INFLATION REPORT / II

2013

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 9 May 2013 and contains the information available as of 19 April 2013. 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 fell slightly below the CNB's target in 2013 Q1
(year on year in %)

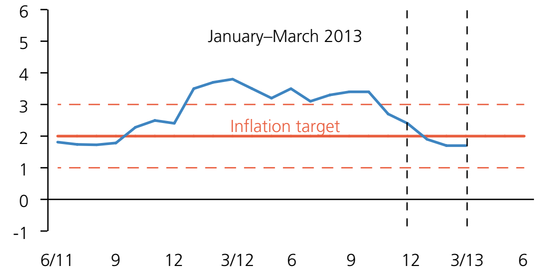


CHART I.2

HEADLINE INFLATION FORECAST

Headline inflation will be slightly below the CNB's 2% target this year despite an increase in indirect taxes
(year on year in %)

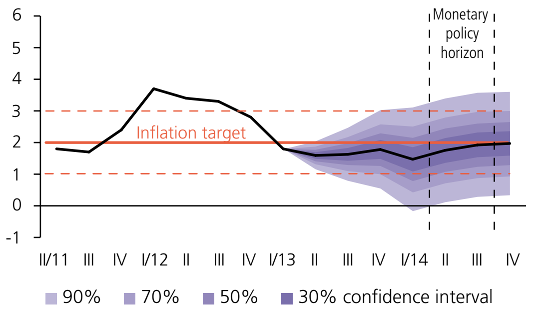
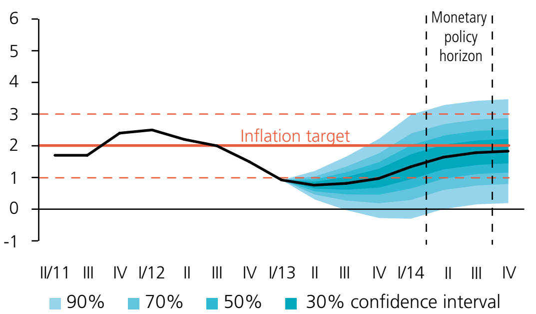


CHART I.3

MONETARY-POLICY RELEVANT INFLATION FORECAST

Monetary-policy relevant inflation will be close to the lower boundary of the tolerance band around the target this year and then return slowly to the target at the monetary policy horizon
(year on year in %)



I. SUMMARY

The year-on-year decline of the Czech economy deepened further in 2012 Q4. In 2013 Q1, headline inflation fell slightly below the CNB's target, while monetary-policy relevant inflation was just below the lower boundary of the tolerance band around the target. The effect of tax changes and administered prices has moderated and food prices are continuing to rise. Import prices are slightly inflationary owing to depreciation of the koruna. By contrast, the domestic economy is dampening inflation. Real economic activity will decrease slightly overall this year owing to subdued domestic and external demand amid continuing fiscal consolidation. The domestic economy will recover gradually in the second half of the year, however, thanks to improving external demand. GDP growth will continue to accelerate next year, reaching almost 2% for the year as a whole. Headline inflation will be slightly below the CNB's 2% target this year despite substantial impacts of changes to indirect taxes. Monetary-policy relevant inflation will be close to the lower boundary of the tolerance band this year and then return slowly to the target at the monetary policy horizon. At the forecast horizon, the exchange rate of the koruna against the euro will appreciate very slowly from a weak initial level. Consistent with the forecast is a slight decline in market interest rates, followed by a rise in rates in 2014.

The **Czech economy** contracted by 1.7% year on year in **2012 Q4** because of falling household consumption and fixed investment. The contributions of the other demand components to economic growth were positive. The forecast assumes only a slight moderation of the year-on-year decline in GDP in 2013 Q1.

In **2013 Q1, headline inflation** fell slightly below the CNB's target (see Chart I.1), while monetary-policy relevant inflation was just below the lower boundary of the tolerance band around the target. The sources of inflation again include tax changes and rising administered prices, although their contribution to inflation decreased. Food prices are also continuing to rise. Inflationary pressures from import prices moderated, but remain positive owing to depreciation of the koruna. Negative adjusted inflation excluding fuels reflects the persisting anti-inflationary effect of the domestic economy.

Economic growth in the effective euro area slowed to 0.4% in 2012 Q4 and probably declined further at the start of this year. According to the assumptions of the forecast, growth is expected to reach 0.5% in effective terms, but the euro area as a whole will – as in the previous year – record a modest recession. The market outlook for low 3M EURIBOR rates reflects expectations of continued easy ECB monetary policy amid an only gradual recovery of economic activity in the euro area in an environment of continuing debt crisis. This is reflected in an outlook for gradual depreciation of the euro against the dollar. Oil prices are expected to fall slightly at the forecast horizon.

According to the forecast, headline inflation will be slightly below the CNB's 2% target this year despite an increase in both VAT rates of one percentage point. After the effect of this tax change drops out in early 2014, inflation will fall more markedly below the target, but later it will slowly converge towards it again (see Chart I.2). **Monetary-policy relevant inflation**, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, will be close to the lower boundary of the tolerance band this year and then return slowly to the target at the monetary policy horizon (see Chart I.3). The overall upward pressures on consumer prices will increase in the near future as the inflationary effect of import prices strengthens due to a weakened exchange rate of the koruna and the anti-inflationary effect of the domestic economy starts to subside gradually. In the longer term, the inflationary effect of import prices will weaken again owing to stable foreign producer price inflation and very slow appreciation of the koruna. The effect of the domestic economy will be slightly anti-inflationary until early 2014. Adjusted inflation excluding fuels will turn slightly positive in the second half of this year and then increase steadily. By contrast, growth in administered prices and food prices will slow noticeably. Fuel prices will show a temporary decline.

Consistent with the forecast is a slight decline in market **interest rates**, followed by a rise in rates in 2014 (see Chart I.4). The low level of foreign interest rates and low inflation, reflecting the subdued domestic economy, are the main factors fostering a decline in interest rates. At the forecast horizon, the **exchange rate of the koruna** against the euro will appreciate very slowly from a weak initial level (see Chart I.5) owing to a renewed slightly positive interest rate differential and a recovery in external demand, reflected in rising net exports.

Generally weak domestic demand in an environment of continuing fiscal consolidation and an only gradual recovery in external demand will lead to a 0.5% decline in the **Czech economy** this year (see Chart I.6). Only net exports and, to a small extent, also government consumption will make positive contributions to economic activity. The other demand components will slow it. In 2013 H2, however, economic growth will start to recover gradually. Next year, the previous years' dampening factors will largely subside and the economy will grow by almost 2%. On the **labour market**, subdued economic developments this year will cause total employment to decrease somewhat and the unemployment rate to increase. Low wage growth in the business sector will reflect the contraction of the Czech economy this year. Wage growth will pick up in 2014 as economic activity recovers more significantly. Wages in the non-business sector will continue to rise at an insignificant rate.

At its monetary policy meeting on 2 May 2013, the Bank Board decided unanimously to **leave key interest rates unchanged**. The risks of the new forecast were assessed as being on the downside. The external outlook (EURIBOR rates and the oil price), the domestic economy and growth in competition in oligopolistic industries are all acting in this direction.

CHART I.4

INTEREST RATE FORECAST

Consistent with the forecast is a slight decline in market interest rates, followed by a rise in rates in 2014
(3M PRIBOR in %)

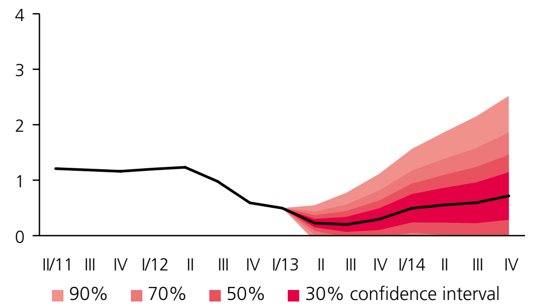


CHART I.5

EXCHANGE RATE FORECAST

The nominal exchange rate will appreciate very slowly from a weak initial level
(CZK/EUR)

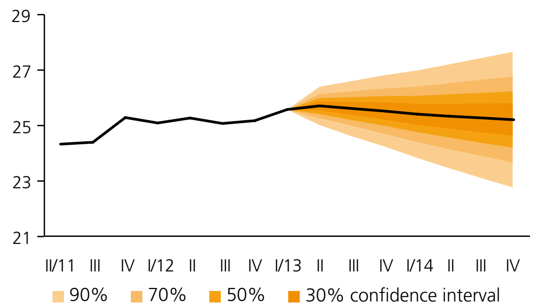


CHART I.6

GDP GROWTH FORECAST

GDP will decline this year overall, but will gradually start to recover
(annual percentage changes; seasonally adjusted)

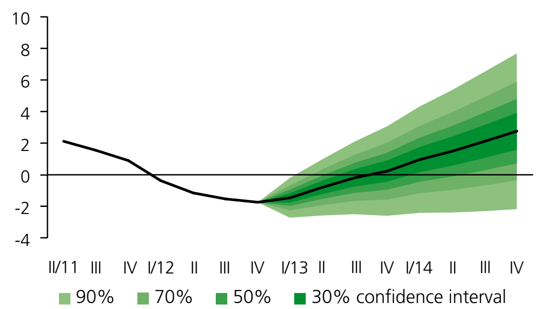


Chart II.1.1

EFFECTIVE GDP IN THE EURO AREA

Economic growth in the euro area probably slowed further at the start of this year but is expected to recover in the second half of the year

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

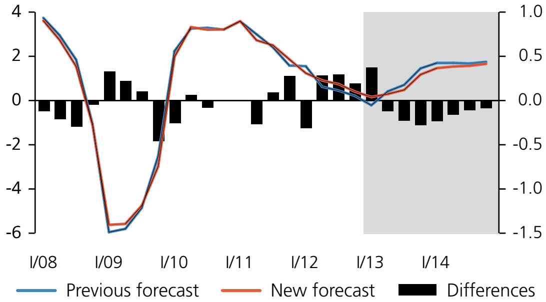


Chart II.1.2

EFFECTIVE PPI IN THE EURO AREA

Producer prices will rise at a moderate and stable pace, reflecting subdued output and a falling outlook for commodity prices

(year on year in %; differences in percentage points – right-hand scale; seasonally adjusted)

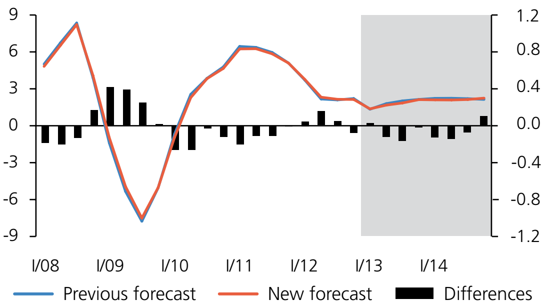
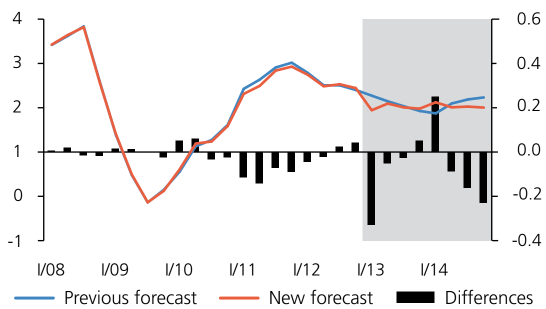


Chart II.1.3

EFFECTIVE CPI IN THE EURO AREA

Effective inflation should fluctuate around the 2% level over the entire forecast horizon

(year on year in %; differences in percentage points – right-hand scale; seasonally adjusted)



II. THE FORECAST, ITS CHANGES AND RISKS

II.1 EXTERNAL ASSUMPTIONS OF THE FORECAST

Economic growth in the effective euro area probably slowed further at the start of this year and will recover in the second half of the year and particularly in 2014. The low producer and consumer price inflation reflects the unwinding of the effect of higher commodity prices and generally weak demand. The persisting low outlook for 3M EURIBOR rates takes into account expectations of continued easy ECB monetary policy. The outlook for the dollar-euro exchange rate over the next two years expects the European currency to depreciate gradually below USD 1.30. The price of Brent crude oil is expected to fall slightly over the forecast horizon from the average level of just over USD 110 a barrel observed in 2013 Q1.

The outlook for the **effective indicator of euro area GDP** foresees a further slowdown in annual growth of 0.3 percentage point to 0.5% this year. Economic activity in the effective euro area should bottom out in early 2013 and is expected to start recovering gradually in the second half of the year (see Chart II.1.1).[1] The euro area as a whole will record a continuing recession this year. By contrast, the more favourable development of the effective indicator is due to a high share of Germany, Slovakia and other major trading partners in the Czech Republic's foreign trade. The expected rate of growth of these countries is well above the euro area average. Effective external GDP growth is predicted to rise to 1.6% in 2014. Compared to the previous forecast, this means a modest shift in the outlook towards lower growth over almost the entire horizon. The risks of further economic slowdown in the euro area are linked above all with the continuing uncertainty surrounding the debt crisis.

The outlook for the **effective indicator of producer prices in the euro area** reflects the unwinding of the effect of high commodity prices and subdued demand (see Chart II.1.2). At 1.8% on average in 2013, it is 0.8 percentage point lower than in 2012. Producer price inflation is expected to pick up slightly to 2.1% as the economy recovers in 2014. The previous forecast had predicted slightly higher figures for both years.

The downturn in consumer demand, linked with fiscal consolidation and generally low economic activity, is taken into account in the outlook for growth in the **effective indicator of consumer prices in the euro area** (see Chart II.1.3). Compared to 2012, consumer price

1 The outlooks for euro area GDP, PPI and CPI and the dollar-euro exchange rate are based on the April Consensus Forecasts (CF). The outlooks for the 3M EURIBOR and Brent crude oil are derived from prices of market contracts as of 8 April 2013. The outlook is indicated by the grey areas in the charts. This convention is used throughout this Report. The differences between the previous and new forecast in the past are due, in addition to revisions, to a change in the seasonal adjustment methodology.

inflation is expected to fall by 0.6 percentage point to 2% in 2013 and to stay at this level in 2014. This means a slightly lower outlook for both years compared to the previous forecast.

The market outlook for **3M EURIBOR interest rates** reflects the weak macroeconomic situation in the euro area over the entire forecast horizon. The absence of major inflation pressures in the medium term in an environment of continuing debt crisis will thus probably necessitate easy monetary policy in the longer term. This was confirmed by ECB representatives in a statement made after the monetary policy meeting on 4 April. Compared to 2012, 3M EURIBOR rates are expected to fall by 0.4 percentage point to 0.2% on average in 2013 (see Chart II.1.4). The expected growth in interest rates in the euro area was thus postponed to the end of this year. Average 3M EURIBOR interest rates are then expected to reach 0.4% in 2014. The outlook for rates has thus been lowered slightly over the entire forecast horizon. The market outlook for foreign rates is in line with the expectations of CF analysts, who also predict the 3M EURIBOR to rise from its current level of 0.2% to 0.4% at the 12-month horizon. CF analysts also expect the ECB's main refinancing rate to stay at the current level of 0.75% at least until mid-2014.

The outlook for the **euro-dollar exchange rate** foresees a gradual weakening of the euro (see Chart II.1.5). The stronger initial level of the euro compared to the previous forecast reflects positive sentiment and a decline in risk aversion on financial markets at the start of this year. The average euro-dollar exchange rate should reach USD 1.30/EUR in 2013. This means a slightly stronger euro compared to both last year and the previous forecast. In 2014, the euro is expected to depreciate to USD 1.27 on average.

The path of the **Brent crude oil price** based on market futures is still slightly falling for this year and the next (see Chart II.1.6). In 2013, the price of Brent crude oil should decrease by USD 6 on average compared to 2012, to USD 106 a barrel. The analysts surveyed in the April CF predict an average price of Brent crude oil of USD 110 a barrel at the 12-month horizon, i.e. USD 9 a barrel higher than the market outlook. The average price of Brent crude oil should then fall further to USD 101 a barrel in 2014 according to market outlooks. Compared to the previous forecast, the whole outlook has shifted downwards by about 2%. The Brent oil price fell to USD 100 a barrel in April 2013, reflecting the risk of slowing global economic growth.

CHART II.1.4

3M EURIBOR

Expectations of continued easy ECB monetary policy are reflected in a low outlook for interest rates
(in %; differences in percentage points – right-hand scale)

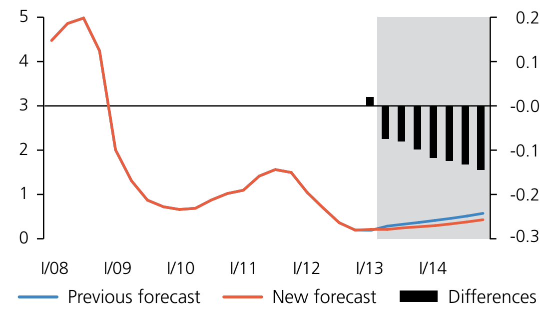


CHART II.1.5

EURO-DOLLAR EXCHANGE RATE

The exchange rate of the euro against the dollar should gradually weaken from an initial level of just above 1.30 USD/EUR
(USD/EUR; differences in % – right-hand scale)

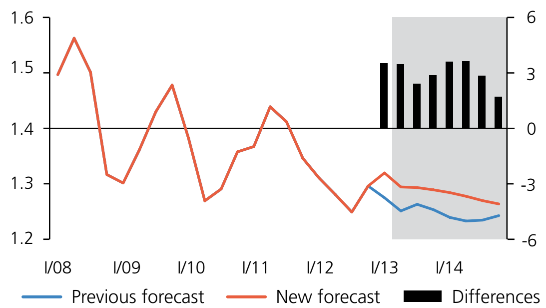
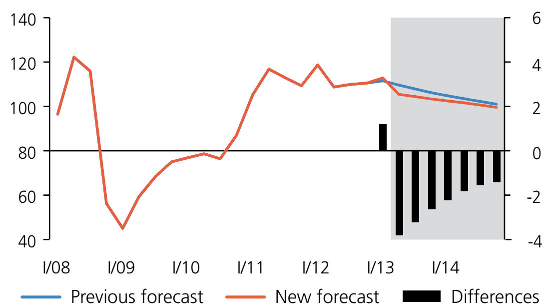


CHART II.1.6

PRICE OF BRENT CRUDE OIL

The market outlook for the price of oil is slightly falling over the entire horizon
(USD/barrel; differences in % – right-hand scale)



II.2 THE FORECAST

The sources of inflation again include tax changes and rising administered prices, although their contribution to inflation decreased. Food prices are also continuing to rise. Inflationary pressures from import prices have moderated, but remain positive owing to depreciation of the koruna. Adjusted inflation excluding fuels is still negative, reflecting the anti-inflationary effect of the domestic economy. This year, headline inflation will be affected by an increase in indirect taxes introduced at the start of the year, but will be slightly below the CNB's 2% target owing to subdued domestic economic activity. Monetary-policy relevant inflation will be close to the lower boundary of the tolerance band around the target this year. Import prices will remain inflationary because of stable foreign inflation, depreciation of the koruna against the euro in the first half of this year and subsequent only very slow appreciation over the forecast horizon. The anti-inflationary pressures from the domestic economy will subside only slowly and will start to push inflation slightly upwards in 2014. This, together with a closing gap in profit mark-ups, will cause both headline and monetary-policy relevant inflation to gradually converge towards the target at the monetary policy horizon. Subdued external and domestic demand amid continuing fiscal consolidation will lead to a 0.5% decline in GDP this year. The economy will grow by almost 2% next year thanks to an expected recovery in external demand and the unwinding of the effect of government consolidation measures. Consistent with the forecast is a slight decline in market interest rates, followed by a rise in rates in 2014.

Annual **headline inflation** dropped to 1.7% on average in 2013 Q1. Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, was 0.9% in the same period, i.e. just below the lower boundary of the tolerance band around the target. The forecast expects headline inflation to be slightly below 2% for the rest of 2013. The first-round effects of changes to indirect taxes will drop out in early 2014 and headline inflation will fall more markedly below the target, but later it will slowly converge towards it again (see Chart II.2.1). Monetary-policy relevant inflation will be close to the lower boundary of the tolerance band this year and then return slowly to the CNB's 2% target at the monetary policy horizon as a result of gradually weakening domestic anti-inflationary pressures and a modest rise in import prices.

Annual **administered price inflation** slowed sharply in 2013 Q1, reaching 3.5% on average (see Chart II.2.2). This was due to several factors. In addition to a moderation of the effect of VAT changes and the exclusion of rents from administered prices following the completion of their deregulation, these factors included a slowdown in annual growth in housing-related energy prices. Despite this, administered price inflation will be most strongly affected this year by prices of electricity, which continue to reflect the pronounced increase in support for renewable resources. Heat prices will also continue to contribute noticeably to administered price inflation, although their

CHART II.2.1

HEADLINE INFLATION AND MONETARY-POLICY RELEVANT INFLATION

Headline inflation will be slightly below the 2% level in 2013, while monetary-policy relevant inflation will be close to the lower boundary of the tolerance band

(year on year in %)

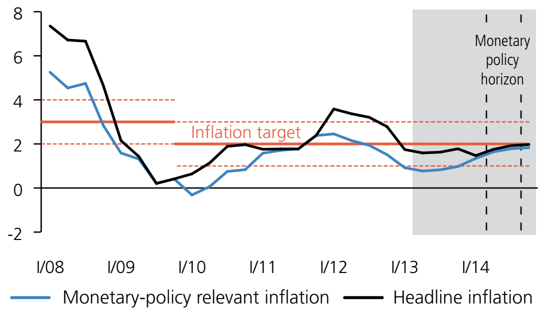
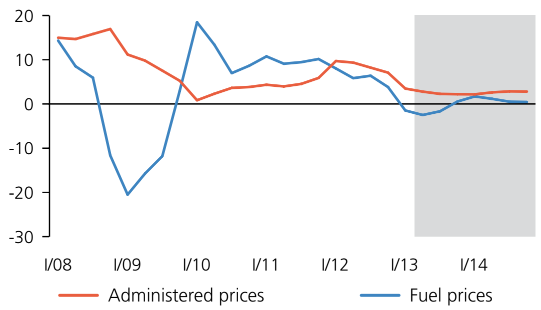


CHART II.2.2

ADMINISTERED PRICES AND FUEL PRICES

Administered price inflation will slow noticeably, while fuel prices will fall in the near term

(annual percentage changes; fuel prices excluding first-round effects of indirect tax changes)



growth will slow markedly due to falling prices of emission allowances and gas. By contrast, a two-digit reduction in the commodity component of the gas price by most large suppliers as a result of rising competition will lead to a negative contribution of gas prices to administered prices. Overall, annual administered price inflation will thus fluctuate between 2% and 3% in 2013 (see Table II.2.1). It will rise somewhat in 2014, largely owing to the expected unwinding of this year's decline in natural gas prices for households amid stability in the other components. The current fall in prices of emission allowances represents a risk to the forecast for administered prices, as it might lead to lower-than-expected heat and electricity prices next year.

Changes to **indirect taxes** contributed 0.7 percentage point to annual inflation on average in 2013 Q1 owing to an increase in both VAT rates of one percentage point in January 2013. At the same time, excise duties on cigarettes also saw another "harmonisation increase" with a contribution to annual headline inflation of 0.1 percentage point. Owing to frontloading by producers, however, this change did not pass through noticeably to prices in Q1, and the forecast expects a lagged impact in Q2. An identical change in excise duties on cigarettes, with a similarly lagged impact, is expected in January 2014. The forecast assumes full pass-through of the above changes to indirect taxes to prices, whereas the second-round effects on inflation expectations and wages are still not expected to be significant.

Annual **net inflation** fell slightly to 0.5% in 2013 Q1 (see Chart II.2.3), with all components of market price inflation showing negligible changes in trend. The forecast foresees an only slight decline in net inflation in Q2, with the gradual unwinding of the annual decline in prices in the adjusted inflation segment being offset by a deepening of the annual decline in fuel prices and a slowdown in food price growth. The expected shift of adjusted inflation to positive figures in 2013 H2 and its subsequent gradual rise will – with the effects of fuel and food prices offsetting each other – foster a gradual increase in net inflation to around 0.8% at the end of this year. The forecast predicts food price inflation to moderate in late 2013/early 2014 as a result of annual agricultural producer price inflation turning negative. However, renewed slight growth in fuel prices and particularly higher adjusted inflation excluding fuels will foster a further gradual increase in net inflation in 2014.

Annual **adjusted inflation excluding fuels** remained negative in 2013 Q1 (see Chart II.2.3), as a deeper annual decline in prices of tradable items was outweighed by an increase in prices of services, due mainly to the shift of the originally regulated rents into the market inflation segment. According to the forecast, adjusted inflation excluding fuels should turn positive in 2013 Q3. Renewed annual growth in import prices will lead to a steady increase in adjusted inflation excluding fuels to around 0.6% at the end of this year. Amid a gradual recovery in domestic demand in 2014, adjusted inflation excluding fuels will then increase further to 1.7%.

Table II.2.1

FORECAST OF ADMINISTRATIVE EFFECTS

The generally moderate growth of administered prices will be due mainly to rising prices of electricity and heat
(annual percentage changes; impacts in percentage points)

	2012 actual		2013 forecast		2014 forecast	
Administered prices – total[a]	6.2	1.16	2.0	0.35	2.8	0.49
of which (main changes):						
electricity	4.2	0.18	3.4	0.15	3.5	0.15
natural gas	4.3	0.12	-3.8	-0.11	0.2	0.00
heat	8.4	0.17	5.0	0.10	5.0	0.10
healthcare	8.3	0.15	2.6	0.05	2.0	0.04
First-round impacts of tax changes in non-administered prices		0.99		0.69		0.14

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 2013 H2
(year on year in %)

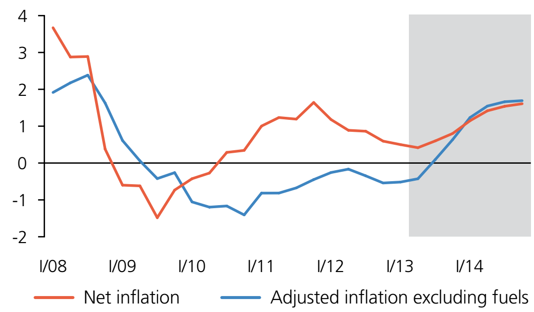


Chart II.2.4

FOOD PRICES AND AGRICULTURAL PRODUCER PRICES

Food price inflation and agricultural producer price inflation will slow this year
(annual percentage changes)

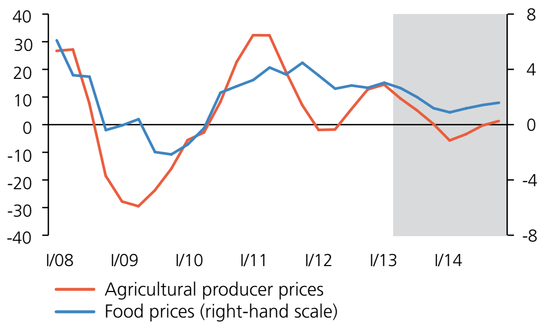


CHART II.2.5

FUEL PRICES AND OIL PRICES

The year-on-year decline in oil prices will culminate in a fall in fuel prices for almost all of this year
(annual percentage changes)

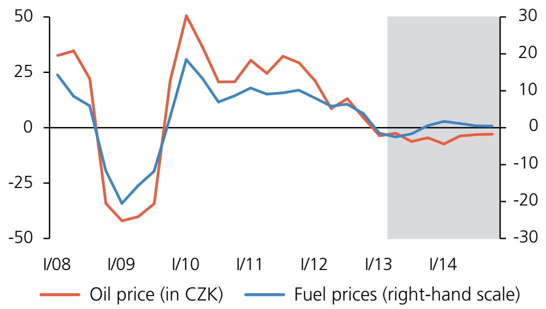


CHART II.2.6

INTEREST RATE FORECAST

Consistent with the forecast is a slight decline in market interest rates, followed by a rise in rates in 2014
(3M PRIBOR and 3M EURIBOR in %)

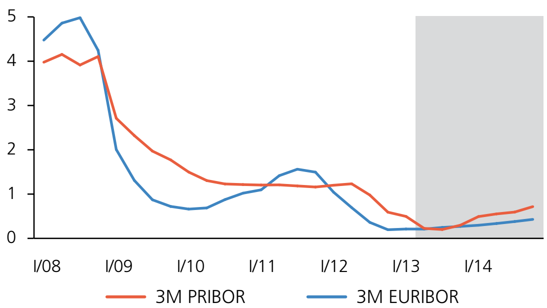
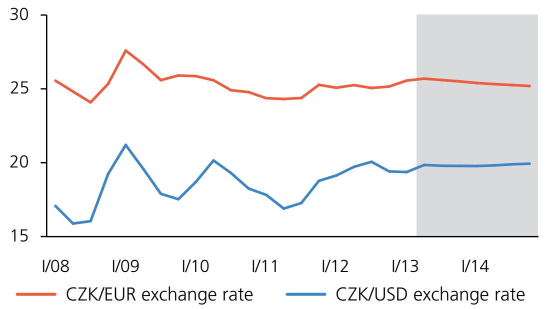


CHART II.2.7

EXCHANGE RATE FORECAST

The exchange rate of the koruna against the euro will appreciate very slowly from a weak initial level
(CZK/EUR and CZK/USD)



Annual **food price inflation** (excluding the first-round effects of tax changes) rose slightly to 3% in 2013 Q1. However, food price inflation will slow until the start of 2014, mainly because of a pronounced slowdown in annual growth in agricultural producer prices, or their temporary switch to a year-on-year decline (see Chart II.2.4).[2]

Annual **fuel price inflation** turned negative in 2013 Q1, mirroring world prices of petrol and Brent oil (see Chart II.2.5). The forecast expects fuel prices to decline in year on year terms almost until the end of this year and then increase only marginally.

Interest rates on the Czech money market and rates with maturities longer than one year remained low in 2013 Q1, reflecting easy monetary policy in the Czech Republic due to the downturn in the Czech economy and low interest rates in the euro area. Consistent with the forecast is a slight decline in market interest rates, followed by a rise in rates in 2014 (see Chart II.2.6). The low level of foreign interest rates and low inflation, reflecting the subdued domestic economy, are the main factors fostering a decline in interest rates.

The **koruna** depreciated **against the euro** to CZK 25.6 on average in 2013 Q1. The short-term forecast for 2013 Q2 assumes a further slight depreciation to an average of CZK 25.7 (see Chart II.2.7). This prediction takes into account the exchange rate level observed at the start of April, which reflects, among other things, the CNB's communication regarding potential interventions in the foreign exchange market. Subdued domestic economic activity and external demand are other factors fostering a weaker exchange rate in 2013 H1. The low outlook for foreign interest rates is acting in the opposite direction. At the longer end of the forecast, a renewed slightly positive interest rate differential and a recovery in external demand, reflected in rising net exports, are leading to very gradual appreciation of the exchange rate to CZK 25.2 against the euro. In light of the CF outlook for a gradually depreciating exchange rate of the euro against the dollar (see section II.1), this implies a slight depreciation of the koruna-dollar rate over the entire forecast horizon.

Quarterly growth in **nominal marginal costs in the consumer goods sector** remained at a low level in 2013 Q1 (see Chart II.2.8). Inflationary pressures from import prices remain positive, albeit subdued, as the effect of exchange rate depreciation is being partly offset by a continued decline in world commodity prices. The effect of the domestic economy, approximated by intermediate goods price inflation, is anti-inflationary due to subdued economic activity accompanied by low wage growth. The estimated impact of growth in export-specific technology is linked to the difference in the evolution of prices of tradables and non-tradables (the Balassa-Samuelson effect), which for some time now has been contributing less markedly

2 Nevertheless, increased volatility in annual food price inflation cannot be ruled out in the months ahead owing to the late arrival of spring weather.

to inflation than in the pre-crisis period. At the start of the forecast horizon, the price pressures on consumer price inflation will increase, as the inflationary effect of import prices will strengthen due to the koruna's weaker exchange rate in 2013 H1. At the same time the anti-inflationary effect of the domestic economy will gradually subside. In the coming quarters, the inflationary effect of import prices will weaken again owing to stable foreign producer price inflation and very slow appreciation of the koruna. The contribution of export-specific technology will increase as economic activity gradually recovers.

Nominal marginal costs in the intermediate goods sector continued to decline in 2013 Q1. Nominal wage growth in the business sector remained very low when adjusted for the one-off effect of tax optimisation (see below) and was thus outweighed by the estimated declining price of capital, which reflects the subdued economic activity and weak investment activity. The contributions of labour-augmenting technology are only slightly anti-inflationary due to weak productivity growth (see Chart II.2.9). Domestic costs will continue to decline moderately until the end of 2013. The contribution of the price of capital will stay negative in the next few quarters, changing only at the end of the forecast horizon along with a continuing recovery in economic activity. Moreover, wage growth will remain low and, in terms of costs, will be largely offset by gradually recovering growth in productivity.

The estimated gap in **profit mark-ups in the consumer goods sector** stayed slightly negative in 2013 Q1, although gradual closure of the gap was apparent (see Chart II.2.10). Subdued pass-through of previous cost pressures to final prices thus persisted in an environment of weak economic activity. The gap in profit mark-ups will turn more negative at the start of the forecast horizon, as the weak domestic demand will prevent prices from rising in line with growth in costs stemming from import prices. The gap in profit mark-ups will converge towards zero again at the end of 2014.

Whole-economy **labour productivity** continued to fall at a rate of around 2% in 2013 Q1. Productivity will start to rise again in 2013 H2 thanks to a gradual recovery in economic activity and a continuing decline in employment. Productivity growth will pick up gradually to just above 3% in late 2014.

Annual growth in the average nominal **wage in the business sector** picked up significantly in 2012 Q4. This was due to a time shift of wages caused by tax optimisation related to the abolition of the cap on health insurance and additional taxation on higher income as from 2013. The average wage rose by 4.2% in this quarter after seasonal adjustment.[3] The impact of tax optimisation is estimated at around 2 percentage points. In line with this shift, the forecast assumes a contrary slowdown in annual wage growth to 0.1% in

3 For details see section III.4.2.

CHART II.2.8

COSTS IN THE CONSUMER SECTOR

The overall inflationary pressures in the consumer sector will increase in the coming quarters from their current low levels
(quarterly percentage changes; contributions in percentage points; annualised)

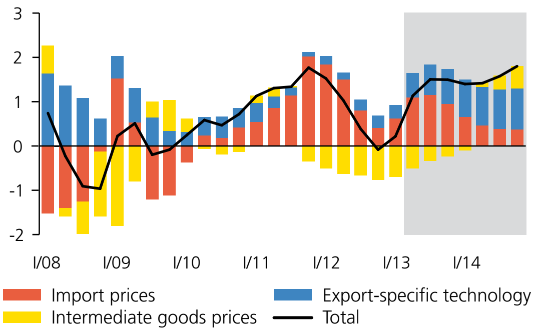


CHART II.2.9

COSTS IN THE INTERMEDIATE GOODS SECTOR

Domestic costs will continue to decline moderately until the end of 2013 as a result of low wage growth and negative contributions from the price of capital
(quarterly percentage changes; contributions in percentage points; annualised)

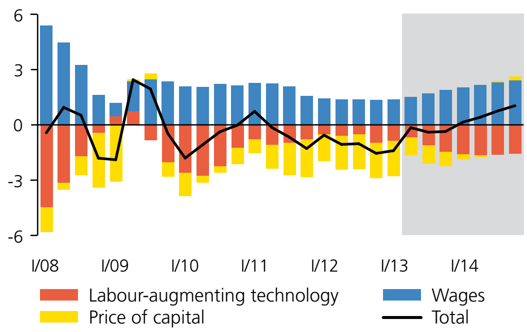


CHART II.2.10

GAP IN PROFIT MARK-UPS IN THE CONSUMER SECTOR

The gap in profit mark-ups will stay negative over the whole forecast horizon
(percentages)

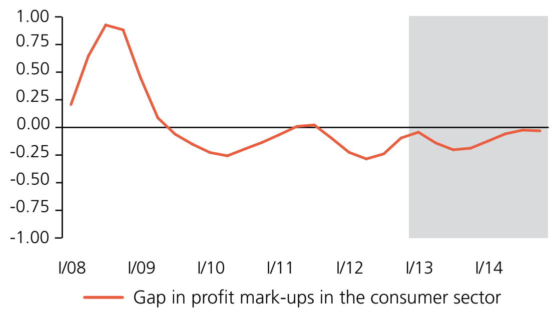


CHART II.2.11

AVERAGE NOMINAL WAGE

Wage growth will remain low this year, but will be volatile due to tax optimisation
(annual percentage changes; business sector – seasonally adjusted; non-business sector – seasonally unadjusted)

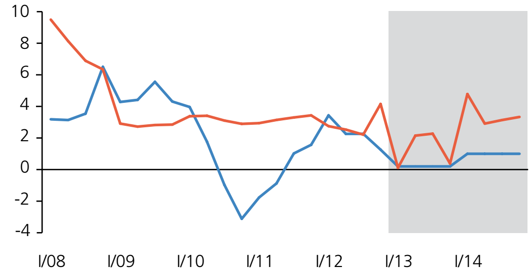


CHART II.2.12

GDP GROWTH FORECAST

GDP will decline slightly this year; economic activity will recover in 2014
(percentage changes; seasonally adjusted)

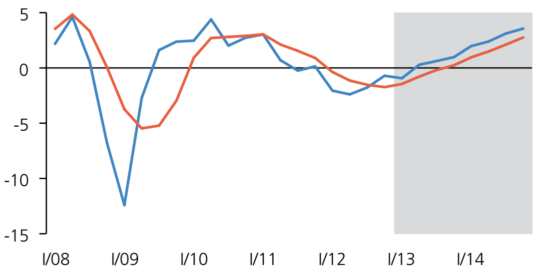
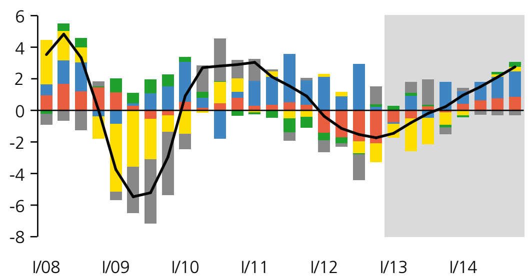


CHART II.2.13

ANNUAL GDP GROWTH STRUCTURE

Only net exports and, to a small extent, government consumption will make positive contributions to GDP growth this year
(annual percentage changes; contributions in percentage points; seasonally adjusted)



2013 Q1. Adjusted for tax optimisation, the estimated wage growth is only slightly above 2%. Adjusted wage growth will remain subdued throughout the year, primarily reflecting weak economic activity. In 2014 it will pick up steadily as the economy recovers. Overall, wages in the business sector will increase by 1.2% and 3.5% in 2013 and 2014 respectively (see Chart II.2.11).

Growth in the average nominal **wage in the non-business sector** will be negligible throughout the year. The forecast expects wage growth in this sector to slow to 0.2% in 2013 Q1 and to stay around this level throughout 2013. Wage growth will remain subdued in 2014, when the average wage in the non-business sector will rise by 1%.

Real GDP recorded a year-on-year decline of 1.7% and a quarter-on-quarter decline of 0.2% in **2012 Q4** (see Chart II.2.12). The annual decline was due primarily to household consumption and gross fixed capital formation. By contrast, inventories, net exports and government consumption made positive contributions to annual GDP. In 2012 as a whole, GDP decreased by 1.2% overall, with all components of expenditure except net exports declining.

The forecast assumes that **economic activity in 2013 Q1** recorded an annual decline of 1.5% and a quarterly decrease of 0.2% (see Chart II.2.13). Household consumption is expected to record an annual decline of 1.5%. Fixed investment probably also contributed negatively to GDP growth. Net exports and changes in inventories were approximately unchanged.

In **2013**, real economic activity will drop by 0.5% due to still restrictive domestic fiscal policy and an only gradual recovery in external demand. Household consumption will be dampened by disposable income, affected mainly by low nominal wage growth and fiscal consolidation. Subdued domestic and external demand will prevent more pronounced growth in total investment, and gross capital formation will continue to decrease throughout 2013; the only exception will be investment in the government sector, where growth in investment activity funded from domestic resources and EU funds is expected.[4] Only net exports and, to a small extent, also government consumption will make positive contributions to GDP growth. However, the contribution of net exports will be much smaller than in 2012 due to only gradual growth in external demand and a fading decline in domestic demand.

GDP will grow by 1.8% in **2014** after the previous years' dampening factors largely subside. The forecast assumes more robust growth in external demand and a neutral effect of fiscal policy. The contribution of government consumption to GDP growth will be slightly positive and growth in government investment, which started this year, is

4 Modernisation of the D1 motorway will be one of the major investment projects in the government sector. This will stimulate construction activity, which is currently subdued, but it may have a temporary adverse effect on other economic sectors due to traffic delays.

expected to continue. Household consumption will start to rise again as a result of moderately accelerating wage growth and the unwinding of the effect of fiscal consolidation. Gross capital formation will remain subdued. New exports will contribute more significantly again to GDP growth as a result of a recovery in external demand.

The continued downturn in economic activity probably manifested itself in a deepening of the quarter-on-quarter decline in **total employment** in 2013 Q1, and this decline will accelerate in the following quarters. In year-on-year terms, however, total employment will continue to grow in 2013 Q1. Subsequently, it will switch to a decline, which will peak in late 2013 and early 2014. The decline in employment will gradually moderate in 2014 (see Chart II.2.14). When converted into full-time equivalents, the currently observed annual decline in the number of employees will continue until 2013 Q2 (see Chart II.2.15). The converted number of employees will return to growth at the end of 2014.

The forecast assumes that the seasonally adjusted **general unemployment rate** increased further to 7.5% in 2013 Q1. Given the subdued economic activity and continued growth in the labour force, the general unemployment rate will continue to rise gradually to 8% at the end of 2013 and will fluctuate around this level during 2014 (see Chart II.2.14). The growth in the unemployment rate will also be a result of a limited ability to further reduce the average hours worked per employee. A continuing increase can also be expected for the seasonally adjusted **share of unemployed persons according to the MLSA**, which will rise gradually to just above 8% owing to a continuing cyclical increase in the number of job applicants registered with labour offices amid a decrease in the population aged 15–64. The share of unemployed persons will remain just above 8% throughout 2014.

Real **household consumption** will decline by 0.5% this year, i.e. significantly less than last year. The continuing decline in consumption will reflect weak growth in nominal and real disposable income, especially wages and salaries, linked with labour market developments and ongoing fiscal consolidation (see Chart II.2.16). Still subdued consumer demand in the near future is also indicated by the available leading indicators, such as a still low – although gradually rising – consumer confidence indicator and a slight decline in retail sales in the first two months of this year (see section III.3). This will be counteracted by slower inflation, despite an increase in indirect taxes, together with an expected decline in the saving rate from its currently high level. Household consumption will rise in 2014 as a result of a recovery in economic activity and an ensuing gradual pick-up in growth in the volume of wages as the impacts of fiscal consolidation subside.

Gross nominal disposable income will decrease by 0.5% this year (see Chart II.2.17). The contribution of its most significant component, i.e. wages and salaries, will be negative. Next year, however, its growth will start to rise gradually in connection with the gradual economic recovery and the expected labour market developments. Another

CHART II.2.14

LABOUR MARKET FORECAST

Total employment will mostly fall and the unemployment rate will rise

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

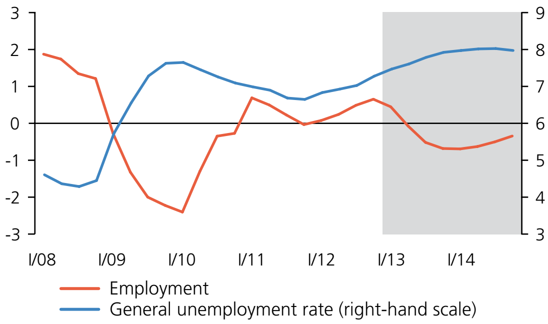


CHART II.2.15

NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENT)

The decline in the number of employees converted into full-time equivalents will start to moderate in 2013 H2

(annual percentage changes; contributions in percentage points)

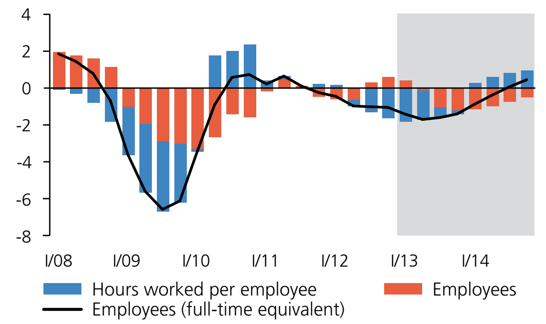


CHART II.2.16

REAL HOUSEHOLD AND GOVERNMENT CONSUMPTION

Household consumption will start to grow in 2014

(annual percentage changes; seasonally adjusted)

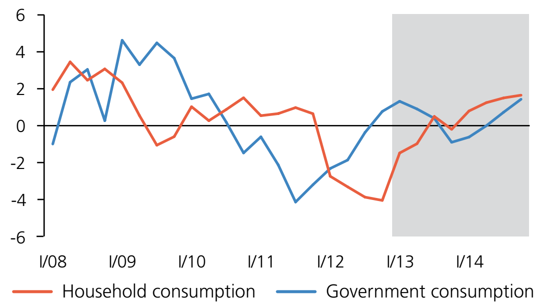


Chart II.2.17

NOMINAL DISPOSABLE INCOME

Disposable income will decrease slightly in 2013; its growth will re-emerge in 2014 due mainly to wages and salaries
(annual percentage changes; contributions in percentage points)

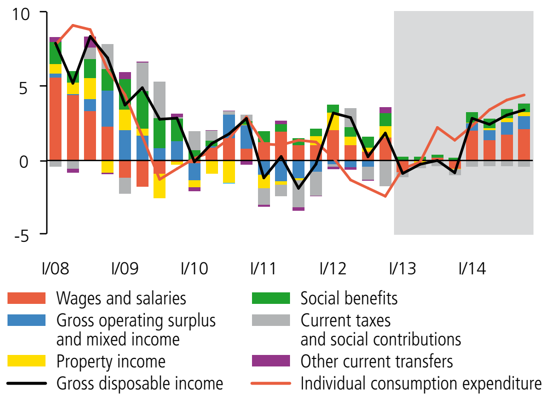


Chart II.2.18

HOUSEHOLD SAVING RATE

The saving rate will gradually go down after having increased sharply last year
(percentages)

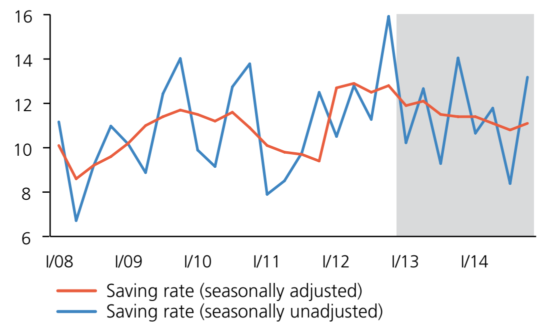
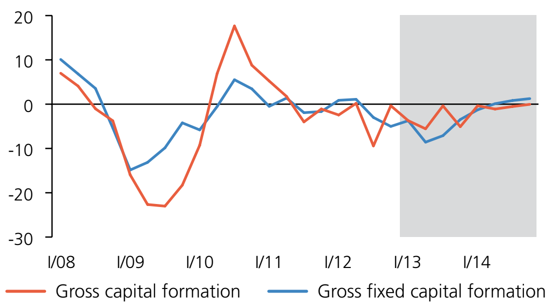


Chart II.2.19

GROSS CAPITAL FORMATION

Gross capital formation will fall this year, but its decline will moderate significantly next year
(annual percentage changes; seasonally adjusted)



significant component of disposable income, social benefits, should record slightly positive contributions over the entire forecast horizon. The contribution of operating surplus and mixed income will start to grow in 2014 thanks to a pronounced economic recovery. Overall, gross disposable income will increase by 3% in nominal terms next year.

The forecast assumes a gradual decline in the **household saving rate** from its current level of above 12% to 11% at the end of 2014 (see Chart II.2.18). Its profile will reflect the gradually improving prospects for the economy, manifesting themselves in faster growth in nominal consumption as against subdued growth in gross disposable income.

Real **government consumption** will increase by 0.4% in 2013 and 2014 (see Chart II.2.16). This will be a result of continued cost-cutting by the government coupled with a low estimate of the government consumption deflator.

Gross capital formation recorded a year-on-year decline of 0.4% in 2012 Q4. This was due to a pronounced decline in gross fixed capital formation amid an increase in inventories, probably caused by an unexpected fall in exports. In 2013 Q1, the forecast assumes that inventories accumulated at the end of 2012 will be used up and hence the stock of inventories will decline. The negative annual growth in gross capital formation should continue,[5] despite a positive contribution from investment in the government sector connected with renewed implementation of projects co-financed from EU funds. Overall, gross capital formation will fall by 3.7% in 2013 (see Chart II.2.19). Although a slight rise in fixed investment is expected as from mid-2014 due to renewed growth in external demand and continued growth in government investment, gross capital formation as a whole will record a decrease of 0.5% in 2014.

Year-on-year growth in real **exports of goods and services** slowed to 1.4% in 2012 Q4. The expected low growth in external demand in early 2013 and the observed developments in the balance of trade in January and February 2013 are reflected in a temporary expected annual decline in exports. Export growth will start to recover again in 2013 H2 in line with external demand, reaching 0.4% in 2013 as a whole and picking up significantly to 8% in 2014 (see Chart II.2.20).

The growth rate of real **imports of goods and services** edged up to 1.2% in 2012 Q4. Imports probably declined in 2013 Q1 owing to the use of inventories accumulated at the end of 2012 and to weaker exports. Imports will decline by 0.3% in 2013 owing to a continuing – albeit moderating – decline in domestic demand and lower export growth, and increase by 6.9% in 2014 as household consumption and import-intensive exports recover.

5 The end-March results of a joint survey conducted by the CNB and the Confederation of Industry of the Czech Republic confirm this outlook in a negative balance of responses concerning investment activity at both the six-month and the one-year horizons.

Net exports at constant prices made a positive – albeit significantly smaller compared to previous quarters – contribution to annual GDP growth in 2012 Q4 (0.2 percentage point). The forecast expects this contribution to drop further temporarily in 2013 owing to low growth in external demand and the fall in exports observed at the start of this year caused by a temporary downturn in auto industry production related to the introduction of a new product line. However, net exports will make a positive contribution to GDP growth on average for this year as a whole (0.5 percentage point). The contribution of net exports will increase again (to 1.2 percentage points) as external demand recovers in 2014.

The balance of payments forecast expects the **current account** deficit, as recorded in the previous two years, to continue to decrease this year and the next (see Table II.2.3). In relative terms, this means a decline in the deficit from 2.4% of GDP in 2012 to 1.3% this year and 0.5% the next. The lower current account deficit in both years will be due to a continuing increase in the trade surplus and partly also to a decline in the income deficit; in 2014, moreover, the services balance will also improve (the surpluses on transport and travel will increase slightly). The growing trade surplus in 2013 is associated on the one hand with an expected year-on-year decline in aggregate domestic demand and a modest decrease in commodity prices on world markets, hindering growth in imports, and on the other hand with an expected gradual recovery in external demand, supporting renewed growth in exports. In 2014, an expected improvement in the terms of trade will play a role, in addition to assumed faster growth in external demand than domestic demand. A slight decrease in the income deficit, associated with a decrease in non-residents' profits from direct investment and a rise in the surplus on interest income, will also foster lower current account deficits in both years. The forecast expects current transfers to remain flat at around zero, i.e. at the level of the previous two years.

The year-on-year improvement in the **capital account** this year is associated mainly with higher expected drawdown of EU funds and, to a lesser extent, with assumed one-off sales of telecommunication frequencies. In 2014, the forecast assumes drawdown of EU funds approximately at this year's level.

The **financial account** surplus is declining significantly over the forecast horizon compared with previous years. Given the weak demand and excess production capacity in Europe, the need for new investment is very limited. In 2013, moreover, the overall direct investment balance will be affected by a major foreign acquisition by a resident. The lower expected year-on-year decrease in the portfolio investment surplus this year is due to an assumption of a slightly lower volume of bond issues abroad by the government and government-controlled companies. A further decrease in the expected net portfolio investment inflow in 2014 is connected with assumed higher interest among residents in investing abroad due to the economic recovery.

CHART II.2.20

REAL EXPORTS AND IMPORTS

Export and import growth will pick up pace in 2013 H2, and the contributions of net exports to GDP growth will subsequently increase again

(annual percentage changes; annual changes in CZK billions; seasonally adjusted)

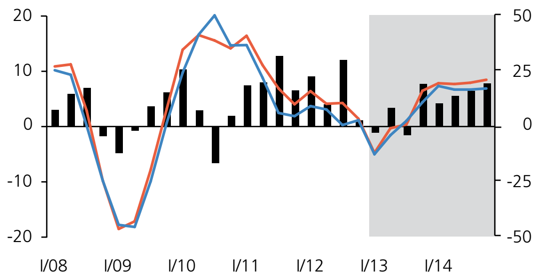


TABLE II.2.2

FORECASTS OF SELECTED VARIABLES

Real disposable income will not rise until 2014, when labour productivity will also start to increase again

(annual percentage changes unless otherwise indicated)

	2012 actual	2013 forec.	2014 forec.
Real gross disposable income of households	-0.3	-1.8	0.7
Total employment	0.4	-0.2	-0.5
Unemployment rate (in per cent) a)	7.0	7.7	8.0
Labour productivity	-1.7	-0.3	2.4
Average nominal wage	2.7	1.0	3.1
Average nominal wage in business sector	2.8	1.2	3.5
Current account deficit (ratio to GDP in per cent)	-2.4	-1.3	-0.5
M2	5.6	3.6	3.1

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)

	2012 actual	2013 forecast	2014 forecast
A. CURRENT ACCOUNT	-94.0	-50.0	-20.0
Trade balance	145.8	170.0	205.0
Balance of services	49.8	50.0	55.0
Income balance	-288.6	-270.0	-280.0
Current transfers	-1.0	0.0	0.0
B. CAPITAL ACCOUNT	51.7	80.0	78.0
C. FINANCIAL ACCOUNT a)	121.7	50.0	40.0
Direct investment	181.1	50.0	65.0
Portfolio investment	42.6	35.0	10.0
Financial derivatives	8.8		
Other investment	-110.8	-35.0	-35.0
D. ERRORS AND OMISSIONS	1.0		
E. CHANGE IN RESERVES (- = increase)	-80.5		

a) forecast excluding operations of banking sector and financial derivatives

TABLE II.2.4

FISCAL FORECAST

Continuing fiscal consolidation will lead to significant decline in the ratio of the general government deficit to GDP as from 2013
(% of nominal GDP)

	2012 actual	2013 forecast	2014 forecast
Government revenue	40.1	41.7	42.1
Government expenditure	44.5	44.1	44.2
of which: interest payments	1.5	1.5	1.6
GOVERNMENT BUDGET BALANCE	-4.4	-2.4	-2.2
of which:			
primary balance [a)]	-2.9	-0.9	-0.6
one-off measures [b)]	-1.5	-0.2	-0.2
ADJUSTED BUDGET BALANCE [c)]	-2.8	-2.2	-2.0
Cyclical component (ESCB method) [d)]	-0.4	-0.9	-0.8
Structural balance (ESCB method) [d)]	-2.4	-1.3	-1.1
Fiscal stance in pp (ESCB method) [e)]	1.1	1.1	0.1
Cyclical component (EC method) [d)]	-0.4	-0.7	-0.2
Structural balance (EC method) [d)]	-2.4	-1.5	-1.7
Fiscal stance in pp (EC method) [e)]	0.9	0.9	-0.3
Government debt	45.8	48.1	48.5

a) government budget balance minus interest payments
b) Impact of the pension reform included for economic reasons in 2013 and 2014.
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)

The future macroeconomic developments described above are reflected in the **government finance** outlook for 2013 and 2014 (see Table II.2.4). The fiscal forecast also takes into account this year's increases in the two VAT rates of 1 percentage point to 15% and 21% respectively, other budgetary consolidation measures adopted in 2011 and 2012 and taking effect at the forecast horizon, and the introduction of the second pillar of the pension system.

According to the **spring notifications** of government deficit and debt, the general government deficit amounted to 4.4% of GDP in **2012**. The overall deficit was significantly affected by the one-off accounting effect of financial compensation in church property restitutions totalling 1.5% of GDP. Financial corrections to several EU-funded operational programmes, which increase general government expenditure, contributed an additional 0.3% of GDP to the deficit. Adjusted for these factors, the government's consolidation efforts in 2012 were stronger than expected by the previous forecast, deepening the economic decline by about 0.6 percentage point. Tighter fiscal policy than assumed in previous forecasts consisted mainly in lower-than-expected gross fixed capital formation and better tax collection. The year-on-year increase in general government debt to 45.8% of GDP was caused by the need to finance the government deficit (adjusted for property settlement with churches) and by bond issues on top of the borrowing requirement totalling 1.8% of GDP.

The government deficit should fall to 2.4% of GDP in **2013** owing to consolidation measures[6] counteracted by a weaker effect of the contracting economy and the continuing labour market downturn. The forecast also expects a recovery in government investment connected with faster drawdown of EU funds and with the domestic component, and relatively subdued real government consumption. As a result of the stronger budgetary consolidation in 2012 than expected by the forecast, the fiscal restriction estimate in 2013 has been lowered slightly by comparison with the assumptions of the previous forecasts. This year the current forecast expects a negative contribution of fiscal policy to economic activity of around 0.6 percentage point, i.e. roughly at the previous year's level. The consolidation measures will affect the economy both through the price effect stemming from the increase in VAT and through lower nominal disposable income, with both factors reducing real household consumption.

A further decrease in the government deficit to 2.2% of GDP is expected in **2014**, owing chiefly to renewed growth in economic activity. On the one hand, the forecast takes into account the continuing effect of the consolidation measures adopted in 2012 (a smaller increase in

6 The consolidation measures adopted in 2012 will have a significant impact in 2013. An overview of these measures and their implications was given in the alternative forecast scenario in Inflation Report II/2012.

pensions and stagnation of state employees' salaries), but on the other hand their restrictive impact on economic growth will be offset by an expected more pronounced recovery in government investment. In 2014, therefore, the overall effect of fiscal policy will be broadly neutral.

The general government **structural deficit** was around 2.4% of GDP in 2012. In connection with the consolidation measures, it is expected to fall markedly below 2% of GDP in 2013–2014 (adjusted for the effect of the pension reform). The expected general government deficit will cause **general government debt** to increase to 48.5% of GDP in 2014. In addition to the expected borrowing requirements of general government owing to persisting public finance deficits, the prediction of this ratio reflects the assumption that the debt reserve created in 2012 will be maintained.

A potential weaker recovery in general government investment activity is a **risk to the fiscal forecast** towards lower deficits and a more restrictive effect of fiscal policy. The forecast also excludes the impact of a change currently being proposed by the government with regard to the implementation of the first stage of the Unified Revenue Collection Agency, which would shift the effect of some related measures from 2015 to 2014 and would have a slightly positive overall impact on the general government balance in 2014. There is also persisting uncertainty about the value of the fiscal multiplier (for details see the higher fiscal multiplier sensitivity scenario in Inflation Report IV/2012).

Chart II.3.1

CHANGE IN THE HEADLINE INFLATION FORECAST

The forecast for headline inflation has been revised downwards slightly this year and upwards slightly next year
(year on year in %; differences in pp – right-hand scale)

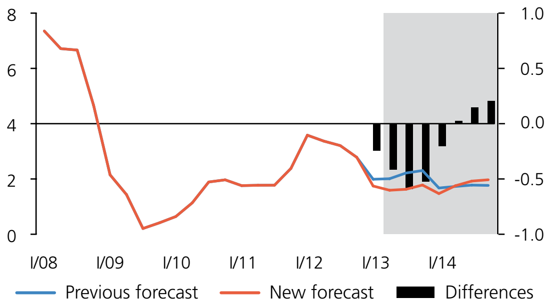


Chart II.3.2

CHANGE IN THE NET INFLATION FORECAST

The forecast for net inflation in 2013 has moved downwards
(year on year in %; differences in pp – right-hand scale)

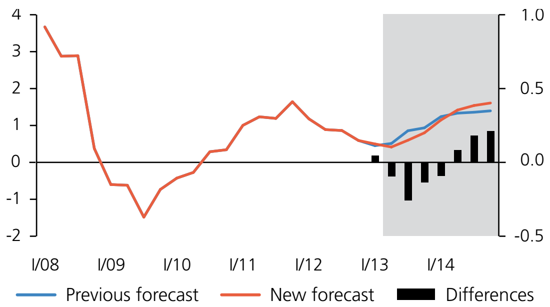
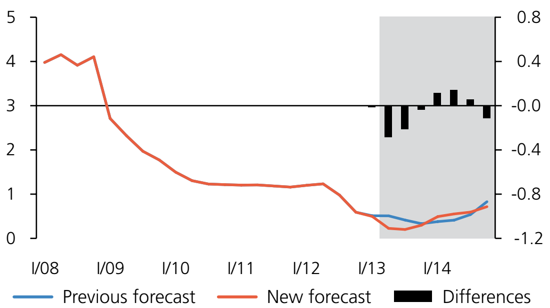


Chart II.3.3

CHANGE IN THE INTEREST RATE PATH

The market interest rate path is lower this year and slightly higher in 2014 on average
(3M PRIBOR in %; differences in pp – right-hand scale)



II.3 COMPARISON WITH THE PREVIOUS FORECAST

The forecasts for headline and monetary-policy relevant inflation in 2013 are lower than in the previous prediction owing to lower administered price inflation and net inflation. In the near future, the interest rate path falls below the previous forecast as a result of lower observed inflation and generally worse economic activity. In 2014, however, the difference in rates is negligible. The evolution of the koruna over the last three months and a worse outlook for net exports shift the exchange rate to weaker levels over the entire forecast horizon. The GDP growth forecast is lower as a result of weaker growth in external demand and expected more subdued domestic investment activity. The predicted growth rate of nominal wages in the business sector adjusted for the one-off effects of tax optimisation is little changed.

The forecast for annual **headline inflation** in 2013 is lower than the previous forecast (see Chart II.3.1). This change is due to lower predictions for net inflation and administered price inflation. By contrast, headline inflation in 2014 has been revised slightly upwards as a result of a marginally higher net inflation outlook, reflecting slightly higher household consumption. The assumptions regarding indirect tax changes remain almost the same as in the previous forecast, so the outlook for **monetary-policy relevant inflation** has changed in a similar way to that for headline inflation.

Expected **administered price inflation** in 2013 is markedly lower than in the previous forecast. The outlook for prices of natural gas, heat and electricity for households has been lowered significantly. Intensifying competition between suppliers of gas to households has led to an announced reduction of more than 10% in the commodity component of the gas price. These factors are supported by the transfer of formerly regulated rents to net inflation.

Compared to the previous forecast, the forecast for annual **net inflation** in 2013 has moved slightly lower (see Chart II.3.2). This is due to lower observed values at the start of this year, a lower short-term prediction for food price inflation and more subdued economic activity. These factors are only partly offset by higher adjusted inflation excluding fuels resulting from the transfer of regulated rents. By contrast, the net inflation forecast for 2014 is slightly higher, due among other things to an assumed more moderate restrictive effect of fiscal policy.

Turning to the **external environment** outlook, by comparison with the assumptions of the previous forecast, the 3M EURIBOR path has decreased slightly over the entire horizon. The expected growth rate of external demand also has decreased slightly over the entire horizon, and the same is true, to a negligible extent, of the foreign producer price outlook.

The forecast for domestic market **interest rates** is slightly lower in 2013 compared to the previous forecast; for most of 2014, by contrast, it is slightly higher (see Chart II.3.3). A more anti-inflationary initial state, reflecting more subdued economic activity, is fostering lower rates at the start of the forecast horizon. Lower rates are also being fostered by a lower administered price outlook and to a small extent also the short-term inflation prediction. In the longer run, the effect of the initial state disappears, whereas the external environment – especially a lower euro area market interest rate outlook – has a more pronounced downward effect (see Chart II.3.4). Counteracting the overall anti-inflationary impact of these factors is a decrease in the estimated effect of fiscal consolidation on overall economic activity and, at the shorter end of the forecast, a weaker short-term exchange rate prediction.

The forecast for the nominal **exchange rate of the koruna against the euro** has been revised to a weaker level at the start of the forecast horizon. The short-term forecast for 2013 Q2 takes into account the exchange rate depreciation until early April, which probably reflected the unfavourable evolution of the Czech economy and the CNB's communication regarding potential foreign exchange interventions (see Chart II.3.5). By comparison with the previous forecast, the exchange rate is at weaker levels over the entire horizon owing to the weaker initial level as well as a worse outlook for nominal net exports, which outweighs the effect of a lower foreign interest rate outlook at the longer end of the forecast.

The forecast for annual **GDP** growth is 0.2 percentage point lower for this year (see Chart II.3.6). This is due to a weaker external demand outlook, which leads to a decline in both exports and imports, and also more subdued investment activity. By contrast, household consumption growth has shifted towards less negative levels owing to a smaller expected impact of fiscal consolidation. The GDP forecast for 2014 is 0.3 percentage point lower as a result of an expected more gradual recovery in external demand and more subdued domestic investment activity, while fiscal policy has been revised from slightly restrictive to neutral.

The contribution of **net exports** to GDP growth will be lower at the start of this year, partly because of a temporary downturn in auto industry production related to the introduction of a new product line, which is also reflected in a short-term weakening of exports in this sector. The lower overall volumes of exports and imports also reflect weaker external demand. From the end of this year, more subdued import-intensive investment will also foster weaker import growth. The contribution of net exports to GDP growth in 2014 will also be slightly lower than in the previous forecast.

The forecast for average **nominal wage** growth in the business sector in 2013 is slightly lower than in the previous prediction. This is due mainly to a lower outlook for domestic economic activity and a higher estimate of tax optimisation in late 2012/early 2013 linked with the abolition of the cap on health insurance and additional taxation of higher income. This one-off factor will lead to a base effect contributing to slightly higher wage growth in 2014 compared to the previous forecast.

CHART II.3.4

DECOMPOSITION OF CHANGES IN THE INTEREST RATE FORECAST

Lower rates are being fostered in 2013 by the initial state, the administered price outlook and the short-term inflation prediction
(3M PRIBOR; percentage points)

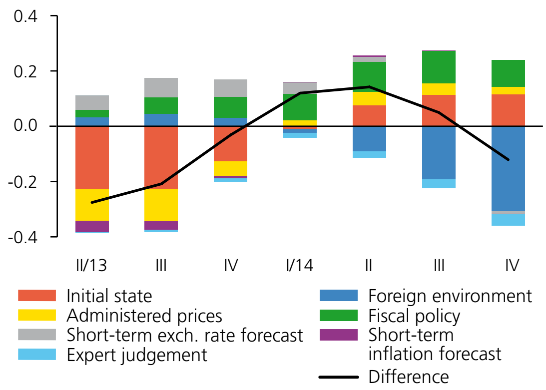


CHART II.3.5

CHANGE IN THE EXCHANGE RATE FORECAST

The exchange rate forecast has moved to weaker levels
(CZK/EUR; differences in CZK – right-hand scale)

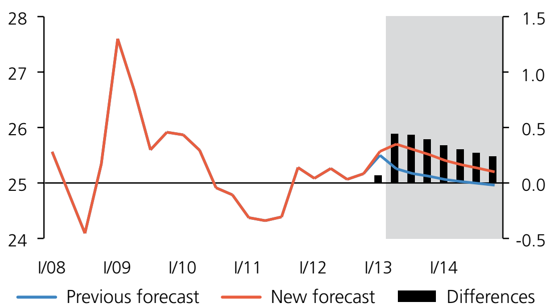
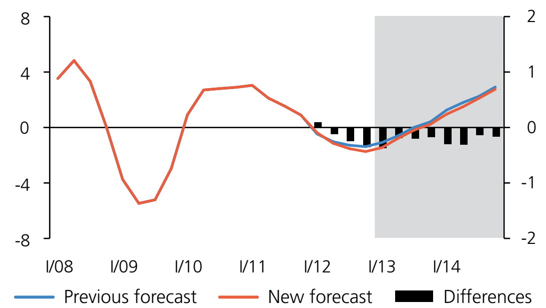


CHART II.3.6

CHANGE IN THE GDP FORECAST

The GDP forecast has been revised downwards slightly
(annual percentage changes; differences in pp – right-hand scale; seasonally adjusted)



II.4 ALTERNATIVE SCENARIOS AND SENSITIVITY ANALYSES

Several risks and uncertainties were identified during the preparation of the forecast. One risk is the potential less favourable evolution of effective external demand and the related current decline in oil prices. Another risk consists in the extent of tax optimisation and estimated wage growth in the business sector adjusted for this optimisation. A persisting uncertainty is the extent of fiscal consolidation measures and their impacts on the real economy. Household consumption and the saving rate also remain a source of uncertainty. However, these risks and uncertainties are not sufficiently clear-cut to lead to the preparation of an alternative scenario. An exchange rate sensitivity scenario was prepared as usual.

II.4.1 Exchange rate sensitivity scenario

The sensitivity scenario quantifies the impacts of a possible **different exchange rate path**. This standard sensitivity scenario assumes a deviation of the nominal exchange rate of ±3% from the forecast in the first quarter of the forecast. Interest rates in that quarter are the same as in the forecast. The exchange rate is thus CZK 26.5/24.9 to the euro in 2013 Q2, compared to CZK 25.7 in the forecast.

The table shows the results of the depreciation scenario, expressed as deviations from the forecast (see Table II.4.1). The scenario of a stronger nominal exchange rate leads to the same results but with the opposite sign.

Exchange rate depreciation improves exporters' price competitiveness and, via higher net exports, leads to higher GDP growth compared to the forecast at the start of the forecast horizon. It also results in higher import prices and temporarily higher inflation. The market interest rate path is therefore higher than in the forecast over the next few quarters. However, GDP growth then slows slightly below the forecast in response to tighter monetary policy and an exchange rate correction.

TABLE II.4.1

EXCHANGE RATE SENSITIVITY SCENARIO

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

	CPI inflation (in pp)	3M PRIBOR (in pp)	GDP growth (in pp)	Nominal exchange rate (CZK/EUR)
II/13	0.0	0.0	0.2	0.8
III/13	0.0	0.3	0.2	0.3
IV/13	0.1	0.3	0.2	0.1
I/14	0.2	0.3	0.1	0.0
II/14	0.2	0.1	-0.2	0.0
III/14	0.1	0.0	-0.3	0.1
IV/14	0.1	0.0	-0.2	0.1

II.5 FORECASTS BY OTHER ENTITIES

Analysts' inflation expectations fell just below the CNB's target of 2% at both the one-year and three-year horizons. The analysts expect GDP to be broadly flat this year. All the analysts were expecting stable key rates before the CNB Bank Board meeting in May. The majority of them also expect the koruna to appreciate slightly and the CNB's 2W repo rate as well as market interest rates to be flat in the following 12 months. The market rate outlook one year ahead also indicates expectations of stability and is slightly above the interest rate path consistent with the new CNB forecast over almost the entire forecast horizon.

Inflation expected by financial market analysts at the one-year horizon fell below the CNB's target in early 2013. The inflation expectations of business managers declined only marginally and remained roughly 0.5 percentage point above the CNB's target of 2% (see Table II.5.1). The analysts' inflation expectations at the three-year horizon fell just below the CNB's target.

The indicator of **inflation perceived by households** was slightly positive in early 2013 (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** is also positive, just above the level of perceived inflation. 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. However, both indicators fell in 2013 Q1.

Both the FMIE and CF analysts expect GDP to be broadly flat this year (see Table II.5.1 and Table II.5.2). Next year the economy should expand by almost 2%, and wage growth should also accelerate slightly. Compared to the average koruna exchange rate so far in April 2013, the analysts participating in both the FMIE and the CF expect the exchange rate to be stronger at the one-year horizon (by 2.5% and 2.2% respectively). Before the May CNB Bank Board meeting, all 13 analysts participating in the FMIE survey were expecting key interest rates to remain unchanged at this meeting and the monetary conditions not to be eased further using foreign exchange interventions. Most of the analysts also expect rates to remain flat at the current level at the one-year horizon. Their estimates for the 2W repo rate lie in the range of 0.05–0.25%.

In contrast to the CNB's new forecast, the analysts do not expect real GDP to decline markedly this year, although their estimates are being gradually revised downwards. Next year they expect the economy to grow at roughly the same pace as predicted by the CNB. Inflation expected at the one-year horizon is just below the CNB forecast. The exchange rate at the one-year horizon differs little from the CNB forecast. The analysts' expectations regarding the 2W repo rate and market rates at the one-year horizon are approximately at the level implied by the 3M PRIBOR path consistent with the new CNB forecast.

TABLE II.5.1

EXPECTED INDICATORS OF FMIE AND CORPORATIONS

The inflation expectations of analysts at the one-year and three-year horizon fell slightly below the CNB's target
(at 1Y; annual percentage changes unless otherwise indicated)

	12/12	1/13	2/13	3/13	4/13
FMIE:					
CPI	2.3	1.8	1.8	1.7	1.7
CPI, 3Y horizon	2.1	2.0	1.9	1.9	1.9
Real GDP in 2013	0.1	0.0	0.0	0.0	-0.1
Real GDP in 2014		1.7	1.7	1.7	1.7
Nominal wages in 2013	2.3	2.0	2.4	2.2	2.1
Nominal wages in 2014		2.6	3.0	2.9	2.9
CZK/EUR exchange rate (level)	24.9	25.0	25.1	25.1	25.2
2W repo rate (in per cent)	0.1	0.1	0.1	0.1	0.1
1Y PRIBOR (in per cent)	0.9	1.0	0.9	1.0	0.9
Corporations:					
CPI	2.5			2.4	

CHART II.5.1

PERCEIVED AND EXPECTED INFLATION

The inflation expectations of households decreased slightly in 2013 Q1
(source: European Commission Business and Consumer Survey)

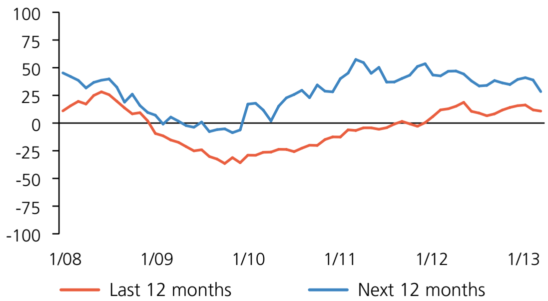


TABLE II.5.2

CF EXPECTED INDICATORS

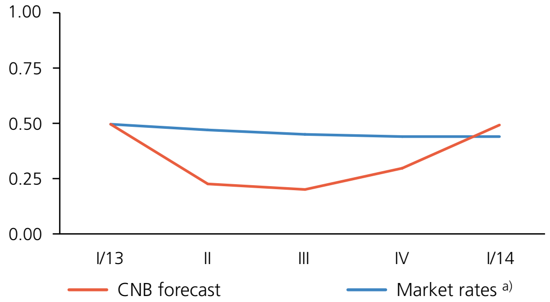
The CF analysts expect the economy to be broadly flat this year
(at 1Y; annual percentage changes unless otherwise indicated)

	12/12	1/13	2/13	3/13	4/13
Real GDP in 2013	0.3	0.3	0.1	0.0	-0.1
Real GDP in 2014		1.9	1.8	1.7	1.7
Nominal wages in 2013	2.4	2.4	2.4	2.3	2.1
Nominal wages in 2014		3.1	3.3	3.0	2.9
CZK/EUR exchange rate (level)	25.1	25.2	25.4	25.3	25.3
3M PRIBOR (in per cent)	0.5	0.5	0.5	0.5	0.5

CHART II.5.2

FRA RATES VERSUS THE CNB FORECAST

The FRA rate outlook is slightly higher than the rates consistent with the CNB forecast until the end of this year
(percentages)



a) for 2013 Q1 and 2013 Q2 the 3M PRIBOR and for 2013 Q3–2014 Q1 the average values of the FRA 3*6, 6*9 and 9*12 rates for the last 10 trading days as of 19 April 2013

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 for 3M rates implies broad stability until the start of next year, roughly in line with expectations of monetary policy rates being left at technical zero with an unchanged money market premium. The market outlook is slightly higher than the interest rate path consistent with the new forecast over almost the entire horizon.

III. CURRENT ECONOMIC DEVELOPMENTS

III.1 INFLATION

Headline annual inflation stood at 1.7% in March 2013 and was thus slightly below the CNB's target. At 0.9%, monetary-policy relevant inflation was just below the lower boundary of the tolerance band around the CNB's target. The further pronounced fall in annual inflation in 2013 Q1 was chiefly due to administered prices and a moderation of the first-round effect of changes to indirect taxes. Market price inflation rose slightly owing to rising food prices and a partial slowdown of the price decline in the segment of adjusted inflation excluding fuels. In an environment of economic decline, market price inflation remained low, however. Low growth in prices of imported consumer goods and falling oil prices also contributed to low market price inflation in 2013 Q1.

III.1.1 Fulfilment of the inflation target

Headline inflation was slightly below the CNB's target in 2013 Q1 (see Chart III.1.1), while monetary policy-relevant inflation was close to the lower boundary of the tolerance band around the target. 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 2013 Q1, we have to examine above all the period roughly from July 2011 to March 2012 (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/2011 forecast with subsequent inflation.

The **Inflation Report IV/2011 forecast** expected headline inflation to rise to just below 3% in 2012 owing to a VAT increase and to fall back below 2% in 2013 (see Chart III.1.1). Monetary-policy relevant inflation was expected to be slightly below the 2% inflation target over the entire forecast horizon. This was to be fostered by slower growth in economic activity and lower annual commodity price inflation. Administered prices and, in the longer run, gradually strengthening cost pressures from the domestic economy linked with a steady acceleration in wage growth and low labour productivity growth were initially expected to act in the opposite direction. The forecast predicted that these domestic inflationary pressures would be partly offset by gradual appreciation of the exchange rate and by the unwinding of commodity price growth, manifesting themselves mainly in lower annual food and fuel price inflation.

CHART III.1.1

FORECAST VERSUS ACTUAL INFLATION

Inflation was slightly above the IR IV/2011 forecast in 2013 Q1
(year on year in %)

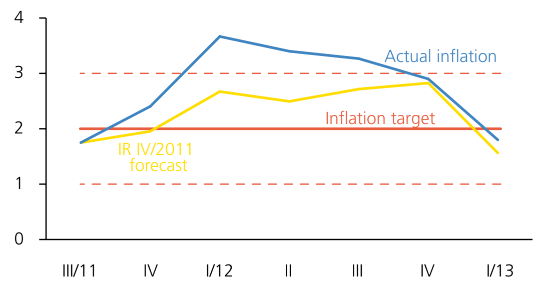


TABLE III.1.1

FULFILMENT OF THE INFLATION FORECAST

The first-round effects of indirect taxes increased inflation, while adjusted inflation excluding fuels was significantly lower than forecasted
(annual percentage changes; contributions in percentage points)

	IR IV/2011 forecast	2013 Q1 outturn	Contribution to total difference
CONSUMER PRICES	1.6	1.8	0.2
Breakdown into contributions:			
administered prices	2.9	3.5	0.1
first-round impacts of changes to indirect taxes[a)]	-0.2	0.7	0.8
food prices[b)]	1.8	3.0	0.2
fuel prices[b)]	-0.2	-1.5	0.0
adjusted inflation excl. fuels[b)]	1.4	-0.4	-0.9

a) impact in non-administered prices on total inflation
b) excluding the first-round effects of changes to indirect taxes

Table III.1.2

FULFILMENT OF THE EXTERNAL ASSUMPTIONS

External factors had a very slight upward effect on domestic inflation

(annual percentage changes unless otherwise indicated)

		IV/11	I/12	II/12	III/12	IV/12	I/13
GDP in euro area[a), b), c)]	p	1.8	1.2	1.2	1.4	1.6	1.9
	o	1.9	1.2	0.9	0.7	0.4	-
PPI in euro area[b), c)]	p	4.7	2.6	1.8	2.3	2.9	2.8
	o	5.1	3.8	2.3	2.2	2.1	1.4
3M EURIBOR	p	1.6	1.3	1.2	1.2	1.2	1.3
(percentages)	o	1.5	1.0	0.7	0.4	0.2	0.2
USD/EUR exchange rate	p	1.34	1.33	1.33	1.35	1.36	1.35
(levels)	o	1.35	1.31	1.28	1.25	1.30	1.32
Brent crude oil price	p	104.5	104.4	102.8	102.0	101.1	100.4
(USD/barrel)	o	109.3	118.7	108.7	109.9	110.5	112.8

p – prediction, o – outturn
a) at constant prices
b) seasonally adjusted
c) effective indicator as defined in the IR IV/2011 forecast

Table III.1.3

FULFILMENT OF THE FORECAST FOR KEY VARIABLES

Observed GDP growth was well below the forecast throughout the period

		IV/11	I/12	II/12	III/12	IV/12	I/13
3M PRIBOR	p	1.0	0.9	0.9	0.9	1.0	1.1
(percentages)	o	1.2	1.2	1.2	1.0	0.6	0.5
CZK/EUR exchange rate	p	24.8	23.7	23.2	22.9	22.7	22.6
(levels)	o	25.3	25.1	25.3	25.1	25.2	25.6
Real GDP[a)]	p	1.3	0.7	1.0	1.3	1.9	2.3
(annual perc. changes)	o	0.9	-0.4	-1.1	-1.5	-1.7	-
Nominal wages[b)]	p	3.5	3.7	3.9	4.3	4.5	4.6
(annual perc. changes)	o	2.6	3.4	2.3	1.3	4.2	-

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

Headline **inflation in reality** was above the forecast over the entire forecast horizon, deviating from it by 0.2 percentage point in 2013 Q1, although the forecast did not count on the increase in both VAT rates at the start of 2013. This difference was a result of opposite deviations of the individual components of inflation. The first-round effects of changes to indirect taxes, which increased headline inflation, were roughly offset by significantly lower adjusted inflation excluding fuels, which remained negative owing mainly to domestic anti-inflationary pressures. Administered price inflation and food price inflation were slightly higher than expected (see Table III.1.1).

External economic factors contributed significantly to domestic inflation. External economic activity showed a strong unexpected contraction compared to the forecast (see Table III.1.2). External production prices initially grew faster than expected, but their growth slowed and was below the forecast in 2012 H2. Oil prices were also higher than forecasted. Foreign interest rates reacted to the worse outlook for economic activity and were well below the expected path. The effect of external developments on domestic inflation was slightly inflationary overall.

Domestic **interest rates and the exchange rate** also differed from the forecast. Interest rates remained stable until mid-2012 and then went down. The exchange rate depreciated significantly at the end of 2011, chiefly as a result of the escalation of the euro area debt crisis. The koruna has stayed at weaker levels until now, among other things as a result of the deteriorating external demand outlook and the CNB's monetary policy and communication (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. Domestic GDP growth deviated increasingly from the forecast because of a stronger-than-expected decline in external demand growth and subdued domestic demand. The latter was affected by continuing domestic fiscal consolidation, the euro area debt crisis and the related uncertainty. Despite the easier domestic monetary policy and weaker koruna exchange rate, these factors were reflected in an unexpected fall in consumption and investment. The volumes of real exports and imports were much lower as well. Wage growth was also noticeably more subdued than forecasted. The comparison of the current data on the GDP growth structure with the forecast is also affected by substantial revisions to the national accounts.

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 in 2011 Q3, the Bank Board assessed the risks to the inflation forecast as being balanced or slightly on the downside and those relating to interest rates as being skewed towards significantly lower levels. In 2011 Q4, the risks to the forecast were tilted towards interest rate stability in the spirit of the alternative scenario (compared to a decline in rates in the baseline scenario), or slightly on the upside, according the Bank Board. In 2012 Q1, the risks to the forecast were assessed as being balanced. Market interest rates remained stable until mid-2012 and then decreased. They thus reflected a gradual change in the path consistent with the forecasts, which had at first predicted a gradual rise in market interest rates. In later forecasts, this rise was changed into rate stability or a modest decline. Headline inflation was slightly below the target in 2013 Q1 despite strong impacts of tax changes, while monetary-policy relevant inflation was close to the lower boundary of the tolerance band around the CNB's target. Almost all the identified risks materialised in the key period, with anti-inflationary risks prevailing overall. From this perspective, based on current knowledge, it seems that the monetary policy pursued between July 2011 and March 2012 should have been easier.

III.1.2 Current inflation

Annual inflation[7] decreased significantly further in 2013 Q1. At 1.7% in March, it was 0.7 percentage point lower than in December 2012 (see Chart III.1.2). This change was due mainly to administered prices and a moderation of the effect of indirect taxes in non-administered prices[8] (see Chart III.1.4).

Turning to the **structure of annual inflation**, however, inflation continued to be affected mainly by administrative factors, i.e. changes to indirect taxes and administered prices. Their share in overall annual consumer price inflation was roughly 75% (see Chart III.1.4).

Owing to an increase in both VAT rates of one percentage point at the start of this year and last year's increase in excise duties on cigarettes, changes to **indirect taxes** contributed about 0.7 percentage point to annual market price inflation in 2013 Q1. Their overall first-round effect on inflation including administered prices was roughly 0.8 percentage point. This, however, was much less than at the end of 2012, helping to slow headline inflation. January 2013 saw a further harmonisation increase in excise duties on cigarettes, although this has so far had only a negligible effect on consumer price inflation owing to frontloading by producers. **Monetary-policy relevant inflation**, i.e. inflation adjusted for the effects of all the changes to indirect taxes, stayed well below annual headline inflation as a result of the tax changes. In March it was 0.9% (see Chart III.1.2).

Annual **administered price inflation** slowed significantly in 2013 Q1. At 3.4% in March, it was almost one half lower than in December 2012 (see Chart III.1.3). This change was due mainly to a marked slowdown in

7 Measured by year-on-year growth in consumer prices.
8 The first-round effect of changes to indirect taxes in non-administered prices was 0.99 percentage point in 2012 Q4 and fell to 0.69 percentage point in 2013 Q1. The first-round effect of indirect taxes within administered prices fell from 0.28 percentage point to 0.13 percentage point in the same period.

CHART III.1.2

INFLATION

Inflation decreased further in 2013 Q1
(year on year in %)

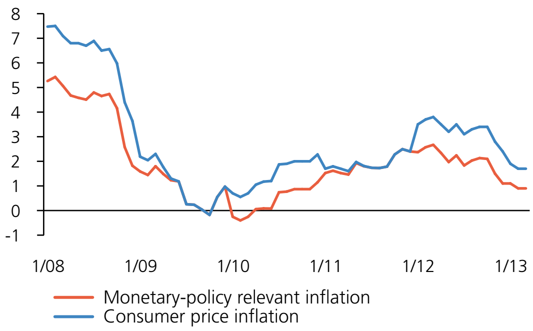


CHART III.1.3

INFLATION COMPONENTS

Administered prices contributed to the decrease in inflation
(annual percentage changes; excluding indirect tax changes)

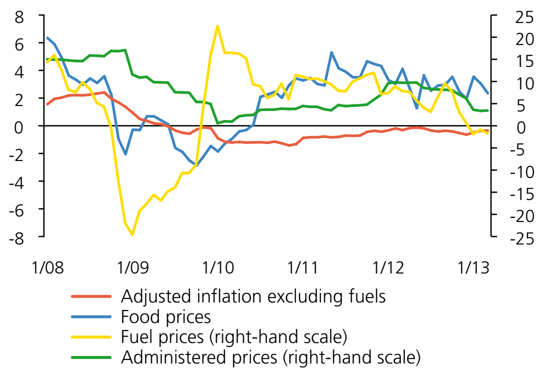


CHART III.1.4

STRUCTURE OF INFLATION

Administrative effects again contributed the most to inflation
(annual percentage changes; contributions in percentage points)

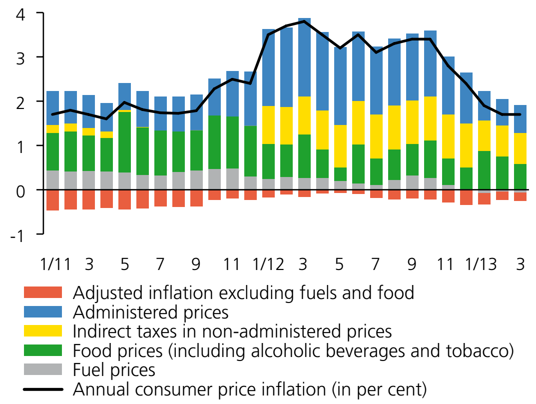


Chart III.1.5

FOOD PRICES

Food price inflation net of tax changes went up slightly in 2013 Q1
(annual percentage changes)

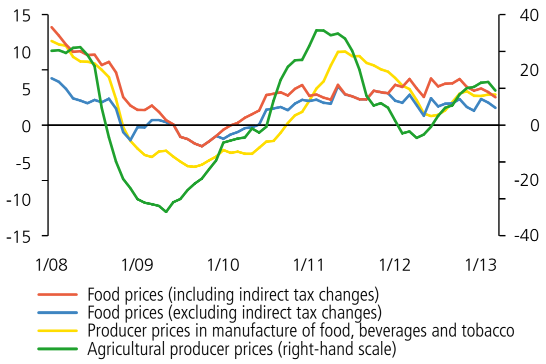
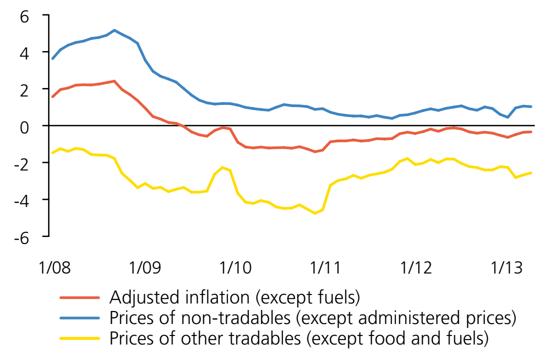


Chart III.1.6

ADJUSTED INFLATION EXCLUDING FUELS

Adjusted inflation excluding fuels turned less negative
(annual percentage changes)



annual growth in housing-related energy prices and to the completion of rent deregulation, which had had a relatively strong effect on administered price inflation in past years. At the start of 2013, this item was transferred within the consumer basket to market prices (adjusted inflation excluding fuels). Slower growth in housing-related energy prices was recorded for heat, electricity and natural gas for households, where prices were affected by growing competition between suppliers. The following text assesses the evolution of the main components of inflation adjusted for the tax changes.

By contrast, **market prices**, as measured by net inflation, again saw a slight rise in annual growth, although at very low levels (from 0.2% in December 2012 to 0.4% in March). The downward trend observed in the final months of 2012 was interrupted in early 2013 by a pick-up in annual food price inflation and partly also by the transfer of previously regulated rents to market prices. This was reflected in a slight reduction in the negative value of adjusted inflation excluding fuels. The effect of these factors was just marginally outweighed by annual fuel price inflation turning negative (see Chart III.1.6).

Despite a moderate rise, net inflation was low overall in 2013 Q1, suggesting a persisting effect of subdued economic activity. Low net inflation was also fostered by falling or only slightly rising import prices of final products for the consumer market, which, however, started to reflect the renewed year-on-year depreciation of the koruna against the euro in February 2013. A sharp decrease in oil price growth on world markets also had an effect.

The renewed increase in annual **food price inflation** in 2013 Q1 (from 2% in December to 2.4% in March; see Chart III.1.5) was due to last year's cost pressures arising from stronger annual growth in agricultural producer prices in crop production since 2012 H2. Turning to the individual food categories, a significant rise was recorded for consumer prices of vegetables and meat. However, their growth was outweighed by an almost 30% year-on-year fall in egg prices due to the high base in March 2012.

The effect of subdued domestic economic activity and low consumer demand was again most apparent in annual **adjusted inflation excluding fuels**, although it turned less negative in 2013 Q1 (from -0.6% in December to -0.3% in March; see Chart III.1.6). This change was due to the above transfer of the faster growing deregulated rents under market services prices (to the category of non-tradable commodities excluding administered prices). By contrast, the annual decline in prices of other tradable commodities excluding food and fuels deepened, mainly because of a double-digit fall in prices of mobile phones.

Fuel prices continued to be affected most of all by a noticeable fall in annual growth in global petrol prices. The weakening of last year's annual growth in fuel prices culminated in an annual decline in 2013 Q1 (-1.7% in March; see Chart III.1.3).

III.2 IMPORT PRICES AND PRODUCER PRICES

Import prices fell in the first two months of 2013 Q1, especially in the case of energy and non-energy commodities and semi-finished products, owing to a decline in commodity prices on global markets. Industrial producer price inflation declined gradually, mainly as a result of weakening world oil price growth, and was only moderate. By contrast, annual agricultural producer price inflation remained high owing to a significant rise in crop product prices. Construction work prices continued to fall amid low demand, while market services prices recorded a significantly slower annual decline and fluctuated around zero.

III.2.1 Import prices

Import prices continued to fall year on year in January and February 2013, recording an annual decline of 0.5% in February (see Chart III.2.1). This was mostly due to import prices of raw materials and semi-finished products (see Chart III.2.2), reflecting the decline in prices of key commodities on world markets.

Import prices were affected most of all in the period under review by the high-weight import prices of **mineral fuels**. In November 2012 these had still been rising at a rate of 6%, but in January they recorded a year-on-year decline, which deepened further to -4% in February. This was due mostly to the unwinding of the surge in dollar oil prices amid a strengthening decline in natural gas prices on world markets. The koruna-dollar exchange rate also played a role in the low annual inflation dynamics in this import category in late 2012/early 2013 (see Chart III.2.3).[9] The contribution of import prices of mineral fuels to overall annual import price inflation was thus negative in January and February, at -0.6 percentage point.

An annual decline in import prices of **non-energy commodities** has been observed since May 2012. In February 2013 it reached almost 8%. The continuing fall in import prices of **semi-finished products** was noticeably more moderate than in the case of non-energy commodities and did not exceed 2% in the first two months of 2013 (see Table III.2.1).

The contribution of **food** import prices to overall import price inflation remained positive in January and February 2013, although their growth is gradually slowing (to 3.3% in February) owing to the evolution of global prices of agricultural commodities and the exchange rate. Import prices of animal and vegetable oils and chemicals and related products also saw lower growth.

9 The koruna-dollar exchange rate appreciated year on year in December 2012 and January 2013 (by 0.8% and 2.9% respectively) and depreciated slightly in February (by 0.8%).

CHART III.2.1

IMPORT PRICES AND PRODUCER PRICES

Import prices fell in 2013 Q1, industrial producer prices went up only slightly and agricultural producer price inflation remained high

(annual percentage changes)

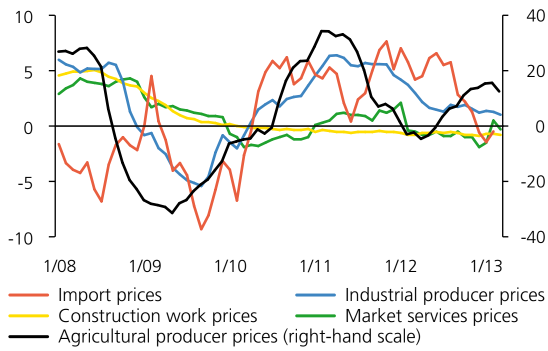


CHART III.2.2

IMPORT PRICES

Energy and non-energy commodities contributed the most to the fall in import prices

(annual percentage changes; contributions in percentage points)

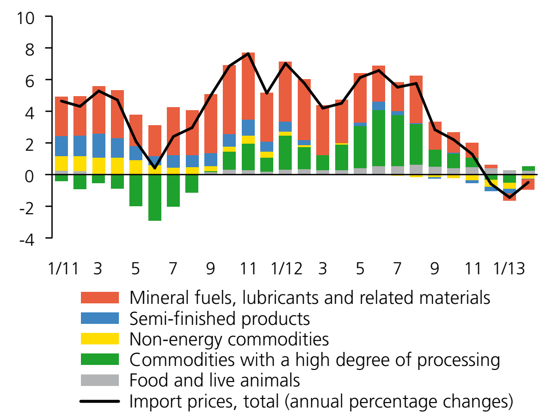


CHART III.2.3

MINERAL FUELS

Prices of imported mineral fuels and lubricants are going down, mainly because of falling prices of oil and natural gas

(annual percentage changes)

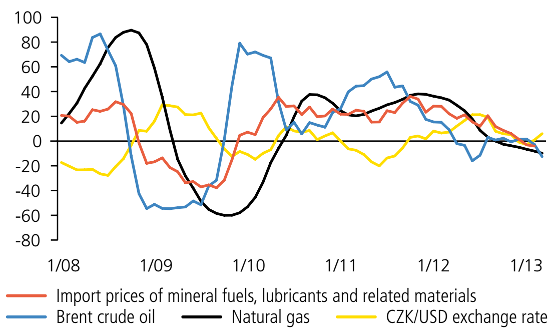


TABLE III.2.1

STRUCTURE OF IMPORT PRICE INFLATION

The number of categories with rising prices dominated, but with a smaller effect on the import price index
(annual percentage changes)

	11/12	12/12	1/13	2/13
IMPORTS, TOTAL	1.3	-0.6	-1.4	-0.5
of which:				
food and live animals	8.0	6.6	4.5	3.3
beverages and tobacco	8.5	7.6	5.4	8.3
crude materials inedible, except fuels	-10.7	-12.9	-11.0	-7.6
mineral fuels and related products	6.0	1.4	-3.1	-4.0
animal and vegetable oils	4.2	3.3	2.8	1.6
chemicals and related products	2.6	2.1	0.3	0.3
manufactured goods classified chiefly by material	-0.8	-1.7	-1.6	-0.2
machinery and transport equipment	0.9	-1.2	-1.3	0.3
miscellaneous manufactured articles	-0.8	-1.5	-1.0	1.0

CHART III.2.4

INDUSTRIAL PRODUCER PRICES

Industrial producer price inflation was only moderate in 2013 Q1, but prices of electricity and food went up
(annual percentage changes; contributions in percentage points)

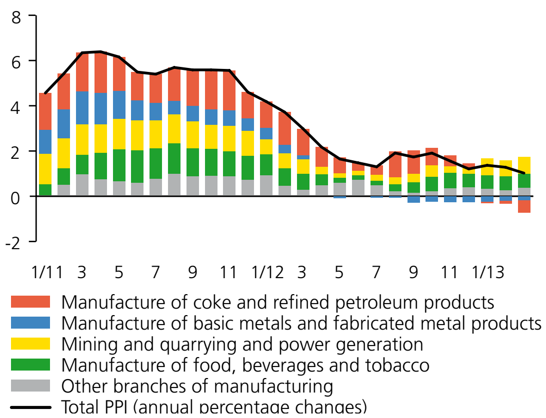
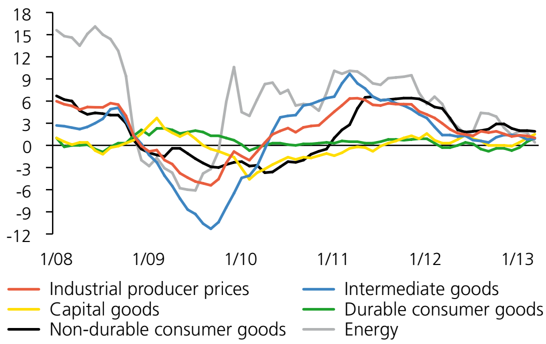


CHART III.2.5

PRODUCER PRICES BY MAIN INDUSTRIAL GROUPINGS

Prices of capital goods and durable goods recorded faster growth, but inflation in other categories moderated
(annual percentage changes)



The growth rate of import prices of **high-value-added commodities**[10] has also been decreasing gradually since 2012 Q3 thanks to a combination of the unwinding of the year-on-year depreciation of the koruna-euro exchange rate and a decline in inflation abroad in an environment of generally subdued demand. This resulted in lower import prices of machinery and transport equipment and miscellaneous manufactured articles at the end of 2012 and in January 2013 (see Table III.2.1). Their return to modest growth in February was due to the renewed year-on-year depreciation of the koruna-euro rate in early 2013.

III.2.2 Producer prices

Industrial producer prices

Industrial producer price inflation continued to fall slightly in 2013 Q1, reaching 1% in March. As in the previous quarter, this was due above all to producer prices in the manufacture of coke and refined petroleum products (see Chart III.2.4).

The fundamental view of the causes and **structure of industrial producer price inflation** is essentially unchanged from the previous quarter. The continuing slowdown was mainly due to an unwinding of the strong annual growth in global oil prices and their subsequent decline. This – coupled with the koruna-dollar exchange rate – fed through to producer prices in the primary oil processing sector (see Chart III.2.5). The decrease in producers' costs also continued to be fostered by sharply falling prices of imported non-energy inputs and prices in mining and quarrying. A renewed rise in domestic energy prices acted in the opposite direction. Growth in food industry prices remained more or less at the previous quarter's elevated level owing to rising prices of agricultural inputs. Given the persisting low demand and weakening growth in prices of most of the main production inputs, the other branches of manufacturing mostly recorded only modestly rising or falling prices.

Owing to the above evolution of dollar oil prices and the koruna-dollar exchange rate, producer prices in the **manufacture of coke and refined petroleum products** switched to a decline in 2013 Q1 (from 2.4% in December 2012 to -6.2% in March in year-on-year terms). The contribution of this industry to overall annual industrial producer price inflation thus decreased to -0.5 percentage point in March (see Chart III.2.4). Producer prices in the **manufacture of basic metals and fabricated metal products** have been falling at a broadly stable annual rate of about 2% since September 2012. Producer price inflation in the **food industry** remained at around 4%, largely because of fast growing prices of crop production inputs, whereas growth in prices of livestock products moderated.

10 This category contains machinery, transport equipment and miscellaneous manufactured articles. Their prices are affected mainly by the koruna-euro exchange rate, which depreciated by 1.7% year on year in February.

Inflation in the **electricity, gas and steam supply industry** went up again in 2013 Q1 (to 3.7% year on year in March). By contrast, prices in mining and quarrying have been falling since April 2012, mainly as a result of a significant decline in coal prices on world markets. Price growth in the water supply and sewerage-related services industry slowed noticeably compared to the previous quarter, but remained high (5.7% in March).

Annual producer price inflation in the **other branches of manufacturing**, comprising the manufacture of high-value-added products, slowed somewhat in 2013 Q1 (see Chart III.2.4). This was largely due to a marked decrease in prices in the chemical and pharmaceutical industry. Other industries saw a gradual weak rise in price growth[11] or a slowing price decline.[12] Amid persisting low demand, however, their annual growth was generally moderate.

Agricultural producer prices

The upward trend in **agricultural producer price inflation**, which started in mid-2012, continued into the first two months of 2013 Q1. In March, the annual growth in these prices moderated somewhat to 12.5%. The still strong rise in agricultural producer prices was due mainly to prices in the crop production category, whose growth rate exceeded 30% in February 2013 and fell only slightly to 27% in March. By contrast, price growth in the higher-weight livestock production category slowed considerably and turned negative in March.

The **main factors** underlying the surge in agricultural producer price inflation in 2012 H2 were adverse weather and resulting below-average harvests in major world producers – notably the USA, Australia and Europe. The weak harvest, together with persisting growth in demand, caused a decrease in global stocks of agricultural commodities. The 2012 harvest in the Czech Republic was also one of the lowest in ten years, down by about 20% from 2011. For most of 2012 and in early 2013, domestic inflation was also affected by a slightly weaker exchange rate of the koruna against both the euro and the dollar. In addition, annual growth in prices of livestock production was affected by the impact of a jump in egg prices in the previous year due to a change in the veterinary rules in the EU, which is now fostering a year-on-year decrease in prices.

Other producer prices

Amid persisting low construction investment demand, **prices of construction work** continued to show an annual decline in 2013 Q1 (of 0.8% in March; see Chart III.2.8). Prices of materials and products consumed in construction showed only modest growth in the same period.

11 This pertained to electrical equipment, machinery and equipment and transport equipment.
12 The decline in prices slowed in the manufacture of textile and clothing, computer, electronic and optical equipment.

CHART III.2.6

PRICES OF METALS AND REFINED PETROLEUM PRODUCTS

Coke and refined petroleum product prices started to fall owing to a decline in import prices of energy commodities
(annual percentage changes)

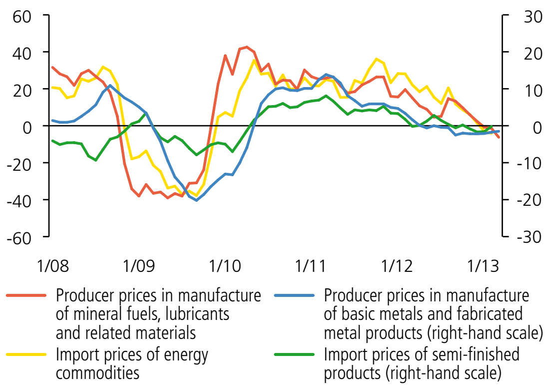


CHART III.2.7

AGRICULTURAL PRODUCER PRICES

Agricultural producer price inflation remained at high levels in 2013 Q1
(annual percentage changes)

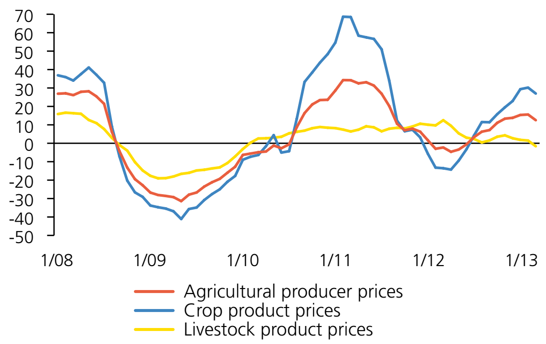
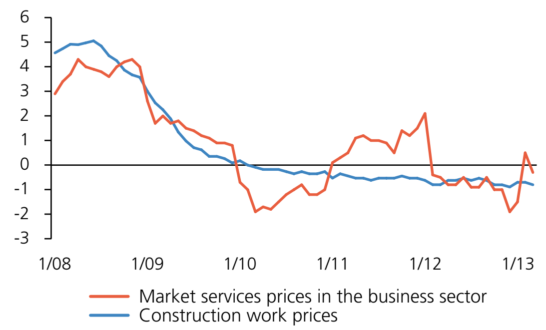


CHART III.2.8

OTHER PRICE CATEGORIES

Prices of construction work continued to decline, while prices of market services fluctuated around zero
(annual percentage changes)



The annual decline in prices of market services moderated significantly in 2013 Q1, and February even saw a temporary modest increase. This change was due largely to prices of advertising services and market research, which recorded a strong annual decline in January, but rose year on year in February and March 2013 (by 5.5% in March). Adjusted for this effect, market services prices would have continued to decline (by 0.8% in March). Prices of architectural and engineering services followed a similar trend, but with less intensity. In 2013 Q1, falling prices were recorded in about half of the market services categories, and most of all in transport and storage. The other branches under review saw continuing slight growth in prices (below 2%).

III.3 DEMAND AND OUTPUT

The year-on-year decline in real GDP deepened further in 2012 Q4 (to -1.7%).[13] In quarter-on-quarter terms, GDP declined by 0.2%. The year-on-year decline was due to household consumption and gross fixed capital formation. By contrast, change in inventories, government consumption and net exports (with export growth slightly exceeding import growth) made positive contributions to economic growth. On the supply side, positive contributions to GDP growth came only from some services. In manufacturing, by contrast, value added decreased year on year for the second consecutive quarter. The estimated output gap continued to open into negative values.

III.3.1 Domestic demand

The year-on-year decline in **domestic demand** slowed significantly in 2012 Q4. This was mostly due to higher additions to inventories compared to the previous quarter. The contribution of government consumption was also slightly positive again after a long-running decline (see Chart III.3.2). Their positive effect on the change in domestic demand growth was only partly offset by a marked deepening of the year-on-year decline in fixed investment and, to a lesser extent, household consumption.

Final consumption

The year-on-year decline in **household consumption** deepened slightly further in 2012 Q4 (to -4.1%; see Chart III.3.3).[14] The sharp annual decline in household final consumption expenditure testified to a persisting effect of the continuing fiscal consolidation, rising unemployment and persisting considerable uncertainty surrounding future economic developments.

Contrary to expectations, the previous weakening growth in **nominal gross disposable income** accelerated again year on year (from 0.3% in 2012 Q3 to 1.9% in Q4). The **real purchasing power**[15] of gross disposable income rose slightly (by 0.2% year on year; see Chart III.3.3) thanks to rising nominal disposable income growth and lower annual inflation. Nonetheless, the year-on-year fall in the real final consumption expenditure of households deepened slightly further.

A closer look at the **structure** of nominal gross disposable income shows that the acceleration of its annual growth in 2012 Q4 was chiefly due to a marked increase in **wages and salaries** (see Chart III.3.4). This – probably one-off – change was due to a time

13 The assessment of GDP expenditure and sources is based on seasonally adjusted data from the quarterly national accounts.
14 In quarter-on-quarter terms, however, household consumption increased by 0.9%.
15 As measured by the household consumption deflator.

CHART III.3.1

GROSS DOMESTIC PRODUCT

The year-on-year decline in GDP deepened further in 2012 Q4
(annual and quarterly percentage changes at constant prices; seasonally adjusted data)

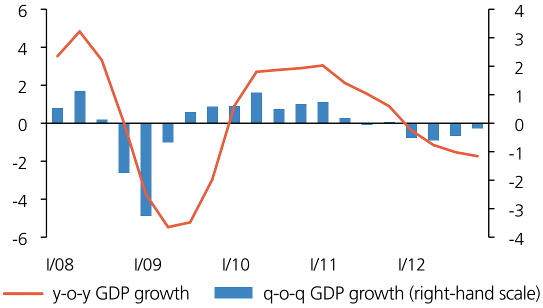


CHART III.3.2

STRUCTURE OF ANNUAL GDP GROWTH

The positive contributions of inventories, net exports and government consumption to GDP growth were outweighed by declines in the other components of domestic demand
(contributions in percentage points; seasonally adjusted data)

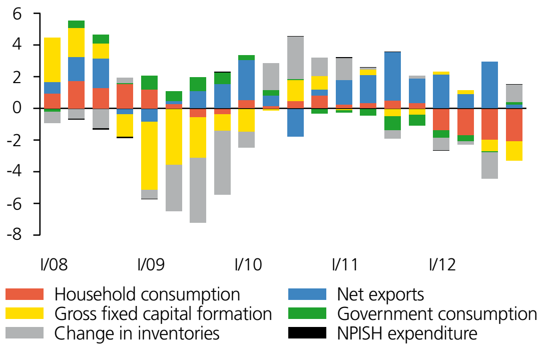


CHART III.3.3

HOUSEHOLD CONSUMPTION EXPENDITURE

Real household expenditure continued to fall sharply
(annual percentage changes)

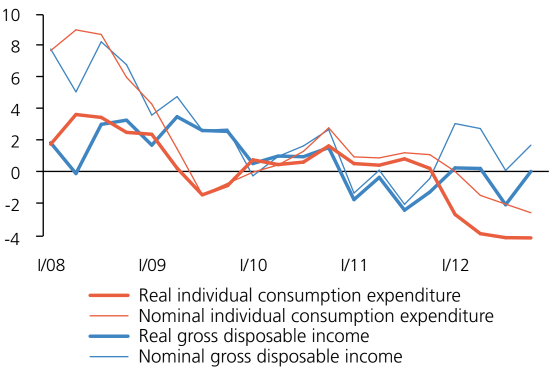


CHART III.3.4

DISPOSABLE INCOME

Nominal gross disposable income growth accelerated again after a previous slowdown

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

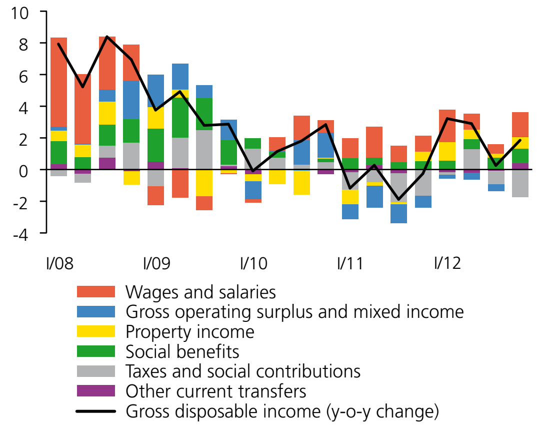


CHART III.3.5

STRUCTURE OF HOUSEHOLD CONSUMPTION

Households continued to cut their spending on non-durable goods and services

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

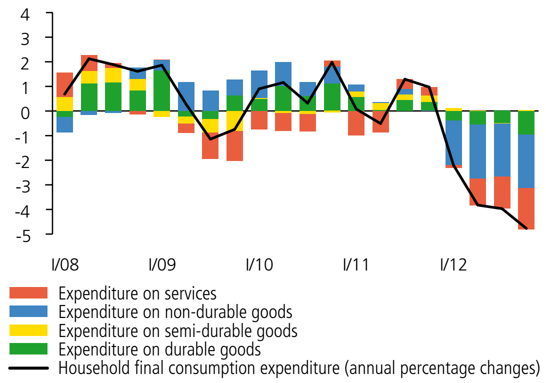
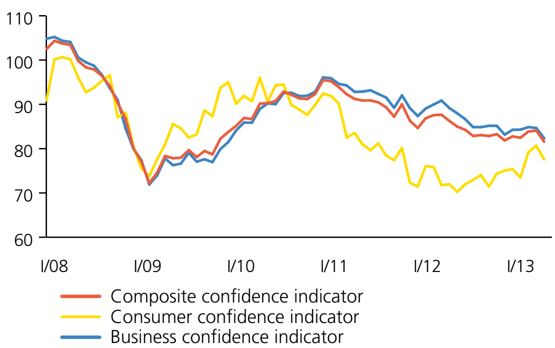


CHART III.3.6

CONFIDENCE INDICATORS

Consumer confidence fell again and remains at a low level

(2005 average = 100; source: CZSO)



shift of extraordinary bonus payments for 2012 in some industries from 2013 Q1 to the end of 2012 because of tax optimisation.[16] The pick-up in nominal disposable income growth in Q4 was fostered to a lesser extent also by property income and social benefits. An improvement was also recorded for the relatively high-weight business income (gross operating surplus and mixed income), which was flat in 2012 Q4 after having declined year on year for seven quarters. Only a year-on-year rise in taxes and social contributions counteracted the growth in households' disposable income.

The downward trend in consumption expenditure amid a modest real increase in gross disposable income (see Chart III.3.3) indicated a persisting increased propensity of households to save. The **gross saving rate of households** fell slightly in Q4 compared to the start of 2012, when it had risen considerably (to just below 13%),[17] but remained noticeably higher than in previous years (12.8%; see Chart II.2.18 in section II.2). This again suggests that households strongly perceive the persisting uncertainty on the labour market and the expected further restrictive fiscal measures (particularly the increase in both VAT rates at the start of 2013) and are trying to set aside financial reserves.

The increased caution of households during the recession was also evidenced by continuing only weak **consumer credit** growth in 2012 Q4 (see section III.5.2) and ongoing changes in the structure of household consumption expenditure. According to the latest CZSO data, households' expenditure on all **consumer goods and services** except semi-durable goods decreased again in 2012 Q4 (see Chart III.3.5). The decline in expenditure on non-durable and durable goods and services gradually deepened in 2012.

The latest available **leading indicators** from the start of 2013 are sending a mixed message. Retail sales are still falling (by 1.7% in February), but this decline is concentrated in the automotive segment, whereas sales in the non-motor-vehicle segment fluctuated around a zero rate of growth in January and February according to seasonally adjusted data. After having risen modestly in the preceding months, the consumer confidence indicator fell again in April and thus remains at a low level (see Chart III.3.6). The expectations regarding unemployment are still high and the economic outlook has worsened again after a previous improvement.

In 2012 Q4, after eight quarters of decline, real **government final consumption expenditure** recorded modest year-on-year growth (of 0.8%).

16 For details see section III.4 *The labour market*.

17 According to seasonally adjusted national accounts data.

Investment

Investment remained subdued in 2012 Q4 amid persisting considerable uncertainty among both households and corporations regarding future economic developments and amid continuing fiscal consolidation (see Chart III.3.7). According to seasonally adjusted data, the year-on-year decline in **fixed investment** deepened to -5% in 2012 Q4.

Turning to **sectors**, the year-on-year decline in fixed investment was due to households and government (see Chart III.3.7), where investment activity has long been affected by low household confidence and by the behaviour of general government (see below). Year-on-year investment growth in the **non-financial corporations sector** weakened significantly in 2012 H2 and its contribution to the overall year-on-year change in fixed investment in Q4 was insignificant. This was reflected in only modest growth in investment in machinery and equipment and a decline in the other categories of fixed investment (see Chart III.3.8). The latest business survey conducted by the CNB and the Confederation of Industry in March signals a continuation of this trend in 2013 H1. This is consistent with the unfavourable outlook for business orders. The positive contribution of the other sectors under review – **financial institutions** and the non-profit sector – to investment growth was negligible.

Investment in the **household sector** fell by 6.4% year on year in 2012 Q4. This was mostly due to investment in dwellings, which recorded a year-on-year decline of 5% (see Chart III.3.8). Uncertain prospects for economic growth and employment were again the main cause of the persisting weak demand for investment in dwellings. In line with this, growth in new mortgage loans was subdued (see section III.5.2). The latest available leading indicators do not yet indicate any noticeable recovery in demand for dwellings in the period ahead – the numbers of housing starts are falling significantly (by 8.5% year on year), growth in mortgage loans is weakening and household confidence is still low despite having increased in early 2013.

The long-running decline in fixed investment in the **government sector**, reflecting problems with the drawdown of EU funds and general government austerity measures, continued into 2012. In Q4, government fixed investment fell by 20.2% year on year.

The positive contribution of **changes in inventories** to GDP growth increased in 2012 Q4 (to 1.1 percentage points; see Chart III.3.2). The increase in additions to inventories was probably linked with unrealised expected business opportunities abroad, as export growth fell significantly compared to the previous quarter. According to the latest business survey conducted by the CNB and the Confederation of Industry in March, there was a marked decline in the year-on-year change in inventories in 2013 Q1, indicating that businesses will draw on their existing stocks in this quarter and reduce their additions to inventories and purchases of new inventories given the gloomy demand outlook.

CHART III.3.7

INVESTMENT BY SECTOR

Investment went down in most of the monitored sectors
(annual percentage changes; contributions in percentage points; constant prices)

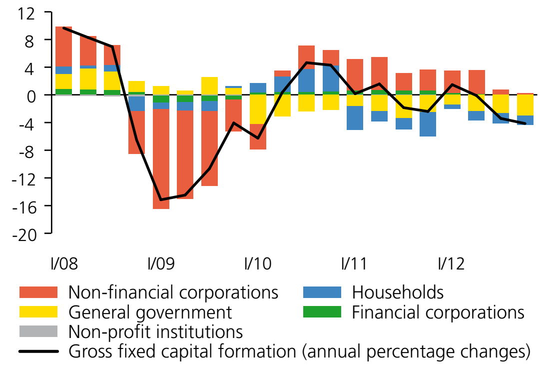


CHART III.3.8

FIXED CAPITAL FORMATION

Fixed investment declined in all categories except other machinery and equipment
(annual percentage changes; contributions in percentage points; constant prices)

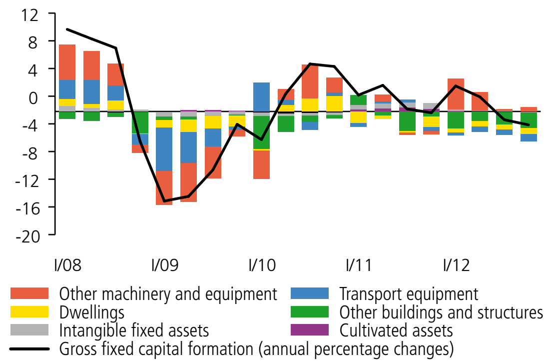


CHART III.3.9

INVESTMENT IN DWELLINGS

Investment in dwellings continued to decline significantly
(annual percentage changes)

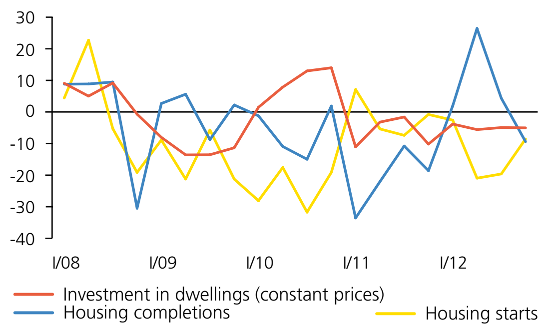


CHART III.3.10

NET EXPORTS

Net exports increased only modestly year on year in 2012 Q4
(sesonally adjusted data; constant prices)

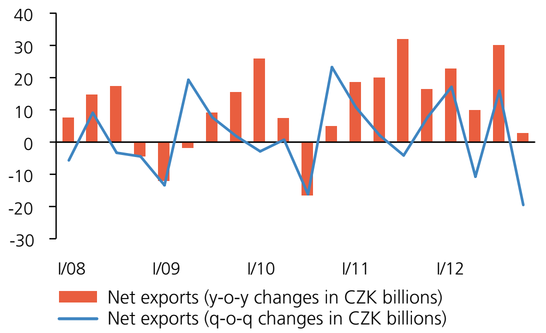


CHART III.3.11

EXPORTS AND IMPORTS

Foreign trade turnover slowed significantly in 2012 Q4, but exports continued to rise somewhat faster than imports
(annual percentage changes; percentage points; constant prices; seasonally adjusted data)

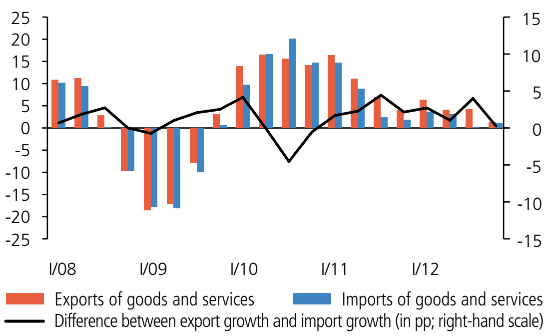
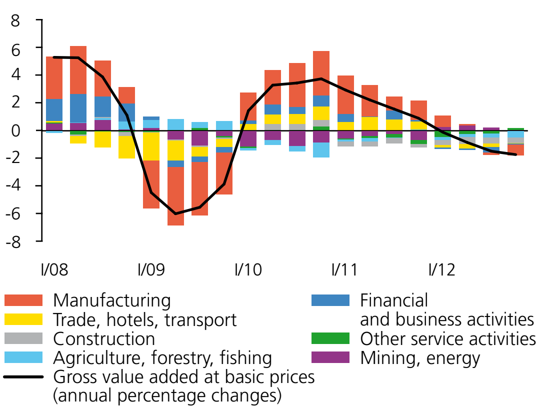


CHART III.3.12

CONTRIBUTIONS OF BRANCHES TO GVA GROWTH

Gross value added continued to decline in 2012 Q4
(contributions in percentage points; annual percentage changes)



III.3.2 Net external demand

Following a sizeable increase in 2012 Q3, **net exports of goods and services**[18] continued to rise year on year in 2012 Q4, but at a much slower rate. The net export surplus was CZK 80.6 billion, which meant a modest year-on-year increase of just under CZK 3 billion. In quarter-on-quarter terms, however, net exports decreased by almost CZK 20 billion (see Chart III.3.10). As in the previous two quarters, the year-on-year growth in net exports was due solely to the trade surplus, as the services surplus fell for the third consecutive quarter. As in the previous eight quarters, the contribution of net exports to GDP growth was positive in 2012 Q4, but fell noticeably to 0.2 percentage point (see Chart III.3.2).

The marked slowdown in annual net export growth was connected with a further weakening of total foreign trade turnover accompanied by a marked decline in the lead of export growth over import growth (to 0.3 percentage point; see Chart III.3.11). **Total exports** rose by only 1.4%, their year-on-year growth rate falling by 2.9 percentage points from the previous quarter. The dynamics of total exports reflected only modest external demand growth in the Czech Republic's major trading partner countries. The slowdown in total export growth manifested itself in more modest growth in goods exports, while growth in exports of services slowed only slightly.

Total imports went up by 1.2% year on year in 2012 Q4, i.e. by 0.9 percentage point more than in the previous quarter (see Chart III.3.11). This very modest annual growth overall was a result of not only the persisting weak domestic demand, but also external demand owing to the high import intensity of Czech exports. In addition to goods imports, continuing growth in services imports contributed to total import growth.

III.3.3 Output

In an environment of weakening domestic and external demand, the annual decline in **gross value added** at basic prices deepened further in 2012 Q4 (to -1.7%; see Chart III.3.12). The weak demand affected the output of different branches with different intensity. Only some services made positive contributions to annual growth in gross value added.

In **manufacturing**, whose production is largely exported, gross value added fell for the second consecutive quarter. Its year-on-year decline deepened further in 2012 Q4 (to -3.4%), while gross value added in the other industrial branches[19] was flat. Overall, the contribution of industry to annual growth in gross value added was negative in Q4 and deepened to 0.8 percentage point (see Chart III.3.12).

18 At 2005 prices, seasonally adjusted.
19 The mining and quarrying and energy supply sectors.

Annual growth in gross value added in industry weakened further amid a real decline in **industrial production**, which strengthened significantly in Q4 to -4.6% (see Chart III.3.13).[20] Only some branches – supporting activities in mining, the manufacture of electrical equipment and particularly the manufacture of chemicals, chemical products and man-made fibres – maintained production growth. Unlike in previous quarters, annual growth in production was also recorded in some other, lower-weight branches (the textile industry in particular). However, output continued to decline year on year in most branches of industry in 2012 Q4.[21] The year-on-year decline in industrial production was again largely due to the manufacture of motor vehicles, trailers and semi-trailers, where the decline in output deepened further (to 4.9%).

The effect of low domestic and external demand on industrial production was reflected in a shift of annual growth in direct exports **sales** (at current prices) and domestic sales[22] into negative territory.

According to seasonally adjusted data, industrial production declined year on year in the first two months of 2013 Q1, although the amount of industrial production has been edging up since the end of 2012 (see Chart III.3.13). According to the April results of the CZSO's business survey, the effect of insufficient demand as a **barrier to growth in industry** increased further, although the number of corporations perceiving no barriers to growth has recently increased slightly (see Chart III.3.14). **Production capacity utilisation** increased according to the April CZSO survey. However, a further deepening of the annual decline in **new industrial orders** in February 2013 – both from the Czech Republic and abroad – does not currently indicate any improvement in the conditions for growth in industrial production in the period ahead (see Chart III.3.15).

As in the previous quarter, only **trade and services** made a slightly positive contribution (0.1 percentage point) to total annual growth in gross value added in 2012 Q4. This was due to a positive contribution from mostly non-market services, i.e. public administration, defence, education, health and social care, and scientific, technical and administrative activities, which was, however, almost fully offset by a decline in value added in market services.[23] According to the CZSO's latest February data, the still declining retail sales and low consumer confidence do not currently indicate that wholesale and retail trade will make any noticeable contribution to value added growth in the first quarter of 2013.

In **construction**, which has long been strongly affected by the downturn in demand, the annual decline in gross value added remained at the previous quarter's level in 2012 Q4 (-4.8%; see Chart III.3.11).

20 According to seasonally adjusted data.
21 Output fell in around 60% of the branches monitored.
22 Domestic sales also include indirect exports through non-industrial corporations.
23 Value added decreased most of all for real estate activities (by 6.7% year on year), while declining only moderately in the other branches.

CHART III.3.13

INDUSTRIAL PRODUCTION

The seasonally adjusted volume of industrial production increased slightly in early 2013
(basic index; year 2010 = 100)

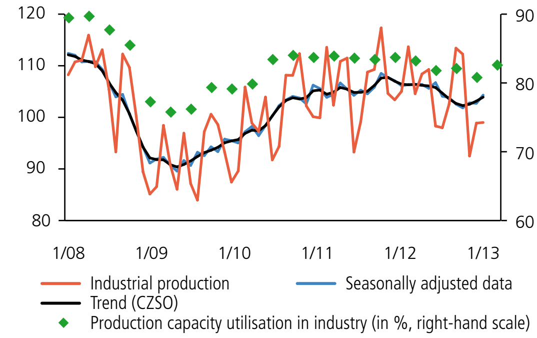


CHART III.3.14

BARRIERS TO GROWTH IN INDUSTRY

The effect of insufficient demand as the main barrier to growth in industrial production continued to increase
(percentages)

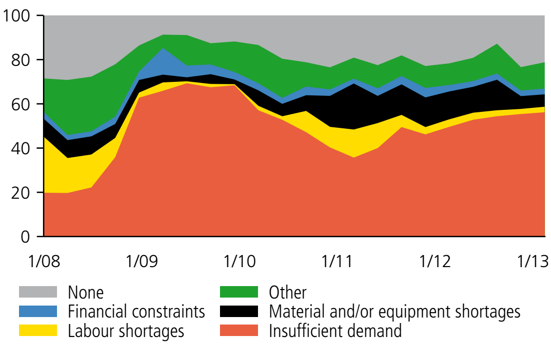


CHART III.3.15

NEW ORDERS IN INDUSTRY

New industrial orders fell sharply
(annual percentage changes)

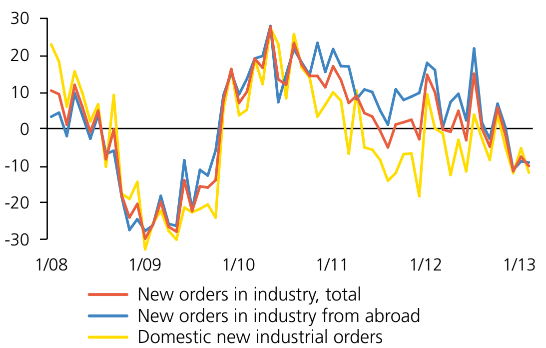


CHART III.3.16

ECONOMIC SENTIMENT

Economic sentiment in the Czech Republic remained more or less unchanged, in contrast to that in Germany and the EU
(long-term average = 100; seasonally adjusted data; source: Eurostat)

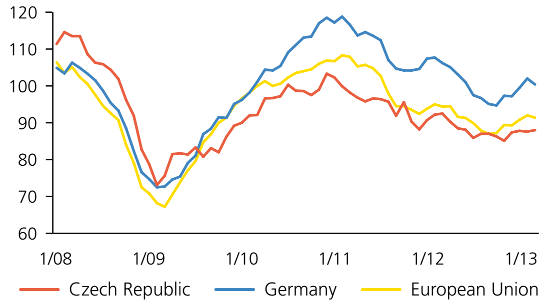


CHART III.3.17

POTENTIAL OUTPUT

The rate of growth of potential output remained low in 2012 Q4 according to the production function calculation
(annual percentage changes)

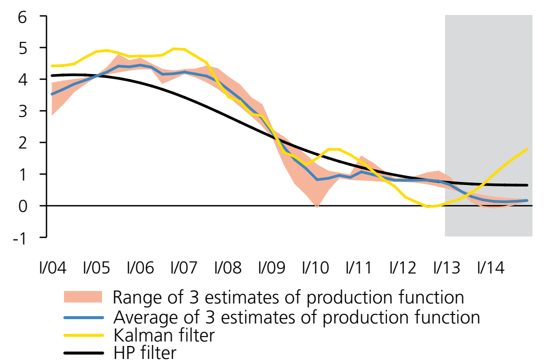
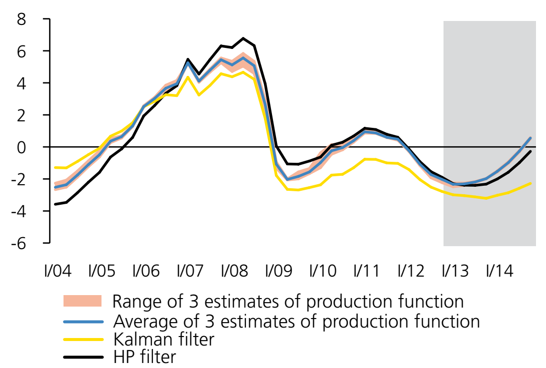


CHART III.3.18

OUTPUT GAP

The output gap opened further into negative values in 2012 Q4
(in % of potential output)



The sizeable annual decline in construction output persisted both for building construction and civil engineering (down by 9.2% and 8.5% respectively in 2012 Q4). According to the CZSO's latest February data, construction output increased year on year, but this rise was partly due to a low base (bad weather in 2012). On the other hand, a fall in the number of building permits and their approximate value suggests that no major improvement in demand for construction work can be expected in the period ahead.

An international comparison reveals that economic sentiment in Germany and the EU as a whole temporarily improved at the start of 2013 compared to the end of 2012, while changing only marginally in the Czech Republic (see Chart III.3.16). The difference between economic sentiment in the Czech Republic and the EU as a whole thus widened further. In March, however, economic sentiment fell again in both Germany and the EU. According to the CZSO's latest business survey results (April 2013), the **overall confidence indicator** also went down again after a series of modest increases (see Chart III.3.6), with both consumer confidence and business confidence falling substantially.

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

The annual growth rate of potential output was flat at a level just below 1% in 2012 Q4. The persisting decline in economic activity was thus reflected in continued opening of the output gap into negative values. According to the **Cobb-Douglas production function** calculation,[24] the growth rate of potential output has recently stabilised at 0.8%[25] (see Chart III.3.17). The output gap opened further to -2%[25] of potential output (see Chart III.3.18). This method suggests a further slowdown in growth in potential output almost to zero at the forecast horizon during 2013 Q1. The related output gap should continue to open into negative values in 2012 Q1. Subsequently, the output gap will gradually close, with full closure occurring in 2014 Q4.

The breakdown of the **contributions of the individual factors** entering the baseline production function reveals that the gradual stabilisation of potential output growth was due to both an unwinding of the negative contribution of equilibrium employment and stabilisation of the growth rate of the contribution of aggregate productivity. However, the estimate indicates that the negative contribution of employment will rise again from 2013 Q2 onwards.

24 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 (the labour-to-GDP ratio). 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.

25 Average of the three calculations.

Together with a gradual slowdown in the contribution of aggregate activity and capital, this will result in a slowdown in annual growth in potential output in the baseline variant (see Chart III.3.19).

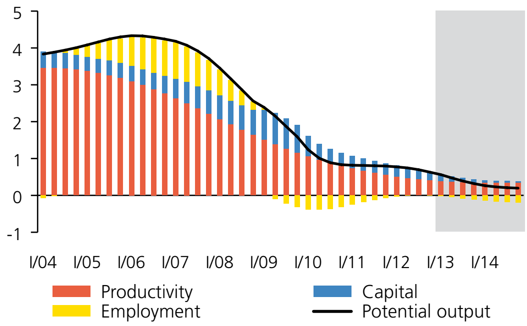
An alternative estimate using the **HP filter**[26] indicates the same growth rate of the output gap (0.8% in 2012 Q4) as the calculation using the production function. The output gap is similar under the two methods until mid-2013, but the HP filter suggests slower closure of the output gap in the second half of 2013 and in 2014 amid a slightly higher growth rate of potential output. The **Kalman filter,** calculated using data including the forecast, indicates flat potential output in 2012 Q4. Over the forecast horizon, however, potential output will start rising again and accelerate to 2%. Compared to the Cobb-Douglas production function calculation, the Kalman filter indicates a greater opening of the output gap into negative values and slower closure.

Chart III.3.19

CONTRIBUTIONS TO POTENTIAL OUTPUT GROWTH

The contribution of aggregate productivity will continue to be the main factor of potential output growth, which, however, will be low

(baseline production function; annual percentage changes)



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

CHART III.4.1

LABOUR MARKET INDICATORS

The number of employees converted into full-time equivalents declined further in 2012 Q4

(annual percentage changes)

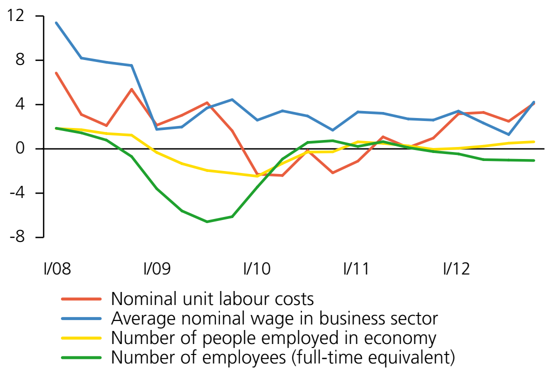


CHART III.4.2

EMPLOYMENT BREAKDOWN BY BRANCHES

The continuing growth in employment was driven by non-market services

(contributions in percentage points to annual change; selected branches; source: LFS)

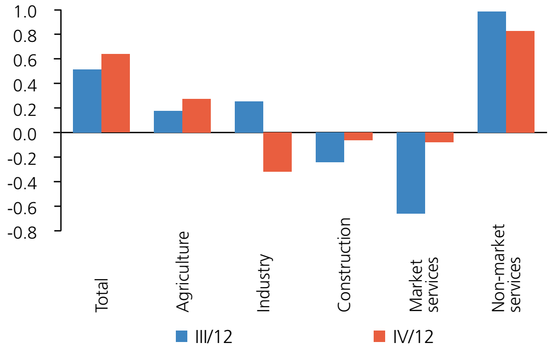
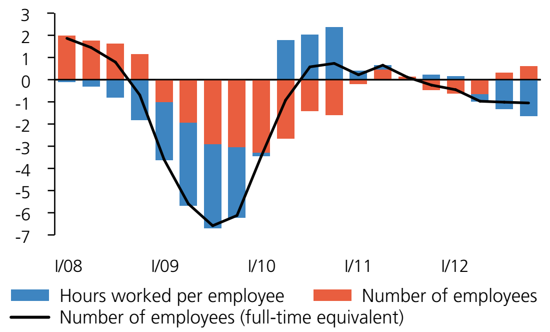


CHART III.4.3

NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENT)

Employers continued to cut working hours due to low demand

(contributions in percentage points; annual percentage changes)



III.4 THE LABOUR MARKET

The labour market continued to be affected by weakening economic activity in 2012 Q4. Total employment and the number of employees increased, but the number of employees converted into full-time equivalents declined further amid continuing cuts in hours worked in a number of industries due to low demand. The general unemployment rate recorded an annual increase amid higher growth in the labour force than in employment. The registered unemployment rate also increased. A sizeable increase in average wage growth and a related increase in unit labour costs were due to the one-off effect of tax optimisation. The decline in whole-economy labour productivity continued at roughly the same pace as observed in the previous quarter.

III.4.1 Employment and unemployment

Annual growth in total **employment**[27] picked up further slightly in 2012 Q4 (to 0.6%; see Chart III.4.1). However, it was affected by employment in the first three quarters, because by the end of the year employment (adjusted for seasonal effects) was flat in quarter-on-quarter terms. As regards its structure, the pick-up in annual employment growth was due mainly to the category of employees,[28] whose growth strengthened to 0.6%. By contrast, growth in the number of entrepreneurs slowed further (to 0.8%). The annual increase was due solely to a significant rise in the number of helping family members, while the numbers of entrepreneurs with and without employees both decreased. The figures were also affected by a methodological change in 2012 Q4.[29]

However, total employment as shown in Chart III.4.1 does not provide exact information about current labour demand, as employers are starting to optimise the amount of labour at this time of persisting recession by cutting working hours again (see Chart III.4.3). The adjustment of the labour market to the subdued economy activity thus continued to be better expressed by the **number of employees converted into full-time equivalents**, which continued to decline year on year in Q4 (by 1.1%). The continued decline in this indicator confirmed that, given the persisting considerable uncertainty about future demand, employers were rationalising their wage costs in the face of lower demand for production by cutting working hours rather than by reducing the number of employees.

As regards sectors, only **non-market services**[30] contributed significantly to the rise in employment in 2012 Q4 (see Chart III.4.2), due mainly to an increase in the number of employees in education and health and social care. Public administration and defence also

27 Employment according to the LFS.
28 Including members of production cooperatives.
29 According to the CZSO, this change was connected with the imputation of the results of a Eurostat pilot test, which affected the categorisation of employment status.
30 Measured by the unconverted number of employees.

saw a renewed slight increase in the number of employees. However, the number of employees in these sectors converted into full-time equivalents decreased year on year, suggesting that part-time work was used in the non-market sector, too. The share of employment growth in **agriculture** in total employment growth was less significant compared to non-market services.

Employment in **industry** returned to a stronger annual decline in 2012 Q4, owing mainly to developments in manufacturing. According to the latest data, the annual decline in the number of employees deepened to around 1.5% in the first two months of 2013.[31] Employment also fell in **market services**, albeit considerably more slowly than in 2012 Q3. The slower decline was primarily due to financial intermediation and insurance and professional, scientific and technical activities. The decline in employment in **construction** also moderated, although the effect of low demand for construction work persisted.

The **general unemployment rate**[32] increased year on year in 2012 Q4, amid faster growth in the labour force than in employment (see Chart II.4.4). In quarter-on-quarter terms, it edged up to 7.3%, adjusted for seasonal effects. The annual growth in the labour force was due mainly to an increasing rate of economic activity[33] in all age groups with the exception of persons aged 30–44.

The **total registered unemployment rate** (MLSA) showed similar developments at the end of 2012, increasing to 9% in the same period. In quarter-on-quarter terms it rose only slightly to 9.1%.[34] The new MLSA indicator of the **share of unemployed persons**,[35] used since the start of 2013, was slightly above the general unemployment rate at the end of 2012. The seasonally adjusted share of unemployed persons recorded an increase to 7.4% in 2013 Q1 compared with previous quarter.

The gradually worsening situation on the labour market is also indicated by the **Beveridge curve**,[36] which moved gradually in the easterly direction during 2013 Q1. The number of vacancies continued to edge down, despite increasing during March (see Chart III.4.5).

CHART III.4.4

UNEMPLOYMENT RATE

The share of unemployed persons continued to rise in 2013 Q1
(percentages; seasonally adjusted data; source: MLSA, CZSO)

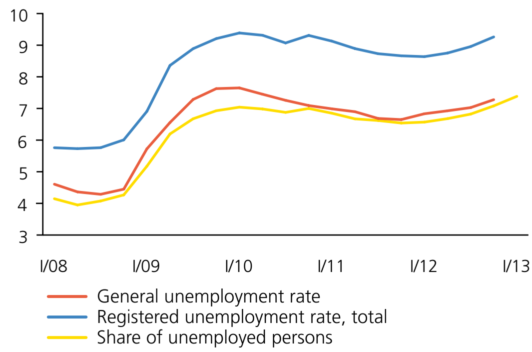
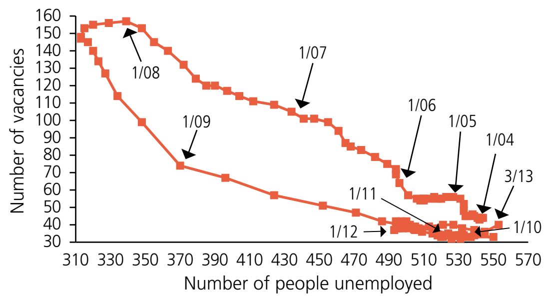


CHART III.4.5

BEVERIDGE CURVE

The number of people unemployed increased
(seasonally adjusted numbers in thousands)



31 Corporations with 50 employees or more, excluding agency workers.
32 In the 15–64 age category. Measured by the ILO methodology (LFS).
33 The rate of economic activity is defined as the ratio of employed and unemployed persons to the population in each age category.
34 Seasonally adjusted data are used for the quarter-on-quarter figures.
35 The share of persons unemployed is the ratio of available job applicants aged 15–64 to the population of the same age.
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.

TABLE III.4.1

WAGES, PRODUCTIVITY, UNIT LABOUR COSTS

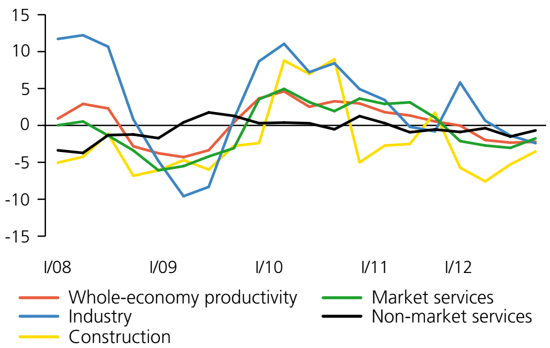
Average nominal wage growth rose noticeably in 2012 Q4, but was affected by the time shift of bonus payments
(annual percentage changes)

	I/12	II/12	III/12	IV/12
Average wage in Czech Republic				
nominal	3.4	2.3	1.5	3.7
real	-0.3	-1.1	-1.7	0.9
Average wage in business sector				
nominal	3.4	2.3	1.3	4.2
real	-0.3	-1.1	-1.9	1.4
Average wage in non-business sector				
nominal	3.4	2.3	2.3	1.3
real	-0.3	-1.1	-1.0	-1.5
Whole-economy labour productivity	0.0	-2.0	-2.3	-2.2
Nominal unit labour costs	3.2	3.3	2.5	4.1

CHART III.4.6

WHOLE-ECONOMY PRODUCTIVITY

Productivity fell in all the monitored sectors
(annual percentage changes)



III.4.2 Wages and productivity

Despite persisting low labour demand, annual growth in the **average nominal wage**[37] picked up significantly (to 3.7%) in 2012 Q4. With annual inflation falling further, the **average real wage** increased by 0.9%. The significant rise in the average wage was due to wages in the business sector, while average wage growth in the non-business sector slowed (see Table III.4.1).

The sizeable pick-up in average annual nominal wage growth in the **business sector** in 2012 Q4 (to 4.2%) was due largely to tax optimisation.[38] Branches usually pay the highest proportion of performance-related bonuses for the previous year in the first quarter of the new year, but some of them shifted such bonuses to 2012 Q4. As a result, the average wage increased by 24.1% year on year in financial intermediation and insurance. It also rose significantly in cultural, entertainment and recreational activities and the electricity supply industry. Average wage growth in other branches was much lower, and in education and real estate activities it declined year on year. The average real wage in the business sector rose for the first time in 2012 (by 1.4%), thanks to its sizeable nominal growth.

Annual average nominal wage growth in the **non-business sector** slowed to 1.3% in 2012 Q4. This slowdown concealed a pronounced weakening of wage growth in education (to 1%). The real decline in the average wage in the non-business sector observed in the previous quarter deepened on account of a more moderate slowdown in annual inflation than in wage growth (see Table III.4.1).

With the real GDP decline weakening slightly and employment rising at a similar pace, the annual decline in **whole-economy productivity**[39] was almost unchanged in 2012 Q4 at close to 2% (see Chart III.4.6). As in the previous quarter, productivity declined in all the monitored sectors. The construction industry recorded the largest fall in productivity, although this decline was more moderate than in the previous quarter. By contrast, the annual decline in labour productivity deepened further in manufacturing and in industry as a whole.

In these circumstances, growth in **unit labour costs**[40] increased year on year in 2012 Q4 (by 1.6 percentage points compared to 2012 Q3, to 4.1%; see Chart III.4.7). The main cause was an increase in the volume of wages and salaries due to tax optimisation, whose effect outweighed the moderation in the economic contraction. As regards

37 The average gross wage converted into full-time equivalents.
38 A "solidarity" tax, i.e. an increase of 7 percentage points in the tax rate for employed persons with income exceeding CZK 103,536 a month, was introduced on 1 January 2013, and the cap on health insurance premium payments was abolished at the same time.
39 Productivity is calculated on the basis of non-seasonally adjusted data.
40 Nominal unit labour costs are calculated on the basis of non-seasonally adjusted data.

sectors, nominal unit wage cost growth accelerated in market services and industry, but slowed in construction and non-market services, thanks mainly to a slight improvement in value added coupled with the absence of any major effect of tax optimisation on wages in these branches.

CHART III.4.7

UNIT LABOUR COSTS

Growth in nominal unit labour costs rose sharply, mainly because of the time shift of bonus payments for 2012
(contributions in percentage points; annual percentage changes)

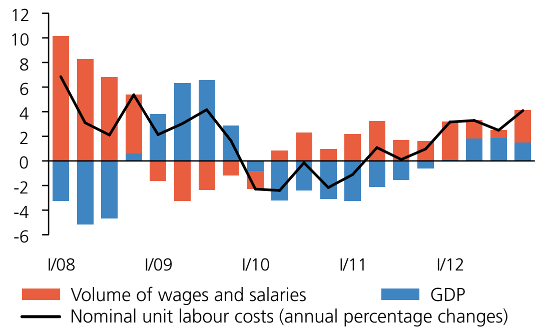


CHART III.5.1

MONETARY AGGREGATES

The annual growth rate of the money aggregates slowed
(annual percentage rates of growth)

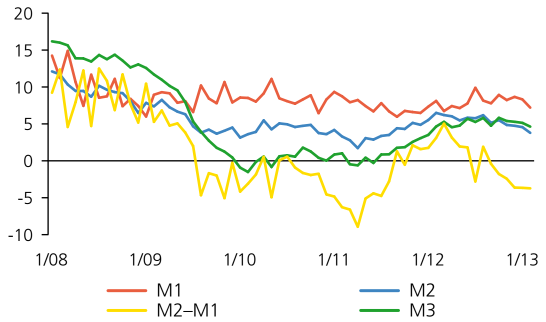


CHART III.5.2

MAIN COMPONENTS OF M2 AND INTEREST RATE SPREAD

A preference for liquidity continues to keep growth in overnight deposits at a high level
(annual flows in CZK billions; spreads in percentage points)

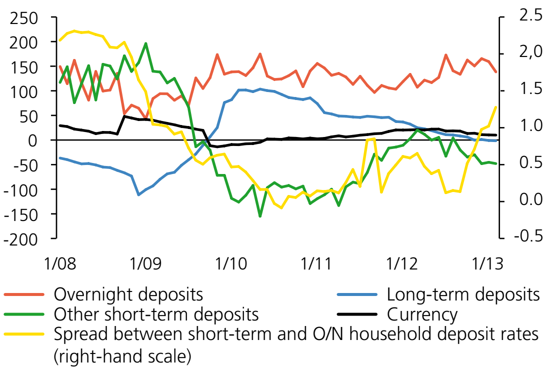
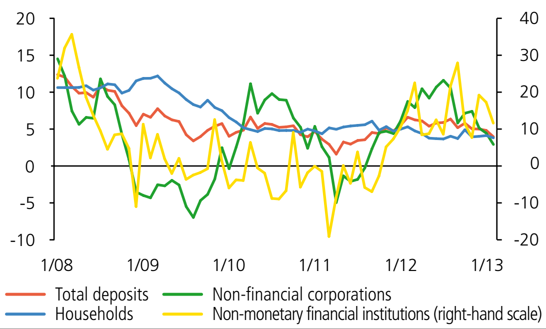


CHART III.5.3

DEPOSIT STRUCTURE OF M2

Growth in deposits of non-financial corporations continued to fall
(annual percentage rates of growth)



III.5 FINANCIAL AND MONETARY DEVELOPMENTS

The annual growth rates of M1 and M2 slowed in 2013 Q1. Although growth in net external assets declined, the growth rate of loans to non-financial corporations abroad increased within their structure. Despite a slight increase in late 2012 and early 2013, the annual growth rate of loans to the private sector remains low in the Czech Republic. It was affected mainly by demand factors associated with the subdued investment and consumer activity of corporations and households. Amid flat money market rates, client interest rates on large corporate loans and long-term loans for house purchase continued to edge down. The performance indicators of non-financial corporations deteriorated. The creation of net financial assets by households increased. Asking prices of apartments were mixed across regions, recording a year-on-year increase in Prague while continuing to fall in the rest of the Czech Republic.

III.5.1 Money

The annual growth rate of **M2** slowed further, reaching 3.8% in February (see Chart III.5.1). The annual rate of growth of M3 also fell to 4.6% (and was thus 1.5 percentage points above the euro area average). Given the deeper annual decline in nominal GDP, the velocity of money slowed further in 2012 Q4.

The annual growth rate of **M1** slowed to around 7% at the start of this year due to lower growth in overnight deposits (see Chart III.5.2). Short-term and long-term deposits declined. The spread between interest rates on short-term and overnight deposits of households increased as a result of some banks' efforts to make time deposits more attractive.

Turning to the **sector structure** of money, households are the main contributor to money growth. The annual rate of growth of these deposits fluctuated around 4% for the fourth consecutive quarter (see Chart III.5.3). The annual growth rate of deposits of non-financial corporations fell further. The growth rate of deposits slowed mainly in transport, while deposits in construction declined. Deposits in most other branches increased in Q1, reflecting a rise in the acid-test ratio of corporations, albeit with less intensity in February, especially in manufacturing, energy, agriculture and property development.

As regards the **sources of creation of money**, annual growth in net foreign assets, which had been affected in 2012 by a net inflow of foreign capital in the form of portfolio and direct investment, recorded a decline. At the end of 2012 this had been due to portfolio investment, but in January 2013 it was primarily a result of an outflow of other capital under foreign direct investment (probably in the energy sector). The foreign assets of banks recorded lower growth as a result of a decline in deposits and almost zero growth in debt securities purchased abroad (see Chart III.5.4). At the same time, annual growth in bank loans to non-resident non-financial corporation picked up again to around 20% (these long-maturity loans increased by CZK 21 billion in January and February; one-third of them were provided to the energy sector, probably for acquisitions in this sector, and two-thirds to other sectors).

III.5.2 Credit

Despite increasing slightly in late 2012 and early 2013, the annual growth rate of **loans to the private sector** remains subdued, amounting to 3.3% in February.[41] Credit growth is being affected mainly by subdued demand in the economy. However, demand for loans rose in part of the bank credit market in Q1 (see Table III.5.1). The previous tightening of credits standards for corporate loans did not continue on the supply side. However, as regards the terms and conditions for approving corporate loans, there was an increase in margins on riskier loans in a relatively large part of the bank credit market due to adverse outlooks for some sectors.

The annual growth rate of **loans to non-financial corporations** was fluctuating just above 2% at the start of this year (see Chart III.5.5). The growth rate of medium-term and long-term loans to domestic corporations increased in late 2012 and early 2013. By contrast, short-term loans for financing working capital decreased. Double-digit growth was recorded in the energy and gas supply industry and in agriculture. On the other hand, loans to manufacturing declined slightly. The higher **demand of corporations for loans** observed in part of the credit market in 2013 Q1 was due to the financing of mergers, acquisitions and restructuring of large corporations, amid greatly reduced fixed investment financing needs.

The **availability of corporate loans** was assessed as very good in 57% of firms and as normal in 28% of firms (according to a survey of non-financial corporations conducted by the CNB and the Confederation of Industry). Firms expect loan availability to improve in the coming twelve months. A small part of the credit market expects credit approval standards to tighten in 2013 Q2 (especially for long-term loans to large corporations), amid unchanged demand for loans.

Loans to households were very subdued at the start of this year. The annual growth rate of such loans slowed further, reaching 4% in February (see Chart III.5.6).

The annual growth rate of **loans for house purchase** decreased to 5.3% in February 2013. This reflected a gradual slowdown in growth in mortgage loans to 5.8% and a decline in building society loans of 5.9%.

41 In the euro area, loans to the private sector continued to decline by around 1% due to both demand and supply factors (although lending is highly heterogeneous across euro area countries). Low economic activity and high uncertainty are affecting the demand side. The supply side is being affected by banks' tighter credit standards for loans to both corporations and households.

CHART III.5.4

FOREIGN ASSETS OF BANKS

The growth in foreign assets of banks reflected increased growth in loans to non-resident corporations

(annual percentage changes; contributions in percentage points; annual percentage rates of growth)

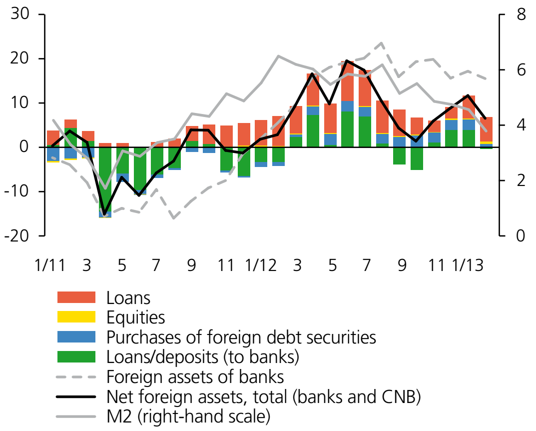


TABLE III.5.1

CHANGES IN BANKS' CREDIT CONDITIONS

Banks' credit standards were almost unchanged overall in 2013 Q1

(net percentages; positive value = tightening standards/conditions, demand growth; negative value = easing standards/conditions, demand decrease)

	Supply			Demand
		Credit terms and conditions: of which		
	Credit standards	Average margin for loans	Banks' margin on riskier loans	Demand for loans
Loans to non-financial corporations				
II/12	14	6	23	7
III/12 [a]	20 (18)	18	21	-5 (6)
IV/12 [b]	37 (19)	8	1	17 (-6)
I/13 [c]	0 (22)	7	46	23 (-21)
II/13 [d]	(9)			(-1)
Loans for house purchase				
II/12	-25	-34	13	8
III/12 [a]	8 (10)	41	17	-41 (21)
IV/12 [b]	-28 (-44)	-30	17	21 (24)
I/13 [c]	-6 (-7)	-27	-26	12 (-19)
II/13 [d]	(-26)			(17)
Consumer credit				
II/12	10	-29	-15	26
III/12 [a]	0 (0)	0	6	24 (-29)
IV/12 [b]	0 (0)	0	7	51 (7)
I/13 [c]	-1 (2)	23	1	5 (9)
II/13 [d]	(30)			(-7)

Note: Net percentages are calculated as the difference between the percentage share of loans provided by banks reporting that standards/conditions have been tightened (or demand increased) and the percentage share of loans provided by banks reporting that standards/conditions have been eased (or demand decreased). The individual responses are thus weighted by the volumes of loans of a given type.

a) Banks' expectations reported in the II/12 survey given in parentheses.
b) Banks' expectations reported in the III/12 survey given in parentheses.
c) Banks' expectations reported in the IV/12 survey given in parentheses.
d) Banks' expectations reported in the I/13 survey given in parentheses.

Chart III.5.5

LOANS TO NON-FINANCIAL CORPORATIONS

Growth in loans to non-financial corporations went up slightly, but new loans decreased at the start of this year
(annual percentage rates of growth; annual percentage changes)

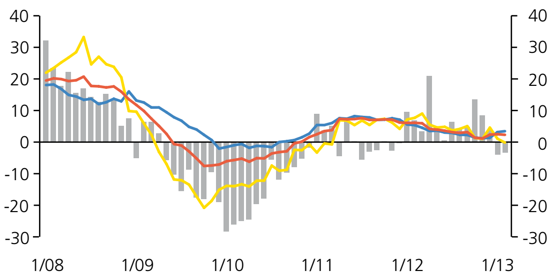


Chart III.5.6

LOANS TO HOUSEHOLDS

Growth in loans to households slowed further, but the number and volume of mortgages went up in March according to Hypoindex
(annual percentage rates of growth; annual percentage changes)

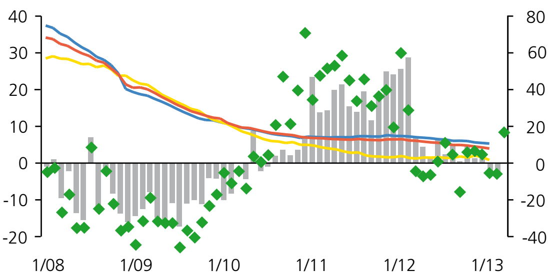
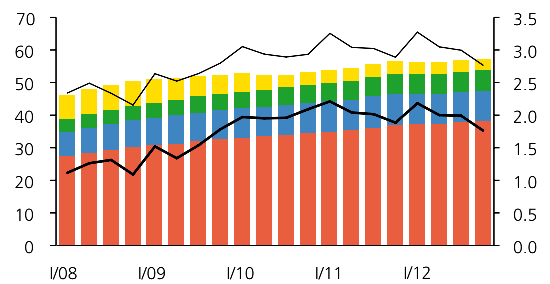


Chart III.5.7

HOUSEHOLD DEBT

Household debt in relation to gross disposable income was almost unchanged in 2012 Q4
(percentage ratios to gross disposable income)



Note: Net interest paid represents the difference between households' loan interest expenses and bank deposit interest income. Interest paid consists of households' borrowing-related interest expenses.

The volume and number of new mortgages decreased year on year amid renewed weak growth in new building society loans. However, the number and volume of new mortgages went up year on year in March 2013 according to Hypoindex. Demand for loans for house purchase increased in only a small part of the credit market amid a continuing, albeit not across the board, easing of credit standards. Higher non-housing-related consumption expenditure by households and the outlook for the residential property market continued to have an adverse effect on households' demand for house purchase loans. Investment in dwellings fell year on year in 2012 Q4. In 2013 Q2, banks expect standards to ease further and demand for loans to increase amid increased competitive pressure (partly due to refinancing of old mortgages).

Following a slight increase at the end of 2012, the annual growth rate of bank **consumer credit** slowed again and stood at 0.8% in February.[42] Loans from non-banks (i.e. leasing and hire-purchase companies) continued to decline at a rate of around 5%. According to banks, demand for consumer credit should decrease further in 2013 Q2, as it is being adversely affected by subdued household spending on consumer durables.

Total **household debt** amounted to around 57% of gross disposable income in 2012 Q4. The ratio of household debt to GDP remained at around 32%. As a result of a decline in interest rates, households' interest burden fell further (see Chart III.5.7).

III.5.3 Interest rates

Monetary policy interest rates

The monetary policy decision-making of the CNB Bank Board in 2013 Q1 was based on the macroeconomic forecast published in the previous Inflation Report. Consistent with this forecast and its assumptions was a slight decline in market interest rates, followed by a rise in rates as from mid-2014. At the February Bank Board meeting, the risks to the previous forecast were assessed as being broadly balanced; uncertainty surrounded the extent and impacts of fiscal consolidation and household behaviour in the areas of consumption and saving. The Bank Board decided unanimously to leave **key interest rates** unchanged. At its meeting in March, the Bank Board assessed the risks to the previous forecast as being tilted to slightly easier monetary conditions, with domestic economic activity, domestic inflation and external developments acting in this direction. The Bank Board decided unanimously to leave key interest rates unchanged. The two-week repo rate and the discount rate were thus set at 0.05% and the Lombard rate at 0.25% with effect from 2 November 2012 (see Chart III.5.8).

42 This reflected a deeper decline in non-purpose credit and in debit balances on current accounts amid weak growth in credit card debt.

At its monetary policy meeting on 2 May 2013, the Bank Board decided unanimously to **leave key interest rates unchanged**. The risks of the new forecast were assessed as being on the downside. The external outlook (EURIBOR rates and the oil price), the domestic economy and growth in competition in oligopolistic industries are all acting in this direction.

Financial market interest rates

Money market interest rates remained at record-low levels in 2013 Q1. This was because the CNB's key interest rates were set at technical zero. PRIBOR interest rates have declined by 0.1 percentage point at 6M–1Y maturities since the start of January, while rates at other maturities have been flat (see Chart III.5.9). **FRA derivative rates** showed no major changes, either. They shifted slightly upwards at the start of 2013 and fell back slightly in late March and early April. The market outlook for 3M rates according to end-April FRA quotations implies expected approximate stability of these rates until the start of next year. It is slightly higher than the interest rate path consistent with the new forecast over almost the entire horizon (see section II).

Interest rates with longer maturities remained at low levels, reflecting the easy monetary policy in the Czech Republic and the euro area and the contraction of the Czech economy. Rates showed a temporary slight increase in January, following similar rise abroad. This reflected a change in the ECB's communication after its monetary meeting in January as well as early repayment of ECB loans drawn by financial institutions under the LTRO programme. In the following months, however, Czech IRS rates mostly fell slightly, again in line with foreign rates.

The average **3M PRIBOR** was 0.5% in 2013 Q1, as expected by the previous forecast. Money market interest rates continued to be influenced by the credit premium. This premium, as measured by the spread between the 3M PRIBOR and the 2W repo rate, was unchanged, averaging just below 0.5 percentage point in 2013 Q1.

The positively sloped **PRIBOR yield curve** was almost unchanged in 2013 Q1. The spread between the 1Y PRIBOR and the 2W PRIBOR fell slightly to 0.5 percentage point. The **IRS yield curve** initially shifted to a slightly higher level in 2013 Q1 and its positive slope increased somewhat. However, it returned roughly to the end-2012 level in March and April. In March, the average 5Y–1Y spread was 0.5 percentage point and the 10Y–1Y spread 1.0 percentage point.

CHART III.5.8

CNB KEY RATES

The CNB left its key interest rates unchanged in 2013 Q1
(percentages)

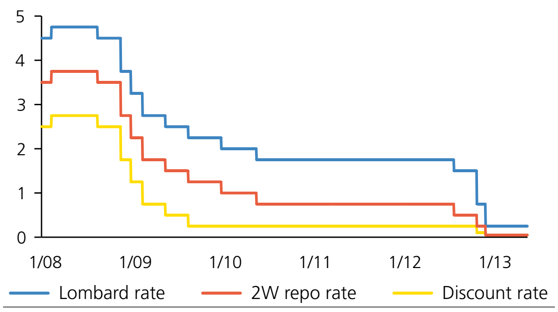


CHART III.5.9

MARKET INTEREST RATES

Interest rates with shorter and longer maturities fluctuated at low levels
(percentages)

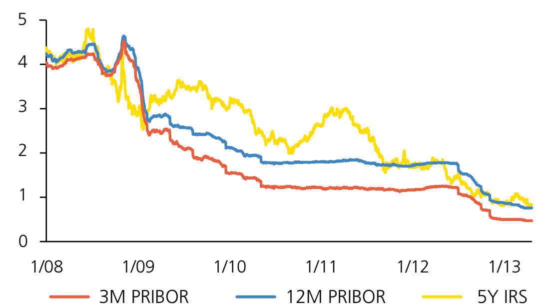


CHART III.5.10

INTEREST RATE DIFFERENTIALS

Interest rate differentials vis-à-vis the euro and the dollar were flat at low levels
(percentage points)

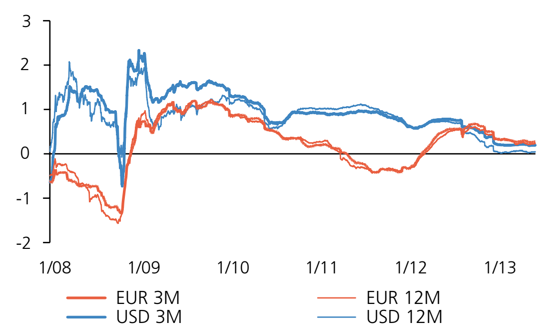


CHART III.5.11

GOVERNMENT BOND YIELD CURVE

The government bond yield curve recorded no major changes
(percentages)

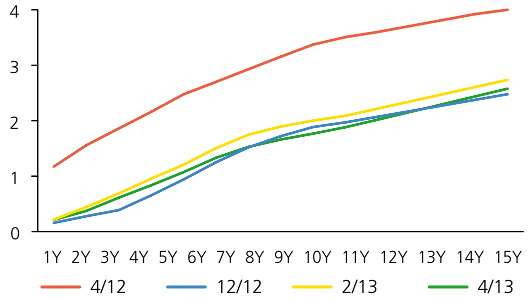


CHART III.5.12

INTEREST RATES ON LOANS TO CORPORATIONS

The interest rate on large corporate loans continued to fall
(new business; percentages)

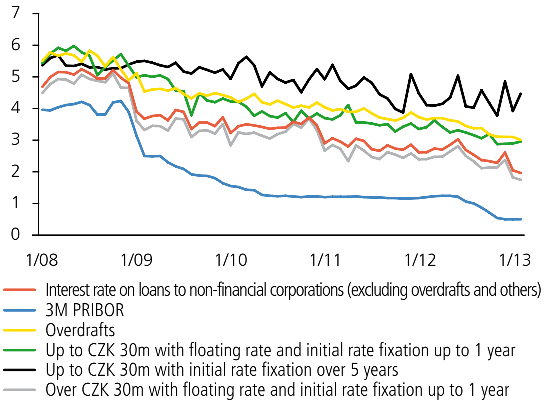
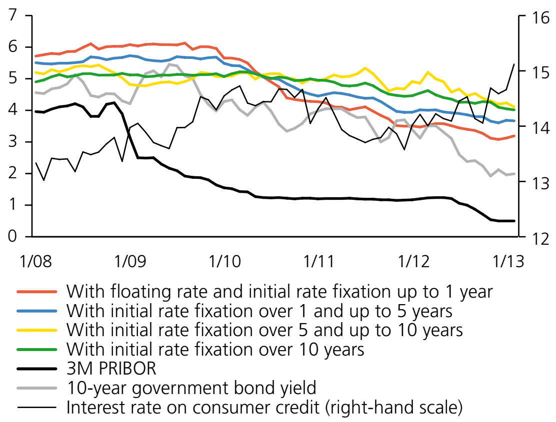


CHART III.5.13

INTEREST RATES ON LOANS TO HOUSEHOLDS

The interest rate on consumer credit increased
(new business; percentages)



Short-term **interest rate differentials** vis-à-vis the two main world currencies (PRIBOR/CZK–EURIBOR/EUR, or LIBOR/USD) reflected the broadly flat key rates in the Czech Republic and on foreign financial markets. The differentials vis-à-vis euro and dollar rates were thus almost unchanged (see Chart III.5.10). The 3M PRIBOR–3M EURIBOR interest rate differential was 0.3 percentage point on average in 2013 Q1 and was at the same level on 19 April.

Twelve auctions of fixed coupon bonds and two auctions of variable coupon bonds have been held on the primary **government bond market** since the start of this year. The total volume of bonds issued was CZK 53.5 billion. Demand strongly exceeded supply in almost all the auctions; the bid-to-cover ratio was 1.9 on average. The Ministry of Finance subscribed the government bonds with very low yields – below 2% for bonds with a maturity of up to 10Y and below 3% for those with a maturity of over 10Y. The government bond yield curve – like the IRS curve – shifted slightly upwards in 2013 Q1 and then moved down again, among other things as a result of the foreign bond market situation. Its positive slope remained approximately unchanged (see Chart III.5.11).

Client interest rates

Following a previous decline, **client interest rates on loans** showed mixed developments in 2013 Q1. The rate on large corporate loans and long-term rates on loans to households for house purchase fell slightly, while consumer credit rates increased and rates on small loans to corporations were almost unchanged.

The **interest rate on loans to non-financial corporations** edged down further to 2%, reaching a new historical low (see Chart III.5.12). This reflected a decline in the rate on large loans of over CZK 30 million to 1.8% (loans provided mainly to large corporations). The interest rate on small loans remained at 3.2% following a previous decline. The spread between the short-term rates on small and large loans is on a declining trend but is currently slightly above its long-term average observed since 2004. This indicates that financial conditions for small and medium-sized enterprises are improving only gradually, as in the euro area. With the 3M PRIBOR flat, the spread between the short-term rate on small loans and the 3M PRIBOR increased slightly, while declining for large loans (see Chart III.5.14).

The **interest rate on loans for house purchase** edged up to 3.7%. Short-term rates with a fixation of up to one year and rates with a fixation of over one year and up to five years increased slightly, while rates with longer fixations fell slightly (see Chart III.5.13). The proportion of new loans with floating rates or rates fixed for up to one year dropped to 18%. Loans with fixations of over one year and up to five years accounted for the largest share (55%). The spread between short-term client and market rates, expressing the risk premium, increased gradually in conditions of increased unemployment. The spread between the average rate on loans for house purchase and the long-term financial market rate increased due to the former rate, while it had been affected until recently by a sharp decline in 10Y government bond yields (see Chart III.5.14). According to Hypoindex, the interest rate on new mortgages went down slightly in March 2013, reaching the end-2012 level.

The **interest rate on consumer credit** increased by a further 0.5 percentage point in 2013 Q1, to 15.1% (see Chart III.5.13). The increase in this rate is mainly due to the continuing economic recession and the related risk of loan default, but it may also currently be linked with the reduction of bank charges. Banks may be offsetting the lower level of charges by raising interest rates. The ratio of non-performing loans to total consumer loans remains relatively high (12.2%). According to banks, the average margin on these loans increased. The rate on overdrafts was 14.7% and the rate on credit card debt dropped to around 23%.

Interest rates on deposits of households and corporations remained low. Rates on overnight deposits edged down to 0.6% for households but were unchanged at 0.3% for non-financial corporations. The rate on deposits redeemable at notice has long been around 2% due to the significant proportion of building society deposits. By contrast, short-term and long-term rates on household deposits with agreed maturity (of up to one year and over two years) increased to 1.8% and 2.2% respectively. These developments were again recorded mainly for small and medium-sized banks and for foreign bank branches, resulting in an increase in the market share of the said categories of banks as regards new deposits with agreed maturity.

Real client interest rates[43] increased at the start of 2013, owing mainly to a decline in expected inflation. Real rates on new loans were 4.4% in February, while real rates on time deposits were 0.1% (see Chart III.5.15).

III.5.4 The exchange rate

The average **exchange rate of the koruna against the euro** was CZK 25.6 in 2013 Q1. This represents a year-on-year depreciation of 2.4% and a quarter-on-quarter depreciation of 1.6% (see Chart III.5.16). A trend of gradual depreciation of the koruna against the euro has been apparent since around mid-September 2012. In this period, the koruna has weakened against the euro from CZK 24.4 to CZK 25.8. It was fluctuating around the latter level in the first half of April 2013.

One of the two main factors affecting the koruna so far in 2013 has been the deteriorating economic situation and continuing public budget crisis in EU countries. As a result of this situation, European

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

CHART III.5.14

CLIENT AND MARKET INTEREST RATE SPREADS

Risk premiums, as expressed by the spread between client and market rates, mostly increased

(percentage points)

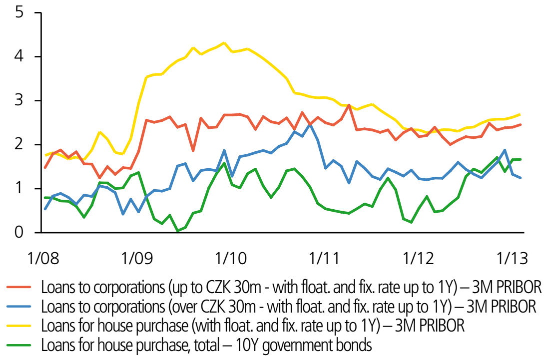


CHART III.5.15

EX ANTE REAL RATES

Ex ante real interest rates on new loans and deposits increased at the start of 2013

(percentages)

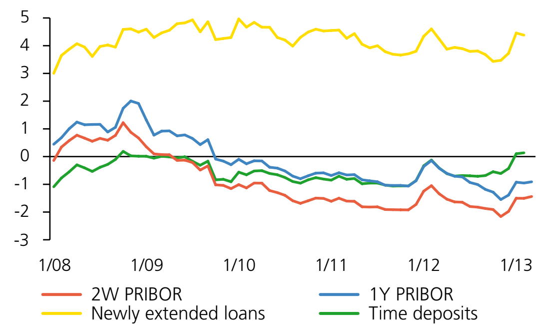


CHART III.5.16

CZK/EUR AND CZK/USD EXCHANGE RATES

The koruna weakened slightly year on year against both the euro and the dollar in 2013 Q1

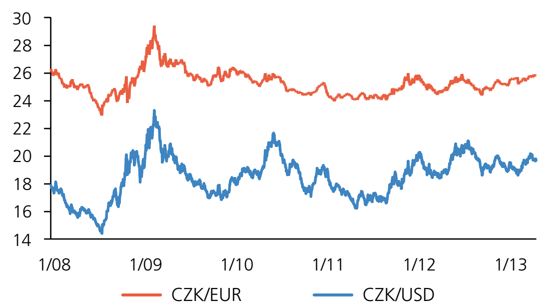


Chart III.5.17

KEY FINANCIAL INDICATORS

The main financial indicators worsened again in 2012 Q4
(annual percentage changes)

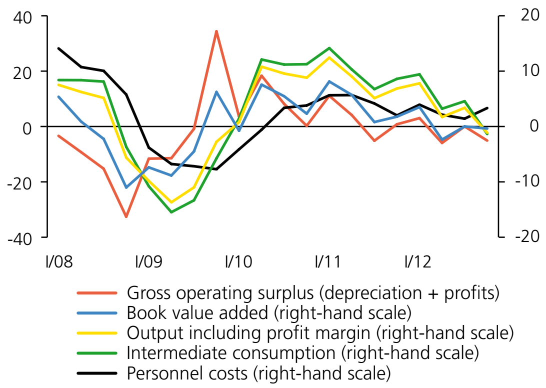


Table III.5.2

PERFORMANCE INDICATORS OF CORPORATIONS

The material cost-output ratio decreased somewhat

	2011 Q4	2012 Q4	Annual percentage changes
Output incl. profit margin (CZK billions)[a]	1,484.8	1,468.3	-1.1
Personnel costs (CZK billions)	214.1	221.3	3.3
Intermediate consumption (CZK billions)	1,122.3	1,107.1	-1.4
Book value added (CZK billions)	362.5	361.2	-0.4
Sales (CZK billions)	1,948.3	1,951.0	0.1
	Percentages	**Percentages**	**Annual changes in pp**
Ratio of personnel costs to value added[a]	59.1	61.3	2.2
Material cost-output ratio[a]	75.6	75.4	-0.2
Personnel cost-output ratio[a]	14.4	15.1	0.7
Ratio of book value added to output[a]	24.4	24.6	0.2

a) CNB calculation

currencies have depreciated against most other convertible currencies.[44] The Swedish krona has been the exception, benefiting from a relatively more favourable domestic situation and also from the publicly declared willingness of the central bank to let the currency appreciate. However, the Czech koruna showed the second strongest depreciation of all the European convertible currencies (behind the British pound) in the period under review. This can be explained, among other things, by easy monetary policy, accompanied by CNB communication about the possibility of exchange rate interventions against the koruna, which has reduced non-residents' interest in holding koruna assets.

The average **exchange rate of the koruna against the dollar** was CZK 19.4 in 2013 Q1. This represents a year-on-year depreciation of 1.2% and a quarter-on-quarter appreciation of 0.2%. The koruna depreciated from around CZK 19 against the dollar at the end of 2012 to CZK 20.2 at the end of March 2013. This depreciation was concentrated in February and March. At the start of April there was a correction and the koruna appreciated slightly. In mid-April it was fluctuating around CZK 19.8 against the dollar. On world markets the dollar appreciated slightly against most European currencies, benefiting from the USA's ability to maintain economic growth while partially reducing its fiscal imbalances.

III.5.5 Economic results of non-financial corporations

The financial results of **non-financial corporations with 50 employees or more**[45] in 2012 Q4 are consistent with the continued weakening of economic activity. Following previous growth, output switched to an annual decline, and growth in sales was replaced by stagnation for the first time in three years. These changes were reflected in a moderate year-on-year decrease in book value added despite a concurrent fall in intermediate consumption (see Chart III.5.17). Gross operating surplus also recorded an annual decline (of 5.1%), due mainly to continued growth in personnel costs.

With intermediate consumption falling faster than output, the **material cost-output ratio**[46] fell slightly year on year in 2012 Q4 (by 0.2 percentage point; see Table III.5.2), whereas in the previous quarter it had risen by almost 1 percentage point. A decreasing material-cost output ratio was visible in most of the sectors monitored, but above all in education, health and social care, cultural and other activities, water supply, waste management and remediation, and professional and scientific activities. In the high-weight manufacturing industry, by contrast, the material cost-output ratio rose year on year, albeit only slightly (by 0.2 percentage point).

44 The exceptions being the yen, depreciated by monetary policy, and the Korean won, weakening due to increasing tensions on the Korean Peninsula.
45 The segment of corporations with 50 employees or more consisted of more than 9,300 non-financial corporations at the end of 2012 Q4.
46 The material cost-output ratio defined as the ratio of intermediate consumption to output.

By contrast, the **personnel cost-output ratio**[47] rebounded from its decline in 2012 Q4 (see Table III.5.2). This was due to a pick-up in the annual growth rate of personnel costs coupled with a decrease in output as a result of persisting low demand. The faster annual growth in personnel costs was due to a marked one-off rise in the average wage owing to tax optimisation (see section III.4.2), while the number of employees decreased in the monitored segment of corporations.

Data for the narrower **segment of large corporations** (with 250 employees or more[48]) indicate similar trends in the main financial indicators in 2012 Q4 as in the larger segment of corporations. Both intermediate consumption and output declined, while annual growth in sales weakened significantly.

III.5.6 Financial position of corporations and households

The **financial liabilities of non-financial corporations** rose slightly year on year in 2012 Q4 (see Chart III.5.18). This rise was due mainly to equity (excluding quoted shares) and issued bonds, while the positive contribution of loans virtually disappeared and the contribution of quoted shares was negative. As regards the **assets** of non-financial corporations, the share of liquid financial assets in the form of currency and deposits continued to grow in Q4. The total net financial position of corporations has long been negative and currently stands at -94% of GDP. The main trends in the balance sheet structure are reflected in the financial indicators; the acid-test ratio of corporations rose sharply in 2012 Q4 and the ratio of market-based financing fell slightly. Corporate solvency increased slightly compared to the previous quarter and was roughly at the level observed in 2011.

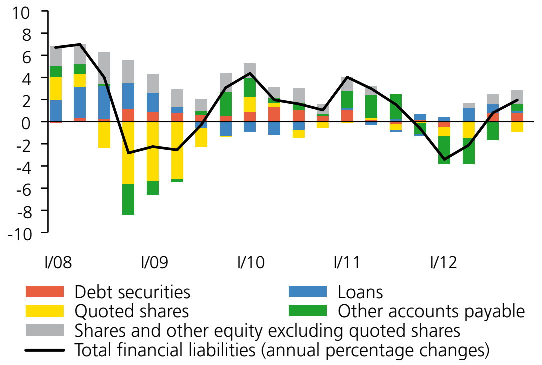
Households are net creditors in the national economy. Their net financial assets have risen quite significantly as a percentage of GDP in recent quarters (and stood at 70% of GDP in 2012 Q4). As regards the financial assets of households, currency in circulation, deposits, saving bonds and life insurance technical reserves increased. In 2012 Q4, moreover, the value of households' shares in investment funds and holdings of unquoted shares[49] grew considerably. Households' financial liabilities are still rising moderately, although more slowly than in previous quarters and much more slowly than financial assets. Long-term loans are the dominant contributor to the growth in financial liabilities.

CHART III.5.18

FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

The financial liabilities of corporations increased slightly year on year in 2012 Q3 and Q4

(annual percentage changes; contributions in percentage points)



47 The personnel cost-output ratio defined as the ratio of personnel costs to output.
48 The segment of corporations with 250 employees or more consisted of more than 1,700 non-financial corporations at the end of 2012 Q4.
49 The rise in the value of unquoted shares held by households was due to revaluation, corresponding to a rise in the book value of corporations' capital in the financial accounts statistics.

Chart III.5.19

STRUCTURE OF HOUSEHOLD FINANCIAL ASSETS

The financial assets of households are growing quite quickly
(contributions in percentage points; annual percentage changes and percentage ratios)

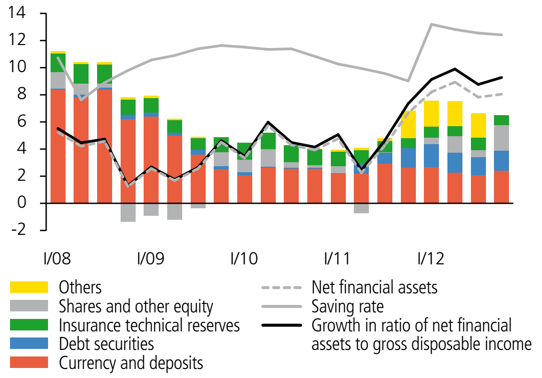
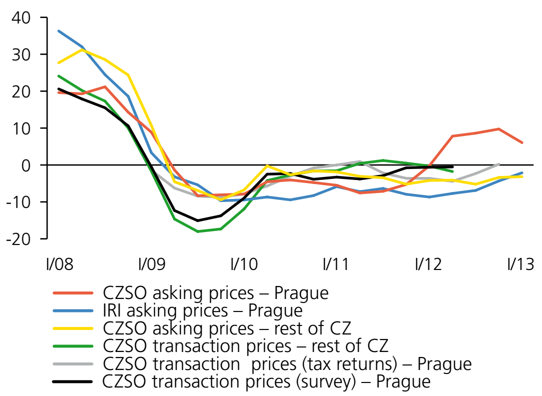


Chart III.5.20

TRANSACTION AND ASKING PRICES OF APARTMENTS

Asking prices of apartments showed mixed developments across regions in 2013 Q1
(annual percentage changes; source: CZSO, Institute for Regional Information)



In recent quarters, annual growth in the net financial assets of households has been around 9% of the annual gross disposable income of households (see Chart III.5.19).[50] The marked acceleration in the creation of net financial assets by households as measured by this indicator is thus qualitatively consistent with the observed evolution of the saving rate recorded in the national accounts in the last few quarters.

III.5.7 The property market

According to CZSO data, **asking prices of older apartments** showed differential developments across regions in 2013 Q1. While asking prices in Prague rose by 6.1% year on year, i.e. at a slower pace than in late 2012, asking prices in the rest of the Czech Republic fell further (by 3.2%; see Chart III.5.20). In quarter-on-quarter terms, asking prices in Prague went up by 0.3%, whereas prices outside Prague fell by 0.8%. As in the whole of 2012, however, CZSO asking prices were the only data source indicating a noticeable rise in prices, whereas alternative sources point to a continuing decrease in asking prices, including in Prague (see, for example, the Institute for Regional Information, according to which apartment prices in Prague declined by 2.1% year on year in 2013 Q1).

Differential price developments across regions are confirmed by the latest CZSO data on **transaction prices** for 2012 Q4, collected in a survey in estate agencies (see Chart III.5.20). According to this index, prices of older apartments in Prague increased by 1.2% quarter on quarter (0.2% year on year), while prices in the rest of the Czech Republic continued to fall relatively sharply (by 1.8% quarter on quarter and 7.0% year on year). Prices of new apartments in Prague grew even more markedly (by 1.8% quarter on quarter and 1.1% year on year). The overall price decline is consistent with the worse macroeconomic environment, the labour market situation and demographic trends.

Different market developments between Prague and the rest of the Czech Republic are also indicated by a comparison of the **number of property market transactions**. While in the Czech Republic outside Prague and Central Bohemia the number of proceedings on entry of ownership rights to houses and apartments fell by a sizeable 15.7% in 2012 as a whole (source: COSMC), this indicator for Prague increased by 5.4%. The recovery in demand for new apartments in property development projects in Prague is confirmed by developers' data, which indicate a rise in the number of apartments sold in 2012 as a whole.[51] The positive sales trend continued into early 2013. In 2013 Q1, sales surged by 49% year on year according to Ekospol

50 The year-on-year change in other financial assets of households in 2011 Q4–2012 Q3 reflects a methodological change to reporting in the sole traders sector.

51 According to Ekospol, the number of apartments sold in development projects rose by 16.2% to 4,014 in 2012; Trigema reported an increase of 20.8% to 4,578 and Skanska a rise of 2.5% to 4,720. According to the COSMC, however, the total number of apartment transfers (i.e. including older apartments) was one order of magnitude higher at almost 38,000.

and by a full 80% according to Trigema. The increase in sales of new apartments is also consistent with a decrease of 7.2% in the number of completed but unsold apartments since the end of 2012 (although the number of completed but unsold apartments went up by 6% in 2012 according to figures from Trigema). The recovery in demand for new apartments in Prague was driven mainly by a drop in apartment prices in some areas and by a fall in mortgage rates, which, together with a relative shortage of rental housing, opened up the possibility of investment property purchases.

The property price sustainability indicators fell further in 2013 Q1. The **price-to-income ratio** declined by 0.3% quarter on quarter (and by 2.6% year on year), while the **price-to-rent ratio** decreased by 2.1% quarter on quarter (and by 2.0% year on year; see Chart III.5.21). Both indices are at thus their lowest levels since 2007 and suggest undervalued property prices. However, despite this partly "statistical" undervaluation and the above-mentioned recovery in the market for new apartments in Prague, the fundamental factors underlying the apartments market remain rather unfavourable, so flat or moderately falling prices can be expected in the future.

CHART III.5.21

APARTMENT PRICE SUSTAINABILITY INDICATORS

The property price sustainability indicators fell again and are close to their minimum values

(2000–2007 average = 100; source: CZSO, Institute for Regional Information)

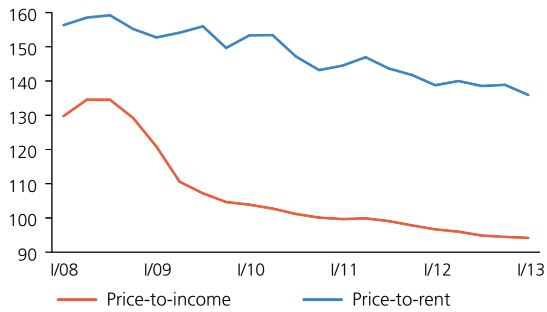


CHART III.6.1

CURRENT ACCOUNT

The current account deficit decreased in 2012, owing to a rise in the trade surplus
(annual moving totals in CZK billions)

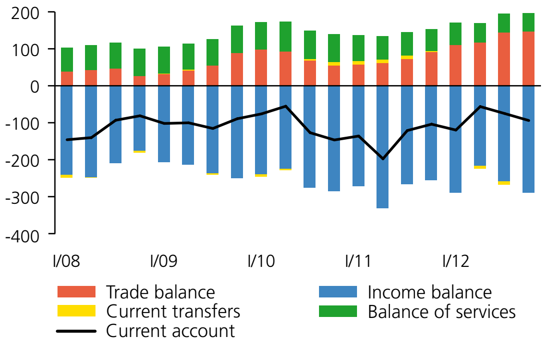


CHART III.6.2

TRADE BALANCE

The year-on-year change in the trade balance was affected most strongly in 2012 by growth in the machinery and transport equipment surplus
(annual accumulation in CZK billions; change of ownership principle)

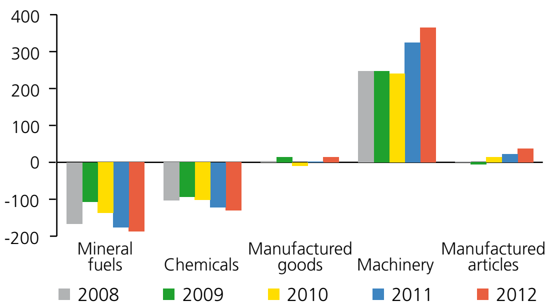
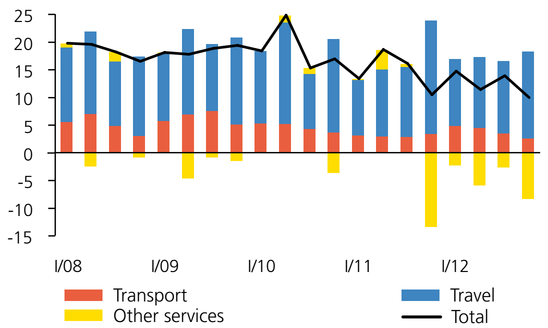


CHART III.6.3

BALANCE OF SERVICES

Travel and transport again contributed to the services surplus in 2012
(CZK billions)



III.6 BALANCE OF PAYMENTS

In 2012, the balance of payments continued to be characterised by a high income deficit, due mainly to income from direct investment going to non-residents. However, its effect on the current account was largely offset by a goods and services surplus resulting from a rising trade surplus. The financial account surplus was driven mainly by a net inflow of direct investment due primarily to estimated earnings reinvested in the Czech Republic, as well as by a surplus on portfolio investment. These net inflows were largely offset by a net outflow of other investment, due chiefly to a rise in the short-term assets of monetary financial institutions abroad.

III.6.1 The current account

The **current account** recorded a deficit of CZK 94 billion in 2012. In year-on-year terms, the deficit fell by almost CZK 10 billion. The decline in the overall deficit was related solely to the trade balance (see Chart III.6.1). The current account deficit was 2.4% of GDP, recording a slight year-on-year fall.

The **trade surplus** for 2012 rose by more than CZK 55 billion year on year to CZK 145.8 billion. The increase in the trade surplus was due to developments in real terms, which were partly offset, however, by the negative price effect stemming from a negative year-on-year change in the terms of trade. The continuing moderation of external demand growth during the year was reflected in a slowdown in exports. However, exports still grew by 7% year on year in nominal terms. This was largely aided by the year-on-year depreciation of the koruna in the first three quarters. The nominal growth rate of imports also followed a downward trend as a result of a constantly high import intensity of exports. At the same time, goods imports were dampened by a deepening decline in total domestic demand. By contrast, high energy prices and a weakening koruna fostered nominal growth in imports. 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 year-on-year growth in the surplus halted in early 2013, with the trade balance decreasing by CZK 3 billion year on year in January and February under the balance of payments methodology.

The **balance of services** recorded a surplus of CZK 49.8 billion in 2012. In year-on-year terms, the surplus dropped by almost CZK 9 billion (see Chart III.6.3). The overall surplus was due mainly to a surplus on travel and to a lesser extent also a surplus on transport. While the former decreased slightly in year-on-year terms, owing to faster growth in debits than in credits, the latter increased, mainly as a result of developments in road transport. By contrast, other services recorded a deficit stemming mainly from a strong increase in debits within business, professional and technical services. At the same time, a year-on-year widening of the other services deficit of more than CZK 10 billion had the largest impact on the overall surplus.

In contrast to the goods and services surplus, the **income balance** ended in a sizeable deficit of CZK 288.7 billion in 2012, up by more than CZK 33 billion year on year. The largest component of the overall balance was a direct investment income deficit of CZK 280.8 billion (see Chart III.6.4), linked mainly with income in the form of dividends paid to non-residents and estimated reinvested earnings in the Czech Republic. Portfolio investment income also ended in a lower deficit. By contrast, other investment income, which comprises income on the CNB's international reserves and interest on bank deposits, and compensation of employees, which is made up mainly of wages, recorded slight surpluses. The year-on-year increase in the overall income deficit was mainly associated with a higher deficit on direct investment income resulting from higher estimated reinvested earnings.

Current transfers recorded a deficit of CZK 1 billion in 2012 (compared to a slight surplus in 2011). Private transfers were the largest contributor to the balance. However, their deficit of CZK 18.4 billion was almost offset by a surplus on government transfers stemming mainly from a surplus on transfers of funds between the Czech Republic and the EU budget. Net drawdown of EU funds, recorded on the current account, amounted to CZK 17.6 billion. However, the year-on-year decline in the balance of current transfers was linked above all with lower credits within government transfers.

III.6.2 The capital account

In contrast to current transfers, the **capital account** ended in a surplus of CZK 51.7 billion, up by CZK 37 billion year on year. The overall surplus was due mainly to net income of CZK 55 billion from the EU budget. The annual increase in the overall surplus was also linked with a sharp rise in capital transfer credits vis-à-vis EU institutions. By contrast, trading in emission allowances shifted from a slight surplus to a slight deficit in year-on-year terms.

III.6.3 The financial account

The **financial account** ended 2012 in a surplus of CZK 121.8 billion (see Chart III.6.5). This was mainly due to net inflows of direct and portfolio investment. However, roughly one-half of the direct and portfolio investment surplus was offset by a net outflow of other investment.

In 2012, **direct investment** recorded a surplus of CZK 181.1 billion, up by more than CZK 134 billion year on year owing to a higher inflow of foreign direct investment (see Chart III.6.6). The overall inflow of foreign direct investment exceeded CZK 207 billion and was linked

CHART III.6.4

INCOME BALANCE

Within the income balance, the direct income deficit increased in 2012
(annual accumulation in CZK billions)

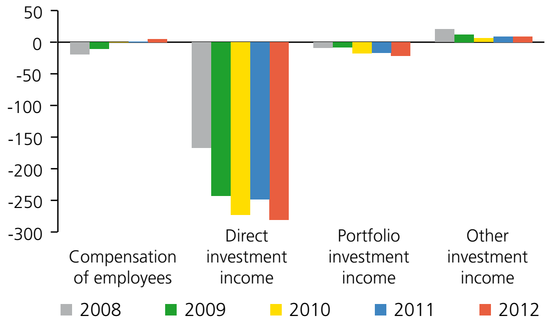


CHART III.6.5

FINANCIAL ACCOUNT

The financial account surplus in 2012 was due mainly to a rise in the net inflow of direct investment
(annual moving totals in CZK billions)

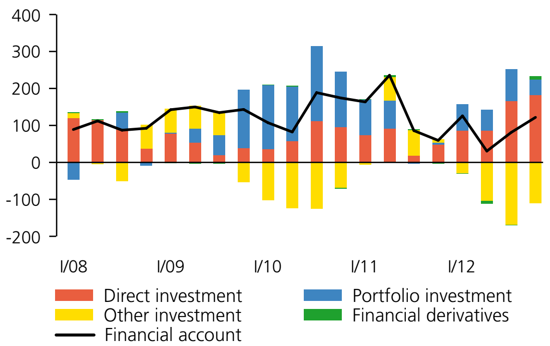
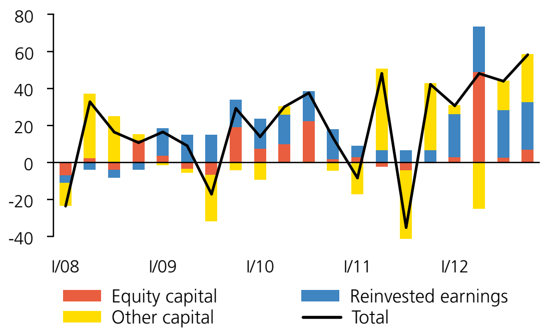


CHART III.6.6

DIRECT INVESTMENT

A net inflow of reinvested earnings contributed the most to the direct investment surplus in 2012
(CZK billions)

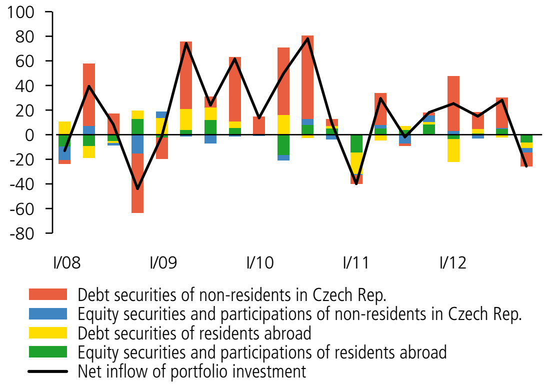


mainly with estimated reinvested earnings (CZK 118 billion). As a result of a significant operation between affiliates connected with a change in ownership, higher investment in equity was also recorded. The annual change in equity flows and the increase in reinvested earnings were also the biggest contributors to the rise in the overall surplus. Reinvested earnings were also the largest component of direct investment by domestic corporations abroad. With regard to industries, the foreign capital inflow (i.e. excluding reinvestment) was channelled primarily into transport and storage followed by manufacture of motor vehicles. The outflow of capital abroad went mainly into the electricity, gas and heat supply sector.

Chart III.6.7

PORTFOLIO INVESTMENT

Portfolio investment recorded a net inflow in 2012, owing to issuance of bonds abroad
(CZK billions)



Portfolio investment also recorded a net inflow – of CZK 42.6 billion – in 2012 (see Chart III.6.7). Issues of Czech government and corporate bonds on foreign markets were the most significant operations. Government and corporate bond issuance abroad also contributed to the increase of almost CZK 37 billion in the overall net inflow. On the other hand, holdings of domestic koruna bonds by non-residents declined. Share holdings of foreign investors also decreased moderately. On the liabilities side, the overall inflow of portfolio investment reached CZK 69 billion. Purchases also dominated domestic investors' transactions in foreign securities. They were connected mainly with an increase in bond holdings. The amount of foreign shares purchased was relatively small.

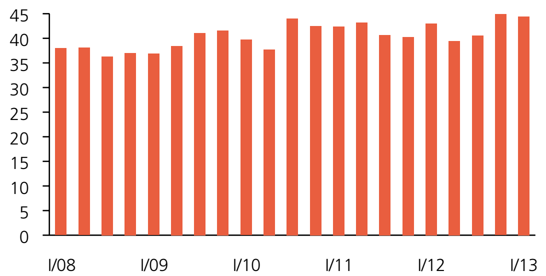
Settlement of **financial derivatives** recorded a net inflow of CZK 8.6 billion. The balance shifted from deficit to surplus, rising by almost CZK 12 billion year on year.

Other investment saw a net outflow of funds totalling CZK 110.6 billion in 2012. The overall deficit was due chiefly to a net outflow of CZK 79 billion in the monetary financial institutions sector, linked above all with a rise in short-term bank deposits and loans abroad and a decrease in non-residents' short-term deposits in the Czech Republic. A net outflow of capital (of over CZK 29 billion) was also recorded in the corporate sector. It was associated mainly with export credits to non-residents and repayment of loans. Other investment in the government sector also ended in a small deficit stemming from repayment of foreign loans from the EIB. The marked year-on-year change in other investment flows was due mainly to a change in the short-term position of monetary financial institutions on the asset side.

Chart III.6.8

CNB INTERNATIONAL RESERVES

The CNB's international reserves decreased slightly in 2013 Q1 compared to the previous quarter in dollar terms
(USD billions, end of quarter)



The **CNB's international reserves** totalled CZK 892.1 billion at the end of 2013 Q1, representing a quarter-on-quarter increase of almost CZK 37 billion. The increase was due chiefly to valuation changes as well as to a surplus on transactions executed for CNB clients and income on the international reserves. In dollar terms, by contrast, the reserves decreased by USD 0.4 billion to USD 44.4 billion in the same period (see Chart III.6.8). The CNB's international reserves covered over 44% of all external debt liabilities of domestic entities at the end of 2012.

III.7 THE EXTERNAL ENVIRONMENT

The euro area economy continued to contract in 2012 Q4, while the USA recorded only a slowdown in growth. A slight year-on-year decrease in euro area GDP is expected for 2013. GDP growth in the USA should exceed 2%, but the final growth rate will depend on the intensity of the impact of the budget cuts adopted there. Consumer price inflation slowed in both the euro area and the USA in March 2013, owing mainly to a drop in energy prices. Inflation pressures can be expected to remain subdued in advanced economies owing to the fall of the Brent crude oil price below USD 100 a barrel in April and stable core inflation. In 2013 as a whole, consumer prices are expected to rise by 1.9% in the USA and 1.7% in the euro area. The result of the Italian parliamentary elections and the Cypriot financial crisis led to a weakening of the euro against the dollar. However, the euro started appreciating again in early April.

III.7.1 The euro area

The quarterly and annual decline in **economic activity** in the euro area deepened in 2012 Q4. GDP fell by 0.6% quarter on quarter (following a drop of 0.1% in Q3), mainly as a result of a larger contraction in domestic demand and a smaller contribution of net exports. Economic activity was down in all euro area countries except Slovakia and Estonia. The annual decline in GDP deepened from 0.6% to 0.9% owing to a lower contribution of net exports and a fall in fixed investment (see Chart III.7.1). According to the April CF, the year-on-year economic contraction will continue in 2013 Q1. Year-on-year data on industrial production and retail turnover for the first two months of this year confirm the expected contraction in GDP in Q1. On average, industrial production fell similarly as in the previous quarter, while the decrease in retail turnover slowed somewhat. The unemployment rate also increased in January and February compared to 2012 Q4, rising by 0.2 percentage point to 12%.

The April CF expects a **slowing year-on-year contraction** in the rest of this year, especially H2, with growth in Q4. This is also indicated by the leading indicators during 2013 Q1. All the monitored indicators increased overall in Q1, signalling at least a slight improvement in the economy from Q2 onwards. By comparison with January, the April CF decreased its GDP growth estimate for this year as a whole by 0.3 percentage point to -0.4% (see Chart III.7.2). It expects a deeper decline in household consumption and fixed investment, slightly weaker export growth and somewhat higher unemployment.

Annual inflation fell by a further 0.1 percentage point to 1.7% in March because of slowing growth in energy prices (see Chart III.7.3). Compared to the January CF, the April CF lowered its estimate of average inflation for this year as a whole by 0.2 percentage point to 1.7%, followed by a further slight decrease next year (see Chart III.7.2). The ECB left its key rate unchanged at 0.75% during

CHART III.7.1

GDP IN THE EURO AREA

The decline in GDP deepened in 2012 Q4 due to a larger contraction in investment and lower positive net exports
(annual percentage changes; contributions in percentage points; seasonally adjusted; source: Datastream)

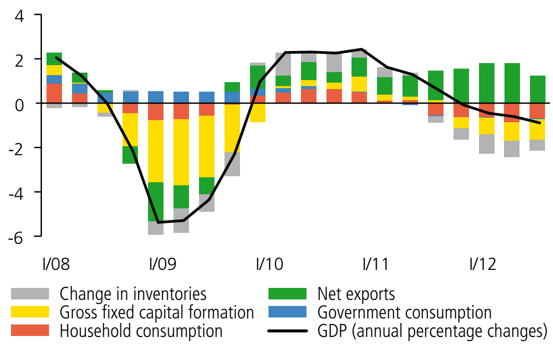
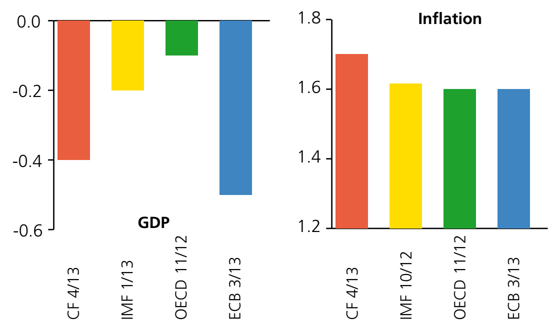


CHART III.7.2

EURO AREA GDP AND INFLATION OUTLOOKS FOR 2013

Euro area GDP should decrease in 2013, while inflation should fall below 2%
(annual percentage changes; source: CF, IMF, OECD, ECB)



Note: Horizontal axis shows most recent forecast data in format "Source month/year of publication". Midpoint of range for ECB.

CHART III.7.3

INFLATION AND PRODUCER PRICES IN THE EURO AREA

Consumer price inflation and producer price inflation gradually weakened during 2013 Q1

(annual percentage changes; source: Datastream)

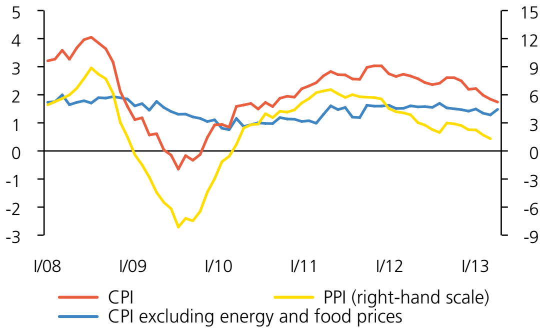


CHART III.7.4

GDP IN GERMANY

GDP growth slowed in 2012 Q4 due to a deeper decline in investment and lower positive net exports

(annual percentage changes; contributions in percentage points; seasonally adjusted; source: Datastream)

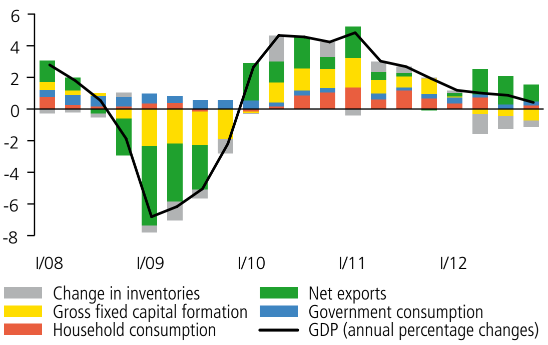
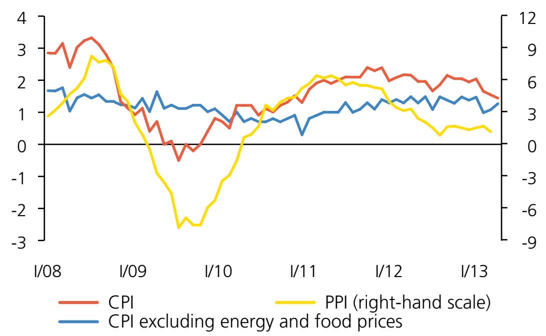


CHART III.7.5

INFLATION AND PRODUCER PRICES IN GERMANY

Consumer price inflation gradually slowed during 2013 Q1

(annual percentage changes; source: Datastream)



2013 Q1. Following the most recent Governing Council meeting on 4 April, the ECB President Mario Draghi stated that the ECB saw no danger of inflation pressures over the medium term owing to weak economic activity. The monetary and credit aggregates support this view. Annual M3 growth fell to 3.1% in February and loans to the private sector decreased by 0.9%.

During March and April the Eurogroup and the "Troika" (the European Commission, the ECB and the IMF) discussed the **request of Cyprus** for EUR 17.5 billion in financial assistance from the euro area rescue funds.[52] According to the approved agreement, Cyprus will receive only EUR 10 billion and will have to raise the remaining funds itself. Among other things, Cyprus will cut pensions and public sector salaries and increase taxes, but the bulk of the funds will be obtained by restructuring the banking sector. The sector faces heavy restrictions. Laiki Bank (the second largest Cypriot bank) will be closed down and the Bank of Cyprus (the largest bank) will be restructured. Holders of deposits exceeding EUR 100,000 in these two banks will lose a large proportion of their funds. According to the latest information, the financial needs of Cyprus up to 2016 will be higher (EUR 23 billion has been mentioned). This would mean Cyprus having to raise EUR 13 billion itself. Large deposit holders would then suffer even larger losses. A fall in GDP of between 8% and 15% is estimated for Cyprus this year.

The quarterly and annual GDP growth rates in **Germany** fell sharply in 2012 Q4. Following a quarterly rise in economic activity of 0.2% in Q3, a contraction of 0.6% was recorded at the close of the year. This stemmed mainly from a marked deterioration of net exports, which was only partly offset by strong growth in inventories. Annual GDP growth fell by 0.5 percentage point to 0.4%, mainly because of a deepening decline in fixed investment and a decrease in the positive contribution of net exports, which outweighed a rise in household consumption and a moderation of the fall in inventories (see Chart III.7.4). The April CF (unchanged from January) expects GDP growth of 0.7% for 2013 as a whole and 1.7% for 2014. This is a markedly better outlook than for the euro area as a whole. In the first two months of this year, industrial production continued to decline (by 2.5% on average) owing to falling exports, but retail turnover returned to annual growth (of 2.3% on average) thanks to low unemployment and rising real wages.

CPI inflation in Germany fell further to 1.4% in March owing to slowing energy price growth (see Chart III.7.5). The April CF expects it to average 1.7% in 2013. Next year, it should rise slightly to 2%.

52 The financial situation of Cyprus deteriorated chiefly as a result of Cypriot banks' links with the Greek financial system. Banks suffered losses owing mainly to the Greek government bond restructuring last year.

Quarterly and annual GDP growth in **Slovakia** fell again in 2012 Q4. The main factor was the decline in economic activity in the euro area and the Czech Republic, on which the Slovak economy is heavily dependent. Slowing industrial production growth and falling retail turnover in January and February 2013 point to a continued weakening of GDP growth. The result is a marked decrease in employment and a rise in the unemployment rate. Compared to January, the April CF lowered its outlook for economic growth from 1.5% to 1.0% in 2013 and from 2.7% to 2.4% in 2014. Inflation fell to 1.9% in March. Growth in producer prices is also slowing.

III.7.2 The United States

Annual and quarterly **US GDP growth** eased to 1.7% and 0.1% respectively in 2012 Q4. The slowdown in growth was due to the impact of Hurricane Sandy, which hit the eastern coast of the USA in October 2012, and to a drop in Defense Department expenditure. As regards the components of demand, investment recorded the highest growth rate, rising by 7.2% year on year. Private consumption increased by 1.8%, maintaining the growth rate seen in previous quarters. Higher exports also contributed to the overall GDP growth. By contrast, government consumption recorded a year-on-year decline of 1.8% (see Chart III.7.6). For 2012 as a whole, GDP growth reached 2.2% and the current account deficit was 3% of GDP.

Industrial production growth accelerated again in March 2013, returning to the 2012 average. On the other hand, the PMI leading indicator in industry fell in March and annual growth in nominal retail sales also slowed considerably. Consumer confidence remains low despite a slight improvement in the labour market, with the unemployment rate down to 7.6% in March.

Although the potential negative effect of significant public finance cuts (the fiscal cliff) was averted at the turn of the year, the further development of the economy will be significantly affected by the impact of across-the-board budget cuts implemented at the beginning of March 2013.[53] President Obama also unveiled the draft budget for 2014. The budget deficit is supposed to be reduced from 5.3% of GDP this year to 4.4% in 2014. However, there is no agreement across the political spectrum yet about how it is to be reduced. The Congressional Budget Office estimates that the government cuts will reduce economic growth in 2013 by 0.6 percentage point (from 2% to 1.4%). According to the April CF, however, **GDP growth in 2013** is expected to be at roughly the same level as in 2012, i.e. over 2%. The Fed's expectations are even more optimistic (see Chart III.7.7).

53 Automatic budget cuts (known as the sequester) were launched in the USA on 1 March 2013. They involve budget cuts in certain federal expenditure categories and are evenly distributed between defence spending and other expenditure. However, large government programmes (Social Security, Medicaid) are exempt.

CHART III.7.6

GDP IN THE USA

GDP growth decreased in 2012 Q4

(annual percentage changes; contributions in percentage points; seasonally adjusted; source: Datastream)

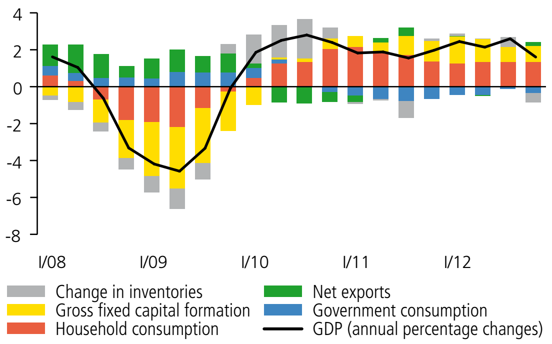
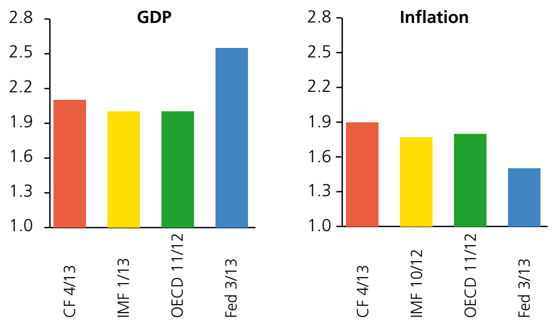


CHART III.7.7

US GDP AND INFLATION OUTLOOKS FOR 2013

GDP growth should stay above 2% and inflation below 2%

(annual percentage changes; source: CF, IMF, OECD, Fed)



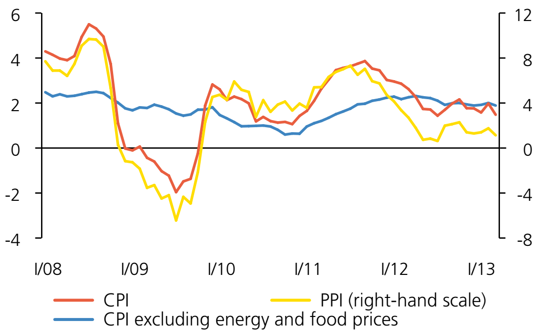
Note: Horizontal axis shows most recent forecast data in format "Source month/year of publication". Midpoint of range for Fed.

Chart III.7.8

INFLATION AND PRODUCER PRICES IN THE USA

Inflation decreased in March 2013

(annual percentage changes; source: Datastream)



Following a marked rise in **consumer prices** in February, annual inflation declined to 1.5% in March. This was mainly due to prices of energy, especially petrol, which pushed the overall index up in February and pulled it back down in March. Energy prices as a whole fell by 2.6% month on month. Given the current decline in oil prices, moreover, energy prices can also be expected to drag the overall price index down in April as well. Inflation excluding energy and food prices reached 1.9% year on year and is maintaining a stable level. The recent developments thus indicate no strong inflation pressures in the economy. Producer price inflation also moderated significantly in year-on-year terms in March (see Chart III.7.8). In 2013 as a whole, CF expects consumer price inflation to stand at 1.9% on average.

The **Fed**, which predicts even lower inflation, thus has space to continue purchasing mortgage and government bonds (at a rate of USD 85 billion a month) until the labour market improves significantly. At 6.8% in March 2013, annual M2 growth was flat at the previous month's level.

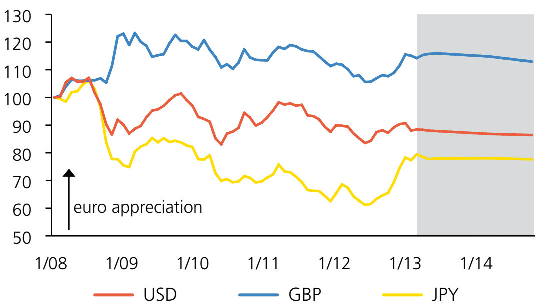
III.7.3 The exchange rate of the euro against the dollar and other major currencies

Chart III.7.9

EURO EXCHANGE RATE AGAINST MAJOR CURRENCIES

The euro strengthened most of all against the Japanese yen in 2013 Q1

(January 2008 = 100; source: Datastream, outlook from CF)



The **exchange rate of the euro against major world currencies** in 2013 Q1 was affected not only by the Cypriot financial crisis, but also by measures taken by central banks abroad (see Chart III.7.9). In January the euro appreciated against the US dollar, mainly on concerns regarding the impacts of the "fiscal cliff" in the USA. In the first week of February it reached its strongest level in 15 months. The subsequent weakening was due not only to the results of the Italian parliamentary elections, but also to the ECB's statement on a continuing accommodative monetary policy stance. In the second half of March, the euro depreciated further against the dollar as a consensus on financial assistance for Cyprus proved difficult to find. In addition, the effect on the exchange rate of the new orientation of Japanese monetary policy materialised in full in 2013 Q1 and the yen weakened against major world currencies. This weakening was supported by the Governor of the Bank of Japan, who introduced additional unconventional measures to help the central bank hit its new inflation target of 2%. The euro also appreciated slightly against the British pound as the Bank of England refused to further expand its quantitative easing programme amid a modest recovery. Overall, between the start of the year and the end of March 2013, the euro weakened by 3% against the dollar, but strengthened by 4% against the pound and by 6% against the yen.

In the **first half of April 2013**, the euro strengthened slightly against major currencies. The publication of the rescue plan agreement for Cyprus led to an easing of financial market tensions. At its April meeting, the ECB left its rates unchanged and announced no new measures, but reiterated the potential risks to growth and its readiness to act if needed.

The **April CF** expects the euro to depreciate slightly against the dollar to USD 1.27 at the one-year horizon. The euro should also weaken against the pound at the two-year horizon, while the CF outlook vis-à-vis the Japanese yen predicts depreciation to the level observed in March and subsequent stability.

III.7.4 Prices of oil and other commodities

In January and the first half of February 2013, the **price of Brent crude oil** rose on increasing optimism about the global economy, further supported by tensions in the Middle East and a weaker dollar. In mid-February the Brent oil price was fluctuating at a nine-month high of around USD 118 a barrel. However, it began to fall again in the second half of February as tensions in the euro area intensified owing to the Cypriot crisis and because of weaker leading indicators for China.

Regular work on refinery equipment, especially in Europe, which markedly lowered refineries' demand for oil, also contributed to the decrease in oil prices. The price continued to fall **in March and early April**, declining even below USD 100 a barrel in the third week of April on concerns about slowing global economic growth due to weaker-than-expected figures on the Chinese economy. During April, the spread between Brent and WTI reached the lows observed in July 2012 (below USD 15 a barrel). In addition to the drop in the Brent oil price, the narrowing of this spread was due to a rise in the price of WTI oil caused by a drop in stocks at the Cushing inland terminal and an expected rise in the capacity of the Seaway pipeline.

The IEA slightly lowered its **forecast for global oil demand** in 2013, which should reach 90.6 million barrels a day. This represents an increase of 0.9%, with the rise in demand from non-OECD countries more than offsetting a fall in demand from OECD countries, especially in Europe and Japan. OPEC also expects a 0.9% rise in demand in its April report. However, the increase in demand should be more than covered by a rise in extraction, mainly outside OPEC (especially the USA and Canada). Industrial stocks of oil and oil products in OECD countries fell seasonally by 32.9 million barrels to 2,664 million barrels at the end of February, but remained above the five-year average for the sixth consecutive month. The fall was caused by lower production of oil products by refineries.

The futures-based **oil price outlook** remains falling and has been moving downwards since mid-February. This decline is being accompanied by a lower number of net long positions of hedge funds and managed money funds, which were down by 17% in March from the end of February according to OPEC. Based on futures, the oil price should be below USD 100 a barrel at the one-year horizon. By contrast, the April CF expects prices to rise towards USD 110 a barrel at the one-year horizon.

CHART III.7.10

OIL AND NATURAL GAS PRICES IN USD

The price of Brent crude oil fell sharply towards USD 100 a barrel, and the outlook expects a further gradual decline
(oil in USD/barrel; gas in USD/1,000 m³ – right-hand scale; source: IMF, Bloomberg)

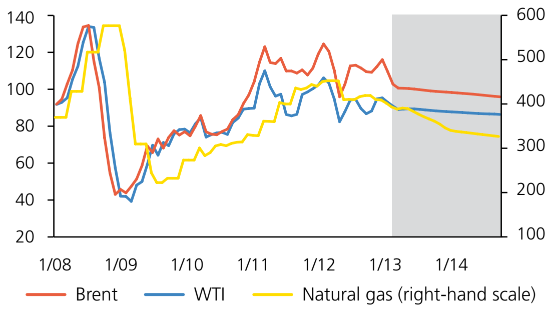


CHART III.7.11

DECOMPOSITION OF KORUNA OIL PRICE GROWTH

The koruna price of oil fell in 2013 Q1 despite the weakening koruna
(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)

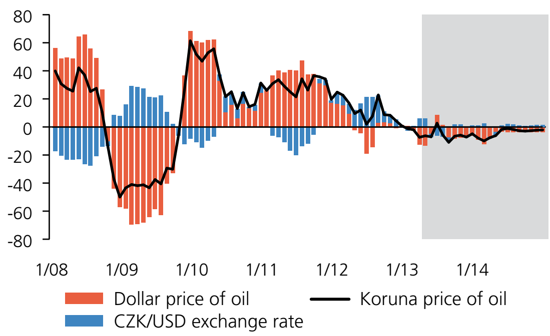
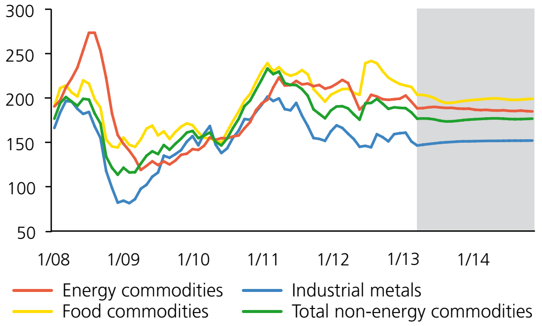


CHART III.7.12

COMMODITY PRICES

Prices of energy and non-energy commodities fell in 2013 Q1
(January 2007 = 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).

The overall **energy commodity index** was flat between September 2012 and February 2013 (see Chart III.7.12), but declined in March and April due to falling oil prices. Its outlook is also slightly falling, with the drop in prices of oil and natural gas expected to be larger than the rise in coal prices.

The **non-energy commodity index** also fell significantly in March and April 2013. The decline in food commodities observed since September 2012 was joined by a decrease in prices of industrial commodities and metals. Food prices have been falling from their summer highs on expectations of the new harvest, and their outlook is now broadly flat. Prices of industrial metals and commodities began to fall in the second half of February 2013, when the global economic outlook was revised downwards. The outlook for industrial metals is slightly rising owing to an upward outlook for aluminium, whose price reached a three-year low in April; the outlook for other metal prices is flat or falling. Prices of industrial commodities are expected to rise only slightly, so rubber prices should not deviate much from their current three-year lows.

CF	Consensus Forecasts
CF	Consensus Forecasts
CNB	Czech National Bank
CPI	consumer price index
CZK	Czech koruna
CZSO	Czech Statistical Office
COSMC	Czech Office for Surveying, Mapping and Cadastre
ECB	European Central Bank
EIB	European Investment Bank
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
FDI	foreign direct investment
Fed	US central bank
FMIE	Financial Market Inflation Expectations
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
GVA	gross value added
HP filter	Hodrick-Prescott filter
IEA	International Energy Agency
ILO	International Labour Organization
IMF	International Monetary Fund
IRI	Institute for Regional Information
IRS	interest rate swap
JPY	Japanese yen
LFS	Labour Force Survey
LIBOR	London Interbank Offered Rate
LTROs	long-term refinancing operations
M1, M2, M3	monetary aggregates
MLSA	Ministry of Labour and Social Affairs
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
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
WTI	West Texas Intermediate

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
The Bank Lending Survey	(Box)	III/2012
The CZK/USD exchange rate at a time of uncertainty	(Box)	III/2012
Easy monetary policy and commodity prices	(Box)	III/2012
The household saving rate	(Box)	IV/2012
Consumption and money savings by household income group	(Box)	IV/2012
The share of reinvested earnings in total FDI income	(Box)	IV/2012
Revision of the quarterly national accounts	(Box)	I/2013

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.

Bid-to-cover ratio: The ratio of total demand to demand coverage in primary auctions of medium-term and long-term government bonds.

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 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).

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.

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: We distinguish between the general unemployment rate (CZSO) and the share of unemployed persons (MLSA). The general unemployment rate is calculated as the ratio of the number of unemployed persons to the total labour force in the 15–64 age category under ILO methodology (LFS). The share of unemployed persons is the ratio of available job applicants aged 15–64 to the population of the same age. This indicator replaced the previously used registered unemployment rate at the start of 2013.

KEY MACROECONOMIC INDICATORS

		years										
		2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
DEMAND AND SUPPLY												
Gross domestic product												
GDP	CZK bn, constant p., seas. adjusted	2,914.5	3,113.5	3,338.4	3,529.4	3,632.1	3,473.9	3,554.9	3,622.2	3,578.9	**3,559.2**	**3,624.3**
GDP	%, y-o-y, real terms, seas. adjusted	4.6	6.8	7.2	5.7	2.9	-4.4	2.3	1.9	-1.2	**-0.5**	**1.8**
Household consumption	%, y-o-y, real terms, seas. adjusted	3.0	3.0	4.4	4.1	2.9	0.3	0.9	0.7	-3.5	**-0.5**	**1.3**
Government consumption	%, y-o-y, real terms, seas. adjusted	-3.3	1.6	-0.6	0.4	1.2	4.0	0.5	-2.5	-1.0	**0.4**	**0.4**
Gross capital formation	%, y-o-y, real terms, seas. adjusted	6.4	4.5	10.6	15.5	1.5	-20.0	5.5	0.3	-3.1	**-3.7**	**-0.5**
Exports of goods and,services	%, y-o-y, real terms, seas. adjusted	13.1	11.9	14.3	11.2	3.5	-10.5	15.0	9.4	4.1	**0.4**	**8.0**
Imports of goods and,services	%, y-o-y, real terms, seas. adjusted	9.5	6.1	11.2	12.8	2.3	-11.7	15.3	6.7	2.1	**-0.3**	**6.9**
Net exports	CZK bn, constant p. of 2005, seas. adjusted	-17.3	84.8	156.3	139.3	174.7	185.3	207.1	294.1	359.7	**380.3**	**440.3**
Coincidence indicators												
Industrial production	%, y-o-y, real terms	10.4	3.9	8.3	10.6	-1.8	-13.6	8.6	5.9	-0.7	-	-
Construction output	%, y-o-y, real terms	8.8	5.2	6.0	7.1	0.0	-0.9	-7.4	-3.6	-7.6	-	-
Receipts in retail sales	%, y-o-y, real terms	3.8	8.1	10.8	10.0	2.7	-4.7	1.5	1.7	-0.9	-	-
PRICES												
Main price indicators												
Inflation rate	%, end-of-period	2.8	1.9	2.5	2.8	6.3	1.0	1.5	1.9	3.3	-	-
Consumer Price Index	%, y-o-y, average	2.8	1.9	2.5	2.8	6.4	1.1	1.5	1.9	3.3	**1.7**	**1.8**
Regulated prices (18.70%)*	%, y-o-y, average	3.5	5.7	9.3	4.8	15.6	8.4	2.6	4.7	8.6	**2.7**	**2.6**
Net inflation (81.30%)*	%, y-o-y, average	1.8	0.7	0.4	1.7	2.4	-0.9	0.0	1.3	1.0	**0.6**	**1.4**
Food prices (including alcoholic beverages and,tobacco) (24.58%)*	%, y-o-y, average	2.8	0.0	-0.2	3.8	3.0	-0.9	0.9	3.9	2.9	**2.2**	**1.3**
Adjusted inflation excluding fuels (53.32%)*	%, y-o-y, average	1.2	0.7	0.6	0.7	2.0	0.0	-1.2	-0.7	-0.3	**0.0**	**1.5**
Fuel prices (3.39%)*	%, y-o-y, average	4.5	7.8	3.7	-0.3	4.3	-11.1	11.8	9.9	6.0	**-1.3**	**1.0**
Monetary-policy inflation (excluding tax changes)	%, y-o-y, average	2.0	1.8	2.3	2.2	4.4	0.9	0.4	1.9	2.1	**0.9**	**1.6**
GDP deflator	%, y-o-y, seas. adjusted	4.0	-0.3	0.5	3.3	1.9	2.3	-1.4	-0.8	1.3	**0.6**	**1.3**
Partial price indicators												
Producer prices	%, y-o-y, average	5.5	3.1	1.5	4.1	4.5	-3.1	1.2	5.6	2.1	**1.2**	**1.4**
Agricultural prices	%, y-o-y, average	9.6	-10.0	1.3	16.4	10.8	-24.3	7.7	22.7	3.6	**7.4**	**-2.0**
Construction work prices	%, y-o-y, average	3.7	3.0	2.9	3.9	4.5	1.2	-0.2	-0.5	-0.7	-	-
Brent crude oil	%, y-o-y, average	32.7	42.1	18.6	12.6	34.3	-36.6	28.7	39.5	0.8	**-4.9**	**-5.1**
LABOUR MARKET												
Average monthly wage	%, y-o-y, nominal terms	6.3	5.0	6.6	7.2	7.8	3.3	2.2	2.4	2.7	**1.0**	**3.1**
Average monthly wage	%, y-o-y, real terms	3.4	3.0	4.0	4.3	1.4	2.3	0.7	0.5	-0.6	**-0.6**	**1.3**
Number of employees	%, y-o-y	-0.2	2.0	1.1	1.8	1.6	-2.2	-2.2	0.0	-0.1	**-0.5**	**-0.8**
Unit labour costs	%, y-o-y	3.7	0.6	0.2	2.4	4.3	2.6	-1.8	0.3	3.3	**1.1**	**0.4**
Unit labour costs in industry	%, y-o-y	1.2	-7.2	-7.2	2.4	-3.3	5.4	-6.3	1.3	2.7	-	-
Aggregate labour productivity	%, y-o-y	5.1	4.6	5.6	3.5	0.8	-2.8	3.5	1.6	-1.7	**-0.3**	**2.4**
ILO general unemployment rate	%, average, age 15–64	8.4	8.0	7.2	5.4	4.4	6.7	7.4	6.8	7.0	**7.7**	**8.0**
Share of unemployed	%, average		6.6	6.1	4.9	4.1	6.2	7.0	6.7	6.8	**7.7**	**8.2**
PUBLIC FINANCE												
Public finance deficit (ESA95)	CZK bn, current p.	-82.9	-101.1	-79.2	-26.7	-85.0	-217.7	-180.7	-124.6	-167.9	**-91.8**	**-85.9**
Public finance deficit / GDP**	%, nominal terms	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.2	-4.4	**-2.4**	**-2.2**
Public debt (ESA95)	CZK bn, current p.	847.8	885.4	948.1	1,023.4	1,104.3	1,286.0	1,437.0	1,569.0	1,758.9	**1,847.3**	**1,925.3**
Public debt / GDP**	%, nominal terms	28.9	28.4	28.3	27.9	28.7	34.2	37.8	40.8	45.8	**48.1**	**48.5**
EXTERNAL RELATIONS												
Current account												
Trade balance	CZK bn, current p.	-13.4	48.6	59.3	46.9	25.7	87.3	53.8	90.3	145.8	**170.0**	**205.0**
Trade balance / GDP	%, nominal terms	-0.5	1.6	1.8	1.3	0.7	2.3	1.4	2.4	3.8	**4.5**	**5.2**
Balance of services	CZK bn, current p.	16.6	37.9	49.0	59.2	73.9	73.9	75.3	58.4	49.8	**50.0**	**55.0**
Current account	CZK bn, current p.	-147.5	-30.9	-67.1	-156.9	-81.3	-89.3	-146.6	-104.0	-94.0	**-50.0**	**-20.0**
Current account / GDP	%, nominal terms	-5.0	-1.0	-2.0	-4.3	-2.1	-2.4	-3.9	-2.7	-2.4	**-1.3**	**-0.5**
Foreign direct investment												
Direct investment	CZK bn, current p.	101.8	279.6	90.3	179.1	36.3	37.7	95.0	46.8	181.1	**50.0**	**65.0**
Exchange rates												
CZK/USD	average	25.7	24.0	22.6	20.3	17.1	19.1	19.1	17.7	19.6	**19.7**	**19.9**
CZK/EUR	average	31.9	29.8	28.3	27.8	25.0	26.5	25.3	24.6	25.1	**25.6**	**25.3**
CZK/EUR	%, y-o-y, real (CPI euro area), avg.	0.0	-6.3	-5.1	-2.2	-12.5	5.4	-4.6	-2.0	1.5	**2.1**	**-0.9**
CZK/EUR	%, y-o-y, real (PPI euro area), avg.	-3.0	-5.6	-1.4	-3.8	-8.8	4.4	-3.2	-2.5	2.7	**2.3**	**-0.4**
Foreign trade prices												
Prices of exports of goods	%, y-o-y, average	3.6	-1.5	-1.2	1.3	-4.6	0.2	-1.0	1.7	2.9	**1.4**	**1.2**
Prices of imports of goods	%, y-o-y, average	1.6	-0.5	0.3	-1.0	-3.3	-3.5	2.0	4.3	4.2	**-0.6**	**0.0**
MONEY AND INTEREST RATES												
M2	%, y-o-y, average	8.8	6.0	9.5	11.6	9.5	5.7	4.3	3.6	5.6	**3.6**	**3.1**
2W repo rate	%, end-of-period	2.50	2.00	2.50	3.50	2.25	1.00	0.75	0.75	0.05	-	-
3M PRIBOR	%, average	2.4	2.0	2.3	3.1	4.0	2.2	1.3	1.2	1.0	**0.3**	**0.6**

* in brackets are constant weights in actual consumer basket

** CNB calculation

– data are not available / forecasted / released

data in bold = CNB forecast

2010				2011				2012				2013				2014			
QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
877.9	887.3	891.8	897.8	904.6	906.1	905.6	905.9	901.2	895.8	891.8	890.2	888.1	888.7	890.1	892.3	896.6	901.9	908.9	916.9
0.9	2.7	2.8	2.9	3.0	2.1	1.5	0.9	-0.4	-1.1	-1.5	-1.7	-1.5	-0.8	-0.2	0.2	1.0	1.5	2.1	2.8
1.0	0.3	0.9	1.6	0.4	0.6	1.0	0.6	-2.7	-3.4	-3.9	-4.1	-1.5	-1.0	0.5	-0.2	0.8	1.2	1.5	1.7
1.5	1.7	0.2	-1.5	-0.6	-2.1	-4.1	-3.2	-2.3	-1.9	-0.4	0.8	1.3	0.9	0.4	-0.9	-0.6	0.0	0.7	1.4
-9.3	6.9	17.6	8.8	5.2	1.7	-4.0	-1.1	-2.4	0.2	-9.4	-0.4	-3.7	-5.6	-0.4	-5.1	-0.4	-1.1	-0.5	0.0
13.9	16.6	15.6	14.2	16.4	11.1	6.9	4.0	6.4	4.1	4.3	1.4	-4.8	-0.3	0.4	6.5	7.8	7.7	7.9	8.5
9.7	16.6	20.1	14.7	14.7	8.8	2.5	1.9	3.7	3.1	0.3	1.2	-5.0	-1.6	1.0	4.4	7.3	6.7	6.7	6.9
53.5	54.2	38.0	61.3	72.1	74.2	70.0	77.7	94.9	84.1	100.1	80.6	92.0	92.5	96.0	99.8	102.5	106.4	112.2	119.2
4.7	9.6	9.7	10.4	10.8	8.2	2.3	2.6	2.7	-0.8	-0.8	-4.0	-	-	-	-	-	-	-	-
-22.7	-8.4	-2.9	-2.3	5.7	-5.3	-9.1	-0.9	-10.0	-6.0	-6.2	-9.0	-	-	-	-	-	-	-	-
0.1	2.0	1.8	1.8	5.2	1.1	0.3	0.7	1.0	-2.0	-1.0	-1.5	-	-	-	-	-	-	-	-
0.7	0.6	1.1	1.5	1.7	1.9	1.8	1.9	2.4	2.7	3.2	3.3	2.8	-	-	-	-	-	-	-
0.7	1.1	1.9	2.1	1.7	1.8	1.7	2.4	3.7	3.4	3.3	2.8	1.7	1.6	1.6	1.8	1.5	1.8	1.9	2.0
0.8	2.3	3.6	3.8	4.4	4.0	4.5	5.9	9.7	9.4	8.2	7.1	3.5	2.8	2.3	2.2	2.2	2.6	2.9	2.8
-0.5	-0.3	0.3	0.4	1.0	1.2	1.2	1.7	1.3	1.0	0.9	0.6	0.6	0.4	0.6	0.8	1.1	1.4	1.5	1.6
-1.4	-0.2	2.3	2.8	3.2	4.1	3.6	4.5	3.5	2.5	2.8	2.7	3.0	2.6	2.0	1.2	0.9	1.2	1.4	1.6
-1.1	-1.2	-1.2	-1.3	-0.8	-0.8	-0.7	-0.4	-0.3	-0.2	-0.4	-0.5	-0.4	-0.2	0.1	0.6	1.2	1.5	1.7	1.7
18.1	13.3	7.0	8.7	10.8	9.1	9.5	10.2	8.0	5.8	6.4	3.8	-1.5	-2.5	-1.7	0.5	1.7	1.2	0.5	0.4
-0.3	0.1	0.8	1.0	1.6	1.7	1.7	2.4	2.5	2.2	2.0	1.5	0.9	0.8	0.8	1.0	1.3	1.6	1.8	1.8
-2.3	-0.8	-0.5	-1.9	-1.8	-1.5	-0.8	1.0	2.0	1.7	1.1	0.6	0.5	0.7	0.6	0.4	0.5	0.9	1.8	2.2
-1.4	1.3	2.2	3.0	5.4	6.0	5.6	5.2	3.6	1.8	1.6	1.6	1.2	1.0	1.4	1.3	1.1	1.4	1.5	1.6
-5.6	-2.8	8.2	22.7	32.4	32.3	19.2	7.1	-1.2	-2.9	5.6	12.7	14.5	9.5	5.2	0.3	-5.7	-3.4	-0.3	1.3
0.0	-0.2	-0.3	-0.3	-0.4	-0.6	-0.5	-0.5	-0.7	-0.6	-0.6	-0.8	-0.7	-	-	-	-	-	-	-
70.5	35.9	11.9	15.8	36.7	49.0	48.0	26.2	13.2	-7.2	-2.5	1.1	-4.5	-2.3	-4.9	-6.4	-9.2	-3.6	-3.6	-3.6
2.8	3.1	2.2	0.7	2.4	2.4	2.4	2.4	3.4	2.3	1.5	3.7	0.1	1.8	1.9	0.4	4.1	2.6	2.8	2.9
2.1	1.9	0.3	-1.4	0.7	0.6	0.6	0.0	-0.3	-1.1	-1.7	0.9	-1.6	0.2	0.3	-1.4	2.6	0.8	0.8	0.9
-3.3	-2.7	-1.4	-1.6	-0.2	0.4	0.1	-0.5	-0.6	-0.6	0.3	0.6	0.4	-0.1	-1.1	-1.2	-1.1	-1.0	-0.8	-0.5
-2.3	-2.4	-0.1	-2.2	-1.1	1.1	0.1	1.0	3.2	3.3	2.5	4.1	2.0	2.5	1.0	-1.1	1.9	0.1	-0.1	-0.3
-8.0	-8.3	-4.6	-4.6	-1.6	1.2	2.9	2.7	0.1	2.8	2.9	5.2	-	-	-	-	-	-	-	-
3.7	4.6	2.5	3.3	3.0	1.8	1.3	0.5	0.0	-2.0	-2.3	-2.2	-1.9	-0.7	0.3	0.9	1.7	2.1	2.6	3.1
8.2	7.2	7.1	7.0	7.3	6.8	6.6	6.5	7.2	6.8	7.0	7.2	7.7	7.4	7.8	7.9	8.3	7.8	8.0	7.9
7.6	6.8	6.6	6.9	7.4	6.5	6.4	6.4	7.1	6.5	6.6	7.0	8.0	7.4	7.6	7.9	8.9	7.9	7.9	8.0
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
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-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
31.0	22.9	-4.5	4.4	33.3	27.3	6.5	23.2	51.8	34.1	34.2	25.6	52.0	44.0	37.0	37.0	61.0	53.0	45.0	46.0
3.5	2.4	-0.5	0.4	3.7	2.8	0.7	2.3	5.7	3.5	3.5	2.6	5.8	4.6	3.8	3.7	6.7	5.4	4.5	4.3
18.3	24.8	15.3	16.9	13.3	18.6	16.1	10.4	14.7	11.4	13.9	9.9	12.0	13.0	14.0	11.0	14.0	15.0	15.0	11.0
22.3	-28.1	-106.4	-34.5	32.9	-89.7	-29.9	-17.3	17.0	-26.1	-48.6	-36.3	45.0	-27.0	-52.0	-16.0	37.0	-14.0	-37.0	-6.0
2.5	-2.9	-11.0	-3.5	3.7	-9.3	-3.1	-1.7	1.9	-2.7	-5.0	-3.6	5.0	-2.8	-5.4	-1.6	4.1	-1.4	-3.7	-0.6
13.9	30.2	37.6	13.3	-8.4	48.1	-35.2	42.3	30.7	48.1	44.0	58.3	-	-	-	-	-	-	-	-
18.7	20.1	19.3	18.2	17.8	16.9	17.3	18.8	19.1	19.7	20.0	19.4	19.4	19.8	19.8	19.8	19.8	19.8	19.9	19.9
25.9	25.6	24.9	24.8	24.4	24.3	24.4	25.3	25.1	25.3	25.1	25.2	25.6	25.7	25.6	25.5	25.4	25.3	25.3	25.2
-6.3	-4.0	-3.2	-4.8	-5.3	-4.3	-1.1	2.5	2.0	2.9	2.0	-0.8	2.1	2.3	2.6	1.5	0.0	-1.2	-1.2	-1.2
-5.8	-3.1	-1.1	-2.8	-5.1	-4.7	-1.9	1.9	3.1	4.4	3.3	0.2	2.1	2.4	2.6	2.2	0.4	-0.7	-0.7	-0.6
-6.5	-0.3	2.2	1.0	0.8	-0.1	1.6	4.6	4.0	3.9	3.3	0.3	0.9	1.0	1.7	2.1	1.4	1.0	1.1	1.3
-4.4	2.5	5.8	4.7	4.7	2.4	3.5	6.5	5.7	5.7	4.7	1.0	-0.5	-1.1	-0.6	-0.1	-0.2	-0.2	0.0	0.3
3.5	5.0	4.8	4.1	3.4	2.6	3.8	4.8	6.1	5.8	5.7	5.0	4.2	4.0	3.2	3.0	3.2	3.2	3.1	2.9
1.00	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.05	0.05	-	-	-	-	-	-	-
1.5	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.0	0.6	0.5	0.2	0.2	0.3	0.5	0.6	0.6	0.7

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