CEE Research

February 16, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** January CPI surprisingly low
- **Hungary:** Market could be in wait-and-see mood before February monetary meeting
- **Poland:** Big changes in interest rate expectations unlikely
- **Romania:** Central bank lowered monetary policy interest rate to 8%
- **Slovakia:** We anticipate SKK correction in coming months

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Overview

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Czech Republic:

- *January CPI surprisingly low*
- *Rent and cigarettes key items*
- *How long will doves prevail?*

Hungary:

- *CPI inflation rose 7.8% y/y in January 2007*
- *GDP rose 3.2% y/y in 4Q06*
- *Market could be in wait-and-see mood before February monetary meeting*

Poland:

- *Trade balance deficit expanded in January*
- *Strong wage growth may become concern*
- *Big changes in interest rate expectations unlikely*

Romania:

- *Central bank lowered monetary policy interest rate to 8%*
- *Trade deficit rose to EUR 11.8bn in 2006*
- *Current account deficit reached EUR 9.97bn in 2006*

Slovakia:

- *We anticipate SKK correction in coming months*
- *Economy grew by impressive 9.5% in 4Q06*

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Market review		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2007
Czech Republic	EUR/CZK	28.26	0.1%	-1.6%	-2.3%			
	3Y (yield bp)	3.08	-6	0	-13	-87	-73	-66
	10Y (yield bp)	3.72	-5	-8	1	-33	-25	-23
Croatia	EUR/HRK	7.36	0.3%	0.0%	-0.1%			
	3Y (yield bp)	3.76	-15	-26	-25	7	37	35
	10Y (yield bp)	4.59	-16	-10	-13	63	70	86
Hungary	EUR/HUF	253.01	0.1%	0.2%	-0.6%			
	3Y (yield bp)	7.72	0	-4	17	377	382	368
	10Y (yield bp)	6.95	-5	-7	102	291	298	276
Poland	EUR/PLN	3.91	-0.5%	-0.4%	-1.9%			
	3Y (yield bp)	4.61	-3	4	-4	67	64	78
	10Y (yield bp)	5.17	-4	-7	-1	112	116	124
Romania	EUR/RON	3.38	0.0%	0.5%	0.2%			
Slovakia	EUR/SKK	34.37	0.7%	1.7%	0.3%			
	3Y (yield bp)	4.32	0	-1	-6	37	39	50
	12Y (yield bp)	4.40	0	6	9	36	29	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. (%)
9	short 10Y CZGB long 10Y GDBR	12/01/07	CZGB 3,8 04/15 DBR 3,75 01/17, EUR/CZK	99.63 97.75	100.29 97.67	-0.66 2.01	1.4	14.3	97.04 96.48	0.82	2.0

Rationale at inception

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
8	long HUGB 5y	13/10/2006	29/01/2006	5.70%

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	28.3	28.3	7.36	7.36	253	253	3.91	3.91	3.38	3.38	34.3	34.3	2.50	3.50	8.00	4.00	8.00	4.75
Mar-07	27.9	28.3	7.35	7.35	253	254	3.75	3.92	3.41	3.39	35.2	34.4	2.50	3.50	8.00	4.00	8.00	4.75
Jun-07	27.7	28.2	7.25	7.25	254	256	3.80	3.92	3.40	3.42	36.0	34.4	2.50	3.50	8.00	4.25	7.75	4.75
Sep-07	27.6	28.1	7.40	7.40	256	259	3.80	3.92	3.39	3.46	35.2	34.4	2.75	3.50	7.50	4.25	7.75	4.75
Dec-07	27.2	28.0	7.40	7.40	255	261	3.75	3.93	3.40	3.49	34.5	34.4	3.00	3.50	6.75	4.25	7.50	4.25

	3m Money Market Rate										10y Govt. Yield				
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK
Spot	2.58	2.58	8.16	8.16	4.19	4.19	7.02	7.02	4.72	4.72	3.72	4.59	7.00	5.18	4.40
Mar-07	2.55	2.62	8.10	8.16	4.30	4.22	7.50	7.20	4.60	4.45	4.15	4.70	6.80	5.35	4.50
Jun-07	2.63	2.69	7.80	8.10	4.35	4.34	8.00	7.00	4.55	4.35	4.20	4.70	6.50	5.25	4.55
Sep-07	2.88	2.80	7.50	7.90	4.35	4.51	8.00	7.20	4.40	4.19	4.25	4.85	6.30	5.10	4.55
Dec-07	3.13	2.93	6.90	7.62	4.55	4.53	8.00	7.30	4.20	4.21	4.30	4.95	6.10	4.90	4.60

Long-term forecasts

GDP growth (%)	2005	2006e	2007f	2008f
Czech Republic	6.1	5.9	4.2	4.5
Croatia	4.3	4.6	4.2	4.6
Hungary	4.2	3.9	2.3	3.2
Poland	3.5	5.6	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	-4.1	-4.1
Croatia	-6.4	-7.1	-7.9	-7.5
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	-3.7	-2.2

CPI (%), eoy	2005	2006e	2007f	2008f
Czech Republic	2.2	1.7	3.3	3.4
Croatia	3.6	2.0	3.0	3.0
Hungary	3.3	6.5	5.2	3.5
Poland	0.7	1.4	2.3	2.3
Romania	8.6	5.0	4.5	3.5
Slovakia	3.7	4.2	2.1	2.4

Budget Balance (%GDP)	2005	2006e	2007f	2008f
Czech Republic	-2.2	-3.3	-4.1	-3.8
Croatia	-4.2	-3.0	-2.8	-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

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Feb-21	Jan PPI inflation	2.3% y/y	2.3% y/y
Croatia		Unemployment rate	17.3%	
		CPI Inflation	2.5% y/y	
Hungary	Feb-20	Jan-Dec 2006 Nominal wages	7.9% y/y	-
	Feb-23	Dec 2006 Retail sales	2% y/y	-
Poland	Feb-19	Jan Industry output	11.8% y/y	11.6% y/y
	Feb-19	Jan PPI inflation	3.0% y/y	2.9% y/y
Romania	No data releases scheduled			
Slovakia	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Auction Diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Feb-21	Feb-26	2010-Feb-18	2.55%	CZK 6bn	3.25%
Hungary		Feb-20	Feb-28	May-30-2007	-	HUF 25bn	8.05%
		Feb-21	Feb-28	Aug-29-2007	-	HUF 30bn	8.05%
		Feb-22	Feb-28	Jan-16-2008	-	HUF 30bn	8.10%
Poland		Feb-19	Feb-21	2007-Feb		PLN 0.9-1.1bn	4.4%
		Feb 21	Feb-23	2012-Apr		PLN 1-2bn	4.9%
Slovakia		Feb-19	Jan-21	May-10-26	4.5	-	4.35-4.40%

Major Markets

Major markets

Ifo Index expected to decline

Euro bond markets are being supported by the positive tone of the US Treasury market, but the hawkish stance of the ECB Council will limit the performance potential. Therefore, we expect the market to stay in the sideways range of 4% to 4.12% for the coming weeks. Next week's data calendar is relatively light, with the release of the Ifo Index the highlight on Friday. We expect the assessment of the current situation index to decline further, after it turned downward in January. The expectation index should stay more or less unchanged, with a risk of a slightly lower reading, as expectations for the euro and oil prices have turned north once again. The second estimates for French and German 4Q GDP will be released, showing the composition of growth in the two countries. In France, private consumption should have remained the growth driver, while for Germany we expect net exports and investment to show the highest dynamic.

US bond market should hold on to recent gains

This week's data was supportive overall for the bond market. Retail sales and industrial production figures came in below expectations. The highlight was of course the testimony of Fed Chairman Bernanke to the US Congress. Bernanke confirmed the current course of monetary policy, disappointing speculation on a more hawkish wording after the strong labor data at the beginning of the month. The already well known warning of inflationary risks was repeated, but the Fed's core scenario remains a gradual ebbing of inflation. Speaking of which, the consumer price inflation on Wednesday will be the only major release next week. Lower gasoline prices should have dampened the overall rate; for the core rate, the market expects the "usual" 0.2% m/m. Deviations from the market's estimates could of course trigger some reaction, although, in our view, sideways-moving markets are the most likely scenario. Currency markets could be affected by the monetary policy meeting of the Bank of Japan on Wednesday. Recent data make it a close call on whether the target rate will be hiked, but we favor the March meeting for the next interest rate move.

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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	3.83		5.36		4.04	4.70	1.31	
Mar-07	3.75	5.25	3.85	3.93	5.20	5.36	4.00	4.80	1.30	1.315
Jun-07	3.75	5.00	3.85	4.08	4.90	5.32	4.20	4.50	1.33	1.320
Sep-07	3.75	4.75	3.90	4.16	4.60	5.23	4.30	4.60	1.33	1.324
Dec-07	3.75	4.50	3.95	4.12	4.40	5.08	4.40	4.70	1.30	1.327

Czech Republic

January CPI surprisingly low

January CPI stood out during the otherwise uneventful week, coming in at 1.3% y/y and thus surprising analysts (1.9%) and the central bank alike. This figure was important for two reasons. The first one was the fact that this was the first month for which CPI was calculated using the revised consumer basket that the Czech Statistical Office announced last week. In addition, January saw a rise in a lot of regulated prices, including energy, rent, water supply, sewage fees and cigarettes. However, these items added only 0.6pp to the overall inflation, and it was the lower than anticipated growth here that caused the overall CPI to undershoot the expectations.

Rent and cigarettes key items

A closer inspection of the itemized data reveals that the main "culprits" behind the lower than expected reading were rent and cigarettes. As for the former, the deregulation of rent appears to be taking longer to feed into inflation, due to both political and time constraints (municipalities, as the major owners of regulated housing, did not want to anger voters ahead of last year's municipal elections). As for the latter, the inclusion of cheaper cigarettes and the increase of their weight in the basket dragged the growth of this component lower, thus lowering the overall CPI.

How long will doves prevail?

The impact of this data can be summarized as follows. As this reading is below the tolerance band of ±1pp around the central bank's 3% target, the previous remarks of some members of the rate-setting body (regarding "them being able to imagine rates' movements in both directions in the foreseeable future") are probably off the table for quite some time to come. The short end of the curve should reflect this development and decline accordingly. What remains to be seen is whether the "dovish-ness" of the central bank will not last longer than previously anticipated. Our main scenario, however, still rests on the central bank remaining concerned about longer-term price development (where the risks point upwards) and thus includes two hikes this year - one in July, the other in October.

As for next week, the dearth of data in the Czech Republic (only PPI is scheduled for release) will send the koruna looking to the USD for impulses. This week, Bernanke's comments and negative surprises sent the dollar lower and created a positive EM sentiment that should help the koruna next week.

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Hungary

CPI inflation rose 7.8% y/y in January 2007

Compared to December, consumer prices rose 1.2% in January, while the 12-month inflation rate accelerated to 7.8% (after the 6.5% published for December 2006). The y/y figure was higher than both my expectation of 7.6% and the market consensus of 7.5%. However, taking the greater than usual uncertainties around the assessment into consideration, the actual figure did not come as a great surprise. The main driver of the January inflation was administrative price hikes (for details see, our short note published Tuesday), for which the CSO accounted more than expected in the January figure. Apart from these effects, food prices caused a negative surprise, rising above the average (+1.4% m/m in January). Excluding seasonal food prices, the monthly increase was 0.7%. Prices of clothes dropped 3.7% m/m, due to seasonal sales. However, it is favorable that prices of durable goods decreased by 0.3% m/m, most likely due to the stronger forint. The most promising part of the figures was that January core inflation rose only 0.1% m/m, which does not suggest overly-strong price-increasing pressure in the economy from market-led factors. It is true that the 12-month CPI core rate accelerated further to 5.6% (from 5% y/y in December 2006), but this was largely due to the very low base figures. (In January 2006, the 12-month core rate stood at just 0.5%). Summarizing the above, I think that the sharp acceleration of the headline inflation basically came from one-off administrative measures, while the core index has thus far not shown a strong second-round inflation effect. Hence, these factors will not force the central bank to act immediately by hiking the base rate in February.

GDP rose 3.2% y/y in 4Q06

According to the CSO's flash estimate, GDP growth slowed down to 3.2% y/y in the fourth quarter of last year (from 3.8% in the third quarter). Calendar-adjusted data showed 3.4% y/y growth. Compared to the previous quarter, GDP rose 0.8%. The breakdown of 4Q GDP will be available on March 9, but it seems certain that the main driver of the economic growth was strong exports, while investments and household consumption showed weak performance.

Market could be in wait-and-see mood before February monetary meeting

This week's macro figures have had a limited market impact, although the CPI figures somewhat mitigated rate hike fears. However, Bernanke's comments on the US economy's prospects and US macro data releases have caused some movements in the forint, again proving that the exchange rate is basically influenced by the international market environment.

As for next week, the market is likely to keep an eye on the December 2006 nominal wage figures (published on Tuesday), although the January numbers (due in March) could be more informative. In addition, the PM said this week that the he would nominate a new central bank governor within a week's time. This is likely to be the most decisive event next week. In the second half of the week, the central bank's rate setting meeting and the Quarterly Inflation Report release (both scheduled for February 26) will gain increasing attention. We think that the structure of the January inflation and the likely reduction of the bank's inflation forecast for 2008 support a "hold" decision at the February meeting.

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Poland

Trade balance deficit expanded in January

January's current account deficit rose to EUR 915mn (expected: EUR -834mn) and the trade balance deficit rose to EUR 1,080mn (expected: EUR -405mn). Exports declined from EUR 9,227mn in November to EUR 7,285mn in December (expected: EUR 8,275mn). Imports were a little bit weaker than expected, reaching EUR 8,365mn. Imports were most likely pushed lower by the decline of the oil price. One month does not make a trend, so the market will get significantly worried only in the case of repetition of much higher than expected deficits.

Strong wage growth may become concern

In further developments, January CPI came in at +1.7% y/y (+0.5% m/m), compared to growth of 1.4% y/y (-0.2% m/m) the month before, thus lining up exactly with analysts' expectations. In addition, corporate wages rose 7.8% y/y for the same time period, exceeding the market forecast by 1.2pp, even though the wages exhibited the (usual seasonal) m/m drop of 12.0%. None of the data changes the outlook for the near-term inflation path in any significant way, but it appears that the relatively strong pace of wages could - if persistent - eventually become a concern for (at least) some of the MPC members. This was basically borne out by the remarks of MPC member Jan Czekaj in an interview Thursday, in which he reiterated the need to remain on watch for signs of possible labor market tightening brought about by the rapid GDP growth and falling unemployment. This expansion - if prolonged - could eventually translate into wage rises and demand pressures.

Big changes in interest rate expectations unlikely

As for next week, industrial sales are expected to accelerate to 11.6% y/y, which could somewhat revive rate hike expectations and support the zloty. Likewise, a lower unemployment rate or higher retail sales could spark temporary strengthening of the zloty and weakening of bonds. PPI should provoke a reaction only in the (unlikely) case of a much higher than expected reading. We do not expect any dramatic changes in the expectations on the future path of interest rates. Overall, the impact of macro releases should again be rather limited, similarly to last weeks' reactions. The zloty also looks relatively immune to political developments, as manifested in last week's Sikorsky and Dorn resignations. It will be the major markets and regional sentiment that should - for the time being - continue to exert the main influences over the zloty.

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Romania

Central bank lowered monetary policy interest rate to 8%

The NBR Board reviewed the developments in the main macroeconomic indicators for both domestic and international financial markets, as well as their prospects in the context of Romania's integration into the European Union. The statistical data confirms the continuation of disinflation and the attainment of the NBR's 2006 objective, with y/y inflation falling to 4.87% in December, below the 5.0% target. This achievement was the result of restrictive monetary and fiscal policies, combined with volatile food price deflation, a slowdown in the administered price dynamics and appreciation of the leu. The most recent macroeconomic indicators show persistently high dynamics of economic growth and productivity, underpinned by investment and consumption expansion, the latter also triggering a widening of the current account deficit. Meanwhile, the increase in the real monetary policy rate spread and the faster than anticipated appreciation of the leu (as a result of stronger capital inflows amid favorable investor sentiment regarding emerging markets, as well as in the context of Romania becoming an EU member state) have led to tighter overall monetary conditions. Developments in foreign exchange and money markets in recent months have highlighted liquidity and interest rate levels, triggering a faster appreciation of the domestic currency, which contributes significantly to the slowdown in aggregate price growth. Money market rates have constantly been below the monetary policy rate so far, which calls for the adoption of measures to enhance the signaling role of the latter.

Based on all of the above, the NBR decided to adjust its broad monetary conditions by lowering the monetary policy rate to 8.0% per annum (from 8.75%). This is to be accomplished by pursuing adequate control of liquidity via open-market operations in line with financial market conditions and by leaving unchanged the minimum reserve requirement ratios. Such a resetting of the level of monetary policy instruments is consistent with the aim to attain medium-term inflation targets in a sustainable manner and the need to ensure financial stability. Even though the baseline scenario of the current projection shows a relative improvement of the medium-term inflation outlook, the risks associated with an increase in wages unsupported by sufficient progress in productivity and a possible easing of fiscal policy require the maintenance of a prudent monetary policy approach.

Trade deficit rose to EUR 11.8bn in 2006

The trade deficit accelerated in FY06 to an annual 51%, up almost 71% compared to December 2005. Exports were 7.6% higher than in December 2005, but almost 21% lower compared to November 2006. The aggregated value of exports in FY06 stood at EUR 25.9bn (+16.2% y/y). The EU accounted for 67.7% of total Romanian exports, 16.3% higher than in 2005. Imports (FOB) were 0.5% lower than in November and 30.7% higher than in December 2005. The aggregated value of imports in 2006 was EUR 37.6bn, 25.9% higher y/y. Imports from the EU during 1.1-31.12.2006 accounted for 62.6% of the total. Following the decline in inward processing trade in 2006, imports of clothing, knitted or crocheted materials and textiles dropped. Hence, Italy lost first place in terms of imports in favor of Germany.

Current account deficit reached EUR 9.97bn in 2006

The current account deficit for 2006 amounted to EUR 9.97bn, up 44.8% y/y. This was due mainly to the wider trade deficit of EUR 11.8bn (FOB prices), which was up 50.6% y/y, with imports rising faster than exports (+25.1% and +16.2%, respectively). The current account deficit was 91% covered by inflows from foreign direct investment worth EUR 9.1bn in 2006 (compared with EUR 5.2bn in 2005). As of year-end 2006, import cover stood at 6.3 months. For this year, we expect a current account deficit of almost 10% of GDP.

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Slovakia

We anticipate SKK correction in coming months

Next week will be without any local data for Slovakia. The markets will therefore likely take direction from the region and major markets. The central bank returned to full acceptance of bids in the 2W repo tender this week, which, along with the release of higher than expected GDP growth figures, led the koruna to six-week highs of 34.25 EUR/SKK (1% stronger than Friday's closing level). The market might test new limits of the central bank's tolerance in the near term. We would expect direct interventions on the FX market if the koruna gets near or below 34.0 EUR/SKK. Despite the possibility of near-term koruna strengthening, we still see a correction to above 35.0 EUR/SKK as likely in the weeks ahead. Therefore, we maintain our call of a weaker koruna and stable rates in 1H07.

Economy grew by impressive 9.5% in 4Q06

Looking back, the Statistical Office released a flash 4Q GDP growth this week. The Slovak economy kept up its rapid pace of growth in the final quarter of 2006, reaching 9.5% y/y, close to the 9.8% seen in the previous quarter. This was faster than expected (market consensus: 8.2%, our estimate: 8.0%). The detailed structure will be released only on March 6, but the Statistical Office indicated that the growth was supported by both domestic and foreign demand, which matches our expectations. We think that household consumption growth did not accelerate from the previous quarter (we expect growth of 6-6.5% y/y), as retail sales actually slowed down in the final quarter. The surprise in comparison with our earlier expectations might have come from higher fixed investments and a greater contribution from net exports. The full-year GDP growth reached 8.2% in 2006. We are sticking to our previous estimate of 2007 growth at 8.2%. Regarding monetary policy, we think that the released figure is rather neutral, as it approached the central bank's projection; at the same time, the strong growth is seen as non-inflationary (please note that the CB sees only a small positive output gap at present). However, we think that the strong growth remains one of the reasons why the central bank will not hurry to decrease policy interest rates.

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Appendix Charts

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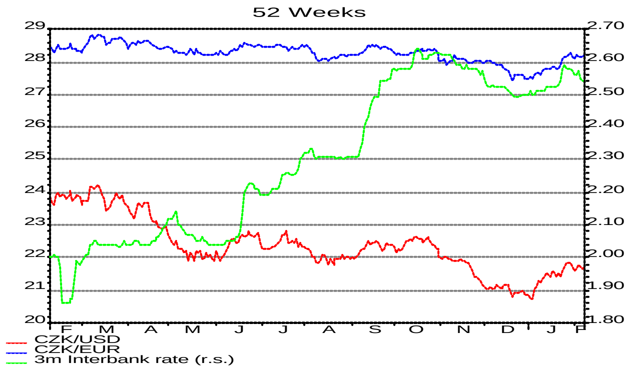
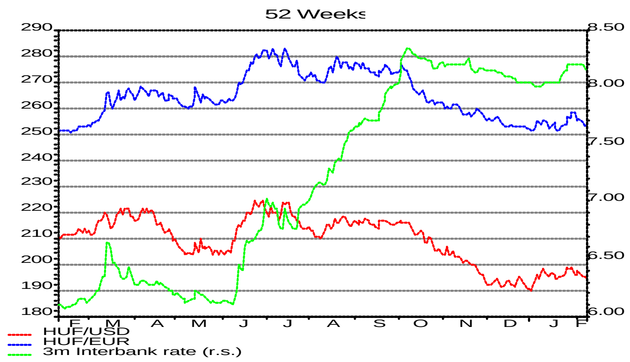
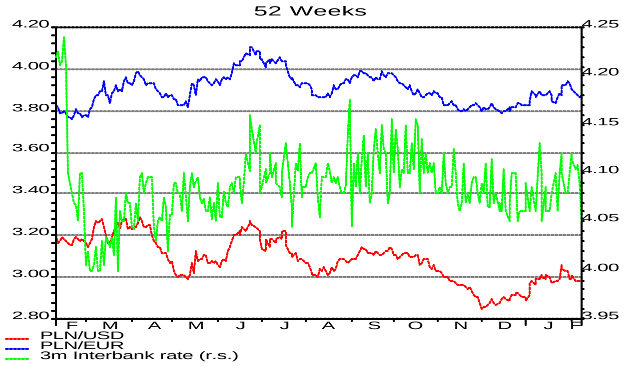
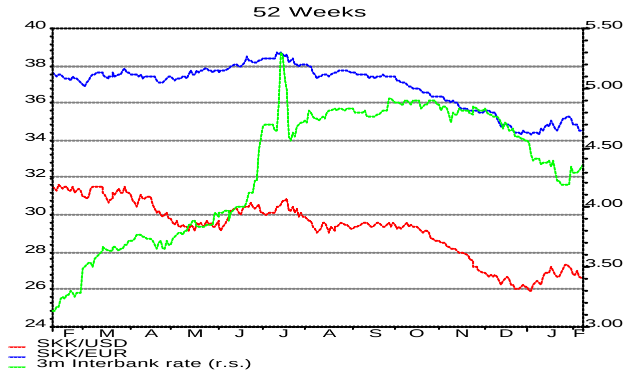
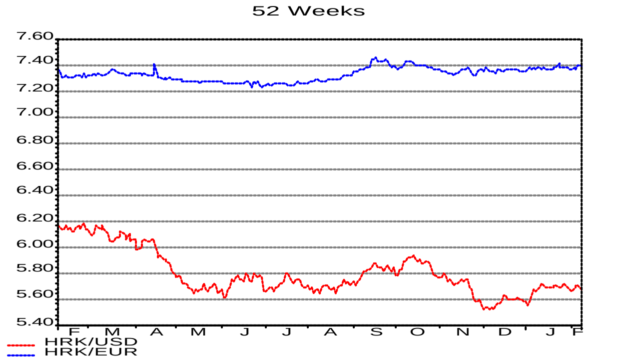
Exchange rates and interest rates (52 weeks)

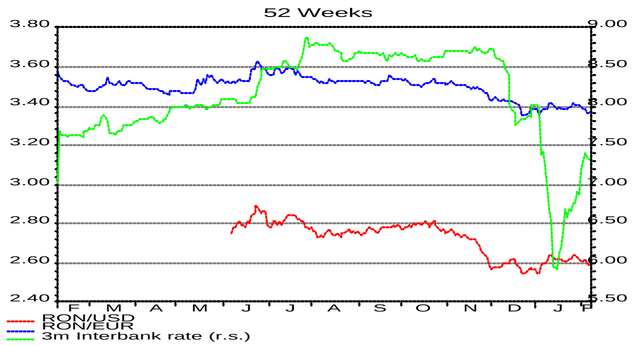








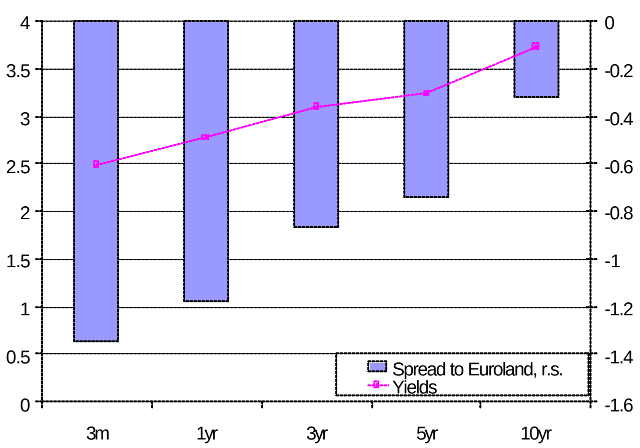




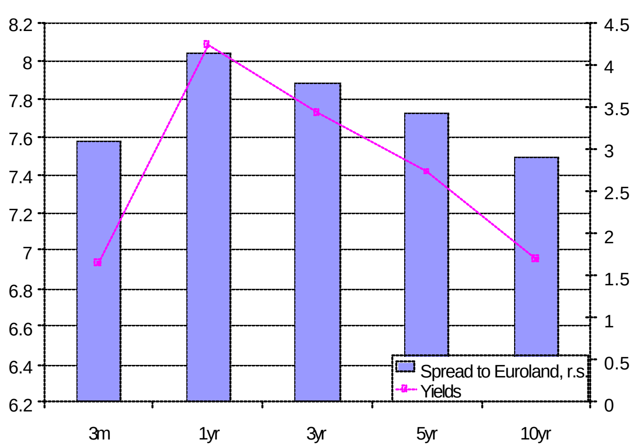
Charts are not updated due to technical problems. Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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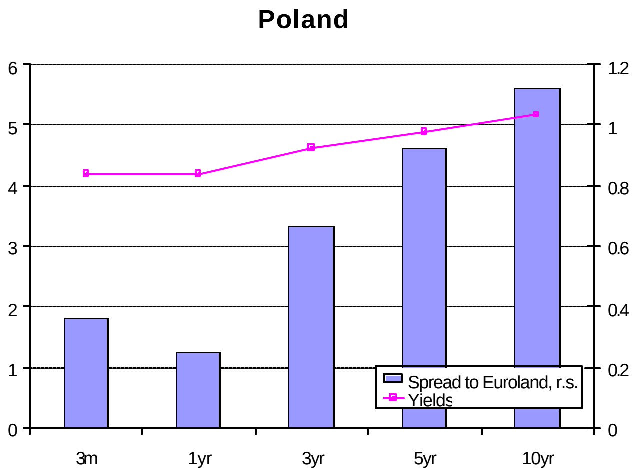

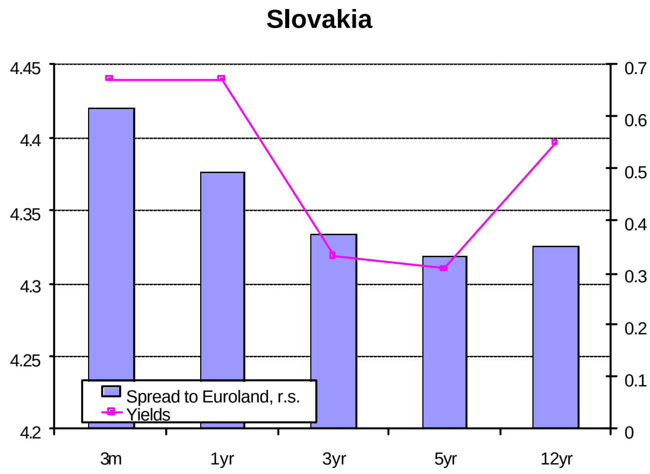

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