

## Measuring financial market inflation expectations – Results of the 62nd measurement (June 2004)

The results of the June survey of financial market expectations differ little from the May forecasts. Only the koruna exchange rate prediction recorded a sizeable change.

11 domestic analysts and three foreign analysts participated in this survey.

### 1. Inflation

VI-04	annual CPI (%)	
	1 year	3 years
min.	1,8	2,0
average	2,7	2,7
max.	3,4	3,0

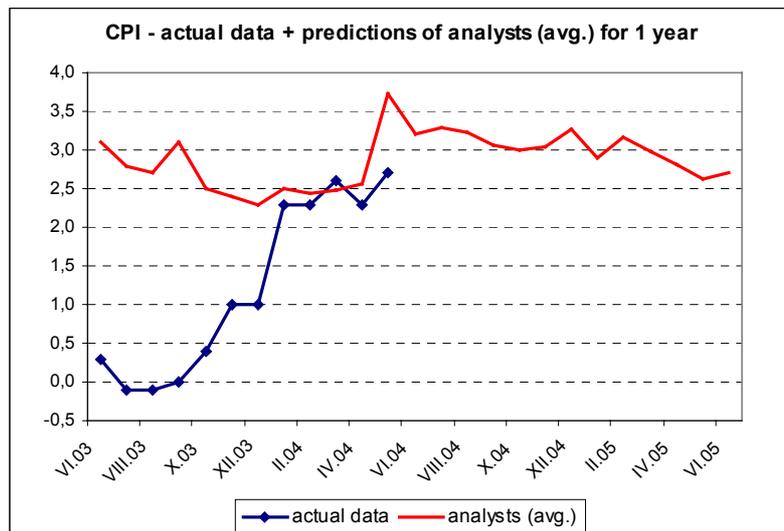
The May inflation figures remained below the expectations of both the market and the CNB, the reason being the weaker-than-expected impact of the VAT changes on retailers' prices. The analysts therefore believe that the changes to VAT and excise duties will continue to unwind over the summer months. According to the analysts, wage growth should be viewed as an inflationary factor. Although this is being accompanied in the private sector by pressure for efficiency gains

and hence for job cutbacks, the situation in the state sector is entirely different. Another upside risk to inflation is the high prices of oil and metals on global markets and the continuing rise in agricultural producer prices, because increasing production costs will exert upward pressure on consumer prices. A pick-up in money supply growth and loans to households was also mentioned. This could lead to stronger-than-expected household expenditure. The current exchange rate of the koruna is conversely counteracting inflation.

According to the analysts, annual CPI inflation should peak at the end of the summer and then gradually fall back until the year end. Inflation should slacken during 2005 due to the high comparison base of 2004, the absence of a rent act and food prices, whose growth is thought to have already peaked. The average prediction for annual consumer price inflation in June 2005 is 2.7%. The forecasts of the individual analysts still range between 1.8% and 3.4%.

At the three-year horizon, the inflation predictions remain fairly stable, the average estimate being 2.7% (compared to 2.9% in May). The analysts say that the price level in the Czech Republic in this period will be subject to similar factors as the level in the euro area.

Prediction for Month of prediction	annual CPI	
	1 Y %	3 Y %
VI-03	3,2	2,7
IX-03	3,1	2,7
XII-03	3,3	2,8
III-04	3,0	2,8
IV-04	2,8	2,9
V-04	2,6	2,9
VI-04	2,7	2,7



## 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
IV-04	3,3	3,6
V-04	3,3	3,6
VI-04	3,4	3,6

VI-04	GDP growth at the end of	
	current year	next year
min	3,1	2,9
average	3,4	3,6
max	3,8	4,5

There are still expectations of a slight pick-up in GDP growth for this year as well as a change in the growth structure, with buoyant household consumption being offset by strengthening investment activity. Only the slowdown in household consumption so far seems more moderate than originally forecasted by the analysts. As demand picks up in the EU member states the export performance of the domestic economy should steadily improve and the balance of services should develop more favourably as well.

The analysts remain more pessimistic in their GDP growth estimates than the CNB in its most recent macroeconomic forecast. By their estimates, economic growth should exceed the 3% level this year (the average of the predictions for 2004 increased slightly to 3.4%) and pick up even further next year (the average of the predictions for 2005 remains 3.6%, although while the domestic analysts all predict faster growth, two of the foreign respondents expect a slowdown to 2.9%).

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

## 3. Interest rates

VI-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	2,6	3,0	4,1	4,2	5,0	5,1
average	2,1	2,9	2,7	3,5	4,2	4,8	5,1	5,5
max.	2,3	3,3	2,9	3,9	4,4	5,3	5,2	6,3

According to the analysts' comments on the May CPI figures, the slower pick-up in inflation in the Czech Republic and the strengthening koruna put back the start of a phase of rate increases by the CNB. This notwithstanding, the analysts concur that a monetary policy tightening is only a matter of time. The macroeconomic figures from the major world economies are encouraging, the robust performance in domestic industry and construction suggest an acceleration of the Czech economy, and cost-push inflation is rising. In the low-interest environment, the onset of demand-pull inflation is a matter of time. The overwhelming majority of the analysts feel that the change in rates will happen at the earliest in July (an increase of 25 basis points), when the CNB will have a revised inflation forecast. A further increase of 25–50 basis points can be expected by the end of 2004 and then a continuing tightening of monetary policy during 2005 H1. As the prediction horizon gets longer the analysts' estimates diverge more significantly. Two analysts estimate the 2W repo rate at 2.50%, two at 2.75%, seven at 3.0% and three at 3.25% in June of next year.

According to the analysts' comments, the outlook for medium-term rates and long-term bonds will be determined primarily by developments on world markets, by expectations regarding the CNB's monetary policy steps and by the state debt financing requirement. The short-term outlook is viewed as neutral to slightly negative. In the longer term the tendency of slight growth in yields should continue. The spread between domestic and German bond yields should be around 80 basis points as of the year-end. However, this is conditional on the current trends in the world and domestic economy

being preserved. An unexpected easing of growth, connected, for example, with the negative effect of high oil prices, or a heightening of geopolitical tension following a massive terrorist attack could bring about a turnaround.

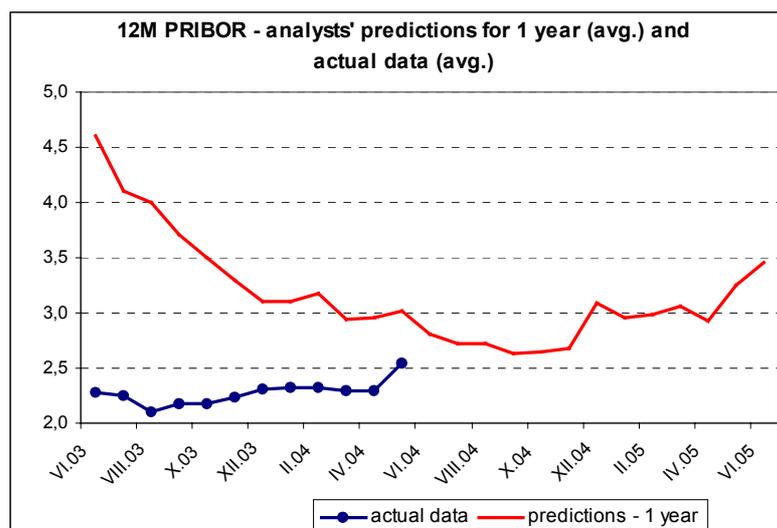
Prediction for Month of prediction	2W repo rate		12M PRIBOR		5Y IRS		CR 3,70/13 yield	
	1 M	1 Y	1 M	1 Y	1 M	1 Y	1 M	1 Y
	%		%		%		%	
VI-03	2,4	2,6	2,2	2,8	2,9	3,5	3,5	4,1
IX-03	2,0	2,3	2,1	2,6	3,6	3,8	4,3	4,4
XII-03	2,1	2,5	2,3	3,1	4,0	4,5	5,0	5,4
III-04	2,0	2,7	2,4	3,1	3,8	4,4	4,7	5,2
IV-04	2,0	2,6	2,3	2,9	3,8	4,3	4,7	5,1
V-04	2,0	2,8	2,5	3,2	4,1	4,7	5,0	5,4
VI-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
9.6.2004	2,00	2,72	4,15	4,99



**4. The exchange rate**

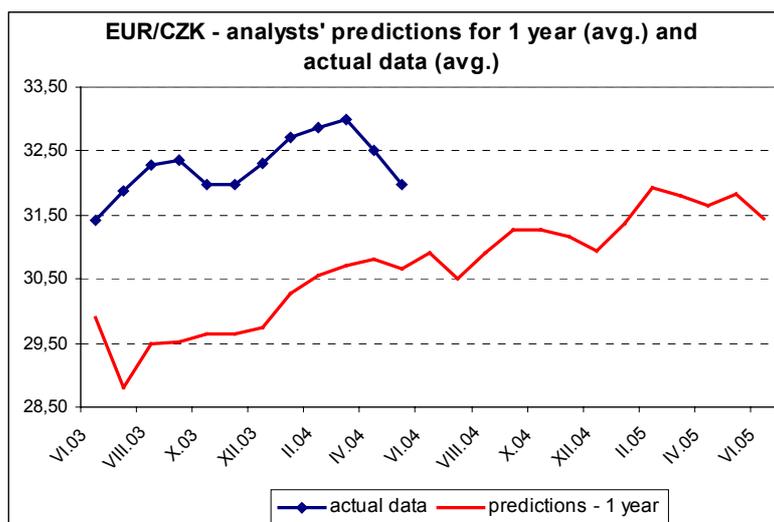
VI-04	EUR/CZK	
	1 month	1 year
min.	31,00	30,00
average	31,63	31,44
max.	32,30	34,00

Prediction for Month of prediction	exchange rate	
	1 month EUR/CZK	1 year EUR/CZK
VI-03	31,39	30,92
IX-03	32,70	31,27
XII-03	31,79	30,94
III-04	32,81	31,81
IV-04	32,28	31,65
V-04	32,25	31,83
VI-04	31,63	31,44

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

9.6.2004	31,335
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At the one-month horizon almost all of the analysts foresee a modest depreciation of the koruna from its present level (prediction average: CZK 31.63/EUR, range CZK 31.00–32.30/EUR). They feel the exchange rate has been recently supported chiefly by the expected onset of a positive interest rate differential, strengthening confidence in faster growth of the Czech economy and positive developments in neighbouring central European markets. They also believe that the inflow of funds from corporate eurobonds issued by Czech entities could play a role. However, the majority view is that the appreciation pressure on the koruna is only transitory and that over the next few days a gradual depreciation should start to prevail. The koruna will probably be weakened in the summer months by repatriation of foreign investment earnings and in the autumn by the debate on the state budget for 2005. A further wave of profit repatriation can be expected at the end of this year and the beginning of the next.



At the long-term horizon, though, most of the domestic analysts expect a steady appreciation of the koruna. Their estimates at one year range between CZK 30.00 and 32.10 to the euro. Besides the positive interest rate differential the koruna should be supported by faster economic growth in the euro area, say the analysts. This will have a positive effect on foreign trade growth and on the inflow of foreign direct investment into the Czech Republic. The portfolio capital inflow may also rise faster, thanks to a widening of the spread between Czech and European bonds and to privatisation.

On the other hand, the foreign analysts are noticeably more sceptical about the koruna. Their estimates for the one-year horizon range between CZK 32.00 and 34.00 to the euro.

The average estimate for the exchange rate of the domestic currency at one year is CZK 31.44/EUR. The average for the domestic analysts is CZK 31.08/EUR and that for the foreign analysts CZK 32.73/EUR.

Prague, 15 June 2004