

# Fixed Income and Foreign Exchange

## CEE Insights

- **Croatia:** Second spot FX intervention in two weeks
- **Czech Republic:** CZK back to strengthening trend
- **Hungary:** Central bank kept base rate on hold
- **Poland:** CB maintains hiking bias, but perceives risks of overshooting target in MT as decreasing
- **Romania:** Central bank continued to attract liquidity at interest rates below key rate
- **Slovakia:** Fitch changed Slovakia's rating outlook to positive

# Overview

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## Croatia:

- Foreign debt growth moderating
- Second spot FX intervention in two weeks



## Czech Republic:

- Rate hiked by 25bps
- Inflation on upswing
- CZK back to strengthening trend



## Hungary:

- Central bank kept base rate on hold
- Forint on weakening path



## Poland:

- New inflation prognosis sees brisker price growth in coming two years
- CB maintains hiking bias, but perceives risks of overshooting target in MT as decreasing
- Polish assets under pressure, due to global turbulence



## Romania:

- Romania - strategic partner for Ford in Europe
- Central bank continued to attract liquidity at interest rates below key rate
- RON faced regional correction this week



## Slovakia:

- Fitch changed Slovakia's rating outlook to positive
- Koruna gains on Monday prompted central bank verbal intervention
- CB to keep rates stable

Rainer Singer  
(Chief Fixed Income Analyst CEE)  
[rainer.singer@erstebank.at](mailto:rainer.singer@erstebank.at)

Friday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2007
Czech Republic	EUR/CZK	28.04	0.6%	2.5%	-1.5%			
	3Y (yield bp)	3.99	0	0	78	-30	-48	-66
	10Y (yield bp)	4.60	-5	-7	89	28	12	-23
Croatia	EUR/HRK	7.32	-0.4%	-0.3%	0.5%			
	3Y (yield bp)	4.56	-1	15	3	21	-7	66
	10Y (yield bp)	5.33	-23	-10	n/a	100	92	n/a
Hungary	EUR/HUF	252.16	-2.4%	-2.2%	-0.3%			
	3Y (yield bp)	7.03	34	14	-52	273	244	368
	10Y (yield bp)	6.69	22	8	33	237	206	276
Poland	EUR/PLN	3.81	-1.0%	-1.1%	0.7%			
	3Y (yield bp)	5.34	7	4	69	104	85	78
	10Y (yield bp)	5.60	2	8	43	128	111	124
Romania	EUR/RON	3.17	-1.1%	-1.6%	6.8%			
Slovakia	EUR/SKK	33.40	-0.8%	0.6%	3.2%			
	3Y (yield bp)	4.58	-3	3	19	24	5	50
	12Y (yield bp)	4.82	-6	-5	51	50	30	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 (%)	Target P/L p.a. (%)	
12	short EUR/SKK	04/06/07	6m Bribid/ 6m Euribor EUR/SKK	3,9/ 4,28%	33.92	33.48	1.30%	1.2%	8.1%	32.8	3.2%	6.4%
13	short EUR/CZK	07/06/07	12m Pribid/ 12m Euribor EUR/CZK	3,21/4,47%	28.39	28.01	1.35%	1.2%	8.0%	26.8	4.7%	4.7%
14	buy SKKFRA 9*12 sell EURFRA 9*12	16/07/07	SKKFRA 9*12 EURFRA 9*12	Spread	Spread		0.34%	0.34%	Spread 0		0.3%	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 than 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%

*To be included in the trading ideas mailing list, please, mail to [rainer.singer@erstebank.at](mailto: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
<b>Spot</b>	28.0		7.28		251		3.83		3.15		33.4		3.00	3.50	7.75	4.50	7.00	4.25
<b>Sep-07</b>	28.2	27.9	7.40	7.40	251	252	3.80	3.83	3.15	3.16	33.1	33.4	3.00	3.50	7.50	4.75	6.75	4.25
<b>Dec-07</b>	27.4	28.0	7.40	7.40	253	254	3.72	3.83	3.18	3.18	32.5	33.4	3.00	3.50	6.75	5.00	6.75	4.25
<b>Mar-08</b>	27.2	27.8	7.40	7.40	255	256	3.70	3.84	3.15	3.20	32.4	33.4	3.25	3.50	6.50	5.00	6.75	4.25
<b>Jun-08</b>	26.9	27.8	7.25	7.25	255	258	3.69	3.85	3.12	3.21	32.5	33.3	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
<b>Spot</b>	3.14		7.45		4.79		6.80		4.33		4.61	5.56	6.65	5.61	4.75
<b>Sep-07</b>	3.05	3.36	7.40	7.38	5.00	4.97	6.85	6.72	4.30	4.35	4.50	5.20	6.40	5.50	4.70
<b>Dec-07</b>	3.13	3.79	6.80	6.99	5.15	5.27	6.55	6.74	4.30	4.20	4.60	5.10	6.10	5.45	4.70
<b>Mar-08</b>	3.30	3.96	6.50	6.68	5.30	5.48	6.45	6.47	4.30	4.17	4.70	5.00	6.00	5.55	4.80
<b>Jun-08</b>	3.38	3.97	6.40	6.61	5.40	5.39	6.35	6.29	4.30	4.21	4.70	4.90	5.90	5.65	4.80

## Long-term forecasts

<b>GDP growth (%)</b>	<b>2005</b>	<b>2006</b>	<b>2007f</b>	<b>2008f</b>	<b>CPI (%), eoy</b>	<b>2005</b>	<b>2006</b>	<b>2007f</b>	<b>2008f</b>
Czech Republic	6.5	6.4	5.6	3.9	Czech Republic	2.2	1.7	3.7	4.5
Croatia	4.3	4.8	5.4	4.7	Croatia	3.6	2.0	3.4	3.0
Hungary	4.2	3.9	2.5	3.2	Hungary	3.3	6.5	5.2	3.4
Poland	3.6	6.1	6.3	5.7	Poland	0.7	1.4	2.5	2.6
Romania	4.4	7.7	6.5	6.3	Romania	8.6	4.9	3.7	4.2
Slovakia	6.0	8.3	8.9	7.1	Slovakia	3.7	4.2	2.8	3.3
<b>C/A (%GDP)</b>	<b>2005</b>	<b>2006</b>	<b>2007f</b>	<b>2008f</b>	<b>Budget Balance (%GDP)</b>	<b>2005</b>	<b>2006</b>	<b>2007f</b>	<b>2008f</b>
Czech Republic	-2.5	-4.0	-3.3	-2.6	Czech Republic	-2.2	-3.3	-4.0	-3.3
Croatia	-6.4	-7.8	-8.2	-7.9	Croatia	-4.2	-3.0	-2.6	-3.0
Hungary	-6.9	-5.8	-4.5	-4.1	Hungary	-7.8	-9.2	-6.5	-5.0
Poland	-1.7	-2.3	-2.6	-3.2	Poland	-4.3	-3.9	-3.4	-3.7
Romania	-8.7	-10.3	-11.4	-11.4	Romania	-0.8	-1.6	-2.8	-2.7
Slovakia	-8.5	-8.4	-3.6	-2.4	Slovakia	-2.8	-3.4	-2.9	-2.9

# Diaries

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## Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
<b>Czech Republic</b>		No releases scheduled		
<b>Croatia</b>	31-Jul	Trade balance	€-950mn	-
<b>Hungary</b>	July-31	June Industrial Producer prices	-2.1% y/y	-1.2% y/y
<b>Poland</b>		No releases scheduled		
<b>Romania</b>		No releases scheduled		
<b>Slovakia</b>	Jul-31	CB meeting	4.25% (on hold)	4.25% (on hold)
	Jul-31	May C/A deficit	SKK -15.7bn	SKK -12.6bn

\*Sources: Bloomberg, Reuters

## Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
<b>Czech Republic</b>		No auction scheduled					
<b>Hungary</b>		July-31	Aug-08	Nov-07-2007	-	HUF 25bn	7.40%
		Aug-02	Aug-08	Oct-24-2012	6.00%	HUF 45bn	6.70%
		Aug-02	Aug-08	Feb-24-2017	6.75%	HUF 40bn	6.60%
<b>Poland</b>		Aug-01	Aug-03	2Y	0%	-	-
<b>Romania</b>		02-Aug-07	06-Aug-07	3/10 Y	-	100,000,000	7.0/6.8%
<b>Slovakia</b>		No auction scheduled					

# Major Markets

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## Major markets

### **Rate hike expected for October**

The flight to quality has pushed yields down over the whole euro government bond curve by about 20 basis points since Friday, July 20. Risk aversion should support the market further this week, but the outcome of the ECB meeting (which will be held as a telephone conference, without a press conference - as usual in the summer) will also be in focus. The press release after this meeting should finally give a clue as to whether the next rate hike should be expected for September or October. If the phrase "very vigilant" is included, we will see the next hike in September; if not, October seems very likely. The high volatility on financial markets points clearly to October, but the still extremely high growth of money supply continues to favor September. We would bet on October, as the ECB Council will be interested in calming market fears. The flash estimate for consumer prices will be released on Tuesday and should stay stable at 1.9%, with a chance of a slight decrease to 1.8%. Sentiment indicators should be reported in line with a general flattening tendency in the industrial and service dynamic during the summer.

### **Impact of important releases to depend on market status**

After the disappointing figures from the housing market and the first GDP estimate for 2Q (which was roughly in line with market expectations), important data is scheduled for next week. Wednesday will bring the release of the ISM index. The market expects a continuation of the good performance of the previous three months. We remain cautious, as the high index number is not inline with other indicators from the US economy. The situation for the labor market, which has remained robust in an environment of poor economic growth, is similar. The next update will bring the July data (on Friday). The markets expect similar numbers as in June, which would again confirm the immunity of labor markets to the adverse environment. The most important issue for next week will be if the markets have already calmed down or if spread widening continues, as well as concerns about the subsequent impact on financial markets and the economy. From the current perspective, we see the risks from the macro releases as spread asymmetrically. While positive surprises have a limited chance of relieving markets, negative surprises could add a lot to the nervousness. All in all, it looks like another volatile week ahead.

*Veronika Lammer, [veronika.lammer@erstebank.at](mailto:veronika.lammer@erstebank.at)  
Rainer Singer, [rainer.singer@erstebank.at](mailto: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	4.25		5.36		4.32	4.78	1.367	
Sep-07	4.00	5.25	4.35	4.39	5.20	5.29	4.50	4.80	1.40	1.369
Dec-07	4.25	5.00	4.35	4.52	4.90	5.13	4.60	4.70	1.37	1.372
Mar-08	4.25	4.75	4.30	4.57	4.70	5.00	4.70	4.70	1.33	1.374
Jun-08	4.25	4.50	4.30	4.52	4.40	4.94	4.70	4.70	1.33	1.376

## Croatia

### **Foreign debt growth moderating**

According to the preliminary debt data for June, foreign debt stood at EUR 30.5bn, +10.2% y/y, confirming the mild moderating trend seen since the beginning of 2007. Banks' foreign debt declined by approximately EUR 100mn, proving that in the current environment of rising global interest rates and with the marginal reserve requirement at 55%, incentives for borrowing abroad are few. On the other hand, corporate sector debt increased by EUR 100mn. With the y/y growth rate at 26.3%, the corporate sector remains the main foreign debt generator. June also brought a higher than usual contribution from the public sector, as the city of Zagreb issued a municipal Eurobond abroad, resulting in a EUR 210mn increase in June (still leaving the y/y comparison virtually flat at +2.1%). For the rest of the year, we expect foreign debt growth to remain broadly unchanged, which would reduce pressure on international indebtedness indicators, helping them to maintain their stabilizing trend.

### **Second spot FX intervention in two weeks**

After the last intervention, appreciation pressures soon piled up again, resulting in an exchange rate below 7.27 and another intervention by the CNB in the amount of EUR 67.9mn. This latest intervention helped the exchange rate to stabilize in the interval 7.28-7.29. On the other hand, money market rates gradually decreased towards 'normal' levels (having remained elevated for almost a month). A record-high reverse repo auction (HRK5.9bn) and two FX interventions (injecting approximately HRK 1bn in new liquidity) have calmed the market. The pure kuna bond market remained flat, while FX-linked bonds moved with the benchmark euro market. A similar trend can be expected for the coming weeks, with rather poor turnovers continuing.

*Alen Kovac, akovac2@erstebank.com*

## Czech Republic

### **Rate hiked by 25bps**

The rate setting meeting was the most important event last week. The CNB acted just as we expected and hiked the key rate by 25bps, so that it now stands at 3% - still low by world standards. The voting was clear, 6:1, although the alternative voted on was not the "keep'em quiet" scenario, but a more hawkish proposal of 50bps hike (according to Governor Tuma, the proposal was "thoroughly debated"). The voting on the alternative of 50bps was probably brought up because of the new inflation prognosis, which painted a considerably gloomier inflation future than the one in April.

The headline inflation prediction was upped considerably, as was the core (MP-relevant) one. Whereas the April prognosis saw core inflation hovering in the lower part of the tolerance band (3% - 1%), the July one sees it mostly in the upper half of that band (at the monetary policy horizon of 12-18 months).

### **Inflation on upswing**

Consumer inflation is headed up: Whereas the April prognosis saw a rise of only 2.7-4.1% in December 2008, the recent prognosis sees it at 3.5-4.9% (which is also the forecast for June 2008 headline inflation). The core inflation is projected to hit 2.6-4.0% in June 2008 (a roughly 50 basis points difference against the April prognosis) and some 3.0-4.4% six months thereafter, also a notable upside correction against the previous forecast. This is in line with the upward revision of the GDP forecast (for 2007 and mildly so for 2008) - 2007 should see GDP grow by 5.5-6.7%, according to the CNB.

The new prognosis is not entirely surprising, given the nature of the data that has been coming in since April. The weaker CZK has surely played a role in the latest prognosis. According to Tuma, it calls for a "consistent rise in rates" (in contrast with a "gradual" rise in April). However, he declined to comment on when such a rise will happen or the extent of the next step. The new prognosis sees the real economy as more inflationary

in 2007 than the earlier prognosis did. The labor market was mentioned by Tuma as one potential pro-inflationary risk.

## **CZK back to strengthening trend**

The koruna instantly responded to the hike by strengthening towards 28.05 CZK per EUR; it strengthened further still afterwards. Our outlook did not change much in light of the recent development. We expected the hike, as well as the hawkish prognosis. We anticipate one more hike by the end of 2007 (in the last quarter or at the immediate beginning of the next year). However, this critically depends on the CZK strengthening in the direction of 27.40 towards the end of 2007. Should this not materialize (the CZK is one of the "uncertainties" of the prognosis, according to Tuma), we could be in for quite a hiking spree.

As for next week, no significant data releases are scheduled.

*Martin Lobotka, mlobotka@csas.cz*

## **Hungary**

### **Central bank kept base rate on hold**

After the unexpected 25bp rate reduction in June, the Monetary Council kept its base rate unchanged (7.75%) last Monday. At the press conference, Governor Simor said that a 25bp rate reduction had also been an option. However, the final decision was relatively unanimous. The main points of the council's statement are as follows. (1) The council still sees the mid-term inflation target of 3% as reachable, while the danger of inflationary expectations diverging from the CPI target has decreased. (2) Uncertainties exist around the interpretations of labor market data; wage growth in the private sector is still higher than productivity increases, even after excluding the distortions related to changes in the administrative environment. (3) The council sees room for further rate cuts. However, the current uncertainties around the international and domestic economic outlook demand a cautious and gradual approach.

All in all, the July decision has basically reflected the council's more cautious stance, in line with our expectations. The communication of the decision was more unanimous, concentrating rather on mid-term economic trends, instead of some short term-based 'noise' indicators. We expect the next rate cut to be carried out in August. At that time, the decision could be based on more detailed information, due to the upcoming Quarterly Inflation Report. However, please note that the current turbulence on capital markets increases the likelihood of a "hold" decision next month, too. Thus, summarizing the base rate outlook, we expect one 25bp cut by the end of September, while the bulk of the reductions should come in the last quarter of 2007.

### **Forint on weakening path**

The largely favorable market sentiment that characterized the recent period turned in the opposite direction last week. The forint suddenly weakened in a relatively short time, approaching the 253 EUR/HUF level. The main reasons for this were the worsening market sentiment and decreasing global risk appetite, based on the current uncertainties around the US subprime credit market as well as the US economic growth outlook, which led to spectacular falls in US and global stock markets. In addition, unfavorable economic news has again arrived from Argentina, making the sentiment on emerging markets even more unfavorable.

We expect the forint to remain vulnerable next week, driven by changes in international sentiment. Even further slipping of the exchange rate cannot be ruled out. However, our view is that, based on the still wide interest rate differential, any weakening of the forint should not be catastrophic.

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



## Poland

### ***New inflation prognosis sees brisker price growth in coming two years***

The central bank is still rather optimistic with regards to the prospects for economic growth, foreseeing GDP expansion of 6.5%, 5.5% and 5.6% along the projection horizon. The research team still sees the risk of inflation moving in the upper half of the tolerance band in 2008-09. However, no overshooting of the tolerance band is expected. Inflation estimates for this year and the next were revised upwards; however, the figure for 2009 was pushed downwards a notch. The projection calls for inflation hovering around 2.8% in 2007 (the middle of the interval where inflation should stay with 50% probability), 3.1% in 2008 and 3.3% in 2009.

### ***CB maintains hiking bias, but perceives risks of overshooting target in MT as decreasing***

The central bank opted to leave the key interest rates unchanged at its July meeting, maintaining the reference rate at the level of 4.50%. This decision was in line with our expectation and hardly surprised the market, as the consensus gradually converged towards the unanimous expectation of 'no change', given the relatively soft rhetoric from central bankers. The accompanying statement said that, "in the medium term, the probability of inflation running above the inflation target decreased to a certain degree, due to the previously implemented monetary policy tightening, though it is still higher than the probability of inflation running below the target." We interpret this as a signal that the council still maintains its hawkish bias, although it appears that the risks to inflation are gradually weakening as the effect of previous hikes shows up. Among the hawkish factors, the MPC still anticipates economic growth exceeding the potential in the coming quarters. Moreover, it sees a possibility of a further build-up in wage pressures and, consequently, inflationary pressures. However, factors that could help to cool the increase in price level were also mentioned, including productivity rises, low imported inflation from abroad and globalization.

All in all, the statement still makes further monetary policy tightening likely, although the tone has become softer in comparison to the previous month. We believe that the still robust domestic demand and tightening labor market in an environment featuring a positive output gap represents a threat to inflation. Hence, we expect another two hikes by the year-end, bringing the key rate to the level of 5.0%. The next move should come in August-September, while we lean slightly more towards the latter month. The reason is that an important input for decision making - GDP data - will be officially out only on the day when the central bank decides on rates. However, in the case of strong data being published in the coming month, an earlier move would become likely. The guidance from MPC members is blurred at present. While dovish-leaning Miroslaw Pietrewicz surprisingly stated that a hike in August cannot be ruled out, fierce hawk Halina Wasilewska-Trenkner asserted that the council was in a comfortable position, as inflation may be around the target in the next 2-3 months.

### ***Polish assets under pressure, due to global turbulence***

Both the zloty and bonds were visibly affected by the jitters on global markets over the past week. Rising risk aversion, widening credit spreads and a drop of the equity markets are just a few of the factors reinforcing investors' nervousness. This makes sentiment towards the region less conducive. The zloty fell by over 1.5% w/w and, technically, an extension of the weakening trend is in the cards. Spreads on government bonds against the Eurozone widened by 20-30 points across the curve this week. Events in the US are critical for further developments. If the gloomier sentiment towards the region persists, Poland will not be spared, and the threshold of 3.84 EUR/PLN (and 3.86 thereafter) may be attacked. Domestically, no major events are scheduled. In the background, the unstable political scene is in focus, with politicians using the threat of early elections on a daily basis (although the latest statement from the PM is that the coalition has not yet fallen apart). This does not have a major influence on trading, in our view. However, if the final decision on holding snap polls comes during the period of rising risk aversion, it could hurt Polish assets.

*Maria Feherova, MFeherova@csas.cz*

## Romania

### **Romania - strategic partner for Ford in Europe**

After 72 years, Ford is returning to Romania. Ford plans to take over the former Daewoo plant in Craiova. The acquisition will mark the direct entry of a second major carmaker onto the Romanian market, after Renault acquired the Dacia plant in Mioveni (1999). It will also bring about the complete transformation of the area. The takeover of the Daewoo plant by Ford will have a similar effect on the Oltenia region as Renault had in Mioveni (Renault brought with it some of its traditional suppliers). With its takeover bid for the Automobile Craiova plant, Ford has committed itself to making direct investments worth EUR 675mn and boosting the number of employees to around 9,000 (compared with 4,000 at present) in the coming years. Ford plans to reach a vertical integration of 60%, which means that more than half of the vehicles components will be produced in Romania. The value of investments expected for Craiova over the coming period depends on a number of factors, such as the price of land and the proximity to main clients. Taking into consideration Ford's intention to boost the number of employees to 9,000, the unemployment rate in Craiova should witness a significant decline over the coming years. According to the privatization calendar, the transaction should be completed by September 1, 2007. The takeover of the Daewoo plant by Ford will have a positive influence on Romania's economic growth by boosting exports and reducing the current account deficit. We expect the car industry's contribution to exports to be worth EUR 4.5-5bn in 2010-2011. Furthermore, the automotive components industry has good prospects; after construction, this is the most dynamic sector of the Romanian economy (having posted an increase of 21.2% in 2006). More than 120,000 employees work in this area of business, with this sector generating 4% of GDP in 2006.

### **Central bank continued to attract liquidity at interest rates below key rate**

The CB continues to drain liquidity in two-week transactions; the amount absorbed on Monday was RON 2bn (EUR 0.64bn), at an average accepted interest rate of 6.54%. The minimum interest rate bid and accepted was 5.50%, while the maximum interest rate accepted was 6.85% and the maximum bid 7.00%. Only 20 banks took part in this auction, as compared to 29 last week. The overall level of liquidity was significantly lower, due to the beginning of the mandatory reserves period - RON 2.1bn (EUR 0.67bn) this week, against RON 6.4bn (EUR 2.4bn) last week. Very short-term interest rates increased after the auction and ON rates (offered level) stood around 7.10%. The CB is signaling its intention to reduce interest rates in order to stop the fast RON appreciation, as the average accepted rate at each of the last three repo auctions was below the key rate of 7.00%. The central bank board will hold its monetary policy meeting to approve the quarterly inflation report on July 31. According to our estimation, the CB will further cut the key interest rate by 25bps to 6.75%, in light of the drop in core inflation of 0.04 pp in June. If the CB keeps the key rate flat at 7.00%, this might signal inflationary pressures and, in a further step, could increase the annual inflation rate forecast from 3.70% to a level above 4.00%. Despite this, we are confident that the CB will achieve its inflation target of 4.00%.

### **RON faced regional correction this week**

The national currency depreciated by 1% on Thursday, trading at 3.16, in a regional correction amid investors' diminishing risk appetite towards some emerging European markets. The national component of this sudden correction was insignificant and the average ON interest rates remained unchanged at 7.10%. August sees important FX inflows from Romanians working abroad that return home for a summer holiday. EUR sales made through commercial banks' exchange offices usually increase by 70% in late summer. We estimate that 3.12 is an important support level, while the resistance level for next week could be 3.22, depending on whether the CB cuts the key interest rate.

*Eugen Sinca, [eugen.sinca@bcr.ro](mailto:eugen.sinca@bcr.ro)  
Cristian Mladin, [cristian.mladin@bcr.ro](mailto:cristian.mladin@bcr.ro)*

## Slovakia

### ***Fitch changed Slovakia's rating outlook to positive***

Fitch Ratings revised the outlook for Slovakia's long-term foreign currency rating (currently 'A') from stable to positive. The agency suggested that an actual upgrade is possible once Slovakia gets a go-ahead for euro adoption. While Fitch said that EMU entry is not certain yet, it sees a higher probability that Slovakia will meet the 2009 target than not (we see a 75-80% chance of a timely euro adoption). Successful evaluation of euro criteria next spring would probably lead to upgrades by other rating agencies as well.

### ***Koruna gains on Monday prompted central bank verbal intervention***

The outlook upgrade prompted koruna strengthening on Monday, when the unit briefly firmed to below the 33.0 EUR/SKK mark. That provoked the central bank into making a verbal intervention, saying that the koruna was perceived as too strong. Also, the central bank said that it would use all of its measures to fight excessive volatility of the currency, just as it did in the past. However, CB action is unlikely at the moment, since the koruna came under selling pressure during the rest of the week amid rising risk aversion. Since Monday, the unit lost 1.2% to 33.40 EUR/SKK (as of noon on Friday). In the medium term, we still expect koruna appreciation (32.5 EUR/SKK at year-end). We see a higher risk of CB intervention only in the range of 32.7-32.9 EUR/SKK, above the former lower boundary of the ERM2 range (which was at 32.69 EUR/SKK).

### ***CB to keep rates stable***

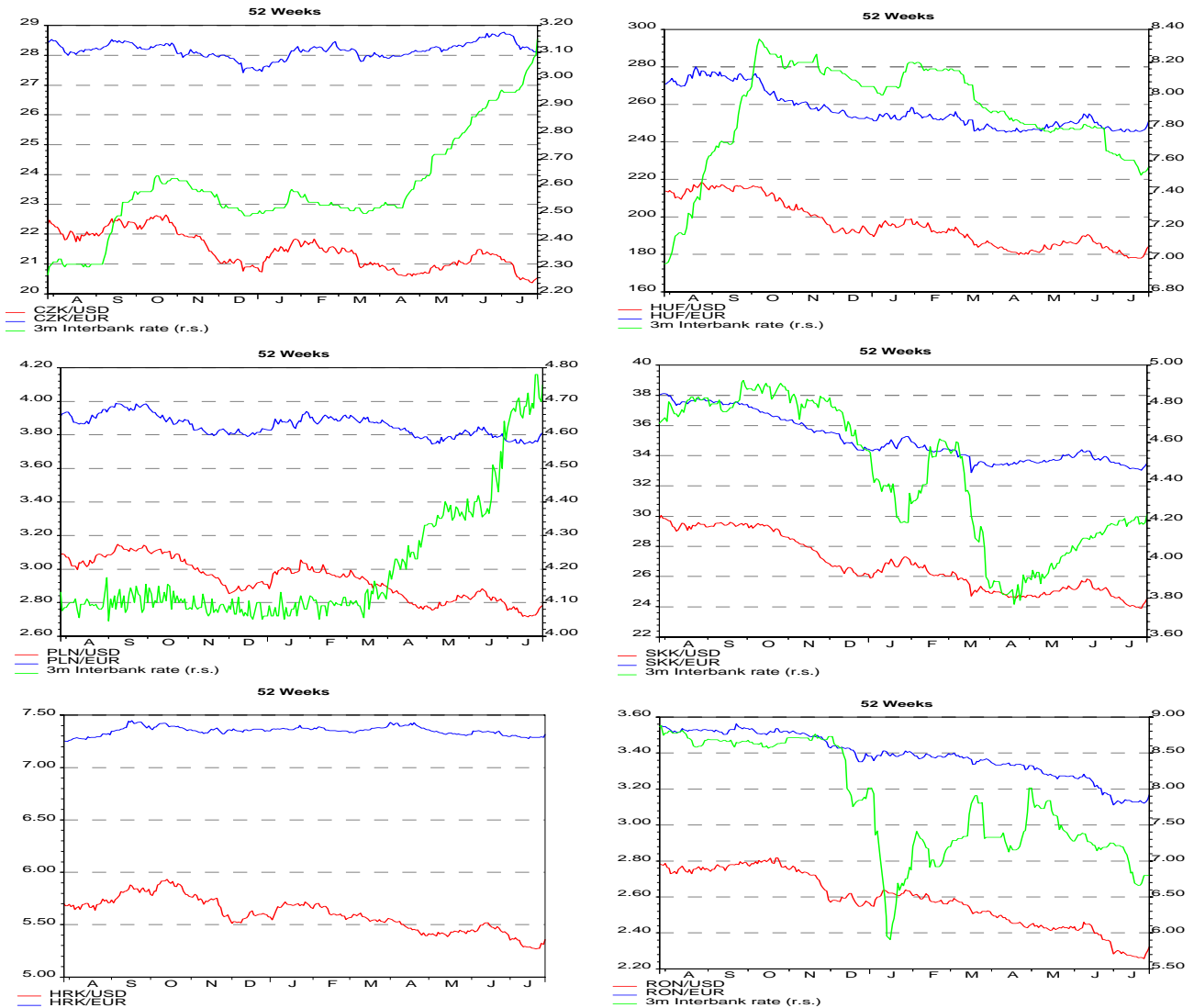
The main event next week will be the central bank meeting on Tuesday, at which we expect no change in interest rates (the headline 2W repo rate is at 4.25%), in line with the market. The koruna is weaker than it was at the time of the central bank comments. Also, due to strong economic growth and inflationary risks, we do not expect the central bank to bring interest rates below the level of European rates, which are expected to reach the level of Slovak rates only in a few weeks (most likely in September). The most likely scenario in our view is that the NBS will wait until the ECB hikes interest rates once more in the autumn, after which the NBS will basically follow the path of the ECB (our core scenario is flat rates until the end of the year).

*Michal Mušák, [musak.michal@slsp.sk](mailto:musak.michal@slsp.sk)  
Mária Valachyová, [valachyova.maria@slsp.sk](mailto:valachyova.maria@slsp.sk)*

# Appendix Charts

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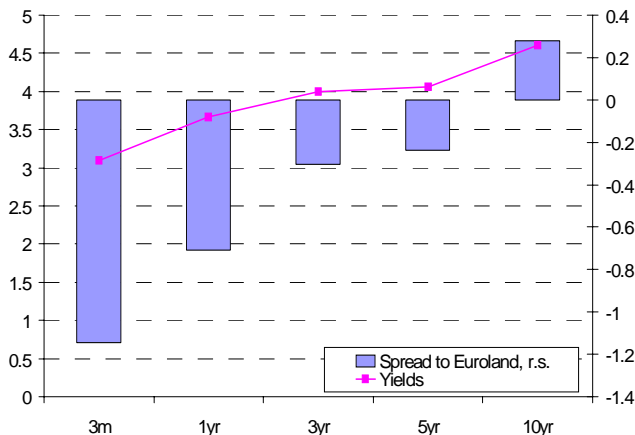
## Exchange rates and interest rates (52 weeks)



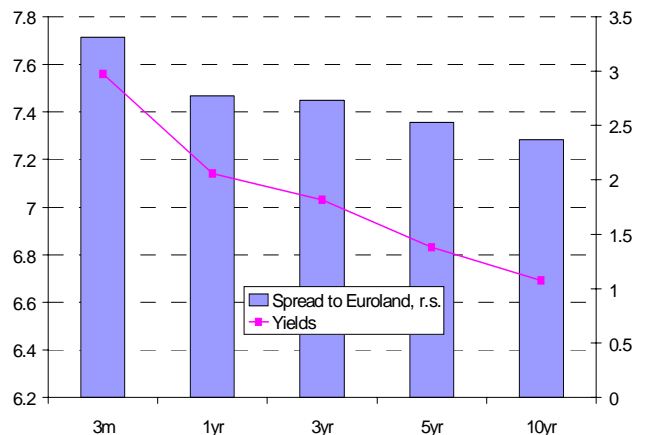
Source: Datastream

## Benchmarks

### Czech Republic



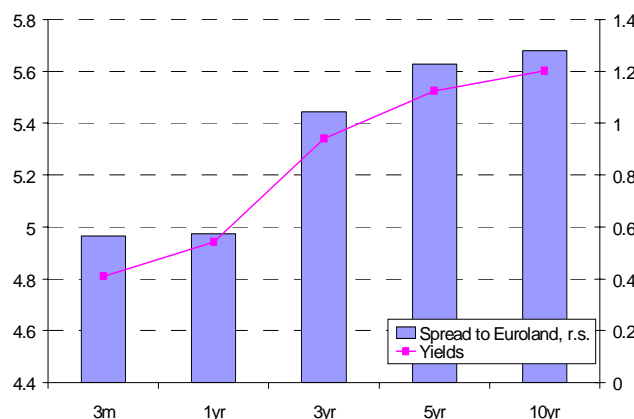
### Hungary



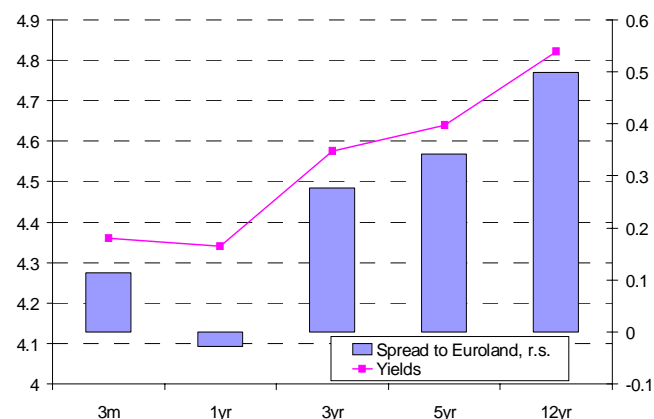
# Appendix Forwards

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## Poland



## Slovakia



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A-1010 Vienna, Austria. Tel. +43 (0)50100-ext.



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# 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  
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  
Thomasz Kasowicz (Equity) +48 22 3306251  
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 Pflingstl +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 Wooloughan +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 Kryszynski (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