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Measuring financial market inflation expectations – Results of the 82nd measurement (February 2006)

Eleven domestic and two foreign analysts sent in their predictions for inflation and other financial market indicators to the CNB's February survey. The analysts left their forecasts virtually unchanged during February. The inflation forecast is completely the same as the January estimates and the forecast for GDP growth is practically identical too. The analysts expect a more moderate rise in interest rates and a negligibly stronger exchange rate of the koruna at the one-year horizon, due to the current evolution of interest rates and the exchange rate. According to the analysts, the GDP growth will continue, driven in particular by exports and investment, with no signs of demand-pull inflationary pressures. In the view of some of the analysts, the monetary conditions will have a neutral effect and the CNB should offset any tightening of the exchange rate component by raising interest rates more slowly.

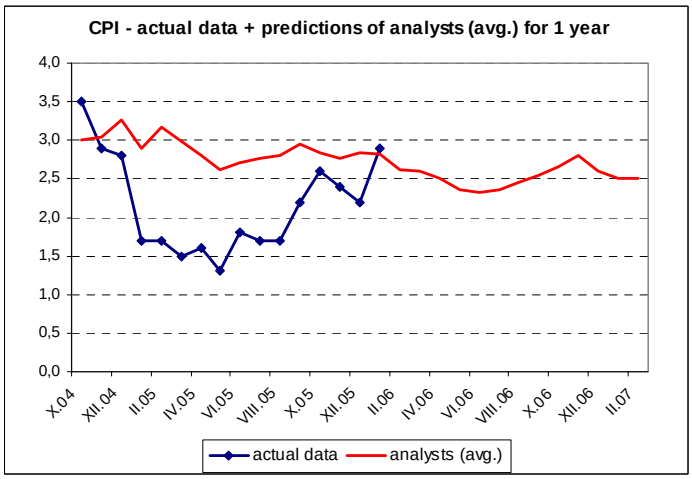
Inflation

II-06	annual CPI (%)	
	1 year	3 years
min.	1,7	1,9
average	2,5	2,4
max.	3,0	2,8

The inflation forecast was unchanged from January. The analysts expect inflation to rise annually by 2.5% at the one-year horizon and 2.4% at the three-year horizon. The primary inflation factor will be growth in regulated prices; nevertheless, the January jump should be followed by a gradual unwinding. During 2006, the increase in excise duties on cigarettes should continue to pass through to cigarette prices (in 2005 only 20% of the increase in duties had passed through to cigarette prices and 80% came from retailers' margins, whereas the analysts expect the reverse ratio this year). The stronger koruna and the lower inflation forecast in Germany, which is reducing import prices, the expected decline in oil prices and the wider output gap, which does not suggest any demand-pull inflationary pressures, all persist.

By contrast, the range of the estimates for the one-year horizon narrowed sharply. This might be linked with the reduced uncertainty about the second-round effect of the increase in regulated prices. The fall in the upper limit of the estimate might reflect the lower pass-through of the growth in administrative prices to inflation expectations expected by some analysts.

Prediction for Month of prediction	annual CPI 1 Y %	3 Y %
I-05	2,8	2,7
II-05	2,6	2,7
IV-05	2,5	2,5
VII-05	2,4	2,5
X-05	2,7	2,5
XII-05	2,6	2,5
I-06	2,5	2,4
II-06	2,5	2,4



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Gross domestic product

Prediction for Month of prediction	GDP growth at the end of this year	 next year
	%	
I-05	3,9	3,9
II-05	4,0	3,9
IV-05	4,0	3,9
VII-05	4,2	4,0
X-05	4,7	4,3
XII-05	4,9	4,4
I-06	4,6	4,4
II-06	4,5	4,4

II-06	GDP growth at the end of	
	current year	next year
min	4,2	3,4
average	4,5	4,4
max	4,9	5,4

The forecast for GDP growth in February remained virtually unchanged by comparison with January; the small decline can be explained by the different number of respondents. The analysts still expect the growth to continue being driven mainly by exports and, newly, by investment in 2006. The continuing inflow of foreign direct investment into export industries (the car industry) and the expected rise in consumer demand in Germany prior to the rise in VAT on 1 January 2007 speak in favour of exports. Nevertheless, the share of net exports in GDP growth will weaken due to the strong koruna. This decline should be at least partially offset by growing domestic demand. In addition to the expected recovery in Germany, investment will profit from a pick-up in the inflow of money from the EU (according to one of the analysts the Czech Republic should achieve as much as CZK 116 billion a year, which is approximately five times the current figure). Consumer demand will be supported by higher disposable income as a result of a reduction in personal income tax, growth in real wages and an expected fall in the unemployment rate; higher energy expenditure will have the opposite effect.

The range of the estimates for 2006 narrowed slightly compared to January. The effect of fiscal policy in the election year remains a risk.

Interest rates

II-06	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	1,75	1,90	1,90	2,90	2,80	3,30	3,30
average	2,02	2,32	2,18	2,62	3,06	3,42	3,46	3,69
max.	2,25	2,50	2,30	3,00	3,20	3,70	3,60	4,00

The interest rate path expected by the analysts continued to decrease slightly compared to the January survey, mainly because of the more appreciated koruna. The analysts expect that in April the CNB will be forced to further decrease its inflation forecast and the implied interest rate path owing to a revision of the future evolution of the exchange rate. The analysts expect the first increase in the 2W repo rate to come in 2006 Q4. Although nobody fully rules out the possibility of a cut in interest rates, according to most of the analysts this is unlikely, primarily because of a widening of the negative CZK-EUR spread.

Only one of the analysts expects a rise in monetary policy rates in February (25 basis points). At the one-year horizon, the rates should fluctuate between 1.75% (predicted by a foreign analyst) and 2.50%. The expected slope of the money market yield curve at the one-year horizon, as measured by 12M PRIBOR – 2W repo rate, remained virtually unchanged at 30 basis points.

The range of the estimates of the 12M PRIBOR at the one-year horizon remained the same as in December. A higher-than-forecasted impact of the second-round effects of the high energy prices remains an upside risk, whereas a stronger koruna could foster lower rates.

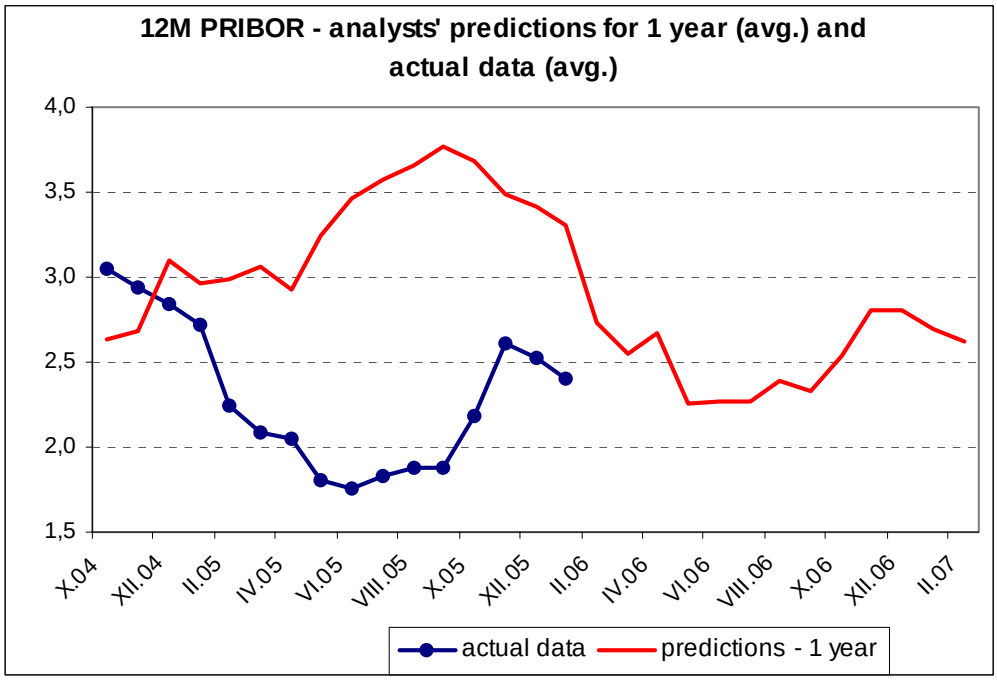
The expected 10-year interest rates should increase at the short-term horizon due to the slight pick-up in inflation and similar growth abroad. Once the cost-push inflation has unwound, yields at the one-year horizon should fall owing to lower net issuance of bonds, the exchange rate of the koruna and the only moderate second-round effects of the higher energy prices. Nervousness prior to the June parliamentary elections in the Czech Republic could pose an upside risk to interest rates.

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	%		%		%		%	
I-05	2,49	2,97	2,77	3,30	3,52	4,06	*4,02*	*4,58*
II-05	2,18	2,35	2,26	2,73	2,95	3,65	3,50	4,15
IV-05	1,98	2,32	2,08	2,68	3,02	3,64	3,73	4,30
VII-05	1,76	1,94	1,78	2,31	2,58	3,21	3,29	3,84
X-05	1,75	2,25	2,06	2,54	2,95	3,36	3,43	3,88
XII-05	2,00	2,40	2,47	2,75	3,21	3,47	3,62	3,89
I-06	2,02	2,38	2,43	2,70	3,11	3,48	3,41	3,77
II-06	2,02	2,32	2,18	2,62	3,06	3,42	3,46	3,69

**/ 10Y benchmark yield*

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
10.2.	2,00%	2,25%	3,10%	3,48%



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The exchange rate

II-06	EUR/CZK	
	1 month	1 year
min.	28,10	27,70
average	28,56	28,07
max.	28,80	28,80

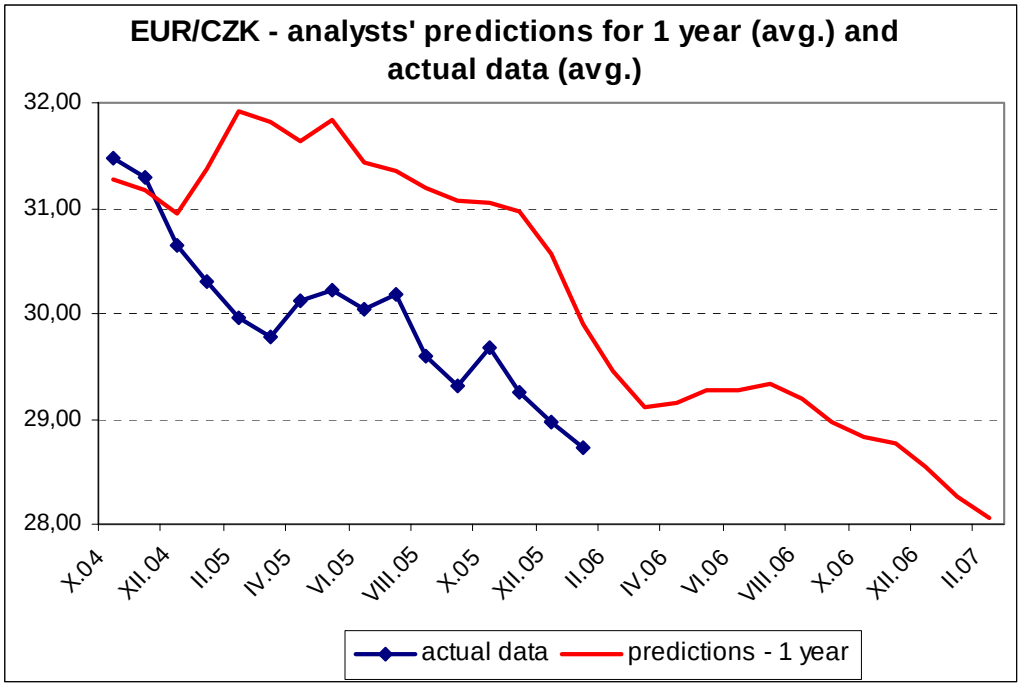
Exchange rate - fixing on the day of deadline for forecasts

10.2.	28,260

Prediction for Month of prediction	**exchange rate 1 month**	**1 year**
	EUR/CZK	
I-05	30,36	29,90
II-05	29,97	29,46
IV-05	29,89	29,15
VII-05	30,09	29,34
X-05	29,43	28,83
XII-05	29,06	28,55
I-06	28,85	28,26
II-06	28,56	28,07

The analysts expected a nominal appreciation of the koruna against the euro of 0.7% in February at the one-year horizon. Compared to January, the expected appreciation slowed from 1.7%. The lower expected pace of appreciation is a result of the current appreciation of the koruna during January and February. Even though the favourable conditions will persist, the analysts do not see the current rate of appreciation of the koruna as justified by the fundamentals and expect it to weaken by 1% at the one-month horizon.

At the longer horizon, faster GDP growth than in the euro area countries, favourable trade balance results, convergence of the Czech economy towards the EU countries and continuing inflow of FDI (the analysts most often mention the expected announcement of the construction of a Hyundai car plant) all speak in favour of the koruna. At the shorter horizon, the koruna could be adversely affected primarily by the negative interest rate differential and political instability in the region, and also by the outflow of dividends expected especially in 2006 H2.



Compared to the January survey, the range of the estimates for the koruna's exchange rate widened slightly at the one-month horizon, but conversely narrowed at the-one year horizon. Risks thus persist more at the shorter horizon. There is uncertainty about whether, and by how much, the koruna will depreciate. At the longer horizon, the estimates for the koruna's exchange rate are concentrated around 28 CZK/EUR (this estimate also concurs with the opinion of one analyst who, owing to the favourable balance of trade figures and the rapid appreciation of the koruna, raised the equilibrium appreciation of the real exchange rate to more than 4% a year).

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