Risks to the Forecast

The central scenario of this Macroeconomic Forecast envisages a YoY decline in real GDP of 1.5% in 2013. After the shocking QoQ fall of 1.3% in Q1 2013, we assume the economy stagnated in Q2 2013 and expect there will be a slight recovery in the forecast horizon. **The risks of such development are still slightly tilted to the downside**.

The assumptions of the central scenario **regarding the external environment** have changed only slightly. Of the risks involved in these assumptions, we stress in particular the economic ones.

The most important **economic risk** related to the external environment is, in our view, the threat of the recession being experienced in the south of the euro zone spilling over to the countries of the Czech Republic's main trading partners. According to the data for Q1 2013, it seems that Germany and Austria, unlike France, have narrowly escaped recession; however, growth in Slovakia and Poland has decelerated sharply.

Future development is extraordinarily unclear. For now, the widely expected recovery for H2 2013 (see e.g. the Spring Forecast of the EC) is supported by business cycle indicators only partially. Therefore, we assume that negative risks slightly exceed the positive ones.

Even though the Czech economy's direct exposure to the problem states in the southern part of the euro zone, except for Italy, is very small (see Box C.1), one cannot, on the grounds of the economies' deep mutual interconnectedness, abstract from their still worsening economic situation. Greece is in depression, while recession in Cyprus, Portugal, Italy and Spain is further deepening. Pronounced downturn of these economies, accompanied by unemployment growth and negligible prospects for any imminent improvement in economic situation, exacerbates **political and social risks**.

Despite austere fiscal policy, these countries have not managed to bring their **government sector debt** down. According to the European Commission's Spring Forecast, gross government sector debt in Greece is expected to increase from 157% to 175% of GDP by the end of this year, in Italy from 127% to 131% of GDP, in Cyprus from 86% to 110% of GDP and in Spain from 84% to 91% of GDP. Only in Portugal is it expected to stagnate at 123% of GDP.

In spite of this data, however, we do not consider **short-term risks related to the debt crisis in the euro zone especially serious**. Relative calm on financial markets is supported by the ECB (owing to its promise of conditional interventions on government bond markets) and by the launch of the ESM. In the long run, however, much will depend on whether the increase in government sector debt is halted and whether the banking sector problems in some countries are resolved. Unfortunately, an escalation of tension on financial markets caused by an unpredictable negative event cannot still be excluded.

As far as internal risks are concerned, the central scenario of the forecast assumes a decline in domestic demand in 2013, with a very slight recovery in 2014. **Internal economic risks also remain tilted to the downside**.

Confidence in future economic development remains very low, though the June business cycle survey results imply the chance of improvement among consumers, and to a lesser extent in industry.

However, "hard" data tend to confirm consumers' cautious behaviour. The situation is also similar for the business sector, which is putting off many investment decisions for this reason. The confidence factor is probably the main explanation for the "freeze" in domestic demand in the Czech economy.

The economic impact of the June 2013 **floods** should not be significant; however, a decrease in net national wealth in the amount of the damage caused cannot be denied. On the supply side, production outages in Q2 2013 were probably negligible since few production capacities were damaged by the floods. However, flood damage repairs could in H2 2013 bring a positive demand impulse in the maximum amount of 0.2% of GDP.

A new negative risk is the risk resulting from the current political instability.