A Forecast Assumptions

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

A.1 External Environment

In line with the previous forecast, the outlook remains varied and subject to considerable uncertainty. In the second half of this year, we expect a slight speedup in global economic growth. Its further strengthening, supported by accommodative monetary policies and an improvement in the situation on financial markets, should occur in 2014.

While the US recovery, which should accelerate next year thanks to rising private consumption, continues, economic growth in the EU is still restricted by the effects of the debt crisis, the burden of fiscal consolidation and the situation on credit markets. Thanks to fiscal and monetary stimuli and growth of prices on stock markets, the expected growth occurred in Japan after the fall in H2 2012. Its stability, however, depends on confidence in fiscal sustainability. The large developing economies are contributing positively to global growth. However, their outlook is differentiated as well. While maintaining China's high growth rate depends on its successful reorientation towards domestic consumption, growth in other countries is often hindered by structural problems.

USA

The US economy continues in recovery that should further strengthen in the next year, in particular thanks to an improvement in the labour market situation. The economy grew by 0.4% QoQ in Q1 2013 (*versus 0.5%*), in 2012 GDP increased by 2.2%. In the course of the year, growth was driven especially by household consumption, partially also by foreign investments.

Fiscal consolidation initiated in Q1 2013 does not contribute to growth positively, though the across-the--board spending cuts (the so-called sequestration), which resulted in uncertainty regarding the economic outlook, have so far had only a temporary impact on consumer confidence. Since April, therefore, consumer confidence has again been on the rise. In H1 2013, a slowdown in private investment growth was recorded due to expiring tax relief deadlines. However, we expect this slowdown to be also temporary. Tax hikes related to the public finance consolidation are offset by growth in the prices of real estate and other assets, which has a positive impact on household wealth. A favourable situation can still be observed on stock markets – the Dow Jones index is hovering above

14,000 points, thus achieving the record-breaking levels of 2007.

The economy remains supported by accommodative monetary policy of the Fed, which has now left interest rates unchanged (at "zero") for 3 full years. With the improving outlook, the discussion of the timing of exit from the quantitative easing programme is again becoming very relevant. Its premature termination could put the economic recovery at risk; on the other hand, any late reaction could result in considerable costs in the form of non-optimal capital allocation. The expansive monetary policy is facilitated by the persistently low inflation rate, as a consequence of the considerable decrease in energy prices; moreover, capacity surplus mitigates the pressure on future growth of prices and wages.

On the labour market, however, the situation has yet to improve. The unemployment rate has gone down over the last 12 months by 0.5 p.p. (in May it was 7.6%). However, such a decline was partially caused by part of the unemployed becoming non-active. On the other hand, authorities are registering a growth in the number of new jobs. Moreover, the number of notices of termination filed by employees is also increasing, as their prospects on the labour market improve.

We have slightly decreased the growth estimate for 2013 to 2.0% (*versus 2.1%*), though we still assume that growth will speed up in H2 2013. In 2014, GDP could increase by 2.9% (*versus 3.0%*). However, it is necessary to reach an agreement on the medium-term fiscal consolidation plan and to solve the unsustainable development of social expenses.

EU

In the euro zone, the decline in economic output continues. In Q1 2013, GDP of the EA12 decreased by 0.3% QoQ (*versus stagnation*), which represented a YoY drop of 1.2% (*versus 0.8%*). On a QoQ basis it was already the sixth consecutive fall in economic output.

Although the situation in individual EA12 countries differs considerably, the general cause of the ongoing recession seems to be the impact of sustained fiscal consolidation, weak consumer confidence and unfavourable conditions on credit markets. In many cases, growth is hindered by economies' structural problems and their low level of competitiveness. Poor

prospects lead to the postponement of consumption and investment of the private sector that would contribute to recovery.

The ECB is still trying to support economic recovery by keeping its interest rates low. However, it appears that even extremely accommodative monetary policy can't fully compensate for the impacts of massive fiscal consolidation. It might be necessary to take additional steps for improving the transmission of measures to the real economy.

Internal divergence in the euro zone can be fittingly illustrated by the unemployment rate, which in May 2013 rose to 12.1% in the EA12 (up by 0.9 p.p. YoY) and to 10.9% in the EU27 (up by 0.5 p.p. YoY). The highest unemployment was in Spain (26.9%), Greece (26.8%, in March), followed by Portugal (17.6%) and Cyprus (16.3%). In contrast, the unemployment rate in Germany decreased to 5.3%, confirming favourable development on the German labour market. On a YoY basis, the unemployment rate increased in 17 EU27 Member States and decreased in 10 EU27 Member States. High unemployment rates in the euro zone have unfavourable implications for household consumption, which considerably complicates government efforts to consolidate public finances.

Economic situation in the euro zone is expected to get better only slightly in H2 2013, when the pace of consolidation ought to slow down and private demand should strengthen due to an improvement in consumer sentiment and continuing stabilization in the banking sector. The short-term outlook for the euro zone is still associated with a high degree of uncertainty. We assume that GDP of the EA12 will decrease by 0.5% (*versus 0.4%*) this year and we expect to see it grow by 1.0% (*versus 0.6%*) in 2014.

We expect relatively favourable development in **Germany**. In Q1 2013, GDP increased by 0.1% QoQ (*versus 0.2%*). At the beginning of the year, exports recorded weak performance, construction slowed due to persisting wintry weather and industrial production stagnated. Nonetheless, expectations of firms indicate that the dip was only temporary. The Ifo index, which in June rose by 0.2 points to 105.9, implies that the business sector has positive expectations for H2 2013. Consumer confidence index increased by 0.3 points on the previous month to 6.8, which was the seventh consecutive increase in a row, and reached the highest level since September 2007.

After the recent fall, domestic investment is also stabilizing, in particular in the renewal of company equipment and facilities. Capacity-creating investments

will probably come only in the medium-term horizon. Low interest rates, rising wages and a favourable situation on the labour market should further positively influence the real estate market and private demand.

Expected improvement in the situation abroad and the high competitiveness of German companies indicate that growth could further accelerate during this year and in 2014. The development in the banking sector, where many institutions are going through the process of deleveraging, will be crucial. As the government's infrastructure investment decisions will be important, results of the autumn parliamentary elections will also be significant. We expect GDP to grow by 0.4% (*versus 0.5%*) this year, while for 2014 we forecast growth of 1.7% (*versus 1.6%*).

The situation in **France** is less favourable. In Q1 2013, GDP decreased by 0.2% QoQ (*versus stagnation*). The economy stagnated for the whole of 2012. Low consumer confidence, growing unemployment rate and the impacts of fiscal consolidation are among the main obstacles to the recovery of private consumption. Low confidence among entrepreneurs and structural problems are reflected in a decrease in investment by the residents and non-residents. This year, GDP could decline by a negligible 0.1% (*versus growth of 0.1%*), while in 2014 the economy could increase by 0.9% (*versus 1.0%*).

Graph A.1.1: **Growth of GDP in EA12**
QoQ growth in % (adjusted for seasonal and working day effects)
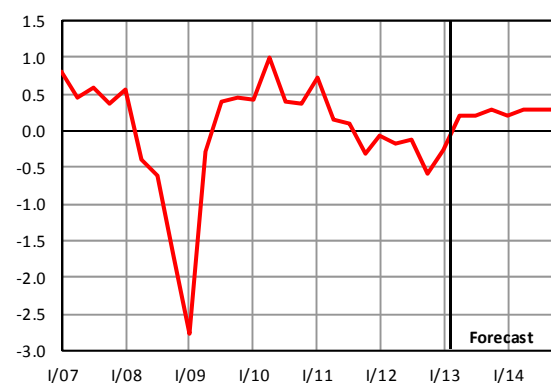
In **Poland**, economic growth slowed down markedly in 2012, with GDP growing by 1.9%. This development was caused by weak domestic demand, in particular private consumption, which is negatively influenced by a decrease in real wages and consumer confidence and a growth in the unemployment rate (it stood at 10.7% in May, which represented a YoY increase of 0.7 pp). As in other countries, continuing fiscal consolidation has a major impact on consumption and investment of the government sector. In its efforts to support growth, the

central bank again decreased the reference rate to a historical minimum of 2.75%; however, we do not expect this measure to have any major impact. We are reducing the growth estimate for 2013 to 1.1% (*versus 1.5%*) and for 2014 we are forecasting growth of 2.2% (*versus 2.4%*).

Slovakia continues to be strongly dependent on the external environment. Economic growth slowed down again, last year to 2.0%. For 2013, we expect a growth of exports in connection with a slight improvement in the situation of trading partners and with the opening of new production facilities in the previous year. However, domestic demand is restricted by fiscal consolidation and the labour market situation (jobless rate increased to 14.2% in May, which was up 0.4 p.p. YoY). We are reducing the growth estimate for 2013 to 1.1% (*versus 1.3%*), while in 2014 economic growth could accelerate to 2.5% (*versus 3.0%*).

Table A.1.1: **Comparison of GDP Forecasts**
up-to-date GDP forecasts of selected institutions, growth rates in %

|	2013				2014			
	MoF	EC	OECD	IMF	**MoF**	EC	OECD	IMF
EA12	**-0.5**	-0.4	-0.6	-0.3	**1.0**	1.2	1.1	1.1
Germany	**0.4**	0.4	0.4	0.6	**1.7**	1.8	1.9	1.5
Poland	**1.1**	1.1	0.9	1.3	**2.2**	2.2	2.2	2.2
Slovakia	**1.1**	1.0	0.8	1.4	**2.5**	2.8	2.0	2.7

Commodity prices

In 2012, the average daily price of Brent crude oil was 112 USD/barrel, historically the highest average price of crude oil (based on whole-year averages). Behind the high price of crude oil there was especially a rise in marginal costs of extraction and production outages resulting from geopolitical events in the Middle East and Africa. Due to overly optimistic expectations for global growth, the price of Brent crude oil averaged 112.9 USD/barrel in Q1 2013 (*versus 112 USD*). At the end of the quarter, however, the outlook for global growth and the demand for crude oil were revised and the market recorded a price correction.

We estimate that the price per barrel averaged 103 USD (*versus 109 USD*) in Q2. For the whole 2013 we predict that the price of crude oil will be 106 USD/barrel (*versus 108 USD*). The slight YoY decrease in price should be caused in particular by a slowdown in growth of the global demand for crude oil and a considerable increase in production capacities. This relates in particular to the USA, where investment in infrastructure is aimed at a more efficient use of the production of US deposits. The decrease in the price of Brent crude is also influenced

by substituting imports into the USA and Canada with American crude oil as the extraction in North America expands. We expect that this slow decrease in the crude oil price will also continue in 2014, when the average price could reach USD 101/barrel (*versus 102 USD*). In addition to the aforementioned factors, excess of supply over demand should continue to play a role.

Graph A.1.2: **Dollar Prices of Brent Crude Oil**
*in USD per barrel*
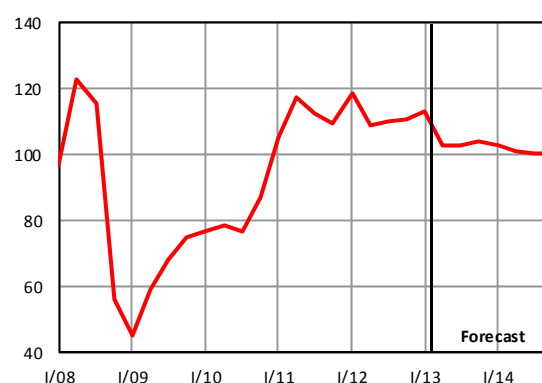
Debt crisis in the euro zone

The period since issuing the last Macroeconomic Forecast has not witnessed any important events that would have a significant impact – either positive or negative – on the course of the debt crisis in the euro zone.

Graph A.1.3: **Spreads over German Bonds**
The difference between yields of 10Y gov. bonds of the respective country and yields of 10Y German bonds, in p.p., monthly averages
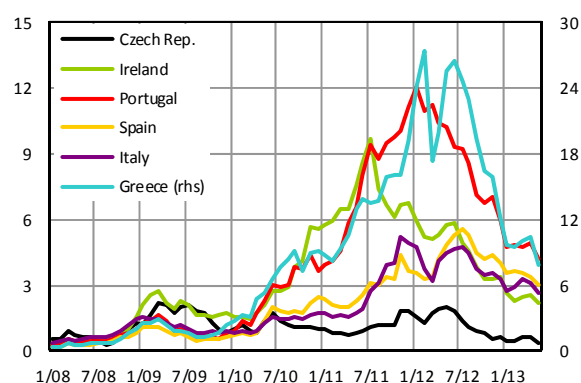
During May and June, the prices of a number of assets (e.g. government bonds, shares) tended to decrease. In the case of government bonds, however, the increase in yields was not restricted only to the problem countries on the euro zone periphery, but it also affected safe American and German government bonds. In the middle of June, the bearish mood on the market was boosted by comments from Mr Bernanke, the Fed Governor, who indicated the possibility of tapering the quantitative easing during the second half of this year. At the end of the month, however, the

situation on the market calmed slightly and the prices of assets started to rise once again.

As far as the euro zone periphery countries (Greece, Ireland, Portugal, Spain and Italy) are concerned, the relatively favourable (in particular compared to the previous year) situation on government bond markets stands in sharp contrast to development in the real economy. All these countries are in recession (according to current data, Ireland entered recession in Q3 2012) while suffering from high unemployment rates, with youth joblessness reaching extremely high levels. In Greece, Spain and Italy, high unemployment in the age group 15–24 has been prevalent for a long time. This fact, however, does not limit the extent of the problem as such or the importance of the negative effects that the current labour market situation will have on the long-term growth potential of these economies.

According to available indicators, economic situation in Cyprus is also quickly deteriorating. With respect to the size of the Cypriot economy, which only makes up 0.2% of GDP of the euro zone, and the minimal reaction of financial markets to the problems related to the negotiations over conditions of the bailout programme, which were experienced in March, the impact (either direct or indirect) of developments in Cyprus on the situation of other states of the EA (except for Greece) or the EU should be minimal.

Despite the relatively calm situation on financial markets, the risk that the debt crisis in the euro zone would escalate cannot be neglected entirely, especially since economic situation in the euro zone periphery countries continues to be very unfavourable. In addition, Q1 2013 GDP data highlights the risk of the recession spilling over from the euro zone periphery to its core. Should this risk materialise, the Czech Republic, as a small open economy with very strong business links to the EA countries, would experience a decrease in foreign demand for its exports, which would likely have knock-on effects on investment activity and household final consumption expenditure. However, highly resilient financial sector (see the Report on Financial Stability 2012/2013 published by the CNB on 18 June) and credible fiscal policy, reflected in low yields on government bonds, remain advantages for the Czech Republic.

Table A.1.2: **Real Gross Domestic Product** – yearly
growth in %, seasonally unadjusted data

	2005	2006	2007	2008	2009	2010	2011	2012	2013 Forecast	2014 Forecast
USA	3.1	2.7	1.9	-0.3	-3.1	2.4	1.8	2.2	2.0	2.9
China	11.3	12.7	14.2	9.6	9.2	10.4	9.1	7.9	7.9	8.1
EU27	2.2	3.4	3.2	0.4	-4.5	2.1	1.6	-0.4	-0.3	1.2
EA12	1.7	3.2	2.9	0.3	-4.4	2.0	1.5	-0.6	-0.5	1.0
Germany	0.7	3.7	3.3	1.1	-5.1	4.2	3.0	0.7	0.4	1.7
France	1.8	2.5	2.3	-0.1	-3.1	1.7	2.0	0.0	-0.1	0.9
United Kingdom	3.2	2.8	3.4	-0.8	-5.2	1.7	1.1	0.2	0.6	1.5
Austria	2.4	3.7	3.7	1.4	-3.8	2.1	2.7	0.8	0.6	1.6
Hungary	4.0	3.9	0.1	0.9	-6.8	1.3	1.6	-1.7	0.4	1.2
Poland	3.6	6.2	6.8	5.1	1.6	3.9	4.5	1.9	1.1	2.2
Slovakia	6.7	8.3	10.5	5.8	-4.9	4.4	3.2	2.0	1.1	2.5
Czech Republic	6.8	7.0	5.7	3.1	-4.5	2.5	1.8	-1.2	-1.5	0.8

Graph A.1.4: **Real Gross Domestic Product**

YoY growth in %, seasonally unadjusted data
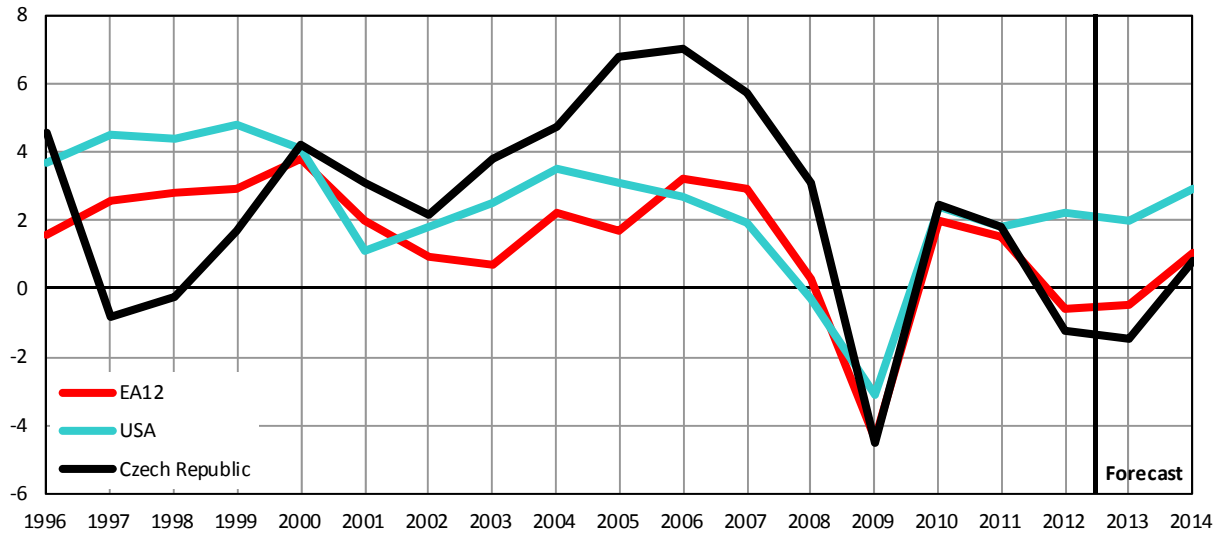
Table A.1.3: **Real Gross Domestic Product** – quarterly

growth in %, seasonally adjusted data

		2012				**2013**			
		Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2** *Estimate*	**Q3** *Forecast*	**Q4** *Forecast*
USA	QoQ	**0.5**	**0.3**	**0.8**	**0.1**	**0.4**	**0.6**	**0.7**	**0.8**
	YoY	2.4	2.1	2.6	1.7	1.6	1.9	1.8	2.6
China	QoQ	**1.6**	**1.9**	**2.1**	**2.0**	**1.6**	**1.9**	**2.0**	**2.0**
	YoY	8.3	7.8	7.6	7.9	7.8	7.8	7.7	7.7
EU27	QoQ	**0.0**	**-0.2**	**0.0**	**-0.5**	**-0.1**	**0.1**	**0.1**	**0.2**
	YoY	0.1	-0.3	-0.4	-0.7	-0.7	-0.5	-0.4	0.3
EA12	QoQ	**-0.1**	**-0.2**	**-0.1**	**-0.6**	**-0.3**	**0.2**	**0.2**	**0.3**
	YoY	-0.1	-0.5	-0.7	-0.9	-1.2	-0.8	-0.5	0.4
Germany	QoQ	**0.6**	**0.2**	**0.2**	**-0.7**	**0.1**	**0.4**	**0.6**	**0.5**
	YoY	1.3	1.0	0.9	0.3	-0.3	0.0	0.4	1.6
France	QoQ	**0.0**	**-0.2**	**0.1**	**-0.2**	**-0.2**	**0.1**	**0.2**	**0.2**
	YoY	0.3	0.1	0.0	-0.3	-0.4	-0.1	0.0	0.3
United Kingdom	QoQ	**0.0**	**-0.5**	**0.7**	**-0.2**	**0.3**	**0.1**	**0.2**	**0.2**
	YoY	0.6	0.0	0.1	0.0	0.3	0.9	0.3	0.8
Austria	QoQ	**0.5**	**0.1**	**0.0**	**-0.1**	**0.0**	**0.3**	**0.6**	**0.5**
	YoY	1.1	0.9	0.9	0.5	0.0	0.2	0.7	1.4
Hungary	QoQ	**-1.4**	**-0.6**	**0.0**	**-0.4**	**0.7**	**0.1**	**0.1**	**0.1**
	YoY	-1.3	-1.7	-1.8	-2.4	-0.3	0.4	0.6	1.0
Poland	QoQ	**0.3**	**0.1**	**0.3**	**0.0**	**0.1**	**0.5**	**0.5**	**0.6**
	YoY	3.5	2.2	1.7	0.7	0.5	0.9	1.2	1.7
Slovakia	QoQ	**0.4**	**0.3**	**0.2**	**0.1**	**0.2**	**0.4**	**0.5**	**0.4**
	YoY	2.9	2.3	1.9	1.0	0.8	1.0	1.2	1.6
Czech Republic	QoQ	**-0.5**	**-0.5**	**-0.3**	**-0.3**	**-1.3**	**0.0**	**0.4**	**0.4**
	YoY	-0.4	-1.1	-1.4	-1.6	-2.4	-1.9	-1.2	-0.5

Graph A.1.5: **Real Gross Domestic Product** – Central European economies
YoY growth in %, seasonally unadjusted data
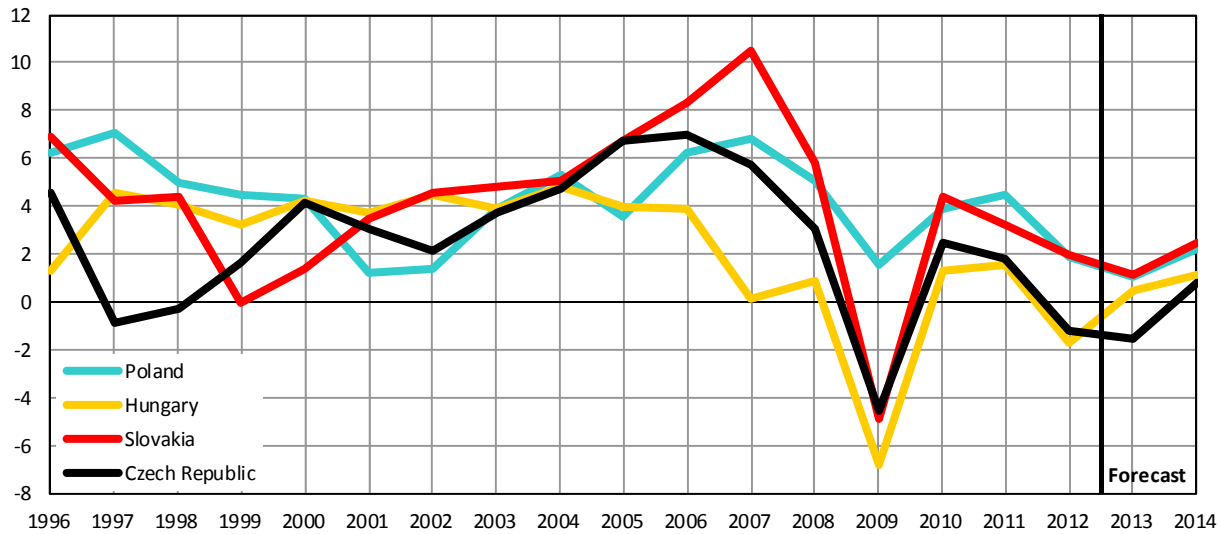
Graph A.1.6: **GDP in the Czech Republic and the neighbouring states**
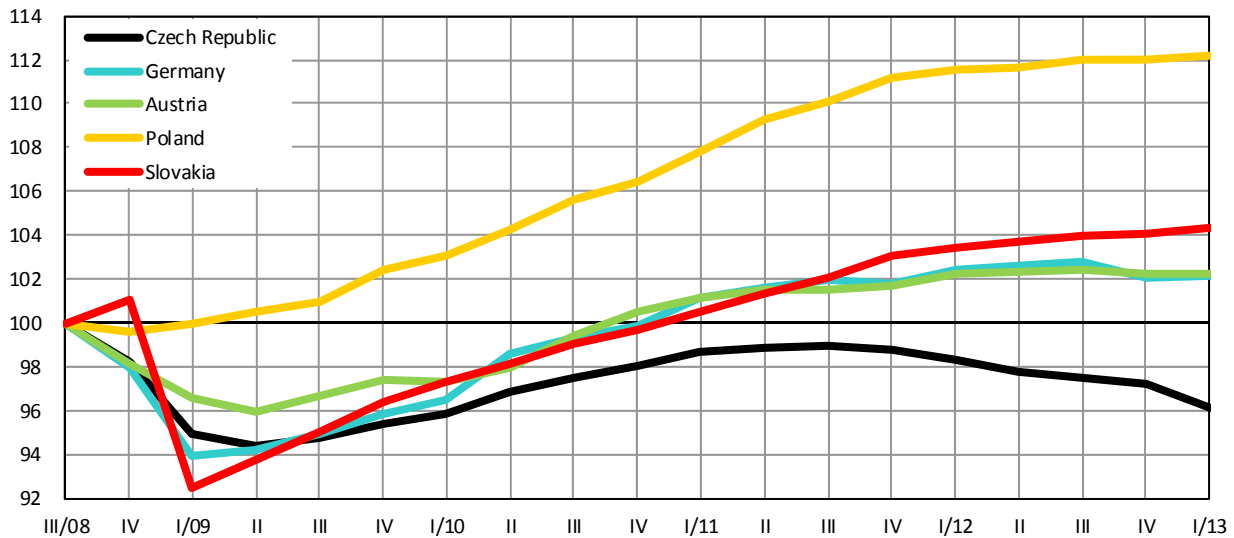*Q3 2008=100, seasonally adjusted data*

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

		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
										Forecast	*Forecast*
Crude oil Brent	*USD/barrel*	**54.4**	**65.4**	**72.7**	**97.7**	**61.9**	**79.6**	**111.0**	**112.0**	**106**	**101**
	growth in %	42.0	20.1	11.2	34.4	-36.7	28.7	39.3	0.9	-5.6	-4.5
Crude oil Brent index *(in CZK)*	*2005=100*	**100.0**	**113.3**	**113.3**	**127.9**	**90.5**	**116.7**	**150.6**	**168.2**	**160**	**154**
	growth in %	32.4	13.3	-0.1	12.9	-29.3	29.0	29.0	11.7	-4.8	-3.9
Wheat	*USD/t*	**152.4**	**191.7**	**255.2**	**326.0**	**223.6**	**223.7**	**316.2**	**313.3**	.	.
	growth in %	-2.8	25.8	33.1	27.7	-31.4	0.1	41.4	-0.9	.	.
Wheat price index *(in CZK)*	*2005=100*	**100.0**	**118.7**	**141.9**	**152.4**	**116.7**	**117.1**	**153.3**	**168.1**	.	.
	growth in %	-9.4	18.7	19.6	7.3	-23.4	0.3	30.9	9.7	.	.

Table A.1.5: **Prices of Commodities** – quarterly
spot prices

|		2012				2013			
		Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2** Estimate	**Q3** Forecast	**Q4** Forecast
Crude oil Brent	USD/barrel	**118.5**	**108.9**	**110.0**	**110.4**	**112.9**	**103**	**103**	**104**
	growth in %	13.0	-7.0	-2.2	1.0	-4.7	-5.4	-6.4	-5.8
Crude oil Brent index *(in CZK)*	2005=100	**173.6**	**164.5**	**169.0**	**164.1**	**167.4**	**157**	**157**	**158**
	growth in %	21.3	8.6	13.6	4.4	-3.6	-4.7	-7.3	-3.6
Wheat price	USD/t	**278.8**	**269.0**	**349.5**	**355.7**	**321.4**	.	.	.
	growth in %	-15.6	-20.6	10.7	27.2	15.3	.	.	.
Wheat price index *(in CZK)*	2005=100	**146.1**	**145.3**	**192.0**	**189.1**	**170.5**	.	.	.
	growth in %	-9.4	-7.4	28.7	31.5	16.7	.	.	.

Graph A.1.7: **Dollar Prices of Oil**
USD/barrel
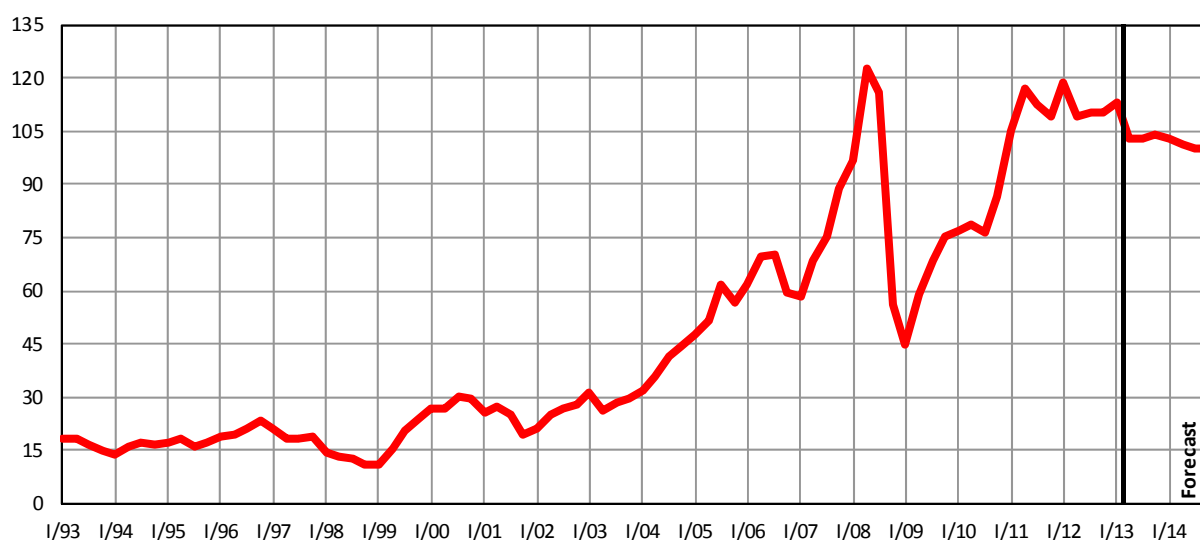
Graph A.1.8: **Koruna Indices of World Commodity Prices**
index 2005=100
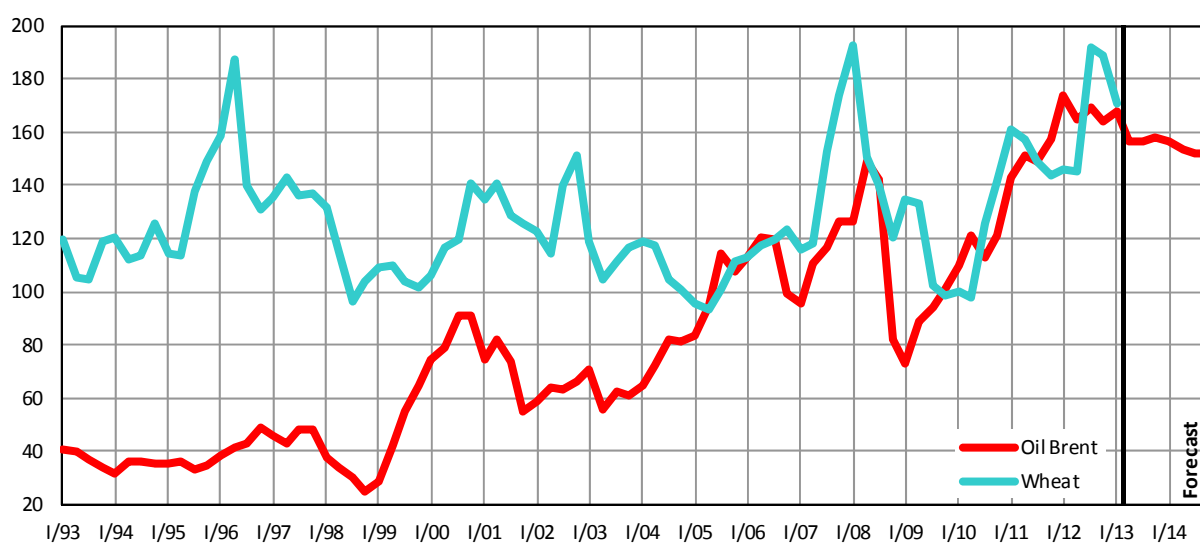
A.2 Fiscal Policy

Last year, the government sector balance ended up in deficit amounting to 4.4% of GDP. Compared to 2011, this was a marked deterioration; however, the result was influenced by two one-off measures (financial compensation to churches and non-refunded EU fund inflows) totalling CZK 71 billion. Had it been adjusted for these measures, the deficit would be 0.8 p.p. lower than in the previous year. In structural terms, the improvement in balance is slightly more pronounced, due to the considerably higher negative output gap in 2012. This development was supported by a number of discretionary changes (e.g. a hike in the reduced VAT rate by 4 pp) and austerity policy across sub-sectors and transactions. Last but not least, a drop in investment expenditure, which was partially caused by reduction in expenditure on projects co-financed by the EU (the impact on the balance only in the amount of national financing) and by a decline in nationally financed investment in the case of local budgets, also contributed to the result.

We expect the government sector deficit to decrease to 2.8% of GDP this year (compared to the last year's deficit adjusted for the aforementioned one-offs, it would mean a deterioration of 0.3 pp). A number of discretionary measures has a positive impact on the government sector balance, e.g. the increase in both VAT rates, changes in direct taxes and modification of the pension adjustment formula. Further deepening of the output gap (see Chapter B.1), on the other hand, has a negative impact on the balance, as it increases its cyclical component. Structural balance should improve by 0.4 p.p., while cyclically adjusted primary balance should be roughly zero.

Compared to the last Macroeconomic Forecast, the current macroeconomic scenario is considerably worse. Nonetheless, the April forecast for 2013 tax revenues was extremely conservative. Moreover, a change in GDP forecast does not have much important impact on the estimate of the revenue side of the government sector. The estimate for the current year draws on cash performance data of the state budget and other microeconomic data, which usually provide a better guide for forecasting the current year than macroeconomic tax bases.

Nevertheless, we have reduced our estimate of the 2013 tax revenues and social security contributions. On the other hand, a positive budget reserve can be seen in estimates of the impact of introducing the pension savings pillar, since the current loss in terms of funds in the public system is, contrary to expectations, fractional (until the end of June only just under 75,000 persons opted out from the public pillar). Basically, these two effects compensate for each other.

On the expenditure side, it is possible to expect somewhat greater pressure on the social system, in particular cash social assistance benefits. However, the original forecast envisaged a certain reserve which should cover the greater number of expected claims. Pension insurance benefits have been more or less developing in line with the original forecast from the Convergence Programme of the Czech Republic.

Current estimates for other revenue and expenditure items have not changed in essence from the estimates made in April. A gradual increase in investment expenditure is forecast, the growth of which will be partially financed from the EU funds.

At present, the risks of estimating the general government sector balance can be seen at several levels. Upside risks include additional income from the sale of emission allowances, which the forecast still does not take into account. Currently, the amount is estimated at approximately CZK 2 billion, but considering the marked price volatility and problems on the European allowances markets the result can only be predicted with great difficulty. Another upside risk is a possible sale of LTE licences to mobile operators. The sale is estimated to bring in 8–14 CZK billion; however, it is not completely clear whether the auction will take place by the end of this year.

On the other hand, there are negative risks as well. Should economic problems deepen, tax revenues could deteriorate. Another problem is a further correction of that part of the EU funds that should have originally been refunded. This year, however, it is expected to be considerably lower (approximately CZK 4 billion). Last year the corrections were related to large operational programmes, but money is mostly drawn again. The last risk is the extent of flood damage. At present, funds released from the state budget and state funds are primarily reallocations on the expenditure side.

General government debt-to-GDP ratio should increase only by 0.2 p.p., especially as a result of the reversal of the MoF's provision based on the revised financing strategy and state debt management in H2 2013.

Considering the ongoing work on the state budget and the drafting of budgets for state funds, as well as their medium-term outlooks, we are only publishing the forecast for 2013.

Graph A.2.1: **Decomposition of the government balance**
in % of GDP
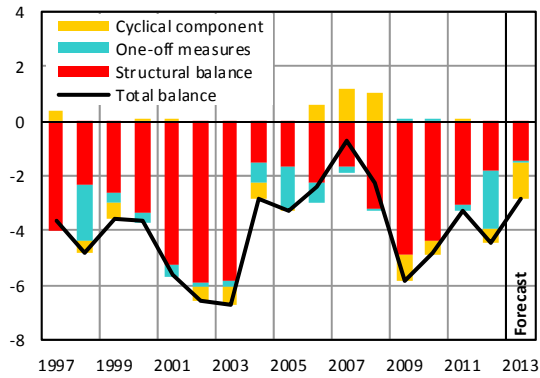
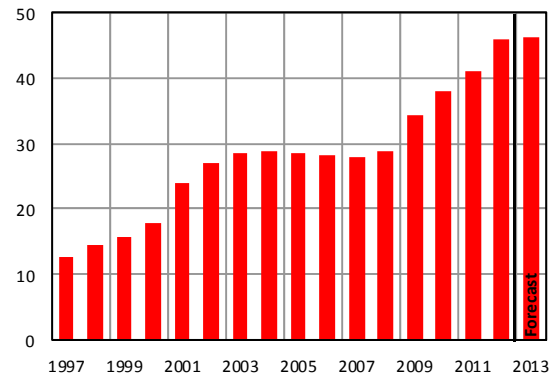Graph A.2.2: **Government Debt**
in % of GDP

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

		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
										Prelim.	*Forecast*
General government balance [1]	*% GDP*	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.3	-4.4	-2.8
Cyclical balance	*% GDP*	-0.6	-0.1	0.6	1.2	1.0	-1.0	-0.4	0.0	-0.5	-1.3
Cyclically adjusted balance	*% GDP*	-2.2	-3.2	-3.0	-1.9	-3.3	-4.8	-4.4	-3.3	-3.9	-1.5
One-off measures	*% GDP*	-0.7	-1.5	-0.7	-0.3	-0.1	0.0	0.0	-0.2	-2.1	-0.1
Structural balance	*% GDP*	-1.5	-1.6	-2.3	-1.6	-3.2	-4.9	-4.4	-3.1	-1.8	-1.5
Fiscal effort [2]	*percent. points*	4.3	-0.1	-0.6	0.6	-1.5	-1.7	0.5	1.3	1.3	0.4
Interest expenditure	*% GDP*	1.1	1.1	1.1	1.1	1.0	1.3	1.3	1.4	1.5	1.5
Primary balance	*% GDP*	-1.8	-2.2	-1.3	0.4	-1.2	-4.5	-3.5	-1.9	-2.9	-1.3
Cyclically adjusted primary balance	*% GDP*	-1.2	-2.1	-1.9	-0.8	-2.2	-3.6	-3.0	-1.9	-2.4	0.0
	% GDP	28.9	28.4	28.3	27.9	28.7	34.2	37.9	41.0	45.9	46.2
Change in debt-to-GDP ratio	*percent. points*	0.4	-0.5	-0.1	-0.3	0.8	5.5	3.7	3.1	4.9	0.2

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] *General government net lending (+)/borrowing (–) including interest derivatives.*

[2] *Change in structural balance.*

A.3 Monetary Policy and the Financial Sector

Monetary policy

The primary monetary policy instrument is the limit interest rate for **2W (two-week) repo operations**, which has been at a historic and technical low of 0.05% since November 2012. Given the economic outlook and development, we can expect it to remain at this level. At the end of Q2 2013, the **interest-rate spread** between the Czech Republic and the EMU deepened to –0.45 p.p., due to the cut in the ECB base rate, while relative to the US it remains at –0.20 to 0.05 pp.

Financial sector and interest rates

In Q2 2013, the **3M PRIBOR** interbank market rate averaged 0.5% (*consistent with the forecast*), where it should stay for the rest of the year. For the whole of this year, 3M PRIBOR should therefore average 0.5% (*unchanged*), just like in 2014 (*versus 0.6%*).

Uncertainty on the interbank market, measured by the spread between 2W or 3M PRIBOR and the 2W repo rate, remains stable between 0.40 and 0.45 pp.

From their currently extremely low levels, long-term interest rates should be increasing only very slightly during the following period. We expect that **yields to maturity of 10-year government bonds** will average 2.0% (*versus 2.2%*) this year and 2.2% (*versus 2.3%*) in 2014. Considering the fact that the Czech Republic's rating is at a good investment level (Standard & Poor´s AA–, Moody's A1, Fitch Ratings A+) with stable outlook, it is possible to expect further successful auctions of government bonds.

In April the CNB conducted another examination of credit terms and bank standards. The survey concluded that in Q1 2013, banks did not change credit standards for loans to non-financial corporations and consumer loans, while they relaxed those for housing loans. For Q2 2013, further tightening of credit standards for consumer loans and loans to firms had been expected, with a further relaxation of standards for housing loans.

The last stress tests of the banking sector, the results of which were published in the Report on Financial Stability 2012/2013 in June, highlighted Czech banks' continuing high resilience to even very negative and highly unlikely shocks.

In Q1 2013, interest rates on loans to non-financial corporations decreased QoQ by 0.1 p.p. to 3.3%, while interest rates on household loans fell by 0.1 p.p. to 6.2%. Rates on household deposits dropped by 0.1 p.p. to 1.1%, while rates on deposits of non-financial corporations stagnated at 0.5%. The slowdown in the growth rate of household indebtedness continues. Growth in total loans to households is driven exclusively by housing loans, while the volume of consumer loans is stagnating. Coupled with lower but still ongoing increase in deposits, the continuing slowdown in the growth of loans to non-financial corporations may imply mitigated investment activity.

The situation concerning non-performing loans (NPLs) remains stabilized. In Q1 2013 their share stood at 5.2% for households (up 0.2 p.p. YoY) and 7.4% for non-financial corporations (down 0.7 p.p. YoY). Given the unfavourable macroeconomic developments, we can assess this positively. On the other hand, it is necessary to bear in mind that the dynamics of NPLs lags behind economic development.

At the end of June 2013, the Prague Stock Exchange's PX index fell below 900 points, i.e. a comparable value against the same period of 2012.

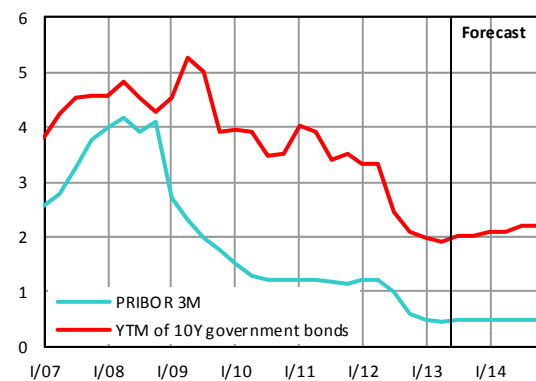Table A.3.1: **Interest Rates, Deposits and Loans** – yearly

		2005	2006	2007	2008	2009	2010	2011	2012	2013 Forecast	2014 Forecast
Repo 2W rate CNB (end of period)	in % p.a.	2.00	2.50	3.50	2.25	1.00	0.75	0.75	0.05	.	.
Main refinancing rate ECB (end of period)	in % p.a.	2.25	3.50	4.00	2.50	1.00	1.00	1.00	0.75	.	.
Federal funds rate (end of period)	in % p.a.	4.25	5.25	4.25	0.25	0.25	0.25	0.25	0.25	.	.
PRIBOR 3M	in % p.a.	2.01	2.30	3.09	4.04	2.19	1.31	1.19	1.00	0.5	0.5
YTM of 10Y government bonds	in % p.a.	3.51	3.78	4.28	4.55	4.67	3.71	3.71	2.80	2.0	2.2
Households – MFI (CR, unless stated otherwise)											
– interest rates on loans	in % p.a.	7.53	6.93	6.63	6.81	7.00	7.00	6.83	6.46	.	.
– loans	growth in %	32.6	32.1	31.7	28.9	16.3	8.7	6.5	4.9	.	.
– loans without housing loans	growth in %	28.6	28.3	27.3	25.3	19.1	8.3	6.8	1.4	.	.
– deposits	growth in %	5.2	7.3	10.6	9.4	10.5	5.4	5.0	4.7	.	.
– share of non-performing loans	in %	4.2	3.7	3.2	3.0	3.7	4.8	5.3	5.2	.	.
– loans to deposits ratio	in %	33	40	48	57	60	61	62	65	.	.
– loans to deposits ratio (Eurozone)	in %	94	99	99	94	89	90	90	87	.	.
Non-financial firms – MFI (CR, unless stated otherwise)											
– interest rates on loans	in % p.a.	4.27	4.29	4.85	5.59	4.58	4.10	3.93	3.69	.	.
– loans	growth in %	10.3	13.9	16.7	17.5	0.2	-6.5	3.3	2.5	.	.
– deposits	growth in %	4.5	10.9	13.2	5.3	-1.7	4.8	0.9	8.2	.	.
– share of non-performing loans	in %	5.7	4.5	3.8	3.6	6.2	8.6	8.5	7.7	.	.
– loans to deposits ratio	in %	113	117	120	134	137	123	126	122	.	.
– loans to deposits ratio (Eurozone)	in %	290	292	296	315	315	294	286	273	.	.

Table A.3.2: **Interest Rates, Deposits and Loans** – quarterly

		2012				2013			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3 Forecast	Q4 Forecast
Repo 2W rate CNB (end of period)	in % p.a.	0.75	0.50	0.50	0.05	0.05	0.05	.	.
Main refinancing rate ECB (end of period)	in % p.a.	1.00	1.00	0.75	0.75	0.75	0.50	.	.
Federal funds rate (end of period)	in % p.a.	0.25	0.25	0.25	0.25	0.25	0.25	.	.
PRIBOR 3M	in % p.a.	1.20	1.23	0.98	0.59	0.50	0.46	0.5	0.5
YTM of 10Y government bonds	in % p.a.	3.34	3.31	2.46	2.09	1.98	1.9	2.0	2.0
Households – MFI (CR, unless stated otherwise)									
– interest rates on loans	in % p.a.	6.59	6.51	6.42	6.31	6.21	.	.	.
– loans	growth in %	5.6	5.1	4.5	4.1	3.7	.	.	.
– loans without housing loans	growth in %	3.9	1.5	0.6	-0.3	-0.4	.	.	.
– deposits	growth in %	5.5	4.4	4.2	4.4	4.1	.	.	.
– share of non-performing loans	in %	5.0	5.2	5.2	5.2	5.2	.	.	.
– loans to deposits ratio	in %	64	64	65	65	64	.	.	.
– loans to deposits ratio (Eurozone)	in %	88	88	87	86	85	.	.	.
Non-financial firms – MFI (CR, unless stated otherwise)									
– interest rates on loans	in % p.a.	3.87	3.86	3.67	3.37	3.27	.	.	.
– loans	growth in %	4.1	1.9	2.0	1.9	2.3	.	.	.
– deposits	growth in %	7.8	11.6	8.3	5.2	4.8	.	.	.
– share of non-performing loans	in %	8.1	7.9	7.6	7.5	7.4	.	.	.
– loans to deposits ratio	in %	125	120	124	118	122	.	.	.
– loans to deposits ratio (Eurozone)	in %	282	280	274	257	257	.	.	.

Graph A.3.1: **Interest Rates**
in % p.a.

Forecast

- PRIBOR 3M
- YTM of 10Y government bonds

Graph A.3.2: **Loans**
YoY growth in %

- Households
- Non-financial corporations
- Households (excl. housing loans)
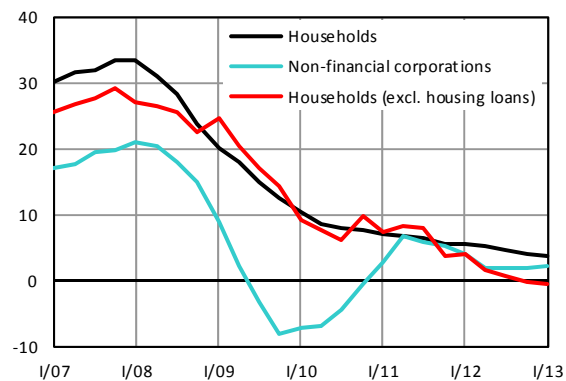
Graph A.3.3: **Deposits**
YoY growth in %

- Households
- Non-financial corporations
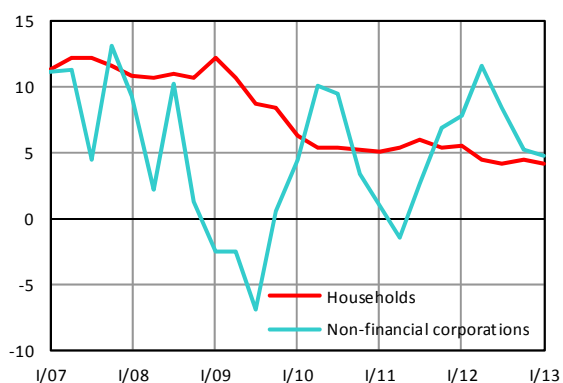
Graph A.3.4: **Non-performing Loans**
ratio of non-performing to total loans, in %

- Households
- Non-financial corporations
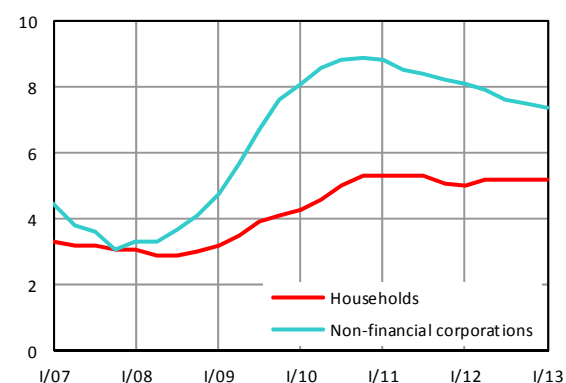
Graph A.3.5: **Loans to Deposits Ratio** – Households
in %

- Czech Republic
- Euro Area
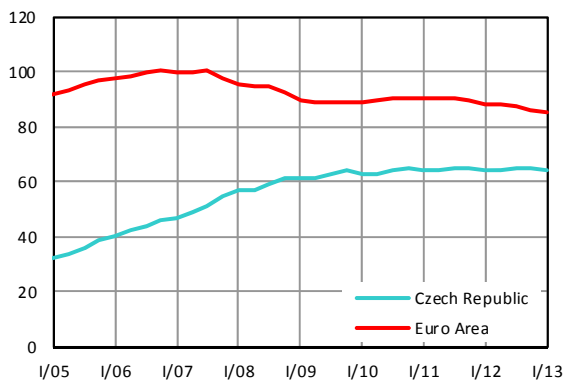
Graph A.3.6: **Loans to Deposits Ratio** – Firms
in %

- Czech Republic
- Euro Area
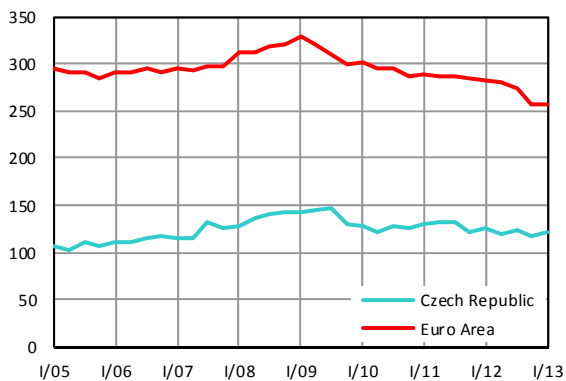
Graph A.3.7: **Ratio of Bank Loans to Households to GDP**
yearly moving sums, in %
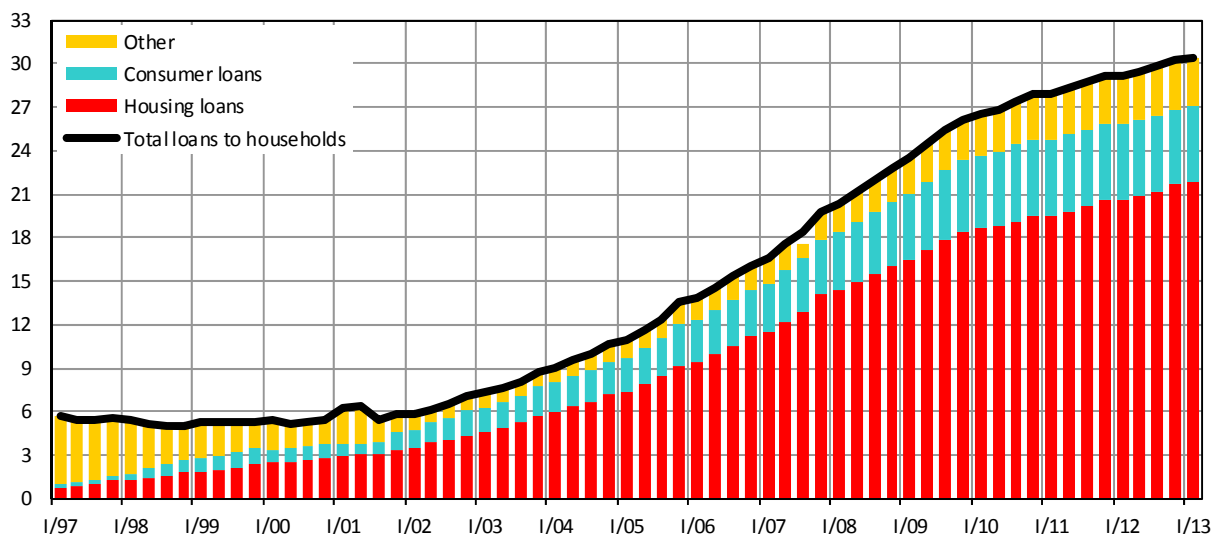
A.4 Exchange Rates

Weak growth of the Czech economy and a negative interest-rate differential towards the EMU resulted in the long-term appreciation of the CZK/EUR exchange rate coming to a halt in 2011. Having weakened in 2012 (on average by 2.2% YoY), the koruna depreciated further by 2.1% in H1 2013. Verbal interventions from the CNB aimed at easing monetary conditions also contributed to this development.

Considering the absence of appreciation pressures on the CZK/EUR exchange rate, we have decided to accept a technical assumption that the exchange rate remains stable at the level prevailing on average in H1 2013 (25.8 CZK/EUR) in both the forecast and the outlook horizon. If the debt crisis in the euro zone escalates, however, considerable movement in either direction cannot be excluded.

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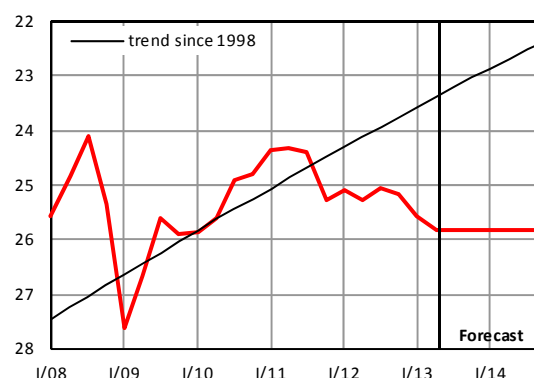*quarterly averages*

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

		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
								Forecast	*Forecast*	*Outlook*	*Outlook*
Nominal exchange rates:											
CZK / EUR	*average*	27.76	24.96	26.45	25.29	24.59	25.14	**25.8**	**25.8**	**25.8**	**25.8**
	appreciation in %	2.1	11.3	-5.6	4.6	2.8	-2.2	-2.4	-0.3	0.0	0.0
CZK / USD	*average*	20.31	17.06	19.06	19.11	17.69	19.59	**19.7**	**19.9**	**19.9**	**19.9**
	appreciation in %	11.3	19.0	-10.5	-0.3	8.0	-9.7	-0.8	-0.6	0.0	0.0
NEER	*average of 2010=100*	90.6	101.2	98.0	100.0	103.1	99.5	**98**	**97**	**97**	**97**
	appreciation in %	2.7	11.7	-3.2	2.1	3.1	-3.5	-1.9	-0.3	0.0	0.0
Real exchange rate to EA12[1]	*average of 2010=100*	92.0	102.5	97.9	100.0	100.7	98.6	**96**	**94**	**94**	**93**
	appreciation in %	3.1	11.3	-4.4	2.1	0.7	-2.1	-3.1	-1.2	-0.6	-0.8
REER	*average of 2010=100*	88.7	102.2	98.1	100.0	102.4	100.1	**.**	**.**	**.**	**.**
(Eurostat, CPI deflated, 36 countries)	*appreciation in %*	2.9	15.1	-4.0	2.0	2.4	-2.3	.	.	.	.

[1] *Deflated by GDP deflators.*

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

|		2012				2013			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
							Estimate	Forecast	Forecast
Nominal exchange rates:									
CZK / EUR	average	25.08	25.26	25.07	25.17	25.57	25.8	25.8	25.8
	appreciation in %	-2.8	-3.7	-2.7	0.4	-1.9	-2.2	-3.0	-2.6
CZK / USD	average	19.14	19.73	20.07	19.42	19.37	19.9	19.9	19.9
	appreciation in %	-6.9	-14.3	-13.9	-3.3	-1.2	-0.7	1.0	-2.3
NEER	average of 2010=100	100.2	99.2	99.3	99.2	98.4	97	97	97
	appreciation in %	-3.2	-4.8	-4.5	-1.3	-1.7	-2.0	-2.0	-2.0
Real exchange rate to EA12 [1]	average of 2010=100	98.5	98.3	98.7	98.8	96.4	95	95	96
	appreciation in %	-2.0	-3.2	-2.8	-0.2	-2.2	-3.1	-4.0	-3.2
REER	average of 2010=100	101.4	99.9	99.7	99.3	.	.	.	.
(Eurostat, CPI deflated, 36 countries)	appreciation in %	-1.7	-3.3	-3.5	-0.5	.	.	.	.

[1] Deflated by GDP deflators.

Graph A.4.2: **Nominal Exchange Rates**
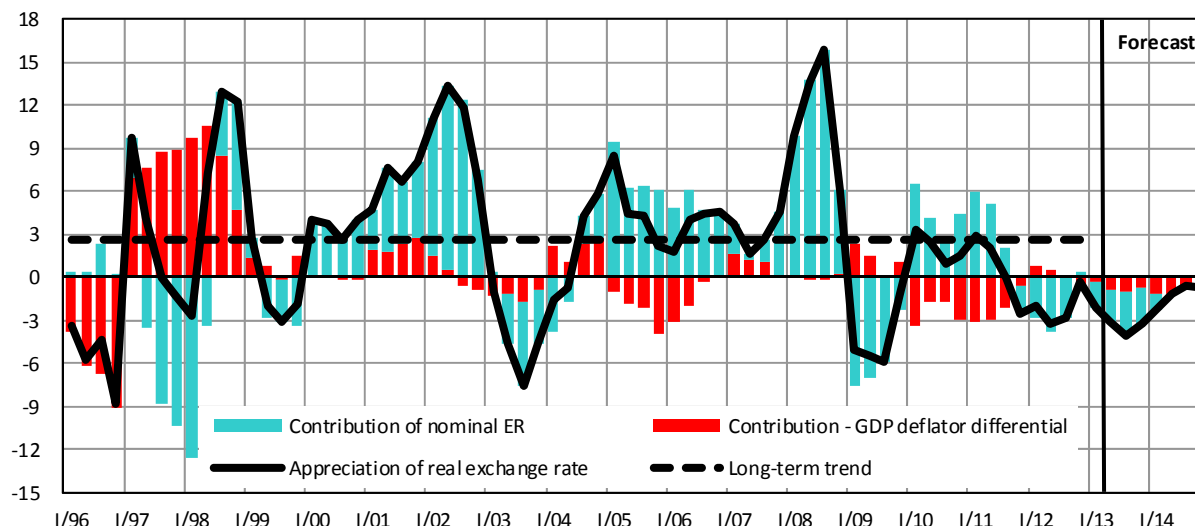*quarterly average, average 2010=100 (rhs)*
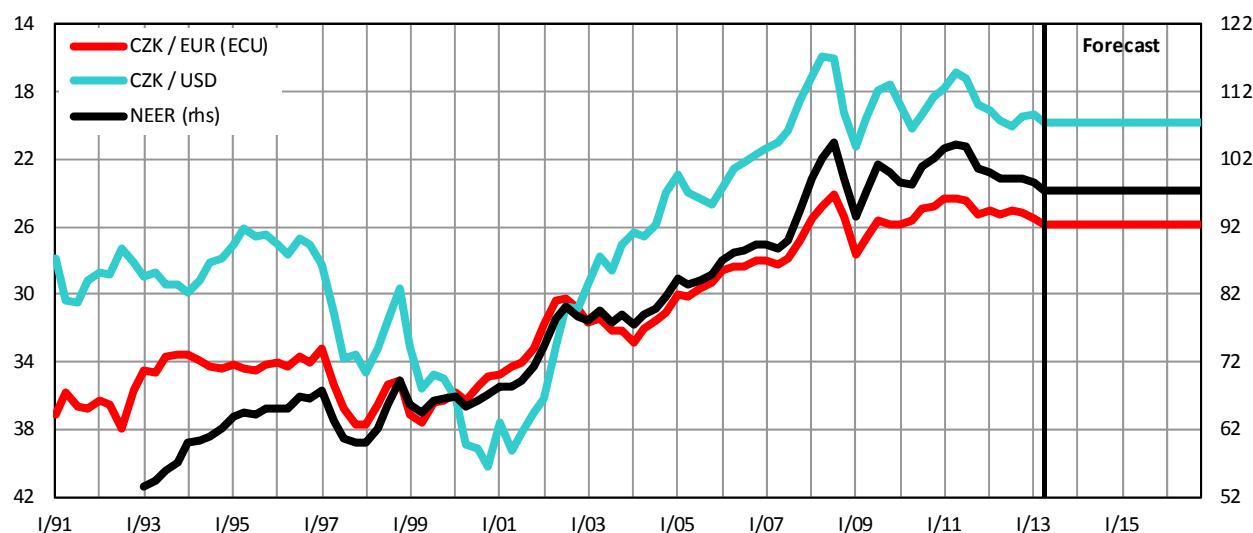
Graph A.4.3: **Real Exchange Rate to EA12**
quarterly average, deflated by GDP deflators, average 2010=100
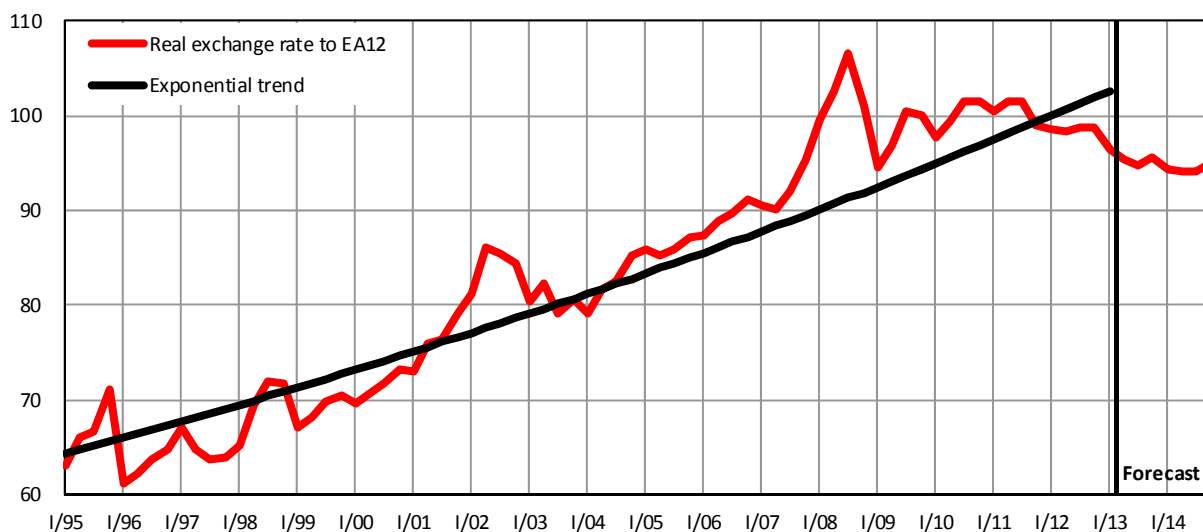
Graph A.4.4: **Real Exchange Rate to EA12**
deflated by GDP deflators, YoY growth in %, contributions in percentage points

A.5 Structural Policies

Business environment

On 1 July 2013, an **amendment to the Commercial Code** came into effect which should result in improving payment morale and reducing company cross default. Although the basic maturity period of invoices has been set at 30 days, this time-limit can be extended upon agreement up to 60 days. In the case of goods or services delivered to a public contractor, the extension up to 60 days is maximal, and must be justified by the nature of the obligation. For other business relations, the time-limit can also be extended over 60 days unless it is grossly unfair towards the creditor. Further, the amendment defines the rate of default interest in the amount of at least eight percentage points above the CNB's reference rate.

On 18 July 2013, the President signed an **amendment to the Act on Export Insurance and Financing with State Aid**. According to the amendment, the aim of which is to support exports, commercial banks will be allowed to grant loans to Czech exporters with interest rates fixed throughout the period of their use and repayment. If the interest rate on the interbank market increases during this period, the difference will be paid by the state to the bank. If the interest rate decreases, the difference will be returned by the banks to the state. The loan rate will be fixed based on the CIRR rate published by the OECD, which is considered to be the minimal rate that is not representing prohibited public support to private entities.

Taxes

Due to a comprehensive change in private law, on 17 April 2013 the government passed a bill on **a change in tax laws in connection with private substantive law recodification**. The act introduces a number of terminological and factual changes, as well as necessary changes in connection with establishing the Single Collection Point, the full launch of which is expected on 1 January 2015.

Major changes include the exemption of dividends and all shares in profit for natural and legal entities paid out between local payers and payers from the EU countries, Switzerland, Norway and Iceland, and extending the time-limit for the exemption of income of natural entities from the sale of securities from 6 months to 3 years, while an annual limit of CZK 100,000 will be introduced for the exemption of income from the sale of securities that are not part of a business property.

The limit for the exemption of income from occasional activities or the occasional lease of movable assets will be increased from CZK 20,000 to CZK 30,000. Income not subject to public insurance premiums (agreements on work performance) will form a separate taxable amount collected by withdrawal at a special rate, while the limit of monthly income will be increased from CZK 5,000 to CZK 10,000.

The maximum limit for the deduction of gifts for public benefit purposes will be increased to 15% for natural entities and unified at 10% for legal entities. Deduction from the tax base will also be allowed for the

acquisition of research and development results from research organizations. In order to support exports, the possibilities for including the value of outstanding receivables in tax costs will be extended, up to the amount of received insurance payments. The act is scheduled to come into effect from 1 January 2014.

In connection with the comprehensive change in private law, on 17 April 2013 the government also passed the **bill on immovable acquisition tax** that should result in reducing the administrative burden of tax payers and the state. The act cancels the Act on Inheritance Tax, Gift Tax and Real Estate Transfer Tax, while preserving the taxation of paid real estate transfers in the form of taxation of the acquisition of immovable property. In contrast to the current legislation, the person of tax payer will be unified into the person of the acquirer, while the institute of guarantor for the purposes of this tax will be cancelled. The act will also decrease the number of cases in which submission of an expert opinion is obligatory according to valuation regulations on the ascertained prices of immovables, and will generally restrict the amount of written materials payers will be obliged to attach to their tax returns. The act should come into effect from 1 January 2014.

Financial markets

On 19 July 2013, the President signed an **amendment to the Act on Investment Companies and Investment Funds**. This should help make conducting business activities on the Czech capital market more attractive. The main changes include extending the group of admissible legal forms for investment funds, and introducing separate regulation of the manager's and administrator's duties. The manager will perform its own portfolio management and related risk management, while the administrator deals only with administrative activities related to investment fund management.

On 30 June 2013, the **Act on Increasing Transparency of Joint-Stock Companies** came into effect, restricting

anonymous ownership of bearer shares. This Act imposes on joint-stock companies with bearer certificated shares the obligation to choose from various means of transforming bearer certificated shares, i.e. physical custody at banks, book entry with the central banker or changing to registered shares. For the purposes of paying out dividends, shareholders holding registered certificated shares will be obliged to open an account with a banking institution, not only to verify the identification of shareholders carried out by the company, but also to monitor the flow of dividends and other monetary payments credited to the given shareholder.

The **amendment to the Act on Savings and Loan Cooperatives** passed by the government on 29 May 2013 tightens up the conditions for cooperative savings banks. From 2017, the balance sheet total will be limited to CZK 5 billion for cooperative savings banks. Upon reaching this total cooperative savings banks are either transformed into banks or will be able to continue their activities but without the possibility of any further growth. The amendment also increases the contributions of savings banks in their risk funds and the Deposit Insurance Fund. The amendment is scheduled to come into effect from 1 January 2014.

Labour Market

On 31 May 2013, the President of the Czech Republic signed an **amendment to the Employment Act,** which should contribute to liberalizing fixed-term employment contracts. In the case of serious operational reasons or because of the special nature of the work (culture or seasonality in agriculture and construction), the amendment will allow repeated fixed-term employment without any limitation, i.e. the period of 3 years will not have to be met from the termination of the previous fixed-term employment relationship. For persons older than 18 years, the amendment also shortens the entitlement to rest between shifts from 12 to 11 hours. The amendment will come into effect on 1 August 2013.

A.6 Demographic Trends

At the beginning of April 2013, 10,513 million people lived in the Czech Republic. Compared to the beginning of the year, the number of inhabitants decreased by three thousand, and this was thus the first recorded decrease since Q1 2004 (the decrease in the number of inhabitants in 2011 was attributable to the census difference). The decrease was caused by a combination of negative natural increase (amid YoY decline in the birth rate) and zero net migration. The ongoing economic recession is clearly markedly reducing the attractiveness of the Czech Republic as a target country for migrants.
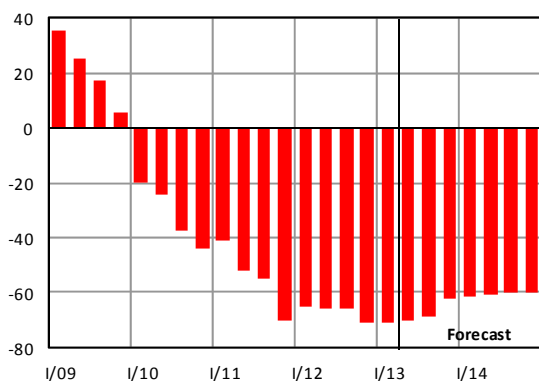
Graph A.6.1: **Groups by Age**
structure in per cent
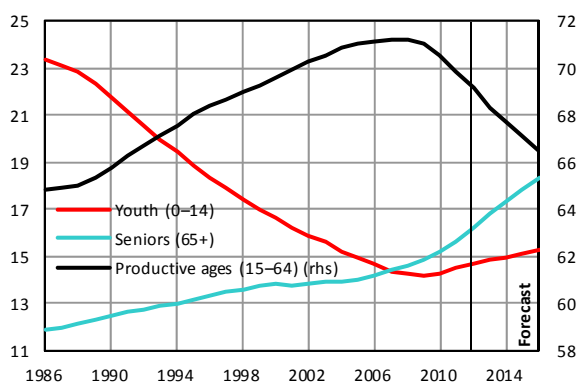
Graph A.6.2: **Czech Population Aged 15–64**
*YoY increases of quarterly averages, in thousands*

In terms of age structure, the share of the population aged 15-64 has been sharply decreasing since 2008 and is likely to decline further (see Graph A.6.1). Persons born at the end of the 1990s, when the birth rate was very low, are exceeding the lower age limit of this group, while the population-strong generation born after the WWII is gradually being classified as senior citizens. In absolute terms, the working-age population is decreasing by nearly 70 thousand people a year (see Graph A.6.2), or by 1.0% in relative terms. Economic impacts of this situation are described in more detail in Chapter B.1.

In contrast, the structural proportion of persons over 64 years in the total population reached 16.2% at the beginning of 2012, and according to the low variant of the CZSO's Demographic Projection, this should increase to more than 20% by 2020. Both the number and the share of seniors in the population are significantly rising due to the demographic structure and further continuation of the intensive process of increasing life expectancy.

Graph A.6.3: **Life Expectancy**
in years
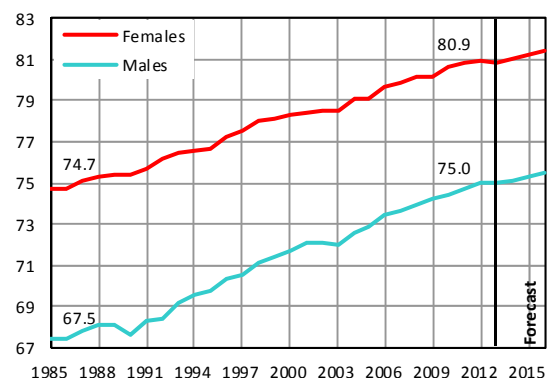
In Q1 2013, as in 2012, the recorded number of old-age pensioners stagnated. However, we assume that this was a one-off occurrence compensating for the unprecedented increase in 2011 (see Graph A.6.5), when potential future pensioners optimized the opportunity to retire during a period when rules for determining pension payments were changed.

The number of pensioners with reduced pensions after early retirement continues to rise, while the number of pensioners entitled to full pension has been decreasing YoY since Q2 2012.

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

	2007	2008	2009	2010	2011	2012	2013 Forecast	2014 Forecast	2015 Outlook	2016 Outlook
Population (January 1)	**10 287**	**10 381**	**10 468**	**10 507**	**10 487**	**10 505**	**10 516**	**10 524**	**10 532**	**10 539**
growth in %	0.4	0.9	0.8	0.4	-0.2	0.2	0.1	0.1	0.1	0.1
Age structure (January 1):										
(0–14)	**1 480**	**1 477**	**1 480**	**1 494**	**1 522**	**1 541**	**1 560**	**1 576**	**1 592**	**1 608**
growth in %	-1.5	-0.2	0.2	1.0	1.8	1.3	1.2	1.0	1.0	1.0
(15–64)	**7 325**	**7 391**	**7 431**	**7 414**	**7 328**	**7 263**	**7 188**	**7 126**	**7 066**	**7 001**
growth in %	0.4	0.9	0.5	-0.2	-1.2	-0.9	-1.0	-0.9	-0.8	-0.9
(65 and more)	**1 482**	**1 513**	**1 556**	**1 599**	**1 637**	**1 701**	**1 768**	**1 821**	**1 874**	**1 929**
growth in %	1.8	2.1	2.9	2.7	2.4	3.9	3.9	3.0	2.9	3.0
Old-age pensioners (January 1)[1]	**2 024**	**2 061**	**2 102**	**2 147**	**2260**	**2340**	**2341**	**2 351**	**2 383**	**2 409**
growth in %	2.0	1.8	2.0	2.1	.	3.5	0.1	0.4	1.3	1.1
Old-age dependency ratios (January 1, in %):										
Demographic [2]	**20.2**	**20.5**	**20.9**	**21.6**	**22.3**	**23.4**	**24.6**	**25.6**	**26.5**	**27.6**
Under current legislation [3]	**35.8**	**35.9**	**36.1**	**36.6**	**37.4**	**37.8**	**38.3**	**38.6**	**39.2**	**39.8**
Effective [4]	**41.6**	**41.5**	**41.8**	**43.6**	**45.9**	**47.9**	**47.6**	**47.8**	**48.4**	**49.0**
Fertility rate	**1.438**	**1.497**	**1.492**	**1.493**	**1.427**	**1.45**	**1.49**	**1.50**	**1.50**	**1.51**
Population increase	**94**	**86**	**39**	**-20**	**19**	**11**	**8**	**9**	**6**	**4**
Natural increase	**10**	**15**	**11**	**10**	**2**	**0**	**1**	**-1**	**-4**	**-6**
Live births	**115**	**120**	**118**	**117**	**109**	**109**	**110**	**108**	**106**	**104**
Deaths	**105**	**105**	**107**	**107**	**107**	**108**	**109**	**109**	**110**	**110**
Net migration	**84**	**72**	**28**	**16**	**17**	**10**	**7**	**10**	**10**	**10**
Immigration	**104**	**78**	**40**	**31**	**23**	**30**	**.**	**.**	**.**	**.**
Emigration	**21**	**6**	**12**	**15**	**6**	**20**	**.**	**.**	**.**	**.**
Census difference	**x**	**x**	**x**	**-46**	**x**	**x**	**x**	**x**	**x**	**x**

[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.*
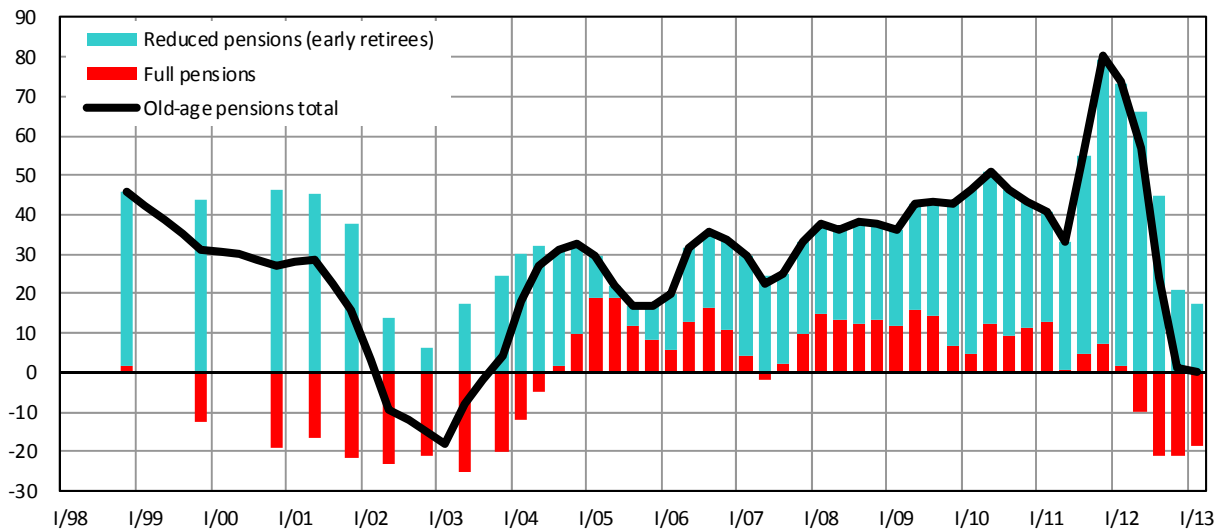
Graph A.6.4: **Dependency Ratios**

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
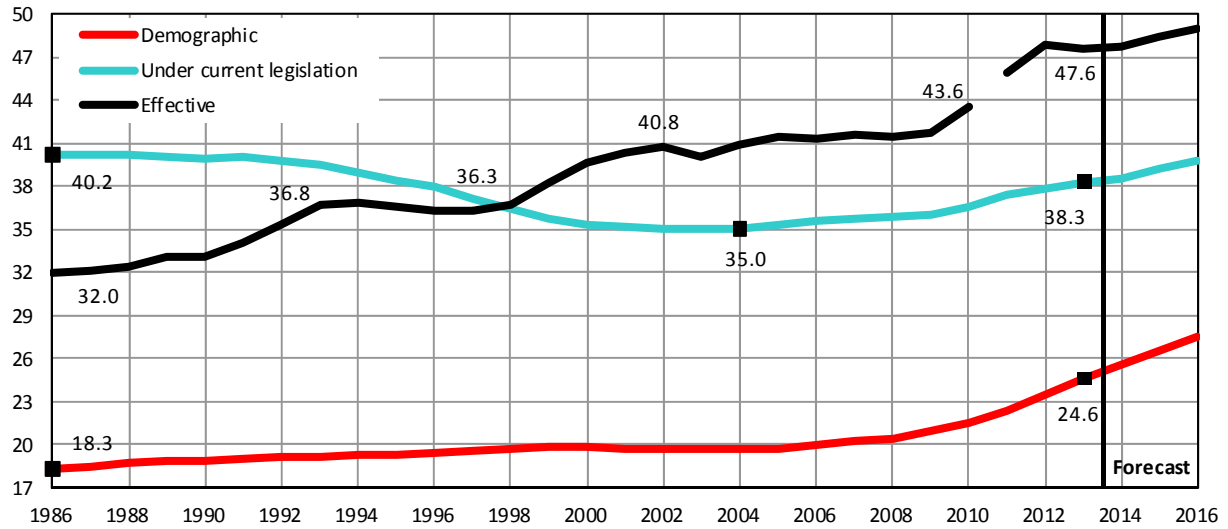
Graph A.6.5: **Old-Age Pensioners**

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.