

Measuring financial market inflation expectations – Results of the 87th measurement (July 2006)

Eleven domestic and two foreign analysts sent in their predictions for inflation and other financial market indicators to the CNB’s July survey. Compared to June, the analysts expect a further pick-up in inflation, to which the CNB will have to respond by raising interest rates more quickly. The forecast for GDP growth this year remains unchanged, although for 2007 it has decreased slightly due to an expected tighter interest rate component of the monetary conditions. While the expected nominal koruna-euro exchange rate remains stable at the one-year horizon, the analysts expect a slight depreciation at the one-month horizon owing to the continuing outflow of dividends and pressures on regional currencies due to the political situation in Slovakia and Poland.

Inflation

VII-06	annual CPI (%)	
	1 year	3 years
min.	2,4	2,1
average	2,9	2,6
max.	3,6	3,1

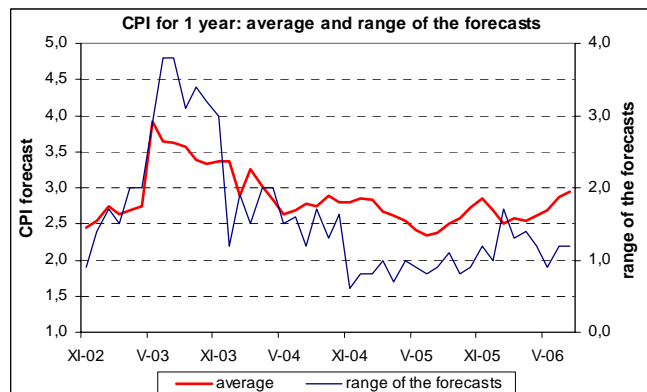
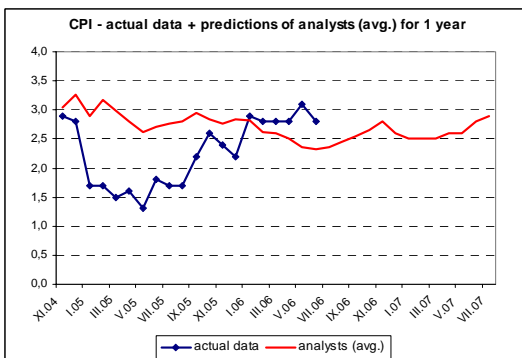
Prediction for Month of prediction	annual CPI	
	1 Y %	3 Y %
VII-05	2,4	2,5
X-05	2,7	2,5
I-06	2,5	2,4
III-06	2,5	2,4
IV-06	2,6	2,4
V-06	2,6	2,5
VI-06	2,8	2,4
VII-06	2,9	2,6

Compared to June, the inflation forecast increased from 2.8% to 2.9% at the one-year horizon, the highest level since September 2004, and from 2.4% to 2.6% at the three-year horizon, the highest since March 2005. The inflation forecast at the one-year horizon is thus approaching the CNB’s inflation target. According to the analysts, the increase in expected inflation is linked with a significant rise in excise duty on cigarettes, an expected rise in food prices (as in Germany + the weekly CZSO survey) and with demand-pull inflation pressures. As regards regulated prices, which will remain the main inflation factor, some analysts took into account the expected faster deregulation of rents.

The chart shows that the uncertainties regarding the inflation forecast at the one-year horizon remain stable compared to June and low by historical standards.¹

The chart shows that the uncertainties regarding the inflation forecast at the one-year horizon remain stable compared to June and low by historical standards.¹

The baseline scenario of the CNB’s July forecast predicts inflation of 3.8% at the one-year horizon.



¹ The difference between the maximum and minimum estimate of the domestic analysts in this survey, due to a more stable data base.

Gross domestic product

VII-06	GDP growth at the end of	
	current year	next year
min	5,0	4,0
average	5,7	4,6
max	6,7	5,3

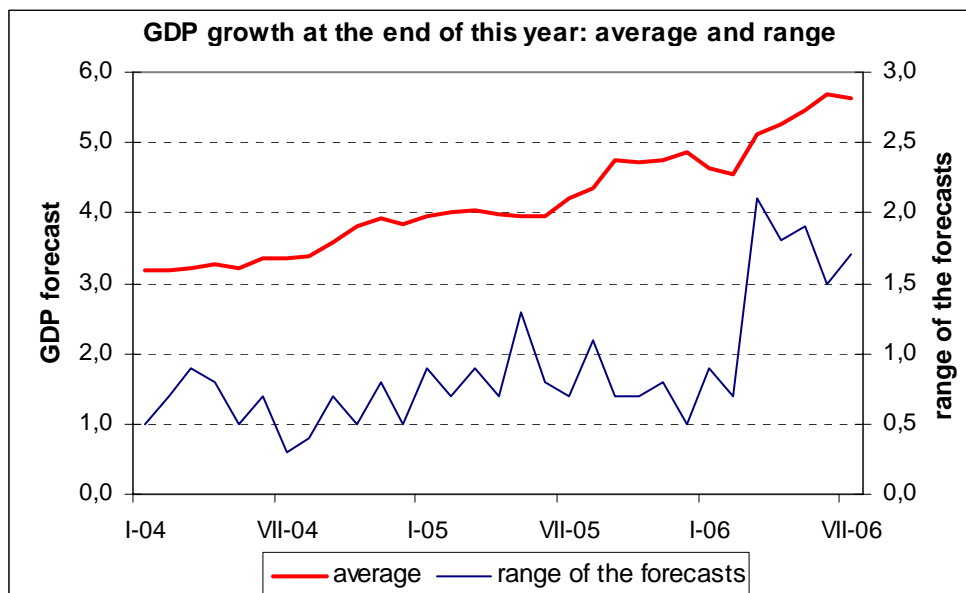
Prediction for Month of prediction	GDP growth at the end of	
	this year	next year
	%	
VII-05	4,2	4,0
X-05	4,7	4,3
I-06	4,6	4,4
III-06	5,1	4,6
IV-06	5,3	4,8
V-06	5,5	4,7
VI-06	5,7	4,8
VII-06	5,7	4,6

The analysts expect economic growth of 5.7% year on year this year, the same figure as in June. However, the estimates for next year decreased, mainly because of expected higher interest rates.

The CNB will have to speed up its monetary policy tightening to prevent an acceleration of inflationary pressures which will negatively affect economic growth. A modest cooling of the euro area economy is another negative factor that will depress domestic economic growth. The expected trends in the growth structure remain unchanged: the contribution of net exports to GDP will be replaced by domestic demand, owing to the strong exchange rate of the koruna.

The range of estimates for 2006 and 2007 widened slightly compared to June (in 2006 an increase in the maximum value and in 2007 a rise in the minimum value). 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 to growth. According to one of the analysts, domestic exports are strongly correlated with German exports and investment.

The baseline scenario of the CNB's July forecast expects GDP to grow by 6.6% in 2006 and 5.1% in 2007.



Interest rates

VII-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	2,50	2,25	2,70	3,60	3,60	4,00	3,50
average	2,12	2,65	2,65	3,04	3,71	3,93	4,08	4,17
max.	2,25	3,00	2,80	3,30	3,80	4,25	4,15	4,60

The analysts expect a faster rise in interest rates due to the higher inflation forecast. According to some of the analysts, the risk of demand-pull inflationary pressures together with a modest depreciation of the koruna and a probable further rise in ECB interest rates will lead to an increase in CNB interest rates as early as this month (6 analysts “for growth” vs. 7 analysts “for stability”, including two foreign analysts). According to one of the analysts, a CNB communication itself (the minutes of the June board meeting) suggests a July interest rate rise. The 2W repo rate should be around 2.65% at the one-year horizon, i.e. again above the June estimates.

The range of the short-term rates expected at the one-year horizon narrowed further compared to June, towards higher values. The analysts thus attach a higher probability to a faster rise in interest rates. A stronger exchange rate and a slower rise in euro rates remain downside risks, while higher demand-pull inflationary pressures are acting towards higher rates.

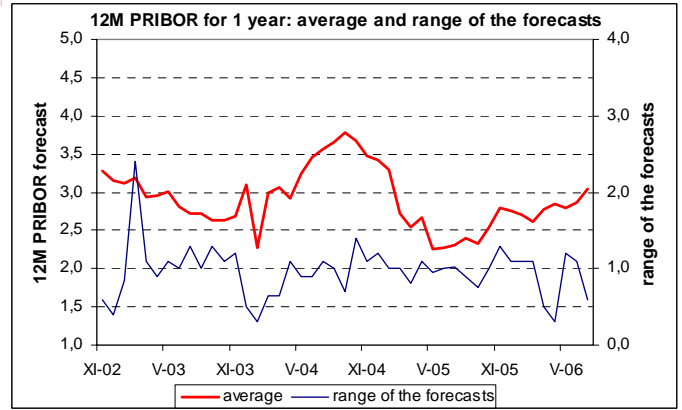
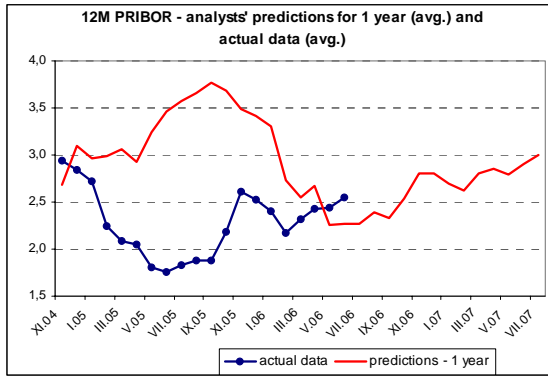
The expected slope of the money market yield curve at the one-year horizon – as measured by the 12M PRIBOR minus the 2W repo rate – rose by 6 basis points to 39 basis points, due to faster growth in the one-year interest rate.

Expected long-term yields were slightly higher than in June. This rise was due to expected growth in yields abroad and to further sales on emerging markets resulting from the political instability in the region. Nevertheless, a sharper increase in domestic yields at the one-year horizon will be prevented by an expected early end to the Fed’s interest rate increases, an expected stabilisation in the region and a renewed appreciation of the koruna. The range of the estimates for the 5Y and 10Y yields mostly narrowed slightly towards higher values. The expected yield curve flattened out, due to lower growth in long-term interest rates than in money market rates.

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
	%		%		%		%	
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
VII-06	2,12	2,65	2,65	3,04	3,71	3,93	4,08	4,17

Actual values of indicators on the day of deadline for forecasts

	2W repo rate	12M PRIBOR	5Y IRS	10Y IRS
12.7.	2,00%	2,74%	3,71%	4,05%



The exchange rate

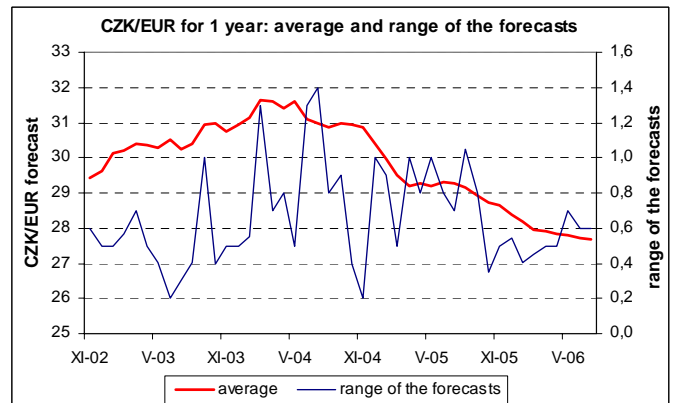
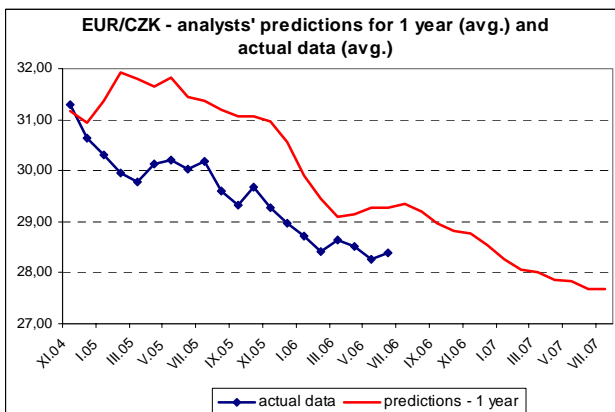
VII-06	EUR/CZK	
	1 month	1 year
min.	28,20	27,20
average	28,53	27,67
max.	28,80	28,20

Exchange rate - fixing on the day of deadline for forecasts

12.7.	28,490
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Prediction for Month of prediction	exchange rate EUR/CZK	
	1 month	1 year
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
VII-06	28,53	27,67

In July, the analysts expected a koruna exchange rate of around CZK 27.67/EUR at the one-year horizon, the same as in June. The expected rate of appreciation of the koruna's nominal exchange rate at the one-year horizon rose from 2.3% to 2.9% due to month-on-month depreciation of the koruna. While the analysts expect the koruna to appreciate in the longer run (due to fast growth of the Czech economy, FDI inflows, an easing of the political instability in the region and the end of the cycle of interest rate increases in the USA), in the short run the koruna is expected to depreciate slightly due to a continuing outflow of dividends, a possible holiday-season slowdown in exports, an expected further interest rate increase by the Fed and instability on emerging markets. The continuing post-election negotiations in the Czech Republic and retrograde steps by the new Slovak government could also have a negative effect on the koruna.



The range of the exchange rate estimates of the domestic analysts remained stable compared to June (see the Chart).² Overall, however, the uncertainty regarding the exchange rate going forward decreased, owing to a narrowing of the range of the estimates among the foreign analysts. This narrower range was due the exclusion of one of the foreign analysts, who stopped covering the currencies of the CEE region (his estimates had deviated markedly towards a weaker koruna in recent months). The opinion is thus strengthening among the analysts that the koruna will appreciate close to CZK 27.70 to the euro at the one-year horizon. The range of the 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 and an escalation of asset sales in the CEE region, could pose a short-term downward risk to the koruna.

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

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Prague, 18 July 2006

² Only two domestic analysts are taken into consideration in the chart for the difference between the maximum and minimum forecast for the koruna-euro exchange rate, due to a more stable data base.