2003

INFLATION REPORT OCTOBER/2003

CNB CZECH NATIONAL BANK

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ABBREVIATIONS USED

CNB	Czech National Bank
CPI	consumer price index
CZK	Czech koruna
CZSO	Czech Statistical Office
ECB	European Central Bank
EC	European Community
ECOFIN	EU Council of Economics and Finance Ministers
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
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
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
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 joint document of the Czech Government and the CNB: *The Czech Republic's Euro-area Accession Strategy*, approved on 13 October 2003. This Inflation Report was approved by the CNB Bank Board on 6 November 2003.

An annex of statistical tables is available, together with this Report, on the enclosed CD and at http://www.cnb.cz/. Unless stated otherwise, the sources of the data presented in this Inflation Report are the CZSO or the CNB.

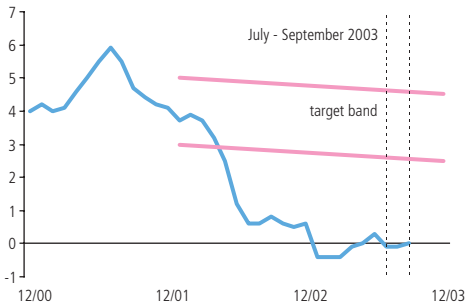
I. SUMMARY

Table I.1
INFLATION FELL SLIGHTLY AGAIN IN 2003 Q3
(annual percentage figures unless otherwise indicated)

	6/03	7/03	8/03	9/03
Consumer price inflation	0.3	-0.1	-0.1	0.0
Industrial producer price inflation	-0.9	-0.6	-0.4	0.0
Money supply growth (M2)	4.2	5.6	5.1	x
3M PRIBOR[a)]	2.33	2.25	2.06	2.06
Nominal CZK/EUR exchange rate[b)]	31.58	32.23	32.44	31.84
State budget balance since January incl. SFAOs,[b)] CZK bn	-53.4	-62.1	-71.9	-80.3
GDP growth at constant prices[c)]	2.1			x
Unemployment rate[b)]	9.5	9.9	10.0	10.1

a) average for the month
b) end-of-month position
c) figure for the quarter ending with the given month

Chart I.1
INFLATION REMAINED BELOW THE TARGET BAND IN 2003 Q3
(annual consumer price inflation; percentages)



The low-inflation trend in the economy continued into 2003 Q3. Annual consumer price inflation fluctuated around zero and remained well below the target band (see Chart I.1). The trend of low economic growth also continued into 2003 Q2, the growth rate slackening slightly relative to the previous period. The persisting gap between the demand for, and supply of, labour remained the main factor affecting unemployment and wages.

The gradual modest pick-up in annual consumer price inflation during Q2 was replaced by very slightly negative outturns in July and August and a figure of zero per cent in September. Annual consumer price inflation in Q3 was slightly lower than in the previous quarter, despite an easing of the disinflationary effect of food prices and renewed annual growth in import prices, reflecting in particular rising raw material prices on world markets and the fading annual appreciation of the koruna's exchange rate. However, given the usual lag, the slightly inflationary effect of these factors had yet to pass through into consumer price inflation. The lower inflation in Q3 was also due to slower annual growth of regulated prices and nontradables prices.

The Czech economy grew slightly slower in 2003 Q2 than in 2003 Q1. The growth continued to be driven by rising domestic demand and, within its framework, mainly by accelerating household consumption and by changes in inventories. Unlike in previous quarters, the contribution of government consumption to the economic growth was zero. This can be attributed mainly to a shift in the structure of drawings on government expenditure on final consumption during the course of the year. The contribution of gross fixed capital formation to the economic growth was negative for the third consecutive quarter. The negative contribution of the external sector persisted and – by comparison with the previous quarter – increased. A fall in income from services and increased imports of consumer goods were the key factors leading to a deterioration of net exports.

The persisting gap between the demand for, and supply of, labour led to an annual decline in employment in Q2 and to an increase in unemployment in both Q2 and Q3. It also contributed to a pick-up in productivity growth and hence to a slowdown in growth of unit wage costs. The situation on the labour market continued to prevent any marked pick-up in nominal wage growth in the business sector. The high wage growth recorded in the non-business sector in Q1 (due to an increase in wage scales at the start of 2003) slowed markedly in Q2. The slight upturn in inflation in Q2 caused nominal wages to grow slightly faster than real wages.

The monetary policy decision-making of the CNB Bank Board in 2003 Q3 was based on the inflation forecast discussed by the Board at its meeting on 31 July 2003 and published in the July Inflation Report. Given the monetary policy transmission lag, the Board focused on hitting the inflation target in July–December 2004. According to the forecast, inflation should be slightly below the middle of the target band at this time. A fall in interest rates in 2003 H2 and stability during the following year were consistent with the starting assumptions of the forecast.

In line with the forecast, and after assessing the additional risks and uncertainties regarding its fulfilment, the Bank Board voted at its meeting at the end of July 2003 to reduce its monetary policy interest rates by 0.25 percentage points with effect from 1 August. In the remaining months of Q3, the forecast risks deviated somewhat in the inflationary direction. On the cost side this concerned a weaker-than-forecast exchange rate of the koruna and higher-than-forecast oil and agricultural producer prices; on the demand side it chiefly involved the risk of a moderation and/or postponement of the

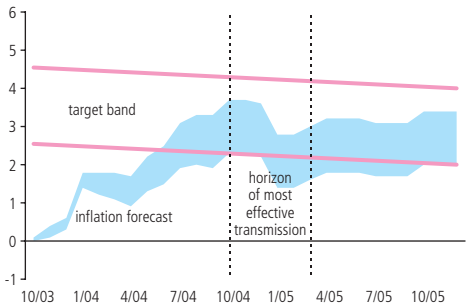
launch of the public finance reform, changes in its structure and the potential spill-over of the public sector's fast growing wages into the business sector. However, the deviation of the risks was very small and presented no threat to fulfilment of the inflation target at the medium-term horizon. Accordingly, the Bank Board left interest rates unchanged for the rest of Q3.

As usual, section IV of this Inflation Report presents the CNB's new macroeconomic forecast. The forecast expects the output gap to remain negative for several quarters. Thanks to an easing of the monetary conditions at the end of 2003 and a gradual recovery in economic growth abroad in 2004, there will be a gradual closing of the output gap from the end of 2003 onwards. The current forecast for inflation is lower than that in July. This is due to a further change of outlook regarding the effect of the output gap on prices and the ensuing changes in the forecast impacts of the adjustments to indirect taxes. During 2004, however, the forecast is for a rise in inflation due to the closing of the negative output gap, an unwinding of the disinflationary exogenous factors, and to the changes to indirect taxes.

Consistent with the forecast are interest rates just below 2% and a modest rise in rates from 2004 H1 onwards. Like previous forecasts, 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. Consistent with the alternative scenarios that the Bank Board considered together with the baseline scenario was a higher interest-rate trajectory.

The annex to this Inflation Report presents the complete wording of a joint document of the Czech Government and the Czech National Bank approved by the Czech Government on 13 October 2003 and published under the title *The Czech Republic's Euro-area Accession Strategy*. This document is of vital importance to future macroeconomic developments in the Czech Republic. It summarises the basic starting points of the Czech Republic's integration into European monetary structures and discusses the expected positive effects and potential risks associated with joining the euro area. The document states that the Czech Republic can be expected to join the euro area in around 2009–2010, provided that it fulfils the Maastricht criteria, including a successful consolidation of public finances, achieves a sufficient level of real convergence, and makes adequate progress with structural reforms guaranteeing sufficient economic alignment with the EU member states. Participation in the ERM II exchange rate mechanism is regarded merely as the gateway into the euro area, and staying in the ERM II for longer than the minimum required period of two years thus does not seem desirable. Therefore, the Czech Republic should join the ERM II only after conditions have been established which enable it to introduce the euro at the time of the assessment of the exchange-rate criterion and to then benefit from its introduction without experiencing any problems

Chart I.2
THE INFLATION FORECAST IS MOSTLY IN THE LOWER HALF OF THE TARGET BAND AT THE HORIZON OF MOST EFFECTIVE TRANSMISSION
(annual consumer price inflation; percentages)



II. INFLATION DEVELOPMENTS

Chart II.1
THE ANNUAL INFLATION OUTTURNS FLUCTUATED AROUND ZERO IN 2003 Q3
(percentages)

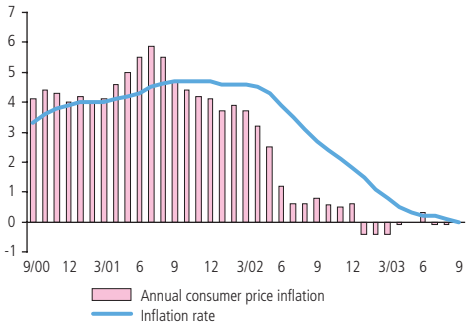


Table II.1
PRICES CONTINUED TO DEVELOP VERY DIFFERENTLY ACROSS THE INDIVIDUAL CATEGORIES OF THE CONSUMER BASKET
(annual percentage changes)

	4/03	5/03	6/03	7/03	8/03	9/03
Food and non-alcoholic beverages	-5.2	-4.3	-1.7	-1.5	-1.4	-0.4
Alcoholic beverages and tobacco	0.8	0.8	0.6	0.6	0.4	0.5
Clothing and footwear	-4.7	-4.7	-4.9	-5.4	-5.6	-5.4
Housing, water, electricity, gas and other fuels	3.2	3.3	3.3	1.6	1.6	1.6
Furnishings, household equipment and routine maintenance of the house	-1.3	-1.5	-1.7	-1.8	-1.9	-2.0
Health	4.7	4.9	4.7	4.0	3.9	3.7
Transport	0.0	-0.6	-0.9	-0.6	-0.1	-0.8
Communications	-2.1	-2.2	-2.3	-3.3	-3.2	-3.9
Recreation and culture	0.5	0.1	-1.3	-1.1	-0.8	-1.1
Education	4.2	4.2	4.3	4.3	4.3	0.3
Hotels and restaurants	1.5	1.5	1.3	1.4	1.5	1.7
Miscellaneous goods and services	2.8	2.7	2.8	2.7	3.0	2.9
Consumer prices	-0.1	0.0	0.3	-0.1	-0.1	0.0

Chart II.2
THE RENEWED GROWTH IN PRICES OF IMPORTED INPUTS HAD YET TO FEED THROUGH SIGNIFICANTLY INTO DOMESTIC PRICES
(annual percentage changes)

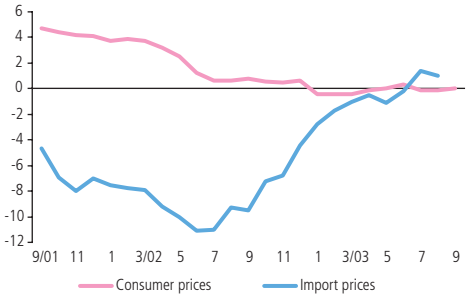
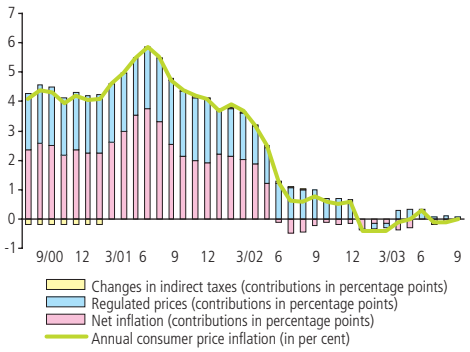


Chart II.3
THE VERY SLIGHT DECLINE IN CONSUMER PRICES IN JULY AND AUGUST WAS DUE TO FALLING MARKET PRICES (= NET INFLATION)



II.1 PAST INFLATION DEVELOPMENTS

As in 2003 H1, annual consumer price inflation saw only very modest changes – of around zero in annual terms – in 2003 Q3. After having fallen to negative values in 2003 Q1 (-0.4% throughout the quarter), it had gradually shifted to positive figures in Q2 (0.3% in June). In the first two months of Q3 inflation was again negative, although its annual outturns were lower than in Q1. This slight decline turned into stagnation in September. Overall, then, inflation was predominantly negative during the first three quarters of 2003. This means that the prediction made by the CNB at the start of this year that the episode of negative inflation would be short-lived did not come true. The inflation rate[1] was zero at the close of 2003 Q3.

Prices again developed very differently across the individual categories of the consumer basket in Q3. The rates of price growth or decline in each category were very mixed, as was the intensity of the changes compared to the end of the previous quarter. A comparison of the numbers of categories with falling and rising prices provides some idea of the differential price developments across the categories of the consumer basket. In this respect there was no change compared to the end of Q2 – the number of categories with increasing and falling prices was equal in June and September. Inflation remained highest in the category of health, although its growth rate slowed markedly. Prices in education saw a similar trend. As in Q2, prices of clothing and footwear fell the most.

As in the previous quarter, inflation was particularly negative in the case of unregulated tradables (within the framework of these commodities the only category not to record an annual decline was alcoholic beverages and tobacco). By contrast, prices of predominantly nontradable items (especially in the services area) continued to record year-on-year growth. However, for the most part their growth moderated during the course of Q3. The largest contribution to annual consumer price inflation came from prices in the housing category (0.4 percentage points in September), although by comparison with the previous quarter their growth rate slackened too.

The low-inflation environment and low inflation expectations persisted in the economy during 2003 Q3. However, the basic framework of the main inflation factors on the supply and demand sides of the economy started to shift towards a more inflationary position in Q3. For the reasons given below, however, this change had yet to pass through significantly into consumer price inflation.

A build-up in inflationary tendencies (i.e. a halt in the annual decline or a pick-up in the growth of prices) was recorded primarily for external cost factors. However, the upturn in growth of raw materials and food prices on world markets was no longer being fully offset in Q3 by annual appreciation of the koruna's weighted exchange rate[2], a fact reflected in import prices. A number of import categories recorded renewed price growth, although this effect did not pass through more markedly into producer and consumer prices. The producer price developments in Q3 merely signalled weakening annual declines towards stagnation. Only in the case of fuel prices did the renewed growth in prices of imported inputs have a more marked impact.

1 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.

2 The weighted exchange rate comprises the euro (80% weight) and the US dollar (20% weight). In 2003 Q3 the year-on-year appreciation of the weighted exchange rate of the koruna softened to -0.42%. The koruna-euro rate recorded an annual depreciation and the koruna-dollar rate a weaker appreciation as compared to the previous quarter.

When assessing the causes of the still only partial/negligible impact of the now predominantly rising import prices on producer and consumer prices, we need to take several facts into account. Although consumer demand continued growing, the economy remained below its potential. Strong competition on the retail market prevented the inflationary cost pressures from passing through into prices. Excess supply persisted in some segments, too. Consistent with these factors acting on the demand and supply sides were heightened efforts on the part of the corporate sector to rationalise its activities and thereby reduce its wage and other costs of production, increase its productivity growth and thus boost its competitiveness on domestic and foreign markets[3]. When determining the factors behind the as yet very weak transmission of the renewed growth in prices of imported inputs into domestic prices, it is also necessary to take into consideration the fact that cost/demand pressures do not usually pass through into prices immediately, but with a lag.

The main factors underlying the continuing low-inflation environment also include the significant progress made in 2001–2002 with price deregulation. This had involved aligning the prices of the vast majority of regulated prices with their market level, which in turn created conditions for smaller changes in regulated prices in the future[4]. Regulated price developments in 2003 Q3 confirmed this assumption. Annual growth in regulated prices moderated in comparison with Q2 by 1.1 percentage points, to 0.4%. This was because there was no significant increase in regulated prices in July 2003 (unlike in July 2002).

The very modest annual decline/stagnation in consumer prices during the course of 2003 Q3 resulted from the combined effect of the low annual growth in regulated prices and falling – and at the end of the quarter flat – market prices, as measured by net inflation[5] (see Chart II.3). Market prices were affected more strongly by the aforementioned anti-inflationary 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 slightly negative annual net inflation outturns in July and August resulted from a decline in food prices, which was partly offset by very weak growth in prices of non-food commodities, as measured by adjusted inflation[6]. Annual net inflation was flat in September (see Chart II.5).

Food prices[7] in 2003 Q3 confirmed a continuing long-term trend of gradual weakening annual decline. In March food prices had recorded an annual decrease of 3.5%; in June the figure was -1% and at the end of Q3 it was only -0.1%. As in the previous quarter, these changes were associated with changes in prices throughout the agricultural-commodity production and processing chain. In this connection it is necessary to mention in particular the renewed growth in agricultural producer prices at the start of Q3 and in food industry prices at the end of this quarter (to 0.2% annually). The aforementioned changes in food commodity prices in Q3 were closely connected with

Chart II.4
THE NEGLIGIBLE ANNUAL REGULATED PRICE INFLATION IN Q3 WAS DUE TO THE ONLY MINOR CHANGES MADE TO PRICES OF REGULATED ITEMS IN JULY 2003
(percentages)

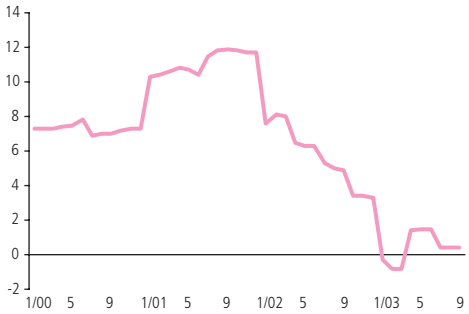


Chart II.5
THE CHANGE TO FLAT NET INFLATION AT THE END OF Q3 WAS THE RESULT OF CONTRARY MOVEMENTS IN FOOD PRICE INFLATION AND ADJUSTED INFLATION
(annual percentage changes)

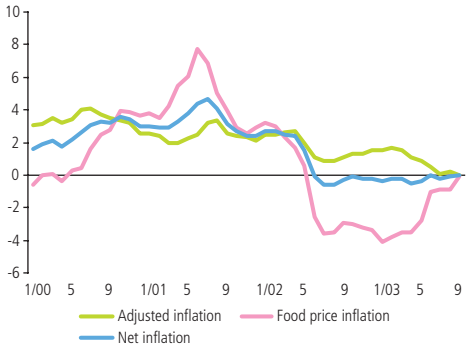
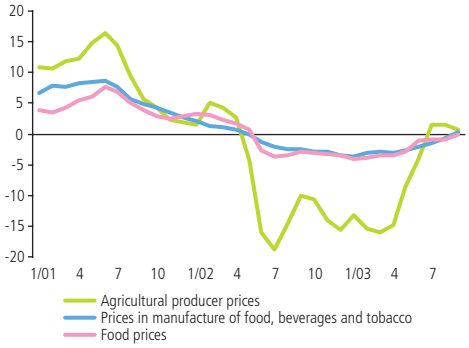


Chart II.6
PRICES THROUGHOUT THE AGRICULTURAL-COMMODITY PRODUCTION, PROCESSING AND RETAIL CHAIN TENDED TOWARDS SLIGHT GROWTH
(annual percentage changes)



3 See Section III.3.4 *Financial performance of non-financial organisations and corporations* and Section III.4 *The labour market.*

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.

Chart II.7
THE TREND OF A DEEPENING ANNUAL DECLINE IN PRICES OF NON-FOOD COMMODITIES (EXCEPT FUELS) HALTED
(percentages)

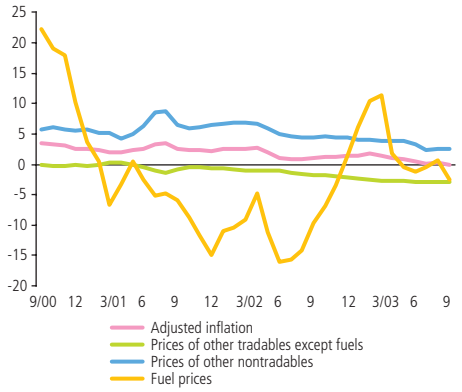


Chart II.8
FUEL PRICES RESPONDED TO THE PREVIOUS CHANGES IN OIL PRICES
(annual percentage changes)

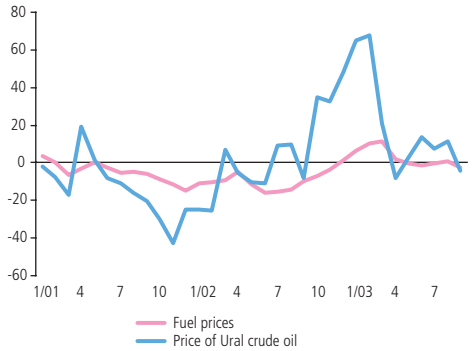


Table II.2
THE INFLATION OUTTURN IN 2003 Q3 WAS LOWER THAN FORECAST
(annual percentage changes; contributions in percentage points)

	April 2002 forecast	September 2003 outturn	Contribution to total difference in perc. points
Annual consumer price inflation	3.3	0.0	-3.3
Breakdown into contributions:			
regulated prices	4.5	0.4	-0.9
indirect taxes	0.0	0.0	0.0
food prices	2.7	-0.1	-0.8
fuel prices	0.4	-2.5	-0.1
adjusted inflation excluding fuels	3.3	0.2	-1.5

the consequences of the poor harvest this year, its effect on the relationship between supply and demand on the agricultural commodities market, and the weakening of the koruna-euro exchange rate (see *Other costs and prices*). In Q3, these effects passed through mainly into consumer prices in the category of "Food and non-alcoholic beverages" whose annual decline moderated by 1.3 percentage points to -0.4% (in September) relative to the end of Q2. Prices of alcoholic beverages and tobacco on the contrary continued to show a slight annual rise (of 0.5% in September).

Prices of non-food commodities ("other tradables except fuels") continued to decline in 2003 Q3. Their decline stopped deepening, remaining flat at the level of -3% throughout Q3. Although prices within this group continued to show very mixed trends, it was clear that they were being affected by the aforementioned factors affecting market prices and probably also by the lagged pass-through of the appreciation of the weighted exchange rate of the koruna in the previous quarter. The still relatively steep annual fall in prices of some commodities (e.g. clothing and household equipment) suggested the existence of excess supply on the retail market.

Fuel prices continued to respond sensitively to movements in oil prices on world markets and the koruna-dollar exchange rate. However, after a sharp acceleration at the start of the year, the annual growth in oil prices moderated in Q2 (from almost 70% in Q1 to below 15%) and remained roughly at this level in Q3 amid considerable volatility. The sharp swing in oil prices at the beginning of the year had been more strongly corrected by a sizeable annual appreciation of the koruna-dollar exchange rate, such that the annual growth in fuel prices had not exceeded 12% in Q1. The slower growth/decline in oil prices in Q2 and Q3 was accompanied by a slowing annual appreciation of the koruna-dollar rate, resulting in an only very modest rise, or a decline, in fuel prices. At the close of Q3, fuel prices recorded an annual decline of 2.5% (September).

Prices of other nontradable goods (i.e. except regulated prices), which are affected chiefly by domestic factors, continued to display annual growth in 2003 Q3. As Chart II.7 shows, however, their growth continued to ease, in July reaching its lowest annual figure (2.4%) since 1991. In August the growth picked up again, but the September figure (2.5%) indicated a continuation of the previous long-running downward trend in growth. This trend is linked mainly with the low inflation expectations in the economy and probably also with the lagged pass-through of the appreciation of the exchange rate in 2003 H1 (which is positively affecting prices of inputs).

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 Q3, one needs to analyse retrospectively the inflation forecasts – and the Bank Board decisions based on them – dating from the first three quarters of 2002. The analysis of the accuracy of the forecasts is limited here to a comparison of the forecast drawn up in April 2002, i.e. approximately in the middle of the aforementioned period, with inflation in September 2003 (see Table II.2).

The April 2002 inflation forecast had indicated that inflation in September 2003 would be roughly in the middle of the CNB's target band (see the April 2002 Inflation Report). The inflation outturn in September 2003 was 3.3 percentage points lower than this forecast. Taking a closer look at the structure of the price developments, it is clear that except for changes to indirect taxes the deviation was attributable to all the

components of inflation – food prices, regulated prices, fuel prices and adjusted inflation except fuels. The main cause of the deviation was the unexpectedly disinflationary development of exogenous factors that lie partly or completely outside the purview of the CNB's monetary policy: an appreciated exchange rate acting via both the direct and indirect channel, weak external demand and falling agricultural producer prices. The deviation of the actual evolution of these factors from the assumptions of the April forecast explains more than one half of the difference between the forecast and the inflation outturn in September 2003. The remainder of this difference was attributable to lower-than-expected growth in regulated prices, a less expansive effect of fiscal policy on domestic demand, and also to changes in the elasticities of the relationships between some endogenous indicators of the forecast (due, for example, to growing competition on the domestic market) – see Table II.3.

Table II.3
THE DEVIATION OF THE SEPTEMBER INFLATION OUTTURN FROM THE FORECAST WAS MAINLY DUE TO DEVIATIONS OF EXTERNAL FACTORS

		2002 Q2	Q3	Q4	2003 Q1	Q2	Q3
Import prices	prediction	-4.9	-4.5	-2.5	-0.2	-0.2	0.5
(annual perc. changes)	outturn	-10.1	-9.9	-6.1	-1.8	0.6	-
CZK/EUR exchange rate	prediction	31.3	31.3	31.3	31.3	31.3	31.3
	outturn	30.4	30.3	30.9	31.6	31.5	32.2
CZK/USD exchange rate	prediction	35.5	34.8	34.4	34.0	33.6	33.5
	outturn	33.1	30.8	30.9	29.5	27.7	28.6
Agricultural prod. prices	prediction	-1.7	-6.5	-5.8	3.0	2.0	3.0
(annual perc. changes)	outturn	-5.8	-14.5	-13.4	-14.9	-9.2	?
Oil prices	prediction	-8.0	-5.8	18.4	9.1	-7.1	-0.9
(annual perc. changes)	outturn	-8.9	9.7	38.5	48.6	2.4	6.2

When interpreting the factors that do lie within the purview of monetary policy, one must take into consideration the forecast's technical assumption of constant monetary policy interest rates[8]. This assumption was not realised, as there have been several interest rate reductions since April 2002. The deviation of actual nominal interest rates from those assumed in the April forecast in itself had an inflationary effect. Despite the decline in nominal interest rates, however, the effect of monetary policy at the time of its largest impact on inflation in September 2003 was slightly restrictive, as the expansive effect of the lower nominal interest rates was outweighed by the restrictive effect of the lower inflation expectations and the appreciated exchange rate of the koruna. The result was lower-than-forecast GDP growth and a higher-than-forecast unemployment rate. The decline in inflation expectations led to a temporary rise in the real incomes of households, which in turn stimulated growth in household consumption (see Table II.4). However, the inflationary pressure from the higher-than-expected growth of household consumption was weaker than the disinflationary pressure from the effect of the tighter monetary conditions on the other components of domestic demand and the effect of the external environment on external demand.

Table II.4
THE FALL IN INTEREST RATES LED TO GROWTH IN HOUSEHOLD CONSUMPTION

		2002 Q1	Q2	Q3	Q4	2003 Q1	Q2
GDP	prediction	2.4	2.6	2.7	3.6	4.0	4.3
(real; annual perc. changes)	outturn	2.1	1.7	1.5	2.4	2.1	-
Unemployment rate	prediction	8.5	8.9	9.1	9.5	8.8	8.9
(percentages)	outturn	8.7	9.4	9.8	10.0	9.5	10.0
Wages	prediction	4.3	5.5	5.7	5.5	5	4.6
(real; annual perc. changes)	outturn	5.7	6.9	5.1	6.2	4.2	-
Household consumption	prediction	3.1	2.9	3.2	3.7	3.7	3.4
(real; annual perc. changes)	outturn	4.3	3.6	3.8	4.4	5.5	-

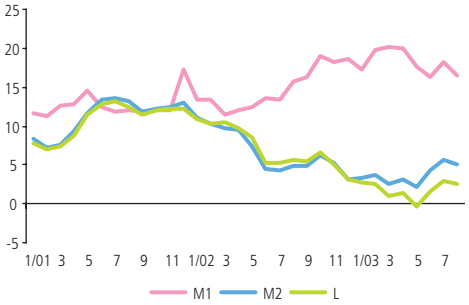
The inflation forecast is the primary source material for the Bank Board's decisions. Also of key importance for its decision-making is an assessment of the possible risks associated with this forecast by the Bank Board members. At the Board's meetings during the first three quarters of 2002 (see the relevant minutes), the risks were perceived as being 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 external 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 during the course of 2002 Q1–Q3. 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 Q3.

8 The April 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 interest rates.

III. INFLATION FACTORS

Chart III.1
ANNUAL M2 GROWTH STARTED TO RISE IN JUNE 2003
(percentages)



Definition of monetary aggregates:

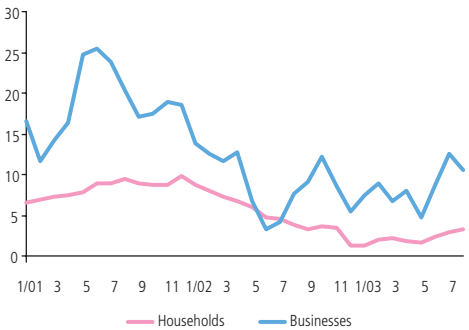
M1 = currency in circulation + CZK demand deposits
M2 = M1 + quasi money
L = M2 + T-bills in portfolios of domestic non-banks

Table III.1
THE ANNUALISED M2 GROWTH SUGGESTS AN INCREASE IN THE INFLOW OF MONEY INTO THE ECONOMY
(percentages)

	1 MONTH	ANNUALISED FOR 3 MONTHS	ANNUALISED FOR 6 MONTHS	1 YEAR
May 03	-0.9	2.9	0.8	2.1
June 03	0.1	4.1	5.6	4.2
July 03	1.6	3.0	4.2	5.6
August 03	1.3	12.2	7.4	5.1

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

Chart III.2
THE INCREASED 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

By comparison with the first five months of 2003, when annual money supply growth had stayed at a relatively low level of around 3% and the absolute money stock grew only negligibly, in June–August 2003 the situation changed and the inflow of money into the economy increased, albeit with fluctuations in the growth rate in the individual months. Annual money supply growth gradually increased from its historical low of 2.1% in May 2003 to 5.6% in July, then fell to 5.1% in August[9].

The money supply growth in June–August 2003 was attributable mainly to continuing growth in lending. The effect of other factors affecting the inflow of money into the economy on a long-term basis (especially from abroad) was not very significant in this period. Annual growth in L developed similarly to the money supply in June–August 2003. Annual M1 growth in this period fluctuated at a markedly higher level (around 17%) than that of the money supply (around 5%). The transaction money included in M1 accounted for approximately 70% of the overall money supply growth in June–August 2003.

Monetary aggregate M2

The increased money supply growth in June–August 2003 also reflected an increased inflow of money into the economy in absolute volume. In June–August 2002 the money stock had fallen by CZK 4 billion (adjusted for the effect of Union Banka's closure), whereas in the same period of 2003 it rose by CZK 46.7 billion. Despite this rise in the volume of money in the economy, there is as yet no danger of a direct inflation risk, since the upturn in money supply growth comes on the back of a long period of stagnation. An increase in annual money supply growth is also visible from the annualised data, particularly in August.

Sector structure of M2

The money supply growth in June–August 2003 concerned both the household sector and, in particular, the corporate sector. In the household sector the annual growth in the money supply was smooth, rising steadily from 1.6% in May to 3.2% in August, whereas in the corporate sector the growth was more unstable and at a higher level. From 4.8% in May, it jumped to 12.6% in July then fell to 10.5% in August.

As regards the deposit structure, the long-term past trends are continuing in both the household and corporate sectors. In the case of households demand deposits still prevail, whereas growth in currency in circulation is rather lower. In the area of households' koruna time deposits the only long-term developing banking product is building society deposits, whose growth, however, is not substituting for the long-term decline in the volume of koruna time deposits in this sector. Whereas building society deposits rose by approximately CZK 6 billion in June–August 2003, the total volume of koruna time deposits fell by a further CZK 6 billion. Foreign currency deposits

9 In May–August, annual money supply growth adjusted for the effect of Union Banka – which in May 2003 closed down and was removed from the banking statistical statements – was around 1 percentage point higher in each month. This applies to all the monetary aggregates.

of households have long been flat. Demand deposits in the corporate sector are also increasing significantly. Besides demand deposits, the growth in the volume of foreign currency deposits is also accelerating in this sector.

Monetary aggregate M1

Annual monetary aggregate growth fluctuated considerably in June–August 2003. From 17.6% in May 2003, it fell to 16.3% in June, then rose to 18.3% in July, only to decline again to 16.4% in August.

The fluctuating annual M1 growth was due in particular to the base used to calculate these monetary aggregates in 2002. As regards the absolute volume of transaction money included in M1, the profile in June–August 2003 was much smoother and the M1 volume increased relatively steadily and strongly. In the first five months of 2003 the average month-on-month M1 growth had been around CZK 4 billion, whereas in June–August 2003 it was around CZK 11 billion. The focus of the M1 growth was in line with the long-running upward trend in koruna demand deposits, whereas the volume of currency in circulation grew more slowly. The share of currency in circulation in the total money stock was flat at 12.8% in June–August 2003. A high level of annual M1 growth is also apparent from the annualised growth for 3 and 6 months.

Table III.2
THE ANNUALISED M1 GROWTH SUGGESTS BUOYANT ANNUAL M1 GROWTH
(percentages)

	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
May 03	1.7	13.7	12.8	17.6
June 03	1.0	22.0	7.7	16.3
July 03	2.0	20.6	18.9	18.3
August 03	1.7	20.1	16.9	16.4

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

Monetary aggregate L

The annual L growth in June–August 2003 was closely associated with the money supply growth. Following a 0.3% decline in May, the annual growth was 1.5% in June, 3.0% in July and 2.0% in August. In addition to the money supply growth, the decline in annual L growth again reflects the continuing long-term decline in the volume of T-bills held by non-banking institutions.

Table III.3
THE ANNUALISED SEASONALLY ADJUSTED L GROWTH CONFIRMS AN UPWARD TENDENCY
(percentages)

	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
May 03	-0.7	0.5	-2.4	-0.3
June 03	0.1	2.1	2.0	1.5
July 03	1.4	3.4	1.7	3.0
August 03	1.3	11.8	6.0	2.6

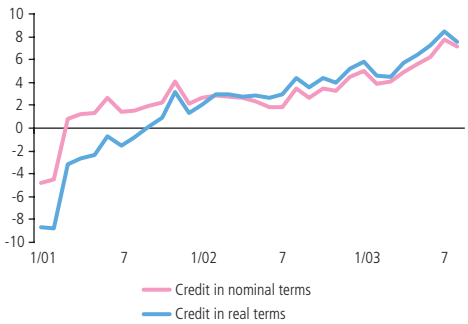
Note: Seasonally adjusted according to deviations from the series smoothed by the centred moving average method (length 13)

III.1.2 Loans extended to businesses and households

The annual growth rate of lending adjusted for non-monetary effects continued to rise in June–August 2003, reaching 7.1% in nominal terms and 7.6% in real terms at the end of the period under review. Loans extended to households were the most important factor in this development, whereas credit to non-financial corporations fell.

Loans extended to households increased annually by 31.9% in relative terms and CZK 50.9 billion in absolute terms in August 2003. As in the previous period, households' demand for housing loans increased. Annual growth in these loans totalled 42% in relative terms and CZK 37 billion in absolute terms in August 2003. Mortgage loans accounted for CZK 23.1 billion and building society loans for CZK 13.9 billion of the growth in the absolute volume of housing loans. The rise in loans supported an increase in gross fixed capital formation, particularly in the case of individuals, whereas for households this indicator had declined in 2003 H1[10]. This trend may have reflected lower investment activity by the self-employed. Demand for mortgage loans was affected in particular by households' awareness that nominal interest rates had fallen to historical lows.

Chart III.3
LENDING CONTINUED TO RISE
(annual percentage changes)



10 According to the SNA, the household sector comprises individuals and the self-employed.

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

	1 MONTH	ANNUALISED FOR		1 YEAR
		3 MONTHS	6 MONTHS	
May 03	-0.4	1.7	5.0	5.6
June 03	1.6	8.5	6.8	6.2
July 03	0.4	7.0	4.1	7.8
August 03	1.1	13.2	7.3	7.1

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

Consumer loans granted to households increased annually by 22.9% in relative terms and CZK 12.6 billion in absolute terms in August 2003. However, their annual growth rate slowed in June–August 2003. In addition to growth in disposable household incomes, consumer loans helped to finance consumption expenditure.

Lending to non-financial corporations fell. However, the annual decline did not accelerate any further between June 2003 and August 2003, being 2.3% at the end of the period under review. For domestic corporations the decline was 3.1%. On the other hand, loans to foreign-controlled corporations rose by 0.6% year-on-year.

The aforementioned developments were also reflected in the structure of credit by type. In June–August 2003, the shares of mortgage loans and building society loans in total loans increased, the share of mortgage loans rising by 1.1 percentage points to 12.1% and that of building society loans by 0.4 percentage points to 7.4%. On the other hand, the proportion of operating loans fell by 0.1 percentage points to 40%, that of investment loans by 1.3 percentage points to 26.7% and that of consumer loans by 0.2 percentage points to 7.5%. The share of other loans in total loans rose by 0.1 percentage points to 6.3% in the period under review.

Turning to the time structure, the share of long term loans increased. Their share of total loans reached 37.5%. The share of short-term loans was flat at 31% and that of medium-term loans fell by 0.5 percentage points to 31.5%.

III.2 YIELDS ON THE FINANCIAL MARKETS

III.2.1 Interest rates

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

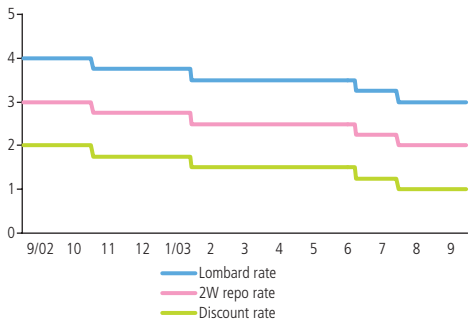
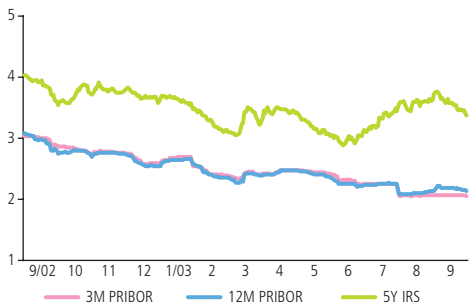


Chart III.5
MARKET INTEREST RATES SHOWED MIXED DEVELOPMENTS
(percentages)



Interest rates were affected by several factors in 2003 Q3. Short-term rates were affected by a further reduction of 0.25 percentage points in the CNB's key rates. The 2W repo rate was lowered to 2%, the Lombard rate to 3% and the discount rate to 1% with effect from 1 August 2003. As with the previous change at the end of June, this adjustment, and in particular its timing, came as something of a surprise to part of the market. Rates on the money market fell immediately after the announcement and stabilised thereafter. However, interest rates with longer maturities at that time responded chiefly to foreign factors: initial speculation emerged regarding a recovery of the US economy and so medium-term and long-term rates started rising from approximately the end of June. The rise in interest rates was also fostered by the stock market situation. The domestic factors included some inflationary risks in the longer term – for more details see the minutes of the CNB Bank Board meetings. This trend lasted until the beginning of September. Interest rates increased at some maturities by almost 1 percentage point during this period. During September, interest rates with longer maturities saw a partial correction of their previous growth after some unfavourable economic figures were released in the USA. PRIBOR spot rate quotations and FRA forward rate quotations at the end of September indicated expectations of stable development in the near future.

In the period under review, the PRIBOR yield curve moved to a lower yield level. At its short end, interest rates went down faster and so the curve's slope turned from negative to positive. Market participants apparently considered the period of declining interest rates to be at an end. Compared to June 2003, the average 1W PRIBOR rate

fell by 0.44 percentage points to 2.02% and the 1Y PRIBOR by 0.10 percentage points to 2.17%. The spread between the two rates was 0.15 percentage points in September (compared to -0.19 percentage points in June).

The IRS yield curve, in contrast, initially moved to a higher yield level, only to start declining moderately during September. Despite this correction, its positive slope increased quite markedly. The largest changes were visible in the middle and longer part of the curve. The average 5Y-1Y spread was +1.34 percentage points and the 10Y-1Y spread +2.08 percentage points.

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. Key rates remained unchanged in both the most important economies. In the euro area the repo rate was 2.0%, while the O/N rate in the USA was 1.0%. Nevertheless, money market rates did not remain stable. Interest rates abroad tended to increase, in contrast to the domestic money market. This affected the interest rate differential. At the end of September, the differential vis-à-vis euro rates was -0.1 to -0.2 percentage points depending on maturity and that vis-à-vis dollar rates was 0.7–0.8 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 25.6 billion. The average gross yields were 2.95%, 4.79% and 2.79%. The first auction, in July, was the first issue in some time not to be fully subscribed for. The lower interest of final investors in participating in the auction had several causes, one of which was undoubtedly changing sentiment abroad, where at that time speculation emerged regarding the onset of a period of rising interest rates. As a result, investors were not interested in investing in a medium-term bond with a low yield. Later, an extraordinary auction took place where a further CZK 4.6 billion worth of this bond was sold. Subsequent auctions proceeded smoothly. The mortgage bond market saw securities issues amounting to CZK 5.35 billion. Issuing activity also continued on the koruna eurobond primary market, where the outstanding volume at the end of September was CZK 138.5 billion.

The changes to the CNB's key rates also resulted in a further decline in client interest rates on loans and deposits. Nominal interest rates on new loans were 3.3% and time deposit rates 1.8% in August. In both cases, the figures were comparable to interest rates in foreign currencies. The interest rate margin between the overall loan and deposit rates remained unchanged, amounting to 3.8 percentage points in August.

Real interest rates[11] 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 still higher than the expected industrial producer price indices. This fact is reflected in the level of real interest rates. Real rates on new loans were 2.5% in August, while real rates on time deposits were -1.4%.

Chart III.6
THE INTEREST RATE DIFFERENTIAL NARROWED SLIGHTLY
(percentage points)

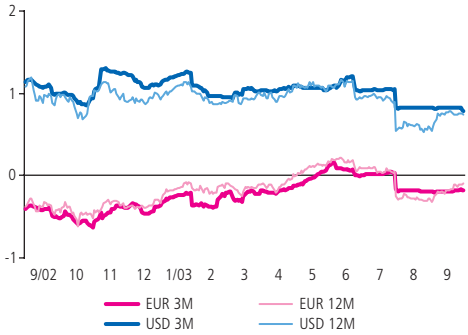
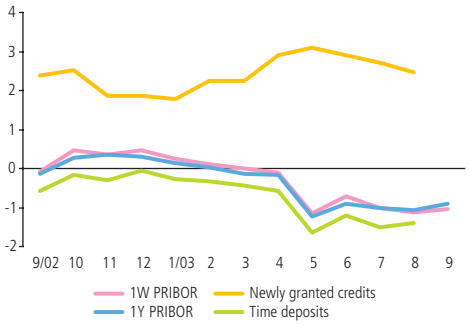


Chart III.7
EX ANTE REAL INTEREST RATES SHOWED MIXED DEVELOPMENTS
(percentages)



11 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.

III.2.2 The exchange rate

The nominal exchange rate of the koruna against the euro depreciated from July until mid-September, approaching its December 2001 level (CZK 32.88/EUR). This was followed by a correction to CZK 32/EUR. The average exchange rate was CZK 32.17/EUR, which represents a year-on-year depreciation of 6.3%.

The koruna's exchange rate responded in particular to the uncertainty surrounding the outcome of the voting in the Czech Parliament on the public finance reform and to the persisting economic and political uncertainties regarding all the currencies in Central Europe. The other main factors included repatriation of dividends, which is concentrated each year into the June–October period, and the reduction of the CNB's key interest rates by one quarter of a percentage point (on 31 July). The vote of confidence in the Government and the approval of the public finance reform proposal by the Czech Parliament brought a turnaround in the situation. The koruna's exchange rate thereafter appreciated to CZK 31.71/EUR (on 26 September) then stabilised around CZK 32/EUR. The exchange rate did not respond to the announcement of further macroeconomic figures (growth in industrial and construction output, the balance of payments deficit, etc.), since they were in line with expectations.

The koruna's exchange rate against the US dollar also depreciated during the course of July and August, falling as far as CZK 30/USD, then subsequently appreciated by almost 10%. The greater volatility of the koruna's exchange rate against the dollar reflected fluctuations of the dollar's rate against the euro beyond the framework of the movements of the koruna's rate against the euro as the reference currency. The quarterly average rate of the koruna against the dollar (CZK 28.61/USD) appreciated by 7% as compared to the same period a year earlier.

The nominal effective exchange rate index[12] recorded a fall of more than 4% in year-on-year comparison in the previous quarter, thus returning to the 2002 Q1 level. In addition to the movement of the nominal effective exchange rate, the real effective exchange rate based on both the CPI and the PPI reflects the lower inflation in the Czech Republic than abroad. In year-on-year comparison, both indices weakened by around 7%.

Chart III.8
AFTER DEPRECIATING SHARPLY, THE KORUNA APPRECIATED AGAIN IN SEPTEMBER

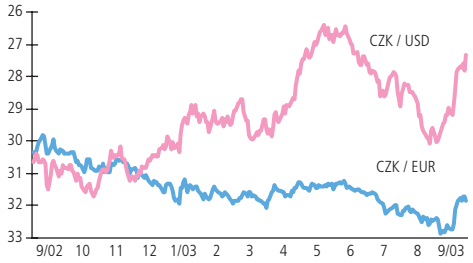
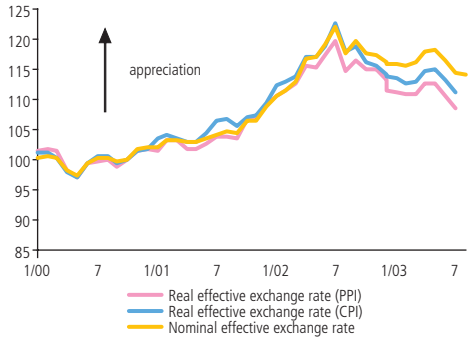


Chart III.9
THE EFFECTIVE EXCHANGE RATES DEPRECIATED IN Q3
(Year 2000 = 100)



III.2.3 Capital flows

The financial account ended 2003 H1 in a surplus of CZK 61.8 billion, down by almost one-quarter compared to the same period of 2002 (CZK 236.7 billion). The main reason for this fall was a sizeable year-on-year decline in sales of property to non-residents[13]. To a lesser extent, the annual decline in the financial account surplus was also attributable to residents' growing interest in foreign debt securities and a decline in non-residents' interest in domestic debt securities. On the other hand, the fall in the surplus was moderated to some extent by greater public sector interest in foreign sources of credit. Foreign direct investment and a decline in the foreign assets of the banking sector have accounted for the major share of the financial account surplus this year. A smaller inflow of capital was also recorded in the area of non-residents' investment in domestic debt securities and borrowing by the public sector.

Table III.5
THE FINANCIAL ACCOUNT SURPLUS RECORDED A LARGE YEAR-ON-YEAR DECREASE IN 2003 H1
(CZK billions)

	2000 H1	2001 H1	2002 H1	2003 H1
Financial account	67.5	83.6	236.7	61.8
Direct investment	96.9	112.3	207.2	66.4
- Czech abroad	-0.8	-2.9	-3.9	-2.4
- Foreign in Czech Republic	97.7	112.3	207.2	68.8
Portfolio investment	-24.4	18.8	10.7	-41.0
- Czech abroad	-42.0	-5.2	-19.3	-54.4
- Foreign in Czech Republic	17.6	24.0	30.0	13.4
Financial derivatives	-2.5	1.2	-4.1	2.9
Other investment	-2.6	-48.7	22.9	33.4
1. Long-term investment	28.8	-8.9	12.7	10.2
- Credit granted abroad	21.3	-1.8	21.9	15.0
- Credit accepted from abroad	7.5	-7.1	-9.2	-4.8
2. Short-term investment	-31.4	-39.8	10.2	23.6

12 Weighted shares in foreign trade, including Russia.

13 In 2002 H1, Transgas had been sold for CZK 124.5 billion and approximately 40% of Česká spořitelna's shares had been sold for CZK 18.8 billion.

The net inflow of direct investment in 2003 H1 amounted to CZK 66.4 billion (compared to CZK 207.2 billion in 2002 H1). The FDI inflow reached CZK 68.8 billion and was made up mainly of the reinvested earnings of foreign-owned firms (CZK 46.4 billion). Sales of property to non-residents, which had been extremely significant in previous years, halted this year. The inflow of foreign capital into capacity-creating investments amounted to around CZK 25 billion. It rose by more than 20% year-on-year and approximately half of it was channelled into industry. A more significant inflow of capital was also recorded in the retail and wholesale and real estate sectors. The biggest investor by territory was the Netherlands and the Netherlands Antilles (which accounted for around one third of the total), followed by Germany, Austria, France and Japan. At about CZK 2.4 billion, domestic direct investment abroad remained insignificant.

The net outflow of portfolio investment in 2003 H1 was CZK 41.0 billion, whereas in the same period a year earlier a net inflow of capital (of CZK 10.7 billion) was still being recorded. The turnaround in capital flows was concentrated exclusively in debt capital, where the annual change amounted to approximately CZK 60 billion. However, in 2003 Q2 the outflow of capital abroad slowed sharply. Foreign assets of residents were up by CZK 54.4 billion in 2003 H1. Residents' interest continued to be concentrated chiefly on bonds, holdings of which increased by CZK 47.9 billion (in the same period a year earlier they had increased by CZK 13.5 billion). The year-on-year rise in residents' interest in foreign bonds was due in particular to the change in the interest rate differential and fading expectations of an appreciation of the koruna. The persisting low level of interest in foreign shares on the part of residents was in line with the ongoing economic recession, or weak growth, in the advanced economies. Non-residents' interest in domestic securities recorded a big year-on-year fall to CZK 13.4 billion and continued to be focused exclusively on bonds.

Financial derivatives transactions remained insignificant in 2003 H1, leading to a CZK 2.9 billion rise in the financial account surplus.

Other investments recorded a capital inflow of CZK 33.4 billion in 2003 H1 (increasing by approximately one half on a year earlier). However, this inflow took place exclusively in Q1 and predominantly took the form of a decline in commercial banks' assets, short-term in particular. The corporate sector reduced its foreign liabilities by around CZK 9 billion in the period under review, similarly to 2002 H1. By contrast, the public sector recorded a gradual rise in interest in foreign capital. The net inflow of capital into the public sector amounted to around CZK 11 billion (e.g. a loan from the EIB).

In 2003 Q3, as in H1, international reserves were not affected by CNB foreign exchange operations aimed at affecting the exchange rate. A foreign loan of approximately CZK 3.8 billion granted to the Czech Government by the World Bank in the early years of the transformation period to supplement the international reserves was repaid ahead of schedule. The change in reserves was also attributable to valuation changes and interest income on the reserves. The international reserves in koruna terms fell from CZK 703.9 billion to CZK 703.0 billion during the course of Q3. In dollar terms, the reserves rose from USD 25.5 billion to USD 25.7 billion.

III.3 DEMAND AND OUTPUT

The long-running growth phase of the Czech economy continued into 2003 Q2. GDP grew for the sixteenth consecutive quarter, rising by 2.1% in 2003 Q2 alone in year-on-year terms. Compared to Q1, this meant a modest slowdown in the growth rate

CHART III.10
TERRITORIAL STRUCTURE OF FDI IN 2003 H1

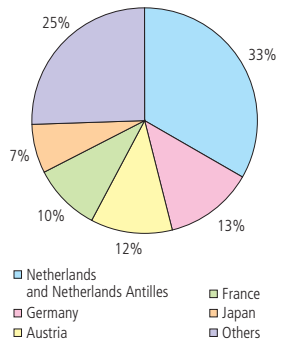


CHART III.11
THE INTERNATIONAL RESERVES WERE VIRTUALLY FLAT IN DOLLAR TERMS IN 2003 Q3
(USD billions)

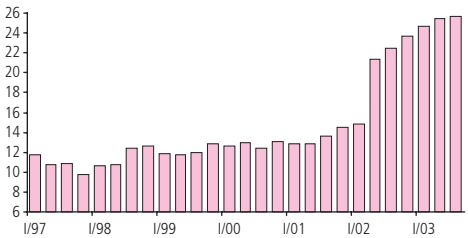
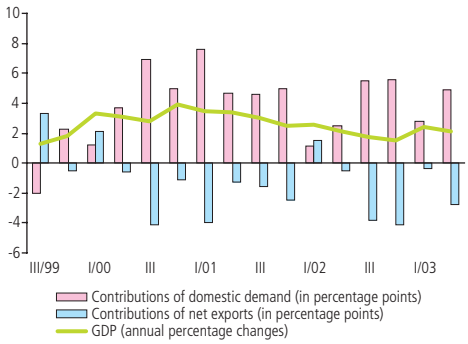


CHART III.12
ACCORDING TO THE CZSO'S LATEST ESTIMATES, ECONOMIC GROWTH SLOWED SLIGHTLY IN 2003 Q2



(of 0.3 percentage points). The output gap was still negative. The economic growth was supported by rising domestic demand. The contribution of the external sector to the GDP growth continued to be negative and increased again in Q2.

The GDP growth was mostly attributable to rising household expenditure on final consumption. The further increase in its annual growth, however, was at the same time one of the causes of more marked growth in imports and an ensuing rise in negative net exports in Q2. The deterioration of net exports was also due to a slowdown in export growth. On the supply side of the economy, the GDP growth was supported most of all by favourable value added in industry.

TABLE III.6
ECONOMIC DEVELOPMENTS IN THE CZECH REPUBLIC'S MAJOR TRADING PARTNERS FAILED TO CREATE CONDITIONS FOR STRONGER CZECH EXPORT GROWTH
(annual percentage changes; seasonally adjusted; source: Eurostat)

	Euro area		EU-15	
	2003 Q1	2003 Q2	2003 Q1	2003 Q2
Gross domestic product	0.7	0.2	0.9	0.5
Final consumption expenditure of households and non-profit institutions	1.6	1.4	1.8	1.6
Government final consumption expenditure	1.8	1.8	1.9	2.0
Gross fixed capital formation	-2.2	-1.0	-1.2	-0.8
Domestic demand	1.3	1.3	1.5	1.4
Exports of goods and services	2.2	-1.0	2.1	-1.3
Imports of goods and services	3.9	1.8	3.8	1.2

The economic developments recorded by the Czech Republic's major trading partners in 2003 Q2 again signalled no pronounced improvement in export conditions for Czech products. GDP growth in both the euro-area countries and the EU-15 was only very modest in 2003 Q2 and weakened by comparison with 2003 Q1 (by 0.5 percentage points to 0.2% and by 0.4 percentage points to 0.5% respectively). In Germany, the Czech Republic's most important trading partner, GDP decreased by 0.2% in Q2. The unfavourable conditions for Czech exports were indicated primarily by low and falling import growth in both the euro area and the EU-15 (see Table III.6). Producers again responded to the continuing low external demand in Germany by shifting part of their export production to other markets. This is why exports of goods recorded relatively rapid growth again in Q2[14]. The koruna's exchange rate also created more favourable conditions for exports than in 2002. However, total exports were still being negatively affected by falling exports of services.

TABLE III.7
THE GROWTH IN DEMAND AND GDP WAS CHIEFLY DUE TO CONSTANTLY RISING HOUSEHOLD CONSUMPTION
(annual percentage changes)

	I/02	II/02	III/02	IV/02	2002	I/03	II/03
Gross domestic product	2.6	2.1	1.7	1.5	2.0	2.4	2.1
Aggregate demand (domestic demand and exports)	2.2	3.1	3.8	3.2	3.1	3.6	4.5
Total domestic demand a)	1.0	2.4	5.1	4.9	3.4	2.6	4.6
Final domestic demand b)	3.8	3.0	3.0	3.1	3.2	2.7	2.7
of which:							
Household consumption	4.1	4.3	3.6	3.8	3.9	4.4	5.5
Government consumption	5.5	3.9	6.0	7.1	5.7	2.5	0.1
Non-profit institutions serving households	8.3	7.9	5.4	6.2	6.8	4.7	2.7
Gross fixed capital formation	2.3	0.4	0.4	-0.1	0.6	-0.3	-0.4
Imports of goods and services	1.8	4.3	6.1	4.9	4.3	4.8	7.0
Exports of goods and services	3.7	4.0	2.3	1.2	2.8	4.8	4.3
Net exports of goods and services (balance. CZK billions)	-25.5	-26.0	-45.4	-66.5	-163.5	-26.9	-37.3
Net exports as a percentage of GDP	-6.9	-6.5	-11.7	-17.2	-10.6	-7.1	-9.2

a) including changes in inventories; b) excluding changes in inventories

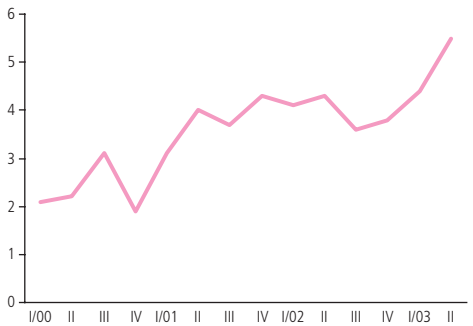
III.3.1 Domestic demand

Given the unfavourable net external demand, domestic demand was again the main engine of economic growth in 2003 Q2. In year-on-year terms the growth in domestic demand rose by 2 percentage points in Q2 compared to Q1, to 4.6%. As in the previous quarter, the domestic demand growth was due chiefly to increasing household expenditure on final consumption, which again accounted for the largest share of aggregate domestic demand in Q2 (54%). Another important factor behind the domestic demand growth was changes in inventories, which were mostly affected by increases in work-in-progress and finished goods. By contrast, materials and supplies saw a modest decline. Unlike in previous quarters, the contribution of government expenditure to final consumption was zero. Gross fixed capital formation again fell short of the level of the same period a year earlier and its contribution to aggregate domestic demand growth was thus negative.

Consumer demand

In 2003 Q2, households' expenditure on final consumption grew for the eighteenth consecutive quarter. Chart III.13 shows that its annual growth picked up further in Q2 to a six-year high (5.5%). In absolute terms, household consumption expenditure recorded an annual rise of CZK 11.5 billion (at constant 1995 prices). As in Q1, the increase in the real consumption expenditure of households was supported not only by the growth rate of gross disposable income, but also by the falling inflation and the increasing willingness of households to make instalment purchases.

CHART III.13
HOUSEHOLD CONSUMPTION EXPENDITURE RECORDED ITS HIGHEST GROWTH IN SIX YEARS IN 2003 Q2
(annual percentage changes)



14 Of 6.4% on a year earlier at constant prices in 2003 Q2.

Household incomes again rose relatively quickly in 2003 Q2. The annual growth in nominal gross disposable income slowed (by 1.1 percentage points compared to Q1), but the growth rate was still high (5.4%). With the price level as measured by the household consumption deflator falling by 0.4%, real disposable income increased more markedly than nominal disposable income.

The continuing rise in household consumption expenditure in Q2 was supported by rising incomes from all major sources. The most significant of these were wages and salaries, which are the main component of households' current income with respect to volume (more than 40%). In Q2, income from wages and salaries recorded annual growth of 5.4% (i.e. CZK 10.8 billion). Gross operating surplus and mixed income and income from social benefits also contributed significantly to the rise in households' current income[15]. In the first case income growth picked up in Q2 (to 5%), whereas the growth rate of income from social benefits was about the same as in Q1 (4.2%). As in the previous quarter, property income attributed to insurance policy holders recorded fast growth (111.6%), representing in absolute terms a contribution of CZK 2.2 billion to the rise in households' current income. Income from non-life insurance claims also showed quick growth (of 46.8%).

In both Q1 and Q2, households' propensity to consume was bolstered by falling inflation, which allowed them to make advantageous purchases. The other factors increasing the willingness of households to borrow were the lower interest rates compared to the previous quarter, commercial bank policy, and rising incomes. The effects of these factors were indicated by the actual consumer credit trend. In Q2, household borrowing increased by CZK 12.2 billion, up by 26.9% on the same period a year earlier. In 2003 H1, household borrowing was up by CZK 21.5 billion, which is almost 40% more than in 2002 H1.

The basic characteristics of the consumption behaviour of households in Q2 were the same as at the start of 2003: a willingness to increase their consumption spending amid rising incomes, and a willingness to borrow thanks to the aforementioned favourable factors.

Government demand

In 2003 Q2, after nine quarters of buoyant growth, government final consumption expenditure was flat at the 2002 Q2 level. Its annual growth was insignificant (0.1%), meaning that for the first time in a long time government final consumption made no contribution to GDP growth.

The drawing on budgeted expenditure on final consumption by the government for 2003 was uneven with respect to structure. Particularly low drawing on the annual budget was recorded as at the end of H1 for the high-volume item "Expenditure on compensation of employees, other payments for work done and insurance" (39.8%). Lower drawing on budget funds was also registered for non-investment purchases and related expenditure (45.7%). By contrast, in the case of non-investment transfers to local public budgets, representing the largest expenditure item of government consumption, the budget funds were drawn at 56.4% as of the end of June, after the regions commenced operation (advance quarterly payments). Drawing on non-investment transfers to central public budgets also exceeded the aliquot amount (58.5% of the budget) owing to high drawing on subsidies to social security and health insurance funds and to the State Agricultural Intervention Fund.

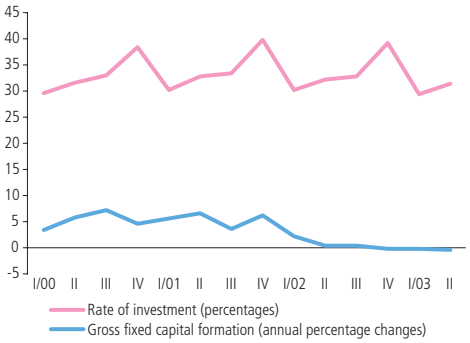
Chart III.14
AFTER QUITE A LONG PERIOD OF BUOYANT GROWTH, GOVERNMENT FINAL CONSUMPTION EXPENDITURE WAS FLAT IN 2003 Q2
(annual percentage changes)

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

Investment demand

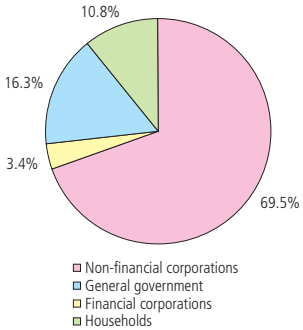
Investment demand saw no major changes in 2003 Q2. The moderate annual decline in gross fixed capital formation[16] that had emerged in Q1 continued. Fixed investment fell by 0.4% in year-on-year comparison, its decline being only slightly greater than in the previous quarter. The causes of the ongoing decline in investment are the same as those mentioned in the previous Inflation Report (July 2003) – the decline is chiefly a consequence of the previous relatively weak external demand (most notably in Germany) and uncertainties in expectations regarding future developments. These factors outweighed the positive impulse of foreign capital inflow in the form of foreign direct investment. It cannot be ruled out that the banks' very cautious approach to providing investment credit also played a role. Given the absence of major investment projects, the investment trend may also indicate that overall corporate investment demand in the Czech Republic is currently saturated. Nonetheless, the rate of investment remained very high (31.4%), recording only a modest year-on-year decline (down by 0.8 percentage points).

Chart III.15
INVESTMENT CONTINUED TO FALL IN 2003 Q2, BUT THE RATE OF INVESTMENT REMAINED RELATIVELY HIGH



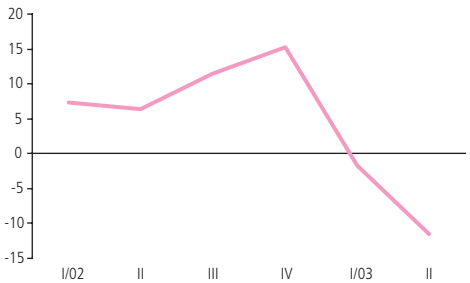
The aforementioned factors fostered a decrease in investment primarily in non-financial corporations. Investment in this sector fell for the fourth consecutive quarter in year-on-year comparison (by 4.7% in Q2). In manufacturing the decline was even more pronounced (9.2%). Despite this, non-financial corporations still accounted for most of the total investment (see Chart III.16).

Chart III.16
INVESTMENT BY NON-FINANCIAL CORPORATIONS RECORDED A YEAR-ON-YEAR FALL, BUT STILL HAD THE LARGEST SHARE IN THE INVESTMENT STRUCTURE
(2003 Q2; percentages)



The largest declines in the sector of non-financial corporations were recorded for investment in tangible and intangible goods (at current prices) by national private corporations and foreign-controlled companies (6.9% and 1.8% respectively). Owing to base effects, investment by public corporations was up by 6.4% in Q2 in year-on-year terms. In manufacturing, as in the previous quarter more than half (52.9%) of the investment in tangible and intangible goods (at current prices) was channelled into the manufacture of transport equipment, followed by the manufacture of food and tobacco, electrical and optical equipment and chemicals, chemical products and man-made fibres. Investment in the manufacture of transport equipment recorded, as in Q1, an annual decrease (of 38.4% at current prices). This had a fundamental effect on investment in manufacturing as a whole. The fall in investment by non-financial corporations was also largely due to a decline in investment activity in the transport and communications industry (-24.9% in year-on-year comparison).

Chart III.17
AFTER A STRONG RECOVERY IN 2002, INVESTMENT BY HOUSEHOLDS FELL IN 2003 H1
(annual percentage changes)



Investment by the household sector also recorded a year-on-year fall. This decline intensified in 2003 Q2 to -11.5%. The declining household investment in 2003 H1, following a period of sizeable growth in 2002, is most probably associated with the termination of the extensive investment wave at the end of 2002. This wave had been facilitated primarily by low interest rates, better availability of mortgage loans, expectations regarding prices on the real estate market, and by an increasing range of properties offered by construction companies. However, an annual rise in the number of housing starts at the same time suggests that we can expect another recovery in investment in the household sector.

Counteracting the decline in total investment was, as in 2003 Q1, increasing investment demand in the government sector (including non-profit institutions) and financial institutions. Although the annual growth rates in these sectors were high

16 At constant 1995 prices.

(21.5% and 85.1% respectively), they were not enough to offset the decline in investment by non-financial corporations and households, which account for most of the total investment (roughly 80%).

The aforementioned investment trends within the individual sectors determined the material structure of gross fixed capital, which developed just as unfavourably as in the previous quarter. Whereas investment in premises and facilities was up by 1% in year-on-year terms and other investment by as much as 36.2%, the active component of the investment – machinery and equipment – recorded a year-on-year decrease of 4.7%.

III.3.2 Net external demand

In 2003 Q2, net exports of goods and services again developed quite unfavourably compared to the previous quarter. In particular, the year-on-year growth rate of imports accelerated (by 2.2 percentage points to 7%), owing to a substantial increase in domestic demand. The deterioration in negative net exports was also due to slackening export growth (down by 0.5 percentage points to 4.3%). At the same time, both exports and imports grew more rapidly in 2003 Q2 than during 2002 as a whole.

However, the deterioration of the relationship between the annual growth rates of exports and imports again led to an annual increase in negative net exports (of CZK 11.3 billion to CZK -37.3 billion). Compared to Q1 there was a deterioration of CZK 10.4 billion. In this situation, the negative contribution of net exports to GDP growth increased again (see Chart III.12). As a percentage of GDP, negative net exports at the same time increased by 2.6 percentage points to -9.2% in year-on-year comparison.

The year-on-year deterioration in net exports was caused by a combination of several factors leading to worse results on both the trade balance and the services balance. The import side felt the effects of the faster growth in domestic demand (consumer demand in particular), which passed through mainly into imports of goods. Exports were unfavourably affected by the ongoing subdued external demand, most notably in Germany. Owing to these factors the trade deficit in Q2 increased by CZK 6.1 billion on a year earlier. The services balance deteriorated by CZK 5.2 billion, with the surplus switching to deficit as a result of deteriorations in all three of its component balances. Exports and imports of goods and services grew for the second consecutive quarter at current prices as well (by 6.8% and 7.1% respectively), since the annual appreciation of the weighted koruna exchange rate was only very modest. The structural development of exports and imports at current prices signalled some changes compared to the previous quarter. Despite the weaker external demand, exports to advanced market economies grew relatively quickly again in Q2 (by 7.4% on a year earlier), but unlike in Q1 exports to transition economies rose rather faster (by 9.1% on a year earlier). Exports to Slovakia in particular showed a pronounced pick-up in growth compared to Q1 (from 4.1% to 15.2%). Growth in exports to Germany was only half of that to Slovakia (7.4%), whereas in Q1 the growth rates for exports to these two countries had been roughly the same.

Turning to the commodity structure, the positive upward trend in the proportion of exports of higher-value-added commodities continued into 2003 Q2. This was evidenced primarily by a further annual rise in the share of mechanical and electrical engineering commodities in total exports of goods (of 2 percentage points to 58.4%). The share of exports of food products, raw materials and semi-manufactures was higher as well (up by 0.8 percentage points to 13.4%). The proportion of exports of other final products was the only one to decrease in year-on-year terms.

Chart III.18
ANNUAL GROWTH IN TOTAL IMPORTS INCREASED IN 2003 Q2
(annual percentage changes; constant prices)

Chart III.19
THE SHARE OF NEGATIVE NET EXPORTS IN GDP RECORDED A YEAR-ON-YEAR INCREASE IN 2003 Q2
(percentages)

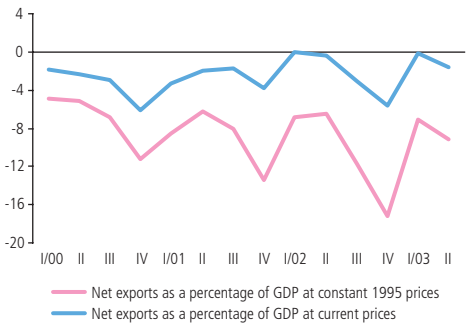
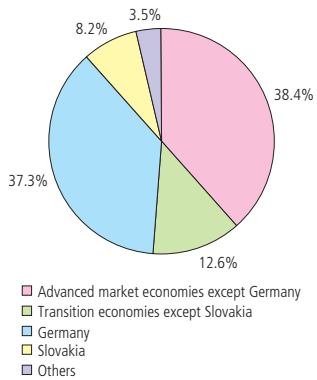


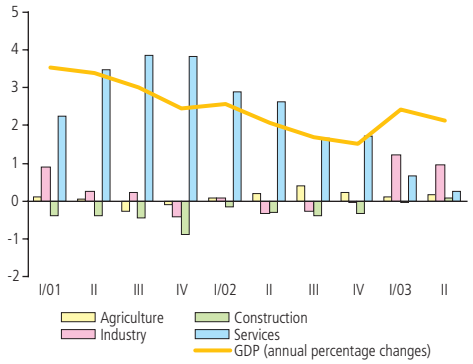
Chart III.20
GOODS EXPORTS WENT MAINLY TO ADVANCED MARKET ECONOMIES
(2003 Q2; percentages)



The more pronounced increase in growth of goods imports compared to the previous quarter was attributable to imports for final consumption and investment. Imports for final consumption were the quickest growing, showing a rise of 3.4 percentage points compared to the previous quarter during Q2, to 10%. Imports for investment also recorded faster growth than in Q1 (9%). Imports for intermediate consumption recorded the slowest growth (5.6%), but were still the largest item of total imports (57.1%).

III.3.3 Gross domestic product

Chart III.21
INDUSTRY MADE THE BIGGEST CONTRIBUTION TO GDP GROWTH IN 2003 Q2
(annual percentage changes; selected contributions in percentage points)



On the supply side of the economy, 2003 Q2 saw a continuation of the positive development of gross value added in industry. Its contribution to GDP growth was the most important; the contribution of the services sector was less significant in this quarter (see Chart III.21). Gross value added also continued to rise in agriculture and, after a long-running decline, it also increased in construction.

The continuing gross value added growth in industry in Q2 (2.9% in year-on-year comparison) was indicated by continuing relatively rapid growth of the industrial production index (up by 5% on a year earlier). This growth was recorded primarily in high-technology foreign-owned industries with good sales opportunities abroad. As in Q1, direct exports of products, goods and services grew faster than industrial production itself (by 7.9% on a year earlier). High growth rates were recorded mainly in the manufacture of transport equipment (10.7%), rubber and plastic products (14.2%), chemicals, chemical products and man-made fibres (8.5%), pulp, paper and paper products (11.2%) and electricity, gas and water supply (10.7%). By contrast, the highly dynamic growth recorded up until 2002 in the manufacture of electrical and optical equipment (of almost 30% a year in the past two years) came to an end this year and is now moving at low levels (0.8% in Q2 in year-on-year comparison).

In lower-value-added industries, production either rose much more slowly or was falling (e.g. manufacture of textiles and textile products was down by 3.8%) and their contribution to value added growth was thus less significant.

Gross value added growth in the services sector was only moderate (0.5% on a year earlier). Despite this, this sector maintained its decisive share in GDP in Q2. The factors behind the relatively sluggish value added growth in the services sector were an annual decline in half of the industries (most markedly in hotels and restaurants: 6.4%) and none-too-significant growth in other industries. Services in the sectors supporting positive structural changes in the economy – business services, research and development (up by 2.1%) and transport, storage, postal services and telecommunications (up by 1.8%) – recorded the fastest growth.

Table III.8
GROSS PROFITS INCREASED OVERALL IN 2003 Q2
(annual percentage changes)

	2003 Q2		
	Organisations, total	Industry	of which: Manufacturing
Income. total	6.6	2.0	-0.5
Output. total	6.5	5.8	6.2
Income from sideline activities	6.9	-15.3	-31.3
Expenses. total	5.8	1.2	0.6
of which: cost of sales	6.2	4.8	5.2
personnel costs a)	3.3	1.2	1.7
depreciation	2.4	4.5	0.8
Book value added	7.3	8.7	9.2
Pre-tax profit	19.7	11.6	-15.3
Net operating surplus	21.0	27.8	30.7

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

III.3.4 Financial performance of non-financial organisations and corporations[17]

Following the none-too-favourable economic results recorded by non-financial organisations in 2003 Q1, the second quarter saw a substantial improvement. According to preliminary results, the pre-tax profit of non-financial corporations was 19.7% higher on aggregate in 2003 Q2 than a year earlier. Net operating surplus and the profit-expenses, profit-equity and profit-output ratios increased as well. The number of loss-making organisations fell by 7.1% thanks to the improving overall economic position of non-financial corporations. The material cost-output ratio, personnel cost-

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

output ratio and ratio of personnel costs to value added all developed favourably as well. Their decreases in 2003 Q1 and Q2 confirm an ongoing effort by corporations to reduce costs and increase labour productivity growth, and thereby strengthen their competitiveness on domestic and foreign markets. This is also evidenced by the continuing rise in book value added per employee. The material cost-output ratio has been falling for almost two years in year-on-year terms (since 2001 Q4)[18].

The favourable trend for most of the economic results recorded by non-financial organisations in 2003 Q2 was attributable chiefly to foreign-controlled private corporations. In Q2, their pre-tax profit was up by 18.4% on a year earlier. Public non-financial corporations, whose share in total profit is not as significant as that of foreign-controlled ones, also recorded a substantial improvement in most financial indicators (including ratios). This positive trend was, however, due rather to a sizeable increase in earnings from sideline activities. Also evident here was a fall in costs, or personnel costs, owing to a falling number of employees and declining other costs. National private corporations still lagged behind foreign-controlled companies with respect to their economic performance.

Across the individual industries, financial performance continued to be very mixed. In Q2, as in Q1, industry saw improvements in most of its financial indicators. By contrast, a deterioration was recorded in manufacturing, mostly as a result of unfavourable financial indicators in the manufacture of basic metals and fabricated metal products, manufacture and repair of machinery and equipment and manufacture of transport equipment. The "lagging behind" the Q1 results in year-on-year comparison in manufacturing was, however, largely due to a deterioration of earnings from sideline activities. By contrast, net operating surplus here showed sizeable growth (30.7%) and the material cost-output ratio, personnel cost-output ratio and ratio of personnel costs to value added all continued to fall in this sector as well.

On aggregate, the financial indicators in the segment of large corporations in 2003 Q2 did not signal the creation of any potential inflationary pressures. On the contrary, the mostly declining personnel cost-output and material cost-output ratios and increasing profitability indicators suggested that corporations were trying to cope with the strongly competitive environment. The material cost-output ratio was not yet signalling any negative effects of the rising prices of imported raw materials and certain other imported inputs on costs and profits.

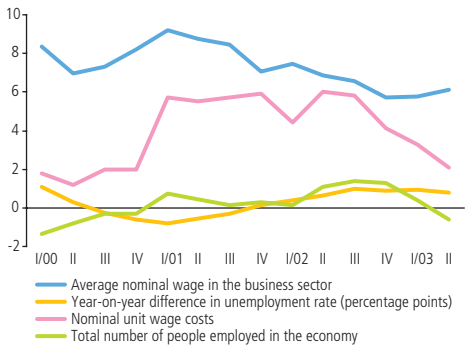
III.4 THE LABOUR MARKET

The developments on the labour market in 2003 Q2 and Q3 suggested a persisting gap between the demand for, and supply of, labour. In the strongly competitive environment, pressure was mounting for a more profound restructuring of production activities in order to cut costs. This was indicated by a sizeable decrease in employment growth at the start of 2003 and a decline in employment in Q2. However, the employment rate in the Czech Republic was still higher than in other accession countries[19]. The decreasing employment and falling supply of vacancies resulted in a further rise in the number of registered unemployed persons and the unemployment rate. The decline in employment contributed in large measure to a pick-up in productivity growth and a more pronounced slowdown in nominal unit wage cost

TABLE III.9
THE MATERIAL AND PERSONNEL COST RATIOS FELL OVERALL AGAIN IN 2003 Q2
(percentages; percentage points; CZK thousands)

	2003 Q2			Change in perc. points against 2002 Q2		
	Organisations total	Industry	of which: Manufact.	Organisations total	Industry	of which: Manufact.
Profit-expenses ratio	7.16	8.47	6.52	0.83	0.79	-1.23
Profit-equity ratio	3.96	4.38	4.84	0.66	0.21	-1.30
Profit-output ratio	9.72	9.18	6.99	1.07	0.48	-1.77
Material cost-output ratio	69.48	73.22	74.17	-0.21	-0.71	-0.71
Personnel cost-output ratio	15.74	12.81	12.75	-0.49	-0.57	-0.57
Ratio of personnel costs to value added	51.58	47.83	49.35	-1.95	-3.52	-3.66
	CZK thousands			Annual percentage changes		
Book value added per employee	139.80	149.16	138.96	10.21	13.45	13.78

CHART III.22
DEVELOPMENTS ON THE LABOUR MARKET INDICATED INCREASED PRESSURE FOR A FALL IN EMPLOYMENT IN THE BUSINESS SECTOR
(annual percentage changes and percentage point changes)



18 Except for 2002 Q2.

19 Comparison between the Czech Republic, Hungary, Poland and Slovakia. Source: Eurostat.

growth at the macroeconomic level. Across the individual sectors, the personnel cost-output ratios showed mixed developments. In industry, nominal unit wage costs continued to decrease in year-on-year comparison.

III.4.1 Employment and unemployment

The relatively low growth in employment in the economy during 2002 and particularly at the start of 2003 changed to an annual decline in 2003 Q2. According to Labour Force Survey (LFS) figures, the decline was 0.6%, which meant a decrease in the number of employed people of 28,200 in absolute terms. The factors behind the more pronounced changes in employment in 2003 H1 probably included in particular the business sector's reaction to the previously relatively low economic growth, uncertainties in expectations of future external demand, and the strongly competitive environment on both domestic and foreign markets. Restructuring and rationalisation, leading to redundancies, was one of the main ways of reducing the personnel cost-output ratio and increasing competitiveness.

The decline in overall employment in Q2 was due solely to an accelerating fall in the number of employees. In 2003 Q1 the number of employees (including members of production co-operatives) had decreased by 1.5% in year-on-year terms, whereas in Q2 the decrease was 2.4% (94,800 people in absolute terms). As in previous quarters, a proportion of those laid off found jobs in the business sector, as evidenced by the rapidly growing number of entrepreneurs since 2002 (up by almost 9% on a year earlier in 2003 Q2). Across the individual sectors the employment trends were mixed and reflected the ongoing structural changes in the economy. In Q2, the largest decreases in employment were recorded in manufacturing, transport, agriculture, and mining and quarrying. Conversely, the number of employees increased in construction and most services.

The decreasing employment in the employees category was also confirmed by the CZSO's business survey. According to preliminary figures, employment in this category fell by 1.1% year-on-year in 2003 Q2 (i.e. by 44,500 people). As in Q1, the number of employees decreased only in the business sector (by 2.2%, or around 73,400 people). In the non-business sector, conversely, employment further increased in Q2 (to 3.9%, i.e. by about 28,900 people). In both the primary and secondary sectors, the declining employment was almost across the board in nature; only in the tertiary sector did branches with increasing employment prevail.

The sluggish economic growth to date and the uncertainties regarding future external demand also had adverse effects on decision-making with respect to 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. At the end of 2003 Q2, the number of vacancies was 6,100 lower than in June 2002. The decline in the number of vacancies continued into Q3, albeit at a slower rate (3,100 in September). This situation is also confirmed by the seasonally adjusted figures on vacancies. In general, the supply of vacancies remained low.

The falling employment and low supply of vacancies implied further growth in the number of registered unemployed people and the unemployment rate. According to the latest available figures for September, the number of unemployed people was up by 36,500 on a year earlier (compared with 46,700 in June 2003). The unemployment rate was 10.1%. Its year-on-year growth was also lower than in 2003 H1.

Chart III.23
THE OVERALL DECLINE IN EMPLOYMENT IN THE ECONOMY WAS DUE TO FALLING NUMBERS OF EMPLOYEES
(annual percentage changes)

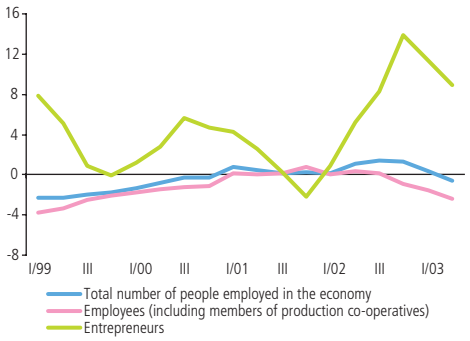


Chart III.24
THE FALLING SUPPLY OF VACANCIES CAUSED UNEMPLOYMENT TO RISE
(seasonally adjusted numbers of people in thousands; source: MLSA)

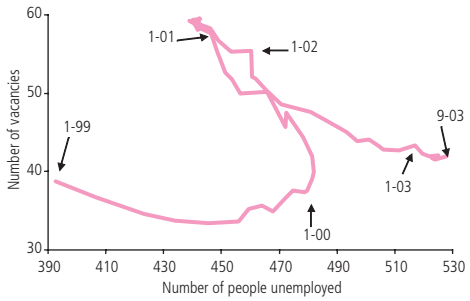
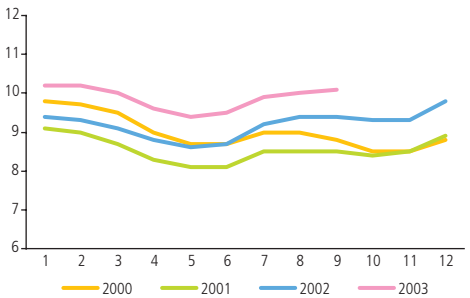


Chart III.25
THE UNEMPLOYMENT RATE INCREASED IN YEAR-ON-YEAR COMPARISON
(percentages; source: MLSA)



With respect to structure, 2003 Q3 saw a modest rise in the long-term unemployment rate (above one year) to an all-time high of 4.1%, according to MLSA figures. Short-term unemployment also increased (to 6%). The rise in long-term unemployment was probably a result of the combined effect of a larger increase in the unemployment rate in the same period of 2002 and the only very limited opportunities to find new work given the low supply of vacancies. Another unfavourable factor from the point of view of demand for labour on the part of firms was the professional and skills structure of the unemployed and the relatively low mobility of the workforce in the Czech Republic. These factors meant that the regional, professional and skills gaps between the supply of, and demand for, labour did not change much. Unemployment rates exceeding the whole-economy average (10.1%) were registered in 33 districts in September 2003, most of them in northern Bohemia and northern Moravia.

III.4.2 Wages and productivity

Following a sharp upturn at the start of 2003, the growth rate of average nominal wages[20] slowed to 6.8% in Q2. These sizeable fluctuations were caused by wage developments in the non-business sector, since the different timing of the revisions to wage scales in 2003 and 2002 strongly affected the base used to calculate the annual indices. Whereas in 2003 the changes in wage scales in the non-business sector were implemented on 1 January, in 2002 they had been made on 1 March. Even after "correction" of the comparison base in March, wages in the non-business sector grew quite quickly (by 9% on a year earlier) in 2003 Q2, thanks to the wage scale revisions. As mentioned in the previous Inflation Report (July 2003), the largest rises in average nominal wages at the start of the year were recorded in the education and health sectors.

In 2003 Q2, the business sector saw a modest pick-up in average nominal wage growth, but this growth was only moderate compared to the previous quarter (0.3 percentage points in year-on-year terms to 6.1%). For the fifth consecutive quarter, the growth rate lagged considerably behind that in the non-business sector. This trend resulted in further convergence of the absolute levels of average nominal wages in the business and non-business sectors. However, the scope for average wage growth in the business sector was limited by the strongly competitive environment.

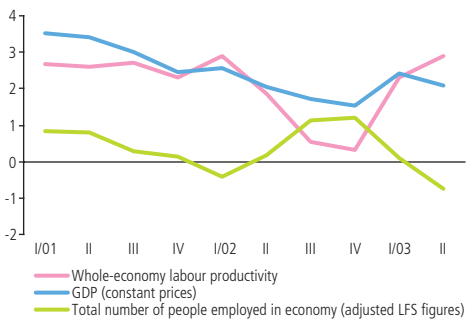
Average real wages in Q2 more or less copied average nominal wages. The exceptional period of faster real wage growth than nominal wage growth amid negative inflation in Q1 was ended by a very weak rise in inflation in Q2[21]. As a result, the annual growth of the average nominal wage in Q2 was only 0.1 percentage points higher than that of the real wage. Overall, average real wages continued to record relatively buoyant growth (6.7% in year-on-year terms), thereby helping to maintain the comparatively stable long-term growth in consumer demand. Particularly important with respect to inflation, however, was the way in which wages developed in relation to the productivity variables.

The growth in whole-economy labour productivity picked up further in Q2. In context with the other relevant variables it was apparent that the pick-up in productivity growth in 2003 H1 was largely due to employment rationalisation in the corporate sector. This is clearly demonstrated by the productivity developments in Q2 – GDP

Table III.10
THE SLOWER GROWTH OF THE AVERAGE NOMINAL WAGE WAS DUE TO WAGES IN THE NON-BUSINESS SECTOR
(annual percentage changes)

	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2002	2003 Q1	2003 Q2
Average wage in monitored organisations (nominal)	7.1	7.7	7.4	6.7	7.2	7.4	6.8
Average wage in monitored organisations (real)	3.3	5.4	6.7	6.2	5.3	7.8	6.7
Average wage in business sector (nominal)	7.4	6.8	6.5	5.7	6.5	5.8	6.1
Average wage in business sector (real)	3.6	4.4	5.7	5.2	4.6	6.2	6.0
Average wage in non-business sector (nominal)	6.0	11.2	11.3	10.3	9.8	14.5	9.0
Average wage in non-business sector (real)	2.3	8.7	10.5	9.9	7.8	15.0	8.9
Whole-economy labour productivity	2.9	1.9	0.6	0.3	1.3	2.3	2.9
Nominal unit wage costs	4.4	6.0	5.8	4.1	5.0	3.3	2.1

Chart III.26
THE FALL IN EMPLOYMENT FOSTERED A PICK-UP IN WHOLE-ECONOMY LABOUR PRODUCTIVITY GROWTH IN 2003 Q2
(annual percentage changes)

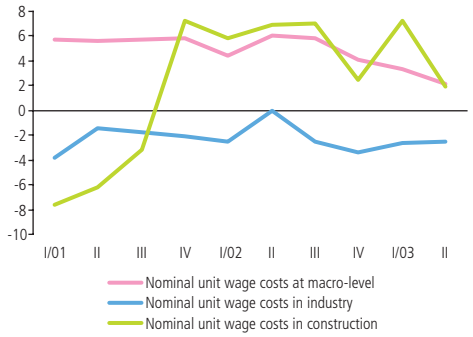


20 In the set of monitored organisations.

21 For details see Section II.1 *Past inflation developments*.

growth did weaken slightly, but the annual growth rate of whole-economy productivity increased thanks to the concurrent fall in employment (to 2.9%). This represents a change in the behaviour of the business sector compared to the previous year (most notably in H2), when the still slowing economic growth had been accompanied by slackening growth in productivity, since employment in the economy had still been increasing. The productivity developments continued to be mixed across the individual sectors. In industry, productivity was still growing very quickly (8.3% in year-on-year terms) amid falling employment[22]. In Q2, productivity also grew in construction.

Chart III.27
NOMINAL UNIT WAGE COSTS INDICATED A FAVOURABLE TREND IN THE WAGE COST-OUTPUT RATIO
(annual percentage changes)

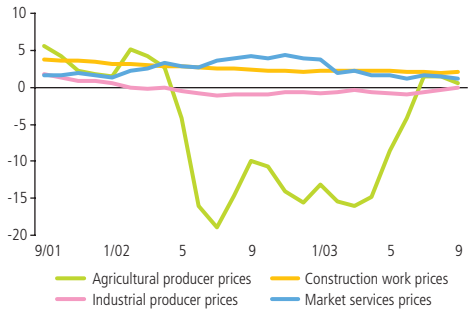


As in 2003 Q1, the pick-up in whole-economy productivity growth in Q2 helped to improve the relationship between wage and productivity variables at the macroeconomic level. Annual growth in nominal unit wage costs slowed to 2.1% (the increase for the whole of 2002 had been 5%). The relationship between wage and productivity variables was particularly favourable in industry[23]. Labour productivity here continued to grow faster than average real wages, and nominal unit wage costs recorded an annual decrease (of 2.5%). Nominal unit wage costs in construction were still rising, but the growth slackened considerably in Q2 (to 1.9%). Positive trends in the personnel cost-output ratio are also suggested by the figures for this ratio in large non-financial corporations (see *Financial performance of non-financial organisations and corporations*).

The further easing of the annual growth in nominal unit wage costs from 5%–6% in the past two years to roughly 2% in 2003 Q2 signalled a weakening of the potential wage-cost and demand-pull pressures on inflation. In industry, the personnel cost-output ratio – which has been falling for several quarters – created room for a decline in prices or an offsetting of any growth in the prices of other production inputs. Analyses of the evolution of producer and consumer prices did not suggest that the previous wage developments in other segments of the economy had been a source of higher inflation (for details see Section II.1 *Past inflation developments*).

III.5 OTHER COSTS AND PRICES

Chart III.28
PRICES IN THE PRODUCTION SECTOR DID NOT CREATE CONDITIONS FOR ANY GREATER RISE IN CONSUMER PRICE INFLATION
(annual percentage changes)



The evolution of the other cost indicators in 2003 Q3 signalled gradually mounting inflationary effects from prices of imported inputs. So far, however, this trend had mostly passed through into producer prices to only a limited extent and was not across the board in nature. Growth in prices of industrial raw materials and food on world markets was still relatively high, but the koruna prices of imports saw only moderate growth (after 26 months of year-on-year decline), chiefly thanks to the ongoing annual appreciation of the koruna-dollar exchange rate since July. What was significant with respect to the existing tendencies, however, was that price increases were recorded in most import categories. In industry, producer prices were flat in September, following their previous already moderate annual decline. A pronounced change in trend was visible in the case of agricultural producer prices, where the previous long-running annual decline was replaced by modest growth. By contrast, construction work prices and market services prices saw continuing relatively stable annual growth at low values.

22 Calculated from sales receipts at constant prices. In 2003 Q2, employment in industry decreased by 3% (year-on-year).

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

III.5.1 Import prices

Growth in prices of industrial raw materials and food on world markets, which is (together with the exchange rate) one of the main determining factors of the koruna prices of imports to the Czech Republic, slowed markedly in 2003 Q2 and Q3 following a sizeable fluctuation at the start of the year. Nonetheless, prices continued to rise comparatively quickly. According to the CZSO world price index[24], annual growth in raw materials and food prices in July and August was still roughly at the previous quarter's level (around 18%), but at the end of Q3 the growth rate slowed considerably (to 9.5% in September in year-on-year terms).

However, the easing of raw materials and food price inflation on world markets in Q2 and Q3 was not across the board in nature, as evidenced by the fairly mixed structural developments within the CZSO world price index. The overall slowdown in the annual growth of this index was fostered in Q3 mainly by prices of energy-producing raw materials, which have the largest constant weight in the index (69.4%). Among the energy-producing raw materials, a gradual decrease in annual growth was recorded for natural gas prices (from 39.6% in June to 28.7% in September). Conversely, oil prices were still showing rising growth in July and August (to 11.9% in August). Their subsequent decline in September (of 5.4% year-on-year), together with the further weakening of growth in natural gas prices, caused the growth rate of prices of energy-producing raw materials to fall at the end of Q3 to about half the level recorded in the previous four months (to 9.7%). In the lower-weight categories of the index, prices also showed mixed developments. Overall, however, they made a positive contribution to the annual growth in the CZSO raw materials index in Q3.

However, the continuing relatively high annual growth in prices of raw materials and food on world markets, accompanied by the upturn in industrial producer price inflation recorded by the Czech Republic's major trading partners[25], did not pass through into koruna prices of imports to the corresponding extent. Some upturn in growth was apparent from July onwards, but this was moderate compared to the raw materials price inflation on world markets (see Table III.11). According to the latest data for August, import prices were up by a mere 1% on a year earlier. The difference in the growth rates of world prices and import prices was, as in previous quarters, mostly due to the koruna's exchange rate. The koruna-euro rate recorded a further increase in its annual depreciation in Q3, but the koruna-dollar rate was still showing a relatively strong, albeit declining, annual appreciation.

The different evolution of world prices of raw materials and food and the koruna-euro and koruna-dollar exchange rates fed through with different intensities into the individual items included in the CZSO import price index. At the same time, the index's structural development confirmed a gradually strengthening trend toward a weakening decline, or strengthening rise, in import prices. This is clearly illustrated by a change in the ratio between the numbers of import categories with falling and rising prices. In March 2003 import prices had recorded annual decreases in seven of the nine categories of the CZSO import price index, whereas in Q3 (according to the latest figures for August) prices in most of the categories increased or were flat (six categories). The fastest growing import prices were in the categories of mineral fuels, crude materials and animal and vegetable oils.

Chart III.29
PRICES OF RAW MATERIALS AND FOOD ON WORLD MARKETS AGAIN RECORDED RELATIVELY FAST GROWTH IN 2003 Q3
(annual percentage changes)

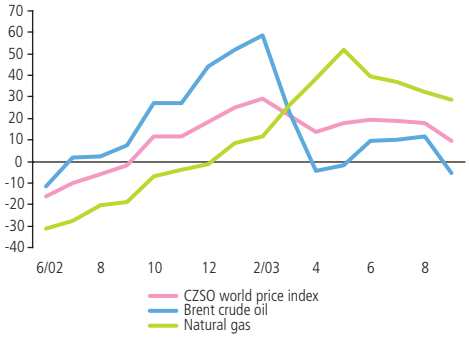


Chart III.30
BUT THE UPTURN IN IMPORT PRICE GROWTH WAS MODERATE FOR NOW
(annual percentage changes)

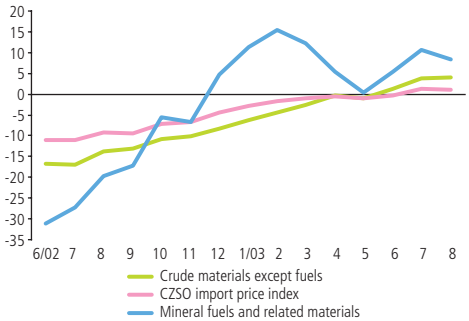


Table III.11
MOST OF THE CATEGORIES OF THE IMPORT PRICE INDEX RECORDED PRICE INCREASES
(annual percentage changes)

	1/03	2	3	4	5	6	7	8
Imports, total	-2,8	-1,7	-1,0	-0,5	-1,1	-0,2	1,4	1,0
Food and live animals	-4,7	-6,1	-5,7	-6,3	-5,4	-4,1	-2,0	-1,6
Beverages and tobacco	-4,1	-4,8	-3,7	-1,5	-3,1	-2,8	1,6	3,1
Crude materials except fuels	-6,3	-4,5	-2,7	-0,2	-0,9	1,4	3,9	4,1
Mineral fuels and related products	11,3	15,4	12,3	5,3	0,4	5,5	10,7	8,3
Animal and vegetable oils	7,9	6,2	3,8	8,7	8,7	7,4	7,5	4,4
Chemicals and related products	-3,2	-1,9	-0,7	0,0	-0,7	0,0	0,3	0,0
Manufactured goods classified by material	-3,3	-2,1	-0,7	1,5	1,9	2,4	4,1	3,1
Machinery and transport equipment	-5,3	-4,3	-3,2	-2,1	-2,6	-2,1	-0,8	-0,7
Miscellaneous manufactured articles	-2,8	-3,0	-2,8	-1,8	-1,6	-1,4	-1,2	-1,6

24 This index is calculated by the CZSO on the basis of prices expressed in US dollars. The figures given here are quarterly averages.

25 Producer prices in Germany, for example, which affect Czech import prices, have been recording annual growth ranging between 1.2% and 1.9% since February (1.6% in August).

Chart III.31
THE SLOWING ANNUAL DECLINE IN INDUSTRIAL PRODUCER PRICES CHANGED TO A STAGNATION IN SEPTEMBER
(percentages)

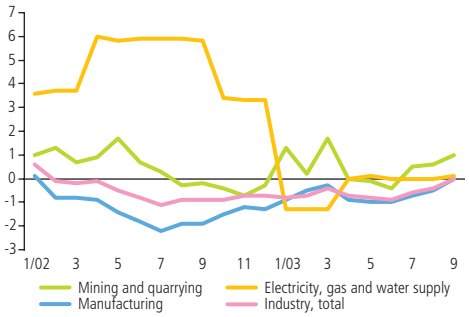


Chart III.32
THE FALLING WAGE COST-OUTPUT RATIO IN INDUSTRY HELPED TO OFFSET THE IMPACTS OF THE RISING PRICES OF IMPORTED INPUTS
(annual percentage changes)

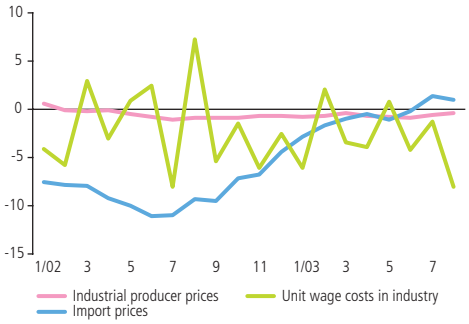
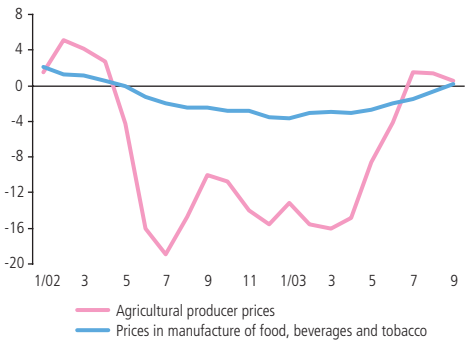


Chart III.33
THE LONG-RUNNING DECLINE IN AGRICULTURAL PRODUCER PRICES WAS REPLACED BY MODEST GROWTH IN 2003 Q3
(annual percentage changes)



III.5.2 Producer prices

Industrial producer prices

Industrial producer prices in 2003 Q3 indicated gradually unwinding disinflation. This was attributable to the aforementioned pick-up in raw materials and food price inflation on world markets, which gradually passed through into import prices. The annual decline in industrial producer prices gradually slackened in Q3, and these prices were flat in September. These features were particularly visible in manufacturing. A further weakening of the price decline here led to stagnation in year-on-year comparison in September. In most of the important branches of manufacturing, annual inflation showed no substantial deviations from the stagnation recorded for the sector as a whole. Where there was an increase in producer prices in some industries, it did not exceed 1.3%.

As in previous quarters, oil-product-processing industries responded fastest to the changes in the market environment. In Q3, the rebound in oil prices on world markets in July and August combined with the weakening annual appreciation of the koruna-dollar exchange rate caused producer prices in the manufacture of coke and refined petroleum products to rise again in August and September (by 1.5% and 1.1% respectively) after a three-month-long annual decline. In the chemical industry, which reacts with a certain lag to changes in oil prices, producer prices were still falling in September (down by 2% year-on-year). Other branches of manufacturing[26] saw a continuation of the long-running downward trend in their annual price decline, which was replaced by a weak annual rise in September (to 0.1%).

The price movements in the other industrial sectors[27] were also moderate. After a slight annual decline (of 0.4% in June), prices in mining and quarrying started growing again (by 1% in September). Producer prices in the electricity, gas and water supply industry were roughly flat at the Q2 level (0.1%). In addition to excess supply, the price stagnation was probably due to the structural changes taking place in these still monopolised industries.

On aggregate, industrial producer prices in 2003 Q3 had yet to indicate any across-the-board upward pressure on consumer prices. The prices of imported inputs did signal a narrowing of the room for a reduction in producers' costs due to falling prices of inputs, or a rise in costs. On the other hand, however, businesses continued to reduce the wage cost-output ratio in conditions of strong competition (for details, see Section III.4 *The labour market*).

Agricultural producer prices

In 2003 Q3, agricultural producer prices registered a turnaround in trend, which meant renewed annual price growth after quite a long period of relatively strong decline (see Chart III.33). During 2003 H1, agricultural producer prices had still been falling (by 12.2% on average), but starting from July they showed modest growth (of 0.6% in September). Renewed inflation was seen in the crop products category, which recorded

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

27 The categories "Mining and quarrying" and "Electricity, gas and water supply".

a sizeable annual price growth in Q3 (8.1% in September)[28]. Prices of livestock products remained below the level of the same period of 2002 (by 3.1% in September).

The main cause of the rising agricultural producer prices in 2003 Q3 was a change in the relationship between supply and demand on the agricultural commodities market resulting from the unfavourable weather conditions in 2003. The previous excess supply on this market, resulting from favourable harvests in previous years, was replaced by excess demand in the case of crop commodities. The shortage of rainfall had particularly adverse effects on the production of cereals, rape, potatoes and other products both at home and in neighbouring countries. Particularly insufficient was the production of fodder crops, which could even lead to a reduction in livestock production. At the same time, the State Agricultural Intervention Fund did not make intervention purchases of wheat at a fixed price as it had done in previous years. In these circumstances, primary agricultural producers are trying to increase prices of some livestock products to at least partially offset the fall in sales from crop production (for example, egg prices rose by 18.9% year-on-year in September).

Producer prices in the related manufacturing industry recorded a moderate annual fall at the start of 2003 Q3, but in September they started to grow slowly (by 0.2%; see Chart III.33).

Construction work prices

Unlike agricultural producer prices, construction work prices saw no substantial changes. Their annual growth has been moving at about 2% since the start of the year. According to the latest CZSO estimates for September 2003, annual construction work price inflation did slacken slightly compared to H1 (from 2.2% to 2.1%), but this change can be viewed as a manifestation of price volatility.

Market services prices

Annual market services price inflation was also relatively low in 2003 Q3 (1.1% in September). Across the individual market services categories the price developments were still mixed, but no major changes from the previous quarter were registered. Sewerage collection charges showed the fastest growth (5.1% in September in year-on-year comparison). By contrast, prices for national goods transport and financial intermediation and insurance showed moderate increases not exceeding 1.5%. Inflation in other business services was somewhat higher (2.1% in September). Only prices of communications services failed to reach the previous year's level (2.5% in September).

The reasons for the broadly subdued market services price inflation are the same – besides demand-side developments they include changing conditions in the competitive environment (for example in telecommunication services for businesses) and a price "slump" following more marked changes in 2002 (for example in insurance).

Chart III.34
THE FLAT CONSTRUCTION WORK PRICE INFLATION CONTINUED INTO 2003 Q3
(annual percentage changes)

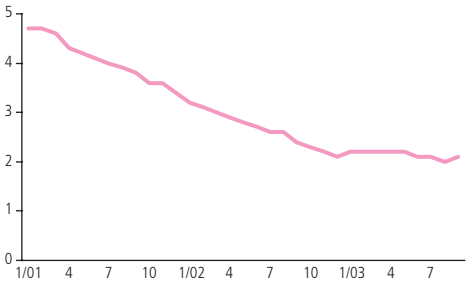
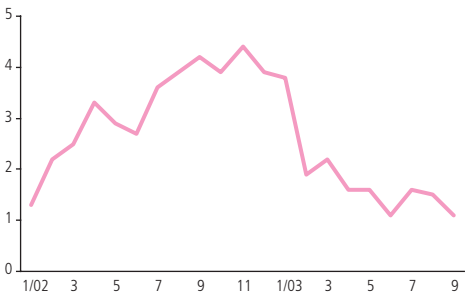


Chart III.35
MARKET SERVICES PRICE INFLATION REMAINED LOW IN 2003 Q3
(annual percentage changes)



28 Producer prices of oil plants, potatoes and vegetables rose (by 9.5%, 31.1% and 3% respectively in September). The producer price of wheat increased by 4.6% between July and September 2003.

IV. THE MACROECONOMIC FORECAST AND ITS ASSUMPTIONS

IV.1 EXTERNAL ASSUMPTIONS OF THE FORECAST

Assumptions made about the external environment are an important factor of the macroeconomic forecast. The key determinants are 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.

In the light of the actual developments since the preparation of the last forecast, the forecast oil prices have been increased somewhat. At the end of 2003, the price of Ural crude oil is thus expected to be around USD 25 a barrel. A gradual fall is predicted thereafter, to USD 23 a barrel at the end of 2004. The forecast for natural gas prices has been revised in the same direction. The expected prices of natural gas have been increased by around 6% compared to the last prediction for the entire forecast period.

The forecast for economic growth abroad has been revised downwards slightly for 2003. More specifically, a stagnation is expected this year in Germany. In 2004, GDP growth in Germany is estimated at 1.6%, rather higher than predicted in the previous forecast.

The assumptions about foreign inflation are little affected by the changes to the economic activity forecast. Annual consumer price inflation in Germany is expected to be 1% in 2003, an increase of 0.1 percentage points compared to the previous forecast. In 2004, consumer price inflation is estimated at around 0.9%, which is conversely a slight decrease compared to the previous forecast. The assumptions about industrial producer prices have been revised in a similar manner: in Germany these prices are expected to increase by 1.2% in 2003 and 0.7% in 2004.

IV.2 INTERNAL ASSUMPTIONS OF THE FORECAST

In addition to the above assumptions regarding the external environment, the forecast is affected by assumptions regarding the domestic economy. 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 5.3% of GDP[29] in 2003. For the period ahead, the public budgets are expected to develop in line with the approved plan for the reform of public finances. The macroeconomic forecast thus assumes a gradual 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 5.1% of GDP. The public budgets' contribution to annual GDP growth, i.e. the fiscal impulse approximation, remains positive in 2004 at 0.3 percentage points. Nonetheless, its expected magnitude in 2004 is only around one third of the 2003 level (0.8 percentage points).

The final form of the forecast is also determined by the predictions for equilibrium macroeconomic variables. The first of these variables is potential output, which according to the forecast is rising at an estimated rate of around 2.5% a year.

29 The Ministry of Finance's revised July 2003 forecast is for a deficit of 6.6% 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.

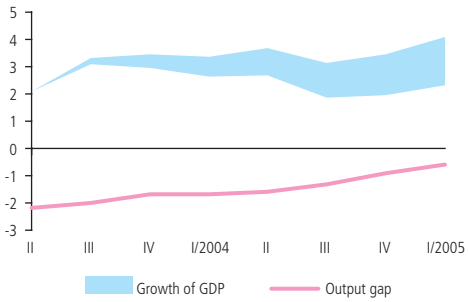
A moderate downward revision of this indicator compared to the previous forecast reflects the sizeable slowdown in investment activity in 2003. Another key variable is the equilibrium real exchange rate. According to predictions, the pace of annual equilibrium appreciation will gradually ease from the current 3.5%. The logic of the relationships between the real rates of return in the Czech Republic and abroad generates an estimate for one-year equilibrium real interest rates at roughly 1.5%.

In contrast to the last forecast, the output gap has stopped widening. The estimate for the present is -2%. The monetary conditions are viewed as very easy in both the exchange-rate and interest-rate components. The last key factor of the forecast is the predicted exchange rate path. The rate is expected to remain stable up to the end of 2004 at CZK 32 to the euro. Thereafter, moderate appreciation tendencies will start to emerge gradually.

IV.3 THE MESSAGE OF THE FORECAST

In 2003 and 2004, GDP growth will fluctuate around the 3% level. For 2003 as a whole, GDP is expected to rise by slightly more than predicted in the previous forecast: by 2.8%. The main factor underlying the growth this year remains household consumption, whose growth is due to high growth rates of real disposable income, but is also a reaction to the easing of the interest-rate component of the monetary conditions in the past. The forecast assumes a gradual rise in export activity in response to the easing of the exchange-rate component of the monetary conditions.

CHART IV.1
THE FORECAST GROWTH IN GDP WILL NOT BE ENOUGH TO CLOSE THE OUTPUT GAP
(percentages)



In 2004, the structure of the growth is expected to change. The forecast is for a gradual decline in the growth rate of household consumption in response to slowing real wage growth, rising unemployment and an autonomous tightening of the interest-rate component of the monetary conditions in 2003 H1. On the other hand, 2004 will see a further pick-up in export growth in response to the easing of the exchange-rate component of the monetary conditions. A gradual increase in investment activity is also expected. The export growth will be offset to a certain extent by a rise in imports, but the forecast nonetheless expects the contribution of net exports to GDP growth to be positive. The aforementioned reversal in investment should be associated with the easing of both components of the monetary conditions and the commencement of a gradual recovery abroad. GDP growth as a whole will, however, be depressed by an expected change in the contribution of government consumption linked with the launch of the Government's reform of public finances. In the course of 2004, the forecast is thus for an initial decline in government consumption growth and afterwards a shift even to negative year-on-year changes. Overall GDP growth is expected to fluctuate around the 3% level in 2004.

A further moderate pick-up in GDP growth is then expected at the start of 2005 owing to a further easing of the monetary conditions during 2004 and to an ongoing recovery abroad. Given the expected rates of GDP growth, the estimate of the current output gap leads to the prospect of its gradual closing. The approach to the modelling and use of the output gap in the CNB's forecasting system is described in the box below.

BOX
Use of the output gap indicator at the CNB

Inflation in the Czech economy is determined both by external factors (e.g. prices of raw materials and foreign inflation) and by domestic factors. The domestic ones can be divided into supply factors (the koruna's exchange rate and productivity) and demand factors. The "output gap" is a frequently used aggregate indicator of the effects of demand factors. This indicator measures the difference between

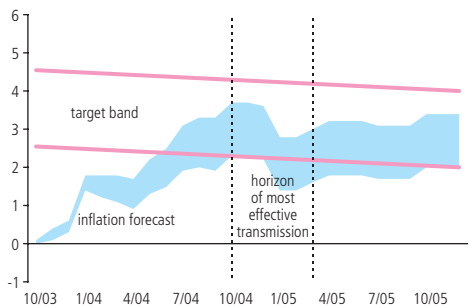
"potential output" and output in the current period. Potential output can be viewed as the level of output that can be produced and sold without giving rise to additional pressures for a change in prices.

The output gap therefore provides in concentrated form valuable information on the existence or absence of demand pressures in the economy. If output is above its potential value, prices will tend to rise. In this situation we speak about a positive output gap. Conversely, if output is below potential, prices will tend to fall and we speak about a negative output gap. The concept of the output gap thus effectively enhances the analysis of demand pressures and their potential price effects beyond the framework of work with GDP growth rates. This is why the Czech National Bank, in line with the practice of numerous analytical teams, uses the output gap in its analyses and forecasts.

However, the output gap is not usually an observable and measurable variable. It can be estimated in several ways. These include, for example, estimating potential output using the production function method or various filtering methods. Filtering here refers to a method for obtaining from a GDP time series those components which have a close relationship to inflation. In its analyses of past economic developments, the CNB uses a multivariate filtering method known as the Kalman filter. This method essentially involves applying ideas of the relationships between the output gap and key macroeconomic variables to past data. Analysis of the historical development of the relationship of key macroeconomic variables, conditioned on set linkages within a closed macroeconomic model, will then indicate the evolution of the output gap. These results are subsequently confronted with the results of the other aforementioned approaches and with expert opinion.

However, the output gap plays a key role not only in the analysis of past developments, but in particular in considerations regarding the future. It is thus an important part of the CNB's forecasting process. The output gap forecast, together with the assumptions regarding the exchange rate and imported inflation, is a key factor in the preparation of the CNB's macroeconomic forecasts, which form the basis for monetary policy decision-making. The CNB's forecast is based on the fact that the future path of the output gap is affected both by the lagged effects of past economic activity (known as persistence) and the settings of the interest-rate and exchange-rate components of the monetary conditions and the external economic environment. The monetary conditions are taken to mean actual values of the koruna's real exchange rate against the euro and of real interest rates with various maturities compared to their equilibrium values. Foreign economic activity is proxied with German GDP or the output gap. Easy monetary conditions, or a positive foreign output gap, then, put simply, generate pressures for growth of the domestic output gap and thus potentially also for a rise in prices.

Chart IV.2
THE INFLATION FORECAST IS MOSTLY IN THE LOWER HALF OF THE TARGET BAND AT THE HORIZON OF MOST EFFECTIVE TRANSMISSION
(annual consumer price inflation; percentages)



The forecast for inflation at the end of 2003 has been downscaled in the light of the recent inflation outturns. Headline inflation should thus be approximately 0.5% at the year-end. Inflation has likewise been revised downwards for 2004 as well. The main factor behind this revision is a change in the expected path of adjusted inflation excluding fuels. The lower forecast for adjusted inflation excluding fuels is due to the slower pass-through of certain inflationary pressures into inflation being observed in the current climate of a persisting negative output gap. This observation, together with supplementary analyses, has led to a downward revision of the secondary effects of the changes to indirect taxes.

However, the strengthened effect of the negative output gap has also passed through into other components of adjusted inflation excluding fuels. Adjusted inflation

excluding fuels should thus be around 2.1% in 2004 Q4, as against the approximately 2.5% predicted in July. In addition to adjusted inflation excluding fuels, the decrease in the headline inflation forecast is due to a reduction in the forecast growth of regulated prices. According to the forecast, headline inflation will be roughly 2.9% at the end of 2004, whereas the July forecast was for a level of around 3%.

The rise in inflation from the end of 2003 will be due chiefly to the gradual closing of the negative output gap and a gradual rise in food prices. The expected effect of imported inflation can be viewed as neutral. In connection with the closing of the output gap, a further pick-up in adjusted inflation excluding fuels and subsequently also headline inflation, and the return of inflation into the inflation target band, is expected at the beginning, and during the course, of 2005.

To sum up, the forecast expects the negative output gap to last until mid-2005 (see Chart IV.1). Nevertheless, owing to an easing of the monetary conditions at the end of 2003 and a gradual recovery in economic growth abroad in 2004, there will be a gradual closing of the output gap from the end of 2003 onwards. Inflation has at the same time been revised downwards because of a further change of outlook regarding the effect of the output gap on prices and the ensuing changes in the forecast impacts of the adjustments to indirect taxes. During 2004, however, the forecast is for a rise in inflation due to the closing of the negative output gap, an unwinding of the disinflationary exogenous factors, and to the changes to indirect taxes.

Consistent with the forecast are interest rates just below 2% and a modest rise in rates from 2004 H1 onwards. Like previous forecasts, 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.

During its decision-making the Bank Board also considered, together with aforementioned baseline scenario, some alternative scenarios. These focused chiefly on uncertainties relating to the settings of the exchange-rate and interest-rate components of the monetary conditions, as well as to effect of the potential moving of hotel and restaurant services to the basic VAT rate. Consistent with these alternative scenarios was a higher interest-rate trajectory compared to the baseline scenario.

The following box provides a closer look at the method used within the CNB's forecasting system to obtain a rough idea of future interest rate movements consistent with the overall macroeconomic forecast.

Box
Monetary policy in the CNB's macroeconomic forecast

The forecast is the key source material for the CNB Bank Board's decisions. The forecast captures the functioning of the entire economy, including monetary policy (see the July 2002 Inflation Report)[30]. The model on which the forecast is based contains a simple central bank reaction function which is in line with the definition of the CNB's objectives and approximately expresses the past interest rate path. The output of the forecast is the implied interest rate trajectory.

30 The CNB's forecasting system is described in detail in a publication entitled "The Czech National Bank's Forecasting and Policy Analysis System", available at http://www.cnb/publikace2.php.

However, this implied trajectory cannot be viewed as binding as regards the future path of interest rates. The arrival of new information following publication of the forecast can change the outlook for the evolution of the economy and the related consistent reaction of the central bank. The second reason is the fact that no simple, model reaction function can entirely precisely express the detailed monetary-policy debate that precedes the decision on the interest rate setting.

The specification of the reaction function used in the CNB's forecasting system assumes that nominal interest rates (ir_t) are changed in response to an expected deviation of inflation from the inflation target in four quarters' time ($\pi^e_{t+4} - \pi^T_{t+4}$) and the present output gap ($y_t - y^*_t$). However, given the considerable uncertainties surrounding monetary policy, interest rates are not changed at once, but gradually, in several steps. This is expressed in the reaction function specification with a lagged interest rate (ir_{t-1}).

$$ir_t = \alpha \cdot ir_{t-1} + (1-\alpha) \cdot \{ir_t^{neutral} + \beta \cdot [(\pi^e_{t+4} - \pi^T_{t+4}) + \gamma \cdot (y_t - y^*_t)]\}$$

If the economy is in equilibrium, i.e. if it has not been disturbed from equilibrium by any demand or supply shocks, interest rates are equal to the "policy neutral" interest rates ($ir_t^{neutral}$), given by equilibrium real interest rates and forecast inflation.

The response of interest rates to economic developments is characterised approximately by the individual parameters of the reaction function (α, β, γ). The degree of uncertainty and the distribution of the change in interest rates into several steps are expressed by the smoothing coefficient (α). The aggression coefficient (β) determines the strength of the reaction of interest rates to the expected deviation of inflation from the target and the output gap. Coefficient γ determines the ratio of the deviation of expected inflation from the target to the output gap. In line with the CNB's defined objectives, this ratio is set strongly in favour of inflation. The specific values of each parameter undergo gradual changes over time depending on how the data base used for their estimation expands.

IV.4 Expectations of economic agents

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

	Consumer price index			1Y PRIBOR
	Financial market	Businesses	Households	Financial market
12/01	3.9	3.9	4.6	5.1
12/02	2.3	2.3	2.3	3.1
1/03	2.5			3.1
2/03	2.4			3.2
3/03	2.5	2.1	4.3	2.9
4/03	2.6			3.0
5/03	3.7			3.0
6/03	3.2	2.6	1.7	2.8
7/03	3.3			2.7
8/03	3.2			2.7
9/03	3.1	2.6	3.1	2.6

The inflation outturns expected by financial market participants showed only minimal changes. Consumer price inflation is expected to pick up gradually, but the rise should not be dramatic. The Czech economy is expected to be affected by higher food and oil prices. In 2004, prices are also expected to rise as a result of the tax changes. The unwinding disinflationary effects of external influences (the global economic recovery) and the low comparison base will also probably play a role. The inflation expectations of other economic agents showed mixed developments[31].

Unlike in the case of inflation, the expected interest rates have been gradually falling since the start of the year. In the immediate future rates are predicted to stabilise, having bottomed out in the opinion of the respondents. In the longer term, they are expected to rise again somewhat. The first increase in the CNB's key rates is expected in approximately mid-2004. The interest rate path consistent with the aforementioned CNB forecast is at a slightly lower level.

31 The inflation expectations of households and businesses in January, March and June 2003 have been revised so that starting from 2003 the inflation-expectations time series corresponds to the new methodology used for surveying and calculating the expectations – see the box in the July 2003 Inflation Report.

ANNEX

THE CZECH REPUBLIC'S EURO-AREA ACCESSION STRATEGY
(Joint Document of the Czech Government and the Czech National Bank)

1. The Czech Republic's process of accession to the European Union is drawing to a successful completion. The negotiations on the financial conditions for accession were completed at the Copenhagen summit in December 2002, and in Athens in April 2003 the Czech Republic's Treaty of Accession was officially signed. Following the referendum on accession held in June 2003, the accession process is to be closed with the ratification of the Treaty of Accession by the parliaments of the EU Member States. The Czech Republic is set to become a Member State of the EU in May 2004.

2. An integral part of the Czech Republic's accession to the EU is the obligation of subsequently joining the euro area. Given the inevitable policy implementation lags, a credible strategy needs to be established for the Czech Republic's integration into European monetary structures. This strategy will then serve as the basis for each particular economic policy, and in particular for monetary policy. For this reason, the Government in its Policy Statement set itself the task of preparing a euro-area accession strategy in co-operation with the Czech National Bank (CNB).

3. This document presents the joint and co-ordinated approach of the Ministry of Finance, the Ministry of Industry and Trade and the CNB to the basic issues associated with the Czech Republic's entry into the Economic and Monetary Union. It summarises the starting points for the Czech Republic's integration into European monetary structures and discusses the positive effects and potential risks associated with joining the euro area. The document recommends that the Czech Republic join the euro area as soon as economic conditions allow for doing so. The timing therefore depends to a large extent on the speed of the real convergence process, achieved by means of structural reforms, and on the nominal convergence process, especially on a rigorous fiscal consolidation.

The Starting Points for Joining the Euro Area

4. The Economic and Monetary Union (EMU) was implemented in three stages on the basis of the Maastricht Treaty. During the first stage, starting in 1990, the liberalisation of capital flows was completed and a single internal market was created. The second stage, starting in 1994, focused on making progress on convergence of the Member States' economies. The third stage involved introducing the non-cash euro and launching the single monetary policy of the European Central Bank (ECB), which sets a single interest rate for the entire euro area. The process of monetary integration was completed by the introduction of euro banknotes and coins into circulation in January 2002.

5. Economic integration within EMU is founded on the euro and on co-ordination of economic and budgetary policies both mutually and among the Member States. This coordination is achieved by means of multilateral surveillance of such polices. The formation of excessive budget deficits is prevented by the *Treaty establishing the European Community and the Stability and Growth Pact* (see Box 1). Within these relatively narrow confines, fiscal policy is left to the discretion of the individual EMU Member States.

BOX 1
Budget Deficits of the EU Member States

Article 104 of the *Treaty establishing the European Community* sets forth that Member States must avoid excessive government deficits. The decision on whether an excessive deficit exists is made by the European Council based on a report presented by the Commission. Where the existence of an excessive deficit is declared, the Council makes recommendations to the Member State concerned with a view to bringing that situation to an end. The recommendations of the Council are not made public unless the Member State fails to respond to the recommendations within the period laid down. In addition, under the *Stability and Growth Pact* financial sanctions may be imposed on euro-area Member States in the form of either a non-interest-bearing deposit requirement or – after two years of the decision to impose sanctions, unless the excessive deficit has in the view of the Council been corrected – a fine.

6. In 1999, eleven countries satisfied the conditions for adopting the euro and consequently established the euro area. They were joined by Greece in 2001. The United Kingdom and Denmark, which at the start of the Maastricht process

insisted on an *opt-out clause*, are not currently part of the euro area. Despite not having an opt-out clause, Sweden also currently remains outside the euro area for domestic political reasons.

7. When it joins the EU, the Czech Republic will automatically participate in the third stage of EMU. It will acquire the status of "Member State with a derogation" regarding the adoption of the euro, i.e. it will not be a member of the euro area in this stage. Upon EU accession, the CNB will become a member of the European System of Central Banks (ESCB). After the Czech Republic adopts the euro, the CNB will become part of the *Eurosystem*, which consists of the ECB and the national central banks of the euro-area Member States.

8. Under the EU legislation, prior to adopting the euro the Czech Republic must therefore be an EU Member State and must have fulfilled the Maastricht convergence criteria (see Box 2), including compatibility between its legal rules and EU law on EMU. The European legislation does not explicitly stipulate a date for adopting the euro or for fulfilling the convergence criteria. Nonetheless, the Czech Republic will have to document periodically the progress of its economy towards fulfilment of the Maastricht criteria in its *Convergence Programme*.

BOX 2
The Convergence Criteria

The *criterion on price stability* requires that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability.

The *criterion on long-term interest rates* requires that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability.

The *criterion on the government budgetary position* means that a Member State has a ratio of planned or actual government deficit to GDP that does not exceed 3%, unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,

- or, alternatively, the excess of the reference value is only exceptional and temporary and the ratio remains close to the reference value.

The *criterion on government debt* means that a Member State has a ratio of government debt to GDP that does not exceed 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The *exchange rate convergence criterion* requires participation for at least two years in the ERM II and observance of the normal fluctuation margins close to central parity provided for by the mechanism for at least two years.

9. The convergence required for entering the euro area is formally assessed according to the procedure laid down in the *EU Treaty*. The final decision is subsequently made by a summit of EU Member States acting on the recommendation of the ECOFIN Council. Those Member States whose economic conditions are assessed as a potential threat to the maintenance of price stability in the euro area will not be able to join the monetary union and will retain the status of Member States with a derogation. These countries will have to wait before they can benefit from euro-area membership and will be at a comparative disadvantage relative to the new euro-area members.

10. The exchange rate convergence criterion requires two-year participation in the ERM II and at the same time movement of the exchange rate close to its central parity. The central parity and fluctuation band within the ERM II will – after being agreed upon between the CNB and the Government – be discussed with the ECB and the Commission and subsequently approved by the ECOFIN Council. In July 2003, the CNB prepared a document entitled *ERM II and the Exchange-rate Convergence Criterion* containing a detailed argumentation of the current position as information for the Czech Government and the public. Given that participation in the ERM II – unlike the irrevocable fixing of the exchange rate within a monetary union – does not

in itself eliminate the risk of currency turbulence, it is regarded merely as the gateway into the euro area. The Government and the CNB agree that staying in the ERM II for longer than the minimum required period of two years does not seem desirable.

Expected Positive Effects

11. The Czech Republic's entry into the euro area will complete the Czech economy's process of integration into European monetary structures. The Czech Republic will be able to participate fully in formulating and implementing the single European monetary and exchange rate policy, which aims to strengthen macroeconomic stability in Europe.

12. Membership of the euro area should have positive impacts on *domestic economic policy*, since the key elements of the system are requirements to achieve balanced public budgets in the medium term and undertake structural reforms supporting long-term sustainable economic growth.

13. Fiscal policy implemented in accordance with the Stability and Growth Pact will reduce the costs of financing public budgets and lead to stabilisation of *long-term interest rates* at a low level. Corporations and households will profit not only from low interest rates, but also from access to the deeper, more liquid and more transparent capital markets of the euro area.

14. The irrevocable fixing of the currency within EMU will increase the stability of the financial sector and reduce the risks of *monetary turbulence*. Sharp fluctuations in the exchange rate present a significant threat to a small open economy in an environment of liberalised capital flows.

15. The domestic enterprise sector in particular will profit from the elimination of *exchange rate risk* vis-à-vis the euro-area countries, which are the Czech Republic's most important trading partners. These benefits will show up as a decline in transaction and hedging costs and a reduction in investment uncertainty. The household sector will profit from greater *price transparency*, which stimulates competition.

16. These positive effects will foster a more stable environment for entrepreneurship, more efficient allocation of resources and subsequently higher economic growth. Euro-area membership may thus further speed up the Czech economy's real convergence towards the EU average.

Potential Risks

17. The Czech Republic's entry into the euro area is associated not only with numerous advantages, but also with some risks, the intensity of which will change over time. These risks are connected primarily with the response of the economy to economic disturbances under the irrevocably fixed exchange rate within the euro area. In the event of insufficient cyclical and structural alignment of the Czech economy and its financial sector with the euro-area economies, economic shocks may have unequal and asymmetric impacts.

18. For the economic policy of the Czech Republic, the loss of independent monetary policy will mean a loss of important instruments that could help to mitigate the negative effects of distinct economic developments at home and abroad and thus facilitate economic convergence. In the run-up to euro-area entry, economic policy will, already in this phase, have to be targeted at achieving rapid economic convergence and at improving the Czech economy's ability to respond, so as to lower the risk of a slowdown in economic growth brought about by asymmetric shocks and their impacts. Although the characteristics of the Czech economy have since the beginning of the transformation converged towards those of the EU Member States, some misalignment of economic cycles and structural discrepancies will remain even after it joins the euro area. Of key importance for ensuring the Czech economy's ability to respond are a stabilising fiscal policy, flexibility on the labour and products markets, and well-functioning financial markets.

19. On the other hand, fulfilment of the conditions and full applicability of the Stability and Growth Pact will require, in addition to a strengthening of the automatic stabilisation effect of fiscal policy, a tightening of fiscal policy in order to ensure the long-term sustainability of balanced public finances. Public finances are a potential barrier to the entry into the euro area not only because of the excessive deficits, but also because of inadequate structural adjustment, especially on the expenditure side. Fiscal policy must not only be ready to fulfil its macroeconomic stabilisation

function, but also be consistent with other structural policies supporting the competitiveness of the Czech economy within the single market.

20. The decision to fix the exchange rate irrevocably and adopt the single monetary policy can only be made when sustainable convergence of the economy and of macroeconomic and microeconomic policies have been achieved (opening of markets, competitiveness within the single market, and increasing economic integration and functioning of institutions on the products, services and capital markets).

Economic alignment

21. The characteristics of the Czech economy have been gradually converging towards those of the EU Member States. Trade with the EU accounts for about two-thirds of the total foreign trade of the Czech economy, and the inflow of foreign direct investment from the EU accounts for as much as four-fifths of all the investment flowing into the Czech economy. Nevertheless, the Czech economic cycle is less aligned with the cycle in the euro area than is that of the average euro-area Member State. In the area of alignment of the real economy and financial sector structures, too, there is room for further improvement.

22. The sufficiency of economic alignment over time and in international comparison can be assessed, for example, by analysing the correlation of the economic cycle with the euro-area countries, by analysing the correlation of demand and supply shocks between the Czech economy and the euro-area economies, or by evaluating structural similarity on the basis of the shares of individual sectors in total value added or on the basis of a set of criteria related to the Czech Republic's international trade and financial sector linkages with the euro-area countries.

Fiscal consolidation

23. The Czech Republic's large public budgets deficits, together with the built-in trends towards a further structural widening of those deficits and inadequate conditions for the symmetrical functioning of automatic stabilisers, represent a serious barrier to effective fiscal stabilisation policy. The aim of fiscal consolidation must be not only to fulfil the Maastricht criteria, but also – in compliance with the Stability and Growth Pact – to achieve in the medium term balanced public budgets facilitating the effective action of automatic stabilisers and flexibility of discretionary expenditure. In the absence of an autonomous monetary policy, fiscal policy will – given the irrevocably fixed exchange rate within the euro area – be the key instrument of macroeconomic stabilisation.

24. An insufficiently consolidated public finance system could have particularly adverse effects during the Czech Republic's participation in the ERM II and in the first few years after it enters the euro area. During this period, the probability of the Czech economic cycle diverging from that elsewhere in the euro area will be higher than in later years. The cyclical misalignment may be reinforced by progress with structural reforms, manifesting themselves as supply shocks with effects on potential output. Moreover, given unified nominal interest rates, the expected positive inflation differential between the Czech Republic and the euro-area average in this period will result in lower real interest rates, which could trigger excessive growth in domestic demand. Therefore, in the years immediately following the Czech Republic's entry into the euro area, prudent fiscal policy will be a key condition for maintaining sustainable economic growth.

25. In response to the long-running unfavourable fiscal situation, the Government has in the course of 2003 prepared and approved a three-year consolidation programme aimed at reducing the public budgets deficit to no more than 4% of GDP by 2006. The consolidation hinges on reductions in public expenditure and a modest rise in the overall tax quota. Together with the proposed series of expenditure and revenue measures, some changes have also been made to the framework within which fiscal processes take place. The principle of medium-term fiscal targeting – implemented by means of binding aggregate three-year expenditure frameworks – has been introduced.

26. The launch of the fiscal balance renewal process will help the Czech economy to move towards a position in which it will be able to aspire to adopt the euro. This is, however, only the first stage and must be followed by another stage of further reductions in public budget deficits resulting from the implementation of more profound structural reforms.

To realise all the benefits of the single currency, eliminate the potential risks and ensure the sound operation of the economy before and after the euro is adopted, it is thus vital to continue with the work already commenced and to steer the fiscal system toward balanced positions.

27. Fulfilling the Maastricht budget criterion alone is not enough. This is clearly documented by the economic difficulties currently being experienced by certain EU Member States who in the past failed to take full advantage of the opportunity to achieve fiscal balance. The need to establish sufficient room for manoeuvre in the fiscal system is underlined by the fact that, as early as in the second half of this decade, the public budgets will start feeling the effects of adverse demographic pressures. Furthermore, radical consolidation is necessary because the budget system will, particularly in the first years after accession, have to find sufficient resources to finance necessary infrastructure investments, which will in turn facilitate the process of real economic convergence.

28. A crucial factor for fiscal policymaking, as well as from the point of view of fulfilling the future EU membership obligations in the area of co-ordination and surveillance procedures, will be the quality of all the national economic statistical data. If these data are not of a high enough standard (with respect to timeliness, reliability, stability and transparency) it will be difficult to correctly understand and evaluate the economic situation and prepare corrective measures. The statistical data are moreover the cornerstone of all the co-ordination and surveillance procedures. Inadequate national economic statistics and government financial statistics are another potential ("technical") barrier to entry into the euro area.

29. The appropriate methods for assessing progress with public finance consolidation include, for example, analysis of the sensitivity of built-in stabilisers by assessing the impacts of GDP fluctuations on the public budgets, analysis of the public budgets' room for manoeuvre for discretionary policy based on the budget structure, or international comparisons of the public budget deficits and the cyclical position of the economy.

The labour market

30. Like the labour market in the EU, the Czech labour market is characterised by relatively low mobility and flexibility of the labour force. Moreover, for several years following accession, restrictions on the free movement of labour from the new member states have to be reckoned with. To strengthen the adjustment mechanisms on the labour market, steps must be taken to increase the flexibility of the labour market and real wages not only in the institutional area, but also in areas such as transport infrastructure and the housing market.

31. The degree of labour market flexibility can be assessed, for example, by evaluating the inter-regional mobility of the population, by analysing the variance in regional unemployment rates, by analysing wage flexibility, by evaluating the share of the long-term unemployed in the total number of people unemployed, or by evaluating the structure of employment.

Euro-area Accession Strategy

32. Under the European legislation, the Czech Republic's entry into the euro area is tied to its accession to the EU. Membership of the euro area will enable the Czech Republic to participate fully in formulating and implementing the single European monetary and exchange rate policy and will lead to a strengthening of the macroeconomic stability of the Czech economy.

33. From the procedural point of view, assuming that the Czech Republic enters the EU in 2004 and fulfils the Maastricht convergence criteria, the first theoretically possible year for joining the euro area is 2007. Given that the ERM II is to be regarded merely as the gateway to joining the euro area, with a maximum participation period of two years, the decision on the timing of the euro's introduction hinges on the outlook for the fulfilment of the other convergence criteria and on the evaluation of the Czech economy's degree of alignment with the euro-area economies. In other words, the Czech Republic should enter the ERM II only after conditions have been established which enable it to introduce the euro at the time of the assessment of the exchange-rate criterion (two years after joining the ERM II) and to then benefit from its introduction without experiencing any problems.

34. The preparedness of the Czech Republic for ERM II participation and euro-area accession will be assessed each year not only with respect to fulfilment of the formal entry criteria, but also by means of detailed economic analyses. Specifically, during the drafting and discussing of the *Convergence Programmes*, the Government will each autumn receive an assessment of the Czech economy's current and expected fulfilment of the Maastricht convergence criteria and an assessment of the degree of the Czech economy's alignment with the euro area. On the basis of this assessment, the CNB and the Ministry of Finance will propose to the Government a decision on whether to initiate the procedure that will take the koruna into the ERM II. Given the intention to participate in the ERM II for the obligatory two years only, the decision to join the ERM II will also imply the date for euro-area entry, i.e. the introduction of the euro in the Czech Republic.

35. This year's assessment was made during the summer months as part of the preparation of the *Pre-accession Economic Programme* for 2003. Under the EU legislation, and given the Czech Republic's position with respect to the ERM II mechanism, the country's potential participation in ERM II as from May 2004, i.e. its expected date of accession to the EU (the earliest possible date), would imply the assessment of the exchange-rate convergence criterion taking place sometime around June 2006. However, the current outlook for the fulfilment of the Maastricht convergence criteria, which takes into account the approved plan to reform public finances, does not indicate that the public budget deficit criterion will be fulfilled by this date. This means that the Czech Republic will not be able to join the euro area at the turn of 2007 and that the Czech koruna will stay outside the ERM II after the Czech Republic's expected accession to the EU in May 2004.

36. The strategic goal of the Government and the CNB is to lay the groundwork for introducing the euro in the Czech Republic. The Government's economic strategy will be to support economic growth, maintain macroeconomic stability, ensure long-term corporate competitiveness and raise employment while reducing the high long-term unemployment rate. In the fiscal area, the Government will, during the current electoral term, prepare the next stage of the fiscal reform in such a way that fulfilment of the Maastricht fiscal criteria is not based on one-off revenues or cuts but is the result of gradual reform steps and far-reaching structural reforms.

37. Until the monetary integration process has been completed, independent Czech monetary policy will continue to be implemented by means of the inflation targeting strategy. Within this system, the inflation targets will be directed at fulfilling the Maastricht convergence criteria on price stability and long-term interest rates.

38. Sufficient alignment of the Czech economy with the euro-area economies in the real and financial spheres, flexible fiscal policy and a well-functioning labour market will be of key importance for the future smooth functioning of the economy within the ERM II and after the subsequent introduction of the euro, when the Czech Republic will give up its autonomous monetary policy. To achieve further progress in these areas, the Czech Republic needs to further deepen the structural reforms directed at increasing the flexibility of the Czech economy and to implement the second stage of the consolidation of its public finance system based on structural reforms of public finances.

39. Provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances, a sufficient level of real convergence is achieved and adequate progress is made with structural reforms guaranteeing sufficient economic alignment with the EU Member States, the Czech Republic can be expected to join the euro area around 2009–2010.

MINUTES OF THE CNB BANK BOARD MEETINGS

MINUTES OF THE BOARD MEETING ON 31 JULY 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 large July situational report, containing the new forecast for inflation and other macroeconomic variables.

Year-on-year inflation in June shifted back to slightly positive values. However, this shift was less significant in comparison to the assumption. One factor behind this development was the exchange rate of the Czech koruna vis-à-vis the dollar, which was also responsible for the continued moderate decline in import prices. A role was also played by the anti-inflationary effect of domestic demand factors, which seemed to be stronger than the assumption in the April forecast.

The forecast still expected year-on-year inflation to accelerate, i.e. relating to how the effects of exogenous factors would shift from a disinflationary to a neutral position. Compared with the last forecast, however, there was a substantial downward reassessment in the expected inflation trajectory. Within the most effective transmission period, the new forecast was headed towards the lower half of the targeted band, despite the planned indirect tax changes, the primary effects of which monetary policy should not react to.

One of the most important factors in the forecast change was the shift of the expected indirect tax corrections associated with EU entry to 2004 and a lower estimate for their primary impact. A shift in restaurant and hotel services from a reduced VAT rate to a base VAT rate was no longer expected. The accepted assumption that the slower dynamics of inflation pressures observed in past months would continue in an environment of a long-term negative output gap also contributed substantially to reducing the inflation forecast. The last factor associated with reducing the inflation forecast was the continuation of weak growth abroad and expectations of lower imported inflation associated with it.

There were less significant changes for the economic growth forecast in comparison with the inflation estimate. Alongside government consumption, household consumption stimulated by the high dynamics of real disposable incomes was still the main growth factor in 2003. The forecast assumed, however, that household consumption growth would gradually ease up. This year, GDP growth would still be restrained by the decline in investments, which was related, among other things, to delays in global economic recovery. On the contrary, net export's contribution to GDP growth would be positive, supported by the easing exchange rate component of monetary conditions. In 2004, the forecast expected another moderate boost in economic dynamics, thanks in particular to a recovery in investment growth. This would involve the effects of easing both components of monetary conditions and the start of economic recovery abroad. In all, though, the forecast implied the absence of more significant demand pressures on inflation up to the end of 2004.

A decline in interest rates during the second half of 2003 and the stability of these rates throughout the following year was consistent overall with this forecast and its assumptions.

Following the presentation of the situational report, the Board discussed the new forecast and the uncertainties associated with it. There was consensus among board members that the downward reassessment of the inflation forecast was more substantial than the figures alone for the last quarter actually suggested, due to the reassessed view for some features of the macroeconomic transmission mechanism. There were concerns in this respect whether or not the corrections in the forecast had been overshot. On the contrary, however, it was stated that this move involved a reasonable reassessment of the forecast, taking into account, among other things, the observed deviations in inflation since the previous assumptions.

Besides the uncertainties concerning the effect of the output gap on inflation, questions also remained about the effect of current monetary conditions on the economy. Inflation expectations, and in this respect even real interest rates, were not easy to assess. The baseline scenario for inflation worked with backward-looking expectations, which would mean relatively tight real rates in view of the actual low inflation. However, it was suggested by some board members that no support for this theory could be found in the available data. According to sample surveys, inflation expectations were at a higher level than the forecast assumed. Household lending and consumption continued to increase rapidly, and there were no signals, even from the corporate sector, that real interest rate settings were perceived as restrictive. From this standpoint, actual interest rate conditions could already be sufficiently eased.

There was also uncertainty over how the strong appreciation of the koruna last year influenced the economy and how favourable the effects of the current easing of exchange rate conditions would be. One view expressed that the stimulating impact of the exchange rate would be relatively strong. On the other hand, it was stated that the exchange rate in and of itself could not significantly accelerate economic growth without a recovery in foreign demand, which had experienced continual delays.

As in previous months, uncertainty continued over the timing of indirect tax changes and implementation of public finance reforms. A view expressed that this uncertainty should be accounted for during decision-making on interest rate settings. Nevertheless, some board members assumed that even exploring the possible alternatives for fiscal development would not change the overall picture, i.e. the absence of demand pressures on inflation during the period of monetary transmission.

Some of the members stressed that the inflation forecast was headed towards the lower half of the target, and after the temporary effect of tax corrections died out, it would return to the lower boundary. Without starting up economic recovery, there was a real threat that inflation would again fall below the targeted band in 2005, while on the other hand, the risk of overshooting the target was very low. In contrast, it was said that demand pressures would undoubtedly increase, however, it was not known how fast and how intense this increase would be. The aim of monetary policy should not be to fully offset the impact of current exogenous shocks, because it could produce unwanted secondary effects. It was mentioned that the demotivating effect of the currently low interest rates on the creation of savings and deposits should also be taken into account.

At the close of the meeting, the Board decided to lower the CNB two-week repo rate by 0.25 percentage points to 2.00%, effective 1 August 2003. The Board also decreased the discount rate and Lombard rate by the same amount to 1.00% and 3.00%, respectively. Five members voted in favour of this decision, and two members voted for leaving rates unchanged.

MINUTES OF THE BOARD MEETING ON 28 AUGUST 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 Štěpánek (Chief Executive Director)

The Board opened the meeting with a presentation of the small August situational report, assessing the consistency of the newly available information with the July forecast assumptions.

Inflation in July 2003 corresponded in principle with the forecast, which anticipated year-on-year price stability. In particular, the absence of the usual rise in regulated rent contributed to another reduction in year-on-year inflation. Contrary to expectations, there was a more substantial seasonal decline in food prices in July. On the other hand, recreation prices registered higher-than-expected growth.

Year-on-year M2 dynamics in July 2003 accelerated at a relatively rapid pace. However, the main reason behind this development was the low initial base last year. Credit growth continued to accelerate, especially in the household sector. Following the last cut in monetary policy rates, interest rates for the money market had slightly declined. The actual shape of the yield curve indicated expectations of stable rates on the market. Annual real interest rates, calculated using measured inflation expectations, were flat on the whole.

External cost factors deviated in an upward direction from the forecast. Global prices of oil and certain other raw materials were higher. In comparison with the forecast assumptions, the exchange rate of the Czech koruna was also weaker vis-à-vis the euro and the dollar. Import prices, therefore, declined only slightly in June 2003 and were now above the level of the forecast. However, this had not yet affected industrial producer prices, whose year-on-year decline corresponded for the most part with the forecast. Agricultural producer prices experienced a faster-than-expected turn towards year-on-year growth.

The data from the real economy indicated that a relatively satisfactory level of economic growth had been reached even in an environment of weak foreign demand. Retail sales rose significantly, which implied possibly higher growth for household consumption and GDP in Q2 2003 than the forecast predicted. Favourable development continued in June 2003 for industry as well. The foreign trade figures for July pointed to accelerating import and export dynamics. The substantial reduction in the balance of services surplus in Q2 would, on the other hand, have an adverse effect on GDP growth. In line with the assumptions, the seasonally adjusted unemployment rate was more or less flat. The forecast also corresponded to wage developments.

Following the presentation of the situational report, the Board turned to a discussion of the risks related to the current forecast. As in the last meeting, some board members once again expressed concerns that the existing forecast could overestimate the effect of certain anti-inflationary factors. In addition, some short-term cost risks were now starting to show up on the inflationary side. These factors included in particular oil prices, agricultural producer prices and the exchange rate.

There was overall consensus among board members that weakening of the exchange rate was one of the most significant real deviations from the forecast assumptions. This weakening could be linked to a decline in FDI inflow and a rise in repatriated profit, a low interest rate differential, a more realistic financial market outlook for the euro accession date in countries of the region, and uncertainty associated with implementing fiscal reforms. The board members, however, put various degrees of emphasis on these factors. One view expressed that, if the exchange rate were maintained at a weaker level for a longer period of time, this could have a favourable effect on the economy, and in turn, a stronger impact on inflation. On the contrary, however, it was stated that without more discernible recovery in the EU, the exchange rate alone could not play a large role in reviving Czech foreign trade.

According to some board members, a significant source of uncertainty was the timing and the form that the public finance reform would actually take. There was a substantial risk that the reform would be loosened during legislative proceedings and that its structure would also adversely change in favour of measures on the income side of public finances. This risk could already show up during preparations for and approval of the 2004 state budget proposal. Delaying reform measures on the expenditure side would inevitably mean implementing stricter measures in the future, accompanied by unfavourable effects on economic performance and stability. There was also more of a danger that excessive wage growth would continue in the public sector, and this, in turn, could have negative effects on wage development in the corporate sector.

A considerable amount of attention was devoted to household lending growth. A concern was expressed whether the low interest rates might not create a bubble in this area. If the ability of households to pay off their loans worsened, this could then have a negative impact on macroeconomic and financial stability in the future. The Board would consider this matter further.

The Board also discussed economic developments abroad. The Q2 2003 economic growth figures for the EU were disappointing. However, optimism concerning future development of the global economy was on the upswing. For the time being, this mainly concerned the United States and Japan. Nevertheless, it was expressed that any recovery in these countries would sooner or later find its way over to Europe.

There was overall agreement among board members that the forecast risks were directed upwards, though only slightly. The low-inflationary assessment of the current economic situation would not change substantially, and there was no danger of not reaching the inflation target in the medium run. If the existing risks were to materialise, this could merely accelerate the expected turn in year-on-year inflation developments towards the CNB's targeted band.

At the close of the meeting, the Board decided unanimously to leave the CNB two-week repo rate unchanged at 2%.

MINUTES OF THE BOARD MEETING ON 25 SEPTEMBER 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 September situational report, assessing the new information and risks associated with the July forecast. It was stated during the presentation that the latest figures on inflation were slightly lower than the forecast predicted. The prices of food had a substantial impact on the situation. Only import prices deviated upwards from the forecast. This, however, was probably only a temporary swing, and import prices should have more of a disinflationary effect during the period of monetary transmission. The components of inflation stabilised during the past three months. The GDP growth data corresponded to the July forecast, though the figures for the specific components showed some deviations from the forecast. For example, household consumption was more dynamic than predicted, while net export was less dynamic in comparison with the forecast. The new balance of payments data were in line with the higher dynamics of household demand and the weak dynamics of demand in Germany. The Czech economy was now going through a phase of stable inflation and growth pulled by domestic demand.

Following the presentation, the Board turned to a discussion on the actual distribution of risks in relation to the July forecast. It was said repeatedly that the risks were distributed evenly in September on both sides of the forecast and that they were weaker than in August. It was mentioned that low inflation formed downward inflation expectations and that this change in expectations contributed to stabilising inflation at a lower level. One view also expressed that the extensive structural changes in the economy would increase the effectiveness of production and competitiveness in services, and in turn, to reducing any potential cost inflation pressures. It was also stated that the character of unemployment could contribute to easing inflation pressures.

The Board focused on the issue of external disequilibrium. Members agreed that the external imbalance could be caused by structural factors as well as the dynamics of domestic demand and that it was important to carry out a more detailed empirical analysis of the situation. The Board would take up this matter again in October when a more detailed analysis was available. A view was also expressed that the problem of the external imbalance – if pulled by domestic demand – should be accounted for when setting fiscal policy, because monetary policy was very limited in its means to react to this disequilibrium.

The Board analysed the possible effects that the fiscal reform underway at this time could have on monetary policy. It was stated that expectations of certain reform steps could affect the decision-making of households, which could, for example, speed up the purchase of goods before potential tax adjustments were made or set up building savings prior to the considered change in conditions. It was mentioned that the currently more lenient position toward the original aims of the reform was a medium-term inflation risk. It was repeated several times that attention should be paid in particular to the content of the reform and whether or not it supported medium-term sustainable development for public finances. The suggested reduction in the deficit alone within a period of three years was nowhere near sufficient enough to ensure sustainable macroeconomic development.

The Board then discussed the results of the analysis devoted to household credits. It was said that banks paid a sufficient amount of attention to emerging risks. It was also mentioned that the dynamics of rising household credits could be a factor that would start to affect the economic cycle from a macroeconomic standpoint, because private consumption was a substantial source of growth. It was also said that the dynamics of household credits changed the structure of financial assets and liabilities, and this could make the economy react more to interest rate changes.

At the close of the meeting, the Board decided unanimously to leave the CNB two-week repo rate unchanged at 2%.

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	-0.1	-0.1	0.0			
Regulated prices	-0.3	-0.8	-0.8	1.4	1.5	1.5	0.4	0.4	0.4			
(contribution to consumer price inflation)	*-0.07*	*-0.15*	*-0.16*	*0.29*	*0.31*	*0.32*	*0.08*	*0.09*	*0.08*			
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*			
Net inflation	-0.4	-0.2	-0.2	-0.5	-0.4	0.0	-0.2	-0.1	0.0			
(contribution to consumer price inflation)	*-0.32*	*-0.17*	*-0.15*	*-0.38*	*-0.30*	*-0.01*	*-0.19*	*-0.10*	*-0.01*			
of which: prices of food. beverages and tobacco	-4.1	-3.8	-3.5	-3.5	-2.8	-1.0	-0.9	-0.9	-0.1			
(contribution to consumer price inflation)	*-1.06*	*-1.06*	*-0.97*	*-0.94*	*-0.76*	*-0.28*	*-0.22*	*-0.22*	*-0.04*			
adjusted inflation	1.5	1.7	1.5	1.1	0.9	0.5	0.1	0.2	0.0			
(contribution to consumer price inflation)	*0.74*	*0.89*	*0.82*	*0.56*	*0.46*	*0.27*	*0.04*	*0.12*	*0.02*			
Inflation rate (annual moving average)	1.5	1.1	0.8	0.5	0.3	0.2	0.2	0.1	0.0			

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	0.1	-0.2	-0.5			
Regulated prices	0.1	0.3	0.2	1.1	-0.1	0.0	0.0	0.0	0.1			
(contribution to consumer price inflation)	*0.03*	*0.06*	*0.03*	*0.23*	*-0.01*	*0.01*	*0.00*	*0.00*	*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*	*0.00*	*0.00*	*0.00*			
Net inflation	0.7	0.2	-0.2	0.0	0.0	0.1	0.0	-0.1	-0.6			
(contribution to consumer price inflation)	*0.55*	*0.14*	*-0.13*	*-0.03*	*-0.04*	*0.05*	*0.03*	*-0.11*	*-0.49*			
of which: prices of food. beverages and tobacco	0.8	-0.2	-0.2	0.1	0.4	0.6	-1.7	-1.0	0.6			
(contribution to consumer price inflation)	*0.22*	*-0.05*	*-0.05*	*0.04*	*0.10*	*0.16*	*-0.44*	*-0.25*	*0.16*			
adjusted inflation	0.6	0.3	-0.1	-0.1	-0.3	-0.2	0.9	0.3	-1.2			
(contribution to consumer price inflation)	*0.33*	*0.18*	*-0.07*	*-0.06*	*-0.14*	*-0.11*	*0.47*	*0.15*	*-0.65*			

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	10.0	9.8	9.3				9.8
Food and non-alcoholic beverages	197.6	3.1	2.8	2.5	2.7	3.2	4.2	1.7	0.3	1.1				2.4
Alcoholic beverages and tobacco	79.2	7.6	7.7	7.7	7.7	7.9	7.6	7.7	7.7	7.9				7.7
Clothing and footwear	56.9	-9.1	-10.0	-10.4	-10.1	-10.1	-10.4	-11.5	-12.6	-12.4				-10.7
Housing, water, electricity, gas and other fuels	236.4	24.9	25.3	25.4	26.5	26.6	26.6	26.9	27.0	27.0				26.2
Furnishings, household equipment and routine maintenance of the house	67.9	-1.1	-1.2	-1.4	-1.6	-1.8	-2.1	-2.3	-2.6	-2.7				-1.9
Health	14.3	13.7	14.2	14.8	15.4	16.3	16.4	17.4	17.5	17.5				15.9
Transport	101.4	4.7	5.2	5.8	5.5	4.5	3.8	3.5	3.8	4.3				4.6
Communications	22.5	7.9	8.9	8.8	9.0	7.5	7.4	7.4	7.4	7.3				8.0
Recreation and culture	95.5	8.5	9.6	8.5	7.7	7.1	7.0	12.5	14.3	6.1				9.0
Education	4.5	11.3	11.4	11.5	11.5	11.5	11.6	11.6	11.6	11.0				11.4
Hotels, cafés and restaurants	74.2	9.2	9.4	9.4	9.5	9.6	9.6	9.9	10.0	10.3				9.7
Miscellaneous goods and services	49.5	14.0	14.6	14.7	14.7	14.6	14.6	14.5	14.7	14.9				14.6

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	9	12	3	6	9
1. Food and non-alcoholic beverages	197.6	4.6	7.9	1.5	2.1	2.5	4.2	1.1
- tradables	197.6	4.6	7.9	1.5	2.1	2.5	4.2	1.1
2. Alcoholic beverages and tobacco	79.2	2.4	5.4	7.4	7.1	7.7	7.6	7.9
- tradables	79.2	2.4	5.4	7.4	7.1	7.7	7.6	7.9
3. Clothing and footwear	56.9	-2.7	-3.9	-7.4	-7.7	-10.4	-10.4	-12.4
- nontradables	1.4	6.1	13.0	17.6	18.3	19.2	20.0	20.9
- tradables	55.5	-2.9	-4.3	-8.0	-8.4	-11.2	-11.2	-13.2
4. Housing, water, electricity, gas and other fuels	236.4	7.8	19.0	25.0	24.3	25.4	26.6	27.0
- nontradables	226.1	8.1	19.7	26.0	25.2	26.3	27.6	28.0
- tradables	10.3	2.3	2.7	4.0	4.0	5.3	4.0	4.5
5. Furnishings, household equipment and routine maintenance of the house	67.9	-0.7	-0.4	-0.7	-1.0	-1.4	-2.1	-2.7
- nontradables	2.9	4.3	7.5	9.8	9.9	10.8	11.2	11.8
- tradables	65.0	-0.9	-0.8	-1.2	-1.5	-1.9	-2.7	-3.4
6. Health	14.3	4.1	8.4	13.3	12.8	14.8	16.4	17.5
- nontradables	11.0	4.9	10.1	16.0	15.4	17.9	19.9	21.2
- tradables	3.3	1.5	2.7	4.6	4.4	4.9	5.1	5.4
7. Transport	101.4	6.9	3.4	5.1	4.1	5.8	3.8	4.3
- nontradables	27.4	6.2	11.7	16.0	16.0	17.2	17.6	18.1
- tradables	74.0	7.2	0.3	1.1	-0.3	1.6	-1.3	-0.8
8. Communications	22.5	1.5	5.7	11.6	8.2	8.8	7.4	7.3
- nontradables	21.0	2.7	8.5	15.6	12.4	13.2	12.0	12.0
- tradables	1.5	-16.4	-34.7	-45.6	-52.1	-54.6	-58.3	-59.8
9. Recreation and culture	95.5	2.0	7.2	7.3	7.2	8.5	7.0	6.1
- nontradables	60.4	4.4	14.3	16.5	16.2	18.8	17.7	16.6
- tradables	35.1	-2.2	-5.0	-8.6	-8.3	-9.2	-11.4	-12.1
10. Education	4.5	3.4	6.8	10.7	11.3	11.5	11.6	11.0
- nontradables	4.5	3.4	6.8	10.7	11.3	11.5	11.6	11.0
11. Hotels, cafés and restaurants	74.2	2.6	5.9	8.5	8.7	9.4	9.6	10.3
- nontradables	74.2	2.6	5.9	8.5	8.7	9.4	9.6	10.3
12. Miscellaneous goods and services	49.5	3.1	8.7	11.7	11.9	14.7	14.6	14.9
- nontradables	22.0	5.7	17.5	25.2	25.8	32.9	33.9	34.8
- tradables	27.5	1.1	1.7	0.9	0.8	0.2	-0.8	-1.0
Household consumer prices, total	1000.0	4.1	8.4	9.2	9.0	9.7	9.9	9.3
Tradables	549.1	2.5	2.9	0.3	0.2	0.3	0.2	-1.2
- food	276.8	4.0	7.2	3.2	3.5	4.0	5.2	3.0
- others	272.3	1.0	-1.5	-2.7	-3.2	-3.5	-4.9	-5.5
Nontradables	450.9	6.0	15.2	20.2	19.7	21.2	21.8	22.1
- others	271.2	4.7	11.5	16.1	16.4	18.5	18.6	19.0
- regulated	179.7	8.0	20.6	26.3	24.6	25.3	26.7	26.8

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	2.3
1/03	2.5		
2/03	2.4		
3/03	2.5	2.1	4.3
4/03	2.6		
5/03	3.7		
6/03	3.2	2.6	1.7
7/03	3.3		
8/03	3.2		
9/03	3.1	2.6	3.1

Source: CNB statistical survey

HARMONISED INDEX OF CONSUMER PRICES

annual percentage changes

	1999	2000	2001	2002	2003
	12	12	12	12	9
Belgium	2.1	3.0	2.0	1.3	1.7
Denmark	3.1	2.3	2.1	2.6	1.7
Finland	2.2	2.9	2.3	1.7	1.2
France	1.4	1.7	1.4	2.2	2.3
Ireland	3.9	4.6	4.4	4.6	3.8
Italy	2.1	2.8	2.2	3.0	3.0
Luxembourg	2.3	4.3	0.9	2.8	2.7
Germany	1.4	2.1	1.4	1.1	1.1
Netherlands	1.9	2.9	5.1	3.5	
Portugal	1.7	3.8	3.9	4.0	3.2
Austria	1.7	1.8	1.8	1.7	1.3
Greece	2.3	3.7	3.5	3.5	
Spain	2.8	4.0	2.5	4.0	3.0
Sweden	1.2	1.3	3.2	1.7	2.3
United Kingdom	1.2	0.9	1.0	1.7	1.4
European Union	1.7	2.2	1.9	2.2	1.9
Czech Republic	2.5	4.0	3.9	0.1	0.0

Source: Eurostat

MONETARY SURVEY

position at month-end in CZK billions

		1999	2000	2001	2002	2003
		12	12	12	12	8
Total assets		1337.5	1412.3	1596.0	1647.3	1705.2
Net foreign assets		570.4	673.1	800.6	912.9	882.3
- assets		940.2	998.8	1088.4	1187.7	1083.9
- liabilities		369.8	325.7	287.8	274.8	201.6
Net domestic assets		767.1	739.2	795.4	734.4	822.9
Domestic credits		1058.5	1068.8	1011.9	911.1	1004.7
Net credit to the government sector		57.5	104.9	236.5	189.9	251.5
- net credit to government		67.7	103.8	246.2	207.4	269.0
- net credit to NPF		-10.2	1.1	-9.7	-17.5	-17.5
Client credits of commercial banks and CNB		1001.0	963.9	775.4	721.2	753.2
CZK credits		824.6	819.7	661.2	620.0	659.2
- businesses		715.7	699.1	524.2	442.5	449.6
- households		108.9	120.6	137.0	177.5	209.6
Foreign currency credits		176.4	144.2	114.2	101.2	94.0
- businesses		173.0	141.9	111.9	99.9	93.1
- households		3.4	2.3	2.3	1.3	0.9
Other net items		-291.4	-329.6	-216.5	-176.7	-181.8
Liabilities						
M2	2)	1337.5	1412.3	1596.0	1647.3	1705.2
M1	1)	447.8	497.7	583.6	692.3	744.8
Currency in circulation		157.9	171.8	180.4	197.8	218.2
CZK demand deposits		289.9	325.9	403.2	494.5	526.6
- households		162.6	195.0	230.2	270.9	327.6
- businesses		124.4	128.0	169.2	221.1	196.0
- insurance companies		2.9	2.9	3.8	2.5	3.0
Quasi money		889.7	914.6	1012.4	955.0	960.4
CZK time deposits		653.1	645.0	742.2	729.6	714.6
- households		537.6	549.8	596.6	568.0	551.4
- businesses		78.9	78.9	120.8	125.7	138.6
- insurance companies		36.6	16.3	24.8	35.9	24.6
Deposit bills of exchange and other bonds	5)	91.3	114.0	112.8	79.6	87.4
Foreign currency deposits		145.3	155.6	157.4	145.8	158.4
- households		80.8	83.7	91.5	79.4	78.2
- businesses		64.5	71.9	65.9	66.4	80.2
Monetary aggregate L	3)	1386.3	1463.5	1643.9	1696.0	1726.8
Annual percentage changes						
M1		10.8	11.1	17.3	18.6	16.4
M2		7.7	5.6	13.0	3.2	5.1
L		7.8	5.6	12.3	3.2	2.6
Client credits of commercial banks and CNB		-4.4	-3.7	-19.6	-7.0	6.7
Client deposits with banks	4)	0.1	3.5	15.7	5.2	3.8

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	8
Non-adjusted credits					
Total credits, CZK and foreign currency					
absolute volumes in CZK billions	1001.0	963.9	775.4	721.2	753.2
annual percentage changes	-4.4	-3.7	-19.6	-7.0	6.7
CZK credits					
absolute volumes in CZK billions	824.6	819.7	661.2	620.0	659.2
annual percentage changes	-2.6	-0.6	-19.3	-6.2	7.7
Foreign currency credits					
absolute volumes in CZK billions	176.4	144.2	114.2	101.2	94.0
annual percentage changes	-11.7	-18.3	-20.8	-11.4	0.0
Adjusted credits 1)					
Total credits, CZK and foreign currency					
absolute volumes in CZK billions	954.7	913.6	932.8	974.9	1019.6
annual percentage changes	-4.7	-4.3	2.1	4.5	7.1
CZK credits					
absolute volumes in CZK billions	782.6	771.8	811.5	861.2	916.1
annual percentage changes	-1.3	-1.4	5.1	6.1	8.5
Foreign currency credits					
absolute volumes in CZK billions	172.1	141.8	121.3	113.7	103.5
annual percentage changes	-17.6	-17.6	-14.5	-6.3	-3.8

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	8
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	31.5
Long-term	36.8	41.2	36.5	34.8	37.5
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	72.1
Households	11.2	12.8	18.0	24.8	27.9
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	40.0
Investment (incl. general housing construction)	31.1	30.8	35.2	29.5	26.7
Mortgage	2.8	4.1	6.7	9.6	12.1
Consumer	2.9	3.3	3.6	7.3	7.5
For privatisation	2.3	2.0	0.4	0.2	0.1
For temporary fund shortage	7.4	9.1	9.8	5.5	1.2
For securities purchase	1.5	1.4	1.7	0.4	0.4
Building savings loans				6.4	7.4
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	9
1. AVERAGE PRIBOR 1)					
- 1 day	5.21	5.23	4.63	2.75	2.00
- 7 day	5.32	5.29	4.79	2.76	2.02
- 14 day	5.40	5.29	4.78	2.76	2.03
- 1 month	5.59	5.32	4.77	2.73	2.04
- 2 month	5.58	5.36	4.72	2.67	2.05
- 3 month	5.58	5.42	4.69	2.63	2.06
- 6 month	5.64	5.60	4.62	2.60	2.11
- 9 month	5.72	5.78	4.61	2.60	2.14
- 12 month	5.84	5.90	4.62	2.60	2.17
2. AVERAGE PRIBID 1)					
- 1 day	5.05	5.11	4.53	2.65	1.90
- 7 day	5.16	5.18	4.69	2.67	1.92
- 14 day	5.23	5.19	4.69	2.67	1.93
- 1 month	5.42	5.22	4.68	2.64	1.94
- 2 month	5.40	5.26	4.62	2.57	1.95
- 3 month	5.41	5.31	4.59	2.54	1.96
- 6 month	5.46	5.49	4.52	2.51	2.01
- 9 month	5.54	5.67	4.52	2.51	2.04
- 12 month	5.67	5.79	4.52	2.51	2.07

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	9
3 * 6	5.57	5.68	4.49	2.52	2.10
3 * 9	5.70	5.85	4.53	2.54	2.14
6 * 9	5.75	5.93	4.53	2.52	2.15
6 * 12	5.94	6.10	4.52	2.58	2.21
9 * 12	6.04	6.19	4.54	2.61	2.29
12 * 24	.	.	.		
9*12 - 3*6 spread	0.47	0.51	0.05	0.10	0.19
6*12 - 3*9 spread	0.24	0.25	-0.02	0.04	0.07

IRS RATES

percentages; monthly averages

	1999	2000	2001	2002	2003
	12	12	12	12	9
1Y	5.92	5.94	4.64	2.63	2.24
2Y	6.54	6.40	4.72	2.85	2.66
3Y	6.95	6.72	4.89	3.18	3.05
4Y	7.16	6.96	5.05	3.46	3.34
5Y	7.26	7.15	5.19	3.70	3.58
6Y	7.29	7.29	5.32	3.91	3.77
7Y	7.28	7.38	5.43	4.08	3.94
8Y	7.27	7.42	5.52	4.23	4.09
9Y	7.27	7.43	5.60	4.36	4.21
10Y	7.27	7.43	5.66	4.47	4.32
15Y	.	.	5.85	4.77	4.66
5Y - 1Y spread	1.34	1.21	0.56	1.07	1.34
10Y - 1Y spread	1.35	1.49	1.02	1.84	2.08

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	3.8	1.9	2.2	2.0	3.5	1.6	3.4	3.2	4.8
7/03	2.3	2.2	3.5	1.7	2.4	2.3	3.6	1.8	2.9	2.9	4.2
8/03	2.0	2.1	3.3	1.8	2.1	2.2	3.4	1.9	2.4	2.5	3.7
9/03	2.0	2.2			2.0	2.2			2.0	2.2	

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	0.5	0.3	1.9	-0.1
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	-1.7	-1.9	-0.4	-2.2
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	0.6	-1.2	-0.1	-0.3	1.2	-0.6	0.8	0.6	2.1	0.2
7/03	-1.0	-1.0	0.2	-1.5								
8/03	-1.1	-1.1	0.1	-1.4								
9/03	-1.0	-0.9			-0.6	-0.4			-1.0	-0.9		

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	8
Newly drawn credits					
in CZK	6.7	6.8	5.9	4.2	3.3
- short-term	6.7	6.5	5.6	3.8	3.0
- medium-term	5.1	8.0	7.5	5.4	3.5
- long-term	10.2	8.1	7.1	5.8	5.6
Credits					
in CZK	7.7	6.9	7.0	5.8	5.0
- short-term	7.4	6.6	6.2	4.7	4.0
- medium-term	8.3	7.8	7.7	6.3	5.1
- long-term	7.6	6.8	7.4	6.2	5.6
Deposits					
in CZK	3.7	3.0	2.6	1.8	1.3
- demand	1.6	1.5	1.4	1.1	0.7
- time	4.7	3.9	3.3	2.2	1.8
- short-term	4.8	4.0	3.4	2.0	1.3
- medium-term	5.6	3.9	3.1	2.1	1.3
- long-term	3.6	3.5	3.2	3.1	3.0

BALANCE OF PAYMENTS 1)

in CZK millions

	1999	2000	2001	2002	2003 2)
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q2
A. Current account	**-50 596.4**	**-104 877.1**	**-124 478.3**	**-144 543.6**	**-44 404.7**
Balance of trade 3)	-65 830.8	-120 825.0	-116 685.0	-71 323.0	-13 383.0
exports	908 756.0	1 121 099.0	1 269 634.0	1 254 394.0	340 381.0
imports	974 586.8	1 241 924.0	1 386 319.0	1 325 717.0	353 764.0
Services	41 501.3	54 559.8	57 984.9	21 850.8	3 741.7
credit	243 851.0	264 806.2	269 689.6	231 131.1	53 903.2
transport	53 520.3	53 734.3	57 492.3	56 560.5	15 432.9
travel	109 142.0	115 071.0	118 133.0	96 289.2	23 471.0
others	81 188.7	96 000.9	94 064.3	78 281.4	14 999.3
debit	202 349.7	210 246.4	211 704.7	209 280.3	50 161.5
transport	27 071.4	27 543.0	30 570.5	29 332.8	8 623.9
travel	51 760.0	49 370.0	52 802.0	51 549.3	12 768.2
others	123 518.3	133 333.4	128 332.2	128 398.2	28 769.4
Income	-46 673.6	-52 978.4	-83 548.9	-123 780.5	-30 839.8
credit	64 298.3	75 439.1	84 892.3	71 445.6	22 762.3
debit	110 971.9	128 417.5	168 441.2	195 226.1	53 602.1
Current transfers	20 406.7	14 366.5	17 770.7	28 709.1	-3 923.6
credit	45 394.4	36 594.6	36 404.9	46 709.0	11 215.4
debit	24 987.7	22 228.1	18 634.2	17 999.9	15 139.0
B. Capital account	**-73.2**	**-198.2**	**-330.7**	**-119.4**	**-36.3**
credit	637.3	223.4	90.4	221.0	41.8
debit	710.5	421.6	421.1	340.4	78.1
Total A + B	*-50 669.6*	*-105 075.3*	*-124 809.0*	*-144 663.0*	*-44 441.0*
C. Financial account	**106 564.4**	**148 046.6**	**172 849.9**	**366 582.6**	**25 949.2**
Direct investment	215 703.9	190 767.4	208 296.1	295 584.5	34 132.4
abroad	-3 107.6	-1 653.7	-6 289.2	-9 034.8	-1 222.4
equity capital and reinvested earnings	-2 585.3	-1 245.9	-5 848.5	-8 611.4	-1 018.7
other capital	-522.3	-407.8	-440.7	-423.4	-203.7
in the Czech Republic	218 811.5	192 421.1	214 585.3	304 619.3	35 354.8
equity capital and reinvested earnings	192 615.5	171 777.2	185 981.4	302 437.1	39 298.0
other capital	26 196.0	20 643.9	28 603.9	2 182.2	-3 943.2
Portfolio investment	-48 268.9	-68 172.9	34 857.3	-46 748.7	-8 249.2
assets	-65 608.0	-86 631.8	4 405.6	-75 602.1	-14 535.9
equity securities	-48 965.2	-44 181.0	9 447.8	-7 807.9	-4 301.7
debt securities	-16 642.8	-42 450.8	-5 042.2	-67 794.2	-10 234.2
liabilities	17 339.1	18 458.9	30 451.7	28 853.4	6 286.7
equity securities	4 394.2	23 810.9	23 203.6	-9 035.7	-3 020.6
debt securities	12 944.9	-5 352.0	7 248.1	37 889.1	9 307.3
Financial derivatives	0.0	-1 402.8	-3 220.3	-4 281.7	3 518.8
assets		-4 501.6	-9 407.6	-15 458.4	623.8
liabilities		3 098.8	6 187.3	11 176.7	2 895.0
Other investment	-60 870.6	26 854.9	-67 083.2	122 028.5	-3 452.8
assets	-91 273.9	35 832.1	-46 144.5	133 121.8	5 220.2
long-term	-23 884.0	21 322.2	1 325.8	28 711.4	155.3
CNB					
commercial banks	-25 858.5	14 362.2	-4 125.8	5 271.7	-791.3
government	977.5	2 937.0	6 928.9	25 333.6	2 064.6
other sectors	997.0	4 023.0	-1 477.3	-1 893.9	-1 118.0
short-term	-67 389.9	14 509.9	-47 470.3	104 410.4	5 064.9
commercial banks	-63 804.7	22 001.9	-45 523.2	122 163.8	-1 924.1
government			-87.1	-2 237.4	2.0
other sectors	-3 585.2	-7 492.0	-1 860.0	-15 516.0	6 987.0
liabilities	30 403.3	-8 977.2	-20 938.7	-11 093.3	-8 673.0
long-term	-1 286.1	-26 212.5	-4 262.6	-869.7	-11 415.8
CNB	-2 083.5	-22.8	-22.0	-20.2	
commercial banks	-7 109.5	-31 523.7	-7 222.2	-8 059.2	-5 900.6
government	-6 384.3	-1 837.6	-5 000.8	-1 517.2	2 219.9
other sectors	14 291.2	7 171.6	7 982.4	8 726.9	-7 735.1
short-term	31 689.4	17 235.3	-16 676.1	-10 223.6	2 742.8
CNB	84.9	-17.0	59.7	-24.3	44.1
commercial banks	36 615.6	-3 812.5	-35 688.6	-3 871.2	-2 854.3
government	-103.2				
other sectors	-4 907.9	21 064.8	18 952.8	-6 328.1	5 553.0
Total A + B + C	*55 894.8*	*42 971.3*	*48 040.9*	*221 919.6*	*-18 491.8*
D. Net errors and omissions, valuation changes	**1 241.9**	**-11 378.5**	**19 112.1**	**-4 974.6**	**15 943.2**
Total A + B + C + D	*57 136.7*	*31 592.8*	*67 153.0*	*216 945.0*	*-2 548.6*
E. Change in reserves (- increase)	**-57 136.7**	**-31 592.8**	**-67 153.0**	**-216 945.0**	**2 548.6**

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 Jun. 1)
ASSETS	1 347 954.9	1 448 400.7	1 544 963.0	1 582 810.8	1 551 119.0
Direct investment abroad	25 114.9	27 899.3	41 176.1	47 285.0	47 820.0
- equity capital	22 415.9	24 797.5	37 633.6	43 490.0	44 100.0
- other capital	2 699.0	3 101.8	3 542.5	3 795.0	3 720.0
Portfolio investment	104 345.3	180 431.3	185 138.6	274 344.7	341 605.2
- equity securities	66 318.2	92 222.9	68 675.5	86 464.7	83 147.3
- debt securities	38 027.1	88 208.4	116 463.1	187 880.0	258 457.9
Financial derivatives 2)		6 347.2	15 754.8	31 213.2	30 861.4
Other investment	757 065.5	736 903.7	778 435.7	515 356.2	426 925.8
Long-term	323 131.1	315 625.5	310 133.9	179 639.6	152 374.2
- CNB 3)		329.1	307.3	280.9	477.6
- commercial banks	89 900.1	75 537.9	79 663.7	67 966.9	52 783.5
- government 4)	210 221.3	220 777.8	210 694.9	97 156.8	85 563.1
- other sectors	23 009.7	18 980.7	19 468.0	14 235.0	13 550.0
Short-term	433 934.4	421 278.2	468 301.8	335 716.6	274 551.6
- CNB 5)		52.9	51.2	376.7	184.6
- commercial banks	336 117.2	314 115.3	359 638.5	213 815.4	171 660.7
of which: gold and foreign exchange 6) 7)	218 995.8	228 961.7	257 138.5	163 032.9	100 030.9
- government			87.1	2 324.5	166.3
- other sectors	97 817.2	107 110.0	108 525.0	119 200.0	102 540.0
CNB reserves 8)	461 429.2	496 819.2	524 457.8	714 611.7	703 906.6
- gold 6)	677.0	4 640.4	4 469.9	4 653.8	4 205.9
- SDR		7.7	31.0	137.1	156.0
- reserve position in the IMF		116.0	5 478.3	7 081.5	9 968.1
- foreign exchange	460 752.2	491 001.2	514 188.0	686 516.1	674 167.8
- other reserve assets		1 053.9	290.6	16 223.2	15 408.8
LIABILITIES	1 458 893.3	1 640 270.0	1 789 030.7	1 989 736.2	2 005 930.3
Direct investment in the Czech Republic	631 505.3	818 411.6	982 335.0	1 187 407.6	1 253 389.4
- equity capital	538 379.3	702 217.8	837 537.3	1 046 837.6	1 118 329.4
- other capital	93 126.0	116 193.8	144 797.7	140 570.0	135 060.0
Portfolio investment	165 579.2	164 592.0	180 346.2	201 120.0	195 896.5
- equity securities	98 011.8	115 670.6	128 740.1	128 097.7	117 358.9
- debt securities	67 567.4	48 921.4	51 606.1	73 022.3	78 537.6
Financial derivatives 2)		5 307.9	11 495.2	22 671.9	25 220.0
Other investment	661 808.8	651 958.5	614 854.3	578 536.7	531 424.4
Long-term	379 172.2	352 323.4	332 593.2	319 061.3	308 627.0
- CNB	197.1	180.4	133.4	114.5	104.0
- commercial banks	118 368.9	84 607.4	73 688.6	63 541.0	59 640.1
- government	20 852.9	19 699.2	9 476.2	9 475.8	17 282.9
- other sectors	239 753.3	247 836.4	249 295.0	245 930.0	231 600.0
Short-term	282 636.6	299 635.1	282 261.1	259 475.4	222 797.4
- CNB	25.8	8.8	68.5	44.2	89.7
- commercial banks	229 988.7	226 176.2	190 487.6	176 196.2	155 987.7
- government					
- other sectors	52 622.1	73 450.1	91 705.0	83 235.0	66 720.0
NET INVESTMENT POSITION	-110 938.4	-191 869.3	-244 067.7	-406 925.4	-454 811.3

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.	30 Jun. 1)
DEBT IN CONVERTIBLE CURRENCIES	813 576.5	808 122.8	811 258.1	792 129.0	745 022.0
of which:					
Long-term	497 872.1	464 323.8	465 687.8	470 599.4	463 703.7
By debtor					
- CNB	12 527.6	180.4	133.4	114.5	104.0
- commercial banks	128 703.3	95 737.1	88 401.4	80 063.7	71 777.6
- government	32 303.5	29 753.5	30 839.2	47 701.3	65 454.8
- other sectors	324 337.7	338 652.8	346 313.8	342 719.9	326 367.3
By creditor					
- foreign banks	257 410.0	228 709.6	229 305.5	223 329.8	213 498.6
- government institutions	4 239.2	3 405.7	2 373.6	1 747.2	1 383.5
- multilateral institutions	58 202.2	67 521.2	70 879.0	69 894.7	77 343.8
- suppliers and direct investors	93 831.4	99 560.2	105 944.3	97 855.0	93 410.0
- other investors	84 189.3	65 127.1	57 185.4	77 772.7	78 067.8
Short-term	315 704.4	343 799.0	345 570.3	321 529.6	281 318.3
By debtor					
- CNB	25.8	8.8	68.5	44.2	89.7
- commercial banks	230 000.5	226 246.1	192 438.4	177 474.4	156 516.7
- government	7.0	2 115.0	465.0	761.0	832.0
- other sectors	85 671.1	115 429.1	152 598.4	143 250.0	123 879.9
By creditor					
- foreign banks	201 808.8	203 333.8	192 126.4	166 140.7	148 933.7
- suppliers and direct investors	81 794.6	106 988.6	116 278.4	121 375.0	99 500.0
- other investors	32 101.0	33 476.6	37 165.5	34 013.9	32 884.6
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	745 022.0
of which:					
- long-term	506 797.8	473 274.7	465 687.8	470 599.4	463 703.7
- short-term	315 704.4	343 799.0	345 570.3	321 529.6	281 318.3

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	6-9
CZK EXCHANGE RATE AGAINST SELECTED CURRENCIES					
- annual/quarterly averages					
1 EUR	36.88	35.61	34.08	30.81	32.17
1 USD	34.60	38.59	38.04	32.74	28.61
100 SKK	83.64	83.64	78.68	72.22	77.05
	12	12	12	12	9
- monthly averages					
1 EUR	36.05	34.82	32.59	31.19	32.35
1 USD	35.63	38.94	36.48	30.65	28.85
100 SKK	84.70	80.07	75.61	74.67	77.98
	31 Dec.	31 Dec.	31 Dec.	31 Dec.	30 Sep.
- last day of the month					
1 EUR	36.13	35.09	31.98	31.60	31.84
1 USD	35.98	37.81	36.26	30.14	27.33
100 SKK	85.08	79.70	74.81	75.18	77.35

B. NOMINAL EFFECTIVE RATE

	1999	2000	2001	2002	2003
					9
CZK nominal effective exchange rate (percentages) (2000=100)					
weights - foreign trade turnover	98.5	100.0	104.3	116.4	114.2
weights - foreign trade turnover SITC 5-8	98.6	100.0	104.4	116.1	113.4

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
					8
CZK real effective exchange rate (percentages) (2000=100)					
a) industrial producer prices					
weights - foreign trade turnover	100.7	100.0	104.0	114.8	108.6
weights - foreign trade turnover SITC 5-8	99.6	100.0	104.6	115.4	109.4
b) consumer prices					
weights - foreign trade turnover	98.8	100.0	105.5	116.5	111.2
weights - foreign trade turnover SITC 5-8	98.2	100.0	106.2	117.3	112.0

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	1-9
STATE BUDGET					
TOTAL REVENUE	567.3	586.2	626.2	705.0	510.5
Tax revenue	540.1	559.5	598.3	627.4	484.2
Taxes on income, profits and capital gains	86.4	87.0	147.4	159.0	129.0
Domestic taxes on goods and services	211.4	216.8	187.0	186.9	139.7
- value-added taxes	138.3	145.9	121.3	118.1	87.0
- excises	73.1	70.9	65.7	68.9	52.7
Taxes on international trade and transactions	12.1	13.6	10.0	9.8	7.3
Taxes on property	6.8	6.0	6.4	7.9	6.3
Social and health security contributions and payroll taxes	210.9	222.2	242.3	258.5	199.2
Non-tax and capital incomes and received subsidies	27.2	26.7	27.9	77.7	26.3
TOTAL EXPENDITURE	596.9	632.3	693.9	750.8	590.8
Current expenditure	537.9	571.4	642.5	697.3	563.0
Capital expenditure	59.0	60.9	51.4	53.5	27.8
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	-80.3
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	9
BCPP					
PX 50	489.7	478.5	394.6	460.7	602.0
PX-D	1296.7	1366.0	1065.6	1166.4	1484.8
PX-GLOB	587.9	570.6	492.9	576.8	746.8
RM-SYSTÉM					
PK-30	713.2	724.8	593.0	672.5	873.5

B. TRADE VOLUMES

in CZK millions

	1999	2000	2001	2002	2003
	12	12	12	12	9
BCPP					
Monthly trade volumes	99 604.0	73 240.5	142 803.6	109 264.8	104 737.8
of which:					
a) shares	13 974.5	11 113.9	12 819.3	17 089.3	30 367.3
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	74 370.5
RM-SYSTÉM					
Monthly trade volumes	22 014.7	4 861.7	2 162.5	4 412.1	386.8
of which:					
a) shares	20 642.3	4 190.1	1 841.0	298.4	331.3
b) units	176.8	25.9	212.2	1.0	3.5
c) bonds	1 195.6	645.7	109.3	4 112.7	52.0

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		
1 August	**2.00**	**1.00**	**3.00**		

MACROECONOMIC AGGREGATES

in CZK millions; annual percentage changes; constant 1995 prices

	1999	2000	2001	2002	2003
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q2
GROSS DOMESTIC PRODUCT					
- in CZK millions	1 421 043	1 467 285	1 512 626	1 542 221	406 905
- percentages	0.5	3.3	3.1	2.0	2.1
FINAL CONSUMPTION					
- in CZK millions	1 042 354	1 058 969	1 102 058	1 150 738	294 640
- percentages	1.9	1.6	4.1	4.4	4.1
of which:					
Households					
- in CZK millions	765 638	783 454	813 026	845 111	221 066
- percentages	1.9	2.3	3.8	3.9	5.5
Government					
- in CZK millions	266 199	263 628	277 719	293 540	70 688
- percentages	2.3	-1.0	5.3	5.7	0.1
Non-profit institutions					
- in CZK millions	10 517	11 887	11 313	12 087	2 886
- percentages	-11.4	13.0	-4.8	6.8	2.7
GROSS CAPITAL FORMATION					
- in CZK millions	467 412	511 229	547 829	554 934	149 530
- percentages	-2.9	9.4	7.2	1.3	5.7
of which:					
Fixed capital					
- in CZK millions	463 128	487 874	514 934	518 193	127 703
- percentages	-1.0	5.3	5.5	0.6	-0.4
Changes in inventories					
- in CZK millions	3 880	22 990	32 513	36 351	21 729
Acquisitions less disposals of valuables					
- in CZK millions	404	365	382	390	98
- percentages	-19.5	-9.7	4.7	2.1	2.1
TRADE BALANCE					
- in CZK millions	-88 723	-102 913	-137 261	-163 451	-37 265
of which:					
Exports of goods					
- in CZK millions	809 783	971 784	1 109 242	1 174 839	319 510
- percentages	8.4	20.0	14.1	5.9	6.4
Exports of services					
- in CZK millions	211 548	223 676	228 169	199 596	46 339
- percentages	-1.8	5.7	2.0	-12.5	-7.9
Imports of goods					
- in CZK millions	920 348	1 106 476	1 275 437	1 329 758	353 757
- percentages	5.1	20.2	15.3	4.3	7.7
Imports of services					
- in CZK millions	189 706	191 897	199 235	208 128	49 357
- percentages	7.2	1.2	3.8	4.5	2.5
FINAL DOMESTIC DEMAND					
- in CZK millions	1 505 482	1 546 843	1 616 992	1 668 931	422 343
- percentages	1.0	2.7	4.5	3.2	2.7
AGGREGATE DOMESTIC DEMAND					
- in CZK millions	1 509 766	1 570 198	1 649 887	1 705 672	444 170
- percentages	0.3	4.0	5.1	3.4	4.6
GROSS DOMESTIC PRODUCT AT CURRENT PRICES					
- in CZK millions	1 902 293	1 984 833	2 175 238	2 275 609	609 776
- percentages	3.4	4.3	9.6	4.6	4.7

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	Q2
Current income	3.9	4.8	5.6	5.2	5.7
of which:					
- gross operating surplus and mixed income	5.2	3.0	6.6	1.4	5.0
- compensation of employees	3.8	4.9	7.1	6.4	5.6
- property income	-15.8	-7.0	-0.4	-8.9	8.4
- social benefits other than social transfers in kind	8.6	9.6	5.9	7.5	4.2
- other current transfers	20.5	10.2	-10.7	15.6	12.8
Current expenditure	5.3	4.8	6.6	8.1	6.2
of which:					
- property income	-11.9	-8.4	1.9	12.5	4.4
- current taxes on income. wealth. etc.	2.5	3.8	4.7	13.9	5.0
- social contributions	4.9	5.9	8.9	5.9	5.7
- other current transfers	20.3	5.6	-0.2	9.1	11.5
Gross disposable income	3.3	4.8	5.1	3.9	5.4
Change in net equity of households in pension funds reserves	-20.0	24.6	47.2	5.8	30.4
Individual consumption expenditure	5.7	5.3	7.6	3.8	5.1
Gross saving	-18.7	0.6	-20.7	4.9	14.0
Gross savings rate	8.33	8.00	6.04	6.10	7.80
(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	Q2
Overall nominal wage	7.5	5.9	8.1	7.0	6.2
Business sector	6.2	6.9	7.7	6.3	5.3
Non-business sector	12.7	2.6	9.6	9.8	9.0
Overall real wage	5.3	1.9	3.2	5.1	6.1
Business sector	4.0	2.9	2.9	4.4	5.2
Non-business sector	10.4	-1.3	4.7	7.9	8.9

C. UNEMPLOYMENT

end of period

	1999	2000	2001	2002	2003
	12	12	12	12	9
Registered job applicants (thousands)	487.6	457.4	461.9	514.4	529.4
Unemployment rate (percentages)	9.4	8.8	8.9	9.8	10.1

Source: CZSO

PRODUCER PRICES

percentage changes

	1999	2000	2001	2002	2003
					9
INDUSTRIAL PRODUCER PRICES					
a) previous month = 100	0.3	0.4	0.1	-0.1	0.4
b) same period of last year = 100	1.0	4.9	2.9	-0.5	0.0
c) average for 2000 = 100	.	0.0	2.8	2.3	1.6
d) December 1999 = 100	.	3.4	6.3	5.8	5.1
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	2.1
c) average for 2000 = 100	.	0.0	4.1	6.9	9.6
d) December 1999 = 100	.	2.3	6.5	9.3	12.1
AGRICULTURAL PRODUCER PRICES					
b) same period of last year = 100	-11.7	9.2	8.4	-9.5	0.6
of which:					
crop products					
b) same period of last year = 100	-15.0	12.6	9.3	-4.6	8.1
livestock products					
b) same period of last year = 100	-10.5	8.0	8.0	-12.1	-3.1
MARKET SERVICES PRICES (excluding interest rates)					
a) previous month = 100	0.3	0.4	0.1	0.3	0.4
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	9.1
d) December 1999 = 100	.	0.6	4.6	8.0	9.8

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	-3.1
Current account balance	-2.7	-5.3	-5.7	-6.4
M2	70.3	71.2	73.4	72.4

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

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