CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** Kuna and MM rates under some pressure
- **Czech Republic:** Government adopted draft 2008 budget
- **Hungary:** 25bp rate cut likely on Monday
- **Poland:** Central bank not likely to pull out its weapons next week
- **Romania:** Inflation risks made a rate hike next week more likely
- **Slovakia:** MinFin: Fiscal revision not major threat to euro adoption

Overview

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Croatia:

- CPI inflation shifting upwards
- Unemployment rate hits another year low
- Kuna and MM rates under some pressure

Czech Republic:

- Government adopted draft 2008 budget
- CNB to hold rate setting meeting next week; no move expected

Hungary:

- 25bp rate cut likely on Monday
- Finance Ministry presented its macro forecast for 2007 and 2008
- 50bp Fed rate cut strengthened forint

Poland:

- Wages soared unexpectedly in August
- Industry expanding slightly below expectations
- Central bank not likely to pull out its weapons next week
- Bonds lost slightly, on back of Eurozone; zloty still strong

Romania:

- 7M current account deficit slowed down
- RON hit 2007 low of 3.43 per EUR
- Inflation risks made a rate hike next week more likely
- MinFin rejected all bids at 3Y benchmark bond auction

Slovakia:

- MinFin: Fiscal revision not major threat to euro adoption
- NBS to leave rates on hold

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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	27.52	-0.1%	0.5%	0.3%			
	3Y (yield bp)	3.95	2	0	74	-17	-17	-66
	10Y (yield bp)	4.63	4	15	92	29	25	-23
Croatia	EUR/HRK	7.31	0.3%	0.3%	0.6%			
	3Y (yield bp)	4.55	5	-21	1	36	70	66
	10Y (yield bp)	5.32	2	-5	n/a	97	109	n/a
Hungary	EUR/HUF	251.06	1.1%	4.0%	0.1%			
	3Y (yield bp)	6.91	-20	-43	-64	279	342	368
	10Y (yield bp)	6.55	-10	-41	21	221	273	276
Poland	EUR/PLN	3.77	0.3%	2.2%	1.7%			
	3Y (yield bp)	5.35	6	-13	70	123	156	78
	10Y (yield bp)	5.66	5	-41	49	132	157	124
Romania	EUR/RON	3.42	-2.4%	-3.9%	-1.0%			
Slovakia	EUR/SKK	33.83	-0.3%	0.1%	1.9%			
	3Y (yield bp)	4.51	5	4	13	33	46	50
	12Y (yield bp)	4.76	5	-1	45	40	51	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	3,9/ 4,28%			-0.2%	-0.7%	32.8	3.2%	6.4%
		EUR/SKK	33.92	33.95	-0.09%					

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		250		3.77		3.37		33.8		3.25	3.50	7.75	4.75	7.00	4.25
Dec-07	28.0	27.5	7.40	7.40	253	252	3.72	3.77	3.30	3.40	32.5	33.8	3.25	3.50	7.00	5.00	7.25	4.25
Mar-08	27.6	27.4	7.30	7.30	255	254	3.70	3.78	3.27	3.42	32.4	33.8	3.25	3.50	6.75	5.00	7.50	4.25
Jun-08	27.3	27.4	7.25	7.25	255	255	3.75	3.79	3.20	3.44	32.5	33.7	3.50	3.50	6.75	5.25	7.50	4.25
Sep-08	27.1	27.3	7.25	7.25	256	257	3.67	3.80	3.24	3.46	32.5	33.7	3.50	3.50	6.50	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	3.47		7.50		5.10		7.29		4.31		4.63	5.32	6.55	5.66	4.71	7.00
Dec-07	3.30	3.46	7.00	7.05	5.20	5.24	7.25	7.83	4.30	4.38	4.55	5.20	6.20	5.65	4.70	6.90
Mar-08	3.40	3.67	6.80	6.67	5.30	5.35	7.60	7.60	4.30	4.39	4.80	5.10	6.00	5.72	4.80	6.85
Jun-08	3.55	3.83	6.70	6.47	5.40	5.37	7.70	7.07	4.30	4.44	4.90	5.00	5.90	5.78	4.80	6.80
Sep-08	3.60	3.89	6.60	6.45	5.57	5.35	7.65	6.85	4.30	n.a.	4.80	5.00	5.80	5.85	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		CNB rate-setting meeting	no change (3.25%)	no change (3.25%)
Croatia	28-Sep	2Q GDP	5.7% y/y	
	28-Sep	Trade balance	€ -850mn	
Hungary	Sep-24	NBH rate-setting meeting	25bp cut (to 7.50%)	25bp cut (to 7.50%)
	Sep-25	July Retail sales	-2.9% y/y	-3.3% y/y
	Sep-28	Aug Industrial producer prices	-2.6% y/y	-2.6% y/y
	Sep-28	2Q07 C/A balance	EUR -1bn	-
Poland	Sept-24	Net core inflation (% y/y)	1.1%	1.2%
	Sept-25	Retail sales (% y/y)	16.6%	16.7%
	Sept-26	CB rate-setting meeting	no change (4.75%)	no change (4.75%)
Romania	No data releases scheduled			
Slovakia	Sep-25	CB policy rate	no change (4.25%)	no change
	Sep-28	August PPI	0.2% m/m, 0.9% y/y	1.0% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Sep-26	Sep-27	2008-Mar-28		CZK 5bn	
Hungary		Sep-24	Sep-26	Nov-07-2007	-	HUF 30bn	7.40%
		Sep-25	Oct-03	Jan-02-2008	-	HUF 25bn	7.35%
		Sep-27	Oct-03	Oct-24-2012	6.00%	HUF 45bn	6.70%
		Sep-27	Oct-03	Feb-24-2017	6.75%	HUF 40bn	6.60%
Poland		No auction scheduled					
Romania		26-Sep-07	28-Sep-07	1Y		100,000,000	6.90%
Slovakia		No auction scheduled					

Major markets

IFO Index in focus

For Euroland, the main indicator will be the IFO Index on Tuesday. The main question is whether the financial market turmoil is starting to spill over into the real economy. Markets are currently expecting more or less unchanged numbers vs. the previous month. The risk is on the downside, in our view, especially for the expectations index. Consumer prices for the "Bundesländer" will be reported in the course of next week, as well as the national preliminary value for September. The unemployment rate for Germany is scheduled for Thursday, as is M3 growth for Euroland. A further slight improvement can be expected in the unemployment rate, while M3 growth in August will be distorted by the liquidity injections by the ECB. So, given that the IFO Index should show at most a slight deterioration, we expect Euroland bond markets to be determined by global trends and spread trading vs. the US.

Series of US releases unlikely to brighten economic outlook

Several releases are scheduled for next week. Tuesday will bring consumer confidence and existing home sales. While markets expect a more or less stable value for the former, a slump is expected for the latter, which in the current environment comes as no surprise. Durable goods orders, which will give an indication of corporate investment, are scheduled for Wednesday. This number should be watched for any effects from the financial market turmoil, keeping in mind that this is a volatile indicator in general. New home sales will be released on Thursday; here, the same applies as for existing home sales. The final estimate of 2Q GDP should hardly get any attention the same day. Finally, the week will close with the Chicago PMI and the consumption price deflator, the Fed's favorite inflation gauge. The markets are still looking for new trading ranges. The recent correction on bond markets has advanced too far, in our view. Thus, given that the upcoming data will at best be subdued, some yield declines seem feasible. The EUR/USD passed the 1.4 level recently, but we think further advances are unlikely. Rather, we expect a downward correction of the EUR/USD.

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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	4.75	4.72		5.20		4.35	4.67	1.406	
Dec-07	4.25	4.50	4.35	4.65	4.60	4.90	4.40	4.60	1.40	1.407
Mar-08	4.25	4.25	4.30	4.55	4.30	4.58	4.70	4.60	1.36	1.408
Jun-08	4.25	4.00	4.30	4.50	4.30	4.55	4.70	4.70	1.33	1.409
Sep-08	4.25	4.00	4.30	4.07	4.20	4.53	4.70	4.70	1.33	1.409

Croatia

CPI inflation shifting upwards

The August CPI acceleration to +2.6% y/y did not come as a surprise; only the rate of acceleration took some off-guard, as CPI jumped by a robust 0.6% m/m. The main driver behind the pickup was food and beverage prices (+1.7% m/m), which was due to the summer drought and negative effects on vegetable prices (as well as the earlier announced hike in bread prices). Hence, inflation developments are predominantly supply side-driven. Food prices should dictate the pace towards the end of the year, making the year-end inflation rate hard to estimate. Oil prices should have a limited effect on CPI inflation, as the government continues to cap retail gasoline prices (at least until the November parliamentary elections), thereby somewhat neutralizing the negative effects. Considering the diminishing base effect towards the year-end, we see the CPI rate in the 3.0-3.5% range, with a greater likelihood of it landing in the upper part of the band.

Unemployment rate hits another year low

Labor market trends remained positive in August, as unemployment slid below 14% (recording 13.8%). This should also be this year's low; towards the year-end, the unemployment rate should increase, as the need for seasonal workers falls off. On the other hand, wage developments do not point to upward pressure, as wage growth in both nominal and real terms remains low (1H07: +5% in nominal terms, +3% in relative terms) and productivity growth remains high (in the 7-10% y/y range), thus having a favorable effect on unit labor costs and meeting the earlier conclusion that inflation is largely supply side-driven.

Kuna and MM rates under some pressure

In recent days, the exchange rate slid out of the 7.32-7.33 band, where it had been hovering for quite some time. The main reason for the strengthening is the national telecom company's IPO, which is increasing demand for kuna liquidity (and thus conversion of FX positions into kuna ones). We continue to see the exchange rate in the 7.30-7.35 range in the upcoming period, with the exchange rate staying closer to 7.30 until the end of September. As we anticipated, money market rates were under some pressure recently (standing around 6%) and higher interest at the CNB reverse REPO tenders was recorded. Pressures should remain until the end of the above-mentioned IPO and bond issue process (i.e. for the coming 2-3 weeks). Afterwards, we expect some relaxation. The bond market is awaiting more details about new government bond issues, which (according to the latest information) has been postponed until early October. The yield curve remained virtually unchanged, while spreads narrowed, due to upward movement on the benchmark market.

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Czech Republic

Government adopted draft 2008 budget

No real economic data was released this week. The government adopted a draft of the 2008 budget. It projects a deficit of CZK 70.8bn (cash methodology), with revenues of CZK 1,037bn and expenditures projected to total CZK 1,107bn. The deficit rises to over CZK 110bn (2.95%, methodology ESA 95) when all the government institutions' balances are taken into account. The budget will now have to be approved in Parliament, which we expect to happen.

CNB to hold rate setting meeting next week; no move expected

As for next week, the CNB banking board will hold its regular rate setting meeting. We are in agreement with the market in not anticipating any move. The reasons for this include the following. First, a rather hawkish member of the board (L. Niedermayer) indicated in an interview that the rates may have reached a level "where it would be possible to leave them unchanged for some time". Since he was most likely one of those voting for a hike in the previous month, and since the voting was tight (4:3), the no-change scenario should prevail this month. Secondly, the CZK is now substantially stronger than what the CNB expected in July, which is also a hike-deterring factor. Thirdly, the risks for the world economy are elevated, which also creates uncertainty for the small, export-oriented economy of the Czech Republic. All things considered, prudence will be exercised and the next hike will be delivered in January 2007.

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Hungary

25bp rate cut likely on Monday

The central bank's rate setting meeting on Monday will be the most watched event next week, as a 25bp rate cut seems likely. According to the latest polls, the majority of financial analysts expect a cautious rate reduction for September, and I share this view. Please note that last month, when the base rate was kept on hold, the monetary council was extremely divided. In the end, the governor's vote proved decisive. As in August, the main reason for the caution was the great degree of uncertainty in the global investment environment. It now seems that the higher than expected 50bp rate reduction from the US Fed's side has made emerging markets more attractive and somewhat increased the appetite for risk, providing more room for the Hungarian central bank to carry out a rate reduction. As for the country's fundamental picture, due to the all-time high oil prices and the ongoing increase in food prices, the NBH is very likely to miss its mid-term inflation goal of 3% in 2008. However, based on their latest comments, they seem to trust that these supply-side price shocks will only have one-off impacts on inflation and will not cause an increase in inflationary expectations. In that case, the mid-term goal could be reachable by 2009. The latest wage figures were basically neutral from the point of view of monetary policy decisions, as ex bonus y/y wage increases in the private sector seem to have come to a halt in July. Last but not least, the GDP downturn may also be a factor, which suggests monetary easing.

As for future prospects, my view is that the next meeting on Monday will be crucial - if the council finally decides to cut the base rate, the rate cutting cycle would continue, and the base rate would decrease to 7% at the end of this year (which is my base forecast). If the council holds rates, this would suggest that they could again become more hawkish in assessing the mid-term inflation outlook or the external market environment. In that case, the monetary easing cycle is likely to drag on for a longer period.

Finance Ministry presented its macro forecast for 2007 and 2008

During its regular press conference on monthly budget figures, the Finance Ministry also presented its latest macro forecast for 2007 and 2008. As for 2007, the GDP growth forecast remained unchanged (2.2% y/y), which did not come as a surprise, taking the very low 2Q figure into consideration. At the same time, the ministry raised its forecast for 2007 average inflation to 7.5% (from 7%). The forecast for the 2007 ESA budget deficit remained at 6.4% of GDP. As for next year, GDP growth should be 2.8%, according to the ministry, somewhat higher than they indicated in the Convergence Program (2.6% y/y). Their forecast for 2008 average inflation has been raised to 4.5%, while they predict a budget deficit of only 4.1% of GDP for next year. (These figures in the Convergence Program are 3.3% and 4.3%, respectively.) The ministry said that there would be a "conservatively planned" budget next year, which would ensure the withdrawal of the "excessive deficit procedure" against Hungary in 2009.

50bp Fed rate cut strengthened forint

The higher than expected US Fed rate reduction led to spectacular forint strengthening this week, as the step has made high-yielding markets more attractive for investors. Thus, in keeping with the more optimistic market sentiment, the forint has reached the levels at which it was traded before the start of the sub-prime crisis. Next week, the widely expected 25bp rate cut from the central bank's side should have only a minimally weakening impact on the exchange rate, provided that the current more bullish market mood continues.

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Poland

Wages soared unexpectedly in August

Wages in the corporate sector took another huge leap upward in August, with their yearly growth galloping by a double-digit number for the first time since the end of 2000. In comparison to the same period of the previous year, they went up 10.5% y/y. One of the causes behind such robust dynamics is the tightness of the labor market. The economy is operating above its potential, and this is also mirrored in labor shortages in some sectors, with unemployment hovering at 8-year lows. This in turn translates into higher wage demands. The robust economy absorbs more and more people. Employment growth accelerated to 4.8% y/y in August. Putting together the pickup in both employment and wages, the aggregate real wage bill increased by an astonishing 14.1% y/y in August, even faster than in July (11.9% y/y). Moreover, it has to be stressed that higher gross wages and employment are not the only sources of income for households. Purchasing power was also supported by the recent cut in disability wage contributions (3pp as of July), which effectively ups net incomes. Moreover, transfers from Poles working abroad play a non-negligible role. Additional inflation pressures might also arise from the public sphere (not included in corporate sector figures), where the soon-to-be-held snap polls led the cabinet to comply with wage-visible increases. All in all, the inflation risks stemming from the higher purchasing power of Polish people continue.

Industry expanding slightly below expectations

The expansion rate of Polish industry returned to single-digit territory in August, crawling slightly under the market (and our) expectations. On a yearly basis, industry gained 9.0% y/y (vs. the consensus estimate at 9.5% y/y). Eliminating the unfavorable seasonal impact, industry would have grown by 9.4% y/y. A visible slowdown was witnessed within energy production (a volatile component, dependent on the season) and mining. The growth rate of manufacturing decelerated only moderately (from 11.2% y/y to 10.4% y/y). Apart from domestic demand, orders from abroad are to thank for the relatively solid performance of Polish industry. Branches containing export-oriented products still show the fastest dynamics (radio, television & telecommunication equipment, transportation equipment, etc.). A further deceleration of industrial output is likely in September, due to working-day effects (September 2007 will have one less working day than last year), but the dynamics should pick up thereafter. We expect the full-year growth to stand at 11.5% y/y.

Central bank not likely to pull out its weapons next week

Polish central bankers will gather to discuss the key rate setting next week. The market is unanimous in expecting a 'no change' verdict this time, with the reference rate expected to stay at 4.75%. Although the current benign inflation reading allows the MPC to assume a waiting stance, the wage data reminds them of the persistent inflation risks, which will necessitate further rate hikes. Our baseline relies on a 25bp rate increase in October, with a significant risk of postponement until November. For next year, we pencil in a further 50bp in hikes. The minutes from the last meeting (when a hike was delivered) revealed that the decision was not unanimous, with some MPC members advising a wait-and-see approach. The discussion revolved primarily around the turbulence on world markets, public finances and the labor market. The latter remains a source of concern, as the excessive wage growth is seen spreading across industry and other sectors of the economy and the hike in the minimum wage should reinforce this tendency. While some central bankers saw the global turmoil as a reason to postpone the hike, others were more relaxed, downplaying the potential impact on the Polish economy and raising the issue of 'moral hazard'. Last but not least, fiscal relaxation was labeled as a potential source of inflation pressure. We fully agree with this point. Even after the approval of the family tax break, which should cost the budget PLN 6.5bn per year, the state budget deficit is finally projected at roughly the same level as before the adoption of these measures. Where is the trick? The Finance Ministry adjusted the estimate of EU funds and dividend income so that the final deficit remains visibly unchanged. However, one should note that the budgetary expenditures are now supposed to reach PLN 310.4bn, which is 13% more than in the original draft (before the family tax relief). Hence, our pro-inflation interpretation of the additional family support remains in place.

Bonds lost slightly, on back of Eurozone; zloty still strong

The Fed's rate cut helped to restore the positive sentiment on the Polish market. The zloty stabilized in the stronger territory reached a week ago around 3.76-3.77 EUR/PLN. Risk spreads on Polish government bonds against their Eurozone peers contracted further by 5-15 basis points w/w. However, the upward march of the European curve meant that Polish yields finally moved a bit higher. Next week's releases will kick off with net core inflation, showing a slump to 1.1% y/y (which we believe is of a temporary nature). This might strengthen the bullish sentiment on the bond market. However, retail sales and the statement following the MPC meeting should remind market players that the hiking cycle is not over yet. Global market sentiment remains a very important variable. Should it remain conducive, the zloty might extend its gains, with the threshold of 3.75 EUR/PLN providing the nearest resistance. The markets do not seem to be disturbed by the upcoming early elections at the moment. However, with their date approaching, higher volatility cannot be ruled out.

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Romania

7M current account deficit slowed down

The current account deficit reached EUR 8.9bn after the first seven months, expanding by 98.3% y/y, compared to 108.6% y/y in the first six months. The slowdown was partly determined by a lower trade balance deficit (+73.7% y/y at the end of July, against +77.1% y/y in 1H). However, the deficit of the income balance rose by 55.1% y/y, revealing important outflows in terms of dividend repatriation. FDI stood at EUR 3.5bn (compared to EUR 4.0bn between January and July 2006) and covered 38.7% of the current account deficit. Another positive effect on the current account deficit came from net current transfers, which include remittances from Romanians working abroad. They increased by 24.8% y/y at the end of July (compared to just 10.9% y/y at the end of June), reaching EUR 3.0bn. This development might have been the effect of important cash transfers during summer holidays. We estimate a current account deficit of around 13.5% of GDP at the end of 2007. A reversal of the current account deficit as a % of GDP will take place no sooner than 2009-2010, and will be triggered by an increase in high value added exports following a sustained investment process.

RON hit 2007 low of 3.43 per EUR

The domestic currency continued to fall against the euro, depreciating by 2.1% w/w and by 2.2% in nominal terms since the beginning of the year. On Monday, the Romanian currency was quoted in the 3.36 zone at the opening of domestic trading, but within one hour, it dropped to 3.3950. On Wednesday, the RON posted a slight recovery to 3.36, benefiting from the Fed's decision to cut the Federal rate by 50bps to 4.75%, which benefited emerging markets, as interest rate differentials increased. However, on Thursday, the RON hovered around a 9-month low against the euro, dropping to the 3.43 zone, after the Ministry of the Economy and Finance rejected all bids at the 3Y bond auction. The sharp decline was due to the decrease of ON interest rates to levels around Eurozone rates in the last days of the mandatory reserve period, as well as the potential political turmoil on the horizon. Romania's powerful Social Democrat Party (PSD) will ask Parliament on Monday to hold a no-confidence vote against the government. If the motion passes, the president will nominate a new prime minister. Romania will have early elections if the prime minister is rejected by Parliament at least twice within 60 days. However, we believe that PSD, the president's PD party, and the new liberal party PLD might come to an agreement, thus avoiding early elections and supporting a common government. Given all of the above, we expect the RON to be traded in the 3.39-3.45 zone next week.

Inflation risks made a rate hike next week more likely

On Monday, the overnight deposits were traded for 6/7% bids/asks, with the money market looking quite stable, after a week of flat rates in proximity to the key rate. However, the situation changed after the NBR's regular 2-week depo auction at variable rate. The NBR had good intentions, showing its willingness to drain RON 5.6bn from the local interbank market, when only RON 5bn was returning to the market from the NBR. The accepted bids topped the level of the key rate (7.0%), which amounted to just RON 3.5bn. The average accepted rate increased to 6.89% (vs. 6.84% previously), while the maximum demanded bids stood at 9.0%. Commercial banks raised their yield expectations recently, since the rebound in inflation, which triggered expectations of a hike of the monetary policy rate by the end of 2007. Given the substantial extra liquidity in the market that was not placed at the NBR, the overnight interest rates fell to 3.2/5% bids/asks the very next day. Starting Wednesday, bids for the overnight tenors declined sharply until the threshold of 2% (which is the level of the facility rate), while the offer rates for ON tenors topped 3.6%. We expect that the short-term interest rates will recover to close to the monetary policy rate next week, as a new reserve period will be starting and the central bank will continue to sterilize excess liquidity for a maximum of 7%, the current level of its policy rate. Considering the latest inflationary developments (determined in part by the depreciation of the national currency), we estimate a possible increase of the monetary policy rate to 7.25% or even 7.50% at the monetary policy meeting on September 26. This would lead to a wider differential between domestic and Eurozone interest rates.

MinFin rejected all bids at 3Y benchmark bond auction

On September 20, the Ministry of the Economy and Finance reopened a three-year benchmark bond auction for the indicative amount of RON 100mn. Primary dealers submitted RON 251mn at the auction, but the MinFin decided to reject all bids, especially as Romania's consolidated state budget posted a surplus (0.5% of GDP) at the end of July. Most likely, the yields demanded by the participants exceeded the current policy rate (7.0%), given the rebound of inflationary pressures. We expect that the MinFin will not accept bids that outpaced the level of the monetary policy rate (7.0%), as Romania still records a budgetary surplus.

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Slovakia

MinFin: Fiscal revision not major threat to euro adoption

In a follow-up to last week's news about a possible upward revision of Slovak fiscal data by Eurostat, the Finance Ministry said that the impact on the 2007 budget should be limited, amounting to no more than 0.23% of GDP. Since the MinFin's last projection of the 2007 general government deficit stood at 2.7% of GDP, limited spending cuts (to provide a buffer) should be enough to fulfill the fiscal criterion. Separately, CB Vice Governor Viliam Ostrozlik also expressed his confidence that the eventual revision should not be a major threat to Slovakia's euro adoption process.

NBS to leave rates on hold

Next week, the main domestic event will be the central bank's policy meeting on Tuesday. With little new information changing the overall economic picture (apart from the acceleration of consumption growth, which speaks in favor of a cautious approach) and the koruna stabilized within a range, the central bank will likely leave rates untouched again. The view is also shared by the market, which expects flat rates by year-end. On the FX market, global factors such as the US rate outlook and risk aversion should be the main influences on the koruna's moves, but euro-related domestic events - such as Eurostat's verdict on the fiscal data - are also worth watching.

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Appendix Charts

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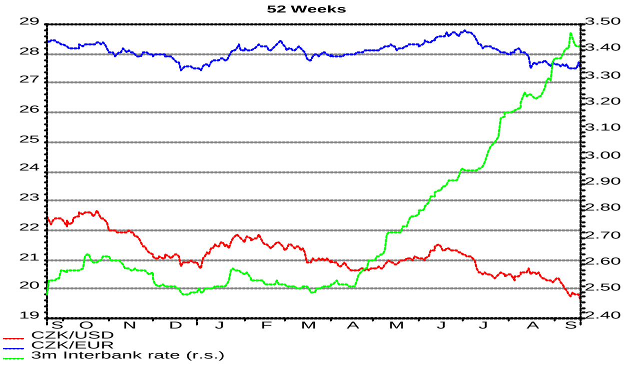
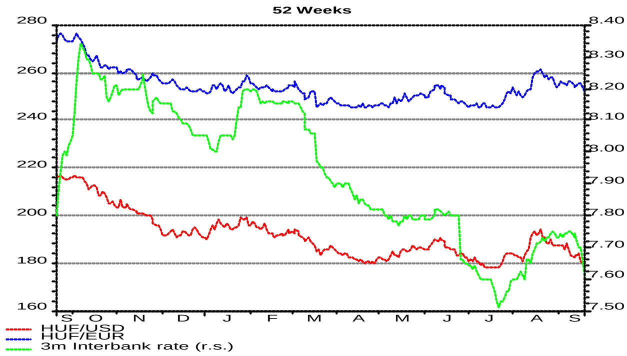
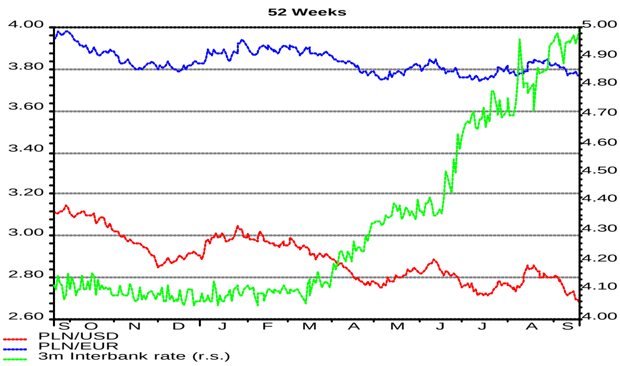
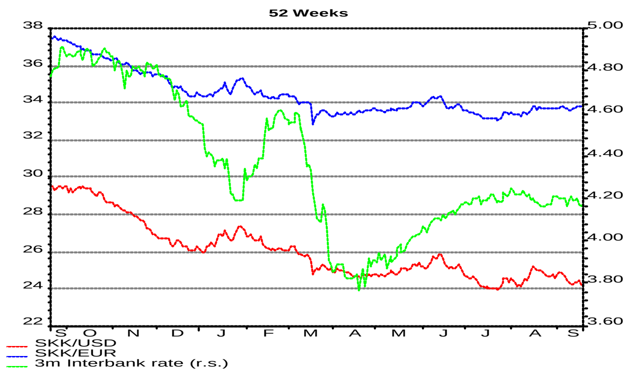
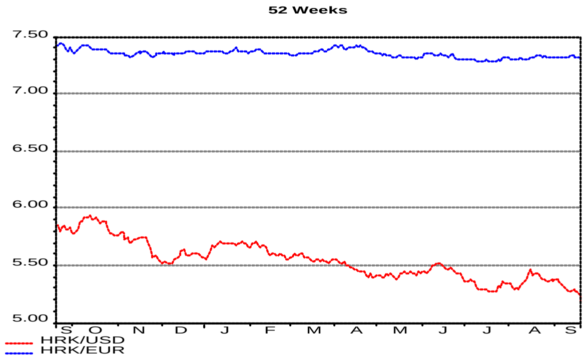
Exchange rates and interest rates (52 weeks)

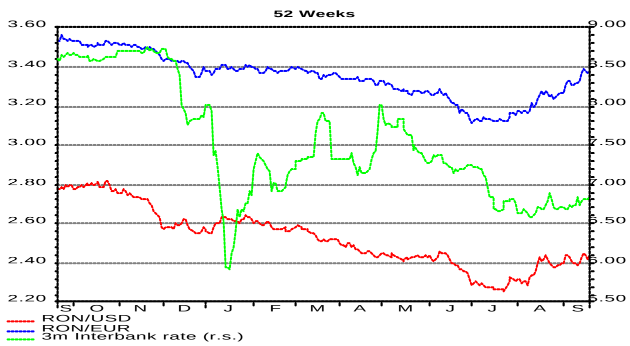








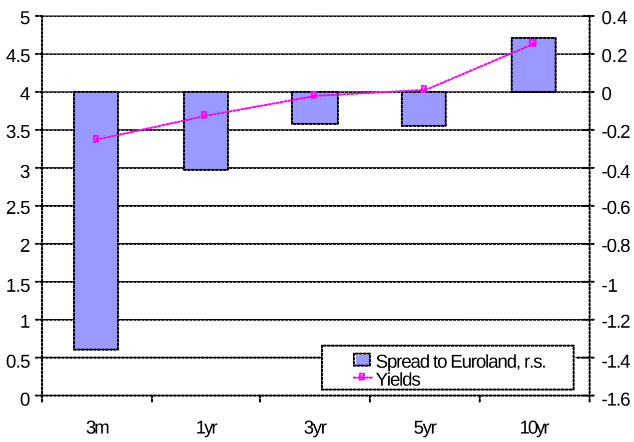




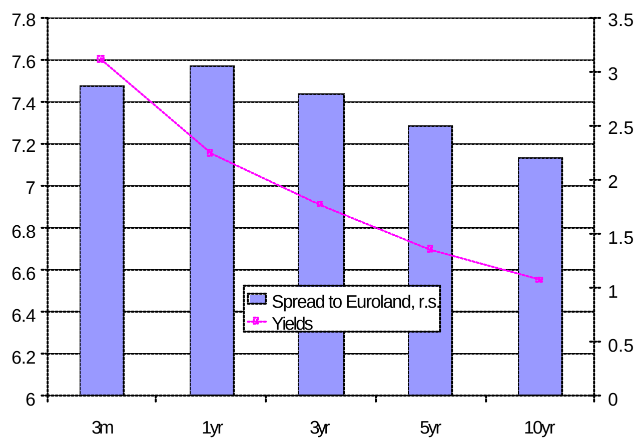
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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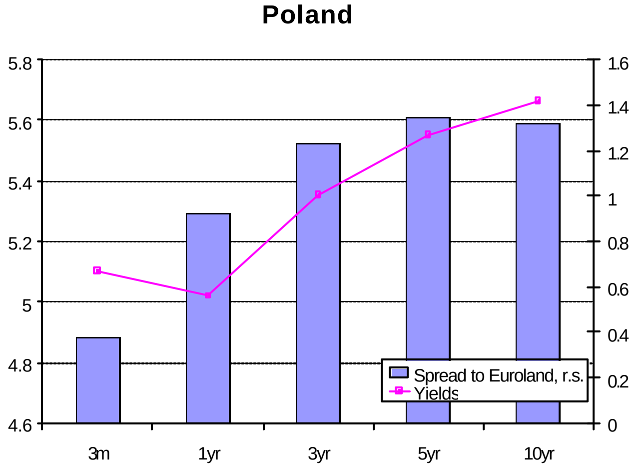

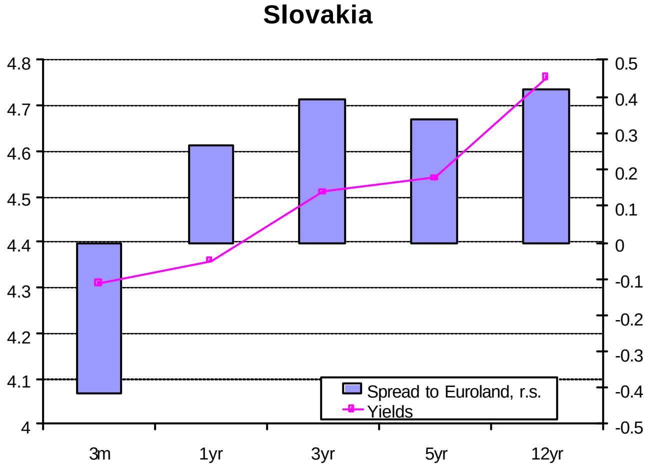

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