



Ministry of Finance

CZECH REPUBLIC

Financial Policy Department

Macroeconomic Forecast of the Czech Republic in a Nutshell

October 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

Macroeconomic Forecast

Forecast Assumptions



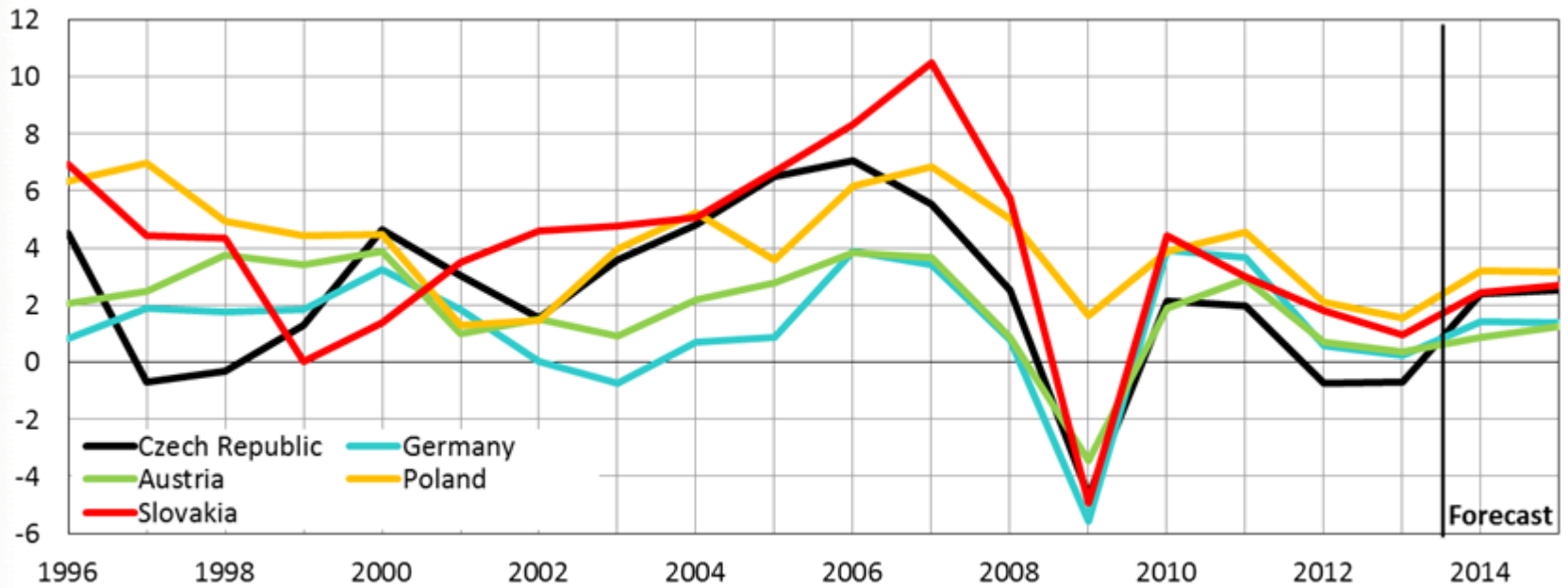
Risks of the forecast

- we regard the scenario risks as roughly balanced
- the uncertainty regarding future developments in the external environment has increased substantially, we assume that economic growth in many states of the EU will be very slow in the upcoming quarters
- 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 pickup in domestic demand is surprisingly strong, which holds true especially for gross capital formation, however, further recovery of the Czech economy will be rather gradual

External Environment

Real Gross Domestic Product – Czech Republic and the neighbouring states

(YoY growth rate, in %, seasonally adjusted data)



Sources: Eurostat and Ministry of Finance's own calculations

External Environment

The outlook for the global economy has deteriorated

- due to slowdown in international trade, tense geopolitical situation and uncertainty associated with the reforms, the outlook for global economic growth has deteriorated, especially in the near term
- after an unexpected drop in the Q1 2014 due to severe weather, the economic growth in U. S. returned to a growth trajectory, domestic demand should be the main driver of growth in 2014
- recovery of the economic activity in the EU slowed down, developments in individual states remain widely varied
- large emerging economies might need to revise their growth models

Economic activity in the euro zone periphery states gradually recovers

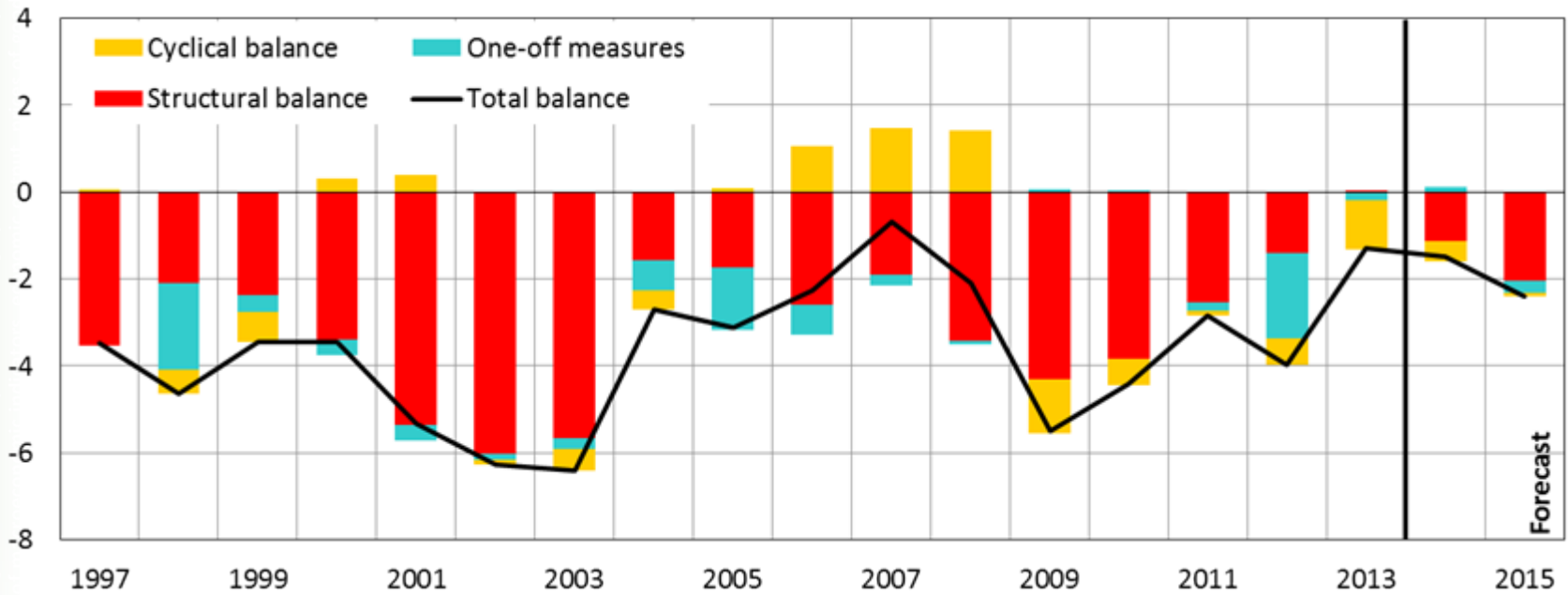
- economic recovery in the euro zone periphery states is very fragile, the risk regarding the quality of bank assets still remains

Macroeconomic Forecast

Fiscal Policy

Net Lending/Borrowing

(in % of GDP)



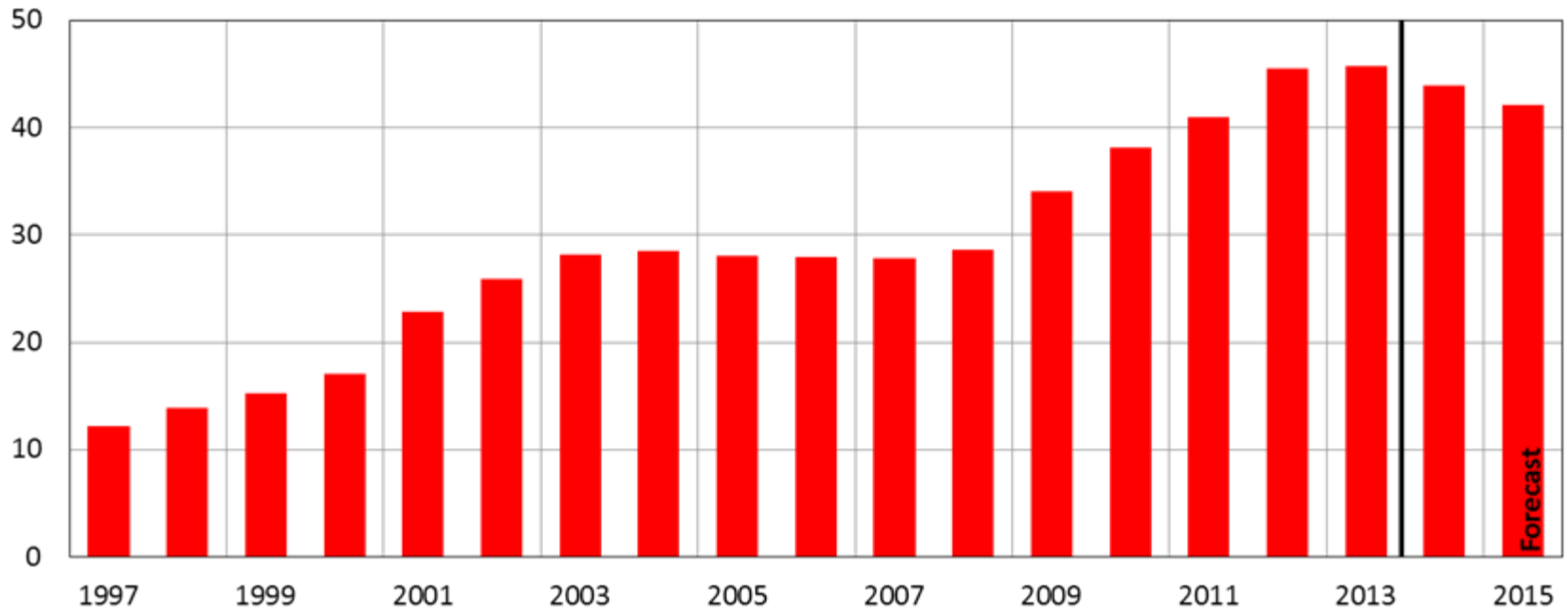
Source: Ministry of Finance.

Macroeconomic Forecast

Fiscal Policy

Government Debt

(in % of GDP)



Source: Ministry of Finance.

Fiscal Policy

- according to the actual CZSO's estimates, the government sector balance ended with a deficit of 1.3% of GDP in 2013
- at the end of 2013, the government debt reached 45.7% of GDP
- for 2014, we predict a government sector balance of -1.5% of GDP
- for 2015, current estimates expect a deepening of government sector deficit to 2.4% of GDP, which reflects government efforts to support the economy through investments, introduction of the third VAT rate of 10% for selected commodities, an increase in the wage bill of state administration and also the reintroduction of the former method of indexation of pensions
- we expect the government debt to GDP ratio should decrease to 43.9% in 2014 and to 42.2% in 2015

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 27.5 CZK/EUR and 20.5 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 1.7% for both 2014 and 2015
- in October 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 Investment Incentives (the Government approved on 3 September 2014)**
- **Amendment to the Act on Public Tenders (the Government approved on 3 September 2014)**
- **Amendment to the Act on Value Added Tax (the Chamber of Deputies approved on 24 September 2014)**
- **Amendment to the Act on Excise Taxes (President signed on 16 September 2014)**
- **Amendment to the Act on Income Taxes (the Chamber of Deputies approved on 24 September 2014)**
- **Bill on Pension Insurance (came into effect on 1 September 2014)**
- **Amendment to the Act on State Social Support (the Chamber of Deputies approved on 24 September 2014)**
- **Amendment to the Act on Public Health Insurance (the Chamber of Deputies approved on 26 September 2014)**

Macroeconomic Forecast



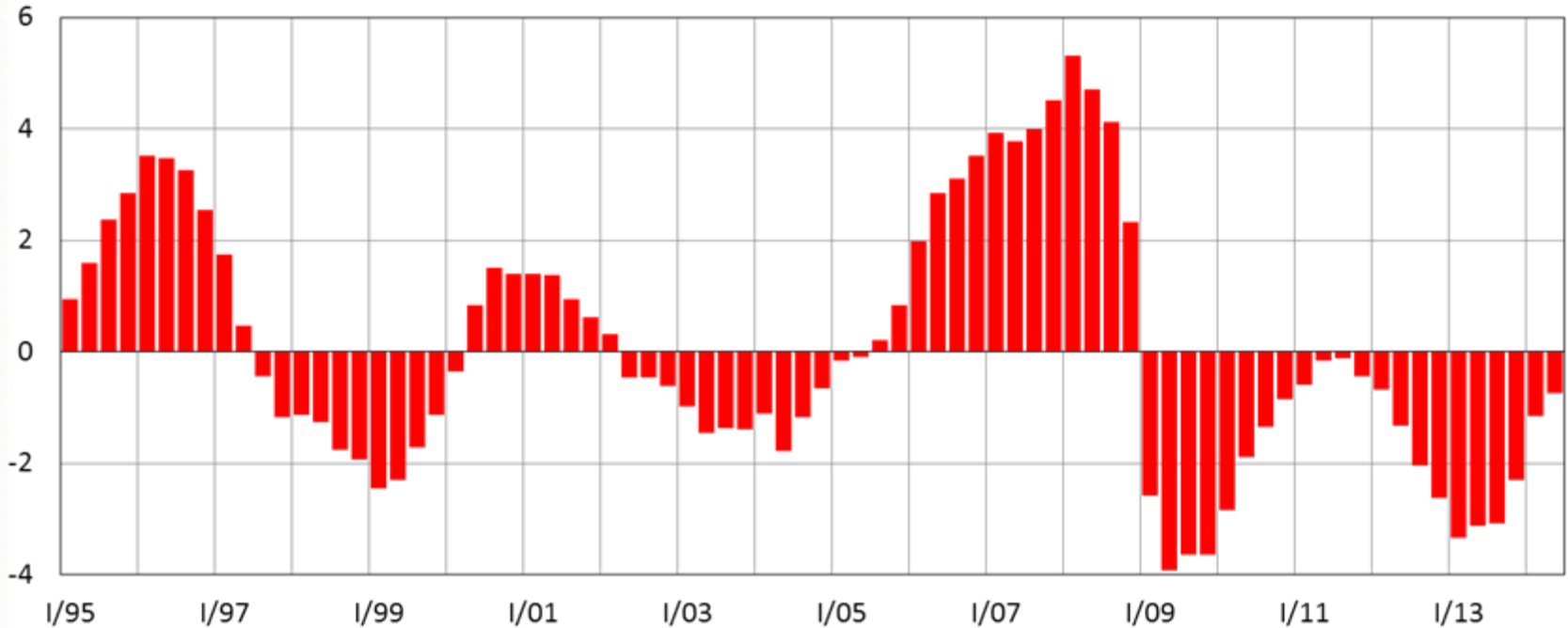
Economic Cycle

Macroeconomic Forecast

Economic cycle

Output Gap

(in % of potential product)

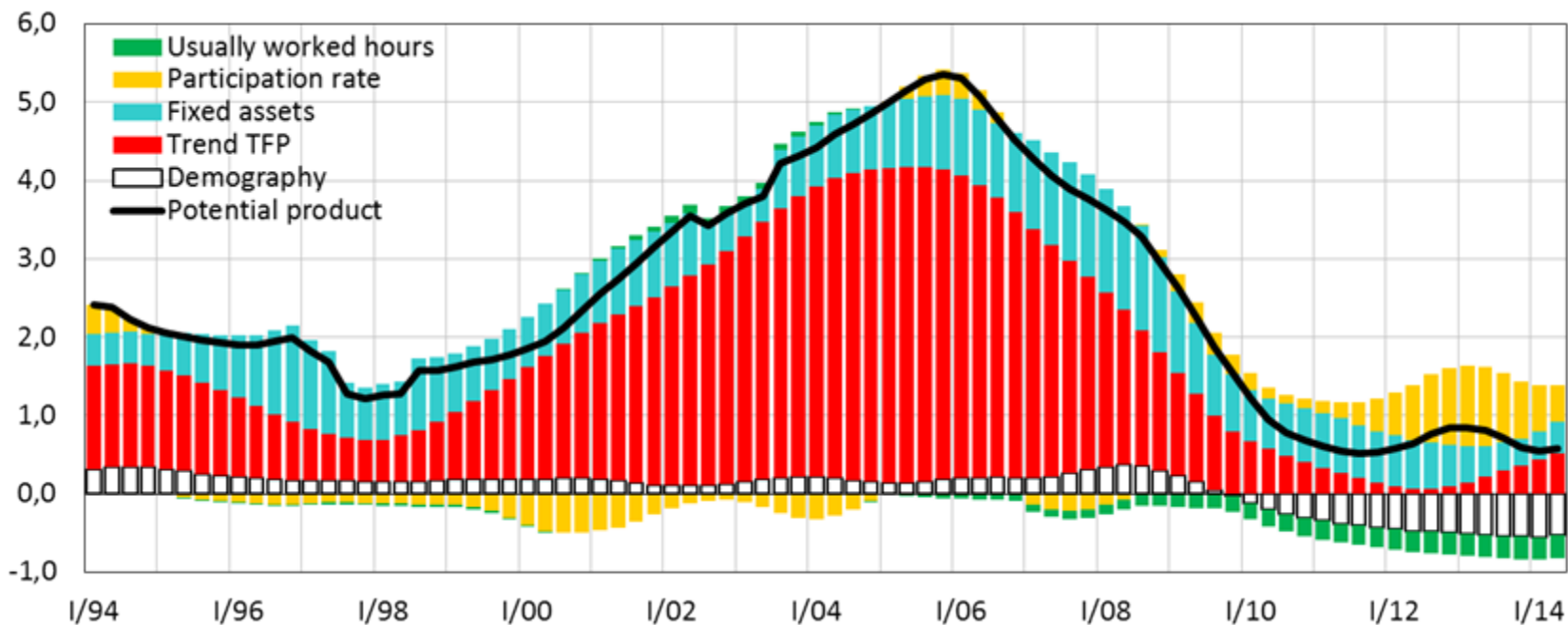


Sources: CZSO, CNB and Ministry of Finance's own calculations

Economic cycle

Potential Product Growth

(in %, contributions in percentage points)



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

Economic cycle

- the economic recovery resulted in mitigation of the negative output gap to -0.8% in the Q2 2014, the negative output gap should close during 2015
- due to long periods of recession or sluggish economic growth, growth of potential product slowed considerably to approximately 0.6% in the Q2 2014
- slowdown of potential product growth was mainly caused by 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, the participation rate in the Czech economy has an anti-cyclical character
- demographic development and the number of usually hours worked slowed potential product growth

Forecast of Macroeconomic Indicators



Macroeconomic Forecast

Main Macroeconomic Indicators

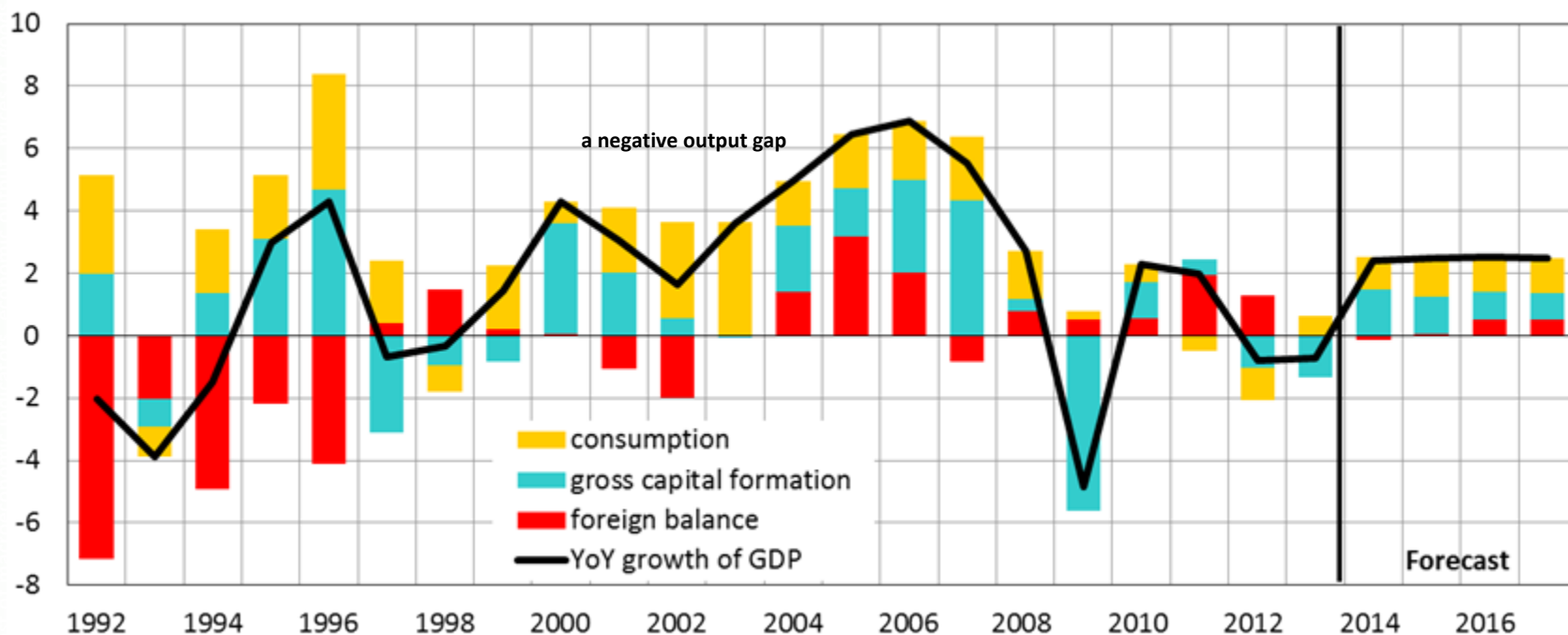
		2010	2011	2012	2013	2014	2015
						<i>Current forecast</i>	
Gross domestic product	<i>bill. CZK</i>	3 954	4 022	4 048	4 086	4 284	4 467
Gross domestic product	<i>growth in %, const.pr.</i>	2,3	2,0	-0,8	-0,7	2,4	2,5
Consumption of households	<i>growth in %, const.pr.</i>	1,0	0,2	-1,8	0,4	1,4	1,7
Consumption of government	<i>growth in %, const.pr.</i>	0,4	-2,9	-1,0	2,3	1,9	2,0
Gross fixed capital formation	<i>growth in %, const.pr.</i>	1,3	1,1	-2,9	-4,4	4,5	4,9
Contr. of foreign trade to GDP growth	<i>p.p., const.pr.</i>	0,5	1,9	1,3	0,0	-0,1	0,0
Contr. of increase in stocks to GDP growth	<i>p.p., const.pr.</i>	0,8	0,2	-0,2	-0,2	0,4	0,0
GDP deflator	<i>growth in %</i>	-1,5	-0,2	1,4	1,7	2,4	1,8
Average inflation rate	<i>%</i>	1,5	1,9	3,3	1,4	0,5	1,5
Employment (LFS)	<i>growth in %</i>	-1,0	0,4	0,4	1,0	0,4	0,3
Unemployment rate (LFS)	<i>average in %</i>	7,3	6,7	7,0	7,0	6,3	6,1
Wage bill (domestic concept)	<i>growth in %, curr.pr.</i>	0,6	2,2	2,1	-0,4	2,9	3,9
Current account / GDP	<i>%</i>	-3,7	-2,6	-1,3	-1,4	0,0	-0,3

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)



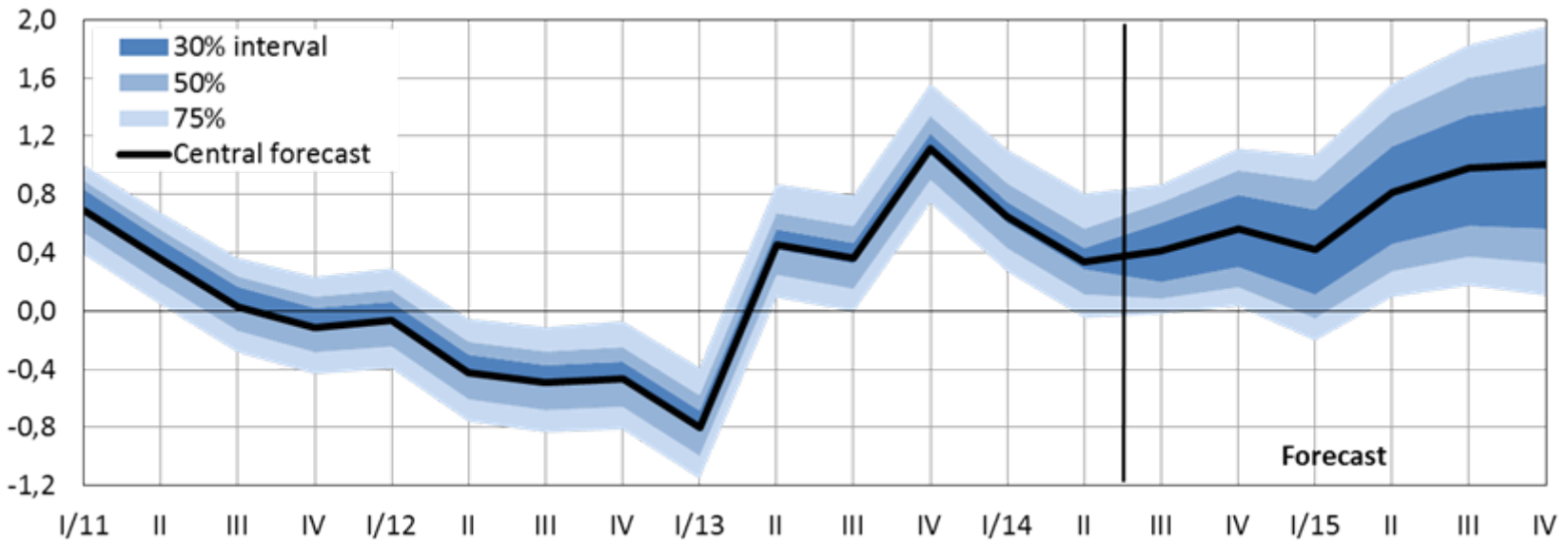
Sources: CZSO and Ministry of Finance's own calculations

Macroeconomic Forecast

Economic Performance

Gross Domestic Product (real)

(QoQ growth rate, in % seasonally adjusted, past probability distribution reflects the actual distribution of data revisions, future probability distribution is based upon the MoF's forecasting performance)



Sources: CZSO and Ministry of Finance's own calculations

Economic Performance

- **this forecast is based on data of the national accounts published by the CZSO on 1 October 2014, new data already fully correspond to the methodology of national accounts ESA 2010**
- **in the Q2 2014, the real GDP increased by 0.3% QoQ, both final consumption expenditure and gross capital formation made a more or less equal contribution to the QoQ growth of GDP, on the contrary, foreign trade mitigated GDP growth**

Economic Performance

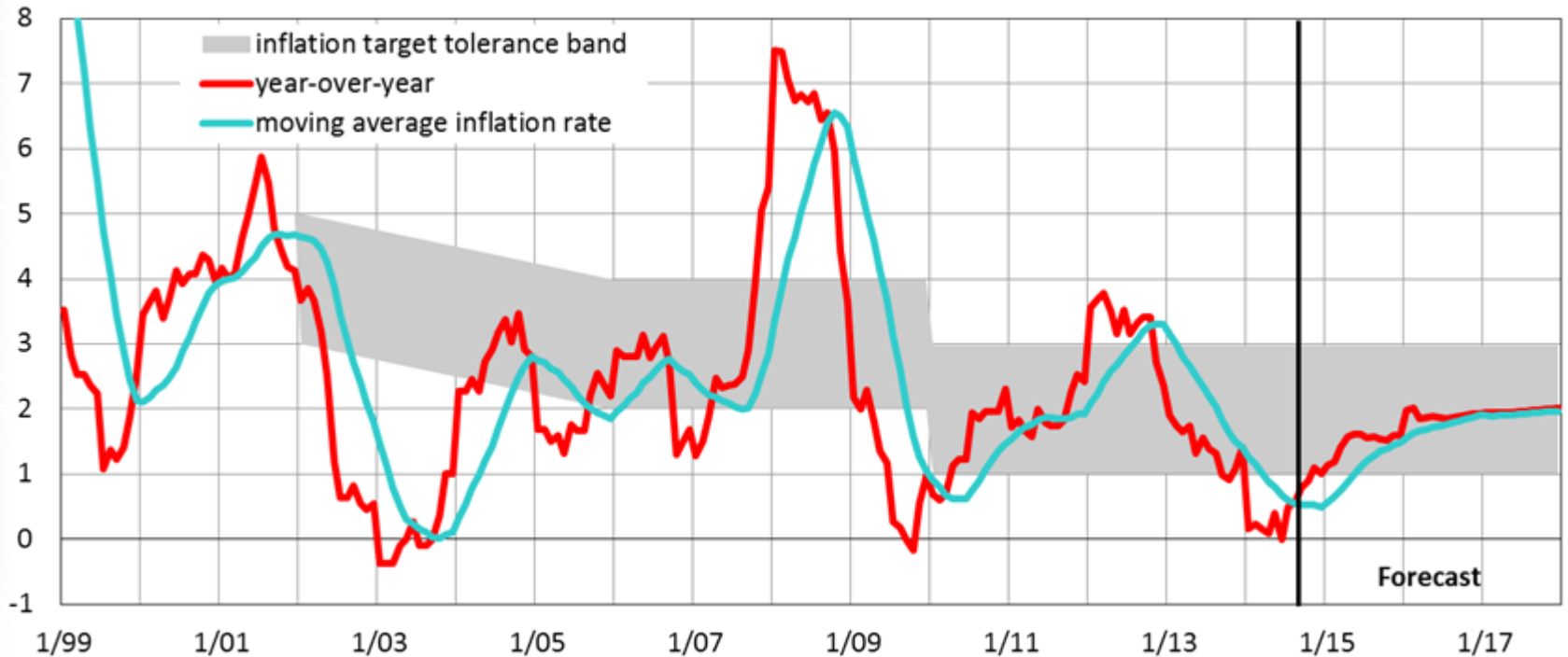
- **real GDP should increase by 2.4% in 2014 and by 2.5% in 2015, the main drivers of the economic growth should be the gross fixed capital formation and the household consumption expenditure**
- **expected increase in household consumption by 1.4% in 2014 and by 1.7% in 2015 reflects improvement in the situation on the labour market and higher consumer sentiment**
- **real government consumption should increase by 1.9% in 2014 and by 2.0% in 2015 because of an increase in payments for healthcare and social benefits in kind**
- **due to the drawdown of money from EU funds, the faster growth of domestic demand as well as the increasing internal sources for financing investment, we expect real growth of gross fixed capital formation of 4.5% in 2014 and 4.9% in 2015**
- **in 2014 and 2015, the contribution of the foreign trade balance to the real GDP growth should be approximately zero**

Macroeconomic Forecast

Inflation

Consumer Prices

(YoY growth rate, in %)



Sources: CZSO and Ministry of Finance's own calculations

Inflation

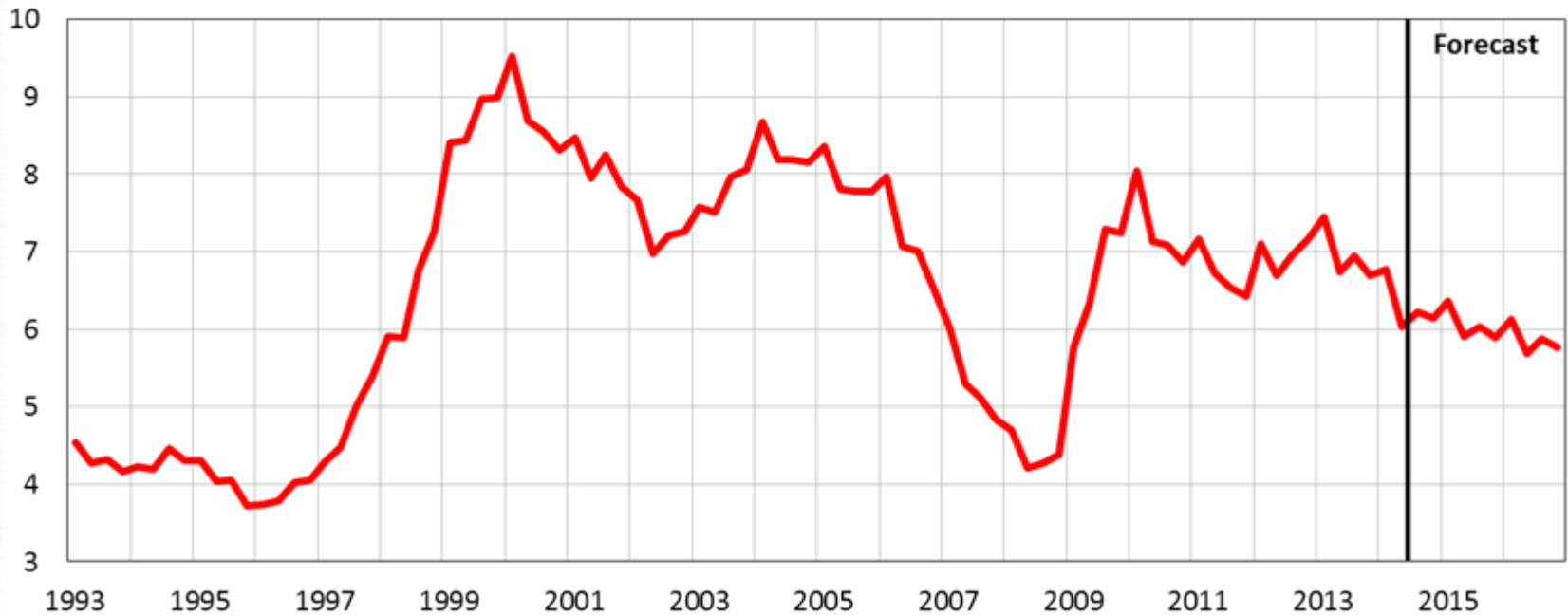
- in spite of the weakening of the Czech koruna due to the CNB's foreign exchange interventions, 2014 should be characterized by very low inflation amounting to 0.5% (the main anti-inflationary factor is a decrease in the electricity price, a negative output gap will contribute in a lower extent)
- due to the expected economic growth and the related closing of the output gap, we estimate 2015 average inflation rate at 1.5% (the CZK/EUR exchange rate should tend to have a neutral impact on inflation)

Macroeconomic Forecast

Labour Market

Unemployment Rate

(Labour Force Survey, in %)



Sources: CZSO and Ministry of Finance's own calculations

Labour Market

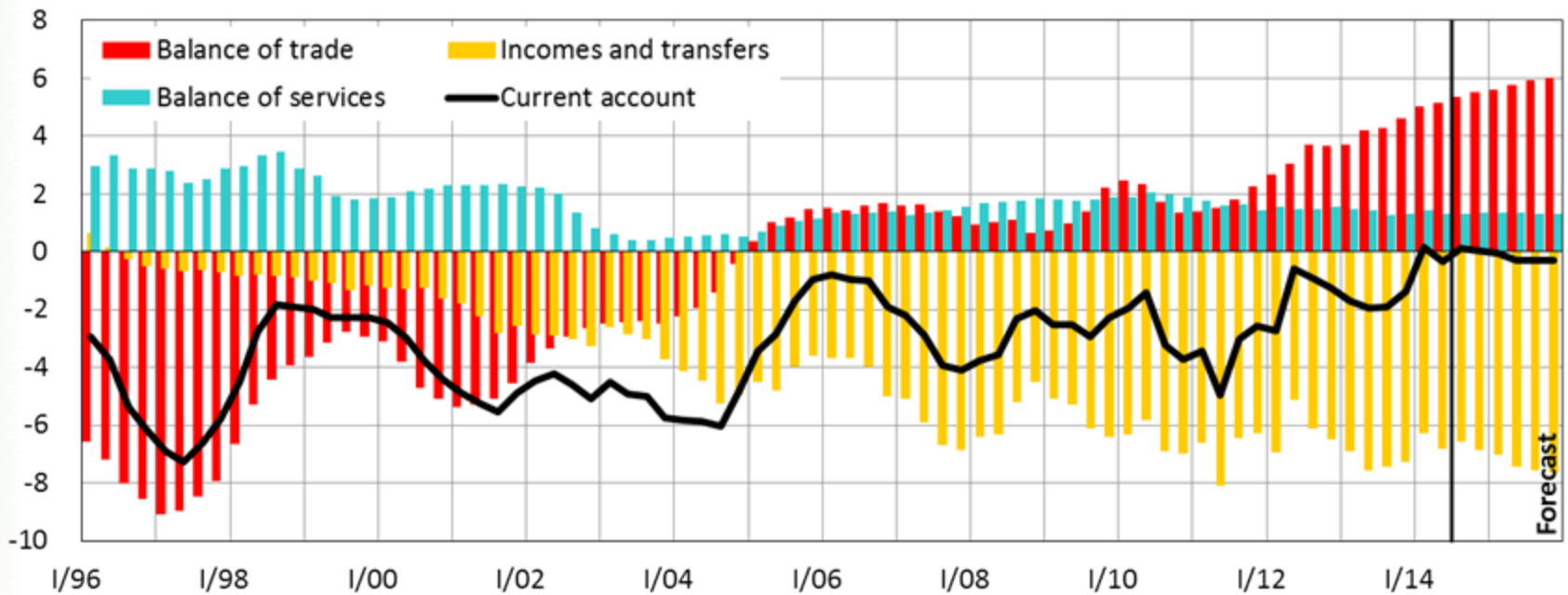
- **due to the market recovery, employment grew by 0.2% QoQ and the unemployment rate according to LFS lowered to 6.0% in the Q2 2014**
- **with higher than expected growth of economic activity, employment should increase by 0.4% in 2014 and further by 0.3% in 2015**
- **the unemployment rate according to LFS should gradually decline to 6.3% in 2014 and to 6.1% in 2015**
- **the wage bill posted a considerable increase in the Q2 2014**
- **based on the positive developments and stabilization of the proportion of part-time jobs in the Q2 2014, we expect that the wage bill could increase by 2.9% in 2014 and by 3.9% in the following year**

Macroeconomic Forecast

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

- the growth of export markets slightly slowed, we expect further slowdown in export market growth because of the less favourable outlook for the development of the external environment
- the weaker exchange rate of the Czech koruna is also reflected in an increase in the trade balance surplus, despite the current loss of international trade growth dynamics the surplus of the trade balance could reach 5.5% of GDP in 2014 and 6.0% in 2015
- we expect the surplus in the balance of services to reach 1.3% 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 7.8% of GDP in 2015
- we assume that the current account will be balanced in 2014 and it could show a negligible deficit of 0.3% of GDP in 2015

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