CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** CPI growth lower than central bank anticipated
- **Hungary:** CPI inflation rose 8.3% y/y in August
- **Poland:** Inflation delivers relatively big downward surprise, hitting lower edge of tolerance band
- **Romania:** Monetary policy needs consistent coordination to reach inflation target
- **Slovakia:** Fiscal gap for 2006 might be revised up, would also affect 2007

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Overview

Czech Republic:

- CPI growth lower than central bank anticipated
- Unemployment at historical low
- CZK should stay at roughly same level for rest of year

Hungary:

- CPI inflation rose 8.3% y/y in August
- IFed rate decision in focus next week

Poland:

- Inflation delivers relatively big downward surprise, hitting lower edge of tolerance band
- Current account again widens under weight of ballooning imports
- Bond market supported by low inflation figure and soft tone of hawkish MPC member

Romania:

- Akzo Nobel to open plant in Romania
- Monetary policy needs consistent coordination to reach inflation target
- MinFin to issue 10-year Eurobonds this autumn
- Central bank continues to sterilize large amounts from money market

Slovakia:

- Fiscal gap for 2006 might be revised up, would also affect 2007
- Slovakia met Maastricht inflation criterion for first time
- Economy continued to grow at quick pace 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	27.48	0.4%	1.8%	0.5%			
	3Y (yield bp)	3.93	-1	0	72	-11	-36	-66
	10Y (yield bp)	4.59	-4	7	88	42	16	-23
Croatia	EUR/HRK	7.33	-0.1%	-0.3%	0.3%			
	3Y (yield bp)	4.50	-2	-15	-4	41	35	66
	10Y (yield bp)	5.30	0	-12	n/a	113	106	n/a
Hungary	EUR/HUF	253.72	0.4%	1.2%	-0.9%			
	3Y (yield bp)	7.11	-10	2	-44	307	285	368
	10Y (yield bp)	6.65	-17	-11	41	248	240	276
Poland	EUR/PLN	3.78	0.8%	0.5%	1.4%			
	3Y (yield bp)	5.29	-17	-12	64	125	117	78
	10Y (yield bp)	5.61	-15	-11	43	144	134	124
Romania	EUR/RON	3.34	-0.4%	-3.9%	1.5%			
Slovakia	EUR/SKK	33.72	0.2%	-0.6%	2.2%			
	3Y (yield bp)	4.46	-5	-11	8	37	31	50
	12Y (yield bp)	4.72	-5	-10	41	55	47	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%			0.3%	1.1%	32.8	3.2%	6.4%
12 short EUR/SKK		EUR/SKK	33.92	33.78	0.42%					

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.

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
13	short EUR/CZK	07/06/2007	14/09/2007	3.0%

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	27.5		7.32		255		3.78		3.32		33.7		3.25	3.50	7.75	4.75	7.00	4.25
Sep-07	28.0		7.40	7.40	255	255	3.80		3.35	3.32	33.1	33.7	3.25	3.50	7.50	4.75	7.00	4.25
Dec-07	27.6	27.4	7.40	7.40	253	256	3.72	3.79	3.30	3.34	32.5	33.7	3.25	3.50	7.00	5.00	7.00	4.25
Mar-08	27.3	27.3	7.40	7.40	255	258	3.70	3.79	3.27	3.35	32.4	33.7	3.50	3.50	6.75	5.00	7.50	4.25
Jun-08	27.1	27.3	7.25	7.25	255	260	3.75	3.80	3.20	3.37	32.5	33.6	3.50	3.50	6.75	5.25	7.50	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	3.52		7.65		5.09		6.75		4.33		4.56	5.30	6.65	5.60	4.64	7.00
Sep-07	3.30		7.50	7.57	5.05		6.85	6.78	4.30	4.37	4.55	5.20	6.60	5.50	4.70	6.90
Dec-07	3.40	3.44	7.00	7.24	5.20	5.16	6.75	6.73	4.30	4.34	4.80	5.10	6.20	5.65	4.70	6.85
Mar-08	3.55	3.75	6.80	6.91	5.30	5.24	6.60	6.59	4.30	4.39	4.90	5.00	6.00	5.72	4.80	6.80
Jun-08	3.60	4.01	6.70	6.71	5.40	4.74	6.45	6.50	4.30	4.40	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	2.2	3.0
Poland	3.6	6.1	6.3	5.7
Romania	4.4	7.7	6.2	6.1
Slovakia	6.0	8.3	8.9	7.1

CPI (%), eoy	**2005**	**2006**	**2007f**	**2008f**
Czech Republic	2.2	2.5	3.9	4.9
Croatia	3.6	2.0	3.4	3.0
Hungary	3.3	6.5	6.0	3.4
Poland	0.7	1.4	2.7	2.9
Romania	8.6	4.9	4.5	4.1
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	-3.1	-3.3
Romania	-8.7	-10.3	-13.5	-14.2
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	-4.2
Poland	-4.3	-3.9	-3.2	-3.5
Romania	-0.8	-1.6	-2.7	-2.7
Slovakia	-2.8	-3.4	-2.6	-2.4

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	No data releases scheduled			
Croatia	20-Sep	Unemployment rate	13.9%	
	21-Sep	Industrial production	6.0% y/y	
Hungary	Sep-19	July Nominal wages	9.5% y/y	-
Poland	Sept-17	Wages in corporate sphere (% y/y)	9.0%	9.2%
	Sept-19	Industrial output (% y/y)	10.9%	9.5%
	Sept-19	Producer prices (% y/y)	1.8%	1.8%
	Sept-20	Minutes from CB meeting (August)	-	-
	Sept-21-25	Retail sales (% y/y)	16.6%	16.7%
Romania	No data releases scheduled			
Slovakia	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Sep-19	Sep-24	2017-Apr-11	4.00%	CZK 6bn	
Hungary		Sep-18	Sep-26	Dec-27-2007	-	HUF 25bn	7.50%
		Sep-19	Sep-26	April-09-2008	-	HUF 25bn	7.45%
		Sep-20	Sep-26	Aug-27-2008	-	HUF 35bn	7.30%
Poland		Sept-17	Sept-19	2008-Sept-17	-	PLN 0.5-1.5bn	
		Sept-19	Sept-21	2012-Apr-25	5%	PLN 1.5-2.5bn	
Romania		20-Sep-07	24-Sep-07	3Y	6.00%	100,000,000	7.00%
Slovakia		Sep-17	Sep-19	May-10-26	4.5%	-	4.8%

Major Markets

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Major markets

Money market slowly calming down

Measures taken by the ECB to calm the money market tensions this week seem to be successful, as longer-term rates started to decline slowly. At the same time, the hawkish rhetoric is still in place, pointing in the direction of a rate increase in 4Q. The Swiss National Bank hiked its 3M CHF Libor target rate by 25 basis points to 2.75% on Thursday. Next week, all eyes will be on the FOMC decision. Euroland data will include the release of the ZEW Survey on Tuesday. The readings of the expectation and current assessment components are likely to again be lower, as the financial market sentiment has worsened further during the last few weeks. The market should not be too surprised at this outcome. Therefore, the reaction should stay muted. More attention will be paid to the flash estimates of purchasing managers. The Manufacturing PMI has declined slowly over the last few months, as the dynamic in this sector is slowly fading, while the Service PMI has held up well. Both indicators are expected to decline slightly in September, but should remain well in the expansionary area.

FOMC meeting and Bernanke testimony to shape markets

Without doubt, the most important event next week will be the FOMC meeting on Tuesday. Expectations are pretty evenly split between a 25bp and a 50bp rate cut. We lean towards the former, as a change of course from the previous meeting (inflation risk) to a 50bp cut within six weeks would be too sharp. Furthermore, we think that the Fed definitely wants to avoid the impression of bailing out the financial sector. In favor of the of 50bp are the recent labor market data and the fact that it has become quite clear that difficult times lie ahead for the US economy. The market reaction will of course also depend on the wording of the press release, which will likely include a rephrased risk assessment, shaping medium-term expectations for monetary policy. Today's data and (especially) retail sales could shift expectations for the FOMC meeting, but uncertainty about the outcome will remain considerable. Further releases today include industrial production, the current account and the Univ. of Michigan Index. On Wednesday of next week, CPI is scheduled, but this release will be dwarfed by the FOMC decision the previous day. Thursday will bring another closely watched event, as Fed Chairman Bernanke will give his testimony to the US Congress (title: "Sub-prime Crisis and its Solution"). So, all in all, it looks like quite an exciting week ahead for markets. For us, the crucial question is whether the recent trends (weaker dollar, lower yields) will come to a halt or continue. A reversal is in our view the most unlikely outcome.

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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	4.75		5.70		4.10	4.34	1.379	
Sep-07	4.00	5.00	4.50	4.79	5.40	5.70	4.20	4.50	1.37	1.389
Dec-07	4.25	4.75	4.35	4.67	4.70	5.16	4.40	4.60	1.40	1.391
Mar-08	4.25	4.50	4.30	4.54	4.50	4.62	4.70	4.70	1.36	1.393
Jun-08	4.25	4.25	4.30	4.43	4.30	4.54	4.70	4.70	1.33	1.393

Czech Republic

CPI growth lower than central bank anticipated

Last week saw the release of quite a few data sets. Most importantly, CPI rose 0.3% m/m (2.4% y/y), mainly on the back of cigarette prices (which added 0.26 p.p. to the m/m growth), the rising prices of vacation packages and regulated rents. This was lower than the CNB expected (2.6% y/y); the difference was due to the lower demand inflation (which decelerated slightly to 1.3% y/y). Most of the price increases that we have seen this year have been due to the administrative measures, and it still remains to be seen whether the pickup that the CNB forecasts for October of this year (demand inflation is forecast to rise from 1.9% in September to 2.6% in October) indeed materializes. As for the implications for monetary policy, this one release is not that important. However, should this trend persist (and we think the stronger koruna should keep import prices on a leash), the CNB board will slacken in terms of its determination to hike. All in all, we expect the CNB to raise the rates in January.

Unemployment at historical low

Other data releases did not bring any surprises. Industrial output rose by 11.5% (seasonally-adjusted: 8.8%), driven as usual by export-oriented sectors (automotive and electronics). The strong growth is associated with the rising wages (real +7% in August) and narrowing of the productivity-wage difference (5.2% vs. 5.9%). Both of these developments have been 'helped' by the lack of workers in some sectors of the economy (unemployment is at a historical low of 6.4%), hitting its structural limits, as evidenced by the large number of unfilled vacancies (over 133,000, against 370,000 people registered as unemployed).

CZK should stay at roughly same level for rest of year

As for next week, no data releases are scheduled. Thus, bonds and the CZK should react only to developments abroad. As we expect the CZK to stay at roughly the current level throughout the remainder of the year (with risks skewed towards a slight weakening in the case of a renewal of risk appetite or outflow of dividends, which have been below our expectation to date), we close our position short EUR/CZK and take the profit. Over the longer term, however, we remain bullish on the CZK, with an expectation of 26.60 at the end of next year.

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Hungary

CPI inflation rose 8.3% y/y in August

Consumer prices remained unchanged in August, while the 12-month inflation rate slowed only minimally to 8.3% (from the 8.4% published for July). The August y/y figure proved to be higher than our estimation of 8% and the market consensus of 8.2% y/y. The negative surprise came from food prices, which increased by 0.1% m/m. Seasonal food prices dropped by 9.9% m/m, but this was offset by a 1.5% m/m increase in the non-seasonal food category. Thus, the data shows that the first wave of food price increases already started in August, which was the main reason for the difference between the actual figure and our forecast. Secondly, the monthly increase in services prices was also higher than expected (0.4%), again fuelled by a 4.4% m/m increase in holiday services prices. Other items in the August CPI index did not come as a surprise. Prices of clothes dropped by 3.4% m/m, due to the continuation of summer seasonal sales, while fuel prices decreased by 1.4% m/m. It is favorable that the monthly increase in durables prices was only 0.1%, despite the forint weakening that took place in August. The seasonally-adjusted core inflation rose 0.4% m/m. Thus, the 12-month core CPI rate slowed further, to 5.4%, from 5.6% in July.

The further increases in food prices will burden the 12-month indexes in the coming months. In September, the 12-month index should slow down (as the 2.5% m/m CPI increase from last September disappears from the calculation), but to a lesser extent than predicted earlier. Thus, the September 12-month index may be 6.3-6.4%, while inflation is unlikely to stand below 6% y/y this year.

Fed rate decision in focus next week

Next week, domestic markets should focus on July wage figures (due on Wednesday). However, these are unlikely to become the main decisive factor at the next central bank rate setting meeting (scheduled for September 24). Apart from the wage figures, the macro calendar is practically empty. Thus, investors will again basically concentrate on global market processes and the formation of global risk appetite. The current slight improvement seen in market sentiment may further support the exchange rate. However, the Fed rate decision on Tuesday should be absolutely decisive. If the expected rate cut fails to materialize, the forint may weaken.

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Poland

Inflation delivers relatively big downward surprise, hitting lower edge of tolerance band

The release of August inflation data came as a striking surprise. While we and the market expected a merely moderate decline in the inflation rate (market cons.: 1.9%, our exp.: 2.0%), it actually fell relatively drastically, reaching 1.5% (compared to the 2.3% seen in July). Examining the nuts and bolts of the released numbers, there were several categories that contributed to the 0.4% m/m decline in prices. First of all, food became cheaper (0.6% m/m), a usual seasonal pattern, thanks to a fresh seasonal supply of vegetables (the prices of which slumped by 13.9% m/m). However, the extent of the decline was greater than we had predicted and is in sharp contrast with the development seen (for example) in Hungary. Among other items, clothing (regular seasonal sales), fuels and some services (communication & recreation) exhibited a decline and helped to compress the price level. Putting all of these influences together, the net core inflation (headline excluding food and fuels), which was the main source of the discrepancy between our forecast and reality, dipped (according to our calculations) to 1.1%, from 1.5% in July.

Demand pressures seem to be feeding into inflation at a slower pace than we had originally assumed. However, we believe that this is merely a temporary phenomenon. The economy is operating above its potential, domestic demand is indeed robust (supported by rising purchasing power of households) and the labor market is tight. We think that the motivation of enterprises to expand their production will sooner or later be reflected in higher inflation pressures in this situation. Therefore, we keep our forecast for the year-end inflation at 2.7% (i.e. above the target). Moreover, the inflation risks pinpointed by the central bank (brisk wage growth, loosening of fiscal discipline) are not likely to evaporate in the coming months. Therefore, we stick to our baseline scenario - that rates will be hiked once more this year by 25bp. However, the surprising decline in inflation represents a risk toward a move coming later than in October.

Current account again widens under weight of ballooning imports

The balance of payments statistics delivered an unpleasant piece of news once again, pointing to deepening external imbalances. The trade balance came in at a high EUR -1,278mn, which translated into a current account gap of EUR -1,300mn. On the last 12M basis, the rolling current account shortfall thus widened to 3.3% of GDP. Although the number itself is still on the safe side, the trend seen in the last months is unfavorable for the zloty. One of the reasons behind the worsening of the current account statistics is the robust import demand. This could be a harbinger of limited production capacities, which are not able to cover strong domestic demand (composed of both consumption and investment demand). Still, the July import volume seems to be extraordinary and is not fully explained by (e.g.) retail sales, in our view. Hence, it very well might turn out to be a one-off. On the other hand, transfers from the EU seem to be lagging behind their typical seasonal pattern this year. Here, we see a potential source of improvement by year-end. We predict the full-year current account gap at 3.1% of GDP.

Bond market supported by low inflation figure and soft tone of hawkish MPC member

This week started with a relatively stable atmosphere, with the zloty gradually sliding into stronger territory. The government approved the 2008 state budget outline on Tuesday. The deficit is targeted at PLN 28bn, which is below the nominal anchor set by the ruling PiS party. However, in comparison with this year's forecasted deficit (MinFin predicts PLN 23bn), it means fiscal expansion. Moreover, it does not contain the effect of recently approved pro-family measures that would widen the deficit further. The market failed to react to the news, most likely because it is still unclear what shape the budget will take under the new administration that is to emerge following the October elections (opinion polls do not provide a clear answer about the potential winner; the platforms of both PiS and Civic are options). After a sluggish beginning of the week, bonds managed to pose visible gains on Thursday, with spreads against the Eurozone dropping by 20-30 basis points on a weekly basis, which translated into the actual decline of yields by 10-20 basis points. The inflation release is the main cause of this rally. The impact of the benign data was reinforced by the relatively dovish comment from prominent MPC hawk Marian Noga, who again emphasized the space for further rate hikes, but also admitted that there might be rate cuts in the second half of 2008. While we do not share this view, the market was strongly supported by this opinion. Next week's data should show that wage dynamics are still high (exceeding productivity gains) and that the spending appetite of households (retail sales) remains relatively strong, which could induce a slight correction of the present bullish mood.

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Romania

Akzo Nobel to open plant in Romania

Dutch group Akzo Nobel, the world's leader in coatings, plans to establish a plant in Romania, in Brasov County. The investment is estimated at EUR 10-15mn. In recent years, the Dutch giant has tested the waters with all major local producers, such as Policolor (held by Romanian Investment Fund Cyprus and The Romanian American Enterprise Fund) and Dufa (held by Advent International Investment Fund), for a potential takeover. However, they eventually gave up and decided to continue operations on the Romanian market through a greenfield investment. The potential growth of the local paint and coatings market is estimated at 15-20% in the next five years, due to real estate investments and the government's thermal rehabilitation program. Akzo Nobel's investment is also a result of the robust upward trend in the construction sector (+31.6% in 1H, against 16.5% in the same period of 2006). Once again, Romania has confirmed its attractiveness for foreign investors. The significant growth potential of the economy and the flexible taxation regime (flat tax at 16%) have created important opportunities for other major world players (e.g. Ford, Nokia) to start up operations in Romania through greenfield investments. We estimate that greenfield projects will be the main driver of future FDIs (since the privatization process in Romania is almost completed) in the next 2-4 years.

Monetary policy needs consistent coordination to reach inflation target

Monthly inflation increased strongly to 0.86% in August, setting the annual inflation rate at 4.96%, near the top of the tolerance interval around the inflation target (4.0%±1 pp). Among the reasons behind this development are the drought that affected agriculture this summer and the increase in administered mail tariffs. Apart from the evolution seen during the first half of the year, core inflation increased in August following the depreciation of the RON. Any monthly inflation greater than 0.10% in September would push the annual rate above 5.0% for two months (September and October), creating a rather uncomfortable situation for the central bank. However, the annual inflation rate will revert to levels below 5.0% in November and December. On September 26, the central bank will have its monetary policy meeting, and it is certain that there will be no further cuts of the monetary policy rate until the end of the year. The keys to reaching the inflation target are good coordination between monetary and fiscal policy and no further increases of administered prices this year. The magnitude of the rise in administered rents in May (+93.49% m/m) and administered mail tariffs in August (+23.26% m/m) created a surprise for the central bank's officials. Such hikes should not be seen anymore in the following months. Considering the latest developments, we revised our inflation forecast for end-2007 upward to 4.5% y/y.

MinFin to issue 10-year Eurobonds this autumn

The Ministry of Finance will issue 10-year Eurobonds with a total value between EUR 0.5bn and EUR 1.0bn. It is possible that part of this money will be spent next year. The consolidated state budget had a surplus of 0.5% of GDP at the end of July, while very low deficits have alternated with low surpluses from the beginning of the year. However, in the second part of the year, the situation will change, and we estimate a budget deficit up to 2.7% of GDP at the end of 2007. Beginning with September, the government needs additional resources to support the first stage of the pension increase and to pay holiday bonuses to state employees of EUR 1.0bn (out of which EUR 0.3bn this year). The government will also spend important resources on ambitious infrastructure projects designed to ensure proper connections to the rest of Europe, reduce travel times and costs to access isolated areas within Romania. Following official statements, the MinFin might cancel some of the remaining auctions for T-bonds on the Romanian market if borrowing costs would be too high. Until now, the borrowed amounts from the Romanian market have been insignificant. Instead, the MinFin might try to obtain additional external financing via bond issues.

Central bank continues to sterilize large amounts from money market

On Monday, the central bank drained RON 4.0bn (EUR 1.21bn) from the market in its regular 2-week maturity depo transaction. The average interest rate stood at 6.84% and the maximum interest rate accepted was 6.94%, just below the central bank's monetary policy rate of 7.0%. The liquidity was again evenly distributed among commercial banks, as 20 banks participated in the depo auction. ON interest rates increased slightly from 5.25%/6.30% to 5.70%/6.70% after the transaction. On Thursday, the central bank issued 3-month CDs with a total amount of RON 0.73bn (EUR 0.23bn). The average interest rate was 6.96% and the highest 7.0%. We estimate that the central bank will continue to sterilize consistent amounts via weekly depo transactions, especially now when the August inflation figures require a vigilant monetary policy. The average interest rate will remain slightly under the monetary policy rate of 7.0%.

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Slovakia

Fiscal gap for 2006 might be revised up, would also affect 2007

The local media reported that Eurostat might revise Slovakia's fiscal deficit for 2006 upwards by 0.7% of GDP (i.e. from 3.4% to 4.1% of GDP), as there may have been some irregularities regarding the accounting of deficits among public media, highway and railway companies. This could also influence Slovakia's fiscal deficit for 2007 (which was budgeted at 2.9% of GDP, and which will be important for the evaluation of Slovakia's plans to adopt the euro in 2009), but the impact is unclear, as some items might have been of a one-off nature. Should the information be confirmed, it poses a risk for Slovakia's euro adoption in 2009. However, since the government still has the chance to postpone some of the investment expenses planned for the end of 2007, it could fulfill the Maastricht criterion even if extra expenses are included in the deficit. The MinFin said that it is in talks with Eurostat about methodology and, even if this brings no result, it is ready to take steps to get this year's deficit below the required limit. Overall, the news poses a risk for EMU entry in 2009, but we still regard timely euro adoption as the most likely scenario. A delay of the euro adoption would likely lead to a weakening of the koruna and growth of long-term yields.

Slovakia met Maastricht inflation criterion for first time

Another Maastricht criterion, inflation, is on a much better path. In August, Slovakia met the inflation criterion for the first time, and we expect the country to continue to do so until the time of evaluation (spring 2008). HICP inflation stagnated in August at 1.2% y/y (the monthly drop of 0.1% was due to food prices and seasonal clothing and shoe sales). National CPI (released earlier) also stagnated at 2.3% in August (a notch above expectations, due to imputed rents and a smaller decrease in food prices). Demand inflation pressures remain muted. We think that the central bank will keep interest rates unchanged and will wait for a move by the ECB, which should hike interest rates by 25bp by year end.

Economy continued to grow at quick pace in July

The July data from the real economy suggested a continuation of the strong growth. Retail sales increased in real terms by 5.9% y/y, while industrial production soared by 18.9% y/y, well above forecasts (due to one-off mining and quarrying of energy-producing materials, which shifted the figure above the average of 15% seen so far this year). Core export sectors maintained their trend-like dynamics, which translated into the expected foreign trade deficit at SKK 1.8bn. The 12M cumulative deficit declined slightly to 3.5% of GDP, from the revised 3.6% in June. We assume the full-year deficit at less than 2% of GDP (compared to 5.7% in 2006). Please note that the Statistical Office announced a methodology change related to electricity. The revision should bring statistically lower trade gaps than in the past.

The koruna's reaction to the possible fiscal deficit revision for last year and the theoretical impact on this year deficit was rather muted. The SKK losses were in line with those of neighboring currencies, erasing the gains from the start of the week. The market thus shares our view that, despite the increased risk for the fulfillment of the fiscal criterion in 2007, the chances for a pass scenario are higher than for a delay of euro adoption.

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Appendix Charts

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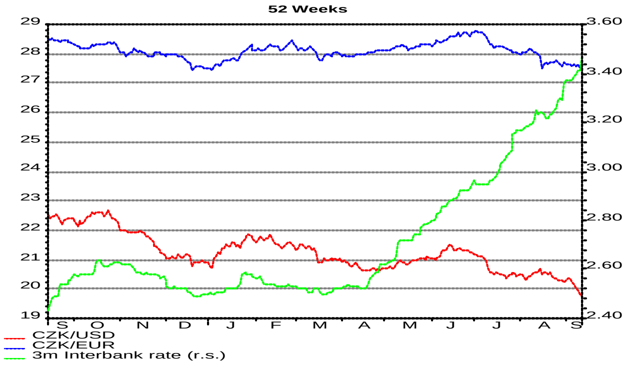
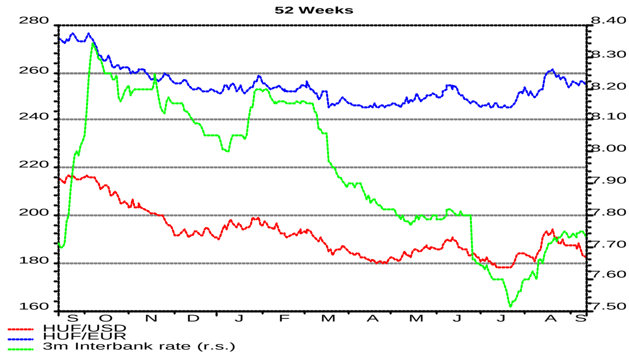
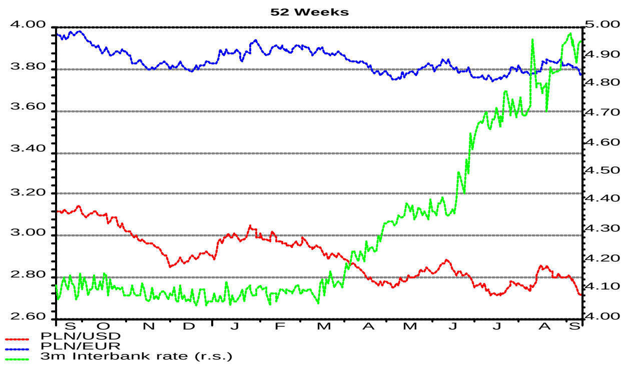
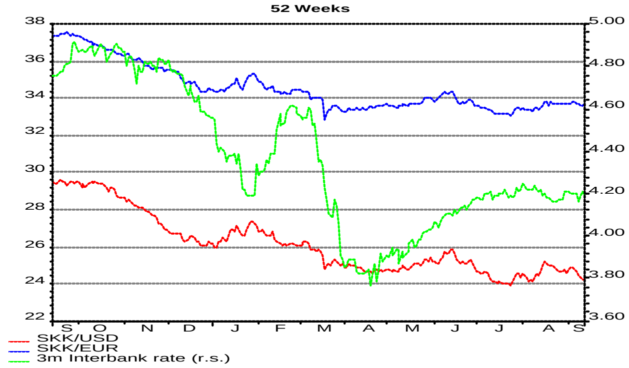
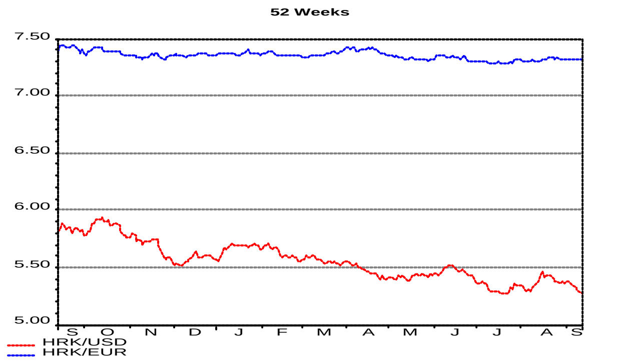
Exchange rates and interest rates (52 weeks)

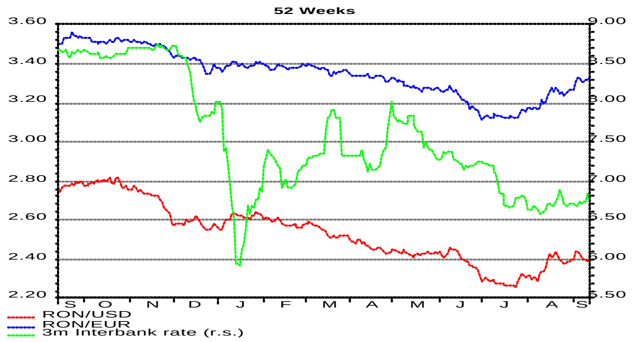








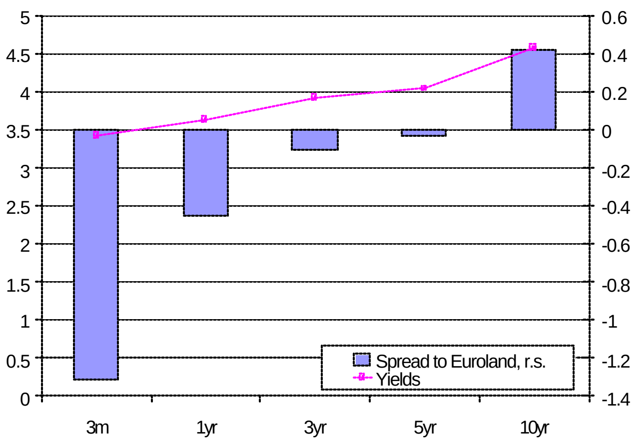




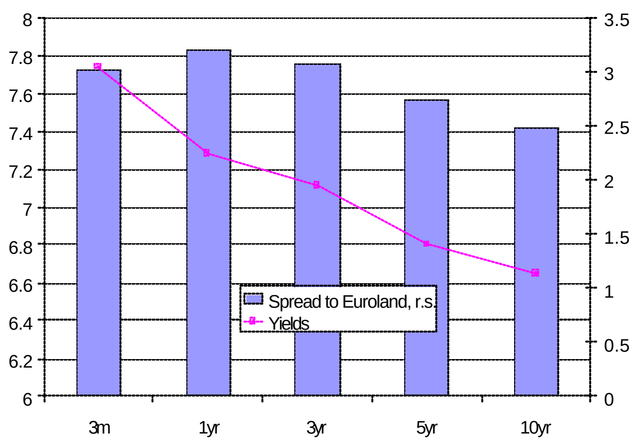
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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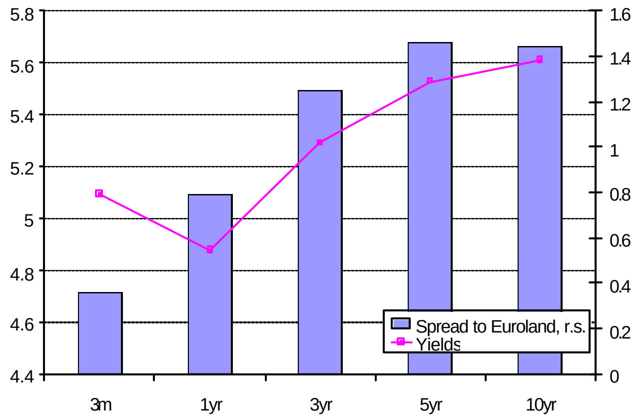

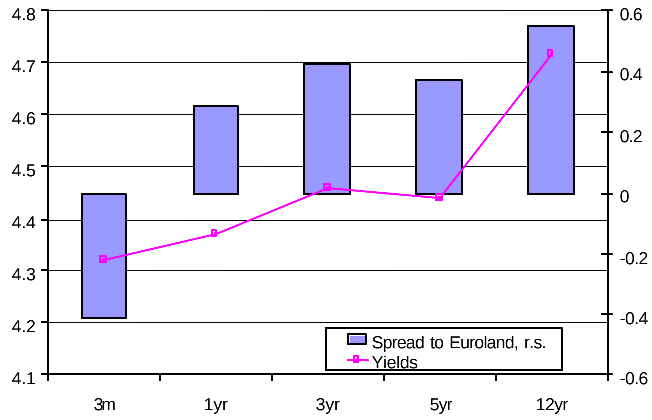

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