CEE Research

September 28, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** October prognosis critical for further rate moves
- **Hungary:** NBH cut base rate by 25bp to 7.50%
- **Poland:** Central bank leaves rate setting alone, but sticks to tightening bias
- **Romania:** RON posted slight recovery, on back of higher short-term interest rates
- **Slovakia:** Eurostat to give final word on fiscal deficit next week

Overview

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Czech Republic:

- Rates kept on hold
- October prognosis critical for further rate moves

Hungary:

- NBH cut base rate by 25bp to 7.50%
- 2Q07 C/A deficit surprised on upside
- Government approved draft budget for 2008

Poland:

- Central bank leaves rate setting alone, but sticks to tightening bias
- Release calendar empty, majors and politics to be watched next week

Romania:

- RON posted slight recovery, on back of higher short-term interest rates
- Short-term interest rates surged above level of sterilization rate
- MinFin sells 1-year discounted treasury bills for 7% yields

Slovakia:

- Central bank left interest rates unchanged
- Current account deficit revised in worse direction
- Eurostat to give final word on fiscal deficit next week

Rainer Singer
(Co-Head CEE FI Research)
rainer.singer@erstebank.at
Juraj Kotian
(Co-Head CEE FI Research)
juraj.kotian@erstebank.at

Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland current	Spreads vs. Euroland - 1m	Spreads vs. Euroland 02/01/2007
Czech Republic	EUR/CZK	27.58	-0.2%	0.2%	0.1%			
	3Y (yield bp)	3.95	0	0	74	-20	-20	-66
	10Y (yield bp)	4.60	-3	5	90	23	32	-23
Croatia	EUR/HRK	7.28	0.5%	0.7%	1.0%			
	3Y (yield bp)	4.56	1	-9	2	35	54	66
	10Y (yield bp)	5.32	0	-4	n/a	93	109	n/a
Hungary	EUR/HUF	250.79	0.1%	2.8%	0.3%			
	3Y (yield bp)	6.94	3	-35	-61	279	327	368
	10Y (yield bp)	6.61	6	-17	24	223	255	276
Poland	EUR/PLN	3.78	-0.3%	1.4%	1.4%			
	3Y (yield bp)	5.39	4	-6	75	124	143	78
	10Y (yield bp)	5.71	4	-17	53	133	155	124
Romania	EUR/RON	3.37	1.3%	-3.6%	0.3%			
Slovakia	EUR/SKK	33.88	-0.2%	-0.2%	1.7%			
	3Y (yield bp)	4.54	3	2	16	39	47	50
	12Y (yield bp)	4.84	8	4	53	48	56	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	33.88	0.12%	0.0%	0.0%	32.8	3.2%	6.4%

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%

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Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	27.6		7.28		251		3.78		3.38		33.9		3.25	3.50	7.75	4.75	7.00	4.25
Dec-07	28.0	27.5	7.40	7.40	253	253	3.72	3.78	3.30	3.39	32.5	33.9	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	3.79	3.20	3.41	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	3.43	32.5	33.8	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	3.10	3.45	32.5		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	3.50		7.43		5.10		7.11		4.31		4.53	5.32	6.60	5.71	4.76	7.00
Dec-07	3.30	3.66	7.00	7.13	5.20	5.30	7.25	6.95	4.30	4.39	4.55	5.20	6.20	5.65	4.70	7.25
Mar-08	3.40	3.78	6.80	6.79	5.30	5.38	7.50	6.79	4.30	4.43	4.80	5.10	6.00	5.72	4.80	7.25
Jun-08	3.55	3.85	6.70	6.62	5.40	5.40	7.50	6.63	4.30	4.46	4.90	5.00	5.90	5.78	4.80	7.25
Sep-08	3.60	3.88	6.60	6.58	5.57	5.40	7.50	6.58	4.30	n.a.	4.80	5.00	5.80	5.85	4.80	7.30

Long-term forecasts

GDP growth (%)	2006	2007e	2008f	2009f
Czech Republic	6.4	5.4	4.1	4.8
Croatia	4.8	5.4	4.7	4.9
Hungary	3.9	2.2	3.0	3.9
Poland	6.1	6.3	5.7	6.1
Romania	7.7	6.2	6.1	6.0
Slovakia	8.3	8.9	7.1	5.1

CPI (%), eoy	2006	2007e	2008f	2009f
Czech Republic	2.5	3.9	4.9	3.2
Croatia	2.0	3.4	3.0	3.0
Hungary	6.5	6.0	3.4	2.3
Poland	1.4	2.7	2.9	2.7
Romania	4.9	4.5	4.1	3.4
Slovakia	4.2	2.8	3.3	3.5

C/A (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.0	-3.5	-3.7	-2.8
Croatia	-7.8	-8.2	-7.9	-8.3
Hungary	-6.5	-4.4	-4.2	-3.9
Poland	-2.3	-3.1	-3.3	-4.3
Romania	-10.3	-13.5	-14.2	-14.1
Slovakia	-8.4	-3.6	-2.4	-1.9

Budget Balance (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.3	-4.0	-3.3	-2.8
Croatia	-3.0	-2.6	-3.0	-3.0
Hungary	-9.2	-6.0	-4.2	-4.1
Poland	-3.9	-3.2	-3.5	-3.4
Romania	-1.6	-2.7	-2.7	-2.7
Slovakia	-3.4	-2.6	-2.4	-2.6

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	No data releases scheduled			
Croatia	4-Oct	Retail trade	5.8% y/y	
	5-Oct	PPI	4.3% y/y	
Hungary	No data releases scheduled			
Poland	No data releases scheduled			
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		Oct-04	Oct-05	04-Jan-2008		CZK 7bn	
		Oct-03	Oct-08	27-Nov-2009	3.25%	CZK 6 bn	
Hungary		Oct-02	Oct-10	Jan-09-2008	-	HUF 30bn	7.35%
		Oct-03	Oct-10	April-09-2008	-	HUF 25bn	7.30%
		Oct-04	Oct-10	Aug-27-2008	-	HUF 35bn	7.15%
Poland		Oct-03	-	2Y	zero	-	-
Romania		No auction scheduled					
Slovakia		Oct-01	Oct-03	Feb-11-14	4.9%	-	4.65%

Major markets

Hawkish ECB to keep rates on hold

For Euroland, the main event next week will be the ECB rate decision on Thursday. We expect unchanged rates for several reasons. Firstly, the council will need more data to assess the impact of the turmoil on financial markets, especially since money market rates still indicate a tight market. Secondly, with the euro reaching new record levels vs. the dollar almost on a daily basis, the ECB will not want to add further pressure on the US currency. However, we still believe that one last hike will come before the end of the year. Monetary aggregates are still growing strongly and the recent inflation figures for Germany came in higher then expected. So, in general, the liquidity shortage and the weak USD have increased the uncertainty for future monetary policy, but we still stick to our expectations of another hike by the ECB. With the ECB very likely to sound a hawkish note, only a further worsening of the outlook for the US economy should trigger yield decreases, in our view.

Recovery of US employment figures likely

Important data is scheduled for the US next week. The ISM index for the manufacturing sector is expected to show a deterioration, thus indicating a slow expansion of the sector. The number estimated looks about right to us, but the risk is on the downside, in our view. Pending home sales on Tuesday and the ISM for the non-manufacturing sector on Thursday will be watched, but are second-tier data. The main event will be the labor market data, released on Friday. After the very weak performance in August, we expect a rebound of non-farm payrolls in September. However, this will not indicate a turnaround of the US economy, but will be a countermovement to the strong reaction of employers to the financial turmoil in the previous month. Still, the numbers could ease the markets' worst fears for the US economy somewhat. As the markets also expect higher employment growth, the downside potential for yields should be limited, at least until Friday. Significant yield drops are only likely if the labor market data shows a big disappointment. Needless to say, this would also increase the pressure on the dollar.

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	4.75	4.79		5.23		4.34	4.56	1.418	
Dec-07	4.25	4.50	4.35	4.69	4.60	5.00	4.40	4.60	1.40	1.421
Mar-08	4.25	4.25	4.30	4.58	4.30	4.60	4.70	4.60	1.36	1.420
Jun-08	4.25	4.00	4.30	4.54	4.30	4.56	4.70	4.70	1.33	1.422
Sep-08	4.25	4.00	4.30	4.11	4.20	4.37	4.70	4.70	1.33	1.422

Czech Republic

Rates kept on hold

Last week, the major news was the CNB rate setting meeting. The CNB unanimously decided to keep the rates on hold, marking a pause in its hiking campaign (it hiked the rates three times this year, including twice in last two sessions) and keeping its key rate at 3.25%. As for the reasons for its decision, the CNB drew on a list of risks to its July prognosis (which called for what we think was a rather rapid rise in the rates). The risks to the headline inflation were seen to be in the upward direction and are mainly due to the reform package adopted in August that will take effect in January 2008 (this reform was not included in the July prognosis). Also included among the risks to the headline were the higher growth of regulated prices and higher food prices.

The risks to the monetary-relevant inflation were anti-inflationary - the stronger CZK, lower August inflation and the risks of rate evolution in the Eurozone (the CNB now mentioned the lower than assumed EURIBOR rate among the risks to its July prognosis, a direct consequence of the current markets tremors) were among those mentioned.

October prognosis critical for further rate moves

As for the further rate setting process, the October prognosis will be of major importance, since it will already include the reform package and new information from the last three months (especially since August). Governor Tuma indicated that it might be possible that the interest rate trajectory implicit in the new prognosis will be "somewhat lower" than previously forecast, with the main channel being the milder secondary effects of (higher) headline inflation. We are not that sure this will be the case (with the economy operating above its potential and unemployment at low levels). Be that as it may, in the shorter term, we think that it will be mainly the stronger CZK and (possibly) the prolonged period of market turbulence that will keep the CNB from hiking further this year. No data releases are scheduled for next week.

Martin Lobotka, mlobotka@csas.cz

Hungary

NBH cut base rate by 25bp to 7.50%

This Monday, the Monetary Council cut the base rate by 25bp to 7.50%. The decision did not come as a surprise; market expectations for the outcome were unanimous. According to the council's statement, the country's fundamental outlook has not changed since the August monetary meeting; the council still expects a negative output gap and a gradual inflation slowdown in the coming two years. The 3% inflation goal can be reached by 2009, provided that the current supply-side price shocks (increase in food and oil prices) only have one-off impacts on consumer prices. Thus, the council will keep an eye on wage developments, whether they indicate possible second-round inflation effects or not. From this point of view, the 2008 wage negotiations could be crucial for the council. (Wage negotiations should start next week in the OET [which is a group comprising the government, employers and unions], and, according to daily newspaper Világgazdaság, the government is to propose wage growth of 4.5% y/y for the private sector.) However, although uncertainties on global markets have not disappeared yet, the pricing of forint assets has improved recently, making a cautious rate reduction possible. Finally, the central bank emphasized that they would have to be very cautious in making future rate decisions. As for the outlook, given the further improvement in the global market environment, we still expect the base rate to decrease to 7% by the end of December.

2Q07 C/A deficit surprised on upside

The central bank posted a C/A deficit of EUR 1.7bn for 2Q07. The 2Q deficit figure proved to be significantly higher than my forecast of a deficit of EUR 1bn. At the same time, the central bank published some revisions. The 1Q07 C/A deficit figure was revised upwards to EUR 1.187bn (from EUR 1.102bn). The current account deficit in 2005 was revised down by EUR 77mn (to EUR 6.013bn), while the deficit in 2006 was revised up by EUR 652mn (to EUR 5.835bn). The structure of the C/A balance in 2Q remained the same. The trade balance again showed a surplus, amounting to EUR 200mn, after the EUR 178mn published for the first quarter. The balance of "Services" showed a surplus of EUR 401mn, thanks to the EUR 404mn surplus in the tourism balance. Thus, the overall 2Q C/A deficit again stems from the deficit of the "Income" balance, which jumped to EUR 2.333bn, from EUR 1.736bn in the first quarter. The high "Income" deficit was due to increasing interest payment obligations, while reinvested earnings and dividend withdrawal also increased in the period. All in all, the structure of the balance is more encouraging than the at-first-sight frightening headline figure.

Government approved draft budget for 2008

This week, the government approved the draft 2008 budget and tax law changes for next year. The budget plans a CF-based deficit of HUF1,240bn, within which the deficit of the central state budget should be HUF 1,138bn. It is positive that next year's budget will finally have a small surplus on the level of the primary balance, which has not been seen since 2000. In addition, the budget will again have "reserves" amounting to around HUF 365bn to prevent any "slippage". At the press conference held this week, Finance Minister Veres again said that next year's budget was planned assuming GDP growth of 2.8% and average inflation of 4.5%. According to the ESA method, the budget deficit will decrease to 4.1% of GDP, from 6.4% of GDP expected for this year. The budget law will be submitted to Parliament by the end of this month and the final vote is scheduled for the middle of December.

Orsolya.Nyeste, orsolya.nyeste@erstebank.hu

Poland

Central bank leaves rate setting alone, but sticks to tightening bias

Poland's central bank opted against changing the rate setting this week. The reference rate thus stays glued at the level of 4.75%. This verdict had been unanimously expected by market analysts. This crucial paragraph accompanied the decision: 'In the Council's assessment, in the medium term the probability of inflation running above the inflation target decreased to a certain degree due to the previously implemented monetary policy tightening, though it is still higher than the probability of inflation running below the target.' We interpret these words as a signal that, even though the rate hikes delivered this year are expected to work, the underlying bias is still toward tighter monetary policy (as the probability of exceeding the inflation target is still higher). We judge the overall tone of the statement as being on the hawkish side. The decline in the price dynamics is viewed as only temporary and inflation is seen near the target at year-end (we agree with this). The MPC still sees the risk of GDP growing at a pace above the potential growth rate. The (unfavorable) gap between wages and productivity is perceived to be deeper than previously estimated. Moreover, the central bank continues to be afraid of inflationary pressures stemming from the fiscal sphere (over the coming month, no favorable news is expected on this front, due to looming snap polls). There are also some anti-inflationary factors mentioned in the statement (the good financial standing of companies, the low external inflation environment, the possible slowdown of the world economy), but we believe that they will not be lasting or strong enough to hamper further monetary policy tightening in Poland (especially as Erste Bank's core scenario still does NOT anticipate a recession of the US economy).

All in all, we believe that strong domestic demand and the tightening labor market in the environment of a positive output gap will make another hike inevitable. Nevertheless, inflation hovering at low levels (almost falling below the lower edge of the target band) might act as a psychological factor, motivating central bankers to take a longer break in the tightening cycle than has been seen so far. That is why we shift our prediction for the next rate move by one month to November (+25bp).

Release calendar empty, majors and politics to be watched next week

On the domestic scene, opinion surveys on political parties' popularity are drawing attention, due to the looming snap polls (October 21). However, these do not provide a clear indication as to who will win, as the ruling Law and Justice (PiS) party alternates with the opposition Civic Platform at the top of the ranking. We believe that the latter has greater coalition potential and is thus more likely to be a part of the future government, which would be welcomed by the markets. Recently, PiS has been hit by the departure of key individuals. Former defense minister Sikorski opted to leave PiS and join Civic Platform, while ex-PM Marcinkiewicz said this week that he would support the opposition candidate in Krakow. The populist parties (Samoobrona and LPR) are hovering near the 5% threshold and there is a real threat they will not make it back into Parliament. Next week's macro calendar is totally empty. Polish assets will hence primarily eye global market tendencies for trading inspiration. Unless some disastrous news comes from the majors, the zloty should hover within the range of 3.75-3.78 (3.80) EUR/PLN for most of the week.

Maria Hermanová (Fehérová) (MHermanova@csas.cz

Romania

RON posted slight recovery, on back of higher short-term interest rates

The Romanian currency gained 0.7% during the week, as it was sustained by an increase of short-term interest rates above the key rate level. However, the transacted volumes were modest, as most of the foreign players refrained from taking new positions in the leu, ahead of the outcome of the censure motion against the government. The domestic currency started the week in the 3.38 zone and remained range-bound in the 3.3800-3.3950 area in the first two days of the week, with no clear direction. Starting Wednesday, the RON took a slight appreciation path towards 3.37, on the back of scarce liquidity conditions driven by the monthly budgetary payments and the NBR's full sterilization. The selling orders came rather from domestic clients for their commercial needs and payments and less from off-shore players, who stayed out of the market this week. On September 26, the National Bank of Romania held a monetary policy meeting that had no influence on the exchange rate, as the decision was already priced in. The NBR decided to maintain the key rate at 7.0%, in line with consensus estimates, despite an upside reversal of headline inflation, indicating that the NBR is confident that it will reach its inflation target of 4% ±1% for 2007. We believe that the RON will remain range-bound in the 3.35-3.40 area next week, considering that the NBR is committed to firm control of liquidity (and as long as political turmoil does not rear its head).

Short-term interest rates surged above level of sterilization rate

The central bank expressed their intention to "pursue firm control of liquidity via open-market operations, seeking to enhance the signaling role of the monetary policy rate and reduce the volatility of interbank money market rates," which indeed already had materialized at Monday's auction. The central bank surprised the market at its regular 2-week deposit auction, as the NBR switched rate sterilization back to the level of the key rate (from variable bid rates previously). Moreover, the NBR drained the whole offer of the commercial banks, which amounted to RON 4.8bn (some EUR 1.4bn). The NBR intends to increase the effective sterilization rate, but keep the monetary policy rate flat. We expect tight interbank liquidity conditions next week as well, as the central bank is likely to restart complete sterilization at the level of the key rate. Therefore, short-term interest rates might continue in the 7/8% zone.

MinFin sells 1-year discounted treasury bills for 7% yields

On September 26, the Ministry of the Economy and Finance held a treasury bond auction of 1-year maturity for the indicative amount of RON 100mn. The overall offer of the primary dealers amounted to RON 286mn, but the MinFin attracted bids no higher than the 7% policy rate. The average yield rose to 7%, from 6.95% at the previous 1Y T-bill auction, as the minimum demanded yield stood at 7%, denoting that participants were not willing to place their liquidities below the actual policy rate, when there are premises for a hike of it in the coming months. We expect yields on the Romanian primary market to remain at the level of the key rate (7.0%) in the short term, as Romania's consolidated budget continues to record a surplus (+0.32% of GDP during January-August).

Melania Hancila, melania.hancila@bcr.ro

Slovakia

Central bank left interest rates unchanged

The central bank left rates on hold for the fifth month in a row, with the 2W repo rate remaining at 4.25% and the overnight corridor at 2.25/5.75%. No proposal to change the interest rates was raised. The decision was in line with the market and our expectations. The central bank acknowledged that inflation risks stemming from food and services prices prevent it from easing the monetary policy in the near future. In our view, the weaker koruna was also an argument for the cautious approach. Going forward, we expect interest rates to stay unchanged in the remaining months of 2007; this view is at present unanimously shared by the market. Next year's outlook depends more on ECB moves. Should the ECB hike rates as we expect it to (also the prevailing market view), no further rate moves are necessary from the Slovak central bank ahead of the 2009 euro adoption. However, if the ECB rate does not go any higher, the NBS would eventually have to cut rates at some point for the ECB and NBS rates to converge. In such a case, we think this cut would most likely be delivered in 2Q08.

Current account deficit revised in worse direction

The central bank revised the current account deficit for the January-June period for the worse to SKK 40.4bn, from the previous estimate of SKK 19.1bn. The revision was due to the updated estimate of dividend outflows, which are typical for the month of June. The new figure is much closer to our earlier expectations; we assume whole-year dividend outflows at SKK 70bn. The central bank also released the July current account deficit, which was at just SKK 100mn, putting the 12-month cumulative deficit at 5.2% of GDP. The current account deficit is improving compared to last year, due mainly to better trade balances (higher exports of cars and electronics); we expect the whole-year deficit at 3.8% of GDP.

Eurostat to give final word on fiscal deficit next week

The most-watched event of the next week will be the news regarding the revision of the fiscal deficit required by Eurostat (some items, such as highways, railways and public media, might be included in the public deficit). The Ministry of Finance estimated the impact of the revisions at 0.7% of GDP for 2006 and at 0.2-0.3% of GDP for 2007 (the latter being critical for the euro-preparedness evaluation). As we argued before, this impact should not significantly endanger Slovakia's meeting of the fiscal Maastricht criteria, as the latest MinFin prognosis for the 2007 deficit was at 2.7% of GDP. However, the market reacted to the news (although with some delay), with koruna sell-offs pushing the currency above the 34.00 EUR/SKK mark to 34.15 EUR/SKK. Prime Minister Robert Fico commented that the government was ready to reduce some spending if necessary for euro criteria fulfillment. This reassured the markets and the koruna bounced back to below 33.90 EUR/SKK in the second half of the week. A more significant revision than that estimated by the MinFin might hurt the koruna (as it poses risks for euro adoption), while an impact in line with current estimates or better could be koruna-supportive.

Michal Mušák, musak.michal@slsp.sk
Mária Valachyová, valachyova.maria@slsp.sk

Appendix Charts

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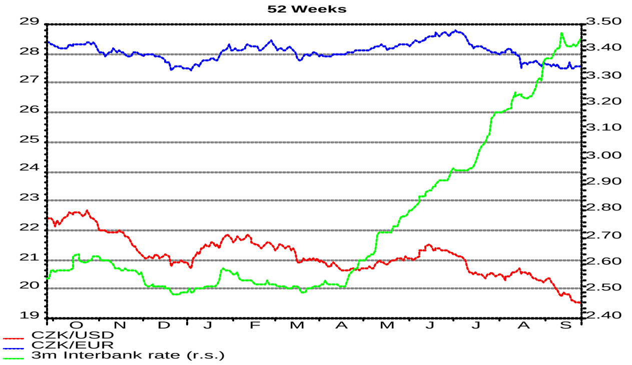
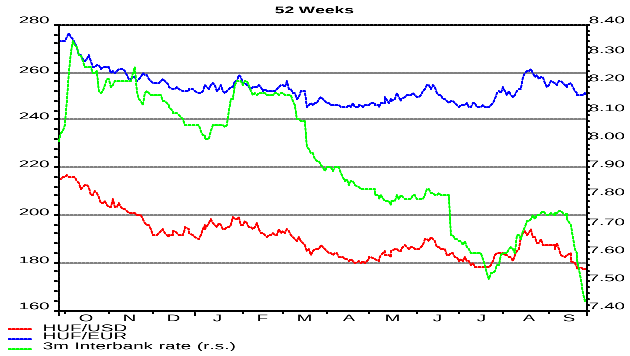
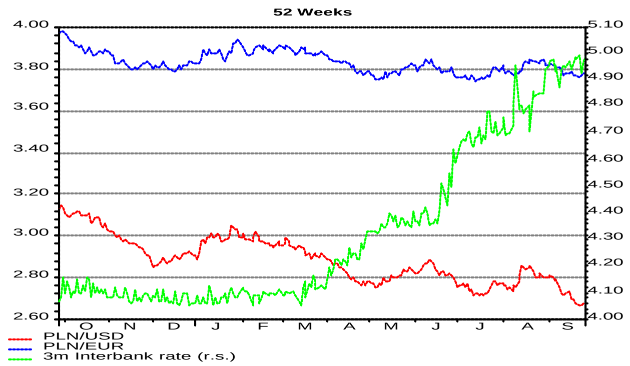
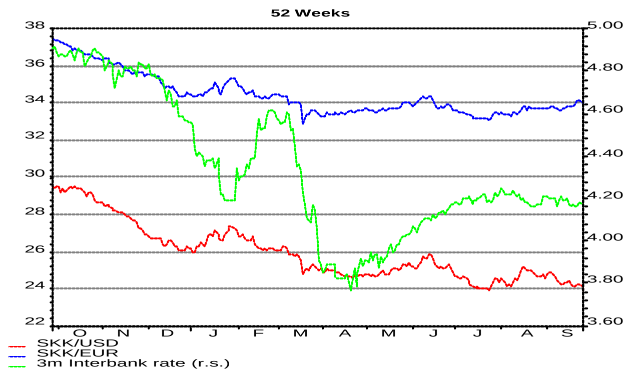
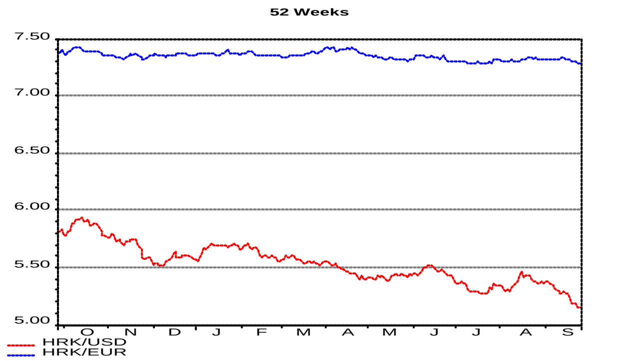
Exchange rates and interest rates (52 weeks)

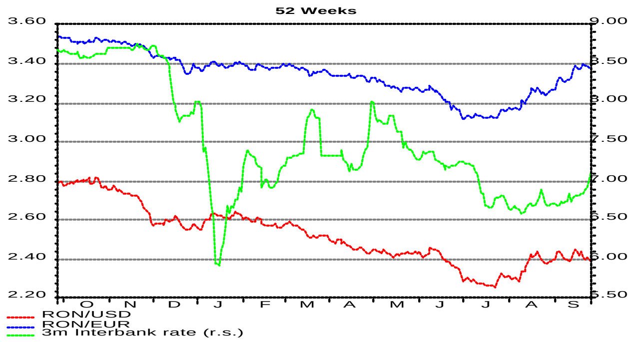












Source: Datastream

Benchmarks

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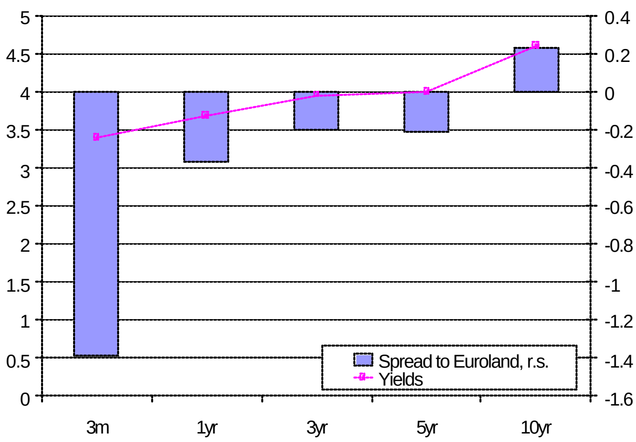

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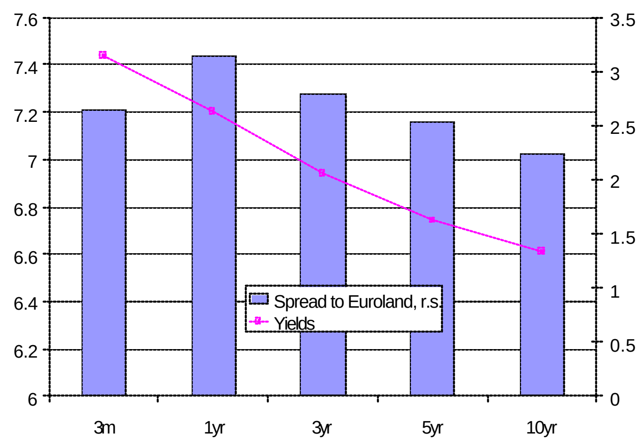

Appendix Forwards

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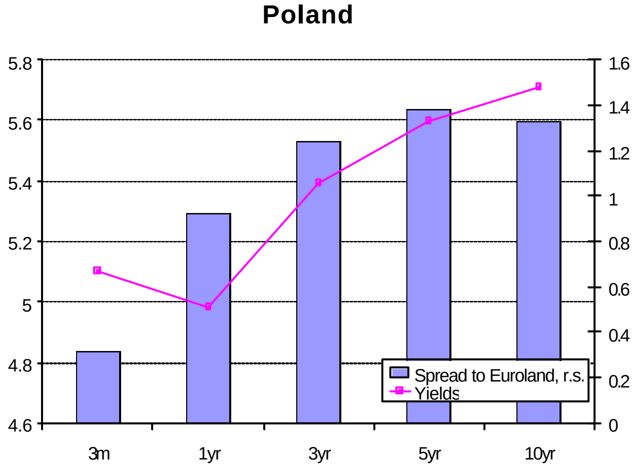

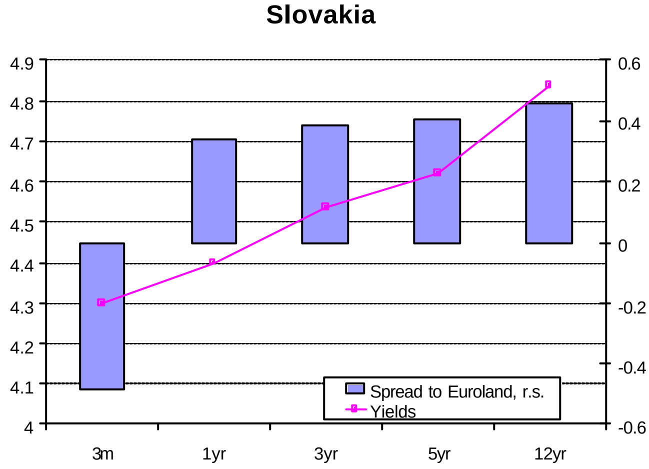

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Contacts

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 Valenta, 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 *(Asia)*	+43 (0)50 100-11723
Jürgen Rene Ulamec, CEFA *(Europe)*	+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	
Co-Head CEE: Juraj Kotian *(Macro/FI)*	+43 (0)50 100-17357
Co-Head CEE: Rainer Singer (*Macro/FI*)	+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
György Zalányi *(Equity)*	+361-235-5135
Orsolya Nyeste *(Fixed income)*	+361 373-2830
Research, Poland	
Artur Iwanski *(Equity)*	+48 22 3306253
Magda Jagodzinska *(Equity)*	+48 22 3306250
Marcelina Hawryluk *(Equity)*	+48 22 3306255
Tomasz Kasowicz *(Equity)*	+48 22 3306251
Piotr Lopaciuk *(Equity)*	+48 22 3306252
Marek Czachor *(Equity)*	+48 22 3306254
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 Barta *(Fixed income)*	+421 2 59 57 4166
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 Wooloughan	+4420 7623-4154
Sales, Croatia	
Zeljka Kajkut *(Equity)*	+385 62 37 28 11
Damir Eror *(Equity)*	+385 62 37 28 13
Sales, Czech Republic	
Michal Brezna (*Equity*)	+420 224 995-523
Ondrej Cech *(Fixed income)*	+420 224 995-577
Michal Rizek	+420 2 2499 5537
Jiri Smehlik (*Equity*)	+420 224 995-510
Pavel Zdichynec *(Fixed income)*	+420 224 995-590
Sales, Hungary	
Róbert Barlai (*Fixed income*)	+361 235-5844
Gregor Glatzer (*Equity*)	+361 235-5144
Krisztián Kandik (*Equity*)	+361 235-5140
Zoltán Szabó (*Fixed income*)	+361 235-5144
Sales, Poland	
Head: Andrzej Tabor	+4822 330 62 03
Pawel Czuprynski *(Equity)*	+4822 330 62 12
Lukasz Mitan *(Equity)*	+4822 330 62 13
Jacek 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