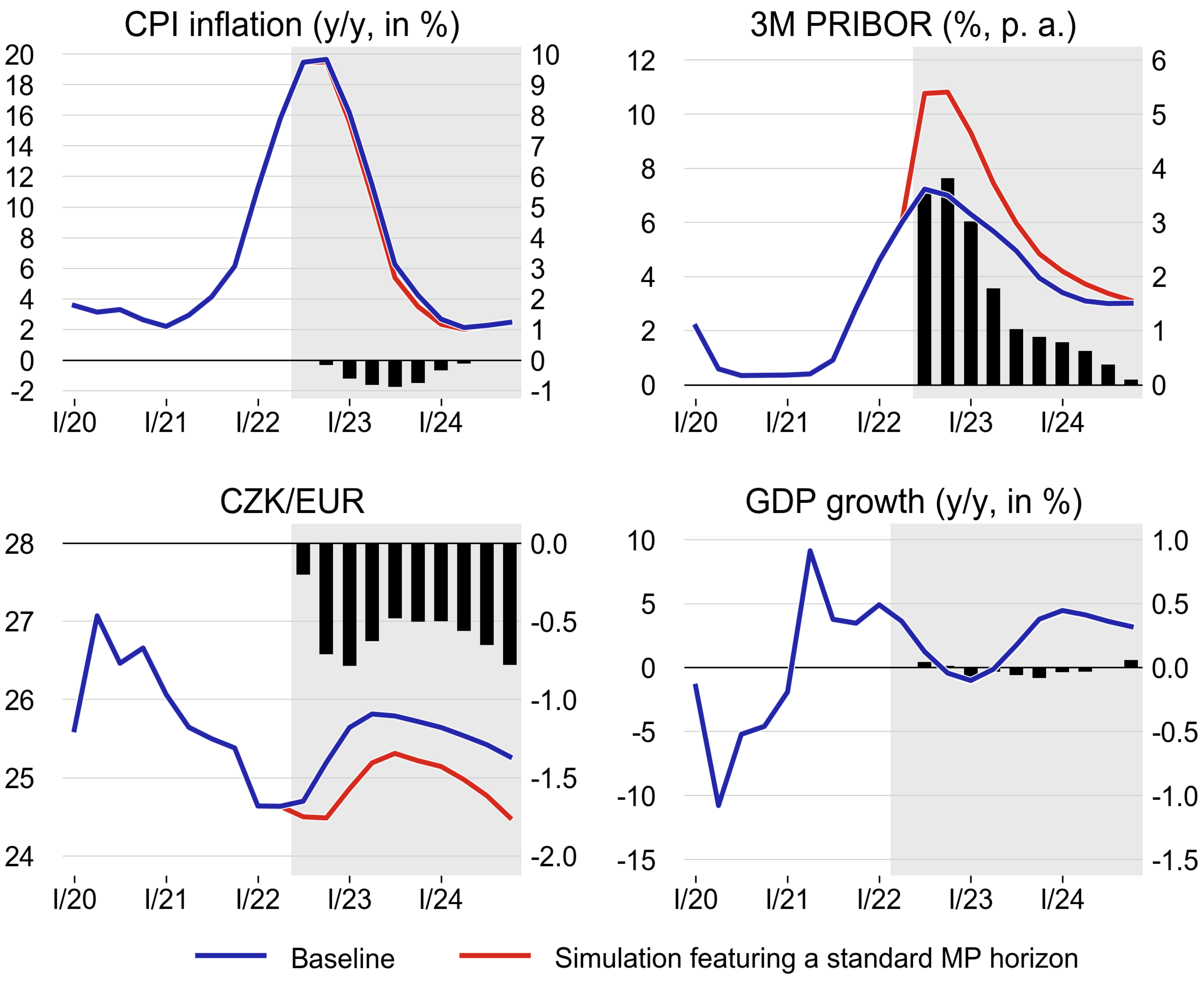
Scenario Featuring Increased Inflation Expectations



- The change in monetary policy reaction function (more distant MP horizon) in the conditions of inflation far above the inflation target could lead to an increase in expected inflation, which would make the quick return to the inflation target more difficult.
- In the scenario, economic agents have their **inflation expectations increased to 5%** until the end of 2023. Subsequently, the expectations gradually return to 2 %.
- **Inflation** gets to even higher values than in the forecast and remains elevated for longer.
- Central bank has to increase **interest rates** significantly higher than in the forecast. This makes the **koruna** temporarily stronger, but in a longer horizon, it gets weaker due to a faster decreasing interest rate differential and higher price level.

Scenario Featuring a Standard MP Horizon



- In the scenario with **standard monetary policy horizon** (12-18 months ahead), the central bank reacts to the strong inflationary pressures stemming from the foreign environment as well as from the domestic economy in a standard way and prevents their pass-through to the price development in the medium-term.
- Standard reaction function of the central bank results in notably higher **interest rates** in comparison to the forecast (with the policy horizon 18–24 months ahead), which ensures stronger **exchange rate of koruna** on the whole simulation horizon.
- Tighter monetary conditions than in the forecast help to anchor the inflation expectations at the 2% target.

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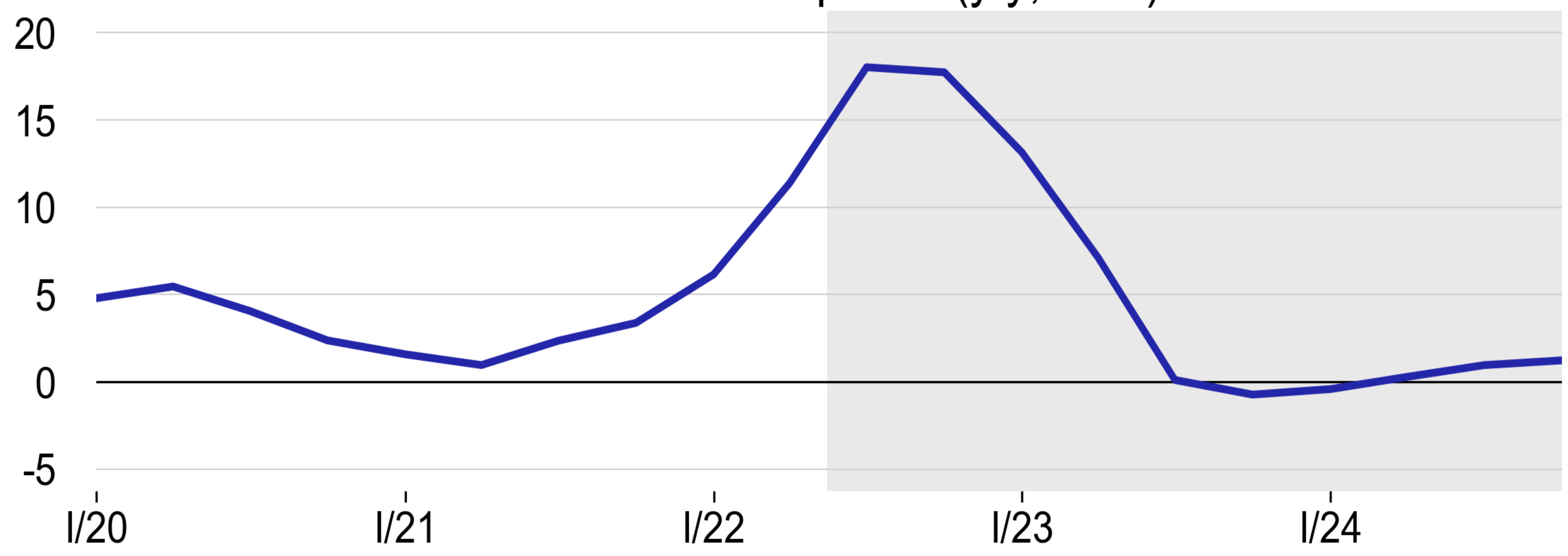
Thank you for your attention

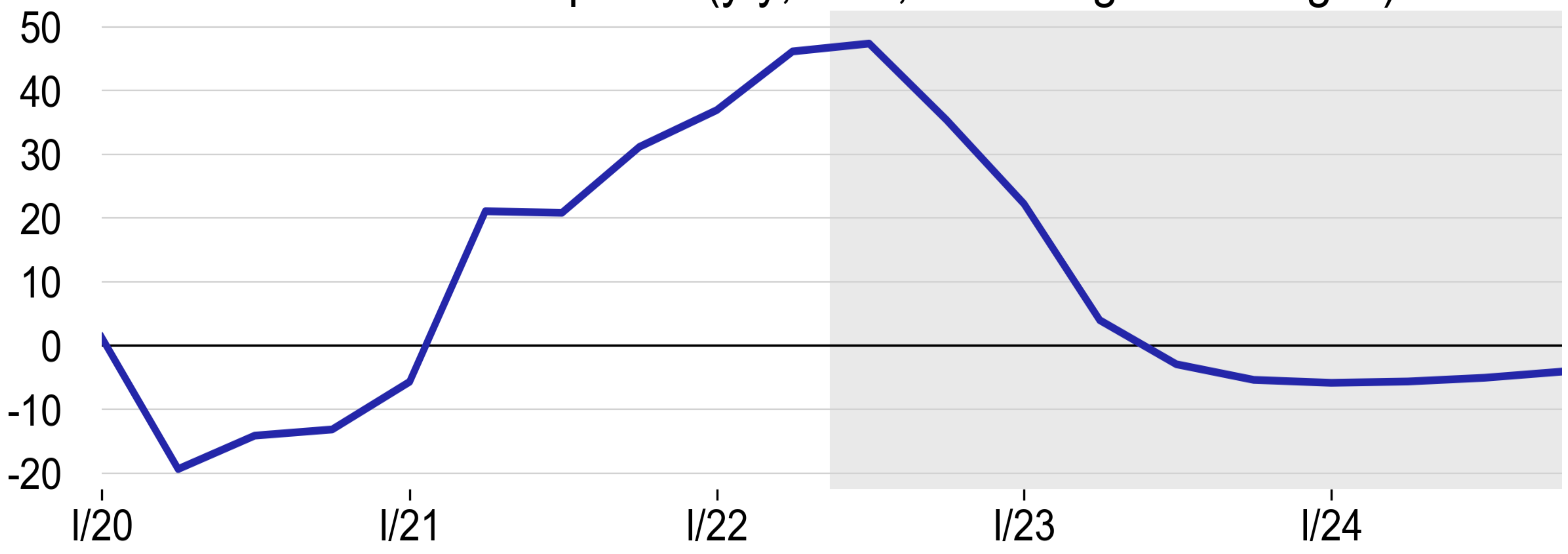
Karel Musil
Director, Macroeconomic Forecasting Division
Monetary Department
Karel.Musil@cnb.cz

Food and Fuel Prices

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

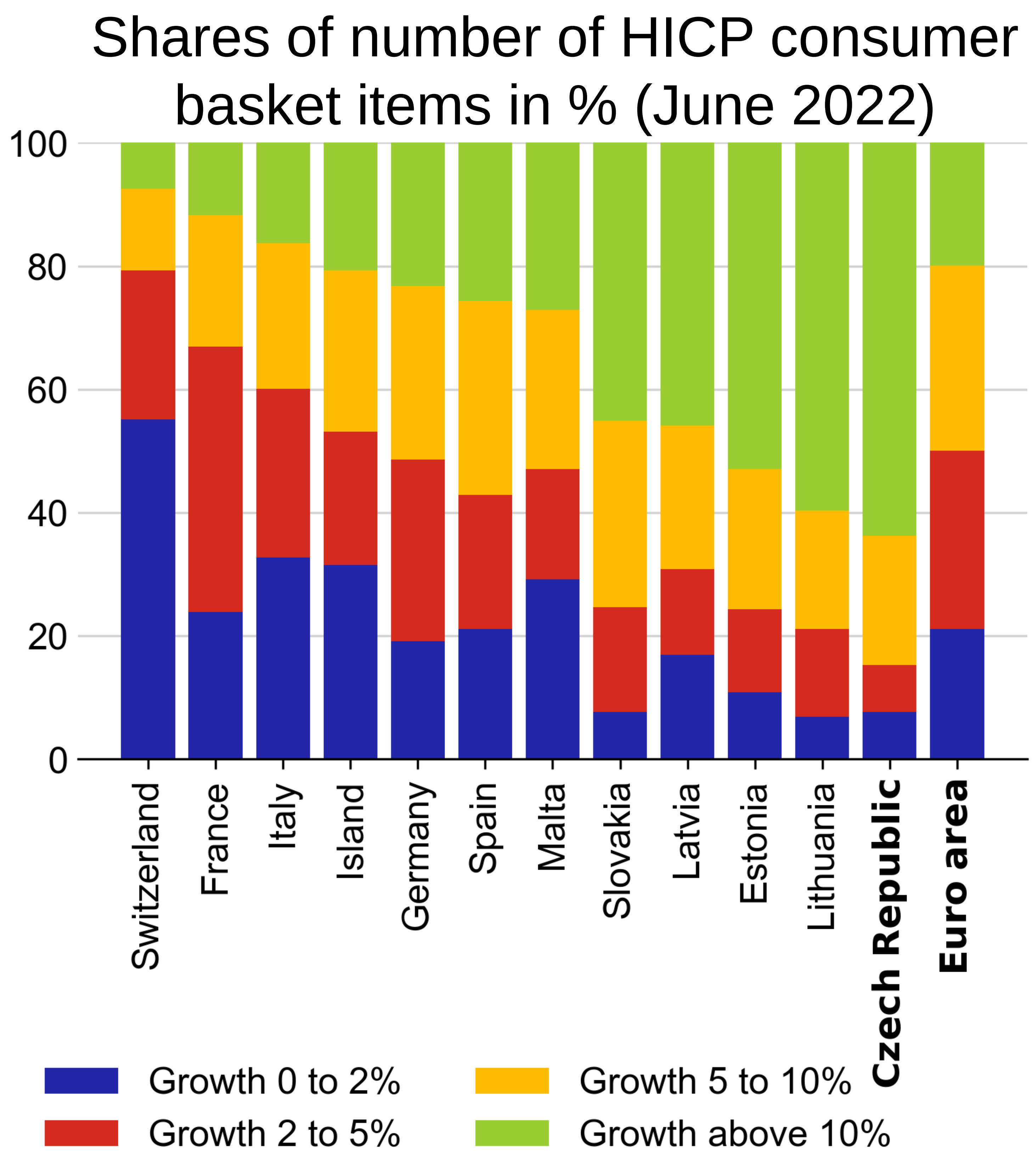


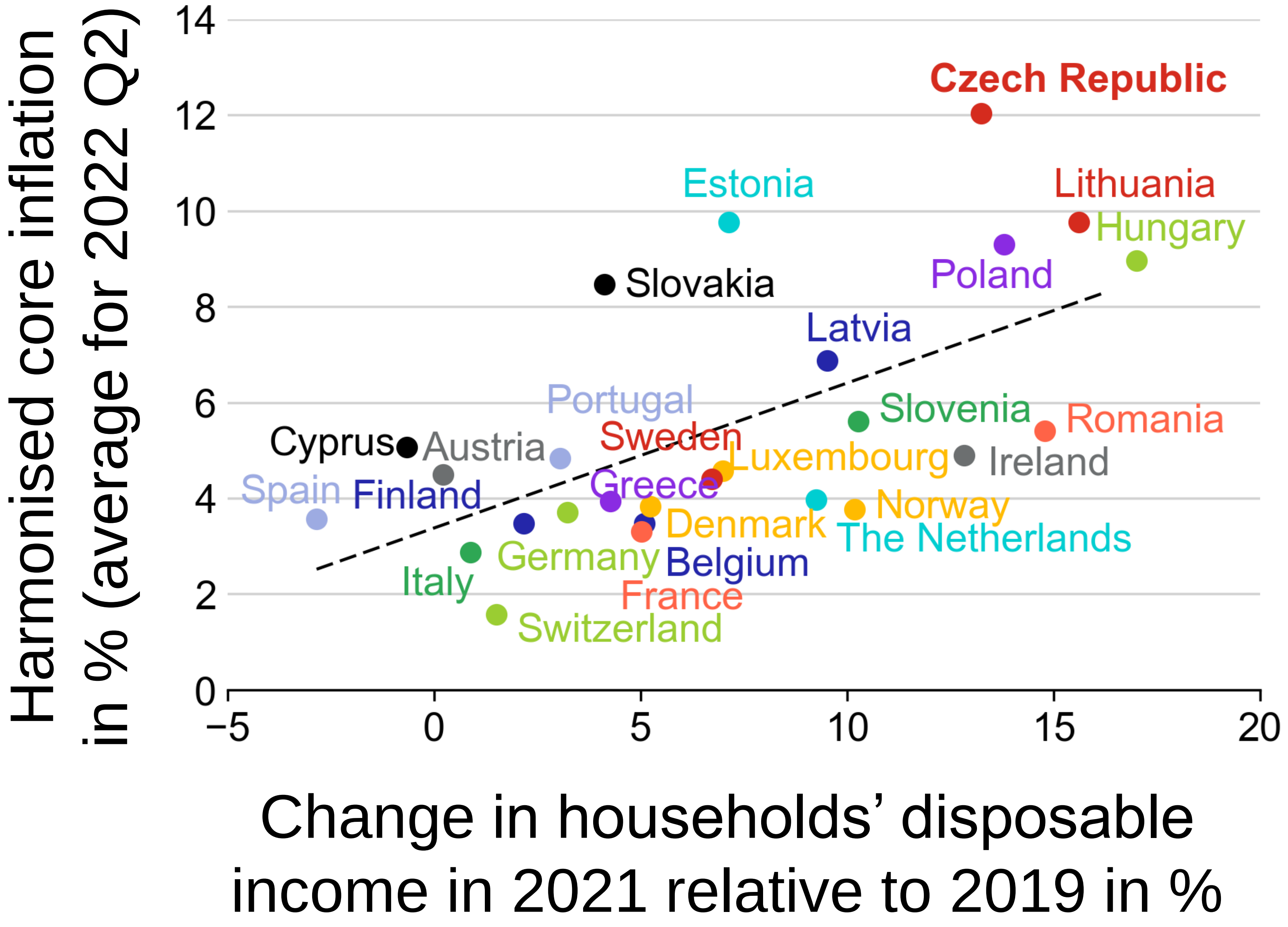
Growth of fuel prices (y/y, in %, excluding tax changes)



- The sharp growth in **food prices** is being driven mainly by still high world agricultural commodity prices and soaring domestic agricultural producer prices. This is going on amid rising energy costs.
- A significant rise in prices can be expected across all food categories in the summer months. It will be fostered in part by the situation in Ukraine.
- The surging food price inflation will peak at the turn of summer and autumn. It will slow distinctly in 2023, owing to an expected correction of world agricultural commodity prices.
- **Fuel price inflation** will be high throughout this year, but it will decrease gradually as global oil prices fall. Prices at filling stations will decrease year on year in the second half of 2023.

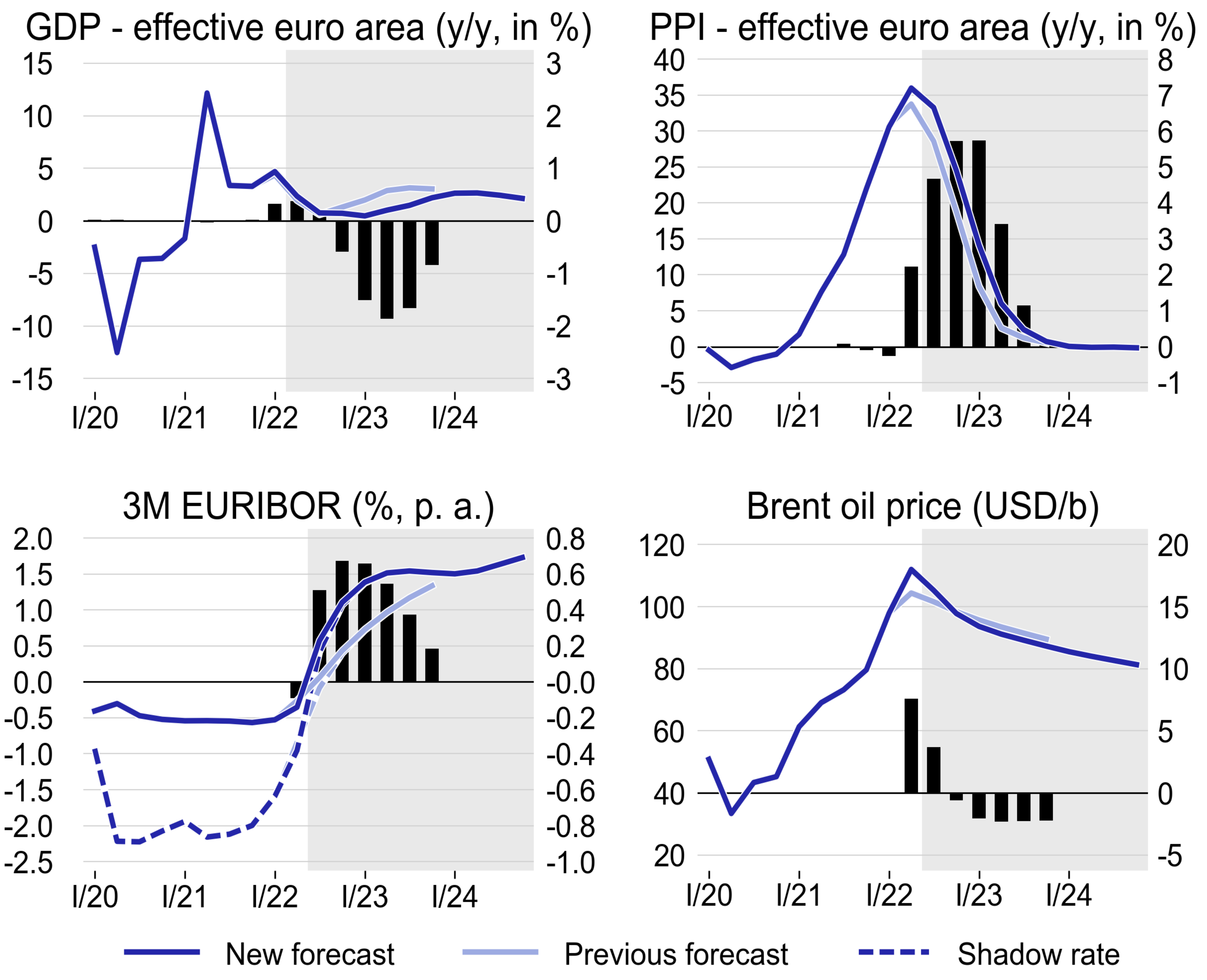
Czech Inflation in the European Context





- On average only about one in five of the 256 HICP **consumer basket items** have risen in price by more than 10% year on year in the euro area, whereas in the Czech economy it was almost two-thirds of items.
- Different **household income growth** during the pandemic explains one-third of the differences in current core inflation in European countries. The Czech Republic has the lowest unemployment rate and one of the highest labour force participation rates in the EU. Czech fiscal policy was one of the most expansionary in 2021.

Comparison with Previous Forecast: Foreign Outlook



- The **foreign economic growth outlook** for late 2022 and early 2023 is worse because of faster depletion of pandemic savings amid higher energy prices than previously expected.
- The higher **foreign producer price outlook** reflects outlooks for higher energy commodity prices and a stronger dollar coupled with longer-lasting supply chain disruptions.
- The **Brent crude oil price** outlook remains sharply falling; the decrease next year reflects a larger global growth slowdown.
- The expected **3M EURIBOR** market interest rate is higher due to the stronger reaction to the faster-rising inflation announced by the ECB.