



Ministry of Finance

CZECH REPUBLIC

Financial Policy Department

Macroeconomic Forecast of the Czech Republic in a Nutshell

July 2014

Macroeconomic Forecast

Structure of the presentation

Forecast Assumptions

- risks of the forecast
- external environment
- fiscal policy
- monetary policy, the financial sector and foreign exchange rates
- structural reforms

Economic Cycle

Forecast of Macroeconomic Indicators

- economic output
- inflation
- labour market
- external relations
- international comparisons



Forecast Assumptions

Risks of the forecast

- we regard the scenario risks as roughly balanced
- situation in the troubled countries on the periphery of the euro area has been gradually calming down further, however, important fundamental factors remain unfavourable
- the possibility of a stronger recovery in development economies represents a positive risk
- positive developments of the Czech economy in the Q1 2014 were, for the large part, due to one-off or temporary factors, therefore further recovery of the economy will be rather gradual
- as far as private consumption is concerned, the question remains to what extent will the increase in consumer sentiment indicator have an effect on households' behaviour

External Environment

The outlook for the global economy remains relatively favourable

- the outlook for global economic growth is relatively positive, in the coming years the global economic growth should be driven by the recovery in developed economies
- after an unexpected drop in the Q1 2014 due to severe weather, the economic growth in U. S. should return to a growth trajectory, domestic demand should be the main driver of growth in 2014
- the economic activity in the euro zone is recovering, however, return to a growth trajectory will be gradual
- economic growth in developing economies has slowed slightly because of structural problems, however, it continues to retain its high dynamics

Escalation of the debt crisis in the euro zone cannot be fully ruled out

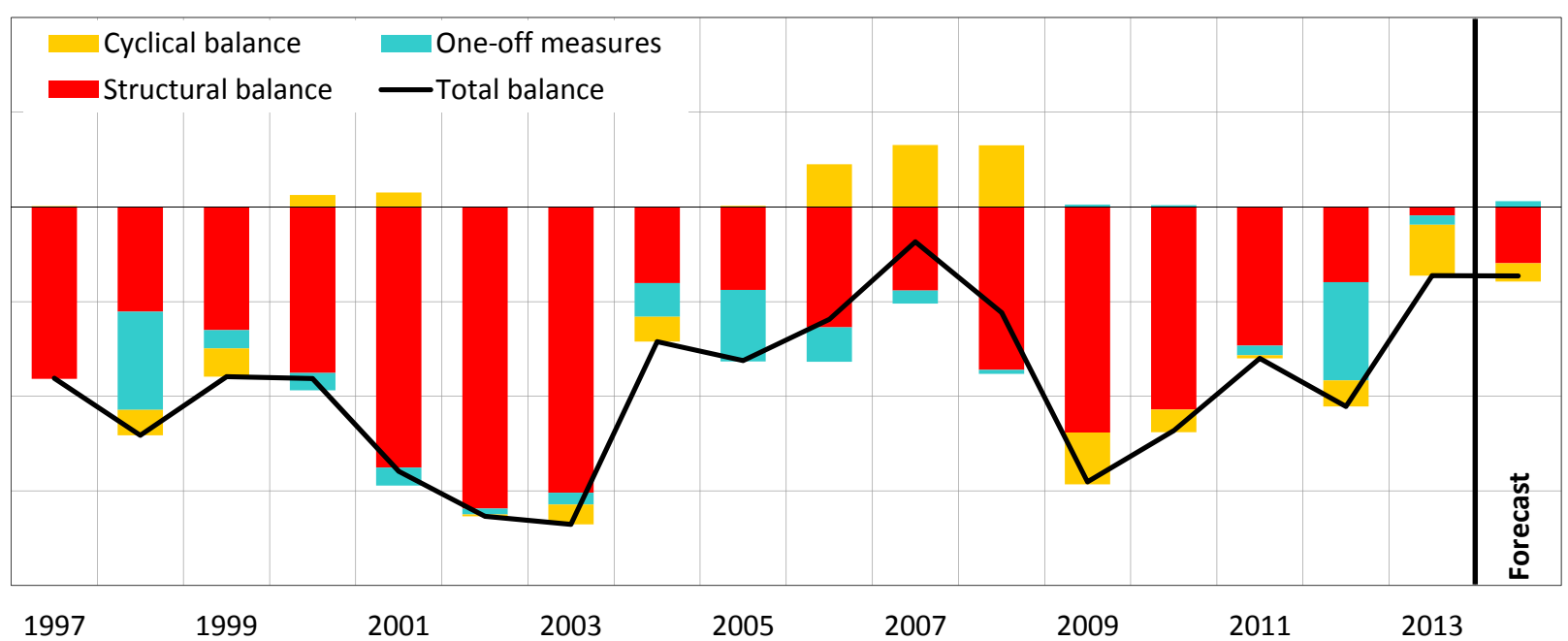
- economic recovery in the euro zone periphery states is very fragile, the risk regarding the quality of bank assets still remains

Macroeconomic Forecast

Fiscal Policy

Net Lending/Borrowing

(in % of GDP)



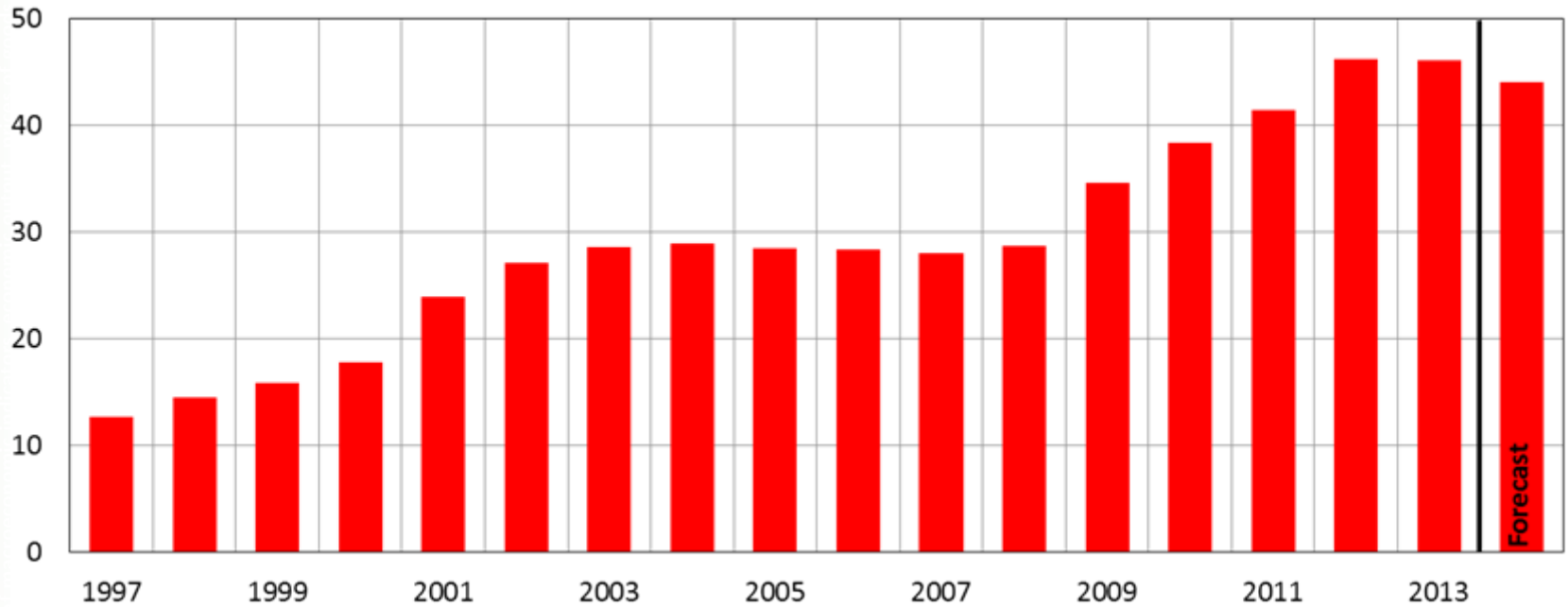
Source: Ministry of Finance.

Macroeconomic Forecast

Fiscal Policy

Government Debt

(in % of GDP)



Source: Ministry of Finance.

Fiscal Policy

- according to the CZSO's estimates, the government sector balance ended with a deficit of 1.5% of GDP in 2013
- in comparison with the deficit of 2012, adjusted for one-off measures (financial compensation to churches and religious organizations and corrections of refunds from the EU), this was an improvement of 1.0 pp
- fiscal effort (year-on-year change of the cyclically adjusted balance between 2012 and 2013) amounted to 1.4 pp
- at the end of 2013, the government debt reached 46.0% of GDP
- for 2014, we predict a government sector balance of -1.5% of GDP
- in 2014, we expect the government debt to GDP ratio should decrease by 2.0 pp to 44.0%

Monetary Policy, the Financial Sector and Foreign Exchange Rates

- effective from 2 November 2012, the Czech National Bank lowered the interest rate for 2W repo operations to 0.05%
- on 7 November 2013, the CNB has initiated foreign exchange interventions against the Czech koruna aimed at keeping the CZK/EUR exchange rate close to 27 CZK/EUR
- we estimate an average exchange rate at 27.4 CZK/EUR and 20.2 CZK/USD in 2014
- for both 2014 and 2015, we expect 3M PRIBOR of 0.4%
- long-term interest rates are low, yields to maturity of 10Y government bonds should reach about 1.9% in 2014 and 2.4% in the following year
- in July 2014, the Czech Republic's rating was stable at a good level of investment, mainly due to macroeconomic stability and a credible fiscal policy (Standard & Poor's AA-, Moody's A1, Fitch A+)

Structural reforms

- **Amendment to the Act on Excise Taxes (the Government approved on 21 May 2014)**
- **Amendment to the Act on Income Taxes (the Government approved on 2 July 2014)**
- **Amendment to the Act on Value Added Tax (the Government approved on 2 July 2014)**
- **Bill Amending Certain Acts in Connection with Establishment and Supervision of Access to the Business of Banks, Savings Banks and Credit Unions as well as Securities Dealers (the Senate approved on 18 June 2014)**
- **Amendment to the Employment Act (the Senate approved on 18 June 2014)**
- **Bill on Pension Insurance (the Chamber of Deputies approved on 20 June 2014)**
- **Amendment to the Act on State Social Support (the Government approved on 2 July 2014)**
- **Amendment to the Act on Public Health Insurance (the Government approved on 2 July 2014)**

Macroeconomic Forecast

Economic Cycle

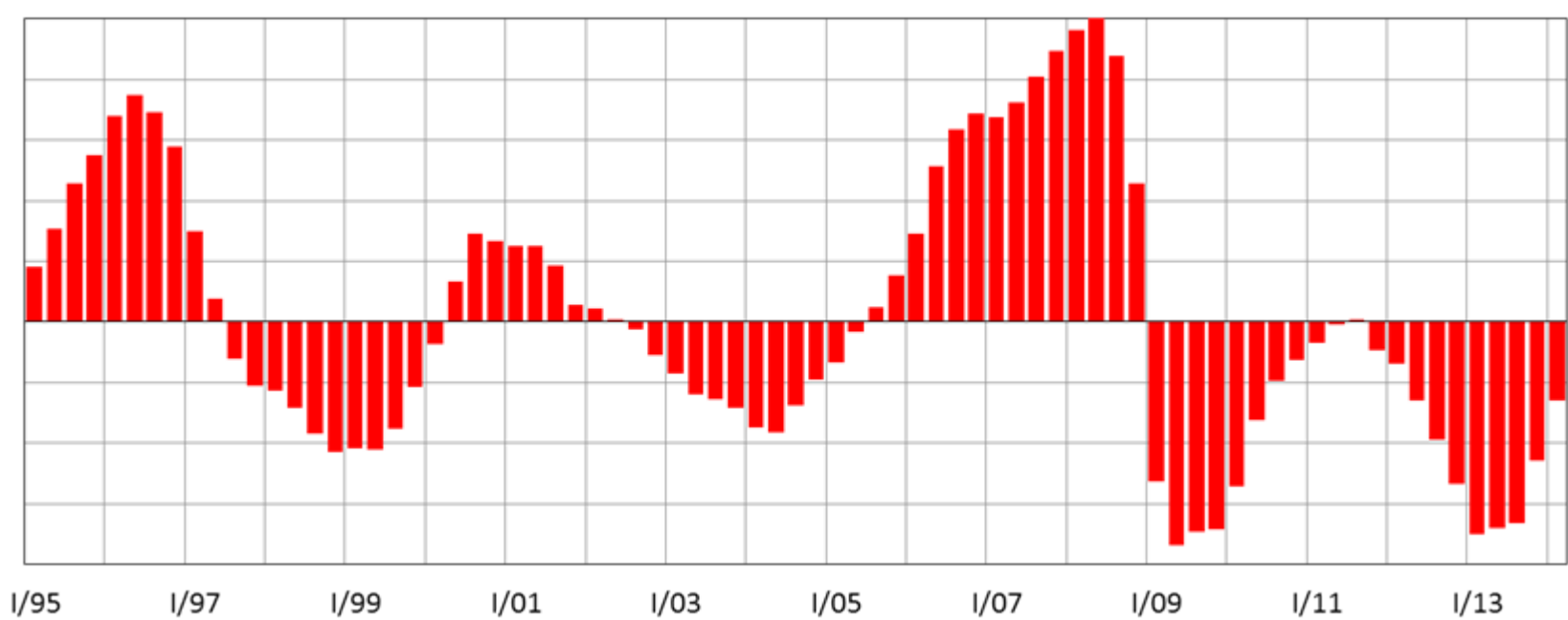


Macroeconomic Forecast

Economic cycle

Output Gap

(in % of potential product)

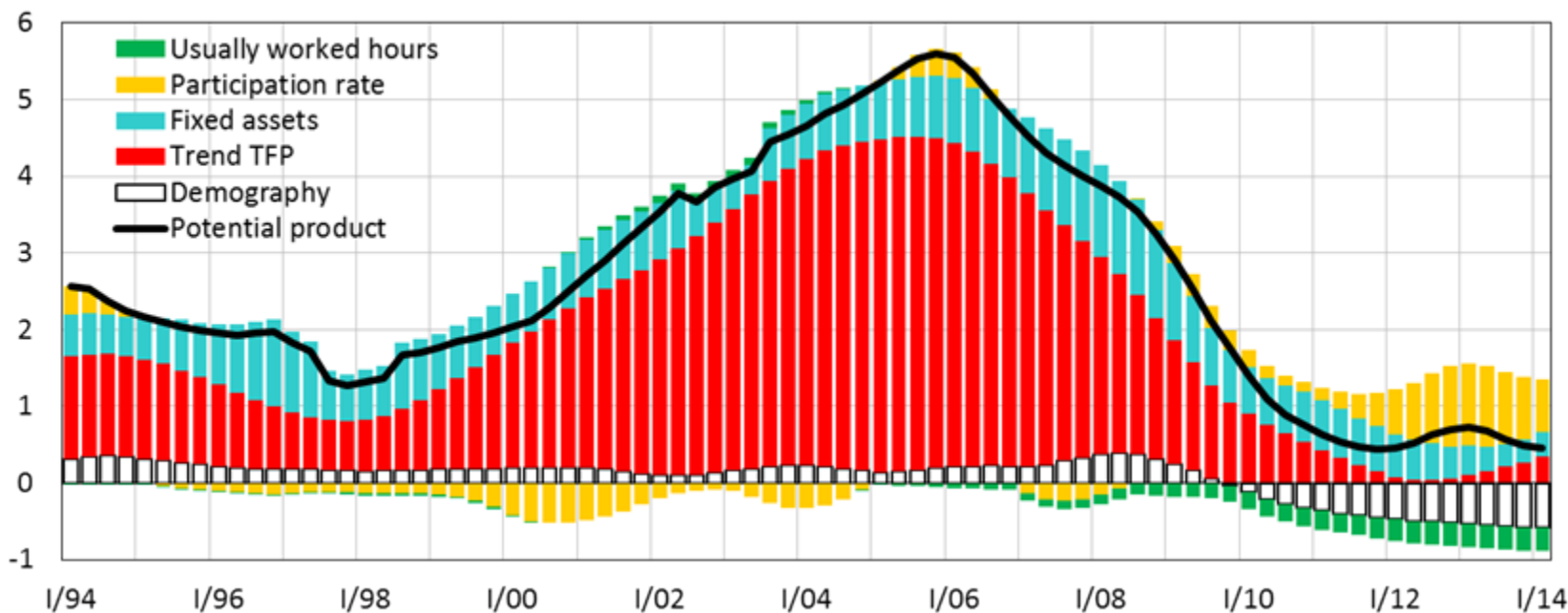


Sources: CZSO, CNB and Ministry of Finance's own calculations

Economic cycle

Potential Product Growth

(in %, contributions in percentage points)



Sources: CZSO, CNB and Ministry of Finance's own calculations

Economic cycle

- from the Q4 2011, the Czech economy is in a negative output gap, however, the strong economic growth resulted in its mitigation to -1.3% in the Q1 2014
- due to long periods of recession or sluggish economic growth, growth of potential product slowed considerably, down to approximately 0.5% in the Q1 2014
- the component most seriously affected is total factor productivity, it has been more or less stagnant since 2011
- deep fall in investment activity led to a gradual reduction of the contribution of the capital stock
- the participation rate has become the most important factor of potential product growth from 2012
- demographic development and the number of usually hours worked slowed potential product growth

Forecast of Macroeconomic Indicators



Macroeconomic Forecast

Main Macroeconomic Indicators

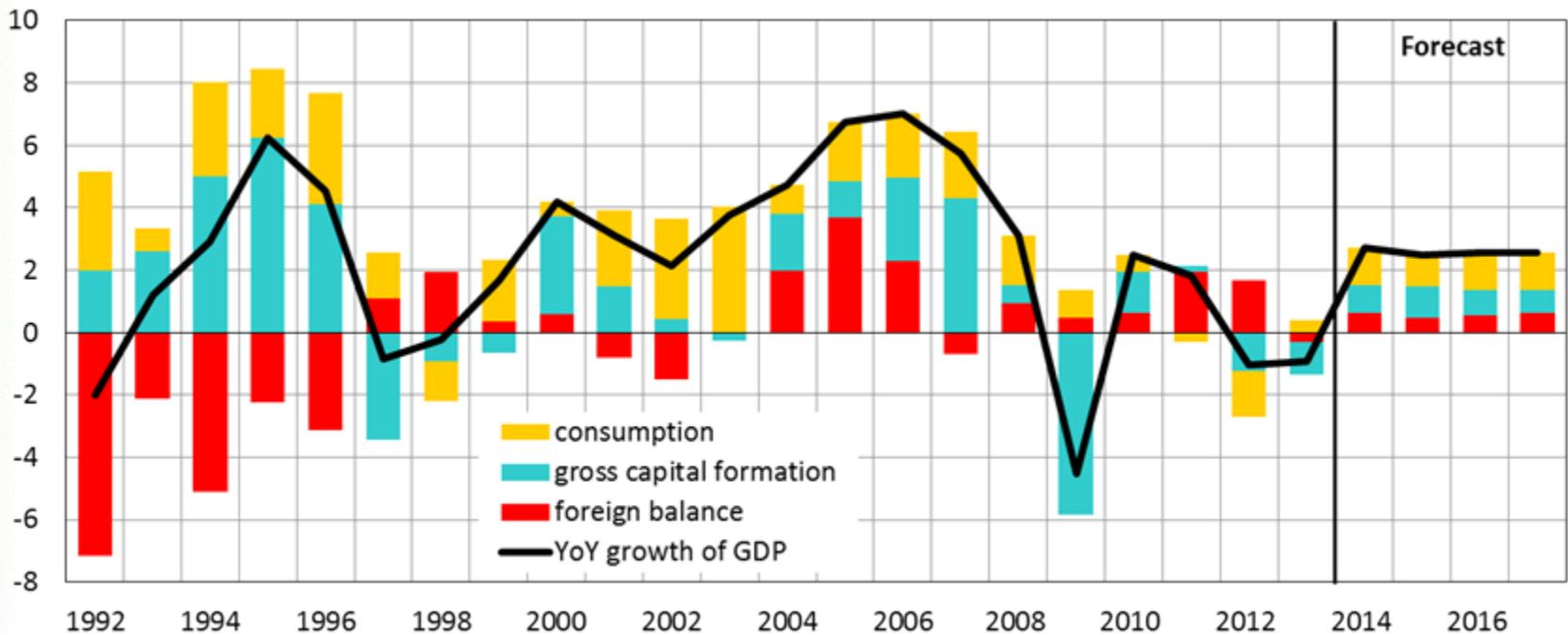
		2010	2011	2012	2013	2014	2015
		<i>Current forecast</i>					
Gross domestic product	<i>growth in %, const.pr.</i>	2,5	1,8	-1,0	-0,9	2,7	2,5
Consumption of households	<i>growth in %, const.pr.</i>	0,9	0,5	-2,1	0,1	1,6	1,4
Consumption of government	<i>growth in %, const.pr.</i>	0,2	-2,7	-1,9	1,6	1,9	1,6
Gross fixed capital formation	<i>growth in %, const.pr.</i>	1,0	0,4	-4,5	-3,5	4,1	3,5
Contr. of foreign trade to GDP growth	<i>p.p., const.pr.</i>	0,6	1,9	1,7	-0,3	0,6	0,5
Contr. of increase in stocks to GDP growth	<i>p.p., const.pr.</i>	1,0	0,1	-0,1	-0,2	0,0	0,2
GDP deflator	<i>growth in %</i>	-1,6	-0,9	1,6	1,9	1,8	1,3
Average inflation rate	<i>%</i>	1,5	1,9	3,3	1,4	0,6	1,7
Employment (LFS)	<i>growth in %</i>	-1,0	0,4	0,4	1,0	0,5	0,2
Unemployment rate (LFS)	<i>average in %</i>	7,3	6,7	7,0	7,0	6,4	6,1
Wage bill (domestic concept)	<i>growth in %, curr.pr.</i>	0,8	2,2	1,8	-0,9	2,8	3,8
Current account / GDP	<i>%</i>	-3,9	-2,7	-1,3	-1,4	0,4	0,0

Sources: CZSO, CNB and Ministry of Finance's own calculations

Economic Performance

Gross Domestic Product (real)

(in constant prices, decomposition of the YoY growth, in percentage points)



Sources: CZSO and Ministry of Finance's own calculations

Economic Performance

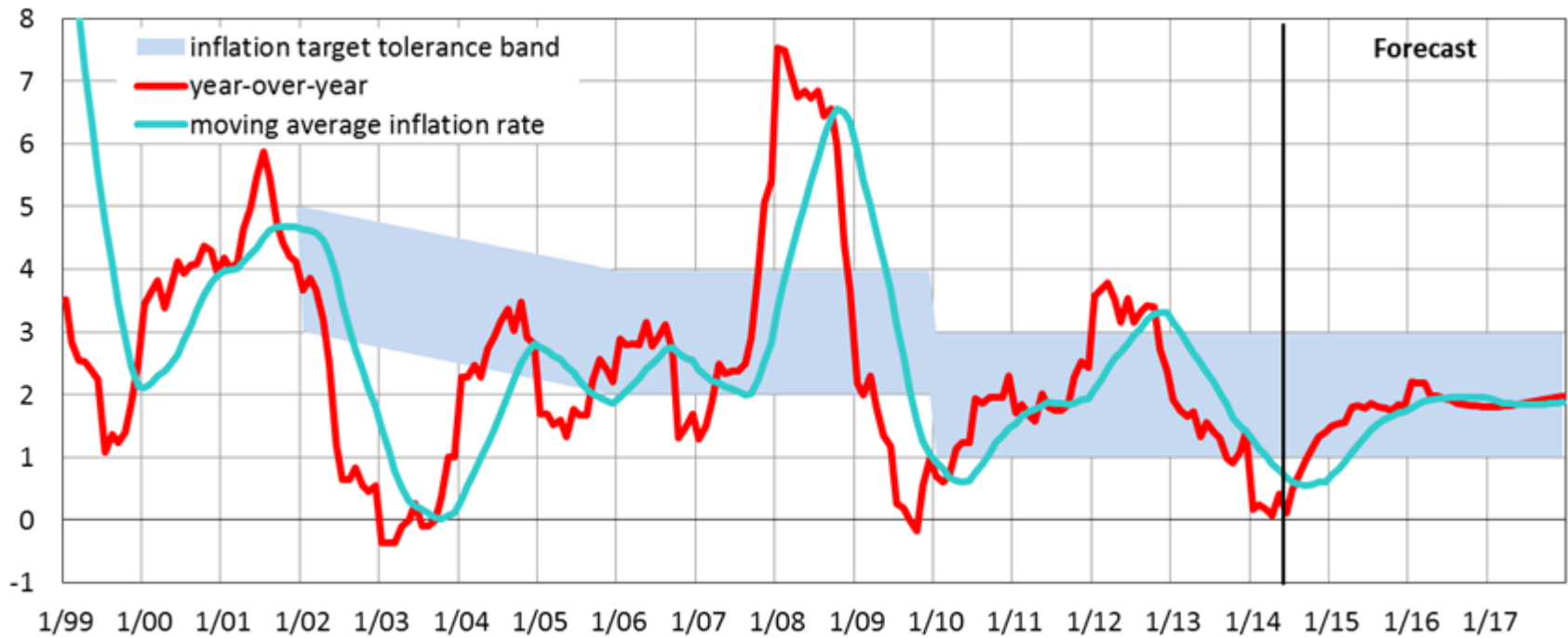
- the strong QoQ growth of 0.8% in the Q1 2014 was largely a product of recovery in domestic demand and positive development of foreign trade
- real GDP should increase by 2.7% in 2014 and by 2.5% in 2015
- expected increase in household consumption by 1.6% in 2014 reflects improvement in the situation on the labour market and in consumer sentiment, for 2015 we expect to see a growth in household consumption by 1.4%
- real government consumption should increase by 1.9% in 2014 and by 1.6% in 2015 because of an increase in payments for healthcare
- due to the necessity to draw down maximum possible resources from EU funds from the 2007–2013 financial perspective until the end of 2015, we expect restoration of investment growth dynamics, which should increase by 4.1% in 2014 and 3.5% in 2015
- in 2014 and 2015, foreign trade will have a pro-growth impact

Macroeconomic Forecast

Inflation

Consumer Prices

(YoY growth rate, in %)



Sources: CZSO and Ministry of Finance's own calculations

Inflation

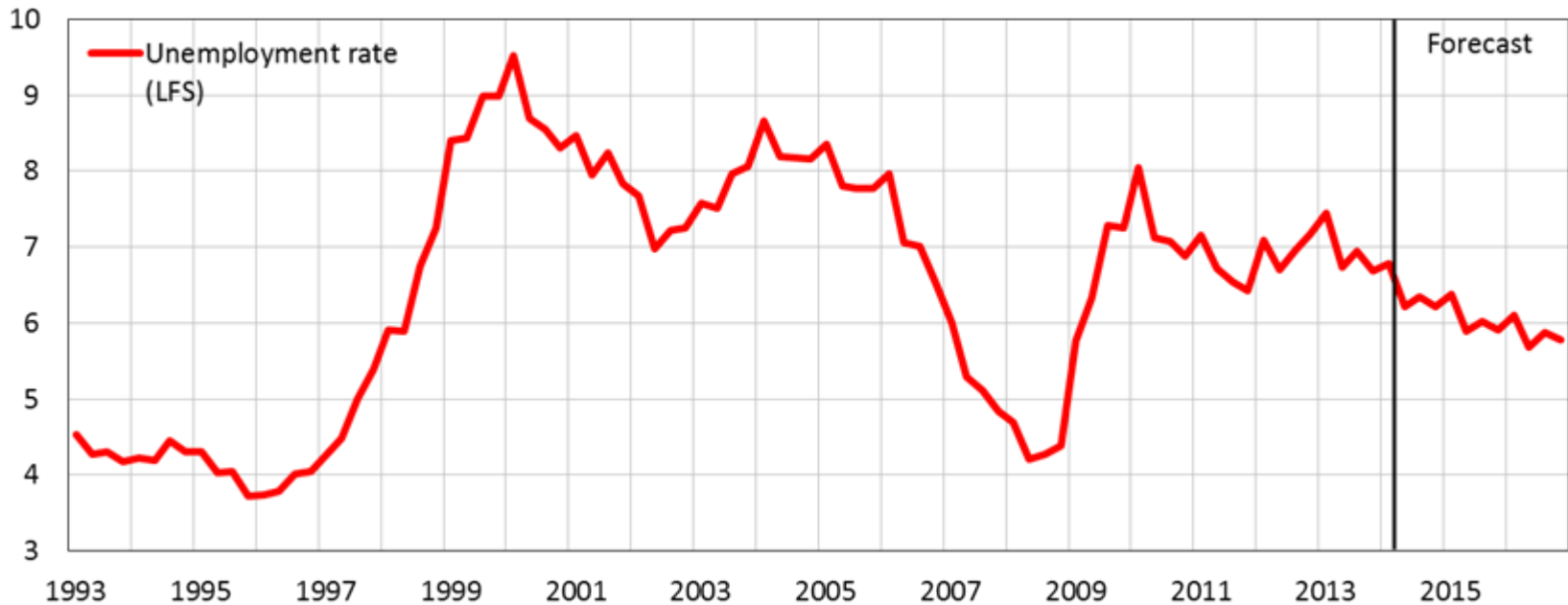
- in spite of the weakening of the Czech koruna due to the CNB's foreign exchange interventions, 2014 should be characterized by very low inflation amounting to 0.6% (the main anti-inflationary factor is a decrease in the electricity price, a negative output gap will contribute in a lower extent)
- due to the expected economic growth and the related closing of the output gap, we estimate 2015 average inflation rate at 1.7%

Macroeconomic Forecast

Labour Market

Unemployment Rate

(Labour Force Survey, in %)



Sources: CZSO and Ministry of Finance's own calculations

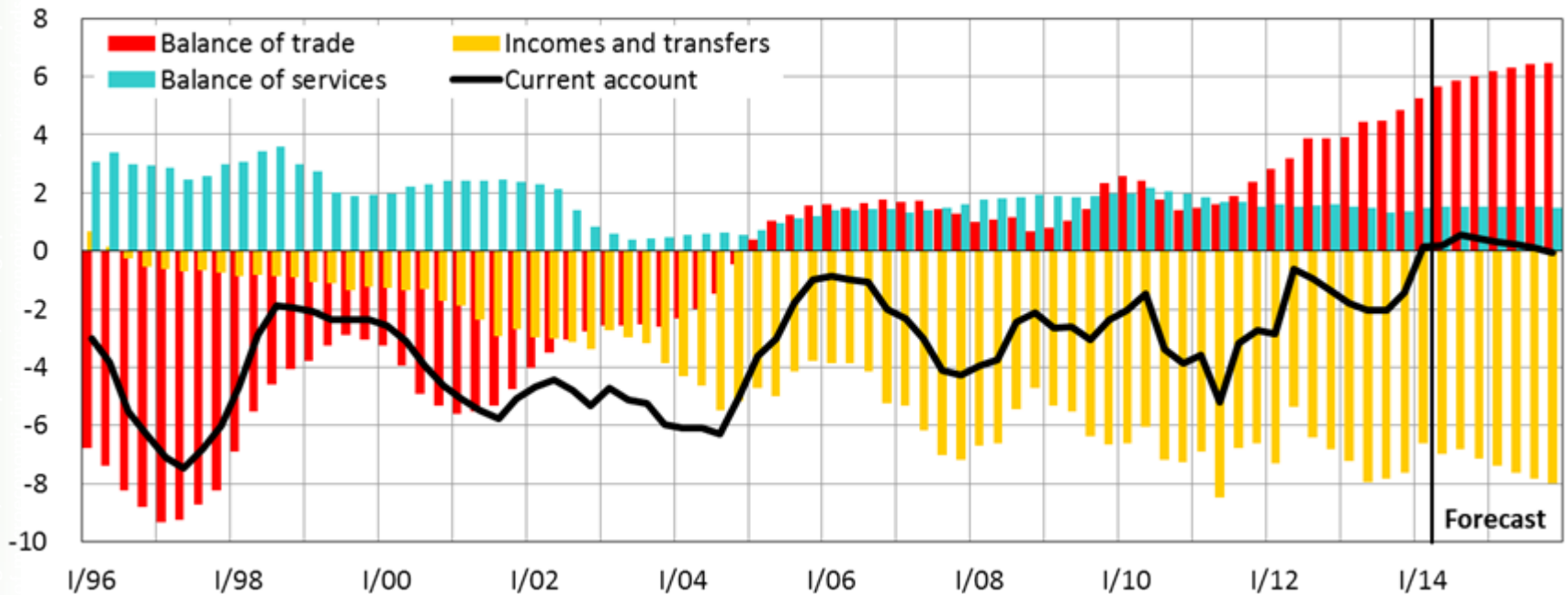
Labour Market

- **due to the market recovery, employment grew by 0.2% QoQ and the unemployment rate according to LFS reached 6.8% in the Q1 2014**
- **with higher than expected growth of economic activity, employment should increase by 0.5% in 2014 and further by 0.2% in 2015**
- **the unemployment rate according to LFS should gradually decline to 6.4% in 2014 and to 6.1% in 2015**
- **the wage bill posted a considerable increase in the Q1 2014, which was mainly due to the statistical effect of managerial bonuses**
- **based on the positive developments in the Q1 2014, we expect that the wage bill could increase by 2.8% in 2014 and by 3.8% in the following year**

External Relations

Current Account

(moving sums of the latest 4 quarters, in % of GDP)



Sources: CNB and Ministry of Finance's own calculations

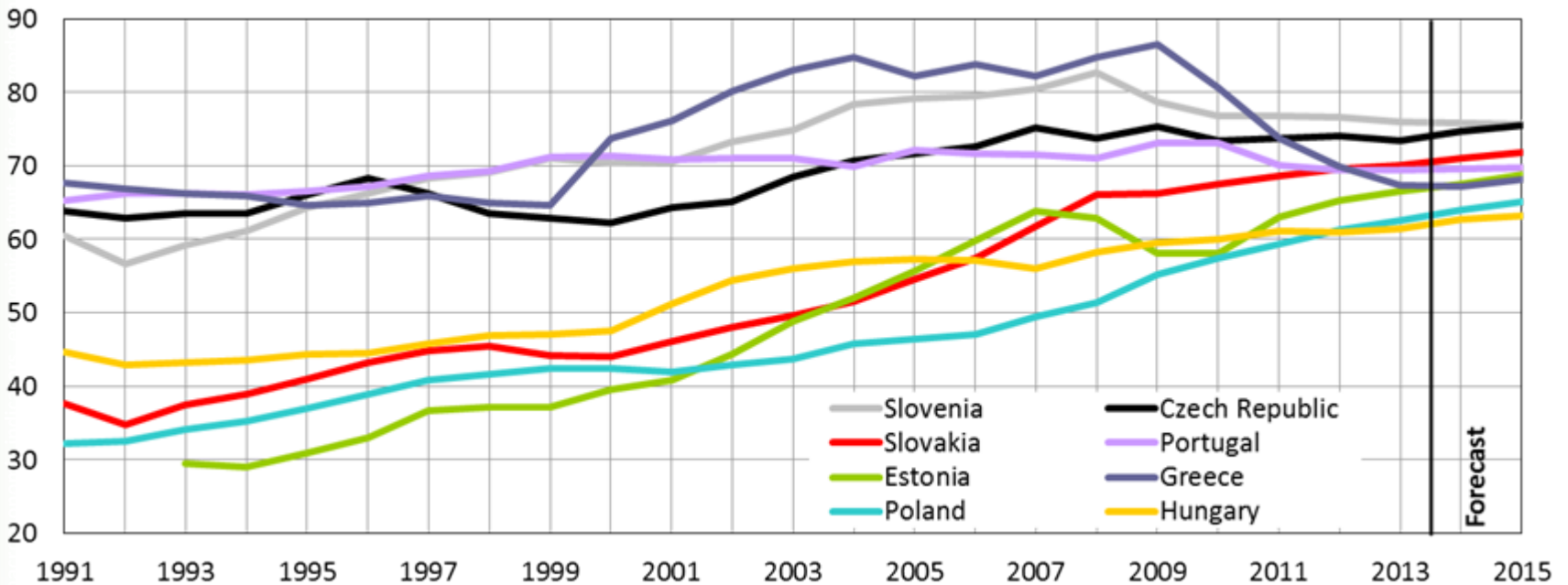
External Relations

- **export markets are growing again, however, we expect more dynamic growth of export markets in the following period due to the recovery in foreign trade**
- **the weaker exchange rate of the Czech koruna is also reflected in an increase in the trade balance surplus, which could reach 6.0% of GDP in 2014 and could increase further to 6.5% of GDP in 2015**
- **we expect the surplus in the balance of services to reach 1.5% of GDP in 2014 and 2015**
- **deficit in the balance of income has been showing a tendency to increase in the long term, it should reach 7.6% of GDP in 2014 and 8.2% of GDP in 2015**
- **we assume that there will be a further slight improvement in the current account balance in 2014 to 0.4% of GDP and the current account would show a surplus for the whole calendar year for the first time since 1993, for 2015 we expect that the current account could be balanced**

International Comparison

GDP per capita – using current purchasing power parities

(EA12 = 100)



Sources: Eurostat, OECD, IMF and Ministry of Finance's own calculations

April 2014

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