CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** July CPI inflation +2.1% y/y
- **Czech Republic:** CNB likely to keep rates on hold next week
- **Hungary:** NBH expected to keep base rate on hold next Monday
- **Poland:** MPC meeting and GDP data key local events next week
- **Romania:** Overnight interest rates soared to credit facility rate at end of reserve period
- **Slovakia:** CB to leave rates on hold

Overview

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Croatia:

- July CPI inflation +2.1% y/y
- Credit growth limits to continue in 2008
- Kuna on weakening path

Czech Republic:

- CNB likely to keep rates on hold next week
- CZK stronger than CNB anticipated
- International situation still crucial

Hungary:

- NBH expected to keep base rate on hold next Monday
- Forint remained volatile

Poland:

- Growth of industry reviving, price pressures from producers still very mild
- Macroeconomic data keeps central bankers on edge, rate hike expected soon
- MPC meeting and GDP data key local events next week

Romania:

- IT industry star among Romanian exporters in 2007
- RON recovered slightly, driven by improvement in market sentiment
- Overnight interest rates soared to credit facility rate at end of reserve period

Slovakia:

- Government approved cigarette tax hike...
- ...and pension system changes intended to gain financial resources
- CB to leave rates on hold

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

Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland current	- 1m	02/01/2007
Czech Republic	EUR/CZK	27.69	-0.7%	1.7%	-0.3%			
	3Y (yield bp)	3.82	5	0	60	-24	-42	-66
	10Y (yield bp)	4.55	11	-8	84	28	20	-23
Croatia	EUR/HRK	7.33	-0.3%	-0.5%	0.3%			
	3Y (yield bp)	4.69	-10	11	15	56	12	66
	10Y (yield bp)	5.36	0	-20	n/a	109	113	n/a
Hungary	EUR/HUF	258.64	1.2%	-4.7%	-2.8%			
	3Y (yield bp)	7.25	-11	55	-30	320	228	368
	10Y (yield bp)	6.87	-13	42	55	260	202	276
Poland	EUR/PLN	3.85	-0.1%	-1.7%	-0.3%			
	3Y (yield bp)	5.46	0	18	81	141	86	78
	10Y (yield bp)	5.78	1	42	61	152	115	124
Romania	EUR/RON	3.26	-0.1%	-4.1%	3.9%			
Slovakia	EUR/SKK	33.77	0.2%	-1.9%	2.1%			
	3Y (yield bp)	4.51	0	-8	13	42	16	50
	12Y (yield bp)	4.80	2	-5	49	55	43	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	33.76	0.48%	0.4%	1.8%	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	27.70	2.48%	2.2%	10.3%	26.8	4.7%	4.7%

Rationale at inception

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

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

Closed positions

#	Recommendation	opened	closed	P/L inc.carry
1	long: PLGB10y / 4m Euribor	16/09/2005	27/10/2005	-3%
2	short: CZGB15y / 6m PRIBID	16/09/2005	21/11/2005	5.97%
5	long: SKK/CZK	09/11/2005	20/01/2006	1.90%
3	short EUR/SKK	29/09/2005	07/02/2006	3.45%
4	EUR/PLN options	21/10/2005	28/07/2006	-2.69%
6	SKK/CZK long	23/03/2006	30/10/2006	2.16%
7	FRA 9*12 short	28/07/2006	08/11/2006	8bp
8	long HUGB 5y	13/10/2006	29/01/2006	5.70%
9	short CZGB/ long GDBR	09/01/2007	27/02/2007	1.80%
10	long CZK/EUR	27/02/2007	19/03/2007	2.30%
11	short CZGB/ long PLGB	07/03/2007	10/05/2007	5.5%
14	long SKKFRA 9x12, short EURF	16/07/2007	13/08/2007	30 bp

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

Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	27.7		7.32		259		3.84		3.25		33.8		3.00	3.50	7.75	4.50	7.00	4.25
Sep-07	28.0	27.6	7.40	7.40	255	260	3.80	3.84	3.22	3.26	33.1	33.8	3.25	3.50	7.50	4.75	7.00	4.25
Dec-07	27.6	27.7	7.40	7.40	253	262	3.72	3.85	3.19	3.27	32.5	33.7	3.25	3.50	7.00	5.00	6.75	4.25
Mar-08	27.3	27.5	7.40	7.40	255	264	3.70	3.85	3.18	3.29	32.4	33.7	3.50	3.50	6.75	5.00	6.75	4.25
Jun-08	27.1	27.4	7.25	7.25	255	266	3.69	3.86	3.15	3.31	32.5	33.7	3.50	3.50	6.75	5.25	6.50	4.25

	3m Money Market Rate										10y Govt. Yield					5y Yield
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK	RO
Spot	3.28		7.63		4.96		6.89		4.29		4.51	5.36	6.85	5.79	4.72	7.00
Sep-07	3.30	3.41	7.50	7.67	5.00	5.05	6.85	6.88	4.30	4.63	4.55	5.20	6.60	5.50	4.70	6.90
Dec-07	3.40	3.54	7.00	7.24	5.20	5.25	6.55	6.71	4.30	4.41	4.80	5.10	6.20	5.65	4.70	6.85
Mar-08	3.55	3.74	6.80	7.05	5.30	5.48	6.45	6.56	4.30	4.46	4.90	5.00	6.00	5.71	4.80	6.80
Jun-08	3.60	3.91	6.70	6.94	5.40	5.40	6.35	6.58	4.30	4.57	4.80	4.90	5.90	5.78	4.80	6.70

Long-term forecasts

GDP growth (%)	2005	2006	2007f	2008f
Czech Republic	6.5	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

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	-2.9	-3.3
Romania	-8.7	-10.3	-11.4	-11.4
Slovakia	-8.5	-8.4	-3.6	-2.4

CPI (%), eoy	2005	2006	2007f	2008f
Czech Republic	2.2	1.7	3.9	4.9
Croatia	3.6	2.0	3.4	3.0
Hungary	3.3	6.5	5.7	3.4
Poland	0.7	1.4	2.7	2.9
Romania	8.6	4.9	3.7	4.2
Slovakia	3.7	4.2	2.8	3.3

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	-3.2	-3.5
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-30	Average Real Wage	0.052	
		Central bank meeting on rates	no change (3.00%)	no change (3.00%)
Croatia	31-Aug	Trade balance	€ -900mn	
Hungary	Aug-27	CB rate decision	no change (7.75%)	no change (7.75%)
	Aug-30	July Industrial producer prices	-3% y/y	-3.4% y/y
	Aug-31	2Q07 Investments	-	-
Poland	Aug-29	Central bank meeting on rates	no change (4.50%)	+25 bp (4.75%)
	Aug-30	2Q real GDP (% y/y)	6.2%	6.1%
Romania	No data releases scheduled			
Slovakia	Aug-28	CB rate decision	no change (4.25%)	no change
	Aug-28	July producer prices	1.0% y/y	1.0% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Aug-30	Aug-31	Aug-29-2008		5 bn CZK	
		Aug-29	Sep-03	Sep-12-2022	4.70%	7 bn CZK	
Hungary		Aug-27	Aug-29	Oct-17-2007	-	HUF 30bn	7.55%
		Aug-28	Sep-05	Dec-05-2007	-	HUF 20bn	7.50%
		Aug-30	Sep-05	Oct-24-2012	6.00%	HUF 45bn	6.95%
		Aug-30	Sep-05	Feb-24-2017	6.75%	HUF 40bn	6.80%
Poland		No auction scheduled					
Romania		No auction scheduled					
Slovakia		No auction scheduled					

Major Markets

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Major markets

ECB confirmed its intention to hike in September

The ECB officially confirmed its intention to hike interest rates in September on Wednesday. This drove yields higher on the short-term segment, resulting in a flattening of the yield curve. Longer-term bond yields moved sideways over the week. Risk aversion decreased in some sectors during the week, but money market liquidity is still very tense, with longer-term Euribor rates trending higher still. Next week, the Ifo Index will be reported and is expected to slightly decline again, similarly to the Purchasing Managers Index released today. However, in contrast to the ZEW (which indicated a recession), the PMIs stayed well within territory indicating economic expansion. This should be confirmed by the Ifo Index. Preliminary consumer prices for August will be released for Germany. We expect stable prices compared to July, on the back of a lower oil price and an increase in food prices. M3 for Euroland should have stayed at elevated levels in July. The first estimate of Euroland consumer prices in August is expected to be reported unchanged at a level of 1.8%.

Markets to remain tense

Generally, concerns about the future impact of the credit market crisis will continue to be decisive for markets next week. In an environment like this, it is hard to judge what impact macro data could have. On one hand, it could be more or less ignored, as the current crisis lets the outlook start from a new basis, giving previous developments less importance. At the same time, in a highly nervous environment, markets could also react unusually strongly to even second-tier data. We tend towards the former scenario, also as poor data from the housing market today (and on Monday) and from consumer confidence on Tuesday should hardly surprise anyone. So, we think that markets will remain cautious in making any commitments, as further negative news from the sub-prime mortgage market could pop up at any time. The markets are even giving a 50bp rate cut at the September Fed meeting a high probability. There is of course a risk for this scenario, but only if the situation worsens further, in our view. So, we stick with our forecast of a rate cut in the fourth quarter, which will be triggered by continuous poor economic data. We think that the Fed wants to avoid the impression of bailing out the markets, as this would set a precedent for the future.

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

Forecasts

	Intervention Rate		3m Money Market Rate				10y Govt. Yield		FX	
	EUL	USA	EUL	Forwards	USA	Forwards	EUL	USA	EUR/USD	Forwards
Spot	4.00	5.25	4.74		5.51		4.25	4.63	1.359	
Sep-07	4.25	5.25	4.45	4.82	5.40	5.44	4.40	4.80	1.33	1.360
Dec-07	4.25	5.00	4.35	4.70	4.90	5.14	4.60	4.70	1.37	1.363
Mar-08	4.25	4.75	4.30	4.67	4.70	4.85	4.70	4.70	1.33	1.364
Jun-08	4.25	4.50	4.30	4.44	4.40	4.77	4.70	4.70	1.33	1.365

Croatia

July CPI inflation +2.1% y/y

The CPI inflation figures were among the few items to draw some market attention during these summer weeks. The July figures surprised on the downside, driven by the decline of food and beverages prices (-1.2% m/m). Clothing and footwear prices (-6.9% m/m) also fell, due to a sales season effect. Hence, on the y/y level, CPI inflation accelerated slightly to 2.1% (from 1.9% in June), while on the monthly level, a robust 0.7% decline was recorded. Prices should accelerate towards the end of the year, as some pressures are likely from the supply side. Bread prices already went up in August and other food prices (e.g. meat) could follow, due to the hot and dry summer. Coupled with the diminishing base effect, we see 4Q CPI inflation figures in the 3-3.5% region.

Credit growth limits to continue in 2008

Last week, the CNB governor announced that limits to credit growth would remain active in 2008. According to this announcement, banks would be allowed to extend credit at a 1% pm pace, meaning that the CNB would again target 12% pa credit growth, as was the case at the end of 2006 (when the CNB introduced this measure). Hence, credit growth is unlikely to deviate significantly from 12%, as excess credit activity is expensive in P/L terms (banks are obliged to purchase low-yielding CNB bills in the amount of 50% of the excess placement) and would likely require financing from abroad. Under the current monetary framework and given global interest levels, this is a scenario that banks want to avoid.

Kuna on weakening path

In recent weeks, as was broadly expected, the exchange rate slightly depreciated towards 7.32-7.33, as the peak of the tourist season is past and the pressure shifts to the depreciation side. In the coming weeks, the exchange rate should remain in the 7.30-7.35 range, with a greater likelihood for the upper part of the band. The bond market has offered very few developments, as the yield curve remained practically unchanged on very thin turnovers, as is usually the case in August.

Alen Kovac, akovac2@erstebank.com

Czech Republic

CNB likely to keep rates on hold next week

The quiet week in the Czech Republic contrasted with the uneasiness on major markets. There were no data releases this last week. As for next week, the situation will not change in any dramatic fashion. The CNB rate setting meeting might be a thrilling event, despite the fact that we think the CNB will opt to keep rates on hold after all and raise them in September. The last analyst meeting at the beginning of August (with some board members, on the occasion of the unveiling of the new inflation prognosis) strongly suggested that the CNB is bent on continuing to hike; a remark was made on there having been a thorough discussion about a 50bps hike already at the July meeting (when, after all, 25bps were added to the key rate). The only thing that kept the board from doing so was the lack of circumstances grave enough to justify such a big tightening step. The inflation prognosis was considerably more hawkish than the one from April, and pretty much all of the board members made comments acknowledging (more or less) the need to push the rates higher. At that time, we were in favor of the next rate hike coming in August.

CZK stronger than CNB anticipated

What has happened since then that made us reconsider the timing? Well, the sub-prime turbulence hitting the shores of Europe (with some investors in Europe finally coming to terms with what is really on their books) apparently forced the closure of some carry trades financed with CZK, thus sending the currency towards 27.50-27.60. This is stronger than what the CNB assumed in its prognosis (28.20), constituting an important anti-inflationary fundamental factor (especially so, should the koruna stay stronger for a longer period). The CZK aside, there are a couple of other factors (decidedly more psychological in nature) that in our view will keep the CNB from acting this month. One of them is the heightened uncertainty about the current financial conditions and the unknown response of the major banks (especially the ECB), particularly if the current conditions persist. Another could be the lower than expected inflation in July, even though this was only due to the cheaper vacation packages (apparently a seasonal issue) and, as such, does not have much of a bearing on the longer-term outlook.

International situation still crucial

As for the outlook for the currency and yields, the situation abroad will be of critical importance. A calming might lead to a renewed appetite for carry, with subsequent weakening of the CZK, while an exacerbation of the trouble would have just the opposite effect on the CZK and would also harm bonds (if the risk aversion led to a sell-off in emerging bond markets). Should the CNB decide to hike nonetheless, this would not come as much of a surprise to the market, since the market does not expect the CNB to stop the tightening anytime soon and the timing as such is not very important (even though the recent strengthening of the koruna did lower expectations for the next hikes as embodied in FRAs).

Martin Lobotka, mlobotka@csas.cz

Hungary

NBH expected to keep base rate on hold next Monday

The most watched event next week will of course be the central bank's rate setting meeting on Monday, at which the debate will once again be over a 'hold' decision or a cautious rate reduction. According to the latest polls, the majority of financial analysts do not expect a rate cut for August, and we tend to share this opinion. However, the bank will again face a dilemma, as there are some arguments for a cautious, 25bp rate reduction, which are as follows. According to the latest statistics, price developments in the economy do not seem to be 'so bad'. The core inflation rate again slowed in July, while wage increases in the private sector seem to have come to a halt in June. The disastrous 2Q GDP figures are likely to have stemmed from the dropping domestic demand, and thus do not suggest the existence of any strong price-increasing pressure in the economy. The problems related to the economic growth could instead be arguments for the council's dovish members. All in all, from the point of view of domestic fundamental factors, it would be possible to continue cautious rate reductions. However, the global turbulence and process of risk revaluation seen in the last few weeks call for further caution, especially taking Hungary's vulnerability into account. In addition, please note that the publication of the Quarterly Inflation Report, which is also due next Monday, makes the whole situation even more complicated. The point is that the expected food price increases and the currently weaker forint may point to higher inflation for 2008. (In May, the bank published a 3.6% y/y average inflation forecast for 2008). Keep in mind, however, that the August inflation forecast for 2008 will not contain the possible price-increasing effects of the weaker forint, as, according to the rules, the forecast published in the August report is made by putting the July average EUR/HUF exchange rate (which was well below 250) into the model. However, the Monetary Council could of course consider the impacts of the weaker forint on inflation in its rate decision. Summarizing the above, we are afraid that the higher inflation risks for 2008 (compared to May), the weaker forint and the currently more uncertain market environment make it impossible for the council to credibly cut rates on Monday. We still believe, however, that rate reductions will accelerate in the last quarter of the year. We thus expect the base rate to stand at 7% at the end of December.

Forint remained volatile

Forint movements this week have again totally reflected changes on global markets. In the second half of the week, as sentiment improved somewhat and the appreciation of the Japanese yen stopped for a while, the forint firmed. However, investors are expected to remain cautious with the forint, as the process of risk revaluation does not seem over yet. Apart from global events, the central bank's rate decision will be in focus next week. The expected 'no rate change' outcome could lend some support to the forint.

Orsolya.Nyeste, orsolya.nyeste@erstebank.hu

Poland

Growth of industry reviving, price pressures from producers still very mild

Industrial output regained steam and quickened to double-digit growth in July. It expanded by 10.4% y/y (vs. a mere 5.6% y/y in June), pulled primarily by activity within the manufacturing sector. This outcome was close to both our forecast (10.1%) and the market consensus (10.5%). One of the major reasons behind the better industry performance was the effect of working days. While in June this effect dampened the growth, in July it was helpful. The breakdown suggests that radio, television & telecommunication equipment (up by a respectable 42% y/y) and transportation equipment (35.6% y/y) are the fastest growing segments. Apparently, the strong domestic demand and solid demand from abroad have kept Polish industry on a track of strong growth.

Macroeconomic data keeps central bankers on edge, rate hike expected soon

The MPC will gather to discuss the key rate setting next week, with a decision to be announced on Wednesday. The majority of analysts (11 out of 18) forecasted a rate rise of 25 basis points in a poll conducted at the beginning of this month. We narrowly favor postponement until September, thus belonging to the minority on the market. The minutes from the July meeting revealed that a proposal to tighten monetary policy was on the table again. The factor that finally tilted the opinion of the majority towards a 'no change' verdict was a desire to scrutinize the macroeconomic data released over the coming month to more properly assess the risk of inflation overshooting the target. We think that the data is unlikely to motivate the central bank to abandon its vigilant mode anytime soon. Both headline and core inflation declined in July and the inflation should extend the declining trend in August, possibly peaking below the threshold of 2.0%. However, this pattern of development had been anticipated by the majority of forecasters, including the central bank. The more important fact is that inflation should again overstep the target by year-end. An ongoing source of concern is that inflationary risks stemming from the labor market have not subsided. Furthermore, the zloty suffered losses over August. In an interview this month, the moderate central banker Czekaj mentioned the possibility of a more sustainable weakening of the zloty (due to the global markets turmoil and growing current account deficit) as a potential pro-inflation factor. Some central bankers might want to increase the interest rate gap against the Eurozone to support the zloty if it does not start to firm soon.

All in all, additional monetary policy tightening can be expected soon. The reason why we have not changed our bet for September is that the decline in the inflation rate (and expectations) might provide space for central bankers to wait for the 2Q GDP data (to be released one day after the meeting) and assess ULC development in the economy as a whole before delivering another move. We forecast interest rates being hiked by a further 50bp in total by December.

MPC meeting and GDP data key local events next week

The Polish fixed income and forex market failed to move out of weak territory this week. The area of 3.84-3.86 EUR/PLN continues to represent a technical wall, fending off the attempts to extend the zloty weakening. Bonds saw additional losses, with spreads against the Eurozone stretching by 5-10 basis points along the curve, which also translated into growth of the yield level. The spread on the 10Y tenor stands at around 155 basis points, a level not seen since October of last year. We maintain that global credit woes will remain the primary driver of the emerging market vehicle. Should the shaky sentiment return, we cannot exclude further losses on the Polish curve. Locally, the MPC meeting will be the most watched event. The majority of analysts expect a 25bp hike, which is already priced in to the curve. Nevertheless, a 'no change' verdict would not trigger much excitement, as the central bankers will maintain their hawkish bias and signal that a hike is in the pipeline soon. On the data front, GDP for the second quarter represents an important event. The growth should slow to 6.2% y/y, vs. the 7.4% seen in the first quarter. The primary reason for this is slower investments, as the first quarter was exceptional, due to good weather conditions. Also, net foreign trade is likely to apply brakes to the growth, to an even greater extent than in 1Q.

Maria Feherova, MFeherova@csas.cz

Romania

IT industry star among Romanian exporters in 2007

Most Romanian IT companies are currently exporting software to the EU and North American countries and, in the coming years, their activity will focus on IT security products and automation equipment. The Romanian IT&C industry has huge potential, given the highly skilled labor force and the important business prospects after EU accession. Many important players have already opened R&D centers in Romania. In 2006, the IT&C industry reported total turnover of EUR 6.7bn, increasing by 24% y/y and by four times compared to the level seen in 2000. Software and IT services represent the most dynamic segment of Romanian industry, with annual growth rates of >40% in recent years. The contribution of the IT&C industry to GDP was around 4.2% in 2006. We estimate that exports will increase from EUR 0.79bn in 2005 and EUR 1bn in 2006 to about EUR 1.33bn at the end of this year.

RON recovered slightly, driven by improvement in market sentiment

The RON has recovered some of its previous losses, gaining 0.7% w/w, due to the improvement in market sentiment after the intervention of the largest central banks to help the global liquidity issue. The RON started strongly on Monday, opening in the 3.25 zone and trading in a narrow band of 3.25-3.26 the whole day, amid modest volumes. The rebound was triggered by the international mood, as, late on Friday, the Federal Bank surprised the market by cutting (by 50bps) the primary discounted rate to 5.75%, easing the global credit crisis. However, the very next day, the domestic currency dropped against the euro to 3.2870 at the closing of the forex session, after trading in the 3.26 zone a few hours earlier. Starting Wednesday, the RON repositioned on an upward path against the single currency, propelled by the increase in domestic short-term rates. The RON strengthened gradually to the 3.24 zone, as the attractive overnight interest rates fueled the appetite of offshore investors. High volatility characterized the forex market worldwide, as trades were conducted based mainly on investors' sentiment, rather than on economics. We maintain our previous forecasts for the week to come, envisaging the RON in the 3.20-3.30 zone, with no clear direction, as international investors have still not figured out the consequences of the US sub-prime mortgage turmoil.

Overnight interest rates soared to credit facility rate at end of reserve period

After the optimal liquidity conditions during the current reserve maintenance period, the liquidity of the domestic money market decreased substantially in the last two days of the reserve period, pushing overnight interest rates up to the 12% threshold, the level of the credit facility rate (Lombard rate). During early trading on Monday, the overnight interest rates were quoted in the 5.7/6.7% zone, before the release of the results of the NBR's deposit auction. The central bank announced a deposit auction for the indicative amount of RON 3bn at the 2-week tender, although RON 3.5bn had matured the very same day. The overall offer reached RON 3.36bn. However, the NBR decided to drain only the initially planned amount (an 89% allotment ratio). As we had anticipated, depo rate interest rates demanded by the banks increased compared to the last auction and the average accepted rate inched up to 6.89% (vs. 6.66% previously), while the minimum interest rate bid rose to 6.40% (from 6.15%). The maximum accepted interest rate topped the monetary policy rate at 7.0%. Starting Wednesday, the short-term interest rates increased substantially, with ON tenders traded for 10/13% bids/asks, as some commercial banks wanted to constitute a large part of their mandatory reserves in the last days of the current period, expecting low interest rates. Unfortunately, this scenario did not come to pass, and they were forced to borrow at higher rates in the last two days of the reserve period. The overnight interest rates stayed high until the NBR announced a repo auction for RON 500mn on Thursday afternoon to avoid a liquidity crunch. Only seven banks placed bids at the one-week repo auction, willing to pay up to 7.50%, while the minimum bids stood at 6.50%. The central bank injected the initially planned amount of RON 500mn at an average interest rate of 7.26%. The allotment reached 80% and the minimum accepted interest rate outpaced the key rate, standing at 7.10%. After the repo auction, the overnight interest rates immediately repositioned lower to 6/8% bids/asks.

We expect short-term interest rates to stabilize in proximity to the key rate next week, as a new reserve period has just started. Considering the last open market operations, the central bank proved its commitment to narrow the gap between the monetary policy rate and the effective sterilization rate. Therefore, the interest rates might come even closer to the 7.0% level of the key rate.

Melania Hancila melania.hancila@bcr.ro
Eugen Sinca eugen.sinca@bcr.ro

Slovakia

Government approved cigarette tax hike...

This week, the government approved a hike of the excise tax on cigarettes for 2008, which should add 0.3pp to the CPI inflation and 0.4-0.5pp to the HICP inflation. The magnitude is bigger than earlier CB expectations. Hence, the tax hike poses a risk for the CB's end-2008 HICP inflation target of 2.0%. Still, it should not endanger the Maastricht inflation criterion, as the expected pre-stocking (as was seen in 2006) should delay the impact to 2-3Q08. Even if there were no pre-stocking and cigarette prices grew already in January, the extent of the hike is not high enough to push inflation above the reference limit.

...and pension system changes intended to gain financial resources

The government also approved changes to the pension system that will allow people to return from private savings schemes to pay-as-you-go during a half-year period (the reverse would also be possible). It also increased the cap for the base for counting social contributions, which will lead to higher labor costs for high-earners. By raising the cap and encouraging people to leave the private pension pillar in favor of PAYG, the government intends to raise resources to fund its objectives without breaching the Maastricht criteria. Both proposals still have to be approved by Parliament.

CB to leave rates on hold

Next week is shortened, due to a public holiday on Wednesday. However, before that, the central bank is to hold a regular monetary meeting. The markets are unanimous in their 'no change' expectations, as the CB is in a waiting mode until the ECB hikes its base rate to 4.25%, which is the current level of Slovak interest rates. Also, the koruna has eased somewhat during the recent surge of global risk aversion (although it is probably still stronger than the equilibrium as seen by the CB).

Michal Mušák, musak.michal@slsp.sk

Appendix Charts

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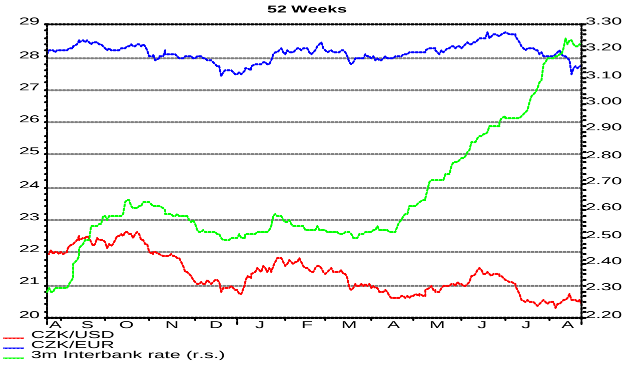
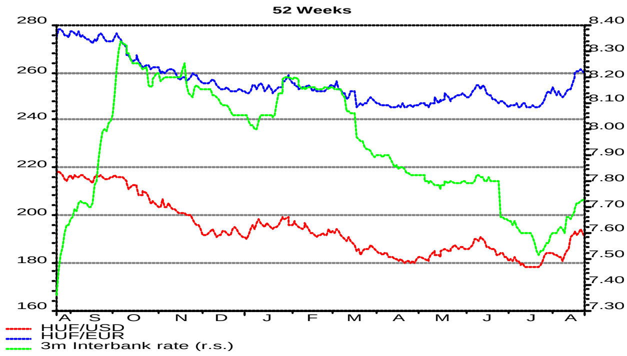
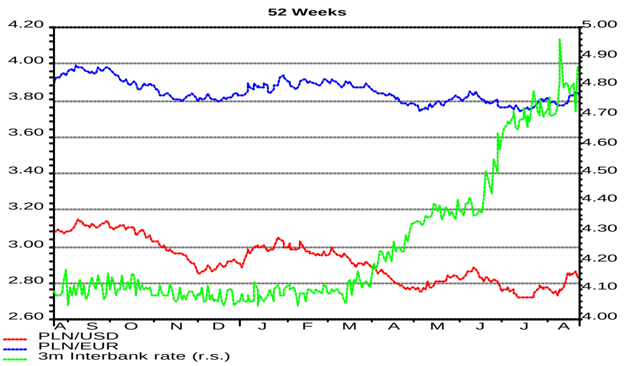
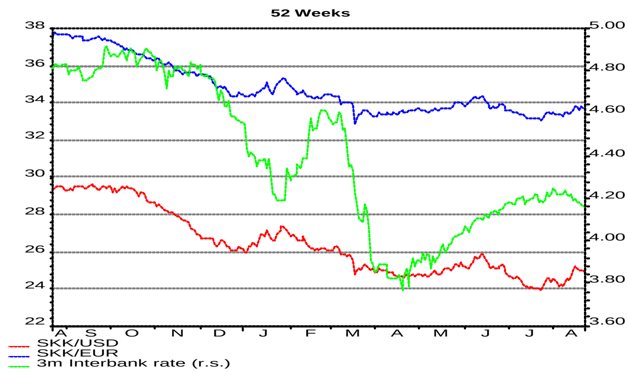
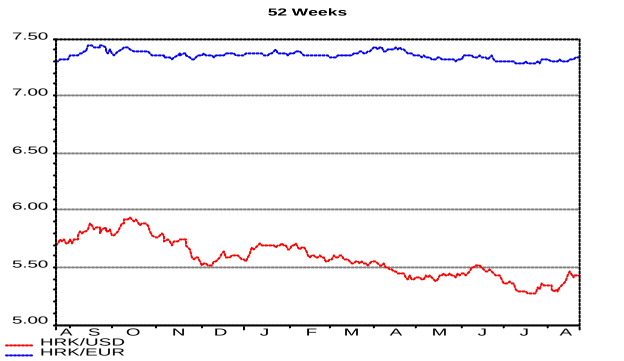
Exchange rates and interest rates (52 weeks)

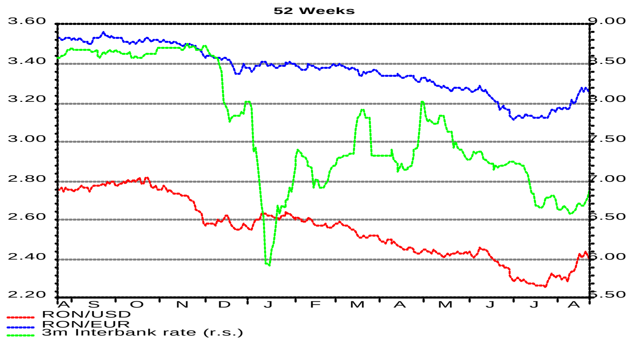








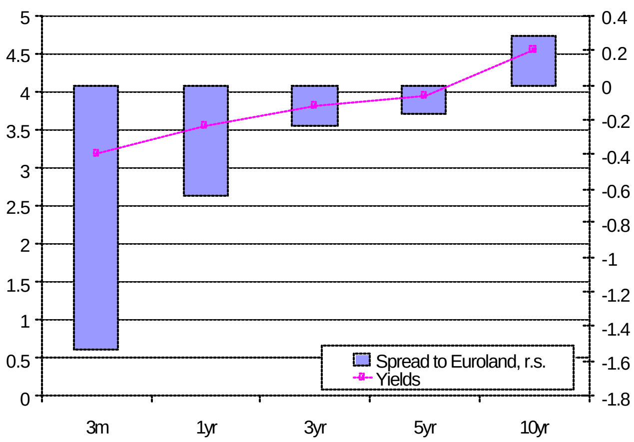




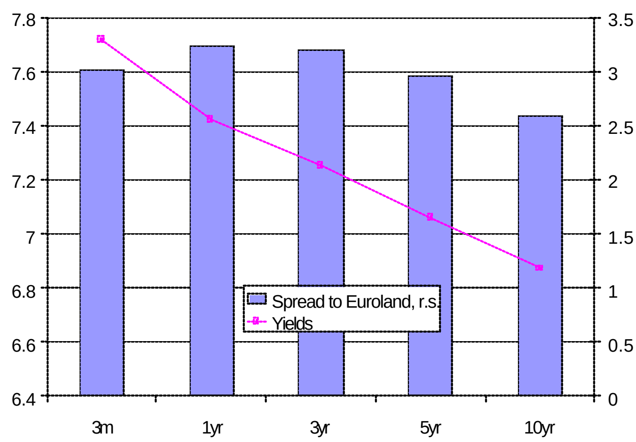
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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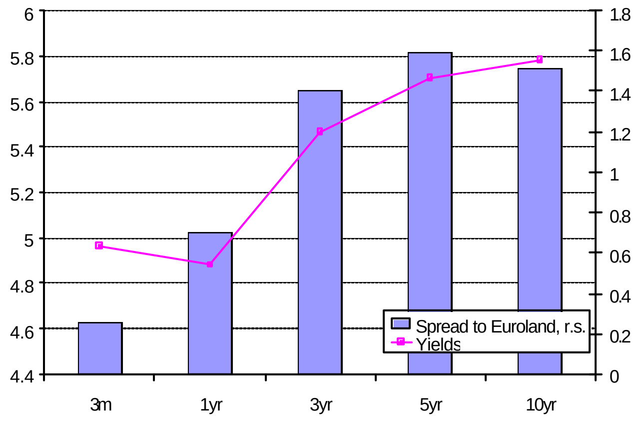
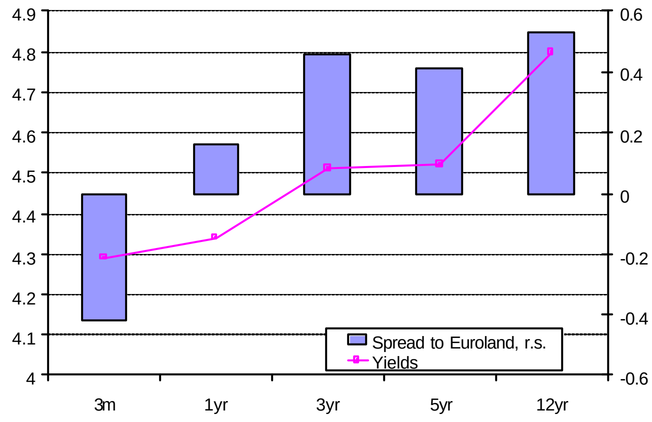
Poland



Slovakia



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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
Tomasz 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 Pfingstl	+43 (0)50 100-83171
Roman Rafeiner	+43 (0)50 100-83172
Equity Sales, London	
Dieter Benesch	+4420 7623-4154
Tatyana Dachyshyn	+4420 7623 4154
Jarek Dudko, CFA	+4420 7623 4154
Federica Gessi-Castelli	+4420 7623-4154
Declan Woolougham	+4420 7623-4154
Sales, Croatia	
Zeljka Kajkut *(Equity)*	+385 62 37 28 11
Damir Eror *(Equity)*	+385 62 37 28 13
Sales, Czech Republic	
Michal Brezna (*Equity*)	+420 224 995-523
Ondrej Cech *(Fixed income)*	+420 224 995-577
Michal Rizek	+420 2 2499 5537
Jiri Smehlik (*Equity*)	+420 224 995-510
Pavel Zdichynec *(Fixed income)*	+420 224 995-590
Sales, Hungary	
Róbert Barlai (*Fixed income*)	+361 235-5844
Gregor Glatzer (*Equity*)	+361 235-5144
Krisztián Kandik (*Equity*)	+361 235-5140
Zoltán Szabó (*Fixed income*)	+361 235-5144
Sales, Poland	
Head: Andrzej Tabor	+4822 330 62 03
Pawel Czuprynski *(Equity)*	+4822 330 62 12
Lukasz Mitan *(Equity)*	+4822 330 62 13
Jacek Krysinski *(Equity)*	+4822 330 62 18
Sales, Slovakia	
Head: Dusan Svitek	+421 2 5050-5620
Rado Stopiak *(Derivatives)*	+421 2 5050-5601
Andrea Slesarova *(Client sales)*	+421 2 5050-5629

Treasury - Erste Bank Vienna

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