

Measuring financial market inflation expectations – Results of the 74th measurement (June 2005)

Eleven domestic and two foreign analysts contributed their predictions for inflation and other financial market indicators to the June CNB's survey. The respondents' expectations are essentially unchanged. The solid growth of the domestic economy, based on the growing export performance of Czech industry, should continue. The low-inflation environment will not exert upward pressure on interest rates, and the koruna should continue its gradual appreciation trend.

1. Inflation

VI-05	annual CPI (%)	
	1 year	3 years
min.	1,8	2,0
average	2,3	2,5
max.	2,6	3,2

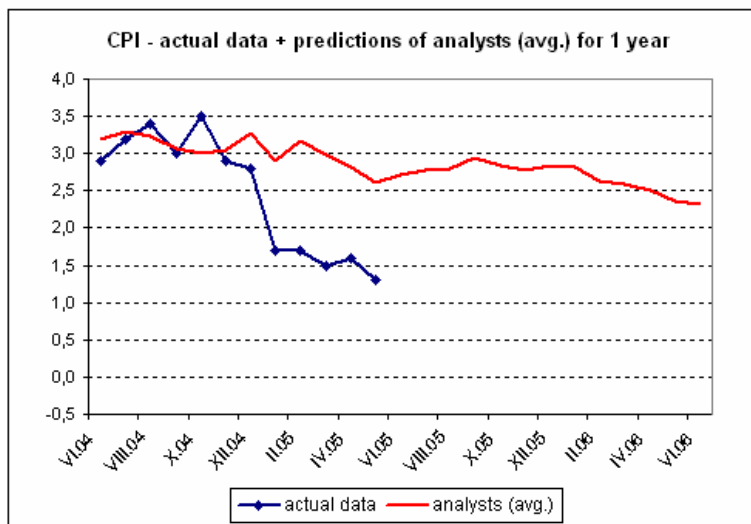
According to the analysts' comments, the May inflation figures confirm the tendencies of recent months. The rapid appreciation of the koruna in the first few months of this year has reduced import prices and hence the overall pace of inflation. Prices are also being kept low by strong competition in the retail sector and cheap imports from Asia. The next few months may yet bring a further decline or stagnation of the price level. According to the

respondents, however, once the effect of the high comparison base of last year has unwound, inflation will gradually rise to around 2% by the end of this year.

Higher housing costs (electricity, rents), higher excise duties on tobacco, and prices of services, particularly in hotels and restaurants, recreation and culture, will have an inflationary impact. The analysts also expect an increase in consumer demand, resulting in a gradual rise in retail prices. On the other hand, prices of consumer goods, especially clothing and footwear, should help slow inflation. The koruna's future 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 2.3%.

The average estimate of the annual inflation rate at the three-year horizon is 2.5%.

Prediction for Month of prediction	annual CPI	
	1 Y	3 Y
	%	%
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
VI-05	2,3	2,5



2. Gross domestic product

Prediction for Month of prediction	GDP growth at the end of	
	this year %	next year %
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
VI-05	4,0	3,9

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

The analysts' concerns about a slowdown in the Czech economy were somewhat dispelled by the 2005 Q1 economic growth data. Net exports were the main factor behind the growth. The export performance of industry should be further boosted by the launch of car production at TPCA Kolín in the months ahead. Due to slackening external demand, however, the contribution of foreign trade to economic growth is expected to weaken. This should be offset by domestic consumption. In a situation of record low mortgage interest rates, households are still favouring long-term housing investment to growth in immediate consumption. Nevertheless, the analysts predict that slightly faster wage growth in this year and a decline in unemployment might boost consumer demand and ensure a higher contribution thereof to GDP growth. Higher government consumption can be expected in connection with the forthcoming elections. The average growth forecast remains at 4.0% for this year and at 3.9% for 2006.

3. Interest rates

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

According to most of the respondents, the absence of inflationary pressures, growth in the potential output of the domestic economy, expectations of a more or less stable koruna exchange rate and a preponderance of "doves" in the current Bank Board should result in a longish period of interest rate stability. Some of the analysts mention that there is still some likelihood of a further reduction of CNB rates in the event of stronger appreciation of the koruna, a cooling of the euro area economy and a reduction of ECB rates. However, stability and a subsequent increase in interest rates depending on the speed of closure of the output gap and the acceleration of consumer demand remains the prevailing scenario. Nevertheless, the expected timing of the first tightening of CNB monetary policy differs significantly among the respondents, the estimates ranging between the end of this year and the end of next year. Generally speaking, the expected interest rate increase has again been shifted further into the future and the forecasts of its extent have been downscaled. The repo rate forecasts at the one-year horizon range between 1.75% and 2.25% (1.75% – seven respondents, 2.00% – four respondents, 2.25% – three respondents).

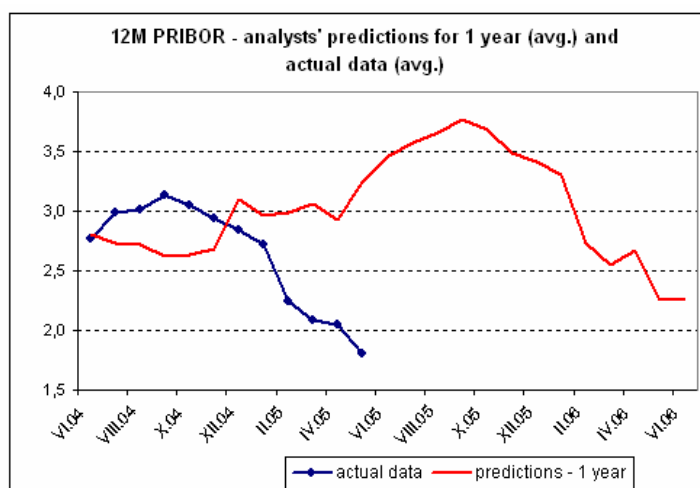
The average estimate for medium-term and long-term rates at the one-month horizon traditionally broadly correspond to their current market levels. In the longer term (one year), the respondents on average expect the yield curve to shift upwards by around 70 basis points in the 5Y segment and by around 50 basis points in the 10Y segment compared to their current levels. The expected yield growth should be affected primarily by developments in Europe and the monetary policy rate settings.

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 %
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
VI-05	1,8	1,9	1,8	2,3	2,6	3,2	3,3	3,8

**/ 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
10.6.	0,02	0,02	0,03	0,03



4. The exchange rate

VI-05	EUR/CZK	
	1 month	1 year
min.	29,50	28,50
average	30,10	29,27
max.	30,60	30,00

Exchange rate - fixing on the day of deadline for forecasts

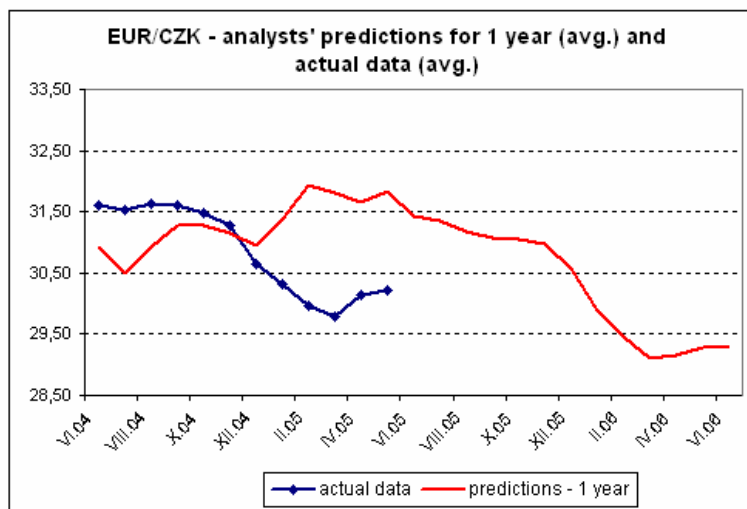
10.6.	30,000
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Prediction for Month of prediction	exchange rate 1 month 1 year EUR/CZK	
	1 month	1 year
VI-04	31,63	31,44
IX-04	31,66	31,07
XII-04	30,89	30,56
III-05	29,48	29,11
IV-05	29,89	29,15
V-05	29,96	29,28
VI-05	30,10	29,27

The average estimate of the koruna's exchange rate at the one-month horizon is just above the level at the time of the survey. The range of the forecasts is quite wide (29.50–30.60). According to one of the comments, the recent currency movements and the structure of the Czech Republic's balance of payments show that several opposing factors are operating on the market and, since none

of them is strong enough to set the future trend, the estimate for the exchange rate going forward is surrounded in uncertainty.

The koruna's exchange rate will continue to be affected primarily by the activities of foreign investors – sentiment on the euro-dollar market and sentiment in the Central European region – as well as by the forthcoming payment of dividends by foreign-owned companies, and, to a lesser extent, the domestic macro data.



In the longer term, most of the analysts incline towards the scenario of gradual appreciation of the koruna. The average estimate for the one-year horizon is unchanged from the last survey at around CZK 29.30/EUR, and the individual forecasts range between CZK 28.50/EUR and CZK 30.00/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 also enjoys fundamental support in the medium term from the improving current account, primarily thanks to the trade balance. On the other hand, the portfolio investment structure shows that investment in fixed-income instruments is sensitive to the interest rate differential, which is negative at present. This is not likely to change for at least the rest of this year, so it cannot be expected to provide support for the koruna.

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

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