

**Measuring financial market inflation expectations – Results of the 85th measurement (May 2006)**

Eleven domestic and three foreign analysts sent in their predictions for inflation and other financial market indicators to the May survey. The analysts' predictions remained virtually unchanged from the April survey. The analysts again revised their 2006 economic growth estimates upwards (probably due to an expected faster recovery in consumer demand), but the inflation forecast at the one-year horizon remained unchanged. CNB communications, together with an appreciation of the koruna, led to a modest decline in expected short-term rates. The expected monetary conditions were the same as in the April survey: a slight decline in the expected 12M PRIBOR was offset by an expected appreciation of the nominal koruna-euro exchange rate at the one-year horizon.

**1. Inflation**

V-06	annual CPI (%)	
	1 year	3 years
min.	2,2	1,9
average	2,6	2,5
max.	3,1	3,0

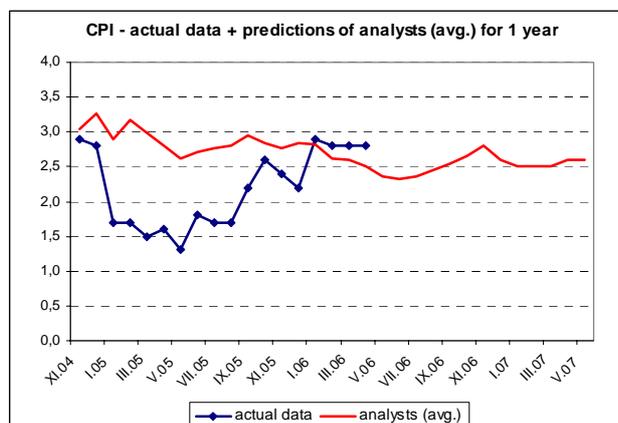
The inflation forecast at the one-year horizon remained at 2.6% year on year. At the three-year horizon, it rose slightly – from 2.4% to 2.5% – due to an increase made by one of the analysts to take account of rent deregulation. The main reason for inflation remained an expected rise in regulated prices (gas in 2006; electricity, gas, heat, water supply and sewerage collection, and rents

in 2007) and indirect taxes (cigarettes in 2006). Nonetheless, the analysts expect that inflation has peaked in 2006 and should fall up to the end of the year. By contrast, a gradual increase towards the inflation target can be expected next year.

The range of the estimates for one year narrowed compared to the April survey, which could suggest lower forecast uncertainties. The uncertainties still include the risk of higher growth in regulated prices, higher oil prices and a possible acceleration of demand-pull inflationary pressures owing to faster closure of the output gap.

The baseline scenario of the CNB's April forecast assumes inflation of 2.9% at the one-year horizon. However, some analysts express doubts regarding the decrease in the forecast for adjusted inflation excluding food and fuels in the CNB forecast in a situation where the exchange rate shock to the koruna at the end of 2005 and the start of 2006 is already fading away at the monetary policy horizon and the CNB, by contrast, is expecting an exchange rate depreciation, and also where the CNB has accelerated the closure of the negative output gap and where greater pass-through of higher energy prices is not very likely.

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



## 2. Gross domestic product

Prediction for Month of prediction	GDP growth at the end of	
	this year %	next year %
V-05	4,0	3,8
VII-05	4,2	4,0
X-05	4,7	4,3
XII-05	4,9	4,4
I-06	4,6	4,4
III-06	5,1	4,6
IV-06	5,3	4,8
V-06	5,5	4,7

V-06	GDP growth at the end of	
	current year	next year
min	4,7	3,6
average	5,5	4,7
max	6,6	5,3

The forecast for GDP growth this year rose slightly further compared to April. The growth will be driven mainly by net exports (cars), which could, however, be replaced by domestic demand next year (households: higher disposable incomes; investment: recovery in

the EU, inflow of money from the EU, FDI inflow – Hyundai). The positive shock of the launching of export-oriented production facilities will disappear from the annual growth rate. The potential growth of the economy is continuing to rise. According to some analysts, potential output could rise by 5.5%–6% this year.

The range of the estimates for 2006 widened compared to April, but for 2007 it narrowed. The effect of fiscal policy in the election year remains an upside risk to growth. A cooling in the USA, which may – via lower exports from Germany – generate a fall in domestic exports, could pose a downside risk. According to one of the analysts, domestic exports are strongly correlated with German exports and investment.

The baseline scenario of the CNB's April forecast expects GDP to grow by 6.1% in 2006 and 5.4% in 2007.

## 3. Interest rates

V-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.	1,75	1,75	2,30	1,90	3,40	2,80	3,80	3,30
average	1,98	2,46	2,43	2,79	3,49	3,64	3,91	3,99
max.	2,00	2,75	2,50	3,10	3,60	4,00	4,10	4,36

The analysts revised the expected interest rate path slightly downwards compared to April. The main reasons are the surprising decrease of the forecast for adjusted inflation (see *Inflation*), CNB communications (...the CNB can afford to leave rates unchanged even if the ECB raises rates further...) and the koruna's appreciation. The first increase expected by the market has thus shifted to the end of 2006 Q3. At the one-year horizon, the two-week repo rate should be around 2.46%, i.e. slightly below the April estimates. The reasons remain the rise in euro rates and the expected faster closure of the output gap.

Compared to the April survey, the range of expected short-term rates at the one-year horizon again widened substantially, owing to the participation of a foreign respondent who expects the rates to decrease. A stronger exchange rate remains a risk of lower rates, whereas faster growth in rates in

the euro area (visible from FRA contracts) and higher demand-pull inflationary pressures are acting towards higher rates.

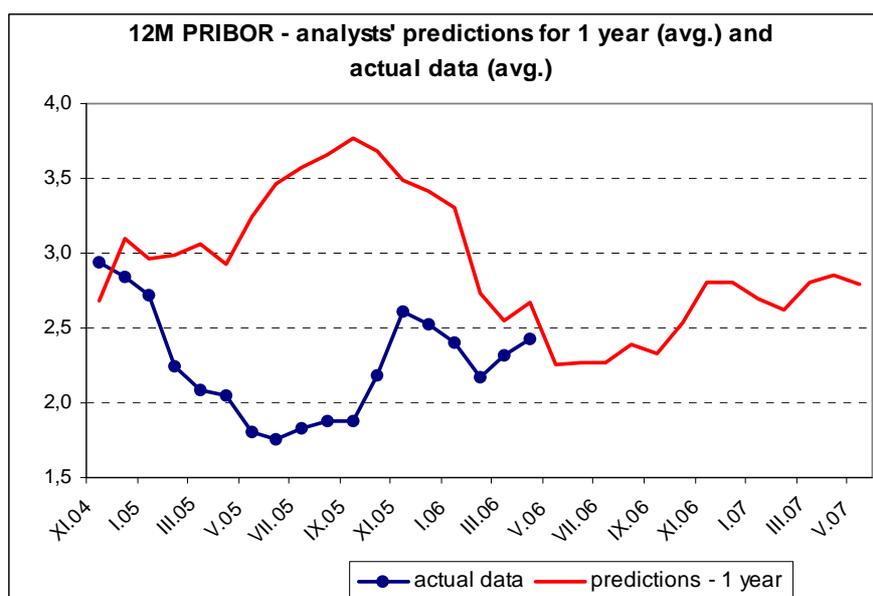
In May, most of the analysts expect a stable two-week repo rate, although one foreign analyst expects it to fall by 25 basis points to 1.75%. The expected slope of the money market yield curve at the one-year horizon – as measured by the 12M PRIBOR minus the 2W repo rate – was the same as in April at 33 basis points.

By contrast, expected long-term yields were slightly higher than in April. This is due to similar yield movements in the euro area and the USA. A correction of the koruna yields cannot be expected until the Fed finishes raising interest rates (which it apparently does not intend to do yet) and the outflow of funds from the CEE region stops. In contrast, political factors (the elections in the Czech Republic and the Slovak Republic) will push yields upwards. The range of the estimates for the 5Y and 10Y yields widened in both directions.

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
	%		%		%		%	
V-05	1,80	2,00	1,80	2,30	2,80	3,30	3,50	3,90
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
III-06	2,00	2,50	2,33	2,77	3,24	3,52	3,63	3,80
IV-06	2,00	2,52	2,40	2,85	3,42	3,69	3,81	3,93
V-06	1,98	2,46	2,43	2,79	3,49	3,64	3,91	3,99

**Actual values of indicators on the day of deadline for forecasts**

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
<b>11.5.</b>	2,00%	2,45%	3,52%	3,96%



#### 4. The exchange rate

V-06	EUR/CZK	
	1 month	1 year
min.	28,00	27,45
average	28,46	27,83
max.	28,90	28,30

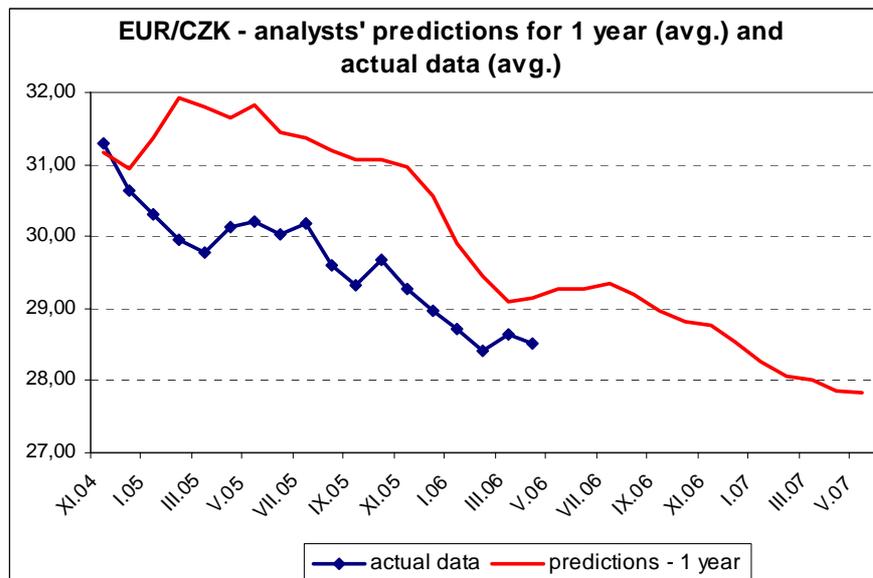
Prediction for Month of prediction	exchange rate	
	1 month EUR/CZK	1 year EUR/CZK
V-05	29,96	29,28
VII-05	30,09	29,34
X-05	29,43	28,83
XII-05	29,06	28,55
I-06	28,85	28,26
III-06	28,82	28,02
IV-06	28,71	27,87
V-06	28,46	27,83

Exchange rate - fixing on the day of  
deadline for forecasts

11.5.	28,230
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In May, the analysts expected a nominal appreciation of the koruna against the euro of 1.4% at the one-year horizon, i.e. less than the 2.7% in April. The analysts partly took into consideration last month's appreciation of the koruna. At the one-year horizon they thus expect an exchange rate of CZK 27.83/EUR. The reasons for the expected appreciation remain the same: in the long run the convergence of the Czech economy, and in the short run the favourable trade balance, FDI inflows, rising stock prices on the Prague Stock Exchange and an expected depreciation of the dollar. The analysts believe, however, that the current exchange rate is fundamentally overvalued and expect it to weaken slightly. An outflow of dividends (expected particularly in 2006 Q3) and the negative interest rate differential will act against the koruna in the short term.

According to one of the analysts, recent events have shown that the koruna is immune to regional turbulence, so the previously expected risk of a koruna depreciation in 2006 Q2 has reduced, despite the June parliamentary elections.



A decline in the uncertainty about the exchange rate going forward is also indicated by a narrowing of the range of the estimates at both the one-month and one-year horizons. The analysts are thus more certain of a modest depreciation of the koruna at the one-month horizon and a continuing appreciation trend at the one-year horizon. A stronger dollar, supported by further rate increases by the Fed, could push the koruna downwards.

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