INFLATION REPORT / OCTOBER

2006

CNB CZECH NATIONAL BANK

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ABBREVIATIONS USED

ARA	Amsterdam-Rotterdam-Antwerp
BCPP	Prague Stock Exchange
ČEZ	České energetické závody, a power utility company
ČMZRB	Czech-Moravian Guarantee and Development Bank
CF	Consensus Forecasts
CNB	Czech National Bank
CPI	consumer price index
ČSOB	Československá obchodní banka
CZK	Czech koruna
CZ-CPA	Classification of Products by Activity
CZ-NACE	Industrial Classification of Economic Activities
CZSO	Czech Statistical Office
EC	European Commission
ECB	European Central Bank
ECOFIN	The Economic and Financial Affairs Committee
EIB	European Investment Bank
EMI	European Monetary Institute
EMS	European Monetary System
ERM	Exchange Rate Mechanism
ESA	European System of National Accounts
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
FDI	foreign direct investment
Fed	Federal Reserve System (the central banking system in the USA)
FRA	forward rate agreement
GDP	gross domestic product
GFS	Government Finance Statistics
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
IRS	interest rate swap
LFS	Labour Force Survey
LIBOR	London Interbank Offered Rate
M1, M2	monetary aggregates (see section III.1.1.)
MF	Ministry of Finance of the Czech Republic
MFIs	monetary financial institutions
MLSA	Ministry of Labour and Social Affairs
MNB	Hungarian National Bank
NBP	National Bank of Poland
NBS	National Bank of Slovakia
NCG	net credit to government
NDAs	net domestic assets
NEAs	net external assets
NPISHs	non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
OMFIs	other monetary financial institutions
O/N	overnight
PPI	producer price index
PRIBID	Prague Interbank Bid Rate
PRIBOR	Prague Interbank Offered Rate
(1W, 1M, 1Y)	(one-week, one-month, one-year)
repo rate	repurchase agreement rate
SFAOs	state financial assets operations
SITC	Standard International Trade Classification
SKK	Slovak koruna
USD	US dollar
VAT	value added tax

In 1998, the Czech National Bank switched to direct inflation targeting. 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 publishing of quarterly Inflation Reports.

Sections II and III of this pivotal document provide information on monetary and economic developments over the past quarter.

Section IV moves the focus of attention from the past to the future. It acquaints readers with the forecast for the Czech economy drawn up at the start of the quarter by the CNB's Monetary and Statistics Department. The inflation forecast and the assumptions underlying it are published with the aim of making monetary policy as transparent, comprehensible, predictable and therefore reliable as possible. 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 forecast is the key, but not the only, input to the Bank Board's decision-making. At its meetings during the quarter, the Bank Board discusses the current balance of risks and uncertainties of the forecast. The arrival of new information since the forecast was drawn up and the possibility of asymmetric assessment of the risks of the forecast and divergent views of some board members on the development of the external environment or the linkages between the various indicators within the Czech economy mean that the Bank Board's final decision need not always correspond entirely to the message of the forecast. Information on the Bank Board's discussions over the past three months and on the reasons for its monetary policy measures in that period is given in the minutes of the Bank Board meetings at the end of this Inflation Report.

This Inflation Report was approved by the CNB Bank Board on 2 November 2006.

Unless stated otherwise, the sources of the data contained in this Inflation Report are the CZSO or the CNB. All the Inflation Reports published to date are available on the CNB website at http://www.cnb.cz/.

Chart I.1
Inflation was close to the point inflation target in 2006 Q3
(annual percentage changes in CPI)

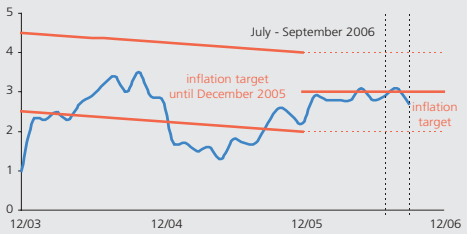


Table I.1
The Czech economy continued to grow at a fast pace in 2006 Q2
(annual percentage changes unless otherwise indicated)

	6/06	7/06	8/06	9/06
Consumer price inflation	2.8	2.9	3.1	2.7
Industrial producer price inflation	1.8	2.4	2.7	2.4
Money supply growth (M2)	8.4	8.6	9.3	-
3M PRIBOR[a)] (in per cent)	2.2	2.3	2.4	2.5
Nominal CZK/EUR exchange rate[a)] (level)	28.39	28.45	28.19	28.38
State budget balance since January incl. SFAOs[b)] (CZK bn)	7.6	-0.4	-6.4	1.5
GDP growth at constant prices[c)]	6.2			-
Unemployment rate[b)] (in per cent)	7.7	7.9	7.9	7.8

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

Headline inflation stayed close to the CNB's point inflation target in 2006 Q3 (see Chart I.1). The Czech economy continued to grow at a fast pace in 2006 Q2, despite a modest slowdown. The favourable economic growth was reflected in continuing growth in wages and in employment. Money market interest rates increased at most maturities during Q3. The koruna's exchange rate against both major currencies was slightly stronger on average in this period than in the previous quarter.

Annual inflation in 2006 Q3 followed a similar course to that in the previous quarter. A slight increase in the first two months of the quarter was replaced by a decline in the final month. As in previous quarters, regulated prices were the main source of annual consumer price inflation. However, their contribution was relatively stable across the individual months, hence the changes in inflation were due to movements in other price categories. The rise in inflation in July and August was generated mainly by an increase in adjusted inflation excluding fuels and an upturn in annual growth in food prices. The decline in inflation in September can be put down mainly to fuel prices, whose gradually slowing annual growth was replaced by a sharp fall in September.

According to preliminary CZSO estimates, annual GDP growth in 2006 Q2 (6.2%) was just under one percentage point lower than the historical high achieved in the previous quarter. The slowing growth of the Czech economy can be put down mainly to foreign trade, whose contribution to GDP growth was close to zero. Compared to the previous quarter, annual growth in gross fixed capital formation also slowed and government consumption recorded a year-on-year decrease. By contrast, inventories showed a significant increase, which may lead to higher fixed investment growth in the future. Household consumption also grew at a slightly slower pace than in the previous quarter.

With the economy growing rapidly, continuing growth in labour demand led, as in the previous period, to rising employment. However, part of the demand for labour was met outside the labour office register, so the registered unemployment rate continued falling more slowly year on year than would correspond to the growth in employment. Annual nominal and real wage growth remained relatively high in 2006 Q2, despite falling slightly compared to the previous quarter. Wages in the business sector continued rising faster than those in the non-business sector.

Interest rates on the money market were particularly affected in 2006 Q3 by market expectations regarding the timing of the rise in the CNB's key interest rates. The markets were expecting the July and – to a lesser extent – September increases in the CNB's key interest rates, so interest rates at most maturities rose in advance. The yield curve shifted to a higher level and its slope became more positive.

The koruna's exchange rate stayed roughly at the end of June level against both major currencies in July. It then appreciated, reaching historical highs against both the euro and the dollar in mid-August. The halt in the appreciation trend in late August and the subsequent minor correction in September was due mainly to rising demand for foreign currency linked with forthcoming dividend payments abroad. Other factors acting in the same direction included a halt in the trend of improvement in the trade balance and a short-lived change in foreign investors' view of the Czech koruna connected with the persisting political instability and information on the public budget situation.

The monetary policy decision-making of the CNB Bank Board in 2006 Q3 was based on the inflation forecast discussed by the Board at its meeting on 27 July 2006 and published in the July Inflation Report. Given the monetary policy transmission lag, the Board focused on hitting the inflation target at roughly the 12–18 month horizon, i.e. in the third and fourth quarters of 2007. According to the July forecast,

inflation should be close to the upper boundary of the toleration band of the point inflation target in this period. Consistent with the baseline scenario was a gradual rise in interest rates.

The Bank Board increased monetary policy interest rates twice in 2006 Q3. At its monetary policy meeting at the end of July, the Board decided by a close majority vote to raise interest rates by 0.25 percentage point with effect from 28 June. At its meeting at the end of September, the Board decided by a majority vote to increase interest rates to the same extent with effect from 29 September. In both cases its decision was consistent with the macroeconomic forecast and its risks, which the Board assessed initially as broadly balanced and later as slightly inflationary.

Section IV of this Inflation Report describes the CNB's new forecast. New data on domestic economic activity has led to a slight reduction of the estimate of the initial output gap. In 2007, the output gap will stagnate at slightly positive values as a result of the combined effects of easy monetary and fiscal policy and relatively low external demand. In 2008, the output gap will return to the values close to zero as a consequence of continuously weak external demand and a reduction in contribution of fiscal policy to growth in demand. The inflation forecast for 2006 and 2007 has been decreased slightly. This change reflects the rather lower demand-pull inflationary pressures at present, the slightly stronger exchange rate of the koruna, a lower outlook for prices of fuel and food, and changes in the outlook for regulated prices and the timing and magnitude of the impacts of indirect taxes. At the monetary policy horizon, inflation will be close to the upper boundary of the tolerance band of the inflation target.

The mechanism of caveats applies as usual to the first-round effects of indirect taxes, whose impact will be particularly pronounced in 2007. Adjusted for these effects, inflation to which monetary policy reacts is initially below the point inflation target, but then increases and lies slightly above the point inflation target at the end of the monetary policy horizon. Consistent with the macroeconomic forecast and its assumptions is a gradual rise in interest rates.

No significant risk leading to the creation of a full alternative scenario was identified in the forecasting process.

Chart I.2
The inflation forecast is close to the upper boundary of the tolerance band of the point inflation target at the monetary policy horizon
(annual percentage changes in CPI)

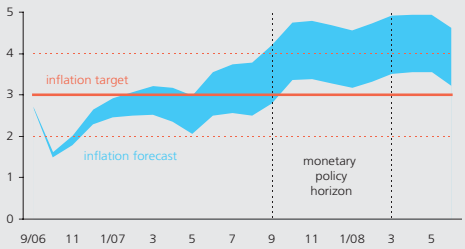


Chart I.3
Excluding the first-round impacts of indirect taxes, inflation is close to the point inflation target at the monetary policy horizon
(annual percentage changes)

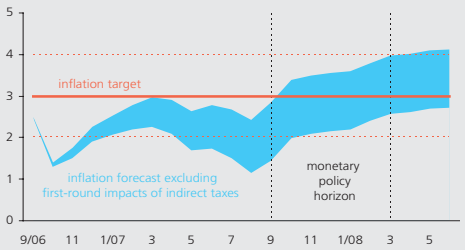


Chart II.1
Inflation decreased at the end of 2006 Q3
(percentages)

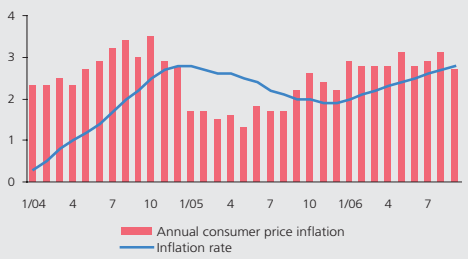


Table II.1
Housing-related prices rose the fastest in 2006 Q3
(annual percentage changes)

	3/06	4/06	5/06	6/06	7/06	8/06	9/06
CONSUMER PRICES	2.8	2.8	3.1	2.8	2.9	3.1	2.7
Food and non-alcoholic beverages	-0.7	-0.4	-0.3	0.9	2.4	2.6	2.6
Alcoholic beverages and tobacco	0.9	1.1	1.5	1.1	1.3	1.3	1.4
Clothing and footwear	-5.9	-6.1	-6.2	-6.5	-7.1	-6.2	-5.9
Housing, water, electricity, gas and other fuels	7.0	7.3	7.4	7.4	7.0	6.9	6.9
Furnishings, household equipment and routine maintenance of the house	-1.6	-1.4	-1.4	-1.5	-1.4	-1.3	-1.1
Health	4.4	4.3	3.9	3.7	3.7	5.8	5.6
Transport	4.2	3.1	4.2	3.2	2.5	2.6	-2.0
Communication	13.2	10.9	17.2	1.4	1.8	2.3	2.8
Recreation and culture	1.8	2.3	2.1	1.4	1.4	1.9	2.1
Education	3.7	3.7	3.7	3.9	3.9	3.9	3.1
Hotels and restaurants	2.4	2.4	2.6	2.7	3.1	3.3	2.5
Miscellaneous goods and services	1.5	1.7	1.8	1.8	2.2	2.2	2.2

Chart II.2
Housing prices remained the main factor underlying the rise in consumer prices in 2006 Q3
(contributions in percentage points; September 2006)

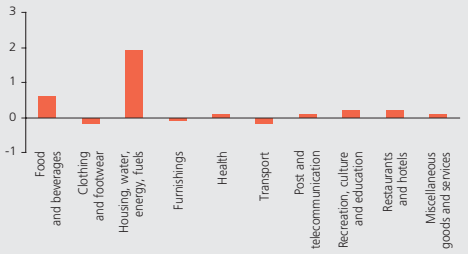
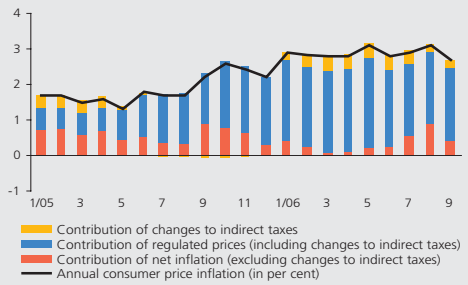


Chart II.3
Consumer price inflation was again affected most strongly by regulated prices in 2006 Q3; the effect of market prices was small
(percentages; contributions in percentage points)



II.1 PAST INFLATION DEVELOPMENTS

Annual inflation[1] decreased overall in 2006 Q3. In July and August it rose above the level reached at the end of 2006 Q2 (by 0.3 percentage point to 3.1% in August), but in September it returned to lower figures. Annual inflation stood at 2.7% in September, 0.1 percentage point lower than in June. The inflation rate[2] increased further in Q3 to stand at 2.8% in September.

The pick-up in annual consumer price inflation in July and August was due chiefly to rising food prices. However, consumer price inflation also increased in five other categories of the consumer basket – health, communication, recreation and culture, hotels and restaurants and miscellaneous goods and services. The renewed slowdown in consumer price inflation to 2.7% in September was largely due to a substantial decline in the rate of growth of fuel prices, which are included in the transport category.[3] Inflation in the housing category also eased, but this was still the highest of the consumer basket categories. The fast growing prices in the housing category also remained the main factor underlying the annual consumer price inflation in 2006 Q3. They accounted for almost three-quarters of the total growth in September. The contribution of food prices was markedly lower, as in the previous quarter (see Chart II.2).

Domestic prices continued to be affected in 2006 Q3 by external cost pressures stemming from the rapid year-on-year growth in prices of energy-producing materials on world markets. However, their effect continued to weaken substantially. Producer price growth in the manufacture of refined petroleum products slowed, turning into an annual decline in September, but most other branches of industry recorded a continued rise in inflation. This indicated gradual pass-through of the rising costs of energy and imported intermediate products to producer prices, amid growing domestic and external demand and faster growth in producer prices abroad. Industrial producer price inflation was nonetheless largely subdued, being also affected by a dampening effect of rapid productivity growth, accompanied by a falling personnel cost-output ratio. These gradual inflationary developments in the industrial producer price area had yet to pass through markedly to consumer prices. Agricultural producer prices, which strongly affect food prices, indicated continuing price growth.

By the CNB's estimation, the economy has been exceeding the potential, non-accelerating inflation level of output since 2005 Q4. Consumer demand growth rose in the first half of 2006. However, consumer prices had yet to indicate any pronounced effect of demand-pull pressures on inflation. Prices of goods and services showed modest growth overall. The rapidly rising prices of energy-producing commodities had sizeable direct effects only on consumer prices of fuels and housing and also indirectly affected food prices (via producer prices).

The main source of annual consumer price inflation was thus again regulated prices, whose annual growth fluctuated just below 10% as a result of a considerable rise in energy prices and telecommunication charges for households in the first half of 2006 (see Chart II.3). Annual growth in market prices remained low in 2006 Q3 (0.5% in September), despite increasing slightly relative to the end of the previous quarter. The modest rise in market prices was mainly due to food prices, which recorded a slight upturn during Q3 (to 1.4% excluding tax effects, or 2.3% including indirect tax changes, in September). Conversely, growth in non-food commodity prices gradually weakened to values close to zero, owing to fuel prices.

1 Measured by annual growth in consumer prices.
2 The inflation rate expressed as the increase in the average consumer price index (basic) for the last 12 months relative to the average for the previous 12 months.
3 This significant change in the rate of growth of fuel prices was due primarily to base effects; the effect of oil price changes was smaller.

The main factor underlying the gradual upturn in food prices[4] was renewed growth of the index of domestic agricultural producer prices in 2006 H1, which was associated, in turn, with a rise in crop product prices. Food prices were also affected by a slight upturn in imported food prices and by energy prices, which raised input costs along the entire food chain, including in the food industry. As in the previous quarter, however, the upturn in food prices was not across the board in nature, but concerned only some commodities, in particular bread and confectionery products, where the rise in prices was probably due not only to rising prices of production inputs (energy, grain), but also to a stronger bargaining position of producers in this industry in relation to large retailers. The increase in food prices was also due to smaller declines in fruit and vegetable prices than would correspond to their usual developments in the summer months. Prices in other food categories mostly continued declining year on year in 2006 Q3. The increases in excise duties as from July 2005 and April 2006 had yet to pass through significantly to cigarette prices, among other things as a consequence of forward buying by producers and retailing of cigarettes at their original prices.

Growth in prices of non-food commodities[5] was moderate overall in Q3 and, as in the previous quarter, did not surpass 1%. In September it slackened markedly, dropping almost to zero (0.1%). The contribution of non-food commodity prices to consumer price inflation was substantially lower than that of food prices. However, these prices continued to show very mixed structural trends, owing to the considerable diversity of the key factors affecting prices in the individual components of this price index. The largest change was recorded by fuel prices, where a continuing trend of slowing price growth culminated in September in a substantial annual decline in prices (of 7.5%). However, the main cause of this change was not the oil price developments on world markets, but base effects. This surge in prices subsequently fostered a decline in annual inflation to almost zero across the entire category of non-food commodities.

Other non-food commodity categories saw smoother price movements in 2006 Q3, as shown in Chart II.5. The year-on-year decline in prices of tradable commodities,[6] which are significantly affected by the external competitive environment, continued (-2.4% in September). As mentioned in previous Inflation Reports, the falling prices in this category are a long-term phenomenon that has been ongoing since the beginning of 2001. The current decline in prices of these commodities is primarily due to the relatively strong year-on-year appreciation of the koruna-euro exchange rate combined with relatively low prices of many consumer products on foreign markets, resulting in mostly falling prices of imports of consumer goods. As in previous quarters, declining prices were recorded particularly in the categories of clothing, footwear, household equipment and furnishings.

Prices of non-tradable market commodities, which consist primarily of services, picked up in 2006 Q3. However, the rise was not sharp and the resultant annual growth (2.5% in September) did not deviate far from the subdued and relatively stable price growth recorded in this category in previous quarters.

Annual growth in regulated prices slowed only modestly in 2006 Q3 (to 9.8%), as no major changes were made to prices of regulated items. Their continuing high annual growth was thus a result of price changes made in the previous three quarters. These changes were made in four steps and included an increase in gas prices in October 2005, a rise in prices of electricity for households in January, an increase in gas prices in April and a rise in regulated telephone charges in May.

Chart II.4
The upturn in food prices continued into 2006 Q3
(annual percentage changes)

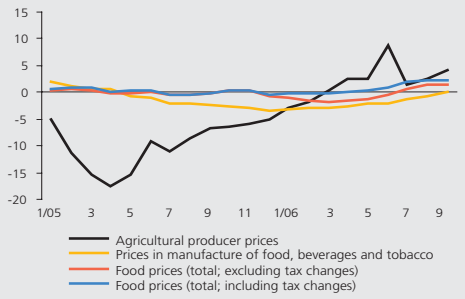


Chart II.5
Growth in prices of non-food commodities was very moderate overall in Q3
(annual percentage changes)

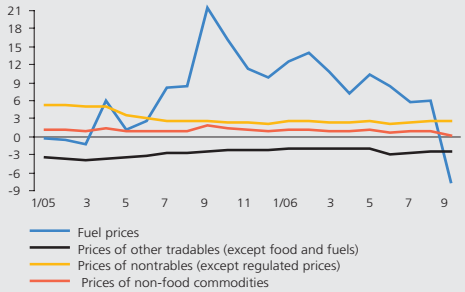
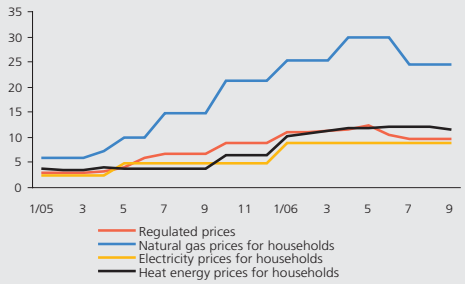


Chart II.6
The high growth in regulated prices was due to rising prices of energy sources for households in the previous three quarters
(annual percentage changes)



4 Consolidated category of prices of food and non-alcoholic beverages and prices of alcoholic beverages and tobacco.

5 Consolidated category of prices of non-food commodities, comprising tradable commodities, non-tradable commodities and fuels.

6 Excluding food and fuels.

Chart II.7
Inflation in the Czech Republic was mostly higher than in the EU countries in 2006 Q3
(annual percentage changes)

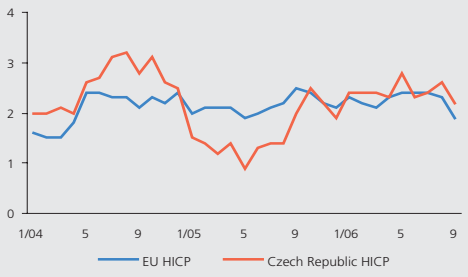


Table II.2
The higher-than-forecasted headline inflation in 2006 Q3 was caused mainly by regulated prices
(annual percentage changes; contributions in percentage points)

	April 2005 forecast	2006 Q3 outturn	Contribution to total difference in perc. points[a)]
Annual consumer price inflation	2.2	2.9	0.7
Breakdown into contributions:			
regulated prices	2.3	9.8	1.6
changes to indirect taxes	0.5	0.3	-0.2
food prices, excluding changes to indirect taxes	1.2	1.1	0.0
fuel prices, excluding changes to indirect taxes	0.4	1.4	0.0
adjusted inflation excluding fuels, excluding changes to indirect taxes	1.7	0.6	-0.5

a) owing to rounding, the sum of the contributions need not be equal to the total difference

Chart II.8
Actual inflation was above the April 2005 forecast over the entire forecast period
(annual percentage changes)

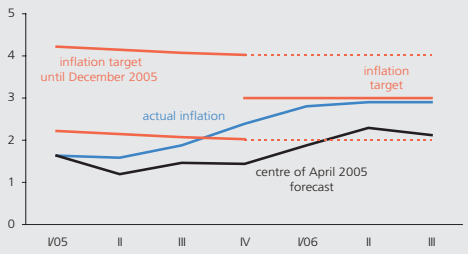


Table II.3
Of the exogenous factors, the price of oil and foreign interest rates deviated the most from the forecast

		II/05	III/05	IV/05	I/06	II/06	III/06
GDP in Germany [a)]	prediction	0.8	1.0	1.1	1.3	1.4	1.5
(annual perc. changes)	outturn	0.9	1.4	1.1	2.2	1.8	-
CPI in Germany	prediction	1.5	1.3	1.2	1.2	1.1	1.2
(annual perc. changes)	outturn	1.7	2.1	2.3	2.0	2.0	1.7
1Y EURIBOR	prediction	2.3	2.3	2.4	2.5	2.6	2.6
(percentages)	outturn	2.2	2.2	2.6	3.0	3.3	3.6
USD/EUR exchange rate	prediction	1.31	1.32	1.32	1.33	1.33	1.32
(levels)	outturn	1.26	1.22	1.19	1.20	1.26	1.27
Oil prices [b)]	prediction	45.6	42.3	40.6	39.6	39.5	39.5
(USD/barrel)	outturn	47.6	57.3	53.3	57.6	65.0	66.7

a) at constant prices, seasonally adjusted
b) Ural crude

Turning to international comparisons, annual HICP inflation in the Czech Republic started to fluctuate generally above that in the EU countries at the beginning of 2006. This difference was mainly due to higher growth in the categories of housing and telecommunication services. In September, annual HICP inflation in the Czech Republic fell markedly to 2.2%, from 2.6% in August. According to Eurostat's flash estimate, the HICP decreased to the same extent in the EU countries in September (to 1.9%). As in August, therefore, inflation in the Czech Republic in September was higher than in the EU countries, as illustrated in Chart II.7.

II.2 FULFILMENT OF THE INFLATION TARGET

Headline inflation was very close to the CNB's point inflation target in 2006 Q3 (see Chart I.1). This section of the Inflation Report briefly analyses the contribution of the CNB's monetary policy to this situation. Changes to interest rates pass through to 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 2006 Q3, one needs to analyse retrospectively the forecasts, and the Bank Board's decisions based thereon, dating roughly from January to September 2005. For comprehensibility, the analysis of the accuracy of the forecasts is limited here to a comparison of the forecast drawn up in April 2005, i.e. approximately in the middle of the aforementioned period, with inflation in 2006 Q3 (see Table II.2).

The April 2005 forecast had predicted a gradual easing of monetary policy from its neutral effect. This development was expected to reflect a gradual easing of the exchange rate component of the monetary conditions, amid a stable easy interest rate component. This prediction, together with a slightly positive contribution from the fiscal impulse amid flat external demand, led to a forecast of slow closure of the negative output gap. This gap was expected to close in 2006 H2. An absence of demand-pull inflationary pressures from the real economy and the effect of the stronger exchange rate were expected to be the main factors of low inflation, which at the monetary policy horizon was expected to be below the CNB's point inflation target. Actual inflation was above the April forecast over the entire forecast horizon, deviating from it by 0.8 percentage point in 2006 Q3 (see Chart II.8). The main factor underlying this deviation was a substantially more inflationary effect of regulated prices than had been forecasted, whereas adjusted inflation excluding fuels and the actual first-round effects of the changes to indirect taxes deviated downwards.

The difference in structure and the generally higher consumer price inflation than had been expected in the April 2005 forecast, were in large part due to the unexpected evolution of factors lying partly or completely outside the purview of the CNB's monetary policy. In particular, these factors included considerably higher growth in regulated prices, linked partly with the development of energy-producing material prices on world markets, and a lag in the price impact of the increases in excise duties on cigarettes in June 2005 and January 2006.

Consistent with the April forecast was a decline in interest rates in the period immediately ahead and flat interest rates thereafter. The actual interest rate path in 2005 Q2 and Q3 was roughly at the forecast level, with one reduction of the monetary policy interest rates by 0.25 percentage point. In the period that followed, however, actual interest rates were higher than forecasted. The overall effect of the slightly higher-than-forecasted nominal interest rates, the higher-than-forecasted inflation and the shift in the perception of equilibrium real interest rates meant that the interest rate component of the monetary conditions from April 2005 onwards was slightly tighter than predicted by the April forecast. The nominal koruna-euro exchange rate was stronger than forecasted, but its effect in 2005 Q2 and Q3, is assessed as easier than in the April forecast owing to changes in the

estimate of the rate of equilibrium real appreciation. In the context of the exchange rate appreciation at the start of 2006, there was then a tightening of the exchange rate component, and the effect of the exchange rate was thus considerably tighter than predicted in the April forecast. To sum up, the overall monetary policy effect was easier than forecasted until 2005 Q3, and subsequently tighter.

When assessing the fulfilment of the inflation forecast, one needs to take into account the changes in the CNB's view of the workings of the economy. Since April 2005, the aforementioned changes have been made to the equilibrium paths of the real exchange rate and real interest rates. As a result of these changes, the effect of the exchange rate component is perceived as easier, and the effect of the interest rate component as tighter, than the assessment in the April forecast. However, the view of the evolution of the monetary conditions as a whole is largely unchanged.

Any revisions to economic indicators, in particular GDP, made since the forecast was drawn up, also have an effect on the fulfilment of the forecast. These revisions, especially those made to the national accounts in March 2006, have markedly increased the estimate of GDP growth in 2004 and 2005. In the absence of any observable inflationary pressures, the revision of the national accounts has generated an increase of more than one percentage point in the estimated growth of the potential, non-accelerating inflation level of output.

Based on the CNB's current knowledge of the workings of the Czech economy and its current knowledge of actual economic developments, the developments since the April 2005 forecast was drawn up can be briefly interpreted in the following way.

By the CNB's estimation, the output gap closed relatively rapidly during 2005 and has been positive since the end of 2005. Underlying this development was easy monetary and fiscal policy during 2005, which outweighed the effect of weak external demand. However, the higher demand-pull inflationary pressures stemming from the higher output gap than predicted in the April 2005 forecast, did not translate into higher adjusted inflation excluding fuels, since the greater-than-expected strengthening of the koruna had a strong anti-inflationary effect. World oil and petrol prices were an important inflationary factor. This factor was reflected in growth in regulated energy prices. The higher-than-expected growth in regulated prices was also due to increases in prices of telecommunication services in June 2005 and May 2006. The minor deviation in food prices from the forecast was due to the good harvest in 2005 and to the appreciation of the exchange rate. However, in 2006 Q2 and Q3 prices of bread recorded an unexpected rise linked, among other things, with the increase in energy prices. The first-round effects of the changes to indirect taxes on cigarettes materialised to a smaller extent, or possibly with a longer lag, than expected. The overall deviation of the individual components of inflation from the forecast thus shifted inflation close to the point inflation target in 2006 Q3.

The inflation forecast is the primary source material for the Bank Board's decisions on monetary policy rates. Also of importance is an assessment of the risks associated with this forecast by the board members. At the Board's meetings during the first three quarters of 2005 (see the relevant minutes), the risks to the forecasts presented were assessed by the Board as being roughly balanced overall. The January forecast, whose risks were viewed by the Board as being anti-inflationary, was an exception. In line with this assessment, the Board deviated somewhat towards lower rates from the recommendations of the forecast. One can say with the benefit of hindsight that of the risks identified by the Board, the most intensively perceived anti-inflationary risk of a stronger exchange rate did in fact materialise, and so did the inflationary risks of higher oil prices, higher regulated prices and the transmission of external inflationary pressures to the domestic economy. However, the inflationary risks materialised to a larger extent.

Table II.4

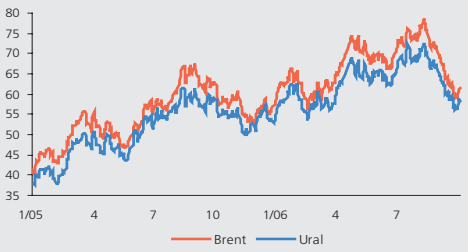
The koruna-euro exchange rate was stronger than expected

		II/05	III/05	IV/05	I/06	II/06	III/06
3M PRIBOR	prediction	1.9	1.6	1.6	1.6	1.8	2.1
(percentages)	outturn	1.9	1.8	2.1	2.1	2.1	2.4
CZK/EUR exchange rate	prediction	30.0	30.1	30.2	30.3	30.3	30.2
(levels)	outturn	30.1	29.7	29.3	28.6	28.4	28.3
GDP	prediction	4.1	3.9	4.0	3.9	4.1	4.2
(real, annual perc. changes)	outturn	6.1	5.9	6.9	7.1	6.2	-
Output gap	prediction	-0.7	-0.6	-0.4	-0.3	-0.2	0.0
(percentages of GDP)	outturn [a)]	-0.5	-0.3	0.3	0.6	0.6	0.5

a) estimate based on the CNB's October 2006 forecast

III.1 THE EXTERNAL ENVIRONMENT

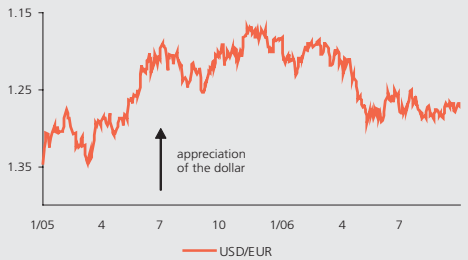
Chart III.1
The price of oil decreased throughout much of 2006 Q3, briefly dipping below USD 60 a barrel at the end of September
(USD/barrel)



The rate of growth of the US economy slowed further in 2006 Q2 and its lead over the euro area, where, in contrast, growth picked up, decreased. Economic growth in the countries of the Central European region in this period was also higher than in the euro area. The dollar's exchange rate against the euro was relatively stable throughout Q3, fluctuating between 1.25 and 1.29 USD/EUR. The price of Brent crude oil fell below USD 60 a barrel at the end of September.

The annual rate of growth of the US economy dropped by 0.2 percentage point to 3.5% in 2006 Q2.[7] Growth in household consumption and fixed investment fell significantly and the external imbalance also widened further. Net exports deteriorated and the ratio of the current account deficit to GDP increased year on year to 6.6%. Personal consumption growth was affected negatively by a decline in the housing market. However, it was partly offset by rises in wages and employment and by a further decrease in unemployment. The unemployment rate fell to 4.6% in September, 0.5 percentage point down from the same period a year earlier. Employment simultaneously increased by 1.3% year on year. Its growth, although lower than in the previous period, supports the view that the slowing growth of the US economy is gradual and there is no danger of a transition into recession for the time being.

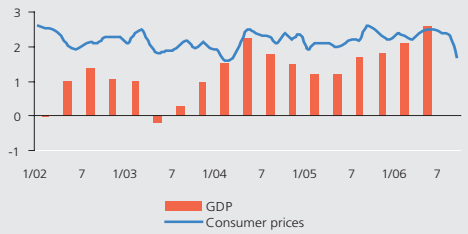
Chart III.2
The dollar's exchange rate was relatively stable in 2006 Q3, fluctuating between 1.25 and 1.29 USD/EUR



Annual inflation in the USA fell to 2.1% in September, thanks to a fall in oil prices and hence a lower rate of growth of import prices. Producer price inflation also dropped by 2.7 percentage points to 0.9%, whereas core inflation rose by 0.1 percentage point to 2.9%. A decline in productivity growth to 1.6% in 2006 Q2, together with a rapid increase in nominal wages, counteracted the decrease in inflationary pressures resulting from the lower energy prices. At its meeting at the end of June, the Fed raised its key rate to 5.25%. At its subsequent meetings in August and September, the Fed left the rate unchanged, thus bringing to an end its series of 17 consecutive rate increases. It also hinted at the possibility that no further monetary policy tightening would be necessary, since the reduction of economic growth to a sustainable level would dampen the current inflationary pressures. The federal budget deficit for the fiscal year 2006 ending in September was down by USD 71 billion compared to the previous fiscal year.

The rate of growth of real GDP in the euro area in 2006 Q2 rose by 0.5 percentage point year on year to 2.6%, from 2.1% in Q1, thanks to faster growth in fixed investment, which rose by 4.6% compared to 3.7% in the previous quarter, and to a positive contribution from net exports. The rapid economic growth fostered a reduction in the unemployment rate of 0.6 percentage point in August compared to the same month a year earlier. Employment also saw significant year-on-year growth of 1.2 percentage points in Q2.

Chart III.3
The euro area recorded a further pick-up in economic growth and a fall in inflation in 2006 Q2
(annual percentage changes)



In July, the euro area trade surplus fell to EUR 1.5 billion from EUR 7 billion a year earlier owing to the high prices of oil and other commodities. At 0.6%, the ratio of the current account deficit to GDP was unchanged in Q2 compared to the previous year. The falling oil prices caused annual consumer price inflation to fall by 0.6 percentage point in September compared to August to 1.7%. Core inflation increased by 0.1 percentage point to 1.5%, although its low level suggested that the inflationary pressures in the euro area are not all that strong. Industrial producer price inflation fell to 5.7% in August, but it remained high, the same as the core industrial producer price inflation of 3.6%, the highest value since 1995. At the start of October, the ECB raised its key rate for the fourth time this year, by 0.25 percentage point to 3.25%. This was due to the risk to price stability given the

7 In this subsection we use seasonally and calendar adjusted data, where available.

current excessively easy monetary policy rates by comparison with the high real GDP growth and the sharp growth in M3.

In 2006 Q2, economic growth also accelerated in Germany, with the annual growth rate increasing to 2.4% from 1.7% in Q1. This was due mainly to high fixed investment growth, while household consumption growth remained low. In contrast to the euro area, the balance of trade deteriorated only very slightly compared to the previous month and year, recording a surplus of EUR 13 billion in July amid high growth in exports and imports. The robust economic growth generated a decrease in the unemployment rate, which fell by more than one percentage point year on year to 10.6%. Annual consumer price inflation fell significantly in September to 1%, from 1.7% in August, thanks to the lower oil prices. Annual producer price inflation was affected by the previous high energy prices, remaining almost unchanged at 5.9% in August.

In the countries of the Central European region, the pace of economic expansion remained high in 2006 Q2, exceeding that in the euro area. In Poland and Slovakia the pace increased and unemployment decreased, whereas Hungary recorded a slowdown in growth and a rise in unemployment.

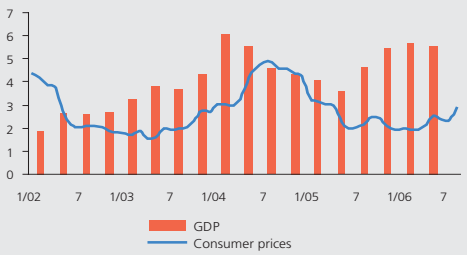
In 2006 Q2, annual real GDP growth in Poland rose by one percentage point to 5.6%. This high growth was fostered by strong domestic and external demand. Household consumption was up by more than 4% and investment by as much as 14%, and the balance of net exports improved. The strong investment and external demand was also associated with a rapid increase in industrial production, which has been fluctuating between 12% and 15% in recent months. Unemployment is still the highest in the EU, but thanks to the favourable macroeconomic developments it recorded a year-on-year decrease of more than two percentage points to 15.5% in August.

Consumer price inflation in Poland has picked up a little, but remains low, standing at 1.6% in both August and September. Producer price inflation was also rising up until July, but in August it fell by 0.1 percentage point to 3.5%, thanks to the favourable oil price developments. In the opinion of the National Bank of Poland, the current price trend does not pose a threat to price stability, but is due to supply-side factors. The NBP considers that the core inflation of 1.3% in August also suggests low inflationary pressures, and so it has left its rates unchanged at 4% for seven consecutive months.

Annual economic growth in Hungary dropped by 0.8 percentage point in 2006 Q2 compared to the previous period, to 3.8%. Whereas the growth rate of household consumption saw just a moderate decline, investment expenditure decreased by almost 4% year on year, in contrast to a strong rise of 9% in Q1. Net exports conversely improved, thanks to lower domestic demand. The economic problems also showed up in a higher unemployment rate in August, which increased in both month-on-month and year-on-year comparison.

These developments in Hungary are a consequence of already adopted and planned fiscal measures aimed at implementing a public finance consolidation approved by the Hungarian Parliament this July. Not only is the "fiscal package" reducing economic growth, it is also negatively affecting prices. For these reasons, consumer price inflation rose by more than two percentage points in September, to 5.9%. The public finance situation also had a negative impact on the exchange rate of the forint, whose depreciation of more than 10% year on year in Q3 contributed to the pick-up in inflation. The MNB has reacted to price and exchange rate developments by tightening monetary policy and has increased its monetary policy rate four times since June by a total of 1.75 percentage points to 7.75%. The last rate increase – of 0.5 percentage point – took place at the end of September.

Chart III.4
In the new EU Member States, GDP growth remained high in 2006 Q2, but inflation simultaneously rose
(annual percentage changes)



The Slovak economy maintained a high rate of annual real growth of 6.3% in 2006 Q2. The increases were high in all the components of domestic demand, ranging between 6% and 8%. The contribution of net exports was higher than in the previous quarter, with exports rising by 21%. The trade deficit nevertheless remained high, with the cumulative trade deficit rising to 6% of GDP in July. Industrial production grew strongly, rising by 13% in August. The rapid economic growth fostered a year-on-year decrease in unemployment of one percentage point in August.

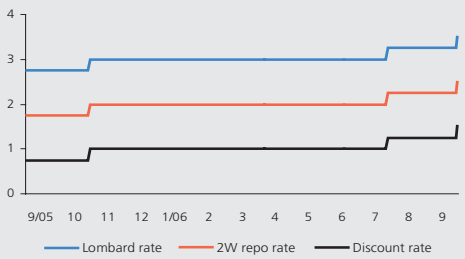
Consumer price inflation in Slovakia remains high. In September, however, after two years of increases, it fell to 4.6%. Producer price inflation decreased as well, to 8.8%. The NBS raised its key interest rate by 0.5 percentage point to 4.5% in July and by another 0.25 percentage point in September. These measures were the NBS's response to worries about high inflationary pressures stemming from both the supply and demand sides. The Bank was concerned about high realwage growth of 4%, against a background of falling unemployment and rising employment accompanied by strong growth in lending.

III.2 THE MONETARY CONDITIONS

According to the CNB's calculations, the settings of the real monetary conditions in 2006 Q3 can be characterised as roughly neutral to slightly tight. This tightness was due to the exchange rate component, whereas the effect of the interest rate component was approximately neutral.[8] The evolution of the two components of the monetary conditions in 2006 Q3 is described in more detail below.

III.2.1 Interest rates

Chart III.5
The CNB raised its key interest rates
(percentages)



Interest rates in 2006 Q3 were strongly affected by two increases in the CNB's key rates. Both cases involved a rise of 0.25 percentage point. The first monetary policy tightening took effect on 28 July. This step had been expected by most financial market participants, as reflected in banks' efforts to deposit free funds on the market at the shortest possible maturities during the week preceding the Bank Board meeting. As a result, these maturities fell significantly below the level of the current repo rate.

Market interest rates remained almost unchanged after the announcement of the monetary policy tightening; in the days that followed, by contrast, they started falling slightly, particularly at longer maturities. This was due to several factors: the accompanying commentary, which was more moderate than expected; the Bank Board's close vote (4:3); and the appreciating koruna. Market participants therefore moderated their previous expectations regarding a faster pace of monetary policy tightening by the CNB. The downward trend halted at the start of September following the publication of the data on inflation in August and GDP growth in 2006 Q2. These figures, together with a modest weakening of the koruna and concerns about the development of public finances, fostered a rise in rates. Market participants again started speculating about further interest rate increases by the CNB. This speculation was also fuelled by comments made by several Bank Board members on the current economic situation.

8 However, the current effect of monetary policy on economic activity and inflation also depends on the settings of the monetary conditions in previous quarters. The accumulated effect of the monetary conditions is assessed as easy. This accumulated easy monetary policy in turn co-determines the starting conditions of the forecast.

The CNB raised its key interest rates again at the end of September. With effect from 29 September, the 2W repo rate is 2.5%, the Lombard rate 3.5% and the discount rate 1.5%. Money market rates rose by 0.4–0.5 percentage point overall in 2006 Q3. The evolution of rates with longer maturities was mixed: those with maturities of up to two years rose, whereas those above two years decreased owing to falling rates on foreign markets. This was due to concerns regarding a weakening of economic growth. PRIBOR spot quotations and FRA forward rates at the end of September 2006 indicated that part of the financial market expects a further monetary policy tightening to occur before the end of 2006.

The PRIBOR yield curve gradually shifted to a higher yield level over its entire length. Its slope also became slightly more positive. The spread between the 1Y PRIBOR and the 2W PRIBOR was 0.66 percentage point in September. Unlike money market yield curve, the IRS yield curve recorded rate increases only at shorter maturities, whereas the longer end of the curve decreased. The slope of the curve remained positive, however. The average 5Y-1Y spread was 0.62 percentage point and the 10Y-1Y spread 0.87 percentage point in September.

The evolution of the interest rate differential on the money market (PRIBID/CZK-LIBOR/EUR, USD) was affected by changes in key rates and movements in interbank market rates. The Fed left its key O/N rate at 5.25% and the ECB raised its refinancing operations rate by 0.25 percentage point to 3% during Q3. The interest rate differential vis-à-vis euro and dollar rates was negative at all maturities.

Four auctions were held on the primary government bond market, with original maturities of 3Y–15Y and a total volume of CZK 22.8 billion. Only the first two auctions were evaluated as successful. In the remaining (September) auctions, it was evident that the bond market was under the influence of negative factors. These included concerns about public finances, persisting political uncertainty and a warning from Standard & Poor's regarding a possible downgrading of the Czech Republic's rating.

The increases in the CNB's key interest rates and the movements in financial market rates were also reflected in client interest rates. Nominal interest rates on new loans were 5.8% and rates on new time deposits 1.9% in August. Real interest rates[9] are affected not only by the level of nominal rates, but also by movements in inflation expectations. Expected consumer price indices are traditionally higher than expected industrial producer price indices. This fact is reflected in the levels of the individual real interest rates. Real rates on new loans were 4.5% in August, while real rates on time deposits were -1.2%.

III.2.2 The exchange rate

The average exchange rate of the koruna against the euro was CZK 28.3/EUR in 2006 Q3, which represents a year-on-year appreciation of 4.5% (and a modest quarter-on-quarter appreciation of 0.4%). The appreciation trend visible since 2004 Q2 peaked in the first half of August at CZK 28.0/EUR; the koruna then depreciated to CZK 28.5 EUR, however. This correction was probably due to a combination of fundamental factors (increasing demand for foreign currency associated with dividend payments to non-residents, and the less favourable trade balance) and negative expectations (the worse evolution of public finances, the debate on the

9 Ex ante real interest rates: nominal interest rates on loans are deflated by the industrial producer price indices forecasted 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.

CHART III.6
Market interest rates mostly rose in 2006 Q3
(v %)

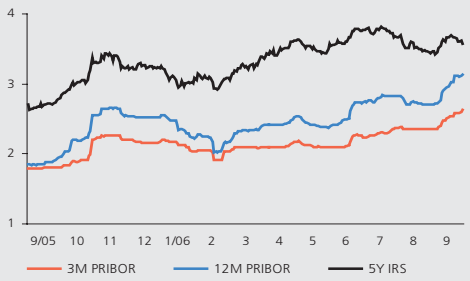


CHART III.7
The interest rate differentials of the koruna vis-à-vis the euro and the dollar fluctuated in negative values
(percentage points)

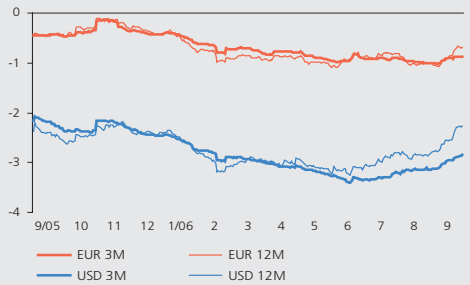


CHART III.8
Ex ante real interest rates on new loans increased slightly
(percentages)

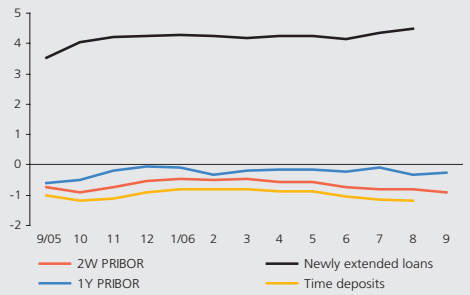
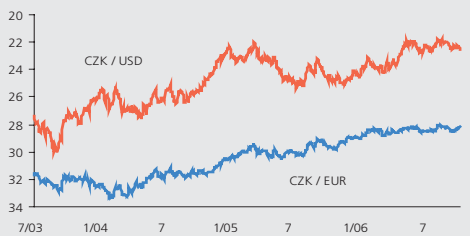


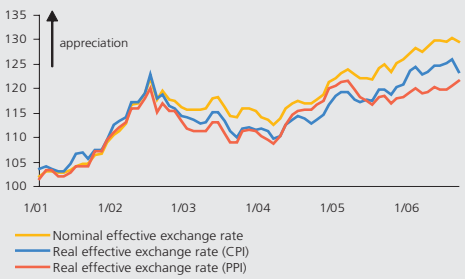
CHART III.9
The koruna's appreciation against the euro and the dollar moderated in 2006 Q3



possible downgrading of the Czech Republic's rating outlook and the increasing political instability in the region). At the end of September, after the CNB had raised its monetary policy rates, the koruna again started to appreciate slightly.

In 2006 Q3, the average exchange rate of the koruna against the dollar was CZK 22.2/USD, which represents a year-on-year appreciation of 8.6% (and a quarter-on-quarter appreciation of 0.2%). The dollar was relatively stable on world markets in 2006 Q3 (fluctuating between USD 1.26 and 1.29/EUR almost all of the time). The dollar exchange rate was affected by the halt to the increases of monetary policy rates in the USA, the signs of a modest slowdown in US economic growth and by a slight pick-up in economic growth in the euro area. Overall, however, these factors did not deflect the exchange rate outside the aforementioned range. The koruna-dollar exchange rate thus primarily reflected domestic effects. As it did against the euro, the koruna appreciated to CZK 21.75/USD in July and in the first half of August, then depreciated gradually to CZK 22.5/USD and, following the rate increase in the Czech Republic, appreciated slightly again to CZK 22.3/USD at the end of September.

Chart III.10
The year-on-year appreciation of the nominal effective exchange rate slackened in 2006 Q3
(Year 2000 = 100)



The nominal effective exchange rate of the koruna strengthened by 3.6% year on year in 2006 Q3. Compared to the previous quarter, the appreciation slackened by around 2 percentage points. This more modest appreciation was chiefly due to the koruna's depreciation against the euro and the US dollar in August and September. Owing to the evolution of the koruna's nominal exchange rate, the year-on-year appreciation of the real effective exchange rate deflated by the CPI moderated slightly as well (to 3.0%). The slowest pace of year-on-year appreciation was recorded by the real effective exchange rate deflated by the PPI (2.6%).

III.3 THE BALANCE OF PAYMENTS

III.3.1 The current account

Table III.1
The current account deficit increased significantly, due to a deterioration in all its items
(CZK billions)

	I-II/03	I-II/04	I-II/05	I-II/06
A. Current account	-45.0	-58.1	-10.5	-47.8
Trade balance	-17.8	-7.1	40.7	37.2
Balance of services	7.5	8.1	10.6	4.3
Income balance	-40.2	-62.2	-76.9	-85.9
Current transfers	5.5	3.2	15.1	-3.4
B. Capital account	-0.1	0.9	2.8	1.1
C. Financial account	56.8	52.4	93.1	21.2
Direct investment	51.5	54.0	166.6	42.5
Portfolio investment	-39.0	64.1	-20.5	-40.8
Financial derivatives	2.9	3.9	0.7	0.6
Other investment	41.4	-69.6	-53.8	18.9
D. Errors and omissions	-2.0	10.5	1.6	25.1
Change in reserves (- = increase in reserves)	-9.7	-5.7	-86.9	0.4

In 2006 H1, the current account showed a deficit of CZK 47.8 billion (i.e. 3.1% of GDP). In year-on-year terms this meant quite a significant rise in deficit (of CZK 37.3 billion). This increase was due to a deterioration in all its items, but particularly current transfers and income. The current account deficit consisted chiefly of the income deficit reflecting mainly the balance of reinvested direct investment earnings. The current transfers deficit also contributed to a small extent.

The trade surplus amounted to CZK 37.2 billion in 2006 H1, which represents a year-on-year decrease in surplus of CZK 3.5 billion. The main reason for a halt in the trend of year-on-year improvement in the trade balance observed for several years was a sharp year-on-year rise in prices of raw materials on world markets, most notably oil, natural gas and non-ferrous metals. To a lesser extent, and particularly in Q2, the trade balance was adversely affected by increasing domestic demand. Exports grew by 12.9% and imports by 13.8% year on year in the first half of 2006. The terms of trade deteriorated by 4%. Export prices fell by 2% year on year, owing mainly to the koruna's year-on-year appreciation against the euro. By contrast, import prices increased by 2%, mostly due to rising prices of raw materials.

The trade balance improvement was again due to favourable developments in the SITC 7 category (machinery and transport equipment). The surplus in this category increased by CZK 37.6 billion year on year, thanks mainly to a rise in the surplus on road vehicles. This effect was, however, moderated by a further year-on-year widening (of CZK 26.8 billion) of the deficit on SITC 3 (mineral fuels). (More than 80% of this was due to year-on-year growth in oil and natural gas prices, while

the rest was due to an increase in the physical volume of imports.) In addition to prices of energy-producing materials, the trade balance was affected by rising prices of non-ferrous metals (with a total effect of CZK 7.5 billion). From the geographical perspective, the trade surplus with the EU continued to increase – by CZK 22.7 billion year on year to CZK 167.0 billion. By contrast, the trade balance with China deteriorated by CZK 13.9 billion to CZK 49.3 billion and that with Russia by CZK 12.9 billion to CZK 45.6 billion.

In 2006 H1, the balance of services showed a modest surplus of CZK 4.3 billion. In year-on-year comparison, however, the surplus decreased by CZK 6.3 billion. The year-on-year decrease in the services surplus was affected most strongly by a decline in receipts from direct investment services provided by corporations (the substantial rise in receipts recorded in 2005 seems to have been a one-off phenomenon). A small year-on-year deterioration was also recorded for receipts from air and railway transport.

The income balance ended in a deficit of CZK 85.9 billion, which represents an annual deterioration of CZK 9.0 billion. However, this deterioration was chiefly due to estimated reinvested direct investment earnings of CZK 51.6 billion, which were up by CZK 12.5 billion year on year. In addition, non-residents' dividends from direct investment increased. The rise in the total income deficit was counteracted by faster growth of the surplus on income on other investment, in particular income on the CNB's foreign exchange reserves and interest income of commercial banks on foreign deposits.

Current transfers recorded a modest deficit of CZK 3.4 billion, deteriorating by CZK 15.1 billion year on year. The year-on-year deterioration on current transfers was largely due to base effects connected with a one-off transaction relating to damages paid to ČSOB by Slovakia (CZK 12.6 billion). Another, less significant, factor was a year-on-year decline in direct compensation from the EU budget to the state budget (a change in the structure of revenues from the EU to the benefit of the capital account).

CHART III.11
The annual moving total of the trade surplus decreased in 2006 Q2
(CZK billions)

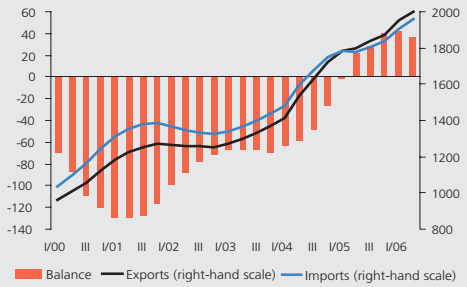
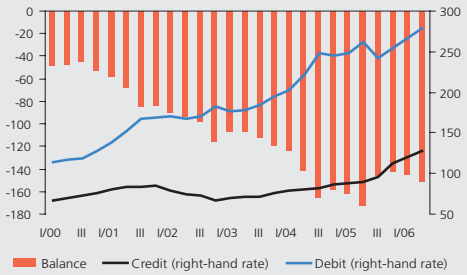


CHART III.12
The annual moving total of the income deficit increased in 2006 Q2
(CZK billions)



III.3.2 The capital account

The capital account recorded a surplus of CZK 1.1 billion in 2006 H1. The year-on-year decline in surplus of CZK 1.7 billion was due to the inclusion of only an accounting write-off of a claim against Iraq under expenditure. Annual growth in revenues totalled CZK 3.0 billion and was associated primarily with income from EU funds and emission allowance trading.

III.3.3 The financial account

In 2006 H1, the financial account showed a surplus of CZK 21.2 billion, or 1.4% of GDP (compared to a surplus of CZK 93.1 billion in the same period of 2005). The surplus was mainly due to direct investment and, to a lesser extent, to borrowing by the business sector. The main reason for the substantial annual decrease in the financial account surplus was a moderation of the net inflow of direct investment, resulting from an absence of major sales of assets to non-residents this year. To a lesser extent it was also due to a rise in residents' interest in investing abroad and to a year-on-year decrease in the volume of government bonds issued abroad. By contrast, a decrease in the financial account surplus was counteracted by a significant slowdown in the outflow of non-residents' capital from domestic equity securities, higher short-term borrowing abroad by the domestic corporate sector and a halt to the outflow of capital via the banking sector.

Chart III.13
Firms registered in Cyprus were the largest foreign investors in the Czech Republic in 2006 H1

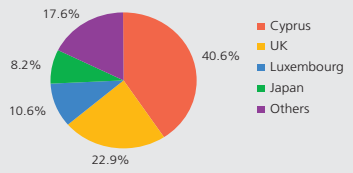


Chart III.14
The net portfolio investment outflow increased in 2006 Q2
(CZK billions)

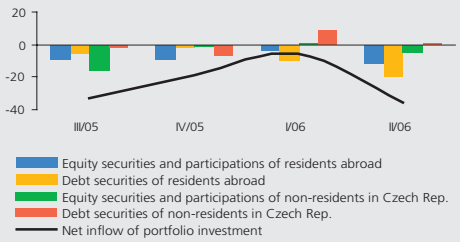


Chart III.15
The CNB's international reserves increased in dollar terms in 2006 Q3
(USD billions)

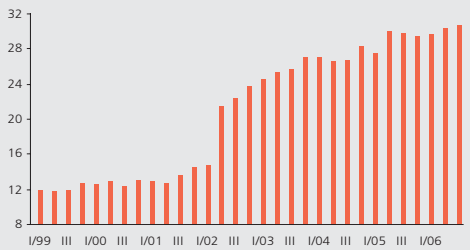


Chart III.16
M2 growth picked up again after slowing in 2006 Q2
(annual percentage changes)

Direct investment ended in a surplus of CZK 42.5 billion, down by CZK 124.1 billion from a year earlier. The total FDI inflow amounted to CZK 62.5 billion and was CZK 106.3 billion lower than a year earlier. The largest item was reinvested earnings of non-residents (CZK 57 billion), whose estimated volume increased year on year. The moderation of the overall inflow was chiefly due to base effects relating to large sales of assets to non-residents last year amounting to about CZK 110 billion (Telecom, Nova, Unipetrol) and, to a lesser extent, to a one-off decrease in investment in equity capital owing to an accounting operation decreasing the equity capital of a major foreign-owned corporation in the Czech Republic. Adjusted for these effects, the inflow of foreign capital remained roughly at last year's level (i.e. about CZK 17 billion). With regard to industries, the foreign capital inflows were channelled primarily into manufacturing (particularly of motor vehicles), real estate and wholesale and retail trade. By territory, the biggest investors were firms registered in Cyprus, the United Kingdom, Luxembourg and Japan. Czech direct investment abroad showed pronounced year-on-year growth, mainly thanks to acquisitions by ČEZ and the estimated rise in reinvested earnings, and amounted to CZK 20.0 billion (compared to an outflow of CZK 2.2 billion in the same period of 2005).

The net outflow of portfolio investment in 2006 H1 was CZK 40.8 billion (compared to CZK 20.5 billion in the same period of 2005). The year-on-year rise in the overall deficit was due predominantly to a year-on-year decrease in government bond issuance on foreign markets, from CZK 30 billion to CZK 6 billion. The outflow of portfolio investment was virtually unchanged in year-on-year terms, amounting to CZK 46.3 billion. On the inflow side (CZK 5.5 billion), there was a marked decline in debt capital inflow, mainly due to the aforementioned lower government bond issuance on the foreign market. The rest of the annual decline can probably be attributed to a widening of the negative interest rate differential of the koruna vis-à-vis the major world currencies. The overall net outflow of debt capital adjusted for the aforementioned government bond issues increased only marginally (by about CZK 4 billion), despite the sizeable widening of the negative interest rate differential. The portfolio investment balance was, however, also greatly affected in year-on-year terms by a considerable moderation of the outflow of foreign capital from the domestic stock market.

Financial derivatives generated a CZK 0.6 billion rise in the financial account surplus. Their turnover was low compared to the other financial account items.

Other investment recorded a net capital inflow of CZK 18.8 billion (compared to an outflow of CZK 53.8 billion in the same period of 2005). The year-on-year change of more than CZK 70 billion was largely due to an almost complete halt in capital outflow via the banking sector and, to a lesser extent, to an increase in the volume of borrowing by the corporate sector. In 2006 H1, the net capital outflow via the banking sector was only CZK 1.3 billion. Apart from the banking sector, the capital outflow was due to a decline in the volume of European Commission funds deposited on accounts with the CNB (of CZK 5.7 billion). The net capital inflow in 2006 H1 was mostly a result of borrowing abroad by the corporate sector (CZK 16.9 billion). This consisted mostly of short-term import credits. To a smaller extent, the total capital inflow under other investment was affected by drawing on foreign funds by the government sector (CZK 8.9 billion). In year-on-year terms, however, drawing on foreign funds declined by around one-half, owing to a decrease in the volume of de-blocking operations (the completion of repayment of Russian debt) and in particular to reduced borrowing from the EIB.

The CNB's international reserves rose by CZK 4.2 billion to CZK 685.8 billion in 2006 Q3. This was mostly due to exchange rate differences. In dollar terms, the reserves rose by USD 0.3 billion to USD 30.7 billion in the same period.

III.4 MONETARY DEVELOPMENTS

Money supply growth picked up again in July and August after slowing slightly in 2006 Q2. The relatively low level of nominal interest rates continued to encourage demand by economic agents for liquid money. The favourable financing conditions were reflected in a further rise in growth in lending to corporations and households. The buoyant growth in long-term loans to corporations was in line with the positive expectations regarding fixed investment. Household indebtedness to MFIs was still affected chiefly by housing loans.

III.4.1 Money

Following a modest decline in Q2, annual M2 growth rose in July and August to 9.3% (see Chart III.16). The annual rate of growth of M2 adjusted for exchange rate movements and other non-transaction effects followed a similar pattern and was 9.9% in August. The growth rate of M2 was consistent with GDP growth at current prices (see Chart III.17).

M1 remained the main contributor to M2 growth, rising by 16% year on year (see Table III.2). Overnight deposits grew the fastest and a slight increase in growth was also recorded for currency in circulation. Growth in quasi money slowed in Q2 and then rose to 1.6% in August. Deposits with agreed maturity followed a similar trend. Within quasi money, growth was recorded for deposits redeemable at notice, thanks to better interest rates than on other deposit products. The July increase in the key monetary policy interest rate fed through to almost all rates on deposit products in August, the increase being greater for corporations than for households. In the case of households, this increase was not reflected in the interest rate on overnight deposits. After rising in Q2 the share of M1 in M2 stayed at 56.8% in August. It thus continued to point to the effect of the relatively low interest rate level, which implied low opportunity costs of holding highly liquid money.

Turning to the sector structure of deposits, the main contribution to M2 growth came from household deposits. The growth rate of deposits of non-financial corporations slowed in Q2 and then picked up again in July and August to just under the March level (see Chart III.18). Koruna deposits continued to be dominant. The share of foreign currency deposits in total deposits increased slightly in Q2 and then stabilised at 10.3%.

The lower annual rate of growth of M2 in Q2 adjusted for exchange rate and other non-transaction effects was due to a decline in net external assets growth. Net external assets were affected by an extraordinary transaction last year, when the sale of assets to non-residents (Český Telecom in particular) led to a step increase in net external assets in June 2005. In terms of its effect on the money supply this transaction was offset by a decline in net credit to the government. Its negative annual rate of growth decreased further, among other things due to the financing of the state budget deficit, and for the first time in two years it thus moved into positive figures in August. The money supply growth in the period under review reflected most strongly a rise in lending to corporations and households. The significance of the individual components in money supply growth is illustrated using annual flows in Chart III.19.

Chart III.17
Money supply growth in 2006 Q2 was in line with GDP growth
(annual percentage changes)

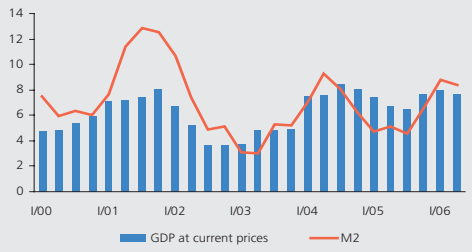


Table III.2
M1 continued to account for much of the money growth
(quarterly averages and end-of-month stocks; annual percentage changes)

	IV/05	I/06	II/06	7/06	8/06	Share in M2, % 8/06
M1	11.1	13.4	14.6	17.3	16.0	56.8
Currency in circulation	10.3	10.0	10.4	10.3	11.7	13.4
Overnight deposits	11.4	14.5	16.1	19.6	17.4	43.4
M2-M1 (quasi money)	1.7	3.7	1.5	-1.0	1.6	43.2
Deposits with agreed maturity	-1.2	-0.2	-3.2	-6.8	-3.7	31.2
Deposits redeemable at notice	11.5	12.7	15.1	17.1	20.3	11.4
Repurchase agreements	11.6	123.0	66.5	51.7	-4.8	0.6
M2	6.6	8.8	8.4	8.6	9.3	100.0

Chart III.18
The main contribution to money supply growth came from household deposits, although growth in deposits of non-financial corporations increased again in July and August
(annual percentage changes)

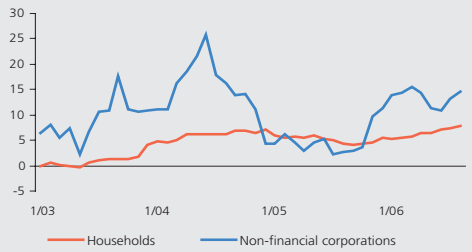


Chart III.19
M2 growth reflected a further rise in lending to corporations and households
(annual flows, CZK billions)

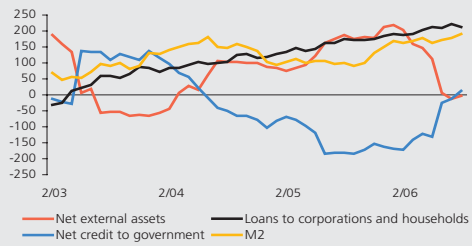


Chart 1 (Box)
The monetary overhang
(percentages)

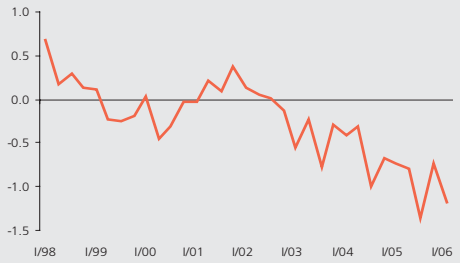


Chart 2 (Box)
The nominal money gap
(percentages)

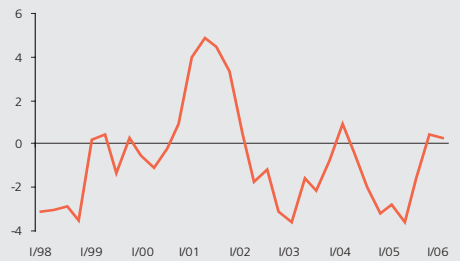


Chart 3 (Box)
The real money gap
(percentages)

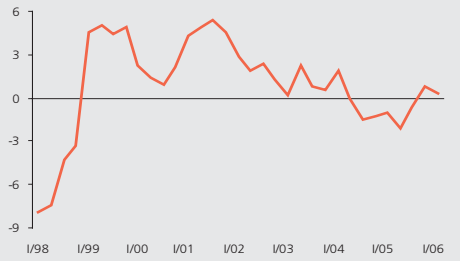


Table III.3
Long-term loans to corporations and loans to households rose the fastest
(quarterly averages and end-of-month stocks; annual percentage changes)

	IV/05	I/06	II/06	7/06	8/06	Share in total loans, % 8/06
Non-financial corporations	12.3	14.3	16.2	18.3	15.8	49.4
Loans up to 1 year	10.1	11.9	13.2	10.6	9.5	18.8
Loans over 1 year and up to 5 years	13.8	10.1	9.1	20.0	15.7	12.5
Loans over 5 years	13.9	20.4	25.4	26.6	23.3	18.1
Households	33.0	33.4	32.4	32.5	32.1	40.5
Consumer credit	31.5	32.7	28.5	28.4	27.1	8.3
Loans for house purchase	35.0	35.0	34.2	34.1	33.7	27.8
Other loans	24.2	25.3	28.8	30.6	31.9	4.4
Non-monetary financial institutions	10.2	6.2	5.5	3.2	2.9	10.1
Total loans	19.1	20.1	20.7	21.7	20.3	100.0

BOX
The role of monetary aggregates in the CNB's forecasts

Monetary aggregates do not enter the CNB forecast directly. The reason for this is that under inflation targeting, where the central bank controls interest rates and withdraws excess liquidity from the money market, the money supply merely reflects economic growth, monetary policy measures and the expectations of economic agents. Nonetheless, monetary aggregates can be used as an auxiliary indicator for verifying the forecast if they contain information on the present or future development of the economy. The CNB therefore analyses, along with numerous other economic indicators, the development of monetary aggregates. This Box summarises the analysis of the information content of the monetary aggregates using the "monetary overhang" and the nominal and real "money gap". These concepts are routinely used by the ECB to analyse monetary aggregates.

The monetary overhang is defined as the percentage deviation of the actual money supply level from the level corresponding to the current position of the economy in the cycle and other fundamentals. It is calculated based on the standard estimate of money demand. The nominal money gap is defined as the percentage deviation of the actual M2 stock from the level it would reach if it grew at the rate reflecting the potential of the economy and the inflation target. The real money gap is defined as the nominal money gap "adjusted" for the difference between CPI inflation and the inflation target. The money gap concept differs from the monetary overhang in that in the case of the latter we analyse the extent to which M2 growth is in line with the actual development of the economy, whereas in the case of the former we investigate the extent to which M2 growth is in line with the long-term equilibrium trends in the economy.

Charts 1, 2 and 3 of this Box present the resulting estimates of the monetary overhang and the money gap. These indicators are not currently positive, hence they are not signalling any inflation risks in the medium term. The resulting monetary indicators can also be statistically tested as an indicator of future CPI inflation. The analyses conducted reveal that these indicators do not have a significant information content in the Czech Republic as regards forecasting inflation at the monetary policy horizon.

Monetary indicators are not used to predict inflation in the CNB's forecasting system; they are used indirectly as one of the coincident and leading indicators of economic activity.

III.4.2 Credit

The relatively strong growth in loans to corporations and households continued in Q2 and into July and August (see Table III.3). Loans to households again accounted for more than half of the growth in loans. The contribution of loans to corporations increased further in Q2. In August, however, it slowed again approximately to the level recorded at the start of the year. The ratio of loans to GDP rose by a further 1.3 percentage point to 37.3% in Q2. By international comparison, the ratio is above the average for Central and Eastern Europe, which is around 32%, but well below the euro area average of around 106%. Koruna loans continued to dominate the loan structure. Debt in foreign currencies is relatively low due to the negative koruna-euro interest rate differential. The share of foreign currency loans

in total loans was 9.9% in August (of which non-financial corporations accounted for 8.9 percentage points, households for 0.1 percentage point and financial institutions for 0.9 percentage point).

Loans to non-financial corporations increased further over the period under review, their annual rate of growth reaching 15.8% in August. Long-term loans rose the fastest, in line with the expected further growth in fixed investment this year. The increase in loans was driven mainly by loans to the machinery and equipment rental sector, manufacturing, trade, sales, repair and maintenance, financial intermediation (except insurance and pension schemes) and transport and storage. The relatively rapid growth in loans to non-financial corporations is linked with the favourable trend in economic activity, the low level of interest rates and the favourable lending attitude of MFIs. The performance of corporations over the last few quarters has been a positive factor. These developments are also affecting the spread between the interest rate on new loans to corporations and the money market interest rate with corresponding maturity, which has been falling since last year.

Corporations borrowed at home and abroad (see Chart III.20). However, the net annual flow of foreign loans remained at only around one-third of that of domestic loans. Within foreign loans, growth in trade credits was particularly strong at 26.1% owing to the pick-up in foreign trade. The rate of growth of foreign financial loans increased by 2.3% but remained low due to the negative interest rate differential of the koruna vis-à-vis the euro.

Annual growth in loans to households slowed on average in Q2, but remained high at around 32%. As regards the structure of MFI loans, housing loans account for roughly two-thirds of the total (see Chart III.21). At 50.4%, mortgage loans remain the fastest growing category. Following a decline last year, the rate of growth of building society loans has picked up since the start of 2006. The buoyant growth in loans for house purchase is due to the favourable interest rates, the supply of such loans and the expected increase in VAT on housing-related construction work (from 5% to 19%) in 2008. 96% of loans for house purchase are long-term and 63% have a long interest rate fixation (of which: 29.1% over 1 year and up to 5 years, 7.5% over 5 years and up to 10 years and 26.4% over 10 years). However, loans for house purchase with short fixations have been recording the strongest growth since last year. In general, this is increasing the sensitivity of households' balance sheets to any future interest rate changes. On the other hand, around 62% of loans in 2005 were obtained by households in the two highest income categories (see the box *Implications of household debt for consumption* in the April 2006 Inflation Report and the assessment of the debt burden in the July 2006 Inflation Report). Housing loans thus remain the least risky loan category.

Consumer credit accounts for roughly one-third of household indebtedness. Its annual rate of growth was 27.1% in August. Unlike in the previous quarters, it was flat in Q2. This was true both for bank overdrafts (connected usually with debit balances on current accounts and with credit cards) and traditional consumer credit. Generally speaking, loans to finance consumption are drawn mainly by lower income households, which also have the highest ratio of principal repayments to net money income (around 4%). Compared to loans for house purchase, consumer credit includes more loans with short-term maturities of up to one year (27.3%, including loans from other financial intermediaries). Roughly 88% of consumer credit is provided with a floating interest rate or a fixation of up to one year, which also increases the sensitivity of households' balance sheets to future interest rate changes, especially at a time of potential gradual growth in interest rates. However, loans with longer fixations have been recording the strongest growth since the start of 2005.

The growth in lending was reflected in a further increase in the ratio of total household debt to GDP, from 17.6% in Q1 to 18.5% in Q2. The debt ratio rose for

Chart III.20
Corporations borrowed at home and abroad
(net annual flows; CZK billions)

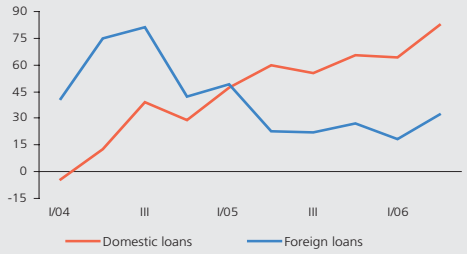


Chart III.21
Total household debt reached almost CZK 600 billion
(outstanding amounts; CZK billions)

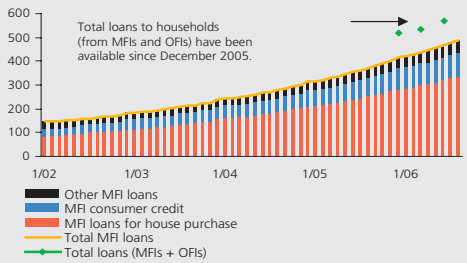


Chart III.22
Interest rates on new loans for house purchase mostly increased
(percentages)

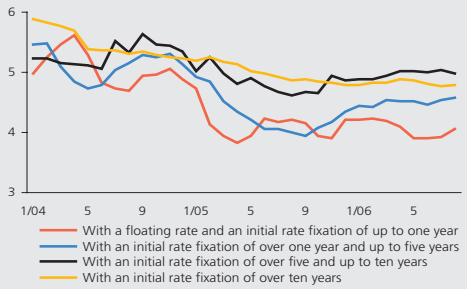
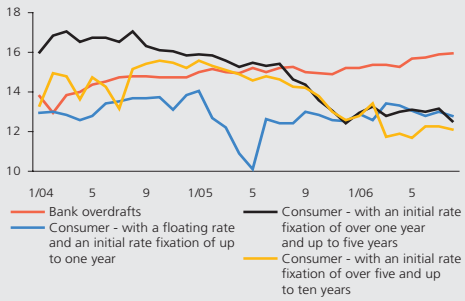


Chart III.23
Interest rates on new consumer credit fell slightly, while the rate on overdrafts continued rising steadily
(percentages)

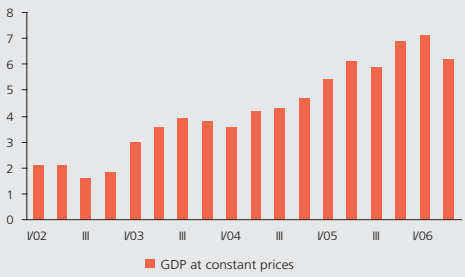


MFI loans in particular (from 14.4% in Q1 to 15.2% in Q2); the rest was due to loans from other financial intermediaries, i.e. hire-purchase and financial leasing companies. In the euro area, the ratio of total household debt to GDP is 58.5%.

The overall interest rate on new loans to non-financial corporations and households was flat in Q2, but rose by 0.2 percentage point in July and August to 5.8%. This increase, which partly reflected the increase in the repo rate in July, affected most short-term interest rates except those on consumer credit and bank overdrafts of non-financial corporations. The short-term interest rate on consumer credit rose modestly in July, but fell back slightly in August. Long-term interest rates increased in Q2, but were flat or falling thereafter, similarly to financial market interest rates with corresponding maturities. Looking at the longer term, an increase in the interest rate on bank overdrafts of households is particularly visible. This could be connected with the rising propensity of clients to repay credit card credit only after a relatively high penalty interest rate starts to apply.

III.5 DEMAND AND OUTPUT

Chart III.24
The rapid economic growth continued into 2006 Q2
(annual percentage changes)



The rapid economic growth continued into 2006 Q2, exceeding 6% for the fifth consecutive quarter. However, its annual rate of growth fell back from the highest level ever recorded in the Czech Republic, i.e. 7.1% in Q1, to 6.2% in Q2. By the CNB's estimation, the economy has been slightly exceeding the potential, non-accelerating inflation level of output since 2005 Q4.

The main demand-side factor underlying the rapid GDP growth was a sizeable increase in gross capital formation, driven by fixed investment and inventories. The contribution of inventories to GDP growth was dominant in 2006 Q2, but that of fixed investment was also significant. Despite being slower than in 2006 Q1, annual fixed investment growth was in line with the current phase of the business cycle and was supported in large measure by foreign capital inflow and the easy monetary policy in the recent past. Household consumption growth increased very slightly year on year. Its contribution to GDP growth was higher than that of fixed investment. By contrast with Q1, the contribution of foreign trade was slightly negative and thus did not support economic growth. This was due to a more pronounced decline in export growth than import growth, which resulted in a moderate deterioration of net exports.[10] Nevertheless, real exports increased rapidly, indicating an ongoing strong export performance of the Czech economy. Government expenditure on final consumption also fell, thus failing to support GDP growth in Q2.

As a result of ongoing structural changes on the supply side of the economy, manufacturing was the largest contributor to GDP growth. The contribution of services was less significant in Q2. Agriculture did not support GDP growth and the positive contribution of construction was negligible.

Table III.4
Growth in final consumption expenditure slowed in 2006 Q2
(annual percentage changes; CZK billions)

	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2
Gross domestic product	5.4	6.1	5.9	6.9	7.1	6.2
Final consumption expenditure	0.8	1.9	3.1	1.4	2.8	1.6
of which:						
Household consumption	1.8	2.5	2.7	2.4	3.7	3.8
Government consumption	-1.4	0.8	4.5	-1.0	0.8	-3.4
Non-profit institutions serving households	1.0	-1.5	-4.1	4.6	1.2	1.6
Gross capital formation a)	1.9	0.6	1.9	7.3	12.4	17.8
Gross fixed capital formation	2.3	3.8	3.8	4.4	6.8	5.3
Net exports of goods and services (CZK billions)	-2.3	-7.6	-16.1	-19.2	8.2	-8.8
Imports of goods and services	10.1	-0.3	6.3	4.8	15.5	10.2
Exports of goods and services	16.5	5.9	10.9	10.1	17.6	10.2

a) Gross fixed capital formation, change in inventories and net acquisition of valuables.

III.5.1 Domestic demand

Growth in final consumption expenditure slowed in 2006 Q2. At 1.6%, it was down by 1.2 percentage points from Q1. As in Q1, it was affected mostly by an annual rise in households' consumption expenditure (of 3.8%). Government

10 In 2006 Q2, net exports turned negative (CZK -8.8 billion). The negative balance was wider than in the same period a year earlier (CZK -7.6 billion).

expenditure fell year on year and the rise in expenditure by non-profit institutions was insignificant. However, a large rise in gross capital formation of 17.8% year on year was the main factor underlying domestic demand growth. Within gross capital formation, additions to inventories grew fastest, mainly as a result of a sharp rise in the volume of work-in-progress in some construction projects and an increase in stocks of goods for resale. Expenditure on gross fixed capital formation rose by 5.3%.

Consumer demand

The gradual increase in consumer demand growth visible since 2005 Q4 continued into 2006 Q2. Compared to 2006 Q1, annual growth in household final consumption expenditure picked up by 0.1 percentage point to 3.8% in Q2. This was in line with the results of a CZSO survey, which indicated that consumer confidence had been strong since the start of the year. The monthly average of the consumer confidence indicator reached a historical high in Q2.

Gross disposable income remained the main source of financing of household final consumption expenditure in 2006 Q2. Compared to 2006 Q1, however, its rate of growth declined to 6.1% in nominal terms. In real terms it fell to the lowest level recorded in the past year (3.3%), owing to higher inflation. The increase in household disposable income was due mainly to income from wages and salaries, the growth rate of which reached its highest level since the beginning of the time series in 2003 (8.3%). Growth in other household income components picked up as well. Only growth in income from social benefits moderated (to 6.7%). The slowdown in disposable income growth in Q2 was due chiefly to a pronounced annual increase in the growth rate of current expenditure[11] compared to the previous quarter (of 4.5 percentage points to 7.6%). Interest expenditure rose the fastest (by 30.7%), indicating increasing expenditure on loans drawn.

Households' disposable income grew more slowly than their consumption expenditure in Q2, but households had other sources of financing of consumption expenditure available, thanks to a reduction of the tax burden on natural persons.[12] Households' consumption expenditure was therefore accompanied by lower saving from income than in the previous quarter. This suggested that the aforementioned additional funds covered only a part of the funds needed to finance the increase in consumption expenditure of 3.8%. Under these circumstances, the saving rate declined year on year to 6.5%. Given the relatively low interest rates, households also borrowed to finance their consumption expenditure. The rate of growth of borrowing fell somewhat in Q2, but remained relatively high (see section III.4 *Monetary developments*).

Investment demand

Growth in fixed investment slackened in 2006 Q2. However, the annual rate of growth of gross fixed capital formation (5.3%) indicated continuing dynamic investment activity in the economy. At 25.5%, the ratio of fixed investment to GDP remained relatively high.

CHART III.25
Consumer demand growth picked up slightly in 2006 Q2
(annual percentage changes)

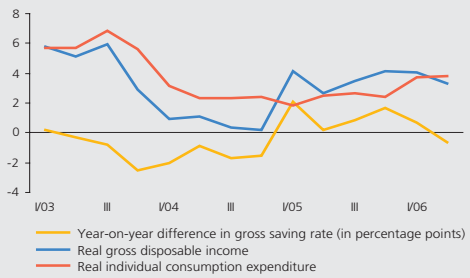


CHART III.26
The consumer confidence indicator reached historical highs in 2006 Q2
(2005 average = 100)

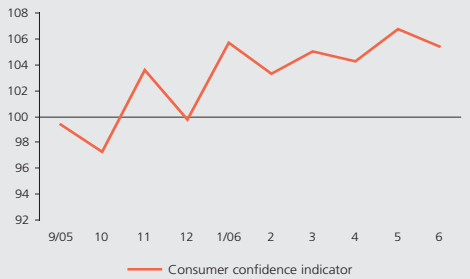
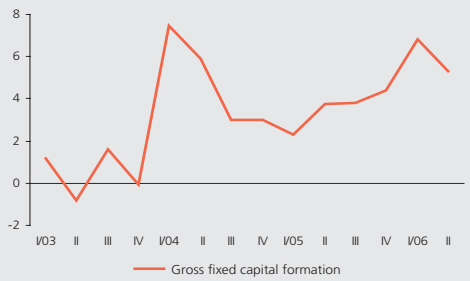


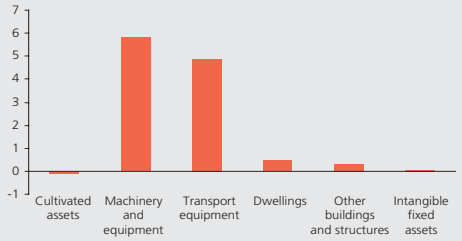
CHART III.27
Growth in fixed investment slackened in 2006 Q2
(annual percentage changes; constant prices)



11 Gross disposable income = current income (compensation of employees, gross operating surplus and mixed income, social benefits and other current transfers) – current expenditure (current income taxes, property taxes, other taxes, social contributions, other current transfers and property income, i.e. interest and rent).

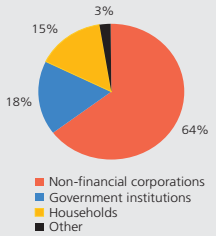
12 The tax burden on natural persons fell owing to the introduction of joint taxation of married couples and an increase in the flat-rate expenditure allowance for self-employed persons.

Chart III.28
Technological investment was the biggest contributor to investment growth in 2006 Q2
(annual changes in CZK billions; constant prices)



In Q2, annual investment growth continued to be driven mainly by technological investment, which is the main component of total investment (about 55%).[13] This investment went mainly into machinery and equipment. As shown in Chart III.28, the contribution of investment in transport equipment was also relatively significant. The rapid annual growth of these two categories, which slowed only moderately in Q2 (to 8.4% and 15.5% respectively), was linked chiefly with the acquisition of machinery and equipment for large investment projects. The contribution of construction investment to the overall increase in total investment in Q2 was lower than that of technological investment, although construction output rebounded in May following a long winter. However, this rebound has so far resulted only in a modest annual increase in investment other buildings and structures of 0.5%, while growth in investment in dwellings recorded a marked slowdown to 2.6%. Under these circumstances, the share of technological investment in total investment rose further in Q2, which was also linked with developments in investment demand across the individual sectors.

Chart III.29
The largest investment volumes were in the non-financial corporations sector
(percentages; current prices; 2006 Q2)

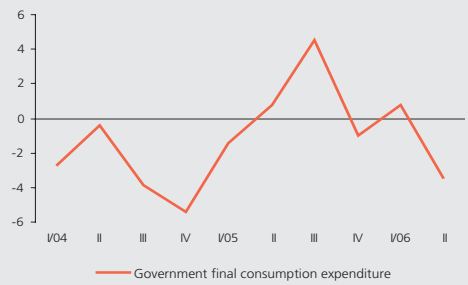


According to partial indicators,[14] investment by non-financial corporations, which went mainly into the purchase of transport equipment and machinery and equipment, probably accounted for most of the increase in total investment in Q2. The dominant share of foreign-owned corporations in total investment by large corporations,[15] especially in machinery and equipment, also indicated a close link between technological investment and foreign direct investment. According to partial indicators, especially data on the acquisition of intangible fixed assets, small and medium-sized enterprises with 20 to 99 employees also contributed to investment growth in Q2 in the national private corporations segment. Investment demand in this segment was aided chiefly by the relatively low level of interest rates as well as by current and future demand.

Households' investment in dwellings also continued to grow in 2006 Q2, albeit at a slower pace than in the previous quarter (2.6% year on year). However, a sizeable increase in housing starts (22.6% year on year) signalled that construction companies and developers expect growing investment in housing by households in the period to come. This expectation seems to be based on the continuing favourable conditions for obtaining mortgages and building society loans, including the low interest rates, the expected increase in VAT on housing construction as from 1 January 2008 and the recently approved housing support for young married couples. Only in the government sector did capital expenditure indicate flat investment financed from public sources. This suggested a continuing decline in the government sector's share in gross capital formation in the current phase of high economic growth.

Government demand

Chart III.30
Government final consumption expenditure declined more sharply in 2006 Q2
(annual percentage changes)



Following a moderate annual increase of 0.8% in 2006 Q1, general government expenditure on final consumption declined in Q2 (by 3.4% year on year). This change was due mainly to base effects.[16] At current prices, final government consumption rose by 1.2% year on year.[17] The largest component of government sector finances is the state budget. According to data for 2006 Q2, the state budget ended in a deficit of CZK 8.1 billion, a deterioration of CZK 3.6 billion

13 At constant 2000 prices.
14 The CZSO only publishes data on the latest developments in investment structure by kind, and not by economic sector.
15 Corporations with 100 employees or more.
16 In 2005 Q2, government consumption included acquisition of military hardware of CZK 4.4 billion.
17 This figure and the figures below in the section *Government demand* are in nominal terms.

compared to the same period a year earlier. This was due to faster annual growth in expenditure (7.6%) than in revenue (6.1%).

Budget revenue was affected by recent and expected changes to tax rates, which had mixed effects on tax collection across the main revenue categories. Collection of excise duties rose sharply owing to extensive forward buying by producers and consumers in anticipation of an increase in excise duty on tobacco products (by almost 35% year on year), whereas collection of direct taxes declined. Collection of corporate income tax also decreased by almost 3%. Collection of personal income tax recorded a significant decline of 15.8%, due chiefly to the overpayment refunds of tax advances in Q2, related to the recently introduced joint taxation of married couples and higher flat-rate expenditure allowances for self-employed persons. On the other hand, the increased inflow of EU funds and high transfers from 2005 reserve funds continued into Q2.

In 2006 Q2, growth in state budget expenditure was particularly affected by rapidly rising transfers to social security and health insurance funds. A second extraordinary advance payment of CZK 2.5 billion was made to health insurance company Všeobecná zdravotní pojišťovna in April. This payment will be offset by reduced payments to this company in the second half of the year. The increase in expenditure on social and health insurance also partly reflected a rise in the assessment base for insurance paid on behalf of persons insured by the state. At almost 20% year on year, growth in debt service costs was also above average. However, this expenditure does not directly affect government demand. By contrast, public employee wage expenditure has a direct impact on demand. Its rate of growth decreased to 4.2% year on year in Q2. An analysis of the state budget developments in 2006 Q2 reveals that general government expenditure did not exert upward pressure on demand in the Czech economy.

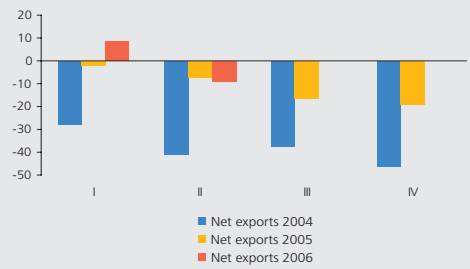
CHART III.31
Following a long period of faster export growth than import growth, their growth rates converged
(annual percentage changes)

III.5.2 Net external demand

In 2006 Q2 the downward trend in negative net exports of goods and services[18] came to a halt after seven quarters. At the same time, growth in foreign trade turnover slowed. However, it remained high, as indicated by annual rates of growth of exports and imports in excess of 10%. As shown in Chart III.31, annual export growth slowed considerably in Q2, but still indicated a continuing strong export performance of the Czech economy. The growth rate of imports also fell, albeit to a smaller extent. This resulted in convergence of the export growth rate and the import growth rate to 10.2%. Under these circumstances, negative net exports increased moderately after a prolonged period of improvement (by CZK 1.1 billion to CZK -8.8 billion)[19] and the contribution of net exports to GDP growth was thus slightly negative.

As in the previous seven quarters, the increase in the net export deficit was counteracted by the trade balance, which ended in a modest surplus of CZK 0.1 billion. Unlike in the previous quarters, though, its year-on-year improvement was only moderate. By contrast, the deficit on the balance of services increased (by CZK 2.8 billion), as in the previous quarter. The evolution of the services balance thus still suggested that the inflow of foreign direct investment into services had yet to affect the services balance to any great extent.

CHART III.32
The net export deficit increased slightly year on year in 2006 Q2
(CZK billions; constant 2000 prices)



18 At constant 2000 prices.

19 At current prices, net exports were positive, but the surplus decreased by CZK 7.2 billion in 2006 Q2. They continued to be strongly influenced by persisting negative annual change in the terms of trade (-1.5%), due to the evolution of the terms of trade for goods.

Within the trade balance, the increase in the net export deficit was due mainly to continuing rapid annual growth in goods imports (11.5%). This was particularly the case with investment imports and imports for intermediate consumption of corporations, owing to the ongoing buoyant growth in investment demand[20] and to collaboration imports, given the high import intensity of Czech exports. Strong annual growth in goods exports, which exceeded 12% in Q2 amid rising external demand, helped to moderate the negative balance. As in the previous quarters, the strong growth in real exports was due chiefly to the launching of export-oriented production facilities in the car industry and further transfers of production from advanced market economies to the Czech Republic. Although the longer-term goods exports trend suggests a moderate weakening of the additional positive effects stemming from the aforementioned factors, export growth continues to record sizeable annual increases in absolute terms (CZK 63.4 billion in 2006 Q2).

Chart III.33
Manufacturing was the biggest contributor to the high GDP growth
(contributions in percentage points; constant 2000 prices; selected branches)

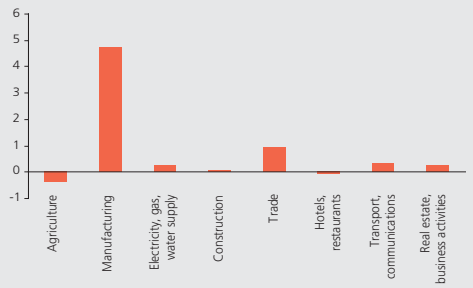


Chart III.34
Gross value added in manufacturing has been rising rapidly since 2004
(annual percentage changes)

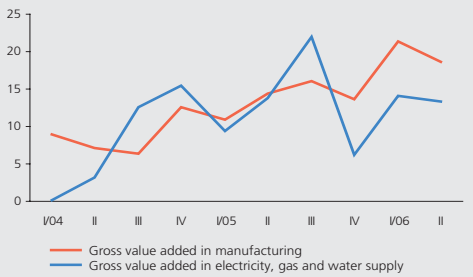
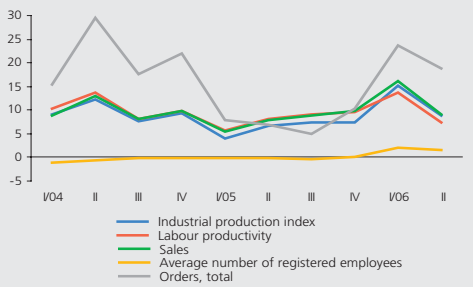


Chart III.35
The continuing growth in industrial production was accompanied by rapid productivity growth
(annual percentage changes)



III.5.3 Output

As in the previous quarter, the continuing dynamic growth in manufacturing was the most important supply-side factor underlying the buoyant growth in gross value added at constant prices in 2006 Q2 (6.6%). The contribution of the services sector to gross value added growth was less significant, as shown in Chart III.33. In the services sector, wholesale and retail trade and commercial services (comprising real estate services, business services and research and development) were the largest contributors to the growth in value added. Overall, gross value added formation growth differed across the individual sectors in 2006 Q2. In some sectors, gross value added formation recorded year-on-year declines.

Although annual growth in gross value added in manufacturing slowed in Q2, it remained very high (at 18.6%) and accounted for around 90% of total value added in industry. Within industry, gross value added in the electricity, gas and water supply sector has also been growing for several consecutive quarters, with the growth rate reaching 13.3% in Q2. Mining and quarrying was the only industry to make a negative contribution to economic growth, as gross value added here declined in year-on-year terms in Q2 after being flat in Q1. The generally fast year-on-year growth in gross value added in industry (17.3%) was achieved amid a rise in industrial production of 8.9%, fostered by higher employment and rapid productivity growth.

The assessment of the causes of the continuing rapid growth in industrial output – as described in previous Inflation Reports – remains the same. They include structural changes, fostered to a great extent by foreign capital, and demand developments in some sectors. The effect of new production facilities, launched with the support of foreign capital and largely export-oriented,[21] has been particularly visible in the manufacture of transport equipment, which has long been showing high annual rates of industrial production growth (17.9% in Q2). The long-running buoyant growth in this industry has facilitated the development of production by domestic companies in related branches. Electrical engineering, where many new facilities have been launched, has also been recording sizeable rates of production growth (18.4% in June). Manufacture of machinery and equipment and manufacture of rubber and plastic products have also been showing very robust growth for some time.

20 i.e. demand for technological investment; for details, see the section *Investment demand*.

21 Overall, almost one-half of industrial output is exported. According to CZSO data, the share of sales from direct exports in total sales of industrial corporations was 48.8% in 2006 Q2.

Looking at 2006 Q2, manufacture of basic metals and fabricated metal products recovered significantly, owing to demand shifts on foreign markets. More than one-third of the monitored industrial branches have recorded strong annual production growth of more than 10% over the past year. The developments in production were very mixed across the other industrial branches. Slightly rising or falling production in some branches suggested that corporations are facing weakening demand for their products due to strong foreign competition (e.g. in the textile industry) or an overall drop in demand for the products of their particular branch.

The contribution of services to gross value added growth in 2006 Q2 was considerably lower than that of industry, but its share in total value added was about 55%.[22] Wholesale and retail trade contributed most to gross value added growth in services, again recording by far the highest absolute increase in gross value added (7.1% year on year). The contributions of transport and commercial services, connected above all with the expansion of real estate services and business services (3.8% and 2.5% year on year respectively), were also more significant. Value added mostly fell year on year in the public services sector. Gross value added in construction rebounded in line with the recovery in construction output in the spring season. By contrast, value added in agriculture again recorded a year-on-year decline.

III.5.4 Financial performance of non-financial corporations[23]

The financial results in 2006 Q2 indicate that pre-tax profit in the non-financial corporations sector continued to develop favourably. Although its annual rate of growth decreased compared to the previous quarter, it remained high at 15.2%. The high profit generation was achieved amid buoyant growth in volume indicators, which was only slightly lower than in the previous quarter, and an improvement in some financial ratios. A rise in output of 13.5%, a rise in book value added of 10.6% and an increase in return on sales of 0.3 percentage point were recorded in year-on-year terms in Q2. Overall, the financial results of large corporations were in line with the overall results of the Czech economy in Q2.

As in 2005 and at the start of 2006, however, the continuing rapid growth in profit generation was achieved amid persisting cost pressures of both external and domestic origin, due chiefly to surging prices of imported energy-producing materials and domestic electricity. As described in detail in section III.7 *Import prices and producer prices*, growth in prices of imported energy-producing materials eased further in Q2. Conversely, growth in prices of imported intermediate goods picked up. Although the import prices of some imported production inputs fell year on year, cost of sales[24] rose 1.3 percentage points faster than output in Q2. As in the previous period, corporations offset the higher material cost-output ratio with slower growth in write-offs and a reduction in the personnel cost-output ratio (from 14.9% in Q1 to 14.3% in Q2). Strong productivity growth, accompanied by much slower wage growth, contributed significantly to the reduction in the personnel cost-output ratio, especially in industry.

The continuing upturn in prices in most manufacturing sectors in 2006 Q2 suggested that, given the favourable demand climate, corporations had partly

Table III.5
Profit generation increased significantly year on year in 2006 Q2
(CZK millions; percentages)

	Q2		Annual changes	
	2006	2005	CZK millions	%
Total income	1,399,077	1,247,853	151,224	12.1
Output without profit margin	963,287	849,023	114,264	13.5
Total expenses	1,306,298	1,167,316	138,982	11.9
Cost of sales	727,006	633,301	93,705	14.8
Depreciation	55,560	50,453	5,107	10.1
Personnel costs	138,026	126,633	11,393	9.0
Book value added	283,827	256,594	27,233	10.6
Pre-tax profit	92,779	80,536	12,243	15.2

Table III.6
The higher material cost-output ratio was offset by a lower personnel cost-output ratio
(percentages; percentage points; CZK thousands)

	2006 Q2 %		Change in perc. points against 2005 Q2	
	Organisations, total	Industry	Organisations total	Industry
Profit-expenses ratio	7.1	8.7	0.2	0.4
Profit-equity ratio	4.1	4.8	-0.1	0.0
Profit-sales ratio	7.4	8.9	0.3	0.4
Asset turnover ratio	29.5	28.6	-1.8	-0.3
Financial leverage	190.5	190.1	-3.5	-3.7
Material cost-output ratio	75.5	x	0.9	x
Personnel cost-output ratio	14.3	x	-0.6	x
Ratio of personnel costs to value added	48.6	42.8	-0.7	-0.8
	CZK thousands per month		Annual percentage changes	
Book value added per employee	59.7	66.9	7.9	8.7

22 In 2005, this share was around 60%. Calculated using gross value added at constant prices.
23 Assessment based on figures for non-financial corporations with 100 employees or more.
24 Cost of sales accounted for 75% of the value of output.

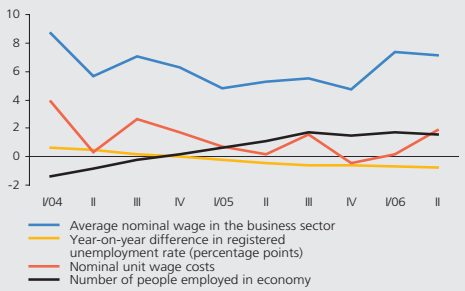
reflected their higher input costs in their prices.[25] Their decision to increase prices was probably supported by faster growth in the output prices of their competitors in major trading partner countries. The changes in prices probably also contributed to an increase in profit margins,[26] which grew by 0.3 percentage point year on year and by 0.4 percentage point in industry. However, asset turnover and financial leverage declined at the same time.[27] Thus, return on equity fell slightly to 4.1%, roughly the same as in 2006 Q1.

Profit generation was very mixed with regard to both ownership structure and sector. Pre-tax profits grew fastest in foreign-controlled corporations (35.6% year on year), which also showed the highest return on equity (6.3%). Profits also increased significantly in public corporations (by 19.7%), albeit on a very low return on equity. Only Czech private corporations recorded lower profits. With regard to sectors, high profits were generated mainly in sectors with the highest shares in GDP growth – manufacturing, trade, business services and real estate, and electricity, water and gas supply. Overall, pre-tax profits recorded year-on-year growth in about 60% of the sectors monitored in 2006 Q2. Profit generation slowed in other sectors, with just one sector posting a loss (agriculture).

III.6 THE LABOUR MARKET

The labour market in 2006 Q2 confirmed the continuing growth in labour demand, benefiting from buoyant economic growth and foreign direct investment and related production. In line with the ongoing structural changes in the economy, employment increased in the secondary and tertiary sectors, fostering a reduction in unemployment. However, the decline in unemployment in Q2 was lower than the increase in employment, as labour demand was partly met outside the labour office register. One of its sources were foreign workers, albeit to a lesser extent than in 2005. A faster decrease in unemployment was prevented by the professional and skills structure of the unemployed, reflected in persisting high long-term unemployment. Although wage growth slackened slightly, the personnel cost-output ratio measured by nominal unit wage cost growth was higher than in the previous quarter as a result of a more pronounced decline in GDP growth compared to wage growth. The increase, however, was not across the board in nature, as nominal unit wage costs in industry continued falling in year-on-year terms.

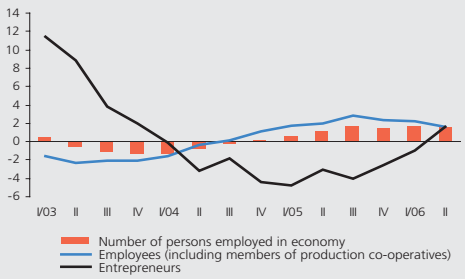
CHART III.36
The buoyant economic growth was accompanied by rising employment
(annual percentage changes; percentage points)



III.6.1 Employment and unemployment

According to Labour Force Survey figures (from the CZSO), annual growth in the number of employed slowed only very moderately (by 0.1 percentage point) in 2006 Q2 compared to Q1, and amounted to 1.6%. There were some changes in structure, though, which were reflected in even more sluggish growth in the number of employees (including members of production co-operatives) and renewed growth in the number of entrepreneurs. This resulted in an identical annual increase in employment in these two categories in Q2 (1.6%), as is shown in Chart III.37. The number of entrepreneurs picked up mainly in real estate and other business activities[28] and, to a lesser extent, in manufacturing and transport.

CHART III.37
The entrepreneurs sector also contributed to the rise in employment in the economy in 2006 Q2
(annual percentage changes)



25 See section III.7 *Import prices and producer prices.*
26 Profit margin = profit / sales
27 Financial leverage = total capital / equity capital
28 Particularly in architectural and engineering activities, related consultancy and computer activities.

As in the previous quarter, the 1.6% annual increase in employment was largely attributable to industry and market services, where development of some activities has long been visible. As regards industry, the largest increase in employment was again recorded in manufacturing (75,800 people year on year). This increase was linked with foreign direct investment and related production and the generally favourable domestic and external demand.[29] Market services again recorded rapid employment growth in real estate, renting and business activities (13.5%, i.e. 38,000). Public services, however, recorded a decline in employment. In some branches, conversely, changes in demand and strong competition exerted significant downward pressures on costs, which led producers to cut jobs. In 2006 Q2, employment declined mainly in agriculture, electricity, gas and water supply and financial intermediation. Overall, the shares of the main sectors in total employment remained almost unchanged in 2006 Q2, with 56.2% of people working in the tertiary sector and industry accounting for 40%.

Continuing growth in labour demand was also indicated by the creation of vacancies. The number of vacancies has been rising considerably since the start of 2006. According to the latest data for July, it was up by more than 37,000 on the same period a year earlier. However, growth in labour demand was only one of the factors behind the higher creation of vacancies, which was also affected by new penalties imposed on employers who fail to report vacancies to labour offices.[30] The share of this factor in the total change in the number of vacancies was particularly apparent in Q1, as shown in Chart III.39. Nevertheless, the Beveridge curve has been indicating since the start of Q2 that higher labour demand has begun to help reduce registered unemployment more significantly. The registered unemployment rate declined by 0.7 percentage point year on year to 8.5% in 2006 Q2. However, the seasonally adjusted registered unemployment rate continued to decline, mainly due to a higher number of unemployed people excluded from the labour office register as a result of penalties.

The annual decline in the number of unemployed still remained below the growth in employment according to the LFS.[31] It was clear that labour demand continued to be partly met outside the labour office register. According to MLSA data, foreign workers – who are mainly employed in industry, construction and real estate – continued to be one of the sources of the rising employment in the economy. Nevertheless, their growth was less significant in the first half of 2006 than in the previous year. As mentioned in the previous Inflation Report, detailed analyses of this phenomenon have revealed that the employment of foreign workers was not directly linked with the Czech Republic's accession to the EU, but was related to labour demand from the skills, profession and costs perspectives.

The gradual improvement in the situation on the labour market for cyclical reasons did not lead to a substantial narrowing of the regional, skills and professional gaps between the supply of, and demand for, labour in Q2. This was confirmed in particular by a persisting relatively high ratio of long-term unemployed[32] to total unemployment, which still exceeded 50% (56.3% under LFS methodology). The regional distribution of unemployment also remained broadly unchanged.

Chart III.38
Employment increased mainly in industry and market services
(annual percentage changes)

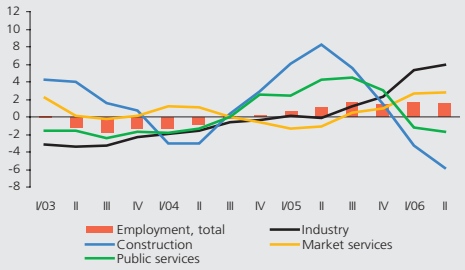


Chart III.39
Demand for labour has started to pass through more into registered unemployment since the start of Q2
(seasonally adjusted numbers in thousands)

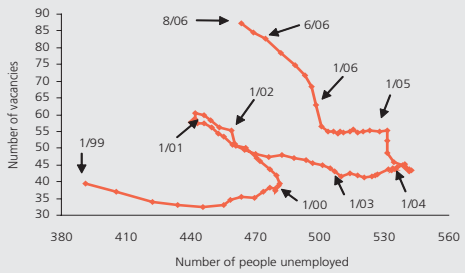
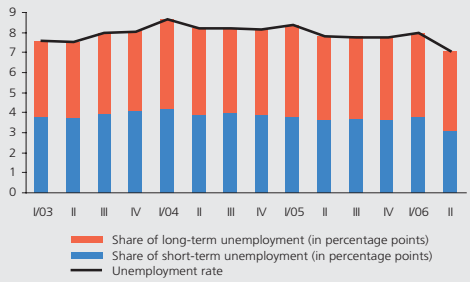


Chart III.40
Underlying the still high unemployment rate was high long-term unemployment
(percentages; source: LFS)



29 The largest increases in employment were recorded in manufacture of parts and accessories for motor vehicles and their engines, treatment and coating of metals, manufacture of metals and manufacture of machinery and equipment.

30 Since January 2006, higher penalties have been imposed for failure to comply with the duty to report vacancies to labour offices.

31 The number of unemployed people declined by 32,000 year on year, while the number of employed people under LFS methodology was 75,300 higher.

32 i.e. those unemployed for more than one year.

III.6.2 Wages and productivity

Year-on-year growth in average nominal wages, following a fairly marked pick-up in 2006 Q1 (to 7.1%), slackened only very slightly in Q2 and amounted to 6.9%. At 3.9%, growth in average real wages was less pronounced owing to higher annual inflation. Overall, average nominal wages rose faster in the first half of 2006 than in 2005.

As in Q1, the contribution of the business sector to the rise in average wages was larger than that of the non-business sector. This was mainly because more than three-quarters of employees in the monitored organisations work in the business sector. Moreover, the average nominal wage growth in the business sector (7.1% year on year) was above the average for the previous two years. The relatively rapid wage growth in the business sector was also evidenced by a 7.1% year-on-year increase in average and median hourly earnings according to MLSA data,[33] which also indicated persisting above-average growth in higher wages (the share of employees with below-average hourly earnings increased to 68.1%).

With regard to sectors, wage trends in the business sector remained very mixed and, according to CZSO figures, inter-industry wage differentiation showed a year-on-year increase in Q2.[34] As in previous quarters, the differences between the growth rates of average wages across individual sectors were due to a number of effects, most notably the level of demand, competition and financial results. Given persisting external cost pressures, stemming mainly from prices of energy-producing resources, another significant factor was the extent to which producers were able to offset these unfavourable effects by increasing productivity or in other ways (for example, by employing foreign workers with lower wage demands etc.). Overall, the fastest growing average wages were recorded in industry in Q2 (8.7%). The increases in market services and construction were 7.3% and 6.3% respectively.

Average wages in the non-business sector grew roughly at the same rate in 2006 Q1 and Q2 (5.9% and 6% respectively). Unlike in the business sector, their growth was slower than in 2005. Average wages in the non-business sector rose at a fairly even pace compared to 2005, when the annual average wage growth fluctuated considerably in the individual quarters, owing to the abolition of the "thirteenth" and "fourteenth" paycheques as of 1 January 2005. In 2006 Q2, average wages grew fastest in health, veterinary and social work. The sizeable year-on-year wage growth in health (9.5%) is still being affected by an extraordinary increase in wage scales in September 2005. Wages in public administration, defence and compulsory social security showed slower growth (5.6% year on year).

The most important factor as regards inflation, though, is whether the continuing relatively buoyant growth in average wages is accompanied by corresponding growth in productivity indicators. The second quarter of 2006 saw a slowdown in annual whole-economy productivity growth, to 5% (see Chart III.42). The interruption of the previous upward trend in annual productivity growth was a result of slowing economic performance and a slight increase in employment.[35] Productivity growth slowed in most of the monitored sectors, including industry,

Table III.7
Average wages rose faster in 2006 H1 than in 2005
(annual percentage changes)

	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2
Average wage in monitored organisations						
nominal	5.7	5.3	6.2	4.6	7.1	6.9
real	4.0	3.7	4.2	2.2	4.1	3.9
Average wage in business sector						
nominal	4.8	5.3	5.5	4.7	7.4	7.1
real	3.1	3.7	3.5	2.3	4.4	4.1
Average wage in non-business sector						
nominal	8.9	5.5	8.6	4.4	5.9	6.0
real	7.1	3.9	6.6	2.0	3.0	3.0
Whole-economy labour productivity	4.8	5.3	5.2	5.9	6.3	5.0
Nominal unit wage costs	0.7	0.1	1.5	-0.4	0.2	1.9

Chart III. 41
Average wage growth picked up in most of the monitored sectors
(annual percentage changes)

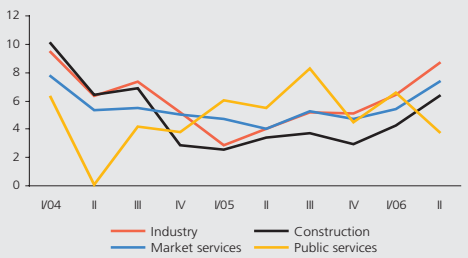
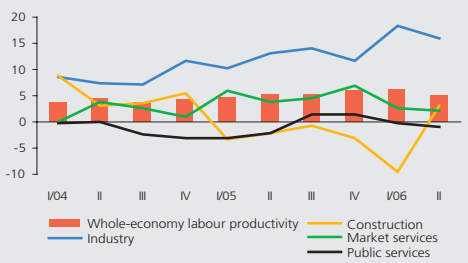


Chart III.42
Whole-economy productivity slowed in 2006 Q2, but remained relatively high
(annual percentage changes)



33 Data from the Average Earnings Information System.

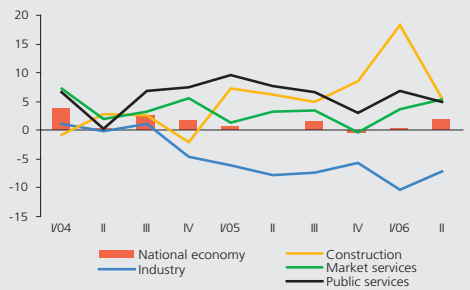
34 The coefficient of variation of average wages (by CZ-NACE category) increased by 1 percentage point to 36.1%.

35 i.e. employment published as part of the national accounts by the CZSO, which, unlike the LFS, does not include entrepreneurs.

although the productivity growth there still achieved extraordinary levels (15.9%). As in previous quarters, productivity in industry was largely associated with the development of mainly export-oriented production supported by foreign direct investment, and also with the favourable domestic and external demand. Market services, where the scope for productivity gains is generally lower, recorded noticeably lower growth rates than industry (2.2%).

Given the more pronounced slowdown in productivity in Q2, the lead of the annual rate of growth of average wages over productivity growth increased. Annual growth in nominal unit wage costs,[36] which are an important indicator of potential inflationary pressures arising from wage developments, thus rose by 1.7 percentage points compared to Q1, to 1.9%. However, this rise was not across the board in nature, as shown in Chart III.43. The personnel cost-output ratio increased in market services, where the increase in employment was not accompanied by a corresponding rise in output.[37] But in industry, where producers are more exposed to external competition, nominal unit wage costs recorded an annual decline (of 7.2%), amid noticeably faster growth in productivity than in wages. One of the other causes of the falling personnel cost-output ratio of production in industry was continuing relatively fast growth in prices of some other production inputs.[38] The personnel cost-output ratio implies that no upward pressures were exerted on output prices in industry as a result of the growing labour demand in Q2.

CHART III.43
Nominal unit wage costs increased again in 2006 Q2
(annual percentage changes)

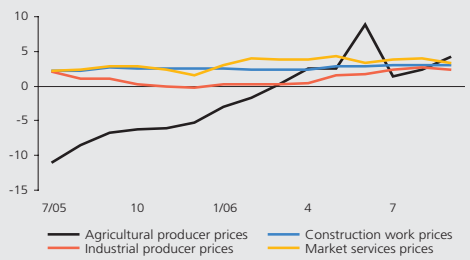


To sum up, then, no across-the-board inflationary pressures were created in the economy in 2006 Q2 owing to unbalanced developments in wages and productivity.

III.7 IMPORT PRICES AND PRODUCER PRICES

A continuing slowdown in the high growth of prices of energy-producing resources on world markets in 2006 Q3 led to a noticeable easing of these external cost pressures on domestic inflation. Although the year-on-year appreciation of the koruna-dollar exchange rate acted in the same direction, import prices of mineral fuels still grew quite rapidly. Industrial producer price inflation picked up further in Q3. Price growth in primary oil processing slowed down and turned negative in September, but prices in most other branches of manufacturing continued to pick up gradually. This was probably due to the long-running high growth in prices of imported energy inputs and electricity and strengthening growth in prices of imported intermediate goods. Given favourable demand and higher growth in foreign producer prices, domestic producers gradually passed their rising costs through to prices. Agricultural producer prices continued to pick up and construction work prices recorded an annual increase.

CHART III.44
Producer price inflation increased in industry and construction in 2006 Q3
(annual percentage changes)



III.7.1 Import prices

Given the high openness of the Czech economy, import prices are an important domestic inflation factor. Their annual growth gradually slowed in 2006 Q2 and in the first two months of Q3, owing mainly to prices of energy-producing materials

36 Nominal wage unit costs = volume of nominal wages and salaries / GDP at constant prices.

37 This was probably largely due to business services and real estate services, where gross value added rose by 2.5% year on year amid a sharp rise in employment (13.5%).

38 See section III.7 *Import prices and producer prices*.

Chart III.45
Slowing growth in world prices of energy-producing materials fostered a further easing of import price growth
(annual percentage changes; contributions in percentage points)

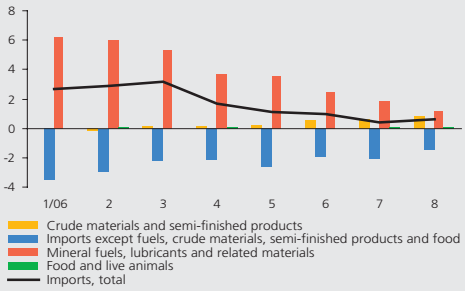


Chart III.46
The koruna-dollar exchange rate again dampened the impacts of the rapidly rising prices of energy-producing materials on domestic prices in 2006 Q3
(annual percentage changes)

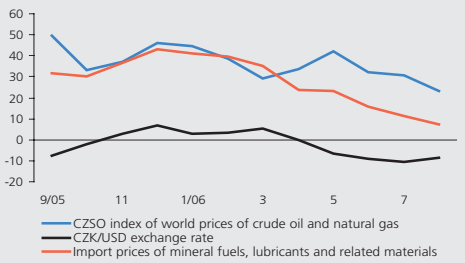


Chart III.47
Import price growth accelerated in the manufactured goods category
(annual percentage changes)

Table III.8
The number of import categories with rising prices increased
(annual percentage changes)

	3/06	4/06	5/06	6/06	7/06	8/06
Imports, total	3.2	1.7	1.1	1.0	0.4	0.6
Food and live animals	-0.8	0.8	0.2	-0.6	0.9	0.6
Beverages and tobacco	-4.5	-7.7	-8.3	-8.6	-8.9	-8.6
Crude materials except fuels	-4.4	-5.9	-8.9	-9.4	-9.9	-7.3
Mineral fuels and related products	35.0	23.9	23.3	15.7	11.4	7.4
Animal and vegetable oils	-4.6	-3.0	-3.8	-1.2	-0.5	2.3
Chemicals and related products	-1.5	-2.5	-2.7	-0.5	-0.5	0.5
Manufactured goods classified by material	1.3	1.6	2.3	4.1	4.6	5.3
Machinery and transport equipment	-0.4	-1.1	-2.3	-2.2	-3.1	-2.2
Miscellaneous manufactured articles	-5.5	-5.8	-6.7	-6.1	-5.8	-5.1

on world markets. Growth in import prices was very modest in July and August, amounting to less than 1%. Chart III.45 shows that the effect of the more moderately, but still rapidly growing import prices of energy-producing materials and a pick-up in prices of manufactured goods was offset by mostly falling prices of other imports.

Annual growth in world prices of energy-producing materials slowed further in 2006 Q2 and this trend continued into the first two months of Q3. The average annual growth in oil and gas prices was still almost 40% in 2006 Q1, but declined to 36% in Q2 and reached 23.2% in August. Slowing price growth was recorded for both the aforementioned energy-producing materials, but was more pronounced in the case of oil. This trend fostered weakening annual growth in import prices of mineral fuels, from 35% at the end of 2006 Q1 to 7.4% in August. This significant change in the rate of growth was also due to a marked year-on-year appreciation of the koruna-dollar exchange rate, as shown in Chart III.46.

Unlike prices of energy-producing materials, import prices of other mineral commodities (except fuels) have been declining year on year since the start of 2006. The decline was gradually deepening until July, when it reached 9.9%. It then moderated to 7.3% in August. This decline was mainly due to falling prices of iron ore, which is an important component of imports of other materials.[39] Prices of other metals, however, increased considerably on world markets according to the CZSO world price index. In August their growth reached an extraordinary 57.9%.

Prices of imported commodities with a higher degree of processing[40] showed a year-on-year decline overall in 2006 Q2 and in the first two months of Q3, although their structural trends were mixed. The highest-weight category of machinery and transport equipment continued to record an annual decline in prices of around 2% in the period under review. However, the decline in import prices of miscellaneous manufactured articles gradually moderated and some import categories saw an upturn in prices. This was most visible in the category of manufactured goods, where growth in import prices picked up noticeably from 1.6% to 5.3% between April and August (see Chart III.47). After a long-running annual decline, prices of imported chemicals and related products rose again in August. The ongoing changes in import prices of commodities with a higher degree of processing were largely associated with the relatively buoyant growth in industrial producer prices recorded by the Czech Republic's major trading partners. As in previous quarters, their impact on domestic prices was softened by the persisting annual appreciation of the koruna-euro and koruna-dollar exchange rates.

Growth in import prices across the individual import categories was reflected in similar mixed developments across the individual producer and consumer price categories. At the same time, it indicated a continuation of two tendencies – a pronounced weakening of the inflationary pressures stemming from the high prices of imported energy-producing materials and, on the other hand, increasing price growth or a shrinking year-on-year decline in prices of some categories of products with a higher degree of processing. Nevertheless, the growth in import prices of energy-producing materials was still fast and, along with faster growing prices of manufactured goods (including intermediate goods), was a source of cost pressures on domestic inflation.

39 Iron ore is not included in the CZSO world price index.

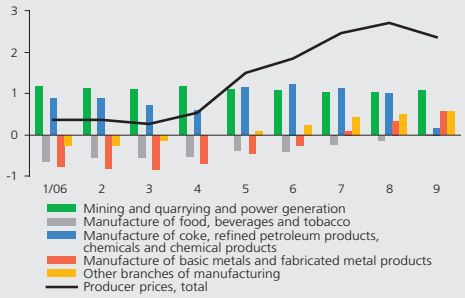
40 This category mainly includes machinery and transport equipment, manufactured goods, miscellaneous manufactured articles and chemicals and related products.

III.7.2 Producer prices

Industrial producer prices

The pick-up in industrial producer price inflation, which, despite some fluctuations, has been clearly visible since the start of 2006, continued into 2006 Q3. However, the further increase in producer price inflation (from 1.8% in June to 2.4% in September) was not driven by prices in the manufacture of refined petroleum products, but mainly by an upturn in price growth in metal processing.[41] A continuing gradual strengthening of producer price inflation in other manufacturing sectors also contributed to the pick-up in industrial producer prices in Q3 (see Chart III.48).

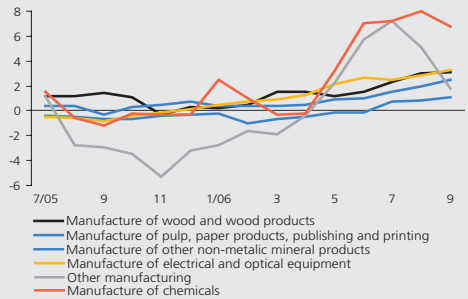
CHART III.48
Prices in the metal processing industry contributed most to the further increase in industrial producer price inflation
(annual percentage changes; contributions in percentage points)



Producer price inflation remained highest in sectors involved in power generation and in the chemical industry. The fast annual price growth in electricity, gas and water supply declined only marginally, remaining at around 8% (7.9% in September). Annual growth in producer prices in the chemical industry gradually picked up as from May this year to stand at 8% in August, then moderated to 6.8% in September. Fast annual price growth was recorded in the manufacture of coke and refined petroleum products until August (11.2%); in September, though, producer prices in this sector showed an annual decline (of 3.1%). However, this significant change was mainly due to base effects, with changes in world oil prices having a less significant effect. But mining and quarrying, which consists mainly of coal mining, saw a continuing annual decline (0.7% in September). Nevertheless, when assessing developments in this sector in 2006, one should take into account the marked price increase in this sector in 2005, which was probably a response of producers to higher demand for coal due to the substantial increases in oil and natural gas prices. The relatively small decline in prices in 2006 thus only slightly corrected the sizeable growth in 2005.

Other industrial sectors saw a continuing upswing in prices. This trend was recorded in most sectors monitored within the industrial producer price index[42] in 2006 Q3. In manufacturing, according to the latest figures for September, sectors with rising prices clearly predominated. Prices in the food industry, whose output prices significantly affect consumer prices of food, saw a slight increase (0.1%), following the previous gradual moderation of their annual decline. This increase was mainly due to renewed growth in prices of domestic inputs of vegetable origin and import prices of food. An annual decline in prices persisted in Q3 only in the manufacture of transport equipment; this decline reached 1.1% in September.

CHART III.49
Most branches of manufacturing saw a continuing upswing in prices
(annual percentage changes; selected branches)



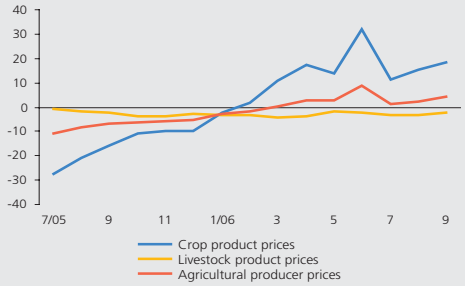
The continuing fast growth in industrial producer prices in 2006 Q3, which was recorded in most of the monitored sectors, represented a clear inflationary trend. A number of price indicators in the business sector indicated that this was probably a result of several factors. These factors included, in particular, the long-running cost pressures stemming from the rapidly increasing import prices of energy-producing materials and electricity, and, since the end of 2006 Q1, the rising prices of imported intermediate goods. Producers seemed to be finding it increasingly difficult to offset these (mainly long-term) cost pressures by increasing productivity or in other ways. Consequently, given the favourable demand climate and the higher producer price inflation in the Czech Republic's major trading partner nations, producers gradually increased their prices.

41 They were also partly affected by the previous year's low base.

42 i.e. sectors included in the Industrial Price Index broken down by CPA section and subsection.

Agricultural producer prices

Chart III.50
The continuing rise in agricultural producer prices was supported by rising prices of crop products
(annual percentage changes)



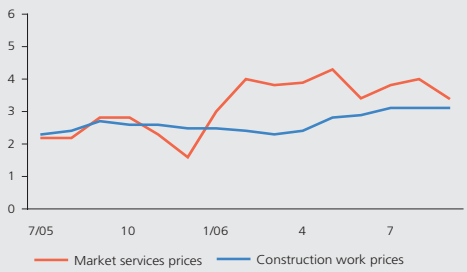
In 2006 Q3, agricultural producer prices showed a continuation of the price growth observed since the end of 2006 Q1 (see Chart III.50). As in Q2, they were volatile. According to the latest data for September, they grew by 4.2% year on year. The continuing increase in agricultural producer prices was due to crop prices, whereas prices of livestock products mostly continued to decline year on year.

A considerable fall in crop price inflation in July (from 32% in June to 11.5%) and a renewed rise in the following two months (to 18.5% in September) was largely due to relatively volatile prices of fruit and vegetables.[43] Prices in the highest-weight category of cereals grew faster in Q3 (to 14.7% in September) and prices of oil crops also rose significantly (to 14.4% in September). Prices of cereals were affected by the contrary effect of a smaller and worse quality harvest this year compared to the previous year. Growth in prices of cereals was also counteracted by annual appreciation of the koruna-euro exchange rate. Taking into account the very low base of 2005, prices of cereals have so far been generally subdued in 2006.

The annual decline in prices of livestock products continued into 2006 Q3, reaching 2.2% in September. Producer prices of most major items of livestock production showed a decline. The main factor underlying the mostly falling prices of livestock products was the exchange rate; a decline in prices of livestock production in some EU countries also played some role.

Other producer prices

Chart III.51
Construction work prices picked up pace in 2006 Q3
(annual percentage changes)



Faster price growth in construction work, observed since April 2006, continued into July. It amounted to 3.1% in July and remained at this level in the following two months. This price growth was probably due to a larger increase in demand for construction work in the spring, followed – with a short lag – by an upswing in prices of materials and products consumed in the construction industry. According to the latest CZSO figures for September, prices of such products and materials showed an annual increase of 2.9%.

Market services prices in the production sector showed no clear trend in 2006 Q3. Although their growth picked up in July and August (to 4% in August), it returned in September to the level observed at the end of Q2 (3.4%). Overall market services prices continued to be most affected by prices in business services and real estate and renting services, which increased by 4.7% year on year in September. Price increases were mainly recorded in advertising, exhibition and trade fair services, owing to increasing demand for such services.

43 Prices of fruit grew by 26.5% in June, 3.9% in July, 22.3% in August and 3.8% in September. The following annual increases in vegetable prices were recorded in the same period: 63.2%, -11.8%, 4.6% and 25.8% respectively..

IV.1 EXTERNAL ASSUMPTIONS OF THE FORECAST

Expectations regarding the external environment are one of the key assumptions of the forecast. For this purpose, the CNB has as usual drawn mainly on the publication Consensus Forecasts, which brings together the forecasts of a range of foreign analytical teams. The current forecast is based on the September data from this publication and the market information effective on the survey date. The euro area is used to proxy for developments in the Czech Republic's major trading partner economies. The CNB forecast uses the outlook for prices of Brent crude oil as an indicator of energy-producing material prices. In addition, the outlook for petrol prices on the ARA markets is used in forecasting fuel prices. Compared to the previous forecast, expectations regarding future external developments have shifted towards higher economic growth, inflation and interest rates, amid lower expected prices of energy-producing materials.

According to the new reference scenario, the effective indicator of consumer prices in the euro area will grow by 1.9% this year and 2.2% in 2007. The rise in effective inflation will be due mainly to a sizeable increase in German inflation resulting from a change in the VAT rate in 2007. After this effect unwinds, the effective indicator of consumer prices in the euro area will grow by 1.7% in 2008. The increase in VAT in Germany should not exert upward pressures on import prices in the Czech Republic. This effect is therefore adjusted for in the forecast. The reference scenario of the October forecast expects growth in the effective indicator of producer prices in the euro area to slow from 5.1% this year to 2.5% in both 2007 and 2008. Owing to the favourable developments in the euro area economies in 2006 Q2, analysts have significantly revised their outlook for economic growth this year. Economic growth in the euro area in effective terms will thus reach 2.3% this year. As a result of the income effect of the VAT change in Germany, economic growth in the euro area will slow to 1.6% in 2007 and pick up slightly to 1.8% in 2008.

Table IV.1
Economic growth will slow down in the euro area in effective terms in 2007

	IV/06	I/07	II/07	III/07	IV/07	I/08	II/08
Brent crude oil prices (USD/barrel)	65.8	68.3	69.7	70.6	71.0	71.0	70.7
ARA petrol prices (USD/t)	570.7	598.0	651.0	666.0	637.3	642.6	704.3
Effective indicator of GDP in euro area (annual, in per cent)	2.5	1.7	1.6	1.5	1.6	1.7	1.8
Effective indicator of producer price inflation in euro area (annual, in per cent)	3.9	2.8	2.1	2.1	2.9	2.9	2.7
Effective indicator of consumer price inflation in euro area (annual, in per cent)	1.8	2.6	2.3	2.1	2.0	1.4	1.7
Nominal USD/EUR exchange rate (level)	1.30	1.30	1.31	1.31	1.31	1.31	1.31
1Y EURIBOR (in per cent)	3.8	3.9	3.9	3.8	3.8	3.8	3.8

The outlook for Brent crude oil prices foresees a decline at the end of this year followed by a moderate increase to roughly USD 70 a barrel next year. Oil prices should remain at this level in 2008. Petrol prices on the ARA markets should progress similarly, rising above USD 700 a ton in summer 2008 following a decline in 2006 Q4.

The expected dollar-euro exchange rate has remained virtually unchanged since July. It is still assumed that the dollar will depreciate gradually to USD 1.3 against the euro at the one-year horizon. The dollar-euro rate is expected to remain broadly stable at that level in 2008. The implied one-year EURIBOR trajectory has shifted much higher than assumed in the previous forecast at the short end of the forecast. It is close to 3.8% over the entire forecast horizon.

IV.2 INTERNAL ASSUMPTIONS OF THE FORECAST

In addition to assumptions regarding the external environment, assumptions about the effects of domestic fiscal policy are an important input to the forecast. The public finance deficit in 2005 was revised significantly from 2.6% of GDP to 3.6% GDP in October. In the light of this revision, the estimate of the public finance deficit under ESA 95 methodology has been increased to 3.5% of GDP for 2006 and 4.0% of GDP for 2007. However, this revision to the forecast does not change the estimate of the fiscal impulse, which approximates the effect of fiscal policy on economic growth. Nevertheless, the impulse has increased slightly compared to the July forecast, primarily as a result of lower expected tax collection. The forecast thus still expects fiscal policy to make a positive contribution to economic growth in 2006–2007. The contribution of fiscal policy to demand growth will be slightly negative in 2008 despite the still high deficit ratio of 3.7% of GDP. At the forecast

horizon, no sizeable additional fiscal stimulus is expected from the inflow of money from EU funds.

Another factor determining the message of the forecast consists of assumptions regarding the equilibrium values of key macroeconomic variables, especially real interest rates, the real exchange rate and the non-accelerating inflation level of output. The current position of the economy in the business cycle and the current settings of the monetary conditions are derived from these assumptions. The evolution of the equilibrium values also provides a framework for the fundamental orientation of the forecast. Among other things, an analysis of past and present developments in economic activity, inflation, the exchange rate and interest rates is used to determine the starting conditions of the forecast and the equilibrium variables. This analysis draws on the linkages between these variables as perceived by the CNB's forecasting system.

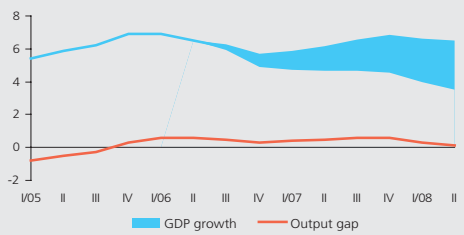
The estimate of the equilibrium variables is unchanged from the previous forecast. At the forecast horizon, the estimate of the rate of equilibrium real appreciation lies between 3.5% and 4%, with a gradually declining tendency. The equilibrium annual real money market interest rate is slightly below 1% and is also declining at the forecast horizon. The assumed long-term growth rate of the non-accelerating inflation level of output is also unchanged at 5%. Following the release of the estimate for GDP growth in Q2 and the revision of the data for Q1, the estimate of the current growth rate of the potential, non-accelerating inflation level of output has been reduced slightly to just below 5.5%.

The new data on real economic activity this year[44] are also reflected in the estimate of the output gap, which in the year to date has been slightly lower than assumed in the July forecast. However, the estimate of the output gap remains positive, i.e. the economy is still slightly above the non-accelerating inflation level of output. The contribution of net exports to economic growth decreased considerably in the first three quarters of 2006. Investment and household consumption have thus become the main engine of growth. Government consumption has so far been flat in 2006 and thus has not contributed to the growth in domestic demand.

Headline consumer price inflation in 2006 Q3 was in line with the July forecast. Faster growth in food prices was offset by smaller-than-expected price impacts of the changes to indirect taxes, as no effect of the higher excise duties effective since 1 April 2006 was observed in cigarette prices even in Q3. The forecasts for regulated prices, adjusted inflation excluding fuels and fuel prices proved to be broadly accurate.

The settings of the real monetary conditions in 2006 Q3, which affect the future course of the business cycle, can be described as neutral to slightly tight overall. The exchange rate component of the monetary conditions is assessed as neutral to slightly tight and the interest rate component as roughly neutral.

Chart IV.1
The output gap remains positive
(annual percentage changes; percentages of GDP; seasonally adjusted)



IV.3 THE MESSAGE OF THE FORECAST

The aforementioned information on domestic and external economic developments collected since the July forecast has partially changed the forecast for the Czech economy. The output gap will remain close to its current level for the rest of 2006 and in 2007, as a result of the contrary effects of easy monetary and fiscal policy

44 For 2006 Q3 this refers to the expected reality.

and relatively low external demand. In 2008, the contribution of fiscal policy to demand growth will be slightly negative and, together with continuing relatively low external demand, will result in a gradual closing of the output gap to zero. If this economic scenario materialises, annual average real GDP growth will be 6.1% in 2006 and slow to 5.6% in 2007 and 4.9% in 2008.

Household consumption will pick up in the next few quarters, chiefly thanks to favourable developments on the labour market and growth in social transfers. The increase in transfers, linked mainly with legislation governing family allowances and with a change in the social benefit system, will be most pronounced in 2007, when it will exceed 10%. Growth in nominal and real disposable income of households will thus accelerate next year, despite a slowdown in the growth of real wages and salaries. In the context of a neutral interest rate component of the monetary conditions, this acceleration will lead to a rise in real consumer spending of 4.4% in 2007. Owing to a slowdown in employment growth, a marked decline in the annual growth of social transfers and a tight interest rate component of the monetary conditions, the rate of growth of real consumer spending will fall slightly below 4% in 2008.

Table IV.2
Growth in real disposable income of households will accelerate next year
(annual percentage changes)

	2006	2007	2008
Real disposable income of households	3.9	4.4	3.7
Total employment	1.4	0.9	0.3
Unemployment rate (in per cent)	8.7	8.0	7.8
Labour productivity	5.0	4.7	4.6
Current account deficit (ratio to GDP in per cent)	-3.9	-3.4	-3.0
M2	8.7	9.5	7.9

The forecast for fixed investment growth in 2006 has been revised downwards to 6.4% due to lower-than-expected growth in gross fixed capital formation in 2006 H1. The rate of growth of gross fixed capital formation will decrease gradually over the following few years. It will be 5.4% in 2007, when the forecast still assumes continuing growth in export demand and inflow of actually allocated foreign direct investment. In 2008, a gradual tightening of the interest rate component of the monetary conditions will lead to a further decline in gross fixed capital formation to just below 5%.

The forecast still assumes a growth trend in export performance, connected with FDI inflow and related changes on the supply side of the economy. Despite an easing exchange rate component of the monetary conditions, weakening external demand growth will cause the growth rate of real exports to fall to 10% in 2007. The continuing easing of the exchange rate component of the monetary conditions will gradually prevail over the relatively weak external demand. Export growth will therefore pick up again slightly in 2008 and exceed 11%. Notwithstanding the rise in consumer demand growth, import growth will fall below 10% in 2007 as a consequence of slower growth in investment imports and the easing of the real exchange rate. Real import growth will pick up pace in 2008, driven by an expansion of collaboration imports in response to the growing exports. Forecasted real import growth will continue to lag behind export growth. The net export deficit will thus fall below CZK 10 billion at constant 2000 prices in 2008.

Table IV.3
Economic growth will gradually slow down
(annual percentage changes)

	2006	2007	2008
Gross domestic product	6.1	5.6	4.9
Household consumption	4.1	4.4	3.8
Government consumption	1.0	-0.7	0.2
Gross fixed capital formation	6.4	5.4	4.9
Imports of goods and services	11.8	9.4	10.7
Exports of goods and services	12.4	10.0	11.5
Net exports of goods and services (in CZK bn, at constant prices)	-37.3	-26.8	-9.2

Over the entire the forecast period, the exchange rate of the koruna against the euro will be close to its current levels. The depreciation pressures stemming from the negative interest rate differential vis-à-vis other currencies and from the higher domestic inflation than in other countries will be balanced by long-term equilibrium appreciation of the real exchange rate.

The inflation forecast for the rest of 2006 has been decreased slightly, owing to reductions in the estimates for growth in regulated prices, the price impacts of the changes to indirect taxes, and growth in fuel prices and adjusted inflation excluding fuels. Inflation at the end of 2007 has been revised only moderately downwards, with lower annual growth in food prices and adjusted inflation excluding fuels being balanced by higher growth in regulated prices and greater impacts of the changes to indirect taxes, owing to a change in timing. At the monetary policy horizon, i.e. in 2007 Q4 and 2008 Q1, inflation will be close to the upper boundary of the tolerance band of the inflation target. Annual consumer price inflation of 3.7% is forecasted for the end of 2008.

Table IV.4
Adjusted inflation excluding fuels will rise
(annual percentage changes)

	IV/06	I/07	II/07	III/07	IV/07	I/08	II/08
Annual consumer price inflation	2.0	2.8	2.8	3.3	4.0	4.0	4.1
Breakdown into contributions:							
regulated prices	5.0	4.9	4.1	4.0	4.9	4.4	4.4
indirect taxes (contributions in p.p.)	0.3	0.3	0.5	1.3	1.3	1.0	0.8
food prices, excluding changes to indirect taxes	1.3	2.8	2.6	0.7	1.2	1.8	2.2
fuel prices, excluding changes to indirect taxes	-5.9	1.0	-5.8	-8.0	0.2	1.8	2.6
adjusted inflation excluding fuels, excluding changes to indirect taxes	1.0	1.3	1.9	2.4	2.7	3.2	3.6

Chart IV.2
The inflation forecast is close to the upper boundary of the tolerance band of the point inflation target at the monetary policy horizon
(annual percentage changes in CPI)

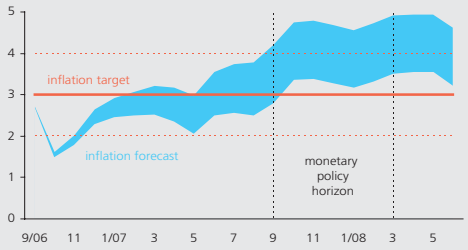


Chart IV.3
Excluding the first-round impacts of indirect taxes, inflation is close to the point inflation target at the monetary policy horizon
(annual percentage changes)

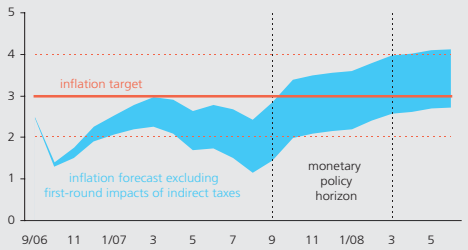


Table IV.5
Inflation expectations at the one-year horizon rose above the CNB's target
(percentages)

	12/05	6/06	7/06	8/06	9/06
Consumer price index					
1Y horizon:					
Financial market	2.6	2.8	2.9	3.1	3.2
Corporations	2.8	2.9			3.0
Households	4.6	5.9			5.0
3Y horizon:					
Financial market	2.5	2.4	2.6	2.7	2.7
Corporations	2.9	3.1			3.2
Households	5.2	9.4			8.1
1Y PRIBOR					
1Y horizon:					
Financial market	2.8	2.9	3.0	3.2	3.2

In the coming years, inflation will be significantly affected by growth in regulated prices and the impacts of tax changes stemming from the need to harmonise excise duties on tobacco products with EU regulations. While the previous forecasts had assumed full pass-through of the tax increases to cigarette prices, the October forecast assumes only partial pass-through, with part of the price impact being reflected in a reduction in producers' profit margins. Assuming that cigarette producers' profit margins fall by 25%, the total impact of the tax increases in April 2006 and January 2007 on consumer prices is estimated at 1.25 percentage points. The total contribution of administrative effects, i.e. changes to indirect taxes and regulated prices, to annual inflation will thus amount to roughly 1.5 percentage points at the end of 2006, 2.2 percentage points at the end of 2007 and 1.1 percentage points at the end of 2008.

The mechanism of caveats applies as usual to the first-round effects of indirect taxes, whose impact will be particularly pronounced in 2007. Adjusted for these effects, inflation to which monetary policy reacts is at the monetary policy horizon initially below the point inflation target, but then increases and lies slightly above the point inflation target at the end of the monetary policy horizon.

Consistent with the macroeconomic forecast and its assumptions is a gradual rise in interest rates.

No significant risk leading to the creation of a full alternative scenario was identified in the forecasting process. Sensitivity analyses were drawn up covering selected uncertainties regarding the baseline scenario of the forecast. These uncertainties relate to the price impact of the changes to taxes on tobacco products, the evolution of the euro area economies and – as usual – exchange rate developments.

IV.4 EXPECTATIONS OF ECONOMIC AGENTS

The CNB monitors the inflation expectations of three sectors (the financial market, corporations, households) at the one-year and three-year horizons. Future inflation expected by financial market participants at the one-year horizon rose above the CNB's target, a level not observed since the end of 2003. Analysts predict that the main inflation factors will be demand-pull inflationary pressures, food prices and expected growth in regulated prices (excise duty on cigarettes and deregulation of rents, water supply and sewage collection charges, and heat supply and electricity prices). The exchange rate of the koruna remains the most substantial downside factor. The inflation expectations of corporations also rose slightly. By contrast, a decline in the expected inflation outturns was recorded for households. However, this indicator is strongly volatile.

At the three-year horizon, the inflation expectations of the financial market are below the CNB's inflation target of 3%. The data for corporations slightly exceed this level. The highest inflation is expected in the household sector.

Expected interest rates also increased in the period under review over the entire length of the yield curve. The interest rate path consistent with the aforementioned CNB forecast was, in the near future, in line with the expectations of financial market analysts. At the longer horizon, it was slightly higher.

ASSESSMENT OF THE FULFILMENT OF THE MAASTRICHT CONVERGENCE CRITERIA AND THE DEGREE OF ECONOMIC ALIGNMENT OF THE CZECH REPUBLIC WITH THE EURO AREA

A joint document of the Ministry of Finance of the Czech Republic and the Czech National Bank approved by the Government of the Czech Republic on 25 October 2006

1 SUMMARY AND RECOMMENDATIONS REGARDING THE CZECH REPUBLIC'S PREPAREDNESS FOR JOINING ERM II

Besides being required to harmonise their legislation with Articles 108 and 109 of the Treaty establishing the European Community and the Statute of the ESCB, EU Member States are required to achieve a high degree of sustainable convergence in order to join the euro area.

This is measured by the fulfilment of four convergence criteria: a high degree of price stability, as apparent from the rate of inflation; sustainability of the government financial position, as measured by the government deficit and government debt; exchange rate stability, as measured by movements in the exchange rate within the normal fluctuation margins of the ERM II system for two years without devaluation; and durability of convergence, as reflected in long-term interest rate levels.

The Czech Republic is obliged to take steps to be prepared to join the euro area as soon as possible. However, setting the date for joining the euro area is within the competence of the Member State and depends on its preparedness. Potential non-fulfilment of the convergence criteria has no direct consequences for the Czech Republic at present.

The only exception is the criterion on the sustainability of public finances, which the Czech Republic has so far been unable to satisfy in a sustainable manner in the area of fiscal deficits. The state's fiscal performance is subject to multilateral surveillance of public finance developments. Failure to observe budgetary discipline led to the commencement of the excessive deficit procedure against the Czech Republic shortly after its accession to the EU. As a result, the Czech Republic undertook in 2004 to reduce its government deficit in a sustainable manner to below 3% of GDP by 2008. In the event of failure to meet this commitment, the Council may decide to suspend funding from the Cohesion Fund.

1.1 ASSESSMENT OF FULFILMENT OF THE CONVERGENCE CRITERIA

The Czech Republic has been compliant with **the criterion on price stability** in 2005 and 2006. However, given the current strict interpretation of the criterion applied by the European Commission and the European Central Bank, it is possible that the fulfilment of this criterion will be endangered if the CNB's current target of 3% is maintained. The likelihood of non-fulfilment of the criterion depends on the outlook for inflation in the Czech Republic (*inter alia* the evaluation of the strength of the impact of the planned changes to indirect taxes): the Ministry of Finance outlook indicates that there should be no problem, whereas the CNB outlook regards future non-fulfilment of the criterion as highly likely if the current inflation target of 3% is maintained. It also depends on the reference value of the criterion, which is derived from inflation in the EU Member States. Downward fluctuations in the reference value hindering fulfilment of the price stability criterion cannot be ruled out under the current interpretation.

The Czech Republic is not compliant with **the criterion on the sustainability of the government financial position.**

The draft 2007 state budget and the related Medium-term Budget Outlook for 2008–2009 do not lay the groundwork for fulfilment of this criterion. According to the 2005 Convergence Programme, a sustainable decrease was expected in the public budgets deficit to below 3% of GDP from 2008 onwards, but the submitted proposals conflict with this goal. This constitutes a major limitation and uncertainty with respect to the future timing of euro adoption. The date for decreasing the deficit below the required 3% is thus highly likely to be postponed. It is premature to consider a new date until a new public finance consolidation strategy has been prepared. The government debt is still relatively low (despite the growth outlook for the coming years) and thus significantly below the reference value of 60% of GDP. However, the postponed reforms, especially those of the pension and health care systems, pose a further risk in terms of the sustainability of public budgets and the future growth of government debt.

Formal assessment of **the exchange rate criterion** will only be possible after the central parity for the koruna's exchange rate is announced and the Czech Republic joins ERM II.

Moreover, this criterion should not be interpreted mechanically, but in relation to other economic fundamentals and their impact on any exchange rate fluctuations. The fluctuations in the CZK/EUR exchange rate have long been smaller than the hypothetical band of ±15%. However, the deviations from the average rate have been quite significant. At present, therefore, we cannot say for sure whether the past developments would have been assessed as compliant with the condition of movement close to the central parity "without severe tensions".

The Czech Republic is currently compliant with **the long-term interest rate criterion** without any problems.

The outlook for several years ahead does not indicate any problems in this area, either. Fulfilment of this criterion is conditional on maintaining financial market confidence in a successful consolidation of public finances delivering sustainability of those finances. Otherwise there may be a downgrading of the Czech Republic's international rating, a higher risk premium on government bonds and consequently an increase in long-term interest rates (above the reference value in the extreme case).

1.2 ASSESSMENT OF ECONOMIC ANALYSES

Numerous indicators speak in favour of relatively early adoption of the euro. These include the high degree of openness of the Czech economy, its close trade and ownership links with the euro area, and the achievement of convergence of the inflation rate and nominal interest rates.

In addition, there are some indicators which have tended to be unfavourable for the Czech Republic in the past, but which have improved in recent years. The positive developments include further progress in real economic convergence in the Czech Republic, including modest convergence of the price level towards that in the euro area; a shift in the characteristics of the financial market closer to the euro area average; the achievement of a high degree of banking system stability; and a modest improvement in the conditions for business.

Insufficient alignment with the euro area economy, which could increase the costs arising from the loss of independent monetary policy, can thus be seen chiefly in

a major difference between the cyclical development of Czech and euro area GDP and in a persisting difference in the price level. A traditional bottleneck as regards the economy's flexibility and ability to adjust to shocks is the labour market, which still exhibits relatively high long-term and structural unemployment and low regional mobility. Some positive changes have occurred recently, for example the introduction of tighter conditions for qualifying for unemployment benefit and registering at labour offices, and easier procedures for setting up businesses. On the other hand, the flexibility of low wages may be adversely affected by the rising ratio of the minimum wage to the average wage. The costs of terminating an open-ended employment contract after a short period of employment remain relatively high by international comparison, and the new Labour Code effective from 2007 will not change this very much. Greater labour market flexibility is thus still one of the key challenges going forward.

Public finances have developed unfavourably since the last assessment. The medium-term outlook for public finances has recently deteriorated. Long-term stabilisation of public budgets below the 3% reference value has not been achieved either. If the euro is to be adopted, this trend has to be reversed and sustainability of public budgets must be ensured.

1.3 CONCLUSIONS AND RECOMMENDATIONS

Based on the aforementioned analyses and in line with the earlier approved document *The Czech Republic's Euro-area Accession Strategy* (the "Strategy"), the Ministry of Finance and the Czech National Bank recommend to the Czech Government that the Czech Republic **should not attempt to enter the ERM II during 2007**.

This decision also means postponing the Czech Republic's potential entry into the euro area beyond the originally planned horizon of 2009–2010 mentioned in the Strategy.

The environment has yet to be created for the Czech Republic to meet the requirements for joining the euro area two years after entering the ERM II and to be able to benefit from adopting the euro to a sufficient extent. The currently deteriorating medium-term outlook for public finances fails to comply with the targets of the Strategy not only in terms of fulfilling the convergence criteria, but also from the point of view of ensuring medium-term balance and long-term sustainability of public budgets. No significant progress has been made either in the area of increasing labour market flexibility.

Any future recommendation regarding ERM II entry therefore depends primarily on having a clear plan for the reform of public finance and other reforms directed at increasing the flexibility of the Czech economy, and particularly that of the labour market. The decision on the ERM II entry date and subsequently on euro adoption must therefore be made only after progress has been achieved in the preparation, and in particular implementation, of such reforms.

As regards future fulfilment of the Maastricht criterion on price stability in a situation where this criterion is interpreted in a very strict manner by EU institutions, it is desirable that no substantial inflationary changes be made to indirect taxes during ERM II participation. Even if this condition is met, the CNB will probably have to decrease the inflation target to a level allowing the criterion on price stability to be satisfied with a high degree of probability. The appropriate timing of this step is in the discretion of the Czech National Bank and will also depend on the progress achieved in reforms targeted at euro adoption.

2 ASSESSMENT OF THE CURRENT AND EXPECTED FULFILMENT OF THE MAASTRICHT CONVERGENCE CRITERIA

The convergence criteria (price stability, public finance sustainability as measured by the government deficit and government debt, exchange rate stability, and convergence of long-term interest rates) are defined in the EC Treaty (the "Treaty") and specified in the Protocol on the convergence criteria and the Protocol on the excessive deficit procedure annexed to the Treaty. Fulfilment of the convergence criteria in a sustainable, and not only one-off, manner is a necessary condition for adoption of the single currency by a Member State with a derogation.

2.1 CRITERION ON PRICE STABILITY

BOX 2.1: DEFINITION OF THE CRITERION ON PRICE STABILITY

Treaty provisions
The first indent of Article 121 (1) of the Treaty requires: "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability".

Article 1 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that: "the criterion on price stability referred to in the first indent of Article 121 (1) of this Treaty shall mean 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. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions."

Application of Treaty provisions in ECB and EC Convergence Reports
With regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate is calculated using the increase in the latest available 12-month average of the Harmonised Index of Consumer Prices (HICP) over the previous 12-month average.

The reference value relating to the values of "at most, the three best performing Member States in terms of price stability" is calculated in practice as the unweighted arithmetic average of the rate of inflation in the three countries with the lowest inflation rates, given that these rates are compatible with price stability.

Implementation of the price stability criterion - current practice
Both the Treaty and the Protocol in some areas leave scope for interpretation by the institutions that assess the fulfilment of the criteria. Therefore, when assessing the fulfilment of the criteria one should also take into account the specific way in which these institutions apply the criterion.

As the Convergence Reports published in 2004 have shown, the EC and the ECB somewhat differ in their specific interpretations of the phrase "best performing Member States in terms of price stability". Both institutions in these reports worked with the three countries with the lowest inflation (Finland, Denmark and Sweden) excluding Lithuania, which recorded an inflation rate of -0.2% in the reference period. However, the decision to exclude Lithuania was justified in

slightly different ways in the two reports. For the Commission the reason was that Lithuania had shown negative inflation, whereas for the ECB it was that inflation in Lithuania over the reference period was judged to have been due to "the accumulation of specific factors"; in the ECB's opinion, including such factors in the calculation of the reference value might have distorted the reference value and reduced its usefulness as an economically meaningful benchmark.

Moreover, the negative verdict for Lithuania[1] in the May 2006 Convergence Reports indicated that a very strict assessment can be expected in future as regards sustainability of the fulfilment of the criterion. If the outlook for the coming months foresees inflation rising above the reference value, the conclusion may be that the country is not succeeding in satisfying the criterion in a sustainable manner.

Implementation of the price stability criterion - a review of current practice and the Czech initiative

The Czech Republic, together with some other countries not participating in ERM II, recently initiated a debate aimed at shifting the interpretation of the price stability criterion so that it better reflects the economic reality and matches the definition of price stability in the euro area countries as expressed by the ECB's inflation target of "below, but close to 2%". This proposal was based on the view of current economic theory regarding the optimal level of inflation. The current interpretation by the European Commission and the ECB of the phrase "best performing Member States in terms of price stability", in the sense of "Member States which have achieved the lowest inflation", does not conform to this view. Although the proposal sought a better interpretation of the aforementioned phrase under the provisions of the Treaty and the Protocol, this initiative, despite all efforts and support from some Member States not participating in ERM II, was not successful.

If one bases the calculation of the reference value on the three countries with the lowest positive inflation, the Czech Republic has been compliant with the criterion on price stability since 2003. The only exception was 2004, when inflation increased temporarily owing to changes to indirect taxes and a simultaneous decrease in the reference value due to exceptionally low inflation in some EU countries. A simple comparison of the current forecast of the Ministry of Finance (from the draft State Budget of the Czech Republic for 2007 and the Medium-term State Budget Outlook for 2007–2009) and the inflation outlook for the EU Member States indicates that there should be no danger of non-fulfilment of this criterion in the future either (see Table 2.1).

Table 2.1: Harmonised Index of Consumer Prices
(average for last 12 months vs. average for previous 12 months, growth in %)

	2003	2004	2005	8/06	2006	2007	2008	2009
Average for 3 EU countries with lowest inflation	1.2	0.7	1.0	1.3	1.2	1.6	1.5	1.5
Reference value (1st line +1.5 p.p.)	2.7	2.2	2.5	2.8	**2.7**	**3.1**	**3.0**	**3.0**
Czech Republic	-0.1	2.6	1.6	2.4	**2.4**	**2.6**	**2.5**	**2.5**

Sources: Eurostat, European Commission, Convergence Programmes and Stability Programmes of Member States, forecast of the Ministry of Finance of the Czech Republic for the draft State Budget of the Czech Republic for 2007 and the Medium-term Outlook for the State Budget of the Czech Republic for 2007–2009.

Note: The outlook for inflation in the European Union for 2006–2007 is taken from the European Commission's spring economic forecast and that for 2008 from the Member States' Convergence Programmes and Stability Programmes (2005).

1 Lithuania recorded a significant rise in inflation between 2004 and 2006. As a result, during the assessment in the spring of 2006, inflation in Lithuania exceeded the reference value for the price stability criterion by 0.1 percentage point.

However, when assessing the future ability to maintain inflation below the reference value, one needs to take into account that the individual countries' inflation forecasts, with few exceptions, do not deviate far from the ECB's inflation target, whereas actual inflation deviates from it significantly more. This may mean a lower inflation level in the countries that form the basis for calculating the criterion, and thus a lower reference value. This was reflected in the criterion in 2003–2005 (as well as in the previous period), when the reference value ranged between 2.2% and 2.7%, i.e. generally lower than in the outlook in Table 2.1. Moreover, the probability of a low reference value is higher than in the past, owing to the larger number of EU Member States, among which three countries with very low inflation will probably be found.

One also needs to take account of the possibility of higher inflation than forecasted by the Ministry of Finance. The CNB's outlook for 2007 and 2008 foresees HICP inflation higher than 3%, which would mean a high probability of future non-fulfilment of the criterion. Among other things, this is because the current inflation target is set in such a way that the price stability criterion is fulfilled at its upper boundary, hence inflationary shocks shifting inflation temporarily above the target may cause the reference value to be exceeded. In the current outlook, the harmonisation changes to indirect taxes on cigarettes – whose effect on the price level may exceed one percentage point in the coming years – represent such a shock.

These facts suggest that if a clear political consensus is reached on the euro adoption date, safe fulfilment of the price stability criterion under the current strict interpretation may require a reduction of the CNB's inflation target from the current level of 3%. At the same time it is desirable that no substantial inflationary changes hindering the fulfilment of the criterion be made to indirect taxes during ERM II participation.

2.2 CRITERION ON THE SUSTAINABILITY OF PUBLIC FINANCES [2]

Government deficit criterion

The first part of the criterion on the sustainability of public finances is focused on short-term to medium-term fiscal developments. The benchmark is the general government deficit under ESA95 national accounts methodology.

The Czech Republic's current public finance parameters prevent it from satisfying the government deficit criterion in a sustainable manner and ensuring anti-cyclical fiscal policy. Fiscal developments confirm that the transitory decline in the deficit to just below 3% of GDP in 2004 was due to extraordinary factors and was not sustainable in the following years (see Table 2.2). The draft state budget for 2007 confirms the deteriorating trend in public finances and hence the Czech Republic's failure to comply with the consolidation strategy that it pledged to implement on joining the EU. It also means a breach of its commitment to the EU to reduce its government deficit in a sustainable and credible manner below 3% of GDP by 2008 (a commitment ensuing from the excessive deficit procedure). The Czech Republic is also in breach of other fiscal recommendations formulated for it by the Ecofin Council.

2 The criterion on the sustainability of public finances is satisfied only when both components of the fiscal criterion, i.e. the government deficit and government debt, are fulfilled in a sustainable manner.

Table 2.2: General government deficit
(ESA 1995 methodology, in % of GDP)

	2003	2004	2005	2006	2007	2008	2009
Reference value	-3.0	-3.0	-3.0	-3.0	**-3.0**	**-3.0**	**-3.0**
Czech Republic*)	-6.6	-2.9	-3.6	-3.5	**-4.0**	**-3.5**	**-3.0**

Sources: CZSO, Government Deficit and Government Debt Notifications (October 2006)

*) The forecasts for 2007–2009 are preliminary Ministry of Finance estimates based on the draft 2007 State Budget submitted by the Government to the lower house of the Czech Parliament. In 2008–2009 these forecasts mechanically take account of the obligation to make the minimum fiscal consolidation efforts laid down in the Stability and Growth Pact, i.e. a minimum reduction in the deficit of 0.5 percentage point a year. These forecasts do not include proposals for the measures needed to deliver this deficit reduction

BOX 2.2: DEFINITION OF THE CRITERION ON THE SUSTAINABILITY OF THE GOVERNMENT FINANCIAL POSITION

Treaty provisions
The second indent of Article 121 (1) of the Treaty requires: "the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with Article 104 of the Treaty".

Article 2 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that this criterion "shall mean that at the time of the examination the Member State is not the subject of a Council Decision under Article 104 (6) of this Treaty that an excessive deficit exists".

Article 104 of the Treaty sets out the excessive deficit procedure. According to Article 104 (2) and (3), the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

1. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:
   - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
   - the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Other Treaty provisions - excessive deficit procedure
The report prepared by the European Commission under Article 104 (3) of the Treaty should also take into account whether the government deficit exceeds government investment expenditure and all other relevant indicators, including the medium-term economic and budgetary position of the Member State.

The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission's report.

In accordance with Article 104 (6) of the Treaty, the EU Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and following an overall assessment, whether an excessive deficit exists in a Member State. Under Article 104 (7) of the Treaty, the EU Council then makes recommendations to the Member State concerned with a view to bringing the deficit below the 3% level within a given period.

Government debt criterion

The second part of the criterion monitors the sustainability of public finances from a longer-term perspective based on the level and trend of the general government debt.

Given its low initial level of government debt, the Czech Republic has no problem fulfilling this criterion. The government debt growth in 2003 largely reflected the inclusion of the majority of the identified indirect liabilities of the government (particularly government guarantees and the classification of Česká inkasní, the Czech Consolidation Agency and their subsidiaries in the general government sector). The ratio of government debt to GDP was stabilised in the subsequent period, thanks mainly to rapid economic growth, but it is expected to gradually increase again in the years to come. Moreover, not even a successful fiscal consolidation will be able to stabilise the government debt level in a sustainable manner if the fiscal system is not prepared for the expected effects of population ageing. This must be ensured by implementing fundamental reforms of the pension system and health care system (see Table 2.3).

Table 2.3: Government debt
(ESA 1995 methodology, in % of GDP)

	2003	2004	2005	2006	2007	2008	2009
Reference value	60.0	60.0	60.0	60.0	**60.0**	**60.0**	**60.0**
Czech Republic*)	30.1	30.7	30.4	30.6	**31.7**	**32.4**	**33.0**

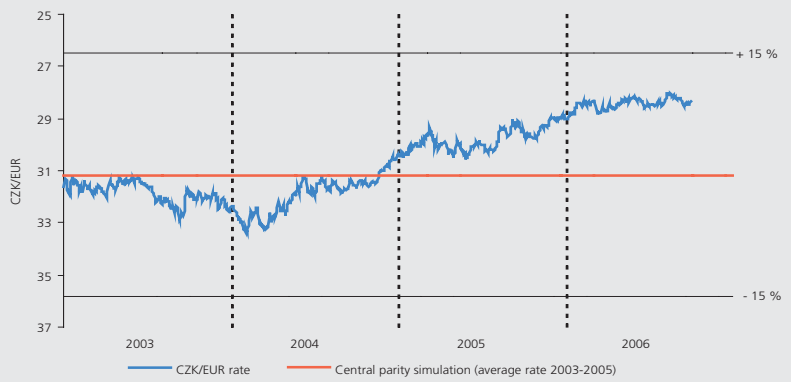
Sources: CZSO, Government Deficit and Government Debt Notifications (October 2006)

*) The government debt projection will be updated following the preparation of the 2006 Convergence Programme.

2.3 CRITERION ON EXCHANGE RATE STABILITY

The Czech Republic does not participate in ERM II, so the central parity of the CZK/EUR rate has not been set yet. For this reason, the exchange rate criterion cannot be formally assessed. In Chart 2.1, the central parity is, for illustration, assumed to be the average of the daily rates for 2003–2005.

Chart 2.1: Nominal CZK/EUR rate



Sources: CNB, Ministry of Finance calculations

Note: In the chart, an upward movement in the exchange rate means an appreciation of the koruna
The hypothetical central parity is simulated by the average rate for 2003–2005.

The fluctuations in the CZK/EUR exchange rate over the last few years have been smaller than the hypothetical band of ±15%. However, the deviations from the average rate have been quite significant. The koruna has been showing an appreciation trend against the euro for some time. The definition of the criterion implies that its interpretation is not entirely clear. In an attempt to reduce this ambiguity, the ECB published a statement in 2003 stating that the assessment of the fulfilment of this criterion would take into account other factors than the exchange rate level alone (see Box 2.3). However, the assessment is not unambiguous even in the light of this statement. We cannot therefore say for sure whether the present situation would be assessed as compliant with the condition of movement close to the central parity "without severe tensions".

BOX 2.3: DEFINITION OF THE CRITERION ON EXCHANGE RATE STABILITY

Treaty provisions

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

Article 3 of the Protocol on the convergence criteria referred to in Article 121 (1) of the Treaty stipulates that: "the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121 (1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last

two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

Application of Treaty provisions in ECB and EC Convergence Reports
The Treaty refers to the criterion of participation in the European exchange-rate mechanism (ERM until December 1998 and ERM II since January 1999).

First, the ECB assesses whether the country has participated in ERM II "for at least the last two years before the examination", as stated in the Treaty.

Second, as regards the definition of "normal fluctuation margins", the ECB recalls the formal opinion that was put forward by the EMI Council in October 1994 and its statements in the November 1995 report entitled "Progress towards Convergence".

The EMI Council's opinion of October 1994 stated that "the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM", that "the EMI Council considers it advisable to maintain the present arrangements", and that "member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfilment of the requirements set out in Article 121 (1) of the Treaty and the relevant Protocol".

In the November 1995 report entitled "Progress towards Convergence" it was stated that "when the Treaty was conceived, the 'normal fluctuation margins' were ±2.25% around bilateral central parities, whereas a ±6% band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to ±15%, and the interpretation of the criterion, in particular of the concept of 'normal fluctuation margins', became less straightforward". It was then also proposed that account would need to be taken of "the particular evolution of exchange rates in the European Monetary System (EMS) since 1993 in forming an ex post judgement".

Against this background, in the assessment of exchange rate developments the emphasis is placed on exchange rates being close to the ERM II central rates.

Third, the issue of the presence of "severe tensions" or "strong pressures" on the exchange rate is addressed by examining the degree of deviation of exchange rates from the ERM II central rates against the euro. Other indicators, such as short-term interest rate differentials vis-à-vis the euro area and their evolution, are used as well. The role played by foreign exchange interventions is also considered.

Successful ERM II participation may be aided in particular by alignment with the euro area economy and consistency of economic policies. The euro-strategy recommends participation in ERM II for the minimum required period of two years only. This implies that "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 and to then benefit from its introduction without experiencing any problems.[3]

3 For details, see the joint document of the CNB and the Czech Government entitled "The Czech Republic's Euro-area Accession Strategy" at http://www.mfcr.cz/cps/rde/xchg/mfcr/hs.xsl/eu_acc_stra.html.

Compared to the present exchange rate regime of managed floating, ERM II entry will be a new element which might have a substantial effect on the behaviour of the exchange rate. The key problem with switching to the ERM II mechanism will be setting the appropriate (sustainable) central parity.

2.4 CRITERION ON LONG-TERM INTEREST RATES

BOX 2.4: DEFINITION OF THE CRITERION ON LONG-TERM INTEREST RATES

Treaty provisions
The fourth indent of Article 121 (1) of the Treaty requires: "the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels".

Article 4 of the Protocol on the convergence criteria referred to in Article 121 (1) of the Treaty stipulates that: "the criterion on the convergence of interest rates referred to in the fourth indent of Article 121 (1) of this Treaty shall mean 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. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".

Application of Treaty provisions in ECB and EC Convergence Reports
First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available.

Second, the notion of "at most, the three best performing Member States in terms of price stability" which is used for the definition of the reference value has been applied by using the unweighted arithmetic average of the long-term interest rates in the three countries with the lowest inflation rates. Interest rates have been measured on the basis of harmonised long-term interest rates, which were developed for the purpose of assessing convergence.

The Czech Republic is currently compliant with the criterion on long-term interest rates and no problems are expected in this area in the future[4] (see Table 2.4).

Table 2.4: 10-year interest rates on government bonds on the secondary market
(average for the last 12 months, in %)

	2003	2004	2005	8/06	2006	2007	2008	2009
Average for 3 countries with lowest inflation	4.12	4.28	3.37	4.06	4.1	4.5	4.4	4.4
Reference value (1st line + 2.0 p.p.)	6.12	6.28	5.37	6.06	**6.1**	**6.5**	**6.4**	**6.4**
Czech Republic	4.12	4.75	3.51	3.68	**3.9**	**4.5**	**4.3**	**4.3**

Sources: Eurostat, Macroeconomic Forecast of the Czech Ministry of Finance (October 2006)

4 As no forecast for the time horizon under review is available for the long-term interest rates of the countries that should, according to the inflation forecast, form the basis for calculating the criterion, the projection of the reference value in Table 2.4 is based on the technical assumption that long-term interest rates will move in line with inflation, i.e. real interest rates will not change. The reference value in 2005–2008 should therefore be viewed as only tentative.

The forecast for interest rates on government bonds in the Czech Republic is dependent on the successful implementation of the public finance consolidation. Any loss of financial market confidence in the outcome of the fiscal reform could very quickly lead to a rise in the risk premium on long-term interest rates and endanger the fulfilment of this convergence criterion.

3 ASSESSMENT OF THE CZECH REPUBLIC'S CURRENT ECONOMIC ALIGNMENT WITH THE EURO AREA

This part summarises the results of a set of analyses directed at assessing the Czech economy's alignment with the euro area over and above the formal criteria, whose fulfilment is assessed in the previous part. Entry into the euro area will fundamentally change the Czech economy's options for adjusting to economic shocks. There will be no possibility of adjusting vis-à-vis the euro area countries, i.e. the Czech Republic's biggest trading partners, through movements in the exchange rate. Monetary policy will be formulated at the euro area level; hence, there will be a risk of the monetary conditions not corresponding to the situation in the Czech economy at any given moment. Therefore, it is important to examine how big this risk is and how well the Czech economy will be able to respond if it materialises.

The analyses are divided into two basic groups by the type of question which they try to answer. The section entitled "Cyclical and Structural Alignment" indicates the size of the risk of economic shocks whose impact on the Czech economy will differ from that on the euro area as a whole ("asymmetric shocks"). The section entitled "Adjustment Mechanisms" answers the question of to what extent the Czech economy is capable of absorbing the impacts of possible asymmetric shocks. The basic theoretical starting point for the underlying analyses is the theory of optimum currency areas. These analyses are aimed at assessing the evolution of the alignment indicators over time and in comparison with selected countries which are euro area members already (Austria, Germany and Portugal[5] were selected), which will become members in the near future (Slovenia) or which aspire to such membership (Hungary, Poland and Slovakia).[6] The conclusion as to whether the Czech economy is sufficiently prepared for adopting the single currency cannot be made in absolute terms, but can ensue from the aforementioned comparison with other countries and the assessment of developments over time. In general, it can be expected that the benefits of adopting the single currency will grow with greater economic alignment and stronger adjustment mechanisms.

3.1 CYCLICAL AND STRUCTURAL ALIGNMENT

The costs arising from the loss of the Czech Republic's own monetary policy will be particularly pronounced if the Czech economy is not aligned with the euro area economy and its development therefore deviates frequently from that in the euro area. The risks arising from the Czech Republic's accession to the euro area will decrease as the degree of alignment increases.

5 The selection of countries is different from last year's; Germany has been included in the analysis, replacing Greece. This change enhances the representativeness of the selection with regard to the diversity of the economic characteristics of the euro area countries monitored. The selection thus includes countries that are comparable in terms of economic level and countries with which the Czech economy has trading links.

6 All the analyses attempted to make comparisons with all the selected countries, but in some cases that was not possible owing to a lack of relevant statistical data.

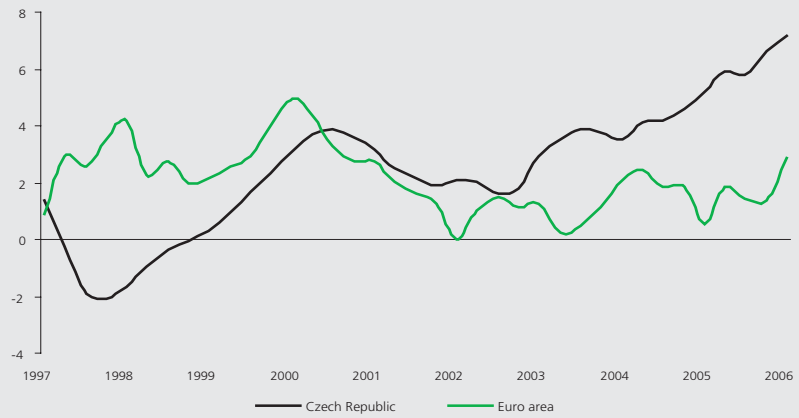
The degree of real economic convergence is an important indicator of the Czech economy's similarity to the euro area. A higher level of such convergence fosters greater similarity of long-run equilibrium development. Indirectly, it can also foster a lower likelihood of cyclical misalignment. A higher degree of convergence prior to ERM II entry and euro adoption decreases the potential future pressures for growth of the price level and equilibrium appreciation of the real exchange rate. Thanks to a pick-up in economic growth, GDP per capita in the Czech Republic has recently started to converge more quickly towards the euro area average. The current level is comparable with the other least advanced countries (see Chart 3.1) and higher than in most of the new EU Member States (except for Slovenia). The price level also converged in 2005, owing mainly to nominal appreciation of the exchange rate. However, the difference in price level relative to the euro area remains sizeable. Going forward, the process of real convergence, and hence also the equilibrium trend of real appreciation of the koruna against the euro, can be expected to continue. The persistence of this trend following accession to the euro area will initially engender a higher rate of inflation in the Czech Republic than in the euro area and, as a result, lower domestic real interest rates (probably even negative in the case of short-term money market rates). If this situation persists in the long term, it could be associated with certain risks.

Chart 3.1: Real economic convergence of selected states towards euro area in 2005
(euro area average = 100)

Source: Eurostat, CNB calculation.

Alignment of the business cycle and similarity of economic shocks are preconditions for a single monetary policy to have an effective and appropriate effect on an economy in a monetary union. Analyses suggest that at the level of overall economic activity the business cycle in the Czech Republic is not converging towards that in the euro area at any great rate (see Chart 3.2). In contrast to the results of last year's analyses, no sign of the increase in the alignment of the cycles recorded in recent years is observed either. The analyses therefore turn out worse for the Czech Republic than for the advanced euro area countries and for Hungary and Slovenia. Nor can any alignment with the euro area be seen at the level of demand-side and supply-side macroeconomic shocks. Conversely, a relatively high degree of alignment with the euro area is observed for industrial activity. The results of an analysis of export activity suggest the possibility of significant alignment between the Czech Republic and the euro area in this area. However, these results are not robust.

Chart 3.2: GDP growth in the Czech Republic and the euro area
(in %, year on year)



Source: Eurostat, CNB calculation.

A gradual increase in the **inflow of money from EU structural funds** is a specific asymmetric shock that might impact on the Czech economy. The biggest economic stimulus for domestic demand in this respect should occur in 2007 and 2008. However, the results of the analysis indicate that it will not require a significant monetary policy reaction or adjustment of the exchange rate of the koruna that would endanger the stay in ERM II and the potential assessment of the Maastricht exchange rate criterion.

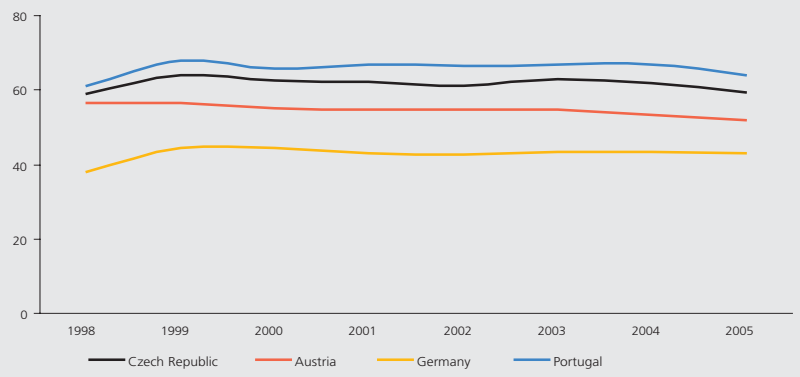
The structure of the Czech economy in terms of product creation is broadly similar to that of the euro area economy, although it retains a specific feature in the form of a higher (and, in recent years, growing) share of industry and a smaller share of services in GDP.

Another asymmetric shock that has hit some economies in the past is rapid convergence of **nominal interest rates** ahead of entry into the monetary union. For a country planning to enter, earlier gradual convergence of such rates is therefore preferable (although this simultaneously reduces the immediate benefits of joining the euro area in terms of investment support and economic growth). The difference between Czech interest rates and euro area interest rates has been zero or negative since 2002, hence the aforementioned risk is virtually non-existent at present. The Czech koruna's **exchange rate** against the dollar has been moving very much in line with the euro's exchange rate against the dollar. Among the countries under comparison, only Slovenia and Slovakia, i.e. countries participating in ERM II, have a greater alignment for this exchange rate. The macroeconomic characteristics of the Czech economy indicate the potential for broadly similar medium-term exchange rate volatility as in the other new EU Member States under comparison. The observed medium-term volatility of the Czech koruna against the euro is comparable in particular with that of the Slovak koruna, is smaller than that of the Polish zloty (and, by some measures, the Hungarian forint) and, conversely, is greater than that of the Slovenian tolar. These differences reflect, among other things, different monetary policy regimes.

The Czech economy's strong **trade and ownership links** with the euro area are the principal argument for adopting the single currency, as they increase the potential benefits arising from the elimination of potential fluctuations in the exchange rate. The euro area is the partner for 60% of Czech exports and 50%

of Czech imports, and strong links with the euro area are also apparent for the other economies under comparison (see Chart 3.3). The Czech economy's ownership links with the euro area on the direct investment inflow side are slightly stronger than in the other countries under comparison. The Czech economy's strong economic integration with the euro area creates conditions for increasing its cyclical alignment with this area. Another positive aspect from this perspective is the high intensity of intra-industry trade with the euro area, which is comparable with Austria and Germany.

Chart 3.3: Exports to the euro area as a percentage of total exports



Source: IMF, CNB calculation.

The analysis of the Czech **financial sector**, and, within it, the banking sector, reveals that despite its relatively smaller size by comparison with the euro area, it need not be expected to have a fundamentally different effect on the economy. Moreover, the monitored indicators have recently recorded further slight convergence towards the euro area. The depth of financial intermediation in the Czech Republic is currently thus roughly one-third of the level in Germany, Austria and the euro area and 45% of that in Portugal. The Czech Republic lags behind these countries in particular in terms of lending. However, as a result of dynamic growth in loans to households and corporations in Czech Republic, client loans are rising as a percentage of both total loans and GDP. On the one hand this trend represents gradual convergence towards the corresponding shares in the euro area, but on the other hand it could pose a risk of loan defaults in the event of a further build-up in household debt. The historical experience of some current euro area countries with high growth in household borrowing suggests that such a trend does not necessarily lead to problems in the financial system. The degree of integration of the Czech stock market and the euro area markets is at a slightly lower level than the German and Portuguese markets and at a similar level as Austria. The speed of elimination of shocks on the Czech stock market has recently increased.

3.2 ADJUSTMENT MECHANISMS

In the absence of independent monetary policy, the flexibility of the economy and its ability to adjust to shocks will be particularly important. The stabilisation function of public budgets, labour and product market flexibility and the ability of the financial system to absorb shocks will therefore be vital for smooth economic development.

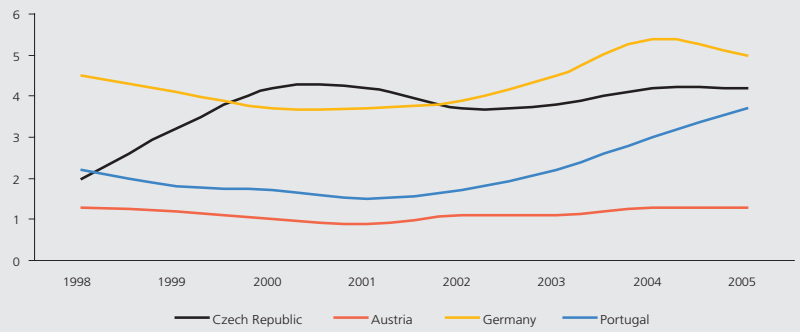
As regards **the public finances of the Czech Republic**, the operability of the stabilisation function within the European fiscal regulations will be crucial. This operability will be proportional in particular to the current distance of the deficit from the 3% reference value. The closer the deficit is to zero in its structural part, the more room there will be at a time of economic weakening for the functioning of automatic stabilisers and, in the extreme case, for the implementation of discretionary measures. The current public finance deficits, however, are largely structural in nature and there is unlikely to be an improvement in this regard in the near future. Moreover, the public finance deficit is increasing at a time of solid economic growth, and the expected future path suggests that this trend will continue. This is at odds with the effort to pursue anticyclical fiscal policy and with the intention to consolidate public finances prior to introducing the euro. The continuing public finance imbalance could be a source of growth in nominal public debt, which will probably lead to increasing debt service costs. Another condition for maintaining fiscal policy effectiveness is to achieve long-term sustainability of public finances, especially by dealing with the effect of population ageing on social system expenditures. The contribution of public finances to the economy's ability to respond flexibly to shocks will clearly be limited until these problems are tackled.

Price and wage flexibility is an important precondition for the economy to be able to absorb shocks to which the single monetary policy cannot respond. The analyses show that no major change has occurred since last year in the outlook for real wage flexibility in the Czech Republic. This flexibility, moreover, seems to be decreasing over time. Since last year the inflation persistence indicator has fallen slightly, but it remains among the highest in the sample of countries under comparison.

The ability of the Czech **labour market** to absorb shocks is largely unchanged from last year and remains average by European comparison (the European labour market itself requires fundamental reforms and may therefore be a fairly low standard). In some areas, though, the labour market is considerably less flexible than in the countries under comparison, and no major improvement is occurring. The institutional rules do not create the right conditions for employment of people with low skills. The main risk factors are the interaction of taxes and social benefits, a rising minimum wage and the costs of terminating open-ended employment contracts.

The labour market is still characterised by relatively high long-term and structural unemployment (see Chart 3.4). Although long-term unemployment is still lower than in some other countries (particularly Poland and Slovakia), it remains a major problem. Moreover, along with Germany the Czech Republic has the largest regional differences in the unemployment rate. This may be due to significant regional gaps between the demand for, and supply of, labour and the low regional mobility of the labour force. If mobility within the Czech Republic can be considered an appropriate indicator of cross-border mobility, this channel, too, will probably not be an effective adjustment mechanism in the event of economic imbalances. That said, the good news is that in 2006 several countries of the EU have opened up or partly liberalised their labour markets for citizens of the new Member States. Conversely, the inflow of foreign labour into the Czech Republic has recently been very dynamic. The vast majority of these foreign workers are in jobs requiring few, if any, qualifications. The inflow of foreign workers bears witness to some degree of flexibility as regards international migration. On the other hand, however, it suggests that some serious problems persist in the Czech labour market.

Chart 3.4: Long-term unemployment: ratio of persons unemployed for more than one year to the labour force
(%)



Source: Eurostat.

Labour market flexibility is to a great extent determined by the institutional rules. OECD analyses and new studies have revealed that collective bargaining has a fairly small effect on wage setting in the Czech Republic. The impact of the minimum wage on the flexibility of low wages and on job creation is also rather lower on average by international comparison, although the ratio of the minimum wage to the average wage has increased sharply in recent years. High minimum wages coupled with high labour taxation can have an adverse effect on job creation. Total labour taxation has been on the rise in the Czech Republic since 2000, and this trend will not be significantly changed by the modest reduction in the tax burden on low-income groups effective since January of this year. The effect of taxation on long-term unemployment and job creation is roughly the same as in Austria, Hungary and Poland, but higher than in Poland and Slovakia. Compared with other countries, the financial incentives to accept a job given by the combination of taxes and benefits are comparable or higher for the short-term unemployed, but average for the long-term unemployed. These incentives improved slightly last year thanks to the introduction of tighter conditions for qualifying for unemployment benefit and registering at labour offices. In the area of permanent employment the degree of job protection is higher than in other countries, which may present a risk in particular as regards the entry of young people to the labour market. By contrast, the introduction of easier procedures for setting up businesses will positively affect job creation. This measure means some further partial improvement in the regulation of the business environment, which by international comparison, however, remains hampered by major administrative obstacles.

Stability and profitability of the financial sector is a precondition for the sector to be able to assist in absorbing the impacts of economic shocks. The percentage of non-performing loans in the Czech Republic has recently recorded an overall decline to a level only slightly higher than the average in the euro area countries. Capital adequacy is currently at a sufficient level comparable with the other countries monitored, but outflow of earnings abroad and the lending activity of banks are causing it to fall slightly. The sector's resilience is enhanced by its high profitability. The Czech banking sector is currently recording stability and an ability to absorb external shocks and adverse economic developments.

MINUTES OF THE BOARD MEETING ON 31 AUGUST 2006

Present at the meeting:
Z. Tůma (Governor), L. Niedermayer (Vice-Governor), M. Singer (Vice-Governor),
M. Erbenová (Chief Executive Director), J. Frait (Chief Executive Director)

The Board was presented with the August situation report, which assessed the new information and the risks associated with the fulfilment of the July forecast.

The annual inflation of 2.9% in July had been 0.1 percentage point lower than predicted by the current forecast. This was a result of lower-than-forecasted growth in regulated prices, adjusted inflation excluding fuels, and fuel prices. This had outweighed the effect of faster growth in food prices, which according to the forecast should have still been falling year on year. Industrial producer prices and import prices had risen faster than forecasted, whereas annual agricultural producer price inflation had fallen sharply compared to the forecast.

Newly available information concerning the supply side and foreign trade and from business surveys signalled a continuation of the previous high GDP growth with a gradual slowing trend in the following quarters, in line with the July forecast. Preliminary estimates based on the evolution of foreign trade suggested a reduction in the year-on-year growth rate of real exports compared to the forecast. Employment and wages were developing in line with the forecast, although a slightly faster decline in registered unemployment was apparent.

After the presentation of the situation report, the Board discussed the risks to the fulfilment of the July forecast. The board members agreed that the economy was developing in line with this forecast and that the risks to it could be regarded as balanced.

The Board agreed that the projected fiscal development posed an upside risk to inflation. The opinion was expressed that owing to the size of the planned budget deficit and the legal nature of a major portion of the planned budget expenditures, the situation was more serious than in the past. It was said that the estimated fiscal impulse had risen from -1.1 percentage point in 2004 to the present 0.2 percentage point and was set to reach 0.5 percentage point in 2007. This represented a considerable fiscal expansion at a time of strong economic growth.

The Board agreed that the sole major downside risk to inflation was a possible nominal appreciation of the exchange rate. In the discussion on this issue it was said that the end of the cycle of interest rate increases in the USA might foster a strengthening of the exchange rate of the koruna. Against this, it was said that the appreciation pressure on the koruna might be eased by the persisting political uncertainty and the slightly worse-than-forecasted development of the balance of payments.

The Board then discussed the balance of payments. The opinion was expressed that a change might occur in the balance of payments trend. It was also said that the rising share of consumption in the rapid economic growth might impact on the volume of imports. In this context, the Board agreed that change in the GDP growth structure had been an integral part of the forecast, hence the modest deterioration in net exports had been expected. It was said that although expected foreign investment would increase export capacity in the future, in the short term there might be negative impacts on the trade balance under technology imports. It was also said that, in addition, the outlook for further foreign direct investment in the longer run was uncertain.

The Board went on to discuss potential developments in the external environment and their effects on the Czech economy. It was said that economic developments abroad in 2007 and 2008 would be important for domestic inflation. Attention was drawn to the relatively high economic growth in the EU countries, which should support the domestic economy. In this context, some surprise was expressed at the worse dynamics of Czech exports. Conversely, some of the board members drew attention to the slowing economic growth in the USA, which might affect demand for European exports.

The Board's discussion also touched on other future uncertainties. Some of the board members expressed concern about the impact of energy prices on domestic manufacturers' earnings and competitiveness. Considerable uncertainty was seen in the shape of the yield curves in the euro area and in the timing and extent of the impacts of the increased tax on cigarettes.

After discussing the situation report, the Board decided unanimously to leave the two-week repo rate unchanged at 2.25%.

MINUTES OF THE BOARD MEETING ON 27 SEPTEMBER 2006

Present at the meeting:
Z. Tůma (Governor), L. Niedermayer (Vice-Governor), M. Singer (Vice-Governor),
M. Erbenová (Chief Executive Director), J. Frait (Chief Executive Director), R. Holman (Chief Executive Director),
P. Řežábek (Chief Executive Director)

The Board discussed the September situation report, which assessed the new information on economic developments and the risks associated with the fulfilment of the July macroeconomic forecast. The annual inflation of 3.1% in August had been 0.2 percentage point higher than predicted by the current forecast. This was primarily a result of rising food prices, which according to the forecast should have fallen. In addition, fuel prices and adjusted inflation excluding fuels had risen rather faster than forecasted. Regulated prices had deviated slightly towards lower-than-forecasted inflation.

The annual real GDP growth of 6.2% in 2006 Q2 had been 1 percentage point lower than predicted by the forecast. As to the structure of the economic growth, the change in inventories in particular had been higher than forecasted. Household consumption had also been slightly higher, while government consumption and gross fixed capital formation had lagged behind the assumptions of the forecast. Exports and imports of goods and services had been slightly below the forecast assumptions in 2006 Q2, while the opposite was true for wage growth. Industrial producer prices had risen faster in August than assumed by the forecast. Agricultural producer prices had recorded the opposite trend. New figures on the external environment suggested a broadly neutral effect as compared to the July forecast, although the individual indicators were showing some deviations from the forecast in both directions.

After the presentation of the situation report, the Board discussed the risks to the fulfilment of the July forecast, which had been consistent with a moderate rise in interest rates in 2006 Q3. The board members assessed the magnitude of the forecast's upside risks to inflation. These risks include the higher domestic inflation in August, the higher outlook for economic growth, inflation and interest rates in the euro area, and finally domestic fiscal developments, especially in the longer run. Conversely, the current fall in global oil prices was discussed as the forecast's main downside risk to inflation. The majority of the board members assessed the risks to the fulfilment of the July forecast as being slightly on the upside. In this context, the opinion was expressed that given continuing relatively rapid growth in potential output, there should be a weakening of potential inflation pressures along with a cyclical slowdown in demand growth.

In the discussion that followed, the Board turned its attention to fiscal development and the associated problems. It was emphasised that the long-term outlook for public finances was deteriorating in particular. Some of the board members mentioned the relatively rapid wage growth in the first half of the year. They were inclined to regard this as only a very slight risk, as the current wage growth might be a delayed reaction to the cyclical growth in economic activity.

The Board moved on to discuss the exchange rate. In this context it was said that in contrast to the previous situation report the exchange rate was no longer an unequivocal downside risk to inflation and that the risks associated with the future evolution of the exchange rate were now more evenly distributed in both directions.

Following its assessment of the risks of the forecast, the Board turned to the issue of the appropriate monetary policy response. As a gradual rise in interest rates is consistent with the July forecast, the prevailing view was that interest rates should be raised at the Board's monetary policy meeting today. The main argument made in favour of this view was that the economy had in the past been in a different phase of the cycle, i.e. below the non-accelerating inflation level of output, with interest rates depressed below their long-run equilibrium level. The observed evolution of the economy was meanwhile in line with this forecast. Now, however, the forecast was predicting a different phase of the business cycle, during which the economy would fluctuate around its equilibrium values for an extended period, and this needed to be appropriately reflected in interest rates.

However, the view was also expressed that the absence of fundamental inflationary pressures allowed the interest rate increase to be postponed and reconsidered at the Board's next monetary policy meeting in October, when

the new macroeconomic forecast would be available. In support of leaving interest rates unchanged it was also said that the ongoing decline in global oil prices might have a downward effect on inflation expectations.

After discussing the situation report, the Board decided by a majority vote to raise the two-week repo rate by 0.25 percentage point to 2.5% with effect from 29 September 2006. At the same time it decided to increase the discount rate and Lombard rate by the same amount, to 1.5% and 3.5% respectively. Five board members voted in favour of this decision, and two members voted for leaving rates unchanged.

MINUTES OF THE BANK BOARD MEETING ON 26 OCTOBER 2006

Present at the meeting:
Z. Tůma (Governor), L. Niedermayer (Vice-Governor), M. Singer (Vice-Governor),
M. Erbenová (Chief Executive Director), J. Frait (Chief Executive Director), R. Holman (Chief Executive Director)

The Board discussed the October situation report containing the new macroeconomic forecast. As in the July forecast, the economy was above the non-accelerating inflation level of output. The current output gap had been revised downwards slightly, owing to the rather lower-than-forecasted second-quarter growth. During 2007, conversely, the output gap was slightly above the July forecast. In 2008, the output gap would gradually close. The forecast predicted a gradual slackening of economic growth from more than 6% in 2006 towards 5% in 2008. Underlying this, the structure of economic growth would change, with the contribution of net exports gradually being replaced by accelerating household consumption. However, gross fixed capital formation would remain a major growth factor.

The October forecast contained some changes relative to the July forecast, especially with regard to the coming four quarters. In the short term, the inflation forecast had been scaled back as a result of lower expected growth in food prices, fuel prices and adjusted inflation excluding fuels. Compared to the July forecast, the estimated impact on inflation of the increase in excise duties on cigarettes had also been reduced and the timing of this effect had been put back slightly. By contrast, the prediction for regulated prices had been revised upwards slightly for 2007. In the course of 2007, according to the forecast, consumer price inflation would thus edge up from lower initial values. As in the July forecast, it would reach the upper boundary of the tolerance band of the inflation target at the end of 2007. In the following two years inflation would thus generally be characterised by a large contribution of administrative effects. Monetary-relevant inflation (adjusted for the first-round effects of changes to indirect taxes) would also pick up pace over the course of the forecast and just exceed the point inflation target at the end of the monetary policy horizon.

Consistent with the new macroeconomic forecast and its assumptions was a gradual rise in interest rates.

After the presentation of the situation report, the Board discussed the uncertainties and risks associated with the forecast. There was a consensus that the new forecast would not lead to any change in the current view of the domestic economy. Over the forecast horizon, the economy would be characterised by quite high growth and rising inflation. The Board also stated that inflation would be affected in the coming quarters by a high weight of administrative effects and would therefore show greater volatility. This volatility would be evident as early as October and November this year, when inflation was expected to dip temporarily below 2% as a result of a reduction in gas prices. The administrative measures were associated with uncertainty in terms of both the timing of their effects on inflation and the degree of pass-through to inflation expectations.

The Board's discussion covered both the upside and downside risks to inflation. On the upside, attention was drawn to the possibility of faster-than-forecasted economic growth in the Czech Republic. In particular, consumer demand might accelerate as a result of positive developments on the labour market, consumer optimism and continuing growth in lending. It was also said that this changed structure of economic growth could have a more inflationary effect, even if the overall rate of growth were to fall.

Better economic growth abroad, especially in the euro area, might also lead to higher inflation. The uncertainty consisted in whether any change in economic growth in the euro area would be cyclical in nature or a reflection of improved structural trends. In the event of higher-than-expected potential growth of the euro area, the need for the ECB to raise interest rates would lessen, which would, in turn, have an anti-inflationary effect in the Czech Republic.

The Board also discussed the labour market situation. It seemed from the available indicators that the turnover of the registered unemployed was rising. It was said that the effect of penalty exclusions from the labour office register might be lower in reality than indicated by the statistics, because in a favourable phase of the economic cycle a proportion of the unemployed would be able to find work themselves without the assistance of labour offices. It was also said that some regions and some sectors might experience workforce shortages, especially in high-demand professions. And that would have an effect on wage growth going forward.

Turning to the downside factors, the Board focused its attention on the future pick-up in adjusted inflation during 2007, which was linked to some extent with the assumption of rising inflation expectations. The majority of the board members agreed that the extent of the pass-through of administrative effects to inflation expectations, and the rise in inflation caused by it, constituted a major uncertainty for the forecast.

The Board's discussion also touched on the fiscal situation. There was uncertainty regarding the economic interpretation of the initial base relating to the revision of the 2005 fiscal deficit, and also regarding fiscal policy in the medium term. The fiscal policy outlook beyond 2007 was currently very blurred owing to political uncertainty.

At the close of the meeting, the Board decided by a majority vote to leave the CNB two-week repo rate unchanged at 2.5%. Five members voted in favour of this decision, and one member voted for increasing rates by 0.25 percentage point.

Table 1a

INFLATION DEVELOPMENT												annual percentage changes
2002	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
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	0.4	1.0	1.0
Regulated prices	-0.3	-0.8	-0.8	1.4	1.5	1.5	0.4	0.4	0.4	1.2	1.2	1.3
(contribution to consumer price inflation)	*-0.07*	*-0.15*	*-0.16*	*0.29*	*0.31*	*0.32*	*0.08*	*0.09*	*0.08*	*0.24*	*0.24*	*0.27*
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	-0.4	-0.2	-0.2	-0.5	-0.4	0.0	-0.2	-0.1	0.0	0.3	0.9	1.0
(contribution to consumer price inflation)	*-0.32*	*-0.17*	*-0.15*	*-0.38*	*-0.30*	*-0.01*	*-0.19*	*-0.10*	*-0.01*	*0.20*	*0.70*	*0.77*
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	0.6	2.5	2.7
(contribution to consumer price inflation)	*-1.06*	*-1.06*	*-0.97*	*-0.94*	*-0.76*	*-0.28*	*-0.22*	*-0.22*	*-0.04*	*0.16*	*0.66*	*0.70*
adjusted inflation	1.5	1.7	1.5	1.1	0.9	0.5	0.1	0.2	0.0	0.1	0.1	0.1
(contribution to consumer price inflation)	*0.74*	*0.89*	*0.82*	*0.56*	*0.46*	*0.27*	*0.04*	*0.12*	*0.02*	*0.04*	*0.04*	*0.06*
Inflation rate (annual moving average)	1.5	1.1	0.8	0.5	0.3	0.2	0.2	0.1	0.0	0.0	0.1	0.1
2004												
Consumer prices	2.3	2.3	2.5	2.3	2.7	2.9	3.2	3.4	3.0	3.5	2.9	2.8
Regulated prices	5.0	4.9	4.7	3.1	2.4	2.4	2.4	2.3	2.3	4.4	4.4	4.4
(contribution to consumer price inflation)	*1.01*	*0.99*	*0.96*	*0.63*	*0.49*	*0.49*	*0.49*	*0.47*	*0.46*	*0.90*	*0.89*	*0.89*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.35*	*0.35*	*0.35*	*0.39*	*0.61*	*0.68*	*0.72*	*0.73*	*0.76*	*0.76*	*0.76*	*0.76*
Net inflation	1.2	1.2	1.4	1.5	2.0	2.1	2.5	2.6	2.3	2.1	1.6	1.5
(contribution to consumer price inflation)	*0.96*	*0.92*	*1.15*	*1.21*	*1.63*	*1.71*	*2.02*	*2.11*	*1.81*	*1.71*	*1.28*	*1.20*
of which: prices of food, beverages and tobacco	2.8	2.8	3.2	3.3	3.4	2.7	3.8	4.2	3.0	2.2	0.7	0.9
(contribution to consumer price inflation)	*0.75*	*0.75*	*0.83*	*0.86*	*0.89*	*0.71*	*1.00*	*1.10*	*0.78*	*0.59*	*0.18*	*0.25*
adjusted inflation	0.4	0.3	0.6	0.6	1.4	1.9	1.9	1.9	1.9	2.1	2.1	1.8
(contribution to consumer price inflation)	*0.21*	*0.17*	*0.32*	*0.35*	*0.74*	*1.00*	*1.02*	*1.02*	*1.03*	*1.12*	*1.10*	*0.96*
Inflation rate (annual moving average)	0.3	0.5	0.8	1.0	1.2	1.4	1.7	2.0	2.2	2.5	2.7	2.8
2005												
Consumer prices	1.7	1.7	1.5	1.6	1.3	1.8	1.7	1.7	2.2	2.6	2.4	2.2
Regulated prices	2.9	2.9	2.9	3.1	4.0	5.8	6.6	6.8	6.8	9.0	9.0	9.0
(contribution to consumer price inflation)	*0.61*	*0.60*	*0.61*	*0.66*	*0.83*	*1.21*	*1.38*	*1.41*	*1.41*	*1.87*	*1.87*	*1.87*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.35*	*0.35*	*0.35*	*0.31*	*0.09*	*0.02*	*-0.02*	*-0.03*	*-0.06*	*-0.06*	*-0.05*	*0.00*
Net inflation	0.9	0.9	0.7	0.8	0.6	0.7	0.4	0.4	1.1	1.0	0.8	0.4
(contribution to consumer price inflation)	*0.72*	*0.75*	*0.59*	*0.68*	*0.46*	*0.53*	*0.35*	*0.35*	*0.89*	*0.80*	*0.65*	*0.32*
of which: prices of food, beverages and tobacco	0.4	0.6	0.4	-0.1	-0.1	0.2	-0.6	-0.6	-0.2	0.3	0.3	-0.7
(contribution to consumer price inflation)	*0.11*	*0.17*	*0.12*	*-0.02*	*-0.03*	*0.04*	*-0.15*	*-0.17*	*-0.05*	*0.07*	*0.08*	*-0.17*
adjusted inflation	1.1	1.1	0.9	1.3	0.9	0.9	0.9	1.0	1.8	1.4	1.1	0.9
(contribution to consumer price inflation)	*0.61*	*0.59*	*0.47*	*0.69*	*0.49*	*0.48*	*0.50*	*0.52*	*0.94*	*0.74*	*0.57*	*0.49*
Inflation rate (annual moving average)	2.8	2.7	2.6	2.6	2.5	2.4	2.2	2.1	2.0	2.0	1.9	1.9
Rok 2006												
Consumer prices	2.9	2.8	2.8	2.8	3.1	2.8	2.9	3.1	2.7			
Regulated prices	11.0	11.0	11.2	11.5	12.4	10.5	9.7	9.8	9.8			
(contribution to consumer price inflation)	*2.27*	*2.28*	*2.30*	*2.37*	*2.55*	*2.19*	*2.02*	*2.06*	*2.05*			
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.21*	*0.34*	*0.39*	*0.39*	*0.39*	*0.39*	*0.39*	*0.21*	*0.21*			
Net inflation	0.5	0.3	0.1	0.1	0.3	0.3	0.7	1.1	0.5			
(contribution to consumer price inflation)	*0.40*	*0.23*	*0.08*	*0.09*	*0.22*	*0.24*	*0.55*	*0.88*	*0.43*			
of which: prices of food, beverages and tobacco	-1.0	-1.6	-1.8	-1.5	-1.3	-0.6	0.5	1.3	1.4			
(contribution to consumer price inflation)	*-0.25*	*-0.41*	*-0.47*	*-0.39*	*-0.34*	*-0.15*	*0.13*	*0.34*	*0.35*			
adjusted inflation	1.2	1.2	1.0	0.9	1.1	0.7	0.8	1.0	0.1			
(contribution to consumer price inflation)	*0.65*	*0.64*	*0.55*	*0.48*	*0.56*	*0.39*	*0.42*	*0.54*	*0.08*			
Inflation rate (annual moving average)	2.0	2.1	2.2	2.3	2.4	2.5	2.6	2.7	2.8			

CNB calculation based on CZSO data

Table 1b

INFLATION DEVELOPMENT												monthly percentage changes
2002	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
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	0.1	0.5	0.2
Regulated prices	0.1	0.3	0.2	1.1	-0.1	0.0	0.0	0.0	0.1	-0.4	0.0	0.0
(contribution to consumer price inflation)	*0.03*	*0.06*	*0.03*	*0.23*	*-0.01*	*0.01*	*0.00*	*0.00*	*0.01*	*-0.09*	*0.00*	*0.00*
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	0.7	0.2	-0.2	0.0	0.0	0.1	0.0	-0.1	-0.6	0.3	0.5	0.3
(contribution to consumer price inflation)	*0.55*	*0.14*	*-0.13*	*-0.03*	*-0.04*	*0.05*	*0.03*	*-0.11*	*-0.49*	*0.22*	*0.39*	*0.20*
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	0.7	1.6	0.8
(contribution to consumer price inflation)	*0.22*	*-0.05*	*-0.05*	*0.04*	*0.10*	*0.16*	*-0.44*	*-0.25*	*0.16*	*0.18*	*0.42*	*0.22*
adjusted inflation	0.6	0.3	-0.1	-0.1	-0.3	-0.2	0.9	0.3	-1.2	0.1	-0.1	0.0
(contribution to consumer price inflation)	*0.33*	*0.18*	*-0.07*	*-0.06*	*-0.14*	*-0.11*	*0.47*	*0.15*	*-0.65*	*0.03*	*-0.03*	*-0.02*
2004												
Consumer prices	1.8	0.2	0.1	0.0	0.4	0.2	0.4	0.0	-0.8	0.5	-0.1	0.1
Regulated prices	3.7	0.2	0.0	-0.5	-0.7	0.0	0.0	-0.1	0.0	1.6	0.0	0.0
(contribution to consumer price inflation)	*0.76*	*0.04*	*0.01*	*-0.10*	*-0.15*	*0.00*	*0.00*	*-0.03*	*0.01*	*0.34*	*-0.01*	*0.00*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.35*	*0.00*	*0.00*	*0.04*	*0.23*	*0.07*	*0.04*	*0.01*	*0.03*	*0.00*	*0.00*	*0.00*
Net inflation	0.9	0.1	0.1	0.0	0.5	0.1	0.4	0.0	-1.0	0.2	0.0	0.2
(contribution to consumer price inflation)	*0.74*	*0.09*	*0.10*	*0.03*	*0.37*	*0.12*	*0.33*	*-0.01*	*-0.78*	*0.12*	*-0.04*	*0.12*
of which: prices of food, beverages and tobacco	1.0	-0.2	0.1	0.3	0.5	-0.1	-0.6	-0.6	-0.6	0.0	0.0	1.1
(contribution to consumer price inflation)	*0.26*	*-0.05*	*0.02*	*0.07*	*0.14*	*-0.03*	*-0.15*	*-0.15*	*-0.16*	*-0.01*	*0.01*	*0.28*
adjusted inflation	0.9	0.3	0.1	-0.1	0.4	0.3	0.9	0.3	-1.2	0.2	-0.1	-0.3
(contribution to consumer price inflation)	*0.48*	*0.14*	*0.08*	*-0.04*	*0.23*	*0.14*	*0.48*	*0.14*	*-0.63*	*0.13*	*-0.05*	*-0.16*
2005												
Consumer prices	0.7	0.2	-0.1	0.1	0.2	0.6	0.3	0.0	-0.3	0.9	-0.3	-0.1
Regulated prices	2.2	0.2	0.1	-0.2	0.1	1.8	0.8	0.0	0.0	3.7	0.0	0.0
(contribution to consumer price inflation)	*0.48*	*0.04*	*0.01*	*-0.05*	*0.02*	*0.39*	*0.16*	*0.00*	*0.01*	*0.78*	*0.00*	*0.00*
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*-0.06*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.05*
Net inflation	0.3	0.2	-0.1	0.1	0.2	0.2	0.2	0.0	-0.3	0.1	-0.2	-0.3
(contribution to consumer price inflation)	*0.26*	*0.13*	*-0.06*	*0.11*	*0.15*	*0.19*	*0.17*	*-0.01*	*-0.26*	*0.05*	*-0.20*	*-0.20*
of which: prices of food, beverages and tobacco	0.5	0.0	-0.1	-0.2	0.5	0.2	-1.3	-0.7	-0.2	0.4	0.1	0.1
(contribution to consumer price inflation)	*0.12*	*0.01*	*-0.02*	*-0.06*	*0.12*	*0.05*	*-0.33*	*-0.17*	*-0.04*	*0.11*	*0.02*	*0.03*
adjusted inflation	0.3	0.2	-0.1	0.3	0.1	0.3	0.9	0.3	-0.4	-0.1	-0.4	-0.4
(contribution to consumer price inflation)	*0.14*	*0.11*	*-0.04*	*0.17*	*0.03*	*0.14*	*0.50*	*0.16*	*-0.21*	*-0.06*	*-0.22*	*-0.23*
2006												
Consumer prices	1.4	0.1	-0.1	0.1	0.5	0.3	0.4	0.2	-0.7			
Regulated prices	4.1	0.2	0.2	0.1	0.9	0.1	0.0	0.2	0.0			
(contribution to consumer price inflation)	*0.89*	*0.04*	*0.03*	*0.02*	*0.21*	*0.02*	*0.00*	*0.04*	*-0.01*			
Influence of indirect tax growth on unregulated prices												
(contribution to consumer price inflation)	*0.16*	*0.13*	*0.05*	*0.00*	*0.00*	*0.00*	*0.00*	*-0.18*	*0.00*			
Net inflation	0.4	-0.1	-0.3	0.2	0.4	0.3	0.6	0.4	-0.9			
(contribution to consumer price inflation)	*0.33*	*-0.05*	*-0.21*	*0.12*	*0.28*	*0.20*	*0.47*	*0.31*	*-0.69*			
of which: prices of food, beverages and tobacco	0.2	-0.6	-0.3	0.1	0.7	0.9	-0.2	0.2	-0.1			
(contribution to consumer price inflation)	*0.04*	*-0.15*	*-0.08*	*0.02*	*0.17*	*0.23*	*-0.05*	*0.05*	*-0.03*			
adjusted inflation	0.5	0.2	-0.2	0.2	0.2	-0.1	1.0	0.5	-1.2			
(contribution to consumer price inflation)	*0.29*	*0.10*	*-0.12*	*0.10*	*0.12*	*-0.03*	*0.53*	*0.26*	*-0.65*			

CNB calculation based on CZSO data

Table 2

CONSUMER PRICES percentage changes; December 1999 = 100

Group	Constant 1999 weights in per mille	Months 1	2	3	4	5	6	7	8	9	10	11	12	Average since start of year
Total - 2002	1,000.0	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
Total - 2003	1,000.0	9.6	9.8	9.7	9.9	9.9	9.9	10.0	9.8	9.3	9.4	9.9	10.1	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	2.2	4.4	5.7	2.8
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	8.0	7.8	7.8
Clothing and footwear	56.9	-9.1	-10.0	-10.4	-10.1	-10.1	-10.4	-11.5	-12.6	-12.4	-12.1	-11.9	-11.9	-11.0
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	26.6	26.6	26.6	26.3
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	-2.8	-3.0	-3.0	-2.1
Health	14.3	13.7	14.2	14.8	15.4	16.3	16.4	17.4	17.5	17.5	16.9	16.3	16.4	16.1
Transport	101.4	4.7	5.2	5.8	5.5	4.5	3.8	3.5	3.8	4.3	4.0	3.7	3.6	4.4
Communications	22.5	7.9	8.9	8.8	9.0	7.5	7.4	7.4	7.4	7.3	7.3	7.3	7.2	7.8
Recreation and culture	95.5	8.5	9.6	8.5	7.7	7.1	7.0	12.5	14.3	6.1	6.3	6.2	6.1	8.3
Education	4.5	11.3	11.4	11.5	11.5	11.5	11.6	11.6	11.6	11.0	12.0	12.0	12.0	11.6
Hotels, cafés and restaurants	74.2	9.2	9.4	9.4	9.5	9.6	9.6	9.9	10.0	10.3	10.5	10.7	10.8	9.9
Miscellaneous goods and services	49.5	14.0	14.6	14.7	14.7	14.6	14.6	14.5	14.7	14.9	15.4	15.3	15.2	14.8
Total - 2004	1,000.0	12.1	12.3	12.4	12.4	12.9	13.1	13.5	13.5	12.6	13.2	13.1	13.2	12.9
Food and non-alcoholic beverages	197.6	7.4	7.1	7.2	7.5	7.1	7.1	6.3	5.4	4.7	4.7	4.8	6.6	6.3
Alcoholic beverages and tobacco	79.2	8.5	8.6	8.7	9.4	11.2	11.8	12.2	12.4	12.3	12.2	12.1	11.6	10.9
Clothing and footwear	56.9	-13.5	-14.3	-14.3	-14.2	-14.1	-14.1	-15.3	-16.1	-15.8	-14.8	-14.6	-14.6	-14.6
Housing, water, electricity, gas and other fuels	236.4	30.1	30.5	30.7	30.2	29.7	29.8	30.2	30.3	30.5	32.2	32.2	32.2	30.7
Furnishings, household equipment and routine maintenance of the house	67.9	-3.1	-3.3	-3.4	-3.4	-3.9	-3.9	-4.2	-4.4	-4.5	-4.6	-4.8	-4.9	-4.0
Health	14.3	16.5	17.0	17.4	17.9	20.3	20.7	20.9	21.2	21.7	21.0	20.6	20.6	19.7
Transport	101.4	5.8	5.8	6.8	6.8	8.2	7.6	7.3	7.2	6.4	7.0	6.6	5.0	6.7
Communications	22.5	24.2	23.1	23.0	22.9	21.5	21.4	21.3	19.7	19.6	21.2	21.1	21.0	21.7
Recreation and culture	95.5	7.4	8.7	7.6	7.0	7.5	9.1	14.9	17.0	8.9	8.4	8.0	7.9	9.4
Education	4.5	12.2	12.6	12.5	12.5	12.9	12.8	12.8	12.8	17.9	18.1	18.1	18.1	14.4
Hotels, cafés and restaurants	74.2	11.8	12.0	12.4	12.6	17.1	17.5	17.7	17.8	18.8	19.3	19.5	19.6	16.3
Miscellaneous goods and services	49.5	17.4	18.3	18.8	18.7	19.9	20.3	20.4	20.3	20.2	20.1	20.3	20.3	19.6
Total - 2005	1,000.0	14.0	14.2	14.1	14.2	14.4	15.1	15.4	15.4	15.1	16.1	15.8	15.7	15.0
Food and non-alcoholic beverages	197.6	6.9	6.9	6.8	6.6	7.3	7.5	5.6	4.6	4.4	5.0	5.2	5.6	6.0
Alcoholic beverages and tobacco	79.2	12.6	12.8	12.7	12.3	12.3	12.5	12.4	12.4	12.3	12.4	12.3	12.4	12.5
Clothing and footwear	56.9	-17.2	-18.2	-18.4	-18.1	-18.1	-18.3	-19.6	-20.7	-20.6	-20.1	-20.0	-20.2	-19.1
Housing, water, electricity, gas and other fuels	236.4	34.7	34.9	35.1	34.9	34.9	35.0	35.6	35.7	35.8	38.9	38.9	38.9	36.1
Furnishings, household equipment and routine maintenance of the house	67.9	-5.2	-5.4	-5.5	-5.7	-5.8	-5.9	-6.1	-6.2	-6.4	-6.4	-6.5	-6.6	-6.0
Health	14.3	25.5	26.1	26.7	27.3	29.1	30.1	30.2	30.4	31.0	29.9	29.5	29.5	28.8
Transport	101.4	3.9	3.7	4.1	6.8	6.9	7.8	9.5	9.6	13.6	13.0	11.1	8.8	8.2
Communications	22.5	21.0	20.1	20.1	20.0	19.9	38.6	39.0	39.0	38.2	38.2	38.1	38.1	30.9
Recreation and culture	95.5	9.8	11.4	10.1	8.9	9.4	10.1	15.8	18.1	10.1	11.2	10.6	10.5	11.3
Education	4.5	14.9	15.6	15.8	15.8	15.8	15.6	15.6	15.6	19.5	20.2	20.2	20.2	17.1
Hotels, cafés and restaurants	74.2	20.4	21.0	21.2	21.5	21.4	21.5	21.2	21.2	22.4	22.8	22.8	22.8	21.7
Miscellaneous goods and services	49.5	20.3	20.9	20.9	20.9	20.8	20.7	20.7	20.6	20.7	20.8	20.9	20.9	20.8
Total - 2006	1,000.0	17.3	17.4	17.3	17.4	18.0	18.3	18.8	19.0	18.2				18.0
Food and non-alcoholic beverages	197.6	6.4	6.2	6.0	6.2	7.0	8.5	8.1	7.3	7.1				7.0
Alcoholic beverages and tobacco	79.2	13.5	13.7	13.7	13.5	14.0	13.7	13.9	13.9	13.9				13.8
Clothing and footwear	56.9	-22.1	-23.0	-23.2	-23.1	-23.2	-23.6	-25.3	-25.6	-25.3				-23.8
Housing, water, electricity, gas and other fuels	236.4	44.1	44.4	44.5	44.8	44.9	45.0	45.1	45.1	45.2				44.8
Furnishings, household equipment and routine maintenance of the house	67.9	-6.8	-6.8	-7.0	-7.0	-7.1	-7.3	-7.4	-7.4	-7.4				-7.1
Health	14.3	30.9	31.3	32.3	32.8	34.1	34.9	35.0	37.9	38.3				34.2
Transport	101.4	8.5	8.7	8.5	10.1	11.4	11.3	12.2	12.4	11.3				10.5
Communications	22.5	38.8	36.0	36.0	33.1	40.5	40.5	41.5	42.2	42.1				39.0
Recreation and culture	95.5	12.0	13.3	12.1	11.4	11.7	11.6	17.4	20.3	12.4				13.6
Education	4.5	20.1	20.2	20.1	20.1	20.1	20.1	20.1	20.1	23.2				20.5
Hotels, cafés and restaurants	74.2	23.6	24.0	24.1	24.4	24.6	24.8	25.0	25.2	25.5				24.6
Miscellaneous goods and services	49.5	21.9	22.5	22.7	22.9	23.0	22.9	23.3	23.3	23.3				22.9

Source: CZSO

Table 3

CONSUMER PRICES - TRADABLES AND NONTRADABLES

percentage changes; December 1999 = 100

Group	Constant 1999 weights in per mille	2002 12	2003 12	2004 12	2005 9	2005 12	2006 3	2006 6	2006 9
1. Food and non-alcoholic beverages	197.6	2.1	5.7	6.6	4.4	5.6	6.0	8.5	7.1
- tradables	197.6	2.1	5.7	6.6	4.4	5.6	6.0	8.5	7.1
2. Alcoholic beverages and tobacco	79.2	7.1	7.8	11.6	12.3	12.4	13.7	13.7	13.9
- tradables	79.2	7.1	7.8	11.6	12.3	12.4	13.7	13.7	13.9
3. Clothing and footwear	56.9	-7.7	-11.9	-14.6	-20.6	-20.2	-23.2	-23.6	-25.3
- nontradables	1.4	18.3	21.1	35.9	37.6	38.4	40.8	41.8	42.5
- tradables	55.5	-8.4	-12.7	-15.9	-22.1	-21.7	-24.8	-25.3	-27.0
4. Housing, water, electricity, gas and other fuels	236.4	24.3	26.6	32.2	35.8	38.9	44.5	45.0	45.2
- nontradables	226.1	25.2	27.5	33.2	36.9	40.1	45.9	46.5	46.5
- tradables	10.3	4.0	5.9	10.7	12.0	12.4	12.6	11.6	15.5
5. Furnishings, household equipment and routine maintenance of the house	67.9	-1.0	-3.0	-4.9	-6.4	-6.6	-7.0	-7.3	-7.4
- nontradables	2.9	9.9	12.3	16.8	17.1	17.3	19.0	20.0	20.3
- tradables	65.0	-1.5	-3.7	-5.9	-7.5	-7.7	-8.2	-8.5	-8.6
6. Health	14.3	12.8	16.4	20.6	31.0	29.5	32.3	34.9	38.3
- nontradables	11.0	15.4	19.9	25.2	38.5	36.5	40.0	43.3	47.7
- tradables	3.3	4.4	5.1	5.6	6.4	6.7	7.1	7.4	7.5
7. Transport	101.4	4.1	3.6	5.0	13.6	8.8	8.5	11.3	11.3
- nontradables	27.4	16.0	18.4	23.0	26.3	26.8	28.6	28.9	30.4
- tradables	74.0	-0.3	-1.9	-1.6	8.9	2.1	1.1	4.8	4.3
8. Communications	22.5	8.2	7.2	21.0	38.2	38.1	36.0	40.5	42.1
- nontradables	21.0	2.1	12.1	32.8	46.5	46.5	46.5	53.9	53.7
- tradables	1.5	95.9	-62.3	-92.6	-80.8	-82.3	-85.8	-94.2	-79.4
9. Recreation and culture	95.5	7.2	6.1	7.9	10.1	10.5	12.1	11.6	12.4
- nontradables	60.4	16.2	16.7	21.2	26.8	27.4	30.0	30.0	32.0
- tradables	35.1	-8.3	-12.1	-15.0	-18.7	-18.6	-18.7	-20.0	-21.3
10. Education	4.5	11.3	12.0	18.1	19.5	20.2	20.1	20.1	23.2
- nontradables	4.5	11.3	12.0	18.1	19.5	20.2	20.1	20.1	23.2
11. Hotels, cafés and restaurants	74.2	8.7	10.8	19.6	22.4	22.8	24.1	24.8	25.5
- nontradables	74.2	8.7	10.8	19.6	22.4	22.8	24.1	24.8	25.5
12. Miscellaneous goods and services	49.5	11.9	15.2	20.3	20.7	20.9	22.7	22.9	23.3
- nontradables	22.0	25.8	36.4	48.4	51.2	51.5	55.4	56.0	56.4
- tradables	27.5	0.8	-1.7	-2.2	-3.6	-3.5	-3.4	-3.5	-3.1
Household consumer prices, total	1,000.0	9.0	10.1	13.2	15.1	15.7	17.3	18.3	18.2
Tradables	549.1	0.6	0.3	0.3	0.1	-0.3	-0.6	0.5	-0.1
- food	276.8	3.5	6.3	8.0	6.7	7.5	8.2	10.0	9.0
- others	272.3	-2.4	-5.8	-7.6	-6.5	-8.3	-9.5	-9.1	-9.5
Nontradables	450.9	19.2	22.0	29.0	33.4	35.2	39.1	39.9	40.6
- others	271.2	16.5	19.4	29.9	33.1	32.8	35.1	35.5	36.4
- regulated	179.7	23.2	26.0	27.7	33.8	38.8	45.0	46.7	46.9

CNB calculation based on CZSO data

Table 4

INFLATION EXPECTATIONS OF SELECTED ECONOMIC SECTORS FOR 12 MONTHS AHEAD annual percentage changes

		CPI	
	Financial market	Businesses	Households
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	2.4	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
10/03	3.0	—	—
11/03	3.1	—	—
12/03	3.3	2.9	4.2
1/04	2.9	—	—
2/04	3.2	—	—
3/04	3.0	3.3	4.9
4/04	2.8	—	—
5/04	2.6	—	—
6/04	2.7	3.1	4.9
7/04	2.8	—	—
8/04	2.8	—	—
9/04	3.0	3.1	1.7
10/04	2.8	—	—
11/04	2.8	—	—
12/04	2.8	3.2	1.5
1/05	2.8	—	—
2/05	2.6	—	—
3/05	2.6	2.7	3.8
4/05	2.5	—	—
5/05	2.4	—	—
6/05	2.3	2.7	3.8
7/05	2.4	—	—
8/05	2.5	—	—
9/05	2.5	2.8	5.2
10/05	2.7	—	—
11/05	2.8	—	—
12/05	2.6	2.8	4.6
1/06	2.5	—	—
2/06	2.5	—	—
3/06	2.5	2.7	4.1
4/06	2.6	—	—
5/06	2.6	—	—
6/06	2.8	2.9	5.9
7/06	2.9	—	—
8/06	3.1	—	—
9/06	3.2	3.0	5.0

Source: CNB statistical survey

Table 5

HARMONISED INDEX OF CONSUMER PRICES

annual percentage changes

	2002	2003	2004	2005	2006
	12	12	12	12	9
European Union (25 countries)	2.1	1.9	2.4	2.1	1.9
European Union (15 countries)	2.2	1.8	2.2	2.2	1.8
Belgium	1.3	1.7	1.9	2.8	1.9
Czech Republic	0.1	0.9	2.5	1.9	2.2
Denmark	2.6	1.2	0.9	2.2	1.5
Germany	1.2	1.0	2.3	2.1	1.0
Estonia	2.7	1.2	4.8	3.6	3.8
Greece	3.5	3.1	3.1	3.5	3.1
Spain	4.0	2.7	3.3	3.7	2.9
France	2.2	2.4	2.3	1.8	1.5
Ireland	4.6	3.0	2.4	1.9	2.2
Italy	2.9	2.5	2.4	2.1	2.4
Cyprus	3.1	2.2	3.9	1.4	2.2
Latvia	1.5	3.5	7.4	7.1	5.9
Lithuania	-0.9	-1.3	2.8	3.0	3.3
Luxembourg	2.8	2.4	3.5	3.4	2.0
Hungary	4.9	5.6	5.5	3.3	5.9
Malta	2.1	2.4	1.9	3.4	3.1
Netherlands	3.2	1.6	1.2	2.0	1.5
Austria	1.7	1.3	2.5	1.6	1.3
Poland	0.8	1.6	4.4	0.8	1.4
Portugal	4.0	2.3	2.6	2.5	3.0
Slovenia	7.1	4.7	3.3	2.4	2.5
Slovakia	3.2	9.4	5.8	3.9	4.5
Finland	1.7	1.2	0.1	1.1	0.8
Sweden	1.6	1.8	0.9	1.3	1.2
United Kingdom	1.7	1.3	1.7	1.9	

Source: Eurostat

Table 6

MONETARY SURVEY					position at month-end in CZK billions
	2002	2003	2004	2005	2006
	12	12	12	12	8
Total assets	1,651.8	1,766.1	1,844.1	1,992.1	2,099.7
Net external assets (NEAs)	926.1	821.5	863.3	1,076.4	1,012.0
NEAs of CNB	715.6	687.5	634.1	724.7	681.8
NEAs of OMFIs	210.5	134.0	229.3	351.7	330.2
Net domestic assets	725.8	944.5	980.8	915.8	1,087.8
Domestic loans	940.0	1,145.6	1,147.0	1,166.6	1,307.1
Net credit to government (NCG) (including securities)	215.8	354.0	257.5	99.1	94.7
NCG to central government (including securities)	260.4	408.7	312.4	163.0	189.9
NCG to other government (including securities)	-44.6	-54.8	-54.9	-64.0	-95.2
Loans to corporations and households					
(excluding securities)	724.2	791.6	889.4	1,067.5	1,212.4
Loans to corporations (excluding securities)	542.7	554.1	574.2	649.7	721.8
Loans to households (excluding securities)	181.5	237.5	315.2	417.8	490.6
Other net items (including securities and capital)	-214.3	-201.1	-166.2	-250.8	-219.3
Holdings of securities	18.5	16.6	18.8	14.4	12.3
Issued securities	-48.6	-51.6	-74.9	-119.1	-119.8
Liabilities					
Monetary aggregate M2	1,651.8	1,766.1	1,844.1	1,992.1	2,099.7
Monetary aggregate M1	787.7	902.8	962.3	1,087.3	1,193.0
Currency in circulation	197.8	221.4	236.8	263.8	282.4
Overnight deposits	589.9	681.4	725.6	823.5	910.6
Overnight deposits - households	315.6	372.1	410.8	456.6	520.3
Overnight deposits - corporations	274.3	309.3	314.7	367.0	390.3
M2-M1 (quasi money)	864.1	863.3	881.8	904.8	906.7
Deposits with agreed maturity	651.2	666.4	675.3	671.4	654.5
Deposits with agreed maturity - households	448.6	439.8	458.6	445.1	432.3
Deposits with agreed maturity - corporations	202.5	226.6	216.7	226.3	222.3
Deposits redeemable at notice	194.3	185.6	198.8	224.1	239.2
Deposits redeemable at notice - households	190.7	182.3	194.6	220.6	235.6
Deposits redeemable at notice - corporations	3.6	3.2	4.2	3.6	3.6
Repurchase agreements	18.6	11.3	7.6	9.3	13.0
Annual percentage changes					
M1	35.0	14.6	6.6	13.0	16.0
M2	3.5	6.9	4.4	8.0	9.3
Loans to corporations and households	-6.6	9.3	12.4	20.0	20.3
M2-M1 (deposits)	-14.6	-0.1	2.1	2.6	1.6
Annual percentage growth rates					
M1	__	15.5	8.3	13.1	16.6
M2	__	8.1	5.8	8.1	9.9
Loans to corporations and households	__	11.8	15.3	20.8	21.2
M2-M1 (deposits)	__	1.2	3.3	2.6	2.2

Table 7

INTEREST RATES ON INTERBANK DEPOSITS

percentages

	2002 12	2003 12	2004 12	2005 12	2006 9
1. Average PRIBOR [1]					
- 1 day	2.75	1.98	2.49	2.00	2.05
- 7 day	2.76	2.02	2.51	2.04	2.25
- 14 day	2.76	2.03	2.51	2.04	2.28
- 1 month	2.73	2.04	2.53	2.05	2.36
- 2 month	2.67	2.06	2.55	2.10	2.42
- 3 month	2.63	2.08	2.57	2.17	2.49
- 6 month	2.60	2.13	2.67	2.33	2.66
- 9 month	2.60	2.22	2.76	2.44	2.81
- 12 month	2.60	2.30	2.85	2.53	2.94
2. Average PRIBID [1]					
- 1 day	2.65	1.88	2.39	1.90	1.95
- 7 day	2.67	1.92	2.41	1.94	2.15
- 14 day	2.67	1.93	2.41	1.94	2.18
- 1 month	2.64	1.94	2.43	1.95	2.26
- 2 month	2.57	1.96	2.45	2.00	2.32
- 3 month	2.54	1.98	2.47	2.07	2.39
- 6 month	2.51	2.03	2.57	2.23	2.56
- 9 month	2.51	2.12	2.66	2.34	2.71
- 12 month	2.51	2.20	2.75	2.43	2.84

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

Table 8

FRA RATES					percentages; monthly averages
	2002	2003	2004	2005	2006
	12	12	12	12	9
3 * 6	2.52	2.23	2.74	2.46	2.80
3 * 9	2.54	2.36	2.81	2.57	2.96
6 * 9	2.52	2.47	2.85	2.66	3.10
6 * 12	2.58	2.64	2.92	2.74	3.22
9 * 12	2.61	2.77	2.97	2.79	3.31
9*12 - 3*6 spread	0.10	0.55	0.24	0.33	0.51
6*12 - 3*9 spread	0.04	0.28	0.12	0.17	0.26

IRS RATES					percentages; monthly averages
	2002	2003	2004	2005	2006
	12	12	12	12	9
1R	2.63	2.41	2.82	2.56	2.97
2R	2.85	2.98	3.06	2.82	3.27
3R	3.18	3.38	3.27	3.00	3.43
4R	3.46	3.69	3.45	3.13	3.52
5R	3.70	3.93	3.62	3.25	3.59
6R	3.91	4.13	3.77	3.33	3.65
7R	4.08	4.29	3.89	3.40	3.71
8R	4.23	4.43	4.00	3.46	3.76
9R	4.36	4.54	4.09	3.52	3.80
10R	4.47	4.64	4.17	3.58	3.83
15R	4.77	4.97	4.40	3.78	4.01
20R	—	5.11	4.54	3.88	4.10
5Y - 1Y spread	1.07	1.52	0.80	0.69	0.62
10Y - 1Y spread	1.84	2.23	1.35	1.02	0.87

Table 9

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
	2W	1Y	new loans	time deposits	2W	1Y	new loans	time deposits	2W	1Y	client loans
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	3.5	3.4	4.5	2.8	2.9	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	2.1	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	3.6	1.7	2.0	2.2	3.6	1.7	2.0	2.2	3.6
10/03	2.0	2.2	3.7	1.7	1.6	1.8	3.3	1.3	2.1	2.3	3.8
11/03	2.0	2.2	3.5	1.8	1.0	1.2	2.5	0.7	1.6	1.8	3.1
12/03	2.0	2.3	3.7	1.7	1.0	1.3	2.6	0.7	1.1	1.4	2.7
1/04	2.0	2.3	5.5	1.4	-0.3	0.0	3.1	-0.9	0.4	0.7	3.9
2/04	2.0	2.3	5.0	1.4	-0.3	0.0	2.7	-0.9	0.5	0.8	3.5
3/04	2.0	2.3	5.1	1.5	-0.5	-0.2	2.6	-1.0	-0.1	0.2	3.0
4/04	2.0	2.3	5.4	1.5	-0.3	0.0	3.0	-0.8	-1.6	-1.4	1.6
5/04	2.0	2.5	5.4	1.5	-0.7	-0.2	2.6	-1.2	-2.7	-2.3	0.5
6/04	2.1	2.8	5.3	1.6	-0.8	-0.1	2.4	-1.3	-3.9	-3.2	-0.8
7/04	2.3	3.0	5.7	1.7	-0.9	-0.2	2.4	-1.5	-4.7	-4.0	-1.5
8/04	2.3	3.0	6.0	1.7	-1.0	-0.4	2.5	-1.7	-5.3	-4.7	-1.9
9/04	2.5	3.1	5.9	1.8	-0.5	0.1	2.9	-1.2	-5.1	-4.5	-1.9
10/04	2.5	3.0	6.0	1.8	-1.0	-0.4	2.4	-1.6	-5.6	-5.1	-2.4
11/04	2.5	2.9	6.1	1.8	-0.4	0.0	3.1	-1.1	-5.3	-4.9	-2.0
12/04	2.5	2.8	6.1	1.9	-0.3	0.0	3.2	-0.9	-4.8	-4.5	-1.5
1/05	2.5	2.7	6.2	1.8	0.8	1.0	4.4	0.1	-4.4	-4.2	-1.0
2/05	2.3	2.2	6.0	1.7	0.6	0.5	4.2	0.0	-4.5	-4.5	-1.1
3/05	2.2	2.1	5.6	1.7	0.7	0.6	4.1	0.2	-3.9	-4.0	-0.7
4/05	2.0	2.1	5.9	1.6	0.4	0.4	4.2	0.0	-3.4	-3.4	0.2
5/05	1.8	1.8	5.7	1.4	0.5	0.5	4.3	0.1	-2.1	-2.1	1.6
6/05	1.8	1.8	5.3	1.4	0.0	0.0	3.4	-0.4	-0.9	-0.9	2.5
7/05	1.8	1.8	5.3	1.4	0.1	0.1	3.6	-0.3	-0.2	-0.2	3.3
8/05	1.8	1.9	5.3	1.4	0.1	0.2	3.5	-0.3	0.7	0.8	4.1
9/05	1.8	1.9	5.1	1.5	-0.4	-0.3	2.8	-0.7	0.8	0.9	4.1
10/05	1.8	2.2	5.6	1.5	-0.8	-0.4	2.9	-1.1	1.5	1.9	5.3
11/05	2.0	2.6	5.4	1.7	-0.4	0.2	2.9	-0.7	2.0	2.6	5.4
12/05	2.0	2.5	5.5	1.7	-0.2	0.3	3.2	-0.5	2.3	2.8	5.8
1/06	2.0	2.4	5.5	1.7	-0.8	-0.5	2.6	-1.2	1.7	2.1	5.2
2/06	2.0	2.2	5.5	1.7	-0.8	-0.6	2.6	-1.1	1.7	1.9	5.2
3/06	2.0	2.3	5.5	1.7	-0.8	-0.5	2.6	-1.1	1.7	2.0	5.2
4/06	2.0	2.4	5.6	1.7	-0.8	-0.4	2.7	-1.0	1.5	1.9	5.1
5/06	2.0	2.4	5.6	1.7	-1.0	-0.6	2.4	-1.3	0.5	0.9	4.0
6/06	2.0	2.6	5.5	1.7	-0.7	-0.2	2.6	-1.0	0.2	0.7	3.6
7/06	2.1	2.8	5.7	1.7	-0.8	-0.1	2.7	-1.2	0.0	0.7	3.5
8/06	2.3	2.7	5.8	1.9	-0.8	-0.3	2.7	-1.2	-0.4	0.0	3.1
9/06	2.3	2.9	—	—	-0.4	0.2	—	—	-0.1	0.5	—

Note: real rates = nominal rates deflated by annual index (CPI/PPI) in given month.
Starting from January 2004, the methodology for new loans and time deposits was changed. Newly drawn credits were replaced by newly extended loans.

Table 10

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	
	2W	1Y	new loans	time deposits	2W	1Y	new loans	time deposits	2W	1Y	new loans	time deposits
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	2.2	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	0.5	-1.3	-0.6	-0.4	1.0	-0.8	-1.0	-0.9	0.5	-1.3
10/03	-0.9	-0.8	0.6	-1.2	—	—	—	—	—	—	—	—
11/03	-1.0	-0.8	0.4	-1.3	—	—	—	—	—	—	—	—
12/03	-1.2	-1.0	0.4	-1.5	-0.8	-0.6	0.7	-1.1	-2.1	-1.8	-0.5	-2.4
1/04	-0.9	-0.6	2.5	-1.4	—	—	—	—	—	—	—	—
2/04	-1.2	-0.8	1.8	-1.7	—	—	—	—	—	—	—	—
3/04	-1.0	-0.7	2.1	-1.5	-1.2	-1.0	1.8	-1.8	-2.8	-2.5	0.2	-3.3
4/04	-0.8	-0.5	2.5	-1.3	—	—	—	—	—	—	—	—
5/04	-0.6	-0.1	2.7	-1.1	—	—	—	—	—	—	—	—
6/04	-0.6	0.1	2.6	-1.1	-1.0	-0.3	2.2	-1.5	-2.7	-2.0	0.4	-3.2
7/04	-0.5	0.2	2.8	-1.1	—	—	—	—	—	—	—	—
8/04	-0.5	0.2	3.1	-1.1	—	—	—	—	—	—	—	—
9/04	-0.5	0.1	2.9	-1.2	-0.6	0.0	2.8	-1.3	0.8	1.4	4.2	0.1
10/04	-0.3	0.2	3.1	-1.0	—	—	—	—	—	—	—	—
11/04	-0.3	0.1	3.2	-1.0	—	—	—	—	—	—	—	—
12/04	-0.3	0.0	3.2	-0.9	-0.7	-0.3	2.8	-1.3	1.0	1.3	4.5	0.3
1/05	-0.3	-0.1	3.3	-0.9	—	—	—	—	—	—	—	—
2/05	-0.3	-0.3	3.3	-0.8	—	—	—	—	—	—	—	—
3/05	-0.4	-0.5	2.9	-0.9	-0.5	-0.6	2.8	-1.0	-1.5	-1.6	1.8	-2.0
4/05	-0.5	-0.4	3.3	-0.9	—	—	—	—	—	—	—	—
5/05	-0.6	-0.6	3.2	-0.9	—	—	—	—	—	—	—	—
6/05	-0.5	-0.5	2.9	-0.8	-0.9	-0.9	2.5	-1.2	-2.0	-2.0	1.4	-2.3
7/05	-0.6	-0.6	2.9	-0.9	—	—	—	—	—	—	—	—
8/05	-0.7	-0.6	2.7	-1.0	—	—	—	—	—	—	—	—
9/05	-0.7	-0.6	2.5	-1.0	-1.0	-0.9	2.2	-1.3	-3.3	-3.2	-0.1	-3.6
10/05	-0.9	-0.5	2.8	-1.1	—	—	—	—	—	—	—	—
11/05	-0.7	-0.2	2.5	-1.1	—	—	—	—	—	—	—	—
12/05	-0.5	-0.1	2.8	-0.9	-0.8	-0.3	2.6	-1.1	-2.5	-2.0	0.8	-2.8
1/06	-0.5	-0.1	3.0	-0.8	—	—	—	—	—	—	—	—
2/06	-0.5	-0.3	2.9	-0.8	—	—	—	—	—	—	—	—
3/06	-0.5	-0.2	2.9	-0.8	-0.7	-0.4	2.7	-1.0	-2.0	-1.7	1.4	-2.3
4/06	-0.6	-0.2	2.9	-0.9	—	—	—	—	—	—	—	—
5/06	-0.6	-0.2	2.9	-0.9	—	—	—	—	—	—	—	—
6/06	-0.7	-0.2	2.6	-1.0	-0.8	-0.3	2.5	-1.1	-3.6	-3.2	-0.4	-3.9
7/06	-0.8	-0.1	2.7	-1.2	—	—	—	—	—	—	—	—
8/06	-0.8	-0.3	2.7	-1.2	—	—	—	—	—	—	—	—
9/06	-0.9	-0.3	—	—	-0.7	-0.1	—	—	-2.6	-2.0	—	—

Note: real rates = nominal rates deflated by inflation expected by selected economic sectors according to the CNB statistical survey.
Starting from January 2004, the methodology for new loans and time deposits was changed. Newly drawn credits were replaced by newly extended loans.

Table 11

KORUNA INTEREST RATES (stock of business)

percentages

	2002 12	2003 12	2004 12	2005 12	2006 8
Koruna interest rates on loans provided by banks to residents:					
Households and non-profit institutions serving households (S.14+S.15) - total	8.77	8.24	7.96	7.20	6.87
- maturity up to 1 year	10.35	11.21	12.82	12.96	13.34
- maturity over 1 year and up to 5 years	10.80	10.17	12.40	11.43	11.22
- maturity over 5 years	7.35	6.65	6.39	5.96	5.86
for consumption - total	13.83	13.83	14.89	13.88	13.70
- maturity up to 1 year	13.05	14.26	15.48	16.22	17.01
- maturity over 1 year and up to 5 years	14.48	13.86	15.17	14.94	14.84
- maturity over 5 years	12.55	13.21	13.45	11.85	11.96
for house purchase - total	7.11	6.31	5.93	5.24	4.99
- maturity up to 1 year	7.67	6.24	4.48	4.29	5.06
- maturity over 1 year and up to 5 years	7.90	7.05	6.57	6.22	6.18
- maturity over 5 years	6.88	6.09	5.89	5.19	4.95
other - total	6.99	7.80	7.50	7.09	6.86
- maturity up to 1 year	6.64	8.49	8.96	9.09	9.18
- maturity over 1 year and up to 5 years	6.34	8.02	7.63	7.17	7.39
- maturity over 5 years	7.61	7.02	6.58	5.79	5.56
Non-financial corporations (S.11) - total	5.19	4.53	4.75	4.20	4.29
- maturity up to 1 year	4.34	4.08	4.35	3.84	5.05
- maturity over 1 year and up to 5 years	5.47	4.64	4.68	4.18	4.23
- maturity over 5 years	6.34	5.14	5.39	4.72	4.63
Koruna interest rates on deposits accepted by banks from residents:					
Households and non-profit institutions serving households (S.14+S.15) - total	1.72	1.30	1.41	1.25	1.22
overnight	0.94	0.50	0.52	0.40	0.39
with agreed maturity - total	2.26	2.02	2.13	1.92	1.90
- with agreed maturity up to 2 years	1.68	0.96	1.37	1.03	1.23
- with agreed maturity over 2 years	3.04	2.90	2.69	2.50	2.38
redeemable at notice - total	1.81	1.26	1.63	1.71	1.88
- redeemable at notice up to 3 months	1.93	1.67	2.14	2.27	2.26
- redeemable at notice over 3 months	1.73	0.98	1.12	0.81	0.98
Non-financial corporations (S.11) - total	1.25	0.85	1.21	0.91	1.14
overnight	0.94	0.64	0.68	0.52	0.76
with agreed maturity - total	2.16	1.50	2.08	1.64	1.84
- with agreed maturity up to 2 years	2.15	1.49	2.05	1.61	1.84
- with agreed maturity over 2 years	3.47	3.04	3.12	2.47	2.42
redeemable at notice - total	1.64	1.17	1.60	1.14	1.43
- redeemable at notice up to 3 months	1.60	1.14	1.49	1.07	1.28
- redeemable at notice over 3 months	2.26	1.32	2.26	1.64	2.07

Table 12

BALANCE OF PAYMENTS [1]					in CZK millions
	2002	2003	2004	2005 [2]	2006 [2]
	Q1 - 4	Q1 - 4	Q1 - 4	Q1 - 4	Q2
A. Current account	-136,378.1	-160,614.6	-167,348.2	-61,670.2	-49,972.9
Balance of trade [3]	-71,323.0	-69,793.0	-26,438.0	40,354.0	9,732.0
exports	1,254,394.0	1,370,930.0	1,722,657.0	1,875,219.0	525,032.0
imports	1,325,717.0	1,440,723.0	1,749,095.0	1,834,865.0	515,300.0
Services	21,850.8	13,236.7	12,539.3	19,411.8	3,478.4
credit	231,131.1	219,151.1	248,535.1	257,998.4	64,277.6
transport	56,560.5	60,556.3	72,308.9	78,763.0	19,478.5
travel	96,289.2	100,310.1	107,231.8	110,948.0	29,234.8
others	78,281.4	58,284.7	68,994.4	68,287.4	15,564.3
debit	209,280.3	205,914.4	235,995.8	238,586.6	60,799.2
transport	29,332.8	33,725.7	38,603.0	43,135.9	10,232.0
travel	51,549.3	54,419.2	58,398.0	57,777.6	15,191.6
others	128,398.2	117,769.5	138,994.8	137,673.1	35,375.6
Income	-115,615.0	-119,858.4	-157,772.9	-142,318.3	-60,206.8
credit	66,790.1	75,508.3	87,040.1	112,322.7	31,042.3
debit	182,405.1	195,366.7	244,813.0	254,641.0	91,249.1
Current transfers	28,709.1	15,800.1	4,323.4	20,882.3	-2,976.5
credit	46,709.0	46,976.7	46,777.3	75,639.7	11,556.0
debit	17,999.9	31,176.6	42,453.9	54,757.4	14,532.5
B. Capital account	-119.4	-82.2	-14,017.0	5,059.2	-1,571.2
credit	221.0	198.2	5,608.2	5,731.1	2,845.0
debit	340.4	280.4	19,625.2	671.9	4,416.2
Total A + B	*-136,497.5*	*-160,696.8*	*-181,365.2*	*-56,611.0*	*-51,544.1*
C. Financial account	347,827.4	157,093.5	183,659.9	137,925.6	20,850.2
Direct investment	270,930.2	53,500.3	101,776.3	242,706.1	18,154.7
abroad	-6,759.3	-5,815.7	-26,067.3	-20,500.1	-16,614.7
equity capital and reinvested earnings	-5,376.8	-3,124.6	-20,260.0	-11,372.3	-16,349.2
other capital	-1,382.5	-2,691.1	-5,807.3	-9,127.8	-265.5
in the Czech Republic	277,689.5	59,316.0	127,843.6	263,206.2	34,769.4
equity capital and reinvested earnings	270,061.0	59,350.4	121,482.9	262,791.9	36,802.9
other capital	7,628.5	-34.4	6,360.7	414.3	-2,033.5
Portfolio investment	-46,748.7	-35,719.1	59,380.4	-72,002.0	-35,309.8
assets	-75,602.1	-83,892.7	-63,897.3	-72,853.9	-31,718.8
equity securities	-7,807.9	5,630.5	-30,109.2	-26,036.2	-11,601.7
debt securities	-67,794.2	-89,523.2	-33,788.1	-46,817.7	-20,117.1
liabilities	28,853.4	48,173.6	123,277.7	851.9	-3,591.0
equity securities	-9,035.7	30,133.5	19,558.6	-36,408.9	-4,372.2
debt securities	37,889.1	18,040.1	103,719.1	37,260.8	781.2
Financial derivatives	-4,281.7	3,860.1	-3,208.0	-2,801.8	2,222.2
assets	-15,458.4	7,083.7	-15,565.8	-1,668.4	713.5
liabilities	11,176.7	-3,223.6	12,357.8	-1,133.4	1,508.7
Other investment	127,927.6	135,452.2	25,711.2	-29,976.7	35,783.1
assets	133,121.8	67,071.3	-30,507.4	-104,419.1	-14,195.9
long-term	28,711.4	1,141.3	20,434.2	-16,360.9	210.1
CNB	—	—	-184.9	-176.3	—
commercial banks	5,271.7	-999.9	505.0	-24,664.6	-3,685.0
government	25,333.6	5,714.3	22,790.7	14,056.5	4,064.6
other sectors	-1,893.9	-3,573.1	-2,676.6	-5,576.5	-169.5
short-term	104,410.4	65,930.0	-50,941.6	-88,058.2	-14,406.0
commercial banks	122,163.8	44,971.2	-34,248.5	-87,102.6	-16,991.8
government	-2,237.4	2,193.8	92.9	9.4	—
other sectors	-15,516.0	18,765.0	-16,786.0	-965.0	2,585.8
liabilities	-5,194.2	68,380.9	56,218.6	74,442.4	49,979.0
long-term	2,853.8	26,361.6	36,550.9	50,238.9	6,441.9
CNB	-20.2	-20.4	-20.5	-19.1	—
commercial banks	-8,059.2	-5,038.0	-1,410.8	311.0	841.4
government	-1,517.2	10,304.7	10,296.1	20,815.1	2,645.7
other sectors	12,450.4	21,115.3	27,686.1	29,131.9	2,954.8
short-term	-8,048.0	42,019.3	19,667.7	24,203.5	43,537.1
CNB	-24.3	-21.4	843.7	5,060.1	-137.0
commercial banks	-3,871.2	37,899.4	-15,344.5	14,802.0	23,025.4
government	—	—	—	—	—
other sectors	-4,152.5	4,141.3	34,168.5	4,341.4	20,648.7
Total A + B + C	*211,329.9*	*-3,603.3*	*2,294.7*	*81,314.6*	*-30,693.9*
D. Net errors and omissions, valuation changes	5,615.1	16,506.7	4,487.5	11,537.0	29,645.7
Total A + B + C + D	*216,945.0*	*12,903.4*	*6,782.2*	*92,851.6*	*-1,048.2*
E. Change in reserves (- increase)	-216,945.0	-12,903.4	-6,782.2	-92,851.6	1,048.2

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

Table 13

INTERNATIONAL INVESTMENT POSITION

in CZK millions

	2002 31 Dec.	2003 31 Dec.	2004 31 Dec.	2005[1)] 31 Dec.	2006[1)] 30 Jun.
Assets	1,579,922.9	1,537,284.6	1,549,333.7	1,823,960.2	1,810,042.8
Direct investment abroad	44,397.1	58,581.5	84,087.4	104,235.0	119,725.0
- equity capital	39,472.1	50,965.5	70,664.0	81,315.0	97,455.0
- other capital	4,925.0	7,616.0	13,423.4	22,920.0	22,270.0
Portfolio investment	274,344.7	343,968.7	372,237.6	428,697.7	466,127.2
- equity securities	86,464.7	47,337.7	76,121.3	107,846.8	123,211.1
- debt securities	187,880.0	296,631.0	296,116.3	320,850.9	342,916.1
Financial derivatives	31,213.2	24,129.5	39,695.3	41,363.7	42,444.1
Other investment	515,356.2	419,090.0	417,071.9	522,961.8	500,120.8
long-term	179,639.6	157,598.6	118,432.7	136,313.4	132,765.4
- CNB	280.9	468.4	600.0	3,184.5	3,010.9
- commercial banks	67,966.9	66,121.3	58,137.8	83,230.4	89,353.6
- government	97,156.8	79,483.9	48,574.9	38,408.5	30,880.9
- other sectors	14,235.0	11,525.0	11,120.0	11,490.0	9,520.0
short-term	335,716.6	261,491.4	298,639.2	386,648.4	367,355.4
- CNB	376.7	98.8	71.7	71.1	172.9
- commercial banks	213,815.4	161,150.2	184,588.0	273,797.2	238,872.5
of which: gold and foreign exchange	163,032.9	115,884.8	128,119.8	197,959.6	133,177.3
- government	2,324.5	102.4	9.5	0.1	0.0
- other sectors	119,200.0	100,140.0	113,970.0	112,780.0	128,310.0
CNB reserves	714,611.7	691,514.9	636,241.5	726,702.0	681,625.7
- gold	4,653.8	4,784.3	4,253.9	5,526.8	5,747.9
- SDR	137.1	238.7	118.0	289.8	324.6
- reserve position in the IMF	7,081.5	11,949.9	9,137.5	4,447.7	3,019.5
- foreign exchange	686,516.1	674,451.8	622,606.4	716,315.2	672,463.8
- other reserve assets	16,223.2	90.2	125.7	122.5	69.9
Liabilities	1,977,177.7	2,064,768.3	2,374,328.4	2,680,707.6	2,726,396.3
Direct investment in the Czech Republic	1,165,529.1	1,161,783.6	1,280,594.8	1,461,976.8	1,520,152.7
- equity capital	1,013,102.9	1,009,391.8	1,121,842.3	1,303,621.8	1,363,752.7
- other capital	152,426.2	152,391.8	158,752.5	158,355.0	156,400.0
Portfolio investment	201,120.0	223,620.4	381,019.4	437,806.0	425,233.8
- equity securities	128,097.7	140,788.6	208,872.1	220,495.8	205,056.3
- debt securities	73,022.3	82,831.8	172,147.3	217,310.2	220,177.5
Financial derivatives	22,671.9	19,448.3	31,806.1	30,672.7	32,364.7
Other investment	587,856.7	659,916.0	680,908.1	750,252.1	748,645.1
long-term	326,321.3	360,279.2	373,456.4	418,926.2	421,343.7
- CNB	114.5	96.1	70.2	47.8	37.5
- commercial banks	63,541.0	58,056.3	52,020.8	51,639.7	51,176.2
- government	9,475.8	22,456.0	32,065.4	52,372.7	55,644.0
- other sectors	253,190.0	279,670.8	289,300.0	314,866.0	314,486.0
short-term	261,535.4	299,636.8	307,451.7	331,325.9	327,301.4
- CNB	44.2	22.8	866.5	5,926.5	200.9
- commercial banks	176,196.2	208,534.0	185,025.2	201,239.4	177,090.5
- government	—	—	—	—	—
- other sectors	85,295.0	91,080.0	121,560.0	124,160.0	150,010.0
Net investment position	-397,254.8	-527,483.7	-824,994.7	-856,747.4	-916,353.5

1) Preliminary data

Table 14

EXTERNAL DEBT					in CZK millions
	2002 31 Dec.	2003 31 Dec.	2004 31 Dec.	2005[1)] 31 Dec.	2006[1)] 30 Jun.
Debt in convertible currencies	813,305.2	895,139.6	1,011,807.9	1,125,917.3	1,125,222.6
of which:					
Long-term	498,833.8	535,995.9	667,327.6	772,917.0	777,730.7
by debtor					
- CNB	114.5	96.1	70.2	47.8	37.5
- commercial banks	80,063.7	73,276.4	64,346.5	65,418.8	63,567.7
- government	47,701.3	69,029.9	147,729.1	221,054.0	232,408.0
- other sectors	370,954.3	393,593.5	455,181.8	486,396.4	481,717.5
by creditor					
- foreign banks	230,589.8	251,535.3	269,081.3	284,541.7	278,443.4
- government institutions	1,747.2	—	—	9,636.0	9,555.5
- multilateral institutions	69,894.7	83,779.6	84,862.4	98,520.8	105,708.3
- suppliers and direct investors	118,829.4	109,287.9	143,301.2	158,690.0	158,300.0
- other investors	77,772.7	91,393.1	170,082.7	221,528.5	225,723.5
Short-term	314,471.4	359,143.7	344,480.3	353,000.3	347,491.9
by debtor					
- CNB	44.2	22.8	866.5	5,926.5	200.9
- commercial banks	177,474.4	210,017.0	188,495.9	202,540.6	178,516.8
- government	761.0	710.0	3,334.6	1,102.4	503.9
- other sectors	136,191.8	148,393.9	151,783.3	143,430.8	168,270.3
by creditor					
- foreign banks	168,200.7	218,436.1	202,372.6	197,384.4	181,208.5
- multilateral institutions	—	—	861.3	5,918.8	194.7
- suppliers and direct investors	112,256.8	105,563.9	98,611.3	97,025.0	113,500.0
- other investors	34,013.9	35,143.7	42,635.1	52,672.1	52,588.7
Debt in non-convertible currencies	—	—	—	—	—
of which:					
- long-term	—	—	—	—	—
- short-term	—	—	—	—	—
Total external debt	813,305.2	895,139.6	1,011,807.9	1,125,917.3	1,125,222.6
of which:					
- long-term	498,833.8	535,995.9	667,327.6	772,917.0	777,730.7
- short-term	314,471.4	359,143.7	344,480.3	353,000.3	347,491.9
Total long-term debt	498,833.8	535,995.9	667,327.6	772,917.0	777,730.7
of which:					
- IMF loans	—	—	—	—	—
- liabilities of government sector and guaranteed by government, and liabilities of entities with majority owned by state	207,325.2	222,120.9	272,202.1	322,318.0	328,048.3
- liabilities of entities with majority private capital	291,508.6	313,875.0	395,125.5	450,599.0	449,682.4

1) Preliminary data

Table 15

EXCHANGE RATES

in CZK; foreign exchange market rates

A. NOMINAL RATE	2002 1 - 12	2003 1 - 12	2004 1 - 12	2005 1 - 12	2006 7 - 9
CZK exchange rate against selected currencies					
- annual/quarterly averages					
1 EUR	30.81	31.84	31.90	29.78	28.33
1 USD	32.74	28.23	25.70	23.95	22.23
100 SKK	72.22	76.75	79.69	77.15	74.89
	12	**12**	**12**	**12**	**9**
- monthly averages					
1 EUR	31.19	32.31	30.65	28.98	28.38
1 USD	30.65	26.32	22.87	24.44	22.30
100 SKK	74.67	78.57	78.81	76.51	75.68
	31 Dec.	**31 Dec.**	**31 Dec.**	**30 Dec.**	**29 Sep.**
- last day of the month					
1 EUR	31.60	32.41	30.47	29.01	28.33
1 USD	30.14	25.65	22.37	24.59	22.38
100 SKK	75.18	78.71	78.63	76.57	75.78

B. NOMINAL EFFECTIVE RATE	2002	2003	2004	2005	2006 9
CZK nominal effective exchange rate (percentages)					
(2000=100)					
weights - foreign trade turnover	116.5	116.0	116.3	123.5	129.5
weights - foreign trade turnover SITC 5-8	116.1	115.6	115.5	122.8	128.9

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	2002	2003	2004	2005	2006 8
CZK real effective exchange rate (percentages)					
(2000=100)					
a) industrial producer prices					
weights - foreign trade turnover	115.2	111.3	114.0	118.9	120.5
weights - foreign trade turnover SITC 5-8	115.9	112.0	115.4	121.1	123.4
b) consumer prices					
weights - foreign trade turnover	116.7	112.9	113.0	118.9	126.0
weights - foreign trade turnover SITC 5-8	117.5	113.7	114.1	120.7	128.3

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

Table 16

PUBLIC FINANCES					in CZK billions
	2002 1 - 12	2003 1 - 12	2004 1 - 12	2005 1 - 12	2006 1 - 9
STATE BUDGET					
Total revenue	705.0	699.7	769.2	866.5	673.5
Tax revenue	627.4	667.5	716.7	770.4	588.1
Taxes on income, profits and capital gains	159.0	172.9	180.7	195.0	139.2
Domestic taxes on goods and services	186.9	198.4	223.2	250.4	194.0
- value-added taxes	118.1	125.6	140.4	146.8	108.3
- excises	68.9	72.9	82.8	103.6	85.7
Taxes on property	7.9	8.8	10.4	8.1	6.1
Social and health security contributions and payroll taxes	258.5	272.4	293.3	311.2	244.0
Non-tax and capital incomes and received subsidies	77.7	32.2	52.5	96.1	85.4
Total expenditure	750.8	808.7	862.9	922.8	672.0
Current expenditure	697.3	745.4	796.8	840.8	623.2
Capital expenditure	53.5	63.3	66.1	82.0	48.8
Public budgets (balance in IMF GFS methodology)	-11.5	-127.7	-89.4	0.6	—
state budget	-45.7	-104.9	-65.0	-61.1	1.5
local budget	-4.3	-2.9	-8.9	7.8	—
state financial assets	—	—	—	—	—
state funds	12.3	6.9	-11.7	-0.5	—
Land Fund	-0.5	-0.1	0.2	1.6	—
National Property Fund	28.4	-27.4	-4.2	51.5	—
health insurance companies	-1.2	0.1	0.2	0.5	—
others	-0.5	0.6	0.0	0.8	—

Table 17

CAPITAL MARKET

last day of the month in points

A. STOCK MARKET INDICES	2002 12	2003 12	2004 12	2005 12	2006 9
BCPP					
PX	460.7	659.1	1,032.0	1,473.0	1,447.5
PX-D	1,166.4	1,642.7	2,551.1	3,731.4	__
PX-GLOB	576.8	816.9	1,232.7	1,811.3	1,813.6
RM-SYSTÉM					
PK-30	672.5	947.5	1,443.5	2,365.0	2,294.9

On 20 March 2006, the Prague Stock Exchange's PX 50 and PX-D indices were replaced by a single index called the PX.
Calculation of both the original indices was terminated on Friday, 17 March 2006. The new main PX index carries on from the PX 50 and takes over its history.

in CZK millions

B. TRADE VOLUMES	2002 12	2003 12	2004 12	2005 12	2006 9
BCPP					
Monthly trade volumes	109,264.8	98,640.0	90,610.5	96,160.5	103,585.8
of which:					
a) shares	17,089.3	28,296.0	46,210.3	56,180.3	60,744.5
b) units	0.0	0.0	0.0	0.0	0.0
c) bonds	92,175.5	70,344.0	44,400.2	39,980.2	42,841.3
RM-SYSTÉM					
Monthly trade volumes	4,412.1	1,103.0	335.8	286.7	196.7
of which:					
a) shares	298.4	1,082.5	332.7	220.9	196.0
b) units	1.0	3.7	3.1	0.0	0.7
c) bonds	4,112.7	16.8	0.0	65.8	0.0

Table 18

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	—	—	—	5.00	—
29 January	8.00	—	—	—	—
12 March	7.50	6.00	10.00	—	—
9 April	7.20	—	—	—	—
4 May	6.90	—	—	—	—
25 June	6.50	—	—	—	—
30 July	6.25	—	—	—	—
3 September	6.00	5.50	8.00	—	—
5 October	5.75	—	—	—	—
7 October	—	—	—	2.00	2.00
27 October	5.50	5.00	7.50	—	—
26 November	5.25	—	—	—	—
2000	No changes made				
2001					
23 February	5.00	4.00	6.00	—	—
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	—	—
2004					
25 June	2.25	1.25	3.25	—	—
27 August	2.50	1.50	3.50	—	—
2005					
28 January	2.25	1.25	3.25	—	—
1 April	2.00	1.00	3.00	—	—
29 April	1.75	0.75	2.75	—	—
31 October	2.00	1.00	3.00	—	—
2006					
28 July	2.25	1.25	3.25	—	—
29 September	2.50	1.50	3.50	—	—

Table 19

MACROECONOMIC AGGREGATES

in CZK millions; annual percentage changes; constant 2000 prices

	2002 Q1 - 4	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q2
Gross domestic product					
- in CZK millions	2,285,488	2,367,818	2,467,615	2,617,783	708,882
- percentages	1.9	3.6	4.2	6.1	6.2
Final consumption					
- in CZK millions	1,709,342	1,817,625	1,832,424	1,865,714	472,807
- percentages	3.5	6.3	0.8	1.8	1.6
of which:					
Households					
- in CZK millions	1,187,163	1,258,158	1,290,086	1,320,539	340,070
- percentages	2.2	6.0	2.5	2.4	3.8
Government					
- in CZK millions	509,591	545,999	528,767	532,242	130,123
- percentages	6.7	7.1	-3.2	0.7	-3.4
Non-profit institutions					
- in CZK millions	12,586	13,362	14,576	14,570	3,681
- percentages	-0.9	6.2	9.1	0.0	1.6
Gross capital formation					
- in CZK millions	720,002	709,600	768,013	789,966	246,939
- percentages	4.6	-1.4	8.2	2.9	17.8
of which:					
Fixed capital					
- in CZK millions	686,128	689,117	721,822	747,836	203,539
- percentages	5.1	0.4	4.7	3.6	5.3
Changes in inventories					
- in CZK millions	30,435	15,642	43,266	39,054	42,601
Acquisitions less disposals of valuables					
- in CZK millions	3,439	4,841	2,925	3,076	799
- percentages	33.0	40.8	-39.6	5.2	3.6
Foreign trade					
of which:					
Exports of goods					
- in CZK millions	1,354,163	1,479,795	1,820,657	2,036,643	578,218
- percentages	5.9	9.3	23.0	11.9	12.3
Exports of services					
- in CZK millions	222,147	212,807	231,549	235,805	58,764
- percentages	-15.7	-4.2	8.8	1.8	-4.7
Imports of goods					
- in CZK millions	1,489,963	1,623,393	1,943,966	2,058,150	578,145
- percentages	4.6	9.0	19.7	5.9	11.5
Imports of services					
- in CZK millions	231,687	235,915	253,370	248,953	63,716
- percentages	7.7	1.8	7.4	-1.7	1.0
Final domestic demand					
- in CZK millions	2,395,470	2,506,742	2,554,246	2,613,550	676,346
- percentages	3.9	4.6	1.9	2.3	2.7
Aggregate domestic demand					
- in CZK millions	2,429,344	2,527,225	2,600,437	2,655,680	719,746
- percentages	3.8	4.0	2.9	2.1	6.6
Gross domestic product at current prices					
- in CZK millions	2,464,432	2,577,110	2,781,060	2,978,157	815,666
- percentages	4.8	4.6	7.9	7.1	7.6

Source: CZSO

Table 20

LABOUR MARKET

annual percentage changes

A. NATIONAL ACCOUNTS FOR THE HOUSEHOLD SECTOR	2002 Q1 - 4	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q2
Current income	6.4	5.9	4.9	5.4	6.6
of which:					
- gross operating surplus and mixed income	2.4	7.7	5.7	3.8	0.9
- compensation of employees	8.5	5.5	5.7	6.1	8.5
- property income	-0.9	5.3	-1.0	5.7	7.0
- social benefits other than social transfers in kind	8.0	3.6	3.4	5.1	6.7
- other current transfers	4.1	10.9	2.2	5.1	8.6
Current expenditure	8.4	9.5	7.5	5.4	7.6
of which:					
- property income	15.1	21.3	12.4	6.4	24.9
- current taxes on income, wealth, etc.	8.2	12.1	7.7	4.9	0.9
- social contributions	8.9	7.2	8.3	6.2	8.6
- other current transfers	4.7	12.5	2.8	1.9	9.7
Gross disposable income	5.6	4.3	3.6	5.4	6.1
Change in net equity of households in pension funds reserves	22.6	15.4	29.1	9.8	-0.8
Individual consumption expenditure	3.5	6.5	5.6	4.2	6.6
Gross saving	31.8	-15.5	-17.8	26.7	-2.9
Gross saving rate	9.90	8.03	5.89	7.08	6.53
(gross saving/gross disposable income - ratio in per cent)					

annual percentage changes

B. AVERAGE WAGES	2002 Q1 - 4	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q2
Whole-economy nominal wage	7.0	6.4	6.2	5.5	6.8
Business sector	6.3	5.5	6.3	5.3	7.0
Non-business sector	9.8	9.8	5.7	6.7	6.0
Whole-economy real wage	5.1	6.3	3.3	3.5	3.8
Business sector	4.4	5.4	3.4	3.3	4.0
Non-business sector	7.9	9.7	2.8	4.7	3.0

Note: including data for the Ministry of Defence and the Ministry of the Interior and an estimate for intelligence services not included in the survey.

end of period

C. UNEMPLOYMENT	2002 12	2003 12	2004 12	2005 12	2006 9
Registered job applicants (thousands)	514.4	542.4	541.7	510.4	454.2
Unemployment rate (percentages)	9.8	10.3	10.3	—	—
Unemployment rate (percentages) [1]	—	—	9.5	8.9	7.8

1) Unemployment rate calculated according to the new methodology from 1 July 2004

Source: CZSO

Table 21

PRODUCER PRICES

percentage changes

	2002	2003	2004	2005	2006 9
Industrial producer prices					
a) previous month = 100	-0.1	0.1	0.6	0.0	-0.2
b) same period of last year = 100	-0.5	-0.3	5.7	3.0	2.4
c) average for 2000 = 100	2.3	1.9	7.7	10.9	13.4
d) December 1999 = 100	5.8	5.4	11.4	14.7	17.3
Construction work prices					
a) previous month = 100	0.2	0.2	0.4	0.2	0.3
b) same period of last year = 100	2.7	2.2	3.7	3.0	3.1
c) average for 2000 = 100	6.9	9.2	13.3	16.6	20.9
d) December 1999 = 100	9.3	11.7	15.8	19.3	23.7
Agricultural producer prices					
b) same period of last year = 100	-9.5	-2.9	8.1	-9.2	4.2
of which:					
crop products					
b) same period of last year = 100	-4.6	-1.0	11.6	-25.0	18.5
livestock products					
b) same period of last year = 100	-12.1	-4.0	6.1	0.4	-2.2
Market services prices					
a) previous month = 100	0.3	0.0	0.2	0.1	0.2
b) same period of last year = 100	3.2	1.6	2.3	1.9	3.4
c) average for 2000 = 100	7.3	9.0	11.5	13.7	18.7
d) December 1999 = 100	8.0	9.7	12.2	14.4	19.4

Source: CZSO

Table 22

RATIOS OF KEY INDICATORS TO GDP					percentage ratios
	2001	2002	2003	2004	2005
Public budgets balance	-2.1	-0.5	-5.0	-3.2	0.0
Public debt	17.2	18.0	21.5	23.7	25.6
Debt in convertible currencies	34.5	33.0	34.7	36.4	37.8
Trade balance [1)]	-5.0	-2.9	-2.7	-1.0	1.4
Current account balance	-5.3	-5.5	-6.2	-6.0	-2.1
M2	67.9	67.0	68.5	66.3	66.9

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

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