INFLATION REPORT / II

2014

CNB CZECH NATIONAL BANK

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

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

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

The forecast is the key, but not the only, input to the Bank Board's decision-making. At its meetings during the quarter, the Bank Board discusses the current forecast and the balance of risks and uncertainties surrounding it. The Bank Board's final decision may not correspond to the message of the forecast due to arrival of new information since the forecast was drawn up and to 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.

This Inflation Report was approved by the CNB Bank Board on 15 May 2014 and contains the information available as of 25 April 2014. 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.

I. SUMMARY

The Czech economy expanded year on year in 2013 Q4 after almost two years of continuous contraction. As expected, both headline and monetary-policy relevant inflation dropped to low but positive values in 2014 Q1, well below the lower boundary of the tolerance band around the CNB's target. The domestic economy remains anti-inflationary for the time being, whereas the weakened koruna is having the opposite effect. GDP will grow by 2.6% this year thanks to accelerating external demand growth and the easing of the monetary conditions via the weaker exchange rate of the koruna. The growth will pick up further to 3.3% in 2015, significantly aided by expansionary fiscal policy. Headline inflation will increase in the near future owing to import price growth. In the longer term, it will reflect growth in economic activity and wages. In early 2015 it will thus be slightly above the CNB's 2% target. Monetary-policy relevant inflation will return towards the target and stay very close to it at the monetary policy horizon. Average inflation will be 0.8% this year and 2.2% in 2015. The forecast expects market interest rates to be flat at their current very low level and the exchange rate to stay at CZK 27 to the euro until the start of next year. This exchange rate level continues to deliver the necessary easing of the monetary conditions.

The **Czech economy** expanded by 1.2% year on year **in 2013 Q4**, with all demand components except inventories making positive contributions. Positive annual growth was recorded for the first time in almost two years, reflecting the bottoming-out of the economy in 2013. Pronounced quarter-on-quarter GDP growth was seen at the year-end. The output gap thus narrowed, but remained strongly negative. A decline in wages in the business sector in 2013 Q4 also had an anti-inflationary effect. Accelerating annual GDP growth is forecasted for 2014 Q1 amid further moderate quarter-on-quarter growth in economic activity and renewed modest year-on-year growth in nominal wages.

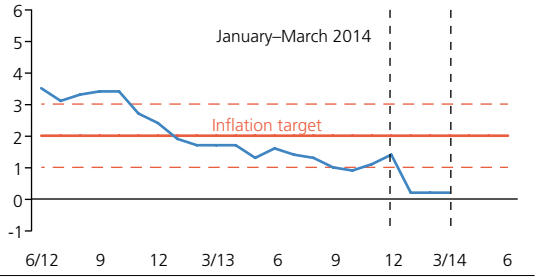
As expected, both **headline and monetary-policy relevant inflation** stood at low but positive levels **in 2014 Q1**, well below the lower boundary of the tolerance band around the CNB's target (see Chart I.1). The now only slightly negative adjusted inflation excluding fuels continued to reflect the anti-inflationary effect of the domestic economy, whereas the weaker koruna acted in the opposite direction via import prices. Administered prices went down significantly year on year, and the effect of the VAT changes implemented in 2013 dropped out of headline inflation.

Economic activity in the effective euro area is rising gradually. According to the assumptions of the forecast, its growth will reach 1.6% this year and increase further to 2% in 2015. Inflation remains very subdued owing to falling energy prices and a stronger euro amid only a gradual recovery in economic activity. Industrial producer prices in the euro area are falling year on year, and in some countries

Chart I.1

FULFILMENT OF THE INFLATION TARGET

Headline inflation was well below the lower boundary of the tolerance band around the CNB's target in 2014 Q1
(year on year in %)



the same goes for consumer prices. According to the assumptions of the forecast, however, this trend will reverse and prices in the euro area will increase at a gradually rising pace. The low outlook for 3M EURIBOR rates takes into account the ECB's still easy current and expected monetary policy. The euro-dollar exchange rate should weaken gradually in the longer term from its currently relatively strong level. Oil prices are expected to fall gradually over the forecast horizon.

According to the forecast, headline inflation will start rising towards the CNB's 2% target in 2014 Q2 and stay slightly above it at the monetary policy horizon (see Chart I.2). **Monetary-policy relevant inflation**, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, will follow a similar path to headline inflation, but at a slightly lower level (see Chart I.3). It will thus be very close to the target at the monetary policy horizon. The overall cost pressures will still increase modestly in the near future owing to import prices, which, despite very low foreign producer price inflation, will gradually be affected by the weaker koruna exchange rate. This effect will then weaken, however, and in 2015 import prices will slow inflation slightly. The current anti-inflationary effect of the domestic economy will dissipate by mid-2014. Inflation will then be affected by a recovery in domestic economy and an upswing in wage growth. As a result, adjusted inflation excluding fuels will turn positive in the near future and then rise further. Food prices will rise over the forecast horizon, due, among other things, to the observed rise in global prices of agricultural commodities. By contrast, administered prices will decline further this year and return to only modest annual growth in 2015. Fuel prices will mostly be declining slightly as a result of global oil and petrol price developments.

The forecast expects market **interest rates** to be flat at their current very low level until the start of 2015 (see Chart I.4), reflecting the 2W repo rate being left at technical zero and an unchanged money market premium. Market rates are forecasted to increase by about 0.6 percentage point in 2015. The **exchange rate of the koruna** against the euro stabilised close to CZK 27.4 at the start of 2014. The forecast expects the exchange rate to return to the CNB's exchange rate commitment of CZK 27 to the euro. According to the analyses, this is still sufficient to avert the threat of deflation and facilitate a faster economic recovery and a faster return of inflation to the CNB's target. According to the assumptions of the forecast, the exchange rate should stay at this level as long as easy monetary conditions are needed, i.e. until the start of 2015. During this period, domestic inflationary pressures should be sufficiently renewed thanks to an economic recovery and rising wages, allowing for a return to conventional monetary policy at the start of 2015. However, this return will not imply appreciation of the exchange rate to the level recorded before the CNB started intervening, as the weaker exchange rate of the koruna will in the meantime pass through to the price level and other nominal variables.

CHART I.2

HEADLINE INFLATION FORECAST

Headline inflation will start to accelerate in 2014 Q2 and will be slightly above the target at the monetary policy horizon
(year on year in %)

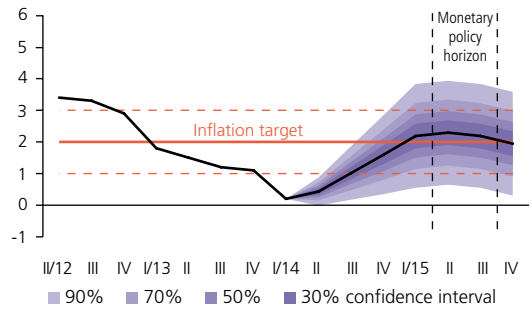


CHART I.3

MONETARY-POLICY RELEVANT INFLATION FORECAST

Monetary-policy relevant inflation will be very close to the target at the monetary policy horizon
(year on year in %)

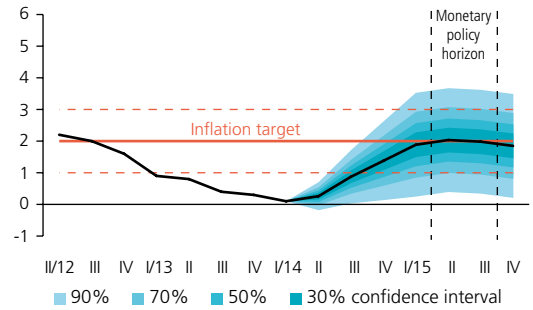


CHART I.4

INTEREST RATE FORECAST

The forecast expects market interest rates to be flat at their current very low level until the start of 2015
(3M PRIBOR in %)

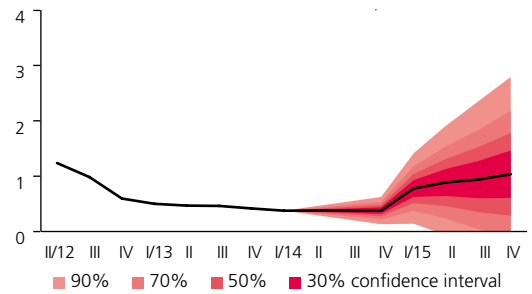
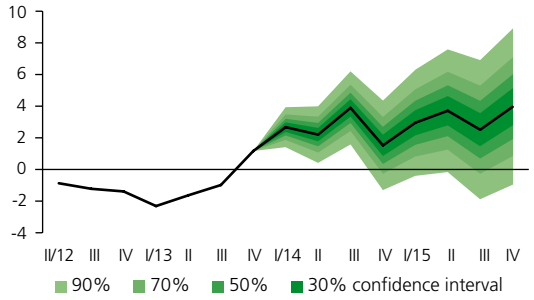


CHART I.5

GDP GROWTH FORECAST

GDP will grow on the back of accelerating growth in external demand, easy monetary conditions and expansionary fiscal policy
(annual percentage changes; seasonally adjusted)



Following last year's contraction of the **Czech economy**, GDP will grow this year (see Chart I.5). Accelerating growth in external demand and easy monetary conditions via the weaker exchange rate of the koruna, coupled with slightly expansionary fiscal policy, will lead to GDP growth of 2.6%. Economic growth will then pick up to 3.3% in 2015, significantly aided by fiscal policy. In 2014, the economic recovery will – with the usual time lag – affect the **labour market**, which will see renewed growth in the number of employees converted into full-time equivalents. The unemployment rate will still be flat this year owing to persisting growth in the labour force. It will start decreasing in early 2015. Wage growth in the business sector will increase noticeably from its current low levels. Wages in the non-business sector will rise at a rather lower rate.

At its monetary policy meeting on 7 May 2014, the Bank Board decided unanimously to keep interest rates unchanged at technical zero. The Board also decided to continue **using the exchange rate as an additional instrument for easing the monetary conditions**. It also confirmed the CNB's commitment to intervene on the foreign exchange market if needed to weaken the koruna against the euro so that the exchange rate of the koruna is kept close to CZK 27 to the euro. The nature of this exchange rate commitment is unchanged. The Bank Board assessed the risks to the new forecast as being slightly anti-inflationary. The Bank Board continues to view the level of the exchange rate commitment at CZK 27 to the euro as appropriate and expects the exchange rate to be kept close to this level at least until the start of 2015. In a debate of the new forecast, however, the Bank Board stated that the probability of a later exit from the exchange rate commitment was increasing. At the same time the Bank Board concluded that domestic interest rates will not necessarily rise as fast as indicated by the forecast in 2015.

II. THE FORECAST, ITS CHANGES AND RISKS

II.1 EXTERNAL ASSUMPTIONS OF THE FORECAST

Economic growth in the effective euro area will gradually pick up pace this year and the next. The currently falling producer prices – reflecting a continuing decline in energy prices and the strong exchange rate of the euro – will go up negligibly over the forecast horizon. Consumer prices will also rise only slightly owing to the slowly recovering demand. The subdued price developments are reflected in the easy monetary policy of the ECB and also in the outlook for 3M EURIBOR rates, which remain at very low levels over the entire forecast horizon. In the longer run, the euro is expected to depreciate gradually against the dollar from its current relatively strong level. The outlook for the Brent crude oil price continues to expect a gradual decline.

The outlook for the **effective indicator of euro area GDP** foresees a pick-up in annual economic growth to 1.6% this year. This is 1.1 percentage points higher than in 2013 (see Chart II.1.1).[1] A further acceleration of economic activity in the effective euro area to 2% is then expected in 2015. Accelerating external economic activity (particularly in industry) is also indicated by rising leading indicators for the euro area. Compared to the previous forecast, the outlook from the whole-year perspective has shifted slightly upwards this year and is unchanged in 2015.

The currently falling **effective indicator of producer prices in the euro area** (see Chart II.1.2) should be stable from the whole-year perspective this year. Despite rising prices of agricultural commodities, the stronger inflationary pressures are dampened by a decline in energy prices and also by a stronger exchange rate of the euro. As the economic recovery gathers pace, producer prices will return to growth in 2014 H2, reaching 1.5% on average in 2015. The outlook is 0.6 percentage point lower for this year than in the previous forecast and remains unchanged for 2015.

The low outlook for the **effective indicator of consumer prices in the euro area** this year mainly reflects a continuing decline in prices of energy for households and only slowly recovering demand. Inflation is likely to be fostered mainly by food prices (see Chart II.1.3). In 2014 as a whole, consumer prices are expected to increase by 1.1% on average. Next year, as growth in economic activity accelerates, consumer price inflation is expected to rise to 1.7% on average. This represents a downward shift of about 0.4 percentage point compared to the previous forecast in both years.

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 14 April 2014. 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 an update of the weights of individual countries in Czech exports.

CHART II.1.1

EFFECTIVE GDP IN THE EURO AREA

External demand growth should gradually accelerate this year and the next

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

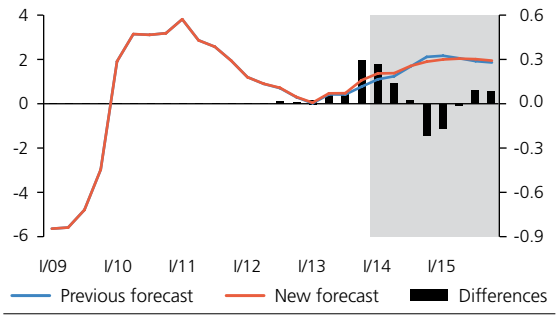


CHART II.1.2

EFFECTIVE PPI IN THE EURO AREA

The subdued producer price inflation primarily reflects the current decline in energy prices and the recent appreciation of the euro coupled with an only gradual recovery of the economy

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

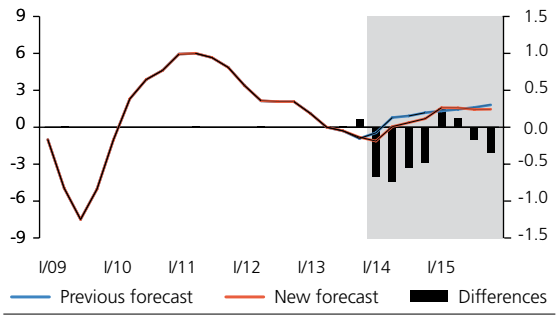


CHART II.1.3

EFFECTIVE CPI IN THE EURO AREA

Effective inflation is currently very low and is below 2% over the entire forecast horizon

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

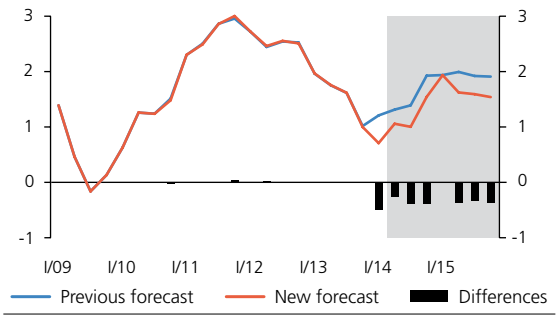


CHART II.1.4

3M EURIBOR

The low interest rate outlook reflects the very subdued inflation and expectations of continued accommodative ECB monetary policy
(in %; differences in percentage points – right-hand scale)

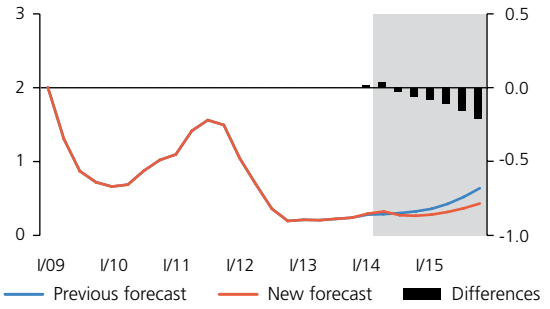


CHART II.1.5

EURO-DOLLAR EXCHANGE RATE

The euro should gradually weaken against the dollar from its relatively strong current level over the entire forecast horizon
(USD/EUR; differences in % – right-hand scale)

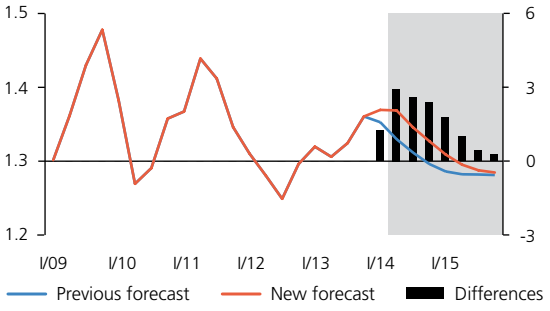
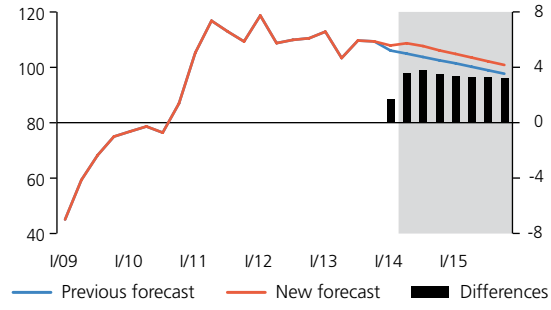


CHART II.1.6

PRICE OF BRENT CRUDE OIL

The market outlook for the crude oil price expects a gradual decline over the entire forecast horizon
(USD/barrel; differences in % – right-hand scale)



The low outlook for **3M EURIBOR interest rates** takes into account the continuing subdued inflation in the medium term and the resulting monetary policy of the ECB, whose representatives still admit the possibility of a further easing. The market outlook expects the 3M EURIBOR to be flat at 0.3% on average this year and the next (see Chart II.1.4). Compared to the previous forecast, this means no change this year. The outlook for 2015 is revised downwards by 0.1 percentage point on average. The market outlook for foreign interest rates is in line with the expectations of the analysts surveyed in the April CF, who also expect the 3M EURIBOR to be flat at 0.3% at the 3–12 month horizon. At the same time, most analysts expect the ECB's main refinancing rate to stay at the current level of 0.25% at least until the end of March 2015.

The outlook for the **euro-dollar exchange rate** is based on the currently relatively strong value of the euro, which reflects improving sentiment resulting from the continued pick-up in economic activity in the euro area and favourable developments in the bond markets of the periphery countries. Compared with the previous forecast, the euro exchange rate is expected to be about 2% stronger over the entire forecast horizon, but it is still forecasted to follow a gradual depreciation trend (see Chart II.1.5). This reflects the expected faster growth of the US economy compared to the euro area and a tapering of the quantitative easing programme in the USA, whereas further monetary policy easing is not ruled out in the euro area. The exchange rate of the euro is thus expected to be USD 1.35 on average this year. In 2015, the euro is expected to depreciate to USD 1.29 on average.

The **Brent crude oil price** is currently slightly higher than in the previous forecast (see Chart II.1.6). This mainly reflects geopolitical tensions associated with the situation in Ukraine and the resulting uncertainty regarding future oil and natural gas supplies from Russia. However, the futures curve remains downward-sloping, and the Brent crude oil price should thus fall from around USD 108 a barrel to about USD 100 at the end of 2015. This means an upward revision of about USD 3 a barrel over the entire outlook horizon compared to the previous forecast. The analysts surveyed in the April CF expect the Brent crude oil price to be close to USD 106 a barrel at the 12-month horizon.

II.2 THE FORECAST

Annual headline inflation dropped sharply in 2014 Q1 to very low but positive values. It will start to pick up gradually in 2014 Q2. Headline inflation will thus get slightly above the CNB's 2% target in early 2015, while monetary-policy relevant inflation will return towards the target. Both headline and monetary-policy relevant inflation will then stabilise close to the target. The inflationary effect of import prices this year reflects the weakening of the koruna amid subdued producer price inflation abroad. The domestic economy will contribute to price growth from mid-2014 onwards, chiefly as a result of a recovery in wage growth. After last year's GDP decline, the economy will grow by 2.6% this year thanks to accelerating external demand growth and the easing of the monetary conditions via the exchange rate of the koruna. The growth will pick up further to 3.3% in 2015, significantly aided by expansionary fiscal policy. The economic recovery will start to have a favourable effect on the labour market. The forecast expects market interest rates to be flat at their current very low level and the exchange rate to stay at CZK 27 to the euro until the start of next year. This exchange rate level continues to deliver the necessary easing of the monetary conditions. The subsequent return to conventional monetary policy will not imply appreciation of the exchange rate to the level recorded before the CNB started intervening.

As expected, annual **headline inflation** dropped sharply to 0.2% on average in 2014 Q1, and was thus well below the lower boundary of the tolerance band around the CNB's target. The slowdown in consumer prices was chiefly due to a fall in administered prices and an unwinding of the first-round effects of the VAT changes made last year. Headline inflation will increase in the period ahead, primarily due to adjusted inflation excluding fuels turning positive as a result of continued growth in import prices. A gradual rise in inflationary pressures from the recovering domestic economy will then cause market price inflation to increase above 2% at the end of this year. Higher inflation will also be fostered by a moderation of the annual decline in administered prices and a pick-up in food prices until the end of 2014. The decline in administered prices will fade out completely in 2015, although their growth will be very low. Headline inflation will thus rise gradually and get slightly above the target at the start of next year (see Chart II.2.1). In 2015 H2 it will slow again and approach the 2% target from above, where it will stabilise. Average inflation will be 0.8% this year and increase to 2.2% in 2015.

Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, dropped to 0.1% on average in 2014 Q1 and thus remained well below the lower boundary of the tolerance band around the target. Over the forecast horizon it will follow a similar path to headline inflation, although at a slightly lower level owing to the first-round effects of changes to excise duty on cigarettes. It will thus stay very close to the CNB's target at the monetary policy horizon.

CHART II.2.1

HEADLINE INFLATION AND MONETARY-POLICY RELEVANT INFLATION

Headline inflation will get slightly above the CNB's 2% target at the start of 2015, while monetary-policy relevant inflation will return towards the target

(year on year in %)

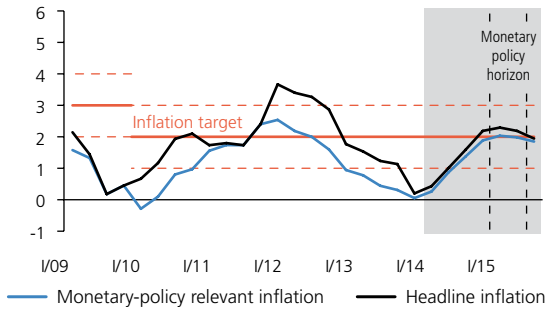


Chart II.2.2

ADMINISTERED PRICES AND FUEL PRICES

Administered prices will fall this year, while fuel prices will rise slightly in the immediate future only
(annual percentage changes; fuel prices excluding first-round effects of indirect tax changes)

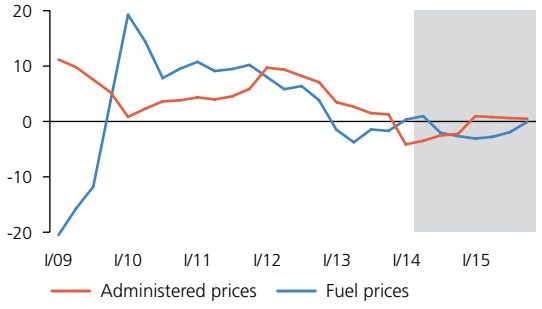


Table II.2.1

FORECAST OF ADMINISTRATIVE EFFECTS

The fall in administered prices in 2014 will be due mainly to a sharp decline in electricity prices, which is, to a lesser extent, expected to continue in 2015
(annual average percentage changes; contributions to headline inflation in percentage points)

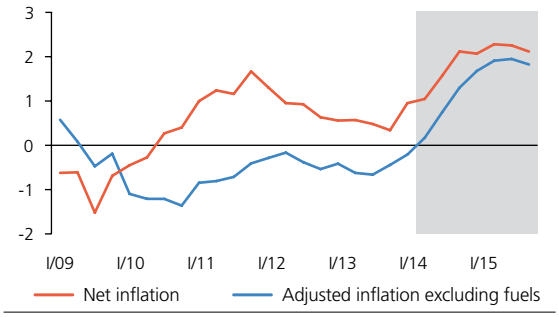
	2013 actual		2014 forecast		2015 forecast	
Administered prices – total[a)]	2.2	0.40	-3.1	-0.52	0.7	0.12
of which (main changes):						
electricity	3.2	0.15	-10.4	-0.49	-4.6	-0.22
natural gas	-3.5	-0.09	-3.4	-0.10	-0.2	-0.01
heat	4.3	0.10	1.1	0.02	3.9	0.08
water	6.7	0.07	3.4	0.03	4.3	0.04
healthcare	2.6	0.05	-6.8	-0.08	4.5	0.05
First-round impacts of tax changes in non-administered prices		0.67		0.17		0.21

a) Including effects of indirect tax changes

Chart II.2.3

NET INFLATION AND ADJUSTED INFLATION EXCLUDING FUELS

Market price inflation will rise quite quickly owing to the weakened exchange rate and recovering economic activity
(year on year in %)



The contribution of changes to **indirect taxes** to non-administered prices averaged 0.1 percentage point in 2014 Q1. The effect of the increase in both VAT rates implemented at the start of 2013 dissipated completely. Annual inflation continued to be affected by the increase in excise duty on tobacco products made in January 2013, which passed through to consumer prices with a substantial lag owing to frontloading. January 2014 saw a further increase in excise duties on cigarettes as a result of the harmonisation change adopted in 2012. Its effect on headline inflation is estimated at about 0.1 percentage point. However, this change has so far been reflected only slightly in final prices owing to frontloading. In addition, the forecast assumes another harmonisation increase in excise duty on cigarettes in accordance with a proposed legislative change,[2] which simultaneously limits frontloading to three months. The effect of this measure on inflation is estimated at about 0.2 percentage point and its full pass-through to consumer prices can be expected at the end of this year. No changes to indirect taxes are yet foreseen by the forecast for 2015.[3]

In early 2014 **administered prices** switched suddenly to a year-on-year decline, which averaged 4.1% in March (see Chart II.2.2). This was mainly a result of a decline in prices of energy for households, a fall in health care prices and weaker year-on-year growth in water supply charges in January (see Table II.2.1). The forecast assumes a gradual moderation of the annual decline in administered prices this year, fostered primarily by the unwinding of the annual decrease in prices of gas for households. The forecast then expects prices of electricity for households to go down again in 2015, reflecting the fall in electricity generation prices already visible on energy exchanges. Owing to an expected increase in prices of other regulated items, however, administered prices will switch to positive, albeit low (below 1%), growth rates at the start of next year.

Annua**l net inflation** increased to 1% on average in 2014 Q1, with adjusted inflation excluding fuels turning less negative and food prices picking up slightly (see Chart II.2.3). The weakened exchange rate of the koruna meanwhile continued to pass through to prices. In 2014 Q2, the forecast expects net inflation to be broadly flat, with adjusted inflation excluding fuels turning slightly positive but a short-term decline in annual food price inflation acting in the opposite direction. Adjusted inflation excluding fuels will gradually increase. This will affect net inflation, which will exceed 2% at the end of this year. Net inflation will remain slightly above this level in 2015.

2 The Czech Republic is obliged to comply with a specific minimum excise duty requirement of EUR 90 per 1,000 cigarettes with effect from 1 January 2014. According to the EU directive, this requirement must be met on the basis of the koruna-euro exchange rate as of the first working day of October 2013. Because the koruna-euro rate is weaker than when the legislation was adopted in 2012, the Czech Republic is not currently compliant with this directive. For this reason, the Ministry of Finance has proposed an additional increase in excise duty on tobacco products, which at the same time takes into account the koruna weakening as from November 2013. The legislation has not yet been adopted, but the forecast takes it into account as it constitutes a harmonisation change to taxes.

3 The government's planned introduction of a third VAT rate has not yet been incorporated into the forecast.

Annual **adjusted inflation excluding fuels** shifted to only slightly negative values in 2014 Q1, with the annual decline in prices of other tradable commodities slowing significantly as a result of the weakening of the koruna. However, its negative value continued to indicate an anti-inflationary effect of the domestic economy, mainly reflecting the low wage growth last year coupled with the recent renewed growth in productivity. Adjusted inflation excluding fuels will turn positive in the near future on the back of continued growth in import prices. Later, it will be affected by renewed domestic inflationary pressures reflecting the economic recovery and accelerating wage growth. As this effect of the domestic economy intensifies, adjusted inflation excluding fuels will gradually rise to almost 2% in 2015 (see Chart II.2.3).

Food prices (excluding the first-round effects of tax changes) recorded faster annual growth on average in 2014 Q1. This reflected the weakening of the exchange rate along with renewed growth in prices of agricultural commodities on world markets. Food price inflation will temporarily slow in Q2, but will then rise again to around 4%, reflecting a sharp increase in agricultural producer prices due to higher prices of agricultural commodities on world markets amid continued growth in prices of imported food commodities (see Chart II.2.4). Growth in consumer prices of food will slow next year as the strong growth in global prices of agricultural commodities gradually subsides.

Fuel prices increased only slightly on average in 2014 Q1, owing to the weakening of the koruna-dollar exchange rate and a simultaneous annual decline in world prices of oil and petrol. Annual growth in fuel prices will temporarily pick up in Q2 due to renewed growth in oil prices on world markets amid slowing annual depreciation of the koruna-dollar exchange rate (see Chart II.2.5). The forecast then expects fuel prices to decline as a result of a fall in oil and petrol prices on world markets.

Domestic money market **interest rates** remained flat at historical lows at all maturities in 2014 Q1. The forecast expects market interest rates to be flat at their current very low level until the start of 2015, reflecting the 2W repo rate being left at technical zero and an unchanged money market premium. Market rates are forecasted to increase by about 0.6 percentage point in 2015 (see Chart II.2.6).

The **exchange rate of the koruna against the euro** stabilised close to CZK 27.4 in 2014 Q1. The short-term forecast for 2014 Q2 assumes an exchange rate of CZK 27.3 to the euro. This level corresponds roughly to the current average exchange rate and the assumed subsequent return of the rate to the exchange rate commitment of CZK 27 to the euro. According to the analyses, this is still sufficient to avert the threat of deflation and facilitate a faster economic recovery and a faster return of inflation to the CNB's target. According to the assumptions of the forecast, the exchange rate should stay at this level as long as easy monetary conditions are needed, i.e. until the start of 2015. During this period, domestic inflationary pressures

CHART II.2.4

FOOD PRICES AND AGRICULTURAL PRODUCER PRICES

Food prices will continue to rise, while agricultural producer prices will start going up again in mid-2014
(annual percentage changes)

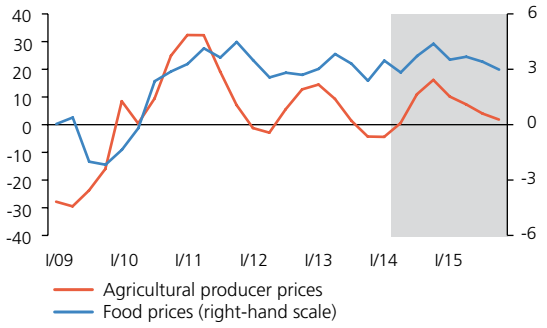


CHART II.2.5

FUEL PRICES AND OIL PRICES

The currently modestly rising fuel prices will start to fall in mid-2014 in line with global prices of crude oil and petrol
(annual percentage changes)

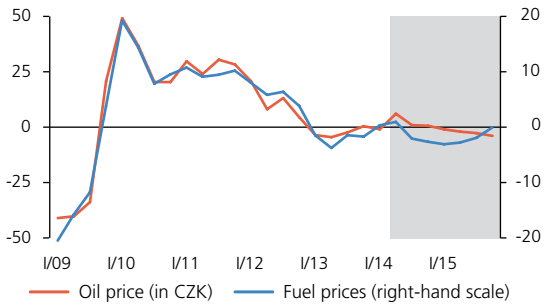
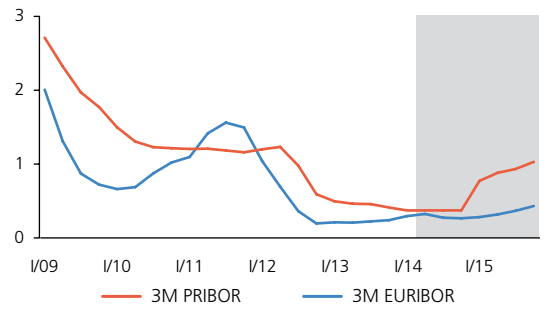


CHART II.2.6

INTEREST RATE FORECAST

The forecast expects market interest rates to be flat at their current very low level until the start of 2015
(percentages)



should be sufficiently renewed thanks to an economic recovery and rising wages, allowing for a return to conventional monetary policy at the start of 2015. However, this return will not imply appreciation of the exchange rate to the level recorded before the CNB started intervening, as the weaker exchange rate of the koruna will in the meantime pass through to the price level and other nominal variables. Given the CF outlook for a gradually depreciating euro against the dollar (see section II.1), this implies gradual depreciation of the koruna-dollar rate this year.

Quarterly growth in **nominal marginal costs in the consumer goods sector** picked up in 2014 Q1 (see Chart II.2.7). This pick-up was due to an increase in the contribution of import prices connected with the weakening of the koruna exchange rate as from November 2013. By contrast, the effect of the domestic economy, captured by intermediate goods price inflation, remains anti-inflationary owing to the previous contraction in economic activity (despite the recovery currently visible in consumption and investment) and to very low nominal wage growth in the business sector amid renewed growth in productivity. The estimated impact on inflation of growth in export-specific technology, linked with different productivity growth in the areas of tradables and non-tradables (the Balassa-Samuelson effect), has been less marked than in the pre-crisis period for some time now. The overall upward pressures on consumer prices will gradually build up further in the near term. Despite very low foreign producer price inflation, import prices will continue to foster higher costs in the consumer sector due to the gradual pass-through of the weakened exchange rate of the koruna. This effect will be strongest in 2014 Q2. After the exit from the regime of using the exchange rate of the koruna as an instrument for easing monetary policy – in early 2015 according to the assumptions of the forecast – import prices will turn slightly anti-inflationary, even though foreign producer prices will pick up pace slightly. The anti-inflationary effect of the domestic economy will dissipate by mid-2014 and the domestic economy will then foster price growth as a result of a forecasted upswing in wage growth and a continued recovery in economic activity. The contribution of export-specific technology will also increase as the economy recovers.

Nominal marginal costs in the intermediate goods sector continued to decline in 2014 Q1. Nominal wage growth in the business sector returned to positive levels after a previous decrease, but remained low (adjusted for the one-off effect of tax optimisation). It was thus outweighed by renewed growth in labour productivity (see Chart II.2.8), reflecting among other things a recovery in investment activity. Domestic nominal costs will begin to rise again relatively quickly in Q2 due to accelerating wage growth, which will be fostered by a recovery in both domestic and external demand and a weaker exchange rate. However, the cost pressures stemming from nominal wage growth will be partly offset by faster productivity growth. The price of capital will not make a positive contribution to the increase in costs until the start of 2015.

CHART II.2.7

COSTS IN THE CONSUMER SECTOR

The overall costs in the consumer sector will increase, initially due to import prices and later also to the domestic economy
(quarterly percentage changes; contributions in percentage points; annualised)

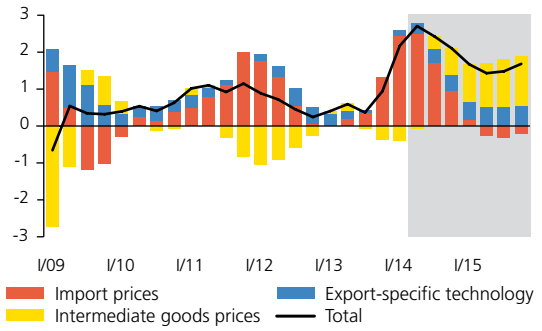
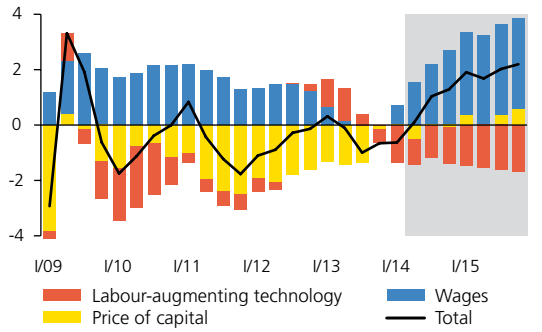


CHART II.2.8

COSTS IN THE INTERMEDIATE GOODS SECTOR

Domestic costs will rise, mainly due to accelerating wage growth
(quarterly percentage changes; contributions in percentage points; annualised)



The estimated gap in **profit mark-ups in the consumer goods sector** was slightly negative in 2014 Q1 with profit mark-ups reflecting the increase in costs resulting from the weaker exchange rate (see Chart II.2.9). The gap in profit mark-ups will turn more negative at the start of the forecast horizon, since costs will temporarily grow faster than prices given the weaker exchange rate. The second half of the year will see a gradual equalisation of profit mark-ups in an environment of growing economic activity. The gap in profit mark-ups will turn slightly positive in mid-2015.

Whole-economy **labour productivity** recorded a slight annual increase in 2013 Q4. The forecast expects a more pronounced upswing in growth to 2% in 2014 Q1. On average, productivity growth is expected to slightly exceed 2% this year and increase further to almost 3% next year. The path of labour productivity will be influenced mainly by a pick-up in economic activity, followed – with a time lag and at a lower pace – by employment growth. This will be visible mainly at the start of the forecast horizon.

The average nominal **wage in the business sector** recorded an unexpected large year-on-year decline of 2.4% in 2013 Q4 (see Chart II.2.10), even after adjustment for the estimated effect of tax optimisation (an adjusted decline of 0.4%). Overall, the wage in the business sector increased by just 0.9% last year (adjusted for tax optimisation). The average wage is expected to see renewed annual growth in 2014 Q1, as indicated by data from the industry and construction sectors for January and February (although these are again distorted due to tax optimisation, this time in the upward direction). The growth is expected to trend upwards as the recovery in economic activity continues. Renewed wage growth is also suggested by the results of wage bargaining and by corporations' wage expectations from the joint survey conducted by the CNB and the Confederation of Industry. Overall, wage growth in the business sector will reach 2.3% in 2014 and pick up further to 4.6% in 2015, boosted by fiscal expansion in addition to higher economic growth (see Chart II.2.10).[4]

Growth in the nominal **wage in the non-business sector** was flat at 0.8% in 2013 Q4. The forecast expects wage growth to rise to 2.2% on average in 2014 and to increase further to 2.7% in 2015 on the back of higher GDP growth and easier fiscal policy.

Real GDP recorded a year-on-year increase of 1.2% and a quarter-on-quarter rise of 1.8% **in 2013 Q4** (see Chart II.2.11). This was due above all to fixed investment, household consumption and net exports. The negative contribution of change in inventories, which recorded

4 According to the assumptions of the forecast, gross wages will be partly affected by a change in health insurance contributions next year, as 2 percentage points of the health insurance rate previously paid by employers will be paid by employees. In response to this change, the forecast expects a slight increase in gross wages of 0.3% of the average gross nominal wage in 2015 H1. Nevertheless, the size of this effect is subject to uncertainty, as is the very implementation of the change in contributions.

CHART II.2.9

GAP IN PROFIT MARK-UPS IN THE CONSUMER SECTOR

The gap in profit mark-ups will be negative until the middle of next year
(percentages)

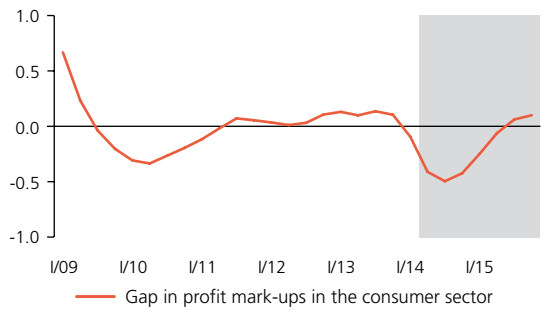


CHART II.2.10

AVERAGE NOMINAL WAGE

Wage growth will pick up noticeably from its current low levels as economic activity recovers
(annual percentage changes; business sector – seasonally adjusted; non-business sector – seasonally unadjusted)

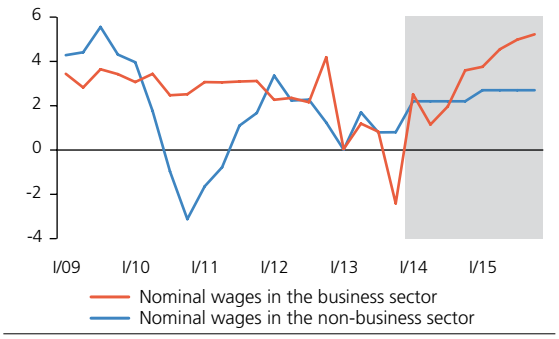


CHART II.2.11

GDP GROWTH FORECAST

GDP will grow this year and the next
(percentage changes; seasonally adjusted)

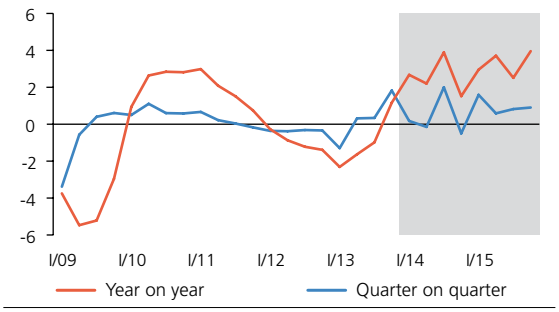
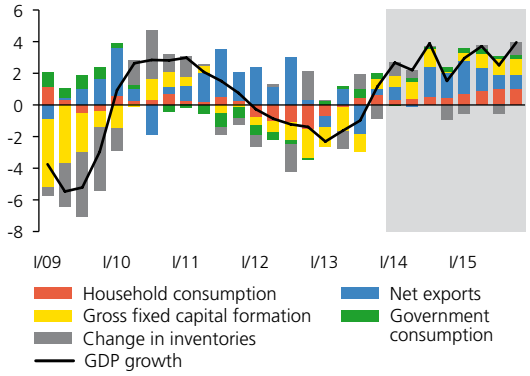


CHART II.2.12

ANNUAL GDP GROWTH STRUCTURE

All components of demand will contribute positively to GDP growth

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



an annual decrease despite a significant effect of frontloading of cigarettes ahead of the increase in excise duty in January 2014, acted in the opposite direction (see Chart II.2.12). In 2013, real economic activity recorded an overall decrease of 0.9%, with developments in the fiscal area making a major restrictive contribution. The forecast assumes that **economic activity in 2014 Q1** rose by 2.7% year on year and 0.2% quarter on quarter. This is indicated by the published data on industrial production, construction production and retail sales. Continued growth in industrial orders (mainly from abroad) and in the sentiment of corporations and households point to an improvement in the perceived economic situation (see section III.3). Significant growth is expected for gross capital formation (although sales of cigarette stocks built up ahead of the increase in excise duty in 2014 are expected to have a major downward effect on the dynamics of inventories) and net exports, while household consumption should increase slightly.

GDP will grow by 2.6% **in 2014**, with economic growth being fostered by a recovery in external demand and the easing of the monetary conditions via the weaker koruna. These factors will enable fixed investment to continue rising during 2014, especially in manufacturing. In 2014, gross fixed capital formation should also be supported by renewed growth in general government investment connected with drawdown of EU funds and renewed growth in government investment from domestic sources.[5] Household consumption will rise more strongly on the back of moderately accelerating wage growth and low inflation. As a result of the recovery in external demand, net exports will contribute positively to GDP growth, but will be partly dampened by a gradual recovery in import-intensive domestic demand.

GDP will increase by 3.3% **in 2015**, boosted by a further slight increase in growth abroad and relatively robust growth in domestic demand in an environment of significantly expansionary fiscal policy. Underlying this will be an expected further pick-up in government investment financed from both domestic and EU sources and a reduction in the tax burden associated with a reform of direct taxes and contributions (although its implementation is subject to uncertainty). In addition to household consumption, gross capital formation will make a positive contribution.[6] Thanks to a continuing recovery abroad the contribution of net exports will also be positive despite continued growth in imports of consumer goods and intermediate goods for production of export goods.

5 The positive supply effect resulting from higher investment from EU funds from the 2007–2013 programme period is partly reduced at the forecast horizon by the fact that these projects are not expected to have such a large and immediate impact on the creation of new production facilities and on technology growth as private sector investment.

6 According to the assumptions of the forecast, private investment will also be supported by a reduction in contributions paid by employers.

At the end of last year, the labour market was still feeling the effects of the previous economic contraction phase. The annual decline in the **number of employees converted into full-time equivalents**, observed for some time now, continued at the same pace but will gradually moderate this year (see Chart II.2.13). Following a recovery in economic activity, the converted number of employees will start to rise again in 2014 Q3 and its growth rate will reach 1.3% at the end of 2015. **Total employment** will increase further in year-on-year terms, albeit at roughly half the pace of the previous year (see Chart II.2.14). Total employment is expected to grow by 0.5% in 2014. Although the forecast assumes slightly lower growth in employment in 2015, it will be accompanied by renewed year-on-year growth in hours worked per employee.

The forecast assumes that the seasonally adjusted **general unemployment rate** was flat at 6.8% in 2014 Q1. It will stay at around this level until the start of 2015, with persisting labour force growth and employment growth roughly offsetting each other. Later, however, employment growth – building on the accelerating economic recovery – will prevail and the general unemployment rate will start to go down gradually (see Chart II.2.14). A gradual decline in the seasonally adjusted **share of unemployed persons**, as determined by the MLSA, from its current level of around 8% can be expected over the entire forecast horizon, due among other things to the already observed slight increase in the supply of vacancies. As a result of the economic recovery, and partly also due to administrative changes (an increase in the number of persons excluded by penalty from the labour office register), the number of registered job applicants is expected to fall to 7% at the end of 2015 amid a slight decline in the population aged 15–64.

Annual growth in real **household consumption** went up in 2013 Q4 (see Chart II.2.15). The forecast expects a slight slowdown in 2014 Q1 connected with a partial correction of the growth in purchases recorded after the koruna was weakened at the end of 2013. However, the January and February retail sales figures indicate that positive annual growth was maintained. The annual growth in household consumption will start to pick up gradually again in 2014 Q2. The long rising consumer confidence indicator suggests that the long-running growth in consumer demand is sustainable (see section III.3). Thanks to the recovery in economic activity, faster annual growth in wages and salaries and the unwinding of the effect of fiscal consolidation, household consumption will thus grow by 0.7% in 2014 and by 1.8% in 2015, when, according to the forecast, the ratio of taxes and contributions to income will decrease. A decline in real interest rates will also foster higher household consumption.

Gross nominal disposable income decreased by 1.7% overall in nominal terms in 2013, with all its components contributing to the decline (see Chart II.2.16). Its low and volatile annual growth rate during the year was strongly affected by the tax optimisation observed in late 2012 and early 2013. The annual growth rate of wages and

CHART II.2.13

NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENT)

The converted number of employees will start to rise in 2014 Q3 as the economy recovers
(annual percentage changes; contributions in percentage points)

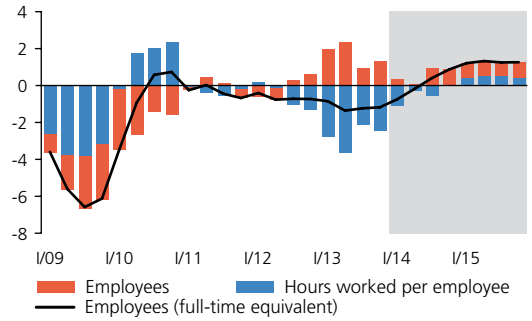


CHART II.2.14

LABOUR MARKET FORECAST

Total employment will continue rising, while the unemployment rate will be flat until the start of 2015 and then start to go down
(annual percentage changes in employment; general unemployment rate in percentages; seasonally adjusted)

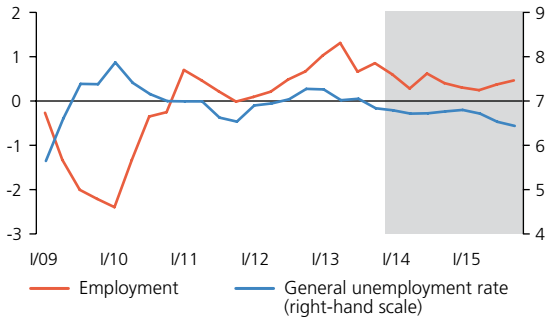


CHART II.2.15

REAL HOUSEHOLD AND GOVERNMENT CONSUMPTION

Household consumption and government consumption will rise gradually
(annual percentage changes; seasonally adjusted)

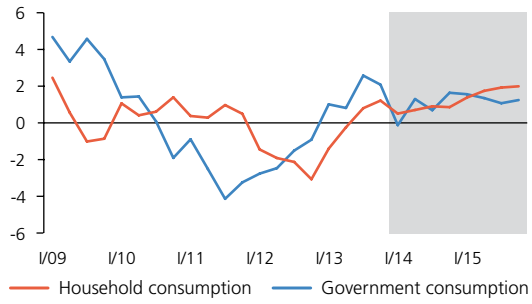


CHART II.2.16

NOMINAL DISPOSABLE INCOME

Disposable income growth will gradually accelerate thanks mainly to growth in wages and salaries amid renewed growth in social benefits
(annual percentage changes; contributions in percentage points)

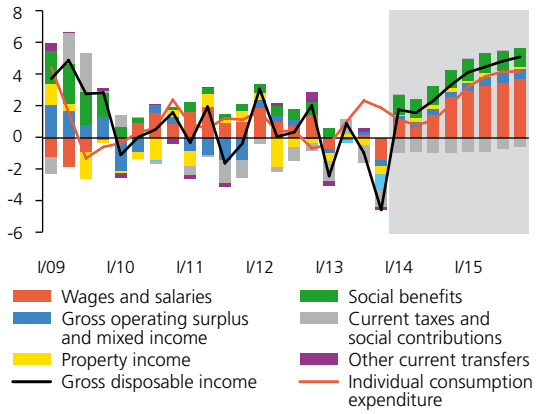


CHART II.2.17

HOUSEHOLD SAVING RATE

The saving rate will increase slightly above 10% over the forecast horizon
(percentages)

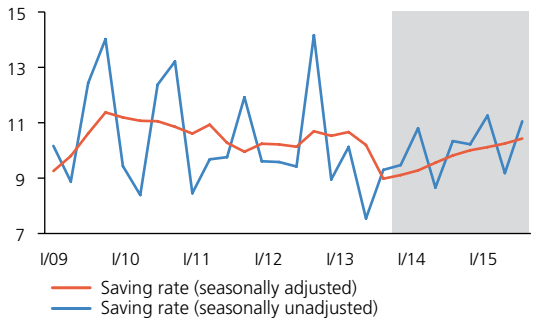
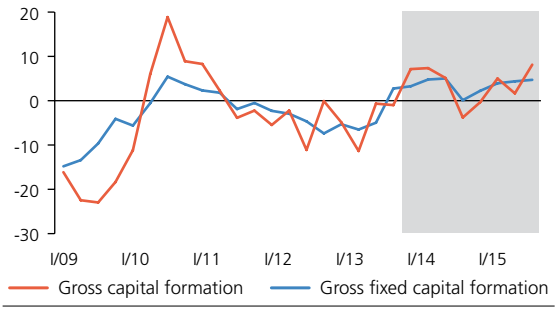


CHART II.2.18

GROSS CAPITAL FORMATION

Gross capital formation will rise at a volatile rate
(annual percentage changes; seasonally adjusted)



salaries will turn significantly positive at the start of the year, first predominantly as a result of the fading effect of tax optimisation, and from mid-2014 onwards also due to a gradual recovery in the labour market. Social benefits will also record significantly positive contributions. Overall, nominal gross disposable income will rise by 2.3% this year and pick up further to 4.7% in 2015.

Following a sizeable decline at the end of 2013, the seasonally adjusted **household saving rate** will gradually return to 10%, owing mainly to quicker growth in wages and salaries (see Chart II.2.17), while easy monetary conditions will act in the opposite direction. The saving rate will increase slightly above 10% in 2015 amid continued slightly faster growth in nominal gross disposable income than in nominal household consumption.

Annual growth in real **government consumption** slowed slightly at the end of 2013. Government consumption increased by 1.6% in 2013 as a whole. It will maintain positive, albeit slightly lower, growth in both 2014 and 2015 (see Chart II.2.15), driven by a combination of increasing growth in nominal government consumption, linked with an easing of the hitherto restrictive fiscal policy, and a rise in its deflator.

Gross capital formation declined year on year in 2013 Q4, with a strong swing to annual fixed investment growth being outweighed by a negative contribution of changes in inventories (despite marked frontloading of cigarettes). The forecast expects a significant year-on-year increase in gross capital formation in 2014 Q1, driven by a continuing recovery in fixed investment. Within investment, the forecast assumes not only a rise in private investment due to a lasting recovery in demand for Czech exports and easy monetary conditions, but also a sizeable contribution of government investment over the entire forecast horizon due to expected increased drawdown of EU funds from the 2007–2013 programme period. Overall, gross capital formation will rise by more than 3% in both 2014 and 2015, driven primarily by fixed investment (see Chart II.2.18). However, it will be highly volatile.[7]

Real **exports of goods and services** accelerated markedly at the close of last year. The forecast expects this trend to continue into 2014 (see Chart II.2.19). Thanks to accelerating external demand, growth in foreign orders in industry and the positive effect of the weaker koruna, export growth will be above 8% in 2014. In 2015 it will slow to 7.1% on average.

7 The frontloading of cigarettes at the close of 2013 in response to the increase in excise duty in 2014 (which contributed roughly 1 percentage point to quarterly GDP growth) will have a negative effect on inventories in the first half of this year. Another wave of frontloading will most probably occur in the second half of the year, although it will be smaller in size because of a proposed legislative change that will allow stocks to be used for only three months subsequently.

Real **imports of goods and services** also increased further in 2013 Q4. Growth in imports of goods and services will rise to 7.9% in 2014 and 6.0% in 2015 on the back of accelerating export growth, a high import intensity of exports and renewed growth in domestic demand.

Net exports at constant prices made a positive contribution to annual GDP growth in 2013 Q4 and should continue to do so over most of the forecast horizon. Overall, the contribution of net exports to annual GDP growth will thus be positive, at 1.1 percentage points in 2014 and 1.3 percentage points in 2015.

The balance of payments forecast expects the **current account** to shift from a deficit of 1.4% of GDP in 2013 to a slight surplus of around 0.5% of GDP this year and the next (see Table II.2.3). This will be due to a continuing increase in the goods and services surplus (in particular the trade surplus) and the current transfers balance. The rise in the goods and services balance will be associated with the expected growth in external demand, the weaker koruna and a slight drop in commodity prices on world markets. A rising income deficit, linked in both 2014 and 2015 mainly with higher earnings of non-residents on foreign investment in the Czech Republic and in 2015 also with a growing deficit on interest income, will affect the current account balance in the opposite direction than the goods and services balance. Current transfers should reach record-high surpluses in both years owing to much higher expected drawdown of EU funds compared to previous years.

The forecasted **capital account** surplus is due solely to drawdown of EU funds.[8] The year-on-year drop in the surplus compared to 2013 is caused by the unwinding of the effect of a large one-off financial transaction in the gas industry executed last year.

The net inflow of **direct investment** will rise slightly in 2014 compared to last year, owing to lower investment by residents abroad and a lower outflow from the Czech Republic in the form of loans from domestic subsidiaries to their foreign parent companies. In 2015, the interest of non-residents in domestic investment should increase in a context of accelerating economic growth in the European and Czech economies. The forecast assumes that investment will still primarily take the form of reinvested earnings, which will record an increasing surplus. Another reason for a stronger direct investment balance should be a decline in the outflow of capital abroad in the form of acquisitions. As regards **portfolio investment**, a significant year-on-year decrease in the surplus is expected this year, linked chiefly with the government's intention to issue new euro-denominated bonds in lower volumes than the euro bonds maturing this year. To a lesser

8 The 50% year-on-year increase in the net drawdown of EU funds in 2014 reflects efforts to minimise non-drawdown of these funds in connection with the end of the 2007–2013 programme period.

CHART II.2.19

REAL EXPORTS AND IMPORTS

Export and import growth will pick up pace as external and domestic demand recovers, aided in 2014 by the weakened exchange rate

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

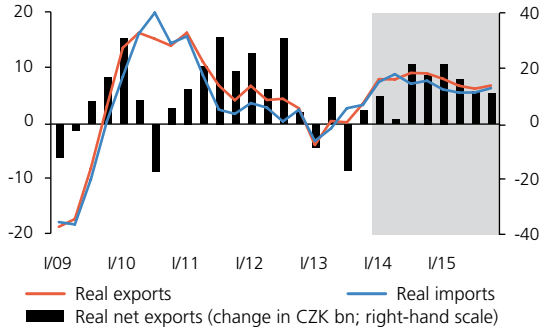


TABLE II.2.2

FORECASTS OF SELECTED VARIABLES

Real disposable income will rise as wage growth picks up, and labour productivity will also start to increase

(annual percentage changes unless otherwise indicated)

	2013 actual	2014 forec.	2015 forec.
Real gross disposable income of households	-2.9	1.8	2.5
Total employment	1.0	0.5	0.3
Unemployment rate (in per cent)[a]	7.0	6.7	6.6
Labour productivity	-1.8	2.1	2.9
Average nominal wage	0.1	2.3	4.3
Average nominal wage in business sector	-0.1	2.3	4.6
Current account balance (ratio to GDP in per cent)	-1.4	0.4	0.5
M2	4.4	4.3	4.6

a) ILO methodology, 15–64 years

TABLE II.2.3

BALANCE OF PAYMENTS FORECAST

The current account should show a modest surplus this year and the next

(CZK billions)

	2013 actual	2014 forec.	2015 forec.
A. CURRENT ACCOUNT	-56.0	15.0	20.0
Trade balance	188.0	250.0	270.0
Balance of services	53.0	60.0	65.0
Income balance	-312.4	-335.0	-355.0
Current transfers	15.4	40.0	40.0
B. CAPITAL ACCOUNT	74.8	60.0	60.0
C. FINANCIAL ACCOUNT[a]	185.4	40.0	65.0
Direct investment	33.2	40.0	75.0
Portfolio investment	91.9	40.0	10.0
Financial derivatives	4.7		
Other investment	55.6	-40.0	-20.0
D. ERRORS AND OMISSIONS	-14.7		
E. CHANGE IN RESERVES (- = increase)	189.5		

a) forecast excluding operations of banking sector and financial derivatives

extent, lower foreign funding of investment by government-controlled corporations and renewed interest of residents in investing abroad due to the economic recovery will also be observed. Stronger interest of non-residents in government koruna bonds will act in the opposite direction. The surplus is expected to drop further in 2015 owing to rising interest of residents in investing abroad, despite a slight increase in the expected inflow of investment in government bonds.

The future macroeconomic developments described above and the current fiscal policy settings are reflected in the **government finance** outlook for 2014 and 2015 (see Table II.2.4).

According to the **spring notifications** of the government deficit and debt, the general government deficit amounted to 1.5% of GDP in **2013**. The annual fall in the government deficit is mainly due to the unwinding of the effect of the financial settlement with churches, which led to a one-off widening of the deficit in 2012, as well as to fiscal consolidation measures and a rise in the government's dividend income. The fiscal restriction was more pronounced in 2013 than expected in the previous forecast and its negative contribution to economic activity was roughly 1 percentage point. Government investment fell sharply, especially the component funded from domestic sources. The decline in the general government deficit below 3% of GDP in 2013 and the outlook for the years ahead should enable the Excessive Deficit Procedure (EDP) to be ended on time.

A further slight decrease in the government deficit to 1.4% of GDP is expected in **2014**, owing mainly to the economic recovery and an associated rise in tax revenues. Acting in the same direction will be CZK 8.5 billion in extraordinary revenues from an auction of frequency bands to mobile operators. In addition, the forecast takes into account the continuing effect of the consolidation measures adopted in 2012 (for example, a smaller increase in pensions) and the harmonisation changes made to excise duty on cigarettes, although their restrictive impact on economic growth will be outweighed by a significant recovery in government investment connected with the implementation of projects co-financed from EU funds and by continued wage growth in the government sector. In 2014, therefore, the overall effect of fiscal policy on economic activity will be slightly expansionary to the tune of around 0.2 percentage point (see Table II.2.5).

According to the legislation in force, a slight increase in the general government deficit to 2% can be expected in **2015**. This is because a tax reform[9] that should result in a considerable decline in direct

Table II.2.4

FISCAL FORECAST

Fiscal policy will start to be expansionary in 2014
(% of nominal GDP)

	2013	2014	2015
	actual	forecast	forecast
Government revenue	40.9	41.0	40.9
Government expenditure	42.3	42.4	42.9
of which: interest payments	1.4	1.4	1.5
GOVERNMENT BUDGET BALANCE	-1.5	-1.4	-2.0
of which:			
primary balance [a)]	-0.1	0.0	-0.6
one-off measures [b)]	0.0	0.2	0.0
ADJUSTED BUDGET BALANCE [c)]	-1.4	-1.6	-2.0
Cyclical component (ESCB method) [d)]	-0.9	-0.6	-0.2
Structural balance (ESCB method) [d)]	-0.6	-1.0	-1.8
Fiscal stance in pp (ESCB method) [e)]	1.7	-0.4	-0.7
Cyclical component (EC method) [d)]	-1.1	-0.7	0.0
Structural balance (EC method) [d)]	-0.3	-1.0	-2.0
Fiscal stance in pp (EC method) [e)]	1.9	-0.6	-1.0
Government debt	46.0	45.8	45.8

a) government budget balance minus interest payments
b) 2013–2015: impacts of pension reform. 2014: impact of auction of mobile frequencies.
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)

Table II.2.5

FISCAL IMPULSE

In 2014 and 2015 the fiscal expansion will have an effect predominantly on investment
(contributions to GDP growth in percentage points)

	2013	2014	2015
	actual	forecast	forecast
Fiscal impulse	-1.0	0.2	0.8
of which impact through:			
private consumption	-0.7	0.0	0.2
private investment	0.0	0.0	0.2
government investment, domestic	-0.3	0.0	0.1
government investment, EU funded	0.0	0.2	0.3

9 The reform consists mainly of changes to direct taxes and social security contributions, a lower VAT registration threshold and higher limits for tax deductions on gifts. Measures contained in the 2014 Convergence Programme aimed at abolishing or modifying some of the tax reform measures will be incorporated into the forecast only after their form and impacts become clearer. The impact of an extension of the lease of supersonic fighter aircraft under ESA 95 methodology is an additional risk to the forecast in the direction of a higher general government deficit.

tax revenue (of almost 0.6% of GDP) takes effect in 2015. The tax reform should therefore offset the effect of the already relatively robust growth on tax revenues next year. In addition, the deficit-to-GDP ratio will be increased by continued rapid growth in government investment, driven by efforts to draw as much EU money as possible from the 2007–2013 programme period, by the restoration of the policy to increase pensions fully in line with inflation, and by the unwinding of the above-mentioned effect of the sale of frequency bands this year. Fiscal policy will therefore be highly expansionary in 2015, making a positive contribution to economic activity of around 0.8 percentage point. As the tax reform also includes a reduction in contributions paid by employers, the expansionary fiscal policy will affect both household consumption and private sector investment.

The general government **structural deficit** fell sharply to around 0.5% of GDP in 2013. It will start increasing again this year and reach about 2% of GDP in 2015. Next year in particular, the fiscal expansion and the related widening of the structural deficit will, in conditions of expected economic growth and closure of the negative output gap, imply a step towards renewed procyclical fiscal policy and divergence from the medium-term objective of 1% of GDP.

The expected evolution of the general government deficit will lead to broad stability of **general government debt** at around 46% of GDP at the forecast horizon. In addition to the expected borrowing requirements of general government owing to persisting deficits, the prediction of this ratio reflects the favourable effect of the recovery in nominal GDP growth.

A weaker recovery in general government investment activity (a more significant one than the previously considered incomplete drawdown of EU funds) and the government's planned postponement or complete abolition of the approved tax reform represent **risks to the fiscal forecast** towards lower deficits and less expansionary fiscal policy.

II.3 COMPARISON WITH THE PREVIOUS FORECAST

The forecasts for headline and monetary-policy relevant inflation are lower than in the previous prediction owing to lower outlooks for administered price inflation and net inflation. GDP growth has been revised upwards in both 2014 and 2015, mainly as a result of a faster expected recovery in both private and government investment and more expansionary fiscal policy overall. The expected growth rate of nominal wages in the business sector this year has shifted lower, partly reflecting data from the close of last year. After the discontinuation of the use of the exchange rate as a monetary policy instrument the interest rate path in the prediction is lower, mainly reflecting a lower outlook for foreign interest rates, lower administered prices and the currently stronger anti-inflationary effect of the domestic economy.

The forecast for annual **headline inflation** in 2014 and 2015 is considerably lower than in the previous forecast (see Chart II.3.1). This is due to a lower outlook for administered prices and a lower net inflation forecast, reflecting slower wage growth and a recovery in investment with favourable effects on productivity. The assumptions regarding the impacts of changes to indirect taxes have changed only marginally, so the outlook for **monetary-policy relevant inflation** has changed in a similar way as that for headline inflation.

The observed annual decline in **administered prices**, along with the decline expected for the rest of this year, is deeper than in the previous forecast, mainly because of a sharper drop in health care prices and a smaller increase in heat prices in January. In the second half of the year the forecast additionally expects more moderate growth in natural gas prices for households. The administered price inflation outlook for 2015 has also been lowered significantly because of an expected decrease in electricity prices, which will reflect the already visible annual decline in electricity generation prices on energy exchanges.

Compared to the previous forecast, annual **net inflation** has been lowered almost over the entire forecast horizon (see Chart II.3.2). As regards its composition, only food prices will record faster growth. Their growth has been revised in light of higher outlooks for world prices of agricultural commodities. Slower observed and predicted nominal wage growth for this year is acting towards lower net inflation in both forecast years and will be reflected above all in gradually rising adjusted inflation excluding fuels.

Turning to the outlook for the **external environment**, expected growth in foreign producer prices has been lowered compared to the assumptions of the previous forecast, partly reflecting lower outlooks for some commodity prices on world markets and a stronger path of the euro-dollar exchange rate. The 3M EURIBOR outlook is lower in the longer run. The outlook for external demand growth is slightly higher this year and unchanged next year.

CHART II.3.1

CHANGE IN THE HEADLINE INFLATION FORECAST

The forecast for headline inflation has moved downwards considerably

(year on year in %; differences in pp – right-hand scale)

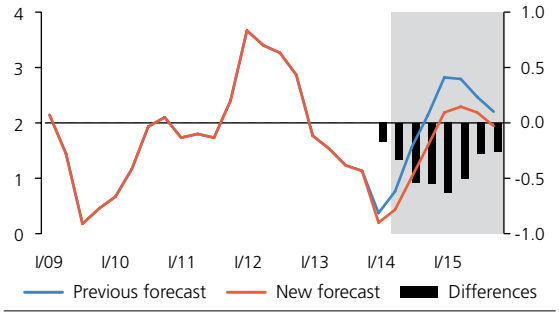
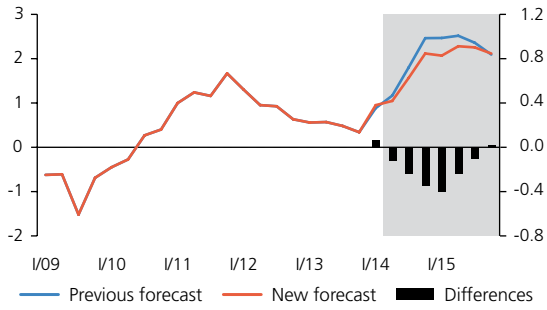


CHART II.3.2

CHANGE IN THE NET INFLATION FORECAST

The forecast for net inflation has been revised to a slightly lower level

(year on year in %; differences in pp – right-hand scale)



The forecast for domestic market **interest rates** this year is virtually unchanged. The lower growth in the 3M PRIBOR from the start of 2015 onwards (see Chart II.3.3) is due to a lower outlook for foreign rates and domestic administered prices and a currently stronger anti-inflationary effect of the domestic economy, caused mainly by more subdued wages.

National accounts data show that the decrease in **GDP** in 2013 was not as large as predicted in the previous forecast. This is due to higher observed figures for household consumption and fixed investment in 2013 Q4. Acting in the opposite direction was lower growth in government consumption and net exports (due partly to imports for investment purposes). GDP growth in 2014 is forecasted to be 0.4 percentage point higher than in the previous prediction. This is due to slightly expansionary fiscal policy and, to a lesser extent, to slightly faster growth in external demand and a rather weaker koruna exchange rate in the first half of this year. The expected growth structure has also changed, with gross capital formation and household consumption contributing more to the recovery (see Chart II.3.4). The GDP growth forecast for 2015 is 0.5 percentage point higher, mainly as a result of greater fiscal expansion.

The contribution of **net exports** to GDP growth in 2013 was smaller than in the previous forecast. However, the effect of the lower exports and higher imports observed in 2013 is partly offset in the forecast, as a rising number of foreign orders in industry suggests a faster recovery in the export sector. Despite a marked increase in exports in 2014, the contribution of net exports to GDP growth in this period will be smaller than in the previous prediction owing to a recovery in import-intensive components of domestic demand. The contribution of net exports at the longer end of the forecast horizon will be similar to the previous forecast.

The forecast for growth in the average **nominal wage** in the business sector has been lowered compared to the previous forecast as a result of more subdued wages in the past, including a decrease in wages at the close of last year. The forecast contains no significant revision for 2015.

CHART II.3.3

CHANGE IN THE INTEREST RATE PATH

The market interest rate path is slightly lower in 2015 owing to a lower outlook for foreign rates and administered prices and a currently more anti-inflationary effect of the domestic economy

(3M PRIBOR in %; differences in pp – right-hand scale)

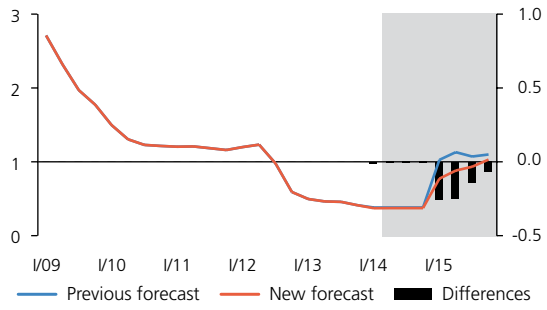


CHART II.3.4

CHANGE IN THE GDP FORECAST

The GDP growth forecast is slightly higher overall both this year and the next

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

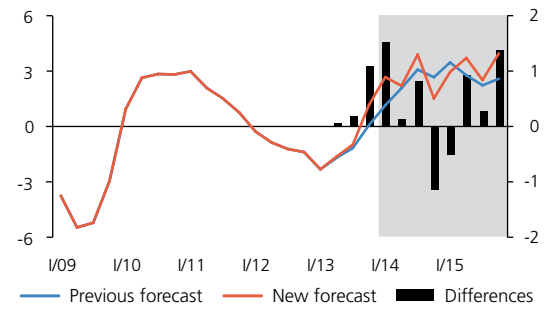


Table II.4.1

EXPECTED INDICATORS OF FMIE AND CORPORATIONS

The inflation expectations of analysts at the one-year horizon have been slightly above the CNB's target since the start of 2014
(at 1Y; annual percentage changes unless otherwise indicated)

	12/13	1/14	2/14	3/14	4/14
FMIE:					
CPI	1.7	2.3	2.3	2.4	2.3
CPI, 3Y horizon	2.1	2.1	2.1	2.1	2.1
Real GDP in 2014	1.9	1.9	1.9	2.1	2.1
Real GDP in 2015		2.6	2.5	2.6	2.5
Nominal wages in 2014	2.3	2.2	2.1	2.2	2.2
Nominal wages in 2015		2.9	2.8	3.0	3.1
CZK/EUR exchange rate (level)	26.9	26.9	27.0	26.9	27.0
2W repo rate (in per cent)	0.1	0.1	0.1	0.1	0.1
1Y PRIBOR (in per cent)	0.7	0.7	0.7	0.8	0.8
Corporations:					
CPI	2.1			1.9	

Chart II.4.1

PERCEIVED AND EXPECTED INFLATION

Perceived inflation and the inflation expectations of households decreased slightly at the start of this year
(source: European Commission Business and Consumer Survey)

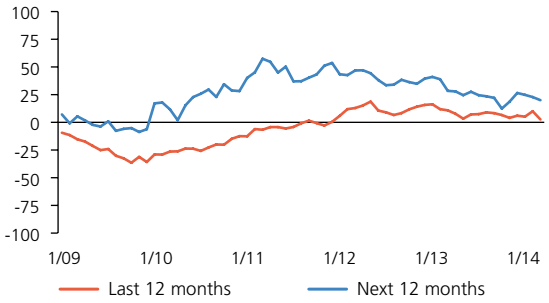


Table II.4.2

CF EXPECTED INDICATORS

The CF analysts expect the economy to grow at a rate of around 2% this year
(at 1Y; annual percentage changes unless otherwise indicated)

	12/13	1/14	2/14	3/14	4/14
Real GDP in 2014	1.8	1.9	1.9	2.0	2.1
Real GDP in 2015		2.6	2.5	2.6	2.6
Nominal wages in 2014	2.4	2.3	2.3	2.0	2.3
Nominal wages in 2015		3.4	3.3	3.2	3.4
CZK/EUR exchange rate (level)	26.8	26.9	26.9	26.9	26.8
3M PRIBOR (in per cent)	0.4	0.5	0.6	0.5	0.5

II.4 FORECASTS BY OTHER ENTITIES

Analysts' inflation expectations were slightly above the CNB's target at both the one-year and three-year horizons. The indicators of inflation perceived and expected by households decreased slightly. The analysts expect the economy to return to growth of around 2% and wage growth to accelerate this year. According to the analysts, the exchange rate of the koruna should appreciate to CZK 27 to the euro or only just below this level at the one-year horizon. All the analysts were expecting key rates to be left unchanged at the May meeting of the CNB Bank Board, and most also expect rates to be flat over the next twelve months. The market rate outlook one year ahead also indicates expectations of broad stability and is roughly in line with the interest rate path in the new CNB forecast until the end of this year.

Inflation expected by financial market analysts at the one-year horizon has been slightly above the CNB's target of 2% since the start of this year, while the inflation expectations of business managers were very close to the target (see Table II.4.1). The inflation expected by analysts at the three-year horizon was flat just above the target.

The indicator of **inflation perceived by households** has been slightly positive since late 2011 and has fallen further in recent months (see Chart II.4.1). This means that households on average felt that prices rose moderately over the last 12 months. The indicator of **expected inflation** is also positive. Following a slight increase in the last two months of 2013 (i.e. after the CNB's announcement that it had started using the exchange rate as an instrument for easing monetary policy), the indicator has declined slightly again since the start of this year. This suggests that the number of respondents who expect prices to rise more rapidly over the next 12 months is slightly higher than the number of those who expect prices to stay the same or increase more slowly than in the recent past.

Both the FMIE and CF analysts expect GDP to grow by roughly 2% this year (see Tables II.4.1 and II.4.2). Next year the economy should accelerate further and wage growth should also rise from its current very low levels. The analysts expect the koruna to appreciate to CZK 27 to the euro or just below this level at the one-year horizon. Before the CNB Bank Board meeting in May, all fourteen FMIE analysts were expecting no changes in key interest rates at this meeting. Most of the analysts also expect the 2W repo rate to remain flat at the current level (0.05%) at the one-year horizon. Their estimates lie in the range of 0.05%–0.25%.

Overall, the analysts expect lower real GDP growth both this year and the next **compared to the CNB's new forecast**. Inflation expected by the analysts at the one-year horizon is in line with the CNB forecast. The analysts' expectations regarding the 2W repo rate and market rates are broadly in line with the 3M PRIBOR path in the new CNB forecast until the end of this year.

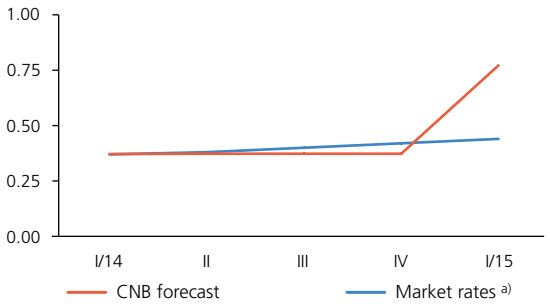
Chart II.4.2 provides a **comparison of expected 3M market rates** derived from FRA quotations and the interest rate path in the new CNB forecast. The current market outlook for 3M rates implies only a negligible rise in 3M PRIBOR rates at the end of this year. This is roughly in line with the prevailing expectations of monetary policy interest rates being left at technical zero at least until the start of 2015 given the current money market premium remaining unchanged. The market outlook is very close to the interest rate path in the new CNB forecast until the end of this year.

CHART II.4.2

FRA RATES VERSUS THE CNB FORECAST

The interest rate outlook derived from FRA quotations is approximately in line with rates in the CNB forecast until the end of this year

(percentages)



a) for 2014 Q1 and 2014 Q2 the 3M PRIBOR and for 2014 Q3–2015 Q1 the average values of the FRA 3*6, 6*9 and 9*12 rates for the last 10 trading days as of 25 April 2014

III. CURRENT ECONOMIC DEVELOPMENTS

III.1 INFLATION

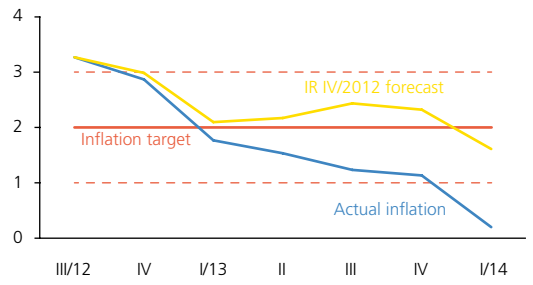
The CNB's decision of November 2013 to start using the exchange rate as an additional monetary policy instrument significantly contributed to averting the threat of longer-term deflation. In line with the CNB's expectations, annual headline inflation fell to low – albeit positive – levels at the start of this year, standing at 0.2% in March. The price level adjusted for the effects of changes to indirect taxes was virtually unchanged year on year in 2014 Q1. It is thus still well below the lower boundary of the tolerance band around the CNB's target. The decline in annual inflation in 2014 Q1 was primarily due to a fall in administered prices together with an unwinding of the effects of the VAT changes made last year. By contrast, annual market price inflation picked up somewhat owing to slightly higher growth in food prices and a shift of adjusted inflation excluding fuels into less negative territory. Overall, however, market price inflation was low despite a noticeable economic recovery and a year-on-year weakening of the exchange rate, mainly because of subdued wage growth at the end of last year. Falling import prices of energy commodities and domestic energy prices also had an anti-inflationary effect. These anti-inflationary factors were partly offset by the effect of rising import prices of products for the consumer market.

III.1.1 Fulfilment of the inflation target

Chart III.1.1

FORECAST VERSUS ACTUAL INFLATION

Inflation was well below the IR IV/2012 forecast in 2014 Q1
(year on year in %)



In 2014 Q1, both **headline and monetary-policy relevant inflation** were on average well below the lower boundary of the tolerance band around the CNB's target (see Chart III.1.1). This section of the Inflation Report briefly analyses the contribution of the CNB's monetary policy to this situation. In order to assess the effect of monetary policy on the fulfilment of the inflation target one needs **to analyse retrospectively the forecasts** and the Bank Board's decisions based thereon in the past. To assess the fulfilment of the inflation target in 2014 Q1, we have to examine not only the period roughly from July 2012 to March 2013 (usually referred to as the "key period"), taking into account interest rate transmission, but also the second half of 2013. This is because monetary policy passes through to inflation with a substantially shorter lag in the regime were the exchange rate is used as an additional monetary policy instrument than when conventional monetary policy instruments, i.e. interest rates, are used. For the sake of clarity, however, the analysis of the accuracy of the forecasts is limited here to a comparison of the Inflation Report IV/2012 forecast with subsequent developments.

The **Inflation Report IV/2012 forecast** expected headline inflation to stay slightly above the CNB's target in 2013 owing to an increase in both VAT rates of one percentage point, and to fall slightly below the target after this tax effect dropped out in early 2014 (see Chart III.1.1). Monetary-policy relevant inflation was expected to stay

in the lower half of the tolerance band around the target until the end of 2014 owing to the disappearance of cost pressures and to generally subdued economic activity. The inflationary effect of import prices was expected to decrease at the start of the forecast due to falling inflation abroad. The anti-inflationary effect of the domestic economy was expected to fade temporarily at the end of 2012, but no pronounced upward pressures on prices in the domestic economy were expected until the end of the forecast horizon. The forecast assumed slowing growth in administered prices, food prices and fuel prices.

Headline **inflation in reality** was below the forecast over the entire period and the deviation increased gradually in 2013. The 1.4 percentage point deviation of actual inflation from the forecast in 2014 Q1 was due to an unexpected decline in administered prices and persisting negative adjusted inflation excluding fuels, reflecting an unexpectedly strong anti-inflationary effect of the domestic economy. Faster growing food prices only partly offset these negative deviations (see Table III.1.1).

External economic factors contributed significantly to domestic inflation. External economic activity recovered more slowly than forecasted (see Table III.1.2). External production prices initially rose somewhat faster than expected, but from the start of 2013 onwards their growth was well below the forecast, declining to negative values. Foreign interest rates were roughly in line with the expected low path, which had already reacted to the escalation of the European debt crisis and the worse outlook for economic activity. Only oil prices were higher than assumed in the forecast. The effect of external developments on domestic inflation was thus slightly anti-inflationary overall.

Domestic **interest rates and the exchange rate** also differed from the forecast. Market interest rates declined in response to the CNB's rate cuts, but in 2013 they were affected by the zero lower bound on monetary policy rates amid a persisting money market risk premium. They were thus slightly above the forecast level. The exchange rate was weaker than predicted, owing – among other things – to CNB communication[10] and, from November 2013 onwards, to the use of the exchange rate as an additional instrument for easing monetary policy (see Table III.1.3).

10 At its September 2012 meeting, the Bank Board had agreed that if it was necessary to use monetary policy tools other than interest rates it would probably use the exchange rate. In November 2012, the Bank Board decided to lower interest rates to technical zero and also to suspend the programme of sales of part of the investment income on international reserves, as a potential conflict could not be ruled out between such operations and monetary policy implementation at a time when monetary policy interest rates were at technical zero. Communication of readiness to use foreign exchange interventions to weaken the koruna if needed continued into 2013.

Table III.1.1

FULFILMENT OF THE INFLATION FORECAST

The deviation of inflation from the forecast was due to an unexpected decline in administered prices and persisting negative adjusted inflation excluding fuels
(annual percentage changes; contributions in percentage points)

	IR IV/2012 forecast	2014 Q1 outturn	Contribution to total difference[c)]
CONSUMER PRICES	1.6	0.2	-1.4
Breakdown into contributions:			
administered prices	2.2	-4.1	-1.1
first-round impacts of changes to indirect taxes[a)]	0.1	0.1	0.0
food prices[b)]	1.4	3.5	0.5
fuel prices[b)]	-0.4	0.3	0.0
adjusted inflation excl. fuels[b)]	1.4	-0.2	-0.9

a) impact in non-administered prices on total inflation
b) excluding the first-round effects of changes to indirect taxes
c) Owing to rounding, the total difference may not be equal.

Table III.1.2

FULFILMENT OF THE EXTERNAL ASSUMPTIONS

External factors had a slight downward effect on domestic inflation overall
(annual percentage changes unless otherwise indicated)

		IV/12	I/13	II/13	III/13	IV/13	I/14
GDP in euro area[a), b), c)]	p	0.3	-0.1	0.6	1.2	1.6	1.8
	o	0.3	0.0	0.5	0.5	1.1	-
PPI in euro area[b), c)]	p	1.1	0.4	1.2	2.1	3.0	2.8
	o	2.1	1.1	0.0	-0.3	-0.8	-
3M EURIBOR	p	0.2	0.2	0.2	0.2	0.3	0.3
(percentages)	o	0.2	0.2	0.2	0.2	0.2	0.3
USD/EUR exchange rate	p	1.29	1.25	1.25	1.25	1.24	1.24
(levels)	o	1.30	1.32	1.31	1.32	1.36	1.37
Brent crude oil price	p	111.4	109.5	107.8	106.1	104.7	103.4
(USD/barrel)	o	110.5	112.9	103.3	109.7	109.4	107.9

p – prediction, o – outturn
a) at constant prices
b) seasonally adjusted
c) IR IV/2012 outlook for effective indicator

Table III.1.3

FULFILMENT OF THE FORECAST FOR KEY VARIABLES

Observed GDP growth was below the forecast over the entire period, while the exchange rate of the koruna was weaker

		IV/12	I/13	II/13	III/13	IV/13	I/14
3M PRIBOR	p	0.5	0.4	0.2	0.2	0.2	0.3
(percentages)	o	0.6	0.5	0.5	0.5	0.4	0.4
CZK/EUR exchange rate	p	24.9	25.1	25.2	25.2	25.2	25.2
(levels)	o	25.2	25.6	25.8	25.9	26.7	27.4
Real GDP[a)]	p	-1.2	-0.8	-0.2	0.3	1.5	2.1
(annual perc. changes)	o	-1.4	-2.2	-1.6	-1.0	1.3	-
Nominal wages[b)]	p	2.3	2.4	2.6	2.7	2.9	3.1
(annual perc. changes)	o	4.0	-0.4	1.1	1.5	-2.4	-

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

Based on the CNB's current knowledge, the **developments since the forecast under review was drawn up** can be summed up in the following way. Domestic GDP growth was much lower owing to lower external demand growth and a sharp contraction in domestic demand in reaction to the uncertainty surrounding future developments, with a significant negative contribution of domestic fiscal consolidation in 2012 and 2013. The evolution of real household consumption reflected negative consumer sentiment and a decline in real disposable income, owing mainly to an increase in indirect taxes and weak wage growth. Investment growth was also lower than forecasted in reaction to the weak domestic and external demand and uncertain outlooks. Export and import volumes also lagged behind the assumptions of the forecast. From the inflation perspective, the subdued economic activity and wages together with the unexpected fall in administered prices outweighed the effect of the weaker koruna, but its intensity has increased since the end of 2013.

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** and **other monetary policy instruments**. At the 2012 Q3 meetings, the risks to the forecast were assessed initially as being balanced and then as being on the downside. The 2W repo rate was lowered by 0.25 percentage point at the September meeting. In 2012 Q4, the Bank Board assessed the risks to the inflation forecast as being balanced or slightly on the downside. At its November meeting, it lowered the 2W repo rate by 0.20 percentage point to technical zero. In 2013 Q1, the risks to the forecast were again initially assessed as being balanced, but at the following meeting they were assessed as tilted to a need for slightly easier monetary conditions. At the same time, the CNB communicated its readiness to use the exchange rate as an instrument if a further monetary policy easing became needed. The Bank Board took this step in November 2013 on the basis of the forecast in Inflation Report IV/2013. In line with the alternative scenario of this forecast, the intervention level was set at CZK 27 to the euro.

Overall, monetary policy in the key period can be assessed as follows. With the benefit of hindsight, it can be said that most of the identified risks materialised in the key period, with anti-inflationary risks prevailing overall. Market interest rates declined in response to the evolution of the CNB's rates, but in 2013 H2 they were affected by the zero lower bound on interest rates. The weakened exchange rate has so far been feeding through to prices in line with the CNB's assumptions, with headline inflation falling to very low – albeit positive – levels in early 2014. The inflation target is thus being significantly undershot at present, but the decision to start using the exchange rate as an additional monetary policy instrument has significantly contributed to averting the threat of longer-term deflation and thereby also the potential threat to overall macroeconomic and financial stability. Without this measure, headline inflation would have been strongly negative in 2014 Q1 (the estimated effect of the exchange rate weakening on inflation is about 1 percentage point). From this perspective, based on current knowledge, it seems that the monetary

policy pursued between July 2012 and the end of 2013 should have been substantially easier, i.e. the monetary policy easing via the weakening of the koruna should have been made earlier.

III.1.2 Current inflation

In line with the CNB's expectations, **annual inflation**[11] dropped sharply in 2014 Q1. At 0.2% in January, it was 1.2 percentage point lower than in December 2013. It then remained at this low positive level until March (see Chart III.1.2). The slowdown in headline inflation was due mainly to a decline in administered prices and the unwinding of the first-round effects of the VAT changes made last year.

In these circumstances, the **structure of annual inflation** shows that the slightly positive annual inflation level in 2014 Q1 was due solely to the effect of market prices and, within them, exclusively to rising food prices (see Chart III.1.3). Overall, administrative factors, i.e. the impacts of changes to indirect taxes and administered prices, fostered a fall in the price level in this period, with the drop in administered prices strongly outweighing the now only modest effect of changes to indirect taxes.

The contribution of changes to **indirect taxes** to annual market price inflation shrank significantly to less than 0.2 percentage point in March as the effect of the increase in both VAT rates made at the start of 2013 dropped out. Annual inflation thus continued to be affected only by the rise in excise duty on tobacco products introduced in January 2013, whose impact passed through to consumer prices with a lag owing to frontloading. As in the previous year, January 2014 saw another increase in excise duty on cigarettes as a result of a harmonisation change adopted back in 2012. The expected impact of this change on headline inflation is estimated at about 0.1 percentage point. However, thanks to substantial frontloading, it has so far passed through to consumer prices to only a negligible extent.

Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of all the changes to indirect taxes, fell to zero in March. It was thus again well below the lower boundary of the tolerance band around the CNB's target and was only slightly lower than headline inflation (see Chart III.1.2).

Following a long period of growth, **administered prices** switched to a strong year-on-year decline in early 2014, reaching -4.1% in March (see Chart III.1.4). This was mainly due to a January reduction in retail energy prices, including decreases in electricity and natural gas prices, a moderation in heat price growth, a fall in health care prices (the abolition of hospital stay fees) and a slowdown in year-on-year growth

11 Measured by year-on-year growth in consumer prices.

CHART III.1.2

INFLATION

Annual inflation dropped sharply in 2014 Q1
(year on year in %)

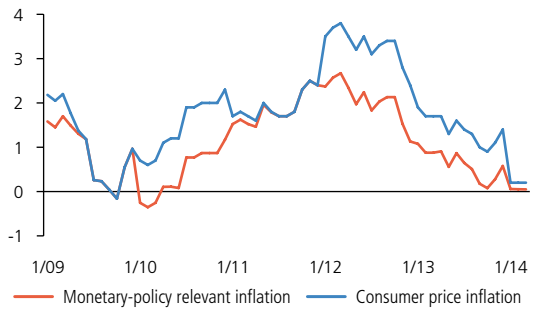


CHART III.1.3

STRUCTURE OF INFLATION

The positive contribution of market prices to inflation was due solely to rising food prices in 2014 Q1
(annual percentage changes; contributions in percentage points)

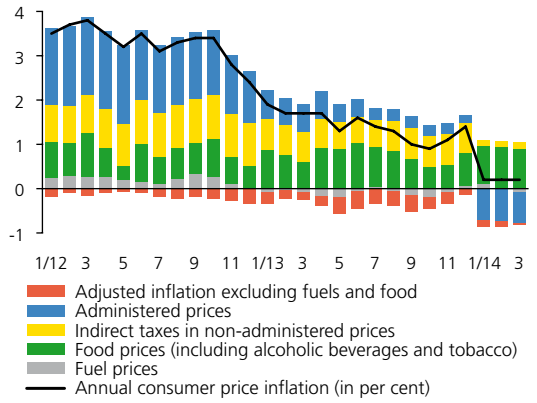
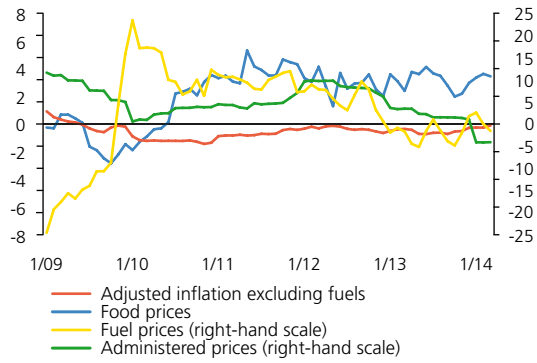


CHART III.1.4

INFLATION COMPONENTS

Administered prices switched to a year-on-year decline, while food prices went up
(annual percentage changes; excluding indirect tax changes except for administered prices)



in water supply and sewerage collection charges. More moderate price growth was also recorded for other administered items. The following text assesses the evolution of the main components of market price inflation adjusted for the tax changes.

Annual **market price inflation**, as measured by net inflation, increased slightly in 2014 Q1 (to 0.9% in March). The increase in net inflation was due to a modest rise in food price inflation coupled with a shift of adjusted inflation excluding fuels into less negative territory. On the other hand, this was partly offset by a renewed annual decline in fuel prices in March. Market price inflation was still low overall, mainly reflecting – despite the continuing recovery – the persisting anti-inflationary effect of the domestic economy, including subdued wage growth (particularly in the business sector). The low market price inflation was also due to falling import prices of energy commodities and domestic energy producers. At the same time, it reflected the weakening of the exchange rate and faster growth in foreign prices of some commodities via import prices of products for the consumer market.

Food prices showed the fastest growth again in 2014 Q1. Their annual growth rate rose to 3.4%[12] in March (i.e. by 0.4 percentage point compared to December 2013; see Chart III.1.5). Their annual growth rate was affected above all by renewed growth in global prices of some food commodities and by the year-on-year weakening of the koruna. The effect of the above factors was also indicated by faster growth in import prices of food (particularly fruit and vegetables) in early 2014,[13] while domestic agricultural producer prices kept falling in year-on-year terms.

Annual adjusted inflation excluding fuels was still negative in 2014 Q1, but shifted almost to zero (-0.1% in March; see Chart III.1.6). This shift was fostered by a substantial moderation of the long-term year-on-year decline in prices of **other tradable commodities** excluding food and fuels. The annual decline in prices in this segment, which are more strongly affected by the exchange rate and foreign prices than non-tradable commodities, moderated by a further 0.4 percentage point compared to November 2013 to -0.4% in March. By contrast, annual growth in prices of **other non-tradable commodities**[14] slowed compared to the end of 2013 (to 0.1%) amid a continuing anti-inflationary effect of the domestic economy. This slowdown was also partly due to the low base of 2012.

After having risen slightly in December 2013, **fuel prices** switched to a year-on-year decline in 2014 Q1 (-1.6% in March; see Chart III.1.4). With the koruna-dollar exchange rate depreciating only moderately year on year, this was a result of a deepening year-on-year fall in petrol and oil prices on global markets.

CHART III.1.5

FOOD PRICES

Food price inflation excluding tax changes accelerated slightly
(annual percentage changes)

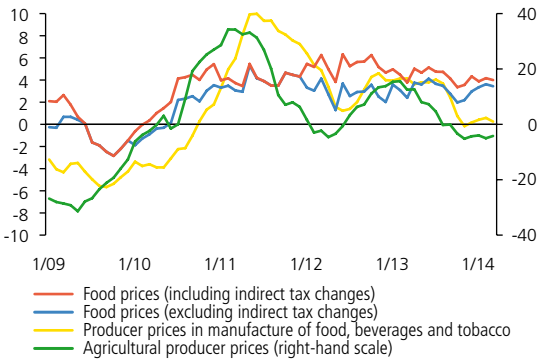
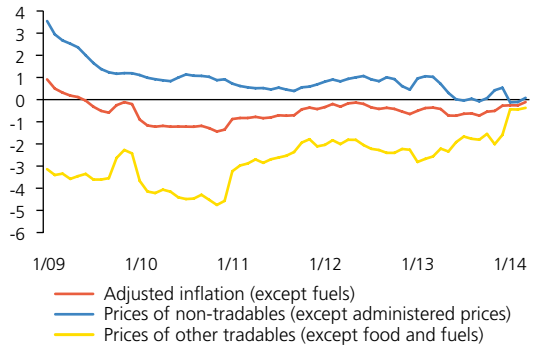


CHART III.1.6

ADJUSTED INFLATION EXCLUDING FUELS

Adjusted inflation excluding fuels shifted almost to zero as a result of a moderation of the decline in prices of tradable commodities
(annual percentage changes)



12 Including the effect of indirect taxes, food prices rose by 4% year on year in March.
13 See section III.2 *Import prices and producer prices.*
14 This segment consists mainly of services.

III.2 IMPORT PRICES AND PRODUCER PRICES

The annual growth in import prices that started in November and December 2013 as a result of the weakening of the exchange rate slowed slightly in the first two months of 2014. This change was due mostly to slowing growth in prices of products with a high degree of processing and, to a lesser extent, to a renewed annual decrease in import prices of energy commodities. Industrial producer prices switched to a year-on-year decline in 2014 Q1, linked mainly with a pronounced fall in electricity prices at the start of 2014 and a renewed year-on-year decline in producer prices in primary oil processing industries. The other branches of industry mostly recorded slightly rising prices. Agricultural producer prices fell year on year as a result of sizeable declines in crop product prices. The decline in prices of market services for the business sector continued to moderate and the fall in construction work prices completely stopped in March.

III.2.1 Import prices

Import prices increased by 3.8% year on year in December 2013 (see Chart III.2.1), reflecting the November weakening of the koruna. Their growth then slowed to 2.9% in January and remained at this level in February. The main cause of the change in import price inflation in early 2014 was a noticeable slowdown in import prices of high-value-added commodities, whose contribution to import price inflation has been by far the highest since November (see Chart III.2.2).

According to the latest data for February, import prices of **high-value-added commodities** accounted for almost two-thirds of the overall annual import price growth. Within this import category, the most significant moderation in early 2014 was recorded for annual growth in import prices of machinery and transport equipment (by 1.5 percentage points compared to December to 3.8% in February). The rate of growth of import prices of miscellaneous manufactured articles saw a similar slowdown (see Table III.2.1).

The slowdown in annual import price inflation in early 2014 was also partly due to import prices of **mineral fuels** (see Chart III.2.2). This was mainly a result of falling global prices of major energy commodities – crude oil and natural gas. The year-on-year decline in natural gas and oil prices on world markets has been in single figures in recent months (see Chart III.2.3).[15] The slightly weaker koruna-dollar exchange rate had the opposite effect on the growth rate of import prices of mineral fuels. However, the decline in oil and natural gas prices was more pronounced, leading to a renewed annual decline in import prices of mineral fuels in January. In February, the decline deepened to -2%. Their negative contribution to annual import price inflation was low, however, at -0.3 percentage point in February.

15 Except for December.

CHART III.2.1

IMPORT PRICES AND PRODUCER PRICES

Import price inflation fell slightly and producer prices went down, even though their decline in construction and market services slowed noticeably

(annual percentage changes)

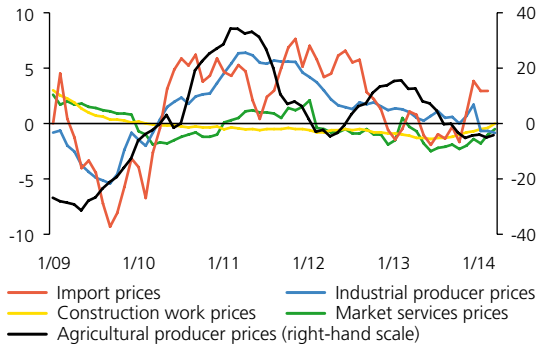


CHART III.2.2

IMPORT PRICES

High-value-added commodities contributed the most to the slowdown in import price inflation

(annual percentage changes; contributions in percentage points)

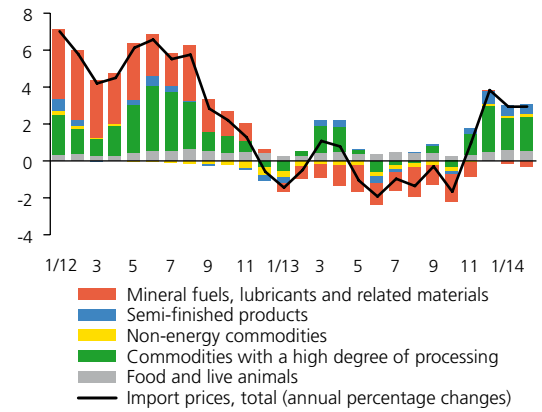


CHART III.2.3

MINERAL FUELS

Prices of imported mineral fuels and lubricants reflected falling global prices of crude oil and natural gas, while the koruna-dollar exchange rate had the opposite effect

(annual percentage changes)

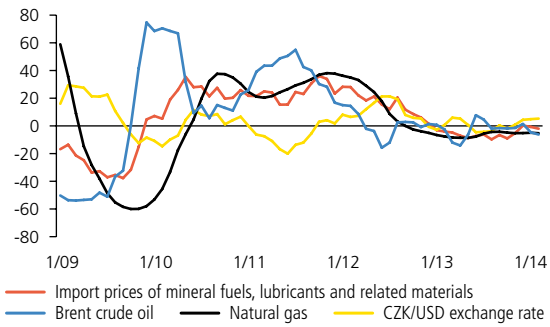


Table III.2.1

STRUCTURE OF IMPORT PRICE INFLATION

Import prices went up in most import categories, but prices of energy commodities went down
(annual percentage changes)

	11/13	12/13	1/14	2/14
IMPORTS, TOTAL	1.0	3.8	2.9	2.9
of which:				
food and live animals	4.0	7.7	9.0	8.2
beverages and tobacco	8.6	6.8	8.1	6.1
crude materials inedible, except fuels	-1.2	2.6	3.8	3.9
mineral fuels and related products	-5.2	0.2	-0.7	-2.0
animal and vegetable oils	-14.2	-12.8	-13.2	-12.9
chemicals and related products	-0.8	1.0	1.2	1.8
manufactured goods classified chiefly by material	1.9	4.1	3.5	3.1
machinery and transport equipment	2.5	5.3	3.4	3.8
miscellaneous manufactured articles	3.3	4.9	3.8	3.3

Chart III.2.4

INDUSTRIAL PRODUCER PRICES

Industrial producer prices fell year on year in 2014 Q1
(annual percentage changes; contributions in percentage points)

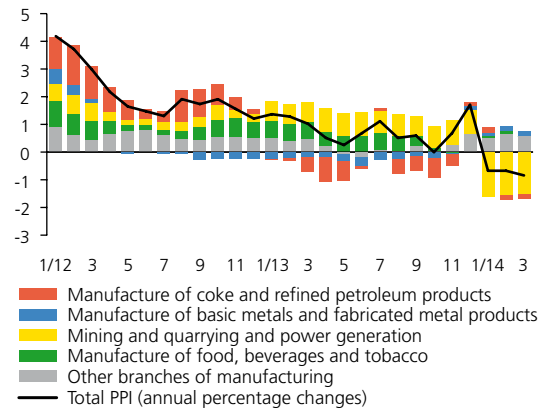
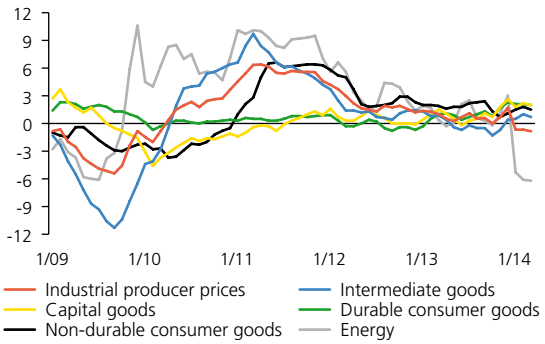


Chart III.2.5

PRODUCER PRICES BY MAIN INDUSTRIAL GROUPINGS

The decline in industrial producer prices was mostly due to prices of energy producers
(annual percentage changes)



Annual growth in import prices of **semi-finished products** also slowed at the start of 2014 (from 4.1% in December to 3.1% in February). Their share in annual import price inflation thus decreased to 0.6 percentage point.

By contrast, the growth rate of import prices in the other categories rose further. The strongest increase was recorded for **food and live animals** (from 7.7% in December to 8.2% in February), mostly owing to foreign prices of fruit and vegetables. The increase in import prices of **non-energy commodities**, which was renewed in December, rose further in early 2014 (to 3.9% in February). Import prices of **chemicals** saw a similar trend, with the annual growth restored in December 2013 picking up slightly in January (see Table III.2.1). However, the contribution of the latter two import categories to annual import price inflation was negligible due to their low weight.

III.2.2 Producer prices

Industrial producer prices

Industrial producer prices saw a marked change in year-on-year trend in 2014 Q1, as the increase in their growth recorded at the end of 2013 was replaced by a decline in 2014 Q1 (0.8% in March; see Chart III.2.4). This significant change was primarily a result of falling prices of electricity, gas and steam and, to a lesser extent, producer prices in the primary oil processing sector. Their dampening effect on annual industrial producer price inflation was only partly offset by the mostly slightly rising prices in some other branches of industry.

It is thus apparent from the **structure of industrial producer** (and import) **price inflation** that the decline was mostly due to falling electricity prices, which were affected by changes on the European electricity market, the primary causes of which can be seen in the rapid rise in shale gas extraction around the world.[16] These factors also affected coal prices on the domestic market, which fell noticeably year on year in 2014 Q1 (see Chart III.2.5). The falling global prices of energy commodities (oil and natural gas), whose impact on domestic prices was only partly offset by the weakening of the koruna, also fostered an annual decline in producer prices. Declining prices of agricultural products of vegetable origin, which made a substantial contribution to the now only weak producer price inflation in the food industry, acted in the same direction. The rapidly rising prices of imported food had no significant effect on overall inflation. A slowdown in producer price inflation in the other branches of manufacturing in 2014 Q1 – following a pick-up at the end of 2013 due to the weakening of the koruna – suggests that producers did not raise their prices further in connection with the weaker exchange rate. The lower energy costs may have contributed to the modest slowdown in their growth.

16 For more details see Box 4 in Inflation Report IV/2013.

The falling global oil prices and the weakened koruna were reflected in producer price inflation in the **manufacture of coke and refined petroleum products**, which decreased again year on year (to -2.7% in March) after rising temporarily in late 2013/early 2014. As a result, this industry's contribution to annual industrial producer price inflation dropped to -0.2 percentage point. The renewed modest growth in producer prices in the **manufacture of basic metals and fabricated metal products** recorded at the end of 2013 continued into 2014 Q1 (2% in March). Annual producer price inflation in the **food industry** was very modest (0.3% in March), mainly because of falling prices of domestic crop inputs (by contrast, prices of livestock products increased).

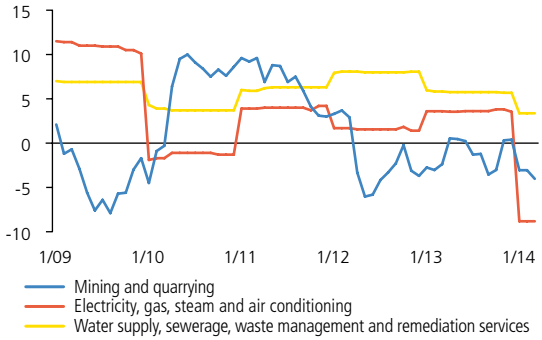
After having risen steadily in 2013,[17] producer prices in **the electricity, gas, steam and air-conditioned air industries** recorded a sharp annual decline in 2014 Q1 (8.8%; see Chart III.2.6). Prices in **mining and quarrying** followed a similar pattern, with weak annual growth at the end of 2013 being replaced by a decline in 2014 Q1 (4% in March). By contrast, prices in the water supply and sewerage-related services industry, whose activities and sources are difficult to substitute, continued to rise year on year in early 2014 (3.4%), although more moderately than in the previous year.[18]

Prices in the **other branches of manufacturing**, comprising the manufacture of high-value-added products, continued to show modest growth in 2014 Q1, although the growth was lower on average than at the end of the previous year (1.4%; see Chart III.2.4). More significant growth was recorded for prices in the manufacture of transport equipment (around 4%) and in the wood-working industry. By contrast, producer prices in the manufacture of pharmaceutical products continued falling.

CHART III.2.6

PRICES OF ENERGY AND WATER-RELATED SERVICES

Electricity prices fell sharply at the start of 2014
(annual percentage changes)



Agricultural producer prices

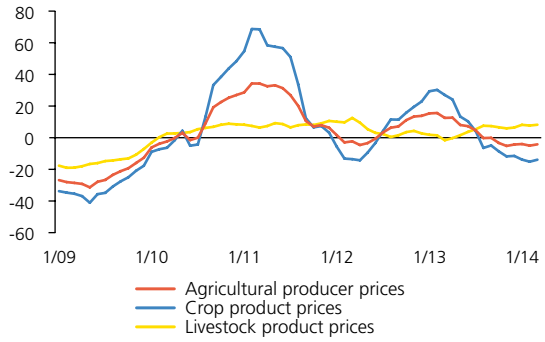
The decline in **agricultural producer prices**, which started in 2013 H2, continued into early 2014 (see Chart III.2.7). The annual decline was 4.2% in March, differing little from the figures recorded at the end of 2013. However, price developments in the two main components of the overall agricultural producer price index continued to be very different: the strong annual decline in crop product prices deepened further in 2014 Q1 (to 13.9% in March), while livestock product prices continued to show rapid growth (8.2% in March). The decrease in crop product prices was chiefly due to sharply falling prices in the dominant-weight categories of cereals and oilseeds.

The **main cause** of the falling agricultural producer prices in 2013 H2 and early 2014 was the above-average harvest in 2013, both in the Czech Republic and abroad. At the end of 2013, this factor was partly

CHART III.2.7

AGRICULTURAL PRODUCER PRICES

The decline in crop product prices deepened in 2014 Q1, while livestock product prices continued to rise
(annual percentage changes)



17 On average, producer prices in this industry rose by 3.6% year on year in 2013.
18 Price agreements in this industry and in the electricity, gas, steam and air-conditioned air industries are usually signed for one year.

offset by the year-on-year weakening of the koruna. In 2014 Q1, however, the global market situation changed significantly and the price levels of most agricultural commodities started to rise noticeably. This was due to several factors, among them expectations of a weak harvest in the USA owing to an extremely hard winter and the unstable geopolitical situation in Ukraine. On the other hand, despite the above facts, crop production (of cereals in particular) is expected to increase further on the global level this year. The increase in foreign spot and forward prices was reflected in producer prices in the Czech Republic only to a small extent in 2014 Q1.

Other producer prices

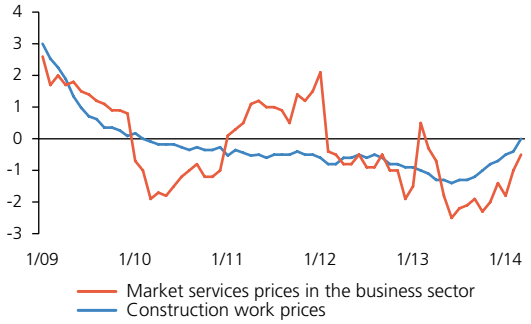
With construction investment demand recovering only slowly, **prices of construction work** continued to show an annual decline in 2014 Q1. However, the decline has been moderating gradually since mid-2013. By March, these prices were flat in year-on-year terms (see Chart III.2.8). Annual growth in prices of materials and products consumed in the construction industry also rose gradually (to 1.1% in March).

Prices of market services for the business sector, whose annual decline moderated noticeably in 2014 Q1 (to -0.5% in March; see Chart III.2.8), showed a similar trend. This trend was observed in numerous categories of services, for example transport services and information, legal and accounting services. By March, prices of services in these categories were showing annual growth. The largest price rises were recorded by postal and courier services (8.2% in March) and by advertising services and market research (4.2% in March).

CHART III.2.8

OTHER PRICE CATEGORIES

The year-on-year decline in prices of construction work and market services moderated significantly further
(annual percentage changes)



III.3 DEMAND AND OUTPUT

2013 Q4 saw renewed year-on-year real GDP growth, which reached 1.2%. In quarter-on-quarter terms, output growth picked up significantly to 1.8%. The year-on-year GDP growth was due to most components of domestic demand; only the contribution of change in inventories was strongly negative. With export growth overtaking import growth, net exports also made a positive contribution to economic activity. On the supply side, manufacturing was the biggest positive contributor to GDP growth. The recovery in economic activity continued into the start of this year. The output gap narrowed slightly, but remained strongly negative.

III.3.1 Domestic demand

In 2013 Q4, **domestic demand** continued to show modest growth (not exceeding 1%) as in the previous quarter. Unlike in Q3, however, the growth was driven mostly by household consumption and fixed investment, which went up again after a long decline (see Chart III.3.2). The contribution of government consumption was also positive. Only a substantial annual decline in additions to inventories fostered a slowdown in domestic demand growth.

Final consumption

Annual growth in the real **final consumption expenditure of households** picked up in 2013 Q4. At 1.2%, it was 0.4 percentage point higher than in the previous quarter.[19] The growth rate of household consumption expenditure increased despite a deeper annual decline in real gross disposable income. In these circumstances, it is likely that the increase in households' real consumption expenditure was fostered to some extent by the weakening of the koruna exchange rate by the CNB and related expectations of price increases in the near future.

Nominal gross disposable income, which is the main source of financing of households' consumption expenditure, saw a significant annual decline in 2013 Q4 (-4.5%; see Chart III.3.3). This deep decline was partly due to the effect of tax optimisation on annual wage growth (see section III.4.2). Nonetheless, gross nominal disposable income growth has been showing a falling trend – despite some fluctuations – since 2009. The real purchasing power of disposable income, as measured by the household consumption deflator, decreased by a significant 5.4%.

The **structure** of nominal gross disposable income shows that its annual decline in 2013 Q4 was due to all its components (see Chart III.3.4). The contribution of wages and salaries, which are the largest component

19 According to seasonally adjusted CZSO data.

CHART III.3.1

GROSS DOMESTIC PRODUCT

2013 Q4 saw renewed year-on-year GDP growth
(annual and quarterly percentage changes at constant prices; seasonally adjusted data)

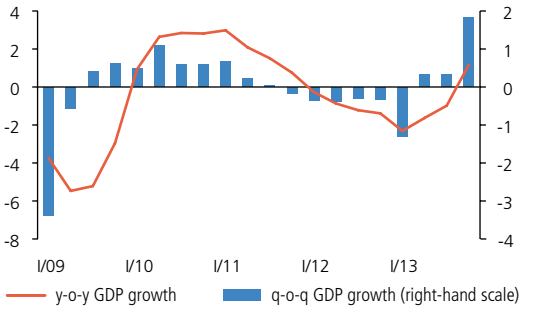


CHART III.3.2

STRUCTURE OF ANNUAL GDP GROWTH

All components of demand except inventories contributed to the year-on-year GDP growth in 2013 Q4
(contributions in percentage points; seasonally adjusted data)

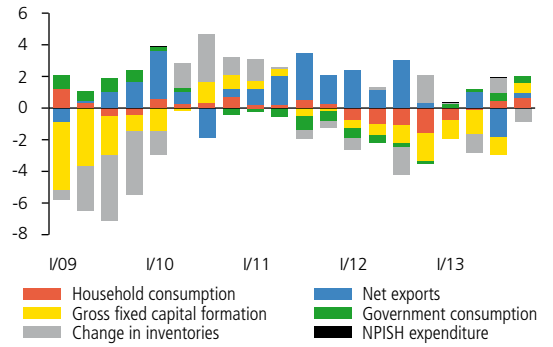


CHART III.3.3

HOUSEHOLD CONSUMPTION EXPENDITURE

Real household expenditure increased year on year, while the decline in real disposable income deepened
(annual percentage changes; seasonally unadjusted data)

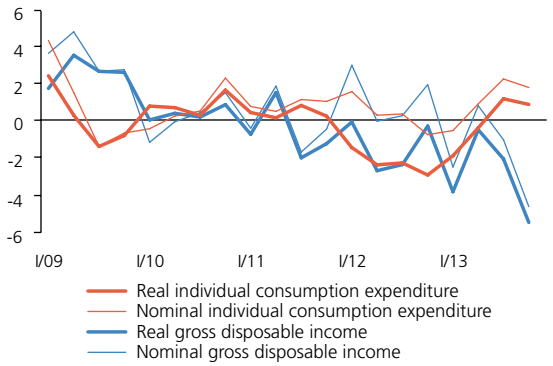


CHART III.3.4

DISPOSABLE INCOME

The year-on-year decline in nominal gross disposable income deepened in 2013 Q4

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

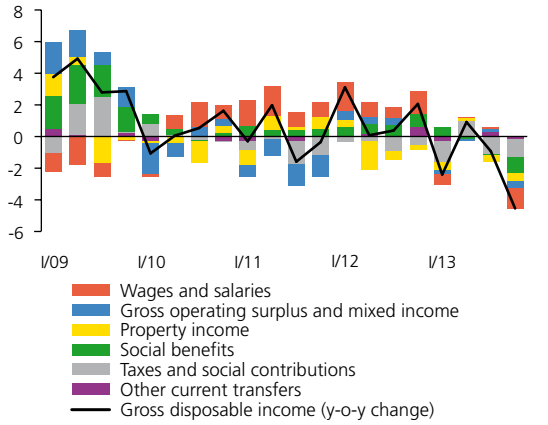


CHART III.3.5

STRUCTURE OF HOUSEHOLD CONSUMPTION

Households' consumption expenditure on non-durable and semi-durable goods increased

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

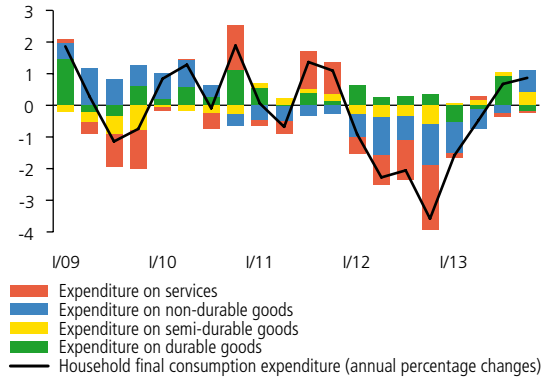
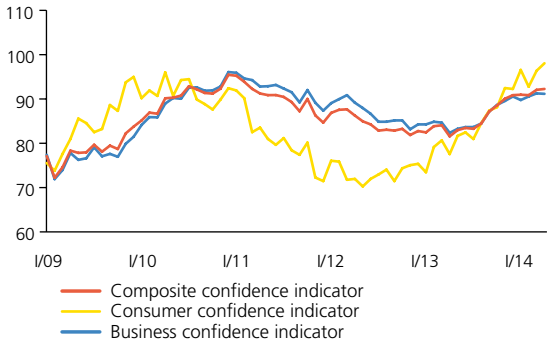


CHART III.3.6

CONFIDENCE INDICATORS

Consumer and business confidence increased further

(2005 average = 100; source: CZSO)



of households' gross disposable income in terms of volume, was the largest (-1.3 percentage points), due to a declining average wage and a falling number of employees converted into full-time equivalents.[20] The contribution of the relatively high-weight business income (gross operating surplus plus mixed income) was also negative again (-0.4 percentage point) following an increase in 2013 Q3. The decline in disposable income was also due in almost equal measure to a fall in property income. In addition, income from social benefits decreased for the second quarter in a row. Households' gross disposable income was reduced even more strongly by payments of taxes and social contributions.

With the annual decline in nominal gross disposable income deepening and households' consumption expenditure rising, the **saving rate** fell further towards 9% in 2013 Q4 (see Chart II.2.17). This was accompanied by a gradual increase in annual consumer credit growth to 2.4% (see section III.5).

In these circumstances, the higher household consumption in 2013 Q4 was also reflected in the **structure of household consumption expenditure.** Households channelled their increased spending primarily into purchases of non-durable goods, which had been declining steadily over the previous three years (see Chart III.3.5). Households' expenditure on semi-durable goods went up as well. By contrast, their spending on durable goods, which had risen quite sharply in 2013 Q3, fell slightly. Expenditure on services was also lower, but its negative contribution to the annual change in household consumption was minimal.

According to the latest available **leading indicators**, retail sales continued to recover at the start of 2014. This was apparent not only in the still rising automotive segment, but also in the rest of the retail sector. In the non-motor-vehicle segment, annual growth in sales[21] of both food and non-food retail goods increased. The consumer confidence indicator went up further (see Chart III.3.6). In particular, there was an improvement in perceptions of the outlook for the economic and financial situation and in expectations regarding unemployment.

Annual growth in real **government final consumption expenditure** slowed slightly in 2013 Q4 compared to the previous quarter, to 2.1%.

Investment

With economic activity gradually recovering, **fixed investment** recorded positive growth of 2.7%[22] in 2013 Q4 (see Chart III.3.7) after more than two years of year-on-year decline. In quarter-on-quarter terms, investment increased for the second quarter in a row, and in Q4 alone the growth exceeded 5%.

20 See section III.4 *The labour market*.
21 According to seasonally unadjusted data.
22 According to seasonally adjusted data. According to seasonally unadjusted data, on which Chart III.3.7 and Chart III.3.8 are based, the increase was 1.7%.

A noticeable recovery in investment activity in 2013 Q4 occurred in the **non-financial corporations sector**, which accounts for about 60% of total investment. The 6.2% annual growth in fixed investment in this sector was linked mainly with a sharp rise in investment in machinery and equipment. It is also likely that non-financial corporations contributed to the growing investment in intangible fixed assets and transport equipment and to the slowing decline in investment in buildings and structures (see Chart III.3.8). The renewed investment growth in this sector primarily reflected corporations' improving view of future demand, which was supported by a favourable trend in orders in industry. According to the latest business survey conducted by the CNB and the Confederation of Industry in January 2014, non-financial corporations also expect investment to increase at the six-month and twelve-month horizons, as indicated by a switch of the weighted balance of expected investment from negative to positive figures.

Investment in the **household sector** decreased year on year again in 2013 Q4, albeit at a slower rate than in Q3 (from -8.7% in Q3 to -7.0% in Q4). Nonetheless, its negative contribution to fixed investment growth was the highest of all sectors (see Chart III.3.7). Unlike in the case of non-financial corporations, leading indicators so far indicate no noticeable improvement in households' investment in dwellings, which is the main component of household investment, as the number of housing completions and starts fell again (by 7.6% and 22.8% respectively). Uncertain prospects for wage growth and unemployment were again the main cause of the persisting weak household demand for investment in dwellings despite still favourable financing conditions.

The long-running annual decline in investment in the **government sector** also slowed in 2013 Q4. This may have been reflected in the slowing decline in investment in buildings and structures. Nonetheless, the decline in government investment was still relatively deep (-7.1%). The persisting decline in government investment activity continued to be affected by problems with the preparation and implementation of projects financed from both domestic and European funds.

Only the contribution of **changes in inventories** to annual GDP growth was negative, after having risen significantly in 2013 Q3 (-0.9 percentage point in 2013 Q4). This volatility was probably due to the use of the previous quarter's substantial frontloading in increased output in Q4. This factor outweighed tobacco product frontloading ahead of the further increase in excise duty implemented in January 2014. However, favourable data on new industrial orders and the latest business survey conducted by the CNB and the Confederation of Industry suggest[23] that inventories can be expected to increase again in 2014 H1.

23 According to this survey, non-financial corporations expect stocks of raw and ancillary materials and semi-finished products to rise strongly in 2014 Q1 and Q2.

CHART III.3.7

INVESTMENT BY SECTOR

The renewed growth in fixed investment was driven by non-financial corporations

(annual percentage changes; contributions in percentage points; constant prices; seasonally unadjusted data)

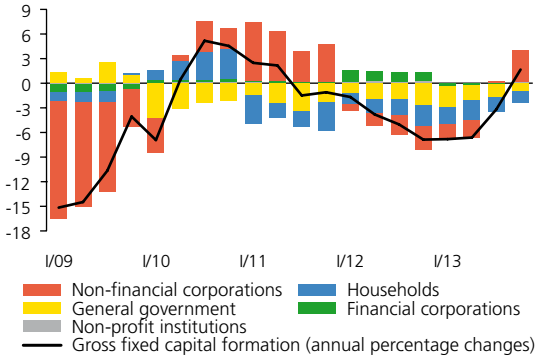


CHART III.3.8

FIXED CAPITAL FORMATION

Investment in machinery and equipment recorded the highest growth

(annual percentage changes; contributions in percentage points; constant prices; seasonally unadjusted data)

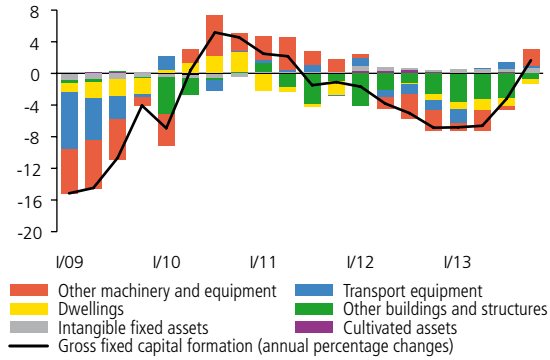


CHART III.3.9

INVESTMENT IN DWELLINGS

The decline in investment in dwellings slowed, but the number of housing starts fell again year on year

(annual percentage changes)

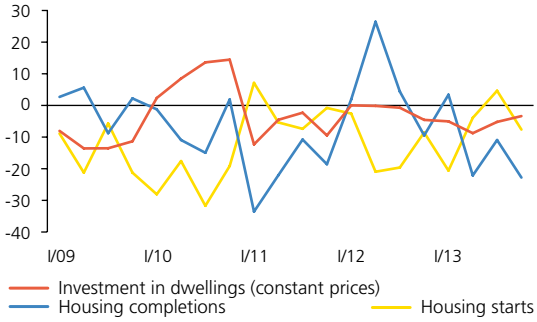


CHART III.3.10

NET EXPORTS

Net exports increased again in 2013 Q4
(seasonally adjusted data; constant prices)

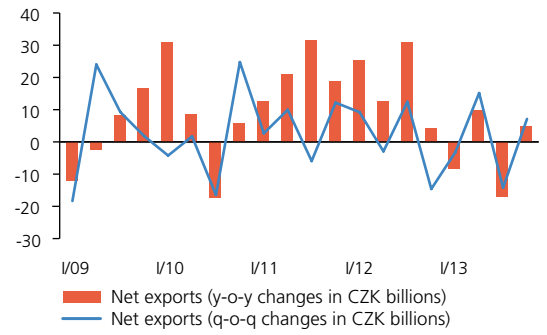


CHART III.3.11

EXPORTS AND IMPORTS

Year-on-year export growth increased sharply in 2013 Q4 and overtook import growth again
(annual percentage changes; percentage points; constant prices; seasonally adjusted data)

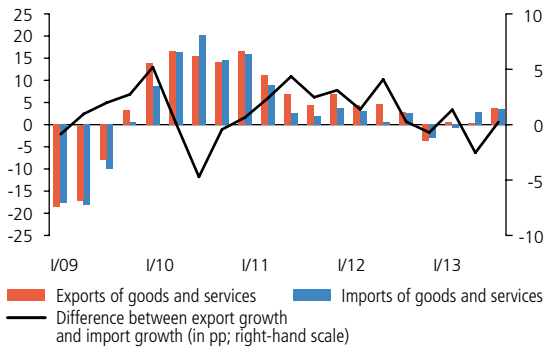
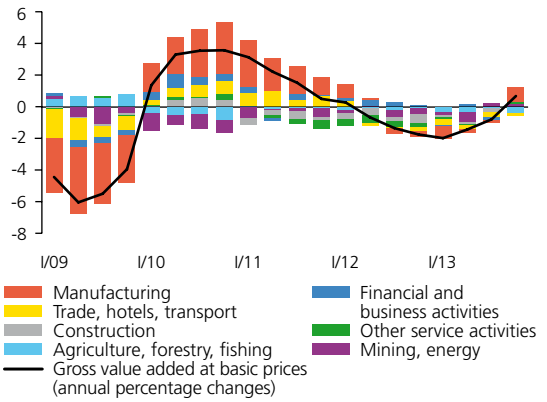


CHART III.3.12

CONTRIBUTIONS OF BRANCHES TO GVA GROWTH

Gross value added increased again after a long period of decline, thanks mainly to the manufacturing sector
(annual percentage changes; contributions in percentage points)



III.3.2 Net external demand

Following a year-on-year decline in 2013 Q3, **net exports of goods and services**[24] increased again in 2013 Q4 (by CZK 4.8 billion; see Chart III.3.10). In quarter-on-quarter terms, the growth was even more pronounced, exceeding CZK 7 billion. The increase in net exports was mainly due to the trade balance, whose surplus increased again after declining in Q3. However, it was also due to a modest annual rise in the services surplus, which had been falling in the previous three quarters. In these circumstances, the contribution of net exports to GDP growth was slightly positive (0.4 percentage point), unlike in the previous quarter, when it had had the opposite effect.

The year-on-year increase in net exports in 2013 Q4 was a result of a renewed lead of export growth over import growth (of 0.2 percentage point). In Q2, the relationship had been the opposite, strongly in favour of imports (see Chart III.3.11). **Total exports** rose by 3.7% year on year, accelerating by 3.4 percentage points compared to the previous quarter. The stronger growth in total exports was linked with an upswing in external demand in the Czech Republic's major trading partner countries. However, exports rose only in the goods category (by 5%), while exports of services shrank for the fourth quarter in a row, thus slowing total export growth. The pronounced increase in export growth was also reflected in a pick-up in total foreign trade turnover.

The noticeable upswing in **total imports** recorded in 2013 Q3 continued in Q4. Total imports rose by 3.5% year on year in 2013 Q4. This represented a further modest increase in growth of 0.6 percentage point compared to the previous quarter.[25] The continuing rise in total imports was linked with the growth in domestic demand and in exports given its traditionally high import intensity. The export recovery was clearly reflected in further growth in imports for intermediate consumption and renewed fast growth in imports for investment purposes. By contrast, as in the previous quarter, falling imports of services reduced the growth in total imports.

III.3.3 Output

Gross value added at basic prices increased again year on year in 2013 Q4 (by 0.7%) after six quarters of decline. In quarter-on-quarter terms, value added grew for the second consecutive quarter. In Q4 alone the growth picked up to 0.8%. The gradual recovery in external demand in particular was reflected most of all in the output of industry. Value added in the other sectors mostly rose only slightly or decreased (see Chart III.3.12). About half of the branches under review made positive contributions to annual gross value added growth.

24 At 2005 prices, seasonally adjusted.
25 An increase of 3.7 percentage points had been recorded in Q3.

The renewed annual value added growth was mostly due to **industry**, which made a positive contribution of 1.1 percentage points in 2013 Q4. This was fostered by the higher-weight **manufacturing sector**, which recorded a marked annual rise in value added of 3.8%. The previous decline in value added in mining and quarrying also disappeared, with value added being flat in year-on-year terms at the end of 2013.

The gross value added growth in industry in 2013 Q4 was consistent with the data on **industrial production** (see Chart III.3.13),[26] which grew by 6.1% year on year in real terms. This was mostly due to fast growing production in **manufacturing**, whose growth rate reached a significant 7%. Output rose in almost three-quarters of the branches monitored. In terms of use, there was rapid growth in production for investment and intermediate consumption (of 8.8% and 6.7% respectively), linked probably with the growth in exports among other things. Production of non-durable goods showed the slowest growth. Production also started growing again in the electricity, gas, heat and air-conditioned air supply industry.

According to the latest available **leading indicators**, the relatively fast real growth in industrial production continued into January and February 2014 (see Chart III.3.13).[27] In February, the biggest positive contribution to annual real industrial production growth came from the manufacture of motor vehicles, trailers and semi-trailers (contribution 2.8 percentage points, growth 16.1%). In addition, the latest available data on direct export sales (which surged by 16.1% at current prices in February) indicated a further marked improvement in export growth in 2014 Q4.[28]

According to the April results of the CZSO's business survey, the overall effect of **barriers to growth in industry** decreased further (see Chart III.3.14). The most significant moderation was recorded for insufficient demand, which, however, remains the biggest limiting factor. At the same time, there was an increase in **capacity utilisation**. Continued rapid annual growth in both foreign and domestic **new industrial orders** in the first two months of 2014 (of almost 20% in February)[29] also suggests a further improvement in the conditions for growth in industrial production in the period ahead (see Chart III.3.15).

The overall negative contribution of **trade and services** to the year-on-year evolution of gross value added was marginal in 2013 Q4 (-0.1 percentage point). This outcome, however, concealed mixed trends in value added across the individual branches. The biggest contributors to the decline in value added in this segment were trade,

26 According to seasonally adjusted data.
27 According to seasonally adjusted data.
28 Domestic sales, which include indirect exports through non-industrial corporations, grew by 5.6% at current prices.
29 New foreign orders increased by 23.0% in February, while new domestic orders rose by 14.1%.

CHART III.3.13

INDUSTRIAL PRODUCTION

The data for February confirmed a rapid recovery in industrial production
(basic index; year 2010 = 100)

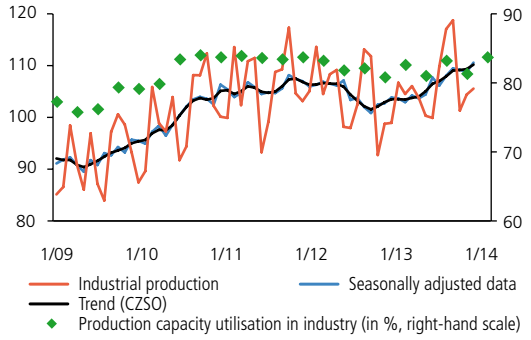


CHART III.3.14

BARRIERS TO GROWTH IN INDUSTRY

The effect of insufficient demand as the main barrier to growth in industrial production decreased noticeably further
(percentages)

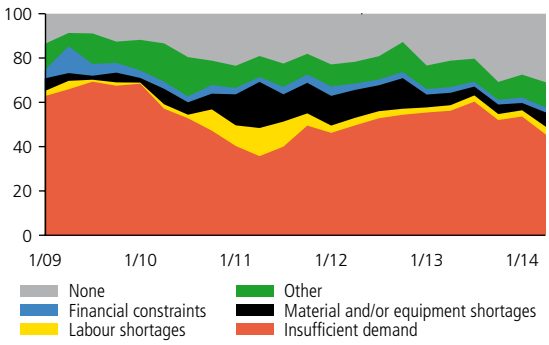


CHART III.3.15

NEW ORDERS IN INDUSTRY

The rapid growth in new industrial orders continued
(annual percentage changes)

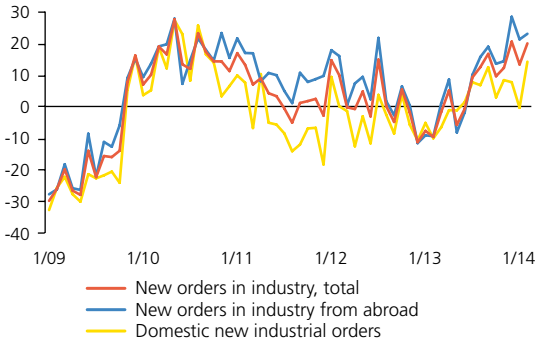


CHART III.3.16

ECONOMIC SENTIMENT

Economic sentiment in the Czech Republic, Germany and the EU is continuing to improve
(long-term average = 100; seasonally adjusted data; source: Eurostat)

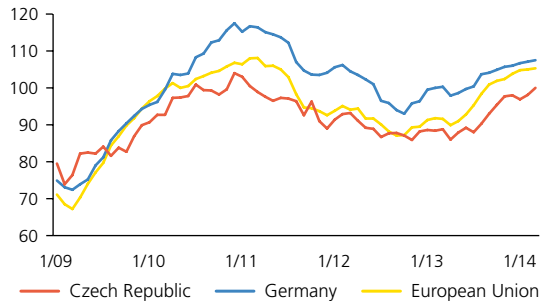


CHART III.3.17

POTENTIAL OUTPUT

The rate of growth of potential output remained only just above 1% in 2013 Q4 according to the production function calculation
(annual percentage changes)

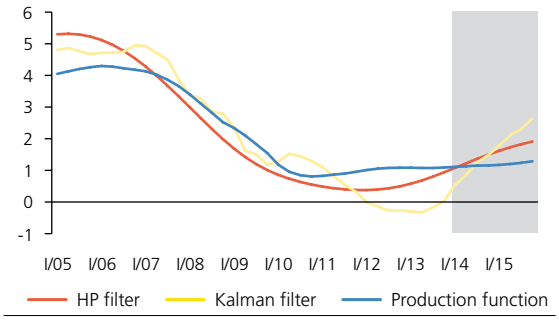
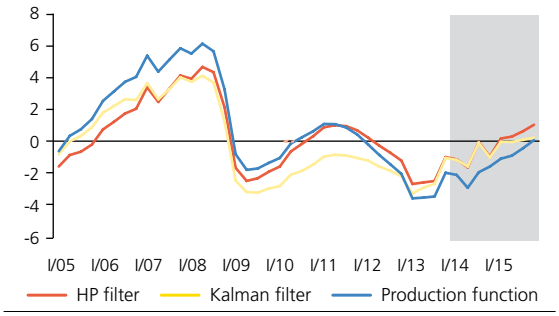


CHART III.3.18

OUTPUT GAP

The output gap remains significantly negative, but will close in 2015
(in % of potential output)



transportation, accommodation and food services, real estate and professional and other activities. On the other hand, financial and insurance activities saw continuing fast year-on-year value added growth of almost 9%. The CZSO's latest leading statistics are signalling a rise in value added in trade in 2014 Q1, although more so in the automotive segment than in other retail segments.

Gross value added in **construction** at constant prices recorded moderate annual growth in 2013 Q4 (0.4%; see Chart III.3.12) after almost three years of decline. However, the year-on-year real decline in construction output continued in both building construction and civil engineering as a result of still low demand for construction work. The rate of decline in building construction output, however, has now fallen to single figures. The CZSO's latest available leading data are signalling a change in trend, as construction output went up in real terms in January and February (by 5% and 6.1% respectively) and building notifications and permits also increased in value despite falling in number.

An **international comparison of economic sentiment**, based on data for March, confirms the previous trends in this indicator both in the Czech Republic and in Germany and the EU as a whole. The upward trend observed in Germany and the EU since the second half of 2012, and in the Czech Republic since April 2013 (despite a minor correction in January this year), is thus continuing (see Chart III.3.16).

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

According to the **Cobb-Douglas production function** calculation, the annual growth rate of potential output remained only just above 1% in 2013 Q4 (see Chart III.3.17). The sizeable quarterly increase in economic activity observed in 2013 Q4 resulted in sharp closure of the output gap, which, however, remained in clearly negative territory (-2% of potential output; see Chart III.3.18). This method suggests stable annual potential output growth this year, with a renewed gradual recovery at the longer end of the forecast horizon. The output gap should then gradually close as the economy starts to grow again, nearing zero in late 2015.

The breakdown of the contributions of the individual **factors of potential output growth** entering the production function points to stability for capital and an increase in the contribution of productivity amid a slightly declining contribution of employment at the forecast horizon. The gradual pick-up in potential output growth will thus be due solely to rising productivity growth. Overall, annual growth in potential output will pick up only slightly to levels of around 1.3% in 2015 (see Chart III.3.19).

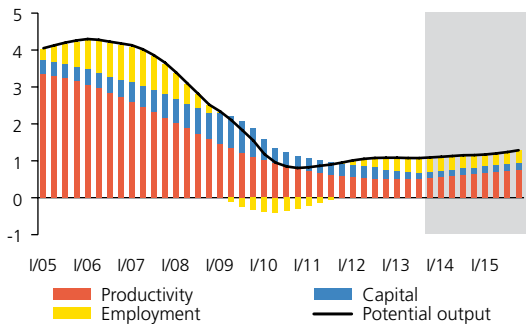
An alternative estimate using the **HP filter**[30] indicates slightly lower potential output growth (0.9% in 2013 Q4) than that calculated using the production function. Under this method, the output gap is currently narrower and the HP filter indicates closure of the output gap in early 2015 amid faster potential output growth. The **Kalman filter** indicates that annual potential output growth will stay at zero in 2013 Q4. Over the forecast horizon, potential output will start rising again and during 2015 accelerate towards 3% (which is the expected long-term growth rate in a steady-state economy). Compared to the Cobb-Douglas production function calculation, the Kalman filter also indicates a more moderate opening of the output gap to negative levels at present and earlier closure over the forecast horizon.

CHART III.3.19

CONTRIBUTIONS TO POTENTIAL OUTPUT GROWTH

The contribution of productivity will gradually increase over the forecast horizon

(production function; annual percentage changes)



30 The estimate using the HP filter also used coefficient λ = 1,600.

CHART III.4.1

LABOUR MARKET INDICATORS

In 2013 Q4, employment growth increased slightly, the number of employees converted into full-time equivalents continued to fall, and the average wage decreased
(annual percentage changes)

III.4 THE LABOUR MARKET

The labour market was characterised in 2013 Q4 by slightly faster employment growth and a decline in unemployment amid increasing economic activity. However, this was accompanied by a pronounced annual decrease in the average wage. At the same time, cuts in hours worked continued in a number of sectors, although in industry this trend virtually halted and the number of employees started to rise. With employment growing faster than the labour force, the general unemployment rate went down. At the same time, the share of unemployed persons stopped rising and even edged down in 2014 Q1. The large decline in the nominal and real average wage was due to falling wages in the business sector. Nevertheless, the data for January and February 2014 point to renewed slightly positive wage growth. Faster economic activity accompanied by only a slight rise in employment resulted in renewed weak growth in whole-economy labour productivity. Unit labour costs recorded a sizeable annual decline, largely because of a fall in the volume of wages and salaries.

III.4.1 Employment and unemployment

Following a pronounced slowdown in the previous quarter, growth in **total employment**[31] strengthened again slightly in 2013 Q4 (to 0.8% year on year; see Chart III.4.1). In quarter-on-quarter terms, total employment (adjusted for seasonal effects) increased by 0.2%. The generally moderate year-on-year growth in employment continued to be driven by an increasing number of employees, while the year-on-year decline in the number of entrepreneurs deepened.

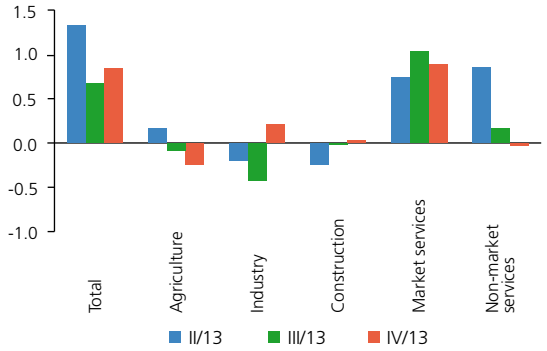
As regards sectors, the largest increase in employment was again recorded in the tertiary sector in 2013 Q4. It accounted for the largest **share in year-on-year growth in total employment** (see Chart III.4.2). However, the year-on-year growth in employment in this sector did not accelerate any further in late 2013; on the contrary, it slowed slightly. For the first time in a long time, the secondary sector – where the economic recovery gradually started to be felt in demand for labour – contributed to faster growth in total employment.

Unlike in the previous three quarters, year-on-year growth in employment in the **tertiary sector** was driven solely by market services[32] in 2013 Q4. Once the higher growth observed in the first half of 2013 had faded away, the number of persons employed in non-market services fell slightly year on year towards the end of the year. The main contributors to this were other activities and education, while some other sectors (e.g. public administration and defence, health care and culture) saw continued employment growth.

CHART III.4.2

EMPLOYMENT BREAKDOWN BY BRANCHES

The continuing growth in employment was due mostly to market services, but the contributions of industry and construction were also positive
(contributions in percentage points to annual change; selected branches; source: LFS)



31 Employment according to the LFS.
32 Especially wholesale and retail trade, hotels, and information and communication activities.

Following a long-running decline, employment in the **secondary sector** increased again in 2013 Q4 (by 0.6%). This growth was most evident in manufacturing, although increases were also recorded in the electricity and water supply sectors in late 2013. According to the latest CZSO figures for January and February, the growth in industrial production observed since mid-2013 was reflected in year-on-year growth in the registered number of employees[33] (of 0.6% and 1.1% respectively). Employment in construction also edged up in 2013 Q4, following a long-running decline. Only the **primary sector** continued to record a year-on-year fall in employment, which deepened further compared to the previous quarter.

As in previous quarters, the number of employees was affected in 2013 Q4 by the use of alternative forms of employment, especially shorter working hours. This resulted in persisting different paths of the number of employees and the number of employees **converted into full-time equivalents** (see Chart II.4.1).[34] The year-on-year decline in the latter indicator continued to reflect employers' efforts to optimise employment in the face of the previous economic downswing and the only slowly diminishing uncertainty about future demand. This decline, which concealed mixed trends in the main sectors under review, remained at the previous quarter's level in 2013 Q4 (see Chart III.4.3).

In **market services**, the decline in the converted number of employees deepened year on year in 2013 Q4. This indicated a year-on-year decrease in average working hours in this sector. In **industry**, by contrast, the year-on-year decline in the converted number of employees has been slowing gradually for three consecutive quarters (to -0.8% in 2013 Q4). This implies that, unlike in market services, the decline in average working hours in industry moderated at the end of 2013. Only in the non-business sector did the converted number of employees continue to increase year on year. A closer look at the evolution and structure of part-time employment in the long term is provided in the following Box 1.

BOX 1
Evolution and structure of shorter working hours

This box describes labour market developments in terms of the **use of shorter working hours** as a reaction to adverse economic developments in the past. The CZSO's Labour Force Survey figures, which allow an analysis of data since 2007, were used for this purpose.

CHART III.4.3

NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENT)

The decline in the converted number of employees stagnated, with the number of employees and average working hours moving in opposite directions
(contributions in percentage points; annual percentage changes)

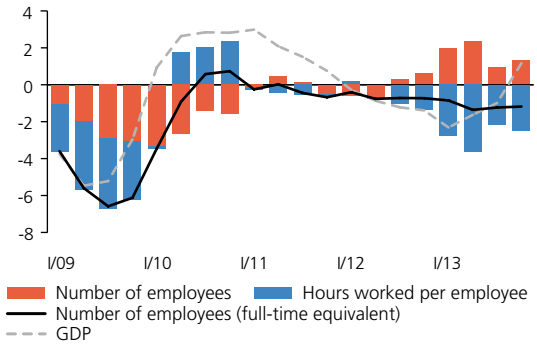
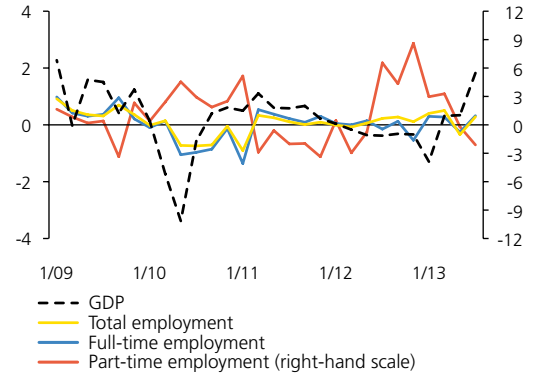


CHART 1 (BOX)

GDP, TOTAL EMPLOYMENT AND ITS COMPONENTS

Part-time employment is strongly countercyclical
(q-o-q changes)



33 Corporations with 50 employees or more, excluding agency workers.
34 In this way employers cut labour costs and reduced the risk of losing permanent qualified workers, who might be difficult to find during the recovery phase.

CHART 2 (BOX)

STRUCTURE OF PART-TIME EMPLOYEES BY GENDER AND AGE

Women make up the majority of part-time employees
(numbers in thousands)

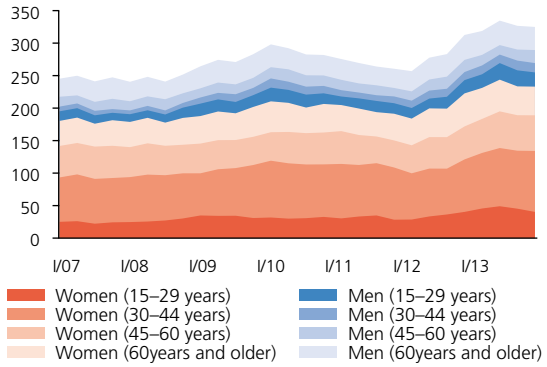


CHART 3 (BOX)

CONTRIBUTIONS OF SELECTED SECTORS TO ANNUAL CHANGE IN SHORTER HOURS WORKED

Education, health and trade have been affecting the dynamics of part-time emloyment the most
(contributions in percentage points to annual change)

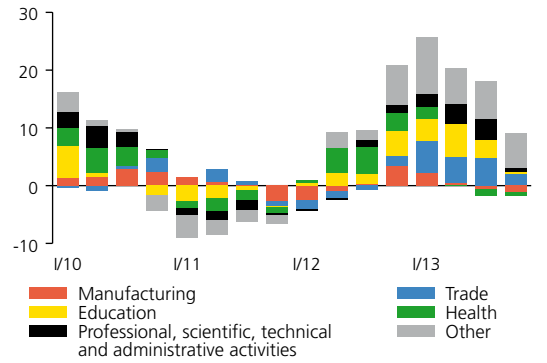
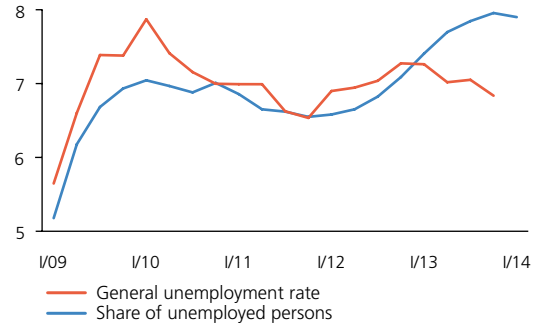


CHART III.4.4

UNEMPLOYMENT INDICATORS

The general unemployment rate decreased in 2013 Q4, while the share of unemployed persons stopped rising and even fell slightly in 2014 Q1
(percentages; seasonally adjusted data; source: MLSA, CZSO)



The number of employees working shorter hours is **strongly countercyclical** (see Chart 1). During a decline in economic activity, the number of employees working full-time is seen to fall, while the number of those working shorter hours rises sharply. This implies that the working hours of some employees have probably been shortened. This phenomenon was observed in 2012. By contrast, the temporary recovery of the Czech economy in 2010 and 2011 led to a decline in the number of employees working shorter hours, with some part-timers probably switching back to full-time work.

As a result of the economic contraction observed until recently, the proportion of employees working shorter hours in the total number of employees has been creeping up since 2012, reaching almost 7% in 2013. This is due mainly to a **growing share of women**, as the figure for men has risen only slightly. Overall, the number of employees working shorter hours increased from less than 250,000 in 2007 to almost 330,000 in 2013 (see Chart 2). Almost three-quarters of this total is made up of women, most of them in the 30–44 age group. Most are therefore probably women returning to the labour market after parental leave. In 2012 and 2013, however, the number of women working shorter hours also increased in the youngest age group (15–29 years). In 2013, their number rose most of all in the sectors of wholesale and retail trade and hotels and restaurants.

Turning to **selected sectors**,[35] education and wholesale and retail trade have been the main contributors to the year-on-year growth in part-time employment in the period since the second half of 2012 (see Chart 3). A large increase in part-time employment was also observed in the high-weight manufacturing sector in late 2012 and early 2013, although this diminished later in 2013 as industrial production recovered. As for the other sectors, the contributions of administration and other support activities and hotels and restaurants are also significant.

With employment growing faster than the labour force, the **general unemployment rate**[36] decreased to 6.8% in 2013 Q4 (see Chart III.4.4). The year-on-year growth in the labour force despite a continued decline in the population was due to an increasing **rate of economic activity**[37] in all age groups. The overall rate of economic activity reached a historical high for the Czech Republic (73.1% after

35 The Labour Force Survey figures contain data only for the main economic sectors. The sum of employed persons working shorter hours in individual sectors may thus not be equal to the total number of persons working shorter hours. Data for individual CZ-NACE sectors have been available only since 2009.
36 In the 15–64 age category. Measured by the ILO methodology according to the LFS.
37 The rate of economic activity is defined as the ratio of employed and unemployed persons to the population in each age category.

seasonal adjustment). The increase was due, among other things, to an extension of the retirement age, demographic trends and also to the use of shorter working hours. According to the latest January and February figures, the seasonally adjusted general unemployment rate decreased slightly further to 6.7% and the rate of economic activity edged up further.

On the other hand, the **share of unemployed persons**,[38] published by the Ministry of Labour and Social Affairs, rose further in both annual and quarterly terms in 2013 Q4 (see Chart III.4.4). This (seasonally adjusted) unemployment indicator then declined slightly to 7.9% in 2014 Q1 owing to a larger decrease in the number of available job applicants than in the population in the given age group.

A gradual improvement of the labour market situation is also indicated by the latest available data for 2014 Q1, according to which the **Beveridge curve**[39] is gradually shifting in the north-westerly direction. This shift is due to a decrease in the seasonally adjusted number of registered job applicants coupled with an increase in vacancies (see Chart III.4.5).

III.4.2 Wages and productivity

The only moderate annual growth in the **average nominal wage** observed during 2013 switched to a pronounced year-on-year decline in 2013 Q4 (of 1.8%; see Chart III.4.6). This significant change in wage dynamics was due to a sizeable decline in the average wage in the business sector, as the average wage in the non-business sector continued to rise modestly. With annual inflation low, the **real average wage** decreased by 2.9%, following a slight rise in the previous quarter (see Table III.4.1).

Following weak growth in 2013 Q2 and Q3, annual average wage growth in the **business sector** switched to a sizeable decline at the end of 2013 (of 2.4%). As expected, the year-on-year figure was clearly affected by the tax optimisation recorded at the end of 2012 (to the tune of almost -2.0 percentage points).[40] However, the average wage recorded a year-on-year decrease even when adjusted for this factor. It also fell in quarter-on-quarter terms. The previous long-running decline in economic activity and the excess supply on the labour market thus had an unexpectedly large effect on wages.

38 The share of unemployed persons is the ratio of available job applicants aged 15–64 to the population of the same age.

39 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.

40 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. In many of the sectors that usually display the highest proportions of performance-related bonuses for the previous year, these bonuses were therefore moved from 2013 Q1 to 2012 Q4. These sectors mainly included financial intermediation, energy and heat supply and cultural, entertainment and recreational activities.

Chart III.4.5

BEVERIDGE CURVE

The rise in the number of unemployed persons halted
(seasonally adjusted numbers in thousands; source: MLSA)

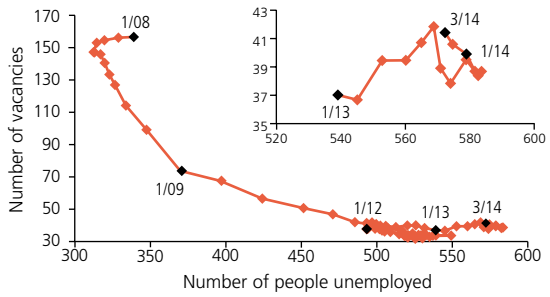


Chart III.4.6

AVERAGE WAGE

The average nominal and real wage both decreased markedly
(annual percentage changes)

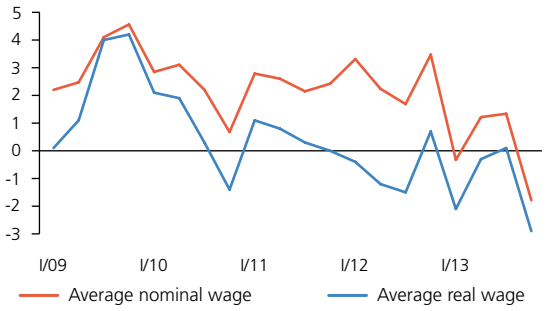


Table III.4.1

WAGES, PRODUCTIVITY, UNIT LABOUR COSTS

The decline in the average nominal wage neared 2% in 2013 Q4
(annual percentage changes)

	I/13	II/13	III/13	IV/13
Average wage in Czech Republic				
nominal	-0.3	1.2	1.3	-1.8
real	-2.1	-0.3	0.1	-2.9
Average wage in business sector				
nominal	-0.4	1.1	1.5	-2.4
real	-2.3	-0.4	0.2	-3.5
Average wage in non-business sector				
nominal	0.0	1.7	0.8	0.8
real	-1.8	0.2	-0.4	-0.3
Whole-economy labour productivity	-4.0	-2.9	-0.8	0.1
Nominal unit labour costs	2.0	1.5	0.4	-3.5

A decline in the average wage was meanwhile recorded in most **branches of the business sector** in 2013 Q4. The only major exceptions were agriculture and hotels and restaurants. Following a previous slight rise, the real average wage in the business sector recorded a sharp year-on-year decrease (of 3.5%; see Table III.4.1). Nevertheless, the January and February data on industry and construction suggest renewed slight wage growth, even when adjusted for tax optimisation.

The average nominal wage in the **non-business sector** maintained the same pace of growth in 2013 Q4 as in the previous quarter, increasing by 0.8% year on year. This subdued growth was due to a rise in the average wage in central government (of 1.3%) and in local government (of 0.7%). Overall, the low annual inflation thus outpaced nominal average wage growth in this sector. This was reflected in a year-on-year decline in the real average wage in 2013 Q4 (of 0.3%; see Table III.4.1).

With real GDP rising slightly faster than employment, **whole-economy labour productivity**[41] started to edge up again in 2013 Q4 (by 0.1% year on year). This was due mostly to industry, where the sizeable year-on-year decline in productivity observed in 2013 H1 turned positive (see Chart III.4.7), mainly because of renewed (seasonally unadjusted) growth in value added in this sector. An increase in productivity was also recorded in construction. Productivity decreased in the other sectors under review, albeit more moderately than in the previous quarter in non-market services. **Productivity per hour** recorded even faster growth than whole-economy productivity, rising by 1.5% year on year in 2013 Q4. This indicator recorded growth in all the sectors under review, most of all in industry and construction.

The sizeable fall in the volume of wages and salaries[42] coupled with the above developments in economic activity as measured by GDP, resulted in a significant decrease in the **unit labour costs**[43] in 2013 Q4 (of 3.5%; see Chart III.4.8). As regards sectors, nominal unit wage costs declined particularly sharply in construction, industry and market services. Weak growth in labour costs was recorded only in non-market services.

CHART III.4.7

WHOLE-ECONOMY PRODUCTIVITY

The halt in the decline of whole-economy labour productivity was due mostly to industry
(annual percentage changes)

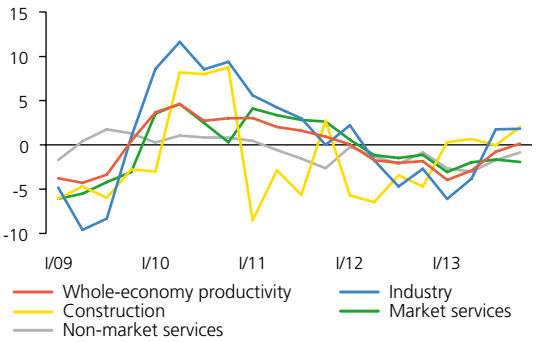
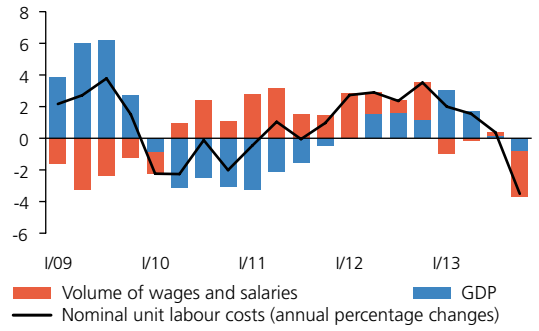


CHART III.4.8

UNIT LABOUR COSTS

Nominal unit labour costs decreased in 2013 Q4, mainly because of a fall in the volume of wages and salaries
(contributions in percentage points; annual percentage changes)



41 Productivity is calculated on the basis of seasonally unadjusted data.
42 Following an insignificant annual increase of 0.3%, the volume of wages and salaries dropped by 2.7% in 2013 Q4.
43 Unit labour costs were calculated on the basis of seasonally unadjusted data.

III.5 FINANCIAL AND MONETARY DEVELOPMENTS

The annual growth rate of M2 remained at around 5% at the start of 2014. Highly liquid overnight deposits were the main component contributing to M2 growth. The growth rate of deposits of non-financial corporations continued to rise, in line with their improved financial situation, while growth in deposits of non-monetary financial institutions slowed. The decline in the velocity of money moderated significantly as a result of the recovery in economic activity. The availability of loans to the private sector improved slightly. The annual growth rate of total loans slowed sharply at the start of 2014, following an increase in late 2013 associated with the financing of renewed growth in corporate fixed investment. By contrast, the growth rate of loans to households rose slightly further, in line with the recovery in consumer demand. The debt burden of households increased at the end of 2013 amid a decline in gross disposable income. Like financial market rates, client interest rates were mostly unchanged or declined slightly. Asking prices of apartments in Prague, and newly also outside Prague, continued to recover at the start of 2014.

III.5.1 Money

The annual growth rate of **M2** remained subdued at the start of 2014, edging up to 4.5% in February 2014 (see Chart III.5.1). With annual nominal GDP growth recovering to 3.5% in 2013 Q4, the decline in the velocity of money moderated significantly. The annual growth rate of M3 was 5.2% in February and is still around 4 percentage points higher than the euro area average.[44] On the asset side, money growth in the Czech Republic was fostered mainly by growth in loans to the private sector and in net foreign assets.

A preference for liquidity maintained the growth rate of M1 high at 7.2% (see Chart III.5.1). This was due to an increase in **overnight deposits** (see Chart III.5.2). Highly liquid money (M1) was the sole component contributing to M2 growth. The negative contributions of the other components mostly moderated. The decline in short-term time deposits (included in M2–M1) slowed further, mainly as a result of corporate deposits. Long-term deposits continued to decline slightly in an environment of low interest rates.

Turning to the **sector structure of deposits**, the M2 growth was fostered mainly by deposits of non-financial corporations and to a lesser extent by household deposits, while growth in deposits of non-monetary financial institutions continued to slow in an environment of reduced risk aversion and search for yield (see Chart III.5.3). The annual

44 In an environment of reduced risk aversion, the relatively low M3 growth in the euro area (1.3%) reflects the efforts of economic agents to achieve higher returns on their assets, for example in investment funds. On the other hand, growth in euro area M3 is being fostered by foreign investors' interest in buying euro area securities, which is manifesting itself in growth in banks' net foreign assets.

CHART III.5.1

MONETARY AGGREGATES

The annual growth rates of M2 and M3 were broadly unchanged overall in 2014 Q1
(annual percentage rates of growth)

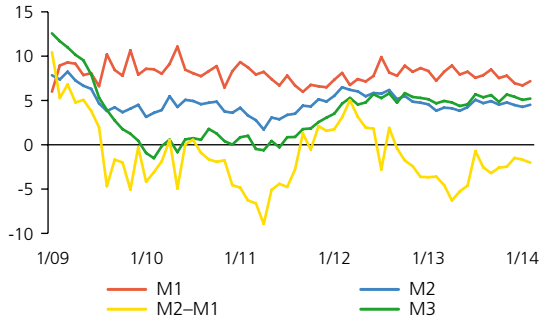


CHART III.5.2

MAIN COMPONENTS OF M2

Overnight deposits remain the main component contributing to M2 growth
(annual flows in CZK billions)

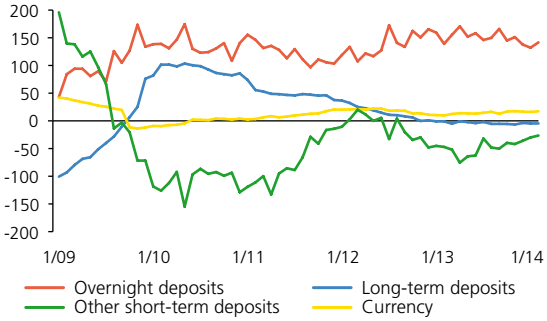


CHART III.5.3

DEPOSIT STRUCTURE OF M2

The contribution of deposits of non-financial corporations to money growth continued to increase
(contributions in percentage points; annual percentage rates of growth)

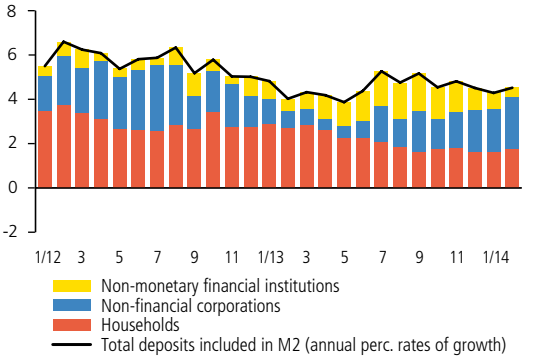


TABLE III.5.1

CHANGES IN BANKS' CREDIT CONDITIONS

Corporate demand for loans according to banks decreased temporarily; banks left their credit standards broadly unchanged
(net percentages; positive value = tightening standards/conditions, demand growth; negative value = easing standards/conditions, demand decrease)

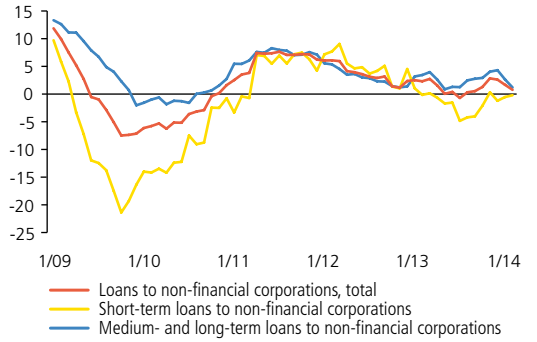
	Supply			Demand
		Credit terms and conditions: of which		
	Credit standards	Average margin for loans	Margin on riskier loans	Demand for loans
Loans to non-financial corporations				
II/13	17 (9)	-36	3	19 (-1)
III/13	0 (20)	-21	0	-7 (23)
IV/13	-2 (0)	-20	2	27 (-8)
I/14	0 (2)	0	20	-26 (29)
II/14	(-16)			(54)
Loans for house purchase				
II/13	4 (-26)	-43	-4	67 (17)
III/13	-4 (-22)	-53	20	61 (-7)
IV/13	0 (27)	22	8	11 (6)
I/14	-4 (-4)	-2	36	-11 (-2)
II/14	(4)			(35)
Consumer credit				
II/13	26 (30)	7	7	69 (-7)
III/13	0 (0)	-9	0	-34 (-15)
IV/13	0 (-7)	-9	-9	-9 (2)
I/14	-18 (16)	-25	-25	76 (-28)
II/14	(22)			(69)

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. Banks' expectations for current period reported in the previous quarter survey given in parentheses.

CHART III.5.4

LOANS TO NON-FINANCIAL CORPORATIONS

After increasing at the end of last year, growth in corporate loans slowed sharply
(annual percentage rates of growth)



growth rate of deposits of non-financial corporations increased to 9% in February 2014. This corresponded to an elevated acid-test ratio of corporations. The growth rate of household deposits remained at 2.5%. The share of foreign currency resident deposits in total resident deposits included in M2 edged up as a result of increased growth in corporate deposits, reaching 8.9% in February 2014 compared to 8.5% in December 2013.

III.5.2 Credit

The annual growth rate of **loans to the private sector** slowed during 2014 Q1, reaching 3% in February. According to the bank lending survey, non-financial corporations' demand for loans and households' demand for house purchase loans both decreased. On the supply side, credit standards for approving loans showed no broad-based changes (see Table III.5.1).[45]

The year-on-year growth rate of **loans to non-financial corporations** slowed sharply to 0.8% during 2014 Q1, following an increase at the end of 2013. Lower growth was recorded for loans with longer maturities, and short-term loans edged down (see Chart III.5.4). As regards cooperation size, demand for loans declined in both small and large firms. According to the bank lending survey, demand was negatively affected by a decrease in financing of inventories and working capital and an increase in corporate bond issuance. The annual growth rate of corporate bonds remained fairly high (20%) despite having moderated last year. On the other hand, demand for loans to finance fixed investment continued to grow, albeit less broadly than at the end of 2013. Demand for loans to finance mergers and acquisitions persists.

Investment loans, which account for around 57% of total corporate loans on average, were little changed in year-on-year terms in 2014 Q1, following an increase in 2013 Q4 due to the financing of renewed growth in fixed investment. The contribution of investment loans to developers and industry (primarily manufacturing and the electricity, gas and heat supply industry) recorded a decline (see Chart III.5.5).

The interest of Czech corporations in **foreign currency loans** has been increasing since the second half of 2013. The annual growth rate of such loans adjusted, among other things, for exchange rate

45 In the euro area, the results of the bank lending survey for 2013 Q4 suggest a continued, albeit less broad-based, tightening of credit standards for corporate loans and a relaxing of standards for loans to households for house purchase. As regards the main factors, funding costs and banks' balance sheet constraints had a neutral effect on the change in standards, while increased competition fostered an easing and a decline in risk perceptions among banks regarding overall economic activity and some sectors fostered a less broad-based tightening. Demand for loans remains weak in all credit market segments. Banks were expecting it to increase in 2014 Q1. The year-on-year decline in loans to the private sector stabilised at 2% in line with the current phase of the business cycle, reflecting only a gradual improvement in loan demand and supply (see *ECB Monthly Bulletin,* April 2014).

changes rose significantly, reaching 18% in December 2013. The share of foreign currency loans in total corporate loans rose to around 21%. This rise was due mainly to loans to developers, since the construction of commercial development projects is usually funded by euro-denominated loans so that rents can be set in euro. Foreign currency loans also increased gradually in some industrial sectors (especially manufacturing, mining and energy) and in wholesale and retail trade. These were euro-denominated loans with longer maturity. The contributions of these sectors shrank in 2014 Q1 and the annual growth rate of foreign currency loans slowed to 9% (see Chart III.5.6).[46] Nevertheless, it remains elevated, mainly as a result of natural hedging by corporations together with an increase in export financing and renewed growth in investment activity.

Credit standards for approving corporate loans remained broadly unchanged in 2014 Q1. For the first time in two years, an easing of standards was fostered by lower risk perceptions associated with the outlook for certain sectors and the overall economic situation. Banks' tendency to relax their credit standards, and hence the improved availability of loans, pertains to loans provided to all types of corporations in terms of size. Moreover, as regards the terms and conditions for approving loans to large corporations, average interest margins fell and banks relaxed their loan size limits and reduced their collateral requirements and loan covenants (see Table III.5.2).

The annual growth rate of **loans to households** increased slightly further to 5.3% in 2014 Q1. The increase in the stock of loans to households was accompanied by higher growth in new business, partly reflecting refinancing of existing loans (see Chart II.5.7).

The annual growth rate of **loans for house purchase** was broadly unchanged. The growth rate of mortgages was 6.4%, while building society loans declined. According to the bank lending survey, household demand for house purchase loans recorded a temporary decrease in 2014 Q1. This was associated with legislative changes arising from the new Civil Code and the Cadastral Act, to which banks reacted by changing their procedures. Rising consumer confidence had a favourable effect on households' demand for loans for house purchase. Banks made no broad changes to their credit standards in Q1. Banks expect demand for house purchase loans to rise in 2014 Q2, although this growth will continue to be driven partly by refinancing of existing loans. Stable apartment prices and greater availability of mortgages are opening up room for investment in property, although a more pronounced recovery in the property market can be expected in 2015 owing to labour market developments.

46 As Chart III.5.6 shows, an increase has also recently been observed in euro-denominated loans with longer maturities provided to non-resident non-financial corporations, especially in mining, energy, telecommunications and wholesale and retail trade.

Chart III.5.5

LOANS TO CORPORATIONS FOR FUNDING FIXED INVESTMENT

The growth in investment loans recorded at the end of 2013 has not continued so far

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

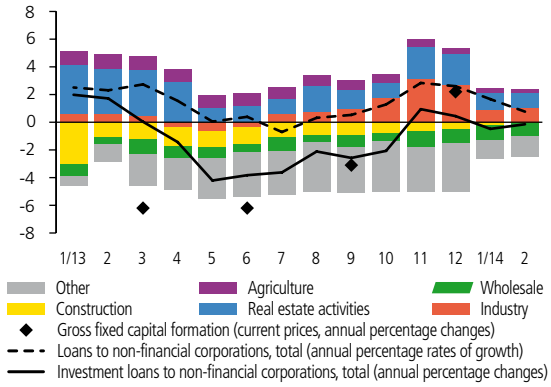


Chart III.5.6

CURRENCY STRUCTURE OF CORPORATE LOANS

The annual percentage rate of growth of loans in foreign currency increased significantly in 2013 Q4

(annual percentage rates of growth adjusted for exchange rate changes; annual percentage changes)

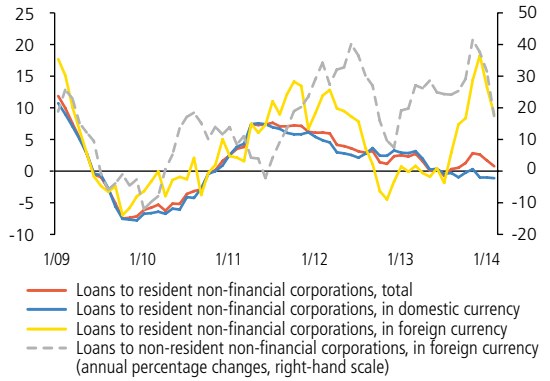


Table III.5.2

CREDIT CONDITIONS BY CORPORATION SIZE

Banks' tendency to improve the availability of loans is visible for both large corporations and SMEs

(net percentages; positive value = tightening standards/conditions; negative value = easing standards/conditions)

	Quarterly averages			
	2012	2013	2014 Q1	2014 Q2[a)]
Credit standards				
Small and medium-sized enterprises	13	4	0	(-17)
Large corporations	22	0	0	(-16)
Banks' average margin on loans				
Small and medium-sized enterprises	-1	-16	0	
Large corporations	18	-8	-18	
Size of loans				
Small and medium-sized enterprises	13	3	0	
Large corporations	29	10	-4	
Collateral requirements				
Small and medium-sized enterprises	26	9	9	
Large corporations	25	1	-8	

a) Banks' expectations for the current period reported in the I/14 survey given in parentheses.

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.

CHART III.5.7

LOANS TO HOUSEHOLDS

The annual rate of growth of loans to households continued to edge up

(annual percentage rates of growth; annual percentage changes)

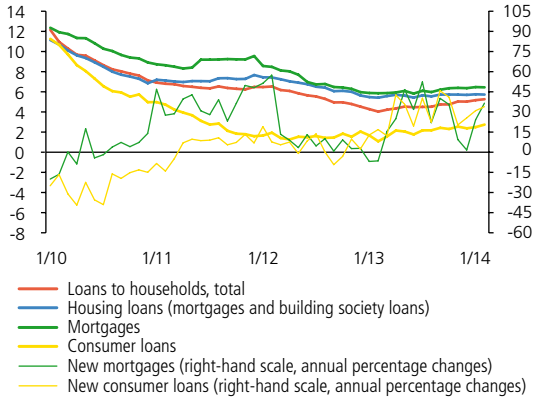


CHART III.5.8

STRUCTURE OF NUMBER OF NEW MORTGAGES

The number of new mortgages for house purchase increased in February and March 2014

(contributions in percentage points; annual percentage changes; source: Fincentrum Hypoindex)

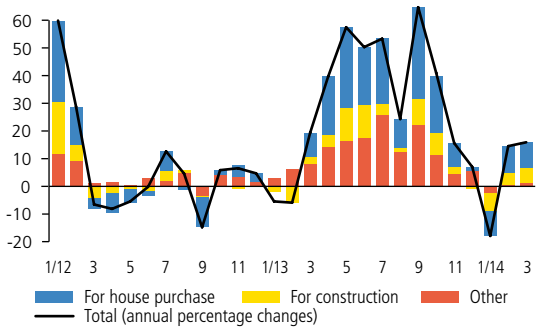
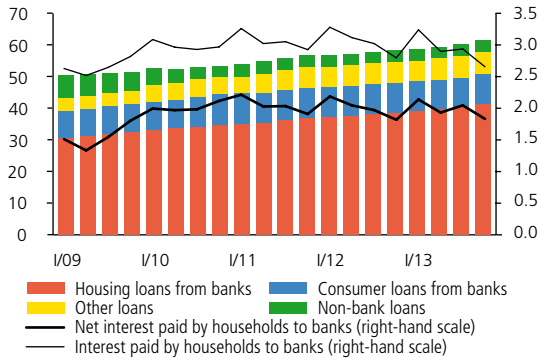


CHART III.5.9

HOUSEHOLD DEBT

Households' debt-to-income ratio is still rising steadily

(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.

According to Hypoindex data for March 2014, the **number and volume** of new mortgages increased by 15.9% and 14.4% respectively year on year amid a further decline in interest rates on new mortgages. This growth was fostered by new mortgages for property purchase and construction (see Chart II.5.8).

The annual growth rate of bank **consumer credit** edged up further, reaching 2.7% in February 2014. By contrast, consumer credit obtained by households from non-banks recorded a year-on-year decline of 1.3%. The growth rate of new bank consumer credit also increased (see Chart III.5.7). Demand for consumer credit rose in a significant part of the bank market (a net percentage of 76%), partly because of consolidation of existing loans accompanied also by an increase in such loans. Rising consumer confidence and higher financing of household spending on durable goods had a favourable effect on household demand. This corresponds to the upturn in consumer demand. The availability of consumer credit improved as a result of an easing of bank credit standards for approving such loans and, in the case of terms and conditions, a decline in banks' average interest margins. Banks expect demand in this credit market segment to increase further in 2014 Q2.

Total household debt increased further to 61.5% of gross disposable income in 2013 Q4. This reflected a decline in disposable income and lower growth in household debt. The equivalent ratio in the euro area remains at a considerably higher level (98.5%), despite currently showing a gradual decline. Czech households' debt-to-income ratio increased vis-à-vis banks, but is declining gradually vis-à-vis non-banks in the long run. The net interest burden on Czech households declined to 1.8% of disposable income. This reflected a decrease in interest payments to banks amid an only slight fall in interest received from deposit accounts (see Chart III.5.9).

III.5.3 Interest rates

Monetary policy interest rates

The monetary policy decision-making of the CNB Bank Board in 2014 Q1 was based on the macroeconomic forecast published in the previous Inflation Report. The forecast assumed that market interest rates would be flat at their current very low level and the exchange rate would stay at CZK 27 to the euro as long as the easing of the monetary conditions was needed, i.e. until the start of 2015. At its meeting in February, the Bank Board decided unanimously to leave **key interest rates** unchanged at their current level, i.e. at technical zero[47] (see Chart III.5.10). The Board also decided to continue using the **exchange rate as an additional instrument for easing the monetary conditions** and confirmed the CNB's commitment to intervene on the foreign exchange market if needed to weaken the koruna so as to maintain the exchange rate of

47 The two-week repo rate and the discount rate were set at 0.05% and the Lombard rate at 0.25% with effect from 2 November 2012.

the koruna close to CZK 27 to the euro at least until the start of 2015. At its meeting in March, the Bank Board again decided unanimously to leave key interest rates unchanged. At the same time, it confirmed the above foreign exchange commitment.

At its monetary policy meeting on 7 May 2014, the Bank Board decided unanimously to keep interest rates unchanged at technical zero. The Board also decided to continue **using the exchange rate as an additional instrument for easing the monetary conditions**. It also confirmed the CNB's commitment to intervene on the foreign exchange market if needed to weaken the koruna against the euro so that the exchange rate of the koruna is kept close to CZK 27 to the euro. The nature of this exchange rate commitment is unchanged. The Bank Board assessed the risks to the new forecast as being slightly anti-inflationary. The Bank Board continues to view the level of the exchange rate commitment at CZK 27 to the euro as appropriate and expects the exchange rate to be kept close to this level at least until the start of 2015. In a debate of the new forecast, however, the Bank Board stated that the probability of a later exit from the exchange rate commitment was increasing. At the same time the Bank Board concluded that domestic interest rates will not necessarily rise as fast as indicated by the forecast in 2015.

Financial market interest rates

PRIBOR rates remained at historical lows at all maturities in 2014 Q1. They thus reflected the setting of the CNB's key interest rates at technical zero (see Chart III.5.11). Three-month **FRA derivative rates** for the near term (3*6) have been flat since the start of the year, while those for longer terms (6*9, 9*12) have risen by around 0.1 percentage point, probably in reaction to favourable data confirming a domestic economic recovery. The market outlook for 3M rates according to end-April FRA quotations implies expected only a negligible rise in 3M PRIBOR rates at the end of the year. This is roughly in line with the prevailing expectations of monetary policy interest rates being left at technical zero at least until the start of 2015 given the current money market premium remaining unchanged. The market outlook is very close to the interest rate path in the new CNB forecast until the end of this year (see section II).

Domestic **interest rates with longer maturities** have remained broadly unchanged (up to 2Y maturity) or edged down (3Y maturity and beyond) since the start of this year. With inflation practically at zero, bond yields reflected foreign investors' increased interest in domestic assets after the weakening of the koruna. Domestic IRS rates and bond yields showed similar developments as long-term rates in the euro area, which were affected by several factors: the mixed message sent out by published macroeconomic indicators, the possibility of the ECB easing monetary policy further owing to the low inflation in the euro area, and the situation in Ukraine. Long-term rates in the USA were little changed overall, since they were affected by a faster economic recovery than in the euro area and also by the ongoing tapering of the quantitative easing programme and related communication by the Fed.

CHART III.5.10

CNB KEY RATES

The CNB left its key interest rates at "technical zero" in 2014 Q1
(percentages)

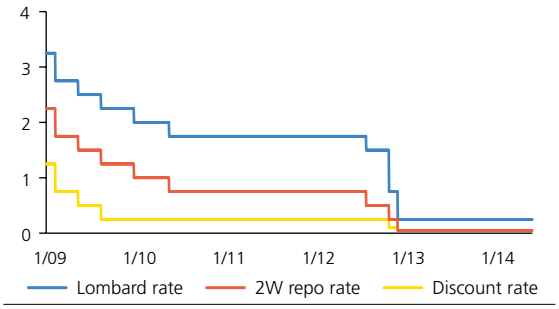


CHART III.5.11

MARKET INTEREST RATES

Money market interest rates were flat at historical lows at the start of this year
(percentages)

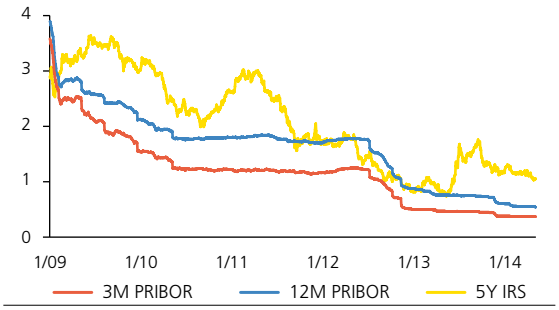


CHART III.5.12

INTEREST RATE DIFFERENTIALS

Interest rate differentials vis-à-vis the euro and the dollar were close to zero
(percentage points)

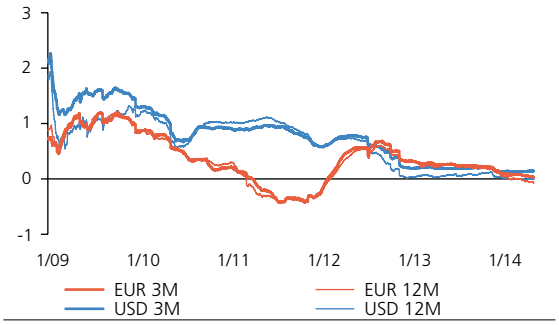


CHART III.5.13

GOVERNMENT BOND YIELD CURVE

The positive slope of the government bond yield curve decreased slightly
(percentages)

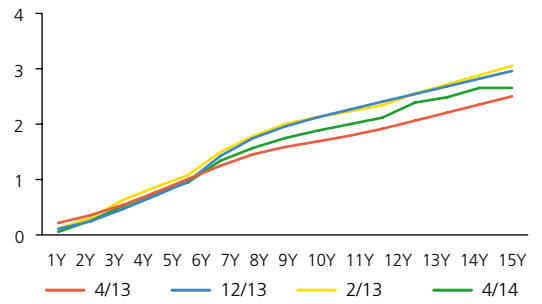


CHART III.5.14

INTEREST RATES ON LOANS TO CORPORATIONS

Interest rates on loans to non-financial corporations decreased slightly in 2014 Q1
(new business; percentages)

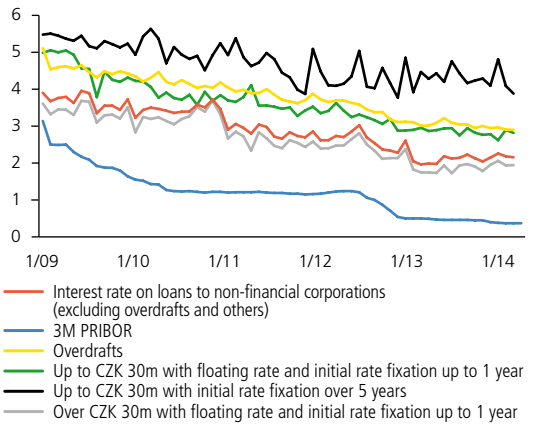
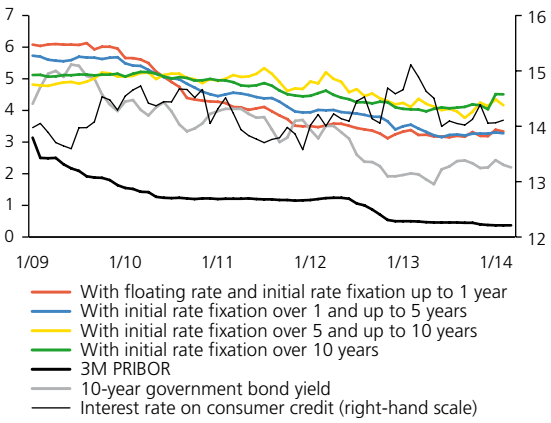


CHART III.5.15

INTEREST RATES ON LOANS TO HOUSEHOLDS

Interest rates on loans to households for house purchase with shorter fixations were flat
(new business; percentages)



The average **3M PRIBOR** in 2014 Q1 was 0.4%, in line with the level foreseen by the previous forecast. The credit premium, as measured by the spread between the 3M PRIBOR and the 2W repo rate, has been just above 0.3 percentage point since the foreign exchange interventions increased the amount of free liquidity in November 2013.

The shape and positive slope of the **PRIBOR yield curve** was unchanged in 2014 Q1. The spread between the 1Y PRIBOR and the 2W PRIBOR was 0.4 percentage point on average in March 2014. The **IRS yield curve** shifted to a lower level in 2014 Q1, although only at its longer end, so its positive slope also decreased slightly. In March, the average 5Y–1Y spread was 0.8 percentage point and the 10Y–1Y spread 1.5 percentage points.

Short-term **interest rate differentials** vis-à-vis the two main world currencies (PRIBOR/CZK–EURIBOR/EUR and LIBOR/USD) reflected the only marginal changes in rates on the Czech and foreign financial markets. The differentials vis-à-vis euro and dollar rates were close to zero (see Chart III.5.12). The 3M PRIBOR–3M EURIBOR differential was 0.1 percentage point on average in 2014 Q1. At the end of April, it stood at zero.

Sixteen auctions of fixed coupon bonds and one auction 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 90.9 billion.[48] Demand strongly exceeded supply in all the auctions. The bid-to-cover ratio was 2.1 on average. Government bonds continued to be subscribed with very low yields close to their historical lows. The government bond yield curve – like the IRS curve – shifted downwards slightly in its medium and longer sections. Its positive slope thus decreased slightly (see Chart III.5.13).

Client interest rates

Like financial market rates, **client interest rates on new loans** were broadly unchanged or edged down during 2014 Q1. Ex ante client real interest rates on new loans and deposits declined in all credit market segments as a result of the January rise in inflation expected by financial market analysts at the one-year horizon.

The **interest rate on loans to non-financial corporations** decreased slightly in nominal terms to 2.2% in February 2014, having hovered at roughly this level for a year. Rates with short-term and long-term fixations both declined (see Chart III.5.14). The interest rate on large loans of over CZK 30 million edged down to 2% and the rate on small loans to 3.1%. At 1.1 percentage points, the spread between these rates remains slightly above its long-term downward trend. The spread between the short-term rate on corporate loans

48 The Czech Republic's Funding and Debt Management Strategy for 2014 assumes issues amounting to CZK 119.2–280.1 billion.

and the 3M PRIBOR narrowed slightly in February (see Chart III.5.16). Rates on corporate loans in the euro area also decreased slightly at the start of the year and are still higher than those in the Czech Republic (the average rate in the euro area was 2.7%).

Turning to households, the **interest rate on loans for house purchase** remained at 3.4% (3.2% for mortgages) in February 2014. The rate on loans fixed for over one year and up to five years, which account for around 77% of all house purchase loans, was 3.3% (see Chart III.5.15). Floating rates and rates fixed for up to one year showed similar developments. By contrast, rates fixed for over five years decreased slightly, probably due to the fall in long-term financial market interest rates. The spread between short-term client and market rates widened slightly in 2014 Q1 (see Chart III.5.16). The spread between the average rate on loans for house purchase and the long-term financial market rate remained broadly unchanged. According to Hypoindex, the interest rate on new mortgages fell to a new historical low in March 2014. Some banks announced further cuts in mortgage interest rates as part of their special spring offers in April 2014. The interest rate on house purchase loans in the euro area remained at 3% in February.

The **interest rate on consumer credit** remained at 14.1%, following a marked decline at the end of 2013 due mainly to a decrease in the rate with a short-term fixation (see Chart III.5.15). By contrast, the APRC rose to 15.1%. The rate on overdrafts and revolving loans declined to 14.3% and the rate on credit card debt was 24.2%. The rate on consumer credit in the euro area remained significantly lower on average (6.6%) than that in the Czech Republic. Unlike in the Czech Republic, the rate with a short-term fixation is gradually increasing.

Interest rates on deposits of households and corporations were little changed in the period under review, except for rates on some time deposits, which increased further. Rates on overnight deposits were 0.4% and 0.2% for households and non-financial corporations respectively. The rate on deposits redeemable at notice of up to three months, comprising relatively highly remunerated building society deposits, remained at 2%. By contrast, short-term and long-term rates on household deposits with agreed maturity rose to 1.8% and 2.6% respectively. This was accompanied by a rise in the volume of such deposits (see Chart III.5.17). The equivalent rates in the euro area declined to 1.6% and 1.9% respectively in February (around 1% for deposits redeemable at notice of up to three months).

Real client interest rates[49] decreased during 2014 Q1 owing to higher expected inflation, while nominal rates showed no major changes. Real rates on new loans were 3.9% in February. The real interest rate on corporate loans was virtually zero. Real rates on time deposits stood at -0.5% (see Chart III.5.18).

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

CHART III.5.16

CLIENT AND MARKET INTEREST RATE SPREADS

The spreads between client and market rates were broadly unchanged
(percentage points)

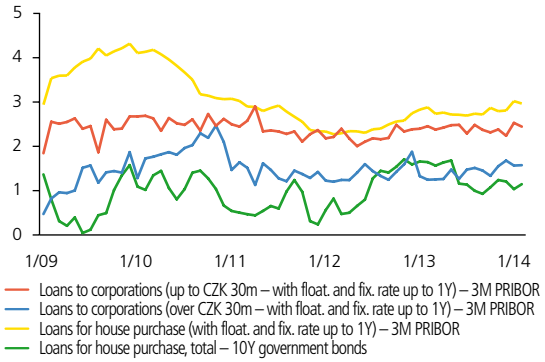


CHART III.5.17

INTEREST RATES ON DEPOSITS

Interest rates on household time deposits with agreed maturity increased
(percentages)

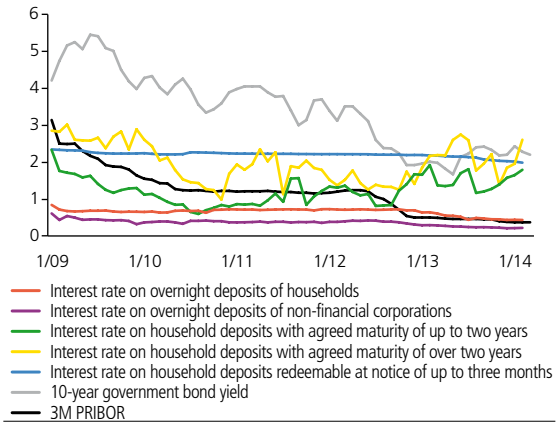


CHART III.5.18

EX ANTE REAL RATES

Ex ante real interest rates on new loans and deposits declined at the start of 2014
(percentages)

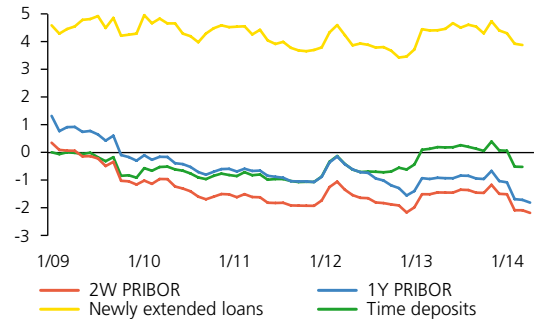


CHART III.5.19

CZK/EUR AND CZK/USD EXCHANGE RATES

The koruna was stable against the euro and the dollar in 2014 Q1, but weakened in year-on-year and quarter-on-quarter terms

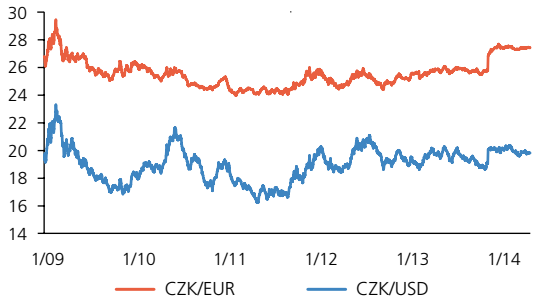


CHART III.5.20

KEY FINANCIAL INDICATORS

The key financial indicators recorded growth in 2013 Q4
(annual percentage changes)

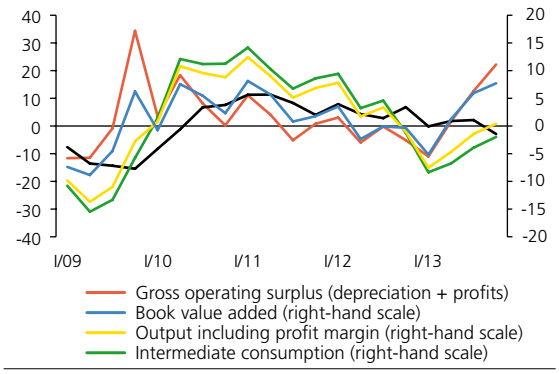


TABLE III.5.3

PERFORMANCE INDICATORS OF CORPORATIONS

The material cost-output ratio and the personnel cost-output ratio both decreased

	2012 Q4	2013 Q4	Annual percentage changes
Output incl. profit margin (CZK billions) a)	1,469.5	1,475.5	0.4
Personnel costs (CZK billions)	221.4	218.2	-1.4
Intermediate consumption (CZK billions)	1,108.2	1,086.3	-2.0
Book value added (CZK billions)	361.3	389.2	7.7
Sales (CZK billions)	1,953.7	1,973.8	1.0
	Percentages	**Percentages**	**Annual changes in pp**
Ratio of personnel costs to value added a)	61.3	56.1	-5.2
Material cost-output ratio a)	75.4	73.6	-1.8
Personnel cost-output ratio a)	15.1	14.8	-0.3
Ratio of book value added to output a)	24.6	26.4	1.8

a) CNB calculation

III.5.4 The exchange rate

The average exchange rate of the **koruna against the euro** was CZK 27.4 in 2014 Q1. This represents a year-on-year depreciation of 7.3% and a quarter-on-quarter depreciation of 2.9% (see Chart III.5.19). The koruna fluctuated in a narrow band between CZK 27.3 and CZK 27.6 to the euro, stabilising at levels close to CZK 27.4 from mid-February. The forecast for the koruna-euro rate for 2014 Q2 assumes an exchange rate of CZK 27.3. Between 1 April and 20 April the average exchange rate of the koruna was slightly weaker than forecasted (by 0.3%).

The exchange rate **commitment of the CNB** to prevent the koruna appreciating significantly beyond CZK 27 to the euro remained the key factor affecting the exchange rate so far this year. The exchange rate movements in the period under review were meanwhile in line with the asymmetric nature of the exchange rate commitment and required no actual foreign exchange market interventions by the CNB. Global financial markets were relatively calm in 2014 Q1. A sizeable depreciation of the Russian rouble was the main exception.

The average **exchange rate of the koruna against the dollar** was CZK 20.0 in 2014 Q1. This represents a year-on-year depreciation of 3.4% and a quarter-on-quarter depreciation of 2.3%. During the quarter, the koruna fluctuated between CZK 19.6 and CZK 20.4 to the dollar, moving in the upper part of the said range in the first half of this period and in the lower part in the second. In the latter part of April, the exchange rate of the koruna against the dollar was roughly CZK 19.8.

III.5.5 Economic results of non-financial corporations

The financial results of **non-financial corporations with 50 employees or more**[50] in 2013 Q4 reflected the ongoing recovery in economic activity. In year-on-year terms, output and sales returned to growth (of 0.4% and 1% respectively) following a decrease in the previous quarter. Annual growth in book value added picked up pace amid a further fall in intermediate consumption (see Chart III.5.20). Gross operating surplus also increased markedly in year-on-year terms, due partly to falling personnel costs in 2013 Q4.

With intermediate consumption falling and output rising, the **material cost-output ratio**[51] fell further year on year in 2013 Q4 (by 1.8 percentage points; see Table III.5.3). The declining material cost-output ratio was due primarily to a sharp decrease in the material

50 The segment of corporations with 50 employees or more consisted of almost 9,300 non-financial corporations at the end of 2013 Q4.
51 The material cost-output ratio defined as the ratio of intermediate consumption to output.

cost-output ratio in the electricity, gas, heat and air-conditioned air supply industry of almost 30%. A significant decline in the material cost-output ratio was also recorded in real estate activities.

The **personnel cost-output ratio**,[52] which had been rising year on year in the previous three quarters of 2013, also decreased in 2013 Q4 (by 0.3 percentage point; see Table III.5.3). This change was due chiefly to a year-on-year drop of 2.8% in the wage component of personnel costs. The decrease in the number of employees was only marginal.

Data for the narrower **segment of large corporations** (with 250 employees or more)[53] indicate similar trends in the main financial indicators in 2013 Q4 as in the larger segment of corporations, although output continued to fall in year-on-year terms.

III.5.6 Financial position of corporations and households

The **financial liabilities of non-financial corporations** rose slightly year on year in 2013 Q4 (see Chart III.5.21). This was due mainly to debt securities issued, shares and other equity excluding quoted shares, and to a lesser extent also to loans. By contrast, quoted shares recorded a negative contribution owing to revaluation. As regards the **assets of non-financial corporations**, the volume of shares and the amount of currency and deposits increased in Q4, as in previous quarters. Other accounts receivable also contributed to the increase in financial assets. The negative net financial position of non-financial corporations fell to -81% of GDP, with liabilities increasing only slightly and financial assets showing stronger growth. The net financial assets of non-financial corporations grew by roughly 4% on average in 2013. The position of non-financial corporations is thus gradually improving.

The main **balance sheet trends** in non-financial corporations are reflected in the financial indicators. The strong annual growth in the acid-test ratio of corporations eased slightly in 2013 Q4. The market-based financing ratio fell slightly. Corporate solvency increased again in 2013 Q4.

Households are net creditors in the national economy. Their net financial position has been rising slightly over the last three years and hovered around 70% of GDP during 2013. As in Q3, the **net financial assets of households** rose by 4.5% year on year in Q4 (see Chart III.5.22). Currency and deposits were the biggest contributor to the growth in financial assets, although their contribution has long been falling gradually. Debt securities, insurance technical reserves and shares and other equity maintained similar growth rates as in the previous quarter. The year-on-year change in debt securities held

CHART III.5.21

FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

The financial liabilities of corporations rose slightly in 2013 Q4
(annual percentage changes; contributions in percentage points)

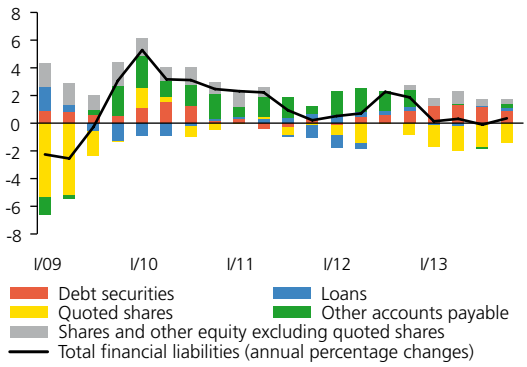
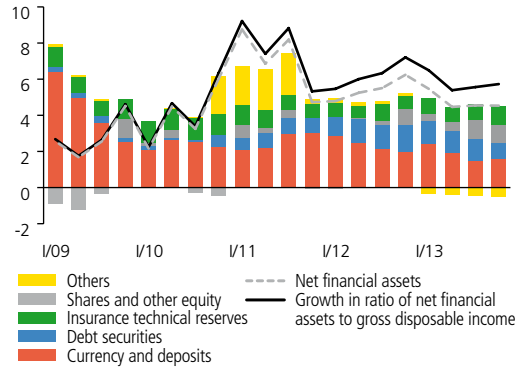


CHART III.5.22

STRUCTURE OF HOUSEHOLD FINANCIAL ASSETS

The net financial assets of households continued to grow at a brisk pace
(contributions in percentage points; annual percentage changes and percentage ratios)



52 The personnel cost-output ratio defined as the ratio of personnel costs to output.
53 The segment of corporations with 250 employees or more consisted of almost 1,700 non-financial corporations at the end of 2013 Q4.

by households was affected by a transaction related to a Christmas issue of saving bonds.[54] Annual growth in the **financial liabilities of households** was 3%. Long-term loans again made the dominant contribution (almost 4 percentage points). In 2013 Q4, year-on-year growth in the net financial assets of households stood at 5.7% of the annual gross disposable income of households.

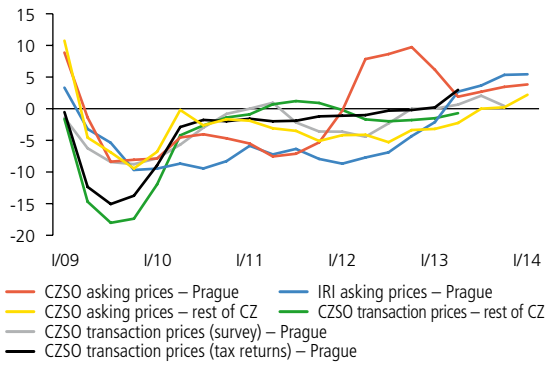
III.5.7 The property market

CHART III.5.23

TRANSACTION AND ASKING PRICES OF APARTMENTS

The recovery in asking prices of apartments recorded in late 2013 continued into 2014 Q1

(annual percentage changes; source: CZSO, Institute for Regional Information)



The growth in **asking prices of older apartments** observed in late 2013 accelerated further in early 2014. This was due to year-on-year developments in asking prices in Prague in 2014 Q1 according to CZSO data (an acceleration of growth from 3.4% in 2013 Q4 to 3.8%; see Chart III.5.23) and newly also a rise in prices in the rest of the Czech Republic (from 0.2% to 2.2%). In contrast to the recovery in CZSO asking prices in 2012, the current asking price recovery is confirmed by alternative data sources such as the Institute for Regional Information, according to which these prices rose by 5.4% in Prague and 1.1% on average outside Prague. Asking price developments outside Prague were very mixed across regions.[55]

As regards **transaction prices of apartments based on the CZSO survey**, the earlier data for 2013 Q3 were revised, with the year-on-year growth in prices of older apartments in Prague rising by 0.8 percentage point to 2% and the year-on-year decline in prices of older apartments outside Prague moderating by 0.4 percentage point to -4.1%. In addition, new data for 2013 Q4 were published, indicating lower increases in transaction prices of apartments compared to asking prices. Year-on-year growth in transaction prices of older apartments in Prague slowed to 0.4%, while prices of new apartments in Prague and older apartments in the rest of the Czech Republic dropped by 0.8% and 3% respectively. In the Czech Republic as a whole, transaction prices fell by 2.1% according to the CZSO survey, a somewhat deeper decline than indicated by the alternative HB index, which fell by 0.2%. Overall, asking and transaction prices based on surveys confirmed the slight recovery on the property market visible in late 2013 following four years of decline. However, this recovery varies considerably across regions. Given the revisions of past data and the not always consistent signals from various data sources, its robustness is still subject to uncertainty.

The uncertainty surrounding the property market recovery is also indicated by a continuing decline in the **number of property market transactions**. The number proceedings on entry of ownership rights

54 The total volume of bonds sold in the Christmas issue was CZK 21.3 billion. Part of the issue was sold to entities other than households, e.g. civic associations, foundations, municipalities and regions.

55 While the price increases in Brno, Hradec Králové and České Budějovice were comparable to Prague (4.5%–5.5%), prices continued to fall in Zlín and Ústí nad Labem (by 4.4% and 6.0% respectively).

to houses and apartments in the cadastre fell by 6.9% in 2013.[56] There are also significant regional differences in the number of transactions: in the Czech Republic outside Prague, the number of proceedings on entry of ownership rights fell by 10.4% in 2013, whereas in Prague it increased by 2.5%. The year-on-year rise in the number of transactions in Prague is in line with a recovery in sales of new apartments in development projects. The number of sales of new apartments rose by 24.9% year on year in 2013 and the growth continued into 2014 Q1 (11.2% year on year).[57]

Property price sustainability indicators mostly increased in 2014 Q1, thanks mainly to the growth in asking prices of apartments (see Chart III.5.24). The **price-to-average wage ratio** increased by 1.1% quarter on quarter and the **price-to-disposable income ratio** by 2.8%. Compared to the lows recorded in previous years, these indices were 2% and 3.8% higher respectively. Although the increase in the two indices means slightly less affordable housing,[58] this is not very significant given the decline in the indices in previous years and the low interest rates on loans for house purchase. According to the IRI, the **price-to-rent ratio** fell by 2% quarter on quarter, but is still 1.6% above the low recorded in early 2013.

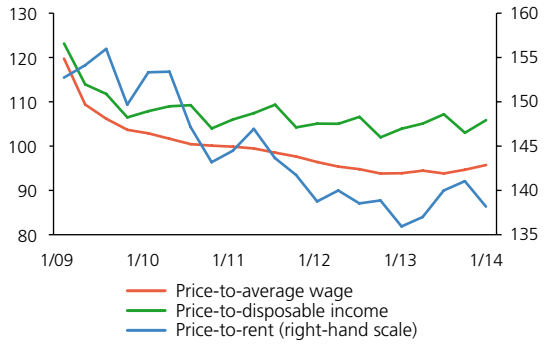
Despite the increase in 2013, all three price sustainability indicators are relatively low compared to their longer-term averages, indicating **undervalued property prices**. However, alternative estimates of property price sustainability based on evaluating the consistency of prices with the growth rates of apartment price determinants suggest that apartment prices are roughly in equilibrium. This is because the recovery in apartment prices observed in 2013 was not in line with these fundamentals, which tended to deteriorate. **Going forward**, property prices will probably continue to recover slowly as domestic economic activity gradually picks up. However, the trends will remain mixed across regions, not only between Prague and the rest of the Czech Republic, but also between individual regions outside Prague.

CHART III.5.24

APARTMENT PRICE SUSTAINABILITY INDICATORS

Except for the price-to-rent ratio, the property price sustainability indicators increased

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



56 The source of the data is COSMC.

57 The source of the data is property development company Ekospol. However, the data are identical to those of other developers (Skanska Reality and Trigema), as these developers have reached an agreement on publishing unified data on the market.

58 It takes an average household longer to earn enough money to buy an apartment.

CHART III.6.1

CURRENT ACCOUNT

The annual moving current account deficit decreased in 2013 Q4, primarily due to an increase in the trade surplus
(annual moving totals in CZK billions)

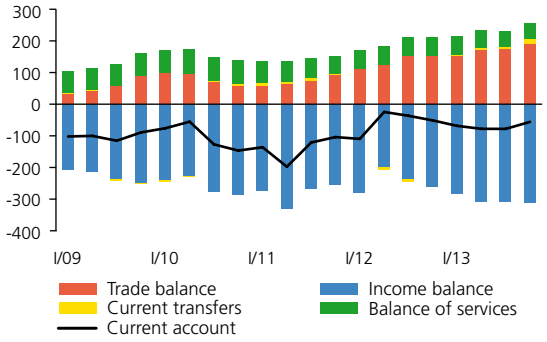


CHART III.6.2

TRADE BALANCE

The year-on-year change in the trade balance was affected most strongly in 2013 by an increase in the machinery surplus
(annual accumulation in CZK billions; change of ownership principle)

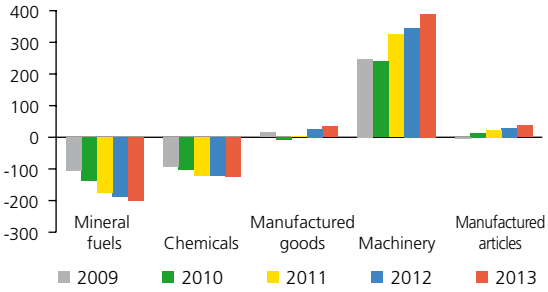
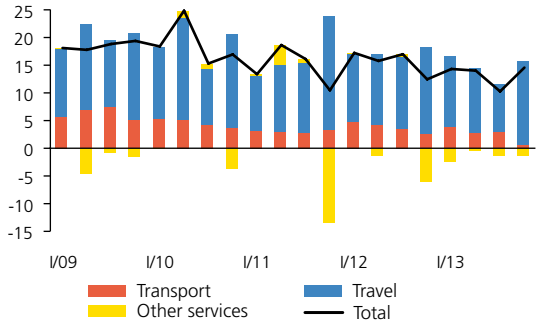


CHART III.6.3

BALANCE OF SERVICES

Travel and transport again contributed to the services surplus in 2013
(CZK billions)



III.6 BALANCE OF PAYMENTS

In 2013, the current account was characterised by a high goods and services surplus, associated with a growing trade surplus. However, its effect on the current account was outweighed by the traditionally high income deficit, linked mainly with direct investment income of non-residents. The biggest surplus on the financial account was recorded by portfolio investment, owing chiefly to purchases of domestic debt securities by foreign investors, followed by other investment, which recorded a significant change at the close of the year due to the foreign exchange interventions to weaken the koruna.

III.6.1 The current account

The **current account** recorded a deficit of CZK 56 billion in 2013. In year-on-year terms, the deficit widened by almost CZK 5 billion. The slight increase in the overall deficit was related mainly to income balance developments. In 2013 Q4 alone, the annual moving current account deficit decreased by more than CZK 22 billion (see Chart III.6.1), falling to 1.4% of GDP.

The **trade surplus** for 2013 rose by more than CZK 39 billion year on year to CZK 188 billion. The rise in the surplus was due to a price effect associated with a positive year-on-year change in the terms of trade, which was offset very slightly by developments in real terms. From Q2 onwards, the recovery in external demand was reflected in renewed real growth in goods exports, whose nominal year-on-year rate for 2013 as a whole exceeded 2%. Goods imports increased by less than 1% in nominal terms in the year as a whole, owing to a decline in H1. Real import growth was fostered by renewed growth in total domestic demand and faster growth in traditionally highly import-intensive exports, especially at the close of the year. At the same time, rising nominal foreign trade turnover was supported by year-on-year deprecation of the koruna against the euro, especially in Q4. Turning to the commodity structure, annual growth in the machinery and transport equipment surplus was the biggest contributor to the rise in the overall surplus (see Chart III.6.2). This was counteracted mainly by a widening of the mineral fuels deficit. The year-on-year growth in the trade surplus continued into 2014 Q1, exceeding CZK 12 billion for January–February.

The **services surplus** reached CZK 53 billion in 2013. In year-on-year terms, it fell by more than CZK 9 billion (see Chart III.6.3). The surplus was due mainly to travel, followed by transport. However, these surpluses declined in year-on-year terms, mainly as a result of higher expenditure by residents on private travel and higher expenditure on air and road transport. Other services recorded a slight deficit, which – by contrast – decreased slightly year on year. Within other services, royalties and licence fees saw the largest deficit.

In contrast to the goods and services surplus, the **income balance** showed a deficit of CZK 312.5 billion, up by almost CZK 53 billion year on year owing to higher debits and a fall in credits. The largest component of the overall balance was again a direct investment income deficit of CZK 305.6 billion (see Chart III.6.4). It was linked mainly with income in the form of dividends paid to non-residents and, to a lesser extent, with estimated reinvested earnings in the Czech Republic. The year-on-year increase in the overall deficit was also due above all to direct investment income. Portfolio investment income also ended in a deficit. By contrast, other investment income and compensation of employees recorded surpluses.

Current transfers recorded a surplus of CZK 15.4 billion in 2013. The current transfers balance rose by almost CZK 18 billion year on year, shifting from deficit to surplus. The largest component was a government transfers surplus exceeding CZK 34 billion. This stemmed mainly from a surplus on transfers of funds between the Czech Republic and the EU, which totalled CZK 36.4 billion on the current account. The year-on-year increase in the overall current transfers balance was also due mainly to higher government transfers from the EU budget. However, roughly one-half of the government transfers surplus was offset by a deficit on transfers of other sectors.

III.6.2 The capital account

The **capital account** recorded a large surplus of CZK 74.8 billion in 2013, up by almost CZK 23 billion year on year. The overall surplus was related above all to income from the EU budget (totalling CZK 44.5 billion) and one-off income connected with the result of international arbitration between energy companies. The year-on-year growth in the overall surplus was linked mainly with this one-off arbitration income, as drawdown of funds from the EU budget recorded on the capital account fell year on year owing to a very high comparison base.

III.6.3 The financial account

The **financial account** recorded a large surplus of CZK 187.9 billion for 2013 (see Chart III.6.5), due to net inflows in all four monitored balances. Roughly one-half of the surplus was due to a net inflow of portfolio investment, followed mainly by other investment and direct investment.

In 2013, **direct investment** recorded a surplus of CZK 33.2 billion (see Chart III.6.6), down by more than CZK 88 billion year on year owing to both a lower inflow into the Czech Republic and a higher outflow abroad. The overall gross inflow reached CZK 97.7 billion, due mainly to estimated reinvested earnings in the Czech Republic (CZK 95.3 billion) and investment in equity capital, linked mainly with an equity capital increase resulting from a one-off operation by

CHART III.6.4

INCOME BALANCE

Within the income balance, the direct investment income deficit increased in particular year on year in 2013
(annual accumulation in CZK billions)

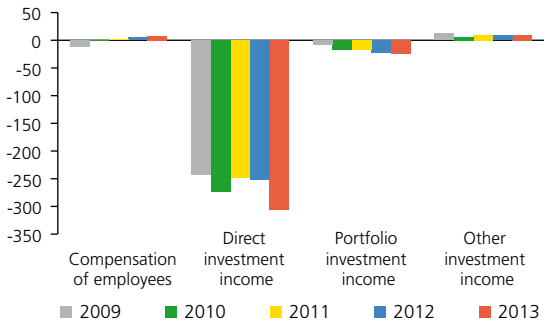


CHART III.6.5

FINANCIAL ACCOUNT

The annual moving financial account surplus significantly increased in 2013 Q4 due mainly to a change in the other investment flow
(annual moving totals in CZK billions)

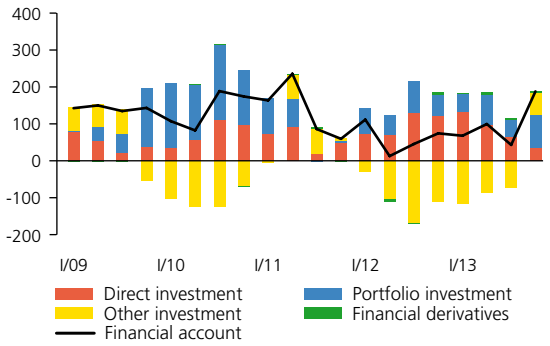


CHART III.6.6

DIRECT INVESTMENT

Reinvested earnings contributed the most to the direct investment surplus in 2013, while other capital recorded a net outflow
(CZK billions)

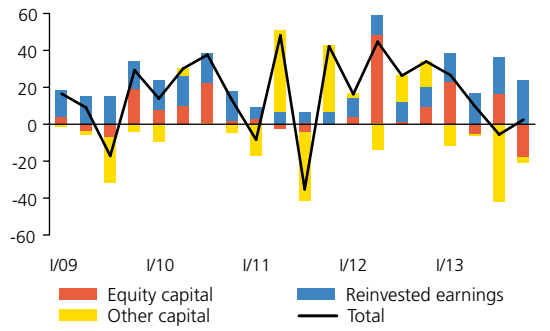


CHART III.6.7

PORTFOLIO INVESTMENT

Portfolio investment recorded a net inflow in 2013, owing mainly to purchases of Czech debt securities by non-residents
(CZK billions)

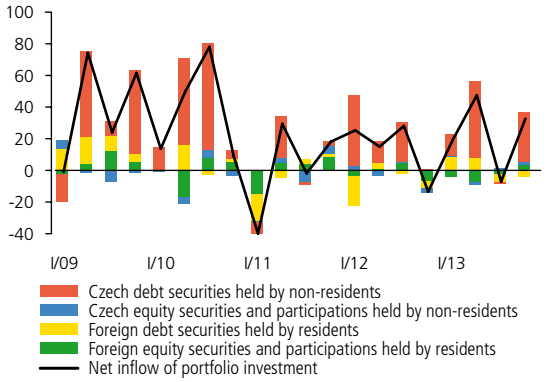
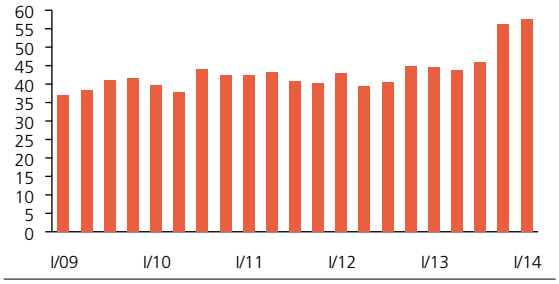


CHART III.6.8

CNB INTERNATIONAL RESERVES

The CNB's international reserves increased in 2014 Q1 compared to the previous quarter
(USD billion; end of quarter)



a foreign energy company. However, these contributions were partly offset in credit relations by repayments by domestic subsidiaries to foreign parent companies. At the same time, the year-on-year change in other capital flows was the biggest contributor to the moderation of the overall net direct investment inflow. Czech direct investment abroad was affected mainly by an equity capital outflow resulting from a significant foreign acquisition by a Czech company and increases in equity shares.

Portfolio investment recorded the largest net inflow on the financial account (CZK 91.9 billion; see Chart III.6.7). The largest operations were purchases of domestic debt securities by foreign investors. They were linked primarily with foreign issues by Czech non-financial corporations in Q2 and purchases of domestic government and bank bonds on the domestic capital market following the weakening of the koruna in Q4. By contrast, holdings of shares by non-residents increased only marginally. Overall, the inflow of portfolio investment on the liabilities side reached almost CZK 95 billion. Purchases also slightly dominated trading in foreign securities. However, they were associated solely with growth in holdings of foreign shares. By contrast, holdings of foreign bonds by residents declined, largely offsetting the share purchases. The year-on-year increase in the net inflow of portfolio investment of more than CZK 37 billion was largely due to a change in flows in residents' trading in foreign debt securities.

Settlement of **financial derivatives** recorded a net inflow of CZK 4.7 billion, down by almost CZK 4 billion year on year.

Other investment also ended in a net inflow, which totalled CZK 58 billion. The overall surplus was due mainly to a net inflow of CZK 87.5 billion in the monetary financial institutions sector. This was linked mainly with a rise in short-term deposits received from foreign banks, which to a large extent are a counterpart of the increase in the international reserves caused by the CNB's foreign exchange interventions in November. Other investment in the government sector also ended in a slight surplus associated with growth in foreign liabilities. The overall surplus was reduced solely by a net outflow of CZK 33.1 billion in the corporate sector, due to provision of loans and growth in deposits abroad as well as repayment of trade credits and financial loans received from abroad. The marked year-on-year change in other investment flows (exceeding CZK 164 billion) was due chiefly to a change in the short-term position of monetary financial institutions.

The **CNB's international reserves** surged in 2013 Q4 owing to the foreign exchange interventions. At the end of 2014 Q1, the reserves totalled CZK 1,143.9 billion, representing a quarter-on-quarter increase of almost CZK 26 billion. This increase was due to a surplus on transactions executed for CNB clients and to income on the international reserves. In dollar terms, the reserves rose by USD 1.3 billion to USD 57.5 billion in the same period (see Chart III.6.8). The CNB's international reserves covered more than 50% of all external debt liabilities of domestic entities at the end of 2013.

BOX 2
The Czech Republic's trade relations with Ukraine and Russia

This box aims to map out goods and services trade between the Czech Republic and Ukraine and Russia in 2013 and to identify the items that would be most affected by political and economic developments in Ukraine and Russia from the Czech Republic's perspective.

Goods trade between the Czech Republic and Ukraine accounted for only 0.9% of the Czech Republic's total goods trade turnover in 2013. In 2005–2013, the trade balance mostly showed slight surpluses. The surplus of CZK 8.7 billion achieved in 2013 was due mainly to a surplus on machinery (especially telephones, including mobile handsets). However, the machinery surplus was largely offset by a deficit on inedible non-energy crude materials, linked mainly with iron ore and concentrates (see Table 1). As in the case of goods, **services trade between the Czech Republic and Ukraine** accounted for a low share of the Czech Republic's total services trade turnover (1.0%, or CZK 8.6 billion in 2013). The services balance with Ukraine recorded modest surpluses in 2005–2013, reaching CZK 6.7 billion in 2013. This was due almost solely to a surplus on travel stemming from revenues from business travel by non-residents.

Compared to Ukraine, **goods trade between the Czech Republic and Russia** accounted for a much higher proportion of the Czech Republic's total goods trade turnover (4.5% in 2013). Russia was the Czech Republic's seventh largest trading partner country as regards exports and the fifth largest importer into the Czech Republic. The trade balance showed marked deficits in 2005–2013, although these were trending downwards thanks to rapidly rising exports. In 2013 the trade deficit was CZK 39.2 billion, owing chiefly to a deficit on mineral fuels relating to oil and natural gas. However, the mineral fuels deficit was largely offset by a machinery surplus, mainly in the subcategory of cars (see Table 2). **Services trade between the Czech Republic and Russia** totalled CZK 21.9 billion last year, accounting for 2.7% of the Czech Republic's total services trade turnover. In 2005–2013 the services balance with Russia recorded small surpluses alternating with small deficits. The overall balance was associated mainly with a stable surplus on travel (mainly due to income to the Czech Republic from private travel by non-residents) and with developments on the other services balance, driven chiefly by merchanting. In 2013 the balance of services ended in a deficit of CZK 4.2 billion.

TABLE 1 (BOX)

FOREIGN TRADE BETWEEN THE CZECH REPUBLIC AND UKRAINE IN 2013

The machinery surplus was largely offset by a deficit on inedible non-energy crude materials
(SITC commodity structure; CZK billions; cross-border statistics)

SITC		Exports	Imports	Balance
0	Food and live animals	0.7	0.3	0.4
1	Beverages and tobacco	0.1	0.0	0.1
2	Crude materials, inedible, except fuels	0.3	13.5	-13.2
3	Mineral fuels, lubricants and related materials	0.1	3.2	-3.0
4	Animal and vegetable oils, fats and waxes	0.0	0.2	-0.2
5	Chemicals and related products, n.e.s.	3.7	0.6	3.1
6	Manufactured goods classified chiefly by material	3.5	2.2	1.2
7	Machinery and transport equipment	21.4	2.9	18.5
8	Miscellaneous manufactured articles	2.3	0.6	1.7
9	Commodities and transactions n.e.c. in the SITC	0.0	0.0	0.0
	Total	32.1	23.4	8.7

TABLE 2 (BOX)

FOREIGN TRADE BETWEEN THE CZECH REPUBLIC AND RUSSIA IN 2013

The mineral fuels deficit was largely offset by a machinery surplus
(SITC commodity structure; CZK billions; cross-border statistics)

SITC		Exports	Imports	Balance
0	Food and live animals	1.6	0.3	1.3
1	Beverages and tobacco	0.6	0.1	0.5
2	Crude materials, inedible, except fuels	0.5	5.1	-4.6
3	Mineral fuels, lubricants and related materials	0.3	129.1	-128.8
4	Animal and vegetable oils, fats and waxes	0.0	0.0	0.0
5	Chemicals and related products, n.e.s.	8.9	5.5	3.5
6	Manufactured goods classified chiefly by material	11.8	9.8	2.0
7	Machinery and transport equipment	82.5	5.1	77.4
8	Miscellaneous manufactured articles	10.0	0.5	9.5
9	Commodities and transactions n.e.c. in the SITC	0.0	0.0	0.0
	Total	116.2	155.4	-39.2

Any further escalation of the geopolitical tensions between Ukraine and Russia leading to a reduction in trade between the Czech Republic and Ukraine, a tightening of the visa regime and the introduction of a trade embargo on Russia would therefore be directly connected with a fall in Czech machinery exports and travel revenues. On the import side, it would simultaneously necessitate a re-direction of supplies and an increase in imports of oil, gas and iron ore and semi-finished products from alternative territories. The impacts of a contraction in trade between the Czech Republic and Russia would be much larger than those of a downturn in trade between the Czech Republic and Ukraine.

III.7 THE EXTERNAL ENVIRONMENT

The euro area recovery is gradually gaining momentum. In 2013 Q4 the euro area economy recorded quarter-on-quarter growth for the third consecutive quarter and even returned to year-on-year growth following seven quarters of decline. The growth will probably pick up pace this year and the next. This should be reflected in a moderate rise in the currently very low inflation. However, the ECB expects euro area inflation to remain significantly below its definition of price stability over the next three years and does not even rule out a further easing of the monetary conditions should inflation expectations decrease. Inflation pressures are not expected in the USA either, even though the US economy is growing at a much stronger pace than the euro area. This is allowing the Fed to carry on with its easy monetary policy, although it is gradually tapering its bond purchases. This, together with the ECB's wait-and-see approach, is delaying the expected appreciation of the US dollar against the euro. Low inflation is also being aided by prices of energy commodities and industrial raw materials, although growth observed in the prices of some food commodities may pose an upside risk.

III.7.1 The euro area

Quarterly **GDP growth in the euro area** accelerated from 0.1% to 0.3% in 2013 Q4, which means the economy grew for the third consecutive quarter. Annual growth was 0.5% in the same period (see Chart III.7.1), but for 2013 as a whole euro area GDP fell by the same amount. The quarterly growth was driven by external demand (the contribution of net exports was 0.4 percentage point). The contribution of domestic demand to quarterly GDP growth was negative, with only gross fixed capital formation and household consumption rising moderately. The economic recovery is visible across euro area countries. Growth accelerated not only in the core countries (Germany and France in particular), but also in Spain and Portugal. The economic contraction in Greece and Cyprus moderated, and the Italian economy switched from stagnation to growth.

The available **data for 2014 Q1** are signalling continued moderate economic growth in the euro area. In February, industrial production increased after stagnating in January and construction output rose for the third consecutive month. Retail sales rebounded in January and February following a decrease in December. However, stronger growth in consumption is being prevented by a persisting high unemployment rate, which has been flat at 11.9% since October 2013. Most leading indicators, including consumer confidence, are looking positive despite a minor decrease in some indicators in March. A recovery in 2014 as a whole is also expected by the outlooks of CF and international institutions, according to which GDP growth should be just above 1% (see Chart III.7.2). In 2015, GDP growth should pick up to around 1.5%.

CHART III.7.1

GDP IN THE EURO AREA

A halt in the domestic demand decline and an increase in net export growth led to annual GDP growth in the euro area in 2013 Q4

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

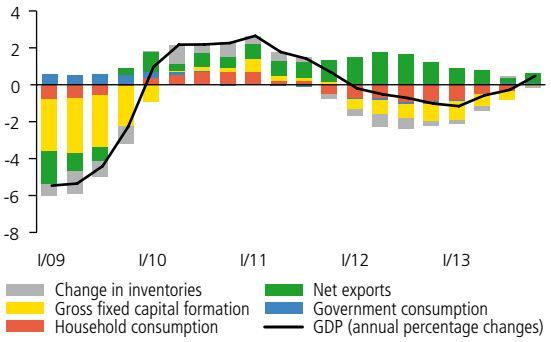
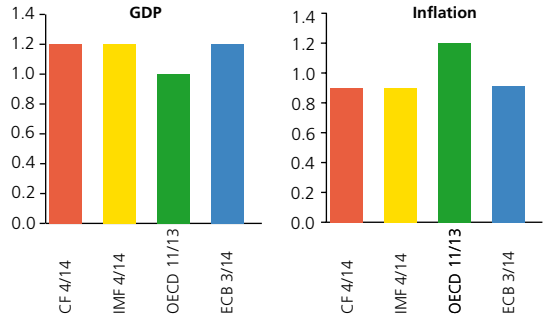


CHART III.7.2

EURO AREA GDP AND INFLATION OUTLOOKS FOR 2014

Euro area GDP growth should be just above 1% in 2014, while inflation should be low

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

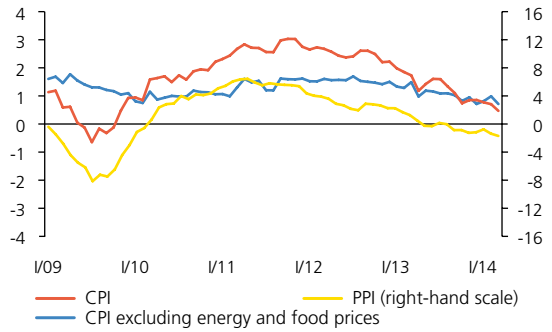


Note: Horizontal axis shows most recent forecast data in format "Source month/year of publication". Midpoint of range for ECB.

CHART III.7.3

INFLATION AND PRODUCER PRICES IN THE EURO AREA

Inflation went down in 2014 Q1, while producer prices fell
(annual percentage changes; source: Datastream)



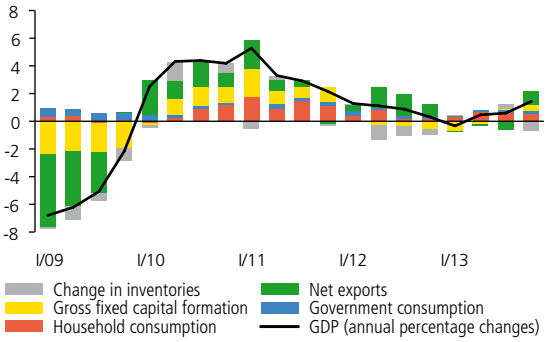
HICP **inflation** in the euro area fell in March for the third consecutive month (to 0.5%). The lower figure in March was partly due to base effects, as Easter had fallen in that month last year. Within the consumer basket, prices of fuels and telecommunication services declined in particular. Core inflation recorded a smaller decrease in March than in February, falling to 0.7%. Inflation pressures are subdued across the euro area, but are lowest in the periphery countries, some of which are experiencing deflation. As in previous months, producer prices fell in February (see Chart III.7.3), even in most of the core euro area countries. The April CF expects consumer price inflation to average just under 1% this year and increase to 1.3% next year.

At the forecast horizon, which was extended to three years in March, the **ECB** expects a slight recovery and inflation well below its definition of price stability (1% this year, accelerating to 1.3% and 1.5% respectively in the next two years). Nevertheless, it left its key rate unchanged at 0.25% in April and took no other measures either. However, it did announce that for the first time it had reached agreement on the possible use of unconventional measures to ease the monetary conditions in the euro area should inflation expectations decrease. The ECB's admission that it might purchase unspecified assets contributed to a decline in bond yields in euro area periphery countries. In Italy, for example, these yields fell to historical lows. For the first time since the debt restructuring in 2012, the Greek government successfully auctioned five-year bonds.

CHART III.7.4

GDP IN GERMANY

GDP growth accelerated in 2013 Q4 thanks to renewed growth in net exports and fixed investment
(annual percentage changes; contributions in percentage points; seasonally adjusted; source: Datastream)



In 2013 Q4, both the quarterly and annual **growth of the German economy** (0.4% and 1.4% respectively) strengthened compared to the previous quarter (see Chart III.7.4). Net exports and, for the first time in a long time, fixed investment returned to growth, and household consumption continued to rise. In 2014 Q1 and 2014 as a whole, the April CF expects economic growth to accelerate to 0.5% and 1.9% respectively. This is also suggested by higher month-on-month and year-on-year growth rates of industrial production and retail sales in January and February than in the previous quarter.

In 2013 as a whole, the German economy grew by 0.4%, the lowest growth rate since 2003 with the exception of the crisis year 2009. The April CF (in line with the German government and the European Commission) expects GDP growth of 1.9% this year and a further slight acceleration to 2% next year. Faster growth in domestic demand – especially household consumption and investment – should be the main source of higher economic activity. The effect of external demand will probably be neutral. Stronger economic growth is also suggested by leading indicators. The consumer confidence indicators recorded the largest increases, but business confidence indicators improved as well.

The **budget** of the German government was balanced last year. The government has undertaken to strive for the same result in 2015–2018. It foresees a deficit of EUR 6.5 billion (-0.2% of GDP) for this year. If future German governments stick to this fiscal policy stance, the debt-to-GDP ratio should be reduced from almost 80% in 2013 to less than 60% within ten years.

Annual inflation in Germany fell by a further 0.2 percentage point to 1% in March because of a decrease in energy, transport and telecommunication prices (see Chart III.7.5). Conversely, faster growth in prices of food and beverages fostered higher inflation. According to the April CF, inflation should remain at roughly the 2013 level (1.4%) in 2014 as a whole and rise to 1.8% next year.

In **Slovakia**, both quarterly and annual economic growth accelerated in 2013 Q4 by comparison with Q3, reaching 0.4% and 1.3% respectively. The stronger GDP growth was aided by higher growth in domestic demand, while net exports had a dampening effect. Employment rose by 0.1% year on year following five quarters of decline. In 2013 as a whole, GDP grew by 0.9%. The April CF expects GDP growth to surge to 2.3% this year and accelerate further to 3% next year. According to CF, the strengthening economic activity will be driven by growth in domestic demand, especially investment and household consumption. The unemployment rate declined by 0.2 percentage point month on month (and by 0.5 percentage point year on year) to 13.7% in March.

Consumer prices in Slovakia fell by 0.1% year on year in both February and March, owing chiefly to lower energy prices. For the same reason, the year-on-year decline in industrial producer prices deepened further in February, to -3.5%. According to the NBS and the April CF, however, there is no risk of long-running deflation, although CF lowered its expected inflation figure for 2014 as a whole to 0.7% (compared to the January prediction of 1.4%) and that for next year from 2% to 1.8%.

III.7.2 The United States

Annual **economic growth in the USA** rose further, from 2.0% in 2013 Q3 to 2.6% in 2013 Q4 (see Chart III.7.6). By contrast, quarterly GDP growth slowed somewhat to 0.7%. Household consumption, which rose by 2.3% year on year, was the biggest contributor to the faster annual growth. The contributions of the other demand components (except government consumption) to GDP growth were also positive. That includes net exports, as exports grew faster than imports. There was a related further decrease in the US external imbalance, with the annual cumulative current account deficit falling to 2.3% of GDP in 2013 Q4.

Following a weaker year-on-year increase in January, **industrial production** picked up pace in the next two months, recording growth of 3.4% for Q1 as a whole. Further growth in the PMI leading indicator for industry in March confirms the strength of the US economic recovery. In addition, the consumer confidence indicator (Conference Board) went up in March, as did the consumer sentiment indicator (University of Michigan) in April. This was reflected in a marked rise in retail sales at current prices in March. The economic recovery will thus probably continue to be based mainly on rising consumer demand in 2014.

CHART III.7.5

INFLATION AND PRODUCER PRICES IN GERMANY

Inflation went down in 2014 Q1, mainly due to prices of energy, while industrial producer prices declined further
(annual percentage changes; source: Datastream)

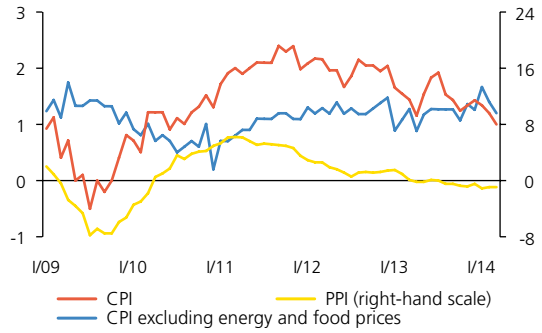


CHART III.7.6

GDP IN THE USA

GDP growth rose further in 2013 Q4
(annual percentage changes; contributions in percentage points; seasonally adjusted; source: Datastream)

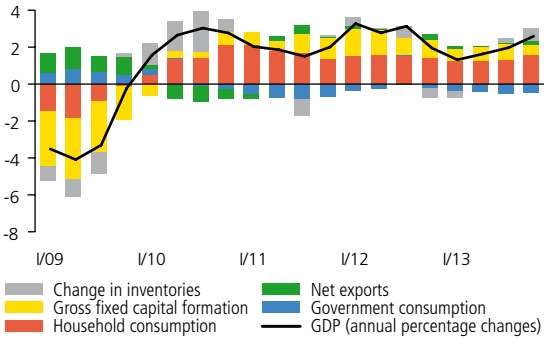
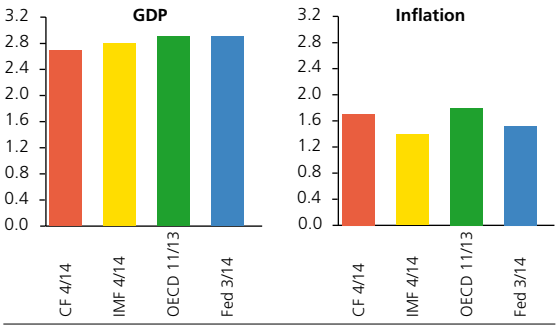


CHART III.7.7

US GDP AND INFLATION OUTLOOKS FOR 2014

GDP growth will probably be relatively buoyant in 2014, while inflation pressures will be subdued
(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.

According to the April CF, **GDP growth in 2014** should reach 2.7% (see Chart III.7.7). This represents a slight downward revision compared to the previous month, but according to the IMF the USA should still be the main driver of global economic growth, given the slowing Chinese economy and expectations of lower growth in the euro area.

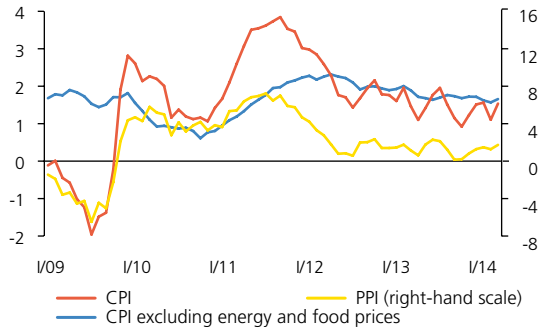
The economic recovery will be accompanied by only **subdued inflation pressures**, as according to the monitored institutions, including the Fed, consumer price inflation should be below 2% over the next two years (see Chart III.7.7). Annual consumer price inflation was 1.4% in 2014 Q1 and producer price inflation was only 0.1 percentage point higher (see Chart III.7.8).

As expected, the **Fed** decided at its March meeting to further reduce its monthly purchases of MBSs and long-term government bonds to USD 55 billion, effective from April. According to the Fed, however, even the observed economic recovery may not result in a rise in inflation pressures. This increases the likelihood of monetary policy remaining easy for an extended period (near-zero interest rates further into 2015). Although the unemployment rate stayed at 6.7% in March, the high proportion of part-time employment and long-term unemployment is worrying according to the Fed.

Chart III.7.8

INFLATION AND PRODUCER PRICES IN THE USA

Inflation has been at relatively low levels since 2012 Q2
(annual percentage changes; source: Datastream)



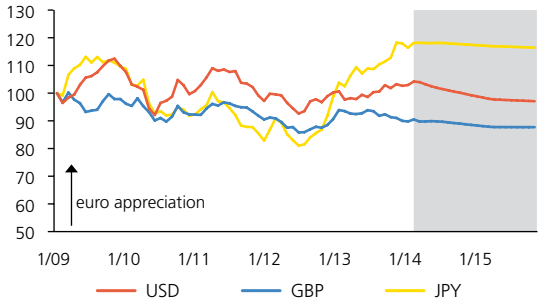
III.7.3 The exchange rate of the euro against the dollar and other major currencies

The **exchange rate of the euro against major world currencies** saw no significant movements in 2014 Q1 (see Chart III.7.9). The euro appreciated slightly further vis-à-vis the US dollar, reaching its strongest level in two and a half years (USD 1.39/EUR) in mid-March. Demand for the single European currency was supported by new data on the euro area economic recovery and by favourable developments in the periphery countries' bond markets. Euro area inflation recorded a further minor slowdown in 2014 Q1, feeding speculation about an easing of the ECB's monetary policy. However, the ECB took no measures for the time being; besides its commitment to leave key rates at current or lower levels for an extended period of time, it merely repeated it was willing to react using asset purchases or other measures if the outlook for inflation or inflation expectations changes. On the other hand, the stronger growth of the US economy is enabling the Fed to continue reducing its monetary stimulus, albeit only gradually so far.

Chart III.7.9

EURO EXCHANGE RATE AGAINST MAJOR CURRENCIES

The euro appreciated slightly further against the dollar in 2014 Q1
(January 2009 = 100; source: Datastream, outlook from CF)



The sizeable **strengthening of the euro against the Japanese yen** observed since mid-2012 came to a halt in 2014 Q1. The positive effect of reforms on economic growth and inflation in Japan, coupled with stable monetary policy, is fostering demand for the Japanese currency. Owing to a further improvement in the UK's economic outlook, the British pound appreciated against other major world currencies in 2014 Q1. However, a question mark hangs over the future course of monetary policy, which could remain easy for an extended time given slowing inflation.

In the first half of April 2014, the **exchange rate of the euro against other major world currencies** was stable. The ECB left its monetary policy stance unchanged, but continued appreciation of the single European currency was mentioned in subsequent comments as a risk to inflation and could therefore increase the likelihood of unconventional measures.

The **April CF** expects the euro to depreciate against all other major world currencies at the one-year horizon. The euro should depreciate the most against the US dollar – by more than 6% to USD 1.29. According to CF, the US dollar should appreciate due to the tapering of the quantitative easing programme in the USA.

III.7.4 Prices of oil and other commodities

During January 2014, the **price of Brent crude oil** moved in a narrow range around a monthly average of about USD 107 a barrel (see Chart III.7.10). In early February it rose to USD 110 a barrel, staying at elevated levels for the entire month before gradually falling back in March. In the first half of April, however, Brent prices returned to levels close to USD 110 a barrel.

The higher oil prices in February were supported mainly by unusually cold weather in the USA, which led to a rise in the price and a fall in stocks of fuel oil. The price decline in March mainly reflected concerns about a slowdown in economic activity in China and lower seasonal demand from refineries. In the second half of March, the situation in Ukraine caused oil prices to fluctuate. News of an agreement between the rebels and the government in Libya, which led to the unblocking of two small export terminals, acted towards a price decrease. At the beginning of April, however, it turned out that growth in Libyan exports would be only gradual, so **concerns about an escalation of the political situation in Ukraine** prevailed. Oil prices were also supported by favourable data from the US economy, especially the labour market.

From a longer-term perspective, the average price of Brent crude oil has been in a relatively narrow range of USD 107–112 a barrel for ten months now. Looking at supply and demand, the market is sufficiently well stocked, as oil extraction growth (especially in North America) exceeds global consumption growth even in the medium-term forecast. This is leading to expectations of gradual growth in free extraction capacity and minor concerns about unplanned extraction shortfalls in risky countries. This may also explain why stocks of oil and oil products in OECD countries have been falling for almost half year now without significantly affecting oil prices. In addition, the amount of oil on the market is currently being increased by supplies from Iran, which may temporarily export to some Asian countries and Turkey under an agreement with Western countries.

CHART III.7.10

OIL AND NATURAL GAS PRICES IN USD

The average monthly price of Brent crude oil has stayed in the narrow range of USD 107–112 a barrel for ten consecutive months now. Its outlook is still slightly falling

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

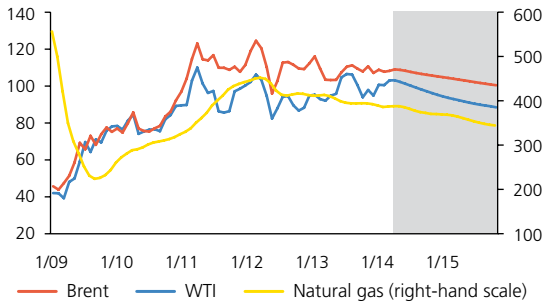
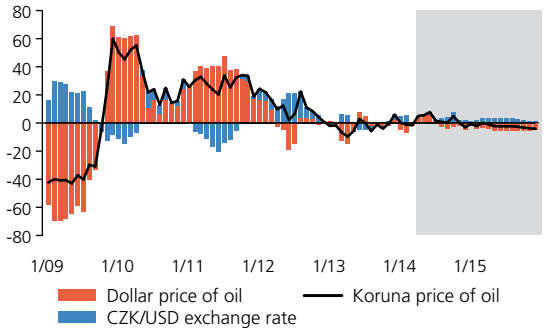


CHART III.7.11

DECOMPOSITION OF KORUNA OIL PRICE GROWTH

The average koruna price should go up slightly in 2014, mainly due to a weaker koruna exchange rate despite a mostly falling dollar price of oil

(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)



The **WTI crude oil price** showed significantly different developments than Brent, especially in January and February, when it rose by more than USD 10 a barrel. The main reason was the opening of the southern branch of the Keystone XL pipeline from the US inland to the Gulf Coast. As a result, oil inventories at the Cushing inland terminal (which is the settlement point for WTI oil contracts) have been falling constantly since then. The Brent-WTI spread has thus narrowed considerably since the start of the year (from almost USD 15 a barrel in mid-January to around USD 5 a barrel in mid-April). However, the US government agency EIA expects the spread to widen again (to roughly USD 10 a barrel). This is based on the assumption that refineries on the Gulf Coast will be unable to process the ever-increasing volume of light WTI oil, as they are better adapted to processing imported heavy and sour oil. Given the persisting ban on exports of crude oil from the USA (which does not affect re-exports), stocks of WTI oil on the Gulf Coast will rise and the WTI price can be expected to drop.

The market **outlook for Brent crude oil prices** remains falling as a result of sufficient supply expected in the market. Favourable expectations, coupled with lower concerns about inflation (owing to the tapering of the monetary stimulus in the USA), have also led to financial investors leaving commodity markets (and moving to stock markets). The EIA expects the average Brent oil price to be USD 105 and USD 101 a barrel this year and the next respectively. These figures are roughly USD 1.5 a barrel lower than the market curve derived from futures contracts. The April CF expects a less marked decrease to USD 106 a barrel at the one-year horizon.

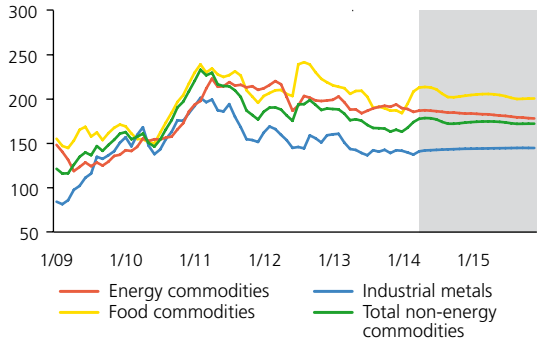
Developments in **prices of non-energy commodities** differ across commodities. The industrial metals price index continues to be affected by fading demand growth in large emerging economies, and its values have therefore been fluctuating around a horizontal trend for almost a year now. The forecast is also flat (see Chart III.7.12). The situation is different for food commodity prices. Their index rebounded in February, following almost a year and a half of decline from the record-high levels reached in August 2012, and continued rising in March and April. This increase was driven mainly by prices of wheat, corn and soy, initially on concerns about the impacts of the icy weather in the USA, and later due also to the political situation in Ukraine and bad weather in Brazil.

CHART III.7.12

COMMODITY PRICES

The industrial metals price index has been flat for a year now, whereas the food commodity price index has been rising sharply since February

(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).

ABBREVIATIONS

APRC	annual percentage rate of charge
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
EDP	Excessive Deficit Procedure
EIA	Energy Information Administration
EIB	European Investment Bank
ESA 95	European System of National Accounts
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
Fed	US central bank
FMIE	Financial Market Inflation Expectations
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
GVA	gross value added
HP filter	Hodrick-Prescott filter
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
M1, M2, M3	monetary aggregates
MBS	mortgage-backed securities
MLSA	Ministry of Labour and Social Affairs
OECD	Organisation for Economic Co-operation and Development
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
SITC	Standard International Trade Classification
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
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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
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The Bank Lending Survey	(Box)	III/2012
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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
Consumption, savings and debt burden of household income groups in 2012	(Box)	III/2013
The announced reduction of quantitative easing in the USA and its effect on yield curves	(Box)	III/2013
Using the exchange rate as an instrument to ease the monetary conditions	(Box)	IV/2013
New steady-state settings in the g3 model	(Box)	IV/2013
Comparison of corporate investment and employment from the perspective of ownership and reinvestment	(Box)	IV/2013
The impact of the growth in unconventional gas extraction on global prices of energy commodities	(Box)	IV/2013
Effects of the weakened exchange rate on consumer prices (input-output analysis)	(Box)	I/2014
Evolution and structure of shorter working hours	(Box)	II/2014
The Czech Republic's trade relations with Ukraine and Russia	(Box)	II/2014

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-average wage ratio: The ratio of the price of an apartment to the sum of the annual average wage over the last four quarters. Higher values of this indicator usually mean that apartments are overpriced. The index is calculated from property transaction prices; the latest data are estimated from asking prices.

Price-to-disposable income ratio: The ratio of the price of an apartment to the sum of disposable income over the last four quarters. Higher values of this indicator usually mean that apartments are overpriced. The index is calculated from property transaction prices; the latest data are estimated from asking prices.

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. This indicator is calculated from asking rents and asking prices of apartments according to the Institute for Regional Information.

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 transaction prices: Prices based, on the one hand, 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. The second, alternative source of data on transaction prices is CZSO data from a survey in estate agencies, for which the time lag is considerably shorter.

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).

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

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

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

KEY MACROECONOMIC INDICATORS

		years										
		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
DEMAND AND SUPPLY												
Gross domestic product												
GDP	CZK bn, constant p. of 2005, seas. adjusted	3,113.5	3,338.4	3,529.4	3,632.1	3,473.9	3,554.0	3,619.0	3,585.0	3,551.1	**3,642.3**	**3,761.8**
GDP	%, y-o-y, real terms, seas. adjusted	6.8	7.2	5.7	2.9	-4.4	2.3	1.8	-0.9	-0.9	**2.6**	**3.3**
Household consumption	%, y-o-y, real terms, seas. adjusted	3.0	4.4	4.1	2.9	0.3	0.9	0.5	-2.1	0.1	**0.7**	**1.8**
Government consumption	%, y-o-y, real terms, seas. adjusted	1.6	-0.6	0.4	1.2	4.0	0.2	-2.7	-1.9	1.6	**0.9**	**1.3**
Gross capital formation	%, y-o-y, real terms, seas. adjusted	4.5	10.6	15.5	1.5	-20.0	5.1	0.9	-4.8	-4.5	**3.8**	**3.6**
Exports of goods and services	%, y-o-y, real terms, seas. adjusted	11.9	14.3	11.2	3.5	-10.5	15.0	9.6	4.7	0.2	**8.7**	**7.1**
Imports of goods and services	%, y-o-y, real terms, seas. adjusted	6.1	11.2	12.8	2.3	-11.7	14.9	7.0	2.5	0.6	**7.9**	**6.0**
Net exports	CZK bn, constant p. of 2005, seas. adjusted	84.8	156.3	139.3	174.7	185.3	213.3	297.2	370.1	359.3	**410.4**	**471.3**
Coincidence indicators												
Industrial production	%, y-o-y, real terms	3.9	8.3	10.6	-1.8	-13.6	8.6	5.9	-0.8	0.5	-	-
Construction output	%, y-o-y, real terms	5.2	6.0	7.1	0.0	-0.9	-7.4	-3.6	-7.6	-6.7	-	-
Receipts in retail sales	%, y-o-y, real terms	8.1	10.8	10.0	2.7	-4.7	1.5	1.7	-1.1	1.0	-	-
PRICES												
Main price indicators												
Inflation rate	%, end-of-period	1.9	2.5	2.8	6.4	1.1	1.5	1.9	3.3	1.4	-	-
Consumer Price Index	%, y-o-y, average	1.9	2.5	2.8	6.4	1.1	1.5	1.9	3.3	1.4	**0.8**	**2.2**
Regulated prices (18.70%)*	%, y-o-y, average	5.7	9.3	4.8	15.6	8.4	2.6	4.7	8.6	2.2	**-3.1**	**0.7**
Net inflation (81.30%)*	%, y-o-y, average	0.7	0.4	1.7	2.4	-0.9	0.0	1.3	1.0	0.5	**1.4**	**2.2**
Food prices (including alcoholic beverages and tobacco) (24.58%)*	%, y-o-y, average	0.0	-0.2	3.8	3.0	-0.9	0.9	3.9	2.9	3.1	**3.6**	**3.4**
Adjusted inflation excluding fuels (53.32%)*	%, y-o-y, average	0.7	0.6	0.7	2.0	0.0	-1.2	-0.7	-0.3	-0.5	**0.5**	**1.8**
Fuel prices (3.39%)*	%, y-o-y, average	7.8	3.7	-0.3	4.3	-11.1	11.8	9.9	6.0	-2.1	**-0.9**	**-2.0**
Monetary-policy inflation (excluding tax changes)	%, y-o-y, average	1.8	2.3	2.2	4.4	0.9	0.4	1.9	2.1	0.6	**0.6**	**1.9**
GDP deflator	%, y-o-y, seas. adjusted	-0.3	0.5	3.3	1.9	2.3	-1.6	-0.9	1.6	1.9	**1.1**	**1.2**
Partial price indicators												
Producer prices	%, y-o-y, average	3.1	1.5	4.1	4.5	-3.1	1.2	5.6	2.1	0.8	**-0.5**	**0.0**
Agricultural prices	%, y-o-y, average	-10.0	1.3	16.4	10.8	-24.3	7.7	22.7	3.6	5.2	**5.8**	**5.8**
Construction work prices	%, y-o-y, average	3.0	2.9	3.9	4.5	1.2	-0.2	-0.5	-0.7	-1.1	-	-
Brent crude oil	%, y-o-y, average	45.0	20.0	9.9	35.4	-36.5	28.4	38.2	0.7	-2.6	**-1.1**	**-4.4**
LABOUR MARKET												
Average monthly wage	%, y-o-y, nominal terms	5.0	6.6	7.2	7.8	3.3	2.2	2.5	2.7	0.1	**2.3**	**4.3**
Average monthly wage	%, y-o-y, real terms	3.0	4.0	4.3	1.4	2.3	0.7	0.6	-0.6	-1.4	**1.5**	**2.1**
Number of employees	%, y-o-y	2.1	1.1	1.8	1.6	-2.2	-2.2	0.0	-0.1	1.6	**0.6**	**0.8**
Unit labour costs	%, y-o-y	0.6	0.2	2.4	4.3	2.6	-1.7	0.4	2.9	0.0	**-0.1**	**2.2**
Unit labour costs in industry	%, y-o-y	-7.2	-7.2	2.4	-3.3	5.4	-5.7	0.4	4.4	0.0	-	-
Aggregate labour productivity	%, y-o-y	4.6	5.6	3.5	0.8	-2.8	3.5	1.9	-1.4	-1.8	**2.1**	**2.9**
ILO general unemployment rate	%, average, age 15–64	8.0	7.2	5.4	4.5	6.7	7.3	6.8	7.0	7.0	**6.7**	**6.6**
Share of unemployed	%, average	6.6	6.1	4.9	4.1	6.2	7.0	6.7	6.8	7.7	**7.7**	**7.2**
PUBLIC FINANCE												
Public finance deficit (ESA95)	CZK bn, current p.	-101.1	-79.2	-26.7	-85.0	-217.4	-177.1	-121.9	-161.1	-56.4	**-57.4**	**-85.1**
Public finance deficit / GDP**	%, nominal terms	-3.2	-2.4	-0.7	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	**-1.4**	**-2.0**
Public debt (ESA95)	CZK bn, current p.	885.4	948.1	1,023.4	1,104.3	1,299.3	1,454.4	1,583.3	1,775.1	1,788.2	**1,844.3**	**1,928.2**
Public debt / GDP**	%, nominal terms	28.4	28.3	27.9	28.7	34.6	38.4	41.4	46.2	46.0	**45.8**	**45.8**
EXTERNAL RELATIONS												
Current account												
Trade balance	CZK bn, current p.	48.6	59.3	46.9	25.7	87.3	53.8	90.3	148.6	188.0	**250.0**	**270.0**
Trade balance / GDP	%, nominal terms	1.6	1.8	1.3	0.7	2.3	1.4	2.4	3.9	4.8	**6.2**	**6.4**
Balance of services	CZK bn, current p.	37.9	49.0	59.2	73.9	73.9	75.3	58.4	62.3	53.0	**60.0**	**65.0**
Current account	CZK bn, current p.	-30.9	-67.1	-156.9	-81.3	-89.3	-146.6	-104.0	-51.3	-56.0	**15.0**	**20.0**
Current account / GDP	%, nominal terms	-1.0	-2.0	-4.3	-2.1	-2.4	-3.9	-2.7	-1.3	-1.4	**0.4**	**0.5**
Foreign direct investment												
Direct investment	CZK bn, current p.	279.6	90.3	179.1	36.3	37.7	95.0	46.8	121.3	33.2	**40.0**	**75.0**
Exchange rates												
CZK/USD	average	24.0	22.6	20.3	17.1	19.1	19.1	17.7	19.6	19.6	**-**	**-**
CZK/EUR	average	29.8	28.3	27.8	25.0	26.5	25.3	24.6	25.1	26.0	**-**	**-**
CZK/EUR	%, y-o-y, real (CPI euro area), avg.	-6.4	-5.1	-2.2	-12.6	5.3	-4.6	-2.1	1.5	3.5	**-**	**-**
CZK/EUR	%, y-o-y, real (PPI euro area), avg.	-5.7	-1.4	-3.8	-8.8	4.3	-3.3	-2.7	2.5	2.5	**-**	**-**
Foreign trade prices												
Prices of exports of goods	%, y-o-y, average	-1.5	-1.2	1.3	-4.6	0.2	-1.0	1.7	2.9	1.2	**3.7**	**-0.3**
Prices of imports of goods	%, y-o-y, average	-0.5	0.2	-1.0	-3.3	-3.5	2.0	4.3	4.2	-0.2	**2.5**	**-0.4**
MONEY AND INTEREST RATES												
M2	%, y-o-y, average	5.9	9.5	11.6	9.5	5.5	4.3	3.5	5.6	4.4	**4.3**	**4.6**
2W repo rate	%, end-of-period, CNB forec. = avg.	2.00	2.50	3.50	2.25	1.00	0.75	0.75	0.05	0.05	**0.05**	**0.58**
3M PRIBOR	%, average	2.0	2.3	3.1	4.0	2.2	1.3	1.2	1.0	0.5	**0.4**	**0.9**

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

2011				2012				2013				2014				2015			
QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
903.5	905.5	905.8	904.3	901.0	897.6	894.7	891.7	880.2	882.9	885.9	902.1	**903.7**	**902.4**	**920.4**	**915.8**	**930.4**	**935.9**	**943.5**	**952.0**
3.0	2.1	1.5	0.8	-0.3	-0.9	-1.2	-1.4	-2.3	-1.6	-1.0	1.2	**2.7**	**2.2**	**3.9**	**1.5**	**3.0**	**3.7**	**2.5**	**4.0**
0.4	0.3	1.0	0.5	-1.4	-1.9	-2.1	-3.1	-1.4	-0.2	0.8	1.2	**0.5**	**0.7**	**0.9**	**0.9**	**1.4**	**1.7**	**1.9**	**2.0**
-0.9	-2.5	-4.1	-3.2	-2.8	-2.5	-1.5	-0.9	1.0	0.8	2.6	2.1	**-0.1**	**1.3**	**0.7**	**1.6**	**1.6**	**1.4**	**1.1**	**1.2**
8.3	2.3	-3.9	-2.2	-5.5	-2.2	-11.1	-0.1	-4.9	-11.4	-0.7	-1.0	**7.1**	**7.4**	**5.1**	**-3.8**	**-0.3**	**5.0**	**1.7**	**8.1**
16.5	11.3	7.0	4.3	6.9	4.4	4.6	2.9	-3.8	0.6	0.3	3.7	**8.1**	**8.1**	**9.3**	**9.2**	**8.2**	**6.9**	**6.4**	**7.0**
15.9	8.9	2.6	1.9	3.8	3.0	0.5	2.6	-3.0	-0.8	2.9	3.5	**7.6**	**9.0**	**7.3**	**7.8**	**6.3**	**5.7**	**5.7**	**6.5**
66.8	76.7	70.8	83.0	92.2	89.2	101.7	87.1	83.8	99.0	84.7	91.9	**93.9**	**100.5**	**106.3**	**109.6**	**115.6**	**116.7**	**118.2**	**120.8**
10.8	8.2	2.3	2.6	2.6	-0.8	-0.9	-4.1	-5.4	-2.4	3.9	6.1	-	-	-	-	-	-	-	-
5.7	-5.3	-9.1	-0.9	-10.0	-6.0	-6.2	-9.0	-11.2	-11.7	-3.9	-3.1	-	-	-	-	-	-	-	-
5.2	1.1	0.3	0.7	0.9	-2.2	-1.1	-1.7	-3.0	0.3	2.6	3.6	-	-	-	-	-	-	-	-
1.7	1.9	1.8	1.9	2.4	2.7	3.2	3.3	2.8	2.3	1.8	1.4	1.0	-	-	-	-	-	-	-
1.7	1.8	1.7	2.4	3.7	3.4	3.3	2.9	1.8	1.5	1.2	1.1	0.2	**0.4**	**1.0**	**1.6**	**2.2**	**2.3**	**2.2**	**1.9**
4.4	4.0	4.5	5.9	9.7	9.4	8.2	7.1	3.5	2.6	1.5	1.3	-4.1	**-3.5**	**-2.5**	**-2.3**	**0.9**	**0.8**	**0.6**	**0.5**
1.0	1.2	1.2	1.7	1.3	1.0	0.9	0.6	0.6	0.6	0.5	0.3	1.0	**1.0**	**1.6**	**2.1**	**2.1**	**2.3**	**2.3**	**2.1**
3.3	4.1	3.6	4.5	3.5	2.6	2.8	2.7	3.0	3.8	3.3	2.4	3.5	**2.8**	**3.7**	**4.4**	**3.5**	**3.7**	**3.4**	**3.0**
-0.8	-0.8	-0.7	-0.4	-0.3	-0.2	-0.4	-0.5	-0.4	-0.6	-0.7	-0.4	-0.2	**0.2**	**0.7**	**1.3**	**1.7**	**1.9**	**1.9**	**1.8**
10.8	9.1	9.5	10.2	8.0	5.8	6.4	3.8	-1.5	-3.8	-1.4	-1.7	0.3	**1.0**	**-2.1**	**-2.6**	**-3.1**	**-2.8**	**-1.9**	**-0.1**
1.6	1.7	1.7	2.4	2.5	2.2	2.0	1.6	0.9	0.8	0.4	0.3	0.1	**0.3**	**0.9**	**1.4**	**1.9**	**2.0**	**2.0**	**1.8**
-1.9	-1.7	-0.9	0.8	2.2	1.9	1.4	1.0	1.9	1.8	1.7	2.3	**2.1**	**1.2**	**0.7**	**0.5**	**-0.5**	**1.1**	**2.4**	**1.9**
5.4	6.0	5.6	5.2	3.6	1.8	1.6	1.6	1.2	0.5	0.7	0.8	-0.7	**-0.4**	**-0.5**	**-0.5**	**-0.4**	**0.1**	**0.2**	**0.1**
32.4	32.3	19.2	7.1	-1.2	-2.9	5.6	12.7	14.5	9.3	1.4	-4.3	-4.4	**0.6**	**11.0**	**16.2**	**10.2**	**7.3**	**4.0**	**1.9**
-0.4	-0.5	-0.5	-0.5	-0.7	-0.6	-0.6	-0.8	-1.0	-1.3	-1.3	-0.8	-0.3	-	-	-	-	-	-	-
36.1	47.6	45.9	25.1	12.7	-7.2	-2.2	1.0	-4.6	-4.3	0.3	-0.7	-4.2	**5.2**	**-1.8**	**-2.9**	**-2.8**	**-4.8**	**-5.1**	**-5.0**
2.8	2.6	2.1	2.4	3.3	2.2	1.7	3.5	-0.3	1.2	1.3	-1.8	**2.5**	**1.3**	**2.0**	**3.3**	**3.6**	**4.2**	**4.6**	**4.8**
1.1	0.8	0.3	0.0	-0.4	-1.2	-1.5	0.7	-2.1	-0.3	0.1	-2.9	**2.2**	**0.9**	**1.0**	**1.7**	**1.4**	**1.9**	**2.3**	**2.8**
-0.2	0.4	0.1	-0.5	-0.6	-0.6	0.3	0.6	2.0	2.4	0.9	1.3	**0.4**	**0.1**	**1.0**	**0.8**	**0.8**	**0.8**	**0.7**	**0.8**
-0.5	1.0	-0.1	1.0	2.7	2.9	2.4	3.5	2.0	1.5	0.4	-3.5	**-0.9**	**-0.6**	**-0.3**	**2.7**	**2.6**	**2.3**	**3.0**	**3.1**
-1.1	0.7	-0.2	2.4	2.2	4.4	6.0	5.1	3.7	2.9	-1.4	-3.9	-	-	-	-	-	-	-	-
3.0	2.0	1.6	0.9	0.1	-1.7	-2.0	-1.8	-4.0	-2.9	-0.8	0.1	**2.1**	**1.9**	**3.3**	**1.1**	**2.6**	**3.5**	**2.1**	**3.5**
7.2	6.8	6.6	6.5	7.2	6.8	7.0	7.2	7.5	6.8	7.0	6.7	**7.1**	**6.5**	**6.7**	**6.7**	**7.1**	**6.5**	**6.5**	**6.4**
7.4	6.5	6.4	6.4	7.1	6.5	6.6	7.0	8.0	7.5	7.5	7.8	8.6	**7.6**	**7.3**	**7.3**	**7.9**	**7.0**	**6.8**	**6.9**
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
33.3	27.3	6.5	23.2	51.7	41.6	33.1	22.3	53.0	61.9	35.9	37.3	**72.0**	**70.0**	**55.0**	**53.0**	**77.0**	**75.0**	**60.0**	**58.0**
3.8	2.8	0.7	2.3	5.7	4.3	3.4	2.2	5.9	6.4	3.6	3.6	**7.7**	**7.0**	**5.3**	**5.0**	**8.0**	**7.1**	**5.6**	**5.2**
13.3	18.6	16.1	10.4	17.2	15.7	16.9	12.4	14.3	14.0	10.2	14.5	**15.0**	**16.0**	**15.0**	**14.0**	**16.0**	**17.0**	**17.0**	**15.0**
32.9	-89.7	-29.9	-17.3	27.2	-4.5	-42.0	-32.0	9.9	-13.8	-42.2	-9.9	**38.0**	**-10.0**	**-25.0**	**12.0**	**38.0**	**-8.0**	**-23.0**	**13.0**
3.7	-9.3	-3.1	-1.7	3.0	-0.5	-4.3	-3.2	1.1	-1.4	-4.3	-1.0	**4.0**	**-1.0**	**-2.4**	**1.1**	**3.9**	**-0.8**	**-2.1**	**1.2**
-8.4	48.1	-35.2	42.3	16.3	44.6	26.3	34.0	26.5	9.7	-5.6	2.5	-	-	-	-	-	-	-	-
17.8	16.9	17.3	18.8	19.1	19.7	20.0	19.4	19.4	19.8	19.5	19.6	20.0	**-**	**-**	**-**	**-**	**-**	**-**	**-**
24.4	24.3	24.4	25.3	25.1	25.3	25.1	25.2	25.6	25.8	25.9	26.7	27.4	**-**	**-**	**-**	**-**	**-**	**-**	**-**
-5.3	-4.3	-1.1	2.6	2.0	2.9	2.0	-0.7	2.2	2.5	3.5	5.9	7.9	**-**	**-**	**-**	**-**	**-**	**-**	**-**
-5.4	-5.0	-2.0	1.6	2.7	4.2	3.2	0.1	1.8	1.8	2.1	4.4	6.6	**-**	**-**	**-**	**-**	**-**	**-**	**-**
0.8	-0.1	1.6	4.6	4.0	3.9	3.3	0.3	1.0	0.7	0.4	2.9	**4.4**	**3.9**	**4.3**	**2.2**	**-0.5**	**-0.5**	**0.0**	**-0.2**
4.7	2.4	3.5	6.5	5.7	5.7	4.7	1.0	-0.3	-0.7	-0.9	1.0	**2.6**	**2.4**	**3.1**	**1.9**	**-0.3**	**-0.4**	**-0.3**	**-0.6**
3.4	2.6	3.7	4.8	6.1	5.8	5.7	5.0	4.2	4.1	4.9	4.6	**4.4**	**4.6**	**3.7**	**4.4**	**5.0**	**4.8**	**4.6**	**4.1**
0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.05	0.05	0.05	0.05	0.05	0.05	**0.05**	**0.05**	**0.05**	**0.45**	**0.56**	**0.61**	**0.71**
1.2	1.2	1.2	1.2	1.2	1.2	1.0	0.6	0.5	0.5	0.5	0.4	0.4	**0.4**	**0.4**	**0.4**	**0.8**	**0.9**	**0.9**	**1.0**

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