October 19, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** CPI upsurge in September
- **Czech Republic:** Strong koruna points to unchanged rates next week
- **Hungary:** Short week ahead with focus on the approaching monetary meetings
- **Poland:** Election result will set the tone for next week's trading
- **Romania:** The comments of the governor weakened the Romanian currency
- **Slovakia:** Eurostat to deliver verdict on fiscal data on Monday

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Overview

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Croatia:

- CPI upsurge in September
- New bond issue confirmed for end of October

Czech Republic:

- Recent current account date likely to be revised
- Lower retail sales due seasonal affects
- Strong koruna points to unchanged rates next week

Hungary:

- Short week ahead with focus on the approaching monetary meetings

Poland:

- Macro data published this week strengthens the case for further monetary policy tightening
- Election result will set the tone for next week's trading

Romania:

- Government adopted 2008 budget draft
- The comments of the governor weakened the Romanian currency
- The Central Bank continued to exert firm control over the money market

Slovakia:

- Harmonised inflation edged up in September
- CB Board's Odor: interest rates close to optimal level
- Change in trade methodology to increase nominal GDP
- Eurostat to deliver verdict on fiscal data on Monday

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	- 1m	02/01/2007
Czech Republic	EUR/CZK	27.32	0.6%	0.7%	1.1%			
	3Y (yield bp)	3.95	0	0	74	-18	-16	-66
	10Y (yield bp)	4.59	-2	-1	88	27	38	-23
Croatia	EUR/HRK	7.33	0.0%	-0.1%	0.3%			
	3Y (yield bp)	4.55	-8	5	1	41	37	66
	10Y (yield bp)	5.27	-4	-3	n/a	95	110	n/a
Hungary	EUR/HUF	250.48	-0.7%	1.4%	0.4%			
	3Y (yield bp)	6.87	-6	-3	-68	274	282	368
	10Y (yield bp)	6.60	0	-10	17	228	248	276
Poland	EUR/PLN	3.69	0.9%	2.3%	3.8%			
	3Y (yield bp)	5.57	13	22	93	144	127	78
	10Y (yield bp)	5.79	8	-10	61	147	145	124
Romania	EUR/RON	3.35	-0.6%	1.0%	1.0%			
Slovakia	EUR/SKK	33.44	0.3%	1.3%	3.1%			
	3Y (yield bp)	4.56	2	6	18	45	41	50
	12Y (yield bp)	4.88	4	15	57	58	48	38

Source: Reuters, Bloomberg (+ means strengthening / - means easing of the exchange rate)

Trading Ideas

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Positions

# Position	Date of opening	Instruments	Entry values	Today's values	flat P/L (%)	flat P/L inc. carry (%)	P/L p.a. inc. carry (%)	Target values	Target P/L flat inc. carry (%)	Target P/L p.a. (%)
	04/06/07	6m Bribid/ 6m Euribor	3,9/ 4,28%			1.3%	3.4%	32.8	3.2%	6.4%
12 short EUR/SKK		EUR/SKK	33.92	33.45	1.42%					

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%

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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	27.3		7.32		251		3.69		3.35		33.4		3.25	3.50	7.50	4.75	7.00	4.25
Dec-07	27.6	27.3	7.40	7.40	253	252	3.72	3.70	3.30	3.36	32.5	33.4	3.25	3.50	7.00	5.00	7.50	4.25
Mar-08	27.3	27.2	7.30	7.30	255	254	3.70	3.70	3.25	3.39	32.4	33.4	3.50	3.50	6.75	5.00	8.00	4.25
Jun-08	27.1	27.1	7.25	7.25	255	255	3.75	3.71	3.21	3.41	32.5	33.4	3.50	3.50	6.75	5.25	8.00	4.25
Sep-08	26.8	27.1	7.25	7.25	256	257	3.70	3.72	3.22	3.44	32.5	33.3	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	3.58		7.43		5.15		7.64		4.35		4.58	5.27	6.60	5.77	4.79	7.00
Dec-07	3.30	3.66	7.00	7.13	5.20	5.32	7.60	8.55	4.30	4.53	4.55	5.20	6.30	5.65	4.70	7.3
Mar-08	3.40	3.77	6.80	6.75	5.30	5.45	8.20	7.90	4.30	4.45	4.80	5.10	6.00	5.70	4.80	7.4
Jun-08	3.55	3.84	6.70	6.54	5.40	5.51	8.20	5.96	4.30	4.51	4.90	5.10	5.90	5.76	4.80	7.4
Sep-08	3.60	3.92	6.60	6.49	5.57	5.39	7.70	7.17	4.30	4.62	4.80	5.20	5.80	5.85	4.80	7.30

Long-term forecasts

GDP growth (%)	**2006**	**2007f**	**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	6.2	6.5	5.5	6.0
Romania	7.7	6.0	6.1	6.0
Slovakia	8.3	8.9	7.2	5.3

C/A (%GDP)	**2006**	**2007f**	**2008f**	**2009f**
Czech Republic	-3.0	-3.5	-3.7	-2.8
Croatia	-7.8	-8.2	-7.9	-8.3
Hungary	-6.5	-4.9	-4.2	-3.9
Poland	-3.2	-4.1	-4.5	-4.9
Romania	-10.3	-13.7	-14.7	-14.7
Slovakia	-7.3	-3.4	-2.4	-1.9

CPI (%), eoy	**2006**	**2007f**	**2008f**	**2009f**
Czech Republic	2.5	3.9	4.9	3.2
Croatia	2.0	3.4	3.0	3.0
Hungary	6.5	6.1	3.6	2.3
Poland	1.4	2.7	2.9	2.7
Romania	4.9	5.7	4.1	3.9
Slovakia	4.2	3.0	3.5	3.5

Budget Balance (%GDP)	**2006**	**2007f**	**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	-2.9	-2.4	-2.6

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Oct-25	CNB Rate-setting meeting	3.25%	3.25%
Croatia	22-Oct	Unemployment rate	14.2%	
	23-Oct	Industrial Production	5.5% y/y	-
Hungary	Oct-25	August Retail sales	-3.9% y/y	-4.4% y/y
Poland	Oct-21	Parliamentary elections	-	-
	Oct-22	Net core inflation (% y/y)	1.3%	1.2%
	Oct-23	Retail sales (% y/y)	14.1%	16.5%
	Oct-25	Minutes from CB meeting (09/2007)	-	-
Romania	No data release scheduled			
Slovakia	Oct-26	September PPI	1.1% y/y	1.1% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Oct-24	Oct-29	2022-Sep-12	4.70%	CZK 7 bn.	
Hungary		Oct-24	Oct-31	Jan-30-2008	-	HUF 25bn	7.30%
		Oct-25	Oct-31	Oct-24-2012	6.00%	HUF 45bn	6.70%
		Oct-25	Oct-31	Feb-24-2017	6.75%	HUF 40bn	6.65%
Poland		Oct-22	Oct-24	2008-Oct-22	-	PLN 0.5-1.0bn	-
Romania		24/10/2007	26/10/2007	1Y	-	100,000,000	7%
Slovakia		No auction scheduled					

Major Markets

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Major markets

Ifo-Index lower than expected

Euro government bonds were driven higher by the rally of US treasuries. However, the 10-year yield spread decreased further to below 20 basis points. ECB officials sent out more hawkish signals by pointing out the risk of rising inflation in 2008. At the moment there seems to be no need for higher key rates as money market rates are still at elevated levels and the Bank Lending Survey showed tighter credit standards. Should money markets calm down in the coming weeks, a hike in the repo rate could occur in December but otherwise a postponement to the first quarter of 2008 seems probable. Next week flash estimates for the Purchasing Manger Indices will be released on Wednesday. After the plunge in September a small rebound can be expected for October. Mainly the Service Index, which was driven down by a plunge in sentiment in the financial sector, should show a better reading in October. On Thursday the Ifo-Index will be released. The higher Euro, tighter credit standard and a new high in the oil price point to a further weakening in the expectation component. In this surrounding, a stabilisation as seen by the ZEW Survey would already be a positive surprise. Preliminary consumer prices for October will be released from Thursday onwards in Germany. A combination of higher energy prices and the end of the base effect on higher taxes on tobacco should result in an unchanged inflation rate of 2.4%.

US housing data in focus

While the market more or less ignored the - at best - neutral inflation data, the numbers from the housing market, released on the same day, triggered strong gains on the bond market and further losses for the dollar. This movement was reinforced the following day by poor quarterly results of the Bank of Amerika. Housing starts and building permits both plunged more deeply than expected and reached 15-year lows in September. At the same time a strong reaction of the construction industry to the (subprime) turmoil in August was to be expected. Anyway, the message is that financial markets are currently deeply concerned about a recession in the US, and are prepared to follow indications that point in this direction. Better-than-expected labour data and retail sales released during the first weeks of the month seem forgotten. Given this environment, sharp attention will be given to the sales figures for existing homes on Wednesday and for new homes on Thursday. At the same time, will it really be a surprise to get confirmation that consumers were not prepared to buy homes after hearing all August about the dire state of the market? So putting it all together, yes, the numbers next week will be bad, yes, fears about a housing market induced recession will increase, and yes, speculations on an interest rate cut at the next FOMC meeting on October 31 will heighten, but no, the September data will not represent the medium-term state of the housing market.

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	4.64		5.18		4.30	4.47	1.428	
Dec-07	4.25	4.50	4.35	4.79	4.60	5.06	4.40	4.60	1.40	1.429
Mar-08	4.25	4.25	4.30	4.56	4.30	4.70	4.70	4.60	1.36	1.430
Jun-08	4.25	4.00	4.30	4.51	4.30	4.53	4.70	4.70	1.33	1.430
Sep-08	4.25	4.00	4.30	4.26	4.20	4.42	4.70	4.70	1.33	1.431

Croatia

CPI upsurge in September

CPI figures surprised in September on the upside posting a robust 1.2% m/m increase, which resulted in the y/y figure accelerating from 2.6% to 3.9%. In addition to clothing prices (+6.1% m/m), which due to seasonal reasons boosted inflation pressures, the main driver behind the strong CPI inflation growth was food and non-alcoholic beverages prices - posting a 2.5% m/m increase. Once again, headline inflation confirmed that it is sensitive to supply-side shocks (note food and non-alcoholic beverages prices have ca. 30% weight in the CPI basket) and are dependent on weather conditions. Towards the year-end we now expect inflation to continue to be under pressure, which is likely to mean inflation above 4% y/y. Pressures will continue to come from food prices, while negative effects from oil price increases could also translate into inflationary pressures. Some administrative price hikes, especially after the November elections, could occur. Hence, after a period of low inflationary pressure in 2H06 and 1H07, inflation figures are likely to feel the strain in the forthcoming period.

New bond issue confirmed for end of October

After a turbulent period on the domestic money market and finalisation of the T-HT IPO process, liquidity conditions in the system stabilised and short-term money market rates shifted back to the 5-6% region. Overall, good system liquidity was also confirmed by the CNB's decision to reject a proportion of the banks' bids (ca. 55% and 30% respectively) on the last two reverse REPO auctions. That could also be a sign that the CNB currently sees MM rates at adequate levels in the light of rising inflation figures. Finally, the new bond issue will take place on October 30 and will be an extension of the foreign currency clause issue with a 2019 maturity worth EUR 300mn. This will be the first non-pure kuna government issue since 2005, hence showing that the Ministry of Finance has not abandoned FX-linked issues and that demand for such issues exists among investors. Finally, FX market developments followed our expectations as, after MM conditions calmed, the exchange rate shifted back to the 7.30-7.35 range and we see it gradually moving towards 7.35-7.40 towards year-end.

Alen Kovac, akovac2@erstebank.com

Czech Republic

Recent current account date likely to be revised

Last week we had data on retail sales and the current account, with the latter providing the surprise. The August deficit was wider than expected (CZK -32.6bn. as against the expectation of CZK -8bn.), which was due to the unexpectedly high outflow of dividends (CZK 23bn.) and reinvestment profits (estimated by the CNB to be about CZK 10bn.). By contrast, the deficit in June and July was lower than our expectations due to lower dividends. Minor hypothesis: we are reminded of the situation last year, when the autumn C/A figures were influenced by estimates of SME dividends, with C/A deficits higher than we expected. However, after the quarterly revisions, they were lowered towards our original estimates. Our view on the CZK, therefore, remains unchanged - we continue to be bullish, as we see 26.6 EUR/CZK at the end of next year.

Lower retail sales due seasonal affects

Retail sales experienced a slowdown, albeit only a technical one. Seasonally adjusted retail sales (no cars) rose 0.3 % m/m in August. Year-on-year growth was 7.2 % - including the car segment would add one tenth of a percentage point to this figure. Sales of non-food items rose at their slowest pace in August (a 'mere' 7.9 % y/y). On the other hand, sales of foods rose at 5.4 %. The slowdown in the dynamics of non-food sales growth was thus directly conducive to the somewhat slower overall growth than we have witnessed over the previous months. However, we do not view this as a break in the overall dynamics, but more of a technicality due to two broad factors: first, households are highly likely to be preparing for the Christmas shopping season, with a tendency to shift the purchases of more luxurious items towards the end of the year (this might have been helped also by few of the retailers already announcing that electronics, for example, will be cheaper towards Christmas, and in part also due to the effect of weaker dollar). Secondly, August is a month of vacations. All in all, the implications of this announcement on monetary policy are negligible.

Strong koruna points to unchanged rates next week

As for the coming week, the number1 event will be the Czech National Bank's rate-setting meeting. Our baseline does not call for a hike in October (we see next 25 bps in January), although we acknowledge that there remains a risk of hiking as early as next week. The reasons for postponing the hikes are basically twofold: first, the strong Koruna (it hit the record of below 27.30 against EUR) that dampens the (summer) firm determination of (at least part of) the Banking board and, secondly, lower demand inflation. Among the major inflation risks (and we would say the major risk) will surely be the labour market, with unions feared to be gaining the upper hand in the wage negotiations for 2008. Next year, two opposing effects will thus come into play - lower social spending will depress consumption while a tight labour market will tend to raise wages and work in the opposite direction.

Martin Lobotka, mlobotka@csas.cz

Hungary

Short week ahead with focus on the approaching monetary meetings

Next Monday and Tuesday are market holidays in Hungary. The expected lower turnover with closed domestic markets, therefore, could bring more volatility to the exchange rate and yields. In the remainder of the coming week, the macro calendar is almost empty with only the August retail sales figure due on Thursday. Its market impact should be limited, however. Instead, the approaching rate-setting meetings of the NBH and FED should gain increasing attention among investors. As for the outcome of the NBH's next meeting (scheduled for October 29), opinions are still divided concerning the possibility of a continuation of cautious rate reductions also in October. It is worth noting, however, that the latest wage figures, published this week, have somewhat increased the likelihood of an October rate reduction. The point is that the mostly monitored regular (ex bonus) annual wage growth in the private sector has been slowing down for some months now, although the latest figure - which showed 10.4% y/y growth in August - is still seen as high. At the same time, the overall gross wage growth in the economy slowed to 7.8 y/y in August, from 10% y/y in July. These wage figures should not be the main arguments in the rate decision, but nevertheless could still help the monetary council in the current controversial and tough situation.

Orsolya.Nyeste, orsolya.nyeste@erstebank.hu

Poland

Macro data published this week strengthens the case for further monetary policy tightening

Economic indicators released in the past few days have strengthened the market expectations that the Central Bank will be yet forced to increase its reference rate. While the abrupt slowdown of the price dynamics in August (to as far as 1.5% y/y) had widely been perceived to be of a temporary nature, the inflation rate made a larger-than-expected leap upwards in September, hitting the 2.3% y/y level. The main driver was the food category. While the regional food price shock seemed to have largely bypassed Poland in previous months, September finally saw price hikes in various food categories, including fruits and vegetables, butter and bread. This nudged up the annual pace of food category growth to 5.1% y/y (from 2.8% y/y in August). Other factors that led to quicker inflation included fuels (on base effects - they declined in the same period of 2006) and some services (e.g. education and hotels). Inflation is likely to increase in the coming months, surpassing the Central Bank's target of 2.5% again and hitting 2.8% at year-end. Food and fuels will rank among the drivers, while the net core inflation should also gradually shift upwards, due to strong domestic demand.

A separate release showed that the pressure on corporate wages cooled a little. As we predicted, their annual growth returned to single-digit territory in September, when they increased by 9.5% y/y. In addition, employment is still growing at a robust 4.7% y/y. We think that the effect of the cut in disability wage contributions might be starting to kick in. The contributions of employers were lowered by 3pp in July and will be cut again by 2pp in January, which increases net wages and might at least partially help to contain gross wage demands. With industrial output slowing sharply on working day effects to 5.2% y/y, labour productivity is still not managing to catch up with wage demands.

We believe the higher-than-expected inflation figure is likely to make central bankers more vigilant. Although it comes primarily on the back of a supply-side shock (food), which monetary policy should not react to, there is a risk of possible second-round effects, given that the economy is operating above its potential. Even though the wage dynamics moderated a bit, this does not represent a reason for optimism either. Combining the increase in wages and employment, the wage bill (i.e. aggregate wages) increased by 12.1% y/y in real terms. This is still close to multi-year highs and confirms that the labour market continues to support households' purchasing power significantly and creates potential inflation risks for the future. On the other hand, as the net core inflation remains below 1.5%, the majority of the council should be comfortable to wait at least one more month before acting. Therefore, we stick to our expectation of no rate change in October, but still consider a 25bp hike to be the most likely scenario in November.

Election result will set the tone for next week's trading

One of the most important events of the next few days will be Sunday's Parliamentary elections. (Please see last week's Insights and Special note sent out this week for a more detailed discussion on this topic.) The markets seem to be ignoring the nearing polls and saw mixed development this week. Thanks to encouraging regional sentiment, the zloty continued its strong rally and marched to below the threshold of 3.70 PLN/EUR. Technical indicators signal that the zloty might start to be overbought and space for a correction is emerging. However, should the elections yield a positive outcome and global market influences remain conducive, we think that further gains are still possible in the short term. Contrary to the currency, bonds suffered losses. As we had expected (please see last week's Insights), the macro data reminded markets that the tightening cycle is not over yet and caused the yield curve to shift upwards along all maturities. The data message was reinforced by the rhetoric of central bankers. Professor Filar (belonging to the hawk camp) said that the majority of the council is still concerned about all inflationary threats. He added it is not a 'wait-and-see' approach, but 'watch carefully and react immediately' approach. This corresponds with our expectation of one more hike this year.

Maria Hermanová (Fehérová), mhermanova@csas.cz

Romania

Government adopted 2008 budget draft

The Romanian government has approved a budget draft for 2008 and will submit it to parliament in early November. The deficit of the consolidated state budget will be 2.7% of GDP, in line with the Maastricht criteria. Public debt will remain under control, starting from a low level at the end of June 2007 (16.5% of GDP). The entire 2008 budget is based on a y/y inflation of 3.8%, a real GDP growth of 6.5% and an average exchange rate of 3.18 against the Euro. The income tax rate will remain flat at 16% in order to consolidate GDP growth and discourage the underground economy. By maintaining the existing taxes and not introducing new ones the fiscal policy aims to be incentive-driven and stable. Social contributions for employers and employees will be lowered by 6 pp in three stages, thus reducing fiscal pressure and revealing new categories of taxable income. The liberal government is currently supported by just 23.8% of the parliament, but generous hikes in state pensions and aids for children might convince the left wing opposition to pass the law, thus increasing the support in parliament to around 55.4%. We estimate that the parliament will approve the budget, although minor changes are possible.

At the end of August, the consolidated state budget had a surplus of 0.32% of GDP and it is possible to see a small surplus at the end of September too. The Ministry of Finance rejected this week all bids at the 5-year T-bonds auction considering the demanded yields to be unacceptable. It is possible to see the same scenario next week, as the Ministry of Finance awaits the Central Bank's decision regarding the monetary policy rate on October 31.

Despite some rather populist measures for 2008, which is an election year in Romania, we consider the 2008 budget as ambitious. The major gains are the development of a stable fiscal system, important capital expenditures, an increase of education spending and in R&D expenditures. Our estimate for end-2008 deficit is 2.7% of GDP.

The comments of the governor weakened the Romanian currency

RON started the week trading in the 3.34 zone and remaining flat vs. Friday, despite the rampant deepening of the current account deficit. In the first eight months of the year, the current account shortfall extended to EUR 10,228mn, rising by 87% as compared to the same timeframe last year. However, it could be noticed that the dynamics as compared to previous months slowed, on the back of higher current transfers and decreasing deficit in incomes. As we had already got used to, the main driver of the C/A shortfall was the trade balance, which recorded a deficit of EUR 10,864mn. Foreign direct transfers reached EUR 4,059mn at the end of August, down 6.2% y/y, but covered only 40% the current account deficit. The governor of the National Bank clipped the wings of speculators on Monday, when warning investors that the NBR is unlikely to consent to abrupt rate moves, despite the steep rebound in inflation. The governor underlined that the main objective of the Central Bank is to maintain the financial stability of Romania, therefore NBR will not sacrifice the current account balance and economic growth for the sake of decreasing inflation in the short term. The governor also expressed hopes that Romania's resurgent inflation will be brought down close to 5% by December. In the light of the governor's comments, we consider that the NBR will hike the monetary policy rate in October by at least 25 bps to give a signal to the market that it is committed to fighting inflation. As the market took time to digest the governor's statement, some players decided to close their positions on the leu, pushing the exchange rate up to the 3.36 zone. The domestic currency recovered in late trading on Wednesday, after the NBR organised another depo auction, draining the whole surplus of the Romanian money market. However, the RON could not hold the gains and retuned into the 3.36 area towards the end of the week.

We expect the RON to remain range-bound in the 3.32-3.37 area, with risks on the downside. Next week the commercial banks will be needing liquidity for their clients' quarterly payments to the state budget, therefore the short-term interest rates might rise above the key rate, offering support for the leu.

The Central Bank continued to exert firm control over the money market

The Central Bank continued to exert firm control over the money market this week, organising two deposit auctions to asure that they have sterilised the whole liquidity on the interbank market. The short-term interest rates (ON, TN) were quite stable during the week, finding equilibrum in the 6.5/7.2% zone. We expect a slight increase of the short-term interest rates next week above the level of the key rate, as the current reserve period will end on Tuesday and companies will have to pay their contributions to the state budget by Thursday.

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

Slovakia

Harmonised inflation edged up in September

Slovak harmonised inflation reached 1.7% y/y in September, slightly above our initial forecast, but in line with what was indicated by the earlier-released CPI. This shows acceleration from 1.2% in y/y in August, due to the base effect and food price growth. Slovakia met inflation criterion again with a 2.1% y/y HICP inflation (12M average is taken) against the 2.6% reference limit.

In reaction, the CB said HICP inflation was higher than its forecast due to food prices. The CB Governor, Ivan Šramko, said that higher food prices might be reflected in the new inflation prognosis, to be released at the end of this month. Nevertheless, higher food prices should not endanger the meeting of the Maastricht criterion (we agree with this). Previously, prices of food were identified as a risk factor in the CB forecasts. The CB's old prognosis assumed HICP inflation at 1.5% at the end of 2007 - we think that figure could be revised up to around 1.7% y/y. We expect the 12M average of annual harmonised inflation at 1.7% in spring 2008, around one percentage point below the Maastricht reference limit.

CB Board's Odor: interest rates close to optimal level

CB Board member Ludovit Odor said that interest rates are close to their optimal level at present (a bit on the tightening side). Odor also suggested that he would prefer the Slovak Central Bank to hold off with rate moves until the ECB hikes its base rate to 4.25%. This is in line with our scenario, which assumes that the Slovak Central Bank taking its lead from the ECB (or, in the case of the ECB keeping rates on hold, we expect a 25bp cut in 2Q08).

Change in trade methodology to increase nominal GDP

As we wrote last week, the Statistical Office revised the trade balance data from 2004 onwards due to different methodology (mainly of electricity trade). The revision had the biggest impact on 2006, when trade balance was revised up by SKK 18bn. This could add to the 2006 real GDP growth around 0.8pp (up to 1pp, according to the Statistical Office). GDP statistics should be revised in the coming weeks.

Eurostat to deliver verdict on fiscal data on Monday

Out of next week's data, only PPI is on the schedule, but it is unlikely to trigger any market response. More importantly, Eurostat should publish fiscal data for EU countries. As a reminder, Eurostat demanded Slovakia to include several items into the fiscal balance that would deepen the deficit, but so far, the extent of any impact on the Euro-important year 2007 is unclear (the MinFin estimated the additional shortfall due to the revision at 0.2-0.3% of GDP). After Monday's fiscal data, markets will be better able to gauge risks related to Euro adoption (the higher the risk of missing the 2009 EMU entry, the worse for the koruna). Our expectation is that the verdict will not endanger Slovakia's Euro adoption chances. We anticipate some - but moderate - koruna appreciation in response.

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

Appendix Charts

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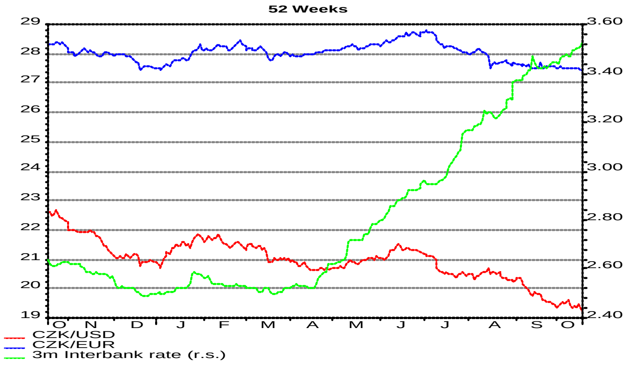
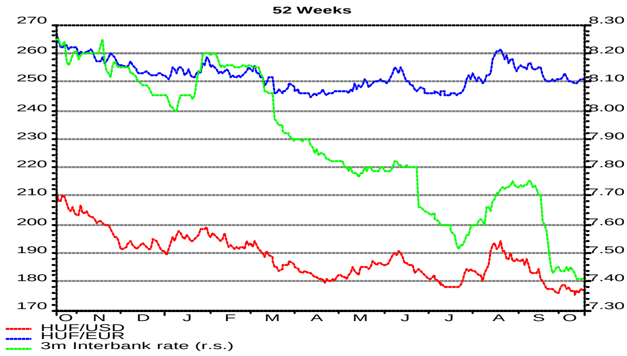
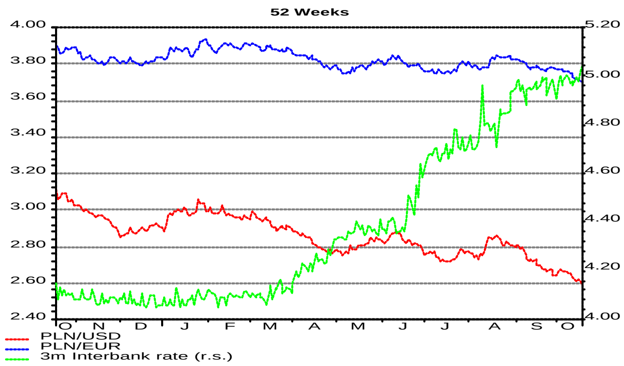
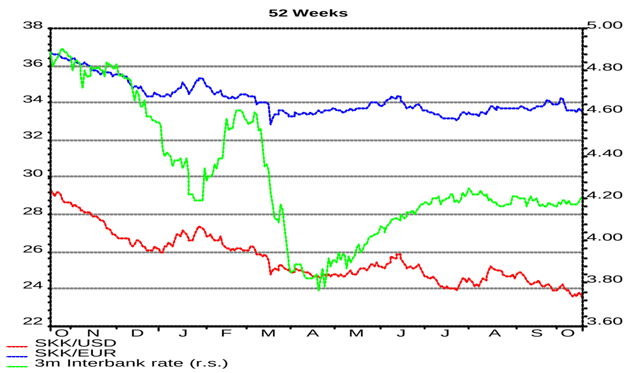
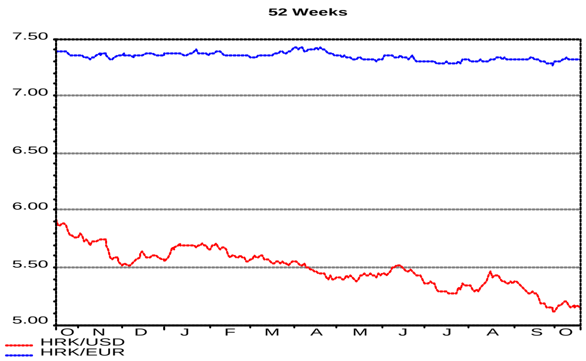
Exchange rates and interest rates (52 weeks)

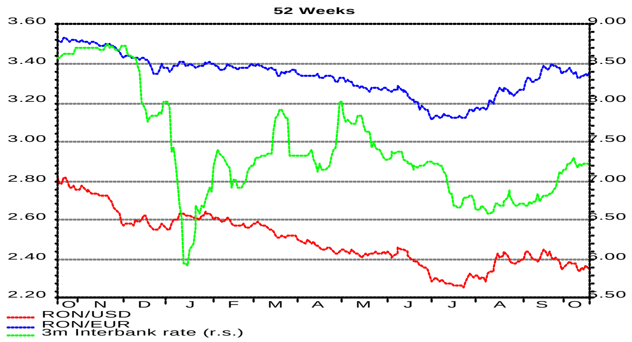








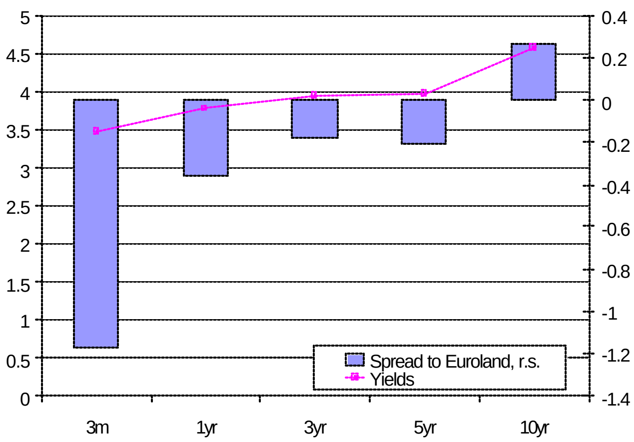




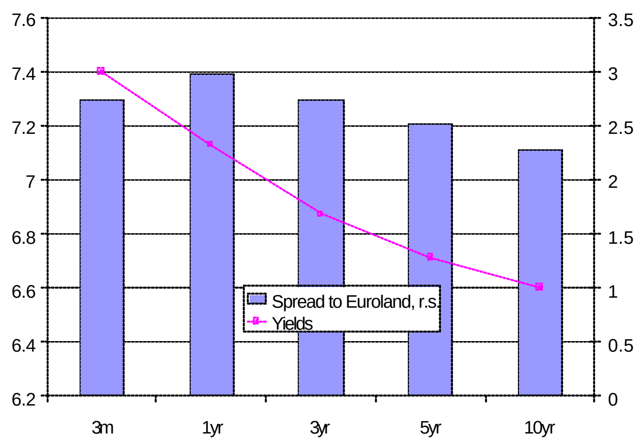
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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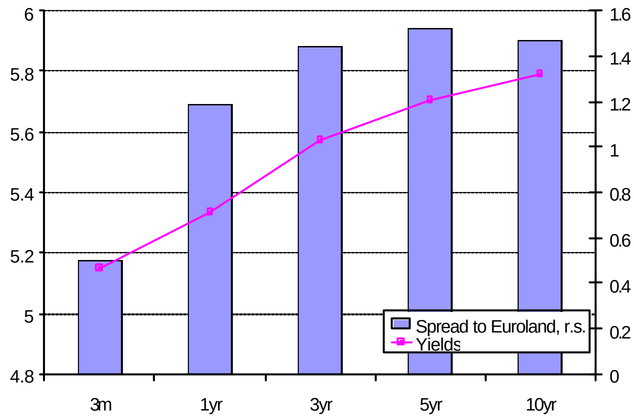
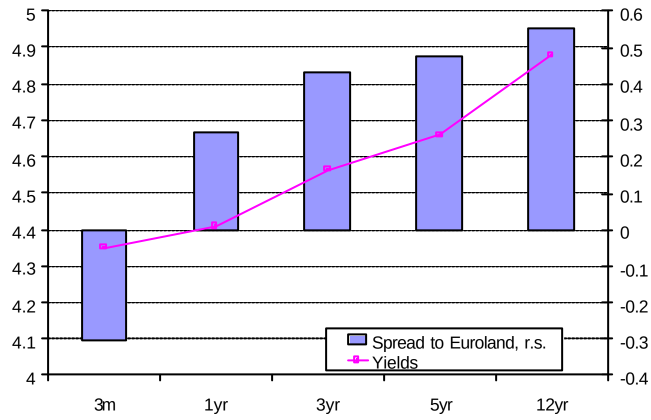
Poland



Slovakia



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Contacts

http://global.treasury.erstebank.com

Group Research

Head of Group Research	
Friedrich Mostböck, CEFA	+43 (0)50 100-11902
CEE Equity Research	
Co-Head: Günther Artner, CFA	+43 (0)50 100-11523
Co-Head: Henning Eßkuchen	+43 (0)50 100-19634
Günter Hohberger *(Banks)*	+43 (0)50 100-17354
Franz Hörl, CFA *(Steel, Construction)*	+43 (0)50 100-18506
Gernot Jany *(Banks, Real Estate)*	+43 (0)50 100-11903
Daniel Lion *(IT)*	+43 (0)50 100-17420
Martina 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
Alihan Karadagoglu *(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/Serbia	
Head:Mladen Dodig	+381 11 22 00 866
Damir Cukman *(Equity)*	+385 62 37 28 12
Alen Kovac *(Fixed income)*	+385 62 37 13 83
Davor Spoljar *(Equity)*	+385 (62) 372 825
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	
Head: József Miró *(Equity)*	+361 235-5131
György Zalányi *(Equity)*	+361-235-5135
Orsolya Nyeste *(Fixed income)*	+361 373-2830
Research, Poland	
Head: 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, 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