

## Measuring financial market inflation expectations — results of the 41<sup>st</sup> measurement (September 2002)

The recent domestic and foreign events have led most analysts to review their inflation and interest rate expectations to a greater or lesser extent. By contrast, the outlook for the expectations of the long-term development of the CZK/EUR exchange rate remains relatively stable. However, the short-term exchange rate predictions have been corrected as a result of the koruna's very quick erasure of the losses recorded immediately after the floods.

### 1. Inflation

IX-02	annual CPI (%)	
	1 year	3 years
min.	2,0	2,4
average	3,1	2,9
max.	3,8	3,5

The September measurement saw a break in the almost year-long gradual decline (or stagnation) in inflation expectations. There was a sizeable increase in average expectations at the one-year horizon. Only a small minority of the analysts left their forecasts at this horizon at the same level or decreased them further. At the longer horizon (3Y), conversely, the average predicted annual rise in consumer prices decreased slightly. The main reason for the expected

faster inflation growth in the coming year is a presumption of higher food price inflation (due to the August floods and to this year's worse harvest) and planned tax changes. Potential inflationary risks are also associated with geo-political developments and the ensuing prospect of growth in oil prices. By contrast, a strong koruna and a slow recovery of the world economy should have a disinflationary effect. Consumer demand and the deteriorating situation on the domestic labour market may also play a role.

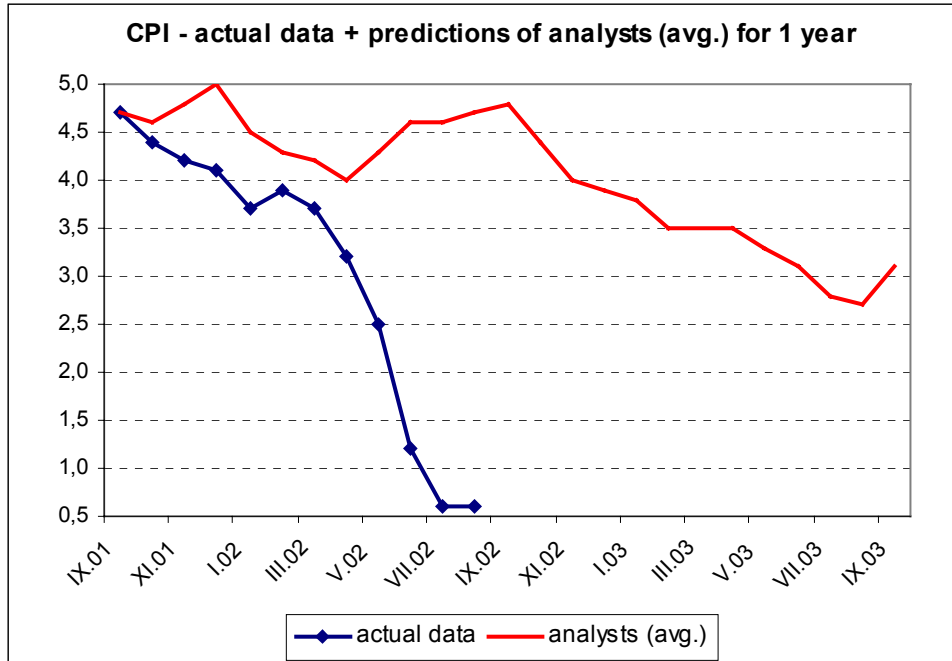
The increase in the inflation forecast at a shorter horizon (1Y) was due mainly to a shift in the predictions of the domestic analysts, who increased their average expectation of consumer price inflation for next September to 3.3% (from 2.9% in August). The foreign analysts increased their September forecast to a lesser extent, to 2.8% (from 2.5% in August). The predictions of the domestic analysts range between 2.3% and 3.8% and those of the foreign analysts between 2.0% and 3.5%.

The estimate of annual consumer price inflation at the three-year horizon decreased by 0.1% compared with August to 2.9%. This decrease was due to very moderate shifts in the predictions in both groups. In the group of domestic analysts the shift is statistically insignificant (the average after rounding being 3.0% for both August and September), whereas in the group of foreign analysts the difference is 0.1% (3.0% in August and 2.9% in September). The range of the predictions remains greater within the group of domestic analysts (2.4%–3.5%) than in the group of foreign analysts (2.7%–3.0%).

#### **The main inflation factors and risks:**

- Fiscal policy
- A pick-up in food price inflation
- Planned tax changes
- Oil prices on world markets

Prediction for Month of prediction	annual CPI	
	1 Y %	3 Y %
IX-01	4,8	3,6
XII-01	3,9	3,6
III-02	3,5	3,3
VI-02	3,1	3,0
VII-02	2,8	3,0
VIII-02	2,7	3,0
IX-02	3,1	2,9



## 2. Interest rates

	1W PRIBOR (%)		12M PRIBOR (%)		12M/1W spread (%)		5Y IRS (%)		CR 6,55/11 yield		analysts' opinion 2W repo rate
	1 month	1 year	1 month	1 year	1 month	1 year	1 month	1 year	1 month	1 year	
<b>IX-02</b>											
<b>min.</b>	2,8	3,2	2,8	3,2			3,5	4,4	4,4	5,0	2,50
<b>average</b>	2,9	3,5	3,0	3,7	0,0	0,2	3,9	4,6	4,6	5,2	2,93
<b>max.</b>	3,1	3,8	3,1	4,3			4,2	4,9	4,7	5,6	3,00

The expected interest rate levels have again shifted downwards. The expected CR 6.55/11 yield remained the same as in the previous measurement. The analysts for the most part expect stable interest rates in the immediate future, owing to increasing doubts regarding the recovery of the world economy and uncertainties regarding the impact of the floods on the domestic economy. The future evolution of rates will depend on developments in the world economy and the exchange rate of the koruna. Emerging inflationary pressures should cause the CNB to tighten its monetary policy at the one-year horizon. Bond yields should track developments on world markets, and a recovery on world stock markets should act as a starting mechanism for a decline in bond prices.

The predictions for short-term rates at the one-month horizon partly reflect considerations about the likelihood of a further lowering of rates by the CNB. Most analysts regard this possibility as less likely, putting it in the context of a potential worsening of macroeconomic indicators around the world and a further sizeable appreciation of the koruna. The expected level of the longer end of the curve and the CR 6.55/11 yield at the one-month horizon differ little from the current situation on the market.

The average predictions for short-term rates at the one-year horizon reflect expectations of a gradual tightening of CNB monetary policy by around 50 basis points (1W PRIBOR: foreign: 3.5%, range 3.3%–3.8%; domestic: 3.5%, range 3.2%–3.8%; 1Y PRIBOR: foreign: 3.5%, range: 3.2%–4.0%, domestic: 3.8%, range 3.4%–4.3%).

Owing to the shifts in the inflation expectations of the domestic analysts, their predictions for the expected level of the koruna 5Y IRS and the CR 6.55/11 yield at the one-year horizon are higher as well (5Y IRS: foreign: 4.5%, range: 4.4%–4.6%; domestic: 4.7%, range 4.4%–4.9%; CR 6.55/11 yield: foreign: 5.1%, range 5.0%–5.3%; domestic: 5.3%, range: 5.0%–5.6%).

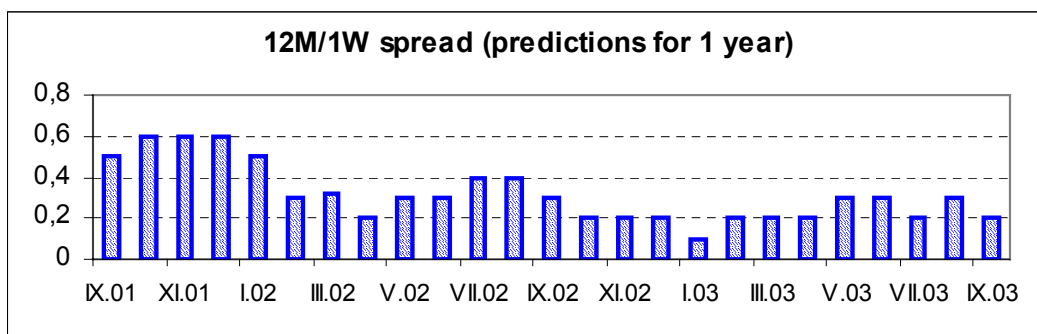
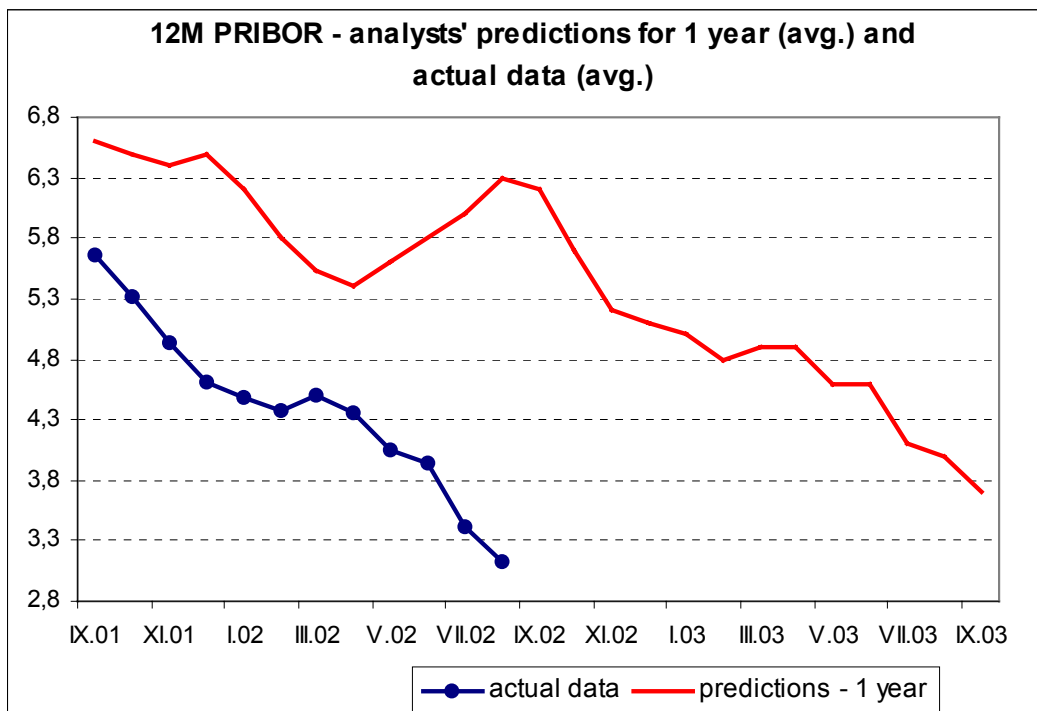
The average two-week repo rate setting deemed appropriate is 2.93%. Whereas all of the domestic analysts (and most of the foreign analysts) consider the appropriate repo rate level to be 3%, two foreign analysts prefer lower values (2.5 % and 2.75%).

Prediction for Month of prediction	1W PRIBOR		12M PRIBOR		12M/1W spread		5Y IRS		CR 6,55/11 yield	
	1 M %	1 Y %	1 M %	1 Y %	1 M %	1 Y %	1 M %	1 Y %	1 M %	1 Y %
IX-01	5,4	5,9	5,8	6,2	0,4	0,3	6,4	6,7	6,7	7,0
XII-01	4,7	4,9	4,7	5,1	0,0	0,2	5,3	5,6	5,6	5,8
III-02	4,3	4,6	4,5	4,9	0,2	0,2	5,3	5,7	5,5	5,9
VI-02	3,8	4,2	4,0	4,6	0,2	0,3	5,0	5,5	5,3	5,8
VII-02	3,4	3,9	3,5	4,1	0,1	0,2	4,3	5,0	4,9	5,5
VIII-02	3,0	3,7	3,1	4,0	0,1	0,3	4,1	4,8	4,7	5,2
IX-02	2,9	3,5	3,0	3,7	0,0	0,2	3,9	4,6	4,6	5,2

*\*/ expected yield of CR 6,40/10*

**Actual values of indicators on the day of deadline for forecasts**

	1T PRIBOR	12M PRIBOR	spread 12M/1T	5R IRS	výnos CR 6,55/11	analysts - avg. 2W repo rate
10.9.2002	3,03	3,03	0	3,95	4,65	2,93



**3. Exchange rate**

IX-02	EUR/CZK	
	1 month	1 year
<b>min.</b>	29,20	28,30
<b>average</b>	30,19	29,51
<b>max.</b>	31,00	31,00

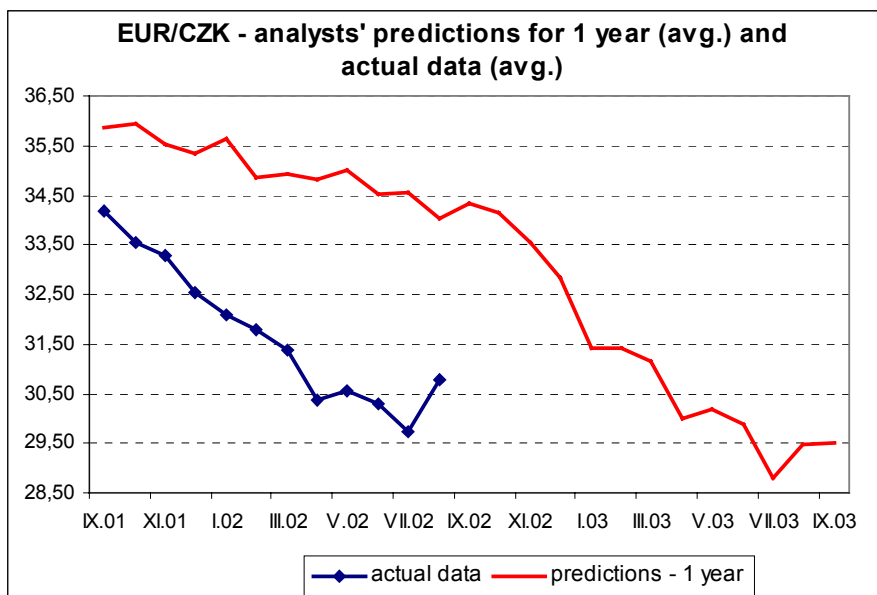
Exchange rate - fixing on the day of deadline for forecasts

<b>10.9.2002</b>	29,92
------------------	-------

Prediction for Month of prediction	exchange rate EUR/CZK	
	1 month	1 year
IX-01	34,05	34,32
XII-01	32,94	32,85
III-02	31,62	31,15
VI-02	30,64	29,90
VII-02	29,10	28,80
VIII-02	31,21	29,49
IX-02	30,19	29,51

Following its temporary depreciation during the August floods, the koruna quickly recovered as the uncertainty and concerns regarding the aftermath of the flooding were outweighed by speculation on an inflow of funds from foreign reinsurers. The analysts predict that the koruna will slowly appreciate in the months ahead. They believe that any stronger appreciation of the koruna will be prevented by the CNB and also, in the next few months, by a foreseen weaker inflow of FDI into the Czech Republic and a probable worsening of the trade and current account balances.

The average estimate for the exchange rate at the one-month horizon is CZK 30.19/EUR. The foreign analysts made larger corrections to their predictions of the koruna's short-term exchange rate than did the domestic analysts. The foreign analysts' expectations of the impact of the floods on the domestic currency had been more sceptical in the previous measurement (forecast in September: CZK 29.93/EUR, the range of the estimates being CZK 29.20–CZK 30.50, whereas in August their average estimate had been CZK 31.47/EUR). The average estimate of the domestic analysts is CZK 30.37/EUR in September, with estimates ranging between CZK 29.50 and CZK 31.00, compared with the August prediction of CZK 30.90/EUR.



Most of the analysts concur that in the long run, factors leading to appreciation of the domestic currency should prevail. A recovery of the global economy and approaching EU entry should bring about increased FDI inflow. In the longer term, the appreciation trend should also be bolstered by expected inflow of portfolio investment.

The average estimate of the CZK/EUR rate for the one-year horizon is 29.51. As in August, the foreign analysts' view is more conservative. Their prediction of the rate at the one-year horizon is CZK 29.63/EUR (ranging between CZK 29.00 and CZK 31.00). The average in the group of domestic analysts is CZK 29.43/EUR (ranging between CZK 28.30 and CZK 30.60).

Prague, 13 September 2002