INFLATION REPORT / II

2012

CNB CZECH NATIONAL BANK

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In 1998, the Czech National Bank switched to inflation targeting. In the inflation targeting regime, the central bank's communication with the public plays a significant role. One of the core elements of this communication is the publishing of quarterly Inflation Reports. Section II of the Inflation Report contains a description of the Czech National Bank's new quarterly macroeconomic forecast, and section III presents its assessment of past economic and monetary developments.

The inflation forecast and the assumptions underlying it are published with the aim of making monetary policy as transparent, comprehensible, predictable and therefore credible as possible. The Czech National Bank is convinced that credible monetary policy effectively influences inflation expectations and minimises the costs of maintaining price stability. Maintaining price stability is the Czech National Bank's primary objective.

The forecast for the Czech economy is drawn up by the CNB's Monetary and Statistics Department. The forecast for inflation at the "monetary policy horizon" (about 12–18 months ahead) is of greatest relevance to the decision-making on the current interest rate settings.

The forecast is the key, but not the only, input to the Bank Board's decision-making. At its meetings during the quarter, the Bank Board discusses the current forecast and the balance of risks and uncertainties surrounding it. The arrival of new information since the forecast was drawn up and the possibility of asymmetric assessment of the risks of the forecast and divergent views of some board members on the development of the external environment or the linkages between the various indicators within the Czech economy mean that the Bank Board's final decision need not correspond to the message of the forecast.

This Inflation Report was approved by the CNB Bank Board on 10 May 2012 and contains the information available as of 20 April 2012. Unless stated otherwise, the sources of the data contained in this Inflation Report are the CZSO or the CNB. All the Inflation Reports published to date are available on the CNB website. Underlying data for the tables and charts presented in the text of this Inflation Report, minutes of Bank Board meetings, and time series of selected economic and monetary indicators (available in the ARAD database) are published at the same internet address.

CHART I.1

FULFILMENT OF THE INFLATION TARGET

Headline inflation increased significantly above the CNB's inflation target in 2012 Q1
(annual percentage changes)

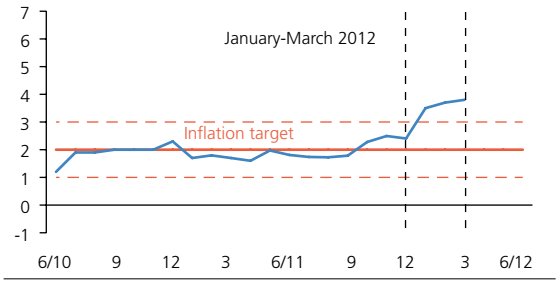


CHART I.2

HEADLINE INFLATION FORECAST

Headline inflation will stay close to its current elevated level in 2012 as a result of the VAT increase, but will fall below the target in 2013
(annual percentage changes)

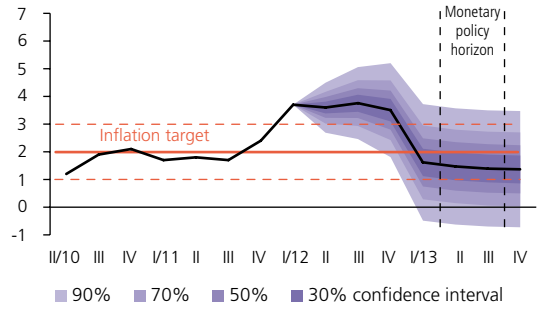
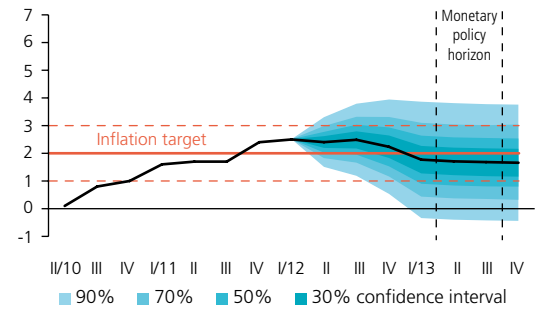


CHART I.3

MONETARY-POLICY RELEVANT INFLATION FORECAST

Monetary-policy relevant inflation will fall just below the target next year
(annual percentage changes)



I. SUMMARY

In 2011 Q4, the annual growth of the Czech economy – driven solely by net exports – recorded a further noticeable slowdown. Headline inflation increased significantly above the CNB's target at the start of this year. Monetary-policy relevant inflation is in the upper half of the tolerance band around the inflation target. The VAT increase, food prices, administered prices and the gradual pass-through of the past exchange rate depreciation to prices are the main sources of inflation. By contrast, the domestic economy is dampening inflation. GDP will be flat this year. Its stagnation will reflect a marked slowdown in external demand and continuing fiscal consolidation. Real economic activity will not recover until 2013. Headline inflation will stay close to its current elevated level this year and will fall below the target at the start of 2013. Monetary-policy relevant inflation will also fall just below the target in 2013. The impacts of the VAT changes on inflation expectations and wages are not expected to be significant. Consistent with the forecast is a decline in market interest rates in the remainder of this year, followed by a rise in rates as from 2013 H2. An alternative forecast scenario capturing the impacts of the government's measures to consolidate public budgets leads to lower interest rates and much slower growth in economic activity amid higher headline inflation in 2013.

The **annual rate of growth of the Czech economy** slowed further to 0.6% in **2011 Q4**, with net exports being the only source of growth. The contributions of the other components were negative (investment in inventories most of all). A further slowdown in annual GDP growth to zero is expected in 2012 Q1.

In 2012 Q1, headline inflation increased significantly above the CNB's target. Monetary-policy relevant inflation was in the upper half of the tolerance band (see Chart I.1). The VAT increase, food prices and administered prices are sources of inflation. Import prices are also inflationary as a result of the recent depreciation of the koruna and rising world commodity prices. Negative adjusted inflation excluding fuels still reflects weak demand and insignificant cost pressures from the domestic economy and thus partly offsets the higher food and fuel prices.

Economic growth in the effective euro area slowed further in 2011 Q4 and this trend is expected to continue this year, with growth reaching 0.5%. This slightly positive growth reflects higher growth in the Czech Republic's major trading partners compared to the average for the euro area, which, as a whole, is recording a modest recession. The low outlook for 3M EURIBOR rates takes into account the ECB's easy monetary policy; this – together with the continuing debt crisis in the euro area – is reflected in an outlook for a gradually weakening euro-dollar exchange rate. Prices of oil and other commodities remain elevated. A very slow decrease in prices on the commodity markets is expected in the longer run.

According to the forecast, headline inflation in the remainder of 2012 will stay temporarily close to its current level, which is elevated as a result of the recent VAT change (see Chart I.2). **Monetary-policy relevant inflation**, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, will be in the upper half of the tolerance band around the CNB's target (see Chart I.3). Both headline and monetary-policy relevant inflation will fall slightly below the target in 2013. Headline inflation will be slightly lower than monetary-policy relevant inflation due to the unification of the two VAT rates at 17.5% at the start of next year (as still assumed in the baseline scenario of the forecast), which has a moderately anti-inflationary first-round effect overall. The overall upward pressures on prices will ease significantly in the coming quarters thanks to a downturn in economic activity and the unwinding of the inflationary effect of import prices. The currently insignificant inflationary pressures from the domestic economy will resurge in the second half of this year as economic activity gradually recovers. The impacts of the VAT increase on inflation expectations and wages are not expected to be significant. Adjusted inflation excluding fuels will gradually rise and turn positive in 2012 Q3. By contrast, food and fuel price growth will slow sharply.

Consistent with the forecast is a decline in market **interest rates** in the remainder of this year, followed by a rise in rates as from 2013 H2 (see Chart I.4). Low growth in domestic economic activity and wages, reflecting a considerable slowdown in external demand and restrictive fiscal policy, and the low interest rate level abroad are pushing interest rates downwards over the forecast horizon. These anti-inflationary factors are only partly offset by the currently elevated inflation, pressures from import prices and the outlook for administered prices at the start of the forecast horizon. Interest rates do not react to the temporary rise in inflation above the target caused by the first-round effects of the changes to indirect taxes. The rise in interest rates from 2013 H2 onwards reflects an expected gradual rise in interest rates abroad and a recovery of the domestic economy. The forecast expects the **koruna-euro exchange rate** to appreciate gradually. In the short term, the exchange rate will be affected by a slightly positive interest rate differential and the favourable external trade developments at the start of this year (see Chart I.5). A renewed recovery of external demand and the expected renewal of long-term real convergence will foster appreciation of the koruna in the longer term.

The **Czech economy** will stagnate overall this year (see Chart I.6). The subdued economic activity will reflect a substantial slowdown of external demand and continuing consolidation of public budgets. Net exports and fixed investment will be the only components to make positive contributions to economic growth; the other components will slow it. GDP will grow again in 2013 (by 1.9%) as external demand recovers. Next year, growth will be fostered by all expenditure components except government consumption. On the **labour market**, the aforementioned economic developments in 2012 will cause total employment to decrease. Total employment will return to growth, albeit modest, at the end of 2013 and the unemployment

CHART I.4

INTEREST RATE FORECAST

Consistent with the forecast is a decline in market interest rates in the remainder of this year, followed by a rise in rates as from 2013 H2
(3M PRIBOR in %)

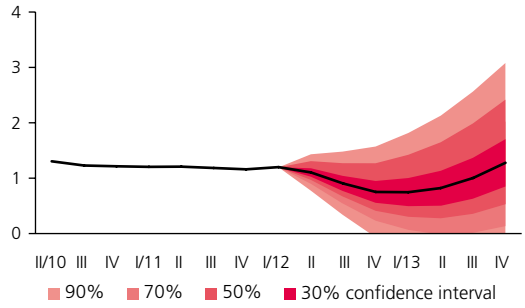


CHART I.5

EXCHANGE RATE FORECAST

The nominal exchange rate will gradually appreciate
(CZK/EUR)

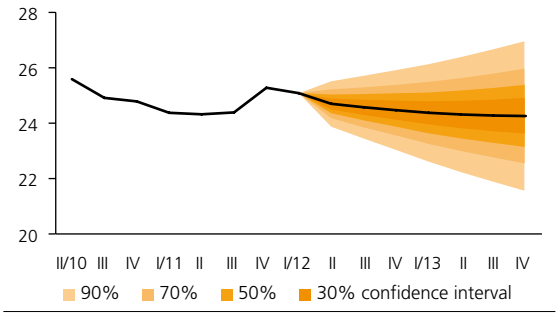


CHART I.6

GDP GROWTH FORECAST

GDP will stagnate overall this year
(annual percentage changes; seasonally adjusted)

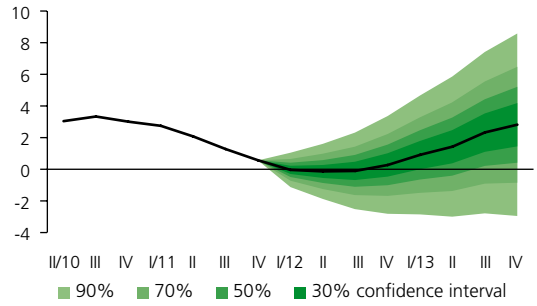


CHART I.7

GDP GROWTH – COMPARISON OF BASELINE AND ALTERNATIVE SCENARIOS

GDP grows significantly more slowly in the alternative scenario than in the baseline scenario in 2013
(annual percentage changes; seasonally adjusted)

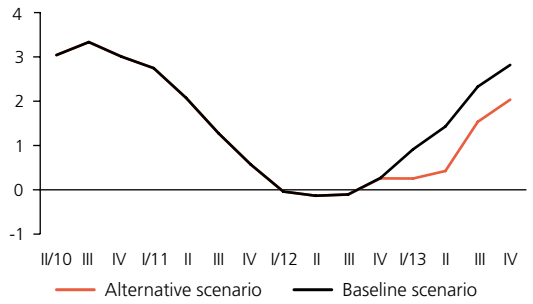


CHART I.8

HEADLINE INFLATION – COMPARISON OF BASELINE AND ALTERNATIVE SCENARIOS

The increase in the two VAT rates pushes headline inflation upwards relative to the baseline scenario as from the start of 2013
(annual percentage changes)

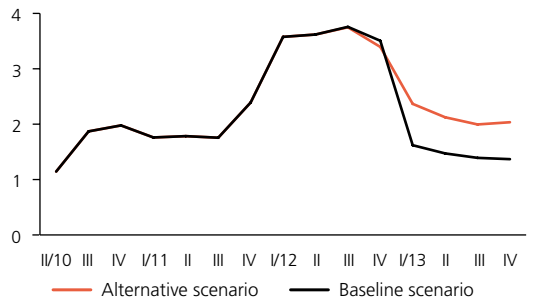
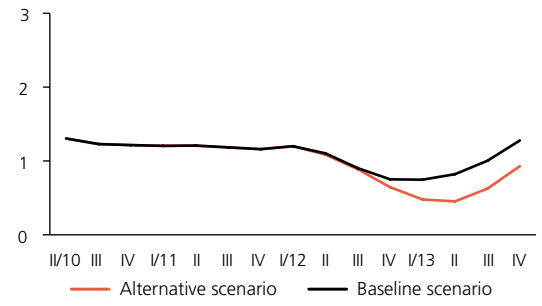


CHART I.9

3M PRIBOR – COMPARISON OF BASELINE AND ALTERNATIVE SCENARIOS

Interest rates are lower in the alternative scenario than in the baseline scenario as from the end of 2012
(in %)



rate will react accordingly. The downturn in the Czech economy will be reflected in roughly flat wage growth in the business sector this year. Wage growth next year will follow the recovery in economic activity and gradually accelerate. Wages in the non-business sector will be flat this year and grow slowly in 2013.

Government proposals of April 2012 aimed at further fiscal consolidation (and for the most part requiring changes to the legislation in force) led to the preparation of an **alternative scenario of additional budgetary measures**. The restrictive fiscal impact will slow economic growth by about 0.8 percentage point in 2013 (see Chart I.7). The increase in both VAT rates by one percentage point will cause headline inflation to rise (see Chart I.8) and – together with other revenue and expenditure measures – will exert downward pressure on the real disposable income of households. The first-round effects of indirect tax changes (of 0.7 percentage point) are not included in monetary-policy relevant inflation, so they do not have a direct impact on interest rates in the simulation. At the same time, the alternative scenario – in line with past experience and the subdued economic activity – does not assume any significant second-round effects of the VAT rate hike on inflation (e.g. due to rising inflation expectations or wages). The lower interest rates from the end of 2012 onwards are thus reacting only to the anti-inflationary pressure generated by the slower GDP growth (see Chart I.9). The exchange rate is almost the same as in the baseline scenario.

At its monetary policy meeting on 3 May 2012, the Bank Board decided by a majority vote to leave interest rates unchanged. The balance of risks was assessed as being inflationary. The demand-side effects of additional fiscal measures in the spirit of the alternative scenario are a downside risk. By contrast, the upside risks include a potential rise in inflation expectations, a slightly weaker koruna-euro exchange rate and higher prices of commodities, especially crude oil. Economic developments abroad represent a risk on either side.

II. THE FORECAST, ITS CHANGES AND RISKS

II.1 EXTERNAL ASSUMPTIONS OF THE FORECAST

Economic growth in the effective euro area is expected to slow sharply this year and to rise gradually again next year. The subsiding effect of high commodity prices and the downturn in industrial production are reflected in a falling outlook for annual producer price inflation. Consumer price inflation will slow as well, owing to cooling economic activity and falling commodity prices. The easy monetary policy of the ECB and slowing economic growth in the euro area are shifting the 3M EURIBOR path downwards. This is reflected in an expected continuing gradual depreciation of the euro-dollar exchange rate. The outlook for the Brent crude oil price foresees a gradual downward trend from the current high values. Given the continuing debt crisis, the risks from the external environment remain significant.

The **outlook for the effective indicator of euro area GDP** foresees a sharp slowdown in growth to 0.5% this year, i.e. 2.2 percentage points lower than in 2011 (see Chart II.1.1).[1] At the same time, expected economic growth in the Czech Republic's main trading partner countries (Germany, Slovakia and Austria) is well above the euro area average. Most euro area countries will go through a fiscal consolidation process necessitated by the escalating debt crisis, which, together with the uncertainty about future developments, will depress domestic demand. An increase in effective external demand growth to 1.6% is expected next year, but the growth rate will stay below that recorded in 2011. The outlook was thus little changed from the previous forecast. The risks to future economic growth are still significant given the continuing debt crisis in the euro area.

Despite the current high prices of energy commodities, the outlook for the **effective indicator of producer prices in the euro area** this year and the next is much lower than in 2011 (see Chart II.1.2), owing mainly to the unwinding of the high commodity prices from annual inflation and to the expected economic slowdown. Producer price inflation should thus be 3.7 percentage points lower this year than in 2011, at 2.3%. A further slight fall to 2.1% is expected in 2013 – despite a gradual depreciation of the euro – as the effect of high oil and natural gas prices subsides. The outlook for producer price inflation is thus slightly higher than in the previous forecast.

The outlook for slowing growth of the **effective indicator of consumer prices in the euro area** (see Chart II.1.3) primarily takes into account the contraction in demand and also the lower contribution of commodity prices. Compared to 2011, consumer price inflation is

1 The outlook for external variables (euro area GDP, PPI, CPI and the dollar-euro exchange rate) is based on Consensus Forecasts (CF) and prices of market contracts (3M EURIBOR, Brent crude oil) as of 10 April 2012. The outlook is indicated by the grey areas in the charts. This convention is used throughout this Report.

CHART II.1.1

EFFECTIVE GDP IN THE EURO AREA

Economic growth in the euro area is expected to slow sharply this year

(annual percentage changes; differences in percentage points – right-hand scale)

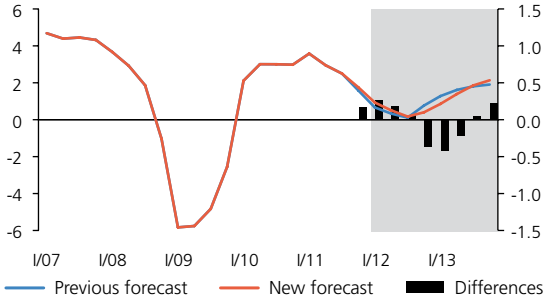


CHART II.1.2

EFFECTIVE PPI IN THE EURO AREA

The falling outlook for producer prices reflects an expected downturn in industrial production and the unwinding of the high commodity prices

(annual percentage changes; differences in percentage points – right-hand scale)

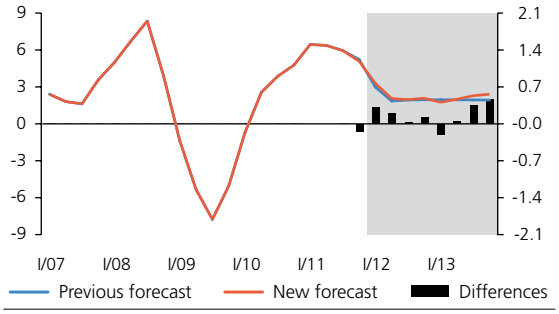


CHART II.1.3

EFFECTIVE CPI IN THE EURO AREA

Effective inflation is just above 2% over almost the entire forecast horizon

(annual percentage changes; differences in percentage points – right-hand scale)

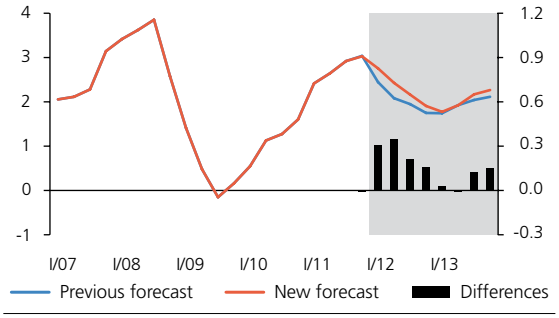


CHART II.1.4

3M EURIBOR

The easy monetary policy of the ECB and slowing economic activity are reflected in a low market rate outlook
(in %; differences in percentage points – right-hand scale)

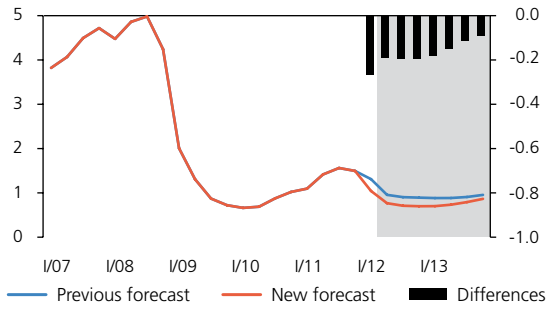


CHART II.1.5

EURO-DOLLAR EXCHANGE RATE

A gradual weakening of the euro-dollar exchange rate is expected over the entire forecast horizon
(USD/EUR; differences in % – right-hand scale)

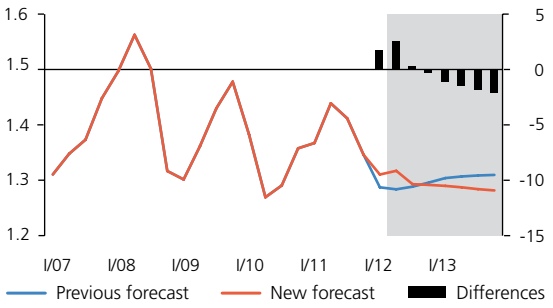
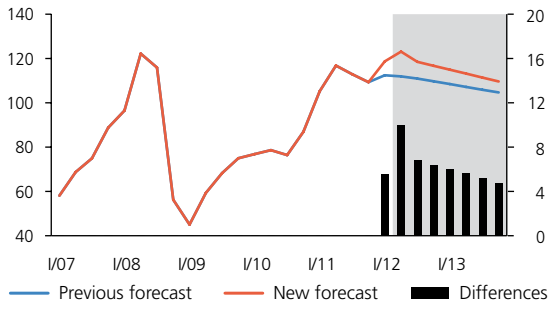


CHART II.1.6

PRICE OF BRENT CRUDE OIL

The market outlook for the price of oil foresees a very gradual decline from the currently elevated level
(USD/barrel; differences in % – right-hand scale)



expected to fall by 0.5 percentage point this year, to 2.3%. Besides fuel and energy prices and rents, indirect taxes will contribute to inflation. In 2013, inflation is expected to fluctuate around the 2% level. The inflation outlook was revised upwards compared to the previous forecast, especially for 2012.

The expected **3M EURIBOR** path reflects the easy monetary policy of the ECB, which renewed its programme to provide long-term liquidity to the banking sector in response to the escalating debt crisis. Compared to 2011, 3M EURIBOR rates are expected to fall by 0.6 percentage point to 0.8% on average this year (see Chart II.1.4). Rates should stay just below this level until mid-2013 and are then expected to rise slightly. Compared to the previous forecast, the market outlook has thus shifted further downwards this year and the next. The market outlook for foreign rates is roughly in line with the expectations of CF analysts this year. At the one-year horizon, however, the analysts expect 3M EURIBOR rates at 1%, i.e. 0.2 percentage point higher than the market outlooks.

The outlook for the **euro-dollar exchange rate** foresees a continuing weakening of the euro, a process which started in mid-2011 (see Chart II.1.5). The average dollar-euro exchange rate is expected to be 1.30 this year, down by about 7% from a year earlier. The euro should weaken slightly further in 2013, to USD 1.29 on average. This is a lower figure than in the previous outlook. The risks going forward are still on both sides. An escalation of the euro area debt crisis could foster a weaker euro, while the dollar could depreciate if the Fed renews its government bond purchase programme.

The outlook for the **Brent crude oil price** based on market futures expects an average oil price of USD 119 a barrel this year (see Chart II.1.6). This means an upward revision of about 6% over the entire outlook horizon compared to the previous forecast, while the gradual downward trend remains unchanged. The current values close to USD 120 a barrel are approaching the record level of 2008. The price is being affected by nervousness associated with geopolitical risks in the Middle East and by positive sentiment linked to growth of the US economy. The slowing global economic growth and the potential escalation of the euro area debt crisis are risks in the opposite direction. The outlook expects the price of Brent crude oil to fall to USD 110 a barrel by the end of 2013. The upward revision of the Brent crude oil price path according to market outlooks is also in line with the expectations of CF analysts, who increased their expectations of the price of WTI oil by 6% to USD 107 a barrel at the one-year horizon.

II.2 THE FORECAST

Headline inflation was 3.7% and monetary-policy relevant inflation 2.5% on average in 2012 Q1. The VAT increase, food prices, administered prices and the gradual pass-through of the past weaker exchange rate to prices are the main sources of inflation. Negative adjusted inflation excluding fuel prices reflects weak domestic demand and low wage growth, and thus partly offsets the higher food and fuel prices. Owing to tax changes, headline inflation will be close to the current elevated values this year, while monetary-policy relevant inflation will be in the upper half of the tolerance band around the CNB's target. Both headline and monetary-policy relevant inflation will fall slightly below the target in 2013. The inflationary effect of import prices will subside in the near future, whereas the currently insignificant cost pressures from the domestic economy will start to resurge in the second half of this year. In 2012, the subdued domestic economic activity will reflect a marked slowdown in external demand and continuing fiscal consolidation. GDP growth will therefore be flat. Next year, in connection with a gradual external demand recovery, GDP growth will reach 1.9%. Consistent with the forecast is a decline in market interest rates in the remainder of this year, followed by a rise in rates as from 2013 H2.

Annual **headline inflation** was 3.7% on average in 2012 Q1. Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, stood at 2.5% in the same period, i.e. above the target. Owing to tax changes introduced in January 2012, headline inflation will stay close to its current elevated levels for almost the entire year (see Chart II.2.1). Monetary-policy relevant inflation will be in the upper half of the tolerance band around the CNB's target this year. Both headline and monetary-policy relevant inflation will fall slightly below the target in 2013. Headline inflation will be slightly lower than monetary-policy relevant inflation due to the unification of the two VAT rates at 17.5% at the start of next year (as still assumed in the baseline scenario of the forecast), which has a moderately anti-inflationary first-round effect overall.

Annual **administered price inflation** rose to 9.7% on average in 2012 Q1. The forecast expects it to fall gradually in the period ahead (see Chart II.2.2). The growth will be due most of all to prices of energy for households and regulated rents. The unwinding of this year's VAT change in early 2013,[2] weaker growth in prices of energy for households and slower growth in regulated rents will cause administered price inflation to fall to around 4%. Annual growth in prices of gas for households will slow in 2013 H2 in line with the expected renewed decline in gas prices on global markets. This will cause administered price inflation to fall just below 3% at the year-end (see Table II.2.1).

2 Unifying the two VAT rates at 17.5% in January 2013 would cause some administered prices to go up. However, the administered prices included in the basic rate, i.e. electricity and gas prices in particular, would simultaneously go down.

Chart II.2.1

HEADLINE INFLATION AND MONETARY-POLICY RELEVANT INFLATION

Headline inflation will temporarily stay close to its current levels (elevated by tax changes) but will fall slightly below the target in 2013 along with monetary-policy relevant inflation
(annual percentage changes)

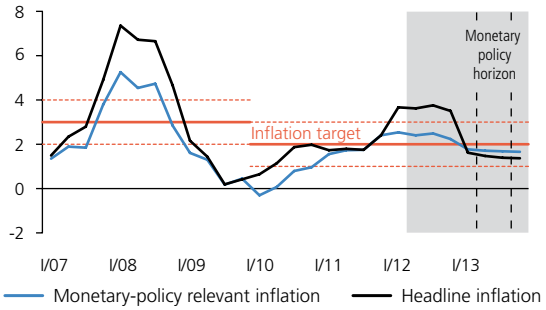


Chart II.2.2

ADMINISTERED PRICES AND FUEL PRICES

Administered price inflation will fall
(annual percentage changes; fuel prices excluding first-round effects of indirect tax changes)

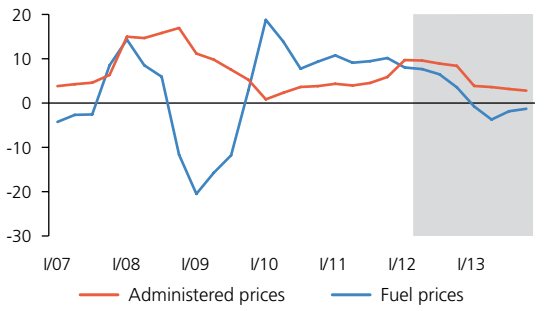


Table II.2.1

FORECAST OF ADMINISTRATIVE EFFECTS

The growth of administered prices will be due mainly to rising energy prices and growth in regulated rents
(annual percentage changes; impacts in percentage points)

	2011 actual		2012 forecast		2013 forecast	
Administered prices – total[a)]	7.0	1.22	7.5	1.40	2.7	0.51
of which (main changes):						
regulated rents	7.7	0.12	17.0	0.20	5.0	0.07
electricity	4.8	0.17	4.5	0.20	-0.1	0.00
natural gas	22.2	0.55	9.0	0.26	0.0	0.00
heat	1.9	0.05	8.0	0.17	5.1	0.12
healthcare	7.0	0.15	9.0	0.16	3.4	0.07
First-round impacts of tax changes in non-administered prices		0.00		0.99		-0.36

a) Including effects of indirect tax changes

CHART II.2.3

NET INFLATION AND ADJUSTED INFLATION EXCLUDING FUELS

Adjusted inflation excluding fuels will turn positive in 2012 Q3
(annual percentage changes)

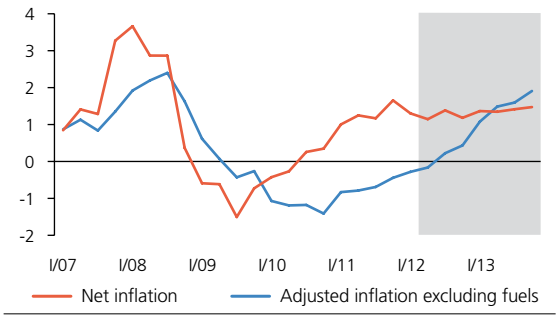


CHART II.2.4

FOOD PRICES AND AGRICULTURAL PRODUCER PRICES

Food price inflation will slow as a result of a decline or only weak growth in agricultural producer prices
(annual percentage changes)

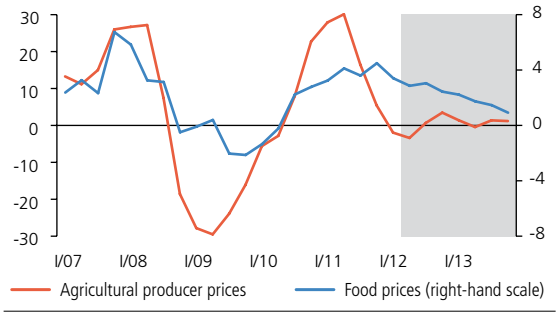
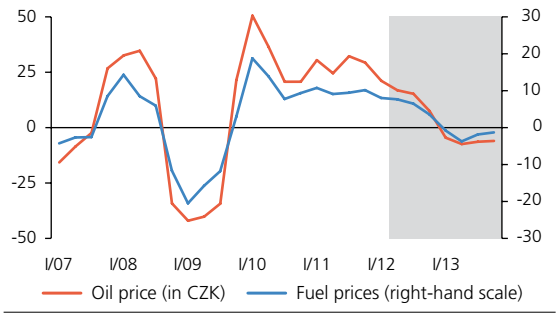


CHART II.2.5

FUEL PRICES AND OIL PRICES

The falling outlook for oil prices will result in a decline in fuel prices next year
(annual percentage changes)



Changes to **indirect taxes** contributed about 1.1 percentage point to consumer price inflation in 2012 Q1 as a result of the increase in the reduced VAT from 10% to 14%. January 2012 also saw a "harmonisation increase" in excise duties on cigarettes, with a contribution to inflation of about 0.1 percentage point. This measure will pass through to consumer prices with a lag during Q2. The forecast still assumes that the two VAT rates will be unified at 17.5% in January 2013, with an overall first-round effect on inflation of about -0.3 percentage point.[3] The effects of all these changes on inflation expectations and wages are not expected to be significant.

Annual **net inflation** slowed to 1.3% on average in 2012 Q1 (see Chart II.2.3), thanks to slower food and fuel price growth. By contrast, adjusted inflation excluding fuels shifted to less negative values. Net inflation will remain broadly stable on average in the coming period as a result of the continuing contrary effects of rising adjusted inflation excluding fuels on the one hand and a gradual moderation of the currently high food and fuel price inflation on the other. In 2013, the effect of the resurgence of domestic inflationary pressures will prevail slightly, and net inflation will be around 1.6% at the year-end.

Annual **adjusted inflation excluding fuels** shifted to less negative values in 2012 Q1 (see Chart II.2.3). Subdued domestic inflationary pressures continued to be apparent. The weak domestic demand constrained growth of sellers' margins in conditions of sharply rising import prices. The forecast expects adjusted inflation excluding fuels to continue to become less negative and to turn positive in 2012 Q3. It will initially be affected above all by a continuing, albeit slowing, rise in import prices. The resurgence of domestic inflationary pressures will prevail in the second half of the year. These two factors will cause adjusted inflation excluding fuels to rise to around 2% at the end of 2013. This will also be fostered by the incomplete pass-through of the decrease in the basic VAT rate to 17.5% in January 2013.

Annual **food price inflation** (excluding the first-round effects of tax changes) fell to 3.4% on average in 2012 Q1, owing to the partial pass-through of the increase in the VAT rate to food prices in advance at the end of 2011. By contrast, food prices were affected in Q1 by a surge in egg prices connected with a change to the EU's veterinary rules and the subsequent lower supply of this agricultural commodity. According to the forecast, annual food price inflation should decrease, partly offsetting the previous high growth in food prices. At the same time it will be affected by base effects and by prices of agricultural commodities. As a result of an annual decline or only weak growth in agricultural producer prices, food price inflation will slow to 2.4% at the end of this year and to 1% at the end of 2013 (see Chart II.2.4).

3 The government's proposal to retain the two VAT rates and raise them both by 1 percentage point is part of the alternative scenario of the forecast (see section II.4). As usual, the baseline scenario works only with measures requiring changes to laws which either have been approved or have at least made sufficient progress through the legislative process.

Annual **fuel price inflation** fell on average in 2012 Q1, but this was mostly due to base effects. The forecast expects a further slight decline in the near term as a result of slower growth in world prices of oil, which will be partly offset by depreciation of the koruna-dollar rate. World prices of oil will switch to an annual decline in 2013, resulting in a slight decrease in fuel prices amid a broadly flat koruna-dollar exchange rate (see Chart II.2.5).

Interest rates on the Czech money market edged up in 2012 Q1. Rates with maturities longer than one year were volatile and also showed a slight increase overall. Consistent with the forecast is a decline in market interest rates in the remainder of this year, followed by a rise in rates as from 2013 H2 (see Chart II.2.6). Low growth in domestic economic activity and wages, reflecting a considerable slowdown in external demand and restrictive fiscal policy, and the low interest rate level abroad are pushing interest rates downwards over the forecast horizon. These anti-inflationary factors are only partly offset by the currently elevated inflation, pressures from import prices and the outlook for administered prices at the start of the forecast horizon. Interest rates do not react to the temporary rise in headline inflation above the target in 2012 caused by the first-round effects of the changes to indirect taxes, to which the escape clause mechanism applies as usual. The rise in interest rates from 2013 H2 onwards reflects an expected gradual rise in interest rates abroad and a recovery of the domestic economy.

The koruna appreciated **against the euro** in 2012 Q1 as the increased uncertainty stemming from the escalation of the euro area debt crisis at the end of 2011 subsided. It remained strong in April 2012. The short-term forecast for the exchange rate for 2012 Q2 is set at an average level of CZK 24.7 to the euro (see Chart II.2.7), reflecting among other things the favourable external trade developments in the first two months of 2012 and a slightly positive interest rate differential. The exchange rate appreciates slightly in the longer term owing to a renewed recovery in external demand and the expected renewal of long-term real convergence. In light of the outlook for a gradually depreciating euro against the dollar according to CF (see section II.1), this implies a broadly stable outlook for the koruna-dollar exchange rate (see Chart II.2.7).

Quarterly growth in **nominal marginal costs in the consumer goods sector** in 2012 Q1 remained similar to that at the end of 2011, owing to the still strong inflationary effect of import prices, reflecting the previous depreciation of the exchange rate and growth in world commodity prices (see Chart II.2.8). By contrast, pressures from the domestic economy, approximated by intermediate goods price inflation, are anti-inflationary owing to persisting weak domestic demand and subdued wage growth. The estimated evolution of export-specific technology is linked to the persisting difference in the evolution of prices of tradables and non-tradables (the Balassa-Samuelson effect), which is now contributing less markedly to inflation than in the pre-crisis period.

CHART II.2.6

INTEREST RATE FORECAST

Consistent with the forecast is a decline in market interest rates in the remainder of this year, followed by a rise in rates as from 2013 H2
(3M PRIBOR and 3M EURIBOR in %)

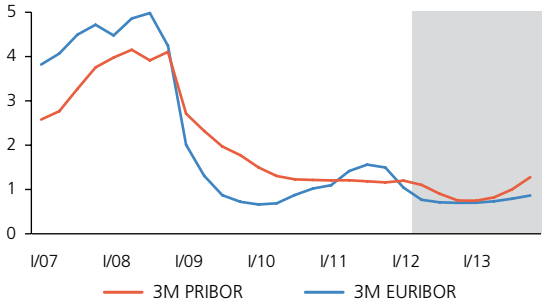


CHART II.2.7

EXCHANGE RATE FORECAST

The nominal exchange rate of the koruna against the euro is appreciating very gradually over the forecast horizon
(CZK/EUR and CZK/USD)

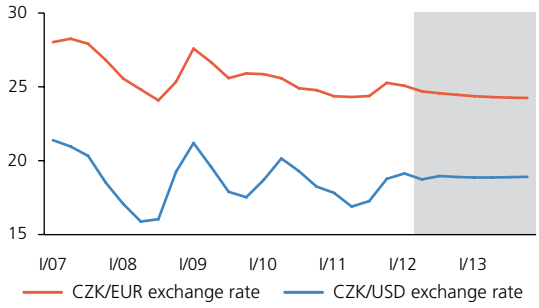


CHART II.2.8

COSTS IN THE CONSUMER SECTOR

Inflation pressures will ease significantly in the near future as the inflationary effect of import prices fades away
(quarterly percentage changes; contributions in percentage points; annualised)

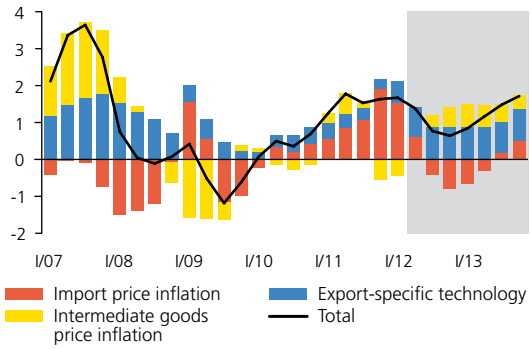


CHART II.2.9

COSTS IN THE INTERMEDIATE GOODS SECTOR

Gradually accelerating wages will be largely offset by growth in labour productivity and a low price of capital
(quarterly percentage changes; contributions in percentage points; annualised)

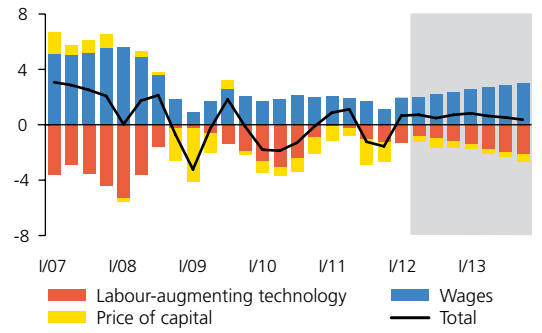


CHART II.2.10

GAP IN PROFIT MARK-UPS IN THE CONSUMER SECTOR

The gap in profit mark-ups will be negative until the end of 2012
(percentages)

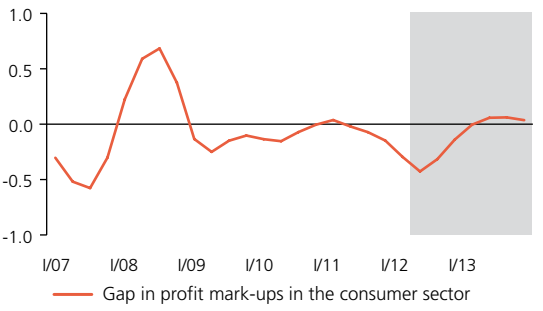
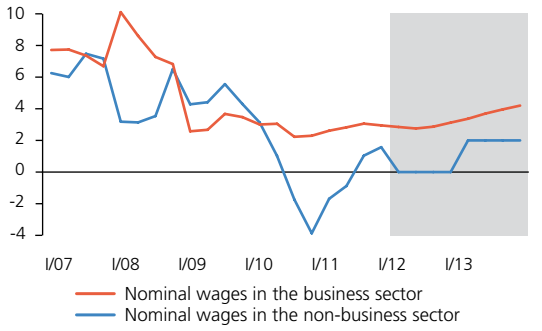


CHART II.2.11

AVERAGE NOMINAL WAGE

Wage growth in the business sector will start to pick up gradually at the end of 2012
(annual percentage changes; seasonally adjusted)



The overall upward pressures on prices in the consumer sector will moderate significantly in subsequent quarters. Import prices will remain inflationary in 2012 Q2, but will later turn anti-inflationary as the impact of the appreciation of the koruna observed at the start of this year and falling inflation abroad manifest themselves with a lag. By contrast, the inflation pressures from the domestic economy will start to resurge in 2012 H2 as economic activity gradually recovers. The gradual return of export-specific technology growth to its long-run level reflects the assumption of long-term appreciation of the equilibrium real exchange rate.

Nominal marginal costs in the intermediate goods sector edged up again in 2012 Q1. Weak growth in nominal wages was partly offset by a rise in labour-augmenting technology (albeit a small one, in line with the observed evolution of whole-economy labour productivity) and a low price of capital (see Chart II.2.9). Domestic cost pressures will remain subdued at the forecast horizon thanks to low wage growth, which will gradually pick up but will be largely founded on labour-augmenting technology growth. The contribution of the price of capital to the rise in costs will be slightly negative at the forecast horizon, reflecting low external demand, manifesting itself in a decrease in production capacity utilisation, and low capital goods prices.

The gap in **profit mark-ups in the consumer goods sector** opened into negative values at the end of 2011 as cost pressures from import prices outweighed the effect of higher consumer prices (see Chart II.2.10). The forecast assumes that the gap in profit mark-ups will be negative until the end of 2012 owing to slightly higher growth in costs than in market prices amid generally subdued economic activity. The gap will close in early 2013, when growth in economic activity is expected to gain momentum.

Annual growth in whole-economy **labour productivity** was flat in 2012 Q1, recording values of around zero. The forecast expects productivity to start rising gradually in Q2, with the growth rate reaching almost 3% at the end of the forecast horizon. The gradual increase in productivity at the start of the forecast period is due mainly to falling employment. At the start of 2013, the main reason will be faster GDP growth amid only a gradual recovery in the labour market. Labour productivity will rise on average by 0.5% in 2012 and 2% in 2013.

Annual growth in nominal **wages in the business sector** slowed to 2.9% (adjusted for seasonal effects) in 2011 Q4. Wages in the business sector maintained a similar growth rate in 2012 Q1, rising by 2.8%; this short-term prediction takes into account the observed relatively high wage growth in industry in January and February 2012. Wage growth will start to pick up gradually in 2012 H2 as economic activity recovers. The surge in wage growth will continue steadily to 4% at the end of 2013. The average wage in the business sector will rise by 2.9% in 2012 as a whole and 3.8% in 2013 (see Chart II.2.11).

The continued consolidation of public budgets will affect the nominal average wage in the **non-business sector**. The forecast expects the government austerity measures to be reflected in a flat average wage this year. Employment in this sector is also expected to stagnate. Average wages in the non-business sector will rise by around 2% in 2013, with employment continuing to stagnate.

Real GDP growth slowed considerably in year-on-year comparison in 2011 Q4, to 0.6%. In quarter-on-quarter terms, GDP declined by 0.1% (see Chart II.2.12). The slowdown in annual GDP growth was due mostly to investment, but also to government and household consumption, whose contributions to economic growth were negative. Net exports were the only component to make a positive contribution.

The forecast expects annual **growth in economic activity in 2012 Q1** to slow further to zero (see Chart II.2.13). This is due mainly to a significant decline in the positive contribution of net exports compared to the previous quarter. Domestic demand made a negative contribution to GDP growth in all components except investment. The forecast expects flat GDP for 2012 as a whole. Only net exports will record a positive contribution to economic activity. The other expenditure components will have a negative or neutral impact on growth.

Domestic demand will remain subdued **in 2012** in all expenditure components. The increase in the reduced VAT rate coupled with weak growth in nominal disposable income, reflecting subdued growth in wages and salaries, will give rise to a slight decline in real private consumption. Continued austerity measures will be reflected in a decrease in real government consumption. As a result of weak external demand and final consumption, fixed investment growth will be only negligible, fostered partly by renewed growth in government investment. The contribution of inventories to annual GDP growth will be negative owing to lower export growth. Despite the subdued external demand, net exports will make positive contributions to GDP growth for most of 2012, reflecting the subdued domestic demand, especially in its import-extensive components (inventories and fixed investment).

In **2013**, the contributions of almost all components to GDP growth should increase thanks to an economic recovery abroad and the overall neutral effect of fiscal policy in the baseline scenario of the forecast. Real economic activity will rise by 1.9% for the year as a whole. Higher wages and salaries, social benefits and profits of small businesses (operating surplus and mixed income) will be reflected in rising disposable income, and private consumption will gradually recover.[4] Gross capital formation will turn positive; in particular, the contribution of fixed investment will increase, reflecting its continued growth in the government sector. Faster growth in effective external

CHART II.2.12

GDP GROWTH FORECAST

GDP will not rise this year

(percentage changes; seasonally adjusted)

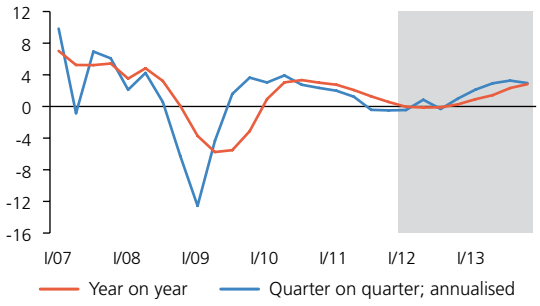
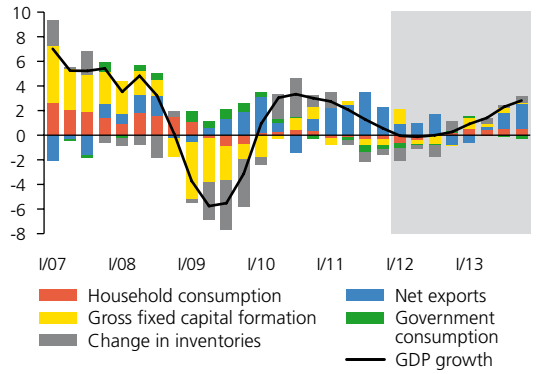


CHART II.2.13

ANNUAL GDP GROWTH STRUCTURE

Only net exports will record positive contributions to GDP growth in 2012

(annual percentage changes; contributions in percentage points; seasonally adjusted)



4 However, the alternative scenario in section II.4 indicates a major downward risk in this area.

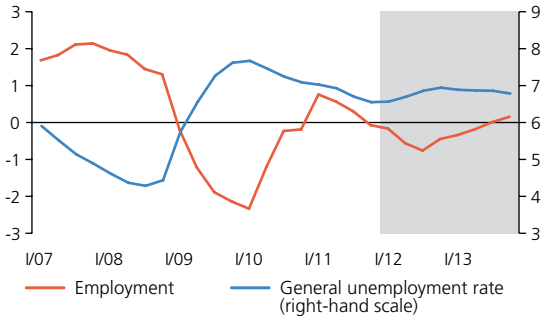
demand will lead to an increase in exports. Import-intensive exports, investment and private consumption will foster higher growth in imports. The contribution of net exports will be positive overall again and slightly higher than in 2012. Government consumption will be the only component to make a negative contribution to GDP growth in 2013. This is linked with expected government spending cuts not requiring legislative changes.

CHART II.2.14

LABOUR MARKET FORECAST

Total employment will fall until mid-2013, and the unemployment rate will edge up

(annual percentage changes in employment; general unemployment rate in percentages; seasonally adjusted)



Total employment switched from year-on-year growth to a modest decline in 2011 Q4. The onset of the economic stagnation phase will manifest itself in overall employment as an increased rate of annual decline, which will bottom out in 2012 Q3. The rates of year-on-year decline will later slow, with employment returning to modest year-on-year growth in mid-2013 (see Chart II.2.14). Overall, employment will fall by 0.5% on average this year. Its decline will decrease to 0.1% next year.

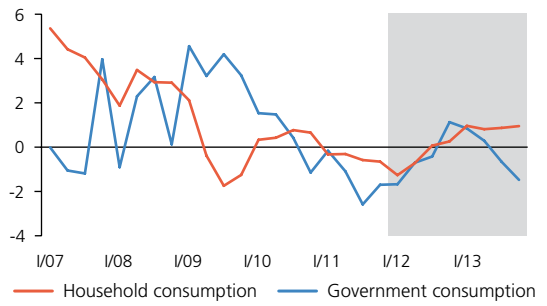
The forecast assumes that the seasonally adjusted **general unemployment rate** was flat at 6.6% in 2012 Q1. This year, however, the rate will increase, reaching almost 7% at the year-end (see Chart II.2.14), owing to a decline in total employment, which will be only partly offset by a continuing decrease in the labour force. In 2013, the general unemployment rate will decline only negligibly, despite an economic recovery. The labour market will react to movements in economic activity with the usual lag. On average, it will be 6.8% in 2012 and 6.9% in 2013. Similar developments can be expected in the seasonally adjusted **total registered unemployment rate**, which will gradually increase to 9% at the end of 2012. Next year, it will come down from this level only marginally. It will therefore be 8.8% on average in 2012 and increase slightly to 8.9% in 2013.

CHART II.2.15

REAL HOUSEHOLD AND GOVERNMENT CONSUMPTION

Household consumption will recover only gradually over the forecast horizon

(annual percentage changes; seasonally adjusted)



Having dropped in 2011 and 2012 H1, real **household consumption** will recover slightly in 2012 H2. The overall decline in household consumption this year (of 0.4%) will reflect relatively weak nominal disposable income growth linked with labour market developments. Real consumption will also be hindered by higher inflation, mainly as a result of the VAT increase. Subdued consumer demand is also indicated by the available leading indicators, such as a low consumer confidence indicator and an only slight increase in retail sales (see section III.3). Consumption will rise by 0.9% in 2013 as a result of faster nominal wage growth and significantly lower inflation (see Chart II.2.15).

The growth in nominal household consumption over the forecast horizon can be largely associated with the subdued growth in **gross disposable income**, which should gradually accelerate over the entire forecast horizon. The most important component of disposable income, i.e. the volume of wages and salaries, will be subdued in the near future[5] but its growth rate will then gradually rise in connection

5 The results of the CZSO business survey show that households do not expect their financial situation to improve over the next 12 months (for details, see section III.3.1).

with the continuing economic recovery and the labour market developments described above (see Chart II.2.16). Another significant component of disposable income, social benefits, should also record positive contributions. The other components will make negligible contributions to disposable income growth.

The forecast expects the **saving rate** to fall in 2012 H1 and start rising again in 2012 H2. The saving rate will recover as conditions on the labour market improve and the substantial effect of the VAT change implemented in January 2012 fades away. However, it will not reach the pre-crisis level until the end of 2013 and will remain below 10%.

Real **government consumption** has been decreasing since the end of 2010 owing to government austerity measures. The forecast expects this trend to continue into 2012 H1; afterwards, government consumption should start rising again temporarily year on year. Government consumption will show negative growth on average in 2012 (-0.4%) and 2013 (-0.3%) because of the expected expenditure cuts aimed at reducing the impact of the shortfall in tax revenues on the general government balance.

Gross capital formation recorded a year-on-year decline of 4% in 2011 Q4, due mainly to changes in inventories. This trend should continue into 2012 Q4, when the contribution of changes in inventories will stop showing negative values. Fixed investment will edge up in both 2012 and 2013, as indicated by data from a business survey conducted by the CNB and the Confederation of Industry and by the data on new industrial orders (see section III.3). Government investment will be a contributing factor as well. Overall, gross capital formation will fall by 1.6% year on year in 2012 and rise by 2.9% in 2013 as economic activity recovers (see Chart II.2.17).

Real **exports of goods and services** continued to record slowing year-on-year growth in 2011 Q4 (5%), while declining in quarter-on-quarter terms. This chiefly reflects the slackening external demand, showing up as lower growth in foreign trade turnover. According to the forecast, exports will increase by 5% on average in 2012. This partly reflects the good trade balance results at the start of 2012 and the gradual recovery in external demand in the following period. Annual export growth should surge to almost 11% at the end of 2013 (see Chart II.2.18), when external demand will show renewed stable growth.

Given the slowdown in most components of domestic demand and exports in 2011 Q4, real **imports of goods and services** also recorded a decline in growth (to 1.8%). Despite a slight decline in domestic private and government consumption and investment in inventories, imports of goods and services will rise by 4.3% on average this year, mainly because of a recovery in import-extensive exports.

Amid slower growth in exports and imports, the contribution of **net exports** to annual GDP growth was positive in 2011 Q4 (2.3 percentage points). With the exception of late 2012 and early 2013,

CHART II.2.16

NOMINAL DISPOSABLE INCOME

Gross disposable income will rise steadily owing to rising social benefits and wages and salaries
(annual percentage changes; contributions in percentage points)

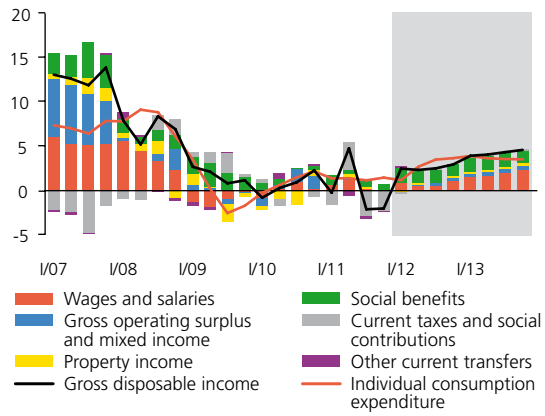


CHART II.2.17

GROSS CAPITAL FORMATION

Gross capital formation will fall this year and rise slightly in 2013
(annual percentage changes; seasonally adjusted)

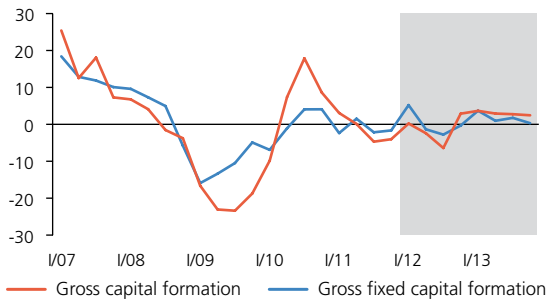


CHART II.2.18

REAL EXPORTS AND IMPORTS

Export and import growth will slow in 2012, but the contribution of net exports to GDP growth will remain positive
(annual percentage changes; annual changes in CZK billions; seasonally adjusted)

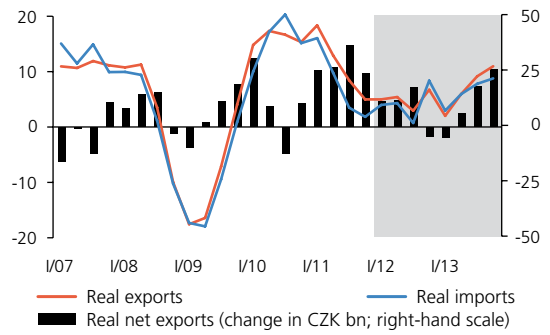


Table II.2.2

FORECASTS OF SELECTED VARIABLES

Real disposable income will not rise until 2013
(annual percentage changes unless otherwise indicated)

	2011 actual	2012 forecast	2013 forecast
Real gross disposable income of households	-1.8	-0.6	1.5
Total employment	0.4	-0.5	-0.1
Unemployment rate (in per cent)[a]	6.8	6.8	6.9
Labour productivity	1.4	0.5	2.0
Average nominal wage	2.2	2.4	3.5
Average nominal wage in business sector	2.7	2.9	3.8
Current account deficit (ratio to GDP in per cent)	-2.9	-2.2	-1.9
M2	3.4	6.8	6.9

a) ILO methodology, 15–64 years

Table II.2.3

BALANCE OF PAYMENTS FORECAST

A rising trade surplus will reduce the current account deficit
(CZK billions)

	2011 actual	2012 forecast	2013 forecast
A. CURRENT ACCOUNT	-109.1	-85.0	-75.0
Trade balance	94.0	135.0	160.0
Balance of services	66.3	60.0	65.0
Income balance	-271.9	-280.0	-300.0
Current transfers	2.5	0.0	0.0
B. CAPITAL ACCOUNT	14.7	8.0	18.0
C. FINANCIAL ACCOUNT	90.8	115.0	85.0
Direct investment	75.2	65.0	65.0
Portfolio investment	5.8	60.0	20.0
Financial derivatives	-3.0		
Other investment[a]	9.8	-10.0	0.0
D. ERRORS AND OMISSIONS	-10.7		
E. CHANGE IN RESERVES (- = increase)	17.2		

a) forecast excluding operations of banking sector

the forecast expects the contribution of net exports to GDP growth to remain positive. Larger contributions will be recorded by net exports towards the end of 2013 (0.8 percentage point on average for the year as a whole) thanks to an upswing in external demand and subsequently also exports.

The balance of payments forecast expects the **current account** deficit to fall quite considerably in 2012 relative to the preliminary 2011 outcome and then to decline further in 2013 (see Table II.2.3). In relative terms, this means a decline in the deficit from around 2.9% of GDP in 2011 to 2.2% this year and 1.9% next year. The expected decrease in the current account deficit in 2012 is due to the expected higher trade surplus, which is associated on the one hand with year-on-year decline in aggregate domestic demand and on the other hand with a slight increase in external demand (see above). At the same time, the market shares of Czech businesses in selected engineering sectors on the European market (road vehicles, general industrial machinery and electrical equipment, machinery and appliances) are increasing. Unfavourable terms of trade will continue to foster a lower trade surplus in 2012. The expected cooling of external demand is reflected in lower export and import growth. Owing to an expected slight decline in commodity prices, the trade surplus will increase again next year. This will be aided by a recovery in external demand. The services balance should decline somewhat this year, mainly because of a fall in the transport surplus. The overall surplus should rise slightly again in 2013, owing mainly to a surplus on other services. The income deficit will widen slightly this year as a result of the expected still high direct investment earnings of non-residents and an increase in net interest expenditure. These two factors will increase the income deficit in 2013, too. Current transfers should remain broadly balanced, since the expected slightly lower net drawdown of EU funds in 2012 will primarily affect the capital account. It will also be negatively affected by a decline in the prices of emission permits on the European market.

The current account deficit will be financed by a slight capital account surplus (due to drawdown of EU funds) and above all by a financial account surplus (due mainly to net inflows of direct and portfolio investment). The net inflow of **direct investment** will be slightly lower in 2012 and 2013 than in 2011 and will be concentrated exclusively in reinvested earnings. The forecast contains negative net investment in equity and other capital in both years, which means a very modest real outflow of capital. As regards **portfolio investment**, foreign government bond issues are the main factor behind the sizeable year-on-year increase in the net capital inflow this year. Modest economic growth in 2013 should help stimulate residents' interest in foreign portfolio investment. However, the overall portfolio investment balance will record a year-on-year decline, mainly because the forecast for 2013 contains foreign government bond issues of about half the size of this year's total.

The future macroeconomic developments described above are reflected in the **government finance** outlook for 2012–2013 (see Table II.2.4). The fiscal forecast (like the previous ones) works with the changes in VAT laid down in the legislation in force: an increase in the reduced VAT rate from 10% to 14% at the start of this year and the unification of the two VAT rates at 17.5% in 2013. The forecast also incorporates the effect of the pension reform, which is scheduled by law to be launched in 2013. The expected revenue from the taxation of lotteries and other games of chance this year and the next has been reduced from CZK 7.2 billion to CZK 4.7 billion based on current information. The budget measures approved by the government in April, which will have an impact on public finances starting in 2013, are not included in the baseline scenario, but form part of the alternative scenario of the forecast (see below and section II.4).

According to the **spring government deficit and debt notifications**,[6] the general government deficit amounted to 3.1% of GDP in **2011** (the forecast in Inflation Report I/2012 had been 3.8%). The lower-than-forecasted government deficit was due mainly to a continuing significant decline in investment. Gross fixed capital formation in the government sector fell mainly in investment financed from domestic sources. The amount of capital transfers related to the drawdown of EU funds last year was in line with previous years. In 2011, the overall restrictive effect of public finances slowed GDP growth by around 1 percentage point through household and government consumption and investment.

The forecast for **2012** expects the general government deficit to edge down to 3% of GDP, mainly as a result of higher revenue stemming from the increase in the reduced VAT rate, which by the CNB's estimation will boost tax revenues by around CZK 29 billion. On the other hand, the economic downturn will be reflected in a tax revenue shortfall and therefore an increase in the cyclical component of the government deficit. The higher living costs of households connected with the VAT increase will be partly offset by a rise in the personal income tax discount for dependent children (estimated impact: CZK 3.4 billion). In addition, the forecast expects government investment to pick up, partly offsetting the shortfall in the previous two years. The resulting effect of fiscal policy will be weakly restrictive, with an estimated impact on real GDP growth this year of around -0.2 percentage point.

6 On 30 March 2012, the CZSO sent Eurostat data on government finance in 2008–2011 as part of the spring government deficit and debt notification. These data have been approved by Eurostat.

TABLE II.2.4

FISCAL FORECAST

The halt in economic growth in 2012 together with the pension reform in 2013 will cause the government deficit to GDP ratio to increase

(% of nominal GDP)

	2011 actual	2012 forecast	2013 forecast
Government revenue	40.3	40.9	40.2
Government expenditure	43.4	43.9	44.0
of which: interest payments	1.4	1.5	1.6
GOVERNMENT BUDGET BALANCE	-3.1	-3.0	-3.8
of which:			
primary balance[a)]	-1.7	-1.5	-2.2
one-off measures[b)]	-0.2	0.0	-0.4
ADJUSTED BUDGET BALANCE[c)]	-2.9	-3.0	-3.4
Cyclical component (ESCB method)[d)]	-0.2	-0.8	-0.8
Structural balance (ESCB method)[d)]	-2.7	-2.2	-2.6
Fiscal stance in pp (ESCB method)[e)]	2.0	0.5	-0.4
Cyclical component (EC method)[d)]	-0.2	-0.5	-0.2
Structural balance (EC method)[d)]	-2.7	-2.5	-3.2
Fiscal stance in pp (EC method)[e)]	1.5	0.2	-0.7
Government debt	41.2	43.3	45.2

a) government budget balance minus interest payments
b) impact of the pension reform included for economic reasons in 2013
c) adjusted for one-off measures; CNB estimate
d) CNB estimate
e) year-on-year change in structural balance (positive value indicates fiscal restriction, negative value fiscal expansion)

According to adopted legislation, a pension reform should be launched in **2013**. A shortfall in social security revenue of CZK 15 billion (for details see BOX 1 *Pension system reform* in Inflation Report IV/2011) coupled with the fiscal impacts of the earlier slowdown in economic growth will lead to a rise in the general government deficit to 3.8% of GDP. The second stage of the VAT rate changes under the legislation currently in effect (unification at 17.5%) will have a roughly neutral effect on the budget. To the same extent as in the previous forecast, the baseline scenario of the forecast for 2013 includes an assumption of additional unspecified spending cuts that are fully within the competence of the government. By contrast, the forecast expects that the stronger growth in government investment will continue into next year. The overall effect of fiscal policy on economic growth in the baseline scenario of the forecast for 2013 will be broadly neutral.

The general government **structural deficit** fell below 3% of GDP in 2011. The current legislation and government measures will cause it to edge down further in 2012. Subsequently, the baseline scenario of the forecast expects moderate autonomous growth in the structural deficit relative to GDP. The expected general government deficit will lead to an increase in general government debt from 41.2% of GDP in 2011 to more than 45% of GDP in 2013.

The planned additional consolidation measures approved by the government on 10 April 2012 and subsequently incorporated into this year's update of the Czech Republic's convergence programme represent a **risk to the fiscal forecast** in the direction of lower deficits. The alternative scenario of the forecast (see section II.4) deals with the quantification of these additional consolidation measures and their impacts on public budgets.

The potential postponement of the pension reform, or of the launch of its second pillar,[7] to 2014 or 2015 for technical reasons, represents another risk to the fiscal forecast. It would reduce the deficit-to-GDP ratio by almost 0.4 percentage point in 2013. Potential property settlement between the state and churches remains an additional risk.[8]

7 The pension reform may be postponed primarily for technical reasons, as the reform assumes that the Unified Revenue Collection Agency will already be up and running. However, the authority will not be established until 2015.

8 In connection with property settlement between the state and churches, financial compensation of CZK 59 billion provided to churches and religious societies is expected in addition to restitutions in kind. In the national accounts statistics, the compensation will probably be reported as a non-recurring general government expenditure in the year in which the law on church property restitutions is passed. This will lead to a one-off increase in the general government deficit under ESA 95 methodology of the same amount (roughly 1.5% of GDP). However, the compensation will be exempted from the calculation of the structural deficit.

II.3 COMPARISON WITH THE PREVIOUS FORECAST

The predictions for headline and monetary-policy relevant inflation in 2012 have both been increased compared to the previous forecast. The outlooks for administered prices and net inflation have been revised upwards. The prediction for inflation in 2013 is virtually unchanged. The interest rate path is little changed. Upward changes in the initial state (higher observed inflation, import prices and wage growth at the start of 2012) and a higher outlook for administered prices are offset by a lower outlook for euro area interest rates and lower short-term predictions for inflation and the exchange rate. Annual GDP growth is unchanged from the previous forecast. The expected growth rate of nominal wages in the business sector has been revised upwards slightly, mainly because of the observed evolution of wages in industry in early 2012.

Compared to the previous prediction, the forecast for annual **headline inflation** is higher for this year and only slightly changed for next year (see Chart II.3.1). Forecasted administered price inflation is higher over the entire forecast horizon, while the net inflation forecast is higher only in 2012. The assumptions regarding indirect tax changes are unchanged. However, their expected first-round effects have been increased by 0.1 percentage point in 2012 compared to the previous forecast owing to a revision of the consumer basket; by contrast, they have been reduced to a similar extent in 2013 (see BOX 1). For this reason, the forecast for headline inflation has been increased by 0.1 percentage point more than that for **monetary-policy relevant inflation**. In 2013, the consumer basket update then acts in the opposite direction to level the changes in the forecasts for headline and monetary-policy relevant inflation.

BOX 1
REVISION OF THE CONSUMER BASKET

A regular revision of the CZSO consumer basket, involving a change in weights and some representative items, took place in January 2012. The new weighting scheme is based on the structure of household consumption in 2010. The weight of administered prices in the consumer basket has been increased slightly. Deregulated rent has been excluded from the definition of administered prices, while workplace and school food items have been included (see the table). Within net inflation, the weight of food has been decreased. The weight of adjusted inflation excluding fuels is slightly lower, with the decrease in the weight of goods (other tradables) outweighing the increase in the weight of services (other non-tradables).

Given the increase in the weights of items with usually higher inflation (administered prices and services prices), the change to the consumer basket represents a shift towards slightly higher

CHART II.3.1

CHANGE IN THE HEADLINE INFLATION FORECAST

The forecast for headline inflation this year has moved upwards
(annual percentage changes; differences in pp – right-hand scale)

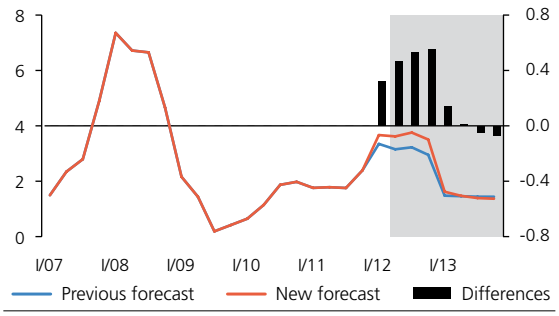


CHART II.3.2

CHANGE IN THE NET INFLATION FORECAST

The price increase observed at the start of this year is reflected in an increase in the net inflation forecast in 2012
(annual percentage changes; differences in pp – right-hand scale)

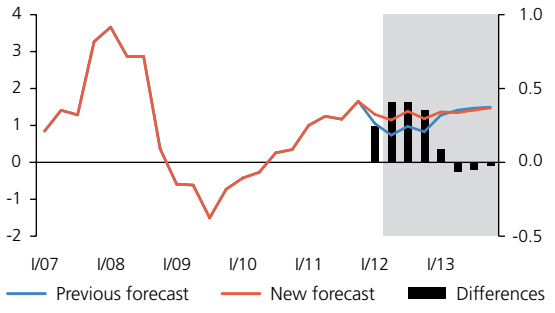


TABLE (BOX)

WEIGHTS OF THE MAIN CATEGORIES IN THE CZSO CONSUMER BASKET

The weight of administered prices in the consumer basket has been increased
(in %)

	Old basket	New basket	Difference
Total	100.0	100.0	0.0
Administered prices	17.1	18.7	1.6
Net inflation	82.9	81.3	-1.6
of which:			
food prices	25.6	24.6	-1.0
fuel prices	3.7	3.4	-0.3
adjusted inflation excluding fuels	53.5	53.3	-0.2
of which:			
other non-tradables	31.5	32.0	0.4
other tradables excluding fuels	22.0	21.4	-0.6

CHART II.3.3

CHANGE IN THE INTEREST RATE PATH

The market interest rate path has been revised only marginally
(3M PRIBOR in %; differences in pp – right-hand scale)

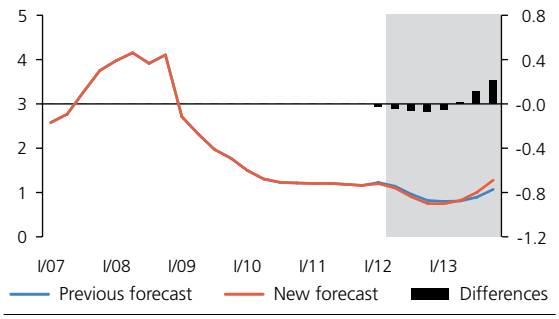


CHART II.3.4

DECOMPOSITION OF CHANGES IN THE INTEREST RATE FORECAST

Higher rates are being fostered by observed inflation, which is offset by a lower outlook for foreign interest rates over almost the entire horizon
(3M PRIBOR; percentage points)

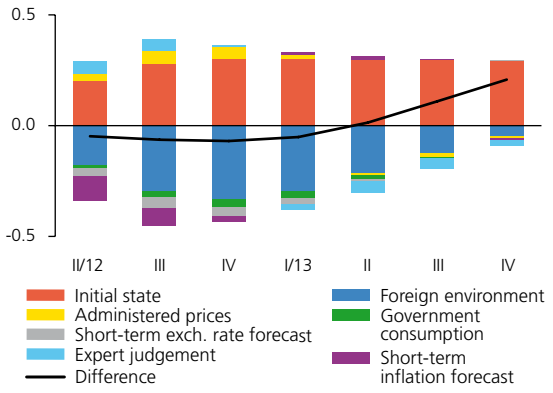
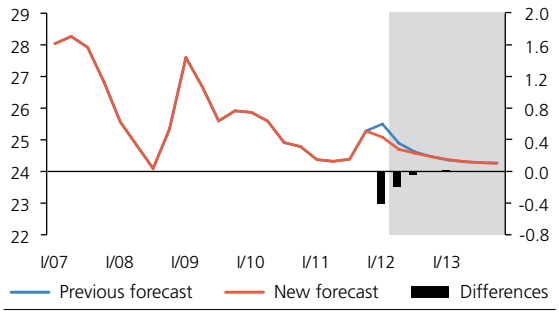


CHART II.3.5

CHANGE IN THE EXCHANGE RATE FORECAST

The exchange rate forecast is stronger at the start of the forecast horizon but unchanged in the longer run
(CZK/EUR; differences in CZK – right-hand scale)



reported inflation. The change in the basket added about 0.1 percentage point to the published figures for January to March 2012 compared to the forecast in Inflation Report I/2012, which was based on the original basket. The change to the consumer basket also led to a slight revision of the first-round effects of the VAT changes in 2012 and 2013. At 1.13 percentage points, the contribution of the increase in the reduced VAT rate from 10% to 14% to consumer price inflation was 0.07 percentage point higher than originally assumed. The new forecast expects that the unification of the two VAT rates at 17.5% in January 2013 will have a first-round effect on inflation of -0.29 percentage point. The earlier estimate, based on the original basket, was -0.22 percentage point.

Expected **administered price inflation** in 2012 is higher than in the previous forecast, mainly as a result of faster expected growth in natural gas prices for households, water supply and sewerage collection charges, and prices in health care. On the other hand, the outlook for regulated rent growth has been lowered. Administered price inflation is also higher in 2013. This is linked with an expected higher growth rate of natural gas prices for households, derived from expected stronger growth in world gas prices and less pronounced year-on-year appreciation of the koruna-dollar exchange rate.

Compared to the previous forecast, annual **net inflation** is higher in 2012, but broadly unchanged in 2013 (see Chart II.3.2). The higher inflation in 2012 is due chiefly to the price increase observed in early 2012, which was linked primarily with food price developments. Import prices are also playing a role in this regard, with the impacts of the past exchange rate weakening and growth in world commodity prices unwinding more gradually.

Turning to the **external environment** outlook, by comparison with the assumptions of the previous forecast, the 3M EURIBOR path has dropped over the entire forecast horizon in response to the continuing euro area debt crisis (see section II.1). The expected growth rate of external demand is little changed in 2012 and slightly lower in 2013. The annual growth rates of foreign producer prices have been revised slightly upwards owing to higher oil prices.

The forecast for domestic market **interest rates** changes only marginally until mid-2013, but it is slightly higher thereafter (see Chart II.3.3). The initial state is acting towards higher rates over the entire forecast horizon, owing to higher observed inflation and import prices and stronger wage growth in the first few months of 2012. The higher outlook for administered prices is also fostering higher rates in 2012. Expert judgement is also contributing to higher rates at the start of the prediction horizon, reflecting the assumption of a more gradual

unwinding of the inflationary effect of import prices and a slightly less restrictive future effect of fiscal policy. By contrast, a lower outlook for foreign interest rates is the main downside factor, complemented by the short-term prediction for inflation and the exchange rate (see Chart II.3.4).

The prediction of the nominal **exchange rate of the koruna against the euro** has been revised towards stronger levels in 2012 Q2 (see Chart II.3.5). This revision is due to the observed stronger exchange rate in Q1 and unexpectedly favourable foreign trade developments in early 2012. In the longer run, the exchange rate forecast is unchanged.

The forecast for annual **GDP** growth is broadly unchanged from the previous prediction (see Chart II.3.6). In 2013, a slightly lower outlook for external demand is offset by less restrictive fiscal policy.

The new forecast expects lower growth in **household consumption**, reflecting above all higher inflation, which is not fully offset by stronger nominal wage growth. Annual growth in **gross capital formation** is lower than in the previous prediction until 2012 Q3 and higher thereafter. This decrease is related, among other things, to newly available data. The future quarter-on-quarter growth rates are higher in both 2012 and 2013. This is connected also with an expected rise in government investment at the forecast horizon following its sharper-than-expected contraction in 2011.

The new forecast for **exports and imports** is affected by unexpectedly high rates of foreign trade turnover at the start of 2012 accompanied by higher trade balance surpluses, together with a higher net export prediction for 2012. In 2013, by contrast, a slightly lower external demand outlook gives rise to slower annual export growth, hence the positive contribution of net exports to GDP growth is slightly smaller than in the previous forecast.

The forecast for average **nominal wage growth** in the business sector is slightly higher than in the previous forecast – 0.4 percentage point higher for 2012 and 0.3 percentage point higher for 2013 (see Chart II.3.7). The higher growth in wages is linked with the wage growth observed in industry in the initial months of 2012 and with an expected stronger upswing in productivity growth, reflecting an expected recovery in government investment in both 2012 and 2013 by comparison with the previous forecast.

CHART II.3.6

CHANGE IN THE GDP FORECAST

The forecast for annual GDP growth is unchanged in both 2012 and 2013

(annual percentage changes; differences in pp – right-hand scale; seasonally adjusted)

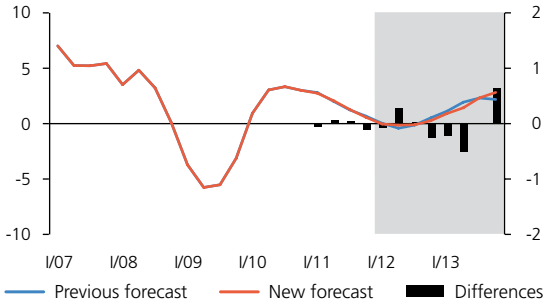
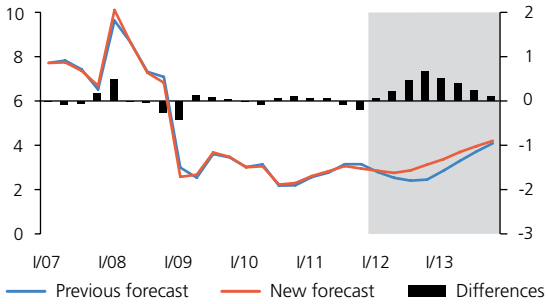


CHART II.3.7

CHANGE IN THE NOMINAL WAGE FORECAST

The business-sector nominal wage forecast is slightly higher

(annual percentage changes; differences in pp – right-hand scale; seasonally adjusted)



II.4 ALTERNATIVE SCENARIOS AND SENSITIVITY ANALYSES

The risks to the forecast continue to be associated with the external situation, in particular the euro area debt crisis. The risk of its impacting on external demand is still assessed as significant, but not skewed in either direction. However, the risk of additional budgetary measures in the Czech Republic crystallised during the forecasting process. This led to the preparation of an alternative scenario. An exchange rate sensitivity scenario was also prepared as usual. Overall, the risks to the baseline scenario are assessed as being skewed towards the alternative scenario, which in 2013 leads to lower interest rates and considerably slower economic growth amid higher headline inflation due to an increase in both VAT rates.

II.4.1 Alternative scenario – additional budgetary measures

The alternative scenario reflects **proposed government measures** aimed at further fiscal consolidation. These measures, which for the most part require changes to the legislation in force, were included in the document on the preparation of the state budget and the draft medium-term expenditure framework for 2013–2015, which was approved by the government in April 2012. They were subsequently incorporated into this year's update of the convergence programme.

The planned measures should reduce the government deficit by almost CZK 58 billion (i.e. 1.4% of GDP) in 2013. More than two-thirds of the measures are on the revenue side and less than one-third involve spending cuts (see Table II.4.1). The resulting **restrictive fiscal impact** will slow economic growth by about 0.8 percentage point next year. This impact will be realised both through a price effect stemming from an increase in both VAT rates, which will reduce real household consumption, and through lower nominal disposable income of households and consequently weaker household consumption. Government consumption will also be slightly lower.

The effects of these measures on the **domestic economy** are shown in Table II.4.2 (in the form of deviations from the baseline scenario of the forecast). The increase in both VAT rates by one percentage point will cause headline inflation to rise (the first-round effect will be 0.7 percentage point) and – together with other revenue and expenditure effects – will exert downward pressure on the real disposable income of households. Household consumption will thus decline by about 1.6 percentage points compared to the baseline scenario. The first-round effects of indirect tax changes are not included in monetary-policy relevant inflation, so they do not have a direct impact on interest rates in the simulation. At the same time, the alternative scenario – in line with past experience and the subdued economic activity – does not assume any significant second-round effects of the VAT rate hike on inflation (e.g. due to rising inflation expectations or wages). The lower

Table II.4.1

ALTERNATIVE SCENARIO: ADDITIONAL BUDGET MEASURES – GOVERNMENT-APPROVED MEASURES

The planned measures will significantly affect public budgets in 2013
(CZK billions unless otherwise indicated)

7% additional solidarity personal income tax	1.8
Abolition of basic allowance for working pensioners	2.0
Reduction of flat-expense deductions for self-employed	3.5
Increase of withholding tax against tax havens to 35%	0.6
1 pp increase in VAT to 15% and 21%[a)]	19.6
Abolition of "green diesel" for agricultural producers	1.6
Higher tax on tobacco	0.1
Abolition of health insurance ceiling	1.8
Increase in real estate tax	1.8
Profit transfer from Lesy CR state company	4.0
Sales of emission permits	2.9
REVENUE MEASURES	39.8
Lower indexation of pensions	9.5
Freezing of wages for state employees	5.5
Abolition of housing benefit subsidy	0.8
Lower subsidies on renewable energy resources	2.0
Lower subsidy to SFDI state fund	0.2
EXPENDITURE MEASURES	18.0
TOTAL REVENUE AND EXPENDITURE MEASURES	57.8
% of GDP[a)]	1.4
Fiscal impulse to GDP in percentage points[a)]	-0.8

a) CNB estimate

Table II.4.2

ALTERNATIVE SCENARIO: ADDITIONAL BUDGET MEASURES – IMPACT ON DOMESTIC ECONOMY

The budget measures will foster higher headline inflation, slower GDP growth and lower interest rates in 2013
(deviations from baseline scenario)

	CPI inflation (in pp)	3M PRIBOR (in pp)	GDP (in pp)	Nominal exchange rate (CZK/EUR)
II/12	0.0	0.0	0.0	0.0
III/12	0.0	0.0	0.0	0.0
IV/12	-0.1	-0.1	0.0	0.0
I/13	0.7	-0.3	-0.7	0.0
II/13	0.7	-0.4	-1.0	0.1
III/13	0.6	-0.4	-0.8	0.1
IV/13	0.7	-0.3	-0.7	0.1

interest rates from the end of 2012 onwards are thus reacting only to the anti-inflationary pressure generated by the slower GDP growth. The exchange rate is almost the same as in the baseline scenario, while nominal wage growth is slightly lower.

II.4.2 Exchange rate sensitivity scenario

The sensitivity scenario quantifies the impacts of a **different exchange rate path**. This standard sensitivity scenario assumes a deviation of the nominal exchange rate of ±3% from the baseline scenario in the first quarter of the forecast. Interest rates in the first quarter of the forecast are the same as in the baseline scenario. The exchange rate is thus CZK 24.0/25.4 to the euro in 2012 Q2, compared to CZK 24.7 in the baseline scenario.

The table shows the results of the depreciation scenario, expressed as deviations from the baseline scenario of the forecast (see Table II.4.3). The scenario of a stronger nominal exchange rate leads to the same results but with the opposite sign.

Exchange rate depreciation improves producers' price competitiveness and, via higher net exports, leads to higher GDP growth compared to the baseline at the start of the forecast horizon. It also results in higher import prices and stronger inflation pressures. The market interest rate path is therefore higher than in the baseline scenario. However, GDP growth then slows slightly in response to tighter monetary policy and an exchange rate correction and returns to the baseline scenario at the end of the forecast horizon.

TABLE II.4.3

EXCHANGE RATE SENSITIVITY SCENARIO

Exchange rate depreciation leads to temporarily higher inflation and faster GDP growth than in the baseline scenario; interest rates increase
(deviations from baseline scenario)

	CPI inflation (in pp)	3M PRIBOR (in pp)	GDP (in pp)	Nominal exchange rate (CZK/EUR)
II/12	0.0	0.0	0.2	0.7
III/12	0.1	0.3	0.2	0.3
IV/12	0.1	0.3	0.1	0.1
I/13	0.2	0.3	0.0	0.0
II/13	0.2	0.1	-0.2	0.0
III/13	0.1	0.0	-0.3	0.1
IV/13	0.1	0.0	-0.2	0.1

Table II.5.1

EXPECTED INDICATORS OF FMIE AND CORPORATIONS

Inflation expectations are slightly above the CNB's target
(at 1Y; annual percentage changes unless otherwise indicated)

	12/11	1/12	2/12	3/12	4/12
FMIE:					
CPI	2.6	2.1	1.9	2.2	2.4
CPI, 3Y horizon	2.1	2.1	2.1	2.2	2.2
Real GDP in 2012	0.2	0.1	0.2	0.1	0.2
Real GDP in 2013		2.0	2.1	2.0	1.9
Nominal wages in 2012	2.8	2.2	2.6	2.6	2.8
Nominal wages in 2013		3.0	3.3	3.3	3.4
CZK/EUR exchange rate (level)	24.2	24.2	24.1	24.1	23.9
2W repo rate (in per cent)	0.7	0.7	0.9	0.9	0.9
1Y PRIBOR (in per cent)	1.8	1.8	1.9	1.9	2.0
Corporations:					
CPI	2.5			2.6	

Chart II.5.1

PERCEIVED AND EXPECTED INFLATION

The inflation expectations of households fell slightly at the start of 2012, whereas perceived inflation increased
(source: European Commission Business and Consumer Survey)

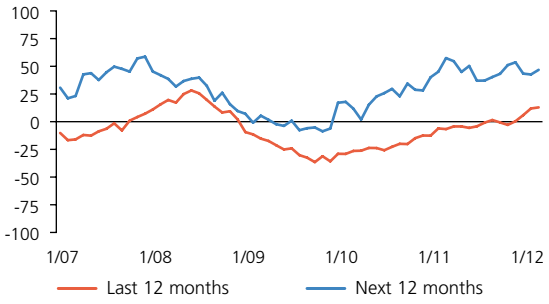


Table II.5.2

CF EXPECTED INDICATORS

The CF analysts expect the economy to be almost flat this year
(at 1Y; annual percentage changes unless otherwise indicated)

	12/11	1/12	2/12	3/12	4/12
Real GDP in 2012	0.3	0.3	0.2	0.1	0.2
Real GDP in 2013		2.0	1.9	1.9	1.9
Nominal wages in 2012	2.8	3.2	3.0	2.8	2.9
Nominal wages in 2013		3.8	3.4	3.4	3.5
CZK/EUR exchange rate (level)	24.3	24.8	24.8	24.6	24.6
3M PRIBOR (in per cent)	1.3	1.3	1.1	1.2	1.3

II.5 FORECASTS BY OTHER ENTITIES

At the start of this year, analysts' inflation expectations were volatile at the one-year horizon and flat at the three-year horizon. They are currently slightly above the inflation target of 2% at both horizons. The analysts expect GDP growth to be almost flat this year and to edge up next year. The majority of them also currently expect the koruna to appreciate and the CNB's key rates to be flat in the following 12 months. All the analysts were expecting stable key rates before the CNB Bank Board meeting in May. The market rate outlook also indicates stability. It is above the path consistent with the baseline and alternative scenarios of the new forecast over the entire forecast horizon.

Inflation expected by financial market analysts at the one-year horizon fell below 2% in early 2012. The analysts thus took into account the fact that the impact of this year's rise in the reduced VAT rate would fall out of consumer price inflation in 2013 Q1. However, they shifted their expectations upwards again in March and April, probably in response to the further planned increase in both VAT rates. Business managers have long maintained their expectations roughly 0.5 percentage point above 2%; in March 2012 they increased them slightly. Thus, the one-year inflation expectation of both groups of respondents are now again above the CNB's target of 2% (see Table II.5.1). The analysts' inflation expectations at the three-year horizon were flat, slightly above the target of 2%.

The indicator of **inflation perceived by households** has been rising gradually from negative values over the last two years and turned slightly positive in late 2011/early 2012 (see Chart II.5.1). This means that households on average felt that prices rose moderately over the last 12 months. The indicator of **expected inflation** has long been positive. This suggests that the number of respondents who expect prices to rise more rapidly over the next 12 months is higher than the number of those who expect prices to stay the same or increase more slowly than in the recent past (although the largest group has long comprised respondents who expect moderate price growth). However, the indicator of expected inflation went down slightly in 2012 Q1.

Both the FMIE and CF analysts expect GDP to be almost flat this year (see Table II.5.1 and Table II.5.2). Next year the economy should expand by around 2%, and wage growth should also pick up pace. Compared to the average koruna exchange rate so far in April 2012, the analysts participating in both the FMIE and the CF expect the exchange rate to be stronger at the one-year horizon (by 3.4% and 0.6% respectively). Before the CNB Bank Board meeting in May, all eleven FMIE analysts were expecting no changes in key interest rates at this meeting. Most of the analysts also expect rates to remain flat at the current level at the one-year horizon. Their estimates for the repo rate lie in the range of 0.75–1.25%. The forecasts for interest rates including market rates have shifted slightly upwards since the start of this year.

Compared to the baseline scenario of the CNB's new forecast, the analysts expect real GDP growth to be similar in both 2012 and 2013. Inflation expected at the one-year horizon is above the CNB forecast. The exchange rate prediction at the one-year horizon differs only slightly from the CNB forecast. Compared to the CNB forecast, the analysts participating in the FMIE expect the koruna to be 1.6% stronger, while the CF analysts predict that it will be 1.3% weaker. The analysts' expectations regarding the 2W repo rate and market rates at the one-year horizon are above the 3M PRIBOR path consistent with the baseline scenario of the CNB forecast.

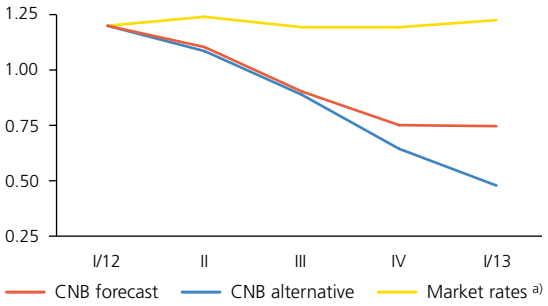
Compared to the alternative scenario of the CNB's new forecast, the analysts expect real GDP growth to be similar in 2012 and higher in 2013. Inflation expected at the one-year horizon is slightly above the CNB forecast. As in the case of the baseline scenario of the CNB forecast, the exchange rate prediction at the one-year horizon differs only slightly from the CNB forecast. The analysts' expectations regarding interest rates are above the 3M PRIBOR path consistent with the alternative scenario of the CNB forecast.

Chart II.5.2 provides a **comparison of expected 3M market rates** derived from FRA quotations and the interest rate path consistent with the new CNB forecast. The current market outlook is above the path consistent with the baseline and alternative scenarios of the new forecast over the entire horizon (the longer the horizon, the wider the deviation).

CHART II.5.2

FRA RATES VERSUS THE CNB FORECAST

The FRA rate outlook is above the rates forecasted in the CNB's baseline and alternative scenarios
(percentages)



a) for 2012 Q1 and 2012 Q2 the 3M PRIBOR and for 2012 Q3–2013 Q1 the average values of the FRA 3*6, 6*9 and 9*12 rates for the last 10 trading days as of 20 April 2012

III. CURRENT ECONOMIC DEVELOPMENTS

III.1 INFLATION

Annual headline inflation was 3.8% and monetary-policy relevant inflation 2.7% in March 2012. In both cases, inflation was above the CNB's target of 2%. The noticeable rise in headline inflation in Q1 was chiefly a result of an increase in the reduced VAT rate as from January 2012, which mainly affected food prices and administered prices. The upward trend in market prices was due to depreciation of the koruna at the end of last year. Low wage growth and persisting weak demand due to fiscal consolidation continued to have a dampening effect.

III.1.1 Fulfilment of the inflation target

Headline inflation was above the CNB's inflation target level in 2012 Q1 (see Chart III.1.1). This section of the Inflation Report briefly analyses the contribution of the CNB's monetary policy to this situation.

In order to assess the effect of monetary policy on the fulfilment of the inflation target one needs **to analyse retrospectively the forecasts** and the Bank Board's decisions based thereon in the past. To assess the fulfilment of the inflation target in 2012 Q1, we have to examine above all the period roughly from July 2010 to March 2011 (referred to as the "key period"), as monetary policy is focused on hitting the inflation target at the 12–18 month horizon. For the sake of clarity, the analysis of the accuracy of the forecasts is limited here to a comparison of the Inflation Report IV/2010 forecast with subsequent inflation.

The **Inflation Report IV/2010 forecast** expected headline inflation to fluctuate close to the 2% inflation target over the whole forecast horizon (see Chart III.1.1). The impacts of the changes to indirect taxes that took effect at the start of 2010 were expected to unwind gradually in 2011 H1. Inflation pressures from the domestic economy were neutral at the start of the forecast horizon. Import prices also had a slight anti-inflationary effect, as the appreciating koruna more than offset faster growth in foreign producer prices. Inflationary pressures from the domestic economy were forecasted to increase slowly due to gradually rising wage growth in the business sector and a modest recovery in economic activity (despite the expected fiscal consolidation). Import prices were also expected to start to have an inflationary effect as a result of a renewed recovery in external demand.

Headline **inflation in reality** was very close to the forecast over almost the entire forecast horizon, but was higher than expected in 2011 Q4 and particularly in 2012 Q1. This deviation was due to much higher administered price inflation (including the effect of the VAT change), with energy prices, regulated rents and water supply and sewerage collection charges all recording stronger growth. Another significant

Chart III.1.1

FORECAST VERSUS ACTUAL INFLATION

Inflation was well above the IR IV/2010 forecast in 2012 Q1
(annual percentage changes)

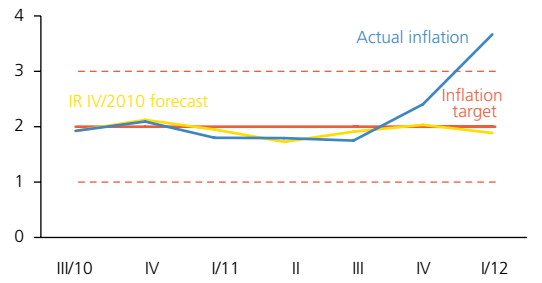


Table III.1.1

FULFILMENT OF THE INFLATION FORECAST

Administered prices and the VAT change fostered significantly higher inflation, while adjusted inflation excluding fuels was lower than forecasted
(annual percentage changes; contributions in percentage points)

	IR IV/2010 forecast	2012 Q1 outturn	Contribution to total difference[b)]
CONSUMER PRICES	1,9	3,7	1,8
Breakdown into contributions:			
administered prices	2,9	9,7	1,1
first-round impacts of changes to indirect taxes	0,0	0,9	0,9
food prices[a)]	1,7	3,5	0,3
fuel prices[a)]	4,5	8,0	0,0
adjusted inflation excl. fuels[a)]	1,5	-0,3	-0,6

a) excluding the first-round effects of changes to indirect taxes
b) owing to rounding, the sum of the contributions is not necessarily equal to the total difference; the contributions are also affected by the change in consumer basket weights from January 2012

factor behind this deviation was the increase in the reduced VAT rate from 10% to 14% in January 2012, which had not been predicted in the IR IV/2010 forecast. Food and fuel price inflation was also slightly higher than expected. By contrast, adjusted inflation excluding fuels, which remained negative, had an anti-inflationary effect. It reflected low domestic inflation pressures (see Table III.1.1).

External economic factors also contributed significantly to domestic inflation. The recovery in external – and therefore also domestic – economic activity, particularly in late 2010/early 2011, was stronger than forecasted. At the same time, world oil prices and international production prices rose more quickly than forecasted throughout the period. Foreign interest rates were also higher than predicted for most of the period under review (see Table III.1.2). Overall, external developments thus fostered higher domestic inflation.

Domestic **interest rates and the exchange rate** also differed from the forecast. Interest rates remained stable over the entire horizon under review and in the end deviated from the forecast, which had expected them to rise gradually. The exchange rate was initially in line with, or slightly weaker than, the forecast. In late 2011 and 2012 Q1, however, the koruna depreciated significantly compared to the forecast level, owing to the escalation of the euro area debt crisis (see Table III.1.3).

Based on the CNB's current knowledge of the workings of the Czech economy and its current knowledge of the actual economic situation, the **developments since the forecast under review was drawn up** can be summed up in the following way. The stronger domestic economic growth was driven – via exports – by a faster recovery of external demand in late 2010/early 2011. However, external demand slowed considerably in the last two quarters. The economy thus followed the asymmetric W-shaped path predicted in the forecast, but with a larger amplitude and rather different timing. The components of domestic demand recorded slower-than-forecasted growth. Wage growth was also more subdued than forecasted. Falling external demand growth at the end of 2011 also led to a decrease in Czech export growth. The comparison of current GDP growth and the IR IV/2010 forecast is also greatly affected by the December 2011 revision of the national accounts. Owing to the above factors, combined with the evolution of global commodity prices, high administered price inflation and the VAT change effective as from January 2012, headline inflation was well above the target in 2012 Q1. The low domestic interest rates reflected, in addition to subdued domestic inflationary pressures, continuing easy global monetary policy and – in the recent period – also a worsening external outlook due to the escalation of the euro area debt crisis.

In addition to the forecast, an assessment of the risks associated with this forecast is important for the Bank Board's decisions on **monetary policy rates**. At its meetings between July 2010 and March 2011, the Bank Board assessed the risks of the forecasts mostly as being

Table III.1.2

FULFILMENT OF THE EXTERNAL ASSUMPTIONS

External factors fostered higher domestic inflation

(annual percentage changes unless otherwise indicated)

		IV/10	I/11	II/11	III/11	IV/11	I/12
GDP in euro area[a), b), c)]	p	2.4	2.5	1.7	1.6	2.0	2.2
	o	3.0	3.6	3.0	2.5	1.8	-
PPI in euro area[b), c)]	p	3.8	3.3	2.2	2.1	2.4	2.5
	o	4.8	6.4	6.4	6.0	5.1	3.3
3M EURIBOR	p	1.0	1.1	1.1	1.2	1.2	1.3
(percentages)	o	1.0	1.1	1.4	1.6	1.5	1.0
USD/EUR exchange rate	p	1.38	1.33	1.33	1.32	1.31	1.31
(levels)	o	1.36	1.37	1.44	1.41	1.35	1.31
Brent crude oil price	p	83.6	85.0	86.0	87.0	87.7	88.4
(USD/barrel)	o	86.9	105.2	116.8	112.9	109.3	118.7

p – prediction, o – outturn
a) at constant prices
b) seasonally adjusted
c) effective indicator as defined in the IR IV/2010 forecast

Table III.1.3

FULFILMENT OF THE FORECAST FOR KEY VARIABLES

Domestic economic activity rose faster than forecasted throughout most of 2011

		IV/10	I/11	II/11	III/11	IV/11	I/12
3M PRIBOR	p	1.2	1.3	1.3	1.3	1.3	1.5
(percentages)	0	1.2	1.2	1.2	1.2	1.2	1.2
CZK/EUR exchange rate	p	24.5	24.4	24.3	24.2	24.1	24.0
(levels)	0	24.8	24.4	24.3	24.4	25.3	25.1
Real GDP[a)]	p	3.0	2.0	1.2	0.9	0.6	1.8
(annual perc. changes)	0	3.0	2.7	2.1	1.3	0.6	-
Nominal wages[b)]	p	2.7	3.3	3.7	3.9	3.6	6.4
(annual perc. changes)	0	1.7	3.1	3.1	2.7	2.1	-

p – prediction, o – outturn
a) seasonally adjusted
b) in the business sector

CHART III.1.2

INFLATION

Inflation increased significantly in 2012 Q1
(annual percentage changes)

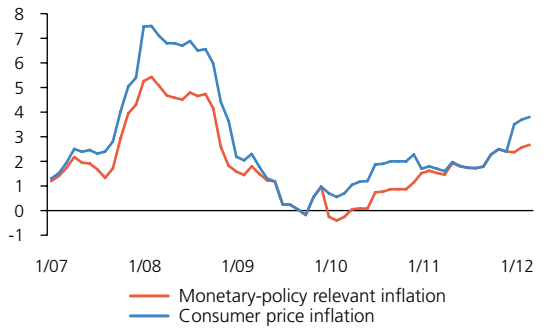


CHART III.1.3

INFLATION COMPONENTS

Most components of inflation contributed to the overall increase
(annual percentage changes; excluding indirect tax changes except administered prices)

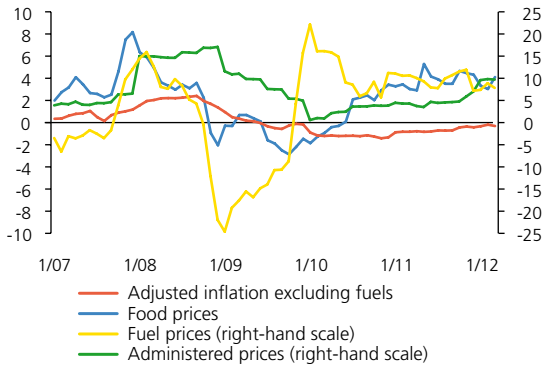
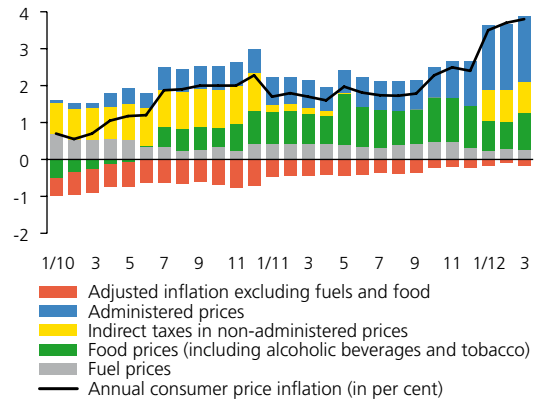


CHART III.1.4

STRUCTURE OF INFLATION

Administered prices, indirect taxes and food prices contributed the most to inflation
(annual percentage changes; contributions in percentage points)



balanced. Market interest rates in the period under review were roughly at the level implied by the forecasts. Headline inflation was slightly below the CNB's target over almost the entire horizon, rising markedly above it only at the end of 2011 and especially in early 2012, primarily because of the increase in the reduced VAT rate. Monetary-policy relevant inflation returned gradually to the target from below, moving above it in late 2011/early 2012. From this perspective, based on current knowledge, it seems that the monetary policy pursued from July 2010 to March 2011 was roughly appropriate.

III.1.2 Current inflation

Annual inflation[9] increased significantly in 2012 Q1 (see Chart III.1.2). In January it rose sharply to 3.5%, mainly as a result of an increase in the reduced VAT rate and a rise in administered prices.[10] The further increase in the following two months of Q1 (to 3.8% in March) was due mostly to a pick-up in food price inflation. Fuel price inflation also went up in Q1. Only adjusted inflation excluding fuels remained negative (see Chart III.1.3).

Turning to the **structure of annual inflation**, since the start of 2012 inflation has again been mainly affected by administrative factors, i.e. the impacts of changes to indirect taxes and administered prices. Market prices accounted for almost one-third of the annual consumer price inflation in March (see Chart III.1.4).

Owing to the increase in the reduced VAT rate, changes to **indirect taxes** contributed 0.9 percentage point to annual market price inflation in March; their overall first-round effect on inflation, including administered prices, was about 1.1 percentage point. **Monetary-policy relevant inflation**, i.e. inflation adjusted for changes to indirect taxes, was therefore below headline annual inflation and stood at 2.7% in March (see Chart III.1.2). A harmonisation increase in excise duties on cigarettes was also implemented on 1 January 2012. However, this change, which is expected to contribute about 0.1 percentage point to inflation, will pass through to consumer prices with a lag, owing to the selling-off of stocks taxed at the lower rate.

However, **administered prices** made the biggest contribution to annual inflation in 2012 Q1 (see Chart III.1.4). Their year-on-year growth surged to 9.7% in March owing to the combined effect of several factors, most notably increases in retail energy prices (electricity, heat, natural gas) and water supply and sewerage collection charges. Increases in prices of regulated items in transport and health care and in regulated rents also contributed significantly to the rise in administered price inflation. These changes were made mostly in

9 Measured by year-on-year growth in consumer prices.
10 The VAT increase was most apparent in the categories of food and non-alcoholic beverages and health care, and partly also housing and transport.

January, when prices of administered items were also affected by VAT changes. The following text assesses the evolution of the main components of inflation adjusted for the tax changes.

Market price inflation, as measured by net inflation, was volatile in 2012 Q1, but, at 1.4%, the year-on-year figure in March was just 0.1 percentage point lower than that in December 2011. This was due above all to substantial changes in food and fuel price growth, as adjusted inflation showed only very slow changes toward less negative values (see Chart III.1.3). Whereas food and fuel prices were mainly affected by external factors, adjusted inflation continued to show a significant effect of subdued demand and the absence of inflationary pressures from the domestic economy. The effect of weak domestic demand was not outweighed even by a sizeable increase in import prices of final products for the consumer market.

Turning to market prices, **food prices** had the largest effect on annual inflation (contributing 1 percentage point in March, adjusted for the changes to indirect taxes). Following a marked increase in 2011 Q4, associated mainly with the partial advance pass-through of the VAT increase to consumer prices before this change came into effect, annual food price inflation (adjusted for the tax changes) slowed at the start of 2012, to 3% in February. Its renewed sharp increase in March (to 4.1%) was connected almost exclusively with an extraordinary increase in egg prices (of 124%) resulting from a sharp decrease in the supply of eggs on the domestic market after suppliers that were not compliant with European poultry breeding directives were banned from the domestic market. A renewed annual decline in agricultural producer prices and slowing – but still high – price growth in the food industry had the opposite effect on food prices (see Chart III.1.5). This indicates that the effect of high prices of agricultural commodities on food prices is rapidly fading.[11] Overall, annual food price inflation including the effect of the increased VAT, which had probably passed through fully to these prices, reached 6.3% in March.

Fuel prices were also quite volatile in 2012 Q1. Their year-on-year annual growth was faster than in December, reaching 7.8% in March (see Chart III.1.3). This rise was due mainly to a marked depreciation of the koruna against the dollar, which was only partly offset by slower annual growth in world oil prices. BOX 2 below gives a closer view of the effect of oil prices and other factors, including the margins of refineries and retailers, on retail fuel prices.

Adjusted inflation excluding fuels, comprising prices of products with a high degree of processing and services, remained in negative values in 2012 Q1, although these values moderated further (to -0.3% year on year in March). The changes in the prices of its main

CHART III.1.5

FOOD PRICES

Food price inflation was affected by extraordinary factors, while the effect of high agricultural product prices subsided
(annual percentage changes)

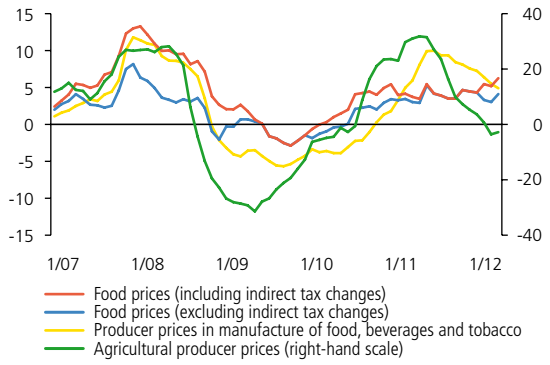
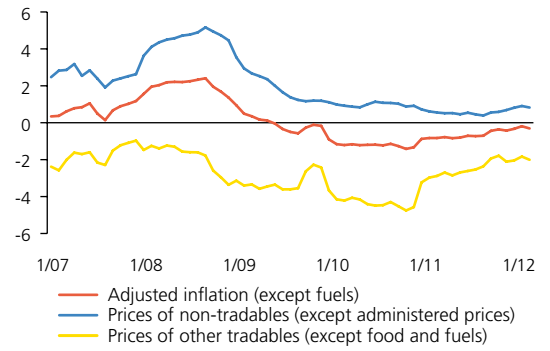


CHART III.1.6

ADJUSTED INFLATION EXCLUDING FUELS

The annual decline in prices within adjusted inflation moderated
(annual percentage changes; excluding indirect tax changes)

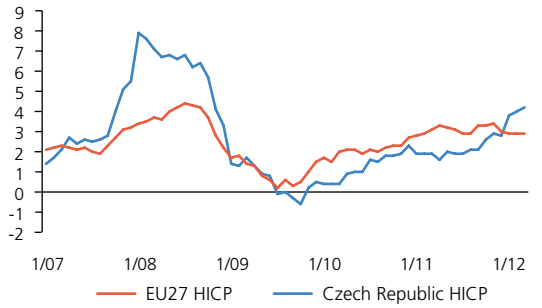


11 This was reflected in a continued fall in the year-on-year growth of bread product prices. Nonetheless, prices of these products were still rising fast. Bread prices went up by 17.5% and prices of bakery products by 19.1% in Q1.

CHART III.1.7

HICP

Annual HICP inflation in the Czech Republic was higher than the EU average for the first time in a long time
(annual percentage changes; source: Eurostat)



components were also insignificant (see Chart III.1.6). Persisting low growth in prices of non-tradable commodities (less than 1%) and a decline in prices of tradable commodities of around 2% suggested that the effect of subdued domestic demand outweighed the effect of the year-on-year depreciation of the koruna against the euro, reflected in a renewed rise in import prices of industrial consumption goods.

By international comparison, consumer prices as measured by the **HICP** rose – for the first time in a long time – faster in the Czech Republic than on average in the EU countries in 2012 Q1. According to Eurostat's latest estimate, annual HICP growth in the Czech Republic was 4.2% in March, while the average figure for the EU countries was much lower, standing at 2.9% in the same month. Annual HICP inflation in the Czech Republic remained higher than CPI inflation. This difference was due mainly to the inclusion in the CPI of the effect of imputed rent, which is not included in the HICP.

CHART 1 (BOX)

DIESEL OIL PRICE FACTORS

The crude oil price is the main factor driving the retail price of diesel oil
(CZK/litre; source: Bloomberg, CZSO, CNB calculation)

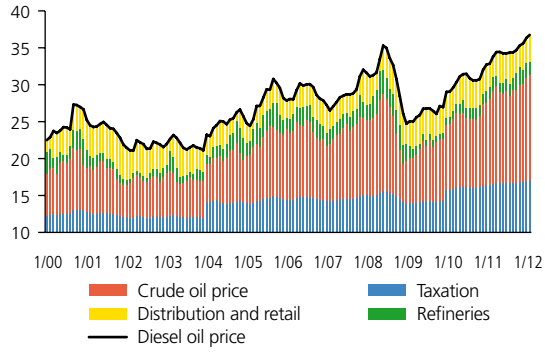
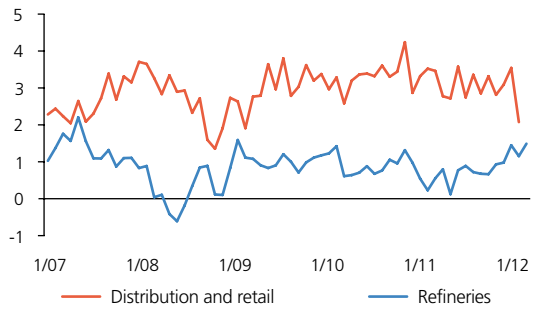


CHART 2 (BOX)

GROSS MARGINS ON NATURAL 95 PETROL

Refineries' gross margins increased at the start of 2012, while retail margins have long been comparatively stable
(CZK/litre; seasonally adjusted; source: Bloomberg, CNB calculation)



BOX 2
FACTORS AFFECTING RETAIL FUEL PRICES

Final prices of petrol and diesel in the Czech Republic (and elsewhere) are affected by market and administrative factors. The **market factors** include the dollar price of oil, the koruna-dollar exchange rate, refining, distribution and marketing costs, and profits of refineries, transporters and retailers. The **administrative factors** include excise duty and VAT (which is levied on the price including excise duty) and indirectly also the tightening of upper limits on the content of harmful substances, the raising of the required minimum proportions of bio-components, and the price of CO_2 emissions in oil processing. **Seasonal swings** in demand/consumption are also relevant to the price of petrol. In the Czech Republic the seasonal effect for diesel prices is smaller, as a large proportion of diesel is consumed in freight and passenger transport, where consumption is spread more evenly (unlike in countries where light fuel oils are also largely used for heating). On the other hand, the price of diesel is more closely connected with the **phase of the business cycle** because of freight transport.

From the perspective of the vertical processing chain, we can divide the prices of petrol and diesel oil into individual components, namely the price of crude oil, gross margins of refineries and retailers (including distributors) and taxation (see Chart 1).

The **minimum excise duty** is determined on the basis of Council Directive 2003/96/EC of October 2003 and amounts to EUR 0.359 a litre for unleaded petrol and EUR 0.330 a litre for diesel. However, actual excise duty is higher in most EU countries. In the Czech Republic, excise duty was last changed with effect from 1 January 2010, when it was increased to

CZK 12.84 a litre for Natural 95 petrol and CZK 10.95 a litre for diesel. As the koruna appreciates/depreciates, excise duty increases/decreases in euro terms. In March 2012, taxes accounted for 51.5% of the price of Natural 95 petrol and 46.2% of the price of diesel.

Refineries' gross margins (the difference between input and output prices) are the smallest part of the final price. Since 2010 they have mostly fluctuated between 0.5% and 3.5% for petrol and between 3.0% and 6.5% for diesel. The price at which European refineries sell their products to customers is universally governed by the price on the Rotterdam commodity exchange. Although there has been much talk recently of refinery closures and subsequent upward pressure on prices, especially for petrol, our calculations do not currently lend too much support to this hypothesis. European refineries are facing increasing competition from modern Asian refineries and only those with sufficient processing capacity and sophisticated technology (enabling them to refine oil of inferior quality) are succeeding. Loss-making plants are gradually being closed down. However, refinery margins are showing no dramatic growth (see Charts 2 and 3).

The **share of transporters and retailers in the final price has** been fluctuating between 7% and 12% over the last two years. However, gross margins have been virtually flat. The koruna price of oil is therefore clearly the biggest factor affecting the level and volatility of fuel prices in the Czech Republic. It is influenced by world oil prices and the koruna-dollar exchange rate. These two factors usually partially offset each other, which means that the koruna price of oil is less volatile than the dollar price. In early 2012, however, the price of oil increased while the dollar was strengthening (see Chart III.7.7). This led to a rise in domestic prices of fuels to historical highs.

Chart 3 (Box)

GROSS MARGINS ON MOTOR DIESEL OIL

Gross margins on motor diesel oil are higher than those on petrol
(CZK/litre; seasonally adjusted; source: Bloomberg, CNB calculation)

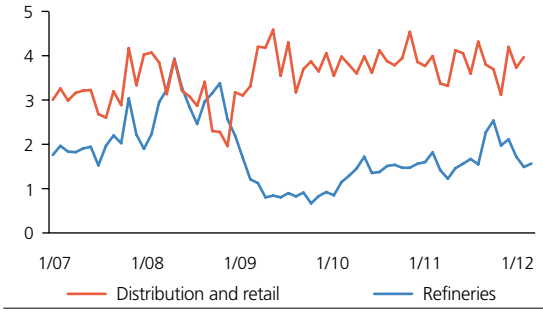


CHART III.2.1

IMPORT PRICES AND PRODUCER PRICES

Import price inflation fluctuated around 6%, industrial producer price inflation slowed, and agricultural producer prices began to fall
(annual percentage changes)

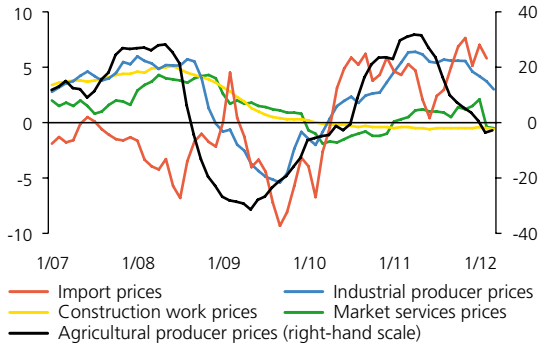


CHART III.2.2

IMPORT PRICES

Import price inflation was again due mainly to prices of imported energy commodities
(annual percentage changes; contributions in percentage points)

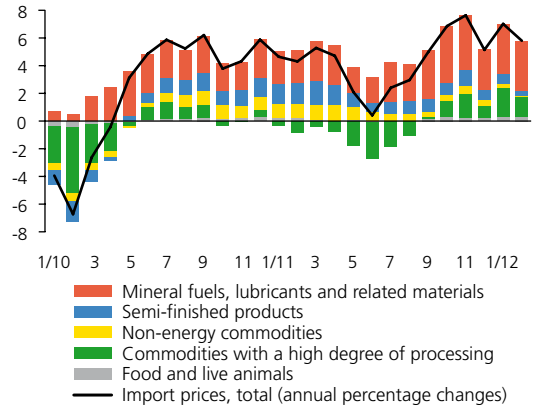
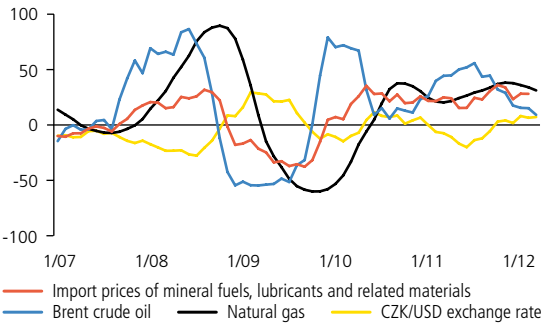


CHART III.2.3

MINERAL FUELS

Year-on-year depreciation of the koruna-dollar exchange rate contributed to the still high growth in import prices of energy commodities
(annual percentage changes)



III.2 IMPORT PRICES AND PRODUCER PRICES

Slowing annual growth in prices of key commodities on world markets, partly offset by depreciation of the exchange rate, fostered slower annual growth of import prices of commodities and semi-finished products. This growth was again reflected most of all in prices of producers at the early stages of the production chain. Import prices of products with a high degree of processing continued to record growth, which was renewed in 2011 Q4 thanks to exchange rate depreciation. Industrial producer price inflation fell further in 2012 Q1 and agricultural producer prices switched to a year-on-year decline. Construction work prices continued to show a modest decline amid persisting low demand, and prices of market services also dropped slightly year on year in Q1.

III.2.1 Import prices

The continuing rise in **import prices** in the first two months of 2012 Q1 was driven mainly by prices of key energy commodities on world markets, but the contribution of products with a high degree of processing was also quite significant (see Chart III.2.2). According to the latest CZSO data, annual import price growth slowed from 7% in January to 5.8% in February.

Fast growing prices of imported **mineral fuels** remained the biggest contributor to annual import price inflation in the first two months of 2012 Q1 (3.6 percentage points; see Chart III.2.2). Although the annual growth rate of world oil prices has been slowing since mid-2011 from values exceeding 50%, it is still high (15.1% in February). Annual growth in world natural gas prices, which follow oil prices with a lag, did not start rising until the second half of 2011. After peaking at 38% in November, it started to weaken gradually, approaching the 30% level in February. Annual growth in import prices of mineral fuels was still high at the start of 2012 (28.1% in February) owing to the combined effect of fast – albeit slowing – growth of world prices of energy commodities and strong annual depreciation of the koruna-dollar exchange rate. In January and February, however, it was lower on average than in the previous quarter.

Annual growth in import prices of **non-energy commodities** continued to slow rapidly despite the sharp depreciation of the koruna against the dollar (from 16% in November to 3.7% in February) and its contribution to import price growth was negligible. Growth in import prices of chemicals and related products and of **semi-finished products** moderated as well (see Table III.2.1). By contrast, annual growth in import prices of **food** picked up to 5.1% in February.

From the perspective of domestic producers, prices of imported inputs (raw materials and semi-finished products) thus showed slower growth in January and February than at the end of 2011. This reflected the mostly slowing annual growth in world commodity prices, but was also due to exchange rate developments. Import prices of **high-value-added commodities**,[12] which resumed their annual growth in September 2011 after a long-running decline, were also affected by the depreciation of the exchange rate (particularly the koruna-euro rate).

III.2.2 Producer prices

Industrial producer prices

The moderation of annual **industrial producer price inflation** observed since the end of 2011 continued into 2012 Q1. Annual industrial producer price inflation decreased by 1.6 percentage points compared to December 2011, to 3% in March (see Chart III.2.4).

The view of the causes and **structure of industrial price inflation** is broadly unchanged from the previous quarter, although the intensity of most key factors moderated further. This inflation continued to be affected by rising prices of imported commodities and semi-finished products, but their growth rate decreased significantly, particularly in the case of non-energy commodities and semi-finished products. The effect of imported energy commodities decreased as well. These cost pressures thus fed through to prices of producers at the early stages of the production chain to a lesser extent (see Chart III.2.4 and Chart III.2.5). The cost pressures stemming from energy producer prices also decreased markedly. At the same time, annual producer price inflation in the food industry continued to slow noticeably, reflecting with a lag a weakening of the cost pressures stemming from high prices of agricultural inputs.

Producer prices in the **manufacture of coke and refined petroleum products** were again the biggest contributor to annual inflation in industry in 2012 Q1. Their contribution to industrial producer price inflation was lower on average than in the previous quarter owing to rapidly slowing world oil price growth. However, annual producer price inflation in this sector was still high in March (15.1%). Annual producer price inflation in the **food industry** also moderated (to 4.9% in March) owing to sharply weakening growth and a subsequent fall in prices of agricultural inputs of domestic origin; their contribution to industrial producer price inflation thus dropped to 0.7 percentage point in March. A significant decline in contribution was also recorded in the case of **manufacture of basic metals and fabricated metal products**, which recorded annual growth of only 1.6% in March (see Chart III.2.6).

12 This category contains machinery, transport equipment and miscellaneous manufactured articles.

TABLE III.2.1

STRUCTURE OF IMPORT PRICE INFLATION

Import prices rose in all categories, and most of all in the case of imported energy commodities
(annual percentage changes)

	11/11	12/11	1/12	2/12
IMPORTS, TOTAL	7.6	5.1	7.0	5.8
of which:				
food and live animals	3.6	2.2	3.9	5.1
beverages and tobacco	11.9	12.5	13.5	10.1
crude materials inedible, except fuels	16.0	11.6	7.7	3.7
mineral fuels and related products	33.9	23.3	28.2	28.1
animal and vegetable oils	20.3	13.6	11.6	4.9
chemicals and related products	7.1	4.8	5.4	3.6
manufactured goods classified chiefly by material	5.3	3.4	3.3	1.7
machinery and transport equipment	1.3	0.2	3.0	1.6
miscellaneous manufactured articles	3.9	2.3	4.0	3.7

CHART III.2.4

INDUSTRIAL PRODUCER PRICES

Industrial producer price inflation slowed further in 2012 Q1
(annual percentage changes; contributions in percentage points)

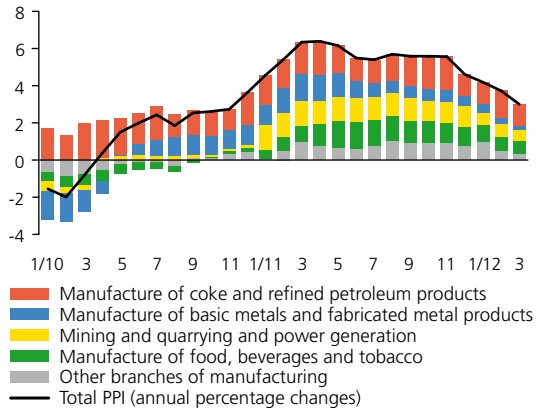


CHART III.2.5

PRODUCER PRICES BY MAIN INDUSTRIAL GROUPINGS

Inflation in the main industrial groupings is gradually falling
(annual percentage changes)

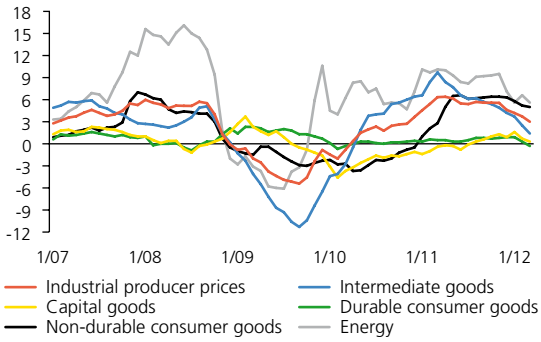


CHART III.2.6

PRICES OF METALS AND REFINED PETROLEUM PRODUCTS

Producer prices in manufacture of coke and refined petroleum products respond to movements in import prices of energy commodities with a short lag
(annual percentage changes)

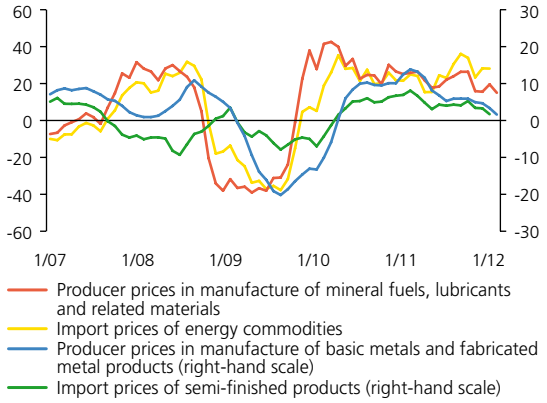
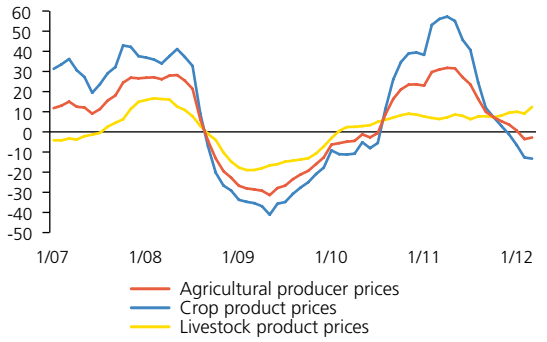


CHART III.2.7

AGRICULTURAL PRODUCER PRICES

Agricultural producer prices have been falling in year-on-year terms since February
(annual percentage changes)



The **electricity, gas and steam industry** also contributed to the slowdown in industrial producer price inflation in Q1 (to 1.7% in March). By contrast, the rate of growth of prices in the water supply and sewerage-related services industry rose further (from 6.3% in December 2011 to 8.1% in March). Price growth in **mining and quarrying** was roughly the same as in the previous quarter (2.9% in March). Overall, the contribution of these industries to annual industrial producer price inflation in 2012 Q1 was about half that in 2011 Q4.

Producer price inflation in **other branches of manufacturing**, comprising the manufacture of high-value-added products, was much slower in 2012 Q1 than in the previous quarter. Chart III.2.4 shows that their contribution to overall annual industrial producer price inflation in March was less than half that recorded in December 2011 (0.4 percentage point). Price growth decreased in most industries, and some industries even saw year-on-year price decreases in March.[13] This was primarily due to persisting low demand and weakening cost pressures for production inputs.

Agricultural producer prices

The gradual slowdown in annual **agricultural producer price inflation** in 2011 H2 culminated in a year-on-year decline in 2012 Q1, which reached -3.6% in February and moderated only slightly to -2.8% in March. This pronounced change was again due solely to crop product prices, which switched to a modest year-on-year decline at the end of 2011. This decline deepened further during Q1 (to 13.3% in March). By contrast, annual growth in prices of livestock products rose further in Q1, reaching double figures (12.4% in March).[14]

The slowdown in annual growth of agricultural producer prices and the switch to an annual decline at the start of 2012 was **a result of various factors** that affected crop commodity prices particularly in 2011. These factors included better weather conditions in 2011, which – together with the return of some traditional exporters to the world market – led to a slight fall in global prices of crop commodities. The domestic harvest in 2011 was also well above average from the longer-term perspective. Some traditionally volatile agricultural producer price items (potatoes, vegetables) started to record significant annual declines of about 40–60%. By contrast, the exchange rate had an inflationary effect in 2011 Q4 and 2012 Q1. At the start of 2012, prices of livestock products were also affected by a sudden rise in egg prices due to stricter veterinary rules in the EU and a related shortfall in production.

13 Prices fell in the manufacture of electrical equipment, computer, electronic and optical products, transport equipment and manufacture of machinery and equipment.
14 The faster growth in livestock product prices was due mainly to higher egg prices, which went up by almost 133% year on year in March.

Other producer prices

Amid persisting low construction investment demand, **prices of construction work** continued to show a slight annual decline in 2012 Q1 (-0.6%; see Chart III.2.8). Annual growth in prices of materials and products consumed in the construction industry moderated gradually, reaching 0.9% in March.

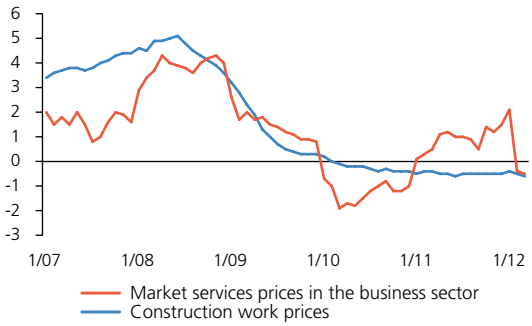
The weak domestic demand was also apparent in **prices of market services**, which recorded a modest decline in 2012 Q1 (-0.4%). This change was due largely to falling prices of architectural and engineering services, advertising services and market research,[15] real estate services and telecommunication services. Higher prices were recorded in transport and insurance.

CHART III.2.8

OTHER PRICE CATEGORIES

Prices of construction work and prices of market services are falling

(annual percentage changes)



15 The biggest change was seen in prices of advertising services and market research, which rose by 19% year on year in January 2012 and then started falling (by 2.1% in March).

CHART III.3.1

GROSS DOMESTIC PRODUCT

Annual GDP growth slowed further in 2011 Q4
(annual and quarterly percentage changes at constant prices; seasonally adjusted data)

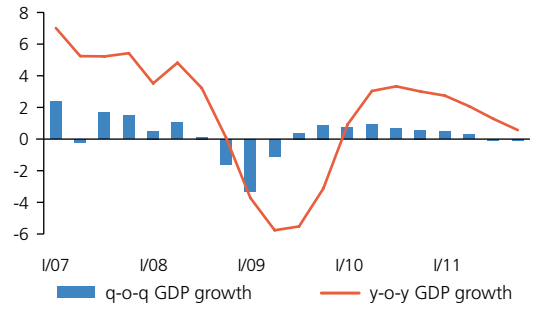


CHART III.3.2

STRUCTURE OF ANNUAL GDP GROWTH

Net exports were the sole contributor to real GDP growth
(contributions in percentage points; seasonally adjusted data)

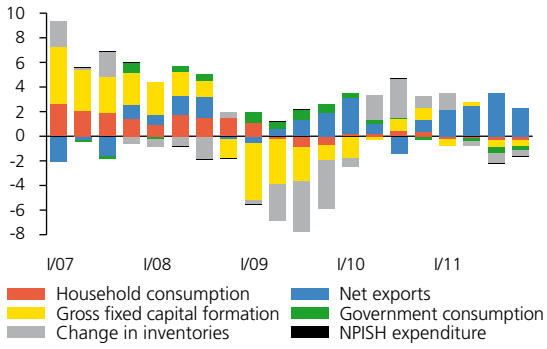
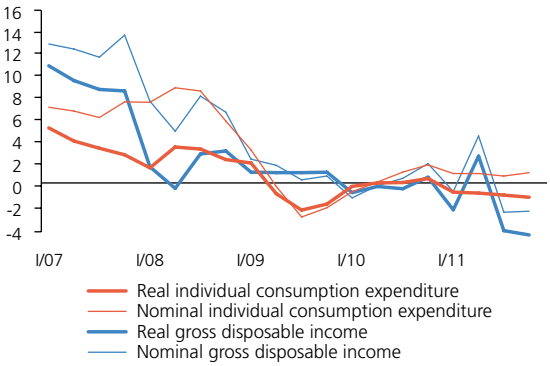


CHART III.3.3

HOUSEHOLD CONSUMPTION EXPENDITURE

The falling household consumption was affected by real disposable income
(annual percentage changes)



III.3 DEMAND AND OUTPUT

Annual real GDP growth slowed further in 2011 Q4 (to 0.6%).[16] *In quarter-on-quarter terms GDP recorded a slight decrease (of 0.1%). In 2011 as a whole, GDP growth was 1.7%. Amid a persisting lead of export growth over import growth, the annual growth in economic activity in Q4 was due solely to net exports, whose contribution, however, was smaller than in the previous quarter. The other expenditure components made no contribution to economic growth in Q4, as expenditure on final consumption and gross capital formation continued falling in year-on-year terms. On the supply side, manufacturing was the biggest contributor to economic growth, although its positive contribution was smaller than in the previous quarter. Gross value added decreased in a number of other industries (construction in particular). The estimated output gap opened deeper into negative territory in 2011 Q4.*

III.3.1 Domestic demand

The annual decline in **domestic demand** continued into 2011 Q4, but was noticeably slower than in the previous quarter. This development was due to most of its components, but most of all to change in inventories (see Chart III.3.2) and, to a lesser extent, government consumption and fixed investment. Only the decline in household consumption deepened slightly in Q4.

Final consumption

In 2011 Q4, **household consumption** showed a continuing trend of deepening annual decline observed since the start of 2011, mainly on account of ongoing fiscal consolidation and recently also a halt of the labour market recovery. In 2011 Q4 alone, however, the annual decline in household consumption expenditure deepened only slightly (by 0.1 percentage point to 0.7%). Falling household consumption continued to be observed in most monitored categories of consumer goods, i.e. non-durable, semi-durable and durable goods. Only real expenditure on services increased again in Q4.

Nominal gross disposable income continued falling year on year in Q4 (by 2%). Moreover, its real purchasing power was eroded by annual inflation more significantly than in previous quarters.[17] Annual inflation rose because of advance pass-through of the increased VAT to consumer prices before this change came into effect.[18] This was reflected in a marked deepening of the decline in gross disposable income (to 4.1% year on year; see Chart III.3.3).

16 The assessment of the evolution of GDP expenditure and sources is based on seasonally adjusted data from the quarterly national accounts.
17 As measured by the household consumption deflator.
18 For details, see section II.1.2 *Current inflation.*

A closer look at the **structure** of nominal gross disposable income shows that only social benefits and property income recorded positive contributions to its annual growth in 2011 Q4. However, their contributions were low (see Chart III.3.4). The contribution of wages and salaries, which are the main component of household income, was neutral. By contrast, the relatively high-weight business income (gross operating surplus and mixed income) continued to record a modest annual decline, mainly reflecting the low domestic demand. The contributions of income from other transfers and in particular from tax payments and social contributions were also negative.

The **gross saving rate** fell gradually during 2011 to around 9% (see Chart III.3.5). This trend was probably due chiefly to the rapidly falling real purchasing power of households, owing to which some households were no longer able to generate savings at the previous level if they wanted to maintain their current level of consumption or prevent it falling further. Consumer credit recorded modest year-on-year decreases from 2011 Q4 onwards (see section III.5.2).

The latest available **leading indicators** do not yet suggest any noticeable recovery in household consumption in the period ahead. The seasonally adjusted real retail sales data for February continued to show only modest growth. The increase in sales of motor vehicles was slower, sales of non-food products rose slightly, and sales of food decreased. The latest results of the March CZSO business survey do not indicate any noticeable change in the consumption behaviour of households either, as the consumer confidence indicator remains on a downward trend. This primarily reflects households' worsening expectations regarding the overall economic situation and unemployment. In such circumstances, households do not expect their financial situation to improve.

The year-on-year decline in real **government final consumption expenditure** moderated to 1.7% in 2011 Q4. This was partly due to base effects, as in quarter-on-quarter terms, government consumption expenditure recorded its biggest fall of 2011 (1.1%). This suggests that austerity measures in the government consumption area were implemented to a greater extent at the end of 2011.

Investment

The subdued and structurally uneven development of **fixed investment** continued into 2011 Q4, indicating – in addition to base effects – persisting substantial uncertainty regarding future demand. In 2011 Q4 alone, fixed investment fell by 1.7% year on year and by 0.2% quarter on quarter.

Investment fell in most sectors (see Table III.3.1). However, in the **non-financial corporations** sector, which accounts for more than half of total investment, fixed investment increased by 6% year on year in Q4. According to the latest business survey conducted by the CNB and the Confederation of Industry in March, the outlook for investment growth in non-financial corporations is rather more optimistic than in the previous quarter. This is evidenced by a substantial decrease in the

CHART III.3.4

DISPOSABLE INCOME

Households' gross disposable income kept falling year on year

(annual percentage changes; contributions in percentage points; current prices)

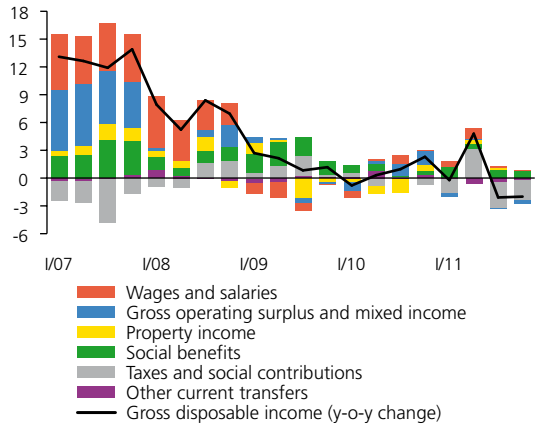


CHART III.3.5

SAVING RATE AND CONSUMER CONFIDENCE INDICATOR

The gross saving rate is gradually decreasing

(percentages; basic index; year 2005 = 100; seasonally adjusted data)

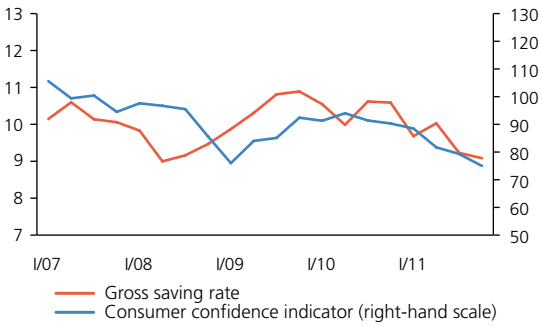


CHART III.3.6

FIXED CAPITAL FORMATION

Fixed investment continued to fall in year-on-year terms

(annual percentage changes; contributions in percentage points; constant prices)

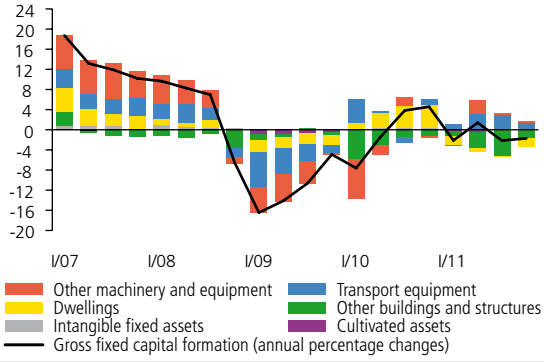


TABLE III.3.1

INVESTMENT BY SECTOR

Investment fell in most sectors, but rose in the non-financial corporations sector
(constant prices; CNB calculation)

	I/11	II/11	III/11	IV/11
Annual percentage changes				
Non-financial corporations	5.8	10.9	4.4	6.4
Households	-10.6	-3.9	-4.6	-11.1
General government	-13.5	-19.1	-18.0	-11.4
Financial corporations	-25.7	-27.2	-10.2	-26.7
Nonprofit institutions serving households	9.8	7.0	2.4	4.1
Share in total fixed investment in per cent				
Non-financial corporations	61.3	62.9	59.4	60.6
Households	20.7	21.0	22.8	21.9
General government	16.0	14.1	15.4	15.4
Financial corporations	1.8	1.7	2.1	1.8
Nonprofit institutions serving households	0.3	0.2	0.2	0.2

CHART III.3.7

INVESTMENT IN DWELLINGS

Investment in dwellings and housing completions kept falling
(annual percentage changes)

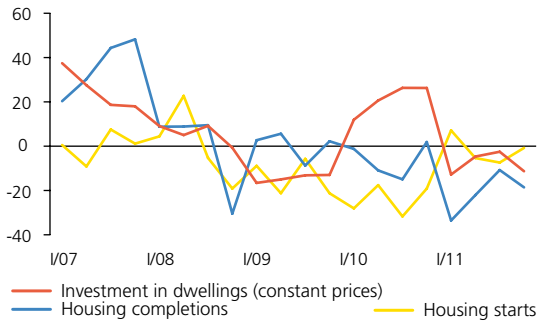
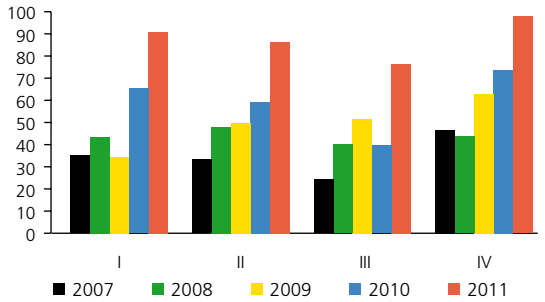


CHART III.3.8

NET EXTERNAL DEMAND

Net exports increased significantly year on year again in 2011 Q4
(CZK billions; constant 2005 prices; seasonally adjusted data)



negative balance of expected investment expenditure at the 6-month horizon and by the balance of expenditure turning positive at the 12-month horizon.

The overall annual fall in investment in 2011 Q4 was due most of all to the household and government sectors. Investment in the **household sector** decreased by 11.1% year on year. Investment in dwellings, which accounts for a large proportion of total household investment, fell throughout the year (by 11.3% in Q4; see Chart III.3.7). Leading indicators[19] do not suggest any noticeable improvement in the outlook for housing demand in the period ahead either. On the contrary, the mostly negative year-on-year changes in these indicators still indicate a generally prudent approach of developers and households to investment in dwellings, mainly because of uncertainty regarding future economic developments and the situation on the labour market. The significant decline in investment in the **government sector** (of 11.4% year on year) in Q4 was due most of all to a decline in the civil engineering area. The fall in investment in other sectors was less significant from the point of view of total investment.

The negative contribution of change in **inventories** to GDP growth fell sharply in 2011 Q4 (to 0.6 percentage point; see Chart III.3.2). According to the latest business survey conducted by the CNB and the Confederation of Industry in March, there was a surplus of corporations expecting stocks of raw and ancillary materials and semi-finished products to rise year on year in 2012 Q1. This suggests that at the very least the decline in additions to inventories should not deepen in this quarter.

III.3.2 Net external demand

Amid a persisting decline in all main components of domestic demand, **net exports of goods and services**[20] were the only source of GDP growth in 2011 Q4 (see Chart III.3.2). Net exports grew for the fifth consecutive quarter in year-on-year terms. In Q4 alone, the surplus was CZK 97.8 billion, up by CZK 24 billion on the same period a year earlier. A pronounced quarter-on-quarter increase in net exports was also recorded (see Chart III.3.8). As in the previous four quarters, the year-on-year growth in net exports was mainly due to the trade surplus. By contrast, the services surplus decreased slightly in 2011 Q4.

Annual growth in total foreign trade turnover decreased considerably further (to 3.5%). Exports still rose faster than imports, although the lead of export growth over import growth decreased to 3.1 percentage points (see Chart III.3.9). **Total exports** grew by 5%, their growth rate falling by a considerable 3.5 percentage points from the previous quarter. The continuing decline in total export growth

19 Data on housing starts and completions.
20 At 2005 prices, seasonally adjusted.

was connected with a further slowdown in external demand growth and persisting uncertainty about future economic developments internationally.

The moderation of annual growth in **total imports** (of 1.7 percentage points compared to Q3, to 1.8%) was less pronounced than that of exports (see Chart III.3.9). The main cause of the continuing slowdown in import growth was the weak domestic and slowing external demand, whose effect was most strongly reflected in a year-on-year decline in investment imports. Imports for intermediate consumption, which are closely connected with export production, continued rising in Q4, albeit at a slower rate. By contrast, growth in imports of services increased.

III.3.3 Output

The gradual slowdown in quarter-on-quarter growth in **gross value added** at basic prices observed during 2011 changed into a decline of 0.8% in Q4. At the end of 2011, gross value added was flat in year-on-year terms (see Chart III.3.10). This was due to continuing – albeit slowing – year-on-year growth in gross value added in manufacturing and in some services, which was fully offset by falling value added in construction, other industrial sectors, wholesale and retail trade and also in some services (see below).

In 2011 Q4, the positive contributions to value added growth at basic prices were thus again created mostly in **manufacturing**, whose production is largely exported to foreign markets. However, amid weakening domestic and external demand and fast growing prices of some significant production inputs, the positive contribution of this sector to annual development in gross value added shrank to 1.9 percentage points in 2011 Q4.

The impact of the low demand on **industrial production** was observed in most branches. However, production continued rising in the major export branches, albeit more slowly than in previous quarters. The key effect of external demand on production in industry was confirmed by the statistics on sales of own products, according to which – even after slowing somewhat – growth in direct export sales stayed in double figures (13.3% at current prices), whereas domestic sales decreased. These results were consistent with the slowing, but still sizeable, real growth in goods exports according to the national accounts (5.8% year on year).[21]

According to seasonally adjusted data, the slowdown in annual industrial production growth continued into January and February 2012. In month-on-month terms, industrial production decreased (see Chart III.3.11). **Capacity utilisation** in industry in January 2012 was roughly the same as in 2011.

21 Seasonally adjusted figure.

CHART III.3.9

EXPORTS AND IMPORTS

Foreign trade turnover continued to slow in 2011 Q4, but exports rose faster than imports

(annual percentage changes; percentage points; constant prices; seasonally adjusted data)

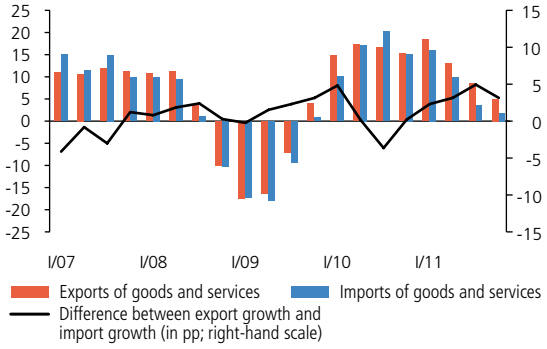


CHART III.3.10

CONTRIBUTIONS OF BRANCHES TO GVA GROWTH

Gross value added was flat in year-on-year comparison in 2011 Q4

(contributions in percentage points; annual percentage changes)

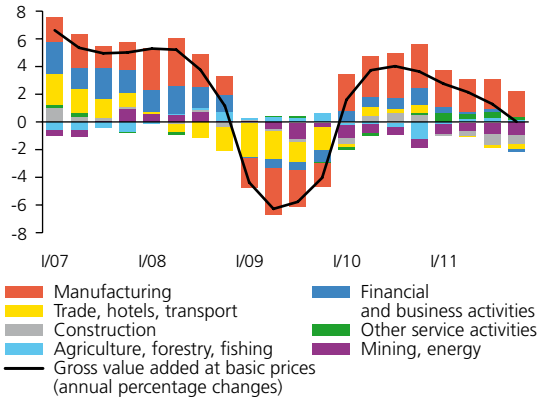


CHART III.3.11

INDUSTRIAL PRODUCTION

The seasonally adjusted volume of industrial production fell moderately in late 2011/early 2012

(basic index; year 2005 = 100)

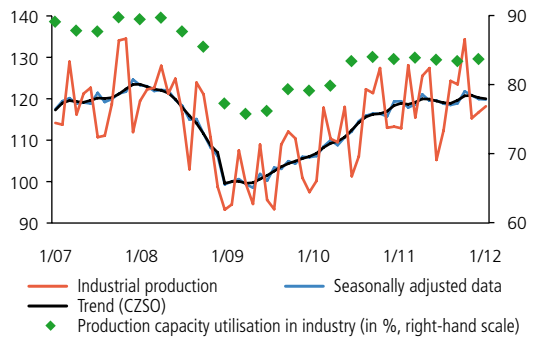


CHART III.3.12

NEW ORDERS IN INDUSTRY

Domestic and foreign orders saw a recovery in growth in January and February
(annual percentage changes)

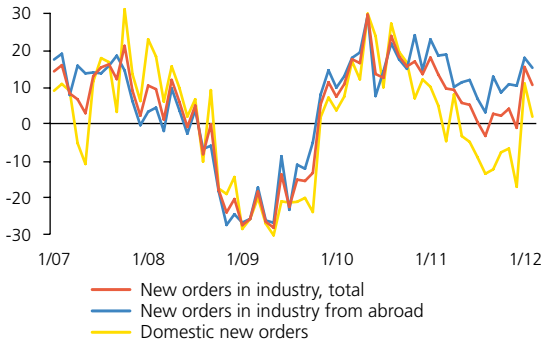


CHART III.3.13

BARRIERS TO GROWTH IN INDUSTRY

The effect of insufficient demand as a barrier remains dominant
(percentages)

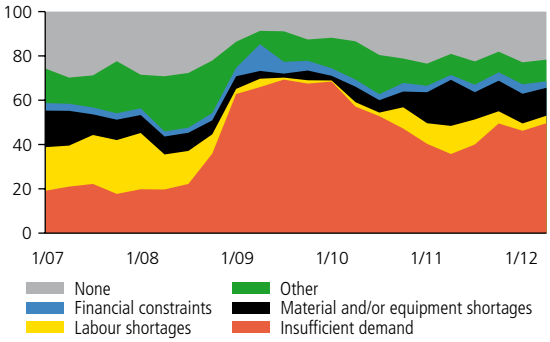
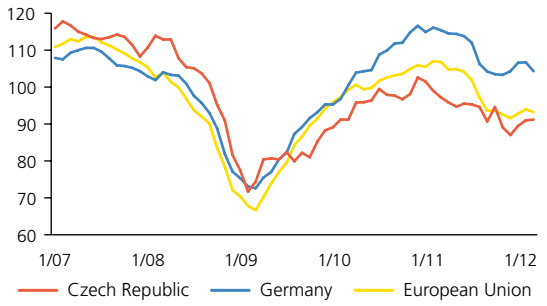


CHART III.3.14

ECONOMIC SENTIMENT

After improving in January and February, economic sentiment in Germany and the EU as a whole deteriorated slightly in March, while it increased modestly in the Czech Republic
(long-term average = 100; seasonally adjusted data; source: Eurostat)



The latest available data on **new industrial orders** for January and February show, however, that industrial production growth can be expected to improve in the months ahead. Growth in orders from abroad increased in January and domestic orders also rose significantly after eight months of decline (see Chart III.3.12).[22] Growth in total orders slowed in February – mainly because of domestic orders – but remained in double figures. Despite this, the latest results of the CZSO's business survey on **barriers to growth in industry**, conducted in April 2012, suggest that the perception of insufficient demand as the main barrier to growth in output in industry persists (see Chart III.3.13).

Amid persisting low domestic demand, the contribution of **services and trade** to total gross value added growth turned negative in 2011 Q4 (-0.4 percentage point). This was chiefly due to wholesale and retail trade, hotels and restaurants and information and communication activities, which are directly exposed to the effect of weakening demand. However, value added in financial intermediation, insurance and some other services[23] continued to rise, albeit at a slower rate than in the previous quarter. An only modest real rise in retail sales confirmed the dampening effect of the weak consumer demand on sales of most retail goods. Only sales of motor vehicles maintained rapid growth. The latest data on sales in January and February 2012[24] do not indicate that wholesale and retail trade will make any major contribution to value added growth in 2012 Q1.

The annual decline in value added in **construction** slowed noticeably in 2011 Q4 (to 8.2%). According to the CZSO, this was due to better weather coupled with higher demand for construction work linked with the expected VAT increase in January 2012, which was reflected in invoicing for an exceptionally high volume of completed orders in December. The annual decline in construction output continued into January and February 2012, and, moreover, was much stronger in February. The outlooks for the near future are also weak. A falling number of building permits issued, strong falls in the approximate value of building notifications and permits, and still pessimistic expectations of businesses operating in this industry according to the CZSO business survey, do not yet indicate any improvement of the situation in construction in the months to come.

The CZSO's business survey shows that the **overall confidence indicator** increased in 2012 Q1. The business confidence indicator improved, while consumer sentiment worsened in February and March after improving in January. Optimism continued to prevail in businesses operating in the services and trade sectors. The balance of industrial confidence indicator remains slightly positive. By contrast,

22 The increase in orders was due most of all to manufacture of motor vehicles, manufacture of machinery and equipment, and manufacture of electrical equipment.
23 In the areas of real estate services, public administration, defence, health and social care.
24 For details see section III.3.1 *Domestic demand*.

negative outlooks strongly prevailed in construction. An international comparison reveals that economic sentiment in Germany and the EU as a whole worsened slightly in March, following an improvement in January and February (see Chart III.3.14).

III.3.4 Potential output and estimate of the cyclical position of the economy

The year-on-year growth rate of potential output continued to slow in 2011 Q4 and the output gap opened further into negative values. According to the calculation of the **Cobb-Douglas production function**,[25] the rate of growth of potential output slowed to 0.9% (see Chart III.3.15) and the output gap opened to -1% of potential output (see Chart III.3.16).[26] The calculation suggests that that the growth rate of potential output will continue to slow in 2012 H1 and will then gradually edge up above 1%. According to the calculation of the production function, the output gap should continue to open into negative values until the end of 2012 and close in 2013.

The breakdown of the **contributions of the individual factors** entering the baseline production function reveals that the slowdown in annual potential output growth in 2011 H2 was due mainly to a negative contribution of equilibrium employment. According to the calculation of the production function, it will be the main factor affecting the path of potential output in 2012. The contributions of capital and aggregate productivity will not change much at the forecast horizon (see Chart III.3.17).

An alternative estimate using the **HP filter**[27] continues to indicate a somewhat higher growth rate of potential product (1.5% in 2011 Q4) than that calculated using the production function. The output gap is similar under both methods in Q4, with the HP filter suggesting a slightly greater opening of the output gap into negative values in 2013. The **Kalman filter** continues to indicate a slightly higher growth rate of potential output in 2011 Q4 (1.7%) and a much more negative output gap (-4.4% of potential output). The persisting sizeable dispersion of the results of the individual methods thus indicates a high degree of uncertainty surrounding the estimates of the current cyclical position of the economy. Nevertheless, all the methods suggest a continuing slowdown in potential output growth and an opening of the output gap into negative values in 2011 Q4.

25 The production function is computed in three ways using different input data. While the first (baseline) variant uses equilibrium employment, the second variant uses total employment. The third variant differs from the baseline variant by using slightly different coefficients α. Coefficient λ = 10,000 is used to filter productivity in the HP filter. The estimates of future potential output and the output gap are based on the CNB's macroeconomic forecast. The inclusion of the forecast helps to reduce the deviation of the HP filter at the end of the data sample. More information on the calculation of potential output can be found in the Box *Uncertainties surrounding the calculation of potential output* published in IR I/2010.

26 Averages of the three calculations for both figures.

27 The estimate using the HP filter also used coefficient λ = 10,000.

CHART III.3.15

POTENTIAL OUTPUT

The rate of growth of potential output slowed further in 2011 Q4 according to the calculation of the production function
(annual percentage changes)

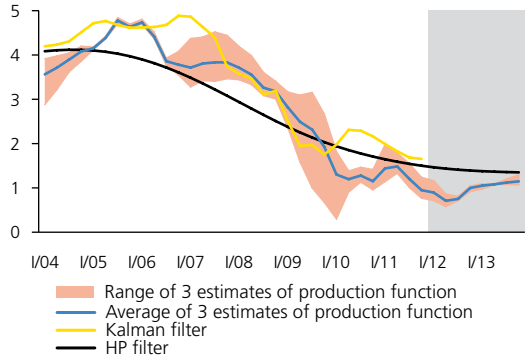


CHART III.3.16

OUTPUT GAP

The output gap opened further into negative values in 2011 Q4
(in % of potential output)

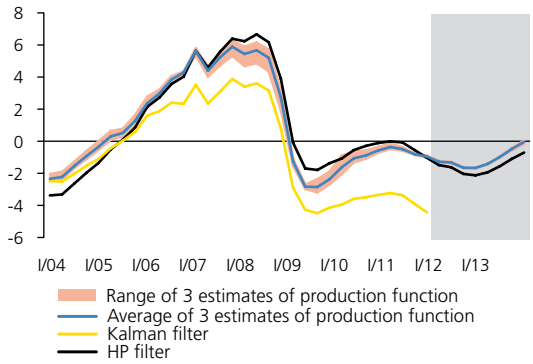


CHART III.3.17

CONTRIBUTIONS TO POTENTIAL OUTPUT GROWTH

A fall in equilibrium employment is contributing to the slowdown in potential output growth
(baseline production function; annual percentage changes)

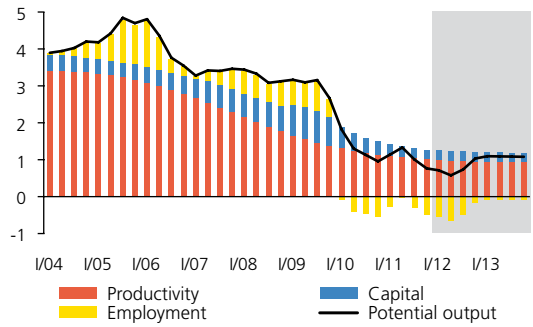


CHART III.4.1

LABOUR MARKET INDICATORS

Employment declined slightly and average nominal wage growth slowed in 2011 Q4
(annual percentage changes)

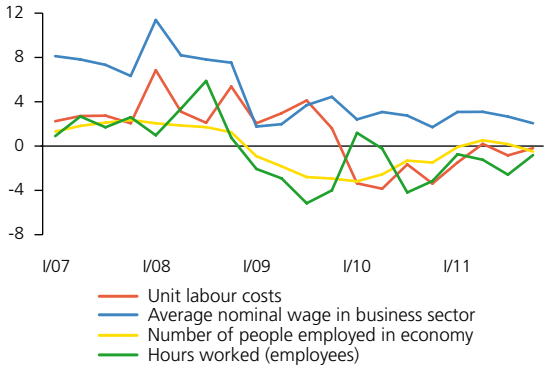
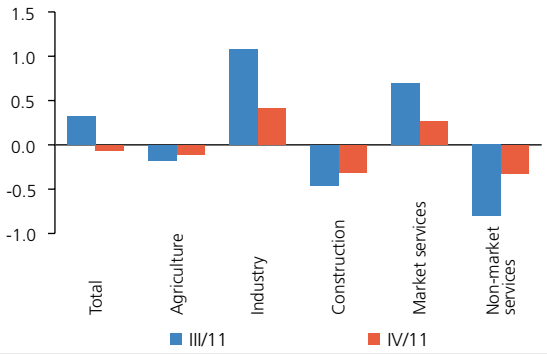


CHART III.4.2

EMPLOYMENT BREAKDOWN BY BRANCHES

Employment growth decreased in industry and market services
(contributions in percentage points to annual growth; selected branches; source: LFS)



III.4 THE LABOUR MARKET

The labour market was affected by slowing economic growth again in 2011 Q4. The previous moderate year-on-year growth in employment was replaced by a slight decline. The general unemployment rate and the registered unemployment rate both fell year on year as the decline in labour force accelerated. However, the registered unemployment rate (seasonally adjusted) remained flat in quarter-on-quarter terms in 2012 Q1. Annual growth in the average nominal wage slowed owing to wages in the business sector, and whole-economy labour productivity growth was close to zero. The annual decline in unit labour costs thus moderated overall and was insignificant.

III.4.1 Employment and unemployment

The evolution of **total employment**[28] in 2011 Q4 indicated continuing adjustment of the labour market to the slowing economic growth. The previous only modest growth in employment switched to a slight annual decline of 0.1% in Q4 (see Chart III.4.1). In absolute terms, the number of employed persons fell by 3,300 year on year. In quarter-on-quarter terms (after seasonal adjustment), employment decreased more substantially (by 0.4%). The slight year-on-year decline in employment was due mainly to a 0.5% fall in the number of employees.[29] This was partly offset by a further year-on-year increase in the number of entrepreneurs (of 1.9%), which reached almost 900,000, taking their share in total employment to a new record high of 18.3%.[30]

The employment situation again differed across the individual sectors in 2011 Q4, depending mainly on demand. Employment continued to rise in **industry**, albeit at a considerably slower pace than in the previous quarter (rising by 1.4%, i.e. 20,100 persons, year on year).[31] The positive contribution of this sector to total employment therefore shrank by more than one half compared to 2011 Q3 (see Chart III.4.2). Employment in export-oriented **manufacturing** remained of key importance for continued employment growth in industry, but the rate of growth of the number of employees moderated significantly in this branch as well (from 4.3% in 2011 Q3 to 2.3% in Q4), due to weakening domestic and external demand. In the other branches of industry, employment either fell year on year or remained roughly flat at the level of the same period a year earlier. The latest January and February data on the number of employees suggest that a further moderation of employment growth in industry as a whole can be expected in 2012 Q1 (the average registered number of employees rose by 1.1% and 0.4% year on year in January and February respectively).[32]

28 Employment according to the LFS.
29 Including members of production cooperatives.
30 For details, see the BOX *Labour market developments during the economic recession and the subsequent recovery* in Inflation Report III/2011.
31 Employment rose by 3.8%, or 52,700 persons, year on year in 2011 Q3.
32 Data from corporations with 50 employees or more, excluding agency workers.

Employment in the **services sector** continued to record a negligible annual decline overall in 2011 Q4 (of 0.1%, or 2,900 persons). As in previous quarters, this decline was due to government austerity measures, which affected non-market services (see Chart III.4.2). Employment still grew in market services, but at a much slower rate than in 2011 Q3. A noticeable decline in employment persisted in **construction**, which was hit hardest by the decline in demand. Despite slowing, this fall in employment still reached 3.4%.

With employment falling only slightly and the labour force declining more significantly,[33] the **general unemployment rate**[34] decreased by 0.5 percentage point year on year in 2011 Q4. Adjusted for seasonal effects, it fell by 0.1 percentage point to 6.6% in quarter-on-quarter terms. The **total registered unemployment rate** (MLSA) showed similar developments, declining by 0.6 percentage point year on year and stagnating at 8.7% in quarter-on-quarter terms in the same period.[35] It remained at the same level in 2012 Q1 (see Chart III.4.3).

The Beveridge curve[36] indicated no distinct positive changes in demand for labour in terms of vacancies in 2011 Q4. The number of unemployed people and the number of vacancies were broadly flat in this quarter. An only slight decline in the number of unemployed people was recorded in 2012 Q1, amid an increase in the number of vacancies (see Chart III.4.4).

III.4.2 Wages and productivity

Annual **average nominal wage growth** slowed to 2% in 2011 Q4. With annual inflation rising, the average real wage declined by 0.4% (see Table III.4.1). This change was due to the business sector, where growth in the average nominal wage slowed by 0.6 percentage point to 2.1% in Q4. By contrast, the **non-business sector** continued to see renewed average nominal wage growth for the second consecutive quarter, following a long period of annual decline due to government austerity measures. Despite increasing, however, its annual growth in Q4 was relatively low (1.6%), and so the average wage in this sector still recorded a year-on-year decline in real terms.

The continuing subdued – and slowing – growth in the average nominal wage in the **business sector** was fostered in Q4 mainly by weakening output growth in industry, associated primarily with external demand. This was due mainly to manufacturing, where growth in the average wage moderated to 2.2% in Q4. The wage decisions of businesses were also influenced by persisting excess labour supply, cost-cutting motives (in particular, offsetting of the increased costs caused by the

33 The decline in the labour force has been observed since 2010 Q2, except 2011 Q2.
34 In the 15–64 age category. Measured by the ILO methodology according to the LFS.
35 Seasonally adjusted data are used for the quarter-on-quarter figures.
36 The Beveridge curve has been affected by legislative changes in effect since 1 January 2012. Since that date, corporations have not been obliged to report the number of vacancies to labour offices.

CHART III.4.3

UNEMPLOYMENT RATE

The registered unemployment rate is flat in quarter-on-quarter comparison
(percentages; seasonally adjusted data; source: MLSA, CZSO)

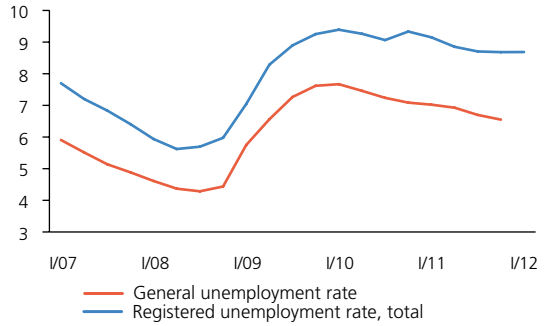


CHART III.4.4

BEVERIDGE CURVE

The number of vacancies remains low
(seasonally adjusted numbers in thousands)

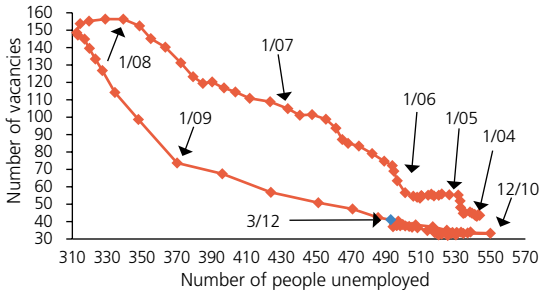


TABLE III.4.1

WAGES, PRODUCTIVITY, UNIT LABOUR COSTS

Average nominal wage growth in the business sector slowed noticeably
(annual percentage changes)

	I/11	II/11	III/11	IV/11
Average wage in Czech Republic				
nominal	2.2	2.3	2.4	2.0
real	0.5	0.5	0.6	-0.4
Average wage in business sector				
nominal	3.1	3.1	2.7	2.1
real	1.4	1.3	0.9	-0.3
Average wage in non-business sector				
nominal	-1.7	-0.9	1.0	1.6
real	-3.3	-2.7	-0.8	-0.8
Whole-economy labour productivity	2.7	1.8	1.1	0.2
Nominal unit labour costs	-1.5	0.2	-0.8	-0.2

CHART III.4.5

WHOLE-ECONOMY PRODUCTIVITY

Whole-economy productivity growth was close to zero
(annual percentage changes)

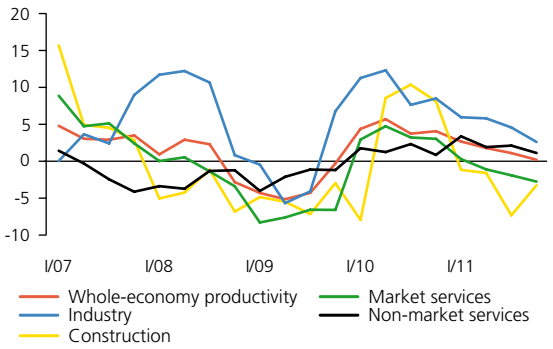
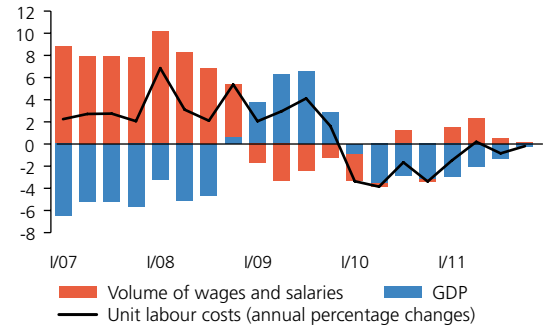


CHART III.4.6

UNIT LABOUR COSTS

The year-on-year decline in nominal unit labour costs was insignificant in 2011 Q4
(contributions in percentage points; annual percentage changes)



fast growing prices of imported energy inputs) and also considerable uncertainty regarding future demand. Wage growth continued in most other branches of the business sector, but was very mixed. On the other hand, the average wage declined in some branches (cultural, entertainment and recreational activities, and administrative and supporting activities).

Year-on-year **whole-economy productivity**[37] growth eased further and was close to zero (0.2%; see Chart III.4.5), amid a further considerable slowdown in GDP growth and an only marginal moderation in employment growth in 2011 Q4. However, productivity continued to be very mixed across sectors. It rose fastest in manufacturing, where it recorded a sizeable 7.2% rise despite slowing. A modest increase in productivity was also recorded in non-market services, while market services saw a persisting annual decline (of 2.8%) amid continued employment growth and a year-on-year decline in value added. In construction, the previous sharp decline in productivity slowed at the end of 2011, reaching 3.3%.

The decline **in unit labour costs**[38] moderated further in 2011 Q4 and was insignificant (at 0.2% year on year; see Chart III.4.6). The slower year-on-year decline in unit labour costs was fostered mainly by a larger decline in GDP growth, which was partly offset by a more modest slowdown in growth in the volume of wages and salaries. Unit labour costs recorded the largest decline in industry, and especially in manufacturing, where the difference between the growth rates of productivity and the average wage narrowed further, but still amounted to a sizeable 5 percentage points. They also decreased in non-market services and construction at the end of 2011, while increasing in market services.

37 Productivity is calculated on the basis of non-seasonally adjusted data.
38 Unit labour costs are calculated on the basis of non-seasonally adjusted data.

III.5 FINANCIAL AND MONETARY DEVELOPMENTS

Annual money aggregate growth rose further. Loans to households and corporations showed stable year-on-year growth of below 6%. Client interest rates remained low, rising only in the case of consumer credit. Money market rates remained flat amid falling long-term government bond yields. Client risk premia remain slightly higher than in 2007 despite a downward trend. Financial indicators and key corporate performance indicators are indicating an improvement. The household debt-to-income ratio increased further. Asking prices of apartments remained broadly unchanged year on year.

III.5.1 Money

The significant pick-up in annual growth in the **broad money aggregates**, which started in mid-2011, continued into 2012 Q1. The growth rate of M2 reached 6.8% in February (see Chart III.5.1). M3 showed a similar trend; its annual growth rate also increased visibly, reaching 4.6% in February.[39] Against the backdrop of falling economic growth, the pick-up in M2 growth was reflected in a further decrease in the velocity of broad money.

Transaction money remained the biggest contributor to the upswing in M2 growth, as a result of higher growth in overnight deposits amid flat growth in currency in circulation (see Chart III.5.2). Annual M1 growth increased to 8.3%. The spread between the interest rates on short-term time deposits and overnight deposits is showing a gradual upward tendency, despite a slight decline observed at the start of the year. The decline in other short-term deposits observed over the last two years thus moderated almost to zero. By contrast, demand of economic agents for long-term time deposits decreased further, primarily reflecting the low interest rates in this segment.

Turning to **money supply factors**, the growth rate of credit to the private sector increased in 2011 compared to 2010 amid persisting sharp growth in government financing (see Chart III.5.3). However, growth in loans to the private sector moderated at the start of 2012, and growth in net credit to the government declined as a result of an increase in government funds due to a bond issue abroad. On the other hand, the annual decline in net foreign assets observed in 2011 halted, primarily because of an outflow of portfolio investment by residents, and net foreign assets switched to modest growth. This reflected the rise in government funds from abroad and the favourable trade balance.

39 M3 growth in the euro area remains subdued, although it increased at the start of this year, reaching 2.8% in February.

CHART III.5.1

MONETARY AGGREGATES

Monetary aggregate growth rose further
(annual percentage changes)

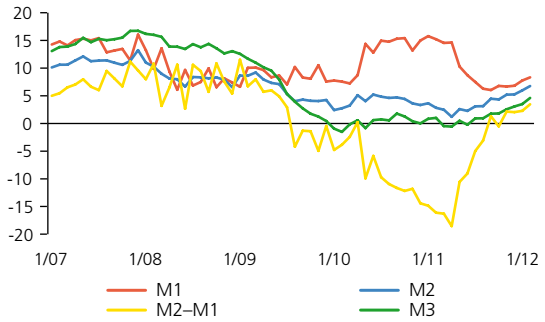


CHART III.5.2

MAIN COMPONENTS OF M2 AND INTEREST RATE SPREAD

Growth in liquidity in the form of overnight deposits increased
(annual flows in CZK billions; spreads in percentage points)

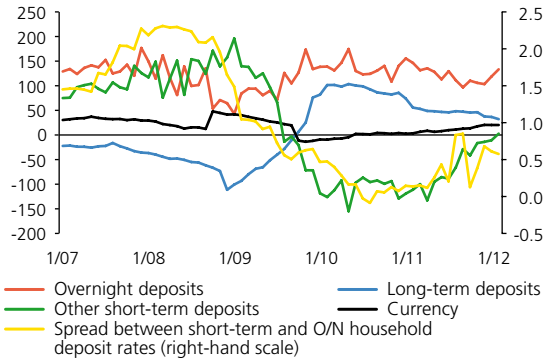
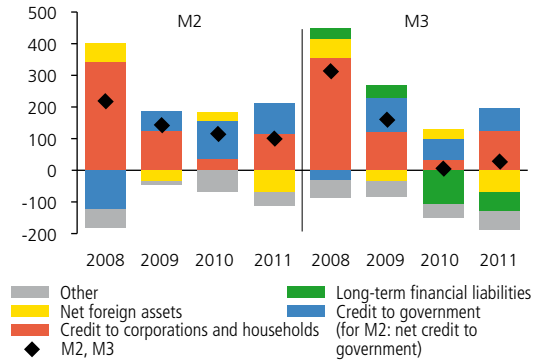


CHART III.5.3

MONEY SUPPLY FACTORS

An increase in loans provided to the economy was reflected in money growth in 2011
(average annual flows in CZK billions)



Note: Long-term financial liabilities of MFIs comprise time deposits with an agreed maturity of more than two years and redeemable at notice of more than three months as well as issued debt securities with maturity of more than two years.

CHART III.5.4

DEPOSIT STRUCTURE OF M2

Growth in deposits of non-financial corporations and non-monetary financial institutions increased, fostering a surge in liquidity growth
(annual percentage changes)

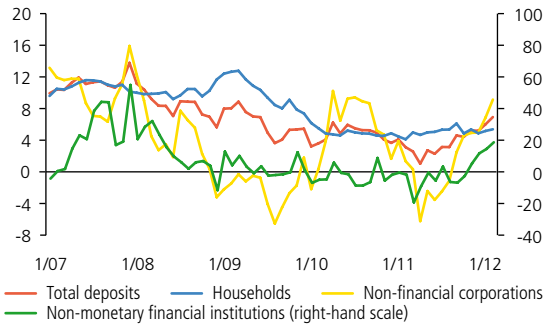


CHART III.5.5

LOANS TO CORPORATIONS AND HOUSEHOLDS

Growth in loans to the private sector decreased slightly
(annual percentage changes; ratios in %)

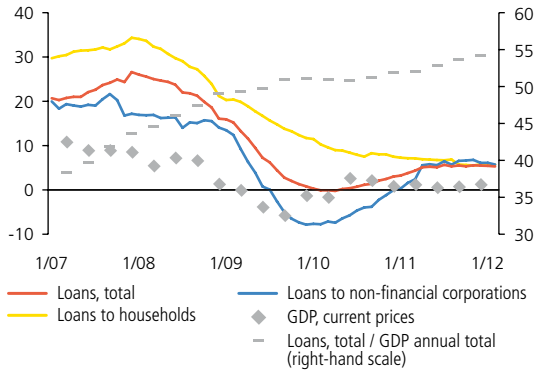
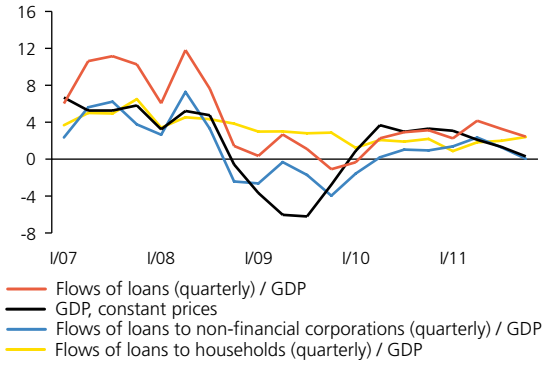


CHART III.5.6

LOANS AND GDP

The ratio of loan flows to corporations to GDP declined in 2011 Q4
(ratios in %; annual percentage changes)



Growth in client **deposits** has continued to record annual growth in recent months, reaching 6.9% in February. The growth rate of household deposits remains around 5%. The upturn in deposits of non-financial corporations recorded since mid-2011 continued and, together with higher growth in deposits of non-monetary financial institutions, fostered a further surge in broad money aggregate growth (see Chart III.5.4). The higher formation of corporate deposits continued to be reflected in growth in their acid-test ratio in a phase of subdued economic growth (see section III.5.6).

III.5.2 Credit

Annual growth in **loans to the private sector** decreased slightly further in 2012 Q1, reaching 5.3% in February (see Chart III.5.5). The decline in the ratio of loan flows to GDP also continued into 2011 Q4, owing to a decline in flows of corporate loans amid higher flows of loans to households (see Chart III.5.6). On the other hand, the ratio of the stock of loans to GDP increased further to around 54%.

In the **euro area**, growth in loans to the private sector remained subdued at the start of this year and below the level in the Czech Republic (around 1%). According to the *Bank Lending Survey*, tensions regarding banks' funding and capital positions and banks' increased risk perceptions concerning the economic outlook contributed to a tightening of credit standards and lower demand for loans in 2011 H2. The unconventional monetary policy measures introduced by the ECB in December 2011 subsequently eased these tensions, with the measures affecting loans with a lag (see *ECB Monthly Bulletin, March 2012*).

The rate of growth of **loans to non-financial corporations** in the Czech Republic declined further, reaching 5.7% in February. The growth rate of long-term and medium-term loans for financing investment slowed, while growth in short-term loans accelerated. Lower loan growth was fostered by all the key sectors except manufacturing. The growth rate of new corporate loans turned positive in late 2011 and early 2012, with large loans (over CZK 30 million) – provided usually to large corporations – being the main contributor to the growth.

As regards **demand factors**, corporate loans reflected the continuing stagnation of economic activity. Corporations demanded fewer loans to finance investment. On the other hand, there was a slight improvement in the business confidence indicator and orders in industry increased (see section III.3).

On the **supply side**, according to surveys conducted by the CNB and the Confederation of Industry, the availability of loans was still relatively good according to almost 85% of the businesses surveyed. Fewer businesses than in the previous survey expect the availability of loans to worsen in the coming twelve months, while the number of businesses expecting an improvement is unchanged (see Chart III.5.7). Turning to the supply of loans, domestic banks continue to have

sufficient primary funds and the client deposit-to-loans ratio increased to around 130% in the first two months of 2012 thanks to faster growth in deposits.

Annual growth in the stock of **loans to households** was almost unchanged in 2012 Q1, reaching 5.7% in February (see Chart III.5.8). Loans for house purchase recorded slightly lower growth, with the stock of mortgages falling by about 1 percentage point to 8.5%, while the decline in building society loans moderated. Consumer credit also fell, while the growth rate of other lending increased. Nevertheless, the rate of growth of **new mortgages** remained relatively high, picking up further compared to December 2011 (see Chart III.5.9). In particular, demand for new loans for house purchase with short fixations increased (34%), but loans with rate fixations of over one and up to five years still accounted for the largest share (48%). The mortgage market was positively affected by the low level of interest rates, the flat or slightly falling property prices and the possibility of advantageously refinancing old mortgages. The ratio of mortgage loans to gross disposable income increased further to 33%. According to the latest Hypoindex data, the volume and number of new mortgages recorded a month-on-month rise in March 2012, but the year-on-year comparison shows a decrease for the first time since mid-2010.

As regards the **structure of new mortgages**, according to Hypoindex data, mortgages for property purchase account for 62%, while loans for property construction and other mortgages, including refinancing of existing loans, both have shares of 19% (see Chart III.5.10). The shares of the first-mentioned two categories have been falling moderately in the longer term, while the share of other mortgages has almost tripled in the last five years, probably due mainly to increasing refinancing of mortgages. Further growth in refinancing can be expected this year, reflecting the terminating fixations of mortgages extended in 2007 and 2008.

Following an increase observed until 2009, the **debt burden of households** (repayments of principal and interest) relative to net money income (the monthly average per person) decreased in 2010 and was almost unchanged at just under 6% in 2011. The debt burden is now about 1 percentage point higher than before the crisis. The ratio of net interest paid on bank loans to deposits is also higher, amounting to around 2% in 2011.

Consumer credit from banks and non-bank institutions fell slightly (see Chart III.5.8), reflecting the restrained consumption behaviour of households amid a further decrease in the consumer confidence indicator in 2012 Q1 (see section III.3). Consumer credit from banks fell by 0.8% year on year, while that from non-bank institutions (i.e. leasing and hire-purchase companies) dropped by 0.2%. By contrast, new consumer credit increased by 7.7%, which, given the still low monthly flows of loans, suggests that new consumer credit was provided for the repayment or consolidation of existing loans (consumer and other credit, e.g. credit card).

CHART III.5.7

AVAILABILITY OF LOANS TO NON-FINANCIAL CORPORATIONS

Fewer businesses expect loan availability to worsen in the coming 12 months than in the previous survey
(percentage shares of firms in total number of firms surveyed)

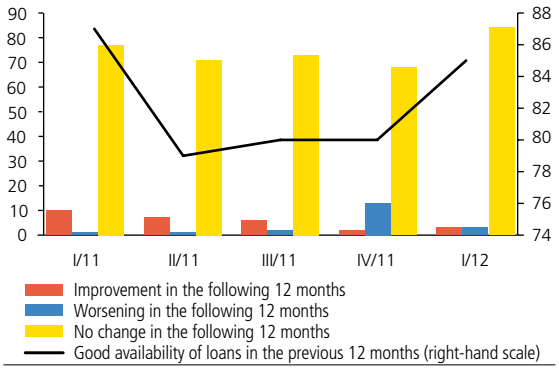
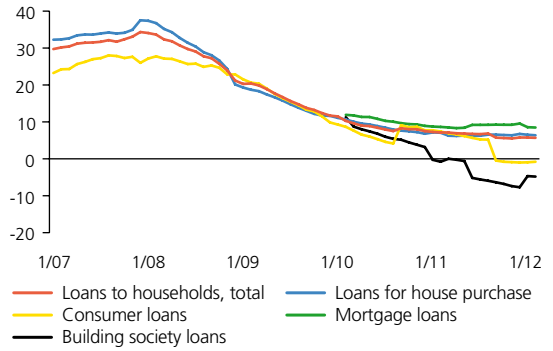


CHART III.5.8

LOANS TO HOUSEHOLDS

The rate of growth of loans to households was unchanged
(annual percentage changes)



Note: Consumer loans have been affected since September 2010 by the merger of a bank with a non-bank institution (which was originally in the category of financial corporations engaged in lending).

CHART III.5.9

NEW LOANS FOR HOUSE PURCHASE

The rate of growth of new mortgages rose in February, according to Hypoindex the number of mortgages decreased year on year in March
(new business; annual percentage changes; interest rate in %)

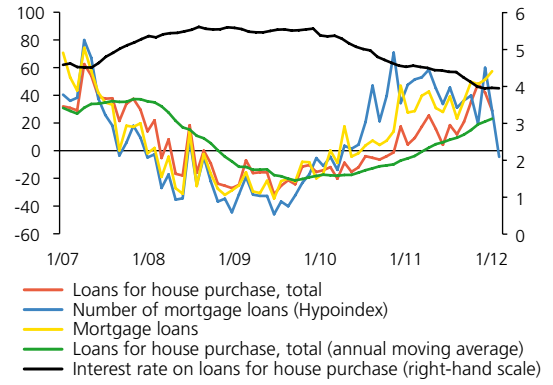


CHART III.5.10

STRUCTURE OF NUMBER OF NEW MORTGAGES

The share of the number of other mortgages, including refinancing, has long been rising
(shares in %; source: Fincentrum Hypoindex)

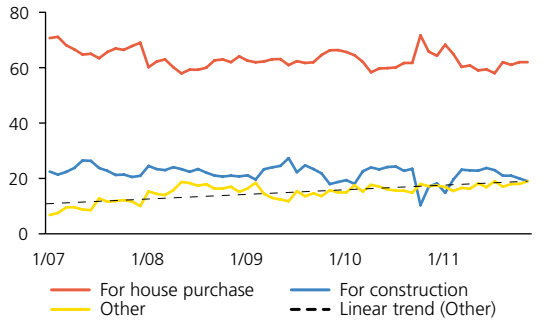


CHART III.5.11

CNB KEY RATES

The CNB has left key rates unchanged since May 2010
(percentages)

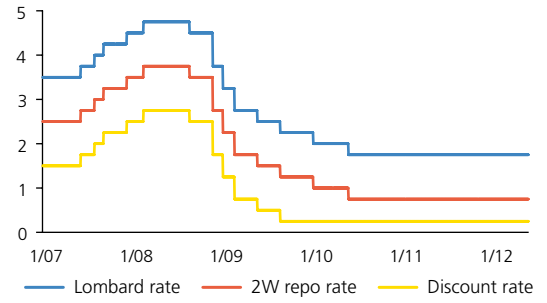
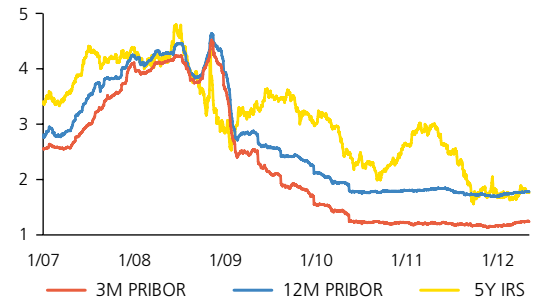


CHART III.5.12

MARKET INTEREST RATES

Money market interest rates increased slightly, while IRS rates were volatile
(percentages)



The ratio of **non-performing loans** to total loans remained elevated in all segments of the credit market compared to the pre-crisis period, staying at 8.1% for non-financial corporations and 5% for households at the start of this year.

III.5.3 Interest rates

Monetary policy interest rates

The monetary policy decision-making of the CNB Bank Board in 2012 Q1 was based on the macroeconomic forecast published in the previous Inflation Report. Consistent with this forecast and its assumption was stability of market interest rates in the near future and a modest decline thereafter. The risks of the previous forecast were assessed as being balanced at both the February and March Bank Board meetings. Accordingly, the Bank Board decided at both meetings to leave the **key interest rates** unchanged. The two-week repo rate has been set at 0.75%, the discount rate at 0.25% and the Lombard rate at 1.75% since May 2010 (see Chart III.5.11).

At its monetary policy meeting on 3 May 2012, the Bank Board decided by a majority vote to leave interest rates unchanged. The balance of risks was assessed as being inflationary. The demand-side effects of additional fiscal measures in the spirit of the alternative scenario are a downside risk. By contrast, the upside risks include a potential rise in inflation expectations, a slightly weaker koruna-euro exchange rate and higher prices of commodities, especially crude oil. Economic developments abroad represent a risk on either side.

Financial market interest rates

Money market interest rates were virtually unchanged in 2012 Q1, with the upward movements at individual maturities not exceeding 0.1 percentage point (see Chart III.5.12). **FRA derivative rates** increased slightly at all maturities (by 0.1–0.2 percentage point). Expectations of long-term stability of CNB interest rates currently prevail on the market. This reflects the absence of domestic inflation pressures, the slowing economic growth and the declining outlook for euro area interest rates on the one hand, and the higher inflation observed at the start of this year together with the communication of the CNB Bank Board on the other. The current market outlook for 3M rates according to FRA quotations implies expected rate stability. It is above the path consistent with the baseline scenario of the new forecast over the entire horizon; the deviation increases as the horizon lengthens (see sections I and II).

Interest rates with longer maturities showed no clear trend and continued to respond mainly to events abroad. Overall, IRS rates have increased at shorter maturities (up to 5Y) since the start of the year, while remaining mostly flat at longer maturities. By contrast, government bond yields have declined slightly, correcting their higher growth relative to IRS rates observed at the end of 2011.

The average **3M PRIBOR** was 1.2% in 2012 Q1 and was thus in line with the expectations of the previous forecast. Money market interest rates continued to be influenced by the credit premium. The spread between the 3M PRIBOR and 2W repo rate increased slightly, amounting to 0.45 percentage point on average in 2012 Q1. The spread has been close to this level since May 2010.

The **PRIBOR yield curve** has barely changed since the start of the year and its slope remains positive. The spread between the 1Y PRIBOR and 2W PRIBOR was around 0.9 percentage point in March 2012. The money market yield curve was again unchanged during April. The **IRS yield curve** shifted in both directions in 2012 Q1, but the changes were not significant and the positive slope of the curve decreased only slightly. In March, the average 5Y–1Y spread was 0.6 percentage point and the 10Y–1Y spread 1.0 percentage point.

Short-term **interest rate differentials** vis-à-vis the two main world currencies (PRIBOR/CZK–EURIBOR/EUR, or LIBOR/USD) reflected developments on foreign markets amid broadly flat rates on the domestic money market. The differentials vis-à-vis dollar rates remained virtually unchanged, while those vis-à-vis euro rates turned positive again (see Chart III.5.13). The 3M PRIBOR–3M EURIBOR interest rate differential was 0.2 percentage point on average in 2012 Q1. On 20 April, it was 0.5 percentage point.

Nine auctions of fixed coupon bonds and six auctions of variable coupon bonds have been held on the primary **government bond market** since the start of 2012. The total volume of bonds issued was CZK 75 billion. Demand exceeded supply in all the auctions – strongly so in some auctions. This means that the Ministry of Finance had no problems subscribing government bonds in the primary market even in an environment of increased risk aversion. Institutional investors showed less interest only in bonds with longer maturities. In addition to koruna bonds, the Ministry of Finance issued EUR 2 billion in ten-year eurobonds at the end of February. The government bond yield curve shifted downwards in 2012 Q1 as a result of the foreign bond market situation, while its positive slope remained unchanged (see Chart III.5.14).

Client interest rates

Following a fall in January, the **interest rate on new loans to non-financial corporations** excluding overdrafts was flat at 2.6% in February 2012 (see Chart III.5.15). Except for a rising rate on the smallest loans, short-term rates with fixations of up to one year on small and large loans were unchanged. Rates with longer fixations mostly declined, correcting the rise observed at the end of 2011. Interest rates on corporate loans reflected the flat money market rates and the fall in client risk premia. Compared to the end of last year, the spread between short-term client and market rates edged down further (see Chart III.5.17). For large loans, extended usually to large corporations, the spread was close to the pre-crisis level of 2007. In the euro area, interest rates were flat or falling at the level of

CHART III.5.13

INTEREST RATE DIFFERENTIALS

Interest rate differentials vis-à-vis the euro and the dollar were positive
(percentage points)

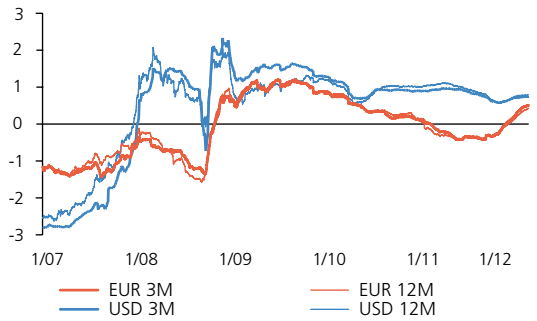


CHART III.5.14

GOVERNMENT BOND YIELD CURVE

The yield curve has shifted downwards since the end of 2011
(percentages)

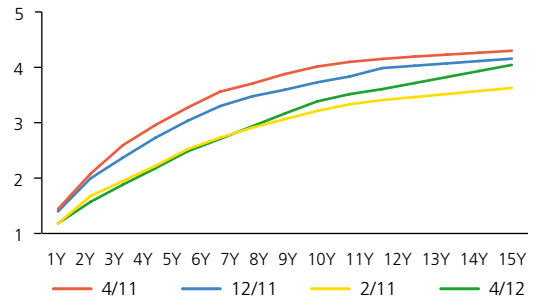


CHART III.5.15

INTEREST RATES ON LOANS TO CORPORATIONS

Interest rates on corporate loans remain low
(new business; percentages)

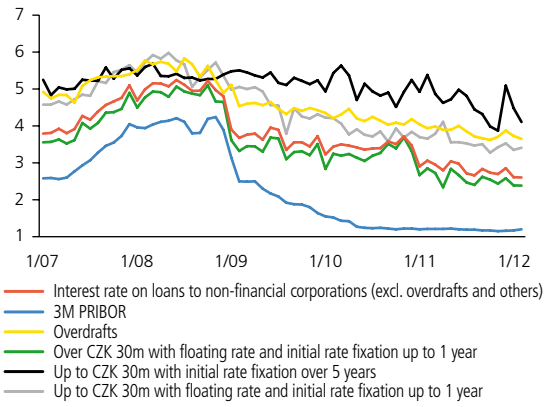


CHART III.5.16

INTEREST RATES ON LOANS FOR HOUSE PURCHASE

Rates on loans for house purchase were virtually unchanged
(new business; percentages)

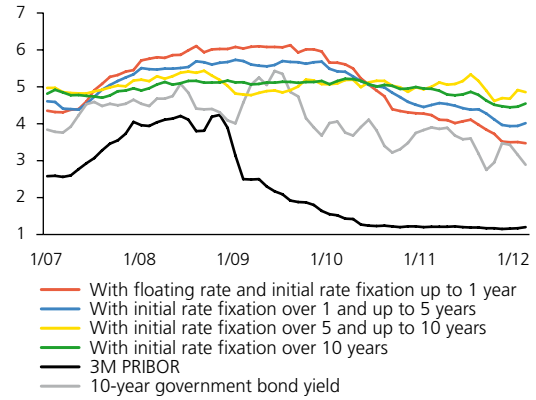


CHART III.5.17

CLIENT AND MARKET INTEREST RATE SPREADS

Banks continued to reduce the spread between short-term client and market rates mainly on house purchase loans and on large corporate loans
(percentage points)

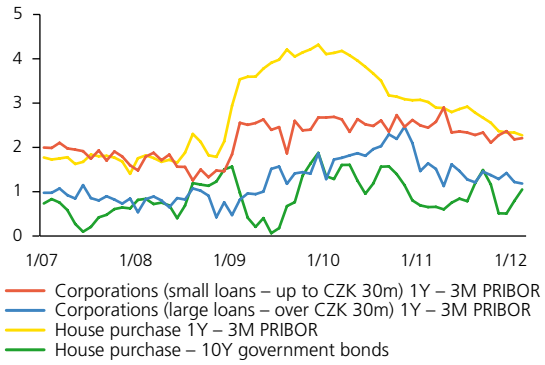
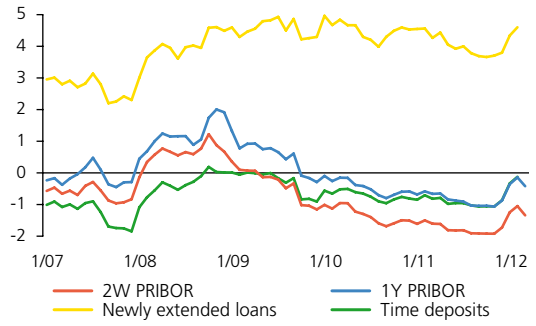


CHART III.5.18

EX ANTE REAL RATES

Ex ante real interest rates on new loans rose in early 2012
(percentages)



3–5%. The differential between rates on corporate loans in the Czech Republic and the euro area thus remained negative, supporting local financing of corporations.

Following previous declines, the **interest rate on loans for house purchase** remained broadly unchanged for households in 2012 Q1, reaching 3.9% in February. Rates with short and long fixations showed similar developments (see Chart III.5.16). The spread between short-term client and market rates also remained virtually unchanged, amid a flat 3M PRIBOR, and remained slightly higher than in 2007. The spread between the average rate on loans for house purchase and the ten-year government bond yield increased as a result of a fall in the said yield (see Chart III.5.17). According to Hypoindex, the interest rate on new mortgages edged up in March 2012. Following increases in 2011, house purchase loan rates in the euro area mostly declined, standing at 3–4% on average.

Following a decline at the end of last year, the **interest rate on consumer credit** increased again to 14.2% in 2012 Q1. The rate on credit cards showed similar rise (to 20.8%), while the rate on overdrafts and revolving loans was virtually unchanged (at 14.4%). The spread between the consumer credit rate and the 3M PRIBOR market rate increased again, following a decline in the first half and at the end of 2011. The aforementioned rates reflect the increased risk of potential non-repayment given the still weak labour market, and probably also the low financial literacy of the Czech households who take out consumer loans.[40] These rates thus continue to be significantly higher than in the euro area, where they amount to 6–8% (and around 17% for credit cards).

Interest rates on deposits remained broadly unchanged in Q1. Only the household deposit rate with an agreed maturity of over two years decreased to 1.4% (the similar rate for total time deposits is 1.3%). The interest rates on overnight deposits of households and on deposits redeemable at notice remained at 0.7% and 2% respectively. Rates on corporate deposits (0.4%) stayed at a lower level.

Real client interest rates[41] increased or became less negative during 2012 Q1 owing to a fall in expected inflation. Real rates on new loans were 4.6% in February, while real rates on time deposits were -0.1% (see Chart III.5.18).

40 These loans are drawn to a fairly large extent by low-income households (almost one-third of households in the two lowest income groups use consumer credit, compared to about one-fifth in the higher income groups).

41 Ex ante real interest rates: nominal interest rates are deflated by the consumer price inflation expected by financial market analysts.

III.5.4 The exchange rate

The average **exchange rate of the koruna against the euro** was CZK 25.1 in 2012 Q1. This represents a year-on-year depreciation of 2.9% and a quarter-on-quarter appreciation of 0.8%. In Q1, the koruna recorded a short-term depreciation from CZK 25.5 to CZK 25.8 against the euro, but it then started to strengthen until mid-March, appreciating by more than 5% in this period. A slight correction to CZK 24.8 was observed afterwards. The average value of the koruna against the euro was CZK 24.7 to the euro in the part of Q2 for which data are available (see Chart III.5.19).

The koruna's exchange rate will continue to be affected mainly by the debt crisis in Europe and its impacts on financial market sentiment. The appreciation of European currencies in Q1 was due to positive perceptions of the ECB's policy (massive provision of liquidity) and to a lesser extent to the measures adopted to solve the problems of Greece. The slight correction in late March and early April was due to rising concerns of financial markets regarding developments in Spain, and especially in its banking sector. The effect of domestic factors on the koruna was not immediately visible. The dominant effect of external factors on the koruna's exchange rate has been apparent since the onset of the financial crisis in Europe in autumn 2008. The koruna is now at the same level against the euro as before the crisis, but is slightly weaker against the dollar. It is significantly stronger against the other Central European currencies and somewhat stronger against the British pound.

The average **exchange rate of the koruna against the dollar** was CZK 19.1 in 2012 Q1. This represents a year-on-year depreciation of 7.4% and a quarter-on-quarter depreciation of 1.9%. In Q1, the koruna appreciated from around CZK 20 to CZK 18.6 against the dollar at the end of the quarter, due to the aforementioned measures to mitigate the debt crisis in Europe. It was slightly weaker again in mid-April, hovering around CZK 18.8 to the dollar.

CHART III.5.19

CZK/EUR AND CZK/USD EXCHANGE RATES

The koruna appreciated against both the euro and the dollar in 2012 Q1

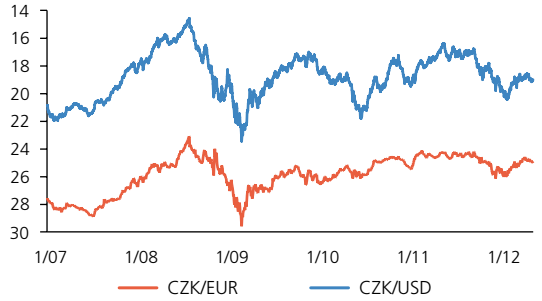


CHART III.5.20

KEY FINANCIAL INDICATORS

The main financial indicators improved in 2011 Q4
(annual percentage changes)

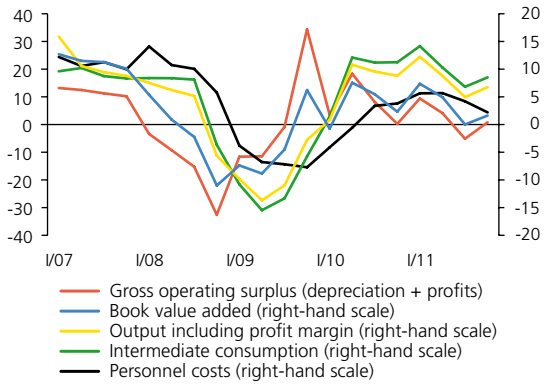


TABLE III.5.1

PERFORMANCE INDICATORS OF CORPORATIONS

The material cost-output ratio continued to increase and the personnel cost-output ratio decreased
(annual percentage changes)

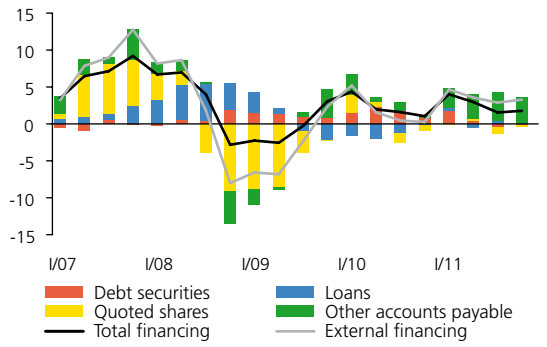
	2010 Q4	2011 Q4	Annual percentage changes
Output incl. profit margin (CZK billions)[a]	1,389.6	1,483.3	6.7
Personnel costs (CZK billions)	209.9	214.5	2.2
Intermediate consumption (CZK billions)	1,033.4	1,121.4	8.5
Book value added (CZK billions)	356.2	362.0	1.6
Sales (CZK billions)	1,817.1	1,949.0	7.3
	Percentages	Percentages	Annual changes in pp
Ratio of personnel costs to value added[a]	58.9	59.3	0.3
Material cost-output ratio[a]	74.4	75.6	1.2
Personnel cost-output ratio[a]	15.1	14.5	-0.6
Ratio of book value added to output[a]	25.6	24.4	-1.2

a) CNB calculation

CHART III.5.21

FINANCING OF NON-FINANCIAL CORPORATIONS

Growth in the total financial liabilities of corporations remains subdued
(contributions to external financing in percentage points; annual percentage changes)



III.5.5 Economic results of non-financial corporations

In the monitored segment of **non-financial corporations with 50 employees or more**,[42] the main monitored indicators improved slightly in 2011 Q4. Faster annual growth in sales and output fostered renewed annual growth in book value added (see Table III.5.1). According to CNB calculations, the gross operating surplus returned to slight annual growth in Q4 following a decline in 2011 Q3, amid a continued slowdown in growth in personnel costs (see Chart III.5.20).

As in previous quarters, the growth in output was accompanied by faster growth in intermediate consumption in Q4, which was reflected in a year-on-year rise in the **material cost-output ratio** (of 1.2 percentage points; see Table III.5.1). This was due mainly to continued fast growth in import prices of energy and non-energy commodities, and also to growth in prices of energy of domestic origin.

The **personnel cost-output ratio** continued to fall year on year (by 0.6 percentage point), as growth in personnel costs slowed further while the growth rate of output increased in Q4. This was fostered both by both weaker growth in the number of employees and slower growth in their average wage.

Data for the narrower **segment of large corporations** (with 250 employees or more[43]) indicate similar developments in financial indicators as in the larger segment of corporations. However, the renewed growth in their book value added and gross operating surplus was somewhat stronger than in the wider segment of corporations.

III.5.6 Financial position of corporations and households

Most financial indicators were pointing to a gradual improvement in corporate profitability in 2011 Q4, amid subdued growth in **external financing**. Annual growth of external financing of corporations edged up to 3.3% (see Chart III.5.21).[44] This growth was due to other accounts payable, amid a slowing decline in securities and almost zero growth in loans. Growth in total corporate financing, which additionally includes shareholders' equity in the form of unquoted shares and other equity, also edged up to 1.8% in 2011 Q4. The higher growth in the financial liabilities of corporations was due mainly to revaluation of securities and valuation changes, while the effect of transactions was lower. The share of market-based financing of corporations via securities in external financing stayed at a relatively

42 The segment of corporations with 50 employees or more consisted of more than 9,300 non-financial corporations at the end of 2011 Q4.
43 The segment of corporations with 250 employees or more consisted of almost 1,700 non-financial corporations at the end of 2011 Q4.
44 The 2011 Q3 data were revised upon the publication of the financial accounts data for 2011 Q4. External financing comprises loans, debt securities, quoted shares and other accounts payable. Total financing comprises all financial liabilities of corporations.

low level (around 18%). The ratio of debt financing of corporations in the form of loans, debt securities issued and other accounts payable to equity remained at 103% as a result of a decrease in debt and a moderation of the previous decline in equity.

The growth rate of **total loans** to non-financial corporations fell almost to zero in year-on-year comparison. This primarily reflected lower growth in loans from domestic banking institutions amid a fall in loans from abroad and loans from other domestic corporations (see Chart III.5.22).

Annual growth in **financial investment by corporations** slowed to 0.5% in 2011 Q4. Having risen strongly, the growth rate of liquid financial assets in the form of currency in circulation and deposits decreased in Q4, amid a more moderate decline in investment in debt securities and shares. The share of financial investment by corporations in total financial investment in the economy was little changed. Corporations continued to hold about 7% of financial investment vis-à-vis the rest of the world, compared to 6% in 2008 and 4% in 2007.

The **debt of non-financial corporations**, as expressed by the ratio of loans and debt security issuance to GDP, has been hovering around 46% recent quarters. It remains lower than in the euro area, where it has dropped slightly below 79% since 2010. The net interest burden on corporations resulting from bank loans relative to gross operating surplus edged down to 3.1%, mainly as a result of an increase in gross operating surplus (see Chart III.5.23). Net interest payments have been fluctuating around this level since 2009, when they recorded a decline, but they remain slightly above the pre-crisis level owing to higher interest paid and lower interest received.

The **financial indicators of non-financial corporations** continue to point to growth in the acid-test ratio, albeit at a lower level than in the previous period due to lower growth in short-term financial assets. The solvency of corporations worsened further amid lower financial leverage (see Table III.5.2).

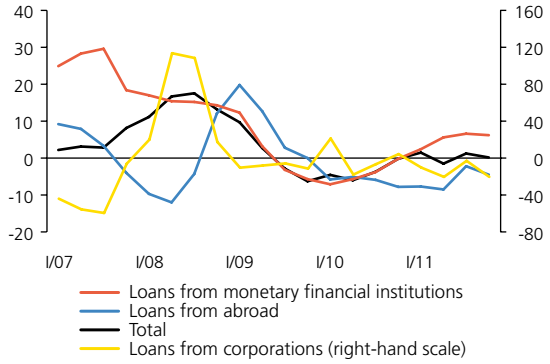
The difference between corporations' **internal funds** (gross savings, i.e. profit and depreciation) and their investment expenditure (i.e. gross capital formation) turned positive in Q4, reaching 0.6% of gross value added on an annual basis. This difference is due mainly to low investment expenditure relative to the pre-crisis period, when it was quite strongly negative.

The annual growth rate of total **financing of households** by banks and non-bank institutions remained just below 6% in 2011 Q4 (see Chart III.5.24). In line with the long-run trend, however, the ratio of household debt to gross disposable income rose further to around 58%, amid zero growth in disposable income. In the euro area, by contrast, the same ratio has been at 99% since mid-2010. The ratios of household debt to GDP and to financial assets in the Czech Republic remained virtually unchanged at just above 30% (compared to about

CHART III.5.22

DOMESTIC AND FOREIGN CORPORATE LOANS

Corporate loans were unchanged in year-on-year comparison
(annual percentage changes)



Note: The time series of loans from other financial institutions is not included owing to a change in methodology in 2011.

CHART III.5.23

DEBT AND NET INTEREST PAYMENTS

The ratios of corporate and household debt to GDP were flat, while the ratio of household debt to income increased
(percentages)

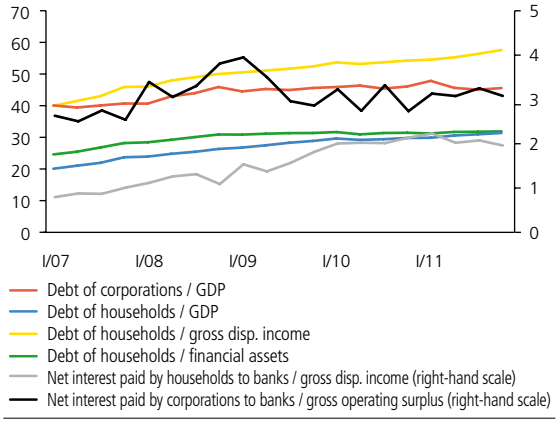


TABLE III.5.2

FINANCIAL INDICATORS OF CORPORATIONS

The acid-test ratio of corporations increased, while solvency decreased further

	I/11	II/11	III/11	IV/11	IV/11
Corporations total[a)]	Annual percentage changes				CZK billions
Equity (shares and other equity issued)	2.5	2.1	-1.4	-0.5	4,055.0
Loans	1.5	-1.5	1.2	0.2	1,468.2
Debt securities	34.4	4.9	-6.4	-2.3	267.2
Quoted shares	-0.7	2.1	-7.2	-1.7	625.3
Other accounts payable	5.3	7.1	7.9	7.3	2,493.9
Total financing[1)]	4.0	3.0	1.6	1.8	8,284.3
Financial assets	5.8	2.7	2.5	0.5	4,640.3
Corporations total[a)]	Annual changes in percentage points				Indicator value in %
Acid-test ratio[2)]	8.7	6.0	15.4	11.2	181.1
Solvency indicator[3)]	0.2	-1.2	-2.2	-4.0	109.7
Financial leverage[4)]	3.6	0.7	4.3	1.1	114.4

a) CNB calculation
1) Total financial liabilities
2) Short-term fin.assets/short-term fin. liabilities (debt securities and loans)
3) Total financial assets/liabilities excluding shares and other equity
4) Total financial assets/shares and other equity issued

CHART III.5.24

FINANCING OF HOUSEHOLDS

Housing loans contributed the most to the growth in total household debt
(contributions in percentage points; annual percentage changes)

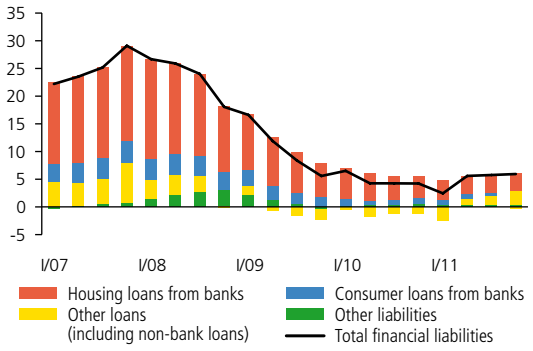


CHART III.5.25

FINANCIAL INVESTMENTS OF HOUSEHOLDS

Growth in households' financial assets remains subdued compared to the pre-crisis period
(contributions in percentage points; annual percentage changes)

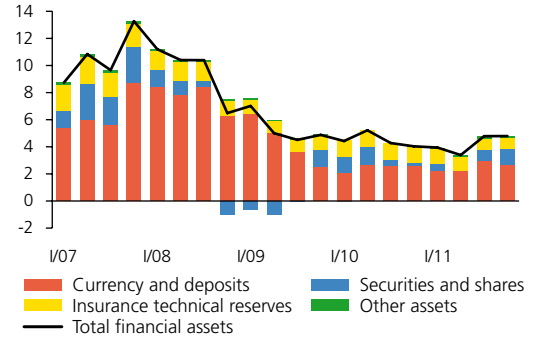
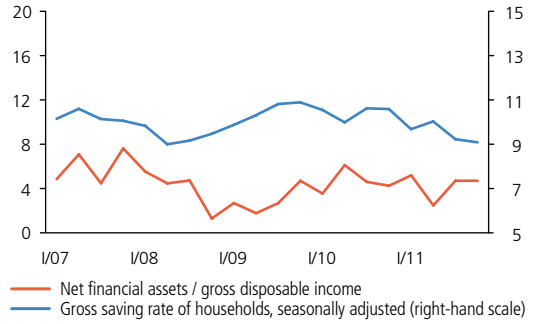


CHART III.5.26

NET FINANCIAL ASSETS AND GROSS SAVING RATE OF HOUSEHOLDS

Growth in the net financial assets of households in relation to gross disposable income was broadly flat in 2011 Q4
(annual percentage changes calculated from annual flows; ratios in percentages)



65% of GDP in the euro area). The interest burden on households, which had been rising until 2009, flattened out and fell slightly to 2% in Q4 (see Chart III.5.23). Households' solvency (as measured by the ratio of financial assets to liabilities) and acid-test ratio (as measured by the ratio of selected short-term financial assets to short-term loans) fell year on year from the previous quarter.

The growth rate of **financial investment by households** stayed at 4.8% in Q4 (see Chart III.5.25). Investment in currency in circulation and deposits were still the main contributors to the growth in financial investment. However, their growth rate is considerably lower than in the pre-crisis period. Households invested slightly more in securities as a result of purchases of saving (retail) government bonds, while investment in insurance reserves was approximately unchanged.[45]

The ratio of growth in **net financial assets of households** to gross disposable income has long been broadly in line with the gross saving rate (see Chart III.5.26). This ratio decreased in 2008 and increased in 2009. The decline in net financial assets initially reflected lower growth in financial assets of households, but in 2009 this was outweighed by a more pronounced fall in financial liabilities, with the opposite effect on net assets. Since 2010, the ratio has been gradually decreasing as a result of lower growth in financial assets amid almost flat growth in financial liabilities of households. The gross saving rate also edged down in an environment of worse consumer sentiment.

III.5.7 The property market

According to CZSO data, **asking prices of apartments** in Prague rose by a relatively strong 3.8% quarter on quarter in early 2012 following three and a half years of declines. Their previous year-on-year decline thus more or less turned into stagnation (a modest decrease of 0.2%; see Chart III.5.27). This increase in asking prices in Prague is not only rather surprising, but also very uncertain, as alternative sources of asking prices of apartments (e.g. the Institute for Regional Information) indicate further absolute price declines in Prague for the same period and deepening declines in year-on-year comparison. Asking prices in the rest of the Czech Republic continued to fall (by 1% quarter on quarter and 4.2% year on year).

45 Currency in circulation and deposits make up 57%, securities 2%, shares (other than shares in investment funds) 21%, shares in investment funds 4%, pension fund reserves 6%, reserves in insurance companies 8% and other assets 2% of the financial assets of households. In Chart III.5.25, pension fund reserves and reserves in insurance companies are included in insurance technical reserves. Deposits of households in the form of building savings account for around 25% of households' total deposits with banks and have been showing a gradual downward trend since 2007.

No new estimate based on tax returns data was available for **transaction prices of older apartments**. Thus, the latest available data are still for 2011 H1. However, the CZSO published a new estimate of transaction prices in 2011 Q4 based on its surveys in estate agencies.[46] This estimate points to a continuing fall in transaction prices in Prague (of 3.2% year on year for older apartments and 2.9% for new apartments) and elsewhere in the Czech Republic (of 4.6% year on year for older apartments). This is confirmed by an alternative estimate of these prices based on the HB index, according to which the year-on-year decline in apartment prices reached 3.0% and was less pronounced in Prague than in the rest of the Czech Republic.

A partial stabilisation of the property market in 2012 Q1 is also indicated by an increase in the **number of property market transactions**. The number of proceedings on entry of ownership rights in the cadastre rose by 7.8% year on year in this period (and increased for the second consecutive quarter) and the one-year moving sum of the number of transactions rose by 2.0% quarter on quarter (see Chart III.5.28). On the other hand, the number of entries of ownership rights to houses and apartments is still falling (by 7.9% year on year; moving sum down by 2.3% quarter on quarter). The number of new mortgages for property purchase continued to rise (moving sum up by 3.1% quarter on quarter; Fincentrum Hypoindex data; see Chart III.5.28). Besides substitution between mortgage loans and building society loans and a rise in refinanced existing mortgages (see section III.5.2), this reflects a recovery in demand for new apartments linked with the "frontloading" effect relating to the increase in VAT on new apartments from 10% to 14% on 1 January 2012.[47] The expected decrease in the number of transactions connected with this frontloading in 2012 has been only partially confirmed so far in 2012 Q1 (a year-on-year decrease in the number of sold apartments of 3.6%). The high and rising number of unsold completed apartments will probably force developers to cover part of the VAT increase themselves, so the growth in prices of new apartments will be slightly lower than the VAT increase.

The property price sustainability indicators remained favourable in 2012 Q1. The **price-to-income ratio** saw a slight quarter-on-quarter increase of 0.4%, but recorded its second lowest figure in six years behind 2011 Q4. The **price-to-rent ratio** decreased for the third consecutive quarter (by 2.1% in Q1). Both indices point to a slight undervaluation of apartment prices (of less than 5%), as confirmed by updated estimates of equilibrium prices using econometric models.

46 This index differs from the transaction price index based on prices from property transfer tax returns, which is the source of data for Chart III.5.27. The advantages of this new index are that it has a shorter publication lag and that it covers prices of new apartments, which are not subject to property transfer tax. On the other hand, this index does not cover property transactions outside estate agencies, its structure is less detailed and its time series is shorter (the oldest data are from 2008).

47 According to Ekospol, the number of apartments sold in Prague rose by 28.4% year on year in 2011. This growth surged in H2.

CHART III.5.27

TRANSACTION AND ASKING PRICES OF APARTMENTS

The year-on-year decline in asking prices of apartments in Prague halted in 2012 Q1 according to CZSO figures
(annual percentage changes; source: CZSO, Institute for Regional Information)

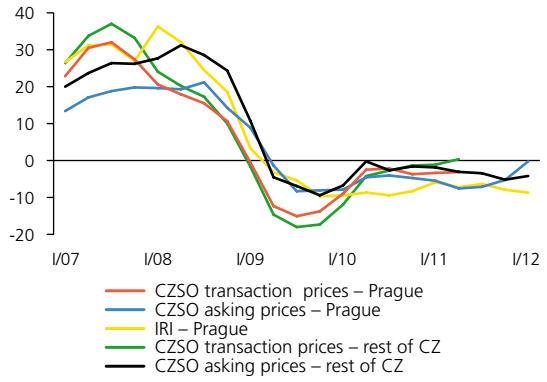


CHART III.5.28

NUMBERS OF TRANSACTIONS IN THE PROPERTY MARKET

The evolution of the number of transactions and the number of mortgages suggests that the property market is stabilising
(2006 average = 100; numbers of transactions as one-year moving sums; source: CZSO, COSMC, Fincentrum Hypoindex)

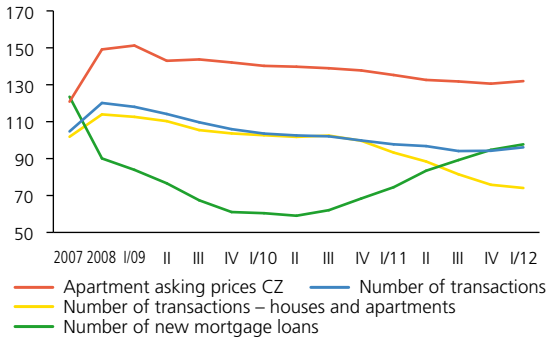


CHART III.5.29

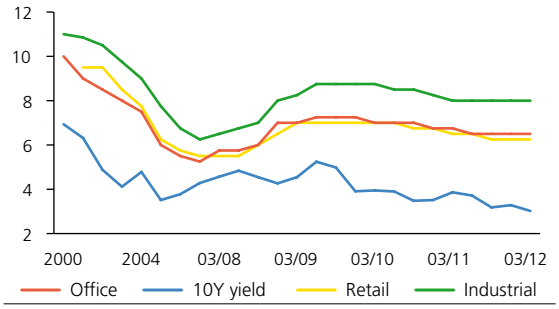
APARTMENT PRICE SUSTAINABILITY INDICATORS

The price-to-rent ratio continued to fall
(2000–2007 average = 100; source: CZSO, Institute for Regional Information)

Chart III.5.30

COMMERCIAL PROPERTY YIELDS

Commercial property yields fell year on year
(percentages; 2000–2007 year data, onward quarterly data; source: Jones Lang LaSalle, Prague Research Forum)



As in the previous period, however, we continue to expect prices of older apartments to remain flat in 2012, primarily in line with labour market developments (see section II.2) and demographic trends (lower population growth).[48]

Total take-up in the **commercial property sector** continued to recover. In addition, the volume of investment transactions increased, totalling EUR 2.1 billion in 2011 as a whole and rising by a marked 165% year on year (Jones Lang LaSalle data). More than one-half of this volume was realised in 2011 Q3, primarily in the retail investment segment. Gross take-up increased as well. The volume of rentals in the office market in 2011 as a whole rose by a sizeable 52%, due chiefly to growth in Q4. The share of renegotiations in gross take-up was down, from 42% in 2010 to 28% in 2011 Q4, so net absorption increased as well, from a negative figure in 2010 to 121,000 m^2. New supply of office space continued to recover, with total office floor area increasing by 3.8% year on year in 2012 Q1. The vacancy rate rose by only 0.3 percentage point quarter on quarter to 12.3% and fell by 0.7 percentage point year on year. Similarly, the vacancy rates for other types of commercial property decreased (to 6.7% for industrial property[49]). The recovery in take-up was also reflected in higher prices and a related modest annual drop in yields on commercial property (see Chart III.5.30). In contrast to the continuing increase in long-term government bond yields, however, the yields have been broadly flat recently.

48 A worse outlook for domestic economic growth connected with developments abroad and the impact of fiscal austerity measures on the income situation of households remain downside risks to property price growth. Foreclosures of apartments or apartment blocks used to secure mortgage loans of developers, for whom the non-performing loan ratio is rising, remain an additional risk.

49 This represents a decrease of 12 percentage points from the record high seen in 2009 Q2. At the same time, the retail vacancy rate fell to 5.0% (from 6.4% in 2009).

III.6 BALANCE OF PAYMENTS

In 2011, the balance of payments was again characterised by a high income deficit, due mainly to dividends from direct investment paid to non-residents, which however recorded a slight decline. Its effect on the current account was largely offset by a goods and services surplus resulting from a rising trade surplus. The overall financial account surplus was driven mainly by a net inflow of direct investment due to earnings reinvested in the Czech Republic. Portfolio investment saw the largest change, recording only a modest surplus compared to the previous year owing to the absence of government bond issues abroad.

III.6.1 The current account

The **current account** recorded a deficit of CZK 109.1 billion in 2011. In year-on-year terms, the deficit fell by almost CZK 38 billion. The decline in the overall deficit was related mainly to trade balance developments (see Chart III.6.1). The annual moving ratio of the current account to GDP decreased in H2, to 2.9% at the close of the year.

The **trade surplus** for 2011 rose by more than CZK 40 billion year on year to CZK 94 billion. The increase in the trade surplus was due to developments in real terms, which were partly offset, however, by the price effect associated with a negative annual change in the terms of trade. The gradual moderation in external demand growth during the year was reflected in a slowdown in goods exports from Q2 onwards. However, its annual nominal growth rate in 2011 as a whole was almost 13% despite year-on-year appreciation of the koruna. The annual nominal growth rate of imports followed a similar downward trend as a result of the high import intensity of exports. Goods imports were also partly dampened by a fall in total domestic demand, which was significantly affected in H2 by base effects connected with the peak in imports for photovoltaic power stations in 2010. By contrast, high energy prices pushed nominal imports upwards. Turning to the commodity structure, growth in the machinery and transport equipment surplus was the biggest contributor to the increase in the overall trade surplus. By contrast, an increase in the deficit on mineral fuels was the strongest factor acting in the opposite direction (see Chart III.6.2). The strong year-on-year rise in the trade surplus continued during 2012 Q1. The surplus increased by almost CZK 17 billion year on year for January and February according to the balance of payments methodology.

The **balance of services** recorded a surplus of CZK 66.3 billion in 2011. In year-on-year terms, the surplus fell by CZK 9 billion (see Chart III.6.3). The overall surplus was linked mainly with a surplus on travel, which fell slightly, however, owing chiefly to higher expenditure by residents on business travel. The annual change in the overall surplus was due above all to a decline in the surplus on transport,

CHART III.6.1

CURRENT ACCOUNT

The current account deficit decreased in 2011, owing mainly to a rising trade surplus
(annual moving totals in CZK billions)

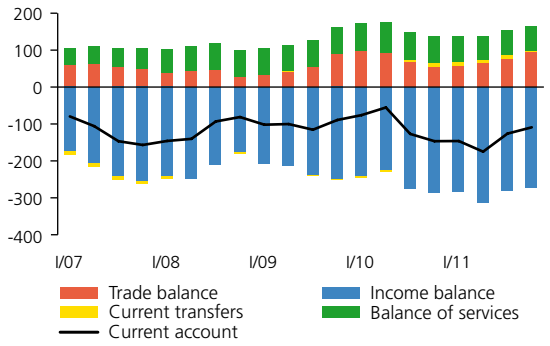


CHART III.6.2

TRADE BALANCE

The year-on-year change in the trade balance was affected most strongly in 2011 by growth in the machinery surplus
(annual accumulation in CZK billions)

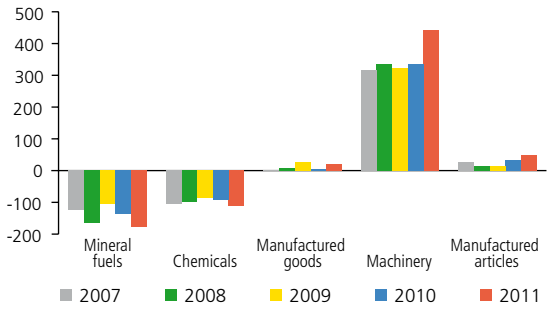


CHART III.6.3

BALANCE OF SERVICES

Travel and transport again contributed to the services surplus in 2011
(CZK billions)

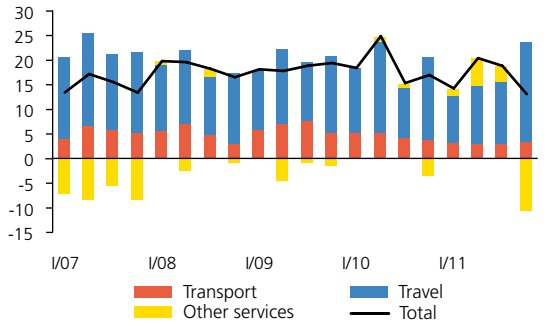


CHART III.6.4

INCOME BALANCE

Within the income balance, the direct investment income deficit decreased in particular in 2011
(annual accumulation in CZK billions)

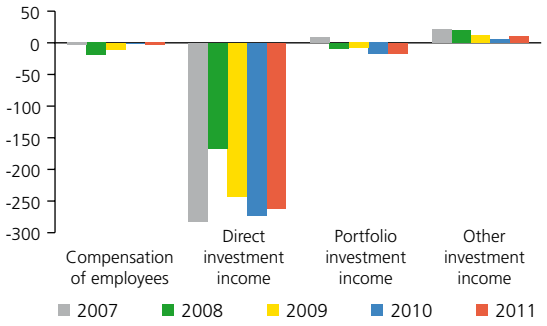


CHART III.6.5

FINANCIAL ACCOUNT

The financial account surplus decreased in 2011, owing mainly to a sharp fall in the net inflow of portfolio investment
(annual moving totals in CZK billions)

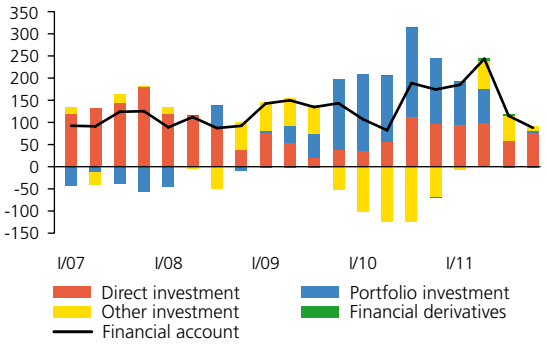
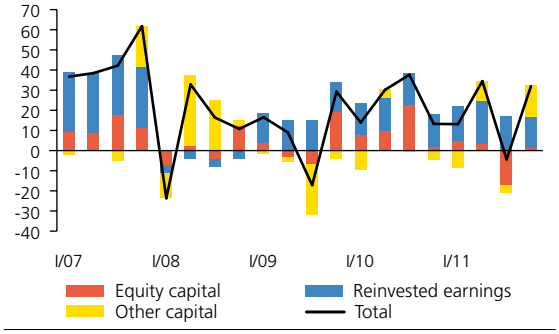


CHART III.6.6

DIRECT INVESTMENT

The direct investment surplus in 2011 was mainly a result of earnings reinvested in the Czech Republic
(CZK billions)



associated mainly with higher debits for road transport. By contrast, other services recorded only a marginal deficit, which decreased slightly, amid mixed developments in the individual sub-components.

In contrast to the goods and services surplus, the **income balance** ended 2011 in a deficit of CZK 271.9 billion, although it declined by CZK 13 billion year on year. The deficit on direct investment income of CZK 262.1 billion, linked chiefly with income in the form of dividends paid to non-residents and estimated reinvested earnings in the Czech Republic, was the largest component of the overall balance (see Chart III.6.4). Portfolio investment income and compensation of employees also recorded slight deficits. The only component to end in a surplus was other investment income, comprising income on CNB international reserves and interest on bank deposits. The year-on-year decrease in the overall income deficit was due to a lower deficit on direct investment income resulting from lower estimated dividend payments.

Current transfers recorded only a slight surplus of CZK 2.5 billion in 2011, down by almost CZK 7 billion from a year earlier. The government transfers surplus reached CZK 18.3 billion, due almost exclusively to a surplus on transfers between the Czech Republic and the EU budget. However, it was largely offset by a deficit on transfers of other sectors. The year-on-year decline in the overall surplus was caused by higher government transfers to the EU budget at the close of the year.

III.6.2 The capital account

The **capital account** also ended in a surplus (CZK 14.7 billion). The year-on-year decline in the surplus of almost CZK 18 billion was due to significantly lower credits. This was chiefly a result of lower net credits from capital transfers, comprising mainly transfers from EU funds, which reached CZK 12.1 billion. The decline in the overall surplus was also due to a fall in net credits from trading in emission allowances.

III.6.3 The financial account

The **financial account** ended 2011 in a surplus of CZK 87.9 billion (see Chart III.6.5). This was mainly due to a net inflow of direct investment. The other components recorded significantly lower balances.

Direct investment recorded a net surplus of CZK 75.3 billion in 2011, down by almost CZK 20 billion year on year owing to a lower inflow of foreign direct investment into the Czech Republic (see Chart III.6.6). The overall gross inflow was CZK 95.6 billion and was linked chiefly with reinvested earnings. Its annual decline was associated with a decrease in the equity capital of some corporations in the Czech Republic, which was partly offset, however, by a rise in the inflow of other capital and reinvested earnings. Reinvested

earnings were also the largest component of direct investment of domestic corporations abroad. With regard to industries, the foreign capital inflow (excluding reinvestment) was channelled primarily into electricity, gas and heat supply. Capital outflows abroad went mainly to manufacture of motor vehicles.

By contrast, **portfolio investment** recorded only a modest net inflow of CZK 5.8 billion (see Chart III.6.7). The year-on-year drop in its surplus of almost CZK 145 billion was connected with the absence of government bond issues abroad and partly also with renewed investor interest in foreign securities. The biggest transactions were purchases of domestic securities by foreign investors, the balance of which exceeded CZK 20 billion. They were related almost solely to an increase in debt securities holdings. Total purchases also dominated resident investor transactions in foreign securities, which were connected only with an increase in bond holdings, whereas sales were predominant in the case of shares.

Settlement of **financial derivatives** was unchanged year on year, resulting in a net outflow of CZK 3 billion.

Other investment saw a net inflow of funds totalling CZK 9.8 billion in 2011. The overall surplus was due chiefly to a net inflow of almost CZK 24 billion in the monetary financial institutions sector, linked mainly with a fall in short-term deposits abroad and repayments of short-term loans provided by residents. Investment in the government sector also ended in a small surplus associated with drawdown of EIB loans. However, the overall inflow was partly offset by a net capital outflow from the corporate sector due to rapid growth in loans provided and deposits abroad. Nevertheless, the net outflow in the corporate sector moderated significantly owing to a rise in liabilities.

The CNB's **international reserves** totalled CZK 797.3 billion at the end of 2012 Q1, representing a quarter-on-quarter drop of more than CZK 6 billion due mainly to valuation changes. In dollar terms, by contrast, the reserves increased by USD 2.8 billion to USD 43 billion in the same period (see Chart III.6.8). The CNB's international reserves covered almost 43% of all external debt liabilities of domestic entities at the end of 2011 Q4.

CHART III.6.7

PORTFOLIO INVESTMENT

Portfolio investment recorded a modest net inflow in 2011, owing mainly to purchases of domestic securities by non-residents
(CZK billions)

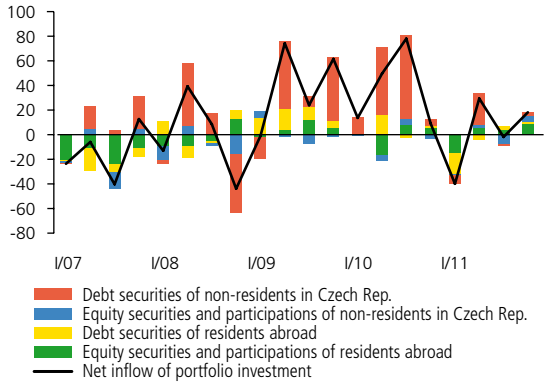
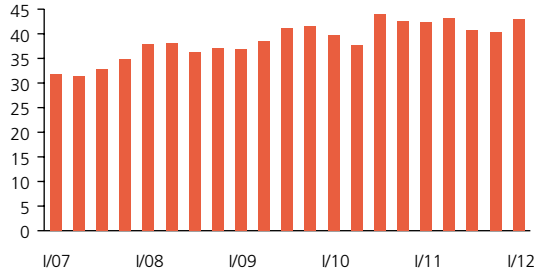


CHART III.6.8

CNB INTERNATIONAL RESERVES

The CNB's international reserves increased in dollar terms in 2012 Q1 compared to the previous quarter
(USD billions)



III.7 THE EXTERNAL ENVIRONMENT

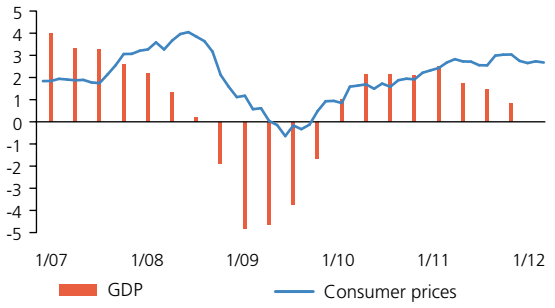
In contrast to the USA, where the economic recovery continued, euro area growth slowed in 2011 Q4 in line with the different expectations for 2012: a modest economic decline in the euro area and relatively smooth growth in the USA. Consumer price inflation has been recording similar sub-3% levels on both sides of the Atlantic since the start of 2012. The largest upward risks to inflation are energy prices and, in the euro area, changes to indirect taxes, while demand-pull inflation pressures remain contained. In February, the ECB carried out its second three-year refinancing operation, while the Fed has so far been waiting with further monetary policy easing. Following a weakening of the euro in early 2012, the dollar-euro exchange rate returned to USD 1.32 and fluctuated around this level until April. The Brent crude oil price rose sharply in February, mainly because of the imposition of an embargo on oil supplies from Iran.

III.7.1 The euro area

CHART III.7.1

GDP AND INFLATION IN THE EURO AREA

GDP growth slowed further in 2011 Q4, while inflation has been flat since the end of 2011
(annual percentage changes; source: Datastream)



Euro area GDP declined by 0.3% quarter on quarter in 2011 Q4 after increasing by 0.1% in the previous quarter. Investment, household consumption and government expenditure declined, while higher net exports acted in the opposite direction. The same factors influenced the slowdown in the annual rate of economic growth from 1.3% to 0.7% in Q4. GDP growth for the whole of 2011 totalled 1.5%. In 2012 Q1, the April CF expects the quarter-on-quarter decline to slow to 0.2%. However, industrial production and retail turnover increased slightly in month-on-month terms in January and February (by 0.2% and 0.5% respectively on average), indicating weak quarterly growth. Some leading indicators are pointing to a further decline in GDP in Q2. The Purchasing Managers' Index (PMI) in manufacturing and the euro area industrial confidence indicator both decreased in March. The euro area economic growth forecasts for the whole of this year prepared by CF, the IMF, the European Commission and the ECB are generally slightly negative, ranging from -0.5% (IMF) to -0.1% (ECB). The outlooks for next year expect renewed growth of between 0.8% and 1.3%.

Euro area inflation was 2.7% in March for the fourth consecutive month. The main reasons for the rapid price growth are strongly rising energy prices and indirect tax changes. According to the April CF, inflation will decline gradually this year but remain above 2% until Q3. The April CF expects average inflation to reach 2.3% in 2012 as a whole (compared to 1.9% expected in the January CF) and to fall to 1.7% next year. The ECB's inflation estimate is similar, although it assumes that inflation will not drop below 2% until early 2013. Money supply growth remains slow (M3 went up by 2.8% year on year in February) and the same applies to loans to the private sector (up by 0.7% in February). According to the ECB, higher inflation could occur only if energy prices or indirect taxes increase faster than expected.

In April, the ECB Governing Council left the ECB's key interest rate unchanged at 1%. In the medium term, it expects stable inflation and a downturn in economic activity with the risk of a deeper economic decline prevailing.

At the end of February, the **ECB carried out its second three-year refinancing operation**. Compared to the first operation in December, the tender attracted more commercial banks (800, versus 520 in December), which obtained more liquidity (EUR 530 billion versus EUR 490 billion). The balance sheet of the Eurosystem (i.e. the ECB and the euro area central banks) thus exceeded EUR 3 trillion and has more than doubled over the last twelve months. The higher number of participating commercial banks was also due to a relaxation of the collateral eligibility conditions. This allowed many small and medium-sized banks to participate. However, the net increase in liquidity is smaller than the sum of the liquidity provided in these two operations, as some of the new funds were used to repay short-term loans from the ECB. The net increase in liquidity is estimated at about EUR 470 billion (EUR 200 billion in the December operation and EUR 270 billion in the February operation). Overall, these operations led to a decrease in short-term market rates below the ECB's main refinancing rate.

In mid-March the **euro area countries approved a second rescue loan for Greece** totalling EUR 130 billion, which should finance the country's needs until 2014. The loan was conditional on the restructuring of most loans held by private institutions. Greece managed to restructure 96% of its bonds held by private institutions and issued under Greek law (86% of private creditors agreed voluntarily). The estimated loss of the creditors is 74%. Greek government debt should fall to 117% of GDP by 2020. The euro area governments also approved the first EUR 39 billion tranche from the EFSF. The IMF will also help out Greece, probably with a contribution of EUR 28 billion. However, the European Commission is demanding that Greece adopt further fiscal austerity measures amounting to 5.5% of GDP in 2013 and 2014.

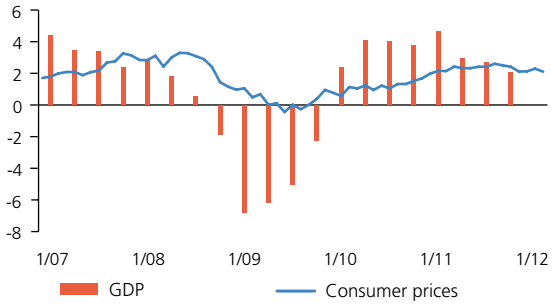
At the end of March, the **euro area finance ministers (the Eurogroup) increased the capacity of both European rescue facilities** (the European Financial Stability Facility and the European Stability Mechanism) to a total of EUR 800 billion. This amount will be available from the middle of this year.

Yields on Spanish government bonds went down following the second three-year refinancing operation (LTRO), but started to rise again in March, reaching 6% in mid-April. This was probably related to the high budget deficit in 2011 and the expected deficit this year, the very sharp forced cuts in government expenditures, the weakened position of Spanish banks and other problems. In the same period, yields on Italian government bonds increased in a similar manner as those on Spanish bonds, but at a roughly 0.5 percentage point lower level.

CHART III.7.2

GDP AND INFLATION IN GERMANY

Economic growth is slowing and inflation has been fluctuating just above 2% since the end of 2011
(annual percentage changes; source: Datastream)



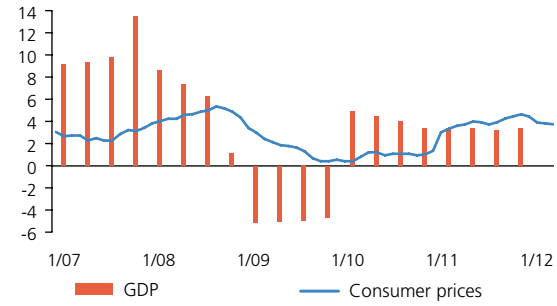
Economic activity in Germany declined by 0.2% quarter on quarter in 2011 Q4 as a result of a weakening of all domestic demand components, following growth of 0.6% in the previous quarter. In year-on-year terms, GDP growth slowed further in Q4, from 2.7% to 2%. A decline in the growth rate of domestic demand also played a central role here. In 2012 Q1, the April CF expects a quarter-on-quarter stagnation of economic activity amid a further slowdown in annual economic growth to 0.7%. In the first two months of 2012, the average growth rate of industrial production fell to 0.5%, from 2.6% in 2011 Q4, and retail turnover switched from growth of 1.3% to a decline of 2%. New industrial orders also decreased by 5% on average. By contrast, unemployment declined to 7.2% in March, the lowest figure since Germany's unification, and most leading indicators (except the PMI in industry, which has fallen below 50% in the last two months) increased in March and April. By comparison with the January CF, the April CF increased its estimate of GDP growth for 2012 as a whole to 0.7%, but lowered the estimate for next year to 1.5%. In particular, the investment estimate was increased for this year. Unemployment is also expected to keep falling.

Inflation in Germany dropped by 0.2 percentage point to 2.3% in February, but is still being pushed by rising energy prices. The April CF expects inflation to slow gradually this year to 1.8% (an increase of 0.2 percentage point compared to the January CF) and to average 2% for the year as a whole (the same increase compared to January). Next year, average inflation is expected to decrease to 1.8%.

CHART III.7.3

GDP AND INFLATION IN SLOVAKIA

GDP maintained a stable rate of growth in 2011 Q4, while inflation has fallen since the start of 2012
(annual percentage changes; source: Datastream)



In **Slovakia** the quarterly GDP growth rate rose by 0.1 percentage point to 0.9% in 2011 Q4 and the annual growth rate increased from 3.2% to 3.4%. Slovakia remains the second fastest growing euro area country behind Estonia. Employment continued to increase year on year. In line with the economic growth estimate for this year, a marked weakening of growth in economic activity can be expected in H1. However, the data for January and February point to continuing strong growth. The monthly and annual increases in industrial production and retail turnover rose significantly in these months compared to 2011 Q4. Unemployment edged down compared to December, to 14% in January and February. For 2012 as a whole, the March CF expects the annual growth rate of the Slovak economy to slow from 3.3% to 1% (fixed investment and industrial production should slow in particular), with stronger growth of 2.6% returning next year. The Slovak Ministry of Finance and the European Commission presented similar predictions.

Annual inflation in Slovakia fell further to 3.9% in March thanks to the unwinding of indirect tax hikes and a slowdown in energy and food price inflation. The March CF expects inflation to fall from 3.9% in 2011 to an average of 2.8% in 2012 as a whole and remain at this level in 2013.

III.7.2 The United States

In 2011, economic growth in the USA was characterised by a rising quarter-on-quarter **GDP growth rate**, which reached 2.9% in annualised terms in 2011 Q4. In year-on-year terms, GDP rose by 1.6% in Q4 and 1.7% in 2011 as a whole (see Chart III.7.4). Investment activity increased by 7.3% year on year in Q4, which represents an upswing compared to the previous period. Annual industrial production growth recorded a modest slowdown to 3.8% in March 2012, but followed an upward path from June 2011 onwards. This is in line with increasing capacity utilisation, which reached 79% in March, almost the same level as before the crisis.

Household consumption rose by 1.7% year on year and by 2.1% in annualised quarterly terms. The consumption growth was probably aided by the Fed's easy monetary policy, reflected in stock market growth (wealth effect) and a decline in mortgage financing costs. Since the end of 2011, the stock market has continued to surge and consumer confidence has increased as a result. Following a decrease in summer 2011, when the economic outlook worsened sharply, the consumer sentiment index (University of Michigan) has rebounded to the levels recorded in early 2011. Annual growth in retail sales slowed compared to September, but was still relatively high at 6.4% in 2012 Q1. A rise in the property market index, which expresses demand for new houses and which rose to almost a four-year high in April, is also good news. The **unemployment rate** continued to fall gradually and stood at 8.2% in March 2012. Net exports also contributed modestly to annual GDP growth amid falling export and import growth. The only component that contributed to a decline in overall GDP growth was government consumption, which fell by 2.8% year on year in 2011 Q4.

The **April CF** left its estimate of US economic growth in 2012 unchanged at 2.3%.

Annual growth in **consumer prices** and producer prices started to slow in October 2011 and stood at 2.6% and 2.8% respectively in March 2012. By contrast, inflation excluding energy and food prices increased until January 2012 and has been flat at 2.3% since. Ten-year government bond yields, which are the target of the Fed's easy monetary policy, remained just below 2% until March 2012. In mid-March they rose to 2.4%, but during April they fell below 2% again. Operation Twist, through which the Fed is trying to flatten the yield curve and support the economy through low long-term interest rates, will continue until June 2012. According to analysts, this is the deadline for a decision on a third round of quantitative easing (QE3). The probability of introducing QE3 would be reduced by continued stable economic growth on the one hand or a risk of inflation pressures on the other hand. The April CF expects average consumer price inflation in the USA to reach 2.3% in 2012, slightly above the Fed's expectations.

CHART III.7.4

GDP AND INFLATION IN THE USA

Annual GDP growth picked up in 2011 Q4 amid falling inflation

(annual percentage changes; source: Datastream)

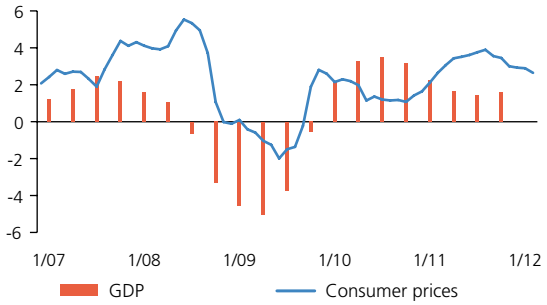
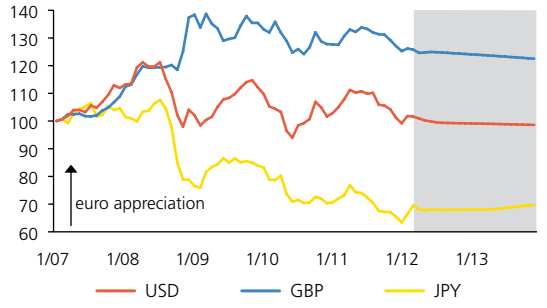


CHART III.7.5

EURO EXCHANGE RATE AGAINST MAJOR CURRENCIES

The euro strengthened more significantly only against the Japanese yen in 2012 Q1

(January 2007 = 100; source: Datastream, outlook from CF)



III.7.3 The exchange rate of the euro against the dollar and other major currencies

In 2012 Q1, the euro was broadly flat against the dollar (see Chart III.7.5). At the start of the year it weakened against the dollar, but a decrease in risk aversion connected with ECB operations caused the exchange rate to return above USD 1.3. Until mid-April, the exchange rate was fluctuating between USD 1.3 and USD 1.34 to the euro. Exchange rate stability was aided by the provision of ECB liquidity in February and by the March agreement on the restructuring of Greek debt, which was accompanied by news of economic recovery in the USA. In February 2012, the euro started appreciating against the Japanese yen (8% year on year) in response to an announcement by the Japanese central bank that it was going to extend its purchases of domestic bonds. The exchange rate of the euro against the pound showed no clear trend. Signs of a modest recovery of the UK economy were offset by still high unemployment and inflation.

The euro weakened from USD 1.33 to USD 1.30 in the **first half of April 2012** as risk aversion increased again in connection with the euro area debt crisis and above all the situation in Spain.

The **April CF** expects the euro to weaken only modestly to USD 1.28/EUR at the two-year horizon. The euro should weaken similarly against the pound, but is expected to strengthen against the Japanese yen.

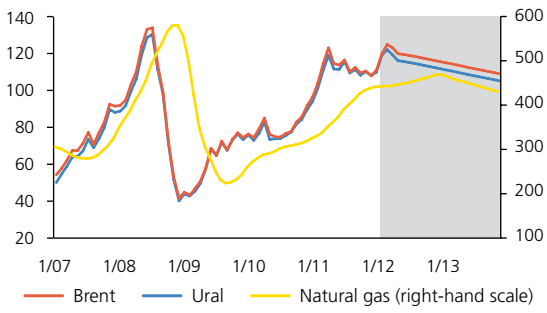
III.7.4 Prices of oil and other commodities

CHART III.7.6

OIL AND NATURAL GAS PRICES IN USD

According to market outlooks, the price of Brent crude oil will be falling over the entire forecast horizon

(oil in USD/barrel; gas in USD/1,000 m³ – right-hand scale; source: IMF, Bloomberg)



In 2012 Q1, the **price of Brent crude oil** discontinued the slightly downward trend observed in late 2011 and rose sharply, especially in February (see Chart III.7.6). The highest level (USD 126.7 a barrel) was recorded at the end of February, and during March the price stayed between USD 122 and USD 126 a barrel. On the demand side, this increase was due to relative optimism regarding future global developments, supported by ECB policy. On the supply side, concerns prevail regarding the sufficiency of oil supplies following the imposition of US sanctions on Iran and the EU embargo on Iranian oil and the possibility of Iran retaliating by closing the Strait of Hormuz. Although the embargo will not take effect until July, refineries using Iranian oil are already cutting back on imports from Iran, and that is feeding tensions in the oil market. The OPEC countries have undertaken to replace Iranian supplies, which is raising questions concerning future spare capacity. Other shortfalls on the supply side are being caused by reductions in supplies from Yemen, South Sudan and Syria due to internal unrest and from the North Sea due to technological issues.

The oil price fell below USD 119 a barrel in April 2012. According to the IEA, this was due to higher supplies from Saudi Arabia and other OPEC countries, a deterioration of the economic outlook for China, tensions surrounding the situation in the euro area, and the possible

release of strategic reserves in the USA, the UK and France. Despite this fall, the **koruna price of oil** is at a historical high, partly because of the weakening of the koruna against the dollar (see Chart III.7.7).

Market outlooks based on Brent oil futures rose together with the oil price, but are predicting a decrease in prices to around USD 107 a barrel at the two-year horizon. At the end of this year, the oil price should drop by about USD 3 to USD 116 a barrel despite rising demand for oil as predicted by the IEA (89.9 million barrels a day in 2012). The price of oil in koruna terms should fall as well (by around 5% by the end of this year).

The **non-energy commodity** price index edged up in 2012 Q1, reversing the downward trend visible since the start of last year (see Chart III.7.8), but it remains well below the highs observed last February. Food commodities, which are going up in price on concerns of a bad harvest in South America due to the drought in recent months, were the main cause of the increase. The other component of the index – prices of industrial metals – rose in the first months of the year due to expanding demand from the emerging markets, which, however, slowed in March and April owing to a worse global outlook, especially for China. The futures-based forecast expects a moderate decrease in prices of food commodities and, conversely, moderate growth in industrial metal prices at the two-year horizon.

Prices of **energy commodities** have been fluctuating within a narrow band since last April and a slight decrease is expected at the two-year horizon based on futures. The exception is the price of coal, which rose in April for the first time since September and whose upward trend is expected to continue.

CHART III.7.7

DECOMPOSITION OF KORUNA OIL PRICE GROWTH

Since 2011 Q4, year-on-year growth in the koruna oil price has reflected simultaneous growth in the global price and a strengthening exchange rate of the USD

(Brent crude oil in CZK/litre – annual percentage changes; contributions of dollar price of Brent crude oil and CZK/USD exchange rate in percentage points; source: Bloomberg, CNB calculation)

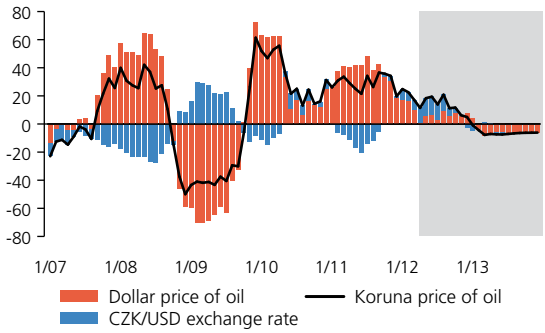
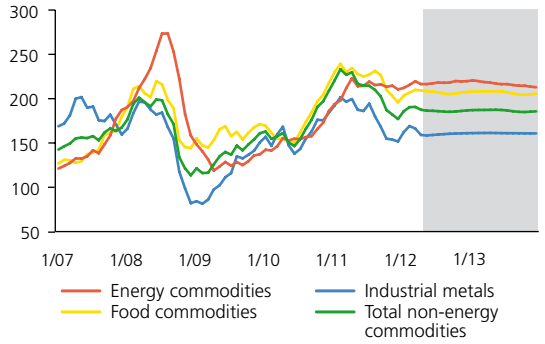


CHART III.7.8

COMMODITY PRICES

Prices of food commodities and industrial metals rose at the start of this year, but the outlook for prices of all commodity categories is broadly stable

(year 2005 = 100; source: Bloomberg)



Note: The structure of the non-energy commodity indices corresponds to the composition of the Economist's commodity indices; the energy commodity index consists of Brent crude oil (0.4), coal (0.4) and natural gas (0.2).

CF	Consensus Forecasts
CNB	Czech National Bank
COSMC	Czech Office for Surveying, Mapping and Cadastre
CPI	consumer price index
CZK	Czech koruna
CZSO	Czech Statistical Office
ECB	European Central Bank
EFSF	European Financial Stability Facility
EIB	European Investment Bank
ERM II	Exchange Rate Mechanism
ESA 95	European System of National Accounts
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
Fed	US central bank
FMIE	Financial Market Inflation Expectations
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
GVA	gross value added
HICP	Harmonised Index of Consumer Prices
HP filter	Hodrick-Prescott filter
IEA	International Energy Agency
ILO	International Labour Organization
IMF	International Monetary Fund
IPP	industrial producer price index
IRI	Institute for Regional Information
IRS	interest rate swap
JPY	Japanese yen
LFS	Labour Force Survey
LIBOR	London Interbank Offered Rate
LTRO	Long-term refinancing operation
M1, M2, M3	monetary aggregates
MLSA	Ministry of Labour and Social Affairs
OECD	Organisation for Economic Cooperation and Development
PAYG	pay-as-you-go
PMI	Purchasing Managers Index
pp	percentage points
PPI	producer price index
PRIBOR	Prague Interbank Offered Rate
(1W, 1M, 1Y)	(one-week, one-month, one-year)
repo rate	repurchase agreement rate
USD	US dollar
VAT	value added tax

Price indices used for the evaluation of inflation	(Box)	April 1998
Analysis of the money supply trend	(Box)	July 1999
Revisions to the statistical data on GDP	(Box)	July 1999
Measuring the inflation expectations of the financial market	(Annex)	October 1999
Oil prices and their impact on inflation	(Box)	July 2000
The effect of oil price changes on the balance of trade	(Box)	October 2000
The methodological framework for evaluating wage developments relative to inflation	(Box)	January 2001
The CNB's monetary policy rates	(Box)	April 2001
The setting of the inflation target for 2002–2005	(Annex)	April 2001
Harmonisation of the reserve requirements with European Central Bank standards	(Annex)	April 2001
Escape clauses pertaining to the new inflation target	(Annex)	July 2001
Changes in economic growth forecasts in the eurozone, Germany, the USA and Japan for 2001 and 2002	(Annex)	October 2001
Strategy for dealing with the exchange rate effects of capital inflows from privatisation of state property and from other foreign exchange revenues of the state	(Annex)	January 2002
Assessment of fulfilment of the CNB's net inflation target in December 2001	(Annex)	January 2002
Prediction of external variables	(Box)	April 2002
Estimated capital flows in 2002 and 2003 and their effect on the exchange rate	(Box)	April 2002
The Balassa–Samuelson effect	(Annex)	April 2002
The CNB changes its type of inflation forecast	(Box)	July 2002
An assessment of the effect of the August floods on Czech economic growth	(Box)	October 2002
The financial conditions of the Czech Republic's accession to the EU	(Box)	January 2003
Implications of the unexpectedly slow growth in regulated prices	(Box)	January 2003
The Czech Republic and the euro – Draft accession strategy	(Annex)	January 2003
Fiscal consolidation and its effect on economic growth	(Annex)	January 2003
Price deregulation in the period of transformation of the Czech economy of the Czech economy	(Box)	April 2003
Revisions to the March 2003 GDP figures	(Box)	April 2003
Credit to households	(Box)	July 2003
The withdrawal of 10- and 20-heller coins and its possible impact on prices	(Box)	July 2003
Indirect taxes and the inflation forecast	(Box)	July 2003
Changes to the methodology for surveying inflation expectations	(Box)	July 2003
ERM II and the exchange-rate convergence criterion	(Annex)	July 2003
Use of the output gap indicator at the CNB	(Box)	October 2003
Monetary policy in the CNB's macroeconomic forecast	(Box)	October 2003
The Czech Republic's euro-area accession strategy	(Annex)	October 2003
Short-run food price prediction methods	(Box)	January 2004
Monetary conditions	(Box)	April 2004
The CNB's inflation target from January 2006	(Annex)	April 2004
The CNB has fully integrated into the European System of Central Banks	(Annex)	July 2004
The exchange rate in the CNB's forecasting system	(Box)	July 2004
Indicators of households' financial situation	(Box)	October 2004
GDP data revision	(Box)	October 2004
Petrol prices and their impact on inflation in the Czech Republic	(Box)	October 2004
Assessment of the fulfilment of the Maastricht convergence criteria and the degree of alignment of the Czech economy with the euro area	(Annex)	January 2005
The structure of lending	(Box)	January 2005
Uncertainty regarding the evolution of public finances in 2005 and 2006	(Box)	January 2005
Inflation expectations in the CNB's modelling system	(Box)	January 2005
The transmission of external cost shocks into domestic prices in 2003–2005	(Box)	April 2005
The effect of the exchange rate on inflation	(Box)	April 2005
The Czech National Bank's position on the revision of the Stability and Growth Pact	(Annex)	April 2005
The effect of EU accession on prices and inflation expectations	(Box)	July 2005
Foreign trade in the first year after the Czech Republic's accession to the EU	(Box)	July 2005
Financial flows between the Czech Republic and the European Union	(Box)	July 2005
The effect of world energy prices on consumer prices	(Box)	October 2005
The performance of large non-financial corporations 1998–2004	(Box)	October 2005

Potential output in the CNB's forecasting system	(Box)	October 2005
Fiscal policy in the CNB's modelling system	(Box)	January 2006
Assessment of the fulfilment of the Maastricht Convergence criteria and the degree of economic alignment of the Czech Republic with the euro area	(Annex)	January 2006
Implications of household debt for consumption	(Box)	April 2006
Effective indicators of external developments	(Box)	July 2006
Oil and petrol prices in the CNB forecast	(Box)	July 2006
The role of monetary aggregates in the CNB's forecasts	(Box)	October 2006
Assessment of the fulfilment of the Maastricht convergence criteria and the degree of economic alignment of the Czech Republic with the euro area	(Annex)	October 2006
Employment of foreign nationals	(Box)	January 2007
The extension of the core prediction model to include the effect of real wages	(Box)	January 2007
The new consumer basket as from January 2007	(Box)	April 2007
Financing of non-financial corporations	(Box)	April 2007
The application of escape clauses to indirect tax changes	(Box)	April 2007
The CNB's new inflation target and changes in monetary policy communication	(Annex)	April 2007
The relationship between interest rates and the structure of new loans for house purchase	(Box)	July 2007
The CNB's new approach to the monitoring of inflation expectations of households in the Czech Republic	(Box)	July 2007
The causes, course and impacts of the current turmoil in global financial markets	(Box)	October 2007
Household debt by income group in 2006 and its impact on consumption	(Box)	October 2007
The causes of the sharp growth in world prices of cereals	(Box)	October 2007
Fiscal measures and their impact on the economy in 2008	(Box)	October 2007
The Czech Republic's updated euro-area accession strategy	(Annex)	October 2007
Changes in the conduct and communication of monetary policy	(Box)	I/2008
Publication of the forecast-consistent interest rate path and the use of fan charts	(Box)	I/2008
The quarterly financial accounts statistics – New statistics at the CNB	(Box)	I/2008
Changes to the CNB's core prediction model	(Box)	I/2008
Assessment of the fulfilment of the Maastricht convergence criteria and the degree of economic alignment of the Czech Republic with the euro area	(Annex)	I/2008
The new g3 structural model	(Box)	II/2008
Joint agreement between the Czech Government and the Czech National Bank and Updated strategy for dealing with the exchange rate effects of foreign exchange revenues of the state	(Annex)	II/2008
The sectoral and production structure of the g3 model	(Box)	III/2008
The withdrawal of 50-heller coins and its possible impact on prices	(Box)	III/2008
The impact of the still fast growing world prices of energy-producing materials on inflation in the Czech Republic	(Box)	IV/2008
Pricing in the g3 model	(Box)	IV/2008
Publication of a numerical exchange rate forecast	(Box)	I/2009
The exchange rate path in the g3 model	(Box)	I/2009
Assessment of the fulfilment of the Maastricht convergence criteria and the degree of economic alignment of the Czech Republic with the euro area	(Annex)	I/2009
Transmission of financial market interest rates to client interest rates	(Box)	II/2009
Proxying external developments after Slovakia's entry to the euro area	(Box)	II/2009
Monetary policy in the g3 model	(Box)	II/2009
Analysts' forecasts in financial market inflation expectations questionnaires: A look back at the past ten years	(Box)	II/2009
Unconventional monetary policy of selected central banks	(Box)	III/2009
Financing and financial investment of corporations and households	(Box)	III/2009
The impact of the recession on public finances in the Czech Republic	(Box)	III/2009
Investment in housing during the business cycle	(Box)	IV/2009
The effect of regulated prices and other administrative measures on inflation in 2008–2009 and their expected future development	(Box)	IV/2009
Exit strategies from unconventional monetary policy instruments planned by selected central banks	(Box)	I/2010
Uncertainties surrounding the calculation of potential output	(Box)	I/2010
Revision of the quarterly financial accounts	(Box)	I/2010
Differences in client interest rates in the Czech Republic and the euro area	(Box)	I/2010
Assessment of the fulfilment of the Maastricht convergence criteria and the degree of economic alignment of the Czech Republic with the euro area	(Annex)	I/2010

Assessment of the accuracy of the outlooks for effective GDP and CPI in the euro area – comparison of forecasts	(Box)	II/2010
Revisions to the expenditure components of GDP	(Box)	II/2010
Business and consumer sentiment in the current phase of the economic cycle according to CZSO and CNB indicators	(Box)	II/2010
The January 2010 consumer basket update	(Box)	II/2010
The effect of new photovoltaic power station installations on economic activity	(Box)	IV/2010
An analysis of household consumption	(Box)	IV/2010
Property-market-related loans in the current phase of the business cycle	(Box)	IV/2010
Forecasts for general government debt and debt service, and sensitivity analyses	(Box)	I/2011
Price-setting behaviour in the Czech Republic (micro data evidence) in relation to the pricing mechanism in the g3 forecasting model	(Box)	II/2011
The relationship between the Brent crude oil price and the dollar exchange rate	(Box)	II/2011
The impacts of changes to VAT rates on the budget and inflation and their components in 2012 and 2013	(Box)	III/2011
Labour market developments during the economic recession and the subsequent recovery	(Box)	III/2011
The debt situation in Italy	(Box)	III/2011
Publication of the Graph of Risks to the Inflation Projection (GRIP)	(Annex)	III/2011
Pension system reform	(Box)	IV/2011
The credit rating of the Czech Republic	(Box)	IV/2011
Germany – the Czech Republic's main trading partner	(Box)	IV/2011
The pass-through of VAT to food prices at the end of 2011	(Box)	I/2012
Extraordinary revision of the quarterly national accounts	(Box)	I/2012
An analysis of the impacts of fiscal measures in the Czech Republic in 2001–2011	(Box)	I/2012
Revision of the consumer basket	(Box)	II/2012
Factors affecting retail fuel prices	(Box)	II/2012

This glossary explains some terms frequently used in the Inflation Report. A more detailed glossary can be found on the CNB website (www.cnb.cz/en/general/glossary/index.html).

Adjusted inflation excluding fuels: The increase in prices of non-food items of the consumer basket excluding items with administered prices, indirect tax changes and fuels.

Administered prices: A sub-category of the consumer basket consisting of items with price ceilings (set at either central or local level), prices regulated on a cost-plus basis (items whose prices may only reflect economically justified costs and a reasonable profit) and administratively fixed fees. The selection of these items is based on the Price Bulletin of the Czech Ministry of Finance.

Balance of payments: Records economic transactions with other countries (i.e. between residents and non-residents) over a particular period. The basic structure of the balance of payments includes the current account, the capital and financial accounts and the change in CNB international reserves.

Consensus Forecasts: A regular monthly publication issued by Consensus Economics bringing together the forecasts of hundreds of prominent economists and analytical teams regarding future world developments. The CNB uses these predictions in its macroeconomic forecast when forming assumptions regarding the future development of the external environment.

Covered bond: A bond collateralised (backed) by long-term assets, usually mortgage loans or public sector loans. The issuers are mostly banks and the issuance of covered bonds is subject to strict legislative rules. Compared to standard bonds, this type of bond has lower credit risk thanks to higher coverage (known as dual recourse), which gives the covered bond holder a preferential claim on the issuer's receivables underlying the mortgage loans or public sector loans and likewise a claim on the issuer. If the issuer defaults, the holder therefore has a preferential right to the assets backing the covered bond.

Current account: Records exports and imports of goods and services, income from capital, investment and labour and unrequited transfers.

Cyclical component of the general government balance: Expresses the effect of the business cycle on the general government fiscal balance.

Discount rate: A monetary policy rate which as a rule represents the floor for short-term money market interest rates. The CNB applies it to the excess liquidity which banks deposit with the CNB overnight under the deposit facility.

Disinflation: A decline in inflation.

Effective euro area indicators: Proxy for the effect of economic activity (effective GDP) and inflation (effective producer prices and consumer prices) in the euro area on the Czech economy. The weights used in the calculation are the shares of the individual euro area economies in the foreign trade turnover of the Czech Republic.

Effective exchange rate: Shows the appreciation (index > 100) or depreciation (index < 100) of the national currency against a basket of selected currencies for a certain time period relative to a base period. The weights applied in the basket are the shares of major trading partners in foreign trade turnover.

Escape clause: Excuses the central bank from its obligation to hit the inflation target. In the flexible inflation targeting regime, it is applied in the event of large shock changes in exogenous factors (particularly supply-side shocks, e.g. indirect tax changes) that are completely or largely outside the purview of central bank monetary policy.

Euro area: The territory of all Member States of the European Union that have adopted the euro as a single currency pursuant to the Treaty Establishing the European Community.

Financial account: Records transactions connected with the creation, liquidation and change in ownership of the financial assets and liabilities of the government, the banking and corporate sectors and other entities vis-à-vis the rest of the world. It consist of direct investment, portfolio investment, other investment and financial derivatives transactions.

Fiscal discretion: Changes made intentionally by the government to general government revenue and expenditure that would otherwise follow an endogenous path determined by economic developments outside the government sector.

Fiscal stance: The annual change in the general government structural balance (in percentage points). A positive figure indicates fiscal restriction and a negative figure indicates fiscal expansion.

Food prices: In CNB documents, the term food prices refers to the consolidated category of prices of food and non-alcoholic beverages and prices of alcoholic beverages and tobacco.

General government balance: Revenues minus expenditures of the general government sector. A negative government balance is called a general government deficit and a positive government balance is called a general government surplus.

General government primary balance: The general government balance net of interest payments (i.e. debt service).

General government structural balance: The cyclically adjusted general government balance adjusted for extraordinary one-off operations. It captures the structural configuration of fiscal policy.

Goods and services balance: The sum of the trade balance and the services balance.

Gross Domestic Product (GDP): The key indicator of economic development. It represents the sum of the value added by all economic sectors. In terms of use it consists of expenditure on final consumption (consumption of households, the government and non-profit institutions), gross capital formation (fixed investment and changes in inventories) and foreign trade (net exports of goods and services).

Inflation: Commonly, inflation is considered to be recurring growth of most prices in the economy. It means a decrease in the real value (i.e. purchasing power) of a given currency relative to the goods and services which consumers buy – if there is inflation in the economy, consumers need ever more currency units of the given country to buy the same basket of goods and services. In practice, inflation is measured by the increment of the consumer price index.

Inflation pressures: Proxied in the CNB's modelling system by the real marginal cost gap in the consumer goods sector. Total inflation pressures are divided into domestic inflation pressures (in the intermediate goods sector) and imported inflation pressures (in the import price sector).

Inflation rate: The increase in the average (basic) consumer price index for the last 12 months relative to the average for the previous 12 months.

Inflation target: The level of consumer price inflation that the CNB endeavours to achieve, set publicly and well in advance.

Lombard rate: A monetary policy interest rate which provides a ceiling for short-term interest rates on the money market. The CNB applies it to the liquidity which it provides to banks overnight under the lending facility.

Monetary aggregates: Represent the amount of money in the economy covered in the monetary survey. According to the national definition, they are calculated from the monetary liabilities of resident monetary financial institutions to other resident sectors in the Czech Republic (households, non-financial corporations and financial institutions excluding the general government). Monetary aggregates differ according to the degree of liquidity of the individual components. The narrow monetary aggregate M1 comprises currency in circulation and overnight deposits. The broad monetary aggregate M2 comprises M1 plus total deposits with agreed maturity and redeemable at notice and repurchase agreements. The broad monetary aggregate M3 (harmonised with EU standards) comprises currency in circulation, overnight deposits, deposits with agreed maturity of up to two years, deposits redeemable at notice of up to three months, repurchase agreements, money market fund shares/units and issued debt securities with maturity of up to two years.

Monetary conditions: Represent the combined effect of interest rates (the interest rate component of the monetary conditions) and the exchange rate (the exchange rate component) on the economy. These are the key variables through which monetary policy can affect economic activity and, through it, inflation. Interest rates and the exchange rate do not necessarily affect the economy in the same direction.

Monetary policy horizon: The time horizon which monetary policy-makers focus on when making decisions and which takes into account the monetary policy transmission lag. This horizon is about 12–18 months ahead.

Monetary policy interest rates: Short-term interest rates associated with monetary policy-making. They comprise the two-week repo rate, the discount rate and the Lombard rate.

Monetary-policy relevant inflation: Inflation to which monetary policy reacts. It is defined as headline inflation adjusted for the first-round effects of changes to indirect taxes.

Money market: The part of the financial markets which is used to obtain short-term loans and where debt instruments maturing in less than one year are traded. T-bills are typical securities traded on this market. Within this market the CNB carries out its repo operations.

Net inflation: Consumer price inflation net of administered prices and adjusted for the first-round effects of changes to indirect taxes. Net inflation consists of food price inflation, fuel price inflation and adjusted inflation excluding fuels. Until the end of 2001, the CNB's inflation targets were set in terms of net inflation. Since 2002, the CNB has targeted headline inflation, using net inflation for analytical purposes only.

Nominal costs in the consumption sector: These comprise output prices in the intermediate goods sector and import sector, as final consumption goods are produced using inputs from these sectors. They also include "export-specific technology", which approximates the productivity differential between the tradables sector and the non-tradables sector and its price effect, known as an analogy to the Balassa-Samuelson effect.

Nominal costs in the intermediate goods sector: Co-determined by prices of production factors, i.e. labour costs and the price of capital. In addition to these components, they are determined by "labour-augmenting technology". This technology can be understood as a concept similar to total factor productivity, e.g. in the Cobb-Douglas production function.

Nominal unit labour costs: The labour costs needed to produce a unit of output. Nominal unit labour costs are calculated as the ratio of the nominal volume of wages and salaries to GDP at constant prices.

Price-to-income ratio: The ratio of the price of an apartment (68 m^2) to the sum of the annual wage in a given region over the last four quarters. Higher values of this indicator usually mean that apartments are overpriced.

Price-to-rent ratio: Indicator of sustainability of apartment prices, calculated as the ratio of the price of the apartment to the annual rent. The price-to-rent ratio is the inverse of the rent return. Higher values of this indicator usually mean that apartments are overpriced.

Producers' margins: The inverse of producers' real marginal costs in the relevant sector. Growth in producers' nominal costs without corresponding growth in the price of production causes a decline in the profit margin, i.e. an increase in real marginal costs. If prices in the sector were perfectly flexible, the price at any given moment would comprise a constant margin over marginal nominal costs. In the consumer sector, a gap in profit mark-ups represents a deviation from the long-term margin level.

Property asking prices: Property sale asking prices in estate agencies. Asking prices should be higher than transaction prices. Property asking prices in the Czech Republic are published, for example, by the CZSO and the Institute for Regional Information (IRI). Formerly also referred to as property supply prices in CNB publications.

Property transaction prices: Prices based on Ministry of Finance statistics from property transfer tax returns and published by the CZSO. These prices are the closest to actual market prices in terms of methodology, but are published with a time delay. Formerly also referred to as property transfer prices in CNB publications.

Repo rate: The CNB's key monetary policy rate, paid on commercial banks' excess liquidity as withdrawn by the CNB in two-week repo tenders.

Technological growth: The situation where the volume of production rises without an increase in the production factors of labour or capital. Growth in technology thus causes the real volume of production to rise given a constant price of production, or the output price to fall relative to input prices given a constant real volume of production.

Unemployment rate: The ratio of the number of unemployed persons to the total labour force. We distinguish between the general unemployment rate, as determined by the CZSO according to International Labour Organisation methodology, and the registered unemployment rate, as determined by the Ministry of Labour and Social Affairs.

KEY MACROECONOMIC INDICATORS

		years										
		2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
DEMAND AND SUPPLY												
Gross domestic product												
GDP	CZK bn, constant p., seas. adjusted	2,787.1	2,915.1	3,114.1	3,339.3	3,530.3	3,632.5	3,467.6	3,557.0	3,616.0	**3,615.9**	**3,683.6**
GDP	%, y-o-y, real terms, seas. adjusted	3.8	4.6	6.8	7.2	5.7	2.9	-4.5	2.6	1.7	**0.0**	**1.9**
Household consumption	%, y-o-y, real terms, seas. adjusted	5.3	3.1	3.0	4.4	4.1	3.0	-0.4	0.5	-0.5	**-0.4**	**0.9**
Government consumption	%, y-o-y, real terms, seas. adjusted	6.0	-3.3	1.6	-0.6	0.4	1.2	3.8	0.6	-1.4	**-0.4**	**-0.3**
Gross capital formation	%, y-o-y, real terms, seas. adjusted	-0.9	6.4	4.4	10.9	15.4	1.3	-20.5	5.6	-1.6	**-1.6**	**2.9**
Exports of goods and services	%, y-o-y, real terms, seas. adjusted	7.6	13.2	11.8	14.2	11.2	3.6	-9.7	16.0	11.0	**5.0**	**7.0**
Imports of goods and services	%, y-o-y, real terms, seas. adjusted	7.4	9.6	6.0	11.1	12.8	2.4	-11.4	15.7	7.5	**4.3**	**6.4**
Net exports	CZK bn, constant p., seas. adjusted	-66.9	-17.7	85.2	156.4	139.3	175.1	198.7	237.8	351.3	**388.1**	**433.7**
Coincidence indicators												
Industrial production	%, y-o-y, real terms	1.6	10.4	3.9	8.3	10.6	-1.8	-13.6	10.3	6.9	-	-
Construction output	%, y-o-y, real terms	9.3	8.8	5.2	6.0	7.1	0.0	-0.9	-7.1	-3.5	-	-
Receipts in retail sales	%, y-o-y, real terms	7.2	3.8	8.1	10.8	10.0	2.7	-4.7	1.3	1.9	-	-
PRICES												
Main price indicators												
Inflation rate	%, end-of-period	0.1	2.8	1.9	2.5	2.8	6.3	1.0	1.5	1.9	-	-
Consumer Price Index	%, y-o-y, average	0.1	2.8	1.9	2.5	2.8	6.4	1.1	1.5	1.9	**3.6**	**1.5**
Administered prices (17.15%)*	%, y-o-y, average	0.6	3.5	5.7	9.3	4.8	15.6	8.4	2.6	4.7	**9.2**	**3.4**
Net inflation (82.85%)*	%, y-o-y, average	0.0	1.8	0.7	0.4	1.7	2.4	-0.9	0.0	1.3	**1.3**	**1.4**
Food prices (including alcoholic beverages and tobacco) (25.63%)*	%, y-o-y, average	-1.2	2.8	0.0	-0.2	3.8	3.0	-0.9	0.9	3.9	**2.9**	**1.6**
Adjusted inflation excluding fuels (53.52%)*	%, y-o-y, average	0.6	1.2	0.7	0.6	0.7	2.0	0.0	-1.2	-0.7	**0.1**	**1.5**
Fuel prices (3.70%)*	%, y-o-y, average	1.5	4.5	7.8	3.7	-0.3	4.3	-11.1	11.8	9.9	**6.4**	**-1.9**
Monetary-policy inflation (excluding tax changes)	%, y-o-y, average	0.1	2.0	1.8	2.3	2.2	4.4	0.9	0.4	1.9	**2.4**	**1.7**
GDP deflator	%, y-o-y, seas. adjusted	0.9	4.0	-0.3	0.5	3.3	1.9	2.0	-1.7	-0.7	**1.4**	**2.7**
Partial price indicators												
Producer prices	%, y-o-y, average	-0.3	5.6	3.1	1.4	4.1	4.5	-3.1	1.2	5.6	**2.9**	**1.8**
Agricultural prices	%, y-o-y, average	-4.5	9.6	-9.8	1.3	16.4	10.8	-24.3	5.6	20.0	**-0.3**	**0.9**
Construction work prices	%, y-o-y, average	2.2	3.7	3.0	2.9	3.9	4.5	1.3	-0.2	-0.5	-	-
Brent crude oil	%, y-o-y, average	15.5	32.7	42.3	20.0	11.1	34.5	-36.7	28.7	39.5	**6.8**	**-5.4**
LABOUR MARKET												
Average monthly wage	%, y-o-y, nominal terms	5.8	6.3	5.0	6.6	7.2	7.8	3.3	1.9	2.2	**2.4**	**3.5**
Average monthly wage	%, y-o-y, real terms	5.7	3.4	3.0	4.0	4.3	1.4	2.3	0.4	0.3	**-1.2**	**2.0**
Number of employees	%, y-o-y	-2.0	-0.2	2.2	1.2	1.9	1.7	-2.1	-2.1	0.0	**-1.2**	**-0.2**
Unit labour costs	%, y-o-y	1.5	3.7	0.6	0.2	2.4	4.3	2.7	-3.1	-0.6	**0.4**	**1.4**
Unit labour costs in industry	%, y-o-y	-1.2	1.2	-7.2	-7.2	2.4	-3.3	0.1	-7.9	-1.3	-	-
Aggregate labour productivity	%, y-o-y	4.6	5.1	4.6	5.6	3.5	0.8	-3.5	4.5	1.4	**0.5**	**2.0**
ILO general unemployment rate	%, average, age 15–64	7.8	8.4	8.0	7.2	5.4	4.4	6.7	7.4	6.8	**6.8**	**6.9**
Registered unemployment rate	%, average	-	10.0	9.5	8.6	7.0	5.8	8.3	9.3	8.9	**8.8**	**8.9**
PUBLIC FINANCE												
Public finance deficit (ESA95)	CZK bn, current p.	-179.8	-82.9	-101.1	-79.2	-26.7	-85.0	-217.7	-180.7	-117.5	**-115.9**	**-153.2**
Public finance deficit / GDP**	%, nominal terms	-6.7	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.1	**-3.0**	**-3.8**
Public debt (ESA95)	CZK bn, current p.	768.2	847.8	885.4	948.1	1,023.4	1,104.3	1,285.6	1,436.6	1,567.8	**1,674.8**	**1,828.1**
Public debt / GDP**	%, nominal terms	28.6	28.9	28.4	28.3	27.9	28.7	34.4	38.1	41.2	**43.3**	**45.2**
EXTERNAL RELATIONS												
Current account												
Trade balance	CZK bn, current p.	-69.8	-13.4	48.6	59.3	46.9	25.7	87.3	53.8	94.0	**135.0**	**160.0**
Trade balance / GDP	%, nominal terms	-2.6	-0.5	1.6	1.8	1.3	0.7	2.3	1.4	2.5	**3.5**	**4.0**
Balance of services	CZK bn, current p.	13.2	16.6	37.9	49.0	59.2	73.9	73.9	75.3	66.3	**60.0**	**65.0**
Current account	CZK bn, current p.	-160.6	-147.5	-30.9	-67.1	-156.9	-81.3	-89.3	-146.6	-109.1	**-85.0**	**-75.0**
Current account / GDP	%, nominal terms	-6.0	-5.0	-1.0	-2.0	-4.3	-2.1	-2.4	-3.9	-2.9	**-2.2**	**-1.9**
Foreign direct investment												
Direct investment	CZK bn, current p.	53.5	101.8	279.6	90.3	179.1	36.3	37.7	95.0	75.2	**65.0**	**65.0**
Exchange rates												
CZK/USD	average	28.2	25.7	24.0	22.6	20.3	17.1	19.1	19.1	17.7	**19.0**	**18.9**
CZK/EUR	average	31.8	31.9	29.8	28.3	27.8	25.0	26.5	25.3	24.6	**24.7**	**24.3**
CZK/EUR	%, y-o-y, real (CPI euro area), avg.	-	0.0	-6.3	-5.1	-2.2	-12.5	5.4	-4.5	-1.9	**-0.8**	**-1.1**
CZK/EUR	%, y-o-y, real (PPI euro area), avg.	-	-3.1	-5.5	-1.3	-3.9	-8.8	4.3	-3.1	-2.3	**0.1**	**-1.5**
Foreign trade prices												
Prices of exports of goods	%, y-o-y, average	0.8	3.6	-1.5	-1.2	1.4	-4.6	0.2	-1.0	1.7	**1.8**	**0.2**
Prices of imports of goods	%, y-o-y, average	-0.3	1.6	-0.5	0.3	-1.0	-3.3	-3.5	2.0	4.3	**3.2**	**-0.9**
MONEY AND INTEREST RATES												
M2	%, y-o-y, average	4.1	7.7	5.3	8.9	11.2	8.4	6.3	4.0	3.4	**6.8**	**6.9**
2W repo rate	%, end-of-period	2.00	2.50	2.00	2.50	3.50	2.25	1.00	0.75	0.75	-	-
3M PRIBOR	%, average	2.3	2.4	2.0	2.3	3.1	4.0	2.2	1.3	1.2	**1.0**	**1.0**

* in brackets are constant weights in actual consumer basket
** CNB calculation
– data are not available / forecasted / released
data in bold = CNB forecast

2009				2010				2011				2012				2013			
QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
870.5	860.9	864.3	872.0	878.6	887.1	893.1	898.3	902.7	905.5	904.5	903.4	**902.3**	**904.3**	**903.5**	**905.8**	**910.6**	**917.2**	**924.6**	**931.3**
-3.7	**-5.8**	**-5.5**	**-3.1**	**0.9**	**3.0**	**3.3**	**3.0**	**2.7**	**2.1**	**1.3**	**0.6**	**0.0**	**-0.1**	**-0.1**	**0.3**	**0.9**	**1.4**	**2.3**	**2.8**
2.2	-0.4	-1.8	-1.4	0.3	0.4	0.7	0.7	-0.4	-0.3	-0.6	-0.7	**-1.3**	**-0.7**	**0.1**	**0.3**	**1.0**	**0.8**	**0.9**	**0.9**
4.6	3.2	4.2	3.2	1.5	1.5	0.4	-1.1	-0.2	-1.1	-2.6	-1.7	**-1.7**	**-0.7**	**-0.4**	**1.1**	**0.8**	**0.3**	**-0.7**	**-1.5**
-16.6	-23.1	-23.4	-18.7	-9.9	7.4	17.9	8.6	3.1	0.1	-4.7	-4.0	**0.2**	**-2.4**	**-6.4**	**2.9**	**3.6**	**2.9**	**2.7**	**2.4**
-17.5	-16.4	-7.1	4.0	14.8	17.3	16.7	15.3	18.4	12.9	8.4	5.0	**5.0**	**5.4**	**2.9**	**6.7**	**2.0**	**6.0**	**9.2**	**11.0**
-17.3	-17.9	-9.4	0.9	10.0	17.2	20.3	15.1	16.0	9.8	3.5	1.8	**4.0**	**4.3**	**0.7**	**8.4**	**3.0**	**5.9**	**7.8**	**8.8**
34.4	49.8	51.5	63.0	65.2	59.2	39.6	73.8	90.8	86.2	76.5	97.8	**102.1**	**98.3**	**94.2**	**93.5**	**97.6**	**104.2**	**112.5**	**119.5**
-19.0	-19.0	-13.2	-2.1	6.9	11.5	10.7	11.8	12.3	9.0	3.7	3.1	-	-	-	-	-	-	-	-
-10.8	1.2	0.3	2.0	-22.7	-8.3	-2.8	-2.1	5.9	-5.2	-9.0	-0.8	-	-	-	-	-	-	-	-
-4.3	-5.1	-5.4	-4.0	-0.2	2.1	1.6	1.5	4.8	1.2	0.5	1.2	-	-	-	-	-	-	-	-
5.0	3.7	2.1	1.0	0.7	0.6	1.1	1.5	1.7	1.9	1.8	1.9	2.4	-	-	-	-	-	-	-
2.2	1.4	0.2	0.4	0.7	1.1	1.9	2.1	1.7	1.8	1.7	2.4	3.7	**3.6**	**3.8**	**3.5**	**1.6**	**1.5**	**1.4**	**1.4**
11.2	9.8	7.5	5.2	0.8	2.3	3.6	3.8	4.4	4.0	4.5	5.9	9.7	**9.6**	**8.9**	**8.4**	**3.9**	**3.6**	**3.2**	**2.8**
-0.6	-0.6	-1.5	-0.7	-0.5	-0.3	0.3	0.4	1.0	1.2	1.2	1.7	1.3	**1.1**	**1.4**	**1.2**	**1.4**	**1.3**	**1.4**	**1.5**
0.0	0.4	-2.0	-2.2	-1.4	-0.2	2.3	2.8	3.2	4.1	3.6	4.5	3.4	**2.9**	**3.0**	**2.4**	**2.2**	**1.7**	**1.5**	**0.9**
0.6	0.1	-0.5	-0.2	-1.1	-1.2	-1.2	-1.3	-0.8	-0.8	-0.7	-0.4	-0.3	**-0.2**	**0.2**	**0.4**	**1.1**	**1.5**	**1.6**	**1.9**
-20.5	-15.7	-11.8	3.7	18.1	13.3	7.0	8.7	10.8	9.1	9.5	10.2	8.0	**7.7**	**6.5**	**3.6**	**-0.8**	**-3.7**	**-1.9**	**-1.3**
1.6	1.3	0.2	0.4	-0.3	0.1	0.8	1.0	1.6	1.7	1.7	2.4	2.5	**2.4**	**2.5**	**2.2**	**1.8**	**1.7**	**1.7**	**1.7**
3.7	2.2	0.3	1.6	-2.6	-1.0	-0.8	-2.4	-1.8	-1.5	-0.6	0.9	**1.5**	**1.2**	**1.5**	**1.6**	**2.5**	**3.2**	**2.7**	**2.2**
-1.1	-3.6	-5.2	-2.6	-1.4	1.3	2.2	3.0	5.4	6.0	5.6	5.2	3.6	**2.5**	**2.9**	**2.7**	**2.1**	**1.8**	**1.7**	**1.7**
-27.8	-29.5	-23.8	-16.0	-5.6	-2.8	8.2	22.7	27.9	30.1	16.6	5.4	-1.9	**-3.4**	**0.7**	**3.5**	**1.4**	**-0.4**	**1.4**	**1.2**
2.8	1.4	0.5	0.3	0.1	-0.2	-0.3	-0.3	-0.4	-0.5	-0.5	-0.5	-0.5	-	-	-	-	-	-	-
-53.3	-51.5	-41.1	33.3	70.5	33.1	11.8	15.8	36.7	49.0	48.0	26.2	13.2	**3.3**	**4.9**	**6.8**	**-2.8**	**-6.3**	**-6.0**	**-6.1**
2.2	2.5	4.1	4.6	2.6	2.7	1.9	0.6	2.2	2.3	2.4	2.0	**2.3**	**2.2**	**2.3**	**2.5**	**3.1**	**3.4**	**3.6**	**3.8**
0.1	1.1	4.0	4.2	1.9	1.5	0.0	-1.5	0.5	0.5	0.6	-0.4	**-1.3**	**-1.3**	**-1.4**	**-0.9**	**1.5**	**1.9**	**2.2**	**2.4**
-0.9	-1.8	-2.8	-2.9	-3.2	-2.6	-1.3	-1.5	-0.1	0.5	0.2	-0.5	**-0.9**	**-1.5**	**-1.5**	**-0.8**	**-0.6**	**-0.3**	**0.0**	**0.2**
2.1	3.0	4.1	1.6	-3.4	-3.9	-1.7	-3.4	-1.5	0.2	-0.8	-0.2	**0.0**	**0.1**	**0.4**	**1.2**	**1.6**	**1.6**	**1.2**	**1.2**
-2.7	1.8	4.1	-2.8	-11.0	-10.4	-5.4	-5.2	-2.0	-0.1	-1.6	-1.4	-	-	-	-	-	-	-	-
-4.3	-5.1	-4.3	-0.3	4.4	5.7	3.7	4.1	2.7	1.8	1.1	0.2	**0.1**	**0.4**	**0.7**	**0.7**	**1.3**	**1.6**	**2.3**	**2.7**
5.8	6.4	7.4	7.3	8.2	7.2	7.1	7.0	7.3	6.8	6.6	6.5	**6.8**	**6.6**	**6.8**	**6.8**	**7.1**	**6.8**	**6.8**	**6.7**
7.5	8.1	8.7	9.0	10.1	9.1	8.8	9.1	9.8	8.7	8.4	8.5	9.4	**8.6**	**8.6**	**8.8**	**9.7**	**8.8**	**8.6**	**8.6**
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
21.6	27.9	19.6	18.3	31.0	22.9	-4.5	4.4	33.7	29.3	7.9	23.2	**58.0**	**36.0**	**21.0**	**20.0**	**56.0**	**43.0**	**32.0**	**29.0**
2.4	3.0	2.1	1.9	3.6	2.4	-0.5	0.4	3.8	3.0	0.8	2.3	**6.5**	**3.7**	**2.1**	**2.0**	**6.0**	**4.2**	**3.1**	**2.7**
18.1	17.7	18.8	19.3	18.3	24.8	15.3	16.9	14.2	20.3	18.8	13.0	**12.0**	**19.0**	**17.0**	**12.0**	**13.0**	**19.0**	**19.0**	**14.0**
9.1	-48.7	-34.8	-14.8	22.3	-28.1	-106.4	-34.5	22.7	-56.8	-57.6	-17.4	**42.0**	**-51.0**	**-55.0**	**-21.0**	**39.0**	**-52.0**	**-50.0**	**-12.0**
1.0	-5.2	-3.7	-1.5	2.6	-2.9	-11.1	-3.5	2.6	-5.9	-6.0	-1.7	**4.7**	**-5.2**	**-5.6**	**-2.1**	**4.2**	**-5.1**	**-4.9**	**-1.1**
16.5	9.0	-17.1	29.3	13.9	30.2	37.6	13.3	13.1	34.5	-4.3	32.0	-	-	-	-	-	-	-	-
21.2	19.6	17.9	17.5	18.7	20.1	19.3	18.2	17.8	16.9	17.3	18.8	19.1	**18.9**	**19.0**	**18.9**	**18.9**	**18.9**	**18.9**	**18.9**
27.6	26.7	25.6	25.9	25.9	25.6	24.9	24.8	24.4	24.3	24.4	25.3	25.1	**24.7**	**24.6**	**24.5**	**24.4**	**24.3**	**24.3**	**24.3**
7.4	6.7	6.1	2.1	-6.1	-4.0	-3.1	-4.7	-5.2	-4.1	-1.0	2.6	2.0	**0.4**	**-0.8**	**-4.7**	**-2.7**	**-1.1**	**-0.5**	**0.0**
8.5	6.1	3.4	-0.6	-6.1	-3.3	-1.1	-2.8	-4.9	-4.6	-1.8	2.0	2.6	**1.5**	**0.1**	**-3.8**	**-3.2**	**-1.7**	**-0.8**	**-0.2**
5.2	1.3	-2.2	-3.5	-6.6	-0.3	2.2	1.0	0.8	-0.1	1.6	4.6	**4.1**	**2.2**	**1.8**	**-0.9**	**-1.0**	**0.2**	**0.6**	**0.9**
1.6	-2.9	-7.0	-5.7	-4.5	2.5	5.8	4.7	4.7	2.4	3.4	6.5	**5.6**	**4.0**	**3.2**	**-0.1**	**-1.5**	**-0.8**	**-0.6**	**-0.5**
8.8	7.5	4.6	4.1	2.8	4.8	4.7	3.8	3.0	2.0	3.6	4.9	**6.8**	**6.5**	**6.7**	**7.0**	**6.6**	**7.7**	**7.1**	**6.4**
1.75	1.50	1.25	1.00	1.00	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	-	-	-	-	-	-	-
2.7	2.3	2.0	1.8	1.5	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	**1.1**	**0.9**	**0.8**	**0.7**	**0.8**	**1.0**	**1.3**

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