



## INFLATION REPORT

JULY 1998

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## I. INTRODUCTION

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Inflation developed much more favourably in 1998 Q2 than in Q1. Beginning in April, both net inflation and CPI inflation slowed. Year-on-year net inflation fell from 7.9% in March to 6.5% in June, while CPI inflation dropped from 13.4% to 12%. This means that year-on-year net inflation fell to the upper limit of the CNB's short-term inflation target range for the first time. The favourable macroeconomic development is creating good preconditions for hitting the short-term inflation target at the end of the year. The first quarter is thus broadly characterised by a confirmation of the medium-term disinflationary trend, in line with the long-term goals of the CNB. In Q1, the downward trend in inflation was not yet sufficiently apparent. This was reflected in the prudent evaluation of the situation in the April Inflation Report. The July report provides evidence of improving conditions for achieving the inflation target. The various risks and uncertainties about future development are less serious compared with Q1.

The ongoing disinflationary process has to a large extent been a consequence of the continuing renewal of the internal and external equilibria. This process has been significantly fostered by restrictive monetary and fiscal policies. Disinflationary factors acted both on the demand and the supply sides. The movement towards macroeconomic balance started in 1997 Q3 and was attributable to a decline in all components of domestic demand in 1998 Q1. The fall in real household incomes and the growing uncertainties on the labour market were the main causes of the year-on-year drop of 1.6% in household consumption. The relatively strong budgetary restrictions introduced by stabilisation packages in 1997, as well as other spending cuts, reduced government expenditure by 2.7% year-on-year. The 2.5% year-on-year drop in Q1 capital expenditures was brought about by a combination of the persisting interest rate level, a reduction in internal funds for investment financing, the commercial banks' prudent approach towards providing credit to the corporate sector, and expectations of lower economic growth in the future. The fall in domestic demand was an important and positive stabilising element of economic development in the last period and contributed to the weakening of demand-led inflationary pressures and an improvement in the trade deficit. As the goods and services export growth rate in Q1 was almost 28% year-on-year and the import growth rate only 17%, net exports are the sole factor contributing to economic growth at present.

The low level of demand is also reflected in monetary development. Despite a slight acceleration in June, the year-on-year increases in the money supply were low in Q2. The gradual flattening of the money market yield curve and the switch in the last period to an inverse slope provide evidence of the gradual improvement in inflationary expectations.

In addition to the contraction of demand, inflationary pressures were also reduced by factors on the supply side. The main cost pressure determinants include the exchange rate, commodity prices on world markets and the relation between the growth rate of real wages and that of labour productivity, as well as industrial producer prices. After appreciating in Q1, the nominal exchange rate of the koruna against the Deutsche Mark remained stable during Q2, attaining the average 1995 level. The real exchange rate deflated by the PPI saw a similar trend, approaching the February 1997 level in May. The real exchange rate deflated by the CPI appreciated in the first half, exceeding its February 1997 peak as early as at the beginning of 1998. Prices of raw materials on world markets developed favourably. In the first half of 1998, the HWWA price index fell 20.1% year-on-year and prices of energy raw materials dropped 27.1%. Real wages also developed favourably.

The gradual renewal of macroeconomic balance was due to a large extent to labour productivity growth. The economic policies that have followed over approximately the past twelve months have not allowed wage increases to outpace labour productivity growth.

Industrial producer prices developed favourably in Q2, largely as a result of monetary restriction accompanied by contracting demand and falling exogenous prices for some material inputs. The low month-on-month increases in industrial producer prices in April and May (0.1% in both months) declined even further to -0.1% in June. Year-on-year PPI inflation slowed from 6.6% in February to 5.6% in

June. The CNB believes that the fall in producer price inflation will continue to bring down CPI and net inflation.

The favourable Q2 inflation trend has been accompanied by a weakening of some of the risks emphasised in the April Inflation Report. In terms of external inflationary factors, the future exchange rate development may be affected by uncertainties in other emerging markets, especially in Central and Eastern Europe. These uncertainties have provided stimuli for changes in the koruna's exchange rate in the past. Concerns persist about the expansiveness of fiscal policy and the continuation of good wage discipline in the Czech economy. Should the situation in these areas deteriorate, inflation would probably not be affected earlier than in 1999.

The CNB expects the favourable disinflationary tendencies to continue in the second half of the year. At the end of 1998, net inflation should be above the lower limit of the 5.5% - 6.5% target range. According to the CNB, this development is adequate in a situation where the exchange rate and world prices of raw materials are having a disinflationary impact. However, both these factors are potentially short-term in nature and a longer-term effect cannot be expected. Should these factors deteriorate in the forthcoming months, there is a "reserve" allowing for the short-term target to be hit. As a result, the inflation target for 1998 is very likely to be achieved and might be jeopardised only if considerable exogenous shocks occur. In the medium term, the CNB expects the disinflationary process to continue. Net inflation at the end of 1999 will be at a level gradually approaching the 3.5% - 5.5% target range set for the year 2000. The CNB expects year-on-year CPI inflation to return to last year's level at the end of 1998 and to fall to a single-digit level as early as the beginning of 1999. Any further reduction in CPI inflation will depend mainly on regulated prices.

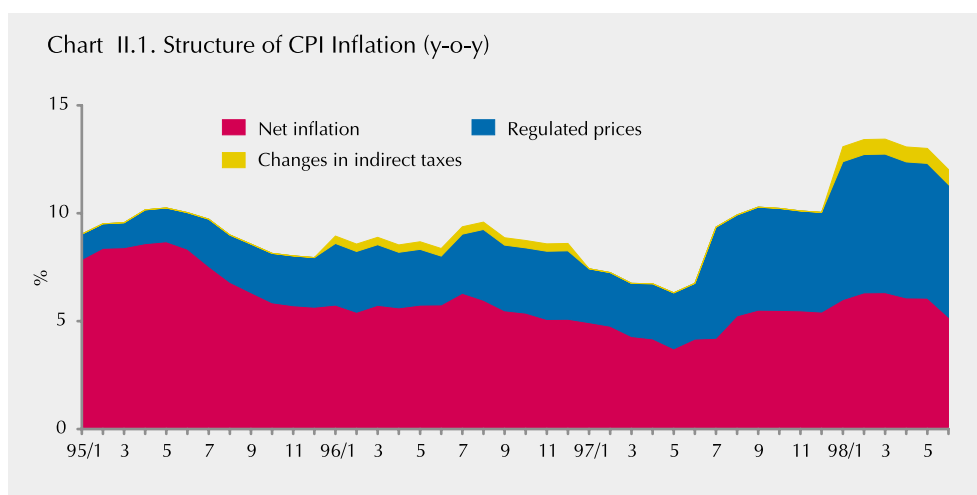
## II. INFLATION DEVELOPMENT

1998 Q2 was characterised by a disinflationary trend. Year-on-year CPI inflation declined during Q2 from 13.4% at the end of March to 12% at the end of June. This was influenced in particular by a gradual fall in net inflation. The rate of regulated price increase (Table II.1.) showed a concurrent moderate fall.

Compared with 1997, when year-on-year CPI inflation stood at 10% at the end of the year, inflation accelerated in the first two months of 1998. This was caused by a significant increase in regulated prices and indirect taxation rates in January this year, and partly also by net inflation. The increase in net inflation in January and February was influenced by the fading effect of the depreciation of the koruna from the end of the previous year and the unusually strong impact of the yearly adjustments to retail prices at the beginning of the year. This was probably a reflection of higher costs related to adjustments in regulated prices and taxes on January 1, 1998, as well as unfavourable expectations of future price development. In contrast to this adverse development at the beginning of the year, month-on-month inflation was very low from March onwards. This was reflected in a further decline in CPI inflation throughout Q2, as well as in year-on-year net inflation, which in June dropped below the level seen at the end of 1997.

Tab. II.1. Basic Data on Consumer Prices

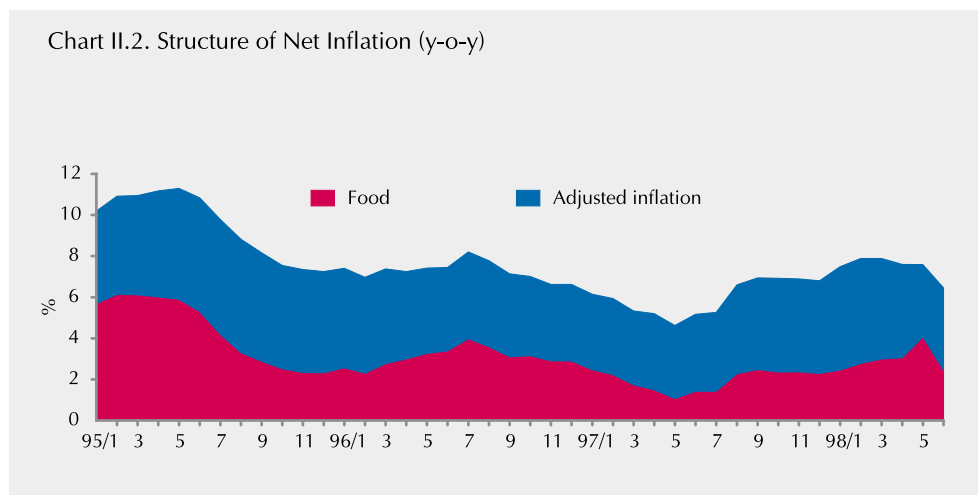
INDICATOR	SITUATION													
	12/97		1/98		2/98		3/98		4/98		5/98		6/98	
CPI INFLATION (Y-O-Y)	10.0		13.1		13.4		13.4		13.1		13.0		12.0	
of which:	<i>share</i>		<i>share</i>		<i>share</i>		<i>share</i>		<i>share</i>		<i>share</i>		<i>share</i>	
Regulated prices	22.7	4.62	30.8	6.39	30.9	6.41	31.0	6.42	30.3	6.30	30.0	6.24	29.9	6.15
Effects of indirect taxes in unregulated prices	0.00		0.70		0.70		0.70		0.70		0.70		0.70	
Net inflation	6.8	5.42	7.5	6.00	7.9	6.31	7.9	6.32	7.6	6.08	7.6	6.07	6.5	5.18
of which:														
- food	5.6	1.82	6.0	1.97	6.8	2.22	7.2	2.40	7.2	2.45	7.5	3.25	5.8	1.96
- adjusted inflation	7.6	3.60	8.5	4.03	8.6	4.09	8.4	3.92	7.9	3.63	7.7	2.82	6.9	3.22
of which:														
Tradables	6.3	4.05	7.4	4.77	7.7	4.96	7.7	4.95	7.5	4.79	7.4	4.70	6.1	3.90
Nontradables	16.8	5.99	23.2	8.31	23.5	8.45	23.6	8.48	22.9	8.28	22.9	8.30	22.7	8.10
INFLATION RATE (annual moving average)	8.5		8.9		9.5		10.0		10.5		11.1		11.5	



In April, the month-on-month CPI increase (of 0.3%) was significantly affected by a rise in regulated prices. In May, the increase was very small (0.1%) due to seasonal influences, while the rise of 0.3% in June was a result of an acceleration in net inflation. Seasonally adjusted month-on-month increases of 0.3% (according to the seasonal adjustment results published by the CSO) were recorded in April and May. In June, the seasonally adjusted value was equal to the unadjusted value.

## Net Inflation

During 1998 Q2, year-on-year net inflation fell from 7.9% at the end of March to 6.5% at the end of June. This decline was caused by favourable development in both the sub-indices of net inflation - food and non-food prices, i.e. adjusted inflation. The food price increase adjusted for administrative influences dropped from 7.2% at the end of March to 5.8% at the end of June. After adjustments for administrative influences, adjusted inflation decreased from 8.4% to 6.9%.

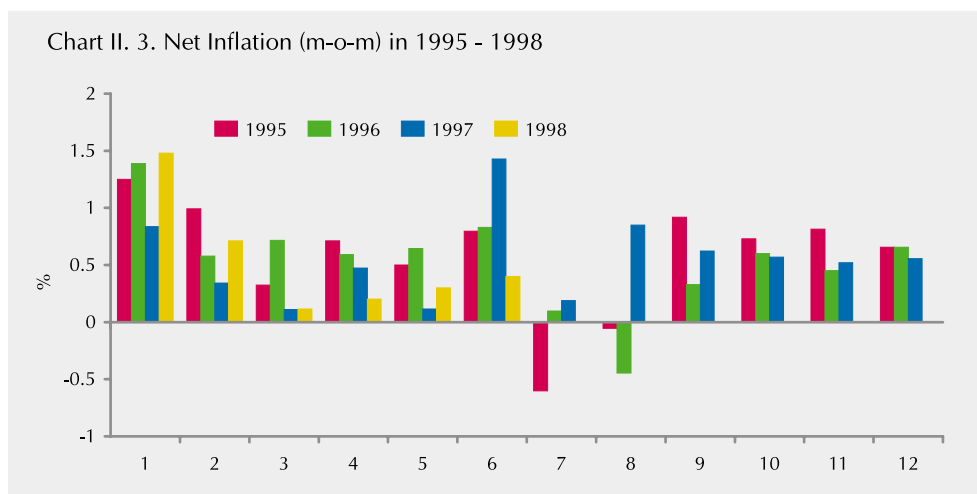


The decline in year-on-year net inflation in Q2 resulted from several factors acting in parallel. In particular, there were declines in all components of domestic demand resulting from restrictive monetary, fiscal and income policies. The fall in private consumption of households, generated by a fall in real incomes during the past twelve months, was also significant. Domestic demand was also influenced by a decline in investment activity due to the deteriorating financial situation of the business and public sectors, the interest rate level and the situation on the capital market. The contraction in domestic demand was also attributable to the development in public finance. Efforts to minimise the public finance deficit were reflected in a year-on-year fall in government consumption and also had an indirect effect on household consumption. Money supply developed in line with domestic demand. In 1996 and 1997, year-on-year monetary aggregate growth dropped significantly because of monetary restrictions. The demand factors mentioned above will affect price development in the medium term.

The decline in year-on-year net inflation in the period under review was also generated by cost factors, the most important of which being the exchange rate. In Q1, the nominal exchange rate gradually appreciated and helped to ease inflationary pressures, though with a lag of several months. Prices of raw materials and food on world markets developed very favourably. Lately, cost inflation has also been affected favourably by wage developments. While in 1996 and 1997 unit wage costs outpaced the GDP deflator and thus created wage cost inflationary pressures, these variables have recently been showing the opposite trend and wage pressures on price growth are decreasing. This trend was visible from 1997 Q4 and continued into Q1 this year. In the period under review, industrial producer prices, which reflect the demand and cost influences mentioned above and in turn affect inflation through costs, developed favourably. The cost factors described above have affected prices in the short run. Prices of raw materials and food on world markets, and to a certain extent also the exchange rate, represent exogenous factors which cannot be influenced by monetary policy.

A more significant fall in year-on-year net inflation was hindered by continuous growth in the prices of unregulated nontradables (around 13%), particularly services. This was influenced largely by cost factors, especially the high share of wages and wage growth.

Month-on-month net inflation reached 0.2% in April, 0.1% in May and 0.4% in June. Apart from the factors mentioned above, the low values in April and May were also due to seasonal influences. Seasonally adjusted net inflation<sup>1/</sup> was 0.2% in April and May, and 0.0% in June.



### Regulated Prices and Administrative Changes

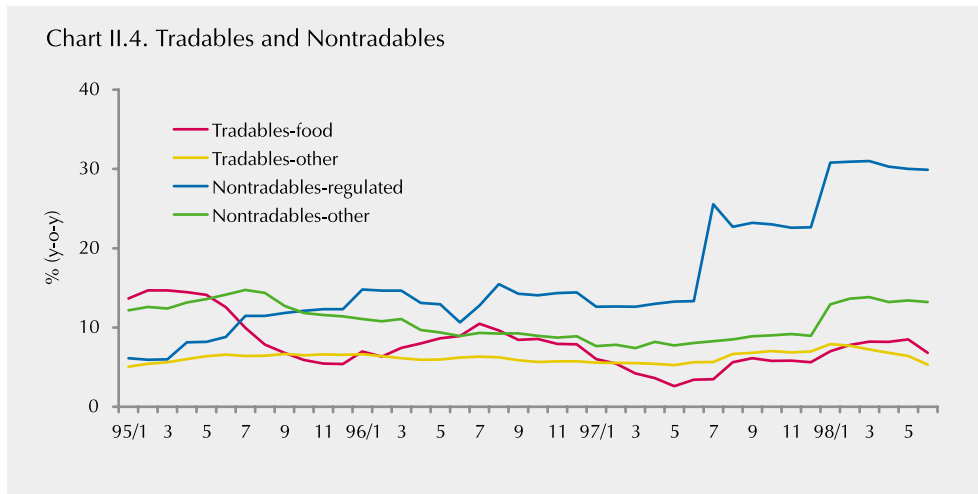
The year-on-year growth in regulated prices dropped during 1998 Q2 from 31% at the end of March to 29.9% at the end of June.

In contrast to 1998 Q1 - when regulated prices rose considerably, excise taxes were increased and subsidies on some prices were cut - the year-on-year rise in regulated prices in Q2 was influenced significantly only by a rise in prices for telephone fees in April. There were no administrative changes. As a result, only April saw a significant month-on-month growth in regulated prices (of 0.6%). In May the increase was 0.0% and in June 0.1%.

### Price of Tradables and Nontradables

While domestic demand, international competition and exchange rate movements contribute most to the development of tradables prices, supply and demand on the domestic market and cost trends are the key factors for prices of nontradables. In 1998 Q2, nontradables prices continued to grow more rapidly than tradables prices. During Q2, the decline in prices of other tradables was the most important factor in the fall in year-on-year net inflation, accounting for 55% of the decrease (the overall drop in year-on-year net inflation in June compared with March was 1.4 percentage points, while the decrease in the year-on-year rise in prices of other tradables adjusted for the share of this group of prices in net inflation was approx. 0.8 percentage points).

<sup>1/</sup> Seasonally adjusted by the CNB using the X 11 Arima method in the SPSS statistical programme.



Year-on-year nontradables price inflation fell during Q2 from 23.6% at the end of March to 22.7% at the end of June. This trend was influenced in particular by very low month-on-month growth in the prices of nontradables with regulated prices in the period under review. Year-on-year inflation of unregulated nontradables, which have a share of approx. 17.5% in net inflation, eased during Q2 from 13.8% at the end of March to 13.2% at the close of June. Prices for repairs, cultural services and recreation rose the most in this group.

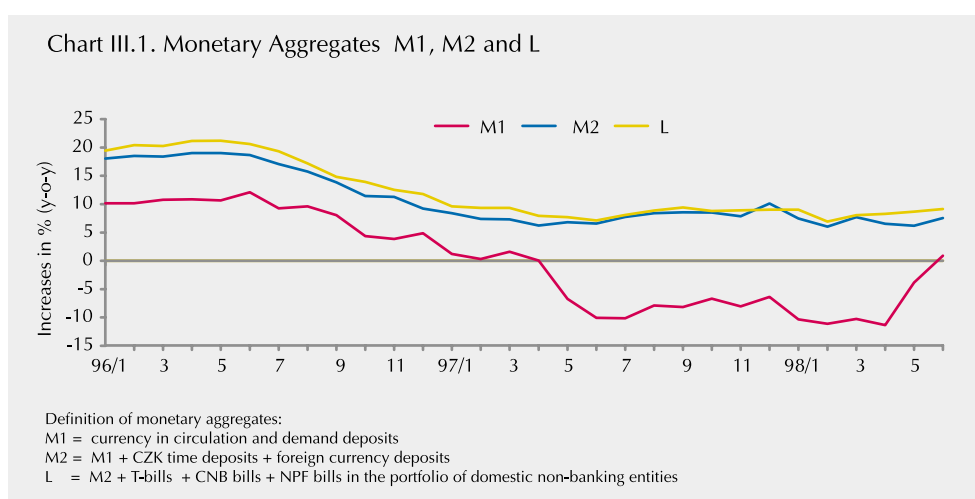
During Q2, year-on-year tradables price inflation declined from 7.7% at the end of March to 6.1% at the end of June. These commodities generate 82.5% of net inflation. Within the tradables group, the year-on-year growth rate for foodstuff prices dropped significantly (from 8.2% at the end of March to 6.8% at the end of June), as did the rate for prices of other tradables (from 7.2% to 5.3%).

### III. INFLATION FACTORS

#### III.1. Money, Interest Rates and Exchange Rates

##### III.1.1. Monetary Aggregates<sup>2/</sup>

In 1998 Q2, monetary aggregates continued to show low growth, despite an acceleration at the end of the quarter. Money supply was affected by a slight decline in client rates - an expression of the ongoing stabilisation of the medium- and long-term segments of the financial market. Year-on-year monetary aggregate increases continue to lag behind the nominal increases in GDP, thus helping to ensure that the CNB's inflation target is hit.



##### Monetary Aggregate M2

Money supply expressed as M2 is one of the basic measures of liquid money in the Czech economy. During Q2, money supply increases accelerated (Table III.1, seasonally adjusted and annualised M2 increases in the past three months). However, the year-on-year monetary aggregate increase in June did not change significantly compared with March.

Tab. III.1. Increases in Seasonally Adjusted M2 (%)

	Annualised for last			
	1 month	3 months	6 months	1 year
March 98	2.6	-4.0	3.9	7.7
April 98	-0.6	3.9	1.8	6.5
May 98	1.3	13.5	3.5	6.2
June 98	2.1	11.3	3.4	7.5

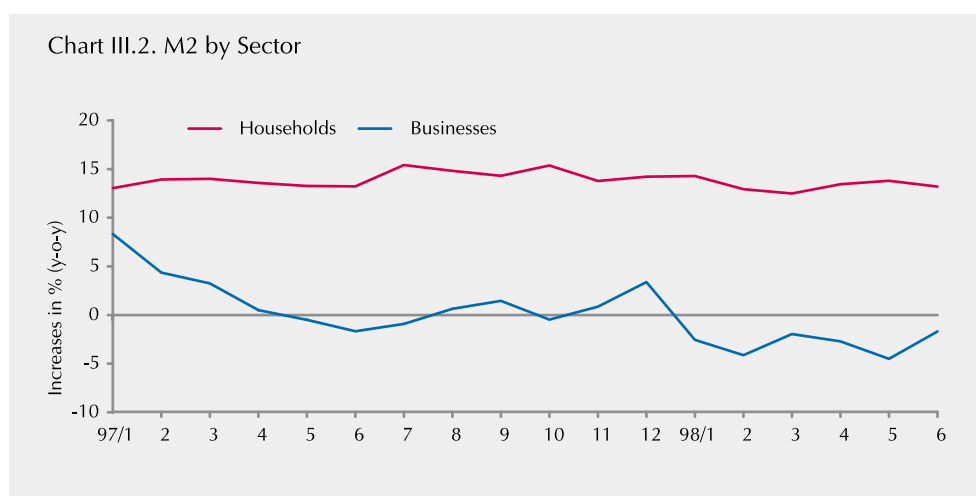
Note: Seasonally adjusted according to deviations from a series smoothed by the centred moving average method (length 13)

<sup>2/</sup> Monetary aggregate data for June 1998 are preliminary

### Structure of Deposits <sup>3/</sup>

In 1998 Q2, the corporate sector's financial assets (measured by the volume of deposits and currency in circulation, chart III.2) increased slightly. The year-on-year change in business financial assets was almost the same in June as it was in March (-2% in March, -1.7% in June) and continues to be very low (during 1996 it amounted to approx. 25%). The net financial position of businesses (i.e. cash and deposits reduced by received credits and issued securities) documents a similar trend, deteriorating further from CZK - 715 bn in March to CZK - 733 bn at the end of June.

Money supply in the household sector is showing faster and more stable growth than in the corporate sphere, due to more steady saving in this sector in the longer term. Year-on-year increases in household deposits and currency in circulation have been maintaining a constant level of approx. 14% since the end of 1996. During 1998 Q2, the financial assets of households rose from 12.5% in March to 13.2% in June. This trend reflects (despite a decline in real household incomes) a preference for saving over consuming, albeit at a slightly lower level than in the past. According to the latest data, the savings ratio of households was 10.5% in 1998 Q1, against 12.6% in 1997 Q1. The stabilised behaviour of households can also be demonstrated by their net financial position, which achieved an annual growth rate of 15.1% in June 1998 against 14.1% in March.



### Monetary Aggregate L

Year-on-year L growth was on the increase throughout Q2 (8.3% in April, 8.7% in May, 9.1% in June). L was affected by the same factors as M2. i.e. particularly by increased credit issues in April and May. Its growth reflects (with regard to real incomes) a preference among businesses for short-term financial investment over non-financial investment.

Tab. III.2. Increases in Seasonally Adjusted L (%)

	Annualised for last			
	1 month	3 months	6 months	1 year
March 98	2.2	3.0	6.2	8.1
April 98	0.7	8.9	6.2	8.3
May 98	1.5	18.7	7.6	8.7
June 98	0.8	12.3	7.5	9.1

Note: Seasonally adjusted according to deviations from a series smoothed by the centred moving average method (length 13)

<sup>3/</sup> In compliance with System of National Accounts (SNA) methodology, money sector structure has been divided into businesses and households (in the April Inflation Report, a division into businesses and individuals was applied).

## Monetary Aggregate M1

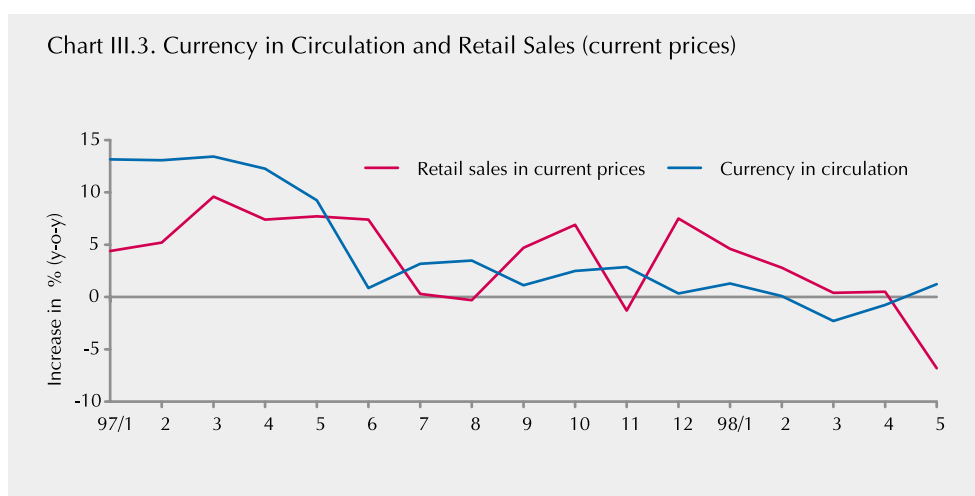
During 1998 Q2, there was a halt in the year-on-year decline of M1. This was influenced in particular by the low base in the previous year, where devaluation expectations caused a shift from currency in circulation and koruna demand deposits to foreign currency deposits. However, the halt was also caused by an acceleration of M1 growth in May - a reflection of the banks' credit issue. Nevertheless, M1 is continuing to grow slowly and is in harmony with the business investment demand trend.

Tab. III.3. Increases in M1 (%)

	Annualised for last			
	1 month	3 months	6 months	1 year
March 98	-0.4	-12.9	-5.9	-10.3
April 98	-0.3	-1.5	-8.1	-11.4
May 98	3.1	2.3	-6.1	-3.8
June 98	0.7	3.4	-9.9	0.9

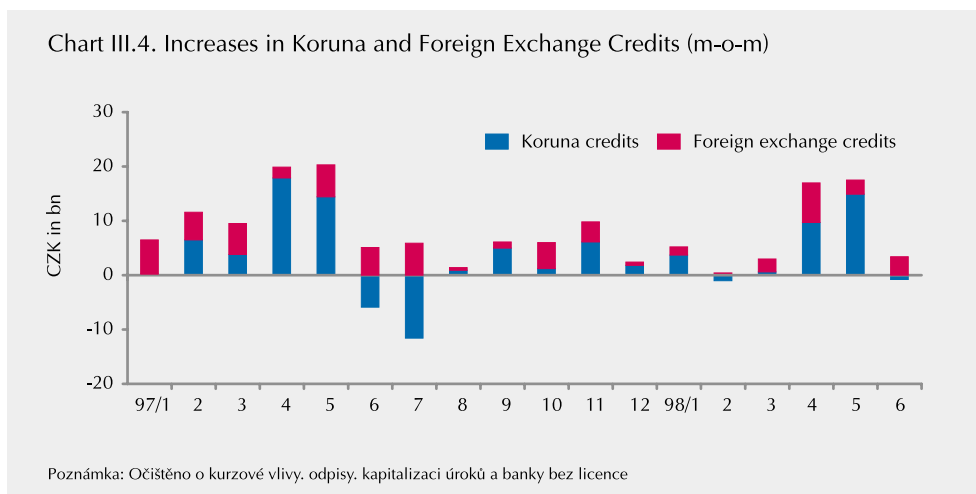
Note: Not adjusted seasonally due to the small significance of seasonal factors

M1 is showing a stagnation of cash volume, corresponding to the trend in retail turnover in current prices. However, cash volume is also being affected to some degree by financial innovations on the domestic banking market.



### III.1.2. Credits

In contrast to the trend described in the previous Inflation Report, 1998 Q2 saw an increase in credit issue. The total volume of extended credits rose by CZK 37 bn (adjusted for exchange rate changes, credit write-offs, capitalisation of interest and banks whose banking licences have been revoked). This increase was primarily due to newly granted short and medium-term credits, with koruna credits prevailing (approx. 65%). Credit issue picked up particularly in April and May.



The faster credit issue growth in 1998 Q2 is also evident from seasonally adjusted credits in the past month as well as in the past three and six months. The increase in credit issue reflects temporarily higher demand from the corporate sector for funds to finance selected operational needs.

Tab.III.4. Increases in Adjusted Total Credits (%)

	Increase in credits during last			
	1 month	3 months	6 months	1 year
March 98	0.0	1.0	2.4	6.4
April 98	1.2	1.2	3.2	6.0
May 98	1.1	2.3	3.6	5.7
June 98	0.5	2.9	3.9	6.0

Note: Adjusted for exchange rate effects, write offs, interest capitalisation, banks with licences revoked and seasonal factors  
Seasonally adjusted according to deviations from a series smoothed by the centred moving average method (length 13)

As to the sector structure of total credits, banks continued to extend credits predominantly to the business sector, which accounted for approx. 90% of the total. The share granted to households did not change significantly (9.6%). As regards the time structure of newly granted credits, short-term credits predominated (83%).

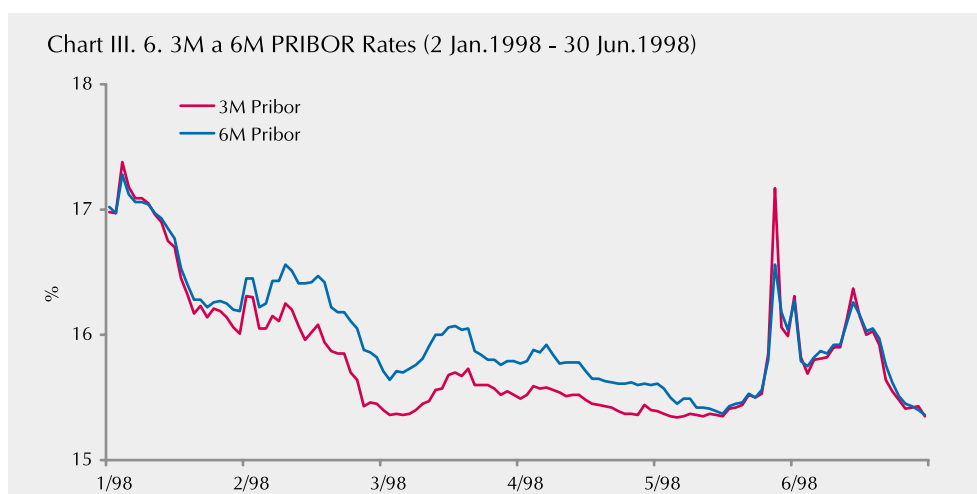
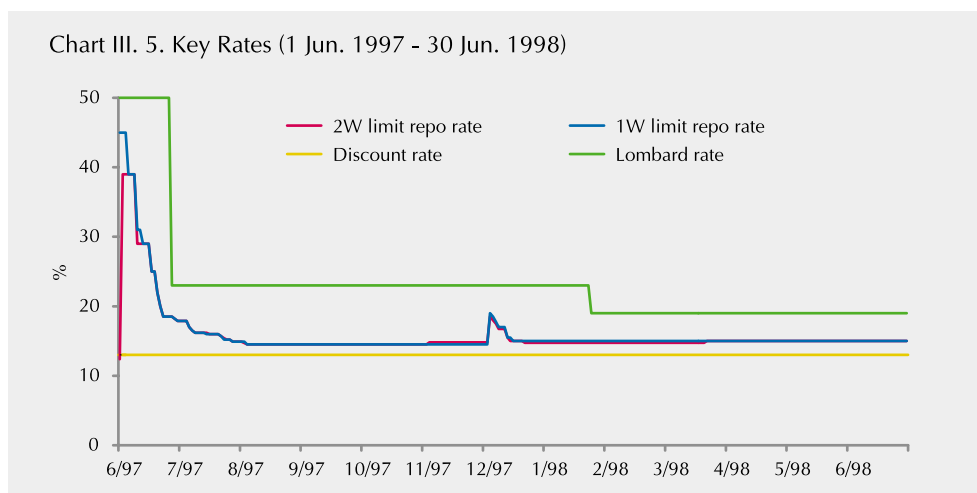
The share of operational credits in total credits increased by approx. 1 percentage point (from 52.7% in March to 53.8% in June). However, the proportion of investment credits fell from 32.1% to 30.4%.

### III.1.3. Interest Rates

In 1998 Q2, there was a temporary hiatus in the downward trend in short-term interest rates typical of Q1. This was influenced by the situation on the Russian financial markets and uncertainties in the pre-election period in the CR. The CNB base interest rate level remained unchanged in the period. The increase in short-term rates was temporarily copied by long-term rates. The average level of short-term interest rates in June rose moderately in comparison with March (up to 3M PRIBOR), while average long-term rates continued to fall. This trend, despite the temporary jump in short-term rates, demonstrates favourable expectations of a decline in inflation. The development described above was also reflected in primary client interest rates on newly granted credits, which dropped slightly in June in comparison with March.

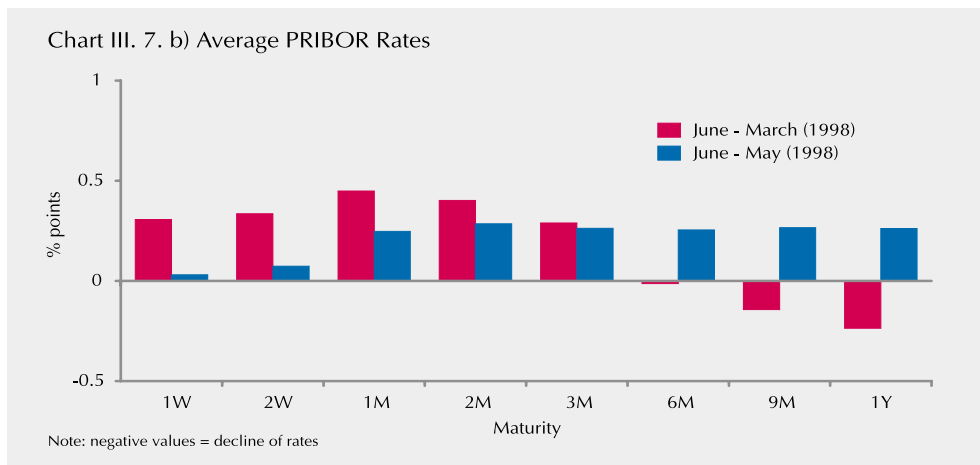
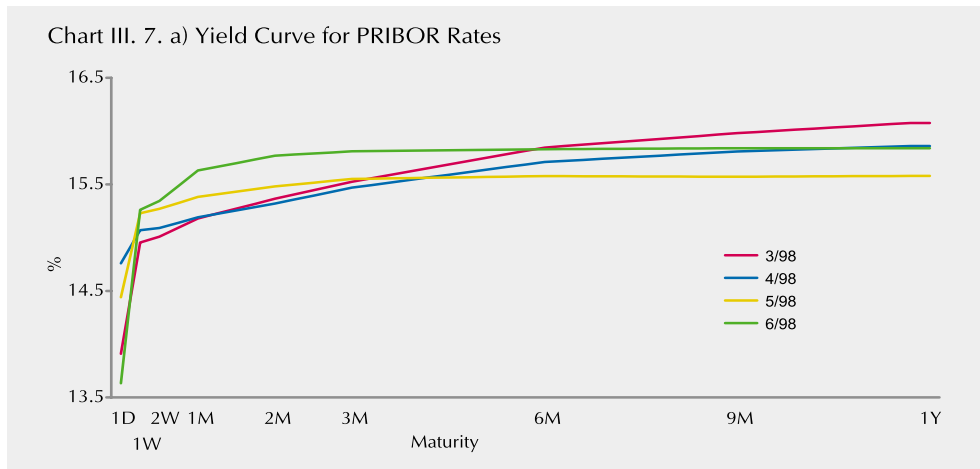
### III.1.3.1. Short-term Interest Rates

In Q2 (up to May 18), interest rates continued to decline gradually as they did in Q1. In mid-May these rates were at their lowest since the beginning of 1998. Starting in the last ten days in May, the smooth fall in short-term interest rates was replaced by marked volatility linked with the transient rise in the overall short-term interest rate level. At Q2 close, short-term interest rates fell back to the level seen prior to the May rise. The CNB's base interest rates remained unchanged during this time.

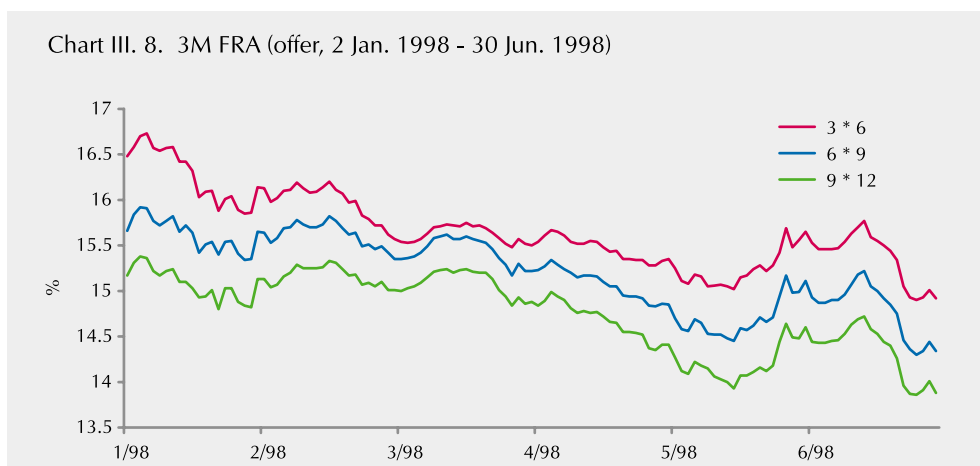


The dynamic development of short-term interest rates affected the position and slope of the entire PRIBOR rate yield curve (graph III.7). Given the stability of the CNB limit 2W repo rate at 15%, the interest rates at the yield curve's shorter end gradually increased over the entire period, as demonstrated by the 1W PRIBOR. The average monthly level of this interest rate gradually went up from 14.95% in March to 15.26% in June. The yield curve's middle and longer ends experienced a similar tendency after their downward trend was disrupted in May. OFFER/BID spread upped slightly, reflecting the temporary instability on the money market resulting from the crisis on the Russian financial market and the uncertainty in the pre-election period in the CR.

In June, the interest rates at the shorter-end exceeded the March level. Medium and longer-term PRIBOR rates fell in comparison with March, indicating an ongoing stabilisation of the financial market and the persistence of positive inflation expectations. After the temporary adverse factors faded, the situation on the financial market calmed at the end of June and interest rates fell rapidly to the mid-May level.



FRA<sup>4/</sup> interest rates mirrored PRIBOR rates. In Q1 a downward tendency in FRA interest rates was evident (except for several adjustments). This became even more marked from April onwards. FRA interest rates reached a minimum in approximately mid-May, with further declines disrupted by the Russian financial crisis and the pre-election uncertainty on the domestic financial market. The heightened PRIBOR interest rate volatility in June was also reflected in FRA rates. When the fluctuations petered away at the close of June, FRA rates renewed their downward trend. The FRA interest rate level at the end of June compared with March demonstrates the strengthening of disinflationary expectations (a decline of 0.4 points in the 3-month horizon is expected with the 3M rate and a fall of 2.3 points in the one-year horizon is expected with the 12 M rate).

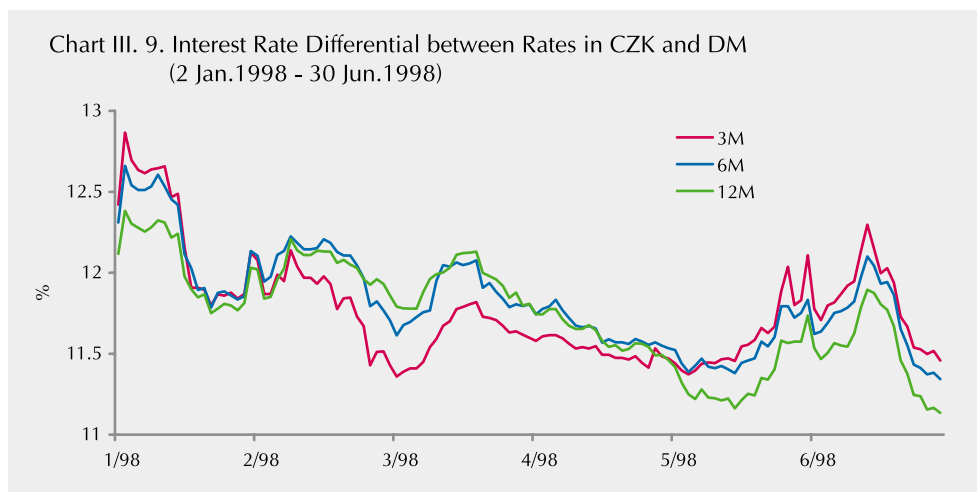


4/ FRA = forward rate agreements

The short-term bond market (T-bills) was also affected by PRIBOR interest rates. The T-bill yield curve (in the interval from 3M to 12M) developed in harmony with interest rates on the interbank deposit market. However, its informative nature is limited, owing to low market liquidity. In addition, the yield's short end is distorted by the quoting banks' diverse approach toward tax arbitrage. Nevertheless, turnovers on the short-term bond market are increasing steadily. In April, May and June, monthly turnover volumes significantly exceeded the values seen in the individual months of the previous quarter, moving around CZK 470 - CZK 500 bn. Outright trades (85 to 90%) continue to predominate over repo trades.

During 1998 Q2, a total of 10 T-bill auctions with 1 - 9M maturities took place. Due to demand overhang in all auctions, the resulting gross yields were below the limit yields, varying between 15.0 and 15.7% depending on maturities and on the latest situation on the market.

Given the stability of foreign interest rates, the interest rate differential (PRIBOR CZK - LIBOR DM) in Q2 reflected interest rate levels on the domestic interbank deposit market. In line with these interest rates, the differential showed a slight but steady downward trend until approx. mid-May 1998. Due to fluctuations on the domestic market this fall was temporarily supplanted by a sharp increase, during which the interest rate differential reached its quarterly maximum (3M 12.3%, 1Y 11.9% on June 15, 1998). At the end of June, after the situation had calmed, the interest rate differential dropped to 11.5% for 3M deposits and to a quarterly low for deposits with longer maturities (1Y 11.1%). This fall was not reflected in the koruna's exchange rate, which appreciated at the end of June.

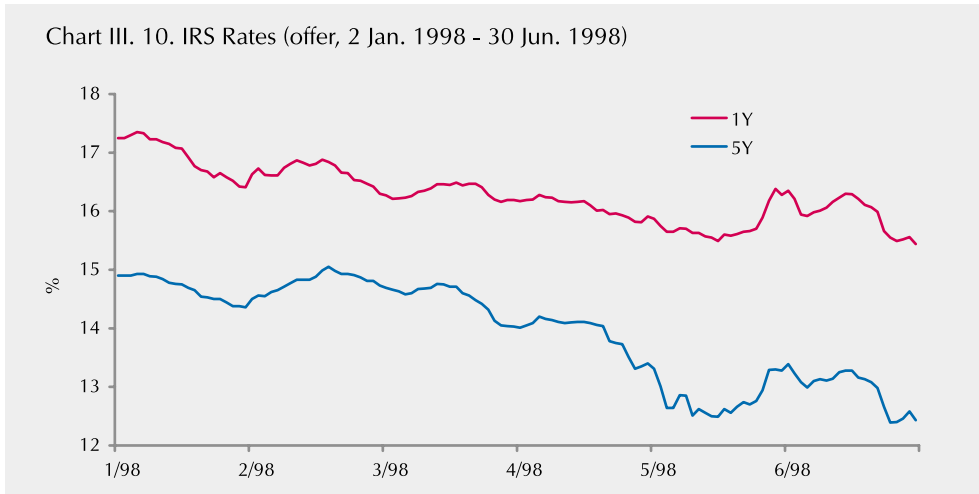


### III.1.3.2. Long-term Interest Rates

In 1998 Q2, the trend in long-term interest rates expressed by quotations on IRS<sup>5/</sup> was characterised by a decline. This intensified in April and at the beginning of May. In this period, the political situation was relatively stable and economic indicators were comparatively favourable. These two factors are the most important ones for investor expectations and thereby also for interest rate development. The downward trend in interest rates was temporarily disturbed at the turn of May and June due to the effect of the Russian financial crisis. Nevertheless, long-term interest rates, contrary to short-term rates, continued to decline, indicating ongoing stabilisation and the disinflationary expectations of the entities operating on the financial market.

<sup>5/</sup> IRS = interest rate swaps = interest derivatives based on exchanging a fixed interest rate with a floating interest rate

Chart III. 10. IRS Rates (offer, 2 Jan. 1998 - 30 Jun. 1998)



The IRS yield curve gradually moved to a lower yield level. At the same time, its inverse slope became more pronounced due to the faster drop in interest rates with longer maturities. This was a result of longer-term disinflationary expectations manifesting themselves more vigorously. During Q2, IRS rates for 1Y maturities dipped by 0.4 percentage points, while for 5Y maturities they fell by 1.5 percentage points and for 10Y maturities by 2.2 percentage points.

Chart III. 11. a) Yield Curve for IRS Rates (offer)

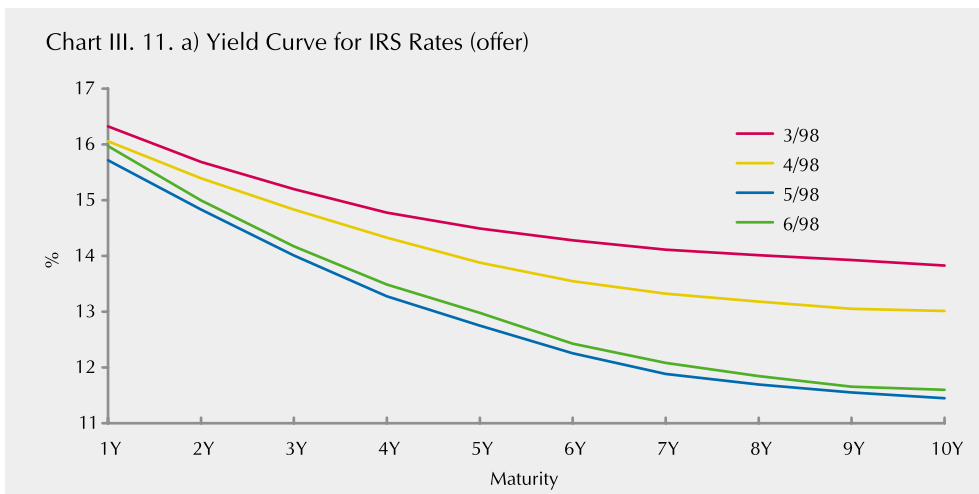
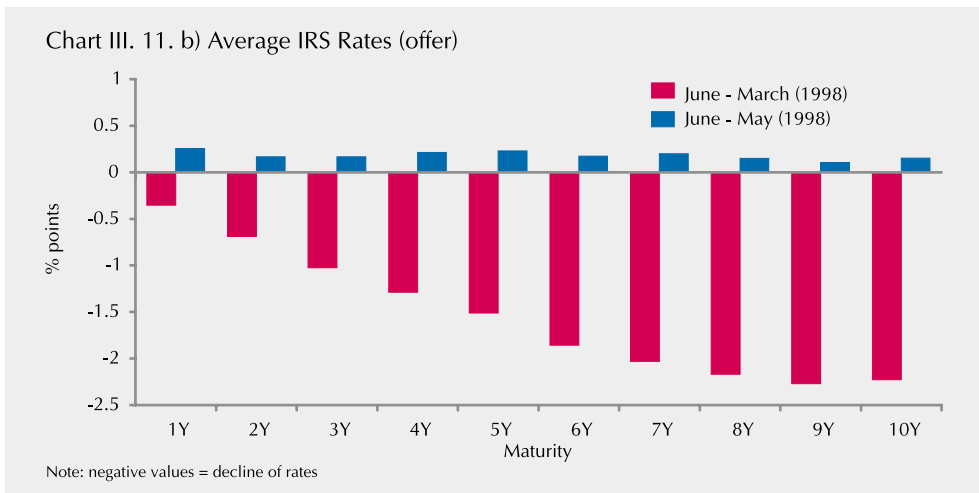


Chart III. 11. b) Average IRS Rates (offer)



The position and slope of government and corporate bond yield curves showed a similar tendency. In accordance with the issue schedule there was one issue on the government bond primary market (CZK 5 bn, 2Y maturity, 14.75% gross yield), along with one corporate bond issue (CZK 6 bn) and three mortgage bond issues (CZK 1.7 bn). The low frequency of new issues demonstrates the lower relevance of this capital market segment.

### III.1.3.3. Client Interest Rates

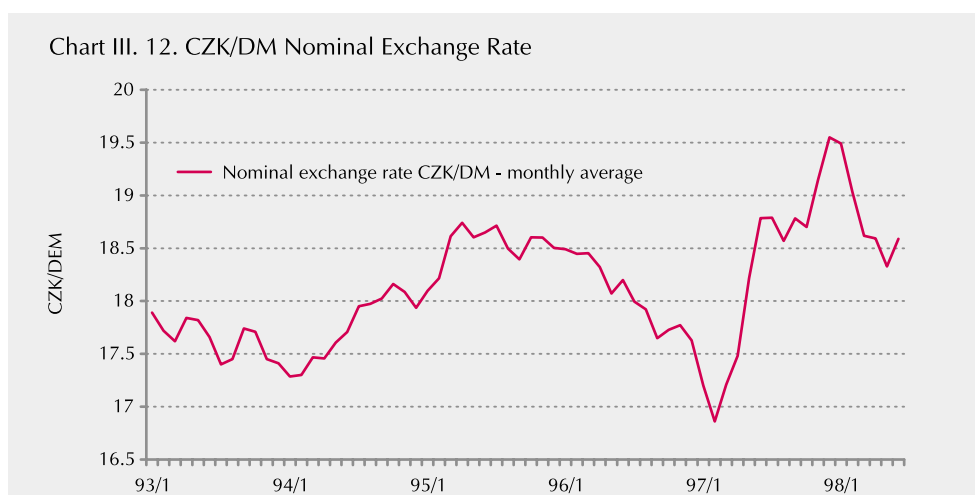
In 1998 Q2, client interest rates on newly granted credits followed the situation on the interbank deposit market. Though the downward trend at the end of May and in the first half of June was interrupted, banks started to cut their reference rates in the last ten days of June in line with inflation expectations. Interest rates on newly granted credits showed a slight fall in June compared with March (16.1% and 16.0% respectively).

Average nominal client interest rates on newly granted short-term credits, which in April (16.3%) differed only negligibly from those in March (16.2%), dipped to 15.8% in May because of interest rate cuts on the interbank deposit market. In June, they edged up again to 16%. The trend in nominal interest rates on newly granted short-term credits was reflected in real interest rates<sup>6/</sup>, which in May fell from 3.2% to 2.8% in CPI terms and from 10.1% to 9.6% in PPI terms. However, in June, in connection with the annual fall in inflation, real interest rates surged to 4% in CPI terms and to 10.4% in PPI terms. As for the quarterly average (3.3% in CPI terms, 10.0% in PPI terms), real interest rates exceeded the Q1 level (2.6%, 9.5%, respectively.)

In comparison with March, average nominal interest rates on short-term time deposits rose only negligibly (11.9% in March, 12.0% in June). However, real interest rates on deposits increased, owing to the year-on-year fall in inflation (-1.5% in March, 0% in June).

### III.1.4. The Exchange Rate

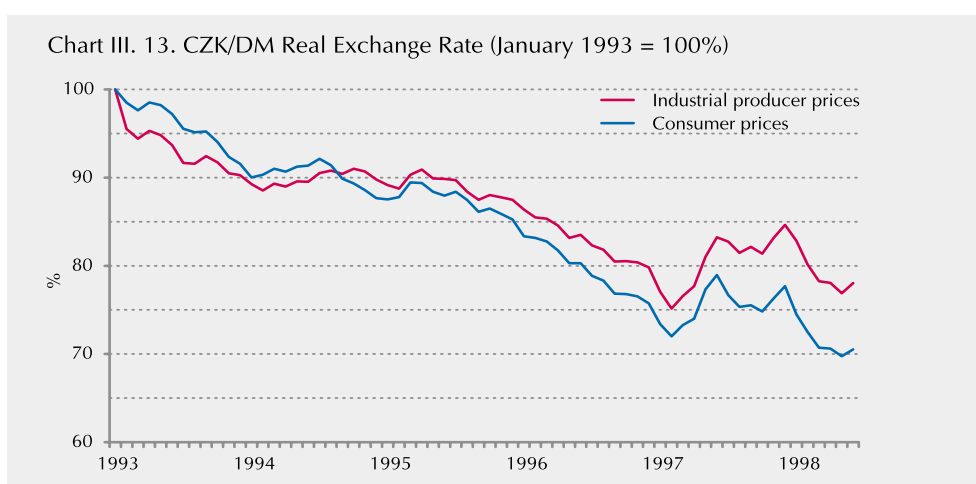
In 1998 Q2, the nominal exchange rate had a stabilising effect on inflation. The favourable trend in fundamentals (inflation, monetary aggregate, trade balance and domestic demand) steadied the average monthly nominal exchange rate at CZK 18.50/DM. On the other hand, the attractiveness of the interest rate differential for foreign capital was impaired from time to time by uncertainty on foreign financial markets, particularly because of the situation in Russia.



6/ Real interest rate = nominal interest rate - the CPI and PPI index in the relevant month

The appreciation of the koruna's average monthly nominal exchange rate against the Deutsche Mark typical of the first three months this year slowed in Q2. A stagnation of the nominal exchange rate in April (at CZK 18.60/DM on average) was followed by an appreciation in May (to an average level of CZK 18.30/DM) and a depreciation in June (back to an average level of CZK 18.60/DM). This trend differs from that seen in Q1, when the exchange rate appreciated by almost one koruna against the Deutsche Mark. This strengthening was attributable to a wearing off of the causes of the exchange rate depreciation in the last months of 1997. The combination of the government crisis in the CR and the increased uncertainty on foreign financial markets stemming from the developments in south-east Asia and Russia was the main reason for the weakening of the exchange rate at the end of 1997.

In Q2 the real exchange rate against the Deutsche Mark in fact copied the nominal exchange rate (the real exchange rate is calculated by deflating the nominal exchange rate by the consumer and industrial producer price indices of the two countries). The nominal rate was the controlling factor for the real exchange rate because of the small changes in both price circles in the two countries in this period. The real exchange rate in Q2 can be characterised by a halt in the exchange rate appreciation typical of Q1 this year. In the last few months the real exchange rate has been reaching the level seen at the beginning of 1997.



### III.1.5. Capital Flows

Since comprehensive data on the balance of payments in Q2 were not available during the preparation of this Inflation Report, this assessment is based on Q1 data. In this period, the financial account ended in a surplus of CZK 24.1 bn (USD 0.7 bn). In comparison with past years, this account shows an outflow of other long-term investments (higher repayments of credits drawn in the past than the drawing on new credits) and higher capital inflow under other short-term investments. The commercial banking sector saw a decline of CZK 60.3 bn in short-term banking assets vis-a-vis non-residents. This was used to honour short-term commitments due and debt services ensuing from financial credits received earlier and also to settle commitments related to off-balance sheet spot and forward transactions.

Tab. III.5. Balance of Financial Account and Foreign Exchange Reserves (CZK in bn)

	Q1					
	1993	1994	1995	1996	1997	1998
Financial account	13.5	19.2	43.0	2.2	22.1	24.1
- direct investment	8.4	-0.4	3.0	8.1	7.9	7.8
- portfolio investment	-0.1	7.2	0.8	-3.5	-5.6	-0.5
- other long-term investment	1.5	7.3	14.0	12.2	11.1	-12.1
- other short-term investment	3.7	5.1	25.2	-14.6	8.7	28.9
CNB foreign exchange reserves (according to Balance of payments, increase -)	-12.2	-20.8	-39.7	13.2	1.1	-30.0

In Q1, net capital inflow under foreign direct investment amounted to CZK 7.8 bn (USD 0.2 bn), which is comparable to the same period in 1997. This was mainly due to the sale of the state-owned stake in Investiční a poštovní banka, which accounted for almost 75% of the total inflow.

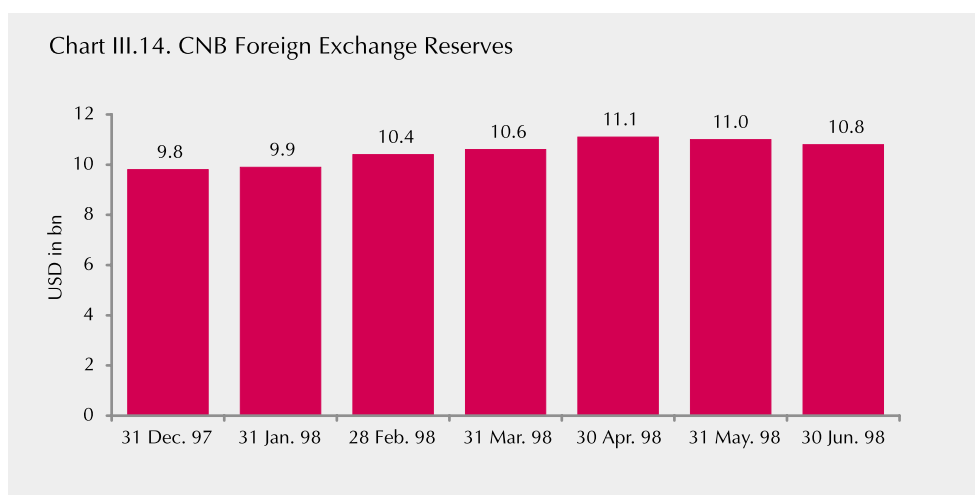
Portfolio investment saw a very moderate outflow of funds abroad - CZK 0.5 bn (USD 14 mil.). Foreign investment in domestic securities amounted to CZK 3.4 bn, while resident investment in foreign securities was higher at CZK 3.9 bn. Total foreign investment in domestic securities on the domestic capital market stood at CZK 131.8 bn (USD 3.9 bn) at the end of March. As of the same date, the stock of foreign investment in domestic securities denominated in foreign currencies totalled USD 1.0 bn (CZK 35.2 bn).

As for other long-term investment, repayments of earlier accepted bank deposits and credits exceeded newly accepted deposits and drawing on new credits, thus causing an outflow of long-term capital totalling CZK 12.1 bn (USD 0.3 bn).

The long-term capital outflow showed up favourably in the foreign indebtedness of the state. As of March 31 this year, external debt stood at CZK 690.6 bn, i.e. USD 20.5 bn, a decline of CZK 58.2 bn against the end of 1997. The external debt/annual GDP ratio was 40.9%.

In Q1, the increase in the CNB's foreign exchange reserves amounted to CZK 30 bn (after excluding exchange rate differences), due in particular to the CNB's interventions on the interbank foreign exchange market. As of the end of March, foreign exchange reserves totalled CZK 357.7 bn (USD 10.6 bn) and were sufficient to cover 3.9 months worth of goods and services imports.

In Q2, CNB foreign exchange reserves rose by approx. CZK 12 bn (after excluding exchange rate movements), especially through operations on the interbank foreign exchange market. As of June 30, 1998, CNB foreign exchange reserves totalled approx. USD 10.8 bn.



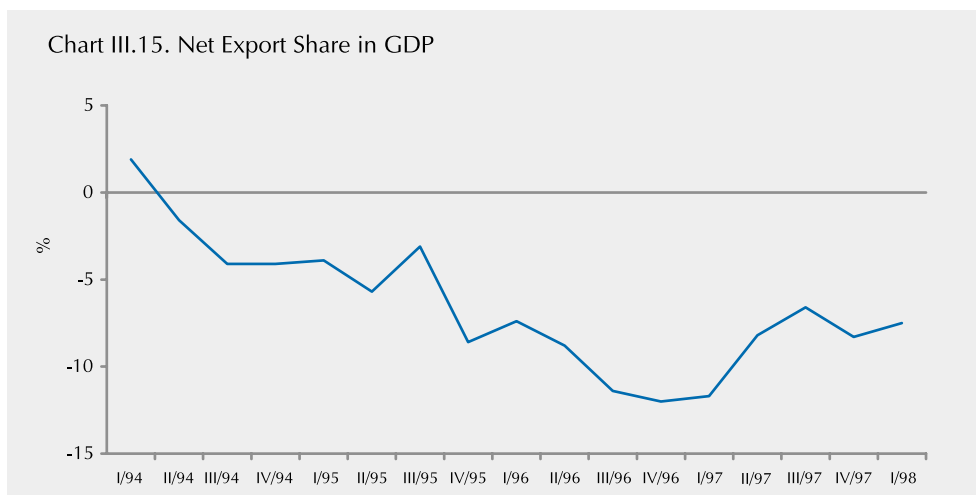
## III.2. Demand and Output

### III.2.1. Introduction

The disequilibrium between domestic demand and output registered in the economy during 1997 continued into 1998 Q1<sup>7/</sup>. The absolute decline in external imbalance measured by trade deficit reached CZK 11.9 bn and its share of GDP dropped by 4.1 percentage points compared with 1997 Q1 to 7.5% .

<sup>7/</sup> The latest available data on GDP and demand as of 31 July 1998 are for 1998 Q1.

This drop in external imbalance was generated for the most part by influences on the domestic demand side, mainly monetary and fiscal restrictions. These were reflected in all components of domestic demand, and consequently in exports (especially consumer exports). The drop in overall as well as final domestic demand was not offset by an adequate rise in external demand, which resulted in declining GDP creation. Aggregate demand grew 6.8% year-on-year.



Tab.III.6. Growth Rate of Real Output and Demand (y-o-y, %)

INDICATOR	SITUATION							
	1995	1996	1997	I/1997	II/1997	III/1997	IV/1997	I/1998
GROSS DOMESTIC PRODUCT	6.4	3.9	1.0	1.2	0.5	-0.1	2.2	-0.9
AGGREGATE DEMAND (domestic demand and exports)	11.9	7.4	3.3	3.8	4.1	0.9	4.4	6.8
DOMESTIC DEMAND (including change in stock position)	9.8	8.5	-0.4	5.2	0.0	-4.4	-1.2	-4.5
of which:								
Household consumption	6.9	7.0	1.6	4.0	5.7	-2.2	-0.3	-1.6
Government consumption	-1.6	4.3	-1.8	1.1	-3.9	-3.2	-1.1	-2.7
Fixed capital formation	21.0	8.7	-4.9	-0.6	-8.5	-9.5	-0.9	-2.5
EXPORTS OF GOODS AND SERVICES	16.1	5.4	10.2	1.3	11.7	11.3	15.5	27.8
IMPORTS OF GOODS AND SERVICES	22.0	12.9	6.7	7.5	9.4	2.4	7.7	17.3

### III.2.2. Domestic Demand

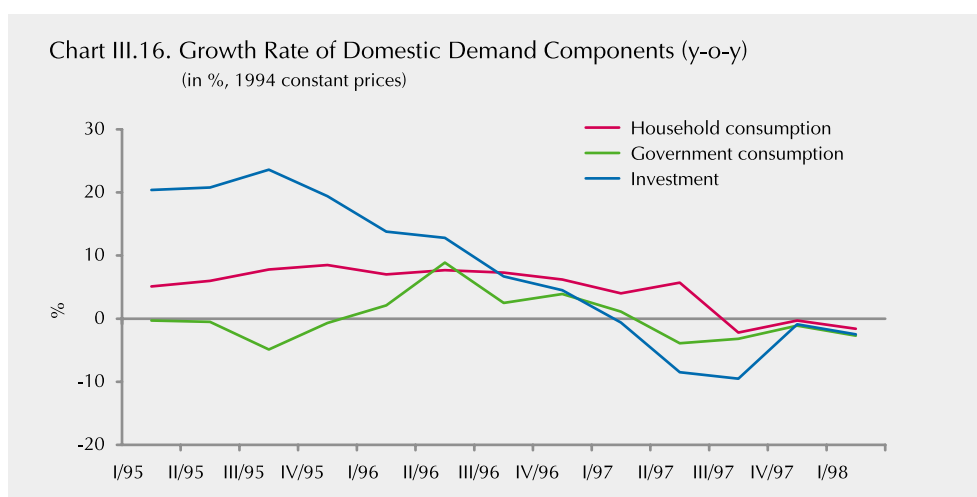
1998 Q1 was characterised by a continuing fall in all components of aggregate domestic demand (including stocks). Aggregate domestic demand dropped 4.5% year-on-year, while the decline in final domestic demand (excluding the effects of changes in stocks) was more moderate at about 2.1%.

This decline in domestic demand was due to a number of factors, the most important being:

- restrictive monetary policy (the effect of the existing interest rates, particularly on newly granted credits);
- fiscal restrictions, leading to a reduction in government demand and investment;
- the continuing prudential approach of banks towards providing credits to the corporate sector with respect to the current level of problem credits, and increased interest in investment in government securities, which give higher yields and lower risks compared with real investment;

- limited wage growth in government institutions and a slowdown in wage increases in the business sector due to the worsening financial performance of businesses and, in part of the corporate sector, also due to ongoing restructuring;
- the overall reduction in government consumption;
- changes in ownership relations, the unfavourable financial situation and increasing pressure for greater competitiveness in the corporate sector, initiating a rise in unemployment and a fall in wage growth in this sector;
- low expectations of future economic growth.

Although the rates of decline in individual components of domestic demand differed, their effect on the absolute year-on-year decline was roughly the same owing to their differing contributions to final domestic demand, and moved between CZK 2.1 - 2.4 bn.



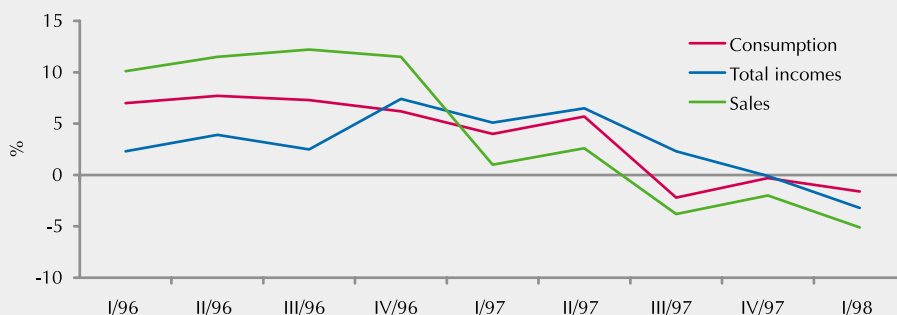
### III.2.2.1. Household Consumption

The downward trend in household consumption, visible from the second half of 1997, continued in 1998 Q1. While in the first half of 1997, real household consumption rose by 4.9%, in the second half it declined in absolute terms by CZK 4.2 bn. In 1998 Q1 this fall continued, reaching 1.6%.

The drop in household consumption was a result of declining real disposable household incomes, due in turn to the parallel effects of decreasing growth in nominal household incomes and accelerating CPI inflation in 1997 and 1998 Q1. This acceleration had the biggest effect on items with substantial weights in household spending (changes in regulated prices of heating, rents, electricity etc.). The drop in consumption was also attributable to a moderate rise in the savings ratio in 1997, clearly stimulated by increasing uncertainty about future developments on the labour market connected with rising unemployment. However, a reduction in the savings ratio in 1998 Q1 signalled that, given the ongoing fall in nominal income growth and the rise in inflation, the space for creating financial reserves had narrowed (according to the Czech Statistical Office, the household savings ratio dropped by 2.5 p.p. compared with 1997 and 2.1 p.p. against 1997 Q1).

Analyses of consumer behaviour indicate a very close correlation between disposable incomes and consumption in the Czech economy. The gradual slowdown in the year-on-year growth of household consumption and the subsequent absolute decline, generated by decreasing real incomes (particularly wages), is illustrated in Chart III. 17.

Chart III.17. Consumption, Household Money Incomes and Retail Sales  
(y-o-y, in %, constant prices)

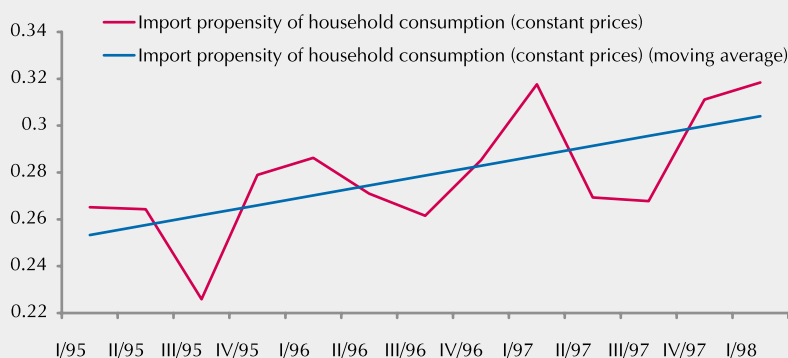


The decrease in effective household demand was also confirmed by changes in the retail sales structure, specifically a drop in sales of road vehicles and durables. A more significant decline in sales of almost all types of services provided to households (especially personal services) testified to the decreasing purchasing power of households.

This gradual contraction of consumer demand generated:

- a weakening of demand inflationary pressures in the economy;
- a substantial reduction of the trade deficit. However, the favourable effect of restrictive monetary and fiscal measures on narrowing the gap between domestic supply and demand was diminished to a certain extent by the rising share of consumer goods imports in household consumption (Chart III.18.)

Chart III.18. Import Propensity of Household Consumption  
(goods import/household consumption)



### III.2.2.2. Investment Demand

Following a substantial year-on-year decline (of 4.9%) in gross capital formation in 1997, a decline of just 2.5% was seen in 1998 Q1. Nevertheless, the rate of investment remained far above the level in OECD countries (28.6% in constant prices).

A steeper drop in investment demand in 1998 Q1 was checked by government sector demand (up 4.4% y-o-y). This was the fastest growing component of overall investment demand in the period. The exceptionally low comparison base from the two previous years played a significant role in this context, as did activities connected with the consequences of the 1997 floods. As public sector capital

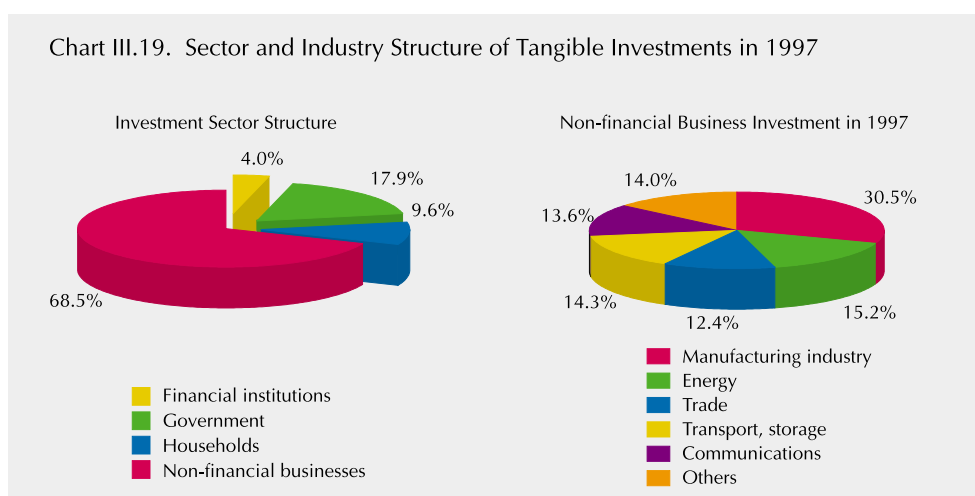
investment fell year-on-year (even in nominal terms), it can be concluded that the amount of government investment may partly reflect deferred invoicing for investment work and deliveries from the previous period.

The non-financial business sector's 1.7% year-on-year growth helped moderate the fall in investment demand in 1998 Q1. The possibilities of financing investment through the domestic financial market were limited (growth in domestic investment credits declined further in 1998 Q1), owing to:

- interest rates of about 16% on investment credits and the relatively low profitability of businesses;
- the increased prudence of commercial banks and their hesitancy in providing long-term investment credits;
- the higher rates of return on financial investments than on real investments.

On the other hand, the drawing on corporate credits abroad increased. The exchange rate also helped improve the terms for imports of investment commodities. This is confirmed by actual investment imports in the first five months of 1998 (see Part III.2.3.).

Investment demand from financial institutions contributed significantly to the decline in 1998 Q1, falling by one-third (-34.3%); this fall was due to a certain degree of investment demand saturation and a deterioration of the financial situation in this sector.



### III.2.2.3. Government Consumption

During 1998 Q1, government consumption fell by 2.7% year-on-year (Chart III.16.), mainly as a result of ongoing restrictions in the area of non-investment spending at both government and municipal level. Only in education was spending roughly at a level corresponding to 1/4 of the full-year budget; in other chapters, particularly those of the ministries of defence and the interior, the spending level was between 15% and 16% of the annual budget (in current prices).

In the first half of 1998, overall public budget expenditure grew by 0.8% in nominal terms, but fell radically in real terms. Capital expenses were static in nominal terms; a more significant nominal rise was registered in public consumption (3.4%). With growth in budget revenues up by 9.0%, public budgets posted a moderate surplus at the end of the first half of 1998.

### III.2.3. Net Foreign Demand

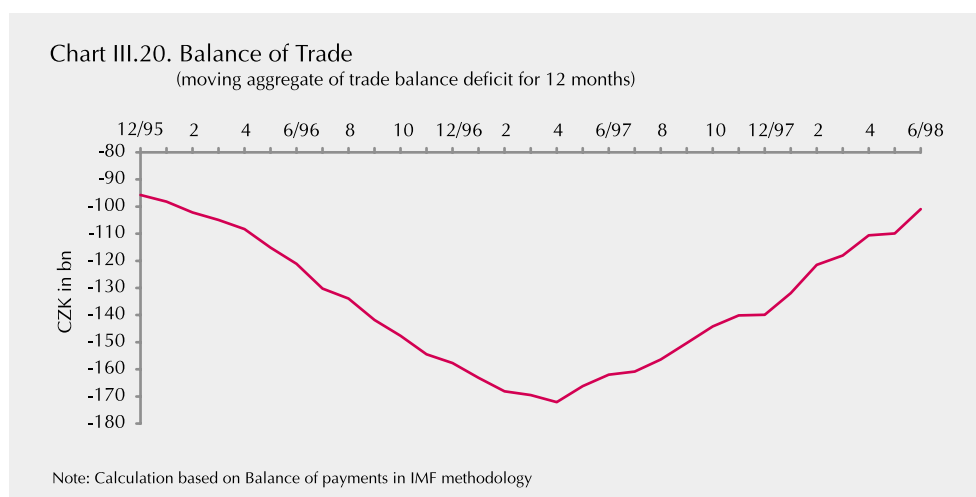
The goods and services balance showed substantially better results in constant prices in 1998 Q1 than in the same period of 1997. This was a result of export growth (27.4%) being higher than import growth (17.3%). The trade deficit (negative net exports of goods and services) was lower in year-on-year terms and its share of GDP fell by 4.1 p.p. to 7.5%.

The overall year-on-year improvement in the trade deficit was caused mainly by the following four factors:

- favourable conditions for sales of Czech products on foreign markets, resulting from a revival in Western European countries and in particular from an acceleration of economic growth in Germany, the CR's main trading partner;
- declining domestic demand, which allowed a larger proportion of domestic production to be sold on foreign markets;
- the effect of completed investments, predominantly by foreign investors, began to be felt; this helped increase the volume of exports with higher value added, including highly sophisticated products;
- export growth was also boosted by the introduction of the floating exchange rate for the koruna and the depreciation of the currency following the exchange rate turbulence in May; this factor faded in the first five months of 1998 as a result of the koruna's appreciation; on the other hand, the koruna's appreciation, together with continuing favourable price developments on world commodity markets, created better conditions for imports; these factors mitigated the potential inflationary cost pressures stemming from the development of import prices.

The trade balance<sup>8/</sup> in 1998 Q2 followed the favourable trend of the previous quarter (Chart III.20.). The deficit for the first half of 1998 diminished by 53% compared with the same period of 1997; in June alone, the balance of trade was almost in equilibrium.

Following weaker growth in 1997, imports have accelerated in 1998 (even when taking into account the extraordinarily low base from the comparable period of 1997). This is a result of continued growth in imports for intermediate consumption, associated with increasing cooperation between businesses (particularly those with foreign ownership interests). Renewed growth in investment imports under the improved exchange rate and price conditions has also played a role. These two import groups accounted for 85.5% of total imports in the first five months of 1998 (calculated on the basis of nominal values). These developments were reflected in the increasing share of imports in GDP.



In the first half of 1998, consumer imports in physical terms moved at about the same level as in the comparable period of 1997. Given the overall decline in domestic consumer demand, this stagnation indicates increasing the import propensity of household consumption (Chart III.18.)

<sup>8/</sup> In current prices according to IMF methodology for compiling the balance of payments; other data in this report are processed according to GDP methodology.

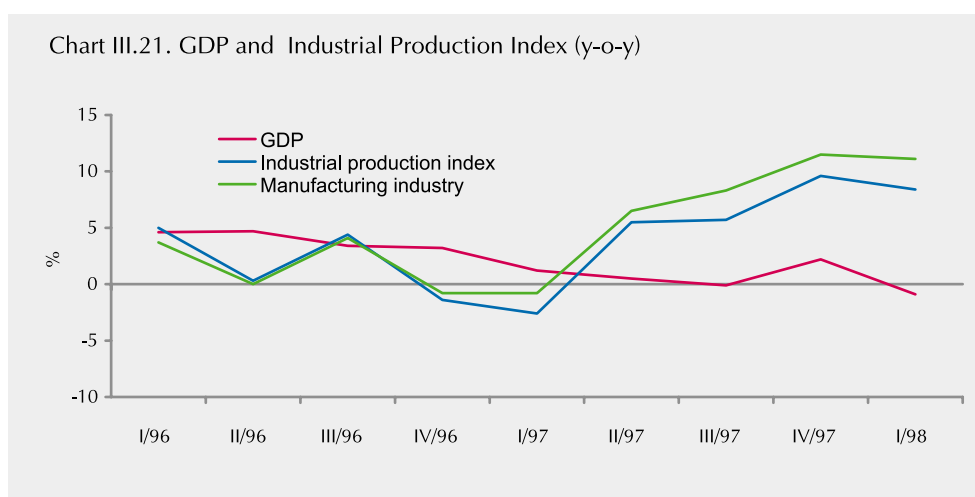
### III.2.4 Output

Gross domestic product declined in 1998 Q1 (-0.9% year-on-year), mainly because of developments in the service sector; growth in value added was registered only in industry. The Q1 result was a continuation of the longer-term trend of gradually weakening GDP growth, which began in the second half of 1996.

In 1998 Q1, the contraction in domestic demand resulted in a decline for almost all types of services (except for communications). Overall, services account for approx. 50% of GDP. The fall in demand also led to a drop in real retail and catering sales (connected to the trend in real household incomes). The largest decline was seen in sales of vehicles and non-food products. Sales in catering and accommodation also fell (by 6.4%). Services for businesses dropped by 5.9% year-on-year, while other services (predominantly of a personal nature) shrank by 11.5%. The weaker demand for services was, together with the fall in disposable household incomes, also generated by a more substantial rise in prices of services (at 14.4%, the market services price index was almost double the rise in industrial producer prices). The year-on-year drop in real retail and catering sales steepened in 1998 Q2 and reached 7.1% for January - May.

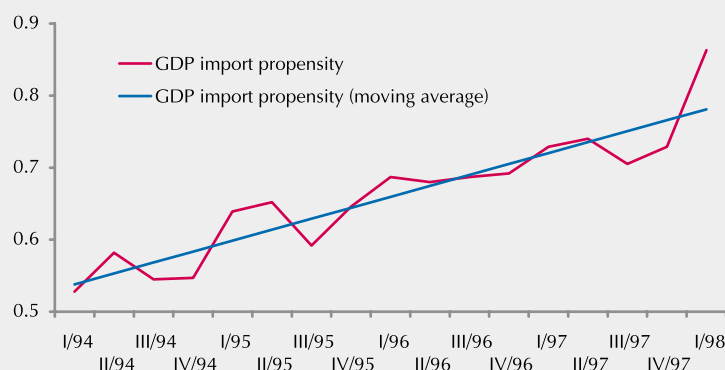
Output also declined in construction (accounting for approx. 6% of GDP). The 4.6% year-on-year growth in construction output in 1998 Q1 was mainly due to the low comparison base from the previous year. In the first five months, construction output receded by 3.1% year-on-year due to shrinking demand for construction work. This stemmed from a lack of funds in both the corporate and public sectors and from changes in investment structure.

At the same time, industrial production grew relatively rapidly; the 8.4% year-on-year rise in 1998 Q1 was achieved with a slightly lower number of workers (3.9% fewer). Given the dwindling domestic demand and increasing import propensity in consumer demand, the growth in industrial production was stimulated predominantly by an expansion of external demand. Despite a moderate slowdown in 1998 Q2, industrial production growth remained comparatively strong (7.1% y-o-y for the first five months).



The growth in industrial production was accompanied by expanding co-operation relations (particularly between businesses with foreign ownership interests). This prompted increased demand for imports of materials and components from other countries, and led to a higher share of imports in GDP (Chart III.22.).

Chart III.22. Share of Goods Import in GDP



Development in industrial production differed in individual branches. Manufacturing industry saw improved value added in 1998 Q1, with a gross value added increase of more than 10%.

The fastest industrial production index growth occurred in manufacture of electrical and optical appliances (+62.4%), means of transport (20.6%), rubber and plastics (14.8%), paper and printing (15.4%) and the chemical and pharmaceutical industry (15%). Average growth rates were achieved in the glass, china and ceramics industry (8.3%), the metal and metal products industry (6%) and in manufacture of machinery and equipment for further production (8.9%). The food and textile industries and energy production and mineral materials extraction were broadly flat; leather industry production fell substantially (-23.8%).

In agriculture, sales of livestock showed a moderate rise. Agricultural sales, monitored by the CSO for large businesses (representing roughly half of agricultural production), increased during the first five months by 1.9% year-on-year in constant prices. The financial indicators of a selected group of major non-financial organisations and corporations were more favourable in 1998 Q1 than in 1997 Q1, indicating an upward trend in the efficiency of manufacturing processes in some branches of the economy and their contribution to GDP. This trend had already been visible in some quarters of the previous year. However, it must be taken into account that the comparison base from the same period of 1997 was very low and that the above indicators are nominal quarterly data for a selected group of organisations.

Tab.III.7. Selected Financial Indicators for Q1 1998 (current prices)

(for non-financial organisations and corporations with more than 100 employees for all industries)

Increase in Q1 1998 (y-o-y)	in %		Q1		change
			1997	1998	in % points
Total revenues	17.0	Profitability of costs (profit/costs)	3.82	5.41	1.59
Total output	16.2	Profitability of equity (profit/equity)	1.50	2.45	0.95
Total costs	15.2	Profitability of output (profit/output)	4.99	7.01	2.02
of which:					
intermediate consumption	14.9	Material costs (intermediate consumption/output)	67.06	66.32	-0.74
personnel cost <sup>1/</sup>	7.9	Wage costs (personnel costs/output)	17.43	16.18	-1.25
Pre-tax profit	63.4				

<sup>1/</sup> Includes wage and other individual costs, remuneration to members of companies and cooperatives, social security costs and social costs

With revenues outpacing costs, gross profit in 1998 Q1 grew by 13.8% against the same period of 1997 and the number of loss-making businesses dropped by one-fifth; relative savings were achieved in material consumption and production wage costs; cost, revenue and equity profitability improved. With respect to cost structure, comparatively rapid growth took place in other, financial and extraordinary costs. These accounted for about one third of total costs and led to an approx. CZK 4 bn deterioration in the economic results of businesses. With respect to sector structure, industry accounted for most of the gross profit (85%). Only transport and agriculture posted losses in 1998 Q1, although these were not as severe as in the previous year.

Nonetheless, the adverse trend in business solvency has continued; overdue commitments at the end of 1998 Q1 were 14.5% higher than for 1997 Q1, and primary indebtedness was up by CZK 21.6 bn to CZK 63.9 bn. Despite some positive signals, the overall financial situation of the corporate sector remained very poor during 1998 Q1 (e.g. the proportion of equity in corporate assets was below 50%), and the aggregate data did not fully demonstrate the increasing differentiation among individual businesses.

### III.3. The Labour Market

#### III.3.1. Wages and Financial Incomes

The downward trend in overall household income growth (increasingly visible since 1994) continued in 1998 Q1. The rise in financial household incomes slowed in nominal terms against the end of 1997 by 2.4 p.p. to 9.7%; in real terms, household incomes dipped by 3.2% and declines were seen in all the main components: wages, social incomes and other incomes. Growth in wages, the main component of household incomes, dropped by 0.5 p.p. against the end of 1997 to 7.7%.

Tab.III.8. Basic Data on Wage Development and Labour Productivity

change in % (y-o-y)

INDICATOR		SITUATION						
		1993	1994	1995	1996	1997	I/1997	I/1998
Household incomes	(nominal)	27.6	19.0	18.4	13.3	12.1	12.6	9.7
	(real)	5.6	8.3	8.5	4.1	3.3	5.2	-3.2
<i>of which:</i>								
Incomes from wages	(nominal)	25.7	19.0	18.1	16.8	8.2	11.1	7.7
	(real)	4.1	8.3	8.2	7.4	-0.3	3.8	-5.0
Average wage	(nominal)	25.0	17.1	17.5	18.0	11.9	13.7	10.9
	(real)	3.5	6.6	7.7	8.5	3.1	6.2	-2.1
National economy labour productivity		1.9	1.6	4.5	2.7	1.7	1.4	0.8
Unit wage costs (nominal incomes from wages / GDP in constant prices)		37.6	15.3	11.0	12.4	7.2	9.7	8.6

A slowdown in nominal wage growth and a decline in real wages were seen in both the business and non-business sectors. In the non-business sector, the slowdown was generated mainly by restrictive wage measures in government institutions (particularly budgetary organisations). In the business sector it was a result of ongoing restructuring, growing competition and the deteriorating financial situation of many companies; these trends led to declining employment and lower average wage growth. Real average wages fell in general. (Tab III.9.)

Tab.III.9. Average Wage change in % (y-o-y)

INDICATOR		SITUATION										
		I/96	II/96	III/96	IV/96	1996	I/97	II/97	III/97	IV/97	1997	I/98
AVERAGE WAGE IN THE CR	nominal	17.4	21.0	16.5	17.1	18,0	13.7	13.0	12.4	8.4	11.9	10.9
	real	7.9	11.6	6.6	7.8	8.5	6.2	6.0	2.3	-1.5	3.1	-2.1
<i>of which:</i>												
Non-business sphere	nominal	15.0	33.0	15.3	18.5	20.6	12.2	11.1	10.2	-6.6	5.8	5.0
	real	5.7	22.6	5.5	9.1	10.8	4.6	4.2	0.3	-15.2	-2.5	-7.3
Business sphere	nominal	18.2	17.1	17.0	16.6	17.1	14.1	13.6	13.0	13.0	13.6	12.6
	real	8.7	7.9	7.0	7.3	7.6	6.4	6.6	2.8	2.6	4.7	-0.6
<i>of which:</i>												
private organisations	nominal <sup>1)</sup>	15.6	16.1	16.0	17.2	16.1	13.7	13.2	11.6	11.9	12.7	11.3
	real	6.3	7.0	6.1	7.9	6.7	6.1	6.2	1.6	1.6	3.9	-1.8
state organisations	nominal <sup>2)</sup>	17.4	28.6	16.2	16.6	19.7	12.8	12.5	11.4	-0.4	8.6	6.8
	real	7.9	18.5	6.3	7.3	10.0	5.2	5.5	1.4	-9.5	0.1	-5.7
foreign organisations	nominal <sup>3)</sup>	16.6	11.7	12.2	18.5	14.3	17.1	12.4	17.1	14.9	17.3	5.1
	real	7.9	18.5	6.3	7.3	10.0	5.2	5.5	1.4	-9.5	0.1	-7.2

1) Include residents (natural and legal entities) without state interest

2) Include residents (natural and legal entities) with state interest

3) Include entities with 100 % foreign capital

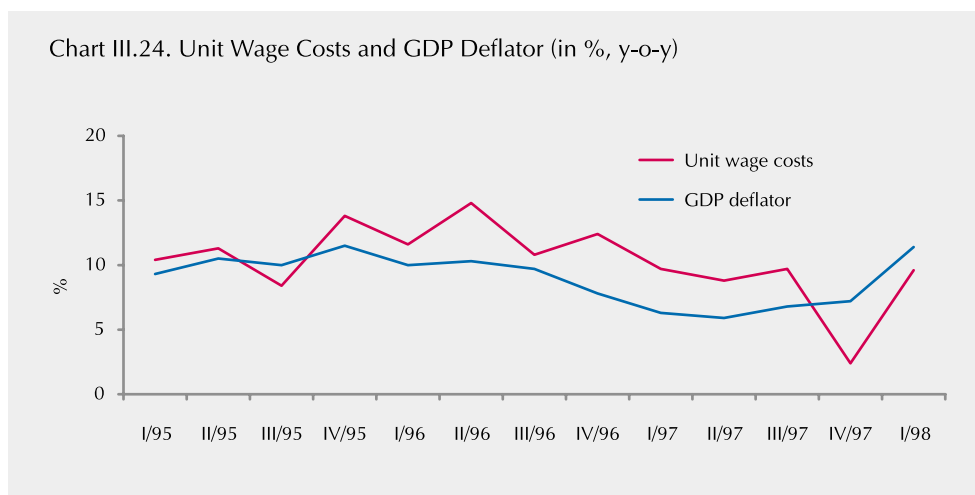
Source: CSO

Social incomes, which represent about 16% of current household incomes, also fell in Q1 (by 2 points against the end of 1997 to 11.2%). This drop was mainly due to a major reduction in health and other benefits. Other incomes, despite showing the greatest decline in growth (down 6.1 p.p. compared with the end of 1997 to 12.6%), still maintained the highest pace of increase.

Labour productivity (measured on the basis of GDP) continued to outpace the average real wage (the relationship between these is one of the indicators of demand inflationary pressure in the economy). However, this favourable trend, visible from 1997 Q3, was maintained as a result of lower labour productivity growth being accompanied by a drop in average wages against the end of 1997. This signalled a further reduction in demand pressure on prices. Labour productivity growth led average real wage growth in both industry and construction.



Nominal unit wage costs, an important cost inflation indicator and consequently an indicator of the competitiveness of domestic production, also showed signs that the favourable 1997 trend was continuing. From 1996 Q1 to 1997 Q3, unit wage costs outpaced the GDP deflator, indicating that actual wage inflationary pressures were only partially reflected in price increases; not until 1997 Q4 and 1998 Q1 were there signs of a gradual narrowing of the gap between unit wage costs and the deflator. This conclusion is borne out by the relationship between unit wage costs and industrial producer prices from 1994 to 1998 Q1; in this period PPI inflation lagged behind unit wage cost growth by 0.8 p.p. on average.



### III.3.2. Employment and Unemployment

In 1998 Q1 the labour market saw a continuation of the changes which started in the previous period. In 1997, employment decreased in absolute terms and unemployment rose. Total employment in the national economy fell by 1.3% in 1998 Q1 against 1997 Q1. The most important factors influencing the labour market in 1997 and at the beginning of 1998 were as follows:

- a slowdown and then decline of economic growth, leading to lower labour demand;
- a restructuring in some industrial businesses, resulting in higher production and labour productivity growth and a decrease in the number of employees in these businesses.

Tab.III.10. Basic Data on Employment and Unemployment

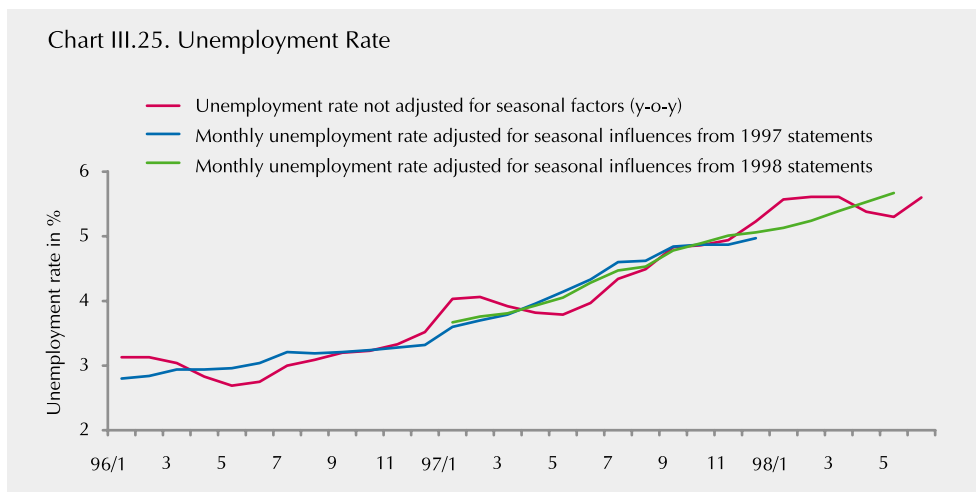
INDICATOR	SITUATION										1998					
	1993	1994	1995	1996	I/97	II/97	III/97	IV/97	1997	1/98	2/98	3/98	4/98	5/98	6/98	
Total number of employees in national economy (averages)																
Year-on-year change in %	-1.6	0.8	2.6	0.6	-0.2	-0.3	-1.4	-1.4	-1.0	-	-	-1.3	-	-	-	
Natural entities - number (in thousands)	4848.2	4884.7	5011.6	5044	4959.3	4952	4945	4941	4949	-	-	4897	-	-	-	
Number of unemployed <sup>1)</sup>																
Natural entities - number (in thousands)			153.0	186.3	199.6	202.6	247.6	-	268.9	287.1	289.2	284.1	277.6	275.3	289.5	
Unemployment rate			2.9	3.5	3.9	4.0	4.8	-	5.2	5.6	5.6	5.5	5.4	5.3	5.6	
Number of applicants per vacancy <sup>1)</sup>			1.7	2.2	2.3	2.5	3.4	-	4.3	4.7	4.6	4.4	4.2	4.4	5.0	

1) end of period balance

With respect to sectors, the fastest year-on-year decreases (greater than 3%) were recorded in construction, agriculture and finance; in industry, the decline was lower (-1.9%), but varied widely in individual branches. Statistical surveys in organisations with 20 or more employees also confirm structural shifts between the various types of organisations. Total employment in monitored organisations dropped by 2.4% year-on-year; this decline was faster in the business sector (2.8%) than in the non-business sector (0.8%). The drop in the business sector was partly absorbed by the small business sector (i.e. companies with less than 20 employees), where employment edged upwards by 1.5%.

For example, in mineral materials extraction (as a result of down-sizing programmes), coke production and oil refining and the leather industry, employment dropped by more than 7%. In contrast, employment rose in wood-processing, electrical and optical appliance manufacture and rubber and plastics production.

The upward trend in the unemployment rate, which strengthened in 1997, continued in 1998 Q1 and Q2. Despite some typical seasonal fluctuations (January - May), the unemployment rate was up another 0.4% at the end of Q2 against the end of 1997 (Chart III.25). In addition to the above-mentioned factors (the decline in economic growth, restructuring), the rise was also influenced by low labour force mobility. This factor contributed to growing regional variations in the unemployment rate and a widening of the regional skills gap between supply and demand on the labour market (structural unemployment). The highest unemployment rates (above 10%) were registered in districts of North Bohemia and North Moravia. As for the skill structure, unemployment grew most for persons with basic education. However, unemployment among secondary school graduates was also gradually on the rise.



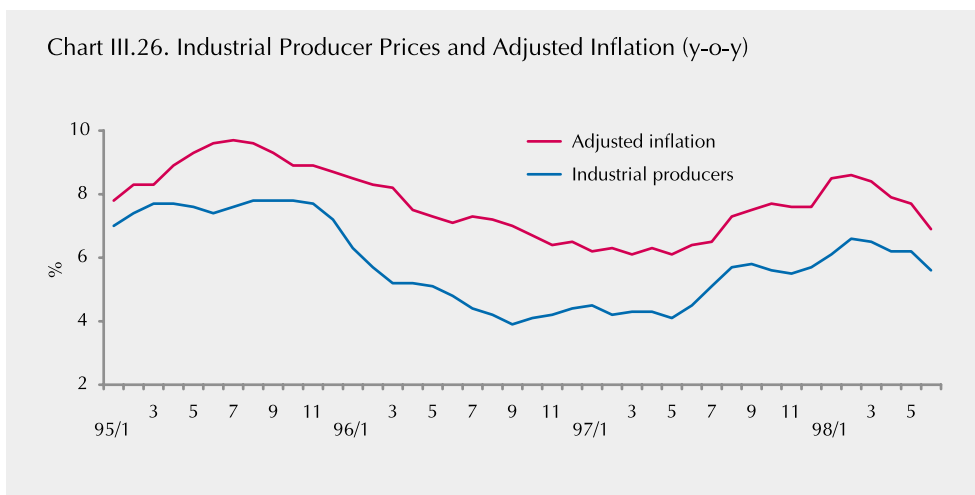
The increasing tightness on the labour market was also signalled by the falling stock of vacancies accompanying the rising unemployment rate. As at the end of June, the number of jobs on offer was down by 4,000 compared with the end of 1997. This meant there were 5 unemployed persons per vacancy in June.

### III.4. Costs and Prices

#### III.4.1. Producer Prices

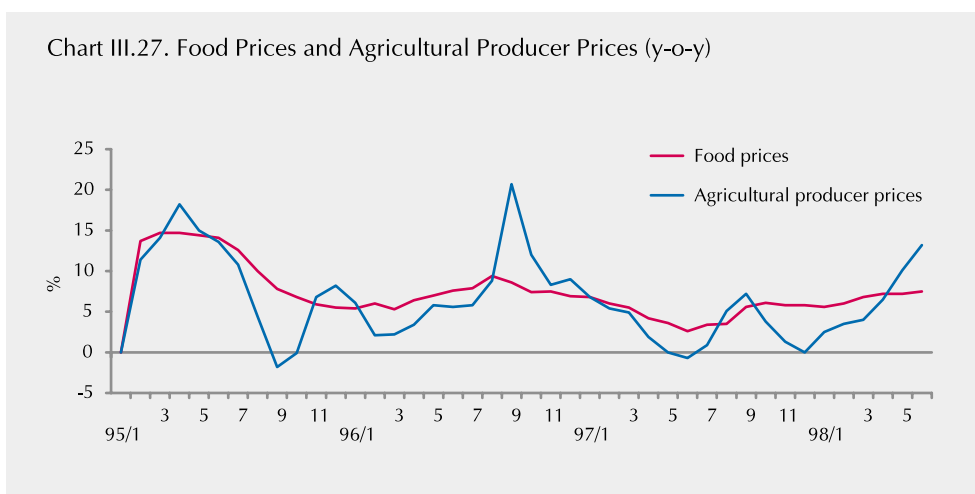
Compared with Q1, when PPI inflation was comparatively high owing to the koruna's depreciation at the end of the previous year and to negative inflation expectations, PPI growth in Q2 practically came to a halt (up by 0.1% in April and May and down by 0.1% in June in month-on-month terms). This was

due to supply and demand factors acting in parallel (weak domestic demand, exchange rate effects, wage growth in industrial corporations, world prices of raw materials). These price movements led to a reduction in year-on-year PPI inflation from 6.5% in March to 5.6% in June.



Prices for construction work grew at a slightly lower rate in 1998 Q2 than in Q1 (10.7% - 11.7% in Q1, slightly above 10% in April and May and exactly 10% in June in year-on-year terms). Despite this moderate decline there was no departure from the long-term trends for these prices. The continuing relatively rapid rise in construction work prices coupled with the overall weakening of demand in the economy suggests that inflation in this area is becoming cost-push (particularly growth in building material prices, etc.).

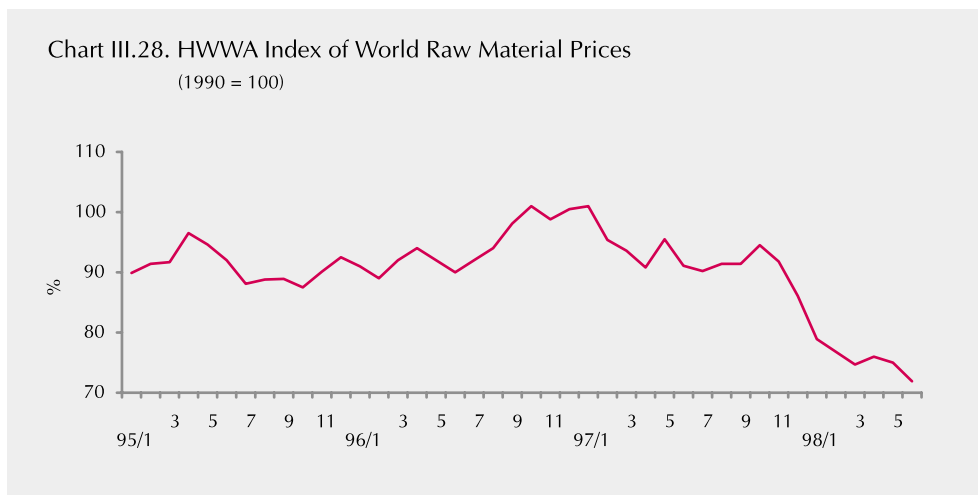
In 1998 Q1, agricultural producer prices increased by 4.5% year-on-year on average and in Q2 by more than 10% (10.1% in April, 13.2% in May and 13.1% in June). Following a gradual decline in year-on-year growth in 1994 - 1997 (10.1% in 1994, 6.1% in 1995, 6.8% in 1996, 2.5% in 1997), agricultural producer prices signalled an upward trend in the first half of 1998, mainly as a result of a longer-term lower growth rate for these prices in comparison with food prices.



### III.4.2. Import Prices

In 1998 Q2, the year-on-year growth in import prices was slower than in Q1. In January - May the rise stood at 3.7%. This comparatively favourable trend was largely due to the appreciation of the koruna's nominal exchange rate and also to a decline in world raw material prices, which was visible in 1997 but became more marked in the first half of 1998.

The raw material and food price index fell by 19.7% in 1998 Q2 compared with 1997 Q2; the steepest decline (24.4%) was registered in prices of energy raw materials. Prices of foodstuffs and industrial raw materials also fell considerably. The positive effect of decreasing world prices of raw materials was partly offset by the exchange rate. In 1998 Q1, the koruna was down 1.9% against the Deutsche Mark in comparison with the same period of 1997.



## IV. MONETARY POLICY MEASURES AND INFLATION OUTLOOK

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### IV.1. Inflation and Its Determinants - An Overview of the Main Trends

Inflationary pressures weakened during 1998 Q2. The month-on-month CPI and net inflation increases confirmed that the favourable trend in March was not an exception, but was the starting point for a several-month correction of the price increases seen in January and February. In line with CNB forecasts, inflation was at its highest in March and then gradually fell. Year-on-year net inflation dropped from 7.9% in March to 6.5% in June and CPI inflation from 13.4% to 12%. This confirms the medium-term disinflationary trend towards the short-term target for net inflation for the end of 1998 and creates good preconditions for hitting the medium-term target for the year 2000. Gradual disinflation is an essential part of the convergence process toward the economic and monetary environment in the EU.

The fall in inflation is a result of a renewal of desirable macroeconomic proportions under the influence of stabilising economic policies, and is a reflection of cost factor development. Restrictive monetary policy and a substantial slowdown in wage growth have helped to reduce domestic demand, which has been falling since 1997 Q2 in all its components. This has also been fostered by fiscal policy following the implementation of the second government package unveiled in mid 1997. While in 1997 Q1, domestic demand grew 5.2% year-on-year, in 1998 Q1 it dropped by 2.1% (excluding stock changes). Private household consumption, the most important component of domestic demand, dropped by 1.6%, mainly because of falling real wage incomes (particularly in connection with wage regulation in the public sector) and also because of the income effect of the rise in a number of regulated prices at the beginning of the year. Both government spending and investment expenses fell because of spending cuts and the prudential behaviour of commercial banks in granting credits to the corporate sector. The tightening of economic policy contributed to a slowdown in economic growth. According to a CSO estimate, GDP fell by 0.9% in 1998 Q1. However, an assessment of the full extent of the economic stagnation will only be possible on the basis of final data. This GDP development is attributable to a necessary correction of unsustainable past trends.

Under the influence of the restrictions in domestic demand, the restoration of external balance continued, leading to a further decline in the ratio of current account deficit to GDP. This was mainly due to the balance of payments deficit falling by roughly one half in the first six months of 1998 compared with the same period of 1997, despite the fact that the strengthening exchange rate gradually made imports cheaper.

The ongoing disinflationary process was boosted in Q2 by the extraordinarily favourable development of the majority of cost factors, some of which can be considered purely exogenous. This impact, positive from the point of view of costs, was connected with the exchange rate, commodity prices on the world markets, the relationship between wage growth and labour productivity growth, and industrial producer prices. Despite some partial short-term fluctuations, the first half of 1998 was broadly characterised by a gradual strengthening of the koruna's nominal exchange rate against the Deutsche Mark. The exchange rate appreciation exerted strong pressure for microeconomic restructuring and adaptation. The real exchange rate also appreciated fairly rapidly in the period. When deflated by the CPI, the koruna's real exchange rate exceeded its February 1997 level at the beginning of 1998. Commodity prices on foreign markets measured by the HWWA Index tumbled by 20.1% in the first half of 1998 compared with the same period of 1997. The deepest decline (27.1%) was registered in prices of energy raw materials. Another favourable factor was a low food price increase.

The increase in cost-push inflation was favourably affected by wage growth. This resulted in converging growth rates for unit wage costs and the GDP deflator and also in a maintaining of the lead of productivity growth over wage growth. The positive trend for all the above factors was reflected in a slowdown in the month-on-month increases in producer prices, which are one of the CPI cost factors. The PPI rose by 0.1% in April and May, while in June it fell by 0.1%. The year-on-year PPI rise slowed from 6.6% in February to 5.6% in June. These wage and industrial price developments were influenced by the restrictive macroeconomic policies in force and by favourable exogenous factors.

## IV.2. Monetary Policy

The CNB's interest rate policy was based on a conditional inflation forecast whose time horizon was gradually extended beyond the end of 1998. During Q2 the CNB left its base interest rates unchanged. The most important of these, the 2W repo rate, was maintained at 15% and served as a basis for other money market rates. While in Q1 the year-on-year price indices were high, year-on-year inflation did not fall substantially during the first two months of Q2. However, CNB forecasts ever more persuasively pointed to the onset of a trend toward a considerable reduction starting in June. The low month-on-month increases in net and overall inflation in Q2 gradually improved the credibility of the monetary policy and the probability of hitting the inflation target for 1998.

This was reflected in inflation expectations, as confirmed by the situation on the money market. Medium-term and long-term money market interest rates gradually fell in Q2. This trend was interrupted by a short-term rate increase in the second half of May and at the beginning of June in connection with the developments on the Russian financial market. Rates dropped again in the second half of June, mainly at the long end of the yield curve, indicating that the money market situation had stabilised and disinflationary expectations had strengthened. The favourable inflation expectations at the end of Q2 were confirmed by FRA and IRS rates. The IRS yield curve in particular showed a shift to a lower yield level and a strengthening of its inverse slope, owing to a more rapid lowering of rates with longer maturities.

Despite the gradual weakening of inflationary pressures, the CNB did not change its base interest rates in Q2. This was mainly because the period of comparatively favourable disinflationary macroeconomic development was still only short and the fading of the above uncertainties about the disinflationary process in the future only slow. In addition, the signs of this favourable trend in inflation appeared when inflation measured by 12-month moving price indices had reached a five-year high. The CNB was also aware that this disinflationary process was partly the result of extraordinarily favourable exogenous factors. The risk of a resurgence of a number of negative factors continued to exist in the monitored period. These included the possible emergence of new wage pressures in connection with the differing wage developments in the public and private sectors, the danger of a renewal of external imbalance and developments in the fiscal area, indicating the possibility of relatively large deficits. Although some of these uncertainties subsided to a certain extent in June, attention was focused on the negative effects of the situation on world financial markets. In view of the high degree of financial openness of the Czech economy, this situation is of great significance. For this reason, the CNB was only able to cut interest rates when the disinflationary process proved to be sustainable and shared by most market participants and when it looked very probable that the inflation target for 1998 would be met<sup>9/</sup>. A premature lowering of interest rates would be tied to a risk of a weakening of monetary policy credibility and a resurgence of inflationary expectations.

The unstable situation on Russian markets and the uncertainties associated with the pre-election period were the main factors behind the comparatively large short-term fluctuations in the koruna's exchange rate. The CNB intervened on the foreign exchange market not to maintain the exchange rate at a certain level or to influence the trend, but to moderate exogenous effects and, through foreign exchange interventions, to ensure relatively smooth shifts in foreign exchange trading between different exchange rate levels.

## IV.3. Future Inflation Factors

Compared with 1998 Q1, when there were significant uncertainties about future macroeconomic developments and inflationary pressures, the situation improved in Q2, creating a favourable environment for a reduction in inflation in the second half of the year.

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9/ The CNB lowered the 2W limit repo rate by 0.5 p.p. to 14.5% effective 17 July 1998.

It is highly probable that the absolute contraction in domestic demand which started in 1997 Q3 also continued into 1998 Q2. The CNB expects a stagnation or slight revival of domestic demand in the second half of 1998, which should not jeopardise price movements either in the next few months or in the longer term. The current domestic demand trend has created favourable conditions for the disinflationary process to continue into 1999.

The slowdown in economic growth and the pressures for restructuring and greater competitiveness in the corporate sector initiated by monetary and fiscal policy and also by the banking sector have gradually led to increasing unemployment. This is limiting the possibility of excessive wage increases.

The high proportion of risk credits and the need for provisioning to cover these are reflected in the more prudent approach of banks towards providing credit and in increased interest in high-quality assets, e.g. investment in government securities. This, together with the low volume of corporate own funds, the insignificant inflow of foreign direct investment, the decreasing expectations of economic growth and the still limited opportunities for drawing funds on the capital market, has slowed down private investment. The CNB expects investment demand to continue to be low in the future, which will ease inflationary pressures in the area of investment assets.

The contraction in domestic demand will reduce the room in the future for cost inflationary stimuli and negative inflationary expectations. The development of most cost inflationary pressures to date has been extraordinarily favourable, and it is not likely that a major turnaround will occur in the months to come. Commodity prices on world markets are not indicating any risk of price shocks in the near future. The influence of the rise in regulated prices will fade, and it is probable that the raising of these prices will slow down next year. Microeconomic development is not showing any signs of a turnaround in the existing trend of productivity growth outpacing wage growth and the GDP deflator growth rate gaining on the unit wage cost growth rate.

The disinflationary process in Q2, however, did not lead to a complete removal of the risks of possible inflationary pressures, only to a depressing of these risks. The exchange rate is one risk factor influencing inflation in the short term, i.e. over the next few months. It can be assumed that the potential exchange-rate inflationary pressure will be suppressed by low domestic demand, but substantial changes in the exchange rate due to exogenous factors are probably the only factor that could complicate the inflation target being hit at the end of 1998. In the longer term, a weakening of the exchange rate under the influence of fundamental indicators cannot be ruled out. This could happen as a result of a resurgence of external imbalance, generated by a possible revival in domestic demand if this revival is not consistent with the level of restructuring achieved and with the improving of corporate sector competitiveness. Wage development remains a medium-term risk factor in view of the share of household consumption in domestic demand and that of wages in national income. Potential pressure for wage increases can be expected in the public sector, where wage growth in the previous period was suppressed compared with the private sector. A possible budget deficit trend in the second half of the year is another risk factor, particularly in the event of a slowdown in economic growth. Increased government spending could have a longer-term impact on inflation, although overall fiscal permission will be quite strongly limited by the Maastricht criteria, which the Government is adhering to. The problem is that such a tendency might initiate, among other things, an unsustainable deterioration in the trade balance again. The fact that agricultural primary producer prices rose more slowly than food prices in the previous period might also play a role. A more substantial price acceleration on the part of primary agricultural producers would be reflected, with a certain time lag, in a food price increase.

At present, inflationary expectations are being favourably affected by the inflation trend to date. In view of the continuing disinflationary process, the CNB expects a further strengthening of the credibility of its inflation targeting strategy. Hitting the inflation target for 1998 would give the CNB's monetary policy a significant boost in credibility.

#### **IV. 4. Inflation Outlook**

The inflation outlook is based on several major factors, namely the CPI and net inflation slowdown during Q2, the favourable current development of demand factors (i.e. factors whose effects are visible with a longer time lag), the outlook for cost inflationary factors, whose effects are visible with a shorter time lag, and the gradual reduction of the risk of a potential upturn in inflation. The CNB expects net inflation to be moving above the lower limit of its 5.5% - 6.5% target range at the end of 1998. This is in line with the CNB's plans and confirms that monetary policy parameters are consistent with its medium-term disinflationary strategy. The fact that the inflation forecast for the end of 1998 is below the centre of the target range corresponds to the better-than-expected development in the exchange rate and in global raw material prices. The disinflationary process is partly attributable to exogenous factors, i.e. factors which cannot be influenced by economic and monetary policy and whose continuing effects cannot be ensured. The inflation target could therefore be threatened only in the case of an extensive exogenous shock.

As a result, the focus of the CNB's disinflationary strategy has been shifted towards ensuring that inflation gradually approaches the medium-term target for the year 2000. The CNB expects net inflation to drop in 1999 to a level creating a smooth transition towards the 2000 inflation target of 3.5% - 5.5%. The CNB will base its monetary policy decision-making in the future period on the development of the above risk factors, and will compensate for potential inflationary stimuli.

The CNB forecasts that CPI inflation will fall by the end of 1998 to the level seen at the end of 1997, and will drop below ten percent in the first few months of 1999. Any further decline in CPI inflation will be conditioned by the extent and rate of future rises in regulated prices.

## MINUTES OF THE CNB BANK BOARD MEETINGS

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### Minutes of the CNB Board Meeting on 30 April 1998

The Board evaluated the economic and monetary situation from the point of view of factors which might incite deliberations on a future change (easing) of monetary policy. These deliberations were based on data on the current situation: the low level of the last month-on-month CPI change and net inflation index, continual improvement of annualised trade and current account balances, strengthening of the nominal exchange rate of the koruna, improving the relationship between productivity and wage increases. The relatively favourable evaluation of the macroeconomic situation given by an IMF mission was mentioned as well.

At the same time, the discussion also dealt with factors which on the one hand correct seemingly favourable data, and on the other, like in previous months, represent potential risk for monetary development. The deceleration of month-on-month CPI inflation was classified as only the first signal of inflation improvement and was accompanied by a substantially higher rise in seasonally adjusted values (+0.4). CPI inflation has recently been reduced by favourable development in global raw material prices. A rise in agricultural product prices could be considered a certain risk for future CPI development.

The Board has classified the situation in the wage area, particularly the differences between the public and private sectors, as the main factor threatening the achievement of macroeconomic stability. The Board stated that preliminary data on the deceleration of wage increases were not convincing enough to rule out (mainly in the context of anticipated new wage requirements) the possible renewal of strong demand pressures. The rise in unit wage costs has inhibited future competitiveness for Czech production, thereby producing risks also for exchange rate development.

A slight decline in interest rates was linked to the calming of the situation on the financial markets. This was generated by some favourable news on economic development and led to a decrease in risk premiums. The general opinion was that positive trends could only have a short-term character while potential risks were more systemic in nature and would become apparent in the medium-term horizon. In view of the above factors, the Board decided not to change the current level of interest rates.

## Minutes of the Board Meeting on 28 May 1998

The Board reviewed factors that would have an impact on inflation in the short as well as medium run. The continuation of low monthly price dynamics was evaluated as an important positive signal. During the discussion, it was said that monthly inflation had been depressed by the exchange rate's low volatility and favourable conditions on international markets with raw materials. It was also mentioned that both factors should be viewed as temporary. Due to a slowdown in inflation, uncertainty on domestic financial markets was reduced and interest spreads fell. However, the sensitive reaction of domestic markets to recent news about developments in Russia demonstrated clearly that the gained stability was fragile.

The economic trends in the first five months of 1998 confirmed that there were positive signals on the real economy side. Consumption as well as retail sales grew more slowly. In order to prevent a negative reversal in these trends, it was stated that wage increases should not exceed productivity gains. The balance of payments data signalled that the stabilisation process was continuing. Some risk factors were identified for the medium-run outlook. The probable impact of external sector development in the Slovak Republic on the domestic trade balance was discussed.

The Board agreed that the ratio of the current account deficit to GDP was significantly reduced and was below the level usually used as a warning indicator. Nevertheless, the risks of reoccurrence of a larger deficit were mentioned together with implications for sustainability of foreign indebtedness. The concern was expressed that the domestic economy should not excessively borrow abroad. The potential for worsening borrowing conditions on international financial markets was taken into account, since foreign investors could change their investment strategies towards emerging markets after the Asian crisis. Investors could also be influenced by estimations of the impact of transition on the domestic banking sector.

The Board emphasised the role of foreign direct investment which should have a stabilising effect on various types of capital transactions. The volume of foreign direct investment was compared to recent numbers in the current account deficit. According to May data, there was a downward trend in volumes of investment, and the structure was less favourable due to a fall of the share of green field investment projects in the total volume of foreign direct investment. The weakened inflow of relatively stable capital was expected to strengthen again in the medium run if recent improvements in the investment environment were reflected in investment decisions.

The situation on domestic financial markets was discussed next. Markets were efficient and performed their regulating role. During periods of short-term capital inflows, the exchange rate appreciated and short-term interest rates decreased. For maturities up to six months, the reaction of markets was significant. Due to exogenous shocks such as important political news, the volatility of the exchange rate remained high and the short-term equilibrium level to which market converged during trading changed often. This feature of the foreign exchange market was an important factor in making monetary policy decisions. The Czech National Bank would not intervene on the foreign exchange market to keep the nominal rate close to a certain level. The Bank, however, would intervene with the aim of smoothing exchange rate movements that were a reaction to an exogenous shock and to a subsequent change in the short-run equilibrium trading level.

The Board carefully examined the expected impact of fiscal policy on the economy. In May, the magnitude of the projected budget deficit was significantly higher than assumed at the end of 1997 when the Bank announced its inflation target. Should this trend continue in the second half of 1998, concern was articulated that an additional inflation impulse might be sent to the economy. The question of what the consequences of transforming a hidden fiscal debt into securities would be for domestic financial markets was considered in this context. The improvement of fiscal transparency was assessed as a very positive factor that would increase the efficiency of financial resource allocation in the economy.

The Board evaluated the January experience with the impact of changes in regulated prices on net inflation. It was concluded that the secondary inflation impulse that was sent from the category of regulated prices to prices included in the index of net inflation was unexpectedly high and was underestimated by the 1997 analysis. However, this higher-than-expected impact on net inflation was compensated with very favourable conditions on the foreign exchange market. It was argued that the July changes in regulated prices would have a different impact on net inflation, since the composition of prices, presumably subject to changes, should be different from January's. Consequently, the impact on net inflation would be smaller due to an income effect.

After discussion of short-term and medium-term factors that influence net inflation, the Board unanimously decided to leave interest rates unchanged. The Board agreed that available information on inflation was favourable and short-term factors forming inflation did not signal that the 1998 target for net inflation would fall short of its goal. However, the medium-term factors when analysed showed several potential risks that could cause net inflation to overshoot the target if an adequate policy reaction is not adopted. Since, according to a likely scenario, all the potential risk factors would not materialise, the strategy to leave the rates unchanged was evaluated as consistent with the medium-term target for net inflation.

## Minutes of the Board Meeting on 2 July 1998

The Board evaluated changes that have taken place in the Czech economy and abroad since the last evaluation of the macroeconomic situation on 28 May 1998. The Board stated that the new May and June data confirmed a gradual decline in demand and inflationary pressures. The change in the slope of the yield curve indicated a fall in inflation expectations. It was said that if inflation expectations continued to decline in the future and nominal interest rates remained unchanged, real interest rates would rise. Furthermore, the inflationary impact occurring during the freeing up of regulated prices would not necessarily show up in total inflation due to the income effect. The nominal exchange rate and commodity prices on world markets have a positive effect on inflation in the short run. The opinion was expressed that due to the Asian crisis, a further decline in world commodity prices could not be ruled out.

It was stated that since the inflation forecast depends on the initial exogenous assumptions, under certain conditions, the inflation forecast showed an inflationary trajectory that came very close to the lower boundary of the inflation target range. Attention was drawn to responding in advance to decreasing demand due to time lags with which monetary policy instruments affect economic and subsequently inflation development.

The Board specified a number of risk factors which in the short or medium run could adversely affect inflation. The situation on world financial markets was identified as one of the risk factors which due to very volatile capital movements could negatively influence disinflation development. The CNB's alternative strategies were considered as possible responses to the vigorous strengthening of the koruna's nominal exchange rate. It was stated that due to the short-term effectiveness of these strategies and possible undesired secondary effects, no central bank intervention was desirable at that time.

Different wage development in the public and private sectors was identified as a factor which might lead to renewed demand pressures.

It was stated that the current account and its non-debt financing would have a significant influence on the sustainability of the disinflationary process. The development on world financial markets, a potential decline in foreign demand and the Czech economy's high import propensity of production were identified as the main risk factors of sustainable development.

Fiscal policy was assessed from a cyclical and structural point of view. Since economic growth was lower than in previous years, public finance performance could not be evaluated exclusively on the basis of the balance. Concentration should be on the structural aspect of the deficit. In this respect, the current development in the fiscal area was not identified as a key factor in terms of demand pressures. However, any likely increase in the public finance deficit was viewed as undesirable because of its inflationary effect.

In closing, the Board decided not to change instruments of monetary policy, and required an elaboration of additional analysis of inflation factors.

## Minutes of the Board Meeting on 16 July 1998

At its meeting on 16 July 1998, the CNB Board assessed the new inflation data and the results of the analyses that had been requested by the Board at its meeting on 2 July 1998. The Board stated that net inflation development was in compliance with the inflation targets. At the end of 1998, net inflation is likely to be in the lower part of the target interval. This would create a favourable position for the achievement of the medium-term target.

The Board opened the meeting by reviewing the latest information on the exchange rate development. The situation on the foreign exchange market was affected by the CNB foreign exchange interventions on Tuesday, 14 July 1998, which probably prevented a further shift in the exchange rate. In this context, several views were expressed about the exchange rate issues. The status of the Czech koruna on financial markets is a very significant factor of exchange rate development. Given the present stage of convertibility, the koruna exchange rate is mainly defined by financial account movements, while the current account affects the exchange rate primarily in cases of more substantial trade disequilibrium and often with a certain time lag.

Although the calming of the situation in Russia has stabilised the situation on financial markets, exchange rate corrections could still be possible in case of the activation of this external factor. Most of the Board members stressed that the latest exchange rate development was not a reason for considering cuts in interest rates and that the exchange rate would not be directly affected by the monetary policy measures. It was mentioned that the Lombard and discount rates might be reviewed in the future.

The effects of monetary policy were the main topic of discussion. Specification of the new government's fiscal and economic policies in the forthcoming two years has been very difficult up to now. This has been reflected in the increased uncertainty faced by the CNB in evaluating the impact of monetary policy measures. It was stated that this posed a serious problem since the weight of monetary transmission was presumably relatively lower in the short run than the weight of fiscal transmission. The formation of inflation expectations and their influence on investment decisions and the saving ratio were identified as an important transmission mechanism of monetary policy. A hypothesis was put forward that cost inflation factors, particularly interest rates, would prevail over the influence of subdued demand. The opinion prevailed that in the Czech economy, the problem consists more in the existence of a certain time lag between contraction of domestic demand and a slowdown in inflation. The opinion that interest rates were a significant cost factor was rejected by the majority of Board members as empirically unfounded, based on the analysis of submitted data.

The CNB Board decided unanimously to cut its two-week repo rate from 15% to 14.5%, effective 17 July 1998. The change in the interest rate reflected the change in the economic situation which was characterised by a lower risk premium and a fall in inflation expectations. The Board assumed that, under the given conditions, the newly set interest rate level was in accord with the achievement of the CNB's medium-term inflation target as well as the target for this year. Further monetary policy measures could be adopted after an analysis of the impact of the July price corrections. If the positive economic trends were to continue, the CNB would be ready to respond adequately. Should the present favourable external conditions significantly worsen or should a more principal change in fiscal policy occur, further tightening of monetary policy would be required.

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