The CNB's Forecast

(Monetary Policy Report, Summer 2023 – update)

IMF/WB Annual Meetings

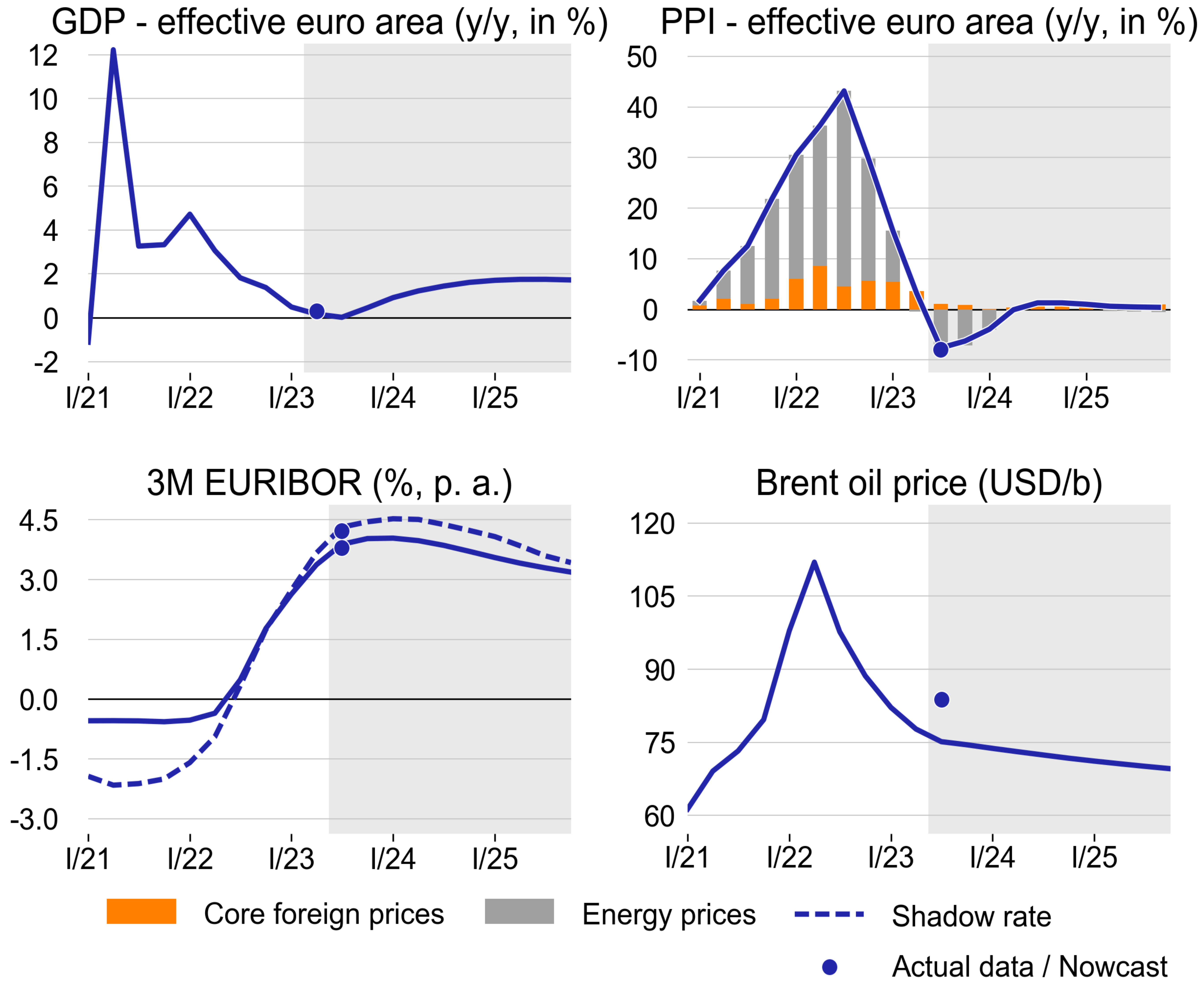
Luboš Komárek
October 2023

CNB CZECH NATIONAL BANK 30

Presentation Outline

1. **Assumptions of the Forecast**
2. Summer Macroeconomic Forecast – Update
3. Monetary Policy Simulations

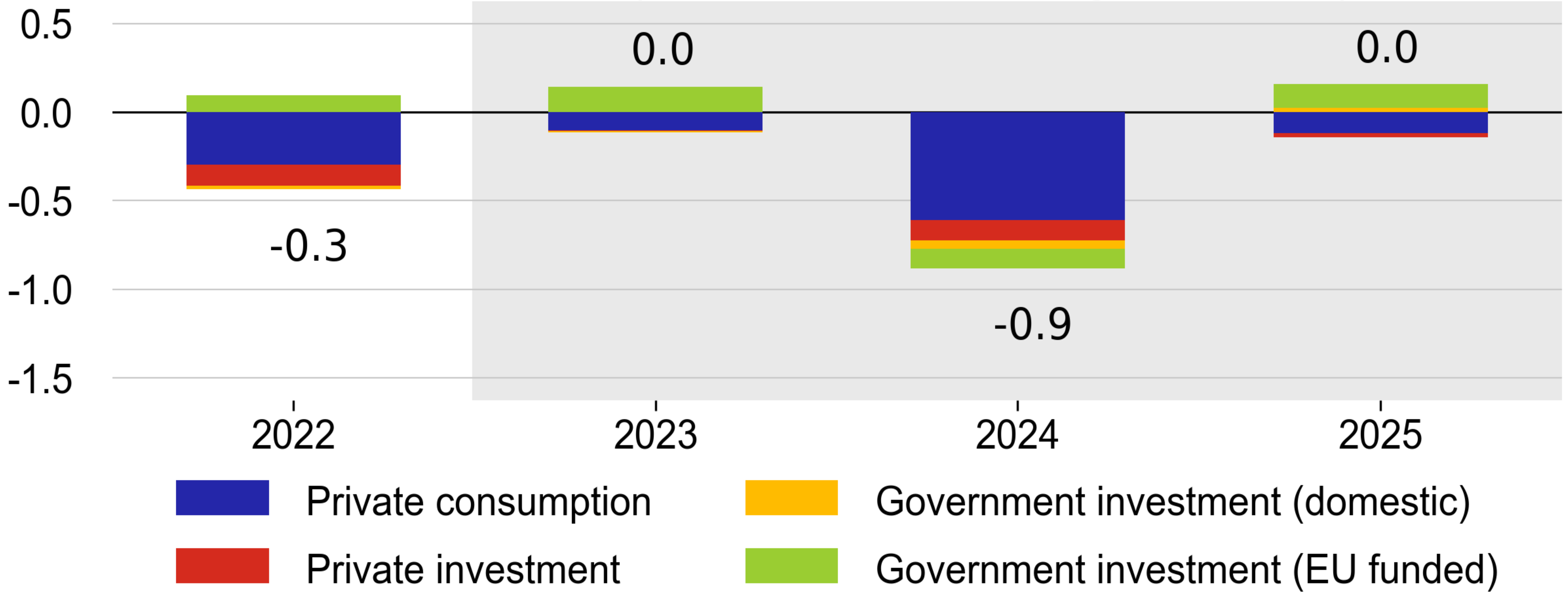
External Environment Outlook



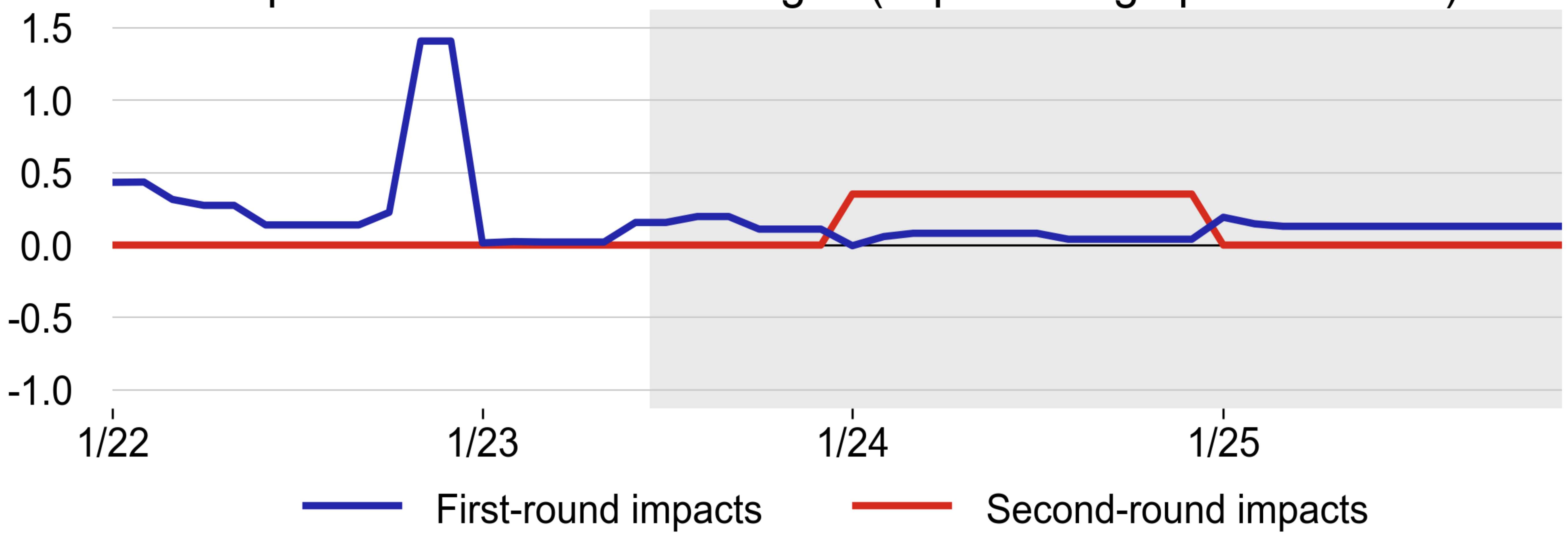
- The slowdown in global demand growth amid tighter monetary conditions will be reflected in a temporary stagnation of the **effective euro area**; growth in economic activity will not recover significantly until 2024.
- The year-on-year decline in **industrial producer prices** in the effective euro 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, albeit from recently increased values.

Fiscal Policy

Fiscal impulse (contributions to GDP growth in pp)



Impacts of indirect tax changes (in percentage points of CPI)



- The **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 help with high energy prices.
- In 2024, GDP growth will be dampened noticeably by the definitive termination of support measures, a 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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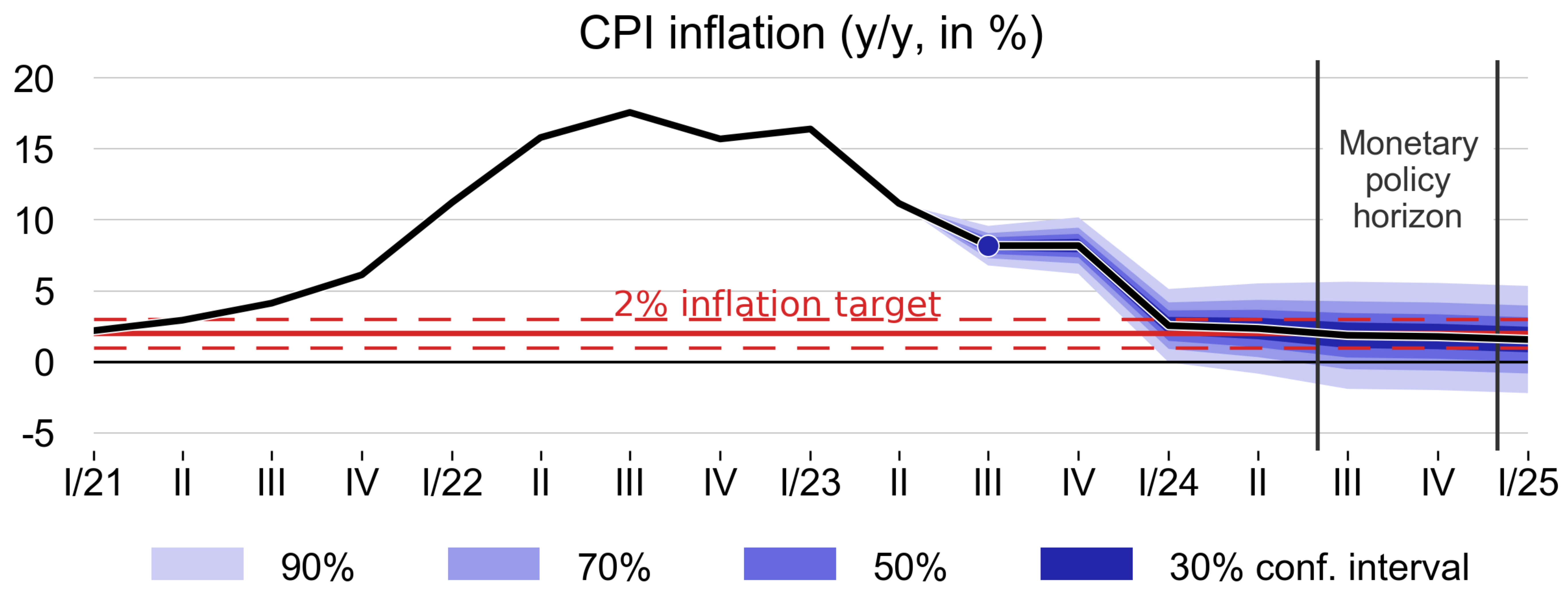
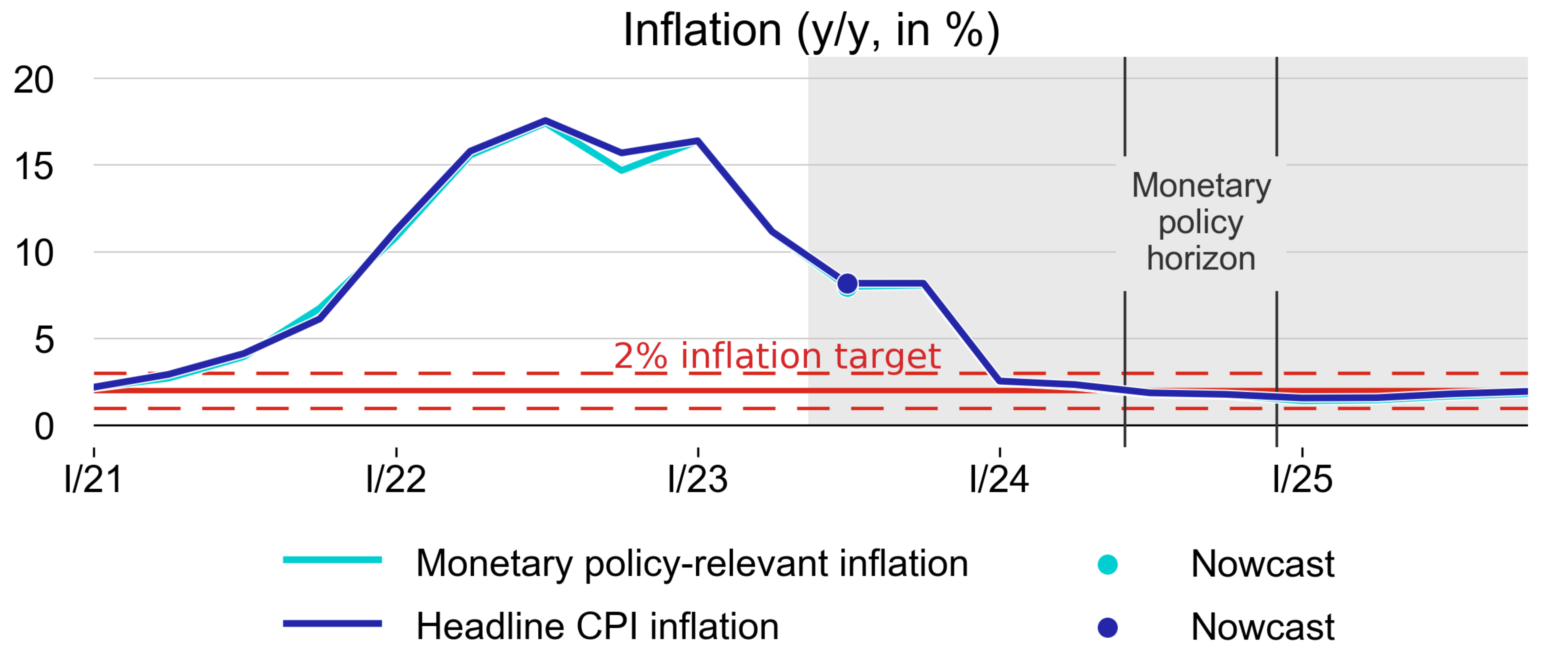
Headline and Monetary Policy-Relevant Inflation

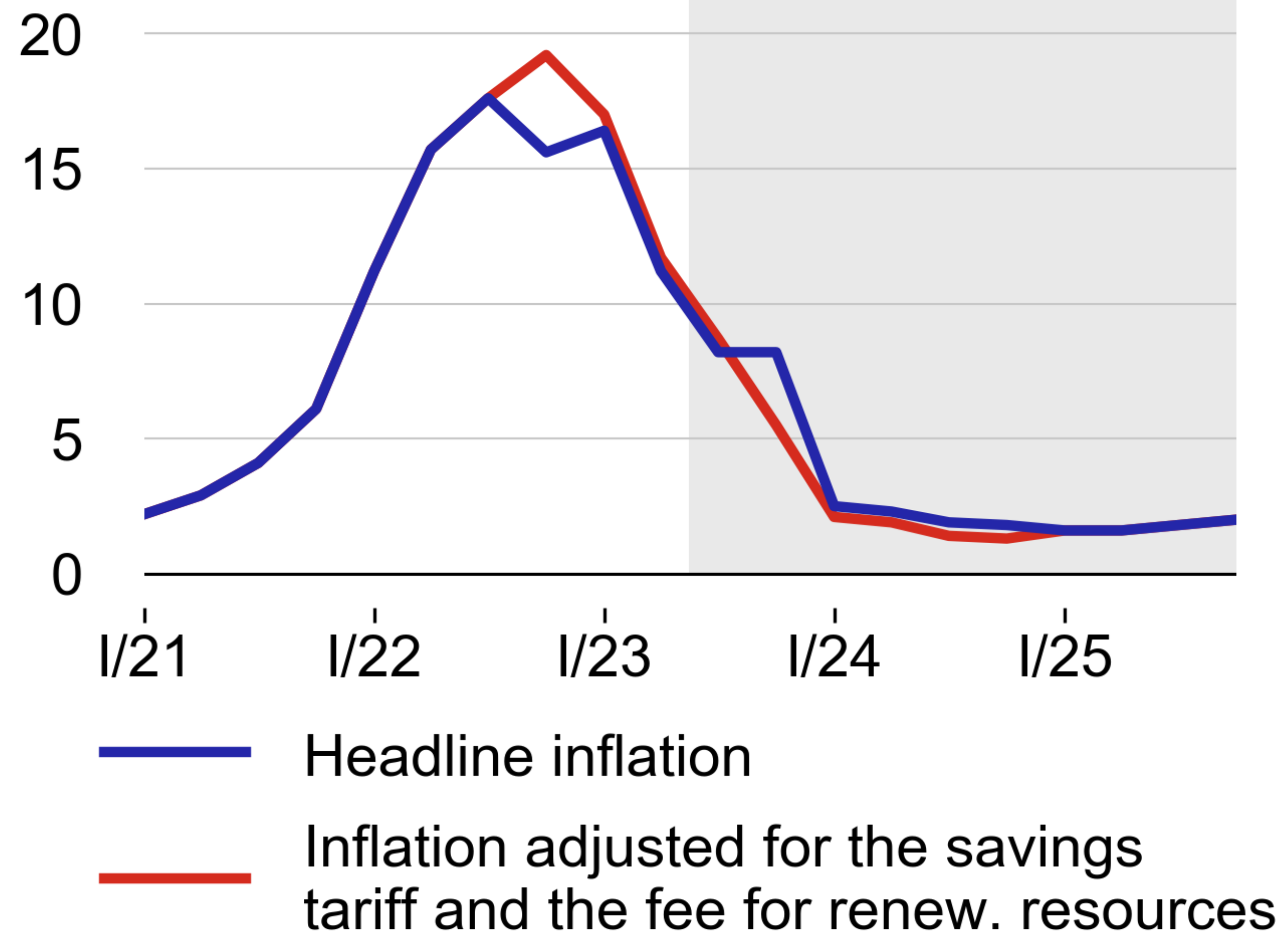




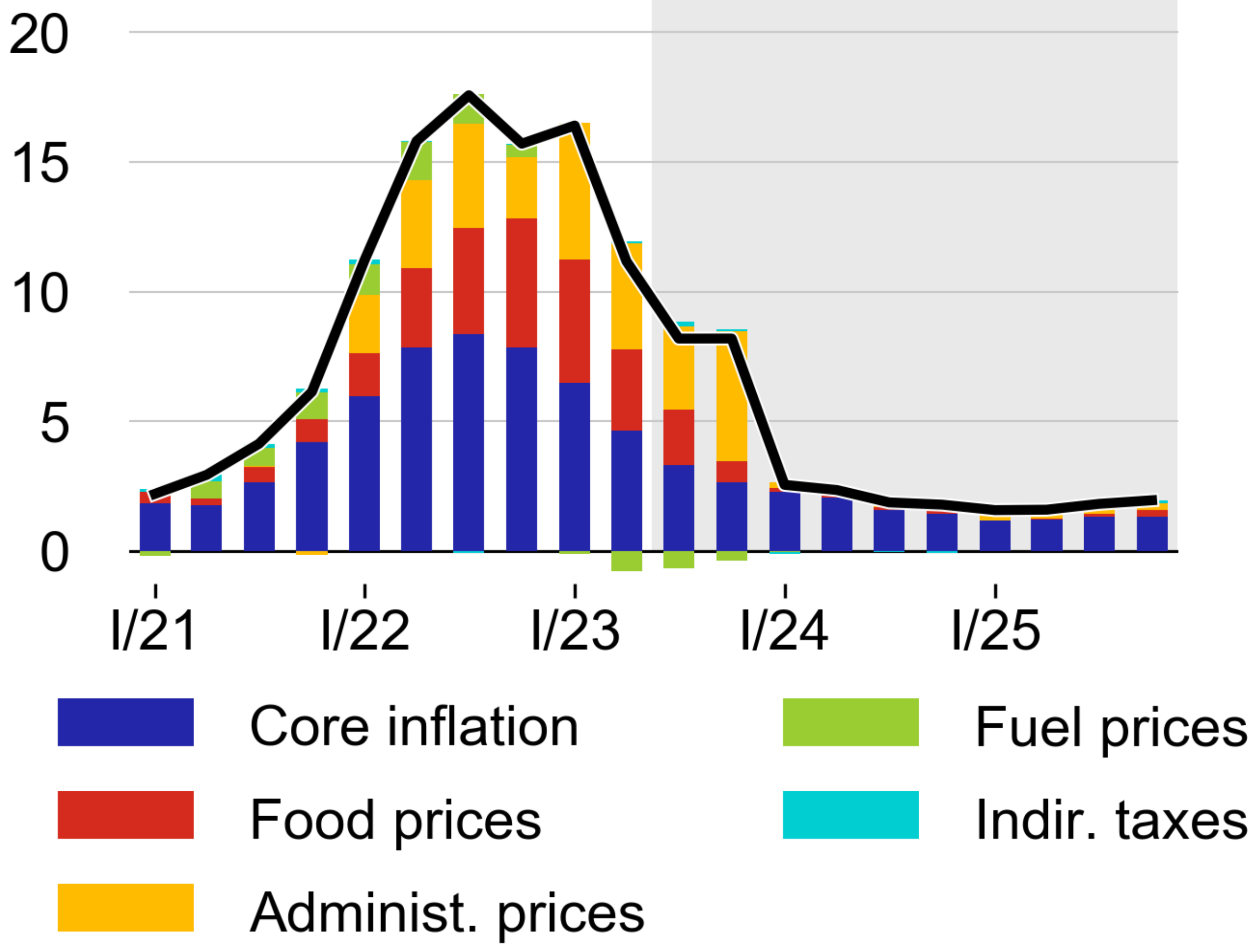
- **Inflation** will slow further in 2023 Q3 and return close to the 2% inflation target at the start of next year.
    - Growth in market prices will decline due to rapidly falling cost pressures from abroad and a continued easing of price pressures from the domestic economy.
    - The profit margins 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

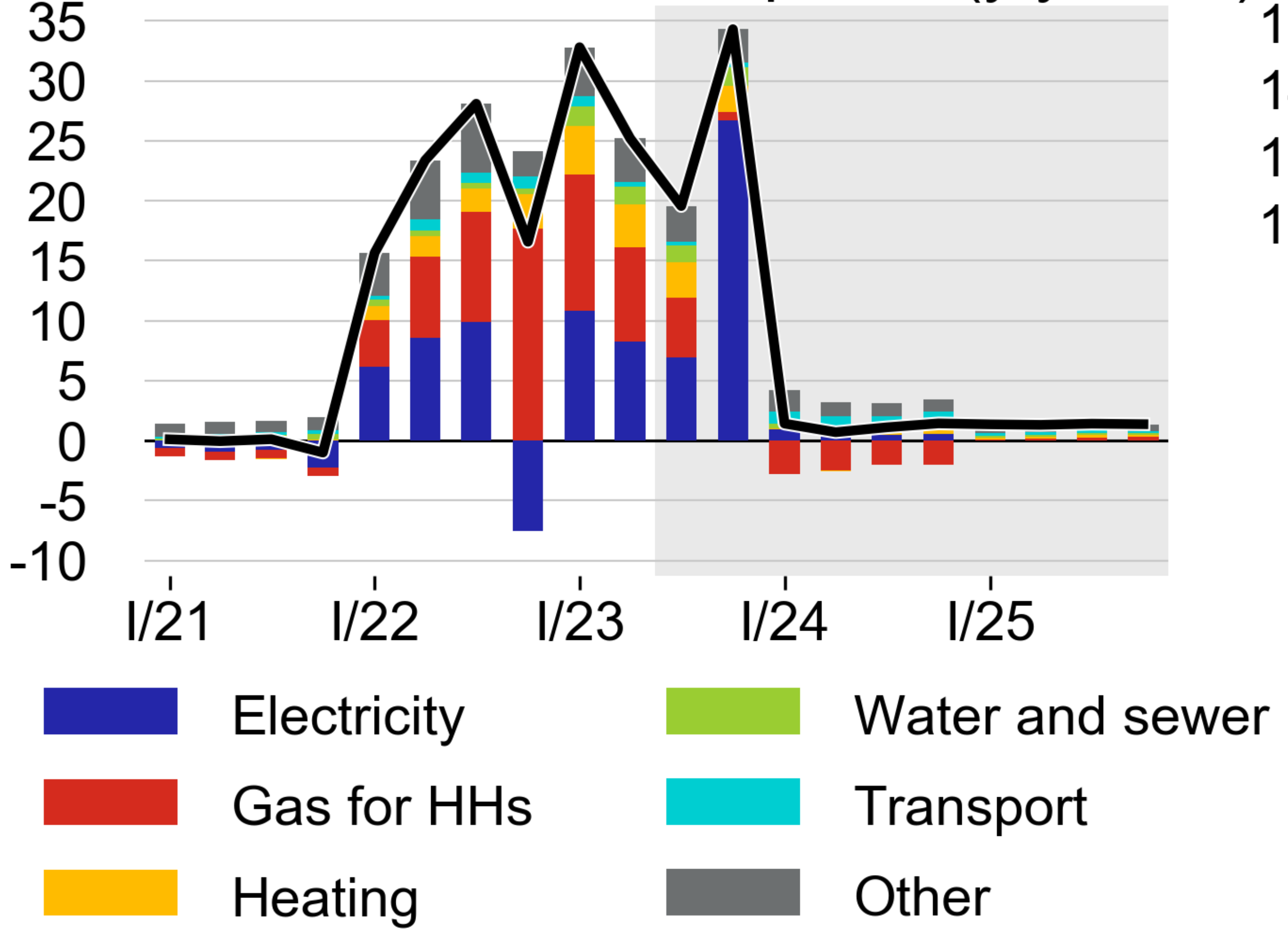
Adjusted headline inflation (y/y, in %)



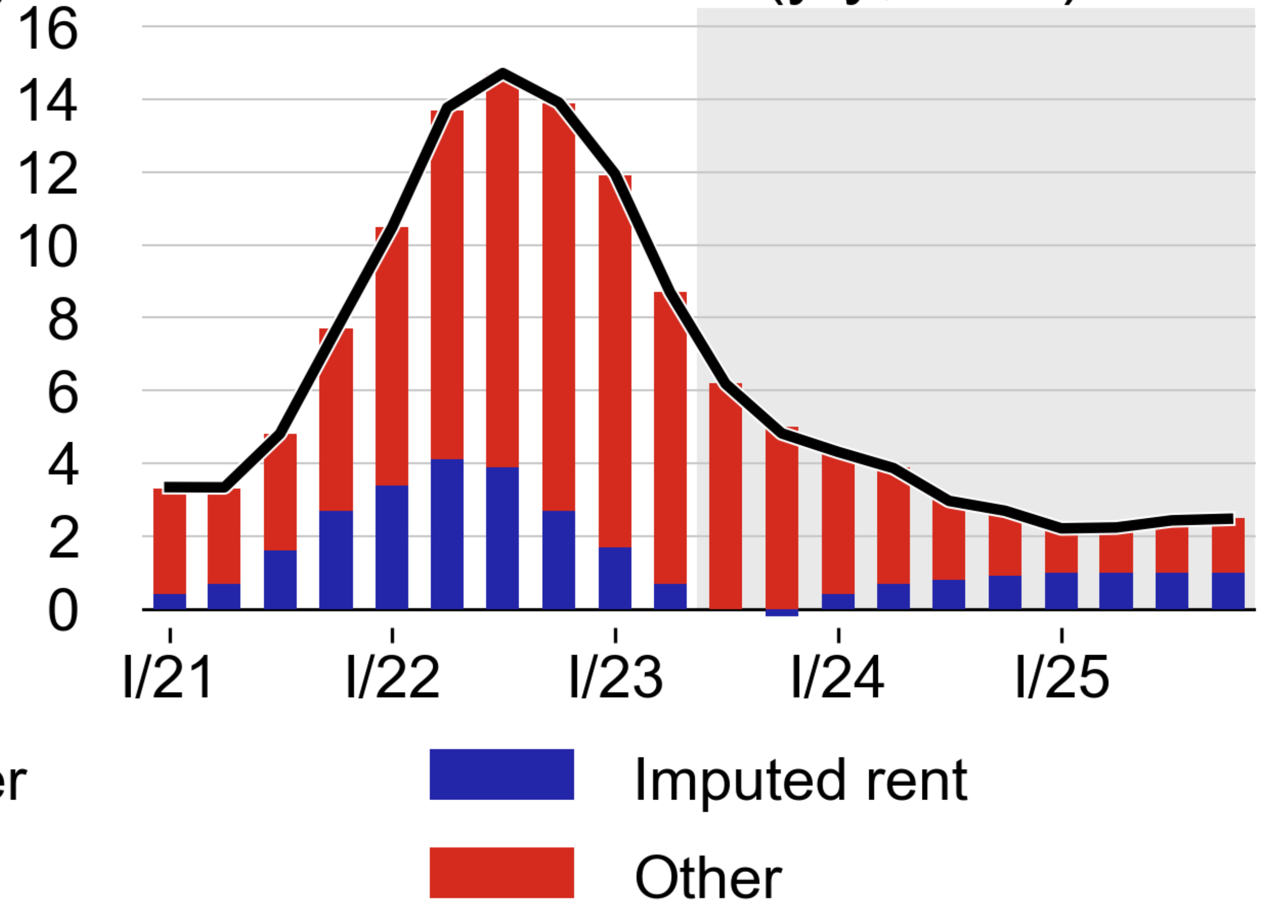
CPI inflation (y/y, in %, contrib. in pp)



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



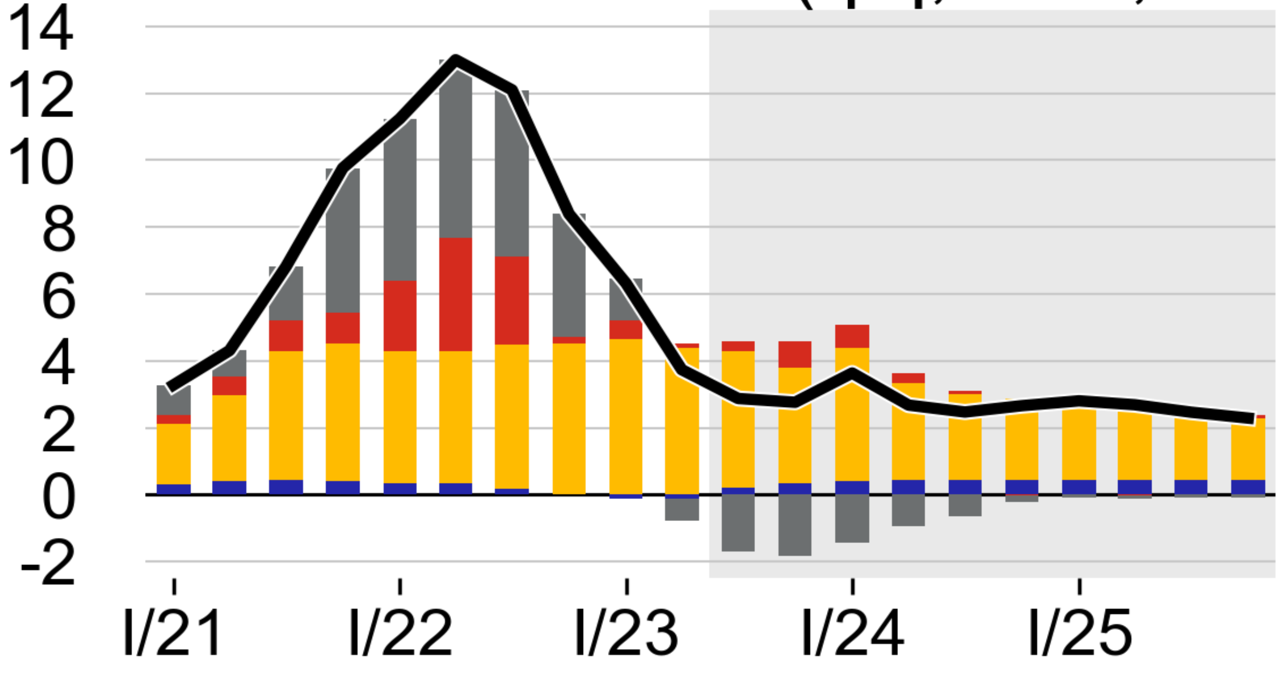
Core inflation (y/y, in %)



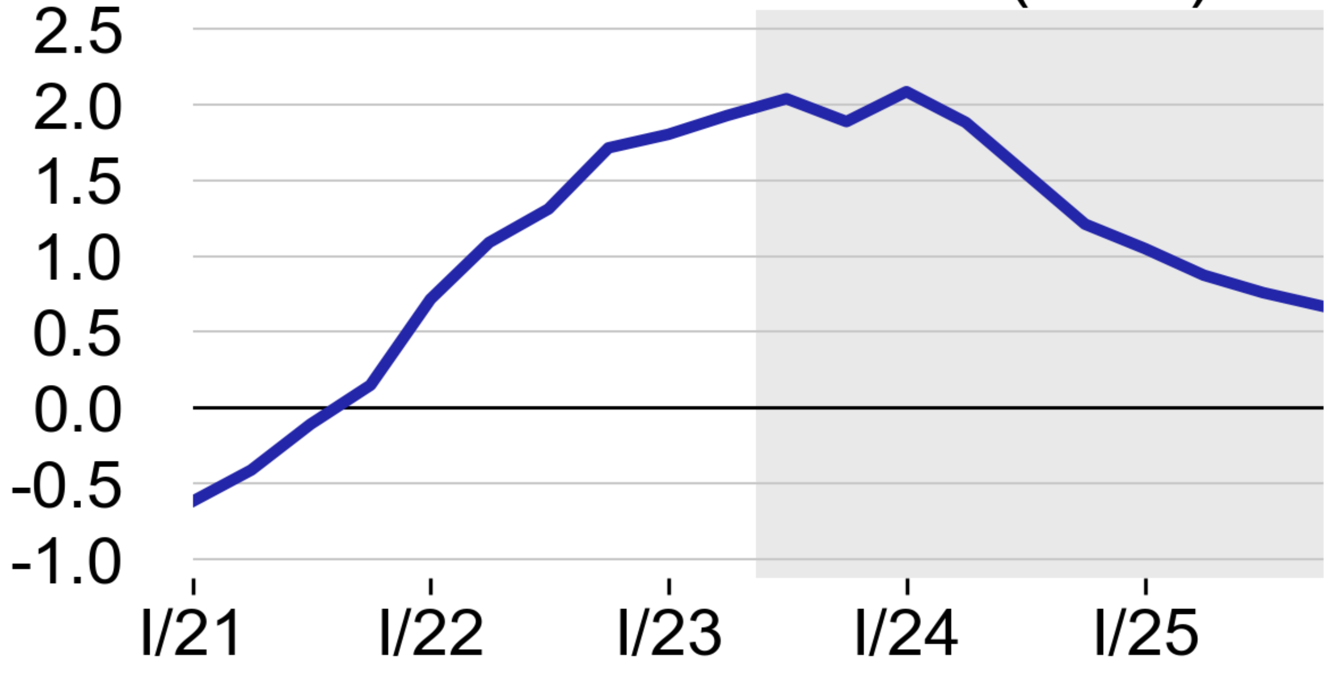
- The government measures to help households with high energy prices affected inflation (via administered prices) most of all in 2022 Q4.
- **CPI inflation** will slow sharply in 2023 Q3 and at the start of 2024, with all components contributing.
- **Administered price inflation** will initially decline. 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.)

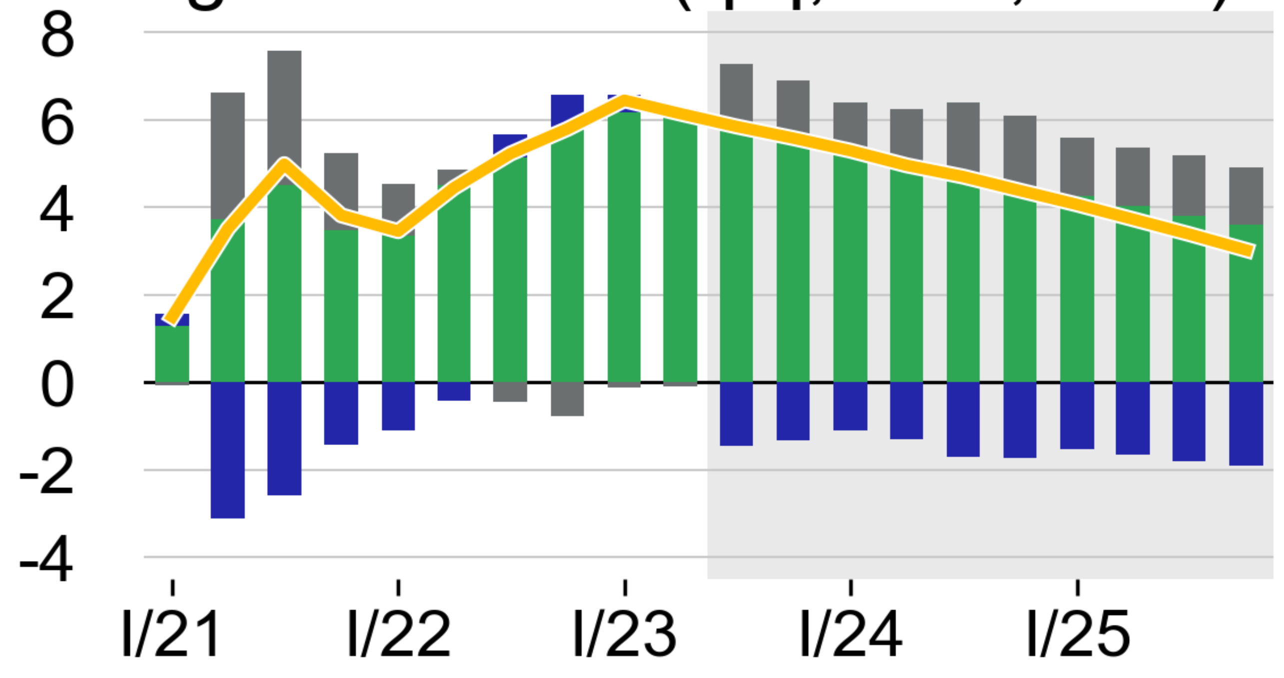


Gap in profit mark-ups
in consumer sector (in %)

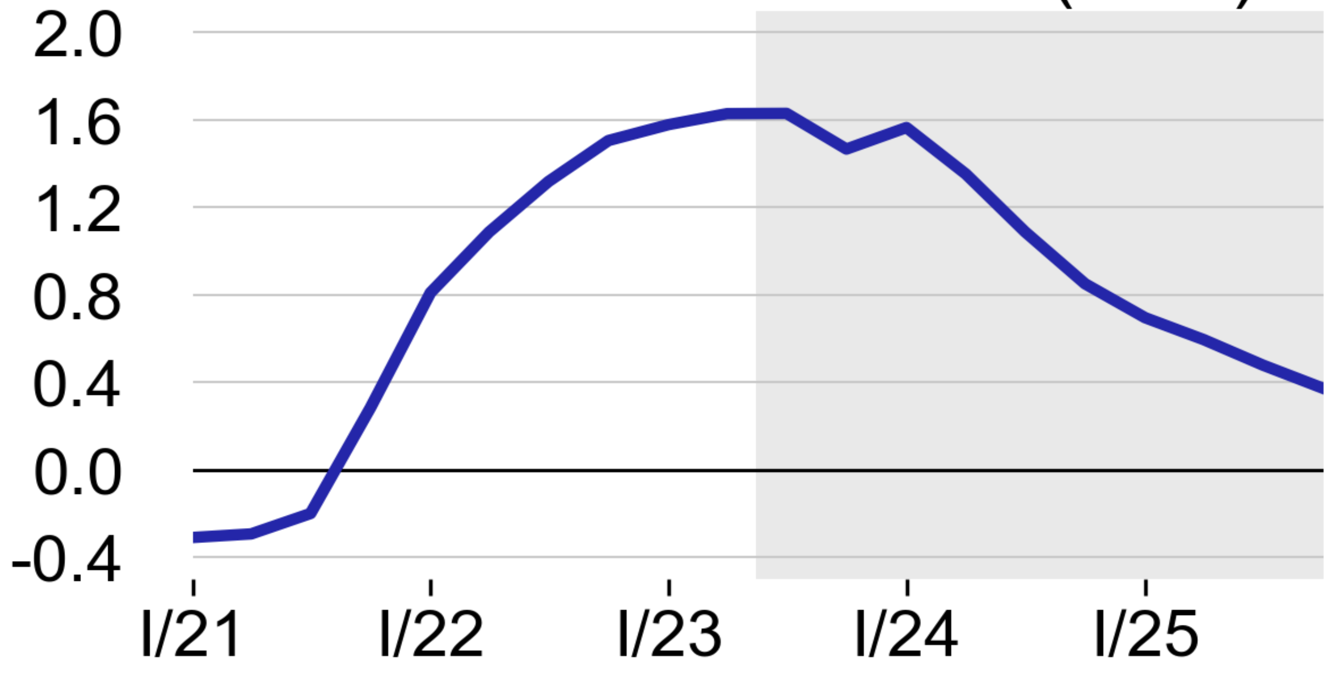


Price convergence
Core import prices
Intermediate goods prices
Energy import prices

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



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

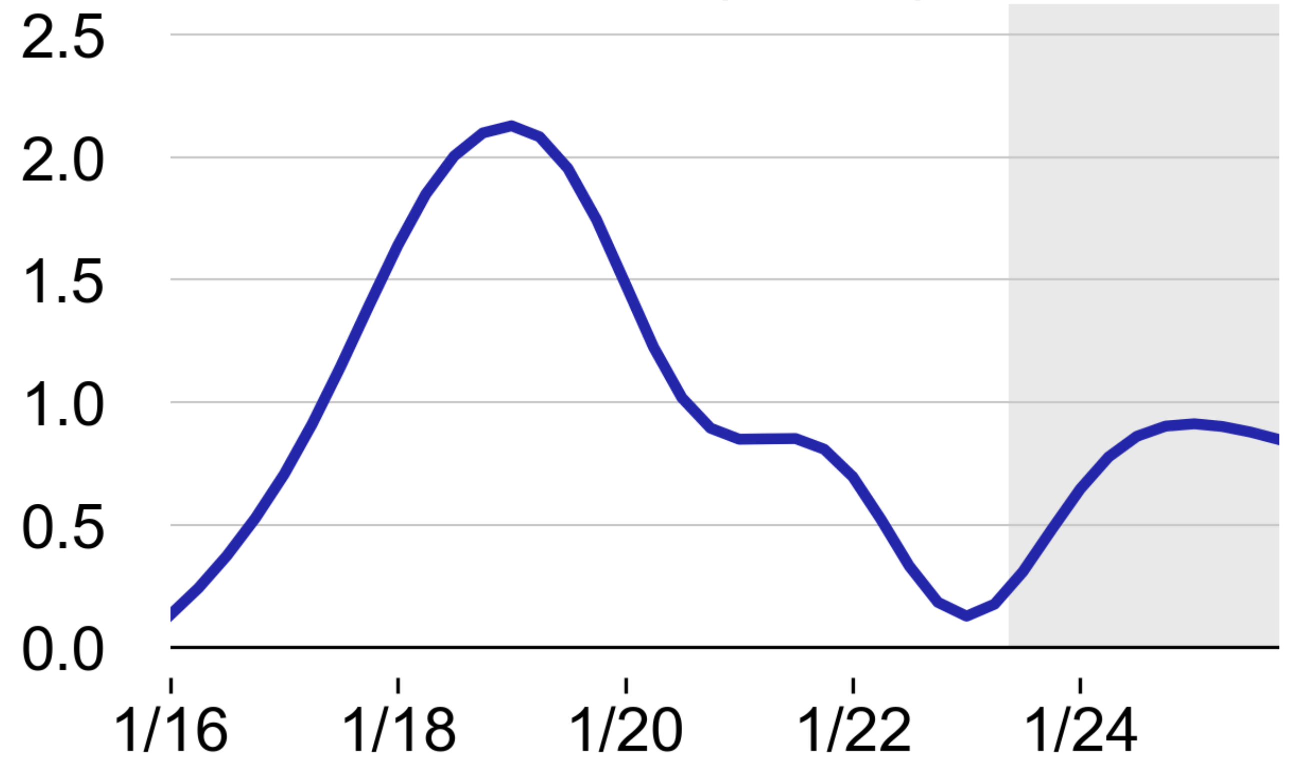


Wages in market sectors
Labor efficiency
Price of capital

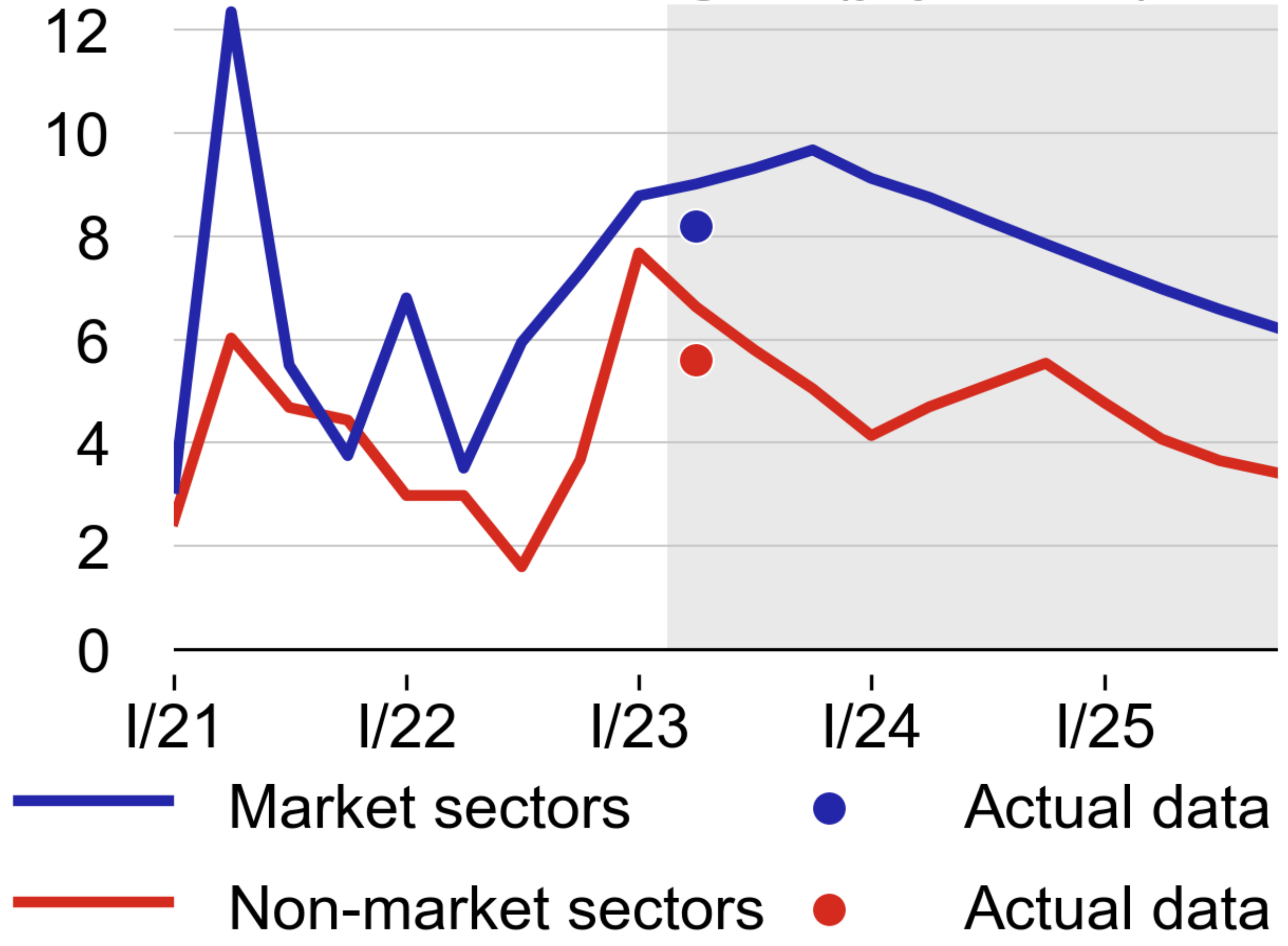
- The **overall cost pressures** will mostly continue to ease, due to a drop in energy import prices and a decrease in the contributions of the domestic economy.
- They will increase temporarily at the start of the next year due to the expected positive direct second-round impacts of the changes to indirect taxes, as reflected in an increased pace of intermediate goods price growth.
- The **domestic cost pressures** will ease gradually as the high wage growth steadily fades, 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

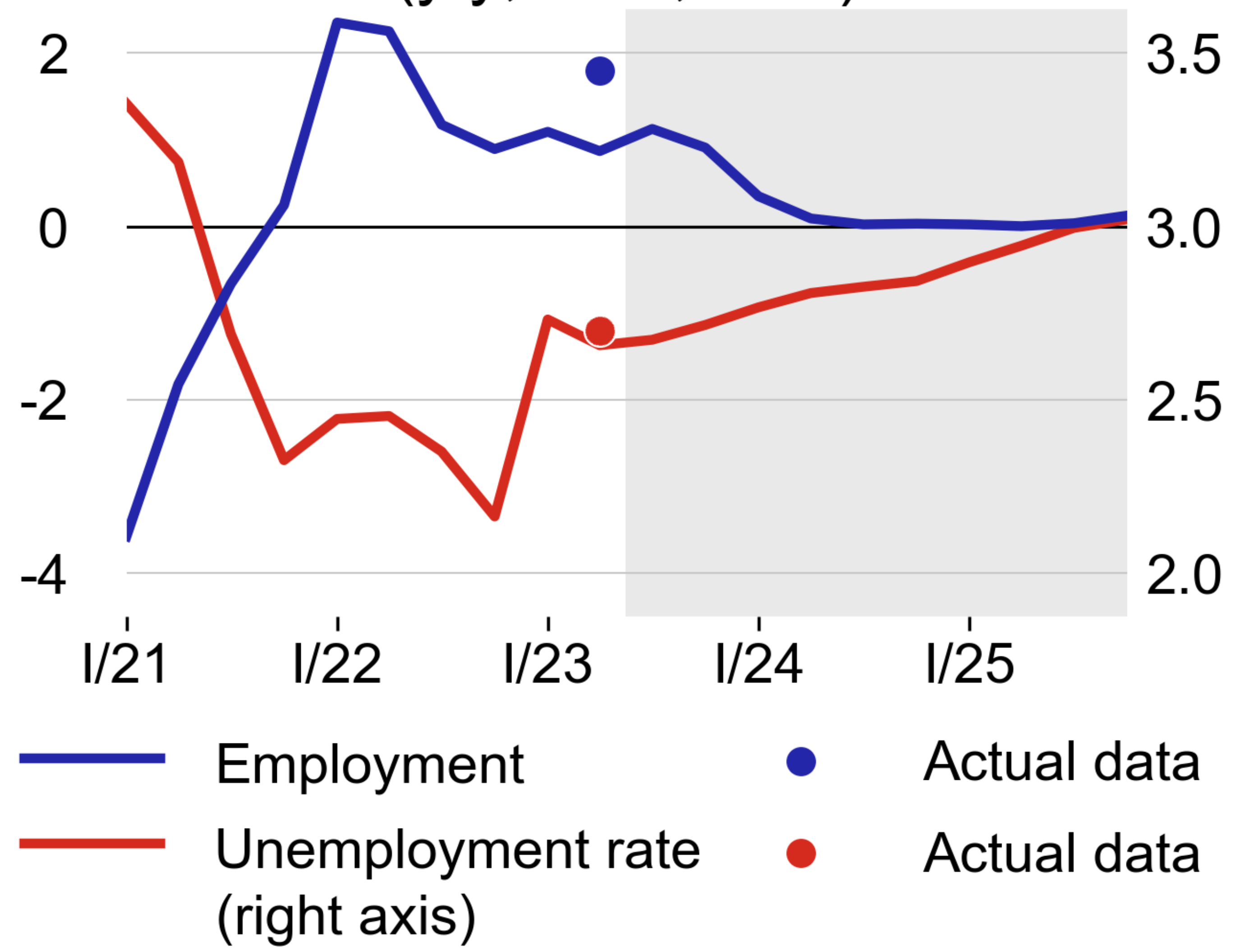
LUCI (index)



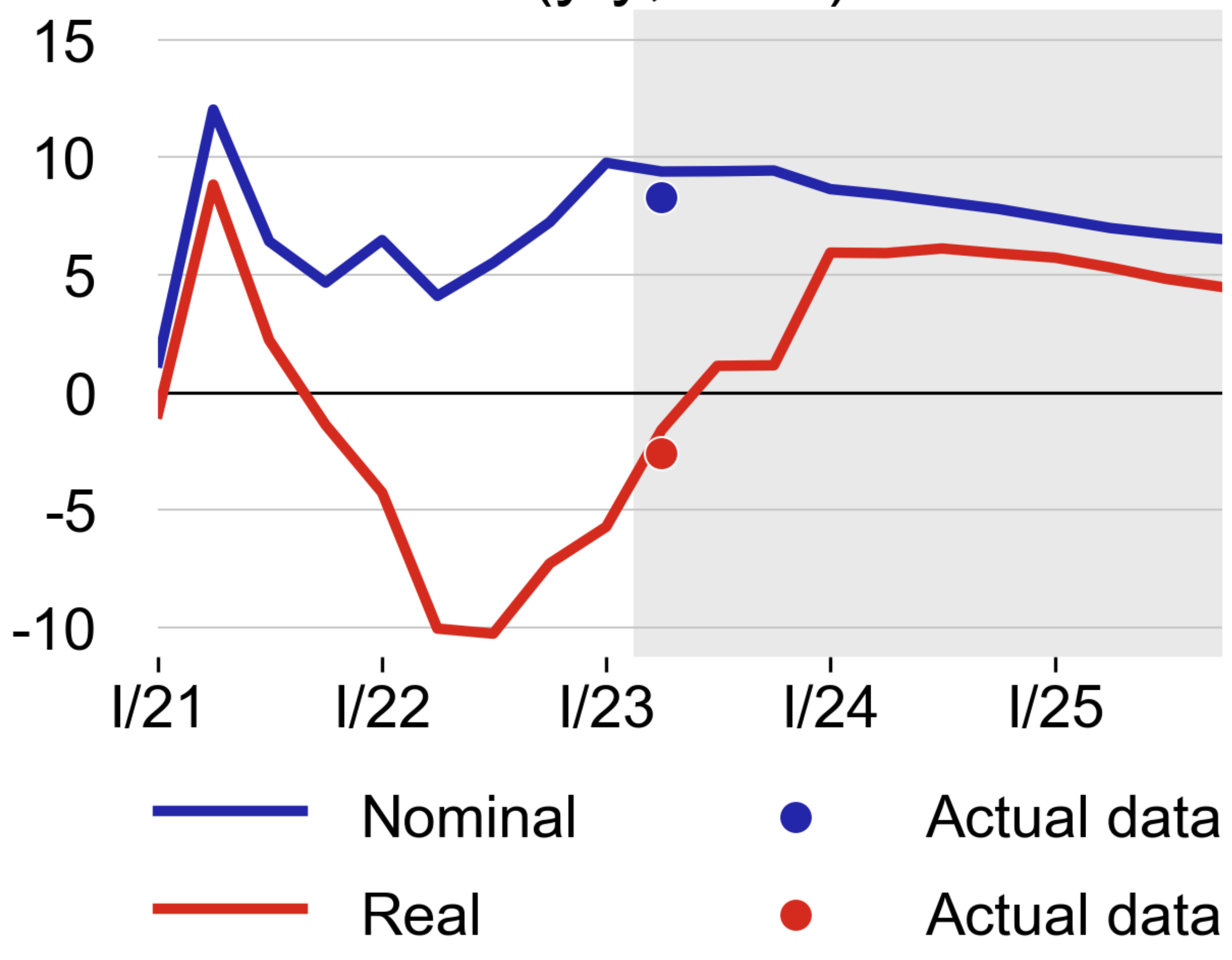
Nominal wages (y/y, in %)



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

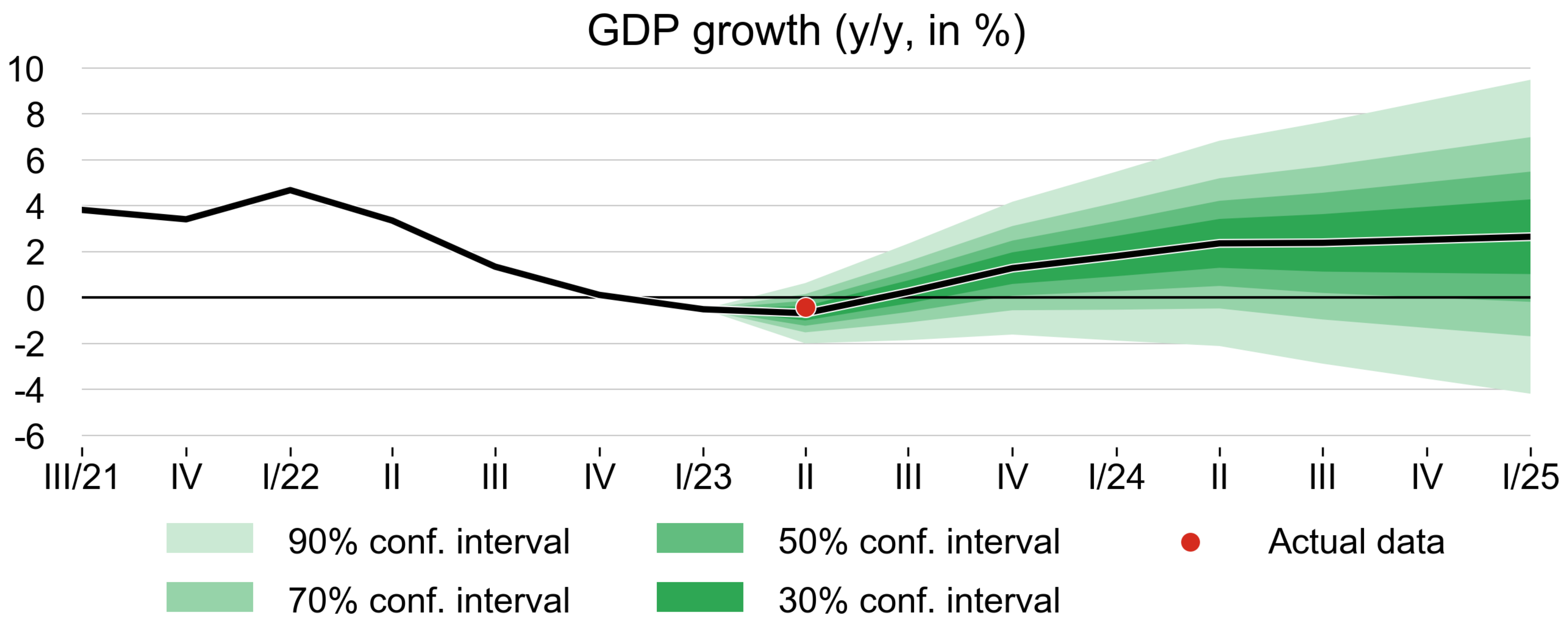


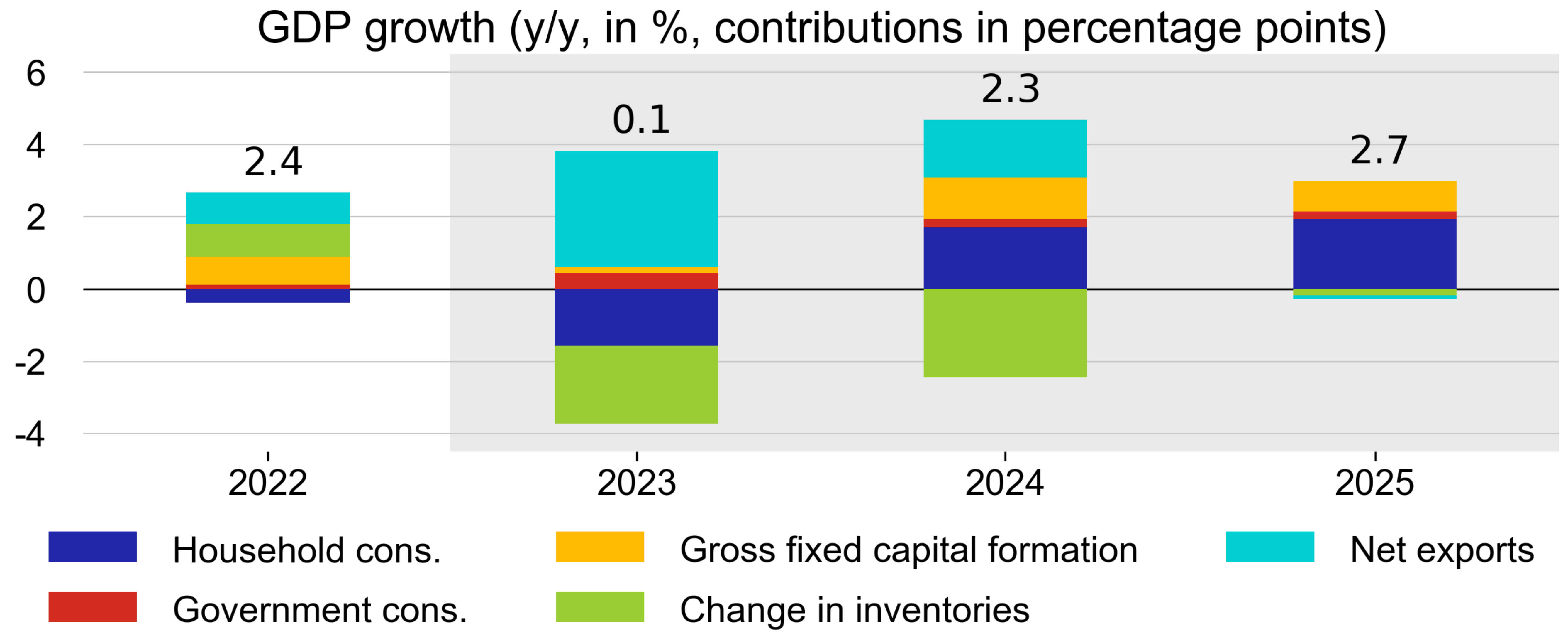
Volume of wages and salaries
(y/y, in %)



- 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. However, according to the 2023 Q2 data, it will probably not accelerate any further.
- **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

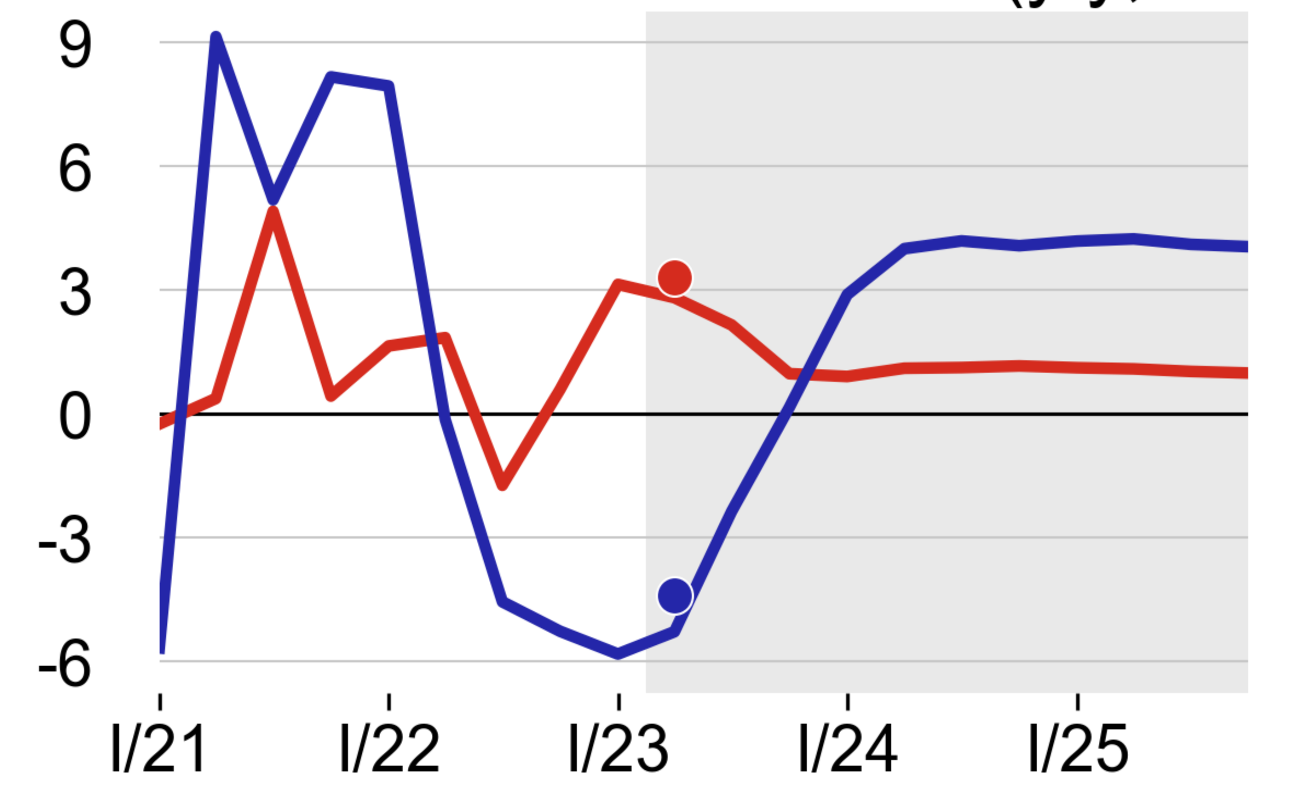




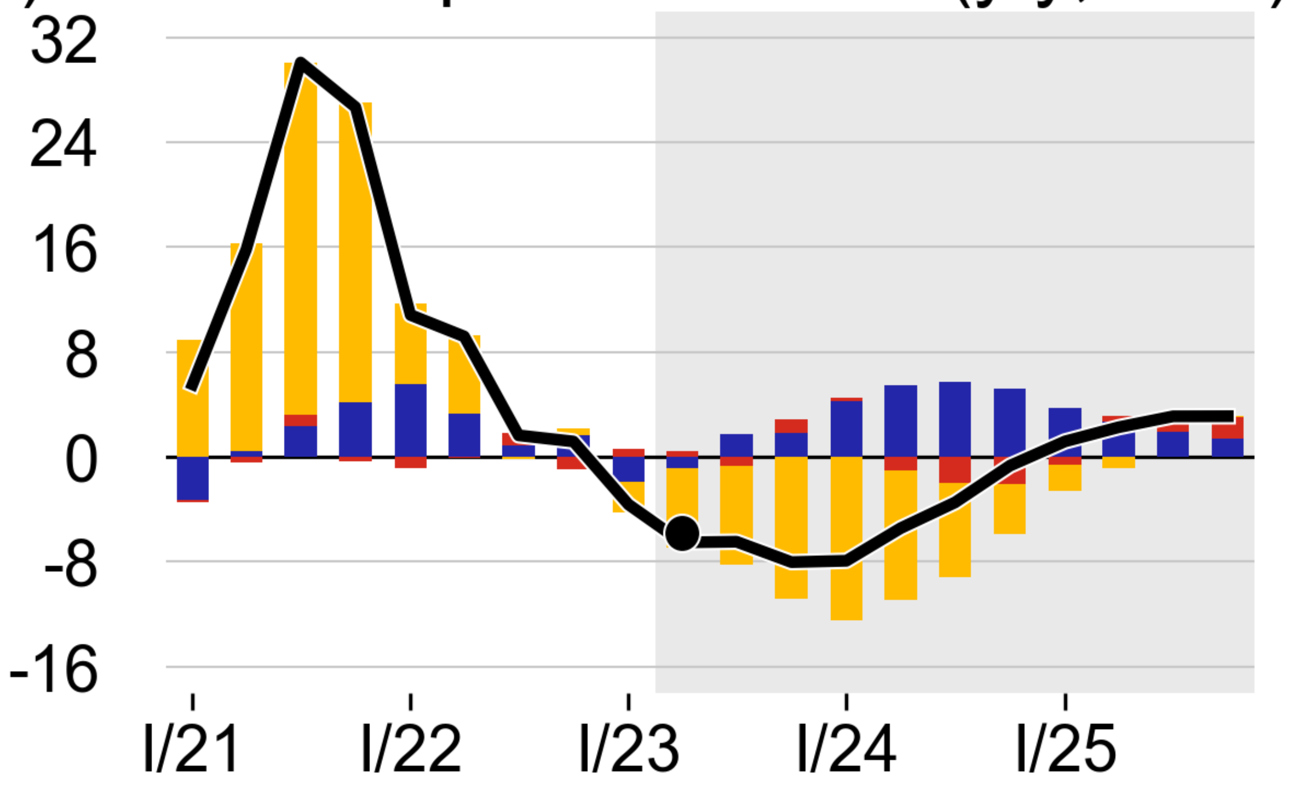
- **Economic activity** will be broadly flat this year due to subdued performance in the first half of the year; next year economic growth will be driven by a recovery in household consumption.
- This year, **GDP** will roughly stagnate in whole-year terms. It will grow by about 2.5% in 2024 and 2025.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

GDP Components

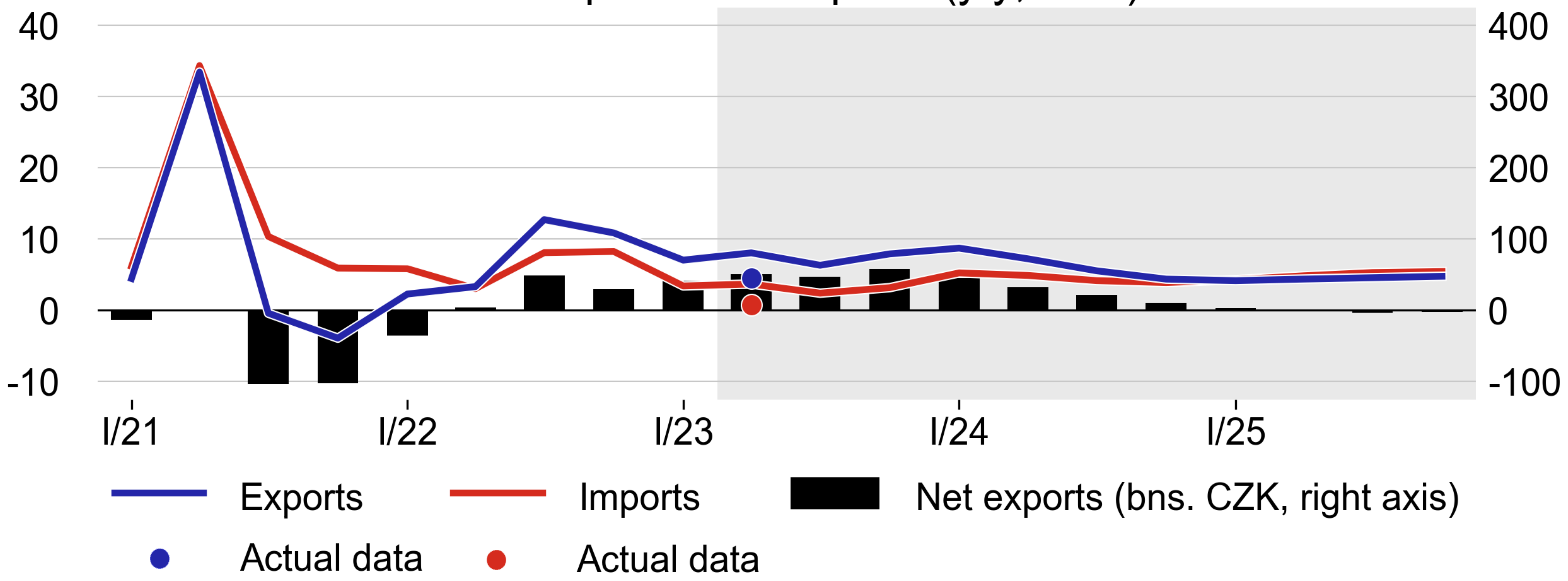
Household and Gov. cons. (y/y, in %)



Gross capital formation (y/y, in %)

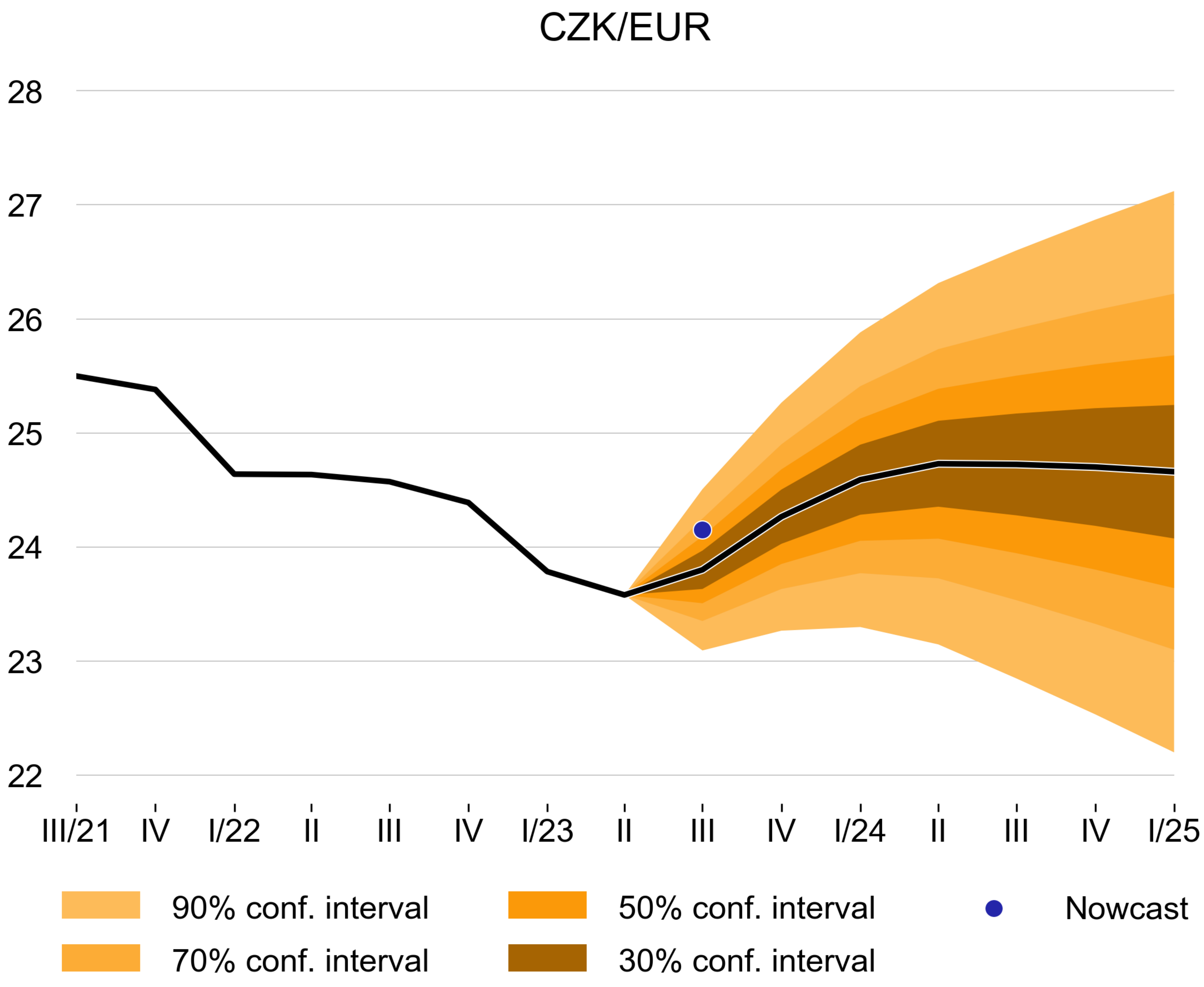


Real exports and imports (y/y, in %)



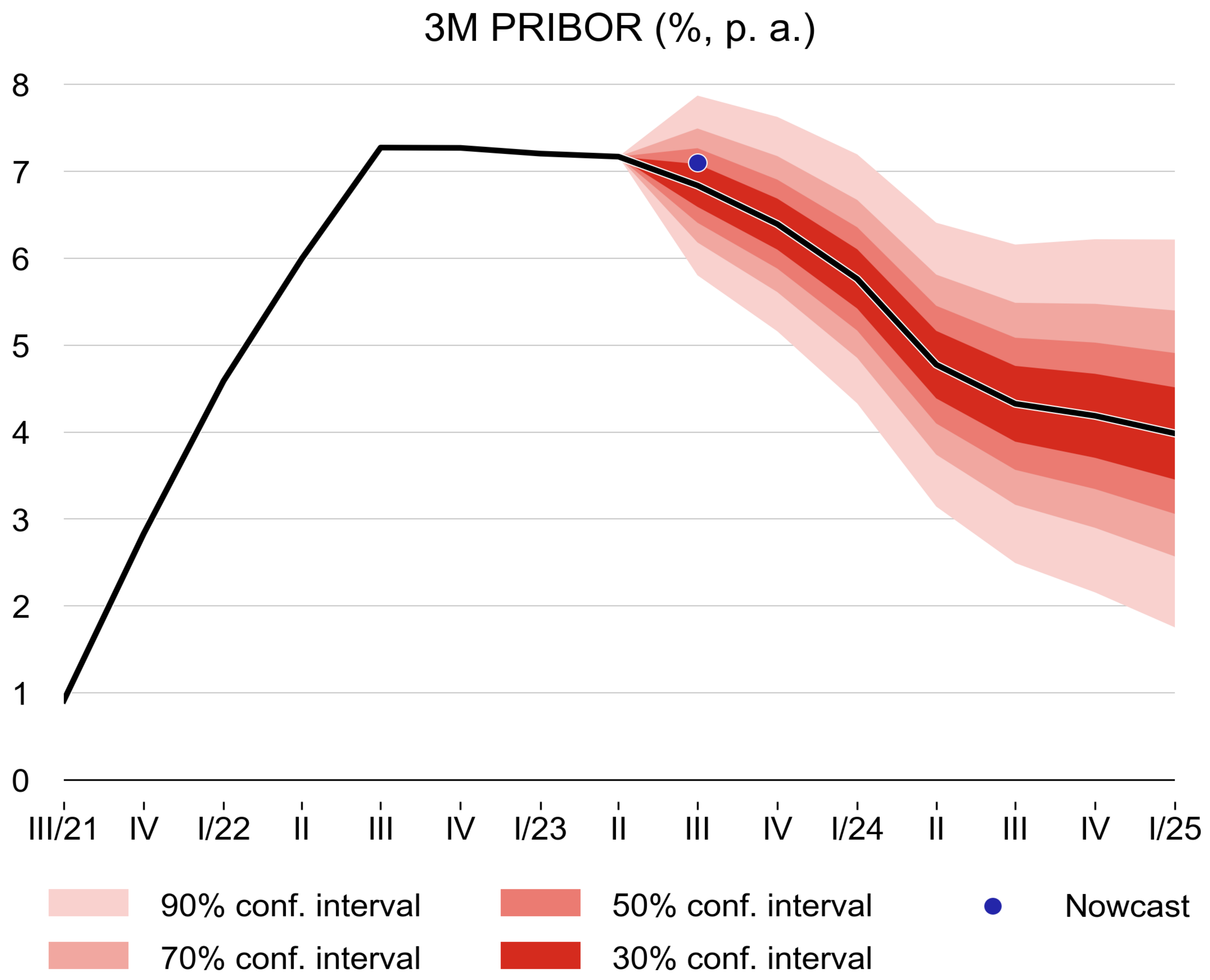
- **Household consumption** will keep falling in year-on-year terms for most of 2023 and start to grow again only at the year-end.
- Real household income will continue to rise next year. Together with a drop in the saving rate, this will result in brisk growth in consumer demand.
- **Government consumption** 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.

CZK/EUR Exchange Rate



- 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. (In fact, the koruna averaged around CZK 24.1 to the euro in 2023 Q3.)
- 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. (In fact, interest rates remained unchanged in 2023 Q3.)
- 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 2024 H2.
- This opens up room for monetary policy to be eased gradually.

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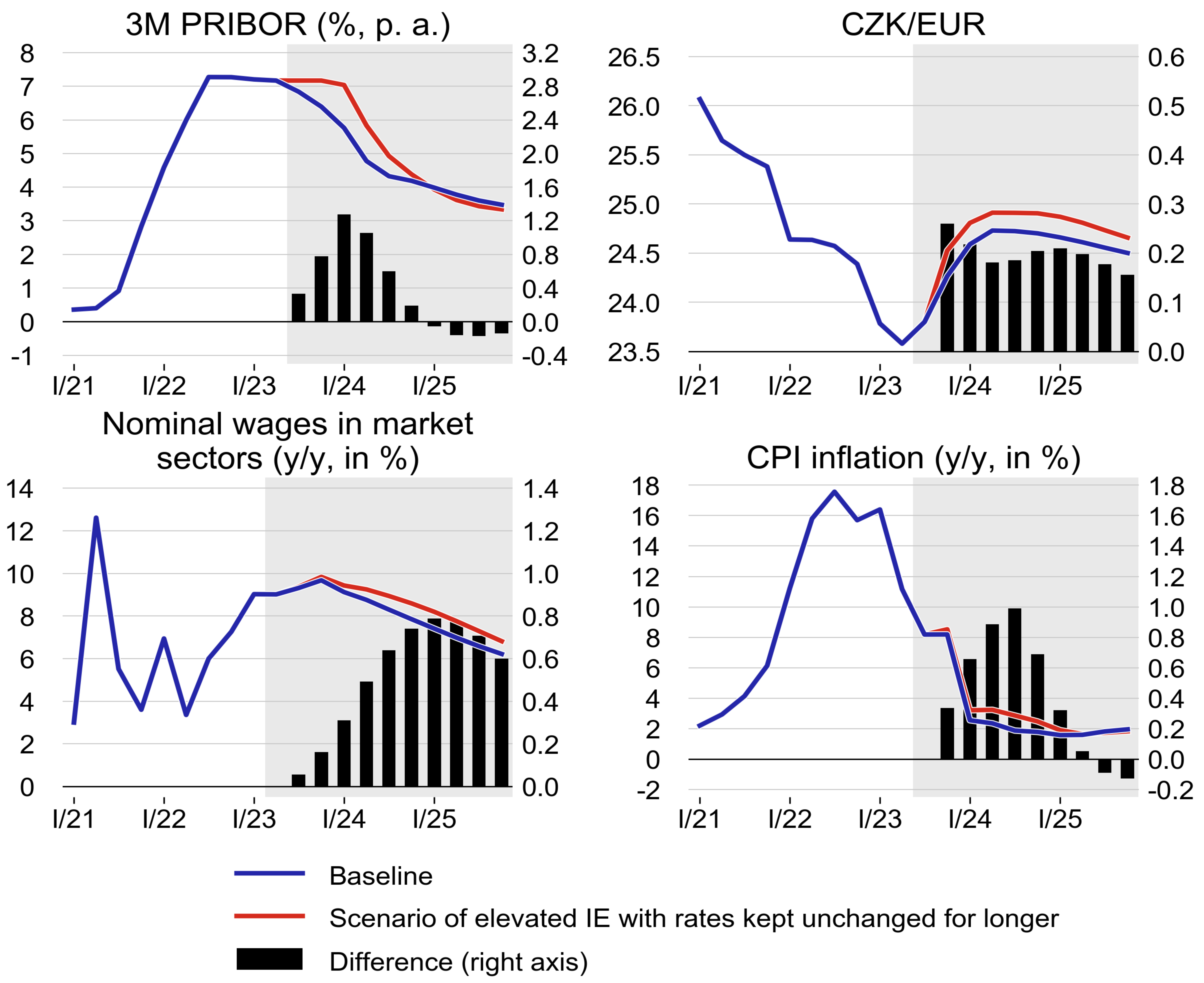
Scenario of Elevated IE with Rates Kept Unchanged for Longer

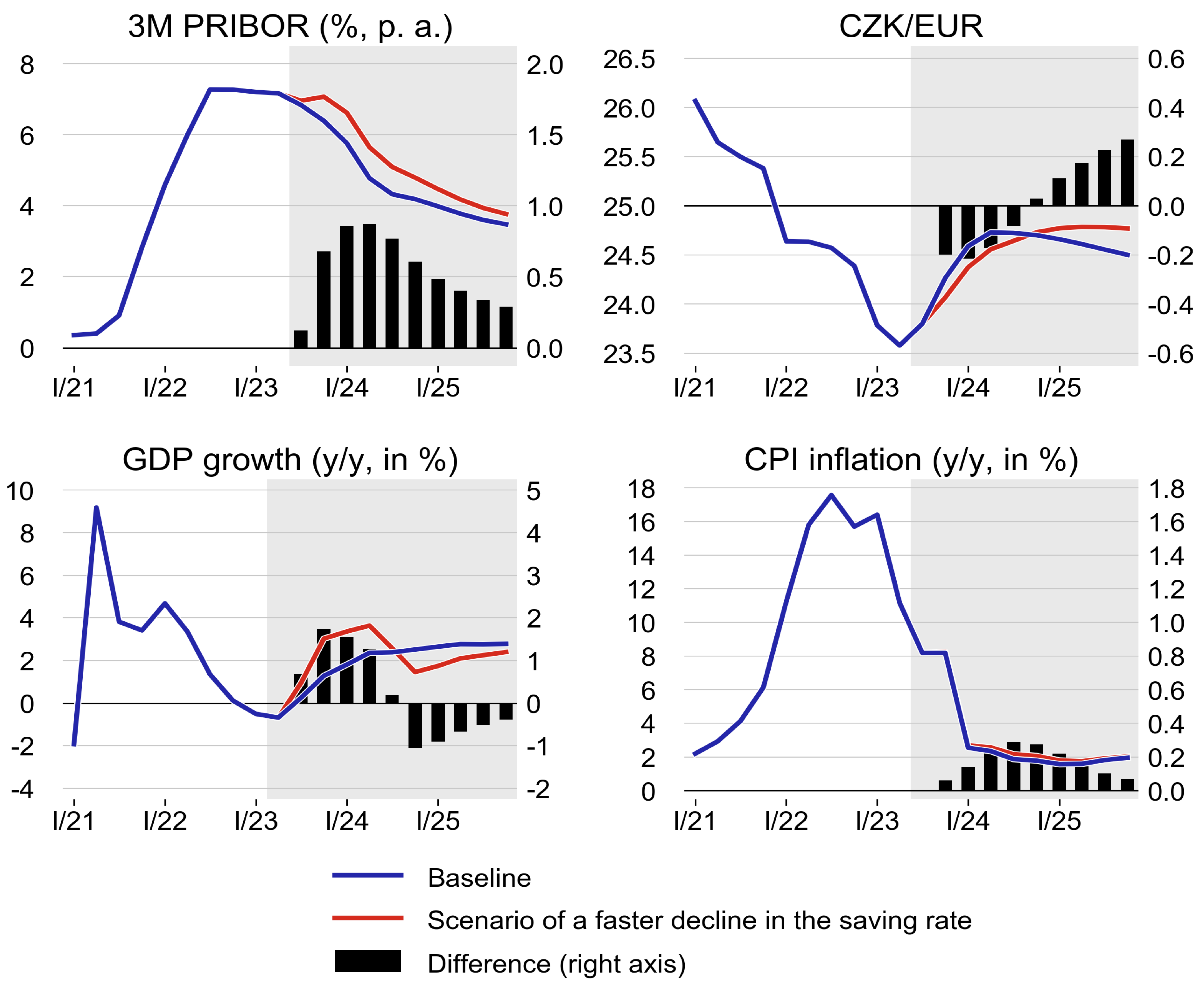


- In addition to elevated inflation expectations, the scenario assumes that **3M PRIBOR** market interest rates stay at 7.2% until the end of this year.
- The elevated **inflation expectations** fundamentally affect economic agents' decisions, generating additional inflation pressures in the economy.
- 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 (1)

- 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 (2)



- 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 is weaker over the course of 2024 and 2025 due to a quicker narrowing of the interest rate differential and a worse trade balance induced by higher import volumes.
- Household consumption will be reflected in visibly faster annual **GDP growth** this year and most of 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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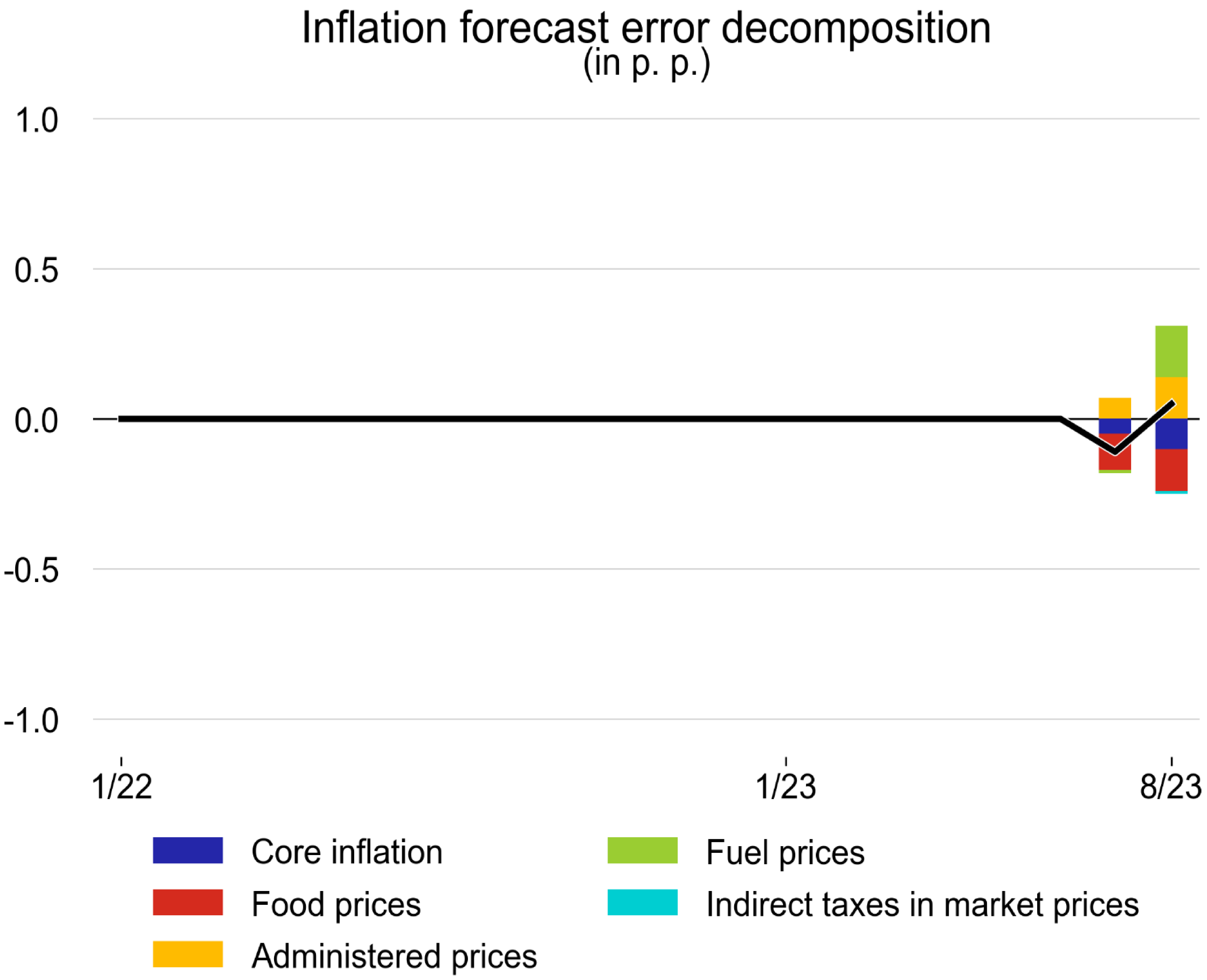
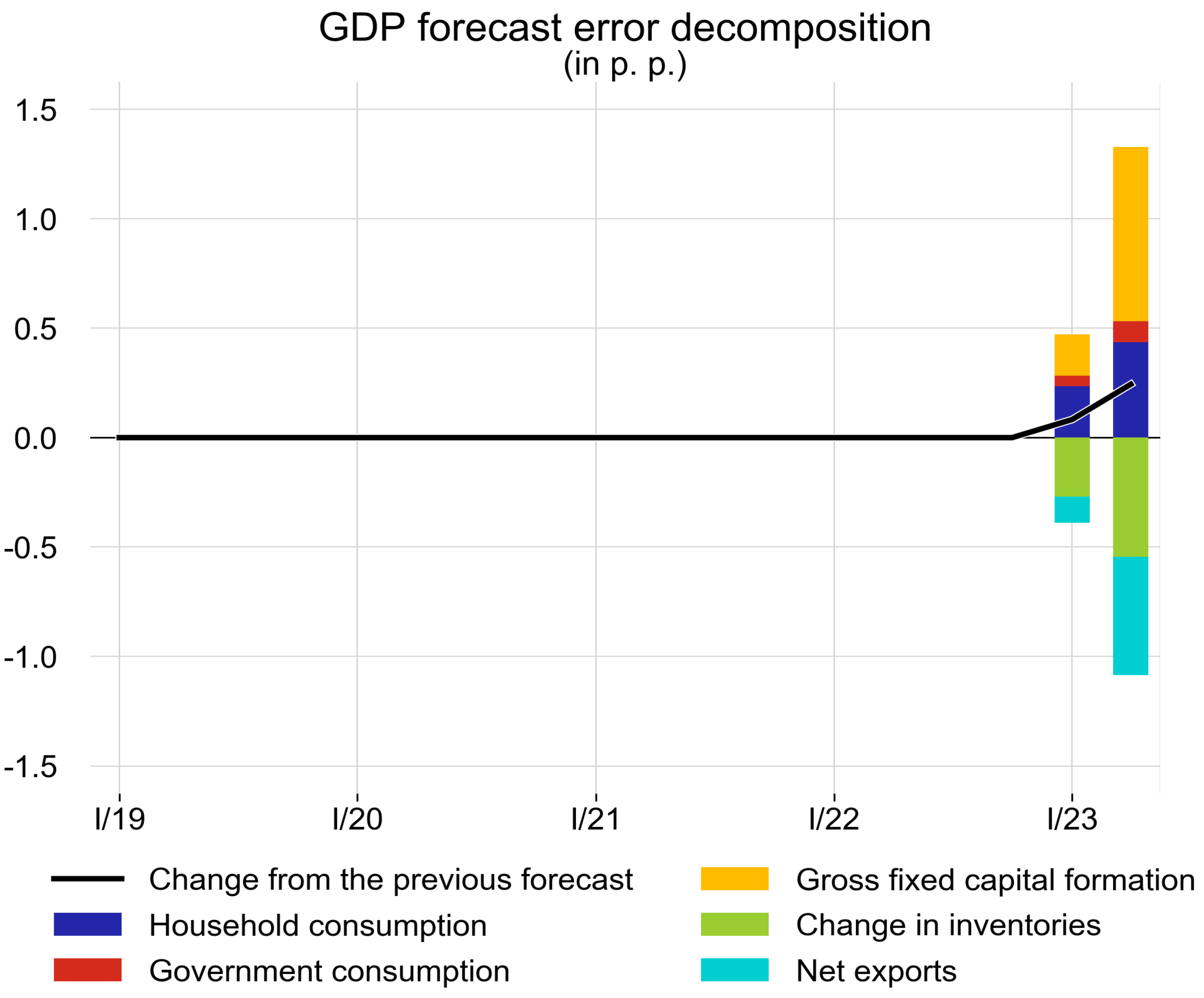
Monetary Department

Observed Deviation from the Forecast – Inflation



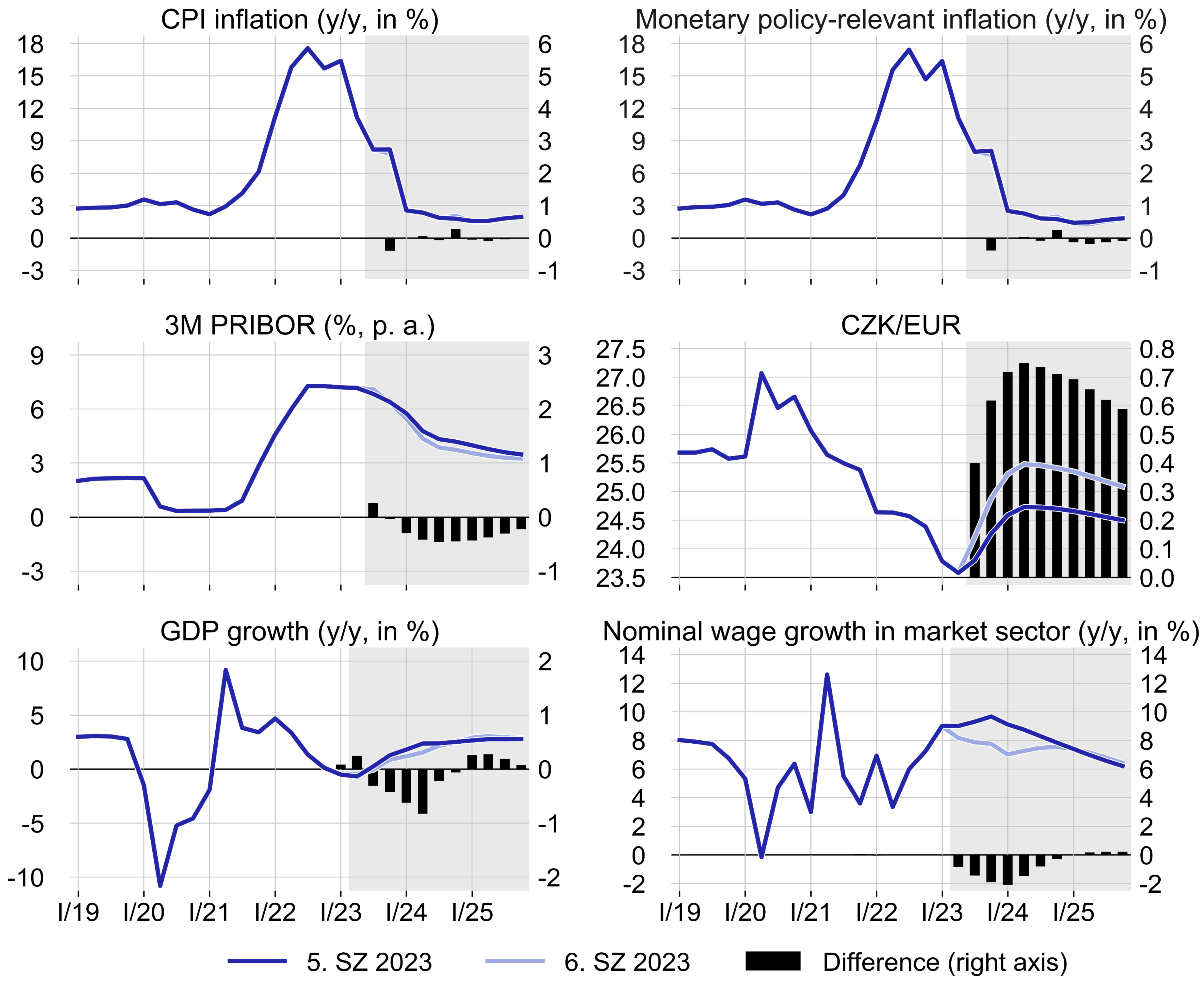
- The new data on **CPI inflation** for July and August broadly confirmed the story of the summer forecast.
- While **core inflation** and **food prices** inflation were slightly lower than predicted, **administered prices** and **fuel prices** grew at a slightly higher pace.

Observed Deviation from the Forecast – GDP



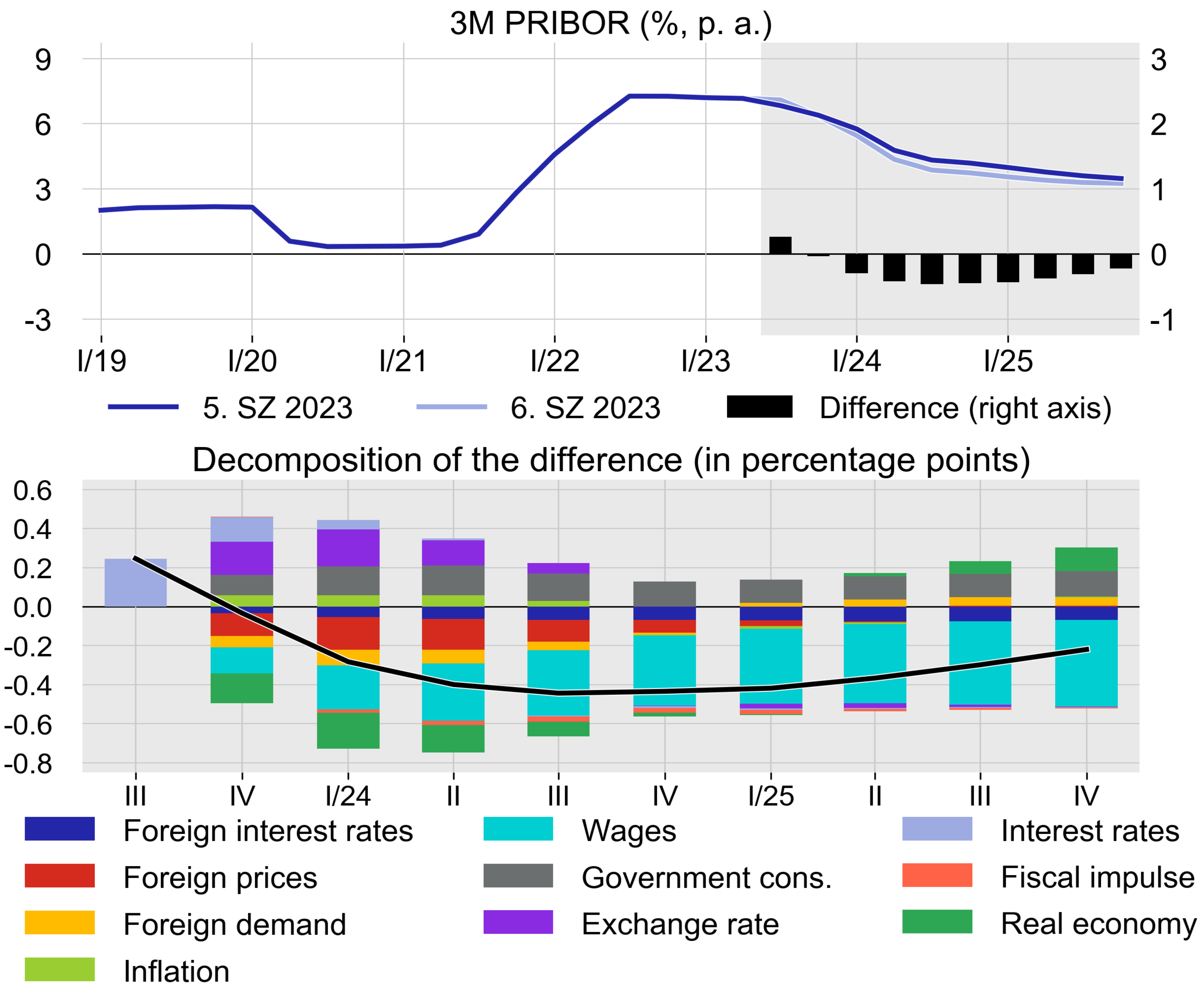
- The overall story of domestic **economic activity** was also confirmed by the data for 2023 Q2.
- The recovery in **household consumption** and **gross fixed capital formation** was stronger than predicted.
- On the other hand, the contributions of **change in inventories** and **net exports** were somewhat lower.

Mechanical Update of the Summer Forecast



- Taking into account the new observed data and updated external outlook, the **inflation** forecast remains virtually unchanged.
- A lower outlook for foreign demand resulted in slightly lower predicted domestic **GDP growth**.
- A lower-than-expected **wage growth** reading led to a sizeable revision of the outlook for nominal wage growth in the market sector.
- Lower cost pressures together with weaker demand are consistent with a somewhat faster decline in domestic **interest rates**.
- The **koruna** is weaker against the euro over the whole forecast horizon. This reflects its observed values and a faster narrowing interest rate differential.

Factors Behind the Change in the Interest Rate Outlook



- The revision of the **interest rate outlook** is driven predominantly by the lower expected **wage growth**, an important cost factor.
- The lower outlook for **foreign producer prices** and higher labour efficiency in the **domestic economy** act in the same direction (i.e. lower inflation pressures and lower interest rates).
- On the other hand, the weaker koruna-euro **exchange rate** and higher **public spending** act in the opposite direction (i.e. higher inflation pressures and higher interest rates).