

## Measuring financial market inflation expectations - results of the 39<sup>th</sup> measurement (July 2002)

The July measurement signals a more marked decline in the analysts' inflation expectations. The macroeconomic data testify to low inflationary pressures. Prices are being affected significantly by the continuing strengthening of the koruna. The predicted levels of short-term and long-term rates are being strongly affected by the change in inflation expectations and by the conviction of the market that the CNB will further ease monetary policy at the end of July. In the predictions of the koruna's future exchange rate, expectations continue to prevail that the domestic currency will continue appreciating.

### 1. Inflation

VII-02	annual CPI (%)	
	1 year	3 years
min.	2,0	2,4
average	2,8	3,0
max.	3,6	3,5

The continuing disinflation is leading the analysts towards the conviction that inflation at the one-year horizon will be within the lower half of the CNB's target range. Most think there is room for a further lowering of CNB interest rates.

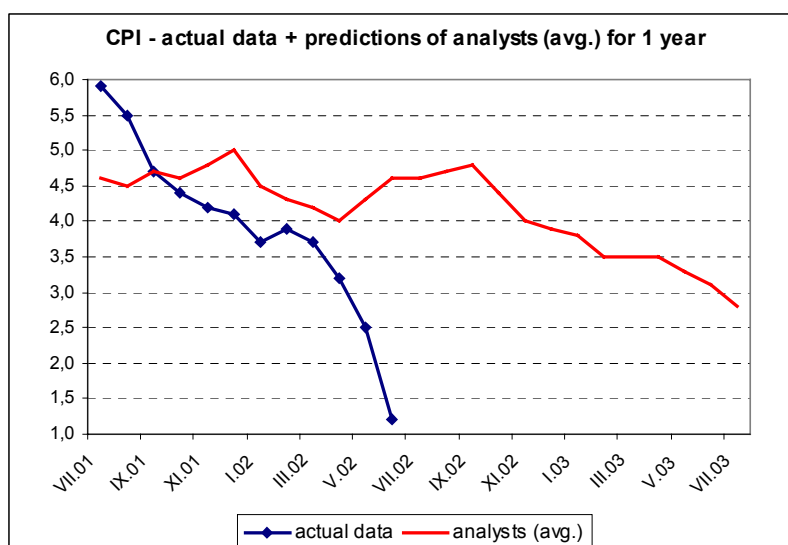
The analysts expect inflation to continue falling over the next few months. At the end of the year, when the favourable base effects fall out, inflation will start rising. However, the growth should not be dramatic. The continuing appreciation of the koruna, food price developments and the putting off of expectations of an economic recovery in the eurozone caused further downward shifts in medium-term predictions of inflation.

In the July measurement, the average value of annual CPI inflation at the one-year horizon fell to 2.8%, from 3.1% in June. Whereas the average estimate in the group of domestic analysts is 3.2%, recording only a negligible change from the previous measurement, the foreign analysts adjusted their estimate considerably to 2.4%, from 3% in June. The domestic analysts' expectations range between 2.5% and 3.6% and those of the group of foreign analysts between 2.0% and 2.8%.

For the three-year horizon, the average expectations of annual CPI inflation are 3%, the same as in June. The average predictions of the domestic analysts remained at 3% (again a negligible increase compared with June — a statistical deviation), while the foreign analysts lowered their predictions to 2.9%, from 3.0% in June. The range of the domestic analysts' predictions (2.4%–3.5%) is again wider than that of the foreign analysts (2.5%–3.5%).

#### The main inflation factors and risks:

- Expansionary fiscal policy.



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

## 2. Interest rates

VII-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.	3,3	3,5	3,3	3,5			4,0	4,6	4,6	5,1	2,75
average	3,4	3,9	3,5	4,1	0,1	0,2	4,3	5,0	4,9	5,5	3,29
max.	3,8	4,5	4,0	4,8			4,7	5,5	5,1	5,8	4,00

The expected level of short-term and long-term interest rates declined considerably for the both time horizons in comparison with June. According to most of the analysts, the lower inflation forecasts and the appreciation of the koruna allow further cuts in CNB key rates. The current market rates reflect strong expectations that the CNB will lower the repo rate by 50 basis points at the end of July. This is visible in the average rate levels expected by the analysts at the one-month horizon. A further rise in rates is not expected until next year and will depend on the intensity of the medium-term inflationary risks and the further development of the koruna's exchange rate. Long-term rates and bond yields could be affected by concerns over the high state budget deficit in the years ahead.

The predictions for short-term rates at the one-year horizon reflect the expectations of a gradual tightening of CNB monetary policy next year. The average predictions of the foreign analysts are 0.1%–0.2% lower than those of the domestic analysts, owing to lower expected inflation. The range of predictions is also slightly narrower (1W PRIBOR: foreign: 3.8%, range 3.5%–4.3%, domestic: 4.0%, range 3.6%–4.5%; 1Y PRIBOR: foreign: 4.1%, range 3.5%–4.4%, domestic: 4.2%, range 3.7%–4.8%).

For the predictions for long-term koruna rates and yields at one year the situation is similar. The average expectations of the foreign analysts are also rather lower than those in the group of domestic analysts (5Y IRS: foreign: 4.8%, range 4.6%–5.3%; domestic: 5.0%, range 4.7%–5.5%; SD 6.55/11 yield: foreign: 5.5%, range 5.1%–5.8% ; domestic: 5.5%, range 5.2%–5.8%).

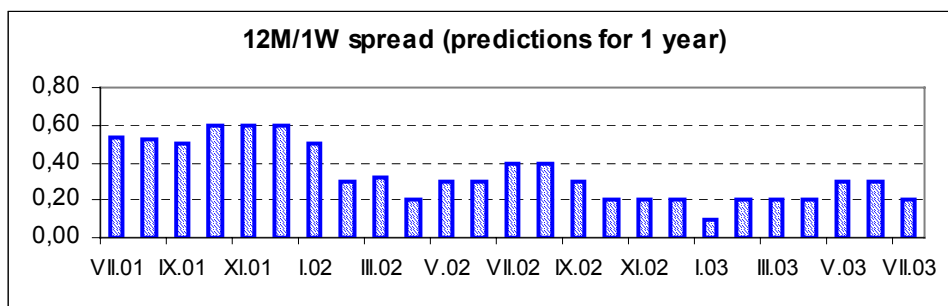
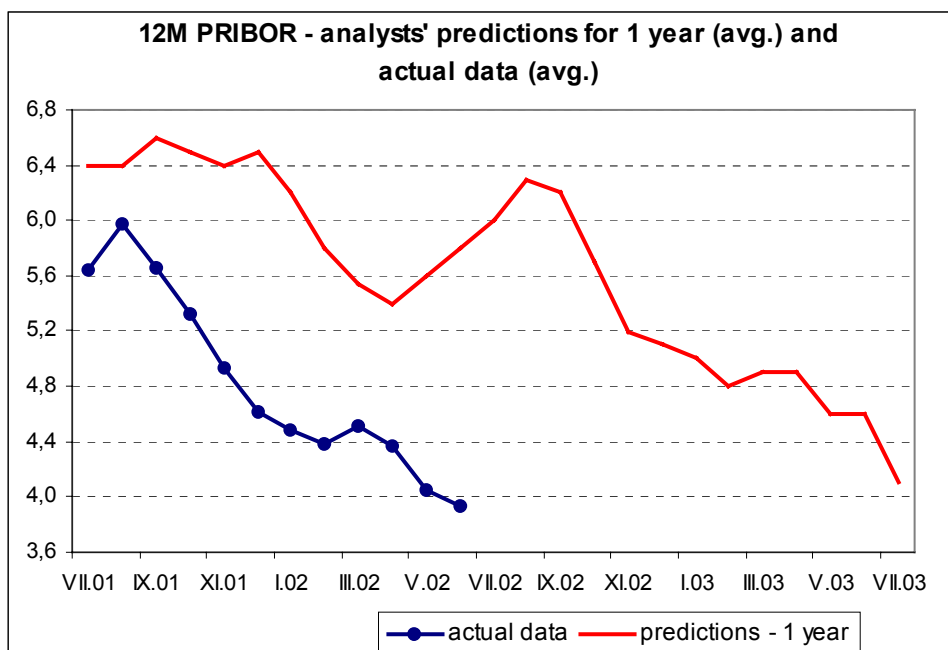
The average appropriate 2W repo rate setting shifted to 3.29% in July from 3.77% in June, with the analysts' opinions ranging between 2.75% and 4.00% (compared with 3.25% and 4.25% in June). The averages in the groups of foreign and domestic analysts are equal at 3.29%. However, the range for the group of domestic analysts (3.00%–3.50%) is considerably narrower than that for the foreign analysts (2.75% - 4.00%).

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 %
VII-01	5,1	5,6	5,4	6,0	0,3	0,4	6,4	6,9	6,8	7,2
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
V-02	3,8	4,3	4,0	4,6	0,2	0,3	5,1	5,5	5,3	5,7
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

\*/ 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
9.7.2002	3,75	3,46	-0,22	4,42	4,88	3,29



### 3. Exchange rate

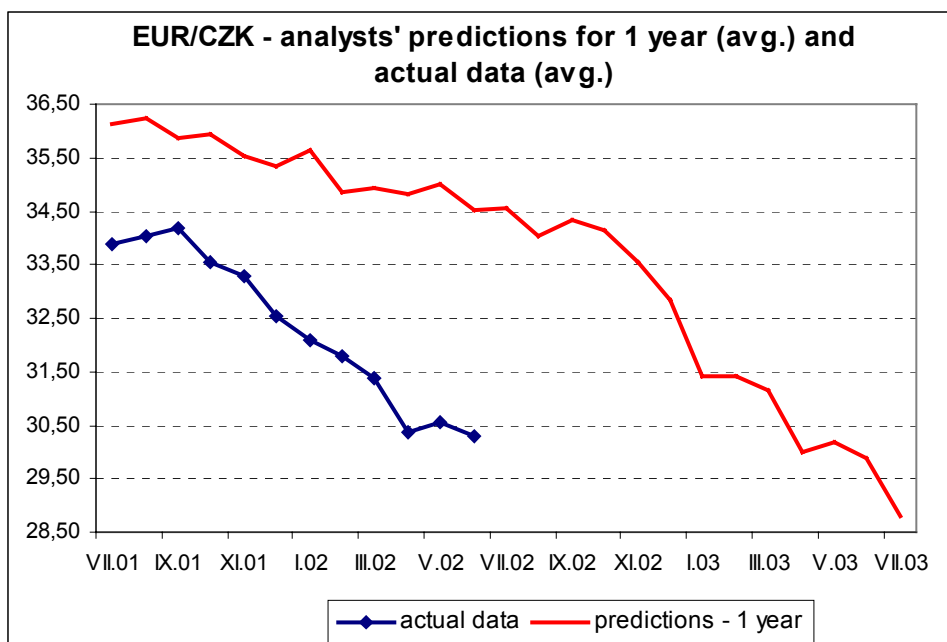
VII-02	EUR/CZK	
	1 month	1 year
min.	28,75	28,00
average	29,10	28,80
max.	29,60	30,50

Prediction for Month of prediction	exchange rate 1 month 1 year EUR/CZK	
	1 month	1 year
VII-01	34,03	34,39
IX-01	34,05	34,32
XII-01	32,94	32,85
III-02	31,62	31,15
V-02	30,73	30,18
VI-02	30,64	29,90
VII-02	29,10	28,80

Almost all the analysts surveyed have changed their predictions for the koruna's exchange rate. The differences compared with the expectations in June are sizeable at the both time horizons.

The average prediction for the 1M horizon is CZK 29.10/EUR, ranging between 28.75 and 29.60. A notable shift in this prediction compared with the June estimates (30.64) is associated with the rapid appreciation of the koruna in the last two weeks (the fixing on 9 July being 29.125). The analysts link the appreciation trend not only with domestic fundamentals, approaching accession to the EU and the inflow of foreign direct investment, but in particular with the trend on world stock markets, the sluggish pace of recovery of the world economy and also to the developments in Central European economies. The opinion prevails that the cuts in CNB key rates expected by the markets for the end of July would not significantly weaken the koruna. According to the analysts, the koruna should continue appreciating slightly. Some of the analysts expect a short-term stabilisation of the koruna's exchange

rate, but expectations of a depreciation at the short-term horizon are the exception in the group of analysts surveyed.



Expectations of a further appreciation of the koruna also show a clear prevalence at the long-term horizon. A potential weakening is being mentioned in connection with the expected slowdown in the inflow of foreign direct investment over the next year. Any delay in the Czech Republic's entry into the European Union would have a strong negative affect on the koruna.

The average estimate of the CZK/EUR rate for the one-year horizon shifted to 28.80 in July, from 29.90 in June. As with the short-term prediction, the expectations of an appreciation of the koruna are stronger with foreign analysts than with domestic analysts. In the group of foreign analysts the average estimate at the one-year horizon is CZK 28.68/EUR4 (ranging between CZK 28.00 and CZK 30.50) and in the group of domestic analysts CZK 28.92/EUR (ranging between CZK 28.00 and CZK 30.30).

Prague, 16 July 2002