CNB's New Forecast

Monetary Policy Report – Winter 2023

Meeting with Analysts

3 February 2023

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Parameters of the MP Regime

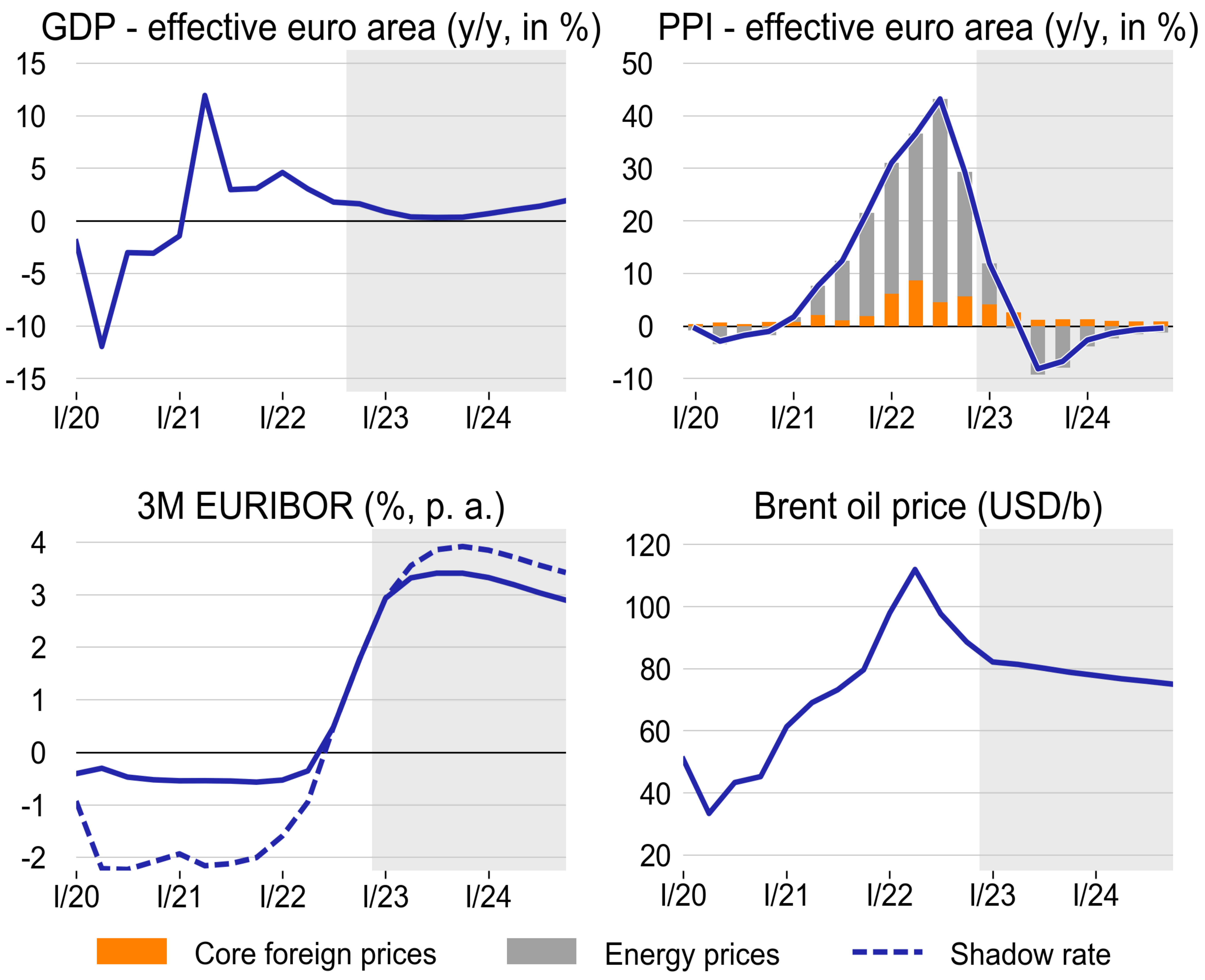
The baseline scenario of the forecast assumes that the central bank sets interest rates in order to fulfil the 2% target at a **monetary policy horizon 12-18 months ahead**.

The previous strong external cost pressures have recently been easing greatly and will largely fade out before the end of this year. The need to exempt major price movements caused by external factors is no longer relevant. Monetary policy has been returned to the standard framework, in which the MP horizon is 12–18 months ahead and covers the first half of 2024.

Presentation Outline

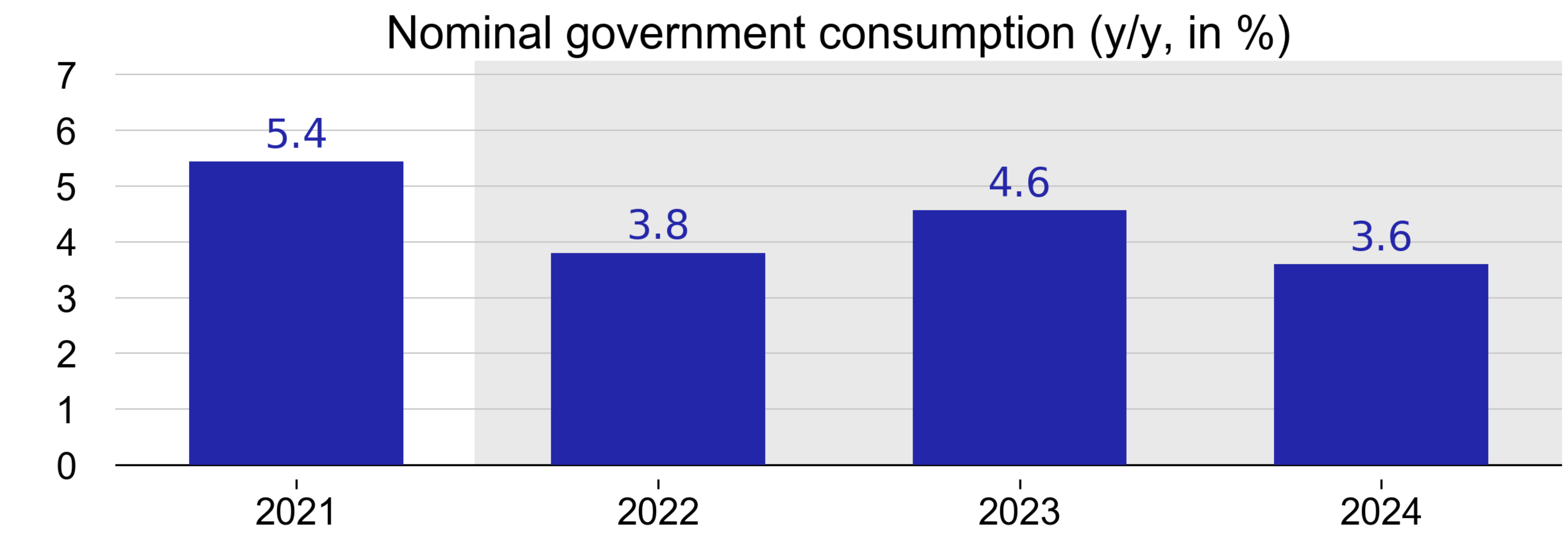
1. **Assumptions of the Forecast**
2. The New Macroeconomic Forecast
3. Comparison with the Previous Forecast
4. Monetary Policy Simulations

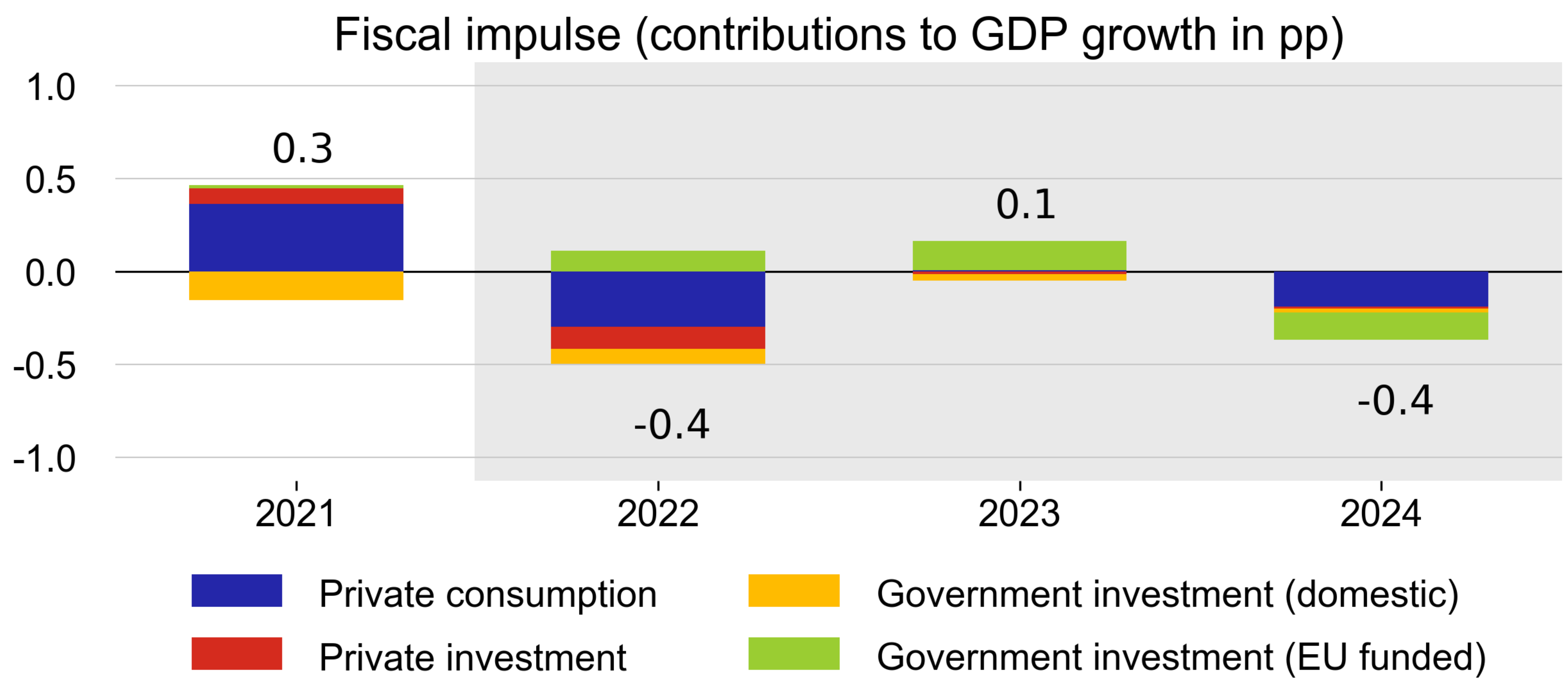
External Environment Outlook



- This year, **effective euro area** will grow only slightly due to slowdown in global demand growth, tightening monetary conditions and a decline in households' real income. The economy will recover in autumn 2023 as supply chain disruptions ease and international trade recovers.
- The **effective euro area PPI** started to decline at the close of last year. The outlook for this year is strongly affected by an expected sizeable correction of gas and electricity prices. Easing of supply chain stress will foster a reduction in the pressure on core inflation.
- The outlook for the **Brent crude oil price** remains falling in expectation of a global economic downturn.
- The market outlook for rising interest rates reflects the **ECB's** expected monetary policy tightening to return inflation to the target.

Fiscal Policy





- **Nominal government consumption** will grow by about 4.5 % this year due to an increase in wages and salaries in the non-market sector and an increase in public expenditure mainly in health care and education, linked with the arrival of Ukrainian nationals. It will slow down slightly next year.
- **Fiscal impulse** will stimulate GDP growth slightly this year due to the continuation of some of the support measures adopted on both the revenue and expenditure sides of public budgets relating to the rise in inflation and the fight against high energy prices.
- The complete end of the temporary support measures and a fall in absorption of EU funds due to a slow start to the new programme period will significantly dampen GDP growth in 2024.

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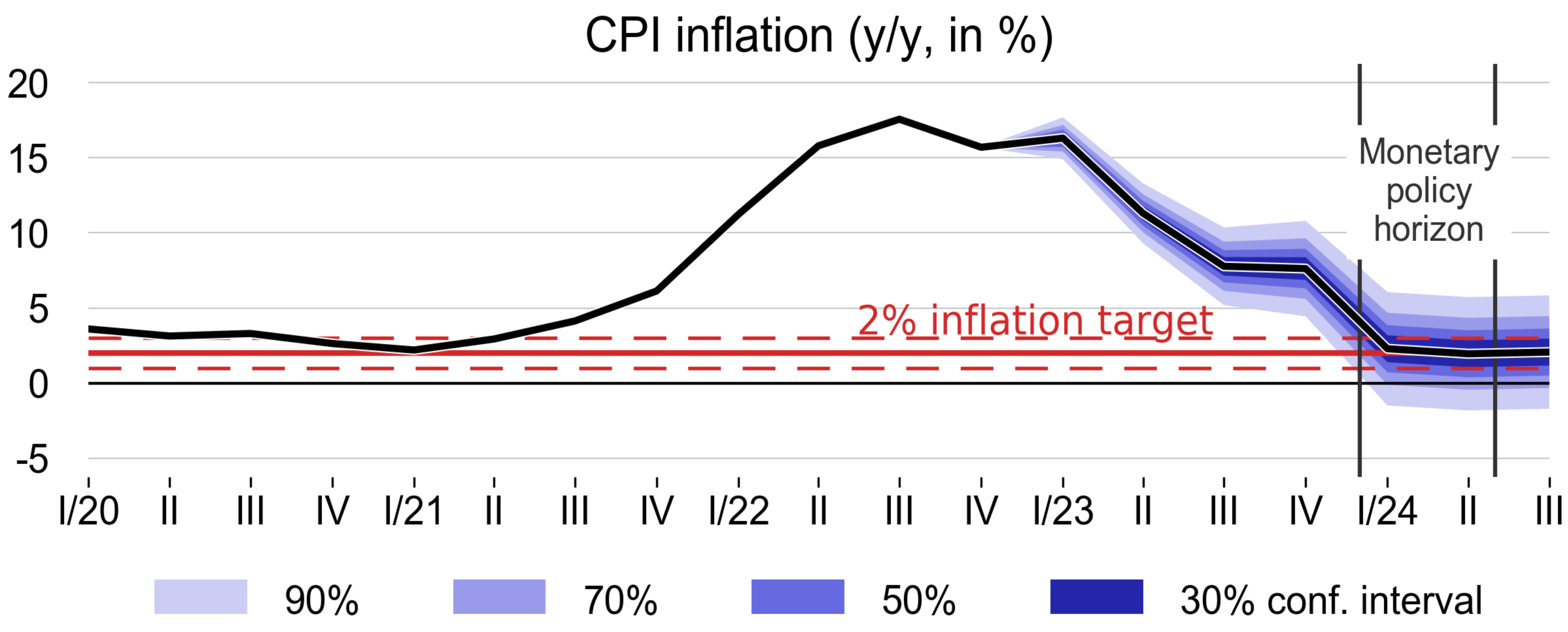
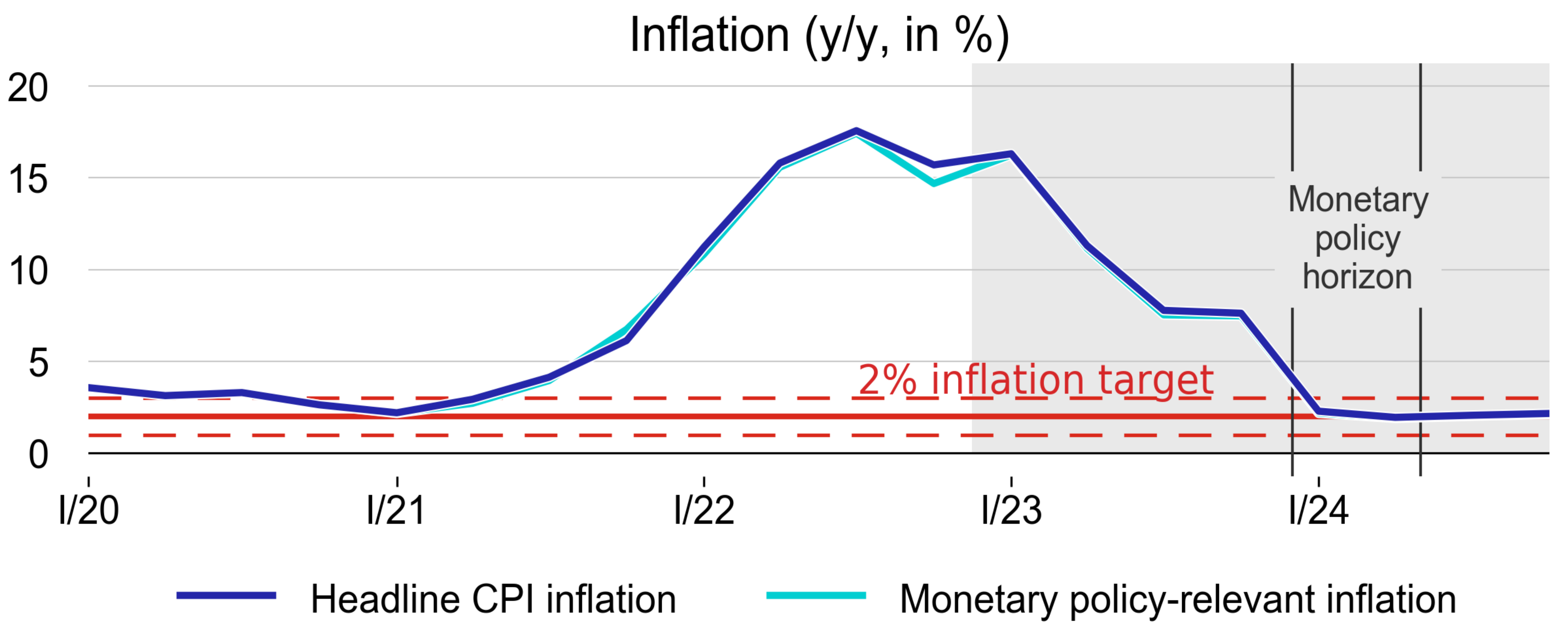
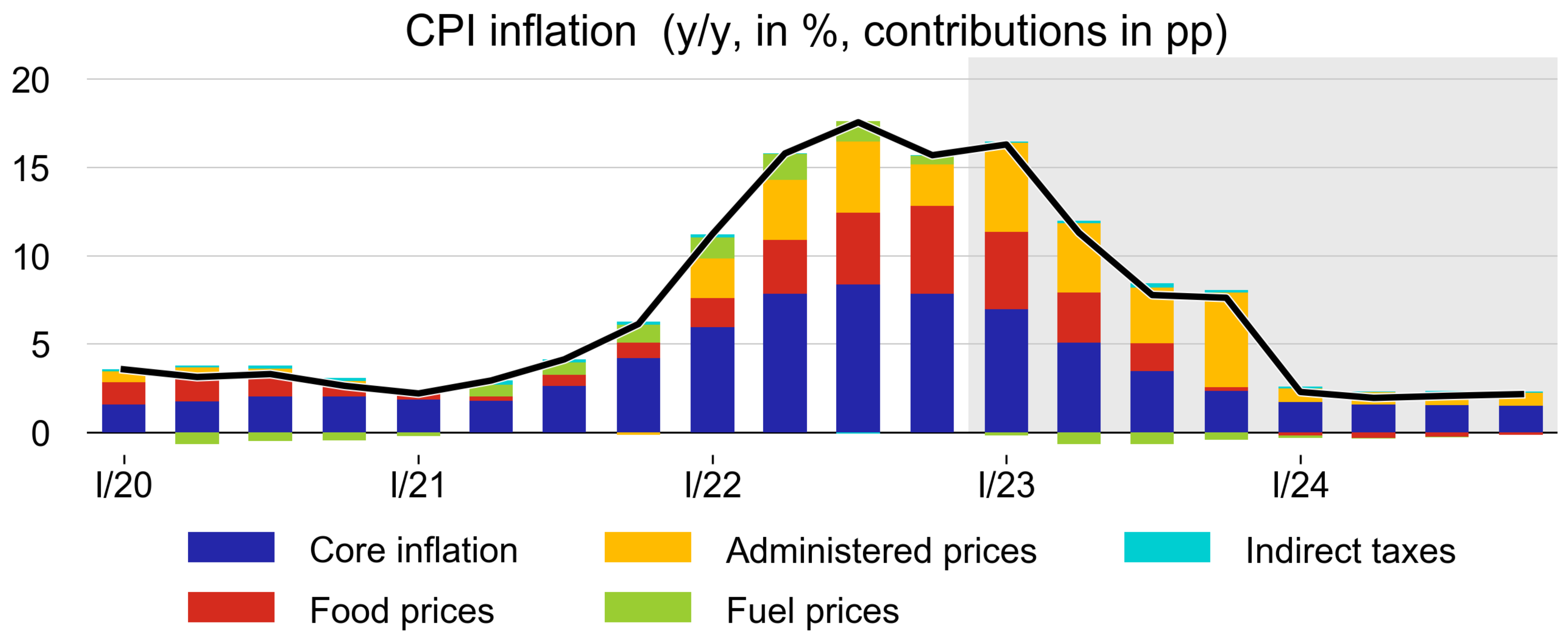
Headline and Monetary Policy-Relevant Inflation

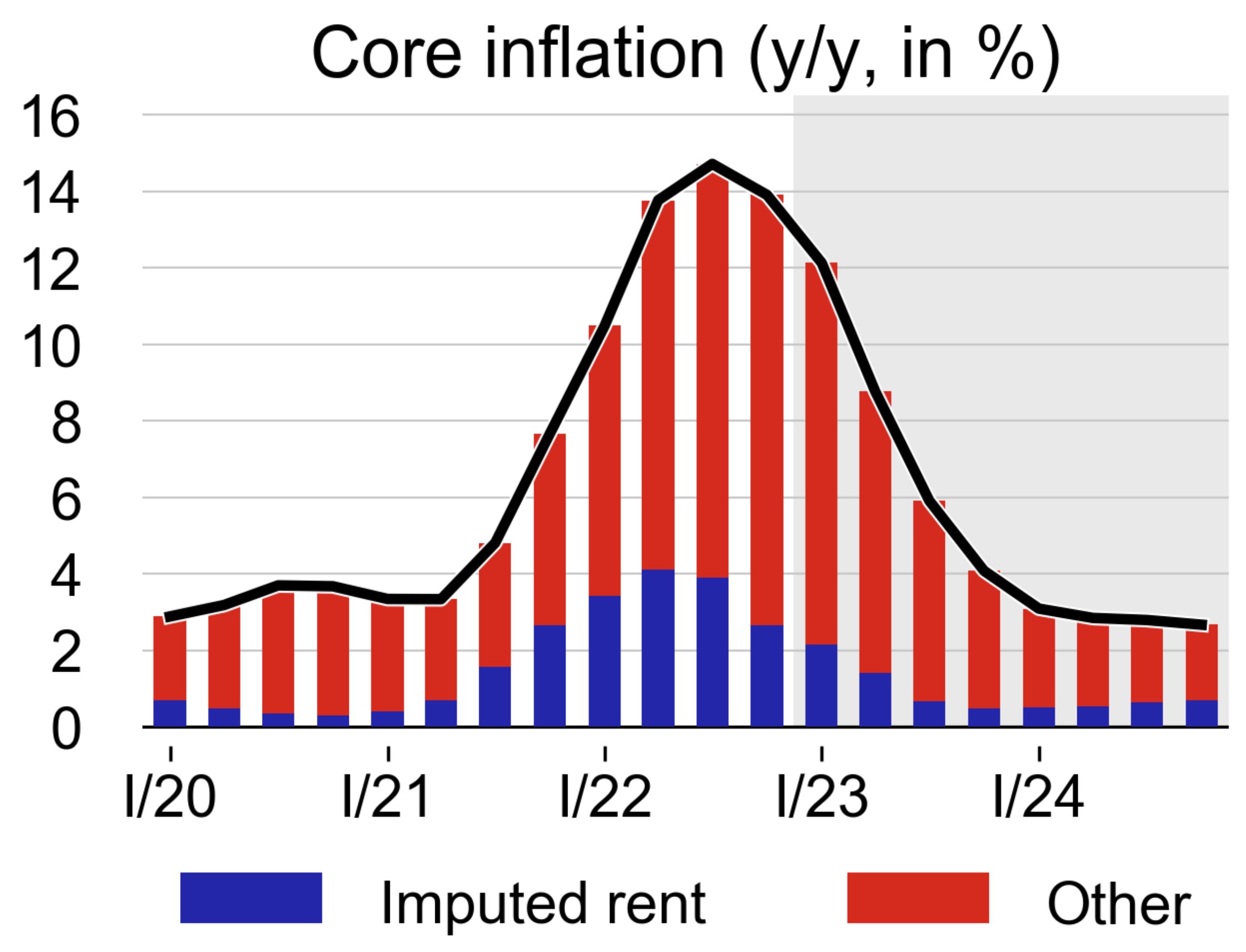


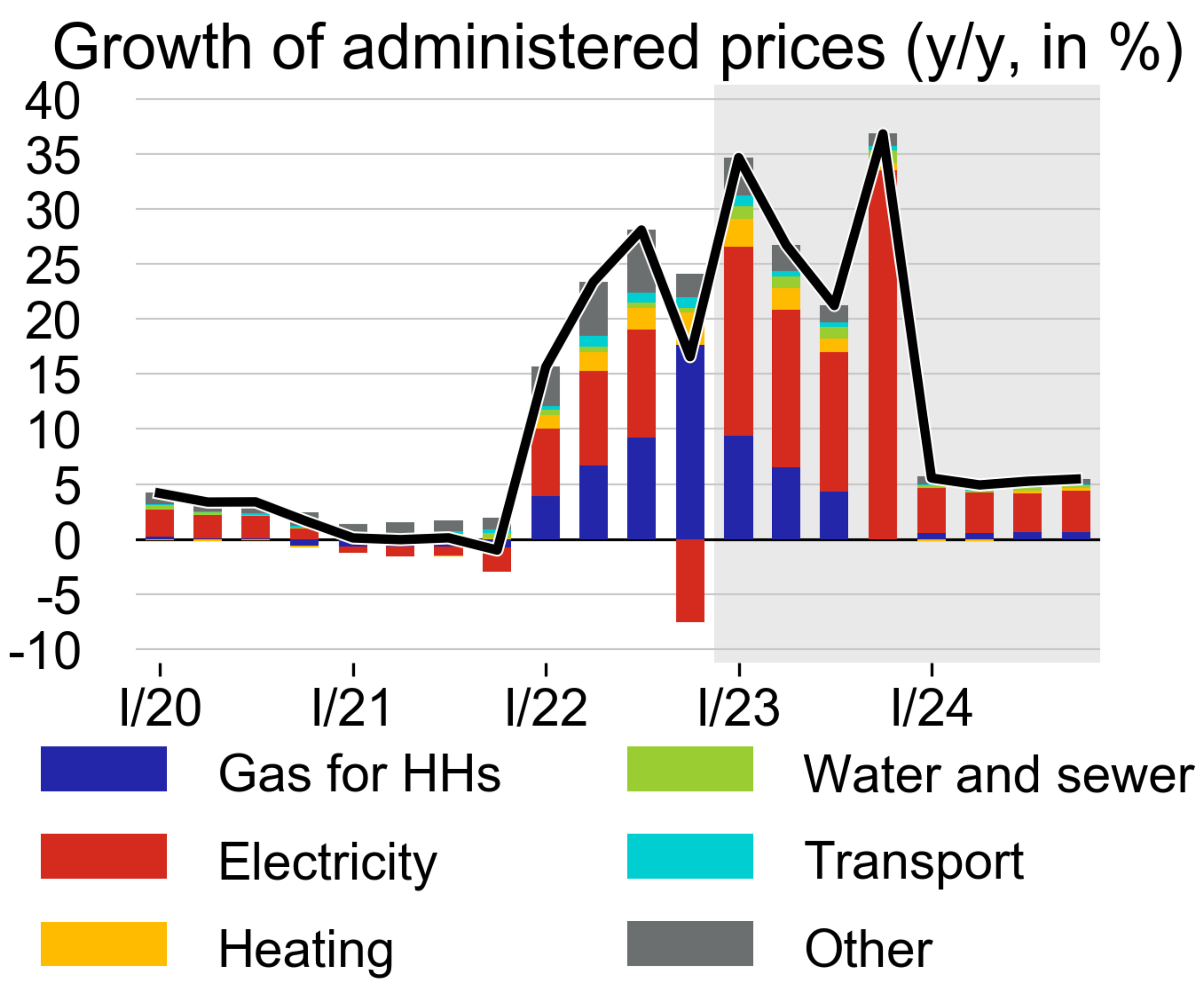


- **CPI Inflation** will rise temporarily above 16% in 2023 Q1 and drop to single digits in the second half of the year. It will return close to the 2% target in the first half of 2024.
  - Market components of inflation will decline due to decreasing cost pressures from both the foreign and domestic economies.
  - The currently peaking profit margins of domestic producers, retailers and service providers will undergo a gradual correction.
  - Tighter monetary policy will contribute to this decline.
- Headline inflation will be above **monetary policy-relevant inflation** over the entire outlook.

Inflation Components, Core Inflation and Admin. Prices

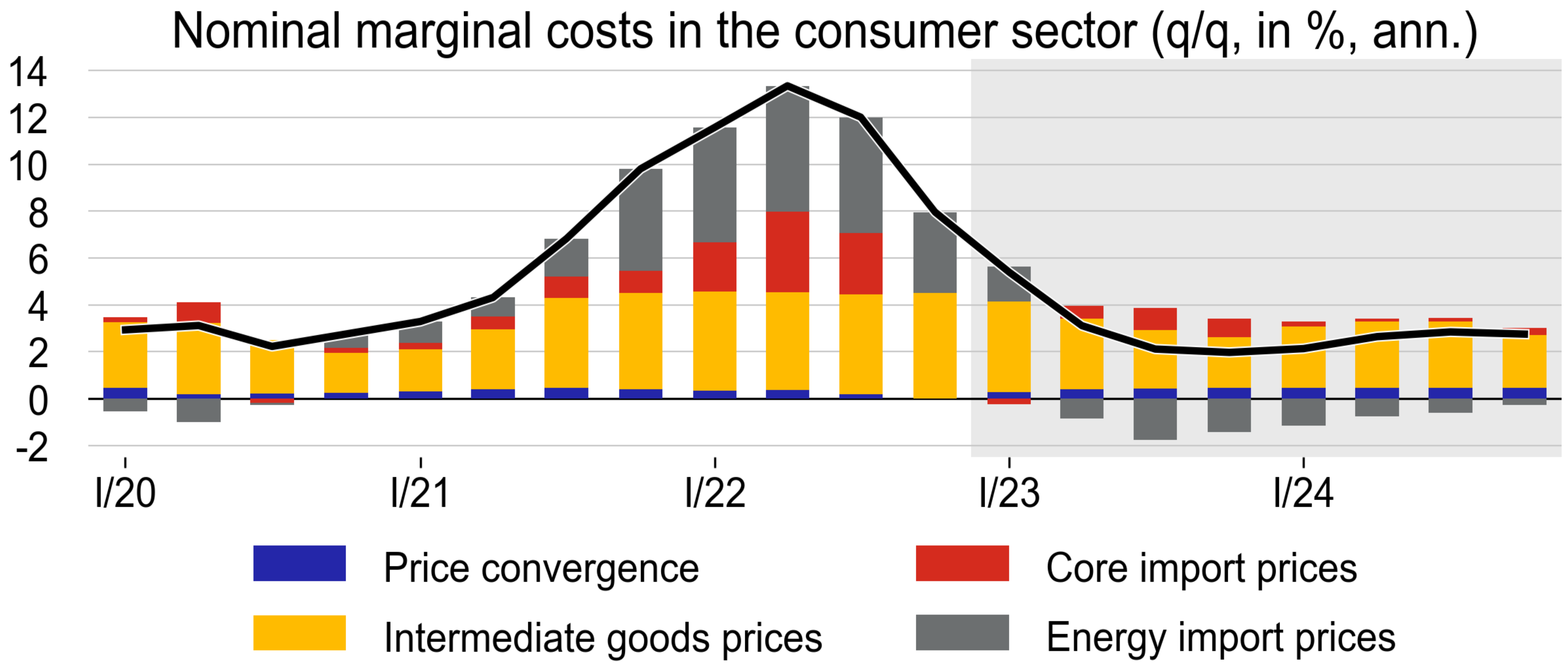


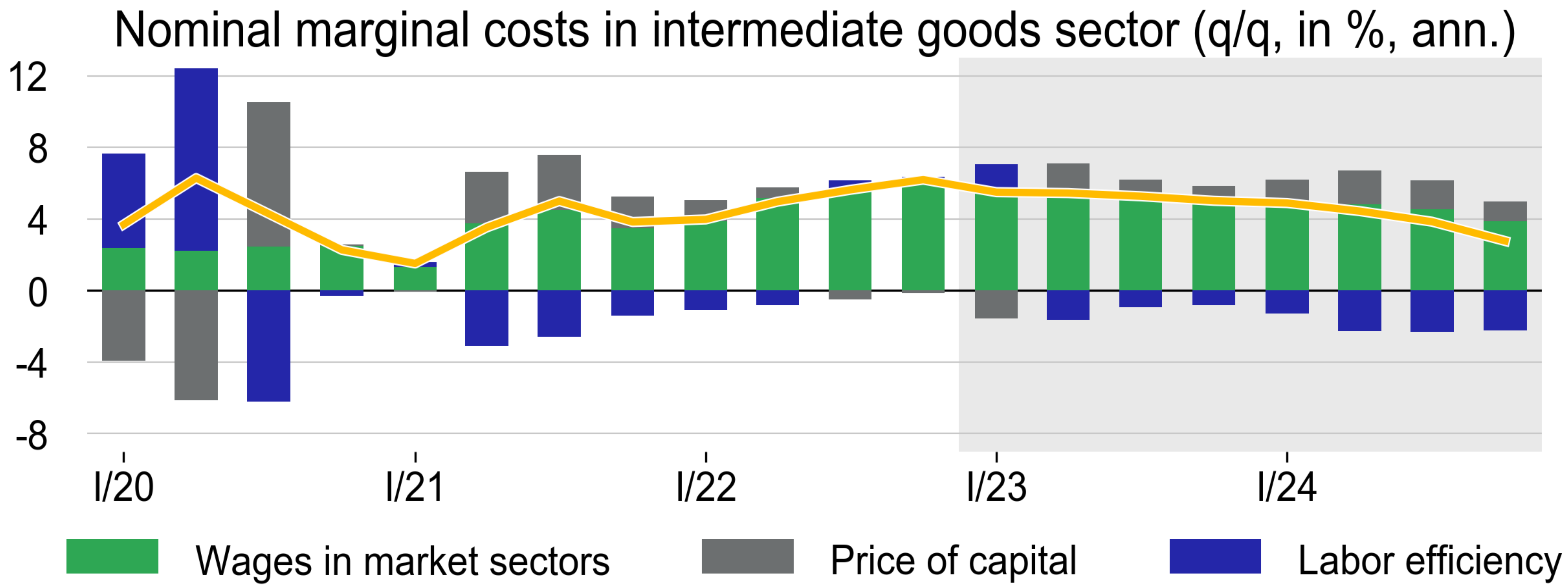




- **CPI inflation** will remain broad-based at the start of 2023; in addition to core inflation, it will be driven by a marked increase in the contribution of administered prices and still high food price inflation.
- Within **core inflation**, growth in tradables and non-tradables prices has started to slow. The drop in core inflation will be fostered by the declining contribution of **imputed rent** in the quarters ahead.
- **Administered price inflation** will be extremely high and simultaneously very volatile this year due mainly to an unprecedented rise in electricity prices and discontinuation of the energy savings tariff. It will not fall markedly until next year.

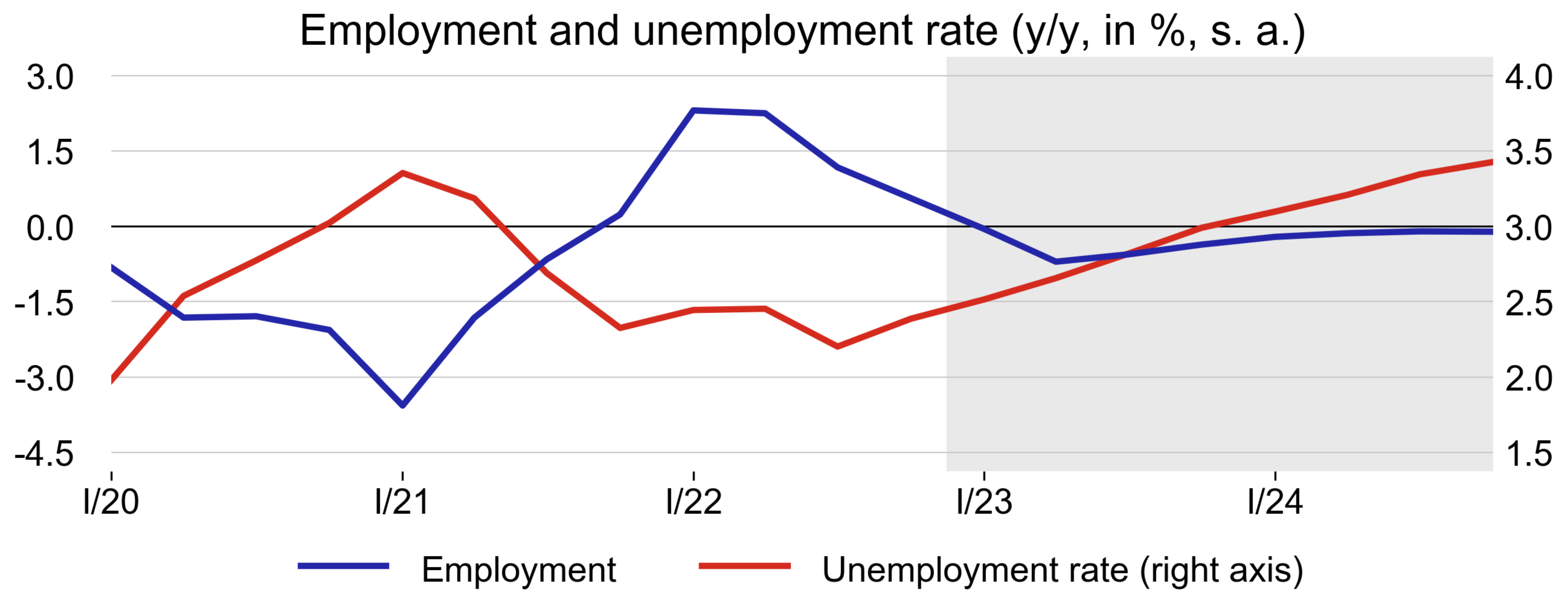
Cost Pressures

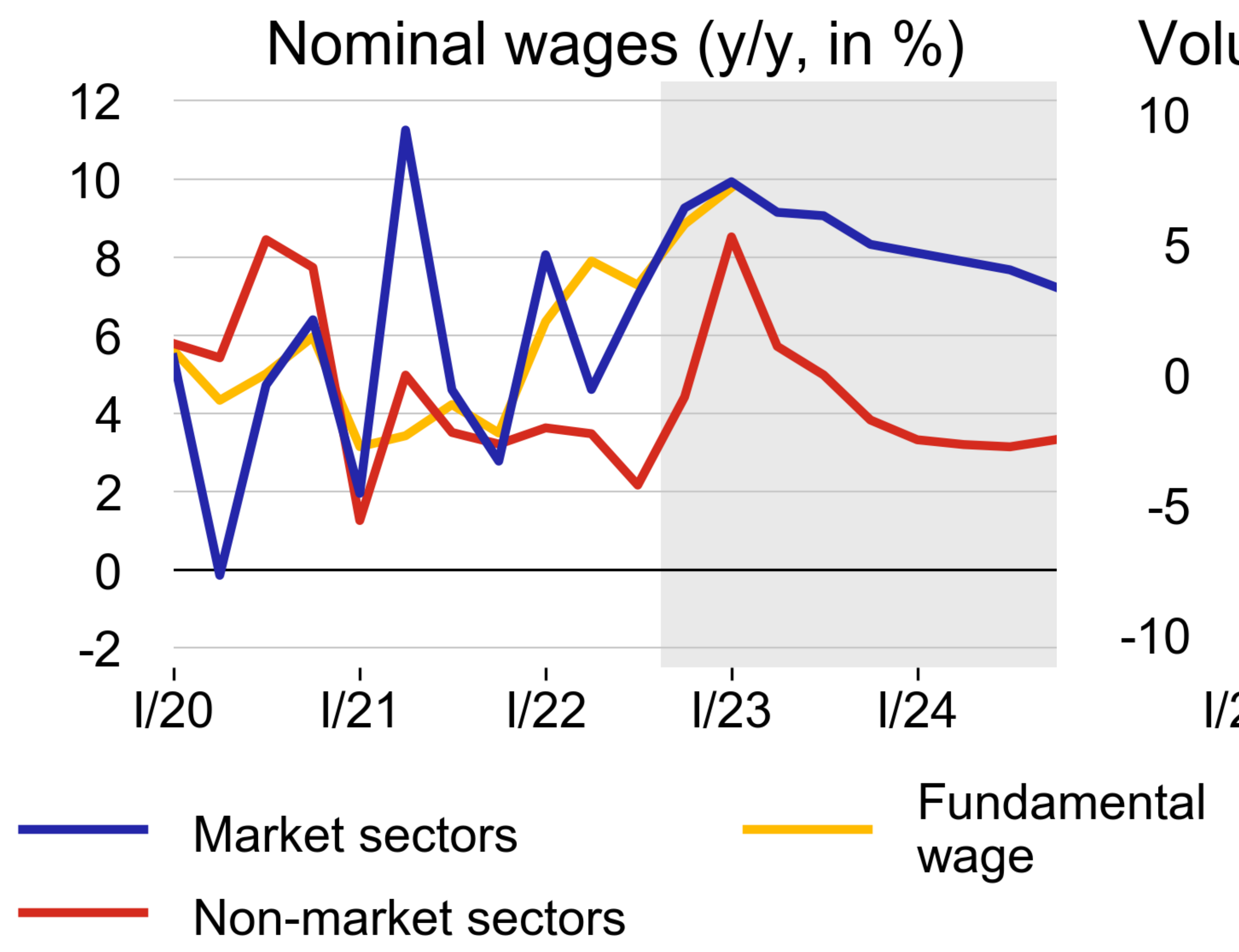


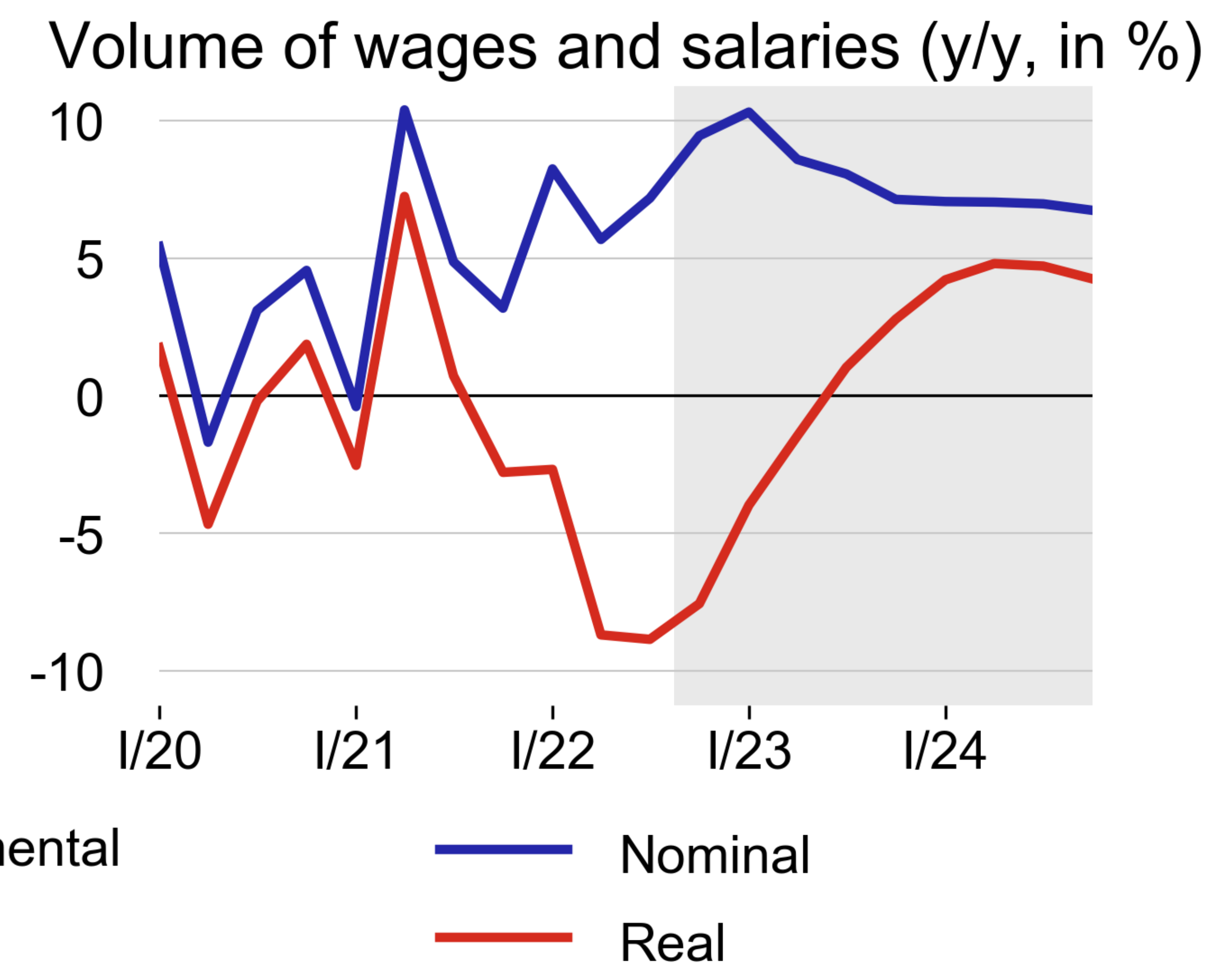


- Growth of **total costs in the consumer sector** slowed in 2022 Q4, because of lower growth in import prices via flat core import prices.
- The overall cost pressures will continue to weaken this year due mainly to a drop in energy import prices and decreasing growth of domestic intermediate goods prices.
- The **domestic cost pressures** will ease slightly at the start of this year but still remain elevated. They will be driven mainly by brisk wage growth, which will fade out only gradually.
- Growth in domestic costs will remain elevated into 2024 especially due to only slowly weakening growth in wages and recovery of economic growth.

Labour Market

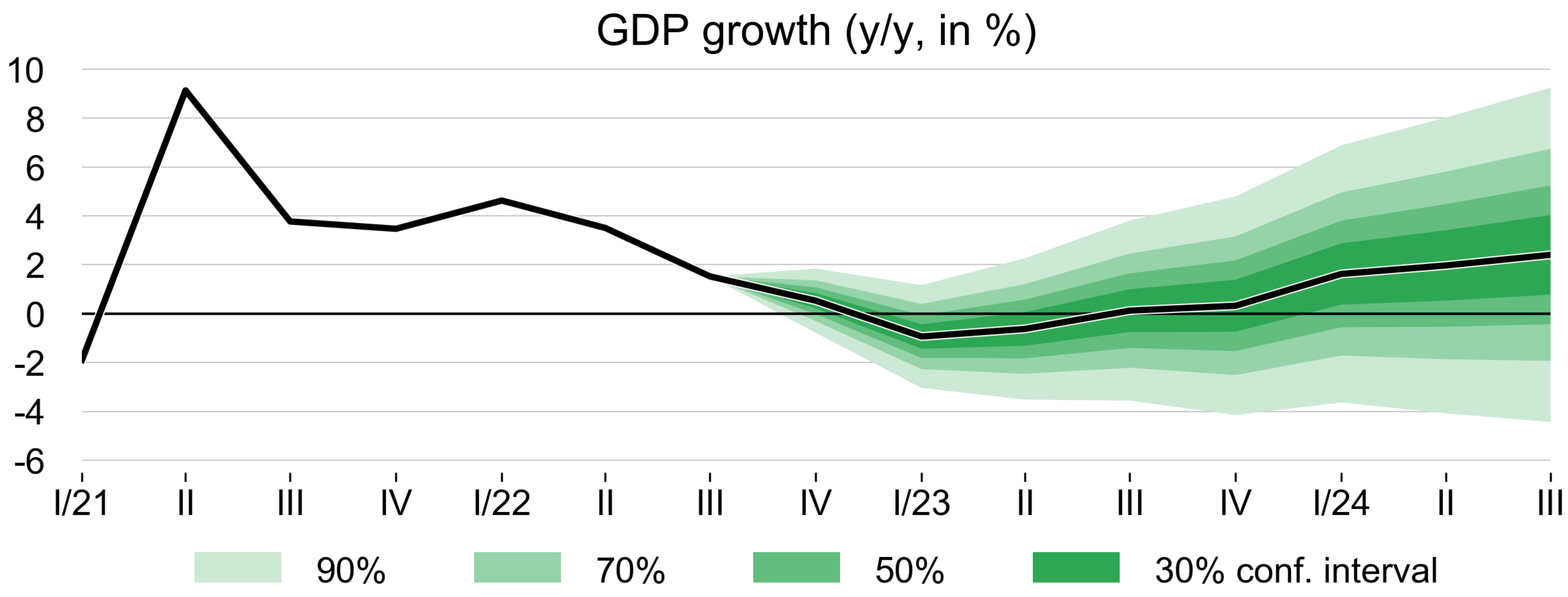


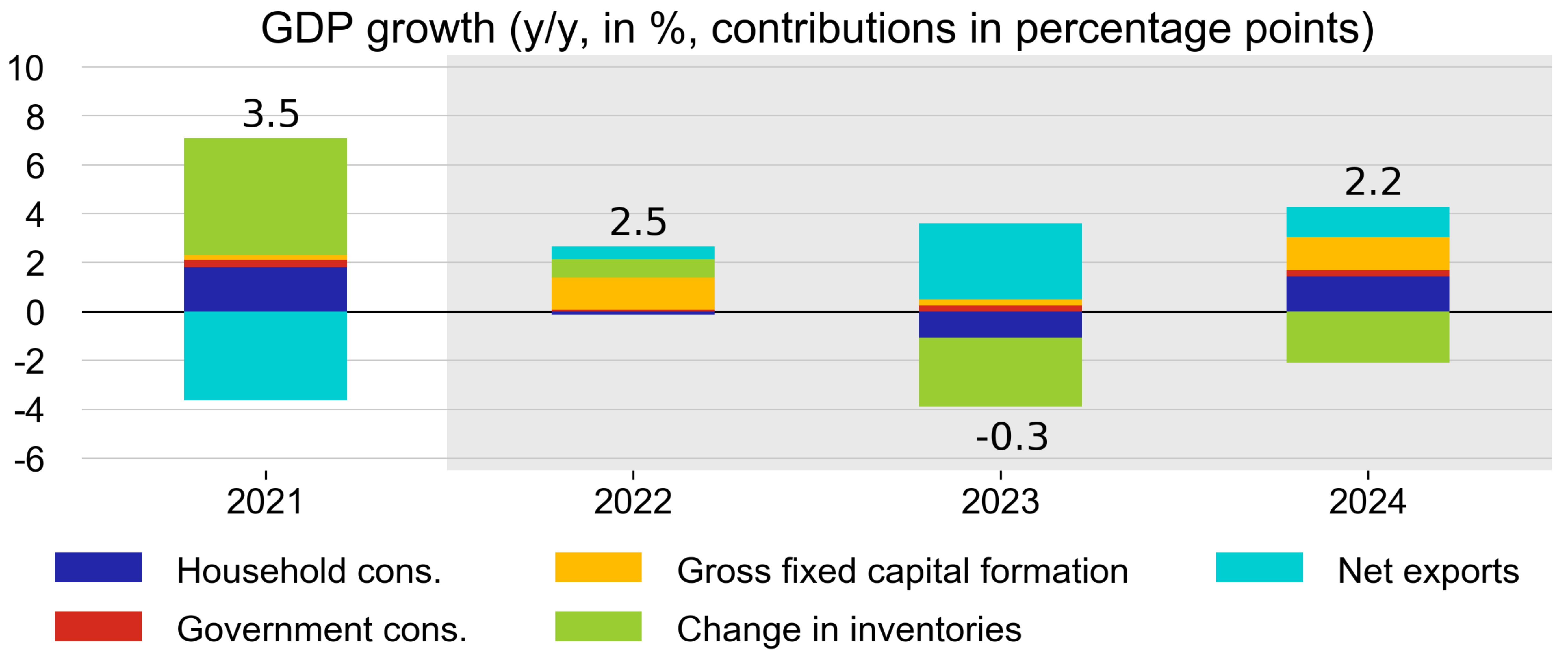




- **Employment** peaked in 2022 and started to decline moderately in the second half of the year. This decline will continue into 2023. The **general unemployment rate** switched to modest growth at the end of last year and will continue to rise this year. This will be due to a temporary worsening macroeconomic situation.
- **Nominal wage growth** will accelerate sharply in market and non-market sectors at the start of 2023. It will remain elevated over the forecast horizon as firms will compensate employees for the decline in real wages.
- **Growth in the real volume of wages and salaries** will be negative over the next few quarters due to high inflation and will thus lead to a decline in household consumption.

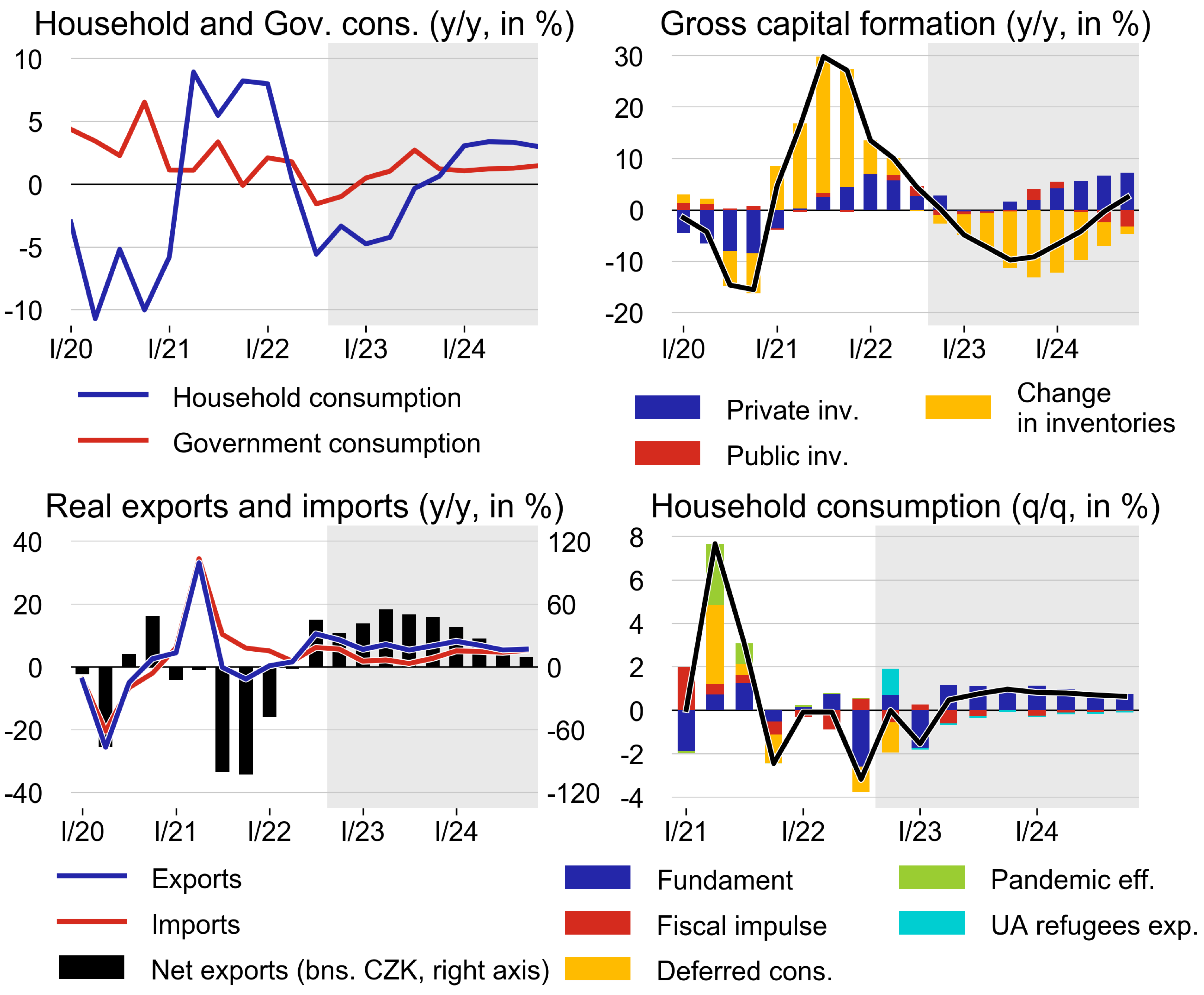
GDP Growth Forecast





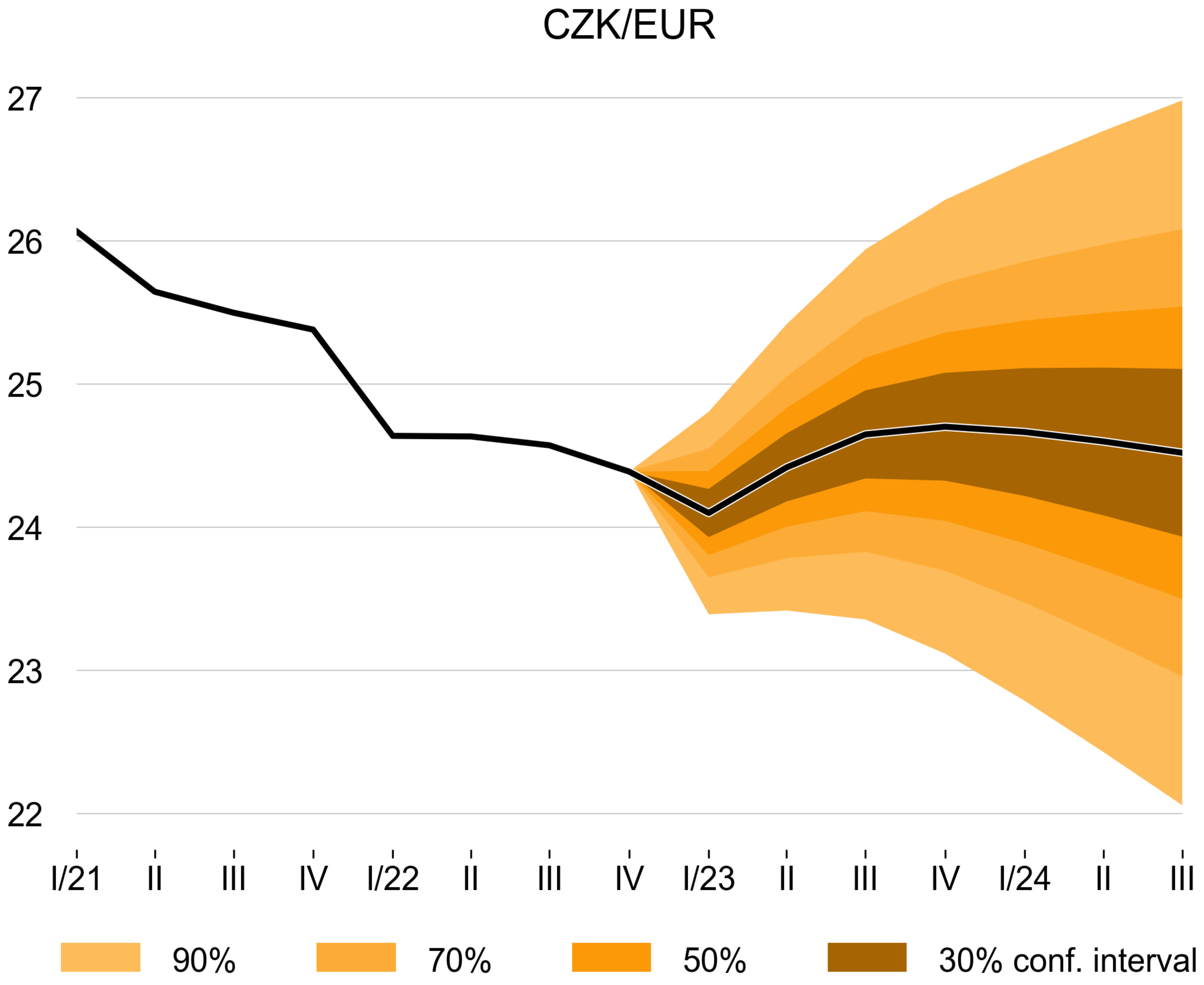
- **Economic activity** will fall slightly due mainly to further deterioration in the financial situation of Czech firms and households, a cooling of external demand and receding problems in global value chains.
- This year, GDP will decrease slightly in **whole-year terms**. It will return to growth of around **2 %** in 2024.
- According to a **preliminary CZSO estimate**, Czech GDP **increased** by **0.4 %** y/y in 2022 Q4 and **decreased** by **-0.3 %** q/q, which is slightly lower than the CNB forecast.
- The domestic economy fell below its **potential** at the end of last year with the onset of the recession and will remain there until mid-2024.

GDP Components



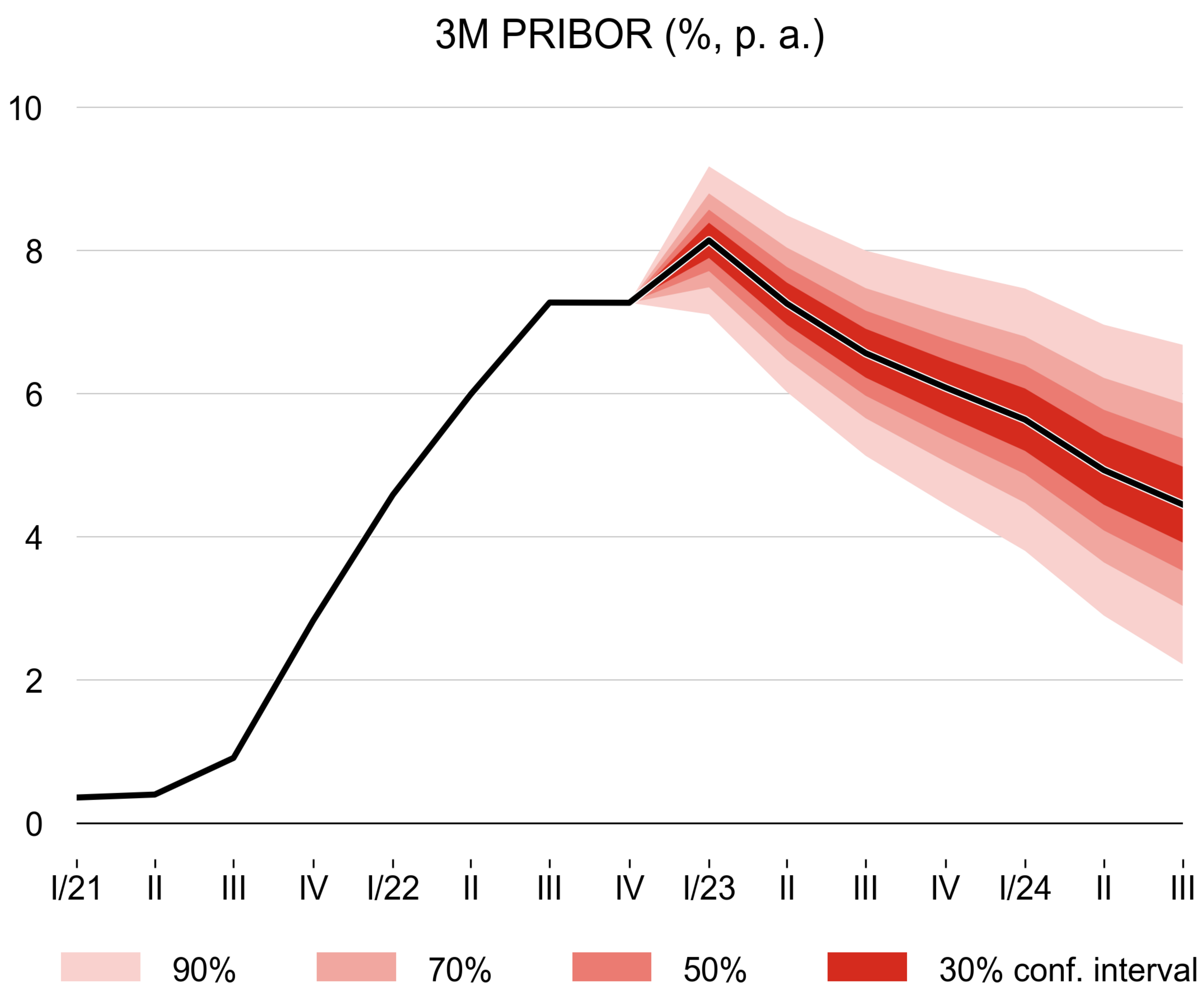
- **Household consumption** will be adversely affected by a sharp fall in real income and negative sentiment, but this fall will be partly offset by government assistance. As a result, household consumption will decline in y-o-y terms for most of this year.
- Households' purchasing power will later improve as inflation drops significantly. Renewed real wage growth will then trigger growth in private consumption.
- **Government consumption** will start to grow again.
- **Growth in total gross investment** will be affected predominantly by **additions to inventories**.
- **Export** and **import growth** will slow slightly this year due to a downturn in external and domestic demand.

Exchange Rate CZK/EUR



- The forecast expects the **koruna** to average CZK 24.1 to the euro in 2023 Q1 and gradually weaken to around CZK 24.5 to the euro in the following quarters.
- The exchange rate will be affected by a **narrowing interest rate differential** vis-à-vis the euro area, which will have a weakening effect.
- After the negative impacts of disrupted global value chains and the impacts of the war in Ukraine fade out, the balance of trade will return to a surplus and global sentiment will improve. This will in turn be reflected in gradual **appreciation** of the koruna during 2024.

Interest Rate Path (3M PRIBOR)



- Consistent with the winter forecast is a rise in **market interest rates** initially, followed by a gradual decline.
- The interest rate reaction reflects the central bank's efforts to fulfil the 2% target robustly at the **monetary policy horizon 12–18 months** ahead, i.e. in the first half of 2024.
- The initial monetary policy tightening will foster a desirable deferral of current consumer and investment demand and reduce the price impacts of the previous excess demand. Fading cost price pressures will result in inflation falling to the target in the 2024 H1. Interest rates will thus be able to start coming down in the course of this year.

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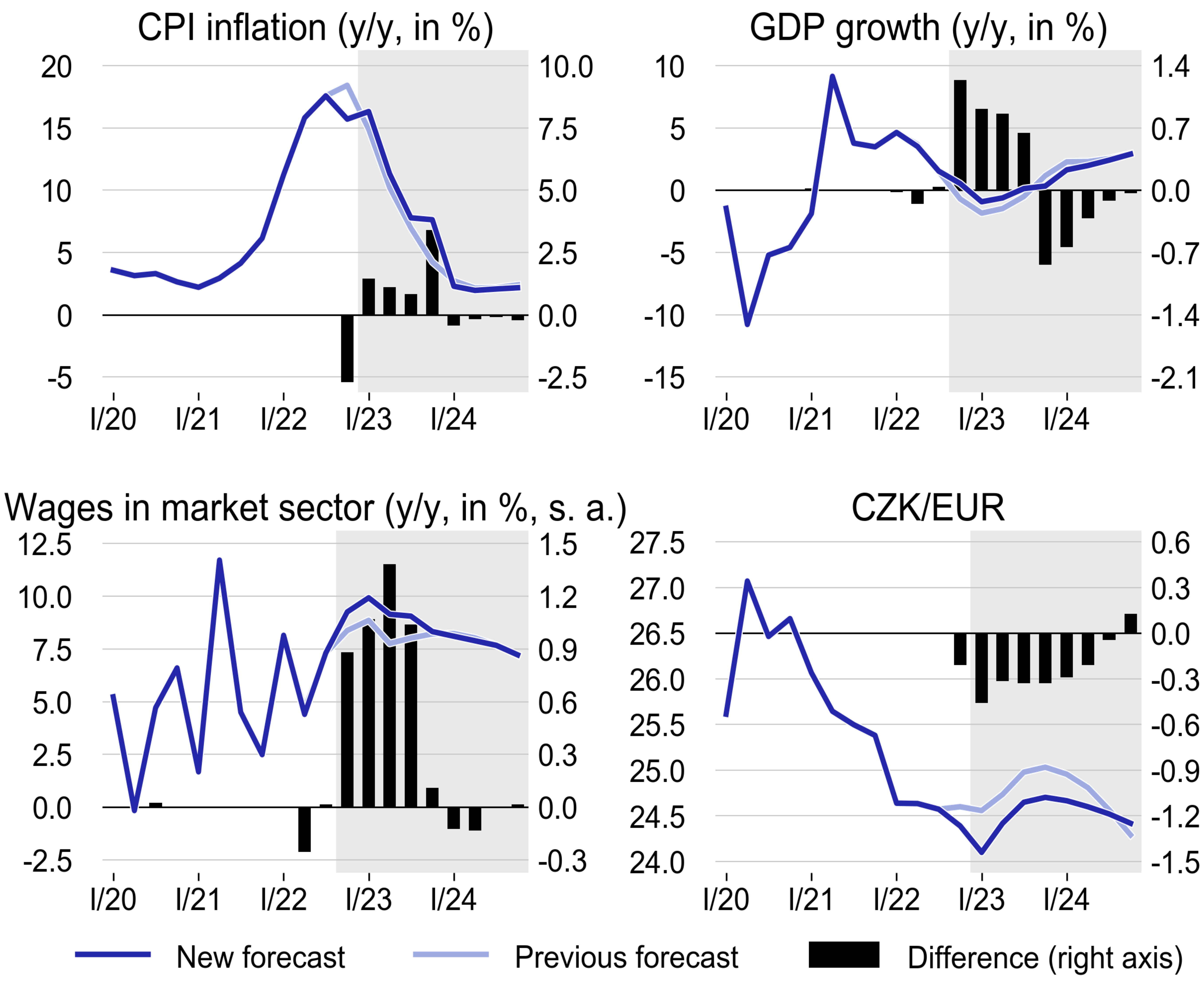
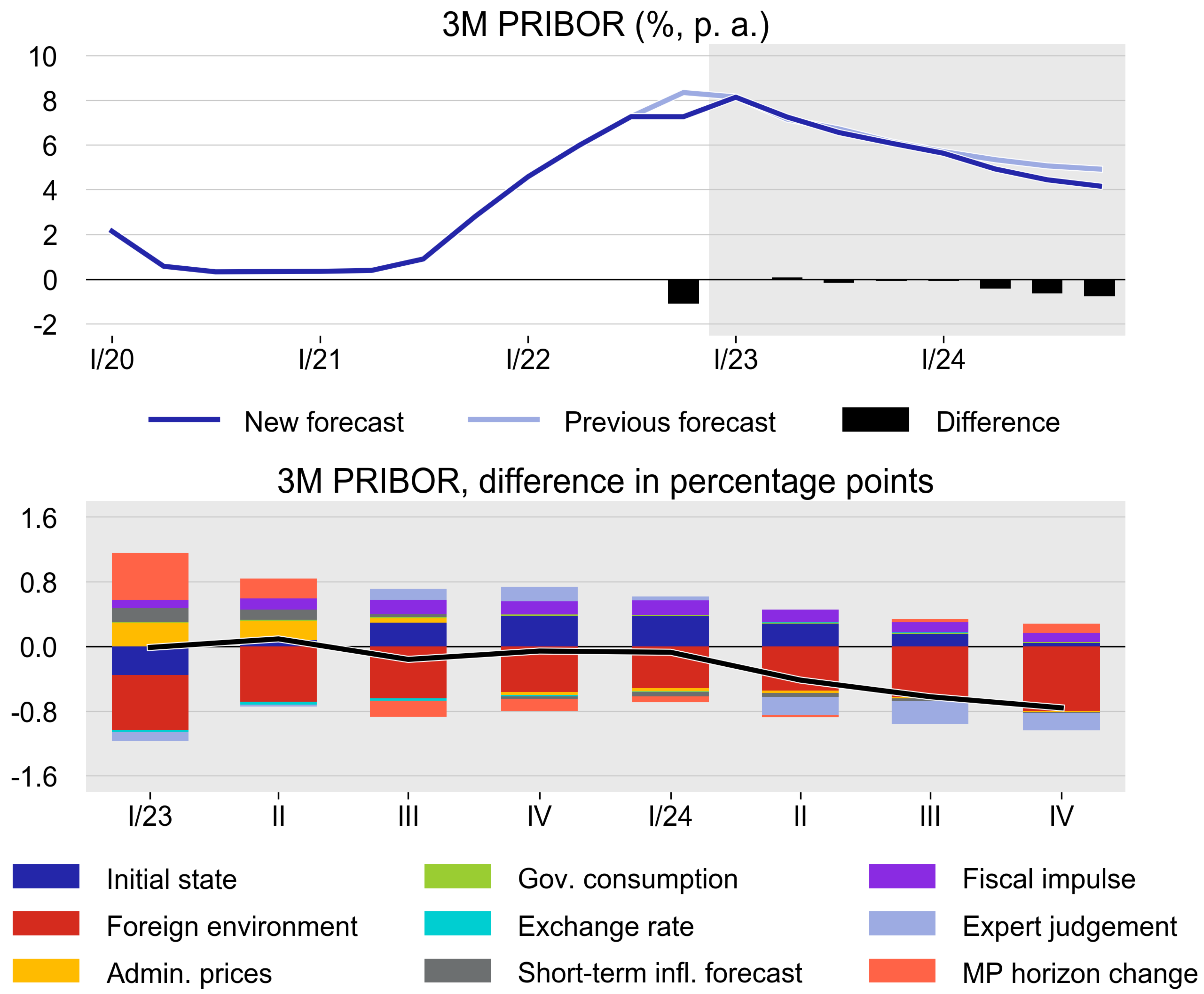
Comparison with Previous Forecast: Domestic Economy



- The upward revision of the **inflation** forecast this year is due to higher administered price and food price inflation.
- The **GDP growth** outlook for this year is higher due to a smaller-than-expected cooling of domestic and external demand. Next year, the growth will be slightly slower.
- The faster **wage growth** this year mainly reflects stronger wage growth at the end of last year.
- The **koruna** will be stronger than in the previous forecast, especially this year
  - The shift to stronger levels at the near end is due to its observed levels.
  - The assumption of a limited pass-through of the rapidly rising interest rates abroad to the koruna's exchange rate via the interest rate differential in the coming quarters acts also in the same direction.

Comparison with Previous Forecast: 3M PRIBOR



- **The interest rate** path remains almost the same this year.
- **The foreign outlook** fosters lower rates over the entire forecast horizon (lower growth in the energy component of foreign PPI, the opposite effect of expected tightening of ECB monetary policy).
- **The shift of the monetary policy horizon** by one quarter closer to the present fosters higher interest rates in 2023 H1.
- **Expert adjustments** initially have a broadly neutral effect (expertly reduced labour efficiency, sharper fall in domestic demand). The entire outlook contains expert adjustments reducing the effect of the narrowing interest rate differential on the exchange rate.

CZECH NATIONAL BANK

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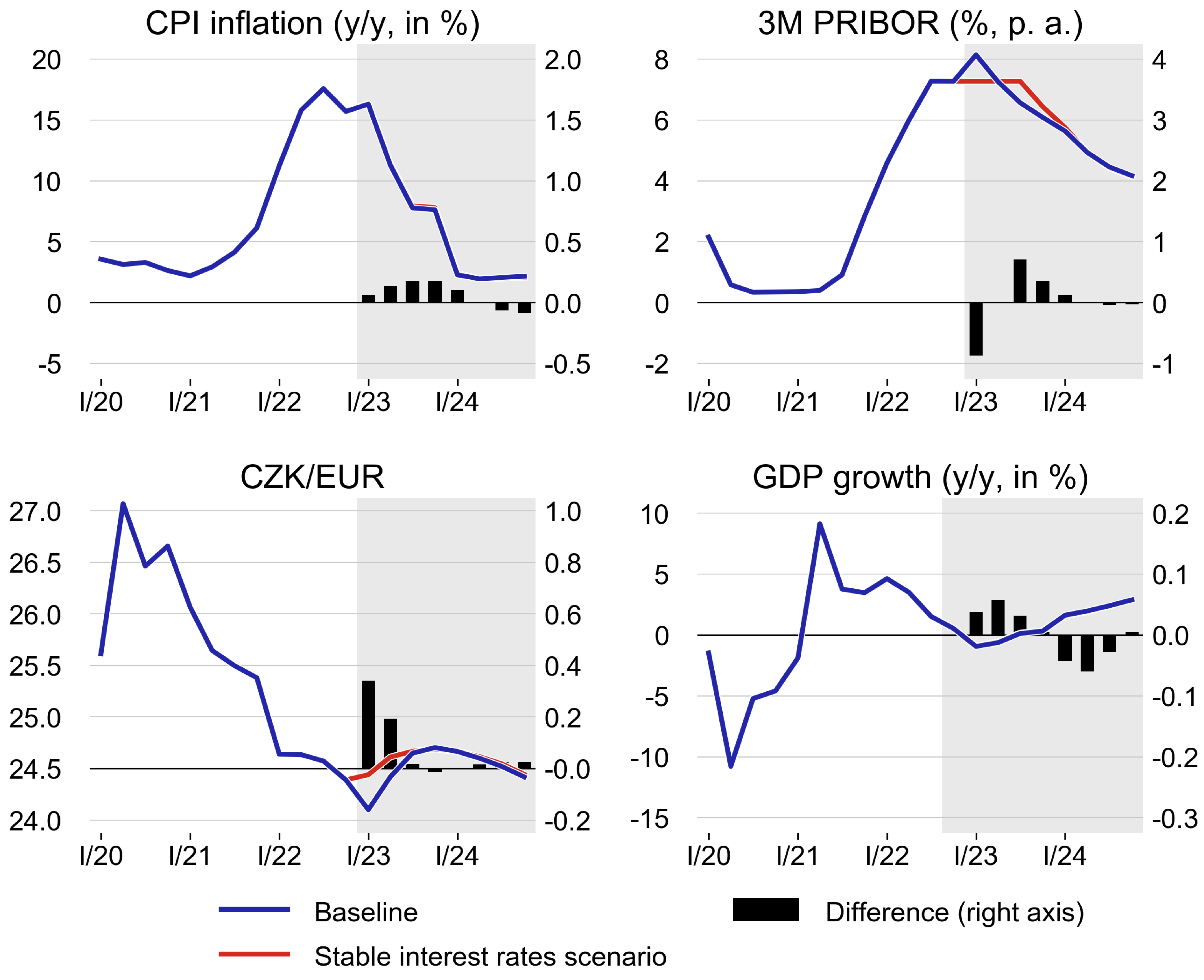
The Stable Interest Rates Scenario



- In this simulation, interest rates are kept at their current levels for three quarters.
- The **market interest rate** path is lower than in the baseline scenario in 2023 Q1. This leads to a weaker **koruna** at the start of the outlook than in the baseline scenario.
- Subsequently, the interest rate path is higher than in the baseline scenario, making room for the exchange rate to return to the baseline scenario path.
- In 2023, **inflation** will stay higher than in the baseline scenario, mainly because of the weaker koruna.
- Inflation will return close to the 2% target at the monetary policy horizon due to a more restrictive effect of interest rates in the second half of this year.

Thank you for your attention

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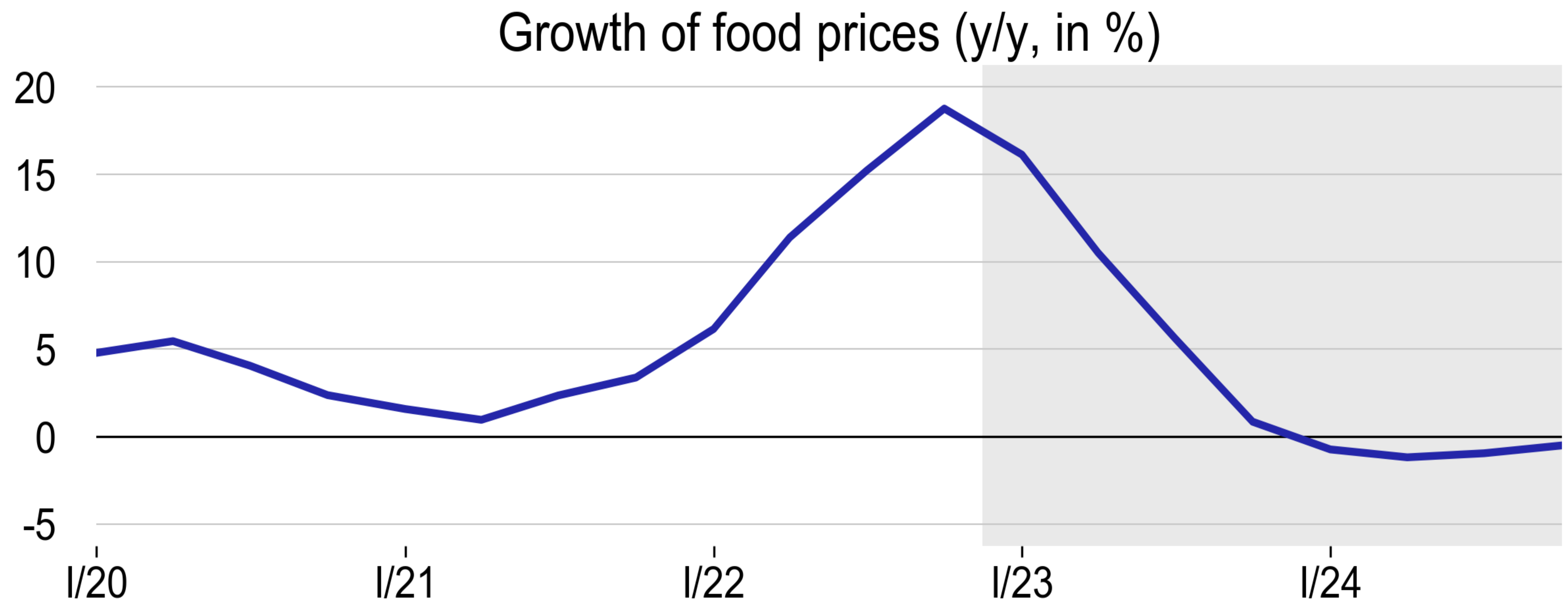
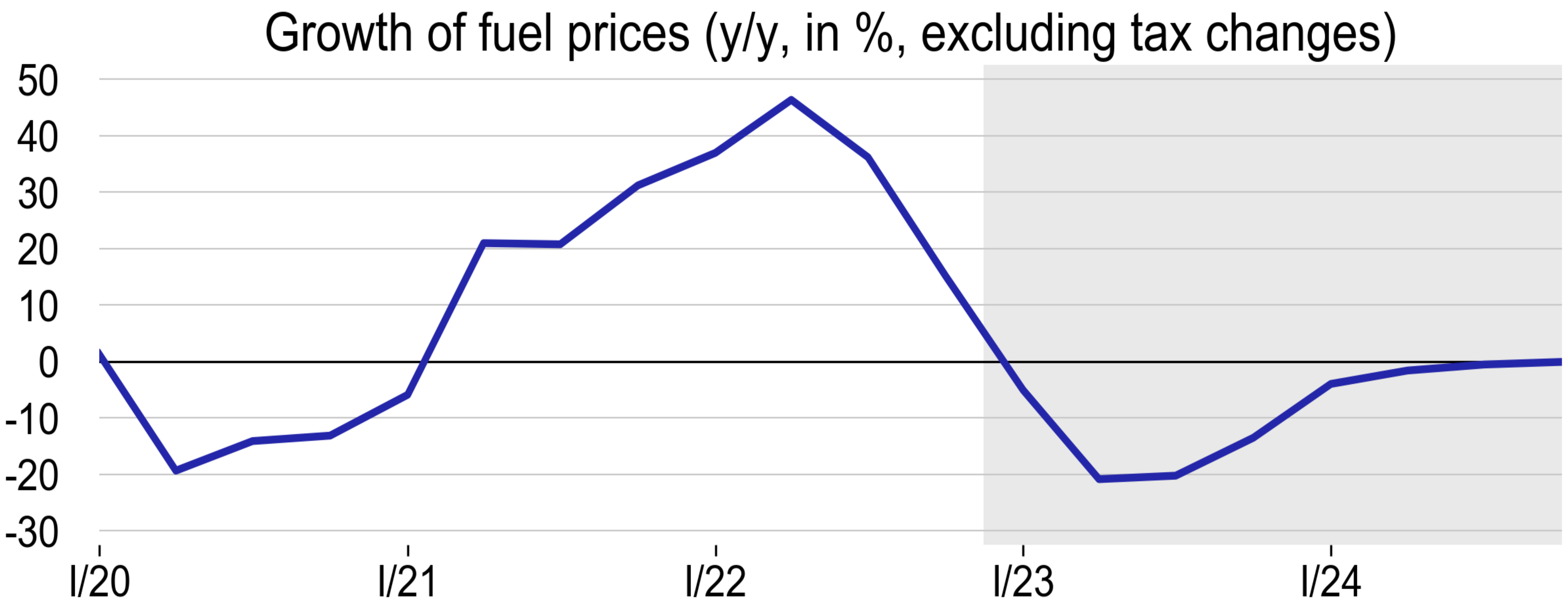
Food and Fuel Prices

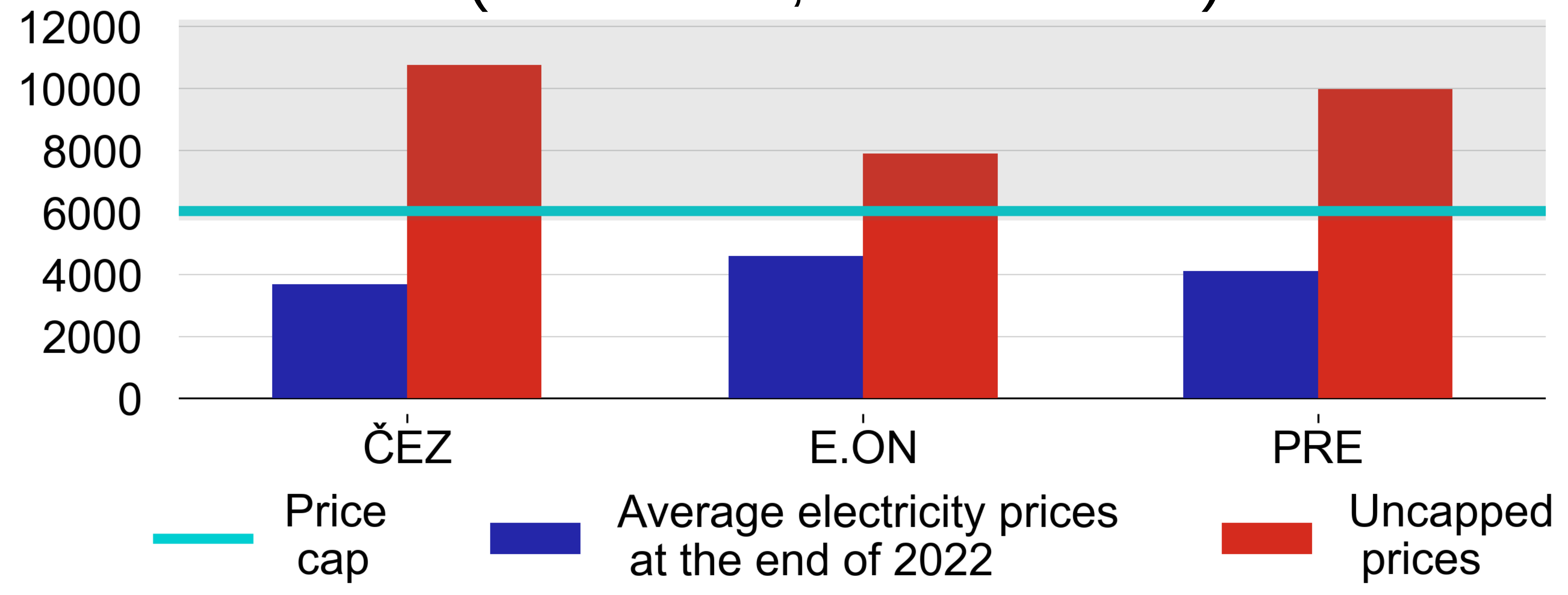


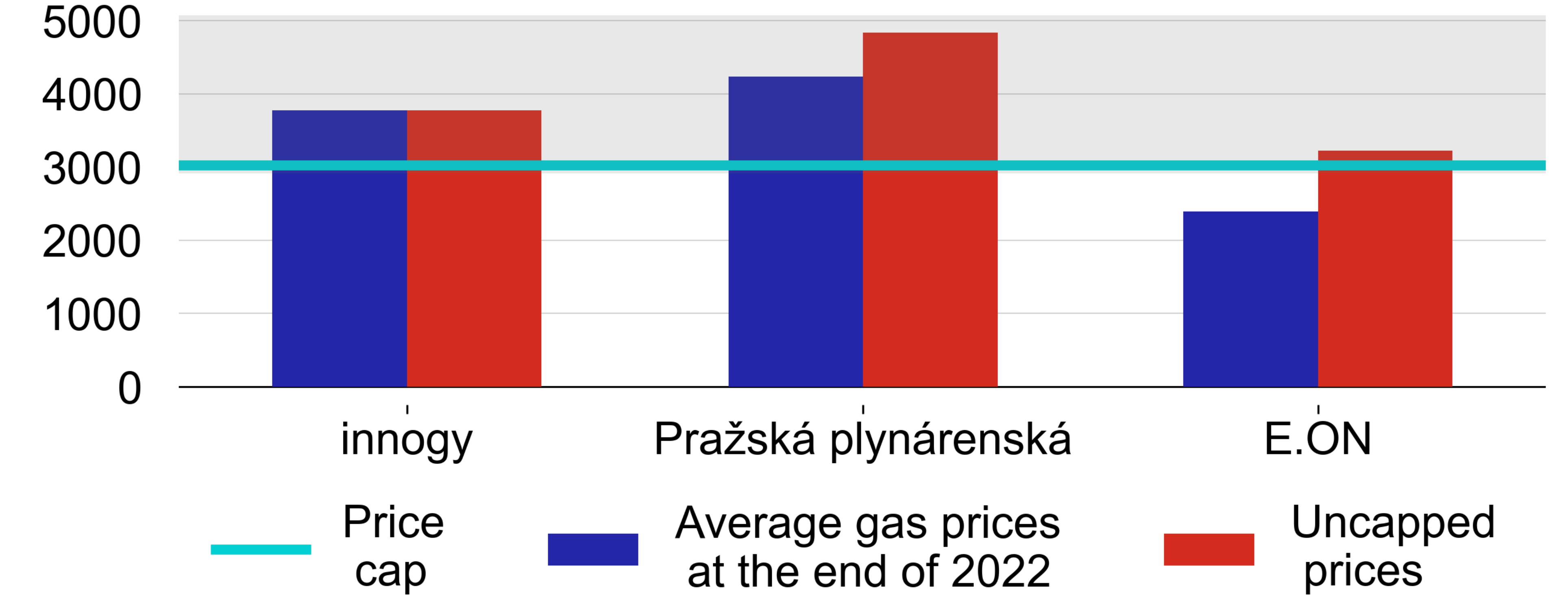


- **Food price inflation** will continue to come down in 2023 Q1 partly because of falling world agricultural commodity prices and domestic agricultural producer prices.
- Over the rest of this year, food price inflation will drop distinctly. At the end of 2023, food prices will begin to fall in year-on-year terms.
- **Fuel price inflation** will start to decline in 2023 Q1 owing to a drop in oil prices and margins along the entire value chain. Prices at filling stations will decrease year on year in 2023 Q1, due mainly to a high base, and will continue to fall for the rest of this year.

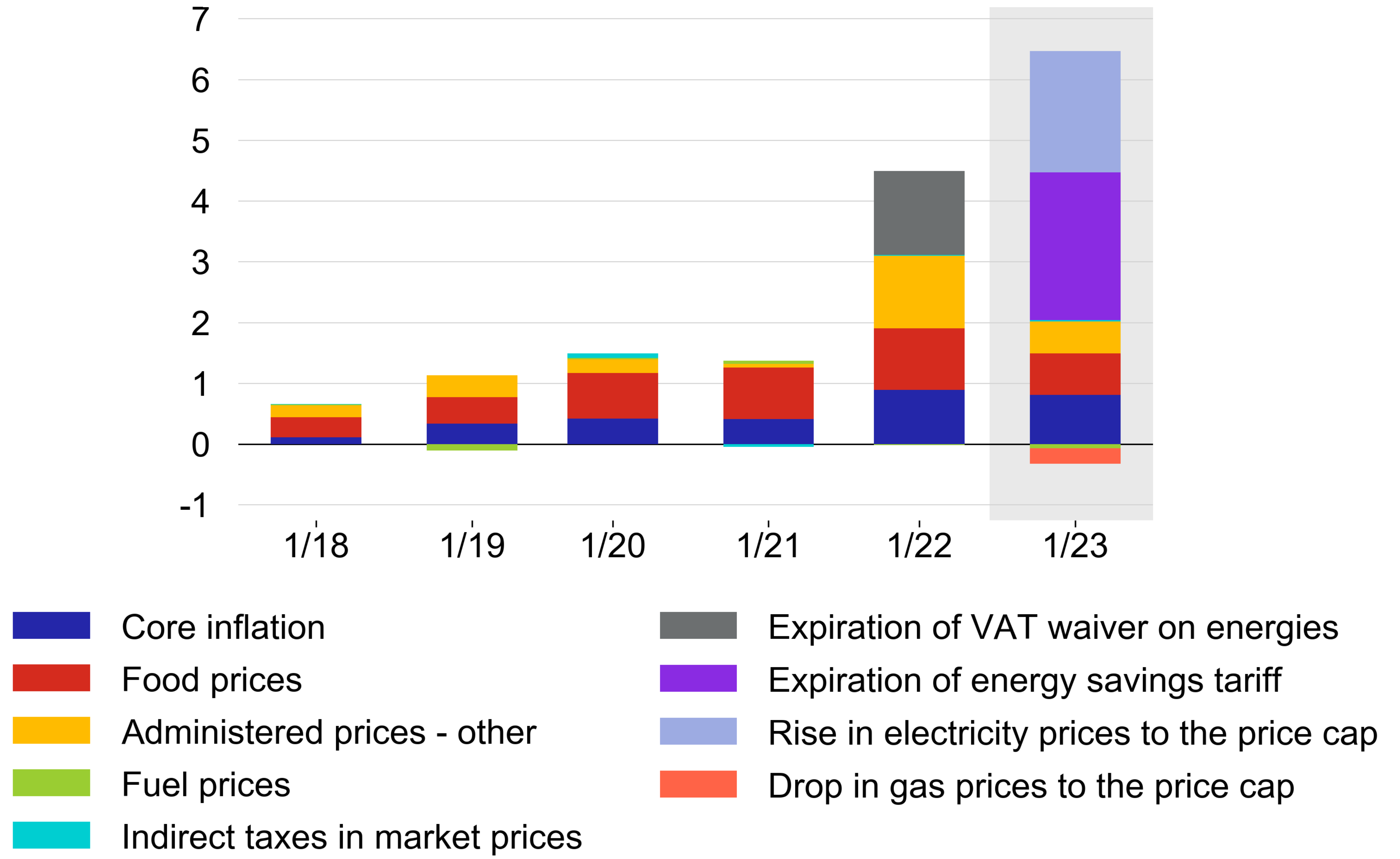
January Inflation Dynamics

Electricity and Gas Price Caps for HHs (CZK/MWh, VAT included)



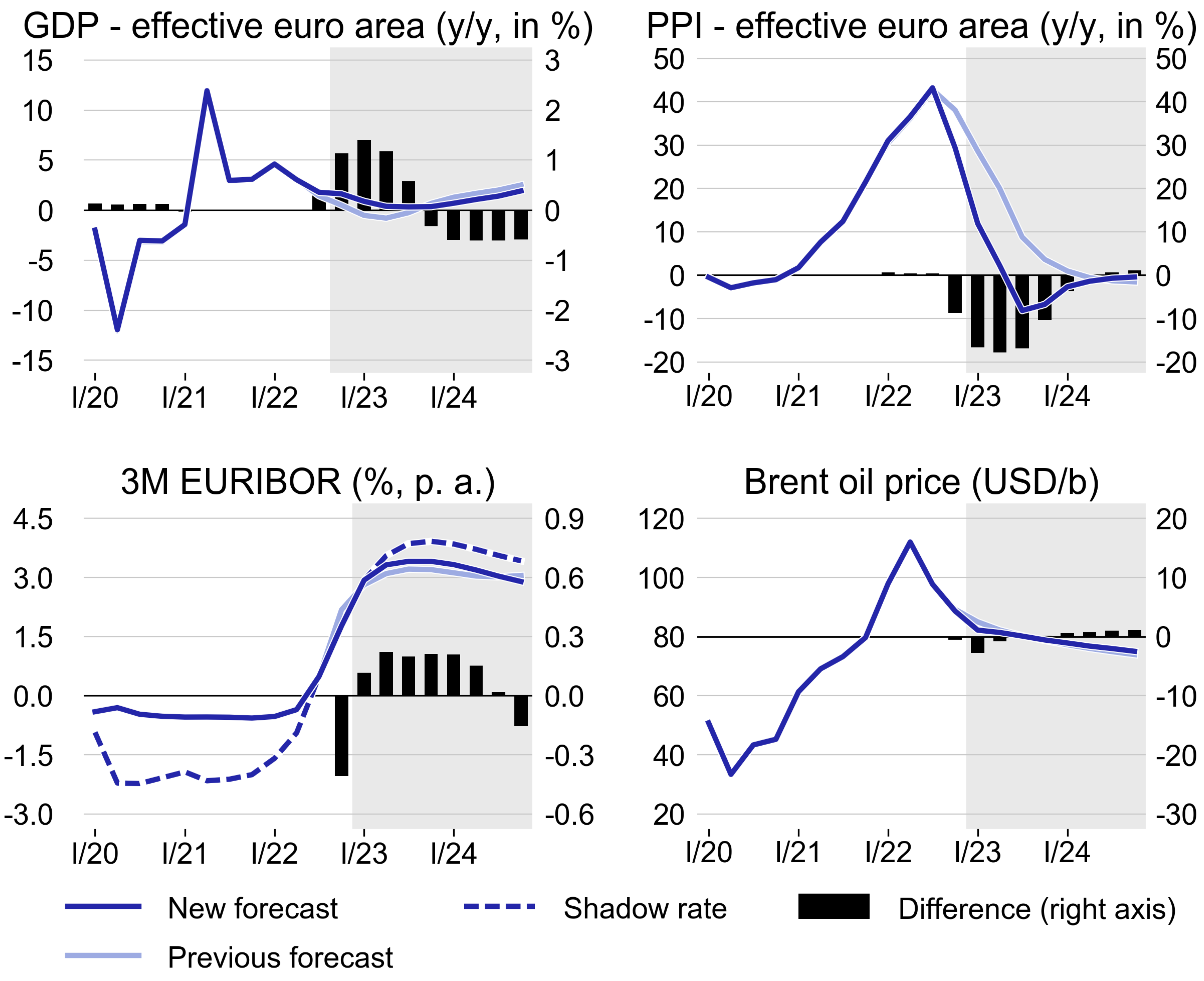


Comparison of January M/M dynamics of CPI (in %, contributions in pp)



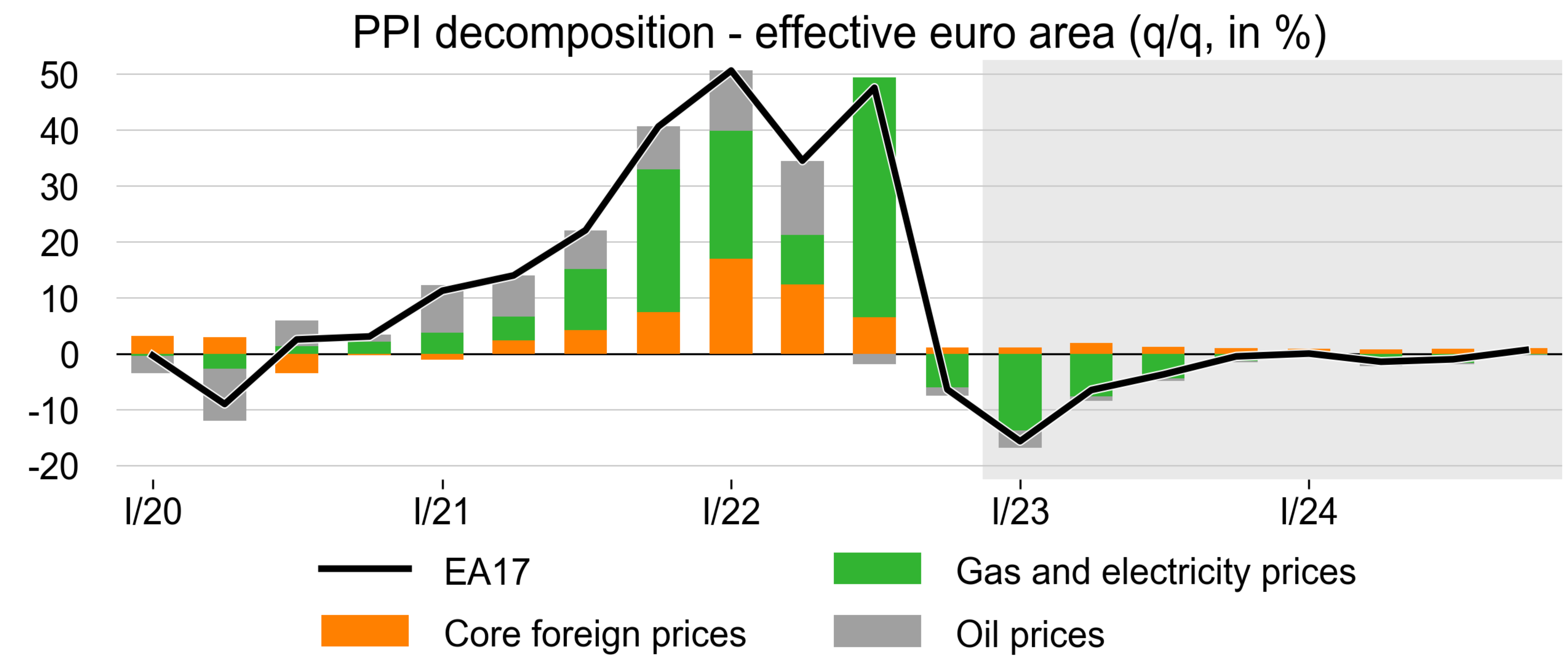
- **Electricity and gas prices for households** would be much higher without the price cap.
- This year's January **dynamics of monthly CPI** will be significantly higher than in the past with main contribution of expiration of energy savings tariff and VAT waiver on energies.

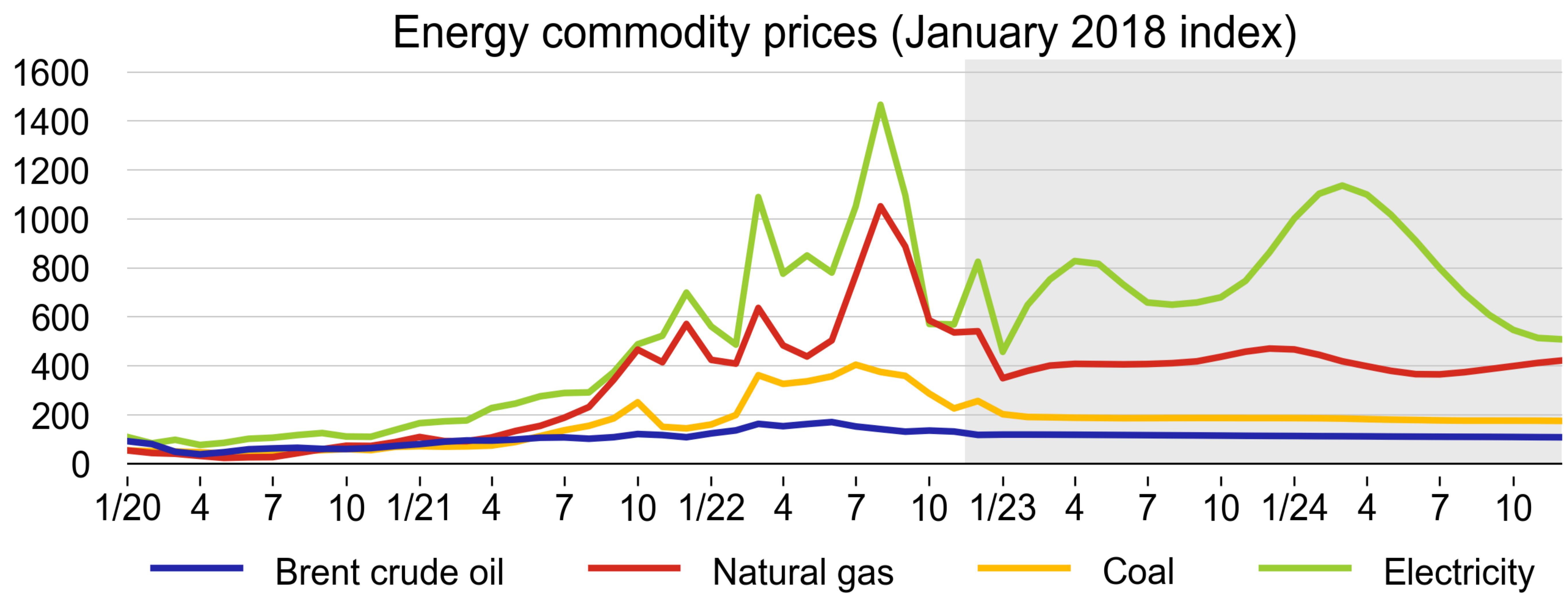
Comparison with Previous Forecast: Foreign Outlook



- The improvement in the **effective euro area GDP growth** outlook for this year is due mainly to the European economy's greater-than-expected resilience during the energy crisis.
- The lower expected **producer price inflation** mainly reflects a sizeable drop in the market outlooks for gas and electricity prices in Europe, due among other factors to this year's mild winter.
- **The Brent oil price** outlook is little changed; there is still a falling trend as a result of weak growth in the global economy.
- The **market interest rate** outlook is slightly higher, reflecting the ECB's hawkish communication in response to a higher outlook for consumer price inflation in the euro area.

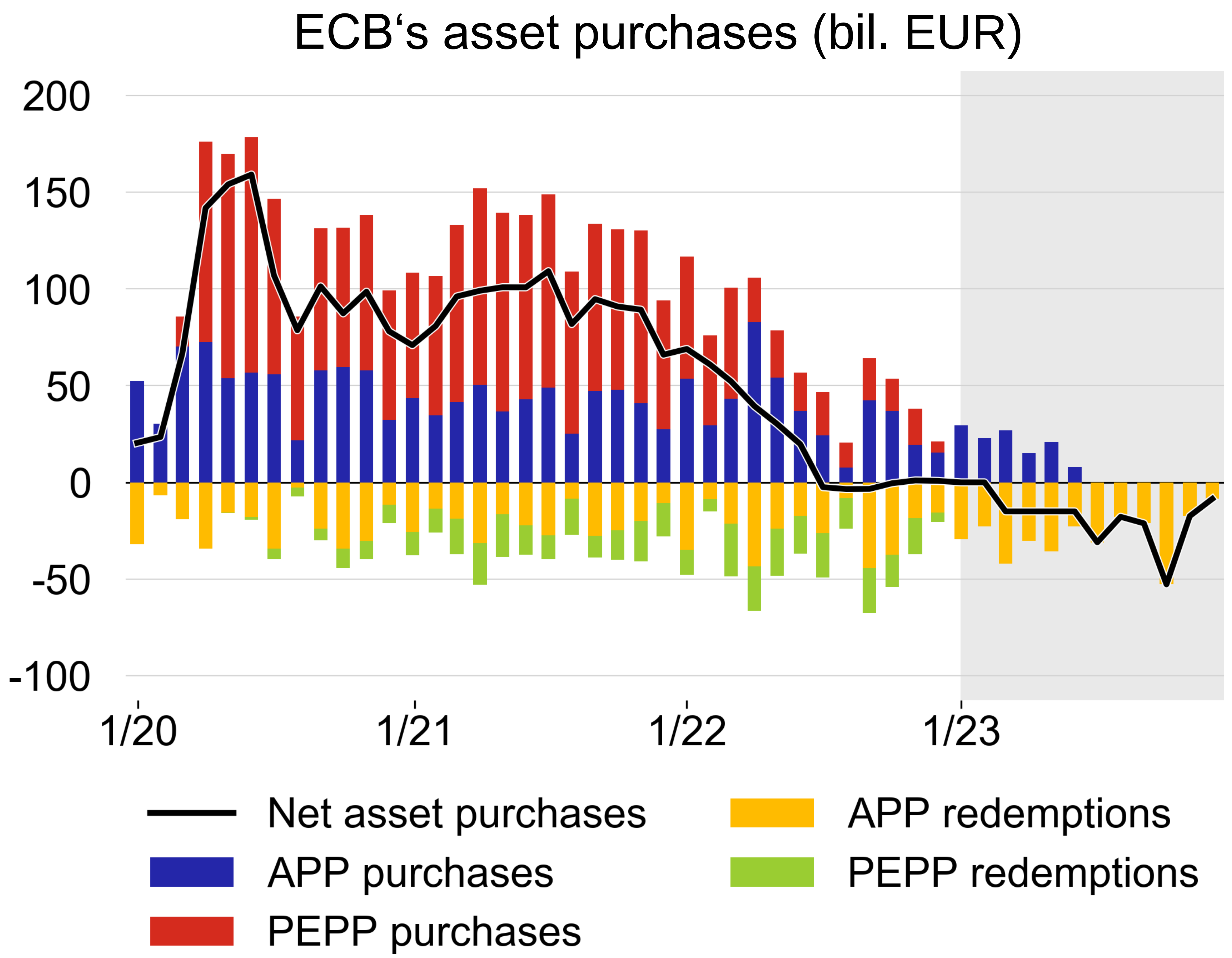
Energy Prices Outlook

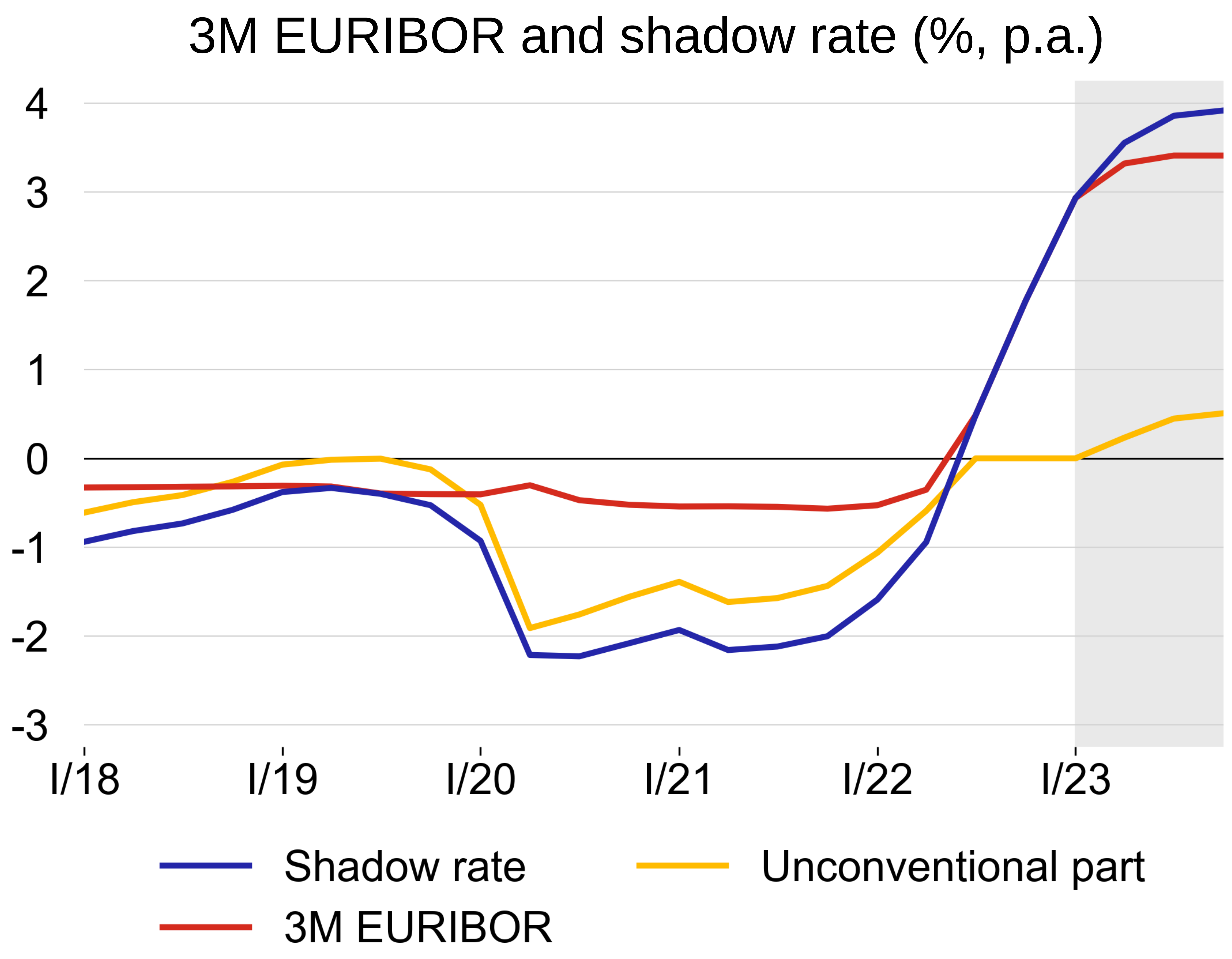




- Drop in effective **euro area PPI** in 2023 will be predominantly driven by gas and electricity prices.

Balance Sheet Operations of ECB





- The volume of financial **assets purchased by the ECB** will start falling in spring 2023, causing the euro area **shadow rate** to move above the 3M EURIBOR due to the unconventional part.