CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** Hawks feeling winter cold?
- **Hungary:** GDP, inflation and nominal wage figures next week
- **Poland:** Indications of November hike
- **Romania:** Short-term interest rates repositioned higher, mirroring key rate increase
- **Slovakia:** Flash 3Q GDP to confirm strong growth

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Overview

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Czech Republic:

- Staring into crystal ball
- CZK below 27
- Hawks feeling winter cold?

Hungary:

- GDP, inflation and nominal wage figures next week
- Range trading should continue in short run

Poland:

- New government taking office
- Indications of November hike
- Situation in Poland similar to that in Czech Republic

Romania:

- RON down 2.2% during week on rating outlook downgrade
- Short-term interest rates repositioned higher, mirroring key rate increase
- MinFin keeps on rejecting bids at debt issues

Slovakia:

- Industrial production rebounding strongly
- Foreign trade revised significantly for better
- Flash 3Q GDP to confirm strong growth

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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	26.85	0.4%	2.3%	2.8%			
	3Y (yield bp)	4.23	29	0	102	30	-19	-66
	10Y (yield bp)	4.63	9	6	92	50	25	-23
Croatia	EUR/HRK	7.34	0.0%	0.0%	0.2%			
	3Y (yield bp)	4.76	-2	10	22	81	52	66
	10Y (yield bp)	5.18	-1	-15	n/a	106	100	n/a
Hungary	EUR/HUF	253.74	-0.7%	-1.6%	-0.9%			
	3Y (yield bp)	7.07	14	7	-48	314	288	368
	10Y (yield bp)	6.59	3	-5	37	246	232	276
Poland	EUR/PLN	3.63	0.5%	3.1%	5.6%			
	3Y (yield bp)	5.80	23	35	115	187	134	78
	10Y (yield bp)	5.62	11	-5	44	149	140	124
Romania	EUR/RON	3.40	-1.9%	-1.4%	-0.6%			
Slovakia	EUR/SKK	33.15	0.5%	1.2%	4.0%			
	3Y (yield bp)	4.50	-3	-5	12	54	42	50
	12Y (yield bp)	4.82	-2	-2	51	68	50	38

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

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	33.14	2.36%	2.2%	5.1%	32.8	3.2%	6.4%
15 short EUR/RON	23/10/07	2m Bubid/ 6m Euribor EUR/SKK	6.8/ 4.33% 3.37	3.41	-1.22%	-1.2%	-26.3%	3.3	2.5%	15.9%

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.

15) Recently, the Romanian Leu weakened against euro suffering from the knock-on effects of investor worries about economic prospects in countries with large external imbalances. We considered EUR/RON exchange rate of 3. 37 as a good level to sell. We expect it to trade around 3.3 at the year-end 2007 because bias towards monetary tightening and gradual increase of the remittances from Romanians who work abroad.

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	26.9		7.33		254		3.62		3.41		33.1		3.25	3.50	7.50	4.75	7.50	4.25
Dec-07	27.0	26.8	7.40	7.40	253	255	3.60	3.63	3.30	3.43	32.5	33.1	3.25	3.50	7.25	5.00	7.50	4.25
Mar-08	27.2	26.8	7.30	7.30	255	257	3.55	3.63	3.28	3.45	32.4	33.0	3.50	3.50	7.00	5.25	8.00	4.25
Jun-08	27.1	26.8	7.25	7.25	255	258	3.60	3.64	3.20	3.48	32.5	33.0	3.50	3.50	6.75	5.25	8.00	4.25
Sep-08	26.5	26.8	7.25	7.25	256	260	3.55	3.66	3.24	3.51	32.5	33.0	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	3.71		7.43		5.27		7.84		4.35		4.62	5.18	6.59	5.62	4.71	7.90
Dec-07	3.30	3.77	7.20	7.40	5.25	5.42	7.60	8.45	4.30	4.44	4.55	5.20	6.35	5.40	4.70	7.40
Mar-08	3.40	3.94	6.95	7.05	5.30	5.65	8.20	7.94	4.30	4.42	4.80	5.10	6.10	5.38	4.80	7.50
Jun-08	3.55	4.04	6.70	6.78	5.40	5.75	8.20	6.10	4.35	4.44	4.90	5.10	5.90	5.35	4.80	7.50
Sep-08	3.60	4.13	6.50	6.75	5.40	5.73	7.70	7.20	4.35	4.56	4.80	5.20	5.80	5.33	4.80	7.40

Long-term forecasts

GDP growth (%)	2006	2007e	2008f	2009f
Czech Republic	6.4	5.4	4.1	4.8
Croatia	4.8	5.9	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

CPI (%), eoy	2006	2007e	2008f	2009f
Czech Republic	2.5	3.9	4.9	3.2
Croatia	2.0	4.0	3.0	3.0
Hungary	6.5	6.2	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

C/A (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.0	-3.5	-3.7	-2.8
Croatia	-7.8	-8.1	-8.0	-8.3
Hungary	-6.5	-5.0	-4.4	-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

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	-3.4	-3.1
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	Nov-13	Current Account (bn. CZK, September)	-13.00	-11.00
	Nov-14	PPI (y/y,October)	4.30%	4.3%
	Nov-14	Retail Sales (y/y, September)	6.80%	6.5%
Croatia	14-Nov	CPI Inflation	4.3% y/y	
Hungary	Nov-13	October CPI	6.5% y/y	6.4% y/y
	Nov-14	Flash 3Q GDP	1.6% y/y	1.2% y/y
	Nov-16	Sept Nominal wages	11.5% y/y	8.9% y/y
Poland	Nov-14	CPI (y/y, October)		2.9%
	Nov-16	Average Gross Wage (y/y,October)		9.2%
Romania	November 12	Inflation rate - October yoy	6.9	6.7
	November 14	C/A deficit - September - EUR million	1,330	-
Slovakia	Nov-12	October CPI	3.0% y/y	2.9% y/y
	Nov-13	Flash 3Q GDP	8.5% y/y	8.5% y/y
	Nov-15	October HICP	1.9% y/y	2.0% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Nov-15	Nov-16	2008-Feb-15		CZK 7 bn.	
Hungary		Nov-13	Nov-21	Feb-20-2008	-	HUF 30bn	7.30%
		Nov-14	Nov-21	June-04-2008	-	HUF 25bn	7.20%
		Nov-15	Nov-21	Oct-22-2008	-	HUF 40bn	7.20%
Poland		No auction scheduled					
Romania		15-Nov-07	19-Nov-07	10 Y	6.75	RON 300 million	7.15%
Slovakia		No auction scheduled					

Major markets

ECB press conference reduced interest rate expectations

The ECB Council kept interest rates unchanged at its November meeting. The wording of the statement was slightly more hawkish than in October, on the back of significantly higher inflation. However, in the context of the still high uncertainty on financial markets, the Council remained in a wait-and-see mode. In the Q&A session, Mr. Trichet stressed the importance of the anchoring of inflation expectations and the need to avoid second-round effects of high oil and food prices. Taken together, a hike in December seems unlikely, and the probability has increased that the end of the hiking cycle has been reached. However, this would only happen in the case that inflation expectations remain low and no further second-round effects occur. In the context of high capacity utilization and low unemployment, this seems rather unlikely to us and could in our opinion only occur in the case of very unfavorable economic developments Although the slide in the USD was only commented on in the Q&A session, the Council seems to be well aware of the possible negative implications of the current plunge in the dollar exchange rate. However, one further rate hike still seems highly likely to us. As money market rates are at elevated levels in any case, the ECB is not in a hurry and can wait to assess further developments until February or March 2008. Next week's data should keep European government bonds from rising further. GDP growth for 3Q will be reported for the major Euro economies and should turn out to be robust for most countries at levels of 0.6% to 0.7% q/q. Euroland inflation should come in at an elevated level of 2.6% for October. The ZEW expectation component (due on Tuesday) should continue to stabilize or even improve slightly. The assessment of the current situation is expected to decline.

US rate cut before end of year not done deal

Recent comments by the Fed chairman were interpreted by the markets as pointing towards a further rate cut as early as in December. We think that wishful thinking played a big role in this assessment. Another rate cut before the end of the year cannot be ruled out, but will depend on the upcoming data, and is definitely not a done deal. We see the recent comments by Bernanke as in line with the balanced risk assessment by the FOMC only a week before. We expect the next rate cut only in 1Q. Next week will bring information on both risks. On Wednesday, the schedule includes retail sales, the monthly gauge for consumer spending. We agree with the market in expecting low growth. From the inflation data the following day, the development of the core rate will get the most attention. The market estimate is a 0.2% m/m change; in the current market environment, deviations on the upside would get more attention than on the downside. Finally, Friday will see the release of industrial production, which should have barely expanded in October. In total, the upcoming data will confirm the slowing of the US economy - especially compared to the strong 3Q. At the same time, though, this is what the Fed is expecting, and it should therefore not change the assessment of the central bankers. Only an outright slump of several indicators could do that, which we do not anticipate. However, nervousness is currently one of the determining market factors. We stand by our opinion that the US dollar is undervalued and that US bonds are overvalued.

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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	4.50	4.58		4.89		4.10	4.25	1.469	
Dec-07	4.00	4.50	4.35	4.66	4.60	4.84	4.40	4.60	1.40	1.471
Mar-08	4.25	4.25	4.30	4.49	4.30	4.49	4.70	4.60	1.36	1.472
Jun-08	4.25	4.00	4.30	4.42	4.30	4.23	4.70	4.70	1.33	1.471
Sep-08	4.25	4.00	4.30	4.19	4.20	4.10	4.70	4.70	1.33	1.471

Czech Republic

Staring into crystal ball

We just finished our quarterly forecast update, which confirmed our major thoughts. Next year, we expect the economy to slow by 4-4.5% y/y, due primarily to the approved reforms. Inflation should rise above 5%. Supply-side effects will be the main factor behind this jump. First, there is VAT, green taxes, regulated prices, etc., which will add 3.1pp to inflation (this year: 1.9pp). Next, food and oil prices will continue at their higher pace. Yes, the demand-pulled inflation will also accelerate, but this should be below the CNB target. The table below summarizes our forecast compared with other crystal ball owners.

	Erste	CNB	MinFin	consensus
GDP 08	4.2	5.0	5.0	5.0
Inflace 12/08	5.0	5.1	3.5	3.4
EUR/CZK 12/	26.3	-	27.0	27.0
3M PRIBOR 1	3.9	-	3.5	3.8

** consensus = Reuters poll from August 8, in this case it is repo*

CZK below 27

Regular readers know our view on the CZK. Some reminders: During 1H07, the CZK depreciated, which was due to carry trades. Looking at the fundamentals, there was no reason for the depreciation. With the mortgage crisis, these carry trades quickly unwound, which caused the CZK to return to its fundamentally-based level, close to 27.4-27.2. The second appreciation wave since October was influenced by the USD. Panic-driven USD depreciation sent money to safe-haven currencies, like the CZK, which pushed the CZK below 27. Exporters also supported the appreciation, as there was a seasonal increase in hedging. Nevertheless, the space for further appreciation is used up. The expected USD correction will bring the CZK to weaker levels. We are not changing our long-term view on the CZK - it will appreciate. We see 26.3 at year-end 2008, due to balance of payment flows. However, in 1H08, we expect the CZK to approach 27.3. This is supported by the 1H fundamentals and seasonal flow (preparation for dividend season and the usual correction at the turn of 1Q and 2Q).

Hawks feeling winter cold?

The CNB increased its inflation forecast. However, this reflected the approved government reforms = administrative measures to which the CNB will not react. The demand-pulled inflation was revised down, due to (i) the CNB forecast overshoot of the actual 3Q inflation figure and (ii) their current assumption of a stronger CZK (27.4 for 4Q07, according to our estimate). The last hawkish argument was also revised with the significant decrease of expected Eurozone rates. The forecast is consistent with "growth in nominal interest rates", although at lower levels than in the July forecast. Of course, the CNB does not say exactly what it means. However, with our knowledge of the CNB model, inflation and the output gap forecast, we can approximate the trajectory. This figure implies another 25bps this year and another 25bps during 1H08.

We expect gradual hikes, as we see a stronger CZK and 3.75% key rate at year-end 2008. However, the recent inflation dynamic prompts concern about the timing. CPI inflation accelerated to 4%, but primarily due to gas and food prices. Our baseline is a hike in January, with the risk (35% probability) of it coming in 4Q07. Looking further into the future, we expect 4.5% in 2009, above the neutral rate (first lowering the inflation target from 3% to 2% in 2010 and a more asymmetric reaction to inflation risk, as we will be closer to the evaluation of the Maastricht inflation criteria).

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Hungary

GDP, inflation and nominal wage figures next week

Next week will be full of macro releases, among which the October CPI figures and the 3Q GDP flash estimate should be the most watched. The October CPI inflation will be published on Tuesday morning. After the large drop seen in September, no further slowdown is expected in the CPI index for the tenth month of the year, in my view. Instead, the 12-month index should have stood at 6.5%, after the 6.4% published for September. This could again mean a relatively high m/m index - around 0.6-0.7%. Food prices are likely to have been the main driver, as the monthly increase in the prices of milk and seasonal foods may have been relatively high in October. In addition, the seasonal increase in clothing prices are sure to have continued in October, while other items in the index are not expected to show significant changes on the monthly level. The flash 3Q GDP estimate is due on Wednesday. After the negative surprise seen in the second quarter (the economy expanded just 1.2% y/y in April-June), GDP growth should have remained below 2% y/y, even in the July-September period. The driver of growth should have remained exports, as industrial output showed some revival in the summer months. As for nominal wages, due to the unfavorable base effects, gross wages in the economy may again have accelerated in September, after the slowdown seen in August, while the most watched regular (ex-bonus) wage increases should have further consolidated.

Looking back at this week, the October budget deficit proved to be somewhat higher than predicted earlier by the Finance Ministry. Despite the ministry's forecast of HUF 31.9bn, the actual deficit was HUF 49.8bn in October, taking the cumulative budget deficit for the first ten months of the year to HUF 1196.9bn, 80.9% of the ministry's latest full-year CF deficit forecast. The reason for the higher monthly deficit was the underestimation of brought-forward (from November to the end of October of this year) wage payments at budget institutions, due to days off seen at the beginning of November. Industrial output growth slowed to a greater extent than expected in September (to 6.2% y/y, from 9.5% y/y), but the adjusted 8.7% y/y figure is still seen as high. Finally, we should mention the September trade balance, for which the surplus amounted to EUR 122.8mn (the biggest surplus in a decade), again suggesting the role of positive net exports in 3Q GDP growth.

Range trading should continue in short run

The forint showed some depreciation this week, due largely to profit taking. The domestic currency again started to move more in line with its regional peers. In the short run, investors should focus on the minutes of the October 29 monetary meeting, due this afternoon, as the "hold" outcome of the October rate decision was extremely tight. Range trading should continue in the short run; domestic markets will first of all concentrate on changes in the EUR/USD, while CPI and nominal wage figures (to be released next week) may provide further impetus for expectations regarding the central bank's next rate decision.

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Poland

New government taking office

Last week, we had no data releases whatsoever. The PLN traded uneventfully around 3.65 per EUR and strengthened against the dollar, due to the overall pressure on the greenback. The Sejm convened for the first time in a new composition. The old government of PM J. Kaczynski resigned, clearing the way for Donald Tusk to be nominated (on Friday) and get a working cabinet together. For more on the outlook, please see our short note, released right after the elections on October 22.

Indications of November hike

Few of the central bankers made themselves heard last week and the MPC appears to be converging toward a hike in November, in line with our expectations. While

Wasilewska-Trenkner did not surprise (given her hawkish credentials) by saying that "the Council could even be close to unanimity on an interest rate decision in November" and that, in her "personal opinion, the probability of a hike in November is higher than 50%", a more dovish member of the Council, Mr. Pietrewicz, also hinted at an imminent hike, saying "another hike this year cannot be ruled out".

Situation in Poland similar to that in Czech Republic

We think the situation in Poland is to a certain degree similar to that in Czech Republic - the economy is booming, wages are rising and unemployment is falling. Both countries are thus in for more hikes. While we expect the next one in January in the Czech Republic, in Poland, the next hike will be delivered this month (despite the fact that the strong zloty dampens to a certain degree the inflationary pressures and thus the number of hikes necessary). One of the reasons why we think the hike was not delivered last month was that the Council wanted to wait for the overall aggregate wage statistics that are going to be made available in the upcoming week. This piece of data should support the growing unit labor costs and thus constitute one more reason for a hike. The other one will in all likelihood come from CPI for October - it will reflect the higher oil and food prices, another pro-inflationary risk that might make it into the wage demands eventually.

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Romania

RON down 2.2% during week on rating outlook downgrade

The RON retreated from the 6-week high hit last week when the NBR hiked the key rate, falling to a 6-week low on Thursday. The RON lost 2.2% w/w, on the back of the worsening macroeconomic outlook. Standard & Poor's revised its outlook for Romania from stable to negative. The outlook change resulted from the limited policy response to Romania's rapidly growing external imbalances, with the background of increasingly difficult global credit conditions. S&P reaffirmed the 'BBB-/A-3' rating for foreign currency, the 'BBB/A-3' rating for local currency sovereign credit ratings and the 'A-' rating for the transfer and convertibility assessment. The agency added that Romania's fiscal and income policies are expansionary, and the upcoming elections are likely to stimulate further increases in current expenditure, reduce the overall quality of governance and intensify inflationary pressures. The RON started the week at 3.34 and fell to 3.37 in just one day, due to the rating outlook downgrade. In the following days, the RON followed a depreciating trend and broke the 3.40 threshold. The local currency hit this week's low on Thursday, amid the poor regional mood, reaching the 3.4170 level. We expect a slight recovery of the national currency next week towards 3.37, on the back of rate hike expectations for the beginning of 2008, as the consumer price index will be released on Monday. We anticipate that headline inflation will surge to 6.9% (consensus estimate: 6.7%), due to sharp increases in food and energy prices.

Short-term interest rates repositioned higher, mirroring key rate increase

Short tender interest rates started to reflect the hike of the monetary policy rate, increasing by 30bps. The Romanian money market was stable during the week, as short tender interest rates remained flat at 7.3/7.9%. On Monday, the NBR held its regular deposit auction at the 2-week tender. The central bank decided to sterilize the overall offer of the commercial banks, which amounted to RON 3.9bn, at the fixed rate of 7.5% (the current level of the monetary policy rate). The high value of the bids submitted by the commercial banks compared to the last deposit auction was not a surprise, as the banks preferred to keep the liquidity at their disposal last week, using it for constituting higher reserves, as they expected the NBR to hike the key rate. On Monday, the central bank presented its quarterly inflation report and raised the inflation forecasts for both 2007 and 2008. The NBR has revised their projection for the headline inflation to 5.7% for end-2007 (in line with our forecast), from 3.9% previously, while the inflation target for this year remained set at 4%, ±1 pps, as they admitted that they will miss this year's target. The NBR also maintained the inflation target for 2008 at 3.8%, ±1 pps, but also increased their year-end forecast to 4.3% (from 3.7% previously). The governor justified the upward revision of the inflation forecasts with the substantial deviation of the trajectory of food prices and the RON's evolution (compared to the NBR's projection). The governor again urged the centrist government to tighten fiscal policies and improve the quality of public spending. He admitted that the strength of a restrictive monetary policy in the current situation (when rate hikes influence inflation only via the exchange rate channel, but further deteriorate the external competitiveness of Romania) is limited. We believe that the central bank will attempt a policy mix, trying to improve both the inflation outlook and the external shortfall. Therefore, we do not see the monetary policy rate outpacing 8.0% in 2008. We expect short-term interbank interest rates to remain stable in the 7.3/7.8% zone, with risks on the downside, if the NBR does not pursue firm control of the money market via its open market operations.

MinFin keeps on rejecting bids at debt issues

The Ministry of the Economy and Finance kept on rejecting all the bids submitted at its debt auctions and acted in the same manner on November 7. The MinFin held an auction to sell treasury bills worth RON 500mn at one-year maturity. The offer of the primary dealers modestly outpaced the indicative amount, reaching only RON 610mn. The limited interest shown for the last state securities auctions reveals investors' unwillingness to place their liquidities for yields below 7.0%, the more so as inflation had sparked lately, reaching 6.0% in September, and given that the NBR has raised the monetary policy rate to 7.50%. In the first ten months of the year, Romania still recorded a surplus on the consolidated budget (around 0.4% of GDP). Therefore, the MinFin can still afford not to attract liquidity. However, we remain confident that the MinFin might begin to attract liquidity from the domestic market in the coming weeks, as it will need money to finance the increased expenditures specific for the year-end.

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Slovakia

Industrial production rebounding strongly

This week's released data showed an expected rebound of the production sector. Industrial production improved significantly m/m in September, as car factories resumed full capacity production after the summer break. Industrial production growth accelerated to 15.4% y/y, up from 5.7% in August, outpacing the market and our slightly more optimistic expectations. Apart from cars, other export-oriented sectors picked up as well, such as electrical and optical equipment (ex-auto manufacturing grew at a strong 11.4%).

Foreign trade revised significantly for better

Hefty production growth also translated into the foreign trade balance, as September trade reached a surplus at SKK 4.7bn. This was well above any expectations (our forecast was an SKK 1.7bn deficit, while the market consensus stood at an SKK 3.3bn shortfall). In addition, the Statistical Office also revised the data for the previous nine months for the better by about SKK 9bn (import was lowered), and the 2007 YTD deficit reached only SKK 2.7bn. On a cumulative 12M basis, the revised trade shortfall amounted to 1.5% of GDP. Consequently, we will very likely revise our full-year trade forecast from the previous SKK 30.4bn shortfall to only around half of this figure (compared to GDP, the trade shortfall could be less than 1%).

Flash 3Q GDP to confirm strong growth

Foreign trade will positively affect the GDP growth in the third quarter, which will be released next week. In line with the market, we expect the figure at 8.5% y/y. The estimate will be released in a new methodology for the first time. Uncertainties around the estimate are greater than usual, as the Statistical Office has not yet released the revised quarterly GDP data, leaving the distribution of the annual 2006 growth between the quarters unknown. Apart from GDP, October consumer inflation will be released on Monday. The national CPI index likely increased by 3.0% y/y, up from the 2.8% seen in September. The monthly gain of 0.3% should reflect the higher prices of services, food and fuels. Annual HICP (to be released on Thursday) should likewise increase to 1.9% y/y. However, the 12-month HICP average should stay well below the expected reference Maastricht limit.

The koruna managed to firm from the 33.3 EUR/SKK traded last Friday to the strongest levels seen since mid-July (below 33.10) in the second half of this week. Much of the appreciation was due to the weaker USD. Today's revision of foreign trade data could provide an additional impulse. We continue to see the koruna at stronger levels until the year-end, at around 32.50 EUR/SKK.

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Appendix Charts

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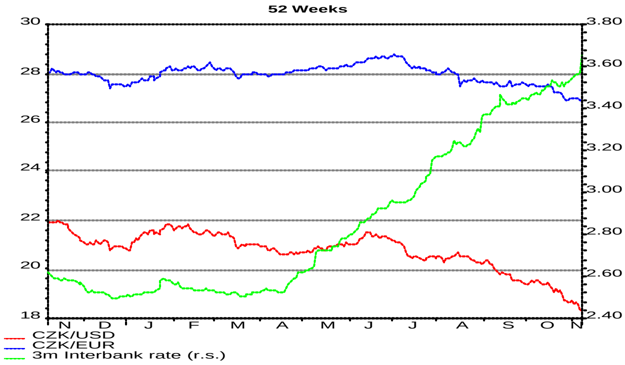
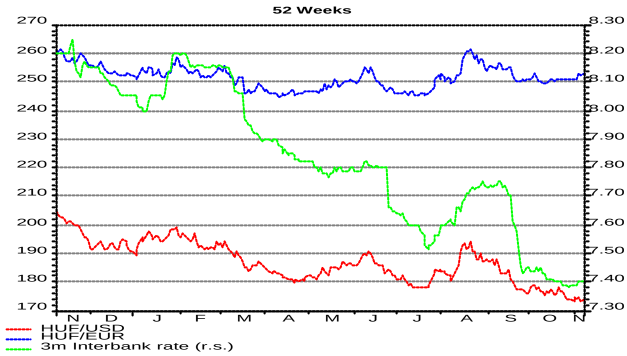
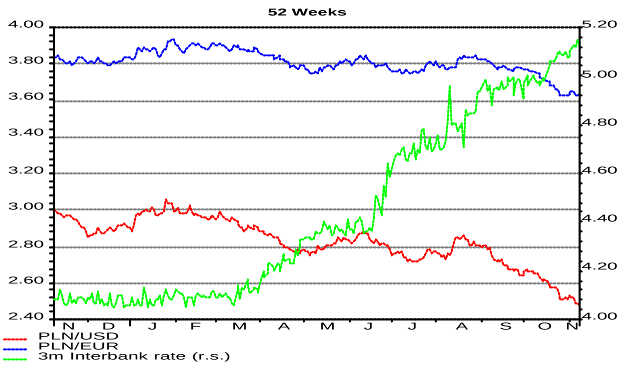
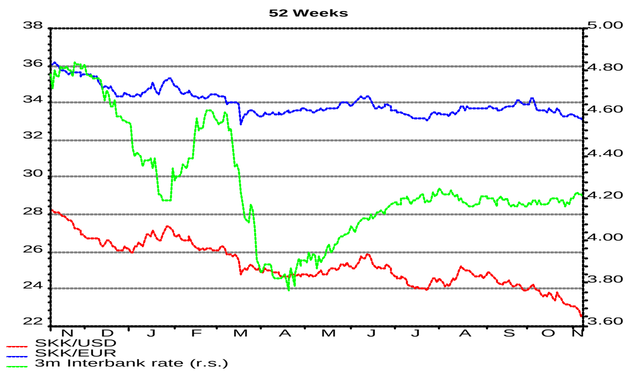
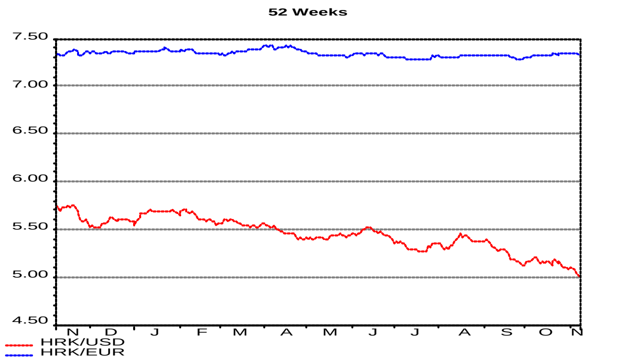
Exchange rates and interest rates (52 weeks)

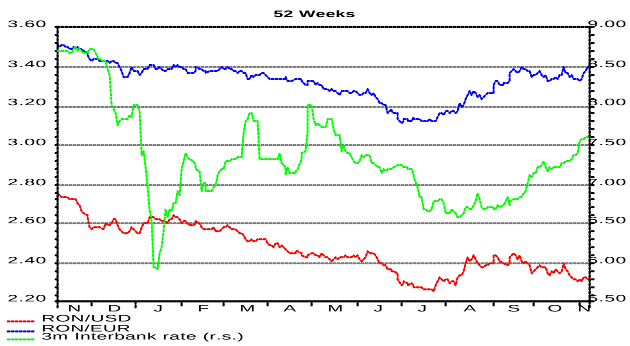








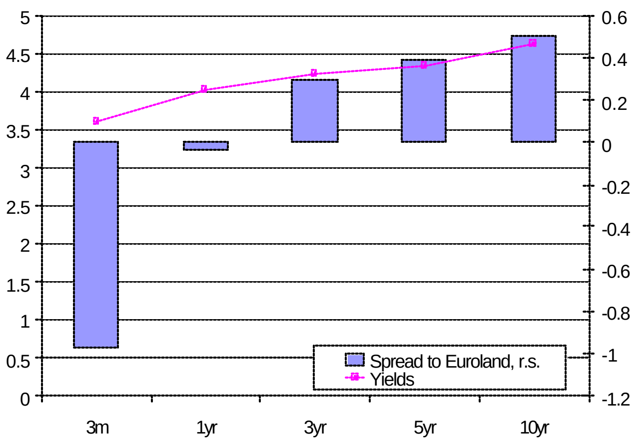




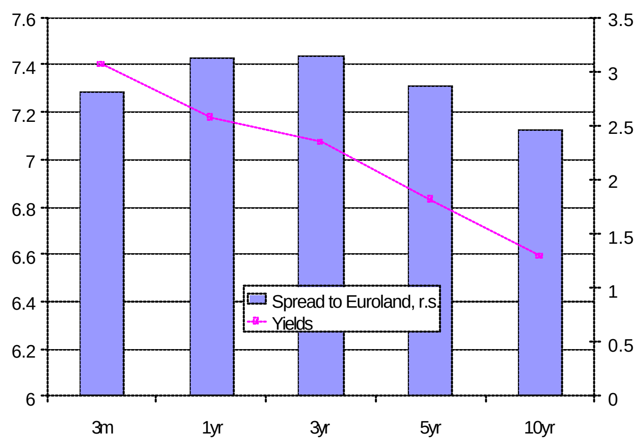
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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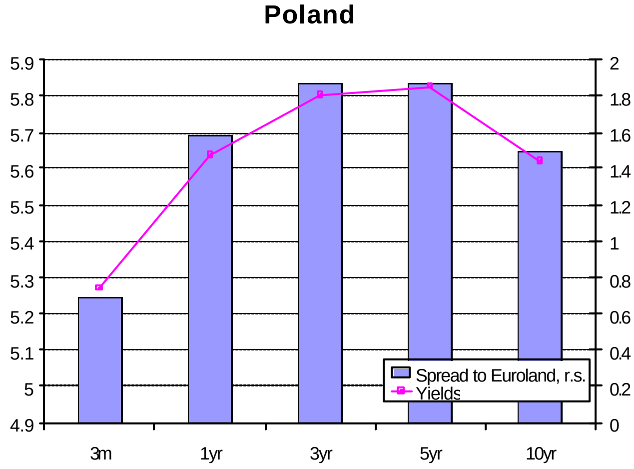

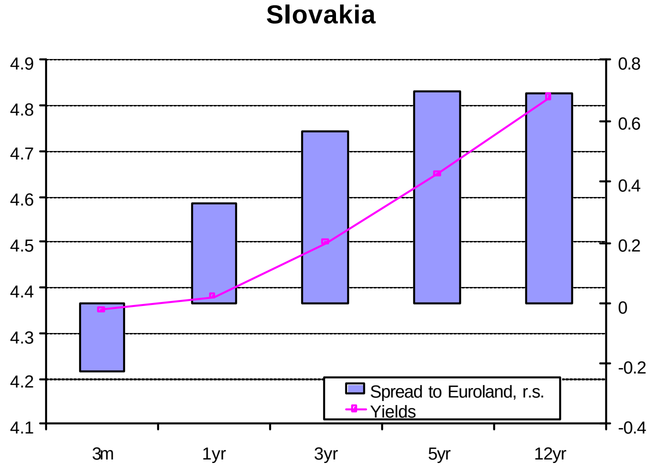

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