

THE CZECH ECONOMY DEVELOPMENT IN 2014

Cross-thematic information

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1. Summary

- The recovery of the Czech Republic economy – which started based on the year-on-year dynamics in the last quarter of 2013 and in the quarter-on-quarter comparison already in Q2 2013 – continued also in 2014 with the rate of GDP¹ growth already starting to weaken in trend year-on-year. The Czech GDP grew faster compared to the dynamics of the EU economy in the year-on-year comparison during the year 2014, quarter-on-quarter only in Q2 and Q3.
- The performance of the Czech economy grew even faster than GDP according to the gross value added dynamics practically in every quarter of 2014. The cause was the pre-stocking with tobacco products by the end of year 2013, which affected the resulting balance of the taxes on products and subsidies on products for the whole year of 2014. The economic growth occurred in the relatively stabilized environment – both external and internal imbalances were improving. The labour market also experienced a positive development. Easier monetary and fiscal conditions supported the growth as well.
- The GDP of the CR increased by 2 % in total for the whole year 2014, the gross value added increased by 2.6 %. The manufacturing industry contributed to the growth the most, being strongly oriented on the foreign demand (+1.5 p.p.). The remaining industries in total were slowing down the economic growth (-0.1 p. p.). The group of branches agriculture, forestry and fishing (+ 0.2 p.p.) and construction also for the first time since 2010 (+ 0.1 p.p.) participated on the growth of the gross value added compared to the preceding year. Services as a whole contributed to the growth already for the second time, their positive effect in addition strengthened from + 0.6 p. p. in 2013 to + 0.9 p. p. in 2014. While the gross value added has already overtaken its level from 2008 (+0.5 %), the GDP remained slightly lower (-0.2 %).
- The volume of the industrial production and retail sales exceeded the boom top from year 2008 for the first time. The consumer confidence was also higher against the year 2008. The construction production hiked up after five years. Despite the growth of newly commenced dwellings, which occurred for the first time after seven years, their number reached however roughly one half of their number in 2007. The stock of construction works on the public orders also increased after five years in construction firms.
- The fact that all main components of the domestic demand contributed to the growth of GDP was a positive feature of the economic development in 2014 (only exception was the change in inventories). Investment – which increased in the quarter-on-quarter comparison already for the sixth time in the last quarter of 2014 – contributed by 1.2 p. p. (based on classical decomposition), the total final consumption expenditure also participated on the economic growth with the same force. While the household consumption itself, positively influenced by the turn on the labour market, contributed to the GDP growth markedly more than in the previous year (+0.2 p. p. in 2013, +0.8 p. p. in 2014), the contribution of the government consumption mildly weakened (+0.4 p. p. in 2013, +0.3 p. p. in 2014). The change in inventories (-0.2 p. p.) hindered the growth of the Czech economy similarly to the two preceding years. The result of the foreign trade – which was in real terms adversely affected by the strength of the domestic demand being reflected in the higher rate of growth of imports (+ 9.6 %) compared to exports (+ 8.8 %) – also contributed negatively to the GDP growth (- 0.1 p. p.), in fact for the first time since 2007.
- The CR registered several historical improvements in the external relations – the surplus on the current account (just second since 1993), record trade balance or „salary balance“ with foreign countries. The outflow of dividends of direct investment was also historically the highest based on the balance of payments data, the amount of reinvested profits was the second highest. This development was enabled by the strong dynamics of sales, especially from exports, and profits, also generated by the weak koruna. The inflow of direct investment from abroad was below the average of the previous three as well as ten years.
- Total price level in the economy increased based on the implicit GDP deflator by 2.3 % in 2014, mostly thanks to the favourable development of prices in the foreign trade with goods. The prices in the industry crossed over into the deflation (- 0.8 %), the consumer price index moved up only by 0.4 %.
- The changes on the labour market were of a complex nature. The unemployment rate fell significantly (to 6.2 %), the total employment in the national account conception climbed up by 0.4 % accompanied by an increase of the number of job vacancies. The proportion of part-time jobs however already

¹ Unless stated otherwise, data regarding the GDP and its components are expressed in real terms and adjusted for seasonal and calendar effects.



decreased. The average nominal wage increased by 2.4 % following stagnation in 2013, the average real wage was higher by 2.0 % after two years of fall.

- The economic growth was recorded without a credit expansion, the companies probably utilized the funds accumulated from the favourable development of their profits to finance the gross fixed capital formation. The decrease of funds on the term deposits continued, since the deposit interest rates for clients including the rates on non-term deposits kept falling.
- The state budget deficit in the amount of 1.8 % of the nominal GDP was the most favourable since year 2008. Its reduction occurred already for the fifth time in a row. The economic revival assisted to the high growth of VAT as well as corporate tax collection, it also decreased the pension account deficit. Its balance recorded the largest positive year-on-year progress since 2007. The three years lasting decrease of state expenditure on investment also halted (+ 9.8 % year-on-year) due to the intensive drawing of resources from the European funds.

2. Overall Economic Performance

Czech economy was further reviving during 2014, ...

The CR economy, which extricated itself out of the recession in Q2 2013, kept further recovering during the year 2014². Its performance was improving – gauged by the quarter-on-quarter change of the gross domestic product (GDP) – without exception throughout the whole year. If in Q1 the GDP increased by 0.3 % and in Q2 as well, it grew identically by 0.4 % in the two remaining quarters. The development of the economy recorded in this way, already favourable, was however underestimated. The pre-stocking with the tobacco products at the end of 2013 leading to increase of the collection of consumption taxes led in fact to the situation, that the balance of taxes on products – which is part of the GDP calculation – considerably increased in the last quarter of 2013 and heightened the dynamics of the GDP growth, nevertheless it was continuously falling during the year 2014 and on the contrary pressed down the GDP dynamics. If we proceed from the quarter-on-quarter changes of the gross value added (GVA), which does not contain this balance and is more suitable for the purpose of capturing the true development, the picture regarding the development of the domestic economy changes for the better. If the GVA increased by 0.7 % quarter-on-quarter in Q1 2014 and identically by 0.5 % in Q2 and Q3, it rose by high 1.1 % in the last three months of the year. As it was evident from the data related to GDP, that the Czech economy kept further reviving in 2014, then it followed from the GVA indicator, that its growth accelerated towards the end of the year.

... GDP formed in 2014 already nearly balanced out its level from 2008

The data for year 2014 confirmed, that the Czech economy already overcame the two years' recession. As the GDP dropped in total by 1.4 % in the CR in years 2012 and 2013, the rise by precise 2.0 % in year 2014 more than compensated for this slump. The GDP created in 2014 already nearly balanced out its level from the top of boom in 2008 (it was lower only by 0.2 %).

All main components of domestic demand, apart from change in the inventories, contributed to the GDP growth in 2014. Investment was „the driving force“, ...

The renewed growth of the gross fixed capital formation, that is investment, contributed the most to the GDP growth in 2014³. Its contribution reached 1.2 p.p., it was positive for the first time after two years and the highest since a strong year 2007, when not only the domestic and foreign companies, but also households significantly invested in the Czech economy. Household final consumption expenditure and government final consumption expenditure share in the economic growth less in 2014, however they were growing opposed to investment already for a second year. While the favourable impact of the government consumption slightly weakened (from +0.4 p. p. in 2013 to +0.3 p. p. in 2014), the size of the household consumption contribution notably increased (from +0.2 p. p. to +0.8 p. p.). The remaining components of the demand, that is the change in the inventories (-0.2 p. p.) and the result of the foreign trade (-0.1 p. p.), slowed down the growth of the Czech economy in 2014.

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

³ Contributions to GDP change without the exclusion of imports for final uses.

... however if we remove the imports meant for final uses from the total imports, then the result of modified foreign trade participated the most on the Czech economy growth

If we exclude the imports meant for final uses from the total volume of imports of goods and services into the CR, since it has in fact nothing in common with the growth of the Czech economy, then the contributions of individual components of demand to the GDP growth change significantly. Investment and final consumption expenditure of households, which are generally satisfied to a large extent by imports – and that was also evident in data for 2014 – contributed in this modified conception by only 0.6 p. p. and 0.2 p. p. respectively. The final consumption expenditure of government also participated on the economic growth less than in the classical conception (+0.2 p. p.), the contribution of the change in inventories did not alter on the contrary, it remained negative (-0.2 p. p.). The foreign trade without imports meant for final uses was thus the main factor in the growth in 2014 (+1.3 p. p.).

Czech economy keeps expanding faster compared to the EU countries and markedly faster than the Euro area

The GDP expanded by 1.5 % in the CR in Q4 2014 year-on-year. Although the rate of growth was adversely affected by the high comparative basis of the previous year (linked to the already mentioned imbalance collection of the consumption taxes), the domestic GDP strengthened more than in the EU economy as a whole (+1.3 %) and markedly more than in countries paying by euro (+0.9 %). The Czech economy was expanding faster compared to both economic areas already five quarters in a row.

Economic development was considerably differentiated in the four biggest union economies towards the end of 2014

Only Germany grew faster than the CR out of the four biggest EU economies quarter-on-quarter in Q4 2014 (it recorded based on the available data the fifth largest addition to GDP out of all EU countries (+0.7 %), following a factual stagnation from the two previous quarter), but also The Great Britain (+0.5 %). The GDP growth decelerated from +0.3 % in France in Q3 2014 to mere +0.1 % in the last quarter, Italy – which faced recession in the first three quarters of 2014 – just stagnated.

Improving situation on the labour market transferred into higher incomes for households and consequently also into higher consumption expenditure in 2014...

The income situation of Czech households already improved (according to the so far known data) in 2014, following three years 2011, 2012 and 2013, which hit their total incomes hard. Continuing growth of the number of employees, lengthening of the real hours worked, growth of real wages in both the business and non-business sphere, but also for instance the increase of the number of self-employed (especially entrepreneurs) – is only a concise outline of the changes on the labour market, which had a positive effect on the household income in 2014, and were consequently also transferred into higher consumption expenditure. If household final consumption expenditure fell in total by 1.2 % in years 2011-2013, they strengthened by 1.7 % in the year of a renewed growth of the Czech economy 2014. They increased the most in the last six years.

... household final consumption expenditure increased by 1.2 % quarter-on-quarter in Q4 2014 itself, the most since Q1 2010

The household consumption expenditure rose by 1.2 % quarter-on-quarter in Q4 itself, more than corresponded to the average for individual quarters of 2014 and the most since the beginning of year 2010. Not only the announced wage increases of state employees effective from the beginning of November 2014 most likely affected the household expenditure, but also the positive expectations of households with respect to future economy development. The results of business cycle surveys from the end of the year also proved this. The consumer confidence in the economy was already so high in the last three months of 2014, that it „attacked“ at the historically highest confidence level from the turn of the boom years 2006 and 2007.

Easier fiscal policy stimulated the domestic demand via growth of the government consumption also in 2014

Despite the dynamics of final consumption expenditure of government being considerably unbalanced during 2014 (with positive quarter-on-quarter additions in Q2 and Q4 and negative in Q1 and Q3), the growth tendencies prevailed. The government consumption strengthened by 1.6 % for the whole 2014, the easier fiscal policy stimulated the domestic demand already for the second year.

Investment increases in quarter-on-quarter comparison already six consecutive quarters, ...

The Czech economy growth was for the most part built on the higher demand for investment in 2014. Even though investment was still markedly lower (-10.4 %) in comparison to year 2008 (it was invested historically the highest 1168 bn CZK (in 2010 prices) in the CR), domestic investment activity evidently improved (+4.7 %) against the year 2013. The fact that investment increases progressively and not occasionally can be assessed in a very positive way. The already six quarters lasting quarter-on-quarter growth suggests, that the investment moods are not only positive, but also stable in the CR.



... it was invested especially into ICT, machinery and equipment; buildings and structures; but also housing more than in 2013

As follows from the type classification of the gross fixed capital formation not seasonally adjusted, investment into ICT, machinery and equipment rose the most in 2014 (+7.4 %), however the investment into buildings and structures (+6.4 %) did not – with respect to the recorded dynamics – lag too much behind either. While the higher purchases of ICT, machinery and equipment were justified especially in expanding the production capacities of the manufacturing companies, the growth of investment into buildings and structures can also be attributed to the renewed construction of large infrastructure developments financed from the public funds. Purchases of the transport equipment – which flourished in 2013 – did not strengthen further (-2.8 %), investment into housing (houses and flats), where especially the households put their resources, on the contrary increased (+1.1 %) for the first time since 2010. Higher incomes of households, effort to create financial reserves for the future, but also the very low interest rates on loans for housing were reflected there.

Notable drop of value of inventories in Q1 and Q4 2014 was also projected in the result for the whole year

Value of inventories declined in total for the whole year 2014 by 9.3 bn CZK (in nominal terms, not seasonally adjusted) due to marked emptying of stores at the beginning and end of the year. While in Q1 2014 the inventories of tobacco products stored up within the frame of the tax optimization in the previous quarter were gradually dissolved, in Q4 2014 a reduction of inventories of goods and incomplete products occurred thanks to the further strengthening demand.

Foreign trade surplus shrank in constant prices due to a strong growth of domestic demand in 2014, ...

Renewed economic growth in the euro area together with a weaker koruna, which assisted the competitiveness of the domestic exporters on the world markets, had a very favourable impact on the exports volume of goods and services from the CR abroad. It jumped by 8.8 %, markedly more than in „poor“ year 2013 (+0.3 %), however it was not enough on the addition to the imports volume (+9.6 %), which was boosted by the force of the domestic demand.

... however in the current prices – thanks to the favourable price development in trade with goods - it rose to historic maximum

Result of the foreign trade with goods and services rose to the historically highest 292.6 bn CZK in nominal terms in 2014. While the surplus of the foreign trade with services itself shrank by 14.4 bn CZK compared to year 2013, excess of exports of goods over its imports increased by 71.4 bn CZK thanks to the positive terms of trade.

The Czech economy has already surpassed the year 2008 according to the gross value added

Total performance of the Czech economy, gauged by the gross value added, increased by 2.6 % in 2014. All industries of the Czech economy together produced goods and services in the volume, which overtook the level of 2008 for the first time. It was higher by 0.5 %.

Manufacturing industry, which is strongly oriented on the foreign demand, together with the services significant by volume contributed the most to the growth of the gross value added in 2014

Manufacturing industry benefiting from the higher demand both abroad and at home already from the half of 2013, contributed by the largest share (+1.5 p. p.) from the view of the supply side to the growth of the CR economy in 2014. The remaining industrial activities in total (CZ-NACE B, D, E) – affected especially by the protracted decline of prices of coal on the world market (mining and quarrying) and a mild winter (energy industry) – slowed down the growth of the economy (-0.1 p. p.). Fine harvest of the agricultural crop was favourably reflected in the performance of the group of activities involving agriculture, forestry and fishing (+0.2 p. p.), the rise of demand for construction activities on part of private persons as well as public clients in the gross value added of construction (+0.1 p. p.). Services as a whole (CZ-NACE G-U), which share in the total performance of the Czech economy roughly by three fifths, participated on the economic growth by 0.9 p. p. force in 2014.

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

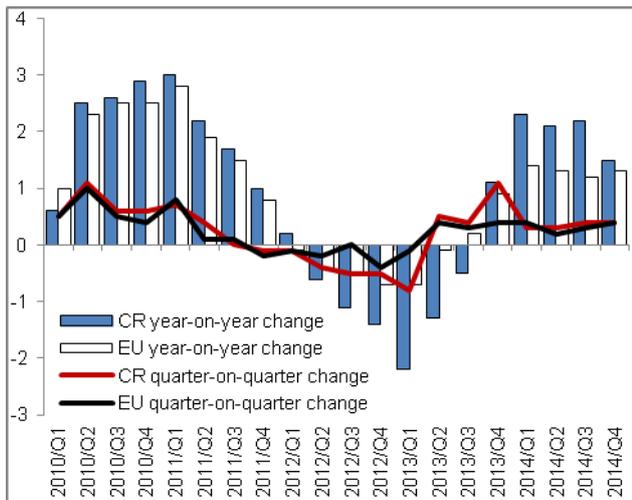
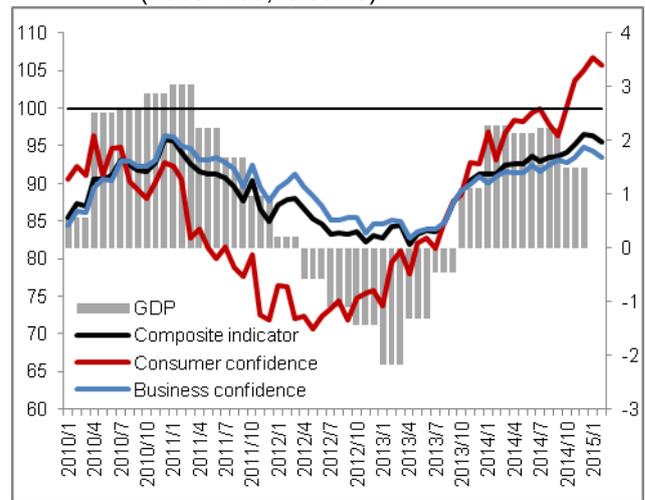


Chart 2 GDP (constant prices, adjusted for seasonal and calendar effects, y/y in %, right axis) and confidence indicator (2005=100, left axis)



Source: CZSO, Eurostat

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

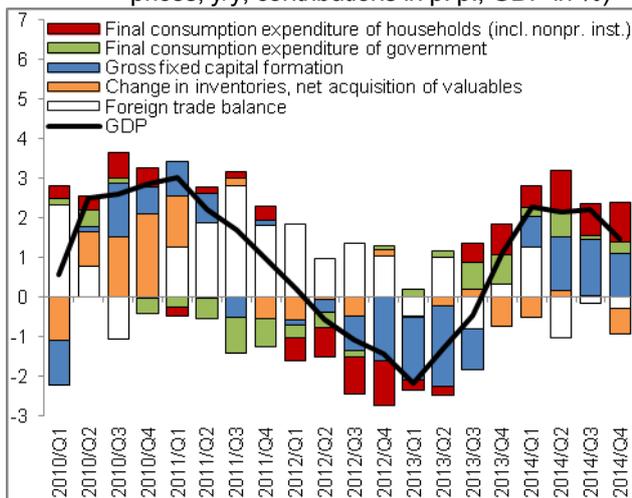
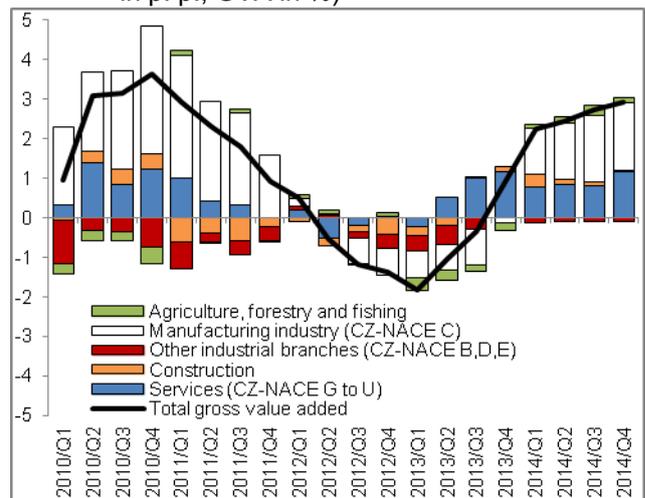


Chart 4 Contributions of branches to GVA change (constant prices, y/y, contributions in p. p., GVA in %)



*contributions to GDP change without the exclusion of imports for final uses

Source: CZSO

3. Branches Performance

Growth of GVA regularly accelerated during 2014, despite gradual transfer to higher last year's basis

Manufacturing industry secured three fifths of GVA growth, construction also contributed positively for the first time since 2010

GVA growth exceeded the dynamics of both aggregate employment and hours worked, which strengthened

Year 2014 brought a confirmation as well as stronger anchoring of growth tendencies in key branches of the Czech economy. Seasonally adjusted aggregate size of gross value added (GVA) carried on in the continued growth initiated in Q4 2013 (in the year-on-year expression), respectively already in Q2 2013 (in the quarter-on-quarter expression). It swayed over the pre-crisis level during Q3 2014 (similar quarter of 2008) and mildly accelerated during the last quarter (by +2.9 % year-on-year, by +2.6 % for the whole year). The GVA growth was driven in three fifths by the export oriented manufacturing industry in 2014. Construction as well as the majority of significant groupings of services (apart from the financial sector and the real estate activities, which did not follow up on the previous successful years) contributed positively (similarly to years of strong boom).

Year-on-year GVA growth was accompanied by a milder growth of employment in 2014 (0.4 %, in the national accounts conception), which however persisted with a similar intensity also in the recent period of a slight recession. The growth of total



mostly in selected services year-on-year

hours worked (1.0 %) was also only moderate, with higher dynamics focussed (similarly to the employment) mainly in the services sector – in the professional, scientific, technical and administrative activities (5.8 %) or real estate activities (3.9 %). The manufacturing industry reacted to a stable increase of new orders only with a certain delay (the number of employees grew only by 0.3 % year-on-year in the H1 2014, in H2 already by 1.6 %, the fastest since the end of 2011). The agriculture also fared well (especially thanks to the plant production), with its GVA growing by a similar rate to the manufacturing industry (6 %) in 2014. Revival of the new public orders mainly in the area of civil engineering construction was reflected in the growth of the whole construction (2.6 %), which however kept losing the job positions, the number of self-employed however increased in contrast to the previous years (by 7 % year-on-year). Similar situation arose in construction even in the period closely after the deep recession of the economy.

Very good harvest (cereals, sugar beet and oilseed rape) pulled up the GVA in agriculture to the highest level since 2009

Public orders as well as mild winter revived construction, where the number of self-employed also grew

Public services participated on the GVA growth of the whole tertiary sector from 40 %, most of other activities however also thrived except for finance and insurance activities, where the GVA exceptionally fell – the most since 2002

The GVA within the bounds of services increased the most in the long-time growing professional, scientific, technical and administrative activities (+ 4.2 %) and in the information and communication activities (+ 3.5 %). The growing demand in these activities converted also into higher numbers of self-employed persons. Public services helped the most within the tertiary sector to the growth of value added in the whole economy thanks to their weight as well as dynamics (+ 2.4 %). The gradual departure from tighter saving measures contributed to this growth, supported also by a more intensive activity of the state in the area of active employment policy. Finance and insurance activities experienced a worse year, with the GVA falling by whole 3 % year-on-year (however it stays by nearly one third higher compared to year 2008, while „only“ by one tenth in the manufacturing industry), which was also reflected in the decrease in the number of jobs. On the contrary the GVA keeps falling in the mining, quarrying and energy activities already six years in a row, affected by adverse prices of commodities on the world market, also by weather fluctuations in the last two years.

Production increased across nearly all manufacturing activities, apart from „small“ activities – printing, wood industry and manufacture of wearing apparel

Industry performance⁴ (gauged by the industrial production index in real terms) added nearly 5 % for the whole year 2014 year-on-year (following stagnation in the previous year). While it grew similarly by more than 6 % in the first two quarters (adjusted for calendar effects), it hit the strong last year's basis in H2 and strengthened by 3.5 %. The revival of foreign demand stood behind the growth, at the beginning especially for transportation vehicles, which gradually spread out (not only by the direct sub supplier relationships) also to a majority of other manufacturing activities, even in case of the domestic demand. Only the marginal activities by production – printing and wood industry, but mainly the manufacture of wearing apparel, whose production was by one third weaker compared to year 2008, remained below the level of year 2013. Outside the manufacturing segment, mining industry continued in the long-term falls (by -2.8 % year-on-year, by whole one fifth compared to 2007), also energy industry with a similar intensity (and already four years in a row), where however the reduction of the production was not accompanied by a resolute decline of job positions.

The mining industry continued in the sharp slump of production from 2013 by further year-on-year fall (-2.8 %), milder slump further persists also in the energy activities (nevertheless without deeper impact on employment)

The motor vehicle industry remained the key growth generator throughout the whole year, participating together with the closest follow-up activities on the growth of production of the whole industry in two thirds

The manufacture of motor vehicles together with other transportation vehicles contributed nearly by one half to the higher productions in the whole industry in 2014, individual sub supplier activities identically also added one tenth – manufacture of rubber (incl. plastic) products as well as manufacture of electrical equipment. The output grew dynamically also in the procyclical strongly and export oriented manufacture of computers, electronic and optical products (by one sixths year-on-year, by 37 % in two last years) and also the petrochemical as well as chemical industry (partly also due to the impact of production limitation in the preceding year due to the floods). The significant industries of manufacture of food products and also metallurgy or manufacture of machinery strengthened on the contrary only mildly (1.5 to 2.5 %), where the weaker domestic new orders (year-on-year) stood in the way of their larger recovery. Manufacture of machinery together with the manufacture of electrical equipment belonged to the only industrial activities, whose production was increasing continuously in the last five years.

⁴ Including activities according to CZ-NACE: B (Mining and quarrying), C (Manufacturing industry), D (Energy industry).

Industry as a whole surpassed the production level from the top of boom for the first time in Q4, most activities however still lagged behind this level

The industry in the aggregate surpassed the production level from the top of boom (beginning of year 2008) in real terms for the first time towards the end of 2014. The manufacture of motor vehicles resp. other transportation vehicles (they overtook the level from year 2007 by 45 %, resp. 54 %) and also associated activities of manufacture of electrical equipment (by one third) were the most instrumental in this. The production was by one quarter higher even in the predominantly investment specialized activities – manufacture of computers, electronic and optical products, resp. repair and installation of machinery and equipment. Majority of industrial activities however did not reach the pre-crisis production level – next to the mining especially some smaller manufacturing activities (manufacture of beverages, textile, wearing apparel, leather products, printing, manufacture of furniture), manufacture of glass, ceramic, porcelain products and construction products (-23 %), manufacture of food products (-13 %) among the more significant activities, metallurgy, manufacture of metal products and energy industry then also by one tenth.

Investment oriented activities mostly drove the industry, the fall of production halted in activities focussed on short-term consumption

Similarly to most boom years, especially the activities oriented on investment drove the industrial production also in 2014 (+8.5 %), followed by activities manufacturing products for long-term consumption (+6.2 %) or intermediate products. After six years of continuous declines, the activities focused on short-term consumption (involving e.g. food, textile, wearing apparel, medicine, toys), also slightly strengthened (1.8 %). The production increased only for investment oriented activities (by one quarter) compared to the boom year of 2007, it decreased by one sixth for products of short-term consumption.

Dynamics of new industrial orders returned to double-digit values, even on the domestic market

The new orders also prove the favourable outlook of industry. They accelerated by one eighth year-on-year in 2014 (the most since 2010). In contrast to the preceding years, the dynamics of domestic orders (+10.5 %,) less significant by weight, did not lag behind the foreign ones. Manufacturing of wearing apparel (with a decreasing value of orders twelve years in a row) and pharmacy (where a mild growth of orders from abroad just managed to compensate the traditional deeper slumps of domestic demand) remained the only activities without more significant near future growth „order“ impulses. The motor vehicle manufacturing and also the computer manufacturers had the highest dynamics of orders. The rate of growth of orders weakened due to the gradual transit to the last year's high basis during 2014 (from 20.3 % in Q1 to 6.5 % in the last quarter), only the chemical, machinery industries as well as computer manufacturers preserved a stable growth dynamics.

The protracted decline in demand persisted in wearing apparel manufacturing, the orders on the opposite grew by one sixth to the manufacturers of computers year-on-year practically throughout the whole year

The year-on-year dynamics of the industrial production (in EU countries) was the fourth highest in the CR in 2014, the strongest long-term growth in the EU appeared in the Central European region and the Baltic region

Only Hungary (+7 %), Luxembourg and fast recovering Ireland (+20 %) overtook the dynamics of the industrial production in the CR (+4.9 % year-on-year) out of the EU28 countries in 2014. The industry of the CR surpasses with its rates of growth the euro area countries as well as the whole EU in the long-term (except for year 2008). Industry already exceeded the production level from 2007 in eleven EU countries, the most in Slovakia (+29 %) and Poland (by one quarter) and Ireland (by one sixth). In Germany, similarly to the CR or Hungary, it tightly exceeded this mark just in 2014. In the whole EU, it was lower nearly by one tenth, mainly due to the South European countries – it fell by one quarter in Italy, nearly by one third then in Greece and Spain.

First growth of construction output after six years, it sank by 27 % in the building and by 16 % in the civil engineering construction between years 2007 and 2013

Year 2014 can be termed as a period of turn from the point of view of the construction industry. Construction production strengthened by 4.3 % year-on-year for the first time after six adverse years in a row (when it shrank in total nearly by one quarter especially due to the impact of the building construction). Both main construction fields thrived for the first time since 2006, when the more significant by weight building construction (+3.4 %) lagged somewhat behind the civil engineering (+6.4 %), whose growth filled by the large transport construction orders was more even throughout the year. The milder winter assisted both construction fields, even though occurring already for the second time in a row.

High year-on-year growth of new orders is connected to the realisation of significant transport routes in civil engineering construction

Substantial revival of construction orders, apparent in the civil engineering already since half of 2013 (value of new orders for businesses with 50 and more employees increased by high 41 % in this field year-on-year, while it practically only stagnated in building construction) however played a more essential role. A larger boom of the building construction was for now prevented by a very prudent „take-off“ of new



<p>Number of completed dwellings fell to the level of 1999, new construction revives despite favourable situation on the mortgage market as well as lower prices of construction works only cautiously so far</p>	<p>dwelling construction. Number of dwellings started did rise by one tenth against the extremely low last year's basis (the lowest since 1996), however it was lower by 45 % against the top of „construction“ boom (2006-2008). A more visible shift in number of dwellings started eventuated only for flat houses year-on-year in 2014 (+1.8 thousand, to the highest level for the past five years), partially also for non-residential buildings and from regions then in Prague and South Moravia. Number of completed dwellings kept inertially falling in the CR (-5 %) down to the lowest level since 1999. Great 37 % (of completed dwellings in the whole CR in 2014) were concentrated in Prague and Central Bohemia.</p>
<p>The five years lasting decline of the average value of one new construction order halted in 2014</p>	<p>Recovery of construction of larger (mainly transportation) projects shows also in the gradual climb of the average value of one newly closed order (from 3.6 mil. CZK in 2013 to 4.0 mil. CZK a year later), similarly to the approximate value of one granted building permit (especially for residential buildings). Total stock of so far not realized construction orders was also higher year-on-year, mostly due to the larger number of orders from the public sector (+23 %), partially also thanks to the dynamically growing value of orders abroad in the last three years (foreign orders formed already one fifth in the portfolio of construction companies orders at the end of 2014). Nominal value of all public construction orders was however by 43 % lower compared to the end of year 2006, by 22 % for the all private orders.</p>
<p>Renewal of growth of construction orders contributes to the employment stabilization in construction so far only slowly, the wage dynamics in construction lagged behind the rates of growth in the whole business sector in the last five years</p>	<p>Protracted „recession“ in construction is being inertially reflected in the continuing reduction of the registered number of employees (by 5 % in 2014), incl. medium and larger companies. Construction in total lost (in physical persons) over 60 thousand of employees against the year 2008. Despite the significant shift, inadequate demand remains the main factor limiting the construction activity according to the business cycle surveys (in 83 % of cases in December 2013, in 68 % a year later). A one third of construction companies expected (at the end of the year 2014) a drop in the number of employees within the upcoming three months (8.5 % expected growth), even 45 % a year ago.</p>
<p>Year-on-year dynamics of the construction production again more favourable compared to the whole EU in the CR after four years</p>	<p>The dynamics of the construction production (+4.3 %) was more favourable compared to the whole EU (+3 %) in the CR (in contrast to the previous four years). EU construction was being driven up especially by the Great Britain and Spain in the in 2014. The production cut one fifth in real terms compared to the boom top (year 2007) in the CR, identically to the whole EU. Only five member countries exceeded this level in 2014 (Germany by 8 %, Poland by 22 %), it was significantly deeper in Slovakia (-26 %) and especially the South European states (Spain -46 %, Italy - 38 %) and Ireland.</p>
<p>Higher sales in services (due to the long-term growth of transportation and warehousing - significant by weight) for the first time since 2008</p>	<p>Real sales in the selected services⁵ recorded their first growth (0.6 %) since the outbreak of the deep recession year-on-year in 2014. Especially the activities, whose sales grow in the long-term and mostly already overtook the „pre-crisis level“, prospered. Nevertheless, the dynamics of sales in services weakened (-1.1 %) in the last quarter of 2014, as a result of the development in warehousing and support activities for transportation (where the sales hit the very high last year's basis). Mostly the transportation and warehousing fare well in the long-term, where the recovery of industry and foreign trade revived their sales in the last two years. The growth of real sales continued in accommodation already for a fifth year (also with price increases for the first since 2008), when the drop out of guests from Russia and Ukraine was abundantly compensated by tourists from more distant, especially Asian countries. Restaurants and food service activities on the contrary continued in the long-term reduction of sales (after more favourable summer period of 2013). Real estate activities as well as professional, scientific and technical activities found themselves in milder, however long-term slowdown.</p>
<p>Twelve quarters lasting growth interrupted in warehousing in Q4 2014, slowdown of dynamics also in land transport year-on-year</p>	<p>On the contrary, job agencies prosper already nineteen quarters in a row and further also (even with more modest rates of growth) the administrative and office activities as well as security and investigation activities, IT activities or programming and broadcasting activities.</p>

⁵ Do not include the activities of trade, finance and insurance, science and research and also public services.

Retail sales (incl. motor vehicle sales and repair) increased year-on-year the most in the past seven years and exceeded the level of boom top (r. 2008) for the first time

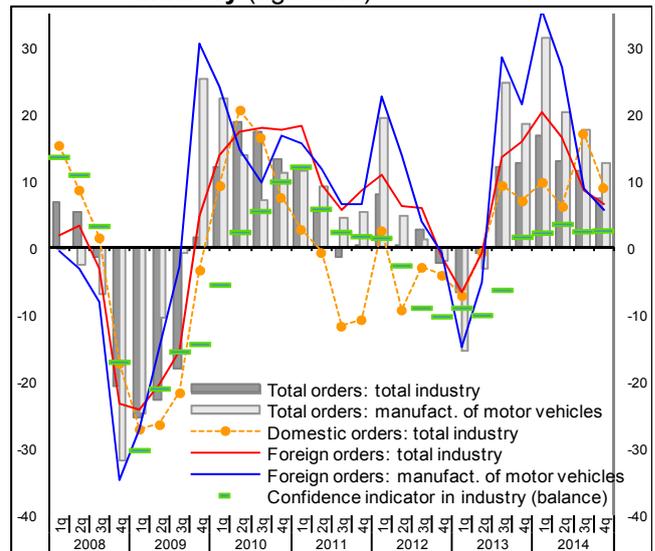
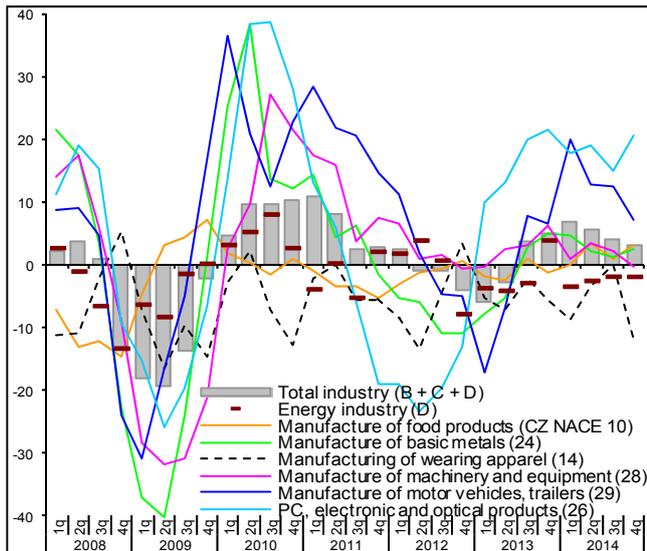
The renewed economic growth gradually followed by the improvement on the labour market mirrored in the consumer confidence indicator, which stayed at the highest level (since March 2007) towards the end of year 2014. Retail sales also reached record levels (CZ-NACE 45 and 47) and strengthened by 5.4 % year-on-year. The dynamic (strongly pro-cyclical) motorist segment was behind the higher sales in more than one half, its sales were aiming for the double-digit values (for sales as well as repair and maintenance of motor vehicles).

Higher sales for non-food goods in specialized shops for all main types of goods – except for pharmaceutical and medical goods

The „non-motorist“ retail segment was traditionally driven by the non-food products (+4.3 %), where the reduction of prices aided especially the sales of computer and communication equipment (+17.2 %) in the long-term. Still the sales grew also in the vast majority of other specialized shops, especially for products meant for households, culture and recreation or shops with textiles, wearing apparel and footwear. The growth of sales for food products (1.3 %) was despite its „modesty“ the highest in the last six years. It was related mostly to the larger stores, the sales continued in long-term declines in the specialized (usually smaller) shops with food. The sales increased at petrol stations after five years (1.7 %), supported also by the high year-on-year December growth (13.6 %), when the very favourable price development of automotive fuel stimulated demand (incl. transit transportation). The dynamic growth further proceeded for internet sellers (19.7 %).

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

Chart 6 **New orders in motor vehicle industry, in total industry** (current prices, y/y, in %) **and balance of confidence indicator for industry** (right axis)

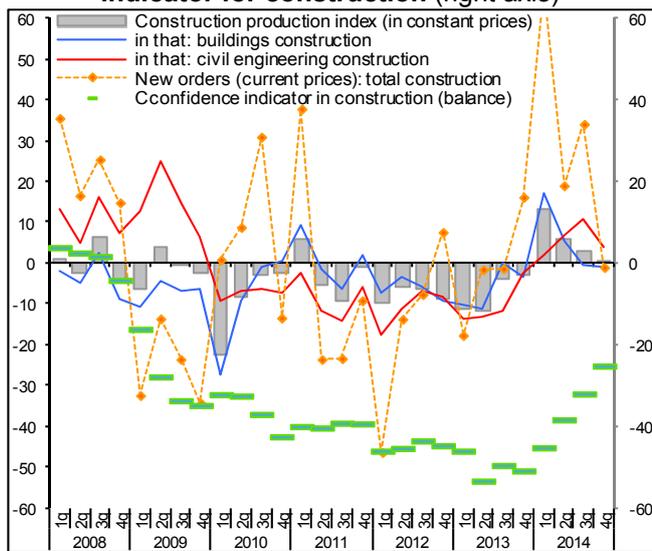


* data adjusted for seasonal and calendar effects

Source: CZSO

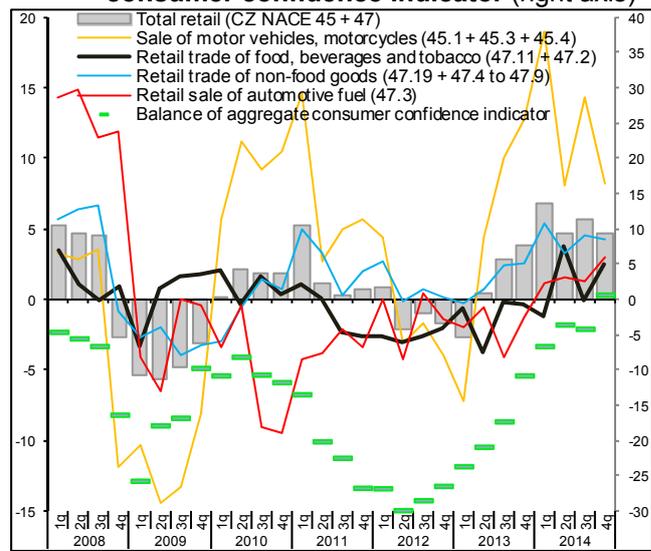


Chart 7 Construction production, value of new orders (y/y, in %) and balance of confidence indicator for construction (right axis)



* data adjusted for calendar effects

Chart 8 Sales in retail incl. motorist segment (constant prices, y/y in %), balance of consumer confidence indicator (right axis)



Source: CZSO

4. External Economic Relations

Historically the best result of external economic relations in several aspects – with a current account of balance of payments surplus, only second for the last 22 years...

External balance of the Czech economy was improving already for the fourth year in a row in 2014. Flows of funds with abroad ended in accumulation of every quarter in surplus on the current account of balance of payments. The whole-year balance was thus also positive (CZK 26.1 bn, the best result in the CR history (surplus of CZK 13.3 bn in 1993).

The capital account also ended in the surplus of revenues over expenditure (CZK 32.2 bn), despite year-on-year deterioration (CZK 82.4 bn in 2013). Lower net revenues from the EU budget mostly affected the thinner surplus in 2014. On the contrary, the financial account was in deficit already third year in a row (last year mostly due to the impact of the portfolio trades) – however its deficit was covered by the current and capital account surpluses. The balance of secondary income⁶ was also negative (current transfers) with CZK -9.7 bn and only a negligible year-on-year improvement (CZK -10.1 bn in 2013) – the monetary transfers increased identically to income (i.e. by CZK 4-5 bn). Higher income occurred only in Q2.

..... thanks to record surplus of the foreign trade with goods and services...

A successful year 2014 in the view of the external balance was influenced mainly by the result of the trade with goods as well as services – the record performance balance was based on the CNB data in surplus of CZK 294.8 bn⁷ (the surplus of the services balance formed on fifth).

Exports as well as imports of services recorded double-digit values year-on-year (+11.2 %, resp. +16.8 %), which sharply contrasted with the „recession“ year 2013 (-1 %, resp. +0.6 %). The significant domestic recovery and favourable foreign demand for services had a positive effect. Both revenues and expenditure increased roughly by one tenth in transportation services year-on-year. Expenditure grew considerably in the tourist industry (+17.6 %), but revenues went up only little (+2.9 %). The rates of growth were double-digit for agents with insurance services, revenues from telecommunication services (+16.6 %), they even grew by one third for leasing of intellectual property (+32.4 %).

The artificial depreciation of koruna following the monetary intervention of the CNB initiated in November 2013 also participated on this favourable nominal result of the

⁶ With respect to the terminology, this chapter respects the shift to BPM6 in the part of the balance of payments. BPM6 is the sixth manual for the balance of payments and the CNB published the results according to it in December 2014 for the first time.

⁷ Both imports and exports of goods in FOB prices.

<p>... despite the historically also highest outflow of funds in the form of dividends from the CR to parent companies of foreign owners of firms in the CR</p>	<p>foreign trade. The rates of growth of export prices exceeded the rates for the import prices nearly the whole last year, which pushed up the trade surpluses.</p>
<p>Much more money arrived on salaries into the CR compared to their outflow - „salary balance“ favourable for the CR already for the third time since 2012</p>	<p>It was just these large trade surpluses which balanced out the traditionally deep deficits in primary incomes given by strong ownership interest of foreign companies in the CR economy. These withdrew on dividends CZK 219.3 bn last year, the most in history. They left CZK 94.2 bn to be reinvested here, which was the second largest volume of reinvested profits since 1993. Nevertheless, it is important to remember, that the size of both the repatriated and reinvested profits was connected to the large incomes given by the weaker koruna, which put some dynamics into the sales as well as profits of especially the exporting companies (but also to their domestic suppliers in trades in euros).</p>
<p>Financial account finished in deficit despite the inflow of foreign direct investment both on the asset and liability side into the country...</p>	<p>The positive „salary balance“, i.e. the difference between the volume of salaries, resp. compensations to employees, of the CR workers abroad (39.3 bn) and foreigners working in the CR (CZK 7 bn represented the next record from the view of external relations in 2014. The surplus in the amount of CZK 22.2 bn was given especially by the size of wages (compensations) of residents abroad. The proportions are impacted by the economic cycle, since the immigration has the nature of labour migration here – that is why the largest outflow of funds in the form of wages (CZK 44.1 bn) occurred during the boom with the resulting balance of CZK -24.8 bn in 2008 (residents brought CZK 19.2 bn from abroad at that time).</p> <p>In contrast to both current and capital account surpluses, the financial account recorded an outflow of funds from the country already for a third year in a row (in the amount of CZK 48 bn in 2014).</p>
<p>... however with considerable outflow of funds in the form of portfolio investment, since the low issues of Czech bonds led to weaker purchases by foreign investors and withdrawing of funds back to their countries; the other investment deficit also adversely affected the financial account result</p>	<p>The foreign direct investment balance was as usual positive (CZK 133.6 bn) with the inflow of direct investment worth CZK 101.4 bn. However, the outflow in the form of investment of domestic entities abroad did not take place – on the contrary, they were withdrawing their investments (CZK -32.2 bn in net).</p> <p>The direct investment into the Czech economy slightly above the hundred billion boundary was lower compared to the previous two years of recession. They have not overcome the three year, resp. ten year average either (CZK 135 bn, resp. CZK 159 bn), most likely due to the rediscovered attractiveness of other markets, especially European, where the foreign direct investors started to again return.</p>
<p>Trade balance in the national conception (FOB/CIF prices) rose nearly by one half to 155.2 bn crowns thanks to exports of motor vehicles and imports of crude petroleum and gas</p>	<p>The flows of portfolio investment followed a completely different scenario year-on-year. CZK 90.3 bn worth left in net the CR in 2014 (CZK 92.8 bn in net expression on the contrary flew in in 2013). The high last year's purchases of foreign bonds and shares by domestic entities were behind this fact (worth CZK 76.6. bn in net). A very positive development of stock markets, mainly those overseas, enticed to investing.</p> <p>The foreign portfolio investors also caused the outflow of portfolio investment from the CR simultaneously – they rather liquidated their positions in the CR (the sales of domestic securities exceeded the purchases, in net by CZK 13.7 bn). It is thus evident, that the lower need to finance the state budget deficit by the bond issues was also reflected in this area. The reverse net outflow of funds amounting to CZK 18.9 bn out of the CR was the result of trades with bonds themselves.</p>
<p>Motor vehicle exports rose by 22 % year-on-year, medicine by 38 % - six</p>	<p>Commodity balance⁸ improved the most in trade with motor vehicles (+65 bn to 354 bn crowns) and trades with the crude petroleum and natural gas (deficit shrank by 32 bn to 161 bn crowns). These two improvements were key for the growth of the trade balance in the national conception (CZK +48.7 bn to CZK 155.2 bn). The balance worsened for 16 items out of 40 product classification (CZ-CPA⁹) items – the most for machinery and equipment n.e.c. (CZK -20 bn), basic metals (CZK -14 bn) or e.g. in shops with PCs and electronics (CZK -8 bn).</p> <p>Exports of goods from the CR were again very successful. Despite the restoration of growth in the Czech economy, with higher domestic demand and thus also the import</p>

⁸ Balance of goods based on the CZ-CPA in the national conception. Exports in FOB prices, imports in CIF prices.

⁹ CPA – Classification of products.



largest items comprising nearly two thirds of exports from the CR grew in total slightly more (+13.8 %) than total exports (+13.1 %) year-on-year

requirements, the exports (+13.1 %) outpaced the imports (+11.8 %) compared to 2013. Six key export commodities of the engineering nature (motor vehicles, metals and metalwork products, PCs and electronics together with electrical appliances and other machinery) comprised 63 % of total exports from the CR and their dynamics was in the aggregate of a double-digit value (+13.8 %), i.e. somewhat above the average rate of growth for the overall exports.

The share of both Germany and the Russian Federation on total exports from the Czech Republic fell

The weight of the EU as the target destination of the exports from the CR increased (+1.3 p. p. to 83 %). The exports rose by an above average pace to Germany (+15.8 %), resulting also in increase of the share of this main partner on total exports (+0.7 p. p. to 32.1 %). The sanction policy restricted the exports to the Russian Federation (-4.6 %), and thus its proportion of total exports from the CR fell from 3.7 % to 3.1 %.

Chart 9 Trade balance (in CZK mil., national concept.; exports/imports in FOB/ CIF prices)

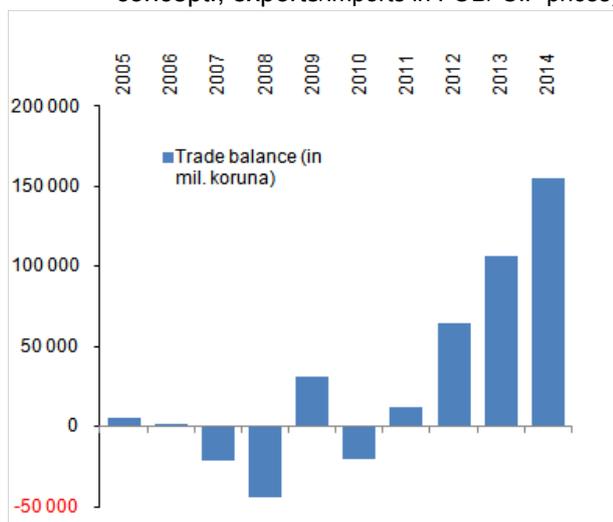
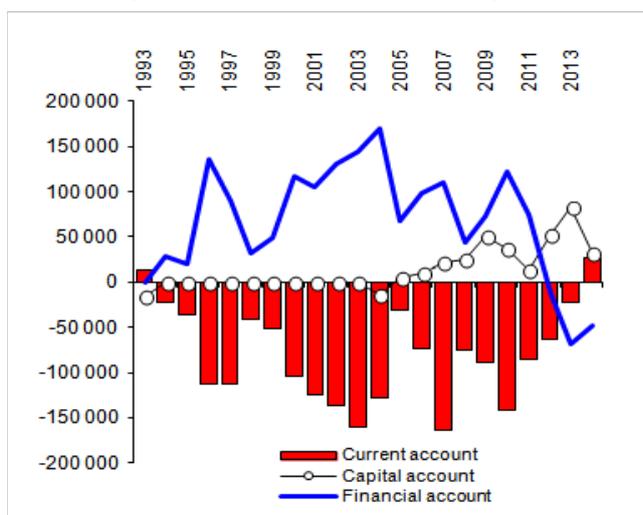


Chart 10 Main Balance of payments components (in CZK mil., stock as of 31.12.)



Source: CZSO, CNB

5. Prices

The favourable development of prices in foreign trade with goods contributed the most to the growth of the total price level in the economy in 2014 (+2.3 %)

Total price level in the economy increased in 2014 – gauged by the implicit GDP deflator not seasonally adjusted – by 2.3 %, the most since the year of the deep recession of 2009 (+2.6 %). The positive price development in the foreign trade with goods contributed the most to the raised price level (terms of trade improved by 2.0 %). While the prices of household purchases were raised up by 0.3 % and prices for goods and services entering the government consumption by 1.7 %, investment (gross fixed capital formation) were being acquired for prices 1.6 % higher than a year ago. Adverse development of prices in foreign trade with services slowed down the growth of the price level (terms of trade -1.6 %).

The inflation rate reaching only 0.4 % in 2014 was the lowest for the last eleven years

The average rate of inflation dropped to mere 0.4 % in 2014. Not only that the growth of the consumer prices was markedly below the target of the Czech National Bank (CNB), which sets it on the level of 2 %, the prices grew the slowest since 2003 (+0.1 %). The weak growth of prices in 2014 was caused mostly by the long-term disinflation in the euro area, which leaked through the prices of imports into the CR, but also via a good harvest of the agricultural crop. The restrictive measures imposed on the foreign trade in Europe – which were reflected in the excess supply of some commodities on the market – also likely played a role in the low growth of consumer prices. Weaker koruna but also the further recovering domestic demand prevented a more notable reduction of the inflation rate in 2014.

The development of oil and natural gas prices on the world commodity

It could be assumed from the development of prices of oil and natural gas on the world market in the second half of 2014 and in the first months of 2015, the threat

market suggests, that the threat of deflation has not been averted yet

of deflation has not been most likely averted in the CR. If a barrel of oil Brent was traded for roughly 110 American dollars on the world commodities market still at the beginning of July, it was less than 50 at the beginning of 2015, and despite a mild price hike during January and February, the prices kept staying remarkably lower year-on-year. The prices of natural gas followed a similar path, being markedly lower in the first months of 2015. As the low prices of these energy commodities will be absorbed by the production chain, they will be most likely gradually reflected also in the prices for consumers.

The consumer prices grew faster in the euro area compared to the CR in H1 2014, however the relation turned around in the second half of the year

While the consumer prices grew faster in the euro area compared to the CR year-on-year in H1 2014, as the harmonised index of consumer prices suggests, the relation turned around in H2. In Q4 2014, when the consumer prices were raised by 0.5 % in the CR year-on-year, by mere 0.2 % in the euro area. Effort of the European Central Bank (ECB) to set in motion the credit market and subsequently also the prices via the record low interest rates, supplying liquidity to banks and purchases of secured bonds from banks, did not bring results. The ECB thus decided to launch a quantitative easing program in January 2015 (and it was launched in March).

While only five EU countries found themselves in deflation in Q1 2014, it was already eight in the last quarter

The growth of consumer prices in the CR fell among the EU countries to the highest in the last quarter of 2014 year-on-year. The prices grew more only in Romania, Austria, Finland, Great Britain, Latvia and Malta. Nevertheless, the year-on-year growth addition did not exceed the 1.5 % boundary in any of these countries. On the opposite more and more countries slumped into deflation. While in Q1 2014 only five Union members recorded a year-on-year fall of the consumer prices, it was six in Q2, already seven in Q3 and even eight in the last quarter.

Prices of food were raised only by 2.3 % in the CR in 2014, the least since 2010, ...

Growth of prices of food in CR significantly slowed down during 2014. If the prices of food were higher by 4.4 % still in Q1 year-on-year, by 1.9 % in Q2, by 1.7 % in Q3 and only by 1.4 % in the last quarter. For the whole year 2014 the prices of food were raised by 2.3 %, the least since 2010 (+1.7 %).

... a good harvest of the agricultural crop played an important role in the low growth of the prices of food

Good harvest of agricultural crop had a direct positive impact on the prices of fruit, which increased only by 0.5 % in 2014, and vegetables, which even fell by 3.7 %, but it was also indirectly reflected in the prices of the bakery products and grain (+0.4 %). Prices of meat in shops were raised by 2.5 % compared to the previous year, the consumers had to pay the most extra for milk, cheeses and eggs (+7.4 %).

Prices of industrial producers headed into deflation in 2014, however price dynamics increased in the manufacturing industry itself, ...

Industrial producer prices, which strengthened by 0.8 % in 2013, headed into deflation in 2014. They fell by 0.8 %, even despite the fact, that the price dynamics rose from +0.2 % in 2013 to +1.0 % in 2014 in the significant manufacturing industry. What then stood behind the price fall in industry? The deflation in mining and quarrying – which struggled with the falling prices of coal already for a third year – deepened, in addition the prices of supplies of electricity and gas were hike reduced in January.

... it was for once thanks to the continuing economic recovery, for second to weaker koruna, which increased the cost of purchasing the inputs from abroad to companies

As apparent from the classification into subdivisions of CZ-CPA, all monitored groups of companies classified as „manufacturing“ raised their prices in 2014. Exceptions were the producers of coke and refined petroleum products (- 1.9 %), which experienced reduced cost for securing the oil supplies in Q4; manufacturers of food products, beverages and tobacco (-0.3 %), which could reduce prices thanks to a good harvest and low buying up prices of agricultural crop; and producers of basic pharmaceutical products (-1.6 %). Regarding the significant groups of firms (in terms of proportion of total performance of the manufacturing industry), manufacturers of transport equipment (+3.5 %) and manufacturers of basic metals and fabricated metal products (+2.4 %) raised their prices the most, companies manufacturing wood products, paper products and companies with printing activities (+ 3.6 %) and manufacturers of textile, clothes and leathers (+ 2.4 %) then among the less significant.

Prices of agricultural producers were reduced by 3.7 % in 2014, milk itself was however traded for prices by 13.1 % higher

Agricultural producer prices were reduced by 3.7 % in 2014. Good harvest – which resulted in high weight of crop harvested – pressed down the prices of all monitored types of cereals; vegetable and horticultural products, potatoes, fruit and industrial crops (i.e. rape plant and sunflower) were also sold cheaper year-on-year. The livestock (cattle, pigs, sheep as well as poultry) was bought up



cheaper compared to 2013, prices of milk on the contrary increased by 13.1 %. These grew most likely especially as a result of expanding worldwide demand for milk products, already for a second year. The prices of milk were raised by 21.9 % in total for years 2013 and 2014.

Construction firms were likely not able to further shrink their margins and the prices of construction works were raised up by 0.5 % in 2014. They increased for the first time since 2009

Prices in construction, which hit their bottom in half of 2013, also continued in a slow growth in 2014. It follows from the basis index of construction works. Prices increased by 0.5 % in construction in total for the year 2014, the price growth of construction works was observed for the first time since 2009. Firms were most likely not able to shrink their margins anymore and prices of construction works thus increased as the companies experienced rising cost of construction production. The fact, that companies – in the view of growth of value of construction orders and rise of the volume of construction production – already quite thrived in 2014, was not mirrored in the prices of construction works to a larger extent. Intensive competition prevented companies from larger price increases.

Larger demand of manufacturing industry for transportation and warehousing, but also for job agency services, assisted the repeated growth of prices of market services in 2014

Prices of market services rose by 0.3 % in 2014, the growth occurred for the first time after two years. Prices of postal and courier services increased significantly (+ 4.9 %), financial services (apart from insurance and pension funding) became more expensive despite a high competition among financial institutions (+4.6 %), the prices of job agencies services, abundantly utilised by the manufacturing industry in this year, also rose markedly (+4.8 %). Higher performance of the manufacturing industry was also reflected in the larger demand for transportation and warehousing, and consequently also in the prices of these services. Prices of freight transport services by road increased by 2.5 %, freight water transport services even by 3.9 %. Prices of warehousing and support activities for transportation remained the same in total for 2014, however this was given by a markedly diversified development at the beginning and during the rest of the year – as prices of warehousing and support activities for transportation declined by 4.6 % year-on-year in Q1, they were by 1.7 % higher in each of the following quarters.

Import prices of goods declined for the first time after thirteen months year-on-year in December 2014

Year-on-year price growth was imported together with goods thanks to the weaker koruna from abroad throughout the whole year 2014, with the exception of December. Prices of imported goods increased by 1.9 % in total in year 2014, however they decreased by the same amount in December itself. The marked depreciation of koruna against euro stopped having an effect on the import prices as a whole, in addition the decline of import prices of mineral fuels deepened (-20.9 %). The deflation again started to be imported from abroad.

Export prices of goods went up by 3.5 % in 2014, the most in last ten years

Export prices of goods went up in total by 3.5 % in 2014, the most in the last ten years. It is apparent, that as to the import side, the forex intervention of the CNB favourably affected prices also here. All goods except for mineral fuels (-5.0 %), food and live animals (-0.2 %), and less significant by value animal and vegetable oils (-3.2 %) were exported for higher prices than a year ago. Crucial commodities in the foreign trade of the CR, i.e. machinery and transportation equipment – which participate roughly by one half on the total exports of goods from the CR - were sold by 3.7 % higher abroad compared to the previous year.

Favourable development of prices in the foreign trade with goods touched all SITC divisions, with the only exception of food and live animals

Favourable price development in the foreign trade with goods in 2014 - i.e. faster growth of export prices compared to imports – improved the terms of trade and thus also the result of the foreign trade in the current prices, and consequently also the overall economic performance of the CR. The terms of trade improved by 1.6 %, the most since 2009 (+3.8 %), when „the bubble burst“ on the world market with oil and the Czech economy benefited from the low import prices of this commodity. Positive development of prices in the foreign trade touched all SITC divisions in 2014, with the only exception of food and live animals. Here, the terms of trade worsened already for the third time, specifically by 4.4 %.

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

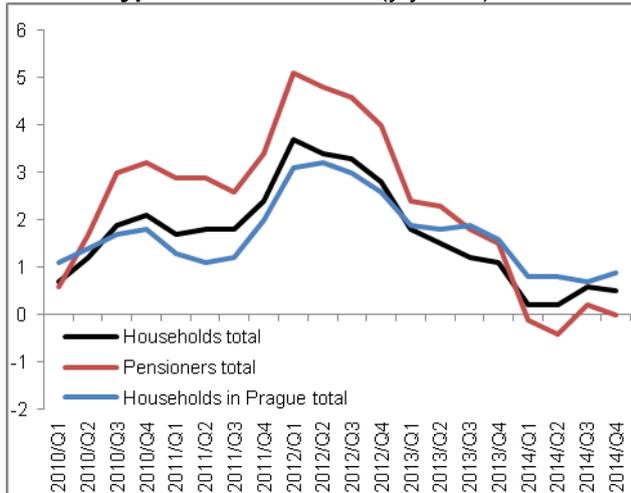
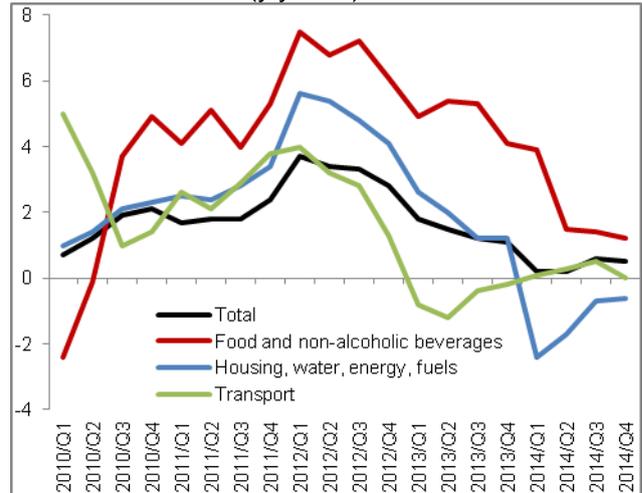


Chart 12 Growth of prices in selected CPI divisions (y/y in %)



Source: CZSO

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

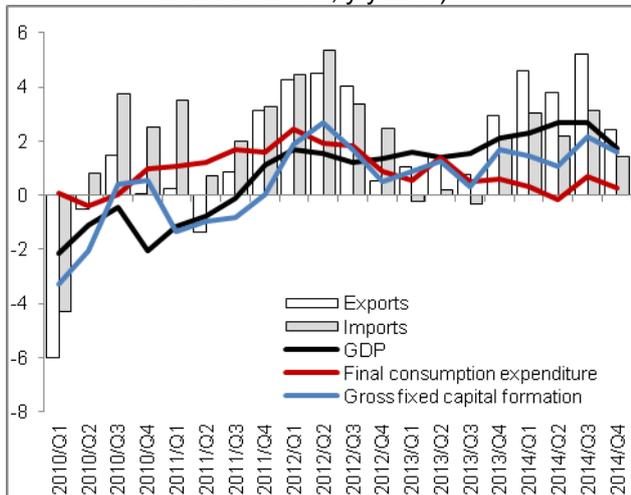
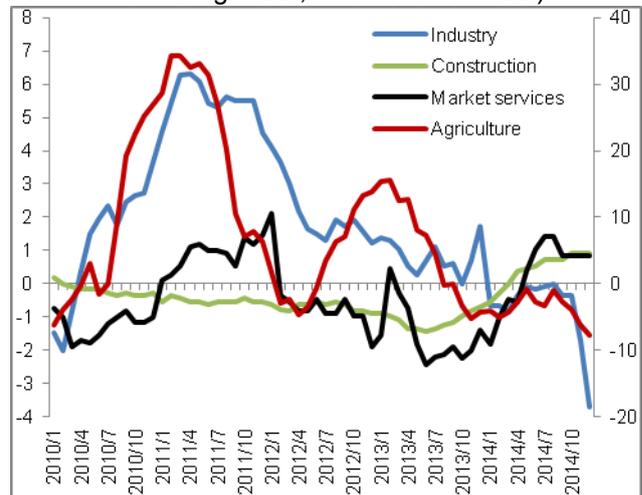


Chart 14 Producer prices (y/y in %, agricultural prices on the right axis, other on the left axis)



Source: CZSO

6. Labour Market

Employment and the real wage went up accompanied by falling unemployment rate in the economy

The economic growth recovery manifested in the growth of employment accompanied by declining unemployment rate year-on-year. Year-on-year growth was recorded both in the business and non-business sphere in 2014 following two years of real wage reduction in the national economy.

Total employment growth remained on the level of years 2012 resp. 2013 year-on-year, a decline occurred for employees

Total employment (seasonally adjusted data regarding the total employment in the national accounts conception, in physical persons) followed the development in years 2012, resp. 2013, when the dynamics of the year-on-year growth remained on the value of 0.4 %. In case of employees themselves, the growth fell from 0.6 % to 0.2 % in 2014. Total number of workers reached 5 104.9 thousand, in that 4 290.6 thousand persons as employees. It was the highest number of employed persons and employees since 2009 (5 110.1, resp. 4336.1 thousand persons).

Increased number of employed persons was ascertained especially in the professional, scientific, technical and administrative activities, effect of agency employees

Mainly the professional, scientific, technical and administrative activities (by 15 thousand persons), public administration, education, health and social work (by 7.9 thousand persons), manufacturing (by 6.9 thousand persons) and real estate activities (by 4.3 thousand persons) shared in the increased number of employed persons by 21.1 thousand compared to 2013. The largest reduction of employed was in the highest extent observed in financial and insurance activities (by 3.7



thousand persons), other service activities (by 3.2 thousand persons), trade, transportation, accommodation and food service (by 2.4 thousand persons) and agriculture, forestry and fishing (by 1.5 thousand persons) year-on-year.

Number of persons not working on employee contracts grew year-on-year after two years

The total number of employed grew faster than number of employees in 2014. Number of self-employed rose by 12.8 thousand persons in 2014, while the reduction arrived at 7.7 thousand persons in 2013 and 4 thousand persons in 2012. The development was mostly the result of the situation in construction (+10.4 thousand persons), where the construction firms with the wake up of activity very likely reached to „schwarzsystem“¹⁰ instead of employment hiring. Further it concerns professional, scientific, technical and administrative activities (+7.3 thousand persons), real estate activities (+1.9 thousand persons) and information and communication (+1.8 thousand persons). Completely different development was found especially in the manufacturing (-4.4 thousand persons), where opposite tendencies compared to construction are most likely taking place.

The proportion of other than „standard“ job contracts fell year-on-year

The proportion of part-time jobs fell year-on-year in 2014, since the growth of employees was slower compared to the total number of hours worked year-on-year (0.2 % vs. 0.5 %). Financial and insurance activities and other service activities were the exceptions, with drop of total hours worked higher in comparison to drop of number of employees (by 1.9 p. p., resp. by 1.2 p. p.). The excess dynamics of employees over hours worked arrived at 0.3 p. p. in 2013. Opposite tendency manifested only in trade, transportation, accommodation and food service and other service activities, when the employees grew less than total hours worked by 0.4 p. p., resp. 0.5 p. p.

Labour productivity already rose year-on-year, opposite development in real estate activities and professional, scientific, technical and administrative activities

Labour productivity per hour (relation between gross value added in the economy and number of hours necessary to its creation) increased by 1.6 % year-on-year in 2014, while its mild reduction was recorded year-on-year in 2013 (-0.2 %). Labour productivity per hour increased mostly in financial and insurance activities (+17.1 %) and real estate activities (+6.3 %) in 2013. In 2014, year-on-year decline was ascertained in real estate activities (-4.0 %) and professional, scientific, technical activities (-1.5 %).

Labour productivity per one employee fell only in real estate activities year-on-year

The labour productivity per employee increased even by 2.2 % thanks to lower growth of employed persons compared to gross value added year-on-year in 2014. Decrease of labour productivity per employee was detected only in real estate activities (by 4.6 %). The fall of this indicator was gauged at 0.9 % in 2013. Opposing trend occurred in financial and insurance activities (+16.7 %, construction (+2.8 %), in real estate activities (+2.7 %) and other service activities (+0.8 %) in this year.

Number of job vacancies exceed the level from 2009

In 2014, the number of job vacancies already did not follow the development from years 2010 to 2013, when their number oscillated in the interval from 33.1 to 39.0 thousand (at the end of the year). According to MLSA, 48.7 thousand job vacancies were available thanks to the economic revival and proactive employment policy by the end of 2014. At the end of 2014 there were already 58.7 thousand, while it was 13 months in a row continued annual growth in their number.

A parallel growth of number of employed and fall of unemployed persons was observed in the economy year-on-year

While the number of employed and unemployed persons (LFSS) aged 15 and more together fell in 2011 and increased concurrently year-on-year in years 2012 and 2013, the number of employed persons already grew (by 0.8 %) year-on-year in 2014 given the fall of number of unemployed (by 12.3 %) year-on-year. General unemployment rate of population aged 15-64 years arrived at 7.0 % in 2013 and the value was 6.2 % in 2014. The same indicator in the age category 15 years and more also amounted to 7.0 % in 2013 and even only 6.1 % in the following year.

General unemployment rate (15-64 years) gradually decreased till October 2014

General unemployment rate based on monthly seasonally adjusted data for population aged 15-64 years reduced from January 6.7 % to 5.8 % in October, it was practically only stagnation in the rest of year 2014. This development concerned both males and females.

10 Schwarzsystem - misclassification of employees as independent contractors.

Rate of economic activity continued to grow, it was above the year's average in the second part of the year

Ceaseless growth of the indicator rate of economic activity in the age category of 15-64 years (LFSS) from year 2009 (70.1 %) up to 73.5 % in 2014 confirms the placement of economically inactive persons on the labour market. Its rate reached above the average for the whole year (roughly 74 %) in the second half of the year.

Real wage increased year-on-year following two years of fall, the growth of nominal wage was only slightly higher than the real wage

Real wage increased by 2.0 % in 2014, both in the whole national economy and in the business and non-business sphere. In nominal terms however, the average monthly wage (to recalculated number of employees) increased only slightly more than the real wage (by 2.4 %) thanks to low inflation rate (+0,4 %) in the CR. While the average nominal wage of employees of firms was somewhat higher compared to the wage in the non-business sphere in 2012, it was the opposite in years 2013 and 2014. The government decision regarding the increase of wage tariffs in the non-business sphere from November contributed to the differentiation of wages in 2014.

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

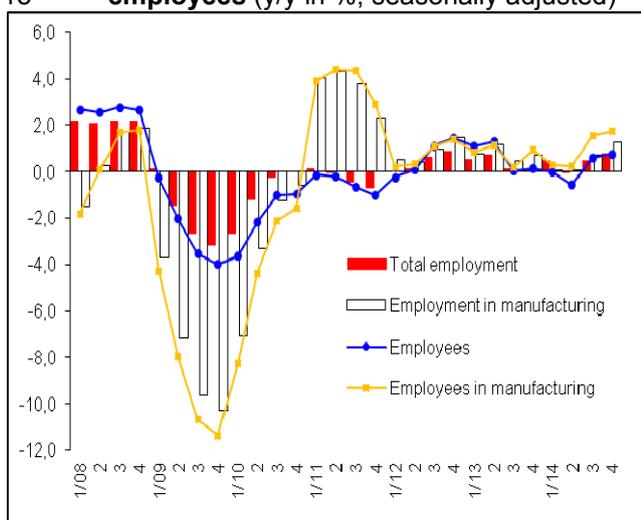
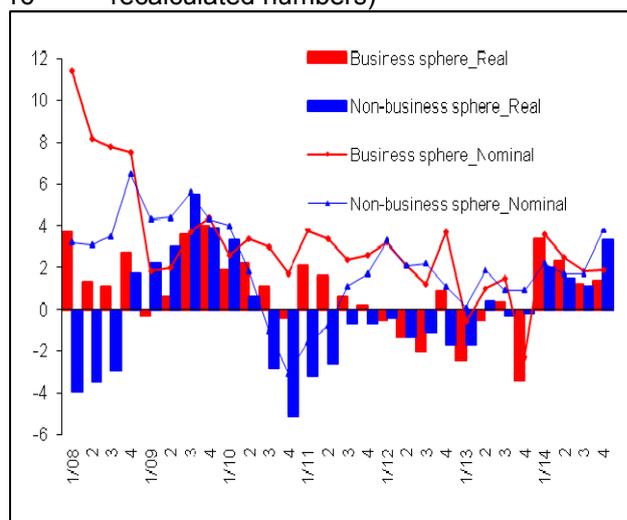


Chart 16 **Nominal and real wage (y/y in %, on recalculated numbers)**



Source: CZSO

7. Monetary Conditions

The Czech economy revived without a credit expansion in 2014

Even though the Czech economy again returned to growth in 2014, it was not financed by debt in such an extent as usual. Only in the last three months of 2014, the year-on-year rates of growth of credit to companies were above the year average (+3.1 %). The households however incurred debts below the year's average (+3.4 %) in the last quarter. Rate of growth of domestic credit (+4.1 %) was thus mostly under the direction of the government sector, especially then the central government – net credit to the government sector increased by 10.2 % year-on-year, credit to the central government (state) by 12.1 %.

Easing of monetary conditions persists

Money supply in the CR economy (M2 aggregate) rose by 4.6 % to CZK 3 429.9 bn in 2014 compared to 2013, that is slightly faster than the nominal GDP growth (+4.4 %). Expansivity of the monetary conditions was thus in this sense relatively small – apparent only in the first and the last quarter, the GDP in current prices grew compared to the additions to money supply faster year-on-year in the last two quarters. Still very low interest rates in the economy had a positive effect on the growth of the Czech economy and as the level of the koruna exchange rate affected by the CNB forex intervention had – koruna fluctuated against euro in monthly averages between values 27.39-27.82 CZK/EUR during 2014, between 25.48-25.95 CZK/EUR in 2013 (from January to October).

Term deposits of both firms and households (deposits with maturity and notice period) markedly shrank in 2014

Both people and firms withdraw from their term deposits (deposits on accounts with maturity and notice period) and the speed of reduction of these deposits is accelerating (-5.1%, -4.9 % and -12.6 % in years 2012, 2013 and 2014). The main motive are apparently the low interest rates deterring from longer period savings,



(-108.1 bn crowns year-on-year, i.e. -12.6%) in the largest drop since 2010; it was a third year of continuous lowering of these deposits in a row

since the one day deposits on the contrary start to rise considerably (by +9.6 %, +8.3 % and +12.5 % year-on-year in the three mentioned years).

The behaviour of Czech households thus mostly had the decisive impact in 2014 on the fact, that deposits in the economy (quasi money) fell towards the end of the year compared to the same period of 2013. It was their second largest fall year-on-year in the time series starting 2002 – the largest reduction was recorded in 2010, this one was however characterised by a very bad situation on the labour market following the preceding crisis. They were lower by 2 % year-on-year in 2013.

High accumulation of funds on the current accounts of companies explains their strong investment activity, which was financed only to a lesser extent by credit

On the contrary, the non-term (one day) deposits – featuring considerably higher liquidity compared to terms deposits – further grew (+12.5 % year-on-year), especially on the giro accounts of households (+13.3 %). Strong accumulation of funds however continues on the current accounts of companies (+11.2 %), when these one day deposits of companies grow by double-digit rates already for the third year in a row. It can be assumed, that these funds represent – apart from usual operation financing – also a significant potential for future investment. Nearly five percent (+4.6 %) year-on-year addition to fixed investment in the Czech economy in 2014, which was the largest for the last seven years, could thus be on the part of companies financed just from the funds accumulated on the current accounts. It likely explains the strong investment activity without any significant indebtedness.

Still, as apparent from the development in Q4, the situation has been likely „returning to normal“, since the rate of growth of the corporate credit accelerated in this quarter and on the opposite the deposits on current accounts of companies grew significantly (CZK +86 bn). Especially the exporters experienced an inflow of additional profits practically during the whole year 2014 as a result of the koruna depreciation following the CNB forex intervention, which the companies likely cumulated on their current accounts (the balances on the current accounts were however lowering in the first half of the year, in times of shareholders' meetings, where the decisions were taken regarding the profit distribution and also their repatriation in firms under foreign control).

Consumer loans and housing loans increased in total identically year-on-year as in 2013, however the volume of consumer loans decreased ...

People keep borrowing from banks, however only with caution. It follows from the bank statistics, that the aggregate credit to population for housing together with consumption credit increased (+4.4 %) by roughly the same rate as in 2013 year-on-year (+4.3 %) to 1.093 tril. crowns. However, while the housing credit rose due to the favourable interest rates and due to anticipation of higher prices of flats in the future by 47.7 bn crowns (i.e. +5.6 %), the volume of consumption credit shrank by one percentage (-1.9 bn crowns).

...while keeping relatively significant share of non-performing loans on total credit to households for consumption

At the same time, the percentage of credit in default remains relatively high for credit on consumption (12.1 % of these loans against 12.2 % in 2013). Bank clients experience difficulties especially with not repaying their debit balances on the giro accounts (9.9 % in default in 2013 and 12.7 % in 2014) and also on the credit cards. Both these products are the most expensive from the view of interest rates charged by the banks.

The proportion of non-performing loans of companies is the lowest for the last five years and proves good financial health of firms strengthened also by the additional profits of exporters brought about by the depreciated koruna

Non-performing loans of non-financial businesses in relation to total credit of this institutional sector arrived at only 6.6 % towards the end of year 2014, which was the least since 2009. Risk lowered also year-on-year (7.2 % at the end of 2013, falling down from its half year). The proportion of non-performing loans of non-financial businesses does not need to present a problem with respect to the relatively good condition of the Czech economy, accumulated profits and so far adequate domestic as well as foreign demand.

Only the segment of entrepreneurs (households-trades), which owed less by 4 % by the end of the year 2014 year-on-year – the volume of their credit however already increased negligibly in 2013 (+ 0.9 %) - shows a relatively large share of non-performing loans for already four years. It was 12.7 % out of total provided credit by the end of 2014, which is roughly the average of the last four years (13 %). It confirms the generally known fact, that the segment of small and medium enterprises is generally more risky for the creditors in the economy.

The already very low deposit interest rates of banks further declined...

Interest rates on non-term deposits fall in case of new deals continuously already a fourth year in a row – it is from 0.72 % p.a. for giro accounts of households towards the end of year 2011 to 0.31 % in December 2014 (from 0.35 % to 0.15 % for firms). The rates of term deposits are also lower year-on-year (from 1.65 % to 1.4 % total deposits with maturity for households, the decrease for firms was less perceptible, at very low levels, i.e. from 0.31 % to 0.29 %). Deposit interest rates are not attractive and people likely search for saving alternatives to saving in banks – the value of their property in funds as well as the pension insurance grows. Direct investments into foreign stock recorded large yields in the past year.

... only the rates for mortgages became cheaper among the lent funds

Consumer loans did not become cheaper to the same extent as the credit for housing real estate acquiring. The rates remained at 14 % (compared to 14.1 % towards the end of 2013), rates of housing credit fell from 3.4 % to 2.9 %). With respect to companies, the difference in the price of the borrowed funds was only negligible (from 2.45 % by the end of 2013 to 2.22 % at the end of 2014, from 2.95 % to 2.9 % for an overdraft).

Chart 17 Credit dynamics (y/y in %)

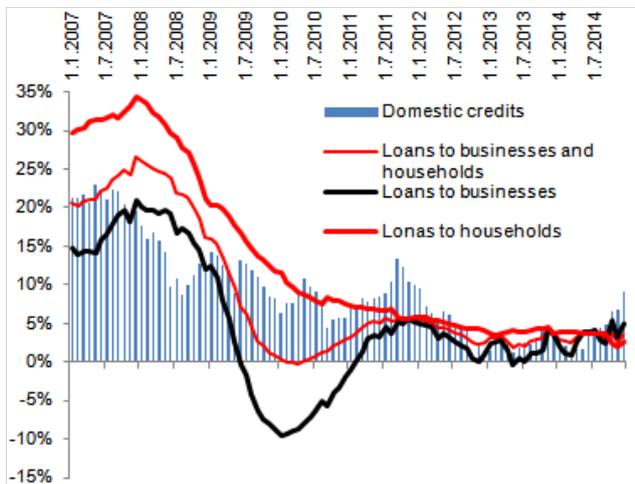
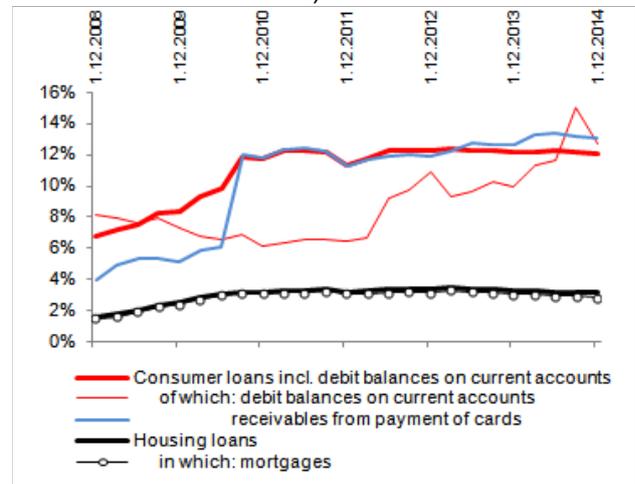


Chart 18 Non-performing loans to households (in % of total loans to households)



Source: CNB

8. State Budget

Depth of the state budget deficit lowered already for fifth time in a row. In 2014, the absolute size of the deficit was the fourth lowest since 2003

Next to long-term effort for fiscal consolidation, especially the gradual growth of the economy and significantly also the record drawing from the EU budget (in connection to the ending programming period) impacted the state budget results during 2014. The 2014 state budget ended (based on cash fulfilment) in the lowest deficit (-77.8 bn CZK) since the beginning of deep economic recession. The size of the deficit was more favourable „only“ by 3.5 bn CZK year-on-year, however it was nearly by one third lower compared to the approved budget for 2014 (by one fifth in the previous year). The development in the first half of the year, when the state even managed a mild surplus, was instrumental in the milder deficit year-on-year. Not only the accumulation of investment expenditure at the end of the year or irregularity of drawing of funds from the EU, but also the large collection of indirect taxes at the beginning of the year caused larger fluctuations during the year¹¹. The state budget (SB) deficit in relation to nominal GDP improved to 1.8 % in 2014 (from last year's -2.0 %). Significantly more favourable result occurred since year 2000 only in 2008 (-0.5 %).

Higher volatility of both revenues and expenditure due to indirect taxes flow and also investment expenditure during the year

¹¹ The higher collection of the consumption tax on tobacco products (planned whole-year revenues were filled from 35 % even in January itself) was connected with the pre-stocking of traders at the end of year 2013 for the reason of subsequent increase of the rates for the tobacco products from 1st January. Higher collection for the VAT at the beginning of the year can be explained by the holdup of the pay out of excessive deductions of VAT (within the initiation of the procedure to remove doubts by the tax administrator for some tax entities), majority of this way "delayed" funds was paid out by the end of 2014.



Lower deficit was secured by lower than anticipated drawing of social benefits as well as savings on non-investment purchases and higher collection of both VAT and corporate taxes

The lead of revenue growth (+ 3.8 % year-on-year) ahead of expenditure (+ 3.3 %) was behind the more favourable result of the state budget deficit year-on-year. Especially the VAT collection (budget surpassed by 11.5 bn CZK) and taxes from corporations (+ 7.0 bn CZK) resulted in the lower than anticipated deficit, savings on non-investment purchases (incl. expenditure on state debt) then on the expenditure side. The anticipated expenditure on social benefits also remained non-fulfilled (-7.5 bn CZK).

VAT collection increased by more than doubled rate of growth year-on-year compared to the growth of total consumption in the economy

The weight dominant tax revenues contributed to the higher year-on-year revenues of the SB by nearly one half (+18.8 bn CZK). Collection of insurance on social security also provided a positive effect (+10.6 bn CZK), as did the revenues outside the tax area (+12.6 bn CZK) supported by intensive drawing from the EU budget and also some extraordinary revenues¹². VAT was the key item for the growth of the SB revenues in 2014, its state-wide collection strengthened by 4.7 % year-on-year, which next to economic recovery also some measures of the tax evasion fight affected. The collection of consumption taxes was on the contrary affected by legislation¹³, and especially for these reasons remained behind the budget anticipations for all its main components. The SB acquired by 4.5 % less from the consumption tax on tobacco products year-on-year. The collection for the most weight significant tax on mineral oils strengthened by 4.7 % (sales of fuel sellers themselves increased by 2.1 % in nominal terms), but also did not meet SB anticipations.

The collection stayed behind the budget anticipations for main types of consumption taxes

The economic recovery transformed into strong growth of corporate tax collection, natural person income taxes (PPIT) from the dependent activity did not fulfil the budget anticipations despite a mild growth

Improved economic situation of companies raised the state-wide collection of corporate taxes by one tenth year-on-year (the fastest growth since 2008). On the contrary, the collection of taxes on natural person income tax from dependent activity (+3.8 %) lagged behind not only the last year's dynamics (+5.3 %), but also the budget anticipations. So far very mild rise of both wages and employment and also the return of basic discount on tax for working retirees are reflected in the rates of growth of the collection. Still, the state-wide collection of taxes from employees for the whole year 2014 found itself above the level of boom top (year 2008) by one seventh, on the contrary it was by more than one quarter lower for corporations (it was dampened next to recession impacts on the profits of companies also by the repeated lowering of the tax rate). The collection from PPIT from capital income was higher by one seventh year-on-year in 2014.

The total SB expenditure rose the most for the last five years year-on-year, still it remained nearly by 30 bn CZK below the budget anticipations

The current expenditure (+2.7 %) contributed to the year-on-year growth of total SB expenditure (+38.5 bn CZK) from three quarters, the continued fall of capital expenditure halted due to the „finish“ at the end of 2014 after three years (+9.8 %). Four fifths of investment expenditure were allocated on the common programs of the CR and the EU. Investment shared in the total state budget expenditure by 9.3 % in 2014, one fifth below the level of years 2009-10, but still more compared to the period shortly before the CR accession to the EU (7-8 %).

Stopping of further deepening of the pension account deficit mostly due to the improved collection of insurance (which for the first time after 2007 fulfilled the budget anticipations in 2014)

The pension expenditure the most significant in volume (in line with budget anticipation) mildly grew year-on-year (+0.8 %). Especially the number of pension recipients, which in fact stagnates nearly ten quarters in a row, affected the size of the pension expenditure given the lower rate of pension adjustment (indexation). The improvement on the labour market was reflected in the growth of social insurance collection on pensions, whose dynamics further strengthened during the year 2014. Pension account balance (as a difference between revenues and expenditure on pensions from the SB) deficit lowered to 45 bn CZK and recorded the largest positive shift year-on-year (lowering of deficit by 5 bn CZK) since 2007.

Other social benefits (without pensions) were by 3.1 % larger year-on-year

The size of all social benefits (excluding pensions) grew year-on-year (+3.1 %). Only funds on unemployment benefits (-4 %), which every fifth registered candidate received at the end of the year, dropped among the more significant items. State

¹² Especially the extraordinary revenue related to the auction of frequency bands for high speed mobile network LTE (+8.5 bn crowns).

¹³ The effect of pre-stocking faded away for the tax on tobacco products (pl. see note 12) during the year and the long-term trends in tobacco products consumption started to prevail. Further planned increase of rates, included in the state budget 2014 proposal, was not approved.

The collection of tax on mineral oils was adversely affected by the re-introduction of the so called "green fuel" as of 1.7.2014.

Lowering of rates occurred for the tax payments on "solar systems" from 26 % to 10 % (resp. from 28 % to 11 %), at the same time lengthening the payment for equipment introduced to operation during the year 2010.

however expended more on other benefits – especially the social care benefits (mostly the material deprivation assistance – by nearly one half more in the last two years), sickness insurance benefits (+10 %), as well as the most volume significant state social support benefits (+0.3 %), where mostly the housing benefits grew (+19 %). Expenditure on all social benefits „cut“ 40.9 % from the budget (in 2013 it was 41.7 %).

The CR acquired from EU budget so far „in net“ 410 bn CZK since the accession to the EU, one sixth of this amount in year 2014 itself

Net positive position of the CR towards the EU budget amounted to 76 bn CZK in 2014 and moved close to the so far record level of year 2013. One half of revenues came from the most significant part in the long-term – the structural funds. The significance of the cohesion funds was strengthening to the detriment of funds on rural development from the view of the CR revenues in the past years. The CR paid into the EU budget 387 bn CZK and received 798 bn CZK in years 2004-2014.

The state debt declined (for the first time since 1995) due to the lowering of foreign indebtedness in 2014

Total state debt mildly decreased (by 19.6 bn CZK) to 1 663 bn CZK during 2014. It was the first lowering of indebtedness since 1995. Full 82 % of the state debt pertained to the inner indebtedness at the end of 2014 (whose size increased by 5.9 % year-on-year).

Chart 19 **Statewide collection of tax revenues (y/y, in %) and development of state budget balance (in bn CZK), data for individual quarters**

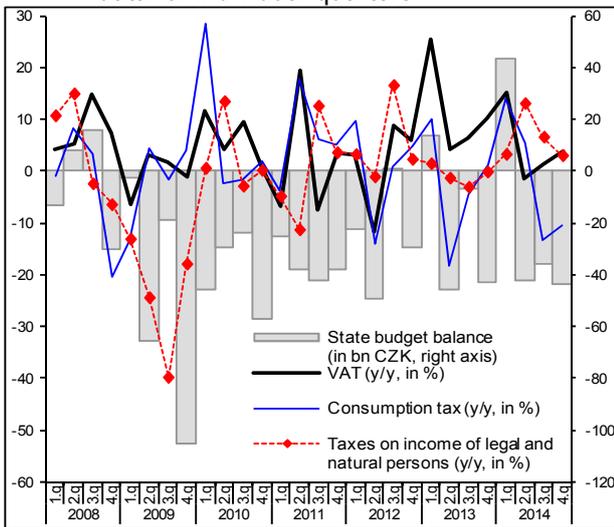
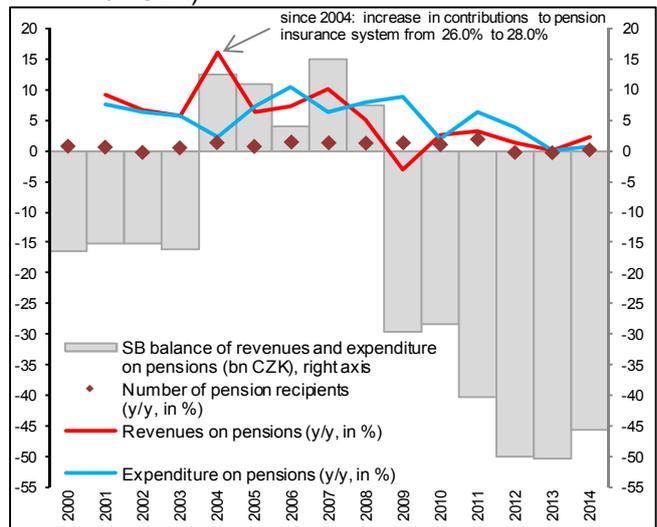


Chart 20 **Number of all pension recipients, revenues, expenditure on pensions from state budget (y/y, in %) and pension account balance (in bn CZK)**



Source: MF CR, CSSA



Chart 21 **Composition of revenues of the CR from the EU budget and net position of the CR towards the EU budget (in bn CZK)**

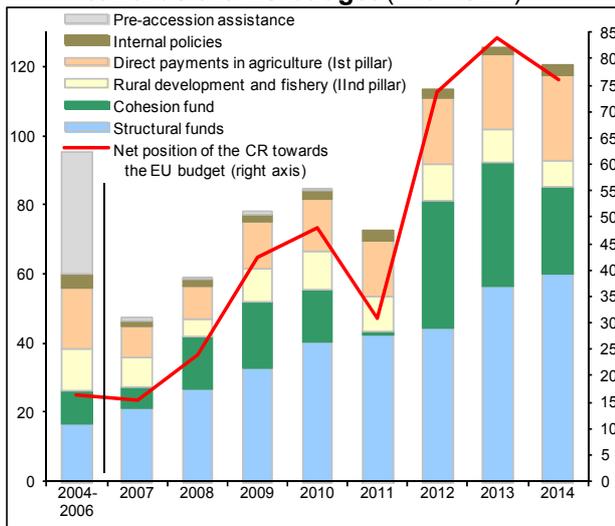
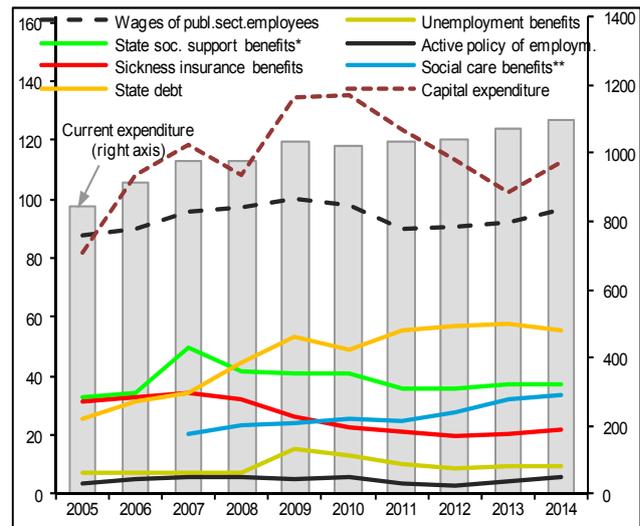


Chart 22 **Selected expenditures of state budget (in bn CZK)**



*incl. foster care benefits

**material deprivation assistance benefits, disability benefits, contribution to care based on Act on State Social Support

Source: MF CR

Sources of data in the whole analysis: CZSO, MF CR, CNB, CSSA, Eurostat, CZSO calculations. Latest information from the CZSO and CNB given in this report has been dated the 13th March 2015.