CNB's New Forecast (Inflation Report I/2019)

Meeting with Analysts

Petr Král

Prague, 8 February 2019

CNB CZECH NATIONAL BANK

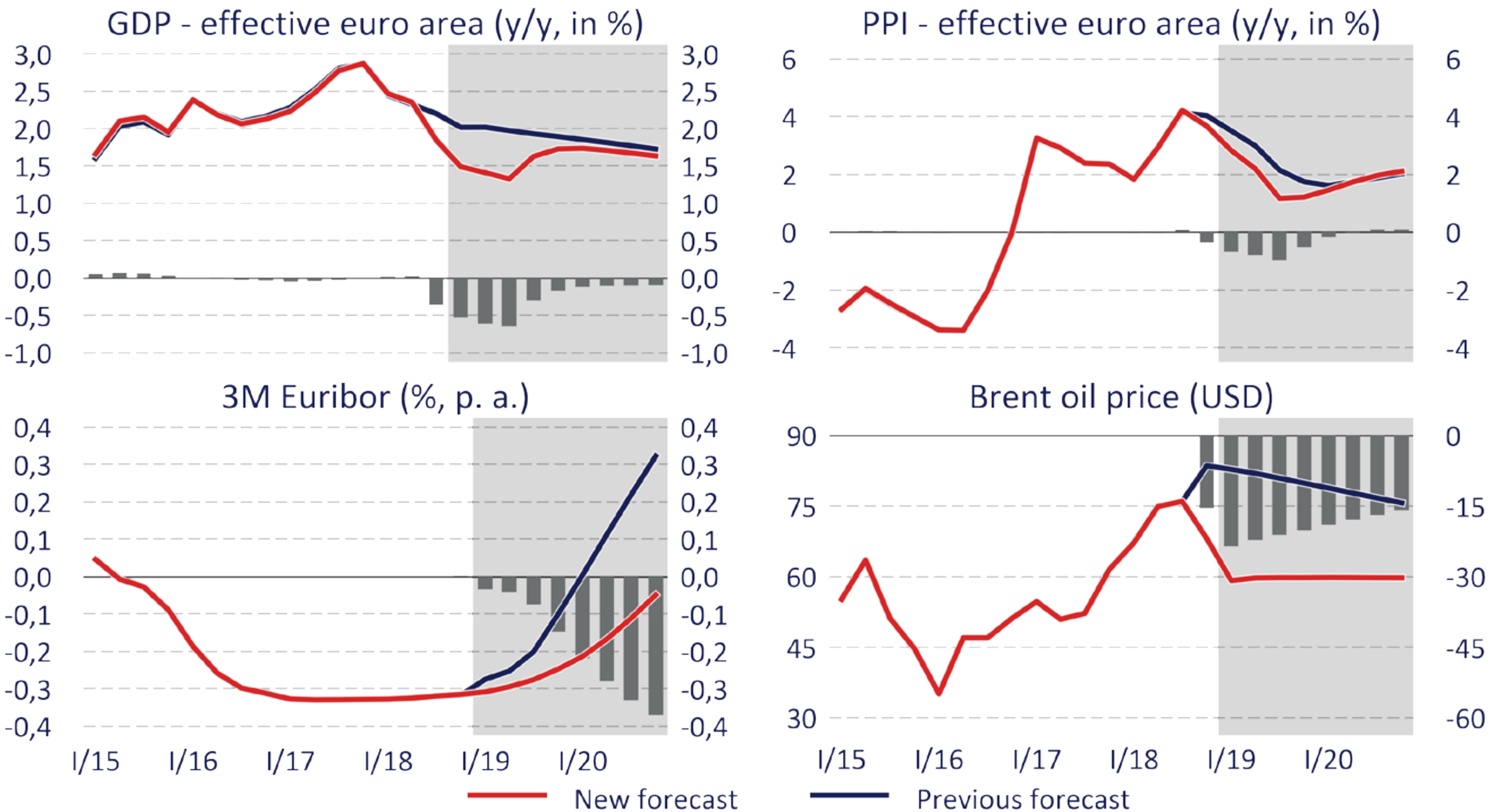
Outline

1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast
4. Sensitivity scenarios

Outline

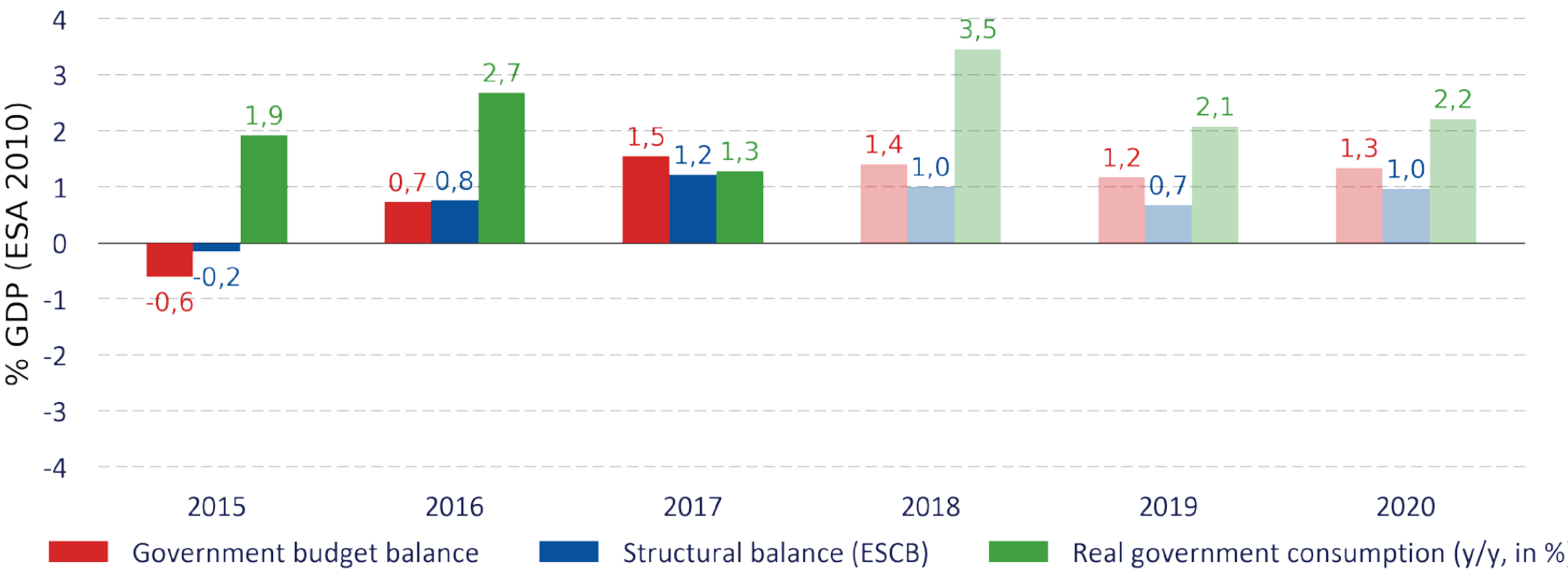
1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast
4. Sensitivity scenarios

External Environment Outlook



- GDP growth in the effective euro area will slow to 1.5% this year and edge up to 1.7% in 2020.
- A decline in oil prices is reflected in slower growth in producer prices in the euro area. Foreign PPI will return to 2% growth in late 2020.
- ECB rates will remain negative over the entire forecast horizon.

Fiscal Policy



- Government budget surpluses, primarily reflecting increased tax revenues due to continued economic growth, will persist.
- The surpluses will remain above 1% of GDP in the next two years. Positive developments will also be apparent in continued structural surpluses.
- Government consumption will grow at a rate slightly above 2% in 2019 and 2020.

Fiscal Impulse

CZECH NATIONAL BANK

Fiscal impulse (contributions to GDP growth in percentage points)

	2017	2018	2019	2020
	actual	forecast	forecast	forecast
Fiscal impulse	0.2	0.8	0.4	0.0
of which impact through:				
Private consumption	0.2	0.4	0.3	0.0
Private investment	-0.1	0.0	0.0	0.0
Government investment, domestic	0.0	0.2	0.0	0.0
Government investment, EU funded	0.0	0.2	0.1	0.0

- Fiscal policy will be expansionary this year and neutral in 2020.
- Compared to last year, the fiscal expansion will be less pronounced in 2019.
- In 2019 the fiscal impulse will materialise mainly through household consumption and will reflect a higher-than-usual increase in old-age pensions and rapid wage growth in the government sector. Growth in government investment will also continue.

Outline

1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast
4. Sensitivity scenarios

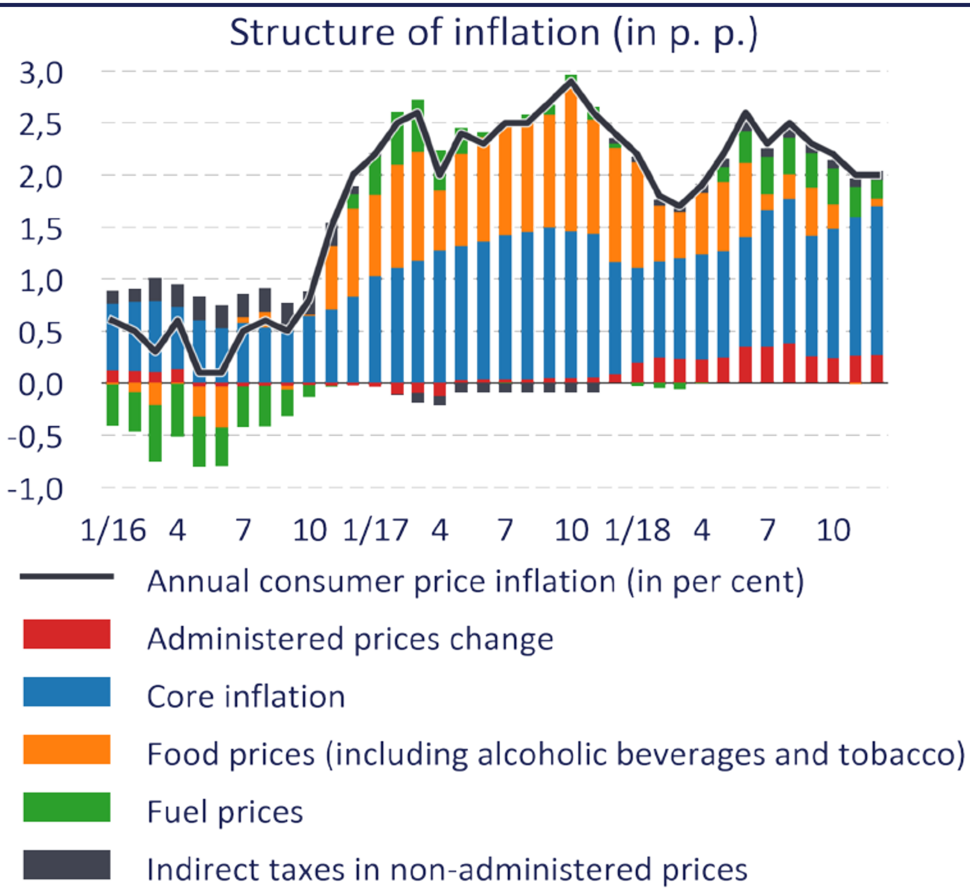
Summary of the New Forecast

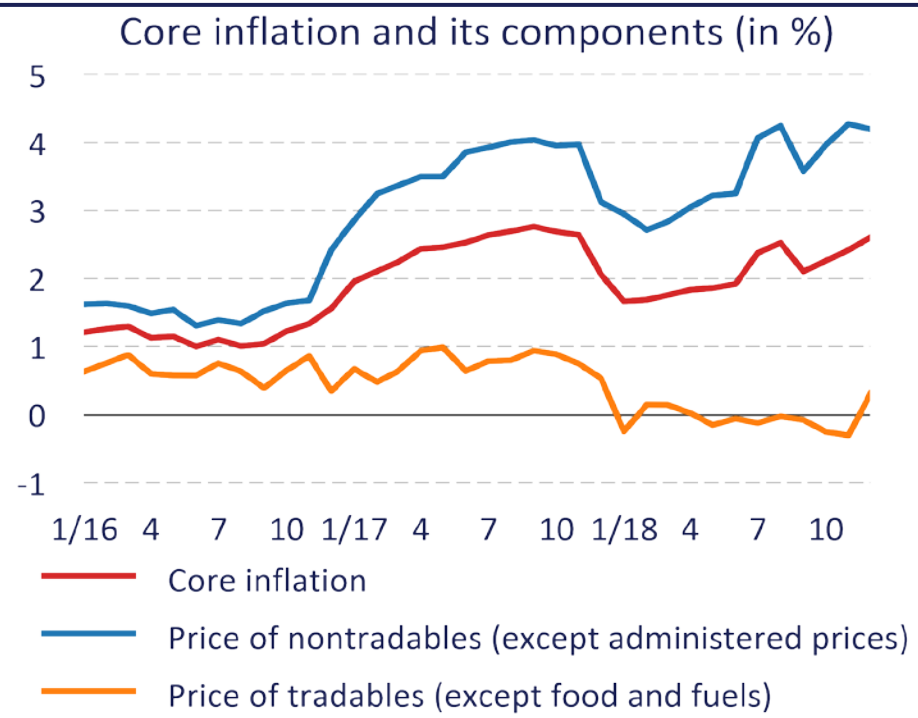
CNB CZECH NATIONAL BANK

- Inflation will rise temporarily at the start of this year and will be very close to the CNB's target in the following periods.
- GDP will grow at a rate of around 3% in the next two years, driven by all components of domestic demand. The negative contribution of net exports will fade away in 2020.
- The continued economic growth is reflected in a very tight labour market, which will inhibit further employment growth. An increase in the minimum wage in 2019 will stimulate wage growth temporarily, but it will slow down gradually.
- Renewed appreciation of the koruna will be linked with a gradual fading of negative global sentiment, a widened positive interest rate differential vis-à-vis the euro and continued real convergence of the Czech economy.
- Consistent with the forecast is broad interest rate stability.

Structure of Inflation

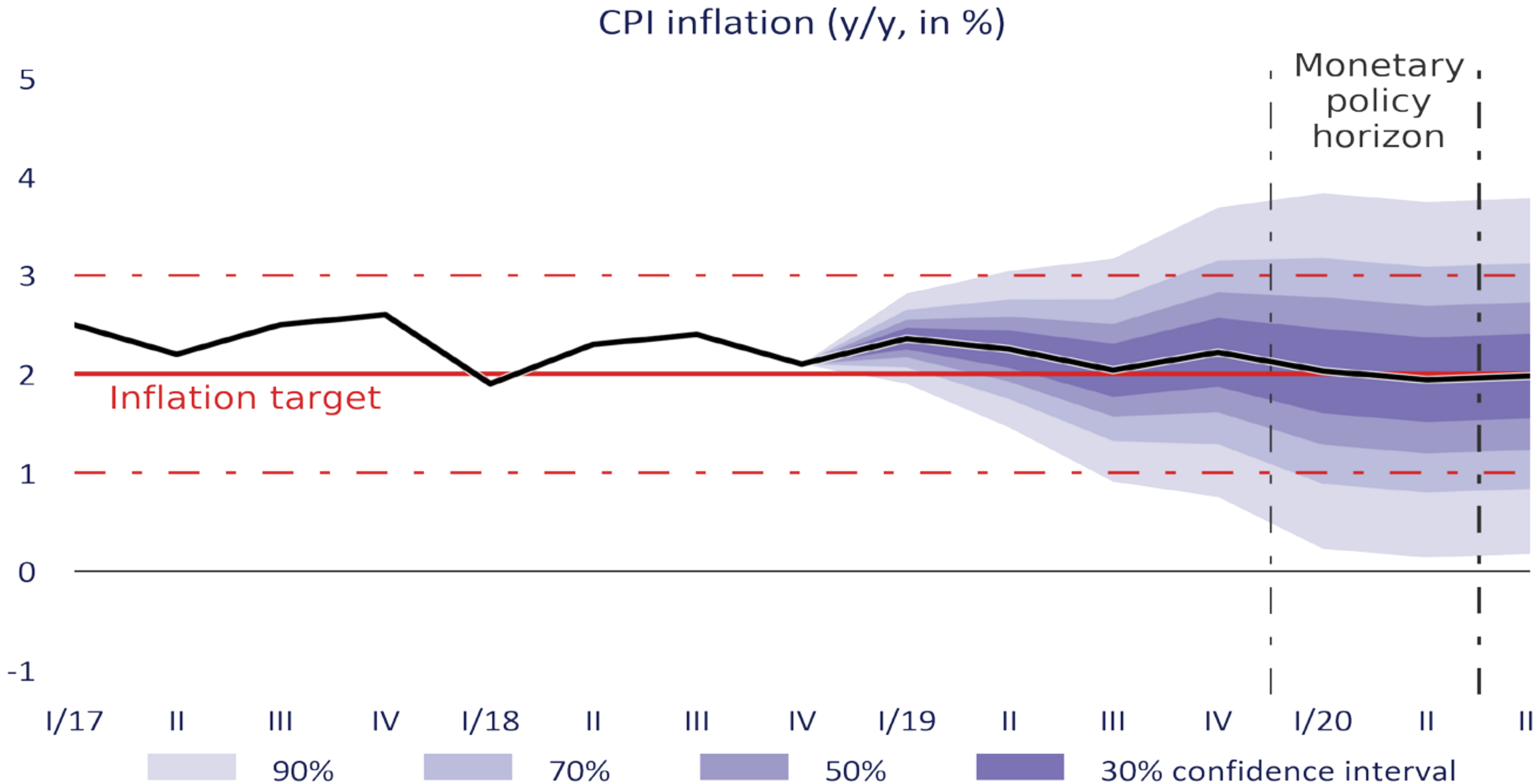
CNB CZECH NATIONAL BANK





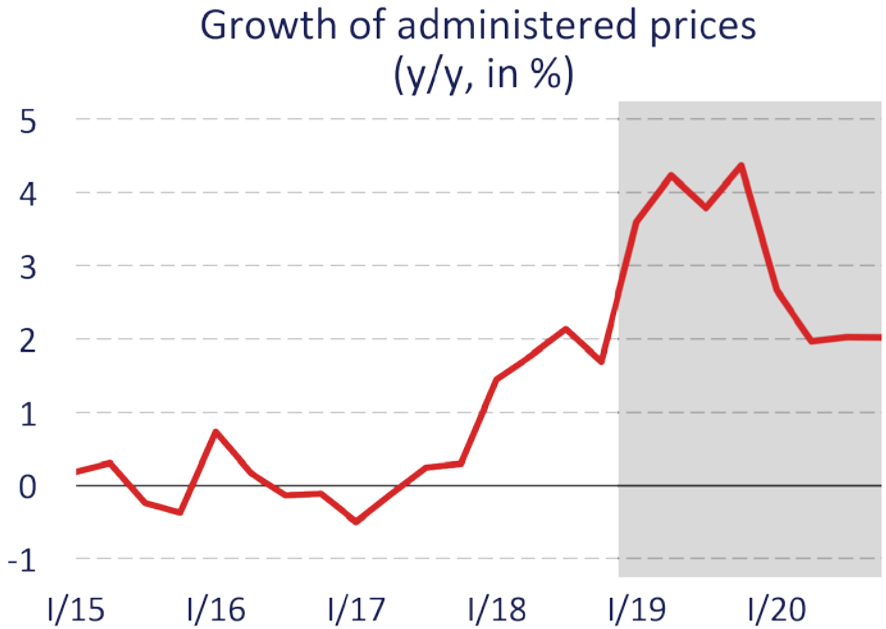
- Inflation declined to 2% in 2018 Q4, which mainly reflected a fade-out of the previous growth in food prices and slower fuel price inflation.
- Core inflation increased due to a pick-up in the growth of nontradables prices, while tradables prices recorded a slight decline for most of the last quarter.
- Growth in administered prices (linked to an increase in electricity prices) also contributed positively to the overall growth in consumer prices.

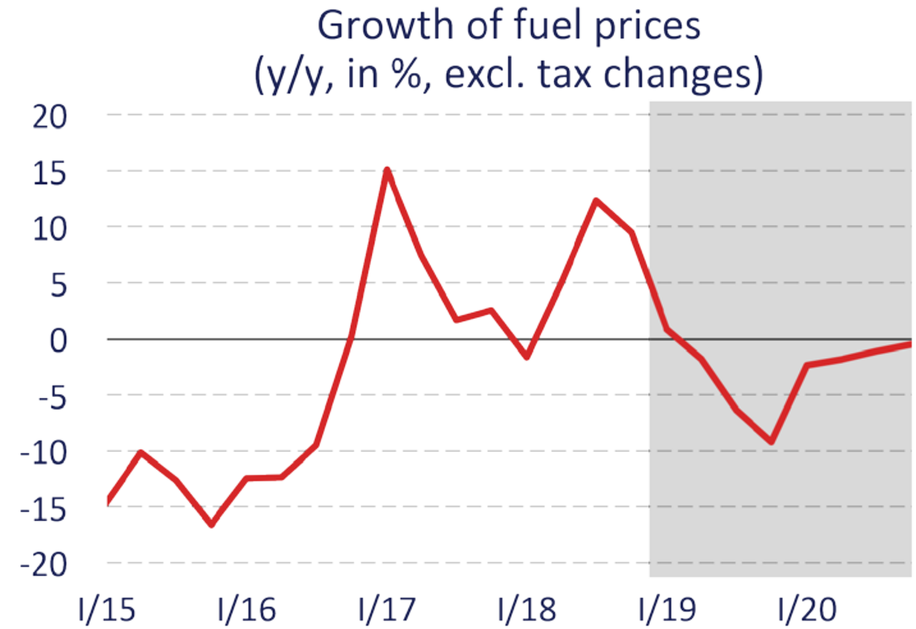
Headline Inflation Forecast



- Following a temporary increase in early 2019, inflation will return to the 2% target and stay very close to it over the monetary policy horizon.
- Monetary policy-relevant inflation will be very close to headline inflation.

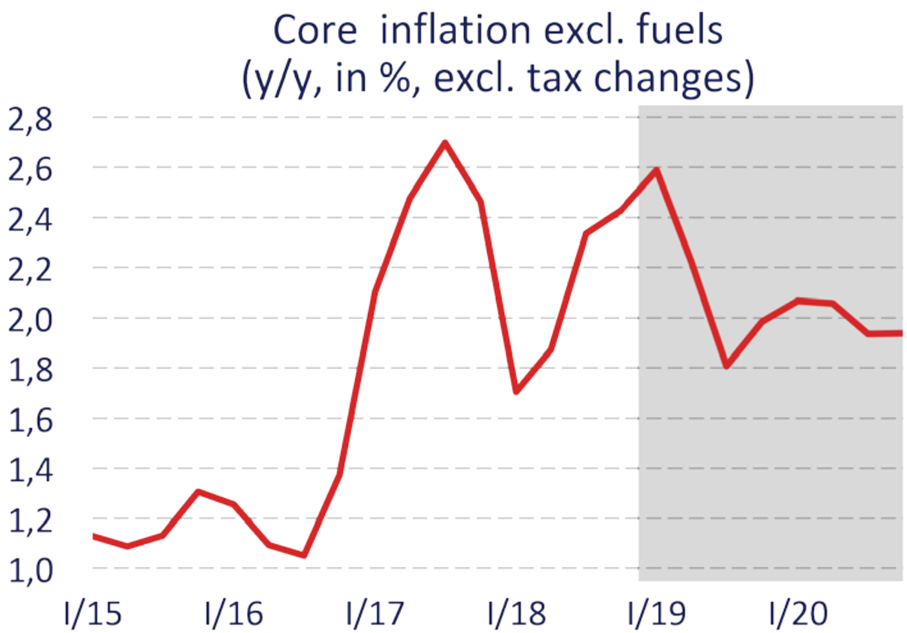
Administered and Fuel Prices

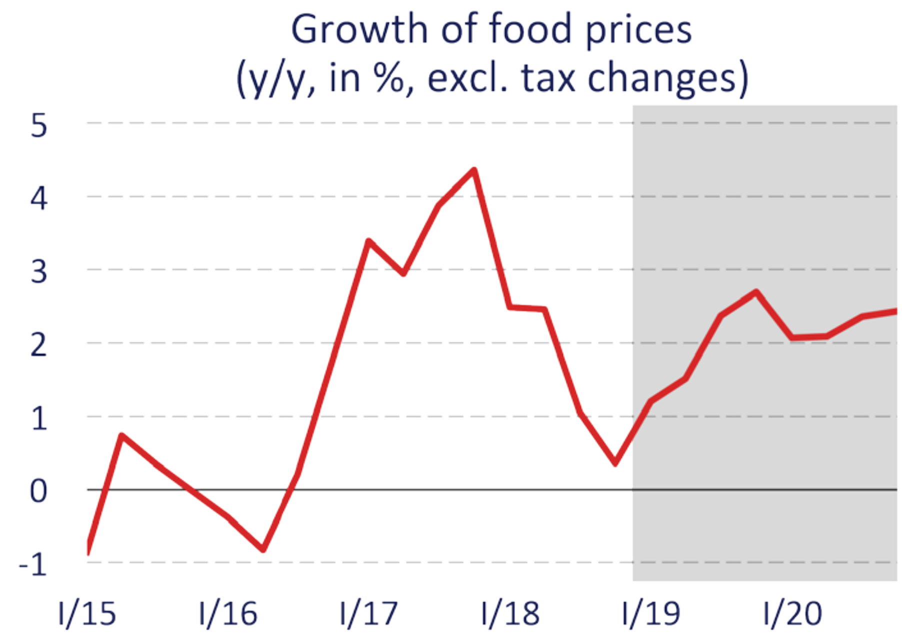




- The previous rapid rise in world prices of energy commodities will foster a marked increase in administered price growth this year. By contrast, administered price inflation will be curbed for most of this year by the fare discounts in public transport introduced recently. In 2020 the dynamics of administered prices will slow down to 2%.
- Fuel prices are heading towards a year-on-year decline, which will deepen gradually this year, reflecting the dynamics of oil prices and renewed appreciation of the koruna against the dollar.

Core Inflation and Food Prices

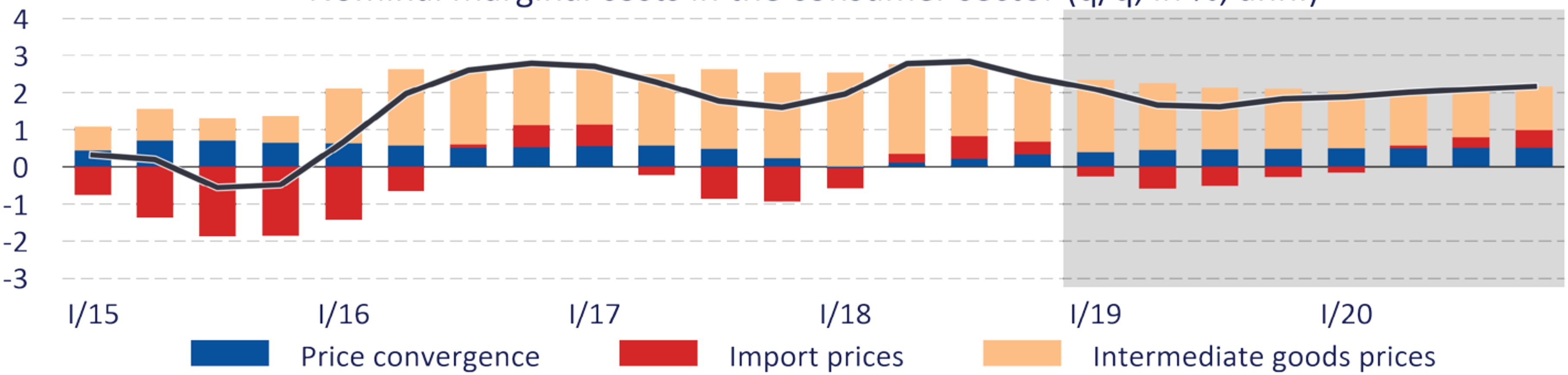




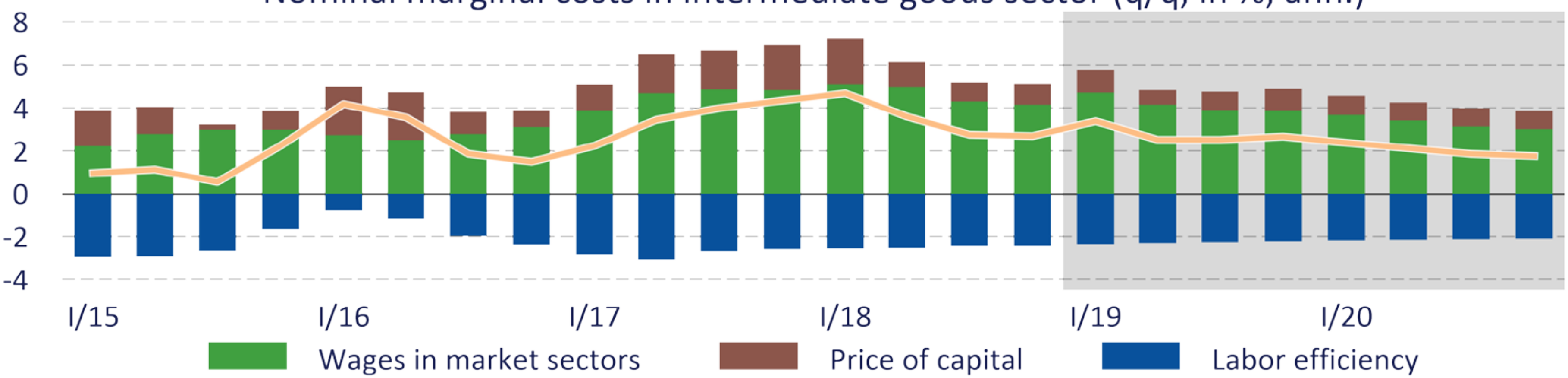
- Core inflation will briefly increase at the start of this year and will then be close to 2%. The initial increase will be due to strong inflation pressures from the domestic economy, which will drive up prices in the non-tradables sector. Later, renewed appreciation of koruna together with a slowdown in foreign prices will be reflected in a decline in core inflation towards 2%.
- Food price inflation will increase markedly on the back of a rise in food commodity prices due to last year’s poor harvest (dry and hot weather).

Inflation pressures

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

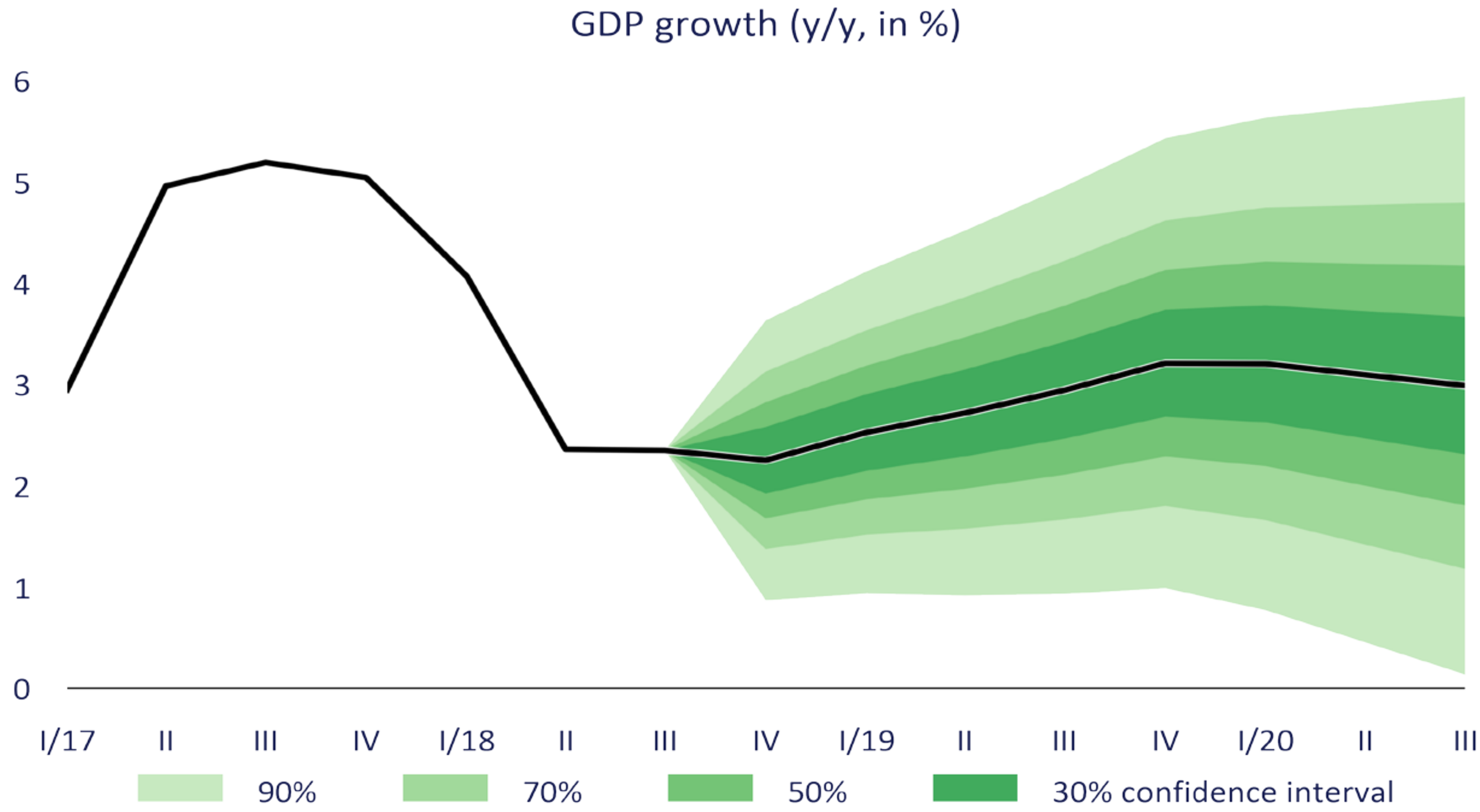


Nominal marginal costs in intermediate goods sector (q/q, in %, ann.)



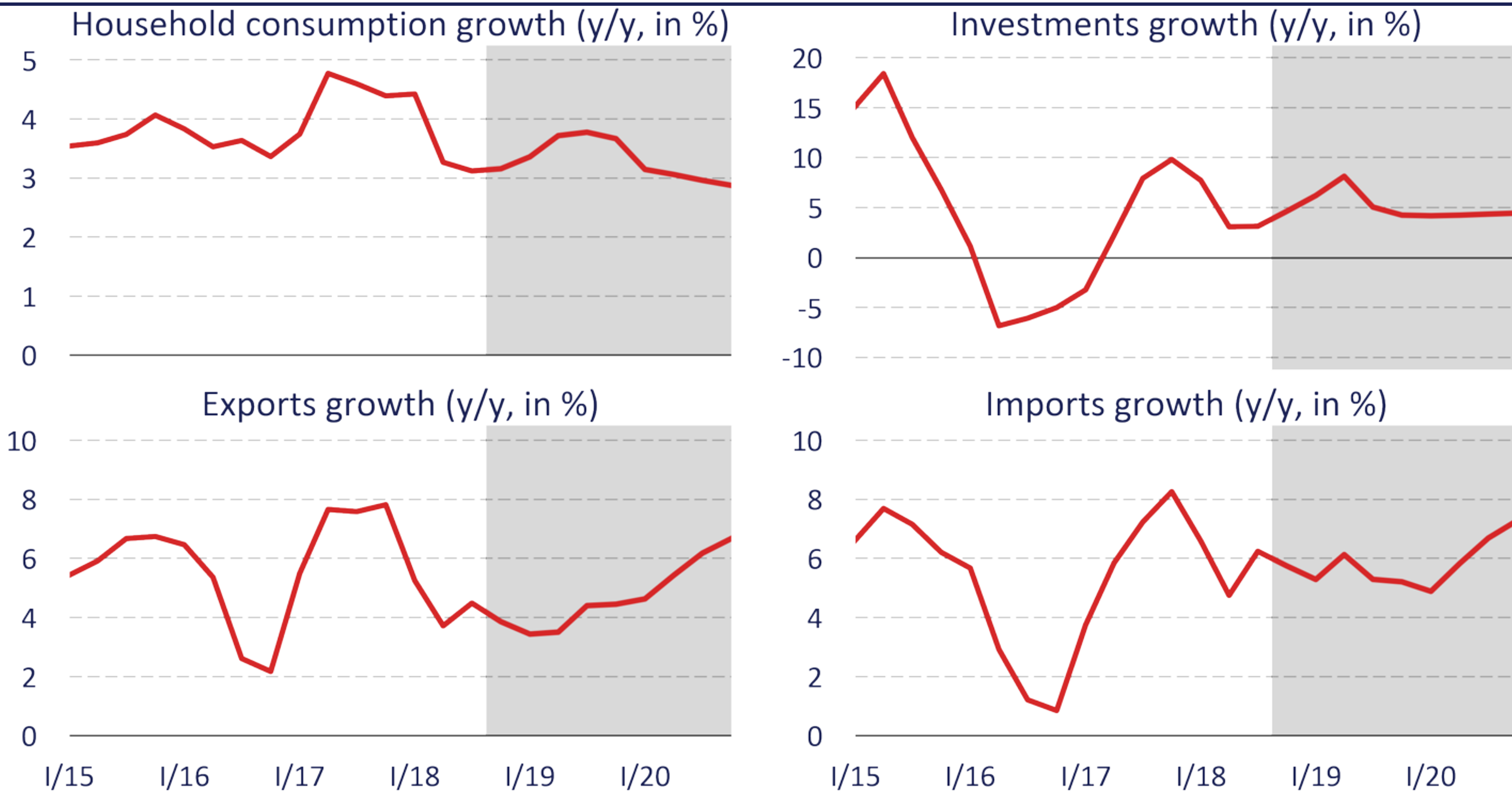
- The overall inflation pressures will moderate during this year owing to a strengthening anti-inflationary effect of import prices. The pressures will increase slightly next year, when the contribution of import prices will turn positive again.
- The strong domestic inflation pressures, reflecting labour market developments, will not weaken until next year.

GDP Growth Forecast



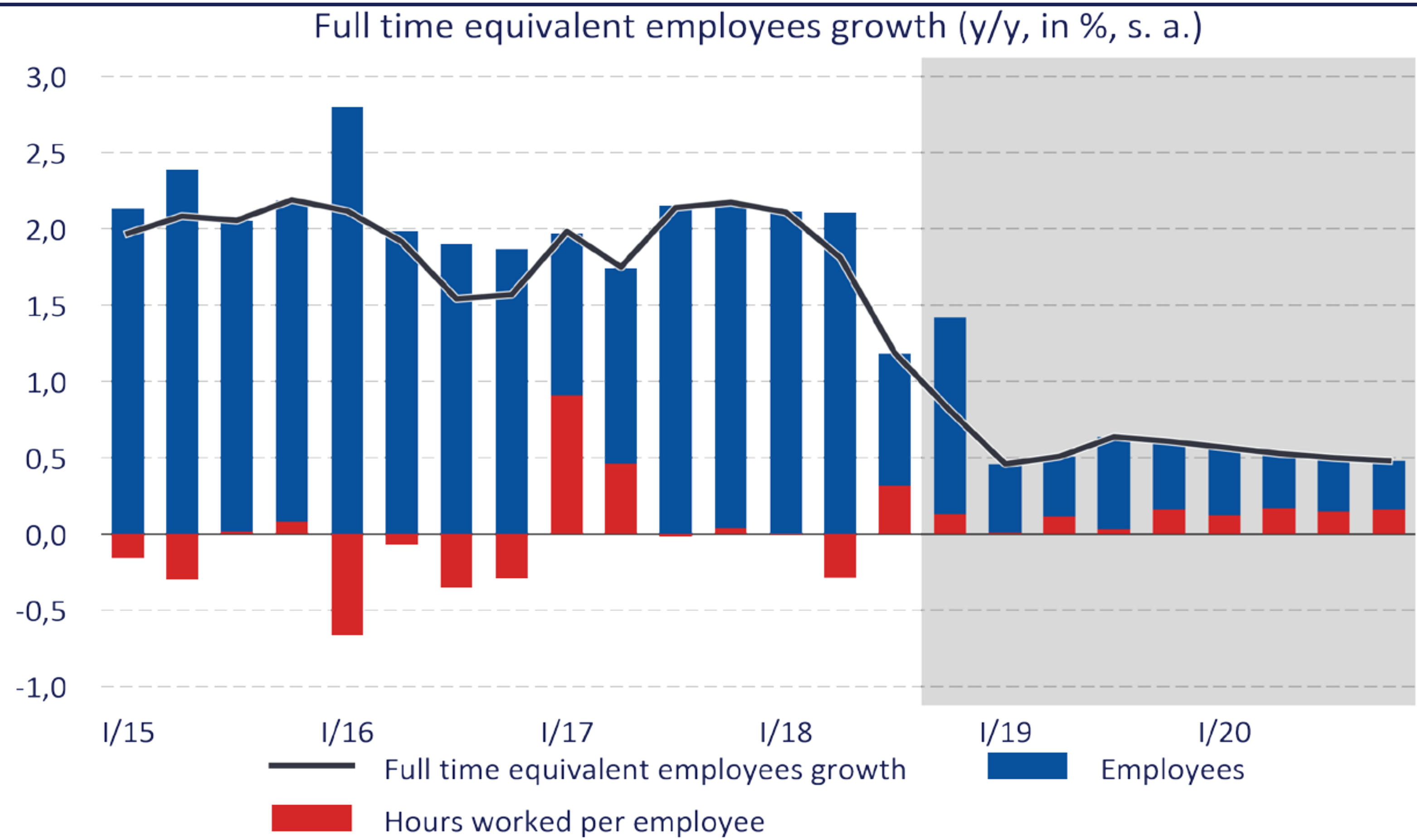
- GDP will grow at a rate of around 3% in the next two years, driven by domestic demand. Household consumption and corporate investment will be supported by persisting optimism of households and continued, albeit slowing, growth in external demand. The positive fiscal impulse will act in the same direction. Net exports will hinder economic growth this year due to subdued export growth.

Aggregate Demand



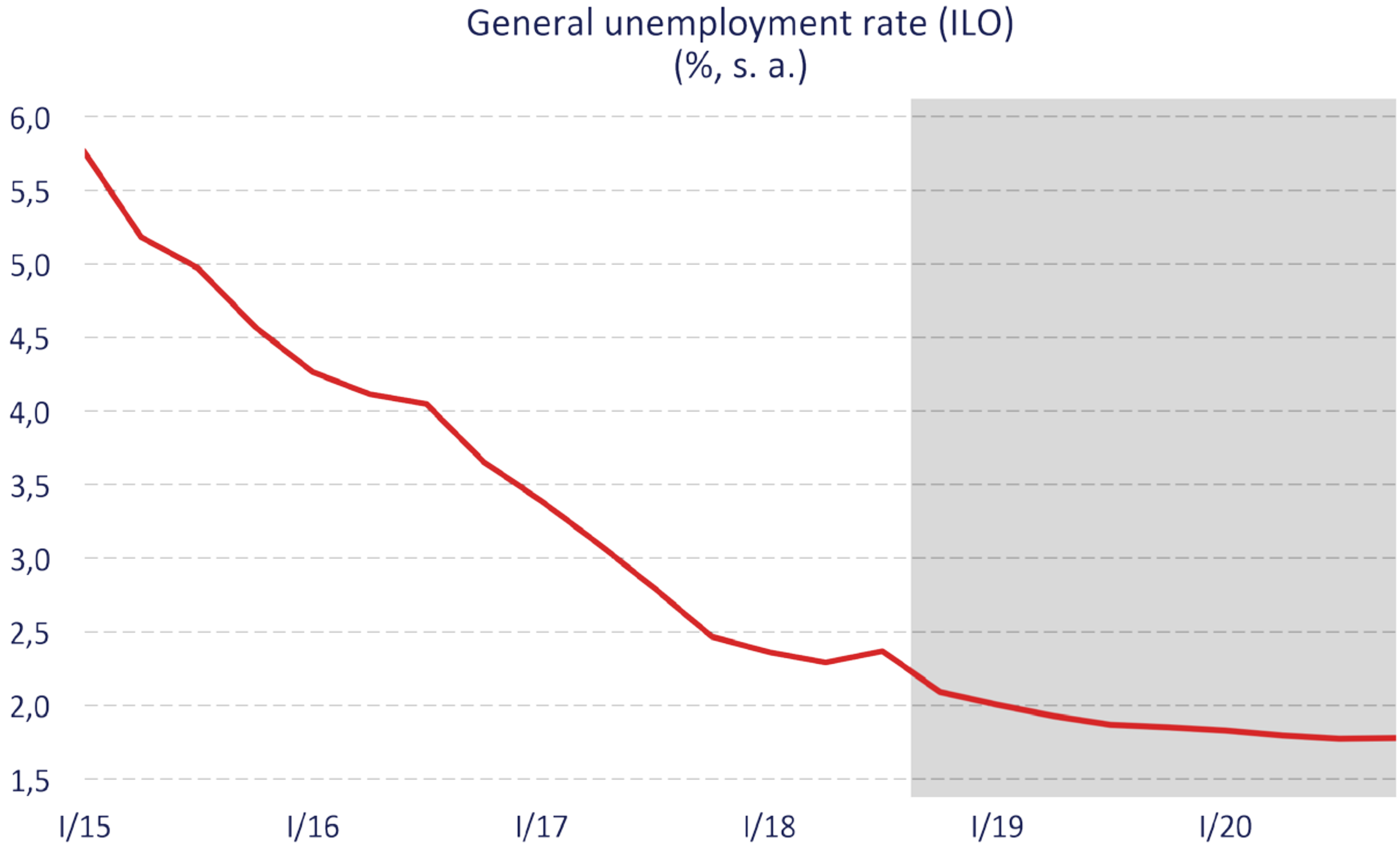
- The continued household consumption growth will reflect rapid, albeit gradually slowing, growth in wages and salaries and other income.
- Investment will continue to be supported by its private and public component.
- The currently muted export growth, due to both fundamental and one-off factors, will recover next year.

Labour Market: Employment



- Employment growth will slow further due to labour shortages.
- Therefore, the tightness in the labour market, linked with a record-low unemployment rate, will be reduced only partially by growth in the labour force.

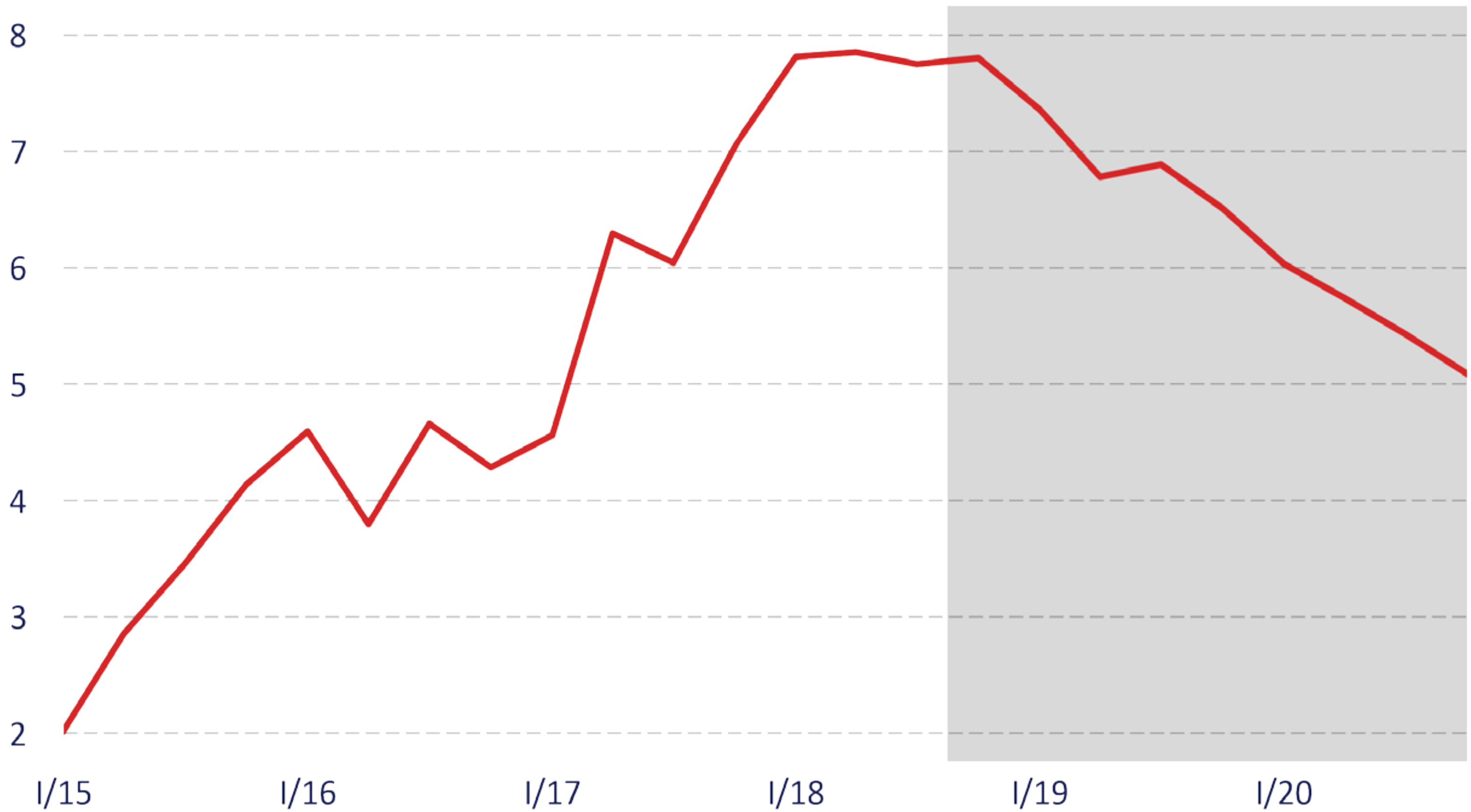
Labour Market: Unemployment



- The currently record-low unemployment rate will not decrease significantly further.

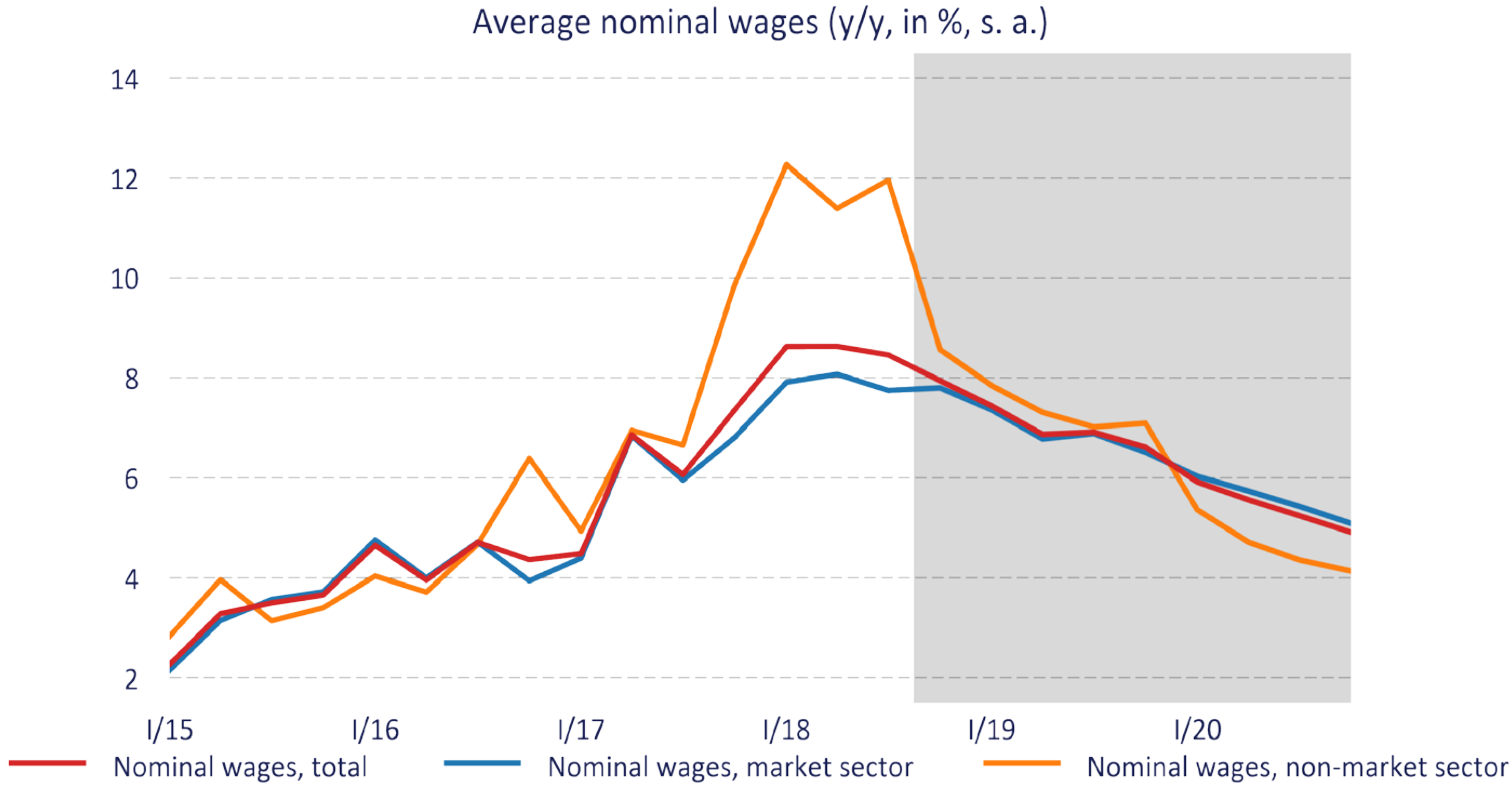
Labour Market: Wage Growth in Market Sectors

Nominal wage growth in market sector (y/y, in %, s. a.)



- The buoyant wage growth in market sectors, reflecting the tight labour market and the increase in the minimum wage, will start to slow during this year.
- Wage growth will slow due to the previous tightening of the monetary conditions and firms' efforts to maintain competitiveness and profitability.

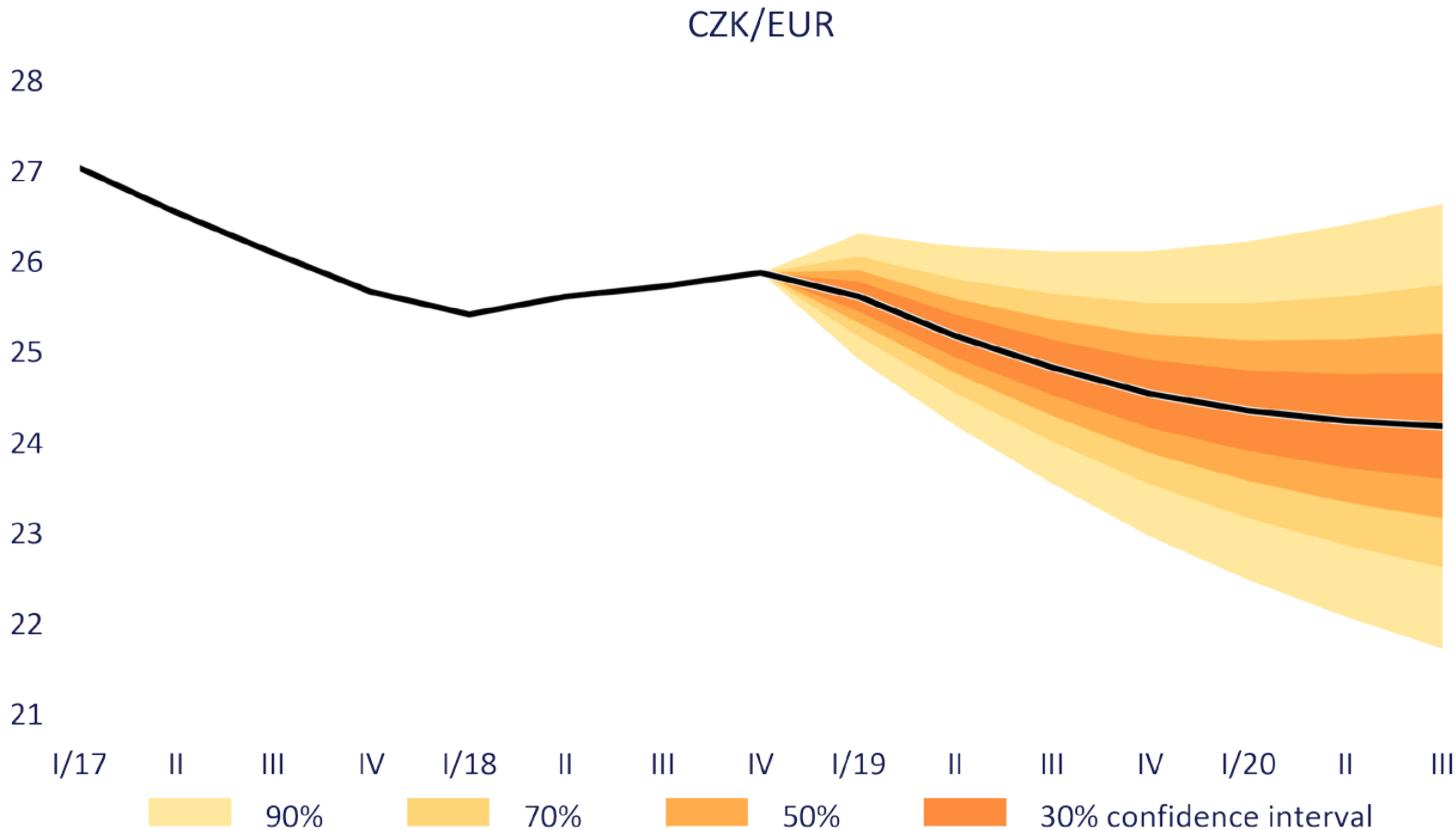
Nominal Wage Growth in Non-Market Sectors



- Pronounced, albeit visibly slowing, wage growth will continue in non-market sectors this year, mainly reflecting an increase in the wages of teachers and, to a lesser extent, other public employees.

CZK/EUR Exchange Rate

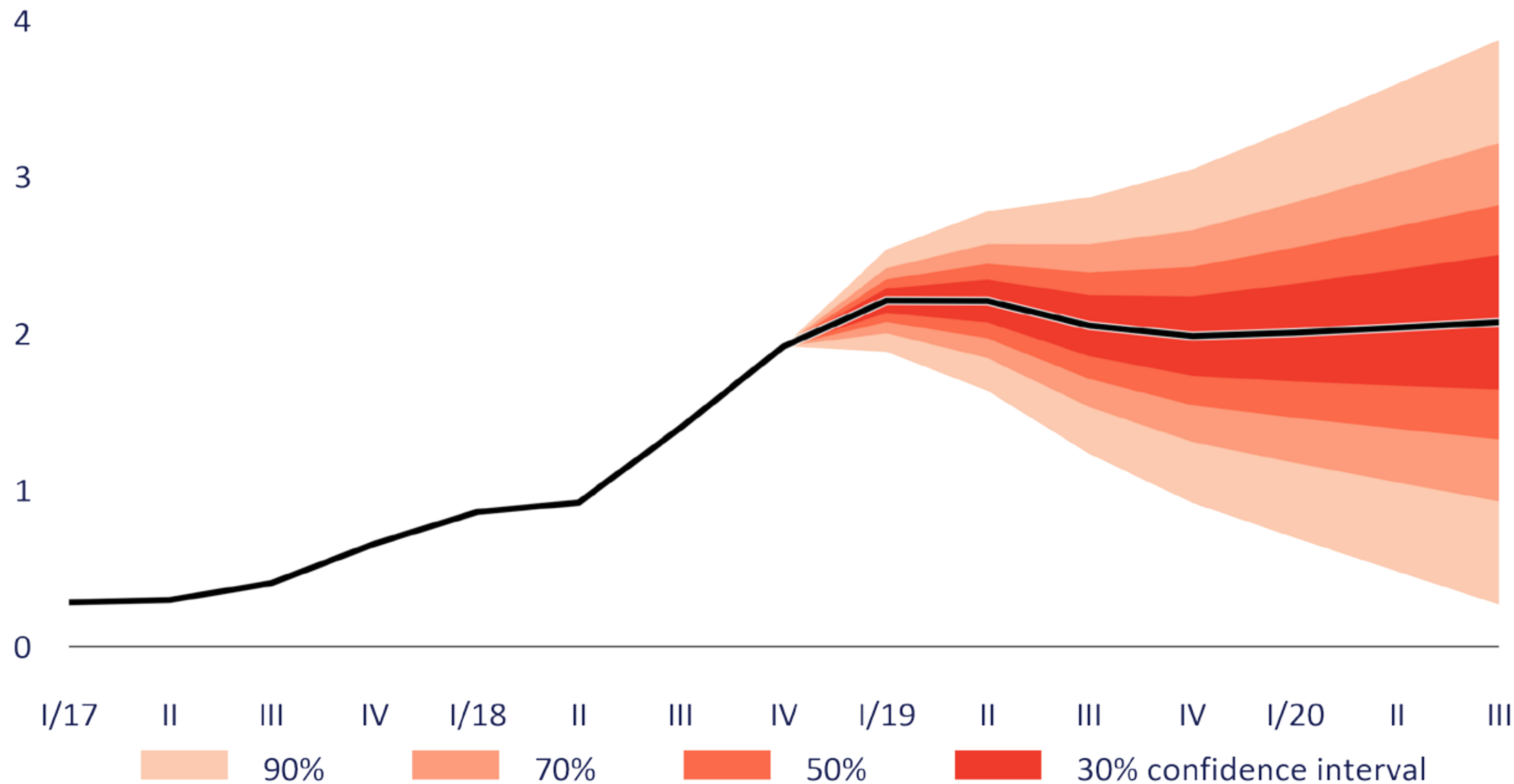
CNB CZECH NATIONAL BANK



- The exchange rate forecast for 2019 Q1 is CZK 25.6/EUR.
- The negative sentiment on foreign exchange markets will gradually fade out.
- The renewed appreciation of the koruna will be driven by a distinctly positive interest rate differential vis-à-vis the euro area and by continued real convergence of the Czech economy coupled with growth in labour efficiency.

Interest Rate Path (3M PRIBOR)

3M PRIBOR (%, p. a.)



- Consistent with the forecast is broad interest rate stability. Upward pressure is being exerted primarily by the weakened koruna. The strong domestic inflation pressures and the pass-through of the higher administered price inflation into other components of inflation are acting in the same direction. Renewed koruna appreciation amid persisting negative interest rates in the EA until the end of 2020 is having the opposite effect.

Outline

1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast
4. Sensitivity scenarios

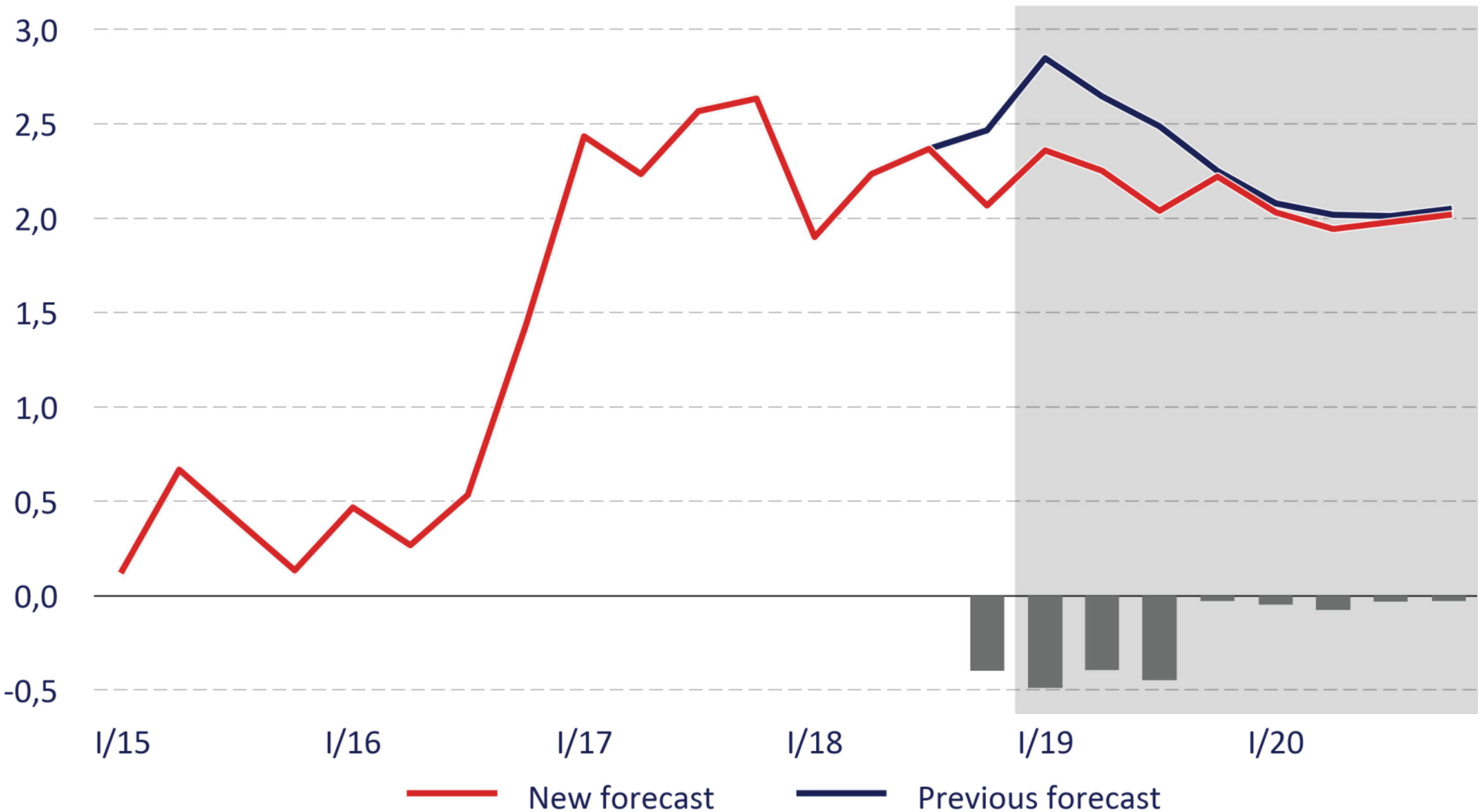
Comparison with the Previous Forecast

CZECH NATIONAL BANK

- The most significant change by comparison with the previous forecast is a lowered outlook for external variables. In particular, the outlook for euro area interest rates has been shifted downwards significantly and external producer price inflation has been reduced due to falling oil prices. External economic activity will also grow more slowly.
- Another change compared with the previous forecast is a later renewal of appreciation of the koruna.
- The strength of the domestic inflation pressures has been revised downwards slightly, mainly as a result of slightly lower growth in domestic economic activity.
- The inflation forecast has been shifted downwards this year, reflecting lower observed figures and a stronger anti-inflationary effect of import prices. An increased outlook for administered prices acts in the opposite direction.
- The new forecast leads to negligibly higher interest rates at the start of this year, due mainly to a weaker initial exchange rate of the koruna and a higher outlook for administered prices. Owing to the lowered path of foreign rates, the new forecast no longer expects domestic interest rates to rise next year.

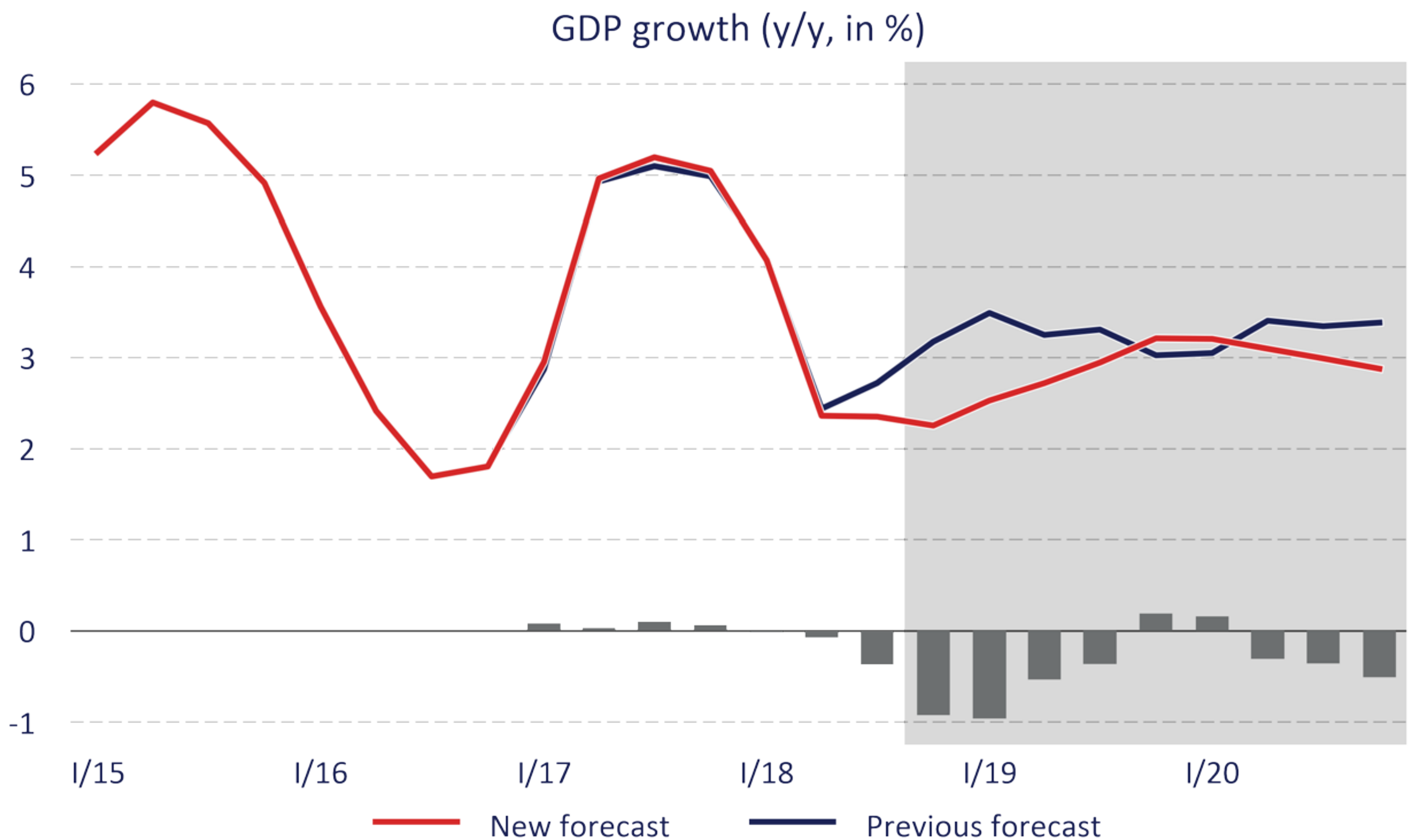
Comparison: Inflation Forecast

CPI inflation (y/y, in %)



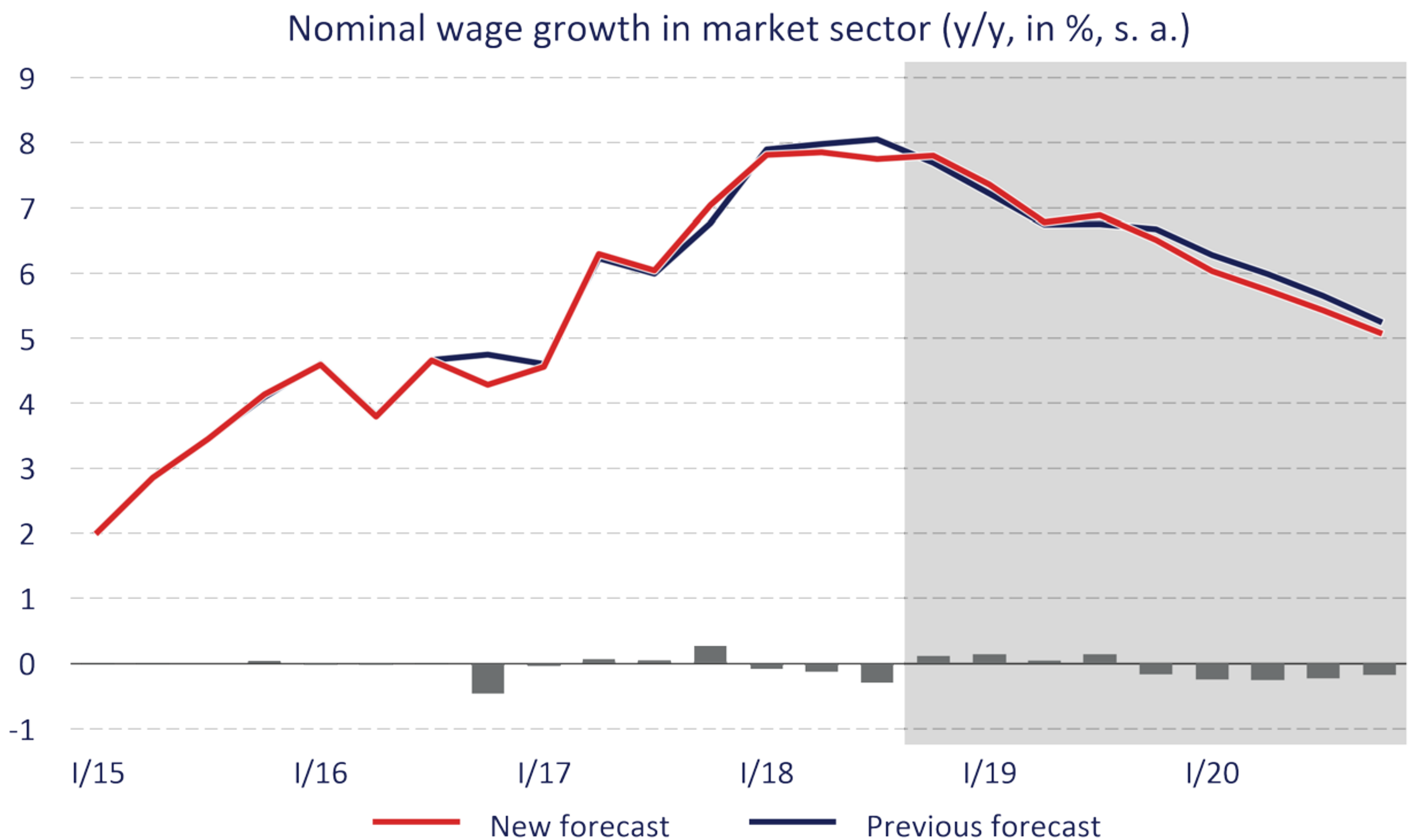
- The inflation forecast is lower for this year but it is almost unchanged in 2020.
- The reduction in the inflation outlook for 2019 is due mainly to the lower observations at the end of last year. In addition, domestic inflation will reflect slower growth in foreign producer prices, hindered also by lower oil prices, through a sharper decline in import prices.

Comparison: GDP Forecast



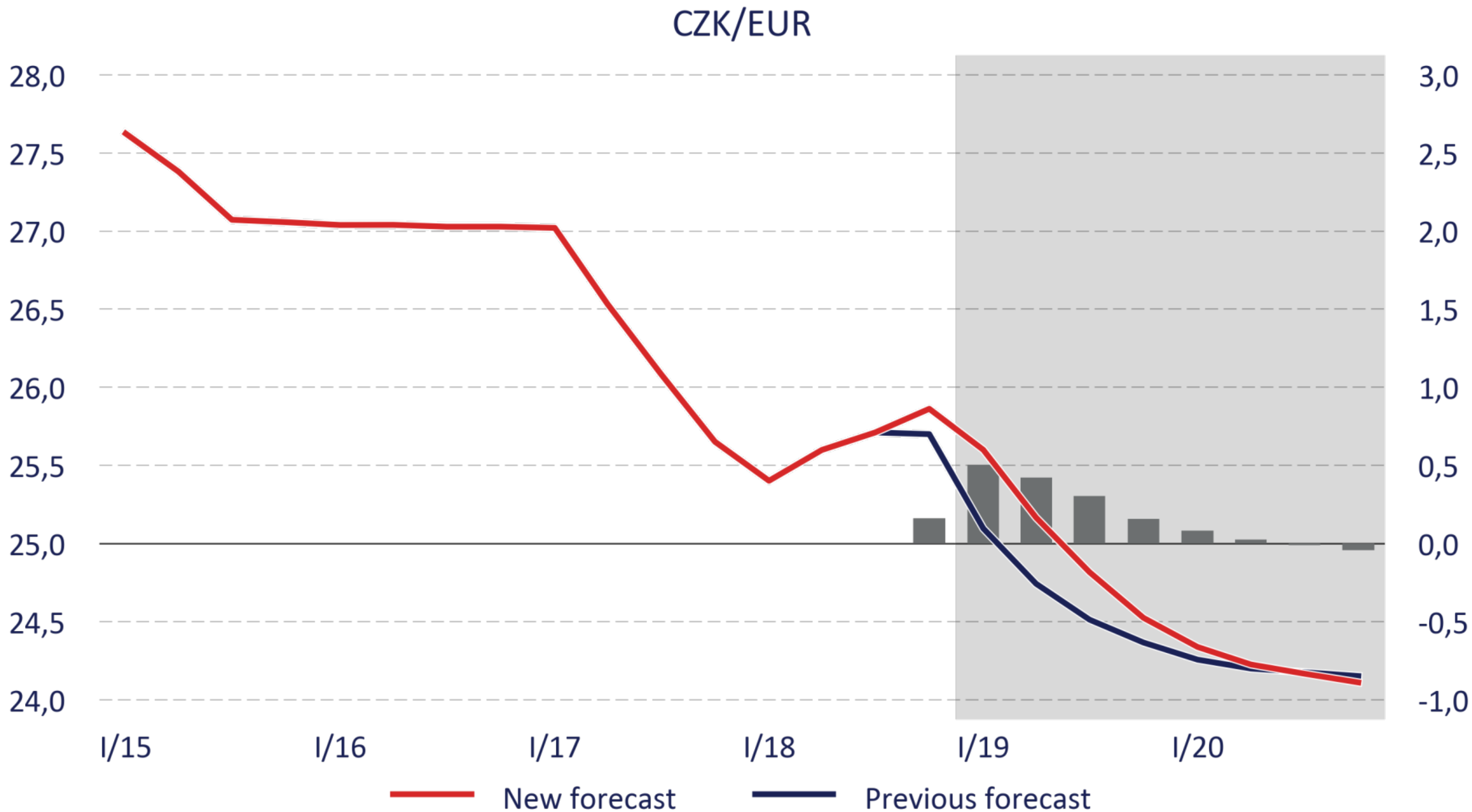
- The forecast for domestic economic growth this year and the next has been shifted downwards.
- The slower GDP growth this year and the next reflects both weaker outlook for external demand and deteriorated price competitiveness of domestic producers (due to lower growth in foreign prices).

Comparison: Nominal Wage



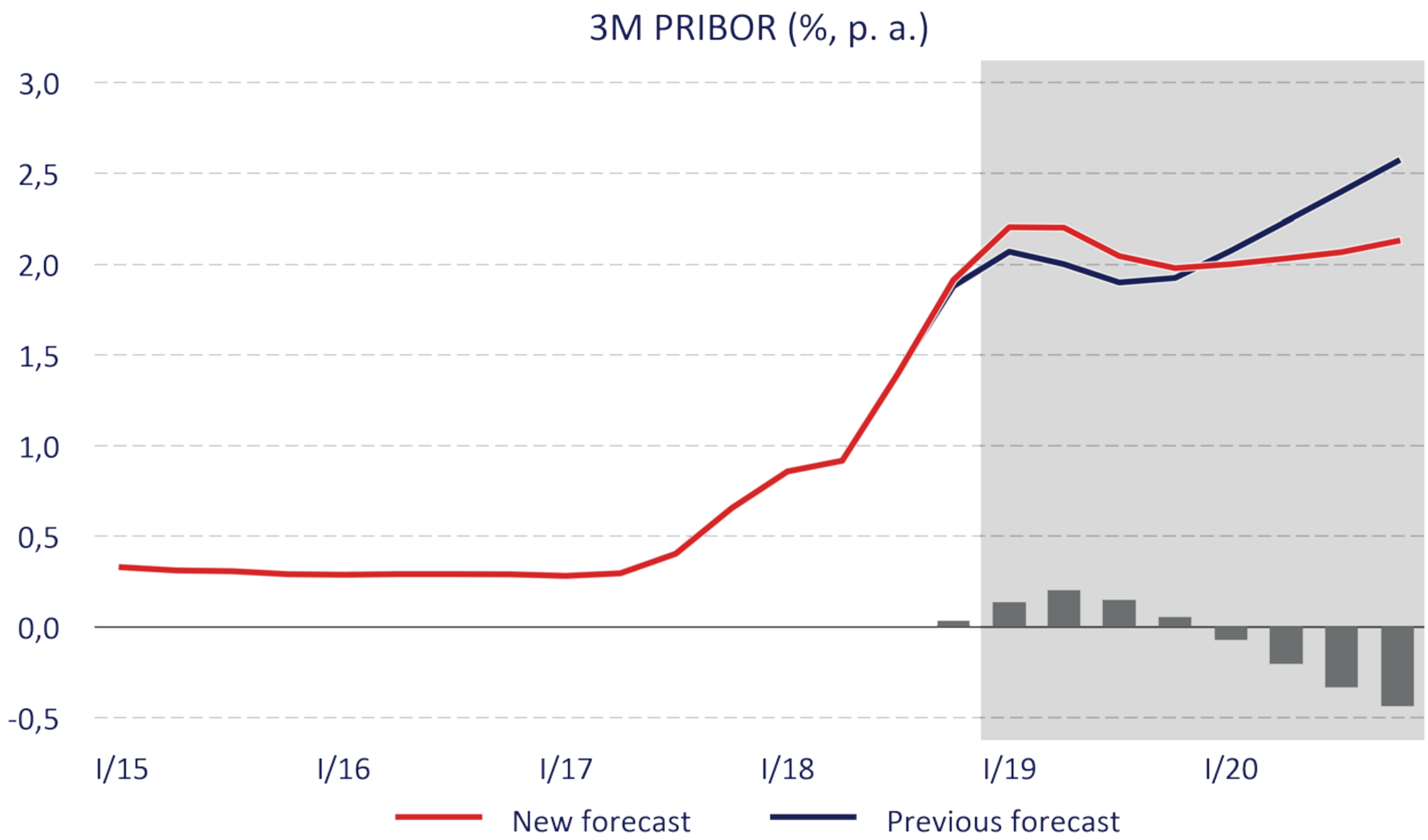
- The wage growth forecast is little changed.
- Short-term indicators suggest that wage growth was slightly higher at the end of last year due to moderately higher payments of one-off bonuses. This effect will gradually fade away. Wage growth will be more moderate from the end of this year onwards due to weaker domestic economic activity.

Comparison: Exchange Rate



- The new forecast for the koruna exchange rate takes into account its markedly weaker levels observed recently compared to the previous prediction.
- The forecast expects the effect of negative sentiment, which has so far dampened the appreciation of the koruna, to fade away a quarter later than assumed by the previous forecast.

Comparison: Interest Rate Forecast

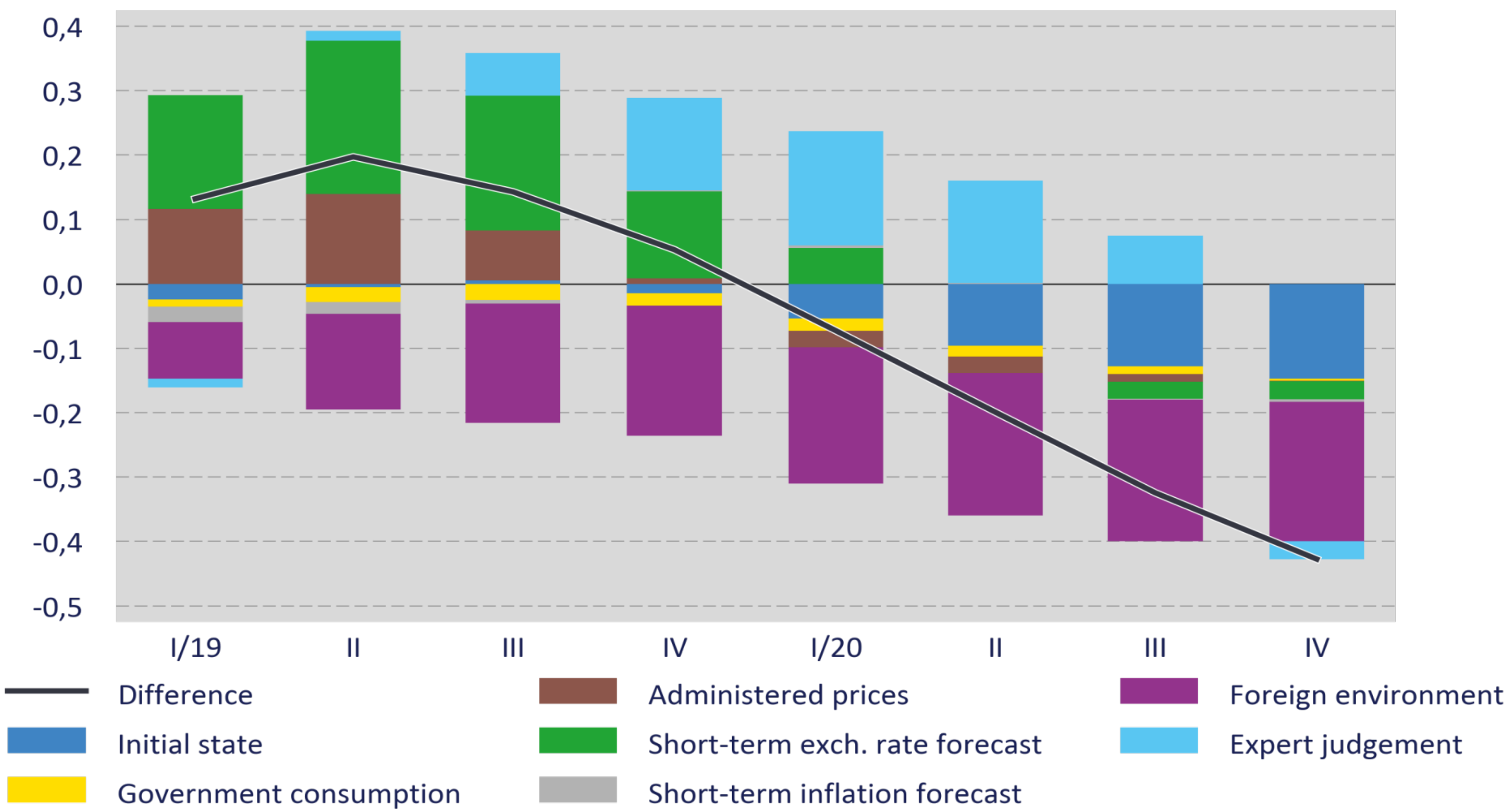


- The forecast implies a negligibly higher domestic interest rate path this year and slightly lower rates next year.

Decomposition of Changes in the Interest Rate Forecast

CNB CZECH NATIONAL BANK

3M PRIBOR, percentage points

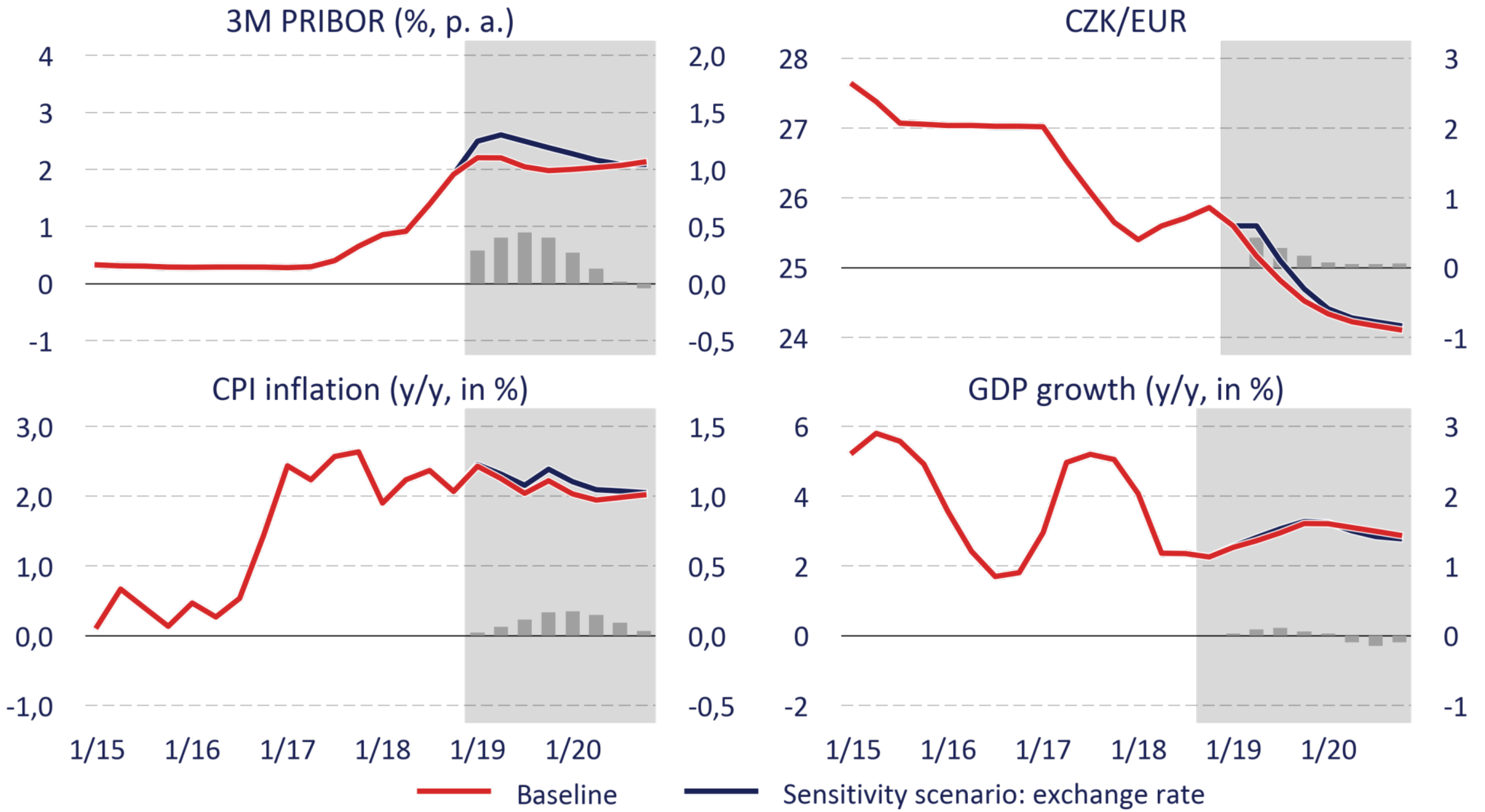


- The initially slightly higher interest rates are due mainly to a weaker koruna, including the related expert adjustment, and to faster growth in administered prices and its pass-through into other components of inflation.
- The flatter (reduced) foreign interest rate outlook, which will prevail at the longer end, is acting in the opposite direction together with the initial state.

Outline

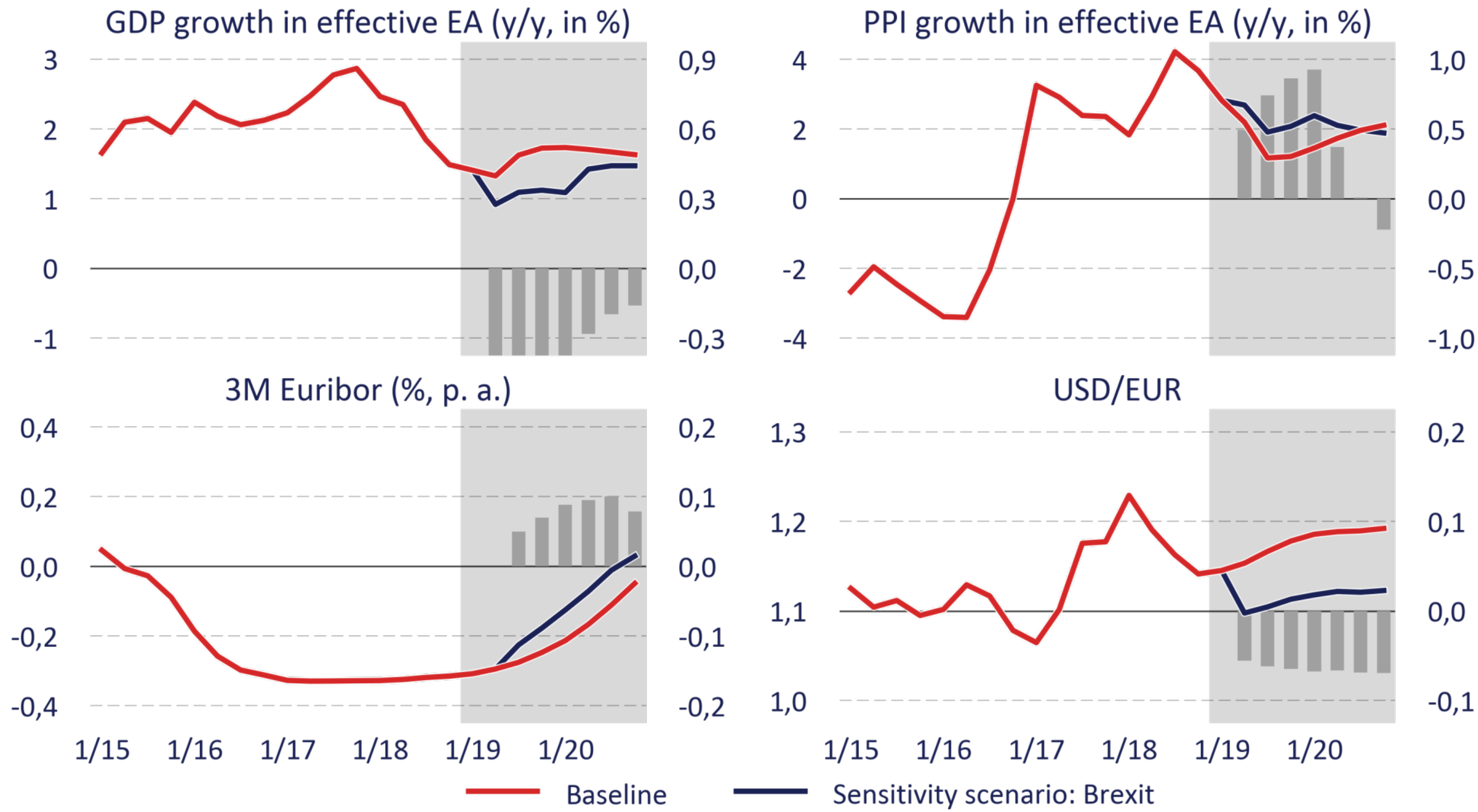
1. Assumptions of the forecast
2. The new macroeconomic forecast
3. Comparison with the previous forecast
4. Sensitivity scenarios

Sensitivity Scenario – Exchange rate



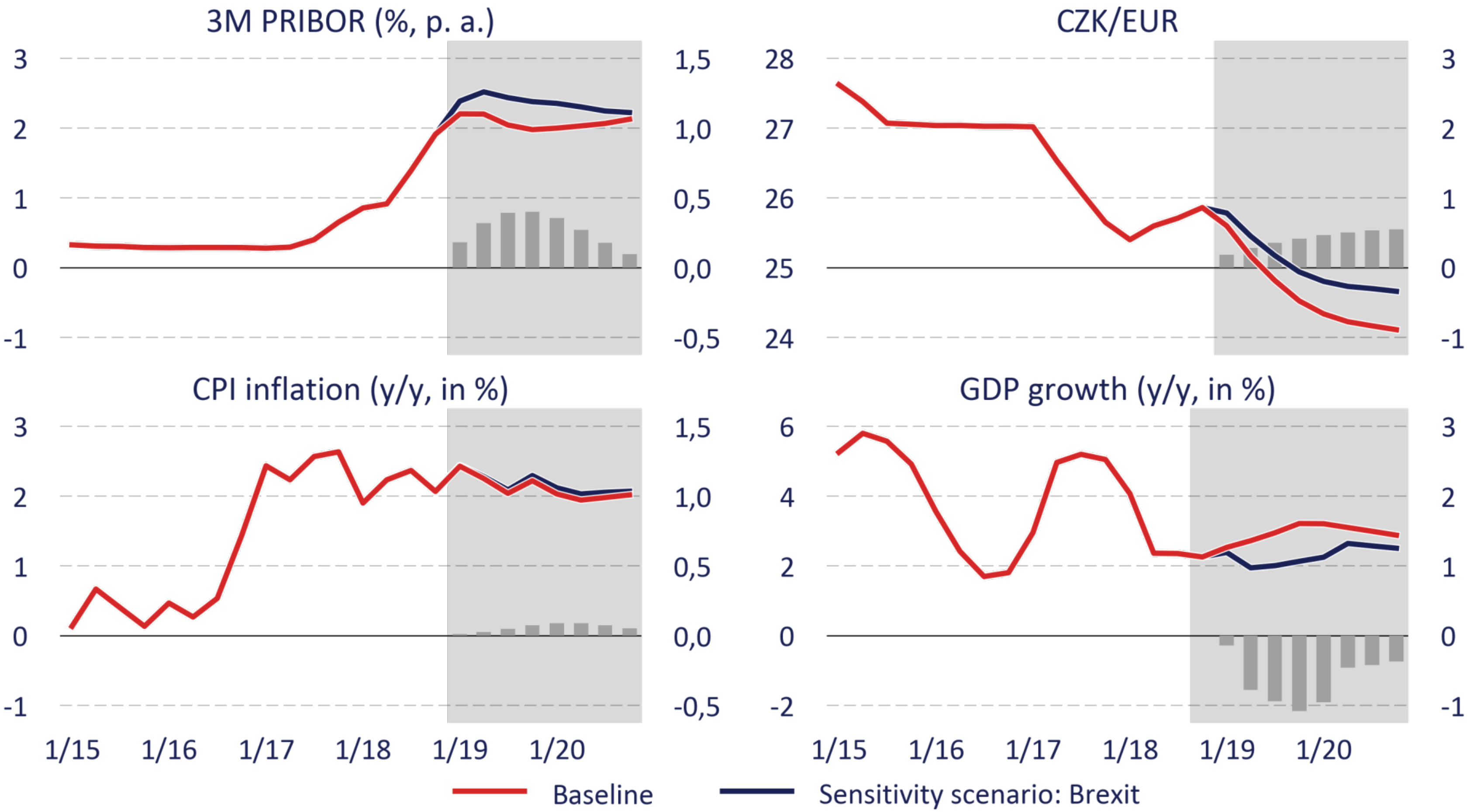
- A significant uncertainty of the forecast is the path of the exchange rate.
- The sensitivity scenario assumes that the koruna will remain at its initial value of 25.6 CZK/EUR also in 2019 Q2.
- The weaker koruna leads to a higher interest rate path than in the forecast. Inflation slightly increases despite the reaction of the central bank.

Sensitivity Scenario – Hard Brexit – foreign economy



- An external risk is described in the sensitivity scenario of a disorderly Brexit.
- Disorderly Brexit is reflected in a fall in trade between the UK and the EA and a worse outlook for the euro area. The euro would depreciate against the US dollar.
- GDP growth in the EA would slow down to around 1% during 2019.
- ECB monetary policy would remain almost the same as in the baseline.

Sensitivity Scenario – Disorderly Brexit – domestic economy



- The Czech economy would be affected by a disorderly Brexit both directly through its bilateral trade with the UK and more severely indirectly via the EA.
- In total, these two channels would lead to a weaker koruna and higher interest rates. CPI inflation would remain virtually unchanged. GDP growth would slow down to around 2% in 2019 due to lower net exports and domestic demand.

Thank you for your attention

CZECH NATIONAL BANK

www.cnb.cz

Petr Král
Monetary Department

Petr.Kral@cnb.cz