

Measuring financial market inflation expectations – Results of the 71st measurement (March 2005)

Twelve domestic and one foreign analyst took part in the CNB's March survey.

The respondents' views on future inflation and GDP growth remained broadly unchanged. The robust appreciation of the koruna and the prevalence of anti-inflationary factors strengthened expectations of a further reduction of CNB rates by 25 or even 50 basis points. In line with the current evolution of the koruna, the forecast for the CZK/EUR rate also shifted upwards.

1. Inflation

III-05	annual CPI (%)	
	1 year	3 years
min.	2,2	2,0
average	2,6	2,6
max.	2,9	3,0

The February data on consumer price inflation fulfilled the analysts' expectations and confirmed the continuing low-inflation environment and the absence of demand-pull inflationary pressures in the Czech economy. According to the respondents' expectations, as the effect of last year's increase in excise duties and VAT changes unwinds, annual inflation should decline further below the lower boundary of the CNB's inflation target band at

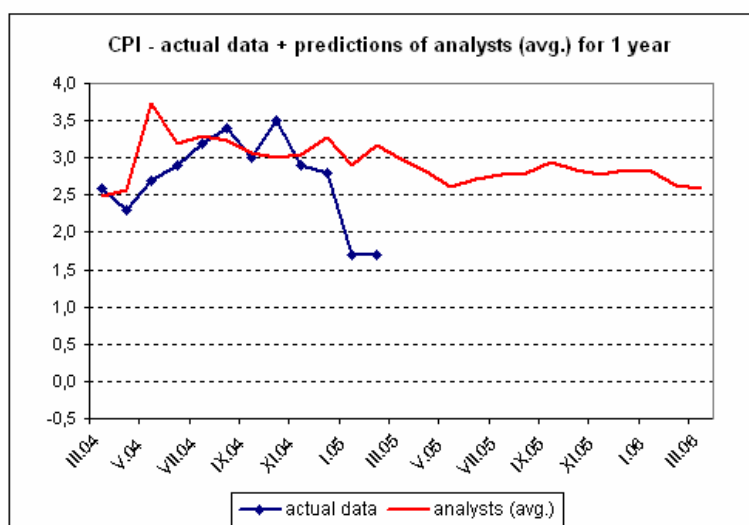
least until the middle of this year. According to their comments, prices can be expected to fall particularly in areas where there is strong competition or where the koruna's exchange rate has a stronger effect. The strongly appreciating koruna is making imported consumer goods, food, electronic goods and fuels cheaper and is forcing domestic producers to adjust their prices to this trend. The demand in the economy is not increasing the pressure on inflation, either.

According to the analysts, inflation should pick up in the second half of this year, mainly because of administrative measures (excise duty on tobacco, a rise in regulated rents). However, annual consumer price inflation should remain well below 3%. The analysts' average estimate for the CPI at the one-year horizon is 2.6%.

Oil prices and a potentially higher rise in rents pose an upside risk to inflation. Certain questions also remain in the public finance area in the run-up to the elections.

At the three-year horizon, the inflation prediction fell slightly, the average estimate in the March survey being 2.6%.

Prediction for Month of prediction	annual CPI	
	1 Y %	3 Y %
III-04	3,0	2,8
VI-04	2,7	2,7
IX-04	3,0	2,9
XII-04	2,8	2,8
I-05	2,8	2,7
II-05	2,6	2,7
III-05	2,6	2,6



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
VI-04	3,4	3,6
IX-04	3,6	3,8
XII-04	3,8	4,0
I-05	3,9	3,9
II-05	4,0	3,9
III-05	4,0	3,9

III-05	GDP growth at the end of	
	current year	next year
min	3,5	3,4
average	4,0	3,9
max	4,4	4,3

The Czech economy should profit this year from past foreign direct investment and accession to the EU. Net exports will remain one of the most significant motors of economic growth this year. The analysts also mention the effect of the launch of car production at TPCA Kolín. Investment growth should remain relatively buoyant, despite an expected slowdown. This year's faster real wage growth and continuing rise in household indebtedness are expected to lead to a recovery in consumer demand. Households' appetite for spending money may also be boosted by declining prices of imported goods thanks to the strong appreciation of the koruna. On the other hand, the analysts' say that too fast an appreciation of the domestic currency might start to endanger exporters by decreasing their competitiveness and might have a negative effect on Czech economic growth.

Czech GDP growth is estimated at around 4% this year, and the analysts' average prediction for 2006 is only slightly lower. The analysts believe that despite the higher growth potential of the Czech economy, structural problems on the labour market continue to put the brakes on growth.

3. Interest rates

III-05	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	2,0	1,8	2,2	2,6	3,2	3,3	3,5
average	2,0	2,3	2,0	2,6	2,9	3,6	3,5	4,1
max.	2,3	2,8	2,2	3,0	3,1	4,0	4,0	4,7

According to the analysts, the low inflation, the build-up of risks on the downside of the forecast and above all the strong koruna are generating pressure for further repo rate cuts. All the domestic respondents expect a repo rate reduction of 25 basis points to 2.00% as early as the March meeting of the CNB Bank Board. If, however, the koruna appreciates further towards CZK 29.00/EUR, the analysts do not rule out a cut of 50 basis points in either one step or two steps in quick succession. According to the analysts, the argument for a double reduction is the fact that in April the CNB will have at its disposal an updated macroeconomic forecast containing the precise implications of the present strong koruna. The argument for a one-off bigger reduction is an effort not to fragment the reduction into small steps, whose overall effect may be less than that of a larger decrease.

Some of the respondents believe that the CNB could start tightening monetary policy at the end of the year, owing to the closing of the output gap and the stabilisation of the exchange rate, and the rate increases should continue into 2006. However, the views on the repo rate at the one-year horizon are again quite mixed, ranging between 2.00% and 2.75%. Most of the estimates are, however, concentrated in the lower part of this range.

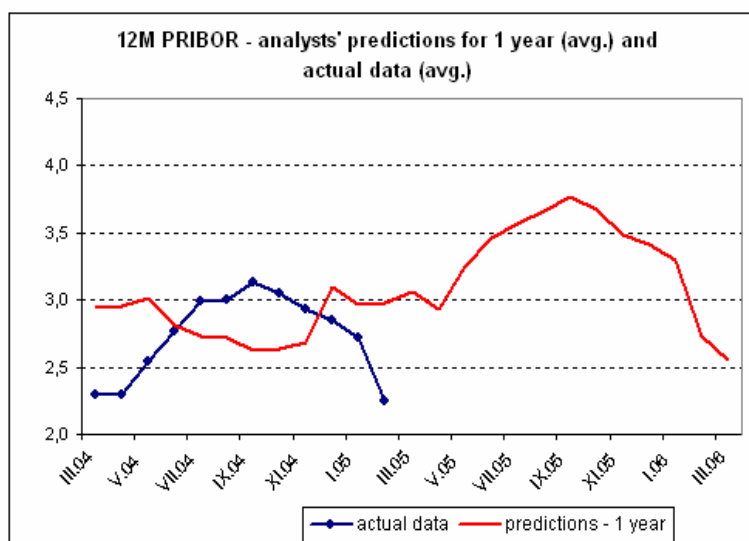
The average estimate for the long end of the yield curve at the nearest horizon is very close to the actual level at the time of the survey. In the longer term (the one-year horizon), expected domestic interest rates and the situation on global markets should be the deciding factors. The respondents on

average expect the yield curve to shift upwards by around 60 basis points compared to the levels 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-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
IX-04	2,5	3,4	3,1	3,8	4,5	4,9	5,2	5,6
XII-04	2,5	3,0	2,9	3,4	3,7	4,3	4,2	4,8
I-05	2,5	3,0	2,8	3,3	3,5	4,1	4,0	4,6
II-05	2,2	2,3	2,2	2,7	2,9	3,7	3,5	4,2
III-05	2,0	2,3	2,0	2,6	2,9	3,6	3,5	4,1

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5R IRS	CR 3,70/13 yield
9.3.	2,25	2,05	2,96	3,52



4. The exchange rate

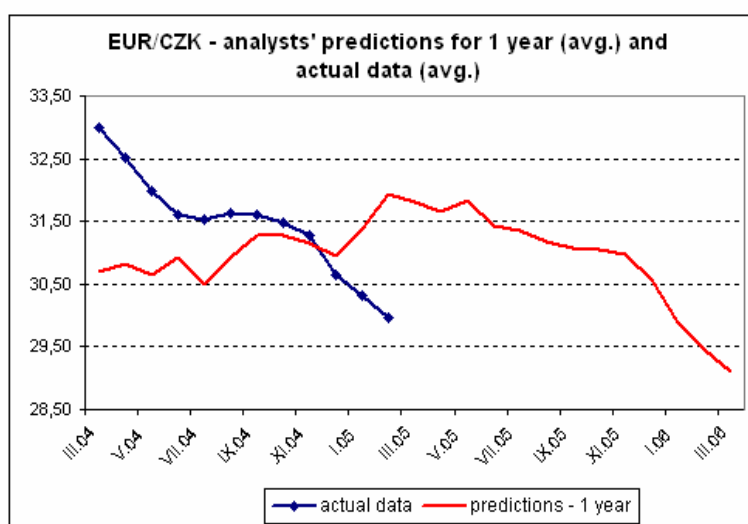
III-05	EUR/CZK	
	1 month	1 year
min.	29,00	28,00
average	29,48	29,11
max.	30,00	29,90

Exchange rate - fixing on the day of deadline for forecasts

9.3.	29,335
------	--------

Prediction for Month of prediction	exchange rate	
	1 month	1 year
	EUR/CZK	
III-04	32,81	31,81
VI-04	31,63	31,44
IX-04	31,66	31,07
XII-04	30,89	30,56
I-05	30,36	29,90
II-05	29,97	29,46
III-05	29,48	29,11

As of the closing date of the survey, the koruna had appreciated to just above CZK 29.30/EUR, despite the January repo rate cut and the crisis on the domestic political scene. The foreign trade and balance of payments data indicate a further improvement in the external imbalance, but the koruna is strongly affected above all by foreign investor interest in the Central European region. One of the analysts comments that despite the evident improvement observed recently in the main economic indicators, the rate of appreciation of the koruna is dramatically outpacing the rate of improvement of the domestic economy, hence a correction can be expected. At the one-month horizon, the respondents expect the exchange rate to move within the band of 29.00–30.00 CZK/EUR. According to their comments, a greater weakening of the domestic currency is likely in the early summer in connection with the repatriation of earnings of foreign-owned corporations. Other factors in favour of a correction include the approaching depreciation of the forint and the widening negative interest rate differential vis-à-vis the USA, which may worsen the sentiment regarding the Central European foreign exchange markets, and also the culminating debate on whether the Czech Republic will ratify the EU constitution in a referendum or in Parliament.



As for the long-term outlook, most of the analysts incline towards the scenario of further gradual appreciation of the koruna. The average estimate for the one-year horizon is CZK 29.11/EUR and the individual forecasts range between CZK 28.00/EUR and CZK 29.90/EUR.

According to the analysts, the expected long-term appreciation of the koruna is based on faster productivity growth and catch-up with the euro area economic level. The koruna should be supported by positive trends in the balance of payments. A declining current account deficit – thanks to the favourable evolution of the trade balance – should be accompanied by a growing financial account surplus, as EU membership and the lower risk premium will stimulate portfolio investment. In addition, significant privatisation revenues are expected this year (Český Telecom, Unipetrol, Vítkovice).

Prague, 22 March 2005