



**Ministry of Finance**

**CZECH REPUBLIC**

Department for Financial Policies

# **Macroeconomic Forecast of the Czech Republic**

**October 2011**

## Macroeconomic Forecast

# Structure of the presentation

## Forecast Assumptions

- external environment
- fiscal policy
- monetary policy, interest rates and exchange rates
- structural reforms

## Economic Cycle

## Forecast of Macroeconomic Indicators

- economic output
- inflation
- labour market
- external relations

# Forecast Assumptions



# External Environment

## Sharp worsening of the global economic outlook during the last quarter

- deepening and extending the debt crisis to the other euro area countries
- increasing no-confidence in the ability of governments in problem countries to repay debts
- nervousness in the financial markets (reduction of activity in the interbank markets, decline in the stock markets accompanied by increased volatility)

## Risks to the future development

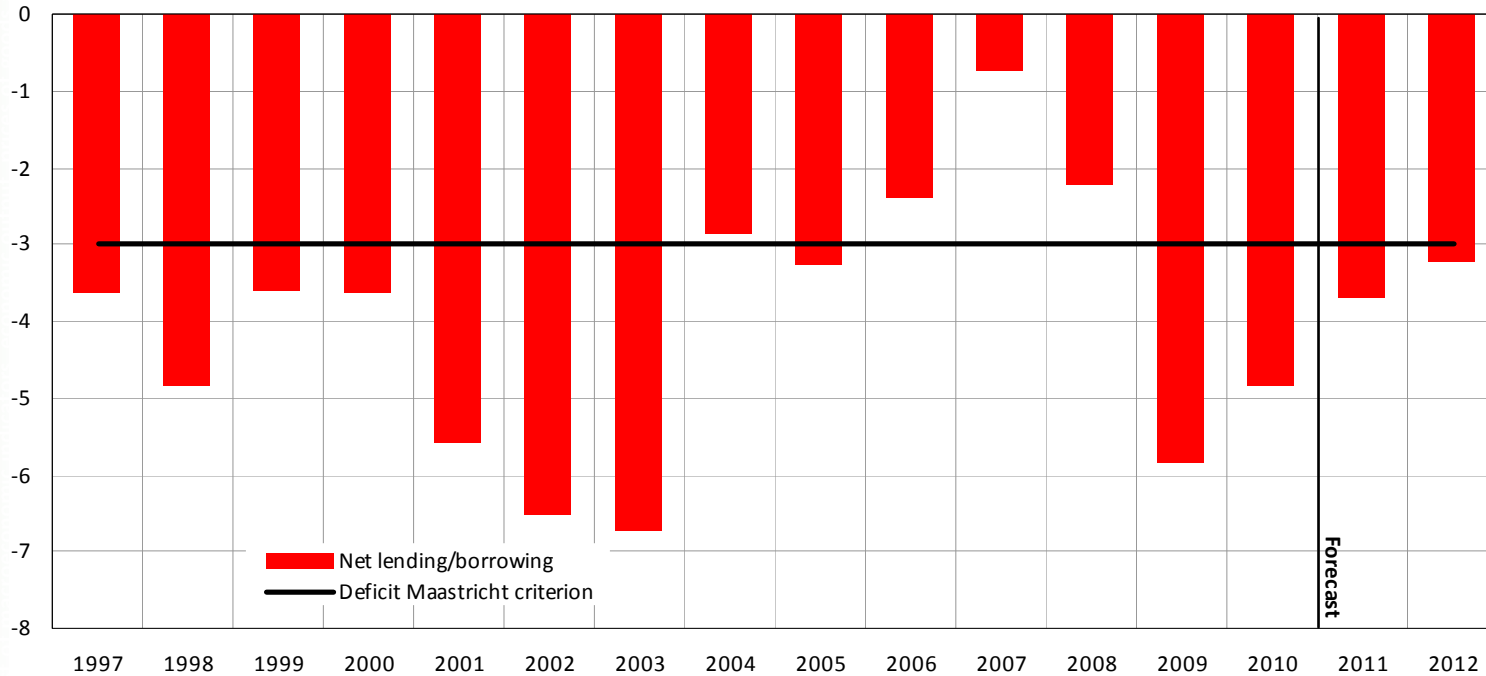
- spread of the debt contagion to the large euro area countries (Italy, Spain)
- eruption of the banking crisis in some European countries

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# Fiscal Policy

## Net Lending/Borrowing

(in % of GDP)



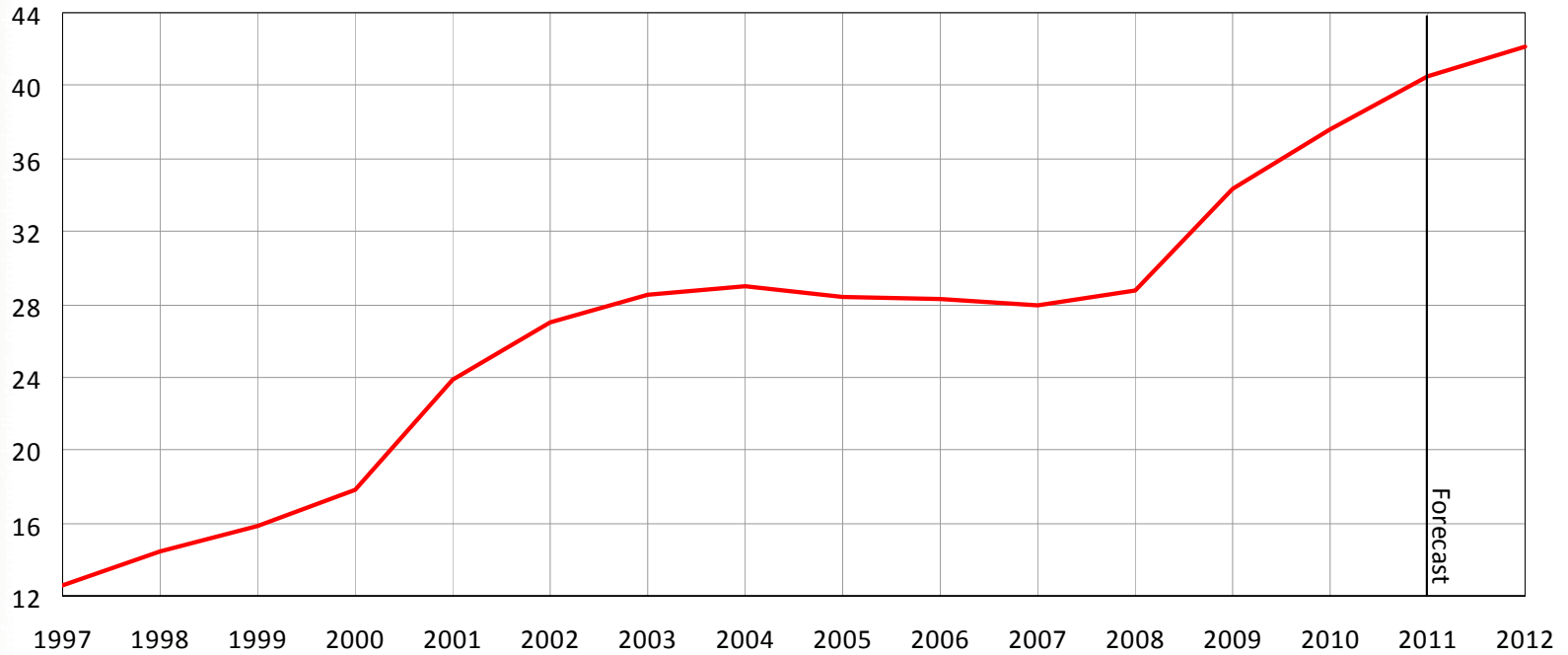
Source: Ministry of Finance.

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# Fiscal Policy

## Government Debt

(in % of GDP)



Source: Ministry of Finance.

## Macroeconomic Forecast

# Fiscal Policy

- in 2010, according to the preliminary estimates, the general government deficit has reached 4.8% of GDP
- the deficit is expected to be reduced to 3.7% of GDP in 2011 due to favourable interest costs and decrease in investment grants for projects co-financed from the EU budget
- risk: adoption of the property settlement with churches and religious communities would increase the deficit by 1.5 p.p. in 2012
- government debt at the end of 2011 is estimated at 40.5% of GDP

## Fiscal Aims

- improvement in the general government balance to 1.9% of GDP in 2014
- achieve balance in the general government sector in 2016



## Monetary Policy, Interest Rates and Exchange Rates

- **CNB's inflation target as annual consumer price index growth of 2% with a tolerance band of  $\pm 1\%$ , effective from January 2010**
- **interest rate for 2W repo operations stood only at 0.75% in the third quarter of 2011**
- **the average value for 3M PRIBOR stagnated in the third quarter of 2011 at 1.2% and a moderate decrease to 1.1% is expected in 2012**
- **deterioration of the situation in the financial markets and increase in the risk aversion led to a gradual weakening of the exchange rate in the third quarter of 2011, we expect an average exchange rate of 24.3 CZK/EUR and 17.5 CZK/USD in 2011**
- **the Czech Republic's rating in October 2011:  
Standard & Poor's – an increase from A to AA- in August  
Moody's and Fitch Ratings - A1**



# Structural reforms

## Approval of major structural reforms

- **3rd pillar of tax reform (the Government approved on 24 August 2011)**
- **pension reform (the Chamber of Deputies approved on 9 September 2011)**
- **amendment to the Labour Code (the Chamber of Deputies approved on 9 September 2011)**
- **social reform I (the Chamber of Deputies approved on 9 September 2011)**
- **first phase of healthcare reform (President signed on 29 September 2011)**
- **second phase of healthcare reform (the Chamber of Deputies approved on 7 September 2011)**

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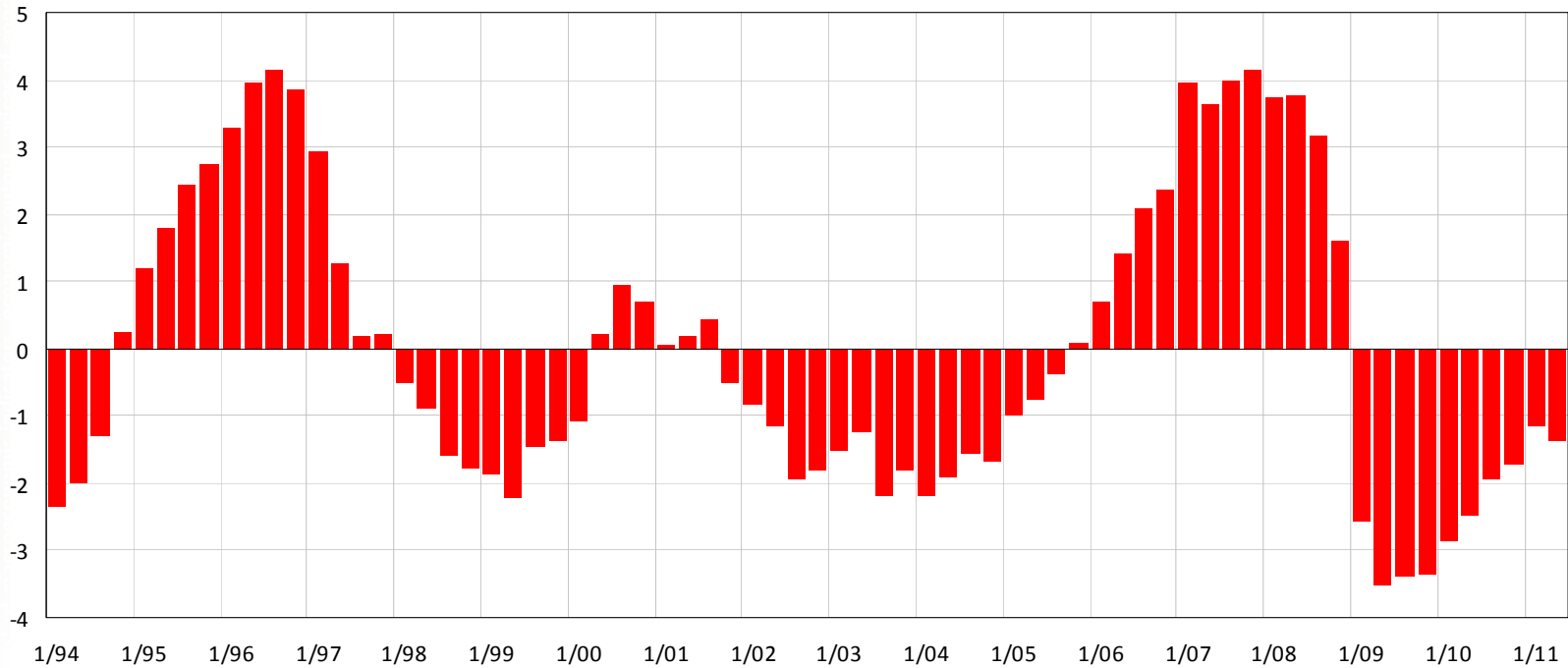
# Economic Cycle

Macroeconomic Forecast

# Economic cycle

## Output Gap

(in % of potential product)

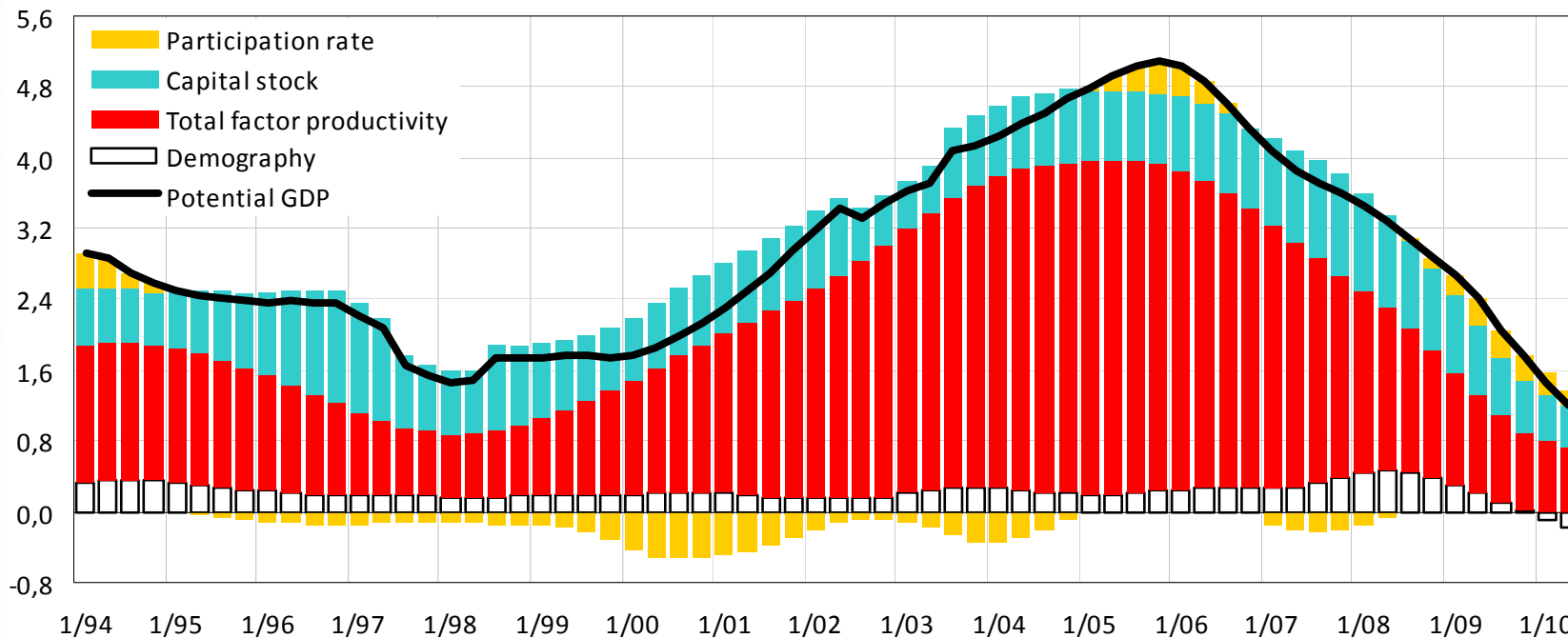


Sources: CZSO, CNB and Ministry of Finance's own calculations

# Economic cycle

## Potential Product Growth

(in %, contributions in percentage points)



Sources: CZSO, CNB and Ministry of Finance's own calculations

## Economic cycle

- economic recession gave rise to a deeply negative output gap
- YoY growth of potential product is gradually lowering and, according to our calculations, the total level of potential output loss due to recession and slow recovery is about 6.8% so far
- the component most seriously affected is total factor productivity, its contribution to the growth fell to only 0.6 p.p. in the first half of 2011
- deep fall in investment activity led to a reduction of the contribution of the capital stock, which remains relatively low
- the labour supply accelerated its growth during the recession and thus partly compensated the moderate decline in working age population

# Forecast of Macroeconomic Indicators





## Macroeconomic Forecast

## Main Macroeconomic Indicators

		2008	2009	2010	2011	2012
					<i>Forecast</i>	
<b>Gross domestic product</b>	<i>growth in %, const.pr.</i>	<b>2,5</b>	<b>-4,1</b>	<b>2,3</b>	<b>2,1</b>	<b>1,0</b>
<b>Consumption of households</b>	<i>growth in %, const.pr.</i>	<b>3,6</b>	<b>-0,2</b>	<b>0,2</b>	<b>-0,6</b>	<b>-0,5</b>
<b>Consumption of government</b>	<i>growth in %, const.pr.</i>	<b>1,1</b>	<b>2,6</b>	<b>-0,1</b>	<b>-1,2</b>	<b>-0,5</b>
<b>Gross fixed capital formation</b>	<i>growth in %, const.pr.</i>	<b>-1,5</b>	<b>-7,9</b>	<b>-3,1</b>	<b>2,1</b>	<b>1,4</b>
<b>Cont. of foreign trade to GDP growth</b>	<i>p.p., const.pr.</i>	<b>1,3</b>	<b>-0,6</b>	<b>1,0</b>	<b>1,7</b>	<b>1,0</b>
<b>GDP deflator</b>	<i>growth in %</i>	<b>1,8</b>	<b>2,5</b>	<b>-1,2</b>	<b>0,0</b>	<b>1,7</b>
<b>Average inflation rate</b>	<i>%</i>	<b>6,3</b>	<b>1,0</b>	<b>1,5</b>	<b>1,9</b>	<b>3,2</b>
<b>Employment (LFS)</b>	<i>growth in %</i>	<b>1,6</b>	<b>-1,4</b>	<b>-1,0</b>	<b>0,4</b>	<b>-0,2</b>
<b>Unemployment rate (LFS)</b>	<i>average in %</i>	<b>4,4</b>	<b>6,7</b>	<b>7,3</b>	<b>6,9</b>	<b>6,9</b>
<b>Wage bill (domestic concept)</b>	<i>growth in %, curr.pr.</i>	<b>8,7</b>	<b>0,0</b>	<b>1,2</b>	<b>2,3</b>	<b>2,7</b>
<b>Current account / GDP</b>	<i>%</i>	<b>-2,2</b>	<b>-2,5</b>	<b>-3,2</b>	<b>-3,1</b>	<b>-3,3</b>

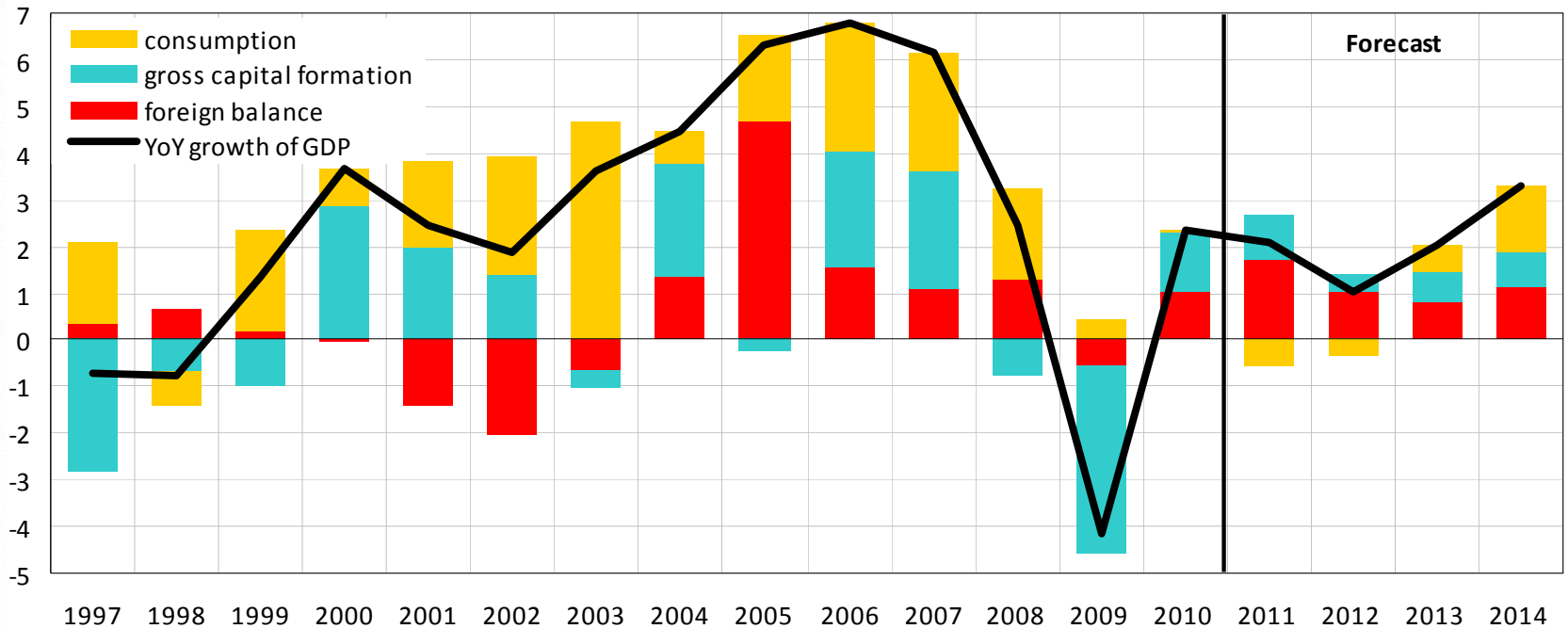
Sources: CZSO, CNB and Ministry of Finance's own calculations



# Economic Performance

## Gross Domestic Product (real)

(in constant prices, decomposition of the YoY growth, in percentage points)



Sources: CZSO and Ministry of Finance's own calculations

## Economic Performance

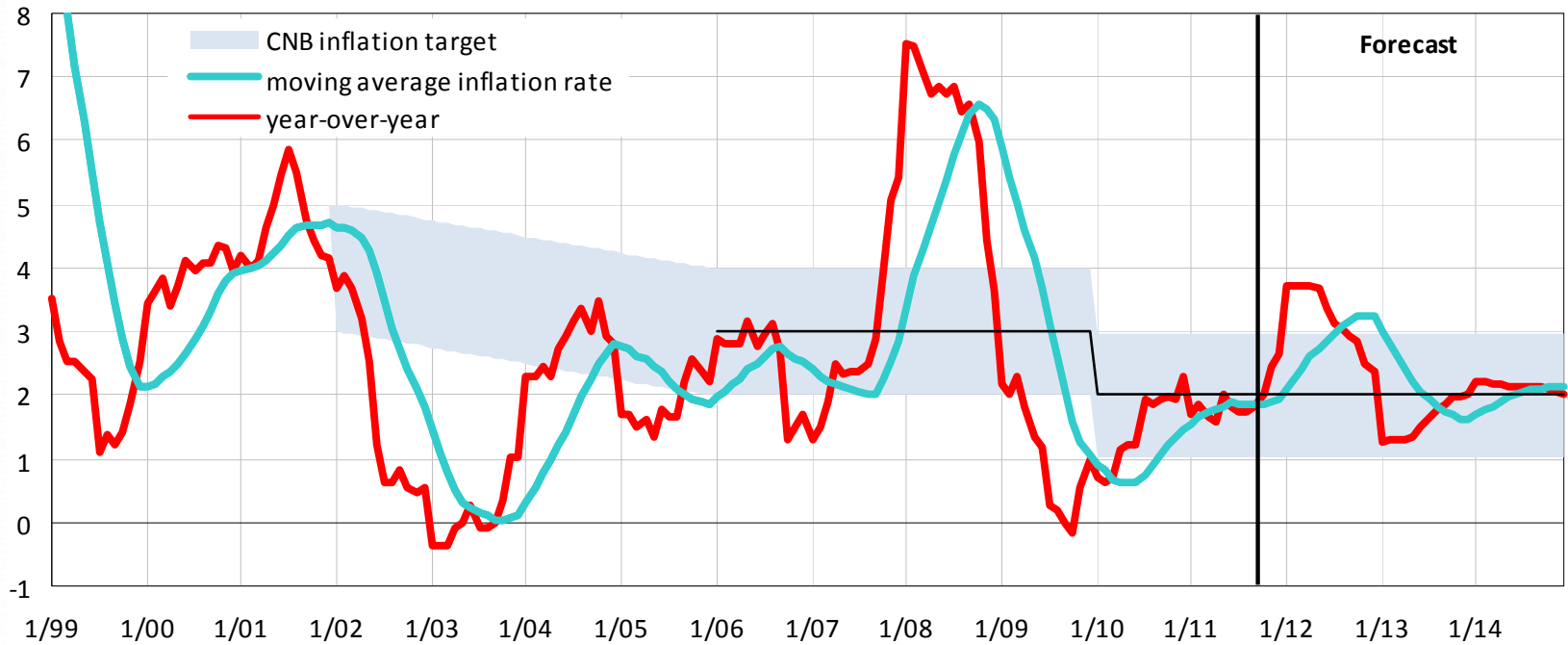
- further development is very uncertain due to concerns about the impacts of the euro area debt crisis and the potential problems in the banking system
- we expect real GDP growth of 2.1% for 2011 and the slowing down to 1.0% next year
- decline in household consumption in 2011 and 2012 is primarily due to unfavourable income situation of the households and consumer concerns
- decline in real government consumption, which began in mid 2010, will last until 2013 (decrease in employment in the public sector and the reduction of purchases of goods and services)
- investment growth will be restored this year, but it should moderately slow down in 2012 because of prevailing pessimism and concerns about the impacts of the debt crisis
- the foreign trade will be probably the main driver of the economic growth in 2011 and the next two years

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# Inflation

## Consumer Prices

(YoY growth rate, in %)



Sources: CZSO and Ministry of Finance's own calculations

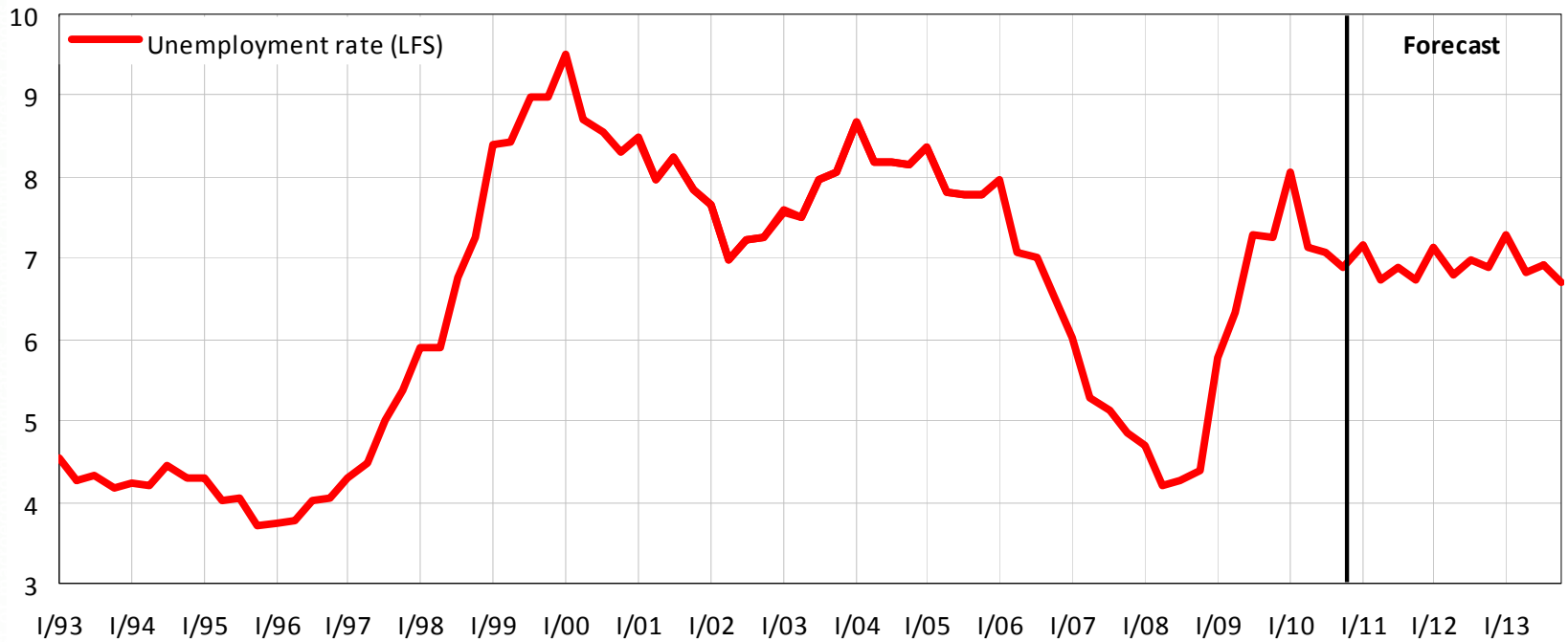
# Inflation

- we expect the average inflation rate in 2011 to reach 1.9%
- we estimate 2012 average inflation rate at 3.2%, mainly due to approved administrative measures (an increase of reduced VAT rate from 10% to 14% will contribute by 1.1 p.p.)

Macroeconomic Forecast

# Labour Market

## Unemployment Rate (Labour Force Survey, in %)



Sources: CZSO and Ministry of Finance's own calculations

# Labour Market

- labour market reflects the economic recovery with delay, deterioration of the situation has not been observed yet
- the employment should increase by 0.4% in 2011, however, we expect the decrease of 0.2% in 2012 due to the expected slowdown in GDP growth and announced further job cuts in the state sector
- in the context of current and expected development of employment and economic situation, the unemployment rate according to LFS is expected to stagnate at 6.9%, while at this level it should also remain in the next year



# Labour Market

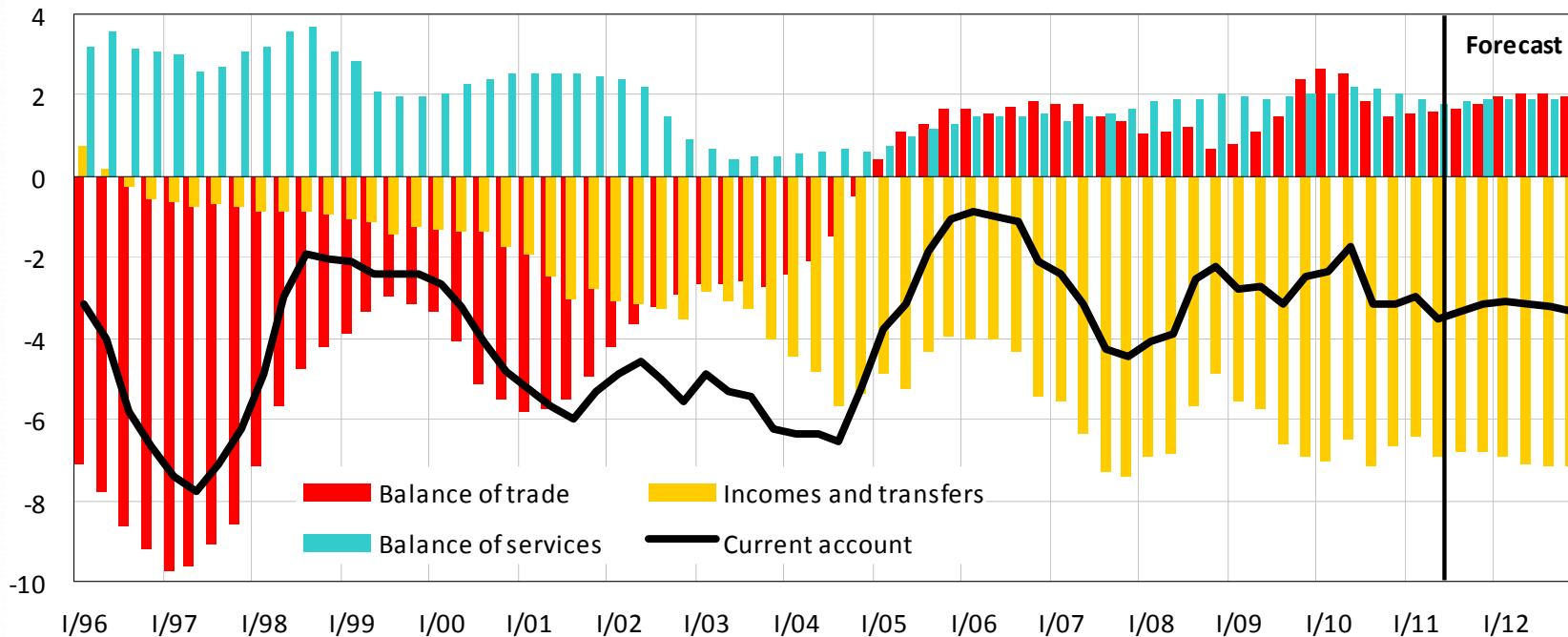
- we expect the wage bill to increase by only 2.3% in 2011, due to cost-saving measures in government sector (decrease in employment and wages in large part of the public sector) the growth will be driven mainly by the business sector
- in 2012, we expect overall wage bill to increase only by 2.7 % because of lower economic performance and further budget savings measures
- based on signals from the business sector and the known intentions regarding salaries in the public sector, we estimate a slight increase of average wage by 2.2% in 2011
- in 2012, we expect the average wage increase of 2.7% (assuming inflation rate of 3.2%, we estimate the real average wage will decrease by 0.5%)



# External Relations

## Current Account

(moving sums of the latest 4 quarters, in % of GDP)



Sources: CNB and Ministry of Finance's own calculations

## External Relations

- world trade growth is slowing, we estimate the balance of trade at 1.8% of GDP in 2011 and 1.9% of GDP in 2012 (slowdown in the export growth will be offset by the stagnation of domestic demand)
- due to the unfavourable outlook for the global economy we expect stagnation or slight decline in the service balance surplus, it should reach about 1.9% of GDP in 2011 and 1.8% of GDP in 2012
- deficit in the balance of income should slightly deepen due to the outflow of investment revenues within foreign direct investment, it should reach about 7.1% of GDP in 2011 and 7.3% of GDP in 2012
- we estimate the ratio of the current account to GDP at -3.1% in 2011 and -3.3% next year
- we do not regard the risk of macroeconomic imbalance as significant

## Macroeconomic Forecast

## International Comparison

## GDP per capita – using current purchasing power parities

		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
									<i>Prelim.</i>	<i>Forecast</i>	<i>Forecast</i>
Slovenia	<i>PPS</i>	17 300	18 800	19 600	20 700	22 100	22 800	20 700	20 900	21 600	22 300
	<i>EA12=100</i>	75	78	79	79	80	83	80	79	79	80
Greece	<i>PPS</i>	19 200	20 300	20 400	21 800	22 500	23 100	21 800	21 500	21 000	21 000
	<i>EA12=100</i>	83	85	82	84	82	84	85	81	77	75
Czech Republic	<i>PPS</i>	15 200	16 300	17 000	18 200	19 900	20 200	19 300	19 500	20 100	20 500
	<i>EA12=100</i>	66	68	69	70	73	74	75	73	74	73
Portugal	<i>PPS</i>	16 400	16 700	17 800	18 600	19 600	19 500	18 900	19 800	20 100	20 400
	<i>EA12=100</i>	71	70	72	71	71	71	73	74	74	73
Slovakia	<i>PPS</i>	11 500	12 300	13 500	15 000	17 000	18 100	17 200	18 100	18 800	19 800
	<i>EA12=100</i>	50	52	55	57	62	66	67	68	69	71
Estonia	<i>PPS</i>	11 300	12 400	13 800	15 600	17 500	17 200	15 000	15 700	16 500	17 800
	<i>EA12=100</i>	49	52	56	60	64	63	58	59	61	64
Poland	<i>PPS</i>	10 100	11 000	11 500	12 300	13 600	14 100	14 300	15 300	16 000	17 000
	<i>EA12=100</i>	44	46	46	47	49	51	55	57	59	61
Hungary	<i>PPS</i>	13 000	13 700	14 200	14 900	15 400	16 000	15 000	15 500	15 900	16 400
	<i>EA12=100</i>	56	57	57	57	56	59	58	58	58	59
Lithuania	<i>PPS</i>	10 200	11 000	11 900	13 100	14 800	15 400	12 900	14 200	14 800	15 700
	<i>EA12=100</i>	44	46	48	50	54	56	50	53	54	56

Sources: Eurostat, OECD, IMF and Ministry of Finance's own calculations

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