

Summary of the forecast

The world economy has been recovering from contraction caused by financial market crisis. Nevertheless due to plans of some EU countries to reduce high budget deficits, restoring thus confidence on government bond markets, recovery in the EU can slow down in future.

The Czech economy came out of recession a year ago and has been increasing its performance since the third quarter of 2009. Recovery nevertheless remains fragile and future development is still encumbered with considerable risks related especially with external environment.

A slight increase in real GDP by 1.6 % is assumed for 2010. Thanks to an increase in imports by our main trading partners, growth should be pulled by means of foreign trade mainly. Under current assumptions, the economy's growth should accelerate to 2.3 % in 2011.

Average rate of inflation is estimated at some 1.6 % in 2010 with growth of consumer prices accelerating to 2.5 % in 2011.

Consequences of lower economic activity are still seen on the labour market. After considerable growth of rate of unemployment (LFS) from 4.4 % in 2008, a maximum of some 7.6 % should be hit in 2010. After that, rate of unemployment should start falling slowly. Employment should decrease by 1.4 % in this year and grow moderately by 0.6 % in 2011. Wage bill should fall by 0.3 in this year. In 2011 wages and salaries could grow by 3.8 %.

Ratio of current account deficit to GDP should remain at favourable level with current account nearly balanced in 2010.

Table: **Main Macroeconomic Indicators**

		2006	2007	2008	2009	2010	2011	2009	2010	2011
		Forecast						Previous forecast		
Gross domestic product	<i>growth in %, const.pr.</i>	6,8	6,1	2,5	-4,1	1,6	2,3	-4,2	1,5	2,4
Consumption of households	<i>growth in %, const.pr.</i>	5,2	5,0	3,6	-0,2	-0,5	2,0	-0,2	-1,1	2,0
Consumption of government	<i>growth in %, const.pr.</i>	1,2	0,7	1,0	4,2	-1,8	-0,9	4,4	-2,5	-0,9
Gross fixed capital formation	<i>growth in %, const.pr.</i>	6,0	10,8	-1,5	-9,2	-4,3	2,5	-8,3	-3,7	2,5
Cont. of foreign trade to GDP growth	<i>p.p., const.pr.</i>	1,5	1,1	1,3	-0,6	1,9	0,6	-0,5	1,8	0,7
GDP deflator	<i>growth in per cent</i>	1,1	3,4	1,8	2,6	-0,2	1,3	2,7	0,2	1,1
Average inflation rate	<i>per cent</i>	2,5	2,8	6,3	1,0	1,6	2,5	1,0	1,5	2,3
Employment (LFS)	<i>growth in per cent</i>	1,3	1,9	1,6	-1,4	-1,4	0,6	-1,4	-0,6	0,1
Unemployment rate (LFS)	<i>average in per cent</i>	7,1	5,3	4,4	6,7	7,6	7,3	6,7	7,9	7,8
Wage bill (domestic concept)	<i>growth in %, curr.pr.</i>	7,9	9,4	8,7	-0,1	-0,3	3,8	-1,7	-0,1	4,3
Current account / GDP	<i>per cent</i>	-2,4	-3,2	-0,6	-1,0	-0,1	-1,0	-1,0	0,4	-0,5
Assumptions:										
Exchange rate CZK/EUR		28,3	27,8	24,9	26,4	25,5	24,6	26,4	25,5	24,6
Long-term interest rates	<i>% p.a.</i>	3,8	4,3	4,6	4,7	3,7	4,0	4,7	4,0	4,0
Crude oil Brent	<i>USD/barrel</i>	65	73	98	62	78	87	62	81	92
GDP in Eurozone (EA-12)	<i>growth in %, const.pr.</i>	2,9	2,7	0,5	-4,1	1,1	1,9	-4,1	1,1	1,9

A Forecast assumptions

The forecast was made on the basis of data, known as of 9 June 2010. No political decisions, newly released statistics or world financial or commodity markets developments could be taken into account after this date.

Data from the previous forecast from April 2010 are marked in italics. Data in the tables covering years 2012 and 2013 are indicative, outlining only the directions of possible developments and as such are not commented on in the following text.

Sources of tables and graphs: CZSO, CNB, Ministry of Finance of the Czech Republic. Eurostat, IMF, OECD, ECB, The Economist, own calculations.

A.1 External environment

Economic output

The world economy has been recovering with especially China, India and other Asian economies reporting strong growth. The recovery was helped by restored rise in the world trade and industrial production. However, improvement is uneven and its sustainability is not fully convincing. Euro-area growth is weak and complicated by financial market turbulences due to concerns over some member countries' indebtedness. Outlook is encumbered with many uncertainties.

US economy has been growing dynamically since the third quarter of 2009. QoQ growths reached gradually 0.6 %, 1.4 % and in the first quarter of 2010 GDP rose by 0.8 % (0.3 %). Rate of inflation fell to 2.0 % in May. Rate of unemployment has been stagnating since January, keeping close below 10 % and reaching 9.7 % in May. Stock markets were growing till the end of April when Dow-Jones broke 11,000 mark but fell again below this level amid nervousness in May and early June. Household consumption was rising by accelerating pace in the last three quarters with exports rising too. Current account deficit was falling till February with trade balance deficit increasing afterward due especially to growing prices of oil.

Weak growth in employment in private sector contributed to decline in optimistic expectations. Fed warned that increase in jobs will be very slow. Concerns are about withdrawal of federal stimulus (out of which about 75 % per cent has been spent), which can cause another decline in consumption. Retail sales fell surprisingly in May. It is also known that the current growth was strongly helped by replacement of company inventories. Policymakers thus face a delicate task, when and how to withdraw

stimulus measures with regard to the state of the economy and public finance.

Fed still keeps the band for key refinancing rate at 0-0.25 %. The dollar strengthened steeply against the euro, by as much as 17 % in early June in comparison with the beginning of the year.

Euro area's (EA12) GDP dropped by 4.1 % in 2009. Since the third quarter of 2009 EA12 economy has been growing, at first by 0.4 % in QoQ terms, in the fourth quarter it was close to stagnation with growth by 0.1 %. Growth in the first quarter of 2010 was also weak, it reached 0.2 % (*unchanged*).

Germany experienced strong recession in 2009 (decline by 4.9 %). Thanks to different structure and strong government interventions, French slump was milder, reaching 2.6 %. Strongest drop in GDP was seen as in some large economies (Germany, United Kingdom, Italy) as in some peripheral EU countries. Impacts of financial crisis were joined by structural problems of many countries. Recovery is uneven, in the euro area there will probably be a drop in GDP of Ireland, Greece and Spain and outside EA e.g. of Lithuania.

Also inflation hits euro area and the EU unevenly. YoY inflation of the euro area was 1.6 % in May, ranging from deflationary Ireland (-1.9 %) through Germany (1.2 %) to Greece (5.3 %). EA12 industrial production has been growing since the mid-2009, increasing by 9.5 % YoY in April 2010, in Germany by 13.9 %. At the same time, however, unemployment is still growing, reaching 10.1 % in EA12 in April. But in Germany it dropped to 7.1 % in April compared to 7.3 % in March.

Due to recession, euro area suffered from asymmetric shocks, exposing its insufficient internal homogeneity. It was demonstrated also by financial market

turbulences, triggered by doubts about Greece's solvency. EU together with the IMF therefore prepared a stabilization plan with debt guarantees to endangered member countries amounting to EUR 750bn.

Fiscal consolidation thus became the topic of the day. Many countries will have more restrictive fiscal policy from 2011. German government has prepared an austerity package, which is to reduce government spending by EUR 80bn over the next four years, and enforced austerity policy also on the G20 meeting, despite especially the US opposition.

In Germany a relatively strong turnaround to growth was recorded as soon as in the second quarter of 2009 but in recent two quarters growth is weak again. In the first quarter of 2010 it reached 0.2 % (0.3 %). Growth results from two contrasting factors, strong exports and weak domestic consumption. The latter started growing again in the first half of 2009 after years of falling and stagnating but has been falling again since the third quarter of 2009. On the contrary, leading indicators (Ifo index) and new orders indicate strong growth of industrial production in the nearest quarters and so outlook for growth of Germany's GDP improved in the short run.

Central European economies are overcoming downturn caused by dependence on exports especially to the EU.

In Slovakia dropout in GDP was stronger in 2009 than in EA12 average (4.7 %). It was caused mainly by high share of exports, cars in particular, and by reduction of foreign investment. Since the second quarter of 2009 the country shows high growths again, pulled by exports. Industrial production grew by 19.3 % YoY in March 2010. Rate of unemployment surpassed 14 %, a four-year high. It results obviously in decline of household consumption from 6 % of YoY growth in 2008 to -0.7 % in 2009. The new government will also struggle with unexpectedly high, almost 7 % public finance deficit.

Poland's economy was the only one in the EU to avoid recession, growing by 1.7 % in 2009, which was helped mainly by the size of domestic market, weakening of zloty and robust fiscal impulse. Growth was pulled by domestic demand, showing a considerable decline in investment. Rate of unemployment is growing slowly, reaching 9.9 % in April 2010. In 2009 public finance

deficit exceeded 7 % of GDP, which is almost twice as much as in the previous year.

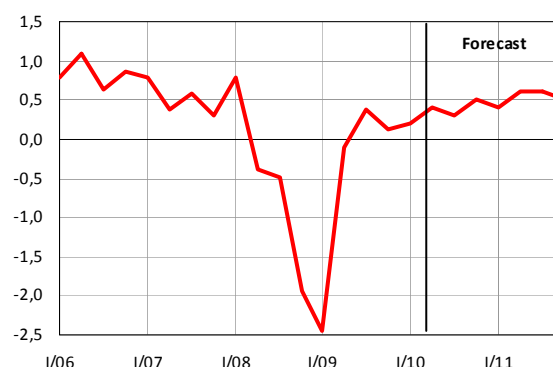
Our forecast is based on the key assumption that no more major shocks will occur on financial markets. For 2010 global recovery is expected with considerable differences among individual regions of the world.

US economy is expected to grow by 2.8 % (2.4 %) in 2010. For 2011 growth is estimated at 3.2 % (2.8 %). The estimate is rather conservative as recovery may be dampened by slow decline in unemployment.

In EA12 economy, growth of GDP is estimated at 1.1 % (*unchanged*) in 2010 and at 1.9 % (*also unchanged*) in 2011. Risk is seen especially in further financial sector turbulences and in high unemployment. When choosing the *exit strategy*, the key question is, to what extent can export replace household consumption.

Graph A.1.1: Growth of GDP in EA12

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

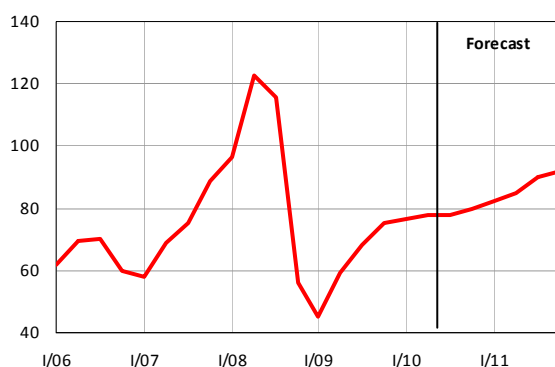


Commodity prices

Average price of Brent oil reached USD 76.7 per barrel in the first quarter of 2010 and in the second-quarter it is estimated at USD 78 (*USD 80*). The price was extremely volatile in recent months, ranging by as much as USD 4 from day to day. Such movements undoubtedly reflect in particular perception of economic recovery or doubts about it due to current EU developments and also effect of dollar strengthening. Consumption is still „two-speed“ as its decline in advanced economies is outweighed with demand in China and other countries.

Estimate of Brent oil price is being lowered slightly to USD 78 per barrel (*from USD 81*). In the medium run growth to values around USD 90 is considered probable. Risks of forecast are seen as balanced.

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



Global financial markets

Developments on the world financial markets have been recently characterized by increased volatility. Debt and liquidity crisis on the EA periphery affects stock and bond prices and lies also behind a significant weakening of the euro. Uncertainty regarding situation in the banking sector of some EA countries (Spain, Portugal) have not helped calm financial markets. Risks further intensify by concerns about impact of announced austerity fiscal measures on economic growth.

Course of Greece-related events gathered speed in the end of April. Negative revision of Greece's deficit for 2009 to 13.6 % of GDP was followed a day later, i.e. on 23 April, by official request of Greece for EA/IMF financial aid. On 27 April S&P cut Greece's rating to junk status. In early May the total size of aid package was increased from original EUR 45bn to EUR 110bn. Greece received the first tranche (EUR 20bn) in mid-May, providing of further financial injections is nevertheless conditioned by implementation of fiscal measures and structural reforms, agreed by Greece with EA/IMF. Under preliminary assessment from mid-June, adopted measures are being implemented as scheduled. For the time being, Greece remains „cut off“ from the financial markets, whose attention is now paid to other EA countries with fiscal imbalances – Italy, Ireland, Portugal and Spain.

Contagion spill-over from Greece to other PIIGS countries accelerated much due to downgrading of Portugal's and Spain's rating in late April. CDS spreads of government bonds widened rapidly, spreads between yields of 10-year government bonds of PIIGS countries and yields of German Bunds were growing, stock indices reacted by sharp drop and the euro weakened against the other key world currencies.

Growing tensions on financial markets triggered a radical policy response in second May week.

EU presented two-component European Financial Stabilisation Mechanism (EFSM), aimed to ensure financial stability in Europe. The first part of EFSM represents widening of the current system of medium-term help to EU countries' balances of payments. All EU member states now have as much as EUR 60bn, these means are implicitly ensured by EU budget. The second part – a more important one – is represented by means of a special body (European Financial Stability Facility), which will be able to borrow up to EUR 440bn on the markets. Only EA countries can draw funds from the EFSF but at the same time act as guarantors for ESFS debt, in proportion to their shares in paid-off ECB capital. Participation in ESFS must be approved in individual countries and the duty to give a guarantee is conditioned by approval in those countries that together represent at least 90 % share in EFSF (consequently, approval by Germany, France, Spain and Italy is needed).

Also the ECB responded to market developments. In order to ensure a proper functioning of monetary-policy transmission mechanism, ECB Governing Council adopted following measures. Till the end of September at least, three-month refinancing operations should be carried out at fixed rate with full allotment, one 6M refinancing operation was carried out in mid-May (although under previous plans the last one should have been carried out in March) and also Fed temporary dollar swap lines were reopened¹. ECB then presented Securities Markets Programme (SMP), under which it conducts interventions in the secondary public and private debt securities markets in order to calm situation on the market. Purchases of securities under this programme are sterilised so that monetary policy stance would not be affected with regard to price stability.

First reactions to the above-mentioned policy measures were positive but the markets calmed down only temporarily. A leap in decline of spreads between yields of 10-year government bonds of PIIGS countries and yields of German Bunds, accompanied by fast narrowing of CDS spreads, was replaced by restored growth of both indicators. Besides concerns about sustainability of the current recovery in the light of planned fiscal restriction, it could have been helped also by other factors such as uncertain situation in the

¹ Fed agreed upon these swap lines also with other central banks (BoE, BoJ, Bank of Canada, Swiss National Bank).

banking sector of some EA countries or by the fact that participation in ESFS is subject to authorisation process.

With regard to considerable complexity of mutual relations among financial sector, government and other sectors of real economy, and also with regard to frequency, with which currently new information

appears (often of quite fundamental character) it is nearly impossible to say how intensive an impact of external developments on the Czech economy will be. But it is still true that external environment represents source of risks for the domestic economy, which needs to be monitored closely.

Table A.1.1: **Real Gross Domestic Product** – yearly
growth in %, sa data

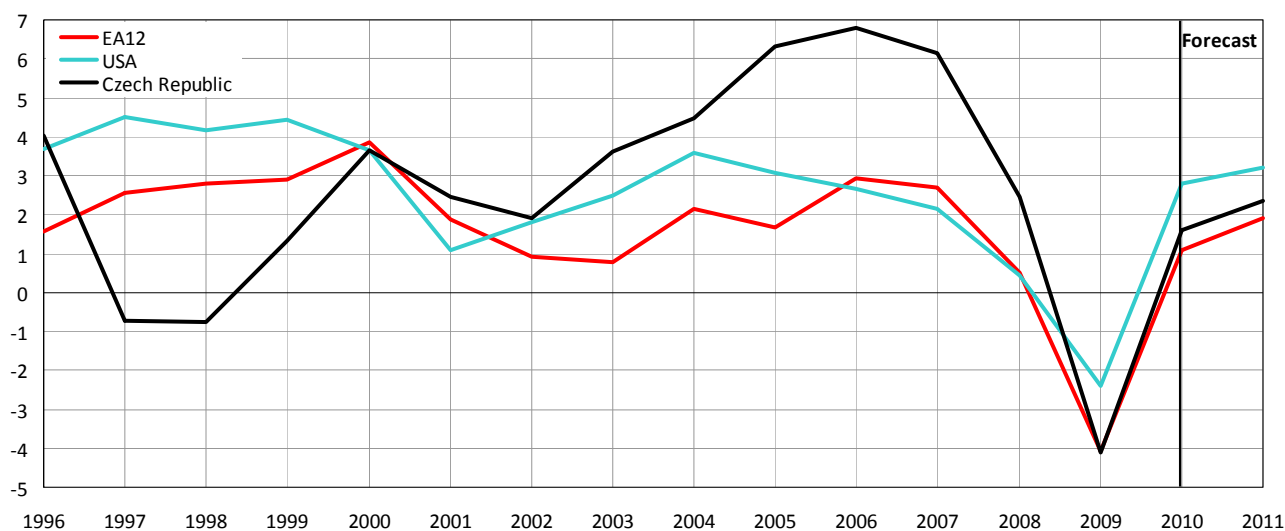
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
									<i>Forecast</i>	<i>Forecast</i>
EU27	1,3	1,4	2,5	2,0	3,2	2,9	0,7	-4,2	1,1	2,0
EA12	0,9	0,8	2,1	1,7	2,9	2,7	0,5	-4,1	1,1	1,9
Germany	0,0	-0,2	1,2	0,8	3,2	2,5	1,3	-4,9	1,5	1,9
France	1,0	1,1	2,5	1,9	2,2	2,4	0,2	-2,6	1,3	1,9
United Kingdom	2,1	2,8	3,0	2,2	2,9	2,6	0,5	-4,9	1,2	2,1
Austria	1,6	0,8	2,5	2,5	3,5	3,5	2,0	-3,6	1,1	1,6
USA	1,8	2,5	3,6	3,1	2,7	2,1	0,4	-2,4	2,8	3,2
Hungary	4,4	4,3	4,9	3,5	4,0	1,0	0,6	-6,3	0,9	1,9
Poland	1,4	3,9	5,3	3,6	6,2	6,8	5,0	1,7	2,9	3,5
Slovakia	4,6	4,8	5,0	6,7	8,5	10,6	6,2	-4,7	3,5	3,9
Czech Republic	1,9	3,6	4,5	6,3	6,8	6,1	2,5	-4,1	1,6	2,3

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

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

Graph A.1.3: Real Gross Domestic Product

growth in %, sa data



Graph A.1.4: Real Gross Domestic Product – Central European new member state economies

growth in %, sa data

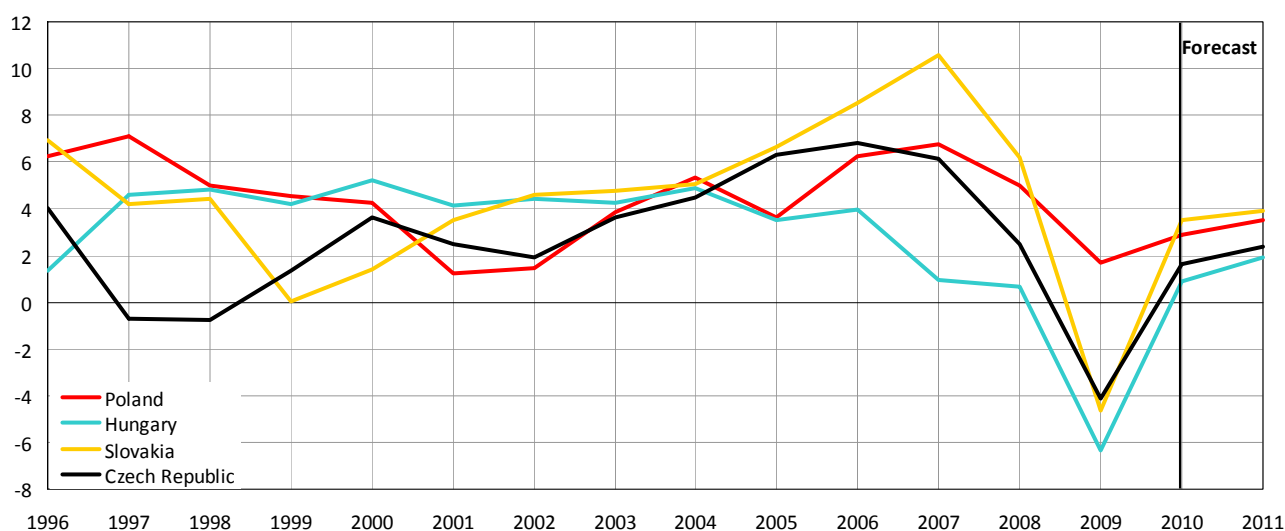


Table A.1.3: Prices of Commodities – yearly

spot prices

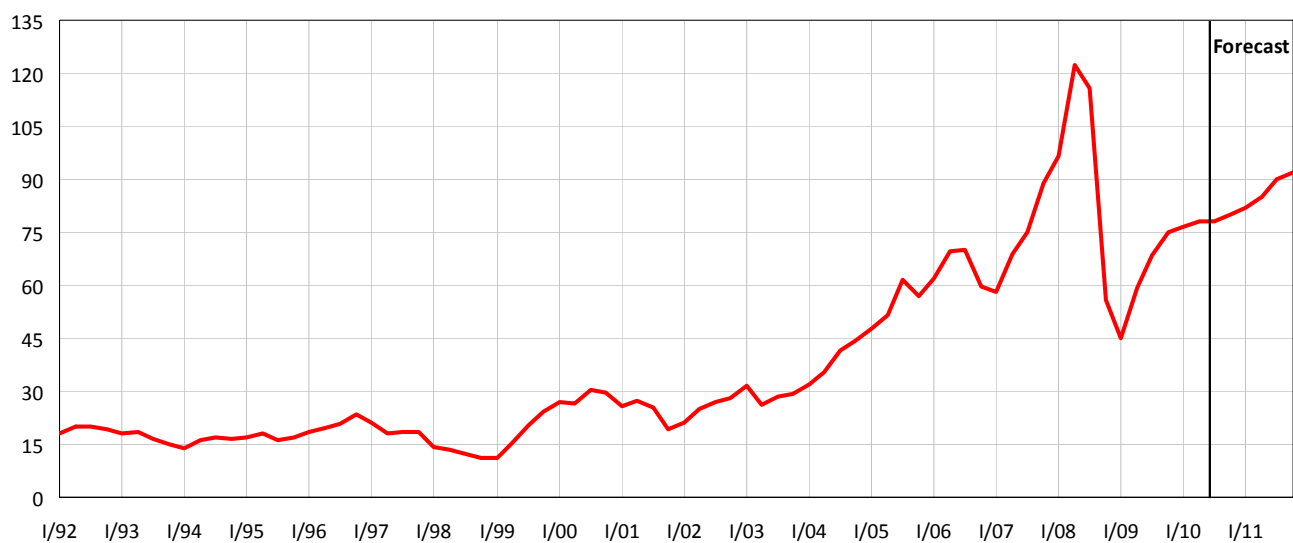
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
		Forecast									
Crude oil Brent	USD/barrel	25,3	28,8	38,3	54,4	65,4	72,7	97,7	61,9	78	87
	growth in % prev. y.	3,6	14,0	33,0	42,0	20,1	11,2	34,4	-36,7	26,3	11,6
Crude oil Brent index (in CZK)	2005=100	63,5	62,4	75,6	100,0	113,4	113,3	127,7	90,5	119	131
	growth in % prev. y.	-10,9	-1,7	21,1	32,3	13,4	-0,1	12,7	-29,1	31,1	10,9
Wheat	USD/t	148,5	146,1	156,9	152,4	191,7	255,2	326,0	223,5	.	.
	growth in % prev. y.	17,1	-1,6	7,3	-2,8	25,8	33,1	27,7	-31,4	.	.
Wheat price index (in CZK)	2005=100	133,2	113,0	110,5	100,0	118,7	142,0	152,1	116,7	.	.
	growth in % prev. y.	0,8	-15,2	-2,3	-9,5	18,7	19,6	7,1	-23,3	.	.

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

		2009				2010			
		Q1	Q2	Q3	Q4	Q1	Q2 Estimate	Q3 Forecast	Q4 Forecast
Crude oil Brent	USD/barrel	45,0	59,1	68,4	75,0	76,7	78	78	80
	růst v %	-53,5	-51,8	-40,8	34,2	70,4	32,0	14,0	6,7
Crude oil Brent index (in CZK)	2005=100	73,0	88,6	93,7	100,7	110	119	121	123
	růst v %	-42,2	-40,5	-34,0	22,2	50,4	34,7	29,3	22,3
Wheat price	USD/t	232,0	248,0	209,0	205,0	196,0	.	.	.
	růst v %	-43,6	-28,4	-34,3	-10,1	-15,5	.	.	.
Wheat price index (in CZK)	2005=100	134,7	133,0	102,4	98,4	100,4	.	.	.
	růst v %	-30,0	-11,7	-26,7	-18,1	-25,5	.	.	.

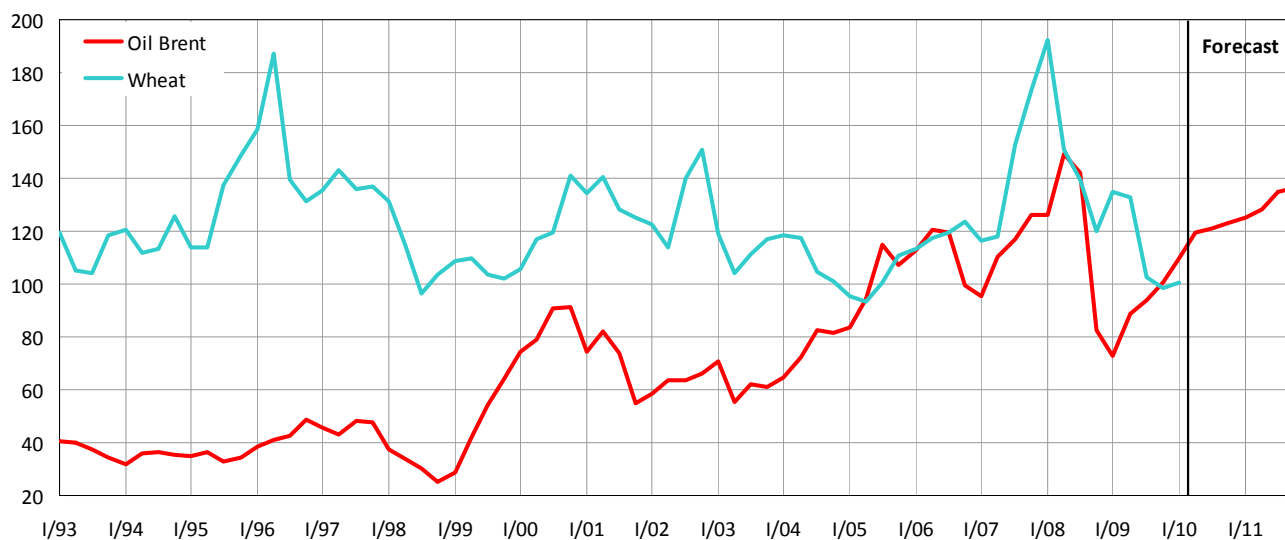
Graph A.1.5: **Dollar Prices of Oil**

in USD/barrel



Graph A.1.6: **Koruna Indices of World Commodity Prices**

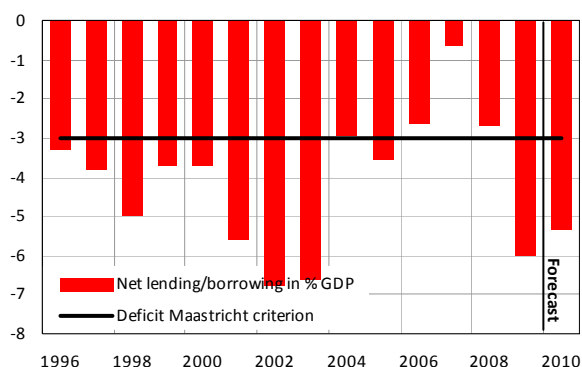
index 2005 = 100



A.2 Fiscal policy

In previous years, performance of government institutions sector was positively influenced in particular by the peak phase of the economic cycle. However, economic recession has been bringing worsening of outcomes since 2008, revealing again structural deficiencies on the expenditure side of the general government.

Graph A.2.1: **Net lending/borrowing**
in % of GDP



Under preliminary CZSO data, general government deficit reached 5.9 % of GDP in 2009. Compared to the October notification its estimate thus improved by 0.7 % of GDP. More favourable result stemmed in particular from higher accrual tax receipts than expected in previous forecasts. Nevertheless, these preliminary data are still affected by certain rate of uncertainty especially as regards tax receipts, in particular corporate income tax, and also gross fixed capital formation.

With regard to unfavourable general government performance, debt reached 35.3 % of GDP by the end-2009. The current unsustainable fiscal policy setting increases the risk that debt will continue growing significantly in future.

On the basis of data from the beginning of the year, the MoF prepared an estimate of autonomous development in 2010, notifying general government deficit of 5.9 % of GDP.

Nevertheless, fiscal target of 5.3 % of GDP remains valid for 2010. To achieve it, the government is set to enforce additional budgetary corrections. It allows especially for reassessment of spending within privatization account means and, in comparison with the original plan, for higher involvement of property income in general budget revenues. Depending on

further development of the deficit, the government is also prepared to propose further tying of expenditures in individual budgetary chapters.

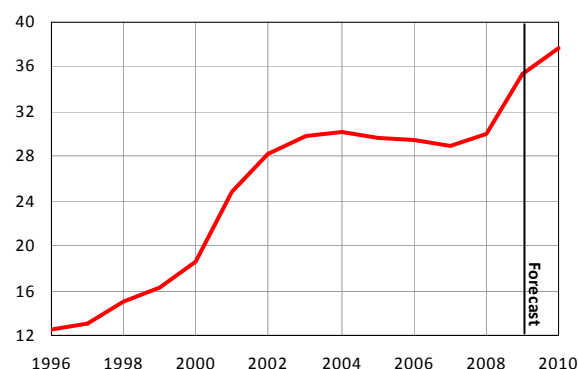
Spring notifications were conceived by the MoF as an “audit” of the general government and updating of the current fiscal plans based on new data from beginning of the year. Comparison of original forecasts with the outcome of spring notifications makes it possible **to identify the size of necessary additional adjustments to achieve the planned target of general government deficit.**

Worsening of the notified deficit in comparison with the Convergence Programme data was caused especially by lower estimate of tax receipts reflecting their collection in the beginning of the year, by lower estimate of revenues from property income, by higher-than-expected expenditures of local budgets indicating as yet rather unwillingness to adjust their spending to expected receipts, and by updating of the size of tied expenditures in individual budgetary chapters.

Although first information on the size of collection of taxes and social security contribution does not correspond fully to expected increase of revenues, this collection in the beginning of the year was still influenced by expiring employer-paid contribution credit and also could reflect partial advance buying of products before an increase in VAT rates.

When assessing fiscal policy results in 2009 and 2010 it is necessary to say that expenditure frameworks valid for these years were set as early as in 2007, i.e in the period of the highest boom and were only minimally changed afterward. Consequently, their setting partially reflected the then optimistic expectations of future economic developments.

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



Also this year the general government debt should reflect development of deficit and reach 37.6 % of GDP. Nevertheless growth of debt is slightly hindered this year by involvement of funds gained by means of bond issuance in past years.

For future years this forecast allows for fiscal consolidation as it is contained in the Convergence

Programme from January 2010 and thus for fulfilment of the Maastricht criterion for government deficit in 2013. The consolidation needs to be regarded as necessary minimum, especially as regards CR commitments toward the EU.

Table A.2.1: Net lending/borrowing and debt

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
										<i>Prel.</i>	<i>Forecast</i>
General government balance	<i>bill. CZK</i>	-132	-167	-170	-83	-107	-84	-23	-99	-214	-196
General government debt	<i>bill. CZK</i>	585	695	768	848	885	948	1024	1105	1282	1383
	<i>growth in %</i>	44,2	18,9	10,5	10,4	4,4	7,1	8,0	7,9	16,1	7,9
	<i>% GDP</i>	24,9	28,2	29,8	30,1	29,7	29,4	29,0	30,0	35,3	37,6
Interest derivatives ¹⁾	<i>bill. CZK</i>	0,0	0,0	-0,5	-0,5	-0,2	-0,4	-0,7	-1,8	-1,3	-1,1
EDP B.9 ²⁾	<i>bill. CZK</i>	-132	-167	-171	-83	-107	-85	-24	-100	-215	-197
	<i>% GDP</i>	-5,6	-6,8	-6,6	-3,0	-3,6	-2,6	-0,7	-2,7	-5,9	-5,3
Interest expenditure	<i>% GDP</i>	1,0	1,2	1,1	1,2	1,2	1,1	1,1	1,1	1,3	1,7
Primary balance	<i>% GDP</i>	-4,6	-5,5	-5,5	-1,8	-2,4	-1,5	0,5	-1,7	-4,6	-3,6
One-off measures	<i>% GDP</i>	0,0	-0,1	-0,3	-0,7	-1,3	-0,2	-0,3	-0,1	0,2	0,1
Cyclical balance	<i>% GDP</i>	0,0	-0,5	-0,5	-0,5	-0,2	0,4	1,1	0,8	-1,2	-1,4
Structural balance	<i>% GDP</i>	-5,6	-6,2	-5,9	-1,7	-2,1	-2,8	-1,5	-3,4	-5,0	-4,1
Fiscal effort	<i>% GDP</i>	-1,8	-0,6	0,3	4,1	-0,4	-0,7	1,3	-1,9	-1,6	0,9

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 to net lending/borrowing from national accounts, this item is adjusted for interest rate derivatives.

Note : The notified deficit for 2009 was 5.9 % of GDP, the notified debt stood at 38.1 % of GDP.

A.3 Monetary policy and interest rates

Monetary policy

To secure price stability, the CNB makes use of **inflation-targeting** regime. Inflation target is generally defined as the YoY increase in the CPI and is set at **2.0 %** (with tolerance band of ± 1 p.p.) from January 2010. Inflation target is set as medium-term with a monetary-policy horizon of 12-18 months.

2W repo rate, which was decreased by 0.25 p.p. to 0.75 % in the second quarter of 2010, is the primary instrument of monetary policy.

ECB left the key refinancing rate at 1.00 % in the second quarter of 2010 and introduced again some measures to support financial markets. Band for key refinancing rate of the US Fed remained at 0-0.25 %.

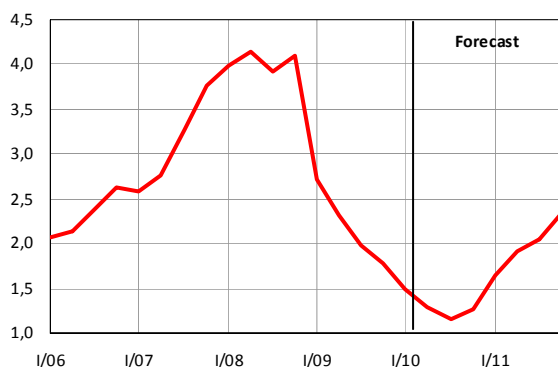
Interest rates

3-month **PRIBOR** rate reached 1.5 % in the first quarter 2010. In the second quarter it is expected to fall up to 1.3 % due to May cut in 2W repo rate.

With regard to expected economic growth, exchange rate and assumption regarding external markets development, a gradual growth of PRIBOR rate is expected approximately since the end of 2010. Average value of PRIBOR 3M is estimated at 1.3 % (1.5 %) in 2010 and at 2.0 % (2.2 %) in 2011.

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

in %



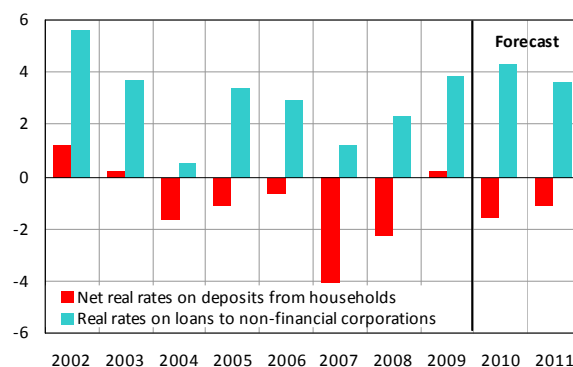
Average yields to maturity of 10-year government bonds stagnated at 3.9 % in the first quarter of 2010, being lower than average EA yields (see Graph A.3.7). They are influenced by expectations of future development of interest rates and also by foreign yields reflecting economic and fiscal situation of European countries. Taking into account assumed development of these factors, a gradual increase of yields of Czech government bonds is assumed since the end of 2010. Average yields could thus reach 3.7 % (4.0 %) in 2010 and 4.0 % (*unchanged*) in 2011.

Interest rates from deposits and credits respond, as a rule, to changes in inter-bank rates with some delay. Moderate growth of these rates is therefore expected in early 2011. Average level of nominal interest rates from credits to non-financial businesses is assumed to reach 4.1 % (4.2 %) in 2010 and 4.4 % (4.6 %) in 2011. As regards nominal rates of household deposits, they are expected to reach on average 1.1 % (1.3 %) in 2010 and 1.3 % (1.4 %).

Average real rates from household deposits after taxation should fall to -1.6 % (-1.2 %) in 2010, with regard to higher growth of prices and major decline in nominal rates compared to the previous forecast, and to -1.1 % (-0.9 %) in 2011. Average real interest rates from credits to non-financial businesses are expected to rise to 4.3 % (3.5 %) in 2010 and to fall slightly to 3.6 % (3.7 %) in 2011.

Graph A.3.2: **Average 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.



Interest rates from new credits to households increased to 15.1 % in the first quarter of 2010 compared to the fourth quarter of 2009. Growth of rates was caused by change in structure of newly provided credits, whose volume grew in QoQ terms, although total stock of provided credits fell. Average interest rate from new credits to non-financial businesses decreased slightly to 4.1 % in the first quarter (without change in the structure the decline would be more considerable).

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

in % p.a.

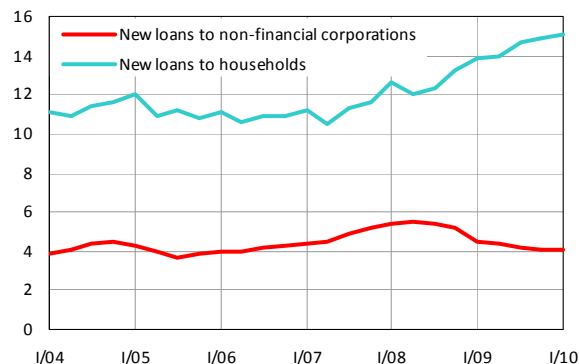


Table A.3.1: **Interest Rates** - yearly
average interest rates in per cent p.a.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
									Forecast	Forecast
Repo 2W CNB (end of year)	2,75	2,00	2,50	2,00	2,50	3,50	2,25	1,00	.	.
Main refinancing rate ECB (end of year)	2,75	2,00	2,00	2,25	3,50	4,00	2,50	1,00	.	.
Federal funds rate (end of year)	1,25	1,00	2,25	4,25	5,25	4,25	0,25	0,25	.	.
PRIBOR 3M	3,55	2,28	2,36	2,01	2,30	3,09	4,04	2,19	1,3	2,0
Government bond yield to maturity (10Y)	4,94	4,12	4,75	3,51	3,78	4,28	4,55	4,67	3,7	4,0
Interest rates on loans to non-financial corpor.	5,82	4,57	4,51	4,27	4,29	4,85	5,59	4,58	4,1	4,4
Interest rates on deposits from households	2,06	1,40	1,33	1,24	1,22	1,29	1,54	1,37	1,1	1,3
Real rates on loans to non-financial corporations ¹⁾	5,65	3,72	0,47	3,38	2,95	1,22	2,33	3,89	4,3	3,6
Net real rates on deposits from households with agreed maturity ²⁾	1,19	0,18	-1,64	-1,13	-0,63	-4,10	-2,26	0,17	-1,6	-1,1

¹⁾ Deflated by domestic demand deflator.

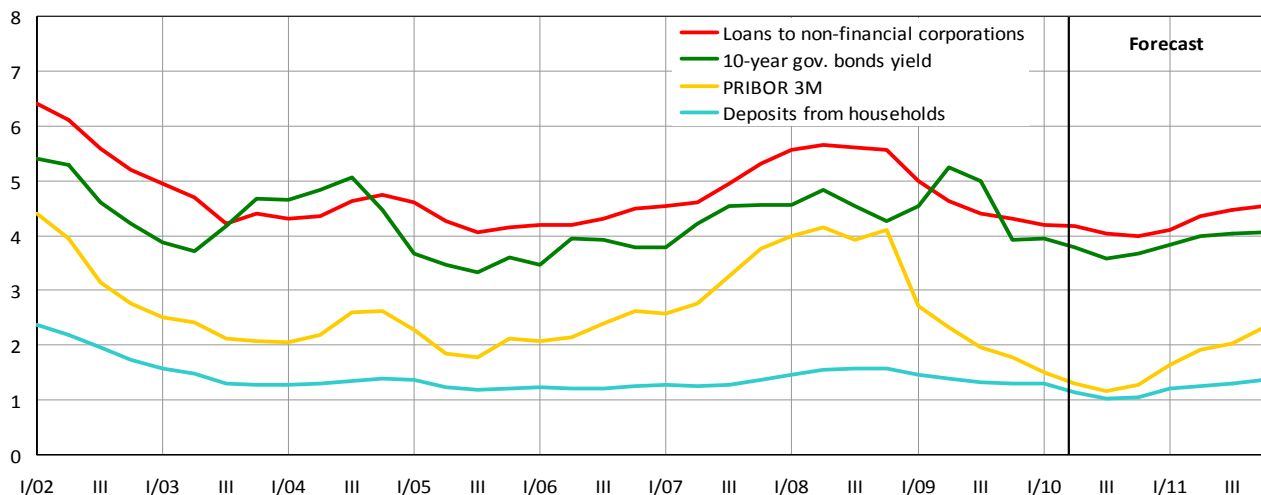
²⁾ Net of 15 % income tax, deflated by CPI.

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

	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Estimate	Forecast	Forecast	
Repo 2W rate CNB (end of period)	1,75	1,50	1,25	1,00	1,00	0,75	.	.
Main refinancing rate ECB (end of period)	1,50	1,00	1,00	1,00	1,00	1,00	.	.
Federal funds rate (end of period)	0,25	0,25	0,25	0,25	0,25	0,25	.	.
PRIBOR 3M	2,71	2,32	1,97	1,77	1,50	1,3	1,2	1,3
Long term interest rates – 10-year government bonds yield to mat.	4,55	5,24	4,99	3,91	3,94	3,8	3,6	3,7
Interest rates on loans to non-financial corporations	4,99	4,63	4,40	4,32	4,19	4,2	4,0	4,0
Interest rates on deposits from households	1,47	1,40	1,33	1,30	1,30	1,1	1,0	1,1

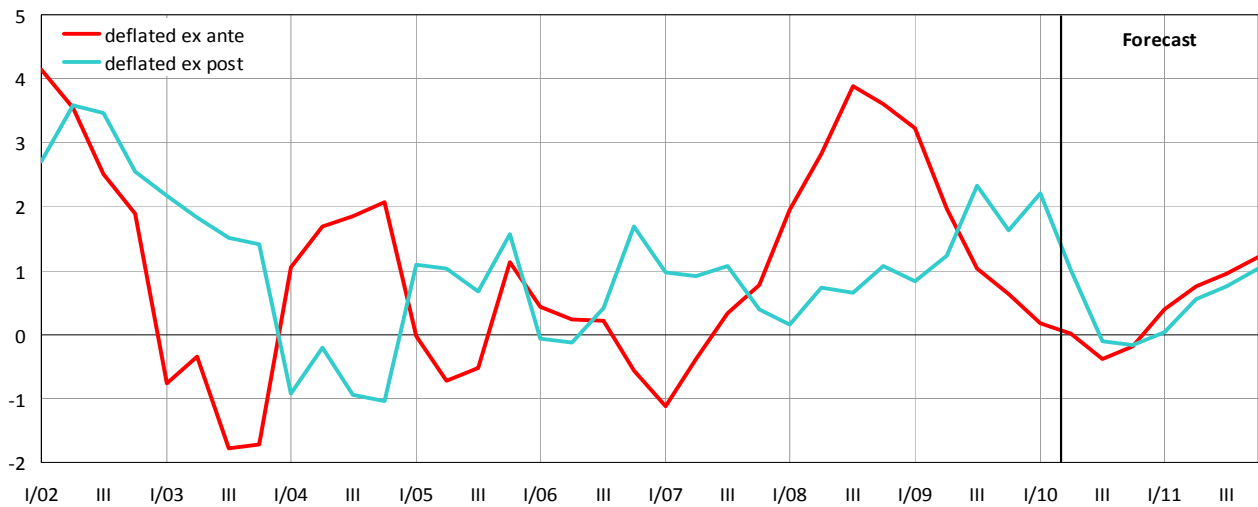
Graph A.3.4: **Interest Rates**

in % p.a.



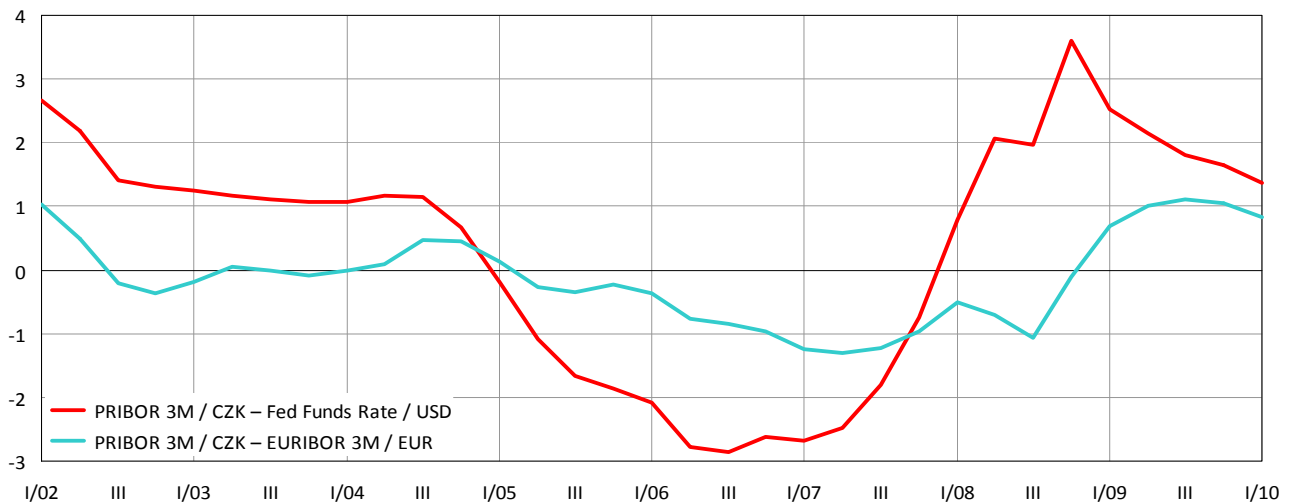
Graph A.3.5: **Real PRIBOR 1Y**

deflated ex post and ex ante by final domestic use deflator, in % p.a.



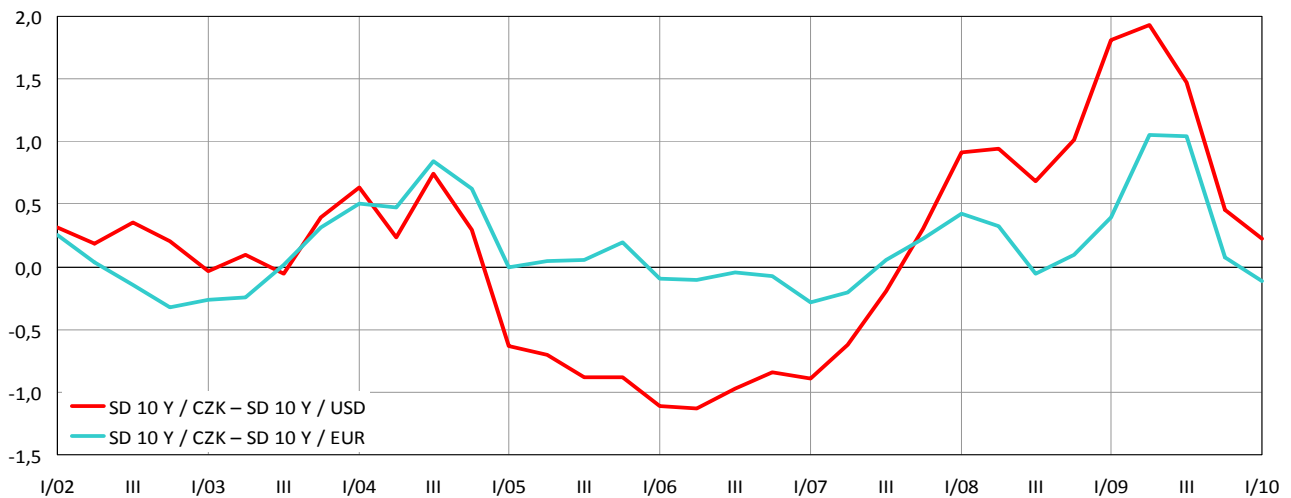
Graph A.3.6: **Short - Term Interest Rate Spread**

in percentage points



Graph A.3.7: **Long - Term Interest Rate Spread**

government bonds, in percentage points



A.4 Exchange Rates

Flexibility of the **exchange rate** helps the economy to respond to unfavourable shocks. Weakening of the exchange rate of the koruna against the euro up to two-year minimum of CZK/EUR 28.46 in February 2009 contributed to abatement of exporters' problems when external demand had weakened sharply in global economic crisis. Average value of the exchange rate in May 2010 was CZK/EUR 25.67, which was by 2.5 % less than the trend value.

Adopted scenario assumes that within the horizon of the forecast to 2011 the exchange rate will hover below the long term trend values, keeping the tendency to moderate nominal and real appreciation.

Graph A.4.1: Exchange Rate CZK/EUR

quarterly averages

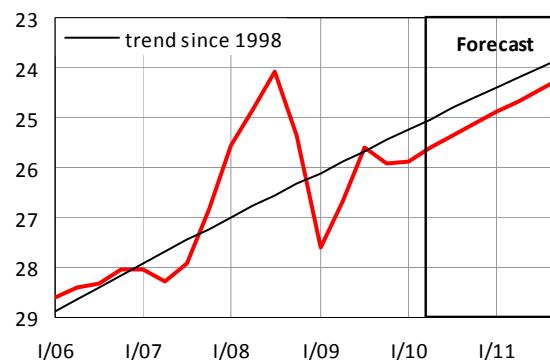


Table A.4.1: Exchange Rates – yearly

				2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
											Forecast	Forecast	Outlook
											Outlook	Outlook	Outlook
Nominal exchange rates:													
CZK / EUR				31,90	29,78	28,34	27,76	24,94	26,45	25,5	24,6	23,7	22,8
	average												
	appreciation	growth in %		-0,2	7,1	5,1	2,1	11,3	-5,7	3,8	3,8	3,8	3,8
CZK / USD				25,70	23,95	22,61	20,31	17,03	19,06	19,8	19,6	18,9	18,2
	average												
	appreciation	growth in %		9,8	7,3	5,9	11,3	19,2	-10,6	-3,6	0,7	3,8	3,8
NEER				94,1	100,0	105,1	107,9	120,4	116,2	118	122	127	131
	average of 2005=100												
	appreciation	growth in %		0,7	6,2	5,1	2,6	11,6	-3,5	1,5	3,4	3,8	3,8
Real exchange rate ¹⁾													
to EA12				95,4	100,0	104,2	107,4	119,1	114,1	117	121	126	131
	average of 2005=100												
	appreciation	growth in %		2,4	4,8	4,2	3,1	10,9	-4,2	2,9	3,3	4,1	3,6

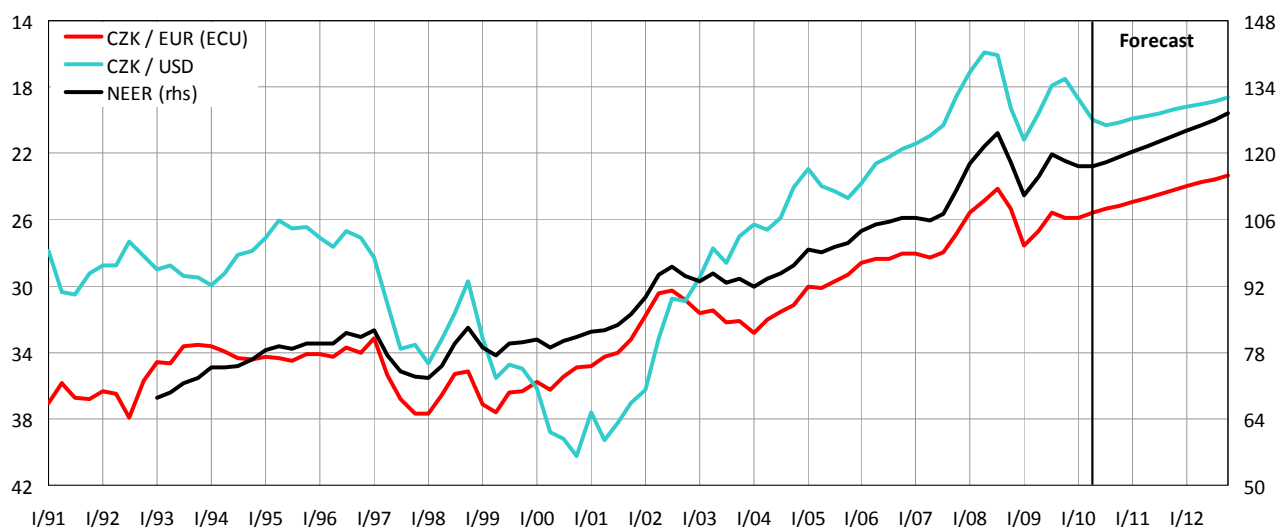
¹⁾ Deflated by GDP deflators.

Table A.4.2: Exchange Rates - quarterly

				2009				2010			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
								Estimate Forecast Forecast			
Nominal exchange rates:											
CZK / EUR				27,60	26,68	25,60	25,91	25,87	25,6	25,4	25,1
	appreciation	growth in %		-7,4	-6,9	-5,9	-2,2	6,7	4,2	0,9	3,1
CZK / USD				21,21	19,59	17,90	17,53	18,71	20,0	20,3	20,1
	appreciation	growth in %		-19,5	-18,9	-10,4	9,8	13,3	-2,0	-11,8	-12,8
NEER				111,1	115,1	119,8	118,5	117,3	117	118	119
	average of 2005=100										
	appreciation	growth in %		-5,7	-5,2	-3,6	0,4	5,5	1,9	-1,5	0,5
Real exchange rate to EA12				109,9	113,2	116,9	116,9	114,7	116	118	121
	average of 2005=100										
	appreciation	growth in %		-5,7	-4,9	-4,6	-1,2	4,4	2,1	0,9	3,7

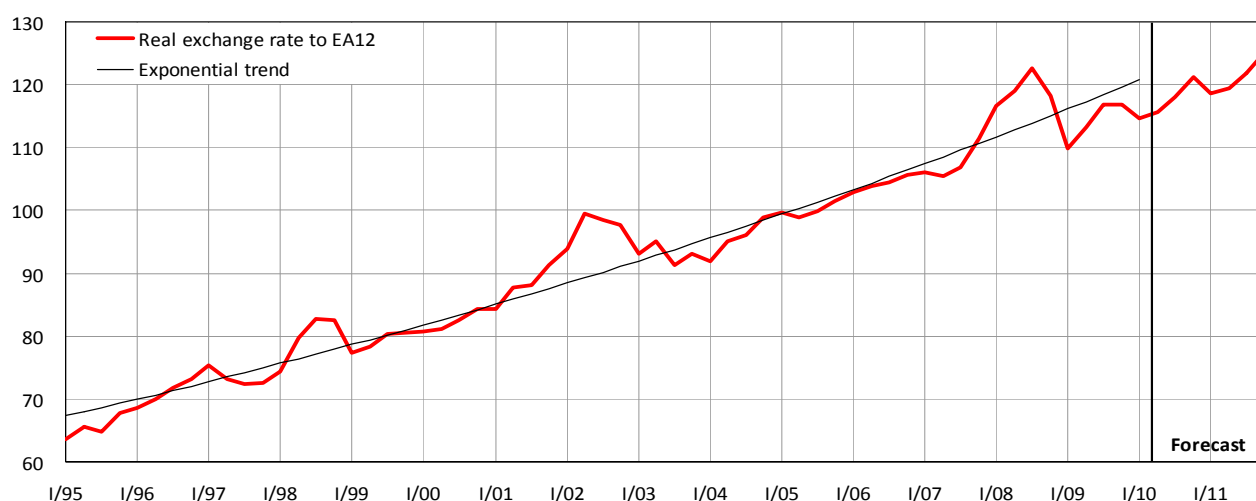
Graph A.4.2: Nominal Exchange Rates

quarterly average, average 2005 = 100 (rhs)



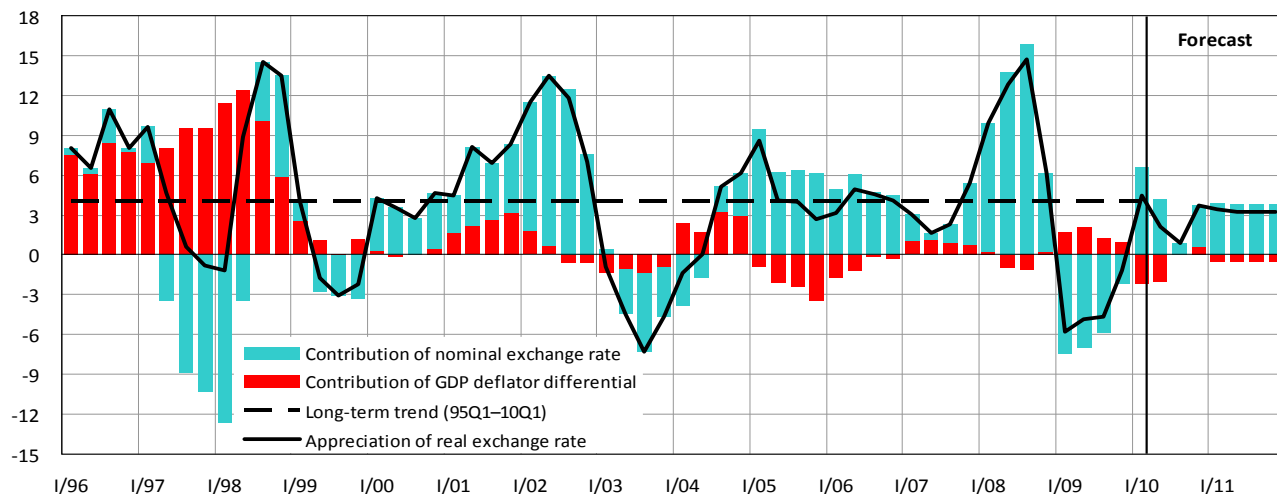
Graph A.4.3: Real Exchange Rate to EA12

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

Overall orientation of structural policies will depend on the programme statement of new coalition government arising from May 2010 elections to the Chamber of Deputies of the Parliament of the Czech Republic.

On its meeting held on 7 June 2010, the Czech government adopted the **National Targets Set on the Basis of Key Targets of „Europe 2020“ Strategy**. Following goals should be achieved to 2020:

- Achievement of total rate of employment (20-64 years) of 75 %;
- Rise in R&D investment to 2.7 % of GDP;
- Rise in share of university-educated people aged 30-34 years to 32 %;
- Reduction in number of pupils leaving schools prematurely to 5.5 %.

The government also decided that specific goals relating to social inclusion and economies in consumption of primary energy sources would be set in the next stage of discussions with the European Commission. Specific measures to meet the set goals will be discussed in the following months.

Business environment

On 21 May 2010 a law became valid that should help **reduce administrative burden of entrepreneurs**. The act amends nine legal regulations and is aimed to simplify and make the existing legislation clearer and improve entrepreneurs' conditions to conduct their business activities. Changes cover especially consumer protection, entering the business and technical legislation.

As of 1 June 2010 an amendment became valid postponing introduction of **basic registers of public administration** by one year at least. The amendment extends the pilot operation of the system to 30 June 2012, setting detailed terms and conditions for transition to full operation of the entire system. Basic registers include registers of population, persons, real estate and territorial identification. They are aimed to make functioning of offices more effective and reduce administrative burden of the population. After launching of the system, one principle will apply to all institutions: every office must at first try to search all required information in one of the above-mentioned

registers and only if it cannot be found there, the office may apply to natural or legal person.

Financial markets

On 15 June 2010 **amendment to the Act on Banks** came into effect, increasing from 31 December 2010 the maximum amount of deposit insurance from EUR 50,000 to EUR 100,000.

Taxation

On 19 April 2010 the Czech government approved **theses for harmonization of tax base for personal income tax with assessment bases for social and health insurance**. The proposal is to reduce administrative burdens, simplify the existing system by means of unifying of circle of persons paying insurance, and unify the base for insurance calculation.

President signed the act on **tax treatment of government bonds determined exclusively for natural persons** on 9 June 2010. Interest yields from these bonds will be taxed by 15 % rate.

Labour market

Strengthening of economic activity was the aim of 2009 amendments to the **Act on Employment and Act on Assistance in Material Poverty**, increasing interconnection of job-seekers' material-security claims with system of assistance in material poverty and introducing stricter rules of active employment policy. The period of support in unemployment was shortened by one month while unemployment benefit was increased – for the first two months it amounts to 65 % of average net monthly earnings reached in the last job, for the next two months to 50 % and for the remaining part of period of support to 45 %.² Changes were made also as regards material-poverty assistance benefits: now they are paid in the form of vouchers for purchase of goods from 35 % at least and 65 % at most.

As regards **health insurance** system, in 2009 payment of sickness benefits was abolished for the first three calendar days of sickness and payment of the benefits by the employer was introduced for the fourth

² Anti-crisis measure that was to increase unemployment benefits to 80 % in the first two months and to 55 % for the remaining part of period of support or to 85 % in case of re-qualification, never became effective.

through fourteenth day. The measure was to eliminate sick pay abuse and to reach lower sickness rate. Changes were accompanied with a cut in **social insurance rate** by 1.0 p.p. Also contributions paid by employees were cut by 1.5 p.p. with rate of physical persons' income tax and tax allowances being preserved. For 2010 reduction thresholds of healthcare insurance were increased and its size was temporarily cut to single 60 % for the whole period of support time. Parameters of calculation algorithm are on the same level from early June 2010 as in 2009. By the amendment to healthcare insurance also the three-day waiting period was abolished for costs of nursing.

An increase in earned net income of persons with children is to be ensured by higher tax allowance/bonus per child in 2010. The size of children's allowances thus gets back to the same level as before anti-crisis package. In connection with consolidation measures of the state budget, **ceilings for social and healthcare security contributions³** were increased for 2010 to 72-multiple of average monthly wage.

Measures of the **first stage of pension reform** came into effect in 2010, extending gradually the statutory retirement age up to 65 years for men and to 62-65 years for women (depending on the number of brought-up children). The amendment extends necessary time of insurance to 35 years and excludes time of study from the category of alternative periods of insurance. Among structural measures, also **strengthening of motivation of older persons** to stay on the labour market is important. Motivation includes more severe cuts in old-age pensions in case of early retirement, and growth of percent term of old-age pension in case of concurrence of employment and drawing a full or partial pension.

³ Maximum assessment base for healthcare insurance will remain preserved after 2010.

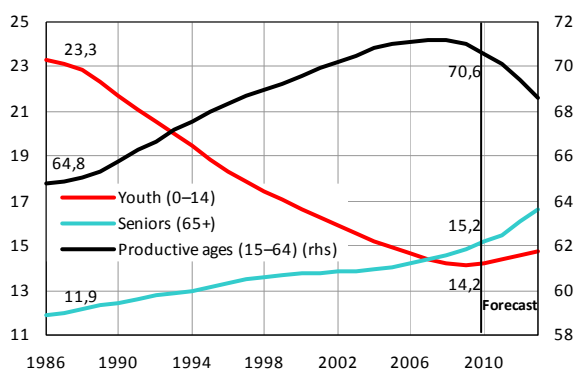
A.6 Demographic trends

Under preliminary data, number of population of the CR grew by 0.4 % in 2009, surpassing the 10.5 mil. threshold for the first time since the mid-forties of the past century.

Despite falling demand for foreign workforce, positive balance of migration kept on relatively high level of 28 thousand people, representing the most important factor of an increase in population although its intensity fell considerably in comparison with 2008.

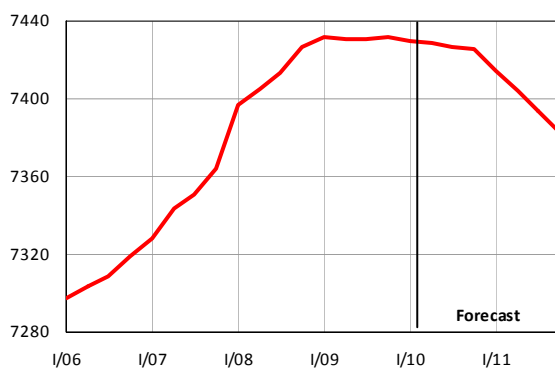
Natural increase of population reached 11 thousand persons, which is 4 thousand less compared with 2008. These characteristics suggest that demographic situation hovers between trajectories of high and mean variant of the CZSO Demographic Projection.

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



In general it can be said that from economic viewpoint the Czech population has still a very favourable structure with high share of working-age population (15 to 64 years), which however obviously reached its maximum at the turn of 2008 and 2009.

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



Also under assumptions of high variant of the projection, net immigration of maximum 40 thousand persons a year can be still expected, which does not outweigh domestic factors worsening slightly the demographic structure.

In our calculations, however, stagnation or following moderate decline in the number of working-age population should be more than compensated by effects within the age structure of the workforce when structural share of age groups with high or growing participation increases. Further rise in labour market flexibility could help create situation when the Czech economy will not suffer from lack of available workforce.

On the other hand, the projection confirms progressing **population ageing process**. For the first time in Czech history, number of people younger than 15 years was lower than number of people in the age category 65+ in 2007. In future the number and share of seniors in the population will grow thanks to demographic structure and further continuation of intensive process of lengthening of average life expectancy. Structural share of inhabitants older than 65 years in total population, which in early 2009 amounted to less than 15 %, should rise to nearly 20 % by early 2020.

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

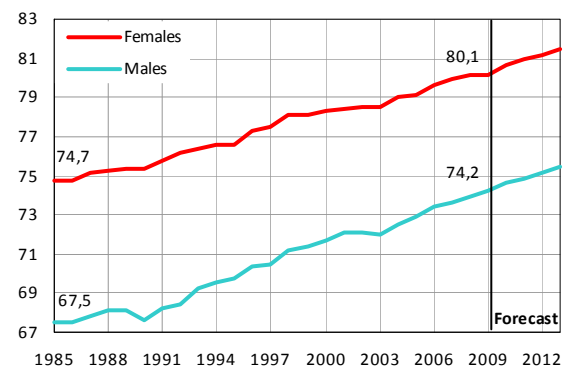


Table A.6.1: Demography
in thousands of persons, end-of-year

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
						Estimate	Forecast	Forecast	Outlook	Outlook
Population (January 1)	10 211	10 221	10 251	10 287	10 381	10 468	10 507	10 560	10 613	10 665
growth in %	0,1	0,1	0,3	0,4	0,9	0,8	0,4	0,5	0,5	0,5
Age structure (January 1):										
(0–14)	1 554	1 527	1 501	1 480	1 477	1 480	1 494	1 516	1 545	1 574
growth in %	-2,2	-1,8	-1,7	-1,5	-0,2	0,2	1,0	1,5	1,9	1,8
(15–64)	7 234	7 259	7 293	7 325	7 391	7 431	7 414	7 407	7 365	7 319
growth in %	0,5	0,3	0,5	0,4	0,9	0,5	-0,2	-0,1	-0,6	-0,6
(65 and more)	1 423	1 435	1 456	1 482	1 513	1 556	1 599	1 636	1 702	1 772
growth in %	0,4	0,8	1,5	1,8	2,1	2,9	2,7	2,3	4,0	4,1
Old-age pensioners (Jan 1)	1 933	1 965	1 985	2 024	2 061	2 102	2 145	2 185	2 221	2 256
growth in %	0,6	1,7	1,0	2,0	1,8	2,0	2,0	1,9	1,6	1,6
Old-age dependency ratios (Jan 1 in %):										
Demographic ¹⁾	19,7	19,8	20,0	20,2	20,5	20,9	21,6	22,1	23,1	24,2
Under current legislation ²⁾	32,8	32,8	33,0	33,3	33,4	33,7	34,2	34,5	34,8	35,2
Effective ³⁾	40,9	41,5	41,3	41,6	41,5	41,8	43,5	44,6	45,0	45,4
Fertility rate	1,226	1,282	1,328	1,438	1,497	1,492	1,51	1,53	1,54	1,55
Population increase	9	31	36	94	86	39	53	53	53	52
Natural increase	-10	-6	1	10	15	11	13	13	13	12
Live births	98	102	106	115	120	118	118	118	117	116
Deaths	107	108	104	105	105	107	106	105	105	104
Net migration	19	36	35	84	72	28	40	40	40	40
Immigration	53	60	68	104	78	40
Emigration	35	24	33	21	6	12

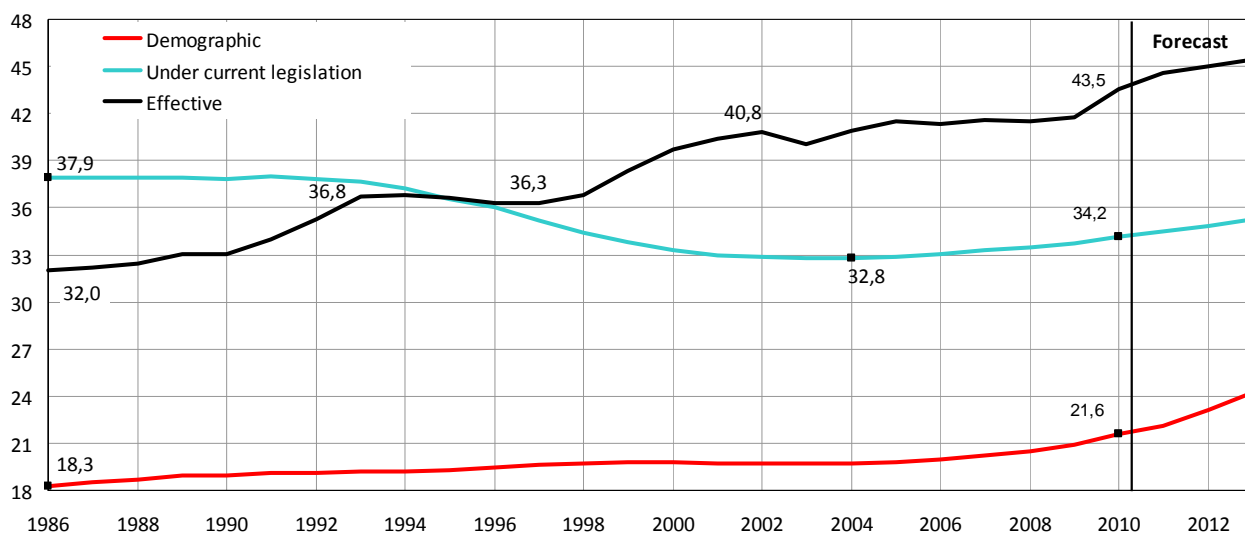
¹⁾ Demographic dependency: ratio of people in senior ages (60 and more) to people in productive ages (20 - 59).

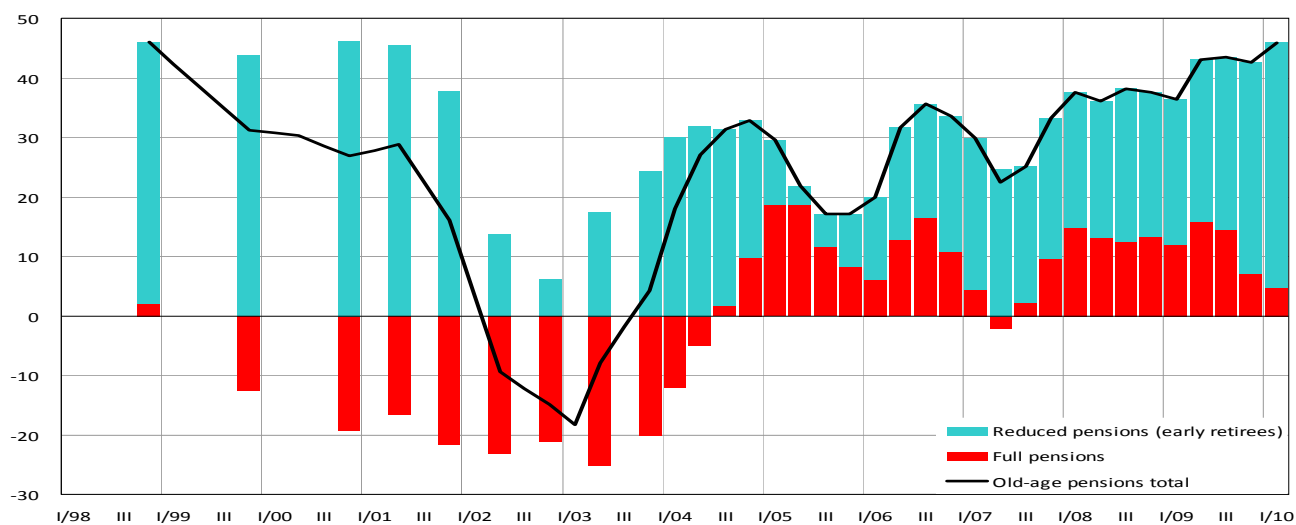
²⁾ Dependency under current legislation: ratio of people above the official retirement age to the people over 19 below the official retirement age.

³⁾ Effective dependency: ratio of old-age pensioners to working people.

Graph A.6.4: Dependency Ratios

definitions – see Table A.6.1, in %



Graph A.6.5: **Old-Age Pensioners***absolute increase over a year in thousands of persons*

B Economic cycle

B.1 Position within the economic cycle

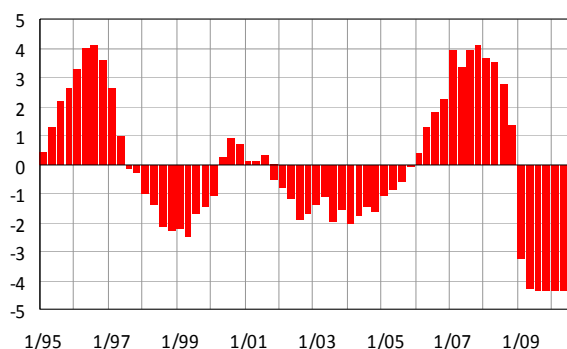
Potential product (PP), specified on the basis of calculation by means of the Cobb-Douglas production function, indicates the level of GDP achieved with average use of production factors. Growth of PP expresses possibilities for long-term sustainable growth of the economy free of imbalances. It can be broken down into contributions of the labour force, capital stock, and total factor productivity. The output gap identifies the cyclical position of the economy and expresses the relationship between GDP and PP. The concepts of potential product and output gap are used to analyze economic development and to calculate the structural balance of the general government.

Under current conditions, however, when steep changes in the level of economic output have occurred, it is very difficult to distinguish the influence of deepening of the negative output gap from slowdown in PP growth. Results of these calculations thus display high volatility and should be treated very cautiously.

Sources of tables and graphs: CZSO, CNB and own calculations.

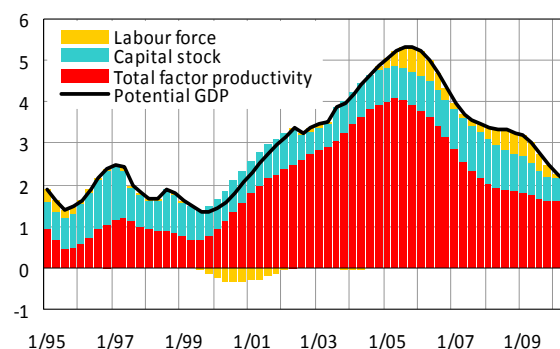
Graph B.1.1.: Output Gap

in % of potential GDP



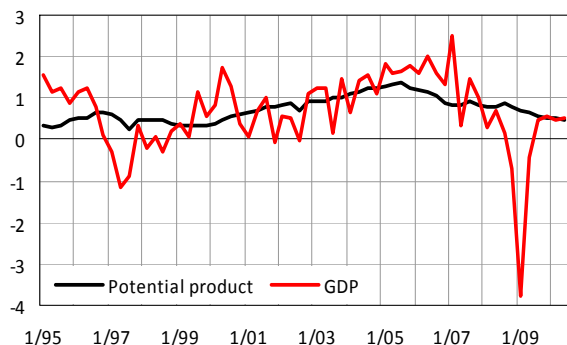
Graph B.1.2: Potential Product Growth

in %, contributions in percentage points



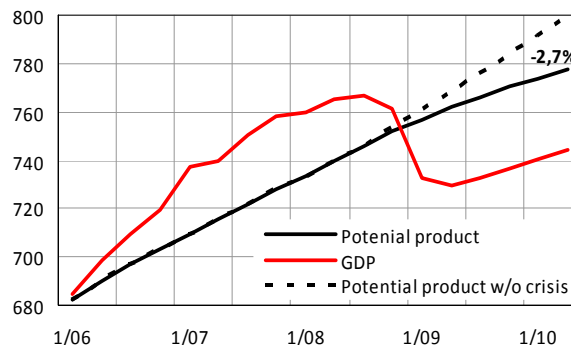
Graph B.1.3: Potential Product and GDP

QoQ growth in %



Graph B.1.4: Levels of Potential Product and GDP

in bill. CZK of 2000



Note: „Potential product w/o crisis“ in graph B.1.4 is a hypothetical level of PP steadily growing from Q4/08 by the average QoQ growth of years 2001–2007.

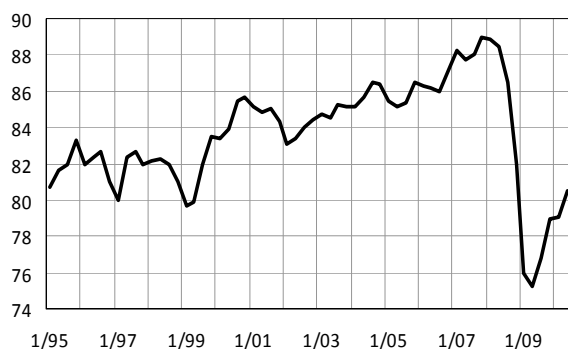
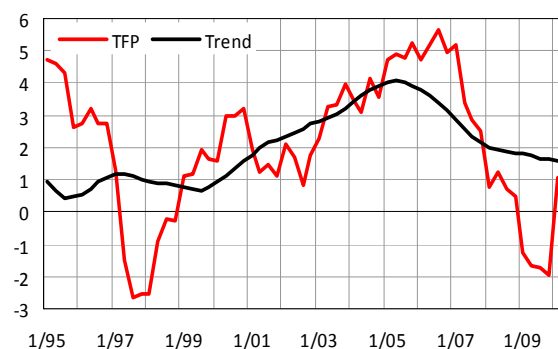
Graph B.1.5: Utilisation of Capacities in Industry
in %Graph B.1.6: Total Factor Productivity
YoY growth in %

Table B.1: Output Gap and Potential Product

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Q1-2
Output gap	<i>per cent</i>	-0,1	-1,4	-1,5	-1,6	-0,6	1,3	3,7	2,8	-4,1	-4,3
Potential output	<i>growth in per cent</i>	2,6	3,3	3,7	4,5	5,2	4,8	3,7	3,3	2,9	2,2
Contributions:											
TFP	<i>percentage points</i>	2,0	2,5	3,0	3,7	4,0	3,5	2,5	1,9	1,7	1,6
Fixed assets	<i>percentage points</i>	0,8	0,7	0,7	0,8	0,8	0,9	1,1	1,0	0,7	0,5
Participation rate	<i>percentage points</i>	-0,4	-0,1	-0,2	-0,2	0,2	0,2	-0,2	0,0	0,2	0,0
Demography ¹⁾	<i>percentage points</i>	0,2	0,2	0,2	0,2	0,2	0,3	0,3	0,4	0,2	0,0

¹⁾ Contribution of growth of working-age population (15–64 years)

Economic recession, which hit the Czech economy at the turn of 2008 and 2009, resulted in an emergence of a deeply negative **output gap**. According to current calculations, it stagnates at some –4.3 % since end of recession, which indicates the lowest utilisation of economic potential in the post-transformation period.

Deep negative output gap reflects in the economy by low utilisation of production capacities in the industry (80.0 % in the first quarter of 2010 compared to long-term average of 84 %), high rate of unemployment (8 % in the first quarter under LFS compared to long-term average of 5.6 %), reduction in the number of vacancies and, last but not least, deep general government deficit.

Total factor productivity (TFP) is the PP component that was hit the most. Economic problems led to YoY decline in TFP by 2.1 %. In the first quarter of 2010, however, a radical turn occurred, with TFP growing by 1.0 %, QoQ, which considerably exceeds its trend growth. The latter shows signs of stability at some 1.6 %, year-on year.

Deep dropout in investment activity led to lowering of contribution of **capital stock** from 1.1 p.p. in the fourth quarter of 2007 to expected 0.5 p.p. in the second quarter of 2010. **Supply of labour**, measured as ratio of labour force to the number of population aged 15-64, which in 2009 paradoxically accelerated its growth, stagnated more or less in YoY terms after withdrawal of stimulation measures in the beginning of 2010.

Year-on-year growth of **potential product** fell probably to 2.9 % over 2009 and obviously reached 2.2 % in the first half of 2010. Gradual stabilization of pace of PP growth could be considerably helped by means of stopping of slowdown in trend TFP growth.

Graph B.1.4 illustrates that economic recession and coping with its consequences have resulted in loss of PP level of some 2.7 %.

Further development of PP will depend on the speed of the economic recovery. To close the negative output gap and to accelerate potential growth again, the economy will have to start reaching higher paces of GDP growth compared to PP.

B.2 Composite leading indicator

Leading composite indicator is compiled from the results of business cycle surveys meeting basic demands made on cyclical leading indicators – economic significance, statistically observable relation to the course of economic cycle

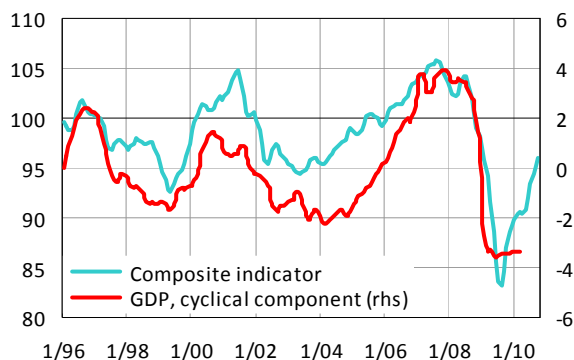
ahead of time and timely and regular availability. Since December 2008 the indicator is compiled from those business cycle indicators that show a high level of correlation with average lead of six months.

Graph B.2.1: Leading Composite Indicator

average 2000=100 (lhs)

synchronized with cyclical component of GDP based on statistical methods (Hodrick-Prescott filter)

in % of GDP (rhs)



Leading composite indicator signalled convergence of relative cyclical component to zero value in the first quarter of 2010 i.e. further QoQ growth of real GDP. Real data confirmed QoQ growth of GDP but relative

cyclical component of GDP remained unchanged in essence.

For the second quarter of 2010 leading composite indicator signals more of stagnation of relative cyclical component of GDP at the level of first quarter of 2010.

CZSO new preliminary data for the first quarter of 2010 accompanied by data revision of 2009 quarterly national accounts led again to relatively considerable shift of the end of time series of relative cyclical component, correlating now more with recent development of composite indicator. It can be assumed even for the future that the current estimate of relative cyclical component of GDP will change.

As in connection with transition to new Classification of Economic Activities (CZ-NACE) the CZSO revised the input time series, value of indicator from April update only is given. New input time series are available from 2003 only, from which follows that the current composite indicator will have to undergo a comprehensive revision.

B.3 Individual business cycle indicators

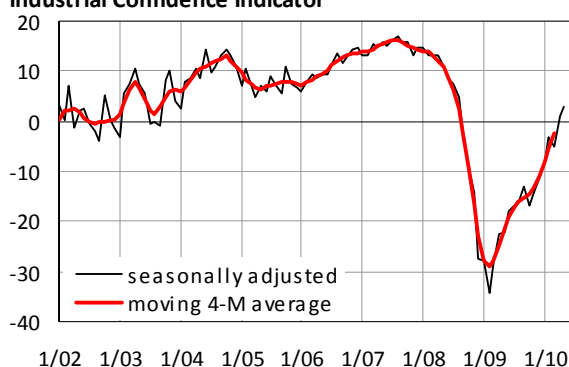
Business cycle surveys express respondents' views of the current situation and short-term outlook and serve to identify in advance possible turning points in the economic cycle. The main advantage lies in quick availability of results reflecting a wide range of effects shaping expectations of economic entities.

The surveys share a common characteristic: respondents' answers do not provide a direct quantification but use more general qualitative expressions (such as better, the same, worse, or growing, not changing, falling, etc.). Trends are reflected in business cycle balance, which is the difference between answers "improvement" and "worsening" expressed in per cents of observations.⁴

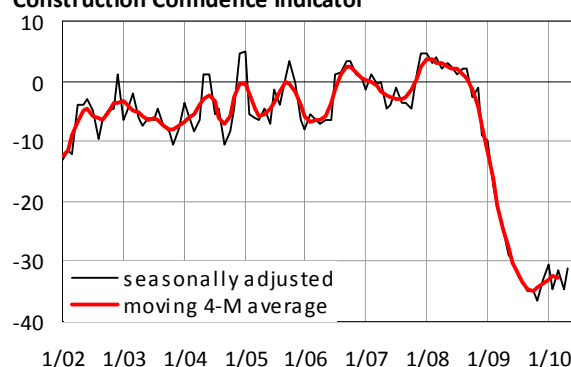
Aggregate indicator of confidence is presented as weighted average of seasonally adjusted indicators of confidence in industry, construction, trade, select sectors of services and of consumer confidence. Weights are established as follows: indicator of confidence in industry is assigned weight of 40 %, those of construction and trade 5 % each, that for selected services 30 % and for consumer confidence 20 %.

Graph B.3.1: Confidence Indicators

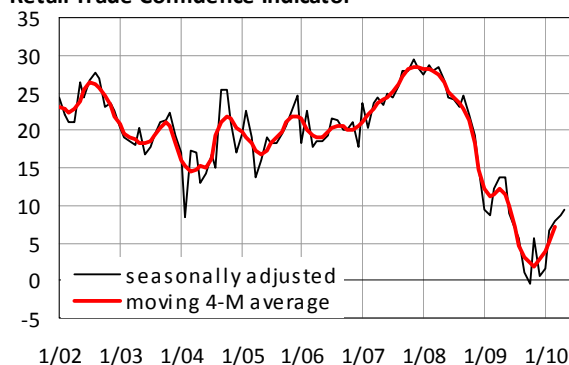
Industrial Confidence Indicator



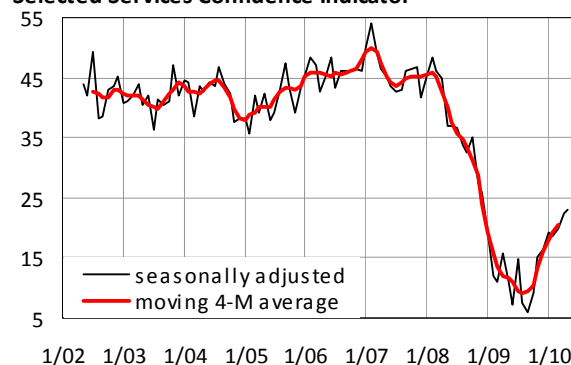
Construction Confidence Indicator



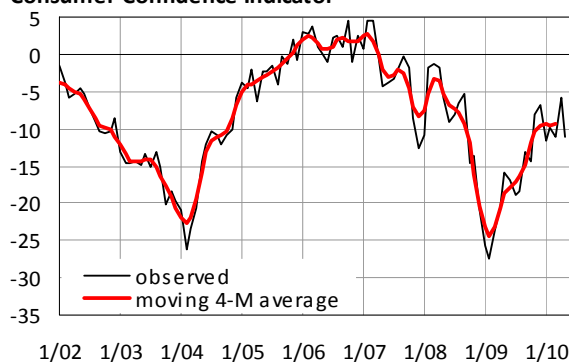
Retail Trade Confidence Indicator



Selected Services Confidence Indicator



Consumer Confidence Indicator



⁴ For methodology of business cycle surveys see CZSO: http://www.czso.cz/csu/redakce.nsf/i/konjunkturalni_przukum.

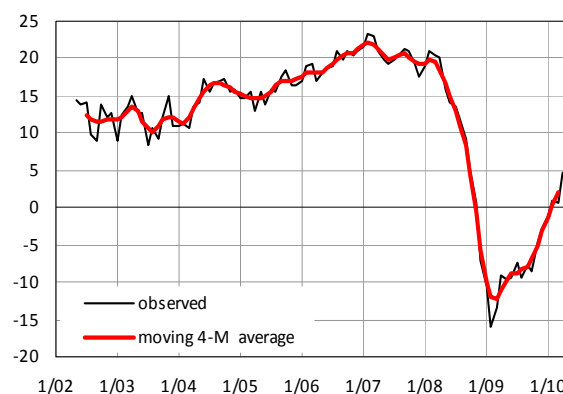
In **industrial businesses**, assessment of performance in April and May 2010 continued to be favourable. Improvement of economic situation and of total and foreign demand continued. In outlook for next three months of 2010, assessment of production activity increased slightly but assessment of employment was still cautious. In three- and six-month horizon a partial improvement of economic situation of businesses is expected.

In construction situation was improving merely slowly in the beginning of the second quarter 2010. For the next three months respondents increased their expectations of construction activity and employment. As regards assessment of economic situation, a major improvement cannot be expected even in the six-month period.

In April and May businesses in **trade** improved their assessment of the current economic situation. However, respondents are not very optimistic as regards outlook. In selected sectors of **services** situation is stable but assessment of expected demand fell slightly.

Consumer confidence decreased moderately in May survey but still remains relatively stable. For the next twelve months consumers allow for worsening of total economic situation as well as of their financial situation. Share of respondents expecting an increase in unemployment rose slightly.

Graph B.3.2: **Aggregate Confidence Indicator**



On the basis of economic entities' opinions it can be assumed that QoQ growth is to be similar in the second and third quarters as in the first quarter. Development of external demand is seen as risk.

Methodical explanation:

Since May 2010 results are in accordance with EU business cycle survey programme developed and published under new Classification of Economic Activities CZ-NACE (national version of NACE Rev. 2), which replaced the formerly used Sectoral Classification of Economic Activities (national version of NACE Rev. 1.1). Changes cover all time series exclusive of indicator of consumer confidence. Time series are recalculated retroactively.

C Forecast of macroeconomic indicators

C.1 Economic output

The Czech economy has been recovering from economic slump at the turn of 2008 and 2009.

In the fourth quarter of 2008 the Czech economy was fully hit by the world economic crisis and entered the recession. Under current CZSO estimates, recession lasted three quarters with seasonally adjusted **real GDP** decreasing by 4.9 % during this period.

In the third quarter of 2009 a turnaround was seen. Pro-growth measures had their impact on the domestic market, Czech firms profited also from stimulation programmes abroad. Stabilization of economies of our main trading partners starting manifesting itself. Since then, GDP grows at a stable pace of 0.5 % QoQ (*compared to forecast of 0.2 % for the first quarter of 2010*). It means YoY growth of real GDP by 1.1 %⁵ (1.2 %) in the first quarter of 2010.

Also during the second quarter of 2010 the economic recovery obviously continued. QoQ growth is estimated at 0.4 % (0.3 %), which means YoY growth by 2.0 % (*unchanged*).

Improved external conditions should outweigh restrictive impacts of stabilization measures. Foreign trade should contribute most to GDP growth in 2010, in the following years also domestic demand should recover. Forecast of GDP growth for 2010 is 1.6 % (1.5 %). In 2011 growth should accelerate slightly to 2.3 % (2.4 %).

Worsening of terms of trade led to YoY stagnation (*growth by 0.7 %*) of **real gross domestic income (RGDI)**, reflecting income situation of the Czech Republic, in the first quarter of 2010. In 2010 real income could rise by 0.6 % (0.7 %). Income situation of the Czech economic entities thus improves much slower than growth of economic output. In 2011 RGDI should grow by 2.1 % (*unchanged*).

Real dynamics reflects also in development of **nominal GDP**, the key variable for fiscal forecasts. In the first quarter of 2010 a YoY decline by 0.6 % (*growth by 1.2 %*) was recorded, when decrease in terms of trade as well as in deflator of gross domestic expenditures prevailed over YoY growth of real economy. In 2010 nominal growth is expected at 1.4 % (1.7 %) and in 2011 at 3.7 % (3.5 %).

As regards **income structure of GDP**, stagnation of the business sphere profitability is expected. In the first quarter of 2010, gross operational surplus fell by 1.1 % YoY (*growth by 1.0 %*). In 2010 growth by 0.7 % (*unchanged*) is expected. In 2011 growth by 3.5 % (1.8 %) can be assumed i.e. with dynamics below the level of nominal GDP.

Forecasts are still related with high rate of uncertainty ensuing especially from external environment development. Risks are deviated more like downward. Impacts of data revisions on past development of the economy can be also relevant. The situation is documented by means of Box C.1.1 and Graph C.1.2 in an annex.

⁵ Data without seasonal adjustment are given in the text, unless stated otherwise.

Box C.1.1: Updating of results of quarterly national accounts

Period of turbulences on financial markets and in the real economy generates more difficult condition for statistical coverage of main financial flows and flows of goods and services in the economy, covered by national accounts. It results objectively in increased volatility and necessity to update gradually the released data. Of course, instability of quarterly national accounts data affects in itself ability of economic forecasts to cover future developments.

The fact that it is difficult to compile quarterly national accounts in time of economic uncertainty, is demonstrated below on development of selected indicators.

Rows of each table cover relative changes in monitored variable since the first quarter of 2009 to the first quarter of 2010. Columns of the table follow development of given YoY changes according to published data of quarterly national accounts from the first quarter of 2009 (published in June 2009) to the first quarter of 2010 (published in June 2010).

It follows from the table for QoQ growth of seasonally adjusted GDP in constant prices how description of depth and course of recession changed over time. The first estimate of QoQ decline in GDP in the first quarter of 2009, released in June 2009, was -3.4 %. Then it was revised downward to -4.8 % in September 2009 while the current estimate from June 2010 is -3.8 %.

It seemed from the quarterly national accounts released in September and December 2009 that recession in terms of formal definition ended by first quarter 2009 as estimated QoQ change in GDP was positive in the second quarter of 2009. However, the current estimate from June 2010 shows a negative value of 0.5 %.

Furthermore, YoY changes in nominal GDP and selected indicators from expenditure and income structure of GDP are mentioned. Interpretation is up to the reader.

Gross domestic product, CZK 2000, qoq growth in %					
	NAQ1/09	NAQ2/09	NAQ3/09	NAQ4/09	NAQ1/10
Q1/09	-3,4	-4,8	-4,4	-4,1	-3,8
Q2/09		0,1	0,2	-0,3	-0,5
Q3/09			0,8	0,6	0,5
Q4/09				0,7	0,5
Q1/10					0,5

Gross domestic product, current prices, yoy growth in %					
	NAQ1/09	NAQ2/09	NAQ3/09	NAQ4/09	NAQ1/10
Q1/09	0,4	-0,6	-0,5	-0,4	-0,1
Q2/09			-1,8	-1,9	-1,9
Q3/09		-2,4	-2,5	-2,8	-2,8
Q4/09				-1,5	-1,7
Q1/10					-0,6

Household consumption, CZK 2000, yoy growth in %					
	NAQ1/09	NAQ2/09	NAQ3/09	NAQ4/09	NAQ1/10
Q1/09	3,0	1,8	2,3	0,9	0,8
Q2/09		1,5	1,8	0,0	0,0
Q3/09			1,1	-0,6	-0,6
Q4/09				-0,9	-0,8
Q1/10					-0,3

Household consumption, current prices, yoy growth in %					
	NAQ1/09	NAQ2/09	NAQ3/09	NAQ4/09	NAQ1/10
Q1/09	4,2	3,2	3,6	2,1	2,0
Q2/09		2,1	2,5	0,8	0,8
Q3/09			0,6	-1,2	-1,2
Q4/09				-0,8	-0,8
Q1/10					0,1

Change in stocks and valuables, bill. CZK 2000					
	NAQ1/09	NAQ2/09	NAQ3/09	NAQ4/09	NAQ1/10
Q1/09	-7	-5	-4	9	20
Q2/09		-23	-26	-12	-6
Q3/09			-23	-4	-2
Q4/09				-33	-35
Q1/10					21

Wages and salaries, current prices, yoy growth in %					
	NAQ1/09	NAQ2/09	NAQ3/09	NAQ4/09	NAQ1/10
Q1/09	2,6	1,0	0,9	-0,3	1,2
Q2/09		-0,5	-0,5	-2,4	-0,8
Q3/09			-1,0	-2,2	-0,5
Q4/09				-1,8	-0,2
Q1/10					-2,2

Expenditures in GDP

QoQ decline in household expenditures lagged two quarters behind contraction of aggregate economic output. Similarly, start of household consumption recovery lagged behind GDP by two quarters. In the first quarter of 2010 household consumption grew 0.7 % in QoQ terms. It means that YoY decline in **real household expenditures on final consumption** reached 0.3 % (*decline by 1.1 %*) in the first quarter of 2010.

Further growth of consumption will be counteracted by still falling employment and ensuing worsening income situation of households. Also budgetary measures to stabilize public finance balance will make themselves felt

over 2010. Growth should be counteracted by announced cuts in public sector salaries too.

In 2010 household consumption is expected to fall by 0.5 % (*decline by 1.1 %*). In 2011 growth of household consumption should be restored at some 2.0 % (*unchanged*).

Government expenditures on final consumption rose by 1.9 % (*decline by 2.1 %*) in real terms in the first quarter of 2010.

In accordance with adopted stabilization measures, austerity behaviour of government institutions is expected as regards both employment in the government sector and purchases of goods and

services. Expected development of government consumption in 2010 should reflect efficient measures to cut government sector deficits. In the following years it should reflect consolidation strategy adopted by the government, which is to ensure meeting of the Maastricht criterion for public finance deficit in 2013.

In 2010 real government consumption is assumed to fall by 1.8 % (*decline by 2.5 %*). In 2011 it should fall by 0.9 % (*unchanged*).

Volume of **gross fixed capital formation** fell by 6.6 % (*decline by 4.7 %*), YoY, in the first quarter of 2010. Purchases of transport vehicles fell by 3.4 %, investments in other machines by 7.5 %. Construction investments in housing fell by 1.5 % only but in other constructions by 9.6 %.

In the current uncertain situation it is necessary to take into account that many investment plans were reconsidered or postponed due to low utilisation of existing capacities. Also capacities, which profited from cheap workforce, can be expected gradually to move elsewhere. Willingness of foreign investors to make new investments or reinvest profits from their business operations in the CR will depend on their situation in

their home countries. Recovery of investment activities is expected as late as in 2011.

After overheating of the housing market in 2007 and 2008, situation should gradually return to trajectory sustainable in the long run. With regard to households' financial situation, negative trajectory deviation can be rather expected in short-term outlook.

On the other hand, reduction of investment could be mitigated by infrastructure investments with contributions from EU funds. For 2010 further decline by 4.3 % (*decline by 3.7 %*) is expected. In 2011 growth dynamics should restore at some 2.5 % (*unchanged*).

Contribution of **foreign trade** (FT) to YoY growth of GDP on seasonally adjusted data reached 1.9 p.p. in the first quarter of 2010 and was thus higher than growth of GDP.

In 2010 positive effect of domestic demand reduction due to stabilization measures as well as ongoing recovery in partner countries should be seen. FT contribution should be distinctly positive, amounting to 1.9 p.p. (*1.8 p.p.*). For 2011 FT contribution is expected at some 0.6 p.p. (*0.7 p.p.*).

C.2 Prices of goods and services

Consumer prices

YoY growth of prices was 1.2 % in May, corresponding thus fully to our expectations. Contribution of administrative measures remained to be the main source of growth (1.3 p.p.). The former consisted in particular of government package to consolidate general government effective from this January and of growth of some regulated prices. Since April effect of an increase of excise taxes on tobacco products (total impact of 0.2 p.p.) is seen. In the same month also prices of gas were increased by 2.8 % (contribution of 0.1 p.p.). Further increase of price gas will be made in July by 4.4 % (contribution of 0.1 p.p.) and in our estimate also in October by some 3.0 % (0.1 p.p.).

Prices in the section of transport are still influenced by growing prices of fuels, pushed upward in particular by weakening of the CZK/USD exchange rate. Average price of Natural 95 petrol was the highest in March from July 2008 and that of diesel oil from September 2008. Due to strong effect of low comparison basis especially from the first half of 2009 thus prices of oil are an important contributor to YoY growth of consumer prices.

Year-on-year declines in prices of food slow down responding thus to development of agriculture producer prices and world prices. Since mid-year their further recovery and positive contributions to CPI are expected. Especially world prices of animal farming products, some of which record YoY growth by tens of per cents this year, can represent considerable inflationary risk for the future.

Another factor, which will push domestic prices upward, is the CZK/USD exchange rate, weaker in YoY terms. A visible depreciation of the koruna occurred in May and weaker CZK/USD exchange rate is assumed also for the following period. Monetary easing as well as ongoing positive gap of real marginal costs indicating decline in profit margins of producers and traders below the long-term level can also become pro-inflationary factors.

On the contrary, weak domestic demand still has anti-inflationary effects, which reflects also restriction of demand for non-food consumption goods. Prices in sections of recreation and culture, clothing and footwear as well as housing furnishings and equipment are still lower in YoY terms. Fragile recovery of domestic economy, persisting position in negative

output gap, still unfavourable conditions on the labour market, moderate growth of real wages and related cooling household consumption create a very limited room for demand-pulled consumer price growth.

On the basis of mentioned assumptions, **average rate of inflation in 2010 is expected to reach 1.6 % (1.5 %)** with December expected increase of prices by **2.6 % (2.3 %)**. Market prices contribution to inflation should return to slightly positive values.

In 2011 gradual recovery of household consumption and positive market inflation over the entire year is expected. Contribution of administrative effects, taking into account proposed government measures to consolidate general government as well as growth of some regulated energy prices, should remain at the same level as in 2010. **Average rate of inflation in 2011 should thus hover around 2.5 % (2.3 %)** with an increase of the prices over the year by **2.2 % (2.1 %)**.

Deflators

Aggregate price level in the economy is stable. **Gross domestic expenditure deflator**, which is a

comprehensive indicator of price developments, fell by 0.2 % (*growth by 0.6 %*) in the first quarter of 2010, YoY. At the same time, deflator of gross fixed capital formation decreased noticeably by 1.7 %. It was due to dropout of prices of transport vehicles by 4.0 % and other machines by 3.8 %.

In 2010 increase of gross domestic expenditure deflator should reach 0.9 % YoY (*1.1 %*) with tendency to gradual growth especially due to acceleration of consumer inflation. In 2011 deflator should grow by 1.8 % (*1.6 %*).

Implicit GDP deflator fell by 1.6 % (*stagnation*) in the first quarter of 2010. Compared to gross domestic expenditure deflator, it was pulled downward by decline of terms of trade by 1.6 % (*decline by 0.7 %*). For 2010 decline of deflator by 0.2 % (*growth by 0.2 %*) is assumed with worsening of terms of trade by 1.4 % (*1.1 %*). In 2011 growth by 1.3 % (*1.1 %*) is expected.

C.3 Labour market and households

Labour market environment underwent significant changes of structural character. In the first quarter of 2010 labour market was hit not only by passed recession but also by expiration of government measures to mediate impacts of economic slump.

Employment

Under Labour Force Survey (LFS), **employment fell by record 2.4 % (1.3 %)**, YoY, in the first quarter of 2010. Shrinkage of the number of employed people by 3.2 % (*1.7 %*) was the decisive factor where probably expiring validity of administrative measure regarding social security credits made itself felt. The measure stimulated employers in 2009 to keep low-skilled and cheap workforce employed. Its abolishment by the end of 2009 led probably the employers to terminating such contracts. Part of the dismissed people probably joined the self-employed persons as number of entrepreneurs (some 17 % of all workers) rose by 1.7 % (*1.1 %*).

Supply of labour stagnated in the first quarter, YoY, when shrinkage of employment by 118 thousand people was nearly offset by growth of the unemployed by 120 thousand people. **Rate of economic activity** (15-64 years) thus stagnated at 69.6 %, YoY, as well as ratio of labour force to population of 15-64 years (70.7 %). Growth of participation thus was dampened due to

institutional components. Higher rate of economic activity given by growth of employment may be seen only after 2010.

Number of legally working foreign nationals fell by 9.6 % YoY in the first quarter and this tendency continued in April and May.

With regard to above-mentioned changes in employment, **rate of employment** (15-64 years) fell by 1.5 p.p. YoY to 64.1 %. Number of persons working in the secondary sector kept on falling considerably. The sector recorded reduction in employment by nearly 117 thousand which was more or less equal to the first-quarter shrinkage of workers in the entire economy, but in comparison with 2009 it was not dampened more considerably by growth in the number of persons employed in the tertiary sector.

With regard to development in employment lagging behind the economy's recovery, decline in employment of 1.4 % (*0.6 %*) is expected in 2010, i.e. shrinkage comparable with 2009. After vigorous dropout in the first quarter, very moderate QoQ growth should follow in the remaining part of the year (seasonally adjusted). In 2011 and 2012 we allow for less than one-percent growths, corresponding to weaker economic dynamics and gradual involvement of free capacities.

Unemployment

It was confirmed that **registered unemployment had peaked** in February 2010. Figures on the number of the unemployed on the seasonally adjusted data for the following three months indicate a **visible decline**. Optimism-generating faster turnover in flows continued, especially as regards growth in the number of job seekers placed and decline in the number of newly reported job seekers. On the other hand, unfavourable turn in development of the long-term unemployed was confirmed with their share in the registered unemployed rising to 26 % (even to 36 % under LFS). Nevertheless their number is still considerably lower than in periods of strong economic growth.

Internationally comparable unemployment rate under LFS reached 8.0 % (8.1 %) in the first quarter of 2010. Similarly as with rate of registered unemployment, LFS rate of unemployment is assumed to fall in the following quarters of 2010, reaching on average 7.6 % (7.9 %) for the entire year with further decline to 7.3 % (7.8 %) in 2011 and 6.8 % in 2012. Improving structural characteristics of labour market are the main cause of more optimistic outlook in the sphere of unemployment.

Wages

Contrary to 2009, the current YoY decline in wage bill is deeper compared to decline in nominal GDP. In the first quarter of 2010 it reached 2.2 %. Taking into account high rate of labour taxation, such development has considerably negative impact on the revenue side of the general government.

With abatement of structural changes (dismissals of less-paid employees and fall in sickness rate), a moderate growth of gross average wage was achieved by 2.2 %

(1.8 %) with 4.5 % shrinkage of employees, especially in industry and construction.

Unit labour costs fell by 2.6 % (1.3 %) i.e. at a double pace than expected. 3.5 % YoY increase in productivity and merely 0.8 % growth of average compensations to employees had favourable impact on the outcome. In the following period gradually accelerating growth of productivity and of unit compensations can be expected. With temperate development of wages and salaries in 2010, a moderate decline of unit labour costs (-0.8 %) can be obviously assumed, while in the following years growth is expected.

On the basis of previous-period data, first-quarter results, business-sector signals, and decisions and intents regarding public-sector salaries for the forthcoming period, a very moderate growth of average wages with gradual acceleration is expected in short-term outlook. Expiring of structural effects will probably lead to 2.4 % growth of gross average wage in 2010, 3.5 % in 2011 and 4.7 % in 2012.

Wage bill is assumed to show YoY decline in the first half of 2010 and grow by some 0.3 % (0.1 %) for the entire 2010. Together with ongoing recovery of the economy, it should grow by 3.8 % (4.3 %) in 2011. Wage bill development should again relate to nominal GDP development.

C.4 External relations

(Balance of payments definitions)

External imbalance, expressed by **ratio of current account (CA) balance to GDP**, reached -1.3 % (-0.8 %) and practically did not change compared to the same period of previous year. Worsening of balance of services, current transfers and balance of income was outweighed by improvement of trade balance.

Drop in demand during economic recession led to steep decline in volume of traded goods. After more than year of export markets slump⁶, reaching its trough in the

second quarter of 2009 (fall by 14.8 %), export markets grew by 3.8 % YoY (1.0 %) in the first quarter 2010. Since the third quarter of 2009 export performance, indicating share of the Czech goods in export markets, has been improving. It grew by 10.8 % YoY (12.0 %) in the first quarter. Such development resulted in an increase in real exports of goods by 15.0 % YoY (13.1 %). Pace of dropout in nominal export and import hit its trough during the first half of 2009 while in the first quarter of 2010 better results were achieved in YoY terms. In the first quarter ratio of trade balance to GDP improved by 2.8 p.p. in annual terms to 5.6 % (5.4 %).

With regard to assumed scenario, further slow growth of oil prices should lead to an increase in fuels balance

⁶ Weighted average of growth of goods import by seven most important trade partner countries (Germany, Slovakia, Poland, Austria, France, United Kingdom and Italy).

deficit (SITC 3) over 2010 and in 2011. Its ratio to GDP should be at some -3.7 % (-3.6 %) in 2010 and rise to -4.1 % (-4.0 %) in 2011.

Taking recovery of trade into account, growth of export markets by 6.6 % (3.5 %) is expected in 2010 with moderate slowdown to 5.5 % (5.2 %) in 2011. Export performance should grow, too.

Surplus of non-fuel part of the balance is expected to rise to 8.8 % of GDP (8.9 %) in 2010 and to 9.1 % of GDP (9.2 %) in 2011. With current growth of deficit of fuel part of the balance, trade balance surplus (in balance of payments definitions) should reach 7.0 % of GDP (6.2 %) and 6.9 % (6.2 %) in 2011. Effect of trade recovery and domestic demand restriction should outweigh higher prices of oil in 2010 at least.

Economic recession influenced foreign trade in services too. Pace of growth of revenues and expenditures on transport services and tourism started falling after long-term growth since mid-2008. These items have switched to decline gradually and surplus of **balance of services** started falling too. It was related especially with higher import of the so-called other services. Surplus of balance

of services worsened from 1.7 % of GDP to 0.1 % of GDP in the first quarter of 2010, YoY. Strong growth of expenditures in the item of other services is assumed to outweigh only moderate improvement of balance of transport and tourism with total balance of services running a deficit.

Balance-of-income deficit, including reinvested and repatriated profits of foreign investors, continues deepening. Volume of yields and costs of this part of the balance decreased with revenues falling more. Both estimate of reinvested profits abroad and interest yields were lower. On the liabilities side of balance of income, increase in estimate of reinvested profit in the CR had the strongest impact. Lowering of compensations to foreign employees had positive impact on balance-of-income development. For 2010 deficit of balance of income is estimated at -6.3 % of GDP (-6.2 %) and for 2011 at -7.3 % of GDP (-7.1 %).

Taking the above-mentioned into account, ratio of **current account** deficit to GDP is estimated to reach -0.1 % (*surplus of 0.4 %*) in 2010. The forecast for 2011 is -1.0 % of GDP (-0.5 %).

C.5 International Comparisons

Comparisons for the period to 2009 are based on Eurostat statistics. Since 2010, our own calculations are used on the basis of real exchange rates.

With use of purchasing power parity method, comparisons of economic output of individual countries within EU are made in PPS (purchasing power standards). PPS is an artificial currency unit expressing quantity of goods that can be bought on average for one euro on the EU 27 territory after exchange rate conversion for countries that use other currency unit than the euro. Under Eurostat data, purchasing power parity of the CR in 2009 was CZK/PPS 18.23 in comparison with EU27 or CZK/EUR 16.98 in comparison with EA12.

Due to economic recession, when adjusted by current **purchasing power parity**, tendency of economic convergence of the CR and other Central European countries (except for Poland, see chapter A.1) toward EA12 average has stopped. Some countries (Baltic states, Hungary, Slovenia), which have been hit by the crisis more than EA12 countries, even experienced decline in their relative economic level.

In 2009 GDP p.c. of the Czech Republic reached some 18 900 PPS, which corresponds to 74 % of EA12 economic output. Thanks to higher growth in the CR than in EA12, relative performance of the Czech economy should start growing again from 2010.

Alternative way of calculation by means of the current **exchange rate** takes into account a market assessment of the currency and ensuing differences in price levels. GDP of the CR p.c. then reaches some EUR 13 100 in 2009, which corresponds to 47 % of EA12 level. Compared with 2008 thus a decline appears given by correction of inappropriate appreciation of the exchange rate in 2008.

Comparative price level of GDP reached some 64 % of EA12 average in 2009. Depreciation of the real exchange rate is seen here in YoY decline by 3 p.p. Such movement helped increase price competitiveness and make overcoming of difficult situation easier. A major depreciation of the exchange rate was seen in Poland where decline of relative price level reached incredible approx. 10 p.p. and helped thus Poland avoid economic recession.

D Monitoring of other institutions' forecast

The Czech Ministry of Finance monitors macroeconomic forecasts of other institutions, engaged in forecasting of future developments of the Czech economy. Forecasts of 13 institutions are continuously monitored from open-access data sources. Of these, 8 institutions are domestic (CNB, Ministry of Labour and Social Affairs, domestic banks and investment companies) and others are foreign (European Commission, OECD, IMF etc.). The forecasts are summed up in the following table.

Sources of tables and graphs: own calculations.

Table D.1: Consensus Forecast

		June 2010			July 2010
		min.	max.	consensus	forecast MoF
Gross domestic product (2010)	%, const.pr.	0,9	2,7	1,6	1,6
Gross domestic product (2011)	%, const.pr.	1,8	3,0	2,4	2,3
Average inflation rate (2010)	%	1,4	2,6	1,7	1,6
Average inflation rate (2011)	%	1,3	2,5	2,0	2,5
Average monthly wage (2010)	%	2,0	3,0	2,4	2,4
Average monthly wage (2011)	%	3,2	4,3	3,9	3,5
Current account / GDP (2010)	%	-2,4	0,1	-0,9	-0,1
Current account / GDP (2011)	%	-3,1	1,0	-1,2	-1,0

Consensus forecasts of **GDP** growth for 2010 have hovered within 1-2 % for a time. Past year's MoF forecasts were mostly more conservative compared to other institutions forecasts, this year's forecasts differ to a minimum extent only.

Institutions assume on average that Czech GDP will increase by 1.6 % in 2010 and by 2.4 % in 2011. These estimates are nearly identical with MoF forecast.

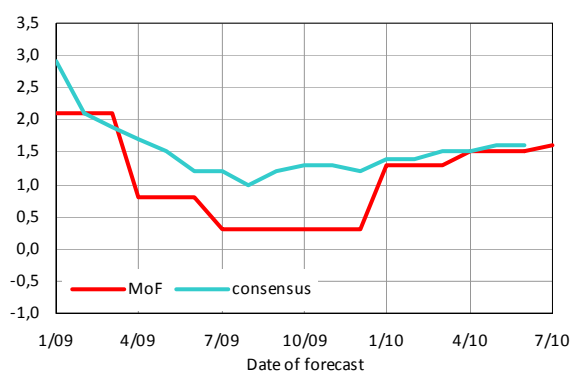
Current forecasts of **rate of inflation** for this year allow for average rate of inflation at some 1.7 % while for 2011 institutions expect acceleration of consumer price growth to 2.0 %. Under MoF forecast average rate of inflation should be higher by 0.5 p.p. in 2011.

For 2010 institutions expect further slowdown in growth of **average wage**. Consensus forecast allows for an increase in average wage by 2.4 % in 2010 and 3.9 % in the following year. MoF forecast is in accordance with this tendency.

Consensus forecasts of **ratio of current account of balance of payments to GDP** allow for deficit at about 1 % in this and next year, current account deficit should then remain at sustainable level. Contrary to average of other institutions' forecasts, the MoF expects nearly balanced current account this year.

Graph D.1: Forecast of Real GDP Growth for 2010

in %



Graph D.2: Forecast of Average Inflation Rate for 2010

in %

