



CENTRAL EUROPEAN WEEKLY

MAY 14, 2007

Dear readers,

due to our movement to the new office, the next CEW will be published on May 28th

- **Czech Republic**
Higher inflation can prompt an interest rate hike
- **Slovakia**
The market awaits record-breaking GDP growth
- **Poland**
Strong budget performance to date but risks to fiscal outlook loom ahead
- **Hungary**
April's inflation readings support rate cut scenario

HIGHLIGHTS

Regional fixed-income market's turned their attention to the April inflation readings last week. The released data was particularly crucial for the Czech and Hungarian markets, because the central banks in both countries are now going to take action, after an extended period of time. Somewhat paradoxically, this month's decisions of the CNB Board and the NBH Monetary Council should run precisely counter to one another – while the base rate in Hungary should go down by 25 basis points next Monday, the Czech repo rate is likely to go up by 0.25% later this month.

April's inflation figures in the Czech Republic were an unpleasant surprise for us. Consumer prices rose much faster than we had expected. Although the rise was particularly driven by food prices, the fact that the headline inflation rate is going up faster than the Czech National Bank anticipated, could make the central bank hike the rates as early as this month. Nevertheless, looking at the composition of the CNB Board, a May rate hike does not appear to be that certain because the outcome of the latest vote on rates, as well as the current comments, indicate that most of the Board Members are still not in favour of

an immediate rate hike (at the moment). In any event, we can expect the decision of the 7-Member Board to be very close this time.

April's inflation in Hungary, by contrast, reassured us that the National Bank of Hungary might go against the global trend and starts to ease its monetary policy. April's inflation should reassure the NBH Council that the (year-on-year) price rise has peaked, and this, together with the strong forint, creates room for cutting the high official interest rates. Arguments for starting the easing cycle should eventually be provided by the new Inflation projection. It should indicate a favourable inflation outlook, although the weather may complicate the headline inflation predictions by the NBH (as well as the other central banks in Central Europe). A warm winter, followed by lingering drought, is likely to affect this year's crop, and will drive food prices throughout the region upwards.

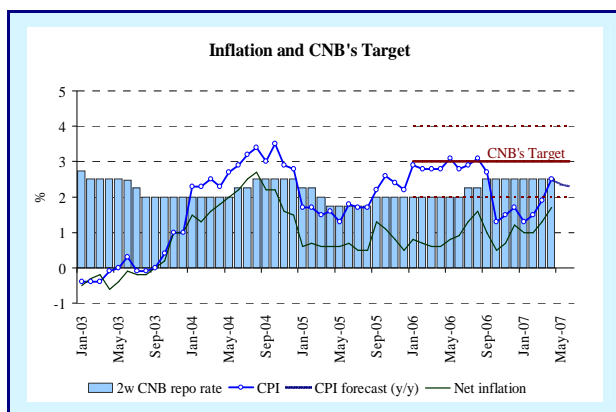




CZECH REPUBLIC

The April inflation rose sharply. Consumer prices grew by 0.7 % m/m (the market expected 0.4 %) and by 2.5 % in year-on-year terms, while the market consensus was 2.2 %. The current growth of CPI is mainly due to foods, which participated by 0.3 percentage point in the m/m growth of inflation. Food prices are growing due to the seasonal development of the prices, but their growth is also partially due to last year's not much successful harvest. As expected, other factors were: higher prices of cigarettes, still reflecting the former increase in excise taxes, and also more expensive petrol, and higher prices of medicaments, regulated rent and seasonal clothing.

The year-on-year inflation, being a target figure of the central bank, has now reached its 7-month maximum level, but it is still 50bps below the target figure set by the CNB. It is still true that a greater part of current inflation was generated by an increase in excise taxes on cigarettes and by the growth of regulated prices. A part of inflation is caused by growing prices of foods, driven by growing prices of agricultural inputs, worse weather conditions and interesting opportunities for primary producers to sell their products abroad. So we still can speak about cost-driven inflation, while demand-driven pressures are still minimal.



The latest inflation figures are so surprising that they are likely to prompt a reaction of the central bank with a view to the fact that the current rate of inflation is 0.4 percentage point above the inflation prognosis and it is highly unlikely that inflation would return to the projected trajectory in the next few months. An increase in interest rates was already discussed at the last session of the Bank Board, when two members of the Board voted for an increase. The new figures can also persuade some of the other members of the CNB's management to vote for higher rates. So it is likely that the CNB will take courage to increase interest rates sooner than in July. It is even likely

that it will do so at its session in May or in June. However, an early action of the CNB does not necessarily mean that rates in the CR will grow more than we originally expected. The market reckons with a triple increase in the repo rate in a year to 3.25. After disclosing new figures, another hike is in sight. In our opinion, however, the launching of a series of hikes in official rates will not leave the Czech koruna cool, and the koruna should start subduing the appetite for increasing the rates. So, we still reckon with only two hikes in the rates to 3.00 % until the end of the year.

The Czech koruna firmly settled within weaker bounds, below EUR/CZK 28.30 last week. Thus it again ignored the mostly upbeat sentiment in neighbouring Central European markets, as well as the continuing rise in rates after the CNB meeting.

This week's fluctuations of the koruna will be very interesting, in view of further EUR/CZK developments. Our opinion is that, with the rise in domestic money market rates, the koruna might slowly return to being under the influence of the regional mood and of all emerging markets. The crucial figure for these markets in the upcoming week should be U.S. core inflation, which, unless being surprisingly high (more than 0.2% m/m), in combination with a continuing rise in stock markets, will favour emerging markets. If the Czech koruna starts to follow on the heels of the further appreciation of the zloty and the forint, in particular, it will be a signal that the era of carry trades using the Czech currency is slowly drawing to a close.

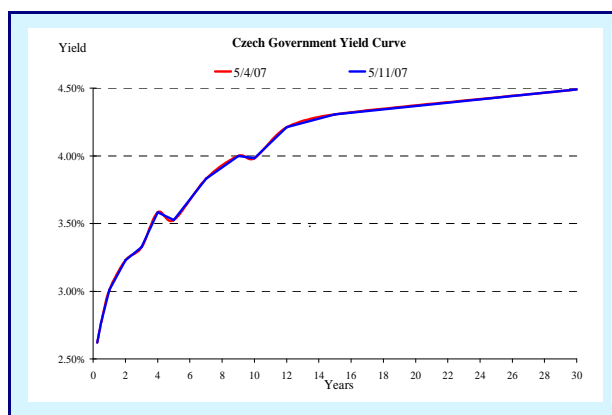
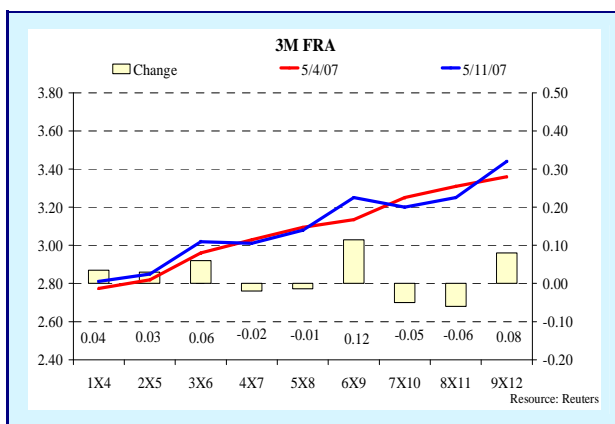
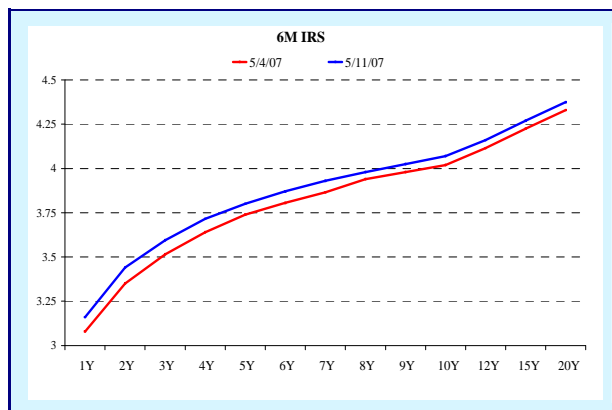
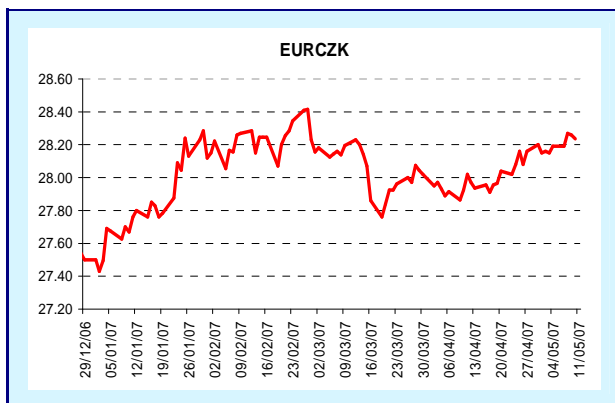
The beginning of last week was calm for **Czech bonds**, but trading amounts were below average, ahead of Tuesday's bank holiday. A major stimulus was April's higher inflation, which made yields go up by 4-9 bps along the full length of the curve, and the yield curve flattened. Also, the 3.55%/2012 government bond, for CZK 7 bn, was supplied in Wednesday's auction. Demand was sufficient, but the Finance Ministry did not like the prices offered, and thus only CZK 6 bn in the bonds was sold.

Higher inflation, set against the previous comments from the Czech National Bank, will probably continue to influence this week's events. What is more, the bearish mood is also likely to dominate Eurozone markets; thus, we can expect that yields will rise again. Another government bond auction will be held this week, this time of the 4.00%/2017 bond for CZK 7 bn. The latest auction of this bond was successful, and therefore investor demand should also be sufficient this time.



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Comparative table for Czech government bonds

Title	Price 11/05/07	Yield 11/05/07	Price change (bps.) to 04/05/07	Yield change (bps.) to 04/05/07	Modif. Duration 11/05/07
GOV/ 2.3 / 26/09/08	98.65	3.32	-11	10	1.3
GOV/ 3.8 / 22/03/09	100.67	3.42	-17	9	1.8
GOV/ 2.6 / 18/10/10	96.41	3.68	-29	10	3.2
GOV/ 6.6 / 05/10/11	111.69	3.61	-42	9	3.7
GOV/ 3.7 / 16/06/13	98.83	3.92	-46	9	5.2
GOV/ 3.8 / 11/04/15	98.39	4.04	-27	4	6.7
GOV/ 7 / 26/01/16	121.14	4.02	-32	3	6.6
GOV/ 4.6 / 18/08/18	103.22	4.23	-20	2	8.5
GOV/ 3.8 / 12/09/20	94.18	4.33	-24	3	10.0
GOV/ 4.2 / 04/12/36	95.17	4.50	-11	1	16.1

EXPECTED DATA

■ Tuesday, May 15, 9:00 Industry (March)

8.0% y/y

The slowdown of industrial output, which we anticipate, is due to there being fewer business days and the high comparative baseline of March 2006. Adjusted for the differing number of days, it is still a two-digit rise, driven

particularly by the automotive and electrical industries, which benefit from the improving foreign demand and the expansion of domestic production capacities.

**Construction (March)****15.0% y/y**

The persisting construction boom is based on the unusually favourable winter weather, which enabled construction firms to continue their field work, and enough contracts financed by the public as well as private sectors. Another contributor to the fast rise in construction output is the housing construction boom, which benefits from low interest rates and the rising standard of living, which evoke demand for new dwellings.

■ Wednesday, May 16, 9:00**PPI (April)****0.3% m/m, 3.6% y/y**

The rising oil prices and their secondary effects probably made the produce price index rise again. The food industry probably also raised its prices, as it is confronted with rising input costs, which are subsequently reflected in the prices of its products. After all, the development of retail food prices indicates increasing cost inflation pressures.

■ Friday, May 18, 10:00**Current Account (March) CZK -4.0 bn**

The fairly low current account deficit is due in particular to the very good foreign trade figure, which posted a surplus of CZK 12.4 bn in March. This surplus will easily cover the balance of income deficit, and thus the current account will again depend on the hardly predictable development of transfers. The current account deficit is eventually likely to be even lower; but, with the start of the dividend season within the months to come, it will probably resume showing double-digit deficits.

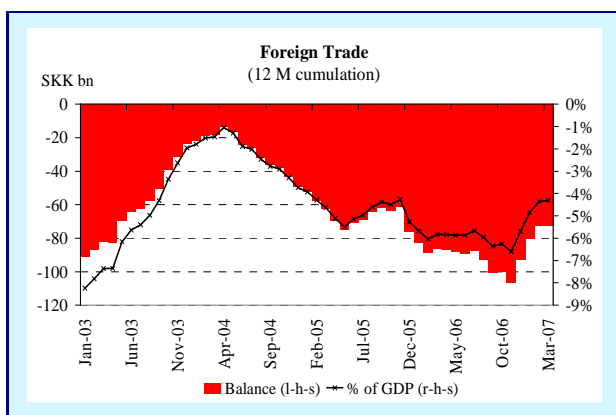
■ Monday, May 21, 9:00**Retail Sales (March)****7% y/y**

We expect that retail sales continued to rise rapidly in March. The lower number of business days works against a fast rise, but the very favourable weather, and this year's earlier start of the spring, are factors that are accelerating purchases of seasonal clothing and gardening equipment, as well as construction materials. The automotive segment has also been rising rapidly since the beginning of the year. Although the rise in retail sales is fairly strong, it has failed to involve demand-pull inflationary pressures thus far, due to the strong market competition, which has expanded with virtual shops on the Internet.



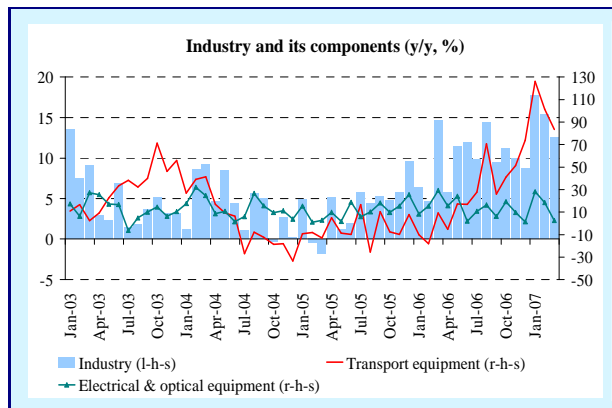
SLOVAKIA

Slovakia's foreign trade again showed a deficit in March. After January's surplus and February's modest shortfall, foreign trade posted a deficit of SKK 4.6 bn this time. However, the March data is also not pleasing, because the year-on-year figure is almost at the March 2006 level. In the first two months, by contrast, we could see a significant year-on-year improvement. Nevertheless, we need to say that, for the first quarter of the year as a whole, the year-on-year data saw a huge improvement, by more than SKK 20 bn. The latest deterioration is due to the slowdown of the rise in exports, from February's 26.6% y/y to 17.2% y/y in March, while there was a moderate rise in imports dynamics to 16.3% y/y (15.8% y/y in February).

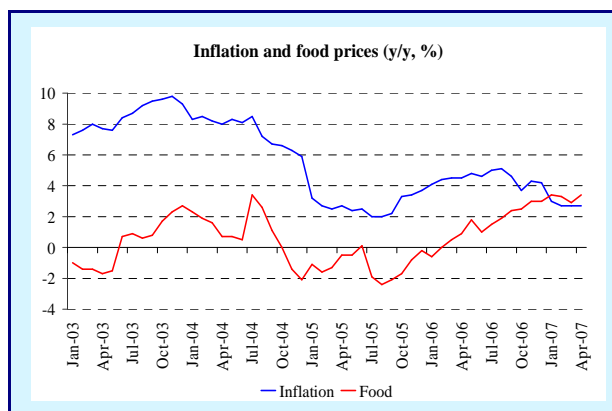


The detailed trade balance structure will be released in a month; therefore, to evaluate the export side of the trade balance, we will use industrial output data, released earlier. Slovakia's industry is strongly export oriented. Industrial output was up by 12.5% y/y in March, following the rise by 15.4% y/y in February. The rise in output slowed in key industries – means of transport, electrical and optical devices, and metal products. This can be partly attributed to a higher comparative baseline, notably in the automotive, electrical, metallurgical, and metalworking industries. On the other hand, machinery production performs very well, in spite of a higher comparative baseline.

By and large, we believe that the March slowdown in exports is temporary. The roll-out of new capacities in the automotive industry is significant. More investments have been announced in the electrical industry, by Sony and Samsung, which should, hopefully, have an effect in late 2007 or even earlier. Hence, we are still optimistic. The cumulative deficit for the last 12 months only fell slightly in March, from SKK 72.5 bn to SKK 72.3 bn. Our full-year deficit forecast is still SKK 31.5 bn, and it should continue to encourage the koruna.



April's price rise was 0.2% m/m, i.e., 0.1% more than the market forecast. The main contributor to this was food (+0.8% m/m), within which the prices of vegetables, followed by bread and cereals, rose the most. The anticipated increase in petrol prices at fuel stations was one of the factors that made the prices in the transport category go up by 0.7% m/m. The other items sprang no significant surprises, and their impact on inflation was only negligible. Year-on-year price growth have stagnated at 2.7% for a third consecutive month. The year-on-year inflation rate should decelerate slightly in May. The development of oil prices on global markets, as well as food prices, are still risk factors. The development of food prices in the neighbouring Czech Republic indicates that we should be cautious. Moreover, the drought at the beginning of the year may also lead to a rise in food prices later this year.

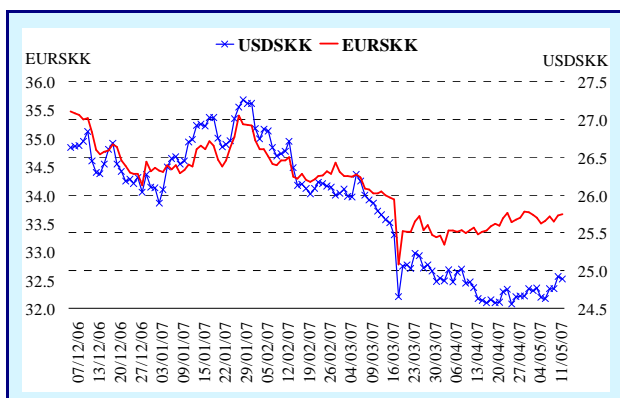


April's inflation data exceeded market forecasts only very slightly and, in our opinion, will not change the central bank's view of the monetary policy. Harmonised inflation (HICP) which is important for the National Bank of Slovakia because of the Maastricht criterion, should be 2.0% in April (2.1% y/y in March). Thus, the inflation development is continuing to be fairly favourable. After the NBS cut rates by a total of 50 bps in March and April, we expect that it will take a breather in May. The monetary policy might be eased again in the third quarter of the year;



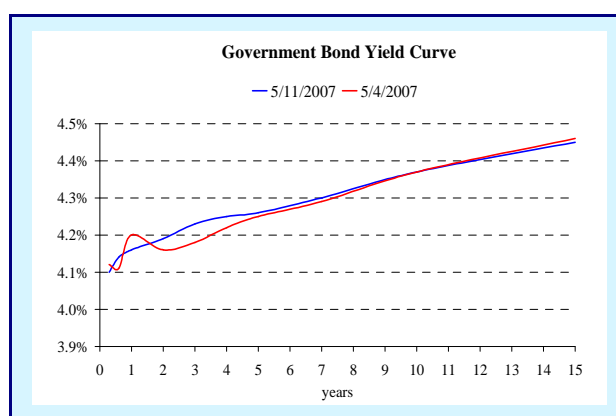
however, this will largely depend on the exchange rate of the koruna. We will see whether the Slovak central bank will cut its base rate to the Eurozone level or not, since ECB President Trichet signalled a June rate hike to 4.0%.

The **forex market** reacted to external factors as well as domestic stimuli. The external factors were less favourable for most of the week. Furthermore, a worse trade balance figure released at the end of the week encouraged koruna bears. Poor exports could already be foreseen from the somewhat poor industrial output figure, released earlier (on Wednesday). Thus, the koruna was slightly weakening throughout the week, from SKK 33.50 per EUR to SKK 33.70 per EUR. As far as the outlook for this week is concerned, Tuesday's GDP data may be the crucial momentum for the Slovak currency. The anticipated record-breaking, double-digit growth may attract speculators and lead to subsequent attempts to push the koruna to SKK 33.30 per EUR. The continuing dividend season has been a counterbalance to speculators (so far at least). If no local corporate client sells the Slovak currency this week, and the external environment (particularly the performance of stock markets) remains favourable, then, after Tuesday's release of GDP data, we could easily see attempts to push the koruna to SKK 33.0 per EUR.



The **money market** initially awaited the outcome of the two-week repo auction, which was held on Monday, because Tuesday was a bank holiday. Another major event was Thursday's auction of 84-day NBS-bills (this year's first). Rates of 1 month and shorter maturities stayed near 4.25% before both auctions, i.e., they gradually climbed to that level after the date of the 84-day NBS-bills auction had been announced. This was related to the pre-positioning (borrowing money) for the auction. After the auction, rates

went down, because enough liquidity remained in the sector. IRS maturities of 1-3 years are rising slightly. The rest of the curve did not change dramatically first. However, the result of the 7Y T-bond auction changed the sentiment on Monday (May 14). The average accepted yield (4.33%) was by about 6-7 bps higher compared to the prices on the secondary market (4.26%). The whole yield curve went slightly up after the release of the auction's result. Strong GDP growth could give rise, in part of the market, to apprehensions of the overheating of the economy. On the other hand, the harmonised inflation (HICP) should fall slightly, from 2.1% y/y to 2.0% y/y, on Wednesday. Overall, we believe that the NBS will take a breather and avoid changing rates in May. The European Central Bank will raise rates to 4.0% in early June, and the gap between the rates of the NBS and the ECB will narrow to only 0.25%.



Indicative yields of government bonds

	Coupon	Maturity	Issue volume	Bid	Ask
SD191	5.0	5.3.2008	SKK 15.0 bn	4.00	3.75
SD203	4.8	14.4.2009	SKK 40.0 bn	4.05	3.75
SD189	4.9	5.2.2010	SKK 15.00 bn	4.05	3.76
SD174	7.5	13.3.2012	SKK 8.31 bn	n.a.	n.a.
SD188	5.0	22.1.2013	SKK 15.0 bn	4.39	4.19
SD199	4.8	2.7.2013	SKK 6.8 bn	4.40	4.25
SD202	4.9	11.2.2014	SKK 24.7 bn	4.32	4.28
SD204	5.3	18.5.2019	SKK 34.4 bn	4.50	4.30
SD205	0.0	5.4.2012	SKK 11.7 bn	4.15	4.05

Source: Bratislava Stock Exchange, CSOB

Interest rate fixing on the money market

% p.a.	O/N	1W	2W	1M	2M	3M	6M	9M	12M
5/7/2007	2.83/3.30	3.72/4.19	3.73/4.21	3.72/4.18	3.71/4.16	3.71/4.16	3.73/4.18	3.75/4.19	3.75/4.19
5/14/2007	2.30/2.72	3.73/4.16	3.74/4.17	3.72/4.16	3.70/4.13	3.71/4.12	3.71/4.13	3.72/4.14	3.73/4.15



EXPECTED DATA

■ Tuesday, May 15, 9:00

Quick Forecast of GDP for Q1 07 **10.8% y/y**

We, just like the entire market, anticipate record-breaking economic growth, driven by the improvement of net exports. The trade balance improved by SKK 20 bn y/y in Q1. Foreign demand should thus become a strong driver of economic growth. Household consumption, encouraged by real wage growth and a credit boom, as well as investment activities, should be secondary drivers. The lower year-on-year comparative baseline of Q1 2006 also signals double-digit growth.

■ Wednesday, May 16, 9:00

HICP **0.2% m/m, 2.0% y/y**

The national CPI was up by 0.2% m/m. We also expect the HICP to rise by 0.2% m/m. That should mean that the year-on-year index should fall slightly, from 2.1% y/y in March to 2.0% y/y in April.



POLAND

According to preliminary data from the Finance ministry the **January-April central budget** gap contracted to only 7-8% of the whole year plan of PLN 30 bn, compared with the 25.7% envisaged originally in the budget act and 16.1% in Q1. The stronger than expected performance came mainly from faster revenue growth and if not for the fact that it was, among other things, the result of unexpected time shifts in corporate tax payments we would have no choice but to call the result impressive. As such though we prefer not to put much weight to the volatile monthly figures and wait for more data which would confirm the uptrend in revenue growth driven by exceptionally strong economic performance. While the fiscal situation in 2007 looks fairly safe the outlook for the more distant future seems a bit less encouraging given the planned reduction in non-pay labor costs and numerous other plans to increase spending proposed by coalition politicians. In the meantime the FinMin came out with a set of preliminary 2008 macroeconomic forecasts for the 2008 budget. The ministry expects real GDP growth to come in at 5.5% y/y next year, which seem to be a fairly reasonable (if not conservative) estimate roughly in line with our expectations. Consumer price inflation is seen at 2.3% y/y on average, which might prove slightly too optimistic, but as such should also act as a safety cushion for the planned growth in nominal revenues. The basic assumptions are roughly in-line with general expectations and were unsurprisingly no market mover – it will be much more interesting to see whether the government eventually decides to pursue the expansive fiscal policy which some politicians from the governing coalition have insisted upon recently. If all the additional spending plans and revenue cuts come into action the market's optimistic perception of the fiscal outlook may quickly deteriorate, which constitutes one of the main upside risks for yields across the curve in the medium and long term.

According to preliminary estimates **fruit crops may be up to 90% lower** than in 2006 this year after low temperatures decimated orchard trees in the first days of May. Fruit prices might edge up by as much as 30-40% later this year according to (pessimistic) estimates made by producers. However, since the weight of fruits in the inflation basket is fairly small (roughly 1.3%) even if the preliminary damage reports are confirmed and if prices grow by as much as producers assume due to lack of adequate supply, we estimate this could push the CPI path up by 0.2-0.3 percentage points at most in H2. Moreover the extent of the upmove could be cut short by substitution effects (of local with imported fruits). We must stress however, that the

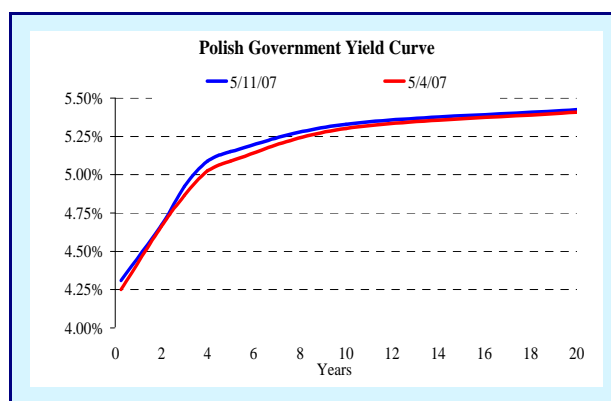
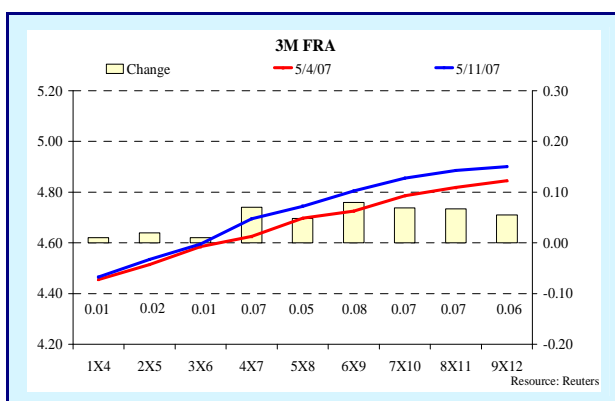
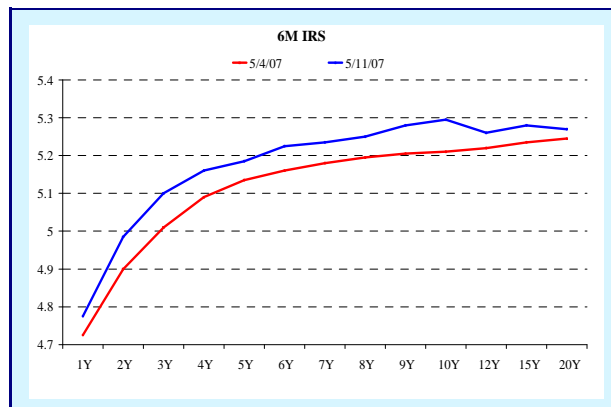
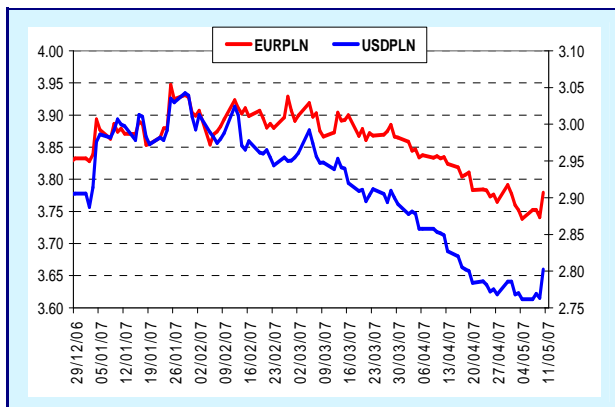
calculations above are based on little more than sheer speculation as both the extent of the damage and its impact on prices is yet to be determined. Under the most pessimistic assumptions however the shock would most likely put the year end y/y inflation above the 2.5% y/y target and push year average price growth up by 0.1 pp. in 2007. Due to the supply nature of the shock the implications of the rise for monetary policy should be limited though.

The **EUR/PLN pair** hovered in a tight range at around 3.75 in the first half of last week with activity still not up to full strength after the holiday break slowdown in the first week of May. Despite several timid attempts to break higher against the euro the zloty eventually settled into sideways trading as the positive bias seen at the start of the month shifted to neutral or even slightly corrective in the run up to the Fed and ECB rate decisions and barrage of domestic features this week.

Over the last several days we remained skeptical on the ST rally potential of the zloty, but in fact, despite the marginal weakening later in the week, with the regional sentiment still positive the PLN has so far been fairly buoyant. Heading into this week the room for a downward correction seems limited as well with global risk conditions still supportive and data which should not hinder expectations of continued robust growth, upside risks to inflationary risks and hence the need for additional monetary tightening.

The return of **bond investors** to the marketplace did little to liven up the price action early this week, and with no macro features worth attention on the domestic agenda yields hovered in tight ranges in subsequent days as investors geared up for the upcoming barrage of domestic data.

And the calendar promises to keep investors busy in the coming days, with the all-important inflation and wage figures as well as the less intriguing current account numbers up for release on Tuesday, Thursday and Friday respectively. Regarding data our CPI estimate is spot on the market consensus of 2.3% y/y, but since general expectations are for a softer result than in March the market would probably react in a stronger (bearish) way to an above-consensus result than to softer headline CPI. Our corporate wage growth estimate is also slightly above the market consensus (9.5% vs. 8.6% y/y) and with labor market risks to inflation in the center of attention of both the market and the MPC the week could very well end with a bearish spin at the short end of the yields curve if our estimate is correct.



Comparative table for Polish government bonds

Title	Price 11/05/07	Yield 11/05/07	Price change (bps.) to 04/05/07	Yield change (bps.) to 04/05/07	Modif. Duration 11/05/07
GOV/ 0 / 12/12/08	93.05	4.67	7	0.80	1.51
GOV/ 6 / 24/03/10	102.13	4.93	-18	6.17	2.57
GOV/ 4 / 24/05/11	97.01	5.09	-21	6.42	3.45
GOV/ 5 / 25/04/12	98.28	5.15	-26	6.21	4.29
GOV/ 5 / 25/10/17	99.34	5.33	-21	2.70	7.66
GOV/ 6 / 23/09/22	103.31	5.42	-15	1.41	9.79

EXPECTED DATA

Wednesday 15 May, 14:00

CPI (April) 0.5% m/m, 2.3% y/y

According to our estimates consumer price inflation came in at 2.3% y/y in April, a touch down from the 2.5% y/y recorded in March and slightly below the central bank target. Food prices increased by 0.8% m/m lat month, due largely to the rise in vegetable and fruit prices while retail fuel prices were up by 3.3% m/m. At the same time the core (ex-food and fuel) CPI component remained flat at 1.7% y/y. Both the Finance Ministry and the Monetary Policy Council have made it clear recently that inflation was expected to drop significantly in the coming months due to the high base (mainly in food and fuel prices) of 2006,

which has long been our baseline scenario. In this case, even though our expectations for April are in-line the market estimate, bonds may tend to react in a stronger fashion to an above consensus (bearish) outcome than to a lower than expected CPI figure. At the same time though the drop in inflation should be completely neutral in terms of the monetary policy outlook since it is in-line with the latest inflation projection published in April when it was not a strong enough reason to keep rates unchanged.



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■ **Thursday, 17 May, 14:00**

Salaries (April) 9.5% y/y

We believe that the fairly strong rise in productivity and tight labor market conditions boosted corporate wage growth in April to a record breaking level of 9.5% y/y. This would be slightly above the market consensus which stands at 8.6% y/y but also higher than the exceptional 9.1% y/y result from March.

■ **Friday, 18 May, 14:00**

C/A balance (March) EUR -300 M.

Balance of trade (March) EUR -200 M.

Despite the massive monthly contribution of EUR 812 m to the common budget Poland remained a net beneficiary of EU related transfers in March as roughly EUR 1425 m in funding transferred back mainly in the form of structural funding and direct subsidies. Nevertheless we also expect imports growth to have accelerated slightly after a surprisingly soft result in February and see exports growth roughly unchanged which would point to a wider trade imbalance. All this puts our March C/A deficit estimate at EUR -300 m.

■ **Monday 21 May. 14:00**

Industrial production (April) 15.0% y/y

We expect an increase in industrial production growth in March because of the larger number of working days than a year ago, which would point to a stable double digit deseasonalised result.

■ **Monday 21 May, 14:00**

PPI (April) 0.3% m/m, 2.1% y/y

We estimate that despite rising fuel prices keep producer price growth moderated visibly, largely due to the extremely high statistical base and the notable strengthening of the zloty.



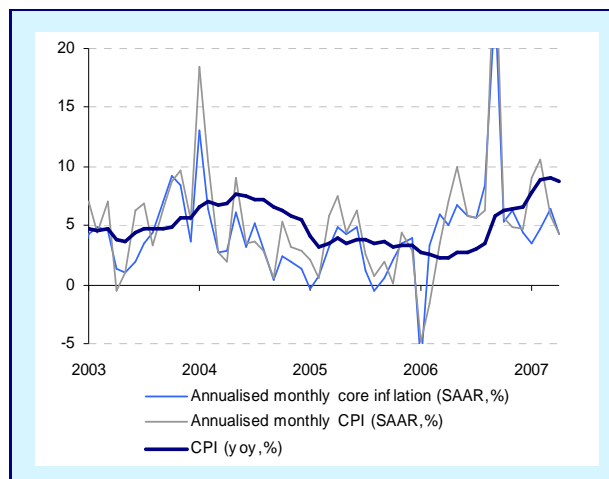
HUNGARY

First and foremost, IMF said last week that it supports the idea to scrap the **HUF's trading band**, but Finance Ministry added that topic is not on the agenda now. Note, that Finmin comment does not rule out a change in the future. As we wrote in our recent KBC Flash report, the band abolishment could be function of growth outlook and foreign exchange market conditions and this August or end of 2007 seem to be possible dates for such a decision depending on growth developments.

Last week's macro data underpinned the expected improvement of fiscal and external balance this year. April's budget posted a small surplus (HUF17bn), which brought year-to-date deficit performance to 45% of the full-year target, which is the same level we had last year. However, revenues and expenditures are above last year's time-proportionate level as some spending items occurred earlier this year, while better tax income performance is result of conservative planning. We expect better-than-expected budget performance in 2007. Based on current revenue trend, it seems possible that the final deficit outcome may be below 6% of GDP, well below official target and consensus estimation of 6.6-6.7%.

Slowdown of **March industrial production** figure to 6.7% yoy in adjusted terms, was in line with expected path of economic activity. Investment related import could have fall with production as trade balance showed further improvement and posted surplus in the same month (EUR 17m vs -248m in 2006). The 12-months rolling trade deficit sum shrank to 2.1% of GDP.

April inflation figure came in at 8.8% yoy, tad below consensus and our estimation of 8.9%. The shock from large-scale increases among regulated prices have been fading away and non-regulated prices also show some cooling, mainly because lower inflation of tradable goods due to the strong exchange rate of the forint. There are widespread concerns about price development of fruit and vegetable prices over coming months as poor rain and cold weather ruined harvest recently. Without any evidence of this in wholesale prices and favourable underlying inflation trend, we did not change our forecast and expect inflation to lower to 8% in August and further to 5.5% by year-end.



The market's focus could turn to **central bank's new projection for 2008 inflation**, which we forecast at 3.4% for the average and 3% for 2008 December. If inflation returns to the 3% target late next year, monetary policy may not require further tightening of conditions and thereby market's expectation for gradual rate cuts could be matched.

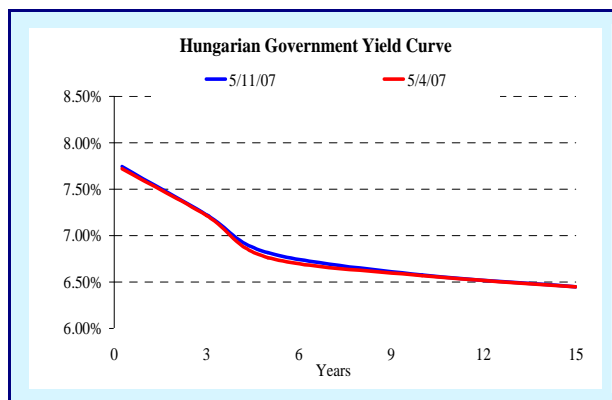
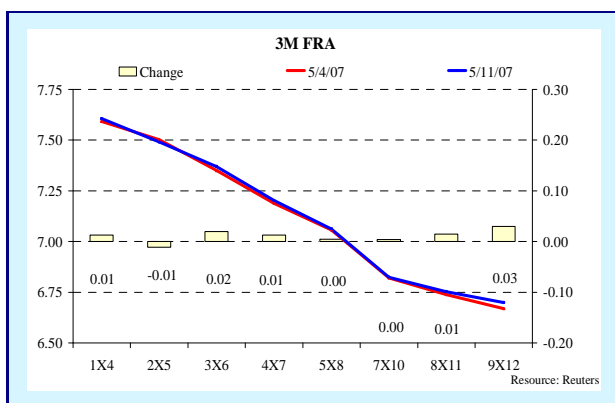
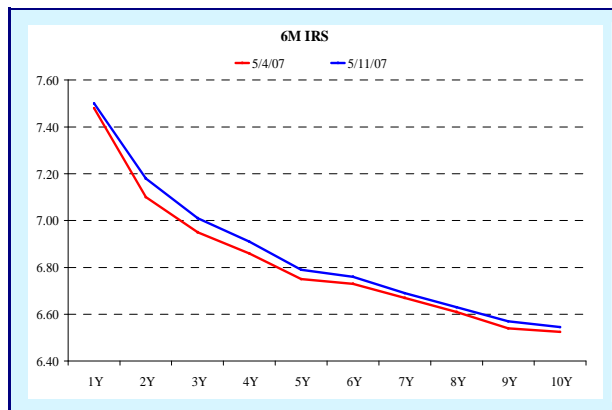
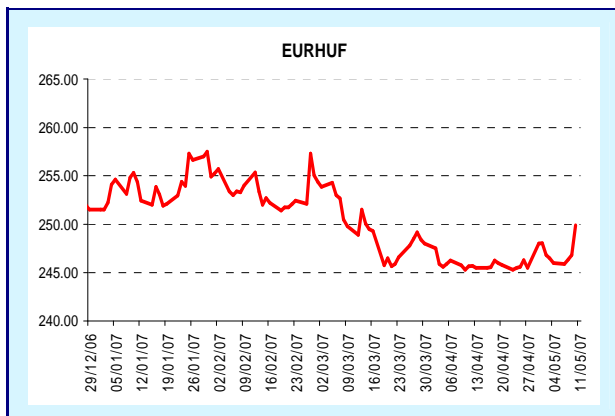
The **HUF exchange rate** movements have been mirroring changes in global risk appetite as domestic news did not alter the general picture. After currency failed to break 249.0, it appreciated back to around 248 and it could hover between 246-249 levels this week. Central bank meeting on May 21 may also leave market's assessment on Hungary unchanged as central bank have relatively narrow room to maneuver, with exchange rate being close to the band and market expecting deep rate cuts.

Bond market seem to be in consolidation mood after massive rally in March-April. The short-end of the curve has priced in 100bp rate cut to 7% by year-end, which is our expectation as well. The long-end seems bit more attractive now with 150bp 5y5y forward spread, which probably has higher relative value to Poland's 70bp level, but it could be a bit premature to expect further convergence of the long-end now. For that to happen, we may need some more evidence about fading fiscal and inflation concerns and so we expect this to happen some months later when inflation's return to the 3% target could be seen clearer and budget's good performance will be also on track. For now, the market could stay driven by global sentiment towards riskier assets and could follow moves in the currency as well.



May 14, 2007

CENTRAL EUROPEAN WEEKLY



Comparative table for Hungarian government bonds

Title	Price 11/05/07	Yield 11/05/07	Price change (bps.) to 04/05/07	Yield change (bps.) to 04/05/07	Modif. Duration 11/05/07
GOV/ 6.75 / 12/04/10	99.28	7.02	-6	2	2.5
GOV/ 7.25 / 12/06/12	101.81	6.82	-23	5	3.9
GOV/ 6.75 / 24/02/17	101.19	6.58	-5	1	6.9
GOV/ 6 / 24/11/23	96.17	6.38	-7	1	9.9

EXPECTED DATA

■ **Tuesday, May 15 9:00**

Real GDP (1Q07) 2% y/y

Preliminary first quarter GDP data will be the first guidance about how much the economy could slow this year on the back of the austerity measures. Market is expecting 2.3-2.4% figure, while we expect somewhat larger drop to 2% growth as domestic demand may have contracted due to decreasing real disposable income of households. Growth picture is also important for timing of possible abolishment of the fluctuation band.

■ **Monday, May 21 14:00**

Central bank meeting Rate cut 0.25% expected

Next Monday's central bank meeting could bring us first rate cut since 2005 September. We expect consensus matching 25bp move that would reduce base rate to 7.75%. 3-months T-Bill, Bubor and FRA market are also giving highest chance for a 25bp cut, hence not delivering the expected move would surprise interest rate markets considerably. New Inflation Report may also sound more optimistic about this year's budget performance, but it could contain some cautiousness about meeting the 3% target next year as uncertainties about 2008 fiscal developments, high actual inflation and possible adverse effects from bad weather on fruit and vegetable prices warrant cautiousness from monetary policy.



May 14, 2007

CENTRAL EUROPEAN WEEKLY

FOREX

TECHNICALS

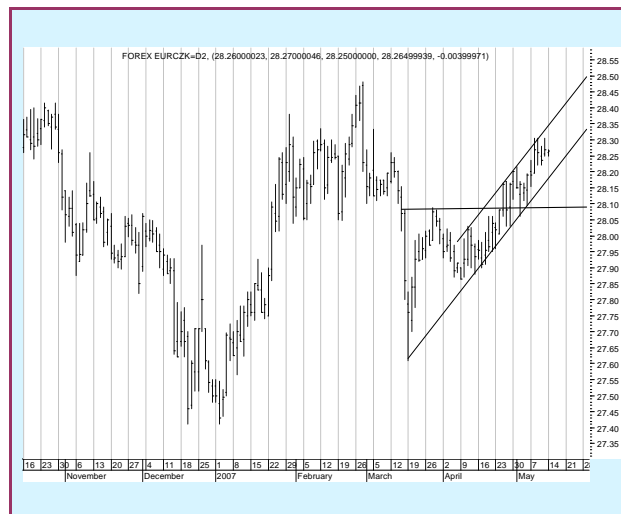
■ EUR/CZK: (28.2500)

DAILY CHARTS:

Pair currently above the neckline of a Short Term Double Bottom (28.0880) and in channel off 27.6100 (see graph).

So far above the LT weekly channel top off Jan 2004 (27.8870): 1st support area at 28.2160 (weekly envelope bottom), with next levels at 28.1550 (last week low), ahead of 28.0880/ 28.0690 (see graph/ weekly Bollinger midline). 27.8870/ 27.8650 (see above/ April 09 low): tough on 1st tests.

1st Resistance area at 28.3050/ .3110 (last week high/ 1st target off 28.0880), with next levels at 28.3320/ .3840 (weekly projection band top/ weekly envelope top): tough on 1st attempts.



■ EUR/PLN (3.7590)

New reaction low, with the pair trying to extend below the neckline of a Medium Term Head And Shoulders bottom (see graph): 1st Support area at 3.7417 (weekly Bollinger bottom), with next levels at 3.7350/ .7321 (new Long Term reaction low/ weekly envelope bottom), ahead of 3.7099/ .7042 (weekly projection band bottom/ Long Term Irregular B limit off 4.3040): tough on 1st tests.

1st Resistance comes in at 3.7749 (weekly envelope top), with next levels at 3.7885 (last week high) and 3.8000/ .8080 (May 01 high/ breakdown daily April 19 low): ideal area to stay below to keep trying Medium Term downside attempts in €.



■ EUR/HUF (247.50)

Below neckline of Triple tops (see graph): 1st Resistance area at 248.00 (weekly Medium Term Moving Average), with next levels at 249.95 (last week high + weekly envelope top).

250.51/ 250.85 = broken weekly channel bottom off 2005 low/ previous reaction low: ideal area to stay below to keep ST current mood intact on HUF.

Support at 247.06 (weekly envelope bottom), with next levels at 245.35 (last week low), ahead of 245.00/ 244.77 (April 23 low/ April 16 low) and 244.35/ .31 (March 19 low/ 2nd target of Triple Tops: see graph).

243.42/ 242.21 = 3rd target/ broken Long Term Weekly Downtrendline off Dec 2003 high: tough on 1st attempts.





■ EUR/SKK (33.5600)

Rebound off 32.7100 with help of Central Bank and rate cut has sent the pair retesting the channel top off 2006 high (see graph).

1st Resistance at 33.7200 (last week high), with next levels at 33.7940/ .8000 (weekly projection band top/ Medium Term reaction high on hourly charts), ahead of 33.8640 (weekly envelope top): tough on 1st tests.

Failure to do so would have new levels at 33.9550 (reaction high off 32.7100), where pause favored.

Support area at 33.5150 (last week low), with next levels at 33.4800/ .4700 (broken weekly channel top off 2006 high/ April 26 low).

33.3200 = April 10 low : tough on 1st tests.





TABLES

Official interest rates (end of the period)

		Current	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Last change	
Czech Rep.	2W repo rate	2.50	2.75	2.75	3.00	3.25	3.25	25 bps	27/09/2006
Hungary	2W deposit r.	8.00	7.50	7.25	7.00	6.75	6.75	25 bps	24/10/2006
Poland	2W inter. rate	4.00	4.25	4.50	4.50	4.50	4.50	-25 bps	28/02/2006
Slovakia	2W repo rate	4.50	4.25	4.00	4.00	4.00	4.00	-25 bps	27/03/2007

Short-term interest rates 3M *IBOR (end of the period)

		Current	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Czech Rep.	PRIBOR	2.77	2.80	2.89	3.08	3.32	3.35
Hungary	BUBOR	7.78	7.40	7.20	7.00	6.70	6.70
Poland	WIBOR	4.43	4.50	4.70	4.70	4.70	4.70
Slovakia	BRIBOR	4.12	4.20	3.90	3.90	4.00	4.00

Long-term interest rates 10Y IRS (end of the period)

	Current	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Czech Rep.	4.12	4.10	4.10	4.08	4.10	4.10
Hungary	6.515	6.50	6.40	6.30	6.20	6.10
Poland	5.32	5.35	5.45	5.45	5.45	5.50
Slovakia	4.57	4.25	4.25	4.30	4.35	4.35

Exchange rates (end of the period)

Current	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
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GDP

	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008
Czech Rep.	5.8	5.5	5.1	4.5	3.9	4.0
Hungary	3.2	2.0	2.2	2.5	2.5	3.0
Poland	6.4	6.7	6.1	5.4	5.2	4.8
Slovakia	8.0	8.2	8.4	7.2	6.8	6.5

Inflation (CPI y/y, end of the period)

	Dec-06	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Czech Rep.	1.9	2.4	2.7	3.4	3.3	2.9
Hungary	9.0	8.4	5.7	4.9	4.4	4.0
Poland	2.5	1.9	1.5	2.1	2.5	2.5
Slovakia	2.7	2.3	2.4	2.0	1.8	1.9

Current Account as % of GDP

	2006	2007
Czech Rep.	-4.2	-3.8
Hungary	-5.8	-4.5
Poland	-2.1	-2.1
Slovakia	-7.9	-4.4

Public finance balance as % of GDP (in ESA95 standards)

	2006	2007
Czech Rep.	-2.95	-3.8
Hungary	-9.8	-6.5
Poland	-3.6	-3.4
Slovakia	-3.6	-2.9



CALENDAR

			Period	KBC/ CSOB	Consensus	Previous
Monday - 14.May						
14:00	PL	M3 y/y	April 07	-	-	17.9
Tuesday - 15.May						
09:00	CZ	Industrial production y/y	Mar-07	8	9.1	15.4
09:00	CZ	Construction work y/y	Mar-07	15		32.5
09:00	CZ	PPI m/m	Apr-07	0.3	0.4	0.5
09:00	CZ	PPI y/y	Apr-07	3.6	3.7	3.6
09:00	HU	Industrial production y/y, details	March 07			
09:00	HU	GDP, preliminary (y/y)	Q1 2007	2	1.9	3.2
09:00	SK	GDP flash estimate y/y	Q1 2007	10.8	10.5	9.6
14:00	PL	CPI y/y	April 07	19	19.2	17.9
14:00	PL	CPI m/m	April 07	2.3	2.5	2.5
14:00	PL	Budget Deficit PLN bn	April 07	0.5	0.5	0.5
Wednesday - 16.May						
09:00	SK	HICP m/m	April 07	0.1	0.1	0.1
09:00	SK	HICP y/y	April 07	1.9	1.9	2.1
12:00	PL	5Y T-bonds auction (bln PLN)	-	2.4432	-	4.35
Thursday - 17.May						
09:00	HU	Wages (gross nominal, y/y)	March 07			
14:00	PL	Wages y/y	April 07	1.5-2.5	-	1.8
Friday - 18.May						
10:00	CZ	Current account (CZK bn)	Mar-07	-4	2	4
14:00	PL	Current Account EUR m	March 07	9.5	8.6	9.1
14:00	PL	Trade balance EUR m	March 07	-300	-480	-424
			Period	KBC/ CSOB	Consensus	Previous
Monday - 21.May						
09:00	CZ	Retail sales y/y	March 07	7	6.5	9.4
14:00	HU	Monetary council NBH (base rate)		-25bps	-25bps	0bps
14:00	HU	Inflation report				
14:00	PL	Industrial Production y/y	April 07	-200	-	-60
14:00	PL	PPI y/y	April 07	15	16.1	11.3
14:00	PL	PPI m/m	April 07	2.1	2.4	3.3
Wednesday - 23.May						
14:00	PL	Manufacturing Climate Index	May 07	0.3	0.6	0.5
14:00	PL	Core inflation y/y	April 07	1.7	-	1.7
Thursday - 24.May						
11:00	HU	T-bond Auction (3-year)				
Friday - 25.May						
10:00	PL	Unemployment rate	April 07	13.7	13.9	14.4
10:00	PL	Retail sales y/y	April 07	17.5	18	19.2

(Figures are in % and not seasonally adjusted: m/m-month on month rise; y/y-year on year rise; r-revised; p-preliminary)



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