2003

INFLATION REPORT JULY/2003

CNB CZECH NATIONAL BANK

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ABBREVIATIONS USED

CCA	Czech Consolidation Agency
CNB	Czech National Bank
CPI	consumer price index
CZK	Czech koruna
CZSO	Czech Statistical Office
ECB	European Central Bank
ECOFIN	EU Council of Economics and Finance Ministers
ECU	European Currency Unit
EFC	Economic and Financial Committee
EIB	European Investment Bank
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EU	European Union
EUR	euro
FDI	foreign direct investment
FRA	forward rate agreement
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IRS	interest rate swap
L	a monetary aggregate (see Section III.1.1.)
LFS	Labour Force Survey
LIBOR	London Interbank Offered Rate
M1	a monetary aggregate (see Section III.1.1.)
M2	a monetary aggregate (see Section III.1.1.)
MLSA	Ministry of Labour and Social Affairs
NCB	national central bank
NPF	National Property Fund
O/N	overnight
PPI	producer price index
PRIBID 1W	Prague Interbank Bid Rate, one-week
PRIBOR	Prague Interbank Offered Rate
(1M, 1Y)	(one-month, one-year)
repo rate	repurchase agreement rate
SGP	Stability and Growth Pact
SITC	Standard International Trade Classification
T-bills	treasury bills
USD	US dollar
VAT	value added tax

FOREWORD

In 1998, the Czech National Bank switched to direct targeting of inflation. In the inflation targeting regime, the central bank's communication with the public plays a significant role. One of the core elements of this communication is the regular publishing of Inflation Reports. In these pivotal documents the central bank provides information on monetary and economic developments in the previous quarter and on the reasons for the Bank Board's monetary policy measures. The Inflation Report also acquaints readers with the view of the Czech National Bank regarding future inflation factors and with the updated inflation forecast. The inflation forecast and the assumptions underlying it are published with the aim of making monetary policy transparent, comprehensible, predictable and therefore reliable. The Czech National Bank is convinced that reliable monetary policy effectively influences inflation expectations and minimises the costs of maintaining price stability. Maintaining price stability is the Czech National Bank's primary objective.

The Annex to this Inflation Report is a document that was published by the CNB in July 2003: *ERM II and the Exchange-rate Convergence Criterion*. This Inflation Report was approved by the CNB Bank Board on 7 August 2003.

An annex of statistical tables is available, together with this Report, on the enclosed CD and at http://www.cnb.cz/.

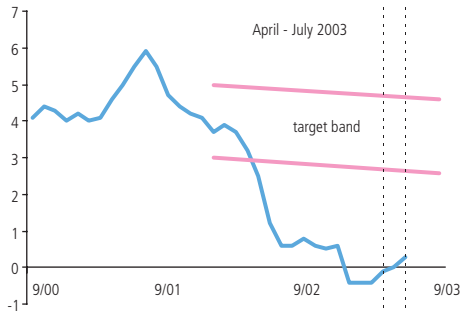
I. SUMMARY

Table I.1
INFLATION ROSE MODESTLY IN 2003 Q2
(annual percentage figures unless otherwise indicated)

	3/03	4/03	5/03	6/03
Consumer price inflation	-0.4	-0.1	0	0.3
Industrial producer price inflation	-0.4	-0.7	-0.8	-0.9
Money supply growth (M2)	2.5	3.1	2.1	n.a.
3M PRIBOR[1)]	2.39	2.45	2.45	2.33
Nominal CZK/EUR exchange rate[2)]	31.95	31.45	31.33	31.58
State budget balance since January incl. SFAOs[2)] CZK bn	-31.8	-64.4	-74.6	-53.4
GDP growth at constant prices[3)]	2.2	-	-	-
Unemployment rate[2)]	10.0	9.6	9.4	9.5

1) average for the month
2) end-of-month position
3) figure for the quarter ending with the given month

Chart I.1
INFLATION REMAINED BELOW THE TARGET BAND IN 2003 Q2
(annual consumer price inflation; percentages)



Consumer price inflation was very low again in 2003 Q2. There was a turnabout compared to the previous period, however, as inflation returned to positive figures in May after four months of negative outturns. Despite this, it remained well below the target band (see Chart I.1). Annual growth in gross domestic product picked up slightly at the start of 2003, following a slowdown that had lasted for three quarters. The seasonally adjusted unemployment rate increased further in 2003 Q2.

Annual consumer price inflation gradually picked up during Q2. In April it remained slightly negative, in May it was zero, and in June it became slightly positive for the first time since the end of 2002. The rise in inflation was chiefly due to a marked slowdown in the annual decline in food prices, which reflected changes in prices throughout the agricultural-commodity production and processing chain. A turnabout in regulated price inflation, brought about mainly by growth in natural gas prices, had the same effect. In contrast, the annual decline in import prices, reflecting a fall in prices of energy-producing raw materials (which had been rising in the previous period) and the annual appreciation of the koruna-dollar exchange rate, again had a disinflationary effect.

The Czech economy grew slightly faster in 2003 Q1 than in 2002 H2. The growth continued to be driven by domestic demand, and particularly household consumption, reflecting growth in disposable income and an increasing willingness to make instalment purchases. Government consumption contributed to the economic growth to a lesser extent. The contribution of gross fixed capital formation remained negative. The decline in investment activity resulted from the persisting weak external demand and uncertainties regarding a future recovery. The negative contribution of net exports declined relative to the previous two quarters. This was due to an improvement in goods exports, fostered in turn by the weaker koruna-euro exchange rate and an upturn in exports to Germany and other euro-area countries, despite the continuing very slow growth of their economies. A worsening services balance and appreciation of the koruna-dollar exchange rate had the opposite effect.

The further widening of the gap between the demand for, and supply of, labour led to an annual rise in unemployment in both Q1 and Q2 and a decline in employment growth in Q1. This contributed significantly to a pick-up in productivity growth and hence to a slowdown in growth of unit wage costs. Growth in overall nominal wages picked up, thanks to a sharp rise in wage growth in the non-business sector (due to an increase in wage scales at the beginning of 2003). In the first four months of 2003, given the negative inflation, real wages grew faster than nominal wages in all segments.

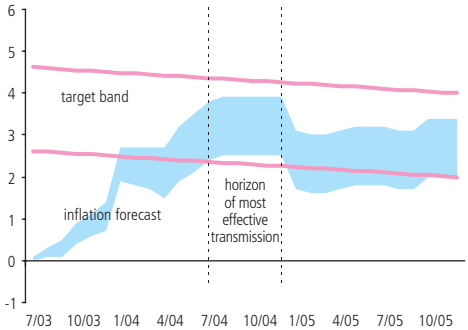
The monetary policy decision-making of the CNB Bank Board in 2003 Q2 was based on the inflation forecast discussed by the Board at its meeting on 24 April 2003 and published in the April Inflation Report. Given the monetary policy transmission lag, the Board focused on hitting the inflation target in April–September 2004. According to the forecast, inflation should be close to the upper boundary of the target band in this period and will probably deviate above it for a brief time, chiefly because of the one-off impact of the increase in indirect taxes. Approximate stability of interest rates in the months ahead and moderate growth thereafter were consistent with the starting assumptions of the forecast.

In line with this forecast, and after assessing the additional risks and uncertainties, the Bank Board voted at its meeting at the end of April 2003 to leave its monetary policy interest rates unchanged. The same decision was made at its meeting at the end of

May. Although the risks had shifted towards a disinflation path since the approval of the inflation forecast (chiefly because of the appreciation of the koruna-dollar exchange rate, the decline in prices of Ural crude oil, and the continuing subdued economic and price developments abroad), the majority of the Bank Board members were of the opinion that the weight of this newly available information was not yet sufficiently large. The Bank Board decided to reduce monetary policy interest rates by 0.25 percentage points only at its meeting at the end of June.

As usual, the Inflation Report also provides a description of the CNB's new macroeconomic forecast. The baseline scenario of the forecast predicts an easing of both components of the monetary conditions in 2003 H2 and an economic recovery abroad in 2004. As a result, there should be a modest pick-up in economic growth in both 2003 and 2004 and a gradual closing of the output gap from 2004 H2 onwards. Inflation has at the same time been revised downwards because of the change to the expected adjustments to indirect taxes and because of the change of outlook regarding the effect of the persisting negative output gap on prices. Between 2003 and 2004, nevertheless, the macroeconomic forecast predicts a gradual rise in inflation due to the changes to indirect taxes, an unwinding of the disinflationary exogenous factors and a gradual fall in the disinflationary effect of the negative output gap.

Chart I.2
THE INFLATION FORECAST IS ON COURSE FOR THE CENTRE OF THE TARGET BAND AT THE HORIZON OF MOST EFFECTIVE TRANSMISSION
(annual consumer price inflation; percentages)



At the horizon of most effective transmission, inflation will be around 3%, i.e. in the lower half of the inflation target band. Consistent with the baseline scenario of the macroeconomic forecast is a fall in interest rates in 2003 H2 and interest rate stability during the course of next year.

In addition to the above-described baseline scenario of the forecast, two alternative scenarios were constructed, expressing some of the major uncertainties of the forecast. The first alternative scenario studied the possibility of economic activity being affected more strongly by the real exchange rate, which is currently estimated as being somewhat easy. The other alternative scenario examined the consequences of the possibility that inflation expectations are less affected by the current exceptionally low inflation. Compared to the baseline scenario, the future path of interest rates consistent with these alternative scenarios is tighter.

In the longer term, the development of the Czech economy will be strongly influenced by the activities connected with the Czech Republic's eurozone accession strategy. This strategy is based on the draft published by the CNB towards the end of 2002. In co-operation with the Ministry of Industry and Trade and by agreement with the CNB Governor, the Ministry of Finance will prepare the document and submit it to the Government by the end of September 2003. The strategy – along with the Pre-accession Economic Programme (PEP) for 2003 – will include the Czech Republic's position regarding the Czech koruna's participation in ERM II and hence also the fulfilling of the exchange-rate convergence criterion as one of the Maastricht convergence criteria.

In this regard, in July 2003 the CNB published a document entitled *ERM II and the Exchange-rate Convergence Criterion,* which is attached to this Inflation Report as an Annex. The core of this document is the CNB's view that ERM II participation should be understood merely as the gateway to joining the eurozone and that staying in the mechanism for any longer than the minimum required period of two years is not desirable. Given the outlook as regards fulfilment of the other convergence criteria, the CNB recommends that the Czech Republic should remain outside the ERM II after its expected accession to the EU in May 2004.

II. INFLATION DEVELOPMENTS

Chart II.1
THE ANNUAL DECLINE IN INFLATION WAS REPLACED BY A RETURN TO POSITIVE FIGURES IN 2003 Q2
(percentages)

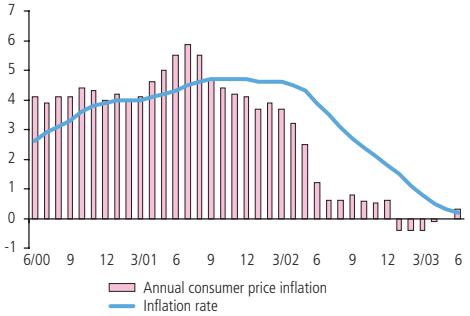


Table II.1
PRICES DEVELOPED VERY DIFFERENTLY ACROSS THE INDIVIDUAL CATEGORIES OF THE CONSUMER BASKET
(annual percentage changes)

	12/02	1/03	2/03	3/03	4/03	5/03	6/03
Food and non-alcoholic beverages	-5.4	-6.3	-6.0	-5.7	-5.2	-4.3	-1.7
Alcoholic beverages and tobacco	1.6	1.7	1.8	2.0	0.8	0.8	0.6
Clothing and footwear	-4.0	-4.6	-4.8	-5.0	-4.7	-4.7	-4.9
Housing, water, electricity, gas and other fuels	4.5	1.1	1.4	1.4	3.2	3.3	3.3
Furnishings, household equipment and routine maintenance of the house	-0.6	-0.7	-0.7	-1.1	-1.3	-1.5	-1.7
Health	4.1	4.1	4.1	4.3	4.7	4.9	4.7
Transport	0.7	1.7	2.1	2.4	0.0	-0.6	-0.9
Communications	2.4	1.8	-2.2	-2.2	-2.1	-2.2	-2.3
Recreation and culture	0.0	1.0	1.0	0.6	0.5	0.1	-1.3
Education	4.2	4.1	4.1	4.2	4.2	4.2	4.3
Hotels and restaurants	2.6	2.6	2.2	1.9	1.5	1.5	1.3
Miscellaneous goods and services	2.9	2.7	3.1	3.1	2.8	2.7	2.8
Consumer prices	0.6	-0.4	-0.4	-0.4	-0.1	0.0	0.3

Chart II.2
IMPORT PRICES CONTINUED TO DEPRESS INFLATION
(annual percentage changes)

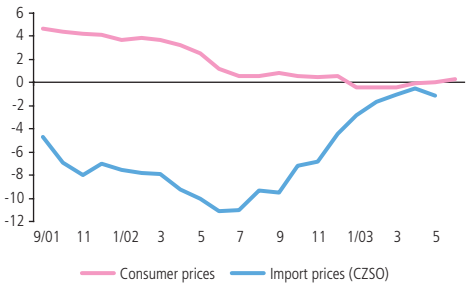
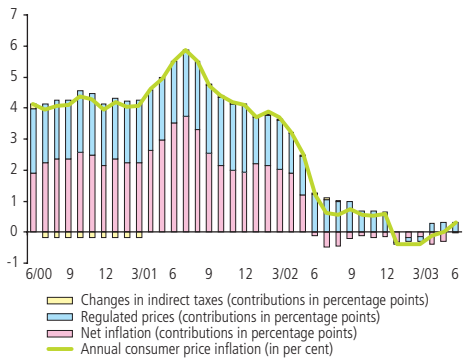


Chart II.3
REGULATED PRICES CONTRIBUTED TO THE SLIGHT UPTURN IN CONSUMER PRICE INFLATION



II.1. PAST INFLATION DEVELOPMENTS

Following four months of slight annual decline, inflation experienced a turnabout[1] in 2003 Q2 and returned to positive figures. However, the growth was only very moderate, an annual outturn of 0.3% being recorded in June. The renewed modest growth in consumer prices confirmed the prediction made by the CNB at the start of this year that the episode of negative inflation would be short-lived. The fall in annual consumer price inflation to its lowest level since the start of the transformation (-0.4% in January 2003) came on the back of seven quarters of gradual decline. Inflation remained at the January level in February and March. Then, after a slightly less negative outturn in April, it gradually headed towards very slight growth at the end of Q2. The inflation rate[2] fell by 0.6 percentage points relative to the end of Q1 to stand at 0.2% in June 2003.

The price developments in the individual categories of the consumer basket in Q2 show that the overall shift in consumer prices from annual decline to growth was not across the board in nature. Indeed, there is considerable differentiation across the categories. This can be illustrated by comparing the number of categories with increasing and falling prices between the end of Q1 and the end of Q2. In March 2003 prices had fallen in four categories and recorded growth in the remaining eight, whereas in June 2003 the number of categories with falling and rising prices was equal at six. Table II.1 shows that underlying the very modest pick-up in consumer prices at the end of Q2 was a more marked increase in prices of housing, water, electricity, gas and other fuels combined with a more considerable weakening of the annual decline in food prices. Inflation also strengthened slightly in the categories of health and education, where prices are still growing the fastest. The direction of the price developments in the other categories of the consumer basket also confirmed the differential price movements. Disinflationary trends were visible mainly for tradables. Prices of clothing and footwear recorded the largest annual fall in 2003 Q2, whereas in previous quarters food prices had been falling most quickly.

Although prices developed differently across the individual categories of the consumer basket, the low-inflation environment and low inflation expectations persisted at the aggregate economic level. With few exceptions, the basic framework of the main inflationary factors on the supply and demand sides of the economy did not change appreciably in 2003 Q2 relative to the previous quarter. Despite the long-running growth in consumer demand, which continued into Q1, the economy remained below potential. Strong competition on the retail market also had an effect. In addition, the still mostly falling import prices put limits on growth in the producer and consumer prices of competing domestic products. Falling prices of a number of inputs simultaneously gave producers some room to lower their prices. Although the upturn in prices of raw materials and food on world markets continued into Q2, the inflationary effect of this factor was offset by persisting annual appreciation of the weighted exchange rate of the koruna.[3] However, the different year-on-year developments between the koruna-dollar exchange rate (relatively strong appreciation) and the koruna-euro rate (slight depreciation) in Q2 may have passed through differently – via import prices – into the consumer prices of each particular commodity.

1 Measured by the annual consumer price index.

2 The inflation rate expressed as the increase in the average consumer price index (basic) for the 12 last months relative to the average for the previous 12 months.

3 The weighted exchange rate comprises the euro (80% weight) and the US dollar (20% weight).

The more marked changes in prices of energy-producing raw materials on world markets had a stronger impact on inflation in Q2. However, they had no across-the-board effect on consumer prices (fuel prices and gas prices for households being most affected). As in the previous period, prices of some products were more strongly affected by greater excess supply on the consumer market. The list of main factors underlying the continuing low-inflation environment also includes the significant progress made in 2001–2002 with deregulation of prices. This involved aligning the prices of the vast majority of regulated prices to their market levels, which in turn implied that changes to regulated prices would have smaller impacts on consumer price inflation in the future.[4]

The slight growth in consumer prices in 2003 Q2 resulted from growth in regulated prices. Net inflation – an indicator of market prices[5] – was flat in June at the level of a year earlier (see Chart II.3). Market prices were affected more strongly by the aforementioned factors than were regulated prices. In the case of tradables, a disinflationary effect prevailed. This spilled into other nontradable (unregulated) commodities, which displayed an overall reduction in annual inflation. From the structural point of view, it was clear that the June stagnation of annual net inflation was due to a marked weakening of the annual decline in food prices and to slower growth in non-food commodities, measured by adjusted inflation[6] (to 0.5% in June).

Food prices[7] declined more slowly in Q2 in year-on-year terms. In March 2003 food prices had decreased by 3.5% year-on-year overall, whereas the decline at the end of Q2 was only 1%. Both the categories included in this index contributed. Prices of food and non-alcoholic beverages recorded the larger change, their annual decline decreasing by 4 percentage points to 1.7% between the end of March and the end of June. Inflation in the category of alcoholic beverages and tobacco meanwhile fell by 1.4 percentage points to 0.6%.

The softer annual decline in food prices in 2003 Q2 was associated with changes in prices throughout the agricultural-commodity production and processing chain. These changes were indicated in particular by much slower declines in agricultural producer prices and food industry prices in Q2. However, the causes of the continuing annual decline in food prices remain the same: persisting excess supply of the main agricultural commodities on domestic and foreign markets, strong competition on the domestic market (mainly via import prices), and other factors (for more details, see *Other costs and prices*).

Unlike food prices, prices of other tradables (except fuels) – another segment of market prices – continued in their long-running trend of gradually deepening decline in 2003 Q2. As compared to the start of 2002, the annual decline in these non-food tradables increased by 2.2 percentage points to 2.9% in June. The continuing disinflationary trend in this segment was due to the continuing appreciation of the weighted exchange rate of the koruna and to the other market factors mentioned in the

Chart II.4
THE FLAT NET INFLATION AT THE END OF Q2 WAS THE RESULT OF CONTRARY MOVEMENTS IN FOOD PRICE INFLATION AND ADJUSTED INFLATION
(annual percentage changes)

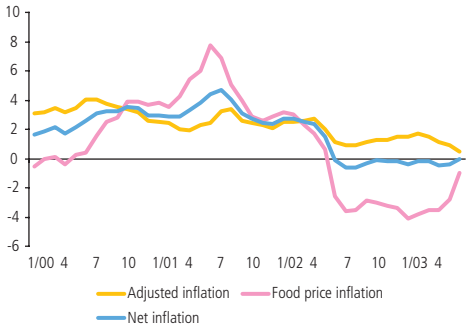


Chart II.5
THE PRICE DECLINE SLOWED THROUGHOUT THE AGRICULTURAL-COMMODITY PRODUCTION, PROCESSING AND RETAIL CHAIN
(annual percentage changes)

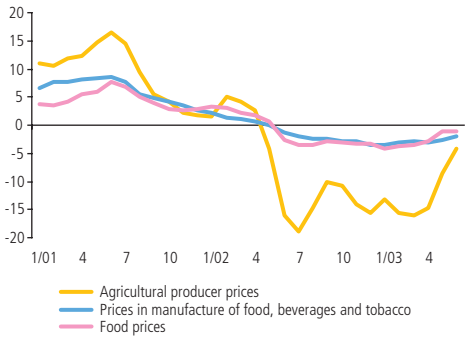
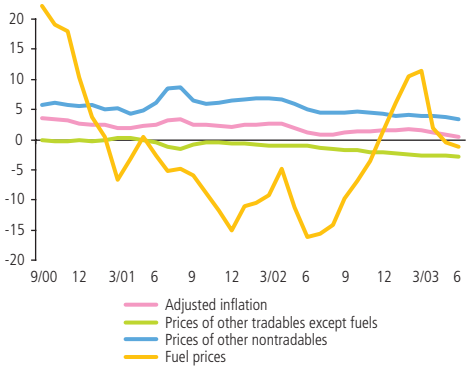


Chart II.6
THE DECLINE IN PRICES OF NON-FOOD TRADABLES (EXCEPT FUELS) DEEPENED
(annual percentage changes)



4 See the April 2003 Inflation Report, Box: *Price deregulation in the period of transformation of the Czech economy.*

5 Net inflation = consumer price inflation net of regulated prices and adjusted for other administrative measures.

6 Adjusted inflation = prices of non-food items of the consumer basket excluding regulated prices and administrative measures, i.e. fuel prices, other tradables prices and other non-tradables prices.

7 Food prices = prices of food and non-alcoholic beverages + prices of alcoholic beverages and tobacco (adjusted for administrative effects). Their share (weight) in the consumer basket is roughly one quarter.

introduction to this section (strong competition on the retail market etc.). Particularly visible was a continuing – and in Q2 very large – decline in prices of clothing and footwear (of 4.9% in June).

Fuel prices continued to respond sensitively to oil prices on foreign markets. In 2003 Q1 fuel prices had reflected the continuing upturn in growth in oil prices from the previous period (rising to 11.4% in March), whereas in Q2 this trend changed significantly. Amid an annual decline in oil prices on world markets and a still relatively strong year-on-year appreciation of the koruna-dollar exchange rate, prices of fuels recorded a slight annual fall of 0.5% in May. This decline increased to -1.2% in June.

Prices of other nontradable (unregulated) goods, which are affected chiefly by domestic factors, continued to rise. However, the increases in 2003 Q2 confirmed a continuation of the gradual downward trend in annual growth (falling by 0.6 percentage points compared to March to 3.3% in June; see Chart II.6). These were the lowest annual growth figures recorded since the start of the transformation. This positive trend was linked mainly with favourable cost inputs and low inflation expectations in the economy.

Annual growth in regulated prices picked up in 2003 Q2 (to 1.5% in June). In 2003 Q1 regulated prices had recorded their first annual decline of the transformation period (due to a reduction in electricity prices for households on 1 January 2003, and owing to lower growth in most other regulated items in January than in previous years; for more details, see the April 2003 Inflation Report), whereas in Q2 they showed slight growth. This change was due mainly to a previous sharply accelerating rise in gas prices on world markets, which by the end of Q1 was no longer being offset by annual appreciation of the koruna-dollar exchange rate. For this reason, gas prices for households were increased in April.

No other administrative changes above and beyond the framework of regulated prices were made in 2003 Q2, nor was annual consumer price inflation affected in this period by any such changes made in the past (the last changes having been made more than a year ago).

Turning to international comparisons, annual consumer price inflation in the Czech Republic was again below the inflation level in the EU countries in 2003 Q2. According to the annual Harmonised Index of Consumer Prices (HICP), Czech consumer prices displayed a slight fall in May (of 0.3%), whereas the EU countries recorded a rise of 1.8%. In Germany, HICP inflation rose by just 0.6%. Inflation in the transition economies was generally higher than in the Czech Republic; only Lithuania recorded an annual decline in prices.

II.2. FULFILMENT OF THE INFLATION TARGET

Changes to interest rates pass through into inflation most strongly with a lag of roughly 12 to 18 months. Accordingly, to assess the effect of monetary policy on the fulfilment of the inflation target in 2003 Q2, one needs to analyse retrospectively the inflation forecasts – and the Bank Board decisions based on them – dating from the end of 2001 and the first half of 2002. The analysis of the accuracy of the forecasts is limited here to a comparison of the forecast drawn up in January 2002, i.e. approximately in the middle of the aforementioned period, with inflation in June 2003 (see Table II.3).

Chart II.7
FUEL PRICES RESPONDED TO THE PREVIOUS CHANGES IN OIL PRICES
(annual percentage changes)

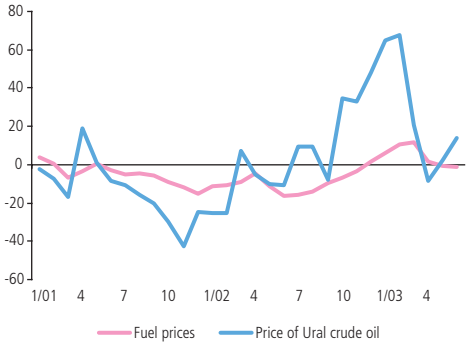


Chart II.8
UNDERLYING THE RISE IN REGULATED PRICES IN 2003 Q2 WAS SHARP GROWTH IN GAS PRICES ON WORLD MARKETS
(annual percentage changes)

Table II.2
IN MAY 2003, CONSUMER PRICE INFLATION IN THE CZECH REPUBLIC WAS LOWER THAN IN THE EU AND MOST TRANSITION ECONOMIES
(annual percentage changes, HICP)

	3/03	4/03	5/03
EU	2.3	2.0	1.8
Germany	1.2	1.0	0.6
Czech Republic	-0.6	-0.4	-0.3
Estonia	2.2	1.1	0.7
Lithuania	-1.0	-0.8	-0.8
Latvia	2.2	2.4	2.5
Poland	0.4	0.1	0.3
Romania	17.1	16.0	14.4
Slovenia	6.3	5.4	5.6
Slovakia	8.2	7.9	7.8

Source: CZSO

The January 2002 inflation forecast had indicated that the inflation target for June 2003 would be fulfilled (see the January 2002 Inflation Report). The inflation outturn in June 2003 was 2.6 percentage points lower than this forecast. Taking a closer look at the structure of price developments, the deviation was due to lower-than-expected growth in adjusted inflation except fuels and lower-than-expected growth in food prices and regulated prices. The main causes of these deviations were unexpectedly disinflationary factors that were partly or completely outside the purview of the CNB's monetary policy: an unexpected disinflationary effect of the external environment, a greater-than-expected decline in agricultural producer prices (see Section III.5.2) and a greater-than-expected appreciation of the koruna's exchange rate (see Table II.4).

When interpreting factors that do lie within the purview of monetary policy, one must take into consideration the January 2002 forecast's technical assumption of constant monetary policy interest rates.[8] This assumption has been violated by several interest rate reductions since January 2002. These interest rate changes acted in the opposite direction than the aforementioned factors. However, an easing of the interest rate component of the real monetary conditions did not occur, since the decline in nominal rates was accompanied by a fall in inflation expectations. The result was higher real interest rates, lower GDP growth and a higher rate of unemployment than assumed in the forecast. On the other hand, the decline in inflation expectations led to a rise in the real incomes of households, which in turn stimulated growth in household consumption (see Table II.5). However, the inflationary pressure from the higher-than-expected growth of household consumption was weaker than the disinflationary pressure from the developments in the external environment, agricultural producer prices and the stronger exchange rate of the koruna.

The inflation forecast is the primary source material for the Bank Board's decisions. Also of key importance for its decision-making is an assessment of the possible risks associated with this forecast by the Bank Board members. At the Board's meetings at the end of 2001 and in 2002 H1 (see the relevant minutes), the risks were perceived as slightly anti-inflationary overall. Among the downside risks, particular emphasis was put on the risk of a greater-than-expected appreciation of the koruna's exchange rate and a deeper and longer-lasting decline in foreign demand. The upside risks – among them the risk of excessive growth in real wages and pro-cyclical fiscal policy – were perceived as less significant.

Subsequent developments confirmed the majority of the risks that the Bank Board had identified at the end of 2001 and in 2002 H1. However, the several reductions in interest rates which ensued from this perception of the risks were not sufficient to eliminate the deviation of actual inflation from the inflation target in 2003 Q2 (see Chart I.1).

Table II.3
THE INFLATION OUTTURN IN 2003 Q2 WAS LOWER THAN FORECAST
(annual percentage changes; contributions in percentage points)

	January 2002 forecast	June 2003 outturn	Contribution to total difference in perc. points
Annual consumer price inflation	2.9	0.3	-2.6
Breakdown into contributions:			
regulated prices	4.3	1.5	-0.5
indirect taxes	0.0	0.0	0.0
food prices	2.6	-1.0	-1.0
fuel prices	0.0	-1.2	0.0
adjusted inflation excluding fuels	2.7	0.6	-1.1

Table II.4
THE DEVIATION OF THE JUNE INFLATION OUTTURN FROM THE FORECAST WAS MAINLY DUE TO DEVIATIONS OF EXTERNAL FACTORS

		2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2
Import prices	prediction	-6.3	-5.8	-5.3	-2.9	-0.7	2.0
(annual perc. changes)	outturn	-7.7	-10.1	-9.9	-6.1	-1.8	-
CZK/EUR exchange rate	prediction	32.3	32.3	32.0	32.0	31.8	31.8
	outturn	31.8	30.4	30.3	30.9	31.6	31.5
CZK/USD exchange rate	prediction	35.8	35.4	34.7	34.3	33.7	33.4
	outturn	36.2	33.1	30.8	30.9	29.5	27.7
Agricultural prod. prices	prediction	1.0	-2.0	-6.5	-5.8	1.0	2.0
(annual perc. changes)	outturn	3.6	-5.8	-14.5	-13.4	-14.2	-9.2
Oil prices	prediction	-24.8	-26.5	-17.5	-14.7	14.4	8.4
(annual perc. changes)	outturn	-15.4	-8.9	9.7	38.5	48.6	2.4

Table II.5
FAST GROWTH OF REAL INCOME LED TO GROWTH IN HOUSEHOLD CONSUMPTION

		2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2
GDP	prediction	2.7	2.6	2.9	3.3	3.7	3.9
(real. annual perc. changes)	outturn	2.6	2.1	1.7	1.5	2.2	-
Unemployment	prediction	9.2	8.6	9.1	9.1	9.0	8.5
(percentage)	outturn	9.1	8.7	9.4	9.8	10.0	9.5
Wages	prediction	4.2	4.9	5.6	4.9	5.0	4.9
(real. annual perc. changes)	outturn	2.4	5.1	6.3	7.1	7.3	-
Household consumption	prediction	3.0	3.1	2.9	3.1	2.9	2.9
(real. annual perc. changes)	outturn	4.1	4.3	3.6	3.8	4.6	-

8 The January 2002 forecast was a conditional forecast, i.e. it was based on the assumption of constant interest rates. Since July 2002, the CNB has been publishing unconditional forecasts, which abandon the assumption of constant rates.

III. INFLATION FACTORS

Chart III.1
ANNUAL GROWTH IN THE MONETARY AGGREGATES DECREASED IN MAY 2003
(percentages)

Definition of monetary aggregates:

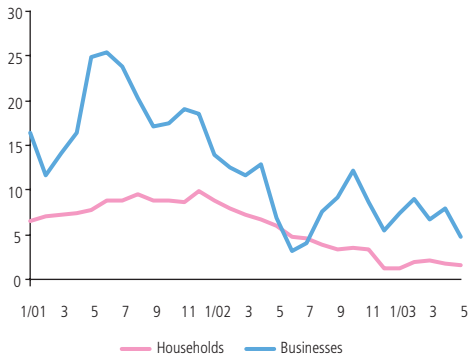
M1 = currency in circulation + CZK demand deposits
M2 = M1 + quasi money
L = M2 + T-bills in portfolios of domestic non-banks

Table III.1
THE ANNUALISED M2 GROWTH SUGGESTS A LOW INFLOW OF MONEY INTO THE ECONOMY
(percentages)

	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
February 03	-0.3	-1.1	2.8	3.7
March 03	-0.2	7.1	1.6	2.5
April 03	1.8	5.4	2.5	3.1
May 03	-0.9	2.9	0.8	2.1

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

Chart III.2
THE LOW INFLOW OF MONEY INTO THE ECONOMY WAS VISIBLE IN ANNUAL M2 GROWTH IN BOTH THE HOUSEHOLD AND CORPORATE SECTORS
(percentages)



III.1. MONETARY DEVELOPMENTS

III.1.1. Monetary aggregates

Annual growth in M2 fluctuated in March–May 2002, but showed a generally declining tendency. Money supply growth fell to a historical low of 2.1% in May 2003. However, this low was not only associated with monetary developments, but was also due to the fact that Union banka, whose banking licence was revoked with final effect in May 2003, was removed from the statistical statements. Annual money supply growth adjusted for the effect of Union banka was flat at 3.0% in May, in line with the average for the first four months of 2003. From the long-term point of view, this level was not high and corresponded to the non-inflationary development of the economy. The money supply growth in March–May 2003 was attributable mainly to continuing growth in lending, the government deficit and a decline in the volume of uncleared items between commercial banks and their clients. Annual L growth showed a downward tendency throughout March–May 2003, with no significant deviations. M1 did not show a pronounced decline until May 2003.

Monetary aggregate M2

The low annual money supply growth also reflects a low inflow of money into the economy in absolute volume. In the first five months of 2002 the money stock had risen by CZK 29 billion, whereas in the same period of 2003 the rise was CZK 26 billion (adjusted for the statistical change). A continuing low inflow of money into the economy is also indicated by the annualised M2 growth.

Sector structure of M2

The fluctuations in annual money supply growth in March–May 2003 chiefly concerned the corporate sector. Nevertheless, even in this sector a downward trend prevailed, so that annual money supply growth, which had stood at 9.0% in February 2003, fell erratically to 4.8% in May. In the household sector, the decline was smoother and less pronounced, from 2.0% in February to 1.6% in May. However, whereas in the corporate sector in March–May 2003 demand deposits were flat and koruna time deposits increased slightly, the household sector saw a continuation of the long-term trend of money supply restructuring in favour of currency in circulation, demand deposits and building society deposits, due to falling interest rates. In the first five months of 2003, building societies recorded an increase of CZK 23.8 billion in deposits, compared to increases of CZK 15.2 billion in 2000 and CZK 7 billion in 2001. In addition to the factor of rates of return, the rising volume of building society deposits reflects expected future changes to building savings schemes. Depositors' efforts to save more money with building societies are leading not only to a growing number of new agreements, but also to rising target sums for existing contracts. However, not even the rise in households' deposits with building societies is eliminating the overall decline in time deposits in this sector. In March–May 2003 building society deposits rose by CZK 20.6 billion, while the other koruna time deposits of households dropped by CZK 32.8 billion. Foreign currency deposits of households (adjusted for exchange rate effects) were flat in March–May 2003, while those of businesses rose modestly (by CZK 2.5 billion).

Monetary aggregate M1

The long-running upward trend in annual M1 growth, which started in March 2002, peaked at 20.2% in March 2003. During the subsequent decline in April and particularly in May 2003, annual M1 growth fell to 17.6% (or to 18.5% adjusted for the revocation of Union banka's banking licence). Despite this decline, the growth rate of M1 remains buoyant and the growth in currency in circulation and koruna demand deposits – supported by low interest rates on time deposits – exceeds the growth in the volume of quasi money. The growing significance of liquid money in the economy is confirmed by the growing ratio of M1 to M2, which rose from 37.2% in May 2002 to 42.9% a year later. Although the growth in the share of transactions money in the overall money stock is mainly due to the high growth rate of demand deposits, the volume of currency in circulation is also displaying significant growth. Its share of the money stock reached 12.7% in May 2003, up by 1.3 percentage points on May 2002.

TABLE III.2
THE ANNUALISED M1 GROWTH SUGGESTS BUOYANT ANNUAL M1 GROWTH INTO THE FUTURE
(percentages)

	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
February 03	2.5	11.9	16.0	19.8
March 03	-0.8	-4.9	11.5	20.2
April 03	2.3	17.3	12.9	20.0
May 03	1.7	13.7	12.8	17.6

Note: Not seasonally adjusted because of the low significance of seasonal factors

Monetary aggregate L

The money supply developments in March–May 2003 also fed through into the monetary aggregate L. In May 2003, L recorded its first-ever fall: of 0.3% (although adjusted for the aforementioned statistical change it rose by 0.6%). In addition to the money supply growth, the decline in annual L growth reflects the continuing long-term decline in the volume of T-bills held by non-banking institutions, which gradually fell from CZK 68 billion in May 2002 to CZK 29 billion in May 2003.

TABLE III.3
THE ANNUALISED SEASONALLY ADJUSTED 6-MONTH L GROWTH CONFIRMS A DOWNWARD TENDENCY
(percentages)

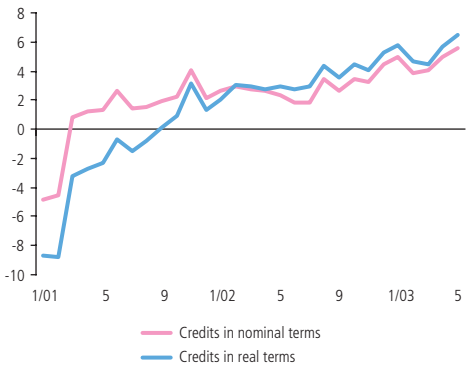
	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
February 03	-0.8	-5.2	-0.8	2.5
March 03	-0.3	1.8	-1.8	1.0
April 03	1.1	-0.1	-1.9	1.4
May 03	-0.7	0.5	-2.4	-0.3

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

III.1.2. Credits granted to businesses and households

The annual growth rate of lending adjusted for non-monetary effects continued to rise in March–May 2003, reaching 5.6% in nominal terms and 6.5% in real terms at the end of the period under review. This was the result of a continuing trend of growth in credit to households. In contrast, credit to non-financial corporations declined in the same period.

CHART III.3
LENDING CONTINUED TO RISE
(percentages)



Loans extended to households continued to grow in March–May 2003 (see the Box: *Credit to households*). Annual growth in these loans rose by 1.4 percentage points to 28.8%. Housing loans accounted for the lion's share of this rise. These loans bolstered households' investment in real estate. Housing loans amounted to CZK 111.7 billion in May 2003, with mortgage loans accounting for CZK 61 billion and building society loans for CZK 50.7 billion. In March–May 2003, housing loans increased by CZK 8.1 billion, with mortgage loans up by CZK 4.8 billion and building society loans up by CZK 3.3 billion. Their annual growth rate picked up by 0.6 percentage points to 36.9%. At the same time, the share of housing loans in households' total debt with banks increased, with mortgage loans rising by 0.9 percentage points to 31.5% and building society loans by 0.4 percentage points to 26.1%.

The absolute volume of consumer credit (including bank overdrafts and loans for temporary shortages of funds) reached CZK 65.8 billion in May 2003. This volume rose by CZK 1.9 billion in March–May 2003. However, the annual growth rate of consumer credit slowed to 26.4%. Consumer loans supported the financing of household consumption.

TABLE III.4
THE SEASONALLY ADJUSTED AND ANNUALISED 3-MONTH AND 6-MONTH CREDIT GROWTH DECREASED
(percentages)

	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
February 03	-0.4	8.5	6.9	3.9
March 03	0.0	5.0	2.5	4.1
April 03	0.8	1.8	0.9	4.9
May 03	-0.4	1.7	0.9	5.6

Note: Adjusted for exchange rate effects, write-offs, unlicensed banks, loan portfolio restructuring, the conversion of Konsolidační banka into the Czech Consolidation Agency (CCA) and the transfer of ČSOB's receivables to the CCA

Loans granted to non-financial corporations went on declining in this period. Their annual decline stood at 3.9% in May 2003. This trend was due primarily to non-financial domestic corporations. In contrast, loans to foreign-controlled non-financial corporations rose by 3.1% year-on-year.

Turning to the structure of credit by type, the proportion of operating loans was flat at 40.1% in March–May 2003, while investment loans fell by 1.5 percentage points to 28%. Continuing rises were also recorded by mortgage loans (up by 1.1 percentage points to 11%) and building society loans (up by 0.5 percentage points to 7.0%). The share of consumer credit stagnated at 7.7% and the share of loans for temporary shortages of funds fell by 4.5 percentage points to 1.1%. Turning to the time structure of credit, the upward trend manifested itself in growth in medium and long-term loans.

Box
Credit to households

Over the last few years, lending to households[9] has been rising at a considerable rate. In 2001 annual growth in credit to households had amounted to 13.7%, whereas in 2002 it reached 28.3% and in May 2003 it was 28.8%.

Turning to international comparisons,[10] the share of total credit extended to households in their consumption in the Czech Republic (12%) is converging towards the level in some of the less advanced EU countries (Greece: 26%), but remains far below the EU average (80%).[11] An analogous trend can be seen in the share of consumer credit in household consumption (3% in the case of the Czech Republic, and 9% and 13% in the cases of Greece and the EU average respectively). As regards the share of consumer credit in total credit, both the Czech Republic and Greece (with approximately 9%[12] and 10% respectively) are slightly above the EU level (8%). As for the share of housing loans in total credit, the Czech Republic (with 14%[13]) is gradually converging towards the level in Greece (20%) and the EU average (32%).

The growth rate of lending to the household sector reflects several facts. First of all, there is a relatively low base, i.e. a low level of borrowing from banks in the past. Given the relatively low level of risk of this sector, once the consolidation of the Czech banking system had been completed households became a target of interest for commercial banks. The banks focused on this sector, innovated and introduced a raft of new credit products, which in turn fostered a sharp expansion in the supply of credit. This was accompanied by growing demand for credit on the part of households. However, the rising demand – as well as being a response to the increased supply – reflected other factors such as growth in households' real incomes, a declining price level and falling interest rates.

The growth rate of lending to households raises a question regarding the possible risks to the financial stability of the banking sector. In general, households are viewed as lower-risk debtors. Whereas the share of classified loans in the total credit of the banking sector amounted to 14.7% in April 2003, the share of classified loans to households in the total credit to this sector was only 5.8%.

9 The subject of the evaluation is the trend in commercial banks' lending to households.

10 To compare commercial banks' lending to the household sector in the Czech Republic with that in other countries, the EU average and Greece have been chosen, i.e. an economic region into which the Czech Republic is being integrated and a country close to the Czech Republic with regard to economic level.

11 The data on international comparisons are drawn from the ECB's monthly bulletins and the Greek central bank's monthly statistical bulletins (data refer to 2001 unless otherwise stated).

12 2002

13 2002

However, despite the current low risk, the higher growth rate of credit to households may generate risks for the banking sector associated with worsening credit portfolio quality and a subsequent impact on its profits. These risks include in particular the possibility of a downturn in economic growth, a higher interest burden and changes in real estate prices. The risk factors may be reduced, for instance, by good quality assessments of households' future financial situation and collateral (mortgages and building savings), by the launch of a commercial register of natural persons' credits in 2002, and by the application of standard mechanisms to assess comprehensively the creditworthiness of clients (comparable in terms of quality with those applied abroad).

III.2. INTEREST RATES

Interest rates were affected by several factors in 2003 Q2. At the start of April, the longer-term interest rates were still being affected by the war in Iraq. When the war ended, interest rates stabilised, showing a slight downward tendency. The CNB at that time published its new inflation forecast, which incorporated the harmonisation of indirect taxes with those in the EU. Since most market entities had been expecting this adjustment, it did not affect the interest rate level strongly. However, interest rates, particularly those with longer maturity, started falling gradually, under the influence of other factors. These included the persisting low inflation, weak domestic economic growth, successful primary auctions of government bonds, the successful referendum on the Czech Republic's accession to the EU, the receding prospects of a recovery in major foreign economies, and the lowering of key interest rates in the eurozone and the USA. The CNB, too, reduced all its key interest rates (by 0.25 percentage points) – the 2W repo rate to 2.25%, the Lombard rate to 3.25% and the discount rate to 1.25% with effect from 26 June 2003. Part of the market was taken by surprise by this adjustment, and in particular by its timing, as most market participants had not expected this easing of monetary policy to happen until the Bank Board's meeting in July. At the end of June, interest rates fell to new historical lows. PRIBOR spot rate quotations and FRA rate quotations indicated that rates might yet be reduced further. However, the individual market participants had mixed views on this issue.

In the period under review, the PRIBOR yield curve initially moved to a higher yield level, apart from at its shortest end. Its slightly negative slope thus decreased temporarily. However, during June it steepened again. Compared to March 2003, the average 1W PRIBOR fell by 0.03 percentage points to 2.47% and the 1W PRIBOR by 0.08 percentage points to 2.28%. The spread between the two rates was -0.19 percentage points in June (compared to -0.14 percentage points in March). These figures show that only small changes took place on the money market.

The IRS yield curve also moved to a higher yield level during April, and then started falling back. The changes were larger than on the money market, particularly in the middle and longer parts of the curve. In June, the average 5Y-1Y spread was +0.74 percentage points and the 10Y-1Y spread +1.55 percentage points. IRS interest rates generally fell by 0.1–0.3 percentage points depending on maturity.

The interest rate differential (PRIBID/CZK-LIBOR/EUR, USD) was affected both by interest rate developments abroad and by interest rate movements on the domestic interbank market. In the eurozone, the repo rate was reduced by 0.5 percentage points to 2.0%. In the USA, key rates were changed by 0.25 percentage points, the O/N rate being lowered to 1.0%. Money market rates responded to the changes in key rates,

Chart III.4
THE CNB LOWERED ITS KEY INTEREST RATES
(percentages)

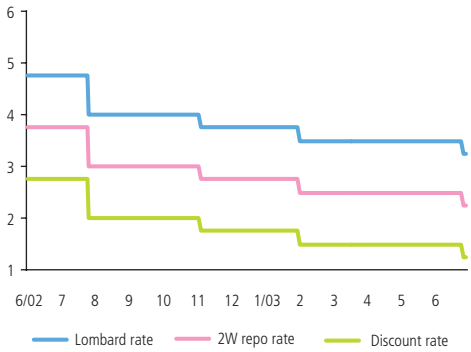
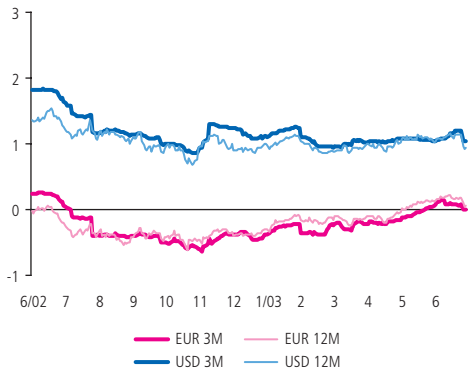


Chart III.5
MARKET INTEREST RATES FOR THE MOST PART FELL
(percentages)

Chart III.6
THE INTEREST RATE DIFFERENTIAL WAS AFFECTED BY THE CHANGES TO KEY RATES
(percentage points)



although foreign interest rates reacted to a greater extent. This was reflected in the interest rate differential. The differential vis-à-vis euro rates returned to positive figures, amounting to 0.0–0.1 percentage point depending on maturity at the end of June. The differential vis-à-vis dollar rates was 0.9–1.0 percentage points.

Three auctions were held on the primary government bond market, with original maturities of 15Y, 3Y and 10Y and a total volume of CZK 28 billion. The interest in Treasury securities remained strong: demand at the auctions always exceeded supply. The average gross yields were 4.26%, 2.72% and 3.68%. During the same period, the mortgage bond market saw securities issues amounting to CZK 2.8 billion. Issuing activity also continued on the koruna eurobond primary market, where the outstanding volume at the end of June 2003 was CZK 136.2 billion.

Given the relatively small changes on the financial market, client interest rates on loans and deposits did not change very much either. In May, nominal interest rates on new loans were 4.0% and time deposit rates 2.0%. Their downward trend has been ongoing for several years; since the beginning of the year they have fallen by 0.2 percentage points. However, the figures do not incorporate the most recent changes to the CNB's key rates at the end of June. The interest rate margin between overall loan and deposit rates remained unchanged at 3.9 percentage points in May.

Real interest rates[14] were affected not only by the aforementioned level of nominal rates, but also by developments in the price indices. The expected consumer price indices are higher than the expected industrial producer price indices. Moreover, the gap between the two indices has widened substantially since the beginning of the year. This fact is reflected in the level of real interest rates. Real rates on new loans were 3.1% in May, while real rates on time deposits were -1.6%.

III.2.1. The exchange rate

The nominal exchange rate of the koruna against the euro remained stable in 2003 Q2. After a short-lived depreciation at the start of April (to CZK 32/EUR), the exchange rate stabilised within the range of CZK 31.20–31.80/EUR. The average exchange rate was CZK 31.48/EUR, which represents a year-on-year depreciation of 3.6%.

The koruna's depreciation at the beginning of April was due to developments on world markets, in particular an appreciation of the dollar against the euro. The government bond auction on 9 April enjoyed strong interest from investors and the koruna firmed to CZK 31.35/EUR. Conversely, following the announcement of a large trade deficit (23 April) it depreciated to CZK 31.75/EUR.

In May, the koruna's exchange rate responded only to the uncertainty surrounding public finances, by briefly depreciating (9 May). In the first week in June, the devaluation of the central rate of the Hungarian forint strongly affected the exchange rate of both the koruna (which weakened to 31.50 CZK/EUR) and all other currencies in Central Europe. The positive outcome of the referendum on the Czech Republic's accession to the European Union had been widely expected, so the announcement of the results did not affect the currency. Following the CNB's rate reductions of 25 basis points on 25 June, the koruna depreciated to CZK 31.56/EUR.

Chart III.7
EX ANTE REAL INTEREST RATES SHOWED MIXED DEVELOPMENTS
(percentages)

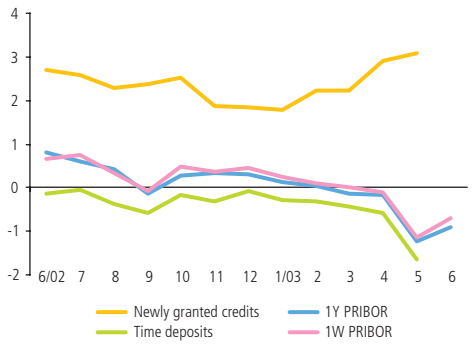


Chart III.8
THE KORUNA REMAINED STABLE IN 2003 Q2

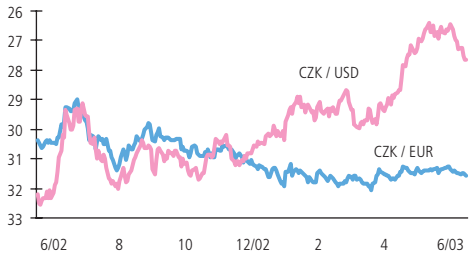
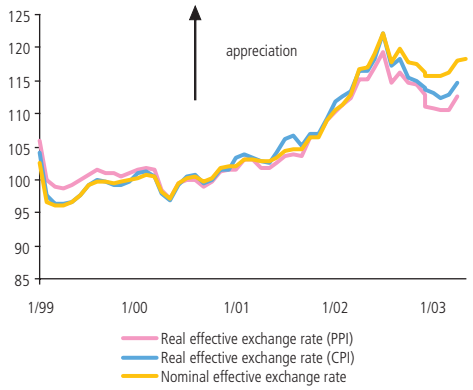


Chart III.9
THE NOMINAL EFFECTIVE EXCHANGE RATE WAS FLAT IN YEAR-ON-YEAR TERMS
(Year 2000 = 100)



14 Ex ante real interest rates: nominal interest rates on credits are deflated by the industrial producer price indices expected by the CNB each month; nominal interest rates on deposits and PRIBOR rates are deflated by the consumer price indices expected by financial market participants each month.

The koruna's exchange rate against the dollar appreciated markedly during Q2, copying the movements of the euro against the dollar. The koruna's appreciation against the dollar peaked on 27 May at CZK 26.39/EUR, then the domestic currency began to weaken again. The quarterly average rate of the koruna against the dollar (CZK 27.74/USD) appreciated by 16.11% year-on-year.

The nominal effective exchange rate index[15] recorded a rise of 2% in June relative to April, but was flat in year-on-year comparison. The real effective exchange rate indices developed in principle in line with the nominal effective rate. However, due to the lower inflation in the Czech Republic they recorded an annual decline of about 2%.

III.2.2. Capital flows

The financial account ended 2003 Q1 in a surplus of CZK 35.3 billion, down by almost one third compared to the same period of 2002. The main reasons for the annual fall in net capital inflow were a substantial increase in residents' interest in foreign debt securities and a decline in non-residents' interest in domestic securities. A decline in foreign assets of domestic commercial banks (of more than CZK 50 billion) was the most important item on the inflow side. Foreign direct investment and drawings on long-term loans by the banking sector and the corporate sector also accounted for the inflow of capital. The outflow side was dominated by purchases of foreign debt securities and by repayments of short-term liabilities by banks and businesses.

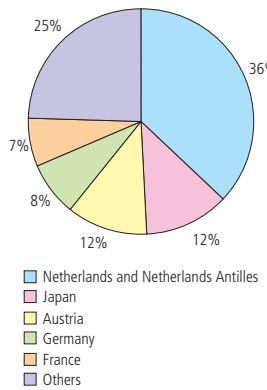
The net inflow of direct investment in 2003 Q1 amounted to CZK 32.3 billion, about the same as in 2002 Q1. The FDI inflow was CZK 33.4 billion, again roughly the same as in 2002 Q1. Reinvested earnings were still the most important item, accounting for almost two thirds of the total inflow (CZK 21.7 billion by the CNB's estimation). Sales of private property to non-residents came to CZK 4.9 billion and sales of state property reached CZK 0.4 billion. In terms of commodity structure, about one third of the total investment was attributable to investments in manufacturing. Also relatively important were investments in the banking sector and wholesale and retail trade. The biggest investor by territory was the Netherlands (which accounted for more than one third of the total), followed by Japan and Austria. At about CZK 1.1 billion, the outflow of direct investment remained insignificant.

The net outflow of portfolio investment was CZK 32.7 billion (compared to a CZK 7.8 billion inflow in 2002 Q1). This meant a continuation of the trend of portfolio investment outflow which started in the second half of 2002 (associated with interest rate developments and changing exchange rate expectations). Foreign assets of residents were up by CZK 39.9 billion. Residents' interest was concentrated almost exclusively on foreign bonds (a three-fold annual increase), whereas interest in equity securities was still very low. Part of the outflow of portfolio investment (about CZK 10 billion), however, reflected only a change in the structure of the assets of commercial banks, with deposits being replaced by bonds. The interest of non-residents in domestic securities saw a substantial decrease, mainly because of lower interest in domestic bonds. Interest in domestic shares was again negligible. The inflow of foreign portfolio investment amounted to CZK 7.2 billion (of which CZK 6.4 billion was attributable to bonds). A bond issue by the City of Prague on foreign markets worth CZK 5.4 billion was responsible for the major part of the inflow.

Table III. 5
THE FINANCIAL ACCOUNT SURPLUS DECREASED IN 2003 Q1 IN YEAR-ON-YEAR TERMS
(in CZK billions)

	2000 Q1	2001 Q1	2002 Q1	2003 Q1
Financial account	43.9	36.9	51.9	35.3
Direct investment	44.5	46.7	33.9	32.3
- Czech abroad	-0.4	-1.4	-1.2	-1.1
- Foreign in Czech Republic	44.9	48.1	35.1	33.4
Portfolio investment	-12.6	9.5	7.8	-32.7
- Czech abroad	-19.6	-1.9	-13.7	-39.9
- Foreign in Czech Republic	7.0	11.4	21.5	7.2
Financial derivatives	-1.9	0.3	0.0	-0.6
Other investment	13.9	-19.6	10.2	36.4
1. Long-term investment	4.9	-4.2	7.2	20.6
- Credits granted abroad	9.6	-6.6	14.8	14.8
- Credits accepted from abroad	-4.7	2.4	-7.6	5.8
2. Short-term investment	9.0	-15.4	3.2	15.8

Chart III.10
TERRITORIAL STRUCTURE OF FDI IN 2003 Q1

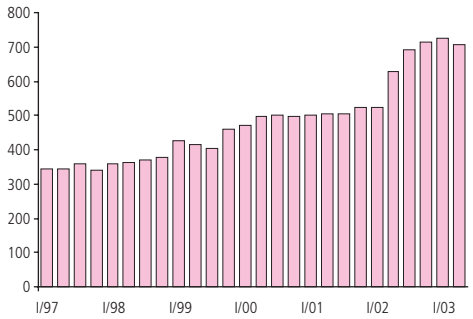


15 Weighted shares in foreign trade, including Russia.

Financial derivatives transactions again had no substantial effect on capital flows. In 2003 Q1, repayments of commitments slightly predominated, leading to a CZK 0.6 billion reduction in the financial account surplus.

Other investment recorded a net capital inflow of CZK 36.4 billion in 2003 Q1. The most significant item was a fall of CZK 53.2 billion in commercial bank assets abroad (short-term assets accounted for three quarters of this fall). The decrease in assets was associated with repayments of bank liabilities and purchases of more lucrative foreign bonds (together totalling about CZK 20 billion). Most of it was, however, used to cover foreign currency demand on the market. The net capital inflow in the area of other investment was also due to the government sector, which had net drawings on funds of CZK 6.6 billion (due in particular to the repayment of Russian debt and the receipt of a loan from the EIB). By contrast, the corporate sector saw an outflow of capital of CZK 13 billion. The main reason for this was a larger decrease in short-term trade liabilities than receivables.

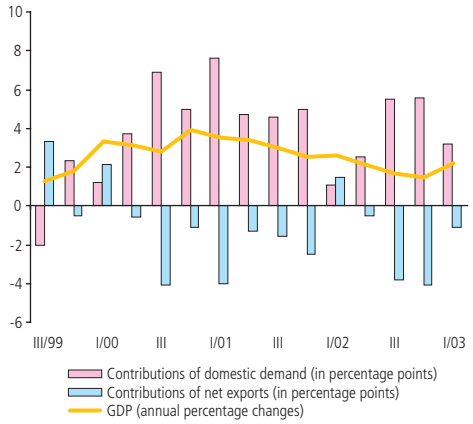
Chart III.11
THE INTERNATIONAL RESERVES RECORDED A SLIGHT FALL IN KORUNA TERMS IN 2003 Q2
(CZK billions)



In 2003 Q2, as in Q1, international reserves were affected most of all by valuation changes (primarily from the dollar's depreciation against both the euro and the koruna). The change in reserves was also attributable to interest income on the reserves and, in April, to the one-off repayment of the Government's liability of CZK 10.7 billion from the international arbitration ruling in the dispute between CME and the Czech Republic. The repayment was covered from a special National Property Fund account held at the CNB and funded from privatisation proceeds. As in the two previous quarters, there were no direct operations in the foreign exchange market aimed at affecting the exchange rate. The international reserves in koruna terms decreased from CZK 725.4 billion at the end of March 2003 to CZK 707.7 billion as of 30 June 2003. In dollar terms, the reserves rose from USD 24.7 billion to USD 25.6 billion in the same period.

III.3. DEMAND AND OUTPUT

Chart III.12
ACCORDING TO THE CZSO'S ESTIMATES, ECONOMIC GROWTH PICKED UP SLIGHTLY IN 2003 Q1



In 2003 Q1, the growth phase of the Czech economy entered its fifteenth consecutive quarter. In Q1 alone, the economic growth rate picked up slightly. Annual GDP growth was 2.2%, up by 0.7 percentage points on the previous quarter. Despite this, the negative output gap persisted. On the demand side, the growth was supported primarily by increasing expenditure on final consumption by households. The share of final consumption by the government was also significant, but its contribution to economic growth was lower than that of household consumption. Gross fixed capital formation showed an annual decrease for the second quarter, and this decline gained pace. The external sector's contribution to the GDP growth was again negative, but much less so than in Q1 (see Chart III.12). As in the previous three quarters, the economic growth in 2003 Q1 was therefore due solely to growing domestic demand. On the supply side of the economy, the GDP growth was still supported primarily by the services sector. An important change was an upturn in value-added growth in industry, after three quarters of year-on-year decline.

The economic growth recorded by the Czech Republic's major trading partners – the euro area and the EU-15 – was very modest in 2003 Q1 and weaker than in 2002 Q4 (falling by 0.4 percentage points to 0.8% and 0.3 percentage points to 1.1% respectively). In Germany alone, annual GDP growth was 0.2% in the first three months of 2003.[16] Of key

16 The data on GDP in Germany, the euro area and the EU-15 are seasonally adjusted.

importance for Czech exports, however, was the fact that import growth in these countries picked up further. In Germany, which is one of the Czech Republic's most important trading partners, imports showed particularly robust growth in Q1 (of 8.3% in year-on-year terms). The improving sales opportunities for Czech products in the euro area and EU-15 were confirmed on the other side by the CZSO's export statistics. The koruna-euro exchange rate also gradually created more favourable conditions for exporters than in the previous period.[17] The koruna-dollar rate continued to show a strong appreciation, a factor that is unfavourable from the point of view of exports.

Although foreign trade activity in the euro area and EU-15 staged something of a recovery at the start of 2003, the economic growth in these areas was, as in the Czech Republic, affected by uncertainties regarding the rate of recovery of the world economy. This fact was indicated above all by falling investment both in the Czech Republic and in the aforementioned European countries. The modest economic growth was, as in the Czech Republic, supported by domestic demand and, within its framework, mainly by growing household consumption.

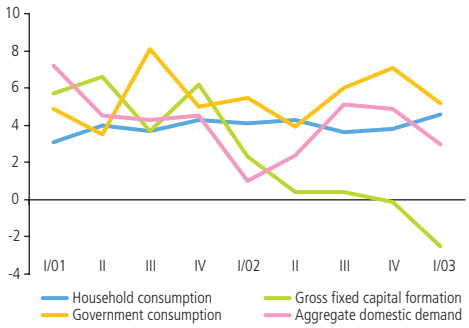
Table III.6
THE MODEST UPTURN IN FOREIGN TRADE IN THE CZECH REPUBLIC'S MAJOR TRADING PARTNERS WAS BENEFICIAL TO CZECH EXPORTS
(annual percentage changes; seasonally adjusted)

	Euro area		EU-15	
	2002 Q4	2003 Q1	2002 Q4	2003 Q1
Gross domestic product	1.2	0.8	1.4	1.1
Final consumption expenditure of households and non-profit institutions	1.0	1.5	1.4	1.8
Government final consumption expenditure	2.5	1.9	2.3	2.0
Gross fixed capital formation	-1.7	-2.3	-1.4	-1.8
Domestic demand	0.8	1.4	1.3	1.6
Exports of goods and services	3.7	3.1	2.9	2.7
Imports of goods and services	2.7	4.8	2.7	4.2

III.3.1. Domestic demand

Domestic demand was the main economic growth factor again in 2003 Q1. In year-on-year comparison, the growth in domestic demand slowed by 1.9 percentage points compared to the previous quarter, to 3%. The growth was due chiefly to rising household consumption, which accounted for about 50% of aggregate domestic demand. Other factors affecting GDP growth in Q1 were the briskly rising government expenditure and changes in inventories. As in the previous quarter, gross fixed capital formation fell short of the level of the same period a year earlier. Its contribution to aggregate domestic demand growth was thus negative.

Chart III.13
THE GROWTH IN DOMESTIC DEMAND AND GDP WAS CHIEFLY DUE TO CONSTANTLY RISING HOUSEHOLD CONSUMPTION
(annual percentage changes)

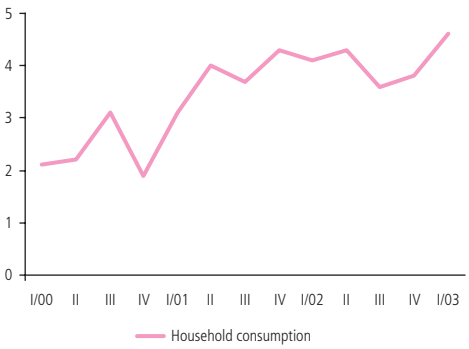


Consumer demand

According to CZSO figures, household consumption expenditure in 2003 Q1 increased for the seventeenth consecutive quarter – by 0.8 percentage points on 2002 Q4 to 4.6% in year-on-year terms. The increase at the start of 2003 was more pronounced than in previous quarters. In absolute terms, it represented an annual rise in household consumption expenditure of CZK 9.1 billion (at constant 1995 prices). As in the previous quarter, the increase in the real consumption expenditure of households was supported not only by the growth rate of disposable income, but also by the falling inflation, the increasing willingness of households to make instalment purchases, and by the relatively high level of consumer confidence.

Annual growth in gross nominal disposable income picked up substantially in 2003 Q1, rising by 4.7 percentage points on the previous quarter to 7.9%, the highest figure for four years. With the price level measured by the household consumption deflator falling by 1%, real disposable income increased more markedly than nominal disposable income. The rapid growth in the disposable income of households was the result of a simultaneous pick-up in growth of income from several sources.

Chart III.14
HOUSEHOLD CONSUMPTION GROWTH ROSE TO THE HIGHEST LEVEL IN ITS 17-MONTH-LONG GROWTH PHASE
(annual percentage changes)



17 The year-on-year appreciation of the koruna-euro exchange rate weakened further during the first two months of 2003 Q1, and March saw a modest annual depreciation.

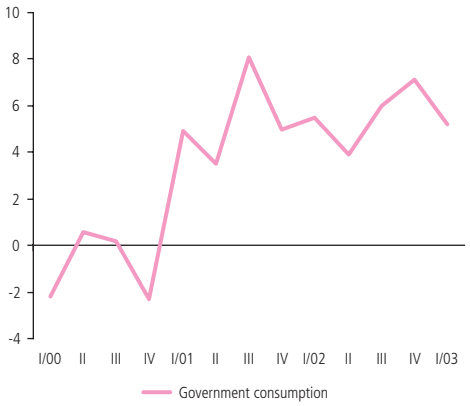
The rise in household consumption expenditure was stimulated above all by high annual growth in wages and salaries. Wages and salaries – the most important component of current household incomes with respect to volume – rose by 6.2% in Q1. At the same time, annual growth in incomes from social benefits[18] picked up as well, reaching a sizeable 9%. The rapid growth in income from non-life insurance also continued, reaching the extraordinary figure of 205.4% in year-on-year comparison and more than CZK 5 billion in absolute terms. This income was associated with insurance claims, particularly after last year's floods. As in 2002, the increasing consumption expenditure of households was also financed from credit. Household borrowing increased by CZK 9 billion in Q1. As in the previous quarter, households' propensity to consume was also bolstered by the falling inflation, which allowed them to make advantageous purchases.

Chart III.15
THE FASTER GROWTH IN HOUSEHOLDS' DISPOSABLE INCOMES WAS ACCOMPANIED BY A SHARP INCREASE IN THE GROSS SAVINGS RATE
(percentages)

To sum up, the consumption behaviour of households at the start of 2003 was characterised by a willingness to increase their consumption spending amid rising incomes, and by a willingness to borrow. These characteristics of household behaviour were indicated by a survey of the market situation of households conducted by Ecoma plus at the start of 2003. In January 2003, the consumption climate index[19] was the highest for the last several years. This, however, did not mean a substantial weakening of households' propensity to save. Only part of households' higher incomes was used for consumption expenditure; a large part was used to strengthen their financial reserves. This was confirmed by a more marked pick-up in household sector deposits (of CZK 16 billion) and in the gross savings rate in Q1. Amid more pronounced disposable income growth (of 7.9% on a year earlier) and a lower growth rate of household consumption expenditure at current prices (of 3.6%), the gross savings rate rose to 9%. In year-on-year comparison this represented a rise of 4 percentage points. This extraordinary increase in disposable income, household consumption and, in particular, the savings rate at the start of 2003, however, can be considered a temporary fluctuation rather than an indication of a significant change in trend (due to the extraordinary incomes from insurance claims, etc.).

Government demand

Chart III.16
ANNUAL GROWTH IN GOVERNMENT FINAL CONSUMPTION EXPENDITURE REMAINED BUOYANT IN 2003 Q1
(percentages)



Government final consumption expenditure maintained a relatively high growth rate in 2003 Q1. In year-on-year comparison it rose by 5.2% and behind household consumption was the largest component of the GDP growth. The growth in real final consumption expenditure by the government was also partly due to an organisational change (the government sector newly includes the track operator Správa železniční dopravní cesty, which has been hived off from the national railway company České dráhy). Without this change, government spending would have grown by 3%. The share of government final consumption expenditure in GDP was 17.4% in Q1, up by 0.5 percentage points from the same period a year earlier.

Drawing on state budget expenditure on government consumption was very mixed in Q1, thanks to the ongoing reform of regional public administration. In the case of non-investment purchases and expenditure on compensation of employees and insurance premiums, only 14.5% of the budgeted amount was drawn as of the end of March (compensation of employees decreased by 0.4 percentage points in year-on-year terms),

18 i.e. social benefits other than social transfers in kind.

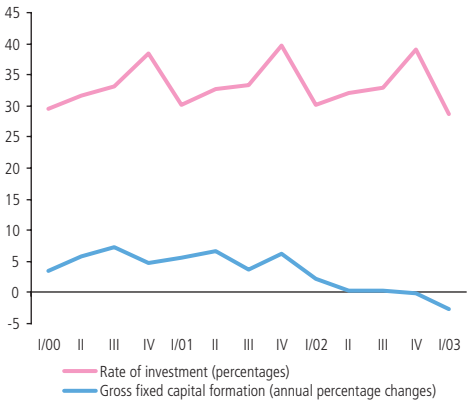
19 The consumption climate index is based on households' answers to the following enquiries: (1) a comparison of their past and present economic situation and living standards; (2) their opinion on their future economic situation and living standards; (3) their satisfaction with the current development of the Czech economy; (4) their opinion on food price and non-food product price inflation; and (5) whether or not they are saving.

whereas in the case of non-investment transfers (subsidies) to central and local public budgets, the drawing on funds greatly exceeded the "time proportions" of the budget. The largest amounts drawn were on non-investment transfers to local budgets (41.1%), this being the result of the earlier releasing of the quarterly subsidy. The drawing on non-investment transfers to central public budgets, consisting largely of transfers to social security and health insurance funds, reached about 32% of the budgeted amount. In year-on-year comparison, this meant a rise of about CZK 3.7 billion. Non-investment subsidies to subsidised and similar organisations were drawn in line with the budgeted amount.

Investment demand

The gradual weakening of the annual growth of fixed investment[20] had changed into a modest annual decline of 0.1% in 2002 Q4, and this decline increased to 2.5% in 2003 Q1. The causes of the falling investment demand are the same – it is chiefly a consequence of the previous relatively weak external demand and considerable uncertainties regarding the extent of a future recovery. These factors outweighed the positive impulse of foreign capital inflow in the form of foreign direct investment. At the same time, there still existed some limits on sources of investment financing, as indicated by the banks' continuing very cautious approach to providing investment credit (except for mortgage loans) and a slowdown in profit creation in the sector of large financial corporations.[21] However, given the absence of major investment projects, the lower investment demand may be an indication that overall production investment demand in the Czech Republic is currently saturated. The rate of investment remained relatively high (28.8%), but year-on-year it declined by 1.4 percentage points.

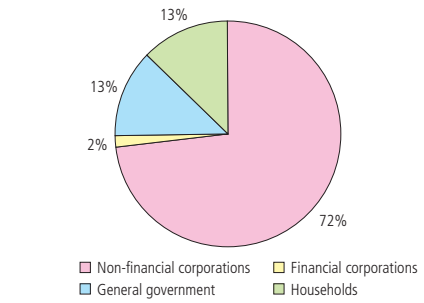
Chart III.17
INVESTMENT FELL AGAIN IN YEAR-ON-YEAR TERMS IN 2003 Q1, BUT THE RATE OF INVESTMENT REMAINED RELATIVELY HIGH



The aforementioned factors affected investment during 2002 and at the start of 2003 chiefly in non-financial corporations. In Q1, investment in this sector fell for the third consecutive quarter in year-on-year comparison (by 5.2%). In manufacturing the decline was even more pronounced (-8.5%). Despite this, non-financial corporations continued to account for most of the total investment (slightly above 70%).

As in the previous quarter, the largest decline in the sector of non-financial corporations was recorded for investment in tangible and intangible goods by public corporations (-40.4% at current prices in year-on-year terms). The falls in investment in foreign-controlled companies and domestic private non-financial corporations were not so steep (-21.8% and -5.1% respectively). In manufacturing, more than half (53%) of the investment in tangible goods (at current prices) was channelled into the manufacture of transport equipment, followed by electrical and optical equipment, basic metals and fabricated metal products, and food products, beverages and tobacco. At the same time, investment in the manufacture of transport equipment recorded an annual decrease of 54.6% (at current prices). This had a fundamental effect on investment in manufacturing and consequently also the non-financial corporations sector.

Chart III.18
INVESTMENT BY NON-FINANCIAL CORPORATIONS PREDOMINATED
(2003 Q1; percentages)



Investment by financial institutions and the household sector also recorded year-on-year falls in 2003 Q1. Financial institutions recorded a particularly large fall (of almost 50%). The decline in investment by the household sector (of 6.1%) signified a change in trend. Any assessment of this change, however, should take into account the fact that the high growth rate of household investment in the previous year (9.9%) had considerably

20 Gross fixed capital formation at constant 1995 prices.

21 See *Financial performance of non-financial organisations and corporations.*

increased the base for the 2003 calculation. The only sector whose investment demand counteracted the decline in overall investment was the government sector. The rise in government investment (including non-profit institutions) was so high that it almost offset the negative contribution of non-financial corporations.

The material structure of gross fixed capital did not develop favourably in 2003 Q1 either. The active component of the investment – machinery and equipment – recorded a year-on-year decrease of 8.5%. Investment in premises and facilities fell by just 1.3%. Only the "other investment" category showed substantial growth (of 50.2%).

III.3.2. Net external demand

In 2003 Q1, the unfavourable trend in net exports of goods and services[22] eased considerably compared to the previous two quarters. Whereas export growth picked up in year-on-year terms (by 3.2 percentage points from the previous quarter to 4%), import growth was flat or slightly falling. Negative net exports amounted to CZK 29.5 billion. This was a deterioration compared to the previous year (of CZK 4 billion), but a substantial improvement against the previous quarter (in 2002 Q4, negative net exports had increased by CZK 33.6 billion in year-on-year comparison). As a percentage of GDP, negative net exports increased by 0.9 percentage points on a year earlier to -7.8%. The contribution of net exports to GDP growth remained negative at the start of 2003.

As in the previous quarter, the annual deterioration in net exports was caused by a worsening of the services balance (of CZK 4.3 billion, with the surplus changing to a deficit). This was largely due to a widening of the other services deficit, owing to low external demand and a fall on the income side. By contrast, the trade deficit narrowed slightly (by CZK 0.3 billion in year-on-year comparison), thanks to a modest improvement in the relative growth rates of exports and imports of goods. Overall, exports and imports of goods at constant prices grew more rapidly in 2003 Q1 than in 2002 Q4. After a year of decline, exports also recorded a renewed rise at current prices (of 5.7%). The structure of goods exports at current prices did not suggest any marked changes compared to the previous quarter. The growth in exports of goods to advanced market economies (7%) was much higher than that to transition economies (2.5%). Nonetheless, the growth rates of exports to Germany and to Slovakia were quite close (at 5.2% and 4.1% respectively). As shown in Chart III.21, the bulk of the exports thus continued to go to advanced market economies, Germany in particular.

Turning to the commodity structure of exports, the positive upward trend in the proportion of exports of higher-value-added commodities continued into 2003 Q1. This is evidenced mainly by the rising share of mechanical and electrical engineering commodities in total exports of goods (annually up by 1.7 percentage points to 58.3%). Conversely, the share of exports of food products, raw materials and semi-manufactures decreased by 0.5 percentage points to 11.9%. However, the proportion of exports of other final products decreased as well.

Total imports of goods at current prices also recorded their first annual increase in a year in 2003 Q1 (of 4.9%). The growth across the individual groups of imports as regards use was quite even, unlike in 2002. The fastest growth was registered by imports for final consumption (6.6%). The growth rates of imports for intermediate consumption and for

Chart III.19
THE SHARE OF NEGATIVE NET EXPORTS IN GDP RECORDED A YEAR-ON-YEAR INCREASE IN 2003 Q1
(percentages)

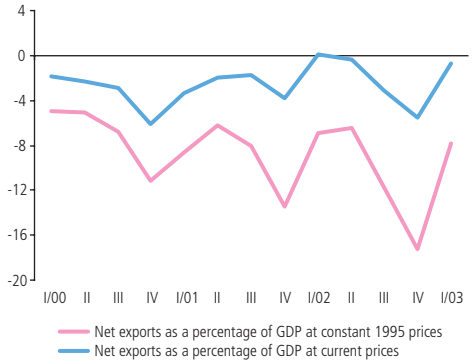
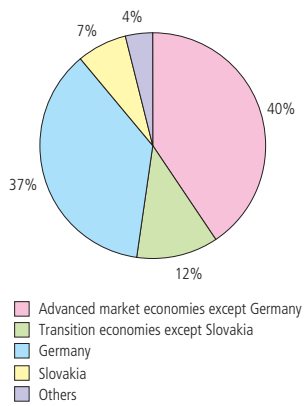


Chart III.20
EXPORTS WERE FAVOURABLY AFFECTED BY RISING GOODS EXPORTS IN 2003 Q1
(annual percentage changes; constant prices)

Chart III.21
GOODS EXPORTS WENT MAINLY TO ADVANCED MARKET ECONOMIES
(2003 Q1; percentages)



22 At constant 1995 prices.

investment were rather lower (4.8% and 4.1% respectively). The share of imports for intermediate consumption in total imports was again the largest (57.6%), this being closely linked to the development of production collaborations in recent years.

III.3.3. Gross domestic product

On the supply side of the economy, there was a fundamental change in value added in industry at the start of 2003. Since 2002 Q2, value added in industry had been declining in year-on-year terms; only manufacturing had shown a modest increase. The renewed growth in 2003 Q1 (of 2.2%, or 1.8% when seasonally adjusted) thus signifies a major change in trend. Industry accounted for almost 45% of annual GDP growth (at basic prices). The favourable trend for value added in industry was also indicated by higher profitability (accompanied by positive developments in the efficiency indicators) and total book value added in large non-financial corporations (see Section III.3.4 *Financial performance of non-financial organisations and corporations*). The favourable trends for production and value added in industry were also attributable to the relatively rapid export growth in Q1, against a background of better sales opportunities than in the previous period.

The high annual growth in industrial production in Q1 (of 6.3%, IPI) was largely due to production in high-value-added industries in foreign-owned companies that are able to sell Czech-made products abroad thanks to their extensive ties with their foreign partners. At the same time, however, it is evident that some industries are reaching capacity and their previous highly dynamic growth is starting to slow. In Q1, this trend was most pronounced in the manufacture of electrical and optical equipment, which grew by a mere 3.3%, after having recorded growth rates in the tens of per cent in past years. By contrast, other higher-value-added industries, such as the manufacture of rubber and plastic products (up by 18.9%), transport equipment (17.1%) and chemicals, chemical products and man-made fibres (7.3%), maintained high growth rates in Q1. In lower-value-added industries, production rose only slightly or stagnated.

However, the services sector still makes the largest contribution to GDP (56%). Its growth rate has been consistently positive since 1997 Q4. In 2003 Q1, gross value added in services increased by 1.8% on a year earlier. The developments in the services sector confirmed the long-term upward trend in value added, particularly in branches directly associated with the ongoing growth of the economy and its structural changes (wholesale and retail trade, transport and storage, communications, and commercial services). In construction, valued added continued falling, albeit at a slower rate than in 2002.

III.3.4. Financial performance of non-financial organisations and corporations[23]

The preliminary financial results of large non-financial organisations (with 100 employees or more) in 2003 Q1 show a deterioration compared to the same period a year earlier. Pre-tax profit fell by 11.2%, and declining profit-expenses, profit-equity and profit-output ratios were likewise recorded. However, the material cost-output ratio, the personnel cost-output ratio and the ratio of personnel costs to value added all developed relatively favourably. This was due to a fall in the growth rate of personnel costs coupled with a rise in the growth rate of output compared to 2002. Slowing

Chart III.22
INDUSTRY BEGAN TO CONTRIBUTE TO GDP GROWTH AGAIN IN 2003 Q1
(annual percentage changes; contributions in percentage points)

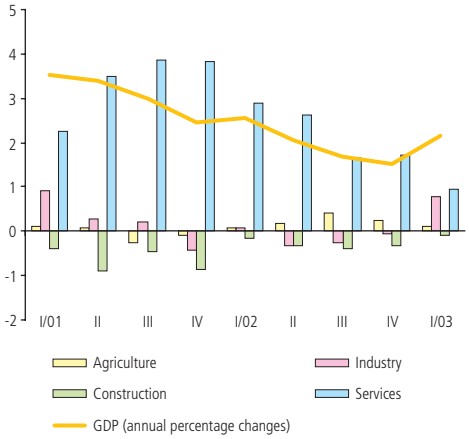


Chart III.23
EXPORTS IN INDUSTRY ROSE VERY RAPIDLY IN 2003 Q1
(2003 Q1; annual percentage index)

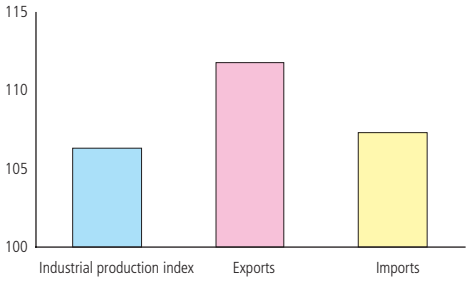


Table III.7
GROSS PROFITS DECREASED OVERALL IN 2003 Q1, BUT ROSE IN INDUSTRY
(annual percentage changes)

	2003 Q1			
	Organisations total	Industry	of which: Manufacturing	Services
Income, total	0.9	-0.6	1.8	5.4
Output, total	4.8	4.7	5.5	9.0
Income from additional activities	-7.9	-28.1	-18.5	3.1
Expenses, total	1.7	-1.5	0.5	9.3
of which: cost of sales	4.3	3.4	4.1	14.3
personnel costs1)	3.3	2.0	2.4	7.5
depreciation	4.0	5.4	4.6	2.2
Book value added	5.9	8.3	9.6	3.9
Pre-tax profit	-11.2	11.4	30.4	-52.1
Net operating surplus	11.9	18.5	28.1	-4.3

1) Comprises wage and other personnel costs, remunerations to members of companies and co-operatives, social security costs and social costs

23 Assessment based on the figures for non-financial organisations and corporations with 100 employees or more, all industries.

Table III.8
BUT THE MATERIAL COST AND PERSONNEL COST RATIOS FELL OVERALL IN 2003 Q1
(percentages; percentage points)

	2003 Q1			Change in perc. points against 2002 Q1		
	Organisations total	Industry	Services	Organisations total	Industry	Services
Profit-expenses ratio	5.95	8.26	2.95	-0.87	0.96	-3.78
Profit-equity ratio	2.96	4.21	1.56	-0.50	0.13	-1.64
Profit-output ratio	7.77	8.63	7.07	-1.40	0.52	-9.01
Material cost-output ratio	68.32	72.15	51.25	-0.32	-0.90	2.39
Personnel cost-output ratio	15.25	11.74	27.77	-0.22	-0.31	-0.38
Ratio of personnel costs to value added	48.12	42.14	56.96	-1.21	-2.60	1.90
	CZK thousands			Annual percentage changes		
Book value added per employee	138.17	156.59	122.64	8.62	12.23	2.68

growth in personnel costs and reductions in workforce were one of the main methods whereby companies tried to cut costs in an effort to defend their export markets in the face of strong foreign competition.

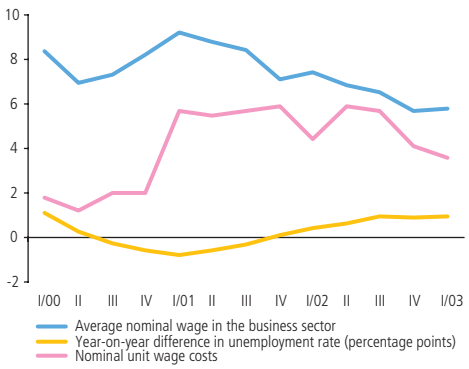
The annual declines in gross profit and the profitability indicators were caused by larger growth in total expenses than in total income. Total expenses rose by CZK 15.02 billion (1.7%), while income grew by only CZK 8.43 billion (0.9%). The structure shows, however, that the gross profit created in Q1 was unfavourably affected by losses in sideline activities. Conversely, the relatively rapid annual growth in net operating surplus (11.9%) is evidence of increasing profitability of core activities. The number of loss-making organisations increased by 17.1% in Q1. The proportion of organisations that owe wages increased as well.

Across the individual industries, however, the financial performance of large non-financial organisations and corporations was very mixed. Deteriorations were recorded in construction and in all branches of services (except for real estate, renting and business activities). By contrast, industrial branches saw marked improvements in their financial indicators, including the ratios. Gross profit here grew by 11.4%. Manufacturing alone registered an annual gross profit increase of 30.4%, which helped to increase its share in total gross profit to 50.9%. This favourable trend was to a large extent due to a relative improvement in export conditions in the Czech Republic's major trading partner nations.

As in previous quarters, the bulk of the gross profit (almost 94%) generated in Q1 was created by foreign-controlled non-financial corporations and private non-financial corporations. Foreign-controlled corporations were the only ones to show an improvement in their financial results. Their gross profit was up by 27% on a year earlier.

Although the aggregate financial performance of large non-financial organisations and corporations was not favourable in 2003 Q1, the industrial and sector structure suggested that this problem was not across the board in nature. Particularly positive from the macroeconomic point of view were the growth in profit from core activities (coming on the back of a period of decline in 2002) and the pick-up in gross profit growth in industry.

Chart III.24
THE LABOUR MARKET DEVELOPMENTS CONFIRMED THE CONTINUATION OF THE 2002 TREND
(annual percentage changes and percentage point changes)



III.4. THE LABOUR MARKET

The developments on the labour market in 2003 Q1 and Q2 signalled a further widening of the gap between the demand for, and supply of, labour. The unemployment rate recorded a year-on-year increase. However, as regards international comparisons with the EU-15 and European transition economies (according to figures for 2002) the unemployment rate in the Czech Republic was not one of the highest. A sharper decline in employment growth in Q1 fostered a pick-up in whole-economy productivity growth. Growth in nominal unit wage costs increased, owing to an increase in wage scales in the non-business sector at the start of 2003. However, thanks to higher growth in productivity, the personnel cost-output ratio decreased. Nevertheless, the growth in nominal unit wage costs and the lead of average real wage growth over whole-economy productivity growth remain high. Across the individual sectors, the personnel cost-output ratios again showed mixed developments. A particularly favourable situation was recorded in industry, where the decline in unit wage costs continued to gain pace.

III.4.1. Employment and unemployment

According to Labour Force Survey (LFS) figures, employment growth slowed further in 2003 Q1. In the previous two quarters, the annual growth in the number of people employed in the national economy had been just above 1%, but in 2003 Q1 employment rose by a mere 0.4%. In absolute terms this meant an increase of 21,200 people, which is roughly half the previous quarter's rise. Slackening growth in employment was also suggested by a fairly sizeable quarter-on-quarter decrease in the number of employed people (of 51,900 from 2002 Q4).

Further evidence of the deteriorating situation on the labour market came from the structural changes ongoing within total employment, most notably falling employment in the employees category and a simultaneously rising number of entrepreneurs (see Chart III.25). Despite the 0.4% growth in total employment, the number of employees (including members of production co-operatives) fell by 1.5% year-on-year in 2003 Q1. The falling employment in the employees category was chiefly a reaction by entrepreneurs to the previous several-quarter-long slowdown in economic growth (caused largely by weak external demand), the ongoing restructuring of the economy and to the rationalising of production activities in the strongly competitive environment.

The modest pick-up in economic growth in 2003 Q1 had yet to feed through into employment, as companies usually respond to changes in economic performance with a certain lag. Turning to the individual sectors of the economy, falling employment was particularly evident in manufacturing, mining and quarrying, and electricity, gas and water supply. In contrast, rising numbers of employed people were recorded in construction and in some service sectors.

The CZSO's business surveys provide a similar picture of employment in the employees category. According to preliminary figures, employment fell by 1.5% year-on-year in 2003 Q1. Only in the business sector did the number of employees decrease (by 2.4%, or around 79,000 people). In the non-business sector, conversely, employment increased by 2.7%, i.e.19,400 people in the same period. As in the previous quarter, the declining employment in the business sector was almost across the board in nature – with the exception of some services[24] falls in employment levels were common to every branch in this sector. The largest falls were again recorded in manufacturing, mining and quarrying, and agriculture.

The previous slowdown in economic growth and uncertainties in expectations regarding demand also adversely affected the creation of vacancies, as registered by labour offices. Since the start of 2002, the number of vacancies on offer has failed to match the level of the same period a year earlier. Turning to 2003 Q2, the number of vacancies was 6,100 lower in June in year-on-year comparison. In relative terms, this meant an increase in job applicants per vacancy from 9.3 in June 2002 to 11.6 in June 2003. The seasonally adjusted figures confirm a continuing fall in vacancies.

The combined effect of all the aforementioned factors that determine the level of employment in the economy was a further increase in unemployment. This was

Table III.9
THE UNEMPLOYMENT RATE IN 2002 WAS LOWER THAN IN THE EU MEMBER STATES AND SEVERAL TRANSITION ECONOMIES
(percentages)

	EU 15	EU 12	Germany	Czech Republic	Slovakia	Poland	Hungary
1998	9.4	10.2	9.1	6.4	.	10.2	8.4
1999	8.7	9.4	8.4	8.6	16.8	13.4	6.9
2000	7.8	8.5	7.8	8.7	18.8	16.4	6.3
2001	7.4	8.0	7.9	8.0	19.4	18.5	5.6
2002	7.7	8.4	8.6	7.3	18.6	19.9	5.6

Note: General unemployment rate as defined by the ILO
Source: Eurostat

Chart III.25
THE DECLINE IN THE NUMBER OF EMPLOYEES WAS OFFSET BY A RISING NUMBER OF ENTREPRENEURS
(annual percentage changes)

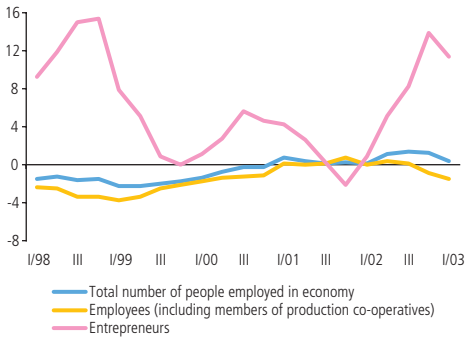
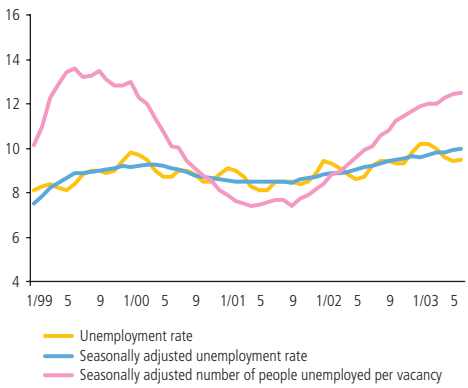


Chart III.26
THE NUMBER OF PEOPLE UNEMPLOYED PER VACANCY INCREASED
(percentages; number of persons; MLSA figures)



24 Wholesale and retail trade, hotels and restaurants, real estate activities, and health, veterinary and social work activities.

Chart III.27
THE UNEMPLOYMENT RATE INCREASED IN YEAR-ON-YEAR COMPARISON
(percentages; MLSA figures)

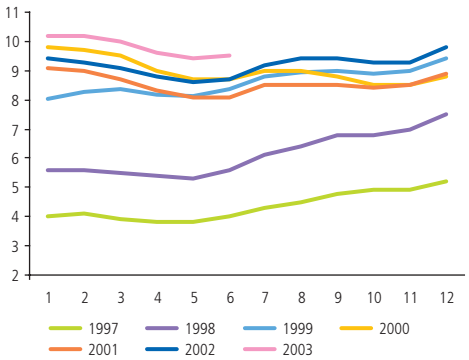


Chart III.28
THE NUMBER OF SHORT-TERM UNEMPLOYED INCREASED FURTHER IN 2003 Q1, ALTHOUGH AT A SLOWER RATE THAN IN THE PREVIOUS QUARTER
(quarter-on-quarter percentage changes; LFS and MLSA figures)

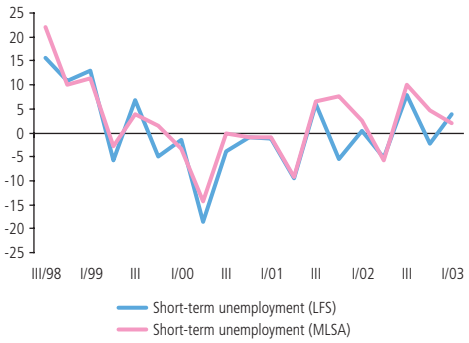


Table III.10
WITH INFLATION NEGATIVE, THE AVERAGE REAL WAGE ROSE FASTER THAN WAGES IN NOMINAL TERMS
(annual percentage changes)

	2001 Q4	2001	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2002	2003 Q1
Average wage in monitored organisations (nominal)	7.7	8.7	7.1	7.7	7.4	6.7	7.2	7.4
Average wage in monitored organisations (real)	3.3	3.8	3.3	5.3	6.7	6.2	5.3	7.8
Average wage in business sector (nominal)	7.1	8.4	7.4	6.8	6.5	5.7	6.5	5.8
Average wage in business sector (real)	2.7	3.5	3.6	4.4	5.8	5.2	4.6	6.2
Average wage in non-business sector (nominal)	9.5	9.8	6.0	11.2	11.3	10.3	9.8	14.5
Average wage in non-business sector (real)	5.0	4.9	2.2	8.7	10.5	9.8	7.9	15.0
Whole-economy labour productivity	2.3	2.6	3.0	1.3	0.6	0.3	1.3	2.1
Nominal unit wage costs	5.9	5.7	4.4	5.9	5.7	4.1	5.0	3.6

Source: CZSO; CNB calculation

indicated both by a further rise in the number of registered unemployed people[25] and by a continuing growth trend for the seasonally adjusted registered unemployment rate. According to the figures for June 2003, the number of registered unemployed people was up by 46,700 and the unemployment rate by 0.8 percentage points to 9.5% on the same period a year earlier. The labour market meanwhile saw persisting regional, professional and skills gaps between the supply of, and demand for, labour. As of June, 18 districts recorded an unemployment rate of more than 12%, most of them in northern Bohemia and northern Moravia.

The further rise in total unemployment manifested itself chiefly in growing short-term unemployment. According to MLSA figures, the number of short-term unemployed (up to one year) increased by 6,100 in 2003 Q1 compared to the previous quarter, while the short-term unemployment rate rose by 0.1 percentage point to 6.2%. The growing mismatches between demand and supply on the labour market meanwhile made it more difficult for those who lost their jobs in the previous period to find work. As a result, the number of long-term unemployed also increased (by around 7,600 in 2003 Q1 compared to 2002 Q4). The long-term unemployment rate rose to a record high in 2003 Q1 (of 3.8%). It stayed at this level in Q2, whereas the short-term unemployment rate fell slightly (to 5.7%). The causes of the rising long-term unemployment are the same as those given in the last Inflation Report – their existence and growth are linked not only with the ongoing restructuring of the economy, but also with the low mobility of the labour force in the Czech Republic.

III.4.2. Wages and productivity

The slackening annual growth of average nominal wages[26] recorded in the past two quarters was replaced at the start of 2003 by a sharp upturn in the rate of growth. This change was caused by wage growth in the non-business sector, where an upward revision of wage scales on 1 January 2003 led to a sizeable pick-up in the growth rate of average nominal wages. Compared to 2002 Q4, average nominal wage growth rose by 4.2 percentage points to 14.5% (a similar revision in March 2002 had caused wages in the non-business sector to rise by 11.2%). The January revision to wage scales related chiefly to workers in the education and health sectors, whose wages rose by almost 17% and 15% respectively following the change.

By contrast, wages in the business sector signalled no major changes in 2003 Q1. The only very slight growth of average nominal wages compared to 2002 Q4 (by 0.1 percentage point to 5.8%) cannot as yet be regarded as a break in the previous gradual downward trend in wage growth linked with the falling demand for labour. The appropriateness of the wage trend must also be assessed in the context of the productivity indicators. A positive example is the relationship between wages and productivity in industry, as described below.

As in the previous quarter, real wages were strongly affected by the falling inflation level. In the monitored organisations as a whole, real wages recorded annual growth of 7.8% in Q1, up by 1.6 percentage points on the previous quarter. In the non-business sector, average real wages rose by an exceptional 5.2 percentage points year-on-year compared to the previous quarter, thanks to faster growth in average nominal wages and negative inflation.

25 The MLSA's unemployment statistics are based on registered unemployment.

26 In the set of monitored organisations.

In the business sector, the rise was just 1 percentage point. These facts undoubtedly contributed to the growth in households' consumption expenditure in early 2003.

Whole-economy productivity growth also picked up in 2003 Q1 (to 2.1% year-on-year). This meant a change in trend, as whole-economy productivity growth had gradually slowed during 2002 (to 0.3% in Q4) in conditions of subdued economic growth and lagged changes in employment. The pick-up in whole-economy productivity growth in the first three months of 2003 was due chiefly to the sharper decline in employment growth than in the previous period.

The positive change in productivity fostered an improved relationship between wage and productivity growth at the macroeconomic level. This was evidenced in particular by annual growth in nominal unit wage costs, which slowed by 0.5 percentage points in Q1 compared to the previous quarter, to 3.6%. Nevertheless, it remained relatively high. The reason was the rapidly rising average wages in the non-business sector, which caused the growth rate of the volume of wages and salaries in the economy to remain flat or increase very slightly in Q1 (to 5.8% year-on-year). Just as in the previous quarter, nominal unit wage costs were also adversely affected by the personnel cost-output ratios in parts of the business sector, for example construction (where nominal unit wage costs recorded annual growth of 7.2% in Q1).

In industry,[27] however, the relationship between wage and productivity growth was again positive in 2003 Q1. Growth in labour productivity[28] remained significantly higher than average real wage growth (4.4 percentage points higher) and nominal unit wage costs recorded an annual fall. This was fostered mainly by rapid growth in labour productivity in foreign-controlled corporations. The persisting relatively fast growth in labour productivity was achieved not only through prior implementation of new investments (linked with the introduction of new technology), but also through rationalisation of production activities, which led to more efficient management of production and inputs. The last-mentioned factors were one of the causes of a continuing decline in employment in industry. In Q1 alone, employment in industry fell by 2.6 percentage points. A downward trend in the personnel cost-output ratio in industry was also suggested by figures on this ratio in large non-financial corporations (see *Financial performance of non-financial organisations and corporations*).

To sum up, the personnel cost-output ratios in the economy showed mixed developments. One positive phenomenon was a continuing decline in the personnel cost-output ratio in industry, which is having to cope with the strongly competitive environment both at home and abroad more than any other sector. The falling or only moderately rising producer prices – in conditions of still mostly falling import prices and a strongly competitive environment on the retail market – suggested that there was again no pass-through of demand or wage-cost pressures into prices in 2003 Q1.

III.5. OTHER COSTS AND PRICES

The development of other costs and prices in 2003 Q2 suggested no major changes that might stimulate wider growth in consumer prices. Growth in prices of industrial raw materials and food on world markets remained relatively high in Q2, but, with the koruna-dollar exchange rate continuing to appreciate, the koruna prices of

CHART III.29
GROWTH IN UNIT WAGE COSTS WAS MIXED
(annual percentage changes)

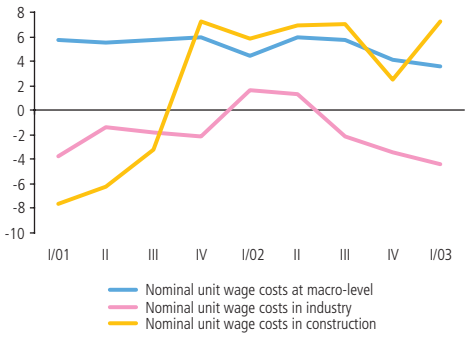


CHART III.30
THE FASTER PRODUCTIVITY GROWTH THAN WAGE GROWTH IN INDUSTRY ENGENDERED A FALL IN THE PERSONNEL COST-OUTPUT RATIO
(annual percentage changes)

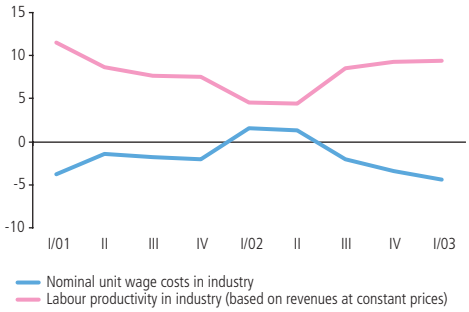
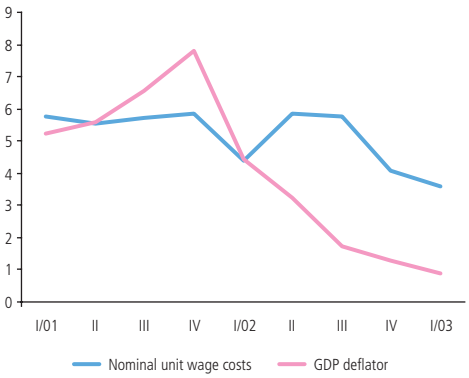


CHART III.31
THE RISE IN THE PERSONNEL COST-OUTPUT RATIO DID NOT LEAD TO GROWTH IN PRICES
(annual percentage changes)



27 Industry covers around 40% of the employees in the statistically surveyed organisations.

28 Calculated from sales receipts at constant prices.

Chart III.32
PRODUCER PRICES CONTINUED TO CREATE CONDITIONS FOR LOW/NEGATIVE CONSUMER PRICE INFLATION
(annual percentage changes)

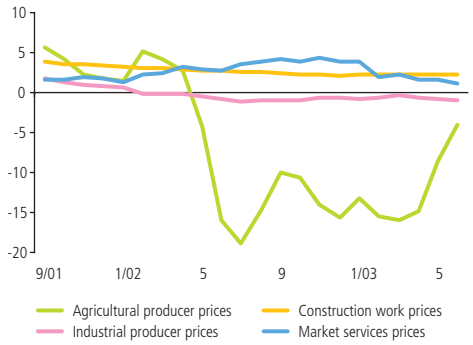


Chart III.33
IN 2003 Q2, PRICES OF INDUSTRIAL RAW MATERIALS AND FOOD RECORDED A CONTINUING RENEWAL OF GROWTH ON WORLD MARKETS
(annual percentage changes; CZSO figures)

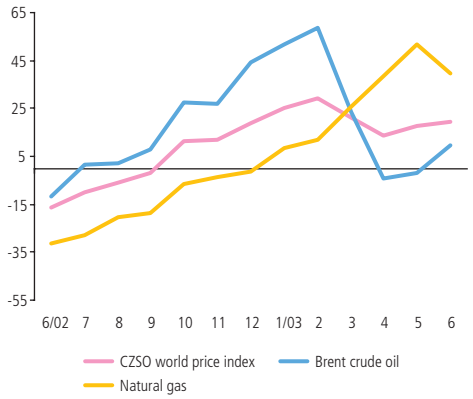
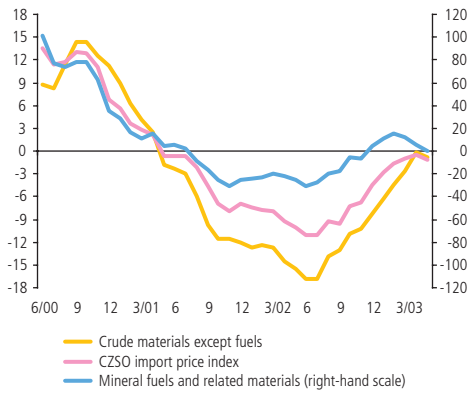


Chart III.34
BUT IMPORT PRICES DECLINED SOMEWHAT OVERALL
(annual percentage changes)



imports for the most part fell in annual terms. Oil prices changed markedly, recording moderate annual decreases in April and May following sharp rises in the previous months. These swings fed through directly into import prices and subsequently into producer prices in oil-product-processing sectors.

In other manufacturing sectors, the decline in producer prices was generally moderate. Conversely, agricultural producer prices continued to record a fairly strong annual decline, although this moderated appreciably in Q2. According to CZSO estimates, annual construction price inflation remained flat and market services price inflation continued to fall.

III.5.1. Import prices

Growth in world prices of imported industrial raw materials and food commodities, measured by the CZSO world price index,[29] was relatively high in Q2, despite being lower than in the previous quarter. In Q1 the CZSO world price index had reached values of 25% on average, whereas in Q2 the growth slowed to 17% on average (19.2% in June).

The main cause of the weaker annual growth in world prices of raw materials was a sizeable change in the dollar prices of oil on world markets. As shown in Chart III.33, the previous buoyant growth (of 23.2% year-on-year in March) was replaced by a modest decline in April and May. In June, oil prices rebounded, recording annual growth of 9.8%. Natural gas prices, which usually react to oil prices with a certain lag, began to rise again at the beginning of 2003. In Q1 and Q2 the growth picked up, reaching 52% in May before falling back to 39.6% in June. These high year-on-year figures helped to sustain the growth in prices of energy-producing raw materials[30] – which are the main component of the CZSO world price index – in April and May (21.2% in May), despite the modest annual falls in the dollar prices of oil. In the lower-weight categories of the index, prices showed very mixed developments. Overall, however, they made a positive contribution to the annual growth in the CZSO raw materials index.

Although in both Q1 and Q2 world prices of industrial raw materials and food (expressed in dollars) displayed relatively buoyant growth and the Czech Republic's major trading partners simultaneously recorded rising inflation,[31] the koruna prices of imports were still generally lower than a year earlier. According to the latest figures for May 2003, their annual decline – at 1.1% – was approximately the same as at the end of the previous quarter. The difference in price movements in these two price groups (world prices in dollars and import prices in korunas) was due mainly to the continuing fairly strong appreciation of the koruna's exchange rate against the dollar, whose impacts on import prices were offset in part by the year-on-year depreciation of the koruna-euro rate.

29 This index is calculated by the CZSO on the basis of prices expressed in US dollars.

30 Energy-producing raw materials have a constant weight of 69.4% in the CZSO world price index.

31 Producer prices in Germany, for example, which affect Czech import prices, were still falling in August 2002 (by 1% year-on-year), but since February 2003 have been recording annual growth (1.3% in May).

The majority of the SITC categories in the CZSO import price index recorded annual declines in koruna import prices in May. Prices again fell most sharply in the food and live animals category, although the decline here did ease a little. Another four categories also recorded smaller decreases, while three displayed annual rises. The increase in the manufactured goods category was a new phenomenon and may have been fostered by the depreciation of the koruna-euro exchange rate.

III.5.2. Producer prices

Industrial producer prices

Industrial producer prices saw no major change in trend in 2003 Q2. The previous modest slowdown in the price decline in 2003 Q1 (from -0.8% in January to -0.4% in March) was replaced by a renewed pick-up of the decline in the subsequent quarter, although according to the most recent figures this did not surpass the -1% level (-0.9% in June). The situation was similar in the most important industrial branch, manufacturing, where the decline in producer prices picked up from 0.3% in March to 1% in June. This was due mainly to the aforementioned combination of the annual fall in oil prices in April and May[32] and the fairly strong appreciation of the koruna-dollar exchange rate, which in turn fed through directly into prices in oil-product-processing industries. In March annual inflation in the manufacture of coke and refined petroleum products had reached 20.6%, whereas in June producer prices in this industry recorded a year-on-year decrease of 5.8%. In the chemical industry, which reacts with a certain lag to changes in prices in the manufacture of coke and refined petroleum products, inflation has so far merely slowed, to 1.7% in June.

In other branches of manufacturing[33] the annual price decline eased in 2003 Q2 (from -1.5% in March to -0.9% in June), after having stagnated in Q1. The main underlying factor was the weakening decline/growth in import prices. The domestic factors – in particular falling wage costs – have so far not exerted any upward pressure on prices. With regard to consumer prices, the important thing was that the structure of producer price inflation still confirmed the broadly universal nature of the price decline (only in a limited number of branches did prices rise somewhat).

Unlike for manufacturing, the overall contribution of the other industrial sectors to the total change in industrial producer prices in 2003 Q2 was negligible. Price growth in mining and quarrying in June switched to a modest annual decline (of -0.4%), and in the electricity, gas and water supply industry, producer prices were flat at the same level as a year earlier in June after having declined slightly at the end of Q1. Underlying these price movements were excess demand and structural changes in previously monopolised industries.

The further decline in industrial producer prices in 2003 Q2 is indicated from another angle by their structural breakdown by main industrial category. As shown in Chart III.37, prices fell slightly in all the monitored categories in Q2.

32 Changes in oil prices feed through into these prices with a lag of roughly one month.

33 i.e. branches other than manufacture of coke and refined petroleum products and manufacture of chemicals, chemical products and man-made fibres.

Table III.11
ANNUAL DECLINES IN PRICES WERE RECORDED IN MORE THAN HALF OF THE CATEGORIES OF THE IMPORT PRICE INDEX
(annual percentage changes)

	12/02	1/03	2	3	4	5
Imports, total	-4.4	-2.8	-1.7	-1.0	-0.5	-1.1
Food and live animals	-4.4	-4.7	-6.1	-5.7	-6.3	-5.4
Beverages and tobacco	-5.2	-4.1	-4.8	-3.7	-1.5	-3.1
Crude materials except fuels	-8.2	-6.3	-4.5	-2.7	-0.2	-0.9
Mineral fuels and related products	4.6	11.3	15.4	12.3	5.3	0.4
Animal and vegetable oils	10.3	7.9	6.2	3.8	8.7	8.7
Chemicals and related products	-5.5	-3.2	-1.9	-0.7	0.0	-0.7
Manufactured goods classified by material	-4.8	-3.3	-2.1	-0.7	1.5	1.9
Machinery and transport equipment	-6.0	-5.3	-4.3	-3.2	-2.1	-2.6
Miscellaneous manufactured articles	-3.1	-2.8	-3.0	-2.8	-1.8	-1.6

Source: CZSO

Chart III.35
INDUSTRIAL PRODUCER PRICES SHOWED A MODEST ANNUAL DECLINE
(percentages)

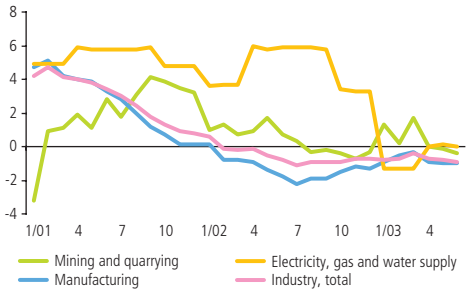


Chart III.36
IN THE MANUFACTURE OF COKE AND REFINED PETROLEUM PRODUCTS, PRODUCER PRICES REACTED DIRECTLY TO CHANGES IN OIL PRICES ON WORLD MARKETS
(annual percentage changes)

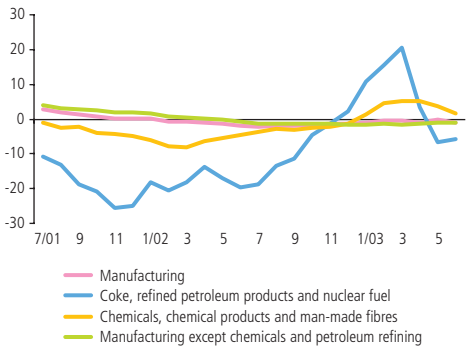
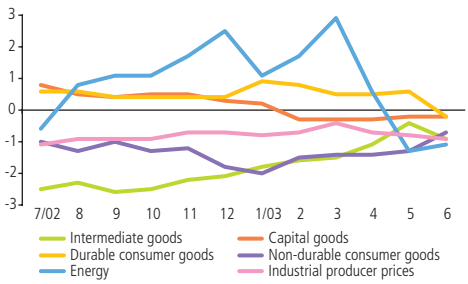


Chart III.37
THE DECLINE IN INDUSTRIAL PRODUCER PRICES IN MOST AREAS OF INDUSTRY WAS ALSO INDICATED BY PRICES IN THE MAIN INDUSTRIAL CATEGORIES
(annual percentage changes)

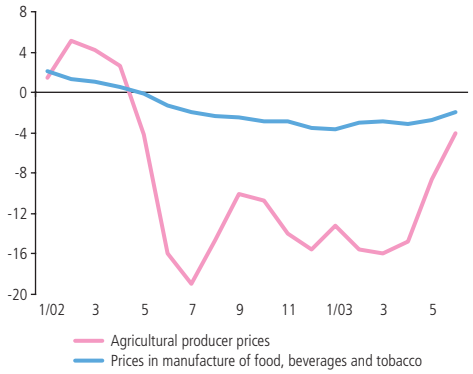


Agricultural producer prices

The trend in agricultural producer prices again differed appreciably from the other price groups in the production sector. Agricultural producer prices recorded a marked year-on-year fall, confirming continued volatility of prices in this area. This volatility is due to both internal and external factors, many of them specific in nature (seasonality of some products and dependence on climatic conditions). In 2003 Q2 the annual decline in agricultural producer prices eased, whereas in Q1 prices had conversely recorded a deepening decline (-16% in March and -4.1% in June). The decline remained across the board in nature, as prices of most domestic livestock and crop products failed to match their levels of the same period a year earlier.[34]

Prices of agricultural products are being affected by excess supply on the agricultural commodities market both at home and abroad. The position of domestic producers as regard finding new sales opportunities is being hampered by the state's limited ability to regulate the import and export of agricultural products. Owing to the further liberalisation of agricultural trade with the EU member states, it is no longer possible, for example, to restrict the import of agricultural products by putting up duties. In the case of exports, one of the factors limiting the export of surplus domestic production is the limited financial resources of the State Agricultural Intervention Fund. This, too, is undermining the competitiveness of domestic producers on agricultural markets. In the case of some agricultural commodities, the persisting, albeit now only moderate, appreciation of the koruna's weighted exchange rate is having an effect (in the case of the koruna-dollar rate this effect is still quite strong). The aggregate result of these primary factors is a continuing annual decline in koruna import prices in the "Food and live animals" category and surpluses of crop and livestock production on the domestic market, which together create the framework for the pricing policies and financial operations of domestic producers.

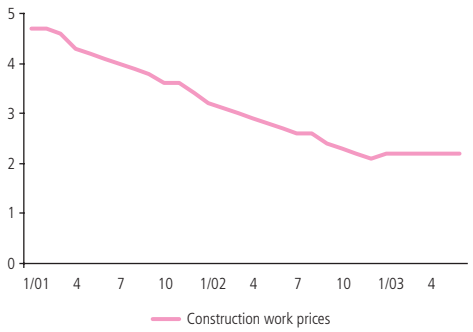
Chart III.38
PRICES OF AGRICULTURAL PRODUCERS AND IN RELATED MANUFACTURING BRANCHES HAVE RECORDED A YEAR-ON-YEAR DECLINE FOR ONE YEAR
(percentages)



Construction work prices

Construction work prices showed no changes in trend in 2003 Q2. According to the latest estimates for June 2003, prices remained flat at the level of the same period a year earlier. After having fallen during 2002 (to 2.1% in December), annual construction work inflation stayed at 2.2% in the first half of 2003.

Chart III.39
THE FLAT CONSTRUCTION WORK PRICE INFLATION CONTINUED INTO 2003 Q2
(annual percentage changes)



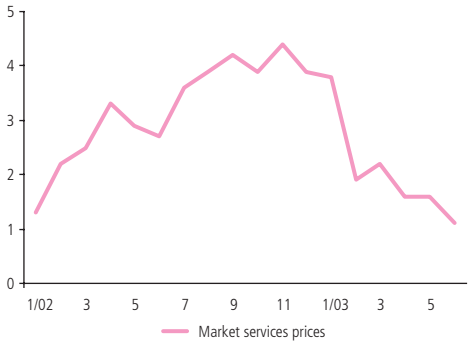
Market services prices

Market services price inflation fell further in 2003 Q2. At the turn of 2003, a figure of around 4% had been recorded. By March this had fallen to 2.2%, and according to the latest data for June it was below the 2% level (at 1.1%). Slowing annual growth in prices was recorded for insurance, financial intermediation, real estate, rental and other business activities, and communication services, where prices have been falling moderately since May. Freight transport prices recorded faster growth as compared to the end of the previous quarter, this being offset in the overall index by the weaker growth in prices in the aforementioned categories.

34 The biggest falls were recorded for pigs, poultry, cereals and potatoes.

The broadly subdued market services price inflation in 2003 Q2 not only reflected demand-side developments, but in some cases also suggested changing conditions in the competitive environment and a certain price "slump" following more marked changes in 2002 (for instance, growth in insurance prices slowed to around one quarter of the previous year's level).

Chart III.40
MARKET SERVICES PRICE INFLATION FELL FURTHER IN 2003 Q2
(annual percentage changes)



IV. THE MACROECONOMIC FORECAST AND ITS ASSUMPTIONS

IV.1. EXTERNAL ASSUMPTIONS OF THE FORECAST

Among the crucial determinants of the forecast are assumptions made about the external environment, most notably prices of energy-producing raw materials, foreign producer price indices and the business cycle in countries accounting for the bulk of Czech foreign trade. As usual, the assumptions regarding the evolution of these variables are taken from the publication Consensus Forecasts, which brings together the forecasts of a whole range of foreign analytical teams.

The forecast for oil prices is virtually unchanged since the last forecast. In 2003 Q3, the price of Ural crude oil is still expected to be just under USD 24 a barrel. A gradual fall is predicted thereafter, to USD 22 a barrel at the end of 2004. In contrast, the forecast for natural gas prices has been revised upwards by around 15% compared to the last forecast for the entire forecast period.

The forecast for economic growth abroad has again been somewhat revised. GDP growth in Germany, which is used as a proxy for growth abroad, is estimated at 0.2% for 2003. The growth forecast for 2004 has also been downscaled from the 1.7% level predicted in April to 1.5% at present.

In line with the downscaling of expected economic growth abroad, there is also a change to the forecasts for prices. Annual consumer price inflation in Germany is expected to be 0.9% in 2003 and 0.8% in 2004, a decrease of around 0.3 percentage points compared to the April forecast for both years. The forecasts for producer prices have also been lowered: industrial producer price inflation in Germany is expected to be 1.2% in 2003 and 0.7% in 2004.

IV.2. INTERNAL ASSUMPTIONS OF THE FORECAST

The forecast is affected not only by assumptions regarding the external environment, but also by assumptions regarding the internal environment. These include the autonomous effect of fiscal policy, the trajectory of the equilibrium values of key macroeconomic variables, and the current position of the economy in the business cycle.

The predicted effect of fiscal policy on the economy is based on an estimated government sector deficit of 4.8% of GDP[35] in 2003 and on the assumption that the Government's current proposal for the reform of public finances will start to be implemented in 2004. In line with the Government's plans to consolidate public finances, the forecast is for a steady decline in the public finance deficits to the target level of 4% of GDP in 2006. For 2004, the forecast is based on a deficit of 4.5% of GDP. According to current information, public finances are to be consolidated by means of active measures on both the income side and the expenditure side, although the emphasis will be on the latter. Nevertheless, the assumptions regarding the future effect of fiscal policy remain one of the key risks of the forecast.

Predictions for equilibrium macroeconomic variables have a major effect on the message of the forecast. One of these key variables is potential output, which according to the forecast is rising at an estimated rate of around 3% a year. Another key variable is the

35 The Ministry of Finance's July 2003 forecast is for a deficit of 7.0% of GDP. However, based on experience in past years and on developments in the first half of this year this would seem to be somewhat on the high side, which is why it has not been incorporated into the CNB's forecast in its full amount.

equilibrium real exchange rate. According to predictions, the pace of annual equilibrium appreciation will ease from the current 3.5% to around 2% by the end of 2004. The rate of equilibrium real appreciation has thus been revised downwards from the previous forecast, in the light of recent exchange rate analyses. From the logic of the relationships between the real rates of return in the Czech Republic and abroad it follows that the predicted course of annual equilibrium real interest rates has risen slightly.

Compared to the last forecast, the current output gap has widened somewhat further. The estimate for Q2 is -2.3%. The monetary conditions are still viewed as moderately easy, thanks mainly to the development of their exchange-rate component. The interest-rate component is meanwhile regarded as somewhat tight. Underlying this assessment is an assumed impact of the current temporarily low inflation figures on inflation expectations. However, the exchange-rate component is considered to be less easy, and the interest-rate component less tight, than expected in the April forecast.

The last key factor of the forecast is the assumed path of the exchange rate. The rate is expected to remain stable up to the end of the year at CZK 31.50 to the euro, as in the April forecast. Unlike in the previous forecast, which had assumed a gradual appreciation from the start of 2004, the rate is now expected to be broadly stable right up to the end of 2004.

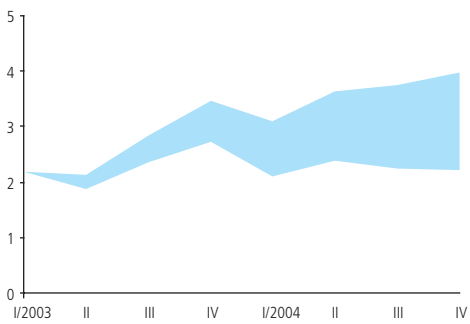
IV.3. THE MESSAGE OF THE FORECAST

GDP growth will pick up a little in the second half of 2003 in response to the previous easing of monetary conditions due to the easing of their exchange-rate component. In Q4, GDP growth of 2.7%–3.5% is expected. For 2003 as a whole, GDP is thus expected to rise by 2.1%–2.9%, similarly to the April forecast. Alongside government consumption, the main factor underlying the growth remains household consumption growth, due in turn to high growth rates of real disposable income. However, the forecast is for a steady fall in the growth rates of household consumption in 2003 in response to slowing growth of real wages, rising unemployment and the tightening of the interest-rate component of the monetary conditions in 2003 H1. GDP growth as a whole is still being depressed by a decline in investment, reflecting the ever more distant global economic recovery and the tightening of real interest rates in 2003 H1. These effects have yet not been offset by the easing of the real exchange rate. The easing of the exchange-rate component of the monetary conditions will, however, foster a positive contribution of net exports to GDP growth.

In 2004, the forecast is for a further modest pick-up in GDP growth to 2.1%–3.8%, despite an expected fall in the growth rate of household consumption, where the effects of the easing of the interest-rate component of the monetary conditions and a fall in the savings rate will be exceeded by a slowdown in households' real disposable income growth. The pick-up in economic growth is therefore due largely to a switch from a decline in investment in 2003 to a rise of around 4.5% in 2004. This turnabout should be linked with an easing of both components of the monetary conditions and the emergence of a gradual recovery abroad. Despite the expected launch of the public finance reform, the forecast is for a positive growth rate of government consumption as well. Net exports can be viewed as neutral, since the pick-up in exports will be offset by growth in imports associated with the increased investment activity.

The forecast for inflation in 2003 has been revised downwards by comparison with the April forecast. One of the factors behind this revision is the moving of the expected accession-related changes to indirect taxes to 2004. The downscaling of the inflation

Chart IV.1
GDP GROWTH WILL PEAK AT THE END OF 2003 AND WILL REMAIN STABLE NEXT YEAR
(percentages)



forecast is also due to slower pass-through of certain inflationary pressures into inflation, in conditions of an already fairly long-lasting negative output gap. Annual adjusted inflation excluding fuels should thus be around 0.6% at the end of 2003, as against the approximately 2.4% predicted in April. Overall, annual consumer price inflation of around 0.7%–1.4% is expected for the end of 2003.

Box
The withdrawal of 10- and 20-heller coins and its possible impact on prices

On 1 October 2003, the 10-heller and 20-heller coins will cease to be legal tender. Retailers have two options for dealing with this: either they can round off all their prices to the nearest 50 hellers (in which case it can be expected that most prices will be rounded upwards), or they can leave their individual prices unrounded and only round off the price of the overall purchase.

In the event of all prices being rounded up to the nearest 50 hellers (this representing the upper limit of the possible impacts on prices of the withdrawal of the coins), one can predict that low-cost items will be most affected by this measure, as a rise in price of, say, 20 hellers would mean a relatively large percentage increase. In contrast, prices of the vast majority of goods costing more than CZK 150 are already rounded off to whole korunas, as are those of roughly half the items costing between CZK 50 and CZK 150. Drawing on these predictions one can estimate the maximum possible impact of the withdrawal of the coins on inflation (see the table).

However, the one-off increase in prices described above can be viewed as highly unlikely. The withdrawal of the 10- and 20-heller pieces was announced well back and many prices have already been rounded off by retailers. Many major retailers have also said that they will only round off prices of total purchases. This means that if, when the coins are withdrawn, only around half the as yet unrounded consumer prices are rounded upwards, the price impact will be no more than 0.3 percentage points. What is more, this impact will probably be spread out over a longer timescale.

Table (Box)
THE ESTIMATED MAXIMUM IMPACTS OF THE WITHDRAWAL OF 10- AND 20-HELLER COINS ON INFLATION ARE RELATIVELY SMALL

	Items costing		Total
	less than CZK 50	CZK 50 - 150	
No. in consumer basket	250	180	430
Constant weight (in per cent)	42.7	19.5	62.2
Average price (in CZK)	20.51	88.76	
Average price increase rounded up (in CZK)	0.25	0.125	
Average price increase (in per cent)	1.22	0.14	
Max. impact on inflation (in p. p.)	0.52	0.03	0.55

Note: Prices of items costing more than CZK 150 are assumed to be already rounded up

For 2004, too, inflation has been revised downwards. The main reason is a change to the extent and timing of adjustments to indirect taxes and a revision to the prediction for annual adjusted inflation excluding fuels. The estimate of the primary effects of the changes to indirect taxes on overall inflation has been scaled down by 1 percentage point, owing to exclusion of the reclassification of hotel and restaurant services from the lower to the main VAT bracket. Annual adjusted inflation excluding fuels in 2004 has been revised from around 3.5% to around 1.5%. This is due to the aforementioned changes in the forecast's assumptions and to the negative output gap's increasing effect as regards the pass-through of inflationary pressures, which should be slower. Estimated annual inflation for June 2004 (in four quarters) has been lowered from April's 4.7%–6.1% to 2.1%–3.5% at present, and for December 2004 (in six quarters) from 4.0%–5.4% to 2.5%–3.9%.

Box
Indirect taxes and the inflation forecast

The price effects of the changes to indirect taxes under consideration in the fiscal reform proposal are divided into two categories in the inflation forecast. The primary effect of the tax change is the price change corresponding exactly to the accounting increase in tax. In the specific macroeconomic environment, however, economic agents may raise their prices by more or less than this amount. Moreover, a response

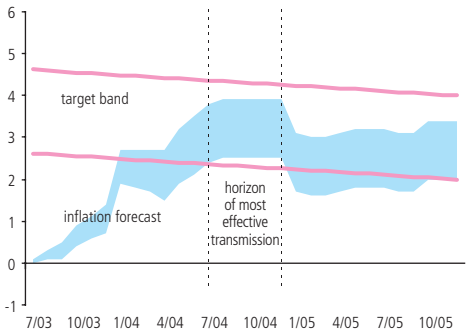
can be expected from other entities whose prices are not directly affected by the tax changes. Rising wage demands, for instance, can also be expected. The higher wage costs may in turn feed through into prices. These additional price impulses are included in the secondary effects of the changes to indirect taxes.

In the CNB's new forecast, the primary effect of the expected changes to indirect tax, i.e. the accounting effect on prices, is 1.0 percentage point. In the present low-inflation environment, bolstered by strong external anti-inflationary impulses and the highly competitive domestic market, the tax changes cannot be expected to have very strong secondary effects. Based on an assessment of past secondary effects, and taking the macroeconomic environment into consideration, the secondary price impacts can be estimated at roughly 0.4 percentage points.

To sum up, the forecast expects the negative output gap to last until mid-2005. Nevertheless, owing to an easing of both components of the monetary conditions in 2003 H2 and an economic recovery abroad in 2004, there will be a modest pick-up in economic growth and hence a gradual closing of the output gap from 2004 H2 onwards. Inflation has at the same time been revised downwards because of the change of outlook regarding the effect of the output gap on prices and because of the change to the expected adjustments to indirect taxes. Between 2003 and 2004, however, the forecast predicts a gradual rise in inflation due to an unwinding of disinflationary exogenous factors, the gradual closing of the negative output gap and the changes to indirect taxes.

Consistent with this forecast is a fall in interest rates in 2003 H2 and interest rate stability during the course of next year. As in April, this forecast assumes that monetary policy will not respond to the primary effects of the changes to indirect taxes but will anticipate the secondary effects.

Chart IV.2
THE INFLATION FORECAST IS ON COURSE FOR THE CENTRE OF THE TARGET BAND AT THE HORIZON OF MOST EFFECTIVE TRANSMISSION
(annual consumer price inflation; percentages)



In addition to the above-described baseline scenario of the forecast, two alternative scenarios were constructed expressing some of the major uncertainties of the forecast. The first scenario captures the continuing uncertainty regarding the consequences of the deviation of the real exchange rate from its equilibrium level. Specifically, compared to the baseline forecast, this scenario assumes that economic activity will be affected more strongly by the real exchange rate, which is currently estimated as being somewhat easy. This assumption implies pressure for faster GDP growth and a slightly tighter future path of interest rates. The second alternative scenario stems from the continuing uncertainty regarding the true level of economic agents' inflation expectations. While the baseline scenario assumes a very strong impact of the current inflation on expectations, the alternative scenario relies more on the data that the CNB obtains from the statistical surveys of inflation expectations. These expectations are currently sizeably higher than actual inflation. Therefore, in the alternative scenario, the current real interest rates are markedly lower compared to the baseline scenario. Thus, a tighter future path of interest rates is consistent with this alternative scenario as well.

IV.4. EXPECTATIONS OF ECONOMIC AGENTS

The inflation outturns expected by financial market participants shifted upwards (for more details, see the Box: *Changes to the methodology for surveying inflation expectations*). This increase was due to a foreseen turnabout in prices of food and to the expected changes to indirect taxes prior to the Czech Republic's accession to the EU. Conversely, the weakening of the dollar, which is making imports of strategic raw

Table IV.1
THE INFLATION EXPECTATIONS OF ECONOMIC AGENTS INCREASED AT THE 12-MONTH HORIZON
(percentages)

	Consumer price index			1Y PRIBOR
	Financial market	Businesses	Households	Financial market
12/01	3.9	3.9	4.6	5.1
3/02	3.5	3.6	3.9	4.9
6/02	3.1	2.7	1.6	4.6
9/02	3.1	1.9	1.3	3.7
12/02	2.3	2.3	2.6	3.1
1/03	2.5			3.1
2/03	2.4			3.2
3/03	2.5	2.1	4.0	2.9
4/03	2.6			3.0
5/03	3.7			3.0
6/03	3.2	2.7	2.3	2.8

materials cheaper, as well as lower oil prices and the weakness of the global economy, could have anti-inflationary effects.

Unlike in the case of inflation, the expected interest rates were little changed. In the immediate future the repo rate was expected to remain flat or even fall a little. In the longer term, the financial market expects interest rates to rise again somewhat. The interest rate profile consistent with the aforementioned CNB forecast predicts a greater reduction in the short term.

Box
Changes to the methodology for surveying inflation expectations

Inflation expectations play a vital role in an inflation targeting system. A central bank operating such a system attempts to steer the inflation expectations of consumers, producers and other economic agents towards its inflation target. If expectations are close to the target, it becomes much easier to hit that target. Inflation expectations also play a pivotal role in the CNB's inflation forecast, and the central bank pays close attention to the results of statistical surveys of inflation expectations.

The CNB started regular measurement of inflation expectations among financial market analysts in May 1999. In June 1999 the survey was extended to businesses and households. The monthly statistical survey of 15 selected domestic and foreign analysts gives the CNB an idea of inflation expectations on the financial market. The quarterly survey of households is based on a large and randomly selected sample of 600 households and gives the CNB an idea of consumers' inflation expectations. The survey of businesses is also performed quarterly, covering 120 managers of major businesses from all sectors of the economy. This gives the CNB a rough picture of producers' inflation expectations. Over time, the CNB's information requirements have changed and several methodological changes have accordingly been made to the surveys in recent years. The most important are as follows:

- financial market participants are only asked about the annual consumer price inflation index they expect at the 12-month and 3-year horizons; a question on future net inflation was dropped in June 2001;
- The number of financial market analysts surveyed has been gradually increased from 10 to 15;
- the business and household sector respondents are asked about their inflation expectations at the 3-year horizon as well as at the 12-month horizon; a question on year-end inflation was dropped in January 2003;
- businesses and households are no longer informed about the latest inflation figure during the surveys (dropped for businesses in June 2002 and for households in March 2003);
- up until March 2003, outliers in the responses of businesses and households were not excluded; expectations were computed as the arithmetic mean of all the answers. Since June 2003, 5% of the maximum responses and 5% of the minimum responses of businesses and households have been removed and average expectations have been computed as the arithmetic mean of the remaining 90%.

ANNEX

ERM II AND THE EXCHANGE-RATE CONVERGENCE CRITERION

1. Introduction

In May 2004 the Czech Republic is likely to become a member of the European Union (EU). On joining the EU, the Czech Republic (just like all the new Member States) will be granted the status of "Member State with a derogation" i.e. it will not immediately adopt the euro. Upon accession, the Czech National Bank (CNB) will become a member of the European System of Central Banks (ESCB). However, it will not participate in monetary-policy decision-making on the European scale until it introduces the euro.

At the end of 2002, the CNB submitted to the Czech Government a document entitled "The Czech Republic and the Euro – Draft Accession Strategy". In this document the CNB proposes implementation of the necessary economic and political measures in such a way "*as not to rule out the possibility of joining the eurozone sometime around 2007*". In its Resolution No. 189 of 24 February 2003, the Government of the Czech Republic noted this document as a basis for further discussion and tasked the Minister of Finance with elaborating a supplement to the Draft Strategy by 30 September 2003, in co-operation with the Minister of Industry and Trade and by agreement with the CNB Governor. This Strategy – along with the Pre-accession Economic Programme (PEP) for 2003 – will include the Czech Republic's position on the Czech koruna's participation in ERM II and hence also its target for fulfilling the exchange-rate convergence criterion (one of the Maastricht convergence criteria).

The aim of this document is to describe the ERM II and the provisions relating to the exchange-rate convergence criterion as the basis for the Czech Republic's official position. The text is structured as follows. Part 2 describes the basic features of the ERM II and explains the exchange-rate convergence criterion. Part 3 discusses the benefits and risks of the Czech koruna's participation in the ERM II. Part 4 deals with institutional aspects of adopting the single currency, and Part 5 sums up the CNB's recommendations in the ERM II area. The document contains two annexes. Annex 1 – "A glossary of terms associated with European monetary integration" – summarises key terms relating to the single currency. Annex 2 provides a historical guide to exchange rate and interest rate developments in selected current eurozone member states prior to introducing the single currency.

In line with the aforementioned Draft Accession Strategy, the Czech National Bank views participation in ERM II merely as the gateway to joining the eurozone and does not recommend staying in the mechanism for any longer than the minimum required period of two years. In the CNB's view, the Czech Republic should enter the ERM II only after conditions have been created that will enable it to introduce the euro at the time of the assessment of the exchange-rate criterion (two years after joining the ERM II). Given the outlook as regards fulfilment of the other convergence criteria, the CNB recommends that the Czech Republic should remain outside the ERM II after its expected accession to the EU in May 2004.

2. ERM II and the Exchange-rate Convergence Criterion

The ERM II (*Exchange Rate Mechanism II*) is a mechanism for fixing the participating currencies against the euro within a fluctuation band. Each currency participating in ERM II has a defined central rate (parity) against the euro and a fluctuation band for movements around the central rate. In the event of exchange rate pressures, both the national central bank and the European Central Bank (ECB) will intervene to keep the exchange rate within the fluctuation band. By contrast, *the exchange-rate convergence criterion* is one of the criteria for adopting the euro. Fulfilling the criterion requires *participation in ERM II and maintenance of exchange-rate stability*. In other words, to fulfil the exchange-rate convergence criterion, the currency must be part of ERM II yet stay within a range that is narrower than the standard ±15% fluctuation band. So, the maintenance of exchange-rate stability is closely linked to the ERM II, but the two terms are not interchangeable, as it is possible for a country to participate in ERM II yet not fulfil – or not even be heading towards fulfilling – the exchange-rate convergence criterion.

A. ERM II

The original ERM – established in connection with the introduction of the euro's predecessor (the non-cash ECU – European Currency Unit) – has undergone dynamic development over the past two decades. Two events in particular shaped the design of the mechanism. The first was the currency upheaval in 1992–1993, when the ERM fluctuation band was widened from ±2.25% to ±15% (August 1993). And the second was the introduction of the single currency (on 1 January 1999), which entailed switching from the multilateral ERM exchange rate system (the principle of a "grid" connecting the individual currencies) to the bilateral ERM II system, where the currencies of the participating countries are linked to the euro. At present, only one country – Denmark – is a member of the system.

The basic features of the ERM II are as follows:

(a) central rates and fluctuation bands of participating countries' currencies against the euro are set by common procedure (involving Finance Ministers, ECB and national central bank governors and the European Commission);

(b) the standard fluctuation band is ±15%, while not excluding the possibility of setting a narrower band;

(c) intervention support of the ECB to the national central banks (NCBs) is automatic at the margins of the band (marginal interventions); any interventions within the band (intra-marginal interventions) need not be – but may be – supported by the ECB;

(d) the ECB and NCBs have a formal right to suspend intervention should the price stability objective be jeopardised;

(e) realignments of central parity are made by the common procedure, which both the ECB and the member states have the right to initiate.

As mentioned above, with regard to the width of the ERM II band it is crucial to differentiate between the functioning of the mechanism and the assessment of exchange rate stability. The setting of the fluctuation band in ERM II is significant for the functioning of the interventions of the national central banks and the ECB. The mechanism for assessing the fulfilment of exchange rate stability, which is closely linked to the ERM II, is described below.

B. The assessment of exchange rate stability

The exchange-rate convergence criterion is one of the Maastricht convergence criteria that have to be fulfilled before the single currency can be adopted. The assessment of fulfilment of the exchange-rate convergence criterion is based on the relevant provisions of the Treaty on European Union (the "Treaty"), as elaborated by the relevant protocol, and by the Council Resolution establishing the ERM II with effect from 1 January 1999. The relevant passages of these official documents are cited in Box 1 below. The present position of the European authorities as regards assessing the exchange-rate stability criterion can be summed up as follows (the CNB's interpretation in parentheses):

(a) Participation in ERM II for at least two years at the time of the assessment is mandatory.

(b) No downward realignment of the central parity within the two-year examination period (upward realignment of the central parity is implicitly possible).

(c) By the CNB's current understanding, and following consultations with the competent EU and ECB authorities, fulfilment of the criterion requires the exchange rate to have been maintained within a fluctuation margin of ±2.25% (i.e. narrower than the standard band) around the central parity in ERM II "without severe tensions" (in other words, maintaining the exchange rate within the narrow margin of ±2.25% "at any cost" by means of excessive interventions or non-market measures will not necessarily be assessed as successful fulfilment of the exchange-rate stability criterion). If the exchange rate moves outside this band, a distinction is to be made

between a breach of the upper margin and a breach of the lower margin (a breach of the upper margin being implicitly more admissible). In such a case it is necessary to examine the duration of the deviation, the reasons for it, and interest rates and intervention policy at the time of the deviation.

To conclude the definition of exchange rate stability it should be mentioned that as European economic integration is a political process, the vagueness of the economic criteria may also reflect an intentional decision to leave some leeway for political decision-making.

BOX 1
Provisions of official EU documents on the fulfilment of the exchange-rate convergence criterion

The relevant Treaty provisions are:

- The third indent of Article 121(1), which refers to the exchange rate criterion as:
"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State".

- Article 3 of Protocol No. 6, which states that:
"The criterion on participation in the exchange-rate mechanism of the European monetary system referred to in the third intent of Article 121(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period".

- The Council Resolution on the establishment of the ERM II (97/C 236/03 of 16 June 1997), which states that:
"With the start of the third stage of economic and monetary union, the European Monetary System will be replaced by the exchange-rate mechanism as defined in this Resolution… …The exchange-rate mechanism will link currencies of Member States outside the euro area to the euro".

The EU expressed its standpoint on the fulfilment of the exchange-rate criterion in ERM II in its 2000 Convergence Report (Directorate-General for Economic and Financial Affairs, No. 70), Annex D, Article D.4. as follows:

- *Participation in the ERM II at the time of the assessment is mandatory.*
- *Participation in the ERM/ERM II for at least two years is expected, although exchange rate stability during a period of non-participation before entering ERM/ERM II can be taken into account.*
- *No downward realignment of the central parity either in the ERM or in the ERM II within the two-year examination period.*
- *Exchange rate to have been maintained within a fluctuation band of ±2.25% around the currency's central parity against the euro. An assessment of any deviation from the ±2.25% fluctuation band would have to take into account the reasons for that deviation. A distinction is to be made between exchange rate movements above the 2.25% upper margin and movements below the 2.25% lower margin.*

3. Benefits and Risks of ERM II Participation

The exchange rate is not an isolated economic variable, but acts in the context of, and in line with, the other key economic variables that shape a country's internal and external economic balance. Moreover, the exchange rate regime is just one element in a set of economic policies and does not have an exclusive or unique position. Whether the exchange rate regime is sustainable and plays a stabilising role depends primarily on whether other variables and macroeconomic policies evolve in a balanced, sustainable and mutually consistent fashion.

Exchange rate regimes can be divided according to their basic features into two broad types: fixed and flexible. A fixed exchange rate is predominantly "leading", i.e. internal developments and economic policy must adapt to the

requirements of maintaining the fixed rate. Successful operation of a fixed exchange rate regime is therefore not compatible, for example, with a long-term fiscal deficit policy or with wage growth that is not in line with productivity growth. By contrast, a flexible exchange rate "follows" other variables and can mitigate the consequences of sub-optimal economic policies. However, even a flexible exchange rate can, in the event of inconsistent economic policies, react sharply to emerging economic imbalances and hence multiply the negative effects of such policies.

The ERM II, which under the EU legislation is a necessary stepping stone along the path towards adopting the euro, is a fixed exchange rate regime. It differs from other fixed exchange rate regimes mainly in that there is an anchor point for exiting the regime (in the form of an irrevocable fixing of the currency against the euro) and in that the country can obtain help from the European Central Bank to maintain its currency within the fluctuation band. However, in common with other fixed rate regimes the ERM II puts high demands on economic policy consistency and macroeconomic stability. With sufficiently prudent policies, a flexible economy and macroeconomic stability, the two-year participation in ERM II with a fluctuation band of ±15% may proceed smoothly. However, fulfilment of the exchange-rate convergence criterion with the narrower margin of ±2.25% does not have to be problem-free.

One of the much-emphasised benefits of participation in ERM II is its role in stabilising the exchange rate (by anchoring exchange rate expectations) and the economy. Also emphasised is its positive effect on macroeconomic policy consistency. These benefits are clearly visible when examining monetary developments in most European economies over the past ten years. The question arises whether the transition economies, which are subject to large inflows of foreign capital and are undergoing economic transformation processes, stand to benefit from participating in ERM II (as compared to the alternative monetary-policy regimes they could operate until introducing the euro) to the same extent as the advanced countries.

(a) the exchange-rate stabilising role of ERM II

The exchange-rate stabilising role of ERM II should derive from the announcement of the central parity, which should provide the markets with a lead and thereby reduce exchange rate fluctuations. This should in turn contribute positively to the country's process of economic convergence to the level of the more advanced EU Member States. Nevertheless, this stabilising role may in practice be limited by two factors. Firstly, the central parity is subject to possible realignments, a fact that reduces both its credibility and its signalling role. In economies with a stable exchange rate (such as Denmark, the only ERM II participant at present) realignment of the central rate is not very likely, hence the possibility of revaluation does not necessarily undermine the stabilising role of the mechanism. However, in the case of transition economies, whose currencies are subject to an appreciation trend associated with real convergence processes, the credibility of the central rate may be eroded over time. Secondly, the standard fluctuation band of ±15% permits substantial exchange rate volatility, so it is questionable whether it will play a stabilising role.

The stabilising effect of ERM II should be further enhanced by the ECB's intervention assistance. However, as stated in section 2.A., such support is automatic only at the margins of the fluctuation band. The ECB's support is not guaranteed for countries wishing to operate a managed float around the central rate, which is meanwhile necessary for fulfilling the condition of exchange rate stability in the likely event that the fluctuation band is wider than ±2.25% (required for fulfilment of the exchange-rate stability condition). In this situation, intra-marginal interventions, i.e. interventions within the band, would be more important. The ECB may conversely restrict such interventions by the national central banks.

(b) ERM II and macroeconomic policy consistency

As mentioned above, participation in ERM II, just as in any other fixed exchange rate regime, requires consistent macroeconomic policies. This assertion is confirmed both by economic theory and by the experience of many economies, including the Czech one (cf. the currency turmoil in 1997). There is also an argument that participation in ERM II will exert effective pressure for faster consolidation of public finances and responsible policies. However, the CNB believes that sustainable fiscal and structural policies should precede the introduction of a fixed exchange rate regime and that

restrictions on the movement of the exchange rate should thus be the consequence of implementing consistent policies, and not the trigger for them.

If a country applies consistent policies, it should be possible – from the purely theoretical perspective – to consider immediate adoption of the euro without the need for the intermediate stage embodied by the ERM II. In a world of massive capital flows, viewing the ERM II as a time test of consistent and sustainable economic policies may be associated with potential costs as the financial markets "test" the willingness of the authorities to maintain the exchange rate within the fluctuation band (cf. the attack on the Hungarian forint in January 2003). So instead of the expected stabilising effect, a fixed exchange rate with a fluctuation band may, on the contrary, lead, in certain situations, to destabilising capital flows.

(c) ERM II as an inflation-stabilising mechanism

Participation in ERM II is also being recommended because of the beneficial effect that a stable exchange rate has in fostering lower and less volatile inflation. A fixed rate fosters price stabilisation both directly – by stabilising import prices – and indirectly by stabilising inflation expectations. However, in the case of the standard ±15% fluctuation band, which permits sizeable exchange rate fluctuations (and where there is also the possibility of revaluation of the central rate), this stabilising role is limited.

A strategy of inflation targeting is being pursued in the Czech economy. In this context the question arises whether inflation targeting is consistent with ERM II. In a small open economy, a relatively stable exchange rate is vital for price stabilisation. Accordingly, close attention is paid to exchange rate movements within the inflation targeting regime. However, the ERM II goes further by explicitly setting a quantitative exchange rate target. In an environment of inflation targeting and simultaneous participation in ERM II, two monetary policy objectives exist alongside each other: a target for inflation and a target for the exchange rate. This may undermine the comprehensibility of monetary policy and affect the central bank's credibility and the effectiveness with which it performs its stabilising activities. This problem is reduced if participation in ERM II is limited to the short period of two years. In the case of a longer stay in the ERM II, or insufficiently compatible economic policies, the combination of inflation targeting and the fixed exchange rate with a fluctuation band could generate macroeconomic pressures.

To conclude this section, it can be said that the ERM II has certain stabilising potential. This potential, however, is dependent on the level of transformation of the economy, the degree of alignment of the economic cycle, and on economic policy consistency. For transition economies – subject to huge inflows of foreign investment exerting appreciation pressures on their domestic currencies – or for countries with insufficiently consolidated structural or fiscal policies, the balance of the costs and benefits of joining the ERM II is not necessarily clear-cut. Such an approach corresponds to the position of the European Commission, which states that "in certain cases, staying outside the ERM II for some time [after accession] may be useful in light of large and volatile capital flows, large fiscal imbalances, and/or risks of large economic shocks" (cf. "Acceding countries and ERM II", a document prepared by the European Commission for the High Level Meeting in Athens on 28 May 2003).

4. Institutional Issues of ERM II Participation and the Setting of the Central Parity

The procedures for ERM II entry and the subsequent irrevocable fixing of the koruna against the euro have been specified in detail. The procedural steps leading to ERM II participation have been laid down in the *Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union (97/C 236/03, 16 June 1997)* and in the *Agreement between the European Central Bank and the national central banks of the Member States outside the euro area* of 1 September 1998.

A. The process of joining ERM II

The key procedural feature of ERM II is the multilateral approach of the Member States to making decisions on issues linked to the functioning of the mechanism. Such decisions are taken by the ministers of the euro area Member States, the ECB and the ministers and central bank governors of the non-euro area Member States participating in ERM II. The

ministers and governors of the central banks of the non-euro area Member States not participating in ERM II have only an advisory vote. Such decisions are preceded by a procedure involving the European Commission and the Economic and Financial Committee (EFC).

For new EU Member States, the first step (which is not, however, a direct part of the procedure for participation in ERM II) is accession to the aforementioned Agreement between the European Central Bank and the national central banks of the non-euro area Member States. It is possible to sign the agreement and request entry into ERM II at a later date.

The procedure itself consists of the following steps (cf. "Procedural steps to allow participation in ERM II", a document prepared by the European Commission for the High Level Meeting in Athens on 28 May 2003):

i. The Exchange-rate Procedure
- may be initiated by a confidential joint request from a minister and a central bank governor from a country requesting entry into ERM II (as well as from the decision-making bodies – see above), addressed to the Ecofin minister of the country holding the EU Presidency;
- at the same time, the EFC member(s) from the initiating country inform the President and the Secretary of the EFC;
- takes place at a closed confidential meeting of the ERM II Committee (see below);
- when consensus can be reached on the central rate and fluctuation band, allows for confirmation of agreement from the authorities of the home countries.

ii. The ERM II Committee
- is called by the EFC President; its members are the EFC members from national administrations, the EFC members from the non-euro area central banks, two representatives of the ECB, two representatives of the Commission, the President of the alternates, the EFC President and Secretary, and two members of the EFC Secretariat;
- the meeting is a kind of "pre-screening" of the countries applying to introduce the euro (the results of the meeting serving as the basis for the "Exchange-rate Procedure"): the Committee discusses and determines whether the macroeconomic framework of the ERM II applicant country is consistent with ERM II entry, notably in connection with the Broad Economic Policy Guidelines and the Stability and Growth Pact;
- the Committee will also discuss the appropriate central rate and fluctuation band;
- the decision-making bodies of the ECB will have meetings prior to the Committee meeting on the central rate and fluctuation band.

iii. The ERM II Exchange-rate Meeting
- is called by the Ecofin minister of the Member State holding the EU Presidency; composition: the ministers of the euro area Member States, the ministers and the central bank governors of the non-euro area Member States, the President of the ECB, representatives of the Commission, and the President and Secretary of the EFC;
- final adoption of the central rate and fluctuation band;
- also confidential; held in the same room as the "Exchange-rate Procedure"

iv. The final communiqué, in the name of the EU, includes the following elements:
- the party initiating the procedure and the parties making the decision
- the decision
- the central rate
- the fluctuation band
- the announcement on the economic policy of the Member State
- a statement on the discussion of intervention points between the ECB and the national central bank

The time schedule for the whole process is not fixed but depends on the degree of agreement reached between the authorities of the Member State and the bodies of the EU. The entire process can be very quick and take just a few days (as in the case of Austria) or it can last for several months (Denmark).

B. The CNB's role in the ERM II participation process

The timing of the adoption of the euro and the initiation of the country's accession to the euro area is a political decision that falls to the Czech Government, acting in co-operation with the CNB. Before the single currency can be adopted, the provisions of the Act on the CNB concerning the currency and the CNB's powers will have to be amended. Other legislation will also have to be revised. The integration of the Czech koruna into the ERM II can be viewed on the one hand as a change in exchange rate regime, for which the CNB bears responsibility (see Box 2), but on the other hand as the start of the euro-adoption process.

BOX 2
The CNB Act and the CNB's role in the euro-area participation process

Article 35(a) of the Act on the CNB: *The Czech National Bank shall, after discussion with the Government, stipulate the exchange rate regime of the Czech currency vis-a-vis foreign currencies, with the proviso that the primary objective of the Czech National Bank must not be jeopardised.*

Article 10(2) *of the Act on the CNB: The Czech National Bank shall act in an advisory capacity vis-a-vis the Government in matters of monetary policy and banking.*

The CNB understands its role in the euro-adoption process within the meaning of Article 10(2). The CNB presumes that it will act as an expert guarantor and initiate discussions in the monetary area, including of any proposals for a change in the exchange rate regime, as it has done hitherto. It should regularly assess the preparedness of the Czech Republic and make suggestions (in co-operation with the Ministry of Finance) to the Government regarding the timing of the individual steps and the macroeconomic and monetary parameters associated with steering the Czech economy towards the euro (the central parity, the conversion rate, the fluctuation band, interventions). A major role in this process will be played by the convergence reports, which are directly aimed at assessing the economy's preparedness for participation in the single currency of the euro area.

5. Conclusions and Recommendations of the CNB

The aforementioned discussions and consultations with EU and ECB representatives have led the Czech National Bank to make the following recommendations:

(a) *The Czech Republic should enter the ERM II only after conditions have been created that will enable it to introduce the euro at the time of the assessment of the exchange-rate criterion (two years after joining the ERM II).* The CNB thus still holds the opinion it expressed in the document: "The Czech Republic and the Euro – Draft Accession Strategy", namely that staying in the ERM II for longer than the minimum required period is not deemed desirable or beneficial to macroeconomic stability. This is because participation in the ERM II alone – unlike the irrevocable fixing of the exchange rate within the monetary union – does not in itself eliminate the risk of currency turbulence.

(b) *CNB recommends that the Czech Republic should remain outside the ERM II for some time after its accession to the EU*. Under the EU legislation, the Czech Republic's potential participation in ERM II as from May 2004 (simultaneously with its expected accession to the EU) would imply the assessment of the exchange-rate convergence criterion taking place sometime around June 2006. Under the fiscal reform proposal of June 2003, however, the public budget deficit is to reach 4.8% of GDP in 2005 and decrease to 4% in 2006. This means it will exceed the Maastricht criterion of 3%. Even the looser interpretation of the criterion, i.e. that "the ratio has declined substantially and continuously and has reached a level that comes close to the reference value", would not, we expect, given the trajectory under consideration, result in fulfilment of this criterion by the time of the assessment in 2006. As the outlook for the public finance deficit is currently a critical factor affecting the timing of the adoption of the single currency, and given the significance of flexible markets in this process, the CNB recommends continuing with the efforts to consolidate public finances and with the structural reforms, in order to improve the efficiency and competitiveness of the Czech economy.

(c) The CNB further recommends that a *mechanism of regular assessment of the fulfilment (and prospects of fulfilment) of the Maastricht convergence criteria and assessment of the Czech economy's alignment with the euro area* be incorporated into the strategy for euro area accession to be submitted to the Government by 30 September 2003. Such regular assessments, which would facilitate the selection of the right time to participate in ERM II, would be implemented on the basis of a joint document of the CNB and the Ministry of Finance for discussion by the Czech Government and would coincide with the preparation and discussion of the convergence programmes every autumn.

ANNEX 1: A GLOSSARY OF TERMS ASSOCIATED WITH EUROPEAN MONETARY INTEGRATION

The euro area *(also known as the **EU-12** – the figure indicating the number of participating countries – and the eurozone)* consists of those EU Member States that have introduced the single currency and in which the single monetary policy of the European Central Bank is conducted. The euro area currently comprises 12 countries: Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. *The United Kingdom, Denmark and Sweden currently remain outside the euro area.*

Economic and Monetary Union (EMU)

Economic and monetary union (EMU and "HMU" in the Czech language) is the name given to the process of harmonising the economic and monetary policies of the Member States of the Union with a view to the introduction of a single currency, the euro. It was the subject of one of the two Intergovernmental Conferences (IGCs) in December 1990.
The Treaty provides that EMU is to be achieved in three stages:

- First stage (1 July 1990 to 31 December 1993): free movement of capital between Member States, closer co-ordination of economic policies and closer co-operation between central banks;
- Second stage (1 January 1994 to 31 December 1998): convergence of the economic and monetary policies of the Member States (to ensure stability of prices and sound public finances);
- Third stage (from 1 January 1999): the establishment of the European Central Bank, irrevocable fixing of exchange rates and introduction of the single currency.

The third stage of EMU was launched in eleven Member States. Four Member States did not adopt the single currency: the United Kingdom and Denmark, both of which possess an opt-out clause under protocols attached to the Treaty establishing the European Community, and Sweden and Greece, which did not meet all of the Maastricht convergence criteria. Greece became the twelfth euro-area Member State on 1 January 2001. The Czech Republic will automatically become an EMU member (with a derogation as regards introducing the euro) upon accession to the EU (see the extract below the title).

European Monetary Union (EMU)

This expression is often confused with the aforementioned terms "euro area" and "economic and monetary union". In the vast majority of cases, though, it is identified (particularly in the British literature) as the area in which the single currency has been introduced (European Monetary Union). This term is rather confusing, however, since in the EU legislation "EMU" refers to Economic and Monetary Union. Under Community law, the Economic and Monetary Union is a broader term also encompassing the system of co-ordination of the economic policies of all the EU Member States. The term "EMU" (i.e. Economic and Monetary Union) is therefore not justified in the Czech language to express monetary co-operation in Europe (the expressions "eurozóna" or "EU-12" being more appropriate).

Opt-out clause

Opting out is an exemption granted to a country that does not wish to join the other Member States in a particular area of Community co-operation. The United Kingdom, for instance, asked to be allowed not to take part in the third stage of economic and monetary union (EMU) and similar clauses were agreed with Denmark as regards EMU (it participates in the third stage, but the termination of its status as a "Member State with a derogation" is conditional on a domestic political decision), defence and European citizenship. The Czech Republic, just like the other acceding countries, will not be granted an opt-out clause.

European Central Bank (ECB)

The European Central Bank was inaugurated on 30 June 1998 and is located in Frankfurt am Main. On 1 January 1999 it took over responsibility for implementing European monetary policy. The ECB ensures that the tasks conferred upon the Eurosystem and the European System of Central Banks (ESCB) are implemented either by its own activities (pursuant

to the ESCB Statute) or through the national central banks. The ECB is governed by the Executive Board, a six-member management team headed by the President.

Eurosystem

The Eurosystem consists of the European Central Bank (ECB) and the national central banks of the EU Member States which introduced the euro in the third stage of economic and monetary union (EMU). Twelve national central banks are therefore participating in the Eurosystem at present. Its decision-making and managing body is the Governing Council (comprising the governors of the euro-area national central banks and the ECB Executive Board). It is tasked with implementing the single monetary policy of the euro area as from 1 January 1999. Its primary objective is to maintain price stability.

The European System of Central Banks (ESCB)

The European System of Central Banks is composed of the ECB and the national central banks of all 15 EU Member States. Unlike the Eurosystem, it includes the national central banks of the EU Member States that have not adopted the euro. Its supreme body is the General Council, comprising the governors of the national central banks of all 15 Member States and the members of the Executive Board. The General Council has limited decision-making powers and will be a decision-making body only as long as there exist Member States with a derogation.

Stability and Growth Pact (SGP)

The Stability and Growth Pact has to be seen against the background of the third stage of economic and monetary union. Its aim is to ensure that the Member States continue their budgetary discipline efforts once the single currency has been introduced. The Pact comprises a European Council resolution (adopted at Amsterdam on 17 June 1997) and two Council Regulations of 7 July 1997 laying down detailed technical arrangements (one on the surveillance of budgetary positions and co-ordination of economic policies and the other on implementing the excessive deficit procedure). In the medium term the Member States have undertaken to pursue the objective of a balanced or surplus budget and to present the Council and the Commission with a stability programme each year. Member States with a derogation and those not taking part in the third stage of EMU are required to submit a convergence programme. The Stability and Growth Pact opens the way for the Council to penalise any participating Member State which fails to take appropriate measures to end an excessive deficit. Initially, the penalty would take the form of a non-interest-bearing deposit with the Community, but it could be converted into a fine if the excessive deficit is not corrected within two years. In the case of high budget deficits a similar procedure will also be applied to Member States with a derogation, although without the threat of financial penalties (a formal procedure).

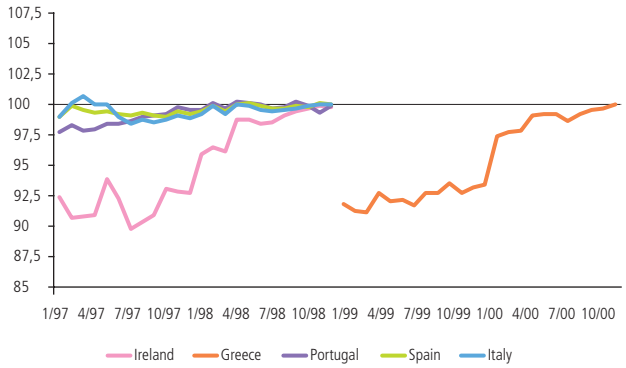
ANNEX 2: EXCHANGE RATE AND INTEREST RATE DIFFERENTIALS IN SOME EU COUNTRIES PRIOR TO INTRODUCING THE EURO

As the two charts below illustrate, the experience of the EU Member States points to the existence of two scenarios:

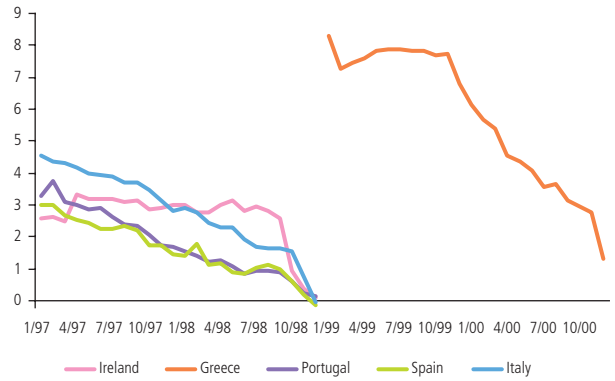
- *exchange rate stabilisation* – in the two years before they joined the euro area, Spain and Portugal stabilised their exchange rates against the German mark within a relatively narrow fluctuation band. Although they had the wide band at their disposal, the volatility of their exchange rates did not exceed the "narrow" ERM band (±2.25%) in this period. These countries also saw a continuously falling and almost identical interest rate differential vis-à-vis Germany, as well as a moderately rising inflation differential (but nevertheless fulfilled the inflation criterion).

- *exchange rate appreciation* – Ireland and Greece initially recorded relatively strong appreciation of their nominal exchange rates inside the standard ERM fluctuation band of ±15%. This appreciation was later partially "accommodated" by revaluations of central parity within the ERM/ERM II (in the case of the punt by 3% in 1995 and in the case of the drachma by 3.6% in 2000). The full cancelling out of the "exchange rate overshooting" (the maximum deviations against the mark were 11.1% for Ireland and 9.2% for Greece) took place through a gradual depreciation of the punt and drachma in line with expectations of the irrevocable fixing of their rates and with a narrowing of the interest differential. This period is shown in the chart.

A. Exchange rates against DEM/EUR
(central parity/conversion rate against EUR = 100; depreciation = growth of the exchange rate)



B. Interest rate differentials against DEM/EUR – (O/N rates in per cent)



MINUTES OF THE CNB BANK BOARD MEETINGS

MINUTES OF THE BOARD MEETING ON 24 APRIL 2003

Present at the meeting:

Zdeněk Tůma (Governor), Oldřich Dědek (Vice-Governor), Michaela Erbenová (Chief Executive Director), Jan Frait (Chief Executive Director), Pavel Štěpánek (Chief Executive Director)

The Board opened the meeting with a presentation of the April situational report containing the new forecast for inflation and other macroeconomic variables.

Inflation still remained very low due to a combination of external factors, such as a sharp decline in agricultural producer prices, the strong year-on-year appreciation of the Czech koruna vis-a-vis the dollar, a continuation of low imported inflation, and slow economic growth abroad. Internal demand pressurès also did not affect price growth.

The forecast still expected inflation to pick up speed in the upcoming period due to the exogenous effects gradually dying out. In contrast to the January situational report, the anticipated harmonisation of indirect tax changes was also accounted for in the forecast. This measure was related to signing of the EU accession agreement, which incorporated tax harmonisation. The direct impact of indirect tax corrections on the price level was estimated to be around 2.5 percentage points over the next two years. As a result, the inflation forecast would be situated slightly above the CNB's targeted band for a temporary period of time. Tax changes would probably have an indirect effect as well via inflation expectations, wage negotiations, etc. According to the forecast, however, these effects would be significantly reduced in view of the current economic situation and the exceptional character of tax changes.

In comparison with the second half of 2002, the rate of economic growth this year should slightly increase. Relatively loose monetary conditions coupled with the associated gradual recovery for investment and net export would have a favourable effect. On the other hand, growth would be dampened by the continuing weak business cycle abroad. This should improve during 2004. A slowdown in household consumption would, nevertheless, occur due to the negative income effect of rising indirect taxes. Hence, GDP growth in both years would evidently remain below 3%, and the unemployment rate would settle at around 10%. The absence of demand pressures on inflation would continue as a result. Starting in 2004, this situation would gradually start to change.

Data on public budget deficits for 2002 were being reassessed downward. Implementation of reform measures had been postponed for now. Therefore, the new forecast anticipated a less ambitious form of fiscal consolidation. According to a sample survey carried out on households, inflation expectations had increased recently, which could reflect the expected price effects of EU accession. However, the forecast did not anticipate any substantial effect on wage negotiations and inflation pressures from these expectations.

The more or less stable interest rates in upcoming months followed by a gradual rise in these rates were consistent with the forecast. This conclusion was conditioned by information available at the time the forecast was formulated and by the assumption that monetary policy would not react to the primary effects of tax changes.

Following the presentation of the situational report, the Board turned to a discussion of the new forecast and the associated uncertainties and implications for setting interest rates. There was consensus among members that the predicted rise in inflation temporarily above the targeted band – caused by anticipated indirect tax changes – could not automatically be considered a reason for increasing interest rates. This particular situation fell under an escape clause. In addition, it was expressed that if tax changes were not included in the scenario, the current inflation forecast could fall below the January forecast due, among other things, to the constant delays in economic recovery abroad, a decline in the risks associated with the price of oil, and flat growth next year. If the rise in taxes were postponed until later, and at the same time, some of the forecast's disinflationary risks materialised, then it would be appropriate not to exclude the possibility of an additional, moderate cut in interest rates.

The Board devoted a considerable amount of time discussing the indirect effects of tax corrections. Most members agreed that these effects would probably be limited in nature. In this respect, it was mentioned that the current low price growth provided a very opportune situation for implementing tax changes. Postponing these changes until they accumulated at some point and time would not be desirable and would increase the risks of secondary inflationary pressures and, in turn, the need to employ monetary policy in the future.

Board members agreed that fiscal development was a significant source of uncertainty. The timing and form of public budget consolidation were not known at present. If reform relied more on increasing taxes than on changing the structure of expenditures, this would be a less favourable option for economic development and interest rate settings. In view of GDP growth, there was also uncertainty about the intensity of investment and net export recovery connected with a certain spontaneous easing of monetary conditions. This easing was caused by nominal exchange rate stability and a decline in real interest rates in the future due to rising inflation expectations. The rate of recovery abroad also remained uncertain. However, in comparison to previous months, the uncertainty associated with the geopolitical situation had been reduced.

At the close of the meeting, the Board decided unanimously to leave the CNB two-week repo unchanged at 2.50%.

MINUTES OF THE BOARD MEETING ON 29 MAY 2003

Present at the meeting:

Zdeněk Tůma (Governor), Oldřich Dědek (Vice-Governor), Luděk Niedermayer (Vice-Governor),
Michaela Erbenová (Chief Executive Director), Jan Frait (Chief Executive Director),
Pavel Racocha (Chief Executive Director), Pavel Štěpánek (Chief Executive Director)

The Board opened the meeting with a presentation of the 5th situational report on economic and monetary development. On the basis of the latest data, it was stated in the report that the risks associated with reaching the forecast had shifted towards a disinflation path a month after approving the inflation forecast. The main reasons behind this shift were the strengthening Czech koruna vis-a-vis the dollar, current oil prices and subdued price developments abroad. During the second third of May, the dollar sùbstantially weakened. The Consensus Forecasts published in May also indicated that this weak position could continue in the future. In contrast to the original assumptions, the price of Ural oil had declined rapidly in April and the beginning of May. Both factors were reflected in industrial producer prices, which in April were 0.7% lower than a year ago. In addition, agricultural producer prices fluctuated below the forecast assumptions.

Higher gas prices and the regular seasonal increase in the prices of fruit and vegetables contributed most to the 0.2% month-on-month rise in April consumer prices. The moderate decline in other food prices and the fact that fuel prices had started to fall worked in the opposite direction. It was indicated in the situational report that price developments in the Czech Republic significantly differed from the situation in EU countries, where year-on-year growth of consumer prices had been above 2% for several months and year-on-year growth of industrial producer prices was even higher.

It was stated during the presentation of the situational report that the change in indirect taxes in 2004 would affect the year-on-year consumer price index by about 1.5% according to the latest figures, which was less than the estimate in the April forecast. This value involved the direct and expected secondary impact of reduced VAT rates for some services towards the base rate as well as higher excise taxes for alcohol, fuels and tobacco products. Contrary to the forecast assumptions, there would apparently not be a shift to higher VAT rates for the restaurant and hotel industry in the near future.

Year-on-year money supply growth reached an historical low of +2.5% at the end of Q1, which was consistent with the exceptionally low inflation values at this time. The situational report pointed to the different approach to M2 used by the European Central Bank to assess the money supply. If this same approach were applied in the Czech Republic, the current year-on-year money supply growth would be 6%.

In the discussion to follow, the Board confirmed the rise in disinflationary risks since the last situational report. However, various opinions dealt with whether the weight of the newly available information could lead to doubts about the current inflation forecast as the main criterion for monetary policy decision-making. Some board members expressed substantial doubts about whether or not the current forecast was consistent and credible enough and recommended as an exceptional case that a new inflation forecast be submitted early to the Board, i.e. for the discussion of the June situational report. On the other hand, it was argued that the shift in risks for reaching the forecast was a natural process and that this, in itself, was not reason enough to formulate a new forecast. In this respect, it was reminded that the European Central Bank constructed its forecast on a half-year basis. The proposal to reformulate a new inflation forecast in advance was rejected by a majority vote. The forecast would be submitted as scheduled at its regular July meeting.

A number of opinions surfaced during the discussion on whether the present exogenous factors were predominantly short-term in nature or whether they had a medium-term character. Some members pointed out that, besides the exogenous risks, there were also significant endogenous disinflationary factors to deal with, such as the increasing negative output gap, agricultural producer prices and the impact of the planned fiscal reforms on wages and other incomes of residents. Emphasis was put on the need to more carefully analyse the development of household indebtedness in relation to the rapid growth of bank and non-bank consumer loans.

It was expressed that the proposal for public finance reform was going in the right direction. This, however, was only the first step, and the proposal as it stood now was not sufficient enough for sustaining public finance development. The new information and changes in the area of indirect taxes were discussed in depth. It was reminded that the recent medialisation of the rise in VAT rates for some services disproportionately amplified its impact on inflation and, in turn, increased the likelihood of higher unfavourable secondary effects from this change.

At the close of the meeting, the Board decided by a majority vote to leave the CNB two-week repo rate unchanged at 2.5%. Five board members voted in favour of the decision, and two members voted for reducing the rate by 0.25 percentage points.

MINUTES OF THE BOARD MEETING ON 25 JUNE 2003

Present at the meeting:

Zdeněk Tůma (Governor), Oldřich Dědek (Vice-Governor), Luděk Niedermayer (Vice-Governor),
Michaela Erbenová (Chief Executive Director), Jan Frait (Chief Executive Director),
Pavel Racocha (Chief Executive Director), Pavel Štěpánek (Chief Executive Director)

The Board opened the meeting with a presentation of the 6th situational report on economic and monetary development. It was stated in the report that the effect of disinflationary cost factors still played a decisive role in consumer prices, especially oil prices and the exchange rate of the US dollar. In comparison to last month, the level of consumer prices had not changed. Within this framework, however, the rate of food price growth had increased to a certain extent while the continued decline in fuel prices worked in the opposite direction. Industrial producer prices were 0.8% lower in May than a year ago.

Data had been published since the last situational report showing higher economic growth than originally expected. This growth was most prevalent in the segment of household consumption. In addition, the trade balance results were better than the forecast had predicted, especially after certain corrections were made in the data. The rise in year-on-year lending (+4.5% in nominal terms) and the structure of lending corresponded to this situation. Household lending contributed most to this development, with year-on-year dynamics reaching 30%.

In this respect, the situational report focused in more detail on household indebtedness in the Czech Republic. It was revealed that the high dynamics of household lending was the result of changes in the supply of banks and other financial institutions, low interest rates and, in particular, the initial low base. In spite of the rapid development of lending, household indebtedness in the Czech Republic still remained below the level typical for EU countries. For banks, household lending is substantially less risky than corporate lending.

Very weak foreign demand accompanied by slowing price growth in the EU helped to sustain the low inflation environment in the Czech economy. In contrast, domestic demand was slightly higher than expected by the inflation forecast. However, even this factor could not be considered a significant inflation risk. Therefore, on the whole, the risks of not reaching the April inflation forecast were once again assessed by the situational report as being asymmetric in a disinflationary direction.

In the discussion to follow, board members agreed that the CNB's approach so far to lowering interest rates was considered to be effective. In an environment of very weak foreign demand, this had helped stimulate domestic consumption. It was impossible to have an immediate effect on unsatisfactory investment development with monetary measures alone.

Several views pointed to the gravity of the current disinflationary risks and their effect during the period of the most effective monetary transmission. Accordingly, a number of different stances examined the choices available for lowering interest rates or leaving the rates unchanged.

The unexpected improvements in data on economic activity this year was an argument in favour of leaving rates at their current level, e.g. GDP growth, industrial production and the trade balance results. It was pointed out that economic growth was concentrated in areas relevant for the future development of inflation: household and government consumption. One opinion expressed that another cut in rates could help create a bubble on the real estate market and an unwanted shift in real interest rates downward to negative values. Even the latest exchange rate developments for the koruna would not lead to tightened monetary conditions. With the impact of leaving lower VAT rates for the hotel and restaurant industry, the next inflation forecast would be shifted down. However, even afterwards, the year-on-year CPIs were expected to fluctuate in the upper half of the targeted band throughout all of next year.

It was reminded in support of lowering rates that the GDP growth figures did not mean yet that the output gap would close up, so its relationship to future inflation was not straightforward. It was also pointed out that the rise in household consumption in Q1 was aided by certain short-lived, temporary effects, such as indemnity payments or the previous term for wage corrections in the public sector. The prepared consolidation of public finances was indicated as being an important anti-inflationary factor, suppressing household and government consumption growth. The yield curves showed expectations of a rate cut of 0.25 points, so a decision to lower rates should not surprise the markets. It was also reminded that all European countries were dealing with the consequences of unsatisfactory growth in the EU and a weakening dollar, and many countries had reacted by lowering rates. One view expressed that if a rate cut were indeed feasible, then it would not be advisable or correct to delay such a decision.

The Board discussed the current account in detail. From the long-term perspective, the current account deficits were rising under the influence of the balance of services and the balance of income. As mentioned during the discussion, this involved the medium- and long-term risk for the future development of the exchange rate and inflation. For the short-term outlook, this risk was still small due to favourable trade balance developments. If the global economy recovered and some of the global risks were reduced, the balance of services should also show improvement. A worsening balance of income was the tangible outcome of previous privatisation and investment; the share of the distribution of profit in reinvested profit and in profit transferred to home countries was important for future developments.

Following the discussion of the 6th situational report, the Board decided by a majority vote to lower the CNB two-week repo rate by 0.25 percentage points to 2.25%, effective 26 June 2003. Four board members voted in favour of cutting rates by 0.25 percentage points, and three members were in favour of leaving rates unchanged. The Board also voted to cut rates by 0.5 percentage points; one member voted in favour and six against this proposal. The discount and Lombard rates were also lowered by 0.25 percentage points to 1.25% and 3.25%, respectively.

INFLATION DEVELOPMENT

annual percentage changes

	1999											
	1	2	3	4	5	6	7	8	9	10	11	12
Consumer prices	3.5	2.8	2.5	2.5	2.4	2.2	1.1	1.4	1.2	1.4	1.9	2.5
Regulated prices	12.1	11.9	11.7	11.1	11.1	11.0	4.4	4.3	4.3	4.2	4.2	4.2
(contribution to consumer price inflation)	*2.97*	*2.90*	*2.87*	*2.75*	*2.74*	*2.72*	*1.13*	*1.12*	*1.12*	*1.08*	*1.08*	*1.09*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.32*	*0.32*	*0.32*	*0.32*	*0.32*	*0.32*
Net inflation	0.7	-0.1	-0.4	-0.3	-0.5	-0.6	-0.5	-0.1	-0.3	0.0	0.6	1.5
(contribution to consumer price inflation)	*0.54*	*-0.06*	*-0.33*	*-0.21*	*-0.37*	*-0.49*	*-0.36*	*-0.06*	*-0.21*	*0.02*	*0.47*	*1.14*
of which: prices of food, beverages and tobacco	-2.0	-3.1	-4.0	-4.3	-4.8	-5.0	-4.8	-4.1	-4.1	-3.6	-2.4	-0.7
(contribution to consumer price inflation)	*-0.61*	*-0.98*	*-1.25*	*-1.34*	*-1.48*	*-1.53*	*-1.44*	*-1.24*	*-1.24*	*-1.09*	*-0.71*	*-0.22*
adjusted inflation	2.6	2.1	2.1	2.5	2.5	2.3	2.5	2.7	2.3	2.5	2.6	3.0
(contribution to consumer price inflation)	*1.15*	*0.91*	*0.92*	*1.13*	*1.11*	*1.04*	*1.08*	*1.17*	*1.04*	*1.11*	*1.17*	*1.35*
Inflation rate (annual moving average)	9.8	8.9	8.0	7.1	6.3	5.5	4.7	4.1	3.4	2.9	2.5	2.1
	2000											
Consumer prices	3.4	3.7	3.8	3.4	3.7	4.1	3.9	4.1	4.1	4.4	4.3	4.0
Regulated prices	7.3	7.3	7.3	7.4	7.5	7.8	6.9	7.0	7.0	7.2	7.3	7.3
(contribution to consumer price inflation)	*1.94*	*1.95*	*1.96*	*1.98*	*1.99*	*2.09*	*1.87*	*1.90*	*1.91*	*1.98*	*1.99*	*1.97*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.32*	*0.32*	*0.32*	*0.14*	*0.14*	*0.14*	*-0.18*	*-0.18*	*-0.18*	*-0.18*	*-0.18*	*-0.18*
Net inflation	1.6	1.9	2.1	1.7	2.1	2.6	3.1	3.2	3.2	3.5	3.4	3.0
(contribution to consumer price inflation)	*1.19*	*1.38*	*1.55*	*1.27*	*1.57*	*1.90*	*2.25*	*2.36*	*2.35*	*2.57*	*2.49*	*2.16*
of which: prices of food, beverages and tobacco	-0.6	0.0	0.1	-0.4	0.2	0.4	1.6	2.5	2.8	3.9	3.9	3.6
(contribution to consumer price inflation)	*-0.16*	*0.00*	*0.02*	*-0.12*	*0.07*	*0.13*	*0.45*	*0.73*	*0.79*	*1.06*	*1.06*	*1.01*
adjusted inflation	3.1	3.2	3.5	3.2	3.4	4.0	4.1	3.8	3.5	3.4	3.2	2.6
(contribution to consumer price inflation)	*1.35*	*1.39*	*1.53*	*1.39*	*1.49*	*1.77*	*1.80*	*1.63*	*1.56*	*1.51*	*1.43*	*1.15*
Inflation rate (annual moving average)	2.1	2.2	2.3	2.4	2.5	2.6	2.9	3.1	3.3	3.6	3.8	3.9
	2001											
Consumer prices	4.2	4.0	4.1	4.6	5.0	5.5	5.9	5.5	4.7	4.4	4.2	4.1
Regulated prices	10.3	10.4	10.6	10.8	10.7	10.4	11.5	11.8	11.9	11.8	11.7	11.7
(contribution to consumer price inflation)	*1.95*	*1.98*	*2.01*	*1.98*	*2.00*	*1.97*	*2.12*	*2.19*	*2.19*	*2.19*	*2.16*	*2.17*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*-0.18*	*-0.18*	*-0.18*	*0.00*	*0.00*	*0.00*	*0.01*	*0.01*	*0.05*	*0.05*	*0.05*	*0.05*
Net inflation	3.0	2.9	2.9	3.3	3.8	4.4	4.7	4.1	3.1	2.7	2.4	2.4
(contribution to consumer price inflation)	*2.37*	*2.23*	*2.24*	*2.62*	*2.97*	*3.52*	*3.74*	*3.31*	*2.54*	*2.15*	*1.98*	*1.92*
of which: prices of food, beverages and tobacco	3.8	3.5	4.2	5.5	6.0	7.7	6.9	5.1	4.0	2.9	2.6	2.9
(contribution to consumer price inflation)	*1.09*	*1.02*	*1.25*	*1.62*	*1.78*	*2.24*	*2.11*	*1.70*	*1.28*	*0.97*	*0.87*	*0.80*
adjusted inflation	2.5	2.4	2.0	1.9	2.3	2.4	3.2	3.4	2.5	2.4	2.3	2.1
(contribution to consumer price inflation)	*1.28*	*1.21*	*0.99*	*1.00*	*1.18*	*1.27*	*1.63*	*1.62*	*1.26*	*1.17*	*1.11*	*1.12*
Inflation rate (annual moving average)	4.0	4.0	4.0	4.1	4.2	4.3	4.5	4.6	4.7	4.7	4.7	4.7
	2002											
Consumer prices	3.7	3.9	3.7	3.2	2.5	1.2	0.6	0.6	0.8	0.6	0.5	0.6
Regulated prices	7.6	8.1	8.0	6.5	6.3	6.3	5.3	5.0	4.9	3.4	3.4	3.3
(contribution to consumer price inflation)	*1.49*	*1.60*	*1.59*	*1.28*	*1.24*	*1.22*	*1.05*	*0.98*	*0.98*	*0.69*	*0.69*	*0.66*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.05*	*0.05*	*0.05*	*0.05*	*0.05*	*0.05*	*0.05*	*0.05*	*0.00*	*0.00*	*0.00*	*0.00*
Net inflation	2.7	2.7	2.5	2.4	1.5	-0.1	-0.6	-0.6	-0.3	-0.1	-0.2	-0.2
(contribution to consumer price inflation)	*2.20*	*2.15*	*2.01*	*1.89*	*1.20*	*-0.12*	*-0.47*	*-0.46*	*-0.22*	*-0.11*	*-0.18*	*-0.15*
of which: prices of food, beverages and tobacco	3.2	3.0	2.3	1.7	0.6	-2.6	-3.6	-3.5	-2.9	-3.0	-3.2	-3.4
(contribution to consumer price inflation)	*0.88*	*0.82*	*0.65*	*0.47*	*0.16*	*-0.72*	*-0.97*	*-0.96*	*-0.79*	*-0.80*	*-0.87*	*-0.93*
adjusted inflation	2.5	2.5	2.6	2.7	2.0	1.1	0.9	0.9	1.1	1.3	1.3	1.5
(contribution to consumer price inflation)	*1.32*	*1.33*	*1.37*	*1.43*	*1.04*	*0.60*	*0.50*	*0.50*	*0.56*	*0.69*	*0.69*	*0.79*
Inflation rate (annual moving average)	4.6	4.6	4.6	4.5	4.3	3.9	3.5	3.1	2.7	2.4	2.1	1.8
	2003											
Consumer prices	-0.4	-0.4	-0.4	-0.1	0.0	0.3						
Regulated prices	-0.3	-0.8	-0.8	1.4	1.5	1.5						
(contribution to consumer price inflation)	*-0.07*	*-0.15*	*-0.16*	*0.29*	*0.31*	*0.32*						
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*						
Net inflation	-0.4	-0.2	-0.2	-0.5	-0.4	0.0						
(contribution to consumer price inflation)	*-0.32*	*-0.17*	*-0.15*	*-0.38*	*-0.30*	*-0.01*						
of which: prices of food, beverages and tobacco	-4.1	-3.8	-3.5	-3.5	-2.8	-1.0						
(contribution to consumer price inflation)	*-1.06*	*-1.06*	*-0.97*	*-0.94*	*-0.76*	*-0.28*						
adjusted inflation	1.5	1.7	1.5	1.1	0.9	0.5						
(contribution to consumer price inflation)	*0.74*	*0.89*	*0.82*	*0.56*	*0.46*	*0.27*						
Inflation rate (annual moving average)	1.5	1.1	0.8	0.5	0.3	0.2						

CNB calculation based on CZSO data

INFLATION DEVELOPMENT

monthly percentage changes

	1999											
	1	2	3	4	5	6	7	8	9	10	11	12
Consumer prices	0.8	0.0	-0.2	0.3	-0.1	0.2	0.8	0.1	-0.1	0.0	0.2	0.5
Regulated prices	1.8	0.2	0.0	0.1	0.0	0.0	1.9	0.0	0.1	0.0	0.0	0.0
(contribution to consumer price inflation)	*0.46*	*0.04*	*0.01*	*0.02*	*0.01*	*0.01*	*0.49*	*0.00*	*0.02*	*0.00*	*0.01*	*0.01*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.32*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Net inflation	0.5	-0.1	-0.2	0.4	-0.1	0.2	0.0	0.1	-0.1	0.0	0.3	0.6
(contribution to consumer price inflation)	*0.36*	*-0.07*	*-0.17*	*0.27*	*-0.08*	*0.16*	*-0.01*	*0.06*	*-0.08*	*0.03*	*0.20*	*0.47*
of which: prices of food, beverages and tobacco	0.9	-0.5	-0.7	0.0	-0.4	0.2	-1.2	-0.2	0.0	0.0	0.3	0.8
(contribution to consumer price inflation)	*0.25*	*-0.13*	*-0.19*	*0.00*	*-0.11*	*0.06*	*-0.35*	*-0.05*	*0.00*	*-0.01*	*0.09*	*0.22*
adjusted inflation	0.2	0.1	0.0	0.6	0.1	0.2	0.7	0.3	-0.1	0.1	0.2	0.6
(contribution to consumer price inflation)	*0.11*	*0.06*	*0.02*	*0.27*	*0.03*	*0.10*	*0.33*	*0.12*	*-0.07*	*0.04*	*0.10*	*0.25*
	2000											
Consumer prices	1.7	0.2	0.0	-0.1	0.2	0.6	0.6	0.2	0.0	0.3	0.1	0.2
Regulated prices	4.8	0.1	0.1	0.2	0.1	0.4	1.0	0.1	0.1	0.2	0.1	0.1
(contribution to consumer price inflation)	*1.29*	*0.04*	*0.02*	*0.05*	*0.02*	*0.10*	*0.27*	*0.02*	*0.03*	*0.06*	*0.03*	*0.01*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*-0.18*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Net inflation	0.6	0.2	0.0	0.0	0.3	0.7	0.5	0.2	-0.1	0.3	0.1	0.2
(contribution to consumer price inflation)	*0.42*	*0.13*	*-0.01*	*-0.01*	*0.21*	*0.48*	*0.34*	*0.18*	*-0.08*	*0.26*	*0.10*	*0.14*
of which: prices of food, beverages and tobacco	1.0	0.1	-0.6	-0.5	0.3	0.4	-0.1	0.7	0.3	1.1	0.3	0.6
(contribution to consumer price inflation)	*0.30*	*0.03*	*-0.17*	*-0.14*	*0.07*	*0.11*	*-0.02*	*0.20*	*0.08*	*0.29*	*0.08*	*0.16*
adjusted inflation	0.3	0.2	0.3	0.3	0.3	0.8	0.8	0.0	-0.4	-0.1	0.0	0.0
(contribution to consumer price inflation)	*0.12*	*0.10*	*0.15*	*0.13*	*0.14*	*0.37*	*0.36*	*-0.02*	*-0.15*	*-0.04*	*0.02*	*-0.02*
	2001											
Consumer prices	1.9	0.0	0.1	0.4	0.6	1.0	1.0	-0.2	-0.7	0.0	-0.1	0.1
Regulated prices	7.7	0.3	0.2	0.3	0.0	0.1	2.1	0.3	0.2	0.1	0.0	0.0
(contribution to consumer price inflation)	*1.43*	*0.05*	*0.05*	*0.06*	*0.00*	*0.01*	*0.41*	*0.06*	*0.04*	*0.03*	*-0.01*	*0.01*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.01*	*0.00*	*0.05*	*0.00*	*0.00*	*0.00*
Net inflation	0.6	0.0	0.0	0.4	0.8	1.3	0.7	-0.3	-1.0	-0.1	-0.1	0.2
(contribution to consumer price inflation)	*0.45*	*0.01*	*-0.01*	*0.31*	*0.57*	*1.07*	*0.56*	*-0.21*	*-0.82*	*-0.10*	*-0.05*	*0.10*
of which: prices of food, beverages and tobacco	1.2	-0.2	0.1	0.7	0.8	2.0	-0.9	-1.0	-0.8	0.0	0.0	0.9
(contribution to consumer price inflation)	*0.33*	*-0.06*	*0.03*	*0.19*	*0.23*	*0.56*	*-0.24*	*-0.27*	*-0.21*	*0.00*	*-0.01*	*0.24*
adjusted inflation	0.2	0.1	-0.1	0.2	0.7	1.0	1.5	0.1	-1.2	-0.2	-0.1	-0.3
(contribution to consumer price inflation)	*0.12*	*0.07*	*-0.04*	*0.12*	*0.34*	*0.51*	*0.81*	*0.06*	*-0.62*	*-0.10*	*-0.03*	*-0.14*
	2002											
Consumer prices	1.5	0.2	-0.1	-0.1	-0.1	-0.3	0.5	-0.2	-0.5	-0.3	-0.2	0.2
Regulated prices	3.7	0.8	0.2	-1.1	-0.1	0.0	1.1	0.0	0.1	-1.3	0.0	-0.1
(contribution to consumer price inflation)	*0.75*	*0.16*	*0.04*	*-0.23*	*-0.03*	*0.00*	*0.23*	*-0.01*	*0.03*	*-0.26*	*0.00*	*-0.02*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Net inflation	0.9	0.0	-0.2	0.2	-0.1	-0.3	0.3	-0.2	-0.7	0.0	-0.1	0.2
(contribution to consumer price inflation)	*0.74*	*-0.03*	*-0.14*	*0.20*	*-0.11*	*-0.24*	*0.20*	*-0.19*	*-0.58*	*0.01*	*-0.11*	*0.13*
of which: prices of food, beverages and tobacco	1.5	-0.4	-0.5	0.1	-0.3	-1.2	-1.9	-1.0	-0.1	0.0	-0.3	0.7
(contribution to consumer price inflation)	*0.41*	*-0.11*	*-0.14*	*0.01*	*-0.08*	*-0.32*	*-0.50*	*-0.25*	*-0.03*	*-0.01*	*-0.08*	*0.18*
adjusted inflation	0.6	0.2	0.0	0.3	-0.1	0.2	1.3	0.1	-1.0	0.0	-0.1	-0.1
(contribution to consumer price inflation)	*0.33*	*0.08*	*0.00*	*0.18*	*-0.04*	*0.08*	*0.70*	*0.07*	*-0.56*	*0.02*	*-0.03*	*-0.05*
	2003											
Consumer prices	0.6	0.2	-0.1	0.2	0.0	0.0						
Regulated prices	0.1	0.3	0.2	1.1	-0.1	0.0						
(contribution to consumer price inflation)	*0.03*	*0.06*	*0.03*	*0.23*	*-0.01*	*0.01*						
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*						
Net inflation	0.7	0.2	-0.2	0.0	0.0	0.1						
(contribution to consumer price inflation)	*0.55*	*0.14*	*-0.13*	*-0.03*	*-0.04*	*0.05*						
of which: prices of food, beverages and tobacco	0.8	-0.2	-0.2	0.1	0.4	0.6						
(contribution to consumer price inflation)	*0.22*	*-0.05*	*-0.05*	*0.04*	*0.10*	*0.16*						
adjusted inflation	0.6	0.3	-0.1	-0.1	-0.3	-0.2						
(contribution to consumer price inflation)	*0.33*	*0.18*	*-0.07*	*-0.06*	*-0.14*	*-0.11*						

CNB calculation based on CZSO data

CONSUMER PRICES

percentage changes; December 1999 = 100

Group	Constant 1999 weights in per mille	Months												Average since start of year
		1	2	3	4	5	6	7	8	9	10	11	12	
Total - 1999	1000.0	-1.6	-1.6	-1.7	-1.5	-1.5	-1.4	-0.6	-0.5	-0.6	-0.5	-0.3	0.1	-1.0
Total - 2000	1000.0	1.8	2.0	2.0	1.9	2.1	2.7	3.3	3.5	3.5	3.8	3.9	4.1	2.9
Food and non-alcoholic beverages	197.6	1.8	1.9	1.1	0.4	0.7	1.3	1.1	1.7	2.1	3.5	3.8	4.6	2.0
Alcoholic beverages and tobacco	79.2	0.5	0.6	0.8	0.9	1.0	1.0	1.4	2.3	2.5	2.5	2.6	2.4	1.5
Clothing and footwear	56.9	-0.7	-1.7	-2.2	-2.1	-2.0	-2.0	-2.5	-2.9	-3.0	-2.8	-2.6	-2.7	-2.3
Housing, water, electricity, gas and other fuels	236.4	4.6	4.8	4.9	5.2	5.3	5.5	7.0	7.2	7.3	7.6	7.8	7.8	6.3
Furnishings, household equipment and routine maintenance of the house	67.9	-0.3	-0.4	-0.3	-0.3	-0.4	-0.6	-0.6	-0.7	-0.7	-0.9	-0.8	-0.7	-0.6
Health	14.3	1.8	2.2	2.6	2.8	3.1	3.5	3.7	3.9	4.1	4.0	3.9	4.1	3.3
Transport	101.4	0.8	1.4	4.0	3.6	4.8	8.4	8.8	8.0	8.6	8.4	8.0	6.9	6.0
Communications	22.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Recreation and culture	95.5	0.1	1.2	0.4	-0.3	-0.4	0.5	3.8	4.7	1.7	0.9	1.1	2.0	1.3
Education	4.5	0.2	0.9	1.0	1.0	1.0	1.3	1.3	1.3	3.3	3.3	3.3	3.4	1.8
Hotels, cafés and restaurants	74.2	0.6	0.9	0.9	1.1	1.3	1.3	1.4	1.5	2.0	2.4	2.5	2.6	1.5
Miscellaneous goods and services	49.5	2.1	2.3	2.4	2.4	2.5	2.6	2.6	2.7	2.7	2.9	3.1	3.1	2.6
Total - 2001	1000.0	6.1	6.1	6.2	6.6	7.2	8.3	9.4	9.2	8.4	8.4	8.3	8.4	7.7
Food and non-alcoholic beverages	197.6	6.0	5.5	5.5	6.4	7.5	10.5	9.2	7.7	6.7	6.6	6.5	7.9	7.2
Alcoholic beverages and tobacco	79.2	3.4	3.9	4.3	4.6	4.9	5.0	4.9	4.9	5.2	5.5	5.6	5.4	4.8
Clothing and footwear	56.9	-3.3	-4.0	-4.0	-3.8	-3.7	-3.7	-3.9	-4.4	-4.4	-4.1	-3.8	-3.9	-3.9
Housing, water, electricity, gas and other fuels	236.4	14.2	14.4	14.6	14.8	15.1	15.4	18.4	18.6	18.8	18.9	19.0	19.0	16.8
Furnishings, household equipment and routine maintenance of the house	67.9	-0.6	-0.6	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.2	-0.3	-0.4	-0.4
Health	14.3	4.7	4.9	5.1	5.3	5.4	5.7	6.5	7.5	8.6	8.9	8.3	8.4	6.6
Transport	101.4	4.9	4.8	4.7	5.8	7.5	8.7	8.2	7.6	7.8	6.5	5.3	3.4	6.3
Communications	22.5	7.2	7.1	7.1	7.0	6.8	6.7	6.6	6.5	6.0	5.9	5.8	5.7	6.5
Recreation and culture	95.5	2.7	3.4	2.9	2.3	3.3	7.0	13.7	15.3	7.1	6.5	6.8	7.2	6.5
Education	4.5	3.4	3.4	3.5	3.5	3.5	3.6	3.6	3.6	6.7	6.8	6.8	6.8	4.6
Hotels, cafés and restaurants	74.2	3.1	3.6	3.3	3.7	4.0	4.1	4.2	4.4	5.2	5.5	5.7	5.9	4.4
Miscellaneous goods and services	49.5	5.0	5.5	6.2	7.3	7.4	7.4	7.7	7.6	7.8	8.4	8.6	8.7	7.3
Total - 2002	1000.0	10.0	10.2	10.1	10.0	9.9	9.6	10.1	9.9	9.3	9.0	8.8	9.0	9.7
Food and non-alcoholic beverages	197.6	10.0	9.4	8.7	8.3	7.8	6.0	3.2	1.7	1.5	1.4	1.0	2.1	5.1
Alcoholic beverages and tobacco	79.2	5.8	5.8	5.6	6.8	7.0	7.0	7.1	7.3	7.4	7.5	7.4	7.1	6.8
Clothing and footwear	56.9	-4.7	-5.5	-5.7	-5.7	-5.7	-5.8	-6.4	-7.4	-7.4	-7.4	-7.4	-7.7	-6.4
Housing, water, electricity, gas and other fuels	236.4	23.5	23.6	23.7	22.6	22.6	22.6	24.9	25.0	25.0	24.2	24.3	24.3	23.9
Furnishings, household equipment and routine maintenance of the house	67.9	-0.4	-0.5	-0.3	-0.3	-0.3	-0.4	-0.5	-0.7	-0.7	-0.8	-0.9	-1.0	-0.6
Health	14.3	9.2	9.7	10.1	10.2	10.9	11.2	12.9	13.1	13.3	13.0	12.8	12.8	11.6
Transport	101.4	3.0	3.0	3.3	5.5	5.1	4.7	4.1	3.9	5.1	4.9	4.6	4.1	4.3
Communications	22.5	6.0	11.4	11.3	11.3	9.9	9.9	11.1	11.0	11.6	9.4	9.3	8.2	10.0
Recreation and culture	95.5	7.4	8.5	7.9	7.2	7.0	8.4	13.8	15.2	7.3	7.2	7.0	7.2	8.7
Education	4.5	6.9	7.0	7.0	7.0	7.0	7.0	7.0	7.0	10.7	11.3	11.3	11.3	8.4
Hotels, cafés and restaurants	74.2	6.4	7.0	7.4	7.9	8.0	8.2	8.4	8.4	8.5	8.6	8.6	8.7	8.0
Miscellaneous goods and services	49.5	11.0	11.2	11.3	11.6	11.6	11.5	11.5	11.4	11.7	11.9	12.0	11.9	11.6
Total - 2003	1000.0	9.6	9.8	9.7	9.9	9.9	9.9							9.8
Food and non-alcoholic beverages	197.6	3.1	2.8	2.5	2.7	3.2	4.2							3.1
Alcoholic beverages and tobacco	79.2	7.6	7.7	7.7	7.7	7.9	7.6							7.7
Clothing and footwear	56.9	-9.1	-10.0	-10.4	-10.1	-10.1	-10.4							-10.0
Housing, water, electricity, gas and other fuels	236.4	24.9	25.3	25.4	26.5	26.6	26.6							25.9
Furnishings, household equipment and routine maintenance of the house	67.9	-1.1	-1.2	-1.4	-1.6	-1.8	-2.1							-1.5
Health	14.3	13.7	14.2	14.8	15.4	16.3	16.4							15.1
Transport	101.4	4.7	5.2	5.8	5.5	4.5	3.8							4.9
Communications	22.5	7.9	8.9	8.8	9.0	7.5	7.4							8.3
Recreation and culture	95.5	8.5	9.6	8.5	7.7	7.1	7.0							8.1
Education	4.5	11.3	11.4	11.5	11.5	11.5	11.6							11.5
Hotels, cafés and restaurants	74.2	9.2	9.4	9.4	9.5	9.6	9.6							9.5
Miscellaneous goods and services	49.5	14.0	14.6	14.7	14.7	14.6	14.6							14.5

Source: CZSO

CONSUMER PRICES - TRADABLES AND NONTRADABLES

percentage changes; December 1999 = 100

Group	Constant 1999 weights in per mille	2000	2001	2002			2003	
		12	12	6	9	12	3	6
1. Food and non-alcoholic beverages	197.6	4.6	7.9	6.0	1.5	2.1	2.5	4.2
- tradables	197.6	4.6	7.9	6.0	1.5	2.1	2.5	4.2
2. Alcoholic beverages and tobacco	79.2	2.4	5.4	7.0	7.4	7.1	7.7	7.6
- tradables	79.2	2.4	5.4	7.0	7.4	7.1	7.7	7.6
3. Clothing and footwear	56.9	-2.7	-3.9	-5.8	-7.4	-7.7	-10.4	-10.4
- nontradables	1.4	6.1	13.0	16.9	17.6	18.3	19.2	20.0
- tradables	55.5	-2.9	-4.3	-6.4	-8.0	-8.4	-11.2	-11.2
4. Housing, water, electricity, gas and other fuels	236.4	7.8	19.0	22.6	25.0	24.3	25.4	26.6
- nontradables	226.1	8.1	19.7	23.5	26.0	25.2	26.3	27.6
- tradables	10.3	2.3	2.7	1.9	4.0	4.0	5.3	4.0
5. Furnishings, household equipment and routine maintenance of the house	67.9	-0.7	-0.4	-0.4	-0.7	-1.0	-1.4	-2.1
- nontradables	2.9	4.3	7.5	9.3	9.8	9.9	10.8	11.2
- tradables	65.0	-0.9	-0.8	-0.8	-1.2	-1.5	-1.9	-2.7
6. Health	14.3	4.1	8.4	11.2	13.3	12.8	14.8	16.4
- nontradables	11.0	4.9	10.1	13.4	16.0	15.4	17.9	19.9
- tradables	3.3	1.5	2.7	4.0	4.6	4.4	4.9	5.1
7. Transport	101.4	6.9	3.4	4.7	5.1	4.1	5.8	3.8
- nontradables	27.4	6.2	11.7	16.0	16.0	16.0	17.2	17.6
- tradables	74.0	7.2	0.3	0.5	1.1	-0.3	1.6	-1.3
8. Communications	22.5	1.5	5.7	9.9	11.6	8.2	8.8	7.4
- nontradables	21.0	2.7	8.5	13.5	15.6	12.4	13.2	12.0
- tradables	1.5	-16.4	-34.7	-41.3	-45.6	-52.1	-54.6	-58.3
9. Recreation and culture	95.5	2.0	7.2	8.4	7.3	7.2	8.5	7.0
- nontradables	60.4	4.4	14.3	17.5	16.5	16.2	18.8	17.7
- tradables	35.1	-2.2	-5.0	-7.3	-8.6	-8.3	-9.2	-11.4
10. Education	4.5	3.4	6.8	7.0	10.7	11.3	11.5	11.6
- nontradables	4.5	3.4	6.8	7.0	10.7	11.3	11.5	11.6
11. Hotels, cafés and restaurants	74.2	2.6	5.9	8.2	8.5	8.7	9.4	9.6
- nontradables	74.2	2.6	5.9	8.2	8.5	8.7	9.4	9.6
12. Miscellaneous goods and services	49.5	3.1	8.7	11.5	11.7	11.9	14.7	14.6
- nontradables	22.0	5.7	17.5	24.2	25.2	25.8	32.9	33.9
- tradables	27.5	1.1	1.7	1.4	0.9	0.8	0.2	-0.8
Household consumer prices, total	1000.0	4.1	8.4	9.6	9.2	9.0	9.7	9.9
Tradables	549.1	2.5	2.9	2.0	0.3	0.2	0.3	0.2
- food	276.8	4.0	7.2	6.3	3.2	3.5	4.0	5.2
- others	272.3	1.0	-1.5	-2.3	-2.7	-3.2	-3.5	-4.9
Nontradables	450.9	6.0	15.2	18.8	20.2	19.7	21.2	21.8
- others	271.2	4.7	11.5	14.8	16.1	16.4	18.5	18.6
- regulated	179.7	8.0	20.6	24.8	26.3	24.6	25.3	26.7

CNB calculation based on CZSO data

INFLATION EXPECTATIONS OF SELECTED ECONOMIC SECTORS FOR 12 MONTHS AHEAD

annual percentage changes

	CPI		
	Financial market	Businesses	Households
1/99			
2/99			
3/99			
4/99			
5/99	5.0		
6/99	4.7	4.3	3.6
7/99	4.8		
8/99	4.2		
9/99	3.9	3.9	2.1
10/99	4.1		
11/99	3.9		
12/99	4.2	3.9	3.1
1/00	4.0		
2/00	4.5		
3/00	4.5	4.3	4.1
4/00	4.2		
5/00	4.1		
6/00	4.4	4.8	4.1
7/00	4.6		
8/00	4.5		
9/00	4.7	5.0	4.6
10/00	4.6		
11/00	4.8		
12/00	5.0	4.7	4.1
1/01	4.5		
2/01	4.3		
3/01	4.2	4.2	4.0
4/01	4.0		
5/01	4.3		
6/01	4.6	4.8	5.1
7/01	4.6		
8/01	4.7		
9/01	4.8	4.8	4.9
10/01	4.4		
11/01	4.0		
12/01	3.9	3.9	4.6
1/02	3.8		
2/02	3.5		
3/02	3.5	3.6	3.9
4/02	3.5		
5/02	3.3		
6/02	3.1	2.7	1.6
7/02	2.8		
8/02	2.7		
9/02	3.1	1.9	1.3
10/02	2.5		
11/02	2.4		
12/02	2.3	2.3	2.6
1/03	2.5		
2/03	2.4		
3/03	2.5	2.1	4.0
4/03	2.6		
5/03	3.7		
6/03	3.2	2.7	2.3

Source: CNB statistical survey

HARMONISED INDEX OF CONSUMER PRICES

annual percentage changes

	1999	2000	2001	2002	2003
	12	12	12	12	5
Belgium	2.1	3.0	2.0	1.3	0.9
Denmark	3.1	2.3	2.1	2.6	2.1
Finland	2.2	2.9	2.3	1.7	1.1
France	1.4	1.7	1.4	2.2	1.8
Ireland	3.9	4.6	4.4	4.6	3.9
Italy	2.1	2.8	2.2	3.0	2.9
Luxembourg	2.3	4.3	0.9	2.8	2.3
Germany	1.4	2.1	1.4	1.1	0.6
Netherlands	1.9	2.9	5.1	3.5	2.7
Portugal	1.7	3.8	3.9	4.0	3.7
Austria	1.7	1.8	1.8	1.7	0.9
Greece	2.3	3.7	3.5	3.5	3.5
Spain	2.8	4.0	2.5	4.0	2.7
Sweden	1.2	1.3	3.2	1.7	2.0
United Kingdom	1.2	0.9	1.0	1.7	1.2
European Union	1.7	2.2	1.9	2.2	1.8
Czech Republic	2.5	4.0	3.9	0.1	-0.3

Source: Eurostat

MONETARY SURVEY

position at month-end in CZK billions

		1999	2000	2001	2002	2003
		12	12	12	12	5
Total assets		1337.5	1412.3	1596.0	1647.3	1658.5
Net foreign assets		570.4	673.1	800.6	912.9	865.8
- assets		940.2	998.8	1088.4	1187.7	1071.6
- liabilities		369.8	325.7	287.8	274.8	205.8
Net domestic assets		767.1	739.2	795.4	734.4	792.7
Domestic credits		1058.5	1068.8	1011.9	911.1	999.3
Net credit to the government sector		57.5	104.9	236.5	189.9	274.9
- net credit to government		67.7	103.8	246.2	207.4	284.4
- net credit to NPF		-10.2	1.1	-9.7	-17.5	-9.5
Client credits of commercial banks and CNB		1001.0	963.9	775.4	721.2	724.4
CZK credits		824.6	819.7	661.2	620.0	632.9
- businesses		715.7	699.1	524.2	442.5	439.9
- households		108.9	120.6	137.0	177.5	193.0
Foreign currency credits		176.4	144.2	114.2	101.2	91.5
- businesses		173.0	141.9	111.9	99.9	90.5
- households		3.4	2.3	2.3	1.3	1.0
Other net items		-291.4	-329.6	-216.5	-176.7	-206.6
Liabilities						
M2	2)	1337.5	1412.3	1596.0	1647.3	1658.5
M1	1)	447.8	497.7	583.6	692.3	711.4
Currency in circulation		157.9	171.8	180.4	197.8	211.4
CZK demand deposits		289.9	325.9	403.2	494.5	500.0
- households		162.6	195.0	230.2	270.9	308.9
- businesses		124.4	128.0	169.2	221.1	188.4
- insurance companies		2.9	2.9	3.8	2.5	2.7
Quasi money		889.7	914.6	1012.4	955.0	947.1
CZK time deposits		653.1	645.0	742.2	729.6	722.0
- households		537.6	549.8	596.6	568.0	557.5
- businesses		78.9	78.9	120.8	125.7	139.2
- insurance companies		36.6	16.3	24.8	35.9	25.3
Deposit bills of exchange and other bonds	5)	91.3	114.0	112.8	79.6	84.7
Foreign currency deposits		145.3	155.6	157.4	145.8	140.4
- households		80.8	83.7	91.5	79.4	74.4
- businesses		64.5	71.9	65.9	66.4	66.0
Monetary aggregate L	3)	1386.3	1463.5	1643.9	1696.0	1687.7
Annual percentage changes						
M1		10.8	11.1	17.3	18.6	17.6
M2		7.7	5.6	13.0	3.2	2.1
L		7.8	5.6	12.3	3.2	-0.3
Client credits of commercial banks and CNB		-4.4	-3.7	-19.6	-7.0	1.3
Client deposits with banks	4)	0.1	3.5	15.7	5.2	1.6

1) M1 = Currency in circulation + CZK demand deposits
2) M2 = M1 + quasi money
3) L = M2 + T-bills and CNB bills in the portfolios of domestic non-banking institutions
4) CZK deposits + foreign currency deposits
5) In 1998 - 2000 including certificates of deposit

CREDIT SUPPLY

	1999	2000	2001	2002	2003
	12	12	12	12	5
Non-adjusted credits					
Total credits, CZK and foreign currency					
absolute volumes in CZK billions	1001.0	963.9	775.4	721.2	724.4
annual percentage changes	-4.4	-3.7	-19.6	-7.0	1.3
CZK credits					
absolute volumes in CZK billions	824.6	819.7	661.2	620.0	632.9
annual percentage changes	-2.6	-0.6	-19.3	-6.2	2.6
Foreign currency credits					
absolute volumes in CZK billions	176.4	144.2	114.2	101.2	91.5
annual percentage changes	-11.7	-18.3	-20.8	-11.4	-7.0
Adjusted credits 1)					
Total credits, CZK and foreign currency					
absolute volumes in CZK billions	954.7	913.6	932.8	974.9	996.2
annual percentage changes	-4.7	-4.3	2.1	4.5	5.6
CZK credits					
absolute volumes in CZK billions	782.6	771.8	811.5	861.2	889.5
annual percentage changes	-1.3	-1.4	5.1	6.1	6.9
Foreign currency credits					
absolute volumes in CZK billions	172.1	141.8	121.3	113.7	106.7
annual percentage changes	-17.6	-17.6	-14.5	-6.3	-4.3

1) Adjusted for exchange rate effects, write-offs, banks with licences revoked and loan portfolio restructuring

CREDIT BREAKDOWN BY TIME, SECTOR AND TYPE

percentages of the total

	1999	2000	2001	2002	2003
	12	12	12	12	5
Time structure					
Total CZK and foreign currency credits	100.0	100.0	100.0	100.0	100.0
Short-term	39.0	36.6	37.5	34.3	31.0
Medium-term	24.2	22.2	26.0	30.9	32.0
Long-term	36.8	41.2	36.5	34.8	37.0
Sector structure					
Total CZK and foreign currency credits	100.0	100.0	100.0	100.0	100.0
Businesses	88.8	87.2	82.0	75.2	73.2
Households	11.2	12.8	18.0	24.8	26.8
Type structure 1)					
Total CZK and foreign currency credits	100.0	100.0	100.0	100.0	100.0
Operating	52.0	49.3	42.6	40.9	40.1
Investment (incl. general housing construction)	31.1	30.8	35.2	29.5	28.0
Mortgage	2.8	4.1	6.7	9.6	11.0
Consumer	2.9	3.3	3.6	7.3	7.7
For privatisation	2.3	2.0	0.4	0.2	0.2
For temporary fund shortage	7.4	9.1	9.8	5.5	1.1
For securities purchase	1.5	1.4	1.7	0.4	0.3
Building savings loans				6.4	7.0
Others				0.2	4.6

1) Owing to new methodology introduced on 1 January 2002, the figures on type structure are not comparable with the previous period's figures

INTEREST RATES ON INTERBANK DEPOSITS

percentages

	1999	2000	2001	2002	2003
	12	12	12	12	6
1. AVERAGE PRIBOR 1)					
- 1 day	5.21	5.23	4.63	2.75	2.47
- 7 day	5.32	5.29	4.79	2.76	2.47
- 14 day	5.40	5.29	4.78	2.76	2.46
- 1 month	5.59	5.32	4.77	2.73	2.41
- 2 month	5.58	5.36	4.72	2.67	2.36
- 3 month	5.58	5.42	4.69	2.63	2.33
- 6 month	5.64	5.60	4.62	2.60	2.28
- 9 month	5.72	5.78	4.61	2.60	2.28
- 12 month	5.84	5.90	4.62	2.60	2.28
2. AVERAGE PRIBID 1)					
- 1 day	5.05	5.11	4.53	2.65	2.37
- 7 day	5.16	5.18	4.69	2.67	2.37
- 14 day	5.23	5.19	4.69	2.67	2.36
- 1 month	5.42	5.22	4.68	2.64	2.31
- 2 month	5.40	5.26	4.62	2.57	2.26
- 3 month	5.41	5.31	4.59	2.54	2.23
- 6 month	5.46	5.49	4.52	2.51	2.18
- 9 month	5.54	5.67	4.52	2.51	2.18
- 12 month	5.67	5.79	4.52	2.51	2.18

1) Commercial banks quoting their rates daily on the interbank deposit market

FRA RATES

percentages; monthly averages

	1999	2000	2001	2002	2003
	12	12	12	12	6
3 * 6	5.57	5.68	4.49	2.52	2.19
3 * 9	5.70	5.85	4.53	2.54	2.19
6 * 9	5.75	5.93	4.53	2.52	2.18
6 * 12	5.94	6.10	4.52	2.58	2.19
9 * 12	6.04	6.19	4.54	2.61	2.18
12 * 24	.	.	.		
9*12 - 3*6 spread	0.47	0.51	0.05	0.10	-0.01
6*12 - 3*9 spread	0.24	0.25	-0.02	0.04	0.00

IRS RATES

percentages; monthly averages

	1999	2000	2001	2002	2003
	12	12	12	12	6
1Y	5.92	5.94	4.64	2.63	2.25
2Y	6.54	6.40	4.72	2.85	2.34
3Y	6.95	6.72	4.89	3.18	2.55
4Y	7.16	6.96	5.05	3.46	2.77
5Y	7.26	7.15	5.19	3.70	2.99
6Y	7.29	7.29	5.32	3.91	3.19
7Y	7.28	7.38	5.43	4.08	3.37
8Y	7.27	7.42	5.52	4.23	3.53
9Y	7.27	7.43	5.60	4.36	3.68
10Y	7.27	7.43	5.66	4.47	3.80
15Y	.	.	5.85	4.77	4.17
5Y - 1Y spread	1.34	1.21	0.56	1.07	0.74
10Y - 1Y spread	1.35	1.49	1.02	1.84	1.55

NOMINAL AND REAL INTEREST RATES (ex post approach)

percentages

	Nominal rates				Real rates based on CPI				Real rates based on PPI		
	PRIBOR		client rates		PRIBOR		client rates		PRIBOR		new client
	1W	1Y	new credits	time deposits	1W	1Y	new credits	time deposits	1W	1Y	credits
1/99	9.2	8.1	10.7	8.2	5.5	4.5	7.0	4.5	8.3	7.3	9.9
2/99	8.2	8.2	10.3	6.6	5.2	5.3	7.3	3.7	8.3	8.3	10.4
3/99	7.8	7.6	9.7	6.1	5.1	4.9	7.1	3.5	7.8	7.6	9.7
4/99	7.4	7.0	9.4	5.8	4.8	4.4	6.8	3.2	7.2	6.8	9.2
5/99	7.0	7.0	8.9	5.6	4.5	4.5	6.4	3.1	6.6	6.6	8.5
6/99	6.9	7.1	9.1	5.3	4.6	4.8	6.8	3.1	6.5	6.7	8.7
7/99	6.6	6.9	8.2	5.2	5.4	5.7	7.1	4.0	6.1	6.4	7.7
8/99	6.4	6.8	8.0	5.0	4.9	5.3	6.5	3.6	5.1	5.5	6.7
9/99	6.1	6.7	8.0	4.9	4.9	5.5	6.8	3.7	4.9	5.5	6.8
10/99	5.8	6.4	7.7	4.8	4.4	4.9	6.2	3.4	3.9	4.5	5.8
11/99	5.5	6.0	7.7	4.8	3.6	4.1	5.7	2.8	3.1	3.6	5.2
12/99	5.3	5.8	6.7	4.7	2.8	3.3	4.1	2.2	1.9	2.4	3.2
1/00	5.3	5.9	7.3	4.6	1.8	2.4	3.8	1.2	1.1	1.7	3.0
2/00	5.3	6.0	7.0	4.5	1.5	2.2	3.2	0.7	0.8	1.4	2.4
3/00	5.3	5.7	7.1	4.5	1.4	1.8	3.2	0.6	0.2	0.6	1.9
4/00	5.3	5.5	7.1	4.4	1.8	2.1	3.6	1.0	1.0	1.3	2.8
5/00	5.3	5.5	7.1	4.3	1.5	1.8	3.2	0.6	0.9	1.1	2.5
6/00	5.3	5.7	6.8	4.2	1.1	1.5	2.6	0.1	0.2	0.6	1.6
7/00	5.3	5.8	6.5	4.2	1.3	1.8	2.5	0.3	0.3	0.7	1.5
8/00	5.3	5.7	6.7	4.2	1.1	1.6	2.5	0.1	0.5	0.9	1.8
9/00	5.3	5.7	6.8	4.2	1.1	1.5	2.6	0.1	-0.1	0.3	1.4
10/00	5.3	5.8	6.6	4.0	0.9	1.3	2.1	-0.3	-0.6	-0.1	0.7
11/00	5.3	5.9	6.7	4.0	0.9	1.5	2.3	-0.3	-0.6	0.0	0.7
12/00	5.3	5.9	6.8	3.9	1.2	1.8	2.7	-0.1	0.3	0.9	1.7
1/01	5.3	5.6	6.3	3.9	1.0	1.3	2.0	-0.3	1.0	1.3	2.0
2/01	5.2	5.3	6.2	3.9	1.2	1.3	2.1	-0.1	0.5	0.6	1.4
3/01	5.0	5.1	6.2	3.7	0.9	0.9	2.0	-0.3	0.9	0.9	2.0
4/01	5.0	5.0	6.2	3.7	0.4	0.4	1.5	-0.9	1.0	0.9	2.1
5/01	5.0	5.1	6.3	3.7	0.0	0.0	1.2	-1.2	1.2	1.2	2.4
6/01	5.0	5.3	6.3	3.7	-0.4	-0.2	0.7	-1.7	1.6	1.8	2.8
7/01	5.1	5.6	6.4	3.7	-0.8	-0.2	0.5	-2.1	2.0	2.6	3.3
8/01	5.3	6.0	6.6	3.7	-0.2	0.5	1.0	-1.7	2.8	3.5	4.1
9/01	5.3	5.7	6.6	3.7	0.6	0.9	1.8	-0.9	3.4	3.8	4.7
10/01	5.3	5.3	6.6	3.7	0.9	0.9	2.1	-0.7	3.9	4.0	5.3
11/01	5.3	4.9	6.3	3.6	1.0	0.7	2.0	-0.5	4.3	4.0	5.4
12/01	4.8	4.6	5.9	3.3	0.7	0.5	1.7	-0.8	4.0	3.8	5.1
1/02	4.7	4.5	5.7	3.2	1.0	0.8	2.0	-0.4	4.1	3.9	5.1
2/02	4.3	4.4	5.1	3.0	0.4	0.5	1.1	-0.8	4.4	4.5	5.2
3/02	4.3	4.5	5.3	3.0	0.6	0.8	1.6	-0.7	4.5	4.7	5.5
4/02	4.2	4.4	5.1	2.9	1.0	1.1	1.8	-0.2	4.3	4.5	5.2
5/02	3.8	4.1	4.9	2.8	1.3	1.5	2.3	0.3	4.3	4.6	5.4
6/02	3.8	3.9	5.0	2.9	2.6	2.7	3.8	1.7	4.6	4.8	5.9
7/02	3.6	3.4	4.5	2.8	3.0	2.8	3.9	2.2	4.7	4.6	5.7
8/02	3.0	3.1	4.4	2.3	2.4	2.5	3.8	1.7	4.0	4.1	5.4
9/02	3.0	3.0	4.5	2.5	2.2	2.1	3.7	1.7	4.0	3.9	5.5
10/02	3.0	2.8	4.6	2.3	2.4	2.2	4.0	1.7	3.9	3.7	5.5
11/02	2.8	2.8	4.2	2.1	2.3	2.2	3.7	1.6	3.5	3.5	4.9
12/02	2.8	2.6	4.2	2.2	2.2	2.0	3.6	1.6	3.5	3.3	4.9
1/03	2.7	2.6	4.1	2.2	3.2	3.0	4.5	2.6	3.6	3.5	5.0
2/03	2.5	2.4	3.9	2.1	2.9	2.8	4.3	2.5	3.2	3.2	4.6
3/03	2.5	2.4	3.9	2.0	2.9	2.8	4.3	2.5	2.9	2.8	4.3
4/03	2.5	2.4	3.9	2.0	2.6	2.5	4.0	2.1	3.2	3.2	4.7
5/03	2.5	2.4	4.0	2.0	2.5	2.4	4.0	2.0	3.3	3.3	4.8
6/03	2.5	2.3			2.2	2.0			3.4	3.2	

Note: real rates = nominal rates deflated by annual index (CPI/PPI) in given month

The average rates on credits in December 1999 were affected mainly by the settlement of medium-term loan receivables for which the interest rate was taken into account in the purchase price. These receivables are incorporated into the interest-rate statistics with a zero interest rate.

REAL INTEREST RATES (ex ante approach)

percentages

	Real rates expected by financial markets				Real rates expected by businesses				Real rates expected by households			
	PRIBOR		client rates		PRIBOR		client rates		PRIBOR		client rates	
	1W	1Y	new credits	time deposits	1W	1Y	new credits	time deposits	1W	1Y	new credits	time deposits
1/99												
2/99												
3/99												
4/99												
5/99	1.9	1.9	3.7	0.6								
6/99	2.1	2.3	4.2	0.6	2.5	2.7	4.6	1.0	3.2	3.4	5.3	1.7
7/99	1.7	2.0	3.3	0.3								
8/99	2.1	2.5	3.7	0.8								
9/99	2.1	2.7	4.0	1.0	2.1	2.7	4.0	1.0	3.9	4.5	5.8	2.8
10/99	1.7	2.2	3.4	0.7								
11/99	1.6	2.1	3.7	0.8								
12/99	1.1	1.6	2.4	0.5	1.4	1.9	2.7	0.8	2.2	2.7	3.5	1.6
1/00	1.3	1.8	3.2	0.6								
2/00	0.8	1.4	2.4	0.0								
3/00	0.8	1.2	2.5	0.0	1.0	1.3	2.7	0.2	1.1	1.5	2.9	0.4
4/00	1.0	1.3	2.8	0.2								
5/00	1.1	1.4	2.8	0.2								
6/00	0.8	1.2	2.3	-0.1	0.5	0.9	1.9	-0.5	1.1	1.5	2.6	0.1
7/00	0.7	1.1	1.9	-0.4								
8/00	0.7	1.2	2.1	-0.3								
9/00	0.6	1.0	2.0	-0.5	0.3	0.7	1.8	-0.8	0.7	1.1	2.1	-0.4
10/00	0.7	1.1	1.9	-0.5								
11/00	0.5	1.0	1.8	-0.8								
12/00	0.3	0.9	1.7	-1.1	0.6	1.1	2.0	-0.8	1.1	1.7	2.6	-0.2
1/01	0.7	1.1	1.8	-0.6								
2/01	0.9	1.0	1.8	-0.4								
3/01	0.8	0.8	1.9	-0.4	0.8	0.8	1.9	-0.4	1.0	1.0	2.1	-0.2
4/01	1.0	0.9	2.1	-0.3								
5/01	0.7	0.7	1.9	-0.6								
6/01	0.4	0.7	1.6	-0.8	0.2	0.5	1.4	-1.0	-0.1	0.2	1.1	-1.3
7/01	0.5	1.0	1.7	-0.8								
8/01	0.6	1.2	1.8	-0.9								
9/01	0.5	0.8	1.7	-1.0	0.5	0.8	1.7	-1.0	0.4	0.7	1.6	-1.1
10/01	0.9	0.9	2.1	-0.7								
11/01	1.2	0.9	2.2	-0.4								
12/01	0.9	0.7	1.9	-0.6	0.9	0.7	1.9	-0.6	0.2	0.0	1.2	-1.2
1/02	0.9	0.7	1.9	-0.5								
2/02	0.8	0.8	1.5	-0.4								
3/02	0.8	1.0	1.8	-0.5	0.7	0.9	1.7	-0.6	0.4	0.6	1.4	-0.9
4/02	0.7	0.8	1.5	-0.5								
5/02	0.5	0.7	1.5	-0.5								
6/02	0.7	0.8	1.9	-0.2	1.1	1.2	2.3	0.2	2.1	2.3	3.4	1.3
7/02	0.7	0.6	1.7	0.0								
8/02	0.3	0.4	1.7	-0.4								
9/02	-0.1	-0.1	1.4	-0.6	1.1	1.0	2.6	0.6	1.7	1.6	3.2	1.2
10/02	0.5	0.3	2.0	-0.2								
11/02	0.4	0.3	1.8	-0.3								
12/02	0.5	0.3	1.9	-0.1	0.5	0.3	1.9	-0.1	0.2	0.0	1.6	-0.4
1/03	0.2	0.1	1.6	-0.3								
2/03	0.1	0.0	1.4	-0.3								
3/03	0.0	-0.1	1.3	-0.4	0.4	0.3	1.7	-0.1	-1.4	-1.6	-0.1	-1.9
4/03	-0.1	-0.2	1.3	-0.6								
5/03	-1.2	-1.2	0.3	-1.6								
6/03	-0.7	-0.9			-0.2	-0.4			0.2	0.0		

Note: real rates = nominal rates deflated by inflation expected by selected economic sectors according to the CNB statistical survey

The average rates on credits in December 1999 were affected mainly by the settlement of medium-term loan receivables for which the interest rate was taken into account in the purchase price. These receivables are incorporated into the interest-rate statistics with a zero interest rate.

COMMERCIAL BANK INTEREST RATES

percentages

	1999	2000	2001	2002	2003
	12	12	12	12	5
Newly drawn credits					
in CZK	6.7	6.8	5.9	4.2	4.0
- short-term	6.7	6.5	5.6	3.8	3.8
- medium-term	5.1	8.0	7.5	5.4	4.2
- long-term	10.2	8.1	7.1	5.8	5.6
Credits					
in CZK	7.7	6.9	7.0	5.8	5.4
- short-term	7.4	6.6	6.2	4.7	4.3
- medium-term	8.3	7.8	7.7	6.3	5.5
- long-term	7.6	6.8	7.4	6.2	5.9
Deposits					
in CZK	3.7	3.0	2.6	1.8	1.5
- demand	1.6	1.5	1.4	1.1	0.9
- time	4.7	3.9	3.3	2.2	2.0
- short-term	4.8	4.0	3.4	2.0	1.6
- medium-term	5.6	3.9	3.1	2.1	1.6
- long-term	3.6	3.5	3.2	3.1	3.1

BALANCE OF PAYMENTS 1)

in CZK millions

	1999	2000	2001	2002	2003 2)
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q1
A. Current account	**-50 596.4**	**-104 877.1**	**-124 478.3**	**-148 060.6**	**-16 303.5**
Balance of trade 3)	-65 830.8	-120 825.0	-116 685.0	-74 840.0	-7 096.0
exports	908 756.0	1 121 099.0	1 269 634.0	1 250 439.0	330 944.0
imports	974 586.8	1 241 924.0	1 386 319.0	1 325 279.0	338 040.0
Services	41 501.3	54 559.8	57 984.9	21 850.8	3 432.5
credit	243 851.0	264 806.2	269 689.6	231 131.1	47 777.3
transport	53 520.3	53 734.3	57 492.3	56 560.5	13 279.4
travel	109 142.0	115 071.0	118 133.0	96 289.2	20 706.7
others	81 188.7	96 000.9	94 064.3	78 281.4	13 791.2
debit	202 349.7	210 246.4	211 704.7	209 280.3	44 344.8
transport	27 071.4	27 543.0	30 570.5	29 332.8	6 921.4
travel	51 760.0	49 370.0	52 802.0	51 549.3	10 610.7
others	123 518.3	133 333.4	128 332.2	128 398.2	26 812.7
Income	-46 673.6	-52 978.4	-83 548.9	-123 780.5	-21 985.4
credit	64 298.3	75 439.1	84 892.3	71 445.6	19 103.4
debit	110 971.9	128 417.5	168 441.2	195 226.1	41 088.8
Current transfers	20 406.7	14 366.5	17 770.7	28 709.1	9 345.4
credit	45 394.4	36 594.6	36 404.9	46 709.0	14 110.3
debit	24 987.7	22 228.1	18 634.2	17 999.9	4 764.9
B. Capital account	**-73.2**	**-198.2**	**-330.7**	**-119.4**	**-39.6**
credit	637.3	223.4	90.4	221.0	23.1
debit	710.5	421.6	421.1	340.4	62.7
Total A + B	*-50 669.6*	*-105 075.3*	*-124 809.0*	*-148 180.0*	*-16 343.1*
C. Financial account	**106 564.4**	**148 046.6**	**172 849.9**	**366 582.6**	**35 335.0**
Direct investment	215 703.9	190 767.4	208 296.1	295 584.5	32 284.4
abroad	-3 107.6	-1 653.7	-6 289.2	-9 034.8	-1 134.4
equity capital and reinvested earnings	-2 585.3	-1 245.9	-5 848.5	-8 611.4	-1 299.8
other capital	-522.3	-407.8	-440.7	-423.4	165.4
in the Czech Republic	218 811.5	192 421.1	214 585.3	304 619.3	33 418.8
equity capital and reinvested earnings	192 615.5	171 777.2	185 981.4	302 437.1	32 193.8
other capital	26 196.0	20 643.9	28 603.9	2 182.2	1 225.0
Portfolio investment	-48 268.9	-68 172.9	34 857.3	-46 748.7	-32 733.5
assets	-65 608.0	-86 631.8	4 405.6	-75 602.1	-39 872.9
equity securities	-48 965.2	-44 181.0	9 447.8	-7 807.9	-2 222.3
debt securities	-16 642.8	-42 450.8	-5 042.2	-67 794.2	-37 650.6
liabilities	17 339.1	18 458.9	30 451.7	28 853.4	7 139.4
equity securities	4 394.2	23 810.9	23 203.6	-9 035.7	715.1
debt securities	12 944.9	-5 352.0	7 248.1	37 889.1	6 424.3
Financial derivatives	0.0	-1 402.8	-3 220.3	-4 281.7	-618.9
assets		-4 501.6	-9 407.6	-15 458.4	-272.0
liabilities		3 098.8	6 187.3	11 176.7	-346.9
Other investment	-60 870.6	26 854.9	-67 083.2	122 028.5	36 403.0
assets	-91 273.9	35 832.1	-46 144.5	133 121.8	67 813.1
long-term	-23 884.0	21 322.2	1 325.8	28 711.4	14 833.5
CNB					
commercial banks	-25 858.5	14 362.2	-4 125.8	5 271.7	14 187.9
government	977.5	2 937.0	6 928.9	25 333.6	995.6
other sectors	997.0	4 023.0	-1 477.3	-1 893.9	-350.0
short-term	-67 389.9	14 509.9	-47 470.3	104 410.4	52 979.6
commercial banks	-63 804.7	22 001.9	-45 523.2	122 163.8	38 981.4
government			-87.1	-2 237.4	2 156.2
other sectors	-3 585.2	-7 492.0	-1 860.0	-15 516.0	11 842.0
liabilities	30 403.3	-8 977.2	-20 938.7	-11 093.3	-31 410.1
long-term	-1 286.1	-26 212.5	-4 262.6	-869.7	5 757.0
CNB	-2 083.5	-22.8	-22.0	-20.2	-10.1
commercial banks	-7 109.5	-31 523.7	-7 222.2	-8 059.2	3 976.9
government	-6 384.3	-1 837.6	-5 000.8	-1 517.2	3 454.4
other sectors	14 291.2	7 171.6	7 982.4	8 726.9	-1 664.2
short-term	31 689.4	17 235.3	-16 676.1	-10 223.6	-37 167.1
CNB	84.9	-17.0	59.7	-24.3	1.4
commercial banks	36 615.6	-3 812.5	-35 688.6	-3 871.2	-14 007.2
government	-103.2				
other sectors	-4 907.9	21 064.8	18 952.8	-6 328.1	-23 161.3
Total A + B + C	*55 894.8*	*42 971.3*	*48 040.9*	*218 402.6*	*18 991.9*
D. Net errors and omissions, valuation changes	**1 241.9**	**-11 378.5**	**19 112.1**	**-1 457.6**	**-6 696.2**
Total A + B + C + D	*57 136.7*	*31 592.8*	*67 153.0*	*216 945.0*	*12 295.7*
E. Change in reserves (- increase)	**-57 136.7**	**-31 592.8**	**-67 153.0**	**-216 945.0**	**-12 295.7**

1) Balance of payments structure based on the Balance of Payments Manual (5th edition), IMF 1993
2) Preliminary data
3) In accordance with customs statistics methodology in force since 1 July 2000

INTERNATIONAL INVESTMENT POSITION

in CZK millions

	1999	2000	2001	2002	2003
	31 Dec.	31 Dec.	31 Dec.	31 Dec.	31 Mar. 1)
ASSETS	1 347 954.9	1 448 400.7	1 544 963.0	1 582 810.8	1 577 415.6
Direct investment abroad	25 114.9	27 899.3	41 176.1	47 285.0	47 955.0
- equity capital	22 415.9	24 797.5	37 633.6	43 490.0	44 330.0
- other capital	2 699.0	3 101.8	3 542.5	3 795.0	3 625.0
Portfolio investment	104 345.3	180 431.3	185 138.6	274 344.7	329 397.6
- equity securities	66 318.2	92 222.9	68 675.5	86 464.7	78 926.5
- debt securities	38 027.1	88 208.4	116 463.1	187 880.0	250 471.1
Financial derivatives 2)	6 347.2	15 754.8	31 213.2	31 485.2	
Other investment	757 065.5	736 903.7	778 435.7	515 356.2	443 171.8
Long-term	323 131.1	315 625.5	310 133.9	179 639.6	160 662.5
- CNB 3)	329.1	307.3	280.9	276.0	
- commercial banks	89 900.1	75 537.9	79 663.7	67 966.9	53 303.8
- government 4)	210 221.3	220 777.8	210 694.9	97 156.8	94 032.7
- other sectors	23 009.7	18 980.7	19 468.0	14 235.0	13 050.0
Short-term	433 934.4	421 278.2	468 301.8	335 716.6	282 509.3
- CNB 5)		52.9	51.2	376.7	207.0
- commercial banks	336 117.2	314 115.3	359 638.5	213 815.4	173 134.0
of which: gold and foreign exchange 6) 7)	218 995.8	228 961.7	257 138.5	163 032.9	104 762.5
- government			87.1	2 324.5	168.3
- other sectors	97 817.2	107 110.0	108 525.0	119 200.0	109 000.0
CNB reserves 8)	461 429.2	496 819.2	524 457.8	714 611.7	725 406.0
- gold 6)	677.0	4 640.4	4 469.9	4 653.8	4 323.2
- SDR		7.7	31.0	137.1	160.9
- reserve position in the IMF		116.0	5 478.3	7 081.5	7 965.6
- foreign exchange	460 752.2	491 001.2	514 188.0	686 516.1	704 036.7
- other reserve assets		1 053.9	290.6	16 223.2	8 919.6
LIABILITIES	1 458 893.3	1 640 270.0	1 789 030.7	1 989 736.2	1 976 910.1
Direct investment in the Czech Republic	631 505.3	818 411.6	982 335.0	1 187 407.6	1 220 726.4
- equity capital	538 379.3	702 217.8	837 537.3	1 046 837.6	1 079 031.4
- other capital	93 126.0	116 193.8	144 797.7	140 570.0	141 695.0
Portfolio investment	165 579.2	164 592.0	180 346.2	201 120.0	184 146.7
- equity securities	98 011.8	115 670.6	128 740.1	128 097.7	112 703.6
- debt securities	67 567.4	48 921.4	51 606.1	73 022.3	71 443.1
Financial derivatives 2)		5 307.9	11 495.2	22 671.9	22 325.0
Other investment	661 808.8	651 958.5	614 854.3	578 536.7	549 712.0
Long-term	379 172.2	352 323.4	332 593.2	319 061.3	326 328.4
- CNB	197.1	180.4	133.4	114.5	103.4
- commercial banks	118 368.9	84 607.4	73 688.6	63 541.0	67 001.8
- government	20 852.9	19 699.2	9 476.2	9 475.8	15 423.2
- other sectors	239 753.3	247 836.4	249 295.0	245 930.0	243 800.0
Short-term	282 636.6	299 635.1	282 261.1	259 475.4	223 383.6
- CNB	25.8	8.8	68.5	44.2	45.6
- commercial banks	229 988.7	226 176.2	190 487.6	176 196.2	161 448.0
- government					
- other sectors	52 622.1	73 450.1	91 705.0	83 235.0	61 890.0
NET INVESTMENT POSITION	-110 938.4	-191 869.3	-244 067.7	-406 925.4	-399 494.5

1) Preliminary data
2) Financial derivatives (from banks position) have been recorded since 31 March 2000
3) At the end of 1999 the receivable from the National Bank of Slovakia was transferred from the non-resident position to the resident position
4) Including foreign currency shares in international non-monetary organisations (The World Bank, EBRD, IBEC, IIB)
5) Since 31 March 2000, this item has included gold not recorded in CNB reserves
6) Gold valued at USD 42.22 per Troy ounce (until 31 December 1999) and at market price (since 31 March 2000)
7) Foreign currency - convertible currencies
8) In compliance with IMF requirements, CNB reserves have been recorded with a more detailed breakdown since 31 March 2000

EXTERNAL DEBT

in CZK millions

	1999	2000	2001	2002	2003
	31 Dec.	31 Dec.	31 Dec.	31 Dec.	31 Mar. 1)
DEBT IN CONVERTIBLE CURRENCIES	813 576.5	808 122.8	811 258.1	792 129.0	762 850.1
of which:					
Long-term	497 872.1	464 323.8	465 687.8	470 599.4	476 432.7
By debtor					
- CNB	12 527.6	180.4	133.4	114.5	103.4
- commercial banks	128 703.3	95 737.1	88 401.4	80 063.7	83 499.8
- government	32 303.5	29 753.5	30 839.2	47 701.3	53 148.1
- other sectors	324 337.7	338 652.8	346 313.8	342 719.9	339 681.4
By creditor					
- foreign banks	257 410.0	228 709.6	229 305.5	223 329.8	226 346.3
- government institutions	4 239.2	3 405.7	2 373.6	1 747.2	1 487.8
- multilateral institutions	58 202.2	67 521.2	70 879.0	69 894.7	75 390.7
- suppliers and direct investors	93 831.4	99 560.2	105 944.3	97 855.0	97 300.0
- other investors	84 189.3	65 127.1	57 185.4	77 772.7	75 907.9
Short-term	315 704.4	343 799.0	345 570.3	321 529.6	286 417.4
By debtor					
- CNB	25.8	8.8	68.5	44.2	45.6
- commercial banks	230 000.5	226 246.1	192 438.4	177 474.4	162 657.8
- government	7.0	2 115.0	465.0	761.0	1 029.0
- other sectors	85 671.1	115 429.1	152 598.4	143 250.0	122 685.0
By creditor					
- foreign banks	201 808.8	203 333.8	192 126.4	166 140.7	151 918.6
- suppliers and direct investors	81 794.6	106 988.6	116 278.4	121 375.0	102 695.0
- other investors	32 101.0	33 476.6	37 165.5	34 013.9	31 803.8
DEBT IN NON-CONVERTIBLE CURRENCIES	8 925.7	8 950.9	0.0	0.0	0.0
of which:					
- long-term	8 925.7	8 950.9			
- short-term					
TOTAL EXTERNAL DEBT	822 502.2	817 073.7	811 258.1	792 129.0	762 850.1
of which:					
- long-term	506 797.8	473 274.7	465 687.8	470 599.4	476 432.7
- short-term	315 704.4	343 799.0	345 570.3	321 529.6	286 417.4

1) Preliminary data

EXCHANGE RATES

A. NOMINAL RATE

in CZK; foreign exchange market rates

	1999	2000	2001	2002	2003
	1-12	1-12	1-12	1-12	3-6
CZK EXCHANGE RATE AGAINST SELECTED CURRENCIES					
- annual/quarterly averages					
1 EUR	36.88	35.61	34.08	30.81	31.48
1 USD	34.60	38.59	38.04	32.74	27.74
100 SKK	83.64	83.64	78.68	72.22	76.36
	12	12	12	12	6
- monthly averages					
1 EUR	36.05	34.82	32.59	31.19	31.41
1 USD	35.63	38.94	36.48	30.65	26.94
100 SKK	84.70	80.07	75.61	74.67	75.67
	31 Dec.	31 Dec.	31 Dec.	31 Dec.	30 Jun.
- last day of the month					
1 EUR	36.13	35.09	31.98	31.60	31.58
1 USD	35.98	37.81	36.26	30.14	27.63
100 SKK	85.08	79.70	74.81	75.18	75.98

B. NOMINAL EFFECTIVE RATE

	1999	2000	2001	2002	2003
					6
CZK nominal effective exchange rate (percentages) (2000=100)					
weights - foreign trade turnover	98.5	100.0	104.3	116.4	118.4
weights - foreign trade turnover SITC 5-8	98.6	100.0	104.4	116.1	117.4

Drawing on CZSO statistics on the geographical and commodity structure of foreign trade for 2000, 23 countries which account for around 90% of the Czech Republic's foreign trade were selected. The weights were processed in two alternatives:
Alternative I, used by the IMF, applies to the Czech Republic's entire foreign trade turnover
Alternative II, used by the European Central Bank, applies to only four commodity groups of the Czech Republic's foreign trade

C. REAL EFFECTIVE RATE

	1999	2000	2001	2002	2003
					5
CZK real effective exchange rate (percentages) (2000=100)					
a) industrial producer prices					
weights - foreign trade turnover	100.6	100.0	104.0	114.5	112.5
weights - foreign trade turnover SITC 5-8	99.5	100.0	104.6	115.2	113.0
b) consumer prices					
weights - foreign trade turnover	98.8	100.0	105.3	116.0	114.7
weights - foreign trade turnover SITC 5-8	98.2	100.0	105.9	116.9	115.3

Source: CZSO - consumer prices and industrial producer prices of the Czech Republic
Monthly IMF publication - International Financial Statistics - and the CNB's own calculations

PUBLIC FINANCES

in CZK billions

	1999	2000	2001	2002	2003
	1-12	1-12	1-12	1-12	1-6
STATE BUDGET					
TOTAL REVENUE	567.3	586.2	626.2	705.0	335.6
Tax revenue	540.1	559.5	598.3	627.4	321.0
Taxes on income, profits and capital gains	86.4	87.0	147.4	159.0	88.4
Domestic taxes on goods and services	211.4	216.8	187.0	186.9	90.1
- value-added taxes	138.3	145.9	121.3	118.1	56.7
- excises	73.1	70.9	65.7	68.9	33.4
Taxes on international trade and transactions	12.1	13.6	10.0	9.8	4.8
Taxes on property	6.8	6.0	6.4	7.9	4.2
Social and health security contributions and payroll taxes	210.9	222.2	242.3	258.5	131.7
Non-tax and capital incomes and received subsidies	27.2	26.7	27.9	77.7	14.6
TOTAL EXPENDITURE	596.9	632.3	693.9	750.8	389.0
Current expenditure	537.9	571.4	642.5	697.3	373.8
Capital expenditure	59.0	60.9	51.4	53.5	15.2
Public budgets (balance in IMF GFS methodology)	-11.1	-62.0	-52.3	-11.8	
state budget	-29.6	-46.1	-67.7	-45.7	-53.4
local budget	18.5	-2.5	-11.2	-4.3	
state financial assets	-5.2	-5.7	.	.	
state funds	-0.6	2.6	11.2	12.3	
Land Fund	-0.3	-0.5	-0.1	-0.5	
National Property Fund	2.9	-11.5	13.2	28.4	
health insurance companies	2.5	2.1	1.4	-1.2	
others	0.7	-0.4	0.9	-0.8	

CAPITAL MARKET

A. STOCK MARKET INDICES

last day of the month in points

	1999	2000	2001	2002	2003
	12	12	12	12	6
BCPP					
PX 50	489.7	478.5	394.6	460.7	535.1
PX-D	1296.7	1366.0	1065.6	1166.4	1326.6
PX-GLOB	587.9	570.6	492.9	576.8	673.1
RM-SYSTÉM					
PK-30	713.2	724.8	593.0	672.5	804.0

B. TRADE VOLUMES

in CZK millions

	1999	2000	2001	2002	2003
	12	12	12	12	6
BCPP					
Monthly trade volumes	99 604.0	73 240.5	142 803.6	109 264.8	133 719.9
of which:					
a) shares	13 974.5	11 113.9	12 819.3	17 089.3	29 053.6
b) units	394.2	61.3	4.3	0.0	0.0
c) bonds	85 235.3	62 065.3	129 980.0	92 175.5	104 666.3
RM-SYSTÉM					
Monthly trade volumes	22 014.7	4 861.7	2 162.5	4 412.1	568.1
of which:					
a) shares	20 642.3	4 190.1	1 841.0	298.4	420.9
b) units	176.8	25.9	212.2	1.0	0.0
c) bonds	1 195.6	645.7	109.3	4 112.7	147.2

CNB MONETARY POLICY INSTRUMENTS

	2W repo rate (%)	Discount rate (%)	Lombard rate (%)	Minimum reserve requirement for primary deposits (%)	
				Banks	Building societies and ČMZRB
	1999				
18 January	8.75				
28 January				5.0	
29 January	8.00				
12 March	7.50	6.0	10.0		
9 April	7.20				
4 May	6.90				
25 June	6.50				
30 July	6.25				
3 September	6.00	5.5	8.0		
5 October	5.75				
7 October				2.0	2.0
27 October	5.50	5.0	7.5		
26 November	5.25				
	2000				
	No changes made				
	2001				
23 February	5.00	4.0	6.0		
27 July	5.25	4.25	6.25		
30 November	4.75	3.75	5.75		
	2002				
22 January	4.50	3.50	5.50		
1 February	4.25	3.25	5.25		
26 April	3.75	2.75	4.75		
26 July	3.00	2.00	4.00		
1 November	2.75	1.75	3.75		
	2003				
31 January	2.50	1.50	3.50		
26 June	2.25	1.25	3.25		

MACROECONOMIC AGGREGATES

in CZK millions; annual percentage changes; constant 1995 prices

	1999	2000	2001	2002	2003
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q1
GROSS DOMESTIC PRODUCT					
- in CZK millions	1 421 043	1 467 285	1 512 626	1 542 221	377 532
- percentages	0.5	3.3	3.1	2.0	2.2
FINAL CONSUMPTION					
- in CZK millions	1 042 354	1 058 969	1 102 058	1 150 738	274 267
- percentages	1.9	1.6	4.1	4.4	4.7
of which:					
Households					
- in CZK millions	765 638	783 454	813 026	845 111	205 892
- percentages	1.9	2.3	3.8	3.9	4.6
Government					
- in CZK millions	266 199	263 628	277 719	293 540	65 536
- percentages	2.3	-1.0	5.3	5.7	5.2
Non-profit institutions					
- in CZK millions	10 517	11 887	11 313	12 087	2 839
- percentages	-11.4	13.0	-4.8	6.8	3.1
GROSS CAPITAL FORMATION					
- in CZK millions	467 412	511 229	547 829	554 934	132 762
- percentages	-2.9	9.4	7.2	1.3	-0.3
of which:					
Fixed capital					
- in CZK millions	463 128	487 874	514 934	518 193	108 622
- percentages	-1.0	5.3	5.5	0.6	-2.5
Changes in inventories					
- in CZK millions	3 880	22 990	32 513	36 351	24 045
Acquisitions less disposals of valuables					
- in CZK millions	404	365	382	390	95
- percentages	-19.5	-9.7	4.7	2.1	2.2
TRADE BALANCE					
- in CZK millions	-88 723	-102 913	-137 261	-163 451	-29 497
of which:					
Exports of goods					
- in CZK millions	809 783	971 784	1 109 242	1 174 839	310 193
- percentages	8.4	20.0	14.1	5.9	8.2
Exports of services					
- in CZK millions	211 548	223 676	228 169	199 596	41 071
- percentages	-1.8	5.7	2.0	-12.5	-19.5
Imports of goods					
- in CZK millions	920 348	1 106 476	1 275 437	1 329 758	337 848
- percentages	5.1	20.2	15.3	4.3	7.4
Imports of services					
- in CZK millions	189 706	191 897	199 235	208 128	42 913
- percentages	7.2	1.2	3.8	4.5	-11.7
FINAL DOMESTIC DEMAND					
- in CZK millions	1 505 482	1 546 843	1 616 992	1 668 931	382 889
- percentages	1.0	2.7	4.5	3.2	2.6
AGGREGATE DOMESTIC DEMAND					
- in CZK millions	1 509 766	1 570 198	1 649 887	1 705 672	407 029
- percentages	0.3	4.0	5.1	3.4	3.0
GROSS DOMESTIC PRODUCT AT CURRENT PRICES					
- in CZK millions	1 902 293	1 984 833	2 175 238	2 275 609	550 594
- percentages	3.4	4.3	9.6	4.6	3.1

Source: CZSO

LABOUR MARKET

A. NATIONAL ACCOUNTS FOR THE HOUSEHOLD SECTOR

annual percentage changes

	1999	2000	2001	2002	2003
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q1
Current income	3.9	4.8	5.6	5.2	7.2
of which:					
- gross operating surplus and mixed income	5.2	3.0	6.6	1.4	3.8
- compensation of employees	3.8	4.9	7.1	6.4	6.5
- property income	-15.8	-7.0	-0.4	-8.9	-2.1
- social benefits other than social transfers in kind	8.6	9.6	5.9	7.5	9.0
- other current transfers	20.5	10.2	-10.7	15.6	34.0
Current expenditure	5.3	4.8	6.6	8.1	5.8
of which:					
- property income	-11.9	-8.4	1.9	12.5	2.1
- current taxes on income, wealth, etc.	2.5	3.8	4.7	13.9	7.1
- social contributions	4.9	5.9	8.9	5.9	8.0
- other current transfers	20.3	5.6	-0.2	9.1	-4.2
Gross disposable income	3.3	4.8	5.1	3.9	7.9
Change in net equity of households in pension funds reserves	-20.0	24.6	47.2	5.8	23.6
Individual consumption expenditure	5.7	5.3	7.6	3.8	3.6
Gross saving	-18.7	0.6	-20.7	4.9	93.3
Gross savings rate	8.33	8.00	6.04	6.10	9.01
(gross saving/gross disposable income - ratio in per cent)					

B. AVERAGE WAGES

annual percentage changes

	1999	2000	2001	2002	2003
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q1
Overall nominal wage	8.2	6.6	8.5	7.3	7.4
Business sector	7.1	7.8	8.2	6.7	5.8
Non-business sector	13.1	2.8	10.0	10.0	14.5
Overall real wage	6.0	2.6	3.6	5.4	7.8
Business sector	4.9	3.8	3.3	4.8	6.2
Non-business sector	10.8	-1.1	5.1	8.1	15.0

C. UNEMPLOYMENT

end of period

	1999	2000	2001	2002	2003
	12	12	12	12	6
Registered job applicants (thousands)	487.6	457.4	461.9	514.4	501.0
Unemployment rate (percentages)	9.4	8.8	8.9	9.8	9.5

Source: CZSO

PRODUCER PRICES

percentage changes

	1999	2000	2001	2002	2003
					6
INDUSTRIAL PRODUCER PRICES					
a) previous month = 100	0.3	0.4	0.1	-0.1	-0.2
b) same period of last year = 100	1.0	4.9	2.9	-0.5	-0.9
c) average for 2000 = 100	.	0.0	2.8	2.3	1.4
d) December 1999 = 100	.	3.4	6.3	5.8	4.8
CONSTRUCTION WORK PRICES					
a) previous month = 100	0.3	0.4	0.3	0.2	0.2
b) same period of last year = 100	4.8	4.0	4.1	2.7	2.2
c) average for 2000 = 100	.	0.0	4.1	6.9	9.2
d) December 1999 = 100	.	2.3	6.5	9.3	11.7
AGRICULTURAL PRODUCER PRICES					
b) same period of last year = 100	-11.7	9.2	8.4	-9.5	-4.1
of which:					
crop products					
b) same period of last year = 100	-15.0	12.6	9.3	-4.6	-0.3
livestock products					
b) same period of last year = 100	-10.5	8.0	8.0	-12.1	-6.2
MARKET SERVICES PRICES (excluding interest rates)					
a) previous month = 100	0.3	0.4	0.1	0.3	-0.5
b) same period of last year = 100	4.1	3.4	3.9	3.2	1.1
c) average for 2000 = 100	.	0.0	4.0	7.3	8.9
d) December 1999 = 100	.	0.6	4.6	8.0	9.6

Source: CZSO

Table 23

RATIOS OF KEY INDICATORS TO GDP

percentage ratios

	1999	2000	2001	2002
State budget balance	-1.6	-2.3	-3.1	-2.0
Public budgets balance	-0.6	-3.1	-2.4	-0.5
Public debt	15.1	17.7	23.8	24.9
Debt in convertible currencies	42.8	40.7	37.3	34.8
Trade balance 1)	-3.4	-6.1	-5.4	-3.3
Current account balance	-2.7	-5.3	-5.7	-6.5
M2	70.3	71.2	73.4	72.4

Note: ratio = indicator/GDP at current prices
1) Source: CZSO

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