

## Measuring financial market inflation expectations – Results of the 86th measurement (June 2006)

Eleven domestic and two foreign analysts sent in their predictions for inflation and other financial market indicators to the CNB's June survey. Compared to May, the analysts expect faster GDP growth, chiefly thanks to faster growth in household consumption. Although long-term inflation expectations remain well anchored, the analysts predict a moderate pick-up in inflation at the one-year horizon. However, the expected appreciation of the koruna will counteract any pronounced increases in the CNB's interest rates. The expected monetary conditions tightened slightly compared to May, owing to a higher interest rate path and an expected appreciation of the nominal koruna-euro rate.

### Inflation

| VI-06   | annual CPI (%) |         |
|---------|----------------|---------|
|         | 1 year         | 3 years |
| min.    | 2,2            | 2,0     |
| average | 2,8            | 2,4     |
| max.    | 3,4            | 3,0     |

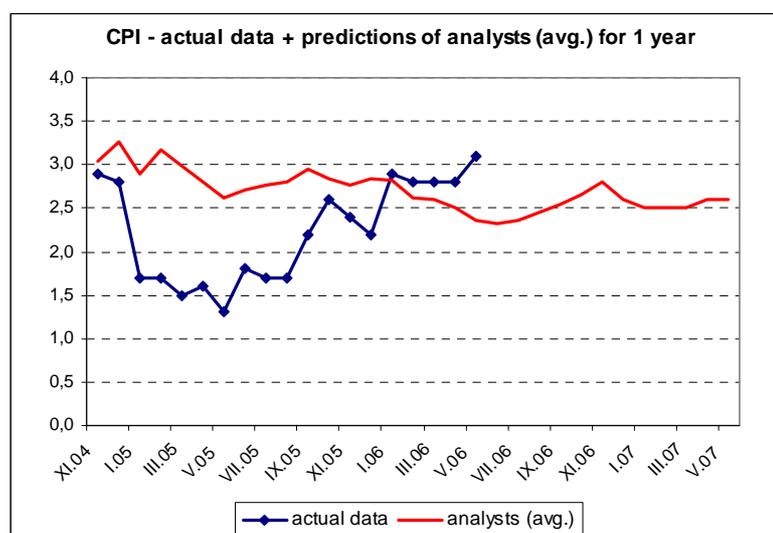
The inflation forecast at the one-year horizon increased from 2.6% to 2.8% in June. At the three-year horizon, conversely, it declined by 0.1% to 2.4%. The inflation forecast thus remains below the CNB's inflation target. The higher inflation expectations are probably due to a pick-up in economic growth, with potential demand-pull inflation pressures. The expected growth in regulated prices, the main inflation factor, (2006: gas; 2007: electricity, gas, heating,

water supply and sewerage collection, and rents) and indirect taxes (2006: cigarettes) is the same as in the May survey.

Although the range of estimates for one year increased slightly compared to the May survey, it remains very low by historical standards. Higher oil prices and a possible acceleration of demand-pull inflationary pressures owing to a faster closure of the output gap remain an inflationary risk.

The baseline scenario of the CNB's April forecast assumes inflation of 3.3% at the one-year horizon. The analysts expect a lower inflation forecast compared to the CNB's forecast, probably due to the expected stronger koruna-euro exchange rate and subsequently lower growth in import prices.

| Prediction for Month of prediction | annual CPI |       |
|------------------------------------|------------|-------|
|                                    | 1 Y %      | 3 Y % |
| VI-05                              | 2,3        | 2,5   |
| VII-05                             | 2,4        | 2,5   |
| X-05                               | 2,7        | 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   |
| VI-06                              | 2,8        | 2,4   |



## Gross domestic product

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

| VI-06   | GDP growth at the end<br>of |           |
|---------|-----------------------------|-----------|
|         | current year                | next year |
| min     | 5,0                         | 4,5       |
| average | 5,7                         | 4,8       |
| max     | 6,5                         | 5,5       |

The analysts also revised their forecast for GDP growth this year and the next. While GDP will increase by 5.7% year on year in 2006, the growth will decelerate slightly to 4.8% year on year in 2007, owing to a slowdown in the

European economy. The analysts expect the changes in the GDP growth structure established in 2006 Q1 to continue. As in 2005, this year's growth will be driven by net exports, but domestic demand will account for an increasing share of the total growth (household consumption: real wage growth, an annual decline in unemployment, generous social and tax policies, low real interest rates; investment: recovery in the EU, inflow of funds from the EU, FDI inflow – Hyundai).

The range of the estimates for 2006 and 2007 narrowed quite significantly compared to May. The effect of fiscal policy in the election year remains an upside risk to growth. A cooling in the USA, which may be reflected – via lower exports from Germany – in 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.

## Interest rates

| VI-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             | 2,00   | 2,40           | 2,10   | 3,50       | 3,20   | 3,90        | 3,60   |
| average | 2,00             | 2,54   | 2,49           | 2,87   | 3,58       | 3,77   | 4,00        | 4,10   |
| max.    | 2,00             | 2,75   | 2,60           | 3,20   | 3,60       | 4,25   | 4,10        | 4,60   |

The analysts revised the expected interest rate path slightly upwards in June. This is due to expected higher GDP growth and the closing output gap, which may imply faster growth in the consumer price index. Most of the analysts expect the first increase in the CNB's interest rates to come in 2006 Q3 (Reuters' survey of 18 May). The 2W repo rate should be around 2.54% at the one-year horizon, i.e. slightly above the May estimates.

The range of the short-term rates expected at the one-year horizon narrowed compared to May. This is due to a reassessment of future interest rates by a foreign analyst, who does not expect them to decline. A stronger exchange rate and a slower rise in euro rates in response to new inflation data

remain a downside risk, while higher demand-pull inflationary pressures are acting towards higher rates.

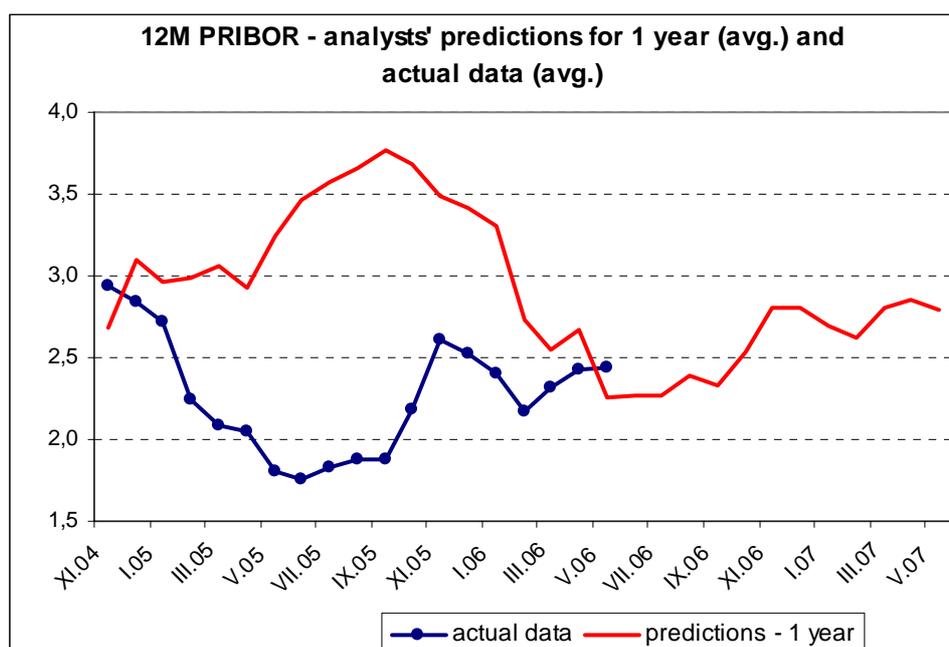
In June, all the analysts expect a stable 2W repo rate at 2.00%. The expected slope of the money market yield curve at the one-year horizon – as measured by the 12M PRIBOR minus the 2W repo rate – was the same as in May at 33 basis points.

Expected long-term yields were also slightly higher than in May. This is due to expected growth in yields abroad, the high GDP in 2006 Q1 and the expected rise in the CNB's rates. 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. Political factors (the post-election negotiations in the Czech Republic and Slovakia and the implementation of the fiscal plan by the new Hungarian government) could foster higher yields in the short run. The range of the estimates for the 5Y and 10Y yields narrowed slightly towards higher figures.

| 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  |
|                                    | %            |      | %          |      | %      |      | %       |      |
| 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 |
| X-05                               | 1,75         | 2,25 | 2,06       | 2,54 | 2,95   | 3,36 | 3,43    | 3,88 |
| 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 |
| VI-06                              | 2,00         | 2,54 | 2,49       | 2,87 | 3,58   | 3,77 | 4,00    | 4,10 |

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

|              | 2W repo rate | 12M PRIBOR | 5Y IRS | 10Y IRS |
|--------------|--------------|------------|--------|---------|
| <b>15.6.</b> | 2,00%        | 2,50%      | 3,60%  | 4,00%   |



## The exchange rate

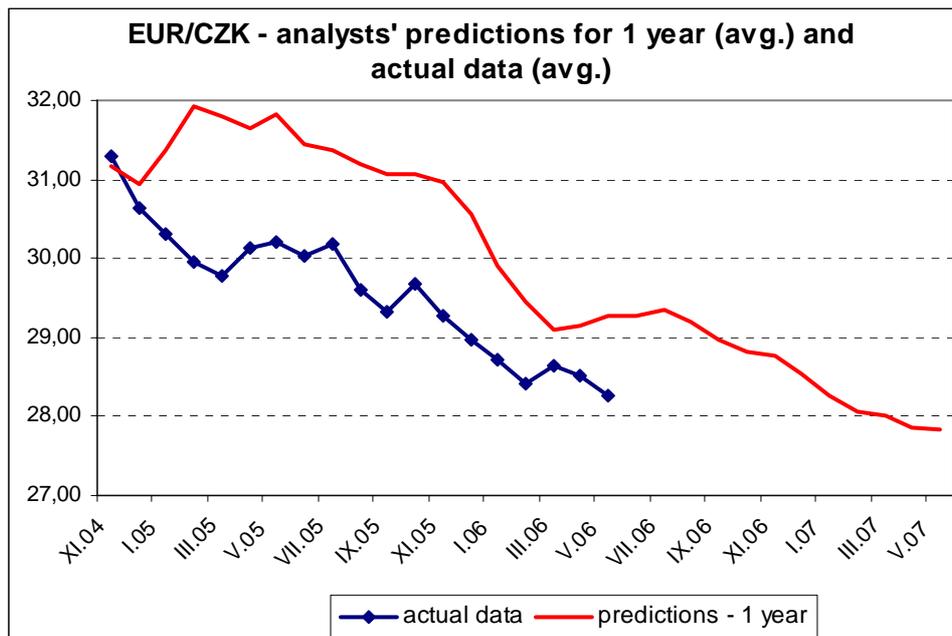
| VI-06   | EUR/CZK |        |
|---------|---------|--------|
|         | 1 month | 1 year |
| min.    | 28,10   | 27,00  |
| average | 28,48   | 27,68  |
| max.    | 28,80   | 28,30  |

Exchange rate - fixing on the day of deadline for forecasts

|       |        |
|-------|--------|
| 15.6. | 28,320 |
|-------|--------|

| Prediction for<br>Month of prediction | exchange rate<br>EUR/CZK |        |
|---------------------------------------|--------------------------|--------|
|                                       | 1 month                  | 1 year |
| VI-05                                 | 30,10                    | 29,27  |
| VII-05                                | 30,09                    | 29,34  |
| X-05                                  | 29,43                    | 28,83  |
| I-06                                  | 28,85                    | 28,26  |
| III-06                                | 28,82                    | 28,02  |
| IV-06                                 | 28,71                    | 27,87  |
| V-06                                  | 28,46                    | 27,83  |
| VI-06                                 | 28,48                    | 27,68  |

In June, the analysts expected a nominal appreciation of the koruna against the euro of 2.3% at the one-year horizon, i.e. less than in May (1.4%). The increase in the expected rate of appreciation is partially due to the depreciation of the koruna in the previous month. Thus, the analysts expect an exchange rate of 27.68 CZK /EUR at the one-year horizon. 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, the fast growth of the Czech economy and an expected depreciation of the dollar. In the short run, however, the analysts expect the koruna to weaken in response to the continuing outflow of dividends, the negative interest rate differential vis-à-vis euro rates and instability on emerging markets. The post-election negotiations in the Czech Republic and Slovakia, as well as the fiscal reforms in Hungary, could also have a negative effect on Central and Eastern European currencies in the short run.



The range of the exchange rate estimates narrowed somewhat in the sample of domestic analysts. Nevertheless, the range of estimates widened overall due to a stronger exchange rate expected by one of the foreign analysts (27 CZK /EUR at the one-year horizon). The analysts thus consensually expect an appreciation of the koruna exchange rate, but it remains an open question how fast the appreciation will be. The range of estimates at the one-month horizon narrowed, hence the analysts are more certain of a modest koruna depreciation at the one-month horizon. A stronger dollar, supported by further rate increases by the Fed, could pose a short-term downward risk to the koruna.

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