November 16, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** CNB: More details on 2008 monetary policy
- **Czech Republic:** Time to be short CZK
- **Hungary:** Higher inflation, lower GDP growth - week of disappointing macro figures
- **Poland:** Wages still increasing at brisk pace
- **Romania:** MinFin sold state securities after nearly two-month absence
- **Slovakia:** Sustainability of inflation still topic of discussion

Overview

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Croatia:

- CNB: More details on 2008 monetary policy
- CPI accelerated further in October

Czech Republic:

- Voices from central bank
- Time to be short CZK
- 50Y bond

Hungary:

- Higher inflation, lower GDP growth - week of disappointing macro figures
- Dilemma at central bank

Poland:

- Wages still increasing at brisk pace
- CPI should stabilize

Romania:

- RON continued to weaken, hitting one-year low
- Short-term interest rates dropped below policy rate
- MinFin sold state securities after nearly two-month absence

Slovakia:

- Food prices caused acceleration of inflation
- Sustainability of inflation still topic of discussion
- Economic growth reached strong 9.4% in 3Q
- Coalition overcame first clash

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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	26.59	1.0%	3.7%	3.8%			
	3Y (yield bp)	4.20	-3	0	99	29	-28	-66
	10Y (yield bp)	4.57	-6	-8	86	45	21	-23
Croatia	EUR/HRK	7.35	-0.2%	-0.4%	0.0%			
	3Y (yield bp)	4.79	3	17	25	88	32	66
	10Y (yield bp)	5.17	-1	-9	n/a	103	83	n/a
Hungary	EUR/HUF	254.13	-0.2%	-1.1%	-1.1%			
	3Y (yield bp)	7.15	8	21	-40	324	267	368
	10Y (yield bp)	6.64	5	1	45	252	219	276
Poland	EUR/PLN	3.66	-0.9%	1.4%	4.6%			
	3Y (yield bp)	5.86	6	30	121	195	129	78
	10Y (yield bp)	5.72	11	1	55	161	136	124
Romania	EUR/RON	3.46	-1.6%	-3.2%	-2.2%			
Slovakia	EUR/SKK	33.05	0.3%	2.0%	4.3%			
	3Y (yield bp)	4.52	2	-3	14	61	26	50
	12Y (yield bp)	4.81	-1	-4	50	69	43	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	33.09	2.51%	2.3%	5.2%	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	3.48	-3.03%	-3.0%	-46.1%	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%

To be included in the trading ideas mailing list, please, mail to rainer.singer@erstebank.at, subject: trading ideas

Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	26.6		7.35		254		3.67		3.46		33.1		3.25	3.50	7.50	4.75	7.50	4.25
Dec-07	27.0	26.6	7.40	7.40	253	255	3.60	3.67	3.30	3.48	32.5	33.0	3.25	3.50	7.25	5.00	7.50	4.25
Mar-08	27.2	26.6	7.30	7.30	255	257	3.55	3.68	3.28	3.51	32.4	33.0	3.50	3.50	7.00	5.25	8.00	4.25
Jun-08	27.1	26.5	7.25	7.25	255	259	3.60	3.69	3.20	3.54	32.5	33.0	3.50	3.50	6.75	5.25	8.00	4.25
Sep-08	26.5	26.5	7.25	7.25	256	261	3.55	3.71	3.24	3.57	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	3.73		7.43		5.32		8.01		4.38		4.57	5.17	6.65	5.72	4.72	8.10
Dec-07	3.30	3.78	7.20	7.41	5.25	5.47	7.60	8.42	4.30	4.45	4.55	5.20	6.40	5.40	4.70	7.40
Mar-08	3.40	3.91	6.95	7.13	5.30	5.73	8.20	7.95	4.30	4.45	4.80	5.10	6.10	5.38	4.80	7.50
Jun-08	3.55	4.01	6.70	6.92	5.40	5.84	8.20	6.14	4.35	4.49	4.90	5.10	5.90	5.35	4.80	7.50
Sep-08	3.60	4.11	6.50	6.81	5.40	5.85	7.70	7.21	4.35	4.58	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	5.9	4.3	5.4
Croatia	4.8	5.9	4.7	4.9
Hungary	3.9	1.7	2.5	3.5
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	4.0	5.1	3.2
Croatia	2.0	4.0	3.0	3.0
Hungary	6.5	6.9	3.9	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	-3.4	-4.0	-3.4
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	-3.9	-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	No data releases scheduled			
Croatia	21-Nov	Unemployment rate	14.5%	
	21-Nov	Industrial production	1.5% y/y	
Hungary	Nov-23	Sept Retail sales	-2.5% y/y	-3.0% y/y
Poland	Nov-20	PPI (October)		2.5%
	Nov/21-Nov/26	Unemployment(October)		11.3%
	Nov/21-Nov/26	Retail Sales (October)		15.5%
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		Nov-22	Nov-23	Feb-22-2008		CZK 7 bn.	
Hungary		Nov-20	Nov-28	Feb-27-2008	-	HUF 30bn	7.30%
		Nov-22	Nov-28	Oct-24-2012	6.00%	HUF 45bn	6.90%
		Nov-22	Nov-28	Feb-24-2017	6.75%	HUF 40bn	6.65%
Poland		No auction scheduled					
Romania		21-Nov-07	23-Nov-07	6 M		RON 500 million	7.40%
Slovakia		No auction scheduled					

Major markets

Short week ahead for US markets

The markets will be closed on Thursday, due to the Thanksgiving holiday; on Friday, trading will be light. So, the markets could get some additional volatility from position closing in advance of the long weekend or low volumes on Friday. Macro indicators will probably not be in the limelight, as concerns about further write-downs of US financial institutions will prevail. The data to be released includes industrial production today, with housing starts and the FOMC minutes on Tuesday. The latter two are the more interesting for market participants - housing starts for obvious reasons, the FOMC minutes because they will contain the new quarterly economic assessments by FOMC members. Going forward, the intervals of economic forecasts will be changed from semi-annually to quarterly. It will be especially interesting to see how deep the marks left by the recent sub-prime crisis are on the assessments of monetary policy makers and how great the dispersion of estimates will be. This information could trigger some speculation about the timing of the next monetary action. However, in any case, the insecurity about the US financial sector should continue, supporting the bond market. The EUR/USD looks vulnerable to a downward correction, in our view.

No important releases scheduled for Euroland

After Euroland was the last of the major markets to report solid growth in 3Q this week, the release calendar for the days ahead does not include anything that would have a market impact. The most interesting data will be the breakdown of German 3Q GDP, as markets might look for signs of a pickup in private consumption. However, it is more likely that, with US markets closed or thinly-traded, Euroland markets should move in a tight range.

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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		4.91		4.07	4.14	1.460	
Dec-07	4.00	4.50	4.35	4.70	4.60	4.86	4.40	4.60	1.40	1.461
Mar-08	4.25	4.25	4.30	4.51	4.30	4.45	4.70	4.60	1.36	1.462
Jun-08	4.25	4.00	4.30	4.43	4.30	4.10	4.70	4.70	1.33	1.462
Sep-08	4.25	4.00	4.30	4.20	4.20	4.01	4.70	4.70	1.33	1.461

Croatia

CNB: More details on 2008 monetary policy

This week, the CNB governor gave a speech providing more details on the course of monetary policy through 2008. No dramatic changes were announced, but some fine-tuning should occur. First of all, the marginal reserve requirement (banks have to deposit 55% of all new foreign borrowings in a non-interest bearing account at the CNB) will remain active. Credit growth limits will also continue, with banks allowed to extend credit at 1% pm (12% pa), and excess credit activity will be penalized more harshly than in 2007, as banks will have to purchase CNB bills worth 75% of excess credit (50% in 2006), which will yield 0.25% (0.75% in 2007). Also, the CNB announced that it would demand more capital for excess credit activity (more details will be known after the December CNB council meeting), meaning higher credit growth would demand higher capital adequacy. Finally, it was also announced that the CNB will increase the Lombard rate from 7.5% to 9.0%. The announced measures point toward tighter monetary conditions in 2008 and further moderation of credit. For a more detailed overview on expected effects, we are still waiting for the next CNB council meeting and the official decision.

CPI accelerated further in October

CPI inflation remained on an upward path, accelerating further in October to 4.3% y/y, vs. the 3.9% recorded in the previous month. On a monthly basis, the strong pressure from September (+1.2% m/m) moderated and growth amounted to 0.3% m/m. The October figure was roughly in line with our expectations. Food and non-alcoholic beverage prices increased 0.3% m/m, which pushed the headline figure up, but considerably below the September increase (+2.5% m/m). As expected, clothing and footwear prices (+3.8%) contributed to a monthly basis price increase, at most (due to seasonal reasons). On a yearly basis, food prices had the most negative impact, which, in combination with the low base from the end of last year, should produce higher CPI figures in the last quarter of 2007. Oil prices should put pressure on the CPI figures, either directly or through a spillover effect from producer prices. Still, one part of the oil price increase should be offset by the currently weaker dollar, thus alleviating part of the inflation pressure. As far as 2007 is concerned, we expect the average figure around 2.7%, while the year-end figure is expected at slightly above 4%. Next year is expected to bring pressure, at least in 1H08 (expected figure in the 4-5% range), as the base effect should continue to negatively influence the y/y rates. Besides the mentioned supply-side pressure, some hikes in administrative prices in the post-election period may occur, boosting the pressure further.

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Czech Republic

Voices from central bank

The next meeting is planned for November 29, in a context of headline inflation above CNB expectations, core inflation below (jump in global food prices), and the CZK stronger than assumed (our bet: they assume 27.50 in 4Q07). So, what are we hearing from the central bank? Niedermayer: "The fact that the inflation outlook needs support from a tighter monetary policy perhaps seems quite clear"; "If the currency continues to be strong, then it will, in the upcoming several months, begin to push a core inflation drop. But the pressure won't be fast enough to prevent inflation from rising to levels higher than usual, let's say above 5%." Yes, inflation will rise above 5%, but due to supply-side shocks like taxes, regulated prices, oil and food. Hikes will mean lower core inflation, which is already suppressed by the CZK. Another hawk, Hampl: "With our rates, we have not yet reached the… base camp"; "I personally can already see the peak of the cycle on the horizon". We think that these two are the ones that voted for a hike at the last meeting. The third is Rezabek, who said it is not about raising or not raising rates, but more about caution. It is not time to ease up - the CPI is at 4% and will go above 5%.

However, the upheaval has to do with items with very low interest rate sensitivity, and is not about core inflation. Moreover, next year, the short-term effect of the government reform will hit consumption. Therefore, we still see only a gradual rate increase, to 3.75 at end-2008, with the first hike in January (risk: 30% probability for 4Q07).

Time to be short CZK

Last week, we wrote about our FX forecast. Although we see 26.3 EUR/CZK at end-2008, during 1H08, we see space for a correction to above 27 (close to 27.3). Short CZK, long EUR means 2.6% plus carry. Add our outlook on the USD and you get 10% plus carry on USD/CZK. For opening of a trading idea, we look at the technicals: loosening of the USD momentum. According to a Reuters poll, analysts see 26.8 in 3M, 27 in 6M and 26.3 EUR/CZK in 12M.

50Y bond

The MinFin will issue a bond with the longest maturity, 50Y, on November 21. The MinFin wants to place on the market CZK 8bn and another CZK 10bn to buy its own book (to support its strategy of moving from short-term bills and decreasing short-term refinancing risks). According to our estimation and available information, there should be low demand from domestic financial institutions, due to shorter portfolio durations.

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Hungary

Higher inflation, lower GDP growth - week of disappointing macro figures

The 12-month CPI inflation rate jumped to 6.7% in October (from the 6.4% published for September), exceeding even my pessimistic forecast of 6.5%. On the monthly level, prices increased by 0.8%. Food prices were again to blame for the higher than expected CPI index, as sharp increases in almost all fields in the food category continued in October. Apart from food prices, there were some increases in the prices of drugs and fuels. Regarding the core rate, the m/m increase is also seen as high (0.5%), while the 12-month core CPI slightly accelerated to 4.4%, from 4.3% in September.

After the publication of the October figures, I significantly revised my inflation predictions upwards for the last two months of the year. As the base effect is no longer supporting any slowdown in the 12-month index and prices of fuels already jumped significantly in November, the CPI should further accelerate in the remainder of the year. Thus, my year-end forecast is now close to 7%. The ongoing inflation acceleration should also negatively affect the 2008 yearly average rate (I increased it to 5.2% y/y), but the expected high 2007 December y/y figure should create a high basis for the 2008 December inflation. Thus, I still believe that the CPI inflation at the end of next year will stand below 4%, provided that the forint exchange rate preserves its relative strength and there are not overly strong second-round effects (stemming from the food and fuel factors).

According to the CSO's flash estimate, GDP slowed further to 1% y/y in the third quarter of 2007, after the 1.2% y/y seen in the second quarter. The actual data again came as a big negative surprise, which basically could be explained by the higher than expected drops in the elements of domestic demand (the breakdown of the figure is not available yet). I still expect some acceleration in the y/y growth rate for the last quarter, but, based on the poor economic performance seen in 2Q and 3Q, the overall 2007 GDP growth now seems sure to remain below 2% y/y.

Dilemma at central bank

The latest GDP growth and CPI figures will again pose a big dilemma for the central bank at the next monetary meeting (scheduled for November 26). Although the fact that the ongoing food and oil price shocks are non-monetary factors, the higher inflation rates expected for 4Q07 and FY08 still increase the likelihood of the central bank putting off rate reductions until next year. Please note that the next Quarterly Report on Inflation is also due on November 26, in which the analysts of the central bank are expected to raise their inflation forecasts for both 2008 and 2009 (compared to the August Report). Thus, it would not be too credible to cut the base rate just in November, in my view. However, a lot will depend of course on the overall tone of the report, i.e. how it will asses the risks of possible second-round inflation effects stemming from the current one-off price shock. Concerning the problems around the possible second-round effects, we should mention that the latest wage figures (published this morning) have shown some promising aspects. As I remarked in the previous Insights, overall y/y gross wages in the economy again accelerated in September (to 8.9%, from the 7.8% seen in August), but the most-watched regular (ex bonus) y/y wage increase in the private sector continued to slow down more spectacularly (to 8.4% from 10.4%). As for the GDP downturn, I do not expect the weak 3Q GDP figure to have a significant direct impact on the monetary policy, although a dovish-side member of the council (Judit Neményi) told Reuters yesterday that the monetary policy should avoid over-tightening.

After the important data scheduled this week, the macro calendar will be nearly empty next week. As markets have started to price out rate reductions carried out this year (due to the higher than expected October CPI figures), the forint has strengthened somewhat. In the second half of the week, however, global risk appetite factors have again played a more important role in the formation of the exchange rate, which is not expected to change in the days ahead. In the second half of next week, 5-year and 10-year bond auctions and the approaching monetary meeting should gain increasing attention among investors.

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Poland

Wages still increasing at brisk pace

The Statistical Office released the average wage figure, confirming that wages are rapidly increasing - the y/y rise reached 9.7% in 3Q, compared to 8.7% y/y in 2Q. While this was the only piece of information released and the drawing of conclusions is thus limited, the nearly double-digit rise makes wages another reason for an interest rate hike to be delivered this month. While wages are clearly pro-inflationary, they are by no means the only factor calling for hikes. As elsewhere, food and fuel prices are keeping the central bankers on guard (Governor Skrzypek said last week these are the biggest threats to inflation) - all the more so, given the relatively higher bargaining power of workers in countries where labor markets are relatively tight, due to booming economies.

This was clearly borne out by the October CPI release - consumer price growth reached 3.0% in October, in line with expectations. The acceleration was mainly due to food prices. This is the same development as that recently observed in most other countries. Thus, the origins of the accelerated inflation are exogenous and out of reach of the NBP's monetary policy. However, there could be legitimate fears of second-round effects, indexation of salary growth and a subsequent wage-inflation spiral. Such fears are supported by the vigorous growth of the Polish economy - especially by the tightening of the labor market. Hawkish members of the NBP Monetary Council will certainly find support for further rate hikes in the accelerating inflation - Ms. Wasilewska-Trenkner said that the Polish economy is in need of more than one hike to subdue inflationary pressures. Basically, it is only the stronger zloty now that has potential to keep a lid on inflation. However, given the underlying fundamentals of the Polish economy, we do not view it as sufficient.

CPI should stabilize

As for the future, we expect stabilization of the CPI; next year's average CPI should remain at around the current level. There are upside risks, however, mainly from further growth of food and other commodity prices. As there are supply-side price pressures, they do not have a direct impact on NBP policy. The Monetary Council will watch for possible secondary effects. All in all, we expect a hike of 25bps (to 5%) to be delivered this month, and we remain convinced that there will be one more hike (to 5.25%) next year, which will then be the peak of the cycle. Apparent inflation pressures could push the rate to 5.5%. Inflation could be partially mitigated by the strong zloty if the current levels persist.

On the political side, the new government was scheduled to be sworn in; the list of minister designates was also published last week. Regarding economic policy, Finance Minister-designate Jacek Rostowski favors quick euro adoption and Treasury Minister-designate Alexander Grad vows to speed up privatization ("Privatization revenues of PLN 2.3bn planned for 2008 are an absolute minimum"), a break with the previous government practice of keeping enterprises in their hands and collecting dividends. These two things, if indeed fulfilled, call for a reduction in the government borrowing needs over the next few years.

As for next week, there will be a release of the PPI index and possibly also of retail sales and unemployment data. Retail sales are expected to have grown quickly (15.5% y/y in October), another sign of strong domestic demand and another indication of the need for a hike.

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Romania

RON continued to weaken, hitting one-year low

The Romanian currency is biased on a downward trend and nothing seems to be helping it to recover these days - not even the NBR's restrictive monetary policy. This week, the RON touched a fresh one-year low against the euro, testing the resistance at 3.47, which held for the moment, amid the worsening investor sentiment toward emerging markets. Lately, off-shore investors decided to reduce some of their exposures to emerging markets, on the back of the deepening credit crisis in the US. However, the RON suffered the biggest losses among its regional peers, as macroeconomic fundamentals have worsened in the past few months. Since June, when the RON tested the 3.00 threshold, the Romanian currency has depreciated by 11.5% in nominal terms against the euro and by 1.2% during this week. The local currency started the week on a stronger foot, trading in the 3.43 zone, but the data on inflation quickly cut the wings of the leu, although the figures were not a surprise for the market. Romania's headline inflation surged to 6.8% y/y, slightly above consensus estimates (6.7%), inducing hard euro buying. The domestic currency might erode the 3.47 resistance zone next week, moving towards the 3.50 threshold, as we do not expect any improvement of investors' perceptions of emerging markets or Romania.

Short-term interest rates dropped below policy rate

Although the monetary policy rate was raised to 7.5% (from 7.0%) on October 31, the short tender interest rates declined by 50 basis points this week, as foreign players decided to sell the domestic currency in favor of the euro. On Monday, the NBR held its regular 2-week tender deposit auction, paying a fixed interest rate of 7.5% (the current level of the monetary rate). The central bank restarted complete sterilization operations, draining RON 3.45bn from the domestic money market. The liquidity seems to be optimally distributed in the banking system, as 15 commercial banks placed bids at the NBR's deposit auction. However, the NBR's complete sterilization did not offer enough support for the leu, as the interest rates for ON, TN, 1W tenors followed a downward path, decreasing to 6.7/7.3% bids/asks until Thursday, due to the high liquidity in the Romanian money market. On November 15, the central bank held its regular monthly certificate of deposit auction at 3-month tender. The NBR canceled the CD auction, as the submitted bids totaled just RON 675mn, below the 75% minimum level of the indicative amount announced by the NBR (RON 1,000mn). The maximum yield demanded by the banks increased by 20 basis points since the previous CD auction, up to 8.23%, while the minimum yield reached 7.39% (from 8.0% in October). The average requested yields stood at 7.79%, 40 basis points higher compared to the previous auction. The low interest shown by the banks for the CD auction, with only 12 banks placing bids, indicates that the market expects the NBR to further hike the monetary policy rate in January. The liquidity of the Romanian money market might increase further next week, putting downward pressure on the short-term interest rates, as the end of the current reserve period approaches and the banks have already put together a large part of their mandatory reserves.

MinFin sold state securities after nearly two-month absence

On November 15, the Ministry of the Economy and Finance finally decided to borrow from the local market, after nearly two months of rejecting all submitted bids. The MinFin sold a 10-year benchmark bond worth RON 230mn, paying an average yield of 7.27%, well above the previous accepted yield of 6.7% in early September. The cut-off rate stood at 7.5% (the current level of the NBR's key rate), while previously, the MinFin paid a maximum yield of 6.71%. The indicative amount stood at RON 300mn, while the submitted bids totaled RON 482mn. It seems that the MinFin finally realized that Romania will no longer be able to borrow cheaply, due to the worsening macroeconomic fundamentals, and decided to step into the market, especially as it had scheduled most of its expenses for December. In the first ten months of 2007, Romania's consolidated budget surplus reached 0.3% of GDP. We believe that the MinFin will attract more 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

Food prices caused acceleration of inflation

Consumer inflation accelerated in October, well above the market and our expectations, to 3.3% y/y, from the 2.8% seen in September (HICP increased by 2.4% y/y, up from 1.7% y/y in September). The upside surprise was caused mainly by food prices (with milk products, bread and cereals and vegetables witnessing the highest increase). In addition, regulated prices in healthcare increased by almost 3% m/m. Demand inflation pressures stayed contained. Harmonized inflation also exceeded the expectations of the central bank, which anticipates the inflation rate slowing down in November. We share this view and see inflation declining to 2.2% y/y. Despite accelerating inflation, Slovakia continued to meet the Maastricht inflation criterion by a comfortable margin; the 12M HICP average stood at 2.1%, while the reference limit was at 2.6%. We expect a similar margin (0.5-0.8pp) in spring 2008, when the euro criteria will be evaluated. The figure will cement the cautious approach of the central bank, which will closely scrutinize potential secondary effects of the higher prices of food. However, the strong koruna (currently still tightening monetary conditions) should prevent the central bank from making any hikes.

Sustainability of inflation still topic of discussion

The sustainability of inflation, the second prerequisite for successful meeting of the Maastricht inflation criteria, was again underlined by European Commissioner for Monetary Affairs Joaquin Almunia. He repeated that sustainability should also be looked at concerning Slovakia's euro evaluation. He pinpointed Slovenia as a negative example, where the price growth soared towards 4% after euro adoption. On the other hand, central bank board member Odor said last week that there is also a very good chance that the sustainability of inflation will be assessed in a positive way.

Economic growth reached strong 9.4% in 3Q

According to a flash estimate from the Stats Office, real GDP growth reached a hefty 9.4% y/y in 3Q07, outpacing our estimate and the market's median at 8.5%. The figure was already calculated using the new methodology. However, revised data for the previous quarters is not yet known (it will be released only on November 28, and detailed 3Q07 GDP growth will be published on November 30). The Stats Office indicated that the real GDP growth for the first three quarters reached 9%, meaning that the figures for the first two quarters must have been revised down by some 0.6-0.9pp (cumulatively), which outweighed the positive surprise from the headline 3Q figure. The Stats Office indicated that the growth was driven by both domestic and foreign demand, which matches our assumptions. The highest value was again added in industry, namely in the production of machines, cars and electronic equipment. The economy thus maintains a quick pace of growth, without overheating (demand inflation pressures remain low). So far, we keep our estimate of the growth in 2007 at 8.9% (possible revisions might come after the revised quarterly data is published).

Coalition overcame first clash

The coalition faced the first more serious clash this week over suspicious land deals by a state fund (run by nominees from coalition member HZDS). The PM demanded that the agriculture minister (from HZDS) dismiss the deputy head of the Slovak Land Fund, who signed the deals. Otherwise, the agriculture minister would be the one to lose confidence. Both parties then exchanged warnings of a government break-up. In the end, the deputy head of the Slovak Land Fund resigned yesterday, which will very likely ease the tensions between the coalition partners.

The koruna tested levels slightly above 32.80 EUR/SKK (which is our recommended target) during the middle of the week, supported by the buoyant GDP growth and positive regional sentiment. Although the profit taking in the second half of the week halted the koruna surge, we continue to see space for further gains. True, it might take some time until the 32.7 EUR/SKK threshold is beaten, as this is the koruna's all-time high (reached in March after ERM-2 parity revaluation) and the stronger margin of the former ERM-2 band (i.e. before revaluation). Back then, the central bank intervened against the koruna to stop its appreciation. These days, there has been no word of objection by the central bank so far. Still, we see increased risk that the central bank might voice its discontent (at least verbally) once the koruna comes close to 32.7 EUR/SKK. However, we continue to forecast the year-end exchange rate at 32.5 EUR/SKK.

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Appendix Charts

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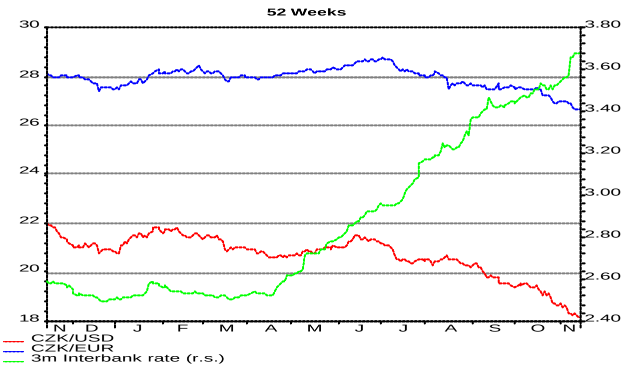
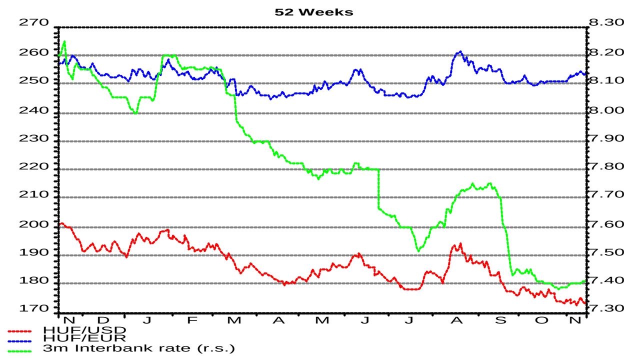
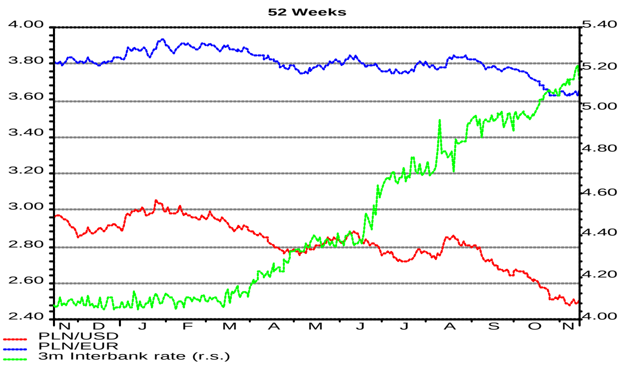
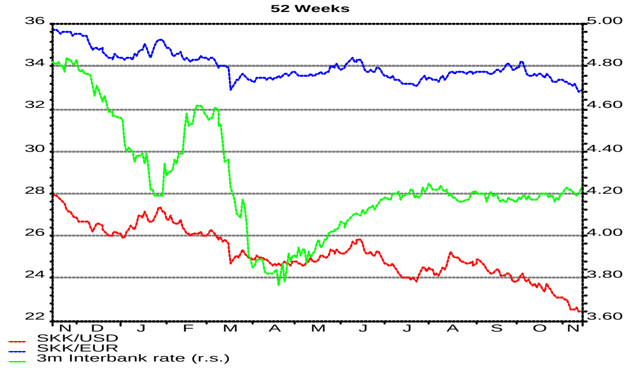
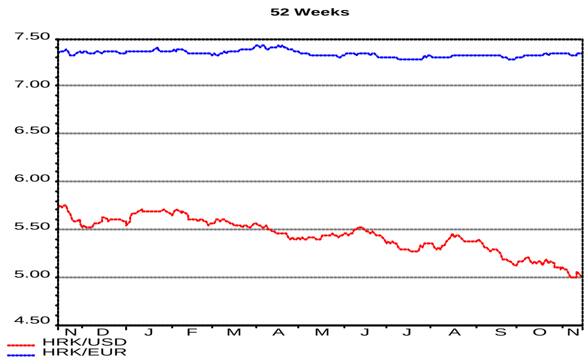
Exchange rates and interest rates (52 weeks)

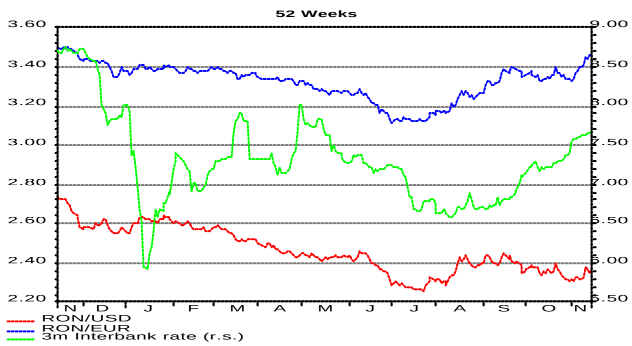








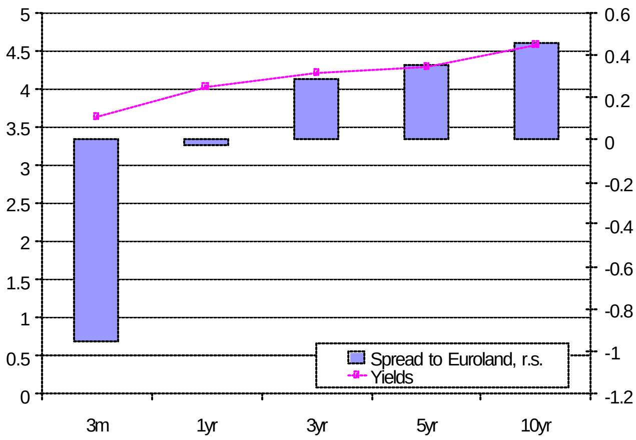




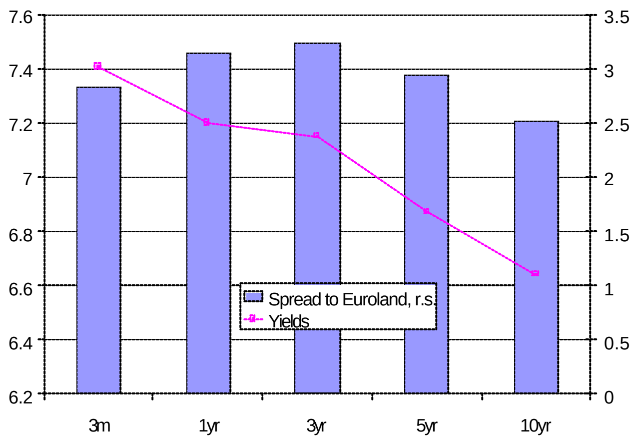
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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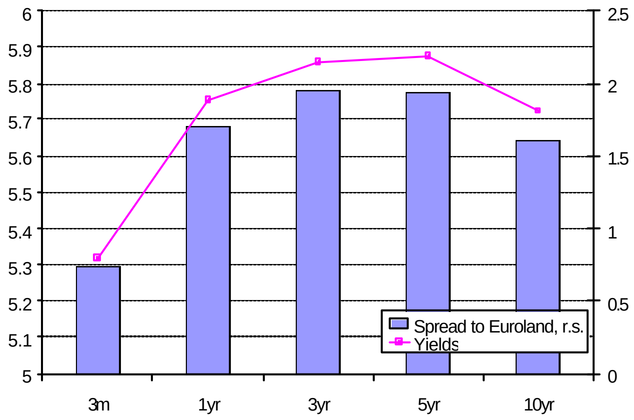
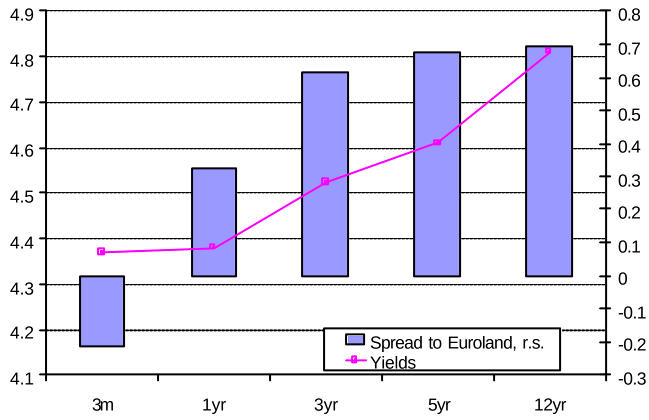
Poland



Slovakia



Published by Erste Bank der oesterreichischen Sparkassen AG Börsegasse 14, OE 543 A-1010 Vienna, Austria. Tel. +43 (0)50100-ext.

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