CEE Research

January 12, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** 3Q GDP: Solid 4.7% y/y growth in line with expectations
- **Czech Republic:** Open trading idea - short CZGB
- **Hungary:** December CPI to be most influential figure next week
- **Poland:** New central bank Governor Skrzypek cautious with his rhetoric so far
- **Slovakia:** CB stepped up its tactics against koruna

Overview

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Croatia:

- 3Q GDP: Solid 4.7% y/y growth in line with expectations
- 3Q C/A surplus declined 2.7% y/y
- Bond and FX markets stable

Czech Republic:

- Open trading idea - short CZGB
- Looking back

Hungary:

- 2006 ESA-based deficit likely at 9.8% of GDP
- December CPI to be most influential figure next week

Poland:

- New central bank Governor Skrzypek cautious with his rhetoric so far
- Markets to watch inflation and trade data next week

Slovakia:

- CB stepped up its tactics against koruna
- December inflation below forecast
- Trade balance widened, but should improve in 2007

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Market review		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2007
Czech Republic	EUR/CZK	27.76	-0.3%	0.5%	-0.5%			
	3Y (yield bp)	3.19	2	0	-2	-72	-50	-66
	10Y (yield bp)	3.80	10	18	9	-21	-11	-23
Croatia	EUR/HRK	7.37	-0.1%	-0.2%	-0.2%			
	3Y (yield bp)	3.99	1	-10	-2	30	56	35
	10Y (yield bp)	4.69	0	6	-3	73	96	86
Hungary	EUR/HUF	253.89	-0.1%	0.0%	-1.0%			
	3Y (yield bp)	7.85	33	18	30	394	396	368
	10Y (yield bp)	7.03	33	18	115	302	311	276
Poland	EUR/PLN	3.87	0.2%	-1.7%	-1.0%			
	3Y (yield bp)	4.62	-2	-8	-3	71	98	78
	10Y (yield bp)	5.21	6	18	4	120	140	124
Romania	EUR/RON	3.40	-0.5%	0.9%	-0.5%			
Slovakia	EUR/SKK	34.51	0.1%	0.9%	-0.1%			
	3Y (yield bp)	4.31	5	-10	-7	41	70	50
	9Y (yield bp)	4.30	4	1	-1	27	55	38

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

Trading Ideas

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Positions

#	Recommendation	Date of opening	Instruments	Entry values	Today's values	flat P/L (%)	flat P/L inc. carry (%)	P/L p.a. inc. carry (%)	Target values	Target P/L flat (%)	Target P/L p.a. (%)
	long HUGB 5Y	13/10/06	5Y HU GB 7,25	97.50	99.25	3.60	7.50	30.1	101	13.47	-
8	Euribor 6M		6M Euribor	3.60	3.88						
	EUR/HUF			266.00	253.24	4.80			263.00		
	short 10Y CZGB	12/01/07	CZGB 3,8 04/15	99.63	99.54	0.09	0.2	0.2	97.04	0.82	2.0
9	long 10Y GDBR		DBR 3,75 01/17, EUR/CZK	97.75	97.68	0.09			96.48		

Stop / loss is generaly at -3%, unless otherwise stated

Rationale at inception

8) We have become bullish on the Hungarian long-term bonds and the forint in the medium term. After the forint firming and decreases in bond yields in the last few days, we think that there is still space for gains; they are attractive at their current level. We think that there is potential for bond investors to enter the market. The target is 7% HUF GB 5Y and 263 HUF/EUR.

9) The long-term CZ yields are determined by the short-term rates, EU yields and the domestic premium. The difference between the CZ and EU curve slopes (10Y/CB rate) approximates this domestic premium. The higher net government bond issuance should increase this premium from 58bp to 73bp. This means 10Y CZ/EU spread at 10bps. The recent negative spread close to 20bps was driven by the December CZK appreciation. I expect the CZK to correct with the beginning of spring and stabilize close to 27.60.

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	5.97%
5	long: SKK/CZK	09/11/2005	20/01/2006	1.90%
3	short EUR/SKK	29/09/2005	07/02/2006	3.45%
4	EUR/PLN options	21/10/2005	28/07/2006	-2.69%
6	SKK/CZK long	23/03/2006	30/10/2006	2.16%
7	FRA 9*12 short	28/07/2006	08/11/2006	8bp

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	27.7		7.37		254		3.87		3.40		34.6		2.50	3.50	8.00	4.00	8.75	4.75
Mar-07	27.7	27.3	7.35	7.35	253	256	3.75	3.87	3.41	3.41	35.2	34.6	2.50	3.50	8.00	4.00	8.75	4.75
Jun-07	27.6	27.6	7.25	7.25	254	258	3.80	3.88	3.39	3.42	36.0	34.6	2.75	3.50	8.00	4.25	8.50	4.75
Sep-07	27.6	27.5	7.40	7.40	256	261	3.80	3.88	3.38	3.43	35.2	34.6	3.00	3.50	7.50	4.25	8.25	4.75
Dec-07	27.3	27.4	7.40	7.40	255	263	3.75	3.88	3.40	3.44	34.5	34.6	3.00	3.50	6.75	4.25	8.25	4.75

	3m Money Market Rate										10y Govt. Yield				
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK
Spot	2.56		8.02		4.20		6.55		4.55		3.80	4.69	7.05	5.21	4.29
Mar-07	2.63	2.68	7.95	7.89	4.30	4.31	7.50	7.40	4.60	4.24	4.00	4.75	6.70	5.35	4.50
Jun-07	2.88	2.79	7.70	7.76	4.35	4.49	8.00	8.00	4.55	4.14	4.25	4.85	6.50	5.25	4.55
Sep-07	3.05	2.95	7.50	7.50	4.35	4.63	8.25	7.80	4.45	4.13	4.30	4.80	6.30	5.10	4.55
Dec-07	3.20	3.12	6.80	7.35	4.55	4.60	8.30	7.70	4.30	4.23	4.30	4.85	6.10	4.90	4.60

Long-term forecasts

GDP growth (%)	2005	2006e	2007f	2008f
Czech Republic	6.1	5.8	4.1	5.1
Croatia	4.3	4.8	4.5	4.3
Hungary	4.2	3.8	2.3	3.2
Poland	3.5	5.5	5.3	5.7
Romania	4.1	7.0	6.5	6.3
Slovakia	6.0	7.9	8.2	6.5

C/A (%GDP)	2005	2006e	2007f	2008f
Czech Republic	-2.0	-4.6	-4.2	-3.8
Croatia	-6.3	-8.3	-8.2	-8.1
Hungary	-6.8	-6.5	-5.6	-5.4
Poland	-1.4	-2.0	-2.8	-3.0
Romania	-8.7	-9.8	-9.2	-9.1
Slovakia	-8.6	-7.5	-2.6	-0.6

CPI (%), eoy	2005	2006e	2007f	2008f
Czech Republic	2.2	2.5	3.5	3.1
Croatia	3.6	3.7	3.3	3.0
Hungary	3.3	6.6	4.8	3.5
Poland	0.7	1.7	2.3	2.3
Romania	8.6	5.0	4.5	3.5
Slovakia	3.7	4.0	2.1	2.4

Budget Balance (%GDP)	2005	2006e	2007f	2008f
Czech Republic	-2.2	-3.4	-5.3	-3.8
Croatia	-4.2	-3.0	-3.0	-3.0
Hungary	-7.8	-9.8	-6.5	-5.0
Poland	-2.4	-1.9	-1.6	-1.2
Romania	-0.8	-1.5	-2.8	-2.7
Slovakia	-2.9	-2.4	-1.7	-1.7

Diaries

Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Jan-15	Industry output (Nov 06)	9.4% y/y	8.0% y/y
	Jan-15	PPI inflation (Dec 06)	2.5% y/y	2.5% y/y
	Jan-16	Current account (Nov 06)	CZK -11bn	CZK -14bn
	Jan-19	Retail sales (Nov 06)	5.4% y/y	5.5% y/y
Croatia	Jan-16	CPI	2.3%	
	Jan-19	Industrial production	5.5%	
Hungary	Jan-16	CPI inflation (Dec 06)	6.6% y/y	6.6% y/y
	Jan-09	Jan-Nov 06 Nominal wages	7.9% y/y	-
Poland	Jan-15	CPI inflation (Dec 06)	1.7% y/y	1.6% y/y
	Jan-16	Current account (Nov 06)	EUR -510mn	EUR -471mn
	Jan-19	PPI inflation (Dec 06)	3.1% y/y	2.9% y/y
	Jan-19	Industry output (Dec 06)	10.1% y/y	8.8% y/y
Romania	No data releases scheduled			
Slovakia	Jan-17	December EU-norm inflation	3.6% y/y	3.7% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Jan-18	Jan-19	2008-Jan-01	-	CZK 5bn	2.80%
Hungary		Jan-16	Jan-24	Apr-25-2007	-	HUF 40bn	7.90%
		Jan-18	Jan-24	June-12-2012	7.25%	HUF 45bn	7.45%
		Jan-18	Jan-24	Feb-24-2017	6.75%	HUF 40bn	7.00%
Poland		Jan-17	Jan-19	2012-Apr-25	4.75%	PLN 1.8-2.8bn	-
Romania		Jan-15	Jan-17	July-18-2007		RON 1bn	6.5%
Slovakia		No auction scheduled					

Major markets

Next ECB interest rate hike likely in March

The ECB Council left key interest rates unchanged at its January meeting. The text prepared for the press conference was very similar to the text released at the December press conference, which made it clear that, at present, there is no intention to raise interest rates in February. In response to a question, President Trichet indicated that a hike in March is probable. A lot of space was dedicated to monetary analysis. The latest rise of M3 to +9.3% y/y might be due to specific effects; therefore, not much significance was attached to this rise. However, the current liquidity supply is more than sufficient and this is viewed as an inflationary risk by the ECB Council.

An interest rate hike in March seems to be very likely now. What will happen afterwards still seems to be open. Should the money supply continue to expand at a rate of 8% to 9% and the economic situation continue to be as good as expected, then there will probably be another interest rate hike in 2Q. In any case, the ECB Council is no longer in such a hurry as it was in 2H06, but is waiting to see the further course of development. Therefore, the likelihood of a pause for the rest of the year has increased.

Next week's data should help to stabilize the longer-term yields. Consumer prices for Euroland should have stayed below 2% in December, as indicated by the flash estimate. Euroland industrial production growth should be increasing, but at a slower pace, due to the dampening effect from lower French industrial production. The ZEW expectation component should increase more strongly than expected, but this should have a limited effect on the bond market.

Good labor market data weighs on US bonds

Today's retail sales will be the next important US release. The risk for the market reaction is asymmetrical, in our view. A better then expected number would likely trigger further yield increases, while a lower number will barely counteract the brightened economic outlook after the good data from the labor market during the last week. This general tendency should persist during the next week. The best scenario for the bond market is unchanged yields. Wednesday will bring producer price inflation and the more important consumer prices on Thursday. The increase of oil prices in December should have definitely been felt, but we expect the core rate (consumer prices) to have remained within the narrow range of recent months. Housing starts (the same day) should also see some attention from the market. Finally, on Friday, the preliminary Univ. of Michigan Index for January will show how consumer sentiment developed during the first weeks of the year.

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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	3.50	5.25	3.76		5.36		4.05	4.74	1.29	
Mar-07	3.75	5.00	3.80	3.97	4.90	5.33	4.00	4.40	1.33	1.295
Jun-07	3.50	4.75	3.80	4.11	4.60	5.23	4.20	4.50	1.33	1.299
Sep-07	3.50	4.50	3.85	4.16	4.40	5.09	4.30	4.60	1.30	1.303
Dec-07	3.50	4.25	3.90	4.06	4.30	5.04	4.40	4.70	1.27	1.307

Croatia

3Q GDP: Solid 4.7% y/y growth in line with expectations

3Q GDP figures showed output growth of 4.7% y/y in real terms. The figure was broadly in line with market expectations (including ours), as the outcome was a minor 0.2pp above our estimate of 4.5%. Looking at the structure of growth, recent trends continued, while some minor surprises occurred. Domestic demand showed signs of recovery, as private consumption accelerated to 3.9% y/y (2Q: 2.1% y/y), which was expected on the basis of the monthly data. Fixed capital formation (supported by 20%+ credit growth rates) remained robust and recorded 9.3% y/y growth, indicating that the ongoing investment cycle is still not running out of steam. On the other hand, net exports had a negative effect on growth. As exports recorded sluggish 2.2% y/y real growth, imports increased by 5.5% y/y, due to acceleration of both consumption and investment activity. This contributed to a widening C/A deficit on an annual basis (see below). Finally, government consumption increased by 1.5% y/y, confirming a mild upward trend in recent quarters. The 3Q GDP figures present no major surprise and we continue to see the overall 2006 GDP figure at 4.6%.

3Q C/A surplus declined 2.7% y/y

The tourism-related C/A seasonal surplus in 3Q06 amounted to EUR 2,176mn, 2.7% below the 3Q05 figure. The goods account deficit reached EUR 2,520mn, up 15% y/y, implying a major contribution to the below-expectation performance. Merchandise exports rose by a solid 12.6% y/y in EUR terms (EUR 2,081mn), but imports increased even more, by 13.8% y/y (EUR 4,233mn). The account performance for services was sluggish, as the annual surplus increased by a minor 4%. Services exports rose by 3%, while imports declined by 3%. A small increase in the services surplus came as a negative surprise, since short-term tourism volume indicators pointed to a better performance than the actual financial outcome recorded in BoP. The income account showed some improvement in 3Q, as the deficit declined by 40% y/y (largely due to higher income inflows from abroad) to EUR 77mn. Finally, current transfers brought no surprise, as they remained virtually unchanged (0.3% y/y) at EUR 270mn. On the financing side, foreign direct investments were down 1.9% y/y. Still, in the first three quarters of 2006, FDI performance was rather robust, as FDI inflows in Croatia increased by 35% to EUR 1,755mn. Portfolio investment also showed a positive development (EUR 363mn). Other investment presented a negative balance of EUR 1,444mn, due chiefly to banks' preferences for repaying part of their expensive foreign liabilities and piling up foreign assets, which escalated in 3Q. Finally, the C/A underperformance in 3Q means that we will revise our 2006 C/A deficit forecast upwards from the current 7.1% of GDP. The revision will be around 1 pct point of GDP.

Bond and FX markets stable

The bond market has performed well, as yields on both kuna bonds with f/c clause and pure kuna bonds remained stable and spreads declined. Market turnovers also indicated solid activity. After the CNB intervened against the kuna at the year-end, the FX rate stabilized at 7.36-7.37 per euro. Thus, the current balance of supply and demand on the FX market implies little volatility, with very mild pressure on the depreciation side (usual seasonal factors). Hence, we do not expect significant FX rate movements in the coming weeks beyond very mild depreciation. As for the data releases, CPI figures are to be released next week and are expected to continue to show alleviated inflationary pressures and a y/y rate similar to those of the preceding months (around 2.5%).

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Czech Republic

Open trading idea - short CZGB

I have written several times about shorting CZGB as a negative convergence play. Putting my money where my mouth is, I have opened this position. My reasoning is as follows. First, I expect the fiscal deficit to increase to CZK 130bn this year (last year: CZK 97bn). Next, a CZK 43bn bond will mature. This implies gross issuance of CZK

160bn (incl. govt. agencies) in domestic bonds. At the same time, we expect CZK 30bn in Eurobonds (without an FX impact, as the conversion will be done off-market). The supply of domestic bonds will be up CZK 120bn (net issuance). Domestic demand for government bonds will be determined by the flow to deposits (building societies, pension funds, mutual funds, insurance companies and deposits). From this inflow, we have to subtract loans (building societies, mortgage, consumer and corporate loans) and bond emission to mortgage bonds. We expect the loans to have higher dynamics than deposits. This means lower domestic demand for bonds. Lower domestic demand and higher net issuance should increase the surplus of the government bond supply. The implication is clear, as the long-term yields are determined by the short-term rates, EU yields and the domestic premium. The difference between the CZ and EU curve slopes (10Y/CB rate) approximates this domestic premium. The higher net government bond issuance should increase this premium from 58bp to 73bp. This means a 10Y CZ/EU spread at 10bps. Second, the recent negative spread close to 20bps was driven by the December CZK appreciation. I expect the CZK to correct with the beginning of spring and stabilize close to 27.60. I estimate the year close at 27.3 EUR/CZK. The lower appreciation compared to the last two years is determined by the less-positive payment balance. From the technical point of view, the CZK should not appreciate.

Looking back

Next week will see the release of industry, PPI, C/A and retail figures. As my estimates are close to the market consensus, I do not see any space for a significant reaction. A brief look back at the CPI data released this week would be useful. CPI prices went up by 0.2% in December, accelerating the y/y inflation to 1.7%. This above-expectation figure was influenced by food prices. With the consumption acceleration (which is also visible in retail sales), demand inflation is germinating - in the last 12M, it has risen almost 1pp, to 1.8% y/y in December. For this year, I expect an acceleration of other foodstuff prices (due to the worse harvest) and demand inflation (consumption to grow by 5% this year). Thus, headline inflation should climb towards 3% y/y. In my view, it is more important that the price development confirms the assumption of accelerating inflation due to food prices and (particularly) higher domestic demand. For this reason, we expect the CNB to hike the rate to 3.00-3.25% this year.

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Poland

New central bank Governor Skrzypek cautious with his rhetoric so far

The Polish Parliament approved Slawomir Skrzypek as the central bank governor this week (by 239 votes to 202). The approval process nicely illustrates the coalition's poor level of unity, as the approval of Skrzypek did not come 'for free'. The ruling PiS party agreed to the requirement of a junior coalition party to guarantee PLN 500mn in wages for teachers and a post for the party at the state TV company. The new governor has been cautious with his rhetoric so far, failing to illuminate his views on topics crucial for the markets, such as monetary policy and euro adoption. He has only issued general statements, such as that he wants to safeguard the currency and foster economic growth, as long as it does not conflict with the goal of price stability. He did not give his opinion on the euro adoption strategy, saying only that there should not be a target date and that he needs 100 days to think about the pros and cons.

Markets to watch inflation and trade data next week

The release calendar is relatively interesting next week. The dynamics of both consumer and producer prices should nose up in December, due primarily to the effect of a lower comparison base; on a monthly basis, the prices should remain flat in the case of CPI and even fall in the case of PPI. We are only slightly greater pessimists than the market with our prediction for CPI inflation at 1.7% (vs. the consensus of 1.6%). The data could influence the short end of the curve, but only in the case of a surprise, given the greater sensitivity to negative (i.e. higher) numbers. January inflation (to be released next month) will draw greater attention, as it will reveal the extent to which retailers used the start of the year as an opportunity to raise prices. Apart from inflation indicators, November trade and current account data will also be published next week. They should only have an impact on the exchange rate in the case of a significant deviation from expectations. The zloty is now in a consolidation phase, but technicals suggest space for further losses in the next couple of days. The level around 3.91 is crucial and, if broken, space for a slide toward 3.98/4.00 EUR/PLN would open.

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Hungary

2006 ESA-based deficit likely at 9.8% of GDP

On Tuesday, the Finance Ministry reported a cash flow-based public sector deficit of HUF 332.8bn for December, which again proved to be somewhat lower than its preliminary forecast of HUF 340bn. The full 2006 CF-based deficit amounted to HUF 2,033.8bn, i.e. 8.7% of GDP (excluding local governments). The December CF-based deficit contained some one-off items. As was known earlier, the state budget took over the debt of the National Motorway Building Company (around HUF 292bn). Furthermore, the Hungarian Railway Company got an unexpected cash injection of HUF 24.4bn in the last days of 2006. This suggests that the ministry accounted for as many items as it could for 2006, which should make the 2007 figures even more impressive. Taking into account the deficit of local governments (around 0.7% of GDP) and the so-called ESA bridge (meaning the accounting differences between the ESA- and CF-based methods, around 0.4% of GDP), the 2006 ESA-based deficit should have reached 9.8% of GDP, a bit lower than the earlier forecast of 10.1%. The official ESA figures for 2006 will only be available this spring.

December CPI to be most influential figure next week

The December CPI figures are due on Tuesday. Nothing special is expected. Most of the inflationary effects from the budget measures (implemented in August and September) have already appeared in consumer prices in the previous months. Thus, the monthly price indexes should have been subdued in December, while the 12-month index could have accelerated a bit further to 6.6% (after 6.4% in November). Hence, the December index will mean a little pause, before another sharp CPI inflation acceleration in the first months of this year.

As for the capital markets, the forint has been following regional sentiment changes this week, and this will not change next week, either. The role of external influences is to remain crucial. In the second half of the week, investors' attention is expected to slowly turn toward the central bank's January rate setting meeting (scheduled for January 22). The above-mentioned December CPI data is not expected to support any change in the base rate.

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Slovakia

CB stepped up its tactics against koruna

After last week's refusal by the central bank to accept a portion of the bids in its regular repo tender failed to achieve the desired effect (i.e. the koruna did not weaken), the central bank stepped up its tactics and rejected an even greater volume in the repo tender this Tuesday. Hence, it left the market with excessive koruna liquidity and effectively lowered money market rates. While the exchange rate did not respond significantly on Tuesday, it weakened on Friday to 34.75 EUR/SKK (down 0.7% compared to Monday), closer to the level desired by the CB. Still, unless the koruna depreciates further, we expect the CB to continue with its repo under-acceptance. While the CB is likely to reject some of bids at the current levels, the bank might even reject all demand if the currency regains its previous strength. Our own expectation is a further weakening of the koruna to around 35.0 EUR/SKK by the end of January (and 36.0 EUR/SKK during the 2Q07 dividend season).

December inflation below forecast

Out of this week's data, inflation was the most watched by markets. The reported 4.2% y/y figure was slightly below our and the market's forecast of 4.3% (which was also the November level). Prices stayed flat m/m. In January, base effects, the strong koruna and the decline of some regulated prices should bring inflation to around 3%. (Although a significant portion of companies set new prices with the beginning of the new year, the overall impact on inflation should be more moderate compared to last year.) We expect inflation to decline to around 2.3% in summer. We see the release as neutral for monetary policy and expect stable rates for all or most of 2007.

Trade balance widened, but should improve in 2007

Other data releases included industrial production and the foreign trade balance. These continue to show the solid performance of export-oriented industries, although strong imports are preventing an improvement of the trade balance, which widened to 6.6% of GDP on a 12M basis (from 6.3% in October). We assume that the imports are related to investment goods and materials connected to the start of production at newly built car factories (or other bigger FDI plants). In that case, higher imports would not mean a risk to inflation, as the imports would not indicate higher consumer demand. In 2007, we expect significant narrowing of the trade balance (as compared to GDP, the deficit should decline to below 2%, from the current 6.6%), due to higher exports of cars and lower imports. Improvement of the foreign trade balance in 1H07 should be overshadowed by other factors, but it should help the koruna appreciation in 2H07.

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Appendix Charts

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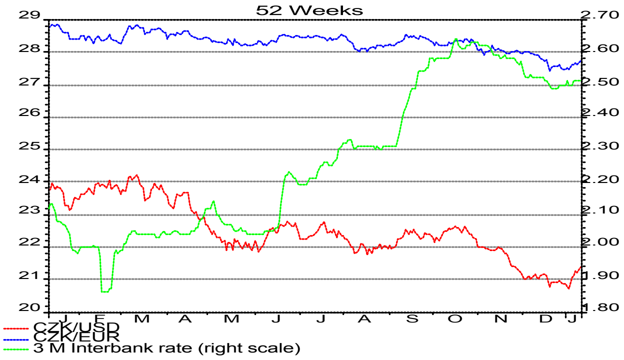
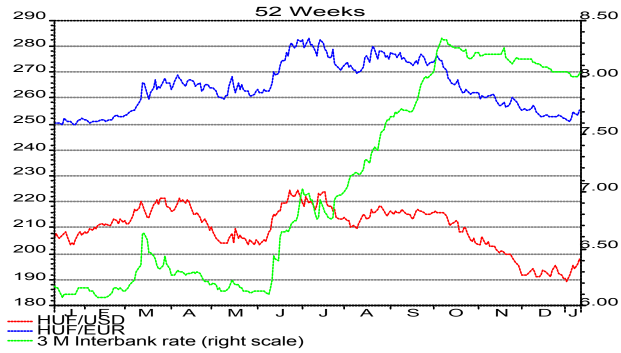
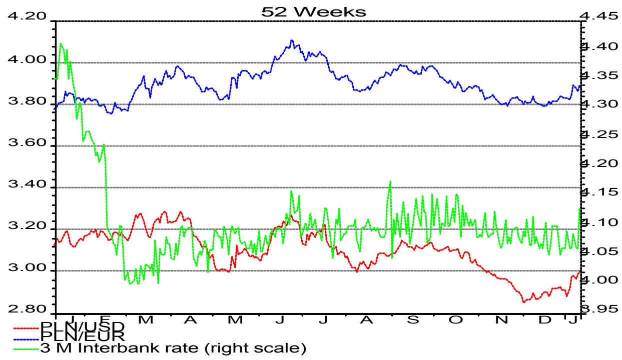
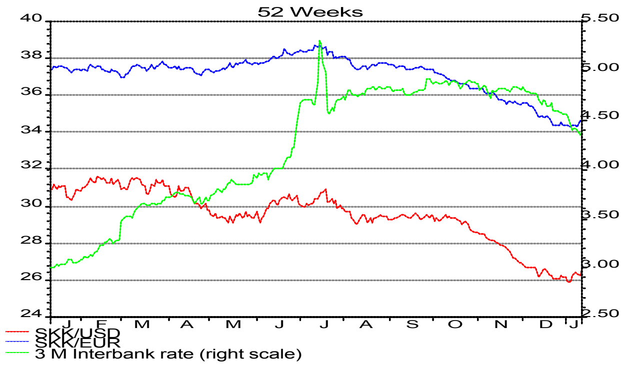
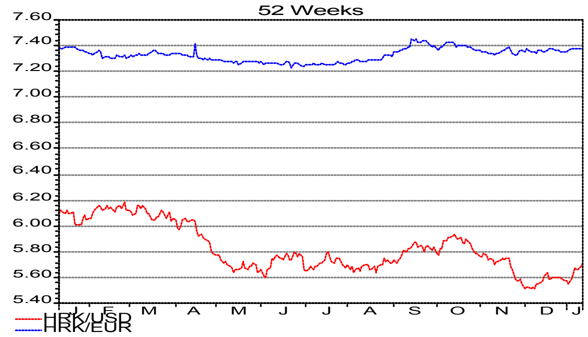
Exchange rates and interest rates (52 weeks)

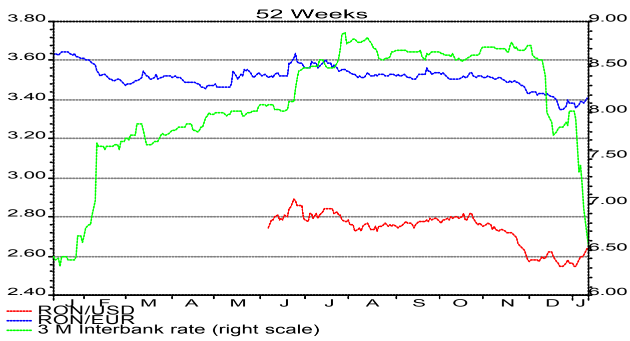








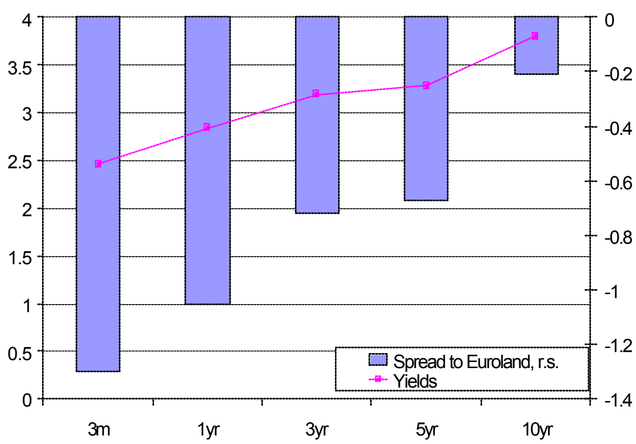




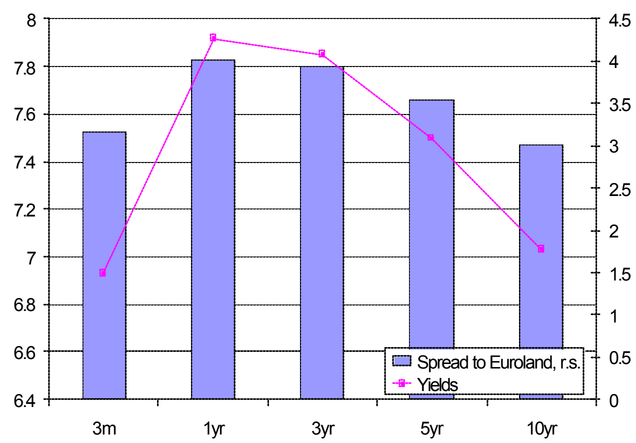
Charts are not updated due to technical problems. Source: Datastream

Benchmarks

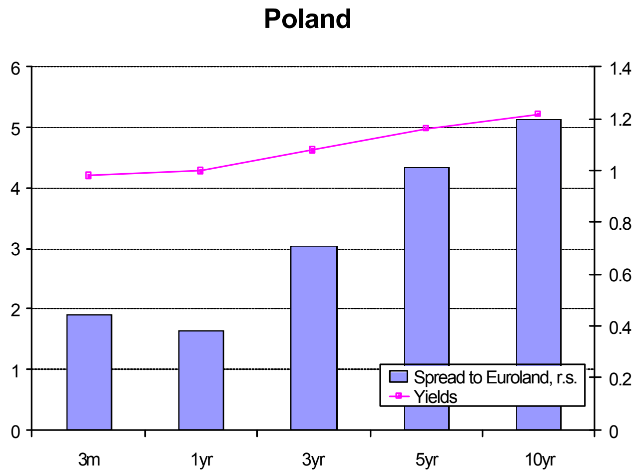
Czech Republic

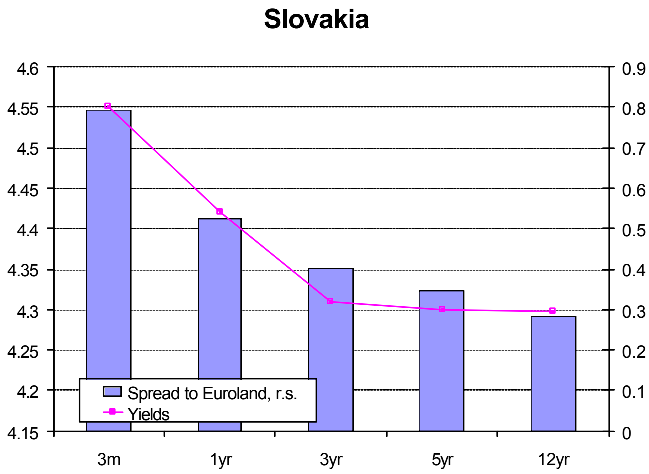


Hungary



Appendix Forwards





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