

A Forecast Assumptions

*The forecast was made on the basis of data known as of **January 13, 2012**. 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 2011 are indicated by italics. Data in the tables relating to the years 2014 and 2015 are calculated by extrapolation, indicating 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 outlook for the world economy has further deteriorated since the October forecast. Even though the US and Germany economies are not performing badly, there are significant risks to future development in connection with the euro zone's debt crisis. A possible slowdown in China is also a big unknown.

The QoQ growth of the **US economy** accelerated to 0.5% (*versus 0.4%*) in last year's Q3. Household consumption, which is the main factor driving growth, is supported by improvements on the labour market – the unemployment rate dropped to 8.5% in December, whereas it was up to 9.0% in October. In addition to consumer confidence, the Purchasing Managers Index is also rising, which is an indicator that industrial production will increase in the near future.

To date, reported earnings of large companies are also rather positive. Stock markets are showing relative optimism, and the Dow Jones index has stabilised above 12,000 points. In November and December, the dollar strengthened against the euro by approximately 10% to 1.28 USD/EUR.

The economy is helped by an accommodating monetary policy and a government aid programme for mortgagers, although it is not clear whether the real estate market has already reached its bottom. In its latest report, the Fed calls for the adoption of additional measures supporting the real estate market. The federal deficit should decrease by approximately 1 p.p. in 2012 from last year's roughly 9% of GDP. The sharp polarisation of the political scene, reinforced by this year's presidential elections, has prevented agreement on a larger savings programme, e.g. in military outlays.

Growth in the euro zone continues to slow. QoQ growth reached 0.1% in Q3 (*versus 0.3%*), while the EA12 grew by 0.8% in Q1. Growth is driven mainly by household consumption, but consumer and investor confidence is waning. Moreover, the uncertainty on financial markets is spreading to the real economy, and

lending activity, for example, is diminishing. Budgetary savings policies are also slowing growth in practically all countries.

The EA12 continues to be driven by Germany, which – unlike the euro zone as a whole – in 2011 surpassed its economic level from before the crisis. According to current estimates, Germany's GDP increased by 3.0% (*versus 2.9%*) in 2011, and QoQ growth reached 0.5% (*versus 0.3%*) in Q3. The growth in the rest of the euro zone, however, is meagre. The French, Spanish and Italian economies have effectively stagnated over the last two quarters, while Portugal and Greece are in recession.

Considerable differences in unemployment rates continue to exist between individual euro zone countries. The unemployment rate remained at 10.3% for the euro zone as a whole in November, while in Spain it rose to 22.9%. It is also high in Ireland (14.6%) and Slovakia (13.5%). In Germany, on the other hand, unemployment continued to decrease to 5.5%. This factual demonstration of a divergent euro zone also represents a significant political problem.

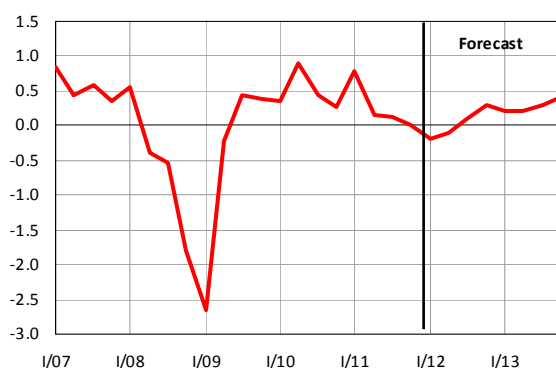
Solving the debt crisis, and in particular preventing its deepening and expansion, continues to be a crucial economic policy issue in the euro zone. The related uncertainty and negative expectations are the main reasons for forecast decreases and fears concerning a second round of recession (more in the subchapter "Debt crisis in the euro zone").

The **Polish economy** grew by 1.0% QoQ in Q1/2011 (*versus 0.7%*), although the unemployment rate rose to 10.0% in November. Economic growth has been driven mainly by investments (particularly in infrastructure), while growth in domestic consumption, which led the economy through the entire Europe-wide recession without a drop, has slightly decreased. This is influenced by the government's programme of fiscal consolidation, which aims to reduce the deficit from ca 5.5% of GDP in 2011 to under 3% in 2012, and by slowing foreign demand. The economy can be expected to slow more significantly in 2012.

As in Q1 and Q2, the **Slovak economy** grew by 0.8% (*versus 0.7%*) QoQ in Q3. Growth has been driven mainly by exports, especially of automobiles. Industrial production expanded by only 0.4% YoY in November, which characterises its deceleration. The economy is afflicted by a high unemployment rate, which apparently is the cause of the slump in household consumption that has spanned four quarters. It can therefore be expected that the Slovak economy will also slacken in 2012.

Graph A.1.1: Growth of GDP in EA12

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



We are holding the growth estimate for the euro zone at 1.7% for 2011, and we expect stagnation in 2012 (*versus growth of 1.0%*).

We have pushed up our growth estimate for the US economy to 1.7% (*versus 1.6%*) for 2011 and to 2.0% (*versus 1.9%*) for 2012.

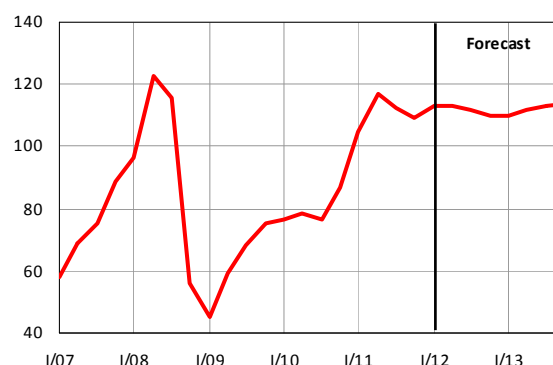
Commodity prices

The boom in commodity prices peaked in spring 2011. The average price of Brent crude oil reached USD 117.1 per barrel in Q2 2011, USD 112.5 in Q3 and USD 109.3 in Q4. Likewise, the price of wheat steadily slipped from USD 339 per ton in Q2 to USD 315.6 per ton in Q3 and down to USD 297.7 per ton in Q4 2011.

The slump was caused especially by fears of a global recession. By the end of 2011, however, anxiety concerning the geopolitical unrest in the Middle East re-emerged and prediction became very difficult. Besides anxiety over a decline in a number of economies (e.g. China), the possibility of restarting Libyan and Iraqi production also is among those arguments for the decrease.

Graph A.1.2: Dollar Prices of Brent Crude Oil

in USD per barrel



The price of Brent crude reached USD 111 per barrel in 2011 (*versus USD 110*). We have pushed up the estimate for 2012 to USD 112 (*versus USD 107*). There are risks to the prediction on both sides, but we consider the risk of price rise to be the more significant.

Debt crisis in the euro zone

The debt crisis in the euro zone has continued with unflagging intensity even in 2012. Since the publication of the last Macroeconomic Forecast, macroeconomic prospects have worsened (see above) and the already high level of uncertainty has increased. Spread of the debt contagion to certain countries at the core of the euro zone also has become a greater risk. Moreover, the two “key crisis” summits held in Brussels in late October and early December yielded no solutions which would be perceived positively on financial markets for more than a few days. It also appears that implementation of several key provisions adopted at these summits can in practice be accompanied by a number of complications.

Reaching an agreement between Greece and private sector representatives about writing off part of the Greek debt has especially proven problematic. This “voluntary” private sector involvement (PSI) will condition a provision of a second bailout package of EUR 130 billion. Greece does not have much time to reach such agreement. As it will need to refinance bonds for EUR 14.5 billion already in March and therefore cannot make do without another financial injection if it is to prevent an uncontrolled default. Considering these facts, the announcement of private sector representatives from Friday, 13 January on a temporary suspension of further negotiations on PSI is undoubtedly negative news. However, this was not the only important event that occurred on Friday the 13th.

On that day, Standard & Poor's cut by two grades the ratings of Italy (from A to BBB+), Cyprus and Portugal (from BBB- to BB), as well as Spain (from AA- to A) and by one notch the ratings of Austria (from AAA to AA+), France (from AAA to AA+), Malta and Slovakia (from A+ to A), as well as Slovenia. Moreover, it maintained a negative outlook for these countries, with the exception of Slovakia. This step by S&P's was not entirely unexpected, as in early December the agency had already put the ratings of almost all states of the euro zone on watch with a negative outlook. Markets, therefore, need not respond in an overly negative manner, depending on to what extent the ratings downgrade was accounted for. The impact on the European Financial Stability Facility (EFSF) bailout fund, however, will be more important. Considering that France and Austria lost the highest rating, there is a risk that the EFSF also could lose its AAA rating. This would likely make the bailout loans to Greece, Ireland and Portugal more expensive and could also potentially limit the EFSF's credit capacity, which, according to the conclusions of the October summit, should be extended up to EUR 1 trillion (using leverage).

However, S&P's may not be the only rating agency to downgrade some of the highest-rated euro zone countries. In mid-December, the Fitch agency put France (as well as Belgium, Ireland, Italy and Spain) on watch with a negative outlook.

The impacts of this unprecedented step by S&P's will likely be felt not only by governments, but also by the banking sector. There is already speculation that some large French banks could have their ratings downgraded as a consequence of the country's downgrade, as the banking and government sectors are particularly interconnected. The exposure of many banks to government bonds of problematic euro zone countries has, for example, a negative impact not only on their economic results, but also on their ratings.

Banks also face relatively strong pressure to increase capital. The European Banking Authority (EBA) recommended that 70 of 91 European banks tested in the last round of European stress tests reinforce their capital position by creating temporary capital buffers. Tier 1 capital adequacy should thus reach at least 9% by the end of June 2012, and the banks should also create a special capital buffer due to their exposures to government bonds. The EBA estimates a need for additional capital of nearly EUR 115 billion, most of which is for Greek, Spanish, Italian and German banks. However, increasing capital from private sources,

which is the EBA's preferred option, could prove difficult (depending on the market situation). Nevertheless, the other options for boosting capital adequacy, i.e. selling assets and limiting the provision of loans, are much worse from a macroeconomic perspective.

Another problem for the banking sector is the lack of confidence on the money market, as clearly indicated by the use of ECB's deposit facility. While in the first half of last year banks on average held under EUR 30 billion overnight (O/N) at ECB, there has been a steady rise since July 2011 and the volume of funds in the deposit facility approached EUR 500 billion at the start of 2012. The widening of the EURIBOR-OIS spread which occurred in the second half of last year paints a similar picture of mutual (mis)trust among banks.

The ECB is trying to mitigate the tension in the banking sector. It initiated a coordinated action in cooperation with the Bank of Canada, Bank of England, Bank of Japan, Swiss National Bank and the US Fed in late November, enabling banks from euro zone countries to acquire liquidity from the ECB in Canadian dollars, British pounds, Japanese yen, Swiss francs or US dollars in case of need. The ECB also decided to provide liquidity within the current dollar swap line under more advantageous conditions.

Having already reduced its main refinancing rate by 25 b.p. in early November, the ECB again cut the rate by 25 b.p. to 1.00% at the start of December. Aiming to support banks' lending activities and to boost liquidity on the money market, it also decreased the mandatory minimal reserves ratio by 1 p.p. to 1%, relaxed the requirements on quality of collateral (banks will also be able to use loans as collateral) and announced two exceptional long-term refinancing operations through which it will provide banks with liquidity for 36 months (at a fixed rate and with full allotment). In the first operation, which took place on 21 December 2011, banks borrowed some EUR 490 billion from ECB (however, EUR 46 billion represented funds "moved" by banks from the 12M refinancing operation conducted in October). The second 36M refinancing operation should occur in February this year.

There is also speculation that ECB had hoped these operations would cause banks to use part of these funds to purchase government bonds, thus enabling ECB to limit interventions on the secondary market of government bonds performed within the Security Markets Programme (since October 2011, the ECB

performed purchases for ca EUR 43 billion, and since the initiation of the programme in May 2010 the volume of purchased bonds surpassed EUR 216 billion). The relatively successful auctions of Spanish and Italian bonds and treasury bills in December 2011 and January 2012 (in comparison with auctions held in November 2011, yields dropped significantly and the demand was relatively solid) indicate that this could truly be the case. Apart from treasury bills, however, short-term bonds were mostly offered in these auctions. The real test will come in subsequent auctions, e.g. of 10Y bonds. Should a significant and more permanent rise in yields on the markets of Spanish and Italian bonds occur, the voices calling for ECB to act as the buyer of last resort in the market for government bonds would likely be much louder – as ECB, unlike EFSF or IMF, has unlimited resources.

Possible large-scale interventions of the ECB on bond markets could mitigate tensions in the short term, but in the long run many refer to increased fiscal integration as a necessary requirement to overcome the debt crisis. Although euro zone countries have declared their will to head towards the creation of a fiscal union, recent efforts in this direction constitute merely proposals for stricter fiscal rules. At the December summit, euro zone representatives agreed to create a so-called fiscal compact, according to which the structural government deficit should not exceed 0.5% of GDP. This rule should be implemented into law in the individual states at constitutional level and should contain automatic correction mechanisms. It

was also agreed to reinforce the excessive deficit procedure (EDP) rules. If a general government deficit were to exceed 3% of GDP, sanctions should be automatic, unless a qualified majority of euro zone countries votes against it. These propositions clearly stem from the idea – though, it should be said, a misguided one – that all the current problems of the euro zone are only due to a lack of fiscal discipline. While this is undoubtedly true in the case of Greece, it is less so, for example, for Spain and Ireland. In any case, this relative disregard of all problems other than fiscal (i.e. external imbalances and differences in competitiveness) was one of the factors that led S&P's to cut the ratings of the euro zone countries all together (see above).

The level of uncertainty concerning future development in the euro zone has thus risen even more. This Macroeconomic Forecast is therefore based on a “no-event” scenario, i.e. a scenario in which the debt crisis will not escalate considerably, but neither will the political leadership manage to find a credible solution to the problems that the euro zone is currently facing. This scenario is not necessarily the most likely scenario for future development. In any other scenario, however, we would have to make presumptions not only about specific events, but also about their timing. We consider such approach to be too restrictive for the purposes of the Macroeconomic Forecast. However, we will continue diligently to monitor events surrounding the debt crisis.

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

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
								<i>Estimate</i>	<i>Forecast</i>	<i>Forecast</i>
USA	3.5	3.1	2.7	1.9	-0.3	-3.5	3.0	1.7	2.0	2.3
EU27	2.5	2.0	3.3	3.2	0.3	-4.3	1.9	1.7	0.0	0.8
EA12	2.2	1.7	3.2	2.9	0.3	-4.2	1.9	1.7	0.0	0.8
Germany	1.2	0.7	3.7	3.3	1.1	-5.1	3.7	3.0	0.1	1.0
France	2.5	1.8	2.5	2.3	-0.1	-2.7	1.5	1.6	-0.1	0.7
United Kingdom	3.0	2.1	2.6	3.5	-1.1	-4.4	2.1	1.0	0.3	1.0
Austria	2.6	2.4	3.7	3.7	1.4	-3.8	2.3	3.2	0.5	1.3
Hungary	4.8	4.0	3.9	0.1	0.9	-6.8	1.3	1.5	-0.2	0.8
Poland	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.2	2.3	2.7
Slovakia	5.1	6.7	8.3	10.5	5.9	-4.9	4.2	3.1	1.2	2.8
Czech Republic	4.7	6.8	7.0	5.7	3.1	-4.7	2.7	1.8	0.2	1.6

Graph A.1.3: Real Gross Domestic Product

YoY growth in %, nsa data

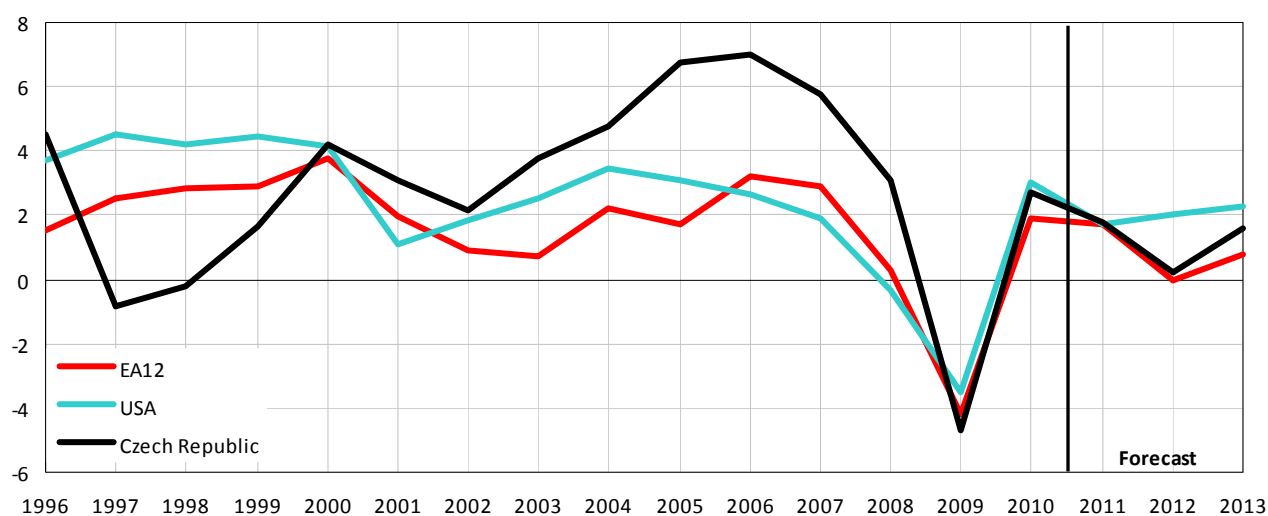


Table A.1.2: Real Gross Domestic Product – quarterly

growth in %, sa data

		2011				2012			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Estimate	Forecast	Forecast	Forecast	Forecast
USA	QoQ	0.1	0.3	0.5	0.5	0.5	0.6	0.4	0.4
	YoY	2.2	1.6	1.5	1.4	1.8	2.1	2.0	1.9
EU27	QoQ	0.7	0.2	0.3	0.0	-0.2	-0.1	0.1	0.3
	YoY	2.4	1.7	1.4	1.2	0.3	0.0	-0.2	0.1
EA12	QoQ	0.8	0.2	0.1	0.0	-0.2	-0.1	0.1	0.3
	YoY	2.4	1.7	1.4	1.1	0.1	-0.2	-0.2	0.1
Germany	QoQ	1.3	0.3	0.5	-0.1	-0.2	-0.1	0.2	0.2
	YoY	4.6	2.9	2.6	2.0	0.5	0.1	-0.2	0.1
France	QoQ	0.9	-0.1	0.3	0.1	-0.1	-0.3	0.0	0.1
	YoY	2.2	1.7	1.5	1.3	0.2	0.0	-0.3	-0.3
United Kingdom	QoQ	0.4	0.0	0.6	0.3	-0.1	-0.2	0.1	0.2
	YoY	1.7	0.6	0.5	1.3	0.8	0.6	0.1	0.0
Austria	QoQ	0.9	0.5	0.3	0.1	0.1	-0.2	0.3	0.2
	YoY	4.4	4.1	2.9	1.9	1.1	0.3	0.3	0.4
Hungary	QoQ	0.5	0.2	0.5	0.1	-0.3	-0.3	-0.1	0.1
	YoY	1.9	1.7	1.5	1.4	0.6	0.0	-0.6	-0.6
Poland	QoQ	1.0	1.2	1.0	0.7	0.5	0.3	0.2	0.3
	YoY	4.5	4.6	4.2	4.0	3.4	2.5	1.7	1.3
Slovakia	QoQ	0.8	0.8	0.8	0.4	0.2	0.1	0.0	0.2
	YoY	3.4	3.3	3.2	2.8	2.2	1.5	0.7	0.5
Czech Republic	QoQ	0.6	0.2	-0.1	0.3	-0.2	0.1	0.2	0.3
	YoY	2.8	2.0	1.2	1.0	0.2	0.1	0.4	0.4

Graph A.1.4: **Real Gross Domestic Product** – Central European economies

YoY growth in %, nsa data

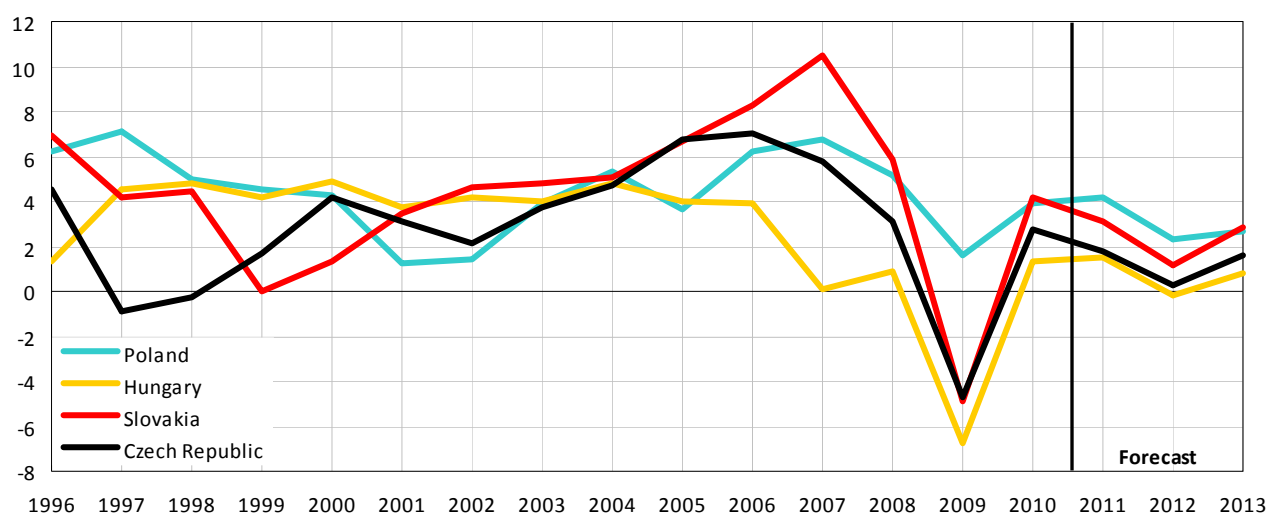


Table A.1.3: **Prices of Commodities** – yearly

spot prices

		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
										Forecast	Forecast
Crude oil Brent	USD/barrel	38.3	54.4	65.4	72.7	97.7	61.9	79.7	111.0	112	112
	growth in %	33.0	42.0	20.1	11.2	34.4	-36.7	28.7	39.2	1.0	0.2
Crude oil Brent index (in CZK)	2005=100	75.5	100.0	113.3	113.3	127.9	90.5	116.8	150.5	169	167
	growth in %	21.1	32.4	13.3	-0.1	12.9	-29.3	29.1	28.9	12.5	-1.1
Wheat	USD/t	156.9	152.4	191.7	255.2	326.0	223.6	223.7	316.2	.	.
	growth in %	7.3	-2.8	25.8	33.1	27.7	-31.4	0.1	41.4	.	.
Wheat price index (in CZK)	2005=100	110.4	100.0	118.7	141.9	152.4	116.7	117.1	153.3	.	.
	growth in %	-2.2	-9.4	18.7	19.6	7.3	-23.4	0.3	30.9	.	.

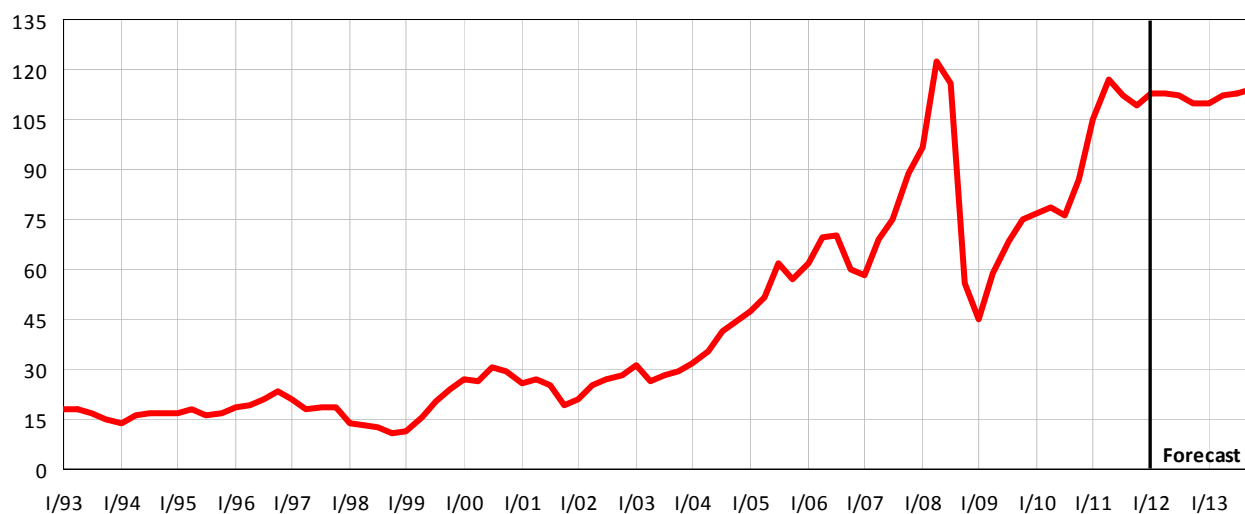
Table A.1.4: **Prices of Commodities** – quarterly

spot prices

		2011				2012			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
						Forecast	Forecast	Forecast	Forecast
Crude oil Brent	USD/barrel	104.9	117.1	112.5	109.0	113	113	112	110
	growth in %	36.8	48.8	47.3	25.6	7.7	-3.5	-0.4	0.9
Crude oil Brent index (in CZK)	2005=100	143.2	151.5	148.7	156.7	171	171	169	165
	growth in %	30.3	24.8	31.8	29.2	19.7	12.7	13.4	5.4
Wheat price	USD/t	330.5	339.0	315.6	279.7	.	.	.	.
	growth in %	68.9	91.0	32.7	-1.4	.	.	.	.
Wheat price index (in CZK)	2005=100	161.3	156.8	149.2	143.8	.	.	.	.
	growth in %	60.9	60.1	18.7	1.4	.	.	.	.

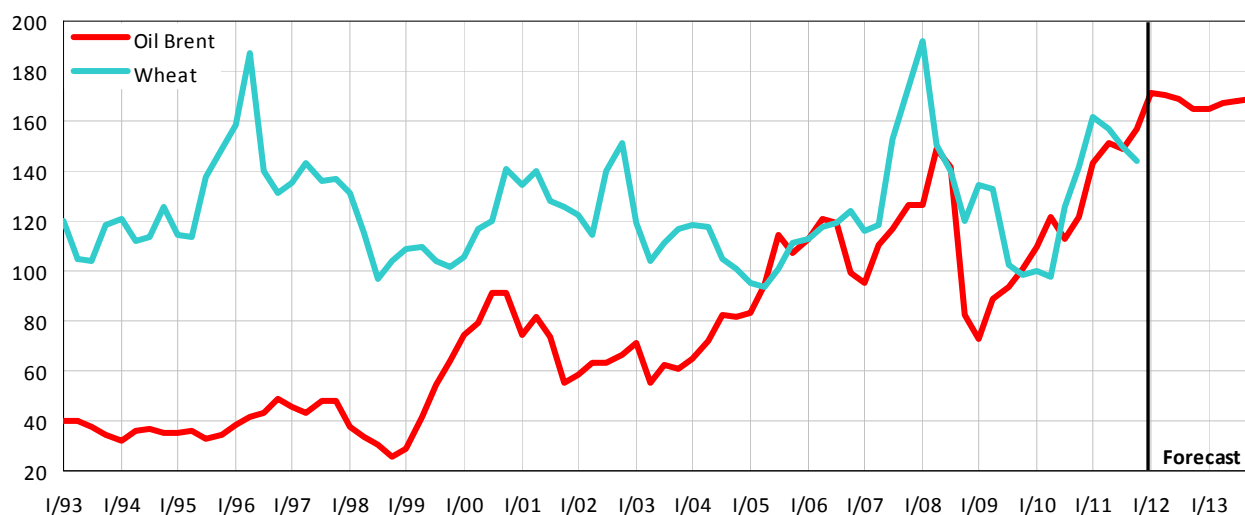
Graph A.1.5: Dollar Prices of Oil

USD/barrel



Graph A.1.6: Koruna Indices of World Commodity Prices

index 2005 = 100



A.2 Fiscal Policy

According to preliminary estimates, the general government deficit was significantly reduced to CZK 143 billion (3.7% of GDP) in 2011.

Although the deficit amount is approximately the same in comparison to data from the October forecast (differing in the order of hundreds of millions), the new estimate incorporates a number of new circumstances which arose during the last quarter of 2011.

First and foremost, tax revenues were reassessed according to the current results for cash performance. Considering that general government revenues are compiled by the accrual method, certain presumptions still need to be made for the accrual purposes. Thus the total reduction of tax revenues by approximately CZK 12 billion is only an estimate.

Value added tax, in particular, has the most significant impact, and the original assumption about growth in collection due to accelerated completion of buildings proved to be optimistic. Nevertheless, this effect should be positive in total for the state budget for 2011 and 2012. The macroeconomic basis of this tax also shows a lower forecast than originally estimated.

The personal income tax has an even stronger influence. Here, the assumptions especially for withholding tax and for taxes on self-employed persons were not fulfilled. For self-employed persons, this effect may be caused by the current economic situation and the recession from the turn of 2008 and 2009, as possible losses from this period may be deducted from the tax liability for subsequent years.

Another significant influence was improvement in the balance of state funds by approximately CZK 7 billion. In this case, this mostly concerns resources for projects which the funds did not manage to invest by the end of last year. The account of funds from privatisation (the former National Property Fund) also showed an improved result. The main purpose of this account is to collect dividends from businesses with state participation and to pay out for repairing environmental damage.

In contrast to original assumptions, however, some savings were also recorded on the expenditure side, and total cash spending in the state budget were thus reduced by almost CZK 12 billion in comparison to the October forecast. Nevertheless, this amount does not fully affect the deficit, as part of the saved expenses applies to European projects that have no impact on

the general government balance. The forecast was calculated with approximately half of the saved amount as Czech resources. Current data indicate that the assumption taken is conservative.

The area of state debt management also developed positively. The original estimate assumed significant savings in comparison to the budget documentation, and current information indicates even slightly more favourable development.

For the other components of the general government (local government institutions and health insurance companies), there likely occurred a slight worsening of the deficit by CZK 1.7 billion.

The current estimate bears certain risks. The main risk is the interruption of payments for some European projects for which pre-financing was already issued in past years. If these funds are not paid, it will be necessary to worsen the general government deficit by the denied amount, which is currently ca CZK 13 billion. To what extent it will be paid in the end is currently very uncertain.

The 2011 estimate overall is set up to be rather conservative and is 0.5 p.p. below the deficit target set in the Convergence Programme from April 2011. Fiscal effort, i.e. the difference in the structural balance between 2011 and 2010, thus represents 0.9 p.p.

We estimate general government debt at the end of 2011 to be 40.7% of GDP, and thus we are generally sticking by the October estimate.

General government finances in 2012 and subsequent years will be fundamentally affected by the dynamics of the domestic economy and its foreign trading partners.

In 2012 the general government deficit may increase to 3.8% of GDP what is by 0.3 p.p. more compared to approved consolidation path (see Graph A.2.1 and Table A.2.1). It is an effect of the new macroeconomic outlook, the impact of which is a decrease in tax revenues sensitive to economic development (mainly VAT and direct taxes) as well as an increase in some expenditures. Therefore the government will have to adopt some consolidation measures.

There are significant risks of downward deviations of foreign demand. Should they be realised, it may be necessary to undertake further austerity measures to maintain the consolidation trajectory.

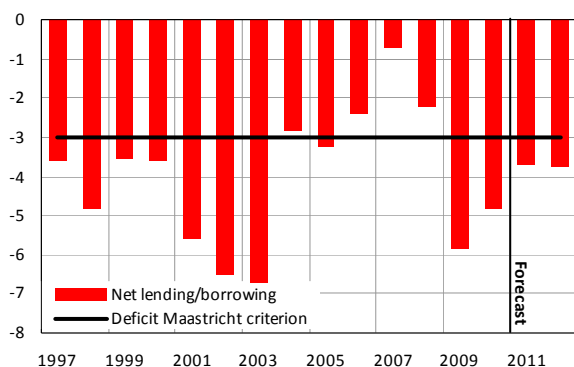
The general government debt in 2012 will probably increase to 43.1% of GDP.

With adequate fiscal policies, the obligation under EDP to bring general government deficit below 3% of GDP

by 2013 should be met. The medium-term budget outlook presumes further gradual improvement in the general government balance, while the targeted deficit trajectory follows a balanced budget in 2016.

Graph A.2.1: **Net Lending/Borrowing**

autonomous projection, in % of GDP



Graph A.2.2: **Government Debt**

autonomous projection, in % of GDP

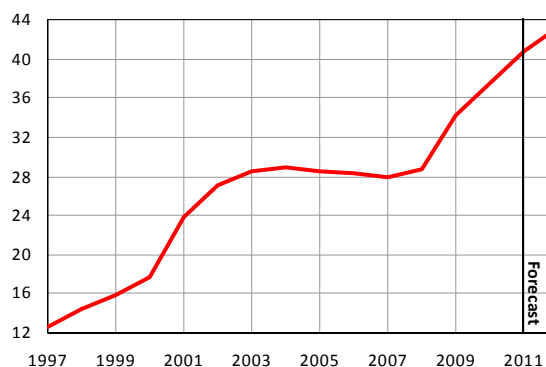


Table A.2.1: **Net Lending/Borrowing and Debt**

autonomous projection without additional fiscal measures

		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
									Prelim.	Estimate	Forecast
General government balance ¹⁾	bill. CZK	-180	-83	-101	-80	-27	-86	-219	-183	-143	-147
	% GDP	-6.7	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.7	-3.8
Cyclical balance	% GDP	-0.6	-0.6	-0.1	0.6	1.2	1.0	-1.1	-0.6	-0.4	-0.8
Cyclically adjusted balance	% GDP	-6.1	-2.2	-3.2	-3.0	-1.9	-3.3	-4.8	-4.2	-3.3	-3.0
One-off measures	% GDP	-0.3	-0.7	-1.2	-0.2	-0.3	-0.1	0.3	0.1	0.2	0.2
Structural balance	% GDP	-5.8	-1.6	-2.0	-2.8	-1.6	-3.2	-5.1	-4.4	-3.5	-3.2
Fiscal effort ²⁾	percent. points	0.1	4.3	-0.4	-0.8	1.1	-1.5	-1.9	0.7	0.9	0.3
Interest expenditure	% GDP	1.0	1.1	1.1	1.1	1.1	1.0	1.3	1.4	1.4	1.3
Primary balance	% GDP	-5.7	-1.8	-2.2	-1.3	0.4	-1.2	-4.6	-3.5	-2.3	-2.5
Cyclically adjusted primary balance	% GDP	-5.0	-1.2	-2.1	-1.9	-0.8	-2.2	-3.5	-2.9	-1.8	-1.7
General government debt	bill. CZK	768	848	885	948	1 024	1 105	1 282	1 418	1 560	1 690
	% GDP	28.6	28.9	28.4	28.3	28.0	28.7	34.3	37.6	40.7	43.1
Change in debt-to-GDP ratio	percent. points	1.5	0.4	-0.5	-0.1	-0.3	0.8	5.6	3.3	3.2	2.4

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⁾ Balance in EDP methodology, i.e. general government net lending (+)/borrowing (-) including interest derivatives.

²⁾ Change in structural balance.

A.3 Monetary Policy and Interest Rates

Monetary policy

The CNB uses an **inflation-targeting** regime to fulfil its target for price stability. It endeavours to ensure that the YoY increase in the headline CPI does not deviate from the medium-term inflationary target of 2% by more than ± 1 p.p. Its main instrument is the interest rate for **2W repo operations**, which was 0.75% at the end of 2011. This can be regarded as a very low rate from a long-term perspective.

Interest-rate differentials of monetary policy rates vis-à-vis the euro zone and the USA are low. At the end of Q4 2011 they were -0.25 p.p. between the Czech Republic and the EMU and from 0.50 to 0.75 p.p. relative to the US. These differentials are adequate from the perspective of international capital flows and exchange rates.

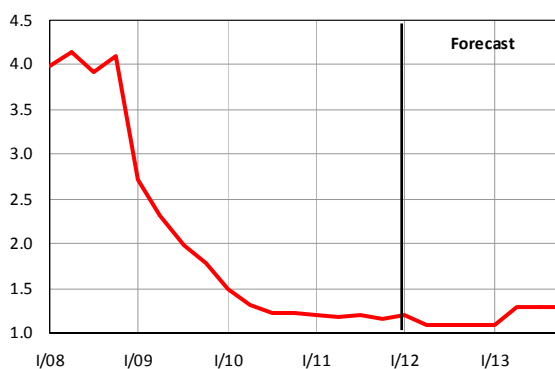
Short-term rates

The average value for **3M PRIBOR** held at 1.2% (*in line with the forecast*) in Q4 2011, as throughout the entire year. We expect a slight decrease to 1.1% (*no change*) for 2012 and a slight rise to 1.3% for 2013.

The spread between the 3M PRIBOR and the 2W repo rate, indicating uncertainty on the interbank market, is only very slowly returning to pre-crisis levels. Research conducted in October on average daily turnovers presents a similar view of the situation on the money market. According to this research, banks perform deposit and repo operations almost exclusively with a maturity of three months or less. The results of stress tests in the Czech banking sector, however, confirm its high resistance even to very negative shocks.

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

in %



Long-term rates

Long-term interest rates should remain above 3% this year. We do not expect them to increase until 2013. We estimate the average **yield to maturity for 10-year government bonds** to be 3.4% (*versus 3.7%*) in 2012 and 3.6% in 2013.

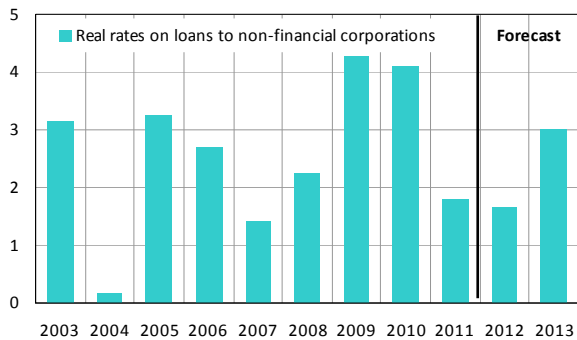
Factors influencing the rather low yield on Czech state bonds especially include the credible fiscal consolidation strategy (see above). It should result, among other things, in a drop in the government's gross borrowing requirement. This year it should be about CZK 243 billion, whereas it reached CZK 279 billion in 2009 and CZK 253 billion a year later. Moreover, it is expected to decrease further in 2013.

The Czech Republic's rating is currently stable at a good investment level – Standard & Poor's AA–, Moody's and Fitch Ratings A1. Further successful issues of government bonds can thus be expected, although there are certain regional risks such as the current problems in Hungary. Credible Czech fiscal policy is also reflected in the negative spread versus average long-term rates in the euro zone (see Graph A.3.6), which, of course, are a combination of the yields of stable countries and those of countries fully hit by the debt crisis. Another escalation of the debt crisis presents a risk of upward deviations.

Interest **rates for deposits and loans** respond with a lag to the fluctuations of interbank rates. Rates for loans to non-financial corporations fell by 0.1 p.p. to 3.9% in Q3 2011, while rates for households' deposits remained level at 1.2%. We estimate that the rates were stable in Q4. We assume that average rates for loans to non-financial corporations will be affected this year by the tension on financial markets and will reach 4.1% (*versus 3.9%*). We expect them to rise further to 4.4% in 2013 in connection with the slight increase in interbank rates. Average household deposit rates should reach 1.1% (*versus 1.2%*) in 2012 and increase slightly to 1.3% in 2013.

Graph A.3.2: Average Real Rates on Loans

rates on loans deflated by end-of-year final domestic use deflator, in % p.a.



The development of real interest rates is fundamental for economic entities. The estimates of nominal interest rates and the gross domestic expenditures deflator imply that the real interest rates for loans to non-financial corporations decreased to 1.8% (*versus* 2.2%) in 2011. A further decrease to 1.6% (*versus* 1.3%) is estimated for 2012, while an increase to 3.0% is expected for 2013.

Table A.3.1: Interest Rates – yearly
average interest rates in per cent p.a.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
								Forecast	Forecast	Forecast
Repo 2W CNB (<i>end of year</i>)	2.50	2.00	2.50	3.50	2.25	1.00	0.75	0.75	.	.
Main refinancing rate ECB (<i>end of year</i>)	2.00	2.25	3.50	4.00	2.50	1.00	1.00	0.75	.	.
Federal funds rate (<i>end of year</i>)	2.25	4.25	5.25	4.25	0.25	0.25	0.25	0.25	.	.
PRIBOR 3M	2.36	2.01	2.30	3.09	4.04	2.19	1.31	1.19	1.1	1.3
Government bond yield to maturity (10Y)	4.75	3.51	3.78	4.28	4.55	4.67	3.71	3.7	3.4	3.6
Interest rates on loans to non-financial corpor.	4.51	4.27	4.29	4.85	5.59	4.58	4.10	3.9	4.1	4.4
Interest rates on deposits from households	1.33	1.24	1.22	1.29	1.54	1.37	1.25	1.2	1.1	1.3
Real rates on loans to non-financial corporations ¹⁾	0.17	3.24	2.68	1.42	2.25	4.27	4.09	1.8	1.6	3.0
Net real rates on deposits from households with agreed maturity ²⁾	-1.64	-1.13	-0.63	-4.11	-2.26	0.17	-1.21	-1.4	-1.4	-0.6

¹⁾ Deflated by gross domestic expenditure deflator.

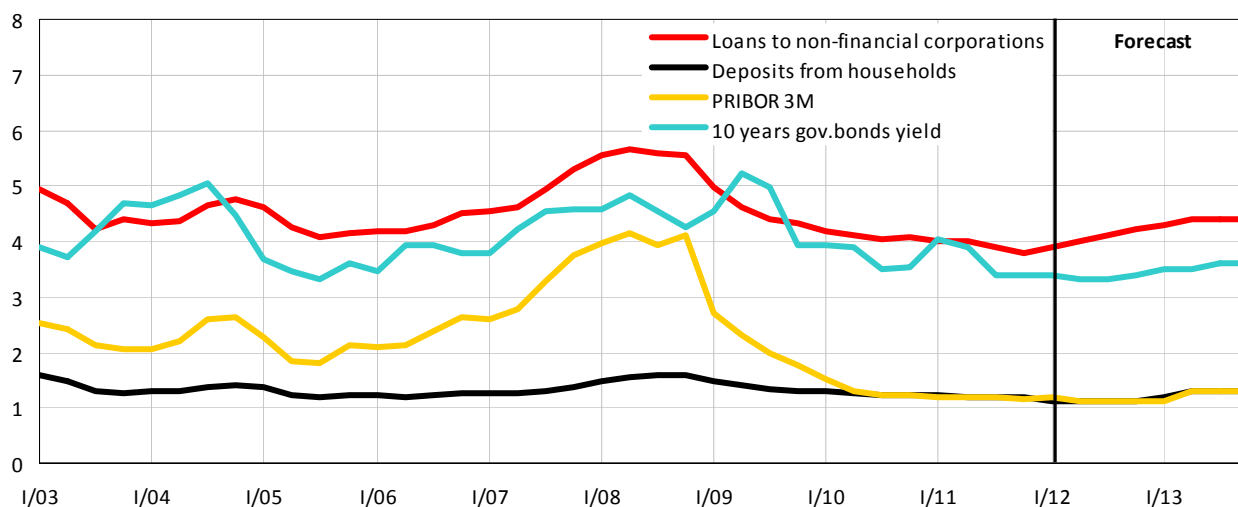
²⁾ Net of 15 % income tax, deflated by CPI.

Table A.3.2: Interest Rates – quarterly
average interest rates in per cent p.a.

	2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
				Estimate	Forecast	Forecast	Forecast	Forecast
Repo 2W rate CNB (<i>end of period</i>)	0.75	0.75	0.75	0.75	.	.	.	.
Main refinancing rate ECB (<i>end of period</i>)	1.00	1.25	1.50	1.00	.	.	.	.
Federal funds rate (<i>end of period</i>)	0.25	0.25	0.25	0.25	.	.	.	.
PRIBOR 3M	1.20	1.21	1.18	1.16	1.2	1.1	1.1	1.1
–10-year government bonds yield to mat.	4.03	3.90	3.40	3.4	3.4	3.3	3.3	3.4
Interest rates on loans to non-fin. corporations	4.00	3.99	3.88	3.8	3.9	4.0	4.1	4.2
Interest rates on deposits from households	1.21	1.20	1.20	1.2	1.1	1.1	1.1	1.1

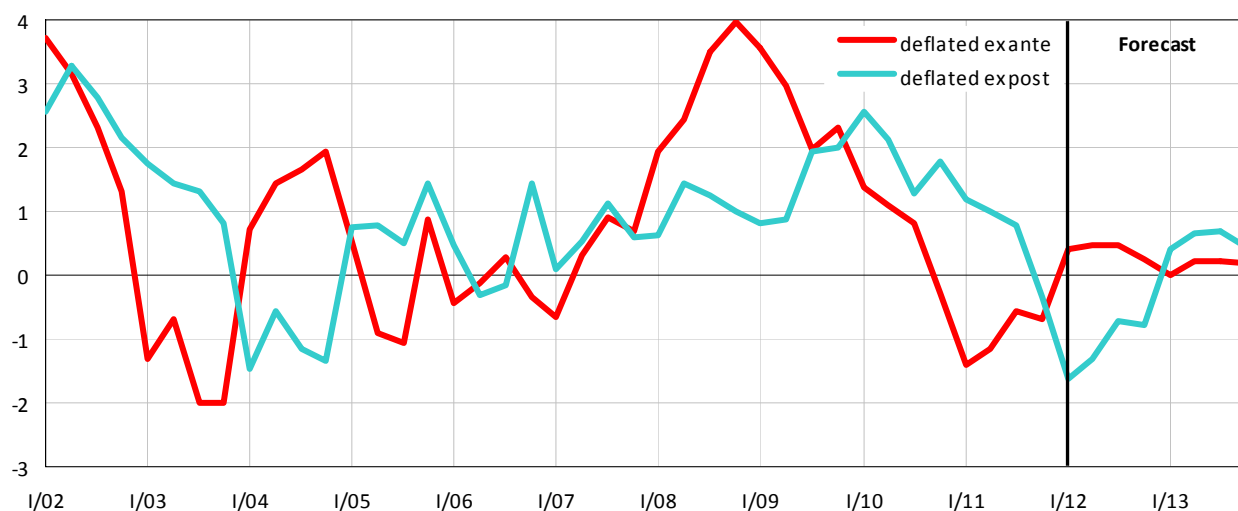
Graph A.3.3: **Interest Rates**

in % p.a.



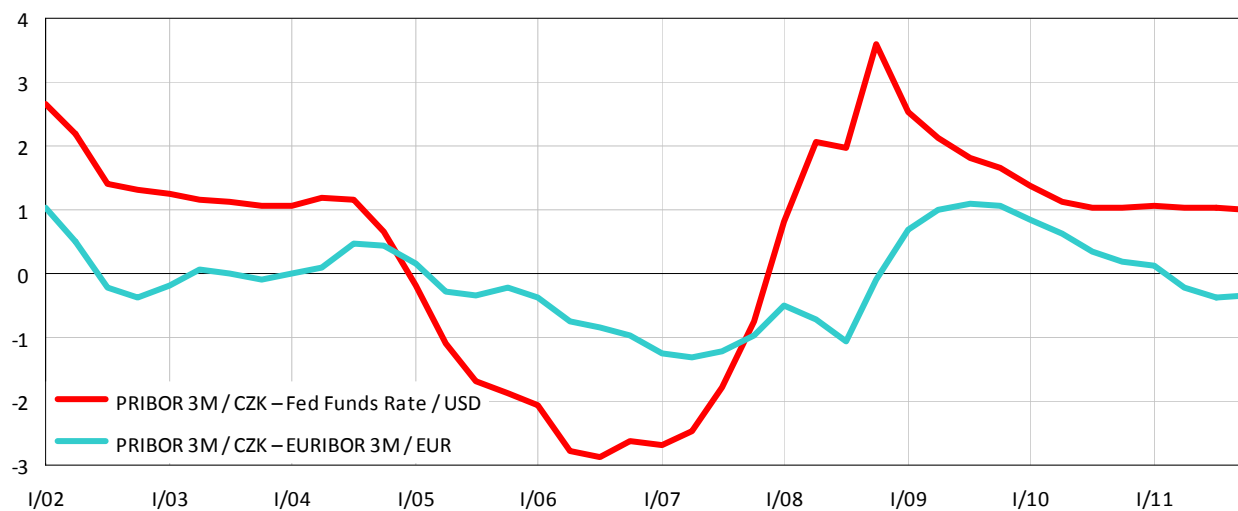
Graph A.3.4: **Real PRIBOR 1Y**

deflated ex post and ex ante by gross domestic expenditure deflator, in % p.a.

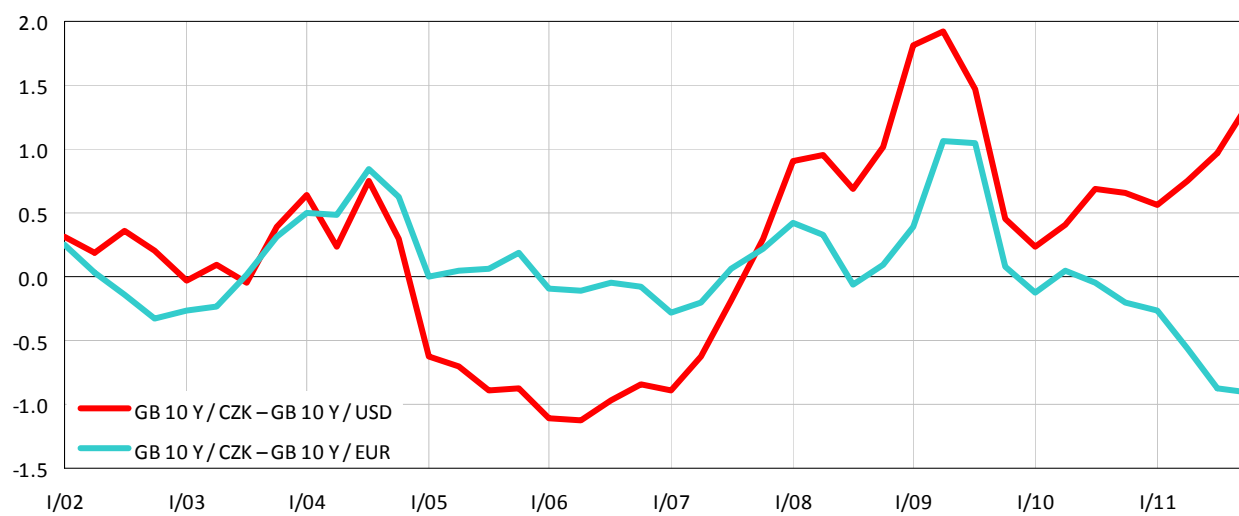


Graph A.3.5: **Short-Term Interest Rate Spread**

in percentage points



Graph A.3.6: Long-Term Interest Rate Spread
government bonds, in percentage points



A.4 Exchange Rates

Over the course of Q4 2011 the Czech koruna weakened relatively sharply from 24.56 CZK/EUR in September to an average of 25.51 CZK/EUR in December. This was due to the very tense situation on financial markets, the growing aversion to risk and partly also to the fact that not all investors sufficiently distinguish the varying macroeconomic conditions of individual countries in our region. Nevertheless, we regard this weakening of the free-floating Czech koruna as positive, because it may help exporters to cope with the expected slowdown in foreign demand, and we do not consider the risk of an increased inflation rate due to a weaker exchange rate to be significant.

Given that the European debt crisis is gradually becoming a chronic phenomenon, we have considerably changed our presumption on the future exchange rate. The average exchange rate should reach 25.6 CZK/EUR (*versus* 23.9 CZK/EUR) in 2012 and should thus be approximately 9% weaker versus the

long-term trend. Moderate appreciation of ca 1.3% per year should resume thereafter. Should the situation in the euro zone's problem countries become more dramatic, volatility would likely increase and the exchange rate would fluctuate sharply in both directions.

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

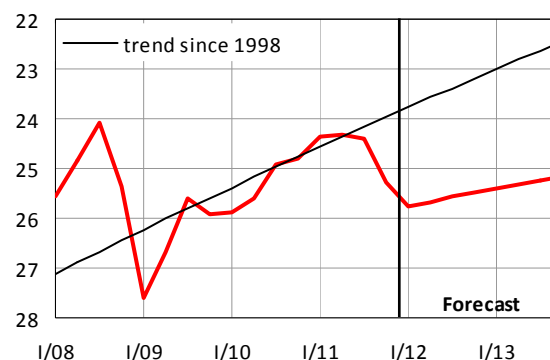


Table A.4.1: Exchange Rates – yearly

		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
							Estimate	Forecast	Forecast	Outlook	Outlook
Nominal exchange rates:											
CZK / EUR	average	28.34	27.76	24.96	26.45	25.29	24.59	25.6	25.3	25.0	24.6
	appreciation in %	5.1	2.1	11.3	-5.6	4.6	2.8	-4.0	1.3	1.3	1.3
CZK / USD	average	22.59	20.31	17.06	19.06	19.11	17.69	19.7	19.4	19.2	18.9
	appreciation in %	6.0	11.3	19.0	-10.5	-0.3	8.0	-10.2	1.3	1.3	1.3
NEER	average of 2005=100	104.1	106.8	119.9	116.5	118.4	122	118	119	121	122
	appreciation in %	4.1	2.6	12.2	-2.8	1.6	2.7	-3.2	1.3	1.3	1.3
Real exchange rate to EA12¹⁾	average of 2005=100	103.8	106.9	119.0	113.5	115.8	117	113	113	114	115
	appreciation in %	3.8	3.1	11.3	-4.6	2.0	1.3	-3.6	0.3	0.5	1.2
REER	average of 2005=100	105.1	108.1	124.4	119.5	121.7	.	.	.	.	.
	(Eurostat, CPI deflated, 36 countries)	5.1	2.9	15.1	-4.0	1.8	.	.	.	.	.

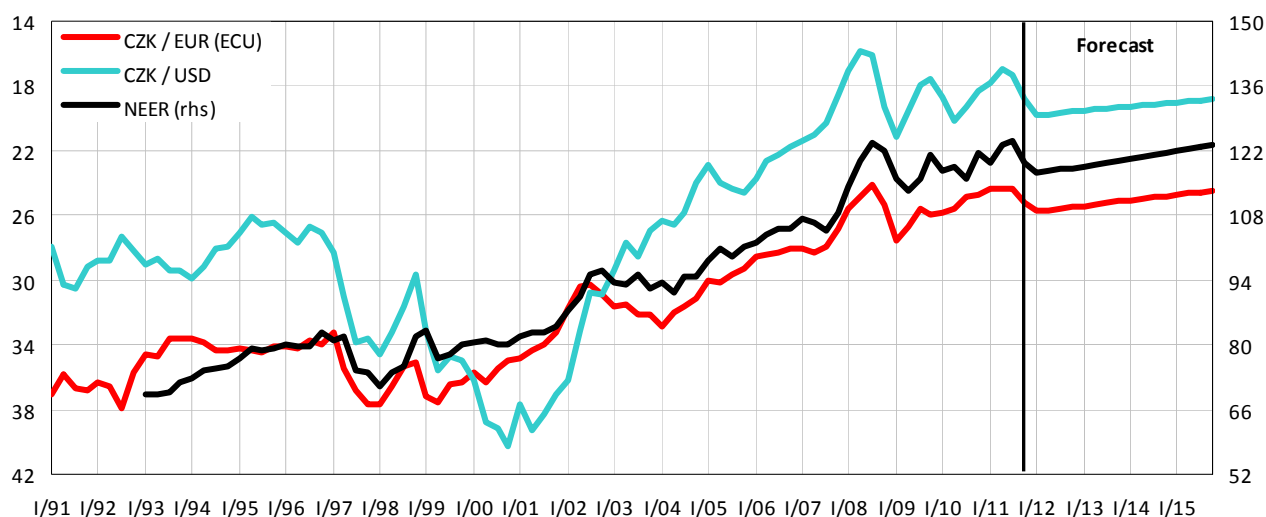
¹⁾ Deflated by GDP deflators.

Table A.4.2: Exchange Rates – quarterly

		2011				2012			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Estimate	Forecast	Forecast	Forecast	Forecast
Nominal exchange rates:									
CZK / EUR	average	24.37	24.32	24.39	25.28	25.8	25.7	25.6	25.5
	appreciation in %	6.1	5.2	2.2	-1.9	-5.3	-5.2	-4.7	-0.8
CZK / USD	average	17.83	16.90	17.27	18.78	19.8	19.7	19.7	19.6
	appreciation in %	5.0	19.3	11.7	-2.8	-10.0	-14.4	-12.2	-4.3
NEER	average of 2005=100	119.3	123.4	124.1	119	117	117	118	118
	appreciation in %	1.3	4.3	7.0	-1.8	-1.8	-4.8	-5.0	-1.0
Real exchange rate to EA12	average of 2005=100	117.7	118.5	118.2	115	112	113	113	114
	appreciation in %	3.8	2.9	0.7	-2.0	-4.7	-4.6	-4.5	-0.7
REER	average of 2005=100	125.4	125.6	125.8	.	.	.	.	.
	(Eurostat, CPI deflated, 36 countries) appreciation in %	4.3	4.5	2.1	.	.	.	.	.

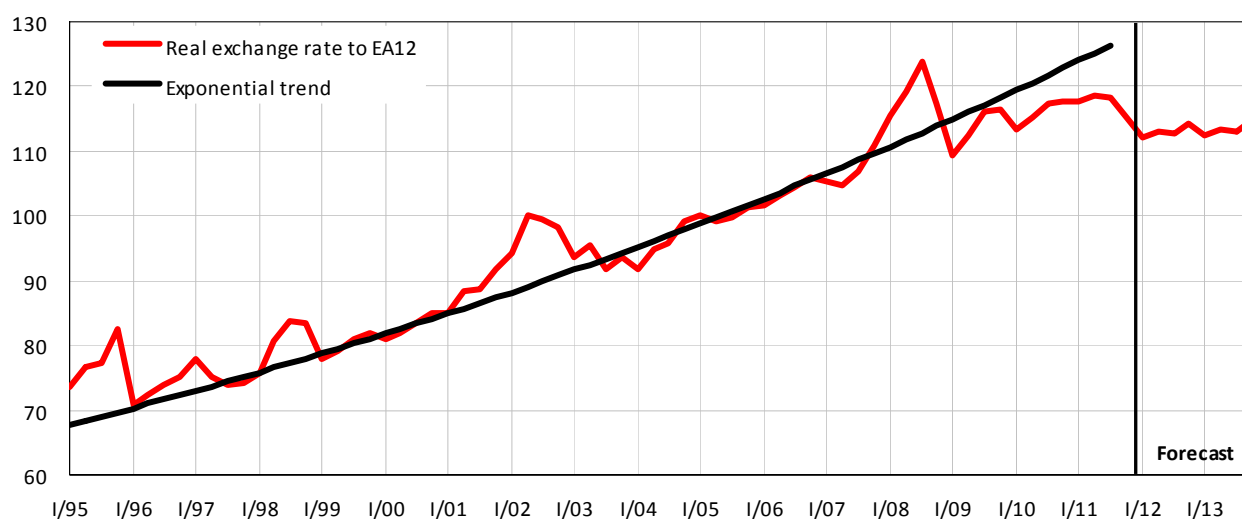
Graph A.4.2: Nominal Exchange Rates

quarterly average, average 2005 = 100 (rhs)



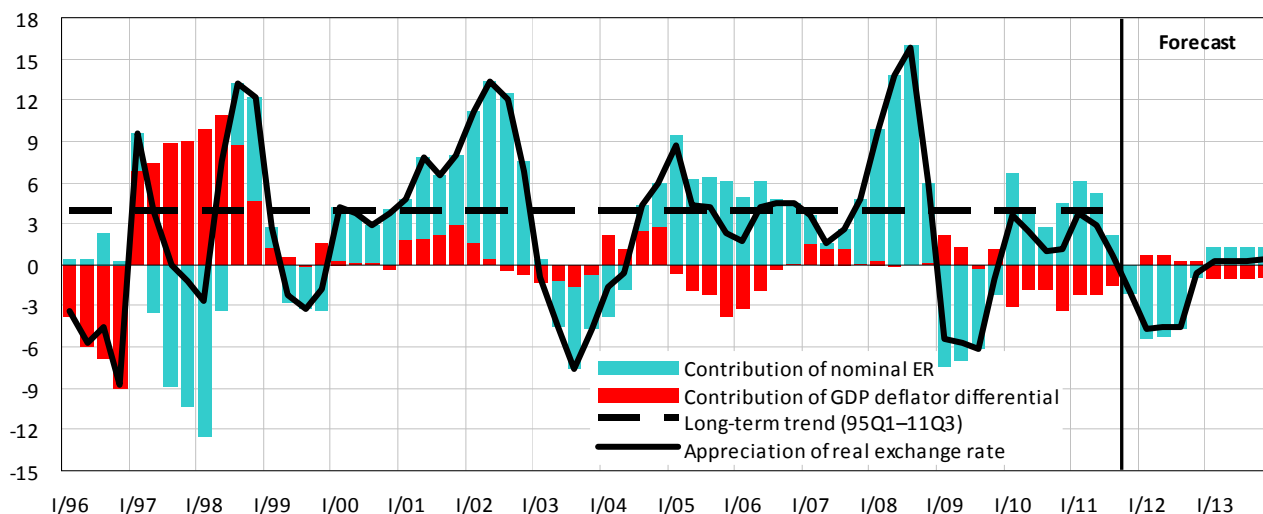
Graph A.4.3: Real Exchange Rate to EA12

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

Business environment

In order to simplify doing business, strengthen motivation to manage companies well, and improve the situation of creditors, the Chamber of Deputies approved on 16 December 2011 a **proposal for the act on Business Corporations**. This legislation governs circumstances relating to the establishment, dissolution and management of companies and cooperatives. Members and former members of the statutory bodies of companies in bankruptcy will be liable with their property for fulfilment of all the company's obligations, if a court so declares. The company must also not pay any funds if by doing so it would put itself into bankruptcy and thus endanger its creditors. The act also decreases the amount of the basic capital required for incorporation of a limited liability company from CZK 200,000 to CZK 1. The act is expected to take effect as from 1 January 2014.

With the aim to increase transparency in public procurement processes, the Chamber of Deputies approved the **amendment of the act on tenders** on 4 November 2011. The amendment decreases the limit for public tenders regarded as small to CZK 1 million, eliminates the possibility to choose contenders in public tenders by lottery and introduces the obligation to cancel a procurement process if in the last round only one offer remains to be considered. It also replaces the supplier's economic and qualification conditions with a statutory declaration as to its economic and financial capability to fulfil the tender and also introduces the institution of major public

tenders (at the state level above CZK 300 million, at local government level above CZK 50 million), for which it tightens up the requirements for both the procurer and the evaluator. The winning company will also have to submit to the procurer a list of sub-suppliers to which it paid more than 10% of the total price of the procurement or more than 5% in case of a major public tender. The amendment is expected to take effect from 1 April 2012 (certain provisions from 1 January 2014).

On 1 January 2012, the **act on criminal liability of legal entities** took effect, allowing the punishment of firms for the likes of money laundering, money counterfeiting, tax evasion, misrepresenting financial data, fraud, corruption, arranging an advantage in awarding a public contract, and damaging or endangering the environment. A statutory body and its members, persons performing management and control activities or employees can all be considered perpetrators. Punishment can take the form of a prohibition of activities for up to 20 years, forfeiture of property, money fines, prohibition to receive grants, and prohibition to participate in public tenders. It is even possible for a company to be liquidated if its activities are primarily criminal.

The aim of the **amendment of the act on investment incentives**, approved by the government on 19 October 2011, is to invite companies focusing on sophisticated technologies and services to the Czech Republic. While the basic parameters of investment incentives will remain unchanged, the amendment will newly introduce the possibility to draw investment

incentives also for companies operating in research and development and strategic services (e.g. software development) and will increase the period during which the company can benefit from tax incentives from 5 years to 10.

Taxes

On 27 December 2011, the president of the Czech Republic approved the proposed act on amending laws related to establishing a single collection point, the purpose of which is to simplify the tax system and reduce tax administration. The act is referred to as the **3rd pillar of tax reform** and comprises a reform of direct taxes and contributions. The reform will discard the concept of a super-gross wage and unifies the individual and corporate income tax rates as well as gift tax rate at 19%. The employer's contributions to social security and public health insurance will be realised by means of a contribution from the total wages to public insurance with a rate of 32.4%. Insurance rates for social security and public health insurance for employees will be unified at 6.5% while the upper limit for the social security premium will be four times the average wage and the limit for the social security premium will be six times the average wage. The basic annual discount per payer in the amount of CZK 24,840 will only be provided up to four times the average wage. Tax deductibility of interest from mortgage loans will be decreased from CZK 300,000 to CZK 80,000 per household. The reform also cancels certain tax deductions, such as advantages provided by the employer for personal public transport to its employees and their family members in the form of free or discounted fares. A compensating tax discount in the amount of CZK 3,000 per year will be introduced in this connection.

Premium rates for social security and public health insurance for self-employed persons will be decreased to 6.5%, but the assessment base will be extended to 100%. Expenditure flat rates will be preserved. The limit for mandatory VAT registration will be decreased to CZK 750,000.

Last but not least, the reform makes dividend income tax-free and introduces a tax for companies in the gambling business. Companies will contribute 20% of the difference between the amounts wagered and the winnings paid, while municipalities will receive 80% of the tax contributions from slot machines and 30% of the tax contributions from other types of gambling.

Tax contributions from lotteries came into effect as from 1 January 2012; other parts of the tax reform

should come into effect as from 1 January 2015. Currently, however, a change of the effective date to 1 January 2014 is already planned.

On 1 January 2012, the **amendment of the act on value added tax** came into effect, increasing the reduced tax rate from 10% to 14%. As of 1 January 2013, the rates should be united at 17.5%.

The **amendment of the act on excise tax** increased the minimum excise tax rate for tobacco products. The increase will be made in two steps, on 1 January 2012 and on 1 January 2014.

Financial markets

The **act amending the conditions of building savings schemes**, the objective of which is to mitigate the impacts upon the state budget of support to building savings, became effective as from 1 January 2012. The maximum amount of state contribution was decreased from 15% to 10%, while the maximum limit for the base will be retained at CZK 20,000 and tax exemptions for interest from building society savings were abolished.

Education, science and research

As from 1 January 2012, the amendment of the act on pre-school, elementary, secondary, tertiary vocational and other education (**amendment of the school act**), reducing the administrative burden on schools and facilitating access to education, came into effect. The amendment simplifies conditions for companies which establish their own kindergartens, fixes the current form of state graduation exams for two years, and clarifies the rules for attending foreign schools.

Energy

The proposal of the **act on subsidised energy sources**, approved by the Chamber of Deputies on 9 November 2011, unifies into a single rule the support for renewable sources, secondary sources, and combined production of electricity and heat from renewable sources. The purpose of the proposal is to efficiently achieve the target for renewable energy sources to cover 13% of consumption in 2020. If the Energy Regulatory Office determines at the end of April of a given year that a licence for construction of power plants with the adequate expected output has already been issued and the environmental commitment has therefore been fulfilled, it will suspend the subsidising of electricity production from renewable sources for the next year. The provision will only apply for new applicants wishing to connect power plants into the

power grid. Most provisions are expected to become effective as from 1 January 2013.

Labour market

As from 1 January 2012, amendments to the Labour Code and Employment Act have become effective, bringing a number of crucial changes to the labour market.

The **amendment of the Employment Act** tightens up the conditions for drawing unemployment benefits and should also considerably impede their misuse. Now, unemployment benefits can be requested by an applicant who worked for a total of at least 12 months in the last two years, while formerly a three-year qualification period was effective. It will also be possible to establish an additional condition for the drawing of unemployment benefits – performing public services – and already from the third month of drawing the benefit. Also tightened up are the conditions for employees who either voluntarily ended their employment intermediated by the labour office or whose employment was terminated due to their severely breaching the employment terms and conditions. The act also adjusts the definition of illegal work so that it is easier to demonstrate.

The **amendment to the Labour Code** should make the labour market more flexible and increase the motivation of companies to create new jobs. The amendment will allow a trial period for senior staff of up to 6 months and a severance payment upon termination of employment due to organisational changes according to the number of years of employment. It will be possible to agree employment for a fixed period of up to 3 years, and it will be possible to extend this twice more by the same period with the same employer. It will now also be possible to

give notice to an employee who seriously breaches a treatment regime in the first 21 days of sick leave. Also the limit of possible hours for employment according to a so-called contract for work was increased from 150 to 300 per year. In case of the wage exceeding CZK 10,000 per month, however, it will be necessary to pay contributions for health and social insurance. The code also introduces more flexibility when determining work shift length and of balancing work time funds.

Health care

The amendment of the Public Health Insurance Act, known as the **first phase of the health care reform**, became effective as from 1 December 2011. The amendment increased payments for hospitalisation from CZK 60 to CZK 100 per day, introduced a single payment per prescription of CZK 30, and required consumers to pay for medicines costing up to CZK 50. It also introduced a definition of standard care, which will in future allow patients to pay extra for above-standard care, as well as electronic auctions for the prices of medicaments, when only a single medicament determined by the State Institute for Drug Control in a tender is paid for by public health insurance. Other medicaments are only paid in the amount of 75% of the basic payment.

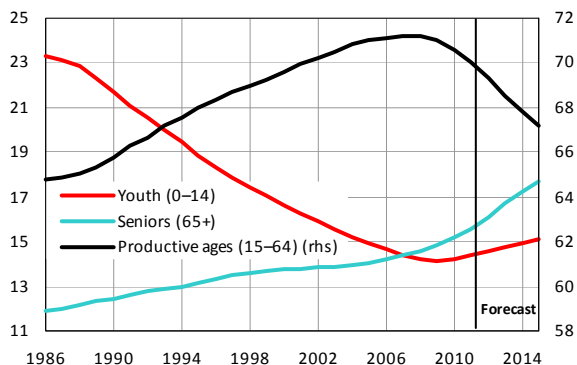
The act on medical services, act on emergency medical services, and act on specific medical services, collectively referred to as the **second phase of the health care reform**, were signed by the President of the Czech Republic on 22 November 2011. The reform governs the rights and obligations of medical personnel and patients, stipulates the conditions for providing emergency medical service, and establishes procedures for performing medical operations which in the majority of cases are irreversible. The acts will become effective as from 1 April 2012.

A.6 Demographic Trends

According to preliminary data, the population of the Czech Republic grew by 16 thousand during Q1–Q3 2011 to reach 10.548 million. The natural population growth (5 thousand) and positive migration balance (11 thousand) were slightly lower against the same period of 2010.

Graph A.6.1: **Groups by Age**

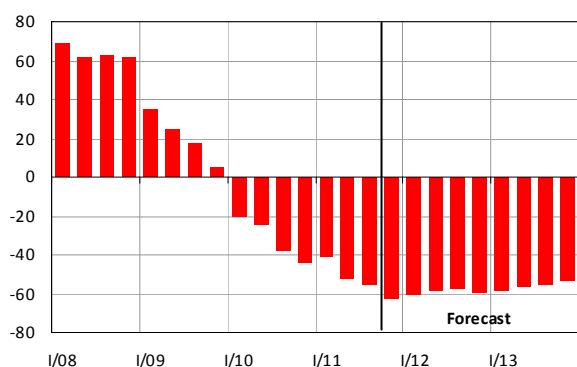
structure in per cent



Regarding age structure, the Czech population reached its peak number of working-age inhabitants (ages 15–64) in 2009 and has been rather strongly decreasing ever since. The largest decrease, by ca 60 thousand people, was probably recorded during 2011 (see Graph A.6.2). Nevertheless, from an economic perspective, the population still has a very favourable age structure, and especially in comparison to Western European countries.

Graph A.6.2: **Czech Population from 15 to 64 Years**

YoY increases of quarterly averages, in thousands



The decline in the working-age population is, however, partially compensated by effects within the age structure of the labour force, as shares of age groups with high or growing participation are increasing. This has been, and will continue to be, supported by extension of the retirement age. Immigration could be another positive factor, but its volume fluctuates greatly and it appears to be positively correlated with the economic cycle.

The continuing **ageing of the population** has been confirmed. The structural proportion of persons over 64 years of age in the total population, which reached 14% in early 2005, should exceed 16% in 2012 and increase to nearly 20% by 2020. The number and proportion of seniors in the population will continue to rise due to the demographic structure and further continuation of the intensive process of increasing life expectancy.

Graph A.6.3: **Life Expectancy**

in years

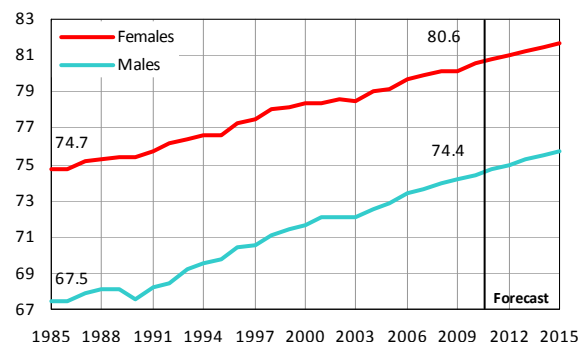


Table A.6.1: **Demography**
in thousands of persons

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
						Estimate	Forecast	Forecast	Outlook	Outlook
Population (January 1)	10 251	10 287	10 381	10 468	10 507	10 533	10 567	10 600	10 632	10 663
growth in %	0.3	0.4	0.9	0.8	0.4	0.2	0.3	0.3	0.3	0.3
Age structure (January 1):										
(0–14)	1 501	1 480	1 477	1 480	1 494	1 518	1 540	1 565	1 588	1 612
growth in %	-1.7	-1.5	-0.2	0.2	1.0	1.6	1.5	1.6	1.5	1.5
(15–64)	7 293	7 325	7 391	7 431	7 414	7 379	7 327	7 268	7 214	7 165
growth in %	0.5	0.4	0.9	0.5	-0.2	-0.5	-0.7	-0.8	-0.7	-0.7
(65 and more)	1 456	1 482	1 513	1 556	1 599	1 636	1 700	1 768	1 829	1 885
growth in %	1.5	1.8	2.1	2.9	2.7	2.3	3.9	4.0	3.5	3.0
Old-age pensioners (January 1)¹⁾	1 985	2 024	2 061	2 102	2 147	2 260	2 315	2 347	2 378	2 409
growth in %	1.0	2.0	1.8	2.0	2.1	.	2.4	1.4	1.3	1.3
Old-age dependency ratios (January 1, in %):										
Demographic ²⁾	20.0	20.2	20.5	20.9	21.6	22.2	23.2	24.3	25.4	26.3
Under current legislation ³⁾	35.6	35.8	35.9	36.1	36.6	37.1	37.4	37.8	38.2	38.7
Effective ⁴⁾	41.3	41.6	41.5	41.8	43.6	45.9	47.0	47.8	48.3	48.7
Fertility rate	1.328	1.438	1.497	1.492	1.493	1.51	1.52	1.53	1.54	1.55
Population increase	36	94	86	39	26	34	33	32	31	29
Natural increase	1	10	15	11	10	9	8	7	6	4
Live births	106	115	120	118	117	116	114	113	112	110
Deaths	104	105	105	107	107	106	106	106	106	106
Net migration	35	84	72	28	16	25	25	25	25	25
Immigration	68	104	78	40	31	.	.	.	.	.
Emigration	33	21	6	12	15	.	.	.	.	.

¹⁾ In 2010 disability pensions of pensioners over 64 were transferred into old-age pensions.

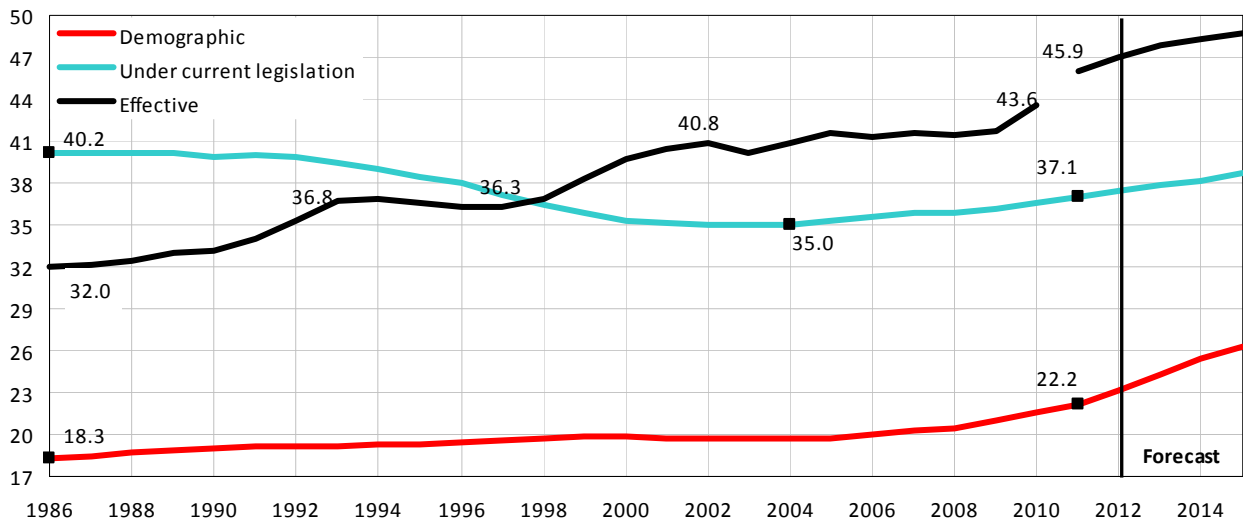
²⁾ Demographic dependency: ratio of people in senior ages (65 and more) to people in productive age (15–64).

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.

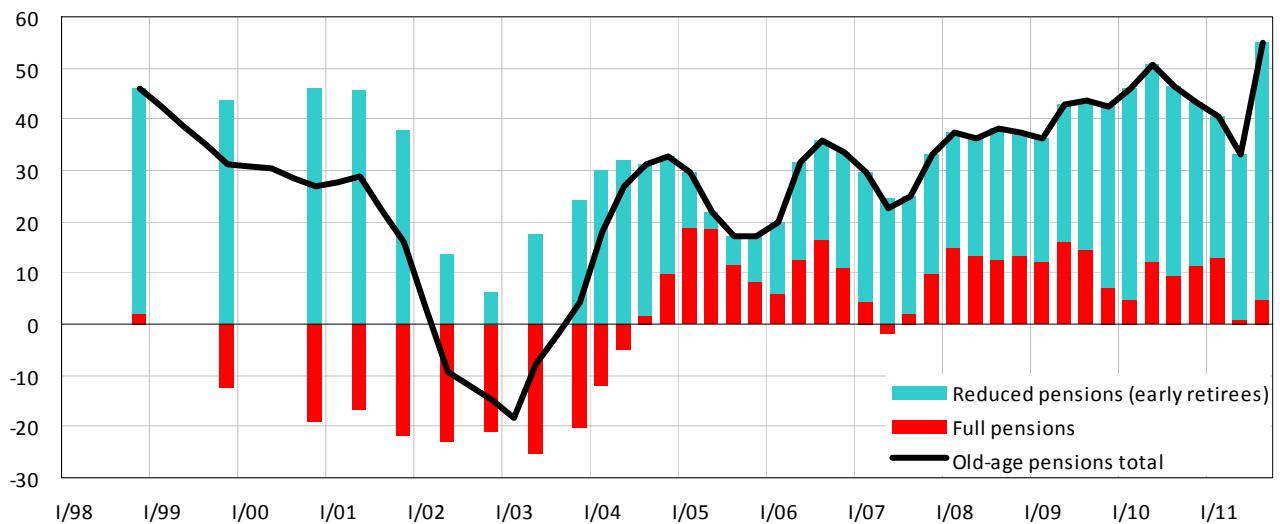
Graph A.6.4: Dependency Ratios

As of January 1, in %, inconsistent between 2010 and 2011 due to transfer of disability pensions to old-age pensions for people over 64 years



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.