

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** 1H07 trade balance deficit up 9.6% y/y
- **Czech Republic:** We revise rates trajectory up
- **Hungary:** Market jitters continued
- **Poland:** Political crisis continues, markets await next Parliamentary session for resolution
- **Romania:** Investor interest in Romanian treasury bills continued, despite declining yields
- **Slovakia:** Inflation delivered positive surprise in July

Overview

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Croatia:

- Labor force survey unemployment rate 11.2%
- 1H07 trade balance deficit up 9.6% y/y
- Money market stable



Czech Republic:

- We revise rates trajectory up
- Why are we below the curve?
- How to play it?
- New macro forecast



Hungary:

- July CPI and 2Q07 flash GDP figures next week
- Market jitters continued



Poland:

- Political crisis continues, markets await next Parliamentary session for resolution
- Market to eye inflation and wage data next week, but global sentiment still dominant factor



Romania:

- Nokia - made in Romania
- Investor interest in Romanian treasury bills continued, despite declining yields
- RON remained unsupported, losing interest rate advantage
- Romanian money market flooded with liquidity, despite NBR sterilization
- Inflation up in July



Slovakia:

- Foreign trade reduced chances for double-digit 2Q GDP growth
- Inflation delivered positive surprise in July

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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	28.13	-0.4%	1.6%	-1.9%			
	3Y (yield bp)	3.96	-2	0	74	-37	-49	-66
	10Y (yield bp)	4.58	-2	-12	87	19	11	-23
Croatia	EUR/HRK	7.31	0.0%	-0.3%	0.6%			
	3Y (yield bp)	4.66	21	5	3	29	1	66
	10Y (yield bp)	5.32	-2	-23	n/a	92	87	n/a
Hungary	EUR/HUF	250.11	0.3%	-1.6%	0.5%			
	3Y (yield bp)	6.96	-9	16	-59	263	229	368
	10Y (yield bp)	6.64	-7	7	26	225	198	276
Poland	EUR/PLN	3.77	0.4%	-0.1%	1.6%			
	3Y (yield bp)	5.34	1	-7	69	101	90	78
	10Y (yield bp)	5.60	1	7	42	121	108	124
Romania	EUR/RON	3.18	-0.3%	-1.4%	6.4%			
Slovakia	EUR/SKK	33.46	-0.2%	-0.3%	3.0%			
	3Y (yield bp)	4.58	-2	-6	20	27	7	50
	12Y (yield bp)	4.82	0	-11	51	46	27	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. (%)
		04/06/07	6m Bribid/ 6m Euribor	3,9/ 4,28%			1.0%	5.6%	32.8	3.2%	6.4%
12	short EUR/SKK		EUR/SKK	33.92	33.55	1.10%					
		07/06/07	12m Pribid/ 12m Euribor	3,21/4,47%			0.8%	4.6%	26.8	4.7%	4.7%
13	short EUR/CZK		EUR/CZK	28.39	28.10	1.03%					
	buy SKKFRA 9*12	16/07/07	SKKFRA 9*12	Spread	Spread		24bp	-	Spread	30bp	-
14	sell EURFRA 9*12		EURFRA 9*12	30bp	24bp	24bp			0		

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%

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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	28.1		7.30		252		3.78		3.18		33.5		3.00	3.50	7.75	4.50	7.00	4.25
Sep-07	28.0	28.1	7.40	7.40	251	254	3.80	3.78	3.20	3.19	33.1	33.5	3.25	3.50	7.50	4.75	7.00	4.25
Dec-07	27.6	28.1	7.40	7.40	253	256	3.72	3.79	3.18	3.21	32.5	33.5	3.25	3.50	6.75	5.00	6.75	4.25
Mar-08	27.3	28.0	7.40	7.40	255	259	3.70	3.78	3.15	3.22	32.4	33.5	3.50	3.50	6.50	5.00	6.75	4.25
Jun-08	27.1	27.9	7.25	7.25	255	259	3.69	3.78	3.12	3.24	32.5	33.5	3.50	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	3.24		7.45		4.86		6.59		4.37		4.57	5.32	6.70	5.60	4.77
Sep-07	3.30	3.38	7.40	7.38	5.00	4.98	6.84	6.88	4.30	4.39	4.55	5.20	6.40	5.50	4.70
Dec-07	3.40	3.74	6.80	7.00	5.20	5.26	6.54	6.70	4.30	4.37	4.80	5.10	6.10	5.45	4.70
Mar-08	3.55	3.94	6.50	6.70	5.30	5.47	6.44	6.49	4.30	4.24	4.90	5.00	6.00	5.55	4.80
Jun-08	3.60	4.02	6.40	6.70	5.40	5.48	6.35	6.43	4.30	4.49	4.80	4.90	5.90	5.65	4.80

Long-term forecasts

GDP growth (%)	2005	2006	2007f	2008f
Czech Republic	6.1	6.4	5.4	4.1
Croatia	4.3	4.8	5.4	4.7
Hungary	4.1	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	2.5	2.7	5.2
Croatia	3.6	2.0	3.4	3.0
Hungary	3.3	6.5	5.3	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	-1.5	-3.0	-3.5	-3.7
Croatia	-6.4	-7.8	-8.2	-7.9
Hungary	-6.8	-5.8	-4.4	-4.2
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	-2.6	-3.0
Hungary	-7.8	-9.2	-6.0	-4.5
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	Aug-13	Industrial output (June, %)	0.098	7.80%
	Aug-14	PPI (July, %)	4.50%	4.40%
	Aug-17	Retail sales (June, %)	5.20%	6.5%
Croatia	Aug-16	CPI	2.4% y/y	-
Hungary	Aug-14	Flash 2Q GDP	2.4% y/y	2.5% y/y
	Aug-14	July CPI	8.3% y/y	8.4% y/y
	Aug-17	June Nominal wages	7.1% y/y	7.3% y/y
Poland	Aug-13	Current account (June, EUR mn)	EUR -770mn	EUR -800mn
	Aug-14	CPI inflation (July, % y/y)	2.3%	2.4%
	Aug-16	Corporate wages (July, % y/y)	9.0%	9.4%
Romania	Aug 16	Current account deficit - June	EUR 1,500 million	
Slovakia	Aug-14	Flash 2Q GDP	9.1%	9.7%
	Aug-16	July HICP	1.2-1.3%	n.a.

*Sources: Bloomberg, Reuters

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast	
Czech Republic		No auction scheduled						
Hungary		Aug-14	Aug-22	Nov-21-2007	-	HUF 25bn	7.35%	
		Aug-16	Aug-22	Aug-24-2010	6.25%	HUF 75bn	6.95%	
		Aug-16	Aug-22	Nov-24-2023	6.00%	HUF 20bn	6.40%	
Poland		No auction scheduled						
Romania		Aug-16	Aug-20	10Y	6.75%	100,000,000	6.8%	
Slovakia		No auction scheduled						

Major Markets

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Major markets

ECB added extra liquidity

Overnight rates increased on Thursday morning, on the back of the search for liquidity in USD. The ECB injected liquidity of EUR 95bn at 4% to bring short-term interest rates down again. The Fed followed suit with USD 12bn and other central banks joined the club. This incident highlights the risk of a "credit crunch" in the US and the risk that this could spread to other economies. As part of the ECB's extra liquidity was converted to USD, the EUR/USD exchange rate lost some ground. Government bonds were strongly supported and showed yield drops of up to 10bp. As the shock of yesterday's events will fade only slowly, the government bond markets should remain at high levels. At the moment, the focus is mainly on the developments on the credit and stock markets, so economic data will have only a minor impact. The main risk for a recession lies in the US of course. However, although European economies are in a phase of strong growth, a serious downturn on the stock markets and a more restrictive lending policy would have dampening effects on European economies, as well. The chances for our scenario of an end to the rate hiking cycle at 4.25% have therefore risen significantly. GDP data for the main economies and Euroland will be released next week. We expect an unchanged growth rate of 0.7% q/q.

Rising probability of rate cut in 4Q

The FOMC statement after the rate decision on Tuesday was only a little more dovish than the June statement. It recognized that "...downside risks to growth have increased", but still referred to the inflation bias. As the fear of a credit crunch is evolving, the standpoint of the Fed could change over the next few weeks. For December, Fed Fund Futures even show an expected rate of 4.8%. The whole yield curve between two and ten years shows a spread of +35bp. Although this seems overdone, we still expect one rate cut by the end of the year. Next week's data round will start with retail sales on Monday. A rebound after the drop in May is expected, but surprises could again be on the downside. More attention will be paid to consumer prices, due on Wednesday. The core rate is expected to stay unchanged.

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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	4.41		5.50		4.35	4.74	1.370	
Sep-07	4.25	5.25	4.35	4.56	5.20	5.36	4.50	4.80	1.40	1.371
Dec-07	4.25	5.00	4.35	4.53	4.90	5.08	4.60	4.70	1.37	1.374
Mar-08	4.25	4.75	4.30	4.63	4.70	4.95	4.70	4.70	1.33	1.376
Jun-08	4.25	4.50	4.30	4.49	4.40	4.88	4.70	4.70	1.33	1.377

Croatia

Labor force survey unemployment rate 11.2%

The 1Q07 labor force survey data surprised slightly on the downside, as the unemployment rate increased from 10.5% in 2H06 to 11.2% in 1Q07, 0.6pp lower than in 1H06. Some seasonal effects may be present in the data, as the Statistics Office started to conduct a labor force survey on a quarterly basis this year; until now, we had semi-annual frequency data. The activity rate fell to 48.2% (from 29.8% in 2H06), with the employment rate down to 42.8%. With respect to 2H06, that means approx. 60ths less employed and 6ths more unemployed. For the rest of 2007, we expect favorable labor market developments to transfer into the LFS figures, with the unemployment rate maintaining a downward trend.

1H07 trade balance deficit up 9.6% y/y

The June trade balance figures were better than expected, as merchandise exports (EUR 758mn), boosted by strong shipping related exports, recorded an 18% y/y increase. On the other hand, imports (EUR 1,547mn) stagnated y/y, increasing just 1.3% y/y. Overall, the trade balance in 2Q07 showed some improvement, especially on the export side; after the weak 1.9% y/y in 1Q07, exports grew by 16.6% y/y. Imports also accelerated in 2Q, increasing 10.7% y/y (7.9% y/y in 1Q07), which, due to a gap in absolute terms, resulted in a 2Q07 trade balance deficit increase (EUR 2,629mn) of 6.1% y/y. The subsequent 1H07 trade deficit widened 9.6% y/y to EUR 4,890mn, thus moderating from the 13.9% y/y seen in 1Q. However, imbalances in the merchandise account remain pronounced, as the export-import coverage ratio is struggling in <50% territory and is expected to continue putting pressure on the current account, which we still estimate in the 8%+ of GDP region in 2007.

Money market stable

After MM rates stabilized at the end of July, August brought no significant changes. Longer-term MM quotations remained in the 5-6% region, while O/N rates (with the start of the new obligatory reserve calculation period) again increased to above 4%. As expected, demand at the reverse repo auction increased by approximately HRK 2bn. Stable MM conditions had a favorable effect on T-bill auctions, as investor interest improved, resulting in the 364-day rate declining from 4.7% to 4.5% and a doubling of the planned T-bill issuance at the last auction. The stable MM performance supported the pure kuna yield curve - especially the longest 10Y issue, as the yield declined from over 5.5% to around 5.3%. In the past ten days, the exchange rate moved in a tight range of 7.30-7.31, in line with our expectations. As the peak of the tourist season is behind us, we anticipate more pressure on the depreciation side and the exchange rate in the 7.30-7.35 range towards the end of August.

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Czech Republic

We revise rates trajectory up

In light of our new macro forecast (see below) and the recent hawkish mood on the CNB board, we have reevaluated our forecast for Czech interest rates in the direction of a faster return to the neutral rate (4%). The minutes reading and last Friday's CNB visit persuaded us that the CNB will deliver another +25bps rate hike already in August or September at the latest. Nevertheless, as we expect CZK appreciation to 27.6 EUR/CZK by the end of the year, we think that the next rate hike (after the August one) will come only at the beginning of next year. As of end-2008, we see rates at 3.75%. The risks to our forecast are skewed upward.

Why are we below the curve?

In comparison with the market, we remain cautious, with a less hawkish forecast than the market has already priced in. The reasons: (i) In the past, there has been FX overshooting in the appreciation direction in reaction to the tightening cycle. Next, (ii) there is global risk connected with the rapid credit spread widening and sharp risk aversion increase, which could stop or even reverse the recent global tightening and

cause an appreciation of the CZK (as the CZK has a reputation as a safe haven and due to unwinding of carry trades).

How to play it?

We still see space for a downward correction on the short end of the yield curve. Our more favored strategy, however, is to short EUR/CZK. Our estimates show a continuation of the fundamental CZK appreciation. A delay would only result in a slower unwinding of carry trades (short CZK, long EM, US), which would keep the CZK from returning to its trend. If the CZK stays for a longer time out of trend on the weaker side, the small open economy pass-through would mean the following: The CNB would increase rates more (due to the high sensitivity of Czech rates to the CZK) to bring inflation down, which would knock out carry trades from the opposite side.

New macro forecast

We expect strong economic growth (5.4%) this year; the primary driver should be household consumption. We assume approval of the reform steps in our baseline scenario, which will slow consumption and GDP growth next year to 4% (by way of social spending cuts and higher VAT, which will outweigh the positive effect from the lower income tax). Inflation will accelerate to 3.9% at the end of 2007 (with the current drop to 2.3% being only temporary) and to 4.9% at the end of 2008 (with the VAT hike impact on inflation approx. 0.8pp). We have changed our end-year forecast for the CZK to 27.6. However, we still hold our long-term positive outlook on the CZK, as we see next year's close at 26.6 EUR/CZK.

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Hungary

July CPI and 2Q07 flash GDP figures next week

Regarding the fundamental outlook, July CPI and 2Q flash GDP figures should be the most influential next week. Both will be released on Tuesday morning. As for the CPI, we expect 8.3% y/y, after the 8.6% published for June. The monthly index may have decreased somewhat, based on the expected seasonal drop in food and clothing prices. GDP may have risen by 2.4% y/y in the April-June period. Positive net exports could have remained the key driver, while the y/y change in household consumption could have turned into negative territory, after the slight increase of 0.6% y/y published for the first quarter.

Looking back at this week, the budget figures did not cause any surprise. The Finance Ministry published a budget surplus of HUF 90.6bn for July, decreasing the cumulative budget deficit for the first seven months of the year to HUF 913.1bn, 59.7% of the Ministry's latest full-year deficit forecast. The July figure did not change the relatively favorable outlook for the remainder of the year. At the same time, industrial output showed an unexpected revival in June. Despite the decrease in the German IFO index, output rose 2.7% compared to May, which led to an 8.7% increase in the yearly index, offsetting the unfavorable base effect. Thus, industrial output was up 8.2% y/y in 1H07. The better than expected performance of industry in June should also have contributed to the lower than expected trade deficit, which amounted to EUR 41.2mn in the sixth month of the year, EUR 114.4mn lower than in June 2006.

Market jitters continued

Domestic markets remained nervous during the week, affected by changes in international market sentiment. Another strengthening of the forint below 250 EUR/HUF (based on the US Fed's optimistic comments on the global economic outlook) proved to be temporary. From Thursday, the forint again started to weaken, due to more unfavorable news on the subprime and credit markets. Although the fact that major central banks have together taken action to prevent liquidity drying out, global concerns over credit markets are unlikely to disappear in the near period. Greater risk aversion should affect the domestic markets negatively. Thus, movements without a clear trend are likely to continue in the days ahead.

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Poland

Political crisis continues, markets await next Parliamentary session for resolution

The turmoil on the Polish political scene does not show any signs of abating. On the contrary, each day brings a fresh dose of strong words. Junior coalition party Self-Defense voted to quit the coalition, while the League of Polish Families is staying in for now, but with demands such as the departure of Prime Minister Kaczynski. Moreover, some irregularities were found in the financial statements of the ruling Law and Justice (PiS) party. If confirmed by the Supreme Court (which is a widely expected scenario), PiS would lose subsidies from the state budget until the end of the parliamentary term. We think this could be a crucial factor, which increases the motivation of PiS to seek the early termination of the current term and tips the scales toward snap polls. The PM would have to weigh the risk of being pushed into the opposition (as opinion polls strongly favor opposition party Civic Platform as the potential winner) against the alternative of staying in the unstable coalition and risking further deterioration in the support from the electorate. The post-holiday session of Parliament (August 22) should provide an answer to this dilemma.

Market to eye inflation and wage data next week, but global sentiment still dominant factor

Polish assets remained in the grip of global sentiment and risk aversion developments. In the first half of the week, the situation was relatively conducive, allowing the zloty to post gains and shoot towards 3.76 EUR/PLN. Bonds remained stable. However, the turbulence on major markets sparked by news concerning BNP Paribas and renewed subprime mania also hit Poland. The zloty weakened only slightly (to above 3.78 EUR/PLN), but the impact was more visible on bonds, where the risk spread against Eurozone bonds widened by 10-20 basis points across the curve over the week. Domestic data also failed to provide support for bonds, as it came out that wages in the whole economy accelerated more than expected, to 8.9% y/y from the 7.1% y/y seen in the first quarter. This signals that wages outside the corporate sector sped up even more than in the corporate sector. The data should only reinforce the hawkish stance of central bankers. An important piece of the mosaic will arrive with next week's releases. We expect the inflation rate to decline to 2.3% y/y from the 2.6% witnessed in June. Base effects will be the main factor to thank (termination of the Internet effect). Another crucial release from the viewpoint of monetary policy is on wages in the corporate sector, where we see space for a mild slowdown to 9.0% y/y, from 9.3% y/y in June. This is due to the fact that the decline in disability pension contributions by employees in July could have eased the pressure on further wage growth to some extent (as it led to an increase in net wages). However, the overall wage dynamics will remain high and the slowdown will not be sufficient to erase the expectations of monetary policy tightening in the future. The data could at most shift market expectations on the next move from August to September (our central call).

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Romania

Nokia - made in Romania

Nokia has received the building licence for its future Romanian plant, with work due to start immediately. Production operations are scheduled to start in 1H08. The new production unit will be located in the Jucu Industrial Park, Cluj County. Nokia plans to build the plant gradually and recruit around 500 employees by the end of 2007, eventually reaching 3,500 employees. The total investment for the new production facility will amount to EUR 60mn. Suppliers of parts for mobile phones have started arriving. A Chinese firm is set to invest EUR 150mn in the "Nokia Village" at the Tetarom III Industrial Park, creating 6,000 new jobs. The Chinese firm is also interested in another investment in Cluj County, put at EUR 250mn, with the details to be confirmed next month. In September, another four firms from Hungary, Finland and Germany that are also suppliers of parts for Nokia will enter the Romanian market. We expect Nokia's total investment to reach EUR 200mn, generating labor tax inflows of EUR 59mn by 2010 and

creating up to 15,000 new jobs in the next five years. Additional infrastructure projects will be developed by 2009 in relation with Nokia's investment, estimated at EUR 133mn.

Investor interest in Romanian treasury bills continued, despite declining yields

On August 9, the MinFin organized an auction to sell 6-month treasury bills for an indicative amount of RON 100mn (EUR 31.5mn). The interest in the Romanian primary market remained high, due to the modest offer, as they bid for lower yields than at the previous 6M T-bill auction; the overall bids exceeded the intended amount by almost 5x (respectively RON 469mn, EUR 148mn). The MinFin decided to attract RON 100mn (EUR 31.5mn), at an average yield of 6.71%, down from the previous 6.83%. The cut-off rate dropped to 6.79%, from 6.88% at the last auction, below the NBR monetary policy rate. As of now, the MinFin has attracted RON 9,185mn (EUR 2,897mn) through its treasury bills and benchmark bonds, out of the RON 12,000mn (EUR 3,785mn) planned to be borrowed from the domestic primary market in 2007. For the remainder of August, the MinFin announced its intention to drain a modest RON 200mn (EUR 63mn) from the Romanian primary market through 12M T-bills and 10Y benchmark bonds (each auction having an indicative amount of RON 100mn, or EUR 31.5mn). The 10Y benchmark bond will be auctioned on August 16 and carries a fixed coupon rate of 6.75%. The average accepted yield at the last comparative auction was 6.8%, while the cut-off rate stood at 6.84%. We expect that yields will approach the 6.75% rate of the coupon, given the limited offer of domestic treasury placement instruments. The MinFin will hold a 12M discounted T-bill auction on August 22, and it is likely that the cut-off rate will near the 7.0% policy rate, as participants will start asking for higher rates, given the prospects of further hikes of the key rate in the coming quarters.

RON remained unsupported, losing interest rate advantage

The Romanian currency maintained its bearish stance from last week, as the poor regional sentiment continued to affect the RON, which even lost the support from the interest rate differentials. Thus, the RON weakened against to 3.1830 per EUR on Monday and Tuesday. However, on Wednesday, the RON posted a slight recovery against the euro, rallying to 3.1550, a two-week high, on the back of the improved regional mood, which was in turn due to the comments from the US Treasury regarding the subprime market. The RON maintained the gains against the euro in early trading on Thursday, but later took a depreciating path, dropping back to the 3.18 zone, as the credit worries regarding the US mortgage market came back to focus and limited the risk appetite of investors towards emerging markets. For next week, we expect range trading, with the 3.19 resistance zone holding. The support zone is seen in the 3.15 area, as the poor regional sentiment will probably put further pressure on the domestic currency.

Romanian money market flooded with liquidity, despite NBR sterilization

The Romanian money market remained flooded with liquidity, despite the NBR's open market operations, as the sterilized amounts were unable to counteract the surplus liquidity. In early trading on Monday, the overnight deposits were traded at 3.5/4.7% bids/asks until the NBR's regular two-week variable rate depo auction. The indicative amount announced by the NBR amounted to RON 3bn (EUR 0.9bn), one billion higher than the deposit that matured the very same day. The NBR decided to drain RON 3.5bn (EUR 1.1bn) from the Romanian money market for a maximum interest rate of 6.45%, sensibly lower than the 6.74% previous cut-off rate. As we anticipated, the interest rates demanded by the commercial banks for the 2-week tender deposits declined substantially, given the high liquidity on the domestic money market, and pushed the average accepted yield to 5.92%, while the minimum requested rate dropped to 5.13%. After the NBR's depo auction, short-term interest rates repositioned higher, approaching the key rate level. However, the recovery of the short-term rates did not last too long, as the next day the overnight interest rates were quoted for 4.2/5.3% bids/asks, which continued until the end of the week.

On Wednesday, the NBR held a 3M certificate of deposit auction for an indicative amount of RON 1bn. The NBR decided to sterilize RON 1.25bn (EUR 0.4bn) at an average accepted yield of 6.78%. The CD auction did not stir too much interest, as the

overall offer amounted to a modest RON 1.3bn and only 14 banks placed bids. The limited participation indicates that commercial banks continue to fear liquidity crunches and prefer to place their liquidities at shorter tenders. The accepted bids topped the 7.0% key rate, while the minimum demanded yields stood at 6.30%, showing some commitment from the NBR to increase the significance of the monetary policy rate. We expect that the commercial banks will raise (towards 6.5%) the yields demanded from the NBR for the regular 2-week depo to be held on Monday, as they may be encouraged by the NBR's latest comments and open market operations.

Inflation up in July

CPI grew 0.29% m/m in July, setting the annual inflation rate at 3.99%, up from 3.80% in June. The price of food went up by 0.56% m/m, with significant price increases for vegetables (+2.59% m/m) and fruits (+2.18% m/m), due to drought effects (as we had anticipated). The main driver of the non-food product increase was the price of tobacco and cigarettes (+4.24% m/m), in line with our expectations, which considered the substantial increase in excise duties. Service tariffs continued the downward trend seen in July (-0.67% m/m), helped by strong appreciation of the RON. According to our estimates, the inflation rate will increase slightly, reaching 4.20% y/y as of the end of 2007. However, this development of the inflation rate was anticipated by the central bank, and there should be no problems in attaining the annual inflation target of 4.0% \pm 1pp.

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Slovakia

Foreign trade reduced chances for double-digit 2Q GDP growth

The past week saw a number of data releases in Slovakia, which brought a mixed message. Consumer demand continued strongly in June (with retail sales up 7.5% y/y), supported by employment and wage gains. On the other hand, the production side of the economy disappointed in June. We had expected a temporary worsening of industrial production and trade balances only in July and August, with summer holidays at the key car plants. While industrial production increased by 12% y/y, it lagged the market (and our) expectations of a 15% growth rate. Also, the FT balance ended June with a deficit of SKK 4.5bn, vs. the expected SKK 0.5n, due mainly to the slower pace of exports. Hence, the market expectations for 2Q GDP growth (to be released next Tuesday) of 9-10% could be scaled down slightly. There are also downside risks to our forecast of 9.1% y/y.

Inflation delivered positive surprise in July

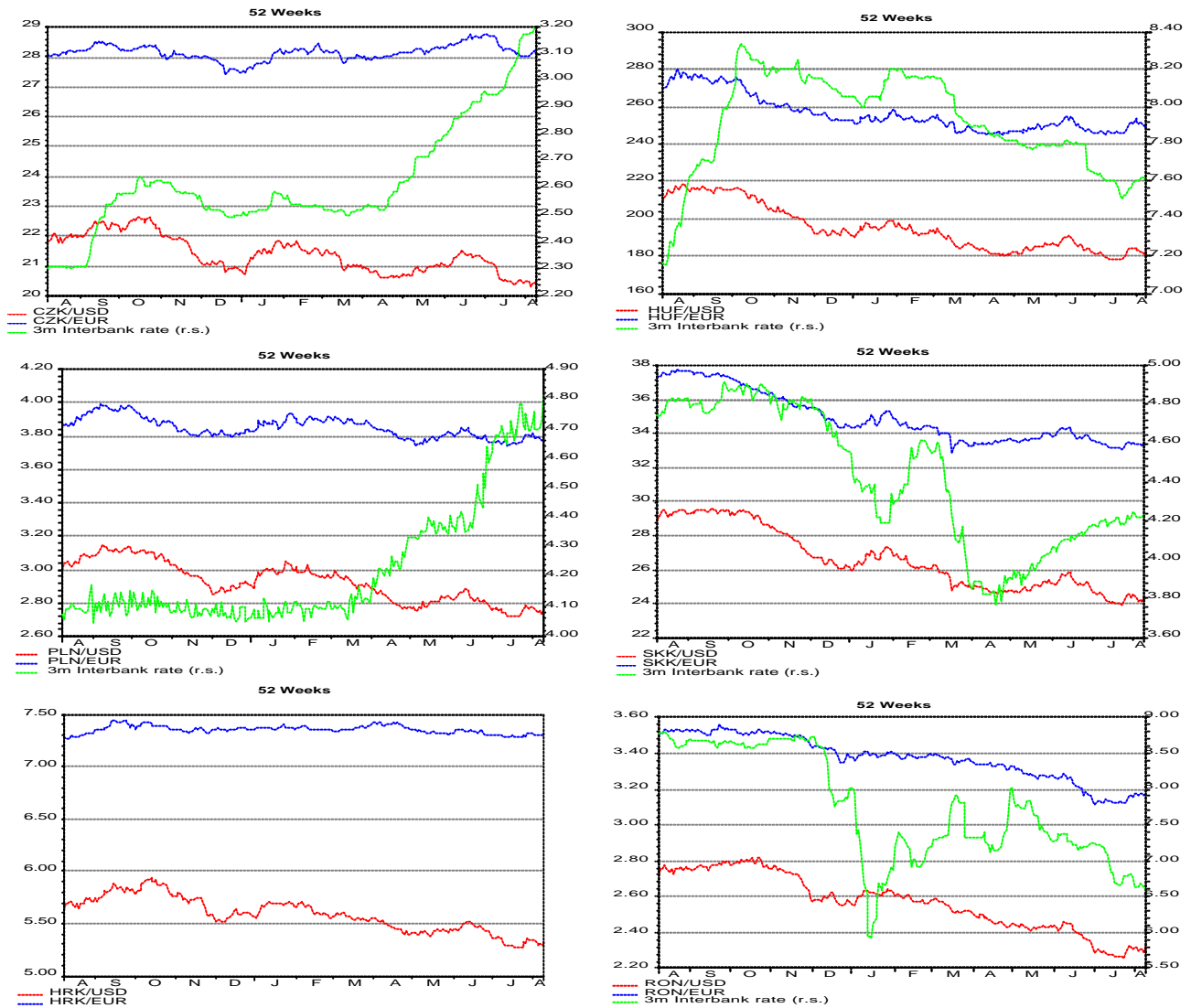
Inflation delivered a positive surprise in July, declining to 2.3% y/y, down from the 2.5% seen in June. In line with the market, we expected a smaller decline to 2.4%. The better than expected result is due to the lower prices of food, which compensated for the higher prices of fuels and healthcare. Positively, demand inflation pressures remain muted. CPI ex volatile food and fuels and imputed rents (our preferred proxy for demand inflation pressures) declined a notch to 1.3% y/y, from 1.4% in June. July HICP (to be released next Thursday) could reach 1.2-1.3% y/y, in our view, marking a decline from 1.5% in June. The slightly better than expected CPI figure confirms the positive inflation outlook and good chances for meeting the Maastricht inflation criterion, which Slovakia could start meeting already from August. We continue to expect stability in Slovak interest rates for the rest of the year.

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Appendix Charts

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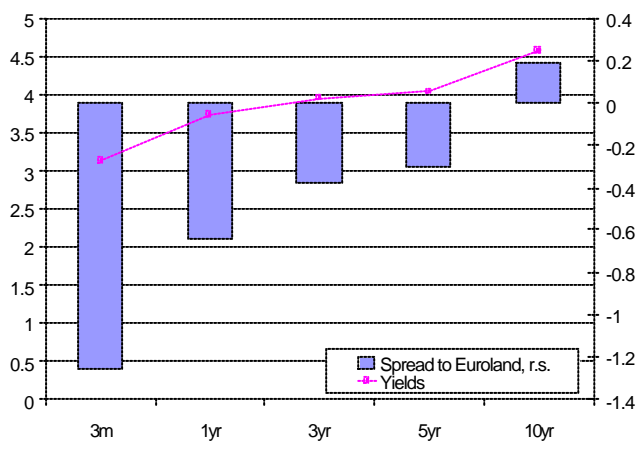
Exchange rates and interest rates (52 weeks)



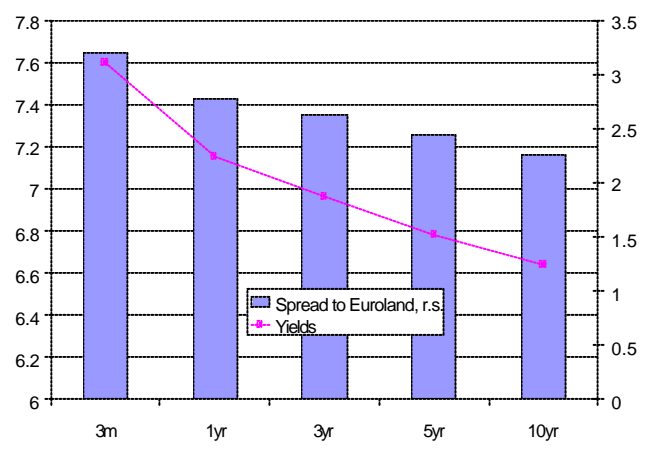
Source: Datastream

Benchmarks

Czech Republic

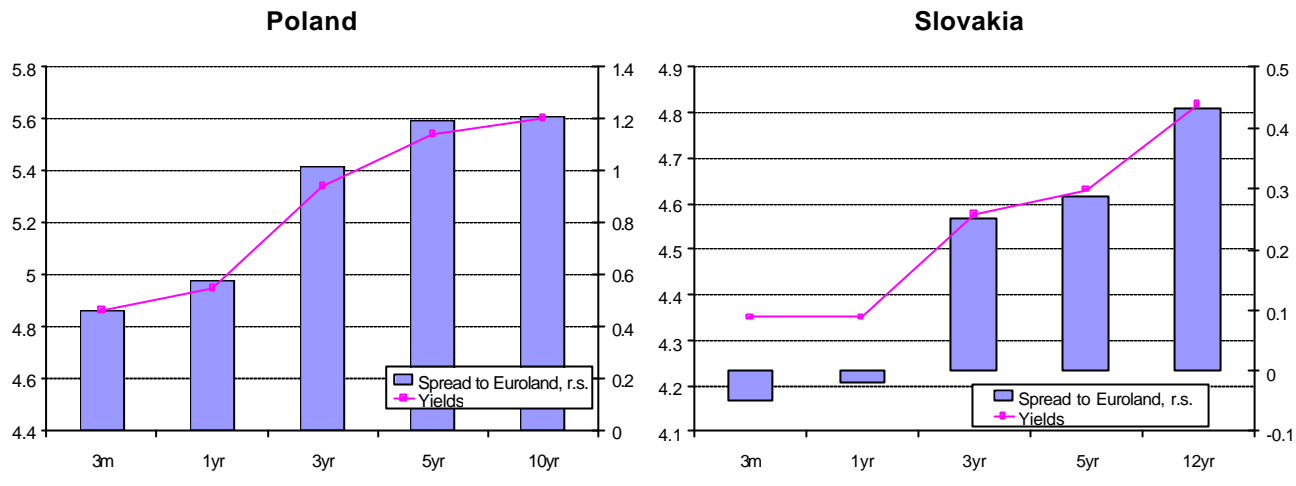


Hungary



Appendix Forwards

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