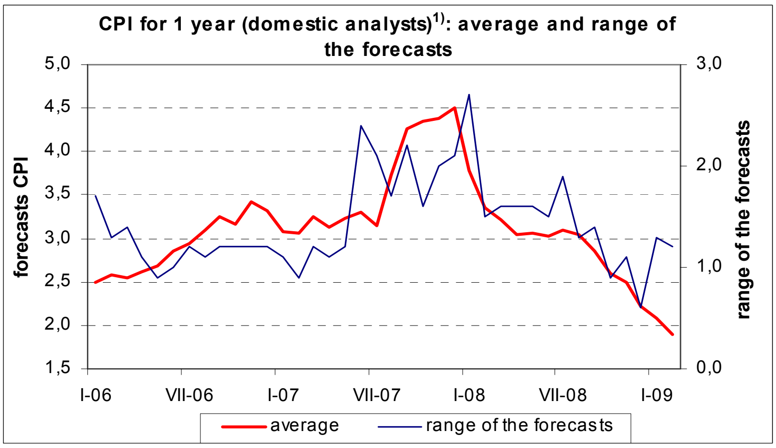
CZECH CNB NATIONAL BANK

Measuring financial market inflation expectations – Results of the 118th Measurement (February 2009)

Nine domestic and three foreign analysts sent in their predictions for inflation and other indicators to the CNB’s February survey. Increasingly bad news from the real economy and an unfavourable economic outlook in the EU, which will lead to weaker domestic demand, made the analysts further strongly decrease their GDP growth forecast. Subdued aggregate demand and lower commodity prices on world markets will further slightly strengthen the deflationary pressures. This is reflected in a rather lower inflation forecast at the one-year horizon. The unfavourable economic developments are creating room for a lowering of key interest rates. However, this could be prevented by excessive depreciation of the koruna against the euro. The current situation forced the analysts to shift their exchange rate forecast to substantially lower levels at the one-month horizon. The adverse economic outlook also understandably produced lower nominal wage growth expectations.

1. Inflation

II-09	annual CPI (%)	
	1 year	3 years
min.	1,2	1,5
average	2,0	2,4
max.	2,4	4,0

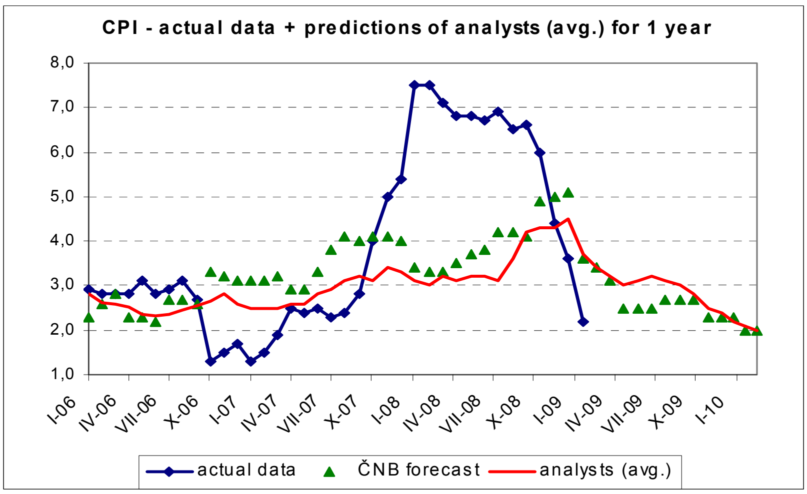


CPI for 1 year (domestic analysts)[1]: average and range of the forecasts

The consensus inflation forecast decreased slightly again at the one-year horizon (*see the chart below*), but remained unchanged at the three-year horizon. The analysts expect annual inflation to fall to 2.0% in February 2010 (compared to the 2.1% forecasted in January). At the three-year horizon, inflation should be around 2.4%. The decline in the forecast at the one-year horizon still reflects falling prices of commodities, especially oil. Weakening external demand, which will – via exports – contribute most to the GDP decrease and to the strengthening deflationary pressures, remains a no less important factor. By contrast, the depreciating exchange rate of the koruna is the only inflationary factor. The range of the inflation forecasts at the one-year horizon narrowed slightly owing to a larger decline in the maximum value, while the range at the three-year horizon widened significantly due to a new high maximum forecasted by one of the foreign analysts.

Prediction for	annual CPI		ČNB
	1 Y	3 Y	1 Y
Month of prediction	%	%	%
II-08	3,4	2,6	0,0
IV-08	3,0	2,6	2Q: 2,5
VII-08	3,1	2,6	
VIII-08	3,0	2,6	3Q: 2,7
X-08	2,5	2,5	
XI-08	2,2	2,5	4Q: 2,0
I-09	2,1	2,4	
II-09	2,0	2,4	1Q: 1,4

[1] Reduced approach on average and the difference between the maximum and minimum estimate via the domestic analysts is due to a more stable data base.

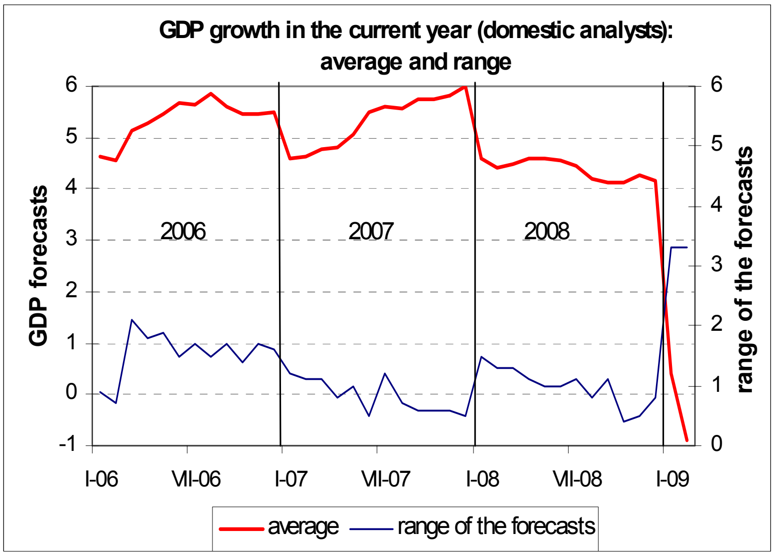


CPI - actual data + predictions of analysts (avg.) for 1 year

2. Gross domestic product

II-09	GDP growth in current year	GDP growth in next year
min	-2,0	-0,5
average	-0,9	1,8
max	1,3	2,8

Prediction for Month of prediction	GDP growth in current year %	GDP growth in next year %
II-08	4,5	4,9
IV-08	4,6	4,8
VII-08	4,5	4,5
VIII-08	4,3	4,2
X-08	4,2	3,2
XI-08	4,2	2,4
I-09	0,5	2,5
II-09	-0,9	1,8



The estimate for GDP growth in 2009 was again revised strongly downwards (from an increase of 0.5% in January to a decline of 0.9% in February). This was due to even weaker external demand than previously expected. The huge deterioration is evidenced by declines in industrial production, new orders and naturally also investment, which is the most sensitive component of aggregate demand in any crisis. According to the analysts, consumers will also adjust to the crisis and falling employment. This will have an adverse effect on growth in household consumption. Moreover, it will be reinforced by worse credit conditions. By contrast, these effects should be dampened by real wage growth. Worse economic developments in the euro area, which may aggravate the economic situation in the Czech Republic even further, is still considered the most significant risk. For 2010, the analysts expect GDP growth to rebound to 1.8%.

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3. Interest rates

II-09	2W repo rate (%) 1 month	2W repo rate (%) 1 year	12M PRIBOR (%) 1 month	12M PRIBOR (%) 1 year	5Y IRS (%) 1 month	5Y IRS (%) 1 year	10Y IRS (%) 1 month	10Y IRS (%) 1 year
min.	1,50	1,00	2,20	2,20	2,50	2,50	2,90	3,00
average	1,69	1,48	2,52	2,38	2,86	3,15	3,33	3,63
max.	1,75	2,00	2,70	2,80	3,60	3,70	4,30	4,40

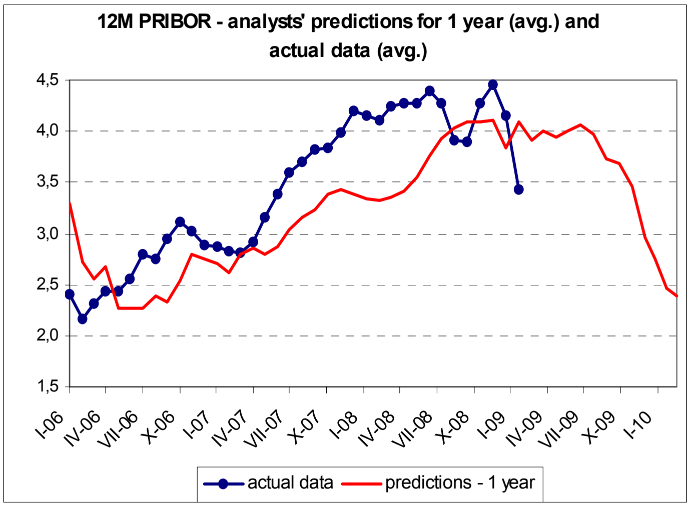
The interest rate forecast on the money market was lowered further because of the adverse economic situation. Compared to the January survey, the biggest decline was recorded for the 12M PRIBOR at the one-month horizon. Unlike money market rates, IRS rate predictions rose slightly across the entire monitored spectrum owing to the current developments and the increase in risk perceptions vis-à-vis the region. This is confirmed by both the domestic CDS and the CDS of other countries in the region.

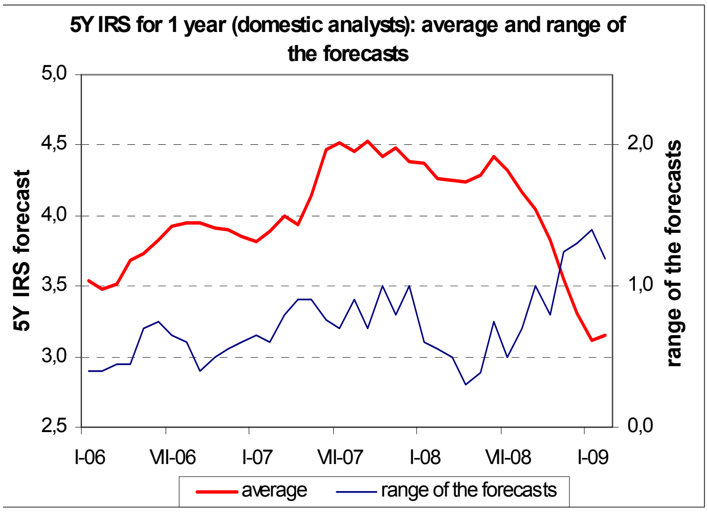
The settings of key interest rates will, according to the analysts, depend mainly on the exchange rate of the koruna and the interest rate settings of the ECB. Some analysts believe that the CNB should avoid the risk of excessive currency depreciation by not widening the interest rate differential between koruna and euro rates. Interbank and client rates could fall markedly as soon as confidence in an economic turnaround is restored and risk premia decline.

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	%		%		%		%	
II-08	3,75	3,75	3,98	3,91	4,09	4,26	4,43	4,48
IV-08	3,80	3,73	4,16	3,94	4,14	4,25	4,40	4,50
VII-08	3,73	3,66	4,26	3,97	4,34	4,33	4,59	4,57
VIII-08	3,50	3,34	3,78	3,74	3,88	4,17	4,32	4,34
X-08	3,22	2,89	3,91	3,46	3,25	3,83	3,71	4,16
XI-08	2,53	2,06	4,19	2,96	3,17	3,55	3,41	4,03
I-09	1,73	1,63	3,28	2,47	2,74	3,12	3,30	3,62
II-09	1,69	1,48	2,52	2,38	2,86	3,15	3,33	3,63

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
11.2.	1,75%	2,73%	2,98%	3,51%



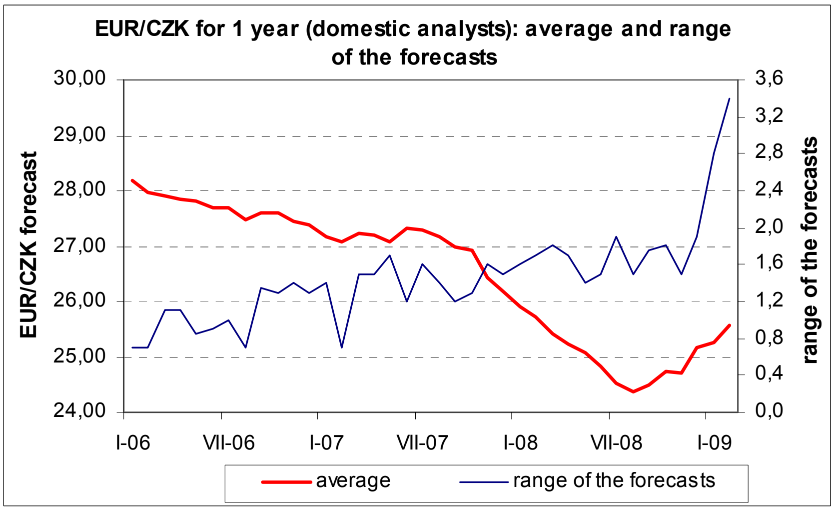


4. The exchange rate

II-09	EUR/CZK 1 month	EUR/CZK 1 year
min.	27,90	24,20
average	28,64	25,71
max.	29,50	27,60

Actual exchange rate

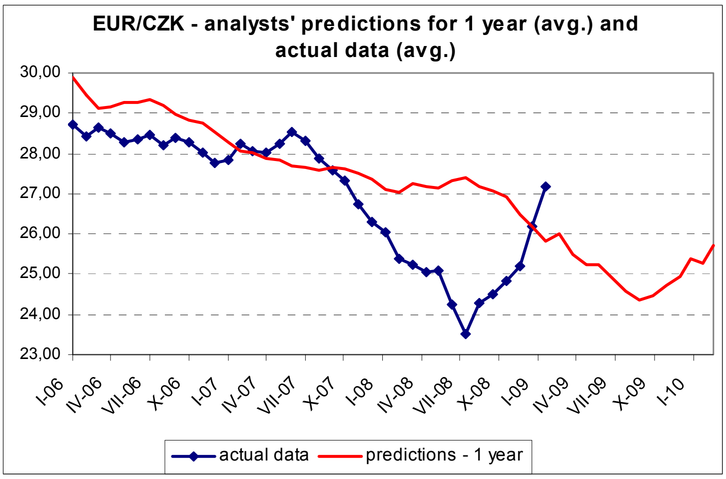
11.2.	28,59



The sharp depreciation of the koruna against the euro naturally affected the consensus forecast, which was shifted almost CZK 2 downwards at the one-month horizon. At the one-year horizon, however, the shift was not so pronounced and the analysts believe that the koruna's exchange rate will return from its current undervalued level to the equilibrium appreciation trend in 2009 H2. The koruna will be very volatile due the uncertainty and currency fluctuations in neighbouring countries. It is expected to be around 25.7 to the euro in February next year.

The recent high exchange rate volatility led to a widening of the range of the extreme forecasts for the koruna's exchange rate. The main reason for this widening was a larger decline in the maximum (weakest) values.

Prediction for Month of prediction	exchange rate 1 month EUR/CZK	exchange rate 1 year EUR/CZK
II-08	25,98	26,01
IV-08	25,36	25,24
VII-08	23,53	24,56
VIII-08	24,31	24,36
X-08	24,90	24,72
XI-08	25,50	24,96
I-09	26,86	25,26
II-09	28,64	25,71

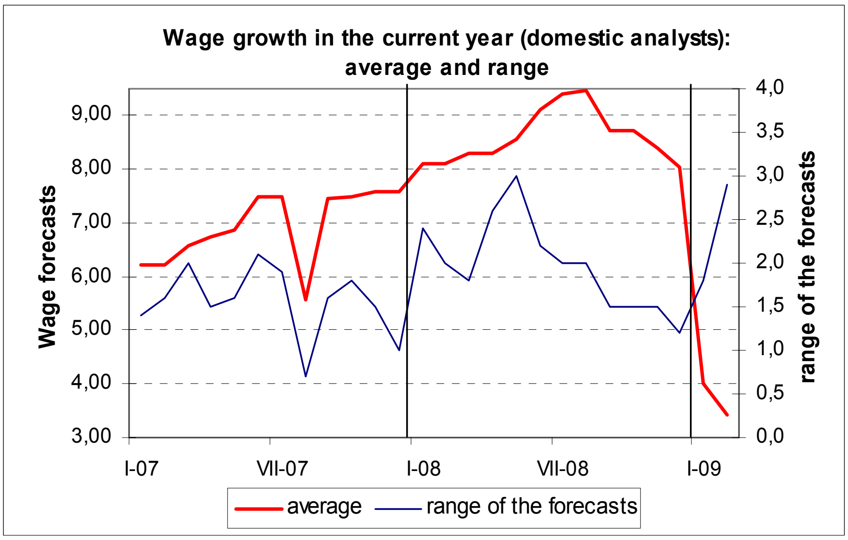


The risk of the exchange rate predictions materialising is strongly skewed towards weaker levels, according to the analysts. Strong depreciation pressures may be generated by unfavourable macroeconomic developments in CEE countries, which are no longer perceived as safe havens with a high degree of stability. A number of countries (Hungary, Estonia) are suffering from macroeconomic instability and a potential loss of confidence, which would result in further significant depreciation of local currencies and would also undoubtedly have a marked adverse effect on the exchange rate of the koruna.

5. Wages

II-09	Wage growth in current year	next year
min	1,6	2,0
average	3,4	4,2
max	4,5	6,0

Prediction for Month of prediction	wage growth in current year %	next year
II-08	8,0	7,4
IV-08	8,3	7,9
VII-08	9,4	7,8
VIII-08	9,4	8,2
X-08	8,8	6,7
XI-08	8,4	6,1
I-09	4,0	4,5
II-09	3,4	4,2



With the news from the real economy worsening, the average wage growth forecast declined as well. Compared to the previous survey, a larger slowdown in growth is expected this year (from 4.0% in January to 3.4% in February). Wages in the public sector should reduce the negative impact of the economic situation on overall wage growth. The analysts who made a distinction between the forecast for wage growth in the business sector and that in the non-business sector expect wages in the business sector to rise by 2.0% and those in the non-business sector by 4.5% year on year in 2009. Next year, they are expected to pick up to 5.3% in the business sector and remain at 4.5% in the non-business sector. The range of the marginal forecasts for both years widened significantly owing to a larger decrease in the minimum estimate.

Owing to slowing inflation, the analysts expect a smaller negative effect on real wages. These could, however, be strongly hit by non-payment of bonuses, which account for a relatively large share of wages in the Czech Republic.

We would like to thank the following respondents for their contributions to this survey of financial market inflation expectations:

Martin Lobotka, Česká spořitelna
David Marek, Patria Finance
Jan Vejmělek, Komerční banka
Pavel Sobíšek, Unicredit Global Research
Michal Brožka, Raiffeisenbank
Petr Dufek, ČSOB
Petr Sklenář, Atlantik FT
Vojtěch Benda, ING Wholesale Banking
Radomír Jáč, Generali PPF
Ivailo Vesselinov, Dresdner Kleinwort
Leila Butt, Economist Intelligence Unit
Miroslav Plouhat, JP Morgan

Special thanks go to the analytical team at Komerční banka, Raiffeisenbank, Česká spořitelna and Economist Intelligence for comments on the forecasts.

Prague, 22 February 2009