A Forecast Assumptions

Sources of tables and graphs: CNB, CZSO, ECB, Eurostat, Ministry of Finance of the Czech Republic, IMF, OECD, The Economist, own calculations.

A.1 External Environment

Economic output

Contrary to the previous forecast, the outlook for the world economy is more varied. In the USA, the recovery is continuing, the outlook is no longer burdened by uncertainties connected to the presidential election, while the so-called fiscal cliff issue has also been partially resolved. In China, the growth rate has declined in conjunction with the global slowdown, however, economic output is keeping to the plan while strengthening domestic consumption is most likely opening the era of a weaker, but more stable GDP growth. In the euro zone, the situation has calmed down partially, linked to reduced risk of the Euro collapsing and escalation of the situation in Greece.

The output of the **US economy** increased in Q3 2012 by 0.7% QoQ (*versus 0.4%*). Growth was driven especially by household consumption, however, consumer confidence has slowed down over the past months. A favourable situation can be seen on the stock markets – the Dow Jones index has returned, after experiencing a decline during the 1st half of Q4, to the level around 13,000 points. The economy is probably entering a period of growth, suggested by the development of new purchase orders in industries. On the property market, house prices have been increasing now for 7 months in a row, which may be interpreted as a sign of expectation of more permanent recovery.

The Unites States are at the beginning of energetic sector expansion. Growing oil and gas production is linked to reducing energetic costs of production which should contribute to increasing USA appeal for investors. This is positively reflected in the unemployment rate which stood at 7.8% in December; the lowest rate for the last four years.

The economy is supported by the Fed's highly accommodative monetary policy. In September 2012, the Fed already started the third round of quantitative easing. Interest rates continue to be "at zero" (or within 0–0.25%) and they should remain at this level, according to an announcement by the Fed, until the unemployment rate (for the larger part likely to be of a cyclical nature) falls below 6.5%.

Uncertainty taking shape at the end of the last year due to automatic cuts in federal spending (the "fiscal cliff") was temporarily resolved by an agreement in the Congress.

For 2013 we have kept our estimate for economic growth at 2.1%, for 2014 we expect growth at 3.0%.

The **economy of the euro zone (EA12)** showed a QoQ decline of 0.1% (*versus 0.2%*) in Q3 2012. The decline in household consumption in the first half of 2012 came to a halt in Q3. The major cause behind weak consumption and declining investments can be attributed to savings policies, which focus on public finance consolidation, and to the related growth of a tendency towards savings. Only net exports practically contributed positively to growth which was not able, however, to compensate for weak domestic consumption and investment.

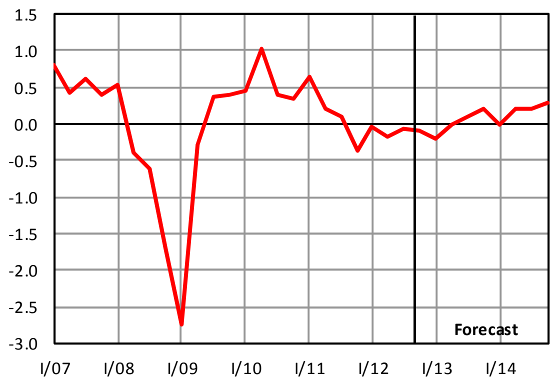
There are still big differences among individual countries. The euro zone continues to be driven by Germany where, together with export, household consumption has also been increasing. However, 60% of German exports are directed to the EU. Therefore, it is a question of time when the slowdown starts to become apparent as a consequence of weak output within the rest of the euro zone and the EU as a whole. Although Germany surprised once again with its resistance towards euro zone recession, we anticipate a slowdown at the turn of 2012 and 2013. Last estimates of the German government suggest identically that the variant of a "soft landing "is expected.

The French economy, which has been *de facto* stagnating since Q2 2011, could see a slight recovery at the end of this year. The large economies of Italy and Spain and four other countries of the EA remain in recession. The British economy emerged from recession in Q3, supported, however, by one-off impulse – the Olympic Games.

The divergence in the development of the euro zone can be seen best, as usual, in the case of the unemployment rate. In November, it already increased to 11.8%, which represented a YoY increase of 1.2 p.p. The highest unemployment rate was in Spain (26.6%), followed by Greece (26.0%, however, the data relates to September), Portugal (16.3%), Ireland (14.6%), and Slovakia (14.5%). On the contrary, the unemployment rate in Germany gradually declined up to 5.4%. In addition to the economic dimension, the situation on the labour market also assumes a political dimension. High unemployment rates have unfavourable implications e.g. for household consumption, which considerably complicates government efforts to consolidate public finances.

Graph A.1.1: **Growth of GDP in EA12**

QoQ growth in % (adjusted for seasonal and working day effects)



We estimate that in 2012 the euro zone's economy decreased by 0.4% (*versus 0.5%*). This year, the economic output of the euro zone could decrease by 0.2% (*versus 0.3%*), however, in 2014 GDP could already grow by 0.5%.

In Q1 2012, YoY growth of **the Polish economy** started slowing down more considerably. One of the causes of the slowdown is the lowest consumption growth since the 1990s, induced by a decrease in real wages and an increase in household savings; in Q3, the slowdown turned into stagnation. Another factor is a decline in public investment and stagnation in construction (after the European Football Championship). Last but not least, Polish firms are being discouraged from investing by the weak output of the euro zone. In 2012, there was nearly 10% appreciation of złoty vis-à-vis the euro, which has unfavourable consequences for exporters. The pressure on the central bank to continue cutting rates is mounting. The economy's slowdown left its mark on the revision of the growth estimate for 2012 to 2.3% (*versus 2.5%*). For 2013 we expect growth at 1.9% (*versus 2.9%*).

In Q3 2012, QoQ growth of **the Slovak economy** reached 0.5% (*consistent with the forecast*). The economy was driven nearly exclusively by car exports. On the contrary, household consumption decreased at the end of the year. Unemployment rate, which has been rising since the beginning of 2012 despite relatively strong GDP growth, is now the fifth highest in the euro zone. Economic growth has likely peaked. We have lowered the estimate for growth in 2013 to 1.7% (*versus 2.1%*).

Commodity prices

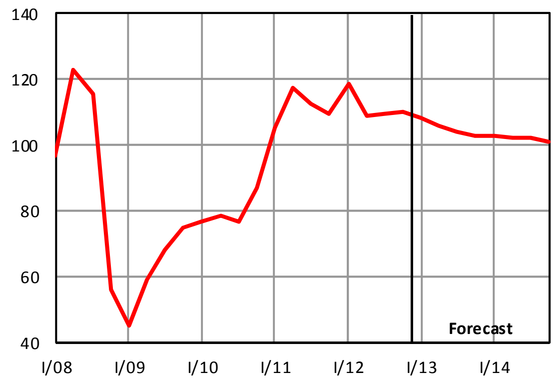
In Q4 2012, the price of Brent crude oil reached an average of USD 110 per barrel (*versus USD 114*) and thus remained unchanged in comparison with Q3. In Q4 of the last year, expectations regarding the impact of quantitative easing and geopolitical risks in the Near East were not met. In 2012, the average daily price of Brent crude oil was USD 111.8 per barrel, a historically record-breaking average price of crude oil.

Compared to 2011, the prices of crude oil showed higher volatility in the last year, especially in Q1 and Q2. Generally, the trend of gradual price growth in 2009 and 2010 turned in stagnation in 2011 and 2012. In 2012, especially unrest in the Middle East, growth of marginal costs of production and, last but not least, threat of a fiscal crisis in the USA were driving price increases. Targeting the price by some important producers, especially Saudi Arabia, increasing production and reserve capacities as well as the recession in the euro zone had the opposite effect.

In 2013, we expect to see a decrease in the average daily price to USD 105 per barrel (*versus USD 115*), especially as a result of a slowdown in global demand for crude oil caused by the assumed slowdown in the global economy, the growth of production capacities (especially the USA) and possible release of strategic reserves. Rising marginal costs of production and the necessity of oil economies in the Middle East to balance their budgets should take effect against a more significant price decrease.

Graph A.1.2: **Dollar Prices of Brent Crude Oil**

in USD per barrel



After a significant growth of cereals prices at the turn of last year's Q2 and Q3 resulting from unfavourable weather, gradual downward correction of prices could have been observed in the remaining part of the year. The main causes of the decline were revisions to the stock of global reserves, a decline in demand for cereals at the end of the year and higher than originally expected production of some important producers. Nevertheless, prices have not yet reached the level of Q1 and Q2 2012. In H1 2013, we expect to see stagnation or a slight decline in prices related to an update of the stock of global reserves. For the prices in H2 2013, long-term weather forecasts and the extent of their fulfilment will be crucial.

Debt crisis in the euro zone

Since the publication of the October 2012 Macroeconomic Forecast, the debt crisis in the euro zone was characterized mainly by searching for (and ultimately reaching) a consensus regarding further fate of the Second Economic Adjustment Programme for Greece, the related exchange of Greek government bonds, reaching an agreement on creating the Single Supervisory Mechanism (SSM) over banks in euro zone countries and, last but not least, also ongoing restructuring of the Spanish banking sector.

After long negotiations with representatives of the IMF, the ECB and the EC (the so-called "Troika"), the first review of the adjustment programme for Greece was concluded. Compared to its original form from February 2012, certain changes to the programme have been made, reflecting both much worse than originally expected macroeconomic development and certain delay in implementing some measures. For example, there was a change to the programme's fiscal targets – Greece does not need to achieve primary surplus of 4.5% of GDP already in 2014, but as late as in 2016 (for 2014, primary surplus of 1.5% of GDP is now assumed).

However, mitigation of fiscal consolidation, together with deteriorated economic outlook, will have a negative impact on the trajectory of government sector debt that, under original assumptions, should have reached 120.5% of GDP by 2020. According to current calculations, the government sector debt should reach 175% of GDP in 2016, though it should decline to 124% of GDP by 2020 and in 2022 it should not exceed 110% of GDP. However, accomplishing these targets, i.e. ensuring sustainability of the government debt (at least "on paper"), should be helped by measures, on which the finance ministers of the euro zone agreed at the end of November.

These measures include, for instance, a decrease in interest rates on bilateral loans granted as part of the first bailout programme (Greek Loan Facility) by 1 p.p. and an extension of their maturity by 15 years; a decrease in interest rates on loans from the EFSF by 0.1 p.p., extension of maturity of these loans by 15 years and deferral of interest payments by 10 years; transfer of the income on the Eurosystem's Securities Markets Programme portfolio of Greek government bonds to the segregated account for servicing the Greek debt; and last but not least, also the buyback of Greek debt.

The buyback offer, applying to the government bonds held by private investors (nominal value of those bonds was EUR 61.4 billion), was announced by Greece on 3 December. Those investors who had accepted this offer, received – in exchange for the Greek government bonds with face value of EUR 31.9 billion (due in 2023–2042) – six-month EFSF bills with nominal value of EUR 11.3 billion. Therefore, Greece has succeeded in accomplishing the original target of EUR 30 billion, on the other hand, it had to offer a higher price (on average 33.8% of the nominal value of bonds) than originally expected.

In reaction to the Greek debt buyback offer, the S&P agency downgraded Greece to SD (selective default). After completing the bond exchange (18 December), however, the agency increased the rating to B− (i.e. higher than the original CCC) and, in addition, it assigned stable outlook to the rating.

However, the buyback, or its success, was above all a key condition for the long postponed release of another tranche of financial aid from the second adjustment programme. The Executive Board of the IMF has not decided yet in this matter (it is expected to do so in the course of January), nevertheless, representatives of the euro zone already authorised releasing EUR 49.1 billion on 13 December. Still in December last year, Greece received EUR 34.3 billion from the EFSF (in the form of securities issued by the EFSF, EUR 16 billion went on recapitalizing banks and EUR 11.3 billion on financing the bond buyback), the remaining EUR 14.8 billion should be released during Q1 this year. Of this sum, EUR 7.2 billion devoted to bank recapitalization (aid will be provided in the form of securities issued by the EFSF) should be released in January, the remaining funds (EUR 7.6 billion) should be paid out in three sub-tranches, the release of each of which will be conditioned by the implementation of measures, on which Greece had agreed with the "Troika".

Restructuring of the Spanish banking sector is continuing in line with the Memorandum of Understanding. The banks, in which The Fund for Orderly Bank Restructuring (FROB) at the end of November had majority capital stake (BFA-Bankia, Catalunya Banc, Novagalicia Banco and Banco de Valencia), transferred problematic assets worth EUR 45 billion to the newly founded "bad bank" (Asset

Management Company for Assets Arising from Bank Restructuring; the so-called Sareb). The other banks to use state aid as part of restructuring should transfer problematic assets (max. to the value of EUR 45 billion) to the "bad bank" during the course of H1 2013.

At the end of November last year, the FROB, the Spanish central bank (Banco de España) and the EC approved restructuring plans of the aforementioned banks. In relation to this step, on 5 December the ESM issued bills and bonds with face value totalling EUR 39.5 billion. Out of this sum, the aforementioned banks at the end of December received EUR 37 billion via FROB, which will use the remaining EUR 2.5 billion to capitalize the "bad bank".

Certain progress has been made concerning the issue of the so-called banking union in the euro zone. At an extraordinary meeting held on 12 and 13 December, the finance ministers of the EU countries succeeded in approving the common position on legislative drafts through which the so-called Single Supervisory Mechanism (SSM) should be established. The SSM will consist of the ECB and national supervisory authorities of the participating countries. In close co-operation with the national supervisory authorities, the ECB should perform supervision over ca 150–180 banks in the euro zone. The conduct of supervision by the ECB is to be strictly separated from its monetary policy functions; for this purpose, a new authority – the supervisory board – is to be established within the ECB. The states outside the euro zone will also be able to participate in the SSM, based on the agreements on close co-operation. The ECB is to assume its supervisory powers on 1 March 2014 at the earliest. However, the ECB will be allowed to perform entrusted tasks immediately, provided the ESM asks the ECB for it unanimously. Negotiations with the European Parliament were initiated with the aim of approving the mentioned legal acts as soon as possible.

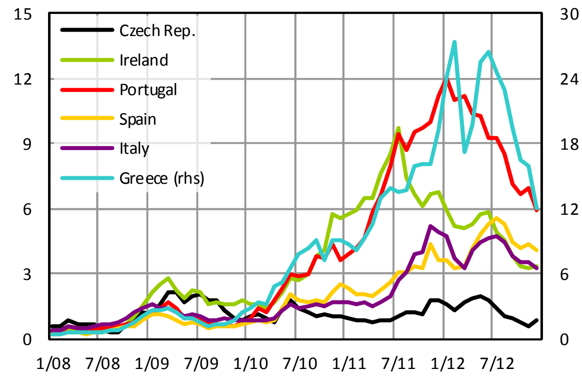
However, the Single Supervisory Mechanism will only be one element of the planned banking union, from which the political representation expects weakening of negative feedback loops between banks and the government sector. A necessary condition for creating the full banking union will be, among others, finding political consensus concerning the single deposit insurance system and the single framework for bank restructuring and/or resolution. Especially the last named point can appear as problematic, as restructuring of banks can be very costly, while willingness of the individual states to share these costs, on the contrary, very low.

Out of other events that have occurred since the publication of the October Forecast, let us also mention that in November, Moody's downgraded France by one notch (from the highest Aaa to Aa1, a negative outlook). Following the downgrade of France, the same agency also slashed the rating of the EFSF and the ESM by one notch, from the highest Aaa to Aa1 (the outlook in both cases was negative). However, for now it does not seem that this step would negatively influence the picture of bailout funds in the eyes of investors, at least judging from the result of the January auction of 3M bills issued by the ESM (the bid/cover ratio exceeded 3, the yield was even slightly negative!).

Since the publication of the last Forecast, the situation in the euro zone has once again calmed down slightly, as evidenced e.g. by the development of government bond yields (see Graph A.1.3). However, we cannot fully rule out the possibility of escalation of the debt crisis in the future, even though the risks have declined compared to the last forecast.

Graph A.1.3: **Spreads over German Bonds**

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



The implementation risks of the second adjustment programme for Greece are considerable (political will for pushing through further austerity measures can be missing), fully meeting the programme conditions, however, goes hand in hand with continuing fiscal consolidation (though slightly more gradual), which could push Greek economy further into depression. For the sake of completeness, let us remind that the current experience of Greece with fiscal consolidation quite clearly shows that fiscal multipliers can be unpleasantly high.

The third and fourth largest economies of the euro zone, i.e. Italy and Spain, are undergoing a recession, accompanied, in the case of the latter country, with an extremely unfavourable situation on the labour market. This situation will show itself more and more, among others, in the quality of balance sheets of banks (the growth of non-performing loans), which represent another weak point of the Spanish economy. So far, the restructuring of the Spanish banking sector has been going in line with the original plans, though one still cannot rule out the possibility of seeing some negative surprises in the future. In Italy, after Mr Monti's resignation as the Prime Minister, there is a political risk connected with the results of the early parliamentary elections scheduled for February.

Negotiations on the bailout programme for Cyprus have not yet been successfully concluded (the bailout should amount to EUR 17 billion, devoted to a large extent to recapitalizing banks, which have been affected by the "voluntary" Greek government bonds write-off). The Cypriot economy may well be insignificant, compared to the size of the economy of the euro zone, however, a "non-agreement" over the bailout programme could send a negative signal to the financial markets.

As a small open economy with very strong links to EU countries, the Czech Republic would understandably be negatively affected by a possible escalation of the debt crisis (the impact on expectations of households and firms, decrease in foreign demand). The main advantage of the Czech Republic is, however, the high resilience of its banking sector towards negative shocks and the credibility of its fiscal policy, as evidenced e.g. by the very low yields on government bonds.

Table A.1.1: **Real Gross Domestic Product** – yearly
growth in %, seasonally unadjusted data

	2005	2006	2007	2008	2009	2010	2011	2012 *Estimate*	2013 *Forecast*	2014 *Forecast*
USA	3.1	2.7	1.9	-0.3	-3.1	2.4	1.8	2.2	2.1	3.0
China	11.3	12.7	14.2	9.6	9.2	10.4	9.1	7.9	7.9	7.7
EU27	2.1	3.3	3.2	0.3	-4.3	2.0	1.5	-0.3	-0.1	0.6
EA12	1.7	3.2	3.0	0.3	-4.4	2.0	1.4	-0.4	-0.2	0.5
Germany	0.7	3.7	3.3	1.1	-5.1	4.2	3.0	0.9	0.6	1.9
France	1.8	2.5	2.3	-0.1	-3.1	1.7	1.7	0.1	0.1	0.5
United Kingdom	2.8	2.6	3.6	-1.0	-4.0	1.8	0.8	0.0	1.0	1.5
Austria	2.4	3.7	3.7	1.4	-3.8	2.1	2.7	0.6	0.9	1.5
Hungary	4.0	3.9	0.1	0.9	-6.8	1.3	1.6	-1.3	0.5	1.0
Poland	3.6	6.2	6.8	5.1	1.6	3.9	4.3	2.3	1.9	2.8
Slovakia	6.7	8.3	10.5	5.8	-4.9	4.2	3.3	2.5	1.7	3.0
Czech Republic	6.8	7.0	5.7	3.1	-4.5	2.5	1.9	-1.1	0.1	1.4

Graph A.1.4: **Real Gross Domestic Product**
YoY growth in %, seasonally unadjusted data

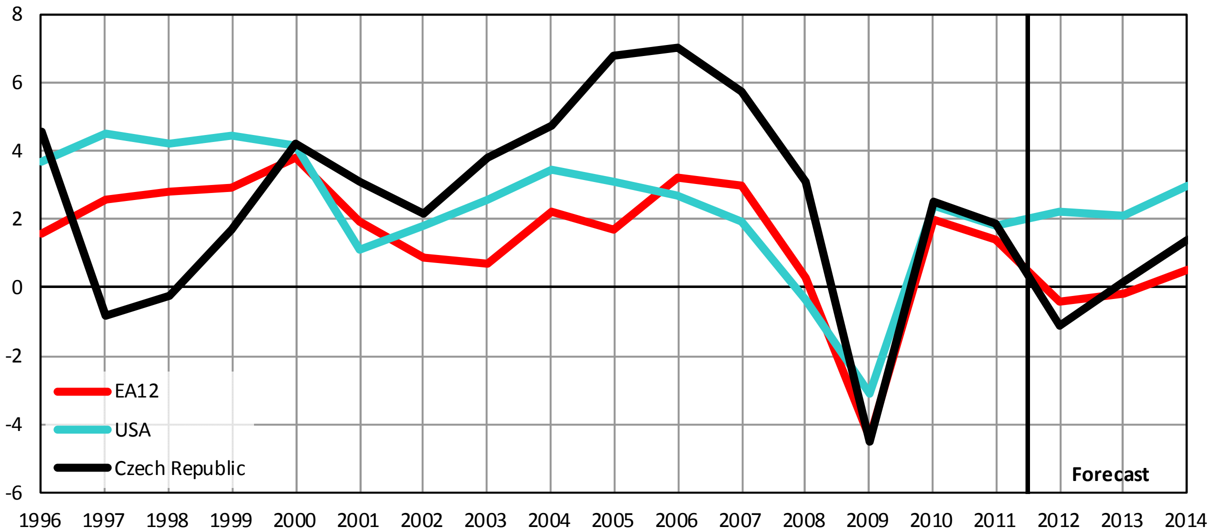
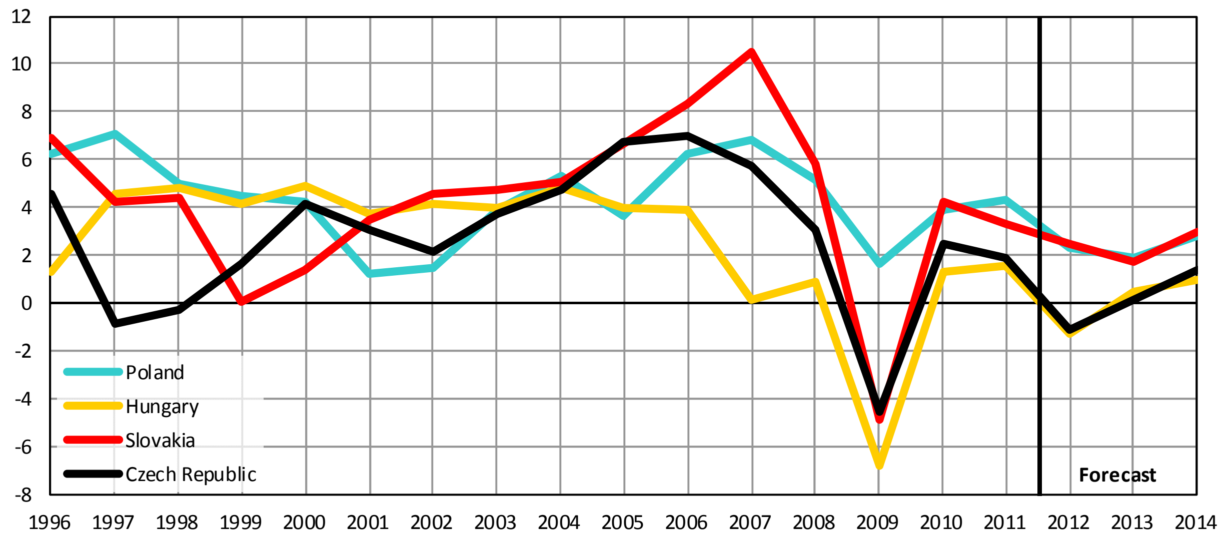


Table A.1.2: **Real Gross Domestic Product** – quarterly
growth in %, seasonally adjusted data

		2012				2013			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Estimate	*Forecast*	*Forecast*	*Forecast*	*Forecast*
USA	*QoQ*	**0.5**	**0.3**	**0.7**	**0.5**	**0.4**	**0.6**	**0.6**	**0.7**
	YoY	2.4	2.1	2.5	2.0	1.9	2.2	2.1	2.3
China	*QoQ*	**1.5**	**2.0**	**2.2**	**1.8**	**1.9**	**1.9**	**2.0**	**2.0**
	YoY	8.3	8.0	7.8	7.7	8.1	8.0	7.8	8.0
EU27	*QoQ*	**-0.1**	**-0.2**	**0.1**	**-0.1**	**-0.2**	**0.1**	**0.2**	**0.2**
	YoY	0.1	-0.3	-0.4	-0.2	-0.3	-0.1	0.0	0.3
EA12	*QoQ*	**0.0**	**-0.2**	**-0.1**	**-0.1**	**-0.2**	**0.0**	**0.1**	**0.2**
	YoY	-0.1	-0.5	-0.6	-0.4	-0.5	-0.4	-0.2	0.1
Germany	*QoQ*	**0.5**	**0.3**	**0.2**	**-0.1**	**-0.1**	**0.2**	**0.5**	**0.4**
	YoY	1.2	1.0	0.9	0.9	0.3	0.2	0.5	1.0
France	*QoQ*	**0.0**	**-0.1**	**0.1**	**0.0**	**-0.2**	**0.1**	**0.2**	**0.2**
	YoY	0.2	0.1	0.0	0.0	-0.2	0.0	0.1	0.3
United Kingdom	*QoQ*	**-0.2**	**-0.4**	**0.9**	**0.3**	**0.1**	**0.2**	**0.3**	**0.2**
	YoY	0.2	-0.3	0.0	0.6	1.0	1.6	0.9	0.8
Austria	*QoQ*	**0.3**	**0.1**	**0.1**	**0.1**	**0.3**	**0.2**	**0.4**	**0.3**
	YoY	0.7	0.5	0.7	0.7	0.7	0.7	1.0	1.2
Hungary	*QoQ*	**-1.1**	**-0.4**	**-0.2**	**0.0**	**0.1**	**0.2**	**0.3**	**0.2**
	YoY	-1.3	-1.4	-1.6	-1.7	-0.4	0.1	0.6	0.8
Poland	*QoQ*	**0.5**	**0.2**	**0.4**	**0.2**	**0.4**	**0.5**	**0.8**	**0.6**
	YoY	3.5	2.3	1.4	1.2	1.2	1.5	1.9	2.3
Slovakia	*QoQ*	**0.5**	**0.6**	**0.5**	**0.3**	**0.4**	**0.3**	**0.4**	**0.4**
	YoY	2.9	2.6	2.5	2.0	1.8	1.6	1.4	1.5
Czech Republic	*QoQ*	**-0.6**	**-0.4**	**-0.3**	**0.0**	**0.1**	**0.2**	**0.2**	**0.3**
	YoY	-0.5	-1.0	-1.3	-1.3	-0.7	-0.1	0.4	0.8

Graph A.1.5: **Real Gross Domestic Product** – Central European economies
YoY growth in %, seasonally unadjusted data



Graph A.1.6: **GDP in the Czech Republic and the neighbouring states**
Q3 2008=100, seasonally adjusted data

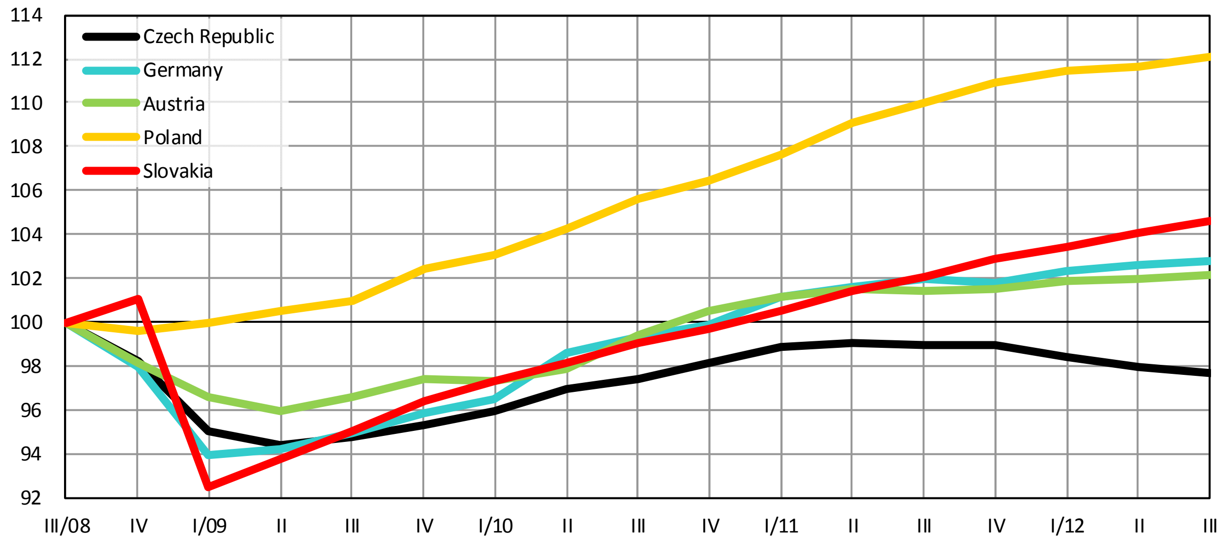


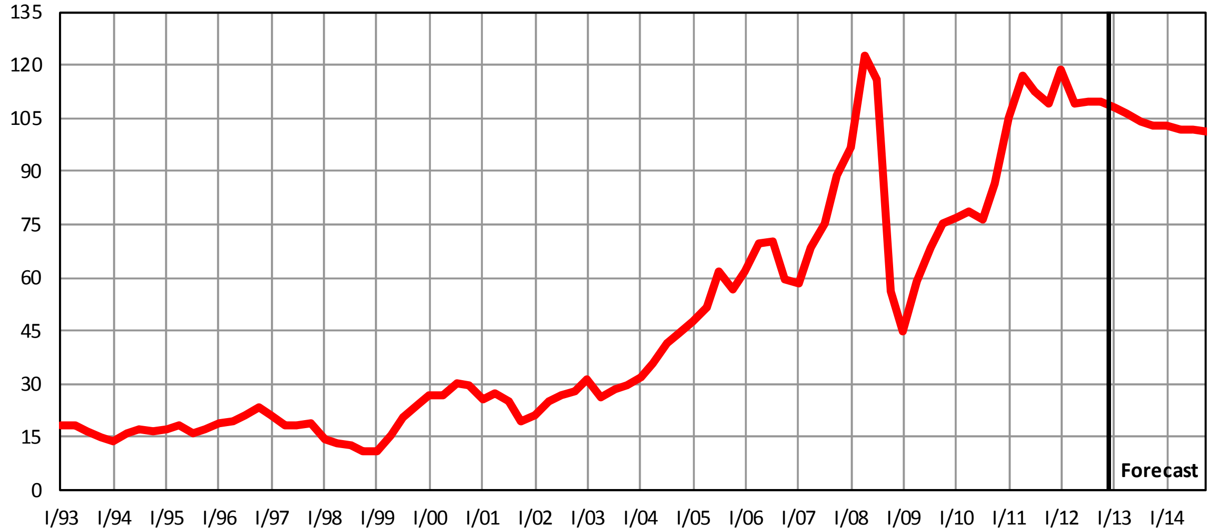
Table A.1.3: **Prices of Commodities** – yearly
spot prices

		2005	2006	2007	2008	2009	2010	2011	2012	2013 *Forecast*	2014 *Forecast*
Crude oil Brent	*USD/barrel*	**54.4**	**65.4**	**72.7**	**97.7**	**61.9**	**79.6**	**111.0**	**111.7**	**105**	**102**
	growth in %	42.0	20.1	11.2	34.4	-36.7	28.7	39.3	0.7	-5.8	-3.1
Crude oil Brent index *(in CZK)*	*2005=100*	**100.0**	**113.3**	**113.3**	**127.9**	**90.5**	**116.7**	**150.6**	**167.8**	**155**	**149**
	growth in %	32.4	13.3	-0.1	12.9	-29.3	29.0	29.0	11.4	-7.7	-3.6
Wheat	*USD/t*	**152.4**	**191.7**	**255.2**	**326.0**	**223.6**	**223.7**	**316.2**	**313.3**	.	.
	growth in %	-2.8	25.8	33.1	27.7	-31.4	0.1	41.4	-0.9	.	.
Wheat price index *(in CZK)*	*2005=100*	**100.0**	**118.7**	**141.9**	**152.4**	**116.7**	**117.1**	**153.3**	**168.1**	.	.
	growth in %	-9.4	18.7	19.6	7.3	-23.4	0.3	30.9	9.7	.	.

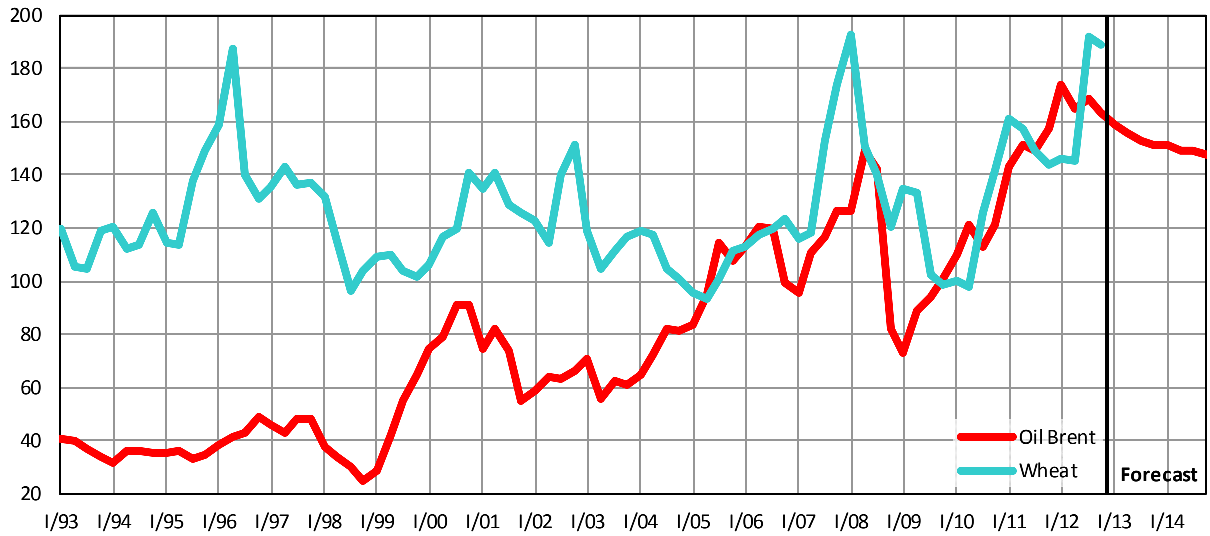
Table A.1.4: **Prices of Commodities** – quarterly
spot prices

		2012				2013			
		Q1	Q2	Q3	Q4	Q1 *Forecast*	Q2 *Forecast*	Q3 *Forecast*	Q4 *Forecast*
Crude oil Brent	*USD/barrel*	**118.5**	**108.9**	**109.5**	**109.8**	**108**	**106**	**104**	**103**
	growth in %	13.0	-7.0	-2.7	0.5	-8.9	-2.7	-5.0	-6.2
Crude oil Brent index *(in CZK)*	*2005=100*	**173.6**	**164.5**	**168.2**	**163.2**	**159**	**156**	**153**	**151**
	growth in %	21.3	8.6	13.1	3.9	-8.4	-5.2	-9.2	-7.5
Wheat price	*USD/t*	**278.8**	**269.0**	**349.5**	**355.7**	.	.	.	.
	growth in %	-15.6	-20.6	10.7	27.2	.	.	.	.
Wheat price index *(in CZK)*	*2005=100*	**146.1**	**145.3**	**192.0**	**189.1**	.	.	.	.
	growth in %	-9.4	-7.4	28.7	31.5	.	.	.	.

Graph A.1.7: **Dollar Prices of Oil**
USD/barrel



Graph A.1.8: **Koruna Indices of World Commodity Prices**
index 2005=100



A.2 Fiscal Policy

In comparison with the October Forecast, there has been a considerable change in the estimate of the 2012 general government sector deficit. According to the updated estimate, the government sector deficit reached CZK 193.4 billion last year, which represents 5.0% of GDP. Compared to the figures sent by the MoF as of 1 October 2012 as part of the Notification of Government Deficit and Debt, the estimate of deficit has been increased by 1.8 p.p. This deterioration, however, was caused by methodical adjustments in the accrual accounting system, namely by classification of the financial compensation to churches, amounting to CZK 59 billion (approximately 1.5% of GDP), and also by capturing the non refunded part of EU resources for the operational programmes Transport, Environment, Education for Competitiveness and the Integrated Operational Programme, totalling CZK 12.1 billion (approximately 0.3% of GDP). According to ESA95 methodology, it is essential to record both of these operations as one-off capital transfer expenses, which in full influence the deficit in 2012. These methodical adjustments have been described in more detail in the Fiscal Outlook of the Czech Republic (November 2012) on page 8.

Without the aforementioned methodical adjustments, the government deficit estimate for 2012 would be CZK 122.2 billion, i.e. by CZK 1.8 billion less than the October estimate. In proportional terms, however, the government deficit estimate would remain unchanged at 3.2% of GDP, though its structure, after taking into account new information, would change. A positive change in the subsector of the central government, caused mainly by a better result of the state budget balance (better by CZK 6.8 bln., compared to October), is to a large extent compensated by a deterioration of expected results of the health insurance companies subsector (by CZK 4.4 bln., compared to October). The estimated balance of the local government subsector is identical to that from October.

In 2012, fiscal effort (defined as a YoY change in the balance adjusted for the impact of economic cycle and one-off and temporary operations), due to deepening of the negative output gap induced by recession, probably achieved 1.0 p.p.

A change in the estimate for 2012 was made in the structure of income and expenditure items. On the revenue side, the expected revenue from VAT was modified due to a decline in household consumption. Together with a decrease in the estimate of social security contributions, this amounts to 0.3% of GDP. On the contrary, in case of corporate income tax, expectations are by 0.1% of GDP more positive.

On the expenditure side, considerable savings of social expenditures were probably recorded (with the exception of pension insurance benefits). Savings relative to the plan are also anticipated for interest payments. Overall savings in interest payments and social benefits amount to circa 0.3% of GDP.

As has been the case over the last two years, a drop in government investments is also anticipated for 2012, although significantly less dramatic. In comparison with the last Forecast, the estimate was reassessed especially due to problems with recognizing outlays in various operating programmes. The drop in investment also reflects the considerable uncertainty regarding the future. As for government operating expenditures, we anticipate further drop in intermediate consumption, reflecting especially the spending freeze approved at the beginning of 2012.

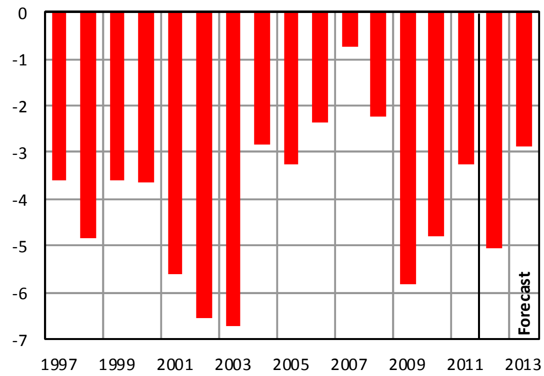
The aforementioned development was in turn decisively evident in nominal expenditures on final government consumption, which in 2012 apparently stagnated or increased by 0.2%, respectively.

In 2013, the general government balance should reach –2.9% of GDP (*unchanged*), and the Czech Republic should thus meet the Maastricht criterion of the government deficit. Compared to the last forecast, for 2013 we anticipate a slightly more considerable drop in household consumption and a slower growth of the wage bill; on the other hand, however, we assume considerably lower yields of long-term government bonds (see Chapter A.3), which should generate sufficient savings in interest payments. Given the current information, we think that these effects will be mutually eliminated.

Due to the deeply negative output gap (see Chapter B.1), the structural balance should reach –1.8% of GDP, and compared to 2012, should thus improve by 0.3 p.p. In 2013, the debt quota should reach 47.8% of GDP, which would be a YoY increase of 2.6 p.p.

Graph A.2.1: **Net Lending/Borrowing**

in % of GDP



Graph A.2.2: **Government Debt**

in % of GDP

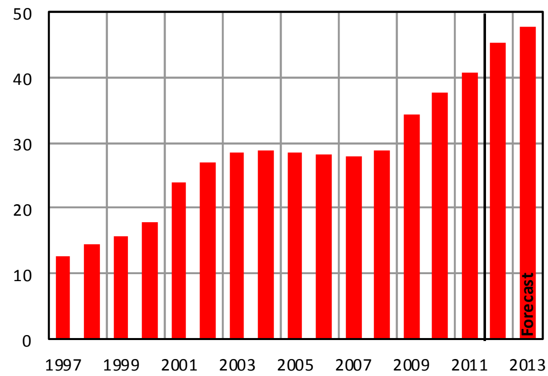


Table A.2.1: **Net Lending/Borrowing and Debt**

		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
										Estimate	*Forecast*
General government balance [1]	*bill. CZK*	-83	-101	-80	-27	-86	-218	-183	-125	-193	-111
	% GDP	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.3	-5.0	-2.9
Cyclical balance	*% GDP*	-0.6	-0.1	0.6	1.2	1.0	-1.0	-0.5	-0.1	-0.8	-1.2
Cyclically adjusted balance	*% GDP*	-2.2	-3.1	-3.0	-1.9	-3.2	-4.8	-4.3	-3.2	-4.2	-1.6
One-off measures	*% GDP*	-0.7	-1.2	-0.2	-0.3	-0.1	0.3	0.0	-0.1	-2.1	0.1
Structural balance	*% GDP*	-1.5	-1.9	-2.8	-1.6	-3.2	-5.1	-4.3	-3.0	-2.1	-1.8
Fiscal effort [2]	*percent. points*	4.3	-0.4	-0.8	1.1	-1.6	-2.0	0.8	1.3	1.0	0.3
Interest expenditure	*% GDP*	1.1	1.1	1.1	1.1	1.0	1.3	1.3	1.4	1.5	1.3
Primary balance	*% GDP*	-1.8	-2.2	-1.3	0.4	-1.2	-4.5	-3.5	-1.9	-3.6	-1.6
Cyclically adjusted primary balance	*% GDP*	-1.1	-2.1	-1.9	-0.8	-2.2	-3.6	-3.0	-1.8	-2.7	-0.4
General government debt	*bill. CZK*	848	885	948	1 023	1 104	1 286	1 437	1 568	1 737	1 848
	% GDP	28.9	28.4	28.3	27.9	28.7	34.2	37.8	40.8	45.2	47.8
Change in debt-to-GDP ratio	*percent. points*	0.4	-0.5	-0.1	-0.3	0.8	5.5	3.6	3.0	4.4	2.6

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] *Balance in EDP methodology, i.e. general government net lending (+)/borrowing (-) including interest derivatives.*

[2] *Change in structural balance.*

A.3 Monetary Policy and the Financial Sector

Monetary policy

The primary monetary policy instrument is the interest rate for **2W repo operations,** which was decreased at the beginning of November 2012 to the historical low of 0.05%. The discount rate was decreased by 0.05 p.p. to 0.05%, the Lombard rate by 0.50 p.p. to 0.25%. Due to negative macroeconomic development and having reached the zero lower bound on interest rates, the CNB is considering the possibility of interventions on the foreign exchange market. Due to the stagnation of the ECB's main refinancing rate, **the interest-rate spread** between the Czech Republic and the euro zone further deepened at the end of Q4 2012 to –0.70 p.p., while the spread relative to the US reached –0.20 to 0.05 p.p.

Financial sector and interest rates

The **3M PRIBOR** rate averaged 0.6% in Q4 2012 (*consistent with the forecast*). In 2012, it reached the average value of 1.0% (*consistent with the forecast*). For 2013 we forecast the value of 0.5% (*unchanged*), for 2014 a small increase to 0.6%.

In October 2012, the volume of deposit and repo operations fluctuated around the July values, as shown by the survey of average daily turnovers on the money market. However, the volume of derivative operations (interest rate swaps, IRSs) decreased considerably, the volume of forward rate agreements (FRAs) was very low (in July, however, zero).

Uncertainty on the interbank market, measured by the spread between 2W or 3M PRIBOR and the 2W repo rate, remains stable after accounting for the typical fluctuations accompanying changes in the 2W repo rate, between 0.4 and 0.5 p.p.

Long-term interest rates in Q4 2012 continued to decrease (to 2.1% on average per quarter), whereby once again historical lows were shifted. On average for the duration of 2012, **yields to maturity of 10-year government bonds** for convergence purposes reached 2.8% (*versus 2.9%*). We estimate that in 2013 the long-term interest rates will fluctuate around 2.2% (*versus 2.7%*). They should also remain at similarly low levels (2.3%) in 2014.

Considering the Czech Republic's very good rating (Standard & Poor´s AA–, Moody's A1, Fitch Ratings A+; stable outlook for all agencies), relatively successful issues of government bonds can be expected. For 2013, the planned gross borrowing need of the government is ca CZK 230 billion, which represents a YoY drop of 25%. In the course of 2012, the reserve for financing state debt was increased by approximately CZK 65 billion, whereby a sufficient cushion was created in the event of unexpected instability on markets. It can also be expected that in the course of this year, retail savings bonds in the volume of CZK 20–40 billion will be issued. It is assumed that in the course of 2013 the share of financing on foreign markets should amount to no more than 40% of the planned annual borrowing requirement.

In October, the CNB conducted another round of examinations of credit terms and bank standards. The survey concluded that in Q3 2012 banks tightened credit standards for loans to non-financial corporations and housing loans, while those for consumer loans were not changed. For Q4 2012 the banks expected a tightening of credit standards for corporate loans, while a relaxing of those for housing loans. In November, the CNB also conducted stress tests of the banking sector (using data as of the end of Q3) which again confirmed the sufficient resilience of banks towards possible negative shocks.

The situation concerning loans in default has been stabilised, as in Q3 their share in total loans stood at 5.2% for households (0.1 p.p. less YoY) and 7.6% for non-financial corporations (0.8 p.p. less YoY). The ratio of household loans to household deposits in the Czech Republic has long been fluctuating around 65% and is approximately one-fourth lower than in the euro zone. We can observe an even more distinct difference between the Czech Republic and the euro zone in the loans to deposit ratio of non-financial corporations. In the Czech Republic this ratio is now around 120–125%, whereas in the euro zone it stands at 270–280%.

In the first half of January 2013, the Prague Stock Exchange's PX index was fluctuating above 1,050 points, i.e. almost 20% higher than a year ago.

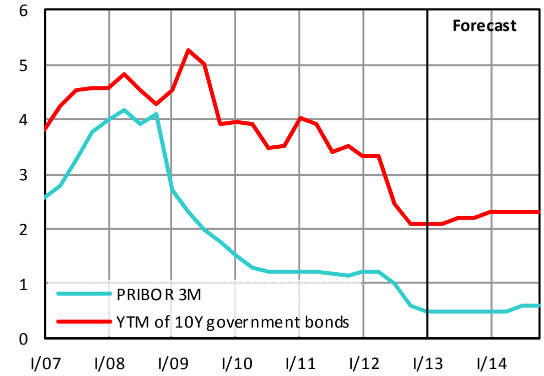
Table A.3.1: **Interest Rates, Deposits and Loans** – yearly

		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
										Forecast	*Forecast*
Repo 2W rate CNB (*end of period*)	*in % p.a.*	2.00	2.50	3.50	2.25	1.00	0.75	0.75	0.05	.	.
Main refinancing rate ECB (*end of period*)	*in % p.a.*	2.25	3.50	4.00	2.50	1.00	1.00	1.00	0.75	.	.
Federal funds rate (*end of period*)	*in % p.a.*	4.25	5.25	4.25	0.25	0.25	0.25	0.25	0.25	.	.
PRIBOR 3M	*in % p.a.*	2.01	2.30	3.09	4.04	2.19	1.31	1.19	1.00	0.5	0.6
YTM of 10Y government bonds	*in % p.a.*	3.51	3.78	4.28	4.55	4.67	3.71	3.71	2.80	2.2	2.3
Households – MFI (*CR, unless stated otherwise*)											
– interest rates on loans	*in % p.a.*	7.53	6.93	6.63	6.81	7.00	7.00	6.83	.	.	.
– loans	*growth in %*	32.6	32.1	31.7	28.9	16.3	8.7	6.5	.	.	.
– loans without housing loans	*growth in %*	28.6	28.3	27.3	25.3	19.1	8.3	6.8	.	.	.
– deposits	*growth in %*	5.2	7.3	10.6	9.4	10.5	5.4	5.0	.	.	.
– share of non-performing loans	*in %*	4.2	3.7	3.2	3.0	3.7	4.8	5.3	.	.	.
– loans to deposits ratio	*in %*	33	40	48	57	60	61	62	.	.	.
– loans to deposits ratio (Eurozone)	*in %*	94	99	99	94	89	90	90	.	.	.
Non-financial firms – MFI (*CR, unless stated otherwise*)											
– interest rates on loans	*in % p.a.*	4.27	4.29	4.85	5.59	4.58	4.10	3.93	.	.	.
– loans	*growth in %*	10.3	13.9	16.7	17.5	0.2	-6.5	3.3	.	.	.
– deposits	*growth in %*	4.5	10.9	13.2	5.3	-1.7	4.8	0.9	.	.	.
– share of non-performing loans	*in %*	5.7	4.5	3.8	3.6	6.2	8.6	8.5	.	.	.
– loans to deposits ratio	*in %*	113	117	120	134	137	123	126	.	.	.
– loans to deposits ratio (Eurozone)	*in %*	290	292	296	315	315	294	286	.	.	.

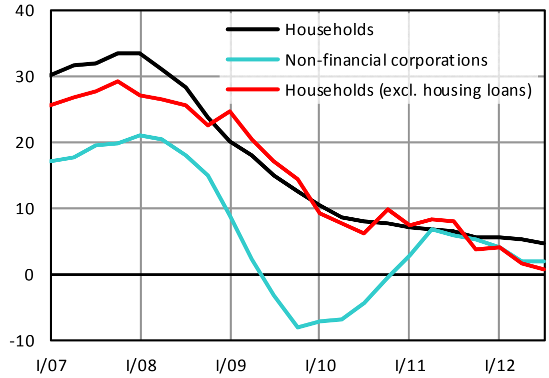
Table A.3.2: **Interest Rates, Deposits and Loans** – quarterly

		2012				2013			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
						Forecast	*Forecast*	*Forecast*	*Forecast*
Repo 2W rate CNB (*end of period*)	*in % p.a.*	0.75	0.50	0.50	0.05	.	.	.	.
Main refinancing rate ECB (*end of period*)	*in % p.a.*	1.00	1.00	0.75	0.75	.	.	.	.
Federal funds rate (*end of period*)	*in % p.a.*	0.25	0.25	0.25	0.25	.	.	.	.
PRIBOR 3M	*in % p.a.*	1.20	1.23	0.98	0.59	0.5	0.5	0.5	0.5
YTM of 10Y government bonds	*in % p.a.*	3.34	3.31	2.46	2.09	2.1	2.1	2.2	2.2
Households – MFI (*CR, unless stated otherwise*)									
– interest rates on loans	*in % p.a.*	6.59	6.51	6.42	.	.	.	.	.
– loans	*growth in %*	5.6	5.1	4.5	.	.	.	.	.
– loans without housing loans	*growth in %*	3.9	1.5	0.6	.	.	.	.	.
– deposits	*growth in %*	5.5	4.4	4.2	.	.	.	.	.
– share of non-performing loans	*in %*	5.0	5.2	5.2	.	.	.	.	.
– loans to deposits ratio	*in %*	64	64	65	.	.	.	.	.
– loans to deposits ratio (Eurozone)	*in %*	88	88	87	.	.	.	.	.
Non-financial firms – MFI (*CR, unless stated otherwise*)									
– interest rates on loans	*in % p.a.*	3.87	3.86	3.67	.	.	.	.	.
– loans	*growth in %*	4.1	1.9	2.0	.	.	.	.	.
– deposits	*growth in %*	7.8	11.6	8.3	.	.	.	.	.
– share of non-performing loans	*in %*	8.1	7.9	7.6	.	.	.	.	.
– loans to deposits ratio	*in %*	125	120	124	.	.	.	.	.
– loans to deposits ratio (Eurozone)	*in %*	282	280	274	.	.	.	.	.

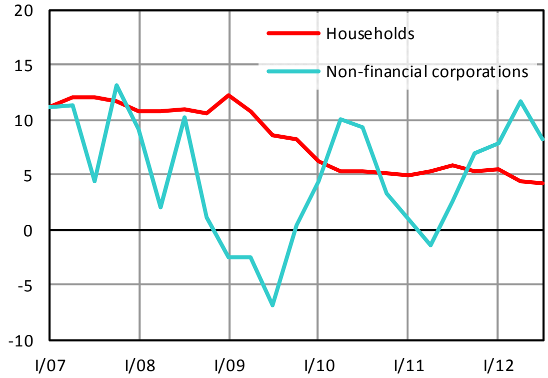
Graph A.3.1: **Interest Rates**
in % p.a.



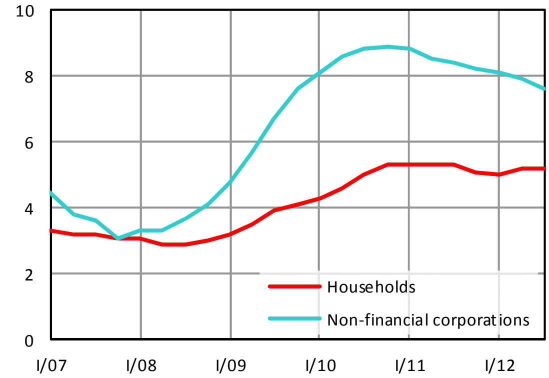
Graph A.3.2: **Loans to Households and Firms**
YoY growth in %



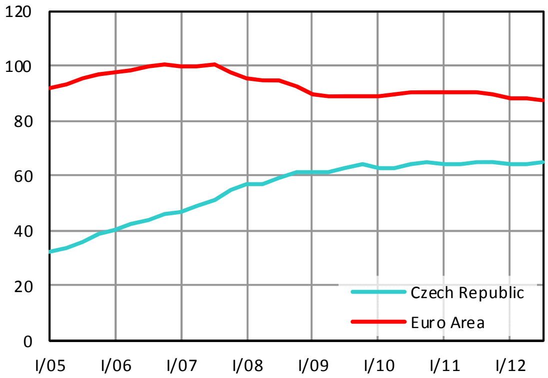
Graph A.3.3: **Deposits of Households and Firms**
YoY growth in %



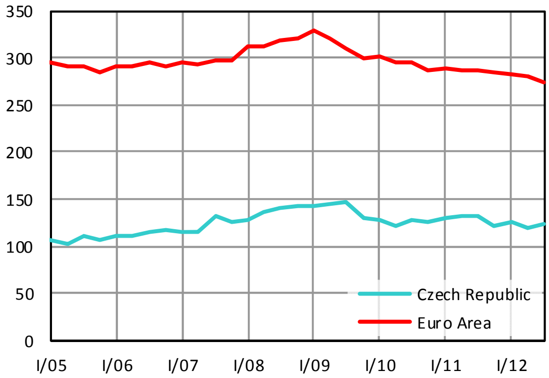
Graph A.3.4: **Non-performing Loans**
ratio of non-performing to total loans, in %



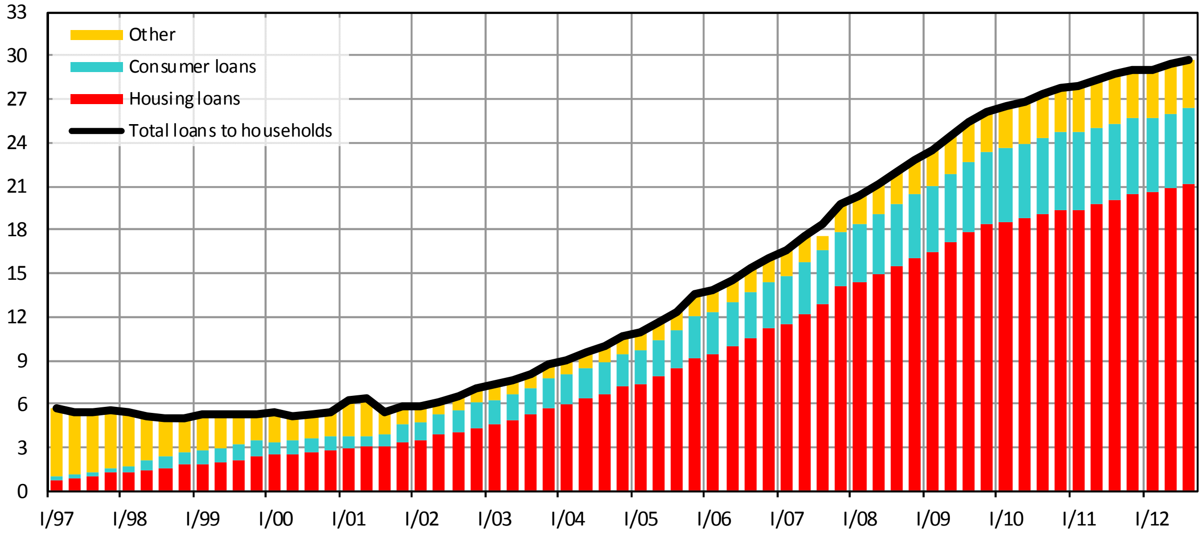
Graph A.3.5: **Households – Loans to Deposits Ratio**
in %



Graph A.3.6: **Firms – Loans to Deposits Ratio**
in %



Graph A.3.7: **Ratio of Bank Loans to Households to GDP**
yearly moving sums, in %



A.4 Exchange Rates

In Q4 2012, the CZK/EUR exchange rate averaged 25.17, thus strengthening by 0.4% YoY. In 2012 on average, however, the koruna weakened against the euro by 2.2%, to which a gradual reduction in the main interest rates by the Czech National Bank contributed.

Considering developments over the last year, we have adjusted the assumption on the trend trajectory of the exchange rate. In 2013, the average rate should reach 24.9 CZK/EUR, further on the koruna should be appreciating by 0.5% per year on average. In Q4 2016, i.e. on the horizon of the outlook, the exchange rate should reach on average 24.5 CZK/EUR.

A short-term risk of the adopted scenario is the CNB's announcement of the possibility of FX interventions with the purpose of CZK weakening, the persisting risk for the CZK exchange rate development subsequently represents the chance of the eurozone crisis escalation.

In the whole forecast horizon, the nominal and real exchange rates should fluctuate below the level of the previous long-term trend.

Graph A.4.1: **Exchange Rate CZK/EUR**
quarterly averages

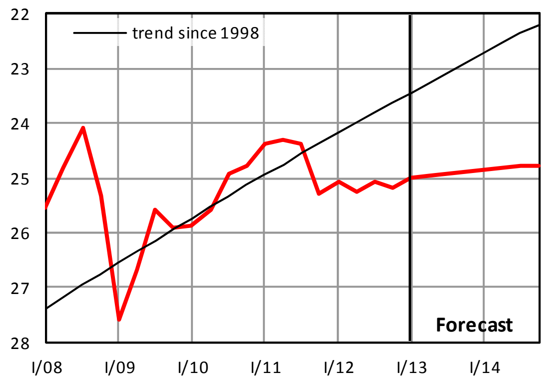


Table A.4.1: **Exchange Rates** – yearly

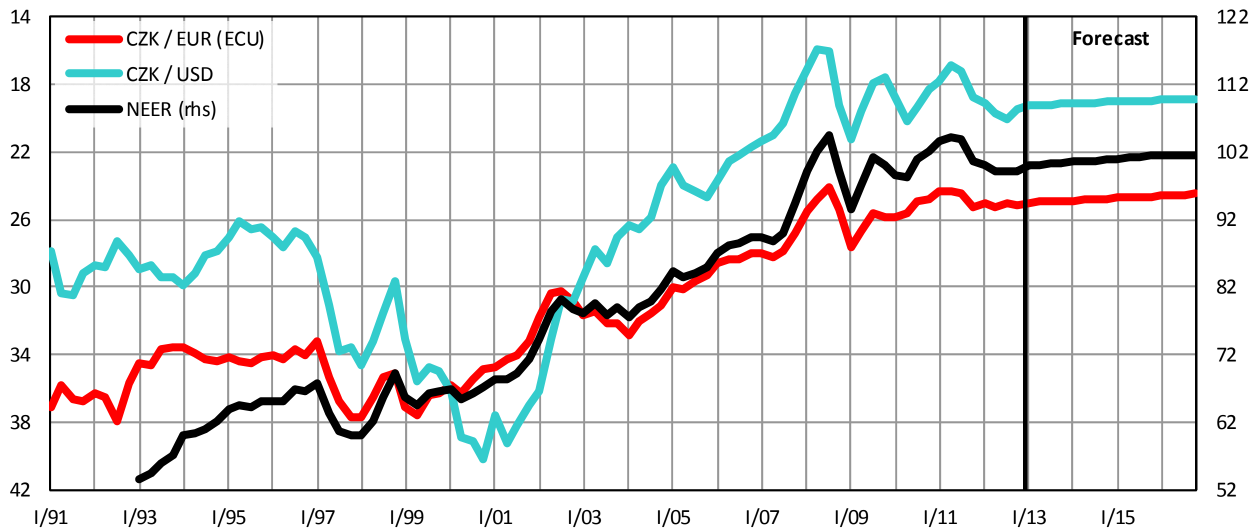
		2007	2008	2009	2010	2011	2012 *Estimate*	2013 *Forecast*	2014 *Forecast*	2015 *Outlook*	2016 *Outlook*
Nominal exchange rates:											
CZK / EUR	*average*	**27.76**	**24.96**	**26.45**	**25.29**	**24.59**	**25.14**	**24.9**	**24.8**	**24.7**	**24.5**
	appreciation in %	2.1	11.3	-5.6	4.6	2.8	-2.2	0.8	0.5	0.5	0.5
CZK / USD	*average*	**20.31**	**17.06**	**19.06**	**19.11**	**17.69**	**19.59**	**19.2**	**19.1**	**19.0**	**18.9**
	appreciation in %	11.3	19.0	-10.5	-0.3	8.0	-9.7	2.1	0.5	0.5	0.5
NEER	*average of 2010=100*	**90.6**	**101.2**	**98.0**	**100.0**	**103.1**	**99.5**	**100**	**101**	**101**	**101**
	appreciation in %	2.7	11.7	-3.2	2.1	3.1	-3.5	0.7	0.5	0.5	0.2
Real exchange rate to EA12[1)]	*average of 2010=100*	**91.9**	**102.3**	**97.8**	**100.0**	**100.8**	**98**	**98**	**97**	**97**	**96**
	appreciation in %	3.1	11.3	-4.4	2.3	0.8	-2.4	-0.5	-0.9	-0.2	-0.4
REER	*average of 2010=100*	**88.7**	**102.1**	**98.1**	**100.0**	**102.4**	**.**	**.**	**.**	**.**	**.**
(Eurostat, CPI deflated, 36 countries)	*appreciation in %*	2.9	15.1	-4.0	2.0	2.4	.	.	.	.	.

[1)] *Deflated by GDP deflators.*

Table A.4.2: **Exchange Rates** – quarterly

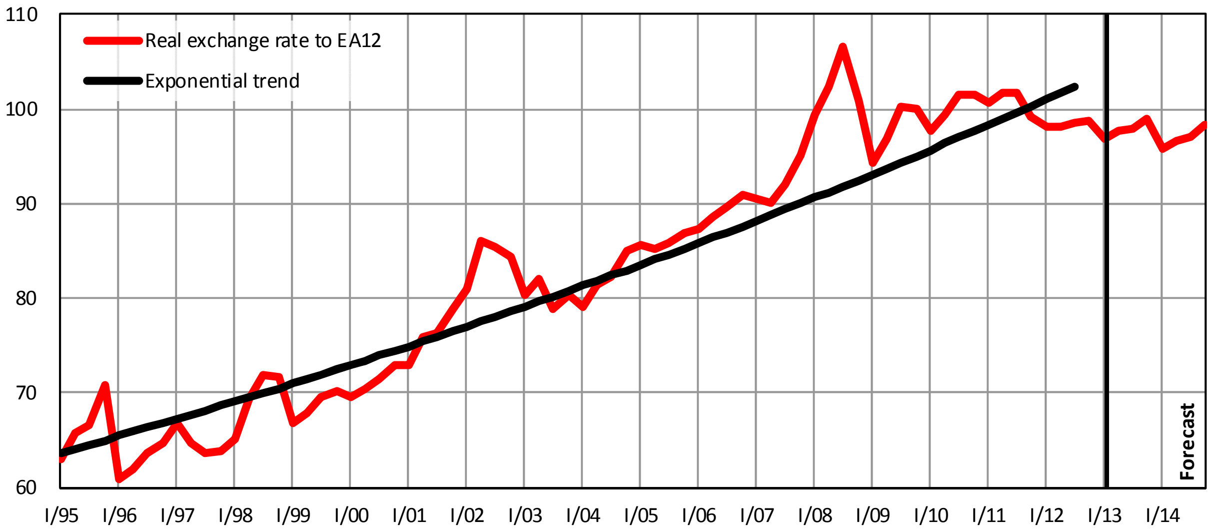
		2012				2013			
		Q1	Q2	Q3	Q4 *Estimate*	Q1 *Forecast*	Q2 *Forecast*	Q3 *Forecast*	Q4 *Forecast*
Nominal exchange rates:									
CZK / EUR	*average*	**25.08**	**25.26**	**25.07**	**25.17**	**25.0**	**25.0**	**24.9**	**24.9**
	appreciation in %	-2.8	-3.7	-2.7	0.4	0.3	1.2	0.5	1.1
CZK / USD	*average*	**19.14**	**19.73**	**20.07**	**19.42**	**19.2**	**19.2**	**19.2**	**19.2**
	appreciation in %	-6.9	-14.3	-13.9	-3.3	-0.5	2.7	4.6	1.4
NEER	*average of 2010=100*	**100.2**	**99.2**	**99.3**	**99.2**	**100**	**100**	**100**	**100**
	appreciation in %	-3.2	-4.8	-4.5	-1.3	-0.2	0.8	1.0	1.1
Real exchange rate to EA12	*average of 2010=100*	**98.1**	**98.0**	**98.5**	**99**	**97**	**98**	**98**	**99**
	appreciation in %	-2.5	-3.6	-3.1	-0.4	-1.3	-0.4	-0.7	0.2
REER	*average of 2010=100*	**123.6**	**121.8**	**.**	**.**	**.**	**.**	**.**	**.**
(Eurostat, CPI deflated, 36 countries)	*appreciation in %*	-1.7	-3.3	.	.	.	.	.	.

Graph A.4.2: **Nominal Exchange Rates**
quarterly average, average 2010=100 (rhs)



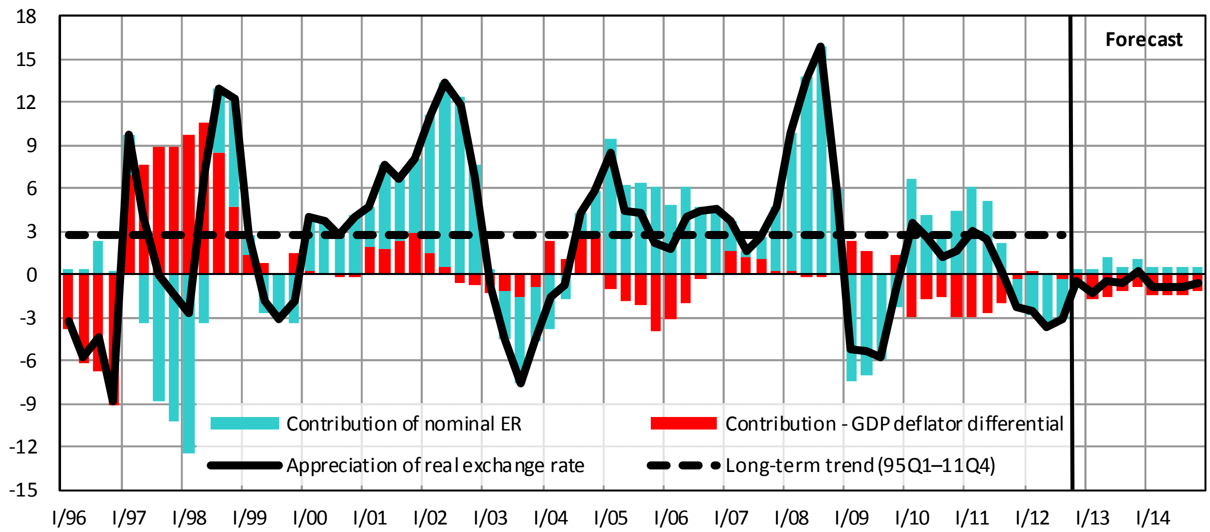
Graph A.4.3: **Real Exchange Rate to EA12**

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



Graph A.4.4: **Real Exchange Rate to EA12**

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



A.5 Structural Policies

On 20 December 2012, the government approved **draft measures to improve conditions of economy development, to support entrepreneurship and employment**. The measures are especially aimed at reducing the administrative burden and making legislation more transparent, raising competitiveness, tax stimulation and prevention of tax evasions, supporting innovations and education, supporting exports and effective use of European funds.

Business environment

In order to strengthen the competitiveness and economic performance of small and medium-sized enterprises, on 12 December 2012 the government approved **2014–2020 concept of support for small and medium-sized enterprises**, in which it set out five strategic priorities (cultivation of the business environment, development of business based on supporting research, development and innovations, promoting business and innovation infrastructure, development of education for business and sustainable energy management). The measures will be financed from the EU structural funds, with national funds used as a supplement.

The purpose of an amendment to the **Insolvency Act**, which came into effect on 1 November 2012, is to prevent abuses of the insolvency law. A court is allowed to reject a creditor's petition for insolvency if it is clearly unfounded and to establish a monetary penalty for such an unfounded insolvency petition.

An **amendment to the Act on the Protection of Competition,** which came into effect on 1 December 2012, should more readily expose cartel agreements. Participants in cartels who cease such operations of their own accord and report other participants to the Office for the Protection of Competition will have the penalty reduced or entirely remitted. The amendment also bars companies already caught in cartel agreements from participating in public tenders and concession agreements.

Taxes

On 1 January 2013, the **Act on Amendments to Tax, Insurance and Other Acts in Relation to Reducing Public Budget Deficit** came into effect. Its purpose is to strengthen the revenue side of the state budget and thereby gradually reduce the public finance deficit. Lump-sum cost deductions for personal income taxes were limited to CZK 800,000 for activities included under the 40% deduction and to CZK 600,000 for the 30% deduction. At the same time, persons benefiting from deductions are not entitled to apply the tax relief in respect of child or wife. The real estate transfer tax was increased from 3% to 4% and the withholding tax on the income of non-residents from such countries with which the Czech Republic has not concluded the double taxation avoidance treaty was increased from 15% to 35%. At the same time, the entitlement to an excise tax refund on diesel fuel for agricultural purposes was at first lowered, and will be abolished from 2014.

Temporary measures valid only in 2013–2015 include introducing a 7% surcharge on personal income tax for incomes exceeding 48 times the average monthly wage, abolishing the basic personal income tax deduction for working pensioners, and cancelling the health insurance contributions cap. During this period, both VAT rates will be increased to 21% and 15%, respectively, while implementation of the uniform rate of 17.5% has been postponed until 2016.

An **amendment to the Act on Excise Taxes** raised the excise tax on cigarettes as of 1 January 2013. A further increase of excise tax will occur in 2014.

On 1 January 2013, an **amendment to the VAT Act** came into effect. The amendment has introduced the institution of an untrustworthy taxpayer, making it possible to identify higher-risk taxpayers abusing the VAT system, whose registration as VAT payers cannot be directly cancelled by the tax administrator. Entrepreneurs accepting taxable supplies from untrustworthy payers are exposed to a risk of liability for unpaid VAT. With effect from 2014, taxpayers, with the exception of individuals with turnover of up to CZK 6 million, will be obliged to make their submissions electronically.

Financial markets

For the purpose of responsible lending and strengthening the position of the consumers, on 7 December 2012 the Chamber of Deputies approved an **amendment to the Consumer Credit Act**. From now on, a creditor will be able to provide a consumer loan only in the case that upon evaluating the consumer's creditworthiness with expert care it will be apparent that the customer is able to repay the loan. The consumer will be able to withdraw from an agreement on intermediation of a consumer loan within 14 days upon concluding it without penalty and without stating a reason for doing so.

Energy industry and environmental protection

On 1 January 2013, **the Act on the Conditions for Trading in Greenhouse Gas Emission Allowances** came into effect. Until the end of 2012, allowances were allocated free of charge on the basis of historical emissions. In the period 2013–2020, the CR will have at its disposal 645 million allowances, out of which 342 million will be sold by auction and 303 million allocated free of charge according to reference values defined by EU regulations. The number of freely allocated allowances will be gradually decreased during this eight-year period. Allowance revenues will be converted into state budget revenues, but at least 50% of revenues will be earmarked for subsequent financing of activities related to climate protection.

On 1 January 2013, an **amendment to the Act on Energy Management**, which should lead to a decrease in the energy demands of buildings, came into effect. According to the amendment, starting from 2021 all new buildings will be constructed as buildings with almost zero energy consumption. New buildings used and owned by public authorities will have to do so already from 2019. Last but not least, the amendment regulates the mandatory energy certification of buildings. Property owners will present an energy performance certificate when selling self-contained units of existing buildings starting from 2013, and, in the case of renting, starting from 2016. Already existing residential or administrative buildings will obtain their certificates gradually over the period 2015–2019 depending on their floor space.

On 1 January 2013, the **Act on Supported Energy Sources** came into effect, concentrating into one single regulation the support for renewable resources, secondary sources as well as the combined production of electricity and heat from renewable resources. The purpose of the act is to efficiently achieve the binding target for the share of renewable energy sources on gross final consumption to the amount of 13.5% in 2020. If, as of 30 May of a given year, the Energy Regulatory Office determines that for a certain type of energy the target defined in the National Action Plan has already been achieved, in the following two years it will not determine any support for electricity production from this source. The provision will only apply to new applicants wishing to connect power plants into the power grid. Last but not least, electricity from solar radiation produced in the facility in 2013 put into operation in 2009 and 2010 will be burdened with obligatory payments up to 28% of subsidies received.

Labour Market

On 1 January 2013, the **pension reform** came into force incorporating the act on pension savings and the act on supplementary pension savings that ensured the second pillar creation and at the same time transformation of the third pillar of the pension system. The newly created second pillar is financed by releasing a part of premiums for pension insurance from the first pillar, whereby the insurance rate for the first pillar of the participant of the second pillar has decreased by 3 p.p., while the participant has to add another 2 p.p. from his or her own funds. Insured persons may decide on this release prior to reaching the age of 35 years. Insured persons who are older than 35 years at the moment of launching the reform can opt out of the pay-as-you-go system no later than on 30 June 2013. Upon making their decision or when the time-limit elapses, however, it is no longer possible to change their decisions.

The old-age pension from the first pillar will consist of a basic and percentage assessment. The basic pension assessment will be paid out in full, regardless of participation in the second pillar, while the percentage assessment will be calculated in order to reflect the length of participation in the second pillar, and thus a lower premium paid out to the first pillar. Old-age pension will be paid from the second pillar in the form of life annuity, life annuity with an agreed payment for inheritance pension to the same amount for a period of three years from the date of the participant's death or life annuity with 20 years certain, whereby a period less than 20 years lapses after the death of the recipient of the pension, the entitlement to pension payment forms part of the inheritance.

The administration of funds will be ensured by pension companies, which will be required to offer four types of funds (general, conservative, balanced and dynamic) reflecting different investment limits, portfolio structure and risk.

An **amendment to the Act on Supplementary Pension Savings,** which came into effect on 1 January 2013, will allow persons close to retirement age the chance to draw a pension from the system of supplementary pension savings even before reaching retirement age. Persons five years below the required age for entitlement to an old-age pension will be entitled to benefits from the third pillar. If the amount of individual payments reaches at least 30% of the average wage, the drawing of benefits will not influence the amount of pension entitlements from the first pay-as-you-go pillar or public health insurance. Participants will be motivated to save in the third pillar by a state contribution and employers by tax benefits, as contributions from employers will be exempt from income tax up to CZK 30,000 per year.

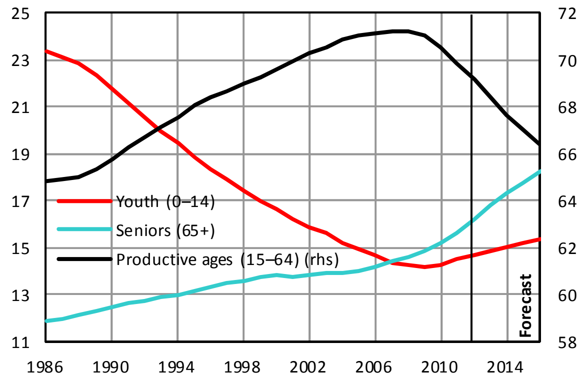
On 9 January 2013, the government approved the draft of the **amendment to the Employment Act,** which should contribute to liberalization of the environment in the area of agreements for a definite period of time. According to the current legal regulation, the duration of the employment relationship for a definite period of time must not exceed 3 years and from the date of the commencement of the first employment relationship it can be repeated no more than twice. In the case of serious operational reasons or reasons for a special nature of the work (seasonality in agriculture or construction), the amendment will allow repeated employing for a definite period of time without any limitation.

According to the **Constitutional Court Verdict** of 27 November 2012, the duty of the persons, who are registered as a job-seekers for a period longer than two months to perform so-called public service without entitlement to remuneration, was cancelled.

A.6 Demographic Trends

At the end of September 2012, 10.513 million people were living in the Czech Republic. During the period from January to September 2012, the population increased by 8 thousand inhabitants. The positive migration balance reached 6 thousand and births exceeded mortality rates by 2 thousand. While the natural population growth decreased only negligibly compared to the same period of the previous year (by 3 thousand persons), the positive migration balance was lower by 8 thousand, especially due to an increase in the number of emigrants.

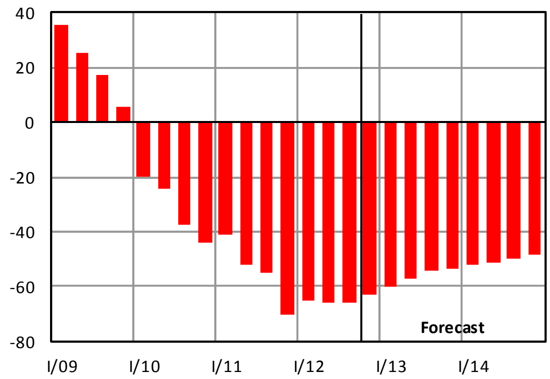
Graph A.6.1: **Groups by Age**
structure in per cent



In terms of the age structure the proportion of the population aged 15-64 has been sharply decreasing since 2008 and will continue to decline (see Graph A.6.1). Persons born in the very weak years in terms of the new-born population at the end of the 1990s exceed the lower limit of this age category, while the population-strong generation born after the Second World War has been incorporated among seniors.

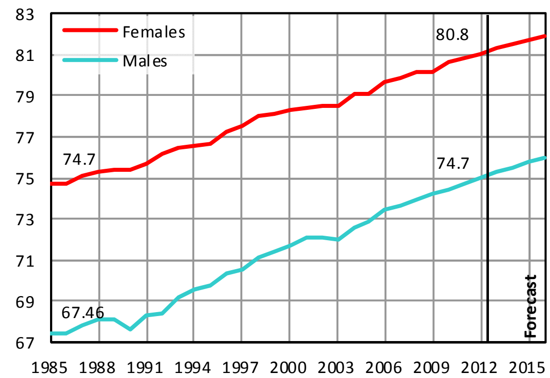
The negative impact from a decline in the working-age population on the labour supply has been compensated by effects within the age structure of the labour force, as the structural shares of age groups with a high or growing participation are increasing. Postponing the retirement age and making the labour market more flexible have the same effect. The ratio of the labour force to the working-age population has thus increased, which makes it possible to maintain a stable or even growing labour force (see Box C.3).

Graph A.6.2: **Czech Population Aged 15–64**
YoY increases of quarterly averages, in thousands



On the other hand, the structural proportion of persons over 64 years of age in the total population reached 16.2% at the beginning of 2012, and according to the middle variant of the CZSO's Demographic Projection, it should increase to nearly 20% by 2020. Both the number and proportion of seniors in the population will be rising considerably due to the demographic structure and further continuation of the intensive process of increasing life expectancy.

Graph A.6.3: **Life Expectancy**
in years



At the end of 2011, the number of old-age pensioners increased dramatically by 3.5% to reach 2.340 million people. In the course of 2012, on the contrary, it stagnated or even slightly decreased. Thus it has been proved that the increase in 2011 was a one-off matter, when potential future pensioners optimized the time of their retirement during the period of changing the rules for determining pension payments.

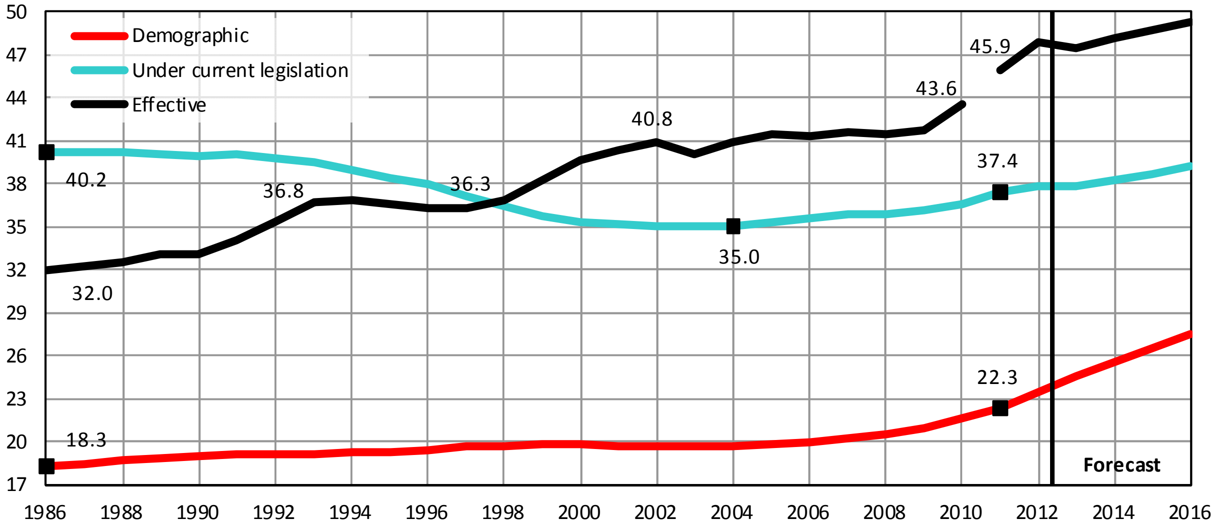
Table A.6.1: **Demography**
in thousands of persons

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
						Estimate	*Forecast*	*Forecast*	*Outlook*	*Outlook*
Population (January 1)	**10 287**	**10 381**	**10 468**	**10 507**	**10 487**	**10 505**	**10 539**	**10 571**	**10 601**	**10 630**
growth in %	0.4	0.9	0.8	0.4	-0.2	0.2	0.3	0.3	0.3	0.3
Age structure (January 1):										
(0–14)	**1 480**	**1 477**	**1 480**	**1 494**	**1 522**	**1 541**	**1 563**	**1 587**	**1 611**	**1 631**
growth in %	-1.5	-0.2	0.2	1.0	1.8	1.3	1.4	1.5	1.5	1.3
(15–64)	**7 325**	**7 391**	**7 431**	**7 414**	**7 328**	**7 263**	**7 207**	**7 154**	**7 105**	**7 055**
growth in %	0.4	0.9	0.5	-0.2	-1.2	-0.9	-0.8	-0.7	-0.7	-0.7
(65 and more)	**1 482**	**1 513**	**1 556**	**1 599**	**1 637**	**1 701**	**1 768**	**1 830**	**1 885**	**1 944**
growth in %	1.8	2.1	2.9	2.7	2.4	3.9	3.9	3.5	3.0	3.1
Old-age pensioners (January 1)[1]	**2 024**	**2 061**	**2 102**	**2 147**	**2260**	**2340**	**2 337**	**2 368**	**2 399**	**2 428**
growth in %	2.0	1.8	2.0	2.1	.	3.5	-0.1	1.3	1.3	1.2
Old-age dependency ratios (January 1, in %):										
Demographic [2]	**20.2**	**20.5**	**20.9**	**21.6**	**22.3**	**23.4**	**24.5**	**25.6**	**26.5**	**27.6**
Under current legislation [3]	**35.8**	**35.9**	**36.1**	**36.6**	**37.4**	**37.8**	**37.8**	**38.2**	**38.7**	**39.2**
Effective [4]	**41.6**	**41.5**	**41.8**	**43.6**	**45.9**	**47.9**	**47.4**	**48.2**	**48.8**	**49.3**
Fertility rate	**1.438**	**1.497**	**1.492**	**1.493**	**1.427**	**1.52**	**1.53**	**1.54**	**1.55**	**1.56**
Population increase	**94**	**86**	**39**	**-20**	**19**	**33**	**32**	**31**	**29**	**27**
Natural increase	**10**	**15**	**11**	**10**	**2**	**8**	**7**	**6**	**4**	**2**
Live births	**115**	**120**	**118**	**117**	**109**	**114**	**113**	**112**	**110**	**109**
Deaths	**105**	**105**	**107**	**107**	**107**	**106**	**106**	**106**	**106**	**107**
Net migration	**84**	**72**	**28**	**16**	**17**	**25**	**25**	**25**	**25**	**25**
Immigration	**104**	**78**	**40**	**31**	**23**	**.**	**.**	**.**	**.**	**.**
Emigration	**21**	**6**	**12**	**15**	**6**	**.**	**.**	**.**	**.**	**.**
Census difference	**x**	**x**	**x**	**-46**	**x**	**x**	**x**	**x**	**x**	**x**

[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.*

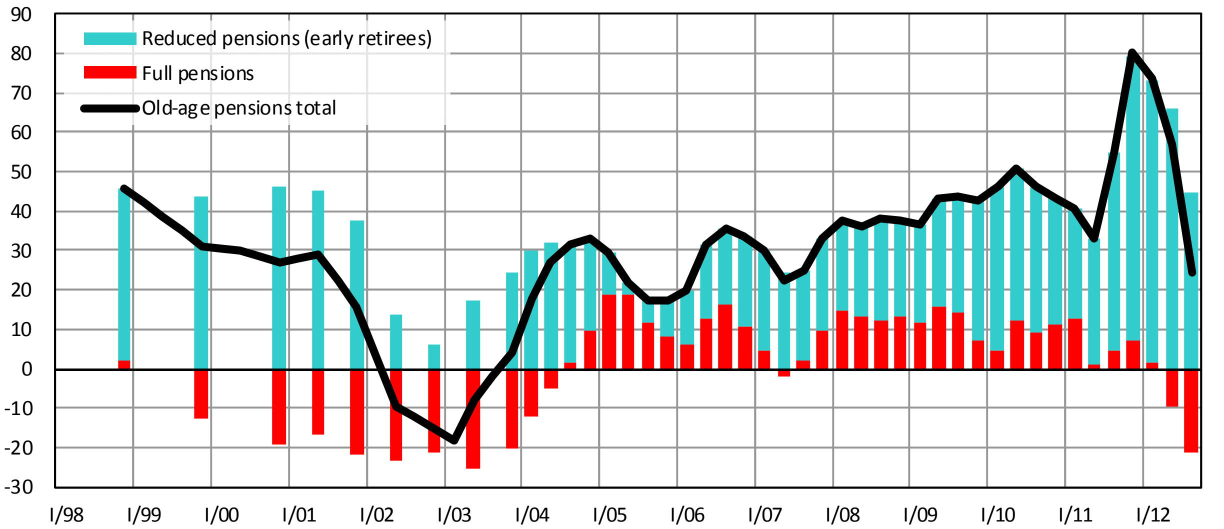
Graph A.6.4: **Dependency Ratios**

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



Graph A.6.5: **Old-Age Pensioners**

absolute increase over a year in thousands of persons



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