INFLATION REPORT / OCTOBER

2007

CNB CZECH NATIONAL BANK

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TABLES IN THE TEXT

ARA	Amsterdam-Rotterdam-Antwerp
BCPP	Prague Stock Exchange
ČMZRB	Czech-Moravian Guarantee and Development Bank
CNB	Czech National Bank
CPI	consumer price index
CZK	Czech koruna
CZSO	Czech Statistical Office
ECB	European Central Bank
ECOFIN	Council of Economics and Finance Ministers
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism
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
GBP	UK pound
GDP	gross domestic product
GFS	Government Finance Statistics
HICP	Harmonised Index of Consumer Prices
HUF	Hungarian forint
ILO	International Labour Organization
IMF	International Monetary Fund
IRS	interest rate swap
LFS	Labour Force Survey
LIBOR	London Interbank Offered Rate
M1, M2	monetary aggregates
MBSs	mortgage-backed securities
MFIs	monetary financial institutions
MNB	Hungarian National Bank
MLSA	Ministry of Labour and Social Affairs
NBS	National Bank of Slovakia
NBP	National Bank of Poland
NCG	net credit to government
NDAs	net domestic assets
NEAs	net external assets
NPISHs	non-profit institutions serving households
OMFIs	other monetary financial institutions
O/N	overnight
PLN	Polish zloty
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

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Implications of the unexpectedly slow growth in regulated prices	(Box)	January 2003
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The structure of lending	(Box)	January 2005
Uncertainty regarding the evolution of public finances in 2005 and 2006	(Box)	January 2005
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Assessment of the fulfilment of the Maastricht convergence criteria and the degree of alignment of the Czech economy with the euro area	(Annex)	January 2005
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The Czech National Bank's position on the revision of the Stability and Growth Pact	(Annex)	April 2005
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Foreign trade in the first year after the Czech Republic's accession to the EU	(Box)	July 2005
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The effect of world energy prices on consumer prices	(Box)	October 2005

The performance of large non-financial corporations 1998–2004	(Box)	October 2005
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Assessment of the fulfilment of the Maastricht Convergence criteria and the degree of economic alignment of the Czech Republic with the euro area	(Annex)	January 2006
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The Czech Republic's updated euro-area accession strategy	(Annex)	October 2007

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 1 November 2007. The annex to this Inflation Report is a document entitled "The Czech Republic's Updated Euro-area Accession Strategy".

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/. Underlying data for the tables and charts given in the text of this Inflation Report are published on the same internet address.

Chart I.1
Inflation was in the lower half of the inflation-target tolerance band in 2007 Q3
(annual percentage changes in CPI)

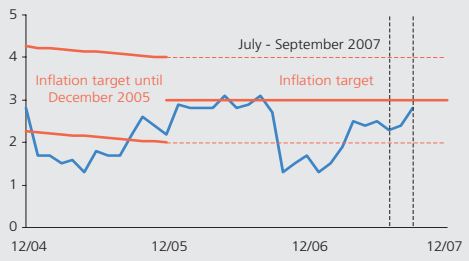


Table I.1
The koruna's exchange rate against the euro appreciated in 2007 Q3
(annual percentage changes unless otherwise indicated)

	06/07	07/07	08/07	09/07
Consumer price inflation	2.5	2.3	2.4	2.8
Industrial producer price inflation	4.6	4.1	3.7	4.0
Money supply growth (M2)	11.2	11.4	11.4	-
3M PRIBOR [a], (in per cent)	2.9	3.1	3.3	3.5
CZK/EUR exchange rate [a], (level)	28.55	28.33	27.86	27.57
CZK/USD exchange rate [a], (level)	21.27	20.64	20.45	19.87
State budget balance since January [b], (CZK bn)	1.3	19.7	22.2	36.3
GDP growth at constant prices [c]	6.0			-
Unemployment rate [d], (in per cent)	6.3	6.4	6.4	6.2

a) average level for the month
b) incl. SFAOs; end-of-month position
c) figure for the quarter ending with the given month
d) registered unemployment (MLSA); end-of-month position

Inflation increased at the end of 2007 Q3 and was close to the inflation target (see Chart I.1). The Czech economy continued to grow at a fast pace in 2007 Q2, despite recording a modest slowdown (see Table I.1). This fostered rising employment and a further decline in unemployment. Money market interest rates rose during 2007 Q3. The koruna's exchange rate appreciated against both major world currencies in this period.

Annual consumer price inflation decreased slightly in July, but gradually rose in August and particularly in September. Inflation was 0.3 percentage point higher in September than in June. This increase was due mostly to changes to indirect taxes, specifically an increase in excise duty on tobacco products. To a lesser extent, regulated prices – particularly prices of housing – also contributed to the faster growth in consumer prices. By contrast, inflation was slowed by adjusted inflation excluding fuels. The contribution of the changes in indirect taxes and regulated prices to headline inflation thus increased from about 50 per cent in the previous quarter to roughly two-thirds in Q3.

Annual GDP growth was 6% in 2007 Q2, slowing slightly compared to the previous quarter. The growth of the Czech economy was due in equal measure to household consumption and gross capital formation, in particular change in inventories. The contribution of foreign trade was far lower. On the other hand, the effect of government consumption on the growth of the Czech economy was slightly negative.

Annual employment growth accelerated further in 2007 Q2, although a more pronounced increase was prevented by a growing shortage of workers in the required occupations. The rising employment coupled with dynamic job creation fostered a sizeable decrease in the unemployment rate. In this situation, annual nominal wage growth remained high, despite slackening compared to the previous quarter. Wages in the business sector continued to rise much faster than those in the non-business sector.

Money market interest rates rose in 2007 Q3 in connection with the increases in the CNB's monetary policy interest rates. Faster growth was recorded for rates at shorter maturities. A higher rise in interest rates at longer maturities was prevented by the situation on foreign markets, where rates were generally falling, and also by the strengthening koruna.

The koruna appreciated against the euro and in particular against the dollar during Q3. The appreciation was due primarily to declining interest in investing in high-interest currencies; the koruna had been used as a financing currency for such investments in the previous period. The koruna's appreciation was also due to a further closing of the negative interest rate differential owing to the rising interest rates in the Czech Republic and to a revision of market expectations regarding euro area rates going forward.

The monetary policy decision-making of the CNB Bank Board in 2007 Q3 was based on the inflation forecast described 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 second half of 2008. According to the forecast, inflation should be slightly above the upper boundary of the tolerance band for the inflation target in this period. Monetary-policy relevant inflation, i.e. inflation adjusted for the first-round effects of changes to indirect taxes, was expected to be in the upper half of the tolerance band for the inflation target at the monetary policy horizon. Consistent with the baseline scenario of the macroeconomic forecast and its assumptions was growth in nominal interest rates.

The Bank Board raised monetary policy rates by 0.25 percentage point with effect from 27 July and by another 0.25 percentage point with effect from 31 August, deciding each time by a majority vote. These decisions were consistent with the macroeconomic forecast. The Bank Board assessed the risks of the forecast as being on the upside regarding headline inflation and conversely on the downside with regard to monetary-policy relevant inflation. The Bank Board identified the approval of the public finance reform as a major upside risk and the evolution of the koruna exchange rate as the main downside risk. At its meeting at the end of September, the Bank Board decided unanimously to leave monetary policy interest rates unchanged.

Section IV of this Inflation Report describes the CNB's new forecast, which takes into account new information obtained since the July forecast was drawn up. The forecast for the economy has changed, primarily as a result of the incorporation of the fiscal reform. A stronger depressing effect of fiscal policy on economic growth will cause the real economy to be anti-inflationary at the end of 2008 and the beginning of 2009. The real economy will subsequently become slightly inflationary again.

The October headline inflation forecast is higher than the July one. This revision reflects above all an increase in the lower VAT rate from 5% to 9%, which will cause a one-off rise in the price level. There will be a sharp one-off increase in annual inflation at the start of 2008, mostly as a result of tax changes and continued growth in regulated prices excluding tax effects. However, the effect of the tax changes will subside in 2009. This, together with a slightly anti-inflationary real economy, will cause inflation to fall towards the inflation target. At the monetary policy horizon, i.e. in 2008 Q4 and 2009 Q1, headline inflation will initially lie above the upper boundary of the inflation-target tolerance band and then drop slightly below it.

The mechanism of caveats applies as usual to the first-round effects of changes to indirect taxes. Monetary-policy relevant inflation is thus slightly above the inflation target at the monetary policy horizon. Consistent with the macroeconomic forecast and its assumptions is growth in nominal interest rates. At its October meeting the Bank Board decided by a majority vote to leave monetary policy interest rates unchanged.

The annex to this Inflation Report is a joint document of the Czech Government and the CNB: *The Czech Republic's Updated Euro-area Accession Strategy,* approved by the Czech Government on 29 August 2007. The document considers domestic and external developments since October 2003, when the original Euro-area Accession Strategy was approved. The document states that the unconsolidated state of public finances remains an obstacle to the fulfilment of the Maastricht criteria. This, coupled with the low flexibility of the economy, and especially the labour market, presents a risk to the operation of the Czech economy in the euro area and prevents it from benefiting from adopting the euro. The euro adoption date will therefore depend on resolving these problem areas in a fundamental reform of public finances and on enhancing the flexibility of the Czech economy.

Chart I.2
At the monetary policy horizon the inflation forecast initially lies above the upper boundary of the inflation-target tolerance band and then drops slightly below it
(annual percentage changes in CPI)

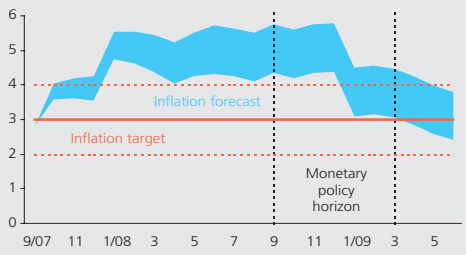
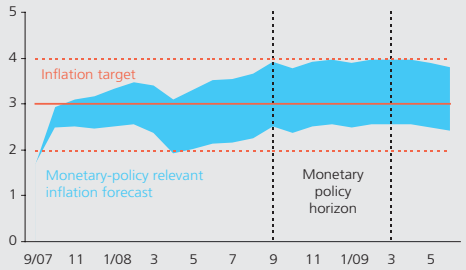


Chart I.3
Monetary-policy relevant inflation lies slightly above the inflation target at the monetary policy horizon
(annual percentage changes)



II.1 PAST INFLATION DEVELOPMENTS

As expected, annual inflation[1] increased further in 2007 Q3 (see Chart II.1). In July and August it fell below the level reached at the end of Q2, but in September it rose again (to 2.8%) and was 0.3 percentage point higher than in June. This pick-up in inflation was due mainly to an increase in excise duties on prices of tobacco products.[2] Prices in the housing category and prices of food and non-alcoholic beverages also recorded substantial increases. The other categories of the consumer basket showed mixed developments and their overall effect on annual consumer price inflation was insignificant in Q3. Annual consumer price inflation thus continued to be driven primarily by prices in just two categories – food[3] and housing (see Chart II.2). The inflation rate,[4] which is affected by inflation developments in the longer run, decreased moderately in 2007 Q3 to stand at 2% in September.

As in Q2, annual consumer price inflation in Q3 was affected most of all by changes to excise duties, which are being adjusted as part of the process of harmonisation of excise duties in EU countries. Charts II.1 and II.3 illustrate their rising effect on consumer prices this year. As a result, annual monetary-policy relevant inflation, which is the main inflation indicator for the CNB's monetary policy decision-making, was lower than headline inflation throughout Q3. Annual monetary-policy relevant inflation dropped by 0.2 percentage point compared to June and stood at 1.7% in September (see Chart II.1).

In addition to changes to excise duties, inflation was affected by other factors on both the supply and demand sides. In particular, major energy and raw material inputs of foreign and domestic origin continued to move in opposite directions. Import prices of non-energy-producing commodities (primarily metals) and domestic electricity prices continued to show fast annual growth, while oil prices and the related koruna import prices of mineral fuels continued to fall year on year. This contrary trend in major input prices passed through variously to producers' costs across the individual branches. In some sectors, favourable terms of trade helped producers to offset their increased input costs.[5] However, some indicators also suggested that producer price inflation in some industries was being noticeably affected by rapidly rising demand and by prices on foreign markets. Overall, annual industrial producer price inflation eased in Q3. By contrast, annual growth in construction work prices continued to rise slowly and a considerable acceleration was again recorded for agricultural producer price inflation.[6] Developments in the labour market suggested faster growth in nominal unit wage costs than in 2006. Consumer demand remained buoyant.

Monetary-policy relevant inflation, i.e. inflation excluding the first-round effects of indirect taxes, remained subdued (1.7% year on year) despite the persisting high

Chart II.1
Inflation increased further in 2007 Q3
(annual percentage changes)

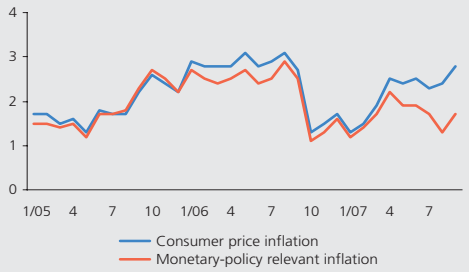
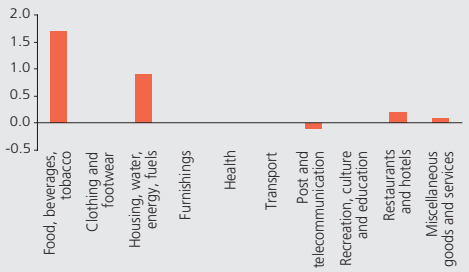


Table II.1
In the consumer basket the fastest-rising prices were recorded in the category of alcoholic beverages and tobacco, including the impacts of increased excise duties
(annual percentage changes)

	6/07	7/07	8/07	9/07
CONSUMER PRICES	2.5	2.3	2.4	2.8
of which:				
food and non-alcoholic beverages	2.6	2.4	2.9	3.2
alcoholic beverages and tobacco	9.7	10.9	14.5	14.8
clothing and footwear	0.0	0.0	-0.3	0.1
housing, water, electricity, gas and other fuels	2.8	3.1	3.3	3.7
furnishings, household equipment and routine maintenance of the house	0.0	0.2	0.1	0.1
health	4.8	4.2	1.9	1.4
transport	0.1	-0.4	-0.6	-0.1
communication	0.2	-0.6	-2.2	-2.9
recreation and culture	0.8	-1.2	-2.7	-0.3
education	2.7	2.7	2.7	1.9
hotels and restaurants	2.7	2.8	2.7	2.9
miscellaneous goods and services	2.2	2.0	1.9	1.9

Chart II.2
Consumer price inflation continued to be driven by food and housing prices
(contributions in percentage points; including first-round impacts of tax changes; September 2007)



1 Measured by annual growth in consumer prices.
2 Tobacco prices were affected by the lagged effect of increases in excise duty introduced on 1 April 2006 and 1 March 2007. They rose by 27.4% year on year in September.
3 Consolidated category of prices of food and non-alcoholic beverages and prices of alcoholic beverages and tobacco.
4 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.
5 For details see section III.5.4 *Economic results of non-financial corporations.*
6 For details see section III.7 *Import prices and producer prices.*

consumer demand. Rising domestic energy prices passed through significantly only to housing prices in the regulated items category. The persisting annual decline in prices of non-food tradable commodities (excluding fuels) was still due in part to year-on-year appreciation of the koruna. Food price inflation was not high overall, but its structure showed a continuing clear recovery in growth of prices of some items, supported by external factors.

Annual growth in food prices[7] remained volatile in 2007 Q3, reaching 2.5% in September. It was slightly lower than in June, mostly because of slowing annual price growth (adjusted for the tax changes) in the alcoholic beverages and tobacco category. At the same time, however, prices of many foodstuffs, particularly those of vegetable origin, were greatly affected by the indirect effect of rising global demand in agricultural commodity markets in a situation of temporarily decreased cereal production.[8] The clear impact of this factor was observed along the entire food chain, including the retail market. Annual growth in prices of bread products and cereals slowed in 2007 Q3, but this was largely due to base effects. After a long period of year-on-year decline, prices of livestock products (meat) also recorded continued annual growth and prices of dairy products and oils rose sharply.

Prices of other tradable goods (excluding fuels and food) continued to show a year-on-year decline in 2007 Q3, falling by 1.5% in September. The long-running decline in prices in this category is largely due to prices of consumer products abroad and to the koruna's exchange rate. The smaller annual decrease in tradables prices in the last two quarters than in the previous period chiefly reflected slower annual appreciation of the koruna-euro exchange rate. This change is likely to have contributed to the fact that the long-running consumer price decline in the clothing and footwear category halted at the end of 2007 Q2 and changed into a modest annual rise in Q3 (of 0.1% in September). By contrast, growth in prices of non-tradable goods, which are affected solely by the domestic competitive environment (primarily services), gradually slowed in 2007 Q3 to 2.3% in September.

In the other price areas, more marked changes were recorded in regulated prices. A further increase in regulated rents and a rise in natural gas prices caused annual regulated price inflation to go up by 0.6 percentage point compared to June, to 4.6% in September. Owing to the evolution of oil prices on world markets and a related fall in mineral fuel import prices, fuel prices continued to show a year-on-year decline (of 1.8% in September).

Turning to international comparisons, annual HICP inflation in the Czech Republic was again above the average inflation level in the EU countries in 2007 Q3. According to the latest Eurostat figures for September, annual HICP inflation in the EU countries was 2.3%, or 0.5 percentage point lower than that in the Czech Republic.

7 Consolidated category of prices of food and non-alcoholic beverages and prices of alcoholic beverages and tobacco. Excludes the effect of changes to excise duties.

8 For details see Box 3 *The causes of the sharp growth in world prices of cereals.*

CHART II.3
Changes to excise duties and regulated prices accounted for most of the consumer price inflation
(contributions in percentage points; annual percentage changes)

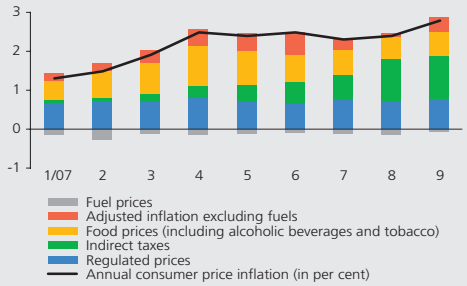


CHART II.4
Food price inflation eased slightly, although numerous items recorded an upswing in price growth
(annual percentage changes, excluding tax changes)

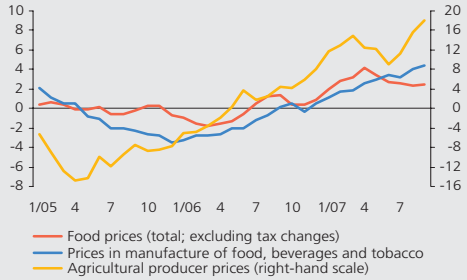


CHART II.5
Growth in prices of non-food commodities was still generally moderate
(annual percentage changes; excluding tax changes)

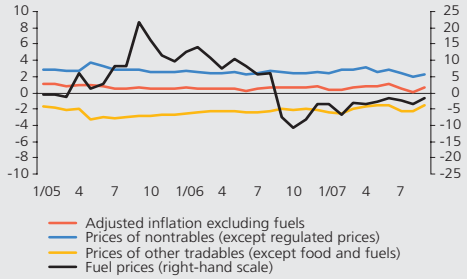
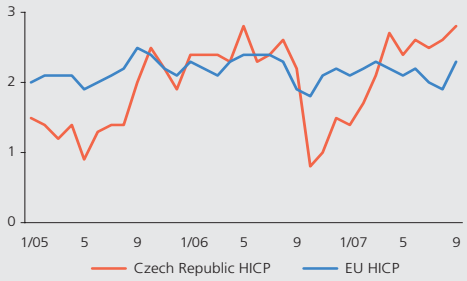


CHART II.6
Inflation in the Czech Republic was above the average level in the EU countries in 2007 Q3
(annual percentage changes)



II.2 FULFILMENT OF THE INFLATION TARGET

Headline inflation was in the lower half of the tolerance band of the CNB's inflation target in 2007 Q3 (see Chart I.1). This section of the Inflation Report briefly analyses the contribution of the CNB's monetary policy to this situation.

To assess the effect of monetary policy on the fulfilment of the inflation target one needs to analyse retrospectively the forecasts and the Bank Board's decisions based thereon in the relevant period. As monetary policy is focused on hitting the inflation target at the 12–18 month horizon, the key period for the fulfilment of the inflation target in 2007 Q3 is roughly from January 2006 to September 2006. For the sake of comprehensibility, the analysis of the accuracy of the forecasts is limited here to a comparison of the forecast drawn up in April 2006 with inflation in 2007 Q3.

According to the April 2006 forecast, headline inflation was expected to decline slightly in 2006 and to rise gradually above the inflation target in 2007 (see Chart II.7). Rising regulated prices of energy for households and higher indirect taxes on cigarettes were expected to push inflation upwards. Pressures from the real economy were expected to build up gradually over the forecast horizon owing to moderately easy real monetary conditions, particularly in the exchange rate component. This was also reflected in a projected rise in adjusted inflation excluding fuels.

Up to and including 2006 Q3, headline inflation developed in line with the forecast. Subsequently, however, it was considerably lower. The deviation recorded in 2007 Q3 primarily reflected lower adjusted inflation excluding fuels. Fuel prices and the first-round impacts of the changes to indirect taxes showed a slightly anti-inflationary trend. Food prices excluding the effects of indirect tax changes rose in line with the forecast. Although regulated prices rose faster than forecasted, their contribution to headline inflation was lower than expected, owing to a change in weights in the consumer basket (see Table II.2).

The overall effect of the external environment on domestic inflation in the period under review was roughly in line with the April forecast. The impact of higher external demand, interest rates and oil prices was offset by lower inflation abroad and a weaker dollar-euro exchange rate (see Table II.3).

According to the current view, the monetary policy settings in the key period were broadly in line with the assumptions of the April forecast. Nominal interest rates developed almost exactly as expected in the key period. This, together with the fact that actual inflation was roughly at the forecast level in this period, meant that the forecast for real interest rates materialised. Likewise, the exchange rate of the koruna did not deviate far from its expected path, appreciating only at the end of 2006. The exchange rate component of the real monetary conditions was thus roughly at the forecast level.

When assessing the fulfilment of the inflation forecast, one needs to take into account changes in the CNB's view of the workings of the economy. The important changes made between April 2006 and the present include an extension of the core prediction model to include the effect of real wages on inflation, a changeover to effective external indicators and a change in the distribution of the real equilibrium appreciation across the individual inflation categories. Other things being equal, these changes would together have led to a lower inflation forecast and to lower forecast-consistent interest rates.

Any revisions made to economic indicators since the forecast was drawn up also have an effect on the fulfilment of the forecast. The new consumer basket

Chart II.7
Actual inflation in 2007 Q3 was significantly lower than the April 2006 forecast
(annual percentage changes)

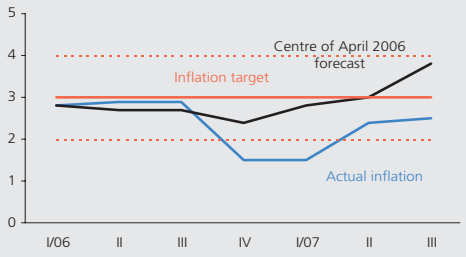


Table II.2
The main source of the deviation of actual inflation from the forecast was lower-than-expected adjusted inflation excluding fuels
(annual percentage changes, contributions in percentage points)

	April 2006 forecast	2007 Q3 outturn	Contribution to total difference a)
CONSUMER PRICES	3.8	2.5	-1.3
Breakdown into contributions:			
regulated prices	3.8	4.5	-0.1 c)
first-round impacts of changes to indirect taxes	1.1	0.9	-0.2
food prices b)	2.4	2.5	0.0
fuel prices b)	2.7	-2.6	-0.2
adjusted inflation excl. fuels b)	2.3	0.4	-0.9

a) owing to rounding, the sum of the contributions need not be equal to the total difference; the contributions are influenced by changes in weights in the consumer basket as from January 2007
b) excluding the first-round impacts of changes to indirect taxes
c) the negative contribution of regulated prices despite the higher-than-expected regulated price inflation is due to the change in weights in the consumer basket

Table II.3
The effect of the external environment on domestic inflation was roughly in line with the April 2006 forecast
(annual percentage changes unless otherwise indicated)

		II/06	III/06	IV/06	I/07	II/07	III/07
GDP in Germany a)	p	1.4	1.6	2.1	1.3	1.0	0.8
	o	2.5	2.7	3.7	3.3	2.5	-
GDP in euro area a), b)	o	2.6	2.7	3.5	3.1	2.6	-
CPI in Germany	p	1.7	1.4	1.3	2.9	2.4	2.0
	o	2.0	1.6	1.3	1.7	1.9	2.1
CPI in euro area b)	o	2.0	1.7	1.5	1.8	1.8	-
1Y EURIBOR	p	3.2	3.4	3.5	3.6	3.7	3.7
(percentages)	o	3.3	3.6	3.9	4.1	4.4	4.6
USD/EUR exchange rate	p	1.22	1.23	1.24	1.25	1.26	1.27
(levels)	o	1.26	1.27	1.29	1.31	1.35	1.37
Oil prices - Ural	p	59.2	54.5	53.2	52.5	52.4	52.4
(USD/barrel)	o	65.0	65.4	56.5	54.3	65.2	73.0
Oil prices - Brent c)	o	69.8	70.2	59.6	58.1	68.7	74.9

p - prediction, o - outturn
a) at constant prices; seasonally adjusted
b) effective indicator; no comparison with the prediction is given, as the indicator was not tracked in the April 2006 forecast
c) USD/barrel; no comparison with the prediction is given, as the indicator was not tracked in the April 2006 forecast

introduced in January 2007, which decreased the weight of items whose prices have long been rising faster and, by contrast, increased the weight of items whose prices have long been rising more slowly, contributed to the lower-than-forecasted inflation during 2007. A large increase in the 2004–2006 GDP growth estimates made via revisions to the national accounts in June 2007 generated an increase in the estimated rate of growth of the potential, non-accelerating inflation level of output and a slight upward revision to the output gap.

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 2006 forecast was drawn up can be summed up in the following way. The inflation pressures from the real economy have been positive and gradually rising since 2006 H2 (see Table II.4). Nevertheless, adjusted inflation excluding fuels was low over the entire period, as the exchange rate of the koruna began to have a strong anti-inflationary effect from 2006 Q4 onwards via lower import prices. For this reason and thanks to the introduction of the new consumer basket, headline inflation was below the inflation target in 2007.

In addition to the message of the forecast itself, an assessment of the risks associated with this forecast is of importance for the Bank Board's decisions on monetary policy rates. At its meetings between January and September 2006 (see the relevant minutes) the Bank Board assessed the risks of the forecasts drawn up in the key period as being roughly balanced. This overall assessment was reflected in the monetary policy decisions of the CNB Bank Board, which were approximately in line with the forecasts. With the benefit of hindsight, one can assess the interest rates in the key period as having been higher than necessary to fulfil the inflation target in 2007 Q3, subject to the application of the ex ante escape clauses to the first-round impacts of changes to indirect taxes.

Table II.4

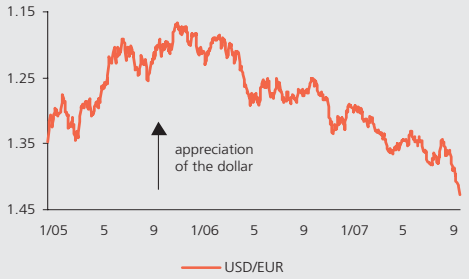
Real economic growth was higher than forecasted, while the koruna-euro exchange rate was stronger than expected

		II/06	III/06	IV/06	I/07	II/07	III/07
3M PRIBOR	p	2.1	2.4	2.7	2.8	3.2	3.6
(percentages)	o	2.1	2.4	2.6	2.6	2.8	3.3
CZK/EUR exchange rate	p	28.6	28.9	29.1	29.2	28.8	28.6
(levels)	o	28.4	28.3	28.0	28.0	28.3	27.9
Real GDP	p	6.3	5.7	5.2	4.9	5.4	5.6
(annual perc. changes)	o	6.5	6.3	6.1	6.4	6.0	-
Inflation pressures	p a)	-0.1	-0.3	-0.3	-0.1	0.1	0.3
from the real economy	o b)	-0.1	0.1	0.3	0.5	0.5	0.6

p - prediction, o - outturn
a) output gap as a percentage of GDP
b) real marginal cost gap; estimate based on the CNB's October 2007 forecast

III.1 THE EXTERNAL ENVIRONMENT

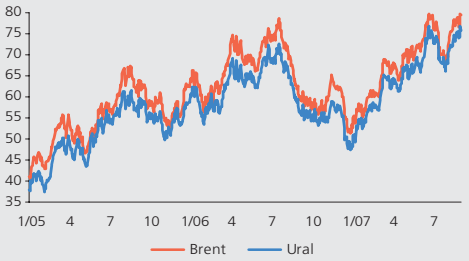
Chart III.1
The dollar weakened against the euro to a historical low beyond USD 1.42/EUR at the end of 2007 Q3



The rate of growth of the US economy increased slightly in 2007 Q2 but remained below that of the euro area, where, in contrast, economic growth slowed. Slovak GDP growth accelerated, and Slovakia remained the fastest growing country in the Central European region. As a consequence of the financial market turbulence and the easing of US monetary policy, the dollar depreciated beyond USD 1.42/EUR at the end of Q3. Oil prices rose to record highs in this quarter, with the price of Brent crude oil nearing USD 80 a barrel.

Annual GDP growth in the USA increased by 0.4 percentage point to 1.9% in 2007 Q2. Despite slowing a little, household consumption growth remained very high, government consumption increased and the decline in fixed investment slowed. Improved net exports also contributed to the faster GDP growth. The housing market crisis, however, deepened further. Sales of both new and existing houses slowed further in August and the stock of unsold houses increased. The sub-prime mortgage market crisis resulted in turmoil in global financial markets in August, which is still going on and whose overall impact on the real economy is uncertain (for details see Box 1 *The causes, course and impacts of the current turmoil in global financial markets*). Consumption in the USA fell slightly, but the financial results of corporations are good and economic growth is being bolstered by a weakening dollar. The unemployment rate increased somewhat in September, to 4.7%, but was virtually unchanged compared to the previous year. The economy created 110,000 new jobs in September, but the three-month total was low, as was the case in August, and roughly half the level in the same period a year earlier.

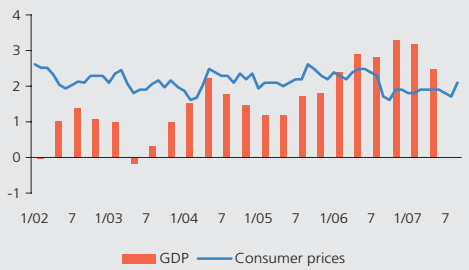
Chart III.2
The price of Brent crude oil repeatedly neared USD 80 a barrel in 2007 Q3
(USD/barrel)



Annual consumer price inflation in the USA rose significantly – from 1.9% in August to 2.8% in September – due to the base effect of energy prices, whose annual growth rate increased by almost 8 percentage points in September. Core inflation remained unchanged at 2.1%. On 18 August, the Fed lowered its key rate by 0.5 percentage point to 4.75%. At the same time it changed – at least temporarily – its monetary policy priority. The Fed now considers the financial market turbulence to be the main problem. This, together with the crisis in the residential property sector, could lead to a marked decline in economic growth or even a recession.

Annual GDP growth in the euro area declined in 2007 Q2, falling to 2.5% from 3.2% in the previous quarter. This slowdown was chiefly due to lower growth in investment (residential investment in particular), which, however, remains the main driver of the economic expansion. By contrast, net exports and inventories contributed to GDP growth. The unemployment rate stayed at a record low of 6.9%, almost 1 percentage point lower than a year earlier. The current account deficit remained unchanged year on year at EUR 7 billion in 2007 Q2. The trade balance improved by EUR 34 billion in the first 8 months of 2007 compared to the same period of 2006, recording a surplus of EUR 16.5 billion.

Chart III.3
Economic growth in the euro area eased again in 2007 Q2
(annual percentage changes)



Consumer price inflation in the euro area rose by 0.4 percentage point to 2.1% in September. This was due to a base effect resulting from energy price volatility in the previous year. Inflation thus rose above the level that the ECB regards as price stability. Monetary aggregate M3 recorded very fast growth of 11.6% in August, almost unchanged from the July figure of 11.7%. The ECB considers this money supply growth level to be a medium-term threat to price stability. At its September and October meetings the ECB left its key rate at 4%, despite having hinted at a further rate hike in August. The reasons for leaving the rate unchanged included slowing growth, an appreciating euro and in particular the continuing turmoil in the financial markets, whose final impact on the real economy is still uncertain. Notwithstanding this, some international institutions (the European Commission, the OECD and the IMF) have already lowered their outlooks for economic growth

in the euro area. Even without a rate increase, the euro-dollar rate hit a record strong level beyond USD 1.42/EUR and the 3M EURIBOR remained high (4.8%). The monetary conditions thus tightened even without any intervention by the ECB, which, moreover, did not rule out the possibility of further rate increases in the future.

The annual rate of growth of the German economy slowed by more than 1 percentage point in 2007 Q2, to 2.5%, largely because of a substantial fall in investment demand growth. This lower economic growth, however, does not signal any fundamental weakening of the German recovery. Much of the slowdown in investment growth in 2007 Q2 was due to the warm winter and the shifting of investment to Q1. Household consumption was adversely affected by a VAT increase introduced at the start of 2007.

Employment in Germany grew by 1.7% year on year in Q2, and the unemployment rate, which was 8.9% on average in Q3, was 1.7 percentage point lower than in the same period a year earlier. Export growth, supported by the lowest labour cost growth in the EU, was strong and had yet to be affected by the appreciation of the euro. The fiscal consolidation is moving ahead very quickly and it is possible that the fiscal deficit will be eliminated in 2007. In September, due to an energy price base effect, consumer price inflation surprisingly increased by 0.5 percentage point compared to August, reaching 2.4% and exceeding the 2% level for the first time in more than two years.

In 2007 Q2, Slovakia remained the fastest growing economy in the Central European region. Moreover, its GDP growth rate accelerated, as did GDP growth in Poland. Inflation in both these countries was low, but rose significantly in September. By contrast, the sluggish GDP growth in Hungary slowed even further, and although inflation in this country declined, it remained the highest in the region.

The strong annual growth of the Slovak economy further accelerated to almost 10% in 2007 Q2. Its main sources were high increases in consumption, net exports and investment. Industrial production rose by more than 11% in July and August. In August, the buoyant economic growth caused the unemployment rate, which has been falling since 2002, to decline further to 8.2%. It was down by 1.7 percentage points from the previous year. The economy is starting to show signs of labour shortages, especially in some occupations.

Annual consumer price inflation in Slovakia increased by 0.5 percentage point to 2.8% in September, as a result of rising energy, services and food prices. According to the NBS, there are currently no inflationary pressures in the economy despite the rise in inflation. The bank has left its key rate unchanged at 4.25% since April 2007.

GDP growth in Poland edged up to 6.9% in 2007 Q2. As in previous periods, the main engine of growth was very high growth in fixed investment (more than 20%). Household consumption, which increased by almost 6% thanks to fast growing real wages and falling unemployment, was also a significant contributor to economic growth. The unemployment rate decreased by more than 3 percentage points year on year in August, to 12%, but remains the highest in the EU.

In September, consumer price inflation in Poland increased unexpectedly by 0.8 percentage point year on year, to 2.3%, mainly as a result of high growth in food prices. In addition to food prices, significant growth was recorded for prices of education and some services. As wage growth was outpacing labour productivity growth, the NBP raised its key rate by 0.25 percentage point to 4.75% at the end of August amid concerns about wage inflation pressures.

Chart III.4
GDP growth slowed further in the 12 new EU Member States in 2007 Q2
(annual percentage changes)

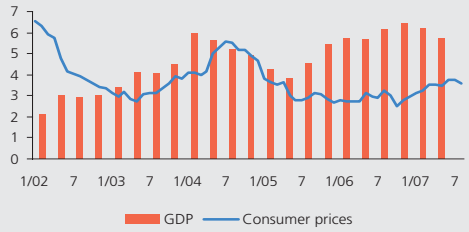
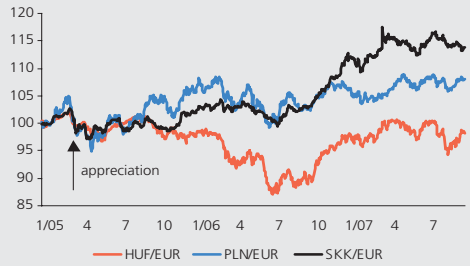


Chart III.5
Among the currencies of the Central European region, the Hungarian forint showed the strongest year-on-year appreciation in 2007 Q3
(average for January 2005 = 100)



In 2007 Q2, annual GDP growth in Hungary dropped by 1 percentage point compared to the previous period, to 1.6%. This fall was due to a decrease in household consumption, very low growth in fixed investment and a sizeable decline (of 9%) in government consumption. By contrast, export growth was almost 15% and has long exceeded import growth, leading to an improvement in the trade balance and the current account. Industrial production rose by around 8% and industrial investment by 36% in Q2, despite total investment being flat.

Thanks to base effects,[9] annual consumer price inflation in Hungary decreased from 8.3% in August to 6.4% in September. The more marked decline in prices which had been expected by the MNB was prevented by higher-than-expected growth in food prices. At the end of September, the MNB lowered its key rate by 0.25 percentage point to 7.5%. The bank mentioned low, below-potential GDP growth, a favourable inflation outlook and falling inflation expectations as the reasons for this decision.

BOX 1
The causes, course and impacts of the current turmoil in global financial markets

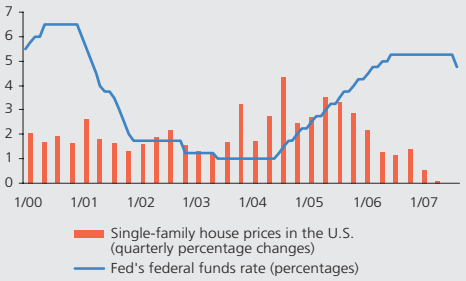
As a result of the crisis in the US sub-prime mortgage market, the global financial markets have been experiencing a period of increased volatility since the July Inflation Report was published. In August, this culminated in a liquidity shortage on the global money market and a threat to the stability of financial institutions with heavy exposures in the sub-prime mortgage market.

The roots of this crisis can be traced back to 2001, when the Fed slashed interest rates in an effort to mitigate the impacts of the bursting of the stock market bubble. The key federal funds rate was lowered from 6.50% to 1.75% during 2001, reached 1% in mid-2003 and remained at this level until mid-2004 (see Chart 1). In real terms, short-term rates in the United States remained negative until mid-2005. Such low interest rates for such a long time fuelled a bubble in the US property market.

The surge in property prices had two main effects. First, the total volume of mortgages soared and households increasingly used money borrowed against the rising value of their homes to fund current consumption. Second, the credit standards of the banks providing mortgages slipped as the value of collateral rose. This trend was bolstered by the fact that the mortgages were not left in the banks' balance sheets but were immediately sold on to investors as "mortgage-backed securities" (MBSs). Whereas in 2001–2003 sub-prime mortgages had accounted for just 10% of total mortgages, in 2006 their share was 33%.

At the start of this year it started to become apparent that the credit cycle was entering a new phase. The Fed's key interest rate of over 5% started to gradually push down property prices. At the same time, the proportion of unpaid mortgages increased, reaching its highest level in almost 20 years. The prices of MBSs and the securities derived from them started to fall. The

CHART 1 (BOX)
The Fed's low interest rates fuelled house price growth



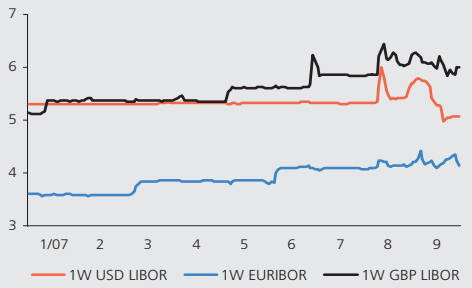
Sources: Office of Federal Housing Enterprise Oversight; Federal Reserve System

9 VAT and regulated prices were increased in September 2006 as part of a package of measures to reduce the budget deficit. As a result, consumer price inflation rose by 2.4 percentage point to 5.9% compared to August 2006.

owners of these securities started to have liquidity problems, resulting in increased demand on the interbank money market. This generated a surge in interest rates – and subsequently also interest rate volatility – on the global money market, particularly at the shortest maturities (see Chart 2).

The strongest responses to this situation came from the European and US central banks, which supplied the interbank market with extraordinary liquidity. Despite a subsequent partial calming of the money markets, there remains much uncertainty among market participants about future developments and about the potential effects of the financial market turbulence on the real economy. So far, some deterioration has occurred in the growth prospects for the US economy (and partly also the European economy), to which the Fed has responded by cutting rates. There has also been a shift in the ECB's rhetoric, as a result of which the financial markets have shifted their view towards rate stability in the euro area.

CHART 2 (BOX)
Interbank interest rates rose sharply in August and became volatile
(percentages)



Source: Bloomberg

III.2 THE MONETARY CONDITIONS

According to the CNB's calculations, the settings of the real monetary conditions in 2007 Q3 can be characterised as roughly neutral. The interest rate component was assessed as being slightly tight, whereas the exchange rate component was slightly easy.[10] The evolution of the two components of the monetary conditions in 2007 Q3 is described in more detail below.

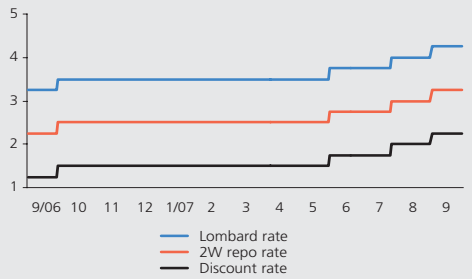
III.2.1 Interest rates

Interest rates showed mixed developments in 2007 Q3 depending on maturity. Short-term interest rates continued to rise steadily, whereas rates with longer maturities (over 1 year) were generally flat or falling. Their evolution was determined largely by the situation on foreign markets, where long-term rates fell due to the crisis on the US sub-prime mortgage market.

The CNB raised its key interest rates in two steps, each time by 0.25 percentage point. With effect from 31 August 2007, the 2W repo rate is 3.25%, the Lombard rate 4.25% and the discount rate 2.25%. The first move at the end of July had been expected by almost all financial market participants. After the announcement of the monetary policy tightening, money market rates continued rising moderately. In mid-August, however, there was an interest rate correction at most maturities. This was generated by the strengthening koruna and lower inflation figures, and also by the crisis on the US sub-prime mortgage market. This crisis did not directly affect the Czech money market.[11] The impact was only indirect, thanks to a change in market expectations towards easier Fed and ECB monetary policy.

The next increase in the CNB's key rates at the end of August was not expected quite so clearly. According to surveys, expectations were skewed slightly towards

CHART III.6
The CNB raised its key interest rates
(percentages)



10 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 being easy. This accumulated easy monetary policy setting in turn co-determines the starting conditions of the forecast.

11 Unlike foreign money markets, which saw rising spreads and falling liquidity.

Chart III.7
Money market interest rates rose in Q3
(percentages)

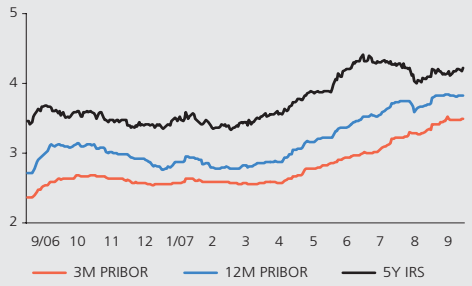


Chart III.8
Interest rate differentials vis-à-vis the dollar narrowed
(percentage points)

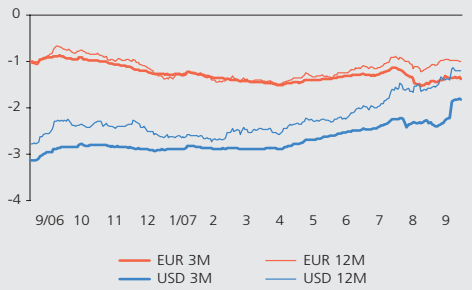


Chart III.9
Ex ante real interest rates on new loans decreased
(percentages)

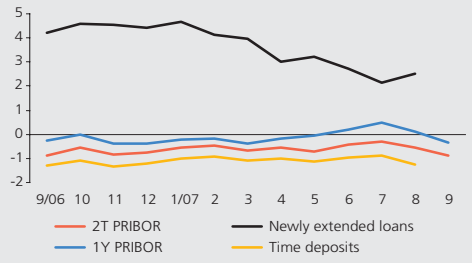
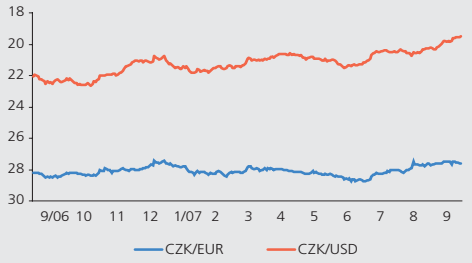


Chart III.10
The koruna appreciated against the euro in 2007 Q3



leaving rates unchanged and raising them in September. Money market interest rates rose by 0.3–0.5 percentage point overall in 2007 Q3, with higher dynamics at the shorter end of the yield curve. Rates with maturities of over one year changed much less (by -0.2 to 0.1 percentage point). PRIBOR spot quotations and FRA forward rates at the end of September 2007 indicated that financial market participants expected a further monetary policy tightening to occur before the end of 2007.

The PRIBOR yield curve gradually shifted to a higher level during 2007 Q3, and its positive slope decreased slightly. The spread between the 1Y PRIBOR and the 2W PRIBOR was 0.53 percentage point in September. The IRS yield curve recorded an increase at its short end, whereas rates at the longer end decreased. Despite this, the slope of the curve remained positive. In September, the average 5Y-1Y spread was 0.41 percentage point and the 10Y-1Y spread 0.66 percentage point.

The interest rate differential on the money market (PRIBID/CZK-LIBOR/EUR or LIBOR/USD) was affected by changes in key rates and movements in interbank market rates resulting from the crisis on the US sub-prime mortgage market. The ECB left its refinancing operations rate unchanged at 4.00% during Q3, while the Fed lowered its key O/N rate by 0.50 percentage point to 4.75%. Overall, the negative interest rate differentials vis-à-vis dollar rates narrowed and those vis-à-vis euro rates were unchanged.

Three auctions were held on the primary government bond market, with original maturities of 5Y, 10Y and 15Y and a total volume of CZK 14.4 billion. The auctions were not very successful since they took place at a time of increased nervousness on the financial markets and expectations of a CNB rate increase. The bonds that were not underwritten were purchased by the Czech Ministry of Finance into its portfolio.

Nominal interest rates on new loans were 6.5% and rates on new time deposits 2.3% in August. Real interest rates[12] are affected not only by the level of nominal rates, but also by movements in inflation expectations. Consumer price inflation expectations increased quite significantly during 2007 Q3, whereas expected industrial producer price inflation declined slightly. Real rates on new loans were 2.5% in August, while real rates on time deposits were -1.2%.

III.2.2 The exchange rate

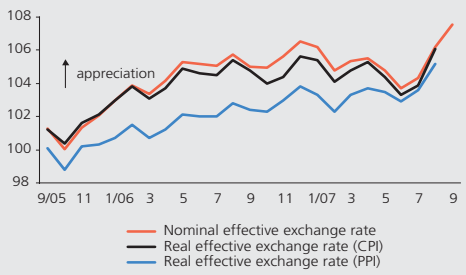
The average exchange rate of the koruna against the euro in 2007 Q3 was CZK 27.9/EUR (see Chart III.10), which represents a year-on-year appreciation of 1.4% and a quarter-on-quarter appreciation of 1.2%. The modest appreciation trend of the koruna seen last year thus resumed after an interruption in Q2. The July turnabout in the koruna's exchange rate was mainly the result of massive closing of "carry trades" on world markets, connected with koruna purchases, with investors shifting their funds to more secure assets amid increasing risk aversion. The koruna's appreciation was also fostered by the CNB's two monetary policy rate increases and by hints at further growth in these rates. Another accompanying factor might have been a revision of financial market expectations regarding euro area interest rates going forward.

12 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 analysts each month.

In 2007 Q3, the average exchange rate of the koruna against the dollar was CZK 20.3/USD, which represents a year-on-year appreciation of 8.5% and a quarter-on-quarter appreciation of 3.0%. Like the koruna-euro rate, the koruna-dollar rate showed a clear appreciation trend over the quarter. In July, the appreciation was due predominantly to bad news from the USA regarding developments in the sub-prime mortgage sector. The dollar's depreciation was also due to an August decrease in the discount rate and above all to a September lowering of the Fed's key interest rate. The koruna also appreciated significantly against the dollar as a result of a series of unfavourable economic figures from the USA.

After a modest depreciation in Q2, the koruna's nominal effective exchange rate appreciated again in 2007 Q3. The nominal effective exchange rate firmed by 0.7%, thus continuing its previous trend (see Chart III.11). The year-on-year appreciation was largely a result of the koruna's appreciation against the euro and also the dollar. This was, however, largely offset by a depreciation of the koruna against the Slovak koruna and also the forint. The real effective exchange rate also appreciated year on year during Q3, as a result of both producer and consumer prices rising faster at home than abroad. In July–August the PPI-deflated real effective exchange rate firmed by 2.0% year on year. The rate of appreciation of the CPI-deflated real effective exchange rate was very modest (0.2% year on year in July–August).

Chart III.11
The nominal and real effective exchange rates both appreciated year on year in 2007 Q3
(year 2005 = 100)



III.3 THE BALANCE OF PAYMENTS

III.3.1 The current account

In 2007 H1, the current account ended in a deficit of CZK 28.3 billion (see Table III.1), or -1.6% of GDP. In year-on-year terms, the deficit doubled. Although the output balance[13] showed a substantial improvement, it only partly offset the year-on-year deterioration in the other two balances. The widening of the income deficit was particularly significant.

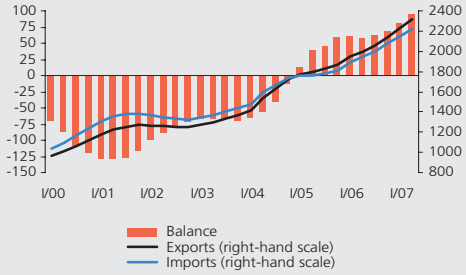
In 2007 H1, the trade balance recorded a surplus of CZK 71.6 billion, up by CZK 26.5 billion on a year earlier. The year-on-year increase in the trade surplus was due exclusively to favourable price developments. The terms of trade recorded a positive year-on-year change of 3.4% in 2007 H1. Roughly one-third of the positive price effects were offset by unfavourable developments in real terms. The buoyant external demand and changes on the supply side of the economy due to past FDI inflows and the relocation of production to the Czech Republic were counteracted by strong aggregate domestic demand growth and appreciation of the koruna against the euro (see Chart III.12). The year-on-year improvement in the trade balance continued into Q3, with the surplus increasing by CZK 3.9 billion in July and August.

As regards the commodity structure, the trade balance showed very mixed trends in 2007 H1. The increase in the overall surplus was aided chiefly by favourable developments in the machinery and transport equipment category. A noticeable improvement was also recorded for the deficit on mineral fuels and the surplus on non-energy-producing materials. Imports of oil and natural gas fell year on year in

Table III.1
The current account deficit increased in 2007 H1 mainly as result of a deterioration of the income balance
(CZK billions)

	I-II/04	I-II/05	I-II/06	I-II/07
A. CURRENT ACCOUNT	-54.3	-2.6	-14.9	-28.3
Trade balance	-4.4	47.2	45.2	71.8
Balance of services	10.6	21.5	18.5	23.1
Income balance	-61.7	-83.8	-75.8	-112.4
Current transfers	1.2	12.5	-2.8	-10.8
B. CAPITAL ACCOUNT	0.8	2.5	0.9	2.9
C. FINANCIAL ACCOUNT	47.4	87.6	19.7	15.4
Direct investment	54.0	166.1	34.4	57.9
Portfolio investment	59.0	-25.9	-44.2	-25.6
Financial derivatives	3.9	0.7	0.6	15.1
Other investment	-69.6	-53.4	28.8	-31.9
D. ERRORS AND OMISSIONS	11.8	-0.6	-6.1	2.3
E. CHANGE IN RESERVES (- = increase)	-5.7	-86.9	0.4	7.7

Chart III.12
The annual moving total of the trade surplus increased further in 2007 H1
(CZK billions)

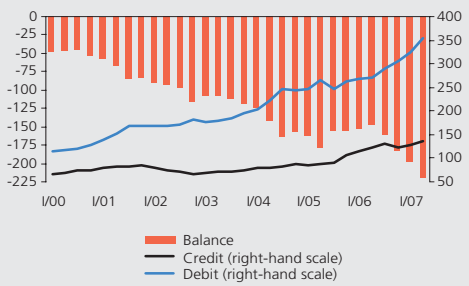


13 The output balance is the sum of the trade balance and the balance of services.

terms of physical volume and particularly in terms of value. By contrast, the surplus on manufactured goods classified by material and the deficit on chemicals recorded considerable deteriorations. From the geographical perspective, the year-on-year trade balance improvement was again due primarily to an increase in the trade surplus with the EU countries (27). Improvements were recorded particularly for trade with Slovakia and also with Germany. However, the total trade deficit with non-EU countries widened, chiefly because of a further increase in the trade deficit with China. By contrast, the high trade deficit with Russia decreased appreciably.

The balance of services ended 2007 H1 in a surplus of CZK 23.1 billion, representing a year-on-year increase of CZK 4.7 billion. The increase in the total surplus was a result of more favourable developments in all three sub-balances. The largest improvements were recorded by the transport and travel surpluses. The other services deficit also narrowed slightly, mainly because of reduced expenditure on financial services. A year-on-year decline in revenues from computer services was the main factor acting in the opposite direction.

Chart III.13
The annual moving total of the income deficit increased further in 2007 H1
(CZK billions)



The income deficit reached CZK 112.4 billion, representing a year-on-year deterioration of CZK 36.6 billion (see Chart III.13). The largest and fastest-growing components of the income balance were estimated reinvested FDI earnings and FDI dividends. The direct investment income deficit thus widened the most (to CZK 110.3 billion) in year-on-year terms. The deficit on compensation of employees, comprising mainly wages, widened as well, owing to growth in expenditure on foreigners working in the Czech Republic. The rise in the total deficit was counteracted above all by growth in the surpluses on income on portfolio investment (mainly dividends) and other investment, representing income on the CNB's international reserves and interest income of commercial banks on deposits abroad.

Current transfers recorded a deficit of CZK 10.8 billion, deteriorating by CZK 8.0 billion year on year due to a sharp increase in debits. The determining factor for the current transfers deficit was a private transfers deficit of CZK 14.7 billion. By contrast, government transfers ended in a surplus. Nonetheless, the balance of transfers between the Czech Republic and the EU budget showed a slight deficit (of CZK 1.0 billion).

III.3.2 The capital account

The capital account recorded a surplus of CZK 2.9 billion in 2007 H1, increasing by CZK 2.0 billion year on year. Its largest component was government revenues from EU funds (CZK 2.9 billion), which, however, decreased slightly in year-on-year terms.

III.3.3 The financial account

In 2007 H1, the financial account showed a surplus of CZK 15.4 billion, or 0.9% of GDP, representing a slight year-on-year decrease. The narrowing of the surplus was due to a net outflow of other investment, linked mainly with a change in flows (allocation) of short-term assets of commercial banks. By contrast, an increase in the total surplus was fostered in particular by growth in the net inflow of direct investment.

Direct investment recorded a surplus of CZK 57.9 billion, representing a year-on-year increase of CZK 23.5 billion. The FDI inflow into the Czech Republic increased year on year, to CZK 68.1 billion. Its largest component was reinvested earnings (CZK 67.3 billion). Investment in equity capital was only one-third of this figure

(CZK 22.6 billion). By contrast, other capital fostered a moderation of the overall inflow, with loans from foreign parent companies being repaid. With regard to industries, the foreign capital inflow was channelled primarily into real estate, followed by financial intermediation. By territory, the biggest individual investor countries were the Netherlands, Cyprus and Korea (see Chart III.14). Czech direct investment abroad decreased year on year, to CZK 10.2 billion. The outflow of capital went chiefly into manufacturing (particularly manufacture of machinery and equipment and also manufacture of chemical products). Geographically, it went mainly to Switzerland, followed by Romania and Slovakia.

Portfolio investment recorded a net outflow of CZK 25.6 billion in 2007 H1, compared to CZK 44.2 billion in the same period of 2006. Amid a very modest decrease in purchases of foreign securities by residents, the annual narrowing of the deficit was due to an increase in non-residents' demand for domestic securities. The outflow of capital was CZK 46.1 billion, about 60% of which was linked with an increase in holdings of foreign shares by domestic entities. This reflected more limited opportunities for investing in domestic equity securities as well as favourable economic developments abroad. Holdings of domestic equity and debt securities by non-residents increased by CZK 20.5 billion. Most of the demand was channelled into bonds. The increase in demand was also due partly to issues of Czech Export Bank bonds on foreign markets (see Chart III.15).

Financial derivatives transactions recorded a net inflow of CZK 15.1 billion. This extraordinarily high annual growth was probably due to the sharp rise in "carry trades".

Other investment recorded a net capital outflow of CZK 31.9 billion (compared to a net inflow of CZK 28.8 billion in the same period of 2006). The change in the overall balance was mainly due to a marked increase in the net outflow of capital through commercial banks (to CZK 41.4 billion). This was chiefly a result of a large rise in short-term bank deposits abroad, linked with a sizeable year-on-year change in flows. By contrast, a net foreign capital inflow into the corporate sector of CZK 9.6 billion fostered a moderation of the overall deficit. In year-on-year comparison, however, this surplus narrowed significantly owing to a considerable decrease in borrowing from abroad. The general government capital flows surplus also narrowed (to just CZK 1.0 billion), mainly because of the termination of repayments of major government receivables.

The CNB's international reserves decreased by CZK 27.2 billion to CZK 638.0 billion in 2007 Q3. This fall was due mostly to valuation changes. In dollar terms, the reserves rose by USD 1.5 billion to USD 32.8 billion in the same period (see Chart III.16).

Chart III.14
Firms registered in Netherlands were the largest foreign investors in equity capital in the Czech Republic in 2007 H1

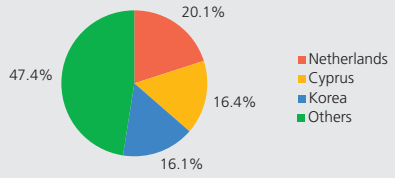


Chart III.15
Portfolio investment recorded a net outflow in 2007 H1

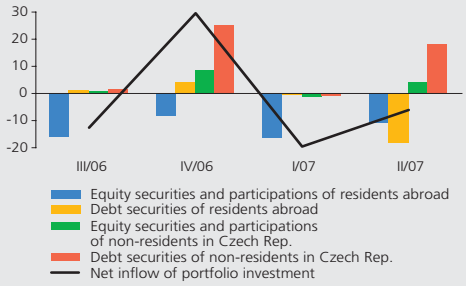
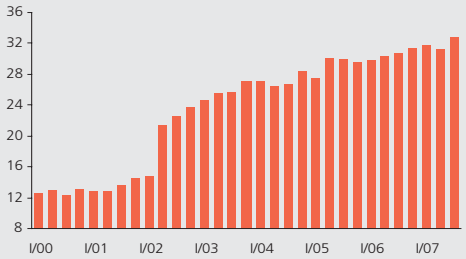


Chart III.16
The CNB's international reserves increased slightly in dollar terms in 2007 Q3
(USD billions)



III.4 MONETARY DEVELOPMENTS

Money supply growth remained relatively high. The main contributor to the growth was still short-term liquid money. However, the rise in key monetary policy interest rates led to a gradual change in the money supply growth structure towards higher growth in quasi money. Demand for loans remained strong despite the rising interest rates. The monetary developments indicate potential further slightly inflationary effects in the medium term.

III.4.1 Money

Annual M2 growth increased further in 2007 Q2 then fell back slightly in July and August, to 11.4% (see Chart III.17). The relatively high M2 growth was associated

Chart III.17
M2 growth remained strong
(annual percentage changes)

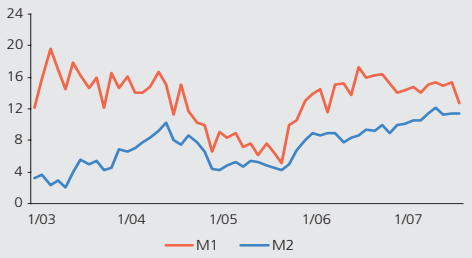


Table III.2
M1 growth slackened while growth in quasi money increased
(quarterly averages and end-of-month stocks; annual percentage changes)

	I/07	II/07	7/07	8/07	Share in M2, % 8/07
M1	14.4	15.1	15.4	12.8	57.6
Currency in circulation	12.0	12.6	11.6	11.2	13.4
Overnight deposits	15.2	15.9	16.6	13.4	44.2
M2-M1 (quasi money)	5.7	7.2	6.0	9.5	42.4
Deposits with agreed maturity	2.3	4.7	3.3	7.8	30.1
Deposits redeemable at notice	18.7	18.4	17.3	15.2	11.8
Repurchase agreements	-40.3	-49.7	-53.0	-11.6	0.5
M2	10.5	11.6	11.4	11.4	100.0

Table III.3
Demand for loans remained high
(quarterly averages and end-of-month stocks; annual percentage changes)

	I/07	II/07	7/07	8/07	Share in total loans, % 8/07
Non-financial corporations	19.2	19.0	19.0	20.5	48.2
Loans up to 1 year	10.5	11.0	14.8	18.6	18.0
Loans over 1 year and up to 5 years	19.2	20.9	18.4	16.0	11.8
Loans over 5 years	29.0	26.6	23.9	25.4	18.4
Households	30.1	31.4	31.7	32.1	43.2
Consumer credit	23.9	26.3	27.3	28.0	8.6
Loans for house purchase	32.4	33.6	33.9	34.2	30.2
Other loans	27.6	27.3	25.9	26.7	4.5
Non-monetary financial institutions	-7.4	-7.4	-7.2	-7.1	8.6
Total loans	20.6	21.3	22.5	23.6	100.0

mainly with growth in loans to corporations and households. The rise in key monetary policy interest rates led to gradual shifts in the money supply growth structure towards less liquid money. Indicators of the appropriateness of the M2 growth (the monetary overhang, the nominal and real money gap) suggest a moderate shift to stronger inflationary effects in the medium term. This year, the money supply has so far risen faster than the estimated equilibrium demand for money.

Within the money supply structure, annual M1 growth recorded a decline while growth in quasi money increased (see Table III.2). Within M1, a slowdown in growth was visible in overnight deposits. Currency in circulation remained relatively stable due to high consumer demand of households. The growth in quasi money was mainly due to deposits with an agreed maturity of up to two years. The higher demand for such deposits compared to demand for overnight deposits reflects widening gaps between the interest rates on individual deposit products. High growth in short-term savings deposits redeemable at notice of up to three months also persists. A smaller annual decline was recorded for repo operations.

Households deposits remained the biggest contributor to money supply growth, in line with the growth rate of disposable income and consumption expenditure. Nevertheless, the contribution of household deposits decreased in July and August, following an increase in Q2, as in the case of deposits of non-financial corporations. By contrast, the contribution of deposits of non-monetary financial institutions increased. Household deposits accounted for 57% of the M2 growth, while deposits of non-financial corporations and non-monetary financial institutions accounted for 16% and 27% respectively.

III.4.2 Credit

Growth in MFI loans to corporations and households has picked up pace this year, and reached 23.6% in August (see Table III.3). The fast growth in loans reflected the buoyant economic growth. Demand for loans remained strong despite the rising interest rates. The average interest rate on new loans rose by 0.6 percentage point to 6.5% in August, owing to the rise in key monetary policy interest rates since the start of the year. The spread between the average interest rate on new loans and the 1Y PRIBOR, characterising the lending conditions, increased slightly in August. However, it is still at one of its lowest levels in three years.

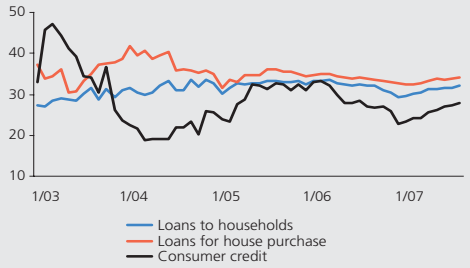
The annual growth rate of loans to non-financial corporations reached 20.5% in August. Since the start of the year short-term loans have recorded more growth, while the rate of growth of medium-term and long-term loans has decreased, although it remains high. The higher corporate demand for short-term loans in Q2 may have been generated by growth in inventories. In particular, loans to the construction industry grew less strongly. Conversely, loans to the machinery and equipment rental sector, including loans to developers, remained the main contributor to the growth in loans to corporations. Loans to such corporations increased by 46.2% in August. Such high growth was due to rising demand for new dwellings, fuelled, among other things, by uncertainty regarding the increase in the VAT rate on construction work. The average interest rate on new loans to non-financial corporations has risen by 0.7 percentage point this year, reaching 4.9% in August. Loans granted to corporations by non-bank institutions, i.e. factoring and forfaiting companies, rose by 16.3% in 2007 Q2 and amounted to just CZK 19 billion (compared to CZK 722 billion for MFI loans).

As regards the structure of overall financing of large non-financial corporations with 250 employees or more, the ratio of internal funds to total liabilities declined, while the ratio of external funds increased. Internal funds and external funds rose

by 3% and 8.7% year on year respectively, i.e. less than nominal GDP growth. Domestic loans grew faster than foreign loans owing to a persisting negative interest rate differential. Koruna loans predominated in domestic loans.

Annual growth in loans to households has recorded a slight rise this year, reaching 32.1% in August (see Chart III.18). The fast growth in loans for house purchase was linked with the development of the property market and with growth in gross disposable income. The rate of growth of consumer credit was affected by relatively high consumer demand. In Q2, households also obtained loans from non-bank institutions, i.e. hire-purchase companies and financial leasing companies, to fund their consumption. These loans recorded annual growth of 11.9% in Q2 and amounted to CZK 108 billion (compared to CZK 648 billion for MFI loans).

CHART III.18
Growth in loans to households increased, with loans for house purchase continuing to show the highest growth
(annual percentage changes)



The expected rise in interest rates and the changes associated with the public finance reform will have opposite impacts on households' disposable income, and those impacts will furthermore differ across the individual income groups. The changes to personal income tax and the introduction of maximum assessment bases for social and health insurance premium payments will increase gross disposable income with effect from 2008. The impact will be strongest in high-income households. According to the macroeconomic forecast, the rise in interest rates will lead to an increase in both the interest expenses and the interest income of households. Taxation of income on mortgage bonds might further increase interest rates on mortgage loans starting in 2008. Gross disposable income of households will be adversely affected by the changes to indirect taxes. The rise in the reduced VAT rate on construction work from 5% to 9% will increase prices of dwellings and thereby generate additional loan repayments, with potential negative impacts on the gross disposable income of some households. The said changes will also lead to slower demand for new loans for house purchase in some households. However, the overall growth rate of loans for house purchase should remain high.

After falling by 0.5 percentage point in the first half of 2007, the average interest rate on new loans to households increased by 0.8 percentage point in July and August, to 11.5%. The interest rate on new loans for house purchase has risen by 0.3 percentage point since the start of the year, to 4.9%. In particular, interest rates with fixations of up to five years have recorded an increase, while rates with longer fixations have decreased. The interest rate on new consumer credit was declining until April but has since risen to 12.5%. Nevertheless, it is still below the end-2006 level.

The ratio of total (bank and non-bank) household debt to gross disposable income further increased to around 43% in Q2. The average debt burden per capita rose slightly to 4.6%. It recorded the fastest growth in low- and medium-income households in 2006 (for details see Box 2 *Household debt by income group in 2006 and its impact on consumption*). Interest expenses paid by households reached 1.7% of gross disposable income and remained lower than interest income (2.7%). Overall, households were the main generators of savings in the economy, despite the rising debt.

BOX 2
Household debt by income group in 2006 and its impact on consumption

Household debt increased as a percentage of gross disposable income in 2006, reaching the 40% level. In terms of the sensitivity of consumption to unexpected changes in interest rates etc., it is important to break the debt

CHART 1 (BOX)
High-income households are borrowing the most
(volumes in CZK thousands; annual per capita averages)

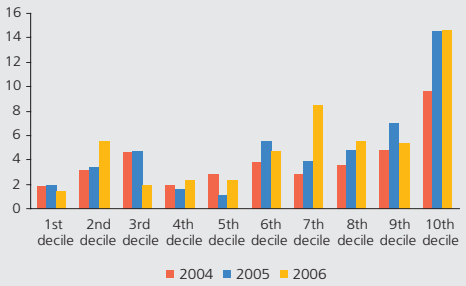


CHART 2 (BOX)
The ratio of newly received loans to net money income rose most of all in low- and medium-income households
(shares in per cent; annual per capita averages)

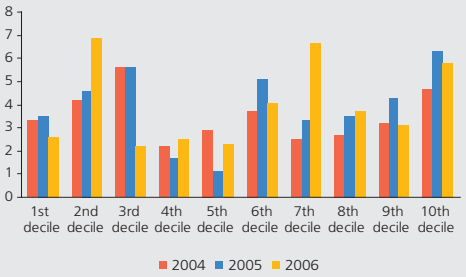


CHART 3 (BOX)
The loan repayment debt burden increased in almost all household income groups
(percentages of net money income)

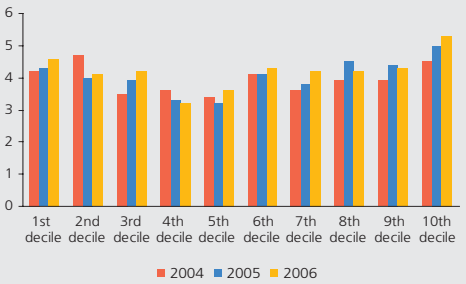
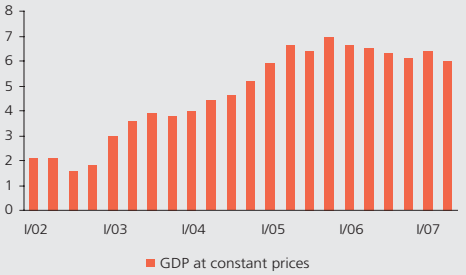


CHART III.19
Economic growth eased in 2007 Q2, but remained high
(annual percentage changes)



down by household income group. According to recently published CZSO family accounts data, high-income households continued to borrow the most in 2006 (see Chart 1). However, the ratio of newly received loans to net money income rose in low- and medium-income households (most of all in the second and seventh deciles), while declining in higher-income households (see Chart 2).

Linked with the impacts of household debt on consumption is to what extent loan repayments (i.e. repayments of principal and interest) burden the income of households and, furthermore, what their saving rate is. Growth in the debt burden makes consumption more sensitive to unexpected changes in interest rates and increases the risk of default. The debt burden of households, as measured by the ratio of repayments to net money income, was 4.3% in 2006. Growth was recorded for most income groups, in particular low- and medium-income households (see Chart 3). The rising debt burden reflected growth in both principal repayments and interest payments. In lower-income households, moreover, it was affected by slower annual income growth. The saving rate is important for smoothing consumption in the event of shocks. The saving rate is low in low-income households (in the first decile the ratio of new savings deposits to net money income was -1.3%) and high in high-income households (11.5% in the tenth decile). The saving rate decreased in both low- and medium-income households in 2006 compared to 2005.

The loan structure is also a significant factor in households' consumption behaviour. In 2006, 13% of households on average had loans for house purchase. The figure was similar across all income groups. This confirms that MFIs are providing mortgages also to households with average and below-average salaries. However, it is reasonable to assume that lower-income households are receiving a smaller loan volume, owing to greater credit constraints. In terms of age breakdown, loans for house purchase were mostly used by younger households.

The information above indicates that the debt-to-income ratio of households increased mainly in low- and medium-income households in 2006. The debt burden increased in most income groups. In lower-income households, it was accompanied by a decline in saving. The debt of these households remains riskier for future consumption. However, the share of the consumption expenditure of lower-income households in total consumption is lower than that of higher-income households.

III.5 DEMAND AND OUTPUT

The strong economic growth, which has been fluctuating around 6% since the start of 2005, continued into 2007 Q2. In 2007 Q2, real GDP growth moderated to 6% and was only slightly below the CNB's July forecast. According to the CNB's calculations, the economy slightly exceeded the potential, non-accelerating inflation level of output for the seventh consecutive quarter.

Turning to the structure of annual real GDP growth, the changes seen in 2006 strengthening the influence of domestic demand continued to be visible. As expected, the rapid growth in household consumption continued into 2007 Q2; as in the previous quarter it was the main driver of economic growth. Annual change

in inventories was also a significant contributor to output formation (see Chart III.20). By contrast, the contribution of gross fixed capital formation, which had been one of the main sources of economic growth in 2006, decreased significantly. According to partial indicators, though, it cannot be ruled out that the considerable slowdown in fixed investment growth in 2007 H1 was only a short-term deviation. As in the previous two quarters, the contribution of the real foreign trade balance to output growth was low, although robust real export growth indicated a still strong export performance of the Czech economy. Imports continued to rise fast and were significantly affected by the rapidly rising domestic demand and the continuing development of international production collaborations. Only the contribution of government consumption to output growth was slightly negative in Q2.

On the supply side of the economy, most branches of industry and services contributed to the buoyant economic growth. Within industry, the largest volumes of value added were generated in manufacturing, which had seen major structural changes in the previous period. Within services, market services were the largest contributor to output growth. Value added growth fell sharply in construction, while gross value added in agriculture continued to fall year on year.

III.5.1 Domestic demand

Annual growth in total final consumption expenditure decreased to 3.9% in 2007 Q2. This growth was due chiefly to a rise of 6.5% in household consumption expenditure, as government expenditure and expenditure by non-profit institutions declined year on year. The largest increase (10.3%) was recorded by gross capital formation, whose contribution to domestic demand growth was identical to that of household consumption. Its rapid growth was largely due to a higher change in inventories year on year. The contribution of gross fixed capital formation was around one-third.

Consumption

The high growth in household consumption continued into 2007 Q2. Although annual growth in household consumption expenditure moderated compared to Q1, it continued to record its highest levels since 2003 (6.5%; see Chart III.21). This was in line with the results of a CZSO survey indicating that the consumer confidence index in Q2 shows a favourable assessment of the economy by households, despite falling from its historically high levels (see Chart III.22).

The slower growth in household consumption in 2007 Q2 was mainly due to disposable income, which is the main source of financing of households' consumption expenditure. Although its nominal annual growth increased in Q2 compared to the previous quarter (to 8%), in real terms the rate of growth of disposable income of households decreased (by 0.8 percentage point to 5.9%), owing to the higher annual inflation. As in previous quarters, the rapid nominal growth in household incomes was mainly driven by wages and salaries – the largest component of household income – which rose by 8% year on year for the reasons specified in detail in section III.6 *The labour market*. It was also significantly affected by social benefits, which rose by 7.8%, and property income. With their consumption expenditure rising faster in year-on-year terms than their disposable income, households financed their consumption expenditure from credit, the growth of which accelerated in Q2 (for details see III.4 *Monetary developments*).

The reasons for households' continued high propensity to consume remained the same as in previous quarters. The main factor was the still favourable consumer

Chart III.20
Economic growth continued to be driven by domestic demand in 2007 Q2
(contributions in percentage points; annual percentage changes)

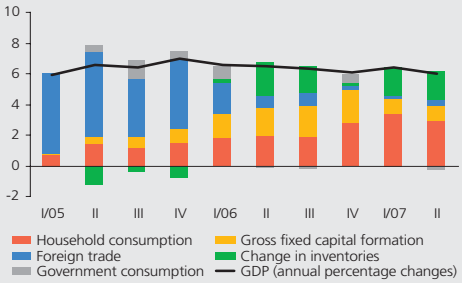


Table III.4
Household consumption and gross capital formation contributed the most to domestic demand growth
(annual percentage changes; CZK billions)

	II/06	III/06	IV/06	I/07	II/07
GROSS DOMESTIC PRODUCT	6.5	6.3	6.1	6.4	6.0
A. FINAL CONSUMPTION EXPENDITURE	2.7	2.4	4.6	4.9	3.9
household consumption	4.1	4.0	5.6	7.2	6.5
government consumption	-0.5	-1.1	2.4	0.2	-1.6
non-profit institutions serving households	4.3	4.1	2.0	-1.3	-0.2
B. GROSS CAPITAL FORMATION a)	15.0	13.8	10.2	11.1	10.3
gross fixed capital formation	7.5	7.8	8.1	4.0	4.2
C. NET EXPORTS OF GOODS AND SERVICES (balance in CZK billions, constant 2000 prices)	1.0	-7.3	-19.7	11.6	0.5
imports of goods and services	12.7	11.8	17.1	16.1	13.9
exports of goods and services	13.0	12.7	17.1	15.3	13.8

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

Chart III.21
Household consumption growth eased in 2007 Q2, but remained very high
(annual percentage changes)

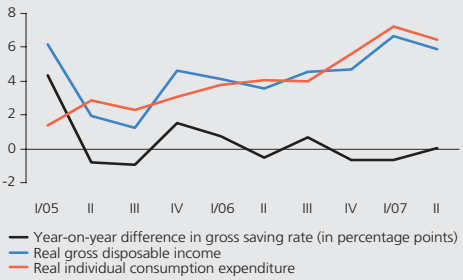
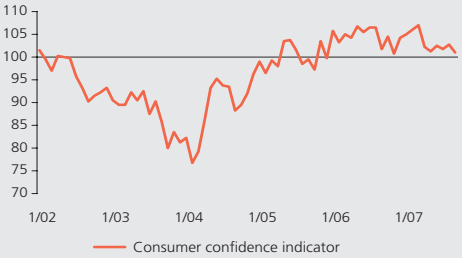


Chart III.22
The consumer confidence index indicated a favourable assessment of the economy in 2007 Q2
(2005 average = 100; seasonally adjusted data)



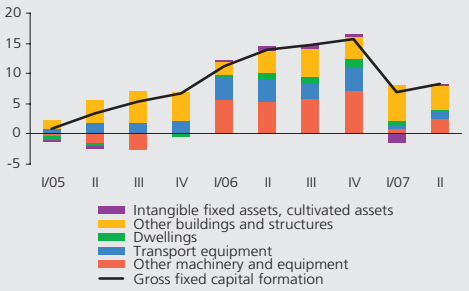
confidence, fuelled by favourable economic developments, growing incomes and expectations of an improving personal financial situation.[14] The propensity to consume was also fostered by falling prices of durable goods. Households effected their growing consumption expenditure in all categories of consumption spending,[15] although the fastest-growing components were expenditure on household equipment and furnishings, hotels and restaurants, transport, leisure and culture. The continuing buoyant growth in expenditure on household equipment was very closely linked with the expansion of housing construction and demographic trends. According to the latest (September) consumer confidence survey, though, household consumption expenditure growth can be expected to slow in the near future.

Government consumption recorded an annual decline of 1.6% in 2007 Q2.[16] This figure suggests that the impact of non-investment government demand on total demand in the Czech economy was neutral to slightly negative in the period under review. According to the data from the state budget, which accounts for the bulk of the government sector as a whole, wages of public employees and other current government expenditure rose in nominal terms.

Investment

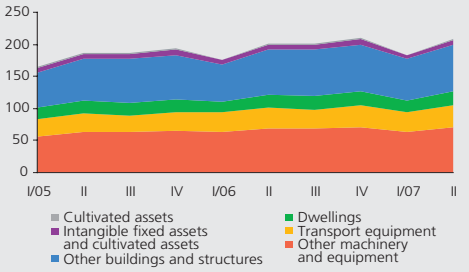
Annual growth in gross fixed capital formation rose only slightly in 2007 Q2, reaching 4.2%. For the second consecutive quarter, fixed investment thus recorded noticeably lower growth than in 2006, when its annual growth had peaked at 8.1% in the last quarter of the year (see Chart III.23). This means that the July forecast's assumption of continuing buoyant fixed capital investment growth in the first half of 2007 did not materialise. The marked slowdown in fixed investment growth was due mostly to technological investment.[17]

Chart III.23
Investment demand grew more slowly in 2007 H1 than in 2006
(annual changes in CZK billions; constant 2000 prices)



The structure of investment and some other partial indicators[18] suggested that most of the monitored sectors contributed to the slower investment growth in 2007 Q2. The causes of the slower-than-expected investment growth can be seen mainly in the non-financial corporations sector, which accounts for roughly two-thirds of total investment. Investment in this sector was most affected by noticeably slower growth in machinery and equipment investment. However, concurrent high growth in capital goods imports and high annual growth in inventories suggested at the same time that the slower growth in machinery and equipment investment might have been only temporary. The hypothesis of a short-term downturn in investment growth in the non-financial corporations sector is also supported by a continuing undiminished inflow of FDI in tangible goods, information about the completion of several large investments, the favourable results of the CZSO's survey of producer confidence in industry and the still favourable conditions for investment financing.

Chart III.24
The investment structure was broadly unchanged in 2007 Q2
(CZK billions; constant 2000 prices)



Investment in dwellings, which primarily concerns the household sector, also recorded slower growth; it rose by just 0.3% in Q2, following an annual increase of 4.5% in Q1. However, taking into consideration the large annual increase in work on the completion of buildings and the number of housing completions in Q2 (30.3%), a rise in investment in dwellings can be expected in the period ahead (i.e.

14 According to the results of the CZSO's consumer confidence surveys.
15 According to the CZSO's family accounts statistics.
16 At current prices it rose by 1.8%.
17 i.e. investment in machinery and equipment and transport equipment.
18 The CZSO only publishes data on the structure of investment by kind, so the analysis of total investment by economic sector is based on partial indicators.

in the form of paid transfers of titles to dwellings from construction firms into private ownership). Only investment by the government sector seemed to record an annual increase in 2007 Q2, as the high 11.6% nominal growth in investment expenditure indicated real growth in investment in this sector.

III.5.2 Net external demand

The unfavourable trend in net exports of goods and services[19] observed in the previous two quarters almost halted in 2007 Q2. Net exports recorded a slight surplus (of CZK 0.5 billion), which was only CZK 0.5 billion lower than in the same period a year earlier (see Chart III.25). The contribution of net exports to GDP growth was thus very low in Q2. As in the previous quarter, the low share of net exports in economic growth was due to high growth in aggregate demand, connected with rapid growth in imports. Although annual import growth moderated in 2007 Q2, it remained high (13.9%). Export growth also slowed, though to a lesser extent than in the case of imports. As a result, the lead of import growth over export growth narrowed to just 0.1 percentage point.

A slight annual increase in the trade surplus, recorded after a stagnation in Q1, was positively reflected in net external demand in 2007 Q2. Its contribution to the improvement in net exports in Q2, however, was again diminished by an annual increase in the services deficit, observed for the sixth consecutive quarter. The widening trade surplus was mainly due to strong exports of goods (15.1%), which – unlike in Q1 – fully offset the effect of fast growing imports of goods. As in previous quarters, the continuing strong export performance of the Czech economy was mainly due to the launching of export-oriented production facilities supported by foreign capital.

On the other hand, the continued rapid annual growth in imports of goods (14.9%) was strongly affected by exceptionally high growth in investment imports, which again markedly exceeded the growth rate recorded by total imports in Q2. An expansion of international production collaborations, resulting in a rising import intensity of production, also significantly helped to keep imports strong. Overall, trade developed significantly faster in goods trade, the turnover of which rose almost three times faster than trade in services, despite a high base.

III.5.3 Output

On the supply side of the economy, the strong annual growth in gross value added at constant prices continued into 2007 Q2. However, it declined by 0.5 percentage point compared to the previous quarter, to 6%. As in previous quarters, two-thirds of the value added growth was due to rising aggregate labour productivity and one-third to increased employment. Continuing high production capacity utilisation in most branches of industry, increasing imbalances in the labour market in some occupations and some other indicators on the supply side suggested that the economy was still growing in Q2 in an environment where actual output was slightly above the potential, non-accelerating inflation level of output.

As in previous quarters, the buoyant economic growth was closely associated with ongoing structural changes, supported primarily by foreign capital.[20] The biggest contributor to the 6% annual growth in gross value added was the services sector,

CHART III.25
Net exports were only slightly lower in 2007 Q2 than a year earlier
(CZK billions; constant 2000 prices)

CHART III.26
Export growth and import growth were again almost balanced in 2007 Q2
(annual percentage changes)

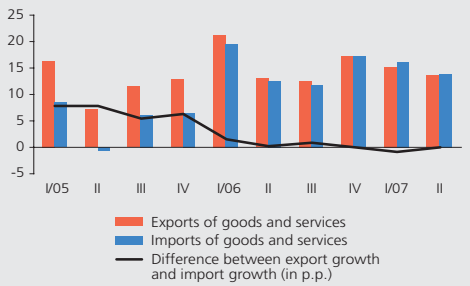
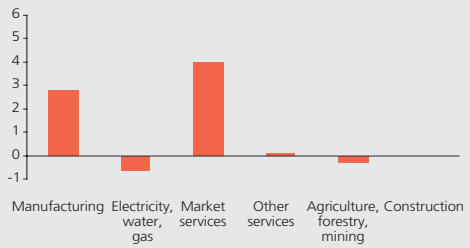


CHART III.27
Services were the biggest contributor to the high economic growth in 2007 Q2
(contributions in percentage points; constant 2000 prices)



19 At 2000 prices.

20 For details see section III.5.4 *Economic results of non-financial corporations.*

Chart III.28
The rapid economic growth was achieved amid high production capacity utilisation
(2005 average = 100)

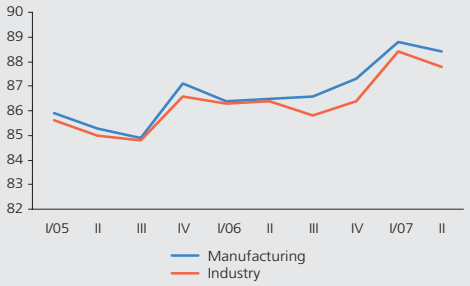
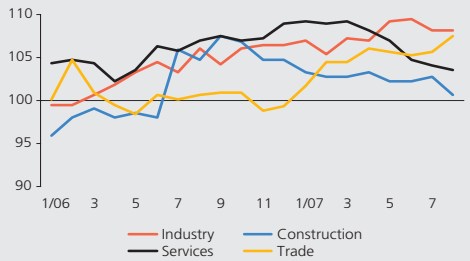


Chart III.29
The confidence indicator in industry was high in 2007 H1
(2005 average = 100)



in particular market services, which accounted for more than 60%. The contribution of manufacturing, which had dominated in 2006, remained relatively high in Q2 (see Chart III.27).[21] The contribution of the other sectors to value added growth was insignificant, with some industries continuing to record the annual decline in value added observed in previous quarters (agriculture and electricity, gas and water supply). In construction, the sharp rise in value added in Q1 was replaced by a very weak increase in Q2.

In manufacturing, value added profited in most branches from the continuing economic boom. According to the CZSO statistics on value added in individual branches,[22] its rapid growth was mainly driven by four branches: manufacture of metals and fabricated metal products, manufacture and repair of machinery and equipment, manufacture of electrical and optical equipment and manufacture of transport equipment. Value added also rose very quickly in the manufacture of rubber and plastic products and the manufacture of other non-metallic mineral products, where there was a clear link with the high demand in construction. These branches accounted for almost 90% of the total annual increase in value added in manufacturing in Q2. The main factors underlying these favourable results were past structural changes supported by foreign capital (in particular, investment in new production and assembly lines)[23] and favourable demand. According to the latest survey of confidence in industry and the expected flow of orders, manufacturing output can be expected to continue rising rapidly in the near future.

In 2007 Q2, annual value added growth in market services was again driven mainly by wholesale and retail trade (more than 40%). Following an exceptional increase in Q1, mainly reflecting a substantial rise in households' consumption expenditure, annual value added growth in wholesale and retail trade slowed to 14.2% in Q2. However, it was higher than in 2006. Market services in real estate, business services and transport services also made major contributions to the value added growth in 2007 Q2.

III.5.4 Economic results of non-financial corporations [24]

According to the available data and the CNB's calculations, the favourable trends in the main indicators of the performance of non-financial corporations recorded in 2007 Q1 continued into Q2. Above all, the rapid annual growth in book value added continued (12.2%), amid a rise in output of 10.2%. The available data permit a further estimate of continuing favourable profit generation and an improvement in the ratio indicators, including the return on equity.

In 2007 Q2, as in previous quarters, profit was generated amid contrary movements in important inputs of both domestic and foreign origin. Falling import prices of oil and natural gas again helped reduce producer costs in Q2. On the other hand, cost pressures continued to increase in connection with the persisting high annual

Table III.5
The rapid growth in book value added continued into 2007 Q2
(CZK billions; annual percentage changes)

	Q2		Annual changes	
	2006	2007	CZK billions	%
Output incl. profit margin a)	1,149.2	1,266.8	117.6	10.2
Intermediate consumption	824.3	902.2	77.9	9.4
Sales, total	1,479.2	1,625.9	146.7	9.9
Personnel costs a)	166.3	183.0	16.7	10.0
Book value added	324.9	364.6	39.7	12.2

a) CNB calculation

21 Value added rose very quickly in the following sectors: manufacturing (year-on-year growth of 10.5%) and market services (growth of 8.1%–14.2%). Three branches accounted for 95% of the total value added growth – manufacturing (around 45%), wholesale and retail trade and repair of motor vehicles (around 30%) and business services (around 20%).

22 According to data on book value added in monitored non-financial corporations with 50 employees or more at current prices.

23 63.1% of sales of foreign-controlled corporations were intended for direct export in 2007 Q2.

24 The assessment is based on a set of corporations with 50 employees or more and draws partly on calculations based on partial data published by the CZSO.

growth in prices of other imported materials (most notably metals), imported intermediate goods and energy-producing commodities of domestic origin. According to the CNB's calculations, the continuing combination of these contrary cost effects resulted in a slight annual decline in the material cost-output ratio in the monitored set of corporations in 2007 Q2 (of 0.5 percentage point; see Table III.6). The personnel cost-output ratio also recorded a slight annual decline in 2007 Q2, following a slight increase in Q1.

The underlying causes of the unexpected change in the previous tendencies in the material cost-output ratio can be seen on both the material cost and output sides. In a number of branches, output was favourably affected by the demand situation, which allowed producers not only to increase sales, but also to raise their export prices. Favourable terms of trade also seem to have had a significant effect for many products. This view is supported by the broadly flat growth in intermediate consumption accompanied by faster growth in output (including profit margin) in Q2 (see Table III.5). The mutual evolution of these two variables suggests that prices of final products rising faster than input prices might have contributed to the decline in the material cost-output ratio in some corporations.

Significant volumes of book value added continued to be generated in foreign-owned corporations (52%). The annual rate of growth of value added reached double figures in these corporations, unlike in public corporations and private domestic corporations.

Table III.6
The material cost and personnel cost-output ratios recorded a slight annual decline in 2007 Q2
(percentages; annual changes in percentage points)

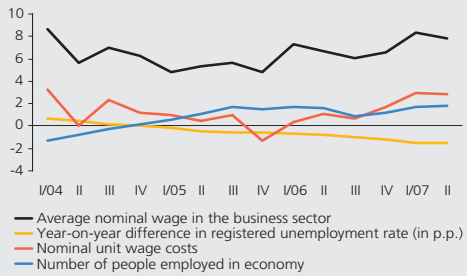
	Q2		Change in p. p. against 2006 Q2
	2006	2007	
Personnel cost-output ratio a)	14.5	14.4	-0.1
Material cost-output ratio a)	71.7	71.2	-0.5
Ratio of personnel costs to value added a)	51.2	50.2	-1.0
	CZK thousands per month		Annual perc. changes
Book value added per employee	56.1	61.7	10.0

a) CNB calculation

III.6 THE LABOUR MARKET

In 2007 Q2, the labour market saw continuing growth in labour demand amid still buoyant economic growth. Ongoing structural changes in the economy and favourable domestic and external demand fostered rising employment in industry and services. The labour market developments also suggested growing labour shortages in some sectors, as is typical of an economy with a positive output gap. The increasing employment and high creation of vacancies generated a further significant decline in the unemployment rate, which was cyclical in nature. However, the relatively high proportion of long-term unemployment persisted, mainly reflecting a problem with the professional and skills structure of the unemployed. Growth in nominal unit wage costs slowed slightly, but still suggested an upward tendency in wage-inflationary pressures compared to the previous period.

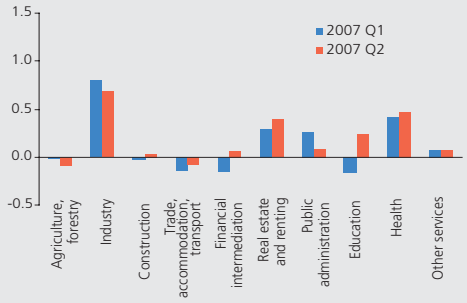
Chart III.30
The continuing buoyant economic growth was accompanied by rising employment
(annual percentage changes; percentage points)



III.6.1 Employment and unemployment

The growth in employment observed since the end of 2004 continued into 2007 Q2 (see Chart III.31). According to CZSO figures, it rose to 1.8%[25] in year-on-year terms, with total employment reaching its highest level since the start of 1998. In line with the ongoing structural changes in the economy the rise was due to industry and services, while agriculture again recorded falling employment.

Chart III.31
Employment rose in industry and services
(contributions in percentage points; selected branches)



25 The number of employed secondary school graduates and university and vocational college graduates increased by 68,400 and 18,700 respectively. This is related to the generally fast growth in the education level of the population.

Chart III.32
High creation of vacancies fostered a fall in unemployment
(seasonally adjusted numbers in thousands)

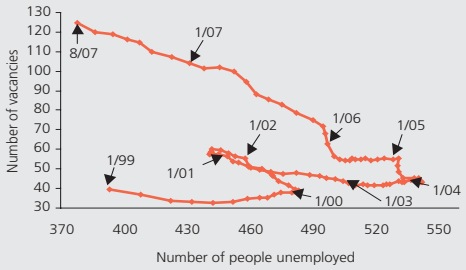


Chart III.33
The rising employment was accompanied by a rapid fall in the number of unemployed people
(annual changes in thousands of persons)

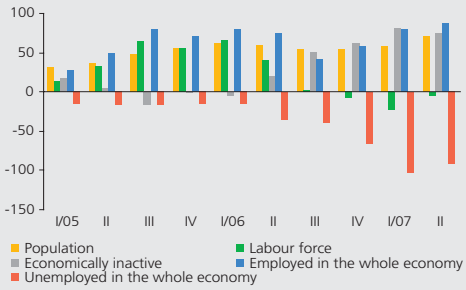


Chart III.34
The number of the long-term unemployed continued to fall, but the long-term unemployment rate remained high
(percentages; percentage points; source: LFS)

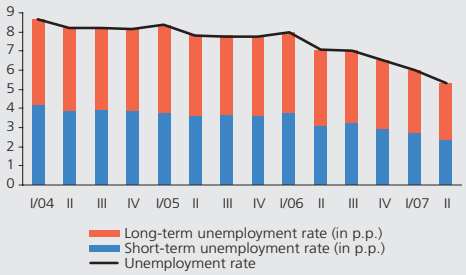


Table III.7
Fast growth in the average wage continued into 2007 Q2
(annual percentage changes)

	I/06	II/06	III/06	IV/06	I/07	II/07
Average wage in monitored organisations						
nominal	7.0	6.6	5.9	6.1	7.9	7.4
real	4.1	3.6	2.9	4.5	6.3	4.9
Average wage in business sector						
nominal	7.3	6.7	6.1	6.6	8.3	7.8
real	4.4	3.7	3.1	5.0	6.7	5.3
Average wage in non-business sector						
nominal	5.9	5.9	5.4	4.4	6.3	5.9
real	3.0	2.9	2.4	2.9	4.7	3.4
Whole-economy labour productivity	5.2	4.9	4.3	4.3	4.4	4.4
Nominal unit wage costs	0.3	1.0	0.7	1.7	3.0	2.8

In 2007 Q2, the largest increase in employment was recorded in services (54,800 people, or 2.1%, in year-on-year terms).[26] Within market services, the largest rise in employment was again recorded in renting and business activities (28,200 people), reflecting growing demand for these services at a time of buoyant economic growth.[27] Significant rises were also recorded in health, veterinary work, education, financial intermediation and other public social and personal service activities. Within industry, employment continued to increase in manufacturing (by 31,500 people, or 2.3%). This rise was linked mainly with foreign direct investment, activities in related branches and the generally favourable domestic and external demand situation.

The growing demand for labour was also met from external sources. This was evidenced by significant annual growth in the number of foreign workers, which reached 26.6% in the first eight months of this year. Nonetheless, some sectors experienced shortages of workers in the required occupations and with the right skills. This was, for example, one of the main reasons for the increased number of buildings under construction. However, growing employment was not seen across the board, as some sectors conversely recorded decreasing employment as a result of strong competition (mainly in trade, agriculture and hotels and restaurants).

Fast growth in the number of vacancies, which are a potential source of rising employment or falling unemployment, also continued into 2007 Q2 (see Chart III.32). The slope of the Beveridge curve meanwhile suggested that the growing labour demand had so far been cyclical in 2007.

The rising employment in Q2 was accompanied by fast declining unemployment and a further decrease in the number of inactive persons, which represent a potential labour force reserve. The general unemployment rate (according to the LFS) fell to a nine-year low (5.3%), the decline being almost across the board in nature. Fast declining unemployment was also confirmed by the MLSA data, according to which the registered unemployment rate declined by 1.5 percentage point year on year to 6.5% in Q2 and continued falling to 6.3% in Q3. This reflected a lower number of newly registered job applicants and a high number of excluded applicants.

The continuing cyclical decline in unemployment fostered a pronounced annual decline in the number of long-term unemployed people in 2007 Q2 (of 55,600 people according to LFS figures). However, this group still accounted for more than half of the unemployed, as shown in Chart III.34. The fact that most of the long-term unemployed have only basic education (70.7%) hinders a more fundamental solution to this problem.

III.6.2 Wages and productivity

The continuing strong economic growth, accompanied by a marked decrease in unemployment, was again attended by fast growth in the average wage in 2007 Q2. Although its annual growth rate moderated by 0.5 percentage point

26 According to CZSO statistics on the number of workers in principal employment by job and sector of the national economy.

27 Within the category of real estate, renting and business activities, employment increased primarily in legal and accounting activities, tax consultancy, including market research and public opinion polling, research and experimental development on natural sciences and engineering, and in software consultancy and supply.

compared to the previous quarter, it was still one of the highest figures recorded in the past five years.

The fast growth in the average wage in 2007 Q2 was driven primarily by wages in the business sector, where the annual growth rate of the average wage reached its second-highest level in three years (7.8%). This was consistent with the position of the economy in a phase of strong economic growth. Corporations increased the remuneration of their employees amid rapid growth in productivity, rising profits in most industries and rapidly falling unemployment. Fast growth in the average wage continued in 2007 Q2 in most monitored branches of the business sector. Wage growth moderated in construction, owing to slower growth in construction work. In the non-business sector, where wages depend mainly on the capacities of the state budget and measures taken by the government, the average wage continued to grow more slowly than in the business sector (5.9% year on year).

As regards inflation, further analysis is needed of whether the continued buoyant growth in the average wage was accompanied by corresponding growth in productivity. As Table III.7 shows, nominal unit wage costs, which indicate the potential build-up of inflation pressures in the wage area, continued rising in year-on-year terms in 2007 Q2. However, their annual growth moderated slightly to 2.8% in Q2, amid stable growth in whole-economy productivity and slower growth in the total volume of wages and salaries. This was due to industry, where nominal unit wage costs again recorded a slight annual decline (of 0.2%) in Q2, following an extraordinary increase at the start of 2007. In manufacturing, which is the main component of industry, the decline in nominal unit wage costs was more pronounced, reaching 2.3%, amid wage growth of almost 8% and high productivity growth. The other monitored sectors contributed to the overall nominal unit wage cost growth (see Chart III.36). Except for public services, where nominal unit wage costs are showing a long-term growth trend and the scope for productivity gains is limited, nominal unit wage costs have not shown an upward tendency in growth. They are highly volatile, being influenced mainly by fluctuations in demand or by other extraordinary effects.

Overall it can be said that nominal unit wage cost growth remained considerably higher than in the previous year, despite showing a slight downturn. In particular, the gradual moderation of the annual decline in nominal unit wage costs in manufacturing can be regarded as a consequence of the changing situation on the labour market at a time of persisting strong economic growth.

CHART III.35
Whole-economy labour productivity rose at a stable rate, but was volatile within individual sectors
(annual percentage changes)

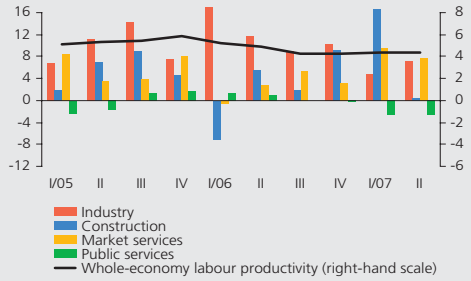
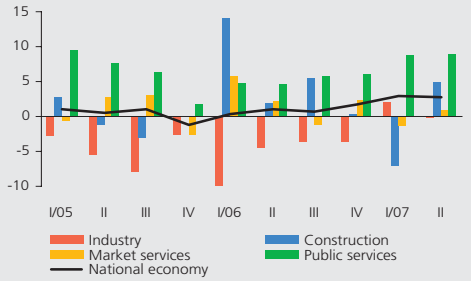


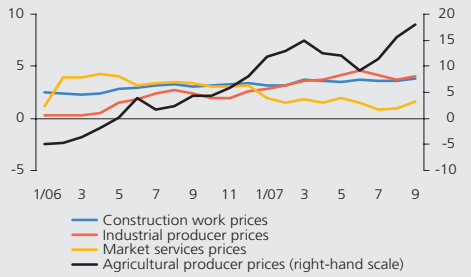
CHART III.36
The slower average wage growth fostered a slight downturn in nominal unit wage cost growth in 2007 Q2
(annual percentage changes)



III.7 IMPORT PRICES AND PRODUCER PRICES

The continuing annual decline in import prices of energy-producing materials fostered a further easing of the external cost pressures on domestic inflation in 2007 Q3. At the same time, however, growth in prices of some imported non-energy-producing materials, particularly metals and food, picked up pace. Prices of some important domestic inputs also continued to rise quickly (electricity and solid fuels). This contrary trend in input prices fed through variously to producers' costs across individual branches. Although annual industrial producer price inflation declined slightly overall, producer prices increased in some branches owing to strong growth in input prices and demand. Construction work prices recorded a continuing gradual pick-up in growth, while market services prices in the business sector continued to rise more slowly than in 2006. By contrast, agricultural producer price inflation recorded a marked increase in Q3, signalling a build-up of potential inflation pressures on food prices.

CHART III.37
Agricultural producer price inflation rose sharply in 2007 Q3
(annual percentage changes)



III.7.1 Import prices

Import prices, which are an important domestic inflation factor, declined by 0.6% year on year according to the latest figures for August. The modest upturn in their growth observed in the previous two months was thus replaced by a slight decline in August, fostered by import prices of mineral fuels and other imports[28] (see Chart III.38).

As in 2007 Q2, the persisting annual decline in import prices of mineral fuels in the first two months of 2007 Q3 was due to the combination of a sizeable annual appreciation of the koruna-dollar exchange rate[29] and a none-too-large annual decline in the CZSO index of world prices of oil and natural gas. The annual decline in import prices of mineral fuels deepened further in August, to 5.8%. However, prices of oil and natural gas moved differently, mainly because prices of natural gas usually react to oil prices with a lag. By contrast, annual growth in prices of other imported materials continued to rise year on year until July (to 13.6%) due to persisting high demand for metals on world markets. This growth moderated in August, but remained high (12.8%).[30] Prices of most other non-energy-producing materials also contributed to the buoyant growth in import prices in this category.

Although import prices of commodities with a higher degree of processing[31] usually exhibit lower volatility than import prices of raw materials, their annual decline deepened in the first two months of 2007 Q3 (see Chart III.38). The decline was due chiefly to import prices of products with a high degree of processing – machinery and transport equipment, whose external inflation is usually lower than that of other imported products (see Table III.8). Import prices of miscellaneous manufactured articles also continued to record an annual decline. By contrast, prices of imported manufactured goods and chemicals (including intermediate goods) continued to grow, albeit at a more moderate pace than at the end of Q2. Only prices of imported foods recorded faster annual growth; this was connected with the fast rising prices of such commodities on world markets.

Import prices in the first two months of 2007 Q3 suggested a continuing contrary trend in the import prices of two key categories of imported raw materials – energy-producing materials and other raw materials. While the declining prices of imported energy-producing materials fostered a reduction in domestic producers' costs, the fast rising prices of non-energy-producing materials signalled a potential build-up of inflationary pressures among some producers, most notably in industry. The continuing upturn in prices of imported foods and the rising prices of manufactured goods also had an inflationary effect. However, prices of imported industrial products intended for the consumer market continued to show an annual decline.

Chart III.38
The annual changes in import prices have been fluctuating close to zero since May
(annual percentage changes; contributions in percentage points)

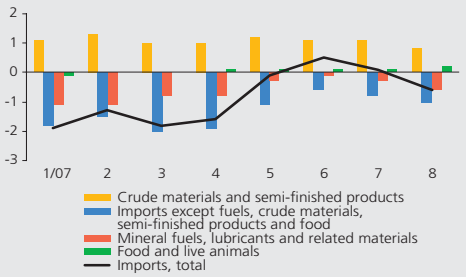


Table III.8
The contrary trend in the import prices of energy-producing and other raw materials continued
(annual percentage changes)

	5/07	6/07	7/07	8/07
IMPORTS, TOTAL	-0.1	0.5	0.1	-0.6
of which:				
food and live animals	1.5	2.3	2.8	4.4
beverages and tobacco	-0.3	1.4	1.5	2.6
crude materials except fuels	7.6	9.1	13.6	12.8
mineral fuels and related products	-3.3	-1.4	-2.7	-5.8
animal and vegetable oils	13.9	17.3	16.9	14.6
chemicals and related products	3.1	3.4	2.2	0.7
manufactured goods classified by material	4.5	4.3	3.6	2.4
machinery and transport equipment	-3.0	-2.4	-2.6	-2.6
miscellaneous manufactured articles	-1.8	-1.1	-1.5	-1.6

28 Prices of imports excluding mineral fuels, raw materials, semi-manufactures and food.
29 The annual appreciation of the koruna-dollar exchange rate was 7.1% in August.
30 Metal prices on world markets rose by 30.1% year on year in July. The growth moderated to 19.1% in August.
31 Primarily machinery and transport equipment, manufactured goods classified chiefly by material, miscellaneous manufactured articles and chemicals and related products.

III.7.2 Producer prices

Industrial producer prices

The gradual pick-up in annual industrial producer price inflation observed since October 2006 halted at the end of 2007 Q2 and changed into a moderate decline in July (to 4% in September). The break in the trend was due mainly to metal manufacture and other branches of manufacturing,[32] as illustrated in Chart III.39.

The significant slowdown in producer price inflation in the manufacture of basic metals and fabricated metal products in Q3 (from 8.7% in June to 5.7% in September) was probably most affected by a marked slowdown in growth in metal prices on world markets. Growth in producer prices also slowed noticeably in mining and quarrying (to 7.4%). Most industries contributed to the decline in annual price inflation in other branches of manufacturing. Prices in the manufacture of transport equipment recorded an annual decline again in Q3 after stagnating in June.

Conversely, producer prices picked up pace in some branches. In particular, the food industry saw a continued upswing in annual price inflation, due primarily to external factors (for details see *Agricultural producer prices*). The annual increase in prices in the manufacture of coke and refined petroleum products in September (6.8%), which had previously been declining, was due to a sharp rise in oil prices on world markets at the end of Q3. Prices in the electricity, gas and water supply industry also increased slightly year on year (to 7.5% in September).

Prices thus continued rising in most industrial branches in 2007 Q3. Overall, annual industrial producer price inflation slackened, but not all branches contributed to the slowdown. Fast price growth or a sizeable upswing in prices was observed in branches where producers faced stronger cost pressures and where the main input commodity is a major component of costs. At the same time, however, prices signalled a pronounced effect from growing domestic or external demand in some branches (in particular manufacture of construction materials, energy sectors, the food industry and metal manufacture).

CHART III.39
Industrial producer price inflation declined in 2007 Q3
(annual percentage changes; contributions in percentage points)

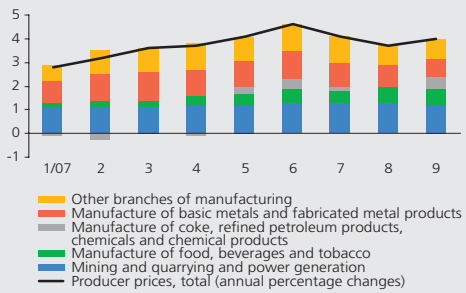
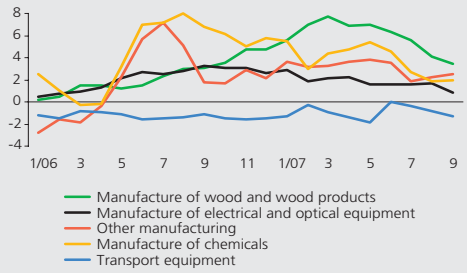


CHART III.40
Several branches of manufacturing contributed to the decline in inflation in industry
(annual percentage changes, selected branches)

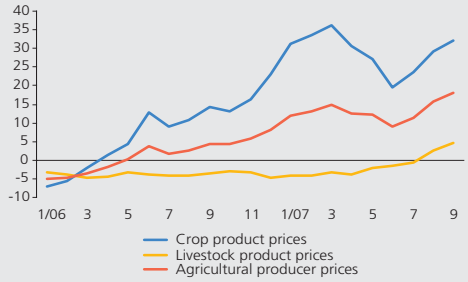


Agricultural producer prices

Annual agricultural producer price inflation rose sharply again in 2007 Q3 (from 9.1% in June to 18.1% in September). This change in trend was due chiefly to a rise in crop price growth to 32.2% in September, which was closely linked with a marked increase in prices of cereals on world markets for the reasons explained in detail in Box 3 *The causes of the sharp growth in world prices of cereals.* Prices of cereals in the Czech Republic showed an extraordinary annual rise of 62% in September. Prices of oil crops, fruit and vegetables also increased.

The faster growth in agricultural producer prices in Q3 was fostered by livestock product prices, where the previous gradual weakening of the annual decline switched to growth, reaching 4.5% in September. This was mainly due to a sharp rise in prices of milk, poultry and eggs, reaching double figures in year-on-year comparison.

CHART III.41
The upswing in agricultural producer price inflation was due to prices of both crop products and livestock products
(annual percentage changes)



32 This includes manufacture of machinery and equipment, electrical and optical equipment, transport equipment, rubber and plastic products, other non-metallic mineral products, wood products, pulp, paper, textiles and textile products, leather products, chemical products and manufacturing products not elsewhere classified.

BOX 3
The causes of the sharp growth in world prices of cereals

Global agricultural and food commodity markets have seen a sharp upswing in prices this year. This trend is due to several key factors.

The first was adverse weather in most European countries, Australia and North America in the second half of 2006, reflected most of all in decreased wheat production this year (due to bad winter wheat planting and for other reasons). In particular, the fall in cereal production in Australia, caused by an extreme drought, can be considered extraordinary. The decrease in this world exporter's production has reduced its exports by around one-third this year. As a result, global wheat production is expected to drop by around 5.4% this year, while production of other cereals (rice and maize) will fall by around 1%. However, the adverse weather led not only to a smaller harvest, but also to a significant decline in the proportion of high-quality food and fodder cereals, further strengthening the upward pressure on their prices.

The fall in global production of cereals, including rice, in 2006 and 2007 is taking place in a situation where the long-term growth trend in global consumption of cereals for food, fodder and biofuel production is expected to continue. The increased demand for these crop commodities is closely linked with the rapid economic growth in China, India, Brazil and other fast growing economies, which have a total population of around 3 billion.

For the aforementioned reasons, crop product stocks are falling sharply and prices are rising as a result. This trend is being observed in all major world markets, particularly in the case of cereals. The high demand for crop products on global markets is indirectly leading to rising prices of these commodities in the Czech Republic. The impact of this effect on domestic prices is apparent both in year-on-year comparison and in absolute terms (koruna prices of some commodities have reached their highest levels since 1990).

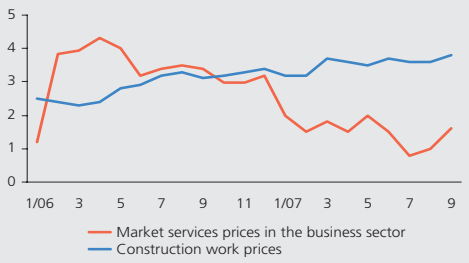
The current high growth in prices of major crop commodities in the Czech Republic (in particular cereals) is exclusively due to external factors, as this year's domestic harvest was average or slightly higher than in previous years according to the latest August CZSO estimates.

Other producer prices

In 2007 Q3, construction work prices showed a continuing gradual rise in annual growth, as observed since 2006 Q2 (to 3.8% in September). This rise was due mainly to persisting high demand for construction work. Prices of materials and products consumed in the construction industry continued to rise faster than construction work prices in 2007 Q3, reflecting not only high demand, but also fast rising prices of some cost inputs (most notably metals). However, their rate of growth moderated to 5.3% in Q3.

Market services prices rose more slowly in 2007 Q3 than in 2006. Although they were volatile in Q3, the 1.6% increase in September was virtually the same as the figure recorded in June. While prices of business services and freight transport showed annual increases in Q3 (of 2.5% and 3.3% respectively), the categories of communications and insurance continued to record an annual price decline. Sewerage collection charges again showed the fastest growth (5.6%).

CHART III.42
Construction work price inflation continued to edge up, but market services prices rose more slowly than in 2006
(annual percentage changes)



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 on the publication Consensus Forecasts, which brings together the forecasts of a range of foreign analytical teams, and market outlooks. The current forecast is based on the September Consensus Forecasts data and the market information effective on the survey closure date. Effective developments in the euro area are 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. The expectations regarding external developments and inflation going forward are essentially unchanged compared to the previous forecast, although the outlook for interest rates has shifted downwards significantly as a result of the financial turbulence.

As regards the outlook for growth in the effective indicator of consumer prices in the euro area in 2007 and 2008, the reference scenario of the October forecast matches the assumptions of the July forecast. Consumer price inflation is expected to be 1.9% this year, 1.7% in 2008 and 1.8% in 2009. This year's VAT increase in Germany should not exert upward pressures on import prices in the Czech Republic. This effect is therefore adjusted for in the forecast. According to the assumptions of the forecast, the effective indicator of producer prices in the euro area will increase by 2.3% in 2007 and 2% in both 2008 and 2009.

The outlook for economic growth in the euro area in effective terms has been lowered only slightly to 2.6% for this year. For 2008 and 2009, a modest slowdown to 2.3% and 2% is expected. The expected effect of external demand on the domestic economy is thus slightly anti-inflationary over the entire forecast horizon.

The price of oil continued to rise in Q3 and was higher than expected by the market at the time the July forecast was prepared. The new market outlook foresees a slow decline in prices over the entire forecast horizon, from an average of USD 74.9 a barrel in 2007 Q3 to USD 71 a barrel at the end of 2009. Compared to the July forecast the outlook has thus shifted upwards, particularly for the nearest quarter. Petrol prices on the ARA markets will move in line with oil prices, with seasonal fluctuations.

The exchange rate of the dollar against the euro depreciated again. The September Consensus Forecasts thus revised the expected future dollar-euro exchange rate towards a weaker dollar again, although a modest appreciation is still expected. The exchange rate of the dollar is expected to be USD 1.35/EUR at the end of 2008 and to firm slightly to USD 1.33/EUR at the end of 2009. The implied one-year EURIBOR path has shifted downwards as a result of the problems on the financial markets and their potential real impacts (described in more detail in Box 1 *The causes, course and impacts of the current turmoil in global financial markets*). The difference compared to the reference scenario of the July forecast is largest for 2008 H1 and then gradually narrows. The average annual rate is expected to be 4.1% in 2008 and 4.4% in 2009.

Table IV.1
Economic growth in the euro area slowed somewhat
(quarterly averages)

	IV/07	I/08	II/08	III/08	IV/08	I/09	II/09
Brent crude oil prices (USD/barrel)	75.1	74.2	73.3	72.8	72.4	72.0	71.7
ARA petrol prices (USD/t)	659.3	663.0	697.0	683.0	659.1	671.4	728.9
GDP in euro area a)	2.2	2.0	2.4	2.4	2.4	2.2	2.0
Producer prices in euro area a)	2.3	2.4	2.1	1.9	1.8	1.9	2.0
Consumer prices in euro area a)	2.0	1.9	1.8	1.6	1.6	1.7	1.8
USD/EUR exchange rate	1.38	1.38	1.37	1.36	1.35	1.34	1.33
1Y EURIBOR (in per cent)	4.2	4.0	4.0	4.1	4.4	4.6	4.5

a) effective indicator, annual percentage changes

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 October forecast has taken account of this year's public finance developments and partly also the 2006 budget update linked with the autumn notifications, and has slightly lowered the estimate of the 2007 deficit to 3.4% of GDP. The 2008 forecast newly incorporates all the reform measures, which, according to the CNB, will lead to a reduction of the deficit to 2.5% of GDP. However, owing to a partial unwinding of the effects of the fiscal measures, the public finance deficit will increase again in 2009, reaching 3.1% of GDP. The fiscal impulse, which approximates the effect of fiscal policy on demand in the economy, will thus fluctuate quite markedly over the forecast horizon. It will move from being positive this year to negative in 2008 and back to being positive in 2009. The contribution of fiscal policy to economic growth in 2007–2008 will be lower overall than was assumed by the previous forecast. It still holds true that no sizeable additional fiscal stimulus is expected from EU fund inflows over the forecast horizon.

Another factor determining the message of the forecast is an assumption regarding the equilibrium values of key macroeconomic variables, especially real interest rates, the real exchange rate, real wages 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, wages, 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 prediction model.

The October forecast did not revise the perception of the equilibrium paths of real interest rates and the real exchange rate, and essentially retained the July forecast settings. Over the forecast horizon, the one-year domestic real equilibrium rate thus lies at 1% and the equilibrium real 1Y EURIBOR at 2%. The estimated rate of equilibrium real appreciation remains unchanged, gradually declining over the forecast horizon from just above 3% to below it. The estimated rate of growth of the potential, non-accelerating inflation level of output lies between 5.5% and 6% both currently and over the forecast horizon. Equilibrium real wages are rising somewhat slower than the non-accelerating inflation level of output over the forecast horizon.

The model uses real marginal costs to proxy for inflation pressures from the real economy. These costs consist of the costs arising from the increasing volume of production (the "output gap") and wage costs (the "real wage gap"). The estimate of the inflation pressures from the real economy for 2007 Q3 has decreased slightly compared to the July forecast, owing to lower-than-expected adjusted inflation excluding fuels. This has generated an estimate of a less open positive output gap, even though domestic economic growth is almost in line with the previous assumptions and the estimate of the external demand gap has been revised slightly upwards towards its equilibrium level. The real wage gap is in line with the expectations of the previous forecast. Its past anti-inflationary effect has now disappeared and the gap has almost closed.

The still moderately rising inflationary pressures from the volume of production, approximated by the output gap, stem from the high GDP growth, which is outpacing potential output growth. The negative output gap closed in 2005 and has remained positive since then. Household consumption and gross capital formation are significant sources of growth. In 2007 H1, fixed investment rose at a

slower pace than expected, but a large increase in inventories over the same period suggests that gross capital formation will probably continue to grow rapidly.

The pressures from real wages had an opposite, anti-inflationary, effect in the past two years. However, the sharp decline in inflation at the turn of this year combined with the upswing in nominal wage growth generated a rise in real wages, which thus converged to their equilibrium level.

Headline consumer price inflation at the end of 2007 Q3 was only slightly lower than expected by the July forecast. However, some of its components deviated markedly from the forecast. Adjusted inflation excluding fuels recorded a downward deviation from the forecast, while food price inflation recorded an upward deviation. The impacts of changes to indirect taxes and the contributions of the growth in regulated prices and fuel prices were only slightly higher than expected.

The current settings of the real monetary conditions, which affect the future course of the business cycle, are assessed as being roughly neutral overall. The exchange rate component is assessed as being slightly easy, while the interest rate component is slightly tight.

IV.3 THE MESSAGE OF THE FORECAST

The aforementioned information on domestic and external economic developments obtained since the July forecast was drawn up has changed the forecast for the Czech economy. The effect of the real economy – captured by the real marginal cost gap – will remain inflationary in 2007 Q4. During 2008, the inflationary effect of the real economy will weaken quickly, changing to slightly anti-inflationary. The inflationary pressures from the real economy will resume at the end of 2009.

The first component of real marginal costs – the output gap – will in essence determine the evolution of the real marginal cost gap described above. Given the roughly neutral real monetary conditions and broadly neutral external demand over the entire forecast horizon, the output gap will be strongly affected by the volatile effect of fiscal policy on the economy (see Box 4 *Fiscal measures and their impact on the economy in 2008*). Up to the end of 2007 the output gap will open slightly further into positive figures. In 2008, however, it will close quickly and turn slightly negative as a result of fiscal restriction. In 2009, it will return to slightly positive values, again due to fiscal policy. Under these assumptions, real GDP growth will be 6.2% this year. In 2008 GDP growth will decrease to 5.0%, and in 2009 it will edge up again to 5.6%.

Turning to the components of future economic growth, household consumption will play the most important role this year, rising by 6.2%. This high rate of growth will be supported by rapid growth in real wages, growth in employment and growth in social transfers resulting from the legislative changes to family allowances and changes in the social benefit system. Consumption will slacken considerably in 2008. In addition to slowing real wage and employment growth, a tightening of the interest rate component of the monetary conditions and the unwinding of the effect of social transfers from the previous year, consumption will be significantly depressed by the effects of the fiscal measures adopted. Overall, these factors will result in a slowdown in the rate of growth of real consumer spending to 3.6%. Household consumption growth will recover to 4.3% in 2009, thanks mainly to an upswing in real wage growth. Higher growth in the volume of wages and household consumption will be counteracted by a modest decrease in employment.

Chart IV.1
The real economy will have moderately anti-inflationary effects in 2008
(percentages)

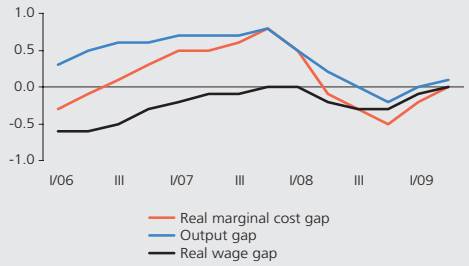


Chart IV.2
GDP growth will slow to 5% next year
(annual percentage changes)

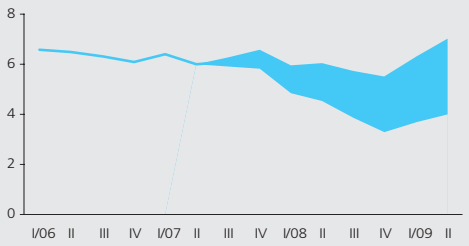


Table IV.2
Household consumption will significantly contribute to economic growth
(annual percentage changes)

	2007	2008	2009
GROSS DOMESTIC PRODUCT	6.2	5.0	5.6
Household consumption	6.2	3.6	4.2
Government consumption	0.6	-0.1	0.7
Gross fixed capital formation	4.9	7.8	8.9
Imports of goods and services	14.0	12.0	10.9
Exports of goods and services	14.0	12.6	11.2
Net exports of goods and services (in CZK bn; at constant prices)	-13.0	3.4	12.7

Investment demand will be the main source of economic growth in 2008 and 2009. Investment activity will be supported over the entire forecast horizon primarily by continuing growth in external demand, foreign direct investment inflows and easy cumulative real monetary conditions. In 2009, higher investment will also be fostered by corporate savings resulting from the tax reform. However, the October forecast lowers the estimate for fixed investment growth in 2007 slightly further, owing to lower fixed capital formation in 2007 H1. Gross fixed capital formation will thus grow by roughly 5% in 2007, but will pick up again to 8% in 2008 and reach 9% in 2009.

The forecast still assumes a growth trend in export performance, connected with FDI inflow and related changes on the supply side of the economy. Owing mainly to a stronger real exchange rate, however, the forecast for real export growth has been lowered slightly for this year and the next. The growth rate will be 14% in 2007 and – owing to a downturn in external demand – 13% in 2008. In 2009, export growth will decline further to 11%. Real import growth will be only slightly lower than real export growth over the forecast horizon. Robust domestic demand growth coupled with a relatively high import intensity of exports will result in annual real import growth of 14% in 2007. Owing to lower domestic demand growth, import growth will slow somewhat to around 12% in 2008 and 11% in 2009.

The second component of the real marginal cost gap – the real wage gap – will have a roughly neutral effect on inflation in the remainder of this year. In 2008, it will temporarily have a downside effect, since rising inflation will cause growth in real wages to lag behind their equilibrium growth rate. In 2009, after an inflation moderation amid inertial nominal wages, the real wage gap will switch back to a neutral to slightly inflationary effect. It will thus bolster the effect of the output gap in individual years. The forecast expects unemployment to decrease further in 2008 and be flat in 2009. The average nominal wage in the business sector will continue to increase at high and rising rates (8.0% in 2007, 8.7% in 2008 and 8.9% in 2009).

In the remainder of 2007, the exchange rate of the koruna against the euro will be close to its current levels. In 2008 and 2009, the forecast assumes a modest nominal appreciation of the koruna. The relatively fast closure of the interest rate differential and the ongoing trend of the koruna's equilibrium real appreciation will foster appreciation of the exchange rate. However, particularly in 2008 the appreciation of the nominal exchange rate will be moderated by higher expected domestic inflation compared to inflation abroad.

The October headline inflation forecast is higher than the July one. This revision reflects above all an increase in the lower VAT rate from 5% to 9%, which will cause a one-off rise in the price level. The forecast assumes a limited pass-through of the VAT rate change and the changes to excise duties and environmental taxes to inflation expectations. Inflation will rise in 2007 Q4 owing to a pick-up in annual growth in regulated prices, food and fuels. There will be a sharp one-off increase in annual inflation in 2008 Q1 as a result of tax changes (in addition to the VAT change these will include a further rise in excise duty on cigarettes and the introduction of environmental taxes) and continued growth in regulated prices excluding tax effects. Inflation growth will also be fostered by rising inflation expectations. The effect of the real economy on inflation will be roughly neutral in 2008. The effect of the tax changes will subside in 2009. This, together with a slightly anti-inflationary real economy, will cause inflation to fall towards the inflation target. At the monetary policy horizon, i.e. in 2008 Q4 and 2009 Q1, headline inflation will initially lie above the upper boundary of the inflation-target tolerance band and then drop slightly below it.

Table IV.3

Wage growth in the business sector will accelerate

(annual percentage changes)

	2007	2008	2009
Real gross disposable income of households	5.7	3.7	3.9
Total employment	1.8	0.8	-0.2
Unemployment rate (in per cent) a)	5.3	4.6	4.7
Labour productivity	4.3	4.2	5.7
Average nominal wage	7.5	7.6	7.8
Average nominal wage in business sector	8.0	8.7	8.9
Current account deficit (ratio to GDP in per cent)	-3.0	-3.0	-2.7
M2	10.8	8.4	6.9

a) ILO methodology

Table IV.4

Adjusted inflation excluding fuels will pick up pace in the coming period

(annual percentage changes; quarterly averages)

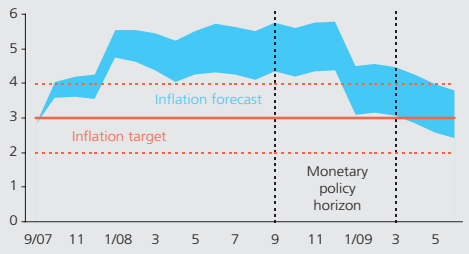
	IV/07	I/08	II/08	III/08	IV/08	I/09	II/09
CONSUMER PRICES	3.9	5.1	4.9	4.9	5.0	3.8	3.3
Regulated prices a)	6.4	9.3	8.7	8.4	7.9	4.8	4.8
First-round impacts of indirect tax changes on consumer prices b)	1.1	2.1	2.1	1.9	1.8	0.6	0.1
Prices of food, beverages, tobacco c)	3.8	2.9	3.1	3.4	3.4	4.0	3.6
Adjusted inflation excl. fuels c)	1.0	1.1	1.2	1.9	2.1	2.3	2.4
Fuel prices c)	4.2	9.9	2.5	1.0	4.5	4.0	3.5
Monetary-policy relevant inflation d)	2.8	2.9	2.7	3.0	3.2	3.2	3.2

a) including changes to indirect taxes
b) contributions in percentage points
c) excluding changes to indirect taxes
d) headline inflation excluding first-round impacts of changes to indirect taxes

Chart IV.3

At the monetary policy horizon the inflation forecast initially lies above the upper boundary of the inflation-target tolerance band and then drops slightly below it

(annual percentage changes in CPI)

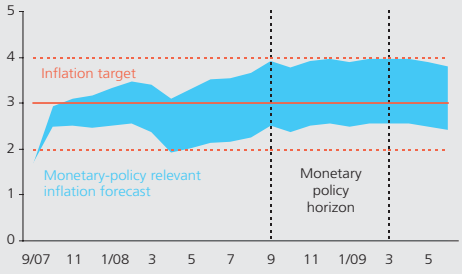


In the coming years, inflation will be significantly affected by changes to indirect taxes. In 2008, the VAT rate will be changed and excise duties and environmental taxes will be harmonised with EU rules. No tax changes are expected in 2009. The average first-round effect of indirect taxes on annual inflation will be 1.2 percentage points at the monetary policy horizon. The mechanism of caveats applies as usual to the first-round effects of changes to indirect taxes. Monetary-policy relevant inflation is thus slightly above the inflation target at the monetary policy horizon.

Consistent with the macroeconomic forecast and its assumptions is growth in nominal interest rates.

No significant risk leading to the creation of a full alternative scenario was identified in the forecasting process. Only a sensitivity analysis was conducted, as usual capturing the uncertainty associated with the exchange rate going forward.

CHART IV.4
Monetary-policy relevant inflation lies slightly above the inflation target at the monetary policy horizon
(annual percentage changes)



BOX 4
Fiscal measures and their impact on the economy in 2008

In line with its July 2007 programme declaration, the government has adopted a number of fiscal measures in order to stabilise public finances, meet the Czech Republic's obligation to speedily correct the excessive government sector deficit in 2008, and gradually reduce its budget deficits in the following years. Most of these measures are included in the Act on the Stabilisation of Public Finances, although some measures were adopted directly by the government under its powers.

The measures on the revenue side of the public budgets consist in transferring the tax burden from direct to indirect taxes. The lower VAT rate will go up from 5% to 9% in 2008, while excise duties on tobacco products will increase to the minimum level arising under harmonisation agreements with the EU. At the same time, new environmental taxes on fuels and energy will be introduced and environmental charges will be increased. By contrast, corporate income tax will be gradually lowered from the current 24% to 21% in 2008 and by a further 1 percentage point in both 2009 and 2010. As for personal income tax, the progressive taxation system (with rates ranging from 12% to 32%) will be replaced by a flat tax on the so-called "super-gross wage", with a single rate of 15% in 2008 which will be reduced to 12.5% in 2009. Some property taxes will also be abolished. In the case of real estate tax, municipalities will be free to set coefficients or exempt agricultural land. The measures on the expenditure side include cuts in state social benefits, most notably reductions in birth and family allowances and child benefits, and the complete abolition of some allowances (the funeral allowance). Sickness benefits will be also reduced as a result of parametric changes. Falling expenditure will be also fostered by a cap on nominal wage growth in selected segments of the public sector to 1.5% a year (in 2008–2010) and the postponement of the effect of the Health Insurance Act.

Overall, the above fiscal measures should reduce the public finance deficit by 1 percentage point of GDP in 2008. This fiscal policy tightening will reduce GDP growth by about 0.5 percentage point next year, mainly by depressing demand in the household sector. The overall impact of the flat tax and social reform will be a slight increase in the nominal income of households, which

may positively affect their consumption, but this impact will be partly offset by a higher saving rate among higher-income households. Conversely, the introduction of payments for health care (visiting the doctor, staying in hospital, prescriptions) and the environmental tax on energy will foster higher growth in household expenditure. In real terms, household consumption will be negatively affected by the increases in the lower VAT rate and the excise duty on tobacco products and by the introduction of environmental taxes. The overall impact on real household consumption growth will thus be negative and can be estimated at around 0.7 percentage point.

IV.4 EXPECTATIONS OF ECONOMIC AGENTS

The CNB monitors the inflation expectations of the financial market and corporations at the one-year and three-year horizons by means of statistical surveys. In addition, it uses a qualitative assessment of past and future inflation by households collected as part of the European Commission Business and Consumer Survey (see Box 2 in the July 2007 Inflation Report).

Future inflation expected by financial market participants at the one-year horizon rose quite significantly. This was mainly because the figures reflected the impacts of the fiscal reform (an increase in the lower VAT rate, higher excise duty on cigarettes). The main inflationary factors are also expected to include demand-pull inflation pressures (wage growth, household consumption). Conversely, the appreciating koruna is expected to have an anti-inflationary effect. The inflation expectations of corporations also rose above the CNB's 3% inflation target. At the three-year horizon, the inflation expectations of both the financial market and corporations are also above the new 2% inflation target valid as from January 2010.

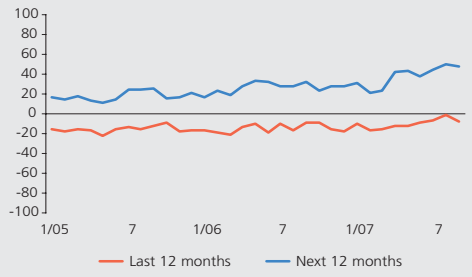
The indicator of perceived inflation remained negative, which means that households on average feel that prices did not rise over the last 12 months. By contrast, the indicator of expected inflation is positive, i.e. the number of respondents who expect prices to increase more rapidly over the next 12 months than in the past exceeded the number of those who expect prices to stay the same. Moreover, this indicator increased in Q3.

In Q3, the interest rates expected by financial analysts increased at all the monitored maturities. The interest rate path consistent with the aforementioned CNB forecast was slightly above the expectations of financial market analysts for the near future. At the longer horizon, it was higher.

Table IV.5
Inflation expectations fluctuated above the CNB's target
(percentages)

	9/06	6/07	7/07	8/07	9/07
CONSUMER PRICES					
1Y horizon:					
Financial market	3.2	3.2	3.1	3.6	4.2
Corporations	3.0	3.0			3.6
3Y horizon:					
Financial market	2.7	2.5	2.5	2.5	2.5
Corporations	3.2	2.9			3.4
1Y PRIBOR					
1Y horizon:					
Financial market	3.2	3.8	3.9	4.0	4.1

Chart IV.5
The indicator of expected inflation increased in 2007 Q3



Source: European Commission Business and Consumer Survey

THE CZECH REPUBLIC'S UPDATED EURO-AREA ACCESSION STRATEGY

(Joint Document of the Czech Government and the Czech National Bank)

Introduction

1. The Czech Republic has participated in the third stage of economic and monetary union (EMU) since its accession to the European Union (EU), when it acquired the status of a Member State with a derogation regarding the adoption of the euro. Consequently, it is not yet a member of the euro area, but has committed itself to introducing the euro and joining the euro area in the future. It is, therefore, vital to have in place a euro adoption strategy serving as a basis for each particular economic policy.

2. Accordingly, the Government approved *The Czech Republic's Euro-area Accession Strategy* in 2003, a document drawn up in cooperation with the Czech National Bank (CNB). As the original Strategy has not been fulfilled, the Government of the Czech Republic and the CNB are presenting an update of the document. This update takes into account domestic and external developments since the original text was approved. Like the original document, it presents the joint and coordinated approach of the Government of the Czech Republic and the CNB to the future adoption of the euro.

Assessment of the Czech Republic's 2003 Euro-area Accession Strategy and past fulfilment of the convergence criteria

3. The Czech Republic's 2003 Euro-area Accession Strategy (hereinafter the "Strategy") summarised the starting points of the nation's integration into the euro area and discussed the expected benefits and risks. The document recommended that the Czech Republic join the euro area *"... as soon as economic conditions allow for doing so"*. The timing of entry depended on the speed of real and nominal convergence of the Czech economy to the euro area economies. Provided that the Maastricht criteria were fulfilled (including a successful consolidation of public finances), a sufficient level of real convergence was achieved and adequate progress was made with structural reforms guaranteeing sufficient economic alignment with the euro area countries, the document expected the Czech Republic to join the euro area around 2009–2010.

4. The Strategy also defined the conditions of entry and the approximate length of stay in ERM II, subject to fulfilment of the exchange rate convergence criterion in the Czech economy.[33] The Strategy stated that the Czech Republic would stay in ERM II for the minimum possible period.[34] It would enter ERM II only after conditions had been established enabling it to adopt the single currency and then benefit from its introduction without experiencing any problems, i.e. only after progress had been achieved in preparing and implementing reforms of public finances and after other reforms had been adopted to increase the flexibility of the Czech economy, and especially the

33 The exchange rate convergence criterion requires participation in ERM II for at least two years without devaluation of the central rate.

34 The idea of the Czech Republic staying in ERM II for the minimum required period was adopted by the CNB and published as early as July 2003 in a document entitled *ERM II and the Exchange-rate Convergence Criterion*.

labour market. Such reforms were vital not only because of the adoption of the euro, but also for their own sake, as they were a precondition for the further sound development of the Czech economy.

5. In the Strategy, the Government and the CNB committed themselves to annually assessing the preparedness of the Czech Republic for euro-area accession, with reference to the current and expected fulfilment of the Maastricht convergence criteria and economic alignment with the euro area. The assessment would result in a recommendation to the Government on whether to initiate the procedure that will take the koruna into ERM II in the year following the assessment. All three assessments conducted since the approval of the Strategy have resulted in a recommendation for the Government not to attempt to enter ERM II the following year. The negative recommendation contained in the most recent assessment, conducted in October 2006, means that the Czech Republic's future accession to the euro area has been postponed beyond the horizon of 2009–2010 envisaged in the original Strategy.

6. The excessive deficit procedure was opened against the Czech Republic on its accession to the EU, owing to its high public budget deficits. This was aimed at reducing the public finance deficit in a sustainable and credible manner below 3% of GDP before 2008. The plan for a gradual reduction in the deficit was endorsed by the EU authorities on the basis of the Convergence Programme submitted by the Government in May 2004. The plan was built on the fiscal targets of the public finance reform approved by the Government in 2003.

7. This fiscal reform, or consolidation programme, was based on cutting public expenditure and modestly increasing the overall tax quota. This was complemented by a change to the institutional setup introducing medium-term fiscal targeting anchored by medium-term spending frameworks. The reform successfully started a restructuring of the revenue side of public budgets. However, the original aims on the expenditure side were abandoned and the measures taken had only a short-term impact. Moreover, the new medium-term expenditure ceilings have been exceeded several times since 2005. The additional income stemming from rapid economic growth was used to increase expenditure rather than to reduce the deficit. The Government thus failed to take advantage of the rapid economic growth to consolidate expenditure in a sustainable manner. Nevertheless, thanks to the good economic situation and to overestimation of the spending plans of individual ministries (manifesting itself in transfers to reserve funds), the original – albeit none-too-ambitious – deficit reduction strategy was fulfilled.

8. However, this trend was interrupted in 2007 owing to a large increase in social expenditure resulting from the 2006 pre-election measures, leading to procyclical fiscal policy. The 2007 consolidation programme's original target of 3.3% of GDP is thus not likely to be met and the Czech Republic is thus unable to end the excessive deficit procedure within the stipulated deadline. The existence of the excessive deficit procedure creates a legal impediment to entry into the euro area, as it implies non-fulfilment of the fiscal convergence criterion. Moreover, the current state of public finances is hampering their stabilising effect over the economic cycle.

9. Unlike the criterion on the general government position, the Czech Republic is compliant with the Maastricht criterion on government debt. Although the government debt recorded significant growth up until 2003, its ratio to GDP was only 30.1% in 2006, as compared to the reference value of 60%, thanks to its relatively low starting level. It has stabilised roughly at this level since then and is not expected to rise substantially in the near future. Fulfilment of the

criterion should thus not be in jeopardy at the expected euro adoption horizon. From the long-term perspective, though, significant upward pressure might be exerted on the government debt if fundamental reforms of the pension and health care systems fail to be delivered.

10. The Czech Republic has been compliant with the Maastricht price stability criterion in recent years. Domestic inflation has long been low, reflecting among other things the successful anchoring of inflation expectations by CNB monetary policy. However, the current outlook for inflation suggests that the reference value for the price stability criterion is likely to be exceeded in 2007 and 2008, mainly because of changes to indirect taxes. Once this one-off shock arising from administrative measures has unwound, inflation will return to lower levels.

11. The Czech Republic has also long been compliant with the criterion on long-term interest rates. Since 2006, domestic long-term interest rates have even been below those in the euro area countries. This mainly reflects the long-standing low-inflation environment in the Czech economy. The long-term interest rate criterion should be fulfilled in the future with no problem, provided that the Czech Republic succeeds in fulfilling the other convergence criteria.

12. Since the adoption of the Strategy, the Czech Republic has continued to apply a floating exchange rate under a monetary policy regime of inflation targeting. Under this regime, the koruna exchange rate is determined by market supply and demand and the CNB intervenes on the foreign exchange market only in exceptional situations.[35] The exchange rate has continued to show a gradual nominal appreciation tendency since the Strategy was adopted. The previous process of catching-up with the price level of the advanced EU countries through the exchange rate and inflation channels has created conditions for balanced fulfilment of the convergence criteria for inflation and interest rates.

13. The stabilisation of inflation at a low level amid low interest rates and strong economic growth can thus be considered positive in terms of fulfilling the Strategy, as can the increasing openness and competitiveness of the Czech economy. By contrast, the evolution of public finances and the lack of reforms aimed at delivering balanced public sector accounts in the long run and making the Czech economy, and especially the labour market, more flexible, can be viewed as unfavourable. This is reflected in failure to fulfil the original ambitions of the Strategy regarding the date of adoption of the euro in the Czech Republic.

14. The original time frame for introducing the euro around 2009–2010 required that attention be given to the practical preparations for the changeover. In November 2005, the Government of the Czech Republic established the office of National Coordinator of the Introduction of the Euro. Subsequently, a National Coordination Group for the Introduction of the Euro was set up. This body prepared a draft scenario for a single-step transition to the euro (approved by the Government in October 2006) and a National Euro Changeover Plan for the Czech Republic (approved by the Government in April 2007). The National Plan covers the technical, organisational, legal and communication aspects of the preparedness of the Czech economy for the introduction and use of the euro for businesses, the public and the state administration.

35 The CNB has never intervened in the foreign exchange market since the adoption of the Strategy.

15. At this stage, the actions of the National Plan are structured independently of the specific changeover date and are thus conceived as a set of tasks to be implemented within a specific time limit before **€**-day (the euro adoption date). The tasks, arranged in terms of time sequence, show that it is necessary to allow at least three years for the technical preparations from the logistical perspective. These preparations thus need to start virtually as soon as the decision is made to join ERM II. The costs associated with the changeover will not be covered from the public funds and will be borne by each private entity itself. For that reason, the target date must be set in such a way that it is sufficiently credible and gives all those involved the chance to plan their expenses efficiently.

Developments in the EU since the Strategy was adopted

16. The introduction of the euro in 1999 was connected with expectations of strong pro-growth impulses, although these were conditional on the implementation of structural reforms. However, many euro area countries failed to make sufficient efforts to implement the necessary reforms. This, coupled with an adverse phase of the business cycle, led to a slowdown in euro area economic growth. The economic stagnation in the euro area chiefly reflected problems in its main national economies, as some smaller countries achieved favourable economic results even in this environment. At present, the euro area is in an upward phase of the business cycle, which is also being reflected in a marked increase in job creation. The experience with the adjustment mechanisms under the single monetary policy thus shows that the economic success of the euro area countries depends primarily on their domestic economic policies. In order for the euro area to operate successfully, these policies should focus on enhancing market flexibility and efficiency. This is an important message for Czech economic policy.

17. The euro has been reinforcing its position as a credible global currency. It has gradually appreciated in recent years following an initial depreciation linked with uncertainty regarding the efficiency of the institutional setup in the euro area and rapid economic growth in the United States. In addition to economic factors, the ongoing appreciation of the euro against the dollar is underpinned by rising confidence in the ECB, the euro and the potential of the euro area economy. Owing to EU enlargement and the growing credibility of the euro, the share of the euro in the foreign trade transactions of many countries and in the international reserves of many central banks is increasing.

18. A revision of the Stability and Growth Pact was approved in 2005, setting different medium-term budgetary objectives for individual countries and putting an emphasis on fiscal consolidation in good times. The Czech Republic set itself this objective as a public budget deficit of 1% of GDP, to be achieved in 2012 according to the Convergence Programme. Most of the EU Member States, which have faced widening fiscal imbalances in recent years, have adopted a series of measures leading to a gradual improvement in their public budgets. Of the new EU Member States, only the Czech Republic and Hungary expect their fiscal development to fall short of their obligations under the Stability and Growth Pact in the near future.

19. The approaches of the new EU Members States, which have not adopted the euro so far but are obliged to do so in the future, remain mixed. Seven out of the ten new Member States that joined the EU on 1 May 2004 opted for a strategy of adopting the euro as soon as possible (Latvia, Lithuania, Estonia, Malta, Cyprus, Slovakia and Slovenia). Consequently, these countries (including Slovenia, which joined the euro area in 2007) joined ERM II as early as 2004 and

2005. However, Lithuania, Latvia and Estonia were forced to delay their plans for euro area entry and have not set new official dates so far. Malta and Cyprus are planning to adopt the euro at the beginning of 2008 and have already received the approval of European institutions. Slovakia is intending to join the euro area at the beginning of 2009. Like the Czech Republic, Hungary and Poland opted to participate in ERM II only for the shortest period necessary to fulfil the exchange rate criterion and make technical preparations for the euro. As in the case of the Czech Republic, the entry of these two countries into ERM II will depend on their expected euro adoption date. However, neither country has set such a date so far. Poland and Hungary are not expected to adopt the euro until 2012 and 2014 respectively. Bulgaria and Romania, which joined the EU in the most recent wave of enlargement, have relatively ambitious plans regarding euro area entry. Bulgaria intends to enter ERM II as soon as possible, and Romania has set 2014 as its target date for euro adoption.

20. Slovenia's changeover to the euro in January 2007 went smoothly from the technical point of view. Slovenia also experienced a temporary rise in perceived inflation, which deviated from actually measured inflation, but this deviation was smaller in scale than that recorded during the cash changeover in the countries of the "first wave". According to preliminary analyses, the transition to euro cash in Slovenia can be assessed as a successful policy, based on active and thorough preparation from the technical and organisational points of view.

21. By contrast, the "old" Member States standing outside the euro area – Denmark and the United Kingdom, which have an opt-out clause, and Sweden, which rejected the euro in a referendum – are not planning to adopt the euro any time soon and are insisting that the euro must be approved in a referendum (and – in the UK – also by the government and parliament). Nevertheless, Denmark has participated in ERM II since 1999, maintaining a fluctuation band of ±2.25% around the central rate on a voluntary basis without experiencing any significant problems.

22. Lithuania's application to join the euro area, submitted in 2006, was turned down owing to its narrow failure to meet the inflation criterion and its adverse outlook for inflation. This example shows that the European authorities (the European Commission, Ecofin and the ECB) apply a strict interpretation of the Maastricht convergence criteria and the other conditions for euro adoption when assessing applicant countries. Besides the strictly legal viewpoint, this interpretation places an emphasis on sustainable fulfilment of the economic criteria after euro adoption.

The ability of the Czech economy to operate in the euro area

23. To benefit from the introduction of the euro, the Czech economy must show a high degree of economic convergence, integration and alignment with the euro area. After the loss of independent monetary policy, flexibility and the ability to adjust quickly to economic shocks will be crucial for maintaining the good performance of the Czech economy. This was already pointed out in the 2003 Strategy. While some of these required features of the Czech economy have been in place for a long time, a need for further improvement is clearly visible in other areas.

24. The factors supporting the introduction of the euro include the high and increasing openness of the Czech economy and its close trade links with the euro area. The euro area accounts for 60% of Czech exports and 50% of Czech imports, while the EU as a whole accounts for more than 85% of Czech exports

and 70% of Czech imports. The Czech economy is also characterised by high direct investment inflows from the euro area. The Czech economy's strong economic integration with the euro area creates preconditions for increased cyclical alignment with this area.

25. The Czech financial sector remains considerably smaller in relation to GDP than the euro area average, but the two sectors are now relatively similar in terms of structure. In the Czech Republic, the ratio of loans to GDP has been rising recently as a result of strong growth in loans to households and corporations. Loan portfolio quality and profitability in the banking sector have increased in recent years. Capital adequacy is falling slightly but remains sufficient for now. The Czech banking sector is currently stable and resilient to external shocks, although this resilience has not yet been tested by adverse economic conditions.

26. Another important step forward by comparison with 2003 is the significant convergence of the Czech Republic's economic level towards the euro area average. GDP per capita at purchasing power parity remains higher in the Czech Republic than in most new EU Member States, slightly exceeding 70% of the euro area average in 2006. The economic level of the Czech Republic can be expected to rise further in the coming years, thereby reducing the difference from the euro area average. The higher degree of real convergence is fostering convergence of the price level, thus reducing the future pressures for equilibrium appreciation of the real exchange rate, which would result in an inflation differential against the euro area average after euro adoption and thereby lower domestic real interest rates.

27. Despite the observed convergence, the difference in the price level compared to the euro area remains relatively sizeable. In 2005, the Czech price level was roughly 56% of the euro area average and 58% of the EU average. Hourly labour costs were about 27% of the euro area average and 31% of the EU average. The process of real convergence and the growth in the relative price and wage levels are likely to continue.

28. As regards aggregate economic activity, a significant difference can still be seen between the business cycle in the Czech Republic and that in the euro area, with no significant alignment taking place. Alignment with the euro area also remains low as regards macroeconomic shocks on the demand and supply sides. The difference in the evolution of the two economies in recent years has been due partly to the pick-up in economic growth in the Czech Republic, which chiefly reflects changes on the supply side of the economy.

29. From the structural point of view, the Czech economy also still differs from the euro area average in having a higher share of industry, which has continued to grow moderately in recent years, and a smaller share of services in GDP. However, a relatively high degree of cyclical alignment can be observed for industrial activity.

30. The current state of public finances in the Czech Republic still greatly limits the room for their macroeconomic stabilising effect. Although the public budget deficits have decreased since 2003, they have remained relatively high despite the rapid economic growth, and the outlook for the near future is rather unfavourable. The deficits are largely structural in nature, reducing the scope for the functioning of automatic stabilisers and, in the extreme case, for the implementation of discretionary measures during economic downturns.

31. The employment rate is rising and total unemployment is falling, chiefly as a consequence of the buoyant economic growth in 2005 and 2006. These

indicators are better than both the EU and euro area averages. However, relatively high long-term and structural unemployment remains a serious problem. To a large extent, the growing demand for labour is thus being satisfied due only to a rising number of foreigners. This flexible feature of the Czech labour market is only partly compensating for its overall rigidity. The mobility of the domestic labour force is generally low and the full liberalisation of labour movement between the Czech Republic and all the old EU Member States in 2011 can be expected to generate only a partial improvement in this area. The rather low flexibility of real wages is also a problem; no significant changes have taken place in this area recently. The overall ability of the Czech labour market to absorb shocks thus remains limited and efforts must be made to enhance it.

32. As regards the institutional setup of the labour market, some favourable and unfavourable changes have occurred since the Strategy was prepared. Increases in the minimum wage have led to a rise in its share in the average wage in recent years. On the one hand, this is reducing the demand for people with low skills. On the other hand, together with certain other factors, especially a tightening of the conditions for claiming benefits, it has resulted in a moderate positive shift in the motivation of the unemployed to seek work since 2005. However, insufficient alignment of the tax and benefit systems remains a serious structural problem. There is a relatively large number of inactive persons who are insufficiently motivated to accept low-paid work. As regards labour law, the conditions for temporary and secondary employment have been tightened somewhat and the conditions for fixed-term employment contracts have been relaxed slightly since 2003. However, the institutional rules are still failing to create good conditions for the employment of people with low skills and for the entry of young people onto the labour market. There has been a partial improvement in the regulatory environment for doing business, but by international comparison it remains hampered by major administrative obstacles.

Economic policy challenges and euro adoption prospects in the Czech Republic

33. The economic policy priority associated with the adoption of the euro in the Czech Republic is fulfilment of the Maastricht criteria. In this area, fiscal policy and the state of public finances are absolutely key areas where fundamental measures need to be taken towards sustainable fulfilment of the convergence criteria. The excessive deficit procedure needs to be ended without delay so that the Czech Republic can restore its credibility as soon as possible and prove that the consolidation process under way is capable of keeping the public finance deficit below 3% of GDP. Conditions for achieving this objective must be created in the state budget for 2008.

34. In this context, the Government and the CNB are aware of the need for further fiscal reforms going beyond those previously approved by the Government for the first phase of fiscal consolidation. That phase represents merely the first step towards sustainable public finances. There is a need to implement further and much deeper changes, especially on the expenditure side of the public budgets. Those changes must reflect the challenges arising in particular from demographic changes (reform of the pension and health care systems), from growth in social benefit expenditure and from the generally high proportion of legally prescribed (mandatory) expenditures.

35. However, fulfilment of the Maastricht fiscal criteria should in no way be regarded as a sufficiently ambitious goal for the fiscal reforms in the medium

term. The only sufficiently ambitious goal is to provably target the public finance deficit – at a rate of at least 0.5% of GDP a year – well below the value of the Maastricht convergence criterion towards fulfilment of the obligation arising under the revised Stability and Growth Pact. In the Czech Republic's case, this means heading in the medium term towards a structural (cyclically adjusted) public budget deficit of no more than 1% of GDP. Only in this situation will it be possible to consider state fiscal policy as sufficiently able to effectively perform its macroeconomic stabilising role following the loss of independent monetary policy.

36. In the monetary policy area, the preconditions for achieving the relevant Maastricht convergence criteria have largely been put in place. In March 2007, the CNB announced a new inflation target of 2% for annual CPI inflation (with a tolerance band of ± 1 percentage point), effective from January 2010. At the same time, it announced that it would allow inflation to descend gradually to the new inflation target far enough in advance so that inflation is close to the target by the date it takes effect. The lowering of the inflation target primarily reflected the longer-term perspective for the operation of the inflation targeting regime in the Czech Republic due to the postponement of the euro adoption date beyond the originally envisaged horizon of 2010 and the currently low inflation in the Czech economy, manifesting itself in inflation expectations anchored at low levels. The new inflation target is simultaneously consistent with the practice of advanced countries and its level corresponds to the rate of inflation that the ECB views as the threshold with regard to the maintenance of price stability. Lower inflation in the Czech Republic in line with the new target furthermore increases the chances of satisfying the Maastricht price stability criterion in the future and will be accompanied in the long run by lower nominal interest rates, thereby also increasing the probability of future fulfilment of the interest rate criteria while not endangering the fulfilment of the exchange rate criteria.

37. The CNB will continue to apply ex ante exemptions to the impacts of changes to indirect taxes, i.e. it will focus its monetary policy decision-making on hitting the target for inflation adjusted for the first-round effects of such tax changes (referred to as "monetary policy-relevant inflation"). However, during the ERM II participation period, which is simultaneously the reference period for the price stability criterion, this system of escape clauses should preferably be no longer necessary and headline inflation ought to gradually merge with monetary policy-relevant inflation. This will be the case only if no major changes are made to indirect taxes during this period. In the event of major tax changes, the CNB would not be able to ensure fulfilment of the price stability criterion by means of monetary policy.

38. Increasing the flexibility of the Czech economy remains another challenge for economic policy and for the future sustainability of the benefits of adopting the euro in the Czech Republic. Some degree of difference in the structural and cyclical properties of the economy will persist even after the single European currency is adopted. Given the non-existence of independent interest-rate and exchange-rate policy instruments, the effectiveness of the economy's internal adjustment mechanisms will thus play a key role in mitigating asymmetric shocks. In addition to the insufficient stabilising role of public finances, the Czech economy's main bottleneck in this area is its still limited ability to adjust flexibly in the labour market and partially also in the product market.

39. As in numerous euro area countries, the Czech labour market suffers from insufficient flexibility, reflecting strict employment protection regulations, a rising minimum wage and high labour taxation. Its insufficiently aligned tax and benefit system creates a demotivating environment, especially for the long-

term unemployed in low-income families with children. A high ratio of social benefits to incomes in low-income households is also having a negative impact on the stabilising ability of fiscal policy. Enhancing the flexibility of the labour market by increasing the mobility of the Czech labour force also remains a challenge.

40. The entrepreneurial environment in the Czech Republic is still being hampered by administrative obstacles, which are high by international comparison. The main problems are the high administrative costs of starting up a business and generally complicated regulatory and bureaucratic processes, which are reducing the competitive pressures on product markets and in the long run adversely affecting job creation and employment. The flexibility of the economy is also being compromised by deficiencies in the legislation and the long time it takes to resolve legal disputes. These reservations, although they affect the introduction of the euro, also relate generally to the Czech Republic's activities in the EU and the international community as a whole.

41. ERM II entry is still viewed as only a necessary condition for adoption of the euro, hence the Czech Republic's stay in ERM II should be kept to the minimum required length of time. In line with the previous Strategy, the decision to join this system must be based on an assessment of the outlook for the fulfilment of the Maastricht criteria as well as an assessment of the degree of economic alignment with the euro area. To retain the option of deciding flexibly on the adoption of the euro, it would be appropriate to continue conducting these evaluations at yearly intervals using the existing analytical tools.

42. However, given the interrelated nature of the factors affecting the Czech economy's ability to operate in the environment of the single European currency, and given the other restrictions of the assessment criteria, it is impossible to identify specific "sufficient" values or to draw up an overall indicator of economic preparedness for adopting the euro. Naturally, such a measure would not be very credible and might overlook certain important economic factors. The assessment of economic alignment should therefore focus on analysing developments in areas that pose risks – as discussed here – to the smooth running of the economy after the euro changeover and in the context of overall economic developments.

43. As the Czech Republic's decision to join ERM II should be made approximately three years ahead of euro area entry, it will be necessary to start making technical, institutional and organisational provision for the euro changeover at roughly the same time, in line with the approved National Changeover Plan.

44. Based on an overall assessment of the Czech economy's ability to operate in the euro area, one can say that some of the preconditions for benefiting from the adoption of the single currency have already been met, but others, by contrast, have yet to achieve satisfactory parameters. The main obstacle to the fulfilment of the Maastricht criteria remains the unconsolidated state of public finances. This, coupled with the low flexibility of the economy, and especially the labour market, simultaneously presents a risk to the operation of the Czech economy in the euro area and prevents it from reaping the benefits associated with adopting the euro.

The euro adoption date will therefore depend on resolving these problem areas in a fundamental reform of public finances and on enhancing the flexibility of the Czech economy. The Government therefore sets itself the task of making maximum reform efforts to remove these obstacles by the end of its term of office.

MINUTES OF THE BOARD MEETING ON 30 AUGUST 2007

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

The meeting opened with a presentation of the August situation report, which focused on summarising the newly available information and on assessing the risks of the July macroeconomic forecast.

At 2.3% in July, annual consumer price inflation had been 0.2 percentage points lower than forecasted. This deviation had been due mainly to lower-than-expected adjusted inflation excluding fuels. The approval of the public finance reform was new information. This would affect inflation primarily by increasing the contribution of growth in indirect taxes. However, monetary policy does not react to the first-round impacts of these taxes. New information from the external environment included a lower outlook for foreign interest rates, linked with the recent turbulence on the U.S. mortgage market. On the labour market, nominal wage growth in the second quarter had been slightly lower than expected.

After the presentation of the situation report, the Board discussed the risks of the July forecast, which predicted a further rise in interest rates. The members agreed that the aforementioned turbulence in global financial markets was not yet significant for the Czech economy and the monetary policy settings. In this context, there was also discussion of the exchange rate, which had appreciated quite considerably over the past month. It was also said that this appreciation could not easily be explained by fundamentals. Mention was made of its link with the liquidation of carry trades in which the Czech koruna had been the financing currency. Some of the members viewed the appreciation of the koruna and the heightened uncertainty regarding its future evolution as a significant downside risk to inflation. Against this, however, it was said that the movement of the exchange rate had brought the economy closer to the sensitivity scenario of the July forecast (i.e. the stronger exchange rate scenario) and that growth in interest rates was consistent with this scenario as well.

The Board then discussed the deviation of adjusted inflation excluding fuels from the forecast. Some of the members argued that this deviation did not confirm the inflationary effect of the interest rate component of the monetary conditions as considered in the forecast. This deviation was meanwhile the biggest in two years, despite only a month having passed since the July forecast. Against this, it was argued that this deviation was largely due to the materialisation of risks associated with changes to the consumer basket. The possibility of seasonality shifts linked with the change in the basket at least partially offsetting this deviation in the future could not be ruled out. Alternative price indices were not suggesting diminishing inflation pressures. In addition, faster-than-forecasted growth in food prices could be expected.

The Board spent quite some time discussing the impacts of the recently approved reform of public finances. It was said that the aggregate impact of the reform on economic growth via a negative fiscal impulse would be relatively small. Some of the members argued, however, that there might be structural impacts linked with redistributions between the household and corporate sectors and between individual household income groups. These might lead to asymmetric impacts on household consumption and company investment, with a possible relative decrease in household demand. Mention was also made of the associated problem of the pass-through of the changes to indirect taxes. It was said that while the first-round impacts of the changes to indirect taxes on prices could be sizeable, the second-round effects would be relatively weak. Nonetheless, the first-round impacts of the tax changes would imply only a one-off increase in the price level, not an increase in long-run inflation, and were therefore irrelevant from the monetary policy perspective, since monetary policy reacts only to the second-round effects of tax changes.

Some of the members also highlighted the anti-inflationary deviation in nominal wage growth from the forecast. Against this, however, the prevailing view was that the new labour market data confirmed the forecast assumptions of an upswing in wage growth and nominal unit wage cost growth. Other labour market indicators, such as employment growth, were conversely fostering faster wage growth. The growing labour demand and limited labour supply might signify the emergence of bottlenecks in the economy. These bottlenecks may already be apparent in the construction industry, for example.

At the close of the meeting the Board decided by a majority vote to increase the CNB two-week repo rate by 0.25 percentage point to 3.25%, effective 31 August 2007. At the same time it decided to increase the discount rate and Lombard rate by the same amount, to 2.25% and 4.25% respectively. Four members voted in favour of this decision, and three members voted for leaving rates unchanged.

MINUTES OF THE BOARD MEETING ON 27 SEPTEMBER 2007

Present at the meeting:
Z. Tůma (Governor), L. Niedermayer (Vice-Governor), M. Singer (Vice-Governor), M. Hampl (Chief Executive Director), R. Holman (Chief Executive Director), V. Tomšík (Chief Executive Director)

The meeting opened with a presentation of the September situation report analysing the new statistical data and assessing the risks of the July macroeconomic forecast. According to the situation report, the changes to VAT, the rise in excise duties and the changes to regulated prices would all be more inflationary than forecasted. Another upside risk to inflation was faster-than-expected growth in food prices. A downside risk, by contrast, was August inflation, which at 2.4% in annual terms had come in 0.2 percentage point lower than forecasted, mainly due to adjusted inflation excluding fuels. Other downside risks included the stronger exchange rate and the interest rate developments abroad. According to the situation report, the overall balance of risks to headline inflation was on the upside, although the risks to monetary-policy relevant inflation[1)] were conversely assessed as being on the downside.

After the presentation of the situation report, the Board discussed the newly available information and the balance of risks of the current forecast. The Board agreed that the balance of risks to monetary-policy relevant inflation was tilted towards the downside. The prevailing view, however, was that information going beyond the assumptions of the July forecast had also emerged since the forecast was created. The turmoil on global financial markets and the approval of the fiscal reform were identified as events raising the uncertainty of the decision-making process above its usual level. Nonetheless, the majority view among those present was that the outlook for the economy expressed in the forecast remained valid.

In a discussion about the fiscal policy changes, the opinion was expressed that the implementation of the tax reform might further spur corporate and private investment. This should lead to an increase in the rate of gross fixed capital formation above the level assumed by the current forecast. Against this, it was said that the reduction in the budget deficit would probably mean a fall in expenditure and hence a decrease in government consumption.

In the context of the turmoil on the financial markets, the Board agreed that lower growth abroad and, as a result, weaker external demand could be expected by comparison with the forecast assumptions. The opinion was expressed that the change in the shape of the yield curve might also reflect a revision of the economic growth outlook. Against this, however, the view was expressed that on this occasion the fall in yields might not necessarily signal a significant cooling, since the yield curves were being affected by short-term factors. Besides, the fall in yields was also a result of central banks' efforts to avert an economic slowdown. Regarding the influence of the potential slowdown abroad on the Czech economy, it was emphasised that unlike in the past the domestic growth was based to a large extent on domestic demand, so any negative external shock could be comfortably accommodated.

The Board discussed the current evolution of the exchange rate and agreed that its present level was strongly anti-inflationary compared to the forecast. The Board also examined the factors possibly underlying the fairly fast appreciation of the koruna. There was broad agreement that one factor was rapid closure of positions using the Czech koruna as the financing currency. It was also said that in the context of an appreciating koruna the fall in short-term interest rates in the EMU should not be overestimated, as a negative interest rate differential could be expected in the short run, and that clearly would not stimulate capital inflows. Against this, the opinion was expressed that in particular the most recent increase in domestic interest rates might have encouraged the appreciation of the exchange rate, and also that the outlook for a possible rate cut by the ECB was important in this context.

1 For more information, see also the texts defining the CNB's inflation targets as from 2006 and 2010, which can be found on its website www.cnb.cz.

A key item of the discussion was the labour market. The view was repeatedly expressed that there were bottlenecks in this market and that the situation there was generally strained. The labour market was regarded as one of the major sources of inflation pressures. Nonetheless, the view was also presented that the reform measures tightening the conditions for providing unemployment benefit as well as the opening up of the market to foreign workers would increase the supply of labour and counter demands for excessive pay rises. As regards nominal unit wage costs, the opinion was expressed that their 2.8% growth was consistent with the inflation target, hence wage costs were not necessarily a direct upside factor for inflation at present. Against this, however, it was said that the current neutral effect of unit wage costs was different from the past situation, when wage costs had been strongly anti-inflationary.

The Board focused in detail on the current inflation situation. It discussed adjusted inflation excluding fuels, which was still fairly low; the forecast, however, expected rising inflation pressures from the real economy. The slowdown in producer price inflation was noted; in the discussion it was said that this may be due to competition and adequate technology, allowing firms to absorb cost pressures. However, it was also pointed out that agricultural producer prices were conversely rising surprisingly fast.

The interpretation of the difference between predicted and actual adjusted inflation excluding fuels in July and August was discussed. A possible technical reason for this difference was a change in seasonality due to the newly defined consumer basket, specifically the changes in representatives and the method used to monitor prices of foreign package holidays. Nonetheless, it was said repeatedly in the discussion that there might also be economic reasons for the lower inflation, in particular greater competition from foreign travel agencies.

At the close of the meeting, the Board decided unanimously to leave the two-week repo rate unchanged at 3.25%.

MINUTES OF THE BOARD MEETING ON 25 OCTOBER 2007

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

The meeting opened with a presentation of the October situation report and the new macroeconomic forecast. The forecast had responded to the changes in the global environment, in particular the significant fall in the one-year EURIBOR interest rate path resulting from the financial market turmoil, the uncertainty regarding its impact on real economic activity and the resulting monetary policy response. The outlook for consumer price inflation in the euro area was unchanged compared to the July forecast. The expected effect of external demand on the domestic economy was assessed as slightly anti-inflationary.

As for the starting conditions in the domestic economy, the anti-inflationary effect of real wages had faded away, in line with the assumptions of the July forecast, while the inflationary impulses from the volume of production persisted. Overall, however, the current inflation pressures from the domestic real economy were assessed as moderate. This assessment was supported by the evolution of adjusted inflation excluding fuels, which had been lower than forecasted in July. The current setting of the monetary conditions was assessed as roughly neutral.

The new forecast incorporated the impacts of all the approved fiscal reform measures. As a result of these measures, the fiscal impulse would be negative in 2008 and then – assuming no further reform measures – turn positive again in 2009, which might cause fluctuations in domestic demand. In line with this, real GDP growth would slow from the 6.2% expected this year to 5% in 2008 and then speed up again to 5.6% in 2009.

The October situation report assessed the risks to the new forecast as being balanced. No risk leading to the creation of an alternative scenario had been identified in the forecasting process. Only a sensitivity analysis had been conducted to determine the impacts of large exchange rate changes. For the first time, the Board was presented with an alternative forecast prepared using the new G3 macroeconomic model. The G3 model is much more detailed, allowing for a more realistic description of the impacts of various economic shocks.

The October headline inflation forecast was significantly higher than the July forecast, owing to the inclusion of a rise in indirect tax rates, an increase in regulated prices and a revision of energy and food price inflation. In 2009, most of these one-off factors would unwind and headline inflation would start to return to the inflation target. Monetary-policy relevant inflation conversely lay below the July forecast, mainly as a result of a lower trajectory of adjusted inflation excluding fuels and faster appreciation of the koruna. Consistent with the macroeconomic forecast and its assumptions was growth in nominal interest rates.

After the presentation of the October situation report, the Board discussed the new forecast. It agreed that despite the fairly sizeable downward revision of adjusted inflation excluding fuels and the implied interest rate path, the fundamental macroeconomic outlook contained in the July forecast still applied. The economy would continue to go through a phase of buoyant economic growth driven by growth in household consumption and investment. This would lead to increasing tightness in the labour market and generate some inflationary pressures. It was said repeatedly that the combination of rising indirect tax rates, regulated rents, energy prices and food prices would affect headline inflation. However, it was also repeatedly emphasised that given the one-off nature of some of these factors, their inflationary effects would dissipate quite quickly in 2009.

A major item of debate was the labour market situation. Some of the board members emphasised that the forecast still assessed the effect of real wages on inflation as being neutral with a tendency towards slight fluctuations and the existing growth in nominal unit labour costs as being consistent with the inflation target. Other board members, by contrast, stressed that there was tightness in the labour market and that tendencies towards the generation of wage-inflation pressures were emerging as a result of the unemployment rate falling below the NAIRU. Moreover, the non-inflationary effect of real wages was conditional on an optimistic assumption regarding labour productivity growth.

Another item discussed was the anti-inflationary effect of the stable inflation expectations, reflecting the low

inflation over the inflation targeting period. It was said repeatedly that in an economy where inflation had long been close to, or below, the inflation target, inflation expectations were well anchored. Inflation, which was being driven by one-off price deregulations and changes to tax rates, should therefore have very limited impacts on inflation expectations. The monetary policy response could thus be more gradual. Against this it was argued that the Czech economy was currently in a different situation than in previous years. In particular, the tightness in the labour market was greatly facilitating the pass-through of one-off shocks to inflation expectations.

During a discussion of the aggregate demand situation the Board agreed that owing to the turbulence and heightened nervousness in the financial markets there was a risk of lower-than-expected growth abroad and, as a result, weaker external demand. As regards domestic demand, it was pointed out that the assumption of the emergence of a positive fiscal impulse in 2009 was based on the absence of any further public spending measures by the government. Further reforms should prevent the fiscal stimulus turning positive in 2009. The opinion was also expressed that the risks of demand-pull inflation were relatively low, as the slight economic slowdown this year – which would intensify in 2008 – was already acting against an overheating of the economy.

The exchange rate was repeatedly identified as a potential risk to the forecast. It was said that in a situation of a predicted narrowing of the interest rate differential, a faster-than-forecasted appreciation of the exchange rate could not be ruled out. The uncertain outlook for foreign interest rates was also identified as a risk with regard to the speed and extent of the appreciation. It was also said in the discussion that even an appreciation trend sometimes undergoes corrections and that in recent years there had also been times when the koruna had surprisingly moved in the depreciation direction.

After discussing the situation report, the Board decided by a majority vote to leave the CNB two-week repo rate unchanged at 3.25%. Five members voted in favour of this decision, and two members voted for increasing rates by 0.25 percentage point.

Table 1a

INFLATION DEVELOPMENT												annual percentage changes
2003	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
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*
First-round impacts of changes to indirect taxes on consumer 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*
Monetary-policy relevant inflation [1]	-0.4	-0.4	-0.4	-0.1	0.0	0.3	-0.1	-0.1	0.0	0.4	1.0	1.0
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 excluding fuels	1.2	1.2	1.1	1.0	1.0	0.6	0.1	0.2	0.2	0.2	0.2	0.2
(contribution to consumer price inflation)	*0.64*	*0.63*	*0.54*	*0.53*	*0.49*	*0.31*	*0.05*	*0.11*	*0.10*	*0.11*	*0.10*	*0.11*
fuel prices	6.1	10.5	11.4	1.9	-0.5	-1.2	-0.5	0.6	-2.5	-2.9	-2.8	-2.0
(contribution to consumer price inflation)	*0.10*	*0.25*	*0.27*	*0.03*	*-0.03*	*-0.04*	*-0.02*	*0.01*	*-0.07*	*-0.07*	*-0.07*	*-0.04*
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*	*0.64*	*0.50*	*0.50*	*0.50*	*0.47*	*0.47*	*0.91*	*0.90*	*0.90*
First-round impacts of changes to indirect taxes on consumer prices (contribution to consumer price inflation)	*0.69*	*0.69*	*0.69*	*0.73*	*0.77*	*0.84*	*0.88*	*0.89*	*0.92*	*0.92*	*0.92*	*0.92*
Monetary-policy relevant inflation [1]	1.6	1.6	1.8	1.6	2.0	2.0	2.4	2.5	2.1	2.6	2.0	1.9
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*	*0.90*	*0.71*	*1.00*	*1.10*	*0.78*	*0.59*	*0.18*	*0.25*
adjusted inflation excluding fuels	0.6	0.7	0.9	0.9	1.0	1.4	1.4	1.4	1.6	1.6	1.6	1.6
(contribution to consumer price inflation)	*0.32*	*0.36*	*0.47*	*0.43*	*0.51*	*0.69*	*0.72*	*0.74*	*0.81*	*0.81*	*0.80*	*0.79*
fuel prices	-4.3	-7.0	-5.6	-3.3	7.9	11.0	10.6	9.7	7.4	11.2	10.5	5.9
(contribution to consumer price inflation)	*-0.11*	*0.19*	*-0.15*	*-0.09*	*0.23*	*0.30*	*0.29*	*0.28*	*0.21*	*0.31*	*0.29*	*0.16*
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*
First-round impacts of changes to indirect taxes on consumer prices (contribution to consumer price inflation)	*0.17*	*0.17*	*0.17*	*0.13*	*0.09*	*0.02*	*-0.02*	*-0.03*	*-0.06*	*-0.06*	*-0.05*	*0.00*
Monetary-policy relevant inflation [1]	1.5	1.5	1.4	1.5	1.2	1.7	1.7	1.8	2.3	2.7	2.5	2.2
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 excluding fuels	1.1	1.1	0.9	0.9	0.9	0.8	0.5	0.6	0.7	0.6	0.5	0.5
(contribution to consumer price inflation)	*0.55*	*0.53*	*0.43*	*0.45*	*0.45*	*0.40*	*0.27*	*0.29*	*0.33*	*0.27*	*0.24*	*0.23*
fuel prices	2.2	2.1	1.4	8.9	1.1	2.7	8.2	8.3	21.6	16.1	11.4	9.8
(contribution to consumer price inflation)	*0.06*	*0.05*	*0.04*	*0.23*	*0.03*	*0.08*	*0.23*	*0.23*	*0.60*	*0.46*	*0.32*	*0.26*
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
2006												
Consumer prices	2.9	2.8	2.8	2.8	3.1	2.8	2.9	3.1	2.7	1.3	1.5	1.7
Regulated prices	11.0	11.0	11.2	11.5	12.4	10.5	9.7	9.8	9.8	4.9	4.8	4.9
(contribution to consumer price inflation)	*2.27*	*2.28*	*2.30*	*2.37*	*2.55*	*2.19*	*2.02*	*2.06*	*2.05*	*1.08*	*1.07*	*1.08*
First-round impacts of changes to indirect taxes on consumer prices (contribution to consumer price inflation)	*0.21*	*0.34*	*0.39*	*0.39*	*0.39*	*0.39*	*0.39*	*0.21*	*0.21*	*0.21*	*0.21*	*0.16*
Monetary-policy relevant inflation [1]	2.7	2.5	2.4	2.5	2.7	2.4	2.5	2.9	2.5	1.1	1.3	1.6
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	0.4	0.4	0.9
(contribution to consumer price inflation)	*-0.25*	*-0.41*	*-0.47*	*-0.39*	*-0.34*	*-0.15*	*0.13*	*0.34*	*0.35*	*0.12*	*0.12*	*0.25*
adjusted inflation excluding fuels	0.6	0.5	0.5	0.5	0.5	0.3	0.5	0.7	0.7	0.6	0.6	0.8
(contribution to consumer price inflation)	*0.32*	*0.28*	*0.26*	*0.27*	*0.26*	*0.14*	*0.25*	*0.35*	*0.33*	*0.31*	*0.32*	*0.39*
fuel prices	12.5	13.9	10.9	7.3	10.4	8.3	5.7	6.0	-7.5	-10.8	-8.4	-3.4
(contribution to consumer price inflation)	*0.32*	*0.36*	*0.29*	*0.21*	*0.30*	*0.24*	*0.17*	*0.18*	*-0.25*	*-0.36*	*-0.27*	*-0.10*
Inflation rate (annual moving average)	2.0	2.1	2.2	2.3	2.4	2.5	2.6	2.7	2.8	2.7	2.6	2.5
2007											**forecast**	
Consumer prices	1.3	1.5	1.9	2.5	2.4	2.5	2.3	2.4	2.8	3.8	3.9	3.9
Regulated prices	3.9	4.3	4.1	4.7	4.0	4.0	4.4	4.4	4.6	6.2	6.4	6.4
(contribution to consumer price inflation)	*0.66*	*0.72*	*0.70*	*0.80*	*0.69*	*0.68*	*0.75*	*0.74*	*0.79*	*1.06*	*1.08*	*1.08*
First-round impacts of changes to indirect taxes on consumer prices (contribution to consumer price inflation)	*0.10*	*0.11*	*0.21*	*0.33*	*0.45*	*0.55*	*0.64*	*1.07*	*1.09*	*1.09*	*1.09*	*1.09*
Monetary-policy relevant inflation [1]	1.2	1.4	1.7	2.2	1.9	1.9	1.7	1.3	1.7	2.7	2.8	2.8
of which: prices of food, beverages and tobacco	2.0	2.7	3.2	4.1	3.5	2.7	2.6	2.3	2.5	3.8	3.8	3.8
(contribution to consumer price inflation)	*0.48*	*0.67*	*0.78*	*1.01*	*0.85*	*0.67*	*0.64*	*0.56*	*0.63*	*0.96*	*0.97*	*0.97*
adjusted inflation excluding fuels	0.3	0.4	0.6	0.8	0.8	1.0	0.5	0.1	0.7	0.9	1.0	1.1
(contribution to consumer price inflation)	*0.19*	*0.20*	*0.34*	*0.43*	*0.46*	*0.57*	*0.27*	*0.08*	*0.37*	*0.49*	*0.57*	*0.58*
fuel prices	-3.5	-6.6	-3.1	-3.6	-2.9	-1.7	-2.5	-3.5	-1.8	3.7	4.0	4.8
(contribution to consumer price inflation)	*-0.14*	*-0.26*	*-0.12*	*-0.15*	*-0.12*	*-0.07*	*-0.11*	*-0.15*	*-0.07*	*0.15*	*0.16*	*0.19*
Inflation rate (annual moving average)	2.4	2.3	2.2	2.2	2.1	2.1	2.1	2.0	2.0	2.2	2.4	2.6

CNB calculation based on CZSO data
1) Monetary-policy relevant inflation = headline inflation adjusted for first-round impacts of changes to indirect taxes

Table 1b

INFLATION DEVELOPMENT monthly percentage changes

2003	1	2	3	4	5	6	7	8	9	10	11	12
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*
First-round impacts of changes to indirect taxes on												
consumer 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*
Monetary-policy relevant inflation [1]	0.6	0.2	-0.1	0.2	0.0	0.0	0.1	-0.2	-0.5	0.1	0.5	0.2
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 excluding fuels	0.6	0.2	-0.2	0.0	-0.1	-0.1	1.0	0.2	-1.4	0.1	0.0	0.0
(contribution to consumer price inflation)	*0.29*	*0.12*	*-0.11*	*-0.02*	*-0.07*	*-0.05*	*0.50*	*0.12*	*-0.70*	*0.06*	*-0.02*	*0.00*
fuel prices	1.6	2.3	1.4	-1.5	-2.8	-2.4	-0.9	1.2	1.6	-0.9	-0.6	-0.7
(contribution to consumer price inflation)	*0.04*	*0.06*	*0.04*	*-0.04*	*-0.08*	*-0.06*	*-0.03*	*0.03*	*0.05*	*-0.03*	*-0.02*	*-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*
First-round impacts of changes to indirect taxes on												
consumer prices (contribution to consumer price inflation)	*0.69*	*0.00*	*0.00*	*0.04*	*0.05*	*0.07*	*0.04*	*0.01*	*0.03*	*0.00*	*0.00*	*0.00*
Monetary-policy relevant inflation [1]	1.2	0.2	0.1	-0.1	0.4	0.1	0.3	0.0	-0.8	0.5	-0.1	0.1
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 excluding fuels	1.0	0.3	0.0	-0.1	0.0	0.3	1.0	0.2	-1.2	0.1	0.0	0.0
(contribution to consumer price inflation)	*0.50*	*0.16*	*0.00*	*-0.06*	*0.01*	*0.13*	*0.52*	*0.13*	*-0.61*	*0.06*	*-0.01*	*-0.01*
fuel prices	-0.8	-0.6	3.0	0.9	8.5	0.4	-1.2	0.4	-0.6	2.6	-1.2	-4.9
(contribution to consumer price inflation)	*-0.02*	*-0.02*	*0.08*	*0.02*	*0.22*	*0.01*	*-0.04*	*0.01*	*-0.02*	*0.07*	*-0.04*	*-0.14*
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*
First-round impacts of changes to indirect taxes on												
consumer 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*
Monetary-policy relevant inflation [1]	0.7	0.2	-0.1	0.1	0.2	0.6	0.3	0.0	-0.3	0.9	-0.3	-0.2
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 excluding fuels	0.5	0.3	-0.2	-0.1	0.0	0.2	0.8	0.3	-1.1	0.0	-0.1	-0.1
(contribution to consumer price inflation)	*0.25*	*0.13*	*-0.09*	*-0.05*	*0.01*	*0.08*	*0.38*	*0.14*	*-0.57*	*0.01*	*-0.05*	*-0.03*
fuel prices	-4.3	-0.7	2.3	8.4	0.7	1.9	4.1	0.4	11.6	-2.0	-5.2	-6.3
(contribution to consumer price inflation)	*-0.12*	*-0.02*	*0.06*	*0.22*	*0.02*	*0.06*	*0.12*	*0.01*	*0.35*	*-0.07*	*-0.17*	*-0.20*
2006												
Consumer prices	1.4	0.1	-0.1	0.1	0.5	0.3	0.4	0.2	-0.7	-0.5	-0.1	0.2
Regulated prices	4.1	0.2	0.2	0.1	0.9	0.1	0.0	0.2	0.0	-0.9	0.0	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*	*-0.21*	*-0.01*	*0.01*
First-round impacts of changes to indirect taxes on												
consumer prices (contribution to consumer price inflation)	*0.16*	*0.13*	*0.05*	*0.00*	*0.00*	*0.00*	*0.00*	*-0.18*	*0.00*	*0.00*	*0.00*	*0.00*
Monetary-policy relevant inflation [1]	1.2	0.0	-0.2	0.1	0.5	0.3	0.4	0.3	-0.7	-0.5	-0.1	0.2
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	-0.5	0.1	0.6
(contribution to consumer price inflation)	*0.04*	*-0.15*	*-0.08*	*0.02*	*0.17*	*0.23*	*-0.05*	*0.05*	*-0.03*	*-0.13*	*0.03*	*0.15*
adjusted inflation excluding fuels	0.7	0.2	-0.2	-0.1	0.0	-0.1	1.0	0.5	-1.2	0.0	-0.1	0.1
(contribution to consumer price inflation)	*0.35*	*0.08*	*-0.11*	*-0.03*	*0.01*	*-0.03*	*0.48*	*0.24*	*-0.57*	*-0.02*	*-0.04*	*0.04*
fuel prices	-2.0	0.5	-0.5	4.8	3.6	0.0	1.6	0.7	-2.6	-5.5	-2.7	-1.2
(contribution to consumer price inflation)	*-0.06*	*0.02*	*-0.01*	*0.14*	*0.11*	*0.00*	*0.05*	*0.02*	*-0.08*	*-0.17*	*-0.08*	*-0.03*
2007											**forecast**	
Consumer prices	1.0	0.3	0.3	0.7	0.4	0.3	0.4	0.3	-0.3	0.4	0.0	0.2
Regulated prices	3.2	0.6	0.0	0.6	0.3	0.1	0.4	0.1	0.2	0.6	0.1	0.1
(contribution to consumer price inflation)	*0.54*	*0.10*	*0.01*	*0.11*	*0.05*	*0.01*	*0.07*	*0.02*	*0.03*	*0.11*	*0.02*	*0.01*
First-round impacts of changes to indirect taxes on												
consumer prices (contribution to consumer price inflation)	*0.10*	*0.14*	*0.15*	*0.12*	*0.12*	*0.10*	*0.10*	*0.25*	*0.02*	*0.01*	*0.00*	*0.00*
Monetary-policy relevant inflation [1]	0.9	0.1	0.2	0.6	0.3	0.2	0.3	0.1	-0.3	0.4	0.0	0.2
of which: prices of food, beverages and tobacco	1.2	0.2	0.1	1.0	0.0	0.1	-0.3	-0.1	0.1	0.7	0.2	0.5
(contribution to consumer price inflation)	*0.30*	*0.04*	*0.02*	*0.24*	*0.01*	*0.03*	*-0.07*	*-0.03*	*0.03*	*0.19*	*0.04*	*0.13*
adjusted inflation excluding fuels	0.3	0.2	0.0	0.1	0.1	0.1	0.4	0.1	-0.6	0.2	0.1	0.1
(contribution to consumer price inflation)	*0.14*	*0.11*	*0.01*	*0.05*	*0.04*	*0.07*	*0.22*	*0.07*	*-0.34*	*0.09*	*0.03*	*0.06*
fuel prices	-2.1	-2.6	3.3	4.3	4.3	1.3	0.8	-0.3	-0.9	-0.2	-2.4	-0.4
(contribution to consumer price inflation)	*-0.08*	*-0.10*	*0.12*	*0.16*	*0.17*	*0.05*	*0.03*	*-0.01*	*-0.03*	*-0.01*	*-0.10*	*-0.02*

CNB calculation based on CZSO data
1) Monetary-policy relevant inflation = headline inflation adjusted for first-round impacts of changes to indirect taxes

Table 2

CONSUMER PRICES

percentage changes; average for 2005 = 100

Group	Constant 2005 weights in per mille	Months 1	2	3	4	5	6	7	8	9	10	11	12	Average since start of year
Total - 2004	1,000.0	-2.5	-2.3	-2.3	-2.3	-1.8	-1.6	-1.3	-1.3	-2.1	-1.6	-1.6	-1.6	-1.9
Food and non-alcoholic beverages	162.6	1.3	1.0	1.1	1.4	1.0	1.0	0.3	-0.6	-1.3	-1.3	-1.2	0.5	0.3
Alcoholic beverages and tobacco	81.7	-3.6	-3.5	-3.4	-2.8	-1.2	-0.6	-0.3	-0.1	-0.2	-0.3	-0.4	-0.8	-1.4
Clothing and footwear	52.4	6.9	6.0	6.0	6.1	6.2	6.2	4.7	3.7	4.1	5.4	5.6	5.6	5.5
Housing, water, electricity, gas and other fuels	248.3	-4.4	-4.1	-4.0	-4.4	-4.7	-4.7	-4.4	-4.3	-4.1	-2.9	-2.9	-2.9	-4.0
Furnishings, household equipment and routine maintenance of the house	58.1	3.0	2.8	2.7	2.7	2.2	2.2	1.9	1.7	1.5	1.4	1.2	1.1	2.0
Health	17.9	-9.4	-9.1	-8.7	-8.4	-6.5	-6.2	-6.0	-5.8	-5.4	-6.0	-6.3	-6.3	-7.0
Transport	114.1	-2.3	-2.3	-1.3	-1.3	-0.1	-0.6	-0.9	-1.0	-1.7	-1.2	-1.5	-3.0	-1.4
Communications	38.7	-5.1	-6.0	-6.0	-6.1	-7.2	-7.3	-7.4	-8.5	-8.7	-7.4	-7.5	-7.6	-7.1
Recreation and culture	98.6	-3.5	-2.3	-3.3	-3.9	-3.4	-2.0	3.3	5.2	-2.1	-2.6	-3.0	-3.1	-1.7
Education	6.2	-4.2	-3.8	-3.9	-3.9	-3.6	-3.7	-3.7	-3.7	0.7	0.9	0.9	0.9	-2.3
Hotels, cafés and restaurants	58.4	-8.1	-7.9	-7.6	-7.4	-3.7	-3.4	-3.3	-3.2	-2.4	-2.0	-1.8	-1.7	-4.4
Miscellaneous goods and services	63.0	-2.8	-2.1	-1.6	-1.7	-0.7	-0.4	-0.3	-0.4	-0.5	-0.6	-0.4	-0.4	-1.0
Total - 2005	1,000.0	-0.9	-0.7	-0.8	-0.7	-0.5	0.1	0.3	0.3	0.1	0.9	0.7	0.6	0.0
Food and non-alcoholic beverages	162.6	0.8	0.8	0.7	0.5	1.2	1.4	-0.4	-1.3	-1.5	-1.0	-0.8	-0.4	0.0
Alcoholic beverages and tobacco	81.7	0.1	0.3	0.2	-0.2	-0.2	0.0	-0.1	-0.1	-0.2	-0.1	-0.2	-0.1	0.0
Clothing and footwear	52.4	2.4	1.2	1.0	1.3	1.3	1.1	-0.6	-2.0	-1.9	-1.3	-1.1	-1.4	0.0
Housing, water, electricity, gas and other fuels	248.3	-1.0	-0.9	-0.7	-0.9	-0.9	-0.8	-0.4	-0.3	-0.2	2.0	2.0	2.0	0.0
Furnishings, household equipment and routine maintenance of the house	58.1	0.8	0.6	0.5	0.3	0.2	0.0	-0.2	-0.3	-0.5	-0.5	-0.6	-0.7	0.0
Health	17.9	-2.5	-2.0	-1.6	-1.1	0.3	1.1	1.1	1.3	1.8	0.9	0.6	0.6	0.0
Transport	114.1	-4.0	-4.2	-3.8	-1.3	-1.2	-0.4	1.1	1.2	4.9	4.4	2.6	0.5	0.0
Communications	38.7	-7.6	-8.2	-8.2	-8.3	-8.4	5.9	6.2	6.2	5.6	5.6	5.4	5.4	0.0
Recreation and culture	98.6	-1.3	0.1	-1.1	-2.1	-1.7	-1.1	4.1	6.1	-1.1	-0.1	-0.6	-0.7	0.0
Education	6.2	-1.9	-1.2	-1.1	-1.1	-1.1	-1.2	-1.2	-1.2	2.1	2.7	2.7	2.7	0.0
Hotels, cafés and restaurants	58.4	-1.1	-0.6	-0.4	-0.2	-0.2	-0.2	-0.4	-0.4	0.6	0.9	0.9	0.9	0.0
Miscellaneous goods and services	63.0	-0.4	0.1	0.1	0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.1	0.1	0.0
Total - 2006	1,000.0	2.0	2.1	2.0	2.1	2.6	2.8	3.3	3.5	2.8	2.2	2.2	2.3	2.5
Food and non-alcoholic beverages	162.6	0.4	0.2	0.0	0.2	0.9	2.3	2.0	1.2	1.0	0.3	0.4	1.5	0.9
Alcoholic beverages and tobacco	81.7	0.9	1.1	1.1	0.9	1.3	1.1	1.2	1.2	1.2	1.3	1.5	0.8	1.1
Clothing and footwear	52.4	-3.7	-4.8	-5.1	-4.9	-5.1	-5.6	-7.6	-8.0	-7.6	-6.8	-6.4	-5.9	-6.0
Housing, water, electricity, gas and other fuels	248.3	5.8	6.1	6.1	6.3	6.4	6.5	6.6	6.6	6.6	6.0	6.0	6.0	6.3
Furnishings, household equipment and routine maintenance of the house	58.1	-0.9	-0.9	-1.1	-1.1	-1.2	-1.4	-1.6	-1.6	-1.6	-1.6	-1.4	-1.4	-1.3
Health	17.9	1.7	2.0	2.8	3.1	4.2	4.9	4.9	7.2	7.5	6.9	6.3	6.3	4.8
Transport	114.1	0.2	0.4	0.2	1.7	2.9	2.8	3.6	3.8	2.8	1.0	0.0	-0.2	1.6
Communications	38.7	6.0	4.0	4.0	1.7	7.3	7.3	8.1	8.7	8.5	8.7	8.5	8.5	6.8
Recreation and culture	98.6	0.7	1.8	0.7	0.1	0.4	0.3	5.5	8.1	1.0	0.2	-0.5	-0.3	1.5
Education	6.2	2.6	2.7	2.6	2.6	2.6	2.6	2.6	2.6	5.2	5.2	5.2	5.2	3.5
Hotels, cafés and restaurants	58.4	1.6	1.9	2.0	2.2	2.4	2.5	2.7	2.9	3.1	3.2	3.3	3.5	2.6
Miscellaneous goods and services	63.0	0.9	1.4	1.6	1.8	1.8	1.8	2.1	2.1	2.1	2.2	2.2	2.2	1.9
Total - 2007	1,000.0	3.3	3.6	3.9	4.6	5.0	5.3	5.8	6.1	5.8				4.8
Food and non-alcoholic beverages	162.6	3.1	3.2	3.3	5.0	4.8	5.0	4.5	4.1	4.2				4.1
Alcoholic beverages and tobacco	81.7	2.6	4.6	6.5	7.7	9.7	10.9	12.2	15.8	16.2				9.6
Clothing and footwear	52.4	-7.3	-7.3	-6.8	-5.7	-5.5	-5.6	-7.6	-8.3	-7.5				-6.8
Housing, water, electricity, gas and other fuels	248.3	8.2	8.5	8.6	9.0	9.3	9.5	9.9	10.2	10.6				9.3
Furnishings, household equipment and routine maintenance of the house	58.1	-1.5	-1.6	-1.6	-1.4	-1.3	-1.4	-1.4	-1.5	-1.5				-1.5
Health	17.9	6.6	6.7	6.7	9.7	10.1	9.9	9.3	9.2	9.0				8.6
Transport	114.1	-0.8	-1.6	-0.4	0.9	2.3	2.9	3.2	3.2	2.7				1.4
Communications	38.7	8.1	8.0	7.9	7.7	7.6	7.5	7.5	6.3	5.4				7.3
Recreation and culture	98.6	1.5	2.3	1.4	0.9	0.8	1.1	4.2	5.2	0.7				2.0
Education	6.2	5.2	5.3	5.3	5.3	5.3	5.3	5.3	5.3	7.2				5.5
Hotels, cafés and restaurants	58.4	4.0	4.2	4.4	4.7	5.0	5.3	5.6	5.7	6.1				5.0
Miscellaneous goods and services	63.0	2.9	3.6	4.0	4.1	4.1	4.0	4.1	4.0	4.0				3.9

Source: CZSO

Table 3

CONSUMER PRICES - TRADABLES AND NONTRADABLES annual percentage changes

2003	1	2	3	4	5	6	7	8	9	10	11	12
Fuel prices	6.1	10.5	11.4	1.9	-0.5	-1.1	-0.6	0.7	-2.5	-2.9	-2.7	-2.0
Other tradables excluding food and fuel prices	-2.3	-2.5	-2.6	-2.7	-2.7	-2.9	-3.0	-3.0	-2.9	-2.7	-2.8	-2.7
Prices of tradables excluding regulated prices	4.0	4.1	3.9	3.9	3.8	3.3	2.4	2.5	2.5	2.4	2.5	2.4
Prices of non-food commodities excluding regulated prices	1.5	1.7	1.6	1.1	0.9	0.5	0.1	0.2	0.1	0.1	0.1	0.1
Prices of tradables - food	-4.1	-3.8	-3.6	-3.5	-2.8	-1.1	-0.8	-0.8	-0.2	0.6	2.5	2.7
Prices of nontradables - 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
2004												
Fuel prices	1.0	-1.9	-0.3	2.0	11.0	14.2	13.7	12.8	10.5	14.4	13.7	8.9
Other tradables excluding food and fuel prices	-2.6	-2.4	-2.2	-2.3	-2.6	-2.6	-2.6	-2.6	-2.9	-2.9	-2.7	-2.8
Prices of tradables excluding regulated prices	3.3	3.3	3.4	3.4	5.2	5.9	5.9	5.9	6.4	6.4	6.3	6.3
Prices of non-food commodities excluding regulated prices	0.9	0.8	1.1	1.1	2.5	2.9	3.0	2.9	3.0	3.2	3.1	2.9
Prices of tradables - food	3.2	3.2	3.5	3.8	3.6	3.1	4.4	4.9	3.7	3.0	1.4	1.6
Prices of nontradables - 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
2005												
Fuel prices	-0.4	-0.6	-1.2	6.1	1.1	2.7	8.2	8.3	21.6	16.1	11.4	9.8
Other tradables excluding food and fuel prices	-3.4	-3.6	-3.8	-3.7	-3.4	-3.1	-2.6	-2.6	-2.4	-2.3	-2.3	-2.3
Prices of tradables excluding regulated prices	5.2	5.2	5.0	5.0	3.5	3.1	2.6	2.6	2.6	2.4	2.3	2.2
Prices of non-food commodities excluding regulated prices	1.6	1.6	1.4	1.8	0.8	0.8	0.8	0.9	1.7	1.3	1.0	0.8
Prices of tradables - food	0.8	1.0	0.8	0.2	0.4	0.4	-0.4	-0.5	-0.2	0.3	0.3	-0.5
Prices of nontradables - 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
2006												
Fuel prices	12.5	13.9	10.9	7.3	10.4	8.3	5.7	6.0	-7.5	-10.8	-8.4	-3.4
Other tradables excluding food and fuel prices	-2.1	-2.1	-2.1	-2.1	-2.1	-2.9	-2.7	-2.6	-2.4	-2.4	-2.3	-2.1
Prices of tradables excluding regulated prices	2.6	2.5	2.4	2.4	2.5	2.2	2.4	2.6	2.5	2.4	2.4	2.5
Prices of non-food commodities excluding regulated prices	1.2	1.2	1.0	0.9	1.0	0.7	0.8	1.0	0.1	-0.1	0.1	0.5
Prices of tradables - food	-0.1	-0.2	-0.3	0.1	0.3	1.0	2.1	2.2	2.2	1.3	1.3	1.6
Prices of nontradables - regulated prices	11.0	11.0	11.2	11.5	12.4	10.5	9.7	9.8	9.8	4.9	4.8	4.9
2007												
Fuel prices	-3.5	-6.6	-3.1	-3.6	-2.9	-1.7	-2.5	-3.5	-1.8			
Other tradables excluding food and fuel prices	-2.4	-2.6	-2.0	-1.6	-1.7	-1.6	-2.2	-2.3	-1.5			
Prices of tradables excluding regulated prices	2.5	2.8	2.9	3.2	2.6	2.8	2.4	1.9	2.3			
Prices of non-food commodities excluding regulated prices	0.1	-0.1	0.4	0.6	0.7	1.0	0.4	0.0	0.6			
Prices of tradables - food	2.4	3.2	4.1	5.5	5.3	5.0	5.3	6.7	7.1			
Prices of nontradables - regulated prices	3.9	4.3	4.1	4.7	4.0	4.0	4.4	4.4	4.6			

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
1/03	2.5	__
2/03	2.4	__
3/03	2.5	2.1
4/03	2.6	__
5/03	3.7	__
6/03	3.2	2.6
7/03	3.3	__
8/03	3.2	__
9/03	3.1	2.6
10/03	3.0	__
11/03	3.1	__
12/03	3.3	2.9
1/04	2.9	__
2/04	3.2	__
3/04	3.0	3.3
4/04	2.8	__
5/04	2.6	__
6/04	2.7	3.1
7/04	2.8	__
8/04	2.8	__
9/04	3.0	3.1
10/04	2.8	__
11/04	2.8	__
12/04	2.8	3.2
1/05	2.8	__
2/05	2.6	__
3/05	2.6	2.7
4/05	2.5	__
5/05	2.4	__
6/05	2.3	2.7
7/05	2.4	__
8/05	2.5	__
9/05	2.5	2.8
10/05	2.7	__
11/05	2.8	__
12/05	2.6	2.8
1/06	2.5	__
2/06	2.5	__
3/06	2.5	2.7
4/06	2.6	__
5/06	2.6	__
6/06	2.8	2.9
7/06	2.9	__
8/06	3.1	__
9/06	3.2	3.0
10/06	3.1	__
11/06	3.4	__
12/06	3.3	3.0
1/07	3.1	__
2/07	3.0	__
3/07	3.2	3.0
4/07	3.1	__
5/07	3.2	__
6/07	3.2	3.0
7/07	3.1	__
8/07	3.6	__
9/07	4.2	3.6

Source: CNB statistical survey

Table 5

HARMONISED INDEX OF CONSUMER PRICES

annual percentage changes

	2003 12	2004 12	2005 12	2006 12	2007 9
European Union (27 countries)	2.1	2.5	2.3	2.2	2.3
European Union (25 countries)	1.9	2.4	2.1	2.2	2.2
Belgium	1.7	1.9	2.8	2.1	1.4
Bulgaria	5.6	4.0	7.4	6.1	11.0
Czech Republic	0.9	2.5	1.9	1.5	2.8
Denmark	1.2	0.9	2.2	1.7	1.2
Germany	1.0	2.3	2.1	1.4	2.7
Estonia	1.2	4.8	3.6	5.1	7.5
Ireland	3.0	2.4	1.9	3.0	2.9
Greece	3.1	3.1	3.5	3.2	2.9
Spain	2.7	3.3	3.7	2.7	2.7
France	2.4	2.3	1.8	1.7	1.6
Italy	2.5	2.4	2.1	2.1	1.7
Cyprus	2.2	3.9	1.4	1.5	2.3
Latvia	3.5	7.4	7.1	6.8	11.5
Lithuania	-1.3	2.8	3.0	4.5	7.1
Luxembourg	2.4	3.5	3.4	2.3	2.5
Hungary	5.6	5.5	3.3	6.6	6.4
Malta	2.4	1.9	3.4	0.8	0.9
Netherlands	1.6	1.2	2.0	1.7	1.3
Austria	1.3	2.5	1.6	1.6	2.1
Poland	1.6	4.4	0.8	1.4	2.7
Portugal	2.3	2.6	2.5	2.5	2.0
Romania	14.1	9.3	8.7	4.9	6.1
Slovenia	4.7	3.3	2.4	3.0	3.6
Slovakia	9.4	5.8	3.9	3.7	1.7
Finland	1.2	0.1	1.1	1.2	1.7
Sweden	1.8	0.9	1.3	1.4	1.6
United Kingdom	1.3	1.7	1.9	3.0	

Source: Eurostat

Table 6

MONETARY SURVEY					position at month-end in CZK billions
	2003 12	2004 12	2005 12	2006 12	2007 8
Total assets	1,766.1	1,844.1	1,992.1	2,188.7	2,339.1
Net external assets (NEAs)	821.5	863.3	1,076.4	972.6	973.7
NEAs of CNB	687.5	634.1	724.7	659.1	653.5
NEAs of OMFIs	134.0	229.3	351.7	313.5	320.2
Net domestic assets	944.5	980.8	915.8	1,216.0	1,365.4
Domestic loans	1,145.6	1,147.0	1,166.6	1,422.4	1,597.7
Net credit to government (NCG) (including securities)	354.0	257.5	99.1	136.3	99.3
NCG to central government (including securities)	408.7	312.4	163.0	206.9	214.7
NCG to other government (including securities)	-54.8	-54.9	-64.0	-70.6	-115.4
Loans to corporations and households (excluding securities)	791.6	889.4	1,067.5	1,286.1	1,498.4
Loans to corporations (excluding securities)	554.1	574.2	649.7	745.5	850.3
Loans to households (excluding securities)	237.5	315.2	417.8	540.6	648.0
Other net items (including securities and capital)	-201.1	-166.2	-250.8	-206.4	-232.3
Holdings of securities	16.6	18.8	14.4	14.0	18.0
Issued securities	-51.6	-74.9	-119.1	-121.8	-145.2
Liabilities					
Monetary aggregate M2	1,766.1	1,844.1	1,992.1	2,188.7	2,339.1
Monetary aggregate M1	902.8	962.3	1,087.3	1,239.8	1,346.3
Currency in circulation	221.4	236.8	263.8	295.3	314.0
Overnight deposits	681.4	725.6	823.5	944.5	1,032.2
Overnight deposits - households	372.1	410.8	456.6	529.3	604.9
Overnight deposits - corporations	309.3	314.7	367.0	415.3	427.3
M2-M1 (quasi money)	863.3	881.8	904.8	948.9	992.9
Deposits with agreed maturity	666.4	675.3	671.4	674.9	705.8
Deposits with agreed maturity - households	439.8	458.6	445.1	433.6	444.1
Deposits with agreed maturity - corporations	226.6	216.7	226.3	241.3	261.8
Deposits redeemable at notice	185.6	198.8	224.1	265.6	275.5
Deposits redeemable at notice - households	182.3	194.6	220.6	260.8	271.6
Deposits redeemable at notice - corporations	3.2	4.2	3.6	4.8	3.9
Repurchase agreements	11.3	7.6	9.3	8.4	11.5
Annual percentage changes					
M1	14.6	6.6	13.0	14.0	12.8
M2	6.9	4.4	8.0	9.9	11.4
Loans to corporations and households	9.3	12.4	20.0	20.5	23.6
M2-M1 (deposits)	-0.1	2.1	2.6	4.9	9.5
Annual percentage growth rates					
M1	15.5	8.3	13.1	14.7	13.2
M2	8.1	5.8	8.1	10.6	11.7
Loans to corporations and households	11.8	15.3	20.8	21.6	24.2
M2-M1 (deposits)	1.2	3.3	2.6	5.7	9.8

Table 7

INTEREST RATES ON INTERBANK DEPOSITS

percentages

	2003 12	2004 12	2005 12	2006 12	2007 9
1. Average PRIBOR [1]					
- 1 day	1.98	2.49	2.00	2.48	3.25
- 7 day	2.02	2.51	2.04	2.51	3.28
- 14 day	2.03	2.51	2.04	2.51	3.29
- 1 month	2.04	2.53	2.05	2.52	3.33
- 2 month	2.06	2.55	2.10	2.54	3.37
- 3 month	2.08	2.57	2.17	2.56	3.46
- 6 month	2.13	2.67	2.33	2.67	3.63
- 9 month	2.22	2.76	2.44	2.79	3.73
- 12 month	2.30	2.85	2.53	2.89	3.82
2. Average PRIBID [1]					
- 1 day	1.88	2.39	1.90	2.38	3.15
- 7 day	1.92	2.41	1.94	2.41	3.18
- 14 day	1.93	2.41	1.94	2.41	3.19
- 1 month	1.94	2.43	1.95	2.42	3.23
- 2 month	1.96	2.45	2.00	2.44	3.27
- 3 month	1.98	2.47	2.07	2.46	3.36
- 6 month	2.03	2.57	2.23	2.57	3.53
- 9 month	2.12	2.66	2.34	2.69	3.63
- 12 month	2.20	2.75	2.43	2.79	3.72

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

Table 8

FRA RATES percentages; monthly averages

	2003 12	2004 12	2005 12	2006 12	2007 9
3 * 6	2.23	2.74	2.46	2.71	3.64
3 * 9	2.36	2.81	2.57	2.83	3.73
6 * 9	2.47	2.85	2.66	2.92	3.75
6 * 12	2.64	2.92	2.74	3.02	3.83
9 * 12	2.77	2.97	2.79	3.08	3.86
9*12 - 3*6 spread	0.55	0.24	0.33	0.37	0.22
6*12 - 3*9 spread	0.28	0.12	0.17	0.19	0.10

IRS RATES percentages; monthly averages

	2003 12	2004 12	2005 12	2006 12	2007 9
1Y	2.41	2.82	2.56	2.86	3.76
2Y	2.98	3.06	2.82	3.09	3.95
3Y	3.38	3.27	3.00	3.21	4.04
4Y	3.69	3.45	3.13	3.31	4.11
5Y	3.93	3.62	3.25	3.40	4.17
6Y	4.13	3.77	3.33	3.46	4.22
7Y	4.29	3.89	3.40	3.52	4.27
8Y	4.43	4.00	3.46	3.58	4.32
9Y	4.54	4.09	3.52	3.63	4.37
10Y	4.64	4.17	3.58	3.68	4.42
15Y	4.97	4.40	3.78	3.83	4.61
20Y	5.11	4.54	3.88	3.89	4.68
5Y - 1Y spread	1.52	0.80	0.69	0.54	0.41
10Y - 1Y spread	2.23	1.35	1.02	0.82	0.66

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
1/03	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	-0.8	-0.2	2.6	-1.0	0.2	0.7	3.6
7/06	2.0	2.8	5.7	1.7	-0.9	-0.1	2.7	-1.2	-0.1	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	2.2	2.9	5.8	1.9	-0.4	0.2	3.0	-0.8	-0.2	0.5	3.3
10/06	2.5	3.1	6.1	2.0	1.2	1.8	4.7	0.7	0.6	1.2	4.1
11/06	2.5	3.0	6.0	2.0	1.0	1.5	4.4	0.5	0.5	1.0	3.9
12/06	2.5	2.9	5.9	2.0	0.8	1.2	4.1	0.3	-0.1	0.3	3.2
1/07	2.5	2.9	6.1	2.1	1.2	1.5	4.8	0.7	-0.3	0.1	3.3
2/07	2.5	2.8	6.1	2.1	1.0	1.3	4.5	0.6	-0.7	-0.4	2.8
3/07	2.5	2.8	6.0	2.1	0.6	0.9	4.1	0.2	-1.0	-0.8	2.4
4/07	2.5	2.9	6.1	2.1	0.0	0.4	3.5	-0.4	-1.1	-0.8	2.3
5/07	2.5	3.2	6.0	2.0	0.1	0.7	3.5	-0.4	-1.6	-0.9	1.8
6/07	2.8	3.4	6.1	2.2	0.3	0.9	3.5	-0.3	-1.7	-1.2	1.4
7/07	2.8	3.6	6.3	2.2	0.5	1.3	3.9	-0.1	-1.2	-0.5	2.1
8/07	3.0	3.7	6.5	2.3	0.6	1.3	4.0	-0.1	-0.7	0.0	2.7
9/07	3.3	3.8	—	—	0.5	1.0	—	—	-0.7	-0.2	—

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			
	PRIBOR		client rates		PRIBOR		client rates	
	2W	1Y	new loans	time deposits	2W	1Y	new loans	time deposits
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
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
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
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
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
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
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
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
1/05	-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
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
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
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
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
4/06	-0.6	-0.2	2.9	-0.9	—	—	—	—
5/06	-0.6	-0.2	2.9	-0.9	—	—	—	—
6/06	-0.8	-0.2	2.6	-1.0	-0.8	-0.3	2.5	-1.1
7/06	-0.9	-0.1	2.7	-1.2	—	—	—	—
8/06	-0.8	-0.3	2.7	-1.2	—	—	—	—
9/06	-0.9	-0.3	2.5	-1.3	-0.8	-0.1	2.7	-1.1
10/06	-0.6	0.0	2.9	-1.1	—	—	—	—
11/06	-0.9	-0.4	2.5	-1.3	—	—	—	—
12/06	-0.8	-0.4	2.5	-1.2	-0.5	-0.1	2.8	-0.9
1/07	-0.6	-0.2	3.0	-1.0	—	—	—	—
2/07	-0.5	-0.2	3.0	-0.9	—	—	—	—
3/07	-0.7	-0.4	2.7	-1.1	-0.4	-0.1	3.0	-0.8
4/07	-0.6	-0.2	2.9	-1.0	—	—	—	—
5/07	-0.7	0.0	2.7	-1.1	—	—	—	—
6/07	-0.4	0.2	2.8	-1.0	-0.3	0.3	3.0	-0.8
7/07	-0.3	0.5	3.1	-0.9	—	—	—	—
8/07	-0.6	0.1	2.8	-1.2	—	—	—	—
9/07	-0.9	-0.4	—	—	-0.3	0.2	—	—

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

	2003 12	2004 12	2005 12	2006 12	2007 8
Koruna interest rates on loans provided by banks to residents:					
Households and non-profit institutions serving households (S.14+S.15) - total	8.24	7.96	7.20	6.80	6.60
- maturity up to 1 year	11.21	12.82	12.96	13.75	13.39
- maturity over 1 year and up to 5 years	10.17	12.40	11.43	11.35	12.15
- maturity over 5 years	6.65	6.39	5.96	5.84	5.75
for consumption - total	13.83	14.89	13.88	13.59	13.12
- maturity up to 1 year	14.26	15.48	16.22	17.31	16.04
- maturity over 1 year and up to 5 years	13.86	15.17	14.94	14.67	15.08
- maturity over 5 years	13.21	13.45	11.85	11.93	11.57
for house purchase - total	6.31	5.93	5.24	4.91	4.84
- maturity up to 1 year	6.24	4.48	4.29	5.39	6.38
- maturity over 1 year and up to 5 years	7.05	6.57	6.22	6.15	6.08
- maturity over 5 years	6.09	5.89	5.19	4.88	4.81
other - total	7.80	7.50	7.09	6.87	6.72
- maturity up to 1 year	8.49	8.96	9.09	9.52	10.26
- maturity over 1 year and up to 5 years	8.02	7.63	7.17	7.74	7.89
- maturity over 5 years	7.02	6.58	5.79	5.51	5.51
Non-financial corporations (S.11) - total	4.53	4.75	4.20	4.45	4.94
- maturity up to 1 year	4.08	4.35	3.84	4.23	4.88
- maturity over 1 year and up to 5 years	4.64	4.68	4.18	4.38	4.84
- maturity over 5 years	5.14	5.39	4.72	4.74	5.08
Koruna interest rates on deposits accepted by banks from residents:					
Households and non-profit institutions serving households (S.14+S.15) - total	1.30	1.41	1.25	1.28	1.27
overnight	0.50	0.52	0.40	0.41	0.46
with agreed maturity - total	2.02	2.13	1.92	1.96	1.95
- with agreed maturity up to 2 years	0.96	1.37	1.03	1.49	1.70
- with agreed maturity over 2 years	2.90	2.69	2.50	2.31	2.17
redeemable at notice - total	1.26	1.63	1.71	1.97	2.03
- redeemable at notice up to 3 months	1.67	2.14	2.27	2.34	2.36
- redeemable at notice over 3 months	0.98	1.12	0.81	1.00	1.02
Non-financial corporations (S.11) - total	0.85	1.21	0.91	1.18	1.49
overnight	0.64	0.68	0.52	0.72	0.94
with agreed maturity - total	1.50	2.08	1.64	2.09	2.49
- with agreed maturity up to 2 years	1.49	2.05	1.61	2.08	2.49
- with agreed maturity over 2 years	3.04	3.12	2.47	2.28	2.16
redeemable at notice - total	1.17	1.60	1.14	1.64	1.69
- redeemable at notice up to 3 months	1.14	1.49	1.07	1.53	1.57
- redeemable at notice over 3 months	1.32	2.26	1.64	2.21	2.41

Table 12

BALANCE OF PAYMENTS [1]					in CZK millions
	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q1 - 4	2007 [2] Q2
A. Current account	-160,614.6	-147,455.7	-48,500.2	-100,324.9	-42,988.8
Balance of trade	-69,793.0	-13,384.0	59,369.5	68,213.0	28,095.7
exports	1,370,930.0	1,722,657.4	1,868,585.8	2,144,005.5	612,774.4
imports	1,440,723.0	1,736,041.4	1,809,216.3	2,075,792.5	584,678.7
Services	13,236.7	16,564.4	36,542.0	34,572.8	13,367.4
credit	219,151.1	247,084.8	282,016.3	300,370.9	81,871.3
transport	60,556.3	69,859.0	76,701.5	84,292.7	26,541.2
travel	100,310.1	107,231.8	111,839.3	113,125.0	32,358.2
others	58,284.7	69,994.0	93,475.5	102,953.2	22,971.9
debit	205,914.4	230,520.4	245,474.3	265,798.1	68,503.9
transport	33,725.7	47,571.4	56,254.1	62,008.2	17,862.9
travel	54,419.2	58,398.0	57,777.6	60,015.4	16,864.0
others	117,769.5	124,551.0	131,442.6	143,774.5	33,777.0
Income	-119,858.4	-156,637.9	-155,700.6	-183,431.3	-77,861.6
credit	75,508.3	87,206.1	105,728.7	121,355.9	37,727.6
debit	195,366.7	243,844.0	261,429.3	304,787.2	115,589.2
Current transfers	15,800.1	6,001.8	11,288.9	-19,679.4	-6,590.3
credit	46,976.7	53,050.6	78,545.3	65,872.5	15,104.2
debit	31,176.6	47,048.8	67,256.4	85,551.9	21,694.5
B. Capital account	-82.2	-14,186.5	4,689.3	8,467.0	245.2
credit	198.2	5,608.2	5,525.2	14,269.5	440.5
debit	280.4	19,794.7	835.9	5,802.5	195.3
Total A + B	*-160,696.8*	*-161,642.2*	*-43,810.9*	*-91,857.9*	*-42,743.6*
C. Financial account	157,093.5	177,312.0	154,767.4	111,611.3	16,096.8
Direct investment	53,500.3	101,776.3	279,630.5	104,307.1	29,209.7
abroad	-5,815.7	-26,067.3	449.0	-30,370.0	-5,572.5
equity capital and reinvested earnings	-3,124.6	-20,260.0	-4,262.8	-29,228.4	-2,746.8
other capital	-2,691.1	-5,807.3	4,711.8	-1,141.6	-2,825.7
in the Czech Republic	59,316.0	127,843.6	279,181.5	134,677.1	34,782.2
equity capital and reinvested earnings	59,350.4	121,482.9	262,471.8	117,628.4	42,217.2
other capital	-34.4	6,360.7	16,709.7	17,048.7	-7,435.0
Portfolio investment	-35,719.1	53,032.5	-81,243.8	-26,882.5	-5,940.5
assets	-83,892.7	-70,245.2	-82,095.7	-68,383.5	-28,822.1
equity securities	5,630.5	-36,457.1	-35,342.4	-43,559.2	-10,717.9
debt securities	-89,523.2	-33,788.1	-46,753.3	-24,824.3	-18,104.2
liabilities	48,173.6	123,277.7	851.9	41,501.0	22,881.6
equity securities	30,133.5	19,558.6	-36,408.9	5,758.0	4,512.8
debt securities	18,040.1	103,719.1	37,260.8	35,743.0	18,368.8
Financial derivatives	3,860.1	-3,208.0	-2,798.6	-6,323.5	11,087.9
assets	7,083.7	-15,565.8	-2,860.9	-10,899.8	1,979.5
liabilities	-3,223.6	12,357.8	62.3	4,576.3	9,108.4
Other investment	135,452.2	25,711.2	-40,820.7	40,510.2	-18,260.3
assets	67,071.3	-30,507.4	-114,430.6	-35,522.5	-67,033.7
long-term	1,141.3	20,434.2	-16,338.0	-6,060.0	-17,794.7
CNB	—	-184.9	-176.3	—	—
commercial banks	-999.9	505.0	-24,641.7	-10,715.5	-18,092.1
government	5,714.3	22,790.7	14,056.5	4,983.6	55.3
other sectors	-3,573.1	-2,676.6	-5,576.5	-328.1	242.1
short-term	65,930.0	-50,941.6	-98,092.6	-29,462.5	-49,239.0
commercial banks	44,971.2	-34,248.5	-87,137.0	24,770.1	-51,439.7
government	2,193.8	92.9	9.4	—	—
other sectors	18,765.0	-16,786.0	-10,965.0	-54,232.6	2,200.7
liabilities	68,380.9	56,218.6	73,609.9	76,032.7	48,773.4
long-term	26,361.6	36,550.9	49,022.1	51,095.2	1,431.7
CNB	-20.4	-20.5	-19.1	-18.1	—
commercial banks	-5,038.0	-1,410.8	311.1	12,733.4	1,254.5
government	10,304.7	10,296.1	20,809.1	9,550.3	2,295.3
other sectors	21,115.3	27,686.1	27,921.0	28,829.6	-2,118.1
short-term	42,019.3	19,667.7	24,587.8	24,937.5	47,341.7
CNB	-21.4	843.7	5,060.1	-4,147.6	56.0
commercial banks	37,899.4	-15,344.5	14,808.8	2,369.2	46,315.3
government	—	—	—	—	—
other sectors	4,141.3	34,168.5	4,718.9	26,715.9	970.4
Total A + B + C	*-3,603.3*	*15,669.8*	*110,956.5*	*19,753.4*	*-26,646.8*
D. Net errors and omissions, valuation changes	16,506.7	-8,887.6	-18,104.9	-17,679.0	18,121.6
Total A + B + C + D	*12,903.4*	*6,782.2*	*92,851.6*	*2,074.4*	*-8,525.2*
E. Change in reserves (- increase)	-12,903.4	-6,782.2	-92,851.6	-2,074.4	8,525.2

1) Balance of payments structure based on the Balance of Payments Manual (5th edition), IMF 1993
2) Preliminary data

Table 13

INTERNATIONAL INVESTMENT POSITION in CZK millions

	2003 31 Dec.	2004 31 Dec.	2005 31 Dec.	2006 31 Dec.	2007[1] 30 Jun.
Assets	1,537,284.6	1,549,333.7	1,875,403.8	1,894,747.4	2,109,405.7
Direct investment abroad	58,581.5	84,087.4	88,772.7	105,600.0	120,170.0
- equity capital	50,965.5	70,664.0	80,061.1	96,510.0	106,710.0
- other capital	7,616.0	13,423.4	8,711.6	9,090.0	13,460.0
Portfolio investment	343,968.7	372,237.6	467,808.5	531,990.4	621,852.7
- equity securities	47,337.7	76,121.3	146,957.6	202,122.7	253,555.4
- debt securities	296,631.0	296,116.3	320,850.9	329,867.7	368,297.3
Financial derivatives	24,129.5	39,695.3	42,556.2	53,456.0	44,904.5
Other investment	419,090.0	417,071.9	549,564.4	547,063.3	657,275.5
long-term	157,598.6	118,432.7	136,314.1	129,684.5	156,046.7
- CNB	468.4	600.0	3,184.5	2,993.8	3,209.2
- commercial banks	66,121.3	58,137.8	83,231.1	87,666.1	113,453.0
- government	79,483.9	48,574.9	38,408.5	29,894.6	30,404.5
- other sectors	11,525.0	11,120.0	11,490.0	9,130.0	8,980.0
short-term	261,491.4	298,639.2	413,250.3	417,378.8	501,228.8
- CNB	98.8	71.7	71.1	131.3	240.4
- commercial banks	161,150.2	184,588.0	273,879.1	233,927.5	312,118.4
of which: gold and foreign exchange	115,884.8	128,119.8	198,042.8	166,580.8	158,762.3
- government	102.4	9.5	0.1	—	—
- other sectors	100,140.0	113,970.0	139,300.0	183,320.0	188,870.0
CNB reserves	691,514.9	636,241.5	726,702.0	656,637.7	665,203.0
- gold	4,784.3	4,253.9	5,526.8	5,690.9	5,919.7
- SDR	238.7	118.0	289.8	346.0	372.6
- reserve position in the IMF	11,949.9	9,137.5	4,447.7	2,324.6	1,809.9
- foreign exchange	674,451.8	622,606.4	716,315.2	648,192.1	657,050.8
- other reserve assets	90.2	125.7	122.5	84.1	50.0
Liabilities	2,064,768.3	2,374,328.4	2,710,646.3	2,928,764.2	3,149,060.5
Direct investment in the Czech Republic	1,161,783.6	1,280,594.8	1,491,564.0	1,617,053.0	1,689,145.7
- equity capital	1,009,391.8	1,121,842.3	1,316,101.8	1,433,723.0	1,523,620.7
- other capital	152,391.8	158,752.5	175,462.2	183,330.0	165,525.0
Portfolio investment	223,620.4	381,019.4	437,806.0	487,994.5	544,846.6
- equity securities	140,788.6	208,872.1	220,495.8	241,594.8	269,872.0
- debt securities	82,831.8	172,147.3	217,310.2	246,399.7	274,974.6
Financial derivatives	19,448.3	31,806.1	31,868.4	36,444.7	43,021.3
Other investment	659,916.0	680,908.1	749,407.9	787,272.0	872,046.9
long-term	360,279.2	373,456.4	417,645.7	448,883.2	475,477.0
- CNB	96.1	70.2	47.8	27.2	18.9
- commercial banks	58,056.3	52,020.8	51,639.8	62,263.6	74,680.5
- government	22,456.0	32,065.4	52,322.1	61,236.4	63,917.1
- other sectors	279,670.8	289,300.0	313,636.0	325,356.0	336,860.5
short-term	299,636.8	307,451.7	331,762.2	338,388.8	396,569.9
- CNB	22.8	866.5	5,926.5	1,779.0	646.9
- commercial banks	208,534.0	185,025.2	201,315.7	193,934.8	242,853.0
- government	—	—	—	—	—
- other sectors	91,080.0	121,560.0	124,520.0	142,675.0	153,070.0
Net investment position	-527,483.7	-824,994.7	-835,242.5	-1,034,016.8	-1,039,654.8

1) Preliminary data

EXTERNAL DEBT

in CZK millions

	2003 31 Dec.	2004 31 Dec.	2005 31 Dec.	2006 31 Dec.	2007[1] 30 Jun.
Debt in convertible currencies	895,139.6	1,011,807.9	1,142,180.3	1,217,001.7	1,312,546.5
of which:					
Long-term	535,995.9	667,327.6	783,533.1	844,844.5	890,750.2
by debtor					
- CNB	96.1	70.2	47.8	27.2	18.9
- commercial banks	73,276.4	64,346.5	65,418.9	76,426.6	93,177.5
- government	69,029.9	147,729.1	221,003.4	246,569.8	269,900.5
- other sectors	393,593.5	455,181.8	497,063.0	521,820.9	527,653.3
by creditor					
- foreign banks	251,535.3	269,081.3	276,594.3	304,855.9	325,874.4
- government institutions	—	—	9,636.0	9,555.5	8,686.0
- multilateral institutions	83,779.6	84,862.4	105,187.7	109,106.6	109,767.5
- suppliers and direct investors	109,287.9	143,301.2	170,586.6	170,625.0	168,700.0
- other investors	91,393.1	170,082.7	221,528.5	250,701.5	277,722.3
Short-term	359,143.7	344,480.3	358,647.2	372,157.2	421,796.3
by debtor					
- CNB	22.8	866.5	5,926.5	1,779.0	646.9
- commercial banks	210,017.0	188,495.9	202,616.9	196,648.2	245,483.1
- government	710.0	3,334.6	1,102.4	350.0	620.0
- other sectors	148,393.9	151,783.3	149,001.4	173,380.0	175,046.3
by creditor					
- foreign banks	218,436.1	202,372.6	197,820.7	192,668.8	221,204.2
- multilateral institutions	—	861.3	5,918.8	1,768.2	643.6
- suppliers and direct investors	105,563.9	98,611.3	102,235.6	123,495.0	117,570.0
- other investors	35,143.7	42,635.1	52,672.1	54,225.2	82,378.5
Debt in non-convertible currencies	—	—	—	—	—
of which:					
- long-term	—	—	—	—	—
- short-term	—	—	—	—	—
Total external debt	895,139.6	1,011,807.9	1,142,180.3	1,217,001.7	1,312,546.5
of which:					
- long-term	535,995.9	667,327.6	783,533.1	844,844.5	890,750.2
- short-term	359,143.7	344,480.3	358,647.2	372,157.2	421,796.3
Total long-term debt	535,995.9	667,327.6	783,533.1	844,844.5	890,750.2
of which:					
- IMF loans	—	—	—	—	—
- liabilities of government sector and guaranteed by government, and liabilities of entities majority owned by state	222,120.9	272,202.1	322,498.4	338,187.3	364,053.6
- liabilities of entities with majority private capital	313,875.0	395,125.5	461,034.7	506,657.2	526,696.6

Table 15

EXCHANGE RATES

in CZK; foreign exchange market rates

A. NOMINAL RATE	2003 1 - 12	2004 1 - 12	2005 1 - 12	2006 1 - 12	2007 7 - 9
CZK exchange rate against selected currencies					
- annual/quarterly averages					
1 EUR	31.84	31.90	29.78	28.34	27.92
1 USD	28.23	25.70	23.95	22.61	20.33
100 SKK	76.75	79.69	77.15	76.16	83.17
	12	**12**	**12**	**12**	**9**
- monthly averages					
1 EUR	32.31	30.65	28.98	27.78	27.57
1 USD	26.32	22.87	24.44	21.02	19.87
100 SKK	78.57	78.81	76.51	79.44	81.51
	31 Dec.	**31 Dec.**	**31 Dec.**	**29 Dec.**	**27 Sep.**
- last day of the month					
1 EUR	32.41	30.47	29.01	27.50	27.61
1 USD	25.65	22.37	24.59	20.88	19.47
100 SKK	78.71	78.63	76.57	79.86	81.50

B. NOMINAL EFFECTIVE RATE	2003	2004	2005	2006	2007 9
CZK nominal effective exchange rate (percentages)					
(2005=100)					
weights - foreign trade turnover	94.0	94.3	100.0	104.6	107.5
weights - foreign trade turnover SITC 5-8	93.8	94.2	100.0	105.0	107.9

Drawing on CZSO statistics on the geographical and commodity structure of foreign trade for 2005, 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	2003	2004	2005	2006	2007 8
CZK real effective exchange rate (percentages)					
(2005=100)					
a) industrial producer prices					
weights - foreign trade turnover	93.1	95.8	100.0	102.0	105.2
weights - foreign trade turnover SITC 5-8	92.6	95.5	100.0	102.3	105.8
b) consumer prices					
weights - foreign trade turnover	95.4	95.3	100.0	104.3	106.1
weights - foreign trade turnover SITC 5-8	94.7	94.9	100.0	104.7	106.9

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
	2003 1 - 12	2004 1 - 12	2005 1 - 12	2006 1 - 12	2007 1 - 9
STATE BUDGET					
Total revenue	699.7	769.2	866.5	923.1	748.5
Tax revenue	667.5	716.7	770.4	801.6	652.3
Taxes on income, profits and capital gains	172.9	180.7	195.0	187.1	161.7
Domestic taxes on goods and services	198.4	223.2	250.4	266.1	209.1
- value-added taxes	125.6	140.4	146.8	153.5	119.6
- excises	72.9	82.8	103.6	112.6	89.6
Taxes on property	8.8	10.4	8.1	8.5	7.2
Social and health security contributions and payroll taxes	272.4	293.3	311.2	333.7	268.5
Non-tax and capital incomes and received subsidies	32.2	52.5	96.1	121.5	96.2
Total expenditure	808.7	862.9	922.8	1020.6	712.2
Current expenditure	745.4	796.8	840.8	912.1	657.4
Capital expenditure	63.3	66.1	82.0	108.5	54.9
Public budgets (balance in IMF GFS methodology)	-127.7	-89.4	0.6	-148.9	__
state budget	-104.9	-65.0	-61.1	-107.0	36.3
local budget	-2.9	-8.9	7.8	-3.9	__
state financial assets	__	__	__	__	__
state funds	6.9	-11.7	-0.5	-6.6	__
Land Fund	-0.1	0.2	1.6	0.2	__
National Property Fund	-27.4	-4.2	51.5	-29.9	__
health insurance companies	0.1	0.2	0.5	0.6	__
others	0.6	0.0	0.8	-2.3	__

Table 17

CAPITAL MARKET

last day of the month in points

A. STOCK MARKET INDICES	2003 12	2004 12	2005 12	2006 12	2007 9
BCPP					
PX	659.1	1,032.0	1,473.0	1,588.9	1,816.3
PX-GLOB	816.9	1,232.7	1,811.3	1,987.4	2,263.0
RM-SYSTÉM					
PK-30	947.5	1,443.5	2,365.0	2,595.3	3,213.6

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	2003 12	2004 12	2005 12	2006 12	2007 9
BCPP					
Monthly trade volumes	98,640.0	90,610.5	96,160.5	112,400.0	115,023.8
of which:					
a) shares	28,296.0	46,210.3	56,180.3	58,915.7	70,835.6
b) bonds	70,344.0	44,400.2	39,980.2	53,484.3	44,188.2
RM-SYSTÉM					
Monthly trade volumes	1,103.0	335.8	286.7	523.0	575.8
of which:					
a) shares	1,082.5	332.7	220.9	440.2	574.5
b) units	3.7	3.1	0.0	1.1	1.3
c) bonds	16.8	0.0	65.8	81.7	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	—	—
2007					
1 June	2.75	1.75	3.75	—	—
27 July	3.00	2.00	4.00	—	—
31 August	3.25	2.25	4.25	—	—

Table 19

MACROECONOMIC AGGREGATES

in CZK millions; annual percentage changes; constant 2000 prices

	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q1 - 4	2007 Q2
Gross domestic product					
- in CZK millions	2,367,818	2,476,074	2,636,842	2,850,199	758,969
- percentages	3.6	4.6	6.5	6.4	6.0
Final consumption					
- in CZK millions	1,817,625	1,837,528	1,882,101	1,945,651	501,833
- percentages	6.3	1.1	2.4	3.4	3.9
of which:					
Households					
- in CZK millions	1,258,158	1,295,066	1,326,419	1,384,675	366,394
- percentages	6.0	2.9	2.4	4.4	6.5
Government					
- in CZK millions	545,999	528,962	541,201	547,292	133,253
- percentages	7.1	-3.1	2.3	1.1	-1.6
Non-profit institutions					
- in CZK millions	13,362	14,579	15,563	16,249	3,989
- percentages	6.2	9.1	6.7	4.4	-0.2
Gross capital formation					
- in CZK millions	709,600	773,884	772,398	863,074	257,100
- percentages	-1.4	9.1	-0.2	11.7	10.3
of which:					
Fixed capital					
- in CZK millions	689,117	716,285	732,585	788,278	208,834
- percentages	0.4	3.9	2.3	7.6	4.2
Changes in inventories					
- in CZK millions	15,642	54,674	37,078	71,707	47,433
Acquisitions less disposals of valuables					
- in CZK millions	4,841	2,925	2,735	3,089	833
- percentages	40.8	-39.6	-6.5	12.9	7.5
Foreign trade					
of which:					
Exports of goods					
- in CZK millions	1,479,795	1,820,657	2,033,180	2,377,490	672,902
- percentages	9.3	23.0	11.7	16.9	15.1
Exports of services					
- in CZK millions	212,807	225,335	254,244	277,344	74,224
- percentages	-4.2	5.9	12.8	9.1	4.9
Imports of goods					
- in CZK millions	1,623,393	1,929,219	2,028,041	2,343,682	661,437
- percentages	9.0	18.8	5.1	15.6	14.9
Imports of services					
- in CZK millions	235,915	263,075	273,590	308,721	80,293
- percentages	1.8	11.5	4.0	12.8	6.5
Final domestic demand					
- in CZK millions	2,506,742	2,553,813	2,614,686	2,733,929	710,667
- percentages	4.6	1.9	2.4	4.6	4.0
Aggregate domestic demand					
- in CZK millions	2,527,225	2,611,412	2,654,499	2,808,725	758,933
- percentages	4.0	3.3	1.6	5.8	6.0
Gross domestic product at current prices					
- in CZK millions	2,577,110	2,817,362	2,994,396	3,220,259	899,674
- percentages	4.6	9.3	6.3	7.5	10.2

Source: CZSO

Table 20

LABOUR MARKET

annual percentage changes

A. NATIONAL ACCOUNTS FOR THE HOUSEHOLD SECTOR	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q1 - 4	2007 Q2
Current income	5.9	4.9	4.4	6.4	7.5
of which:					
- gross operating surplus and mixed income	7.7	5.7	-0.8	2.7	3.4
- compensation of employees	5.5	5.7	6.2	6.7	7.9
- property income	5.3	-1.0	1.2	15.4	21.8
- social benefits other than social transfers in kind	3.6	3.4	4.7	8.6	7.8
- other current transfers	10.9	2.2	7.9	3.6	3.5
Current expenditure	9.5	7.5	4.5	7.7	6.7
of which:					
- property income	21.3	12.4	-5.4	40.7	19.7
- current taxes on income, wealth, etc.	12.1	7.7	0.7	0.8	-1.2
- social contributions	7.2	8.3	6.5	8.9	7.8
- other current transfers	12.5	2.8	2.5	5.1	8.8
Gross disposable income	4.3	3.6	4.3	5.8	8.0
Change in net equity of households in pension funds reserves	15.4	29.1	11.1	19.6	51.1
Individual consumption expenditure	6.5	5.6	3.3	6.0	8.6
Gross saving	-15.5	-17.8	23.0	6.2	9.1
Gross saving rate	8.03	5.89	6.57	6.60	5.78
(gross saving/gross disposable income - ratio in per cent)					

annual percentage changes

B. AVERAGE WAGES	2003 Q1 - 4	2004 Q1 - 4	2005 Q1 - 4	2006 Q1 - 4	2007 Q2
Whole-economy nominal wage	6.4	6.2	5.3	6.4	7.2
Business sector	5.5	6.3	5.3	6.7	7.6
Non-business sector	9.8	5.7	5.7	5.4	5.9
Whole-economy real wage	6.3	3.3	3.3	3.8	4.7
Business sector	5.4	3.4	3.3	4.1	5.1
Non-business sector	9.7	2.8	3.7	2.8	3.4

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	2003 12	2004 12	2005 12	2006 12	2007 9
Registered job applicants (thousands)	542.4	541.7	510.4	448.5	365.0
Unemployment rate (percentages) 1)	—	9.5	8.9	7.7	6.2

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

Source: CZSO

Table 21

PRODUCER PRICES

percentage changes

	2003	2004	2005	2006	2007 9
Industrial producer prices					
a) previous period = 100	0.1	0.6	0.0	0.2	0.1
b) same period of previous year = 100	-0.3	5.7	3.0	1.6	4.0
c) average for 2005 = 100	-8.2	-3.0	0.0	1.5	6.3
Construction work prices					
a) previous period = 100	0.2	0.4	0.2	0.3	0.5
b) same period of previous year = 100	2.2	3.7	3.0	2.9	3.8
c) average for 2005 = 100	-6.1	-2.6	0.2	3.1	7.9
Agricultural producer prices					
a) previous period = 100	0.6	0.2	-0.4	0.7	4.3
b) same period of previous year = 100	-2.9	8.1	-9.2	1.1	18.1
c) average for 2005 = 100	2.1	10.4	0.0	1.1	21.6
Market services prices					
a) previous period = 100	0.0	0.2	0.1	0.3	0.9
b) same period of previous year = 100	1.6	2.3	1.9	3.3	1.6
c) average of 2005 = 100	-1.9	0.4	0.0	3.3	5.4

Source: CZSO

Table 22

RATIOS OF KEY INDICATORS TO GDP					percentage ratios
	2002	2003	2004	2005	2006
Public budgets balance	-0.5	-5.0	-3.2	0.0	-4.6
Public debt	18.0	21.5	23.4	25.5	27.3
Debt in convertible currencies	33.0	34.7	35.9	38.1	37.8
Trade balance [1]	-2.9	-2.7	-0.5	2.0	2.1
Current account balance	-5.5	-6.2	-5.2	-1.6	-3.1
M2	67.0	68.5	65.5	66.5	68.0

Note: ratio = indicator/GDP at current prices
1) CZSO source in FOB values

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