CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** One more hike is to come
- **Hungary:** Forint strengthens, bond market consolidates
- **Poland:** Inflation well below the forecasts but MPC to stay on the alert
- **Romania:** Investments soared 29% y/y in 2007
- **Slovakia:** CB officials: we did not mean to affect the exchange rate

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Overview

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Czech Republic:

- **Inflation remains elevated**
- **One more hike is to come**
- **Industrial output has not eased on stronger koruna yet**

Hungary:

- **February CPI and budget balance figures in line with expectations**
- **Monetary policy - comments from rate-setters**
- **Forint strengthens, bond market consolidates**

Poland:

- **Current account continues to widen on LTM basis**
- **Inflation well below the forecasts…**
- **…but MPC to stay on the alert**
- **Next week quite rich in domestic data releases**

Romania:

- **Investments soared 29% y/y in 2007**
- **FDIs covered 61% of the C/A deficit in January**
- **General consolidated state budget had surplus of about 0.2% of GDP in the first two months**

Slovakia:

- **CB officials: we did not mean to affect the exchange rate**
- **Inflation increased but Maastricht limit not endangered**
- **Foreign trade in surplus in January**

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland current	- 1m	02/01/2008
Czech Republic	EUR/CZK	25.04	0.2%	1.9%	6.0%			
	3Y (yield bp)	4.19	19	0	-12	94	59	41
	10Y (yield bp)	4.64	5	7	-10	88	63	53
Croatia	EUR/HRK	7.26	0.2%	0.2%	0.6%			
	3Y (yield bp)	5.80	2	-8	49	266	257	140
	10Y (yield bp)	5.80	4	-7	27	208	197	135
Hungary	EUR/HUF	258.73	2.2%	1.6%	-2.1%			
	3Y (yield bp)	9.18	-2	115	163	593	475	365
	10Y (yield bp)	8.57	20	105	146	481	358	290
Poland	EUR/PLN	3.54	0.4%	1.8%	1.6%			
	3Y (yield bp)	6.33	-3	53	14	308	252	229
	10Y (yield bp)	5.99	-9	105	2	223	185	176
Romania	EUR/RON	3.71	-0.3%	-2.3%	-3.5%			
Slovakia	EUR/SKK	32.34	1.1%	2.5%	3.8%			
	3Y (yield bp)	4.17	5	-6	-42	74	91	52
	11Y (yield bp)	4.58	2	-4	-24	82	62	48

Source: Reuters, Bloomberg (+ means strengthening / - means easing of the exchange rate)

Trading Ideas

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Positions

Currently no open trading idea

Rationale at inception

Currently no open trading idea

Closed positions

#	Recommendation	opened	closed	P/L inc.carry
1	long: PLGB10y / 4m Euribor	16/09/2005	27/10/2005	-3%
2	short: CZGB15y / 6m PRIBID	16/09/2005	21/11/2005	6.0%
5	long: SKK/CZK	09/11/2005	20/01/2006	1.9%
3	short EUR/SKK	29/09/2005	07/02/2006	3.5%
4	EUR/PLN options	21/10/2005	28/07/2006	-2.7%
6	SKK/CZK long	23/03/2006	30/10/2006	2.2%
7	FRA 9*12 short	28/07/2006	08/11/2006	8bp
8	long HUGB 5y	13/10/2006	29/01/2006	5.7%
9	short CZGB/ long GDBR	09/01/2007	27/02/2007	1.8%
10	long CZK/EUR	27/02/2007	19/03/2007	2.3%
11	short CZGB/ long PLGB	07/03/2007	10/05/2007	5.5%
14	long SKKFRA 9x12, short EURF	16/07/2007	13/08/2007	30 bp
13	short EUR/CZK	07/06/2007	14/09/2007	3.0%
15	short EUR/RON	23/10/2007	21/11/2007	-4.9%
12	short EUR/SKK	04/06/2007	04/12/2007	1.6%
16	long USD/CZK	29/11/2007	14/01/2008	-3.1%
17	long 3y HUGB / 3m Pribor	05/12/2007	08/02/2008	-6.8%
20	short EUR/SKK	22/01/2008	13/02/2008	2.9%
19	long USD/CZK	21/01/2008	18/02/2008	-3.6%
18	short EURRON	31/12/2008	28/02/2008	-0.6%

To be included in the trading ideas mailing list, please, mail to rainer.singer@erstebank.at, subject: trading ideas

Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	25.1		7.27		258		3.54		3.72		32.3		3.75	4.88	7.50	5.50	9.00	4.25
Mar-08	26.0	25.0	7.25	7.25	261	258	3.55	3.55	3.68	3.72	32.5	32.3	4.00	4.50	7.50	5.75	9.50	4.25
Jun-08	26.8	25.1	7.20	7.20	260	261	3.60	3.60	3.65	3.78	32.5	32.3	4.00	4.50	7.50	5.75	9.50	3.75
Sep-08	26.3	25.1	7.25	7.25	256	263	3.55	3.55	3.60	3.85	32.5	32.3	4.00	4.00	7.25	5.75	9.50	3.50
Dec-08	25.9	25.1	7.30	7.30	256	266	3.51	3.51	3.50	3.90	32.5	32.3	4.25	4.00	7.00	5.75	9.00	3.50

	3m Money Market Rate										10y Govt. Yield					5y Yield
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK	RO
Spot	4.02		8.16		6.03		10.67		4.28		4.58	5.80	8.50	5.98	4.57	10.20
Mar-08	4.10	4.06	8.00	8.23	6.00	6.10	11.00	10.34	4.25	4.29	4.70	5.80	8.20	5.95	4.65	10.30
Jun-08	4.14	4.18	7.60	8.44	5.95	6.50	10.50	9.54	3.85	4.36	4.60	5.60	7.50	5.80	4.65	10.10
Sep-08	4.09	4.18	7.30	8.43	5.95	6.25	10.20	8.45	3.70	4.28	4.70	5.40	6.80	5.80	4.65	9.60
Dec-08	4.14	4.17	7.00	8.35	5.90	5.89	9.80	7.89	3.70	4.07	4.80	5.30	6.50	5.55	4.70	9.30

Long-term forecasts

GDP growth (%)	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	6.4	6.6	4.3	5.4
Croatia	4.8	5.7	4.6	4.8
Hungary	3.9	1.3	2.2	3.2
Poland	6.1	6.5	5.5	5.7
Romania	7.9	6.0	6.1	6.0
Serbia	5.7	7.3	6.3	6.8
Slovakia	8.5	10.4	6.7	5.0
Ukraine	7.1	7.3	6.6	6.0
CEE8 weighted average	**6.3**	**6.2**	**5.2**	**5.4**

CPI (%), eoy	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	2.5	4.9	5.1	4.2
Croatia	2.0	5.8	3.1	3.5
Hungary	6.5	7.4	4.6	3.1
Poland	1.4	4.0	3.4	2.7
Romania	4.9	6.6	5.4	4.5
Serbia	6.6	10.1	4.9	5.5
Slovakia	4.2	3.4	3.7	3.9
Ukraine	11.6	16.6	12.8	11.5
CEE8 weighted average	**4.1**	**6.5**	**5.2**	**4.4**

Unemployment (%)	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	8.1	6.6	6.3	6.1
Croatia	10.5	9.8	9.4	9.0
Hungary	7.5	7.7	7.6	7.5
Poland	14.9	11.4	9.3	8.0
Romania	5.2	4.1	4.0	3.9
Serbia	20.9	20.0	19.0	18.0
Slovakia	10.4	8.4	7.6	7.4
Ukraine	7.4	6.4	5.4	4.2
CEE8 weighted average	**10.6**	**8.7**	**7.7**	**7.0**

3M rates (average, %)	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	2.3	3.1	4.1	4.4
Croatia	4.5	5.6	7.0	5.5
Hungary	7.0	7.7	7.6	6.5
Poland	4.2	4.6	5.8	5.5
Romania	8.8	7.8	10.3	7.8
Serbia	22.1	11.3	11.2	10.0
Slovakia	4.3	4.3	4.0	4.2
Ukraine	13.5	9.8	10.9	10.0
CEE8 weighted average	**6.5**	**6.0**	**7.1**	**6.3**

C/A (%GDP)	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	-3.0	-3.2	-3.6	-2.2
Croatia	-7.8	-8.3	-8.1	-7.9
Hungary	-6.5	-5.2	-4.7	-4.3
Poland	-3.2	-3.7	-5.0	-5.6
Romania	-10.4	-13.9	-15.0	-15.0
Serbia	-11.7	-16.8	-16.0	-16.2
Slovakia	-7.2	-5.3	-4.5	-4.1
Ukraine	-2.9	-4.1	-3.7	-4.2
CEE8 weighted average	**-5.2**	**-6.0**	**-6.5**	**-6.5**

Budget Balance (%GDP)	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	-2.9	-1.9	-2.9	-2.7
Croatia	-3.0	-2.3	-2.8	-3.0
Hungary	-9.2	-5.7	-4.0	-3.9
Poland	-3.9	-2.6	-3.2	-2.9
Romania	-1.6	-2.3	-2.7	-2.7
Serbia	0.2	-1.0	-0.5	-0.5
Slovakia	-3.7	-2.2	-2.1	-2.4
Ukraine	-0.7	-2.8	-2.7	-3.0
CEE8 weighted average	**-3.5**	**-2.7**	**-3.0**	**-2.9**

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Mar-18	Retail Sales (%, YoY)	5.00%	4.40%
Croatia	Mar-20	Industrial production	4.5% y/y	
	Mar-20	Unemployment rate	15.1%	
Hungary	Mar-19	Jan Nominal wages	-	5.9% y/y
	Mar-21	Jan Retail sales	-4.3% y/y	-4.1% y/y
	Mar-21	Minutes from CB meeting (02/2008)		
Poland	Mar-17	Average corporate wage (% y/y)	10.4%	11.0%
	Mar-19	Producer prices (% y/y)	3.0%	3.0%
	Mar-19	Industrial output (% y/y)	13.9%	10.4%
	Mar-20	Minutes from CB meeting (02/2008)		
	Mar-21	Net core inflation (% y/y)	2.8%	-
Romania	No data releases scheduled			
Slovakia	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		No auction scheduled					
Hungary		Mar-18	Mar-26	June-25-2008	-	HUF 40bn	8.30%
		Mar-19	Mar-26	Sept-24-2008	-	HUF 25bn	8.50%
		Mar-20	Mar-26	Jan-28-2009	-	HUF 40bn	8.50%
Poland		No auction scheduled					
Romania		20-Mar-08	24-Mar-08	5Y	8.25%	RON 500 mn	9.00%
Slovakia		No auction scheduled					

Major markets

Curve flatter on back of hawkish ECB rhetoric

The Euro yield curve became flatter again on the back of hawkish comments from Axel Weber, head of the German Bundesbank, and a further fall in US longer-term yields and higher inflation. This week's inflation data for February came in at 3.3% - above the flash estimate of 3.2%. Main drivers were food and energy as well as housing, hotels and restaurants and transport. Next week only the flash estimates of the Reuters PMI's for manufacturing and services will gain attention. In February, sentiment in the manufacturing sector deteriorated slightly while sentiment in the service sector improved a little. As all input factors like raw material prices, energy prices, data for US economy, EURUSD and financial stress worsened further in March, there seems little chance of any improvement in sentiment indicators. However, the ZEW Survey improved in March, so maybe these indicators could surprise to the upside also. This would be another dampening factor on hopes for interest rate cuts in Euroland and could result in a further short-term flattening of the yield curve. Over the medium term, we expect the curve to become steeper from the current level.

75bp rate the most likely outcome of next week's FOMC meeting

Without doubt the most important event of next week will be the FOMC meeting on Tuesday. At the same time, the only question for debate is if the Fed Funds Rate will be cut by 50 or 75 bp. In any case, market outlook will barely brighten and the press release after the FOMC meeting will leave the door wide open for further rate cuts. We have long been in favour of a 50bp rate cut on Tuesday, while markets have favoured 75bp (at times even 100bp) during recent weeks. After the most recent disappointing retail sales, admittedly a 75bp rate cut has become more likely, so we change our core scenario accordingly. Still, the outcome is not as clear as assessed by the market. Recently introduced measures by the central bank to improve liquidity on the market seem like a better tool to solve the current problems than interest rate cuts, especially given the ever rising commodity prices. At the same time, a huge interest rate cut is needed to further calm markets. A 75bp rate cut remains the most likely outcome even if today's CPI numbers come in above expectations. Next week's macro indicators are generally second tier, with industrial production on Monday being the most important one. So, the FOMC meeting will not have to share the spotlight, unless yet another financial institution announces difficulties.

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Forecasts

	Intervention Rate		3m Money Market Rate				10y Govt. Yield		FX	
	EUL	USA	EUL	Forwards	USA	Forwards	EUL	USA	EUR/USD	Forwards
Spot	4.00	3.00	4.60		2.80		3.77	3.49	1.555	
Mar-08	4.00	2.25	4.20	4.67	2.40	2.78	4.00	3.60	1.55	1.554
Jun-08	3.75	2.25	4.00	4.54	2.40	2.55	4.00	3.80	1.52	1.547
Sep-08	3.50	2.25	3.75	4.48	2.50	2.28	4.30	4.20	1.47	1.539
Dec-08	3.50	2.25	3.70	4.33	2.60	2.32	4.50	4.40	1.40	1.533

Czech Republic

Inflation remains elevated

Last week saw the release of several data, among which were CPI, industrial production and unemployment. Czech CPI stayed at 7.5% in January (market: 7.5%; CS: 7.4%), which is m/m growth of 0.3%. The month-on-month growth of prices in February was driven by housing (water, sewage, heating) and some food items (bread) as well as seasonal effects (higher prices of winter vacation packages). Bringing down the overall level were prices in transportation (fuel and strengthening of CZK), some food items (milk, butter) and electronics (dollar effect). The stronger CZK is also reflected in the fact that while services recorded a 1% m/m rise, goods fell by 0.2%. Y/y growth was the same as in January (7.5%) and was accounted for by steeper prices of those items that are influenced by January changes (VAT, administrative regulations - electricity, heating, etc.), higher fuel prices (y/y growth is not curbed by the stronger CZK) and - despite the somewhat slower dynamics of food prices - by them also. Electronics and car prices were down on a y/y basis.

One more hike is to come

Higher inflation will remain with us for the good part of the year. Year-on-year growth should slow down on the base effects (higher oil prices in 2007, food price shock) and stronger CZK and - towards the end of 2008 and beginning of 2009 - also on the reforms that will bring down from the annual numbers. Inflation is some 0.8 p.p. above the CNB prognosis, the CZK is approximately 3% stronger compared to the prognosis. Higher inflation remains a risk for the central bank and since we expect the CZK to weaken we see a space for one more rate hike towards the end of 2Q and beginning of 3Q.

Industrial output has not eased on stronger koruna yet

Industrial production surprised on the upside where growth reached 9.3%, exceeding our expectation (+6.5%) and that of the market (+5%). Growth was driven by electronics and cars, both of which posted double-digit y/y growth. So far (as was visible already in the Trade balance data) a strong koruna does not have much of an impact on the Czech economy. The expected slowdown in EU and a stronger CZK for a longer period of time will lower exports eventually, though, and will thus be reflected also in slower industrial production. We expect growth of 5.5-6% this year. Next week, retail sales are scheduled for release. Our expectation is 5%; consumers' purchasing power is being eroded by higher prices, so retail sales this year are expected to grow at a slower rate than last year.

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Hungary

February CPI and budget balance figures in line with expectations

Macro figures published this week did not come as any surprise. The 12-month CPI inflation rate slowed to 6.9% in February (from 7.1% published for January). The data proved to be slightly lower than previous estimations (7%), while the structure of the index more or less met expectations, as well. Rising by 8.2 m/m, household energy prices put the strongest pressure on the monthy CPI index, due to the accounting for gas (15.4% m/m) and electricity price (9.8% m/m) increases in the statistics. It seems favourable, however, that price increasing pressures in the foodstuff catagory have started to mitigate (+0.8% m/m in Februry), after sharp rises characterised the previous months. Apart from the foodstuffs and administratively determined household energy prices, other items have still not shown strong (second round) price pressure in the economy. Please note that the yearly index of market services further slowed to 6.8% from the 7.1%, seen in January. All in all, given the lack of demand pull inflation, from the point of view of fundamentals, the figures eased the necessity for an immediate central bank rate hike.

The budget deficit amounted to HUF 215.9bn in February, which was slightly more favourable than the ministry's preliminary forecast of HUF 219.8bn. The deficit for the first two months of the year reached HUF 182.1bn. Concerning the outcome of the referendum held last Sunday, more than 3 million people voted for cancelling the doctor visit fee, the daily fee at hospitals and university tuition fees by January 2009, at the latest, thus the referendum clearly passed. (It passes if 25% of the roughly 8 million eligible voters votes in the same way.) The government now plans to abolish these fees as of April, but we continue to believe the measure will not jeopardise reaching the budget deficit goal of 4% of GDP this year. However, given the huge slap in the face electors gave the governing parties last Sunday in referendum, market worries that the slumping popularity of the government could mitigate the commitment to the continuation of fiscal reforms might intensity in the mid run.

Monetary policy - comments from rate-setters

This week saw a few interesting comments from some rate-setters in the monetary council. Tamás Bánfi who is known as the most dovish rate-setter in the council said in an article in the daily "Népszabadság" that the badly chosen inflation target was the reason for not achieving it even in 2009. He said that the inflation criterion must be met, but not necessarily over two years. Please note that earlier Governor Simor had commented on market rumours regarding the possible abandoning of the central bank's mid-term CPI goal of 3% y/y as ridiculous and unfounded. The central bank officially distanced itself from the personal opinion of Bánfi in a statement. Our view is that abandoning the mid-term CPI target is very unlikely, unless the ECB discards its 2% y/y inflation target, but this latter option seems nonsensical. Later on in the week, another rate-setter Judit Neményi gave an interview to Reuters in which she reinforced that achieving the inflation target was the main priority for the central bank. She added, however, that the CB could reach its CPI goal with steady rates, but the current re-pricing of global risks may force the bank to hike the base rate. And finally, Governor Simor welcomed the government's new plan to curb the quasi monopoly of the state-owned power wholesaler (MVM). He said that the liberalisation of electricity prices in January did not go along with the creation of market competition, which has led to unjustified electricity price rises and a negative impact on the inflation outlook.

Forint strengthens, bond market consolidates

The liquidity measures announced by the FED on Tuesday have globally improved sentiment on markets. This could have been the main role in the forint strengthening below 260 against the EUR. Long-term bond yields have consolidated continuously during the week, but they are still far above the levels seen before the last week's panic. On Thursday, the 10Y bond auction attracted healthy demand (HUF 140bn vs. the offered amount of HUF 40bn), which seems positive in the light of the liquidity dry-out, seen last Friday. The GDMA (Government Debt Management Agency) said this morning that it was not planning any extra measures or changes, considering that the issue plan and Hungarian bonds are attractive at their current levels. However, in the coming period, it is ready to prepare for a more hectic global market environment.

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Poland

Current account continues to widen on LTM basis

The current account balance ended in a deficit of EUR 1249mn in the first month of the year and almost matched the market consensus exactly, which is a rare occurrence. The high December shortfall hence indeed turned out to be a one-off event, as we had assumed. Surplus on the services account increased slightly, but the main driver of the decrease in the current account gap (in comparison to the previous month) was primarily a more encouraging picture in the trade balance. Seasonal factors are to thank, as December imports are traditionally higher due to the Christmas season. So, while the annual dynamics of exports accelerated to 22.9% y/y in January (confirming solid performance from Polish exporters), the pickup in the growth of imports was much slower. The current account deficit continued to widen on the past 12-month basis. In January it totalled approximately 3.6% of GDP. Further worsening is expected in the months ahead (as far as 5.0% of GDP for the whole year) due to the solid domestic consumption and investment demand, which will lend support to imports on the one hand and slowing exports (due to a global slowdown and stronger zloty) on the other. Nevertheless, the coverage by FDIs remains satisfactory (96%) and hence the January number does not carry any negative implications towards the currency, in our view.

Inflation well below the forecasts…

February price development was more favourable than the market had anticipated. The annual inflation rate reached 4.2% y/y, which was well below the market estimate of 4.6% y/y and also surpassed our more optimistic forecast of 4.5% y/y. The impact of the revision in the weighting system was the main reason behind the surprise. The Statistical Office recalculates weightings each year, in order to reflect the structure of household expenditure more faithfully. As a result of the new weighting scheme, the January number was revised downwards to 4.0% y/y from 4.3% y/y reported earlier. The downward correction was aided by the decline in the share of the fastest growing categories of food and housing. On the other hand, the weighting of items whose prices are in deflation on a yearly basis (such as clothing and recreation) has increased.
Looking at the structure, the monthly pickup in consumer prices was driven primarily by housing (which was pulled up by the significant rise in electricity +8.7% m/m). Food dynamics have begun to lose steam with prices increasing by a mere 0.2% m/m in February, as a result of which the annual growth slowed down. Global pressures remain the main risk factor, as they could easily ignite the price rises in this category again. From the central bank's standpoint, the ongoing increase in the dynamics of services could be worrying. The pace of annual growth within healthcare, restaurants and education accelerated for the third month in a row. Consequently, we estimate that the net core inflation (headline excluding food and fuels) should have made a big leap upwards as far as 2.8% y/y in February from a mere 1.7% y/y witnessed at the end of last year.

…but MPC to stay on the alert

Inflation moved further off the central bank's tolerance band (1.5-3.5%) in February. Nevertheless, it has probably still not reached this year's peak. Depending on the final agreement on gas prices, inflation could yet nose up in the coming months. The lower-than-expected spot headline number might satisfy the doves at MPC, but we believe that the majority of central bankers will have stayed tuned on a hawkish tone. The main reason is that the structure of inflation showed further deterioration (pickup in the prices of services), which might be a signal that second-round effects are slowly starting to emerge. Moreover, labour market developments will continue to represent an inflation risk going forward. Therefore, we retain our expectation that the central bank will raise key interest rates soon. The exact timing will be influenced by the data scheduled for release next week. We prefer March as the date of the nearest move as we think that the MPC would like to anchor inflation expectations at the beginning of the year when wages are being negotiated. A desire to prevent a situation where Poland will be in tightening mode and the ECB starts cutting rates is another argument for an early hike.

Next week quite rich in domestic data releases

The situation on the bond market stabilised this week. The spreads on Polish government papers against their Eurozone peers managed to contract. Quite a few data releases are in the bag for next week. Bond markets will have a keen eye on wages in the corporate sphere. We predict only a mild slowdown to 10.4% y/y from 11.5% y/y in January. The actual number could tilt the scales towards a hike either in March or April, but is not likely to erase the rate hiking expectations, in our view, as the dynamics should remain robust. Industrial output growth will remain in double-digit territory and even improve somewhat in comparison to January as working day effects will be helpful. The release of net core inflation and PPI will be another piece pointing to a need for tighter monetary policy.

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Romania

Investments soared 29% y/y in 2007

Romanian National Institute of Statistics this week released detailed information about the GDP structure in 2007. Gross fixed capital formation increased significantly to 28.9% y/y (compared to 19.3% y/y in 2006), mainly supported by investments in the construction sector. Households final consumption slowed to 10.2% y/y in 2007 (against 11.4% y/y in 2006) thanks to soaring inflation. Consumption might decelerate further in 2008 due to tighter monetary policy from the Central Bank and stronger fiscal and income policies implemented by the Government. Foreign trade made a negative contribution to economic growth, as imports received a boost in 1H07 via RON appreciation and the removal of some customs duties after Romania's accession to the EU. However, the first results for 2008 show a better outlook for the trade balance as exports gained speed, backed by the manufacturing industry. The industrial production of means of road transport went up by 48.6% y/y in January and provided strong support for exports. For 2008 we estimate an increase in gross fixed capital formation of about 18% y/y, while household consumption is likely to decelerate further (+8.8% y/y).

FDIs covered 61% of the C/A deficit in January

The C/A deficit reached EUR 1.1 billion in January 2008 (+16.8% y/y). Although the numbers were no great surprise, the structure of the C/A deficit has changed a lot compared to 2007. The income balance deficit was the main determinant of the C/A deficit in January 2008 as it widened by 21.2% y/y following higher interest payments on loans granted to the real economy and the banking sector. The trade balance deficit, the traditional driver of the C/A imbalance during previous years, lost speed rapidly to only 0.8% y/y. Important FDIs directed towards industry and a weaker RON had a positive impact on the trade balance. In line with our estimates, net current transfers went down. The remittances of Romanians working abroad continued to increase, although at a slower pace. We forecast a C/A deficit of about 15% of GDP at the end of 2008.

General consolidated state budget had surplus of about 0.2% of GDP in the first two months

The general consolidated state budget had a surplus of about 0.2% of GDP in the first two months of 2008 according to a press statement given by the Minister of Finance. Collection of indirect taxes increased 113.3% y/y in nominal terms in January 2008. VAT rose by 158.9% y/y while excise duties increased by 58.2% y/y due to a base effect and tighter execution of the state budget. Tax collection was affected by a change in VAT methodology regarding imports and the removal of some excise duties in 1Q07, after Romania's accession to EU. However, the situation looks better now and the support for economic growth is considerable. Higher revenues from the consolidated state budget (+65.9% y/y during the first two months) might dispel some rumours regarding the Government's potential incapacity to support a pensions hike in 2008. The governor of the Central Bank and the Minister of Finance have recently agreed to follow a more coherent mix of macroeconomic policies in order to reduce inflation by the end of the year, to offer support for RON and to control the external imbalances. The 2008 budget was initially built around a fiscal deficit set to 2.7% (according to local standards) but the European Commission signalled that, according to Maastricht criteria, the consolidated budget deficit was likely to exceed 3%. The Ministry of Finance announced in early March that it would submit a revised budget with a consolidated fiscal deficit of 2.3% of GDP (local standards), maintaining capital expenditure unchanged.

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Slovakia

CB officials: we did not mean to affect the exchange rate

At the beginning of the week the koruna erased losses related to last week's comments from the CB governor and stabilised later within a 32.25-32.40 SKK/EUR range. The market reacted sensitively to recent officials' comments on the exchange rate as the time of setting the conversion rate approaches. The Bank Board seemed to be unhappy with the strong reactions of the market to its statements and issued a press release stating that the Board's previous remarks were not intended to influence the exchange rate, but rather were meant in a general way. Also, the press release rejected the notion that the Bank Board was divided on monetary policy decisions. The idea that CB officials have conflicting views on the exchange rate was recently brought up by the PM after several comments seemed to hint at different preferences for the euro conversion rate strength.

Inflation increased but Maastricht limit not endangered

February inflation data was slightly disappointing showing an increase in national inflation to 4.0% y/y from 3.8% y/y a month earlier, against expected stagnation. The main source of upward surprise in the CPI was the growth of imputed rents by almost 4% on a monthly basis. While these are not included in the consumer basket of HICP inflation, the increase in prices of services - such as healthcare - which have higher weights in HICP, pushed the EU-norm inflation above expectations as well to 3.4% from 3.2% in January. Food prices grew only slightly stronger than we estimated, leaving the question, whether recent excessive food price growth was only temporary or permanent, unanswered. We see this factor as the main upside risk to our forecast for 2008. Nevertheless, one month ahead of euro evaluation Slovakia continues to meet inflation criterion with a sizeable buffer of about 1pp. While discussions about sustainability are possible, with such a big cushion, Slovakia should get the nod to adopt the euro.

Foreign trade in surplus in January

On the other hand, the January foreign trade balance brought a positive surprise, reaching a surplus of SKK 6.6bn, above the market forecast of SKK 4.3bn surplus and our even more pessimistic estimate (exports accelerated to 16.4% y/y up from 9.4% in December). On a 12M basis, the trade balance improved from (revised) 1.2% of GDP in December to 1.1% of GDP in January. The detailed structure is not known yet.

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Appendix Charts

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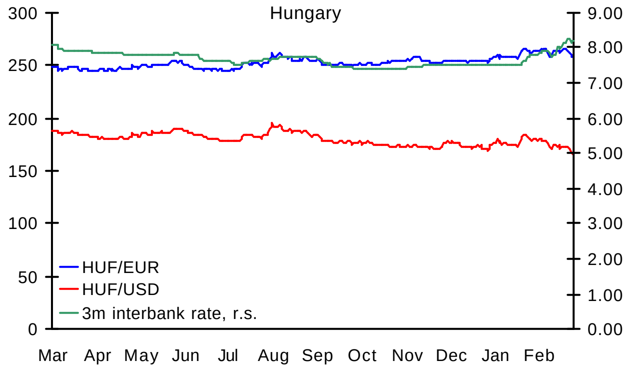
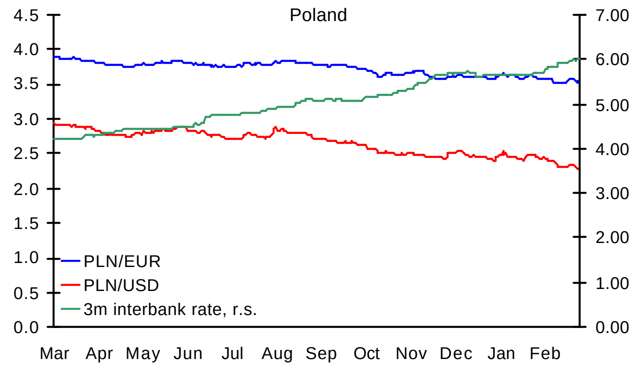
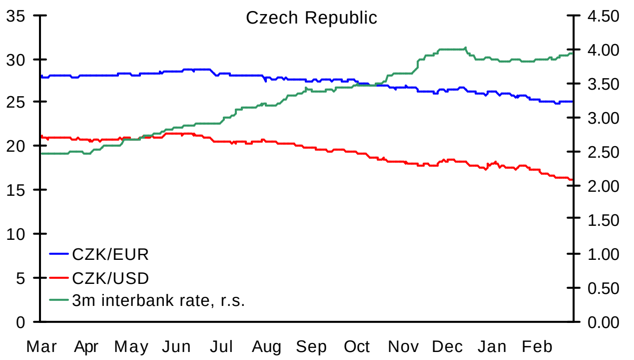
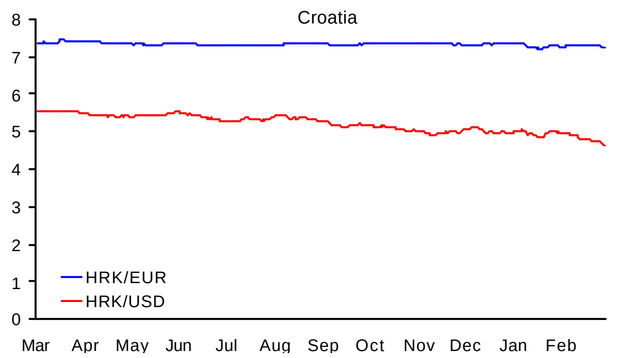
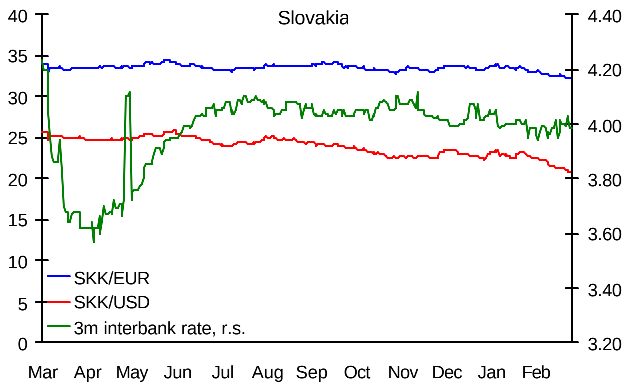
Exchange rates and interest rates (52 weeks)

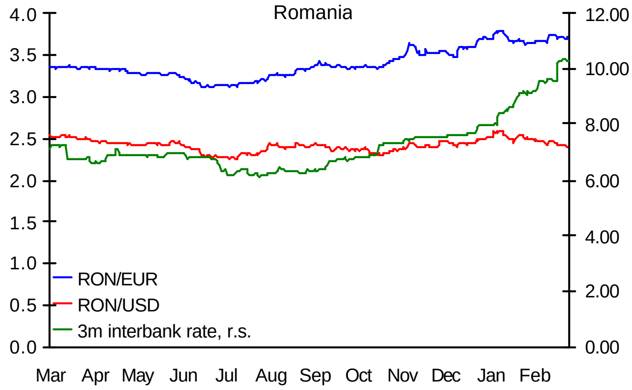








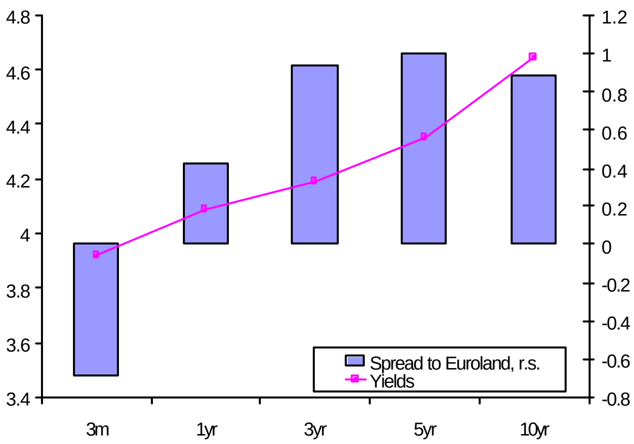




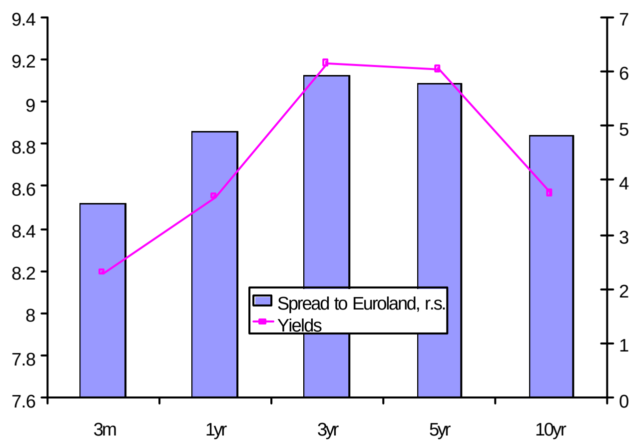
Source: Bloomberg

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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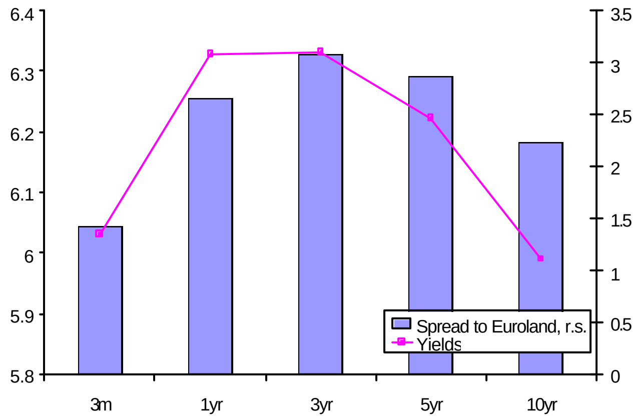
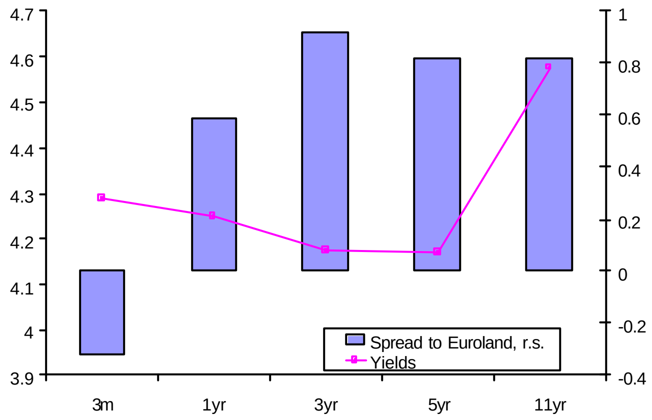
Poland



Slovakia



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