C Forecast of the Development of Macroeconomic Indicators

C.1 Economic Output

The recovery of the Czech economy is still continuing. However, the quarterly national accounts published in March 2011 have given rise to fears that economic growth is slowing. According to data at that time, the QoQ growth of seasonally adjusted GDP was to decelerate to 0.3% in the fourth quarter of 2010, which influenced preparation of the April forecast of the Ministry of Finance of the Czech Republic. According to current data, however, the QoQ GDP growth in the fourth quarter of 2010 reached 0.5%. The seasonally adjusted real GDP grew QoQ by 0.9% in the first quarter of 2011, representing a YoY increase[3] of 3.1% (*versus 2.3%*). The fears of slowing growth thus were not confirmed. Nevertheless, the level of seasonally adjusted GDP is still 0.6% below the previous peak from the third quarter of 2008.

Economic growth in 2011 and 2012 should be driven by foreign trade. Growth in household consumption should be limited by fiscal consolidation measures, and government consumption should decrease. The end of inventories replenishment after the recession also must be taken into account. We expect moderate growth acceleration to 2.5% (*versus 1.9%*) for 2011, and in 2012 we expect growth dynamics to be maintained at 2.5% (*versus 2.3%*).

The substantially worsening terms of trade led **real gross domestic income** (RGDI), which reflects the income situation of the Czech economy, to grow more slowly than GDP. In the first quarter of 2011, it grew YoY by only 0.7% (*versus a decline of 0.3%*). The income situation of Czech economic entities thus has improved more slowly than has the growth in economic output. RGDI should level off in 2011 (*versus a decline of 0.2%*) and grow by 2.3% in 2012 (*unchanged*).

Real dynamics are causing **nominal GDP** (which is a key variable for fiscal forecasts) to be higher than originally anticipated. YoY growth of 2.2% (*versus 0.8%*) was reported in the first quarter of 2011. We expect nominal GDP growth of 1.7% (*versus 1.3%*) for 2011 and 5.2% (*versus 5.0%*) for 2012.

Regarding the **income structure of GDP**, we expect to see a gradual rise in the profitability of the business sector. The gross operating surplus increased by 2.7% YoY in the first quarter of 2011 (*versus a decline of 0.7%*). Growth of 1.0% (*versus stagnation*) can be expected for 2011, and in 2012 the increase in operating surplus should reach 5.6% (*versus 5.2%*).

Forecasts still reflect the high level of uncertainty ensuing especially from developments in the external environment. Impacts of data revisions on past economic development also may be relevant.

Expenditures on GDP

In the first quarter of 2010, seasonally adjusted **household consumption** fell by 0.6 % QoQ. That means that the YoY drop in real household expenditures on final consumption reached only 0.4% (*versus 0.7%*) in the first quarter of 2011. The unfavourable income situation of households, and especially the decrease in wages in part of the public sector, continues to work against an increase in consumption. We expect household consumption growth dynamics at a level of around 0.5% (*versus 0.7%*) for 2011. The increase in the reduced VAT rate from 10% to 14% will slow consumption growth in 2012. That is one reason why we expect an increase of just 2.0% (*versus 1.9%*), which is below the growth in economic output.

Government expenditures on final consumption in the first quarter of 2011 fell in real terms by 1.2% (*versus 3.2%*). The causes of the more moderate decrease are discussed in Chapter A.2. In accordance with adopted stabilisation measures and the approved consolidation strategy, government institutions are expected to behave thriftily regarding both employment and purchases of goods and services. Government consumption should decrease by 2.4% (*versus 3.4%*) in 2011. We expect consumption expenditures to continue to decline in 2012 by 2.1% (*versus 2.5%*).

Gross fixed capital formation increased YoY by 3.7% (*versus 0.3%*) in the first quarter of 2011. (At the same time, the drop in investments for 2010 was revised from 4.6% to 3.1%.) Purchases of vehicles especially contributed to the recovery of investment dynamics, as these increased by 20.2%. Construction investments in non-housing structures grew by 8.8%. By contrast, purchases of machinery other than vehicles fell by 4.9% and housing investments declined YoY by 2.3%. The willingness of foreign investors to make new investments or to reinvest profits from their business

[3] *Data without seasonal adjustment are presented in the remaining text, unless stated otherwise.*

operations in the Czech Republic will also depend on the situations in their home countries. A gradual shift in capacities that profited from inexpensive labour can be expected as well. The influence of infrastructure investments and contributions from EU funds should have a positive effect, and investors should also be attracted by the macroeconomic stability in the Czech Republic.

We have adjusted the previous forecast for 2011 in accordance with the revision of growth in 2010. Growth in investments should be restored at a level of 1.9% (*versus 0.7%*), while growth of about 3.2% (*unchanged*) is expected for 2012.

The contribution of **change in inventories** to YoY GDP growth in the first quarter of 2011 on seasonally adjusted data was zero. We expect a contribution of 0.4 p.p. (*unchanged*) for 2011 and 0.2 p.p. (*versus 0.1 p.p.*) for 2012.

The contribution of **foreign trade** to YoY GDP growth on seasonally adjusted data reached 2.5 p.p. for the first quarter of 2011. The external balance is positively influenced by the ongoing recovery in trading-partner countries accompanied by concurrent limited growth in domestic demand. We expect a foreign trade contribution of 1.9 p.p. (*versus 1.8 p.p.*) for 2011, while for 2012 we expect 1.1 p.p. (*unchanged*) due to the export volume's slower growth rate.

The estimated figures do not at all anticipate any changes connected to the revision of national accounts to be carried out by the CZSO at the end of September 2011.

C.2 Prices

Consumer prices

The YoY growth in consumer prices accelerated to 2.0% (*versus 1.9%*) in May, with a contribution from administrative measures of 0.6 p.p.

The YoY acceleration of inflation was caused primarily by prices in the food and non-alcoholic beverages sector, which reflects increase in prices of domestic agricultural producers and food commodities on global markets. The price levels of food and non-alcoholic beverages surpassed the 2008 peak already in April, and YoY growth has now lasted 12 months in a row. We expect food prices to have a pro-inflation impact for the rest of the year as well.

In the transport sector, two opposing tendencies are present in YoY terms: car prices are falling while fuel prices are rising. The price of Natural 95 petrol reached its historic maximum of CZK 35.21/l in May. The accepted assumptions about future dollar prices of oil and the CZK/USD exchange rate lead to higher CZK oil prices as compared to the previous forecast and contribute to the increased inflation estimate.

The impacts of administrative measures will be substantial for the remainder of this year, as well. We estimate their contribution to YoY consumer price index growth in December 2011 to be 0.9 p.p. (*versus 0.8 p.p.*). The gas price increases in June and July will have a total impact of 0.2 p.p.

Inflation impulses, which are primarily external and caused especially by high commodity prices, are mitigated by the persistent cyclical position of the Czech economy in the negative output gap, slow improvement of the labour market situation, and moderate growth in wages. We continue to regard the inflation as cost–push inflation.

Considering the presented circumstances and projections, we estimate that the average inflation rate will reach 2.3% (*versus 2.1%*) in 2011, with a price increase of 3.0% (*versus 2.5%*) YoY in the end of the year.

In 2012, inflation will be influenced considerably more by administrative measures. The increase in the reduced VAT rate from 10% to 14% will have the greatest influence, and we estimate its impact on the CPI to be 1.1 p.p. after revision. In view of the forecasted low elasticity of demand for goods affected by the VAT increase, we assume its full reflection in consumer prices. Of indirect taxes, excise taxes on cigarettes and tobacco will continue to grow (impact 0.1 p.p.). In terms of regulated prices, we expect the greatest impact from electricity (0.2 p.p.). This will depend, however, on what limit of funds from the state budget the government will set for grants to finance additional costs connected with supporting the production of electricity from renewables. The unregulated component of the electricity price (the actual electricity) will be influenced by future development of markets in Germany. The uncertainty of price development in the housing sector is due also to a possible price increase for solid waste collection. The increased hospital-stay fee is already incorporated into the forecast (impact 0.1 p.p.). We expect administrative measures to make up about two thirds of the YoY growth in consumer prices in 2012. The contribution in December should be 2.3 p.p. (*forecast unchanged*).

The inflation expectations, which we regard as well founded, should not be influenced by the larger extent of administrative measures next year, as the measures mentioned have a one-off character with regards to consumer price dynamics.

Based on the above, we estimate an average inflation rate of 3.5% (*versus 3.2%*) in 2012, with a December price increase of 2.9% (*unchanged*). The market price increase should be positive for the entire forecast horizon.

In the outlook for 2013 and 2014, inflation should stay within the tolerance band for the Czech National Bank's inflation target. This outlook presumes that in January 2013 the VAT rate will be unified at 17.5%, which should have an impact of –0.2 p.p. on the CPI.

Deflators

The aggregate price level in the economy has increased only moderately. The **gross domestic expenditure deflator**, which is a comprehensive indicator of domestic inflation, grew by 1.4% (*versus 1.2%*) in the first quarter of 2011 as compared to the same period of last year. It should increase by 1.7% (*versus 1.5%*) in 2011 and by 3.0% (*versus 2.8%*) in 2012, due primarily to acceleration in consumer inflation.

The value of the **implicit GDP deflator** fell by 0.9% (*versus a 1.4% decline*) in the first quarter of 2011. Unlike the gross domestic expenditure deflator, it was driven downward by the 2.8% decline (*versus 3.0%*) in the terms of trade. We expect a decline in the deflator of 0.8% (*versus 0.5%*) for 2011 and growth of 2.6% (*versus 2.7%*) for 2012.

C.3 Labour Market

The labour market reflects the improving economic situation and is slowly approaching the standard lag in cyclical development relative to the economic cycle as measured by output. However, the impact of administrative decisions is evidenced by the further decline in average wages in the state-run sector.

Employment

According to the Labour Force Survey (LFS), employment rose YoY in the first quarter of 2011 by 0.7% (*versus 0.6%*).

With regards to employment by sector, according to preliminary data the most significant YoY growth in employee numbers was recorded in the secondary sector (over 30,000 persons) and mostly in the manufacturing industry. The number of employees in the tertiary sector increased only slightly, and the number of persons in the primary sector remained basically the same.

The dynamic increase of the category of entrepreneurs and self-employed continued, although its rate slowed to 4.3% YoY from 7.5% in the fourth quarter of 2010 due to deceleration in growth among self-employed persons to 6.3%. The continuing increase in the self-employed demonstrates employers' persisting interest in tax optimisation, but the rate deceleration and the fact that the YoY decline in employees and entrepreneurs with employees has halted give hope that the development will gradually improve.

The **rate of employment** (15–64 years of age) rose YoY by 0.9 p.p. to 65.0%. Growth in the age category of 55–59 years in particular was a very positive phenomenon, reaching 3.2 p.p. in the fourth quarter of 2010. Nevertheless, the departure of higher age categories into non-activity continued.

Rate of economic activity (15–64 years) was constant at 70.1% in a YoY comparison. However, the labour supply continued to fall YoY in the first quarter of 2011 due to the declining number of working-age persons. The lower supply was evidenced by a decline in the number of unemployed persons. Another part of dismissed workers entitled to old-age pension opted for non-activity. According to Czech Social Insurance Administration statistics, however, growth in the number of old-age pensioners has recently slowed.

Due to employment's lag in reviving compared to the economic recovery and the beginning of stabilisation, employment rose in the first quarter of 2011 in accordance with the forecast. For 2011 and 2012, however, we continue to look for growth of less than 1%, corresponding to rational personnel policy, incorporation of available capacities, and continuing restrictive policy in the state-run sector.

Unemployment

After a sharp increase at the end of 2010 caused by dismissals in the government sector, registered unemployment has fallen more quickly in 2011 than we anticipated in the previous forecast. Another positive development is that already in April and May there was a YoY decline in job seekers in all regions.

The internationally comparable unemployment rate according to LFS reached 7.2% (*as forecast*) in the first quarter of 2011, representing a YoY decline of 0.7 p.p.

Considering past development and the factors presented below, we expect a drop in the LFS unemployment rate to 6.7% (*versus 6.9%*) in 2011 and 6.4% (*versus 6.5%*) in 2012. This more optimistic outlook for unemployment is made possible especially by the improving structural characteristics of the labour market and expected economic growth. The new legislative adjustments should contribute, as well.

Wages

The **wage bill** (NA, domestic concept) grew by 2.4% (*versus 1.8%*) in the first quarter of 2011, along with growth in production. The discrepancy between the forecast and current outcome must be attributed in part to the growth revision for 2010 from 0.1% in the April forecast to the currently valid 1.2% (the change of opinion was most striking in the first quarter; the YoY decline of 2.4% was reduced to 0.7%).

For 2011, we expect an increase in the wage bill of 2.3% (*versus 2.1%*). As a result of the gradual economic recovery and the improvement in the situation for businesses, we also expect the YoY growth in the overall wage bill to continue. Austerity measures in the budget will continue to forestall higher growth. As the most important data basis, the estimated wage bill of CZK 1,289 billion is entirely in agreement with the state budget's macroeconomic framework for 2011 (CZK 1,288 billion).

Assuming wage bill growth in the government sector, as well, we expect total growth of 4.4% in 2012.

The **average wage** (CZSO, company-based method, full time equivalent) grew nominally by 2.1% (*as forecast*) YoY in the first quarter for the economy as a whole. This was due exclusively to the business sector (3.0% growth), while it continued to fall in the non-business sector (by 1.7%). The differing development in these sectors has led to a situation in which the average wage in the non-business sector (CZK 22,608), which employs a significantly higher proportion of university-educated employees, has fallen below the average nominal wage in the business sector (CZK 23,266).

On the basis of data from previous periods, signals from the business sector, and known intents and decisions regarding public sector salaries for the forthcoming period, growth in average nominal wages is expected to become more moderate in the forthcoming period. We expect growth of 2.3% (*versus 2.6%*) for 2011, driven exclusively by the business sector, and of 4.0% (*versus 4.1%*) for 2012.

C.4 External Relations

(a balance of payments perspective)

The external imbalance, expressed as the **ratio of the current account balance to GDP,** reached –3.4% (*versus −3.9%*) in the first quarter of 2011, worsening YoY by 0.3 p.p. This was caused exclusively by a 0.9 p.p. deterioration of the trade balance. Other components of the current account achieved better or similar results YoY.

World trade continued to grow in the first quarter of 2011. After the strong growth in export markets[4] by 12.2% in 2010, its rate slowed somewhat in the first quarter of 2011 to 10.5%. For 2011 and 2012, we expect export markets growth of 7.0% and 6.9%, respectively. Similarly, we anticipate a somewhat lower growth rate for Czech imports and exports in the coming two years than that achieved in past four quarters (19.9% for exports, 22.4% for imports). We estimate that the **trade balance** will reach 0.6% of GDP in 2011 (*versus 0.7%*) and 1.1% of GDP (*versus 1.4%*) in 2012. This estimate is burdened by significant uncertainties, however. Due to methodology changes, the results of the available time series on foreign trade vary greatly. Hence, the analysis of the structure and tendencies of foreign trade for previous periods and any forecast of its further development is highly problematic. According to the CZSO, the various time series should be harmonised in September 2011.

In view of the oil price scenario, we assume the current high prices of raw materials will remain high over the course of 2011 and 2012, thus increasing the fuels balance deficit (SITC 3). Its ratio to GDP reached –3.7% in 2010, and we expect it to increase further to ca −4.8% (*versus –4.4%*) and –4.9% (*versus –4.1%*) in 2011 and 2012, respectively.

The **balance of services** surplus remained steady YoY at 1.8% of GDP (*versus 1.9%*) in the first quarter of 2011. Revenues and expenditures from all components of the balance of services grew for the second quarter in a row. Considering the relatively positive development of the global economy at present, we expect moderate improvement in the balance of services for the rest of 2011 and also in 2012, increasing to ca 2.0% of GDP this year and 2.1% of GDP next year.

The deficit in the **income balance**, which includes foreign investors' reinvested and repatriated profits, showed only a weak growth tendency. Income payments increased slightly, especially from portfolio investments, while revenues were roughly unchanged. The income balance from direct investments achieved moderately better results YoY. Revenue grew faster than expenditure consisting primarily of reinvested profits,. The balance of compensation of employees continues to improve due to domestic industrial enterprises' low demand for employing foreigners. We expect this trend to continue in 2011, and with a steady investment income balance we estimate a slight decrease in the income deficit to 6.7% of GDP (*versus no change at −7.0%*). We anticipate the deficit will increase gradually again to –7.0% of GDP (*versus −7.3%*) in 2012.

Within this context, we estimate that the **current account** deficit as a proportion of GDP will reach –3.9% (*versus −4.0%*) in 2011. The forecast for 2012 is –3.6% of GDP (*versus –3.4%*). A current account deficit of this size presents no significant risk of macroeconomic imbalance.

[4] *Weighted average growth in goods imports by the seven most important trade partner countries (Germany, Slovakia, Poland, Austria, France, United Kingdom and Italy).*

C.5 International Comparisons

Comparisons for the period up to and including 2010 are based on Eurostat statistics. Since 2011, our own calculations are 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 on EU27 territory after exchange rate conversion for countries that use currency units other than the euro. Using updated Eurostat data, purchasing power parity of the Czech Republic in 2010 was CZK 17.87/PPS in comparison to the EU27 or CZK 16.92/EUR in comparison to the EA12.

As a result of the economic crisis, per capita GDP adjusted using current purchasing power parity fell in 2009 in the Czech Republic and in other Central European countries. The only exception was Poland, which was not hit by recession. By contrast, recession hit the Baltic countries and Slovenia especially hard, and their relative economic levels compared to the EA12 decreased. Last year, the economic recession continued only in Greece, while in the other monitored economies economic recovery led to GDP growth. The relative economic level compared to the EA12 fell not only in Greece, however, but also in the Czech Republic and Slovenia.

In 2010, per capita GDP of the Czech Republic reached ca PPS 19,500, corresponding to 73% of EA12 economic output. The relative economic level of the Czech Republic compared to the EA12 decreased by 2 p.p. against the previous year and, according to Eurostat data, fell below the level of Portugal. We believe it is necessary to view this data simply as a preliminary estimate, since real GDP growth in the Czech Republic surpassed that in the EA12 by 0.6 p.p., whereas growth in Portugal lagged behind the EA12 by 0.4 p.p. Population growth reached 0.3 p.p. in the EA12 and 0.2 p.p. in the Czech Republic, while it stagnated in Portugal. Finally, country rankings according to GDP will still be influenced by data revisions for 2010.

An alternative way of calculating GDP per capita by means of the current **exchange rate** takes into account the market valuation of the currency and ensuing differences in price levels. In the case of the Czech Republic, this indicator amounted to ca EUR 13,800 in 2010, i.e. nearly half of the EA12 level (49%). Due to growth recovery and gradual appreciation of the exchange rate, the pre-crisis level of 2008 should be surpassed as early as this year.

The comparative price level of GDP in the Czech Republic reached 67% of the EA12 average in 2010. Depreciation of the real exchange rate was reflected in a YoY drop in the price level by 4 p.p. in 2009, which significantly helped to boost the competitiveness of the Czech economy. Much faster exchange rate depreciation was seen in Poland, where decline of the relative price level reached almost 12 p.p. and thus helped Poland to avoid economic recession.

The comparative price level of Czech GDP grew already by 3 p.p. last year and should continue to rise gradually, led by productivity growth and growth in the Czech economy’s competitiveness due to factors not related to price.