CEE Research

June 29, 2007

# Fixed Income and Foreign Exchange

# CEE Insights

- **Croatia:** GDP - Robust 7% y/y growth in 1Q
- **Czech Republic:** CZK in summer tunnel
- **Hungary:** NBH cut base rate by 25bp to 7.75%
- **Poland:** CB surprised with rate hike
- **Romania:** Interest rates still high after central bank repo transaction
- **Slovakia:** ECB - Sustainability of inflation will be crucial to euro

ERSTE BANK

# Overview

http://global.treasury.erstebank.com

## Croatia:

- GDP: Robust 7% y/y growth in 1Q
- Upsurge in MM rates
- Exchange rate appreciating towards 7.30

## Czech Republic:

- CZK in summer tunnel
- Does CZK offer higher upside potential?
- CZK rates kept on hold

## Hungary:

- NBH cut base rate by 25bp to 7.75%
- Hungary posted C/A deficit of EUR 1.102bn for 1Q07
- Forint again firm

## Poland:

- CB surprised with rate hike
- Domestic demand growing nicely
- PLN reaction to interest rate hike muted

## Romania:

- Interest rates still high after central bank repo transaction
- Ministry of Finance and Economy scraps 1-year T-bill auction
- Ministry of Finance and Economy to issue 3Y and 10Y bonds in 3Q

## Slovakia:

- Central bank kept rates on hold, as expected
- ECB: Sustainability of inflation will be crucial to euro
- Upcoming months should bring appreciation of koruna

Rainer Singer
(Chief Fixed Income Analyst CEE)
rainer.singer@erstebank.at

| Thursday's close | | Current | w/w | m/m | ytd | Spreads vs. Euroland | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | current | - 1m | 02/01/2007 |
| Czech Republic | EUR/CZK | 28.69 | -0.2% | -1.2% | -3.7% | | | |
| | 3Y (yield bp) | 3.99 | 9 | 0 | 78 | -50 | -77 | -66 |
| | 10Y (yield bp) | 4.69 | 3 | 42 | 98 | 13 | -13 | -23 |
| Croatia | EUR/HRK | 7.30 | 0.3% | 0.0% | 0.7% | | | |
| | 3Y (yield bp) | 4.23 | 8 | 22 | -31 | -31 | -21 | 66 |
| | 10Y (yield bp) | 5.25 | 12 | 28 | n/a | 60 | 71 | n/a |
| Hungary | EUR/HUF | 245.03 | 1.5% | 2.4% | 2.6% | | | |
| | 3Y (yield bp) | 6.89 | -15 | -10 | -66 | 240 | 262 | 368 |
| | 10Y (yield bp) | 6.63 | -13 | 7 | 19 | 206 | 216 | 276 |
| Poland | EUR/PLN | 3.76 | 0.7% | 1.7% | 1.8% | | | |
| | 3Y (yield bp) | 5.29 | 2 | 33 | 64 | 80 | 58 | 78 |
| | 10Y (yield bp) | 5.64 | -2 | 7 | 47 | 108 | 94 | 124 |
| Romania | EUR/RON | 3.16 | 1.2% | 3.5% | 7.1% | | | |
| Slovakia | EUR/SKK | 33.77 | 0.1% | 0.9% | 2.1% | | | |
| | 3Y (yield bp) | 4.54 | 7 | 27 | 16 | 4 | -9 | 50 |
| | 12Y (yield bp) | 4.87 | -1 | 28 | 56 | 33 | 20 | 38 |

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

# Trading Ideas

*http://global.treasury.erstebank.com*

## Positions

| Position # | 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 inc. carry (%) | Target P/L p.a. (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| 12 short EUR/SKK | 04/06/07 | 6m Bribid/ 6m Euribor<br>EUR/SKK | 3,9/ 4,28%<br>33.92 | 33.66 | 0.77% | 0.7% | 10.9% | 32.8 | 3.2% | 6.4% |
| 13 short EUR/CZK | 07/06/07 | 12m Pribid/ 12m Euribor<br>EUR/CZK | 3,21/4,47%<br>28.39 | 28.71 | -1.10% | -1.2% | -19.8% | 26.8 | 4.7% | 4.7% |

## Rationale at inception

**12)** The Slovak koruna might soon become an attractive buy. While we do not rule out short-term weakening, we see these eventual dips into the 34.0-34.2 EUR/SKK range as a good opportunity to buy the Slovak currency, as we expect it to strengthen in the euro run-up. We advise profit taking at 32.8 EUR/SKK, as the previous ERM-2 band at 32.69 EUR/SKK could be defended by the central bank. The expected time horizon is six months.

**13)** EUR/CZK is currently by roughly 0.30 CZK weaker that we estimate its fundamental level should be. Even though we expect milder appreciation this year than what we have seen over previous years, we still see Koruna strengthening owing to the convergence of Czech economy and real and monetary flows. Our prognosis for July 2008 sees CZK at 26.80 and hence we recommend entering long positions in CZK against EUR.

## 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% |
| 9 | short CZGB/ long GDBR | 09/01/2007 | 27/02/2007 | 1.80% |
| 10 | long CZK/EUR | 27/02/2007 | 19/03/2007 | 2.30% |
| 11 | short CZGB/ long PLGB | 07/03/2007 | 10/05/2007 | 5.5% |

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

# Forecasts

*http://global.treasury.erstebank.com*

## 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** | 28.7 | | 7.30 | | 246 | | 3.76 | | 3.17 | | 33.8 | | 2.75 | 3.50 | 7.75 | 4.50 | 7.00 | 4.25 |
| **Sep-07** | 28.2 | 28.7 | 7.40 | 7.40 | 251 | 248 | 3.80 | 3.77 | 3.14 | 3.19 | 33.1 | 33.8 | 3.00 | 3.50 | 7.25 | 4.50 | 7.00 | 4.25 |
| **Dec-07** | 27.4 | 28.6 | 7.40 | 7.40 | 253 | 249 | 3.75 | 3.77 | 3.18 | 3.21 | 32.5 | 33.7 | 3.00 | 3.50 | 6.75 | 4.50 | 6.75 | 4.25 |
| **Mar-08** | 27.2 | 28.5 | 7.40 | 7.40 | 255 | 251 | 3.73 | 3.78 | 3.20 | 3.23 | 32.4 | 33.7 | 3.25 | 3.50 | 6.50 | 4.75 | 6.75 | 4.25 |
| **Jun-08** | 26.9 | 28.5 | 7.25 | 7.25 | 255 | 252 | 3.70 | 3.78 | 3.15 | 3.24 | 32.5 | 33.5 | 3.25 | 3.50 | 6.50 | 5.00 | 6.50 | 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** | 3.00 | | 7.67 | | 4.71 | | 7.26 | | 4.32 | | 4.52 | 5.42 | 6.65 | 5.64 | 4.84 |
| **Sep-07** | 3.05 | 3.46 | 7.30 | 7.16 | 4.60 | 5.05 | 6.85 | 6.93 | 4.30 | 4.50 | 4.50 | 5.00 | 6.40 | 5.25 | 4.70 |
| **Dec-07** | 3.13 | 3.77 | 6.80 | 6.76 | 4.85 | 5.30 | 6.55 | 6.76 | 4.30 | 4.55 | 4.60 | 5.10 | 6.10 | 5.20 | 4.70 |
| **Mar-08** | 3.30 | 3.97 | 6.50 | 6.49 | 5.05 | 5.49 | 6.45 | 6.74 | 4.30 | 4.59 | 4.70 | 5.00 | 6.00 | 5.30 | 4.80 |
| **Jun-08** | 3.38 | 3.98 | 6.40 | 6.47 | 5.15 | 5.44 | 6.35 | 6.39 | 4.30 | 4.64 | 4.70 | 4.90 | 5.90 | 5.40 | 4.80 |

## Long-term forecasts

| **GDP growth (%)** | **2005** | **2006** | **2007f** | **2008f** |
|---|---|---|---|---|
| Czech Republic | 6.5 | 6.4 | 5.6 | 3.9 |
| Croatia | 4.3 | 4.8 | 4.6 | 5.0 |
| Hungary | 4.2 | 3.9 | 2.5 | 3.2 |
| Poland | 3.6 | 6.1 | 6.2 | 5.6 |
| Romania | 4.4 | 7.7 | 6.5 | 6.3 |
| Slovakia | 6.0 | 8.3 | 8.9 | 7.1 |

| **CPI (%), eoy** | **2005** | **2006** | **2007f** | **2008f** |
|---|---|---|---|---|
| Czech Republic | 2.2 | 1.7 | 3.7 | 4.5 |
| Croatia | 3.6 | 2.0 | 3.0 | 3.0 |
| Hungary | 3.3 | 6.5 | 5.2 | 3.4 |
| Poland | 0.7 | 1.4 | 2.5 | 2.6 |
| Romania | 8.6 | 4.9 | 3.7 | 4.2 |
| Slovakia | 3.7 | 4.2 | 2.8 | 3.3 |

| **C/A (%GDP)** | **2005** | **2006** | **2007f** | **2008f** |
|---|---|---|---|---|
| Czech Republic | -2.5 | -4.0 | -3.3 | -2.6 |
| Croatia | -6.4 | -7.6 | -8.6 | -9.4 |
| Hungary | -6.9 | -5.8 | -4.5 | -4.1 |
| Poland | -1.7 | -2.3 | -2.6 | -3.0 |
| Romania | -8.7 | -10.3 | -11.4 | -11.4 |
| Slovakia | -8.5 | -8.4 | -3.6 | -2.4 |

| **Budget Balance (%GDP)** | **2005** | **2006** | **2007f** | **2008f** |
|---|---|---|---|---|
| Czech Republic | -2.2 | -3.3 | -4.0 | -3.3 |
| Croatia | -4.2 | -3.0 | -2.8 | -3.0 |
| Hungary | -7.8 | -9.2 | -6.5 | -5.0 |
| Poland | -4.3 | -3.9 | -3.4 | -3.4 |
| Romania | -0.8 | -1.6 | -2.8 | -2.7 |
| Slovakia | -2.2 | -2.3 | -1.7 | -1.7 |

# Diaries

*http://global.treasury.erstebank.com*

## Looking ahead

| Country | Date | Release/event/figures | Our expectation | Consensus* |
|---|---|---|---|---|
| **Czech Republic** | July-2 | Trade balance (04/2007) | CZK 4.8bn | |
| **Croatia** | 4-Jul | Retail trade | 6.0% y/y | |
| | 6-Jul | PPI | 2.7% y/y | |
| **Hungary** | July-06 | May Industrial output | 8.8% y/y | - |
| **Poland** | No data releases scheduled | | | |
| **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** | | July-03 | July-04 | 2007-Oct-3 | - | CZK 5bn | 3.00% |
| **Hungary** | | July-03 | July-11 | Oct-10-2007 | - | HUF 30bn | 7.55% |
| | | July-05 | July-11 | June-12-2012 | 7.25% | HUF 45bn | 6.80% |
| | | July-05 | July-11 | Feb-24-2017 | 6.75% | HUF 40bn | 6.65% |
| **Poland** | | July-04 | July-06 | July-25-2009 | 0.00% | 500-1500 mln PLN | |
| **Romania** | | 05-Jul-07 | 09-Jul-07 | N/A | N/A | 500,000,000 | - |
| **Slovakia** | | No auction scheduled | | | | | |

# Major Markets



## Major markets

***ECB rate decision most important event for Euroland***

The ECB rate decision will be next week's most watched event for Euroland. After the hike in June, it is close to certain that interest rates will remain on hold at the upcoming meeting, even given that the strong pace of M3 growth continued in May. However, at the following press conference, ECB President Trichet will leave the door wide open for a further interest rate hike. As this is already expected to come in September, only indications of an earlier hike should move the markets, which we see as unlikely. The other data for next week includes PMI indices, which should confirm the good status of the Euroland economy.

***Nothing new from Fed; important releases scheduled for next week***

The latest FOMC meeting brought hardly any news. Interest rates were left unchanged, as was the assessment of the risks for the future. The recent lower reading of core inflation was mentioned, but more data of this kind will be needed to reduce the committee's inflation concerns. For next week, important data is scheduled for release. On Monday, the ISM index will give indications on the current status of the US manufacturing sector. The previous number surprised on the upside, and the market expects an unchanged number. We think that the recent uptick of the ISM index is not an indication of an upswing of the economy, but is rather due to a successful inventory correction. It is difficult to judge if this has already come to an end. The ISM index for the non-manufacturing sector on Thursday should be of lesser importance. Finally, the most watched gauge of the US economy, the labor market report, is scheduled for Friday. As usual, the data will be decisive for shaping interest rate expectations. For non-farm payroll gains, the market expects a lower number than for the previous month; we think the drop could be even more pronounced than the markets estimate.

*Veronika Lammer, veronika.lammer@erstebank.at*
*Rainer Singer, rainer.singer@erstebank.at*

**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 | 5.25 | 4.17 | | 5.36 | | 4.55 | 5.09 | 1.350 | |
| **Sep-07** | 4.00 | 5.00 | 4.35 | 4.39 | 4.90 | 5.33 | 4.50 | 4.80 | 1.33 | 1.354 |
| **Dec-07** | 4.25 | 4.75 | 4.35 | 4.56 | 4.60 | 5.28 | 4.60 | 4.70 | 1.33 | 1.357 |
| **Mar-08** | 4.25 | 4.50 | 4.30 | 4.66 | 4.30 | 5.22 | 4.70 | 4.70 | 1.30 | 1.360 |
| **Jun-08** | 4.25 | 4.25 | 4.30 | 4.64 | 4.30 | 5.31 | 4.70 | 4.70 | 1.30 | 1.362 |

## Croatia

***GDP: Robust 7% y/y growth in 1Q***

1Q GDP showed robust 7.0% y/y growth in real terms, thus considerably exceeding our expectations. As expected, domestic demand was the main driver behind the highest growth rate since 3Q02. In line with monthly frequency indicators, private consumption expanded strongly, recording +7.1% y/y (the highest growth since 4Q02). Fixed capital formation surprised positively, while construction work and capital goods imports supported ongoing solid investment activity. Hence, investments are again in the 10%+ region (posting 11.2% y/y). Government consumption was in line with expectations, growing 2.8% y/y. Exports posted moderate growth (+3.0% y/y), as trade balance figures suggested, while the import increase was slightly weaker than anticipated at 3.7% y/y. As expected, the net export contribution was negative. In line with the strong 1Q figures, the 2007 GDP forecast is likely to be revised upwards from the current 4.6% y/y.

***Upsurge in MM rates***

This week, MM developments were in the spotlight, as recent developments reminded us of the MM history prior to CNB repo auctions, when 'volatile' was the best word to describe the market. Tight liquidity conditions were further boosted by the start of tourist season and the long holiday weekend (which usually drain liquidity from the system). Also, speculation about a telecom dividend payout and government bond issuance at the beginning of July further supported market neurosis. Hence, MM rates surged, peaking on Thursday at 9.05% (the highest rate since August 2005). In line with that, we saw record-high demand at the reverse repo auction (HRK 5.4bn). Somewhat surprisingly, the CNB decided to accept only 75% of total offers (a scenario seen for the first time), further supporting market anxiety, as market quotations exceeded 10%. Although the situation has stabilized somewhat recently, MM rates are still at rather high levels.

***Exchange rate appreciating towards 7.30***

After some depreciation pressures in the first two weeks of June, the second half brought pressure in the opposite direction. As tourist activity intensified and kuna liquidity dipped to low levels, pressure on the appreciation side mounted. The 7.30 level was seen to be a solid resistance point, but, in the upcoming period, appreciation pressure should strengthen further, eventually pushing the exchange rate below 7.30. The likelihood of the CNB entering the FX market increases as exchange rate movements deviate from gradual appreciation. MM developments were not supportive of the pure kuna bond market and yields were under slight upward pressure. Next week, a new bond issue will be placed on the market. Given the current market conditions, it is hard to estimate market interest, but it is likely to be rather poor.

*Alen Kovac, akovac2@erstebank.com*

## Czech Republic

***CZK in summer tunnel***

From the technical point of view, the CZK is still moving in an upward sloping trend channel. The RSI indicates that the CZK is oversold, which is confirmed by fundamentals. However, during the summer, current account flows will not support the CZK (weaker trade balance and dividend season peak). From the seasonal analysis, we can see that the CZK has tendencies to jump to stronger levels in August and appreciate during the autumn. That is our baseline, as we expect 27.4 at the end of the year.

***Does CZK offer higher upside potential?***

The risks are skewed towards a weaker CZK in terms of the longer deviation from the appreciation trend. Looking into the past, we have seen a one-year deviation from the appreciation trend - 2003, when the CZK depreciated by 4% (this year, the CZK started with 27.8 EUR/CZK; 4% means 28.9). However, the loss was wiped away in 2004 and the CZK returned to its trend. Looking at fundamentals, the recent deviation has increased the potential upside from cumulating long CZK positions.

As long as we are on the subject of CZK fundamentals, we should mention that the trade balance figure will be released on Monday. I expect a further y/y improvement to close to CZK 5bn.

***CZK rates kept on hold***

As expected, the Czech National Bank kept rates on hold. The press conference was more interesting than the vote outcome. Although the boss of the CNB's forecasting team is named Holub (which means dove in Czech), the rhetoric had a hawkish tone. The board still sees pro-inflationary risks: inflation pressure from the labor market, the EMU economy, rate growth, higher inflation and the weak CZK. The voting - four for stability and one for a +25bps hike - did not look convincing for a hiking campaign. However, Governor Tuma said that the argument against a hike was fear of marking themselves as "panic-mongers" (after two consecutive hikes). What is next? Tuma said that he cannot foresee the timing and magnitude of the next move and cannot exclude a 50pbs hike. We expect a hike in July, due to the weak CZK (we do not expect a turn toward appreciation during the next two months) and strong consumption growth, which is accelerating demand inflation. Moreover, the board will have an updated macro forecast. The most probable scenario is +25bps, although the risk of +50bps is increasing. The next rate development will be connected with the CZK. If the CZK follows our baseline scenario and returns to an appreciation trajectory during autumn, the hawkish mood will weaken and the next hike will come at the beginning of next year. However, if the global uncertainty (primarily a question about the direction of Fed rates) and carry trades overshadow domestic fundamentals and the CZK stays at weaker levels, then we see space for an additional 25-50bps in rate hikes this year.

*David Navrátil, dnavratil@csas.cz*

## Hungary

***NBH cut base rate by 25bp to 7.75%***

On Monday, the central bank unexpectedly cut its base rate by 25bp to 7.75%. As rate cut expectations disappeared from the markets after last week's publication of the higher than expected April wage figures, the consensus for the outcome of the Monday meeting was "hold". Even more surprisingly, the decision was not very close, as a solid majority of the council (nine members) voted for a 25bp reduction. The crucial factors supporting the reduction in the base rate are as follows. (1) It became clearer that inflation had reached its peak during the last few months, while core inflation developments do not suggest that inflationary expectations are stuck at high levels. (2) Concerning wages and labor markets, the Monetary Council's statement said that "whitening" of the economy had a bigger role in the wage formation than expected earlier. According to the bank's own calculations, the seasonally-adjusted, short-based regular wage index in the private sector is slowing. Thus, they do not expect a further increase in the wage dynamics in the coming months.

The change in communication - mainly concerning wages - was rather confusing for the markets. The Council's current view on wage developments seems inconsistent with their previous communications. The above-mentioned arguments largely contradict the fact that, in May, the bank highlighted strong wage growth in the private sector as the main reason to keep the base rate on hold. Unfortunately, neither the statement nor the press conference after the decision managed to explain to the markets how it took just one month for the Council to see that the impact of higher wages would not appear in consumer prices. No wonder that the markets started to suspect that the main reason for the Monday rate reduction was basically the uncomfortably strong forint, which is again dangerously close to the strong edge of the band. Later on in the week, the central bank obligingly said that the exchange rate had not affected the Monday rate decision. However, the question marks around the central bank's decision may again bring the conflict between the FX band and the inflation targeting system into the spotlight; i.e. in some situations, the proximity of the strong edge may force the bank to carry out unfounded (from the point of view of the inflation outlook) rate reductions in order to defend the band.

***Hungary posted C/A deficit of EUR 1.102bn for 1Q07***

The central bank reported a C/A deficit of EUR 1.102bn for 1Q07. The figure proved to be somewhat higher than my forecast of a deficit of EUR 0.95bn. However, it still showed an improvment compared to the same period of 2006, when the C/A deficit amounted to EUR 1.455bn. The structure of the C/A balance did not show significant changes compared to previous quarters. Similarly to 4Q06, the trade balance showed a surplus, amounting to EUR 128mn. Exports jumped by 19.2% y/y, with imports rising 15.8% y/y in January-March 2007. The balance of "Services" also showed a slight surplus, amounting to EUR 140mn. Thus, the overall C/A deficit again stemmed from the deficit of the "Incomes" balance, which was EUR 1.473bn in the first quarter. On the financing side of the balance, inward and outward non-debt capital transactions showed a net outflow of EUR 61mn in 1Q07. The net FDI balance was slightly positive (amounting to EUR 480mn), while non-debt-creating portfolio investments showed a net outflow of EUR 541mn.

***Forint again firm***

The central bank's rate cut on Monday did not seem to have any particular affect on the exchange rate. Then, in the second half of the week, the forint again started to strengthen, supported by the zloty (due to the unexpected rate hike in Poland) and the more favorable market environment. The exchange rate was rather immune to the Fed rate decision (announced on Thursday), although it again caused a slight increase in long US bond yields.

No important domestic macro figures are scheduled for next week. Thus, range trading is expected on the markets, with the forint following the development of the Polish zloty.

*Orsolya.Nyeste, orsolya.nyeste@erstebank.hu*

## Poland

***CB surprised with rate hike***

On Wednesday, the central bank hiked the key reference rate by 25bps, pushing it to 4.50%. Such a step was largely unexpected. Our personal view (shared by most other analysts) anticipated hikes being deferred until a new inflation prognosis is available in July. The rationale behind the move was basically the one we referred to in our latest Macroscope on the Polish National Bank. The economy is in full swing, with a recovery being - in the MPC's view - driven by the strong world economy and the recovery in the euro area, with the labor market posing a major risk for the inflation outlook and slightly slower industrial output over the recent period threatening to lower productivity growth. What stirred the MPC into action was the latest data on wage growth (faster) and industrial production (slower), which threaten to translate into a widening productivity-wage gap (households' disposable incomes have risen 11% in real terms over the year, taking into account both the falling unemployment and higher average wages). Even though few anti-inflationary factors were identified (low external prices, relatively high productivity growth, good financial results of enterprises), these were found to be insufficient to keep inflation at bay. The risks of inflation overshooting the target were found to be higher than the risk of undershooting. The determination of the MPC to closely monitor the growth and structure of domestic demand (including the degree of the expansionary fiscal policy stance, the relationship between wage and labor productivity growth, the zloty exchange rate and the impact of globalization) suggests that this may not be the end of it for this year, and that the MPC might decide to hike again with relatively short notice, should it again find the monetary conditions to be overly relaxed. We are currently reviewing the impact of this decision and may revise our estimate of the trajectory of interest rates.

One of the more hawkish MPC members, Halina Wasilewska-Trenkner, said that an interest rate increase may suffice in the case of slower wage growth than production growth. Furthermore, the zloty should remain strong and there should not be any marked spike in oil prices.

***Domestic demand growing nicely***

Retail sales continued their fast growth, supported by declining unemployment and the growth of wages in May. The 14.8% rise was only slightly weaker than the market consensus figure. The strong growth of domestic demand should support the economy, which should continue its brisk expansion. The unemployment rate declined to 13.0%, which should further support demand and the economy. Despite the still relatively high unemployment rate, there is apparently a lack of qualified workers in some sectors of the economy, which may accelerate wage growth and create inflation pressures. The development of wages will be critically important for the further development of the NBP's monetary policy.

***PLN reaction to interest rate hike muted***

The zloty's reaction to the surprise interest rate hike was relatively muted, due mainly to strong technical resistance around 3.78 per euro. Technical factors could limit room for zloty strengthening in the near-term horizon as well. The Polish 10-year bond is influenced mainly by developments on major European bond markets, so its reaction to the NBP decision was mild. The two-year bond reacted surprisingly strongly. Both the zloty and bonds should return to watching major markets - especially to swings in risk aversion.

*Luboš Mokráš, lmokras@csas.cz*

## Romania

***Interest rates still high after central bank repo transaction***

In line with our expectations, the CB stepped into the market through a repo transaction in a trading session characterized by a shortage of liquidity, due to payments to the state budget and high ON interest rates (15% offer level). The CB injected RON 2.56bn (EUR 0.81bn) in a repo transaction at a 7% maximum accepted interest rate. This is the first repo transaction in 2007 with the repurchase date set after two weeks, a long interval that represents half of the minimum reserves period. We believe that the CB is concerned about market liquidity and is trying to stabilize very short-term interest rates at levels close to the key interest rate. At its meeting June 25, the board of the CB decided to pursue an adequate control of liquidity via open-market operations, in line with money market conditions. There were 13 banks participating in the auction and the allotment reached 100%. After the auction announcement, ON interest rates reverted to levels around 8%. The CB reduced the banks' opportunity to participate in repo transactions by requiring securities from a single series. This decision facilitates the access of strong banks to repo transactions and creates hard conditions for banks with lower financial power. Banks with important volumes of securities from one issue of the CB or the Ministry of Finance and Economy are able to receive money at the repo rate (7%) and to offer these amounts at higher rates (over 8%).

In line with our expectations, the RON appreciated further this week, due to high domestic interest rates and regional sentiment (especially the development of the PLN and HUF). As long as there is a small amount of securities eligible for repo transactions in the market, interest rates will remain high. We estimate that, in a future repo transaction, the CB will inject only RON 1bn (EUR 0.31bn) into the market. Despite a possible intervention, very short-term interest rates will remain over 7% (the offer level) and this will generate further RON appreciation pressure, a cyclical evolution during the summer also triggered by speculative capital inflows.

***Ministry of Finance and Economy scraps 1-year T-bill auction***

In a market characterized by low liquidity and by the central bank repo transaction, the Ministry of Finance and Economy rejected all bids at Wednesday's tender to sell RON 100mn (EUR 31.5mn) in 1-year T-bills. Investors bid for RON 245mn (EUR 77.3mn) worth of the debt. Romanian yields are on a slightly decreasing trend; at the previous 1-year T-bill auction, the average yield was 7.14%, while the highest accepted yield was 7.18%. The Ministry of Finance and Economy had already sent signals to the market regarding the possibility of canceling remaining auctions in the case of too high borrowing costs. At this moment, there is only one outstanding central bank CD issue in the Romanian market, with the maturity date July 13. Considering this factor and the auction suspended by the MinFin, there are fewer securities eligible as collateral for banks' repo transactions.

***Ministry of Finance and Economy to issue 3Y and 10Y bonds in 3Q***

Romania plans to issue RON 2.6bn (EUR 0.82bn) in local currency bonds and bills in tenders in the third quarter of this year, up from the RON 2.1bn (EUR 0.66bn) sold in the second quarter. So far, the government has issued around RON 8bn (EUR 2.5bn). Although the volumes are rather low compared with other peer countries in the region, the resumption of issuing state securities, particularly those of the medium- and long-term variety, are seen as the basis and benchmark for the development of other fixed income debt instruments and a placement opportunity for private pension funds. We reiterate our estimation regarding a slight reduction in the future yields of state securities. The Ministry of Finance and Economy can do this either by rejecting all bids at future auctions, or by decreasing the volume of the securities issued per auction. We estimate that the general consolidated budget will have a small surplus in the first six months of the year. Thus, the Ministry of Finance and Economy will face no pressure in attracting resources at any cost.

*Dumitru Dulgheru, dumitruteodor.dulgheru@bcr.ro*

## Slovakia

***Central bank kept rates on hold, as expected***

After the central bank's 'no change' decision, the 2W repo rate remains at 4.25%, with O/N rates at 2.25/5.75%. The market was unanimous in expecting that rates would remain on hold and no other proposal was raised. The koruna currently does not necessitate lower interest rates, as the average exchange rate was weaker in June than in April, when the central bank last cut rates. CB Governor Ivan Sramko suggested that he sees no new or materializing inflation risks. Despite that, we regard the oil price to be a risk factor that is not threatening at present, but which could potentially affect inflation in 2008. While average 12M inflation in Slovakia will probably be below the required Maastricht limit (in April 07-March 08, which is the probable evaluation period), there is uncertainty about the requirement that 'a member state has a price performance that is sustainable' and whether, within this provision, the inflation outlook for 2008 might also be taken into consideration (see below). This speaks in favor of a cautious stance by the central bank. We expect Slovak interest rates to be kept on hold until the ECB hikes its base rate to 4.25% (expected in September) and then flat rates until euro adoption in 2009. In other CB-related events, Parliament approved nominee Viliam Ostrozlik for the post of vice governor. He already serves on the bank board as a regular member and we do not expect a significant impact on monetary policy from his appointment.

***ECB: Sustainability of inflation will be crucial to euro***

Reuters published an ECB memo that stressed the importance of the sustainability of low inflation with regards to fulfillment of the Maastricht inflation criterion. The memo noted several factors that helped the recent disinflation process, including the koruna appreciation, lower world energy prices and the government pressure on gas and electricity distributors. We agree that inflation will likely accelerate once Slovakia adopts the euro (price convergence will then no longer pass through exchange rate appreciation, just through inflation). On the other hand, if all of the nominal convergence criteria are met (i.e. in the case of inflation, if it is below the reference limit), Slovakia would have a good position in euro negotiations, especially as the inflation criterion is expected to be met with a healthy margin. We estimate the probability of euro adoption in 2009 to be 75-80%.

***Upcoming months should bring appreciation of koruna***

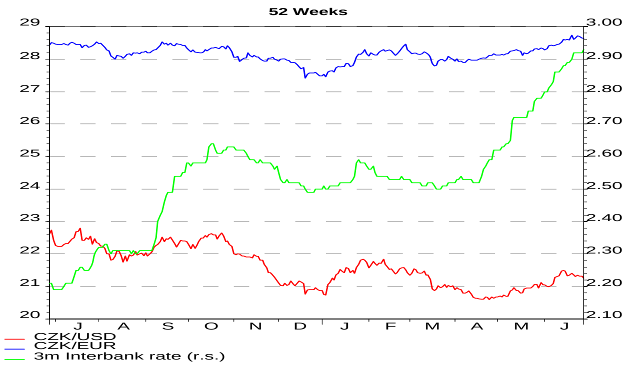
The koruna opened this week near 33.75 EUR/SKK and stood close to this level on Friday. The favorable regional atmosphere, following a surprising Polish rate hike, helped the koruna to erase earlier losses triggered by the published ECB memo. Timely euro adoption is crucial for foreign investors, which have built up large koruna positions (during CB interventions) with the intention to convert them at a fixed exchange rate once Slovakia adopts the European currency. If euro adoption were to be delayed for some reason, some of these investors would close their positions and the koruna would weaken significantly. On the other hand, euro adoption in 2009 as planned (which we expect) is consistent with appreciation of the koruna. Our end-year forecast stands at 32.5 EUR/SKK.

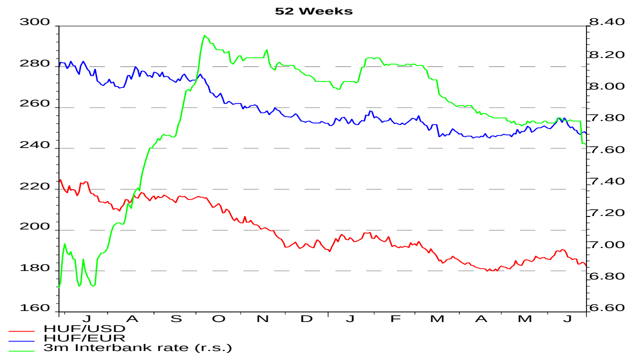
*Michal Mušák, musak.michal@slsp.sk*

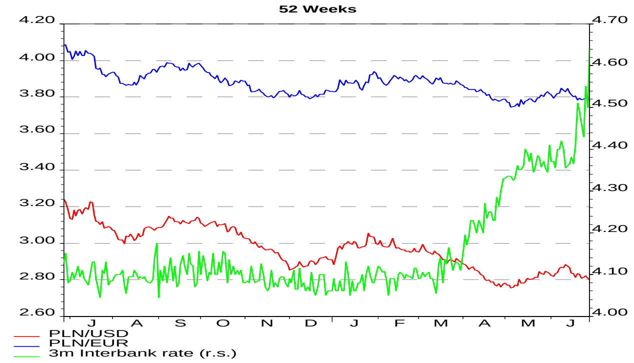
# Appendix Charts

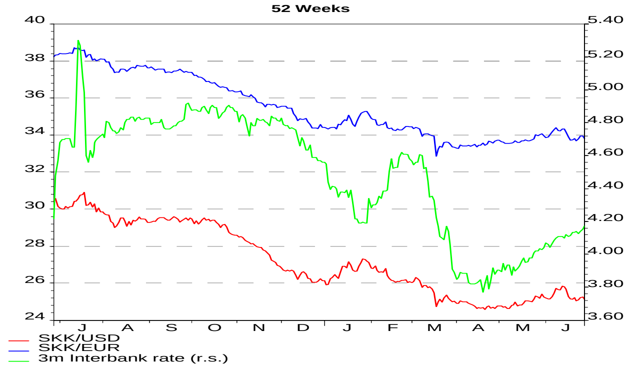
http://global.treasury.erstebank.com

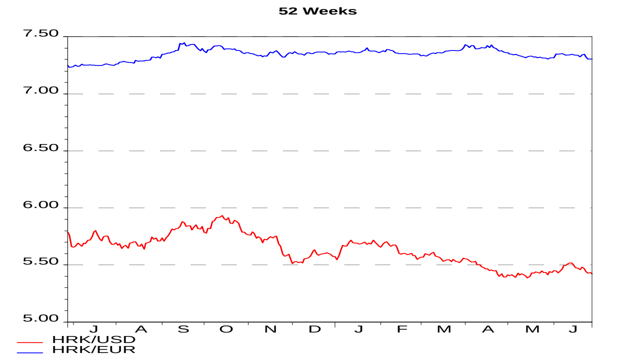
## Exchange rates and interest rates (52 weeks)

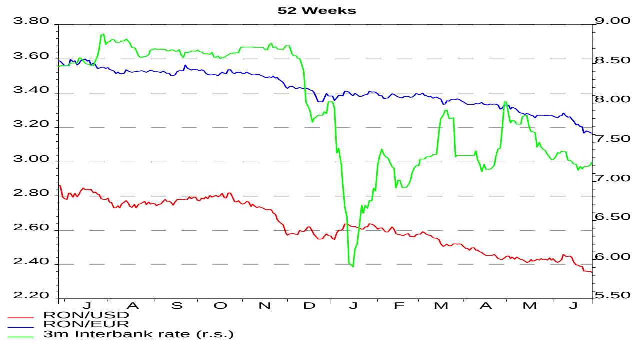


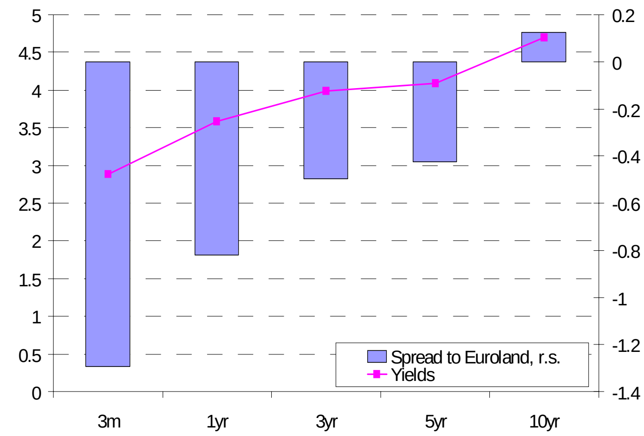



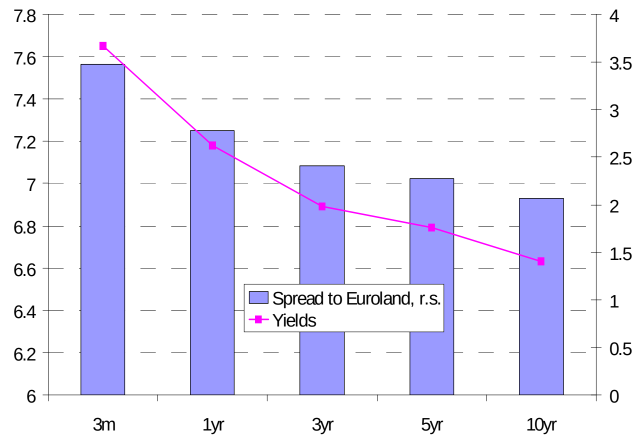

*Source: Datastream*

## Benchmarks

### Czech Republic



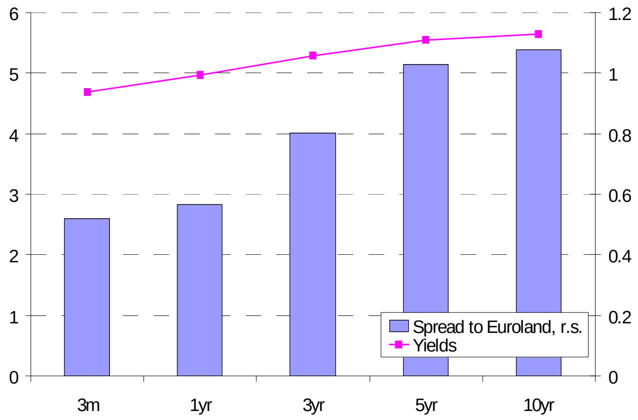

### Hungary



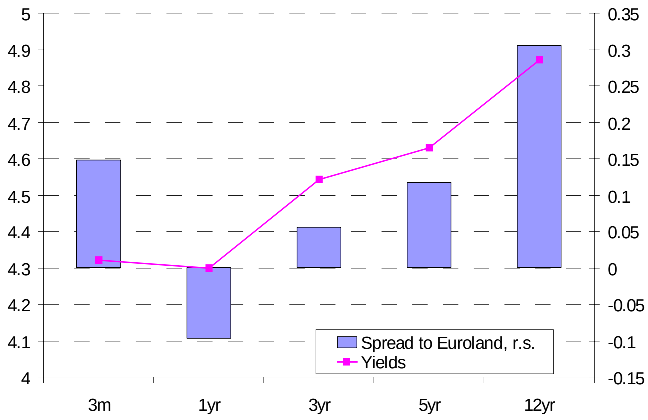
# Appendix Forwards

*http://global.treasury.erstebank.com*

Poland




Slovakia




**Published by Erste Bank der oesterreichischen Sparkassen AG Börsegasse 14, OE 543 A-1010 Vienna, Austria. Tel. +43 (0)50100-ext.**

**Erste Bank Homepage: www.erstebank.at On Bloomberg please type: ERBK <GO>.**

# Contacts

http://global.treasury.erstebank.com

## Group Research

| | |
|---|---|
| **Head of Group Research** | |
| Friedrich Mostböck, CEFA | +43 (0)50 100-11902 |
| **CEE Equity Research** | |
| Co-Head: Günther Artner, CFA | +43 (0)50 100-11523 |
| Co-Head: Henning Eßkuchen | +43 (0)50 100-19634 |
| Günter Hohberger *(Banks)* | +43 (0)50 100-17354 |
| Franz Hörl, CFA *(Steel, Construction)* | +43 (0)50 100-18506 |
| Gernot Jany *(Banks, Real Estate)* | +43 (0)50 100-11903 |
| Daniel Lion *(IT)* | +43 (0)50 100-17420 |
| Martina Pasching, MBA *(Transp., Paper)* | +43 (0)50 100-11913 |
| Tamás Pletser, CFA *(Oil & Gas)* | +361 235-5133 |
| Christoph Schultes *(Insurance, Utilities)* | +43 (0)50 100-16314 |
| Vera Sutedja, CFA *(Telecom)* | +43 (0)50 100-11905 |
| Vladimira Urbankova *(Pharma)* | +4202 24 995 940 |
| Gerald Walek, CFA *(Machinery)* | +43 (0)50 100-16360 |
| **International Equities** | |
| Hans Engel *(Market strategist)* | +43 (0)50 100-19835 |
| Ronald Stöferle | +43 (0)50 100-11723 |
| Jürgen Rene Ulamec, CEFA | +43 (0)50 100-16574 |
| **Macro/Fixed Income Research** | |
| Head: Veronika Lammer (*Euroland,SW*) | +43 (0)50 100-11909 |
| Veronika Posch (*Corporates*) | +43 (0)50 100-19633 |
| Rainer Singer (*US, Japan*) | +43 (0)50 100-11185 |
| Elena Statelov, CIIA (*Corporates*) | +43 (0)50 100-19641 |
| **Macro/Fixed Income Research CEE** | |
| Rainer Singer (*Chief Analyst CEE)* | +43 (0)50 100-11185 |
| **Editor Research CEE** | |
| Brett Aarons | +420 224 995 904 |
| **Research, Croatia** | |
| Damir Cukman *(Equity)* | +385 62 37 28 12 |
| Alen Kovac *(Fixed income)* | +385 62 37 13 83 |
| **Research, Czech Republic** | |
| Head: Viktor Kotlan *(Fixed income)* | +420 224 995-217 |
| Petr Bartek *(Equity)* | +420 224 995 227 |
| Maria Feherova *(Fixed income)* | +420 224 995 232 |
| Jan Hajek, CFA *(Equity)* | +420 224 995 324 |
| Radim Kramule *(Equity)* | +420 224 995 213 |
| Martin Lobotka *(Fixed income)* | +420 224 995 192 |
| Lubos Mokras *(Fixed income)* | +420 224 995 456 |
| David Navratil (*Fixed income*) | +420 224 995 439 |
| Jakub Zidon *(Equity)* | +420 224 995 340 |
| **Research, Hungary** | |
| József Miró *(Equity)* | +361 235-5131 |
| Orsolya Nyeste *(Fixed income)* | +361 373-2830 |
| **Research, Poland** | |
| Artur Iwanski *(Equity)* | +48 22 3306253 |
| Magda Jagodzinska *(Equity)* | +48 22 3306250 |
| Piotr Lopaciuk *(Equity)* | +48 22 3306252 |
| Marek Czachor *(Equity)* | +48 22 3306254 |
| Grzegorz Zawada, CFA *(Equity)* | +4822 538 6200 |
| **Research, Romania** | |
| Head: Lucian Claudiu Anghel | +4021 312 6773 |
| Mihai Caruntu (*Equity*) | +4021 311 27 54 |
| Dumitru Dulgheru *(Fixed income)* | +4021 312 6773 1028 |
| Cristian Mladin *(Fixed income)* | +4021 312 6773 1028 |
| Loredana Oancea (*Equity*) | +4021 311 27 54 |
| **Research, Serbia** | |
| Mladen Dodig | +381 11 22 00 866 |
| **Research, Slovakia** | |
| Head: Juraj Kotian *(Fixed income)* | +421 2 59 57 4139 |
| Michal Musak *(Fixed income)* | +421 2 59 57 4512 |
| Maria Valachyova *(Fixed income)* | +421 2 59 57 4185 |

## Institutional Sales

| | |
|---|---|
| **Head of Sales Equities & Derivatives** | |
| Michal Rizek | +4420 7623-4154 |
| Brigitte Zeitlberger-Schmid | +43 (0)50 100-83123 |
| **Equity Sales Vienna XETRA & CEE** | |
| Hind Al Jassani | +43 (0)50 100-83111 |
| Werner Fuerst | +43 (0)50 100-83114 |
| Josef Kerekes | +43 (0)50 100-83125 |
| Ana Milatovic | +43 (0)50 100-83131 |
| Stefan Raidl | +43 (0)50 100-83113 |
| Simone Rentschler | +43 (0)50 100-83124 |
| **Sales Derivatives** | |
| Christian Luig | +43 (0)50 100-83181 |
| Manuel Kessler | +43 (0)50 100-83182 |
| Sabine Kircher | +43 (0)50 100-83161 |
| Christian Klikovich | +43 (0)50 100-83162 |
| Armin Pfingstl | +43 (0)50 100-83171 |
| Roman Rafeiner | +43 (0)50 100-83172 |
| **Equity Sales, London** | |
| Dieter Benesch | +4420 7623-4154 |
| Tatyana Dachyshyn | +4420 7623 4154 |
| Jarek Dudko, CFA | +4420 7623 4154 |
| Federica Gessi-Castelli | +4420 7623-4154 |
| Declan Woolooghan | +4420 7623-4154 |
| **Sales, Croatia** | |
| Zeljka Kajkut *(Equity)* | +385 62 37 28 11 |
| Damir Eror *(Equity)* | +385 62 37 28 13 |
| **Sales, Czech Republic** | |
| Michal Brezna (*Equity*) | +420 224 995-523 |
| Ondrej Cech *(Fixed income)* | +420 224 995-577 |
| Michal Rizek | +420 2 2499 5537 |
| Jiri Smehlik (*Equity*) | +420 224 995-510 |
| Pavel Zdichynec *(Fixed income)* | +420 224 995-590 |
| **Sales, Hungary** | |
| Róbert Barlai (*Fixed income*) | +361 235-5844 |
| Gregor Glatzer (*Equity*) | +361 235-5144 |
| Krisztián Kandik (*Equity*) | +361 235-5140 |
| Zoltán Szabó (*Fixed income*) | +361 235-5144 |
| **Sales, Poland** | |
| Head: Andrzej Tabor | +4822 330 62 03 |
| Pawel Czuprynski *(Equity)* | +4822 330 62 12 |
| Lukasz Mitan *(Equity)* | +4822 330 62 13 |
| Jacek Krysinski *(Equity)* | +4822 330 62 18 |
| **Sales, Slovakia** | |
| Head: Dusan Svitek | +421 2 5050-5620 |
| Rado Stopiak *(Derivatives)* | +421 2 5050-5601 |
| Andrea Slesarova *(Client sales)* | +421 2 5050-5629 |

## Treasury - Erste Bank Vienna

| | |
|---|---|
| **Sales Retail & Sparkassen** | |
| Head: Manfred Neuwirth | +43 (0)50100-84250 |
| **Equity Retail Sales** | |
| Head: Kurt Gerhold | +43 (0)50100-84232 |
| **Domestic Sales Fixed Income** | |
| Head: Thomas Schaufler | +43 (0)50100-84225 |
| **Treasury Domestic Sales** | |
| Head: Gottfried Huscava | +43 (0)50100-84130 |
| **Corporate Desk** | |
| Head: Leopold Sokolicek | +43 (0)50100-84601 |
| Alexandra Blach | +43 (0)50100-84141 |
| Roman Friesacher | +43 (0)50100-84143 |
| Helmut Kirchner | +43 (0)50100-84144 |
| Christian Skopek | +43 (0)50100-84146 |
| **Fixed Income Institutional Desk** | |
| Head: Thomas Almen | +43 (0)50100-84323 |
| Martina Fux | +43 (0)50100-84113 |
| Michael Konczer | +43 (0)50100-84121 |
| Ingo Lusch | +43 (0)50100-84111 |
| Ulrich Inhofner | +43 (0)50100-84324 |
| Karin Rauscher | +43 (0)50100-84112 |
| Michael Schmotz | +43 (0)50100-84114 |