

## E Looking back at 2012

Comparing the economic results with the respective forecasts represents an important part of the forecasting work. The MoF has carried out a comparison of the macroeconomic framework for the 2012 State Budget, based on the Macroeconomic Forecast of July 2011, with the first published data for this year. It is necessary to point out that these data

cannot be considered as final results of 2012, since the results will certainly be revised several times in the future (most likely, the first revision will already be conducted on 30 April when the results of the definitive annual national accounts for 2010 and semi-definitive accounts for 2011 will also be published).

Table E.1: The Macroeconomic Framework for the 2012 State Budget – Comparison with the Actual Data

		2012 State Budget (July 2011)				Outcome (April 2013)				Difference (outcome – forecast)			
		2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
		Forecast											
Gross domestic product	growth in %, const.pr.	-4.1	2.3	2.5	2.5	-4.5	2.5	1.9	-1.3	-0.4	0.2	-0.6	-3.8
Consumption of households	growth in %, const.pr.	-0.2	0.2	0.5	2.0	0.2	1.0	0.7	-3.5	0.4	0.8	0.2	-5.5
Consumption of government	growth in %, const.pr.	2.6	-0.1	-2.4	-2.1	4.0	0.5	-2.5	-1.0	1.4	0.6	-0.1	1.1
Gross fixed capital formation	growth in %, const.pr.	-7.9	-3.1	1.9	3.2	-11.0	1.0	-0.7	-1.7	-3.1	4.1	-2.6	-4.9
Cont. of net exports to GDP growth	p.p., const.pr.	-0.6	1.0	1.9	1.1	0.5	0.5	2.0	1.5	1.1	-0.5	0.1	0.4
GDP deflator	growth in %	2.5	-1.2	-0.8	2.6	2.3	-1.4	-0.8	1.4	-0.2	-0.2	0.0	-1.2
Average inflation rate	%	1.0	1.5	2.3	3.5	1.0	1.5	1.9	3.3	-	-	-0.4	-0.2
Employment (LFS)	growth in %	-1.4	-1.0	0.2	0.4	-1.4	-1.0	0.4	0.4	-	-	0.2	0.0
Unemployment rate (LFS)	average in %	6.7	7.3	6.7	6.4	6.7	7.3	6.7	7.0	-	-	0.0	0.6
Wage bill (domestic concept)	growth in %, curr.pr.	0.0	1.2	2.3	4.4	-2.1	0.7	2.2	2.0	-2.1	-0.5	-0.1	-2.4
Current account / GDP	%	-3.2	-3.8	-3.9	-3.6	-2.4	-3.9	-2.7	-2.4	0.8	-0.1	1.2	1.2
Government sector balance	% of GDP	-5.9	-4.7	-4.2	-3.5	-5.8	-4.8	-3.3	-4.4	0.1	-0.1	0.9	-0.9
<u>Assumptions:</u>													
Exchange rate CZK/EUR		26.4	25.3	24.2	23.5	26.4	25.3	24.6	25.1	-	-	0.4	1.6
Long-term interest rates	% p.a.	4.7	3.7	4.0	4.3	4.7	3.7	3.7	2.8	-	-	-0.3	-1.5
Crude oil Brent	USD/barrel	62	80	110	112	62	80	111	112	-	-	1	0
GDP in Eurozone (EA-12)	growth in %, const.pr.	-4.1	1.7	1.9	2.0	-4.4	2.0	1.4	-0.6	-0.3	0.3	-0.5	-2.6

It is obvious from the Table E.1 that the economic results of 2012 were considerably worse compared to the forecast. The year 2012 represented a period when the Czech economy was frozen in the recession, instead of the gradual and stable recovery after the year 2009. The economic cycle in the euro zone has been developing in a considerably worse manner. However, we cannot omit the internal factors inside the Czech economy that impacted considerably especially household consumption and fixed capital formation. The common feature of all factors mentioned is the fact that they can only be forecast and quantified with great difficulty in the horizon of 18 months (from July 2011 to December 2012) in the budgetary forecast.

In July 2011, a rather optimistic mood prevailed in both world and European economies. It appeared that the economies of the countries in the heart of the euro zone were recovering well from the deep recession at the turn of 2008 and 2009. In Q1 2011 the German

economy showed a QoQ increase in real GDP of 1.5%; Slovakia, Poland, Austria and France increased their performance identically by 1.0%. The problems of countries in the south of the euro zone, fluctuating at that time on the verge of stagnation (except for Greece), seemed to be bearable in the environment of strong economic growth, reaching 0.8% in the EA12 as a whole. Positive expectations regarding further development prevailed.<sup>8</sup>

Similarly, the Czech economy appeared to be in a good shape. For Q1 2011 the CZSO recorded QoQ growth of GDP of 0.9%, which was the highest level at that time since the end of 2007. (This figure was gradually made more precise, at present amounting to 0.7% and was surpassed by Q2 2010 with the currently valid growth of 1.1%). Growth was driven by foreign trade (a contribution of 2.0 p.p. in 2011, the highest level since

<sup>8</sup> For example, OECD forecast for GDP growth of the euro zone in 2012 was 2.1%.

2006). Except for the fiscal deficit, which hovered below the EU average, however, the economy did not show any imbalances. It was thus expected that positive effects would also gradually reach household consumption and investment.

A favourable situation was also reflected in relatively optimistic economic forecasts (see Table E.2).

Table E.2 **Comparison with other official forecasts**

	Date of forecast release	GDP	Consumption of households	Gross fixed capital formation
		<i>growth in %, const. pr.</i>	<i>growth in %, const. pr.</i>	<i>growth in %, const. pr.</i>
CNB	May 2011	2.8	2.4	4.9
EC	May 2011	2.9	2.0	3.8
IMF	April 2011	2.9	-	-
OECD	May 2011	3.5	2.6	4.8
<b>Average</b>		<b>3.0</b>	<b>2.3</b>	<b>4.5</b>
MoF	July 2011	2.5	2.0	3.2

Even though we were aware of all the risks, we decided to opt for a neutral forecast which was in line with the situation at that time and did not deviate from opinions of other institutions which deal with economic forecasting. As can be seen from Table E.2, the MoF forecast was the most conservative with regard to uncertainties in the external environment and in terms of the reaction of domestic demand to fiscal consolidation measures underway, especially an increase in the VAT reduced rate from 10% to 14%, effective from 1 January 2012.

In the course of H2 2011 and H1 2012, however, the debt crisis escalated in some particular parts of the euro zone (uncertainties regarding the bailout programme for Greece when the bailout programme of May 2010 had appeared to be insufficient; speculations regarding the default of Greece and also its possible subsequent departure from the euro zone; problems in the Spanish banking sector). The positive effects of often unprecedented measures, such as a “voluntary” write-off of a part of the Greek debt in March 2012 and a massive liquidity injection provided by the ECB to banks as part of two extraordinary long-term refinancing operations in December 2011 and March 2012, were however beneficial only in the short-term. A change in this respect was brought as late as by the ECB’s announcement of introducing the new programme for purchasing government bonds on secondary markets (Outright Monetary Transactions), contributing considerably to settling of the debt crisis in the course of H2 2012 (see Graph A.1.3).

Austerity fiscal measures in problematic countries of the south of the euro zone resulted in deepening the recession there to an extent which exceeded all expectations. That said, the development on financial markets and fiscal consolidation effects also resulted in a slowdown in economic growth in countries in the heart of the euro zone. The pressure on increasing the capital adequacy of European banks could have to a certain extent resulted in a credit crunch. The unfavourable situation culminated in Q4 of 2012 when nearly all states of the euro zone (except for Slovakia and Estonia)<sup>9</sup> recorded a QoQ decrease in GDP.

Surprisingly, this situation in the Czech economy was not directly apparent in the contribution of foreign trade to GDP development. It even managed to achieve a better result by 0.4 p.p. compared to the Forecast. Steady increases in Czech exporters’ performance, a slight weakening of the Czech koruna and above all a dramatic slump in domestic demand, which resulted in the slowdown of imports, all contributed to this outcome.

What was behind such a sharp decrease in domestic demand? It is possible to partially find an explanation in the fiscal consolidation currently underway. It seems that in the European context, however, the fiscal restriction in the Czech Republic was somewhat weaker. If we would use the the YoY change in the structural balance to approximate the magnitude of the restriction, based on data from the Winter 2013 European Economic Forecast, we can see that the restriction in the Czech Republic was weaker than the EU average (0.7 p.p. versus 1.1 p.p.). At the same time, development in the EU was not determined just by the “south”. Germany, for example, consolidated at the pace of 1.4 p.p. and in spite of that in 2012 recorded real GDP growth of 0.7%.

The sharp decline in confidence in further economic development is more likely to be the main cause of the fall in domestic demand. The sensitively perceived threat of unemployment, instability of the economic environment and dramatic news concerning the social impact of situations in countries worst affected have led to a more pronounced drop in consumer confidence than during the so-called deep recession (see Graph B.2.5). The consequence of this was consumers’ extremely cautious behaviour and an increase in the savings rate (from 9.8% in 2011 to the estimated 12.6%<sup>10</sup> in 2012) to be on the safe side in case of a further worsening of the economic situation.

<sup>9</sup> Data for Ireland were not known at the time of preparing this text.

<sup>10</sup> Data were published only after the closing date of the text.

This, together with the not too significant slowdown in wage bill growth, has resulted in the sharp decline in real household consumption by 3.5%. The general condition of households was also considerably worse than at the beginning of the first phase of the recession at the turn of 2008 and 2009.

Similarly, a number of segments within the business sector postponed investment decisions for the same reason – resulting in a decrease in fixed capital formation of 1.7% and a decrease in inventories of 0.4 p.p. of GDP.

The forecast of consumer price growth was relatively precise, the slightly lower value was caused by the complete absence of demand inflation.

An apparent difference in GDP deflator growth (by 1.4% compared to the budgeted 2.6%) was primarily caused by a methodological change in the household consumption deflator. In July 2011 it still held true that the household consumption deflator growth for both current and previous years was more or less identical to that of the consumer prices inflation. With an inflation rate of 3.3%, however, the household consumption deflator increased by just 2.3% in 2012. Another factor was the lower than expected growth of the gross fixed capital formation deflator where low investment demand was observed.

A decrease in economic output also became apparent on the labour market, while an increase in the unemployment rate was partially mitigated by the labour market reform which introduced a number of measures with the objective of a greater flexibility to employment relationships between the employer and the employee and thus increasing both labour supply

and demand. It included e.g. a tightening of the rules for unemployment benefits (mandatory community service jobs, shortening of the reference period by one year), modifications of the probation period, severance pay, temporary employment and more flexible labour time arrangements.

Taking into account economic development, employment growth was, very surprisingly, completely in line with the forecast. This fact can be explained by the stronger than anticipated effects of labour market reform, especially through increased motivation to seek a job. Other factors include a change in households' behaviour due to a worsening of social conditions which led to an increase in labour supply. On the labour demand side, employers' efforts to limit staff dismissal also had a positive effect on employment development, which became evident in the decrease in hours worked per employee.

Coupled with the worse than expected economic situation of the private sector and a decrease in real labour productivity, this development resulted in lower nominal growth of the average wage and wage bill. The difference between the currently valid figures and the forecast, however, does not deviate from the past data revisions.

According to the preliminary estimate of the CZSO, the government sector balance in 2012 ended up with the deficit of 4.4% of GDP. However, were there no one-off measures (financial compensation to churches and corrections of the non-refunded part of EU resources), the deficit would have amounted to 2.5% of GDP. One can say, therefore, that the government succeeded in continuing with fiscal consolidation despite economic headwinds.