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# The Czech Economy Development in the first half of 2014

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## 1. Summary

- The Czech Republic economy found itself in the phase of a solid recovery in the first half of the year 2014, which arrived after two years lasting recession. The GDP<sup>1</sup> grew more than twice as fast as its addition for the EU 28 in both quarters of 2014 year-on-year. The economies of Poland and Hungary grew compared to the CR faster, however compared to Slovakia, the GDP of the Czech Republic developed more favourably, which was last observed in the last quarter of 2009 (higher recorded growth was nevertheless also influenced by the lowered comparative basis in the CR in 2014). According to the half-yearly data, external economic relations, state budget as well as the labour market enjoyed a favourable development.
- Still there was a clear pattern for most of the significant monitored parameters describing the economy of a distinctly more favourable development in Q1 2014 compared to Q2. There the Czech economy already only stagnated in the quarter-on-quarter comparison, the GDP growth prevailed still markedly higher in the year-on-year comparison (+2.7 %, in Q1 +2.9%). For the whole first half year, the performance of the domestic economy expanded by 2.8% year-on-year.
- All the main components of demand with the exception of the foreign trade result strengthened in Q2. The increased expenditure on investment, whose year-on-year addition (+6.9 %) was three times higher compared to the growth of investment in the EU 28 and overtook the dynamics in the euro area nearly five times, brings especially hope from the view of the future growth of the economy. However, the overall gross capital formation increased even faster than investment, which proves the notably slower decline of stock of inventories year-on-year. As starts to be apparent in the Q2 itself based on numbers regarding the structure of the GDP estimate, despite the higher intensity of the positive effect of household final consumption expenditure (+1.9 %) year-on-year, their quarter-on-quarter growth arrived at only 0.2 %, similarly to the government sector (+2.3 %, but -0.3 % quarter-on-quarter).
- In the aggregate, the final consumption expenditure contributed to the GDP growth 1.5 p.p. in Q2 (1.1 p.p. in Q1), expenditure on investment 1.5 p.p., i.e. nearly the same comparing to the preceding three months (+1.4 p.p.) and the change in the inventory stock (+0.8 p.p. against -0.6 p.p. from Q1) also worked towards the growth of GDP. On the contrary, the foreign trade result decreased the growth of GDP (-1.1 p.p.) compared to its positive contribution in Q1 (+0.9 p.p.).
- Performance of all sectors of economy increased by 3.3 % in Q2 year-on-year, which was the highest growth of the gross value added for the past three and a half years. The manufacturing industry contributed two thirds (+2.2 p.p.), its influence being the strongest, similarly to the two previous quarters. For the half year, a positive contribution of construction and services to the growth of gross value added was also recorded, which was before last apparent in Q1 2011.
- Output development in construction indicates a rebound (+8.3 % year-on-year in Q1, +3.9 % in Q2 2014), while the repeated year-on-year growth occurred in the two in a row quarters in this industry for the first time since the turn of years 2007 and 2008.
- Prices rose according to the overall level by 2.5 % in the economy year-on-year. It was however mostly due to the movement of prices in the foreign trade, since the consumer prices in fact stagnated year-on-year (+0.2%) and prices decreased by 0.2% as a result of lowered energy prices in the industry (they rose by 1.8 % in the manufacturing industry).
- Foreign direct investment inflow was markedly lower in the half year compared to the previous two years (by 21.5 bn to 56.2 bn crowns year-on-year), since the investors left significantly less of their profits in the CR, their repatriation on the contrary heightened. Nevertheless, it did not worsen the result of external economic relations, as all three components of balance of payments showed surpluses. Especially the positive influence of trade in goods was strong given the continuing high growth of motor vehicle export.
- Aggregate employment (5 145.5 thousand persons) was the highest in the economy since Q1 2009. Still, it only stagnated in Q2 itself (+3.9 thousand persons), which shows a weakening effect of part-time jobs and temporary work, which on the contrary pushed up the aggregate number of employed persons in the years of recession. The average nominal wage increased by 2.8 % year-on-year for the half year, real wage by 2.6 % (by 2.3 % and 2.1 % resp. in Q2).
- Economic recovery has not been projected into a more marked growth of domestic credit for now. Decline of firm deposits proves that the companies most likely finance their fixed investment for the

<sup>1</sup> The data regarding GDP and its components expressed in in real terms and adjusted for seasonal and calendar effects, unless stated otherwise.

most part from their own resources. People continue to withdraw funds from their term-deposits, which is accompanied by the growth of deposits on the savings accounts. Both the bank and non-bank consumption credit grows for the second quarter in a row.

- After six years of deficits, the half-year state budget ended in a surplus. The collection of corporate tax (+8.4 %) and VAT (+7%) increased significantly due to the economic recovery. The CR recorded the highest net position towards the EU budget (56 bn crowns) historically. State debt did not increase also due to the lowering cost of its servicing.

## 2. Overall Economic Performance

Gross domestic product growth halted in quarter-on-quarter comparison in Q2 2014, it was by 2.7% higher in year-on-year comparison...

Renewed growth of the gross domestic product (GDP) initiated in Q2 2013 and accelerating towards the end of the year, halted in the quarter-on-quarter comparison in Q2 2014<sup>2</sup>. The performance of the domestic economy, as a result of the prevailing effect of the low comparative basis, kept a markedly higher growth compared to the same period of the previous year (+2.9 % in Q1, +2.7 % in Q2, +2.8 % in the aggregate for the whole H1). It was just a year ago – that is in Q2 2013 – when the domestic economy stepped out of its so far longest recession.

... due to the contribution of all significant demand components apart from the foreign trade result

All significant demand components with the exception of the foreign trade result<sup>3</sup> contributed to the growth of gross domestic product by 2.7 % in year-on-year comparison in Q2 2014. Gross capital formation as a whole contributed to the growth of GDP already second quarter in a row, specifically by 2.3 p.p.<sup>4</sup> The contribution influenced mostly the fixed capital investment, strengthening already third quarter in a row, newly however the change of the inventory stock (inventory stock was falling milder than in the same period of the previous year) also contributed to the growth of the Czech economy performance opposed to the preceding quarter. Household final consumption expenditure, the main demand component, kept expanding. The same was valid for the final consumption expenditure of government institutions. Household consumption (+1.0 p.p.) contributed to the growth for the fourth quarter in a row, consumption of government institutions (+0.5 p.p.) even sixth quarters in a row. Export and import balance worsened and slowed down the Czech economy in its growth (-1.1 p.p.) in Q2 2014. If import in the year-on-year comparison expanded (due to a strengthening domestic demand) to a similar extent as in the preceding quarter, the rate of growth on the part of export decreased. The reason was a decelerating economic development in the European Union.

Higher dynamics of GVA quarter-of-quarter compared to the GDP in first half of 2014 ...

Gross value added (GVA), which reflects the economic development better than the gross domestic product itself, continued increasing in the quarter-on-quarter comparison in Q2 2014 (+0.5 %). Higher dynamics of GVA compared to GDP was apparent already in Q1 (HPH +1.4 %, HDP +0.8 %). The decreasing collection of tax on products (including VAT, consumption taxes) reflecting in the lower balance of taxes on products and subsidies on products, which is added to the GDP, was the cause. This was a marked difference compared to the second half of 2013, when the collection of taxes on products rose (even the balance of taxes on products and subsidies on products was improving) and the GDP grew faster than the GVA.

... due to extraordinary influences on the part of supply associated with an uneven taxes on products collection

Especially the in advance announced growth of the consumption tax on tobacco products, commencing in the CR at the beginning of 2014, was the reason behind a markedly different development of GVA and GDP. While the tobacco product sellers heightened their stocks in the last six months of 2013 (collected consumption tax was growing, which was increasing the GDP dynamics), they were selling them out in the first half of 2014 (collected consumption tax was decreasing and on the contrary lowering the GDP dynamics).

<sup>2</sup> In real terms, adjusted for seasonal and calendar effects - unless stated otherwise.

<sup>3</sup> The additions to growth of expenditure of GDP are used including the imports for final use in the subsequent text. If we exclude these imports, the percentage contributions of individual GDP components to its growth are different.

<sup>4</sup> If we exclude the imports for final use, which modify the structure of individual contributions to growth, the effect of gross capital formation to GDP growth would be 1.6 p.p., the contributions of final consumption expenditure of households to economic growth zero, the contribution of the government sector 0.3 p.p. Contribution of the foreign trade in this version, i.e. excluding the imports for final use, would be positive in the amount of 0.8 p.p.



Economic recovery lost its power in the European Union. Germany decreasing in Q2 2014 quarter-on-quarter, France stagnating, ...

Economic recovery lost its power in the EU, especially then in countries using the euro – as apparent from the last available data. While the gross domestic product of the whole union of twenty-eight countries was by 0.4 % higher quarter-on-quarter in the last quarter of 2013, its growth slowed down to 0.3 % and 0.2 % resp. in the first two quarters of 2014. Germany, the largest EU economy, shifted from quarter-on-quarter growth of GDP in Q1 2014 (+0.7 %) into a decrease (-0.2 %). France, the second largest EU economy, stagnated the whole first half of 2014. The United Kingdom, the third largest member, was partially saving the situation, with the performance stably increasing by 0.8 % quarter-on-quarter in both quarters.

... the GDP dynamics weakened in Slovakia and Poland

The development also in other Union countries, especially in Slovakia and Poland, was essential for the Czech Republic, strongly pro-export oriented country. The expansion of these economies slowed down. In the aggregate, the not so positive results of GDP in the European Union for Q2 2014, but also the possible (mainly then the indirect) impacts of the restrictive measures put on the foreign flows of goods and services in Europe, at the least reduced the strength of the optimistic sentiments with respect to the future domestic development.

The households spent more than in Q2 2014 last by the end of 2011, ...

The final consumption expenditure of households kept growing in Q2 2014, it strengthened in quarter-on-quarter comparison already for the fourth time (+0.2 %). It was higher by 1.9 % year-on-year, by 1.8 % in total for the whole first half-year. The growing household consumption was consistent with the still heightening consumer confidence in the economy, which nearly reached the level of first half-year of 2008 – as can be seen from the business cycle surveys – in June 2014.

The growing willingness of households to spend most likely lay in their overall increasing incomes, as signalled by the still improving situation on the labour market. The number of unemployed persons aged 15 and over (according to the LFS) dropped to 327.7 thousand persons and it was the smallest since Q1 2009 (i.e. in last five years and a quarter), at which time the impacts of crisis had not yet fully manifested on the domestic labour market. The number of employed persons was apart from the preceding quarter, favourably affected by a moderate winter, on the contrary the highest since Q1 2009. The average wage grew in real terms by 2.1 % year-on-year in Q2 2014, this growth was not influenced by the extraordinary effects connected with the paid out bonuses in contrast to the previous period any more. Employees in all economic activities earned higher wages compared to the year before.

... they „indulged themselves“ more in especially the durable goods year-on-year

Households mainly increased the purchases of durable goods in the first half of 2014. These were, as apparent from the data regarding consumption in the so called domestic conception<sup>5</sup> not seasonally adjusted, higher by 6.6 % year-on-year. Buyers kept utilising the falling prices of these products. Households also spent more for the semi-durable goods (+1.6 %) and services (+2.4 %) than in the first half of 2013. They restrained only the purchases of non-durable goods (-0.3 %), including the significant by weight food.

Government institutions despite the fluctuations of their consumption keep stimulating the economic activity

Final consumption expenditure of the government institutions continues to fluctuate notably, as follows from the quarter-on-quarter changes. While its volume expanded by 1.6 % quarter-on-quarter in Q1, it weakened by 0.3 % in Q2. Its trend, however, strengthens already six quarters in a row. The sector of government institutions increased consumption by 2.3 % year-on-year (by 1.3 % in Q1). The final consumption expenditure of government institutions has been expansive already six quarters in a row, i.e. the government institutions stimulate the economy in its growth.

In Q2 2014 year-on-year, addition of investment into fixed capital was the highest since top of boom in 2008, ...

Investment into the fixed capital (gross fixed capital formation) fell in Q2 2014, probably as a result of high comparable basis in the previous quarter, partially also due to rather unfavourable information newly arriving from abroad. They weakened by 1.5 % compared to Q1 2014. However, the domestic investment was higher by very impressive 6.9 % (by 6.4 % in Q1 2014) compared to the same period of the preceding year, which was the largest addition since the top of boom in 2008. They rose by 6.6 % in total for the whole first half of the year year-on-year.

<sup>5</sup> It is related to the purchases of goods and services realised on the CR territory regardless of the fact, whether residents or non-residents expend the funds.

... investment rose both into technical equipment (transport equipment, machinery and equipment) and base facilities (buildings and structures)

As can be seen from the object structure of gross fixed capital formation (non-seasonally adjusted), there was more investment both into the technical equipment, i.e. transportation equipment (+11.0 %) and machinery and equipment (+6.1 %) and the base facilities, i.e. the buildings and structures (+10.6 %) compared to the previous year in Q2 2014. Manufacturing companies shared probably the most in the markedly heightened investment activity, when they benefited from the stronger demand year-on-year. The demand for dwellings (-1.4 %), which is set especially by the households, kept further decreasing. Even the improved situation on the labour market, which apparently led to the increase of their income, has not altered this state – households were still very cautious regarding the investment into the real estate. There was invested into the dwellings only 29.8 bn crowns in nominal terms in Q2, which was by 8.0 bn crowns less compared to the same period of 2008.

Change of the inventory stock despite the continuing „destocking“, contributed to the economic growth in Q2 2014

The value of stocked inventories mildly fell in Q2, as can be observed from the change in the inventory stock (by 0.6 bn crowns in nominal terms against the preceding quarter). Stocks were however falling less than in Q1 2014, when they decreased by 4.9 bn crowns, and with a much smaller intensity compared to the same period of the previous year, when they even slumped by 8.2 bn crowns. The change in the inventory stock contributed to the year-on-year growth of the performance of the CR economy in Q2 2014, due to a lower destocking against the previous year.

Difference between exports and imports increased year-on-year only thanks to positive effect of terms of trade in Q2 2014, the surplus worsened in real terms

The surplus of foreign trade with goods and services decreased in real terms year-on-year in Q2 as a result of a higher growth of imports (+11.3 %) compared to exports (+8.9 %) and it contributed to the gross domestic product development in a negative way. The difference between exports and imports however strengthened in the nominal expression, it reached 77.2 bn crowns and it was by 8.3 bn crowns higher on a year before. Its increase occurred due to a positive development of prices in the foreign trade, when the export prices were raised by 4.2 %, the import prices rose only by one half 2.1 %.

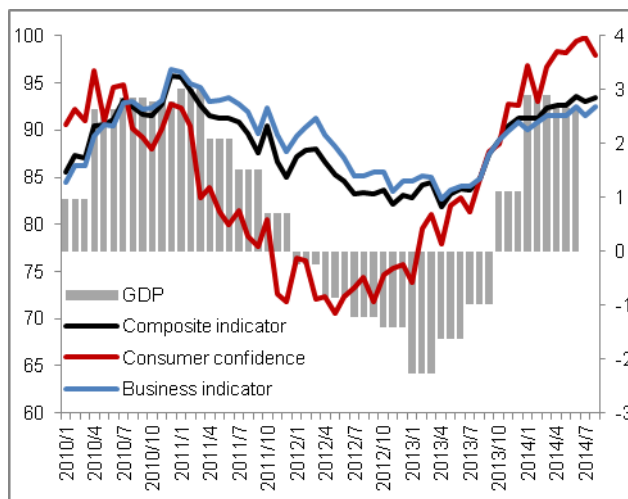
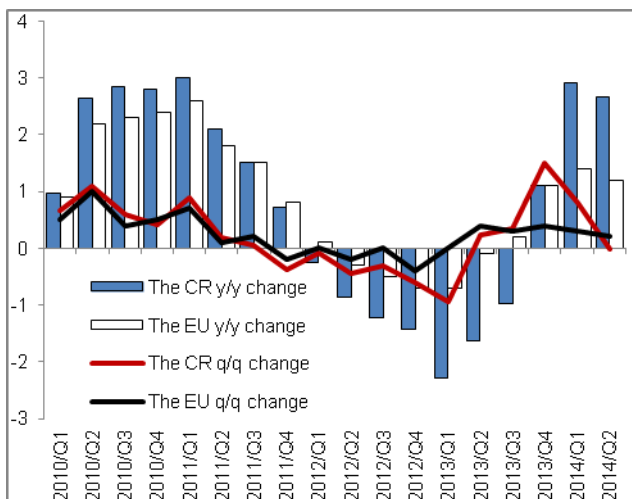
Growth of the Czech economy conducted by very good results of manufacturing industry year-on-year in Q2 2014, similarly to both previous quarters

Gross value added of the domestic economy increased by 3.3 % in Q2 2014 year-on-year, which was most than the GDP itself. It was the largest addition to performance on the supply side for the last three and a half years. It was especially thanks to the manufacturing industry. Its performance increased, as a result of marked growth of the foreign demand, partially also domestic, by 8.7 % year-on-year. It contributed to the growth of gross value added on the level of whole economy for the third quarter in a row, while its positive influence was gaining pace (while it contributed to the growth 1.1 p.p. in the last quarter of 2013, it was already 2.1 p.p. and 2.2 p.p. resp. in Q1 and Q2 2014). The contribution of the remaining part of industry – mining and quarrying, energy industry, water supply – was in total zero in Q2 2014. Services as a whole, with a proportion in the aggregate performance of the Czech economy roughly of three fifths, also shared in the growth, similarly to the manufacturing industry, nevertheless only by 1.0 p.p. and thus by much less force. While the cluster relatively less significant by volume of agriculture, forestry and fishing was stagnating, the construction whose performance increased already for the third time year-on-year, added the remaining 0.1 p.p.

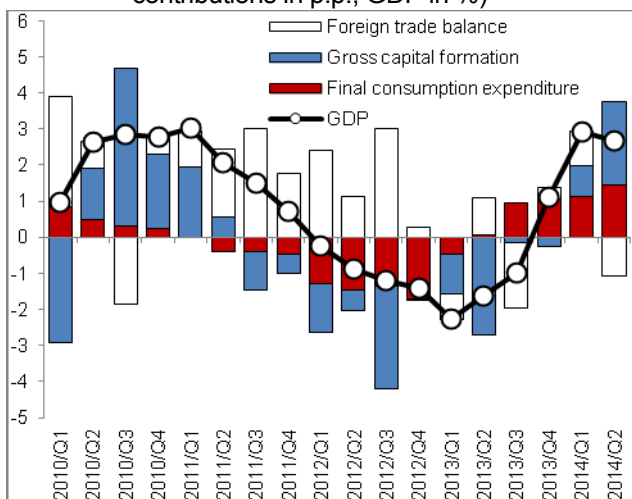
Chart 1 **GDP** (constant prices, adjusted for seasonal and calendar effects, in %)

Chart 2 **GDP** (constant prices, adjusted for seasonal and calendar effects, y/y in %, r. a.) **and confidence indicators** (2005=100, l. a.)

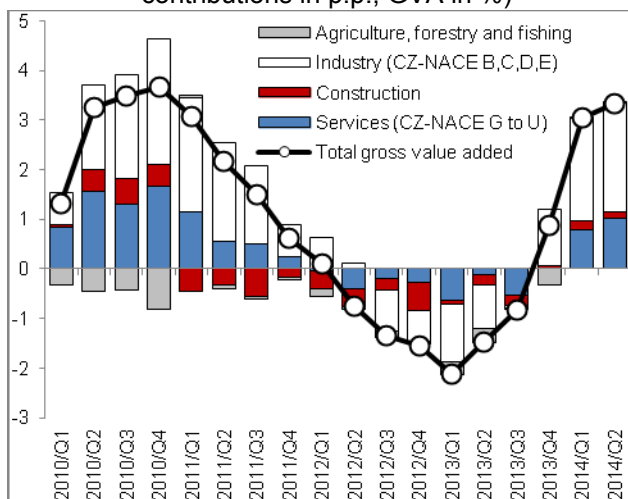




**Chart 3 Contributions of expenditure items to GDP change (constant prices, y/y, contributions in p.p., GDP in %)**



**Chart 4 Contributions of economic activities to change in GVA (constant prices, y/y, contributions in p.p., GVA in %)**



Source: CZSO

### 3. Industry Performance

Performance of all activities viewed through the GVA dynamics improved for the fifth time in a row quarter-on-quarter

Gradual revival of the Czech economy performance continued in the first half of 2014, when the gross value added (GVA) sustained quarter-on-quarter growths already five quarters in a row. The performance of all activities hiked up by 3.2 % year-on-year for the whole first half-year (without significant dynamics differences between Q1 and Q2), and it thus reached its fastest rate of growth since the beginning of year 2011 (rate of growth close to those in 2010, when the economy was recovering from a strong recession).

Growth of GVA was pushed from more than two thirds by the dynamically growing manufacturing industry year-on-year...

Mainly the dynamically growing manufacturing industry played a major role in the higher GVA for a third quarter in a row year-on-year (growth of this industry by more than 8 % in both Q1 and Q2). While the manufacturing industry represented one of the few growing activities still at the end of 2013 (+4 %), nearly all the main groups of activities (incl. agriculture and construction) already positively impacted the higher aggregate GVA during this year, except for the financial sector, where the very high comparative basis knocked down their results, given their more volatile character in the long-term.

...GVA nevertheless higher in all main activities (except for financial sector)

This year's growth of GVA overtook the dynamics of aggregate employment as

Significant recovery of the GVA dynamics occurred in H1, accompanied by a more modest growth of the employment (+0.3 %, in the national accounts conception),

well as hours worked, which strengthened especially in services sector year-on-year

which however have lasted for more than two years. The total hours worked also increased slightly year-o-year (+0.8 %) with higher dynamics concentrated (similarly to employment) mainly to the services sector (mostly in the IT activities and real estate or professional, scientific, technical and administrative activities). On the contrary, the manufacturing industry had to handle a marked increase of orders with nearly unchanged employment as well as hours worked. Also due to the effect of expectations of favourable harvest, the eleven quarters in a row lasting year-on-year decline of GVA halted in the agriculture, forestry and fishing, nearly the same can be said also with respect to construction (simultaneous effect of "launch" of larger orders and favourable climatic conditions) and in the aggregate also with respect to public services (where the long-term fall of employment ceased also thanks to the recovery in community service activities already last year).

Halting of long-term adverse development in agriculture and construction

Industrial production kept a high year-on-year dynamics from the end of the last year, however the rates of growth slightly weakened in the quarter-on-quarter comparison during 2014

Industrial performance<sup>6</sup> (gauged by the index of production) also continued in its tendencies initiated in the second half of the last year during the year 2014. The recovery of foreign demand, at the beginning especially for transportation vehicles, gradually leaked not only by sub-supplier relations to majority of other manufacturing activities, including in case of the domestic demand. Industrial production (adjusted for calendar effects) kept a high dynamics from the end of the last year, when it increased similarly by 6.2 % in both Q1 and Q2. Expressed quarter-on-quarter, the slight growth of activities from the beginning of the last year lasts, nevertheless the growth dynamics of total output gradually slightly weakens (1.2 % and 0.6 % in Q1 and Q2 resp.) compared to the end of the year 2013 (+2.4 %).

Manufacture of motor vehicles contributed to growth of output in the whole industry from two fifths in H1, together with its main associated sub-supplier activities then from nearly two thirds

The manufacture of motor vehicles contributed to the current this year's growth of output from two fifths year-on-year (with the growth of the industry itself by one sixth), one tenth was similarly added by the associated activities of manufacture of rubber and plastic products, manufacture of electrical equipment and also manufacture of metal structures. Dynamic growth experienced also the output in strongly export oriented (however less significant by weight) activities of manufacturing of computer, electronic and optical products (nearly by one fifth in H1), the (petro-) chemical and pharmaceutical industry also to a lesser extent. The higher output of manufacturing of other non-metal mineral products (by one tenth) also reflects the gradual recovery of the construction orders.

Year-on-year growth of industrial output expanded into all significant activities apart from the energy industry at the beginning of the year

In H1 2014, the output of nearly all partial industrial activities grew year-on-year (a year ago only one third), except for some smaller activities marked by a long-term fall of mainly the domestic demand (manufacture of textiles and printing – also due to the drop of expenditure on advertising services) and also the energy industry (whose output dynamics has lagged behind the manufacturing industry for a long-term). Protracted fall stopped in mining and quarrying (due to higher performance in mining of building matter), when this year's output exceeded the very low basis from the beginning of the last year by 1 %. In H1, the output of activities oriented on investment increased in total by one tenth year-on-year (machinery, vehicles), accompanied by contrasting rates of growth of outputs for consumption long-term (+8%) and short-term (+2 %) - including e.g. food, beverages, tobacco, wearing apparel.

One tenth growth of output of industrial activities focussed on investment contrasted with a weak dynamics of output for short-term consumption

This year's output of manufacturing industry close to the level of top of boom, by more than one fifth below in mining, metallurgy, furniture, wearing apparel or leather working activities

In spite of the current growth, the output in the whole of industry has not so far reached the level of top of boom (H1 2008), when it still lagged behind this goal in real terms by 2 % in H1 2014. It was higher in one third of activities, especially in the manufacture of motor vehicles (by one third) and related activity of manufacture of electrical equipment (by one quarter) and manufacture of computers, electronic and optical products (by one eighth).

<sup>6</sup> Including the CZ-NACE activities: B (Mining and quarrying), C (Manufacturing industry), D (Energy industry)





Rate of growth of foreign orders stable lasting already one year, foreign orders higher across all main activities year-on-year	Turn in the industry dynamics was allowed by a marked recovery of foreign demand during 2013. Year-on-year growth of the nominal value of foreign orders already four quarters without larger fluctuations stays within double-digit values (16.5 % n Q2) and it is driven especially by the manufacture of motor vehicles (35 % and 27 % in Q1 and Q2 resp.). The manufacturers of computers, electronic and optical products and also the metallurgy industry also recorded by one fifth higher orders from abroad throughout the whole half-year. At least a low growth has been however apparent this year across all observed industrial activities (with longer-term production cycle and larger stock of orders). The rate of growth of foreign orders slightly decreased in majority of activity during H1 (especially due to a higher last year's basis) <sup>7</sup> apart from manufacturers of other transportation vehicles – mostly for the railway transport, which in addition managed to access the foreign markets also for the whole previous year.
High growth of foreign orders for manufacture of rail transportation	Domestic industrial orders reached compared to the foreign ones only a one half dynamics in the last four quarters. In both this year's quarters, they grew only for manufacturing of transportation vehicles and main associated sub-supplier activities and also for manufacturers of computers, metalworking and textile industry (where they halted drop of demand lasting nearly two years). Exceeding dynamics of value of new orders from abroad above the domestic has been a long-term phenomenon for the CR industry (except for years 2006 and 2008). Direct export sales were higher in nominal terms (thanks to both exchange rate effects and growth of foreign demand) by 17 % in H1, domestic sales added less than 2.5 % year-on-year.
Rate of growth of domestic industrial orders lags behind the foreign in the long-term also due to the clothing, textile or pharmaceutical industry	The industrial businesses reacted to a relatively stable growth of demand by only a very slight growth of employment so far. This was expected by only every seventh company in the manufacturing industry in July 2014 (77 % managed with the current state). Similar proportion of businesses anticipated a growth of the production activity in the coming three months (at the beginning of this year however, nearly one quarter). Aggregate seasonally adjusted balance of the confidence indicator in industry oscillates in the positive values (+1 to 3p.) already since November 2013, still the level from the turn of 2010 and 2011, when the economy was recovering from a deep recession, has not been reached yet. Seasonally adjusted confidence indicator in industry lowered from 1 p. (end of 2013) to -2.7 p. (in August 2014) in Germany.
Growth of demand for industrial products has not so far led to a more significant growth of employment in this activity	Industrial production increased by 1.4 % (in Germany by 1.9 %) n the EU28 in this year's H1 year-on-year. The CR (+6.2 %) belonged (also due to the effect of lower last year's basis) together with Hungary or Romania to a group of five countries with the highest growth. Seven union members have so far overtaken the level of output reached six years ago (Poland and Romania by one sixth, Slovakia nearly by one tenth), the CR together with Germany and Hungary fell closely below it (most of south-European countries even by a whole quarter). Both central European and Baltic countries have a higher dynamics of output in the long-term.
The mild fall of the confidence indicator (industrial) in Germany is also a risk for keeping the current growth rates of industry in the CR	It can be assumed based on results of various output indicators as well as qualitative data from business cycle surveys in this industry, that the construction has most likely already hit its bottom in the CR during the last year. Construction output recorded the first growth after 11 quarters at the beginning of 2014, when it added 8.3 % year-on-year (3.9 % in Q2). Repeated year-on-year growth in two successive quarters occurred for the first time since the turn of years 2007 and 2008. The fall in the quarter-on-quarter expression stopped already in the autumn of the last year, it however recurred in Q2 2014.
Current rate of growth of industrial output in the CR belongs to the fastest in the EU, in the long-term the most dynamic central European and Baltic countries	Both building construction and civil engineering construction expanded by a similar rate of growth in total for the H1 2014 year-on-year. Favourable climatic conditions as well as low comparative basis (especially from the beginning of last year) also contributed next to the demand recovery to a higher output. This year's construction output corresponded in real terms to the level reached in H1 2003 and it was lower by 30 % (in building construction) and by 20 % (civil engineering construction) compared to the top of boom (H1 2008). The value of new orders increased (for the businesses with 50 employees and more) year-on-year by one third in the whole construction in the CR in the context of last year's historical lows in H1 (even by more
Construction output has bounced off the last year's bottom, strong growth year-on-year also due to the impact of favourable climatic conditions in Q1	Still the construction output remains in real terms by nearly 28 % below the level of top of boom in H1, as well as below the level of the year before last
Still the construction output remains in real terms by nearly 28 % below the level of top of boom in H1, as well as below the level of the year before last	Value of new orders higher year-on-year already third

<sup>7</sup> Nevertheless, the double digit growth was also achieved according to preliminary data in July (14 %, despite high last year basis - the value of orders was by 9 % higher year-on-year in July 2013).

quarter in a row, fall of average size of order also halted...

...inadequate demand however remains the main barrier to further growth of the whole industry according to construction managers

Both domestic public and private orders contributed to the renewed growth of total stock of construction orders by a similar part, the foreign demand however contributed the most

Only a narrow range of construction companies however most likely benefits from the dynamic growth of foreign orders

Recovery of new orders has not yet stopped the fall of registered number of employees in construction, less than one tenth of construction firms considers the growth of employment in the short-term

Mild recovery of started dwelling construction due to extremely low year-on-year basis and favourable weather conditions at the beginning of the year

The frequency of finished dwellings stays on the ten year minimum

than 60 % in the civil engineering construction). The value of new orders was (81 bn crowns in H1 2014) the third lowest since 2004 (in the civil engineering construction since 2007). The drop of the average value per 1 new order (due to both a legislative change and a factual lack of large orders) halted (the average value constituted 3.7 mil crowns in H1, by one fifth more year-on-year), similarly to the average value of issued construction permits. In August 2014, three quarters of construction businesses considered the inadequate demand to be the barrier of the growth of whole industry despite the overall recovery (less than in December 2013 – i.e. 83 %, but also still the most out of all EU countries), nearly one half than in the industry.

The growth of demand in construction also rebound in the total stock of not yet realised orders in the last three quarters. This was by nearly one quarter higher at the end of both Q1 and Q2. The stock of public orders ceased its year-on-year fall after 18 quarters at the beginning of 2014. The volume of private orders also increased by one tenth year-on-year (following nearly two years of continuous falls). However, the orders from abroad, whose stock doubled at the end of Q2 year-on-year (and it consisted of a whole one fifth in the total portfolio of orders of construction firms with 50 and more employees), contributed to a major extent to the rise of the value of orders this year. The value of foreign orders has already been rising eight quarters in a row. Especially some large construction companies thus most likely managed to partially compensate the deep slump of the value of orders on the domestic market.

Despite recent demand recovery, the long-term decrease of the registered number of employees continued, not yielding much even in H1 (-5 % in Q2, -7.6 % last year). The industry thus lost over 50 thousand of „root“ job positions in the last four years only. The share of companies expecting employment stabilisation increased in the last year (already 75 % in August), but only every twelfth construction company planned to hire new employees in the upcoming three months. The balance of the aggregate confidence indicator in construction has been slightly rising since last year's August, still it remains in deeply negative values and has not even exceeded the level of most of the year 2010 so far.

Construction activity on the flat market reflects the economic situation of households with a higher persistence. It is also majorly affected by the market saturation resulting from the intensive construction in the boom years also supported by the demographic changes. The number of dwellings started increased year-on-year in H1 (+11 %), still it was in absolute terms the 2<sup>nd</sup> lowest value since the half of 90s. The more intensive dwelling construction in Prague, which was higher for all types of buildings year-on-year (apart from dwellings for seniors), stands behind the growth of more than one half. On the contrary, only the construction of flat houses revived more significantly in the whole CR (reaching 5-year maximum, but only near one half of the level of top of boom). The number of completed dwellings (10.6 thousand) was the lowest during the past decade in the CR in H1 2014, given the simultaneous drop of both flat houses (-14 % year-on-year) and family houses (-10 %).



Sales continued in mild year-on-year growth in market services	Sales in selected services <sup>8</sup> in total continued in mild growth initiated in the half of 2013. They rose „only” by 1.2% in real terms year-o-year in H1, however it represented the highest half-yearly growth since 2008. Especially the activities, whose sales grow in the long-term, fared the best and usually already exceeded the „pre-crisis level”. It is in the first place the transportation and warehousing, where the accelerated year-on-year growth is connected with the overall revival mainly in industry and foreign trade in the last four quarters. Both warehousing (+6.1% in H1) and significant by weight land transportation (+4.7%) achieved good results. Also the majority of administrative and support activities fared better. Specifically both the job agencies (+16.7 %, growth of sales already 17 quarters in a row), administrative and office activities (+7.4 %), the demand for security and detective services and hiring and leasing (vehicles and machinery) has been increasing for a shorter time. Information and communication activities have also earned more in H1 (+1.8 %), when the publishing activities and music and motion picture industry achieved better results following a longer slump. Mostly the continuously expanding foreign clients has driven up the sales in accommodation (+3.3 %) for already 16 months, while they transferred from long-term falls only to stagnation in restaurants and food service activities.
Transportation, accommodation, information technologies and some administrative as well as support activities fare the best in the long-term	
Long-term slump continued for most professional, scientific and technical activities and real estate activities	
The highest year-on-year growth of sales for advertising (since 2008) due to low comparative basis and growth of demand in connection with elections	Sales have been falling in fact continuously in professional, scientific and technical activities as well as real estate activities since 2009 (by nearly one third and one fifth resp. in real terms in six years). Only management consultancy activities and partially advertising activities halted the negative trend, the growth in market research and public opinion polling has been on the contrary exhausted after nearly three years. The air transportation has not followed up with the more hopeful last year's results (-3.3 % in H1 2014), travel agencies also continued in the long-term slump (their sales being even against a low last year basis by one tenth weaker). The sales in both economic activities were weaker by one quarter compared to the level six years ago.
Improving consumer sentiment reflected in the retail sales year-on-year accelerating dynamics	Overall revival in the economy as well as the gradual decrease of unemployment influenced the consumer's confidence indicators, which lay the highest in Q2 since the spring 2008. Retail sales rose by 5.7 % in H1 (year-on-year growth adjusted for calendar effects apparent continuously since July 2013). The strengthening motorist segment (+12.6 %) contributed to a high dynamics from one half, its sales growing in real terms already five quarters in a row (both in sale as well as repairs and maintenance).
Retail sales growth was driven by still dynamic motorist segment from one half this year	The sale of non-food products has traditionally drove the „non-motorist segment” of retail (+ 4.3 % in H1 2014), when the sale strategies aided especially the sellers of computer and communication appliances (by 18 % year-on-year). The sales for products predominantly for household equipment, culture and recreation and also clothing, footwear and leather products however also grew. Nevertheless, the sales of sellers of paper goods and books stagnated, the sales of pharmaceutical and medical products remained in long-term decrease (they decreased by 8 % in two years). The sales of food products ceased its fall after nearly three years, strengthening by 3.8 % year-on-year in Q2 (partially also due to the „shift” of the Easter holidays to the end of April). The fall of retail sales also stopped in specialised (usually smaller) shops predominantly with food due to the development in Q2 for the first time since 2005. The dynamics of growth strengthened for sales of motor fuels (by 1.6 % in Q2) as a result of lower last year's basis as well as increased sale of new vehicles. Very high dynamics of sales prevailed for internet sellers for already six quarters (by +17 % in Q2), their sales have doubled in real terms in the last five years.
Cessation of long-term decrease of sale of food, even in specialised shops	
Sales of internet sellers doubled in real terms in the last five years	

Chart 5 **Production in industry and selected manufacturing activities**  
(constant prices, y/y, in %)

Chart 6 **New orders in manufacture of motor vehicles and industry in total** (l.axis, y/y, in %) **and balance of confidence indicator in industry** (r.axis)

<sup>8</sup> They do not include the activities of trade, finance and insurance, science and research and also public services.

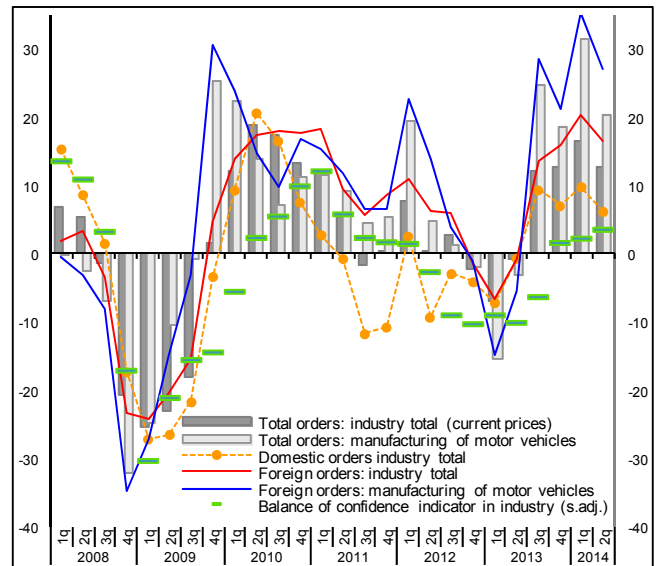
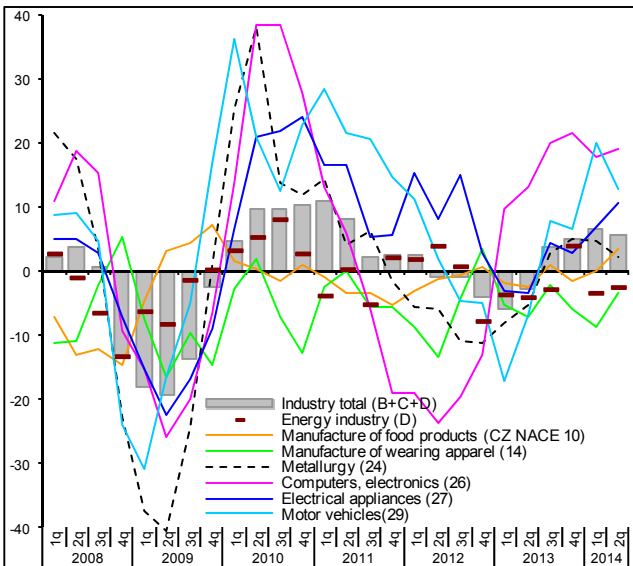
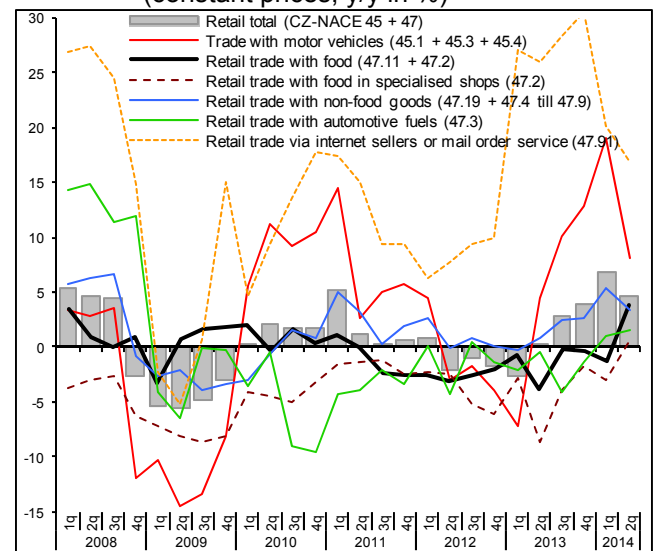
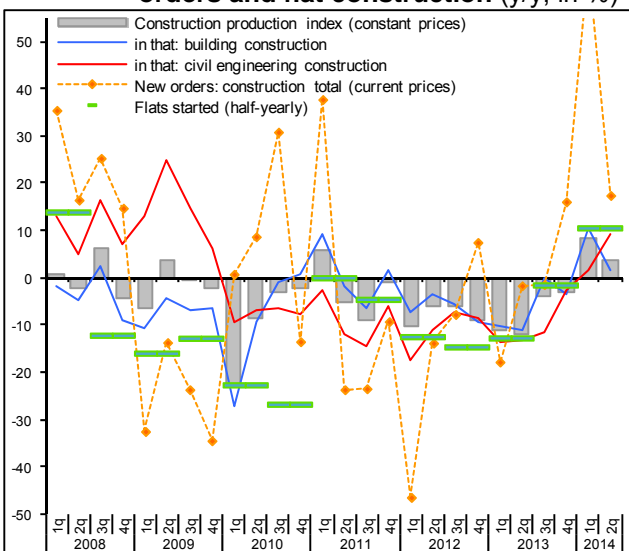


Chart 7 Construction production, value of new orders and flat construction (y/y, in %)

Chart 8 Retail sales incl. motorist segment (constant prices, y/y in %)



Source: CZSO

## 4. External Economic Relations

External economic relations of the Czech republic do not display any troubles with an economic stability in H1 2014

External balance of the CR economy was very good according to the results of the flow of money captured in the balance of payments for H1 2014. All three items of the balance of payments recorded surplus and the positive balance of the current and capital account in total (59.6 bn crowns) was even historically the best half-year result. The current account surplus arrived in relation to the nominal GDP at 1.9 %.

Favourable result on the current account eventuated even despite the income balance deficit – which is the most affected by the outflow of dividends from profits of owners of foreign companies in the CR – , being the second deepest in the time series since 1993. It was because the output balance was very strong. Current account surplus was also assisted by the notable improvement of the current transfers balance (by nearly 20 bn crowns due to the effect of revenues from the EU budget year-on-year).

Again return to current account of balance of payments in surplus, compared to past weaker surplus on the financial

Financial account surplus was relatively weaker against the comparable periods of years 2013 and 2012, it was caused by a lowered inflow of investment from abroad only to a lesser extent. The outflow of funds in the form of portfolio investment played a major role (in net purchases of both foreign shares and bonds realized by



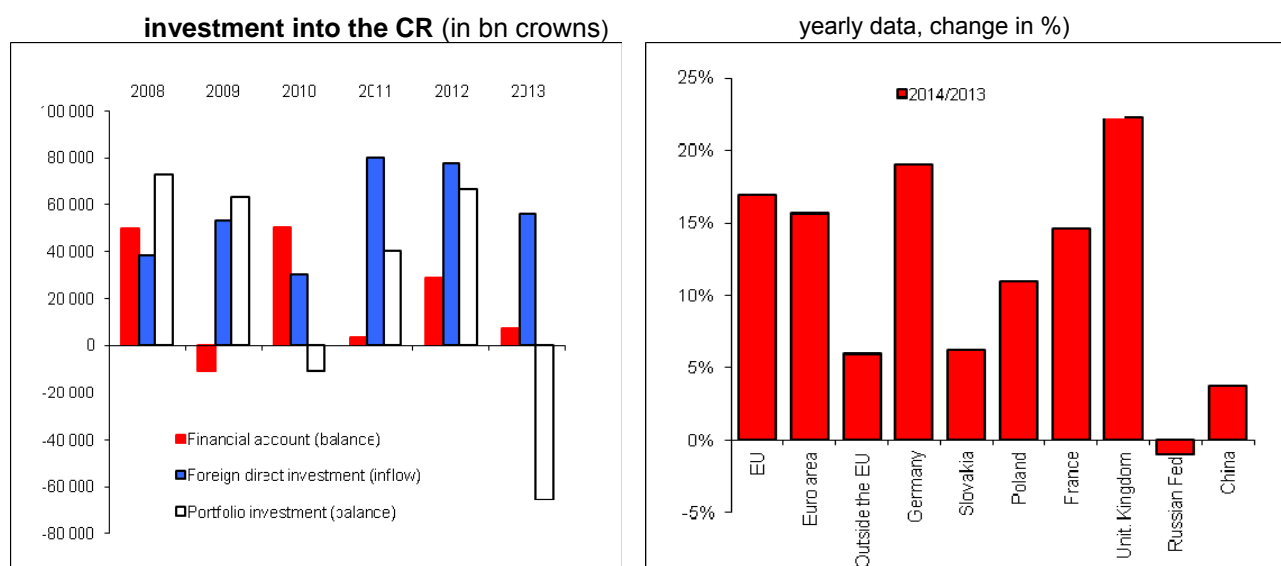
account caused by net outflow of portfolio investment	domestic entities). The result of activities of foreign portfolio investment was also the outflow of funds from the CR in contrast to their inflows, which have eventuated since last months of year 2011 (the development is most likely connected to the lower issues of Czech government bonds).
Trade balance with a record half-yearly result...	Current account of the balance of payments finished in better result for the half-year 2014 compared to the same period of 2013. It was from a mild deficit (-3.9 bn crowns) at that time in a surplus in the amount of 38.2 bn crowns by the end of July 2014. It was especially the result of trade with goods and services balance surplus, i.e. trade balance, whose surplus rose by more than one fifth (+20.9 %) year-on-year to 173 bn crowns. Thus, it had the main share on the recorded favourable external imbalance of the CR economy in H1.
... given the markedly improved performance in trade with goods and services with both imports and exports growth by one fifth year-on-year (much less however quarter-on-quarter) ...and a mild growth of services balance surplus	The growth of both exports and imports of goods was the strongest by one fifth according to half-year data from the balance of payments year-on-year – however only by +0.8 % and +1.1 % (!) quarters-on-quarter-, since the crisis period of 2009. It also contrasts with the falls of exports and imports in the same period of 2013 year-on-year (-1.7 % and -1.6 % resp.), when the weakened European demand and an absence of domestic revival had a negative effect.  The balance of tourism as well as transportation improved (revenues +6.7 % and +10.6 % resp. To 70.6 bn and 24.8 bn resp., expenditures +16.2 % and +10.3 % resp. to 48.8 bn and 46.6 bn crowns resp.). The mild deficit of the CR trade in other services improved towards the balancing out of revenues and expenditures in trade with these services from the half-year of 2013 (107 bn and 106.2 bn crowns resp.). The resulting surplus of the services balance then slightly strengthened to 30.3 bn crowns (+7.1 %) for the first half of 2014 year-on-year, which was roughly the average of the previous three years (31 bn crowns). The half-yearly surplus of the services balance however has not reached the values from years 2008-2010.
Dividend outflow apparently very strong in Q2 – half yearly income balance deficit the second deepest since 1993; „wage“ balance with abroad improved according to data for Q1 2014	The income balance was however in favourably influenced by the continuing outflow of foreign investors' profits from their direct investments in the CR. Its deficit arrived at 153 bn crowns, which was the second deepest deficit of the income balance since year 1993. It was not apparent in the Q1 itself – more detailed data are not yet available for Q2 -, on the contrary the dividend outflow was the smallest since 2010 in this quarter. However, the decisions regarding the profits repatriation are made only after the economic results for the previous year are known on the shareholders meeting usually in Q2. It was then, when most likely the significant dividend outflow occurred, which must have also affected the recorded half-yearly result.  It can be observed from the first three months of 2014 given the absence of results for Q2 that the balance significantly improved between revenues from work of nationals abroad and the cost of foreigners labour in the CR (positive balance of +2.7 bn crowns, which did not reach even one bn in the previous two years). Such high surplus was recorded despite the fact, that due to the intensifying immigration into the CR (probably mostly for work) motivated by the revival of the Czech economy, also caused the increase of the cost of labour of foreigners (by nearly 1.6 bn crowns).
Direct investment from abroad declined	A lower inflow of foreign direct investment into the CR was a negative phenomenon in H1 2014 (by 21.5 bn to 56.2 bn crowns year-on-year), especially for inputs to equity of companies as well as the reinvested profits (drop of 73.5 bn to mere 14.3 bn crowns). Their flows were even larger in both of the preceding recession years for the comparable period, which however could be connected to the price of assets in times of recession (another root can lie in the „re-orienting“ of direct investors to developed European countries with signals of their economies revival, which could be seen in the first months of 2014).  Weaker direct foreign investment into the CR contributed to an essential reduction of the financial account of the balance of payments surplus (7.3 bn against 29.1 bn crowns in the same period of 2013).
Foreign portfolio investors reduced their positions once because of the bond repayments on the part of	Apparent lower attractiveness of the Czech Republic to foreign investors is not displayed only for direct investment, but especially the portfolio investment. While the inflow of funds in net bond purchases and property securities into the CR

Czech government together with their lower issues...	<p>exceeded their outflow by 66.4 bn crowns in the half year of 2013, it was exactly the opposite in the same period of 2014 (-65.4 bn crowns).</p> <p>Such situation occurred in the CR last in year of the monetary crisis (1997), while the outflow of funds in the form of debts was apparent also in years 1996 and 1998 at that time. Current situation can be explained by the fact that a reduction occurred in the issuance of bonds on a large scale by the government sector especially in this year's Q2 in contrast to the preceding six years. Foreign portfolio investors thus not only have less opportunity for purchases, but they also „return“ the already held bonds with ending maturity back to the CR to the debt issuers.</p>
... domestic portfolio investors found very attractive especially the foreign share markets	<p>Domestic portfolio investors on the contrary buy in net on a grand scale, which enlarges their foreign assets. Their net purchases of foreign shares (26.2 bn crowns) played a role in the outflow of funds from the country in the half-year 2014 (38 bn) and were most likely motivated by strong growths of stock exchange indices. Domestic investors possibly deduced especially in Q2, that this growth – considered by some experts for a „bubble“-, will still continue further.</p>
Balance of item Other investment did not significantly affect the financial account surplus	<p>With respect to the item of other investment on the financial account of the balance of payments, whose balance has highly influenced the result of this account in the last quarters, the massive transfers of funds within the scales of many tens of billions from the commercial banks in the CR and subsequently back, which caused it, were not so apparent any more – there „arrived“ in net 66 bn crowns for the item of short-term liabilities of commercial banks into the CR in the half-year 2014, net outflow in the amount of 65 bn crowns was recorded in Q1.</p>
The rate of growth of exports of four largest items faster for half-year year-on-year than the total exports due to strong dynamics of motor vehicle exports	<p>The total of four main groups of product classifications: motor vehicles (358 bn, exports rise +26.6 % year-on-year), computers and electronic appliances (142 bn, +153.4 %), electrical equipment (129 bn, +13.6 %) and other machinery products (172 bn crowns, +10.1 %) again constituted more than one half of the total exports from the CR – based on the CZSO data related to the foreign trade in the national conception, in current prices in Q1 2014. The growth of their half yearly exports was in total higher compared to the rate of total exports from the CR year-on-year. At the same time, with the exception of exports of computers and electronics, the exports of other three „strong“ items were considerably slower in Q2 (for machinery goods with one-digit dynamics) compared to the pace of Q1. It is also valid for the aggregate exports from the CR.</p>
Weakened dynamics of exports across territories in Q2, rate of growth of imports also slowing down	<p>Deceleration of the rate of growth of exports of goods from the Czech Republic indicates a slightly dampened foreign demand in Q2 2014, which has not however manifested only via German economy. Exports from the CR slowed down across territories in Q2 (for exports into countries outside the EU from 7.8 % in Q1 to 4.5 %, to the euro area from 17.8 % to 13.6 %, to Germany from 21.5 % to 16.3 %, to Slovakia from 7% to 5.4 %, to Poland from 12.7 % to 9.3 % and into the United States from 25.4 % to 19.2 %).</p> <p>The exports increased the most into the United Kingdom for the whole half year of 2014 year-on-year, given their strong economic revival, the exports into the Russian Federation on the contrary dropped due to the development connected with the so called Ukraine-Russia crisis of the political nature.</p>
Effect of the depreciated crown exchange rate	<p>Weakening of rates of growth was also apparent for the total imports in Q2 the year-on-year. The loss of their dynamics given the weakened export pace is logical, with the view of strong export import interconnectedness of the Czech economy. The exchange rate also affected the values of both imports and imports via the prices in the foreign trade in the year-on-year comparison, when the CNB monetary intervention artificially depreciated the crown in November 2013.</p>
Significant growths also of smaller items in value, fall of energy commodities export	<p>Exports of pharmaceutical products increased out of the “non-machinery” commodities nearly by one half (+49.2 %) in the first half of 2014 year-on-year and the exports of furniture (+22.8 %) or tobacco products (+22.2 %) also rose significantly. The exports of coal and electricity fell (similarly by 15.4 %), affected by the development of prices on the world commodity markets.</p>

Chart 9 **Financial account balance and portfolio investment, inflow of direct**

Chart 10 **Export change from the CR year-on-year** (selected countries and groupings, half





Source: CZSO

## 5. Prices

Aggregate price level in the economy was by 2.5 % higher in year-on-year comparison in Q2 2014. It grew the most in last five years.

Aggregate price level in the economy (based on the GDP implicit deflator, seasonally adjusted) increased by 2.5 % year-on-year in Q2, more than in Q1 (+2.2 %). It rose the most in the last five years (by +2.6 % in Q2 2009). Overall growth of prices in the economy was impacted by a favourable development of prices in the foreign trade. Terms of trade improved by 2.1 %, they were higher last at the end of 2009. Prices of goods and services entering the household consumption continued to grow very little (+0.2 %), prices of products acquired by government institutions were raised by one percentage year-on-year. Prices of investment goods increased by 1.1 % year-on-year.

Consumer prices rise remained very low year-on-year

The growth of consumer prices remained very weak year-on-year. While the prices rose by 1.1 % in the last quarter of 2013, they grew only by 0.2 % - following a jump lowering of energy prices at the beginning of the year- in both Q1 and Q2 2014. The growth of consumer prices remained at a very low level in spite of higher prices of the imported goods (which also partially have an effect directly on the prices for consumers, especially then on the prices of inputs in the manufacturing companies) and growing pressures on the side of domestic demand, to which the data regarding the consumption and investment pointed at in the first half of the year.

Zero growth of consumer prices lay in the short-term fluctuation of the prices of seasonal goods in 2014 year-on-year

The inflation rate, expressed by the addition to the consumer price index to the same month of the previous year, moved only negligibly above the zero value during the first half of 2014, it even directly „attacked“ this psychological boundary in June. However, it occurred only due to a short-term fluctuation in the prices of seasonal goods, the prices for consumers returned back to a mild growth in July.

Prices, according to the HICP year-on-year changes, grew less than in the European Union as a whole in the CR in the first half of 2014

Consumer prices grew less than in the EU 28 as a whole in the CR in the first half of 2014. It follows from the harmonised index of consumer prices (HICP). While the prices grew in the aggregate by 0.8 % and 0.7 % in the Union in quarters year-on-year, they grew only by 0.3 % and 0.2 % in the CR. Larger increase of prices was observed compared to the CR in seventeen member countries of the EU in the first three months of 2014, already in twenty in Q2. Still the raised prices remained, in contrast to an array of other countries, in positive values in the CR. Greece faced deflation for a fifth quarter in a row, Bulgaria for a fourth, Cyprus third. The decrease of prices lasted two quarters in Portugal and Slovakia year-on-year. The price reductions also commenced in Hungary in Q2 2014.

Those households, expending a higher proportion of their outlays on energies, especially benefited from the lower domestic energy prices in

Especially the households of seniors benefited from the lower energy prices (electricity, gas) in the first half of 2014 (they expend on these costs larger proportion of their outlays compared to the average households or households living in Prague). While the expenditures for energies share 15.9 % in the total expenditures of households of seniors (based on the consumer basket of 2012),

Q1 and Q2 2014.  
Households of seniors  
also belong here.

they share 10.3 % for an average household and only 8.4 % for households living in Prague. While the households in Prague paid for all goods and services by 0.8 % more on a year ago in both first quarters of 2014, the average households then by 0.2 %. The price of total expenditures was on the contrary reduced for households of seniors. They paid for the purchased goods and services by 0.1 % less in comparison to the same period of the preceding year, by 0.4 % less in Q2 2014.

Prices of food and non-alcoholic beverages were raised up only by 1.5 % in Q2 2014 year-on-year, the least in the last four years

Consumers paid more for food and non-alcoholic beverages only by 1.5 % in Q2 compared to the same period of the previous year, the least since Q2 2014 (-0.1 %). It was certainly positive news for households, hit by a long-term noticeable rise of food prices. They saved for purchases in individual segments for non-alcoholic beverages (-1.7 %) and fruit (-1.2 %). Vegetables were cheaper (-10 %) due to a marked fall of prices of new potatoes. The households paid a little extra for bakery products and cereals (0.6 %), prices of meat rose by 3.3 %. The prices of milk, cheese and eggs went up the most. These products were more expensive in the aggregate, as a result of raised prices of milk and dairy products across the whole production chain, by more than one tenth.

Growth of prices intensifies in the manufacturing industry year-on-year

Deflationary development continued in the segment of industrial producers, caused especially by the cheaper supplies of energies. Prices of industrial producers fell by 0.7 % in Q1 year-on-year, by 0.2 % in Q2. Only the manufacturing industry was instrumental in the milder slump of prices – given the persisting and basically non-changing deflation in the energy industry and the deepening fall of prices in mining and quarrying. The prices only stagnated in the manufacturing industry in the last three quarters of 2013, they started to gain pace in the first half of 2014 (by +1.1 % in Q1 year-on-year, by +1.8 % in Q2). The acceleration of the rate of growth can be possibly attributed in part to the weaker crown, which raised the prices of imported inputs (being subsequently also reflected in the prices of final products), in part to the boosting demand.

Only the producers of basic pharmaceutical products and electrical appliances lowered prices out of the thirteen main segments of the manufacturing industry in Q2 2014 year-on-year

The firms processing wood, further then the manufacturing of paper and printing (+4.1 %), put the prices up the most with respect to the structure of the manufacturing industry in Q2. The producers of coke and refined petroleum products significantly increased their prices (+3.9 %) after five quarters of deflation. The manufacturing of motor vehicles kept the dynamics of prices from the previous quarter (by +4.0 % in Q1, by +3.8 % in Q2), where mostly the parts and accessories of motor vehicles became more expensive. Only two groups lowered the prices out of the thirteen main segments of the manufacturing industry (based on Classification of Products CZ-CPA), which was the best result since Q1 2012. Specifically, they were the manufacturers of basic pharmaceutical products (-2.1 %) and manufacturers of electrical equipment (-0.7 %).

Prices of agricultural producers fell less compared to the previous three months in Q2 2014 year-on-year. The fall of prices of vegetable production slowed down, the growth of prices of the animal production strengthened

Prices were falling in agriculture already a third quarter in a row, however the deflation moderated. While the prices of agricultural producers were lower by 4.2 % in the last quarter of 2013 year-on-year and by 4.4 % in the first three months of 2014, it was already only by 2.1 % in Q2. The fall of prices of vegetable production slackened, the growth of prices of animal production somewhat increased. Grain was cheaper by 16.5 % in Q2 year-on-year (less was paid for all types of grain), the agriculturists charged less by 4.9 % for the industrial crops. The buyers paid more for vegetables, fruit than year ago, the potatoes were also more expensive.

Prices of construction works increased by 0.5 % in Q2 2014 year-on-year, prices of market services by 0.3 %. The prices of construction works have not been raised the whole seventeen preceding quarters, ...

Prices of construction works slowly climbed up, based on their trend index, since the half of 2013. The winter with both above average temperatures and precipitations also assisted in their growth, when it enabled to companies finish their jobs also in the winter months alternatively start new jobs earlier than in the spring. The trend of growing prices of construction works was already reflected in the year-on-year growth in Q2, which has not manifested the whole preceding seventeen quarters. The prices of construction works were higher by 0.5 % in comparison to the same period of the previous year. Still the truth remained, that the prices of cost of construction production grow faster than the prices of construction works. The pressure on the margin of construction firms thus mitigated, however it has not been stopped yet.





...eight quarters in the segment of market services

The fall of prices of market services year-on-year crossed over to a mild growth in Q2 (+0.3 %). The providers of market services raised their prices for the first time after eight quarters of decreases. The significant land transport and transport via pipelines, whose prices accelerated to 1.7 % in Q2 from 0.6 % in Q1, apparently benefited from the growing performance of the domestic manufacturing industry. The same was also valid for the less significant water transport (whose prices stalled in the first three months of the year, however they already grew by 5.2 % in Q2) and warehousing and support activities for transportation (-4.6 % in Q1, +1.7 % in Q2). The weaker deflation in the segment of telecommunication services also contributed to the growth of market services as a whole. While the prices of telecommunication services were lower by one fifth in Q1 year-on-year, it was already only by 8 % in Q2. The impact of substantial reduction of prices of tariffs, occurring in the first half of 2013, started to gradually wane from the year-on-year changes.

Growth of prices of imported goods weakened in Q2 2014 year-on-year, ...

Imported goods were more expensive due to a weaker crown in both quarters of 2014 year-on-year (similarly to the end of 2013). Prices of imports were higher by 2.4 % in Q1, by 1.3 % in Q2. It would represent an import of deflation, if it was not for the weaker crown, similarly to the majority of year 2013. The imported deflation would affect the majority of goods, except for among the more significant groups only the food and live animals. It arises from the exchange rate adjusted development of prices in the foreign trade.

... the same was also valid for prices of goods heading from the domestic economy abroad, ...

The domestic goods directed abroad were more expensive in a year-on-year comparison, nevertheless the rate of growth weakened similarly to the import side. While the export firms were selling for more by 4.1 % in Q1, the export prices were by 3.4 % higher in Q2. All groups of products participated in the slump of the rate of growth apart from other materials and chemicals, whose prices grew more in the second quarter of 2014 than in Q1, and animal and vegetable oils, which reduced prices less compared to Q1.

... still the terms of trade strengthened more compared to the previous three months

Terms of trade stayed positive in the foreign trade with goods (they improved by 1.7 % in Q1 year-on-year, by 2.1 % in Q2). Despite the dynamics of growth of both export and import prices weakening between Q1 and Q2, the terms of trade strengthened. The Czech economy benefited from the positive development of prices in the foreign trade already sixth quarter in a row.

Chart 11 Growth of consumer prices for individual types of households (y/y in %)

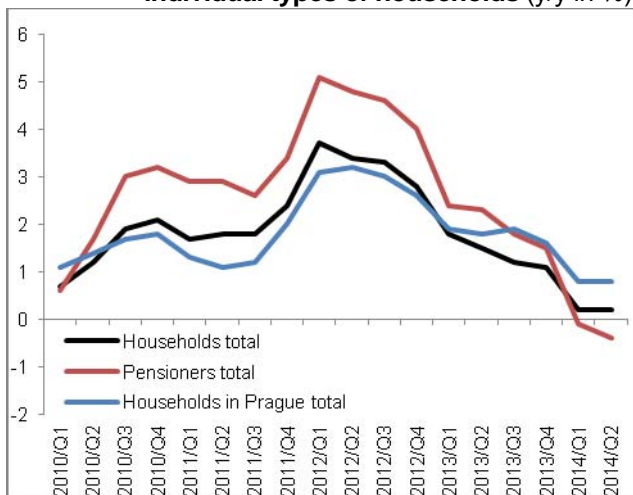


Chart 13 Deflators (adjusted for seasonal and calendar effects, y/y in %)

Chart 12 Growth of prices in selected CPI divisions (y/y in %)

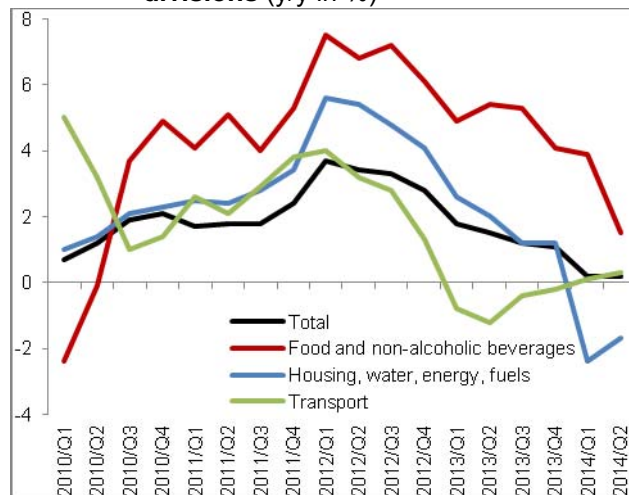
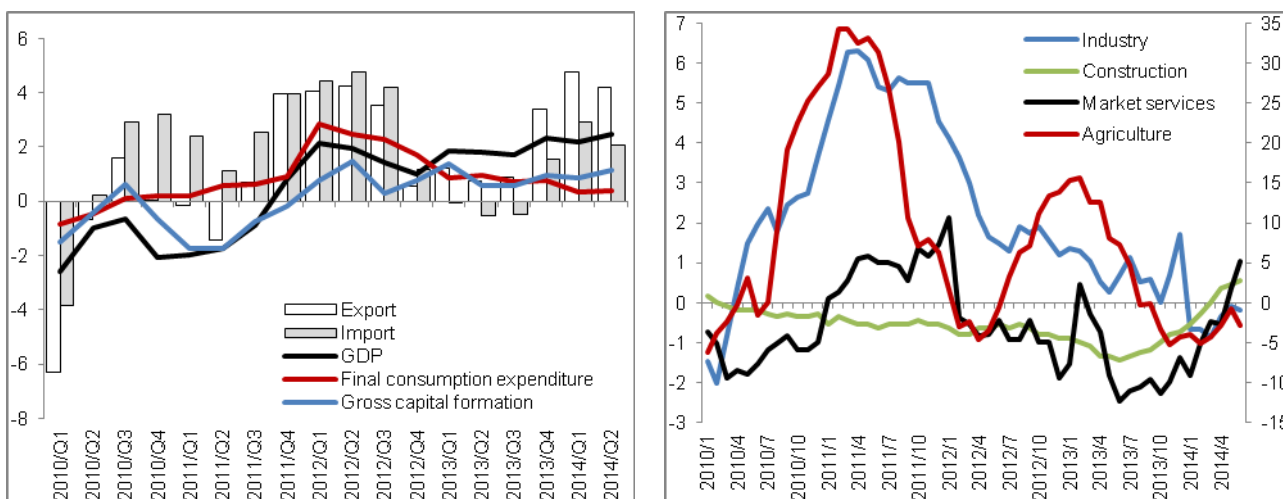


Chart 14 Producer prices (y/y in %, agriculture on right axis, other on left axis)



Source: CZSO

## 6. Labour Market

Labour market lost dynamics – addition to aggregate employment only one quarter in half-year 2014 compared to year-on-year addition in half-year 2013....

Aggregate employment increased in the CR economy – in the national accounts conception and using seasonally adjusted data – considerably less in half year of 2014 year-on-year than in the same period of 2013. It can be assumed, that the effect of rising numbers of part-time and temporary jobs, which was typical for the recession years and which put up the aggregate numbers of the employed persons, is possibly waning.

... still the aggregate employment in the CR is the highest since the pre-crisis period of 2009

The number of employed persons increased by 30.281 thousand in the CR economy year-on-year during the half-year of 2014 (i.e. +0.1 %), while by 117.898 thousand persons (+1.3 %) in the same period of 2013. The addition to employment eventuated for the most part in Q1 2014 (+26.641 thousand person, i.e. +0.5 %).

The labour market acquired only 3.6 thousand persons in the CR in Q2 2014, while it was 26.6 thousand persons year-on-year in the same period of 2013

Despite the moderation of increments the Czech economy however employs the most persons since the pre-crisis period more than five years ago – there were 5 145.5 thousand persons employed in total in the CR by the end of Q2 2014. The statistics recorded more last in Q1 2009 (5 179.5 thousand persons).

Part-time and temporary jobs start to dwindle

The loss of dynamics became apparent only in Q2 2014, when the aggregate employment did rise year-on-year, however it was the lowest addition since Q1 2012 – the number of employed increased only negligibly by 3639 persons compared to the same period of 2013. This contrasts sharply with the high year-on-year additions (by 27 thousand up to 66 thousand) of employed persons, which the Czech economy registered since the half of 2013 till this year's first quarter.

It can be concluded, that the weaker growth on the labour market was also affected by the fact, that the numbers of persons working part-time did not grow any more. On the contrary, the proportion of part-time jobs fell for the first time after the rising tendency since the beginning of year 2012 according to the Labour Force Sample Survey (LFSS), specifically to 6.4 % out of total number of employed persons in comparison to 6.6 % from the last quarter of 2013. The share of temporary jobs also decreased, the decrease was first observed already in Q4 2013 (10 % out of total number of employees compared to 10.2 % in the preceding quarter) and it continued further also in the first three months of 2014 (9.1 %).

Very high growth of number of employed persons likely influenced by jobs in the form of „svarcysystem“ and

The lowering of number of part-time jobs arose more for the female employment (share of 10.3 % compared to 10.5 % in the last quarter of 2013) than for the employed males (the share stagnated to 3.3 % out of total number of employed persons).

Employed persons did increase in six out of ten economic activities and their divisions monitored by the national accounts year-on-year, however only in four quarter-on-quarter.



immigration of foreign workers in construction year-on-year

The large increase of employed persons is a surprise in the positive sense of the word in construction quarter-on-quarter (+6 thousand persons seasonally adjusted, i.e. +1.4 % after drops by 1.3 % and 0.5 % in the two preceding quarters). It occurred practically for the first time since the last three months of year 2009. The change of employed persons was positive, even if only negligibly, in this sector year-on-year (+0.3 thousand persons). It is however obvious, that the progressing recovery of construction is to a large extent saturated with respect to employment in this activity in construction in the CR by the growing numbers of other types of jobs than employee contracts – the number of employees actually significantly fell especially year-on-year (-15.7 thousand persons). The repeated increase of the number of workers from abroad likely also plays a role – as shown by the data regarding the immigration into the CR for this year's first half year -, which have larger proportion in construction than in other economic activity in the Czech economy.

Growing numbers of self-employed...

It seems, that the trend apparent in construction can be generalised to the whole economy – the firms do not execute much the hiring to „root numbers“. The numbers of employees themselves actually notably decreased year-on-year, by 15.8 thousand persons, while the numbers of employed persons mildly grew (by mentioned 3.6 thousand persons). It means that the rising numbers of self-employed influenced the aggregate employment in the CR economy. According to the LFSS, the numbers of entrepreneurs without employees increased by 5.7 % year-on-year, those with employees increased by 1.4 % year-on-year.

...in contrast to the fall of employees in the economy as a whole

With respect to the situation in economic activities, the numbers of persons with the employee status declined more (except for the above mentioned construction) only in the activity cluster of Trade, transport, accommodation, food service activities (-10.9 thousand persons) year-on-year, where the reduction can be anticipated mostly in the trade – the traders look possibly also this way due to the risk of falling margins, how to reduce costs. The division of Other activities also recorded less employees (-1.6 thousand persons), information technologies and telecommunications then a stagnation (-0.1 thousand persons). The industry in total, especially the manufacturing, was hiring employees. Numbers (+2.5 thousand and +6.5 thousand persons resp.) however indicate that the job positions were on the contrary disappearing in the non-manufacturing economic activities.

Jobless persons considerably relatively reduced, labour market reacts to the economic recovery

The unemployment rate again fell according to the LFSS seasonally adjusted in Q2 2014 (to 6.3 % of population aged 15-64 years) to a large extent compared to Q1 (the unemployment rate only stagnated in the amount of 7 % then compared to the last three months of 2013 with 6.9 %). The number of employed was lower by 19.1 thousand persons in Q2, by 39.4 thousand persons then year-on-year, which suggests that the reduction of number of persons without job is accelerating. There were by 21.2 thousand persons unemployed longer than one year less year-on-year, which was roughly the same compared to the reduction in Q1 year-on-year. However, the proportion of long-term unemployed rose due to the decrease of the aggregate unemployment (to 43.2 % against 41.1 % from Q1 2014).

Male unemployment rate was falling gradually from 5.6 % in January to 5.1 % in July 2014 during the half-year, the female rate fluctuated more from 8.2 % in January to 7.5 % in July.

Positive development of average gross nominal wage and also the real wage thanks to low inflation of consumer prices

Average nominal monthly wage (per recalculated numbers of employees) increased to 25 550 crowns by the end of Q2 and its addition thus arrived at 2.3 % year-on-year (+2.8 % for the half year 2014 year-on-year). The middle value of wages was by more than four thousand crowns lower against the average wage in Q2 (21 385 crowns). Since the movement of consumer prices has been only very weak, the real wage rose by 2.1 % in the CR economy year-on-year.

The average wage rose by 2.5 % in nominal terms in the business sector, in that the most in trade (+3.9 %), mining and quarrying and also in financial and insurance activities (similarly by 2.8 %). The wage rose by 2.3 % in real terms in the business sector. The nominal growth presented 1.7 % in nominal terms and

+1.5 % in real terms in the non-business sector.

Employees in the financial and insurance activities received a distinctly higher pay rise (+6.6 %) against the average growth of nominal wage in the business sector (+ 3 %) and non-business sector (+1.9 %) year-on-year.

Chart 15 Total employment and numbers of employees (y/y in %, seasonally adjusted)

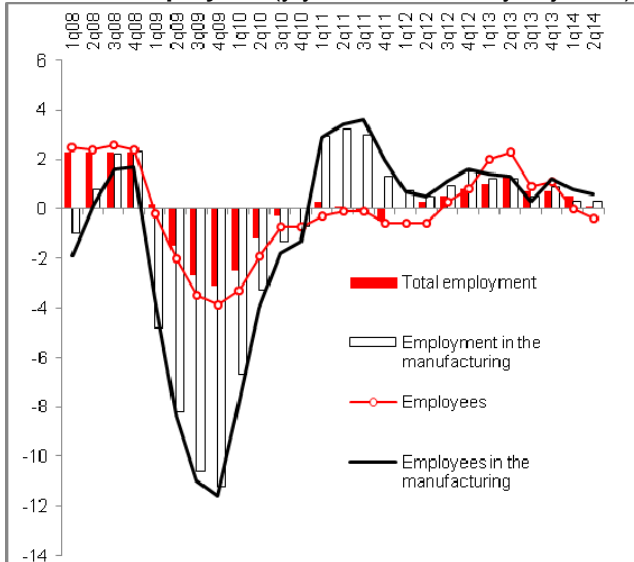
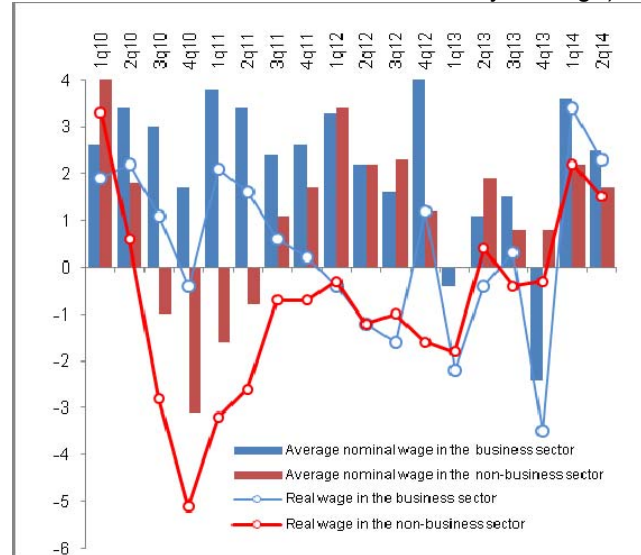


Chart 16 Nominal and real wage (y/y in %, recalculated numbers, monthly average)



Source: CZSO

## 7. Monetary Conditions

Growth of the stock of money slower to nominal addition to GDP...

The prevailing historically low level of basis interest rates in the economy and the exchange rate mode affected by the CNB monetary intervention from November 2013 characterised the monetary conditions in H1 2014. The stock of money (according to the M2 aggregate) increased by 3.9 % year-on-year and arrived at 3 270.8 bn crowns at the end of June. Its growth was lower compared to the growth of the nominal GDP (+5.2 %) year-on-year, while the additions were practically the same in Q1 (+5.1 % against +5.2 % in case of nominal GDP).

... and the smallest since half of 201

Growth of the money stock was thus the lowest addition in the Czech economy since the half of year 2011 (according to year-on-year data monitored always towards the end of each quarter). It was influenced especially by the counter movement of a significant fall of deposits, mainly the firm on one side and the growth of non-term deposits on the other side. A stronger dynamics of credit is missing.

Deposits, especially the business deposits are declining – companies likely use them to partially finance their investment, as evident from the gross fixed capital formation dynamics in H1 2014

A substantial acceleration of the deposit withdrawals occurred during Q2 itself especially for businesses, which „sucked out“ from the deposits with a notice term nearly 22 bn crowns, i.e. -12.3 % (even though the reduction constituted only 15.4 bn crowns against the same period of the previous year, so the withdrawals on such scale is a relatively new thing in Q2). Given that the credit to companies on the contrary rose by 14.9 bn crowns in Q2 itself (+1.5 % by the end of June compared to levels from the end of march), it can be assumed, that the companies thus financed their with respect to past strong fixed investment mostly from own resources in Q2. These resources were relatively high, since both the cash of companies and their deposits on current accounts were accumulating with very low investment in two years of recession

Money in decline also on term deposits of households, but their significant increase on non-term deposits...

People were withdrawing money from their term deposits (-49.4 bn crowns year-on-year, -21.3 bn crowns quarter-on-quarter) and they had deposited 635.4 bn crowns on these accounts by the end of June. The decline thus accelerated in Q2. The positive development of gross disposable income of households, evident in Q1, has not been apparently yet reflected in their behaviour (+2.6 % year-on-year, when the balance of gross primary incomes increased even by 3.6 %), which could be explained by both



the hesitation and uncertainty of households following the materialized recession or also the continuing inequality in the income distribution.

... is given apart from other influences likely the most by the interest rate policy of banks – which results together with the effect of withdrawal of deposits in lowering of household incomes from property already several quarters in a row, which consist for most part just of the interest income from deposits

However, it can especially represent the logical behaviour of households with respect to the interest rate conditions of deposits – the rates on term deposits are so low, that it is more advantageous for the savers to hold money on non-term deposit, which are in addition more liquid (even though the interest rates of non-term deposits of households<sup>9</sup> in banks consisted for new deals of 0.39 % p.a. in Q2, it consisted e.g. for deposits with a notice period over three months even only 0.57 % p.a.). A strong growth of non-term (one-day) deposits of households, which increased by 109 bn year-on-year (+9.1 %) and by 45 bn crowns (+3.6 %) in Q2 itself, proves this assumption. Secondly, the fact, that households incomes from their property, which are dominated by interest income, further fell also in Q1 2014 year-on-year (-3.3 %) following the slump by 8.4 % in the last quarter of 2013, also points to this assumption.

Economy grows without the credit expansion – growth of domestic credit affected especially by net credit of government sector

The increase of credit dynamics, which would correspond to the relatively favourable rate of after-recession recovery – the Czech economy grew faster than the EU economy in H1- , has not eventuated so far. Domestic credit rose by 4.1 % year-on-year. It is the most in the last two years, however this growth can be attributed for the most part to the increase of net credit to the government sector (+6.3 %). The credit to companies as well as households increased less year-on-year, specifically by 3.9 % and 3.6 % respectively (it is even the lowest addition observed in individual quarters in case of households historically year-on-year).

Mortgages from banks to population start to rise mildly faster, bank consumer loans also revive somewhat for third quarter in a row...

Even though the people in the aggregate borrow from banks with a decreasing intensity, with respect to the rates of growth of bank credit provided – the consumer loans from non-bank institutions however gain pace already second quarter in a row -, mortgages to population deepen their pace (+5.7 % year-on-year in Q2), which even increases since autumn 2013. The bank credit to population, whose balances were falling every quarter commencing September 2011 year-on-year, show additions since the last quarter of the past year year-on-year, even though only very modest (+0.3 % in Q2 2014).

...together with short-term consumer credit from installment sale companies; loans in the form of financial leasing also start to grow following their slumps

The non-bank entities also lend to households on consumption, but only short-term (+4.8 % in Q2), while the levels of these loans rise also a third quarter in a row. The levels of loans to households with longer maturity from these intermediaries nevertheless keep falling (the risk is obviously still perceived). It is not valid for the leasing financing (loans in the form of financial leasing also grow already a third quarter in a row).

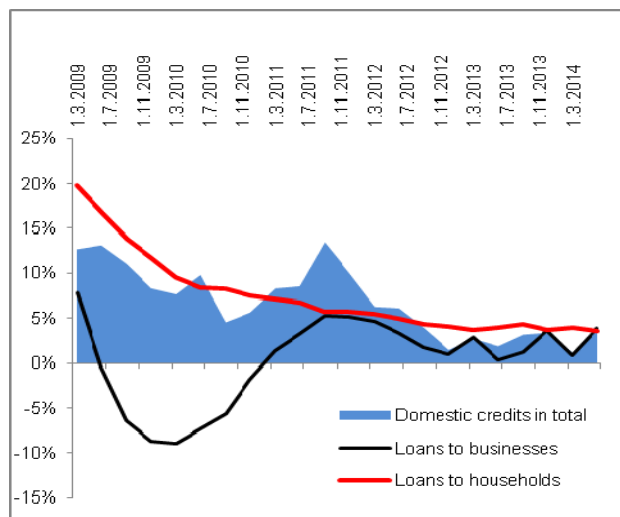
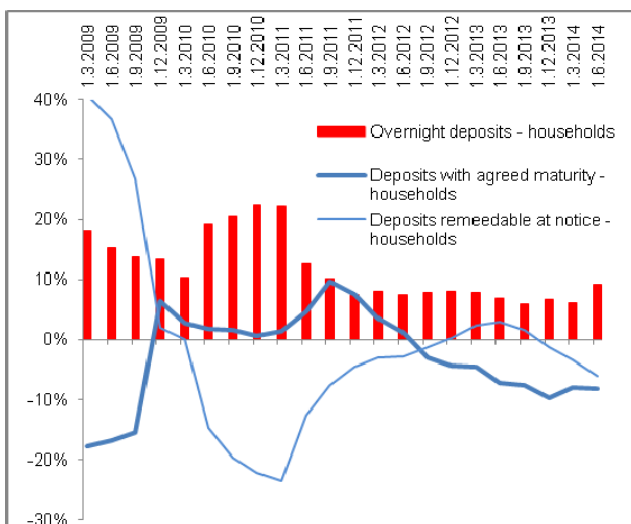
Weak crown influenced the size of net foreign assets

A strong growth of net foreign assets expressed in crowns, especially the net foreign assets of CNB (+37.2 % year-on-year) relates to the weakening of the Czech crown exchange rate from November 2013.

Chart 19 **Household deposits (y/y, in %)**

Chart 20 **Loans to businesses, loans to households, Domestic credits in total (y/y, v %)**

<sup>9</sup> Incl NISH.



Source: CNB, own calculations

## 8. State Budget

State budget surplus for the first time since 2008 in H1...

...driven by the growth of all main revenue components...

Effort to complete drawing of remaining funds at the end of program period „pushed“ the revenues from the EU to historical maximum

VAT collection remains above the level of budget anticipation

Higher collection of consumption taxes significant by volume is considerably affected by the legislative changes

Collection of corporate tax bounced off from the record low level of the previous three years

Prevailing uncertainty on the labour market so far prevents a higher growth of

Trend towards continuing stabilisation of public budget has also proved during the year 2014. At the end of Q2, the state budget finished (based on cash fulfilment) in surplus of 1.4 bn crowns, which was the highest in the last eight years, and it improved in relation to nominal GDP to +0.1 % (from last year's -1.7 %, resp. record -4.1 % in H1 2010). The budget has been pulled out of deficit by revenues (higher by nearly 40 bn crowns year-on-year), which more than adequately compensated the restrained growth of total expenditures (+1.1 %).

So far the highest revenues from the EU (in H1: 84 bn crowns) historically and further also the extraordinary revenue of the chapter Czech Telecommunication Office from the auction of frequency bands for high speed mobile network LTE (8.5 bn crowns) contributed to the strengthening of total revenues (year-on-year +7 %) from more than one third. The increased collection of VAT as well as consumption taxes were evenly reflected in the higher tax revenues (+25 bn crowns), the collection of direct taxes then also to a lesser extent. The state-wide collection of dominant by weight VAT added 7 % year-on-year (while the budget anticipated stagnation compared to last year collection). Both the gradual revival of private consumption and the measures against the tax evasions and more prudent approach to excessive VAT deduction pay out, are reflected in the improved collection.

All important groups of consumption taxes were on the contrary affected by the change of legislation<sup>10</sup>. The state budget gained from the most significant consumption tax – tax on mineral oils, despite the weaker growth of sales at petrol stations, by 7 % more year-on-year. The higher collection of tax on tobacco product by more than one fifth was affected by the intensive prestocking of traders at the end of year 2013<sup>11</sup>. The significance of „solar taxes“ gradually dissipates for the state budget due to legislative changes.

The state wide collection of the corporate tax strengthened by 8.4 % in H1 year-on-year, when it was falling in the same period of the three preceding years. The collection was influenced especially by the economic situation of large companies and their restructuring in 2013. On the contrary, the physical person income taxes (PPIT) from dependent activity remained due to a more modest growth (+4.7 %) the only more significant budget item of the state, whose collection does not fulfil the budget anticipation this year. The so far rather subdued growth of both wages and

<sup>10</sup> The increase of rates for consumption tax on tobacco products from 1.1. (it was also realised in the same period in the previous year); cancelling the right to tax return on mineral oils used for agricultural primary production (so called „green fuel“) for tax on mineral fuels; lowering of rates from 26 % to 10 % (from 28 % to 11 % resp.) for tax payments on „solar systems“ accompanied at the same time by lengthening the payment for equipment introduced to operation during the year 2010.

<sup>11</sup> The collection of these taxes planned for whole year of 2014 was already fulfilled from 35 % only for first this year's month (from 29 %, also due to prestocking in last year's January). The effect of prestocking will be gradually subduing during the year and the more long-term trends of tobacco consumption will be more apparent apart from the higher rate in the total collection. The collection was already higher by less than one tenth by the end of August 2014 year-on-year.



collection of physical person income tax ...

...which as the only more significant income item remained below the level of last year fulfilment in H1 2014

employment is projected into the rates of growth of the collection. Still, the state wide collection of taxes from employees hovered 13 % above the level of top of boom (H1 2008) in H1 2014, on the contrary it was nearly by one quarter lower for corporations (it was dampened next to the impacts of recession on profits of companies also by the repeated lowering of the tax rate). The collection from PPIT from capital income increased by more than one tenth also due to the volume of bank deposits year-on-year. The collection of PPIT from self-employed also progresses favourably, especially as a result of cancellation of some tax reliefs when using capital expenditure allowances.

Investment was falling already fourth year in a row and reached 45 % of the level in H1 2010

Mild growth of total expenditure (+6,2 bn crowns) was driven only by current expenditure year-on-year (+1.5 %), the capital expenditure continued in decline already fourth year in a row. This year's fall of investment<sup>12</sup> was milder in contrast to the preceding years (and in comparison to year 2013) as well as anticipated by the budget. The lower anticipation of investment is connected to the decreasing need to cofinance the projects covered from the revenues from the EU associated with the finishing programming period, partially also by the transfer of funds (8 bn crowns) to non-investment transfers (repair and maintenance of the rails). The investment shared in overall state expenditure by 5.3 % this year, by more than one half below the level of years 2008-10, but still more than in period 2006-7 (4.5 %).

Stagnating expenditure on pensions reflects the lower rate of adjustment as well as demographic trends

Expenditure on pensions the most significant by volume (in line with the budget anticipations) stagnated year-on-year. The number of recipients mostly influences the size of expenditure on pensions given the lower rate of adjustment, this number in fact stagnating eight quarters in a row. Adverse last year's development for collection of social insurance on pensions halted, when it strengthened by 2.4 % year-on-year. The pension account deficit lowered to 16 bn crowns according to the preliminary data in H1 2014 (by 3.5 bn crowns year-on-year), when it reached the best result in the last four years.

Mild improvement of pension account due to revival of insurance collection

Expenditure of other social benefits were higher apart from the unemployment benefits year-on-year, however below the level of budget anticipations

The state expended by 3.5 % more on other social benefits (even though their drawing was with respect to the approved budget year-on-year lower). The resources for the unemployment benefits somewhat declined in line with the situation on the labour market (-1.5 %), however the state spent more on other benefits – especially the social care allowances (mostly the aid in material hardship and care allowance), the sick benefits as well as significant by volume state social support (+1.2 %). Expenditure on all social benefits (including also pensions) cut from the budget 41 %, (two years ago 42 %).

Long-term trend of growth of expenditure on state debt halted thanks also to the favourable development of interest rates in H1 2014

The legislatively amended higher payments for state insures and subsidies to the education system significant by volume as well as expenditure on wages of state employees (+ 3.3 %) contributed to the growth of current expenditure (+8 bn crowns). The state on the contrary saved on the non-investment purchases above the frame of the budget anticipations and also for expenditure connected to state debt, which fell for the first time since 2010 year-on-year.

Net position of the CR towards the EU budget was the highest in history in H1 2014

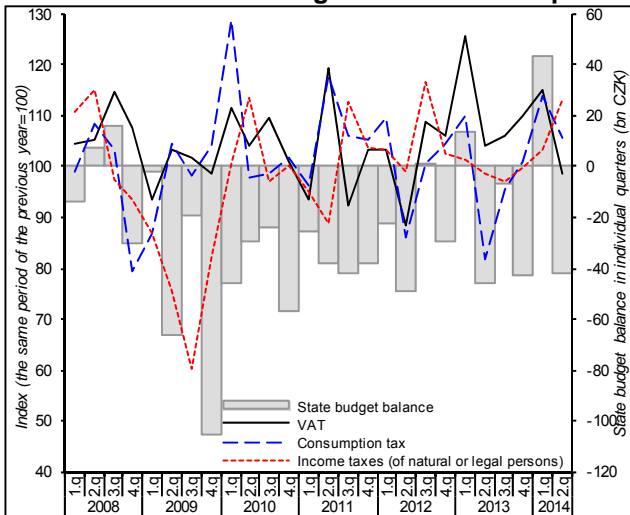
Even despite a mild increase in payments to the EU budget (+1.2 bn crowns) the intensive drawing of all funds from the EU was reflected in further strengthening of positive position of the CR towards the EU budget. It arrived at record 56.4 bn crowns for H1 2014. The positive balance of the CR in relation to the European budget reached nearly 390 bn crowns since the accession to the EU till the half of year 2014 (given the total revenues of nearly 760 bn crowns). Especially the faster drawing of funds from the Structural and Cohesion Funds stayed behind the markedly higher balance. Direct payments (from Common agricultural policy) constituted more than one quarter of total revenues in H1 2014.

The size of state debt stagnated also due to repayment of foreign bonds in Q1

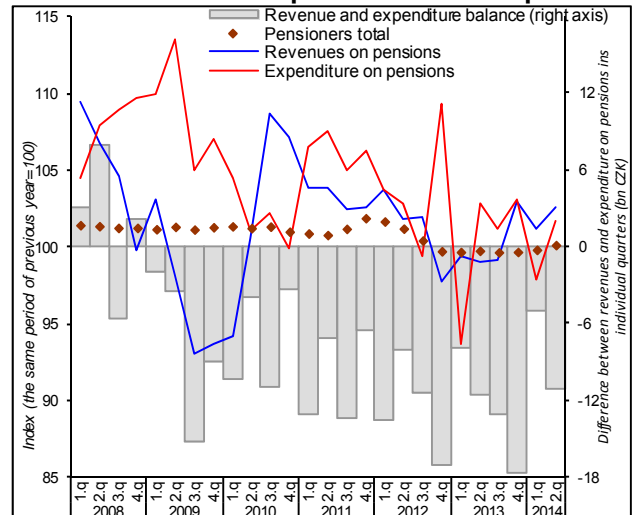
The overall state debt has not changed in first half year and it arrived to 1683 bn crowns at the end of June. Nearly four fifths of the total debt belonged to internal indebtedness (it increased by 53 bn crowns since the beginning of the year). Both the repayments of foreign bonds and an absence of new borrowing (during the whole this year's half year) favourably impacted the development of the external debt.

<sup>12</sup> The size of capital expenditure (50.8 bn crowns) was also higher by 5.7 % during the first eight months of 2014.

**Chart 21 State-wide collection of tax revenues and state budget balance development**

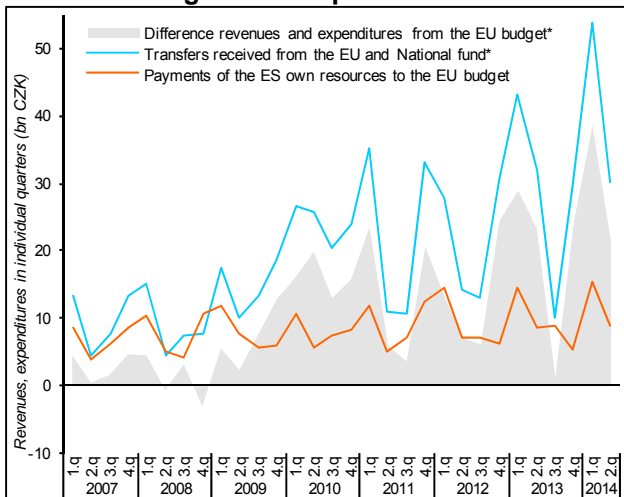


**Chart 22 Pension account balance and number of pensioners development**



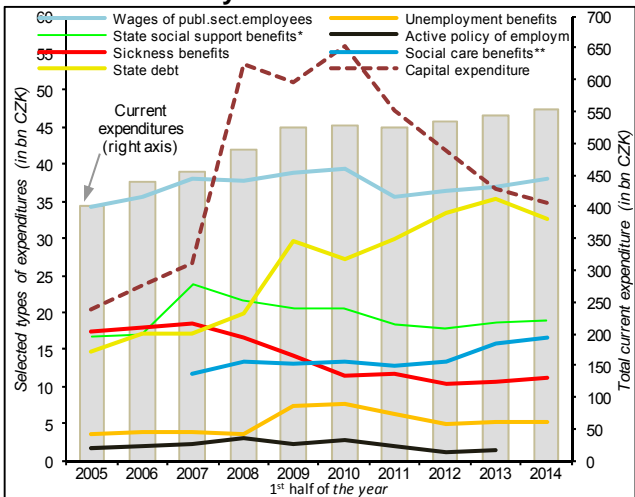
Source: MF CR, ČSSA

**Chart 23 Revenues and expenditures of the state budget with respect to the EU**



\*only the funds to cover expenditure on Common agricultural policy under management of Ministry of Agriculture are included out of transfers received from the EU

**Chart 24 Selected state budget expenditures in 1<sup>st</sup> half-year 2005-2013**



\* Foster care benefits and grants are also included  
\*\* Include: Material need benefits, Benefits for persons with disabilities, Care benefits (under the Act on Social Services)

Source: MF CR

Sources of data in the whole analysis: CZSO, MF CR, CNB, Eurostat, CZSO calculations.

Latest information from the CZSO and CNB given in this report has been dated the 15th September 2014.

