

Measuring financial market inflation expectations – Results of the 80th measurement (December 2005)

Eleven domestic and two foreign analysts sent their predictions for inflation and other indicators into the December CNB's survey. Compared to the November forecast, the inflation forecast dropped modestly. According to the analysts, the lower second-round effects of relatively higher energy prices than they had recently expected will not lead to such robust growth in interest rates. By comparison with the November forecast, the lower interest rate path expected by the analysts, along with the expected lower appreciation of the koruna, will result in slightly easier monetary conditions and faster GDP growth next year.

1. Inflation

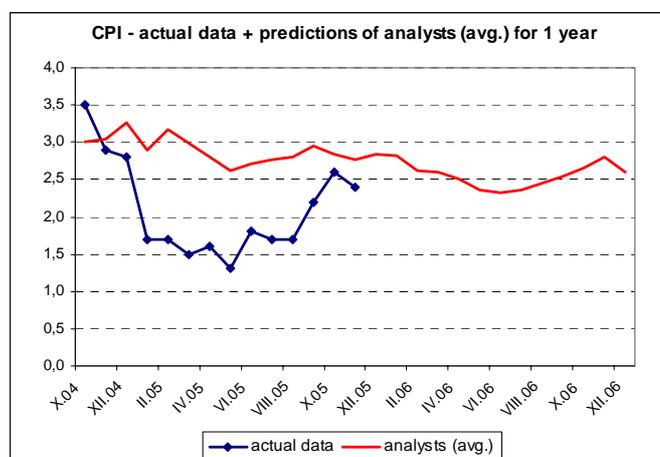
XII-05	annual CPI (%)	
	1 year	3 years
min.	2,0	2,0
average	2,6	2,5
max.	3,0	3,2

The inflation forecast decreased slightly compared to the November forecast. The analysts addressed expect the CPI to rise annually by 2.6% and 2.5% at the one-year and three-year horizons respectively. According to the analysts, long-term inflation expectations are thus well anchored. The downward revision of the inflation forecast is due to

lower-than-expected CPI growth in November, when *inter alia* a drop in fuel prices was observed, owing to cheaper oil. According to the analysts, the second-round effect of the relatively high energy prices may therefore not be as significant as they had originally expected. Regulated prices (gas, electricity and probably rent and excise duty on tobacco products) and oil prices (which have been rising again in December) will be of key importance for inflation going forward. After the unwinding of the cost shock, which will push inflation above 3% at the start of 2006, inflation can be expected to return below the inflation target.

The range of the estimates narrowed slightly compared to November, possibly reflecting lower risk regarding the potential spill-over of the high energy prices into inflation expectations. However, the lower number of respondents may be the limiting factor here.

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
XII-05	2,6	2,5



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
XII-05	4,9	4,4

XII-05	GDP growth at the end of	
	current year	next year
min	4,5	3,8
average	4,9	4,4
max	5,0	4,7

In December the analysts made an upward revision to their GDP growth forecasts for this year and the next. The revision of the estimates is due to the favourable GDP results in 2005 Q3 and expectations of slightly easier monetary conditions in 2006 compared to the November survey. A lower interest rate path and a lower appreciation of the koruna are expected. Other signs of recovery in Europe are viewed positively as well.

The structure of the expected growth remains unchanged. Growth will continue to be driven mainly by net exports in 2006, although their weight will slowly weaken and they will be partly replaced by a slight upturn in consumer demand due to decreasing unemployment and increasing real wages.

The range of the estimates for 2006 narrowed significantly compared to November, possibly reflecting reduced uncertainty surrounding future developments in Germany and greater confidence in the recovery in domestic consumer demand.

3. Interest rates

XII-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	3,10	2,80	3,50	3,30
average	2,00	2,40	2,47	2,75	3,21	3,47	3,62	3,89
max.	2,00	2,75	2,60	3,00	3,30	3,70	3,90	4,20

By comparison with the November survey, the expected interest rate path declined slightly (by 10 basis points on average). The analysts expect the CNB to increase interest rates less sharply, owing to a downward revision of the inflation forecast. The likelihood of a revision of the inflation forecast along with a revision of the expected interest rate path has also been mentioned several times by CNB representatives. The lower interest rate path is due to a stronger exchange rate of the koruna, which is tightening the monetary conditions and pushing back the expected rise in the CNB's interest rates.

According to the analysts, rates should remain flat at the CNB's December monetary policy meeting. Most analysts expect a rate increase in 2006 Q1, while some of them expect a further rise to 2.5% by the end of 2006.

The range of the estimates of the 12M PRIBOR at the one-year horizon narrowed slightly compared to November. The higher-than-forecasted impact of the second-round effects of the high energy prices remains an upside risk. Conversely, a stronger koruna could foster lower rates. Rates in the euro area will be another important factor of expected monetary policy.

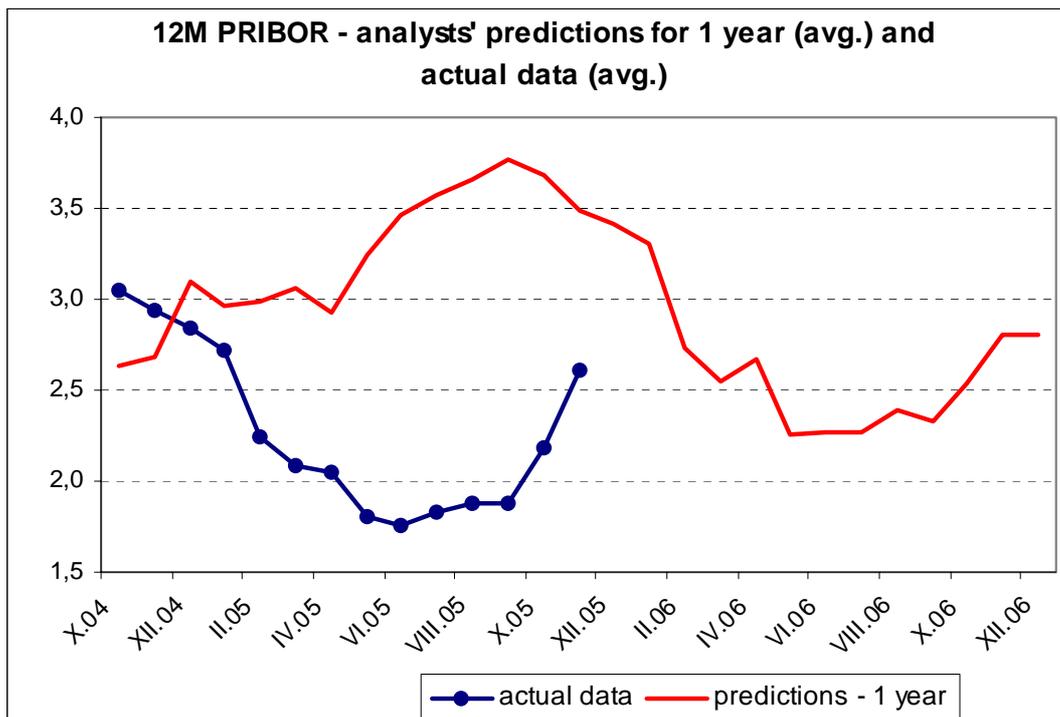
By comparison with the November survey, the expected long-term interest rates decreased slightly, too. Whereas they should drop at the one-month horizon, they are expected to rise at the one-year horizon. This is due to global developments and unpredictable fiscal policy, as it is not clear what deficit will be recorded this year, how much the government intends to raise from eurobond issuance in 2006, or whether it will use the approved framework to issue CZK 22 billion to pay its guarantee to the CNB.

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
	%		%		%		%	
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
XII-05	2,00	2,40	2,47	2,75	3,21	3,47	3,62	3,89

**/ 10Y benchmark yield*

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
9.12.	2,00%	2,53%	3,26%	3,65%



4. The exchange rate

XII-05	EUR/CZK	
	1 month	1 year
min.	28,86	27,90
average	29,06	28,55
max.	29,40	29,70

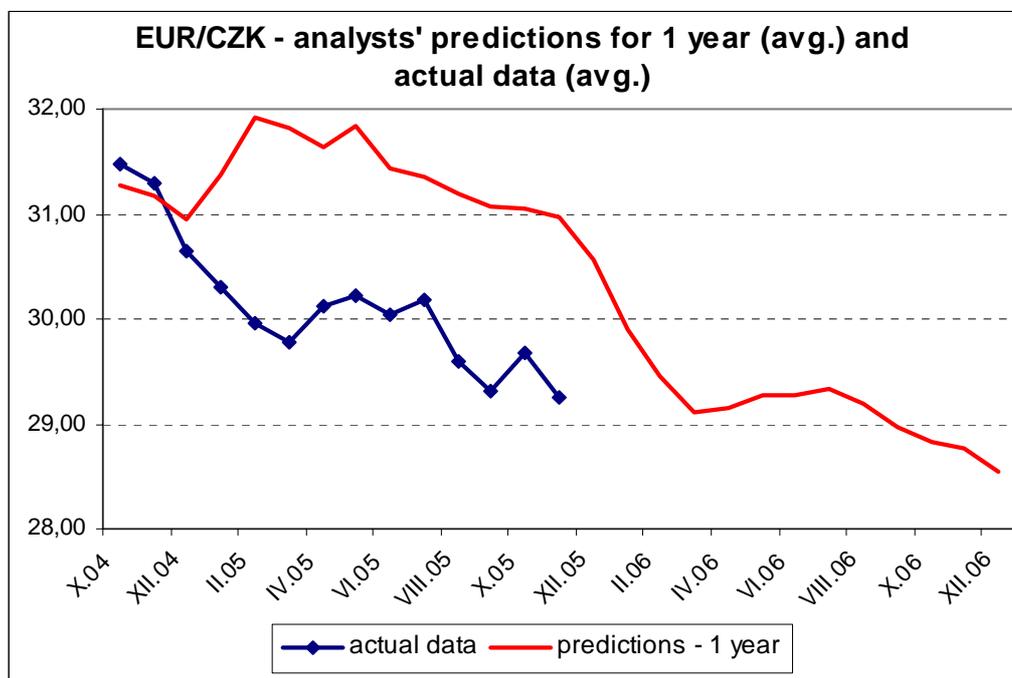
Prediction for Month of prediction	exchange rate	
	1 month EUR/CZK	1 year EUR/CZK
XII-04	30,89	30,56
III-05	29,48	29,11
VI-05	30,10	29,27
VII-05	30,09	29,34
IX-05	29,28	28,97
X-05	29,43	28,83
XI-05	29,33	28,76
XII-05	29,06	28,55

Exchange rate - fixing on the day of deadline for forecasts

9.12.	29,035
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The expected rate of appreciation of the koruna against the euro declined compared to November. The market expects a 1.7% appreciation at the one-year horizon, compared to the 2.1% predicted in November. This is due to the November appreciation of the koruna in response to the calming of the situation as regards the Polish zloty, Slovakia's ERM II entry and technical factors. The expected lower appreciation might also be due to the slowing improvement in the trade balance.

Nonetheless, the positive outlook for the koruna remains unchanged. The reasons are by now well known: faster GDP growth than in the euro area countries, the convergence of the Czech economy towards the EU countries, and the continuing FDI inflow (here the analysts most often mention the expected announcement of the construction of the Hyundai car factory).



The range of the estimates for the koruna's exchange rate remained the same as in the November survey. There was a shift to a stronger level at both horizons. The weakest koruna exchange rate is as usual predicted by the foreign analysts (one of them predicts 29.70 CZK /EUR). This might

be due to an expected shift of the interest rate differential in favour of euro rates. Conversely, faster appreciation of the koruna might be fostered by a halt in interest rate increases by the Fed.

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