A Forecast Assumptions

*The forecast was made on the basis of data known as of **11 January 2011**. No political decisions, newly released statistics, or world financial or commodity market developments could be taken into account after this date.*

Data from the previous forecast of October 2010 are indicated by italic font. Data in the tables relating to the years 2013 and 2014 are calculated by extrapolation, outlining only the direction of possible developments, and as such are not commented upon in the following text.

Sources of tables and graphs: Czech Statistical Office (CZSO), Czech National Bank (CNB), Ministry of Finance of the Czech Republic, Eurostat, IMF, OECD, European Central Bank (ECB), The Economist, our own calculations.

A.1 External Environment

Economic output

The world economy continues to recover, but the improvement is uneven and its tempo is thus far moderate. In all developing economies, including China and India, a moderate slowing of their rapid growth is expected in 2011. The growth in advanced economies is weaker, but, in contrast to previous assumptions, optimism is growing, and especially in the US. Commodity prices have begun markedly to rise.

The US economy grew QoQ by 0.9% and 0.4%, respectively, in the first two quarters of 2010 and by 0.6% (*versus 0.5%*) in the third quarter. The inflation rate in October was 1.2%. The unemployment rate, which had been steady since January 2010 at just below 10%, decreased to 9.4% in December (9.8% in November).

Despite a relatively modest growth rate (according to predictions, GDP for 2010 should exceed its 2007 level), modest optimism prevailed in the American economy at the turn of the year. Strong holiday season consumption (while household consumption had been growing for five quarters already, it had done so more slowly than in the years of prosperity) contributed to this view, as did rising stock markets. The greatest stimulus was an unexpectedly strong employment gain in the private sector, as well as the first significant decrease in the unemployment rate. It is expected, however, that the labour market stills needs some years to recover. The majority party and opposition reached a consensus on prolonging tax breaks for 2011, which positive news was immediately reflected in the moods of consumers and corporations alike.

Meanwhile the process of unburdening companies and entrepreneurs continues. It is presumed that stronger recovery will occur only when real estate prices have consolidated and begin to rise. The national debt has reached 100% of GDP, and several states and a number of municipalities are on the verge of bankruptcy.

Stimulation to the economy is being provided by the central bank, which is holding the band for the key refinancing rate at 0–0.25% and continues in “quantitative easing”, which is not expected to end before the third quarter of 2011.

Euro zone GDP (EA12) grew QoQ in 2010’s second and third quarters by 1.0% and 0.3% (*versus 0.4%*), respectively. However, the greatest contribution to the strong growth was from the German economy.

The development in the euro zone is unbalanced, as the GDP of Greece, Ireland and Spain decreased in 2010, and these countries will apparently be near zero growth or in decline again this year. Inflation, too, is unbalanced in the euro zone. In December, the YoY euro zone inflation increased, especially due to the influence of rising energy prices, to 2.3% from 1.9% in November. Price growth ranged from deflation in Ireland (–0.8%) to 1.9% in Germany and 5.2% in Greece. Industrial production in the EA12 has been growing: for November YoY by 7.4%, and in Germany by 11.4%. Meanwhile, high unemployment persists. It is stuck at 10.1% in the EA12, and it is 20.6% in Spain, 14.5% in Slovakia and 13.9% in Ireland. Germany is the exception, where it has been 6.7% already for four months.

The situation in Germany is interesting, and in a way exceptional. After falling under the EA average to −4.7% in 2009, growth strongly above the EA average followed in 2010 (3.6%). Although the extreme growth in the second quarter (2.2% QoQ) was undisputedly a one-time phenomenon, the German economy grew by a solid 0.7% (*as predicted*) in the third quarter, and leading indicators point further to continuing strong economic activity. It is positive that the growth is not only an effect of strong exports but also of domestic consumption.

Most euro zone countries continue to follow fiscal consolidation programmes. The ECB continues to maintain the main refinancing rate at 1.00% and is supporting some economies by purchasing their government bonds. Economic policy in the euro zone faces a difficult task. Even if the problems with solvency of some countries are successfully fended off, the developing divergences among the member countries is considerable; and the effectiveness of the German economy on the one hand and stagnation of such a large economy as that of Spain on the other will surely raise differences of opinion as to their resolution.

Polish and Slovak economies both are benefiting from not having problems in the banking sector.

Slovakia once again is showing rapid GDP growth, which, as was the case before the recession, is driven by exports. For the third quarter, growth of 1.0% QoQ (*versus 0.4%*) was reported. We estimate overall growth for 2010 at 4.1% (*versus 4.0%*). Industrial production in October 2010 grew by 13.3% YoY. The unemployment rate in November stood at 14.5%, which was the second highest in the euro zone. An apparent result is a decline in household consumption, which had long been one of the growth drivers: Through three quarters of 2010 it decreased by 0.5% YoY. The public finance deficit deteriorated against expectations to ca 8% of GDP for 2010, and the government has prepared consolidation measures to reduce it by ca 2.5 p.p. this year.

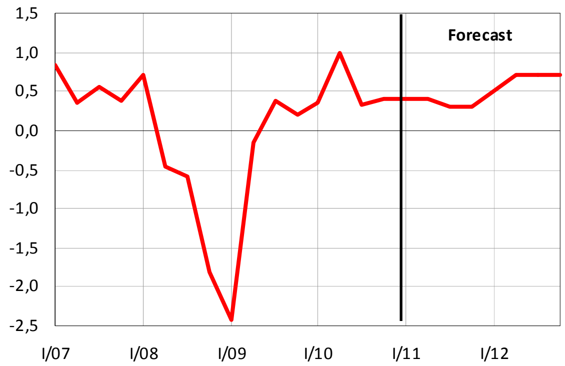
Poland's economy was the only one in the EU to avoid recession in 2009, and it continues to grow dynamically. QoQ growth was 1.1% (*versus 0.5%*) in the third quarter. Growth in 2010 is estimated at 3.8% (*versus 3.2%*). The size of the domestic market makes it possible for growth to be driven by domestic demand, which, in contrast to Slovakia, has grown continuously (by 3% for the first three quarters of 2010). Unemployment stagnated at 9.8% in November. Growth in 2011 will be supported by infrastructure investments ahead of the coming European football championships. The public finance deficit for 2010 approached 8% of GDP and the national debt 55%, leading to the initiation of saving measures and increase in VAT.

Our forecast again stands on an assumption that no more major shocks will occur on financial markets. Recovery is expected in 2011, albeit with considerable differences among the world's various regions. While growth in advanced economies will be relatively weak despite a certain improvement, growth of developing markets will remain dynamic.

We expect that the US economy grew by 2.8% (*versus 2.7%*) in 2010. For 2011, we are boosting our growth estimate to 2.9% (*versus 2.5%*). Recovery will remain dampened by high unemployment.

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

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



In the EA12 economy, we estimate GDP growth for 2010 at 1.7% (*versus 1.6%*). In 2011, too, growth should reach 1.7% (*versus 1.5%*). Risks are represented by problems in the financial sector of many countries, high public budget indebtedness, and uneven development across euro zone countries.

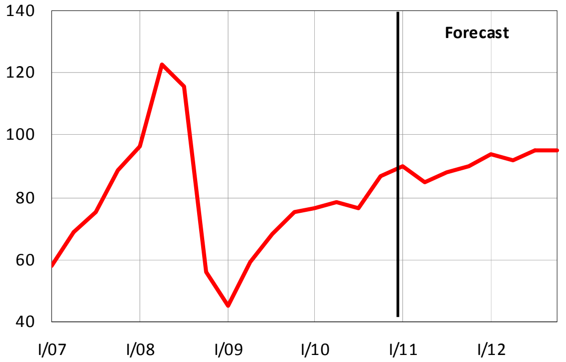
Commodity prices

Renewed upward pressure on commodity prices in the last quarter of 2010 is a symptom of growth expectations. The average price for Brent crude in the fourth quarter of 2010 reached USD 86.7/barrel (*versus USD 79*), and compared to the previous quarter it increased by 14%. The average for 2010 was USD 79.7.

Anticipating future development is exceptionally difficult, as conflicting influences are at work. While consumption is still decreasing in advanced economies, this is offset by generally rising demand from China and other countries. Another influence is renewed speculation on commodity prices and the dollar exchange rate. Influences limiting oil demand are an opposite effect. In its latest Energy Outlook 2010, the International Energy Agency regards political actions to limit rising oil demand and the resulting emission to be one of the key factors.

For 2011, we have adjusted our estimate upward to USD 88/barrel *(versus USD 84)*. Risks in that forecast are for upward deviations.

Graph A.1.2: **Dollar Prices of Brent Crude Oil**
in USD per barrel



Food prices, too, have been rising significantly. In December, FAO's index of food commodities broke through the record high from June 2008. The IMF's comparable index also has approached its maximum. Although in the case of cereal grain prices weather anomalies in 2010 were primarily responsible, the influence of speculation, as in summer 2008, should not be underestimated.

Global financial markets

The public finance crisis on the euro zone's periphery reached its next stage in late November 2010, as Ireland requested aid from the joint rescue mechanism of the EU and IMF. The overall amount of assistance should be EUR 85 billion, but the Irish government should itself contribute EUR 17.5 billion to this sum (from the National Pensions Reserve Fund and other sources). The amount of external aid should "only" be EUR 67.5 billion. Ireland should obtain one third of this amount (EUR 22.5 billion) via the EFSM[1], one third through the IMF, and the remaining EUR 22.5 billion from EFSF[2] and in the form of bilateral loans from the United Kingdom, Denmark and Sweden.

Up to EUR 35 billion should then be directed to the Irish banking sector, the relative size of which (in proportion to the size of the Irish economy) is one cause of Ireland's current problems. Of this EUR 35 billion, EUR 10 billion should be used immediately to recapitalise banks.

What is interesting about the whole matter of aid to Ireland is the fact that the country had long been rejecting EU/IMF aid, and it was especially EU representatives who exerted pressure on Ireland in this regard. The apparent reason was fear of spreading financial contagion to other PIIGS countries, especially Portugal and Spain, should Ireland hesitate too long in its aid request (although Ireland, unlike Greece, had not had acute liquidity problems). The hopes of preventing the spread of financial contagion by including Ireland into the EU/IMF rescue mechanism, however, were in vain. That is because the same chain of events recurred as in May: rapid escalation of tensions on financial markets, a political reaction (Ireland's request for financial aid) and a temporary calming, followed by a renewed growth in yields and spreads.

The rhetoric by which the political representatives of states finding themselves caught in the financial markets' "spotlights" try to calm the financial markets (rather unsuccessfully) is also characteristic. Thus, Ireland maintained at first that it is unlike Greece, while now Portugal and Spain insist that they are not like Greece and Ireland. The yields of PIIGS countries' government bonds, spreads over German bonds (i.e. in essence a risk premium) and CDS spreads are meanwhile at record high levels and with no visible tendency to fall. Although January auctions of Portuguese and Spanish bonds met with reasonable interest, the investors required high yields. Especially in Portugal's case, these are untenably high in view of its growth outlook.

The rating agencies also responded to developments in the euro zone, again lowering credit ratings for some PIIGS countries. Fitch lowered Ireland's rating by three grades in December (from A+ to BBB+, stable outlook), and Moody's even by five grades (from Aa2 to Baa1, negative outlook). Neither did Portugal escape a downgrade, as Fitch cut its rating by one grade (from AA– to A+, negative outlook) at the end of the year. In January, the same agency lowered the rating of Greece (from BBB– to BB+, negative outlook), whose long-term liabilities thus became the non-investment grade.

Even though Greece (according to a November evaluation mission of the European Commission, ECB and IMF) fulfilled at the end of September all quantitative criteria required for providing another financial aid tranche amounting to EUR 9 billion from euro zone countries and the IMF, the November revision of government sector deficit and debt data (the government sector deficit for 2009 was revised from 13.6% to 15.4% of GDP, government sector debt for the same period from 115.1% to 126.8% of GDP) clearly shows that Greece is just at the beginning of a long road to remedy its public finance.

There also is speculation about the possibility of increasing the funds for the present rescue

[1] *European Financial Stability Mechanism*
[2] *European Financial Stability Facility*

mechanism. At the same time, however, a permanent rescue mechanism is being discussed, the establishment of which already obtained the support of the European Council in December. This European Stability Mechanism (ESM) should replace the current EFSF and EFSM mechanisms from the middle of 2013. In case a euro zone country would be in financial difficulties, and if this would only be a case of liquidity crisis, the ESM would provide financial assistance to this country, conditioned upon fulfilling negotiated conditions. If, however, it were concluded that the country in question was insolvent, then so-called *collective action clauses* (CAC) would be invoked. In essence, this refers to a set of rules which should be an integral part of all bonds of euro zone countries issued from 2013 and should provide a legal framework for negotiations between the debtor and creditors. The latter should, among other things, have the option to decide a change of payment conditions by a qualified majority (extending the maturity, taking a haircut, etc.).

A certain problem connected to ESM is the need to change primary legislation. From a purely economic view, however, it is fundamentally much more important that a possible approval of the ESM would lower the attractiveness of bonds issued from 2013, especially in comparison to bonds not including CAC (CAC explicitly allows for investors to take a haircut). An important question, therefore, is whether implementing CAC would lead to an increase in the required yields on government bonds, which in turn would negatively influence the stability of public finances.

In view of the considerable complexity in the relationships between the financial sector, government, and other sectors of the real economy, and in view of the frequency with which new information (often of fundamental importance) is emerging, it is almost impossible to determine whether, when and how intensively will the developments abroad impact on the Czech economy. Nevertheless, it still holds that the external environment is an important source of risks for the domestic economy and that it should be monitored closely.

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

	2003	2004	2005	2006	2007	2008	2009	2010 *Estimate*	2011 *Forecast*	2012 *Forecast*
EU27	1,3	2,5	2,0	3,2	3,0	0,5	-4,2	1,7	1,8	2,1
EA12	0,8	2,1	1,7	3,0	2,8	0,4	-4,1	1,7	1,7	2,0
Germany	-0,2	1,2	0,8	3,4	2,7	1,0	-4,7	3,6	2,3	2,1
France	1,1	2,5	1,9	2,2	2,4	0,2	-2,6	1,6	1,6	2,0
United Kingdom	2,8	3,0	2,2	2,8	2,7	-0,1	-4,9	1,7	1,9	2,0
Austria	0,8	2,5	2,5	3,6	3,7	2,2	-3,9	1,8	1,8	2,0
USA	2,5	3,6	3,1	2,7	1,9	0,0	-2,6	2,8	2,9	3,1
Hungary	4,0	4,5	3,2	3,6	0,8	0,8	-6,7	1,1	2,4	3,1
Poland	3,9	5,3	3,6	6,2	6,8	5,1	1,7	3,8	4,0	4,3
Slovakia	4,8	5,1	6,7	8,5	10,5	5,8	-4,8	4,1	3,1	4,1
Czech Republic	3,6	4,5	6,3	6,8	6,1	2,5	-4,1	2,5	2,2	2,7

Graph A.1.3: **Real Gross Domestic Product**
YoY growth in %, nsa data

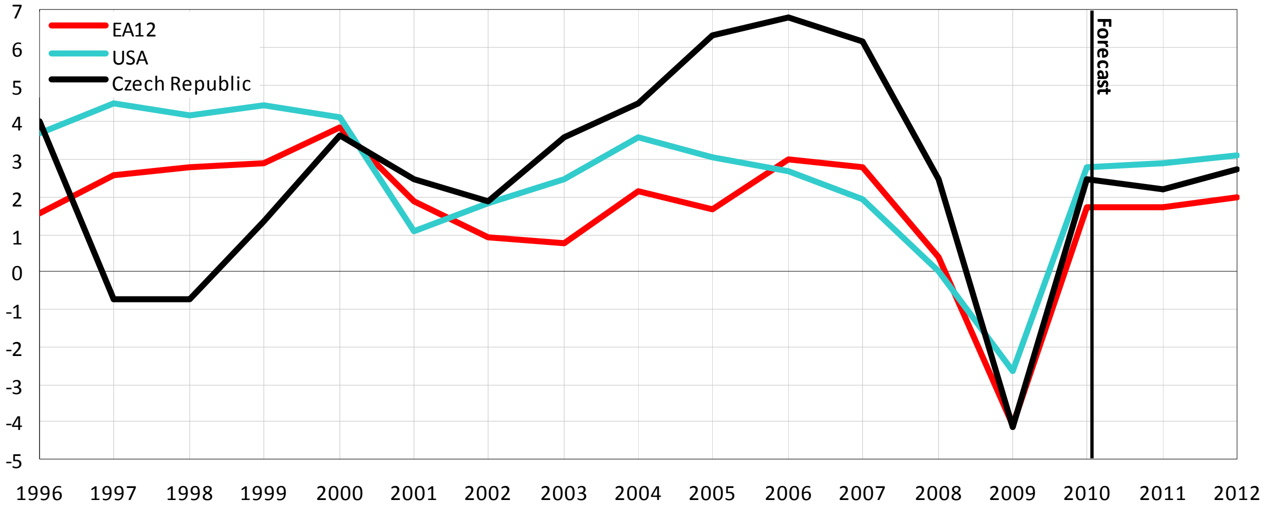


Table A.1.2: **Real Gross Domestic Product** – quarterly
growth in %, sa data

		2010				2011			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Estimate	*Forecast*	*Forecast*	*Forecast*	*Forecast*
EU27	*QoQ*	**0,4**	**1,0**	**0,5**	**0,4**	**0,4**	**0,5**	**0,3**	**0,3**
	YoY	0,6	2,0	2,2	2,3	2,3	1,8	1,6	1,5
EA12	*QoQ*	**0,4**	**1,0**	**0,3**	**0,4**	**0,4**	**0,4**	**0,3**	**0,3**
	YoY	0,8	1,9	1,9	2,1	2,2	1,5	1,5	1,4
Germany	*QoQ*	**0,6**	**2,3**	**0,7**	**0,5**	**0,5**	**0,4**	**0,3**	**0,3**
	YoY	2,1	3,9	3,9	4,1	4,0	2,1	1,7	1,5
France	*QoQ*	**0,2**	**0,6**	**0,3**	**0,5**	**0,4**	**0,3**	**0,5**	**0,4**
	YoY	1,2	1,6	1,7	1,6	1,8	1,5	1,7	1,6
United Kingdom	*QoQ*	**0,3**	**1,1**	**0,7**	**0,5**	**0,3**	**0,5**	**0,3**	**0,4**
	YoY	-0,3	1,6	2,7	2,7	2,7	2,0	1,6	1,5
Austria	*QoQ*	**0,0**	**1,2**	**0,9**	**0,4**	**0,3**	**0,3**	**0,3**	**0,3**
	YoY	0,1	2,1	2,5	2,5	2,8	1,9	1,3	1,2
USA	*QoQ*	**0,9**	**0,4**	**0,6**	**0,5**	**0,8**	**0,8**	**0,9**	**0,9**
	YoY	2,4	3,0	3,2	2,5	2,4	2,8	3,0	3,4
Hungary	*QoQ*	**1,0**	**0,4**	**0,8**	**0,3**	**0,6**	**0,6**	**0,7**	**0,7**
	YoY	-1,1	0,6	2,2	2,6	2,1	2,4	2,2	2,6
Poland	*QoQ*	**0,7**	**1,2**	**1,3**	**0,4**	**1,0**	**1,0**	**1,2**	**1,0**
	YoY	3,1	3,8	4,7	3,7	4,0	3,8	3,6	4,3
Slovakia	*QoQ*	**0,8**	**1,0**	**1,0**	**0,7**	**0,6**	**0,6**	**0,9**	**0,9**
	YoY	4,6	4,4	4,2	3,5	3,3	2,9	2,8	3,0
Czech Republic	*QoQ*	**0,6**	**0,8**	**1,0**	**1,0**	**0,1**	**0,4**	**0,5**	**0,3**
	YoY	1,0	2,3	2,8	3,5	2,9	2,6	2,1	1,4

Graph A.1.4: **Real Gross Domestic Product** – Central European new member state economies
YoY growth in %, nsa data

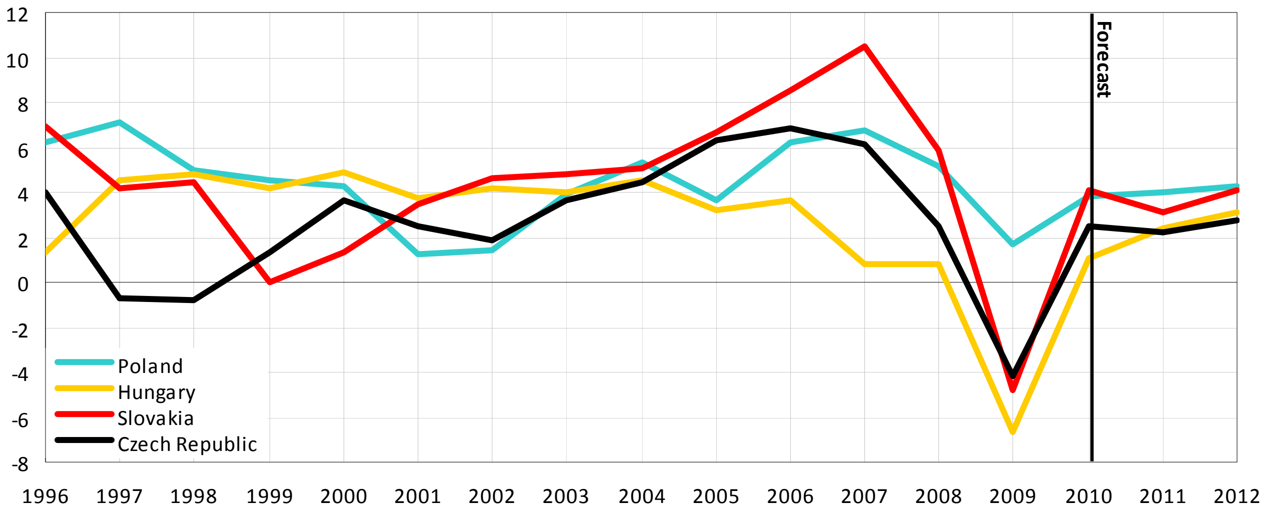


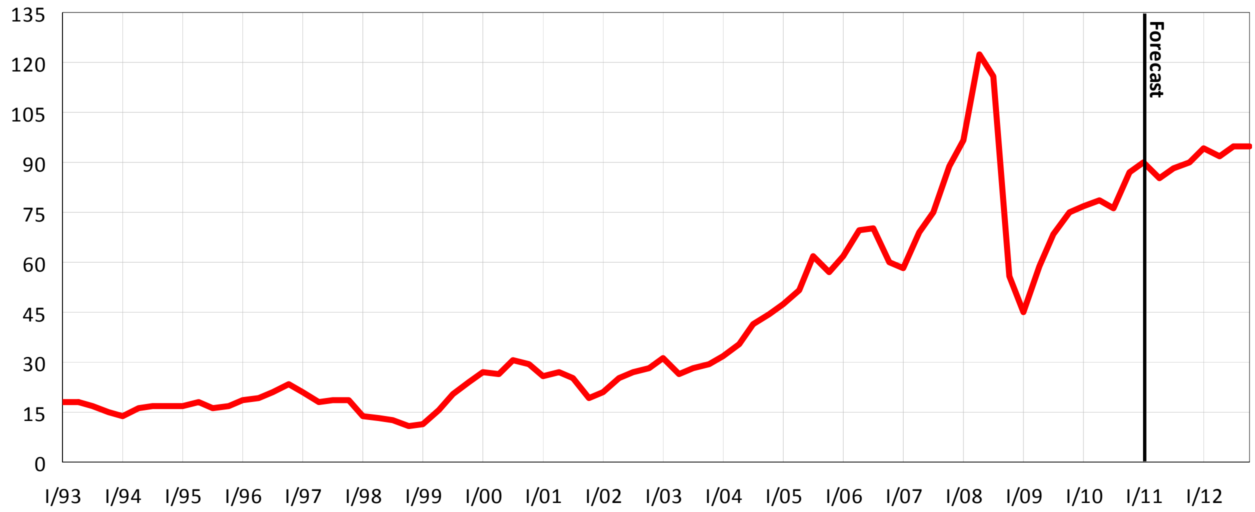
Table A.1.3: **Prices of Commodities** – yearly
spot prices

		2003	2004	2005	2006	2007	2008	2009	2010	2011 *Forecast*	2012 *Forecast*
Crude oil Brent	*USD/barrel*	**28,8**	**38,3**	**54,4**	**65,4**	**72,7**	**97,7**	**61,9**	**79,7**	**88**	**94**
	growth in %	14,0	33,0	42,0	20,1	11,2	34,4	-36,7	28,7	10,8	6,5
Crude oil Brent index *(in CZK)*	*2005=100*	**62,4**	**75,6**	**100,0**	**113,4**	**113,3**	**127,7**	**90,5**	**116,8**	**126,7**	**131,0**
	growth in %	-1,7	21,1	32,3	13,4	-0,1	12,7	-29,1	29,1	8,5	0,0
Wheat	*USD/t*	**146,1**	**156,9**	**152,4**	**191,7**	**255,2**	**326,0**	**223,6**	**223,8**	.	.
	growth in %	-1,6	7,3	-2,8	25,8	33,1	27,7	-31,4	0,1	.	.
Wheat price index *(in CZK)*	*2005=100*	**113,0**	**110,5**	**100,0**	**118,7**	**142,0**	**152,1**	**116,7**	**117,1**	.	.
	growth in %	-15,2	-2,3	-9,5	18,7	19,6	7,1	-23,3	0,3	.	.

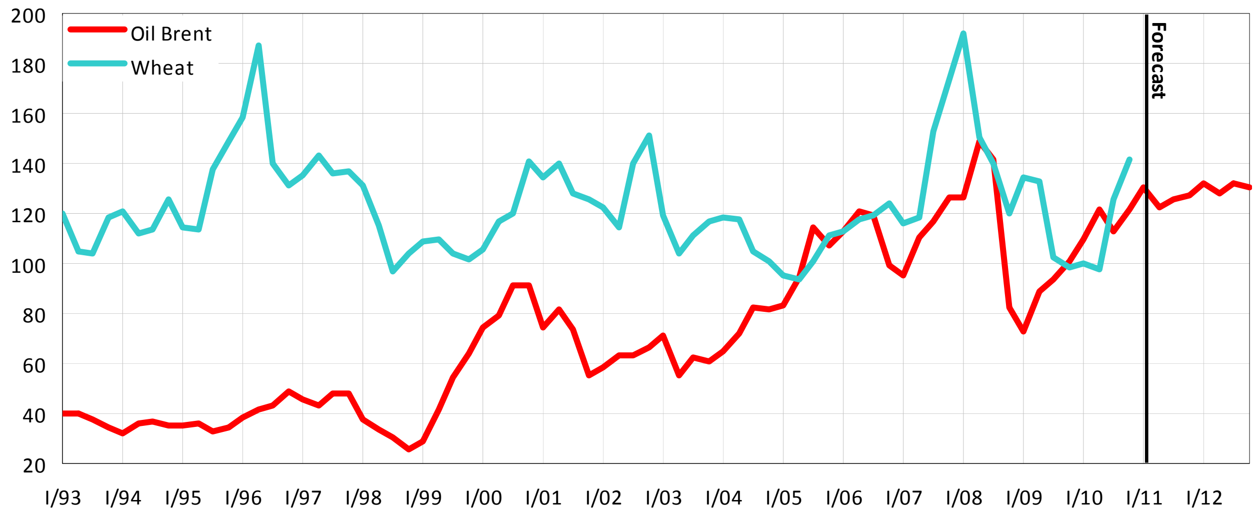
Table A.1.4: **Prices of Commodities** – quarterly
spot prices

		2010				2011			
		Q1	Q2	Q3	Q4	Q1 *Forecast*	Q2 *Forecast*	Q3 *Forecast*	Q4 *Forecast*
Crude oil Brent	*USD/barrel*	**76,7**	**78,7**	**76,4**	**86,8**	**90,0**	**85,0**	**88,0**	**90,0**
	growth in %	70,4	33,2	11,7	15,7	17,3	8,0	15,2	3,7
Crude oil Brent index *(in CZK)*	*2005=100*	**109,9**	**121,4**	**112,9**	**121,3**	**130,4**	**122,2**	**125,6**	**127,5**
	growth in %	50,4	37,0	20,4	**20,5**	18,7	0,6	11,3	5,1
Wheat price	*USD/t*	**195,7**	**177,5**	**237,9**	**283,9**	.	.	.	.
	growth in %	-15,6	-28,4	13,9	38,2	.	.	.	.
Wheat price index *(in CZK)*	*2005=100*	**100,2**	**97,9**	**125,7**	**141,9**	.	.	.	.
	growth in %	-25,6	-26,4	22,9	43,9	.	.	.	.

Graph A.1.5: **Dollar Prices of Oil**
USD/barrel



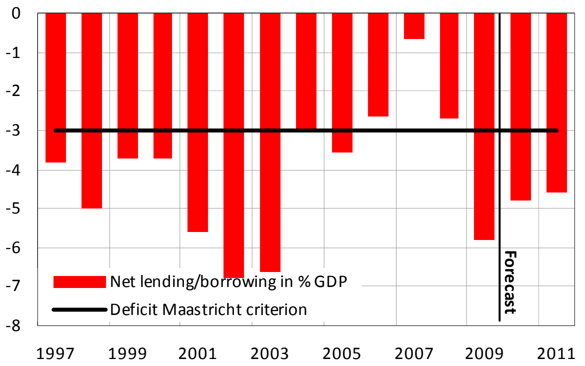
Graph A.1.6: **Koruna Indices of World Commodity Prices**
index 2005 = 100



A.2 Fiscal Policy

While in past years, general government performance was positively influenced particularly by the peak of the economic cycle, the most recent recession had been bringing worsening results since 2008. This revealed structural deficiencies in general government operations.

Graph A.2.1: **Net Lending/Borrowing**
in % of GDP



According to preliminary estimates by the Ministry of Finance, the **general government deficit** has reached CZK 176.7 billion, which is 4.8% of GDP.[3] In comparison with the previous estimate in October, when the deficit was estimated higher by more than CZK 13 billion (5.1% of GDP), this is a moderate improvement.

The improvement is caused by positive developments on financial markets, where interest rates have dropped in all issued maturities on the yield curve for government bonds. This indicates a decline in the risk premium for the Czech Republic and reflects positive evaluation of the fiscal consolidation strategy being implemented. This fact had already been partially reflected in the previous estimate.

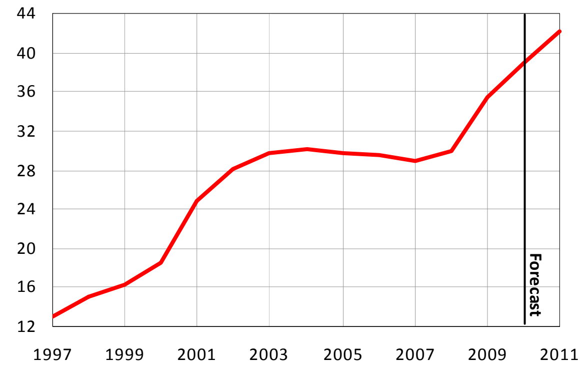
On the expenditures side, the category of state social support has been developing positively. Due to active government measures in 2010, there has been a moderate decline in expending for this area. There was also a moderate decline in government sector labour costs, which is a result of personnel optimisation at the individual offices.

Although last year's outcome appears quite optimistic, some facts should be highlighted. While tax receipts in 2010 rose by more than 3%, this growth was significantly influenced also by legislative measures on the revenues side (in particular, boosting VAT as well as excise taxes on mineral fuels, beer and tobacco products). Another risk may stem from macroeconomic developments in case of an adverse shock coming from abroad. Developments on financial markets, too, may be uncertain, as these are by their nature very volatile and often do not reflect fundamental factors. The current advantage, occurring due to the decline in the yield curve, may in future very quickly turn threatening, and especially if the current problems of the euro zone will worsen.

The estimate as to the amount of the general government deficit for 2010 bears a high level of risk. Particularly uncertain is the impact of EU funds, which may significantly influence the final outcome. Another problem lies in the estimate of accrued tax revenue, especially for corporate tax, as it is difficult to predict the development of tax settlement for 2010 which will not occur until halfway through this year.

Concerning the individual segments of the government sector, the most pronounced improvement was in the state and local budgets. By contrast, the results for health insurance companies and privatisation operations have moderately worsened compared to the October forecast, mainly due to higher costs for covering environmental liabilities.

Graph A.2.2: **Government Debt**
in % of GDP



We estimate the general government debt at 38.9% of GDP for the end of 2010, which still remains relatively well below the Maastricht convergence criteria.

The state budget for 2011 and medium-term state budget outlook for 2012–2013 presume further continuous improvements in the general government balance up to 2.9% of GDP in 2013. Compared to the Convergence Programme of the Czech Republic from January 2010, the government has tightened its fiscal aims for the following years. At the same time, it has

[3] *More precise information for 2010 will be available 1 April 2011, when the CZSO sends its notifications on the past four years to Eurostat.*

set the aim of balancing operations in the general government sector in 2016, on the assumption there will be economic growth in that period. Although the current setting of fiscal policies is given by the government-approved expenditure frameworks, conceptual structural reforms are planned for 2012 and 2013 and should be presented this year.

With respect to the sustainability of public finance and intergenerational solidarity, it is absolutely crucial to tackle structural deficiencies. In the medium term, a goal of 1% of GDP (MTO) for the structural deficit of the general government is set for the Czech Republic under the Stability and Growth Pact. At the current fiscal policy setting, this goal would not be fulfilled within the years covered by the outlook. The structural deficit is expected to have reached 4.0% of GDP, then to slide gradually to 2.2% of GDP in 2013. At the given fiscal policy setting and assumptions of further consolidation, the level of debt should hit its maximum of some 44% of GDP in 2013 and then diminish slowly in subsequent years.

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

		2002	2003	2004	2005	2006	2007	2008	2009	2010 *Estimate*	2011 *Forecast*
General government debt	*bill. CZK*	**695**	**768**	**848**	**885**	**948**	**1024**	**1105**	**1282**	**1438**	**1603**
	growth in %	18,9	10,5	10,4	4,4	7,1	8,0	7,9	16,1	12,1	11,5
	% GDP	**28,2**	**29,8**	**30,1**	**29,7**	**29,4**	**29,0**	**30,0**	**35,4**	**38,9**	**42,1**
General government balance	*bill. CZK*	**-167**	**-170**	**-83**	**-107**	**-84**	**-23**	**-99**	**-209**	**-175**	**-173**
Interest derivatives [1]	*bill. CZK*	0,0	-0,5	-0,5	-0,2	-0,4	-0,7	-1,8	-1,2	-1,3	-1,3
EDP B.9 [2]	*bill. CZK*	**-167**	**-171**	**-83**	**-107**	**-85**	**-24**	**-100**	**-210**	**-177**	**-174**
	% GDP	**-6,8**	**-6,6**	**-3,0**	**-3,6**	**-2,6**	**-0,7**	**-2,7**	**-5,8**	**-4,8**	**-4,6**
One-off measures	*% GDP*	**-0,1**	**-0,3**	**-0,7**	**-1,3**	**-0,2**	**-0,3**	**-0,1**	**0,3**	**0,2**	**-0,3**
Cyclical balance	*% GDP*	**-0,5**	**-0,5**	**-0,5**	**-0,2**	**0,4**	**1,1**	**0,8**	**-1,0**	**-1,0**	**-1,1**
Structural balance	*% GDP*	**-6,2**	**-5,9**	**-1,7**	**-2,1**	**-2,8**	**-1,5**	**-3,4**	**-5,1**	**-4,0**	**-3,2**
Fiscal effort	*% GDP*	**-0,6**	**0,3**	**4,1**	**-0,4**	**-0,7**	**1,3**	**-2,0**	**-1,6**	**1,0**	**0,9**
Interest expenditure	*% GDP*	**1,2**	**1,1**	**1,2**	**1,2**	**1,1**	**1,1**	**1,1**	**1,3**	**1,2**	**1,8**
Primary balance	*% GDP*	**-5,5**	**-5,5**	**-1,8**	**-2,4**	**-1,5**	**0,5**	**-1,6**	**-4,5**	**-3,6**	**-2,7**

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] *Hedging instruments used to avoid interest rate change risk.*

[2] *General government net lending/borrowing relevant for fulfilment of Maastricht convergence criteria. Compared with net lending/borrowing from national accounts, this item is adjusted for interest rate derivatives.*

A. 3 Monetary Policy and Interest Rates

Monetary policy

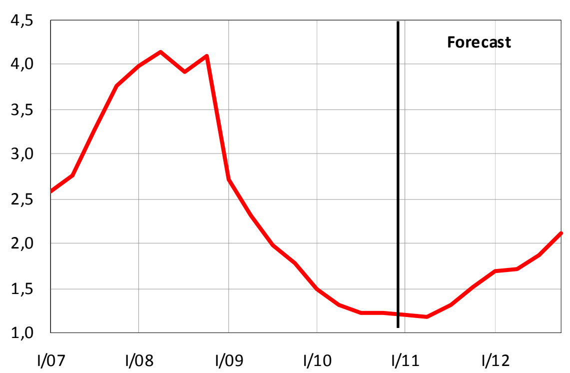
The CNB's main policy objective is price stability. To achieve this, the central bank uses an **inflation targeting** regime. By means of monetary instruments, the CNB influences total inflation so that the YoY increase in the CPI does not deviate from the medium-term inflationary target of 2% by more than ± 1 p.p. The main monetary policy instrument is the interest rate for **2W repo operations**, which stood at 0.75% as at the end of 2010.

In relation to price levels, the CNB also monitors developments in **interest rate differentials** versus the main world economies. The interest-rate differentials may significantly affect international capital flows and thus affect price levels in the individual countries through the exchange rate. At present, there are no important pressures from this perspective, especially due to the relatively narrow interest rate spreads, which, as of the end of 2010, were at −0.25 p.p. between the Czech Republic and EMU and relative to the US at 0.50 to 0.75 p.p.

Interest rates

The average value for **3M PRIBOR** held at 1.2% (*in line with the forecast*) in the fourth quarter of 2010. For the whole of 2010, 3M PRIBOR was 1.3% and for 2011 it is predicted at 1.3% (*forecast unchanged*). A moderate increase in the PRIBOR rate is expected from the second half of 2011, but this should be neither dramatic nor dampen the fragile recovery of an economy already weakened by restrictive cost-saving measures. We look for 3M PRIBOR to average 1.9% in 2012.

Graph A.3.1: **PRIBOR 3M**
in %



Long-term interest rates should slowly rise in the coming years and thus reflect the economic recovery in progress. Given the Czech Republic's current ratings (as of 3 January 2011, Moody's: A1, stable outlook; Standard & Poor's: A+, positive outlook; Fitch Ratings: AA–, positive outlook), further successful issues of government bonds can be expected. Moreover, according to the updated "Funding and Debt Management Strategy of the Czech Republic", due to the ongoing fiscal consolidation, the central government's net borrowing requirement should decrease from CZK 168 billion in 2010 to CZK 106 billion in 2011.

Any possible newly emerging debt or financial issues in EMU countries could, however, increase the risk premium on government bonds and boost the costs for funding the state debt. Assuming a positive scenario, we predict the average **yield to maturity for 10-year government bonds** to be 3.8% (*versus 3.9%*) and 4.0% in 2011 and 2012, respectively.

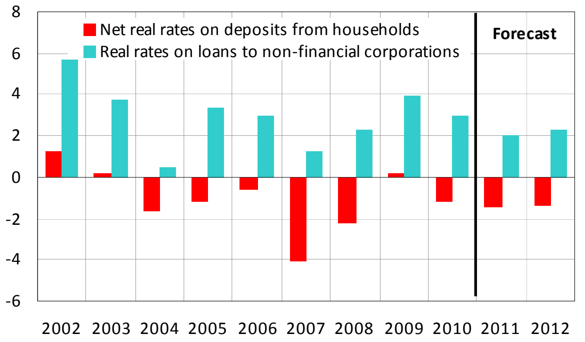
Interest **rates for deposits and loans** respond to changes in interbank rates with a lag of several months. In this light, their further decrease to 4.1% for loans to non-financial corporations and 1.2% for household deposit rates could be observed in the third quarter of 2010. In the fourth quarter, we expect stable rates. Interbank rates point to average lending rates to non-financial corporations of roughly 4.1% (*versus 4.2%*) in 2011 and 4.4% in 2012. Household deposit rates should reach 1.2% in 2011 (*in line with the forecast*) and in 2012 rise slightly to 1.3%.

The real economy is influenced especially by real interest rates. The development of nominal interest rates, CPI and final domestic use deflator implies a decrease in real interest rates for loans to 2.0% (*versus 2.3%*) and for deposits to −1.5% (*versus −1.4%*) in 2011. In 2012, rates will very likely increase slightly: to 2.3% for loans and to −1.4% for deposits.

Weighted average interest rates for new loans to households rose by 0.1 p.p. to 13.9% in the third quarter of 2010 (were it not for a QoQ change in structure, the rates would have decreased by 0.3 p.p.). Interest rates for new loans to non-financial corporations continued their decline to 3.9% (by 0.1 p.p.).

Graph A.3.2: **Av. Real Rates on Credits and Deposits**

rates on credits deflated by end-of-year final domestic use deflator, rates on time/savings deposit (net of 15% income tax) deflated by end-of-year CPI growth, in % p.a.



Graph A.3.3: **Interest Rates on New Loans to Households and Non-Financial Corporations**

in % p.a.

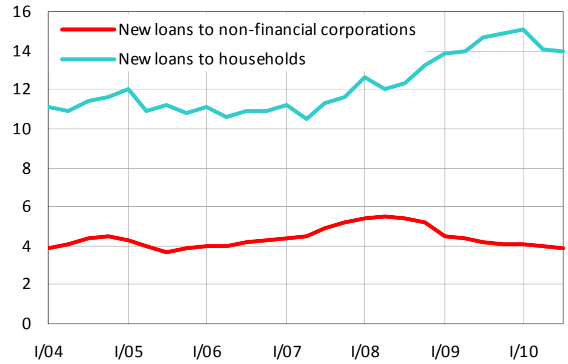


Table A.3.1: **Interest Rates** – yearly

average interest rates in per cent p.a.

	2003	2004	2005	2006	2007	2008	2009	2010 *Estimate*	2011 *Forecast*	2012 *Forecast*
Repo 2W CNB *(end of year)*	2,00	2,50	2,00	2,50	3,50	2,25	1,00	0,75	.	.
Main refinancing rate ECB *(end of year)*	2,00	2,00	2,25	3,50	4,00	2,50	1,00	1,00	.	.
Federal funds rate *(end of year)*	1,00	2,25	4,25	5,25	4,25	0,25	0,25	0,25	.	.
PRIBOR 3M	2,28	2,36	2,01	2,30	3,09	4,04	2,19	1,31	1,3	1,9
Government bond yield to maturity (10Y)	4,12	4,75	3,51	3,78	4,28	4,55	4,67	3,71	3,8	4,0
Interest rates on loans to non-financial corpor.	4,57	4,51	4,27	4,29	4,85	5,59	4,58	4,1	4,1	4,4
Interest rates on deposits from households	1,40	1,33	1,24	1,22	1,29	1,54	1,37	1,3	1,2	1,3
Real rates on loans to non-financial corporations [1]	3,72	0,47	3,38	2,95	1,24	2,27	3,97	3,0	2,0	2,3
Net real rates on deposits from households with agreed maturity [2]	0,18	-1,64	-1,13	-0,63	-4,10	-2,26	0,17	-1,2	-1,5	-1,4

[1] *Deflated by domestic demand deflator.*

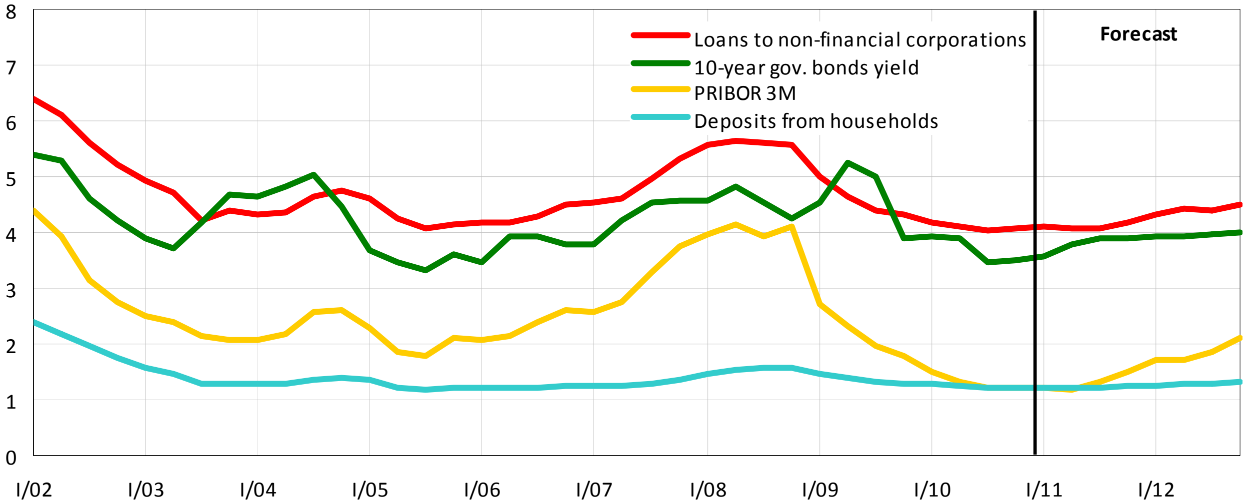
[2] *Net of 15 % income tax, deflated by CPI.*

Table A.3.2: **Interest Rates** – quarterly

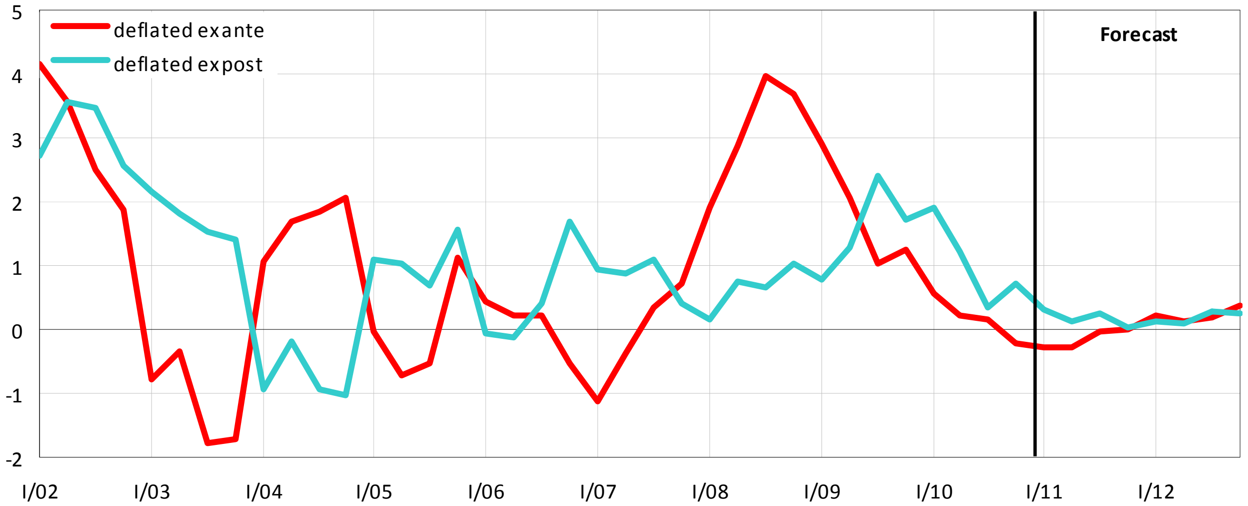
average interest rates in per cent p.a.

	2010 Q1	2010 Q2	2010 Q3	2010 Q4 *Estimate*	2011 Q1 *Forecast*	2011 Q2 *Forecast*	2011 Q3 *Forecast*	2011 Q4 *Forecast*
Repo 2W rate CNB *(end of period)*	1,00	0,75	0,75	0,75	.	.	.	.
Main refinancing rate ECB *(end of period)*	1,00	1,00	1,00	1,00	.	.	.	.
Federal funds rate *(end of period)*	0,25	0,25	0,25	0,25	.	.	.	.
PRIBOR 3M	1,50	1,30	1,23	1,21	1,2	1,2	1,3	1,5
Long term interest rates – 10-year government bonds yield to mat.	3,94	3,90	3,48	3,51	3,6	3,8	3,9	3,9
Interest rates on loans to non-fin. corporations	4,19	4,11	4,05	4,1	4,1	4,1	4,1	4,2
Interest rates on deposits from households	1,30	1,27	1,22	1,2	1,2	1,2	1,2	1,2

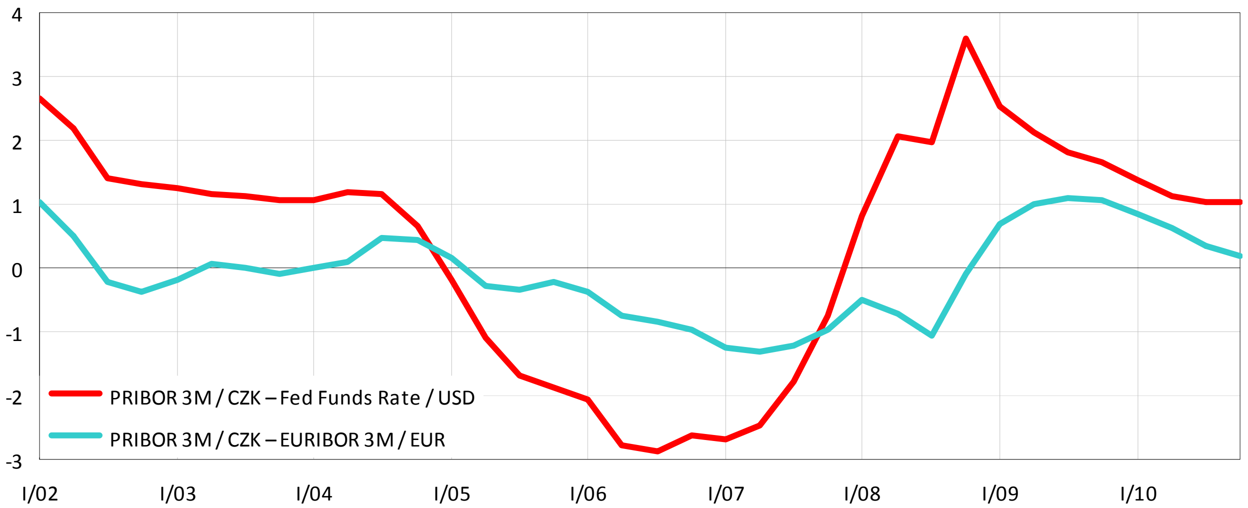
Graph A.3.4: **Interest Rates**
in % p.a.



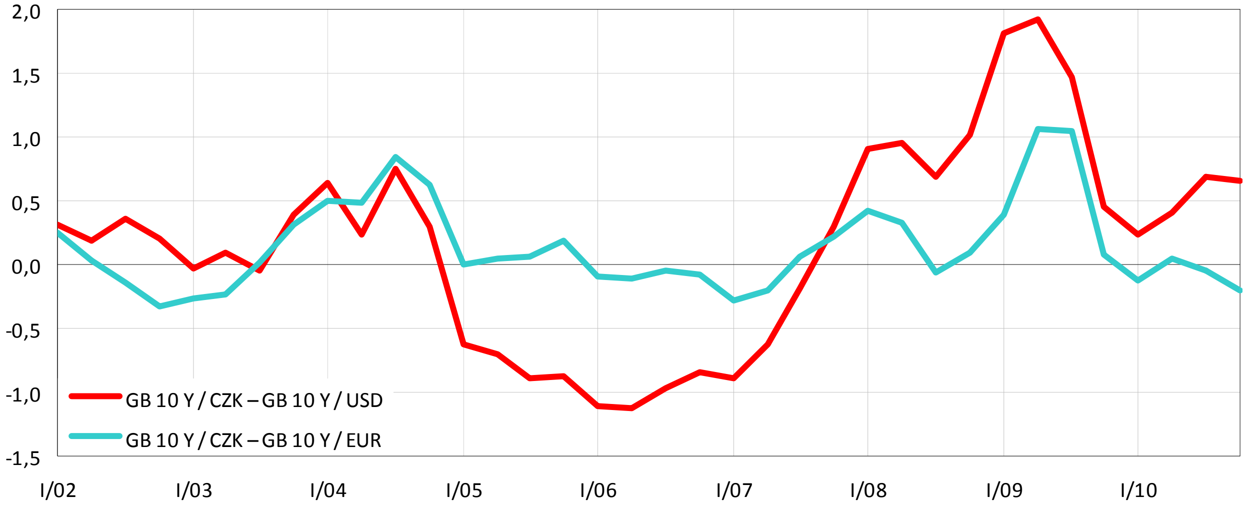
Graph A.3.5: **Real PRIBOR 1Y**
deflated ex post and ex ante by final domestic use deflator, in % p.a.



Graph A.3.6: **Short-Term Interest Rate Spread**
in percentage points



Graph A.3.7: **Long-Term Interest Rate Spread**
government bonds, in percentage points



A.4 Exchange Rates

The CZK/EUR exchange rate weakened slightly during the fourth quarter of 2010 from 24.53 CZK/EUR in October to 25.16 CZK/EUR in December. The average exchange rate for the fourth quarter of 2010 was 24.79 CZK/EUR, roughly in accordance with the trend value.

The adopted scenario assumes the tendency for slight increase in the nominal and real rate will remain in the coming months and until the end of 2012. Such tendency would conform to the long-term trend trajectory and results from positive gap of productivity growth in the Czech economy relative to euro zone countries, and that should protect the competitiveness of Czech exporters.

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

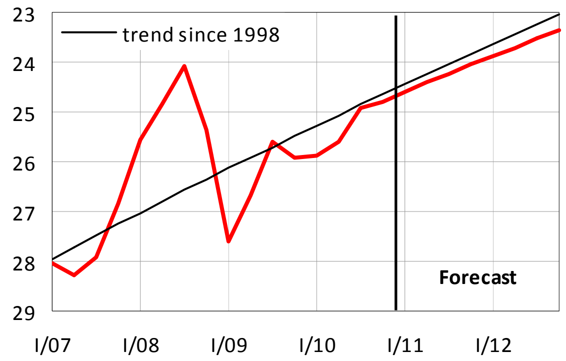


Table A.4.1: **Exchange Rates** – yearly

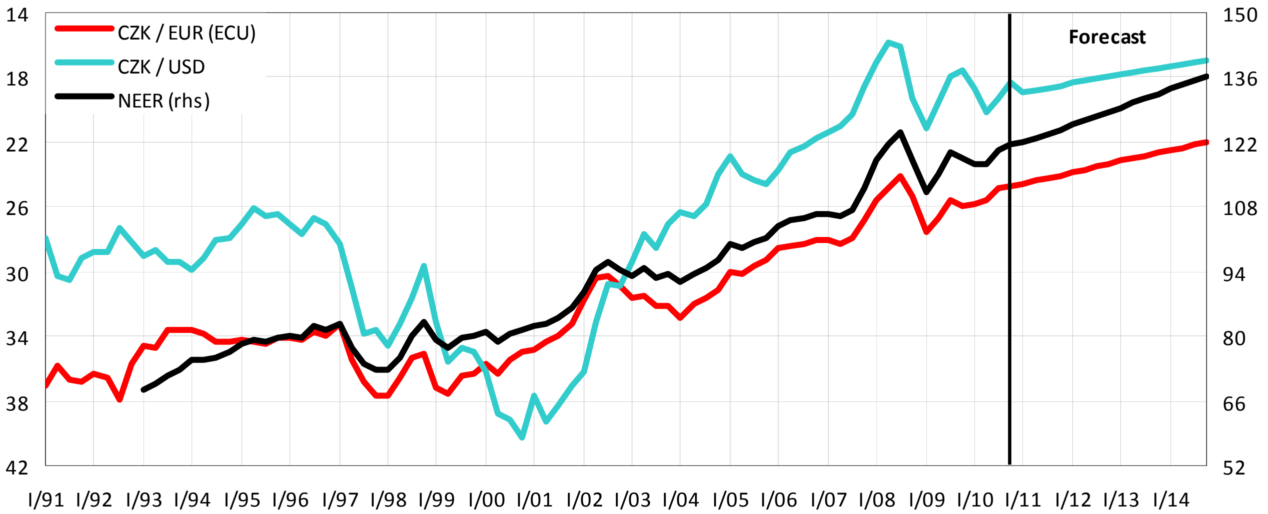
			2005	2006	2007	2008	2009	2010 *Estimate*	2011 *Forecast*	2012 *Forecast*	2013 *Outlook*	2014 *Outlook*
Nominal exchange rates:												
CZK / EUR		*average*	**29,78**	**28,34**	**27,76**	**24,94**	**26,45**	**25,29**	**24,3**	**23,6**	**22,9**	**22,2**
	appreciation	*growth in %*	7,1	5,1	2,1	11,3	-5,7	4,6	3,9	3,0	3,0	3,0
CZK / USD		*average*	**23,95**	**22,61**	**20,31**	**17,03**	**19,06**	**19,11**	**18,7**	**18,2**	**17,6**	**17,1**
	appreciation	*growth in %*	7,3	5,9	11,3	19,2	-10,6	-0,3	2,1	3,0	3,0	3,0
NEER		*average of 2005=100*	**100,0**	**105,1**	**107,9**	**120,4**	**116,2**	**119**	**123**	**127**	**131**	**135**
	appreciation	*growth in %*	6,2	5,1	2,6	11,6	-3,5	2,6	3,5	3,0	3,0	3,0
Real exchange rate to EA12[1)]		*average of 2005=100*	**100,0**	**104,3**	**107,5**	**119,4**	**114,4**	**118**	**121**	**125**	**129**	**133**
	appreciation	*growth in %*	4,8	4,3	3,1	11,1	-4,2	3,1	3,0	3,1	3,2	2,8

[1)] *Deflated by GDP deflators.*

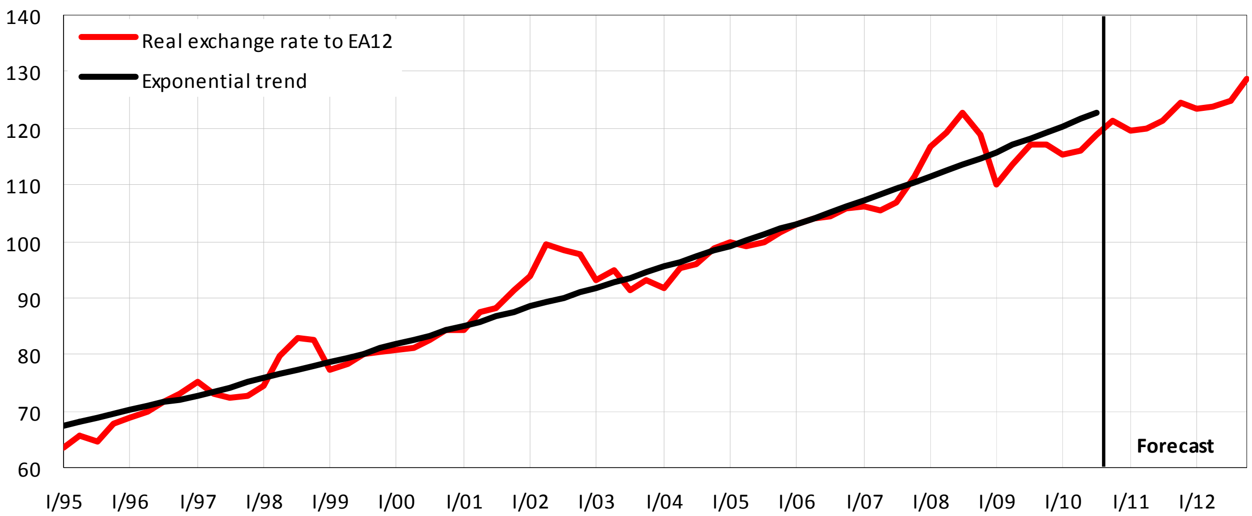
Table A.4.2: **Exchange Rates** – quarterly

			2010				2011			
			Q1	Q2	Q3	Q4 *Estimate*	Q1 *Forecast*	Q2 *Forecast*	Q3 *Forecast*	Q4 *Forecast*
Nominal exchange rates:										
CZK / EUR			**25,87**	**25,59**	**24,91**	**24,79**	**24,6**	**24,4**	**24,2**	**24,1**
	appreciation	*growth in %*	6,7	4,3	2,7	4,6	5,1	4,8	2,8	3,0
CZK / USD			**18,71**	**20,16**	**19,30**	**18,26**	**18,9**	**18,8**	**18,6**	**18,5**
	appreciation	*growth in %*	13,3	-2,8	-7,3	-4,0	-1,1	7,3	3,5	-1,4
NEER		*average of 2005=100*	**117,3**	**117,3**	**120,3**	**122**	**122**	**123**	**124**	**125**
	appreciation	*growth in %*	5,5	1,9	0,4	2,7	4,0	4,8	2,9	2,5
Real exchange rate to EA12		*average of 2005=100*	**115,3**	**116,2**	**118,9**	**121**	**120**	**120**	**121**	**125**
	appreciation	*growth in %*	4,7	2,4	1,6	3,5	3,8	3,4	1,9	2,7

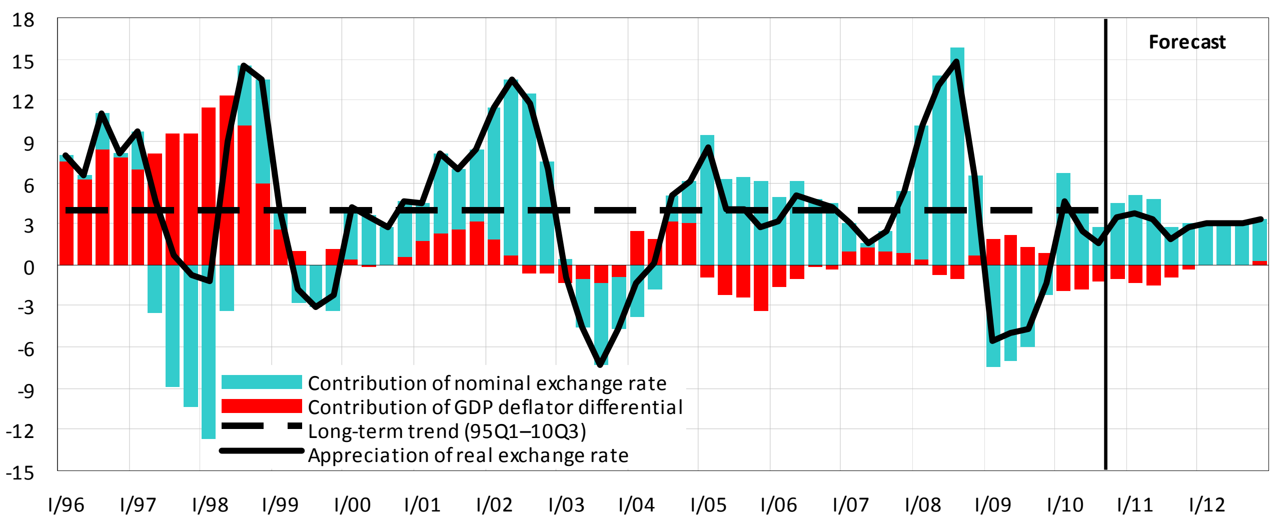
Graph A.4.2: **Nominal Exchange Rates**
quarterly average, average 2005 = 100 (rhs)



Graph A.4.3: **Real Exchange Rate to EA12**
quarterly average, deflated by GDP deflators, average 2005 = 100



Graph A.4.4: **Real Exchange Rate to EA12**
deflated by GDP deflators, YoY growth, in percentage points



A.5 Structural Policies

Currently the Czech Republic's government is preparing the **National Reform Plan**[4], which is to include a schedule of key structural reforms to which the government of the Czech Republic has pledged in its programme statement. Some of the main reforms include reform of the pension and health care systems, a new income tax act, reform of tertiary education, support for science and research, and a fight against corruption. A proposal for the National Reform Plan should be presented at the end of February or start of March 2011, and the reforms should then be implemented by 2012.

Business environment

An **amendment to the Accounting Act** came into effect on 1 January 2011, aiming to reduce the administrative burdens on accounting entities which do consolidation accounting. The amendment also adjusts administrative penalty according to principles of legislation on offences and administrative torts.

The **Strategy for Computerisation of Public Procurement for the period of 2011 to 2015** was ratified by the government of the Czech Republic on 5 January 2011. The new strategy aims to reduce the costs and administrative burden of public buyers and at the same time increase the transparency of the whole public procurement process.

Taxes

The **Tax Code Act** came into effect on 1 January 2011 and replaces the Taxes and Fees Administration Act valid since 1992. The new tax code reduces administrative costs and simplifies the administrative process, limits some competencies of the Minister of Finance (remission of taxes), and introduces a new concept of tax execution.

On the same day, an **amendment to the Income Tax Act** came into effect. The main changes include reducing the annual amount of the tax deduction per taxpayer by CZK 1,200 in 2011 due to flood damage. Also introduced is the taxation of pensions of employed pensioners whose annual income from employment, business activity or leasing exceeds CZK 840,000.

An amendment to the Value Added Tax Act, which should help curb tax evasions, was ratified by the Chamber of Deputies on 17 December 2010. The amendment will allow return of taxes in relation to accounts receivable that are difficult to collect and introduce security for unpaid taxes. It is presumed the amendment will come into effect on 1 April 2011.

Financial markets

In June 2010, an **amendment to the Act on Banks** came into effect, doubling the ceiling for insured bank deposits to EUR 100,000.

On 1 January 2011, an **amendment to the Act on Building Savings Schemes and State Support for Building Savings Schemes** came into effect, with the purpose of reducing the impact of support to building savings schemes on the state budget. State support contributed this year will be taxed at a 50% rate, and from 2012 the maximum amount of state support will be CZK 2000. The amendment also introduced taxation of interest earned on building savings schemes.

Energy

An amendment to the Act on Promoting the Use of Renewable Sources of Energy, limiting the increase of electricity prices due to rapid growth in photovoltaic power stations, came into effect on 1 January 2011 (see more in Box C.1.1).

On 5 January 2011 the government approved a draft **amendment to the Energy Act**, which implements the so-called third EU energy package, the intent of which is the separation of gas transport from its production and trade under Czech law. The amendment to the Energy Act should liberalise the energy market, improve consumer protection in the energy market, and strengthen the authority and independence of the Energy Regulatory Office.

Labour market

In connection with consolidation measures under the state budget, the **social and health insurance ceilings** have been raised to 72 times the average monthly wage for 2010. This condition also is preserved for social insurance for 2011, whereas the maximum assessment base for health insurance already is effective indefinitely. Despite a proposal that would have decreased the social security insurance rate paid by the employer by 0.9 p.p. in the new year, under the valid legal regulation it remains at the present 25% level. Meanwhile, the possibility for employers to deduct half of wage compensation for a period of work

[4] *This is not the National Reform Programme that the Czech Republic regularly produces as part of the Europe 2020 strategy.*

incapacity from the insurance premium was cancelled. In contrast, for employers with 25 employees or fewer and enrolled into a special insurance payment system with premiums 1 p.p. higher, the refunding of half of the wage compensation is introduced.

With regard to **sickness insurance** benefits, the payment of benefits was abolished for the first three calendar days of illness and payment of the benefits by the employer was instituted for the 4th through 14th days of sickness. This measure has been broadened for 2011 to 2013 to include up to the 21st calendar day of sickness. At the same time, the amount of sickness benefit is still assessed based on only 60% of the daily assessment base while increasing the reduction limits reflecting past development of the average wage. In case of self-employed individuals, the abuse of financial aid for maternity leave has been restricted by more closely linking pension and sickness insurance.

In 2010, measures for the **first stage of pension reform** came into effect, gradually increasing the statutory retirement age to 65 years for men and to 62–65 years for women (depending on the number of children raised). The amendment increases the required insurance period to 35 years and excludes studies from the range of non-contributory periods. An important structural measure is the substantial further **strengthening of the motivation for older persons** to remain in the labour market by a marked shortening of old age pension in case of early retirement and increase in the percentage allowance of an old age pension in a case of concurrence of employment and the receiving of a partial or full pension. The government has newly approved taxation of pension benefits of employed pensioners if these exceed three times the average wage.

Regarding new **benefit measures**, on 1 January 2011 the social bonus (for low-income families with dependent children) was abolished, the birth bonus will be given only for firstborns in low-income households and the summary size of the parental benefit will be the same in the four-year variant as when the benefit is drawn for two years.

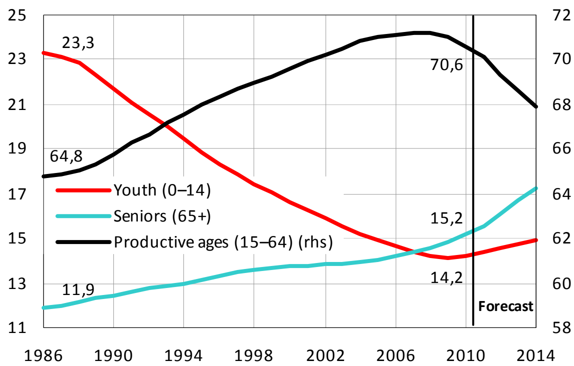
Unemployment support now excludes the possibility of working under certain conditions while receiving unemployment benefits, and those who terminate their own contracts without serious cause or by agreement should draw only 45% of the assessment base. Moreover, such benefit will be provided only after the period corresponding to the amount of severance or leaving pay expires. Only then will the period of support begin to run and with appropriate amount of support. When the job seeker decides to begin in self-employment, he/she can receive a so-called bridging contribution from the labour office, intended to cover operating costs for five months up to one-quarter of the average wage.

A.6 Demographic Trends

According to preliminary data, the population of the Czech Republic grew by 20 thousand to 10.527 million persons from the first to third quarter of 2010. The natural increase in population reached 10 thousand persons, which is equivalent to the same period of 2009.

Considering the falling demand for foreign workers, the positive balance of migration, on the other hand, reached only 10 thousand persons compared with 26 thous. in the first half of 2009. It is almost certain that the assumption of a 2010 migration balance of 40 thous. in the high version or 25 thous. in the central version of the demographic projection will not be fulfilled. Evidently, the period of demographic structural improvement due to immigration of working-age foreigners has thus come to an end (at least temporarily).

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

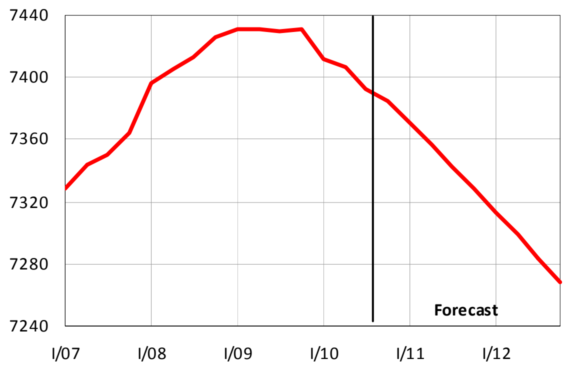


The low migration balance leads us once again to start using the central version of the CZSO Demographic Projection 2009 to formulate our assumptions for the Forecast.

It can be said that from an economic point of view the Czech population at present continues to have a very favourable structure with a high proportion of working-age people (15–64 years), which, however, clearly reached its maximum at the turn of 2008 and 2009.

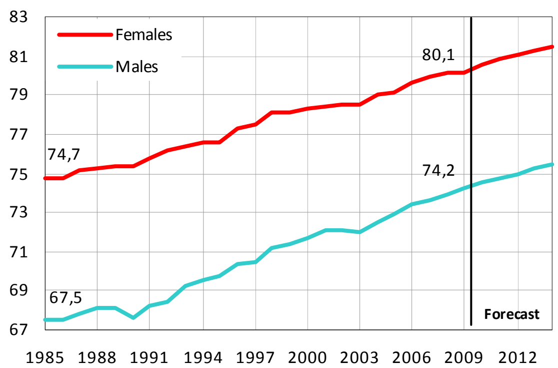
Based on our calculations, however, a moderate decline in the working-age population should be more than compensated by the effects within the age structure of the workforce as the structural proportions of age groups with high or growing participation increase.

Graph A.6.2: **Czech Population from 15 to 64 Years**
quarterly averages, in thousands



This will be further supported by the enacted extension of the retirement age. Further rise in labour market flexibility should help create a situation wherein the Czech economy will not suffer from a lack of suitable workforce.

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



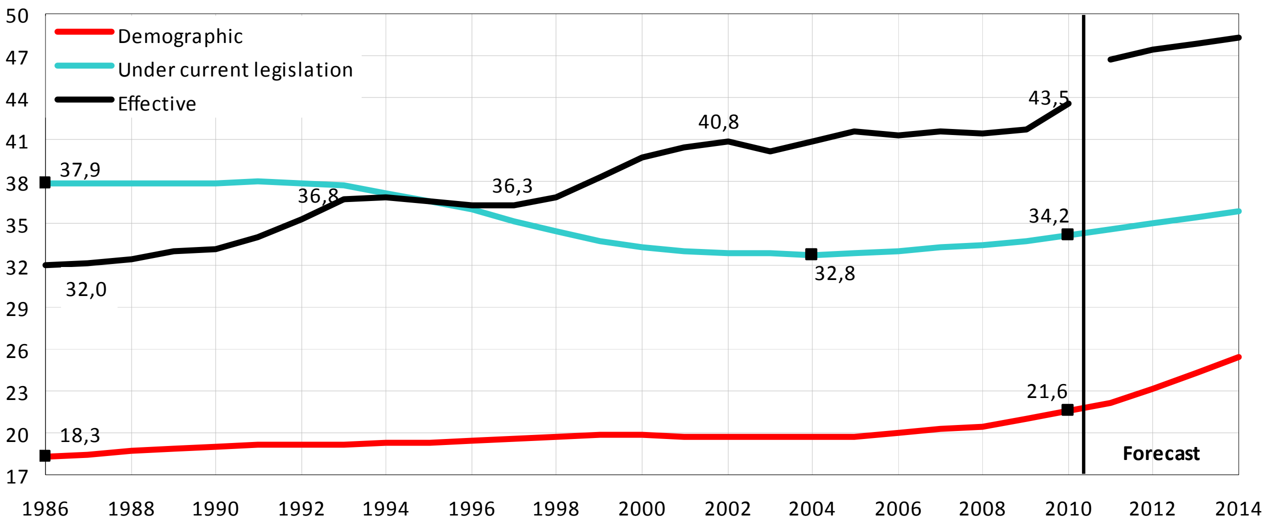
On the other hand, the continuing **process of population ageing** has been confirmed. In 2007, for the first time in Czech history, the number of people younger than 15 years was lower than the number of people in the 65+ age category. In future, the number and proportion of seniors in the population will rise due to the demographic structure and the continuation of the intensive process to extend the life expectancy. The structural proportion of persons over 64 years of age in the total population, which was just below 15% in early 2009, should increase to nearly 20% by the beginning of 2020.

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

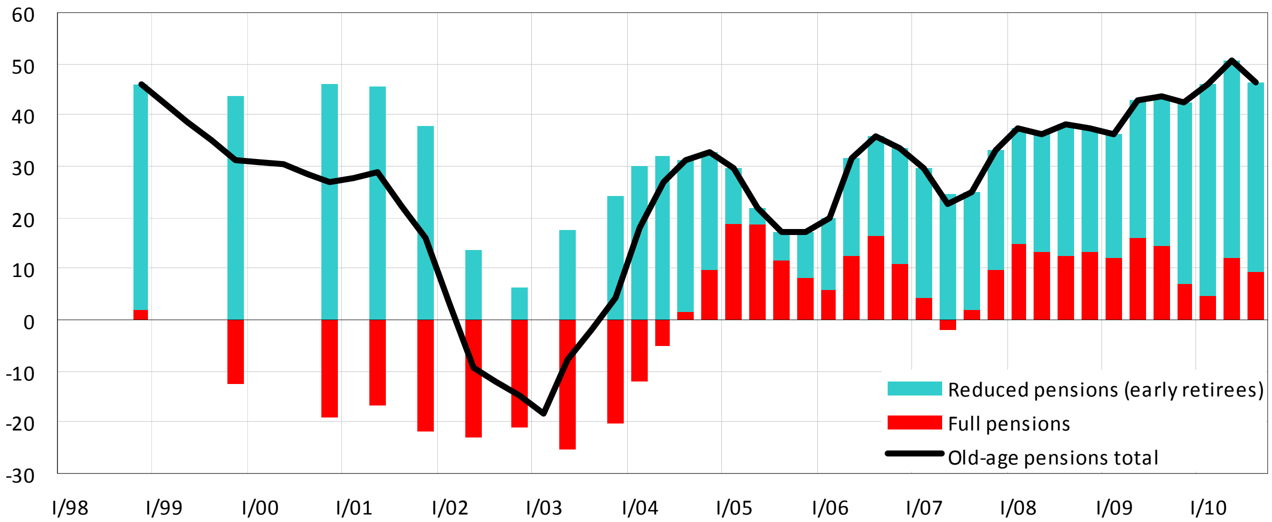
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
						Estimate	*Forecast*	*Forecast*	*Outlook*	*Outlook*
Population (January 1)	**10 221**	**10 251**	**10 287**	**10 381**	**10 468**	**10 507**	**10 526**	**10 560**	**10 594**	**10 625**
growth in %	0,1	0,3	0,4	0,9	0,8	0,4	0,2	0,3	0,3	0,3
Age structure (January 1):										
(0–14)	**1 527**	**1 501**	**1 480**	**1 477**	**1 480**	**1 494**	**1 512**	**1 538**	**1 563**	**1 586**
growth in %	-1,8	-1,7	-1,5	-0,2	0,2	1,0	1,2	1,7	1,6	1,5
(15–64)	**7 259**	**7 293**	**7 325**	**7 391**	**7 431**	**7 414**	**7 380**	**7 324**	**7 264**	**7 211**
growth in %	0,3	0,5	0,4	0,9	0,5	-0,2	-0,5	-0,8	-0,8	-0,7
(65 and more)	**1 435**	**1 456**	**1 482**	**1 513**	**1 556**	**1 599**	**1 634**	**1 699**	**1 767**	**1 828**
growth in %	0,8	1,5	1,8	2,1	2,9	2,7	2,2	4,0	4,0	3,5
Old-age pensioners (January 1)[1)]	**1 965**	**1 985**	**2 024**	**2 061**	**2 102**	**2 145**	**2 299**	**2 335**	**2 370**	**2 405**
growth in %	1,7	1,0	2,0	1,8	2,0	2,0	.	1,6	1,5	1,5
Old-age dependency ratios *(January 1, in %)*:										
Demographic [2)]	**19,8**	**20,0**	**20,2**	**20,5**	**20,9**	**21,6**	**22,1**	**23,2**	**24,3**	**25,4**
Under current legislation [3)]	**32,8**	**33,0**	**33,3**	**33,4**	**33,7**	**34,2**	**34,6**	**35,0**	**35,4**	**35,9**
Effective [4)]	**41,5**	**41,3**	**41,6**	**41,5**	**41,8**	**43,5**	**46,7**	**47,5**	**47,9**	**48,3**
Fertility rate	**1,282**	**1,328**	**1,438**	**1,497**	**1,492**	**1,50**	**1,51**	**1,52**	**1,53**	**1,54**
Population increase	**31**	**36**	**94**	**86**	**39**	**19**	**34**	**33**	**32**	**31**
Natural increase	**-6**	**1**	**10**	**15**	**11**	**10**	**9**	**8**	**7**	**6**
Live births	**102**	**106**	**115**	**120**	**118**	**117**	**116**	**114**	**113**	**112**
Deaths	**108**	**104**	**105**	**105**	**107**	**107**	**106**	**106**	**106**	**106**
Net migration	**36**	**35**	**84**	**72**	**28**	**10**	**25**	**25**	**25**	**25**
Immigration	**60**	**68**	**104**	**78**	**40**	**.**	**.**	**.**	**.**	**.**
Emigration	**24**	**33**	**21**	**6**	**12**	**.**	**.**	**.**	**.**	**.**

1) *In 2010 disability pensions of pensioners over 64 were transferred into old-age pensions.*
2) *Demographic dependency: ratio of people in senior ages (60 and more) to people in productive age (20–59).*
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**
in %



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.