Measuring financial market inflation expectations – Results of the 54th measurement (October 2003)

The October survey brought only minimal changes in the analysts' expectations as compared to September. The inflation outlook remains stable, as does the predicted short-term interest rate level. Estimates of the yield on the ten-year bond moved upwards by roughly 15 basis points. The outlook for the koruna's exchange rate at the one-year horizon also remained stable.

Eight domestic and two foreign analysts participated in this survey.

1. Inflation

X-03	annual CPI (%) 1 year	3 years
min.	0,5	2,0
average	3,0	2,7
max.	3,7	3,3

The average of the inflation expectations remains stable, although the individual forecasts show minor changes in both directions. In the months to come, inflation is expected be driven upwards by higher food, oil and other commodity prices. This rise will be bolstered by the withdrawal of the 10- and 20-heller coins. Lower prices of electricity and gas will have the opposite effect. In 2004, the price level will be affected by increases in excise duties and VAT adjustments.

The average annual consumer price inflation expected for October 2004 is 3.0%, with the domestic analysts again typically expecting a higher figure (domestic analysts: average 3.3%, range 2.7%–3.7%; foreign analysts: average 1.7%, range 0.5%–2.8%). However, a question mark hangs over the information value of the data from the foreign analysts owing to the small number of respondents in the October survey.

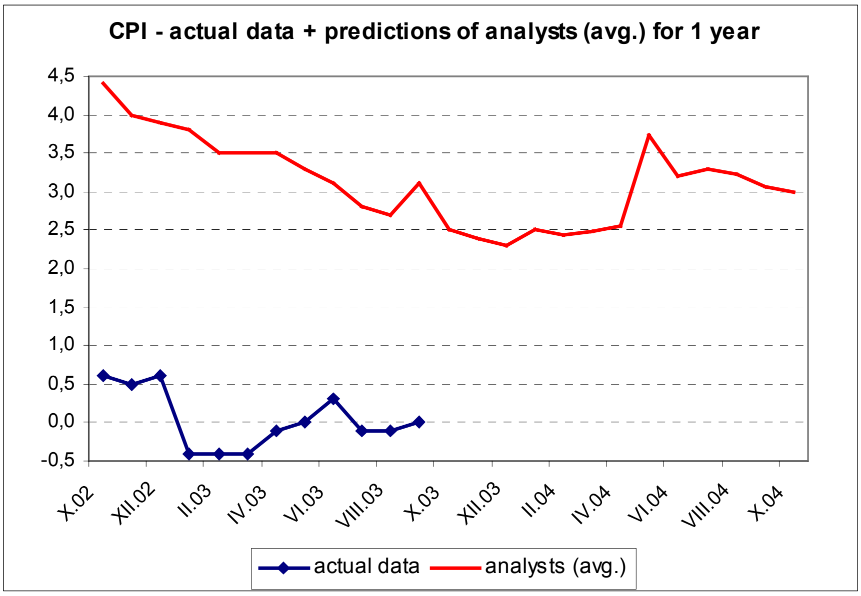
Turning to the medium-term outlook (three-year horizon), the inflation predictions remain stable, the average being 2.7% (as in September). The forecasts of the two groups are identical. The range of the estimates remains narrower than for the shorter time horizon (domestic analysts: 2.7%, range: 2.3%–3.0%; foreign analysts: average: 2.7%, range: 2.0%–3.3%). The speed and intensity of the world economic recovery remain the determining factor for inflation at the three-year horizon.

The CNB's expectation for inflation at the one-year horizon moved 0.4% below the analysts' overall average estimate in October. The CNB's forecast thus lay virtually in the middle of the interval formed by the average forecasts of the foreign and domestic analysts.

The main inflation factors and risks:

- *Food prices*
- *Prices of oil and other commodities*
- *Increases in certain taxes*
- *Fast wage growth*

Prediction for Month of prediction	annual CPI 1 Y %	3 Y %
X-02	2,5	2,9
XII-02	2,3	2,8
III-03	2,5	2,9
VI-03	3,2	2,7
VIII-03	3,2	2,6
IX-03	3,1	2,7
X-03	3,0	2,7



2. Interest rates

X-03	1W PRIBOR (%)		12M PRIBOR (%)		12M/1W spread (%)		5Y IRS (%)		CR 3,70/13 yield		analysts' opinion
	1 month	1 year	1 month	1 year	1 month	1 year	1 month	1 year	1 month	1 year	2W repo rate
min.	1,9	1,5	2,0	1,8			3,3	2,7	4,3	3,8	1,50
average	2,0	2,3	2,1	2,6	0,1	0,2	3,6	3,8	4,4	4,6	2,00
max.	2,1	2,6	2,2	2,9			3,7	4,5	4,7	5,5	2,50

The domestic analysts generally continue to believe that rates have now bottomed out. Although many of them feel that inflation is creating room for a reduction in interest rates, they consider stability at the current setting to be the most likely scenario at least until the middle of next year. The most compelling reasons for their not expecting a further reduction in the CNB's rates are as follows: GDP growth is being driven exclusively by consumption and a high growth rate of consumer loans; the fact that in conditions of a zero interest rate differential the koruna's exchange rate is far more vulnerable to depreciation and the probability of a further rate reduction by the ECB is falling; and finally there has been an autonomous easing of monetary conditions owing to a slight depreciation of the effective exchange rate in recent months. As for bonds, the analysts expect continuing pressure for yield growth, fuelled by the improving performance of the leading world economies.

The two participating foreign analysts expect a further rate reduction by the CNB – of 25–50 basis points – and a corresponding downward shift of the entire yield curve.

The predicted level of rates and yields at the one-month horizon is as usual very close to the market level at the time of survey. The average predictions of the two groups at this time horizon are the same for short-term rates and very close for long-term rates and the government bond yield. In the analysts' opinion, domestic bond yields should continue to correlate with the trends in Europe and, given the rising national debt, gradually stabilise above the Bund curve.

The average predictions for short-term rates and the 5Y IRS at the one-year horizon remained unchanged from the previous month. The predictions for the 10Y bond yield were up by about 10 basis points (1W PRIBOR – foreign analysts: average 1.6%, range 1.5%–1.7%; domestic: average 2.5%, range 2.3%–2.6%; 1Y PRIBOR – foreign: average 2.0%, range 1.8%–2.1%; domestic: average 2.8%, range 2.7%–2.9%; 5Y IRS – foreign: average 2.7%, both 2.7%; domestic: average 4.1%, range 3.7%–4.5%; CR 3.70/13 yield – foreign: average 3.9%, range 3.8%–3.9%; domestic: average 4.8%, range 4.4%–5.5%).

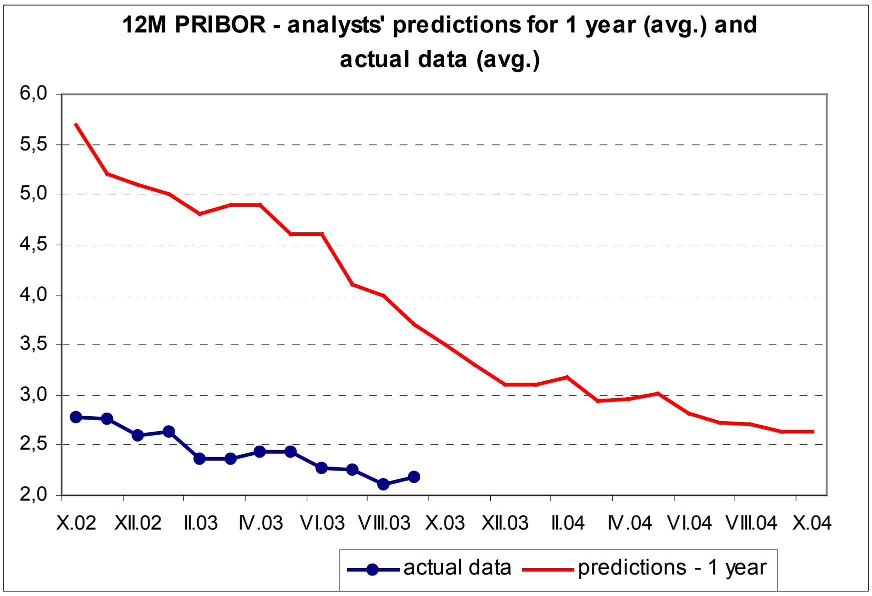
The average "appropriate setting" of the two-week repo rate was 2.00% in October (as in September). The domestic analysts' expectations again range between 2.00% and 2.50% (average within the group 2.09%), whereas the foreign analysts see this rate's optimal setting between 1.50% and 1.75% (average within the group 1.63%).

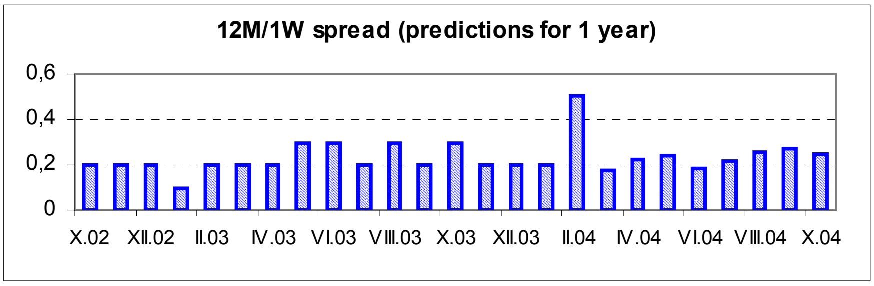
Prediction for Month of prediction	**1W PRIBOR** 1 M (%)	1 Y	**12M PRIBOR** 1 M (%)	1 Y	**12M/1W spread** 1 M (%)	1 Y	**5Y IRS** 1 M (%)	1 Y	**CR 3,70/13 yield** 1 M (%)	1 Y
X-02	2,7	3,1	2,7	3,5	0,0	0,3	3,5	4,2	*4,1*	*4,8*
XII-02	2,6	2,9	2,6	3,1	0,0	0,2	3,6	4,2	*4,2*	*4,6*
III-03	2,4	2,7	2,3	2,9	-0,1	0,2	3,0	3,8	*3,6*	*4,3*
VI-03	2,4	2,6	2,2	2,8	-0,1	0,2	2,9	3,5	*3,5*	*4,1*
VIII-03	2,0	2,4	2,1	2,7	0,1	0,3	3,4	3,9	4,2	4,5
IX-03	2,0	2,3	2,1	2,6	0,1	0,3	3,6	3,8	4,3	4,4
X-03	2,0	2,3	2,1	2,6	0,1	0,2	3,6	3,8	4,4	4,6

**/ CR 6,55/11 yield*

Actual values of indicators on the day of deadline for forecasts

	1T PRIBOR	12M PRIBOR	spread 12M/1T	5R IRS	CR 3,70/13 yield	analysts - avg. 2W repo rate
10.10.2003	2,02	2,15	0,13	3,60	4,53	2,00





3. Exchange rate

X-03	EUR/CZK 1 month	EUR/CZK 1 year
min.	31,60	30,00
average	31,92	31,28
max.	32,50	34,00

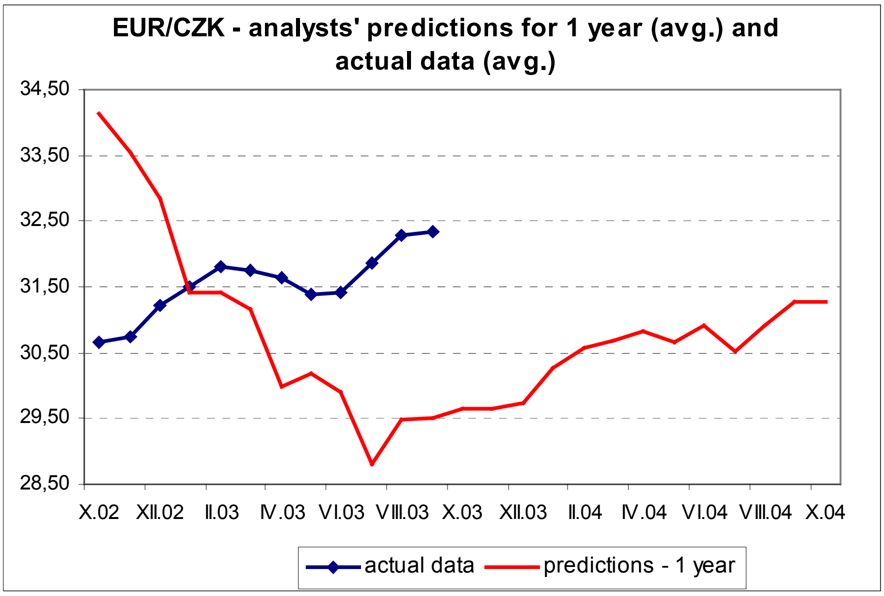
Prediction for Month of prediction	exchange rate 1 month EUR/CZK	exchange rate 1 year EUR/CZK
X-02	30,63	29,65
XII-02	30,94	29,74
III-03	31,74	30,70
VI-03	31,39	30,92
VIII-03	32,09	30,92
IX-03	32,70	31,27
X-03	31,92	31,28

Exchange rate - fixing on the day of deadline for forecasts

10.10.2003	32,095

The analysts expect the CZK/EUR rate to be within the range of 31.60–32.50 at the one-month horizon. The foreign analysts maintain their more pessimistic view, expecting the CZK/EUR rate on average at 32.05 (range: 31.60–32.50), whereas the average estimate within the group of domestic analysts is CZK 31.89/EUR (range: 31.60–32.00).

According to the analysts' comments, the passing of reform laws in the Chamber of Deputies (the lower house of the Czech parliament) has significantly reduced the political risks. These risks have not been eliminated completely, however, since the laws have to be yet debated in the Senate (upper house) and approved by the President. Another uncertainty identified by the analysts is the debate on the state budget for next year. In the event of complications, they do not rule out the possibility of the koruna weakening to CZK 32.50/EUR, but they consider it more likely that it would move between CZK 31.50 and 32.00 in the remaining months of the year.



Most of the respondents believe that the koruna will appreciate over the course of next year. The majority view is that the effects of the ongoing inflow of foreign direct investment and the global economic recovery will be felt in the medium term. On the other hand, they mention the necessity of accepting the fact that the domestic currency will at certain times be weakened by payments of dividends from the earnings of domestic firms to their foreign owners.

Only one of the respondents (foreign) expects a depreciation of the koruna at this horizon.

The average estimate for the exchange rate at the one-year horizon is CZK 31.28/EUR. The foreign analysts continue to have a more pessimistic view of the koruna's development. Their average estimate for October 2004 is CZK 32.50/EUR, with a wide prediction range (31.00–34.00), while the domestic analysts' average is CZK 30.97/EUR (range: 30.00–31.70).

Prague, 17 October 2003