C Forecast of the Development of Macroeconomic Indicators

C.1 Economic Output

Latest Development of GDP

In the first quarter of 2014, real GDP increased by 0.8% QoQ[3] (*versus a decrease of 0.5%*), which corresponded to growth of 2.9% in a YoY comparison (*versus 2.0%*). Stockpiling of cigarette tax stamps before the excise tax on cigarettes was increased in January was reflected unfavourably in GDP dynamics in the first quarter 2014 (GVA increased by 1.1% QoQ); nonetheless, the effect was weaker than we estimated. Domestic demand and net exports also developed better, compared with our estimate. Household consumption increased by 1.5% YoY in real terms (*versus 0.3%*) and government consumption by 1.3% (*versus 1.0%*). Gross capital formation was 3.3% higher (*versus 4.7%*), with gross fixed capital formation increasing by 5.6% (*versus 3.4%*). Year on year growth of exports reached 10.1% (*versus 4.2%*), while imports increased by 9.6% (*versus 3.7%*).

Apart from household and government expenditure on consumption, gross fixed capital formation and net exports contributed to the QoQ increase in GDP. However, gross capital formation mitigated QoQ growth of GDP due to the predominant effect of inventory reduction.

With the exception of the change in inventories, all expenditure components contributed positively to the YoY growth of real GDP in the first quarter of 2014.

In terms of the structure of household expenditure, growth in household consumption was driven by expenditure on semi-durable and non-durable goods and services. The recovery of expenditure on services and non-durable goods can be interpreted as a sign of tight household budgets becoming somewhat less constrained (they were most constrained in 2012 and 2013). This has been supported by a positive development in compensation of employees, or (more precisely) gross disposable income, as well as by generally optimistic developments of the main labour market indicators. Increasing consumer sentiment also played a certain role and manifested itself in a decrease in the household savings rate. On the other hand, expenditure on durable goods has not yet recovered. Faster recovery of household consumption than that envisaged in the April Macroeconomic Forecast was the main reason why the forecast differed from the actual development of GDP in the first quarter of 2014. Owing to the fact that we are able to identify reasons for the reported growth of household consumption, we adjust the July Forecast accordingly.

Investment in other machinery and equipment, other buildings and structures and transport equipment contributed to the growth of real gross fixed capital formation in the first quarter of 2014. We believe that our hypothesis from the April Forecast, where we predicted a recovery of investment activity primarily due to a better drawdown of the EU funds, has been proven correct. Further, the increasing investment activity was positively affected by developments in foreign trade (growing demand for production leading to an increase in the volume of internal sources for financing investment). For these reasons, the higher growth of investment is partially reflected in the forecast for the remaining part of 2014. However, in terms of its impact on the upward revision of the forecast for GDP growth, this change of opinion is significantly less important than the one associated with/related to household consumption.

In the first quarter of 2014, foreign trade contributed positively to GDP growth alongside an improvement in the terms of trade. In the first quarter of 2014, real gross domestic income increased by 4.3% YoY (*versus 3.2%*).

In nominal terms, GDP increased by 5.2% (*versus 3.8%*) in the first quarter of 2014. In terms of the income structure of GDP, compensation of employees increased by 3.4% YoY (*versus 1.4%*). A high QoQ growth of gross operating surplus of 8.3% (*versus 6.5%*) signals the growing volume of internal sources for financing investment, while the relatively high growth of compensation of employees contributed considerably to an increase in gross disposable income of households.

GDP Estimate and Forecast

With regard to the aforementioned reasons, we expect that growth of household consumption and gross fixed capital formation will be higher in 2014 than we assumed in the April Forecast. On the other hand, we believe that the high growth of exports (which together with growth of gross domestic expenditure also led to considerably higher than expected growth of imports) was a somewhat temporary phenomenon

[3] *QoQ changes referred to in the text are expressed using seasonally adjusted data; in other cases, seasonally non-adjusted data are used.*

strongly related to the unexpectedly high growth of the German economy, as well as to the depreciation of the Czech koruna. With respect to the fact that we have not fundamentally changed the forecast for the development of the external environment, we expect the contribution of foreign trade to GDP growth in this year to be only slightly higher, compared with the April Forecast. Therefore, any increase in the forecast for GDP growth is related to a change in viewpoint regarding the growth of gross domestic expenditure.

Specifically, we estimate that real GDP increased by 0.3% QoQ (*unchanged*) in the second quarter of 2014. This conclusion is supported by both the aforementioned view concerning the exceptionality of high exports growth in the first quarter of 2014 and the development of the composite leading indicator, which signalled lower GDP growth for the second quarter of 2014 in comparison with the first quarter of 2014. For the third quarter of 2014, we forecast approximately the same QoQ growth; the expected acceleration of growth in the last quarter is connected with the effect of stockpiling cigarette tax stamps as a consequence of another scheduled change in excise taxes.

We estimate that real GDP increased by 3.0% YoY (*versus 2.1%*) in the second quarter of 2014. In terms of its structure we estimate that household consumption increased by 1.7% (*versus 0.7%*) and government consumption by 2.2% (*versus 0.7%*). We are also revising the estimate for the growth of gross fixed capital formation up to 6.0% (*versus 3.4%*). With regard to the recovery in foreign trade, we estimate that exports increased in real terms by 7.2% YoY (*versus 4.0%*) in the second quarter of 2014, as did imports (*versus 3.6%*).

As stated above, in terms of the contributions of expenditure components to GDP growth for the whole of 2014, basically only the opinion regarding household consumption has undergone fundamental change.

We expect that real GDP will increase by 2.7% (*versus 1.7%*) in 2014; in 2015 economic growth could slow slightly to 2.5% (*versus 2.0%*). Change in the opinion on GDP development in 2015 stems also from the upward revision to the forecast for growth of gross domestic expenditure, but in this case it is mainly a result of a change in the forecast for growth of gross capital formation.

Due to a quicker improvement in the situation on the labour market as well as higher consumer sentiment, we are increasing the forecast for the growth of household consumption in 2014 to 1.6% (*versus 0.6%*). For 2015, we have left the forecast for household consumption almost unchanged, and we expect it to grow by 1.4% (*versus 1.5%*).

We revise the forecast for government consumption growth in 2014 and 2015 up mainly due to an increase in health insurance companies' payments for health care. We assume that real government consumption will increase by 1.9% (*versus 0.8%*) in 2014 and by 1.6% (*versus 0.7%*) in 2015.

The drawdown of money from the EU funds, faster growth of domestic demand, higher dynamics of foreign trade as well as the increasing internal sources for financing investment will all be reflected in real growth of gross fixed capital formation, which should increase by 4.1% in 2014 (*versus 2.7%*) and by 3.5% in 2015 (*versus 2.0%*).

Foreign trade should also have a pro-growth effect in 2014 and 2015; however, its contribution to GDP growth remains essentially unchanged. Real exports could increase by 7.4% (*versus 3.8%*) in 2014, while imports could increase by 7.2% (*versus 3.4%*). For 2015, we expect growth of both exports and imports to decelerate to 4.8% (*versus 4.2%*) and 4.7% (*versus 3.8%*), respectively.

Nominal GDP will probably grow by 4.6% (*versus 3.6%*) in 2014, whereas in 2015 we forecast its growth at 3.8% (*versus 3.7%*).

C.2 Prices

Consumer Prices

Year on year growth of consumer prices has been very low this year. In May it reached only 0.4% (*versus 0.8%*), of which 0.1 pp could be attributed to last year's increase in the excise tax on cigarettes and -0.5 pp to regulated prices, where a decrease in the price of electricity had the greatest impact.

When examining the contributions of individual segments of the consumer basket to YoY inflation, the situation has not changed markedly since the beginning of 2014. In May, the biggest contribution (0.4 pp) was again seen in the segment food and non-alcoholic beverages and the smallest contribution in housing (–0.4 pp).

In spite of the weakening of the koruna due to the CNB's foreign exchange interventions, **2014** should be characterized by a very low average inflation: it is likely to be the second lowest (after the year 2003) in the history of the independent Czech Republic. It is clear from Graph C.2.2 that very low inflation will be maintained due to the extraordinary development of administrative measures, the contribution of which to the YoY growth of consumer prices in December 2014 should be –0.3 pp (*versus 0.0 pp*).

The decrease in the forecast for the contribution of administrative measures relates to the longer than originally expected negotiations over the further increase in excise taxes on cigarettes following the transposition of the EU directive. We assume that the impacts of this increase (0.2 pp) will be reflected in consumer prices as late as during 2015. The negative contribution of regulated prices (–0.4 pp) will outweigh the positive contribution of indirect taxes (0.1 pp attributable to this year's increase in the excise tax on cigarettes) more significantly in YoY inflation in December 2014 compared to the assumptions of the April Forecast.

Weakening of the koruna exchange rate resulting from the CNB's exchange rate commitment is likely to be the only more significant pro-inflationary factor in 2014. However, it seems that the pass-through effect is lower than we expected. The impact of the price of crude oil and unit labour costs on inflation should be neutral, while the still negative output gap should prevent growing demand from feeding through to prices.

The first quarter of 2014 was already the eighth quarter in a row of disinflation in the Czech economy. However, we estimate that YoY inflation did not slow any further in the second quarter of 2014. Moreover, the forecast expects inflation to start accelerating in the following quarters.

Despite the very loose monetary policy, both in the exchange rate and interest rate components, the **average inflation rate in 2014** should reach only 0.6% (*versus 1.0%*), with a YoY increase in prices of 1.4% (*versus 2.0%*) in December 2014.

In **2015**, several administrative measures should be reflected in consumer prices. In addition to the aforementioned increase in the excise tax on cigarettes, these include the introduction of the second reduced VAT rate of 10% applying to drugs, books and essential infant nutrition (an impact on YoY inflation of –0.1 pp) and the abolition of selected fees in healthcare (an impact of –0.2 pp). Within the group of regulated prices, electricity prices should fall, although not as significantly as in 2014. On average, regulated prices should stagnate in 2015.

Barriers preventing growing demand from being reflected in prices should gradually disappear in 2015, inflation should be supported by a slight growth in unit labour costs (Table C.3.3). Unlike this year, the CZK exchange rate should tend to have a neutral impact on inflation. According to the forecast assumptions, the dollar crude oil price should be a slightly anti-inflationary factor.

We expect YoY inflation to approach the 2% target of the CNB in 2015, more so than in the remaining part of 2014. **In 2015, the average inflation rate** should reach 1.7% (*versus 2.3%*), with a YoY increase in consumer prices of 1.8% (*versus 2.0%*) in December.

Deflators

The gross domestic expenditure deflator, which is a comprehensive indicator of domestic inflation, grew by 0.5% YoY (*versus 0.2%*) in the first quarter of 2014. In terms of its structure, the growth was a result of both an increase in the household and government consumption deflator and an increase in the gross capital formation deflator. The factors underlying the development of the household consumption deflator are identical to those we mentioned above when analysing the development of the consumer price index. Growth of the gross fixed capital formation deflator as well as the household consumption deflator was influenced, to a certain extent, by the CNB's intervention in the form of the depreciation of the Czech koruna. Investment demand is still too weak for the time being to consider demand factors for price growth.

Terms of trade increased by 1.8% (*versus 1.5%*) in the first quarter of 2014; these were also influenced by the depreciation of the Czech koruna.

The implicit GDP deflator, which is a result of the gross domestic expenditure deflator and terms of trade, increased on a yearly basis by 2.3% (*versus 1.7%*) in the first quarter of 2014.

We forecast the gross domestic expenditure deflator to grow by 0.7% (*versus 0.8%*) in 2014, and for 2015 we forecast it to grow by 1.1% (*versus 1.4%*). The terms of trade could show growth of 1.1% (*versus 1.2%*) in 2014, while they could increase by 0.3% (*versus 0.5%*) in 2015.

In relation to these values, we forecast the implicit GDP deflator growth of 1.8% (*unchanged*) for in 2014 and of 1.3% (*versus 1.7%*) in 2015.

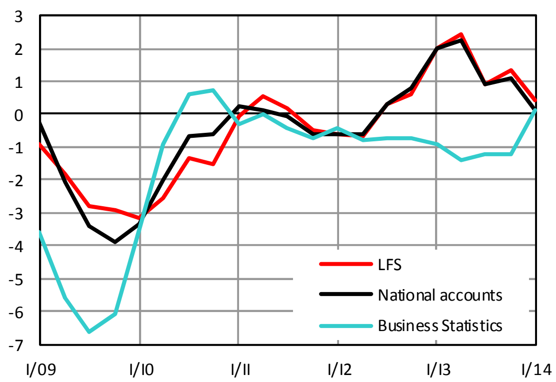
C.3 Labour Market

At the beginning of 2014, the behaviour of the labour market was still somewhat anomalous from the macroeconomic perspective. Although YoY growth in employment continued, the dominant contribution of an increase in the number of entrepreneurs does not correspond to the behaviour typical for a period of recovery. Unemployment according to the LFS continued to decline more significantly than registered unemployment. Wage growth was consistent with the shift of bonuses, growing levels of employment and stabilization of the number of full-time jobs, although its extent was higher than expected.

Employment

According to the LFS, **employment** grew by 0.8% YoY (*versus 0.6%*) in the first quarter of 2014. Unlike the previous year, this development was mainly caused by an increase of 2.8% (*versus a decrease of 0.8%*) in the number of persons in the category of entrepreneurs, while the number of employees increased by 0.4% (*versus 0.9%*). The impact of economic recovery is also apparent in the increase in the number of employees according to business statistics, where upon closer inspection the significant positive contribution of manufacturing becomes clear.

Graph C.3.1: **Employees in Different Statistics**
YoY growth rate, in %, business statistics in full-time equivalent



Source: CZSO

The share of part-time jobs again decreased slightly in the first quarter of 2014. It is nevertheless markedly higher than prior to 2013; from the demographic point of view, women aged 25–49 years contributed predominantly to this outcome. This, together with the rising number of own-account workers, provides evidence that labour supply is still elevated since households want to secure extra income.

With higher than expected growth of economic activity, employment should increase by 0.5% (*versus 0.2%*) in 2014 and further by 0.2% (*unchanged*) in 2015.

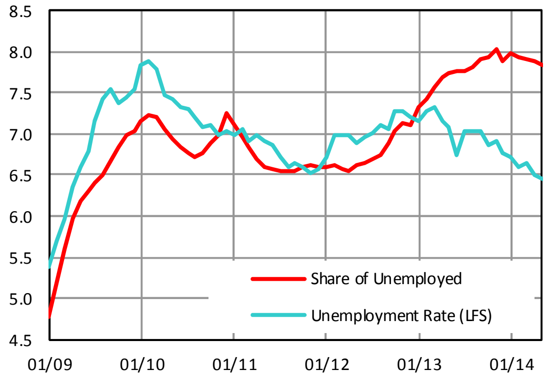
Since mid-2010, **the employment rate** of the population aged 15–64 has been showing continuous growth. In the first quarter of 2014, it increased further by 1.2 pp YoY (*versus 0.9 pp*). Unlike the previous period, from the perspective of business employment statistics, this increase applied not just to occasional working activities.

The economic activity rate (15–64 year-olds) grew by 0.8 pp YoY in the first quarter of 2014 (*versus 0.6 pp*). The increase in participation, after reaching extreme values at the turn of 2012 and 2013, is slowing gradually, which could reflect the anti-cyclical character of participation in the Czech economy. Its lasting increase continues to reflect the motivation of some households to compensate for adverse development of real disposable income by means of formal and informal gainful activities. In the forecast horizon, we expect a trend increase in the economic activity rate (15–64 years), due in part to the increasing statutory retirement age.

Unemployment

Compared to other EU states, the unemployment rate (LFS) in the Czech Republic is one of the lowest. Nevertheless, the number of job applicants registered at labour offices at the beginning of 2014 has reached its highest level in the Czech Republic's history. In spite of the expected continuous decrease in the number of registered unemployed in 2014, this would only mean stagnation in annual terms.

Graph C.3.2: **Indicators of Unemployment**
seasonally adjusted data, in %



Source: CZSO, Ministry of Labour and Social Affairs, own calculations
Note: Share of unemployed (Ministry of Labour and Social Affairs) is defined as a share of available job seekers aged 15 to 64 years in the population of the same age.

The discrepancy between the LFS and registered unemployment (also apparent in long-term unemployment figures) results from the fact that current legislation tolerates limited extra income during the registered form of unemployment, while the definition of unemployed persons according to the LFS excludes any remunerated work. In addition, registration at labour offices is a condition for being granted a number of social benefits and need not necessarily reflect purely motivation towards extra income.

In accordance with the improvement in the forecast for the development of real GDP and its components, we have also modified the forecast for unemployment rate development. Compared to the April Forecast, we expect a faster decrease in the unemployment rate, which could reach, on average for the whole of 2014, 6.4% (*versus 6.8%*) and 6.1% in 2015 (*versus 6.6%*).

Wages

A high increase in the wage bill and the average wage in the first quarter of 2014 could lead, together with other structural factors, to a relatively positive development in both 2014 and 2015.

The wage bill (national accounts methodology, domestic concept) posted a considerable increase of 3.5% YoY (*versus 1.4%*) in the first quarter of 2014, which was mainly due to the statistical effect of managerial bonuses now being disbursed during the standard time period. Last year, these bonuses were shifted to the fourth quarter of 2012 as a result of the introduction of a solidarity surcharge for income tax from 2013. In addition to this temporary phenomenon, the YoY increase in the share of overtime work in the business sector is a positive signal for the future.

Based on the positive developments in the first quarter of 2014 and better forecast for real GDP and real labour productivity growth in 2014, we expect that the wage bill could increase by 2.8% in 2014 (*versus 1.8%*). In addition to the improving situation in the private sector, a positive impulse for future developments (also after 2014) should be the continuing slight increase in the wage bill in the state administration, even though the signalization effects for the private sector seem to be relatively weak, as implied by an analysis of the past years. Another positive factor for the development of wages might be, at least in the short term, stabilization in the proportion of part-time jobs, the structure of which indicates that their hourly remuneration could be relatively lower compared to standard forms of employment. On the other hand, the permanently increased proportion of informal jobs poses a risk for future developments. This conclusion can be supported in particular by the historically highest difference between unemployment according to the LFS and registered unemployment. For 2015, we expect an increase in the wage bill of 3.8% (*versus 3.5%*).

Average wage (business statistics, full-time equivalent) increased by 3.3% (*versus 2.1%*) in the first quarter of 2014, and – given the very low inflation – posted the highest real growth (3.1%) since 2010. The statistical effect of shifting extraordinary bonuses was also apparent. However, a positive signal for the future is a relatively high growth of the median wage (2.9%), as this statistic is not subject to the effects of the timing of managerial bonuses. For the aforementioned reasons concerning the wage bill, we expect the average wage to grow by 2.7% in 2014 (*versus 2.1%*) and by 3.7% in 2015 (*versus 3.4%*).

C.4 External Relations

(balance of payments methodology)

In the first quarter of 2014, the ratio of the current account balance to GDP reached a surplus (in the annual sum) of 0.2% (*versus a deficit of 1.1%*), which meant a YoY improvement of 1.9 pp. The trade balance surplus and the surplus of the balance of current transfers increased by 1.4 pp and 0.2 pp, respectively. The income balance deficit also decreased, falling by 0.5 pp. In contrast, the surplus of the balance of services decreased by 0.1 pp; apart from this, however, all other items on the current account improved.

Export markets[4] increased by 1.7% in 2013. Their growth accelerated throughout the course of 2013, and this tendency was also maintained in the first quarter of 2014, when export markets increased by 5.9% (*versus 3.9%*). The expected recovery of world trade and domestic demand in the economies of the main trade partners should influence export market dynamics positively. Export markets could increase by 5.7% (*versus 3.3%*) on average for the whole of 2014, and for 2015 we expect a slight slowdown of growth to 3.6% (*versus 3.1%*). The development of export markets should be reflected positively in the foreign trade results.

The forecast development of export markets should also be accompanied by an increase in export performance, which indicates a change in the share of the volume of Czech goods on foreign markets. The expected growth of export performance of 2.4% (*versus 0.8%*) in 2014 and 1.4% in 2015 (*versus 1.2%*) should be supported, considering the weakening of the EUR/CZK exchange rate, by the improved price competitiveness of Czech exporters.

The results of foreign trade in goods gradually improved during 2013. The relatively significant increase in the volume of exports and imports recorded in the second half of 2013 also continued in the first quarter of 2014. The weaker exchange rate of the Czech koruna is also reflected in an increase in the trade balance surplus. The surplus of the trade balance could reach 6.0% of GDP in 2014 (*versus 6.1%*) and could increase further to 6.5% of GDP (*versus 6.9%*) in 2015.

In annual terms, the deficit in the fuel balance (SITC 3) reached 5.0% of GDP in the first quarter of 2014 (*versus 5.1%*). With regard to the expected scenario for crude oil prices and the development of the koruna exchange rate, we assume that in the course of 2014 and 2015 the deficit in the fuel balance will stagnate or slightly decrease. It should reach 5.0% of GDP (*unchanged*) in 2014 and 4.7% of GDP (*versus 4.6%*) in 2015.

Imports of services have been increasing for more than three years at a higher pace than exports of services, and thus the surplus of the balance of services has gradually been decreasing. Since the end of 2012, the surplus of the balance of tourism and transport has been decreasing, whereby constantly rising expenditure has combined with an approximate stagnation in revenues. In the last two quarters, there was a slight improvement of the balance of services as a result of an improvement in the balance of so-called other services. In the first quarter of 2014, its total surplus in annual terms remained at 1.5% of GDP (*versus 1.4%*), i.e. it was unchanged YoY. We expect that in 2014 and 2015 the surplus of the balance of services will stagnate at 1.5% of GDP (*in both years versus 1.4%*).

In annual terms, the deficit in the income balance, which comprises reinvested and repatriated earnings of foreign investors, decreased by 0.5 pp (compared with the first quarter of 2013) to 6.9% of GDP (*versus 8.0%*) in the first quarter of 2014. The decrease in the deficit was caused not only by a decline in the volume of dividends paid from foreign direct investments abroad (their payments could have been merely postponed, at least partially), but also an improvement in the balance of compensation of employees. In spite of this partial decrease in the deficit in the income balance, however, its long-term upward trend will probably remain unaffected. The income balance could show a deficit of 7.6% of GDP (*versus 8.2%*) in 2014 and 8.2% of GDP (*versus 8.8%*) in 2015.

Under the given circumstances, we assume that there will be a further slight improvement in the current account balance in 2014 to 0.4% of GDP (*versus –0.4%*). Current account of the balance of payments would show a surplus for the whole calendar year for the first time since 1993. We expect that the current account could be balanced in 2015 (*versus –0.3%*).

[4] *Weighted average of growth in imports of goods from the six most important trade partners (Germany, Slovakia, Poland, France, the United Kingdom and Austria).*

C.5 International Comparisons

Comparisons for the period up to and including 2013 are based on Eurostat statistics. Since 2014, our own calculations have been used on the basis of real exchange rates.

Using the purchasing power parity method, comparisons of economic output for individual countries within the EU are made in PPS (purchasing power standards). PPS is an artificial currency unit expressing a quantity of goods that can be bought on average for one euro in the EU28 territory after converting the exchange rate for countries using currency units other than the euro. Using updated Eurostat data, the purchasing power parity of the Czech Republic in 2013 was CZK 17.98/PPS compared to the EU28, or CZK 17.24/EUR compared to the EA12.

Due to the recession, GDP per capita measured in **current purchasing power parity** declined in 2009 in all monitored countries, with the exception of Poland. While most states have gradually recovered from the crisis, in Greece the absolute economic level continued to fall without interruption until 2013. The absolute economic level also decreased slightly in Croatia in 2010, in Portugal in 2011 and in Slovenia in 2013. In 2009–2013, the relative economic level vis-à-vis the EA12 countries also declined in all the aforementioned economies, the largest drop (19 pp) being recorded in Greece. In contrast, the economic level relative to the EA12 average is increasing most quickly in the Baltic states. In the period 2009–2013, it increased by 15 pp in Lithuania, by 13 pp in Latvia and by 8 pp in Estonia.

In the Czech Republic, the economic level measured by GDP per capita adjusted by current purchasing power parity was approximately 20,600 PPS in 2013, corresponding to 73% of economic level in the EA12. Thanks to strong economic growth, the relative economic level of the Czech Republic in comparison with the EA12 countries increased by 13 pp in the years 2000–2007. Afterwards, however, due to periods of recession and only negligible economic growth, the convergence process stopped. In 2008–2013, economic level of the Czech Republic ranged between 73% and 75% of the EA12 average. However, we expect the economic level of the Czech Republic to grow by 2 pp in 2014 and it to stagnate in 2015.

Calculated alternatively using the exchange rate, which takes into account the market valuation of the currency and ensuing differences in price levels, GDP per capita in the Czech Republic in 2013 reached approximately EUR 14,200, i.e. 49% of the EA12 level. In 2013, both the absolute and relative levels of GDP per capita adjusted for the exchange rate decreased; a decline to which the adoption of the exchange rate commitment by the Czech National Bank in November 2013 also contributed. With regard to the assumption that the CNB will use the exchange rate as an additional monetary policy instrument until mid-2015, in 2014 we expect a further decrease in both absolute and relative levels.

When comparing price levels, the **comparative price level of GDP** in the Czech Republic decreased by 2 pp in 2013, thus reaching 66% of the EA12 average. The expected slight decrease in the comparative price level by 3 pp in 2014 should help maintain the Czech economy’s competitiveness.