

Measuring financial market inflation expectations – Results of the 73rd measurement (May 2005)

Eleven domestic and two foreign analysts took part in the CNB's May survey. Its results confirm the respondents' previous assumptions – a persisting low-inflation environment, a longish period of flat and then slowly rising interest rates, domestic economic growth of around 4% and gradual appreciation of the domestic currency.

1. Inflation

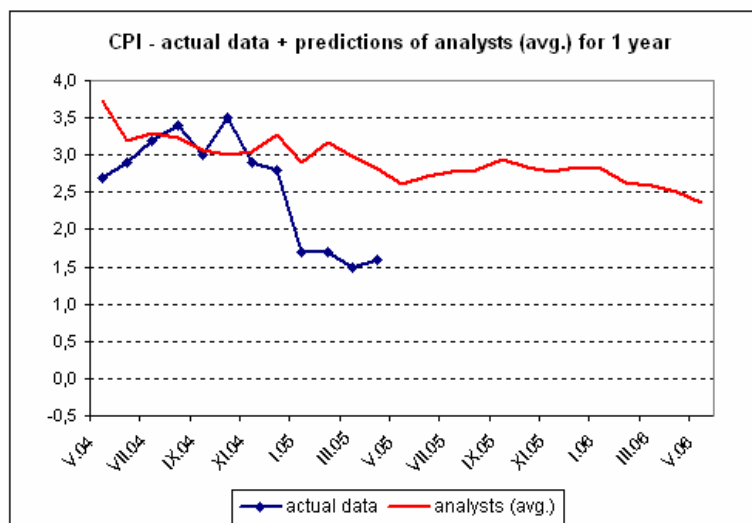
V-05	annual CPI (%)	
	1 year	3 years
min.	1,7	2,0
average	2,4	2,4
max.	2,6	3,0

According to the analysts' comments, the April figures again confirm the predominance of anti-inflationary pressures in the Czech economy. At the same time they say that the leading indicators do not suggest any sizeable growth in cost or demand factors that would drive inflation to a higher level either. The emergence of demand-pull inflation is also being prevented by low inflation expectations.

The respondents expect inflation to decline further in the months to come, close to 1%. A decline in goods prices due to the strong koruna, increasing competition in the retail sector, cheap imports from Asia and falling prices in agriculture should outweigh a gradual rise in services prices and the potential effect of fuel prices. Inflation should stabilise in the second half of the year and then increase gradually, but the analysts expect no aggressive consumer price growth. Higher housing costs (electricity, rents), higher excise duties on tobacco, and prices of services (hotels and restaurants, recreation, culture) should have an inflationary effect, whereas prices of consumer goods (clothing and footwear in particular) are expected to have the opposite effect. The koruna's exchange rate and food price inflation, which will depend on this year's harvest, will be important factors. The analysts' average estimate for the CPI at the one-year horizon is 2.4%.

At the three-year horizon, the inflation prediction saw a further slight decrease, to 2.4%.

Prediction for Month of prediction	annual CPI	
	1 Y %	3 Y %
V-04	2,6	2,9
VI-04	2,7	2,7
IX-04	3,0	2,9
XII-04	2,8	2,8
III-05	2,6	2,6
IV-05	2,5	2,5
V-05	2,4	2,4



2. Gross domestic product

Prediction for Month of prediction	GDP growth at the end of	
	this year %	next year %
V-04	3,3	3,6
VI-04	3,4	3,6
IX-04	3,6	3,8
XII-04	3,8	4,0
III-05	4,0	3,9
IV-05	4,0	3,9
V-05	4,0	3,8

V-05	GDP growth at the end of	
	current year	next year
min	3,2	2,9
average	4,0	3,8
max	4,5	4,4

According to the analysts' estimates, Czech GDP growth should fluctuate around 4% this year, driven by net exports, rising investment and household consumption. The strong koruna and weaker economic growth in Europe, most notably Germany, are risks to the forecast, however. Compared to previous surveys, the analysts place greater emphasis on the fact that the risks to economic growth are gaining in strength. The balance of trade has been developing surprisingly positively so far, but the reverse side is a sharp fall in the rate of growth of foreign trade. The analysts mention both a decrease in export volumes and a lower number of imports of machinery, production equipment and materials, indicating a decline in investment activity in the Czech Republic and a potential moderation of manufacturing activity. In addition, some respondents say that no major upturn in domestic consumer demand can be seen so far either.

The average growth forecast for 2006 decreased slightly compared to previous surveys this year, from 3.9% to 3.8%.

3. Interest rates

V-05	2W repo rate (%)		12M PRIBOR (%)		5Y IRS (%)		10Y IRS (%)	
	1 month	1 year	1 month	1 year	1 month	1 year	1 month	1 year
min.	1,8	1,8	1,6	1,9	2,7	3,0	3,3	3,5
average	1,8	2,0	1,8	2,3	2,8	3,3	3,5	3,9
max.	1,8	2,5	2,1	2,8	3,1	3,9	3,8	4,4

Most of the analysts had not expected the CNB Bank Board's April decision to reduce the repo rate to 1.75%. Many of them believe that an activist approach to monetary policy prevailed in the new Board. Nonetheless, the majority of the respondents do not expect further rate cuts. The prevailing scenario is one of a longish period of flat interest rates at their current levels and a modest rise next year. One of the comments justifies this view by stating that a further interest rate reduction would have only a small impact as regards returning inflation to the target band and, moreover, would not be of much help to the Czech economy, since inflation is being pushed down by the koruna's exchange rate, and the effect of the rate cut on the koruna had been negligible. Furthermore, the low prices are being supported by very strong competition in the retail market. An easing of interest rates would not even boost consumption via loans; on the contrary, the more than 40% growth in mortgage loans might already pose a threat to financial stability. Nevertheless, the analysts admit that a sizeable and long-term appreciation of the koruna, a cooling of the euro area economy and a reduction in ECB rates might force the CNB to ease monetary policy further. In the baseline scenario, however, most of the respondents expect the disinflationary factors in the domestic economy to unwind and the euro area economy to pick up, with a positive knock-on effect on the domestic economy. The timing of the turnaround in the CNB's monetary policy will depend on the koruna-euro exchange rate, interest rates in the euro area and the rate of growth of domestic consumption. The views on the repo rate at the one-year horizon range between 1.75% and 2.50% (1.75% – six respondents, 2.00% – three respondents, 2.25% – three respondents, 2.50% – one respondent).

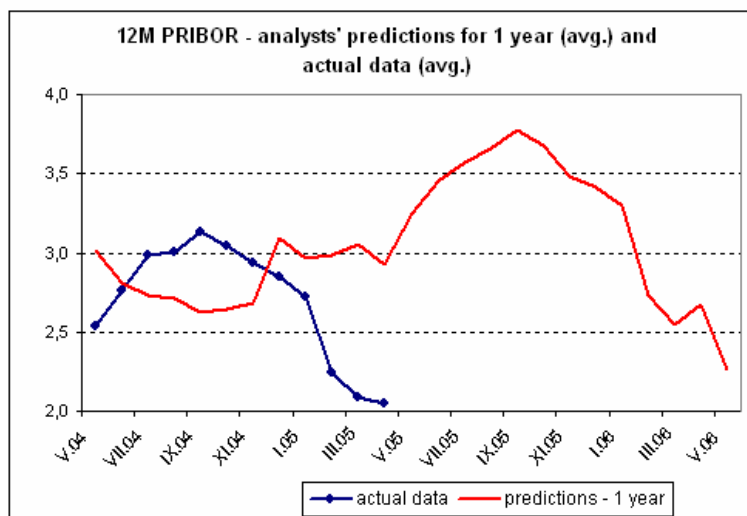
The average estimate for medium-term and long-term rates at the one-month horizon reflects the assumption that they will fluctuate around their current levels, thanks to the stable outlook for the interest rate settings and to low inflation. Turning to the longer-term outlook (one year), expectations regarding the evolution of domestic interest rates and the situation on global markets should be the key factors. The respondents on average expect the yield curve to shift upwards by around 50 basis points compared to the current level.

Prediction for Month of prediction	2W repo rate		12M PRIBOR		5Y IRS		10Y IRS	
	1 M	1 Y	1 M	1 Y	1 M	1 Y	1 M	1 Y
	%	%	%	%	%	%	%	%
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
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
III-05	2,0	2,3	2,0	2,6	2,9	3,6	3,5	4,1
IV-05	2,0	2,3	2,1	2,7	3,0	3,6	3,7	4,3
V-05	1,8	2,0	1,8	2,3	2,8	3,3	3,5	3,9

**/ 10Y benchmark yield*

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5R IRS	CR 3,70/13 yield
11.5.	0.02	0.02	0.03	0.03



4. The exchange rate

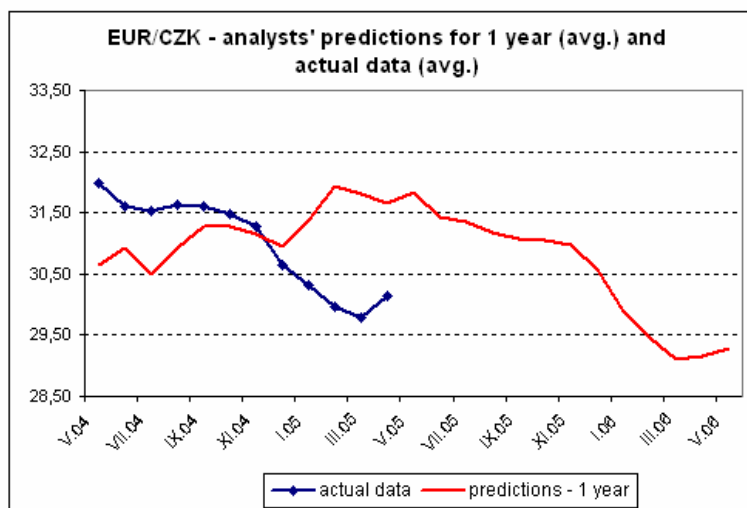
V-05	EUR/CZK	
	1 month	1 year
min.	29,50	28,50
average	29,96	29,28
max.	30,50	30,50

Exchange rate - fixing on the day of deadline for forecasts

11.5.	30,010
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Prediction for Month of prediction	exchange rate	
	1 month	1 year
	EUR/CZK	
V-04	32,25	31,83
VI-04	31,63	31,44
IX-04	31,66	31,07
XII-04	30,89	30,56
III-05	29,48	29,11
IV-05	29,89	29,15
V-05	29,96	29,28

The average estimate of the koruna's exchange rate at the one-month horizon is just below the level at the time of the survey. The range of the forecasts is again quite wide (29.50–30.50). According to the comments, a more volatile koruna can be expected in the weeks ahead. The respondents believe that the major factor affecting the exchange rate will be developments in the region. By contrast, the koruna should continue to more or less ignore developments on the domestic political scene. A greater weakening of the domestic currency is likely in the early summer in connection with the repatriation of earnings of foreign-owned companies.



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 29.28/EUR and the individual forecasts range between CZK 28.50/EUR and CZK 30.50/EUR.

According to the analysts, the koruna's expected long-term appreciation trend 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.

We would like to thank the following respondents for their contributions to the May survey of financial market inflation expectations:

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