E The Year 2011 in Retrospect

Comparing actual economic outcomes with those forecasted is an important part of the work behind preparing forecasts. The Ministry of Finance of the Czech Republic has thus prepared a comparison of the macroeconomic framework of the state budget for 2011 and the published data for this year. Readers should be aware that these data cannot be deemed final for 2011, as the quarterly national accounts in particular will surely still be revised several times.

Moreover, the revision of the national accounts system carried out in 2011 significantly complicates any comparison of forecasted and actual values. The revision was made in order to improve methodology on the basis of Eurostat requirements, as reflected by the change in definitions of certain indicators (especially for foreign trade), changes in data sources and processing methods, and the switch to a new classification of industries under NACE, rev. 2. In March 2011, the Czech National Bank also carried out a revision in the payments balance area.

Table E.1: **Comparison of the 2011 State Budget Macroeconomic Framework with the Actual Outcome**

Summary of main indicators		2011 State Budget (July 2010 Forecast)			Outcome (April 2012)			Difference (Outcome–Forecast)		
		2009	2010	2011	2009	2010	2011	2009	2010	2011
Gross domestic product	*growth in %, const.pr.*	-4.1	1.6	2.3	-4.7	2.7	1.7	-0.6	1.1	-0.6
Consumption of households	*growth in %, const.pr.*	-0.2	-0.5	2.0	-0.4	0.6	-0.5	-0.2	1.1	-2.5
Consumption of government	*growth in %, const.pr.*	4.2	-1.8	-0.9	3.8	0.6	-1.4	-0.4	2.4	-0.5
Gross fixed capital formation	*growth in %, const.pr.*	-9.2	-4.3	2.5	-11.5	0.1	-1.2	-2.3	4.4	-3.7
Cont. of foreign trade to GDP growth	*p.p., const.pr.*	-0.6	1.9	0.6	0.8	0.9	2.6	1.4	-1.0	2.0
GDP deflator	*growth in per cent*	2.6	-0.2	1.3	1.9	-1.7	-0.7	-0.7	-1.5	-2.0
Average inflation rate	*per cent*	1.0	1.6	2.5	1.0	1.5	1.9	0.0	-0.1	-0.6
Employment (LFS)	*growth in per cent*	-1.4	-1.4	0.6	-1.4	-1.0	0.4	0.0	0.4	-0.2
Unemployment rate (LFS)	*average in per cent*	6.7	7.6	7.3	6.7	7.3	6.7	0.0	-0.3	-0.6
Wage bill (domestic concept)	*growth in %, curr.pr.*	-0.1	-0.3	3.8	-2.1	-0.4	1.1	-2.0	-0.1	-2.7
Current account / GDP	*per cent*	-1.0	-0.1	-1.0	-2.4	-3.9	-2.9	-1.4	-3.8	-1.9
General government balance	*% GDP*	-6.6	-5.3	-4.8	-5.8	-4.8	-3.1	0.8	0.5	1.7
Assumptions										
Exchange rate CZK/EUR										
Long-term interest rates	*% p.a.*	26.4	25.5	24.6	26.4	25.3	24.6	0.0	-0.2	0.0
Crude oil Brent	*USD/barrel*	5	4	4	5	4	4	0	0	0
GDP in Eurozone (EA-12)	*growth in %, const.pr.*	62.0	78.0	87.0	61.9	79.6	111.0	0.0	1.6	24.0

Note: General government balance (in ESA 95) based on the April 2011 Convergence Programme. The change of 2009 data is due to data revisions.

The macroeconomic framework of the state budget for 2011 was prepared based on the Ministry of Finance's Macroeconomic Forecast from July 2010.

At that time, the global economy had been slowly recovering from the financial crisis and subsequent recession from the turn of 2008 and 2009. Economic growth at that time was very fragile as well as uneven, both geographically and through time. The prevailing uncertainty concerning the state of public budgets in the southern wing of the euro zone, especially in Greece, further hindered recovery.

The Czech economy also recovered slowly. A problem, however, was the amount of the general government deficit, which had reached 6.6% of GDP[11] in 2009 as a result of the recession and the adopted anti-crisis package. Deficit targets at 5.3% of GDP for 2010 and 4.8% for 2011 were therefore established in the Convergence Programme from April 2010. Considering the pending elections, however, the measures required to achieve the established goals for 2011 were not yet implemented.

The Forecast from July 2010 had been based on a scenario assuming continuation of the gradual and modestly accelerating recovery.

In preparing the state budget for 2011 **(i.e. after publication of the July Forecast)**, the new government that was formed on the basis of the election outcome from the end of May 2010 adopted restrictive measures in the extent of CZK 78 billion, or ca 2.0% of the expected GDP. For the most part, these consisted of spending cuts. One such measure, for example, was 10% reduction of the wage bill in a vast majority of central government institutions. This partly explains the deviation in the wage bill's growth rate in Table E.1.

Economic development since publication of the Forecast from July 2010 has been decidedly uneven.

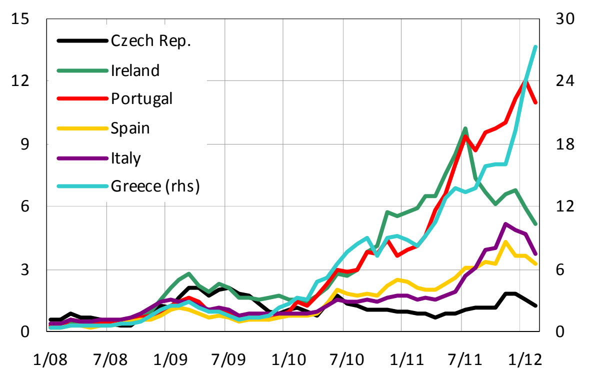
[11] *According to data from the Convergence Programme of April 2010. Calculated using current data, the deficit was 5.8% of GDP.*

While in the second half of 2010 the intensity of recovery both in the Czech Republic and around the world exceeded that of the forecast scenario, the 2nd half of 2011, in particular, was significantly affected by escalation of the debt crisis in the euro zone.

In July 2010, the sole euro zone country receiving international financial aid was Greece. By November 2010, Ireland, too, had requested assistance from the EA/IMF, though from today's perspective the spread of contagion to other countries on the periphery of the euro zone was relatively limited. Portugal requested international financial aid in May 2011, while Spain and Italy came under the scrutiny of financial markets in the second half of 2011. At that time, moreover, concerns regarding the health of the banking sector in the euro zone also emerged due to banks' exposure to government bonds of problematic countries. Uncertainty regarding the possible spread of problems to the real economy was also prevalent, and the euro zone's ability to survive this crisis in its present form was being questioned.

Graph E.1: **Spreads over German Bonds**

The difference between yields of 10Y gov. bonds of the respective country and yields of 10Y German bonds, in p.p., monthly averages



Source: ECB

With a fiscal consolidation strategy regarded as credible by financial markets and rating agencies, the Czech Republic was not and is not considered to be a risky country as regards the debt crisis. Nevertheless, it has not avoided unfavourable economic impacts.

Owing to its openness, the Czech economy has developed similarly to certain neighbouring EU economies. **Economic growth** was slower than originally expected in 2011. The difference between the forecasted and actual development was 0.6 p.p. and was caused by domestic demand. According to current data, the contribution of domestic demand was 2.7 p.p. lower than forecasted. Household consumption was restricted by households' unfavourable income situation and low level of confidence, while government consumption was limited by the adopted consolidation measures. Investments in the government sector fell surprisingly sharply. Also an unexpectedly high comparison base from the end of 2010, to which the solar panel bubble contributed, decreased the final result. The contribution of foreign trade, on the other hand, was 2.0 p.p. higher than forecasted, as the slowdown in imports growth due to decline in domestic demand was considerably stronger than the slowing in exports resulting from lower foreign demand. (A comparison of the nominal and real values of individual indicators would not be adequate given the revision.)

The **average inflation rate** in 2011 was 0.6 p.p. lower than the original estimate. The cause of the overvaluation was the more limited scope of administrative measures. At the time of preparing the July Forecast, an increase in the lower VAT rate from 10% to 12% was being considered. In the end, however, this did not take place. In terms of market prices, the impact of the unexpectedly high oil prices was offset by the cyclical position of the Czech economy and the worsened conditions on the labour market as well as the related moderate growth in wages and household consumption.

Oil prices shot up in the first half of 2011 (to USD 123/barrel in April), while the forecast assumption had envisaged an upper limit of USD 90. One determining factor of this spike was geopolitical unrest in the Middle East and North Africa, the so-called "Arab Spring". The high oil prices were eventually reflected in the economy, and in particular by a worsening of terms of trade (in addition to the data revision), which considerably impacted the **GDP deflator**.

Although real GDP growth was lower than estimated, the **unemployment rate** fell faster than we had expected. It was 0.6 p.p. lower than the original estimate of 7.3%. This may be explained by the additional drop in the number of hours worked per employee as compared to the expectations for growth as well as by the improved ability of the labour market to absorb the unemployed through self-employment. The low growth in the **wage bill**, which was 2.7 p.p. lower than forecasted, was caused primarily by fiscal measures implemented for 2011 (drop in the wage bill and payments in the regulated sphere), lower economic growth, and continuing increased pressure on employers to reduce labour costs.

According to notifications from April 2012, the **general government balance** reached –3.1% of GDP in 2011. Despite the less positive economic development, it was 1.7 p.p. of GDP better than indicated by the trajectory in the 2010 Convergence Programme.