

Measuring financial market inflation expectations – Results of the 65th measurement (September 2004)

The September survey of financial market expectations showed slight upward shifts in the average estimates of annual consumer price growth, the GDP growth expected for both this year and the next, and also the expected interest rate levels

The CNB received forecasts from 13 domestic analysts and three foreign analysts in September.

1. Inflation

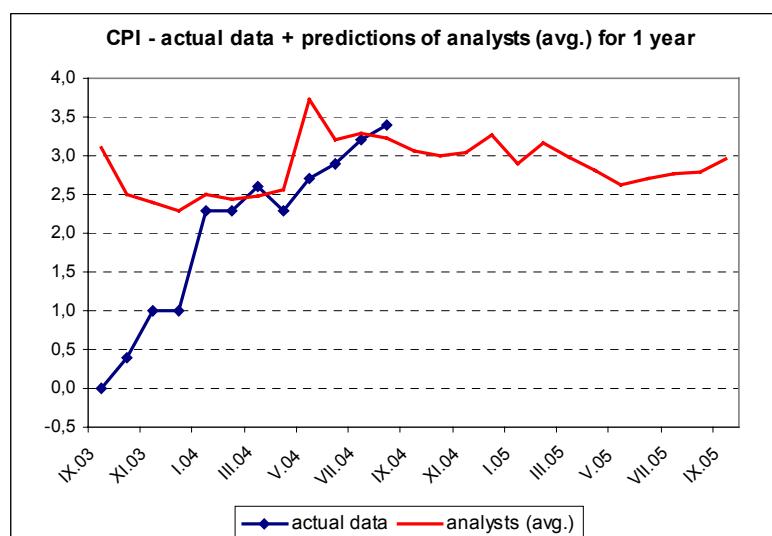
IX-04	annual CPI (%)	
	1 year	3 years
min.	2,5	2,4
average	3,0	2,9
max.	3,8	3,6

This survey saw a moderate increase in most forecasts of future inflation. The respondents justify this increase primarily by an 11% rise in gas prices this October and by higher electricity prices as from January 2005.

According to the analysts, the environment in the Czech Republic is still a low inflation one despite the gradual CPI growth, since this year's pick-up in inflation is mostly due to changes in indirect taxes. Thanks to strong competition, they see only a limited probability of the high industrial producer price inflation passing through into consumer prices. The analysts see as positive the slowing price growth in agriculture and high estimates for this year's harvest. They expect inflation to peak in October, when annual inflation should come close to 4%. In the final months of the year it should moderate owing to decreasing upward pressures on prices in agriculture and transport. At the end of the year it should be between 3.2% and 3.6% according to the analysts' comments. The modest decline in inflation should continue into next year. Most analysts expect inflation to return below the 3% level. It will be affected among other things by oil prices on world markets. An expected appreciation of the koruna against the euro and the dollar should have a positive effect.

At the three-year horizon, the inflation predictions remain more or less flat, ranging between 2.6% and 2.9%. The average estimate for September was 2.9%. Inflation in the Czech Republic at this horizon will be subject to similar influences as the euro area price level.

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



2. Gross domestic product

Prediction for Month of prediction	GDP growth at the end of	
	this year %	next year %
III-04	3,3	3,7
IV-04	3,3	3,6
V-04	3,3	3,6
VI-04	3,4	3,6
VII-04	3,4	3,7
VIII-04	3,4	3,6
IX-04	3,6	3,8

IX-04	GDP growth at the end of	
	current year	next year
min	3,2	3,3
average	3,6	3,8
max	4,0	4,8

Owing to favourable data from the real economy most respondents shifted upwards their predictions of GDP growth for this year and the next. The average estimate for both time horizons thus increased by 0.2%, to 3.6% for this year and 3.8% in 2005.

The growth of the Czech economy should be driven mostly by investment. The recovery of the global, and in particular European, economy and stronger external demand support a rise in the production capacities of domestic firms. The contribution of net exports to GDP growth remains negative, but the situation is improving. By contrast, the current low growth in real wages is, say the analysts, a limiting factor for household consumption.

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

3. Interest rates

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

The analysts say that the CNB will probably continue slowly increasing interest rates. The pace and extent of the monetary policy tightening, however, will depend on inflation and the speed of closure of the output gap. Most respondents expect the repo rate to stand at 2.75% at the end of this year. In their view, it is highly likely that another 25 basis point increase from the current level will occur in October, when the CNB Bank Board will have a new inflation and GDP growth forecast at its disposal. However, given the latest macroeconomic figures confirming the strength of the domestic economy, some thoughts are emerging that the CNB might even raise rates twice this year. However, the analysts do not think this necessary given the favourable structure of the present growth, which does not indicate any demand-pull inflationary pressures.

The tightening of monetary policy should continue in 2005. The estimates for the repo rate at the one-year horizon range between 3.00% and 4.00%. The largest number of respondents (seven) put the repo rate at this horizon at 3.25%. The second most frequent estimate is 3.50% (six respondents).

The analysts expect only a very slight movement in medium-term rates and for the ten-year bond yield at the one-month horizon, with most respondents predicting a moderate increase. The analysts believe that the outlook for a further increase in CNB interest rates should tend to affect the short end of the yield curve, as the medium and long ends of the curve are determined primarily by developments on world markets. These are more likely to decline, owing to uncertainty regarding

when the US economy will switch to a sustained growth phase. As for domestic factors, bond yields could be affected by the debate on the state budget for next year.

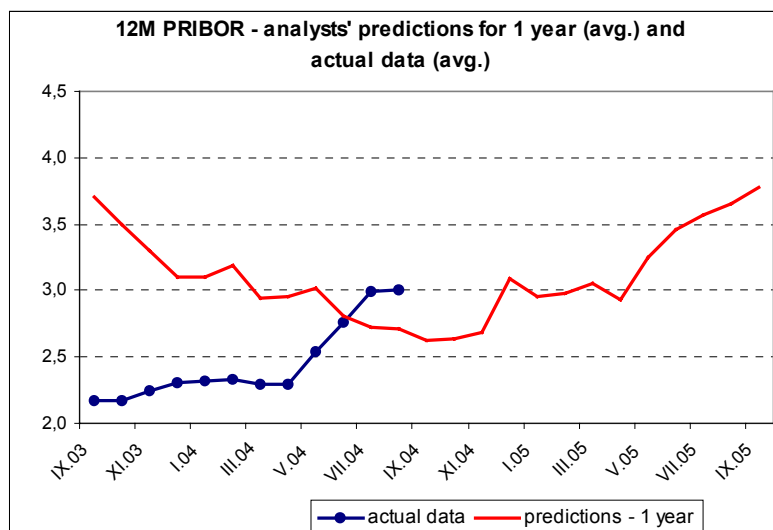
As to the longer-term outlook, expectations regarding the evolution of CNB rates and the situation on world markets should be the key factors. The respondents forecast the global economy to return to stronger growth and the yield curve to shift upwards.

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
	%		%		%		%	
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
VI-04	2,1	2,9	2,7	3,5	4,2	4,8	5,1	5,5
VII-04	2,3	3,0	2,9	3,6	4,4	4,9	5,2	5,6
VIII-04	2,4	3,2	3,0	3,7	4,3	4,8	5,1	5,5
IX-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
10.9.	2,50	3,11	4,47	5,14



4. The exchange rate

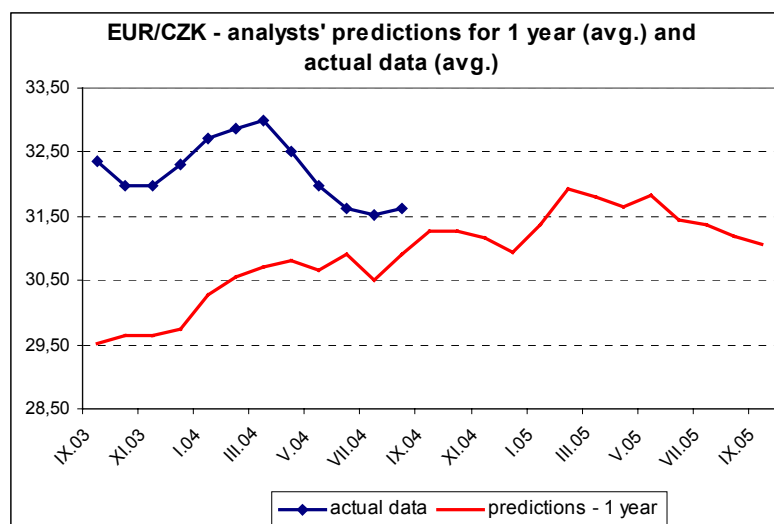
IX-04	EUR/CZK	
	1 month	1 year
min.	31,30	30,50
average	31,66	31,07
max.	32,20	33,00

Exchange rate - fixing on the day of deadline for forecasts

10.9.	31,760
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Prediction for Month of prediction	exchange rate EUR/CZK	
	1 month	1 year
IX-03	32,70	31,27
XII-03	31,79	30,94
III-04	32,81	31,81
VI-04	31,63	31,44
VII-04	31,53	31,36
VIII-04	31,51	31,19
IX-04	31,66	31,07

The range for movement of the koruna's exchange rate at the one-month horizon is CZK 31.30–32.20/EUR, although the majority of the estimates lie within a narrow interval of CZK 31.50–31.70 /EUR, i.e. just below the level at the time of the survey. According to the analysts, good foreign trade results, dynamic growth in industrial production, a pick-up in GDP growth and expectations of a rise in the CNB's interest rates all speak in favour of the koruna. By contrast, the negotiations on the state budget for next year, continuing repatriation of foreign investors' earnings and the evolution of the euro-dollar exchange rate pose a risk to the koruna.



In the medium term, the analysts believe the koruna's exchange rate will be affected by the ratio between the current account and financial account balances, and in particular by the volume of foreign direct investment. Continuing FDI inflow, faster economic growth in the Czech Republic than in the euro area and a sizeable increase in the interest rate differential should result in a gradual moderate strengthening of the koruna. This is expected by the majority of the respondents in this survey. Only one foreign analyst still expects the koruna to weaken to CZK 33/EUR.

Prague, 17 September 2004