

## Measuring financial market inflation expectations – Results of the 59<sup>th</sup> measurement (March 2004)

The March survey of financial market expectations saw no significant changes. The analysts still expect a pick-up in inflation during the months ahead, a tightening of monetary policy by the CNB in the second half of this year, an upward shift of yield curves, and a gradual appreciation of the koruna.

Eleven domestic analysts and one foreign analyst took part in this survey.

### 1. Inflation

III-04	annual CPI (%)	
	1 year	3 years
min.	2,0	2,3
average	3,0	2,8
max.	4,0	4,0

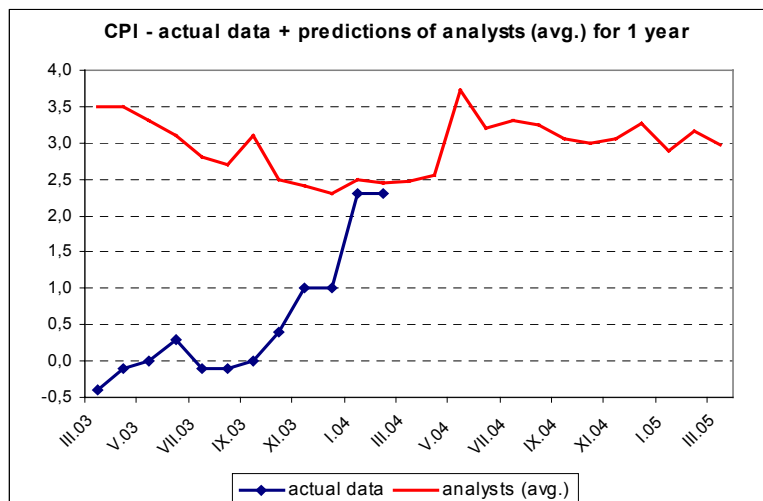
The average of the predictions for consumer price inflation at the one-year horizon fell slightly from February and is 3.0% for March 2005. The forecasts of the individual analysts range between 2.0% and 4.0%.

Consumer price inflation was flat in February. According to the analysts' comments, this suggests that retailers did not take advantage of the January rise in regulated prices and

tax adjustments to increase prices in general. In the months ahead, inflation will be driven upwards by further VAT changes and, at least up until this year's harvest, by higher food and producer prices. The May price increase generated by the moving of most items from the lower VAT rate to the basic rate will probably be moderated by a reduction of the basic VAT rate from 22% to 19%. However, these adjustments have yet to be approved by the Senate and the President. Further developments in the area of rent regulation are still uncertain.

The analysts expect inflation to calm in 2005 as the tax adjustments disappear from the statistical bases. The predictions for consumer price inflation in 2004 are based on the tax adjustments – both those already effected and those under preparation – and on the continuing food price and cost-push inflation. In 2005, however, the analysts expect the first demand-pull pressures to emerge, owing to the foreseen closing of the output gap. At the three-year horizon, the inflation predictions remain more or less stable, the analysts' average estimate being 2.8%.

Prediction for Month of prediction	annual CPI	
	1 Y %	3 Y %
III-03	2,5	2,9
VI-03	3,2	2,7
IX-03	3,1	2,7
XII-03	3,3	2,8
I-04	2,9	2,9
II-04	3,2	2,8
III-04	3,0	2,8



### 2. Gross domestic product

Prediction for Month of prediction	GDP growth at the end of	
	this year %	next year %
I-04	3,2	3,6
II-04	3,2	3,6
III-04	3,3	3,7

III-04	GDP growth at the end of	
	current year	next year
min	2,9	2,9
average	3,3	3,7
max	3,8	4,5

The majority of the analysts foresee a slight pick-up in GDP growth for 2004 as well as a change in the growth structure. Slackening household consumption due to slower real wage growth and high unemployment should be offset by rising investment activity. A positive contribution from net exports, connected with a recovery of demand in EU member states, can also be gradually counted on. The services balance should also improve.

According to the estimates, economic growth should exceed the 3% level this year (average of the predictions for 2004: 3.3%) and pick up even further next year (average of the predictions for 2005: 3.7%).

The risks to this scenario are a slower recovery of the world economy and weaker inflow of foreign investment.

### 3. Interest rates

III-04	2W repo rate (%)		12M PRIBOR (%)		5Y IRS (%)		CR 3,70/13 yield	
	1 month	1 year	1 month	1 year	1 month	1 year	1 month	1 year
min.	2,0	2,5	2,3	2,8	3,5	4,0	4,5	4,5
average	2,0	2,7	2,4	3,1	3,8	4,4	4,7	5,2
max.	2,0	3,0	2,4	3,4	4,1	4,6	5,0	6,3

The approaching date of the first expected increase in the CNB's rates is reflected in a gradual upward shift of the expected short-term rate levels. According to the analysts, a pick-up in inflation, higher inflation expectations, a weaker koruna, an economic recovery abroad and a gradual closing of the output gap in the Czech Republic will necessarily lead to a gradual tightening of monetary policy by the central bank. Some respondents expect a first repo rate increase of 25 basis points as early as this July; a 2W repo rate of 2.5% is foreseen at the year end. However, the expectations at longer horizons differ quite widely: for next year, six analysts expect the 2W repo rate at 2.5%, four analysts at 2.75% and two respondents at 3.0%.

According to the analysts' comments, the outlook for medium-term rates and long-term bonds will be determined primarily by developments on European markets and the prospects for the Czech economy. In the short term, some analysts expect a stagnation or even a decrease, but most of the respondents expect a modest rise. At the longer-term horizon, the baseline scenario remains a global economic recovery and further, albeit moderate, yield growth. The risks to this scenario are the evolution of the euro-dollar exchange rate and an inability of the government to deal decisively with the public finance issue.

In the case of the 12M PRIBOR, the 5Y IRS and the ten-year bond, the average predictions for the one-month horizon are about 10–15 basis points above the level at the time of the survey.

The average predictions for rates at the one-year horizon are 65–80 basis points above the market level at the time of the survey.

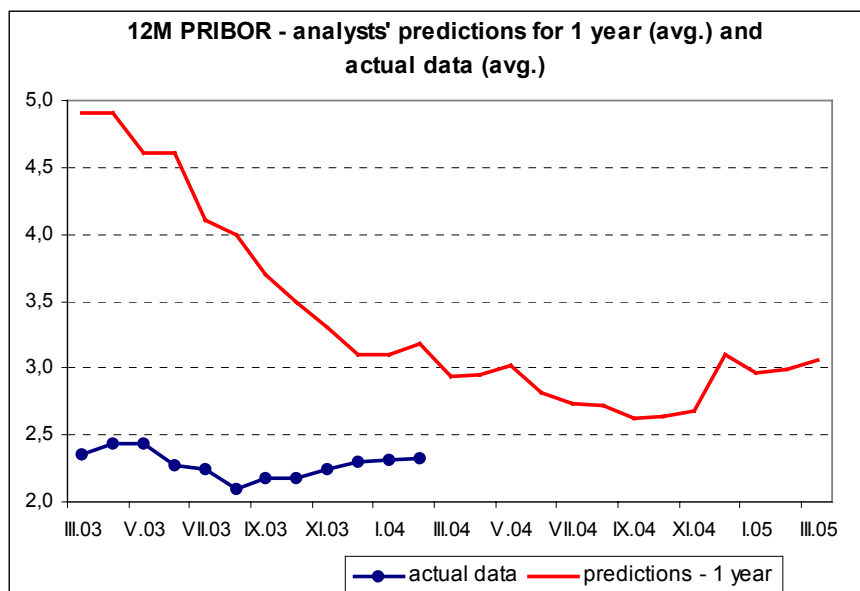
Prediction for Month of prediction	2W repo rate		12M PRIBOR		5Y IRS		CR 3,70/13 yield	
	1 M	1 Y	1 M	1 Y	1 M	1 Y	1 M	1 Y
	%		%		%		%	
III-03	2,4	2,7	2,3	2,9	3,0	3,8	3,6	4,3
VI-03	2,4	2,6	2,2	2,8	2,9	3,5	3,5	4,1
IX-03	2,0	2,3	2,1	2,6	3,6	3,8	4,3	4,4
XII-03	2,1	2,5	2,3	3,1	4,0	4,5	5,0	5,4
I-04	2,0	2,5	2,3	3,0	3,8	4,3	4,7	5,2
II-04	2,0	2,6	2,3	3,0	4,0	4,4	4,8	5,2
III-04	2,0	2,5	2,3	3,0	3,8	4,3	4,7	5,2

/\* expected level of 1W  
PRIBOR

\*/ CR 6,55/11  
yield

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

	2W repo rate	12M PRIBOR	5R IRS	CR 3,70/13 yield
<b>10.3.2004</b>	2,00	2,30	3,71	4,55



**4. The exchange rate**

<b>III-04</b>	<b>EUR/CZK</b>	
	1 month	1 year
<b>min.</b>	32,30	30,50
<b>average</b>	32,81	31,81
<b>max.</b>	33,50	34,00

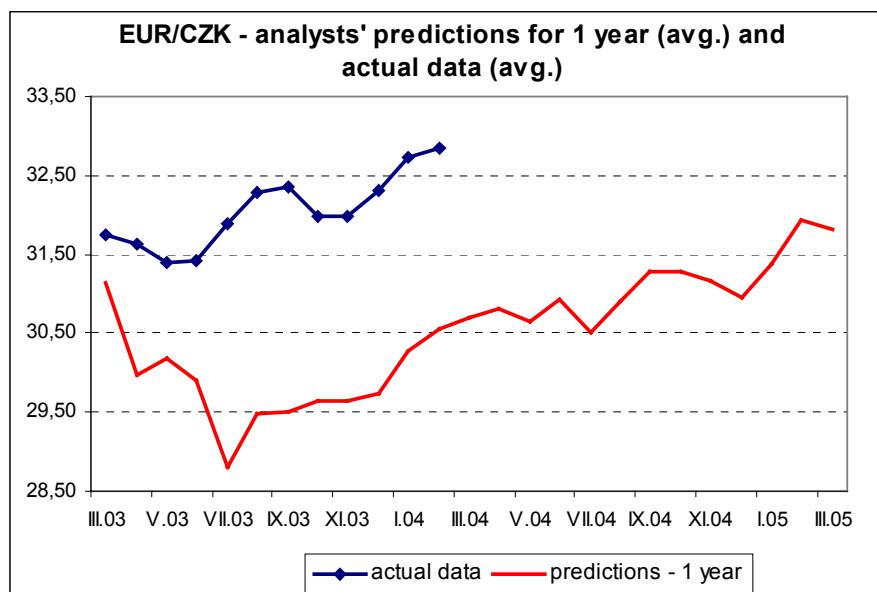
<b>Prediction for Month of prediction</b>	<b>exchange rate EUR/CZK</b>	
	1 month	1 year
III-03	31,74	30,70
VI-03	31,39	30,92
IX-03	32,70	31,27
XII-03	31,79	30,94
I-04	32,34	31,37
II-04	32,96	31,93
III-04	32,81	31,81

**Exchange rate - fixing on the day of deadline for forecasts**

<b>10.3.2004</b>	33,185
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The respondents expect the koruna's exchange rate to be within the range of CZK 32.30–33.50/EUR at the one-month horizon, the average expectation being CZK 32.81/EUR. The domestic analysts tend to expect a modest appreciation of the koruna beyond the level of CZK 33.00/EUR, whereas the foreign respondent still expects a weakening to CZK 33.50/EUR.

According to analysts' comments, working against the Czech koruna in the short term is its use as a source for financing investments in the Slovak koruna, for which investors are speculating on an appreciation. The strength of the euro against the dollar is also playing a role. The speculative positions and short-term flows of portfolio investment should also affect the koruna in subsequent weeks, so greater fluctuations in the koruna-euro exchange rate can be expected. The koruna may also be influenced by potential stronger fluctuations in the euro-dollar rate and more marked movements in the regional currencies.



The average estimate for the exchange rate of the domestic currency at the one-year horizon is CZK 31.81/EUR. Again, the domestic analysts foresee a trend of gradual appreciation of the koruna, whereas the foreign analyst expects a depreciation.

According to the domestic experts, the gradual appreciation of the koruna should stem from the real convergence of the Czech economy towards the EU average. However, this long-term trend will be interrupted by numerous fluctuations as the koruna's exchange rate reacts to portfolio investment flows, foreign direct investment, dividend payments, the political situation and a possible Czech eurobond issue.

Prague, 17 March 2004