CNB Forecast (Monetary Policy Report Summer 2022 – update)

IMF/WB Annual Meetings

October 2022

Luboš Komárek (Monetary Department)

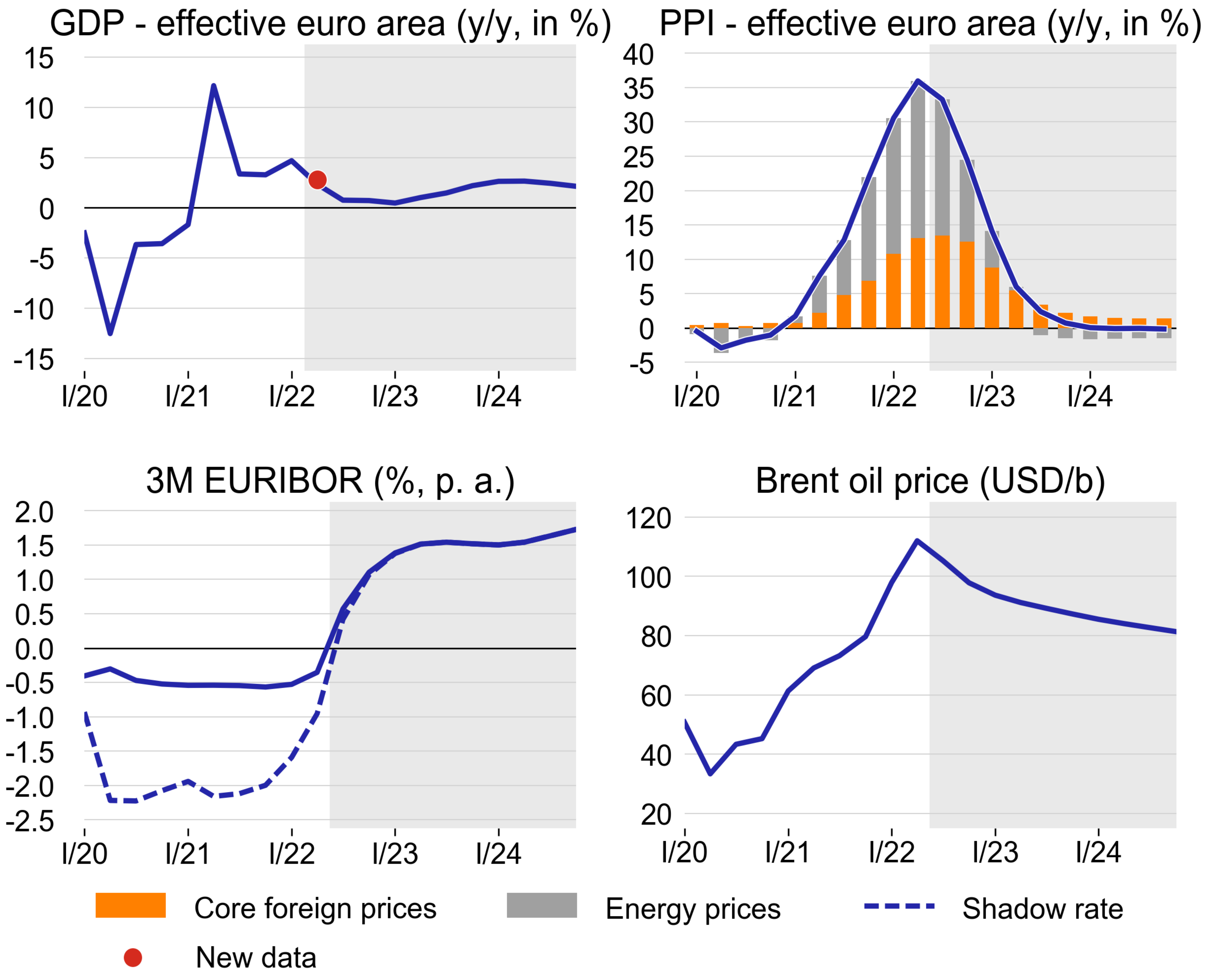
CZECH NATIONAL BANK

Presentation Outline

1. **Assumptions of the Forecast**

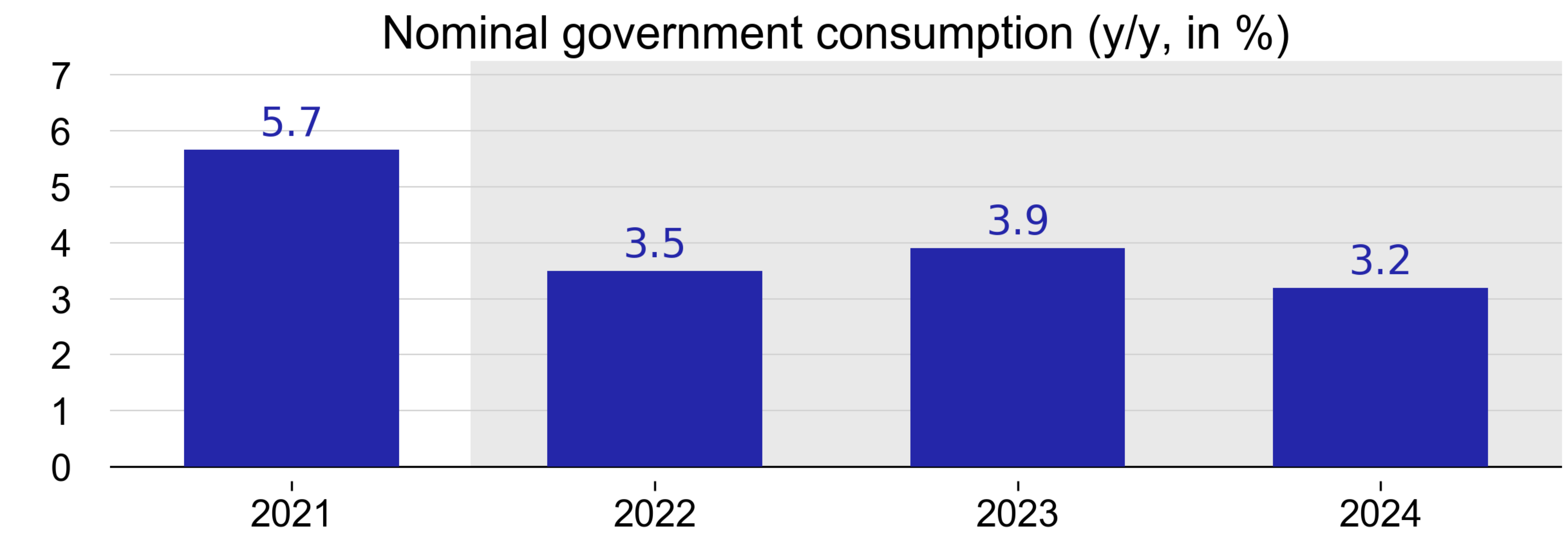
2. New Macroeconomic Forecast

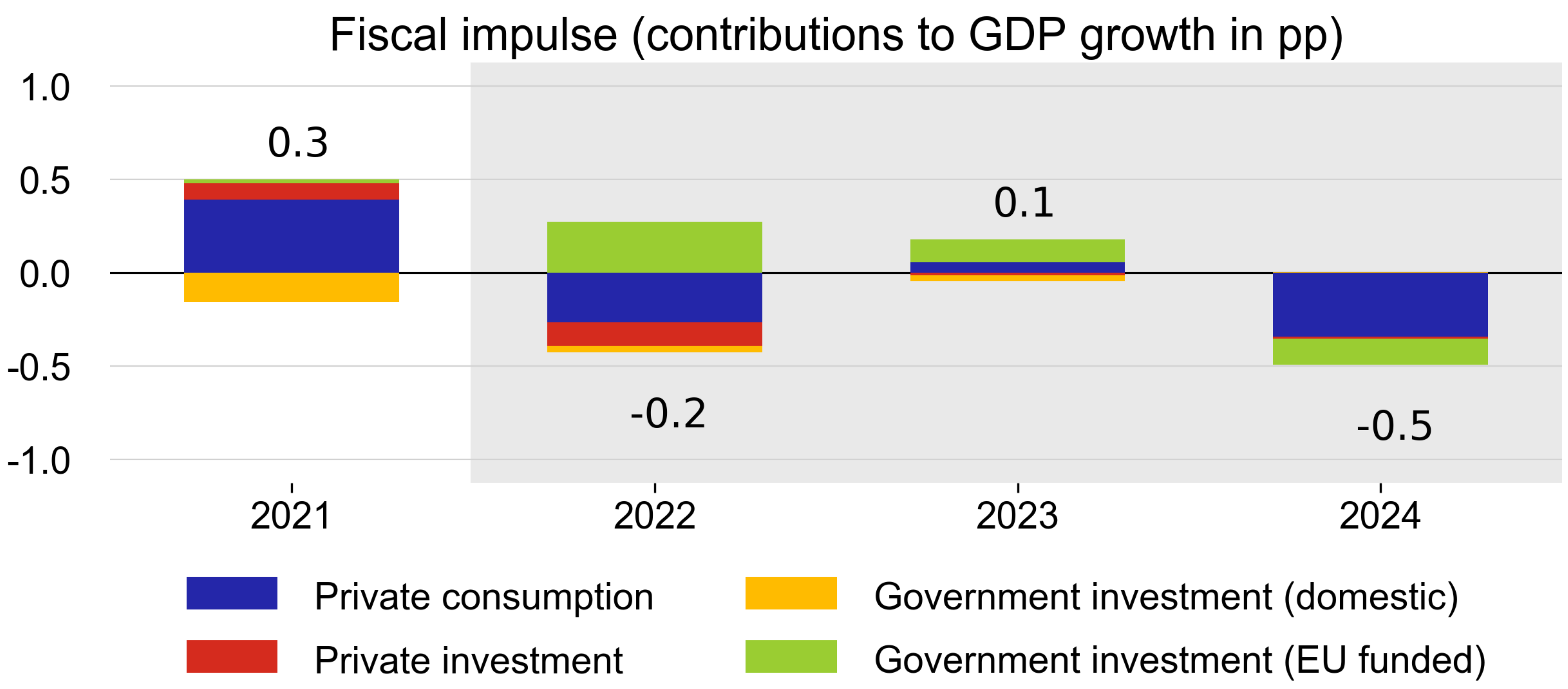
External Environment Outlook



- **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 pressures.
- The market outlook for rising interest rates reflects the **ECB's** expected reaction to the increasing inflation pressures.

Fiscal Policy





- A large part of previously high pandemic-related spending will be ended this year. This, together with a wage freeze or only moderate wage growth for government employees, 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, the **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 remain in place until next year, when the fiscal impulse will turn slightly positive.

Fiscal Measures Related to Rising Energy Prices

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(in billion CZK)	**2022**	**2023**	**Total**	**Note**
Remission of the fee on renewable energy sources	4.5	18.0	22.5	
Energy saving tariff for households	10.4	0.0	10.4	
Subsidy to match capped energy prices		100.0	100.0	
Subsidy program for companies for increased energy costs	15.0		15.0	
Energy compensation for companies	0.5	1.5	2.0	
TOTAL EXPENDITURE	**30.4**	**119.5**	**149.9**	(+) = higher expenditure
Reduction of consumption tax on diesel fuel	-7.4	-12.6	-20.0	
Windfall tax (taxation of extraordinary profits)		95.0	95.0	
TOTAL REVENUES	**-7.4**	**82.4**	**75.0**	(+) = higher revenue / (-) = lower revenue
TOTAL IMPACT ON THE GOVERNMENT BUDGET BALANCE	**-37.8**	**-37.1**	**-74.9**	(-) = higher deficit

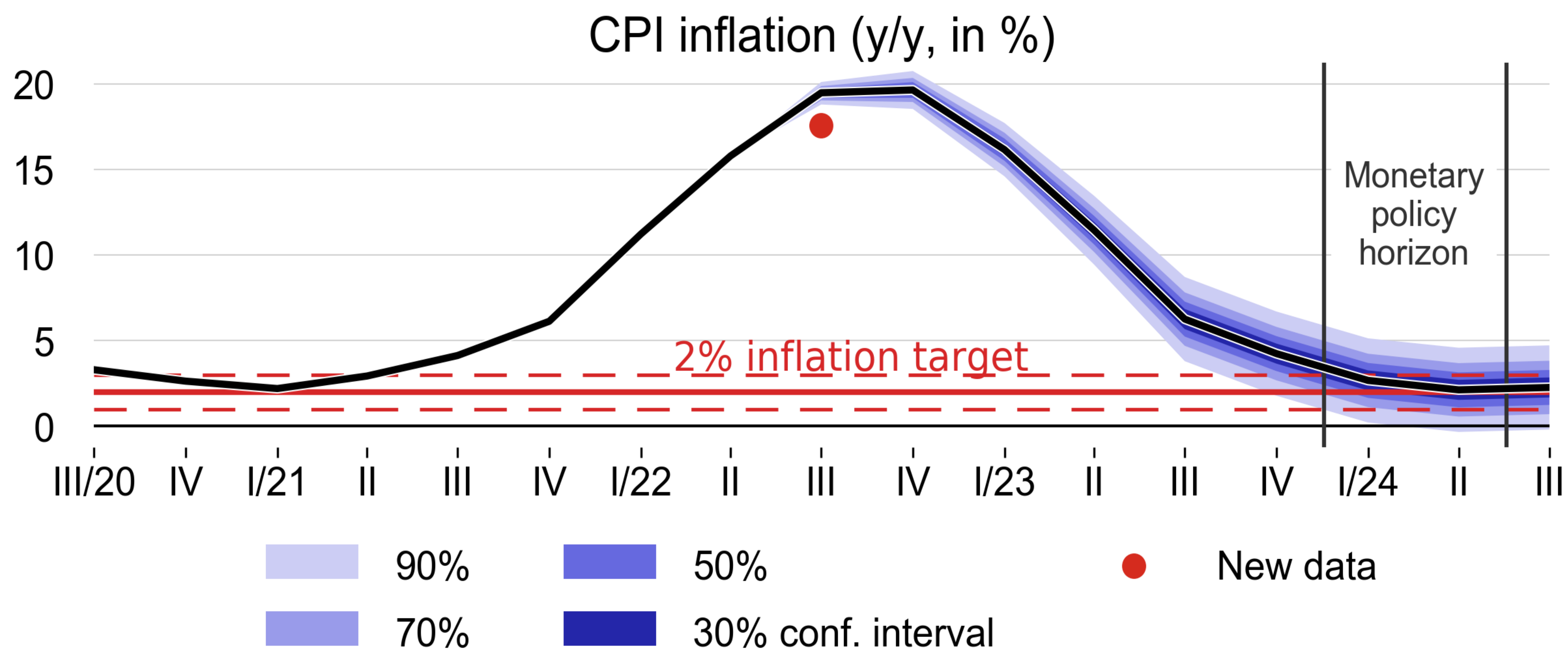
- The government’s **biggest expenditure** to tackle the energy crisis is the introduction of **subsidies to match the cap on energy prices** next year. However, these are designed to be almost completely covered by **windfall tax** (taxation of extraordinary profits of selected sectors).
- An energy saving tariff for households was originally planned for both 2022 and 2023. It has recently been cancelled for 2023 in favour of capping energy prices.
- At present, this newly available information does not significantly change the total estimated **fiscal impulse** for this year and the next in comparison to our summer forecast.

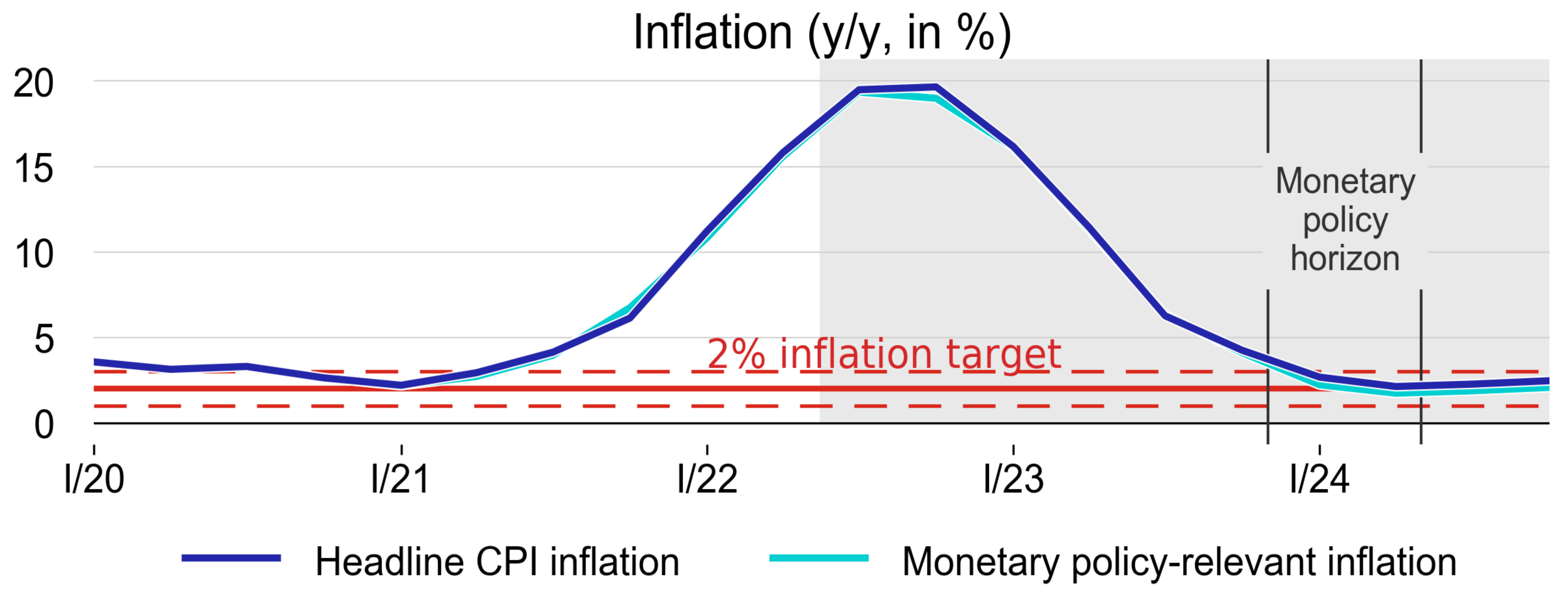
Presentation Outline

1. Assumptions of the Forecast

2. **New Macroeconomic Forecast**

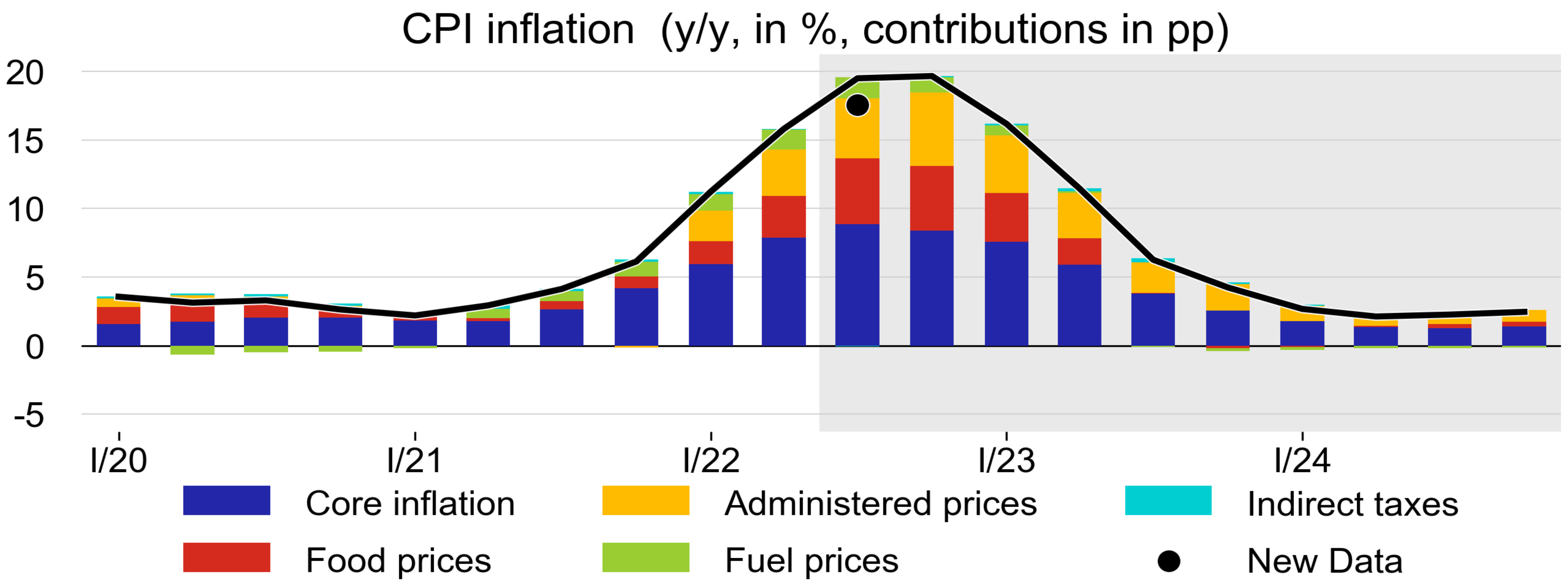
Inflation

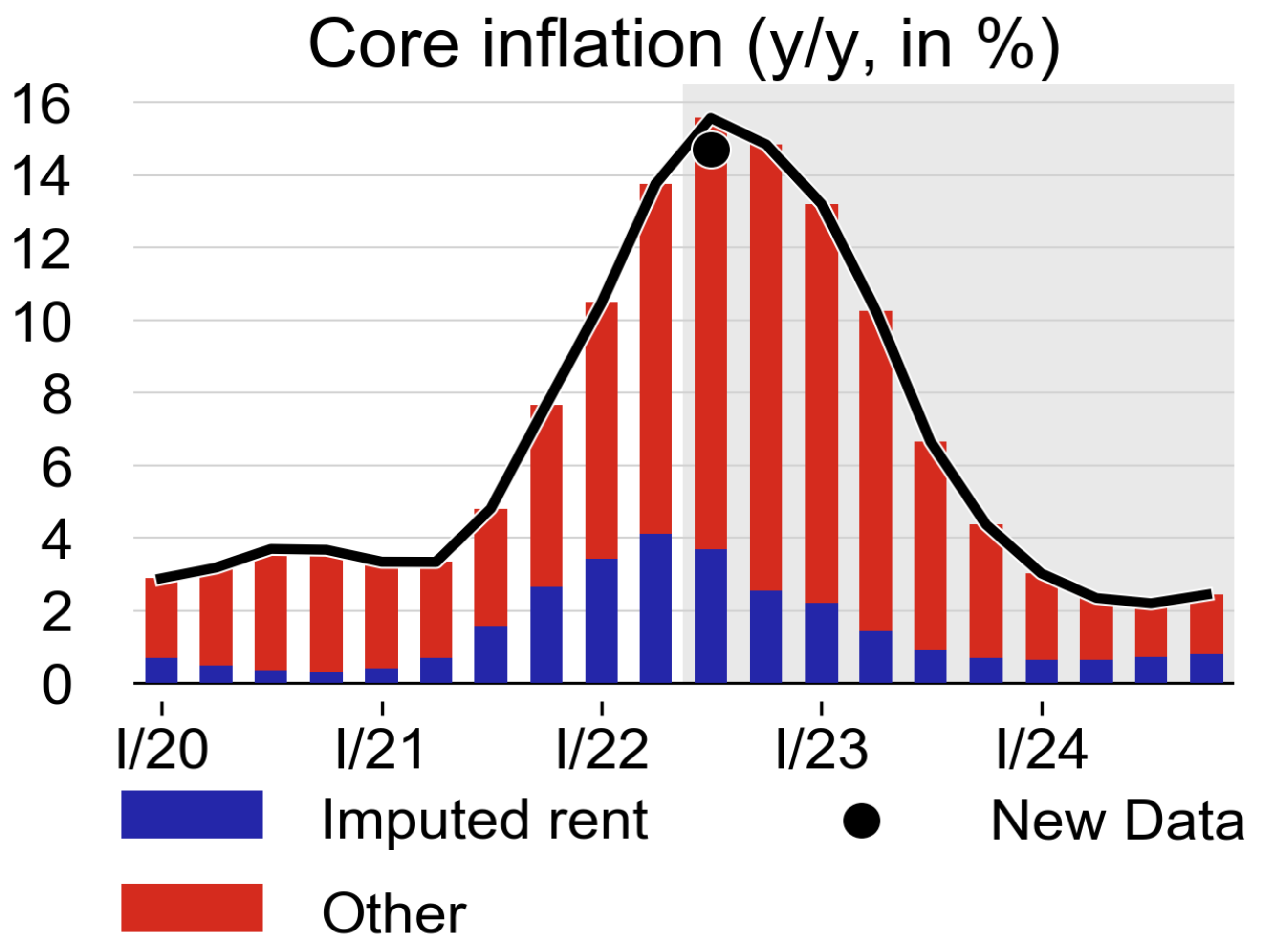


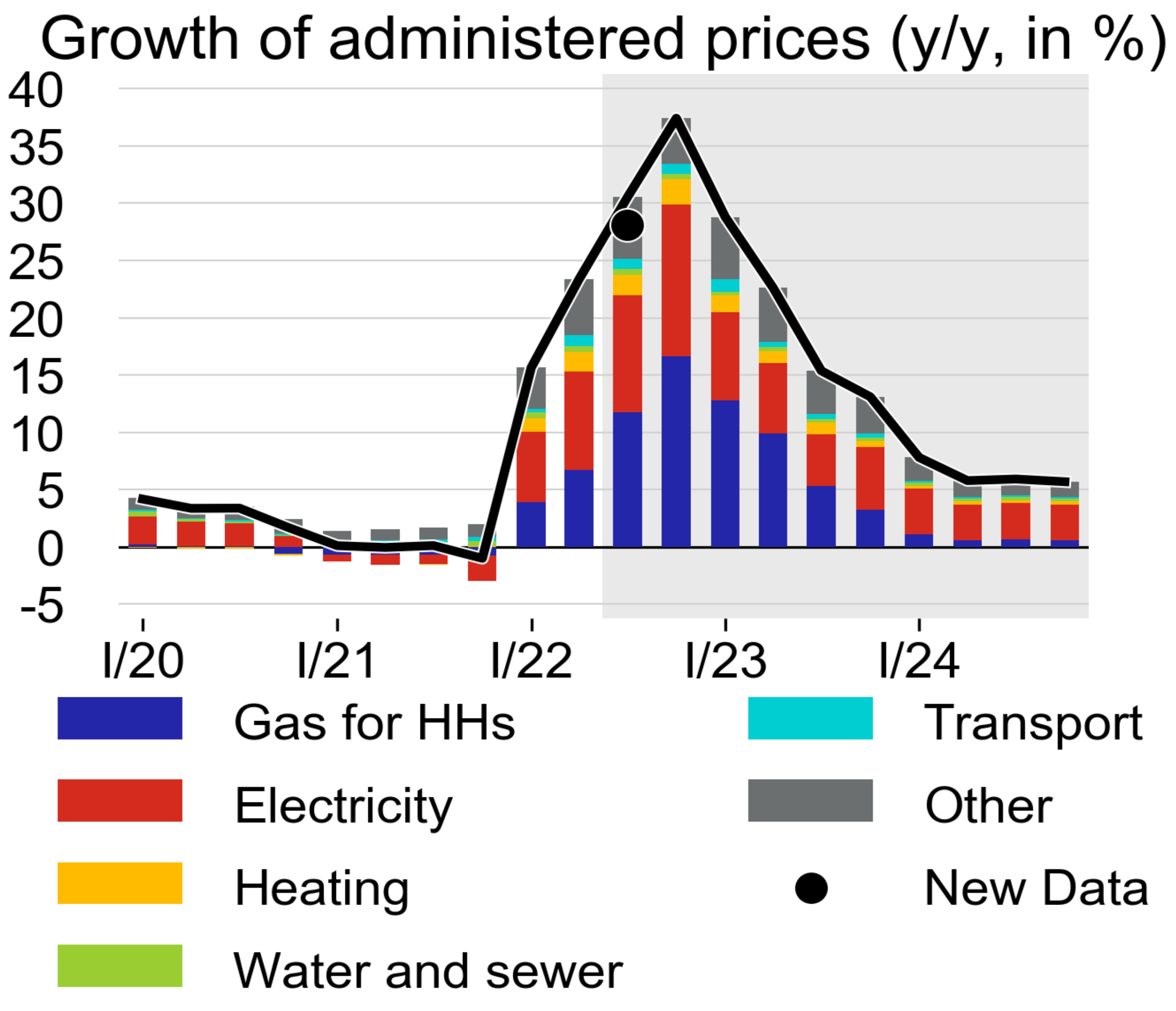


- **CPI inflation** could approach 20% in 2022 Q3 and Q4 and then start to fall.
- It will decrease close to the inflation target at the monetary policy horizon (18–24 months ahead, i.e. in the first half of 2024) due in part to the previous tightening of monetary conditions.
- Changes to indirect taxes 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

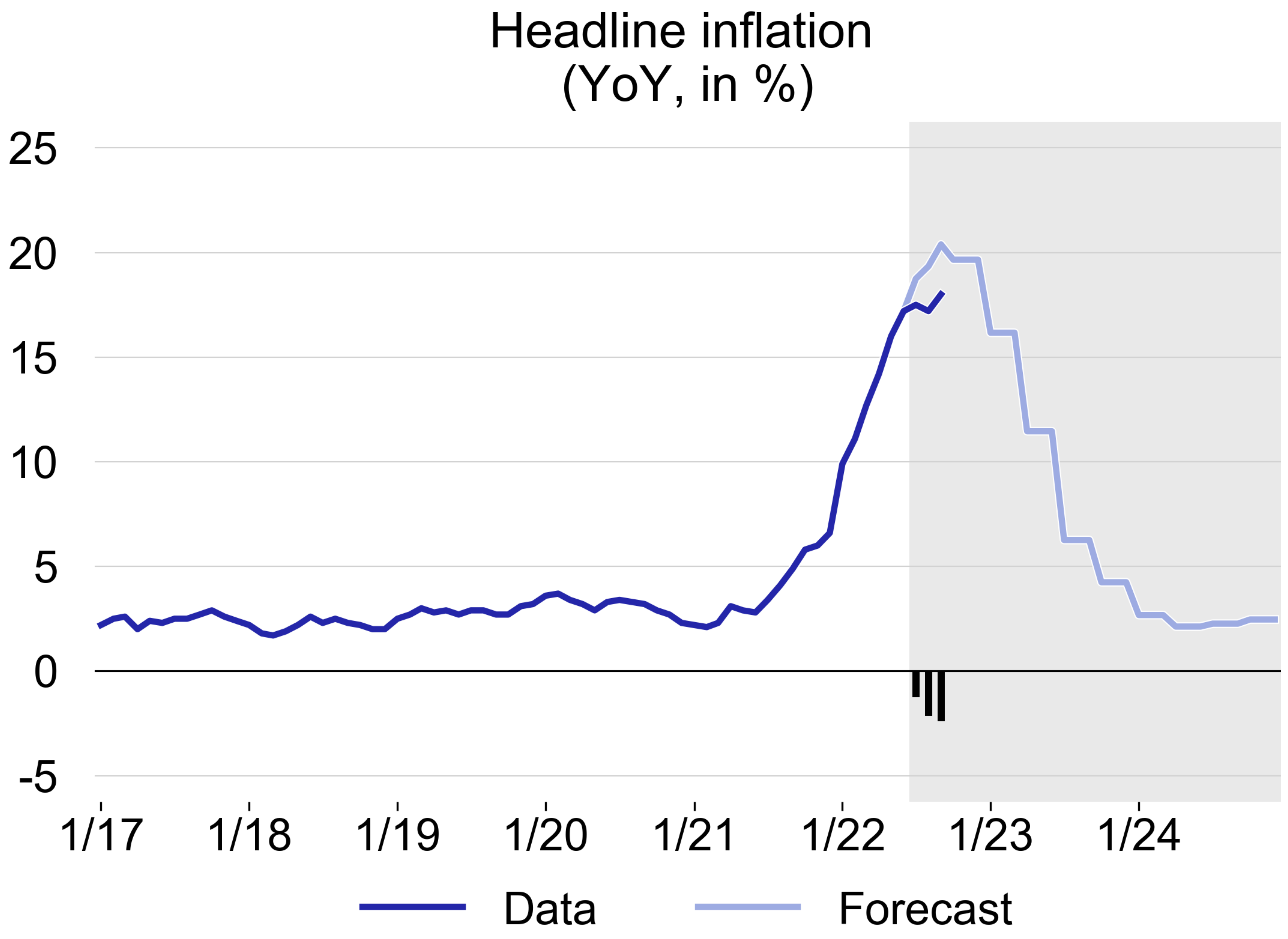






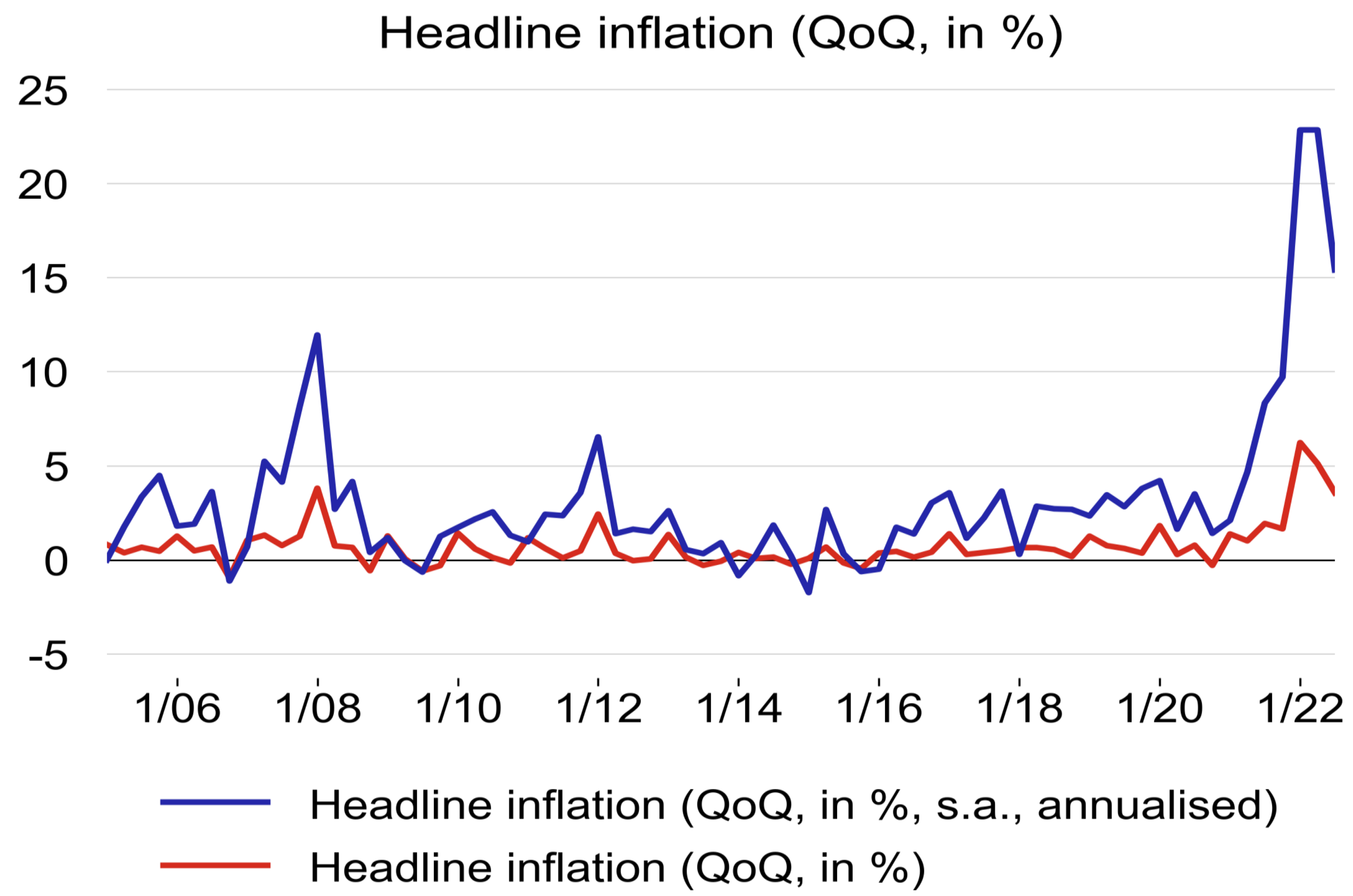
- The escalating **price growth** will continue to be dominated by core inflation, but growing contributions of administered prices and sharply rising food prices will also play a significant role.
- Within **core inflation**, there is significant growth in prices of tradables and especially nontradables, 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.

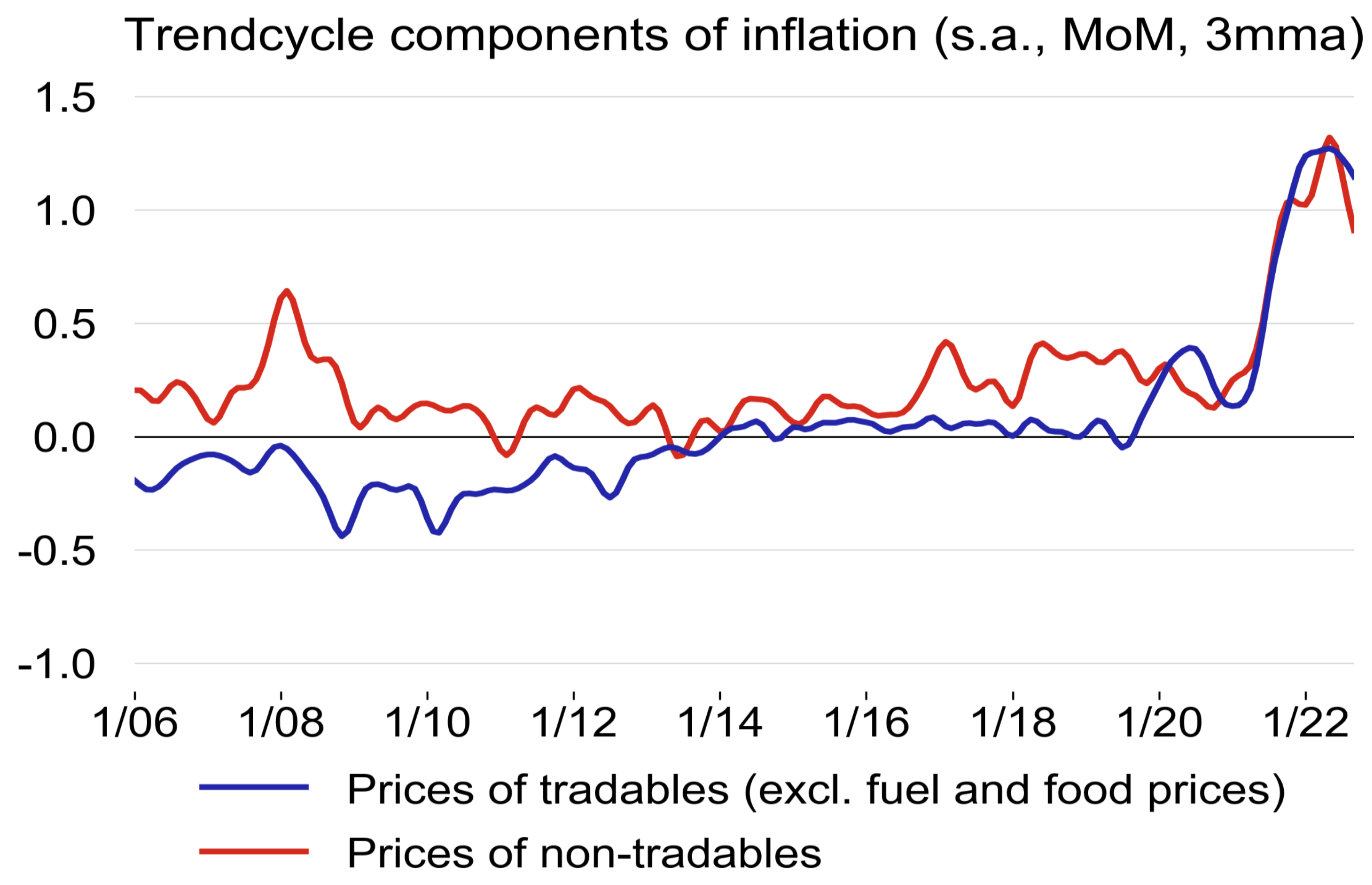
CPI – Summer Forecast vs. Reality



- The evolution of inflation in Q3 signals the **possibility of inflation peaking at a somewhat lower level than expected**.
- **A moderation of price growth** will be fostered in the subsequent period by an easing of the dynamics of production costs, a decline in households' purchasing power, and the stabilising effect of the previous monetary policy tightening helping to cool domestic demand.

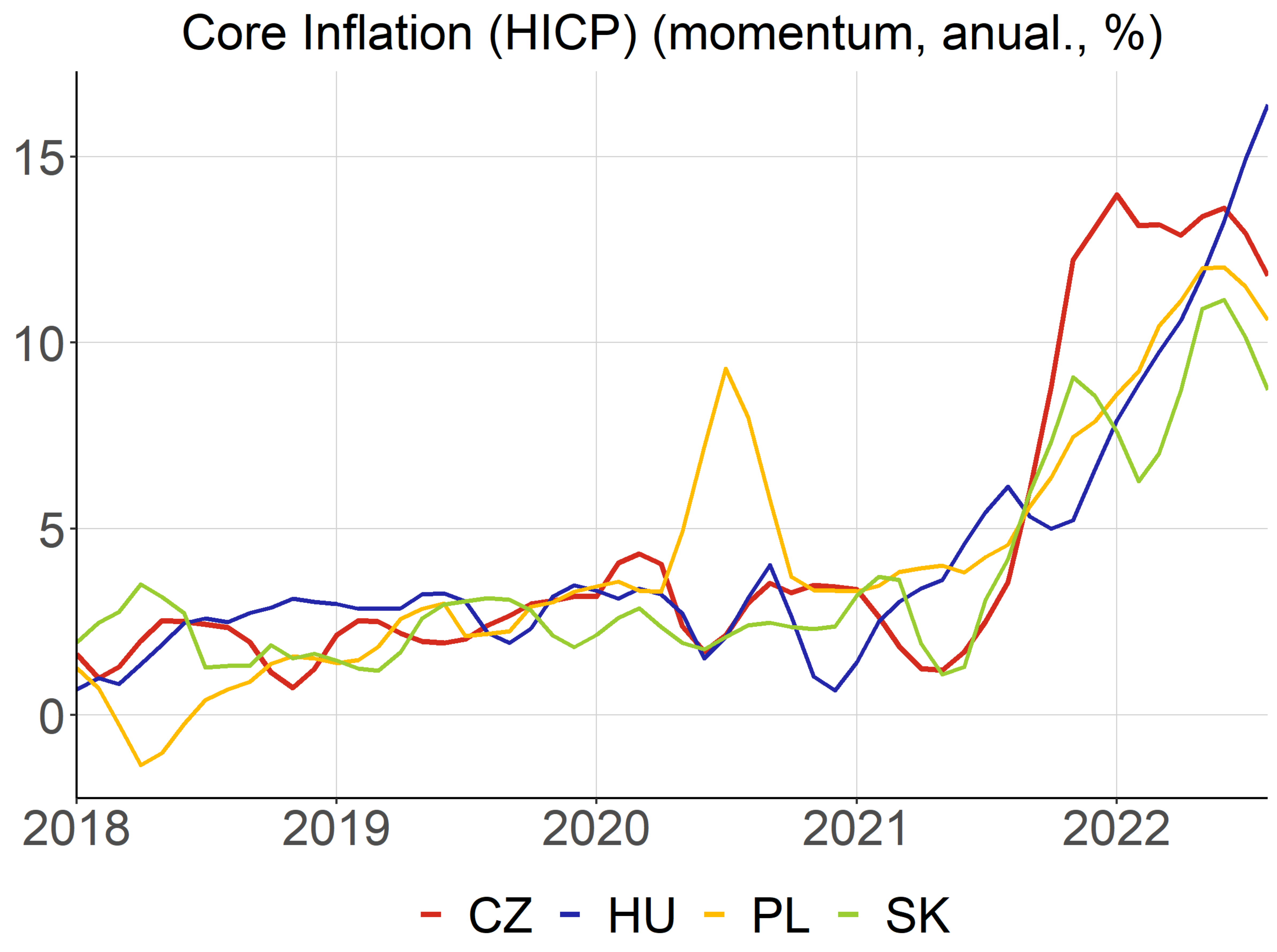
CPI – Summer Forecast and Reality





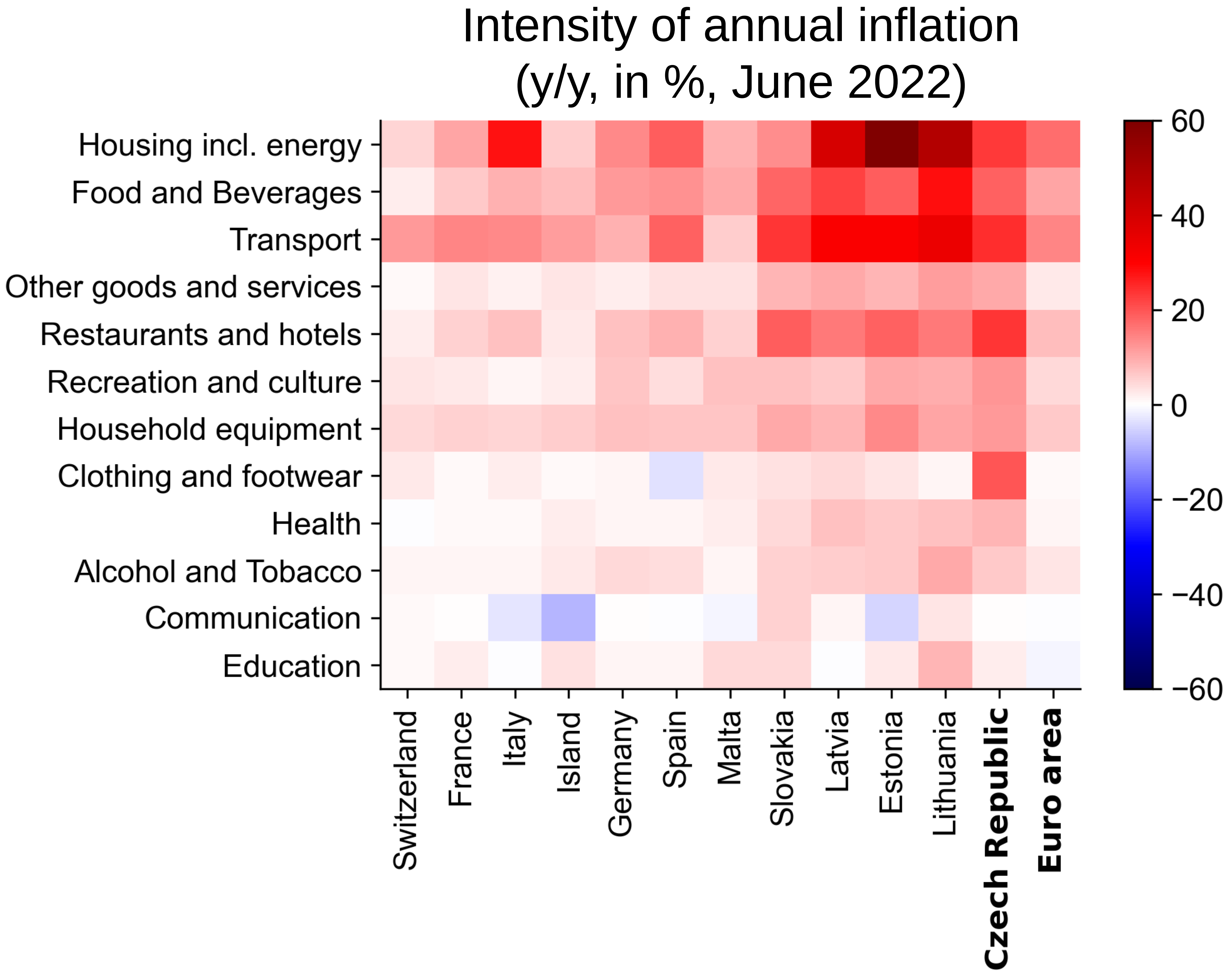
- The observed data **confirm a peak in inflation**, which the CNB forecast predicted in the second half of 2022.
- The effect of the fading post-Covid recovery of domestic demand is especially visible in **tradable goods** prices, which decelerated more slowly than services.
- The contribution of the cost of **owner-occupied housing** in the form of imputed rent, which had previously been exceptionally high, declined slightly during Q3.

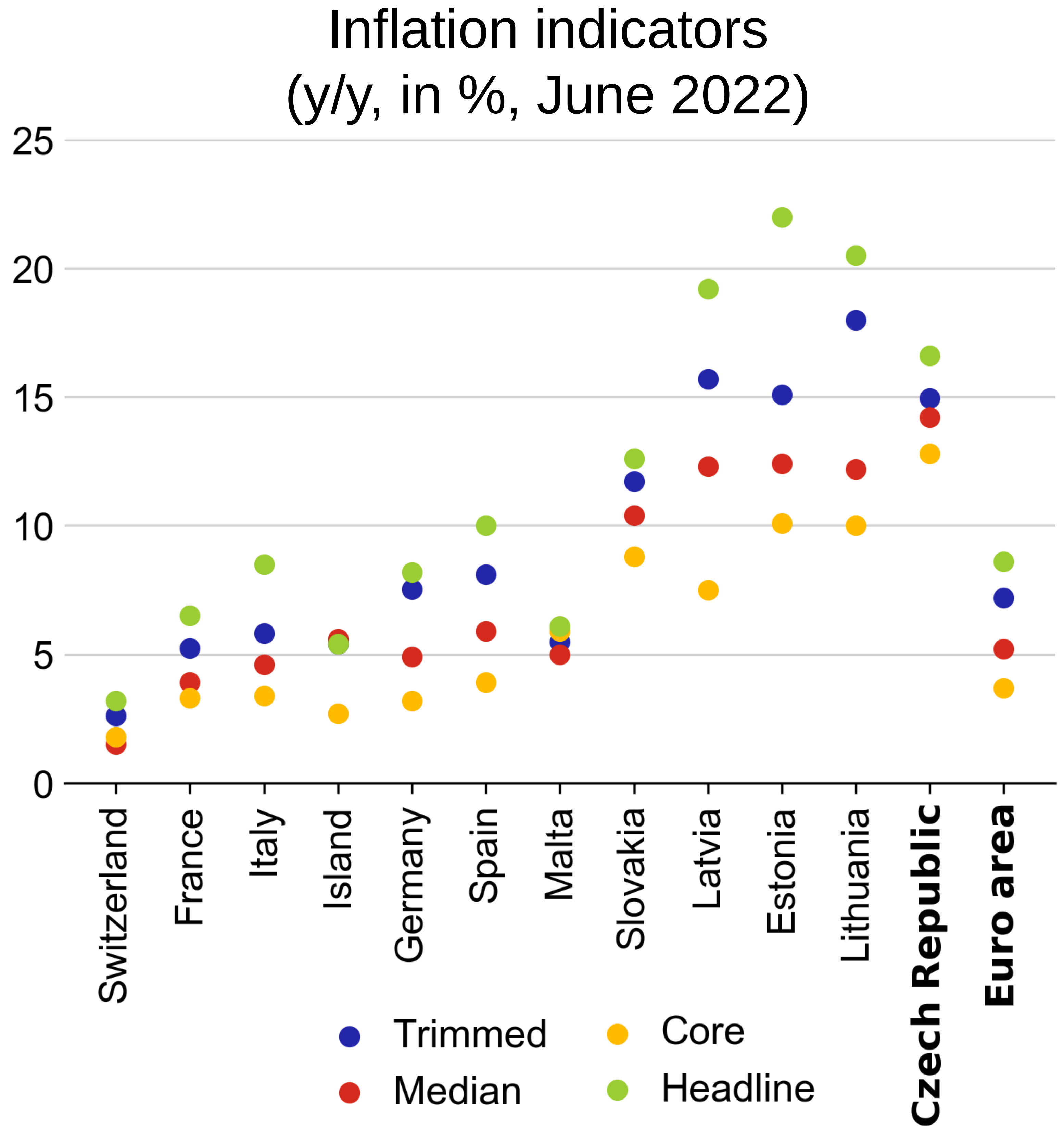
Core inflation in the V4 countries



- **Core inflation** in CZ, PL, SK is slowing in contrast to HU.
- It is still very high in all V4 countries.

Czech Inflation in the European Context





- Price growth in the main **consumer basket categories** shows that inflation in the countries under review was driven mainly by growth in housing (including energy and fuel), transport and food prices. The Czech Republic holds “first place” 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%.

Labour Market

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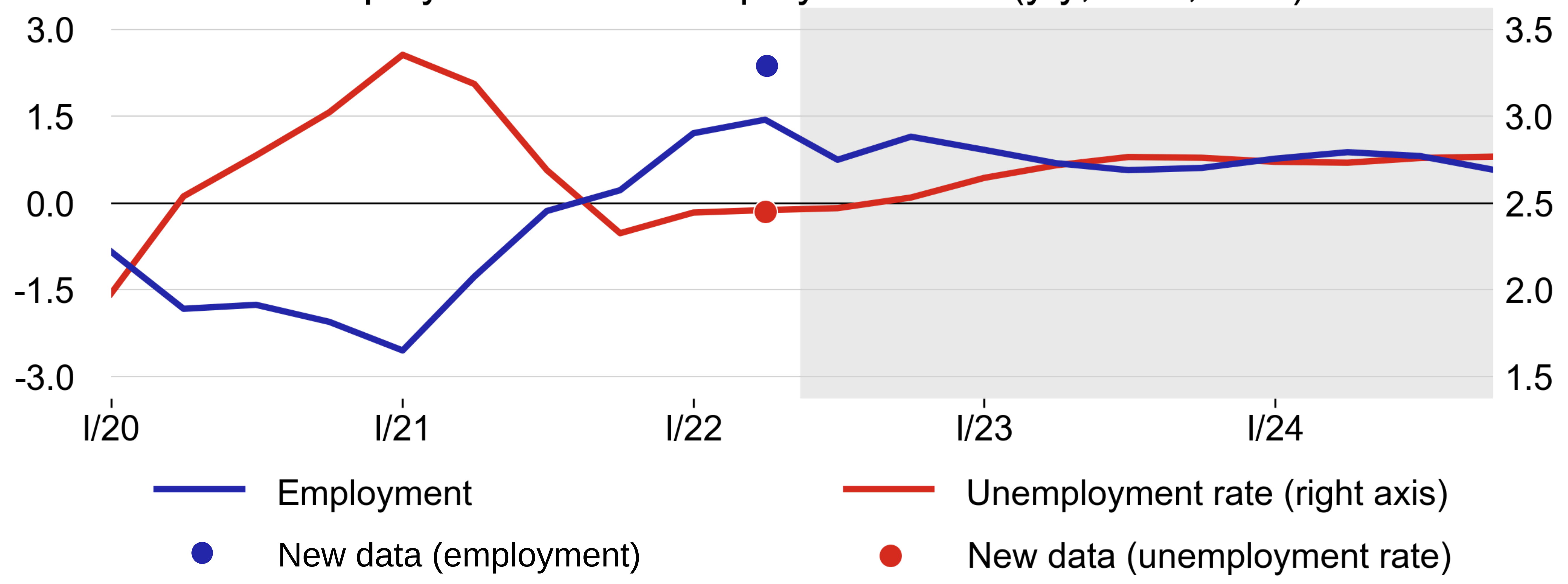
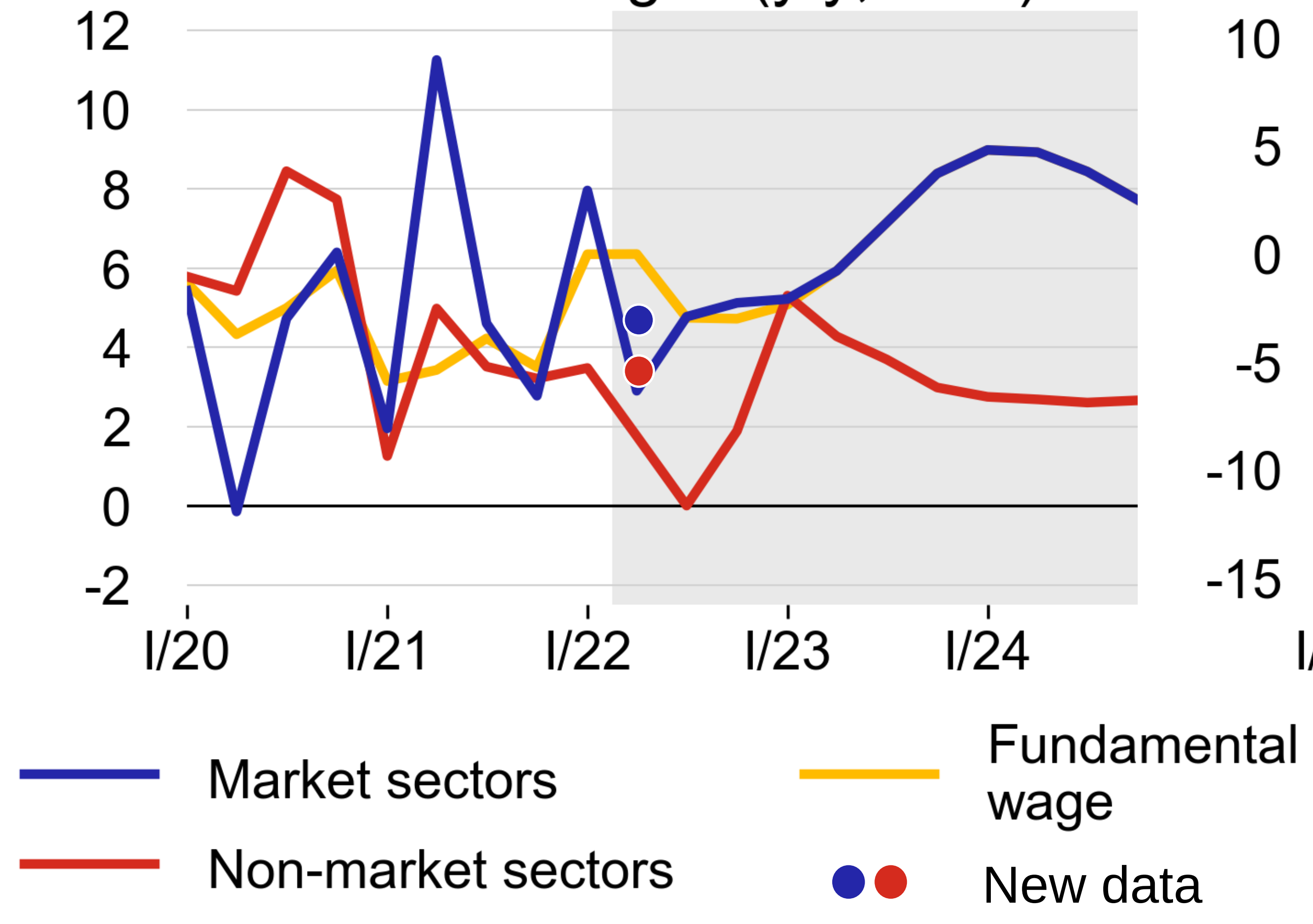
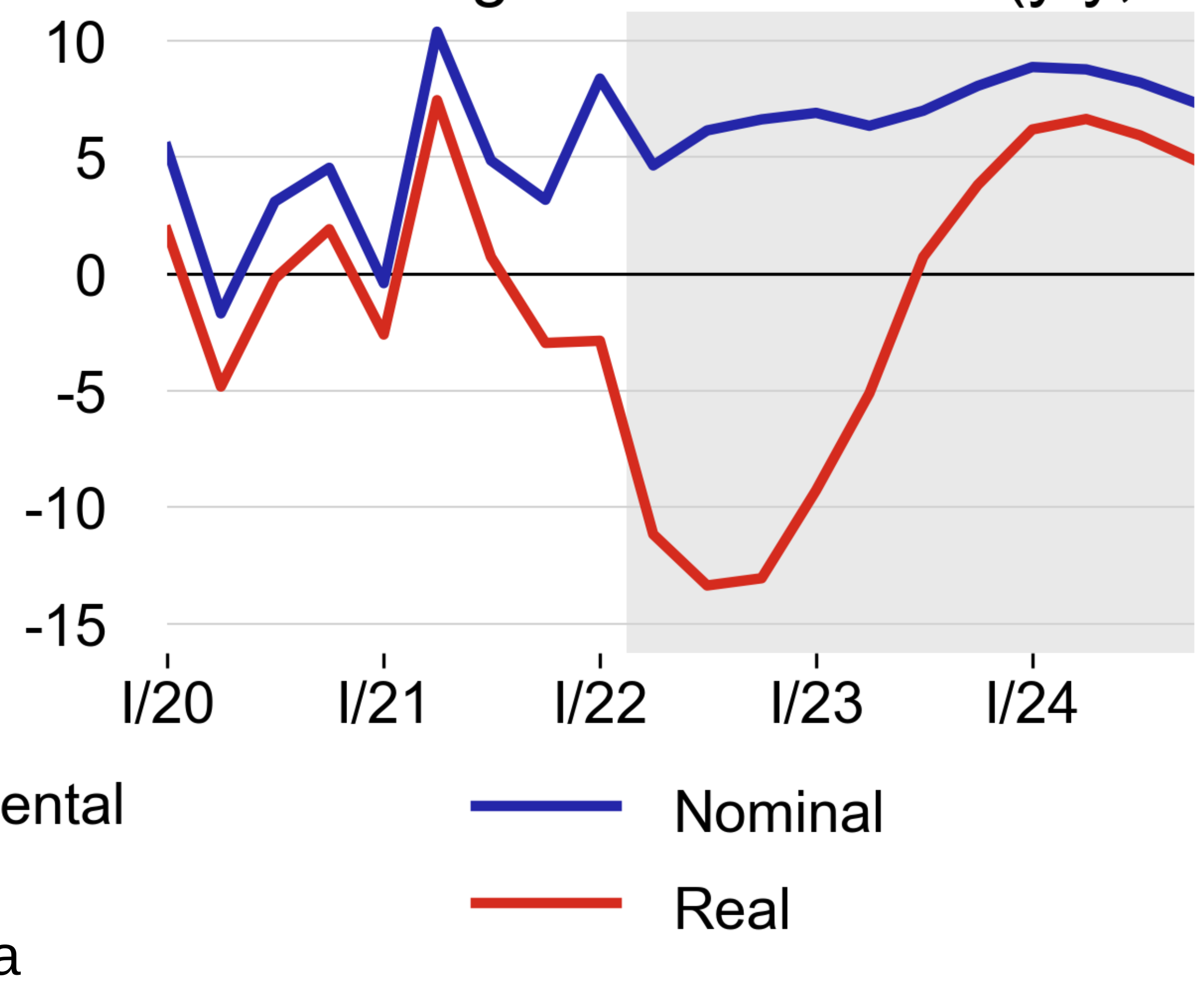
Employment and unemployment rate (y/y, in %, s. a.)



Nominal wages (y/y, in %)

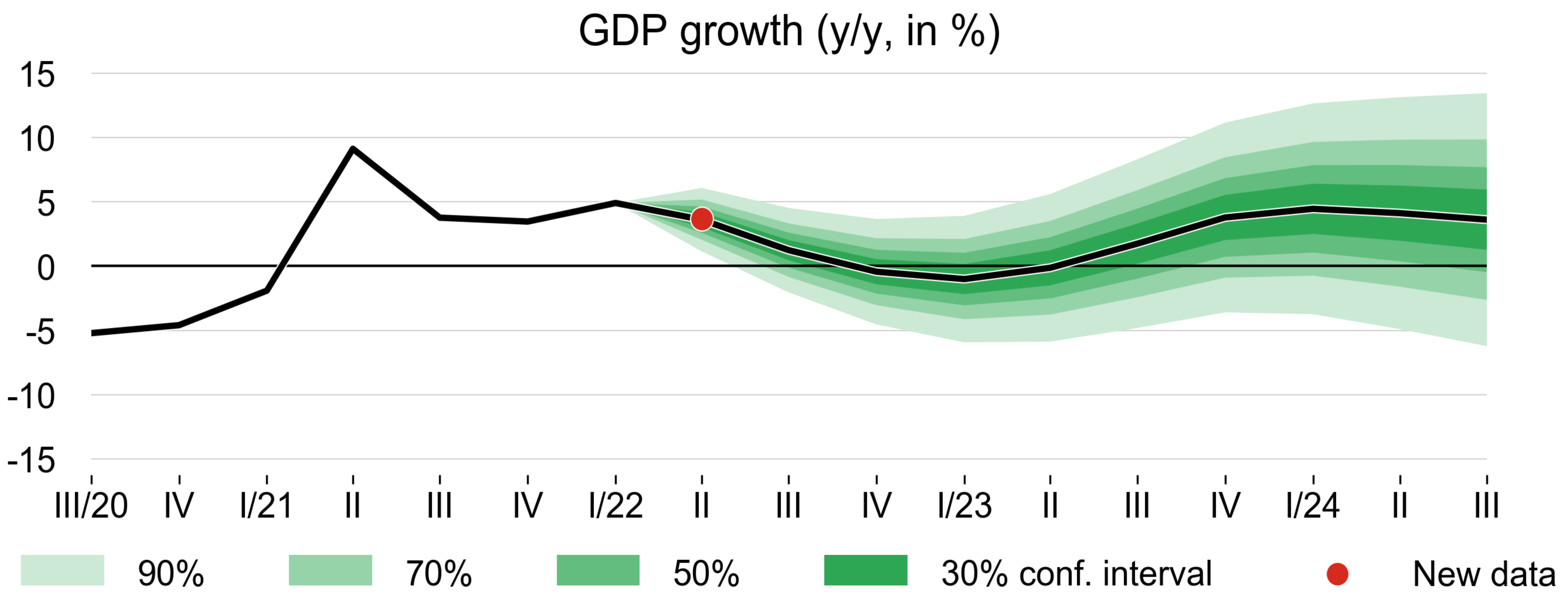


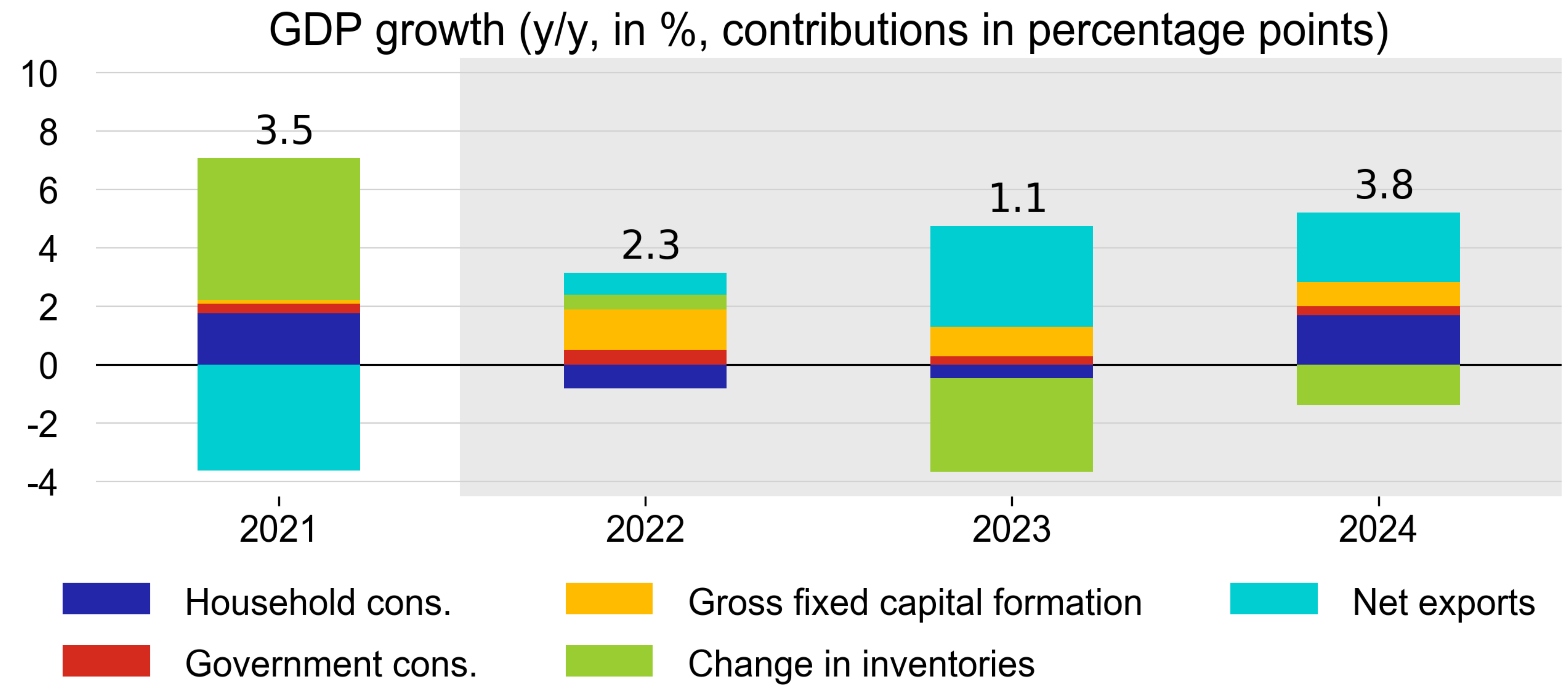
Volume of wages and salaries (y/y, in %)



- **Employment** will continue to rise, with 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.

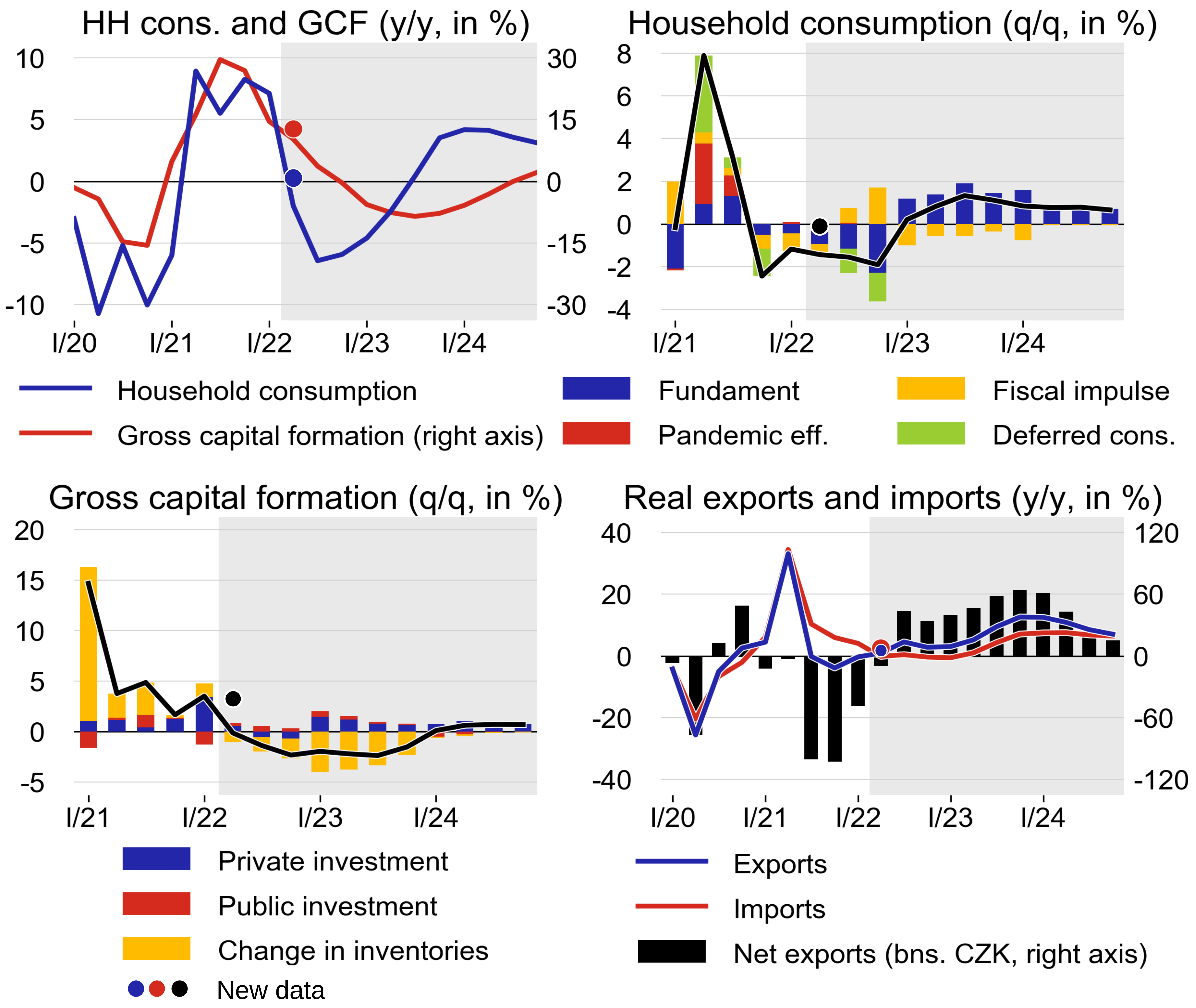
GDP Growth Forecast





- **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 temporarily below its **potential**.

GDP Components



- **Household consumption** will decrease this year due to a sharp decline in households' real income and sentiment, with higher interest rates and the depletion of forced savings 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

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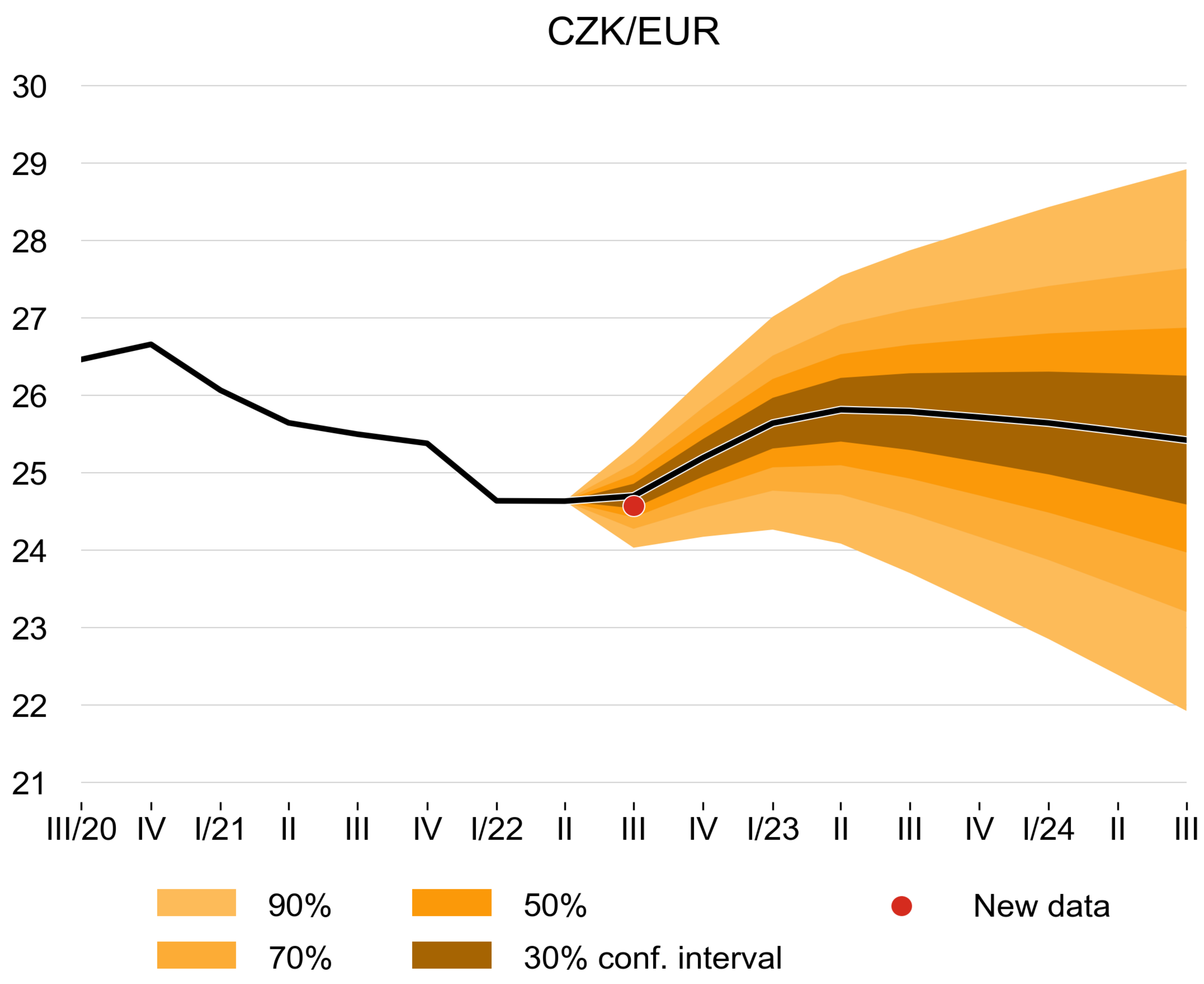
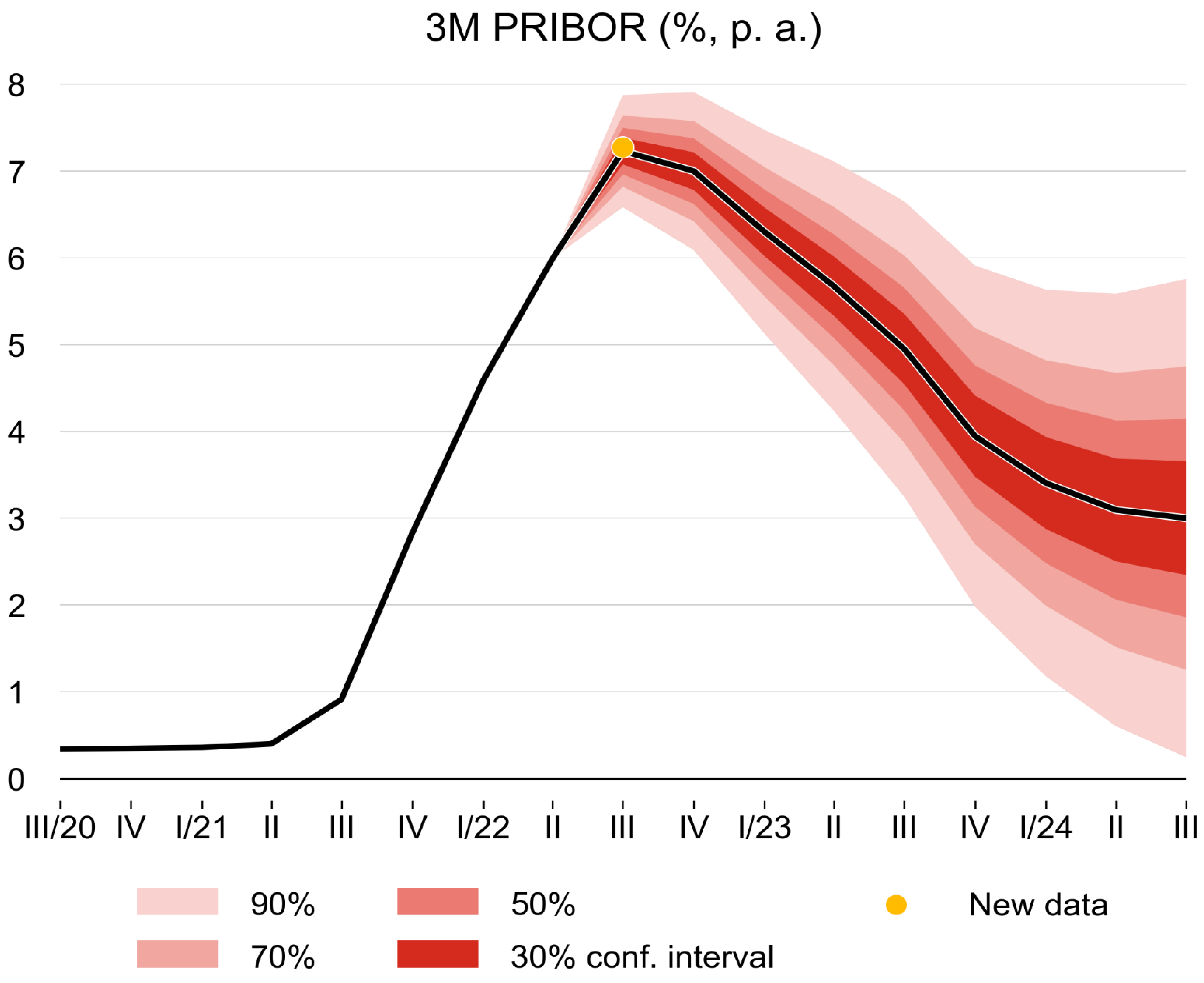


- The forecast predicted the **koruna** to average CZK 24.7 to the euro in 2022 Q3.
- In the coming quarters, the koruna will depreciate slightly, reaching just below CZK 26 to the euro in mid-2023.
- This will be due mainly to a worsening trade balance and negative sentiment in the region, factors caused 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 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.

Graph of Risks to the Inflation Projection (GRIP)

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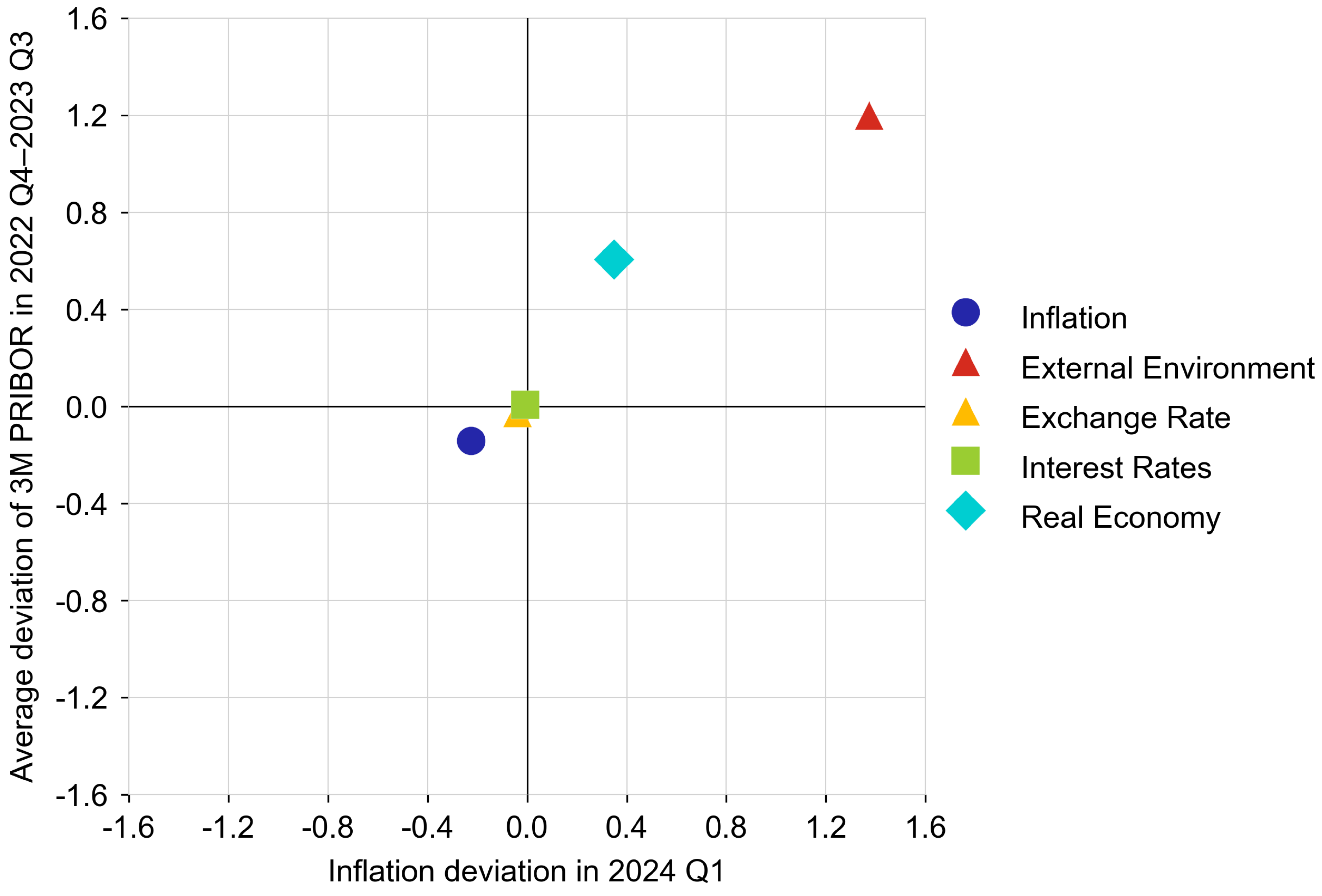

- Overall, the **newly available information obtained since the summer forecast** was prepared implies considerably **higher levels of domestic inflation and interest rates** overall in the GRIP simulation than in the summer forecast.
- The strongest factor in this direction is a **higher outlook for ECB interest rates** and for the core and energy components of the PPI in the effective euro area.
- The **lower inflation figures** observed in Q3 so far and a revision of the administered price forecast as a result of the **government's newly planned ceiling on energy prices** foster slightly lower inflation and interest rates.

MP Decision (29 Sep); Risks and Uncertainties of the Forecast

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6.00%	**7.00%**	8.00%
discount rate	**2W repo rate**	Lombard rate

VOTING ON THE 2W REPO RATE

LEAVE UNCHANGED at 7.00%	FOR AN INCREASE to 7.75%
5	2

The Bank Board confirmed that it is **ready to continue to fight inflation until it is fully under control, i.e. stabilised at the 2% target**. This means interest rates will remain relatively high for some time.

The Bank Board assessed the **risks and uncertainties** of the summer forecast as being significant and going in both directions:

Inflationary risks:

- faster wage growth
- more expansionary fiscal policy
- a higher outlook for foreign producer prices
- risk of inflation expectations becoming unanchored from the CNB's 2% target and the related risk of a wage-price spiral

Anti-inflationary risks:

- growing likelihood of recession abroad
- stronger-than-forecasted downturn in domestic consumer and investment demand
- introduction of measures to limit growth in energy prices
- faster-than-expected decline in core inflation

Uncertainties:

- future course of the war in Ukraine
- availability and prices of energy
- future monetary policy stance abroad

Thank you for your attention

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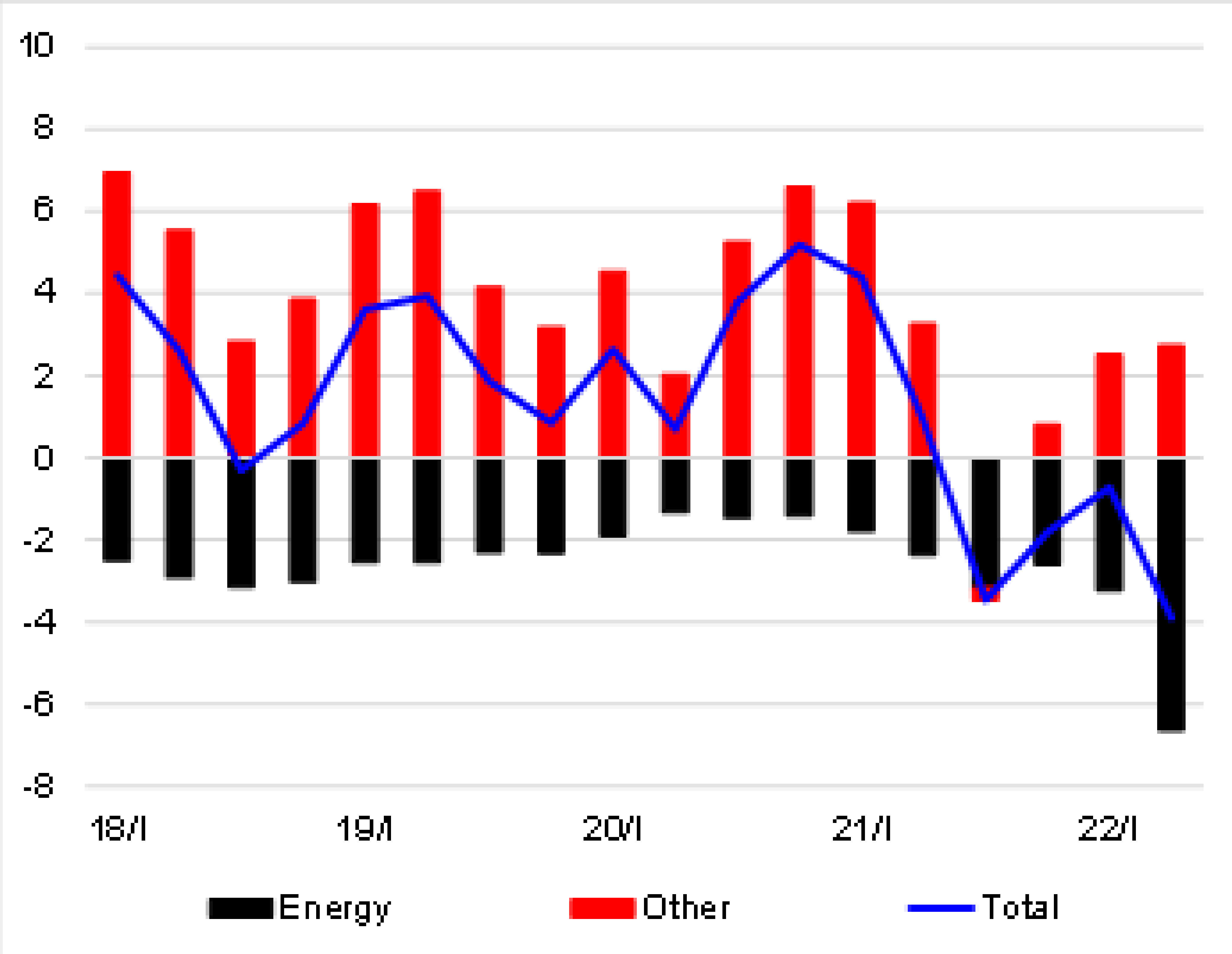
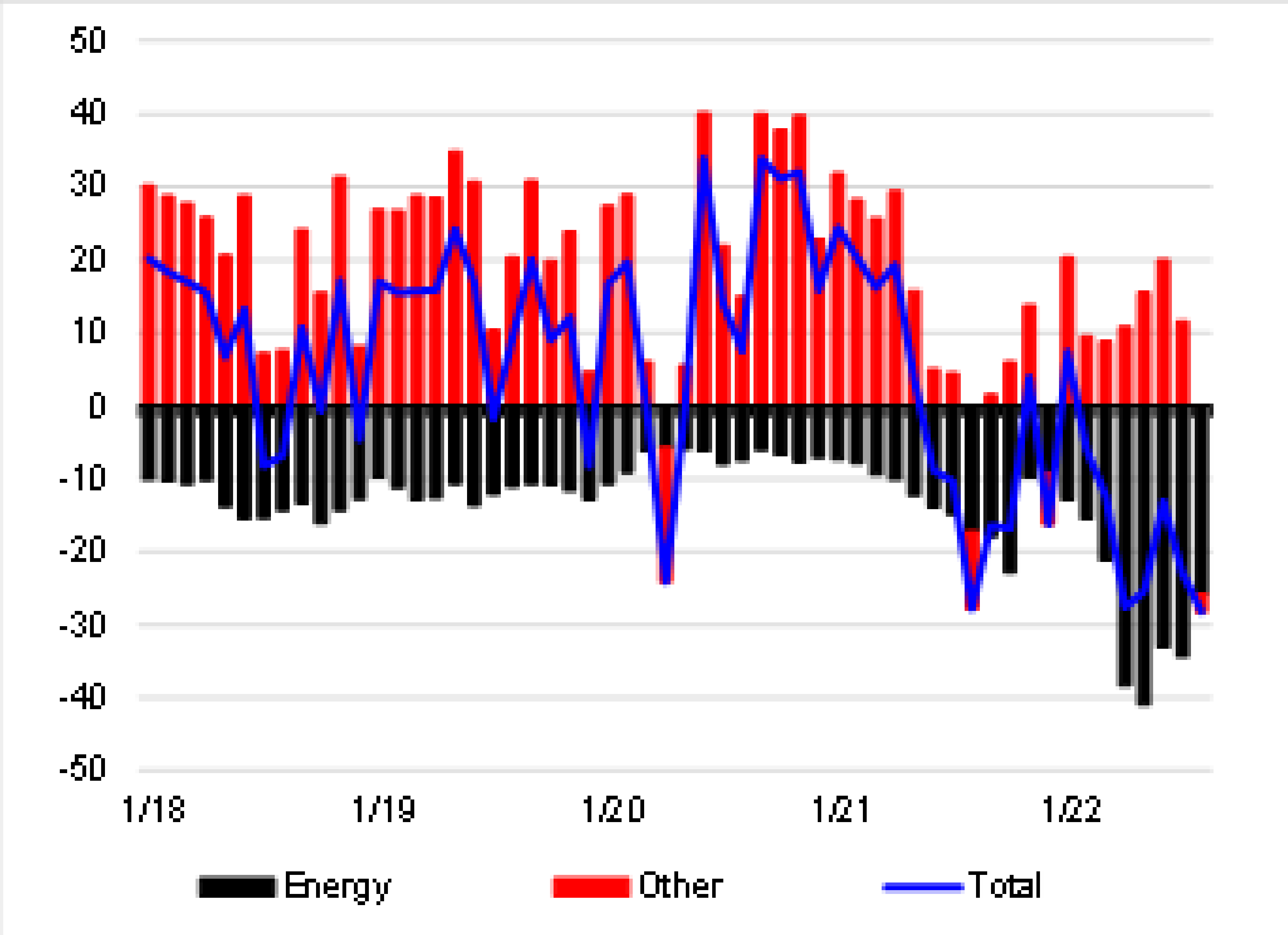
Goods Trade Balance

Goods trade balance in % of GDP, quarterly



Goods trade balance in CZK billion, monthly



Goods Trade Balance

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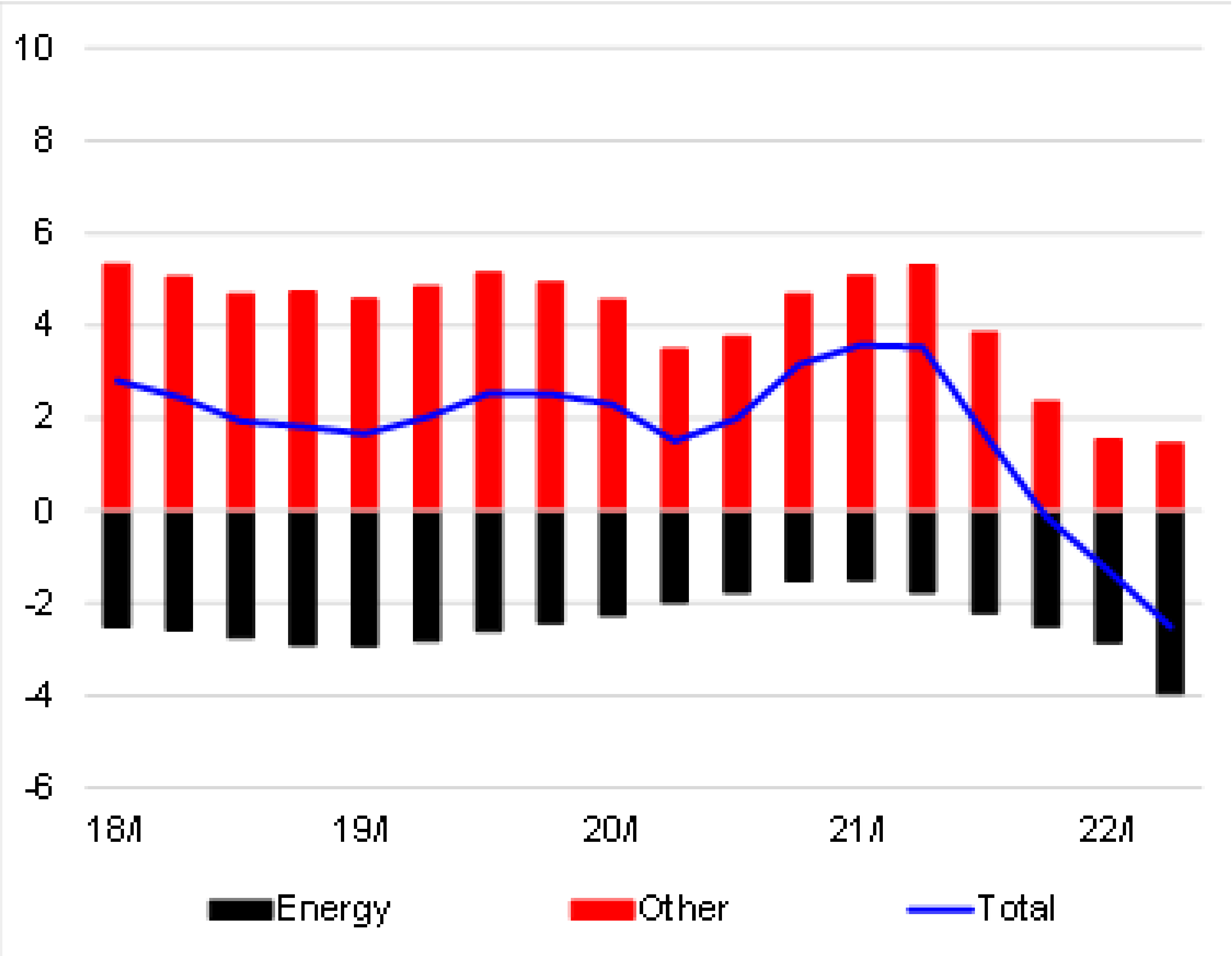
Goods trade balance in % of GDP, four-quarter moving sum



Goods trade balance in CZK billion, 12-month moving sum