

A Forecast Assumptions

A.1 External Environment

Compared with the previous forecast, the outlook for global economic growth has barely changed; however, the uncertainty associated with future developments still persists. A relatively favourable outlook stems from an expected pickup in activity in developed economies, which should be the main drivers of global economic growth in the years of the outlook period. Due to structural problems, economic growth in emerging economies has been slowing down moderately, yet its dynamics remains high. Therefore, the gap between growth rates in developed and emerging economies keeps narrowing.

Fears of a more significant slowdown of the Chinese economy have not so far come true, although the risks related to vulnerability of the local financial market persist. Private sector indebtedness keeps growing, liberalisation of the banking sector is far from finished and the loan market is considerably distorted. Effort continues to be made to shift the growth model to a sustainable one, which would be based on domestic demand, and to gradually liberalise economic environment. Other large emerging economies, in which the last year's capital outflow highlighted internal imbalances and underlined the need for structural reforms, might need to revise their growth models too. However, a new inflow of foreign capital might lead to the needed reforms being postponed, which could have a negative impact on economic growth in the future.

Uncertainty associated with the outlook is highlighted by the geopolitical tensions in Ukraine. Owing to the fact that neither Russia nor Ukraine is an important export market for the Czech Republic, the conflict in Ukraine should not have a substantial impact on the Czech economy. Nevertheless, some exporters and importers, especially those who conduct their business in the regions affected by the conflict, could face complications. Potential escalation of the tensions accompanied with sanctions imposed by the West, however, could have a significant negative impact on some EU member states' growth. The impact on individual states of the EU would vary, depending on the extent to which their economies are exposed to Russia. Economies of EU member states could be affected also indirectly, through a decline in confidence of households and firms. As regards the developments in Ukraine, it is necessary to note that the states of the

EU are, to a great degree, dependent on importing oil and natural gas from Russia.

USA

The American economy surprised on the downside in the first quarter of 2014 as GDP dropped by 0.7% QoQ (*versus growth of 0.6%*). The poor outcome resulted primarily from severe weather, which acted as a brake on economic activity in the first months of this year. Private consumption was the only positive contributor to GDP, other components stagnated or decreased.

The data released in recent weeks, however, confirm that the economy has returned on a growth trajectory in the second quarter of 2014. Irrespective of its temporary drop, domestic demand should remain the main driver of the US economy. Rising consumer confidence and increasing net worth of households (real estate prices are growing, Dow Jones and S&P 500 stock market indices are hovering around historical highs) should have a positive impact on consumption of households. Unemployment rate is expected to fall further, possibly coming close to 5% in mid-2015. Firms' investment activity is approaching the pre-crisis level, while growth of loan activity is supported by improving conditions on financial markets.

The economy is still supported by accommodative monetary policy, but the Fed keeps on tapering the quantitative easing. Beginning in July, the monthly volume of asset purchases is reduced further by \$10 billion, to \$35 billion. The Fed's decision reflects its assessment of the state of the US economy, most notably the situation on the labour market. Growth has stabilised and the economy should be able to operate without larger stimuli. The Fed considers inflation pressures to be noisy, although it has revised up the outlook for short-term interest rates. Short-term rates could, therefore, start rising sooner than it had been indicated at the beginning of this year.

Unemployment rate reached 6.3% in May, declining by 1.2 pp in a YoY comparison. However, falling jobless rate is accompanied by decreasing participation rate, which remains a long-term problem.

Given the unexpectedly poor performance of the US economy in the first quarter, we have revised our forecast for GDP growth in 2014 down to 2.0% (*versus 2.8%*). However, we still assume that growth should be driven mainly by private consumption and investment.

Risks to the forecast of economic growth associated with short-term uncertainty about fiscal policy have subsided, but the debate about medium-term plan for fiscal consolidation is still necessary. We expect GDP growth to accelerate to 3.1% in 2015 (*versus 3.0%*).

EU

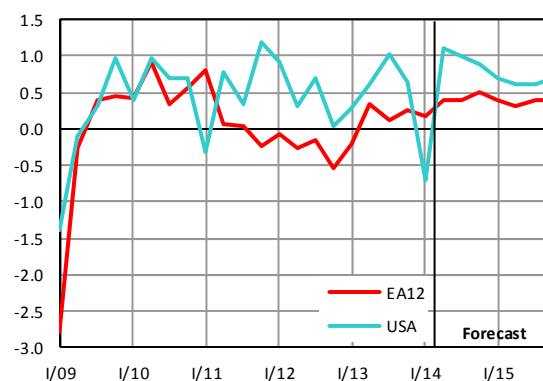
In both the EA12 and the EU28 as a whole, a gradual pickup in economic activity continues. Developments in individual states of the EA12 remain widely varied, although the forecasts (however inaccurate they may turn out to be) expect growth rates in individual states of the EA12 to converge. GDP in the euro area rose by 0.2% QoQ (*versus 0.3%*) in the first quarter, which represented a YoY increase of 0.9% (*versus 1.0%*). In the euro area as a whole, a gradual rise in domestic demand can be observed. Sentiment is improving not only on the financial markets, but also in industry, as well as in services. In many cases, however, structural problems and low competitiveness put a brake on these economies' recovery.

The already very accommodative monetary policy of the ECB was eased further in June, in reaction to persisting low inflation. The main refinancing rate was cut to a new historical low of 0.15%, but decreasing the interest rate on the deposit facility to -0.10%, bringing it therefore into negative territory, was the unprecedented move. These measures were, in fact, in line with our previous forecast. Moreover, the ECB did show its determination to enhance the functioning of the monetary policy transmission mechanism by announcing a series of new targeted longer-term refinancing operations that are aimed at supporting bank lending (excluding loans to households for house purchase) to the euro area non-financial private sector. This measure targets only supply of loans, not demand for loans, and the question therefore remains to what extent will this measure actually boost credit growth in the euro area. Apart from other measures, the ECB decided to suspend the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme (according to the Consolidated financial statement of the Eurosystem as at 20 June 2014, the value of accumulated purchases under this programme surpassed €160 billion). At the same time, the ECB has confirmed that its monetary policy will remain accommodative for an extended period of time. A potential further easing of monetary policy could include a programme of purchases of asset backed securities (where the underlying asset would be loans to the euro area non-financial private sector).

Situation on the labour market in the EU28 as a whole has stabilised. In May, unemployment rate in the EU28 and in the EA12 was 10.3% and 11.6% respectively. However, considerable differences among individual states persist. The worst situation is still in Greece, where jobless rate stood at 26.8% in March. Of the EU28 countries, for which the data for May were available as at the cut-off date, the highest jobless rate was recorded in Spain (25.1%), followed by Croatia (16.3%) and Cyprus (15.3%). The lowest rate of unemployment was in Austria (4.7%) and in Germany (5.1%).

We expect domestic demand to strengthen this year, thanks to the improved sentiment of consumers and firms and an ongoing stabilisation of the banking sector. Private investment and consumption should, therefore, be the main drivers of growth. GDP in the EA12 is assumed to increase by 1.1% (*unchanged*) this year. Growth is expected to accelerate to 1.6% (*versus 1.5%*) in 2015.

Graph A.1.1: **Growth of GDP in EA12 and in the USA**
QoQ growth rate, in %, seasonally and working day adjusted



Source: Eurostat, own calculations

Positive developments can be seen in **Germany**. GDP increased by 0.8% QoQ (*versus 0.4%*) in the first quarter of 2014. Mild weather, which caused part of the economic activity to be shifted from the second quarter to the first quarter, was behind the faster than expected growth. The biggest positive contributions to GDP growth came from gross capital formation and expenditure on consumption, while net exports had the opposite effect. Besides low rates of the ECB that have a positive effect on the whole economy, consumption of households is boosted also by a very good situation on the labour market. Together, these factors impact positively on the real estate market. Expected slowdown of the economy, which should follow the strong performance in the first quarter, is reflected in the Ifo index, which in both May and June recorded the first declines in many months. However, sentiment in the business sector is still on a high level.

Consumer climate (GfK Consumer Climate indicator), which had been flat since March of this year, improved slightly in June and July. Expected pickup in output in developed economies and high competitiveness of German firms should contribute positively to growth also in this year. Preserving favourable conditions on credit markets, however, will be crucial. We forecast GDP to increase by 2.0% this year (*versus 1.7%*), while for 2015 a slight slowdown of growth to 1.8% (*unchanged*) is expected.

The situation in **France** is less favourable. GDP was flat in a QoQ comparison (*versus growth of 0.2%*) in the first quarter of 2014; positive contributions to growth came only from change in inventories and valuables and government consumption. A more significant recovery of the French economy isn't underway yet. Therefore, the gap between the performance of the two biggest economies in the euro area (Germany and France) keeps widening. Measures that were taken to give a boost to low-income households and the business sector are likely to have an effect in the second half of the year. A pickup in private investment, which stagnated over the last two years, is expected. Situation on the labour market is likely to have stabilised. However, high unemployment rate and problems with job creation put a brake on the recovery of private consumption. Another problem is that sales from abroad of some industrial sectors have been low, meaning that strongly positive contributions of net exports to GDP growth cannot be expected in the future. We estimate the economy to grow by 0.9% (*unchanged*) in 2014. In 2015, GDP growth could further accelerate to 1.4% (*unchanged*).

Performance of the **Polish** economy in the first quarter of this year was a positive surprise. GDP increased by 1.1% QoQ (*versus 0.6%*), the main drivers of growth having been fixed investment and consumption of households. Unemployment rate continues decreasing, leading to a rise in consumer confidence, which, together with low inflation rate, should contribute to a recovery in domestic demand during this year. The central bank should keep monetary policy rates, which have stayed at the historical low of 2.50% since mid-2013, unchanged at least till the end of this year. Given the better than expected developments in the first quarter, we have revised our estimate for this year's GDP growth up to 3.2% (*versus 2.5%*). Recovery in the euro area and domestic investment should be the main positive drivers, but growth will be hampered by fiscal consolidation. In 2015, GDP growth could slightly decelerate to 3.1% (*versus 2.8%*).

GDP of **Slovakia** increased by 0.6% QoQ (*in line with the estimate*) in the first quarter of 2014. Expenditure on final consumption (mainly household consumption) and gross fixed capital formation were the positive contributors to the 2.0% YoY increase in the first quarter. Thanks to favourable developments in the countries of trading partners, we expect Slovak export performance to improve this year. Consumption of households should pick up owing to an increase in real wage. We have revised our forecast for GDP growth in 2014 up slightly to 2.4% (*versus 2.2%*). In 2015, GDP growth could accelerate to 2.9% (*unchanged*).

Business Cycle Indicators in the EU

The Economic Sentiment Indicator, which is published by the EC, continued to rise in the second quarter of 2014 in the EU. Besides construction, where strongly negative sentiment still prevails, all components of the indicator have improved, compared with the previous quarter. The most substantial improvement has been recorded in the consumer segment. In industry, services and trade there has been only a small improvement in respondents' assessment. For the second quarter of 2014, the Economic Sentiment Indicator signals a small acceleration of quarterly GDP growth in the EU, which is in line with our Forecast.

In the second quarter of 2014, growth of the ESI gradually came to a halt in Germany, while in France the indicator even fell marginally, owing largely to worse assessment in industry. Following a long period of a relatively steep rise in the indicator, economic sentiment is now stagnating in Italy. In Slovakia, on the contrary, the indicator started to grow after the preceding correction. Even though the ESI in Germany, unlike in the other monitored countries (i.e. Slovakia, France and Italy), shows a strongly positive balance, the fact that its growth came to halt is assessed with caution, given the pace of recovery.

For the second quarter of 2014, the composite leading indicator signals a minor correction of relative cyclical component of GDP in the EU, particularly in Germany. This is consistent with a slight widening of the negative output gap (production function method) in the EU, which the EC assumes will be the case this year.

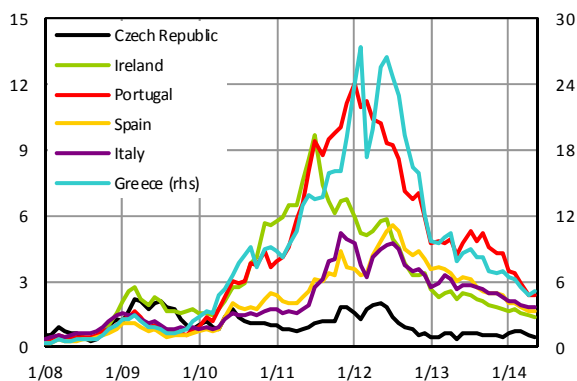
Situation in the Troubled Economies of the Euro Area

The latest data confirm that economic activity on the euro area's periphery (Ireland, Portugal, Spain, Italy, Greece and Cyprus) has been gradually picking up, or, at the least, stabilising. Cyprus, where GDP recorded another rather strong QoQ decline – by 0.7% – in the first quarter of 2014, has remained an exception.

Market sentiment towards the euro area periphery has improved further (see Graph A.1.2). However, the marked decline in yields of (not only) 10Y government bonds, which in the case of Ireland, Italy, Portugal and Spain are at or close to the historical lows, does not, apparently, reflect economic fundamentals. Search for yield, under the conditions of highly accommodative monetary policy (the ECB had been expected to further ease its monetary policy stance, which it did, although the speculations that the ECB would resort to quantitative easing have been proved unfounded) and extremely low, in some periphery countries even negative, inflation rate, is much more likely to explain the observed increase in the price of government bonds.

Graph A.1.2: Spreads over German Bonds

The difference between yields of 10Y gov. bonds of the respective country and yields of 10Y German bonds, in pp, monthly averages



Source: Eurostat

Positive market sentiment towards the euro area periphery, whatever its cause might be, is sure to be behind the success of the first auction (which could not have taken place were it not for the positive market sentiment) of long-term Greek government bonds since 2010 (in April, Greece sold 5Y government bonds worth €3 billion, demand surpassed €20 billion). Even Cyprus, owing to the successful June auction of 5Y government bonds, managed to return to the primary market, circa one year after its bailout programme had been signed and sealed.

Ireland and Spain, which have already exited their bailout programmes, were joined in May by Portugal. However, the disbursement of the final tranche was affected by the Portuguese Constitutional Court, which

in late May rejected certain austerity measures. Moreover, it should soon decide on the compliance with the constitution of other austerity measures. The government has therefore decided to introduce alternative measures, which would bring down budget deficit to the target, only after all the rulings of the Constitutional Court had been announced. This also means that Portugal did not receive the last tranche (worth €2.6 billion) of the programme financing; the disbursement was conditional upon the government introducing alternative austerity measures by the end of June. Taking into account Portugal's comfortable cash reserve and regained access to the primary government bonds market, however, not receiving the final tranche should not pose a problem for Portugal.

Quality of banks' balance sheets poses a significant downside risk to future developments on the euro area periphery. Comprehensive assessment of banks, which is being performed by the ECB prior to its assuming full responsibility for supervision under the Single Supervisory Mechanism, could reveal capital shortfalls so large that the respective banks might be unable to cover them by the allowed instruments within the specified period (six months following the comprehensive assessment, extended to nine months for those shortfalls identified in the adverse stress test scenario). In this regard, one has to point out that the euro area member states' representatives reached a preliminary political agreement on the ESM direct (bank) recapitalisation instrument.

Future developments in the economies on the euro area periphery are subject to downside risks. Sudden worsening of the market sentiment towards the region, which could be caused by the results of the comprehensive assessment of European banks, cannot be excluded. It is therefore premature to consider the euro area crisis to be over, notwithstanding certain improvement of the situation.

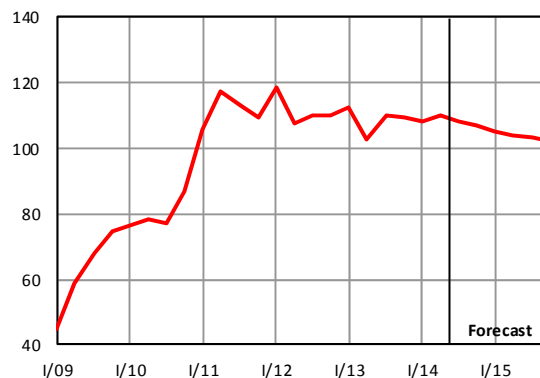
For the Czech Republic, a small open economy with strong business links to the euro area, any potential escalation of the crisis in the euro area could lead to a decrease in foreign demand for its exports. This could have an indirect impact on investment activity and final consumption expenditure.

Commodity Prices

The price of Brent crude oil averaged \$109.7/barrel in the second quarter of 2014 (*versus \$106*). Higher than expected price of oil results primarily from geopolitical factors (Iraq, Ukraine). These factors account for the upward revision to the forecast, above all in the near term. However, we have not changed our view of the market fundamentals. This year, the price of oil should be declining marginally, mainly due to increasing production capacity and the extent to which the US and Canadian imports are substituted for domestic production, and low inflation rate. On average, the price could reach \$108/barrel (*versus \$105*) this year. Growth of supply should surpass growth of global demand also in 2015, and the price should therefore decrease further to \$104/barrel (*versus \$101*). Risks to

the upside related to escalation of geopolitical conflicts are significant.

Graph A.1.3: **Dollar Prices of Brent Crude Oil**
in USD per barrel



Source: U. S. Energy Information Administration, own calculations

Table A.1.1: **Real Gross Domestic Product – yearly**

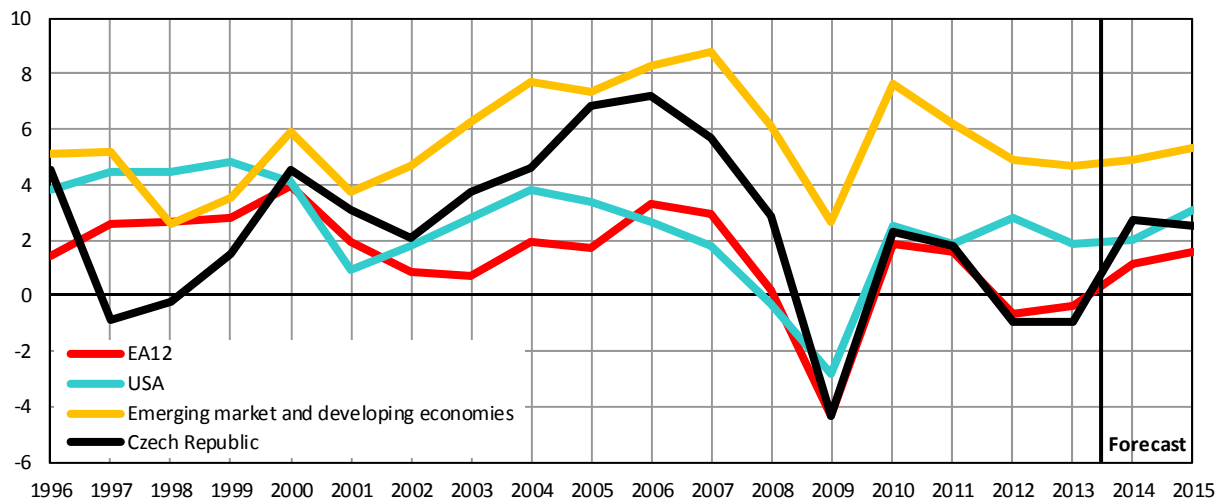
growth rate, in %, seasonally adjusted data (except for the Czech Republic)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
									Forecast	Forecast
World	5.3	5.4	2.8	-0.6	5.2	3.9	3.1	3.0	3.6	3.9
USA	2.7	1.8	-0.3	-2.8	2.5	1.8	2.8	1.9	2.0	3.1
China	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.4	7.3
EU28	3.5	3.2	0.3	-4.5	2.0	1.7	-0.3	0.1	1.5	1.8
EA12	3.3	2.9	0.2	-4.4	1.9	1.6	-0.6	-0.4	1.1	1.6
Germany	3.9	3.4	0.8	-5.1	3.9	3.4	0.9	0.5	2.0	1.8
France	2.7	2.2	0.1	-2.9	1.9	2.1	0.4	0.4	0.9	1.4
United Kingdom	2.8	3.4	-0.8	-5.2	1.7	1.1	0.3	1.7	2.8	2.5
Austria	3.8	3.7	0.9	-3.5	1.9	2.9	0.7	0.4	1.4	1.8
Hungary	4.0	0.1	0.7	-6.7	1.0	1.6	-1.7	1.2	2.8	2.2
Poland	6.2	6.8	5.1	1.6	3.9	4.5	2.1	1.6	3.2	3.1
Slovakia	8.3	10.5	5.8	-4.9	4.4	3.0	1.8	0.9	2.4	2.9
Czech Republic	7.0	5.7	3.1	-4.5	2.5	1.8	-1.0	-0.9	2.7	2.5

Source: CZSO, Eurostat, IMF, NBS China, own calculations

Graph A.1.4: Real Gross Domestic Product

YoY growth rate, in %, seasonally adjusted data



Source: Eurostat, IMF, own calculations

Note: Emerging market and developing economies comprising 154 countries (according to the IMF's classification)

Table A.1.2: Real Gross Domestic Product – quarterly

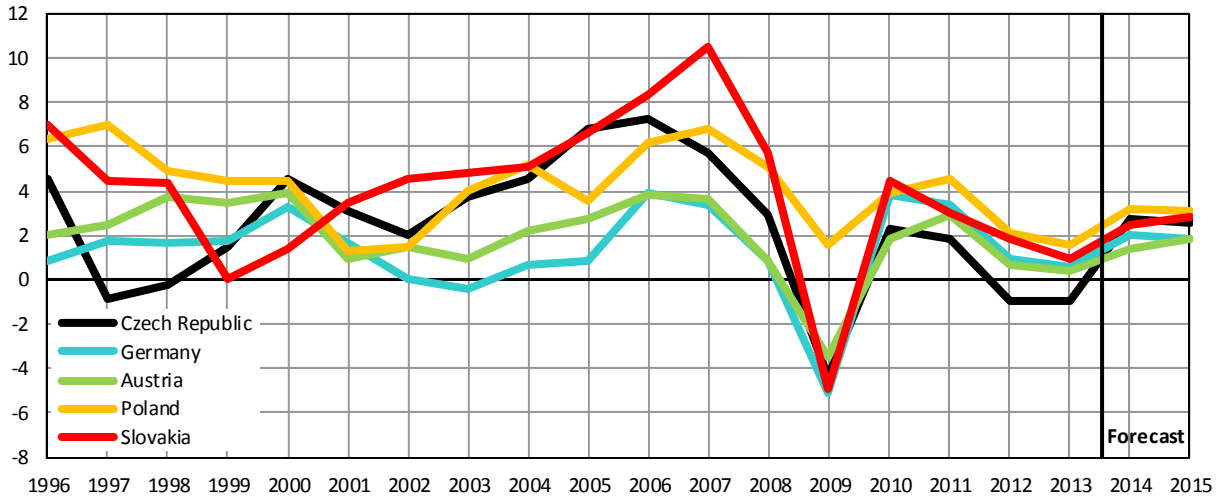
growth rate, in %, seasonally adjusted data

		2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
						<i>Estimate</i>		<i>Forecast</i>	
USA	QoQ	0.3	0.6	1.0	0.7	-0.7	1.1	1.0	0.9
	YoY	1.3	1.6	2.0	2.6	1.6	2.1	2.0	2.3
China	QoQ	1.6	1.9	2.2	1.8	1.7	1.8	1.6	1.6
	YoY	7.8	7.8	7.9	7.7	7.8	7.7	7.1	6.9
EU28	QoQ	0.0	0.4	0.3	0.4	0.3	0.4	0.4	0.5
	YoY	-0.7	-0.1	0.2	1.0	1.4	1.4	1.5	1.6
EA12	QoQ	-0.2	0.3	0.1	0.3	0.2	0.4	0.4	0.5
	YoY	-1.2	-0.6	-0.3	0.5	0.9	1.0	1.2	1.5
Germany	QoQ	0.0	0.7	0.3	0.4	0.8	0.4	0.3	0.4
	YoY	-0.3	0.5	0.6	1.4	2.3	1.9	1.9	1.9
France	QoQ	0.0	0.6	-0.1	0.2	0.0	0.3	0.5	0.4
	YoY	-0.2	0.7	0.3	0.8	0.8	0.5	1.0	1.2
United Kingdom	QoQ	0.4	0.8	0.8	0.7	0.8	0.6	0.5	0.5
	YoY	0.5	1.7	1.8	2.7	3.1	3.0	2.6	2.4
Austria	QoQ	0.0	0.0	0.3	0.4	0.2	0.4	0.6	0.5
	YoY	0.3	0.1	0.4	0.7	0.9	1.3	1.6	1.7
Hungary	QoQ	0.8	0.3	1.1	0.7	1.1	0.3	0.4	0.4
	YoY	-0.3	0.5	1.8	2.9	3.2	3.2	2.5	2.2
Poland	QoQ	0.1	0.8	0.8	0.7	1.1	0.6	0.6	0.6
	YoY	0.5	1.3	2.0	2.5	3.5	3.3	3.0	2.9
Slovakia	QoQ	0.1	0.4	0.4	0.6	0.6	0.7	0.7	0.8
	YoY	0.5	0.7	1.0	1.6	2.0	2.3	2.6	2.8
Czech Republic	QoQ	-1.0	0.2	0.4	1.5	0.8	0.3	0.4	0.7
	YoY	-2.3	-1.6	-1.0	1.1	2.9	3.0	3.0	2.1

Source: Eurostat, NBS China, own calculations

Graph A.1.5: Real Gross Domestic Product – Czech Republic and the neighbouring states

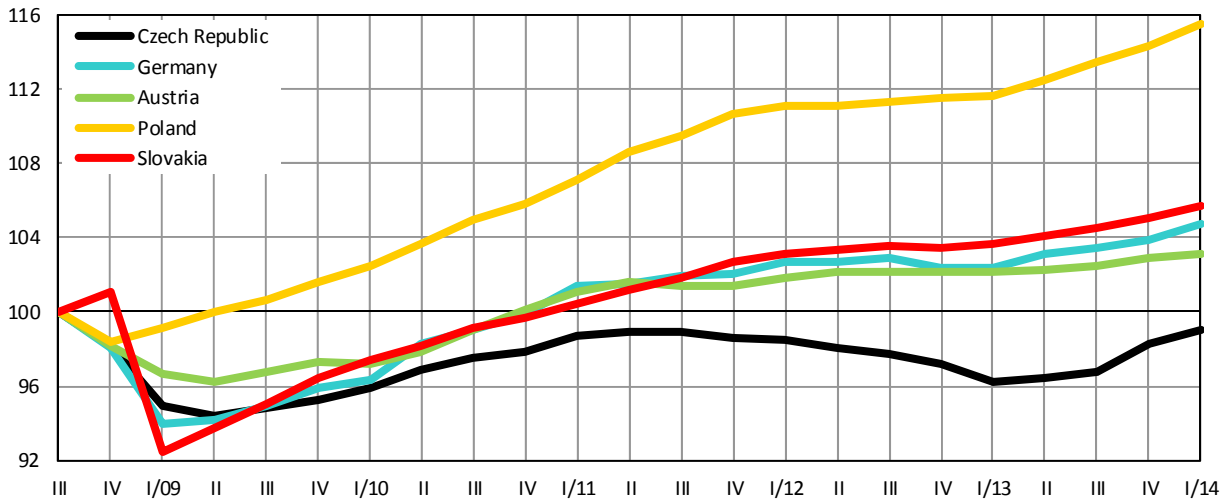
YoY growth rate, in %, seasonally adjusted data



Source: Eurostat, own calculations

Graph A.1.6: Real Gross Domestic Product – Czech Republic and the neighbouring states

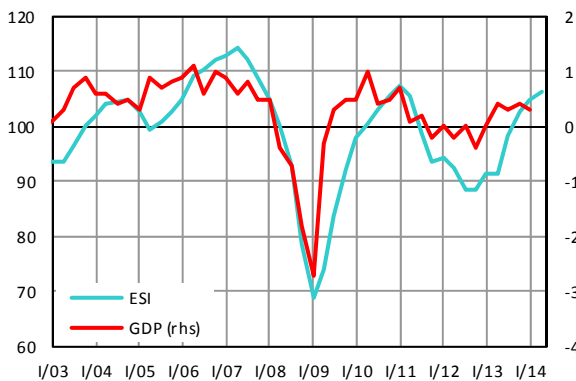
Q3 2008=100, seasonally adjusted data



Source: Eurostat, own calculations

Graph A.1.7: ESI and GDP Growth in the EU

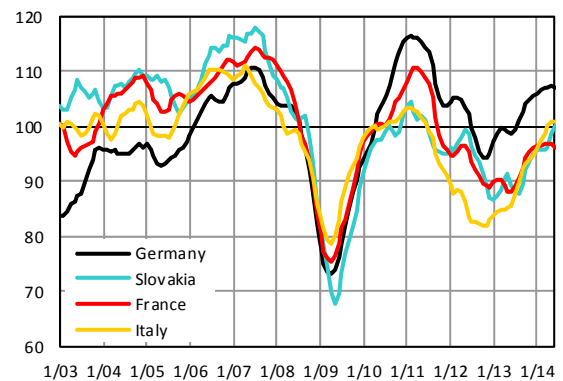
indicator – quarterly averages, QoQ growth in %, sa data



Source: EC, Eurostat

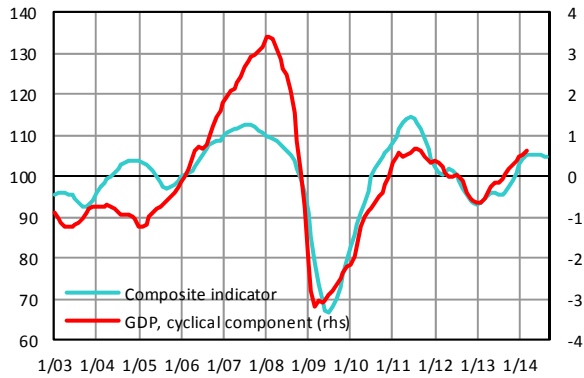
Graph A.1.8: ESI in Selected Trading Partner Countries

3-month moving averages



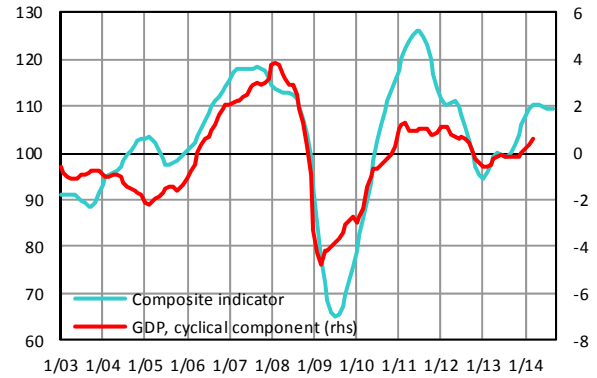
Source: EC

Graph A.1.9: Composite Leading Indicator – EU
monthly data, 2005=100, cyclical component in % of trend GDP



Source: EC, Eurostat, own calculations

A.1.10: Composite Leading Indicator – Germany
monthly data, 2005=100, cyclical component in % of trend GDP



Source: EC, Eurostat, own calculations

Table A.1.3: Prices of Selected Commodities – yearly spot prices

		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
											Forecast	Forecast
Crude oil Brent	USD/barrel	65.1	72.4	96.9	61.5	79.6	111.3	111.6	108.6	108	104	
	growth in %	19.6	11.1	34.0	-36.5	29.3	39.9	0.3	-2.6	-0.4	-4.4	
Crude oil Brent index (in CZK)	2005=100	112.5	111.5	123.9	88.4	116.1	150.4	167.0	162.5	167	160	
	growth in %	12.5	-0.9	11.1	-28.6	31.4	29.5	11.0	-2.7	2.8	-4.0	
Wheat	USD/t	191.7	255.2	325.9	223.4	223.7	316.2	313.3	312.2	267	254	
	growth in %	25.8	33.1	27.7	-31.5	0.1	41.4	-0.9	-0.3	-14.4	-5.0	
Wheat price index (in CZK)	2005=100	118.3	140.2	150.7	117.1	116.4	152.8	168.1	167.2	147	141	
	growth in %	18.3	18.4	7.5	-22.3	-0.6	31.3	10.0	-0.5	-11.8	-4.5	

Source: IMF, U. S. Energy Information Administration, own calculations

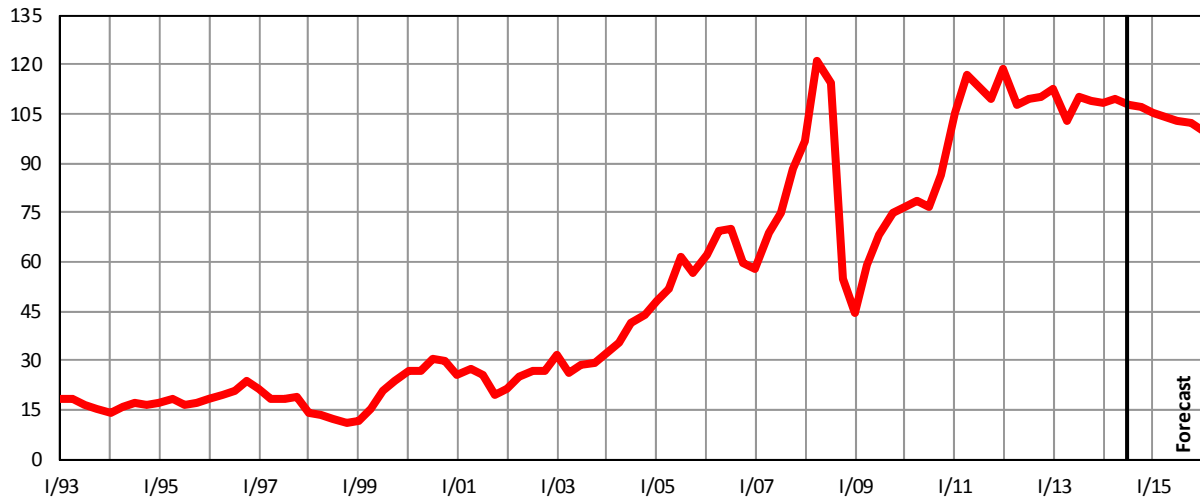
Table A.1.4: Prices of Selected Commodities – quarterly spot prices

		2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
						Estimate	Forecast	Forecast	Forecast
Crude oil Brent	USD/barrel	112.4	102.6	110.2	109.2	108.1	109.7	108	107
	growth in %	-5.3	-4.8	0.5	-0.8	-3.8	7.0	-2.0	-2.0
Crude oil Brent index (in CZK)	2005=100	166.6	155.1	164.5	163.7	165.7	168.0	168	166
	growth in %	-4.1	-4.6	-2.2	0.1	-0.5	8.3	2.1	1.7
Wheat price	USD/t	321.4	313.8	305.9	307.8	297.1	296	233	243
	growth in %	15.3	16.7	-12.5	-13.5	-7.6	-5.6	-23.9	-21.2
Wheat price index (in CZK)	2005=100	170.5	169.9	163.4	165.1	163.0	162	130	135
	growth in %	16.7	17.0	-14.9	-12.7	-4.4	-4.4	-20.7	-18.2

Source: IMF, U. S. Energy Information Administration, own calculations

Graph A.1.11: Dollar Prices of Oil

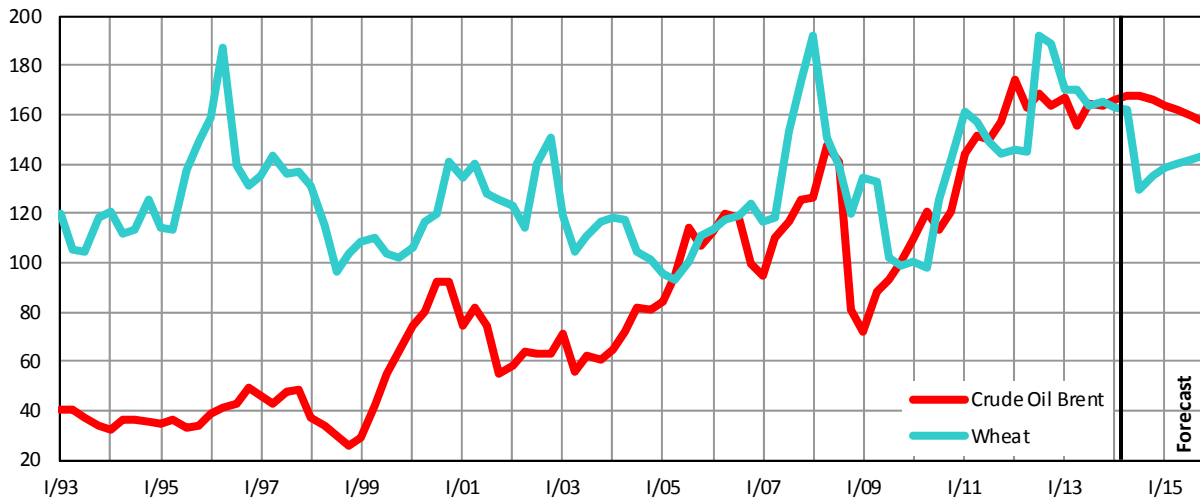
USD/barrel



Source: U. S. Energy Information Administration, own calculations

Graph A.1.12: Koruna Indices of Prices of Selected Commodities

index 2005=100



Source: IMF, U. S. Energy Information Administration, own calculations

A.2 Fiscal Policy

According to the CZSO's estimate, the government sector balance in 2013 ended with the deficit amounting to 1.5% of GDP, which was an improvement of 2.8 pp compared to 2012. A considerable part (1.8 pp) of this figure, however, is owing to the fact that specific transactions (financial compensation to churches and religious organizations and a correction to the reimbursement from EU funds) were included in the deficit of 2012. Had it been adjusted for these operations, the deficit would have decreased by 1 pp.

The structural balance (the balance adjusted for the effect of the business cycle and one-off and temporary operations) reached -0.2% of GDP in 2013. Fiscal effort (YoY change in the structural balance), which was 1.4 pp in 2013, has now exceeded 1 pp for the third year in a row.

On the revenue side, the substantial reduction in the structural balance was especially due to a 1 pp increase in both VAT rates, which caused revenues to rise by nearly 0.4% of GDP. The second largest discretionary effect on the revenue side were modifications to personal income tax (for example, abolishing the basic discount for working pensioners, a solidarity surcharge of 7%, limitation of expenditure lump-sums), which had a total impact of approximately 0.2% of GDP. Changes to other taxes were only slight and largely compensated one another.

As for expenditure, the largest savings occurred in gross fixed capital formation (government investment); nearly 0.4% of GDP YoY. The decrease was mainly seen in investment financed from domestic sources with a full impact on government sector deficit. This development was most apparent in local budgets and less so in central government.

Based on current data, we can expect the government sector deficit to reach 1.5% of GDP in 2014. Compared to the estimate in the April Forecast, the expected deficit is now 0.3 pp lower. The new estimate takes into consideration current development of cash fulfilment, quarterly national accounts and also reflects an improvement in the forecast for economic developments. On the revenue side, there will be an improvement in tax incomes, mainly direct taxes and VAT. In contrast, the expected development of excise taxes has been revised down slightly, due to the development of revenues from taxes on tobacco products. With respect to the considerable stockpiling, which was collected in January and February this year,

a considerable amount has been transferred in favour of 2013 due to tax accrualization (nearly half of income for the whole year was already drawn according to cash fulfilment in February 2014). On the expenditure side, lower expenditure on interest payments can be expected thanks to a very stable debt development and relatively favourable development on the financial markets. This also demonstrates that the Czech Republic is perceived very positively by the financial markets.

On the revenue side, there are only relatively moderate discretionary tax measures in 2014, of which the most significant is a decrease in payments from electricity generated by solar radiation (however, the period in which these payments will be made was extended), with an impact of approximately 0.1% of GDP; other non-autonomous changes have a relatively small impact. Revenues include CZK 8.5 billion from the sale of licences to mobile operators.

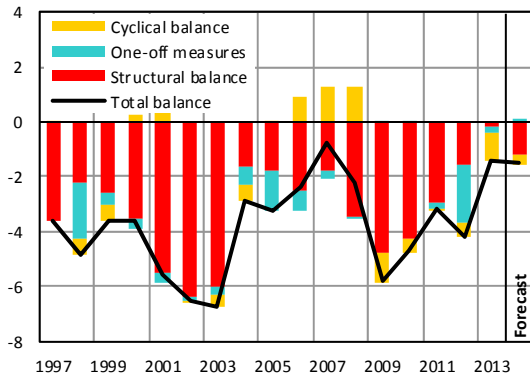
On the expenditure side, the estimate envisages an increase in government consumption of 2%, which will be driven by the development of social benefits in kind (payments of health insurance companies for health care). These should increase by 3%, a rise that reflects in part an increase in payments for state insured persons and also a change in the Reimbursement Decree in favour of strengthening levels of hospital care.

Government investment is also expected to show a relatively large increase, mainly in investment financed from EU sources. For Czech investment, a similar value is expected to that in 2013. In this case, the impact on the deficit is considerably limited, as most funds invested in such manner will be subsequently refunded to the Czech Republic from the EU budget.

In 2013, government sector debt reached 46.0% of GDP. Mainly due to stagnation in the level of state budget debt, the debt quota should decrease by 2 pp to 44.0% of GDP at the end of 2014.

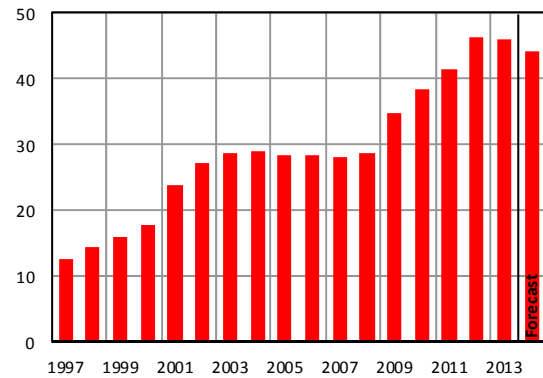
At present, we regard the risks to the forecast as balanced. If the assumption about full use of the allocation from the EU structural funds for the last programming period was not met, there would be savings on Czech financing. On the revenue side, the risk lies in the development of tax income, which is very dependent on the development of relevant macroeconomic tax bases.

Graph A.2.1: **Decomposition of the Government Balance**
in % of GDP



Source: CZSO, own calculations

Graph A.2.2: **Government Debt**
in % of GDP



Source: CZSO, own calculations

Table A.2.1: **Net Lending/Borrowing and Debt**

		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
										Prelim.	Forecast
General government balance ¹⁾	% GDP	-3.2	-2.4	-0.7	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-1.5
	bill. CZK	-101	-80	-27	-86	-218	-179	-122	-162	-56	-59
Cyclical balance	% GDP	0.0	0.9	1.3	1.3	-1.1	-0.5	-0.1	-0.6	-1.1	-0.4
Cyclically adjusted balance	% GDP	-3.3	-3.3	-2.0	-3.5	-4.7	-4.2	-3.1	-3.7	-0.4	-1.1
One-off measures	% GDP	-1.5	-0.7	-0.3	-0.1	0.0	0.0	-0.2	-2.1	-0.2	0.1
Structural balance	% GDP	-1.8	-2.5	-1.8	-3.4	-4.8	-4.3	-2.9	-1.6	-0.2	-1.2
Fiscal effort ²⁾	percent. points	-0.1	-0.8	0.8	-1.7	-1.3	0.5	1.3	1.3	1.4	-1.0
Interest expenditure	% GDP	1.1	1.1	1.1	1.0	1.3	1.3	1.4	1.5	1.4	1.3
Primary balance	% GDP	-2.2	-1.3	0.4	-1.2	-4.5	-3.4	-1.8	-2.8	-0.1	-0.2
Cyclically adjusted primary balance	% GDP	-2.2	-2.2	-1.0	-2.5	-3.5	-2.9	-1.8	-2.2	1.0	0.2
General government debt	% GDP	28.4	28.3	27.9	28.7	34.6	38.4	41.4	46.2	46.0	44.0
	bill. CZK	885	948	1 023	1 104	1 299	1 454	1 583	1 775	1 788	1 789
Change in debt-to-GDP ratio	percent. points	-0.5	-0.1	-0.3	0.8	5.9	3.8	3.0	4.7	-0.1	-2.0

Source: CZSO, own calculations

Note: Government debt consists of the following financial instruments: currency and deposits, securities other than shares excluding financial derivatives and loans. Government debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The nominal value is considered to be an equivalent to the face value of liabilities. It is therefore equal to the amount that the government will have to refund to creditors at maturity.

¹⁾ General government net lending (+)/borrowing (-) including interest derivatives.

²⁾ Change in structural balance.

A.3 Monetary Policy, Financial Sector and Exchange Rates

Monetary Policy

Even after the CNB cut the limit interest rate for 2W (two-week) repo operations to 0.05% in November 2012, disinflation continued, given domestic economic developments and other factors (e.g. commodity prices). In order to prevent long-term undershooting of the inflation target and to accelerate the return to a situation when it will again be able to use its standard instrument, the Bank Board of the CNB decided on 7 November 2013 to use the exchange rate as another monetary policy instrument. Interventions on the foreign exchange market (in the volume of approximately EUR 7.5 billion) were only carried out in November; since then, the mere existence of the exchange rate commitment and the declared resolution of the CNB to meet this commitment have been enough to maintain the exchange rate above the level of 27 CZK/EUR.

Financial Sector and Interest Rates

In the second quarter of 2014, the **3M** (3-month) **PRIBOR** interbank market rate averaged 0.36% (*in line with the forecast*). The 3M PRIBOR should also remain at 0.4% on average in 2014 and 2015 (*unchanged in both cases*).

With respect to very weak inflationary pressures, long-term interest rates remain at historically low levels. With regard to the expected development of short-term interest rates and the trajectory of fiscal policy, no marked increase in long-term rates should occur in the medium-term horizon, either. **The yield to maturity on 10-year government bonds** for convergence purposes reached only 1.8% (*versus 2.4%*) in the second quarter of 2014. We have revised the forecast for 2014 down to 1.9% (*versus 2.4%*); in 2015, long-term interest rates should increase to 2.4% (*versus 2.6%*).

In April 2014, the CNB conducted another bank lending survey which concluded that credit standards had not changed in any segment of the credit market in the first quarter of 2014. For the second quarter of 2014, the banks expected an easing of standards for corporate loans and, conversely, their tightening for consumer loans to households and housing loans.

The last bank stress tests, the results of which were published by the CNB in the Financial Stability Report 2013/2014, again showed that the banking sector is sufficiently resilient to even very unfavourable shocks.

Stability of the sector owes mainly to the high capital adequacy of banks.

In connection with the development of primary interest rates, client interest rates are still at very low levels. In the first quarter of 2014, interest rates on household deposits remained unchanged from the previous quarter at 0.9%, while rates on company deposits decreased by 0.1 pp to 0.3%. The rates on loans to households also decreased by 0.1 pp QoQ to 5.7%; the rates on loans to non-financial corporations remained at 3.1%.

Growth in loans to households continues to be relatively low, and is mainly driven by housing loans. The YoY growth of consumer loans has recently been oscillating around zero; nevertheless, pronounced growth has been recorded for so-called 'other loans', which comprise e.g. loans to sole traders. Loans to non-financial corporations have seen a YoY decrease in the recent quarters, although loans in foreign currency recorded a considerable increase. However, there was a one-off surge at the rate in which these loans were taken out shortly after the aforementioned exchange rate commitment had been introduced.

The situation concerning non-performing loans remains stable. In the first quarter of 2014 their share stood at 5.0% for households (0.1 pp less QoQ, 0.2 pp less YoY) and decreased to 7.2% for non-financial corporations (0.1 pp less QoQ, 0.2 pp less YoY).

The Prague Stock Exchange Index PX ranged from 1,000 to 1,050 points in the second half of June 2014, but fell below 960 points at the beginning of July. Still, the PX Index was nearly 10% higher than at the beginning of July 2013.

Exchange Rates

After the CNB announced at the beginning of November 2013 that it would start using the CZK/EUR exchange rate as an additional monetary policy instrument, the koruna weakened sharply vis-à-vis the euro. The koruna was weakening gradually also in the following days: at the end of 2013 the exchange rate was up to 7% weaker compared to the level before the interventions. In this year, the exchange rate has so far been hovering around the level of 27.50 CZK/EUR, without any significant fluctuations. In the first half of 2014, the koruna weakened by 6.4% YoY on average.

In order to forecast the CZK/EUR exchange rate, arbitrary assumptions about the date when the CNB will stop using the extraordinary exchange rate

instrument and the exit strategy had to be made. Based on available information, we have made a technical assumption that the exchange rate would remain stable at 27.45 CZK/EUR until the end of the second quarter of 2015. Subsequently, the koruna should again start strengthening slightly against the

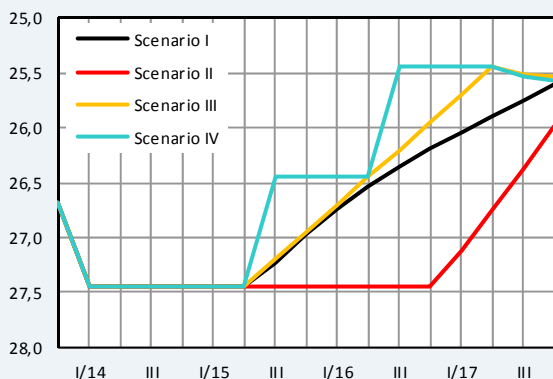
euro, which is in accordance with the CNB's statement that it will not allow sharp appreciation of the koruna after discontinuing the exchange rate commitment. Various scenarios of discontinuing the exchange rate commitment and model simulations of their impacts are shown in Box A.3.

Box A.3: Model based conditional forecast for key macroeconomic variables in different scenarios for discontinuing the exchange rate commitment

This box summarizes the results of a model conditional forecast, which examines the impact of four different scenarios for returning to the floating exchange rate on the fundamental macroeconomic indicators in the horizon by the end of the year 2017. To create the conditional forecast we used the adjusted model of the IMF¹, which by its nature corresponds to the new Keynesian economics and enables an analysis of monetary policies. The reduced-form model consists of 17 equations organized in four economic blocks – aggregate demand (the IS curve), aggregate supply (the Phillips curve), uncovered interest rate parity and monetary policy rule (the Taylor rule). The model also covers economic developments abroad.

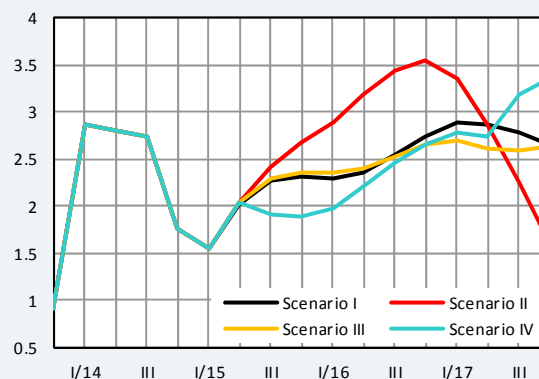
All the considered scenarios are based on the assumption that the nominal CZK/EUR exchange rate will be maintained, as part of the regime of using the exchange rate as a monetary policy instrument, at the level of 27.45 CZK/EUR until the end of the second quarter of 2015. According to current information, the CNB should not discontinue the exchange rate commitment before the second quarter of 2015; indeed, the CNB might not take such step until even later. Starting in the third quarter of 2015, we model four different scenarios of discontinuing the exchange rate commitment. Scenario I assumes a jump termination in which the exchange rate is immediately transferred to a free-floating regime. Scenario II considers the situation when the current exchange rate commitment will be discontinued as late as in the fourth quarter of 2016; until then, the exchange rate will remain at the level of 27.45 CZK/EUR. Scenario III models the regime's gradual termination, whereby in the period from the third quarter of 2015 to the second quarter of 2017 the CNB tolerates the koruna to strengthen by a maximum of 0.25 CZK/EUR per quarter. Scenario IV assumes that in the period from the third quarter of 2015 to the second quarter of 2016 the CNB will allow the rate to appreciate to a maximum 26.25 CZK/EUR. For the period from the third quarter of 2016 to the second quarter of 2017, this limit will be shifted to 25.25 CZK/EUR, and after that the koruna exchange rate would enter the free-floating regime. Moreover, all of the scenarios assume that the CNB will keep the interest rate constant before the free-floating exchange regime is reached. We emphasize that all scenarios were created purely for the purpose of this conditional forecast, and in no way do they intend (or are able) to anticipate the CNB's future steps in the exchange rate policy area.

Graph 1: Nominal CZK/EUR Exchange Rate



Graph 2: Real Gross Domestic Product

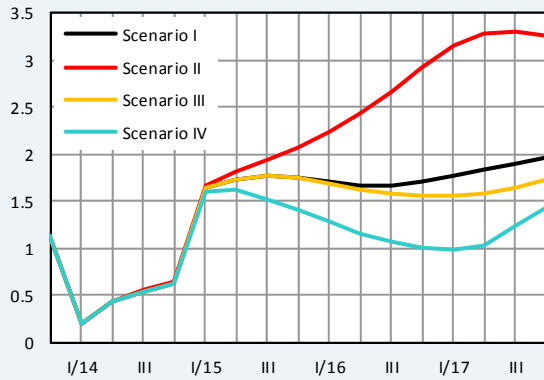
YoY growth rate, in %



¹ Based on Beneš, Hurník, Vávra (2008): *Exchange Rate Management and Inflation Targeting: Modeling the Exchange Rate in Reduced-Form New Keynesian Models*. *Czech Journal of Economics and Finance*, 58(3–4), p. 166–194

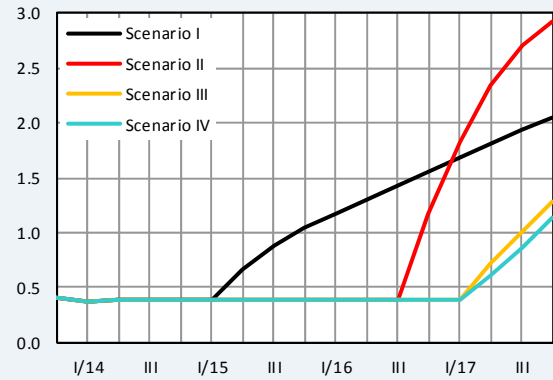
Graph 3: Consumer Price Index

YoY growth rate, in %



Graph 4: Short-term Interest Rates

in % p. a.



The graphs above show the model conditional forecast for selected macroeconomic aggregates from the second quarter of 2014 to the fourth quarter of 2017. For each variable, the development in each scenario is shown. As is clear from the graphs, different approaches to discontinuing the foreign exchange interventions regime would have different impact on the real economy. However, the results of the model must be understood rather as qualitative, not as the precise forecast for the development of macroeconomic variables in the given scenario.

Table A.3.1: Interest Rates, Deposits and Loans – yearly

		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
											Forecast	Forecast
Repo 2W rate CNB (end of period)	in % p.a.	2.50	3.50	2.25	1.00	0.75	0.75	0.05	0.05	.	.	
Main refinancing rate ECB (end of period)	in % p.a.	3.50	4.00	2.50	1.00	1.00	1.00	0.75	0.25	.	.	
Federal funds rate (end of period)	in % p.a.	5.25	4.25	0.25	0.25	0.25	0.25	0.25	0.25	.	.	
PRIBOR 3M	in % p.a.	2.30	3.09	4.04	2.19	1.31	1.19	1.00	0.46	0.4	0.4	
YTM of 10Y government bonds	in % p.a.	3.78	4.28	4.55	4.67	3.71	3.71	2.80	2.11	1.9	2.4	
Households – MFI (CR, unless stated otherwise)												
– interest rates on loans	in % p.a.	6.93	6.63	6.81	7.00	7.00	6.83	6.46	6.03	.	.	
– loans	growth in %	32.1	31.7	28.9	16.3	8.7	6.5	4.9	4.0	.	.	
– loans without housing loans	growth in %	28.3	27.3	25.3	19.1	8.3	6.8	1.4	0.5	.	.	
– deposits	growth in %	7.3	10.6	9.4	10.5	5.4	5.0	4.7	3.2	.	.	
– share of non-performing loans	in %	3.7	3.2	3.0	3.7	4.8	5.3	5.2	5.2	.	.	
– loans to deposits ratio	in %	40	48	57	60	61	62	65	65	.	.	
– loans to deposits ratio (Eurozone)	in %	99	99	94	89	90	90	87	84	.	.	
Non-financial firms – MFI (CR, unless stated otherwise)												
– interest rates on loans	in % p.a.	4.29	4.85	5.59	4.58	4.10	3.93	3.69	3.19	.	.	
– loans	growth in %	13.9	16.7	17.5	0.2	-6.5	3.3	2.5	0.1	.	.	
– deposits	growth in %	10.9	13.2	5.3	-1.7	4.8	0.9	8.2	4.4	.	.	
– share of non-performing loans	in %	4.5	3.8	3.6	6.2	8.6	8.5	7.7	7.4	.	.	
– loans to deposits ratio	in %	117	120	134	137	123	126	122	117	.	.	
– loans to deposits ratio (Eurozone)	in %	292	296	315	315	294	286	273	246	.	.	

Source: CNB, ECB, Fed, own calculations

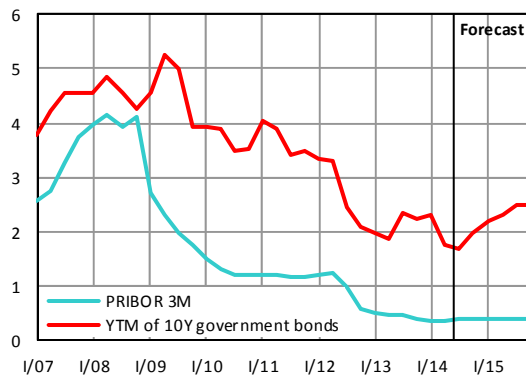
Table A.3.2: Interest Rates, Deposits and Loans – quarterly

		2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
								Forecast	Forecast
Repo 2W rate CNB (end of period)	in % p.a.	0.05	0.05	0.05	0.05	0.05	0.05	.	.
Main refinancing rate ECB (end of period)	in % p.a.	0.75	0.50	0.50	0.25	0.25	0.15	.	.
Federal funds rate (end of period)	in % p.a.	0.25	0.25	0.25	0.25	0.25	0.25	.	.
PRIBOR 3M	in % p.a.	0.50	0.46	0.46	0.41	0.37	0.36	0.4	0.4
YTM of 10Y government bonds	in % p.a.	1.98	1.88	2.35	2.24	2.30	1.76	1.7	2.0
Households – MFI (CR, unless stated otherwise)									
– interest rates on loans	in % p.a.	6.21	6.09	5.96	5.83	5.73	.	.	.
– loans	growth in %	3.7	3.9	4.1	4.2	3.9	.	.	.
– loans without housing loans	growth in %	-0.4	0.1	0.7	1.7	1.9	.	.	.
– deposits	growth in %	4.2	3.6	2.7	2.4	1.8	.	.	.
– share of non-performing loans	in %	5.2	5.2	5.1	5.1	5.0	.	.	.
– loans to deposits ratio	in %	64	65	66	66	65	.	.	.
– loans to deposits ratio (Eurozone)	in %	85	84	84	84	83	.	.	.
Non-financial firms – MFI (CR, unless stated otherwise)									
– interest rates on loans	in % p.a.	3.27	3.23	3.17	3.09	3.06	.	.	.
– loans	growth in %	2.3	0.2	-1.2	-0.9	-1.9	.	.	.
– deposits	growth in %	4.8	1.9	4.7	6.1	7.1	.	.	.
– share of non-performing loans	in %	7.4	7.6	7.4	7.2	7.2	.	.	.
– loans to deposits ratio	in %	119	119	117	111	112	.	.	.
– loans to deposits ratio (Eurozone)	in %	256	252	245	232	234	.	.	.

Source: CNB, ECB, Fed, own calculations

Graph A.3.1: Interest Rates

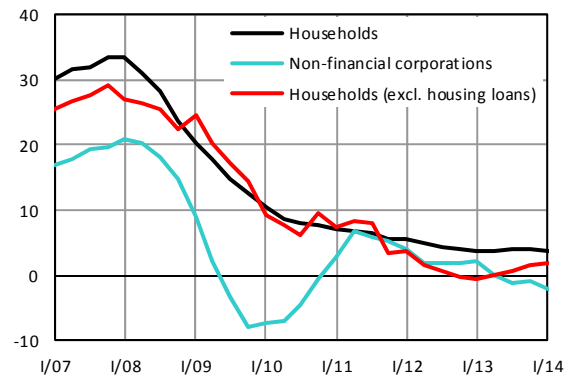
in % p.a.



Source: CNB, own calculations

Graph A.3.2: Loans

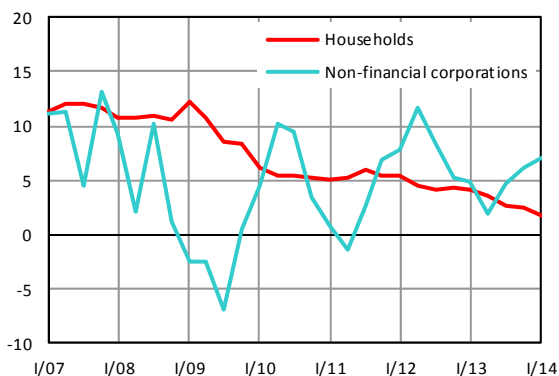
YoY growth rate, in %



Source: CNB, own calculations

Graph A.3.3: Deposits

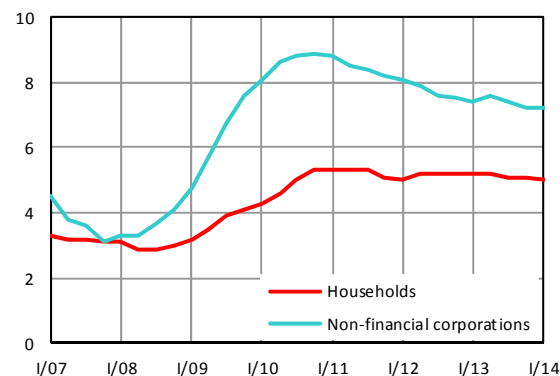
YoY growth rate, in %



Source: CNB, own calculations

Graph A.3.4: Non-performing Loans

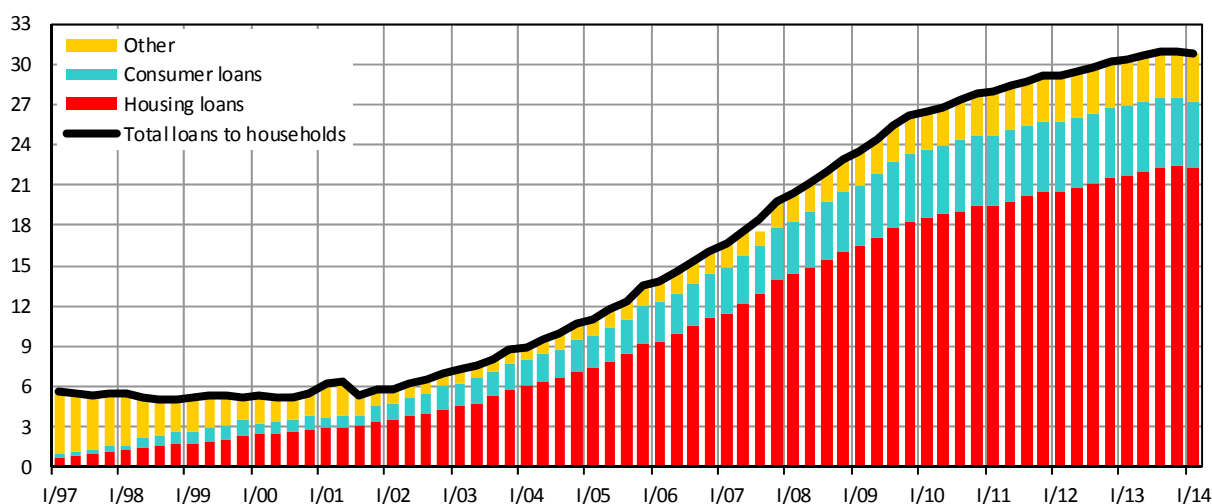
ratio of non-performing to total loans, in %



Source: CNB, own calculations

Graph A.3.5: Ratio of Bank Loans to Households to GDP

yearly moving sums, in %



Source: CNB, CZSO, own calculations

Table A.3.3: Exchange Rates – yearly

		2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
								Forecast	Forecast	Outlook	Outlook
Nominal exchange rates:											
CZK / EUR	average	24.96	26.45	25.29	24.59	25.14	25.98	27.4	27.4	26.9	26.4
	appreciation in %	11.3	-5.6	4.6	2.8	-2.2	-3.2	-5.3	0.3	1.7	1.8
CZK / USD	average	17.06	19.06	19.11	17.69	19.59	19.57	20.2	20.3	19.9	19.6
	appreciation in %	19.0	-10.5	-0.3	8.0	-9.7	0.1	-3.0	-0.4	1.7	1.8
NEER	average of 2010=100	101.2	98.0	100.0	103.1	99.5	97.3	93	93	95	97
	appreciation in %	11.7	-3.2	2.1	3.1	-3.5	-2.2	-4.4	0.3	1.7	1.8
Real exchange rate to EA12¹⁾	average of 2010=100	102.5	97.9	100.0	100.7	98.8	96.1	92	92	93	95
	appreciation in %	11.3	-4.4	2.1	0.7	-1.9	-2.8	-4.6	0.5	1.5	1.8
REER	average of 2010=100	102.7	98.9	100.0	102.0	99.2	96.9	.	.	.	.
	(Eurostat, CPI deflated, 37 countries)	14.9	-3.7	1.1	2.0	-2.8	-2.3	.	.	.	.

Source: CNB, Eurostat, own calculations

¹⁾ Deflated by GDP deflators.

Table A.3.4: Exchange Rates – quarterly

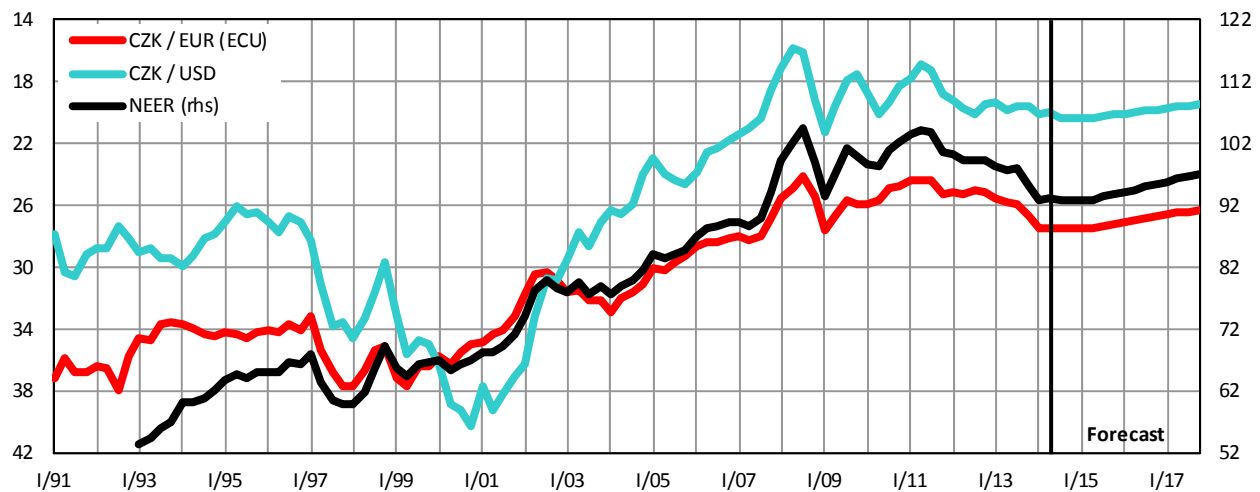
		2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
						Estimate	Forecast	Forecast	Forecast
Nominal exchange rates:									
CZK / EUR	average	25.57	25.83	25.85	26.66	27.44	27.45	27.4	27.4
	appreciation in %	-1.9	-2.2	-3.0	-5.6	-6.8	-5.9	-5.8	-2.9
CZK / USD	average	19.37	19.78	19.52	19.59	20.04	20.02	20.3	20.3
	appreciation in %	-1.2	-0.3	2.8	-0.9	-3.3	-1.2	-4.0	-3.6
NEER	average of 2010=100	98.4	97.6	98.0	95.1	93.0	93.1	93	93
	appreciation in %	-1.7	-1.7	-1.3	-4.1	-5.5	-4.6	-5.1	-2.3
Real exchange rate to EA12 ¹⁾	average of 2010=100	97.0	96.4	96.2	94.6	91.6	91	91	93
	appreciation in %	-1.6	-2.0	-2.8	-4.5	-5.5	-5.5	-5.2	-2.2
REER (Eurostat, CPI deflated, 37 countries)	average of 2010=100	98.5	97.3	97.4	94.4	.	.	.	.
	appreciation in %	-2.1	-1.8	-1.4	-4.0	.	.	.	.

Source: CNB, Eurostat, own calculations

¹⁾ Deflated by GDP deflators.

Graph A.3.6: Nominal Exchange Rates

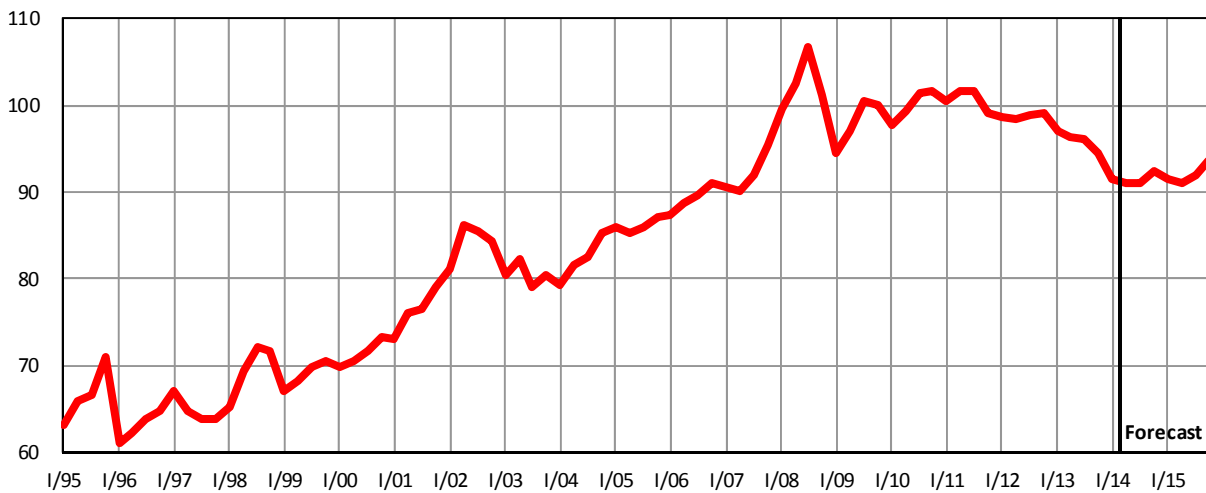
quarterly averages, average 2010=100 (rhs)



Source: CNB, own calculations

Graph A.3.7: Real Exchange Rate to EA12

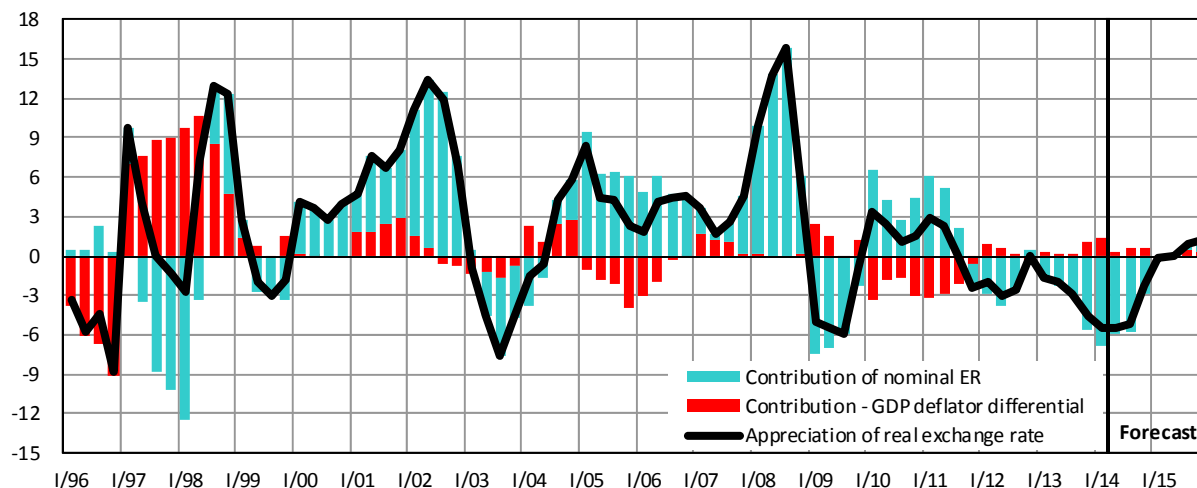
quarterly averages, deflated by GDP deflators, average 2010=100



Source: CNB, Eurostat, own calculations

Graph A.3.8: Real Exchange Rate to EA12

deflated by GDP deflators, YoY growth rate in %, contributions in percentage points



Source: CNB, Eurostat, own calculations

A.4 Structural Policies

Taxes

On 21 May 2014, the government approved **the amendment to the Act on Excise Taxes**. In reaction to the weakening of the CZK/EUR exchange rate, the amendment modifies the rates of excise tax on tobacco products in order to meet the EU minimum requirement for the excise tax level, i.e. €90 per 1,000 cigarettes. The amendment should come into effect on the first day of the third month following the month of the declaration (in the forecast we assume that the amendment will be effective as of 1 January 2015).

On 2 July 2014, the government approved **the amendment to the Act on Income Taxes**. Tax credits for the second child will increase annually by CZK 2,400 and for the third and any additional child by CZK 3,600. The current lump-sum expenditure of 60% and 80% will be preserved, but now they will be limited by an income ceiling of CZK 2 million. Old-age pensioners with annual incomes not exceeding CZK 840,000 will again be allowed to apply the basic discount per tax payer. The amendment is scheduled to come into effect on 1 January 2015.

The amendment to the Act on Value Added Tax approved by the government on 2 July 2014 introduces a second reduced value added tax rate of 10% on drugs, books and essential infant nutrition. The amendment should be effective from 1 January 2015.

Financial Markets

On 18 June 2014, the senate approved the **bill amending certain acts in connection with the establishment and supervision of access to the**

business of banks, savings banks and credit unions as well as securities dealers, implementing the EU Directive on the taking up of the business of credit institutions and their prudential supervision under Czech law. The new legal regulation introduces capital reserves which the CNB can require banks, cooperative savings banks and investment firms to hold in order to strengthen the capital resources and limit systemic risks. Simultaneously, the responsibility for supervision of the liquidity of branches of Member State banks (not subsidiary banks) will be transferred from the supervisory authority of the host state to the supervisory authority of the home state. The act should come into effect on the day of its announcement, and some selected parts of it on 1 January 2015 and 1 January 2016.

In order to reduce the risk of corruption, on 9 April 2014 the government approved the **amendment to the Bill Amending Certain Acts on the Financial Market**. According to the new legal regulation, mandatory cashless payments will no longer just apply to cases when obligations are settled by payment, but to all payments (loans, gifts). The limit for mandatory cashless payments will be reduced from CZK 350,000 to CZK 270,000, while recipients will be obliged to refuse any payment above the new limit if it is not made as a cashless payment. The amendment also transposes the EU Directive defining the requirements for credit transfers and direct debits in EUR. The amendment is expected to come into effect on the first day of the calendar month following its announcement.

Energy and the environment

On 12 May 2014, the government approved the **amendment to the Act on Conditions for Trading in Allowances for Greenhouse Gas Emissions**, transposing the EU Directive into Czech law. The amendment imposes the duty on operators to return any allowances that were assigned and issued to them in an unauthorized manner. If operators breach this duty, a sanction can be imposed on them. The amendment is scheduled to come into effect on 1 January 2015.

Labour Market

The amendment to the Employment Act, approved by the Senate on 18 June 2014, reintroduces the category of disadvantaged persons. The employment of these persons will be supported with a contribution of up to CZK 5,000 per month. The contribution to shared intermediation of employment for job agencies will be reduced from CZK 5,000 to a maximum CZK 500. In contrast, the amount for placing in work an unemployed person will increase from CZK 1,250 to a maximum of CZK 6,250 if such person stays in the job for at least 6 months. The amendment should come into effect on the first day of the month following its announcement.

In order to improve the balance between the work life and family life of parents with small children and to increase their participation in the labour market, on 20 June 2014 the Chamber of Deputies approved **a draft bill to provide childcare services in a children's group**. The act introduces a new type of service consisting in looking after and taking care of children from the age of one year until mandatory school attendance. The provider of the service can be the employer of a parent, a church, local government unit,

A.5 Demographic Trends

At the beginning of the second quarter of 2014, 10.517 million people lived in the Czech Republic. Its population increased by 5 thousand during the first quarter of 2014, whereby the population loss of 2013 was more than compensated.

In the first quarter of 2014, net migration rate again returned to positive figures (+5 thousand). The number of births (26 thousand) was similar to that of the same quarter of 2013. Roughly the same number of deaths, however, represented a 5 thousand decline in a YoY comparison. It is interesting that in absolute terms, the greatest decrease in number of deaths was seen in the

generally beneficial company, foundation, university or association. The act should come into effect on 1 September 2014.

Social and Health Insurance

On 20 June 2014, the Chamber of Deputies approved **a draft bill on pension insurance**, regulating the rules for indexation of pensions. For pension increases, the amount is set so that the increase in average old-age pension would equal the amount of 100% growth of the total consumer price index and one third of real wage growth. From 2015, the average independently paid old-age pension will increase by at least 1.8%. The amendment to the act should come into effect on 1 September 2014.

The amendment to the Act on Insurance Premium for Public Health Insurance that came into effect on 1 July 2014 increases the monthly payment for state insured persons from CZK 787 to CZK 845. At the same time, however, health insurance companies will be obliged to compensate healthcare providers for the shortfall in income resulting from the cancelled fees for hospitalization.

In order to support families with small children, on 2 July 2014 the government approved the **amendment to the Act on State Social Support**. The amendment introduces a maternity grant of CZK 10,000 also for the second child, and at the same time it increases the coefficient on which the entitlement to maternity grant is based. The amendment should come into effect on 1 January 2015.

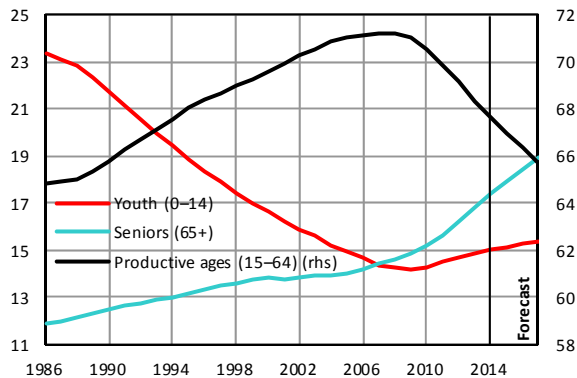
The amendment to the Act on Public Health Insurance approved by the government on 2 July 2014 cancels fees for prescriptions and outpatient treatment. The amendment is scheduled to come into effect on 1 January 2015.

age group 80–89 years. The surprisingly sharp drop in the death rate in this age category could have been influenced, at least partially, by the unusually warm weather in this period.

The number of inhabitants of the Czech Republic has narrowly exceeded the previous high from the beginning of 2013 and is still very close to the post-WWII **population peak**. It seems so far that the central variant of the CZSO's Population Projection will prove correct, with a very slight increase in population in the near future. Beyond the outlook horizon, we can

in all likelihood expect a long-term decrease in the number of inhabitants of the Czech Republic.

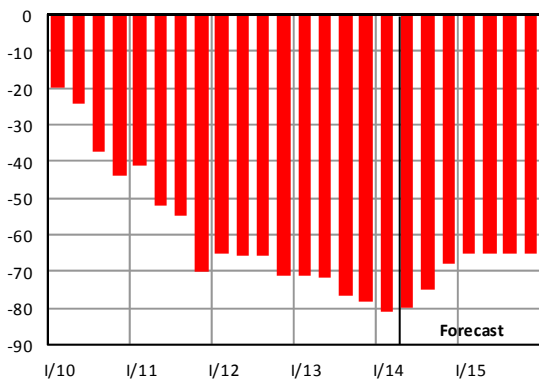
Graph A.5.1: Age Groups
structural shares in %



Source: CZSO, own calculations

According to the published results of the population age structure at the beginning of 2014, the decrease in the structural proportion of the **population aged 15 to 64** (see Graph A.5.1) continued unabated. This decline is predominantly explained by natural change, whereby persons born at the turn of the millennium, when the birth rate was very low, are now exceeding the lower age limit of this group, while the population-strong generation born after WWII is gradually being classified as senior citizens.

Graph A.5.2: Czech Population Aged 15–64
based on LFS, YoY increases of quarterly averages, in thousands



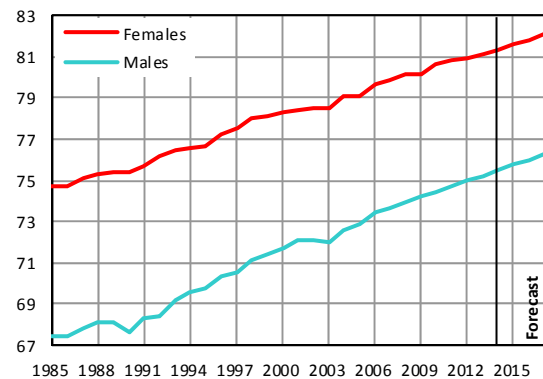
Source: CZSO, own calculations

In the following years, the rate of this decrease should slacken somewhat. Nonetheless, in absolute terms, the

working-age population should continue to decline by approximately 60–70 thousand people a year (see Graph A.5.2), which is a decrease of just below 1% a year. Economic impacts of this situation are described in more detail in Chapter B.1.

In contrast, the structural proportion of **persons over 64 years** in the total population reached 17.4% at the beginning of 2014, and should regularly increase by 0.5 pp annually. The number of seniors in the population is significantly rising due to demographic structure and the continuing intensive process of increasing life expectancy; in the outlook horizon, i.e. at the beginning of 2017, the number of persons in this category should come close to 2 million.

Graph A.5.3: Life Expectancy
in years



Source: CZSO

In such situation it is quite a paradox that the number of **old-age pensioners** has been stagnant since 2012. In structural view, the number of pensioners with reduced pensions after early retirement is continuing to rise quite dynamically (by 20 thousand YoY at the beginning of April 2014), while the number of pensioners entitled to a full pension has decreased YoY by 16 thousand. The share of reduced pensions has already reached 23.9%, compared to 19.0% at the end of 2009. A certain decoupling is occurring between the proportion of potential pensioners (probably better qualified with secure jobs) who are postponing their retirement and another section of the population that is taking advantage of early retirement more often.

Table A.5.1: Demography

in thousands of persons (unless stated otherwise)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
							Forecast	Forecast	Outlook	Outlook
Population (January 1)	10 381	10 468	10 507	10 487	10 505	10 516	10 512	10 518	10 522	10 524
<i>growth in %</i>	0.9	0.8	0.4	-0.2	0.2	0.1	0.0	0.1	0.0	0.0
Age structure (January 1):										
(0–14)	1 477	1 480	1 494	1 522	1 541	1 560	1 577	1 593	1 605	1 615
<i>growth in %</i>	-0.2	0.2	1.0	1.8	1.3	1.2	1.1	1.0	0.8	0.6
(15–64)	7 391	7 431	7 414	7 328	7 263	7 188	7 109	7 044	6 979	6 913
<i>growth in %</i>	0.9	0.5	-0.2	-1.2	-0.9	-1.0	-1.1	-0.9	-0.9	-0.9
(65 and more)	1 513	1 556	1 599	1 637	1 701	1 768	1 826	1 881	1 938	1 996
<i>growth in %</i>	2.1	2.9	2.7	2.4	3.9	3.9	3.3	3.1	3.0	3.0
Old-age pensioners (January 1)¹⁾	2 061	2 102	2 147	2 260	2 340	2 341	2 340	2 357	2 381	2 404
<i>growth in %</i>	1.8	2.0	2.1	.	3.5	0.1	0.0	0.7	1.0	1.0
Old-age dependency ratios (January 1, in %):										
Demographic ²⁾	20.5	20.9	21.6	22.3	23.4	24.6	25.7	26.7	27.8	28.9
Under current legislation ³⁾	35.9	36.1	36.6	37.4	37.8	38.3	38.8	39.5	40.1	40.6
Effective ⁴⁾	41.5	41.8	43.6	45.9	47.9	47.6	47.2	47.3	47.8	48.1
Fertility rate	1.497	1.492	1.493	1.427	1.452	1.460	1.45	1.45	1.45	1.46
Population increase	86	39	-20	19	11	-4	6	4	2	1
Natural increase	15	11	10	2	0	-2	-3	-5	-7	-9
Live births	120	118	117	109	109	107	104	102	100	98
Deaths	105	107	107	107	108	109	107	107	107	107
Net migration	72	28	16	17	10	-1	9	9	9	9
Immigration	78	40	31	23	30	30	.	.	.	.
Emigration	6	12	15	6	20	31	.	.	.	.
Census difference	x	x	-46	x	x	x	x	x	x	x

Source: Czech Social Security Administration, CZSO, own calculations

¹⁾ In 2010 disability pensions of pensioners over 64 were transferred into old-age pensions.

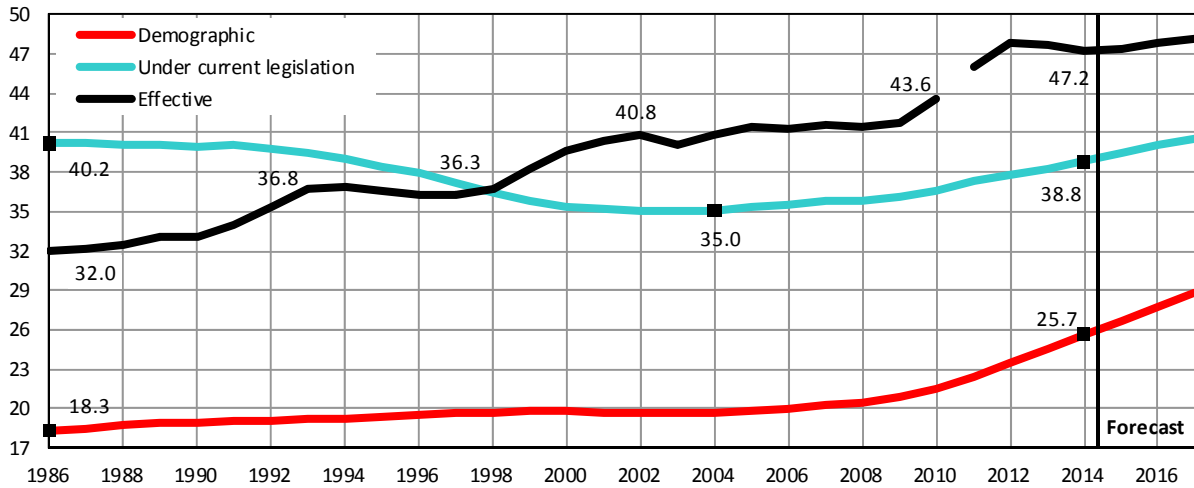
²⁾ Demographic dependency: ratio of people in senior ages (65 and more) to people in productive age (15–64).

³⁾ Dependency under current legislation: ratio of people above the official retirement age to the people over 19 below the official retirement age.

⁴⁾ Effective dependency: ratio of old-age pensioners to working people.

Graph A.5.4: Dependency Ratios

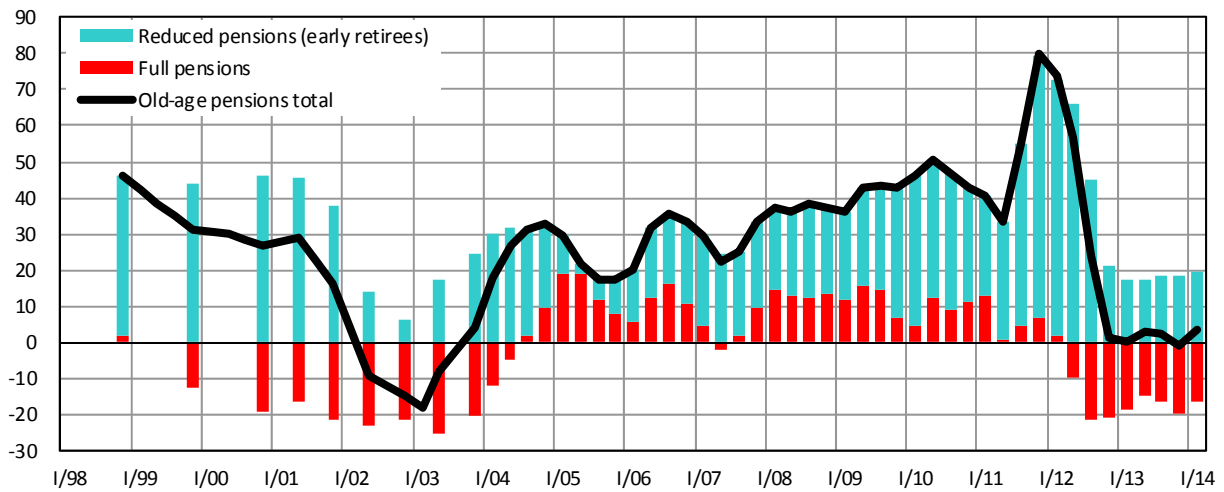
As of January 1, in %, inconsistent between 2010 and 2011 due to transfer of disability pensions to old-age pensions for people over 64 years



Source: CZSO, own calculations

Graph A.5.5: Old-Age Pensioners

absolute increase over a year in thousands of persons



Source: Czech Social Security Administration, CZSO, own calculations

Note: Transfer of disability pensions to old-age pensions for people over 64 years in 2010 is not included.