CNB’s New Forecast

Monetary Policy Report – Summer 2023

Meeting with Analysts

4 August 2023

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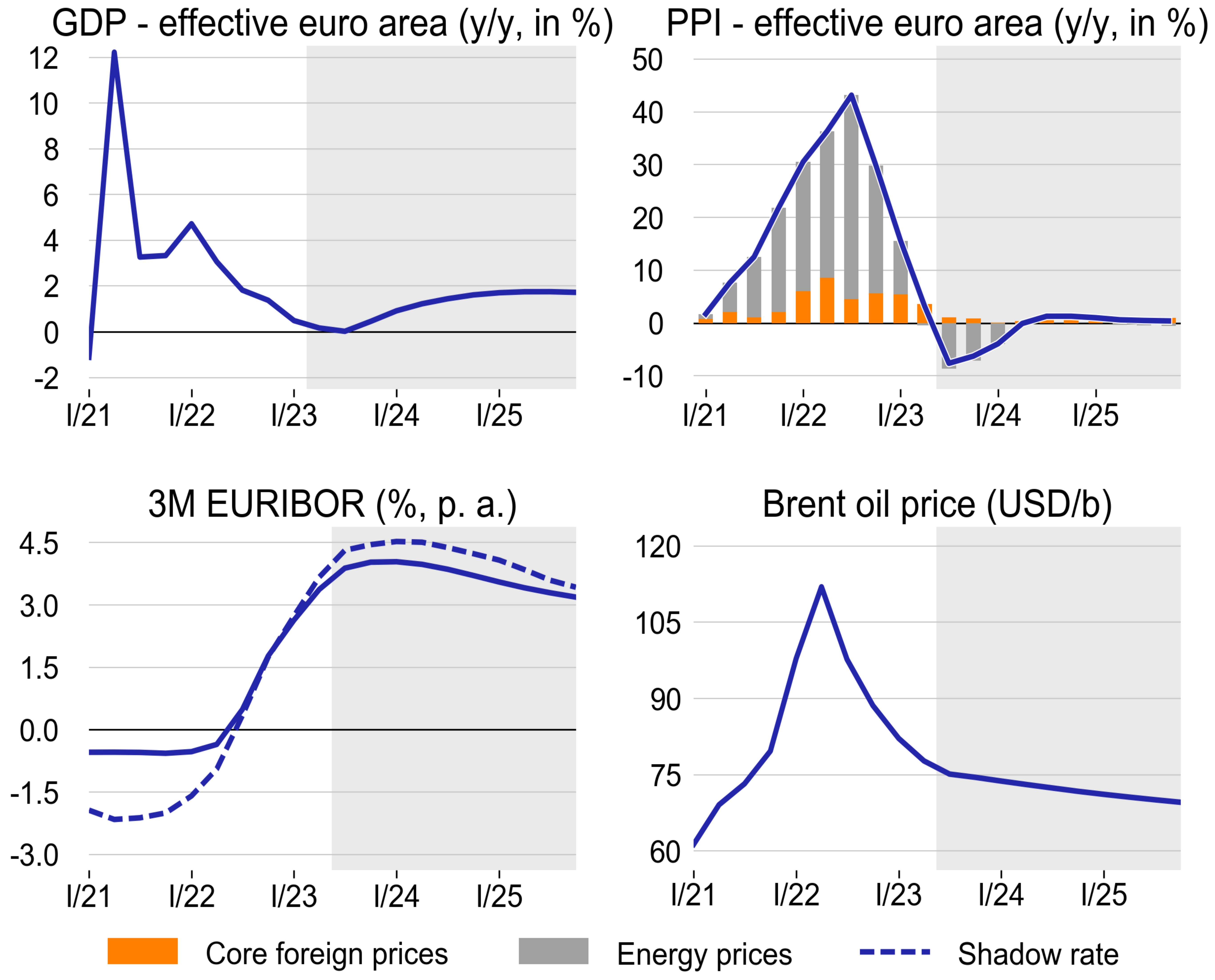
Presentation Outline

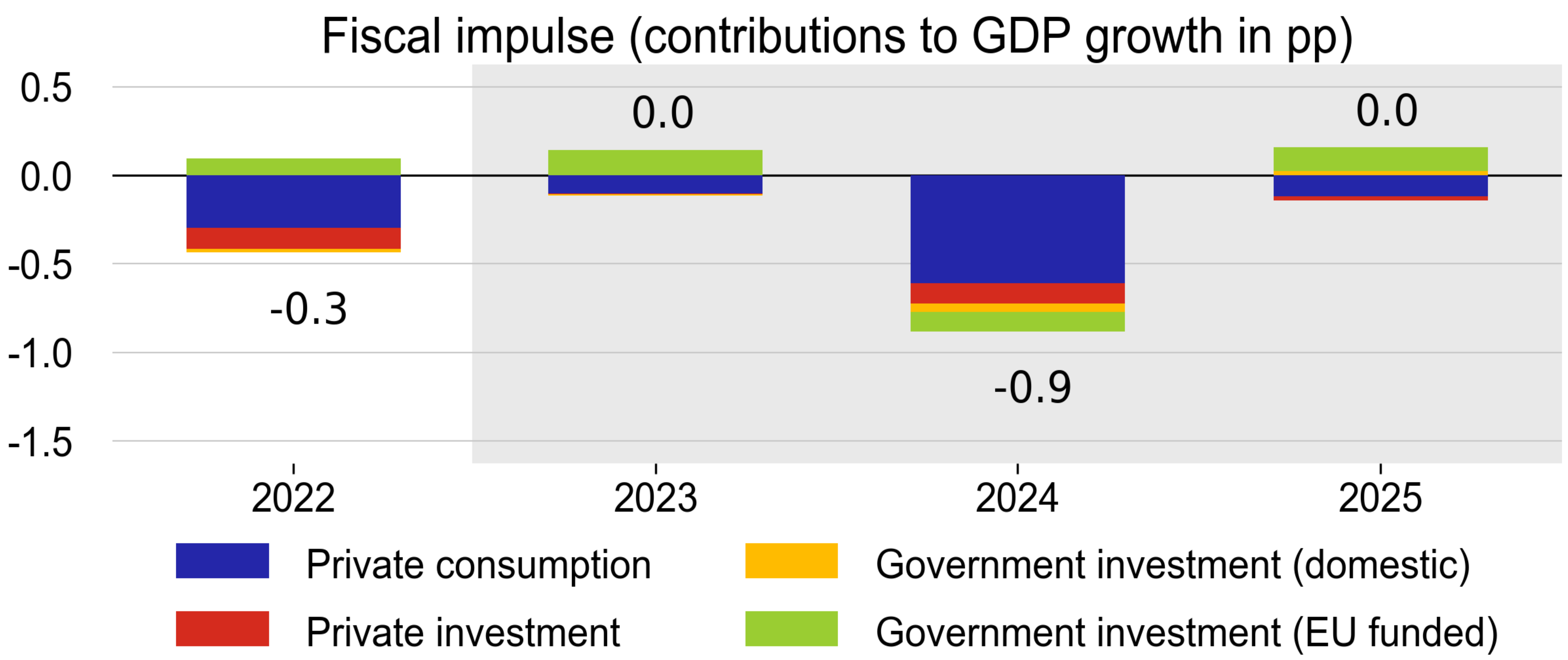
1. **Assumptions of the Forecast**
2. The New Macroeconomic Forecast
3. Comparison with the Previous Forecast
4. Further Scenarios

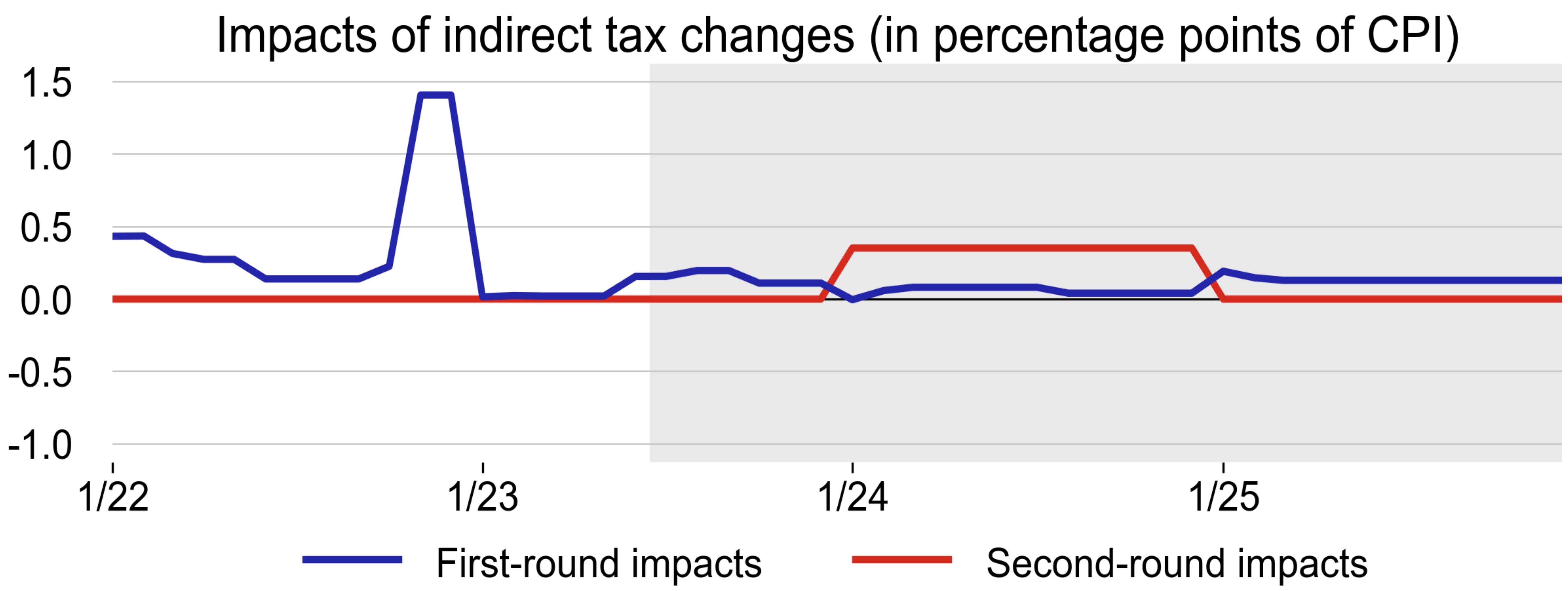
External Environment Outlook



- The slowdown in global demand growth amid tighter monetary conditions will be reflected in a temporary stagnation of the **effective euro area**; growth in economic activity will not recover significantly until 2024.
- The year-on-year decline in **industrial producer prices** in the effective euro area will be driven by the energy component this year.
- The **3M EURIBOR** interest rate outlook reflects further tightening by the ECB, including a reduction of its balance sheet.
- The outlook for the **Brent crude oil** price remains slightly falling.

Fiscal Policy





- **Fiscal impulse** will have a roughly neutral effect on GDP growth this year. The fade-out of some of last year's support measures is offset by the continuation of some of the measures adopted on both the revenue and expenditure sides of public budgets relating to the high inflation and the help with high energy prices.
- In 2024, GDP growth will be dampened noticeably by the definitive termination of support measures, the fiscal consolidation package, a fall in absorption of EU funds and a decrease in pension expenditure.
- In 2025, the overall effect of fiscal policy will be broadly neutral.
- The first-round and direct second-round impacts of **changes to indirect taxes** will mainly reflect the planned measures contained in the government's consolidation package.

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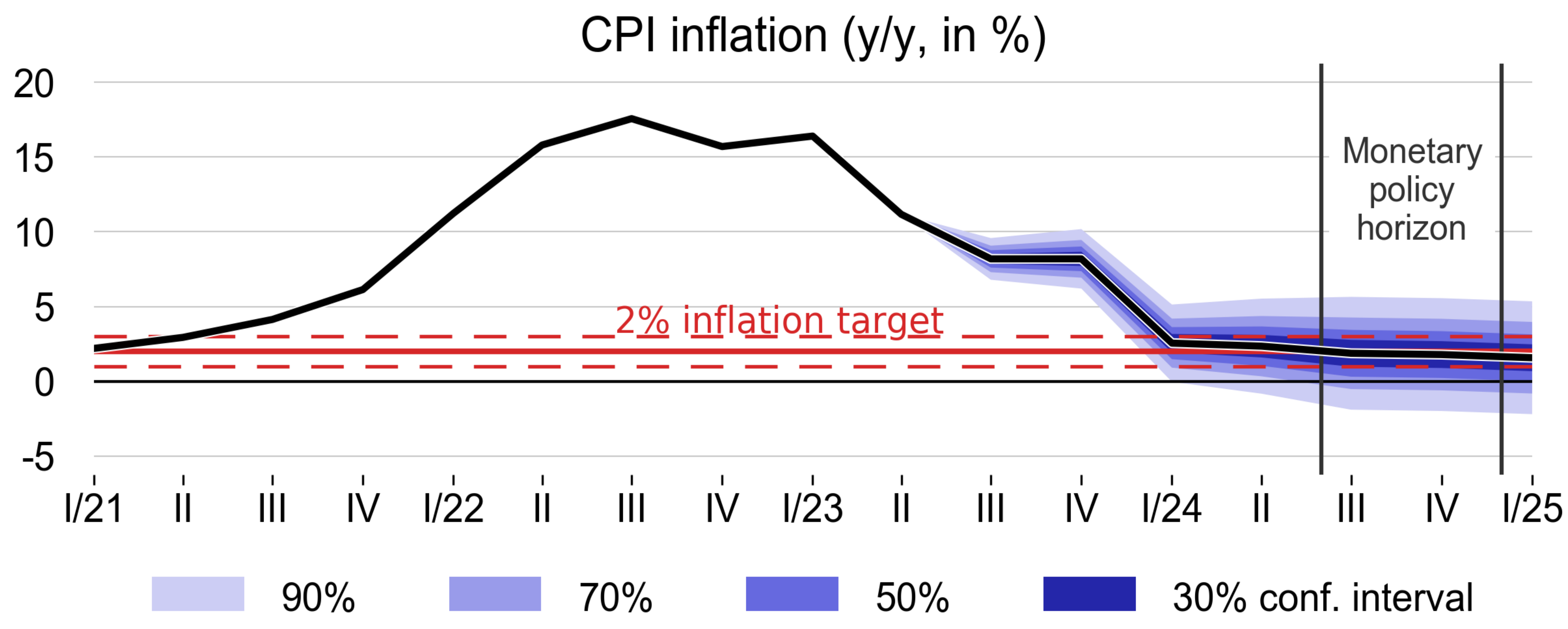
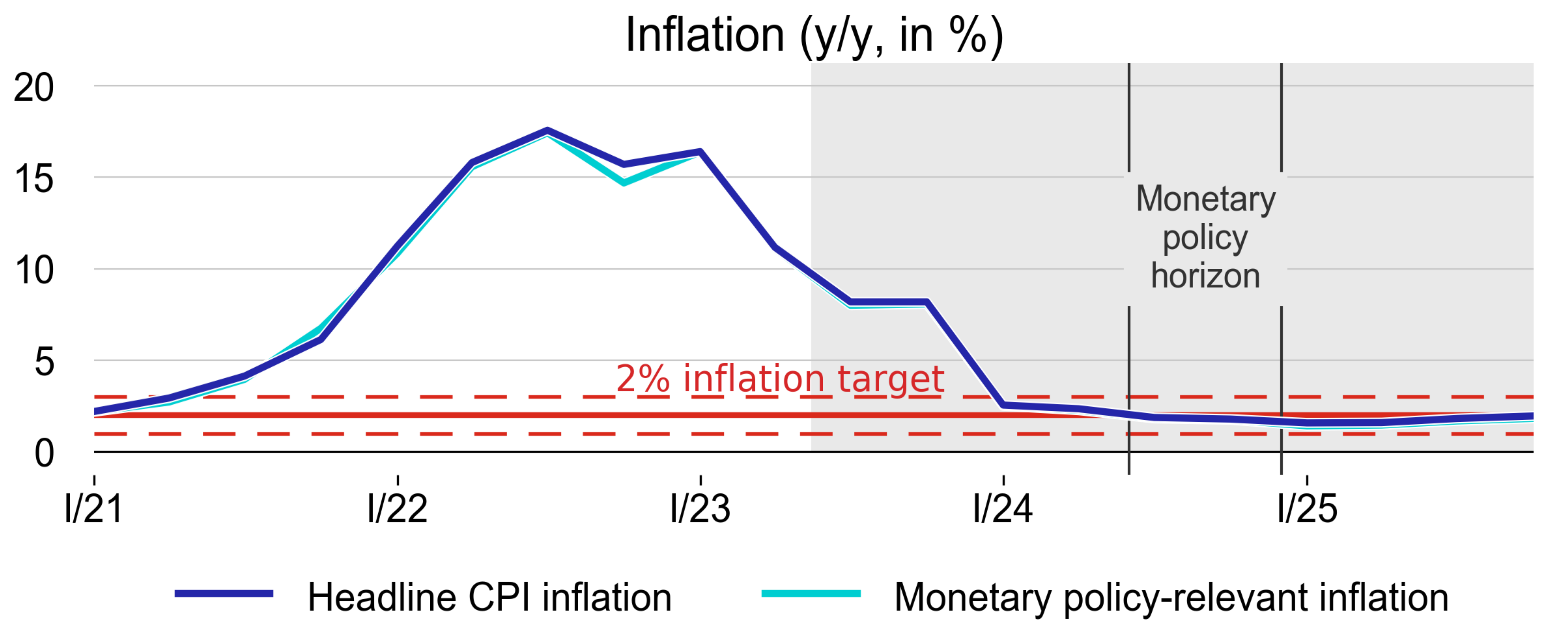
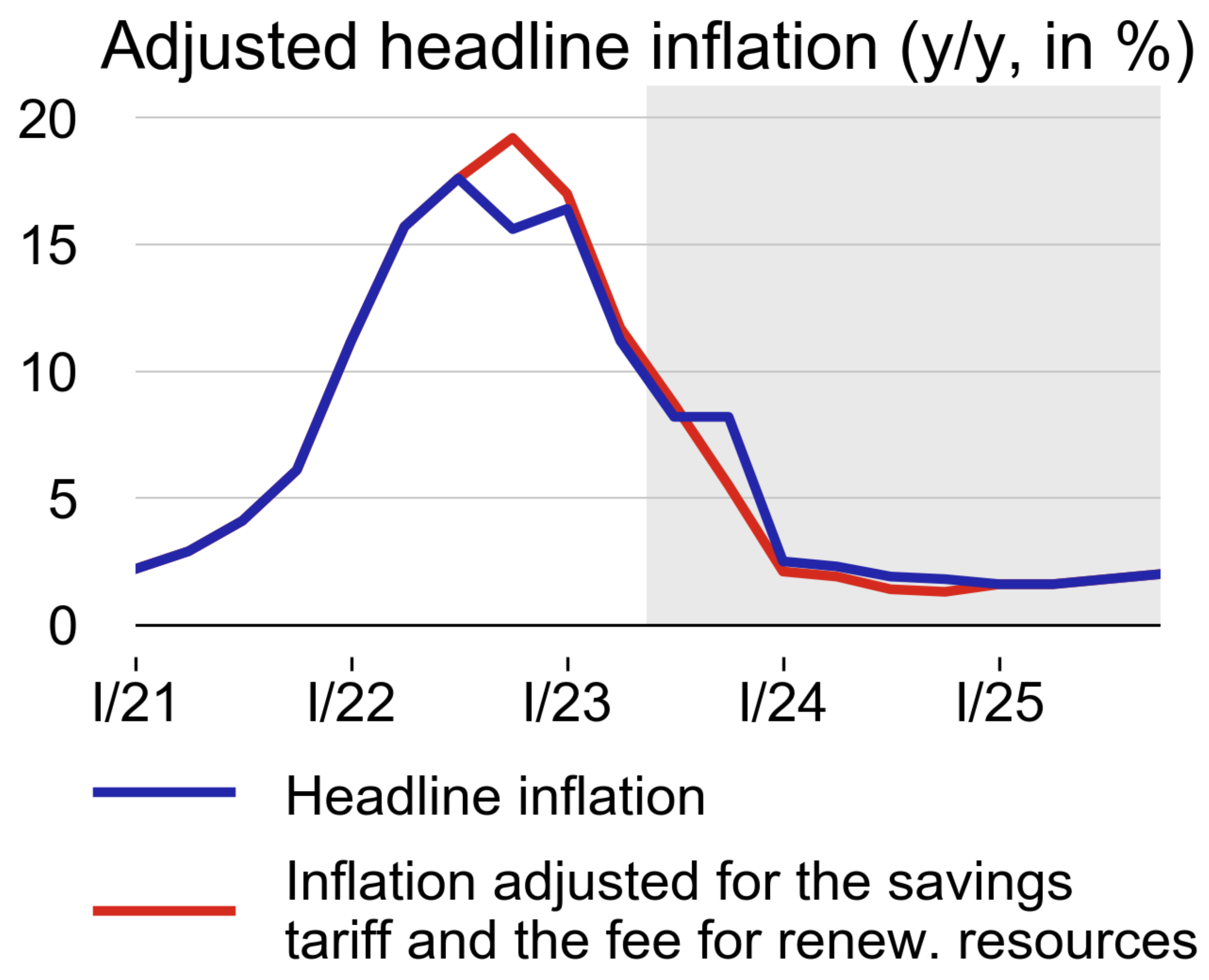
Headline and Monetary Policy-Relevant Inflation

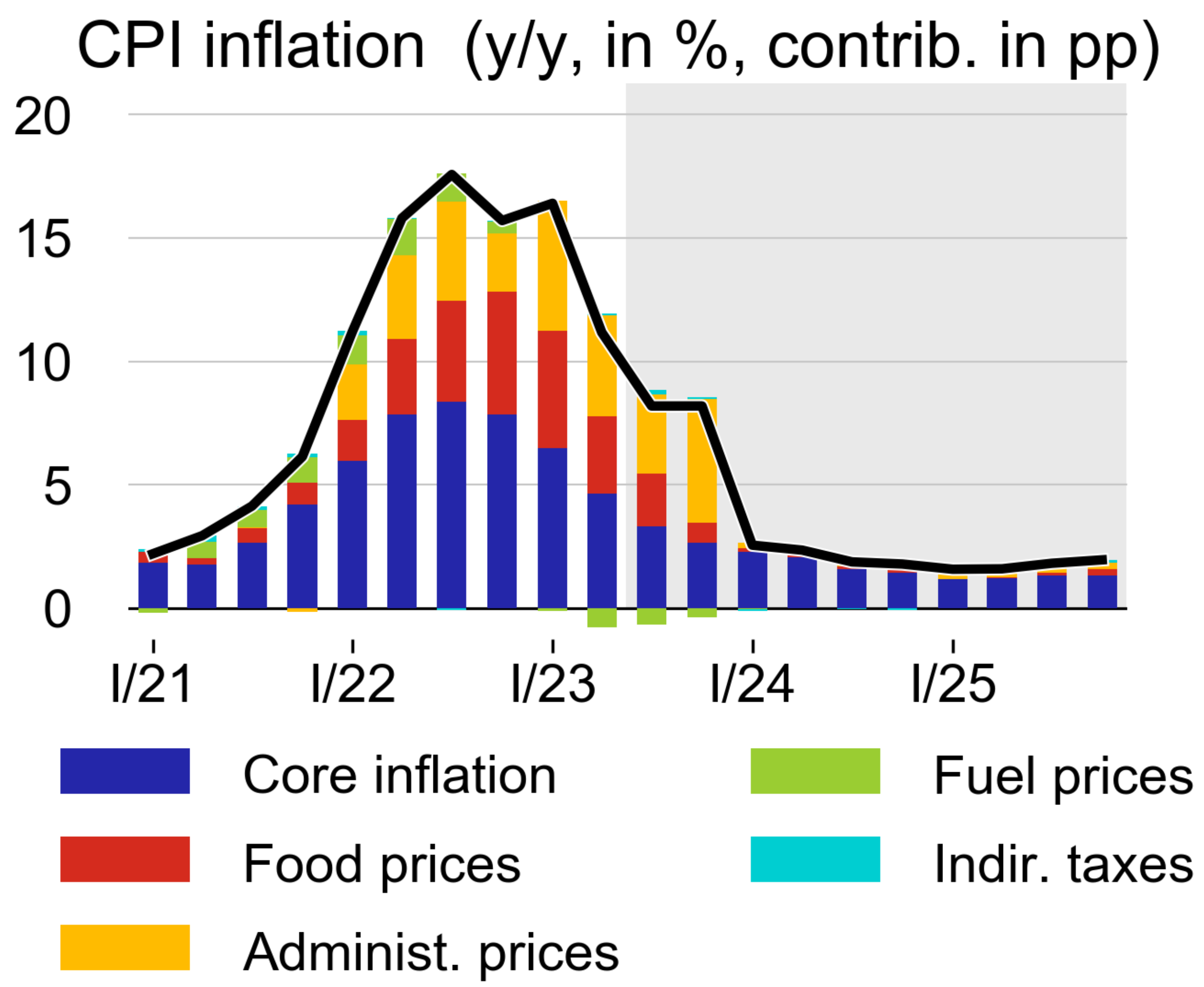


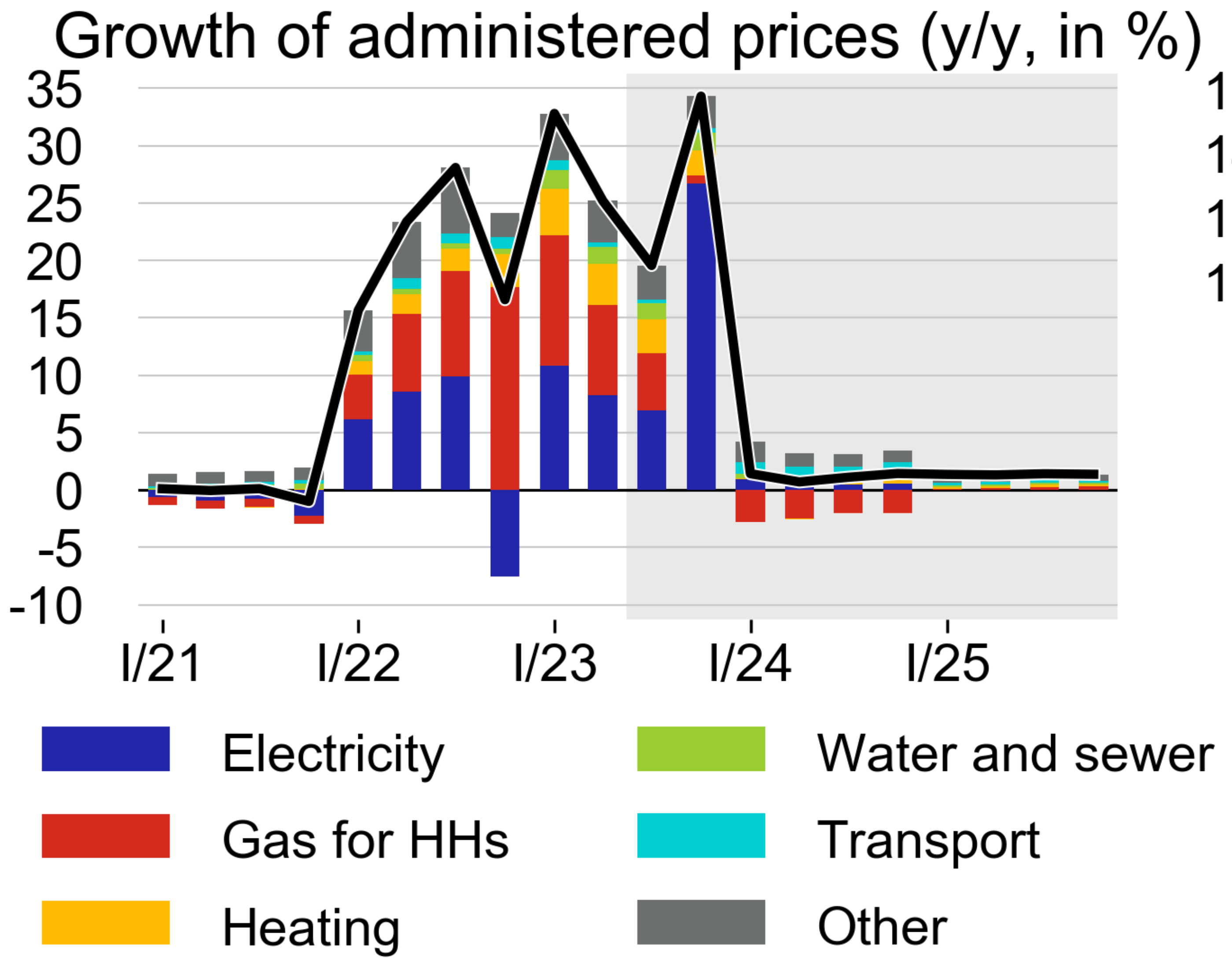


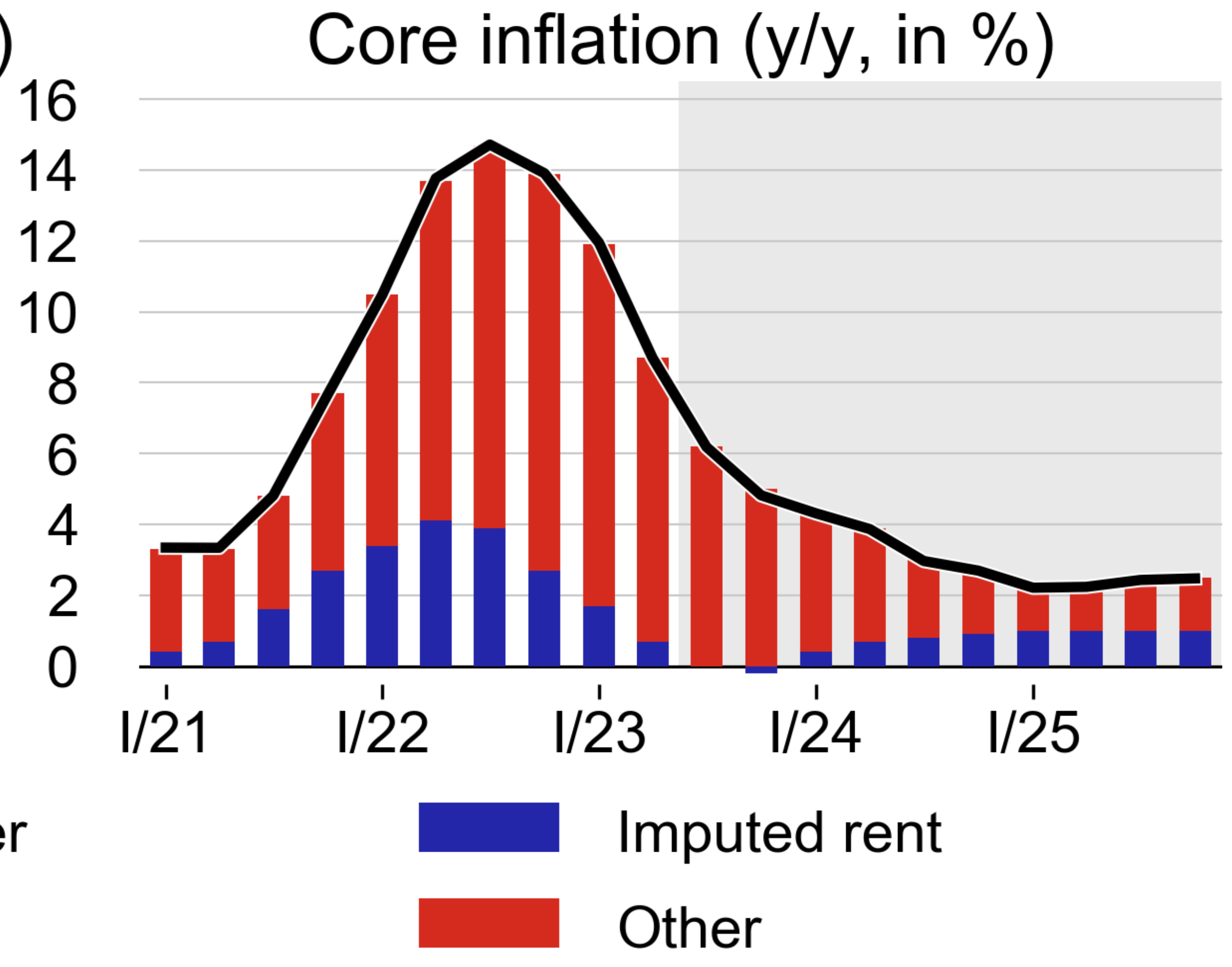
- **Inflation** will slow further in 2023 Q3 and return close to the 2% inflation target at the start of the next year.
  - Growth in market prices will decline due to rapidly falling cost pressures from abroad and a continued easing of price pressures from the domestic economy.
  - The profit margins of domestic producers, retailers and service providers will undergo a gradual correction.
  - The downward trend in annual inflation will halt temporarily in 2023 Q4 on account of base effects due to last year's drop in electricity prices caused by the government's energy savings tariff.
- Headline inflation will be slightly above **monetary policy-relevant inflation**.

Inflation Components, Core Inflation and Admin. Prices





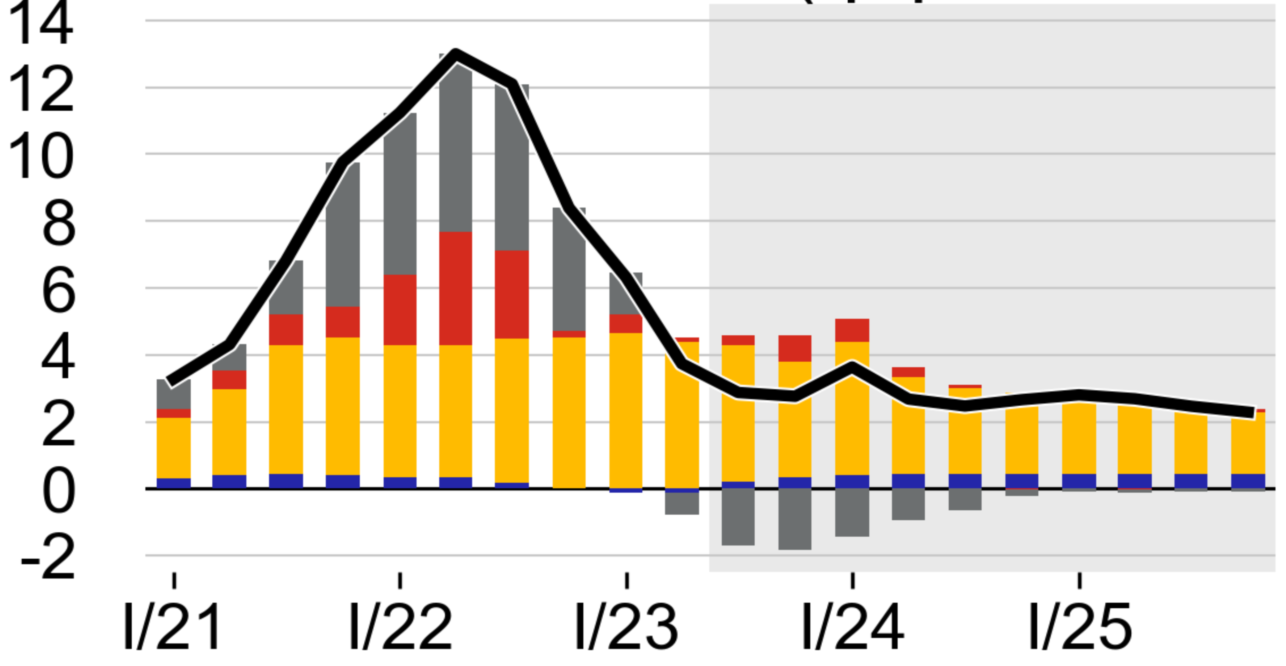




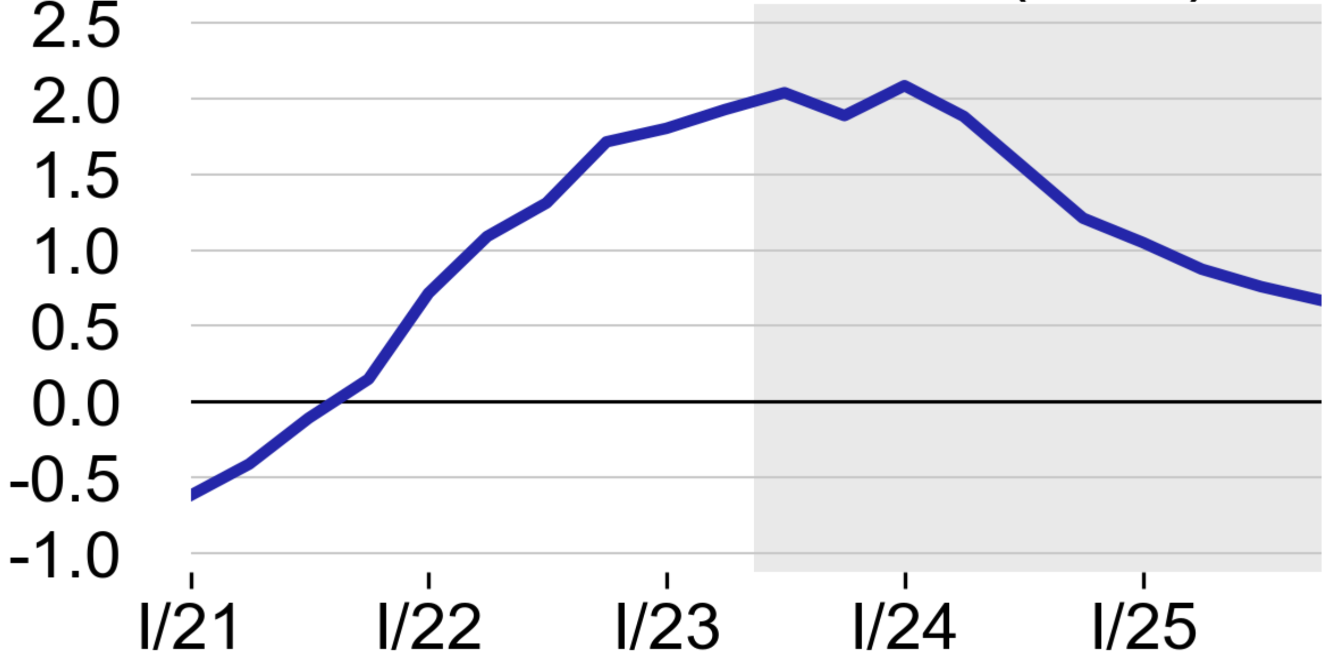
- The government measures to help households with high energy prices affected inflation (via administered prices) most of all in 2022 Q4.
- **CPI inflation** will slow sharply in 2023 Q3 and at the start of 2024, with all components contributing.
- **Administered price inflation** will initially decline. It will rise temporarily at the end of this year on account of a reduced base and will drop sharply at the start of the next year.
- **Core inflation** will slow due to a decline in overall inflation pressures and to the contribution of imputed rent temporarily turning negative.

Cost Pressures and Profit Mark-ups

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

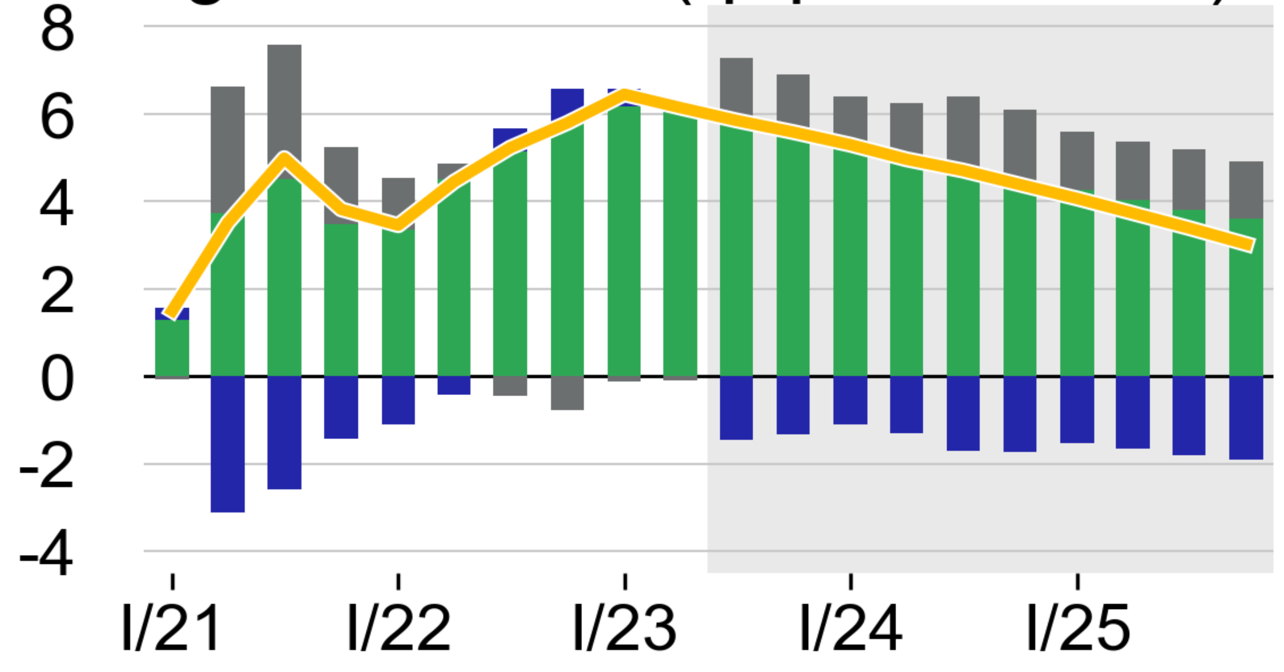


Gap in profit mark-ups
in consumer sector (in %)

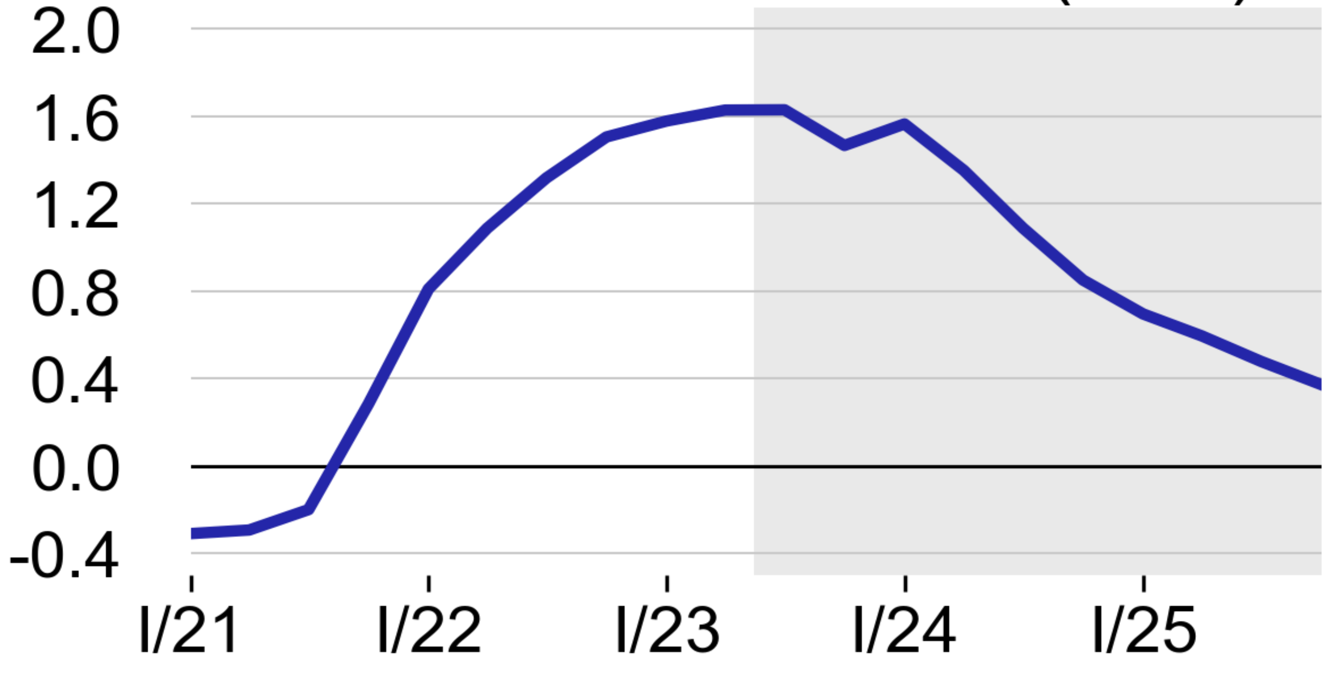


Price convergence
Core import prices
Intermediate goods prices
Energy import prices

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



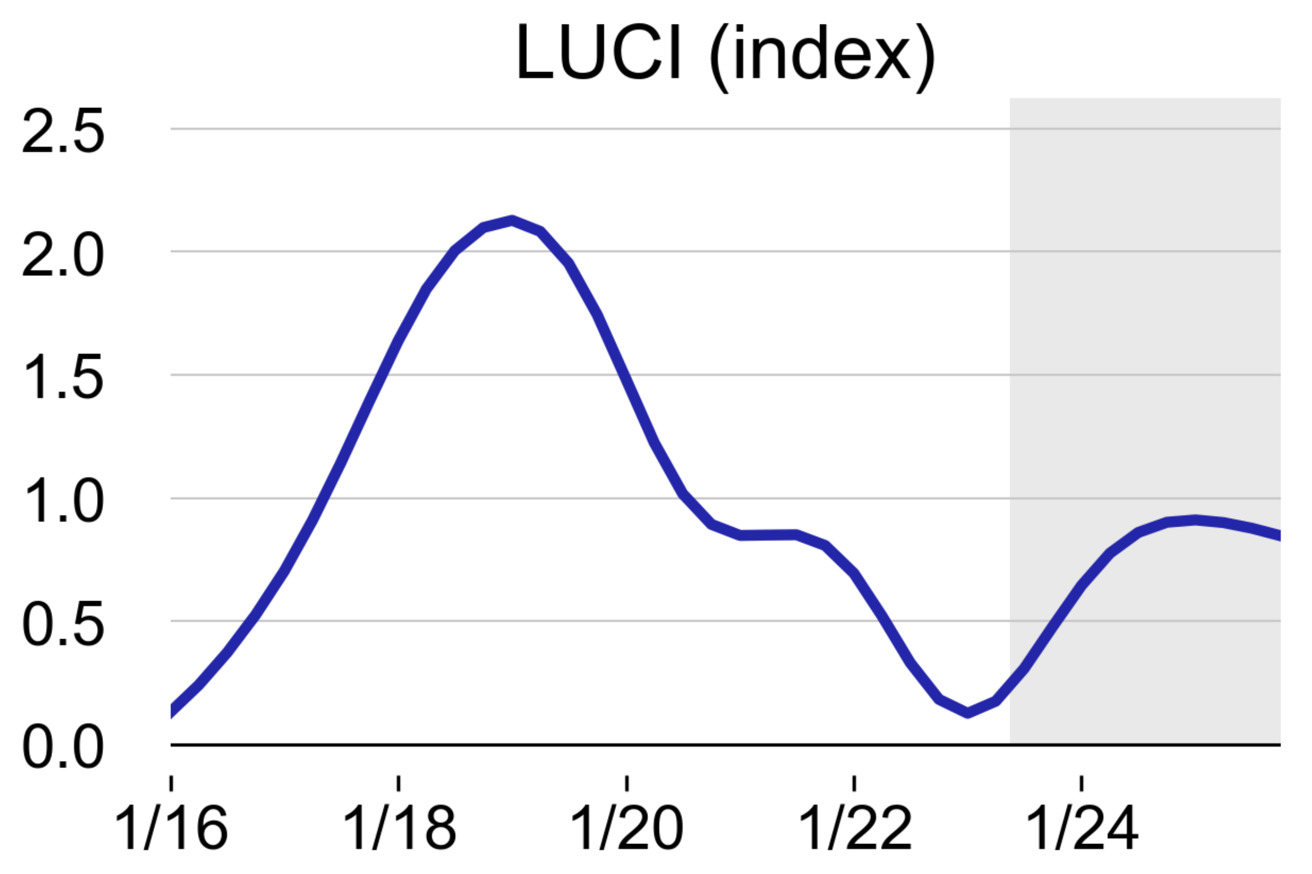
Gap in profit mark-ups
in intermediate sector (in %)

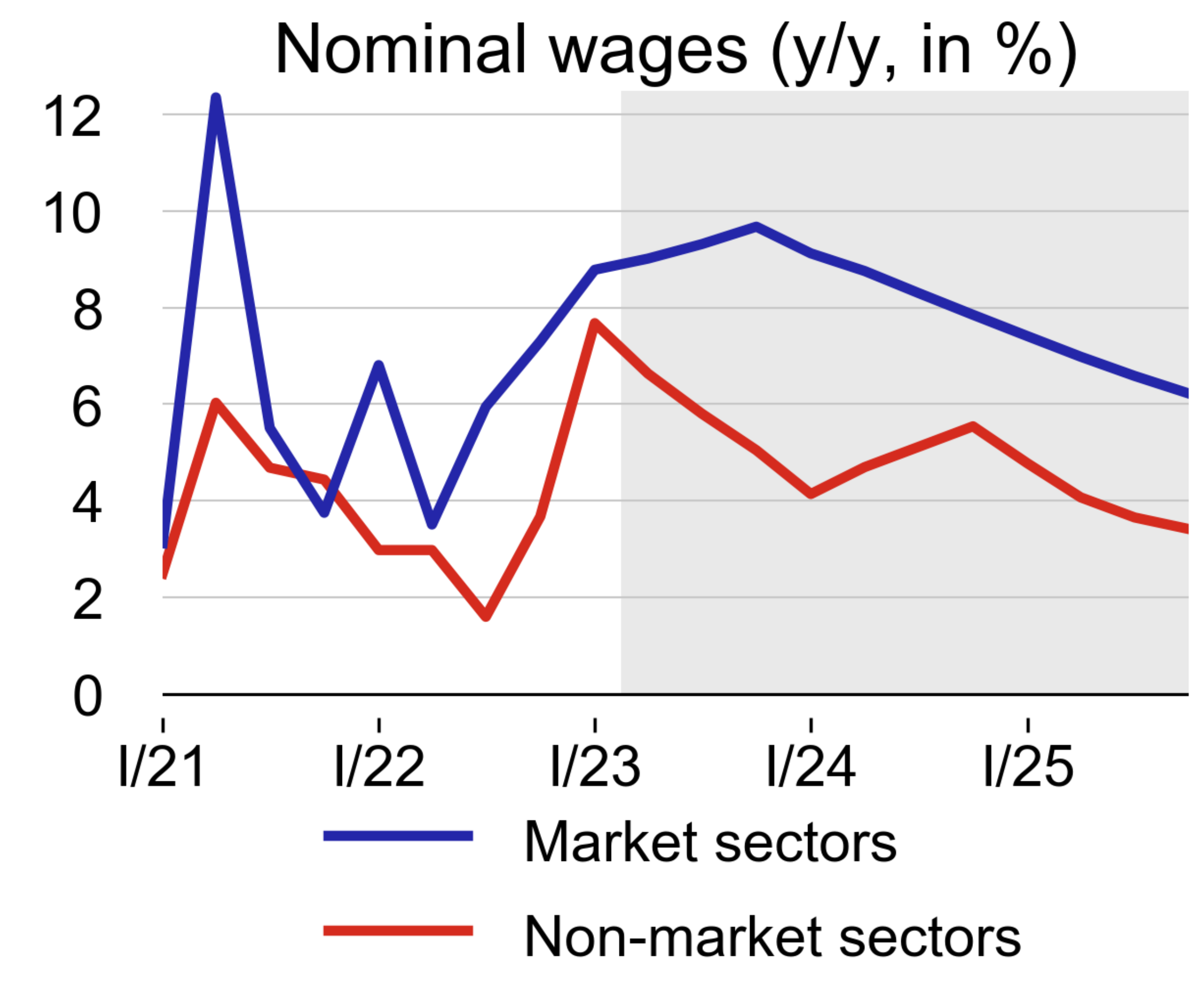


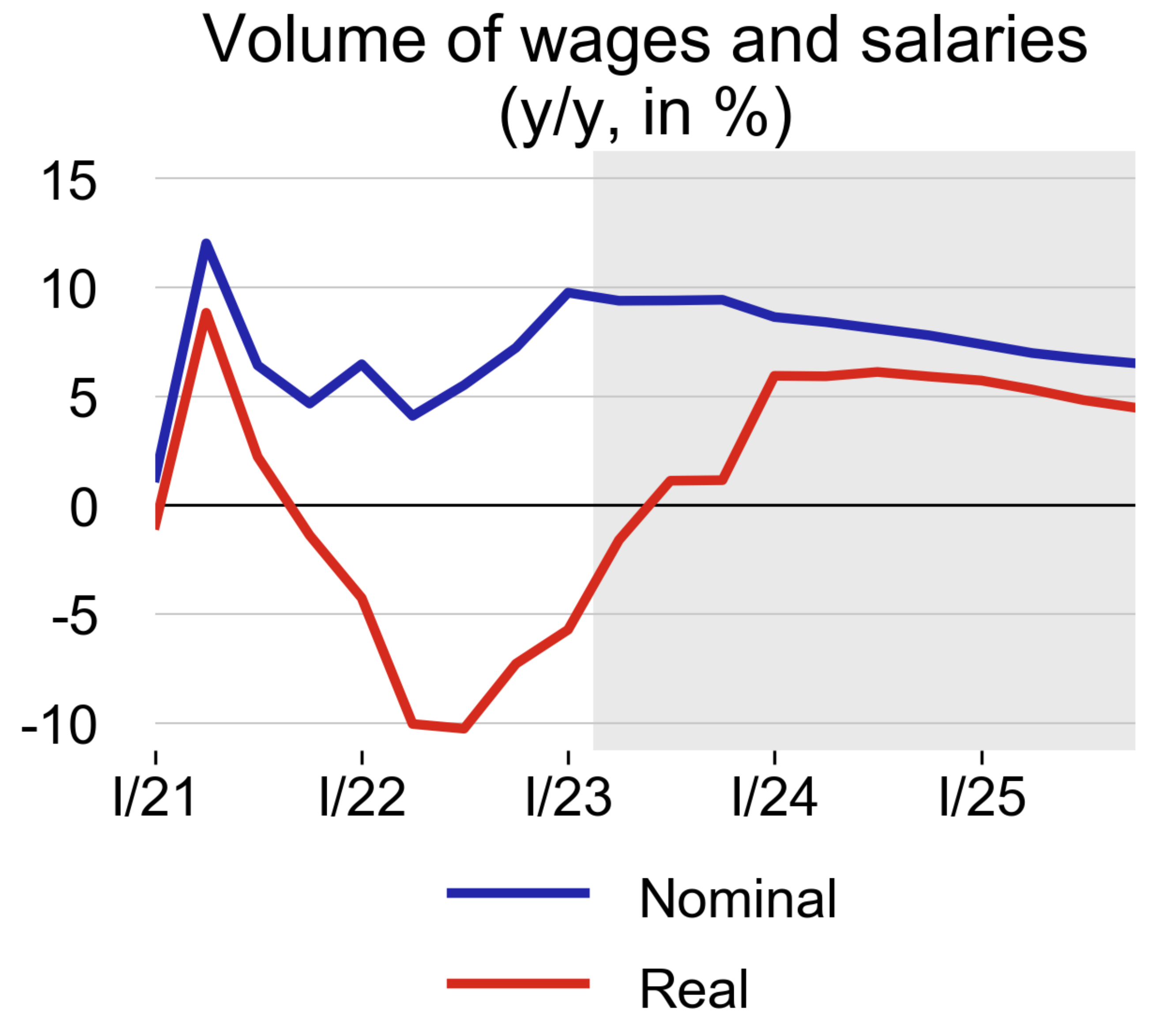
Wages in market sectors
Labor efficiency
Price of capital

- The **overall cost pressures** will mostly continue to ease, due to a drop in energy import prices and a decrease in the contributions of the domestic economy.
- They will increase temporarily at the start of the next year due to the expected positive direct second-round impacts of the changes to indirect taxes reflected in an increased pace of intermediate goods prices growth.
- The **domestic cost pressures** will ease gradually as the high wage growth will steadily fade, but will remain elevated.
- The positive gap in **mark-ups** will start to narrow gradually next year amid only slowly recovering domestic demand dampened by tightened monetary and fiscal policy.

Labour Market

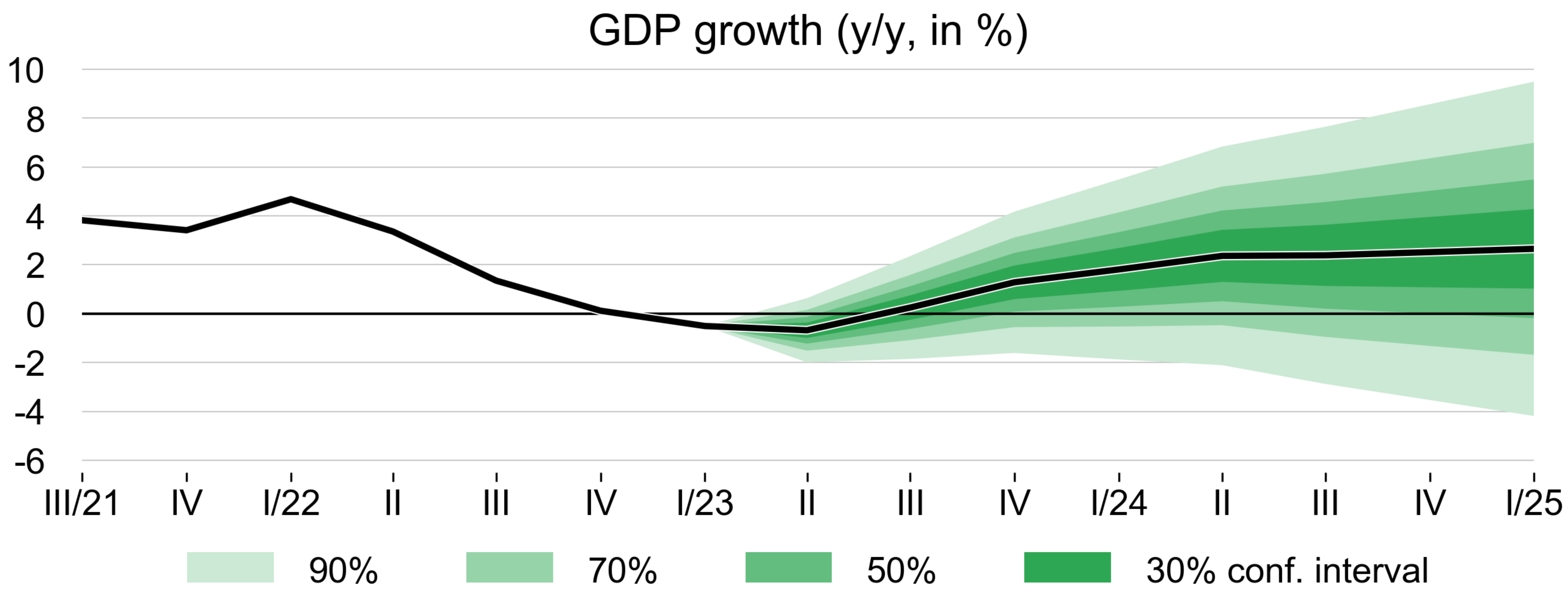


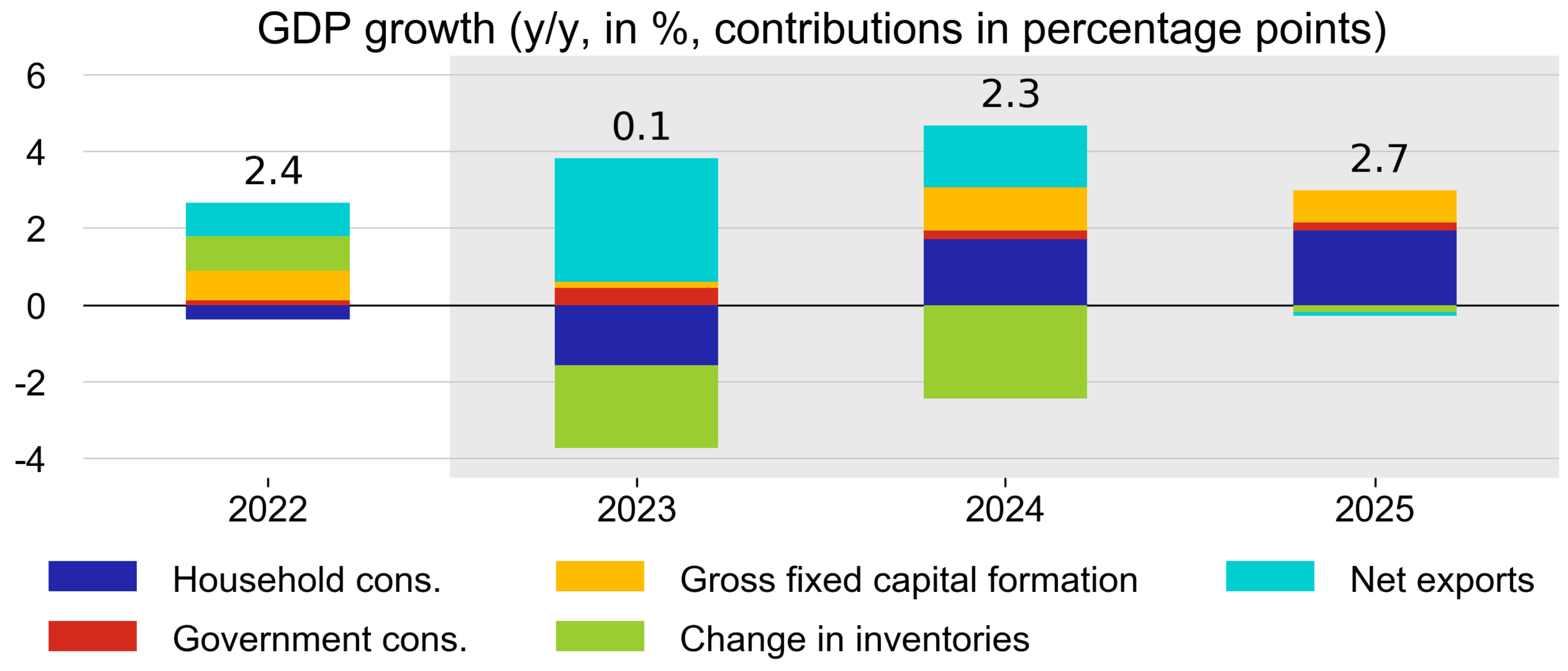




- From the perspective of the **LUCI**, the labour market will not cool any further but conversely will start to overheat again.
- The brisk **nominal wage growth** will recede only slowly, due to the situation in the market sector.
- **Employment** will grow until the end of the year. The **general unemployment rate** will increase only very moderately.
- **Growth in the real volume of wages and salaries** will turn positive again in mid-2023 and thus help household consumption to recover.

GDP Growth Forecast

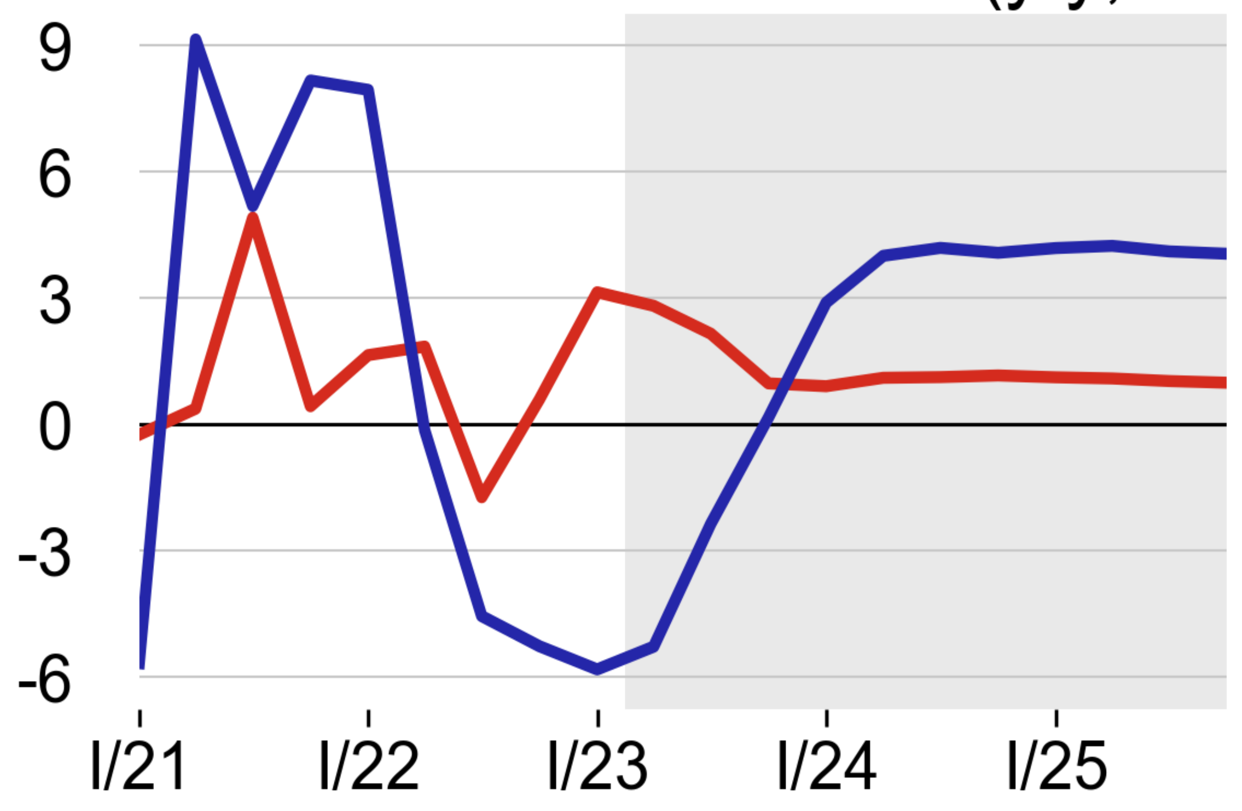




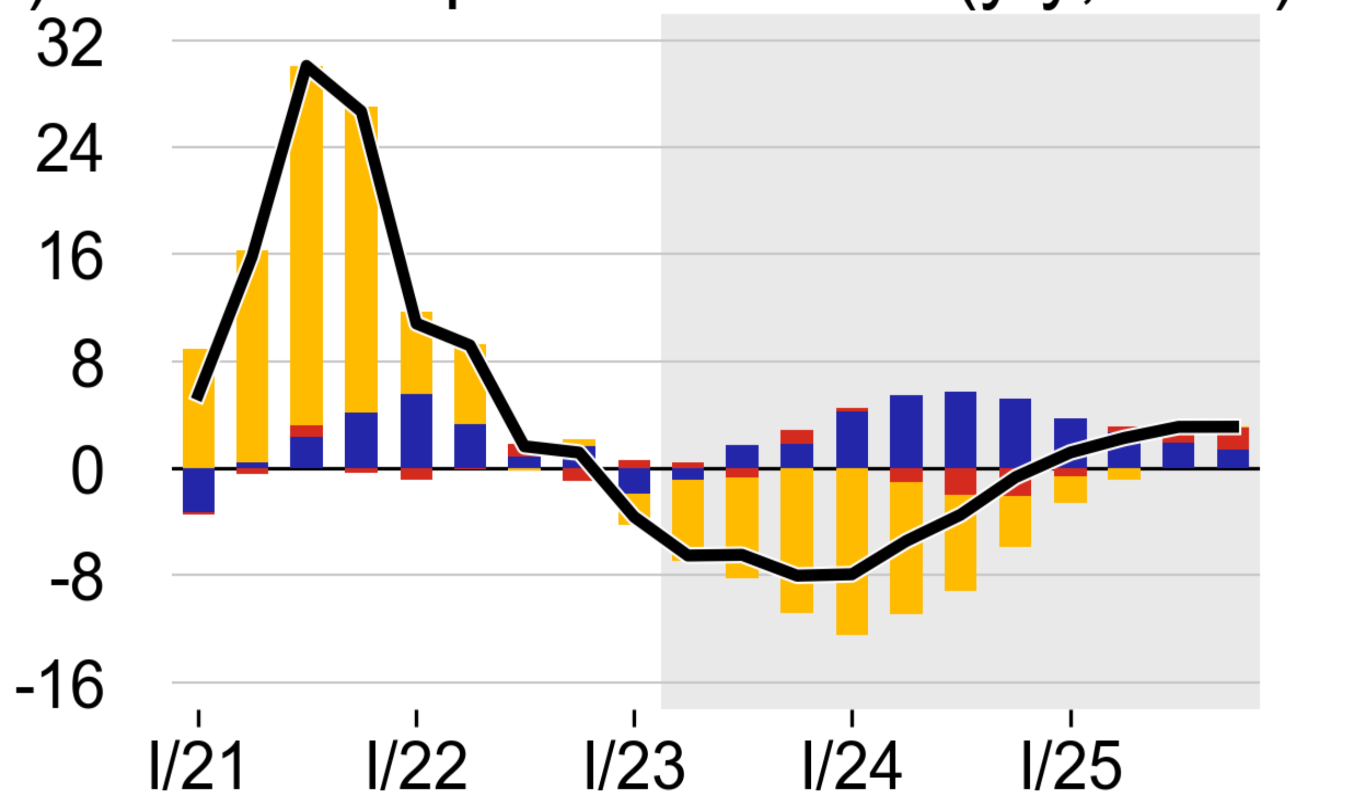
- **Economic activity** will be broadly flat this year due to subdued performance in the first half of the year; next year economic growth will be driven by a recovery in household consumption.
- This year, **GDP** will roughly stagnate in whole-year terms. It will grow in 2024 and 2025 by about 2.5%.
- According to a preliminary CZSO estimate, Czech GDP decreased by 0.6% y/y in 2023 Q2 and increased by 0.1% q/q, which is roughly in line with the CNB forecast.

GDP Components

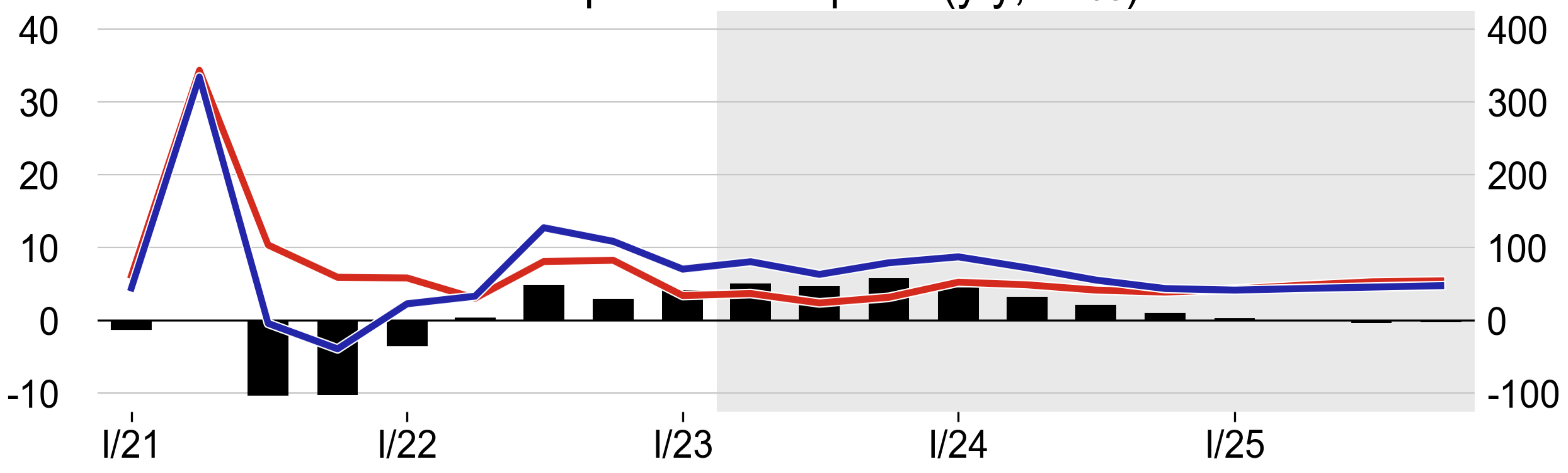
Household and Gov. cons. (y/y, in %)



Gross capital formation (y/y, in %)

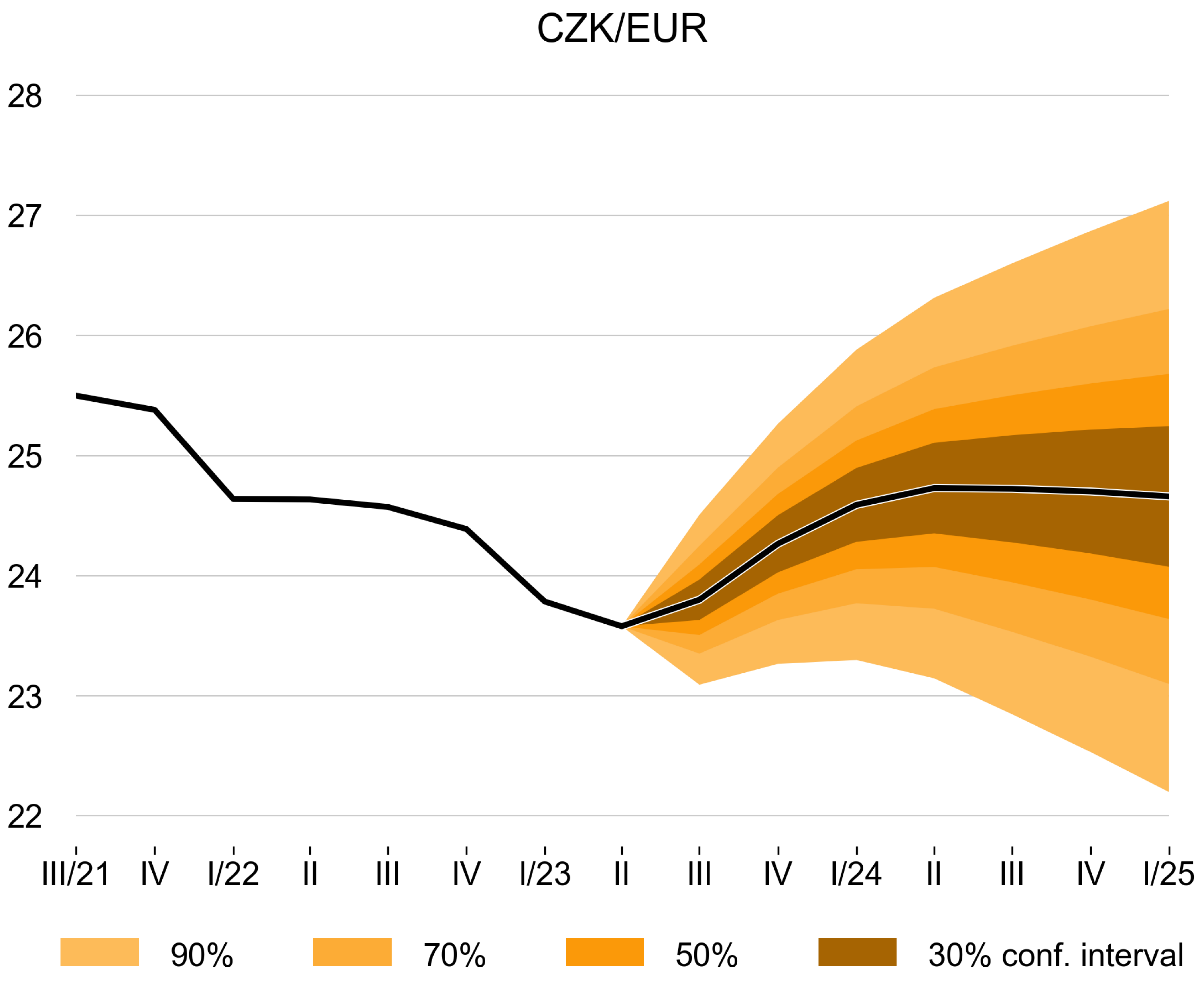


Real exports and imports (y/y, in %)



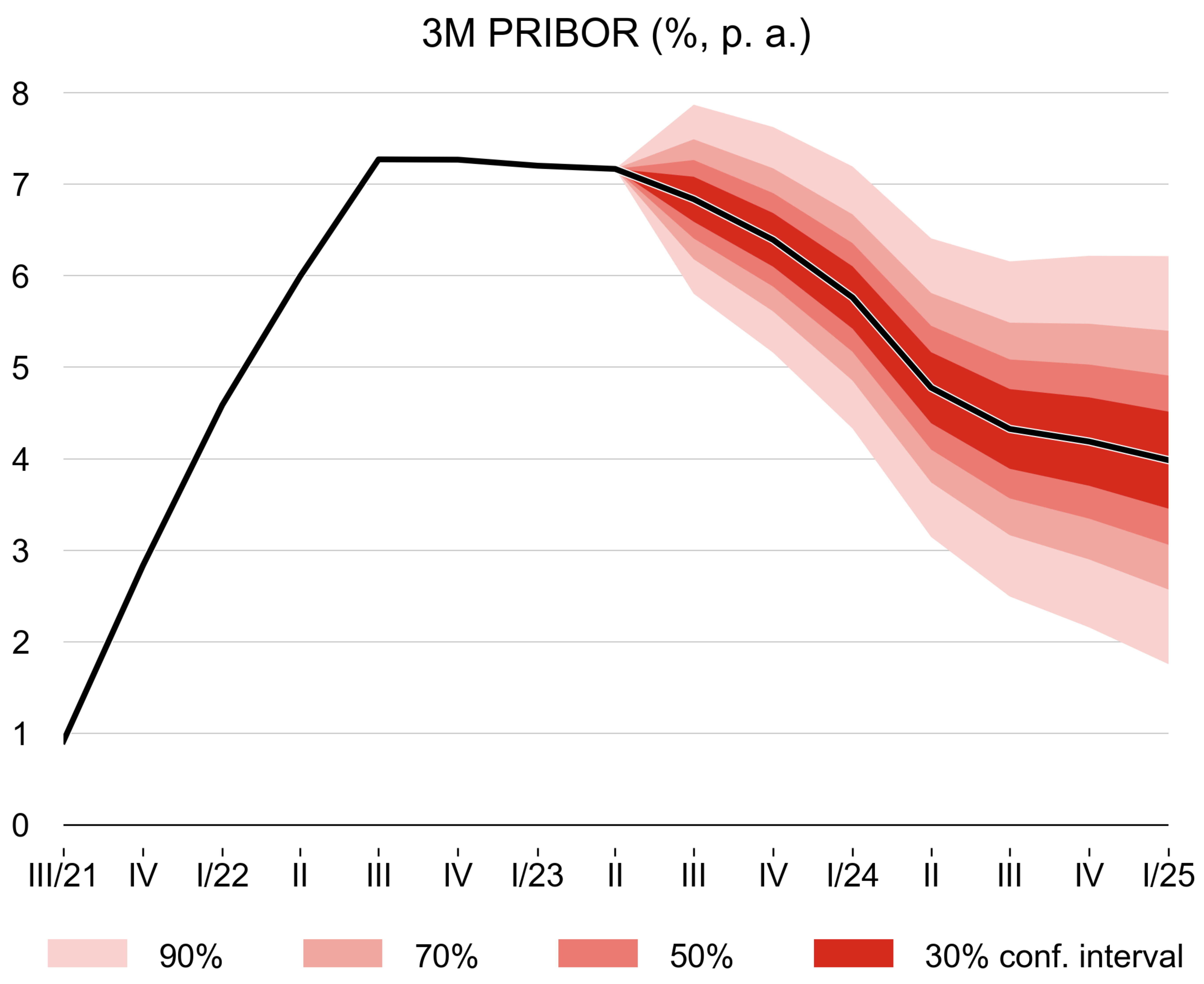
- **Household consumption** will keep falling in year-on-year terms for most of 2023 and start to grow again only at the year-end.
- Real household income will continue to rise next year. Together with a drop in the saving rate, this will result in brisk growth in consumer demand.
- **Government consumption** will grow at a subdued pace.
- **Growth in total gross investment** will be affected predominantly by **additions to inventories** until the end of 2024.
- **Imports** and above all **exports** will achieve solid growth rates due to the unwinding of supply chain problems and later a recovery in external demand, and in the case of imports also domestic demand.

Exchange Rate CZK/EUR



- The forecast expects the **koruna** to average CZK 23.8 to the euro in 2023 Q3 and gradually weaken to just above CZK 24.5 to the euro in the quarters ahead.
- It will be affected by a receding of the wave of positive **sentiment** and a **narrowing interest rate differential** vis-à-vis the euro area, which will have a weakening effect.
- A more pronounced depreciation of the koruna will be prevented by a renewed trade surplus due to the fade-out of the issues in global value chains and a lessening of the immediate economic and inflationary impacts of the war in Ukraine.

Interest Rate Path (3M PRIBOR)



- Consistent with the summer forecast is a decline in **market interest rates** over the entire outlook.
- This is in line with the fading of extraordinary inflation pressures from the external environment and with the second-round effects of high inflation in the domestic economy.
- The switch of foreign price pressures in the production sector to a deflationary effect combined with a gradual moderation of the high domestic inflation will result in consumer price inflation falling to close to the target at the start of next year. Inflation will remain close to the target at the monetary policy horizon, i.e. in the 2H 2024.
- This opens up room for monetary policy to be eased gradually.

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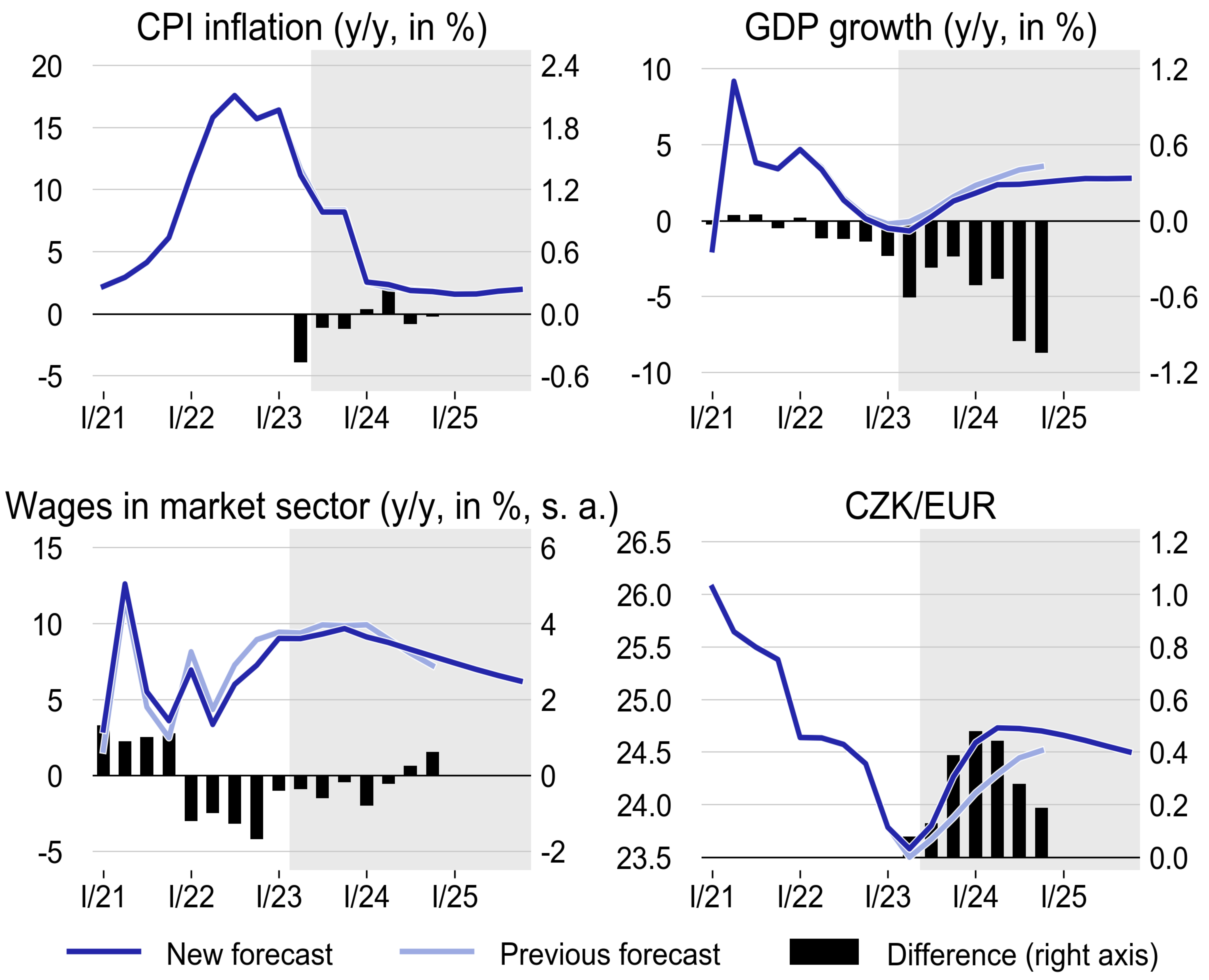
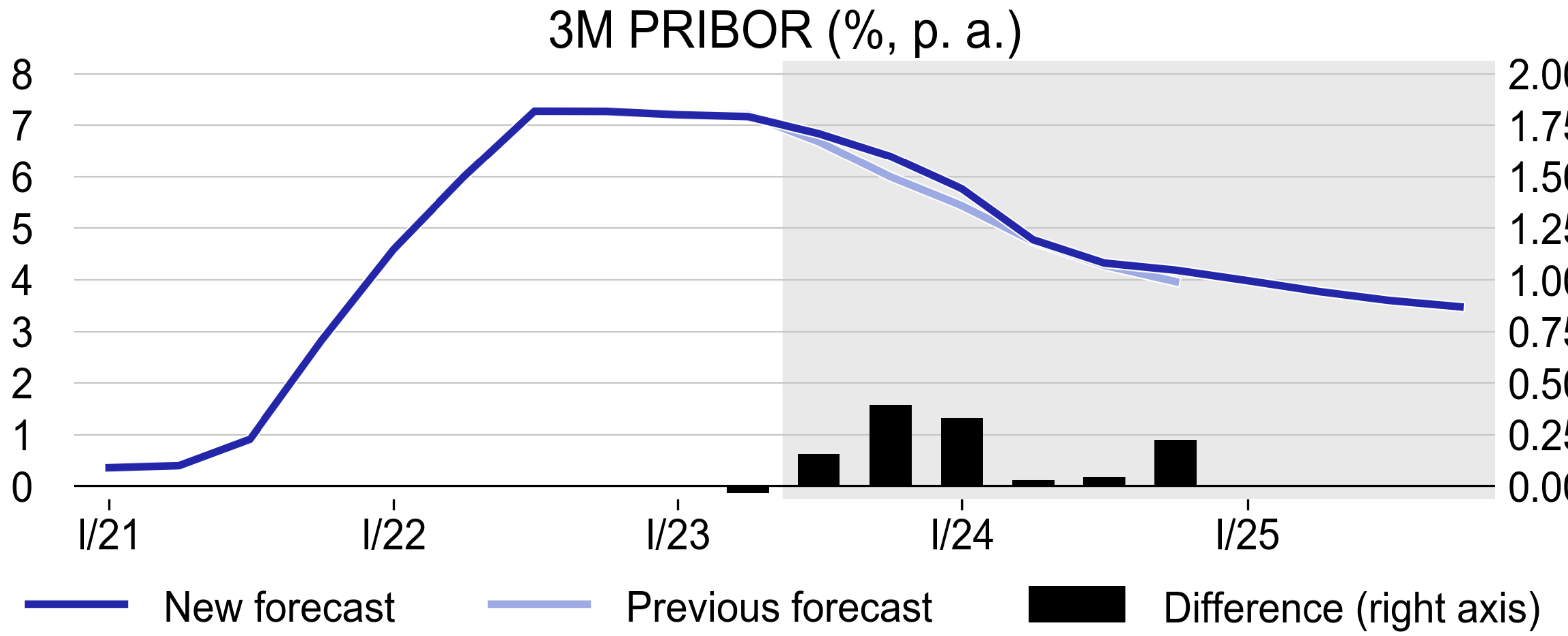
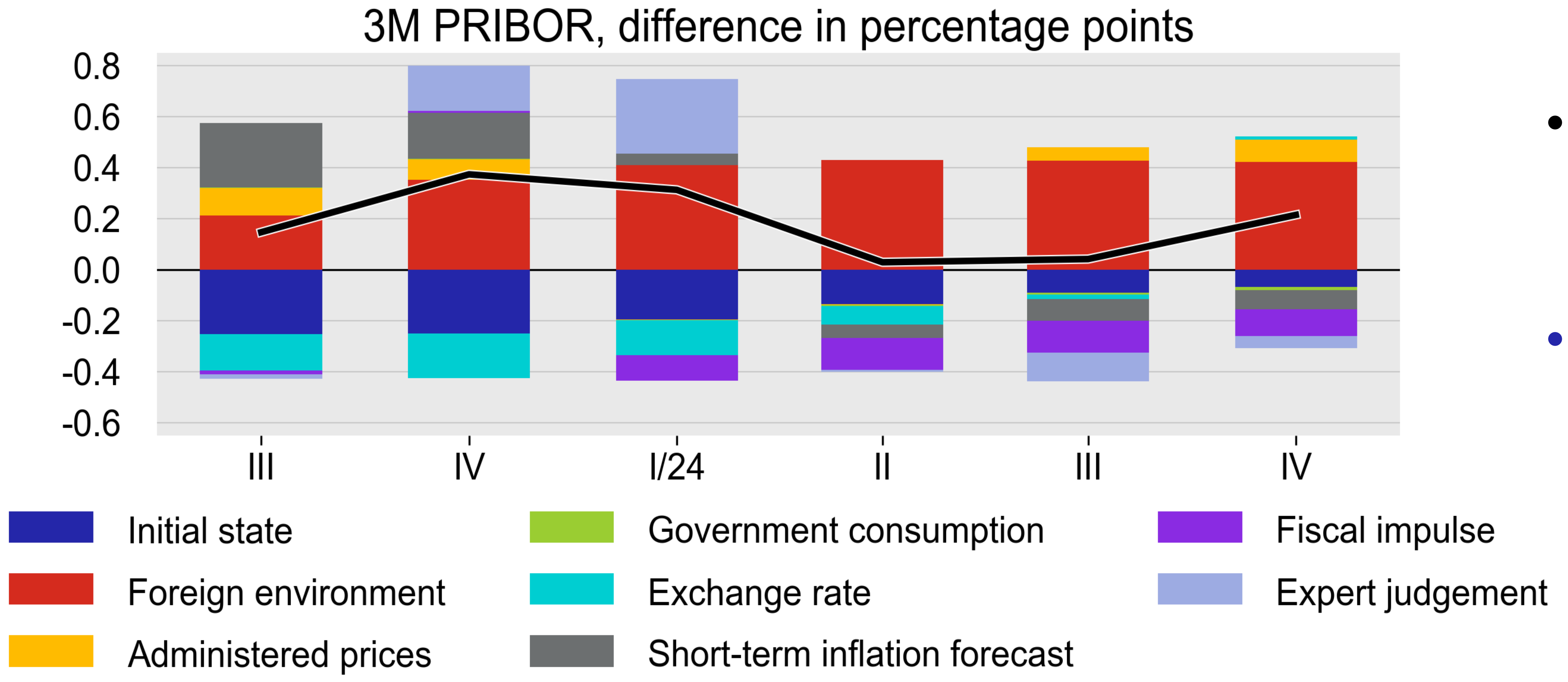
Comparison with the Previous Forecast: Domestic Economy



- The slight downward revision of the **inflation** forecast this year is due mainly to lower core inflation.
- The **GDP growth** outlook is lower due to lower expenditure on most of its components; economic activity will be dampened by the consolidation package next year.
- This year's slightly lower **wage growth** reflects the weaker wage growth observed at the start of this year.
- The shift in the **exchange rate** to weaker levels reflects a more quickly narrowing **interest rate differential** vis-à-vis the euro area. The nearer end of the forecast horizon is impacted mainly by weaker observed levels.

Comparison with the Previous Forecast: 3M PRIBOR





- **The initial state** fosters slightly lower rates due primarily to lower energy import prices.
- **The foreign environment** mainly reflects a more pronounced expected tightening of ECB monetary policy, which will outweigh the effect of a somewhat deeper decline in the energy component of foreign PPI.
- **The short-term exchange rate forecast** for 2023 Q3 causes a downward revision. Conversely, **the short-term inflation forecast** fosters higher rates this year.
- The positive contributions of **administered prices** reflect the expected increase in the price of the road toll vignette at the start of 2024.
- **Expert adjustments** first foster higher rates (inflationary effect of the expected immediate impacts of changes to indirect taxes). Next year, expert adjustments in the direction of stronger exchange rate prevail over slower closure of the gap in mark-ups.

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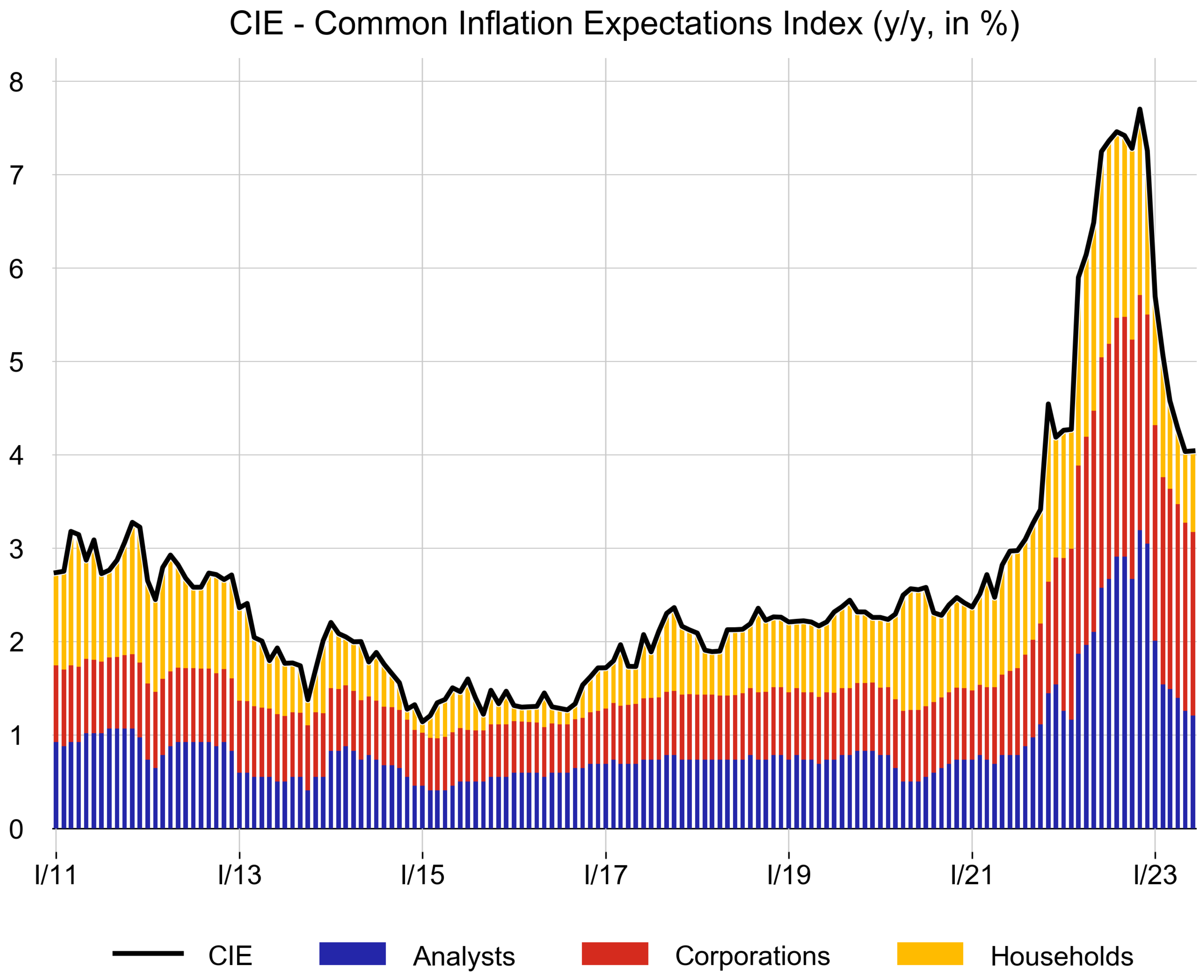
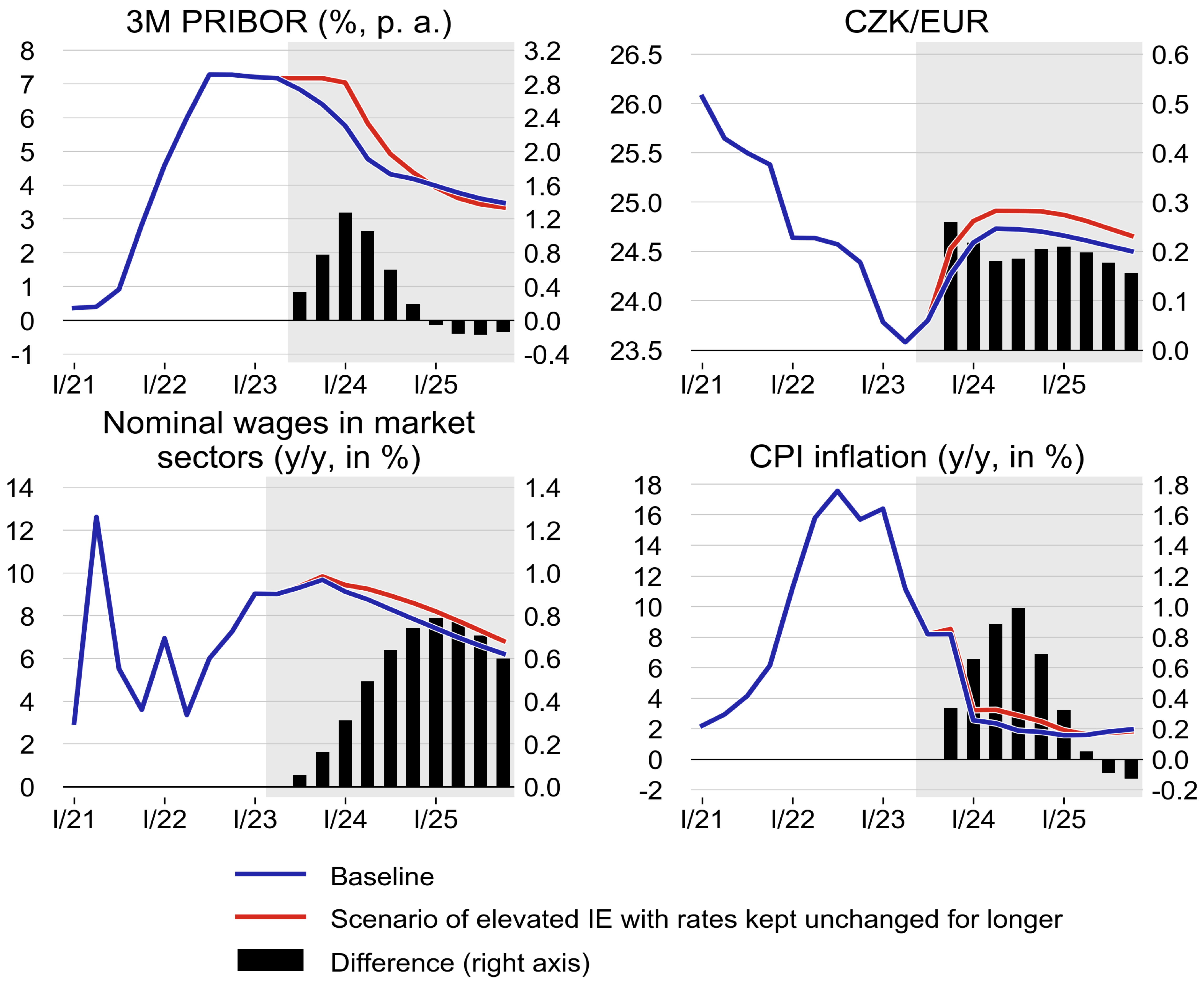
Modelling Elevated IE Using the CIE Index



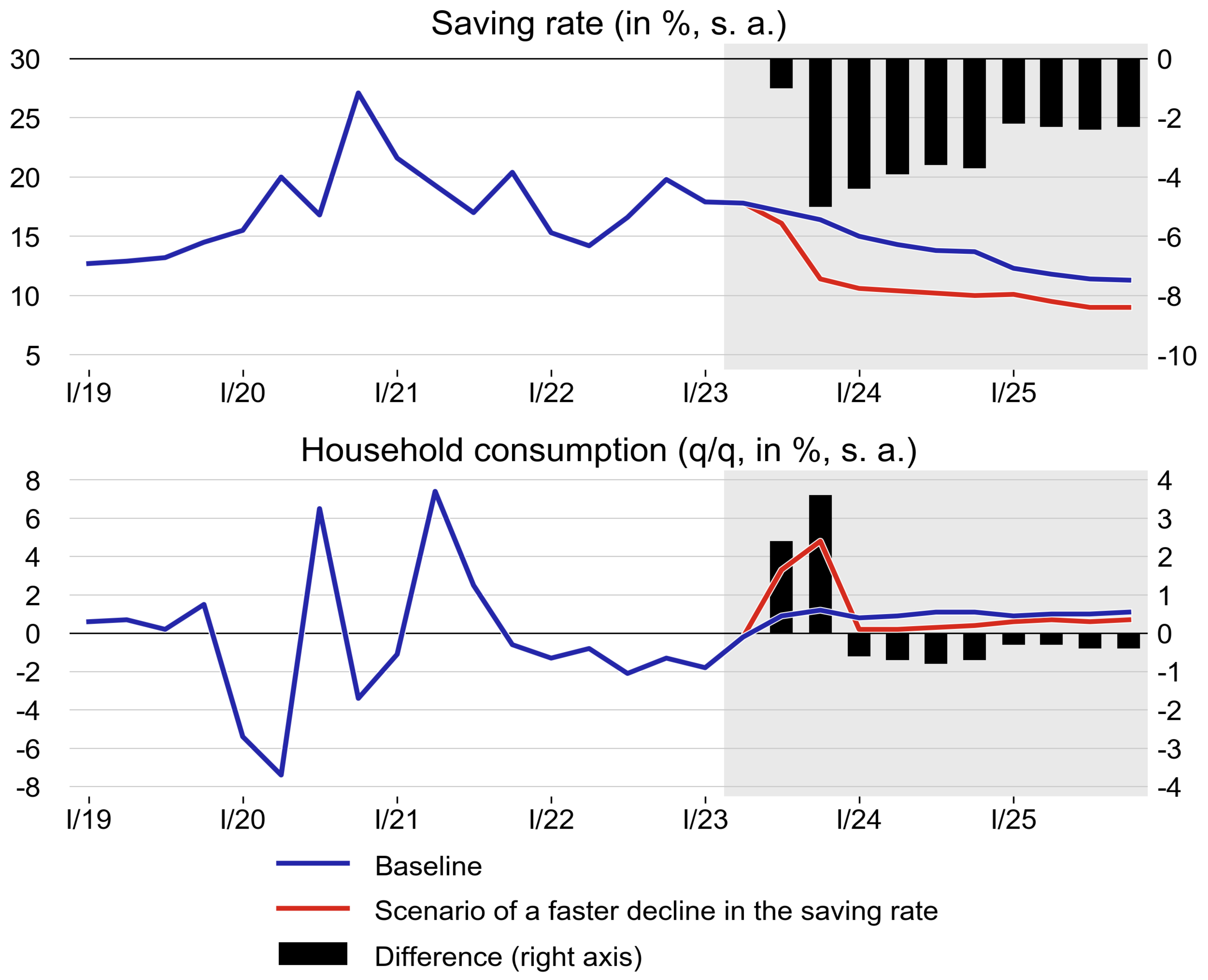
- As in the spring forecast, the approach to modelling elevated inflation expectations uses the **Common Inflation Expectations (CIE)** index which aggregates data on the expected change in inflation one year ahead taken from surveys of IE of the **financial market, businesses** and **households.**
- The values of the index are used as a source of information for making adjustments to inflation expectations in the extended g3+ model.
- The calibration of the adjusted model was chosen so that inflation expectations in the model approximate the course of the CIE index in recent quarters and especially in 2023 Q2.

Scenario of Elevated IE with Unchanged Rates Kept for Longer



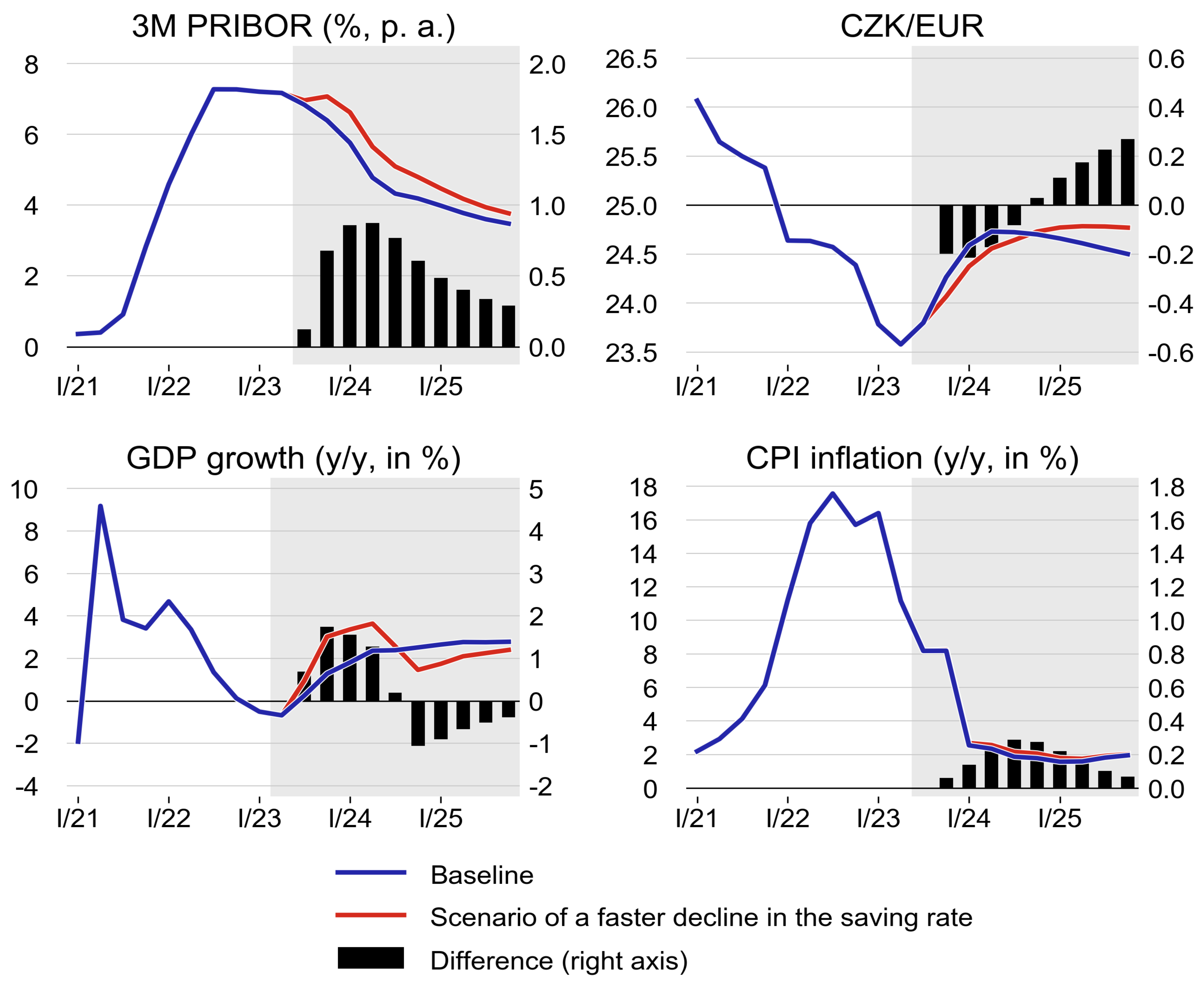
- In addition to the elevated inflation expectations, the scenario assumes that **3M PRIBOR** market interest rates stay at 7.2% until the end of this year.
- The elevated **inflation expectations** fundamentally affect economic agents' decisions, generating additional inflation pressures in the economy.
- The central bank leaves **interest rates** unchanged. However, this response is not sufficient to offset the effect of the elevated inflation expectations.
- This in turn manifests itself mainly in faster **nominal wage growth** and a higher **inflation rate** than in the baseline scenario. Additional depreciation pressure due to an increase in the risk premium leads to weaker levels of the **koruna** over the forecast horizon.

Scenario of a Faster Decline in the Saving Rate I



- This scenario captures the potential impacts of a faster decline in the **saving rate** to its long-term average than assumed in the baseline scenario.
- Like the baseline, this scenario assumes that inflation expectations stay anchored to the 2% target.
- The scenario also assumes that the saving rate decreases from its current level to 12% by the end of this year and subsequently declines steadily further over the next two years.
- This implies significantly faster quarter-on-quarter growth in **household consumption** in the second half of 2023 than in the baseline scenario.

Scenario of a Faster Decline in the Saving Rate II



- The central bank responds to the stronger demand-driven inflation pressures with a distinctly higher **interest rate path** relative to the baseline scenario.
- The **koruna** is initially stronger than in the baseline scenario, owing to a larger interest spread vis-à-vis the rest of the world; but weaker over the course of 2024 and 2025 due to a quicker narrowing of the interest rate differential and worse trade balance induced by higher import volumes.
- Household consumption will be reflected in visibly faster annual **GDP growth** this year and most of the next year.
- **Inflation** will reach slightly higher levels at the monetary policy horizon than in the baseline scenario.

Thank you for your attention

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