

Measuring financial market inflation expectations – Results of the 76th measurement (August 2005)

Thirteen domestic analysts and one foreign analyst sent in their predictions for inflation and other financial market indicators to the CNB's August survey. The respondents' expectations are essentially unchanged. The analysts slightly increased their forecasts for inflation and short-term interest rates at the one-year horizon, and their prediction for GDP growth this year rose modestly again. Compared to the July survey, the analysts expect a tighter exchange rate component of the real monetary conditions due to a revision of the koruna's exchange rate forecast towards stronger appreciation.

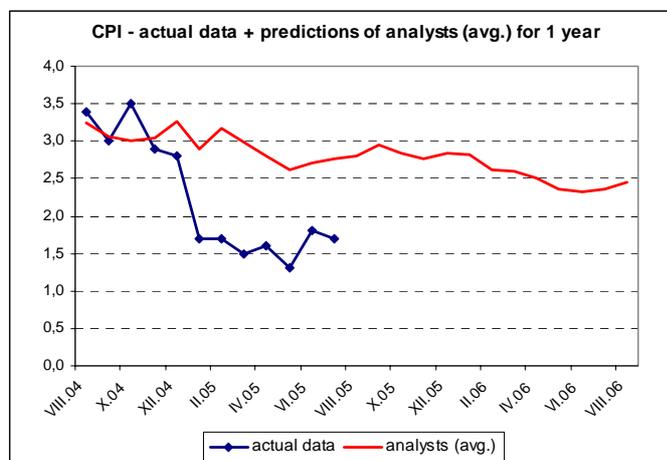
1. Inflation

VIII-05	annual CPI (%)	
	1 year	3 years
min.	1,8	2,0
average	2,5	2,6
max.	2,9	3,1

The inflation forecast further increased slightly at the one-year horizon compared to the July survey. According to the analysts, inflation should gradually rise in the months ahead, returning to the CNB's target band at the end of this year (and perhaps approaching 2.5% in December). However, it should continue to remain below the CNB's inflation target.

According to the analysts, the main upside risks to inflation are high oil prices and changes to regulated prices (planned increases in electricity and gas prices, rents and excise duties on tobacco). The evolution of food prices remains an unknown. Sound GDP growth, driven mainly by net exports and expectations of slower closure of the output gap, will continue to curb demand-pull inflationary pressures. According to the analysts, these pressures should emerge in late 2006/early 2007, when the output gap should close and switch to positive figures. The downside risks to inflation can be seen mainly in the expected appreciation of the koruna, which will keep import prices at lower levels.

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



2. Gross domestic product

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

VIII-05	GDP growth at the end of	
	current year	next year
min	4,0	3,4
average	4,3	4,0
max	5,1	4,5

Roughly half of the respondents in the August survey further increased their forecasts for GDP growth this year. According to the analysts' comments, the growth will continue to be driven mainly by net exports. By comparison with the previous year, investment slowed and the contribution of household and government consumption should also remain weaker. The investment growth last year, combined with a falling import propensity of Czech industry, and also the Czech Republic's accession to the EU, which has strengthened perceptions of Czech product quality, have initiated rapid growth in the Czech Republic's export performance. Domestic exporters have thus been more successful on foreign markets, despite the appreciating exchange rate of the koruna. According to one respondent, domestic exporters are not passing the koruna's appreciation through into product prices, but are trimming their margins, and free funds for investment are consequently declining. The reason for the decline in domestic consumption despite growing disposable income, say the analysts, is a higher savings ratio and above all a preference for long-term housing investment over immediate consumption.

Next year, however, the growth structure is likely to change. A cooling of the euro area economy remains a risk for the Czech Republic. This would cause exports to decline and the contribution of net exports to GDP to fall. Continuing appreciation of the koruna against the euro would not help domestic exporters, either. However, the fall in net exports could be offset by growing consumption by households and the government, which, prior to elections, will try to win votes with more expansive fiscal policy.

3. Interest rates

VIII-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.	1,75	1,75	1,70	1,80	2,50	2,75	3,20	3,25
average	1,75	2,09	1,85	2,39	2,71	3,21	3,41	3,80
max.	1,75	2,50	2,00	2,70	2,90	3,75	4,30	4,40

The forecast for short-term and long-term interest rates went up slightly at the one-year horizon, while long-term rates remained unchanged. The number of respondents who at this horizon expect a rise in the 2W repo rate increased perceptibly compared to the last survey. The expected pace of the monetary policy tightening also increased. (Of the fourteen respondents, four predict the repo rate at 2.00%, six at 2.25%, one at 2.50% and three at the current level. In the previous survey, seven analysts had expected a rise to 2.00% or 2.25% and six had expected stability at the current level.)

The analysts say that rising inflation, the gradual closing of the output gap and the subsequent risk of demand-pull inflationary pressures will lead to a gradual tightening of monetary policy by the CNB. However, the pace of that tightening will also depend on the koruna's exchange rate, since faster appreciation of the domestic

currency leads to tighter monetary conditions and hence reduces the need to achieve the same effect via higher interest rates. According to the analysts, future ECB monetary policy will be of great importance. An increase in ECB rates would widen the negative interest rate differential and lead to an outflow of funds from domestic assets into euro assets. The subsequent depreciation of the koruna would conversely generate a need for a faster tightening of domestic monetary policy.

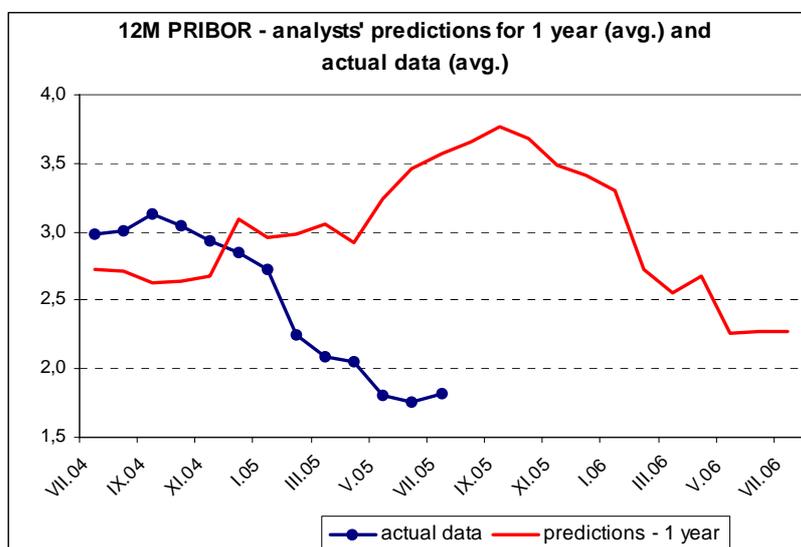
The average estimates for medium-term and long-term rates at the 1M horizon are very close to their current levels. At the 1Y horizon, the analysts on average expect the yield curve to shift upwards by around 50 basis points at the 5Y maturity and by 40 basis points at the 10Y maturity compared to their current levels. The expected increase in yields should be affected primarily by the CNB's monetary policy rate settings and developments in the euro area.

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
	%		%		%		%	
VIII-04	2,40	3,20	3,00	3,70	4,30	4,80	5,10	5,50
IX-04	2,52	3,36	3,14	3,77	4,45	4,88	5,17	5,60
XII-04	2,49	3,04	2,91	3,41	3,68	4,27	4,15	4,76
III-05	2,02	2,26	1,99	2,55	2,90	3,58	3,49	4,08
VI-05	1,75	1,93	1,75	2,27	2,59	3,22	3,28	3,85
VII-05	1,76	1,94	1,78	2,31	2,58	3,21	3,29	3,84
VIII-05	1,75	2,09	1,85	2,39	2,71	3,21	3,41	3,80

**/ 10Y benchmark yield*

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
10.8.	1,75%	1,89%	2,75%	3,31%



4. The exchange rate

VIII-05	EUR/CZK	
	1 month	1 year
min.	29,45	28,40
average	29,77	29,20
max.	30,50	30,00

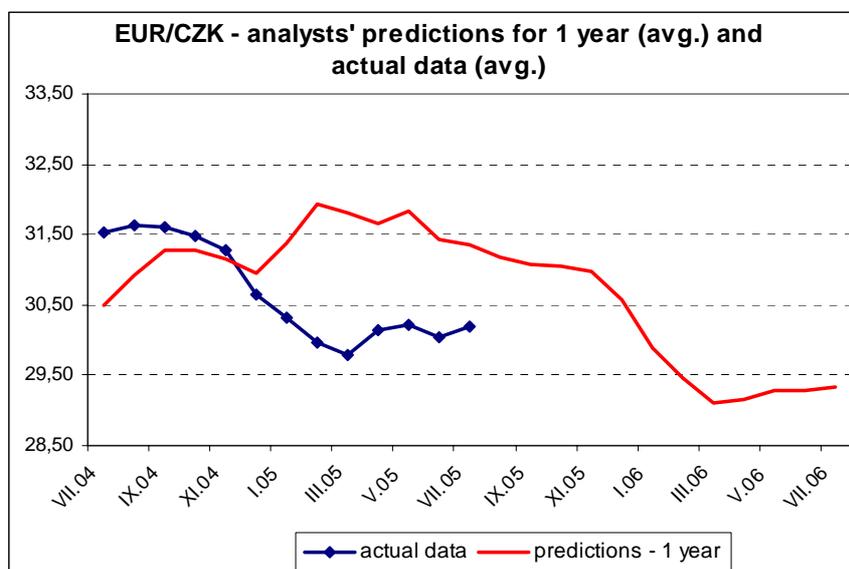
Exchange rate - fixing on the day of deadline for forecasts

10.8.	29,360
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Prediction for Month of prediction	exchange rate EUR/CZK	
	1 month	1 year
VIII-04	31,51	31,19
IX-04	31,66	31,07
XII-04	30,89	30,56
III-05	29,48	29,11
VI-05	30,10	29,27
VII-05	30,09	29,34
VIII-05	29,77	29,20

The short-term forecast for the koruna-euro exchange rate has seen a major change connected with the current appreciation of the domestic currency. The analysts on average expect an exchange rate of CZK 29.80 to the euro at the one-month horizon. The individual forecasts range between CZK 29.45 and CZK 30.50 for the euro.

At the nearest horizon, the koruna will continue to be affected by opposing factors – domestic data (trade balance, GDP), movements of other regional currencies, the negative differential. Repatriation of dividends can be expected to have a major effect during August, although the main wave most probably occurred in July. The koruna may also be negatively affected by potential capital outflows connected with the growth in long-term US yields and also by the uncertainty surrounding the September elections in Poland.



At the longer horizon, the majority of the analysts stick to the scenario of gradual appreciation of the domestic currency. The forecast for the koruna-euro exchange rate at the one-year horizon shifted slightly in August towards a stronger koruna. The average estimate is CZK 29.20/EUR, with the individual forecasts ranging from CZK 28.40/EUR to CZK 30.00/EUR. The analysts consider the real and nominal convergence of the Czech economy to the European economy to be the main reason for the appreciation of the koruna's nominal exchange rate against the euro. The koruna is being supported by favourable economic fundamentals, especially the high economic growth and the better-than-expected evolution of the balance of trade.

Acting against the koruna, by contrast, are repatriation of dividends and outflow of portfolio investment, which is sensitive to the interest rate differential. According to most of the analysts, the interest rate differential will

remain negative for shorter-maturity instruments at least until the end of 2005. Although this year the outflow of dividends abroad has declined relative to last year (owing to last year's repatriation of accumulated earnings following the Czech Republic's accession to the EU), the long-term trend should be the opposite, given that the profitability of foreign-owned firms will increase.

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

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