

Measuring financial market inflation expectations — results of the 42nd measurement (October 2002)

Following the September increase in the inflation forecast at the one-year horizon, the analysts substantially decreased their predictions in October. The reasons were the government's failure to push through its proposed tax adjustments, the surprisingly low September CPI outturn and the continuing pessimism regarding a global economic recovery. The weakening growth in the domestic economy together with the absence of inflationary pressures resulted in expectations of a further easing of CNB monetary policy and consequently in a decline in the level of expected rates. A consensus expectation of an appreciation of the koruna still prevails in the long-term outlook, but the rate of that appreciation could slow, particularly in the opinion of the foreign analysts.

1. Inflation

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

After a temporary increase in September, there was a further decline in the inflation forecasts for the one-year horizon in October. The main reason for this is the government's failure to push through its proposed tax adjustments and the ensuing restriction of the planned changes to an increase in excise duties on alcohol and cigarettes only. Other reasons include the surprisingly low CPI outturn in September, the strong koruna, the decreasing growth in the domestic

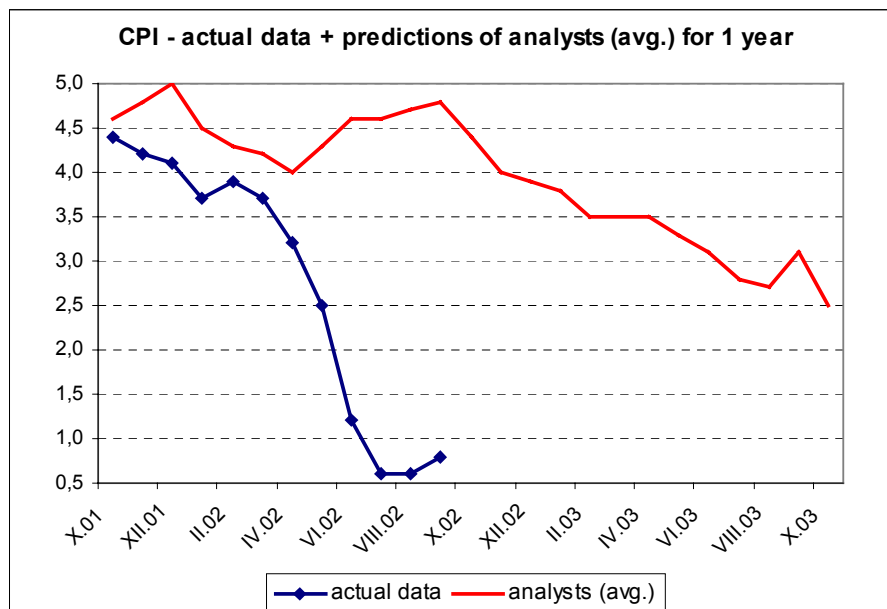
economy and the weakness in the US and eurozone economies. The analysts therefore do not see any serious inflation impulses at present. Food prices should start growing in the months ahead but should not have any substantial effect on the headline inflation rate. The strong koruna and weak demand should continue to have a disinflationary effect. Oil price growth on world markets is the only risk factor going forward; the results of wage bargaining will be important as well. At the three-year horizon, the prediction remains at the September level, reflecting an assumption that the growth in the Czech economy will get nearer to its potential level in the years ahead.

In October, the domestic analysts' average expectation for consumer price inflation at the one-year horizon decreased to 2.7% from 3.3% in September. Their predictions range between 2.0% and 3.4%. The foreign analysts decreased their forecast to 2.3% (from 2.8% in September). Their predictions range between 1.5% and 2.7%.

The estimate of annual consumer price inflation at the three-year horizon remained at 2.9%, as in September. This prediction is identical for both groups of analysts, with a slightly greater range in the predictions being seen, as in previous months, within the group of domestic analysts (the foreign analysts' estimates ranging between 2.5% and 3.5%, the average being 2.9%, and those of domestic analysts between 2.3% and 3.5%, the average also being 2.9%).

The main inflation factors and risks:

- Oil prices on world markets



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

2. Interest rates

X-02	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	
min.	2,5	2,5	2,4	2,6			3,1	3,4	3,9	4,0	2,50
average	2,7	3,1	2,7	3,5	0,0	0,3	3,5	4,2	4,1	4,8	2,71
max.	2,9	3,7	2,9	4,2			3,7	4,5	4,3	5,4	3,00

Most analysts believe that the low inflation expectations (the risk of a deflationary environment has even been mentioned) allow for a further reduction in CNB key rates of 25–50 basis points. Accordingly, the expected short-term and long-term interest rate levels have again shifted downward at both time horizons. The analysts expect that after a likely easing of CNB monetary policy at the end of October, interest rates could remain stable for quite a long period. A gradual return of inflation to the CNB's target band next year, a recovery in foreign demand and higher GDP growth will, in the view of most respondents, generate the need for a 25–50 basis point increase in rates in the second half of next year. The level of long-term rates and bond yields should be affected primarily by the behaviour of the eurozone markets.

The prediction for the 1W PRIBOR at the one-month horizon reflects an assumed repo rate reduction of 25–50 basis points by the CNB at the end of October. These expectations are also manifest in the short-term forecasts for the 1Y PRIBOR, the 5Y IRS and the SD 6.55/11 yield, since the predicted values of these indicators are slightly below their current levels on the market at the time of the prediction.

The average predictions for short-term rates at the one-year horizon reflect the above-mentioned expectations of a tightening of CNB monetary policy next year (1W PRIBOR: foreign: average 3.1%, range 2.5%–3.5%; domestic: average 3.1%, range 2.5%–3.7%; 1Y PRIBOR: foreign: average 3.6%, range 3.3%–4.0%, domestic: average 3.4%, range 2.6%–4.2%). Long-term rates and yields should track movements on world markets, in particular the German bond market. Most analysts expect that with the recovery of the US and eurozone economies, the rising inflation in the Czech Republic and with the growth in foreign demand, long-term rates and yields should be higher than their current levels at the one-year horizon (5Y IRS: foreign: average 4.0%, range: 3.4%–4.4%; domestic: average 4.3%, range 4.0%–4.5%; CR 6.55/11 yield: foreign: average 4.7%, range 4.0%–5.2%; domestic: average 4.9%, range: 4.4%–5.4%).

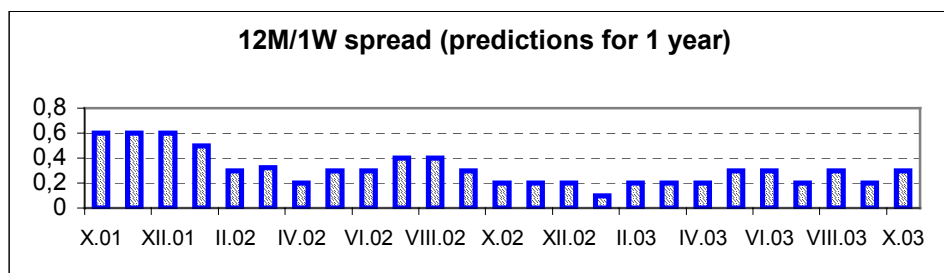
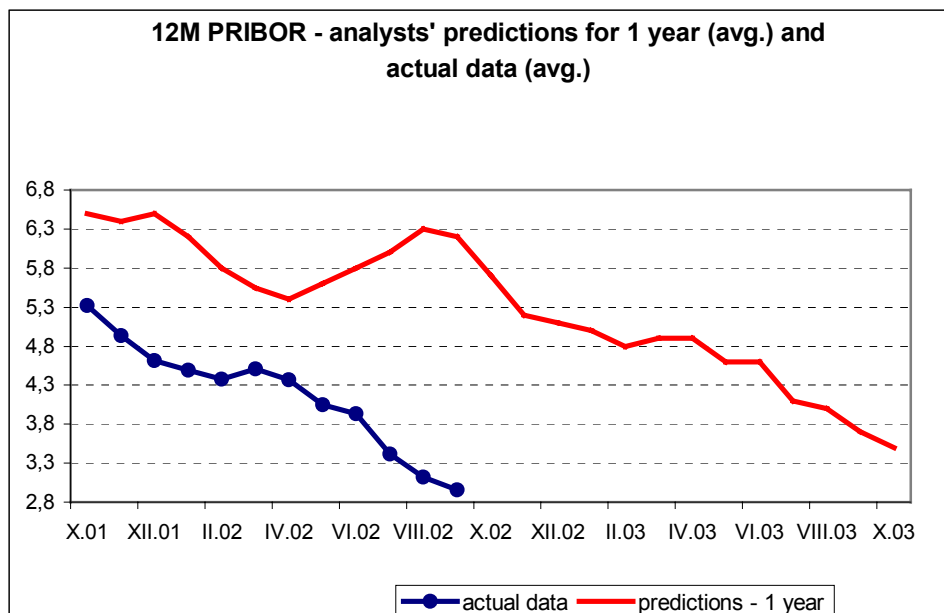
The average two-week repo rate setting deemed appropriate is 2.71%. Whereas most domestic analysts consider the optimal repo rate level to be 2.75% (average within the group 2.79%, range 2.5%–3%), the foreign analysts prefer 2.5% (average 2.6%, range 2.5%–2.75%).

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
	%		%		%		%		%	
X-01	5,3	5,6	5,4	5,7	0,1	0,2	5,8	6,3	6,2	6,6
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
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
X-02	2,7	3,1	2,7	3,5	0,0	0,3	3,5	4,2	4,1	4,8

**/ 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
9.10.2002	3,03	2,76	-0,26	3,57	4,22	2,71



3. Exchange rate

X-02	EUR/CZK	
	1 month	1 year
min.	30,00	28,00
average	30,63	29,65
max.	31,20	32,00

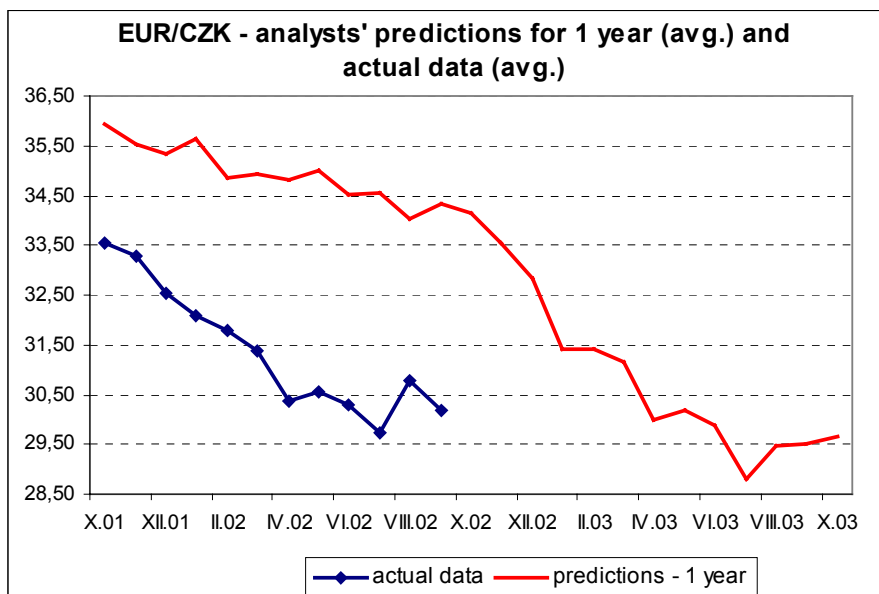
Prediction for Month of prediction	exchange rate	
	1 month	1 year
EUR/CZK		
X-01	33,78	35,93
XII-01	32,94	32,85
III-02	31,62	31,15
VI-02	30,64	29,90
VIII-02	31,21	29,49
IX-02	30,19	29,51
X-02	30,63	29,65

Exchange rate - fixing on the day of deadline for forecasts

9.10.2002	30,67
-----------	-------

The prediction of the CZK/EUR rate at the one-month horizon is most affected by speculation of a lowering of interest rates by the CNB at the end of October. The wider negative interest rate differential vis-à-vis the eurozone should lead to a temporary weakening of the koruna. Another risk factor for the koruna is the potential negative result of the Irish referendum on ratification of the Nice Treaty to be held on 19 October.

The average estimate for the exchange rate at the one-month horizon is CZK 30.63/EUR, with the foreign analysts expecting a more substantial depreciation than the domestic analysts (foreign: average CZK 30.87/EUR, range CZK 30.35–CZK 31.20, domestic: average CZK 30.46/EUR in September, range CZK 30.00–CZK 30.70).



Most of the analysts still expect the koruna to appreciate in the long run. The reasons they give for this opinion are a renewed narrowing of the negative differential in connection with the expected reduction of ECB rates in the near future, a gradual recovery of the global economy, and the approaching EU accession and ensuing renewed increase in FDI inflow. On the other hand, there also exists an opinion that the phase of the koruna's strengthening is over and that from now we shall see a moderate depreciation to CZK 32/EUR in October 2003.

The average estimate of the CZK/EUR rate for the one-year horizon is 29.65 in October. As in the previous two months, the foreign analysts' view is more conservative. Their prediction of the rate at the one-year horizon is CZK 30.33/EUR (ranging between CZK 29.00 and CZK 32.00). The average in the group of domestic analysts is CZK 29.17/EUR (ranging between CZK 28.00 and CZK 30.40).

Prague, 16 October 2002