

Measuring financial market inflation expectations – Results of the 63rd measurement (July 2004)

The results of the July survey of financial market expectations differ little from the June forecasts. Some of the analysts increased their consumer price inflation forecasts at the one-year horizon, and the GDP growth estimate for 2005 went up slightly. The predictions for short-term and long-term interest rates also rose modestly and the estimates of the koruna-euro exchange rate shifted towards appreciation.

In June we received forecasts from 11 domestic analysts and two foreign analysts.

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

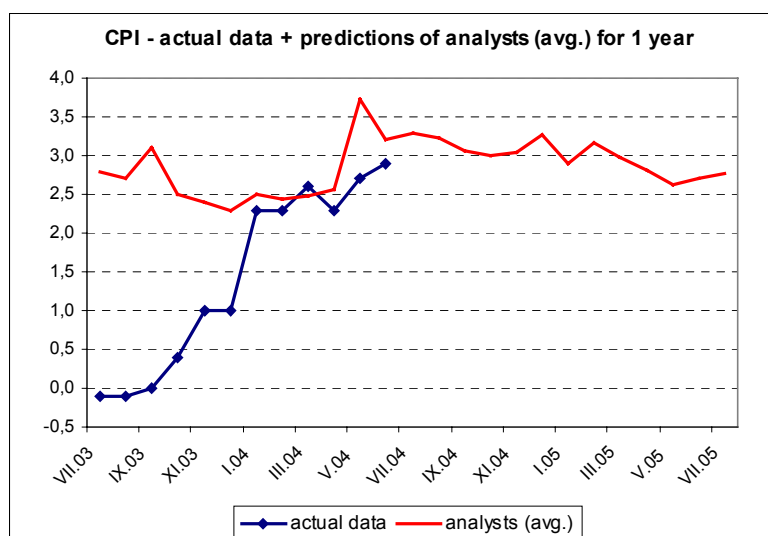
According to the analysts, the inflation outlook in the Czech Republic remains favourable despite the June pick-up in inflation. They say that the effect of the increase in indirect taxes on consumer prices has so far been only subdued and so they expect the tax changes to continue affecting prices over the next few months. They predict that inflation will peak at the end of August and the beginning of September (with annual CPI inflation growth of up to 4%), by which time the rising producer prices will

have passed through partly into consumer prices. At the same time, though, some of the analysts say that the present high prices of raw materials, most notably oil and metals, should gradually undergo a correction. Inflation should be favourably affected by a stronger koruna vis-à-vis the euro and the dollar. Owing to the May decline in prices of agricultural products, an easing of the upward pressures on food prices can also be expected in the months ahead. Inflation should therefore start falling in the autumn. The CPI inflation estimates for the end of this year vary around 3.5%.

The analysts expect annual CPI inflation to return below 3% next year. The upside risks to inflation include growth in food prices (albeit slower than this year), rent changes, more changes to excise duties, and continuing growth in prices in the categories of restaurants and recreation and culture. Prices in the categories of shoes and clothing, transport and equipment for the house should have the opposite effect on inflation.

At the three-year horizon, the inflation predictions remain more or less stable, the average estimate being 2.6% (compared to 2.7% in June). The analysts say that prices in the Czech Republic in this period will be subject to similar influences as in the euro area.

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



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. The slowdown in household consumption still 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 gradually 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 being 3.4%) and pick up even further next year (the average of the predictions for 2005 rose slightly to 3.7%, although while the domestic analysts all predict faster growth, one foreign respondent expects a slowdown to 2.9%).

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

3. Interest rates

VII-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.	2,2	2,5	2,6	3,0	4,3	4,5	5,1	5,3
average	2,3	3,0	2,9	3,6	4,4	4,9	5,2	5,6
max.	2,3	3,3	3,1	4,1	4,5	5,2	5,3	6,0

The CNB took most of the analysts by surprise with the June timing of its first interest rate increase. Given the current market conditions and the latest released figures, most of the respondents expect the repo rate to remain unchanged in July. However, they expect interest rates to be increased another one or two times – in steps of 25 basis points – in the remainder of the year. The pace of the monetary policy tightening will depend, they say, on the evolution of inflation and economic growth. The updated inflation forecast to be discussed by the Bank Board at the end of July should provide the analysts with a clearer idea about the CNB's next steps in this area. The respondents expect a further gradual increase in interest rates in 2005. Their estimates for the CNB's 2W repo rate at the one-year horizon range between 2.50% and 3.25% and the expectations of some of the analysts are 25 basis points higher than in the previous survey (only one analyst estimates the 2W repo rate at one year at 2.50%; two put it at 2.75%, two at 3.00% and six at 3.25%).

According to the analysts' comments, the near-term outlook for medium-term rates and long-term bonds will be determined primarily by developments on the domestic political scene, by expectations regarding the CNB's interest rates and, as usual, by the behaviour of world bond markets. Jitters associated with the government crisis should keep bonds under pressure. The market will anxiously await the publishing of the minutes of the latest Bank Board meeting and the revision of the CNB's inflation forecast. Consequently, higher volatility can be expected, along with a tendency towards yield growth and a further widening of the spreads between Czech and German yields. Increases in domestic interest rates will be the most important factor for yields in the medium term.

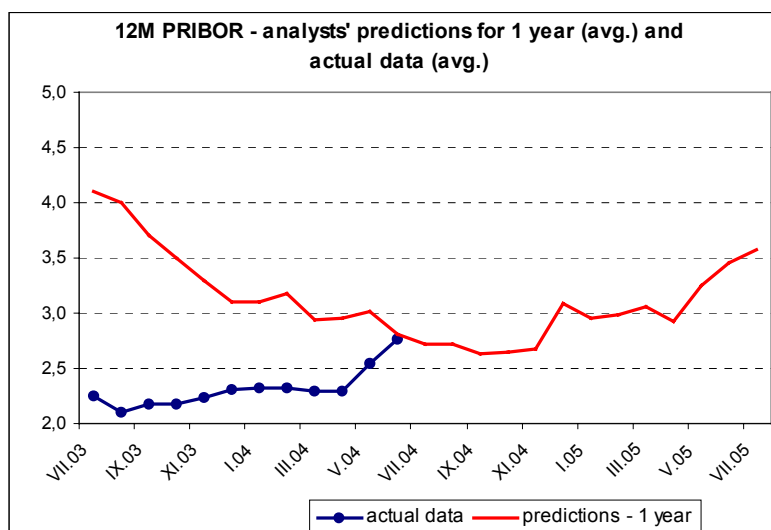
Complications with forming a government could have a negative effect. Yields on world markets should return to growth and also affect the Czech koruna bond market in the same direction.

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
	%		%		%		%	
VII-03	2,2	2,4	2,2	2,7	3,1	3,5	3,9	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
V-04	2,0	2,8	2,5	3,2	4,1	4,7	5,0	5,4
VI-04	2,1	2,9	2,7	3,5	4,2	4,8	5,1	5,5
VII-04	2,0	2,5	2,3	3,0	3,8	4,3	4,7	5,2

/ expected level of 1W PRIBOR*

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5R IRS	CR 3,70/13 yield
13.7.2004	2,25	2,99	4,41	5,22



4. The exchange rate

VII-04	EUR/CZK	
	1 month	1 year
min.	30,80	30,00
average	31,53	31,36
max.	32,20	34,00

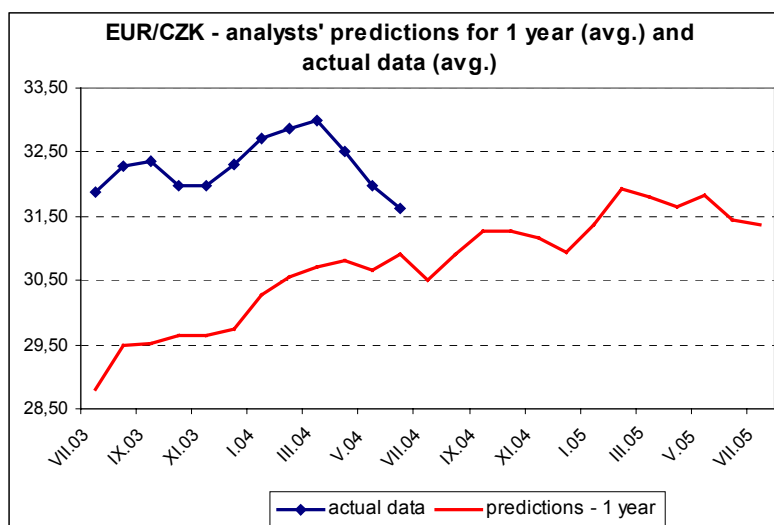
Prediction for Month of prediction	exchange rate 1 month 1 year EUR/CZK	
	1 month	1 year
VII-03	31,48	30,51
IX-03	32,70	31,27
XII-03	31,79	30,94
III-04	32,81	31,81
V-04	32,25	31,83
VI-04	31,63	31,44
VII-04	31,53	31,36

Exchange rate - fixing on the day of deadline for forecasts

13.7.2004	31,480
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The respondents' near-term estimates for the koruna's exchange rate vary considerably, as they did in June. The koruna-euro rate predictions lie within a fairly wide range of CZK 30.80–32.20, largely because two strongly contradictory factors are currently acting on the koruna. According to the analysts, the koruna's exchange rate against the euro will be affected in the near future primarily by events on the political scene, seasonal repatriation of the earnings of foreign owners of Czech firms and the expected evolution of the CNB's interest rates.

They also say that an important factor in the autumn will be the ruling coalition's ability to push through the state budget for next year in the lower house of parliament. A further wave of profit repatriation and an associated transitory depreciation of the koruna can be expected at the end of this year and the beginning of the next.



According to the domestic analysts, the long-term outlook for the koruna is positive, mainly thanks to the Czech Republic's generally bright prospects as a member of the EU. The koruna should be supported by solid economic growth and a generally better balance of payments (stronger foreign investment inflow, growing export performance of the Czech economy, inflow of portfolio capital due to a widening spread between Czech and European bonds).

The foreign analysts remain more sceptical about the koruna. Their estimates for the one-year horizon range between CZK 33.00 and 34.00 to the euro. The analyst who gave the estimate of CZK 34.00 says that the koruna's current strength is not based on fundamentals. A global slowdown is expected next year, which will not give the CNB much room to raise rates. The foreign exchange market would then view the koruna as too expensive by comparison with other Central European currencies and would start using it again to finance purchases of these currencies.

Prague, 16 July 2004