Overall performance of the economy

- ***In the first half of the year, GDP recorded a year on year fall by 0.75% with a more dramatic drop in Q2 by 1%***

In the first half of 2012, the volume of goods and services produced in the Czech Republic was 0.75% lower than in the same period of 2011. This resulted from a deeper year on year drop from 0.5% in Q1 2012 to 1% in Q2. The year on year drop in Q2 against the year on year development in Q1 was recorded by practically all components of the GDP expenditure side[1], with the exception of gross capital formation and import of services. For the first time since the last quarter of 2009, the gross value added posted a slump in the Czech economy. The negative tendencies thus deepened.

- ***The loss of Czech economic performance was in the y-o-y comparison significantly deeper (-1%) than in the EU-27 (-0.3%)…,***

The year on year drop of GDP in Q2 was also recorded by Europe, for the first time since the last quarter of 2009. The debt-related problems of the euro area led to a deeper fall of its GDP (-0.5%) than with the GDP of the EU-27 (-0.3%). The economies of six EU countries posted an even deeper slump than the Czech Republic: Portugal (-3.3%), Italy (-2.5%), and also Slovenia (-2.2%) and Hungary (-1.1%). Norway (+4.8%) and Slovakia (+3%) were the fastest growing economies. German GDP rose by 1%.

The European economic problems are augmented by budgetary issues, as the economy of the USA grew in Q2 by 2.3% in a year on year comparison and the GDP of Japan, still stimulated by recovery impulses after the natural disaster, by 3.6%.

- ***… q-o-q drops seen in Q2 stand at almost half of the EU countries***

With regard to the short-term trajectory, more and more EU-27 countries are sinking deeper into problems. Of the total of 21 states that have already provided data concerning GDP to Eurostat, 11 reported a quarter on quarter drop, nine of these a drop deeper than the Czech Republic – apart from southern countries struck by the debt crisis, these were also countries with mono-product orientation such as Finland (-1.1%) with fluctuating growth and slumps since the crisis, Slovenia (-1%) with problems since the beginning of 2011 and EU-15 states like Belgium, Denmark and the United Kingdom (identically at -0.5%). In Q2, the most effective performance was shown in a quarter on quarter comparison by Sweden (1.4%) and Slovakia (+0.7%). Germany, defying the unfavourable development in external demand, increased its GDP by 0.3% against Q1.

- ***Other countries in recession together with the Czech Republic***

Despite the fact that neither the EU-27 nor euro area are in technical recession as a whole due to the quarter on quarter stagnation in Q1, based on the data available such a recession was, together with the Czech Republic, recorded by states such as Italy, Spain, Portugal, Slovenia, Hungary and the United Kingdom. However, the reasons behind the recession are varied – apart from serious debt problems of southern countries, the crisis was caused e.g. by the poor performance of the service sector (Great Britain) or a strong effort to solve imbalances (Hungary with fiscal consolidation – in the ranking of the EU-27 states, this country had the highest relative government surplus).

- ***Data at the half year mark were influenced by worse development in Q2***

The drop was particularly due to the influence of lower final consumption expenditure and its impact on the GDP of the Czech Republic. For the first half of 2012, these expenditures recorded a real drop of 2.2%. Households reduced their consumption by 2.9% and the government sector by 0.7%. As a result of the diminution of inventories, the gross capital formation was year-on-year significantly lower at the half year mark of 2012 (-7.9% after +2.1% in the same period of 2011), but it was not the case for investment as such – the gross fixed capital formation increased by 0.8% (-0.2% at the half year mark of 2011), due to the stagnation in

[1] Unless stated otherwise, the data on GDP and its components are given in real terms and adjusted by seasonal and calendar effects. even in comparisons with the EU.

Q2. Therefore, these investment represented one of two components of GDP expenditures whose development in Q2did not worsen the overall development for the first half of 2012.

Exports for the first half of the year grew in real terms by 5.4% with a slower pace of the export of services (+3.2%) than the export of goods (+5,8%). Imports, suffering from weak domestic demand, grew by only 2.1% against first half year of 2011 as a result of a significant loss of the pace of the import of goods (+1.5%) with a growth of the import of services by 6.1%. (Together with investment, the import of services was the second expenditure component where the year on year development in Q2 did not post worse results than Q1.)

However, the lost pace concerning the exchange of goods and services with foreign countries is massive, as for the first half of 2011 exports from the Czech Republic rose year on year in real terms by 15.6% and imports by 12.8%. Due to the position of net exports, as the only contributor to GDP growth for several consecutive quarters, this situation poses a risk to the economic development of the Czech Republic should yet another drop in foreign demand occur.

In the European context, exports from the Czech Republic grew faster than exports from the EU-27, but in Q2 the pace slowed, while there was an increase in the EU. There was a similar situation with imports, which saw a recovery in Q2 in the EU, while their dynamics in the Czech Republic continued to decline.

- ***Only foreign trade contributed to GDP growth in the fourth consecutive quarter***

There have been no changes in the character of the contribution of each of the expenditure components in relation to GDP. In Q2, GDP was pulled down for the sixth consecutive quarter by increasingly lower consumption expenditure, which reduced dynamics by 1.9 p.p., while in Q1 it was reduced by only 1.3 p.p. – again GDP growth slowed under lower consumption of both households (-1.7 p.p. against -1.2 p.p. in Q1), and the government (-0.2 p.p. against -0.1 p.p.). Also a strong positive contribution of foreign trade was reduced to +2.1 p.p. in comparison with +3 p.p. in Q1. However, it remained the only expenditure component that worked towards the growth of GDP (already in four consecutive quarters). The gross capital formation affected growth negatively in Q2 (-1.3 p.p.), but not with such force as in Q1 (-2.2 p.p.). The gross fixed capital formation as such has not contributed to the slowdown of the GDP pace – in Q2 its influence was neutral, while it supported GDP growth in Q1 (+0.4 p.p.).

The reduced expenditure of households worked towards the decrease of GDP also in the EU-27, but with less intensity than in the Czech Republic (-0.3 p.p.). As opposed to Czech GDP, government consumption increased the growth of GDP in the EU (+0.1 p.p.), as well as net exports (+1.2 p.p.). However, the development of inventories and investment in the EU-27 had a negative influence (-0.9 p.p. and -0.4 p.p. respectively).

- ***The slump in household final consumption expenditure was the second deepest in the EU after Portugal***

Both positive and negative contributions to GDP growth were determined by the dynamics of its components. The slump of household final consumption expenditure (-3.3%) in the Czech Republic in Q2 was in a year on year comparison the second deepest in the EU after Portugal (-5.9%). The highest rate was reported by households in the poorer countries of the EU (Bulgaria, Romania, Lithuania), but also in Germany (+1.5%).

The drop in demand of Czech households was apparent in year on year terms as early as the beginning of 2011. However, in the first two quarters of 2012 the drop further deepened. Quarter on quarter, household expenditure fell less significantly in Q2 2012 (-1.1% against -1.8% in Q1). Despite this, the drop was the third deepest in the EU after Finland and Cyprus, where the drops were sudden and did not follow the trend as in case of the Czech Republic.

- ***In EU-27, government expenditures rose by 0.4% in y-o-y***

Also savings in government consumption expenditure increased and in Q2 2012 these expenditure was 0.9% lower in a year on year comparison (in Q1 by 0.5%, while in the same periods of 2011 the Czech government sector consumed in a year on year comparison 1.3% less and 0.4% less respectively). The cuts were

comparison, in the Czech Republic, the cuts increased the drop to y-o-y -0.9%

apparent even compared to Q1 (-1.1%, while household consumption decreased quarter on quarter by the same rate).

In Europe, however, government expenditure rose in a year on year comparison by 0.4% in the EU-27 in Q1 and Q2 2012, driven by their growth in large economies (Germany +1.1%, France 1.3%). According to available data from Eurostat, government expenditure dropped in all 12 countries of the EU in a year on year comparison, and quarter on quarter in nine countries. In the Czech Republic, the intensity of cuts in government expenditure in Q2 was in a quarter of quarter comparison the third most intensive after Slovenia and Slovakia. Year on year, 10 countries made more severe cuts in government expenditures than the Czech Republic. According to data from 2011, the debt of Czech government is the seventh lowest in the EU.

- ***Strong q-o-q growth of investment, y-o-y stagnation***

The strong quarter on quarter increase of investment in Q2 2012 (+7%) was very positive, although it might have been affected by the comparative base (a sharp drop by 8% in Q1). Moreover, second quarters report certain periodicity with strongest quarter on quarter increases from the entire year. This was the case of the last two years (in 2011 even with quarter on quarter growth by 8.7% in Q2) and also in 2003–2005. It is the extreme of Q2 2011 that explains how investment in the Czech Republic in a year on year comparison in the same period of 2012 only stagnated.

Despite complaints that restrictions in the Czech economy are very strong and do not give adequate room for investment, in this regard the situation in Europe is much worse – the volume of investment has been on the decline for two consecutive quarters (in the EU-27 in Q2 y-o-y by 2%, in the eeuro area by 3%). Cyprus and Portugal with double digit slumps followed by Spain and Slovenia are among five countries with the most dramatic drops in investment for several consecutive quarters. Double digit growth is recorded by the Baltic states and Romania.

- ***Half year stagnation of gross value added following the decline in Q2; a better result was recorded only by three industries with low weighting***

Gross value added in the first half of the year against the same period in 2011 posted real stagnation (+0.04%), while in Q1 2011 it grew year on year by 2.2%. The manufacturing industry recorded the best results (+5.7%). However, in the same period in 2011, this increase was almost two times this figure (+10.5%). Concerning the resources generated, the results were largely worse against results from the first half of 2011. The results were only better with regard to activities connected with real properties, in aggregate for industry under the heading "Professional, scientific, technical and administrative activities" and also concerning activities under the so-called other services. On the whole, these industries form only 15% of the volume of gross value added in the Czech economy.

The most dramatic year on year slump was recorded by the construction industry in the first half of 2012 (-9.9%), which meant that the drop for the same period in 2011 (-5%) deepened again. Surprisingly enough, the gross value added reported in the finance industry and the insurance industry (-5.1% against +4.4% in the first half of 2011) was lower. As a result, the significant drop from Q1 2012 surfaced (-7.9%), and could have been alleviated only partially in Q2 (-2%). The finance and insurance industries thus were among the last two activities that were more successful in Q2 than in Q1, by either higher gross value added reported, together with public services (public administration, defence, education, health and social care), or by alleviation of the previous drop (information and telecommunication activities).

Despite the decrease in the gross value added in Q2 (-0.3%) and its half year stagnation, its development was more favourable than that of GDP. In EU-27 the year on year drop of gross value added was more moderate (-0.2%), while in the euro area (-0.3%) it was equal with the Czech Republic.

- ***Real domestic***

The Czech Republic posted half year profit from foreign trade generated by

income grew slower than GDP, y-o-y trading losses lower

favourable development of prices in 2009 for the last time. Since then, the development of exchange rates has yielded only a loss standing at CZK 22.1 billion at the half year of 2012. Against the half year calculations for 2011 and 2010, this loss was lower, for which lower flows of goods in the first half of 2012 compared to the previous years could be responsible. Real gross domestic income in Q1 and Q2 posted year on year drops, even more significantly than in comparable periods in 2011. A deeper slump also occurred in comparison with the pace of GDP in real terms.

Chart No. 1 **Gross domestic product** (in real terms, adjusted for seasonal and calendar effects, change in %)

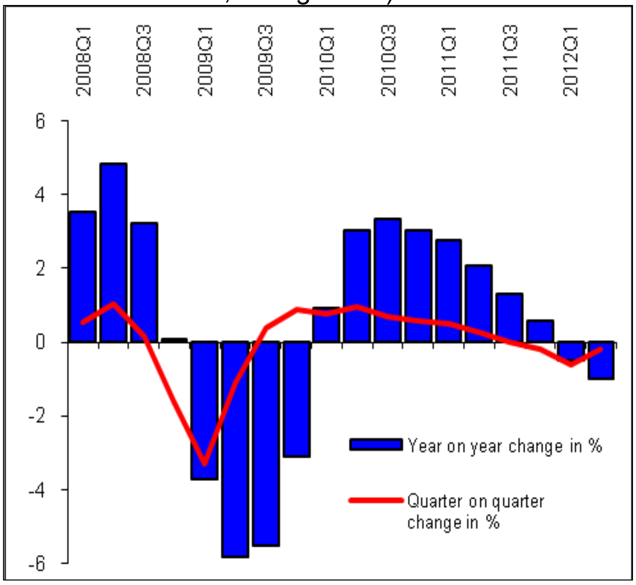


Chart No. 2 **GDP** (y/y in %) **and confidence indicators by Business Cycle Survey of CZSO**

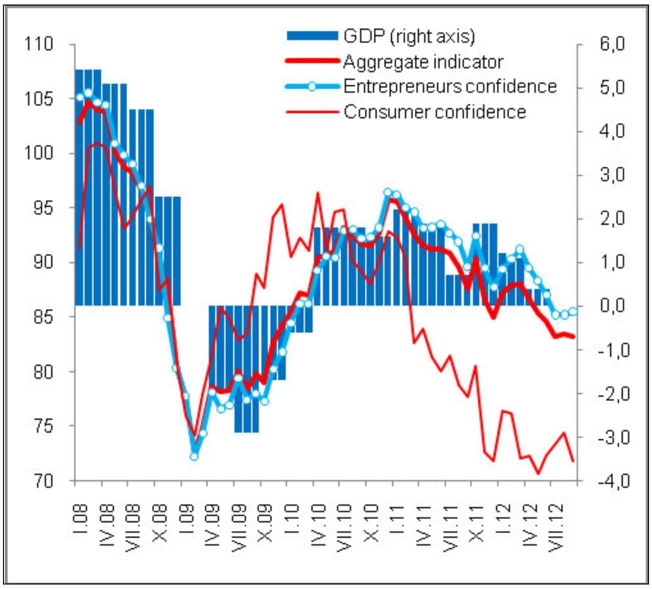


Chart No. 3 **Contribution of expenditure items in GDP growth** (in c.p.)

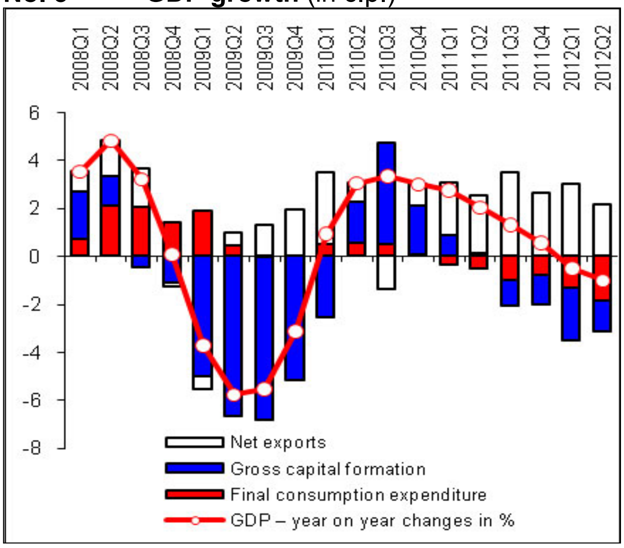
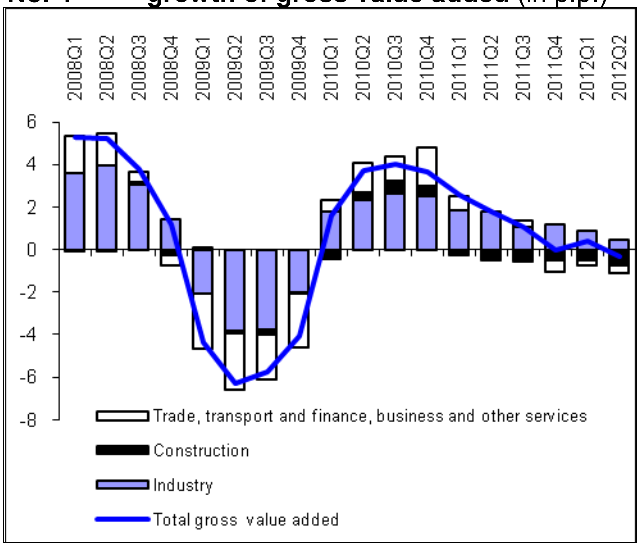


Chart No. 4 **Contribution of industries in relation to growth of gross value added** (in p.p.)



Source: CZSO