CZECH CNB NATIONAL BANK

Measuring financial market inflation expectations – Results of the 79th measurement (November 2005)

Thirteen domestic analysts and one foreign analyst sent in their predictions for inflation and other financial market indicators to the CNB's November survey. Compared with the October survey there was a modest increase in the market inflation forecast, due to a re-evaluation of fuel prices and regulated prices. The slightly higher price pressures (some analysts expect only 20% pass-through of the high energy prices into inflation expectations) will make the CNB further tighten its monetary policy. However, the absence of demand-pull inflationary pressures and the expected appreciation of the koruna will act against a faster rise in interest rates. The GDP growth estimate remains unchanged.

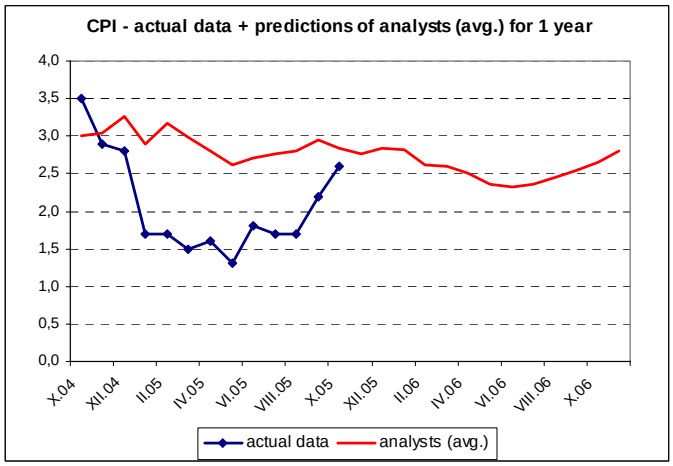
1. Inflation

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

The inflation forecast has risen slightly compared to the October survey. The market expects year-on-year CPI growth of 2.8% at the one-year horizon and 2.6% at the three-year horizon, which is the first increase in the estimate in four months. The re-evaluation of the inflation forecast was due to concerns about faster growth in fuel prices and regulated prices (gas and electricity, and probably also rents and excise duty on tobacco products). Demand-pull inflation will be greatly subdued by the slowly closing output gap and the expected appreciation of the koruna. The size of the second-round effects of the high oil prices seems to be of key importance for the fulfilment of the inflation forecast. Some analysts expect only 20% pass-through of the energy price growth into inflation expectations. After the unwinding of the cost shock, which will push inflation above the 3% level at the start of 2006, inflation can be expected to return below the inflation target.

The range of the estimates was slightly wider than in October, reflecting the higher risk regarding the potential greater spill-over of the high energy prices into inflation expectations.

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



2. Gross domestic product

Prediction for Month of prediction	GDP growth at the end of this year	 next year %
XII-04	3,8	4,0
III-05	4,0	3,9
VI-05	4,0	3,9
VII-05	4,2	4,0
IX-05	4,7	4,2
X-05	4,7	4,3
XI-05	4,7	4,3

XI-05	GDP growth at the end of	
	current year	next year
min	4,1	3,3
average	4,7	4,3
max	4,9	4,9

The forecast for GDP growth did not chang from the October survey. The growth structure remains the same as well. Net exports will be the main driving force in both 2005 and 2006, but their contribution to the total growth will decrease in 2006 owing to nominal appreciation of the koruna. Nonetheless, the fall in exports will be at least partially offset by a modest rise in household consumption due to decreasing unemployment and increasing real wages. Investment growth should increase slightly next year thanks to the expected recovery in Germany. By contrast, a stronger koruna and higher oil prices, which reduce firms' profit margins, could act in the opposite direction.

Whereas the monetary conditions are assessed by the market as easy at present, they should gradually become slightly restrictive due to rising interest rates and continuing appreciation of the koruna. As a result, GDP growth could decrease in the following year.

The range of estimates for 2006 widened compared to October, reflecting uncertainty about the expected recovery of the German economy and the effect of the exchange rate component of the monetary conditions on the real economy.

3. Interest rates

XI-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.	2,00	2,00	2,20	1,90	3,20	2,80	3,60	3,30
average	2,04	2,46	2,55	2,80	3,32	3,57	3,77	4,00
max.	2,25	2,75	2,70	3,20	3,50	3,90	3,90	4,30

The interest rate path expected by the market rose compared to October. The market incorporated the October rise in the CNB's interest rates into its predictions and shifted the expected market curve to higher levels. Owing to concerns about a pick-up in inflation, which the CNB itself has also expressed publicly several times, the expected money market yield curve also steepened further. According to the market, the CNB will have to continue raising interest rates to prevent inflation from rising above the inflation target owing to the second-round effects of the high energy prices. According to the analysts, rates should remain flat at the CNB's November monetary-policy meeting. Most analysts expect a rate increase in 2006 Q1; at the one-year horizon, the rates should be raised to about 2.5%, i.e. 25 basis points more than the analysts expected a month ago.

The range of estimates of the 12M PRIBOR widened compared to October, reflecting the uncertainty regarding the expected evolution of inflation. The higher-than-predicted impact of the second-round effects of the high energy prices is a risk acting towards higher rates. Conversely, a stronger koruna could foster lower rates. The development of rates in the euro area will be another important factor of expected monetary policy. At least one of the analysts believes that the CNB's monetary policy will not be able to deviate from ECB rates by more than ±25 basis points.

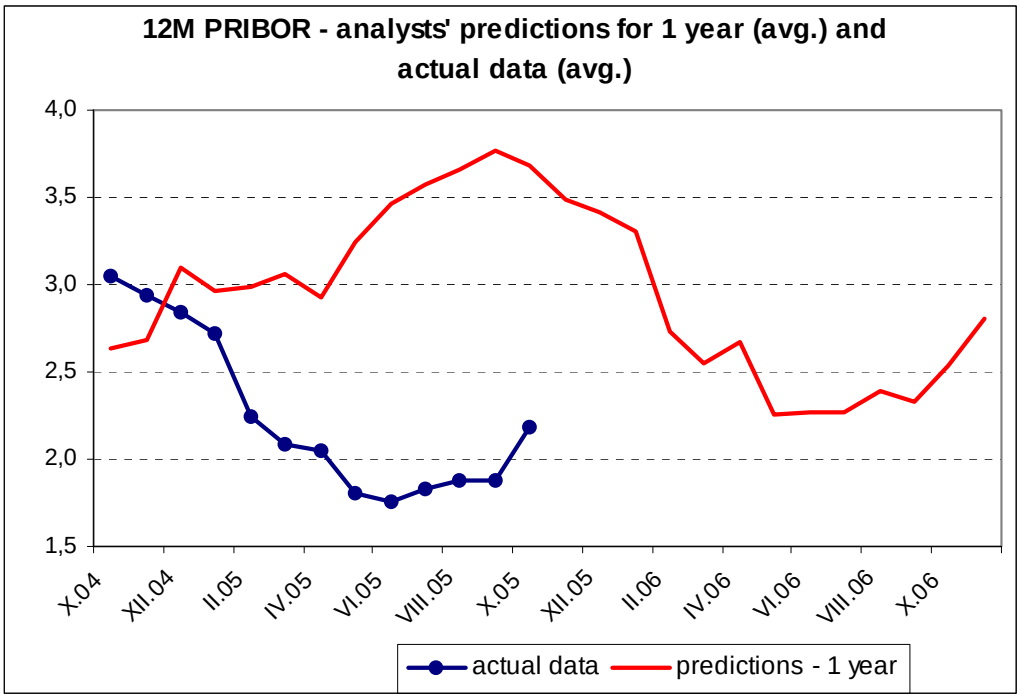
The movements in expected long-term interest rates at the one-year horizon were mixed. The expected five-year rates increased, whereas the expected ten-year rates slightly decreased. At the one-month horizon, however, they should be lower than their current levels.

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	%		%		%		%	
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
IX-05	1,75	2,06	1,86	2,32	2,71	3,15	3,31	3,69
X-05	1,75	2,25	2,06	2,54	2,95	3,36	3,43	3,88
XI-05	2,04	2,46	2,55	2,80	3,32	3,57	3,77	4,00

**/ 10Y benchmark yield*

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
10.11.	2,00%	2,64%	3,44%	3,84%



4. The exchange rate

XI-05	EUR/CZK	
	1 month	1 year
min.	29,10	28,00
average	29,33	28,76
max.	29,60	30,00

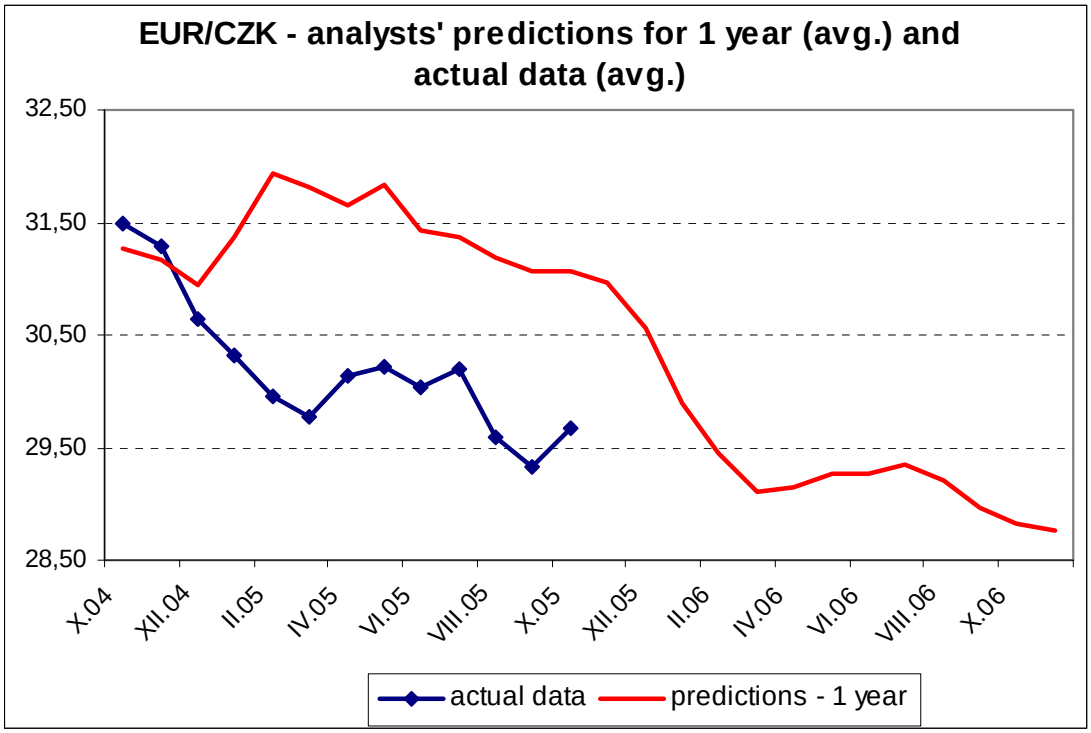
Exchange rate - fixing on the day of deadline for forecasts

10.11.	29,370

Prediction for Month of prediction	exchange rate 1 month EUR/CZK	1 year
XII-04	30,89	30,56
III-05	29,48	29,11
VI-05	30,10	29,27
VII-05	30,09	29,34
IX-05	29,28	28,97
X-05	29,43	28,83
XI-05	29,33	28,76

The expected extent of the koruna's appreciation against the euro decreased compared to the October survey. The market expects a 2.1% appreciation at the one-year horizon, compared to the 2.5% predicted in October. The reasons are the strengthening of the koruna in response to the October increase in the CNB's interest rates and the rise in the inflation forecast, together with the expected raising of ECB rates.

Nonetheless, the positive outlook for the koruna remains unchanged. The reasons are by now well known: the convergence of the Czech economy towards the EU countries, reflected, among other things, in an equalisation of the relative prices of goods and services via real exchange rate appreciation (higher inflation in the Czech Republic than in other countries or nominal appreciation of the koruna), the favourable trade balance (which by 2006 should completely offset the outflow of dividends) and the inflow of portfolio investment into Czech shares.



The range of the estimates for the koruna's exchange rate at the one-year horizon is the same as in the October survey. The foreign respondent is sticking to the weakest level of 30 CZK/EUR. At the one-month horizon the range widened slightly towards stronger figures. This could be due to an expected widening of the interest rate differential, assuming that domestic interest rates grow faster than euro rates. The appreciating dollar and negative regional sentiment (especially in Hungary) remain a contrary short-term risk.

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