ČESKÁ ČNB NÁRODNÍ BANKA

# Measuring financial market inflation expectations – Results of the 75th measurement (July 2005)

Eleven domestic and two foreign analysts sent their predictions for future developments of inflation and other financial market indicators into the July CNB's survey. Respondents' expectations do not change more principally. The only major revision has been made to GDP growth, which should accelerate primarily in 2005 as a result of easier monetary conditions in 2004 and 2005. Compared to the June survey, the analysts expect above all an easier interest rate component of the monetary conditions due to a slight upward revision of the inflation forecast.

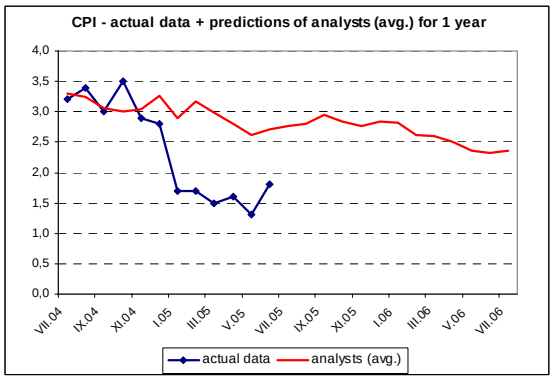
## 1. Inflation

| VII-05 | annual CPI (%) | |
|---|---|---|
| | 1 year | 3 years |
| **min.** | 1,9 | 1,9 |
| **average** | 2,4 | 2,5 |
| **max.** | 2,8 | 3,1 |

Compared to the June survey, the inflation forecast slightly increased at the 1Y horizon, mainly due to the unexpectedly high June growth in consumer prices (especially due to a one-off effect of an increase in telecommunication services prices). However, according to the analysts, inflation should remain below the CNB's inflation target.

The analysts expect the high oil prices as well as higher housing costs (electricity, rents etc.) and excise duty on tobacco to remain the main pro-inflationary risks. Sound GDP growth, driven mainly by net exports, has not created demand-pull inflationary pressures so far. According to the analysts, these should occur between 2006 Q2 and Q3 when the output gap will close and switch into positive figures. The downside risks can be seen in the expected appreciation of the koruna that keeps import prices at lower levels. This factor should also persist in the coming months.

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



## 2. Gross domestic product

| Prediction for<br>Month of prediction | GDP growth at the end of<br>this year | <br>next year |
|---|---|---|
| | % | |
| VII-04 | 3,4 | 3,7 |
| IX-04 | 3,6 | 3,8 |
| XII-04 | 3,8 | 4,0 |
| III-05 | 4,0 | 3,9 |
| V-05 | 4,0 | 3,8 |
| VI-05 | 4,0 | 3,9 |
| VII-05 | 4,2 | 4,0 |

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

The analysts increased the forecast of GDP growth in 2005 and 2006 due to a further slight easing of the interest rate component of the monetary conditions. According to the analysts, net exports and investment will remain the main factor underlying the growth this year, while household and government consumption will remain weak. Some are of the opinion that foreign investors have completed or are completing the wave of their investment; thus, the power of domestic exports starts to show only now. Also taking into account weak consumer demand, preventing robust import growth, and a decline in imports of manufacturing machinery due to already completed investments, the trade balance should remain in surplus. The fall in the current household consumption in the environment of record low levels of interest rates is interpreted by the analysts as a preference for long-term housing investment. This hypothesis is also supported by record high demand for mortgage loans.

Nevertheless, the growth structure might change already in 2006.A possible weakening of economic growth in Germany would result through declining exports from the Czech Republic in a decrease in the contribution of net exports to GDP. The ongoing real appreciation of the koruna against the euro would not play into the hands of domestic exporters, either. In contrast, the fall in net exports could be eliminated by rising consumption, both household and government, with the latter striving for re-election by means of its expansionary fiscal policy.

According to some analysts, the output gap should close at the turn of 2006 H1 and H2 as a result of easier monetary conditions.

## 3. Interest rates

| VII-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 | 1,7 | 1,8 | 2,5 | 2,8 | 3,1 | 3,3 |
| **average** | 1,8 | 1,9 | 1,8 | 2,3 | 2,6 | 3,2 | 3,3 | 3,8 |
| **max.** | 1,8 | 2,3 | 1,9 | 2,8 | 2,7 | 3,6 | 3,5 | 4,0 |

The forecast of short- and long-term interest rates remained unchanged compared to the June survey. Most of the analysts expect an increase in the 2W repo rate at the one-year horizon (four analysts of the 13 respondents expect an increase to 2.00% and three analysts to 2.25%; six analysts predict stability at the current level). In contrast to the last survey, the tightening of monetary policy by the CNB has been further delayed and the radical rise in the interest rates has been moderated.

The gradual closing of the output gap and the subsequent risk of demand-pull inflationary pressures are the main determinants of the expected increase in interest rates. According to the analysts, the future ECB monetary policy will be of great importance. If the ECB increases its interest rates at the 1Y horizon, there will be pressures towards the koruna‘s depreciation through the enhanced attractiveness of euro-denominated assets. In order to prevent the easing of the monetary conditions, the CNB will be forced to increase rates. Nevertheless, there is still the risk of the opposite development – a cut in the rates by the ECB, which, however, is not topical according to the analysts.

The average estimate for medium- and long-term rates at the 1M horizon is slightly above the current values. On average, the analysts expect the yield curve to shift upwards at the 1Y horizon, by around 60 basis points at

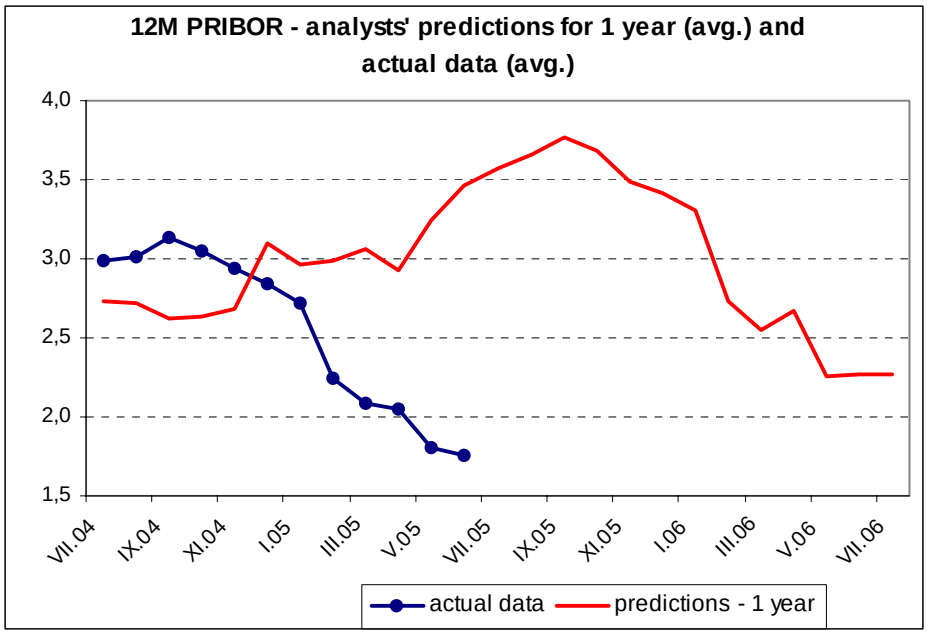
the 5Y maturity and 50 basis points at the 10Y maturity, as compared to their current levels. The expected slope of the yield curve, measured as 10Y – 1Y, should remain stable at 150 basis points at the 1Y horizon. The expected yield increase should be primarily affected by the developments in the euro area and the CNB's monetary policy rate settings.

| Prediction for | 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 |
| Month of prediction | % | | % | | % | | % | |
| VII-04 | 2,3 | 3,0 | 2,9 | 3,6 | 4,4 | 4,9 | *5,2* | *5,6* |
| 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* |
| 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 |
| VII-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 | 5Y IRS | 10Y IRS |
|---|---|---|---|---|
| **12.7.** | 1,75% | 1,77% | 2,63% | 3,27% |




## 4. The exchange rate

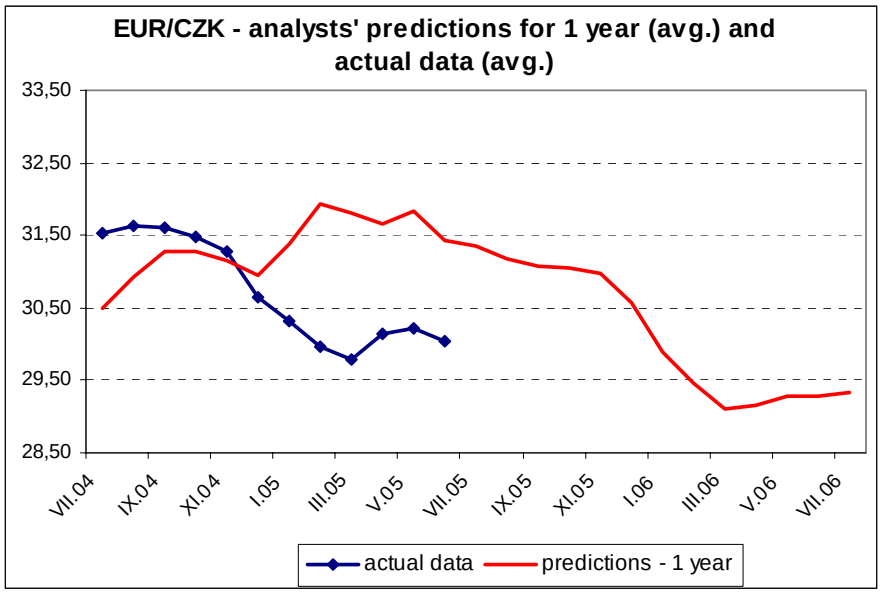
| VII-05 | EUR/CZK | |
|---|---|---|
| | 1 month | 1 year |
| **min.** | 29,80 | 28,60 |
| **average** | 30,09 | 29,34 |
| **max.** | 30,60 | 30,20 |

| Prediction for | exchange rate | |
|---|---|---|
| | 1 month | 1 year |
| Month of prediction | EUR/CZK | |
| VII-04 | 31,53 | 31,36 |
| IX-04 | 31,66 | 31,07 |
| XII-04 | 30,89 | 30,56 |
| III-05 | 29,48 | 29,11 |
| V-05 | 29,96 | 29,28 |
| VI-05 | 30,10 | 29,27 |
| VII-05 | 30,09 | 29,34 |

**Exchange rate - fixing on the day of deadline for forecasts**

| | |
|---|---|
| **12.7.** | 30,210 |

The forecast for the koruna's exchange rate against the euro remained unchanged. On average, the analysts expect a slight appreciation of the exchange rate to 30.10 at the 1M horizon, with individual forecasts ranging between CZK 28.80 – 30.60 for the euro. At the short-term horizon, the koruna will be affected by a number of opposing factors. The expected outflow of dividends (up to CZK 45 billion in 2005) should act towards a slight depreciation. This should be, however, fully offset by excellent results of the trade balance and the positive sentiment regarding currencies in the central European region. One of the analysts mentions a repeated increase in the global fund portfolio managers ' appetite for risk, which could act towards a stronger koruna in the coming months.




The forecast for the koruna's exchange rate against the euro also remained unchanged at the 1Y horizon. On average, the analysts expect a slight appreciation of the exchange rate to 29.30, with individual forecasts ranging between CZK 28.60 -30.20 for the euro. The main reason for the appreciation of the koruna's nominal exchange rate against the euro (one of the analysts estimates 2% p.a.) is the real and nominal convergence of the Czech economy to the European economy. The koruna enjoys fundamental support in the medium term also due to the improving current account, primarily thanks to the development of the trade balance.
On the other hand, a rising outflow of dividends and an outflow of portfolio investment, sensitive to the interest rate differential, could act against the koruna. According to most of the analysts, the interest rate differential will remain negative for instruments with shorter maturities at least until the end of 2005. In the longer term, the koruna could be affected in both directions by the expected monetary policies of the ECB and the CNB.

We would like to thank the following respondents for their contributions to the July survey of financial market inflation expectations:
David Marek, Patria Finance
David Navrátil, Česká spořitelna
Jan Vejmělek, Komerční banka
Vladimír Pikora, Volksbank
Helena Horská, Raifffeisenbank
Jan Kubíček, Newton Holding
Petr Sklenář, Atlantik Finance
Markéta Šichařová, Next Finance
Marek Fér, ČSOB
Patrik Rožmberský, Živnobanka
Radomír Jáč, PPF Asset Management
Gillian Edgeworth, Deutsche Bank London
Anders Faergemann, AIG International Limited
Special thanks go to the analytical teams at Česká spořitelna, Komerční banka and Raiffeisenbank for their comments on the forecasts.

Prague, 15 July 2005