A Forecast Assumptions

A.1 External Environment

Compared with the previous forecast, the outlook for global economic growth has deteriorated, especially in the near term. Slowdown in international trade, tense geopolitical situation and uncertainty associated with the reforms being undertaken in emerging economies and in some EU member states are the reasons for the revision. Disregarding the short-term volatility, growth dynamics in advanced economies, with the exception of the euro area, continues to strengthen. Structural problems put a brake on the emerging economies' growth potential. The gap between the 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. Following a slowdown in domestic demand, which was related to the government's effort to curb the growth of credit activity and to a correction on the real estate market, China's growth surprisingly accelerated in the second quarter. However, the risks related to vulnerability of the local financial market persist, 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 the 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.

Uncertainty associated with the outlook is highlighted by the geopolitical tensions in Ukraine. The new EU sanctions against Russia are primarily aimed at the institutions on the financial markets, and the energy and arms industries. Access of the major Russian state-owned banks to capital markets was restricted. At the same time, trade with arms has been banned, just like exports of certain technologies used in oil drilling, which may cause severe difficulties for Russian oil drilling companies in future. The USA have imposed similar sanctions against Russia. Owing to the fact that neither Russia nor Ukraine is among the most important export markets for the Czech Republic, the conflict in Ukraine should not have a substantial impact on the Czech economy. Nevertheless, some exporters and importers could face complications. An escalation of tensions accompanied with the sanctions imposed by the West has already had an adverse effect on growth in some EU member states. The impact on individual EU countries varies, depending on the extent to which the economies are exposed to Russia. So far, the sanctions have had a negative impact on market sentiment rather than on export performance of the EU.

USA

The American economy recorded a strong QoQ growth of 1.0% (*versus 1.1%*) in the second quarter of 2014. The deep drop in the first quarter of 2014, when severe weather acted as a break on economic activity, was only one-off. In the second quarter of 2014, therefore, the economy resumed solid pace of growth from the end of the last year, which was in line with expectations. The main contributions to growth came from consumption and investment to machinery and equipment.

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 still hovering around record highs) will have a positive impact on consumption of households. Firms' investment activity is approaching the pre-crisis level, while banks' lending activity continues to rise.

The economy is still supported by accommodative monetary policy. However, the Fed keeps on tapering quantitative easing. Beginning in October, the monthly volume of asset purchases is reduced further by $10 billion, to $15 billion. The Fed's decision reflects its positive assessment of the state of the US economy. In the Fed's view, favourable developments on the labour market have run out of steam somewhat, but economic growth has stabilised and the economy should be able to operate without larger stimuli. So far, the Fed has assessed long-term inflation expectations as stable, and the risks to the economic outlook and the situation on the labour market as balanced. The risk of a long-term undershooting of the 2% inflation target has slightly decreased since the beginning of the year.

In September, the unemployment rate fell below 6% (to 5.9%) for the first time since the outbreak of the crisis, declining by 1.3 pp YoY. However, falling jobless rate is accompanied by decreasing participation rate, which remains a long-term issue. Unemployment rate is expected to decline further towards 5% in mid-2015. Taking into account the low growth of the working-age population, the economy is slowly approaching the point of full employment; full capacity utilization should lead to inflation pressures in the next year.

Given that the return of the US economy to a growth trajectory after the poor performance in the first quarter was in line with the estimate from the July Macroeconomic Forecast, we have revised our forecast for GDP growth in 2014 only marginally up to 2.1% (*versus 2.0%*). 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 2.9% in 2015 (*versus 3.1%*).

EU

As at the cut-off date, the data according to the national accounts standard ESA 2010 were available only for some of the EU countries.

In the second quarter of 2014, GDP growth rate slowed down to 0.2% QoQ (*versus 0.4%*) in the EU28, whereas in the EA12 GDP remained unchanged (*versus growth of 0.4%*), compared with the first quarter. In a YoY comparison, GDP increased by 1.2% (*versus 1.4%*) in the EU28 and by 0.7% (*versus 1.0%*) in the EA12. Developments in individual member states of the EA12 remain widely varied. Generally, some slowdown of both domestic demand and foreign trade can be observed. In many countries of the EA12, however, structural problems and uncertainty related to the effects of the reforms that are being undertaken put a brake on these economies' recovery.

The ECB eased monetary policy further in September, in reaction to ongoing disinflation and decreasing inflation expectations. All monetary policy rates were cut by 10 basis points– the main refinancing rate to 0.05%, the interest rate on the marginal lending facility to 0.30% and the interest rate on the deposit facility to –0.20%. At the same time, the ECB introduced the Asset-Backed Securities Purchase Programme (underlying assets consisting of claims against the euro area non-financial private sector) and the Covered Bond Purchase Programme, in which covered bonds issued by MFIs domiciled in the euro area will be purchased. The programmes will last for at least two years and both will start in the fourth quarter of 2014. Their aim, just like the aim of the previous extraordinary measures taken by the ECB (Targeted Longer-Term Refinancing Operations), is to improve the functioning of the transmission mechanism of monetary policy and support provision of credit to the non-financial sector. Easing of monetary policy is in line with the July Macroeconomic Forecast. The ECB has confirmed that it stands ready to take further steps, should they be needed.

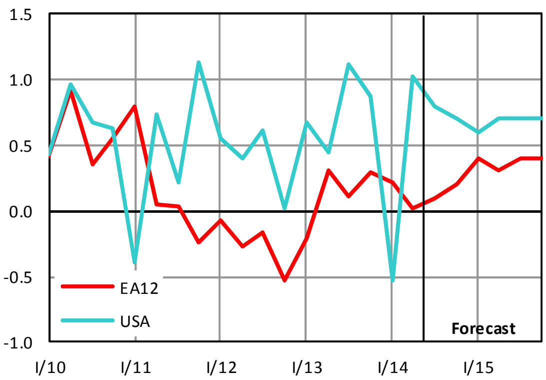
Situation on the labour market in the EU28 as a whole has stabilised. In August, unemployment rate in the EU28 and in the EA12 was 10.1% and 11.5% respectively. However, considerable differences among individual states persist. The worst situation is still in Greece, where jobless rate stood at 27.0% in June. Of the EU28 countries for which the data for August were available as at the cut-off date, the highest jobless rate was recorded in Spain (24.4%) and Croatia (16.5%), the lowest rate of unemployment was in Austria (4.7%) and in Germany (4.9%).

We expect that the stagnation of GDP in the EA12, which occurred in the second quarter, will be followed by a gradual pickup in activity in the second half of the year and throughout 2015. However, growth should be significantly weaker than it was expected in the last Forecast. Risks to the forecast include the persisting high unemployment rate, uncertainty related to the effects of the reforms that are being undertaken and the developments on the credit market. GDP in the EA12 is assumed to increase by 0.7% (*versus 1.1%*) this year. Growth is expected to accelerate to 1.1% (*versus 1.5%*) in 2015.

Germany posted a surprising 0.2% QoQ drop in GDP (*versus a 0.4% increase*) in the second quarter of 2014. The unfavourable outcome, however, is partly due to one-off factors (very mild winter), which caused part of the economic activity to be shifted from the second quarter to the first quarter. Considering the performance of the German economy in the first half of 2014, the average quarterly GDP growth rate was cca 0.3%, which represented a slight slowdown of just 0.1 pp, in comparison with the second half of 2013. Exports increased only modestly in the second quarter. Exports within the EU recorded a modest rise, whereas trade with the countries outside the EU was almost stable. Firms' investment expenditure on machinery and equipment did not reach the same dynamics as at the beginning of the year. The pickup in investment activity that begun in the first half of 2013 was thus disrupted. The main problem in the case of investment is weak demand in the EA12 and the reluctance of households and the government to spend. The Ifo index declined for the 4th consecutive month in September, especially the expectations component. The first decrease in a long time posted the GfK Consumer Climate indicator, although its value still remains high. Low rates of the ECB continue to 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 pickup in output in developed economies and high competitiveness of German firms should contribute positively to growth. Data on industrial production imply that the economy could return to growth in the second half of this year; compared with expectations from the beginning of the year, however, the growth will be much lower. We expect GDP to increase by 1.4% this year (*versus 2.0%*) as well as in 2015 (*versus 1.8%*).

The situation in **France** remains unfavourable. GDP was flat again in a QoQ comparison (*versus growth of 0.3%*) in the second quarter of 2014; recovery of the French economy is still to come. Measures that were taken to give a boost to low-income households and the business sphere haven't had effect so far. A pickup in private investment, which stagnated over the last two years, is expected. Situation on the labour market is not getting any better – high rate of unemployment, which reached 10.5% in August, and problems with job creation put a brake on private consumption. Low exports of certain industrial sectors pose another problem. Therefore, strongly positive contributions of net exports to GDP growth cannot be expected in future. The government has announced that meeting the deficit target for this year is unlikely, which jeopardizes exiting the Excessive Deficit Procedure in 2015. Furthermore, the required fiscal consolidation will have a negative effect on economic activity. We expect the economy to grow by just 0.4% (*versus 0.9%*) in 2014. In 2015, GDP growth could slightly accelerate to 0.8% (*versus 1.4%*).

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

In **Poland**, GDP increased by 0.6% QoQ (*in line with the estimate*) in the second quarter. Even though the first quarter of 2014 was marked by an exceptionally strong momentum, growth in the second quarter matched the dynamics observed in the last year. The relative importance of domestic demand, which should remain the main driver of growth even in 2015, is increasing thanks to the stable situation on the labour market and low inflation. Monetary policy rates have stayed at the historical low of 2.50% since mid-2013, despite the inflation target not being met. Uncertainties related to the outlook for the EA12 persist and they are expected to have a negative effect on investment activity, just like the unfavourable state of trade relations with Russia. We leave the estimate for this year's GDP growth unchanged at 3.2%. In 2015, GDP growth could slightly decelerate to 3.0% (*versus 3.1%*).

GDP of **Slovakia** increased by 0.6% QoQ (*versus 0.7%*) in the second quarter of 2014. Final consumption expenditure and investment were the main drivers of growth. Given the assumed developments in the EA12, however, we expect foreign demand to slow down in the second half of the year. Investments are also likely to be weaker because of the uncertainty related with the outlook. Consumption of households should get a boost from rising real wages and employment. Consumption of the government sector should contribute positively to growth in this year; however, its contribution should be negative in the next year due to the additional planned fiscal consolidation. On the other hand, the expected slowdown in domestic demand should be reflected positively in the contribution of net exports to GDP growth. We leave our forecast for GDP growth in 2014 at 2.4%. In 2015, economic growth could accelerate to 2.7% (*versus 2.9%*).

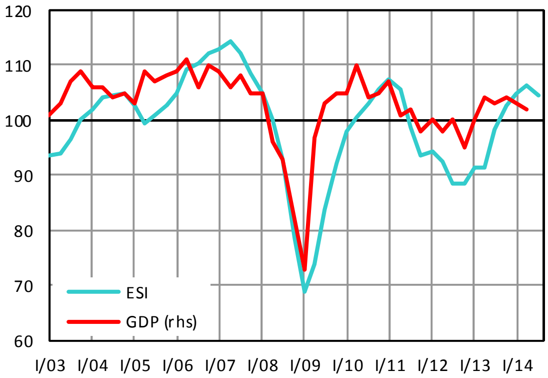
Business Cycle Indicators in the EU

The Economic Sentiment Indicator, which is published by the EC, decreased in the third quarter of 2014 in the EU, thus disrupting the growth trend. Assessment of consumers, as well as respondents in trade, industry and services deteriorated, compared with the previous quarter. On the other hand, sentiment increased in construction, although it remains strongly negative. For the third quarter of 2014, the Economic Sentiment Indicator signals a small deceleration of quarterly GDP growth in the EU, which is in line with our Forecast.

In France, the decline of the ESI came to a halt in the third quarter of 2014, whereas in Slovakia the ESI continued to grow moderately. In Italy, the assessment of respondents started to worsen, likely in connection with the economy entering a technical recession. In Germany, the ESI continued decreasing, albeit from significantly positive levels, as all components of the indicator deteriorated. According to the Ifo indicator, the weaker sentiment in Germany is due to the fading optimism in assessing the current economic situation and worsening expectations.

Graph A.1.2: **ESI and GDP Growth in the EU**

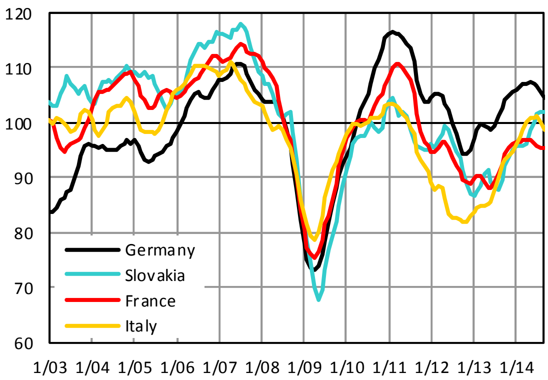
ESI – quarterly averages, GDP – QoQ growth rate in %, sa data



Source: EC, Eurostat

Graph A.1.3: **ESI in Selected Trading Partner Countries**

3-month moving averages

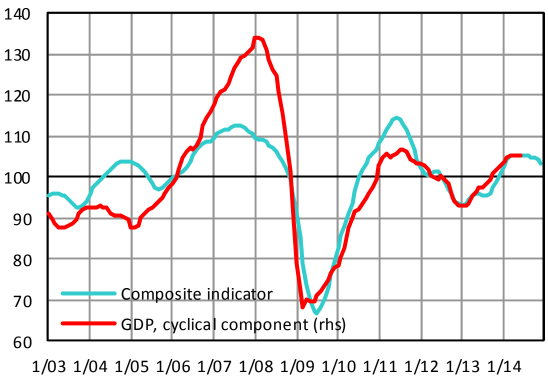


Source: EC

For the third quarter of 2014, the composite leading indicator signals that the relative cyclical component of GDP in the EU will keep on deteriorating. This is consistent with a slight widening of the negative output gap in the EU, which is in line with the European Commission's estimate for this year.

Graph A.1.4: **Composite Leading Indicator – EU**

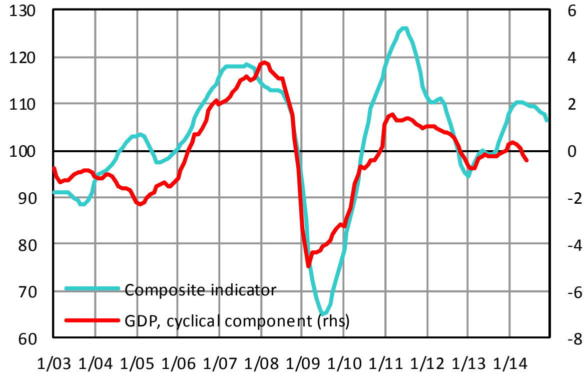
monthly data, 2005=100, cyclical component in % of trend GDP



Source: EC, Eurostat, own calculations

Graph A.1.5: **Composite Leading Indicator – Germany**

monthly data, 2005=100, cyclical component in % of trend GDP



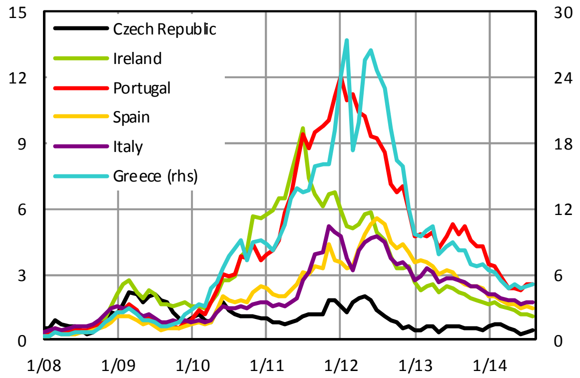
Source: EC, Eurostat, own calculations

Situation in the Troubled Economies of the Euro Area

The latest data have confirmed that economic activity has been gradually picking up in Ireland, Portugal and in Spain. The Italian economy re-entered a technical recession in the second quarter of 2014; given the magnitude of quarterly GDP changes, however, the developments over the last four quarters can be regarded rather as stagnation. Greek GDP recorded a 24th consecutive YoY decline in the second quarter of 2014, but the speed at which economic output is falling has slowed down considerably. Cyprus, where GDP was more than 10% lower in the second quarter of 2014 than in the second quarter of 2011, still finds itself in a protracted recession.

Graph A.1.6: **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

Market sentiment towards the euro area periphery remains favourable (see Graph A.1.6). However, the yields on (not only) 10Y government bonds, which in the case of Ireland, Italy, Portugal and Spain are at the historical lows (at the end of September, the yield on 2Y Irish government bonds on the secondary market was even negative), do not, apparently, reflect the economic fundamentals. Search for yield, under the conditions of highly accommodative monetary policy and extremely low, and in some periphery countries even negative, inflation rate, is much more likely to explain the high price of government bonds.

Ireland is trying to make use of the positive market sentiment towards the euro area periphery by seeking early repayment (refinancing) of the loans provided by the IMF within the bailout programme. Loans from the IMF, whose participation in the bailout programme for Ireland[1] totals €22.5 billion, are scheduled to be fully repaid in 2023. The problem, however, is the interest rate on the IMF loans, which is approximately 5%, as the yield on Irish 10Y government bonds is hovering below 2%. By refinancing the IMF loans, Ireland could therefore achieve considerable savings, estimated at €1.5 billion (cca 1% of GDP) over the maturity of the loans. However, early repayment of the IMF loans must be formally approved by other creditors who financially participated in the bailout programme (so far, Ireland has managed to secure political support for its plan). If Ireland failed to secure their consent and still insisted on early repayment of the IMF loans, it would have to make an early repayment of the loans from other creditors as well.

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. 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.

Another, though not that significant, risk present future developments in Greece. Funds from the Greek bailout programme, or – more precisely – from the part provided by the euro area states via the European Financial Stability Facility, have been almost completely drawn down. The programme envisages the IMF financing continuing until mid-2016; however, in 2015 and 2016 the IMF should provide Greece with "only" €9 billion in total. The question as to whether or not Greece will need another bailout programme or some other form of help, e.g. partial (official) debt forgiveness, is thus becoming even more pressing. The prospects for Greece being able to almost fully finance itself on the primary market, starting in 2015, have not looked very good so far.

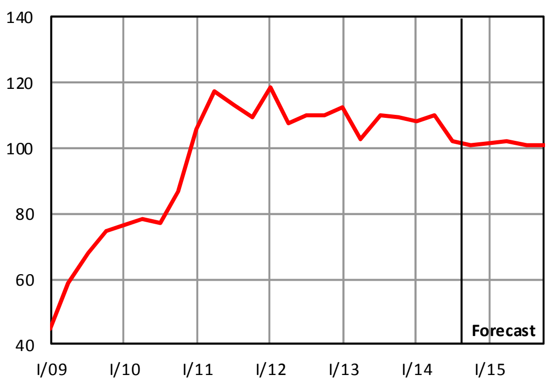
Future developments in the economies on the euro area periphery are subject to downside risks. Sudden worsening of the market sentiment towards the region, which could be caused by the results of the comprehensive assessment of European banks, cannot be excluded. It is therefore premature to consider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

Given the high openess of the Czech economy and strong business links to the euro area, a 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 \$102.0/barrel (*versus \$108*) in the third quarter of 2014. Lower than expected price of oil results primarily from weaker demand for oil, reflecting the weaker performance of the global economy, and an unexpectedly rapid return of the Libyan production to the markets. These factors account for the minor downward revision to the forecast, above all in the near term. However, we have not changed our view of the market fundamentals. The price of oil should continue to decline moderately, mainly due to increasing production capacity and the extent to which domestic production in the US and Canada substitutes for imports of oil, and deteriorated outlook for the EU. A gradual decline in the price of oil is also in line with the situation on derivatives markets. That market volatility could increase as a result of the rather tense geopolitical situation remains a risk. On average, the price of Brent crude oil could reach \$105/barrel (*versus \$108*) this year. In 2015, the price could decrease further to \$101/barrel (*versus \$104*).

Graph A.1.7: **Dollar Prices of Brent Crude Oil**
in USD per barrel



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

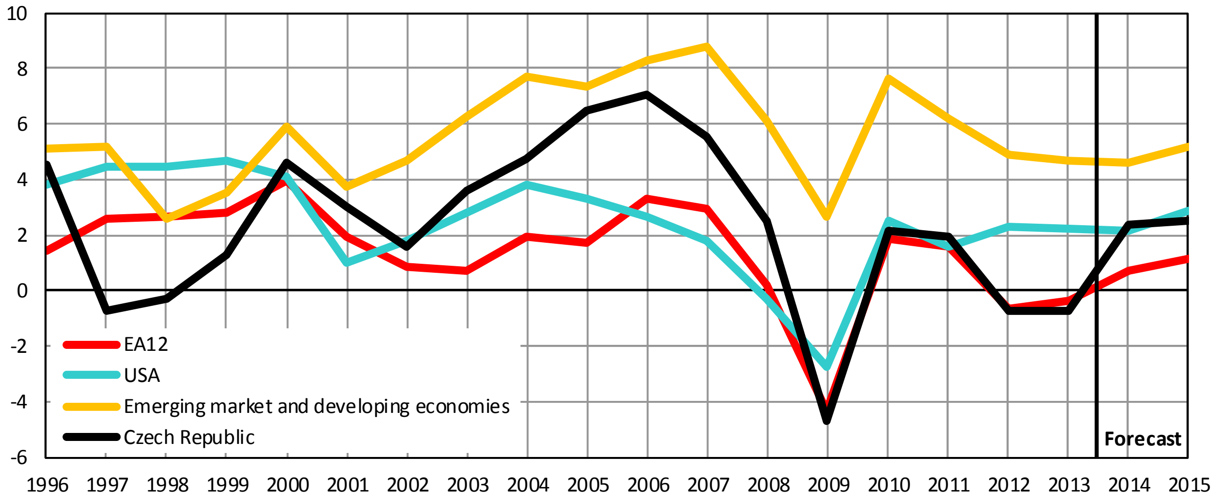
[1] *International financial help totalled €67.5 billion; apart from the IMF, the EU contributed €22.5 billion, the euro area €17.7 billion, the remaining €4.8 billion was provided in the form of bilateral loans from the UK, Sweden and Denmark*

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 *Forecast*	2015 *Forecast*
World	5.3	5.4	2.8	-0.6	5.2	3.9	3.1	3.0	3.3	3.8
USA	2.7	1.8	-0.3	-2.8	2.5	1.6	2.3	2.2	2.1	2.9
China	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.3	7.3
EU28	3.5	3.2	0.3	-4.5	2.0	1.7	-0.3	0.1	1.1	1.3
EA12	3.3	2.9	0.2	-4.4	1.9	1.6	-0.6	-0.4	0.7	1.1
Germany	3.9	3.4	0.8	-5.6	3.9	3.7	0.6	0.2	1.4	1.4
France	2.6	2.3	0.1	-2.9	1.9	2.1	0.4	0.4	0.4	0.8
United Kingdom	2.8	3.4	-0.8	-5.2	1.7	1.1	0.3	1.7	3.0	2.7
Austria	3.8	3.7	0.9	-3.5	1.9	2.9	0.7	0.3	0.9	1.3
Hungary	4.0	0.1	0.7	-6.7	1.0	1.6	-1.7	1.2	3.3	2.4
Poland	6.2	6.8	5.0	1.6	3.9	4.5	2.1	1.6	3.2	3.2
Slovakia	8.3	10.5	5.8	-4.9	4.4	3.0	1.8	0.9	2.4	2.7
Czech Republic	6.9	5.5	2.7	-4.8	2.3	2.0	-0.8	-0.7	2.4	2.5

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

Graph A.1.8: **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 *Estimate*	Q4 *Forecast*
USA	*QoQ*	**0.7**	**0.4**	**1.1**	**0.9**	**-0.5**	**1.0**	**0.8**	**0.7**
	YoY	1.7	1.8	2.3	3.1	1.9	2.5	2.2	2.0
China	*QoQ*	**1.6**	**1.8**	**2.3**	**1.7**	**1.5**	**2.0**	**1.6**	**1.6**
	YoY	7.8	7.5	7.8	7.6	7.5	7.7	7.0	6.9
EU28	*QoQ*	**0.0**	**0.4**	**0.3**	**0.4**	**0.3**	**0.2**	**0.1**	**0.3**
	YoY	-0.7	-0.1	0.2	1.1	1.4	1.2	1.0	0.9
EA12	*QoQ*	**-0.2**	**0.3**	**0.1**	**0.3**	**0.2**	**0.0**	**0.1**	**0.2**
	YoY	-1.2	-0.6	-0.3	0.5	0.9	0.7	0.6	0.5
Germany	*QoQ*	**-0.4**	**0.8**	**0.3**	**0.4**	**0.7**	**-0.2**	**0.3**	**0.2**
	YoY	-0.6	0.1	0.3	1.1	2.2	1.3	1.3	1.0
France	*QoQ*	**0.0**	**0.7**	**-0.1**	**0.2**	**0.0**	**0.0**	**0.1**	**0.2**
	YoY	-0.2	0.7	0.3	0.8	0.8	0.1	0.3	0.3
United Kingdom	*QoQ*	**0.5**	**0.7**	**0.8**	**0.7**	**0.8**	**0.8**	**0.6**	**0.6**
	YoY	0.7	1.8	1.8	2.7	3.0	3.1	2.9	2.8
Austria	*QoQ*	**0.0**	**0.0**	**0.3**	**0.4**	**0.1**	**0.2**	**0.3**	**0.3**
	YoY	0.3	0.0	0.4	0.7	0.8	0.9	0.9	0.9
Hungary	*QoQ*	**0.7**	**0.4**	**1.1**	**0.7**	**1.1**	**0.8**	**0.6**	**0.4**
	YoY	-0.4	0.5	1.8	2.9	3.3	3.7	3.2	2.9
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	3.1	3.0
Slovakia	*QoQ*	**0.1**	**0.4**	**0.5**	**0.6**	**0.7**	**0.6**	**0.6**	**0.7**
	YoY	0.5	0.6	1.0	1.6	2.2	2.4	2.5	2.6
Czech Republic	*QoQ*	**-0.8**	**0.5**	**0.4**	**1.1**	**0.6**	**0.3**	**0.4**	**0.6**
	YoY	-2.2	-1.3	-0.5	1.1	2.6	2.5	2.5	2.0

Source: Eurostat, NBS China, own calculations

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

		2006	2007	2008	2009	2010	2011	2012	2013	2014 *Forecast*	2015 *Forecast*
Crude oil Brent	*USD/barrel*	**65.1**	**72.4**	**96.9**	**61.5**	**79.6**	**111.3**	**111.6**	**108.6**	**105**	**101**
	growth in %	19.6	11.1	34.0	-36.5	29.3	39.9	0.3	-2.6	-3.1	-3.6
Crude oil Brent index *(in CZK)*	*2005=100*	**96.9**	**96.0**	**106.7**	**76.1**	**100.0**	**129.5**	**143.8**	**139.9**	**142**	**141**
	growth in %	12.5	-0.9	11.1	-28.6	31.4	29.5	11.0	-2.7	1.5	-0.6
Wheat	*USD/t*	**191.7**	**255.2**	**325.9**	**223.4**	**223.7**	**316.2**	**313.3**	**312.2**	**268**	**219**
	growth in %	25.8	33.1	27.7	-31.5	0.1	41.4	-0.9	-0.3	-14.2	-18.3
Wheat price index *(in CZK)*	*2005=100*	**101.7**	**120.4**	**129.5**	**100.6**	**100.0**	**131.3**	**144.4**	**143.7**	**129**	**109**
	growth in %	18.3	18.4	7.5	-22.3	-0.6	31.3	10.0	-0.5	-10.4	-15.4

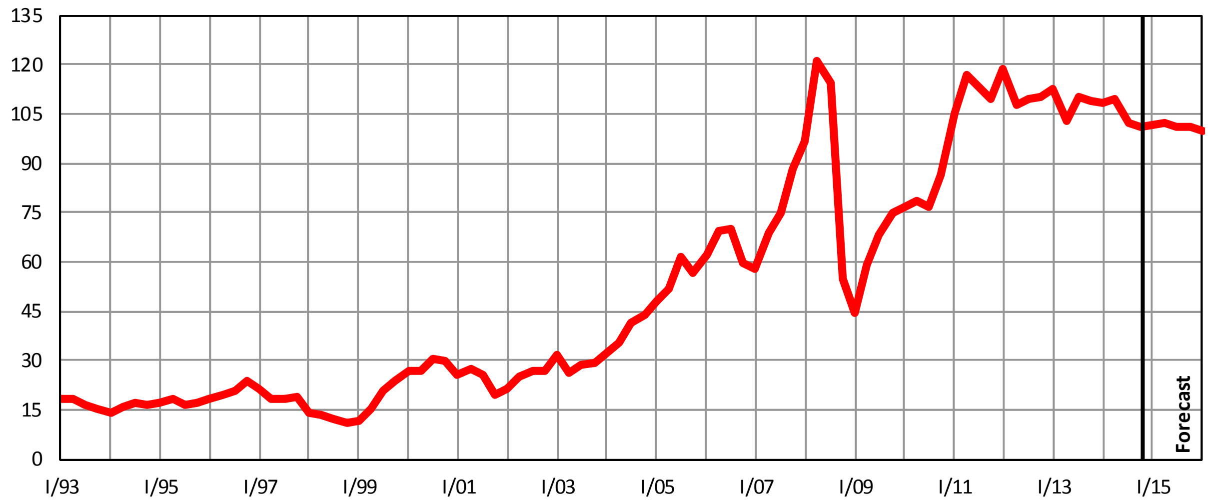
Source: IMF, U. S. Energy Information Administration, own calculations

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

		2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
								Estimate	*Forecast*
Crude oil Brent	*USD/barrel*	**112.4**	**102.6**	**110.2**	**109.2**	**108.1**	**109.7**	**102.0**	**101**
	growth in %	-5.3	-4.8	0.5	-0.8	-3.8	7.0	-7.5	-7.5
Crude oil Brent index *(in CZK)*	*2005=100*	**143.5**	**133.6**	**141.7**	**140.9**	**142.7**	**144.6**	**140.0**	**141**
	growth in %	-4.1	-4.6	-2.2	0.1	-0.5	8.3	-1.2	-0.2
Wheat price	*USD/t*	**321.4**	**313.8**	**305.9**	**307.8**	**297.1**	**322.1**	**248**	**204**
	growth in %	15.3	16.7	-12.5	-13.5	-7.6	2.6	-19.1	-33.6
Wheat price index *(in CZK)*	*2005=100*	**146.5**	**146.0**	**140.4**	**141.8**	**140.0**	**151.7**	**121**	**102**
	growth in %	16.7	17.0	-14.9	-12.7	-4.4	3.9	-13.6	-28.3

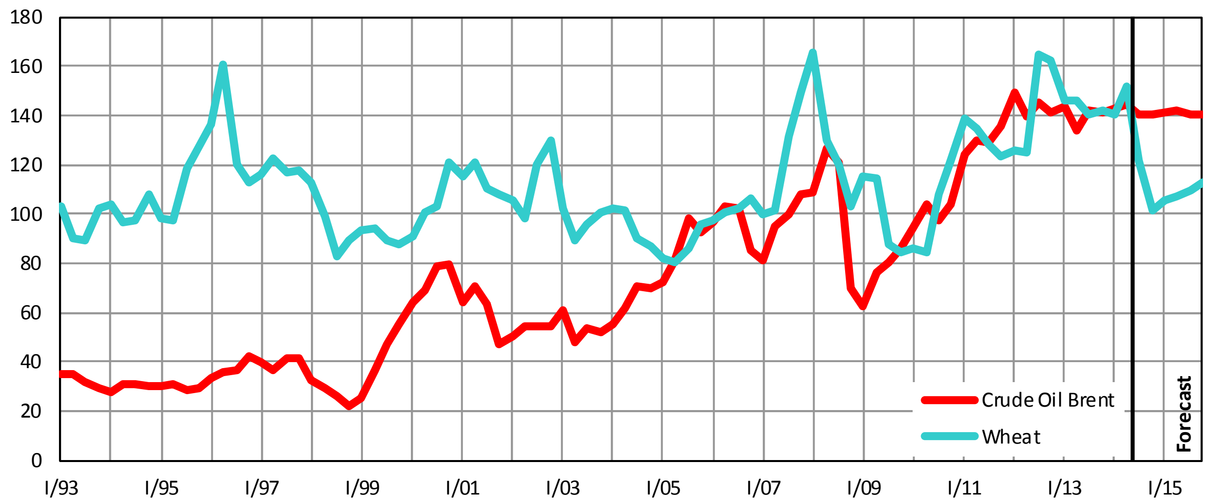
Source: IMF, U. S. Energy Information Administration, own calculations

Graph A.1.9: **Dollar Prices of Oil**
USD/barrel



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

Graph A.1.10: **Koruna Indices of Prices of Selected Commodities**
index 2010=100



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

A.2 Fiscal Policy

According to the current data, the government sector balance in 2013 ended with the deficit of 1.3% of GDP, which was an improvement of 2.7 pp compared to 2012. Considerable part of the improvement (1.8 pp), however, is due to specific transactions in 2012 (fin. compensation to churches and religious organizations and a correction to the reimbursement from EU funds). Disregarding their effect, the deficit fell by 0.9 pp. In comparison with the April notification, the estimate of the general government deficit in 2013 has improved by 0.2 pp (originally 1.5% of GDP). Although this partly follows from an absolute change in the deficit, the transition to the new methodology ESA 2010 has also had a significant impact by setting the level of nominal gross domestic product higher (see Box C.1). Therefore, all indicators have decreased as a ratio to GDP.

Structural balance (i.e. the balance adjusted for the effect of the business cycle and one-off and temporary measures) was balanced in 2013. The YoY change in the structural balance, the so-called fiscal effort, has exceeded 1 pp for several years in a row.

The considerable fiscal effort in 2013 was achieved both on the revenue and expenditure sides. On the revenue side, in particular there was a 1 pp increase in both VAT rates, which contributed to fiscal effort by nearly 0.4 pp. The second significant discretionary revenue measure were modifications to personal income tax (e.g. abolishing the basic discount for working pensioners, which can be, however, requested retrospectively; a solidarity surcharge of 7%, limitation of expenditure lump-sums) totalling 0.2 pp. Changes to other tax revenues were only minor and largely compensated one another.

On the expenditure side, there was yet another more substantial decrease in gross fixed capital formation (government investment) in 2013, by nearly 0.4% of GDP YoY. The decrease occurred mainly in investment financed from domestic sources which have a full impact on government sector balance. It was apparent both in local budgets and central government.

We expect the government sector deficit to reach 1.5% of GDP in 2014. Compared to the estimate in the previous Macroeconomic Forecast, the forecast of the absolute deficit level deteriorated slightly, yet thanks to the aforementioned transition to the ESA 2010 methodology the forecast of the relative deficit level has not changed. The structural balance should reach –1.1% of GDP and fiscal effort –1.2 pp.

On the revenue side, a relatively high (cca 4%) growth in the revenues from direct taxes can be expected. In contrast, a slight decrease can be expected in indirect taxes, in particular due to a decrease in revenues from taxes on tobacco products. According to the accrual methodology, the considerable stockpiling of the first two months of 2014 is included in tax revenues of 2013. In 2014, there was no major discretionary tax change, and the dynamics is thus caused by tax base dynamics. The revenue side was influenced by the sale of LTE frequency bands worth CZK 8.5 billion to mobile operators. An increase can also be expected for accrual investment subsidies from the EU, which are the main source of growth in government investment in 2014.

On the expenditure side, compared to the last forecast we can expect greater dynamics of government consumption, which should increase by 2.9% in current prices in annual terms. Consumption will be driven especially by social benefits in kind (expenditure of health insurance companies on health care), due partly to an increase in contributions for state insured persons and partly to the less restrictive Reimbursement Decree strengthening hospital care in particular. The assumption regarding wage bill growth in the government sector was also increased: it should rise by approximately 3% compared to last year. The assumption regarding the dynamics of the purchase of goods and services in the government sector remains at approximately the same level of 1.6%.

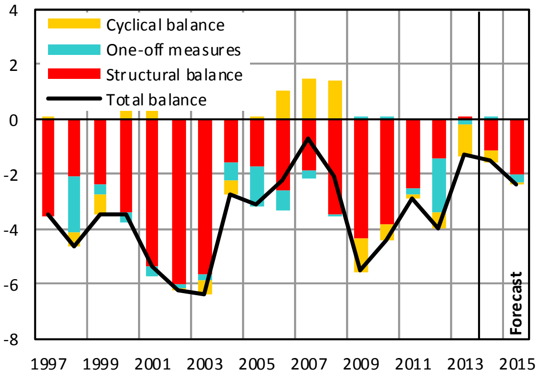
After several years of decline in investment activity of the government sector, we can expect it to grow by nearly 5% in 2014. It will be driven especially by the expenditure of projects co-financed from the EU funds.

For 2015, current estimates expect a deepening of government sector deficit down to 2.4% of GDP, which reflects government efforts to support the economy. Not only should government consumption grow relatively quickly, but investment in particular should increase. Investment should be again driven by the EU funds. The estimate of the balance also expects the introduction of the third VAT rate of 10% for selected commodities, an increase in the wage bill of state administration and also the reintroduction of the former method of indexation of pensions. The estimate of the balance in 2015 includes a one-off imputation of approximately 0.2% of GDP of the lease of the JAS 39 Gripen jet fighters.

Government debt in 2013 reached 45.7% of GDP. In particular thanks to stabilization of the state budget debt, government sector debt should decrease in 2014 in relative terms to 43.9% of GDP, in 2015 it should further decrease to 42.2% of GDP.

Graph A.2.1: **Decomposition of the Government Balance**

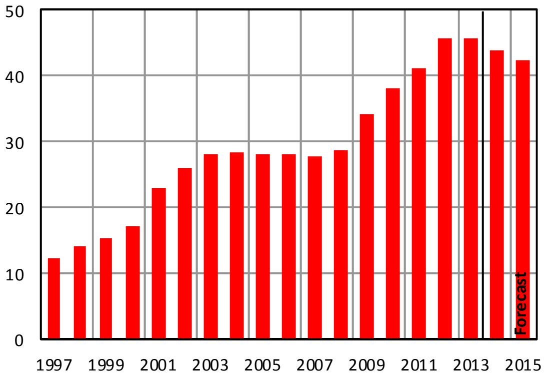
in % of GDP



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**

		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
									Prelim.	*Forecast*	*Forecast*
General government balance [1)]	*% GDP*	-2.3	-0.7	-2.1	-5.5	-4.4	-2.9	-4.0	-1.3	-1.5	-2.4
	bill. CZK	-79	-27	-85	-216	-175	-115	-162	-53	-64	-107
Cyclical balance	*% GDP*	1.0	1.5	1.4	-1.3	-0.6	-0.1	-0.6	-1.1	-0.5	-0.1
Cyclically adjusted balance	*% GDP*	-3.3	-2.2	-3.5	-4.3	-3.8	-2.7	-3.4	-0.2	-1.0	-2.3
One-off measures [2)]	*% GDP*	-0.7	-0.3	-0.1	0.0	0.0	-0.2	-2.0	-0.2	0.1	-0.3
Structural balance	*% GDP*	-2.6	-1.9	-3.4	-4.3	-3.8	-2.6	-1.4	0.0	-1.1	-2.0
Fiscal effort [3)]	*percent. points*	-0.9	0.7	-1.5	-0.9	0.5	1.3	1.1	1.4	-1.2	-0.9
Interest expenditure	*% GDP*	1.0	1.1	1.0	1.2	1.3	1.3	1.4	1.4	1.3	1.2
Primary balance	*% GDP*	-1.2	0.4	-1.1	-4.3	-3.1	-1.5	-2.5	0.0	-0.2	-1.2
Cyclically adjusted primary balance	*% GDP*	-2.3	-1.1	-2.5	-3.0	-2.5	-1.4	-1.9	1.2	0.2	-1.1
General government debt	*% GDP*	27.9	27.8	28.7	34.1	38.2	41.0	45.5	45.7	43.9	42.2
	bill. CZK	979	1 066	1 151	1 336	1 509	1 648	1 842	1 869	1 881	1 883
Change in debt-to-GDP ratio	*percent. points*	-0.1	-0.1	0.9	5.4	4.1	2.8	4.5	0.2	-1.8	-1.8

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 (–)

2) One-off and temporary measures are such measures that have only a temporary impact on public budgets. Besides their temporary impact on overall balance, these measures are usually of non-recurring nature and very often result from the events that are beyond the direct power of the government.

3) 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 macroeconomic 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 would again be able to use its standard instruments, the Bank Board of the CNB decided on 7 November 2013 to use the exchange rate as an additional monetary policy instrument. Interventions on the foreign exchange market (in the volume of approximately €7.5 billion) were carried out only in November 2013; 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 third quarter of 2014, the **3M** (3-month) **PRIBOR** interbank market rate averaged 0.35% (*in line with the forecast*). The 3M PRIBOR should remain at 0.4% on average also in 2014 and 2015 (*unchanged in both cases*).

With respect to very weak inflationary pressures and low primary interest rates, long-term interest rates still remain at historically low levels. With regard to the expected development of short-term interest rates, to the considerable demand for government bonds and the expected 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 1.4% (*versus 1.7%*) on average in the third quarter of 2014. For the whole of 2014 we forecast a value of 1.7% (*versus 1.9%*); long-term interest rates could remain at this level also in 2015 (*versus 2.4%*).

In July 2014, the CNB conducted another bank lending survey which concluded that in the second quarter of 2014 credit standards had eased for corporate loans, tightened for consumer loans to households and didn't change significantly for housing loans. The same direction of changes in credit standards was expected by banks also for the third quarter of 2014.

In connection with the development of primary interest rates, client interest rates are steady at very low values. In the second quarter of 2014, interest rates on household deposits remained unchanged from the previous quarter at 0.9%, and rates on company deposits did not change either, remaining at 0.3%. The rates on loans to households decreased by 0.1 pp QoQ to 5.7%; the rates on loans to non-financial corporations also decreased by 0.1 pp to 3.0%.

Growth in loans to households, driven mainly by housing loans, has now been relatively low for a long time (see Graph A.3.2). Consumer loans have been slightly decreasing recently, although the volume of the so-called "other loans", which include e.g. loans to sole traders, rises. Loans to non-financial corporations have seen a YoY decrease in the recent quarters, although foreign currency loans recorded a pronounced increase. However, there was a one-off surge in the rate at which these loans were taken out shortly after the aforementioned exchange rate commitment was introduced.

The share of non-performing loans is slightly decreasing. In the second quarter of 2014 it reached 4.9% for households (0.1 pp less QoQ, 0.3 pp less YoY), and decreased to 7.2% for non-financial corporations (QoQ stagnation, 0.4 pp less YoY).

The Prague Stock Exchange Index PX oscillated around 1,000 points in the second half of September 2014, which represented QoQ stagnation and slight YoY growth.

Exchange Rates

Except for August and the beginning of September 2014, the CZK/EUR exchange rate has been hovering around the level of 27.50 CZK/EUR since the beginning of 2014. The koruna weakened to this level after the CNB started using the exchange rate as an additional monetary policy tool at the beginning of November 2013 (see above). For the first three quarters 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, as well as its exit strategy, have had to be made. Based on the available information (especially the CNB's statement that it will not stop using the exchange rate as a monetary policy instrument before 2016), we have made a technical assumption that the exchange rate will remain stable at 27.5 CZK/EUR until the end of the second quarter of 2016. Subsequently, the koruna should again start strengthening slightly against the euro, approximately by 0.5% QoQ. This is in accordance with the CNB's statement that it will not allow considerable appreciation of the koruna after discontinuing the exchange rate commitment.

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

		2006	2007	2008	2009	2010	2011	2012	2013	2014 *Forecast*	2015 *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	1.7	1.7
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

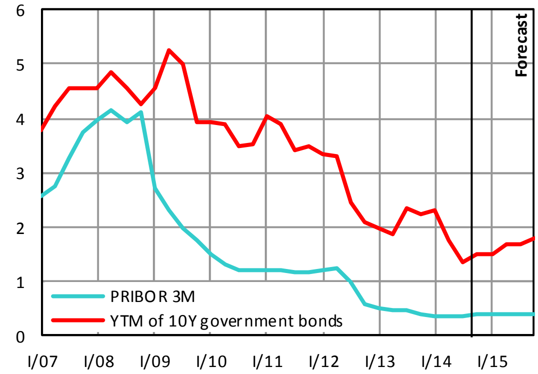
Table A.3.2: **Interest Rates, Deposits and Loans** – quarterly

		2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4 *Forecast*
Repo 2W rate CNB (*end of period*)	*in % p.a.*	0.05	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	0.05	.
Federal funds rate (*end of period*)	*in % p.a.*	0.25	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	0.35	0.4
YTM of 10Y government bonds	*in % p.a.*	1.98	1.88	2.35	2.24	2.30	1.76	1.36	1.5
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**

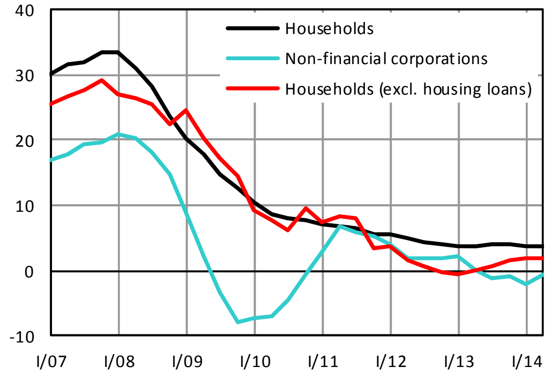
in % p.a.



Source: CNB, own calculations

Graph A.3.2: **Loans**

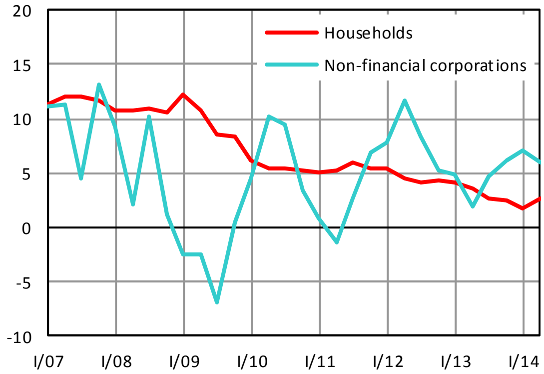
YoY growth rate, in %



Source: CNB, own calculations

Graph A.3.3: **Deposits**

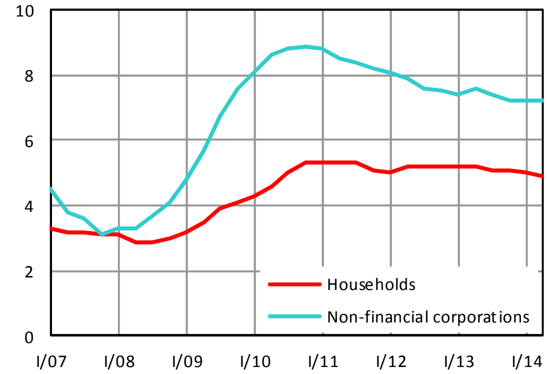
YoY growth rate, in %



Source: CNB, own calculations

Graph A.3.4: **Non-performing Loans**

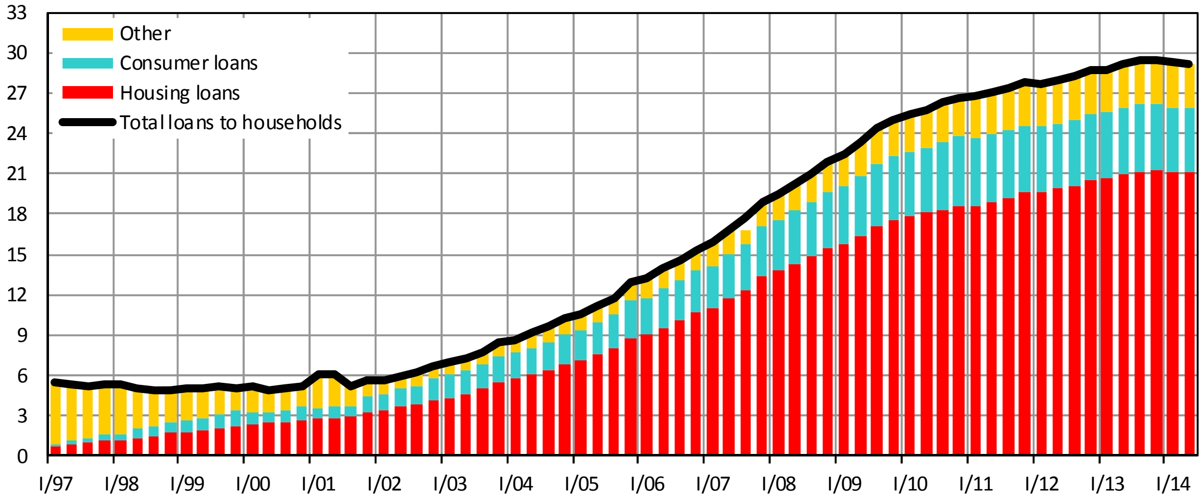
ratio of non-performing to total loans, in %



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 *Forecast*	2015 *Forecast*	2016 *Outlook*	2017 *Outlook*
Nominal exchange rates:											
CZK / EUR	*average*	**24.96**	**26.45**	**25.29**	**24.59**	**25.14**	**25.98**	**27.5**	**27.5**	**27.4**	**26.9**
	appreciation in %	11.3	-5.6	4.6	2.8	-2.2	-3.2	-5.5	0.0	0.4	1.9
CZK / USD	*average*	**17.06**	**19.06**	**19.11**	**17.69**	**19.59**	**19.57**	**20.5**	**21.2**	**21.1**	**20.7**
	appreciation in %	19.0	-10.5	-0.3	8.0	-9.7	0.1	-4.6	-3.0	0.4	1.9
NEER	*average of 2010=100*	**101.2**	**98.0**	**100.0**	**103.1**	**99.5**	**97.3**	**93**	**92**	**93**	**94**
	appreciation in %	11.7	-3.2	2.1	3.1	-3.5	-2.2	-4.8	-0.3	0.4	1.9
Real exchange rate to EA12[1)]	*average of 2010=100*	**102.0**	**97.8**	**100.0**	**101.4**	**99.3**	**96.3**	**92**	**93**	**93**	**95**
	appreciation in %	11.4	-4.1	2.3	1.4	-2.1	-3.0	-4.3	0.7	0.3	1.9
REER	*average of 2010=100*	**102.7**	**98.9**	**100.0**	**102.0**	**99.1**	**96.9**	**.**	**.**	**.**	**.**
(Eurostat, CPI deflated, 37 countries)	*appreciation in %*	14.9	-3.7	1.1	2.0	-2.9	-2.3	.	.	.	.

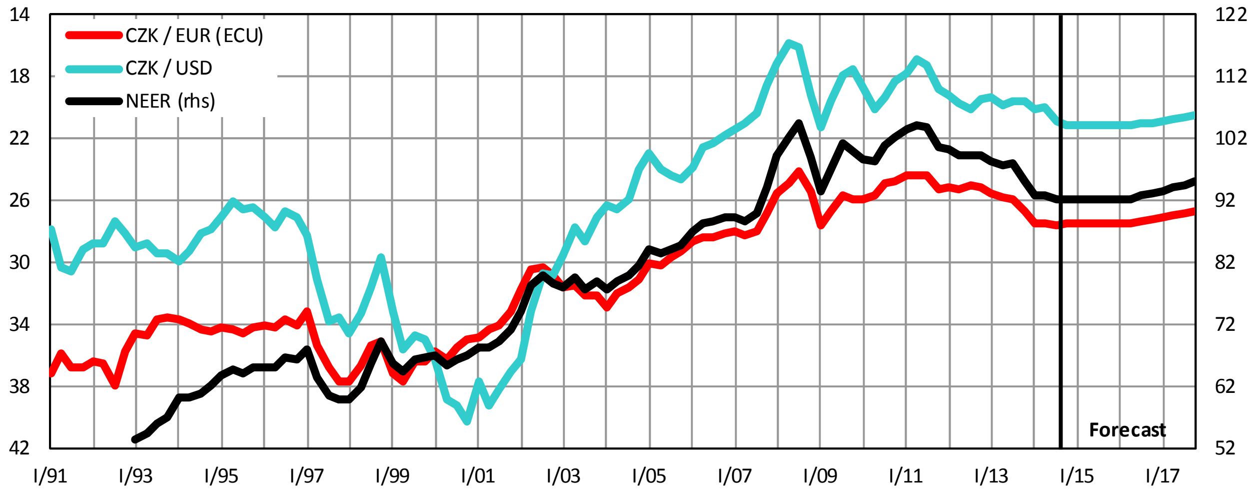
Source: CNB, Eurostat, own calculations
1) Deflated by GDP deflators.

Table A.3.4: **Exchange Rates** – quarterly

		2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3 *Estimate*	2014 Q4 *Forecast*
Nominal exchange rates:									
CZK / EUR	*average*	**25.57**	**25.83**	**25.85**	**26.66**	**27.44**	**27.45**	**27.62**	**27.5**
	appreciation in %	-1.9	-2.2	-3.0	-5.6	-6.8	-5.9	-6.4	-3.1
CZK / USD	*average*	**19.37**	**19.78**	**19.52**	**19.59**	**20.04**	**20.02**	**20.84**	**21.2**
	appreciation in %	-1.2	-0.3	2.8	-0.9	-3.3	-1.2	-6.4	-7.4
NEER	*average of 2010=100*	**98.4**	**97.6**	**98.0**	**95.1**	**93.0**	**93.0**	**92.1**	**92**
	appreciation in %	-1.7	-1.7	-1.3	-4.1	-5.5	-4.7	-6.0	-3.0
Real exchange rate to EA12 [1)]	*average of 2010=100*	**97.2**	**96.6**	**96.6**	**94.9**	**91.8**	**92.3**	**91**	**93**
	appreciation in %	-1.9	-2.4	-2.9	-4.8	-5.6	-4.4	-5.3	-1.9
REER	*average of 2010=100*	**98.3**	**97.2**	**97.4**	**94.4**	**93.0**	**.**	**.**	**.**
(Eurostat, CPI deflated, 37 countries)	*appreciation in %*	-2.1	-1.9	-1.3	-3.9	-5.4	.	.	.

Source: CNB, Eurostat, own calculations
1) Deflated by GDP deflators.

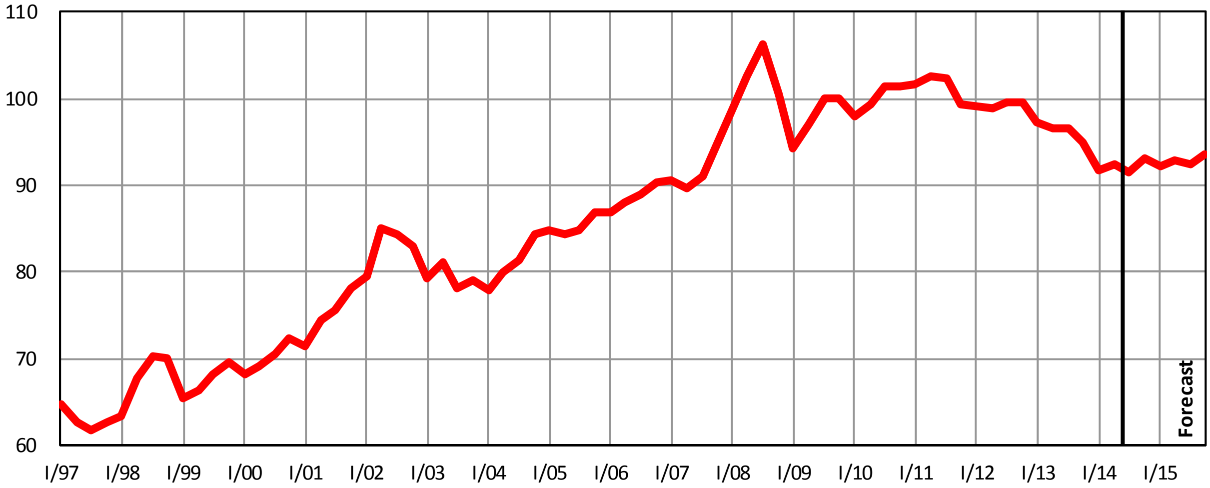
Graph A.3.6: **Nominal Exchange Rates**
quarterly averages, average 2010=100 (rhs)



Source: CNB, own calculations

Graph A.3.7: **Real Exchange Rate to EA12**

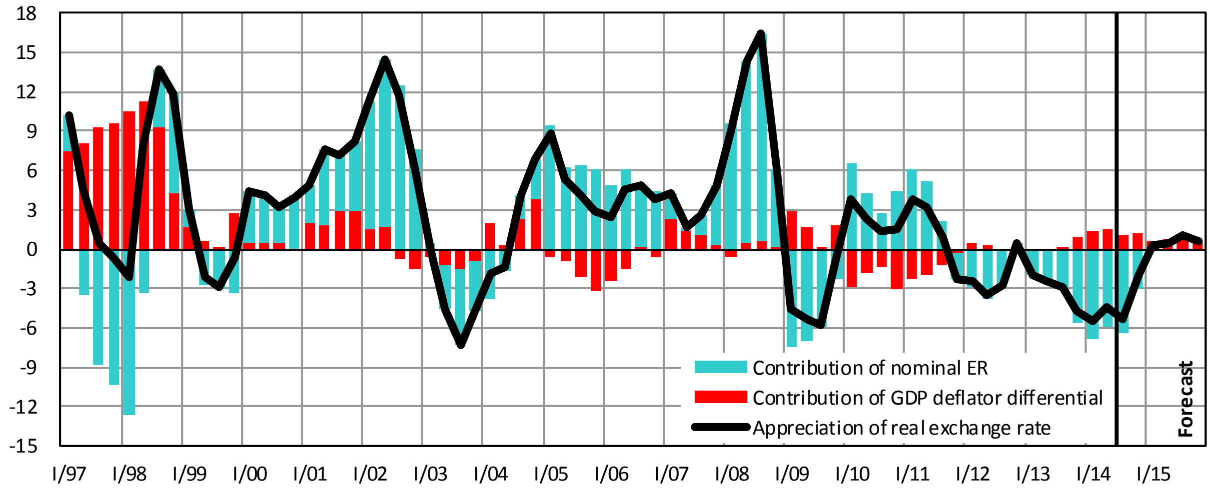
quarterly averages, deflated by GDP deflators, average 2010=100



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

Business Environment

On 3 September 2014, the government approved **the amendment to the Act on Investment Incentives,** thereby introducing new stimuli and at the same time removing some limiting conditions from the investment incentive system. The amendment extends the number of regions in which material support will be provided for creating new jobs and the requalification or training of employees. In this connection, it introduces the concept of Special Economic Zones, in which the subsidy for a newly created job will be up to CZK 300,000 and exemption from property tax will stretch up to 5 years for new corporations. Investment incentives will also now be provided to data centres and call centres that create more than 500 jobs. In contrast, the requirement for the minimum number of newly created jobs will decrease for projects involving technological and strategic services centres, and the 75% limit on the maximum rate of support for low-tech sectors will be abolished. The amendment should come into effect on 1 January 2015.

The amendment to the Act on Public Contracts approved by the government on 3 September 2014 extends the criteria applicable to selecting the economically most suitable bid to include other partial evaluation criteria (assessment of the organization, qualifications and experience of employees or the impact on employment of persons with more difficult access to the labour market). The amendment also cancels the obligation of the contracting authority to annul the tender procedure in the case of only one bid. The amendment is scheduled to come into effect on 1 January 2015.

In order to increase the quality, effectiveness and transparency of public administration, on 27 August 2014 the government established the Government Council for Public Administration and approved the **Strategic Framework for the Development of Public Administration of the Czech Republic for 2014–2020**. Its defined strategic targets include the modernization and revision of public administration, the optimization of its performance across the country, increasing accessibility and transparency using eGovernment tools and the professionalization and development of human resources in the sector.

Taxes

The amendment to the Act on Value Added Tax approved by the Chamber of Deputies on 24 September 2014 introduces second reduced value added tax rate of 10% on drugs, books and essential infant nutrition. The amendment should be effective from 1 January 2015.

In order to improve the collection of taxes, on 27 August 2014 the government approved another **amendment to the Act on Value Added Tax** establishing the institute of inspection reports, introducing temporary reverse charge for selected goods or services, and retaining the turnover limit of CZK 1 million per year for obligatory registration for value added tax. The amendment is scheduled to come into effect on 1 January 2015, in respect of inspection reporting from 1 January 2016.

On 16 September 2014, the President of the Czech Republic signed **the amendment to the Act on Excise Taxes**. In response to the weakening of the CZK/EUR exchange rate, the amendment regulates 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. At the same time, the amendment reintroduces the refund of the mineral oils tax for persons using these oils in agricultural primary production in the amount of 40% and 57%. The amendment will be effective as of 1 December 2014.

The amendment to the Act on Excise Taxes aimed at limiting tax fraud was approved by the government on 27 August 2014. The amendment introduces a register of persons dealing with special mineral oils for persons acquiring these oils as bulk goods or placed in packaging exceeding 220 litres. The amendment is scheduled to come into effect on 1 January 2015.

On 24 September 2014, the Chamber of Deputies approved the **amendment to the Act on Income Taxes**. Tax credits for a second child will increase annually by CZK 2,400 and for a third and any additional child by CZK 3,600. The current lump-sum expenses in the amount of 80% and 60% will be preserved, but the absolute amount of deduction using the lump-sum will be limited by the amount of CZK 1.6 million and CZK 1.2 million, respectively. 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.

Financial Markets

The **Act amending Certain Acts in Connection with Establishing Access to and Supervision of the**

Activities of Banks, Savings Banks and Credit Unions as well as Securities Dealers came into effect on 22 July 2014. The Act implements the EU Directive on the access to the activity 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 capital endowment and limit systemic risks. Simultaneously, 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. Some selected parts of the act will come into effect as late as on 1 January 2015 and 1 January 2016.

In order to reduce the risk of corruption, on 24 September 2014 the Chamber of Deputies 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, whereby 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 26 September 2014, the Chamber of Deputies 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. A sanction can be imposed on operators if they breach this duty. The amendment is scheduled to come into effect on 1 January 2015.

Education, Science and Research

On 27 August 2014, the government approved **an amendment to the Education Act**. The amendment regulates conditions for education of students with special educational needs, adjusts the position of head teachers and establishes a register of pedagogical employees that should provide information on the status and development of the pedagogical profession. The amendment also introduces uniform final examinations of secondary education subjects with certificate of apprenticeship, and extends the competences of preparation classes of basic schools. The act is scheduled to come into effect on the first day of the calendar month following its announcement, and some selected parts of it on 1 September 2015 and 1 September 2016.

On 9 July 2014, the government approved the **Education Policy Strategy of the Czech Republic until 2020**, defining the basic framework for the further development of education. The Strategy defines three basic cross cutting priorities: reducing inequality in education, supporting high-quality teaching and teachers as its key prerequisite and the effective management of the education system.

Labour Market

The amendment to the Employment Act signed by the President of the Czech Republic on 8 July 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 of CZK 500. In contrast, the amount for placing an unemployed person in work will increase from CZK 1,250 to a maximum of CZK 6,250, provided such person stays in the job for at least 6 months. The amendment will be effective as of 1 January 2015.

On 3 September 2014, the government approved **an amendment to the Employment Act** which withdrew the possibility of awarding and providing unemployment benefits to job applicants who occupy a position as member of a trading company or cooperative. The amendment is scheduled to come into effect on 1 January 2015.

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 23 September 2014 the Chamber of Deputies once again 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 such service can be the employer of a parent, a church, local government unit, a generally beneficial company, foundation, university or association.

By the **Government Order on Minimum Wage** of 15 September 2014, the minimum wage will increase by CZK 700 to CZK 9,200 as of 1 January 2015.

Social and Health Care Systems

The draft Bill on Pension Insurance which came into effect on 1 September 2014 regulates the rules for the 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%.

In order to support families with small children, on 24 September 2014 the Chamber of Deputies 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.

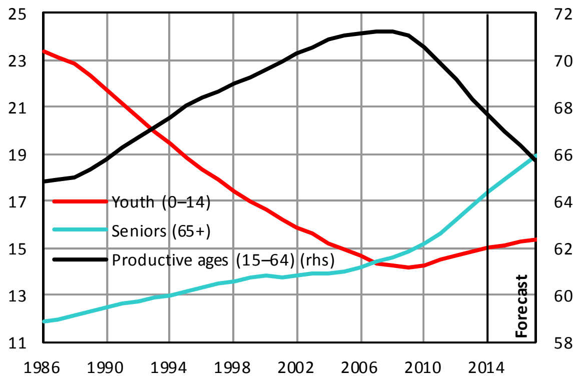
The amendment to the Act on Public Health Insurance approved by the Chamber of Deputies on 26 September 2014 cancels fees for prescriptions and outpatient treatment. The amendment is scheduled to come into effect on 1 January 2015.

A.5 Demographic Trends

In mid-2014, 10,522 million people lived in the Czech Republic. Its population increased by 9 thousand during the first half of 2014.

This renewed rise in population is mainly due to higher immigration. Twenty-three thousand persons moved from abroad (9 thousand more than in the first half of 2013). In the first half of 2014, the net migration rate again returned to positive figures (+8 thousand). The highest balance was for citizens of Slovakia (3 thousand) and Russia. As far as citizens of Ukraine are concerned, the number of persons who moved both in and out of the country was high, with roughly zero balance. It cannot yet be concluded with certainty whether this renewal of positive net migration is a one-off occurrence, or if the Czech Republic is again becoming a target of migration flows.

Graph A.5.1: **Age Groups**
structural shares in %

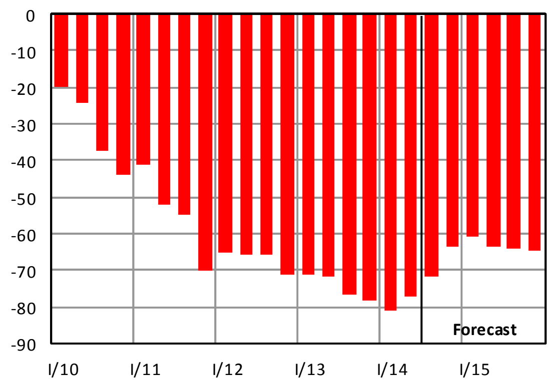


Source: CZSO, own calculations

The number of births (53 thousand) was similar to that of the same period in 2013, but the number of deaths was approximately 5 thousand lower in a year-on-year comparison.

As far as the age structure is concerned, in the second quarter of 2014 there was a relatively pronounced slowdown in the YoY decline in **population aged 15–64 years** (see Graph A.5.2), probably thanks to migration. 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 age 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

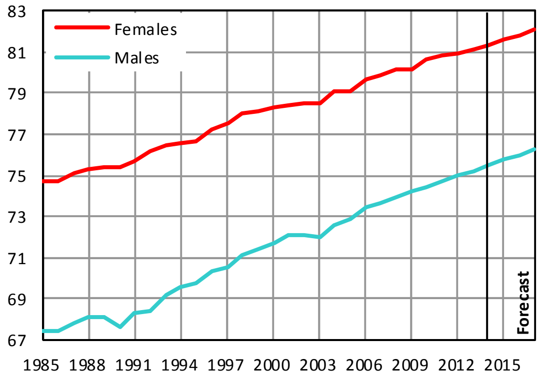
Also in the following years, in absolute terms the working-age population should continue to decline by approximately 60–70 thousand people a year, which is an annual decrease of just below 1%. The economic impacts of this situation are described in more detail in Chapter B.1.

In contrast, the structural proportion of **persons aged over 64 years** in the total population reached 17.4% at the beginning of 2014 and should regularly increase by approximately 0.5 pp annually. The number of seniors in the population is significantly increasing due to demographic structure and the ongoing rise in life expectancy. The number of persons in this category should approach 2 million at the end of the outlook horizon, i.e. at the beginning of 2017. From the perspective of pension system sustainability, however, increases in retirement age are adequate to match the prolonging life expectancy in the next 20–25 years.

It has become clear that the stagnation in the number of **old-age pensioners** from the beginning of 2012 until the end of 2013 was a temporary phenomenon caused by a change in the rules for calculating pensions during the parametric change in the pension system in 2011. YoY growth in the number of old-age pensioners reached 13 thousand at the beginning of July 2014. At the same time, the number of pensioners with reduced pensions following early retirement is continuing to rise quite dynamically (by 20 thousand), while the decline in the number of pensioners entitled to a full pension has slowed down to 7 thousand. The share of reduced pensions has already reached 24.0%, compared to 19.0% at the end of 2009.

Graph A.5.3: **Life Expectancy**

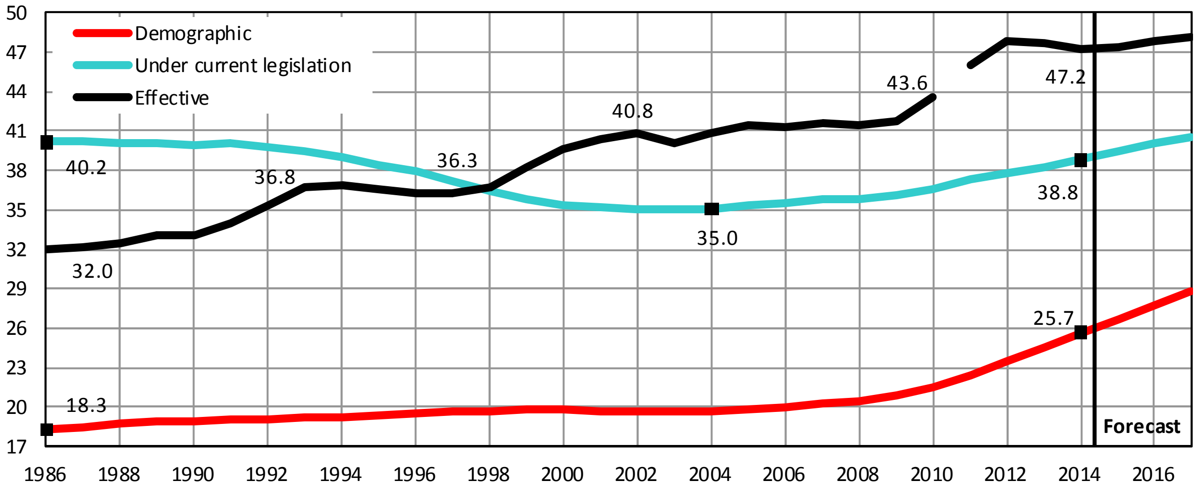
in years



Source: CZSO

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



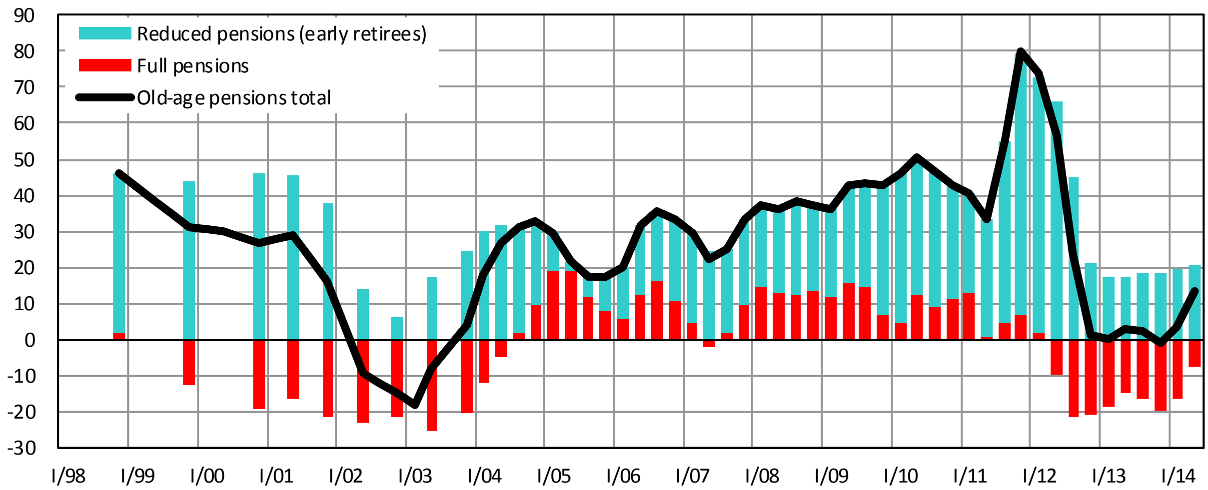
Source: CZSO, own calculations

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**	**10 523**	**10 527**	**10 529**
growth in %	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**	**1 606**	**1 615**
growth in %	-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**	**7 047**	**6 983**	**6 917**
growth in %	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**	**1 882**	**1 939**	**1 997**
growth in %	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**	**2260**	**2340**	**2341**	**2340**	**2 358**	**2 383**	**2 406**
growth in %	1.8	2.0	2.1	.	3.5	0.1	0.0	0.8	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**	**39.4**	**40.0**	**40.5**
Effective [4)]	**41.5**	**41.8**	**43.6**	**45.9**	**47.9**	**47.6**	**47.2**	**47.4**	**47.8**	**48.2**
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**	**10**	**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**	**13**	**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.5.5: **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.