INFLATION REPORT / III

2014

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 the 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 7 August 2014 and contains the information available as of 18 July 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

Annual growth in the Czech economy picked up pace in 2014 Q1. Both headline and monetary-policy relevant inflation stood at very low levels in 2014 Q2, well below the lower boundary of the tolerance band around the CNB's target. The low inflation was due to a continuing decline in administered prices, fading food price growth and subdued inflation in the euro area. By contrast, the anti-inflationary effect of the domestic economy abated as expected, and the weakened exchange rate of the koruna continued to act in the inflationary direction via import prices. Owing to accelerating external demand and easy domestic monetary conditions, GDP will grow by almost 3% this year. A similar economic growth rate will be maintained in the next two years. Headline inflation will go up owing mainly to rising economic activity and accelerating wage growth. By contrast, the inflationary effect of import prices will fade. Headline inflation will reach the CNB's 2% target in 2015 H2, i.e. at the monetary policy horizon. Monetary-policy relevant inflation will be slightly lower than headline inflation and will thus be just below the target at the monetary policy horizon. The forecast expects market interest rates to be flat at their current very low level and the koruna exchange rate to be used as an instrument for easing monetary policy until 2015 Q3. The subsequent return to conventional monetary policy will not imply appreciation of the exchange rate to the level recorded before the CNB started intervening.

The **Czech economy** expanded by 2.9% year on year **in 2014 Q1**, with all demand components except inventories making positive contributions. In quarter-on-quarter terms, GDP rose for the fourth consecutive quarter and picked up pace significantly in late 2013/early 2014. The output gap thus narrowed, but remains negative. The forecast predicts a similar annual GDP growth rate in the second quarter of this year as in the first quarter.

Both **headline and monetary-policy relevant inflation** stood at very low levels **in 2014 Q2**, well below the lower boundary of the tolerance band around the CNB's target (see Chart I.1). Administered prices continued falling year on year and the previous increase in food prices faded out. Fuel prices recorded only weak growth. However, adjusted inflation excluding fuels turned positive after almost five years of decline. This was fostered by the fading anti-inflationary effect of the domestic economy, reflecting strong GDP growth and renewed wage growth, together with the inflationary effect of the weakened exchange rate of the koruna via import prices.

Economic activity in the effective euro area is gradually accelerating. According to the assumptions of the forecast, its growth will reach 1.5% this year and increase further to 2% in the next two years. Inflation in the euro area remains very subdued owing to falling commodity prices, appreciation of the euro and a strongly negative output gap. Industrial producer prices in the euro area are falling year on year and consumer price inflation is very low. According to the assumptions of the forecast, however, this trend will reverse and

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 Q2
(year on year in %)

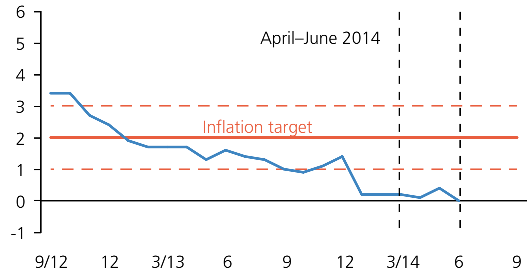
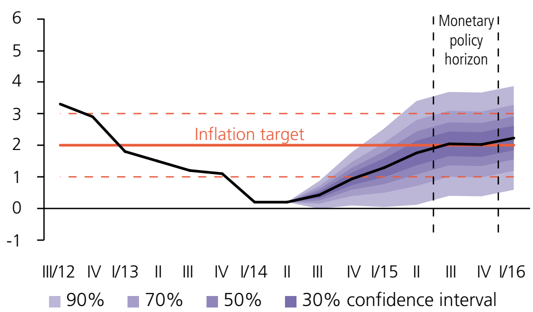


CHART I.2

HEADLINE INFLATION FORECAST

Headline inflation will start rising in 2014 Q3 and will be close to the target at the monetary policy horizon
(year on year in %)



prices in the euro area will gradually rise again. The low outlook for 3M EURIBOR rates reflects the recent monetary policy easing by the ECB. The euro is expected to depreciate gradually against the dollar from its current relatively strong level. Oil prices are expected to fall gradually over the forecast horizon from a slightly elevated initial level.

According to the forecast, headline inflation will start rising towards the CNB's 2% target in 2014 Q3 and stay very close to 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. It will thus stay just below the CNB's target at the monetary policy horizon (see Chart 1.3). The overall upward pressures on consumer prices will temporarily ease slightly in the near future, as the contribution of import prices will fade due to very weak foreign producer price inflation and continued stability of the koruna-euro exchange rate. By contrast, the growing domestic economy and accelerating wage growth will be reflected in prices over the entire forecast horizon. This will result in a steady increase in adjusted inflation excluding fuels. Administered prices will decline further this year and the next and return to only low growth in 2016. Food prices will show only a weak increase in the near future and accelerate next year. Fuel prices are expected to grow modestly until mid-2016 and then fall slightly in light of the outlook for global oil and petrol prices.

The forecast expects market **interest rates** to be flat at their current very low level until 2015 Q3, reflecting the 2W repo rate being left at technical zero and an unchanged money market premium. Market rates are forecasted to increase by around 0.5 percentage point at the end of 2015 after the exit from the regime of using the exchange rate as a monetary policy instrument (see Chart I.4). Interest rates will then rise further. The **exchange rate of the koruna against the euro** stayed close to CZK 27.4 in 2014 Q2. Given its low observed volatility, the forecast expects the exchange rate to remain at this level in the next few quarters, slightly weaker than the announced asymmetric exchange rate commitment (i.e. CZK 27 to the euro). The forecast expects the exchange rate to be used as a monetary policy instrument until 2015 Q3. By then, thanks to the economic recovery and rising wages, domestic inflationary pressures should be sufficiently restored to allow a return to conventional monetary policy. However, this return should not result in the exchange rate appreciating 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.

Following the contraction of the **Czech economy** over the last two years, GDP will grow this year (see Chart I.5). Accelerating growth in external demand and easy monetary conditions via a weaker koruna and exceptionally low interest rates, coupled with higher government investment, will lead to GDP growth of almost 3%. In the following two years, the economy will record similar growth rates, with fiscal

CHART I.3

MONETARY-POLICY RELEVANT INFLATION FORECAST

Monetary-policy relevant inflation will be just below the target at the monetary policy horizon
(year on year in %)

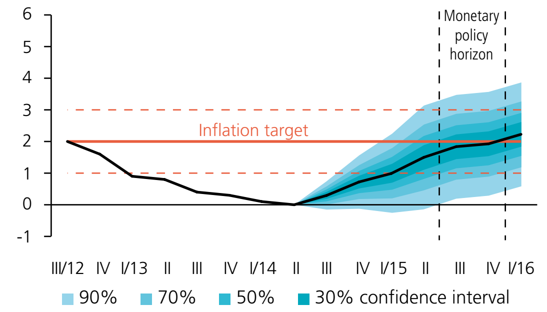


CHART I.4

INTEREST RATE FORECAST

The forecast expects market interest rates to be flat at their current very low level until 2015 Q3
(3M PRIBOR in %)

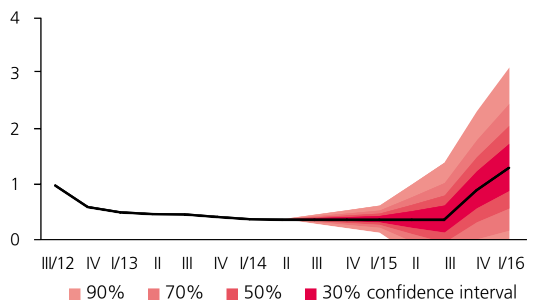
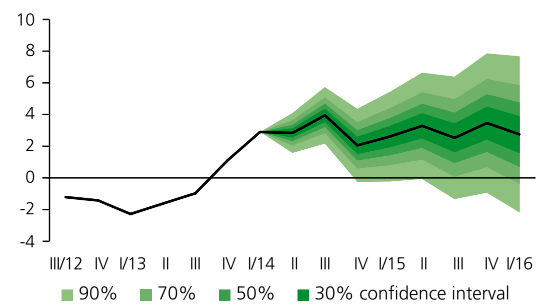


CHART I.5

GDP GROWTH FORECAST

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



policy and the drawdown of EU funds making a significantly positive contribution in 2015 and a slightly negative contribution in 2016. The economic recovery is already manifesting itself in the **labour market** in renewed growth in the number of employees converted into full-time equivalents. This growth will rise further. By contrast, the unemployment rate will decrease gradually. Wage growth in the business sector will increase noticeably and wages in the non-business sector will rise at a rather lower rate.

At its monetary policy meeting on 31 July 2014, the Bank Board decided unanimously to keep interest rates unchanged at technical zero. The Bank 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 asymmetric nature of this exchange rate commitment is unchanged. The Bank Board assessed the risks to the new forecast as being slightly anti-inflationary, with longer-lasting very subdued inflation in the euro area and lower food prices in the near future acting in this direction. The Bank Board therefore decided to continue using the exchange rate as a monetary policy instrument at least until 2016. The Bank Board would have to find a further noticeable increase in anti-inflationary factors before moving the exchange rate commitment to a weaker level.

II. THE FORECAST, ITS CHANGES AND RISKS

II.1 EXTERNAL ASSUMPTIONS OF THE FORECAST

External economic activity is expected to pick up pace gradually further this year and the next and to slow slightly in 2016. The observed decline in commodity prices together with the impacts of the previous lengthy downturn in economic activity shifts the outlook for industrial producer price inflation this year to strongly negative levels. Producer prices will show weak growth in the longer term. Consumer prices will also rise only slightly owing to the slowly recovering demand. The subdued inflation and the resulting recent monetary policy easing by the ECB are reflected in a low outlook for 3M EURIBOR rates. The euro is expected to depreciate gradually against the dollar from its current relatively strong level. The outlook for the Brent crude oil price expects a gradual decline from a slightly elevated initial level.

The outlook for the **effective indicator of euro area GDP** indicates a pick-up in annual economic growth to 1.5% this year, with substantial differences persisting across countries (see Chart II.1.1).[1] Economic growth in the effective euro area is expected to rise further to 2% next year. A modest slowdown to 1.8% is forecasted for 2016. Compared to the previous forecast, this means a shift in the outlook towards slightly slower external demand growth this year, while the longer-term outlook is almost unchanged.

The observed substantial decline in agricultural commodity and energy prices, coupled with the impacts of the previous lengthy economic downturn, are reflected in the outlook for the **effective indicator of producer prices in the euro area** (see Chart II.1.2). After having stagnated in 2013, this indicator is expected to fall by 0.8% on average this year. In addition to the June CF, this low figure takes into account the latest data for Germany and Slovakia in particular. A renewed rise in industrial producer price inflation is expected in the next two years. As the economic recovery gathers pace, producer prices are expected to rise by 1.4% on average next year and accelerate to 2.1% in 2016. The outlook is substantially lower than the previous forecast, particularly for this year.

The expected growth of the **effective indicator of consumer prices in the euro area** mainly reflects low prices of food and energy for households amid a persisting negative output gap and only slowly recovering consumer demand. Consumer price inflation is expected to slow significantly on average for 2014 as a whole to 0.8% (see Chart II.1.3). Next year, as economic activity accelerates, consumer

1 The outlooks for euro area GDP, PPI and CPI and the dollar-euro exchange rate are based on the June Consensus Forecasts (CF). The outlooks for the 3M EURIBOR and Brent crude oil are derived from prices of market contracts as of 7 July 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 further accelerate this year and the next

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

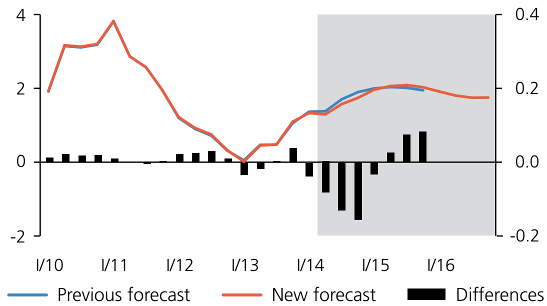


CHART II.1.2

EFFECTIVE PPI IN THE EURO AREA

The sharp decline in industrial producer prices this year primarily reflects the previous economic downturn and low commodity prices

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

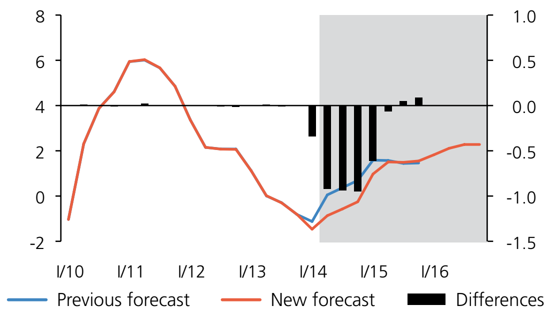


CHART II.1.3

EFFECTIVE CPI IN THE EURO AREA

Effective inflation 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)

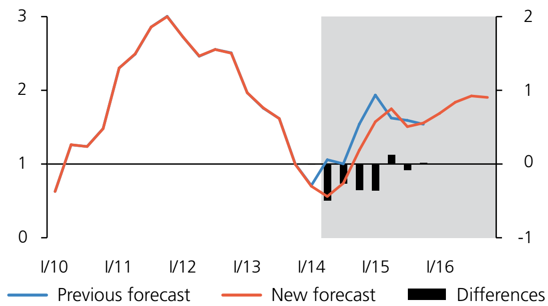


CHART II.1.4

3M EURIBOR

The low 3M EURIBOR outlook reflects the very subdued inflation and the further easing of monetary policy by the ECB
(in %; differences in percentage points – right-hand scale)

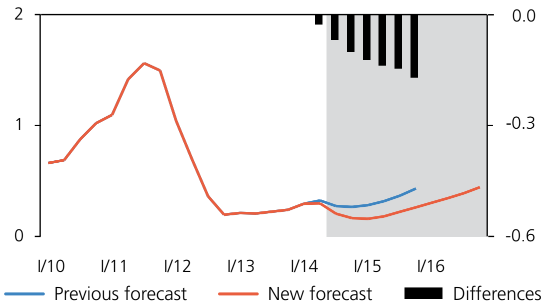


CHART II.1.5

EURO-DOLLAR EXCHANGE RATE

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

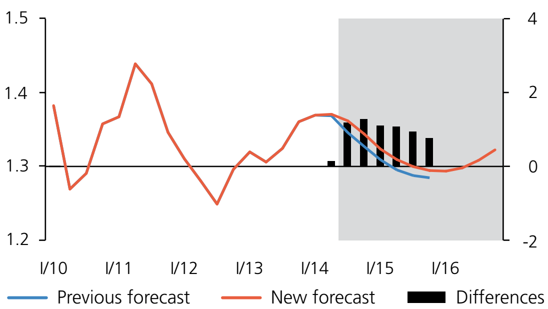
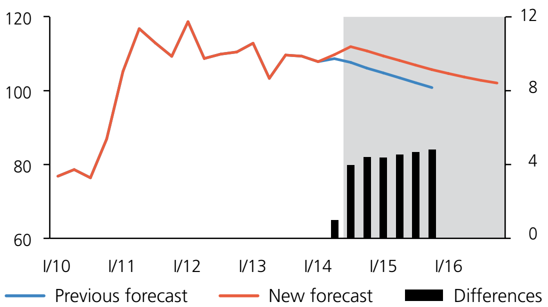


CHART II.1.6

PRICE OF BRENT CRUDE OIL

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



price inflation is expected to rise to 1.6% on average. In 2016 it will reach 1.8%. This represents a downward shift in the outlook compared to the previous forecast.

The low market outlook for **3M EURIBOR** interest rates over the entire forecast horizon mainly reflects the further easing of monetary policy by the ECB. On 5 June, in response to very subdued inflation, the ECB lowered its main refinancing rate by 0.25 percentage point to 0.15% and its deposit rate into negative territory (-0.10%) and announced a number of other measures (see section III.7 for details). The market outlook expects the 3M EURIBOR to be flat at 0.2% on average this year and the next (see Chart II.1.4). Compared to the previous forecast, this means a minimal change this year. The outlook for 2015 has been revised downwards by 0.1 percentage point on average. In 2016, the average 3M EURIBOR rate should rise slightly to 0.4%. The market outlook for foreign interest rates is in line with the expectations of the analysts surveyed in the June CF, who also expect the 3M EURIBOR to be flat at 0.2% 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 at least until the end of June 2015.

The outlook for the **dollar-euro exchange rate** is based on the currently relatively strong euro, but the forecast still expects it to weaken gradually (see Chart II.1.5). Compared with the previous forecast, the euro exchange rate is expected to follow a slightly stronger path over the entire forecast horizon, despite the ECB monetary policy easing mentioned above. The average rate is expected to be USD 1.36 to the euro this year. Over the next two years, the euro is expected to depreciate towards USD 1.30.

The outlook for the **Brent crude oil price** based on market futures contracts expects a falling path from an elevated initial level of roughly USD 110 a barrel to about USD 102 a barrel at the end of 2016 (see Chart II.1.6). This reflects the expected global growth rate and the geopolitical risks in Ukraine, associated with uncertainty regarding future oil and natural gas supplies from Russia, civil unrest in Iraq and lower oil production in Libya and Iran. An upward revision of about USD 4 a barrel has been made over the entire forecast horizon. The market outlook is roughly in line with the expectations of the analysts surveyed in the June CF, who expected the Brent oil price to be USD 105 a barrel at the 12-month horizon.

II.2 THE FORECAST

Annual headline inflation remained at very low, albeit non-negative, levels in 2014 Q2. In 2014 Q3 it will start rising gradually, and in 2015 H2 it will return – together with monetary-policy relevant inflation – to the 2% target, where it will stay in 2016. The inflationary effect of import prices will fade this year owing to subdued inflation abroad amid a stable exchange rate. The domestic economy will start to contribute to price growth from the second half of this year onwards, chiefly as a result of a recovery in wage growth. After last year's GDP contraction, the economy will grow by almost 3% this year owing to accelerating growth in external demand, the easing of the monetary conditions via the exchange rate of the koruna and exceptionally low interest rates, and higher government investment. In the following two years, the economy will record similar growth rates, with fiscal policy and the drawdown of EU funds making a significantly positive contribution in 2015 and a slightly negative contribution in 2016. The economic recovery will 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 koruna exchange rate to be used as an instrument for easing monetary policy until 2015 Q3. The subsequent return to conventional monetary policy will not imply appreciation of the exchange rate to the level recorded before the CNB started intervening.

Annual **headline inflation** remained at very low, albeit non-negative, levels in 2014 Q2 (0.2% on average) and was thus well below the lower boundary of the tolerance band around the CNB's target. According to the forecast, headline inflation will increase to 0.4% in 2014 Q3, primarily due to a continuing increase in adjusted inflation excluding fuels and renewed growth in food prices. It will then accelerate further owing to the inflationary effect of a noticeably expanding domestic economy and rising wages, and from mid-2015 onwards it will be close to the CNB's 2% target (see Chart II.2.1).

Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, was zero on average in 2014 Q2, remaining 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, but in 2014 and 2015 it will be slightly lower owing to the first-round effects of changes to indirect taxes.

The contribution of changes to **indirect taxes** to headline inflation averaged just under 0.2 percentage point in 2014 Q2. This was due to two harmonisation increases in excise duties on cigarettes in January 2013 and January 2014. In both cases the effect on end prices was spread over time because of frontloading by producers and retailers. The forecast assumes another harmonisation increase in excise duty

CHART II.2.1

HEADLINE INFLATION AND MONETARY-POLICY RELEVANT INFLATION

Headline inflation and monetary-policy relevant inflation will return to the 2% target from their current very low levels in 2015 H2

(year on year in %)

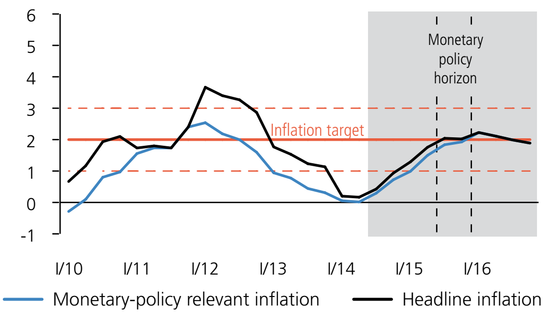


Chart II.2.2

ADMINISTERED PRICES AND FUEL PRICES

Administered prices will continue falling in 2014 and 2015, while fuel prices will rise slightly

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

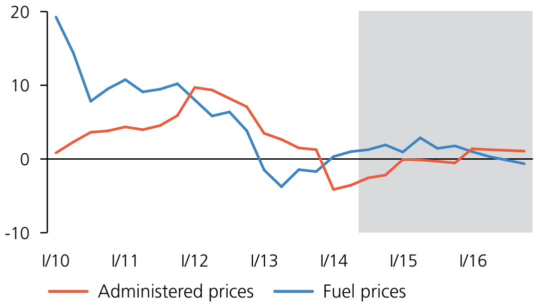


Table II.2.1

FORECAST OF ADMINISTRATIVE EFFECTS

The fall in administered prices in 2014 and 2015 will be due mainly to a decline in electricity prices and the abolition of fees in health care

(annual average percentage changes; contributions to headline inflation in percentage points)

	2013 actual		2014 forecast		2015 forecast		2016 forecast	
Administered prices – total[a]	2.2	0.40	-3.1	-0.53	-0.3	-0.03	1.2	0.23
of which (main changes):								
electricity	3.2	0.15	-10.4	-0.49	-3.0	-0.14	0.5	0.02
natural gas	-3.5	-0.09	-3.5	-0.10	0.5	0.02	-0.5	-0.01
heat	4.3	0.10	0.7	0.02	4.3	0.09	2.2	0.05
water	6.7	0.07	3.4	0.03	4.2	0.04	2.2	0.02
healthcare	2.6	0.05	-5.4	-0.06	-17.9	-0.21	3.3	0.04
First-round impacts of tax changes in non-administered prices		0.67		0.17		0.17		0.00

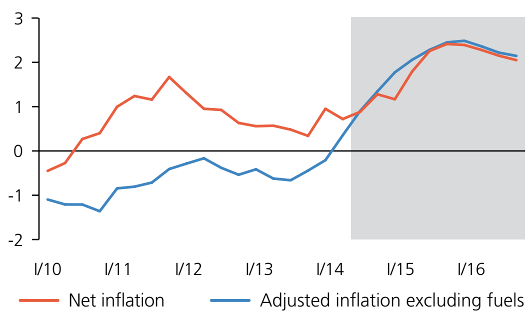
a) Including effects of indirect tax changes

Chart II.2.3

NET INFLATION AND ADJUSTED INFLATION EXCLUDING FUELS

Market price inflation will rise further, initially owing to the weakened koruna and later as a result of a recovery in economic activity and the labour market

(year on year in %)



on cigarettes.[2] Its overall effect on prices of about 0.2 percentage point should be spread over the final few months of 2014 owing to legislative restrictions on frontloading. The forecast also assumes the introduction of a second reduced VAT rate of 10% on medicines, books and irreplaceable infant food with effect from 1 January 2015. The first-round effect of this change on headline inflation is -0.07 percentage point and pertains primarily to non-administered prices. No changes to indirect taxes are foreseen by the forecast for 2016.

The year-on-year decline in **administered prices** continued in 2014 Q2 (see Chart II.2.2) owing to a sharp fall in retail energy prices, the abolition of hospital stay fees and weaker year-on-year growth in water supply and sewerage collection charges at the start of this year. This was partly offset in Q2 by a slower decline in gas prices and rising prices of medicines and spa stays. The forecast assumes a further moderation of the annual decline in administered prices in 2014 H2, fostered by renewed gas price growth, faster growth in heat prices and a further slowdown in the year-on-year decline in health care prices. The forecast expects administered prices to decrease by 0.3% in 2015, mainly due to the abolition of fees in health care (except for emergency treatment) with effect from 1 January 2015 with an overall impact on headline inflation of -0.2 percentage point. Retail electricity prices are expected to fall slightly following a decline in forward contracts for electricity generation. Growth in gas prices is very subdued. Water supply and sewerage collection charges and heat prices are expected to rise modestly. The introduction of a second reduced VAT rate of 10% will make a slight negative contribution to administered price inflation. Administered prices will make a slight positive contribution to inflation in 2016 amid subdued growth in most of their components (see Table II.2.1).

Annual **net inflation** fell to 0.7% on average in 2014 Q2 (see Chart II.2.3). This stemmed mainly from subdued growth in food prices. By contrast, adjusted inflation excluding fuels turned positive and fuel prices continued to edge up. The forecast expects net inflation to start increasing again gradually in 2014 Q3. It will exceed 2% in the second half of 2015 and remain slightly above this level in 2016.

Annual **adjusted inflation excluding fuels** turned positive for the first time in five years in 2014 Q2, averaging 0.4%. It was thus visibly affected by the weakened exchange rate of the koruna. This factor was gradually joined by the effect of a pronounced recovery in the domestic economy and renewed wage growth. The forecast assumes a further increase in adjusted inflation excluding fuels in the quarters

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 last year, a further increase in duty on tobacco products has been proposed. The amendment passed its second reading in the Chamber of Deputies (the lower house of the Czech Parliament) when the forecast was being completed.

ahead as the economy and the labour market continue to recover. Due to domestic inflationary pressures, adjusted inflation excluding fuels will accelerate during 2015, rising above 2% at the year-end and then falling slightly (see Chart II.2.3).

Food prices (excluding the first-round effects of tax changes) recorded slower annual growth in 2014 Q2 and switched to a slight decline in June. This was fostered by a sharp fall in prices of potatoes and fruit and weaker price growth for other items. Agricultural producer prices continued to decrease year on year, while the weakening of the koruna acted in the inflationary direction through prices of imported food. The forecast expects growth in food prices to be low in the period ahead. It will intensify in 2015, boosted by import prices of food and the lagged effects of higher agricultural producer prices. Food price inflation will be above 2% in 2016 (see Chart II.2.4).

Fuel prices continued to show subdued annual growth in 2014 Q2, reflecting a slightly weaker koruna-dollar exchange rate and growth in world prices of petrol and oil. Growth in fuel prices should remain modest in the quarters ahead. It will slow at the start of 2016 and switch to a slight annual decline in mid-2016 in connection with the outlook for international prices of petrol and oil and a slight appreciation of the koruna against the dollar (see Chart II.2.5).

Domestic money market **interest rates** remained flat at historical lows at all maturities in 2014 Q2. The forecast expects market interest rates to be flat at their current very low level until 2015 Q3, reflecting the 2W repo rate being left at technical zero and an unchanged money market premium. Market rates are forecasted to increase by around 0.5 percentage point at the end of 2015 after the exit from the regime of using the exchange rate as a monetary policy instrument (see Chart II.2.6). Interest rates will rise further in 2016.

The **exchange rate of the koruna against the euro** stayed close to CZK 27.4 in 2014 Q2. Given its low observed volatility, the exchange rate is assumed to remain at this level over the next few quarters, slightly weaker than the announced asymmetric exchange rate commitment (i.e. CZK 27 to the euro). The forecast expects the exchange rate to be used as a monetary policy instrument until 2015 Q3. By then, thanks to the economic recovery and rising wages, domestic inflationary pressures should be sufficiently restored to allow a return to conventional monetary policy. However, this return should not result in the exchange rate appreciating 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 and the next.

Quarterly growth in **nominal marginal costs in the consumer goods sector** edged up further in 2014 Q2 (see Chart II.2.7). This rise was due to a change in the effect of the domestic economy (as expressed by

CHART II.2.4

FOOD PRICES AND AGRICULTURAL PRODUCER PRICES

Food prices will start going up in 2015 and continue to rise in 2016
(annual percentage changes)

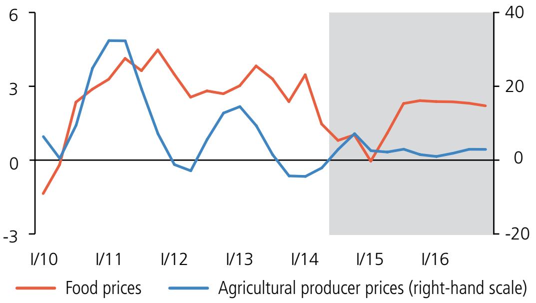


CHART II.2.5

FUEL PRICES AND OIL PRICES

Fuel prices will continue to show subdued annual growth until mid-2016
(annual percentage changes)

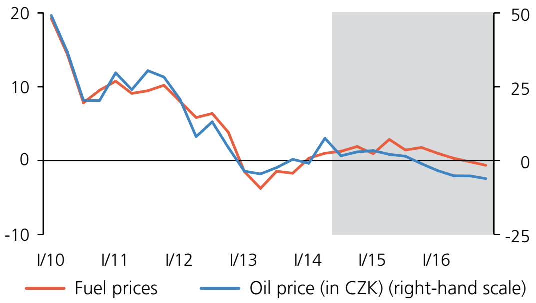


CHART II.2.6

INTEREST RATE FORECAST

The forecast expects market interest rates to be flat at their current very low level until 2015 Q3
(percentages)

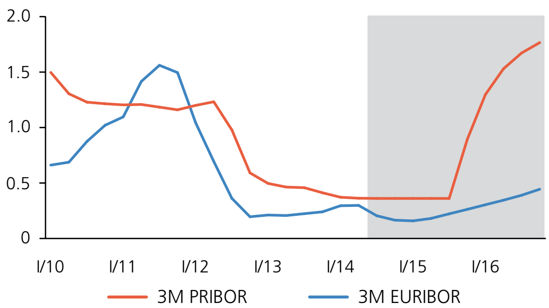


CHART II.2.7

COSTS IN THE CONSUMER SECTOR

The overall upward pressures on prices in the consumer sector will start to be dominated by the effect of the domestic economy, while the effect of import prices will gradually weaken
(quarterly percentage changes; contributions in percentage points; annualised)

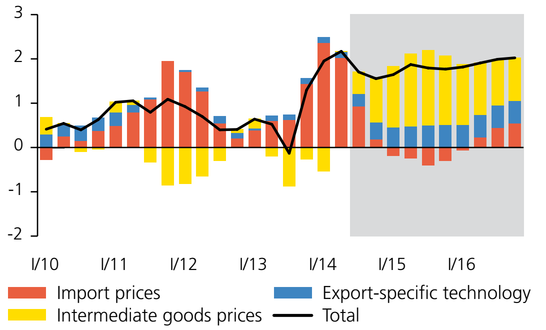


CHART II.2.8

COSTS IN THE INTERMEDIATE GOODS SECTOR

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

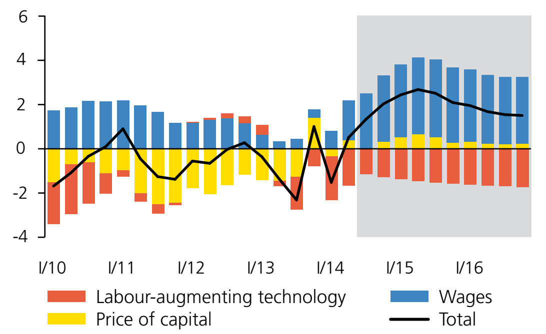
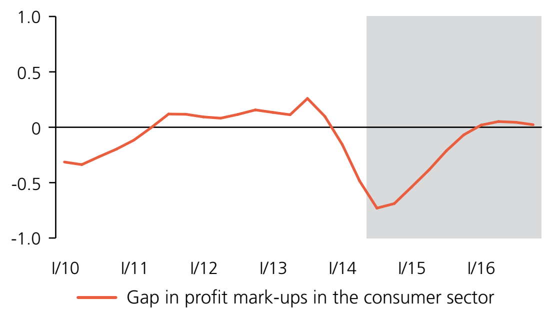


CHART II.2.9

GAP IN PROFIT MARK-UPS IN THE CONSUMER SECTOR

The gap in profit mark-ups will be negative until the start of 2016
(percentages)



intermediate goods price inflation), which shifted from anti-inflationary to neutral owing to the observed recovery in economic activity and renewed wage growth. The contribution of import prices to the growth in costs remained positive but decreased slightly in connection with the flat exchange rate of the koruna since the start of this year and the currently deflationary developments in foreign producer prices. The estimated impact on inflation of growth in export-specific technology, linked with different productivity growth in 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 temporarily ease slightly in the near future, as the contribution of import prices will fade and turn slightly anti-inflationary in 2015 due to very low foreign producer price inflation and continued stability of the koruna-euro exchange rate. With foreign producer prices rising, import prices will start to make a slightly positive contribution to inflation again in 2016. Accelerating wage growth and a continued recovery in economic activity will be reflected in costs in the inflationary direction over the entire forecast horizon. The contribution of export-specific technology will also gradually increase.

Nominal marginal costs in the intermediate goods sector recorded slightly positive growth in 2014 Q2. This was due mainly to nominal wage growth in the business sector, which, however, was largely offset by an increase in labour productivity. The price of capital also made a positive contribution to marginal costs, reflecting a recovery in investment activity and an increase in the investment deflator (see Chart II.2.8). Domestic nominal costs will continue to rise in the quarters ahead due to accelerating wage growth. However, the cost pressures stemming from nominal wage growth will be partly offset by faster productivity growth over the entire forecast horizon. The price of capital will also contribute weakly to the growth in costs in 2015 and 2016.

The estimated negative gap in **profit mark-ups in the consumer goods sector** widened further in 2014 Q2 due to very subdued inflation amid growth in nominal costs (see Chart II.2.9). The gap in profit mark-ups will turn even more negative at the start of the forecast horizon, since domestic costs will grow faster than prices, which will be slowed to a large extent by short-term factors on the supply side (in particular, a decline in traditionally volatile food price items). Profit mark-ups will gradually narrow in an environment of continued growth in economic activity in the second half of this year, owing to the gradual pass-through of increasing costs to final prices. The gap in profit mark-ups will turn slightly positive at the start of 2016 and stay at that level throughout the year.

Whole-economy **labour productivity** recorded a sharp year-on-year upswing above 2% in 2014 Q1. The forecast expects a similar pace of growth in Q2 and in 2014 as a whole on average. Productivity growth will increase to 2.8% in 2015 and fall back slightly to 2.5% in 2016. The path of labour productivity will be influenced by a pick-up in economic activity, followed – with a time lag and at a lower pace – by employment growth.

The average nominal **wage in the business sector** rose significantly year on year in 2014 Q1 (by 3.6%). However, this was partly due to tax optimisation in late 2012 and early 2013. The unwinding of this effect in 2014 Q2 will cause annual wage growth to slow to 1.6%. Average wage growth in the business sector should start to pick up pace significantly in the second half of this year on the back of improving external demand, a continued pronounced recovery in domestic economic activity and a gradual return of inflation to the target. Overall, wage growth in the business sector will reach 2.8% in 2014 and pick up further to 4.9% in 2015 and 5.1% in 2016 (see Chart II.2.10). This is broadly consistent with the forecasted real economic growth of around 3% and inflation close to the 2% target.

Growth in the average nominal **wage in the non-business sector** was 2.2% in 2014 Q1. The forecast expects wage growth to rise to 2.7% on average this year. The growth rate of wages in the non-business sector should increase further to 3% in 2015, amid more pronounced GDP growth and easier fiscal policy, and slow again to 2.7% in 2016.

Real GDP recorded a year-on-year increase of 2.9% and a quarter-on-quarter rise of 0.8% **in 2014 Q1** (see Chart II.2.11). This sharp quarterly growth was recorded despite the dampening effect of sales of cigarettes stocks built up in the previous quarter ahead of the increase in excise duty. Adjusted for this effect, GDP growth would be even higher. Although the year-on-year growth was mostly due to fixed investment, all the other components of demand except change in inventories made positive contributions (see Chart II.2.12).

According to the forecast, **economic activity in 2014 Q2** rose by 2.8% year on year and 0.2% quarter on quarter. This is indicated by the published data on industrial production, construction production and retail sales. This assumption is also based on the observed increase in industrial orders (new orders from the Czech Republic and, in particular, new orders from abroad). Indicators of the economic sentiment of firms and households point to an improvement in the perceived economic situation and positive expectations about future growth. The results of the bank lending survey also indicate the onset of a pronounced recovery in the credit market, driven by firms' demand for loans to finance investment, working capital and inventories and households' demand for loans for house purchase. The expected GDP growth is being fostered by continued very positive annual growth in gross fixed capital formation and long-running annual growth in household consumption. The contribution of government consumption to GDP growth will rise in 2014 Q2, while the contribution of net exports will temporarily be negative.

GDP will grow by 2.9% **in 2014** as a whole, with economic growth being fostered by a recovery in external demand, the easing of the domestic monetary conditions via the weaker koruna and exceptionally low interest rates, and partly also by fiscal policy. The forecast expects fixed investment to continue rising during 2014,

CHART II.2.10

AVERAGE NOMINAL WAGE

Wage growth will pick up noticeably on the back of a recovery in economic activity and a gradual return of inflation to the target

(annual percentage changes; business sector – seasonally adjusted; non-business sector – seasonally unadjusted)

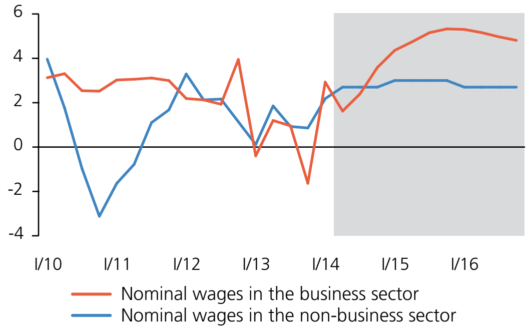


CHART II.2.11

GDP GROWTH FORECAST

GDP will grow at a rate of around 3% over the forecast horizon

(percentage changes; seasonally adjusted)

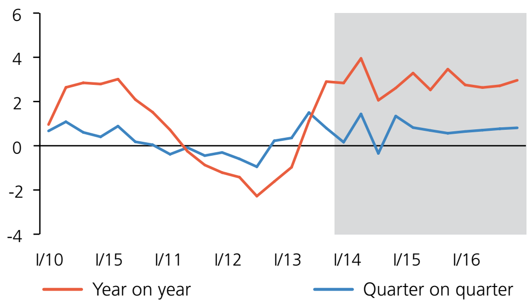
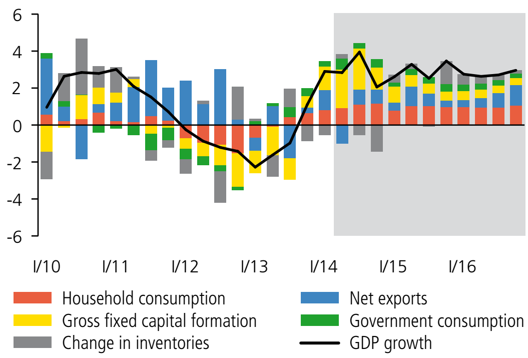


CHART II.2.12

ANNUAL GDP GROWTH STRUCTURE

All components of demand will contribute positively to GDP growth over the forecast horizon

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



especially in manufacturing. Gross fixed capital formation should also be supported by continued growth in general government investment connected with the drawdown of EU funds and by robust growth in government investment from domestic sources.[3] GDP growth will also be affected by cigarette frontloading, which will make it very volatile. Household consumption will continue to rise strongly on the back of accelerating wage growth and low inflation. As a result of the recovery in external demand and the weakening of the koruna, net exports will contribute positively to GDP growth (except in 2014 Q2) amid a gradual recovery in import-intensive domestic demand.

GDP will increase by 3% **in 2015**, boosted by a further slight increase in economic growth abroad in the first half of the year and relatively robust growth in domestic demand in an environment of more expansionary fiscal policy. Underlying this will be an expected further pick-up in government investment financed from both domestic and European sources. In addition to household consumption, gross capital formation will make a positive contribution. Due to increasing external demand, the contribution of net exports will also be positive despite continued growth in imports of consumer goods, machinery and equipment, and intermediate goods for production of export goods.

GDP growth will slow slightly to 2.8% **in 2016** due to an expected modest slowdown in external and domestic demand and slightly restrictive developments in the fiscal area. Gross capital formation will continue to increase, but its pace will be slowed by a decrease in investment growth in the government sector. The other components, i.e. household and government consumption and net exports, will also make positive contributions to GDP growth. A slight slowdown in export growth will primarily reflect the above-mentioned outlook for external demand.

The labour market was positively affected at the start of this year by the continuing economic recovery. The **number of employees converted into full-time equivalents** edged up year on year in 2014 Q1 following a long period of decline. A further pick-up in growth is expected in the rest of this year, fostered mainly by a rise in average hours worked per employee (see Chart II.2.13). Growth in the number of employees converted into full-time equivalents should average 0.9% in 2014 as a whole and rise further to 1.1% in 2015. A slightly slower pace is expected in 2016. Annual growth in **total employment** will stay approximately at the Q1 level until the end of this year and average 0.9% for 2014 as a whole (see Chart II.2.14). The forecast assumes a slight slowdown in 2015 and 2016, although this will be accompanied by renewed year-on-year growth in average hours worked per employee.

CHART II.2.13

NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENT)

The converted number of employees will steadily rise as the economy recovers

(annual percentage changes; contributions in percentage points)

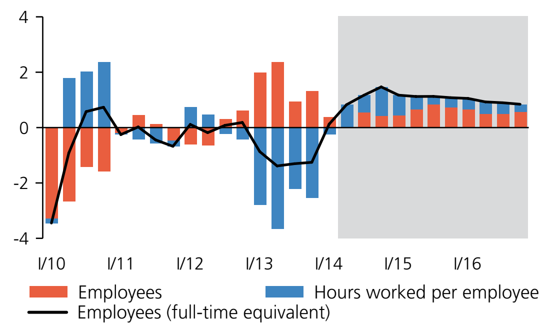
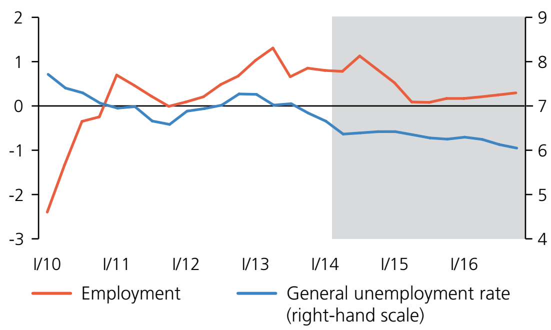


CHART II.2.14

LABOUR MARKET FORECAST

Total employment will continue rising slowly, while the unemployment rate will initially be flat and then start to go down again in 2015

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



3 The positive supply effect resulting from higher investment from EU funds from the 2007–2013 programme period is partly reduced in the forecast 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.

The forecast assumes that the seasonally adjusted **general unemployment rate** declined further to 6.4% in 2014 Q2. It will stay 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 continued economic growth – will prevail and the general unemployment rate will start to go down again 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 just below 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 unemployed persons is expected to fall further to 7% at the end of 2016 amid a slight decline in the population aged 15–64.

Growth in real **household consumption** accelerated to 1.5% in 2014 Q1 (see Chart II.2.15) due to an increase in expenditure on services for the first time in two years and continued growth in expenditure on non-durable and semi-durable goods. The forecast expects year-on-year growth in household consumption to continue rising in the rest of this year. A steadily rising consumer confidence indicator and renewed growth in disposable income suggest that the long-running growth in consumer demand is sustainable (see section III.3). Household consumption will thus rise by 1.9% in 2014 as economic activity recovers significantly, annual growth in wages and salaries accelerates and the effects of fiscal consolidation unwind. Consumption will continue to grow at a similar pace in 2015 and 2016.

Gross nominal disposable income turned positive again in 2014 Q1, due mainly to renewed growth in wages and salaries (see Chart II.2.16). The significant contribution of this highest-weight item was also affected by tax optimisation in late 2012 and early 2013 as well as by an incipient recovery in the labour market. Thanks to this recovery, wages and salaries will remain the biggest contributor to annual growth in gross nominal disposable income over the entire forecast horizon. Social benefits and profits of small businesses will also make positive contributions. Overall, nominal gross disposable income will rise by 3.2% this year and pick up further to around 4.5% in 2015 and 2016.

Following a sizeable decline at the end of 2013, the seasonally adjusted **household saving rate** edged up at the start of 2014 but remained well below 10%. The saving rate will gradually increase over the forecast horizon, mainly because of a recovery in wages and salaries (see Chart II.2.17). The saving rate will exceed 10% again in both 2015 and 2016 amid continued slightly faster growth in gross disposable income than in household nominal consumption.

CHART II.2.15

REAL HOUSEHOLD AND GOVERNMENT CONSUMPTION

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

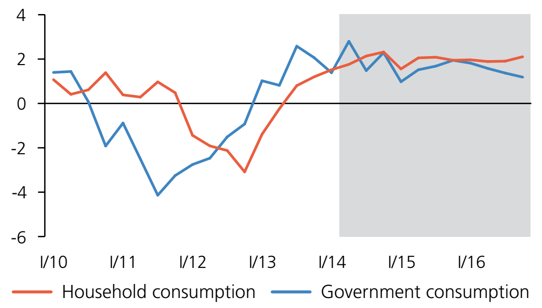


CHART II.2.16

NOMINAL DISPOSABLE INCOME

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

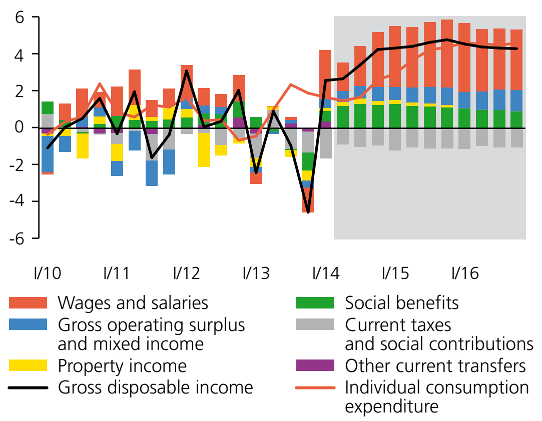


CHART II.2.17

HOUSEHOLD SAVING RATE

Following a sizeable decline in late 2013, the saving rate will increase slightly above 10% over the forecast horizon
(percentages)

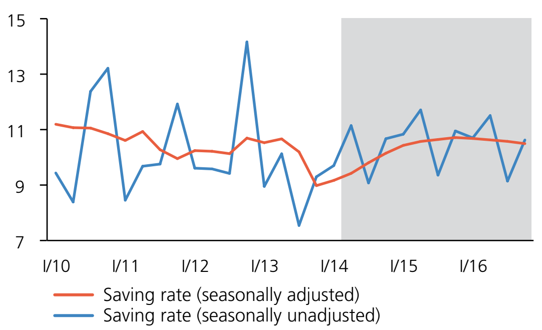


CHART II.2.18

GROSS CAPITAL FORMATION

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

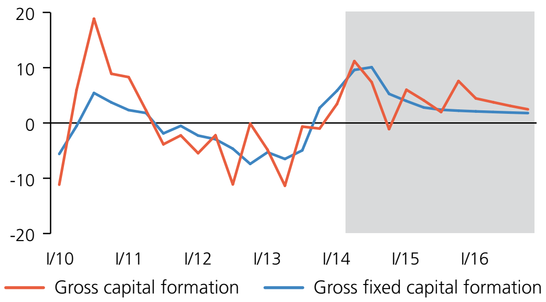


CHART II.2.19

REAL EXPORTS AND IMPORTS

Real exports and imports will increase as foreign and domestic demand recovers, aided by the weakened koruna
(annual percentage changes; annual changes in CZK billions; seasonally adjusted)

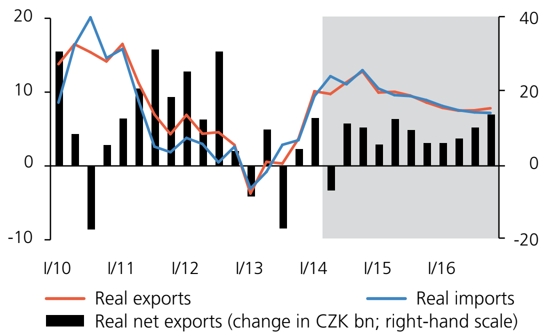


TABLE II.2.2

FORECASTS OF SELECTED VARIABLES

Real disposable income will rise as wage growth picks up, and labour productivity will also increase
(annual percentage changes unless otherwise indicated)

	2013 actual	2014 forec.	2015 forec.	2016 forec.
Real gross disposable income of households	-2.9	3.3	2.6	1.8
Total employment	1.0	0.9	0.2	0.2
Unemployment rate (in per cent)[a]	7.0	6.4	6.3	6.2
Labour productivity	-1.8	1.8	3.0	2.9
Average nominal wage	0.0	2.7	4.6	4.6
Average nominal wage in business sector	-0.2	2.8	4.9	5.1
Current account balance (ratio to GDP in per cent)	-1.4	-0.4	0.2	0.2
M2	4.4	4.5	5.7	5.1

a) ILO methodology, 15–64 years

Annual growth in real **government consumption** slowed slightly at the beginning of this year. Overall, government consumption will rise by 2%, mainly because of higher expenditure in health care year on year. It will maintain positive, albeit slightly lower, growth in the next two years (see Chart II.2.15), with increasing growth in nominal government consumption (as a result of a recovery in compensation of employees in the government sector and government intermediate consumption) being outweighed by a slightly accelerating deflator.

The annual growth rate of **gross capital formation** turned positive in 2014 Q1 for the first time in more than two years, despite a pronounced decline in inventories.[4] The recovery in gross capital formation was thus driven by a continued increase in year-on-year fixed investment growth. The forecast expects gross capital formation to record a sizeable annual rise in 2014 Q2 as well, fostered by the renewal of inventories for production and a continued recovery in fixed investment. As part of this, private investment will increase due to growing effective external demand and easy monetary conditions. Government investment will also pick up owing mainly to the drawdown of EU funds from the 2007–2013 programme period. Overall, gross capital formation will rise by 5.1% in 2014. It will maintain positive, albeit slightly lower, growth in 2015 and 2016 (see Chart II.2.18).

Real **exports of goods and services** accelerated markedly to around 10% in 2014 Q1. Thanks to accelerating external demand, favourable developments in foreign industrial orders and the continuing positive effect of the weakened koruna, export growth will increase slightly further in the rest of this year (see Chart II.2.19), averaging about 11% in 2014 as a whole. In 2015 it will slow to 9.5% on average. In 2016 it will decline further to 7.7% owing to slightly slower growth in external demand.

Real **imports of goods and services** also increased considerably in 2014 Q1. Imports of goods and services will also rise at a double-digit rate this year, by 11% in 2014 as a whole, on the back of accelerating export growth, a high import intensity of exports and renewed growth in domestic demand. In the next two years the forecast expects a slight slowdown in growth due to export developments.

The contribution of **net exports** at constant prices to annual GDP growth exceeded 1 percentage point in 2014 Q1. However, this contribution will temporarily turn negative in Q2 on account of the renewal of import-intensive inventories for production. It will then return to positive territory. Overall, the contribution of net exports to annual GDP growth will be positive at 0.4 percentage point in 2014, 0.6 percentage point in 2015 and 0.7 percentage point in 2016.

4 The frontloading of cigarettes at the end of 2013 in response to the increase in excise duty in 2014 had a negative effect on inventories in 2014 H1. 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 allowing stocks to be used for only two months subsequently.

The balance of payments forecast expects the **current account** deficit to shrink significantly from 1.4% of GDP in 2013 to 0.4% of GDP this year and shift to a slight surplus of around 0.2% of GDP in the next two years (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 a rise in the current transfers surplus compared to 2013. The rise in the goods and services surplus will be associated with the expected growth in external demand, the weakened koruna and a slight drop in commodity prices on world markets. A rising income deficit, linked mainly with higher earnings of non-residents on foreign direct investment in the Czech Republic and in 2015 and 2016 also with a growing deficit on interest income, will continue to affect the current account balance in the opposite direction than the goods and services balance. Current transfers should reach record-high surpluses in 2014 and 2015 owing to intensive expected drawdown of EU funds from the 2007–2013 programme period. In 2016 the current transfers surplus should decrease again as a result of lower drawdown of these funds after the switch to the new programme period.

The forecasted **capital account** surplus is due solely to drawdown of EU funds. 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 surplus will decline further in 2016 for the same reasons as the expected decrease in the current transfers balance.

The net inflow of **direct investment** will rise considerably in 2014 owing to expected much lower investment by residents abroad, a slight increase in reinvested earnings in the Czech Republic and a one-off credit operation of an extraordinary amount between a foreign parent company and its Czech subsidiaries with no link to real investment activity in the Czech Republic. In 2015 and 2016, in a context of accelerating growth of the European and Czech economies, the interest of both non-residents in domestic investment and residents in investment abroad should increase amid a rise in the overall surplus. The forecast assumes that investment will still primarily take the form of reinvested earnings, which will record an increasing surplus. As regards **portfolio investment**, a shift from a marked surplus to a slight deficit is expected this year, linked with the redemption of euro-denominated government bonds. Increased interest of residents in investing abroad, and, to a lesser extent, lower foreign funding of investment by government-controlled corporations, will also play a role. In 2015 and 2016, portfolio investment flows are expected to be broadly balanced amid slightly rising interest of residents in investing abroad and a stronger increase in interest of non-residents in Czech government bonds.

Table II.2.3

BALANCE OF PAYMENTS FORECAST

The current account should show a modest surplus next year
(CZK billions)

	2013 actual	2014 forec.	2015 forec.	2016 forec.
A. CURRENT ACCOUNT	-56.0	-15.0	10.0	10.0
Trade balance	188.0	235.0	255.0	290.0
Balance of services	53.0	65.0	70.0	75.0
Income balance	-312.4	-355.0	-355.0	-375.0
Current transfers	15.4	40.0	40.0	20.0
B. CAPITAL ACCOUNT	74.8	60.0	60.0	40.0
C. FINANCIAL ACCOUNT[a)]	185.4	65.0	35.0	75.0
Direct investment	33.2	160.0	85.0	115.0
Portfolio investment	91.9	-15.0	0.0	-10.0
Financial derivatives	4.7			
Other investment	55.6	-80.0	-50.0	-30.0
D. ERRORS AND OMISSIONS	-14.7			
E. CHANGE IN RESERVES (- = increase)	189.5			

a) forecast excluding operations of banking sector and financial derivatives

Table II.2.4

FISCAL FORECAST

Fiscal policy will be expansionary in 2014 and 2015 and slightly restrictive in 2016
(% of nominal GDP)

	2013 actual	2014 forecast	2015 forecast	2016 forecast
Government revenue	40.9	41.0	41.4	41.1
Government expenditure	42.3	42.2	42.9	42.1
of which: interest payments	1.4	1.4	1.4	1.4
GOVERNMENT BUDGET BALANCE	-1.5	-1.2	-1.5	-1.0
of which:				
primary balance [a]	-0.1	0.3	-0.1	0.4
one-off measures [b]	0.0	0.2	-0.2	0.1
ADJUSTED BUDGET BALANCE [c]	-1.4	-1.4	-1.3	-1.1
Cyclical component (ESCB method) [d]	-1.1	-0.6	-0.1	0.1
Structural balance (ESCB method) [d]	-0.3	-0.8	-1.2	-1.2
Fiscal stance in pp (ESCB method) [e]	1.8	-0.5	-0.4	0.0
Cyclical component (EC method) [d]	-1.2	-0.8	-0.3	0.0
Structural balance (EC method) [d]	-0.2	-0.6	-1.0	-1.1
Fiscal stance in pp (EC method) [e]	2.0	-0.4	-0.4	-0.1
Government debt	46.0	45.4	44.9	43.9

a) government budget balance minus interest payments
b) 2013–2016: impacts of pension reform and sales of emission permits
2014: impact of auction of mobile frequencies
2015: impact of extension of lease of supersonic fighter aircraft
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

The fiscal impulse will have an impact primarily through government investment over the forecast horizon
(contributions to GDP growth in percentage points)

	2013 actual	2014 forec.	2015 forec.	2016 forec.
Fiscal impulse	-1.0	0.2	0.5	-0.2
of which impact through:				
private consumption	-0.7	0.0	0.1	0.0
private investment	0.0	0.0	0.0	0.0
government investment, domestic	-0.3	0.0	0.1	0.0
government investment, EU funded	0.0	0.2	0.3	-0.2

The future macroeconomic developments described above and the current fiscal policy settings are reflected in the **government finance** outlook for 2014–2016 (see Table II.2.4).[5]

A further slight decrease in the government deficit to 1.2% of GDP is expected in **2014**, owing mainly to accelerating economic growth 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. The slightly restrictive effect of these measures 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 domestic sources 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).

In **2015** the general government deficit will increase to 1.5% of GDP despite continuing buoyant economic growth. This will reflect the abolition of fees in health care, the introduction of a second reduced VAT rate of 10%, an increase in benefits and deductible items for children and a one-off increase in pensions going beyond the restoration of the policy to increase them fully in line with inflation. The higher deficit will also be due to continuing rapid growth in government investment, driven by efforts to draw as much EU money as possible from the previous programme period. The rise in the overall deficit will also be supported by the accounting effect of an extension of the lease of supersonic fighter aircraft of 0.2% of GDP, although this will not have a real impact and is regarded as an extraordinary, or one-off, measure. On the other hand, the forecast no longer includes the 2011 tax reform measures, which will most likely be amended or abolished. All this implies that the expected effect of fiscal policy next year will be highly expansionary,[6] making a positive contribution to economic activity of around 0.5 percentage point.

In **2016** the general government deficit can be expected to fall to 1% of GDP as a result of continuing economic growth and the unwinding of the one-off effect of the lease of fighter aircraft. Government investment will decline year on year in a context of the end of the previous programme period for drawing down EU funds and the start of the new one. Fiscal policy will therefore be slightly restrictive in 2016, making a contribution to economic activity of around -0.2 percentage point.

5 In 2013, the general government deficit reached 1.5% of GDP. As a result, the ECOFIN Council terminated the Excessive Deficit Procedure (EDP) against the Czech Republic.
6 The forecast incorporates draft legislative changes aimed at implementing the government's programme declaration, which has already been approved by the government and passed on to the Czech Parliament.

The general government **structural deficit** fell sharply to around 0.3% of GDP in 2013. It will start increasing again this year and will slightly exceed the medium-term objective of 1% of GDP in 2015 and 2016.

The expected evolution of the general government deficit will lead to a decline in the **ratio of general government debt to GDP** to around 44% at the end of 2016. In addition to the expected borrowing requirements of general government owing to persisting deficits, the prediction of this ratio reflects the favourable effect of sizeable nominal GDP growth.

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. The expected exchange rate path is slightly weaker compared to the previous prediction. GDP growth has been revised upwards in 2014, mainly as a result of a faster expected recovery in private investment and stronger household consumption. In 2015, by contrast, GDP growth will be slower on account of less expansionary fiscal policy. The expected growth rate of nominal wages in the business sector this year has shifted higher, reflecting higher wage growth at the start of the year and stronger growth in economic activity. The interest rate path is lower, mainly reflecting a stronger anti-inflationary effect of the external environment and administered prices and a related postponement of the expected exit from the use of the exchange rate as a monetary policy instrument.

The forecast for annual **headline inflation** in 2014 and 2015 H1 is considerably lower than in the previous prediction (see Chart II.3.1). This is due to a lower outlook for administered prices and net inflation, reflecting short-term supply-side factors (weaker food price dynamics) as well as a significant downward revision of foreign producer prices. These factors are only partly offset by stronger wage growth and a weaker exchange rate slightly above the CNB's exchange rate commitment. The assumptions regarding the impacts of changes to indirect taxes have changed only marginally (owing to the inclusion of a second reduced VAT rate of 10%), so the outlook for **monetary-policy relevant inflation** has changed in a similar way as that for headline inflation.

The outlook for **administered prices** in 2014 has changed only marginally compared to the previous forecast. The administered price forecast for 2015 has shifted from positive annual growth to a slight decrease, mainly because of the inclusion of the government's plan to abolish fees in health care, which outweighs the expected less pronounced decline in electricity prices.

Compared to the previous forecast, annual **net inflation** is lower until mid-2015 (see Chart II.3.2), despite stronger growth in economic activity and a weaker exchange rate. Although these two factors will be reflected in higher adjusted inflation excluding fuels, they will be outweighed by more subdued growth in prices of food and fuels. At the end of 2015 net inflation shifts slightly higher as a result of higher wage growth in the previous period and a later exit from the exchange rate commitment.

Turning to the **assumptions regarding the external environment**, the producer price outlook for the effective euro area has been lowered compared to the previous forecast, more strongly reflecting the previous long-running downturn in economic activity, falling prices of agricultural commodities and energy on world markets and

CHART II.3.1

CHANGE IN THE HEADLINE INFLATION FORECAST

The forecast for headline inflation has been moved downwards considerably until mid-2015

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

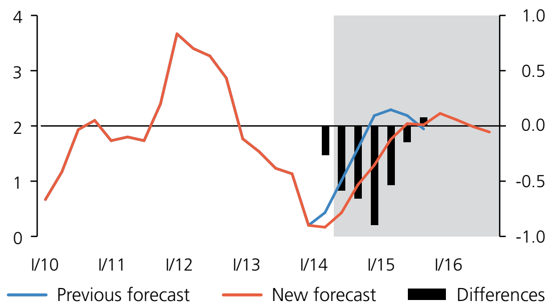
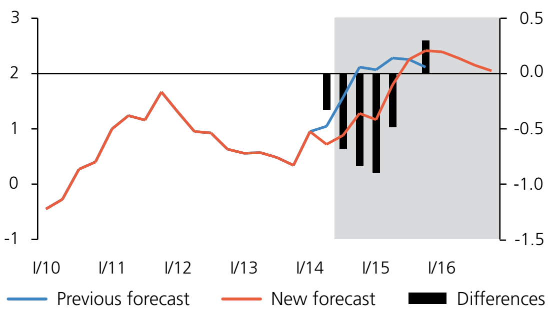


CHART II.3.2

CHANGE IN THE NET INFLATION FORECAST

The forecast for net inflation has been revised to a lower level until mid-2015

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



a stronger path of the euro-dollar exchange rate. The 3M EURIBOR outlook has shifted to a lower level (especially in the longer run) as a result of a further easing of monetary policy by the ECB. The outlook for external demand growth is also slightly lower this year, but is almost unchanged in the longer run.

The forecast for domestic market **interest rates** in 2015 has shifted lower (see Chart II.3.3). This is because the previous forecast had assumed a return to the standard monetary policy regime in early 2015, whereas the new forecast expects the exchange rate to be used as a monetary policy instrument until 2015 Q3 due mainly to a lower outlook for foreign producer prices and domestic administered prices. A lower outlook for foreign interest rates is also pushing down the 3M PRIBOR path.

In terms of both the current level and the outlook for the next few quarters, the **exchange rate of the koruna against the euro** is slightly weaker than assumed in the previous forecast, having stabilised around CZK 27.4 to the euro. The forecast expects that the use of the exchange rate will continue until 2015 Q3, i.e. longer than in the previous prediction.

The national accounts data for 2014 Q1 imply a more pronounced acceleration in **GDP** growth than assumed in the previous forecast. This is due to higher observed outcomes for household consumption, net exports and government consumption. Acting in the opposite direction was lower growth in gross capital formation, within which an unexpectedly sharp decline in inventories outweighed a more pronounced rise in fixed investment. GDP growth is forecasted to be 0.3 percentage point higher in 2014. Stronger economic growth will be fostered by a larger contribution of gross capital formation and household consumption, supported by higher growth in wages and salaries. By contrast, the GDP growth forecast for 2015 is 0.3 percentage point lower, mainly as a result of less pronounced fiscal expansion than in the previous forecast (see Chart II.3.4).

The contribution of **net exports** to GDP growth in early 2014 was larger than in the previous forecast. Despite a marked increase in exports – supported by the weaker exchange rate – the contribution of net exports over the rest of the forecast horizon will be smaller than in the previous prediction, as growth in the import-intensive components of domestic demand has been revised upwards.

The forecast for growth in the average **nominal wage** in the business sector in 2014 is slightly higher than in the previous forecast as a result of higher past outcomes and a faster recovery of the domestic economy. The forecast contains no significant revision of wage growth for 2015.

CHART II.3.3

CHANGE IN THE INTEREST RATE PATH

The market interest rate path is lower given the assumed later return to the standard monetary policy regime
(3M PRIBOR in %; differences in pp – right-hand scale)

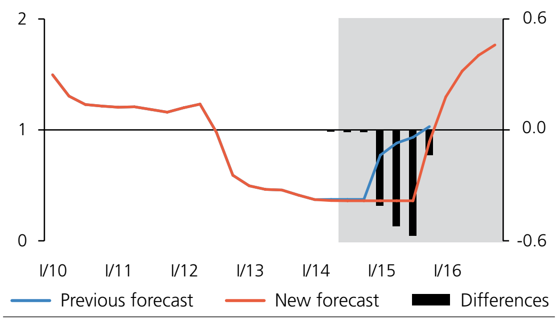


CHART II.3.4

CHANGE IN THE GDP FORECAST

The GDP growth forecast is slightly higher this year and slightly lower next year
(annual percentage changes; differences in pp – right-hand scale; seasonally adjusted)

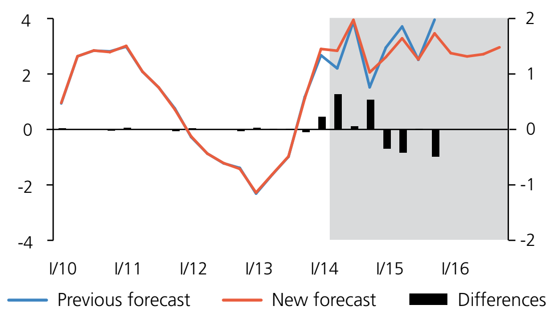


Table II.4.1

EXPECTED INDICATORS OF FMIE AND CORPORATIONS

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

	3/14	4/14	5/14	6/14	7/14
FMIE:					
CPI	2.4	2.3	2.1	2.2	2.1
CPI, 3Y horizon	2.1	2.1	2.0	2.0	2.0
Real GDP in 2014	2.1	2.1	2.2	2.5	2.5
Real GDP in 2015	2.6	2.5	2.6	2.7	2.7
Nominal wages in 2014	2.2	2.2	2.0	2.4	2.6
Nominal wages in 2015	3.0	3.1	3.0	2.9	3.0
CZK/EUR exchange rate (level)	26.9	27.0	27.0	27.0	27.1
2W repo rate (in per cent)	0.1	0.1	0.1	0.1	0.1
1Y PRIBOR (in per cent)	0.8	0.8	0.7	0.7	0.7
Corporations:					
CPI	1.9			1.8	

Chart II.4.1

PERCEIVED AND EXPECTED INFLATION

Perceived inflation and the inflation expectations of households decreased slightly in 2014 Q2
(source: European Commission Business and Consumer Survey)

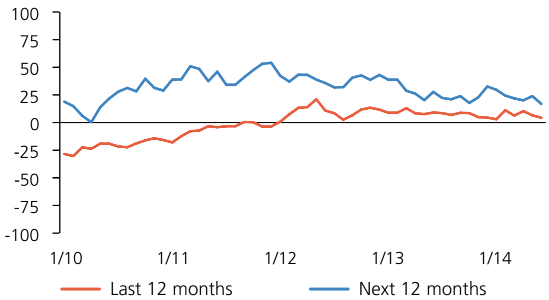


Table II.4.2

CF EXPECTED INDICATORS

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

	3/14	4/14	5/14	6/14	7/14
Real GDP in 2014	2.0	2.1	2.1	2.3	-
Real GDP in 2015	2.6	2.6	2.6	2.7	-
Nominal wages in 2014	2.0	2.3	2.0	2.2	-
Nominal wages in 2015	3.2	3.4	3.4	3.2	-
CZK/EUR exchange rate (level)	26.9	26.8	26.9	26.9	27.0
3M PRIBOR (in per cent)	0.5	0.5	0.5	0.5	-

II.4 FORECASTS BY OTHER ENTITIES

Analysts' inflation expectations have been at or slightly above the CNB's target at both the one-year and three-year horizons in recent months. The indicators of inflation perceived and expected by households are decreasing slightly. The analysts predict that the economy will grow by more than 2% this year and accelerate further next year. They expect wages to show similar developments. According to the analysts, the exchange rate of the koruna should appreciate towards CZK 27 to the euro at the one-year horizon. Almost all the analysts expect interest rates to be flat over the next twelve months. The market rate outlook one year ahead also indicates expectations of broad interest rate stability and is very close to the interest rate path consistent with the new CNB forecast over the entire forecast horizon.

Inflation expected by financial market analysts at the one-year horizon has been slightly above the CNB's target of 2% in recent months, while the inflation expectations of business managers have been slightly below the target so far in 2014 (see Table II.4.1). The inflation expected by analysts at the three-year horizon has constantly been flat at, or very close to, the target.

The indicator of **inflation perceived by households** has long been slightly positive (see Chart II.4.1). Households therefore feel on average that prices rose moderately over the last 12 months. The indicator of **expected inflation** is also positive. This implies 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. However, following a slight increase in the last two months of 2013 (i.e. after the CNB announced that it had started using the exchange rate as an instrument for easing monetary policy), the indicator of expected inflation has mostly declined again since the start of this year.

Both the FMIE and CF analysts expect GDP to grow by more than 2% this year (see Tables II.4.1 and II.4.2). Next year the economy should accelerate further and wage growth will also rise. The analysts expect the koruna to appreciate towards CZK 27 against the euro at the one-year horizon. Before the CNB Bank Board meeting in July, all twelve FMIE analysts were expecting no changes in key interest rates at this meeting. Almost all 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%.

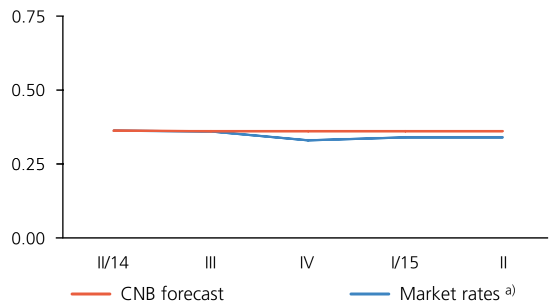
Overall, the analysts expect slightly lower real GDP growth both this year and the next **compared with the CNB's new forecast**. By contrast, inflation expected by the analysts at the one-year horizon is just above the CNB forecast. The analysts' expectations regarding the 2W repo rate and market rates are broadly in line with the 3M PRIBOR path consistent with the CNB forecast.

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 expected stability at least until mid-2015. This is in line with the analysts' outlook for the one-year horizon, which expects monetary policy interest rates to be left at technical zero and the current money market premium to remain unchanged. The market outlook is very close to the interest rate path consistent with the new CNB forecast over the entire horizon.

CHART II.4.2

FRA RATES VERSUS THE CNB FORECAST

The interest rate outlook derived from FRA quotations is in line with the interest rate path consistent with the new CNB forecast over the entire horizon
(percentages)



a) for 2014 Q2 and 2014 Q3 the 3M PRIBOR and for 2014 Q4–2015 Q2 the average values of the FRA 3*6, 6*9 and 9*12 rates for the last 10 trading days as of 18 July 2014

III. CURRENT ECONOMIC DEVELOPMENTS

III.1 INFLATION

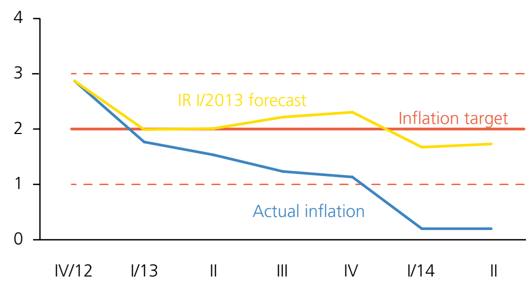
The CNB's decision of November 2013 to start using the exchange rate as an additional monetary policy instrument significantly contributed to averting the threat of deflation driven by insufficient demand and the economic downturn. Headline inflation has been at low but non-negative levels since the start of this year, averaging 0.2% in 2014 Q2. The price level adjusted for the effects of changes to indirect taxes was unchanged year on year in 2014 Q2. It is thus still well below the lower boundary of the tolerance band around the CNB's target. The weakened exchange rate has so far been feeding through to inflation mainly via higher import prices, but it has also contributed to faster growth in the domestic economy and to a positive change in the labour market. In line with the CNB's forecast, their previous long-term anti-inflationary effect has thus disappeared quickly. These factors are currently visible mainly in adjusted inflation excluding fuels, which is continuing to rise gradually after returning to positive values. The decline in annual inflation recorded in Q2 was thus also fostered by a significant slowdown in food price inflation.

III.1.1 Fulfilment of the inflation target

CHART III.1.1

FORECAST VERSUS ACTUAL INFLATION

Inflation was well below the IR I/2013 forecast in 2014 Q2
(year on year in %)



In 2014 Q2, 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 Q2, we have to examine the period roughly from October 2012 to March 2014, which takes into account the different lengths of transmission of interest rates and the exchange rate. This is because monetary policy passes through to inflation with a substantially shorter lag in the regime where the exchange rate is used as a monetary policy instrument than when 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 I/2013 forecast with subsequent inflation.

The **Inflation Report I/2013 forecast** expected headline inflation to be close to the CNB's 2% target in 2013 despite 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 generally subdued economic activity. The domestic economy was expected to remain slightly anti-inflationary until mid-2014. By contrast, the slightly inflationary contribution of import prices was expected to persist over the entire forecast horizon owing to steady growth in foreign producer prices and only slow appreciation of the exchange rate. The forecast assumed slowing growth in administered prices and food prices and a temporary decline in fuel prices.

Headline **inflation in reality** was below the forecast over the entire period and the deviation increased gradually. The 1.5 percentage point deviation of actual inflation from the forecast in 2014 Q2 was due to an unexpected decline in administered prices and low adjusted inflation excluding fuels, reflecting an unexpectedly strong anti-inflationary effect of the domestic economy over most of the forecast horizon. Food and fuel prices were in line with the forecast (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 were well below the forecast and turned negative in mid-2013. Foreign interest rates were rather lower, even though the forecast had assumed continued easy monetary policy of the ECB. Only oil prices were slightly higher than assumed in the forecast. The overall effect of external developments on domestic inflation in late 2013/early 2014 was thus anti-inflationary, fostering a need for noticeably easier monetary conditions.

Domestic market **interest rates** were broadly stable. They were affected by the zero lower bound on monetary policy rates amid a persisting money market risk premium. The **exchange rate** was much weaker than forecasted, owing – among other things – to CNB communication and, from November 2013 onwards, to the use of the exchange rate of the koruna as an additional instrument for easing monetary policy (see Table III.1.3).

Based on the CNB's current knowledge, the **developments in the Czech economy since the forecast under review was drawn up** can be summed up in the following way. Domestic GDP growth was lower in 2013 despite higher-than-expected government consumption. This was due to a sharp contraction in domestic demand in reaction to the uncertainty surrounding future economic developments, coupled with strongly restrictive fiscal policy. These factors were reflected mainly in an unexpectedly significant fall in investment. However, external demand was also slightly lower than forecasted. At the end of 2013, by contrast, GDP picked up pace, thanks mainly to increasing real household and government consumption and investment. Real household consumption growth turned positive in 2013 despite falling real wages, reflecting their unexpected slowdown in nominal growth and decline in late 2013. Exports and imports also lagged behind the forecast in 2013, but were higher in 2014 thanks, among other things, to the weakening of the koruna.

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 low adjusted inflation excluding fuels

(annual percentage changes; contributions in percentage points)

	IR I/2013 forecast	2014 Q2 outturn	Contribution to total difference
CONSUMER PRICES	1.7	0.2	-0.5
Breakdown into contributions:			
administered prices	3.0	-3.6	-1.1
first-round impacts of changes to indirect taxes[a)]	0.1	0.2	0.1
food prices[b)]	1.5	1.4	0.0
fuel prices[b)]	1.0	1.0	0.0
adjusted inflation excl. fuels[b)]	1.3	0.4	-0.5

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

Table III.1.2

FULFILMENT OF THE EXTERNAL ASSUMPTIONS

External factors had an anti-inflationary effect on domestic inflation overall, fostering a need for noticeably easier monetary conditions

(annual percentage changes unless otherwise indicated)

		I/13	II/13	III/13	IV/13	I/14	II/14
GDP in euro area[a), b), c)]	p	-0.2	0.4	0.7	1.5	1.7	1.7
	o	0.0	0.5	0.5	1.1	1.3	-
PPI in euro area[b), c)]	p	1.3	1.8	2.0	2.1	2.2	2.2
	o	1.1	0.0	-0.3	-0.8	-1.5	-
3M EURIBOR	p	0.2	0.3	0.3	0.4	0.4	0.5
(percentages)	o	0.2	0.2	0.2	0.2	0.3	0.3
USD/EUR exchange rate	p	1.28	1.25	1.26	1.25	1.24	1.23
(levels)	o	1.32	1.31	1.32	1.36	1.37	1.37
Brent crude oil price	p	111.5	109.6	107.9	106.2	104.8	103.5
(USD/barrel)	o	112.9	103.3	109.7	109.4	107.9	109.8

p – prediction, o – outturn
a) at constant prices
b) seasonally adjusted
c) IR I/2013 outlook for effective indicator

Table III.1.3

FULFILMENT OF THE FORECAST FOR KEY VARIABLES

Observed GDP growth was initially below the forecast, but has been faster since the end of 2013

		I/13	II/13	III/13	IV/13	I/14	II/14
3M PRIBOR	p	0.5	0.5	0.4	0.3	0.4	0.4
(percentages)	o	0.5	0.5	0.5	0.4	0.4	0.4
CZK/EUR exchange rate	p	25.5	25.3	25.2	25.1	25.1	25.0
(levels)	o	25.6	25.8	25.9	26.7	27.4	27.4
Real GDP[a)]	p	-1.1	-0.6	0.0	0.4	1.3	1.8
(annual perc. changes)	o	-2.3	-1.6	-1.0	1.1	2.9	-
Nominal wages[b)]	p	1.4	1.8	2.0	1.9	2.9	2.8
(annual perc. changes)	o	-0.6	1.0	1.5	-2.3	3.6	-

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

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**. The Bank Board assessed the risks of the forecasts mostly as being either balanced or slightly on the downside over the entire key period. As the zero lower bound on interest rates had been reached, the CNB at the start of 2013 started communicating its readiness to use the koruna exchange rate as an instrument if 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. The main parameters of the exchange rate commitment and the related CNB communication were not changed at the following monetary policy meetings during the key period.

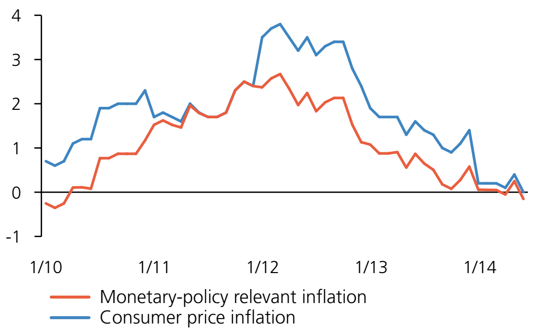
Overall, monetary policy in the key period can be assessed as follows. With the benefit of hindsight, it can be said that most of the identified risks materialised in the key period, with anti-inflationary risks clearly prevailing overall. The stronger domestic anti-inflationary factors and more subdued inflation in the euro area were only partly offset by a weaker koruna, affected initially by CNB communication and from November 2013 onwards also by the CNB's exchange rate commitment. The weakened exchange rate has so far been feeding through to prices in line with the CNB's assumptions, with headline inflation having been at very low – albeit non-negative – levels since the start of 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 contributed significantly to averting the threat of deflation driven by insufficient demand and the economic downturn. Without this measure, headline inflation would have been strongly negative in 2014 H1, as the estimated effect of the weakening of the koruna on inflation is about 1 percentage point. Overall, based on current knowledge, it seems that the monetary policy pursued between October 2012 and March 2014 should have been substantially easier, i.e. the monetary policy easing implemented via the weakening of the koruna should have been made earlier and possibly with even greater force.

CHART III.1.2

INFLATION

Annual inflation was at very low levels in 2014 Q2

(year on year in %)



III.1.2 Current inflation

Annual inflation[7] was at low levels in 2014 Q2 and was somewhat lower than expected. After a modest increase in May (to 0.4% from 0.1% in April) the price level was flat in year-on-year terms in June (see Chart III.1.2). This was largely due to unexpectedly low growth in food prices, which switched to a slight year-on-year decline in June. Lower inflation also continued to be fostered by the pronounced annual decline in administered prices observed since the start of 2014.

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

Turning to the **structure of annual inflation**, the decline in administered prices was offset mainly by rising food prices in April and May. However, this growth came to an end in June (see Chart III.1.3). Market prices excluding food and fuel prices, which returned to growth in April after a very long period of annual decline, were thus the main inflationary component. Changes to indirect taxes associated with a harmonisation increase in excise duty on cigarettes and tobacco introduced in January 2014 also had a slight inflationary effect.

The contribution of changes to **indirect taxes** to annual market price inflation was almost 0.2 percentage point in 2014 Q2 and was due exclusively to harmonisation adjustments to excise duty on cigarettes and tobacco made at the start of 2013 and the start of 2014. Their impact on consumer prices is spread over time owing to substantial frontloading of tobacco products by retailers.

Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of all the changes to indirect taxes, fell to slightly negative levels in June (-0.2%). It was thus again well below the lower boundary of the tolerance band around the CNB's target.

The year-on-year decline in **administered prices**, caused by a sharp fall at the start of this year, continued into 2014 Q2, although its pace slowed somewhat compared to the previous quarter, reaching -3.2% in June (see Chart III.1.4). As mentioned in the previous Inflation Report, the annual decline in administered prices was caused by a reduction in retail energy prices (decreases in electricity and natural gas prices and a significant weakening of heat price growth) and the abolition of hospital stay fees amid a small increase in water supply and sewerage collection charges at the start of 2014. This trend was gradually offset slightly by other items of administered prices, particularly in health care, where the biggest contribution came from rising prices of medicines and spa stays. The following text describes the year-on-year evolution of the main components of market price inflation adjusted for the tax changes.

Annual **market price inflation**, as measured by net inflation, fell in 2014 Q2 (from 0.9% in March to 0.4% in June). The fall in annual net inflation was due to much lower food price growth compared to the previous quarter. By contrast, the return of adjusted inflation excluding fuels to positive figures and renewed modest growth in fuel prices acted in the inflationary direction. Annual market price inflation remained low overall in 2014 Q2. Its structure, however, now clearly reflected the effect of the weakened koruna and the continuing economic recovery on consumer prices.

Food prices made the strongest contribution to inflation in April and May, but their annual growth turned slightly negative in June (from 2.2% in May to -0.1% in June). This fall, which came on the back of a very long period of growth (since mid-2010), was due mainly to

CHART III.1.3

STRUCTURE OF INFLATION

The very low inflation is due to a decline in administered prices together with the fading out of growth in food prices in June
(annual percentage changes; contributions in percentage points)

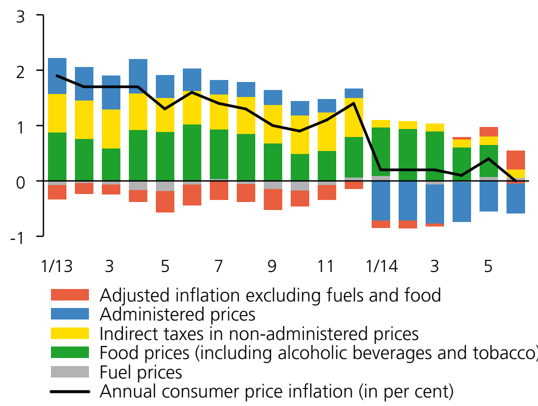


CHART III.1.4

INFLATION COMPONENTS

Administered prices continued to decline in 2014 Q2, food price inflation fell sharply in June, and adjusted inflation excluding fuels went up
(annual percentage changes; excluding indirect tax changes except for administered prices)

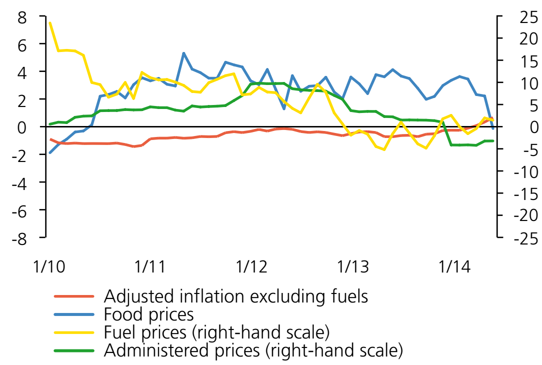


CHART III.1.5

FOOD PRICES

Annual food price inflation turned slightly negative in June
(annual percentage changes)

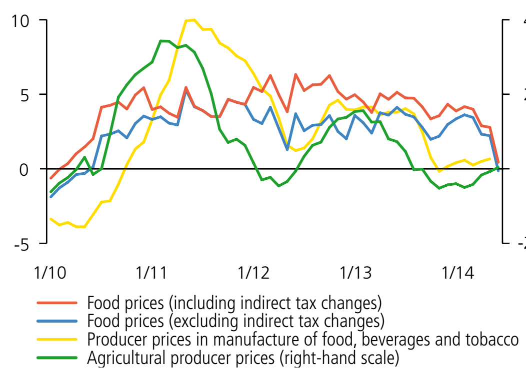


CHART III.1.6

STRUCTURE OF FOOD PRICE INFLATION

The decline in food prices in June was due mainly to prices of vegetables (including potatoes) and fruit
(contributions in percentage points to annual percentage changes)

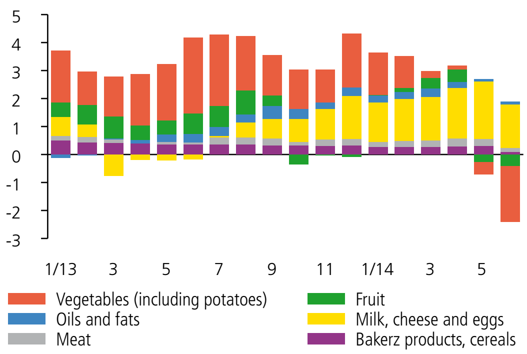
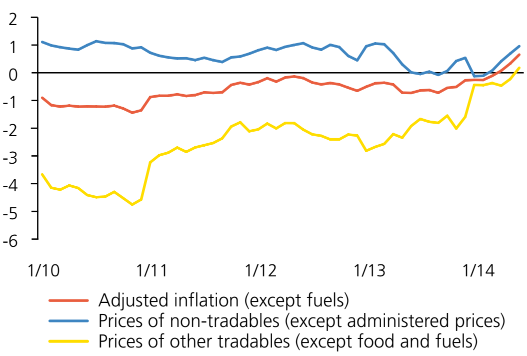


CHART III.1.7

ADJUSTED INFLATION EXCLUDING FUELS

Adjusted inflation excluding fuels returned to positive levels in 2014 Q2, aided by both its components
(annual percentage changes)



a sharp year-on-year fall of 53.3% in prices of new potatoes in June.[8] However, the downward trend in food price inflation was apparent across all components, reflecting a sustained fall in agricultural producer prices (see Chart III.1.5) and a pronounced slowdown in growth of food import prices. Annual growth in prices of dairy products and poultry slowed markedly (see Chart III.1.6). Year-on-year price decreases were recorded for fruit and bakery products (5.5% and 1.0% respectively).

After almost five years, annual **adjusted inflation excluding fuels** returned to positive levels in April and increased further in May and June (to 0.3% and 0.7% respectively; see Chart III.1.7). This was fostered by the return of **prices of other tradable commodities** to annual growth (of 0.2% in June) after a long period of decline. These prices thus clearly reflected the weakening of the exchange rate. The increase in adjusted inflation in Q2 was moreover due to **prices of non-tradable commodities**,[9] whose annual growth rose to 1.0%. They were most affected by factors associated with the pronounced recovery in domestic economic activity.

Fuel prices returned to annual growth in 2014 Q2 (1.5% in June). This change stemmed from global petrol prices, which reflected an increase in the price of Brent crude oil connected with the ongoing conflicts in Ukraine and the Middle East.

8 The month-on-month increase in prices of (new) potatoes in June 2013 (85.9%) had been much higher than usual owing to a poor harvest. By contrast, potato prices recorded a correction in June this year, falling by 10% month on month.
9 This segment consists mainly of services.

III.2 IMPORT PRICES AND PRODUCER PRICES

Annual growth in import prices slowed further in the first two months of 2014 Q2. 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 non-energy commodities. The annual decline in industrial producer prices moderated gradually and was only weak in June. This was due to a continuing year-on-year decline in producer prices in the energy industry amid renewed year-on-year growth in producer prices in manufacturing. Prices of market services for the business sector and construction work prices switched to growth in 2014 Q2 amid a continuing recovery of economic activity.

III.2.1 Import prices

Following a year-on-year surge at the end of 2013 reflecting the November weakening of the koruna, the rate of growth of **import prices** has been slowing so far in 2014 and stood at 1% in May (see Chart III.2.1).

This slowdown was mostly due to **products with a high degree of processing**. Nonetheless, they were still the largest contributor to overall annual import price inflation in May (see Chart III.2.2). Within this import category, the categories of machinery and transport equipment and miscellaneous manufactured articles both recorded lower annual import price growth in the period under review. In the former category, annual import price growth slowed to 1.6% in April and then rose to 2% in May.[10] Annual import price inflation in the latter category was noticeably lower, reaching just 0.3% in May (see Table III.2.1).

The slowing annual growth in import prices of **semi-finished products** observed since the start of 2014 has also contributed significantly to a lower rate of growth of import prices since the start of this year (see Chart III.2.2). Their growth increased only slightly compared to April to 2% in May. However, import prices of **food and live animals** still rose quite quickly (by 4.8% in May), even though their growth rate also slowed noticeably.

Import prices of **non-energy commodities**, which temporarily returned to growth following the November exchange rate weakening, started falling again in March (by 5.3% in May). Import prices of **mineral fuels** also helped to slow annual import price inflation, as

10 However, import prices in this category showed very mixed trends. In May, import prices of general industrial machinery and equipment and electrical equipment showed the fastest growth (4.7% and 4.2% respectively), while those of road vehicles recorded modest growth (0.5%) and those of office machines and automatic data processing machines went down (-0.9%).

CHART III.2.1

IMPORT PRICES AND PRODUCER PRICES

Import price inflation fell further, prices in industry went down slightly overall, and prices in construction and market services recorded renewed growth

(annual percentage changes)

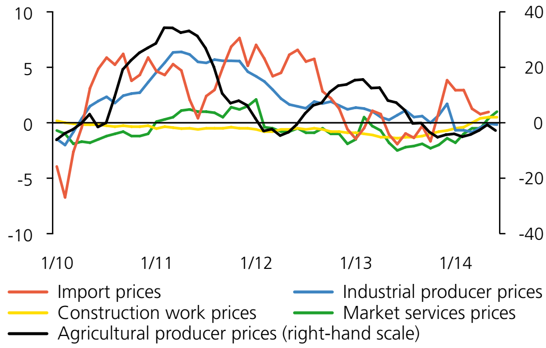


CHART III.2.2

IMPORT PRICES

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

(annual percentage changes; contributions in percentage points)

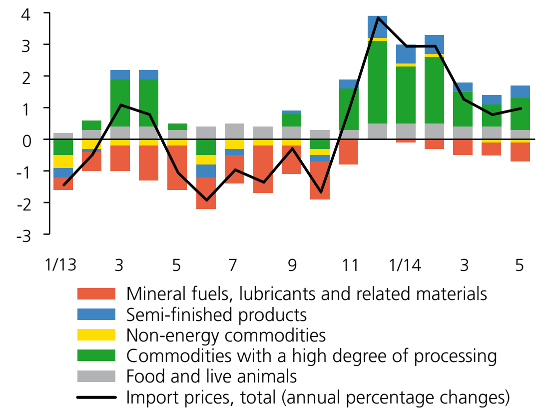


CHART III.2.3

MINERAL FUELS AND LUBRICANTS

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

(annual percentage changes)

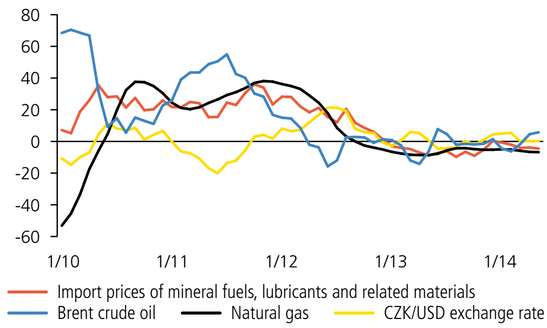


TABLE III.2.1

STRUCTURE OF IMPORT PRICE INFLATION

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

	2/14	3/14	4/14	5/14
IMPORTS, TOTAL	2.9	1.3	0.8	1.0
of which:				
food and live animals	8.2	6.4	6.2	4.8
beverages and tobacco	6.1	3.9	4.4	2.7
crude materials inedible, except fuels	3.9	-1.3	-3.9	-5.3
mineral fuels and related products	-2.0	-4.1	-3.8	-4.5
animal and vegetable oils	-12.9	-11.8	-8.9	-7.7
chemicals and related products	1.8	0.5	0.3	1.2
manufactured goods classified chiefly by material	3.1	1.9	1.6	2.0
machinery and transport equipment	3.8	1.9	1.6	2.0
miscellaneous manufactured articles	3.3	1.5	0.3	0.3

CHART III.2.4

INDUSTRIAL PRODUCER PRICES

The year-on-year decline in industrial producer prices was weak in June
(annual percentage changes; contributions in percentage points)

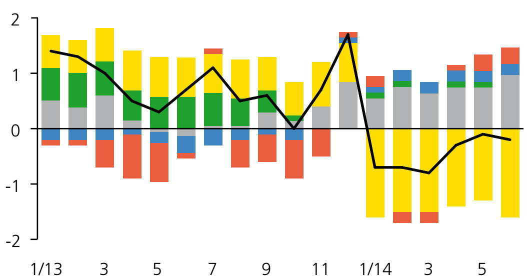
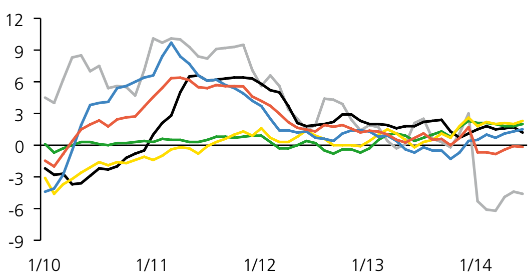


CHART III.2.5

PRODUCER PRICES BY MAIN INDUSTRIAL GROUPINGS

The decline in industrial producer prices was due to a fall in energy producer prices, as prices in other categories went up
(annual percentage changes)



their annual decline deepened to 4.5% in May. They were affected by a continuing fall in global gas and coal prices. The weakened koruna-dollar exchange rate had a negligible opposite effect, as the weakening of the koruna against the euro was largely offset by appreciation of the euro against the dollar. Global oil prices meanwhile switched from decline to year-on-year growth in April (see Chart III.2.3).

III.2.2 Producer prices

Industrial producer prices

After a marked year-on-year decline in 2014 Q1, mainly as a result of falling electricity, gas and steam prices, **industrial producer prices** recorded a more modest fall in 2014 Q2. Underlying this change was renewed growth in producer prices in the primary oil processing sector accompanied by faster growth in prices of high-value-added commodities. According to the latest data for June, the overall decline in industrial producer prices was weak (at 0.2%; see Chart III.2.4).

It is apparent from the **structure of industrial producer price inflation** that the insignificant annual decline at the end of 2014 Q2 was a result of a continuing decline in energy producer prices (see Chart III.2.5) and, on the other hand, a continuing increase in producer prices in manufacturing. As mentioned in previous Inflation Reports, the falling electricity prices were due in part to changes in the European coal and electricity market.[11] This factor also affected coal prices on the domestic market, which kept falling year on year in 2014 Q2. However, global oil prices, whose impact on domestic prices has also been affected by the weakening of the exchange rate, returned to year-on-year growth in April and contributed to renewed growth in producer prices in the primary oil processing sector. By contrast, the effect of the still relatively fast growing import prices of food has yet to be reflected noticeably in producer prices in the food industry, as they were flat in June. A modest pick-up in producer price inflation in the other branches of manufacturing in 2014 Q2 probably reflected the weakening of the koruna as well as a gradual recovery in demand for their products.

Turning to the **individual branches of manufacturing**, producer prices in the manufacture of coke and refined petroleum products recorded the fastest growth in 2014 Q2, rising by 4.2% in June after a decline of almost 3% in March for the reasons given above. The year-on-year increase in prices in this branch was also partly due to base effects. The moderate annual producer price growth in the food industry switched to stagnation in June, mainly because of still falling prices of domestic inputs of vegetable origin. Prices in the manufacture of basic metals and fabricated metal products continued

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

to show modest year-on-year growth (2.1% in June). Inflation in the other branches of manufacturing, comprising the manufacture of high-value-added products, rose slightly in 2014 Q2 (see Chart III.2.4). Several branches contributed to this rise.[12]

Prices in **mining and quarrying** showed a persisting annual decline, which deepened slightly further compared to the previous quarter (to -4.8% in June). This was largely due to coal prices, which have been falling since the start of this year. Consistent with this was a fall in producer prices in the **electricity, gas, steam and air-conditioned air industries**, which have been declining by almost 9% since the start of 2014 (8.7% in June; see Chart III.2.6). 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 (by 3.4% in June).

Agricultural producer prices

The annual decline in **agricultural producer prices** observed since August 2013 moderated in 2014 Q2 (see Chart III.2.7). The decline was 2.8% in June, down by 1.4 percentage points from the end of the previous quarter. However, price developments in the two main components of agricultural producer prices remained very different. Livestock product prices continued to show pronounced annual growth (8.6% in June), due almost entirely to milk prices. By contrast, crop product prices kept falling, although the decline moderated in 2014 Q2 (to 11.6% in June). This trend was particularly apparent for cereals and oilseeds, which had contributed significantly to the large decrease in crop product prices in the previous period. At the same time, the substantial growth in potato prices observed for almost two years switched to a year-on-year decline at the end of 2014 Q2.

The **main cause** of the falling agricultural producer prices in 2013 H2 and early 2014 was the above-average harvest in 2013 (particularly of cereals and oilseeds), both in the Czech Republic and abroad. At the end of 2013, this factor was partly offset by the year-on-year weakening of the koruna, which gradually passed through to domestic agricultural producer prices during the first half of this year. The moderation of the decline in agricultural commodity prices in 2014 H1 was also due to short-term factors, most notably an extremely hard winter in the USA and the unstable geopolitical situation in Ukraine. However, their impact was dampened by favourable outlooks for crop production this year, when global stocks should increase despite expected growth in global consumption. The increase in livestock product prices was predominantly due to milk prices, whose growth was due to constantly rising global demand combined with falling global production in the second half of last year.

12 Prices in the wood processing industry recorded significant year-on-year growth (of 4.3%). Producer prices in the manufacture of chemicals and chemical products and machinery and equipment increased as well (by 2.3% and 0.9% respectively). Annual growth in prices in the manufacture of transport equipment returned to 4% in June.

CHART III.2.6

PRICES OF ENERGY AND WATER-RELATED SERVICES

Electricity prices have been falling sharply since the start of 2014
(annual percentage changes)

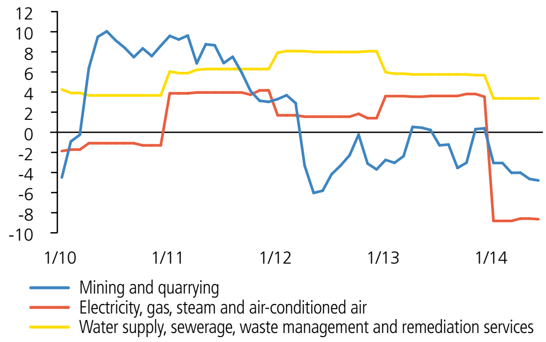


CHART III.2.7

AGRICULTURAL PRODUCER PRICES

The decline in agricultural producer prices moderated in 2014 Q2
(annual percentage changes)

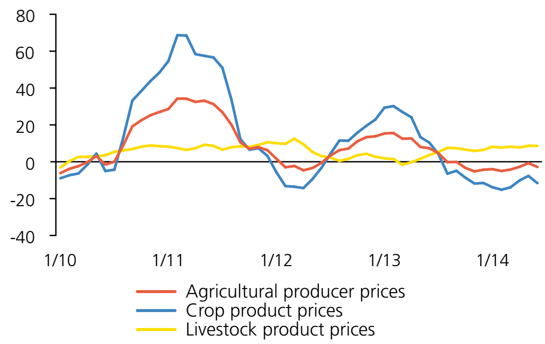
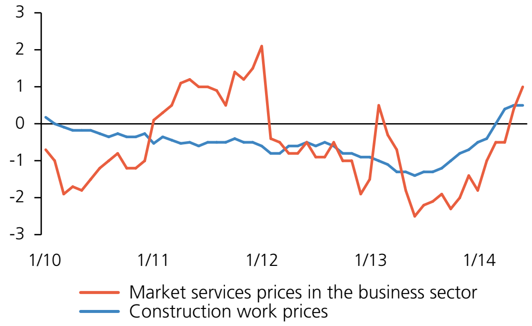


CHART III.2.8

OTHER PRICE CATEGORIES

Prices of construction work and market services switched to modest annual growth following a lengthy decline
(annual percentage changes)



Other producer prices

In 2014 Q2, **construction work prices** continued to reflect the recovery in construction production observed since late 2013/early 2014. Following a lengthy decline, construction work prices switched to modest annual growth (0.5% in June; see Chart III.2.8). Prices of materials and products used in construction continued to show modest growth (1% in June).

Prices of market services for the business sector also saw renewed growth after almost two years of decline (1% in June; see Chart III.2.8). In June, prices of most services were flat or rising. The largest price growth was recorded by postal and courier services (8.2% year on year). Growth in prices of other services was modest and did not exceed 3%. Only in advertising services and market research and in rental and operational leasing services were prices still falling.

III.3 DEMAND AND OUTPUT

Annual real GDP growth picked up significantly to 2.9% in 2014 Q1. In quarter-on-quarter terms, economic activity increased by 0.8%. The year-on-year GDP growth was due to most components of domestic demand; only the contribution of change in inventories was negative. With export growth extending its lead over 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 output gap started to close gradually.

III.3.1 Domestic demand

Annual **domestic demand** growth rose to 2% in 2014 Q1. It was driven mainly by fixed investment, whose growth rate rose significantly compared to the previous quarter (see Chart III.3.2). The positive contribution of household consumption increased as well, whereas that of government consumption was slightly lower than in the previous quarter. An annual decline in change in inventories continued to foster a slowdown in domestic demand growth, but to a lesser extent than in the previous quarter.

Final consumption

Real **final consumption expenditure of households** continued to grow in 2014 Q1, as it has been since 2013 Q3. At 1.5%, the annual growth was 0.3 percentage point higher than in the previous quarter.[13] The growth rate of household consumption expenditure increased thanks to renewed growth in households' real gross disposable income. Its downward trend, observed since 2011, thus came to an end (see Chart III.3.3).

This significant change in the growth rate of **gross nominal disposable income**, which is the main source of financing of households' consumption expenditure, was partly due to tax optimisation in late 2013/early 2014. Owing to base effects, this optimisation also had a strong effect on year-on-year wage growth at the end of 2013 and the start of 2014. At the start of this year, however, wage growth was also driven by rising productivity and increasing labour demand in an environment of continuing economic recovery (see section III.4.2). Nominal gross disposable income grew by 2.6% year on year in 2014 Q1. Its **real purchasing power** increased by 2.3% year on year amid low inflation.[14]

13 According to seasonally adjusted CZSO data.
14 As measured by the household consumption deflator.

CHART III.3.1

GROSS DOMESTIC PRODUCT

Annual GDP growth picked up significantly in 2014 Q1
(annual and quarterly percentage changes at constant prices; seasonally adjusted data)

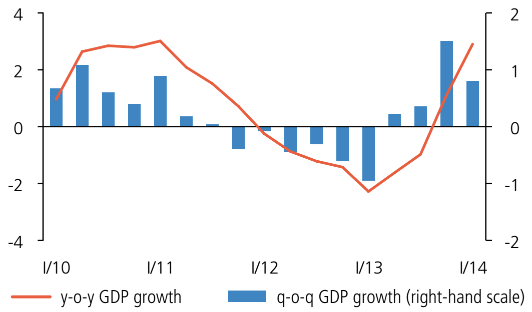


CHART III.3.2

STRUCTURE OF ANNUAL GDP GROWTH

All components of demand except inventories contributed to the annual GDP growth in 2014 Q1
(contributions in percentage points; seasonally adjusted data)

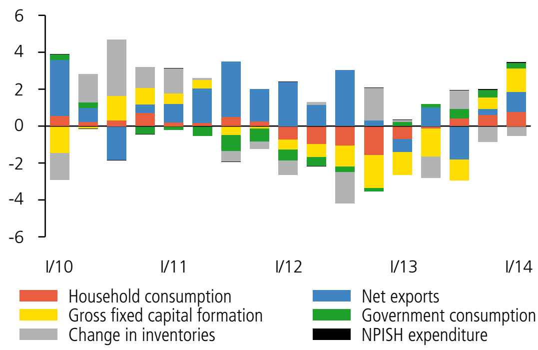


CHART III.3.3

HOUSEHOLD CONSUMPTION EXPENDITURE

Gross disposable income recorded renewed growth in 2014 Q1
(annual percentage changes; seasonally unadjusted data)

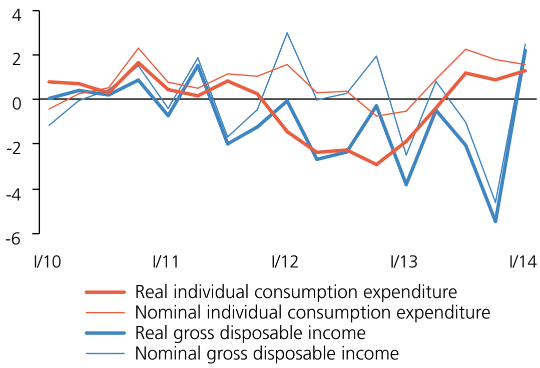


CHART III.3.4

DISPOSABLE INCOME

All components of household income contributed to the renewed growth in nominal gross disposable income

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

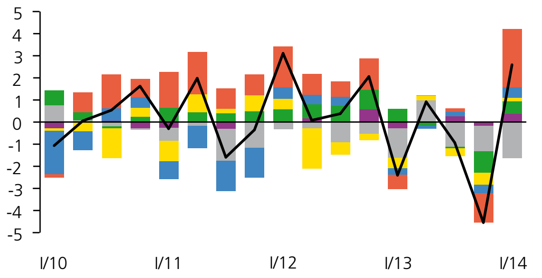


CHART III.3.5

STRUCTURE OF HOUSEHOLD CONSUMPTION

Households channelled their increased spending mostly into services in 2014 Q1

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

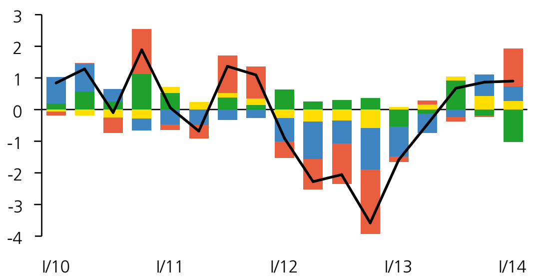
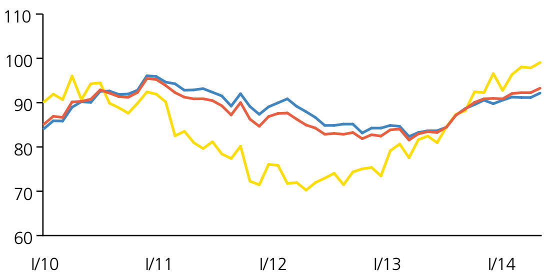


CHART III.3.6

CONFIDENCE INDICATORS

Consumer and business confidence increased further

(2005 average = 100; source: CZSO)



In 2014 Q1, the **structure** of the annual growth in households' nominal gross disposable income was dominated by wages and salaries, which are its largest component in terms of volume (see Chart III.3.4).[15] Business income (gross operating surplus plus mixed income), which had still been falling in the previous quarter, contributed to disposable income growth to a lesser extent. Rising property income, social benefits and other transfers, which had also decreased in 2013 Q4, showed similar developments. Only the contribution of taxes and social contributions to annual gross disposable income growth was negative as usual in 2014 Q1.

With nominal gross disposable income rising faster than households' consumption expenditure, the **saving rate** increased slightly above 9% in 2014 Q1 (see Chart II.2.17). Consumer credit growth picked up slightly year on year (by 0.3 percentage point to 2.7% compared to December 2013), but was still subdued (see section III.5).

In these circumstances, the continuing household consumption growth was accompanied by partial changes in the **structure of household consumption expenditure**. Whereas in 2013 Q4 households had channelled their increased spending primarily into purchases of non-durable goods, in 2014 Q1 the biggest increase was recorded for expenditure on services (see Chart III.3.5). At the same time, expenditure on non-durable and semi-durable goods continued rising year on year. On the other hand, households reduced their expenditure on durable goods. In 2013 Q4 and 2014 Q1, households thus concentrated most on increasing their spending on current consumption goods (services and non-durable goods),[16] which had long been mostly declining.

According to the latest available **leading indicators**, seasonally adjusted annual retail sales growth stayed positive in April and May 2014, although it was lower than in previous months. This was apparent not only in the still quickly rising automotive segment, but also, to a lesser extent, in the rest of the retail sector. In the non-motor-vehicle segment, annual growth in retail sales[17] of non-food goods continued decreasing, whereas annual growth in sales of food goods fluctuated from clearly positive to slightly negative values owing to a different timing of Easter shopping than last year. The consumer confidence indicator continued to go up gradually. In particular, there was an improvement in perceptions of the outlook for the economic and financial situation of households and also for unemployment (see Chart III.3.6).

Annual growth in real **government final consumption expenditure** slowed slightly in 2014 Q1 compared to the previous quarter, to 1.4%.

15 In 2014 Q1, households' wages and salaries accounted for 62% of total gross disposable income.
16 This spending accounts for almost 90% of household consumption expenditure.
17 According to seasonally unadjusted data.

Investment

With economic activity recovering, year-on-year growth in **fixed investment** rose to 5.8%[18] in 2014 Q1 (see Chart III.3.7). In quarter-on-quarter terms, investment growth slowed somewhat following a previous strong increase, but still reached almost 2%.

The continued recovery in investment activity in 2014 Q1 was mostly driven by **non-financial corporations** (see Chart III.3.7). The 8.5% annual growth in fixed investment in this sector was linked mainly with a sharp rise in investment in machinery and equipment. Non-financial corporations also probably contributed to the fast growing investment in transport equipment and buildings and structures (see Chart III.3.8). The continuing 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 June 2014, non-financial corporations also expect investment to increase at the six-month and twelve-month horizons.[19]

Overall investment growth in 2014 Q1 was also supported by investment in the **government sector**, which has mostly been falling in the last two years (see Chart III.3.7). The renewed growth in government investment (11.2% year on year) was chiefly due to an increased effort to accelerate the drawdown of EU funds, which is time-limited. This resulted in a higher number of public contracts signed in 2013 H2, which started to be implemented in 2014.

However, investment in the **household sector** was still falling (by 9.3% year on year) in 2014 Q1. Leading indicators so far indicate only a slow improvement in households' investment in dwellings,[20] which is the main component of household investment. Household confidence in future growth of the economy, employment and wages, which is gradually improving as the economic recovery continues, remains the main factor. Financing conditions for investment in dwellings are still favourable. Developers' view of future household demand for investment in housing improved somewhat, as indicated by renewed growth in the number of housing starts in 2014 Q1 (4.8% year on year).

The contribution of **changes in inventories** to annual GDP growth was negative again in 2014 Q1 (-0.5 percentage point), but less so than in the previous quarter. This was probably due to a combination of sales of stocks of tobacco products from the previous quarter and an unexpected decline in stocks for production owing to higher-than-expected external demand. The still favourable data on new industrial orders and the latest business survey conducted by the CNB and the Confederation of Industry suggest, however, that inventories can be expected to increase quite significantly in 2014 Q2.

18 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 5.6%.
19 A further increase in investment activity is expected in the remainder of this year, thanks mainly to the construction of LTE networks by the three largest mobile operators.
20 Household investment in housing dropped by 1.8% year on year in 2014 Q1.

CHART III.3.7

INVESTMENT BY SECTOR

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

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

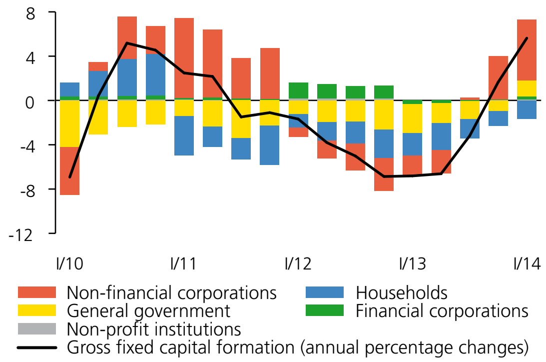


CHART III.3.8

FIXED CAPITAL FORMATION

There was growth in investment in machinery and equipment, transport equipment and buildings and structures

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

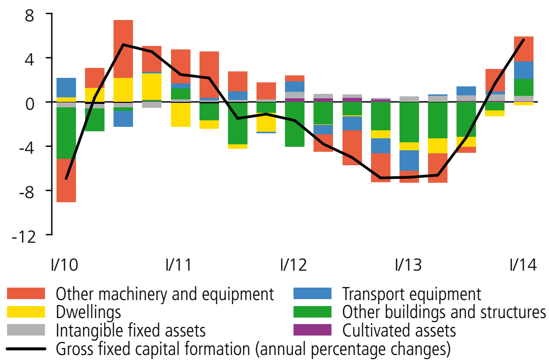


CHART III.3.9

INVESTMENT IN DWELLINGS

The decline in investment in dwellings slowed and the number of housing starts increased in 2014 Q1

(annual percentage changes)

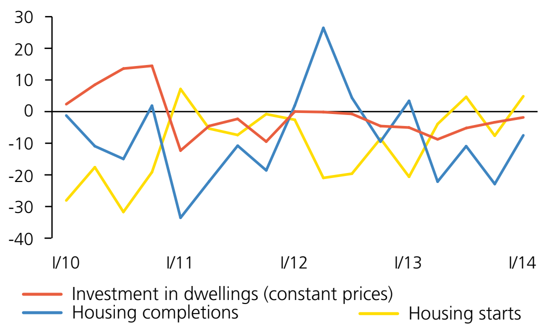


CHART III.3.10

NET EXPORTS

Net exports increased further in 2014 Q1
(seasonally adjusted data; constant prices)

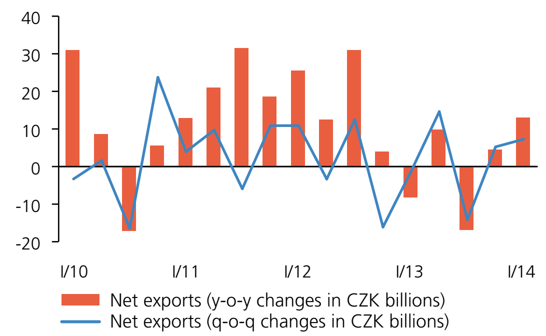


CHART III.3.11

EXPORTS AND IMPORTS

Annual growth in total foreign trade turnover picked up significantly in 2014 Q1, while the lead of export growth over import growth increased slightly
(annual percentage changes; percentage points; constant prices; seasonally adjusted data)

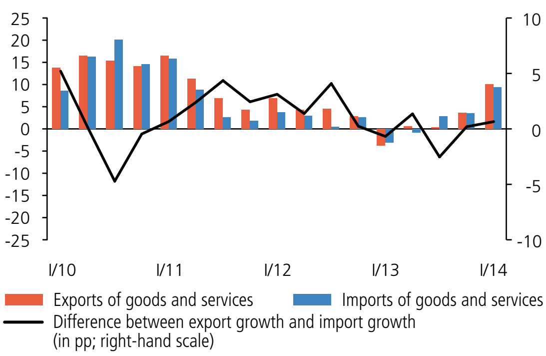
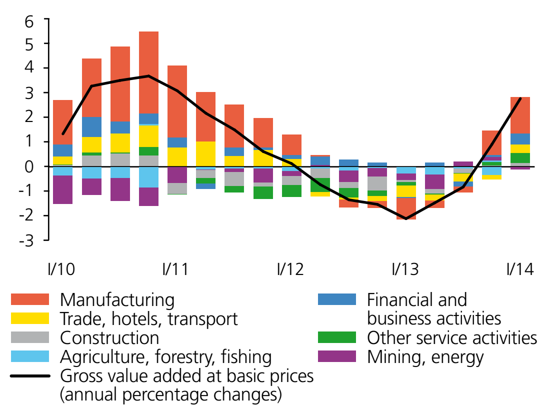


CHART III.3.12

CONTRIBUTIONS OF BRANCHES TO GVA GROWTH

Manufacturing was the biggest contributor to the pick-up in gross value added in 2014 Q1
(annual percentage changes; contributions in percentage points)



III.3.2 Net external demand

Net exports of goods and services[21] continued rising year on year in 2014 Q1 for the second consecutive quarter (see Chart III.3.10). The net export surplus increased by CZK 13 billion year on year and also rose in quarter-on-quarter terms (by more than CZK 7 billion). The year-on-year increase in net exports was due to both the trade balance and the services balance, whose surpluses grew noticeably faster than in the previous quarter. As in the previous quarter, the contribution of net exports to annual GDP growth was thus positive and rose to 1.1 percentage points (see Chart III.3.2).

The year-on-year increase in net exports was a result of a greater lead of export growth over import growth (from 0.2 percentage point in 2013 Q4 to 0.7 percentage point in 2014 Q1; see Chart III.3.11). At the same time, annual growth in total foreign trade turnover picked up significantly. **Total exports** rose by 10.1% year on year, accelerating by 6.4 percentage points compared to the previous quarter. The stronger growth in total exports reflected a further pick-up in external demand growth in the Czech Republic's major trading partner countries and the weakening of the koruna. The increase in total exports was linked mainly with rapid growth in goods exports (10.8%). It was also fostered by a renewed increase in exports of services following four quarters of decline.

Annual growth in **total imports** also rose significantly in 2014 Q1 (by 6 percentage points). The rapid year-on-year growth in total imports (of 9.5%) was linked with stronger growth in domestic demand and in exports given their traditionally high import intensity. An increase was recorded primarily for imports of goods, particularly of commodities for investment purposes. After two quarters of decline, services also made a modest contribution to total import growth.

III.3.3 Output

In 2014 Q1, **gross value added** at basic prices continued to record growth, which had been renewed in the previous quarter. The rate of growth picked up markedly, being almost 2 percentage points higher than in the previous quarter and reaching 2.8%. In quarter-on-quarter terms, value added grew for the fourth consecutive quarter. In 2014 Q1 alone the growth was 1.1%. The continuing recovery in domestic and external demand was reflected most of all in manufacturing output, but value added also showed growth in most other sectors (see Chart III.3.12). Only mining, energy supply and insurance and financial intermediation made negative contributions to annual gross value added growth.

21 At 2005 prices, seasonally adjusted.

The contribution of **industry** to the overall annual rise in gross value added in 2014 Q1 was 1.4 percentage points (see Chart III.3.12). This was fostered by the high-weight **manufacturing sector**, which recorded a marked annual rise in value added of 5.9%.

The gross value added growth in industry in 2014 Q1 was consistent with the data on **industrial production** (see Chart III.3.13),[22] which grew by 6.7% year on year in real terms. This rise was mostly due to fast growing production in **manufacturing**, whose year-on-year growth rate reached a significant 9.1%. However, the production growth was relatively broad-based and was recorded in almost 90% of all the branches of industry under review. In terms of use, there was rapid growth in production for investment and long-term consumption (of 11.8% and 9.3% respectively). Production of non-durable goods showed the slowest growth. Production decreased only in power generation.

According to the latest available **monthly indicators**, the relatively fast real growth in **industrial production** continued into April and May 2014, although it slowed in May (see Chart III.3.13).[23] In May, the biggest positive contribution to annual real industrial production growth came from the manufacture of motor vehicles, trailers and semi-trailers (contribution 1.9 percentage points, growth 11.9%). The latest data on direct export **sales** indicated that export growth would remain high in 2014 Q2 (10.7% at current prices in May), but domestic sales growth fell sharply to low levels.[24]

The latest data on new **industrial orders** for April and May also suggest that industrial production will continue growing, as new orders rose by 8.7% overall. This growth was driven by still rising orders from abroad, as domestic orders dropped slightly in May (see Chart III.3.14).

According to the July results of the CZSO's business survey, the effect of **insufficient demand as a barrier to growth** decreased (see Chart III.3.15). By contrast, the effect of labour shortages increased slightly, in line with the economic recovery picture. Nevertheless, **capacity utilisation** in July was slightly lower than in the previous quarter.

The overall contribution of **trade and services** to annual gross value added growth was positive in 2014 Q1 (1,2 percentage point). This was due to almost all services sectors, particularly public administration and real estate activities, which recorded value added growth of around 3%. The CZSO's latest leading statistics are signalling a rise in value added in trade in 2014 Q2, more so in the automotive segment than in other retail segments.

22 According to seasonally adjusted data.
23 According to seasonally adjusted data, industrial production rose by 8.9% in April and 5.1% in May.
24 Domestic sales include indirect exports through non-industrial corporations.

CHART III.3.13

INDUSTRIAL PRODUCTION

Annual growth in industrial production is still fast despite slowing in May
(basic index; year 2010=100)

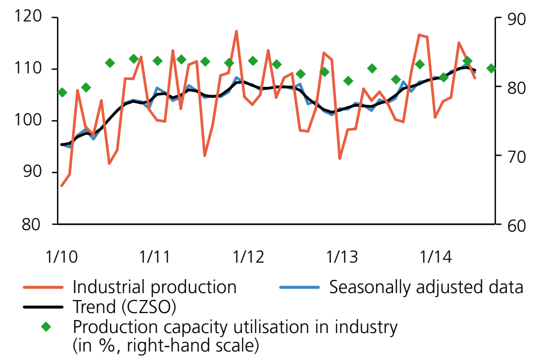


CHART III.3.14

NEW ORDERS IN INDUSTRY

The rapid growth in new industrial orders from abroad continued, although it did slow somewhat
(annual percentage changes)

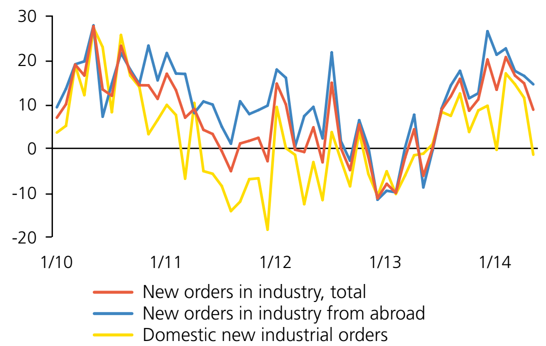


CHART III.3.15

BARRIERS TO GROWTH IN INDUSTRY

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

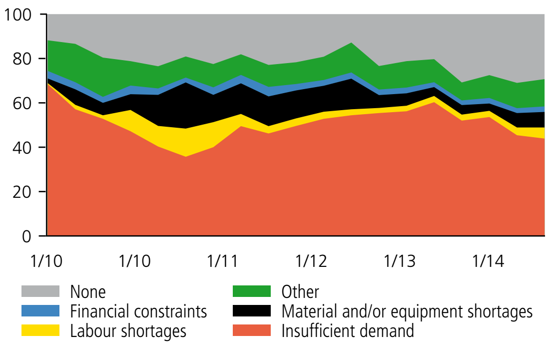


Chart III.3.16

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)

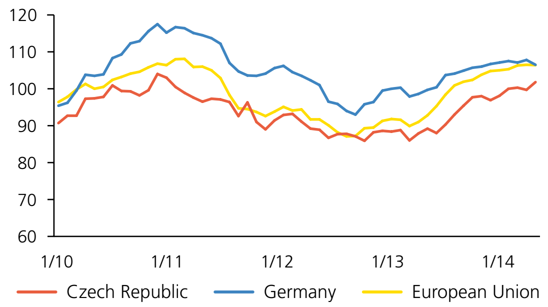


Chart III.3.17

POTENTIAL OUTPUT

The rate of growth of potential output remained above 1% in 2014 Q1 according to the production function calculation
(annual percentage changes)

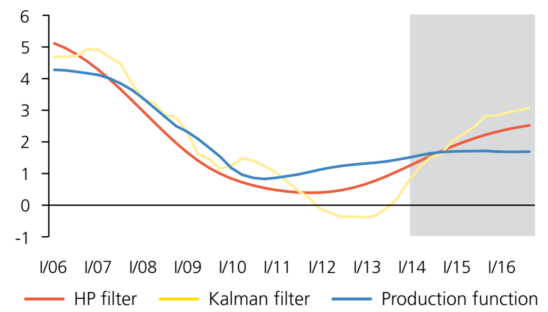
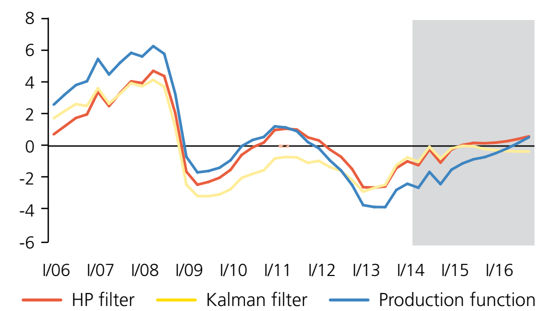


Chart III.3.18

OUTPUT GAP

The output gap is gradually closing
(in % of potential output)



Gross value added growth in **construction** accelerated to 2.4% in 2014 Q1 compared to the close of last year, when gross value added returned to annual growth following almost three years of decrease (see Chart III.3.12). This was fostered above all by a recovery in output in building construction thanks to favourable weather conditions. The CZSO's latest available monthly data show that construction output continued growing in April and May (by 6.9% and 2.4% respectively in real terms). Fast double-digit annual growth in new orders in construction according to the CZSO survey in 2014 Q1 in both building construction and civil engineering is consistent with those data. The approximate value of building notifications and permits also increased in May (by 17.9%), although their number is still falling.

An **international comparison of economic sentiment**, based on data for June, confirms the previous tendencies 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 is thus continuing (see Chart III.3.16). The levels of these two foreign indicators converged in June. The upward trend in the Czech Republic has been ongoing since April 2013.

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 above 1% in 2014 Q1, with a slightly upward tendency (see Chart III.3.17). The further sizeable quarterly growth in economic activity observed in 2014 Q1 resulted in a further narrowing of the output gap, which, however, remained in significantly negative territory (-2.4% of potential output; see Chart III.3.18). This method suggests a further gradual pick-up in potential output growth this year, with subsequent stability at 1.7% at the longer end of the forecast horizon. The output gap should continue to close gradually, nearing zero in mid-2016.[25]

The **individual factors entering the production function** point to an increasing contribution of productivity over the forecast horizon, partly offset by a gradual decline in the contribution of employment amid a broadly flat contribution of capital. Overall, annual growth in potential output will rise only slightly to levels of around 1.7% in 2016 (see Chart III.3.19).

25 The volatility of the output gap this year and the next is due to fluctuations in GDP caused by frontloading by cigarette manufacturers in response to an increase in excise duty (see section II.2). A smoother closing of the negative output cap can be expected in reality.

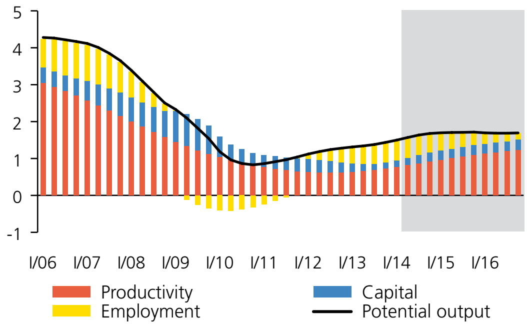
An alternative estimate using the **HP filter**[26] indicates lower potential output growth (1.2% in 2014 Q1) than that calculated using the production function. Under this method, the output gap is currently less negative and the HP filter indicates a swing to slightly positive levels in mid-2015 amid faster potential output growth going forward. The **Kalman filter** indicates that annual potential output growth will stay at lower levels in 2013 Q4 than suggested by the two previously mentioned methods. Over the forecast horizon, however, potential output will start rising again, accelerating to 2.5% by the end of 2016. 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 faster convergence to zero 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)



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

III.4 THE LABOUR MARKET

The economic recovery, which intensified significantly in late 2013 and early 2014, favourably affected the labour market situation in 2014 Q1. Employment growth remained at the previous quarter's level, unemployment declined and the number of employees converted into full-time equivalents increased slightly year on year following a lengthy decline. With employment growing faster than the labour force, the general unemployment rate continued to go down. The share of unemployed persons also started to decline gradually in 2014 Q1. The average wage started to grow again in year-on-year terms in 2014 Q1, due mainly to rising wages in the business sector. The data for April and May 2014 point to continued moderate growth in the average wage. Faster economic activity accompanied by only a slow rise in employment resulted in faster growth in whole-economy labour productivity. Unit labour costs recorded a slight annual increase due to a sizeable upswing in the volume of wages and salaries.

III.4.1 Employment and unemployment

Total employment[27] grew at the same pace in 2014 Q1 as in the previous quarter (by 0.8%; see Chart III.4.1). In quarter-on-quarter terms, total employment (adjusted for seasonal effects) increased by 0.4%. Unlike the previous quarter, the continued moderate growth in employment was driven by an increasing number not only of employees but also of entrepreneurs.

As regards sectors, employment grew most in the secondary sector (see Chart III.4.2). This suggested a continued increase in demand for labour in this sector connected with the recovery in economic activity. Following a larger increase in 2013 Q4, employment in the tertiary sector increased only moderately and its positive contribution to the annual growth in total employment declined significantly in 2014 Q1.

The **primary sector** continued to record a year-on-year fall in employment, which deepened further due to a decline in employment in agriculture.

The renewed modest annual growth in employment in the **secondary sector** observed in late 2013 picked up considerably in 2014 Q1 (to 2.3%). Although the largest annual growth in the number of employed persons continued to be observed in manufacturing, the electricity and water supply sectors also showed fast growth in employment. According to the latest figures for April and May, the continued annual growth in industrial production was reflected in year-on-year growth in the registered number of employees[28] (of 1.9% and 1.6% respectively). Nevertheless, employment in construction declined again year on year, following a one-off weak increase in 2013 Q4.

27 Employment according to the LFS.
28 Corporations with 50 employees or more, excluding agency workers.

CHART III.4.1

LABOUR MARKET INDICATORS

In 2014 Q1, employment continued to rise, the number of employees converted into full-time equivalents increased slightly, and the average wage went up
(annual percentage changes)

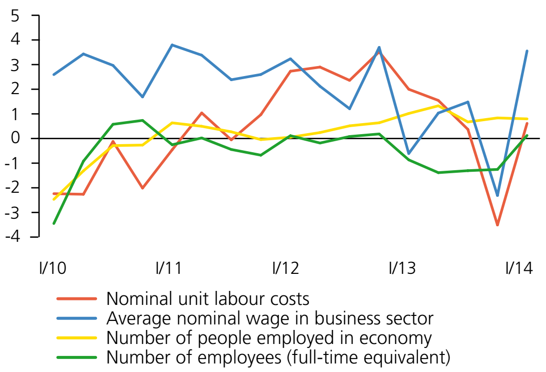
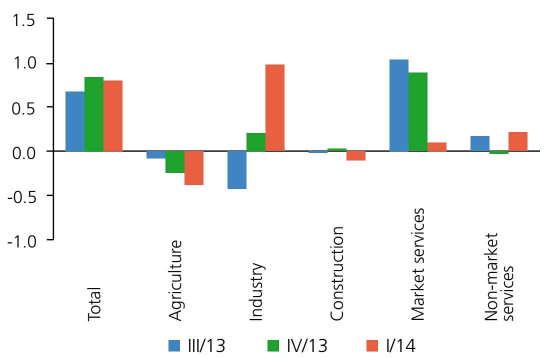


CHART III.4.2

EMPLOYMENT BREAKDOWN BY BRANCHES

The continuing growth in employment was due mostly to industry, while the contribution of market services decreased significantly
(contributions in percentage points to annual change; selected branches; source: LFS)



The moderation in annual growth in employment in the **tertiary sector** in 2014 Q1 (to 0.5%) was due to a sharp fall in employment growth in market services. This was driven mainly by a further decline in the number of employed persons in financial intermediation and insurance, which resulted in a deeper annual decline in employment in this sector. The growth rate of the number of employees in wholesale and retail trade and repair of motor vehicles also moderated significantly. On the other hand, demand for some other professions increased, especially in information and communication activities and administration and other supporting activities. Unlike in market services, employment in non-market services returned to annual growth in 2014 Q1 on the back of a substantial increase in the number of persons employed in health and social care.

The continuing economic recovery gradually started to feed through to the **number of employees converted into full-time equivalents**. This was indicated by renewed weak annual growth in this indicator in 2014 Q1 (of 0.1%, compared to -1.3% in 2013 Q4; see Chart III.4.3). This was observed in both the business and non-business sectors; in the former the annual decline in the converted number of employees was close to zero, while in the latter this indicator showed weak growth.

However, the number of employees and average hours worked per employee were very mixed across the sectors of the national economy. Average hours worked per employee were shortened in **industry** and **non-market services**, where the number of employees grew faster than the converted number of employees. By contrast, the number of employees in **market services** declined after a long period of growth, but the converted number of employees increased slightly amid a rise in average hours worked. The converted number of employees in **construction** has long been decreasing significantly.

With employment growing faster year on year than the labour force, the **general unemployment rate**[29] decreased further to 6.7% in 2014 Q1 (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**[30] in all age groups. The overall rate of economic activity reached a historical high for the Czech Republic (73.4% after 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 figures, the seasonally adjusted general unemployment rate decreased further to 6.5% and 6.4% in April and May respectively and the rate of economic activity fell slightly.

29 In the 15–64 age category. Measured by the ILO methodology according to the LFS.
30 The rate of economic activity is defined as the ratio of employed and unemployed persons to the population in each age category.

CHART III.4.3

NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENT)

The converted number of employees increased slightly
(annual percentage changes; contributions in percentage points)

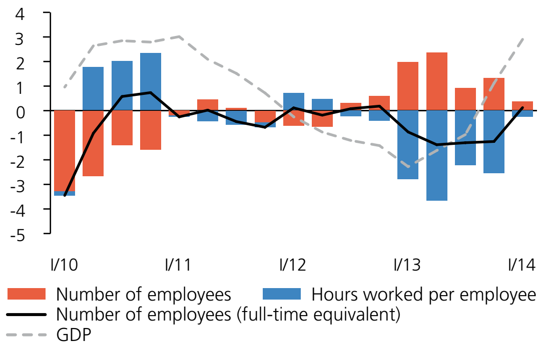


CHART III.4.4

UNEMPLOYMENT INDICATORS

The general unemployment rate decreased further in 2014 Q1 and the share of unemployed persons also fell slightly
(percentages; seasonally adjusted data; source: MLSA, CZSO)

CHART III.4.5

BEVERIDGE CURVE

The number of vacancies has been rising and the number of unemployed persons falling since the start of 2014
(seasonally adjusted numbers in thousands; source: MLSA)

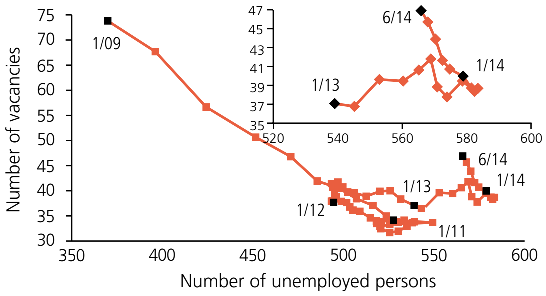


CHART III.4.6

AVERAGE WAGE

The average nominal and real wage both increased markedly in 2014 Q1
(annual percentage changes)

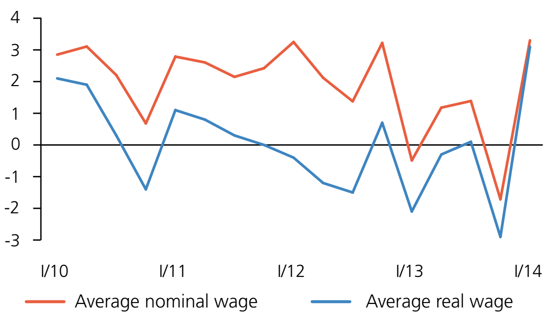


TABLE III.4.1

WAGES, PRODUCTIVITY, UNIT LABOUR COSTS

Annual growth in the average nominal wage exceeded 3% and labour productivity also increased
(annual percentage changes)

	II/13	III/13	IV/13	I/14
Average wage in Czech Republic				
nominal	1.2	1.4	-1.7	3.3
real	-0.3	0.1	-2.9	3.1
Average wage in business sector				
nominal	1.0	1.5	-2.3	3.6
real	-0.4	0.2	-3.5	3.4
Average wage in non-business sector				
nominal	1.9	0.9	0.9	2.2
real	0.4	-0.4	-0.3	2.0
Whole-economy labour productivity	-2.9	-0.8	0.1	2.3
Nominal unit labour costs	1.5	0.4	-3.5	0.6

The **share of unemployed persons**,[31] published by the MLSA, also decreased in 2014 Q1 (see Chart III.4.4). This (seasonally adjusted) unemployment indicator then declined further to 7.8% in 2014 Q2 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 Q2, according to which the **Beveridge curve**[32] is gradually shifting in the north-westerly direction. This shift is due to a decrease in the seasonally adjusted number of registered job applicants, driven by an increase in the number of persons excluded from the register due to finding jobs or by penalty,[33] coupled with an increase in vacancies (see Chart III.4.5).

III.4.2 Wages and productivity

Following a long period of mostly slight growth or decline, the **average nominal wage** increased by 3.3% in 2014 Q1 (see Chart III.4.6). This significant change in wage dynamics was due mainly to faster growth in the average wage in the business sector, while the contribution of the non-business sector was less significant. With annual inflation low, the **real average wage** increased by 3.1% (see Table III.4.1).

Following weak growth in 2013 Q2 and Q3 and a sharp decline in late 2013, average wage growth in the **business sector** picked up to 3.6% in 2014 Q1. In real terms the average wage in this sector rose by 3.4%. As expected, the year-on-year average wage growth figure was clearly affected by the tax optimisation recorded at the end of 2012 (expected to be almost 2 percentage points).[34] However, faster wage growth was apparent even when adjusted for this factor, and the seasonally adjusted average wage increased by 0.5% quarter on quarter. The continuing economic recovery, accompanied by labour productivity growth, thus started to affect the wage growth rate in the business sector.

As regards the **branches of the business sector**, the average wage increased the most in financial intermediation and insurance (by 10% year on year), which, however, was hit the hardest by the

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

32 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.

33 The main reasons for excluding a person from the labour office register by penalty include refusal to take a suitable job, illegal work, refusal to do community service, refusal to do agreed retraining and failure to cooperate with the labour office.

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

time shift in wages due to tax optimisation. Wage growth exceeding 4% was also recorded in information and communication activities, agriculture and manufacturing. The April and May figures for industry and construction suggest continued wage growth in 2014 Q2 at 1.8% and 0.9% respectively, while the slowdown from the previous quarter can be attributed to the fading out of the previously mentioned effect of tax optimisation.

Average nominal wage growth also picked up in the **non-business sector** in 2014 Q1 (to 2.2% year on year). This generally subdued growth was due to a rise in the average wage in central government (of 3.6%) and local government (of 1.0%). Even more pronounced wage growth was recorded in the negligible-weight sector of social security funds (almost 6%). Given the low annual inflation, real average wage growth was only slightly different from nominal wage growth, reaching 2% (see Table III.4.1).

With real GDP rising faster than employment, annual growth in **whole-economy labour productivity**[35] picked up pace in 2014 Q1 (to 2.3% year on year). This was due mostly to industry, where labour productivity rose by a considerable 4.5% year on year[36] (see Chart III.4.7). Relatively fast productivity growth was also recorded in construction (up by 3.8%), while productivity in market and non-market services increased only moderately. Growth in **hourly labour productivity** also picked up, but its annual rate was about half that of whole-economy productivity. Industry again recorded fast growth in hourly labour productivity, but construction saw slower growth. Hourly labour productivity in market and non-market services fell slightly.

The sizeable upswing in growth in the volume of wages and salaries[37] coupled with the above developments in economic activity resulted in a slight annual rise in **unit labour costs**[38] in 2014 Q1 (of 0.6%; see Chart III.4.8). As regards sectors, nominal unit labour costs rose mainly in market and non-market services. They recorded weak annual growth in industry, while declining in manufacturing. Unit labour costs continued to fall quickly in construction.

CHART III.4.7

WHOLE-ECONOMY PRODUCTIVITY

The growth in whole-economy labour productivity was due mostly to industry and construction

(annual percentage changes)

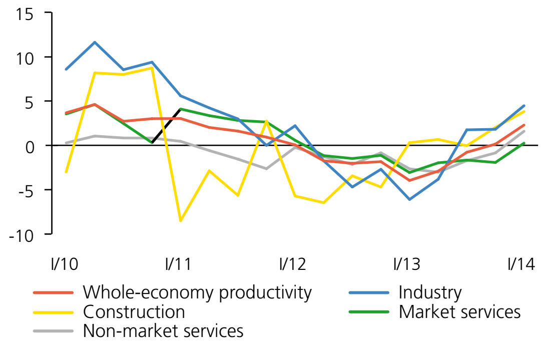
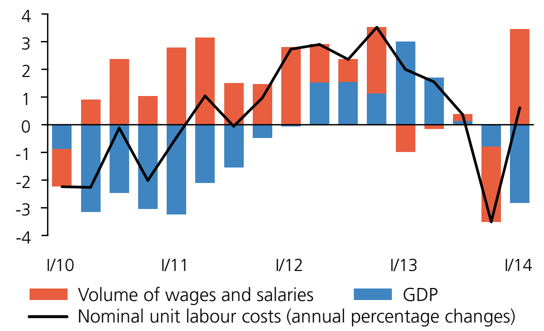


CHART III.4.8

UNIT LABOUR COSTS

Nominal unit labour costs rose slightly in 2014 Q1 owing to a sizeable increase in the volume of wages and salaries

(contributions in percentage points; annual percentage changes)



35 Productivity is calculated on the basis of seasonally unadjusted data.
36 Productivity growth was even higher in manufacturing (5.5%).
37 Following a fall of 2.7% in 2013 Q4, the volume of wages and salaries increased by 3.5% in 2014 Q1.
38 The wage cost-output ratio as measured by nominal unit labour costs was calculated on the basis of seasonally unadjusted data.

CHART III.5.1

MONETARY AGGREGATES

The growth rates of M2 and M3 increased slightly during 2014 Q2
(annual percentage rates of growth)

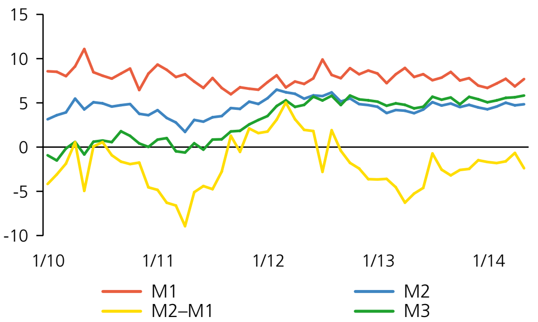


CHART III.5.2

MAIN COMPONENTS OF M2

A preference for liquidity is keeping growth in overnight deposits at a high level in an environment of low interest rates
(annual flows in CZK billions)

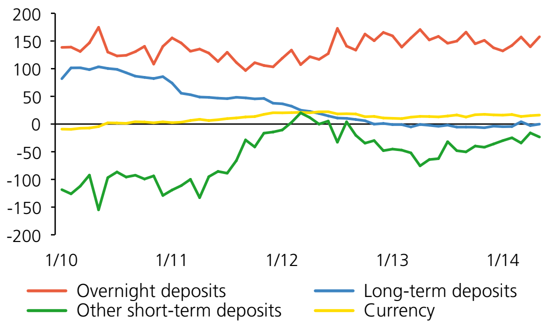
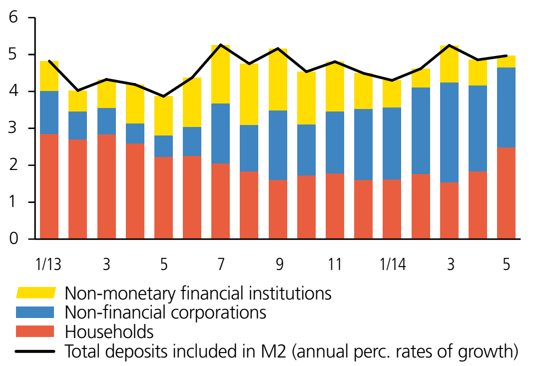


CHART III.5.3

DEPOSIT STRUCTURE OF M2

Higher money supply growth was fostered by deposits of non-financial corporations and newly also by household deposits to a greater extent
(contributions in percentage points; annual percentage rates of growth)



III.5 FINANCIAL AND MONETARY DEVELOPMENTS

The previous long-observed sharp decline in the velocity of broadly defined money halted due to growth in economic activity. The annual growth rate of M2 increased slightly in 2014 Q2. This growth continues to be fostered mainly by highly liquid overnight deposits. The growth rate of household deposits started to accelerate, in line with the observed change in the labour market. In addition, the increased growth in deposits of non-financial corporations persisted, reflecting improved operating profits supported by a recovery in external demand and the weakened koruna. The availability of loans to corporations improved due to lower risk perception regarding future economic growth and higher competition between banks. Growth in corporate loans picked up as a result of relatively strongly rising corporate demand for the financing of mergers and acquisitions, fixed investment and operating needs. Growth in loans to households for house purchase also increased. Broad growth in demand for loans is also expected in these segments in 2014 Q3. Money market interest rates were flat and long-term government bond yields fell slightly. Some client interest rates dropped to new historical lows. The exchange rate of the koruna against the euro and the dollar was stable in Q2. Growth in property prices in Prague in the first half of 2014 was confirmed. Prices are also recovering in the rest of the Czech Republic.

III.5.1 Money

The annual growth rate of **M2** increased slightly during 2014 Q2, reaching 4.8% in May (see Chart III.5.1). With annual growth in nominal seasonally adjusted GDP running at 5.2% and annual growth in seasonally adjusted M2 at 4.6%, the decline in the velocity of money halted in 2014 Q1 for the first time in many years. On banks' asset side, the M2 growth was fostered by an increase in net external assets, reflecting a current account surplus and an inflow of investment. Growth in loans to the private sector also contributed to the increase in M2 to a smaller extent.

As in the case of M2, the annual growth rate of **M3** edged up in the period under review (to 5.8% in May). M3 growth in the Czech Republic is almost five percentage points above the euro area average. The weak growth in M3 in the euro area is due to outflows of money into more highly remunerated and riskier products outside M3 on the demand side and by the ongoing deleveraging process on the financial sector side.

As in the euro area, a preference for liquidity is fostering high M1 growth in the Czech Republic (7.7% year on year in May; see Chart III.5.1), reflecting increased demand of non-financial corporations and households for **overnight deposits** (see Chart III.5.2). Highly liquid money (M1) remains the sole component contributing to M2 growth. The decline in other short-term deposits slowed. Long-term deposits remained flat in an environment of low interest rates, in line with the trend observed over the last two years.

Turning to the **sector structure of deposits**, the M2 growth was fostered mainly by deposits of non-financial corporations and households. Growth in deposits of households increased to 3.6% in May, consistent with the observed change in the labour market. By contrast, the annual growth rate of deposits of non-financial corporations dropped slightly to 8.2% amid a recovery in economic activity. Its still fairly high level continues to correspond to an elevated acid-test ratio of corporations. Growth in deposits of non-monetary financial institutions continued to slow as a consequence of search for yield outside M2 (see Chart III.5.3). The share of foreign currency deposits in total resident deposits included in M2 stayed at around 9% as a result of an increased proportion of corporate deposits.

III.5.2 Credit

The annual growth rate of **loans to the private sector** picked up during 2014 Q2, reaching 4.2% in May. According to the July bank lending survey, corporations' demand for loans and households' demand for house purchase loans both increased in Q2. On the supply side, banks' credit standards applied to such loans were eased or were broadly unchanged in Q2 (see Table III.5.1). The results of the survey indicate an easing of the terms and conditions applied to loans. This is generally in line with the faster growth in economic activity and lower risk perception in the financial market. Banks expect a similar pattern in 2014 Q3.

The results of the bank lending survey in the euro area in 2014 Q1 also indicated an overall stabilisation of the situation. **Banks in the euro area** feel that demand for loans is increasing in a context of unchanged or easier credit standards.[39]

The year-on-year growth rate of **loans to non-financial corporations** in the Czech Republic rose to 2.1% in 2014 Q2 (see Chart III.5.4). However, the increase in loans was due solely to loans to corporations under foreign control, as loans to domestic corporations continued to decline. According to the bank lending survey, corporations' demand for long-term loans increased. Demand increased in large corporations and partly also in small and medium-sized enterprises. It was favourably affected by growth in financing of mergers and acquisitions and business restructuring, as well as by growth in fixed

39 In the euro area, demand for loans increased slightly in 2014 Q1, while credit standards applied to loans to enterprises were broadly unchanged and those for loans to households were eased. The change in standards reflected unchanged balance sheet constraints and cost of funds. For the first time since 2007, euro area banks perceive a decline in the risks associated with expected aggregate economic activity as well as increased competition in all segments of the credit market. Demand for loans increased. In the case of enterprises, this was due to increased financing needs for working capital and inventories and a further moderation of the decline in demand for loans to finance fixed investment. As for households, the increase in demand for loans for house purchase was due to increased consumer confidence and housing market prospects. Demand for consumer credit increased for the first time since 2010 (see *ECB Monthly Bulletin*, May 2014).

TABLE III.5.1

CHANGES IN BANKS' CREDIT CONDITIONS

Demand for corporate loans and house purchase loans increased in 2014 Q2; this was accompanied by easier or unchanged credit standards

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

	Credit supply: of which			Demand for loans
	Credit standards	Average margin for loans	Margin on riskier 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	-28 (-16)	-29	3	30 (54)
III/14	(-32)			(56)
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 (4)	-37	-33	57 (35)
III/14	(-42)			(31)
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	35 (22)	0	4	-5 (69)
III/14	(9)			(-12)

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 previous quarter survey given in parentheses.

CHART III.5.4

LOANS TO NON-FINANCIAL CORPORATIONS

Growth in corporate loans with longer maturities increased during 2014 Q2

(annual percentage rates of growth)

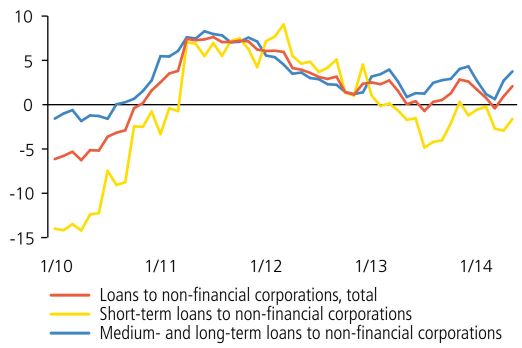


Chart III.5.5

LOANS TO CORPORATIONS FOR FUNDING FIXED INVESTMENT

Investment loans to property developers showed the largest growth during 2014 Q2

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

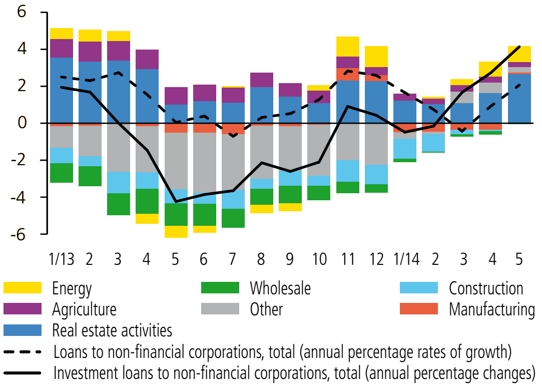


Chart III.5.6

CURRENCY STRUCTURE OF CORPORATE LOANS

The annual rate of growth of foreign currency loans to domestic non-financial corporations remains elevated

(annual percentage rates of growth adjusted for exchange rate changes and other non-transaction effects; annual percentage changes)

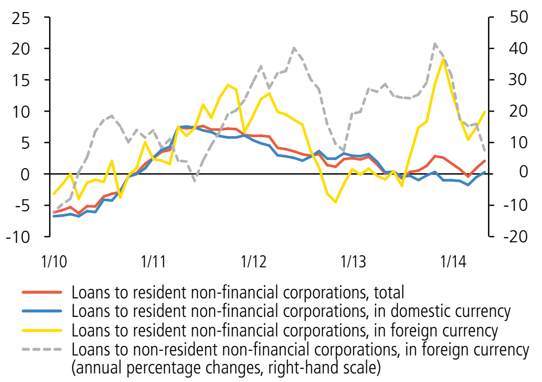


Table III.5.2

CREDIT STANDARDS AND SELECTED CREDIT CONDITIONS BY CORPORATION SIZE

The availability of corporate loans increased, as credit standards were eased in a large part of the banking market for the first time in two years

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

	Quarterly averages				
	2012	2013	2014 Q1	2014 Q2	2014 Q3[a]
Credit standards					
Small and medium-sized enterprises	13	4	0	-26	(-35)
Large corporations	22	0	0	-46	(-32)
Banks' average margin on loans					
Small and medium-sized enterprises	-1	-16	0	-27	
Large corporations	18	-8	-18	-46	
Size of loans					
Small and medium-sized enterprises	13	3	0	0	
Large corporations	29	10	-4	-4	
Collateral requirements					
Small and medium-sized enterprises	26	9	9	0	
Large corporations	25	1	-8	-35	

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

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

investment and, to a lesser extent, in working capital and inventories. By contrast, increased issuance of corporate bonds and the use of internal resources of corporations continued to reduce demand for loans. Annual growth in corporate bond issues was high at around 15% in 2014 Q1, although it has been gradually slowing since the start of 2013. Banks expect demand for loans to rise across the board in 2014 Q3 as well.

Investment loans used to finance fixed capital formation, which account for around 56% of corporate loans, rose further in 2014 Q2. As at the end of last year, this was fostered by growth in loans to developers and the energy sector. The contribution of loans to manufacturing was approximately zero following previous negative figures. Investment loans to the construction and wholesale and retail trade sectors were also broadly unchanged (see Chart III.5.5).

The interest of Czech corporations in **foreign currency loans** rose again in 2014 Q2. The annual growth rate of such loans adjusted for exchange rate movements and other non-transaction effects picked up to 9.9% in May (see Chart III.5.6). The share of foreign currency loans in total corporate loans was around 21%. This development 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. By contrast, growth in foreign currency loans slowed in industry and wholesale and retail trade. Even so, it remains elevated in some sectors, mainly as a result of natural hedging by export-oriented corporations when financing renewed growth in investment activity.

Credit standards applied to corporate loans were eased significantly in 2014 Q2 for the first time in the two years since the survey was launched (see Table III.5.1). This was due to a decrease in risk perception regarding the outlook for overall economic activity, an increase in competitive pressures and, to a lesser extent, to an improvement in the funding and liquidity situation of banks. The easing of standards and terms and conditions was more pronounced for large corporations (see Table III.5.2).

The annual growth rate of **loans to households** decreased slightly to 5% in 2014 Q2, following a gradual increase recorded since the start of 2013 (see Chart III.5.7). Growth in **loans for house purchase** was broadly unchanged. Amid a continued decline in interest rates, mortgage growth accelerated slightly (to 6.7% in May), while building society loans continued to decline (-6.2%). According to Hypoindex data for June 2014, the number and volume of new mortgages increased by around 32% and 34% respectively quarter on quarter in Q2 as a whole, amid a further decline in interest rates on such loans. In year-on-year terms, the numbers and volumes of new mortgages continued to decline in June (mainly because of increased refinancing of existing loans last year), although more moderately than in the preceding month. Households' demand for mortgages increased in 2014 Q2, partly due to compensation for the temporary fall at the start of this year. This had been caused by legislative changes arising from the new Civil Code and Cadastral Act (see Table III.5.1). Demand was favourably affected by an improved outlook for the residential property market, corresponding to the recovery in asking prices of apartments, and by increased consumer confidence. Banks' credit standards were little changed, with most factors (cost of funds, competitive pressures and risk perception) fostering an easing. Consistent with this are banks' expectations for 2014 Q3, which indicate an easing of standards and further growth in demand.

Turning to new housing loans, the share of **refinancing** of existing loans decreased slightly from 47% in January 2014 to 45% in May 2014 (see Chart III.5.8). Within this, refinancing of loans from other banks increased – probably due to increased competitive pressures – and currently stands at 14%. The average interest rate on refinanced loans and other negotiations to existing loans for house purchase was 3.2% in May. The rates on refinanced loans from other banks and loan extensions were also slightly higher (at 2.8% and 3% respectively).

The modest recovery in **consumer credit** observed in the previous period halted in 2014 Q2. The annual growth rate of consumer credit dropped slightly to 2.2% (see Chart III.5.7). Loans provided by non-banks continued to decline (by 3.2%). Demand for consumer credit was unchanged in 2014 Q2 following a previous across-the-board increase. Households' cautious approach to obtaining such credit and the use of other forms of financing (savings) adversely affected demand. Credit standards were tightened due to changes in internal policies in some banks. Banks expect consumer credit demand and supply to follow a similar pattern in 2014 Q3.

Total household debt remained at 61.4% of nominal gross disposable income in 2014 Q1 (see Chart III.5.9). The increase in households' financial liabilities was offset by renewed growth in nominal gross disposable income. The equivalent ratio in the euro area is much lower, averaging 98%. An increase in interest payments to banks caused the net interest burden on Czech households to rise to 2.1% of disposable income. It has been fluctuating around this level over the last four years.

The debt burden (the ratio of interest and principal to income) was unchanged for high-income households in 2013 compared to 2012, while increasing slightly further for the other **income groups of households**. New borrowing increased for medium-income households and in the third and ninth deciles. Consumption increased in nominal terms in most income groups of households. It increased most noticeably in the highest-income households despite falling income. The fall in their income was probably linked partly with tax optimisation, which resulted in a shift of bonuses from 2013 to 2012. The consumption-to-income ratio of the highest-income households increased and these households had a rather smaller proportion of their income left after covering loan repayments compared to the previous year (see Chart III.5.10). The saving rate of high-income households decreased but remains high (around 15%, compared to 8% for total households). The shape of the Lorenz curve indicates that the inequality of the distribution decreased further for new loans in 2013

Chart III.5.7

LOANS TO HOUSEHOLDS

Growth in loans to households decreased slightly as a result of lower consumer credit growth

(annual percentage rates of growth; annual percentage changes)

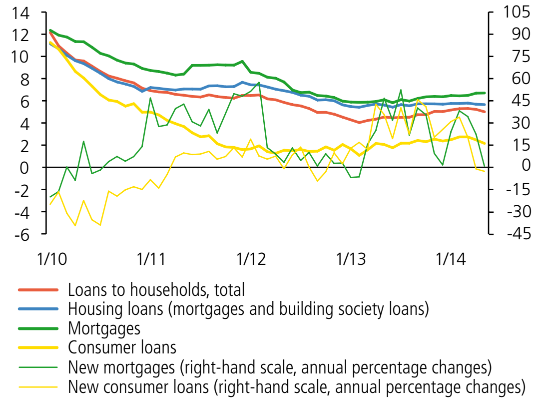


Chart III.5.8

STRUCTURE OF NEW LOANS TO HOUSEHOLDS

Refinanced loans and other negotiations to existing loans for house purchase account for just under half of new loans; the equivalent figure for consumer loans is approximately 13%

(new business; shares in %)

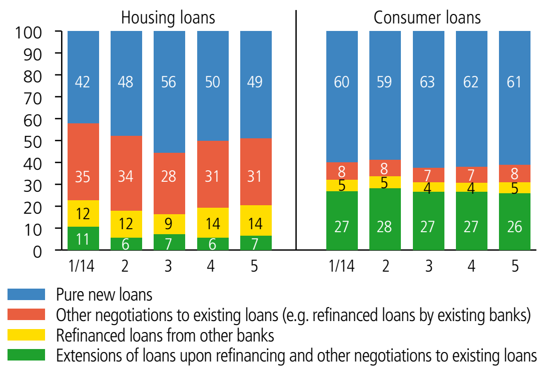
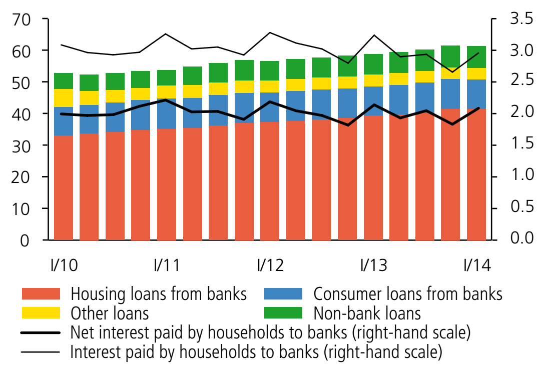


Chart III.5.9

HOUSEHOLD DEBT

Households' debt-to-income ratio was broadly unchanged in 2014 Q1

(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.

CHART III.5.10

HOUSEHOLDS' INCOME BURDEN BY CONSUMER EXPENDITURE AND LOAN REPAYMENTS

High-income and, to a lesser extent, medium-income households had rather a smaller proportion of their income left after covering consumption and loan repayments in 2013 compared to the previous year

(percentages ratios to net money income)

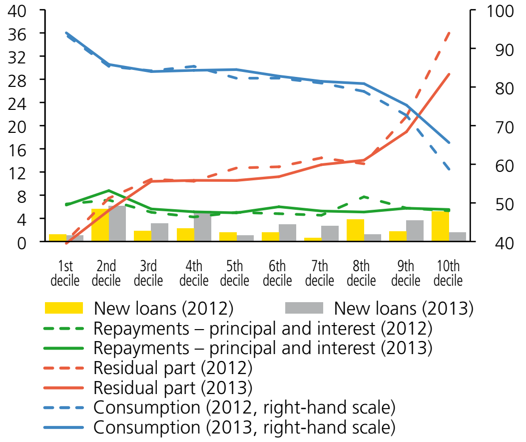
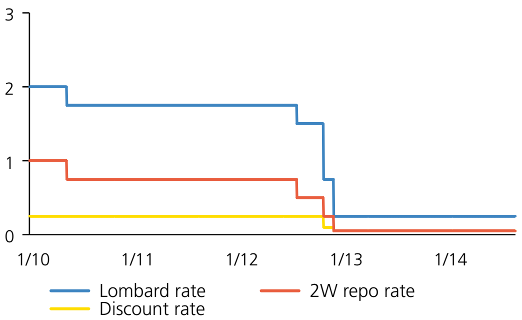


CHART III.5.11

CNB KEY RATES

The CNB left its key interest rates at "technical zero" in 2014 Q2

(percentages)



– households with above-median income accounted for around 60% of loans (compared to 70% in 2012). These households meanwhile accounted for 80% of total savings (compared to 90% in 2012).

III.5.3 Interest rates

Monetary policy interest rates

The monetary policy decision-making of the CNB Bank Board in 2014 Q2 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 until the start of 2015. Accordingly, the Bank Board decided unanimously at its meeting in May to leave **key interest rates** unchanged at their current level, i.e. at technical zero[40] (see Chart III.5.11). 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 Bank Board assessed the risks to the previous forecast as being slightly anti-inflationary. The Bank Board stated that it expects the exchange rate to be kept close to CZK 27 to the euro at least until early 2015 and that the probability of a later exit from the commitment was increasing. At the same time the Bank Board concluded that domestic interest rates would not necessarily rise as fast as indicated by the previous forecast in 2015. At its meeting in June, the Bank Board also decided unanimously to leave key interest rates unchanged. At the same time, it confirmed the above exchange rate commitment. The balance of the risks to the forecast was assessed as being moderately anti-inflationary; given the balance of risks, the Bank Board stated that the CNB would not discontinue the use of the exchange rate as a monetary policy instrument before 2015 Q2, and it did not rule out a further shift of the exit from this regime.

At its monetary policy meeting on 31 July 2014, the Bank Board decided unanimously to keep interest rates unchanged at technical zero. The Bank 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 asymmetric nature of this exchange rate commitment is unchanged. The Bank Board assessed the risks to the new forecast as being slightly anti-inflationary, with longer-lasting very subdued inflation in the euro area and lower food prices in the near future acting in this direction. The Bank Board therefore decided to continue

40 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.

using the exchange rate as a monetary policy instrument at least until 2016. The Bank Board would have to find a further noticeable increase in anti-inflationary factors before moving the exchange rate commitment to a weaker level.

Financial market interest rates

PRIBOR rates remained at historical lows at all maturities in 2014 Q2. They thus reflected the setting of the CNB's key interest rates at technical zero (see Chart III.5.12). Three-month **FRA derivative rates** edged down, especially for the longer term. The rates probably responded to the information issued at the press conference following the CNB Bank Board May meeting that the probability of a later exit from the exchange rate commitment than expected by the previous forecast was increasing and that domestic interest rates would not necessarily rise as fast as indicated by the previous forecast in 2015. The market outlook for 3M rates according to end-July FRA quotations implies stability of the 3M PRIBOR at least until mid-2015. This is in line with the prevailing expectations that monetary policy interest rates will be left at technical zero until the same date given the current money market premium remaining unchanged. The market outlook is very close to the interest rate path in the new CNB forecast over the entire horizon (see section II).

Domestic **interest rates with longer maturities** decreased in line with euro area rates, which mainly reflected the expected and subsequently implemented easing of monetary policy by the ECB. The downward trend in foreign rates was also partly due to events in Ukraine and Iraq, which increased market nervousness and hence demand for safer assets. The published macroeconomic indicators sent out a mixed message; interest rates thus reflected the prospect of a long period of very low rates as indicated by ECB and Fed representatives. Domestic interest rates with longer maturities fell by as much as 0.4 percentage point in 2014 Q2, depending on maturity. With inflation practically at zero, domestic bond yields reflected foreign investors' continuing increased interest in domestic assets, as observed since the weakening of the koruna last year, in addition to external factors. Domestic IRS rates and bond yields were at historical lows at most maturities in mid-July.

The average **3M PRIBOR** in 2014 Q2 was 0.4%, in line with the level foreseen by the previous forecast. The credit premium on the money market, as measured by the spread between the 3M PRIBOR and the 2W repo rate, stood at 0.3 percentage point.

The shape and slope of the **PRIBOR yield curve** were unchanged in 2014 Q2. The spread between the 1Y PRIBOR and the 2W PRIBOR was 0.4 percentage point on average in June 2014. The **IRS yield curve** shifted to a lower level in 2014 Q2, although only at its longer end, so its positive slope decreased at the same time. In June, the average 5Y–1Y spread was 0.4 percentage point and the 10Y–1Y spread 1.1 percentage points.

CHART III.5.12

MARKET INTEREST RATES

Money market interest rates were flat at historical lows, while rates with longer maturities went down
(percentages)

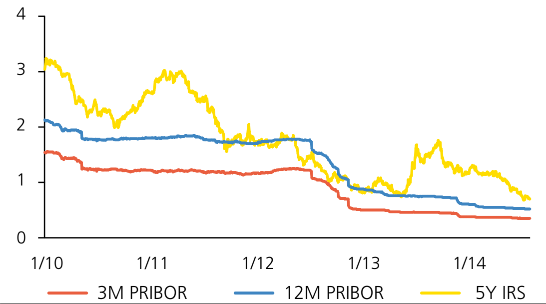


CHART III.5.13

INTEREST RATE DIFFERENTIALS

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

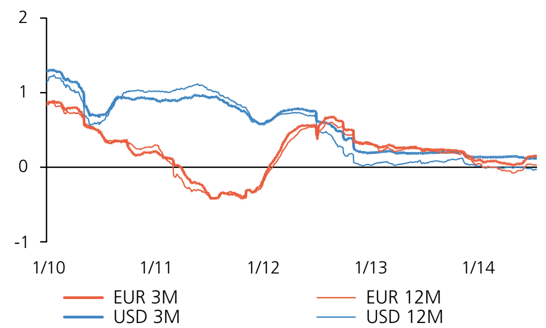


CHART III.5.14

GOVERNMENT BOND YIELD CURVE

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

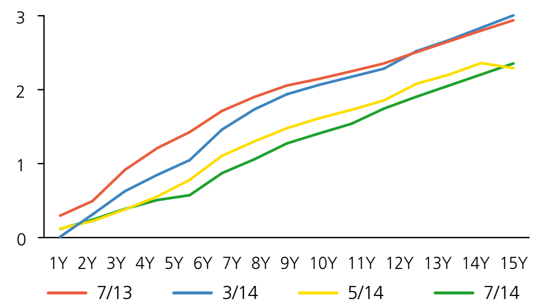


CHART III.5.15

INTEREST RATES ON LOANS TO CORPORATIONS

The interest rate on loans to non-financial corporations decreased
(new business; percentages)

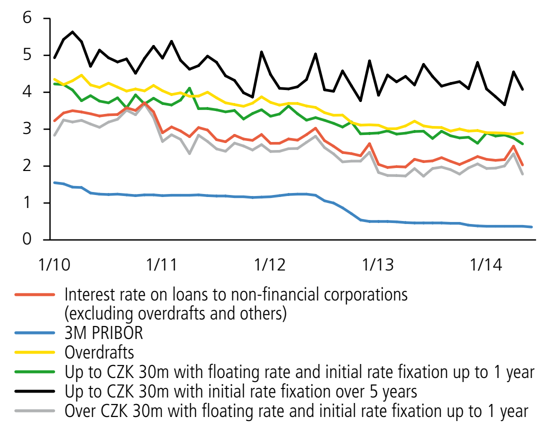
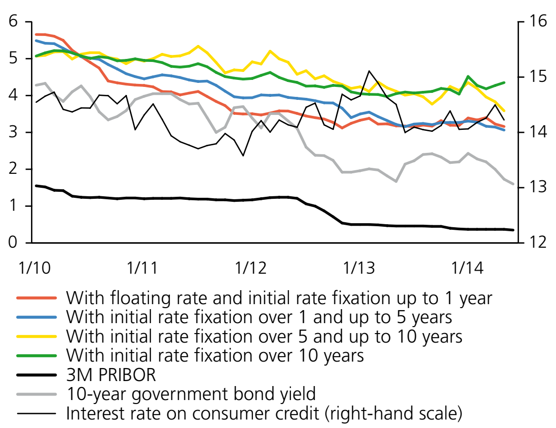


CHART III.5.16

INTEREST RATES ON LOANS TO HOUSEHOLDS

Interest rates on loans to households for house purchase fell to new historical lows
(new business; percentages)



Short-term **interest rate differentials** vis-à-vis the two main world currencies (PRIBOR/CZK–EURIBOR/EUR and LIBOR/USD) reflected the broad stability on domestic and US financial markets. Short-term rates fell slightly vis-à-vis the euro area in June, following the easing of monetary policy by the ECB. The differentials vis-à-vis euro and dollar rates were close to zero (see Chart III.5.13). The 3M PRIBOR–3M EURIBOR differential was 0.1 percentage point on average in 2014 Q2. At the end of July 2014, it was 0.2 percentage point.

Seven auctions of fixed coupon bonds and three auctions of variable coupon bonds were held on the primary **government bond market** in 2014 Q2. The total volume of bonds issued was CZK 49.7 billion.[41] Demand (increasingly from abroad) exceeded supply in all the auctions. The bid-to-cover ratio was 1.7 on average. The government bonds were subscribed at historically low yields. The Ministry of Finance also issued a sixth issue of state saving bonds totalling CZK 1.4 billion. The lower investor demand compared to previous issues was due to lower interest rates and limits on purchases per investor. The government bond yield curve – like the IRS curve – shifted downwards in its medium and longer sections. Its positive slope thus decreased (see Chart III.5.14).

Client interest rates

Client interest rates on new loans and deposits mostly declined slightly or were little changed in 2014 Q2. This development was recorded in an environment of a stable 3M PRIBOR and a continued decline in the ten-year government bond yield to 1.6% in June. Following a decline at the start of 2014, the ex ante real interest rate edged up to 1.1% for loans for house purchase in May as a result of lower expected inflation, while remaining flat at 11.9% for consumer credit. The real rate on corporate loans was virtually zero. The real rate on household deposits with agreed maturity remained negative at -0.6%.

The **interest rate on loans to non-financial corporations** decreased to 2% in nominal terms in May 2014, reversing its previous increase caused by the short-term rate on large loans. Rates with short-term and long-term fixations both declined (see Chart III.5.15). The average rate on large loans of over CZK 30 million edged down to 1.8% and the rate on small loans to 2.9%. At 1.1 percentage points, the spread between these rates is slightly above the average recorded since 2007. The spread between the short-term rate on corporate loans and the 3M PRIBOR narrowed slightly in May (see Chart III.5.13). Rates on corporate loans in the euro area also decreased slightly in the period under review, but are still higher than those in the Czech Republic (the average rate in the euro area was 2.6%).

41 The Czech Republic's Funding and Debt Management Strategy for 2014 assumes issues amounting to CZK 119.2–280.1 billion. Bonds totalling CZK 116.9 billion have been issued since the start of this year.

Turning to households, the **interest rate on loans for house purchase** edged down further, reaching a new historical low of 3.2% in May (3% for mortgages). Hypoindex figures indicate a further decrease in mortgage interest rates in June 2014. The rate on loans fixed for over one year and up to five years, which account for around 72% of all house purchase loans, fell slightly to 3.1% in May (see Chart III.5.16). However, the biggest declines were recorded by short-term rates of up to one year and long-term rates fixed for over five years and up to ten years. This was reflected in increased household interest in these types of loans. By contrast, rates fixed for over ten years increased. The spread between short-term client and market rates narrowed slightly in 2014 Q2. Conversely, the spread between the average rate on loans for house purchase and the long-term financial market rate increased on account of a decline in long-term government bond yields (see Chart III.5.17). The interest rate on house purchase loans in the euro area fell slightly to 2.9% in May.

The **interest rate on consumer credit** dropped slightly to 14.2% in May. It has been hovering close to this level for around a year now (see Chart III.5.16). The APRC declined negligibly to 15.2%. The rates on overdrafts and revolving loans and credit card debt showed similar developments, remaining fairly high at 14.2% and 23.9% respectively. Due to higher credit risk, the rate on consumer credit remains well above that in the euro area, where it stands at 6.5% on average.

Interest rates on client deposits remained broadly unchanged in the period under review. Rates on overnight deposits stayed at 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 and stably remunerated building society deposits, dropped slightly to 1.9%. Short-term and long-term rates on household deposits with agreed maturity declined to 1.4% and 1.7% respectively in the previous quarter, although both rates went up slightly in May (see Chart III.5.18). The equivalent rates in the euro area also decreased slightly and were at approximately the same level as in the Czech Republic.

Real client interest rates[42] increased slightly during 2014 Q2 owing to lower expected inflation, while nominal rates showed no major changes. Real rates on new loans were 3.9% in May, while real rates on time deposits were -0.4% (see Chart III.5.19).

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

Chart III.5.17

CLIENT AND MARKET INTEREST RATE SPREADS

The spreads between short-term client and market rates narrowed

(percentage points)

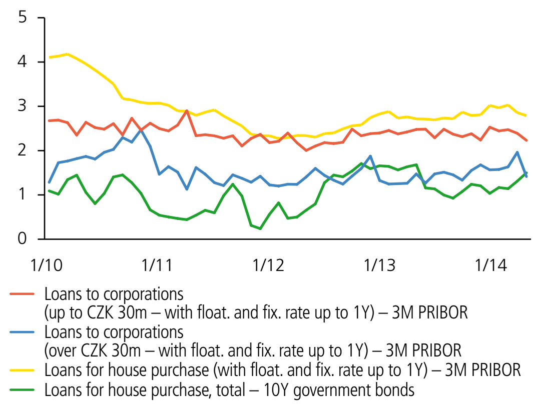


Chart III.5.18

INTEREST RATES ON DEPOSITS

Interest rates on household time deposits with agreed maturity decreased during 2014 Q2, while other rates were broadly unchanged

(percentages)

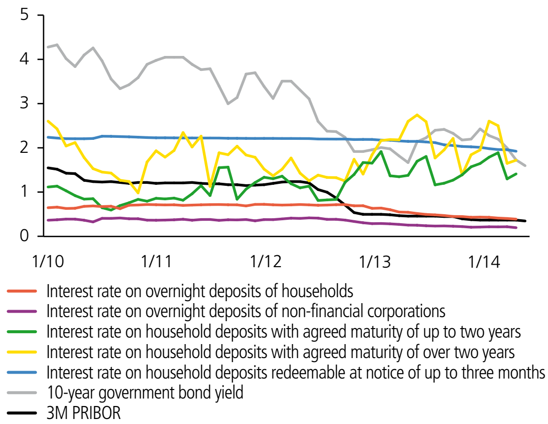


Chart III.5.19

EX ANTE REAL RATES

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

(percentages)

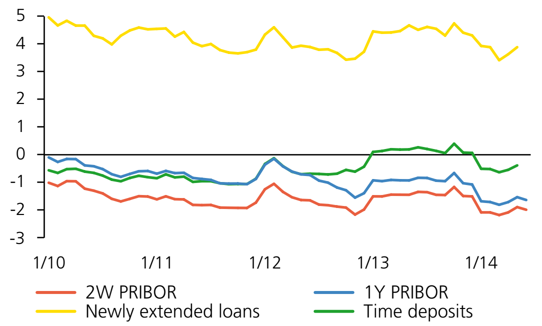


CHART III.5.20

CZK/EUR AND CZK/USD EXCHANGE RATES

The koruna was stable against the euro and the dollar in 2014 Q2

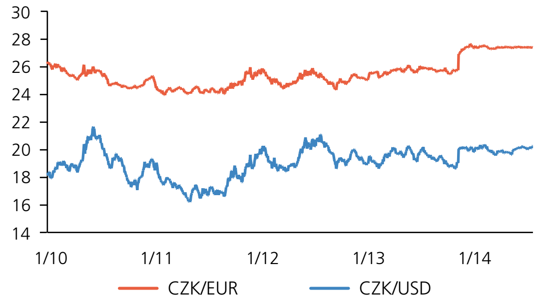


CHART III.5.21

KEY FINANCIAL INDICATORS

The rate of growth of the key financial indicators of non-financial corporations rose considerably in late 2013/early 2014

(annual percentage changes)

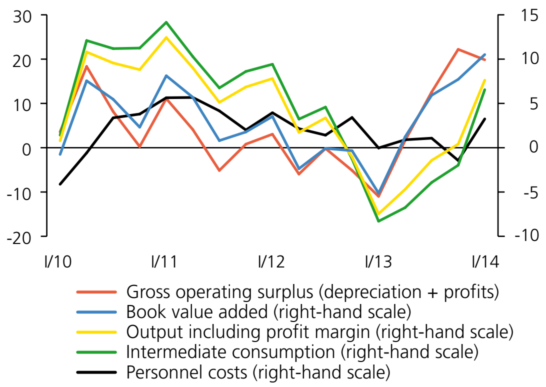
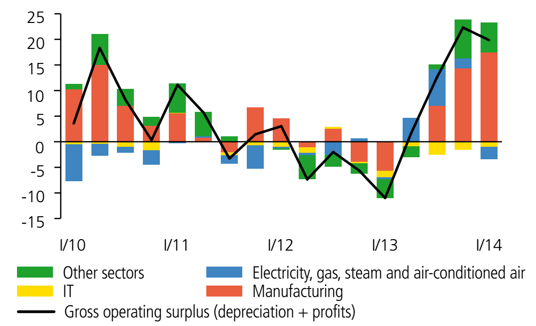


CHART III.5.22

OPERATING PROFIT BY SECTOR

Corporations in manufacturing were the biggest contributor to the high growth in operating profit

(annual percentage changes; contributions in percentage points)



III.5.4 The exchange rate

The average **exchange rate of the koruna against the euro** was CZK 27.4 in 2014 Q2. This represents a year-on-year depreciation of 6.3% and quarter-on-quarter stability (see Chart III.5.20). The koruna fluctuated in a very narrow band between CZK 27.3 and CZK 27.5 to the euro and spent most of the period in an even narrower range just above CZK 27.4 to the euro. The koruna was 0.3% weaker than the forecast for 2014 Q2 (CZK 27.3). In the first half of July, the koruna remained flat at around CZK 27.4 to the euro.

The exchange rate **commitment of the CNB** to maintain the exchange rate at CZK 27 to the euro remained the key factor affecting the exchange rate in the period under review (and so far this year). The exchange rate movements were in line with the asymmetric nature of the exchange rate commitment and still required no actual foreign exchange market interventions by the CNB. Global currency markets were also relatively calm in 2014 Q2. The Canadian dollar, the British pound and the Russian rouble all appreciated (although in the case of the rouble this represented a partial correction of the sharp weakening recorded in the previous quarter).

The average **exchange rate of the koruna against the dollar** was CZK 20.0 in 2014 Q2. This represents a year-on-year depreciation of 1.2% and a quarter-on-quarter appreciation of 0.1%. During the quarter, the koruna fluctuated between CZK 19.7 and CZK 20.3 to the dollar. In first half of July, the koruna fluctuated within an even narrower range of CZK 20.0 and CZK 20.2 to the dollar.

III.5.5 Economic results of non-financial corporations

The financial results of **non-financial corporations with 50 employees or more**[43] were very favourable in 2014 Q1. Corporations' output and sales rose considerably year on year. Output grew at a faster pace than intermediate consumption, which contributed to a stronger year-on-year rise in book value added. Gross operating surplus (operating profit) also maintained the high annual growth observed in the previous quarter (see Chart III.5.21). From a historical perspective, growth in operating profit was exceptionally high in late 2013/early 2014.

The marked change in the dynamics of the main financial indicators of non-financial corporations at the close of 2013 and at the start of 2014 was due to several **factors**. The strong annual growth in sales and output was due mainly to the recovery in domestic and external demand and the weakened koruna exchange rate since November 2013. The two last-mentioned factors were reflected in a pick-up in annual growth in direct export sales at current prices.

43 The segment of corporations with 50 employees or more consisted of 9,000 non-financial corporations in 2014 Q1.

In particular, corporations in manufacturing recorded high annual growth in sales, output and operating profit (see Chart III.5.22). With regard to the **ownership structure of corporations**, this was true above all of foreign-owned corporations, whose production is mostly export-oriented. Their share in the annual increase in operating profit within the monitored set of non-financial corporations rose to almost 80% in 2014 Q1 (see Chart III.5.23).

Although the exchange rate weakening was reflected in import prices of commodities and materials, the **material cost-output ratio**[44] continued to fall in 2013 Q4 and 2014 Q1 (by 0.7 percentage point in 2014 Q1; see Table III.5.3), as output rose faster than intermediate consumption. This was particularly visible in manufacturing, where output growth was in double figures. The decrease in the material cost-output ratio in early 2014 was also due to a drop in electricity prices.

The **personnel cost-output ratio**[45] also fell year on year in 2014 Q1 (by 0.6 percentage point), although the wage component of personnel costs increased by 4% year on year as a result of an increase in the average wage and a slight rise in the number of employees. However, output grew at a considerably faster pace (7.6% year on year).

Data for the narrower **segment of large corporations** (with 250 employees or more)[46] indicate similar trends in the main financial indicators in 2014 Q1 as in the larger segment of corporations.

III.5.6 Financial position of corporations and households

The annual growth rate of **financial liabilities of non-financial corporations** increased in 2014 Q1 (see Chart III.5.24). This was due to stronger growth in shares and other equity excluding quoted shares (owing chiefly to revaluation of unquoted shares) as well as to a moderation of the year-on-year decline in quoted shares. Annual growth in the **financial assets of non-financial corporations** rose to 8% in Q1. This was due mainly to shares and other equity, and in particular to unquoted shares as a result of the above-mentioned revaluation. In addition, higher growth in currency and deposits contributed to the stronger growth in financial assets. The negative net financial position of non-financial corporations fell to 80% of GDP, with financial assets rising faster than financial liabilities. The net financial position of non-financial corporations is thus improving gradually.

The main **balance sheet trends** in non-financial corporations are reflected in those corporations' financial indicators. The acid-test ratio of corporations recorded a marked year-on-year rise in 2014 Q1,

44 The material cost-output ratio defined as the ratio of intermediate consumption to output.
45 The personnel cost-output ratio defined as the ratio of personnel costs to output.
46 The segment of corporations with 250 employees or more consisted of almost 1,700 non-financial corporations in 2014 Q1.

CHART III.5.23

OPERATING PROFIT BY TYPE OF OWNERSHIP

Foreign-controlled corporations accounted for most of the growth in operating profit

(annual percentage changes; contributions in percentage points)

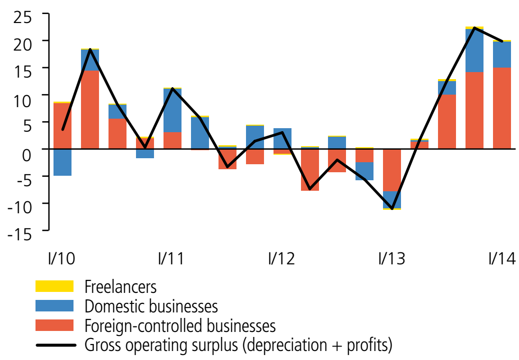


TABLE III.5.3

PERFORMANCE INDICATORS OF NON-FINANCIAL CORPORATIONS

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

	2014 Q1	2013 Q1	Annual percentage changes
Output incl. profit margin (CZK billions)[a]	1,401.6	1,302.3	7.6
Personnel costs (CZK billions)	204.2	197.8	3.3
Intermediate consumption (CZK billions)	1,012.8	950.6	6.6
Book value added (CZK billions)	388.8	351.8	10.5
Sales (CZK billions)	1,833.8	1,698.0	8.0
	Percent-ages	**Percent-ages**	**Annual changes in pp**
Ratio of personnel costs to value added[a]	52.5	56.2	-3.7
Material cost-output ratio[a]	72.3	73.0	-0.7
Personnel cost-output ratio[a]	14.6	15.2	-0.6
Ratio of book value added to output[a]	27.7	27.0	-0.7

a) CNB calculation

CHART III.5.24

FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

Growth in the financial liabilities of corporations accelerated

(annual percentage changes; contributions in percentage points)

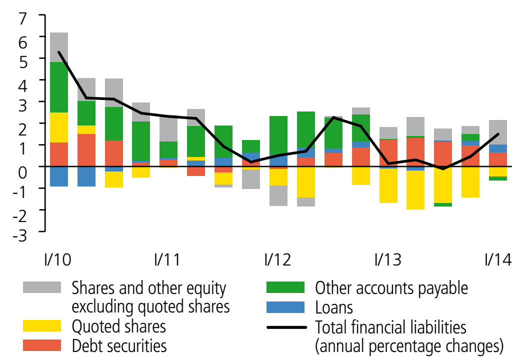


Chart III.5.25

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)

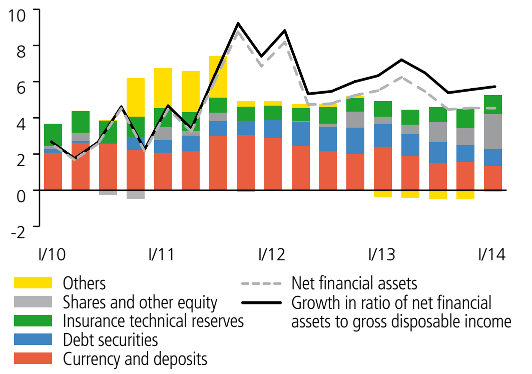
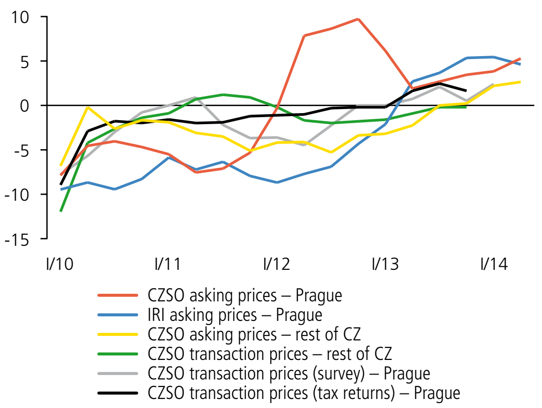


Chart III.5.26

TRANSACTION AND ASKING PRICES OF APARTMENTS

Developments in the property market in 2014 H1 confirm growth in property prices in Prague; prices are also starting to recover in the rest of the Czech Republic

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



though partly due to a low base in 2013 Q1. The market-based financing ratio was unchanged year on year. Corporate solvency, as expressed by total financial assets relative to liabilities excluding shares and other equity, increased again year on year in 2014 Q1.

Households are traditionally net creditors in the national economy. Their net financial position is stable at around 70% of GDP. Annual growth in **net financial assets of households** accelerated to 6% in 2014 Q1. This increase represented 7.6% of the annual gross disposable income of households (see Chart III.5.25). Growth in gross **financial assets** also increased, to 5%. Shares and other equity were the biggest contributor to this growth. They increased in value owing mainly to revaluation of unquoted shares and also to investment in mutual fund shares. In addition, debt securities and insurance reserves again contributed to the growth. By contrast, the contribution of currency and deposits, which is still positive but has long been falling gradually, acted towards a slowdown in growth in financial assets, mainly because of a decrease in other deposits. Annual growth in the **financial liabilities of households** was 3.4%. Long-term loans again made the dominant contribution (almost 4 percentage points).

III.5.7 The property market

Asking prices of older apartments continued to rise in 2014 Q2, achieving significant growth rates not only in Prague, but also for the second consecutive quarter outside Prague (5.3% and 2.6% year on year respectively according to CZSO data; see Chart III.5.26). This represents a further acceleration of year-on-year price growth compared to 2014 Q1 (from 3.8% in Prague and 2.2% outside Prague). By contrast, the alternative data source IRI suggests a slight slowdown (from 5.4% to 4.6% in Prague and from 1.1% to 0.2% outside Prague). However, the confirmation of rising prices in Prague from multiple sources remains an important data reliability indicator given the previous mismatch between estimates of asking price growth across information sources in 2012. Asking price developments in regions outside Prague were very mixed according to the IRI, with the price changes ranging from -4.2% to 4.4%. Prices often increased in regions where they had recorded a year-on-year decline in the previous quarter and vice versa. The price recovery outside Prague therefore still cannot be regarded as very robust.

The estimate of **transaction prices of apartments based on tax returns** in the first two quarters of 2013 was revised towards a lower rate of growth in Prague (1.6%) and a higher rate of decline outside Prague (-0.3%). However, newly available estimates for Q3 and Q4 indicate sharper growth in transaction prices in Prague (of 2.5% and 1.6% respectively) and a now very moderate price decline in the rest of the Czech Republic (-0.2% in both quarters). Newer data on transaction prices from the CZSO survey for 2014 Q1 also indicate that transaction prices in Prague have switched to growth (of 2.4% year on year) after prices from this survey had been flat for more than one year. These prices also newly increased in the rest of the Czech Republic (by 0.8%). According to the same source, prices also rose in the segment of new apartments in Prague, which had previously been the only segment in the capital city to show a decline in prices. Now, however, their annual growth rate is the same as that of older apartments (2.4%). Moreover, the recovery on the new apartment market in Prague is confirmed by a rise in sales in 2014 Q2 (of almost one-third year on year)[47].

Overall, then, asking prices have been more dynamic than transaction prices, in line with the onset of an apartment price growth phase. A price recovery is also suggested by the stronger price growth in Prague than in the rest of the Czech Republic, as prices usually change earlier in Prague than elsewhere in the Czech Republic. However, the extent of the recovery in actual transaction prices is difficult to estimate at this time.

Property price sustainability indicators recorded contrasting trends in 2014 Q2. While the indicators of housing affordability rose slightly owing to the increase in apartment prices,[48] the price-to-rent ratio declined as a result of an increase in rents (see Chart III.5.27). The **price-to-average wage ratio** and the **price-to-disposable income ratio** were up by 1 percentage point and 4.5 percentage points respectively from the lows reached in late 2012. The **price-to-rent ratio** decreased despite mixed year-on-year developments in house prices across regions. This indicator fell in all regions except Brno (by 0.2% year on year in Prague and by 4.3% outside Prague). This fall was due to year-on-year rent increases in most regions, which outweighed the annual growth in prices of housing.

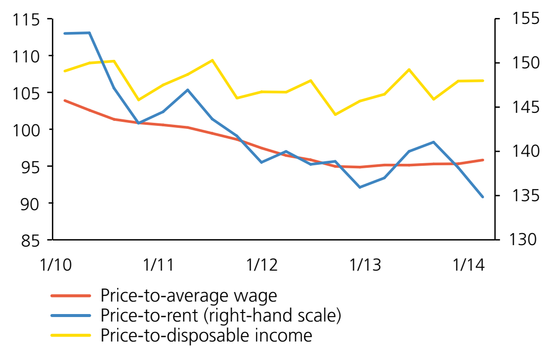
Overall, the conclusions presented in Financial Stability Report 2013/2014 and Inflation Report II/2014 have been confirmed. The house price sustainability indicators combined with other methods of assessing property prices continue to indicate that prices are close to their estimated equilibrium values. Moderate growth in property prices can be expected to continue in the rest of 2014 as economic activity recovers. Further property price growth in the subsequent period will be conditional on an improvement in the labour market and above all on the expected recovery in wage growth.

CHART III.5.27

APARTMENT PRICE SUSTAINABILITY INDICATORS

Property price sustainability indicators recorded rather contrasting trends in 2014 Q2

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



47 Harmonised data from property developers Ekospol, Skanska Reality and Trigema. These data are currently the only available information on transactions, as earlier COSMC data on the number of entries of proceedings ceased to be published at the end of 2013 due to legislative changes. Publication is expected to resume by the end of 2014.

48 For 2014 Q2, the increase in apartment transaction prices was proxied by growth in asking prices according to the CZSO.

CHART III.6.1

CURRENT ACCOUNT

The annual moving current account deficit switched to surplus in 2014 Q1, primarily due to a decrease in the income deficit
(annual moving totals in CZK billions)

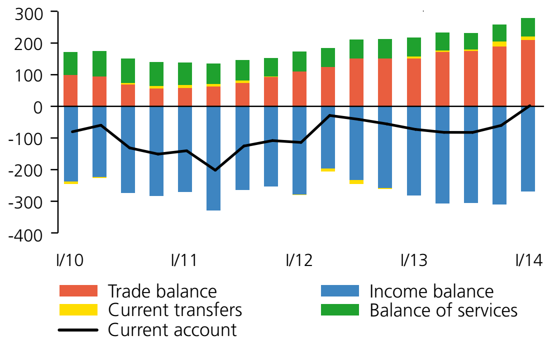


CHART III.6.2

TRADE BALANCE

The year-on-year change in the trade balance was affected most strongly in 2014 Q1 by an increase in the machinery surplus
(accumulation since start of year in CZK billions; change of ownership principle)

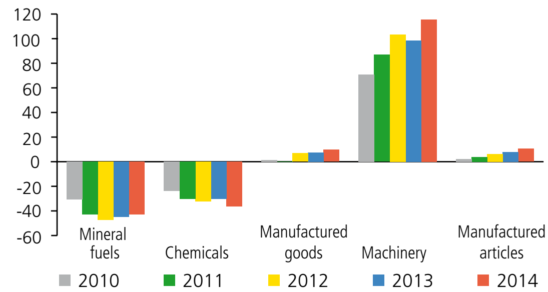
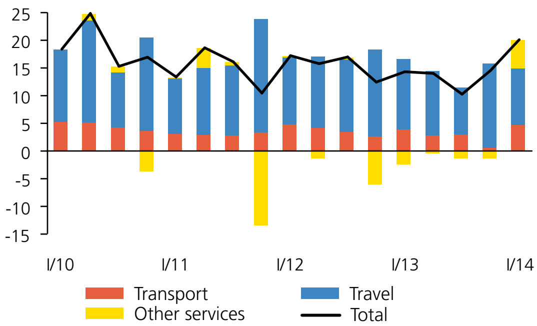


CHART III.6.3

BALANCE OF SERVICES

All three sub-balances contributed to the services surplus in 2014 Q1
(CZK billions)



III.6 BALANCE OF PAYMENTS

In 2014 Q1, the balance of payments was characterised as usual by a high goods and services surplus, associated mainly with a trade surplus. Only about one-quarter of its effect on the current account was offset by the income deficit, which decreased significantly year on year as a result of very low dividends paid to non-residents on their direct investment in the Czech Republic. Direct investment recorded the biggest surplus on the financial account, thanks mainly to Czech investment abroad, which was dominated by reverse flows into the Czech Republic. However, this surplus, together with the net inflow of portfolio investment, was outweighed by a large net outflow of other investment, due mainly to repayment of short-term liabilities to non-residents.

III.6.1 The current account

The **current account** recorded a surplus of CZK 72.3 billion in 2014 Q1. In year-on-year terms, the surplus increased by more than CZK 62 billion, mainly because of a lower income deficit. The annual moving current account deficit turned into a slight surplus for the first time in twenty years (see Chart III.6.1). This surplus reached 0.2% of GDP, up by 1.6 percentage points on the previous quarter, when it had still been negative.

The **trade surplus** rose by more than CZK 19 billion year on year to CZK 72.2 billion in 2014 Q1. The rise in the trade surplus was due mainly to a price effect associated with a positive year-on-year change in the terms of trade, whereas the impact of favourable real developments was only modest. Annual growth in nominal trade turnover accelerated further compared to the previous quarter, mainly due to developments in real terms. The recovery in external demand and the weakening of the koruna were reflected in double-digit growth in goods exports. The marked increase in both total domestic demand and exports fed through to rapid growth in all three components of imports as regards use – imports for final consumption, imports for intermediate consumption and above all investment imports. Turning to the commodity structure, growth in the machinery and transport equipment surplus was the biggest contributor to the year-on-year rise in the overall surplus (see Chart III.6.2). Nevertheless, the year-on-year growth in the trade surplus slowed significantly during Q2, totalling less than CZK 3 billion for April–May.

The improvement in the goods and services balance was also due to the **services surplus**, which reached CZK 20.1 billion. In year-on-year terms, it rose by almost CZK 6 billion (see Chart III.6.3). All three component balances contributed to the surplus in this quarter. Roughly one-half of the surplus was due to the travel surplus, which, however, recorded a year-on-year decline caused by rapid growth in expenditure by residents on private travel. By contrast, the balances on transport and other services increased. Other services, which switched from deficit to surplus owing to a rapid rise in credits, made a key contribution to the year-on-year increase in the overall surplus. This was due mainly to merchanting and computer services.

In contrast to the goods and services surplus, the **income balance** showed a deficit of CZK 25 billion. However, the deficit decreased by almost CZK 41 billion year on year. This decrease was linked mainly with a lower direct investment income deficit as a result of very low dividends paid to non-residents, whereas earnings reinvested in the Czech Republic increased slightly. However, the largest component of the overall balance was again a direct investment income deficit of CZK 28.8 billion (see Chart III.6.4), linked in this quarter mainly with estimated reinvested earnings in the Czech Republic. Portfolio investment income also ended in a slight deficit. By contrast, compensation of employees and other investment income recorded modest surpluses.

Current transfers recorded a surplus of CZK 5 billion in 2014 Q1, down by almost CZK 4 billion from a year earlier. Government transfers were their largest component. The government transfers surplus reached CZK 11 billion, stemming almost exclusively from a surplus on transfers between the Czech Republic and the EU budget (CZK 11.6 billion). However, it was largely offset by a deficit on other transfers. The year-on-year drop in the overall surplus was linked mainly with lower net income from the EU budget.

III.6.2 The capital account

The **capital account** also recorded a surplus (CZK 21.4 billion). The overall surplus was due above all to income of CZK 20.3 billion from the EU budget recorded on the capital account. The year-on-year rise in the overall surplus of almost CZK 21 billion was also related to improved drawdown of funds from the EU budget.

III.6.3 The financial account

The **financial account** ended 2014 Q1 in a deficit of CZK 40.7 billion, associated with a net outflow of other investment. Roughly one-half of this outflow was offset by the combined surplus of the other three balances, in particular a net inflow of direct investment and, to a lesser extent, a net inflow of portfolio investment. In total annual terms, however, the financial account still ran a surplus (see Chart III.6.5).

Direct investment recorded a net inflow of CZK 29.5 billion in 2014 Q1 (see Chart III.6.6), with rather unusual structural developments. The inflow of foreign investment into the Czech Republic was only slightly above CZK 13 billion. It was linked solely with estimated reinvested earnings. These, however, were largely offset by an outflow of funds abroad, primarily in credit relations, but also in equity. A similar pattern was visible in Czech direct investment

CHART III.6.4

INCOME BALANCE

Within the income balance, the direct investment income deficit decreased significantly year on year in 2014 Q1
(accumulation since start of year in CZK billions)

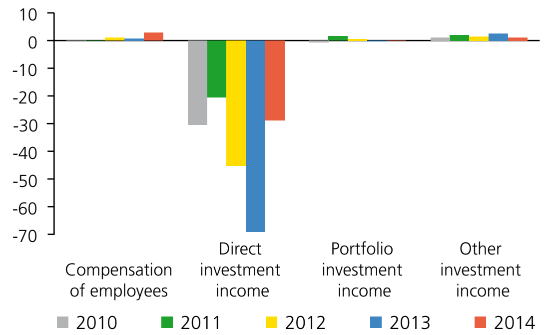


CHART III.6.5

FINANCIAL ACCOUNT

The annual moving financial account surplus decreased in 2014 Q1 due mainly to a decrease in the other investment net inflow
(annual moving totals in CZK billions)

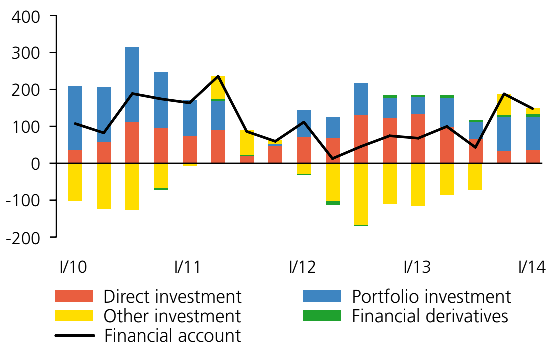
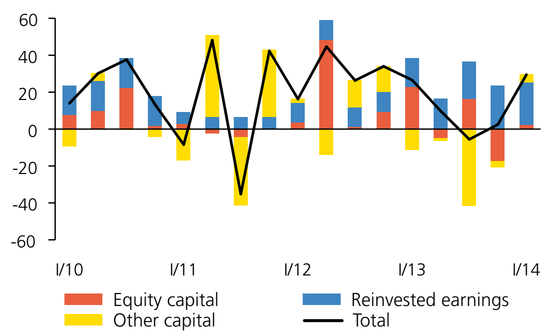


CHART III.6.6

DIRECT INVESTMENT

Reinvested earnings contributed the most to the direct investment surplus in 2014 Q1
(CZK billions)

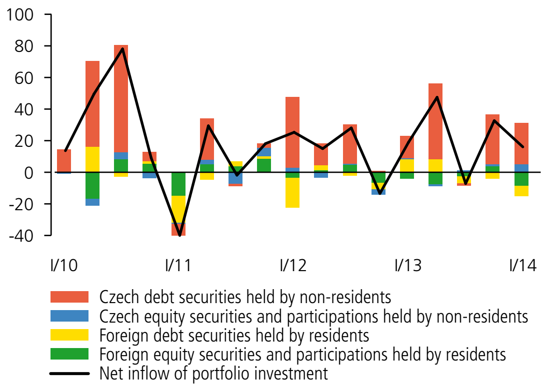


abroad. Only reinvested earnings acted towards an increase in Czech investment abroad. However, in this case their value was significantly outweighed by an opposite flow of investment back into the Czech Republic, especially in credit relations. This was linked with repayment of loans provided by domestic parent companies to their foreign subsidiaries. The resulting decrease in Czech investment abroad was also the biggest contributor to the overall direct investment net inflow. This surplus increased only slightly year on year, as the marked annual decline in the inflow of foreign investment into the Czech Republic and the annual change in Czech investment flows abroad almost offset each other.

CHART III.6.7

PORTFOLIO INVESTMENT

Portfolio investment recorded a net inflow in 2014 Q1, owing mainly to purchases of Czech debt securities by non-residents
(CZK billions)



Portfolio investment also recorded a net inflow (of CZK 16 billion; see Chart III.6.7). The largest operations were purchases of government and corporate bonds by foreign investors in the domestic capital market. Holdings of domestic shares by non-residents also increased slightly. Overall, purchases of domestic securities exceeded CZK 31 billion. Purchases also dominated trading in foreign securities by domestic investors, where demand for shares and bonds was broadly balanced. In year-on-year terms, the net portfolio investment inflow decreased slightly owing to renewed interest in foreign bonds among domestic investors.

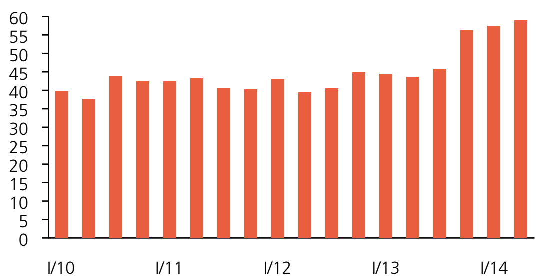
Settlement of **financial derivatives** led to a net inflow of CZK 2.8 billion, representing a slight year-on-year increase.

By contrast, **other investment** recorded a large net outflow of CZK 89.1 billion, roughly double the previous year's figure. The overall deficit was due mostly to a net outflow of CZK 71 billion in the monetary financial institutions sector. This was linked mainly with repayment of short-term liabilities accepted from abroad in the previous quarter. The corporate sector also recorded a significant capital outflow, mainly because of growth in short-term export credits and deposits abroad. Other investment in the government sector also ended in a small deficit associated with repayment of loans from the EIB. The year-on-year increase in the overall net outflow was due chiefly to a change in the short-term position of monetary financial institutions.

CHART III.6.8

CNB INTERNATIONAL RESERVES

The CNB's international reserves further increased in 2014 Q2 compared to the previous quarter
(USD billions; end of quarter)



The **CNB's international reserves** totalled CZK 1,185.7 billion at the end of 2014 Q2, representing a quarter-on-quarter increase of more than CZK 44 billion. This increase was due mainly to a surplus on transactions executed for CNB clients. In dollar terms, the reserves rose by USD 1.5 billion to USD 59 billion in the same period (see Chart III.6.8). The CNB's international reserves covered 53% of all external debt liabilities of domestic entities at the end of 2014 Q1.

BOX
The life cycle of foreign direct investment and its impact on the balance of payments

In the late 1990s the Czech Republic adopted a policy aimed, among other things, at boosting the inflow of foreign direct investment (FDI), which until then had been fairly insignificant. The following text describes the three phases of FDI flows recorded to date. These are also the three main **phases of the FDI life cycle** in the Czech Republic. The description focuses on the amount and structure of the capital inflows and the distribution of earnings into reinvestment and dividends.

The **first phase** (1998–2002) saw a strong inflow of capital from abroad (see Chart 1). Most of the newly generated FDI earnings were reinvested in the Czech Republic. In this period the capital inflow was strongly supported by sales of state-owned property to non-residents and the average annual FDI inflow reached 8.8% of GDP. In the **second phase** (2003–2007), the investment structure changed gradually. In particular, the amount of earnings generated and reinvested in the Czech Republic increased. The Czech Republic's attractiveness to foreign investors in the Central European region started to decline somewhat in this period. In addition, sales of state-owned property ceased to play an important role. Nevertheless, capital continued to flow into the Czech economy at a significant annual average level of 5% of GDP. As for the distribution of FDI income, the ratio of dividends to reinvestment was initially roughly one-to-one, but by the end of this phase dividends had started to exceed reinvestment (see Chart 2).

In the **third phase** (2008–2013), the outbreak of the economic and financial crisis caused a major change in the external conditions and the average annual FDI inflow fell to 2.5% of GDP. Foreign parent companies often got into trouble and used retained and newly generated earnings to fund either themselves or their other subsidiaries in third countries. The privatisation process ground almost to a halt and some foreign firms sold off their assets in the Czech Republic for various reasons. The value of FDI earnings generated by foreign firms in the domestic economy declined. This was reflected in a fall in reinvested earnings as firms struggled to maintain or increase their dividend payments (see Chart 2). The overall FDI inflow decreased significantly in this period owing to a sizeable decrease in investment in equity.

In the first phase, the value of **dividends** paid to non-residents was negligible (only 0.6% of GDP on average), but in the second phase it rose to 2.9% of GDP and during the economic crisis it reached 5.3% of GDP while maintaining

CHART 1 (BOX)

STRUCTURE OF FDI IN THE CZECH REPUBLIC

The FDI inflow structure has gradually changed in favour of reinvested earnings
(CZK billions)

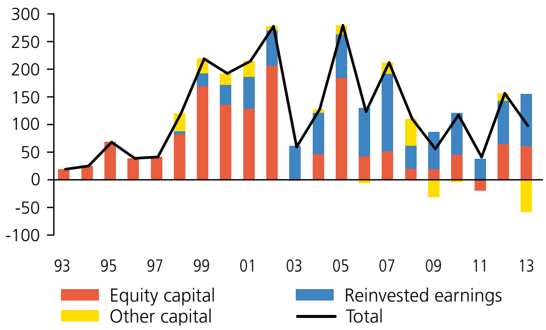


CHART 2 (BOX)

FDI EARNINGS – DEBIT SIDE

The ratio of dividends to reinvested earnings went up considerably during the economic crisis
(CZK billions)

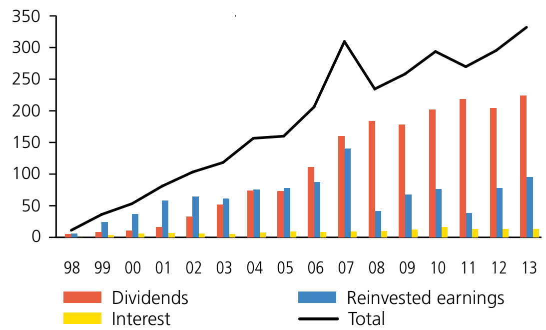


TABLE 1 (BOX)

INTERNATIONAL COMPARISON OF FDI RETURNS

FDI returns were higher in the Czech Republic than in neighbouring countries
(percentages; average for period; source: Eurostat, CNB calculations)

	2003–2008	2009–2012
Czech Republic	13.8	12.5
Hungary	10.8	8.4
Poland	10.8	9.4
Slovenia	8.8	3.3
Slovakia	14.7	9.4

an upward trend.[49] **The return on investment**[50] increased steadily from about 8.4% in 1999 to 13.5% in 2004. Since then it has been flat or falling very slightly. Looking at other Central European countries (see Table 1), the pre-crisis return on direct investment in the Czech Republic and Slovakia was much higher (3–5 percentage points) than in Hungary, Poland and Slovenia (Eurostat data; euro as reference currency). After 2008, the difference compared to other countries increased as a result of a sharper decline in returns in other Central European countries than in the Czech Republic. The FDI return in the Czech Republic was 3–4 percentage points higher on average than that in Poland, Slovakia and Hungary. Compared to Slovenia, which was hit hard by the crisis, the FDI return was roughly four times higher. The different investment returns across countries were due to different investment structures, life cycle phases and depths and sectoral impacts of the crisis in the various countries.[51]

49 The most recent value for 2013 was 5.8% of GDP.
50 Return on investment = total FDI earnings / FDI stock in previous year.
51 The proportion of non-resident firms in sectors with above-average earnings, such as banking, utilities and telecommunications, is much lower in Poland and Slovenia than it is in the Czech Republic. The massive investment inflow phase started earlier in Hungary and later in Slovakia than it did in the Czech Republic.

III.7 THE EXTERNAL ENVIRONMENT

The euro area economy continued to show modest growth in 2014 Q1, and the same is expected in Q2. The ECB responded to the observed disinflationary pressures by further easing its monetary policy in June. GDP in the USA recorded a one-off quarterly decrease in Q1, owing mainly to icy weather at the start of the year. In contrast to the euro area, inflation increased in the USA in 2014 Q2. This, together with other economic conditions, allowed the Federal Reserve to continue tapering its bond purchases. In response, the exchange rate of the euro against the US dollar weakened in 2014 Q2. Oil prices rose temporarily in June in a context of geopolitical tensions, but then declined again.

III.7.1 The euro area

Quarterly **GDP growth in the euro area** slowed from 0.3% in 2013 Q4 to 0.2% in 2014 Q1. The growth was driven by domestic demand (with all its components rising, especially change in inventories), whereas the contribution of net exports was negative. Compared to the previous quarter, the euro area recovery was spread less evenly across the member states. In particular, the German economy and a recovery in Spain contributed to the overall increase in GDP. The French economy stagnated and the Netherlands recorded a marked contraction. By contrast, annual economic growth in the euro area strengthened from 0.5% in 2013 Q4 to 0.9% thanks to the contribution of domestic demand – mainly household consumption and investment. The effect of net exports was neutral (see Chart III.7.1).

In 2014 **Q2**, the June CF expects the quarterly and annual rates of economic growth recorded in Q1 to be more or less maintained. This outlook is supported by the industrial production and retail figures for the first two months of Q2. Their average growth rates were almost unchanged from 2014 Q1. The leading indicators for June do not indicate any change in the pace of economic growth either.

The **June CF outlook** predicts euro area **economic growth** of 1.1% for 2014 as a whole, accelerating to 1.5% in 2015. The ECB presented a similar outlook in June (1.0% and 1.7% respectively) and the IMF also has a comparable future growth estimate (see Chart III.7.2).

HICP inflation in June was unchanged from May, remaining at 0.5%, i.e. well below the ECB's definition of price stability (see Chart III.7.3). Inflation is being reduced by food prices (-0.2%) and prices of non-energy commodities (-0.1%), whereas services prices (1.3%) are pushing it upwards. The decline in industrial producer prices moderated to -1% in May.

The **June CF** expects no further fall in **inflation** in the second half of this year. On the contrary, it predicts a moderate increase in inflation in Q4, with this trend continuing into 2015. Average inflation is expected

CHART III.7.1

GDP IN THE EURO AREA

Growth in domestic demand – especially fixed investment and household consumption – was the biggest contributor to the increase in GDP growth in 2014 Q1

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

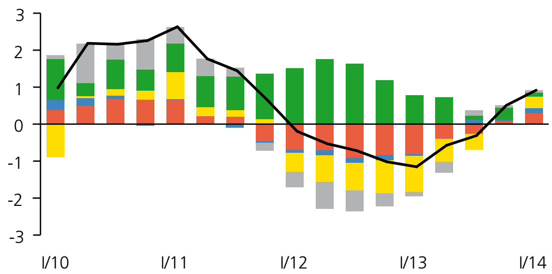
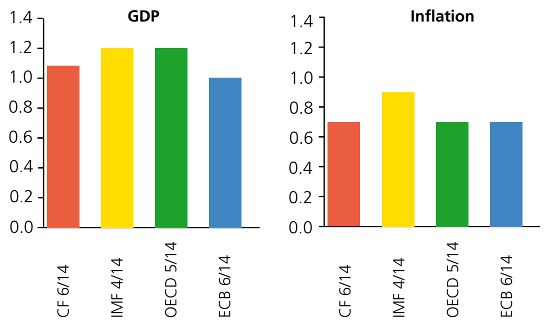


CHART III.7.2

EURO AREA GDP AND INFLATION OUTLOOKS FOR 2014

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

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



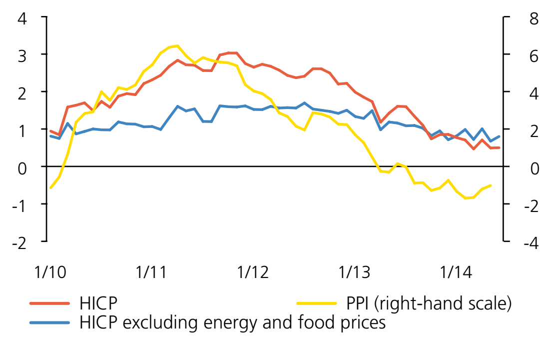
Note: Horizontal axis shows most recent forecast data in format "Source month/ year of publication". Midpoint of range for ECB.

CHART III.7.3

INFLATION AND PRODUCER PRICES IN THE EURO AREA

Inflation went down further in 2014 Q2 compared to the previous quarter, while the decline in producer prices moderated

(annual percentage changes; source: Datastream)



to be 0.7% in 2014 as a whole and 1.2% in 2015. The ECB published a similar forecast in June. Compared to March it lowered its inflation estimate from 1% to 0.7% and from 1.3% to 1.1% respectively.

At its June meeting, the ECB introduced several measures to further ease monetary policy. It lowered its key interest rate on the main refinancing operations of the Eurosystem by 10 basis points to 0.15%, the rate on the deposit facility by 10 basis points to -0.10%[52] and the rate on the marginal lending facility by 35 basis points to 0.40%. In addition, the ECB announced the introduction of targeted longer-term refinancing operations (TLTROs)[53] aimed at improving bank lending to the euro area non-financial private sector. The liquidity injected earlier under the Securities Markets Programme (SMP) will also cease to be sterilised.[54] Furthermore, the ECB announced that it would intensify preparatory work related to outright purchases of asset-backed securities (ABSs), i.e. preparatory work for quantitative easing. As well as extending the existing eligibility of additional assets as collateral until September 2018, the ECB will continue conducting its main refinancing operations (MROs) at a fixed rate and with full allotment at least until the end of 2016.

In July the ECB made no further changes to its interest rates, but repeated its commitment to keep rates at present levels for an extended period of time in view of the current outlook for inflation. In addition, it announced a change in the frequency of monetary policy meetings from one month to six weeks. The ECB also decided to adjust the TLTROs to a maximum amount of EUR 1 trillion. As in June, the risks to economic growth were identified as being on the downside and the risks to inflation as being limited and broadly balanced overall.

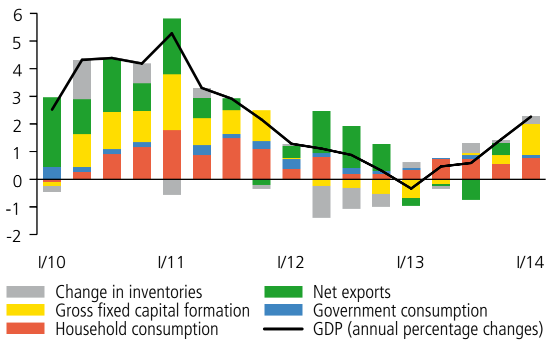
Economic growth in Germany strengthened substantially in both quarter-on-quarter and year-on-year terms in 2014 Q1 (from 0.4% to 0.8% and from 1.4% to 2.3% respectively). In both cases, the increased growth was due to rising domestic demand. Household and government consumption increased, as did investment (both fixed investment and investment in inventories), due among other things to the very mild winter. The contribution of net exports was roughly neutral (see Chart III.7.4).

CHART III.7.4

GDP IN GERMANY

GDP growth accelerated further in 2014 Q1 thanks to increased contributions from household consumption and fixed investment

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



52 The negative deposit facility interest rate also applies to: (i) banks' average reserve holdings in excess of the minimum reserve requirements; (ii) government deposits held with the Eurosystem that exceed certain thresholds; (iii) Eurosystem reserve management services accounts if not currently remunerated; (iv) participants' account balances in TARGET2; (v) non-Eurosystem balances (overnight deposits) of national central banks held in TARGET2; and (vi) other accounts held by third parties with Eurosystem central banks when stipulated that they are not currently remunerated or are remunerated at the deposit facility rate.

53 TLTROs totalling EUR 400 billion and maturing in September 2018 were announced in June. The total amount in the first two operations (September and December 2014) will be limited by an initial allowance equal to 7% of the total amount of loans to the euro area non-financial private sector, excluding loans to households for house purchase, outstanding on 30 April 2014. The borrowing allowance in subsequent operations will be derived from newly provided loans. After two years it will be possible to repay early. The interest rate will be derived from the repo rate plus 10 basis points and interest will be paid in arrears when the borrowing is repaid.

54 In addition, the special-term refinancing operations with a maturity of one maintenance period were discontinued.

The **June CF** expects both quarterly and annual economic growth to slow in **2014 Q2**. This is also indicated by a marked slowdown in both month-on-month and year-on-year growth in industrial production and retail sales in the first two months of Q2. The leading indicators (Ifo, ZEW and the PMI in manufacturing) fell slightly in June (especially the outlook component), confirming the expected economic slowdown.

The June CF estimates **GDP growth** of 2% for both **2014 as a whole and 2015**. Similar outlooks were published by the German government, the Bundesbank and the European Commission. The IMF expects economic growth to be somewhat lower (1.7% and 1.6% respectively).

Inflation in Germany edged up by 0.1 percentage point to 1% in June (see Chart III.7.5). Growth in services prices accelerated (to 1.6%) and the decline in energy prices slowed (to -0.3%). These items slightly outweighed a halt in growth in food prices. The June CF reduced its outlook for average inflation to 1.2% this year, but still expects it to rise to 1.8% next year.

The German government and the Bundesbank both expect a broadly **balanced state budget** this year. German public finances recorded similar results in the previous two years. As a result of nominal GDP growth, the ratio of total general government debt to GDP will decrease from 81% at the end of 2012 to around 75% at the end of 2014.

The growth rate of **Slovak GDP** increased in both quarter-on-quarter and year-on-year terms in 2014 Q1 owing to faster growth in domestic demand, in particular household consumption and fixed investment. A higher contribution of domestic demand to GDP growth outweighed a lower contribution of net exports.

Average **growth in industrial production and retail sales** weakened somewhat in April and May compared to 2014 Q1. This suggests that quarterly economic growth will probably slow slightly in Q2. The June CF increased expected economic growth to 2.5% in 2014 as a whole and to 3.1% next year. The IMF and Infostat predict similar developments. The unemployment rate edged down to 12.8% in May.

Consumer prices in Slovakia returned to a decline of 0.1% following year-on-year stagnation in June, mainly because of a deeper decline in food prices (-1.7%). The future path of inflation is uncertain. The June CF expects prices to grow by 0.4% in 2014 as a whole, but an average drop in industrial producer prices of almost 4% in the first five months of this year coupled with a decline in prices of food and energy indicates that inflation for the year as a whole will probably be lower. In early June, the NBS lowered its consumer price inflation estimate for the whole of this year to 0.1%.

CHART III.7.5

INFLATION AND PRODUCER PRICES IN GERMANY

Inflation went down further in 2014 Q2, mainly due to prices of energy and food, while the decline in industrial producer prices stopped deepening

(annual percentage changes; source: Datastream)

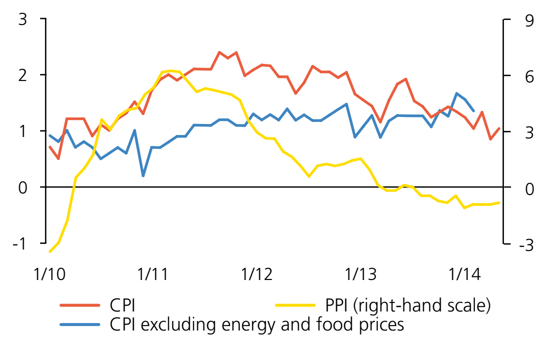


CHART III.7.6

GDP IN THE USA

GDP growth slowed in 2014 Q1

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

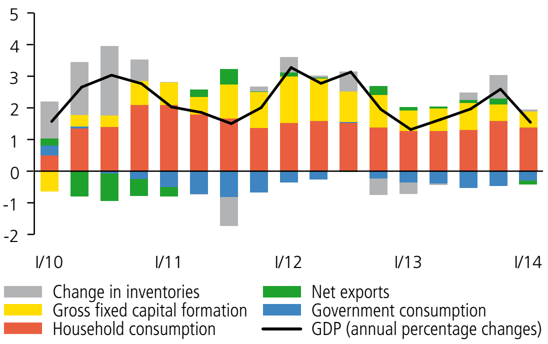
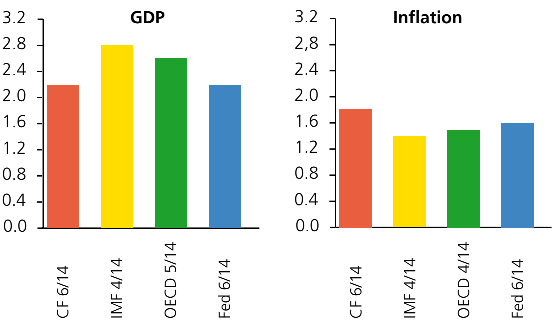


CHART III.7.7

US GDP AND INFLATION OUTLOOKS FOR 2014

Relatively rapid GDP growth is expected in 2014, while inflation pressures will be subdued

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



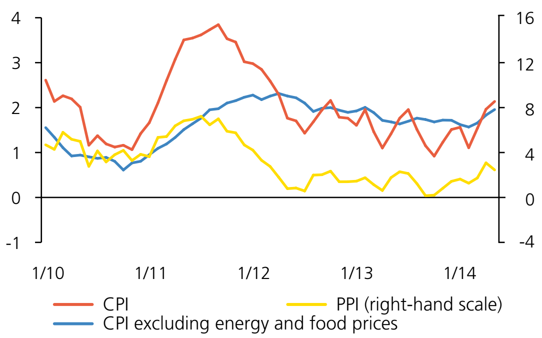
Note: Horizontal axis shows most recent forecast data in format "Source month/year of publication". Midpoint of range for Fed.

CHART III.7.8

INFLATION AND PRODUCER PRICES IN THE USA

Inflation increased in 2014 Q2

(annual percentage changes; source: Datastream)



III.7.2 The United States

Annual **economic growth in the USA** slowed to 1.5% in 2014 Q1 from 2.6% a quarter earlier (see Chart III.7.6). In quarter-on-quarter terms, GDP declined by 0.7%. This weak result reflected icy weather at the start of the year and a surprising drop in expenditure on health services. A positive sign, however, is that household consumption, which increased by 2.0% year on year, remains the engine of economic growth, as in previous quarters. With the exception of government consumption, the other components of domestic demand also contributed to the growth. By contrast, the contribution of net exports was slightly negative, as real import growth outpaced real export growth in Q1. The annual cumulative current account deficit was flat at 2.4% of GDP in 2014 Q1. A downward trend in government expenditure contributed to a lower annual cumulative budget deficit of 2.9% of GDP in 2014 Q1.

Industrial production started to pick up pace year on year in January and recorded growth of 4.3% in May. The PMI leading indicator in industry also stayed in the expansion band in June, at roughly the same level as in May. This indicates an acceleration in industrial production in 2014 Q2 as a whole. The pick-up in economic growth in Q2 is confirmed by retail sales, which rose by 4.5% year on year and 2.3% quarter on quarter in Q2 at current prices. The favourable picture is additionally illustrated by a further drop in unemployment to 6.1% in June. Indicators of consumer confidence (Conference Board) and consumer sentiment (University of Michigan) also increased in the same month, with consumer confidence reaching its highest level in more than five years.

According to the June CF, **GDP growth in 2014** should reach 2.2% (see Chart III.7.7). This represents a downward revision of expected growth, primarily reflecting the weaker first quarter of the year.

By contrast, the outlook for **consumer price inflation** remains anchored below 2% despite a rise in inflation in the course of 2014 Q2. In May alone, consumer prices rose by 2.1% year on year. However, producer price inflation slowed to 2.5% year on year in May (see Chart III.7.8).

According to a statement made by the **Federal Reserve**, however, the current rise in consumer prices does not pose a risk and is taken more as a short-term fluctuation. At its June meeting, the FOMC decided to further reduce its monthly purchases of MBSs and longer-term Treasury securities. In addition, it decided that all purchases should be ended following the meeting in October 2014. The markets are therefore turning their attention increasingly to the timing of the future monetary policy tightening through an interest rate increase.

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** in 2014 Q2 was affected mainly by the further easing of monetary policy by the ECB. The euro appreciated slightly against the US dollar during April, but this trend reversed in early May. ECB President Mario Draghi hinted at a press conference in the second week of May that monetary policy might be eased further at the June meeting. The May data confirmed persisting low inflation in the euro area and a subdued economic growth outlook. The June meeting of the ECB brought a further impulse for a weakening of the single European currency in the form of a monetary policy easing (see section III.7.1 for details). By contrast, the Federal Reserve continued to taper its bond purchases.

The euro weakened **against the Japanese yen and the British pound** during 2014 Q2. Interest in the Japanese currency was supported by economic news and by a stable monetary policy outlook at least until the end of 2014. The recovery in the UK was confirmed to be broad and robust. The unemployment rate there fell to its lowest level in five years. On the other hand, inflation remains below the central bank's target, so monetary policy is not expected to be tightened until 2015.

In the first half of July 2014, the exchange rate of the euro against major world currencies was stable. There were no changes in ECB monetary policy, but the central bank repeated that it was ready to use other instruments should the period of low inflation last too long.

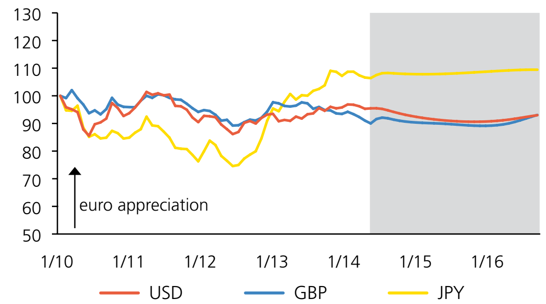
At the one-year horizon, the **June CF** expects the euro to depreciate by 4.2% against the US dollar and by 1.2% against the British pound. By contrast, the euro is expected to appreciate by 1.2% against the Japanese yen (see Chart III.7.9).

CHART III.7.9

EURO EXCHANGE RATE AGAINST MAJOR CURRENCIES

The euro depreciated against major world currencies in May and June

(January 2010 = 100; source: Datastream, outlook from CF)



III.7.4 Prices of oil and other commodities

The monthly average **price of Brent crude oil** rose only slightly in April and May (to USD 108 and USD 109 a barrel respectively; see Chart III.7.10), mainly because of the political situation in Ukraine. However, the price increase accelerated in mid-June in reaction to the armed uprising in northern Iraq. The Brent crude oil price briefly climbed above USD 115 a barrel and the monthly average for June rose to USD 112 a barrel. In the rest of June and the first half of July, however, prices fell back below USD 106 a barrel as traders became convinced that oil extraction and export facilities, which are mostly located in southern Iraq, were not threatened. Oil prices are also being pushed down by expectations that an agreement between rebels and the Libyan government will soon allow oil exports from Libya to increase.

CHART III.7.10

OIL AND NATURAL GAS PRICES IN USD

The price of Brent crude oil increased in June in reaction to the conflict in Iraq, but then fell back. The outlook is only slightly falling

(oil in USD/barrel; gas in USD/1,000 m^3 – right-hand scale; source: IMF, Bloomberg)

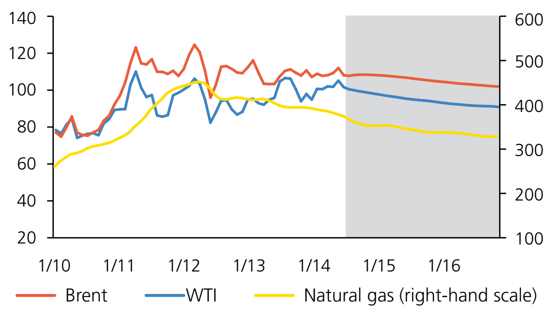


CHART III.7.11

DECOMPOSITION OF KORUNA OIL PRICE GROWTH

The koruna price of oil should be flat; a slight decline is expected in 2016 thanks to a falling dollar price and a slight appreciation of the koruna

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

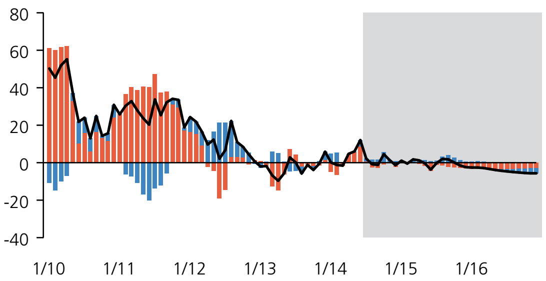
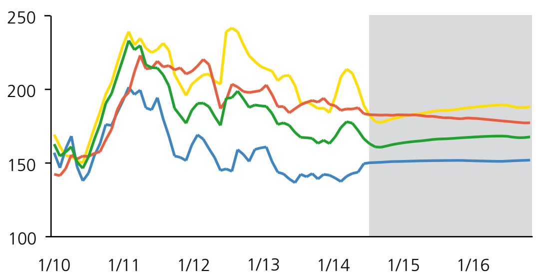


CHART III.7.12

COMMODITY PRICES

The industrial metals price index rose slightly, whereas the food commodity price index decreased significantly

(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).

Demand for oil is currently being depressed by low activity at refineries, which are facing low margins, especially in Europe. The IEA lowered its demand prediction for this year on the basis of weaker current economic data. By contrast, supply is sufficient despite shortfalls in Libya. Exports from Iraq have not been affected by the conflict there, and exports from the Kurdish part of Iraq are growing. Iran is meanwhile taking advantage of a temporary agreement with global superpowers to supply oil to customers in Asia. Moreover, rising oil extraction in the USA is greatly reducing US demand for oil imports there. These factors, coupled with expectations that Libyan oil will soon return to world markets, are pushing the oil price downwards regardless of the persisting geopolitical risks. The sufficient supply of physical oil on the market is confirmed by a surge in commercial stocks of oil and oil products in OECD countries in April and May and also preliminarily in June.

The **market outlook** expects Brent crude oil prices to be flat at roughly the current level until the end of 2014 (annual average: USD 108.5 a barrel) and then follow a slightly downward path (annual average in 2015: USD 106.7 a barrel). The EIA upped its forecast for the average Brent crude oil price by USD 2 to USD 110 a barrel this year and by USD 3 to USD 105 a barrel next year. This is in line with the June CF, which expects a Brent price of around USD 105 a barrel one year ahead. According to the EIA, the average WTI discount to Brent should be around USD 9 a barrel this year and rise to USD 10 a barrel next year.

Supply-side developments dominated **non-energy commodity markets** in the past three months. The food commodity price index decreased significantly due to cereals (see Chart III.7.12). The decline started roughly in mid-May and is due to a bumper wheat harvest in the Black Sea area and significantly better growing conditions for corn and soy in the USA compared to last year thanks to good weather. The easing of geopolitical tensions related to developments in Ukraine also had a short-term effect. By contrast, the industrial metals price index rose slightly and has a flat outlook, as the improving outlook for demand in the USA and China is offset by surplus production capacity in the sector.

ABSs	asset-backed securities
APRC	annual percentage rate of charge
CF	Consensus Forecasts
CNB	Czech National Bank
COSMC	Czech Office for Surveying, Mapping and Cadastre
CPI	consumer price index
CZK	Czech koruna
CZSO	Czech Statistical Office
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EIA	Energy Information Administration
EIB	European Investment Bank
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
FDI	foreign direct investment
Fed	US central bank
FMIE	Financial Market Inflation Expectations
FOMC	Federal Open Market Committee
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
GVA	gross value added
HICP	harmonised index of consumer prices
HP filter	Hodrick-Prescott filter
IEA	International Energy Agency
Ifo	Institute for Economic Research
ILO	International Labour Organization
IMF	International Monetary Fund
Infostat	Slovak Institute for Information and Statistics
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
MROs	main refinancing operations
NBS	National Bank of Slovakia
OECD	Organisation for Economic Co-operation and Development
PMI	Purchasing Managers Index
pp	percentage points
PPI	producer price index
PRIBOR	Prague Interbank Offered Rate
(1W, 1M, 1Y)	(one-week, one-month, one-year)
repo rate	repurchase agreement rate
SMP	Securities Markets Programme
TLTROs	targeted longer-term refinancing operations
USD	US dollar
VAT	value added tax
WTI	West Texas Intermediate
ZEW	Zentrum für Europäische Wirtschaftsforschung (Centre for European Economic Research)

Forecasts for general government debt and debt service, and sensitivity analyses	(Box)	I/2011
Price-setting behaviour in the Czech Republic (micro data evidence) in relation to the pricing mechanism in the g3 forecasting model	(Box)	II/2011
The relationship between the Brent crude oil price and the dollar exchange rate	(Box)	II/2011
The impacts of changes to VAT rates on the budget and inflation and their components in 2012 and 2013	(Box)	III/2011
Labour market developments during the economic recession and the subsequent recovery	(Box)	III/2011
The debt situation in Italy	(Box)	III/2011
Publication of the Graph of Risks to the Inflation Projection (GRIP)	(Annex)	III/2011
Pension system reform	(Box)	IV/2011
The credit rating of the Czech Republic	(Box)	IV/2011
Germany – the Czech Republic's main trading partner	(Box)	IV/2011
The pass-through of VAT to food prices at the end of 2011	(Box)	I/2012
Extraordinary revision of the quarterly national accounts	(Box)	I/2012
An analysis of the impacts of fiscal measures in the Czech Republic in 2001–2011	(Box)	I/2012
Revision of the consumer basket	(Box)	II/2012
Factors affecting retail fuel prices	(Box)	II/2012
The Bank Lending Survey	(Box)	III/2012
The CZK/USD exchange rate at a time of uncertainty	(Box)	III/2012
Easy monetary policy and commodity prices	(Box)	III/2012
The household saving rate	(Box)	IV/2012
Consumption and money savings by household income group	(Box)	IV/2012
The share of reinvested earnings in total FDI income	(Box)	IV/2012
Revision of the quarterly national accounts	(Box)	I/2013
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
The life cycle of foreign direct investment and its impact on the balance of payments	(Box)	III/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 impulse: A variable taking into account the effect of fiscal policy on economic activity in the short run.

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										
		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
DEMAND AND SUPPLY												
Gross domestic product												
GDP	CZK bn, constant p. of 2005, seas. adjusted	3,338.4	3,529.4	3,632.1	3,473.9	3,554.0	3,619.0	3,585.0	3,551.1	**3,655.3**	**3,763.9**	**3,867.9**
GDP	%, y-o-y, real terms, seas. adjusted	7.2	5.7	2.9	-4.4	2.3	1.8	-0.9	-0.9	**2.9**	**3.0**	**2.8**
Household consumption	%, y-o-y, real terms, seas. adjusted	4.4	4.1	2.9	0.3	0.9	0.5	-2.1	0.1	**1.9**	**1.9**	**2.0**
Government consumption	%, y-o-y, real terms, seas. adjusted	-0.6	0.4	1.2	4.0	0.2	-2.7	-1.9	1.6	**2.0**	**1.5**	**1.5**
Gross capital formation	%, y-o-y, real terms, seas. adjusted	10.6	15.5	1.5	-20.0	5.1	0.9	-4.8	-4.5	**5.1**	**4.9**	**3.4**
Exports of goods and services	%, y-o-y, real terms, seas. adjusted	14.3	11.2	3.5	-10.5	15.0	9.6	4.7	0.2	**11.0**	**9.5**	**7.7**
Imports of goods and services	%, y-o-y, real terms, seas. adjusted	11.2	12.8	2.3	-11.7	14.9	7.0	2.5	0.6	**11.4**	**9.6**	**7.5**
Net exports	CZK bn, constant p. of 2005, seas. adjusted	156.3	139.3	174.7	185.3	213.3	297.2	370.1	359.3	**387.6**	**422.0**	**459.7**
Coincidence indicators												
Industrial production	%, y-o-y, real terms	8.3	10.6	-1.8	-13.6	8.6	5.9	-0.8	-0.1	-	-	-
Construction output	%, y-o-y, real terms	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	10.8	10.0	2.7	-4.7	1.5	1.7	-1.1	1.2	-	-	-
PRICES												
Main price indicators												
Inflation rate	%, end-of-period	2.5	2.8	6.4	1.1	1.5	1.9	3.3	1.4	-	-	-
Consumer Price Index	%, y-o-y, average	2.5	2.8	6.4	1.1	1.5	1.9	3.3	1.4	**0.4**	**1.8**	**2.1**
Regulated prices (18.70%)*	%, y-o-y, average	9.3	4.8	15.6	8.4	2.6	4.7	8.6	2.2	**-3.1**	**-0.3**	**1.2**
Net inflation (81.30%)*	%, y-o-y, average	0.4	1.7	2.4	-0.9	0.0	1.3	1.0	0.5	**1.0**	**1.9**	**2.2**
Food prices (including alcoholic beverages and tobacco) (24.58%)*	%, y-o-y, average	-0.2	3.8	3.0	-0.9	0.9	3.9	2.9	3.1	**1.7**	**1.4**	**2.3**
Adjusted inflation excluding fuels (53.32%)*	%, y-o-y, average	0.6	0.7	2.0	0.0	-1.2	-0.7	-0.3	-0.5	**0.6**	**2.1**	**2.3**
Fuel prices (3.39%)*	%, y-o-y, average	3.7	-0.3	4.3	-11.1	11.8	9.9	6.0	-2.1	**1.1**	**1.8**	**0.1**
Monetary-policy inflation (excluding tax changes)	%, y-o-y, average	2.3	2.2	4.4	0.9	0.4	1.9	2.1	0.6	**0.3**	**1.6**	**2.1**
GDP deflator	%, y-o-y, seas. adjusted	0.5	3.3	1.9	2.3	-1.6	-0.9	1.6	1.9	**1.4**	**1.7**	**1.9**
Partial price indicators												
Producer prices	%, y-o-y, average	1.5	4.1	4.5	-3.1	1.2	5.6	2.1	0.8	**-0.3**	**0.7**	**1.9**
Agricultural prices	%, y-o-y, average	1.3	16.4	10.8	-24.3	7.7	22.7	3.6	5.2	**0.9**	**2.3**	**2.2**
Construction work prices	%, y-o-y, average	2.9	3.9	4.5	1.2	-0.2	-0.5	-0.7	-1.1	-	-	-
Brent crude oil	%, y-o-y, average	20.0	9.9	35.4	-36.5	28.4	38.2	0.7	-2.6	**-0.2**	**-1.7**	**-3.3**
LABOUR MARKET												
Average monthly wage	%, y-o-y, nominal terms	6.6	7.2	7.8	3.3	2.2	2.5	2.5	0.0	**2.7**	**4.6**	**4.6**
Average monthly wage	%, y-o-y, real terms	4.0	4.3	1.4	2.3	0.7	0.6	-0.8	-1.4	**2.3**	**2.7**	**2.5**
Number of employees	%, y-o-y	1.1	1.8	1.6	-2.2	-2.2	0.0	-0.1	1.6	**0.3**	**0.7**	**0.5**
Unit labour costs	%, y-o-y	0.1	2.4	4.4	2.5	-1.7	0.4	2.9	0.1	**0.8**	**2.7**	**2.8**
Unit labour costs in industry	%, y-o-y	-7.2	2.4	-3.3	5.4	-5.8	0.4	4.4	0.3	-	-	-
Aggregate labour productivity	%, y-o-y	5.6	3.5	0.8	-2.8	3.5	1.9	-1.4	-1.8	**1.8**	**3.0**	**2.9**
ILO general unemployment rate	%, average, age 15–64	7.2	5.4	4.5	6.7	7.3	6.8	7.0	7.0	**6.4**	**6.3**	**6.2**
Share of unemployed	%, average	6.1	4.9	4.1	6.2	7.0	6.7	6.8	7.7	**7.7**	**7.2**	**7.0**
PUBLIC FINANCE												
Public finance deficit (ESA95)	CZK bn, current p.	-79.2	-26.7	-85.0	-217.4	-177.1	-121.9	-161.1	-56.4	**-46.8**	**-65.1**	**-45.1**
Public finance deficit / GDP**	%, nominal terms	-2.4	-0.7	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	**-1.2**	**-1.5**	**-1.0**
Public debt (ESA95)	CZK bn, current p.	948.1	1,023.4	1,104.3	1,299.3	1,454.4	1,583.3	1,775.1	1,788.2	**1,840.0**	**1,905.4**	**1,954.6**
Public debt / GDP**	%, nominal terms	28.3	27.9	28.7	34.6	38.4	41.4	46.2	46.0	**45.4**	**44.9**	**43.9**
EXTERNAL RELATIONS												
Current account												
Trade balance	CZK bn, current p.	59.3	46.9	25.7	87.3	53.8	90.3	148.6	188.0	**235.2**	**255.0**	**290.0**
Trade balance / GDP	%, nominal terms	1.8	1.3	0.7	2.3	1.4	2.4	3.9	4.8	**5.8**	**6.0**	**6.5**
Balance of services	CZK bn, current p.	49.0	59.2	73.9	73.9	75.3	58.4	62.3	53.0	**65.1**	**70.0**	**75.0**
Current account	CZK bn, current p.	-67.1	-156.9	-81.3	-89.3	-146.6	-104.0	-51.3	-56.0	**-14.7**	**10.0**	**10.0**
Current account / GDP	%, nominal terms	-2.0	-4.3	-2.1	-2.4	-3.9	-2.7	-1.3	-1.4	**-0.4**	**0.2**	**0.2**
Foreign direct investment												
Direct investment	CZK bn, current p.	90.3	179.1	36.3	37.7	95.0	46.8	121.3	33.2	**160.0**	**85.0**	**115.0**
Exchange rates												
CZK/USD	average	22.6	20.3	17.1	19.1	19.1	17.7	19.6	19.6	-	-	-
CZK/EUR	average	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.	-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.	-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	-1.2	1.3	-4.6	0.2	-1.0	1.7	2.9	1.2	**4.0**	**0.4**	**0.8**
Prices of imports of goods	%, y-o-y, average	0.2	-1.0	-3.3	-3.5	2.0	4.3	4.2	-0.2	**1.9**	**0.6**	**-0.1**
MONEY AND INTEREST RATES												
M2	%, y-o-y, average	9.5	11.6	9.5	5.7	4.3	3.6	5.6	4.4	**4.5**	**5.7**	**5.1**
2W repo rate	%, end-of-period, CNB forec. = avg.	2.50	3.50	2.25	1.00	0.75	0.75	0.05	0.05	**0.05**	**0.18**	**1.26**
3M PRIBOR	%, average	2.3	3.1	4.0	2.2	1.3	1.2	1.0	0.5	**0.4**	**0.5**	**1.6**

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

2012				2013				2014				2015				2016			
QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
902.0	897.9	895.2	889.9	881.4	883.4	886.5	899.8	907.0	908.5	921.5	918.3	930.7	938.3	944.8	950.1	956.3	963.0	970.4	978.3
-0.2	-0.9	-1.2	-1.4	-2.3	-1.6	-1.0	1.1	2.9	2.8	3.9	2.1	2.6	3.3	2.5	3.5	2.8	2.6	2.7	3.0
-1.4	-1.9	-2.1	-3.1	-1.4	-0.2	0.8	1.2	1.5	1.8	2.1	2.3	1.6	2.1	2.1	1.9	2.0	1.9	1.9	2.1
-2.8	-2.5	-1.5	-0.9	1.0	0.8	2.6	2.1	1.4	2.8	1.5	2.3	1.0	1.5	1.7	1.9	1.8	1.6	1.4	1.2
-5.5	-2.2	-11.1	-0.1	-4.8	-11.4	-0.7	-1.0	3.4	11.2	7.4	-1.1	6.0	4.1	2.0	7.6	4.4	3.8	3.1	2.5
6.9	4.4	4.6	2.9	-3.7	0.6	0.3	3.7	10.1	9.8	11.3	12.8	9.9	10.0	9.5	8.6	7.9	7.5	7.5	7.8
3.8	3.0	0.5	2.6	-3.1	-0.8	2.9	3.5	9.5	12.2	11.1	13.0	10.5	9.6	9.5	8.9	8.1	7.6	7.3	7.2
92.8	89.5	102.0	85.9	84.6	99.3	85.1	90.3	97.6	92.6	96.6	100.7	103.4	105.4	106.3	106.9	109.5	112.8	116.6	120.8
2.6	-0.8	-0.9	-4.1	-5.9	-2.8	3.7	5.0	6.7	-	-	-	-	-	-	-	-	-	-	-
-10.0	-6.0	-6.2	-9.0	-11.2	-11.7	-3.9	-3.1	8.4	-	-	-	-	-	-	-	-	-	-	-
0.9	-2.2	-1.1	-1.7	-2.7	0.4	2.9	3.8	6.7	-	-	-	-	-	-	-	-	-	-	-
2.4	2.7	3.2	3.3	2.8	2.3	1.8	1.4	1.0	0.7	-	-	-	-	-	-	-	-	-	-
3.7	3.4	3.3	2.9	1.8	1.5	1.2	1.1	0.2	0.2	0.4	0.9	1.3	1.8	2.0	2.0	2.2	2.1	2.0	1.9
9.7	9.4	8.2	7.1	3.5	2.6	1.5	1.3	-4.1	-3.6	-2.6	-2.2	-0.1	-0.1	-0.3	-0.5	1.4	1.3	1.2	1.1
1.3	1.0	0.9	0.6	0.6	0.6	0.5	0.3	1.0	0.7	0.9	1.3	1.2	1.8	2.3	2.4	2.4	2.3	2.1	2.0
3.5	2.6	2.8	2.7	3.0	3.8	3.3	2.4	3.5	1.5	0.8	1.0	0.0	1.1	2.3	2.4	2.4	2.4	2.3	2.2
-0.3	-0.2	-0.4	-0.5	-0.4	-0.6	-0.7	-0.4	-0.2	0.4	0.9	1.3	1.8	2.1	2.3	2.4	2.5	2.4	2.2	2.1
8.0	5.8	6.4	3.8	-1.5	-3.8	-1.4	-1.7	0.3	1.0	1.3	1.9	0.9	2.9	1.4	1.8	1.0	0.3	-0.2	-0.6
2.5	2.2	2.0	1.6	0.9	0.8	0.4	0.3	0.1	0.0	0.3	0.7	1.0	1.5	1.8	1.9	2.2	2.1	2.0	1.9
2.1	1.9	1.4	1.0	1.9	1.8	1.7	2.3	2.2	1.6	1.2	0.7	0.5	1.9	2.0	2.2	1.9	1.6	2.2	1.9
3.6	1.8	1.6	1.6	1.2	0.5	0.7	0.8	-0.7	-0.2	-0.1	-0.1	0.4	0.8	0.9	0.9	1.7	1.8	2.0	2.0
-1.2	-2.9	5.6	12.7	14.5	9.3	1.4	-4.3	-4.4	-2.1	2.9	7.2	2.5	2.2	3.0	1.5	1.0	1.8	2.9	2.9
-0.7	-0.6	-0.6	-0.8	-1.0	-1.3	-1.3	-0.8	-0.3	0.5	-	-	-	-	-	-	-	-	-	-
12.7	-7.2	-2.2	1.0	-4.6	-4.3	0.3	-0.7	-4.2	6.2	-1.5	-0.9	0.1	-2.3	-1.6	-2.8	-3.3	-3.5	-3.3	-3.0
3.2	2.1	1.4	3.2	-0.5	1.2	1.4	-1.7	3.3	1.8	2.5	3.4	4.1	4.4	4.8	4.9	4.8	4.7	4.6	4.4
-0.4	-1.2	-1.5	0.7	-2.1	-0.3	0.1	-2.9	3.1	1.7	2.0	2.5	2.8	2.6	2.7	2.8	2.6	2.5	2.5	2.5
-0.6	-0.6	0.3	0.6	2.0	2.4	0.9	1.3	0.4	0.0	0.5	0.4	0.4	0.6	0.8	0.7	0.7	0.5	0.5	0.6
2.7	2.9	2.4	3.5	2.0	1.5	0.4	-3.5	0.6	-0.2	-0.4	3.1	2.7	2.2	3.3	2.5	3.1	3.0	2.7	2.3
2.2	4.4	6.0	5.1	3.7	2.9	-1.4	-3.9	0.1	-	-	-	-	-	-	-	-	-	-	-
0.1	-1.7	-2.0	-1.8	-4.0	-2.9	-0.8	0.1	2.3	2.1	2.9	1.0	2.1	3.2	2.4	3.3	2.6	2.4	2.5	2.7
7.2	6.8	7.0	7.2	7.5	6.8	7.0	6.7	6.9	6.2	6.4	6.4	6.7	6.2	6.2	6.2	6.6	6.1	6.1	6.0
7.1	6.5	6.6	7.0	8.0	7.5	7.5	7.8	8.5	7.6	7.2	7.3	8.0	7.0	6.9	7.1	7.7	6.9	6.7	6.8
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
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51.7	41.6	33.1	22.3	53.0	61.9	35.9	37.3	72.2	69.0	48.0	46.0	75.0	72.0	54.0	54.0	82.0	80.0	64.0	64.0
5.7	4.3	3.4	2.2	5.9	6.4	3.6	3.6	7.6	6.8	4.6	4.3	7.7	6.8	5.0	4.8	8.0	7.2	5.6	5.4
17.2	15.7	16.9	12.4	14.3	14.0	10.2	14.5	20.1	18.0	14.0	13.0	20.0	19.0	17.0	14.0	21.0	20.0	19.0	15.0
27.2	-4.5	-42.0	-32.0	9.9	-13.8	-42.2	-9.9	72.3	4.0	-61.0	-30.0	55.0	-9.0	-39.0	3.0	58.0	-15.0	-32.0	-1.0
3.0	-0.5	-4.3	-3.2	1.1	-1.4	-4.3	-1.0	7.7	0.4	-5.9	-2.8	5.6	-0.8	-3.6	0.3	5.7	-1.4	-2.8	-0.1
16.3	44.6	26.3	34.0	26.5	9.7	-5.6	2.5	29.5	-	-	-	-	-	-	-	-	-	-	-
19.1	19.7	20.0	19.4	19.4	19.8	19.5	19.6	20.0	20.0	-	-	-	-	-	-	-	-	-	-
25.1	25.3	25.1	25.2	25.6	25.8	25.9	26.7	27.4	27.4	-	-	-	-	-	-	-	-	-	-
2.0	2.9	2.0	-0.7	2.2	2.5	3.5	5.9	7.9	6.7	-	-	-	-	-	-	-	-	-	-
2.7	4.2	3.2	0.1	1.8	1.8	2.1	4.4	6.5	5.6	-	-	-	-	-	-	-	-	-	-
4.0	3.9	3.3	0.3	1.0	0.7	0.4	2.9	4.1	3.6	5.1	3.1	1.0	0.9	0.1	-0.1	0.1	0.6	1.1	1.3
5.7	5.7	4.7	1.0	-0.3	-0.7	-0.9	1.0	2.4	1.4	2.5	1.4	0.4	1.4	0.5	0.1	-0.3	-0.5	0.1	0.2
6.0	5.8	5.7	5.0	4.2	4.1	4.9	4.6	4.6	4.7	3.8	4.8	5.1	5.6	6.1	5.9	6.0	5.3	4.7	4.2
0.75	0.75	0.50	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.58	0.99	1.22	1.36	1.46
1.2	1.2	1.0	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.9	1.3	1.5	1.7	1.8

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