July 20, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** CNB to hike rates by 25 bps, as data and interviews indicate
- **Hungary:** NBH may keep the base rate on hold next Monday
- **Poland:** Overall, we expect key rates to stay flat next week
- **Romania:** Central bank keen on consolidating the downward trend in interest rates
- **Slovakia:** We bet on spread convergence between Slovak and EMU interest rates

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Overview

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Czech Republic:

- Retail sales did not break any record but remained firm nonetheless
- CNB to hike rates by 25 bps, as data and interviews indicate

Hungary:

- NBH may keep the base rate on hold next Monday
- Calm, summer trading on markets

Poland:

- The new inflation prognosis should nudge the inflation trajectory upwards
- How would data released over the past week affect the mood at Polish MPC?
- First, inflation surprised on the downside
- Labor market still supportive for household consumption
- Industry activity slows for the second month in a row
- Overall, we expect key rates to stay flat next week

Romania:

- Central bank keen on consolidating the downward trend in interest rates
- Romania sells RON 100 million in 10-year T-bonds, yields on a downward trend
- Unemployment fell to 4.2% in May

Slovakia:

- We bet on spread convergence between Slovak and EMU interest rates
- Koruna approaches level of last intervention

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2007
Czech Republic	EUR/CZK	28.27	0.0%	1.2%	-2.3%			
	3Y (yield bp)	4.01	3	0	80	-52	-64	-66
	10Y (yield bp)	4.67	0	3	96	12	3	-23
Croatia	EUR/HRK	7.29	0.0%	0.7%	0.8%			
	3Y (yield bp)	4.58	0	28	4	3	-23	66
	10Y (yield bp)	5.56	1	23	n/a	101	71	n/a
Hungary	EUR/HUF	245.54	0.0%	1.4%	2.4%			
	3Y (yield bp)	6.71	-9	-34	-84	218	256	368
	10Y (yield bp)	6.51	-5	-24	1	196	213	276
Poland	EUR/PLN	3.75	-0.2%	0.7%	2.1%			
	3Y (yield bp)	5.30	-4	7	65	77	74	78
	10Y (yield bp)	5.61	-2	-24	43	106	98	124
Romania	EUR/RON	3.12	0.4%	3.0%	8.3%			
Slovakia	EUR/SKK	33.14	0.3%	1.7%	4.0%			
	3Y (yield bp)	4.62	0	13	24	10	1	50
	12Y (yield bp)	4.90	0	1	59	38	29	38

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

Trading Ideas

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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 (%)
12	short EUR/SKK	04/06/07	6m Bribid/ 6m Euribor	3,9/ 4,28%			2.2%	17.4%	32.8	3.2%
			EUR/SKK	33.92	33.18	2.24%				
13	short EUR/CZK	07/06/07	12m Pribid/ 12m Euribor	3,21/4,47%			0.4%	3.2%	26.8	4.7%
			EUR/CZK	28.39	28.24	0.53%				
14	buy SKKFRA 9*12 sell EURFRA 9*12	16/07/07	SKKFRA 9*12 EURFRA 9*12	Spread 30bp	Spread 20bp	0.1%	0.1%	9.1%	Spread 0	0.3%

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.

14) We bet on a narrowing of the spread between Slovak and European interest rates on a 9M horizon. Currently, SKKFRA 9x12 is traded 30bp below EURFRA 9x12, while Slovakia's expected euro entry in 2009 should ensure advance convergence of money market rates. Even in the case of Slovakia missing euro adoption in 2009, this should result in growth of domestic interest rates, making such a scenario profitable as well.

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%

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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	28.2		7.28		246		3.75		3.13		33.1		2.75	3.50	7.75	4.50	7.00	4.25
Sep-07	28.2	28.2	7.40	7.40	251	247	3.80	3.76	3.11	3.14	33.1	33.1	3.00	3.50	7.25	4.75	6.75	4.25
Dec-07	27.4	28.2	7.40	7.40	253	249	3.72	3.76	3.13	3.16	32.5	33.1	3.00	3.50	6.75	5.00	6.75	4.25
Mar-08	27.2	28.1	7.40	7.40	255	251	3.70	3.77	3.17	3.18	32.4	33.1	3.25	3.50	6.50	5.00	6.75	4.25
Jun-08	26.9	28.0	7.25	7.25	255	251	3.69	3.77	3.12	3.19	32.5	33.0	3.25	3.50	6.50	5.25	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	3.08		7.57		4.78		6.66		4.36		4.66	5.56	6.50	5.60	4.83
Sep-07	3.05	3.36	7.30	7.17	5.00	4.94	6.85	6.80	4.30	4.39	4.50	5.20	6.40	5.50	4.70
Dec-07	3.13	3.67	6.80	6.66	5.15	5.24	6.55	6.64	4.30	4.43	4.60	5.10	6.10	5.45	4.70
Mar-08	3.30	3.96	6.50	6.38	5.30	5.46	6.45	6.63	4.30	4.49	4.70	5.00	6.00	5.55	4.80
Jun-08	3.38	3.94	6.40	6.28	5.40	5.39	6.35	6.39	4.30	4.30	4.70	4.90	5.90	5.65	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	6.3	5.7
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	-3.2
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	-3.7
Romania	-0.8	-1.6	-2.8	-2.7
Slovakia	-2.8	-3.4	-2.9	-2.9

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	July-26	Rate-setting meeting CNB	25bps	25bps
Croatia	-	-	-	-
Hungary	July-23	NBH rate setting meeting	no change (7.75%)	no change (7.75%)
	July-24	May Retail sales	-1.7% y/y	-1.4% y/y
Poland	July-24	Unemployment (06/2007)	12.7%	12.5%
	July-24	Retail sales (06/2007)	13.9% y/y	14.9% y/y
	July-25	MPC rate setting meeting	no change	no change
Romania	-	-	-	-
Slovakia	Jul-27	June PPI	1.1% y/y	1.2% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		No auction scheduled					
Hungary		July-24	Aug-01	Oct-31-2007	-	HUF 30bn	7.45%
		July-25	Aug-01	Feb-13-2008	-	HUF 25bn	7.20%
		July-26	Aug-01	July-02-2008	-	HUF 35bn	7.00%
Poland		No auction scheduled					
Romania		25-Jul-07	27-Jul-07	25-Jul-08	-	100,000,000	7.00%
Slovakia		No auction scheduled					

Major Markets

Major markets

Full calendar with little impact

Euro government bond yields have remained in a sideways trend between 4.5% and 4.7% for nearly two months now. We expect this consolidation to continue over the next few weeks, more or less following the US market. Euroland data next week will include the Ifo-Index and Euroland PMIs. We expect the Ifo-Index to decrease slightly in both components. As the ZEW surprised to the downside last week, this should be already in line with market expectations. In the medium term, we expect the Ifo-Index to move sideways within a range of 104 and 107, which still points to very healthy growth. The PMIs, on the other hand, showed surprisingly strong numbers in June. On the back of an even higher EUR/USD exchange rate and an equally high oil price, PMIs should finally settle down and stabilise. Preliminary inflation data for Germany will be released in the second half of the week. A small increase to 1.9% after 1.8% in June is likely on the back of higher food prices and still high energy prices. M3, reported on Thursday, should stay at a high level but confirm the flattening out of the bank lending growth rate.

US Housing data and 2Q GDP in focus

Fed chairman Bernanke's recent report to the US parliament hardly revealed anything new. The risks stemming from inflation were reiterated and risks for economic growth in either direction were mentioned. The growth estimate for 2007 was revised slightly downwards. Inflation data, also released on Wednesday, was more or less in line with market expectations, with only food prices surprising on the upside. For next week, data from the housing market will be released on Wednesday and Thursday. The indicators should confirm the ongoing weakness in this area of the economy, with surprises on the downside possible. Friday will bring the first estimate of GDP growth in 2Q. Private consumption is likely to have decelerated, while inventories will have contributed positively, in our view. Next week's data should be supportive for bonds; whether it will suffice for the 10-year maturity to dip below the 5% remains to be seen. This will also depend on the performance of stock markets. Fundamentals will not support the dollar, but EUR/USD has got stuck around 1.38 currently, which points to some technical correction ahead.

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Forecasts

	Intervention Rate		3m Money Market Rate				10y Govt. Yield		FX	
	EUL	USA	EUL	Forwards	USA	Forwards	EUL	USA	EUR/USD	Forwards
Spot	4.00	5.25	4.23		5.36		4.51	5.01	1.379	
Sep-07	4.00	5.25	4.35	4.41	5.20	5.35	4.50	4.80	1.40	1.382
Dec-07	4.25	5.00	4.35	4.59	4.90	5.30	4.60	4.70	1.37	1.385
Mar-08	4.25	4.75	4.30	4.71	4.70	5.23	4.70	4.70	1.33	1.387
Jun-08	4.25	4.50	4.30	4.68	4.40	5.20	4.70	4.70	1.33	1.389

Czech Republic

Retail sales did not break any record but remained firm nonetheless

The most important data release of last week was the retail sales figure for May. This did not break any records but nonetheless remained solid at a real and seasonally unadjusted y/y growth rate of 7.0 % (including the car segment, comprising cars and repairs). As usual, the biggest contributors were electronics, construction materials and furniture with the most dynamic segment in terms of growth rate being household goods and clothing (probably in conjunction with ongoing clearances taking place in this robustly growing market). The automotive segment (vehicle sales + repairs) rose 12.3 %, certainly not a sign of slackening domestic demand. All in all, the case for monetary policy is clear; this number is certainly not going to make the Board want to reconsider its stance.

CNB to hike rates by 25 bps, as data and interviews indicate

After all, we will find out for sure next week since the Board's rate-setting meeting will be held on Thursday. We expect a 25 bps hike to be delivered on Thursday (the key rate will then stand at 3.00%). The fact that interest rates hikes are imminent was unambiguously borne out in the recent interview with one of the most dovish members of the Board, Mr. Rezabek. He spoke of the need to remain on guard about inflation ("a number of inflation risks have built up") and added that the new prognosis, due out this month, will probably make a strong point for a hike. He did not forget to mention, however, that the risk of overreacting is - in his view - as present as ever, pointing to the CNB's track record of undershooting the target. All in all, in light of his dovish stance, his remarks make the hike look like a sure thing.

In addition, it is hardly surprising that Mr. Singer, another member of the Board (albeit with arguably more hawkish leanings) made, in a separate interview with Reuters, hawkish comments indicating basically the same thing. He perceives significant inflation risks, cites the weakness in the Koruna as compounding the risks of CPI going above the tolerance band and points towards the recent PPI increase (y/y 4.6 %, marking a 2-year high), as suggesting there will not be any near-term impetus on price growth slowdown. Even though in the recent past, PPI has not translated much into CPI, this period roughly coincided with a period of continuous Koruna strengthening. With the recent bout of weakness in CZK and the strong economy, the fear is that this counterbalancing effect might disappear.

Also, as already indicated, the new inflation prognosis will be unveiled next week; the expectation is that it will call for a more rapid hike.

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Hungary

NBH may keep the base rate on hold next Monday

The most important event next week will be the Central Bank's rate setting meeting on Monday. After keeping the base rate on hold in May and the unexpected 25bp reduction in June, the council will face a big dilemma next week. According to the latest polls, the majority of financial analysts do not expect the continuation of rate cuts in July and we tend to share this view. One thing seems sure: the final outcome would be much more divided than usual.

Let's begin with a summary of what had happened in May and June. In May, the bank published its Quarterly Inflation Report. The main messages of the publication were that inflation would go down close to the mid-term target of 3% y/y and the economic balance situation would significantly improve in the mid run. But, despite the favourable tone of the report and the market consensus of that time (expecting the first rate cut for May-June), the council kept the base rate on hold, justifying the decision mainly by the rapid increase in wages in the private sector, which seemed to be one of the strongest concerns for the council. Basically, the rate decision and the Bank's statement in May, in our view, largely reflected the council's very cautious stance, suggesting that the rate-cutting process would start only in August-September, instead of May-June. However, just one month later, in June, the bank still cut the base rate, even though the wage figures had showed further acceleration in private sector's wage growth. To put it in a nutshell, in May the Bank's comments were too hawkish and put much emphasize on wage developments, compared to the fact that one month later they cut the rates and issued a statement pointing rather to the other side. It seems there was a communication failure on the council's part, thus no wonder many rate setters have tried to make their arguments for their decisions clearer since the June meeting. Central Bank Governor Simor said this week that market analysts had put too much emphasis on wage figures last month, by predicting that high wage growth figures could alone prevent the Bank from rate reductions.

So what's going to happen on Monday? The main problem for the markets is that now it's not altogether clear to what extent the council looks at the different economic indicators on which they decide, as it is not too easy to make judgments on the domestic inflation outlook. It seems that wage figures will once again have lesser impact on the decision, although the fact that, according to the latest statistics, y/y increases in regular wages in the private sector seem to have been stuck at high levels (see our Short Note, published Wednesday). The increase in core inflation in June and the relatively unfavourable structure of the June inflation figures should have much impact. These suggest for us that the council will again be more cautious and postpone the next rate cut until August. But one should note, however, that even the continuation of rate cuts should not come as a surprise, as the Governor also said not long ago that 12-month inflation was expected to be close to the Central Bank's mid-term target of 3% by the end of 2008 or the beginning of 2009. In addition, changes in the council (two hawkish members Auth and Adamecz will no longer vote after their mandates expired on July 2, while Júlia Király will take part in the Monetary Council's work for the first time) and the strong forint also make the situation more complicated. What is certain is that communicating either decision will present the greatest challenge for the council next Monday.

Calm, summer trading on markets

The forint remained strong during the week, basically affected by international sentiment. The 3-year bond auction on Thursday showed healhy demand for the paper, indicating favourable market sentiment and high risk appetite. Next week markets will basically concentrate on the rate desion and the press conference on Monday. Later on in the week, as the macro calendar is practicaly empty, euro/dollar movements should be one of the main decisive factors. The forint is expected to continue moving within a relatively tight range.

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Poland

The new inflation prognosis should nudge the inflation trajectory upwards

The MPC will be presented with the fresh update of the quarterly Inflation report from the Central Bank's research team this month. We expect that the inflation trajectory will be nudged upwards. To begin with, the April version predicted inflation hovering around 2% around this time of year. However, hard data showed a return of inflation back above the target (to 2.6%). Hence the starting point for the prognosis will be higher. Additionally, the new report should contain an evaluation of the effects of the decline in tax wedge (3pp July 2007, 4pp January 2008) and possibly also the impact of co-hosting the soccer championship Euro 2012. Both will reinforce the pressures on inflation.

How would data released over the past week affect the mood at Polish MPC? First, inflation surprised on the downside…

There was a rich stream of macroeconomic data published during the past week, which provides additional input for the monetary policy council (MPC). To begin with, CPI inflation jumped up by 0.3pp to 2.6% y/y. Nevertheless, an increase in the inflation rate was a widely expected scenario and the released number even undershot the market consensus. Apart from quickening annual dynamics of prices within the food and fuels category, the June rise in headline inflation can be partially ascribed to the slight increase in net inflation (by 0.1pp to 1.7% according to our prediction). Admittedly, this is still not a disastrous number. The Central Bank has perceived the relative stability of the net inflation as a signal of low inflationary pressures.

Labor market still supportive for household consumption

Undoubtedly, patterns of development witnessed in the labour market are still a thorn in the sides of central bankers. Wages in the corporate sphere failed to moderate and even accelerated in June as far as 9.3% y/y. What is more, the expanding economy clearly continues to swallow more and more workers. The annual dynamics of employment in the corporate sphere went up by 0.2pp as far as 4.6% y/y. Plugging this figure together with the rise in wages and rise in inflation, the outcome is that the real wage bill (wages x employment in real terms) surged 11.5% y/y (versus 11.1% y/y in May). This indeed suggests a significant boost to the disposable income of households and could raise concerns at MPC with regard to a potential inflationary impact.

Industry activity slows for the second month in a row

Industrial output showed an unexpectedly sharp slump to notch an annual growth of a mere 5.6% y/y in June. This is likely to leave MPC members with mixed feelings. On the one hand, weakening industrial output could be a prophet of weakening economic activity (heading back towards the potential). On the other hand, it implies some deterioration in the wage-productivity relationship, which has negative implications for inflation risks. As other pieces of data tend to signal that household spending should remain solid (still robust retail sales, accelerating wages and quickly falling unemployment, plus the expected boost from lower tax wedge), we guess that the hawkish interpretation will prevail.

Overall, we expect key rates to stay flat next week

To sum up, the MPC is not likely to abandon its (implicit) tightening bias, in our view. The new Inflation report will point to a higher inflation trajectory. However, we think that the MPC has already discounted this fact when hiking in June. Also, the rhetoric of central bankers is cautious at present and even the hawks seem to prefer waiting for more data before raising their hands for another move. In particular, necessity to scrutinize the GDP data was mentioned. That points to August/September as the earliest date for the next move (GDP is out on August 29, which is exactly the date of the MPC decision). Still, robust domestic demand and a tightening labour market in an environment of positive output gap represent a threat to inflation. Hence we foresee the reference interest rate rising by 50bp by the year-end, hitting the 5.0% level. We still believe that the monetary tightening cycle should culminate in 2009, with key interest rates hitting the level of 5.75%.

Rate setting meeting is the key local event for next week

The markets will be looking at retail sales numbers in the upcoming week, but the main local event will be the rate setting meeting of the Central Bank. In the poll carried out at the beginning of the month (Reuters), 5 analysts out of 16 predicted the next rise to come as early as this month. However, this assessment might have changed as, according to a Bloomberg poll (which nevertheless contains a slightly different group of analysts), expectations are unified at present, converging towards the 'no change' scenario. Therefore, the actual outcome should not affect the markets with post-meeting communication being crucial. As the markets already price in rate hikes in months ahead, the statement would have to be very hawkish to hurt bonds or support zloty. The exchange rate of the zloty against the euro hovered within a tight range of 3.73-3.76 PLN/EUR this week. Technically, the unit is ripe for correction (according to ROC + MACD sent out a sell signal for the zloty). The closest technical barrier on the road north is 3.78 PLN/EUR. Bonds should engage in range-trading at least until the MPC meeting. As usual, development on the core markets will be the important factor.

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Romania

Central bank keen on consolidating the downward trend in interest rates

Based on good market liquidity, the central bank reinforced its intention to bring down interest rates through a second competitive depo transaction this year. Well balanced distribution of liquidity among the bank operators was also reflected in the large number of participants in the auction (29 banks as compared to 18 banks one week before) and this contributed to a steeper decrease sterilisation interest rate.

Total bids submitted by banks amounted to RON 6.5 billion (EUR 2 billion), four times higher than in the previous sterilisation meeting. However, the central bank decided to drain only RON 3 billion (EUR 960 million) from the market with no impact at all on the very short-term interest rates, which have since remained at a low level (2.94% ON), and even on a decreasing trend for the remaining part of the week (1.78% ON on Thursday). The interest paid by the National Bank for the funds attracted went down by 135 basis points on average as against last week, standing at 5.31% (6.66%) and the downward trend in the sterilisation interest rate was possibly also due to the large number of participants in the auction.

Excess liquidity will mean that many banks will have to place funds with the central bank through the deposit facility (overnight) at 1% interest rate. The start of the new mandatory reserves period (July 24th) should bring back short-term interest rates to the range of 6.75-7%. The only factor that could trigger an interest rate increase above the estimated level is tax payments to the state budget, which are due as of 25th July.

The central bank will take a more pro-active approach in lowering interest rates in order to temper a too rapid appreciation of the RON and thus to minimize as much as possible an upward correction later on. This has become clearer lately and, in view of an overall favourable outlook for CPI (core inflation has been on a downward trend in the past 3 months while headline inflation stood at around 3.8% despite liberalisation in some administered prices) it is likely that the central bank will cut the key interest rate by another 25 basis point to 6.75% as of July 31st (next Board Meeting).

The National Bank is expected to further adjust the base calculation of the mandatory reserves in a bid to come closer to the EU practice. Currently, the central bank charges a 20% ratio for RON liabilities and 40% ratios for FX liabilities. For example, deposits with maturities longer than 2 years could be exempted from the calculation base. However, mandatory reserves rates will only be reduced gradually the reason being that the central bank wants to keep monetary aggregates and inflation pressures under control with an eye in the 2008 parliamentary elections.

RON FX rate was less volatile than in previous weeks in line with some other regional currencies with a trading range of 3.12-3.135 against the Euro and it is likely to keep on this trend next week amidst a dull FX market with no big transaction volumes (summer holiday). While interest rates dropped drastically, RON depreciation was minor and this was mainly due to the sale orders coming from private individuals, which are commonplace during the summer period.

Romania sells RON 100 million in 10-year T-bonds, yields on a downward trend

In line with our expectations, Romanian state securities yields continue to decline. The Ministry of Finance and Economy sold RON 100 million (EUR 31.9 million) in 10-year T-bonds with an average accepted yield of 6.80% against 6.91% at the previous auction and highest accepted yield of 6.84%, down from 6.98%.

Banks bided 4.5 times higher, offering RON 448.8 million (EUR 143.5 million). Since the Ministry of Finance and Economy is in a comfortable position considering the surplus of the general consolidated state budget of 0.16% of GDP after the first five months of the year, it might cancel some auctions if borrowing costs are too high or budget surplus is maintained.

Banks are eager to participate in T-bonds and treasury bills auctions, since they currently have an excess of liquidity and, on the other hand, in a possible future scenario of liquidity shortage, state securities will allow them to take part in the Central Bank's repo transactions.

Unemployment fell to 4.2% in May

The number of unemployed people enrolled was 369.8 thousand as of end-May, down by 111 thousand as compared to the same period in 2006 when the unemployment rate stood at 5.5%.

A step up in activity, particularly in seasonal activities such as construction (which has been influenced by good weather conditions so far) and services were behind the positive downward trend both in male and female unemployment rates.
For the year-end we estimate an unemployment rate of around 5.2% once the seasonal activities assume a lower profile.

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Slovakia

We bet on spread convergence between Slovak and EMU interest rates

We issued a recommendation to buy SKKFRA 9x12 and sell EURFRA 9x12 as we do not expect Slovak rates to come below Eurozone on a 9M horizon. On Monday, SKKFRA 9x12 was traded 30bp below EURFRA 9x12 (the spread has narrowed to 20bp since then but remains negative), while Slovakia's expected euro entry in 2009 should ensure advance convergence of money market rates. Even in the case of Slovakia missing euro adoption in 2009, this should result in growth of domestic interest rates, making such a scenario profitable as well. We see a minor risk that Slovak and Eurozone rates will converge later than in April 2008, but this could be circumvented by entering FRA 12x15 instead of FRA 9x12.

Koruna approaches level of last intervention

Amid low liquidity, the koruna moved within the 33.1-33.3 SKK/EUR range. The lower boundary of the range is also the strongest exchange rate since early April and the level of the Central Bank's last intervention against the koruna. We expect the Central Bank to be more lenient at present. However, since the koruna has come closer to the stronger margin of the initial ERM-2 band at 32.69 SKK/EUR (and there is some uncertainty about interpretation of Maastricht criterion), we see increased risk of intervention within 32.7 32.9 SKK/EUR.

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Appendix Charts

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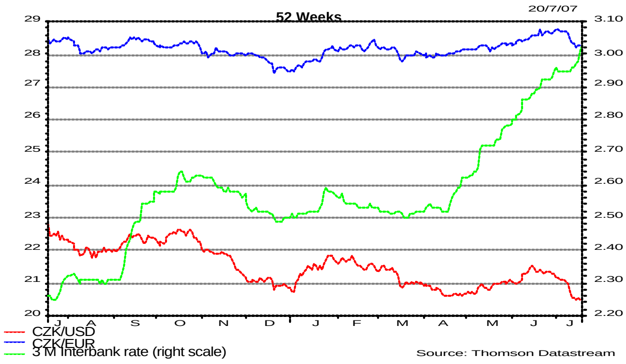
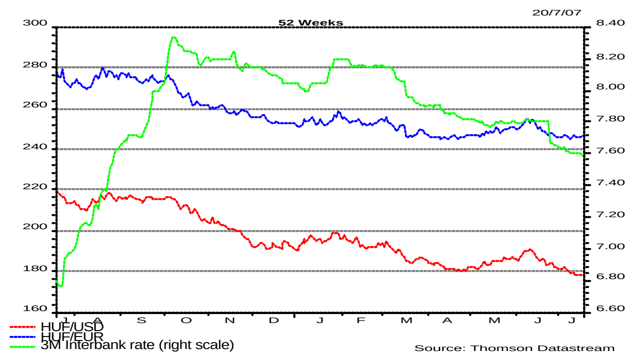
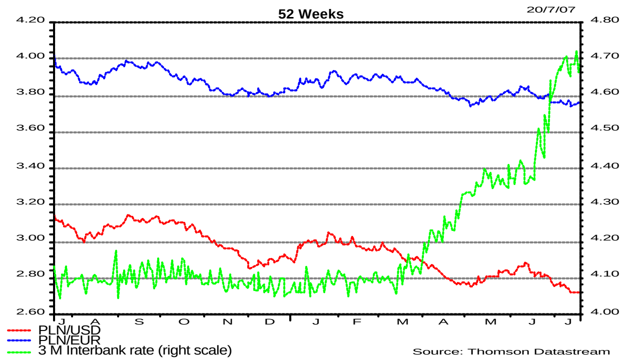
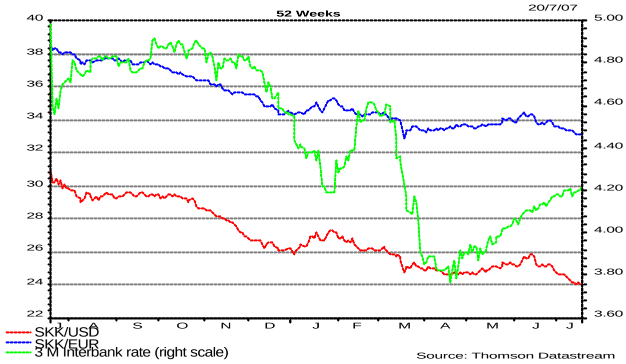
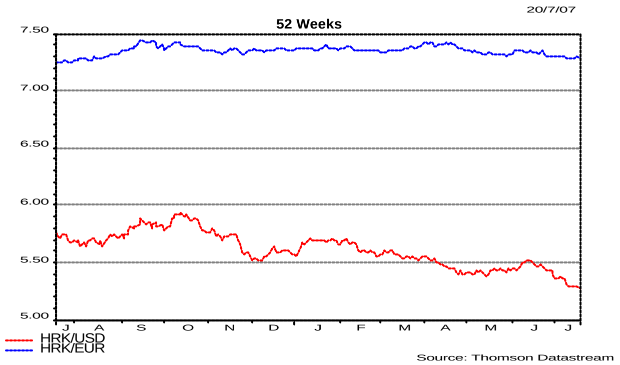
Exchange rates and interest rates (52 weeks)

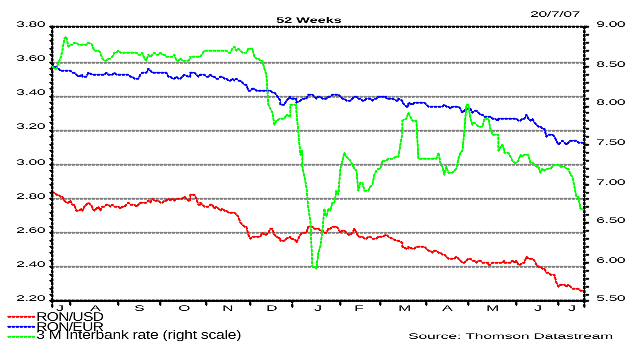








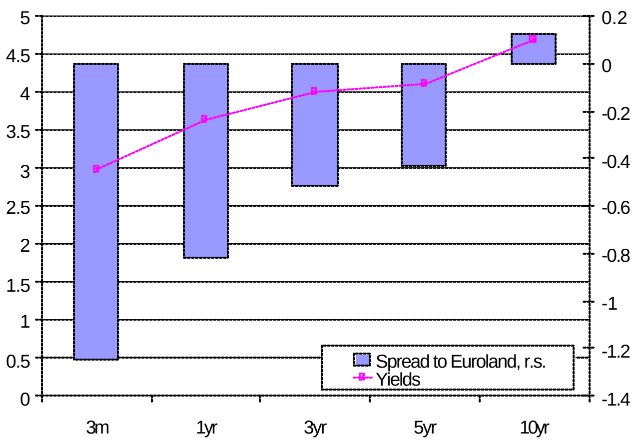




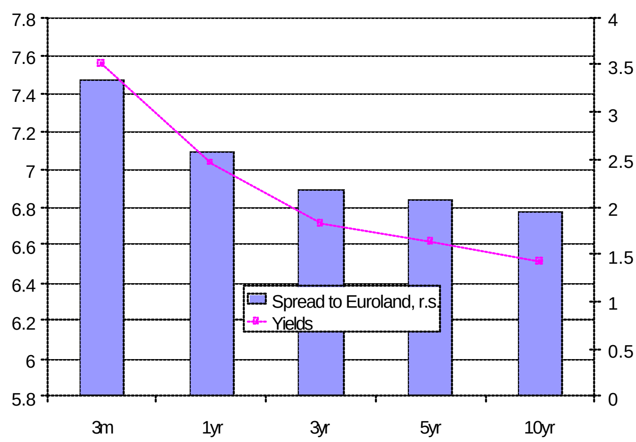
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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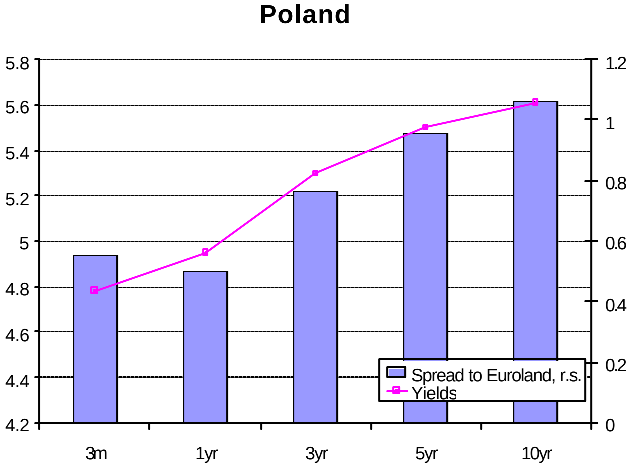

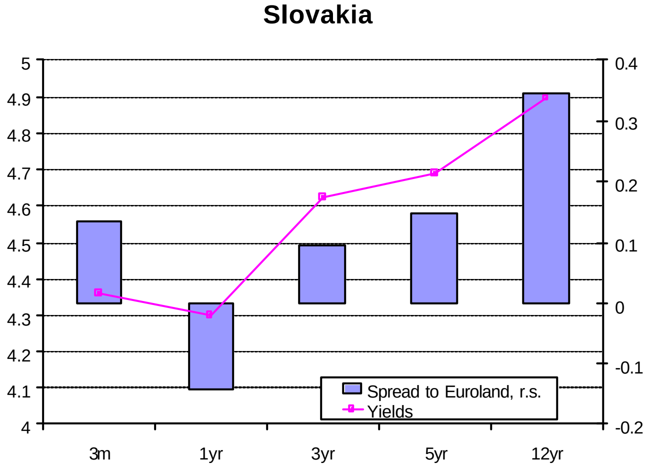

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