November 30, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** CPI accelerated further in October
- **Czech Republic:** Central bank dovish, but market could be more hawkish
- **Hungary:** Change in monetary policy highlights
- **Poland:** More hikes to come
- **Romania:** RON recovered some of its recent losses against euro
- **Slovakia:** Coalition crisis inflamed and diffused again

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Overview

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Croatia:

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

Czech Republic:

- Yes, CNB hiked, but…
- Central bank dovish, but market could be more hawkish

Hungary:

- Change in monetary policy highlights
- Not too bright economic outlook in new Inflation Report
- Updated Convergence Program sent to Brussels today
- November budget and 3Q GDP breakdown in focus next week

Poland:

- 3Q GDP growth exceeded our expectation
- More hikes to come

Romania:

- RON recovered some of its recent losses against euro
- Short tenor interbank interest rates stabilized near policy rate

Slovakia:

- Coalition crisis inflamed and diffused again
- GDP growth confirmed at 9.4% in 3Q07
- Central bank kept interest rates steady
- Koruna responded to volatile politics

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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	26.28	1.7%	2.3%	5.1%			
	3Y (yield bp)	4.21	2	0	100	44	-16	-66
	10Y (yield bp)	4.59	4	10	88	52	31	-23
Croatia	EUR/HRK	7.32	0.2%	0.4%	0.4%			
	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	254.19	1.0%	-1.3%	-1.1%			
	3Y (yield bp)	7.30	1	37	-25	353	291	368
	10Y (yield bp)	6.83	-5	27	60	276	237	276
Poland	EUR/PLN	3.63	1.5%	0.0%	5.5%			
	3Y (yield bp)	6.02	-1	45	138	225	156	78
	10Y (yield bp)	5.73	-11	27	55	166	131	124
Romania	EUR/RON	3.54	2.8%	-5.5%	-4.3%			
Slovakia	EUR/SKK	33.39	0.6%	-0.1%	3.2%			
	3Y (yield bp)	4.57	5	6	19	75	48	50
	12Y (yield bp)	4.81	0	-1	50	72	64	38

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

Trading Ideas

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Positions

# Position	Date of opening	Instruments	Entry values	Today's values	flat P/L (%)	flat P/L inc. carry (%)	P/L p.a. inc. carry (%)	Target values	Target P/L flat inc. carry (%)	Target P/L p.a. (%)
12 short EUR/SKK	04/06/07	6m Bribid/ 6m Euribor	3.9/ 4.28%			2.0%	4.1%	32.8	3.2%	6.4%
		EUR/SKK	33.92	33.19	2.19%					
16 long USD/CZK	29/11/07	6m Libid/ 6m Pribor	4,91/3,99%			-0.9%	-337.8%	19.7	9.3%	18.7%
		USD/CZK	17.93	17.76	-0.93%					

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.

16) Recent events sent the Koruna off its fundamentally warranted level, both against EUR and against USD (overly pessimistic view of the U.S. economy. We therefore suggest to exploit the misalignment and thus recommend shorting CZK against USD. Two things will be of crucial importance for our recommendation – evolution of interest rate differential between Eurozone and US and how much of a slowdown there will be in the US. Our baseline is soft-landing, of course, a recession in US would weaken dollar further. Our view is that the combination of weakening of CZK to EUR and strengthening of the dollar vis-à-vis EUR should return exchange rate to around 19.70 in a 6-months time. The recommendation also carries a positive interest yield.

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%
15	Short EUR/RON	23/10/2007	21/11/2007	-4.9%

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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	26.3		7.35		254		3.63		3.52		33.3		3.50	3.50	7.50	5.00	7.50	4.25
Dec-07	27.0	26.3	7.40	7.40	255	254	3.60	3.63	3.50	3.53	32.5	33.3	3.50	3.50	7.50	5.00	7.50	4.25
Mar-08	27.2	26.2	7.30	7.30	255	256	3.55	3.64	3.45	3.56	32.4	33.2	3.50	3.50	7.25	5.25	8.00	4.25
Jun-08	27.1	26.2	7.25	7.25	255	258	3.60	3.65	3.40	3.60	32.5	33.2	3.50	3.50	7.00	5.50	8.00	4.00
Sep-08	26.5	26.2	7.25	7.25	256	261	3.55	3.67	3.35	3.63	32.5	33.2	3.50	3.50	6.75	5.50	7.50	4.00

	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	3.92		7.43		5.54		8.07		4.33		4.58	5.17	6.83	5.72	4.71	8.10
Dec-07	3.30	3.93	7.40	7.48	5.25	5.73	7.80	8.28	4.30	4.33	4.55	5.20	6.60	5.70	4.70	7.40
Mar-08	3.40	3.85	7.20	7.29	5.60	5.96	8.20	7.98	4.30	4.39	4.80	5.10	6.50	5.65	4.80	7.50
Jun-08	3.55	3.93	6.95	7.09	5.70	6.02	8.20	6.23	4.15	4.41	4.90	5.10	6.10	5.60	4.80	7.50
Sep-08	3.60	4.08	6.70	6.98	5.70	5.86	7.70	7.23	4.15	4.50	4.80	5.20	6.00	5.55	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	5.8
Romania	7.7	5.7	6.1	6.0
Slovakia	8.5	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	3.4	3.0	2.7
Romania	4.9	6.1	4.8	4.2
Slovakia	4.2	3.3	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	-5.1	-4.5	-4.1
Poland	-3.2	-4.1	-4.5	-4.9
Romania	-10.3	-13.7	-14.7	-14.7
Slovakia	-7.2	-3.3	-3.1	-2.8

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	-2.4	-2.7	-2.7
Slovakia	-3.3	-2.9	-2.4	-2.6

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Dec-5	Trade Balance (October),CZK bn.	4.00	
	Dec-7	GDP-Q3	5,8%	
Croatia	21-Nov	Unemployment rate	14.5%	
	21-Nov	Industrial production	1.5% y/y	
Hungary	Dec-06	November budget balance	HUF -170bn	-
	Dec-06	Oct Industrial output	6.6% y/y	-
	Dec-07	Oct Trade balance	-	-
	Dec-07	3Q07 GDP breakdown	1% y/y	1% y/y
	Dec-07	Minutes of Nov 26 monetary meeting	-	-
Poland		No data releases scheduled		
Romania		Industrial production October - y/y	4.6	
Slovakia	Dec-07	October industrial production	-	-

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Dec-5	Dec-10	Oct-18-2012	3.55%	CZK 7 bn.	
		Dec-6	Dec-7	Mar-03-2008		CZK 5 bn.	
Hungary		Dec-04	Dec-12	March-12-2008	-	HUF 45bn	7.40%
		Dec-06	Dec-12	Aug-24-2010	6.25%	HUF 80bn	7.25%
		Dec-06	Dec-12	Nov-24-2023	6.00%	HUF 20bn	6.70%
Poland		No auction scheduled					
Romania		No auction scheduled					
Slovakia		No auction scheduled					

Major Markets

Major markets

ECB projections to show higher inflation and lower growth

The focus next week will again be on the ECB Council meeting. A rate change is highly unlikely, but the update of the ECB staff forecast will gain some attention. A rise in inflation forecasts as well as a reduction in growth forecasts seems sure; the question has to do with the volume of the revision. The wording of the press conference should not change significantly compared to the November meeting, still indicating a wait-and-see approach with a bias toward raising interest rates. On the same day, the Bank of England will make its policy decision. On Thursday and Friday, factory orders and industrial production figures for Germany will be released. The latest indicators for the manufacturing sector were mixed. The Ifo Index indicated an improvement in sentiment, while the Reuters PMIs showed a more cautious assessment. After the plunge in September, we expect factory orders to increase again. Industrial production should show a small gain.

Important data likely to confirm subdued economic dynamic

Important releases are scheduled for next week. On Monday, the ISM index, a gauge of US manufacturing, will likely indicate stagnating output in an overall difficult economic environment. For the following days, only second-tier data will be released. However, Friday will bring the release of the labor market report. After strong gains of non-farm payrolls in the previous month, the weekly data points to a significant slowdown in November. So, these two decisive pieces of information from the US economy should confirm the current subdued dynamic. Markets will mainly be driven by (daily) changing levels of risk appetite - all the more so, as the verdict on the outcome of the upcoming FOMC meeting on Dec. 12 is already out. We also believe in yet another rate cut before year-end, as recent comments from FOMC members point in this direction. Obviously, the renewed increase of stress on financial markets is concerning the Fed and fears seem to be heightening that the continued high level of interest rates could eventually affect the real economy.

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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	4.72		5.05		4.00	3.91	1.483	
Dec-07	4.00	4.25	4.35	4.80	4.70	4.99	4.30	4.20	1.43	1.478
Mar-08	4.25	4.25	4.15	4.60	4.30	4.53	4.60	4.50	1.38	1.478
Jun-08	4.25	4.00	4.15	4.50	4.20	3.95	4.70	4.60	1.35	1.478
Sep-08	4.25	4.00	4.35	4.33	4.20	3.80	4.70	4.60	1.35	1.476

Croatia

CNB: more details on 2008 monetary policy

This weeks CNB governor gave a speech providing more details on course of monetary policy throughout 2008. More or less no dramatic changes were announced but some fine tuning would occur. First of all, marginal reserve requirement (banks have to deposit 55% of all new foreign borrowings at non-interest bearing account within CNB) would remain active. Credit growth limits also, as banks would be allowed to extend credit at 1% pm (12% pa), and excess credit activity would be penalized harsher than in 2007, as banks would have to purchase CNB bills worth 75% of excess credit (50% in 2006) which would yield 0.25% (0,75% in 2007). Also CNB announced that it would demand more capital for excess credit activity (more details would be known after the December CNB council meeting), meaning higher credit growth would demand higher capital adequacy. Finally it was also announced that CNB would increase lombard rate from 7.5% to 9.0%. Announced measures are pointing towards more tighter monetary conditions in 2008 and expectedly further moderation of credit. For more detailed overview and expected effects we should still wait for the next CNB council and 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

Yes, CNB hiked, but…

In October, the CNB revealed its new forecast, saying that it indicated increasing rates, but they subsequently did nothing to the rates. November came and they said that the risks to the forecast were modestly on the downside. They then hiked rates to 3.5%. Curious? If you guess that this means that the CNB is now in a hawkish mood, you will be really confused after seeing what was said at the press conference (presentation at:

http://www.cnb.cz/m2export/sites/www.cnb.cz/en/monetary_policy/bank_board_minutes/2007/TK_11SZ2007_AJ.pdf)

As we wrote in our Macroscope on the CNB, there were strong arguments for both camps. Hawks: The very swiftly accelerating inflation. Doves: Inflation is pulled by supply-side factors; the expectation of a consumption slowdown next year; and, last but certainly not least, the CZK.

Governor Tuma confirmed that the discussion was tough and tight (voting: 5:2). Then, he even said that the next step could go in either direction. It is clear that the CZK is the main reason. He indirectly said that if the CZK continues to appreciate, it could prompt a discussion about cuts. My final thought: A hike is a tactical decision in a situation in which inflation is climbing above the target and wage negotiations are in progress. This does not mean that the next one will follow quickly. We expect the next hike to come in 2Q08, after the expected CZK correction to above 27.

Central bank dovish, but market could be more hawkish

Inflation is climbing and will go much higher. We estimate 4.5% y/y for November, with upside risk (to be released December 10). Moreover, with the beginning of next year, the Czech Republic is likely to approach 6%! The story is clear: food, oil and regulated prices, plus taxes. Demand inflation is compressed below the target. Therefore, we do not expect the CNB to react fiercely. However, the market could price in other hikes, which could increase the short-term end of the yield curve. These expectations could move the EUR/CZK to even stronger levels. My idea is therefore to short short-term CZGB in 6M horizon and then turn the position (inflation deceleration in 2H08+CZK appreciation).

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Hungary

Change in monetary policy highlights

On Monday, the Monetary Council kept the base rate on hold (7.50%), in line with the market consensus. At the same time, a change was noticeable in the bank's communication. While statements and the large number of split decisions in the previous months suggested that rate reductions were just a question of time, on Monday, both the governor's press conference and the latest statement from the Monetary Council pointed to some changes in the monetary policy's highlights - it has again become more hawkish. The main reason is as follows. According to the Council, the ongoing food and energy price shocks are more persistent than previously thought, putting stronger than expected upward pressure on the overall inflation, despite the sluggish domestic demand (stemming from fiscal adjustment measures). In this situation, the Monetary Council will focus on cooling inflationary expectations. Lower interest rates will only arrive if risks of possible second-round inflation effects have significantly mitigated. Thus, the central bank will closely monitor price and wage setting developments in the private sector. To sum it up, despite the expected low GDP growth figures, the more hawkish comments do not suggest rate reductions being carried out in a relatively amount of short time. The central bank seems to be afraid of inflation expectations being stuck at high levels. This week (after the rate decision), the governor mentioned that even a rate hike could come if wage increases in the private sector were higher than productivity growth. Although I do not think a rate hike is a likely scenario (the majority of private sector companies cannot afford excessive wage hikes without profit losses), the very cautious stance of the Monetary Council should continue in the months ahead.

Not too bright economic outlook in new Inflation Report

The more hawkish stance of the Monetary Council was backed by the new quarterly Report on Inflation, in which the staff of the NBH raised its forecast for the 2008 average inflation to 5% y/y (from the 4.5% published in August). For 2009, the new inflation forecast is 3% y/y (after just 2.4% y/y in August), with risks on the upside. Hence, the disinflation process is to continue at a slower pace than expected. As for the GDP growth outlook, the 2007 projection was cut to 1.6% y/y (from 2% in August), while for 2008 and 2009 the bank expects 2.4% y/y (2.7% y/y in August) and 3.2% y/y (3.4% y/y in August) GDP growth, respectively. The central bank projects only a slow revival of GDP growth in the mid-run, based on the expected improvement in consumption, while they do not expect significant acceleration of investment.

Updated Convergence Program sent to Brussels today

On Wednesday, the government approved the update of Hungary's Euro Convergence program, which has to be submitted to the EU by December 1. Some changes have been made in the new version. As for the budget balance figures, the government cut the deficit forecasts for both 2007 and 2008 to 6% of GDP (from the latest 6.4% of GDP) and to 4% of GDP (from 4.1% of GDP), respectively. Projections for 2009 and 2010 remained unchanged (3.2% and 2.7% of GDP, respectively). As for economic growth, the government remained optimistic. Although they had to cut the 2007 GDP forecast to 1.7% y/y (which seems realistic), they expect economic growth to reach 4% y/y already in 2009.

November budget and 3Q GDP breakdown in focus next week

Among the macro figures, the preliminary November budget balance and the breakdown of 3Q GDP should be the most watched items next week. As for the budget balance, earlier this month the Finance Ministry projected a deficit of HUF 172.2bn for November. The breakdown of 3Q GDP is expected to reinforce the domestic demand downturn. The CSO published preliminary 3Q investment figures this week, which showed a disappointing 2.5% y/y decline.

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Poland

3Q GDP growth exceeded our expectation

Last week, the major events were the MPC's rate setting meeting and the 3Q GDP release. As for the GDP, the growth was slightly better than our expectation - the Polish economy expanded 6.4%, driven by higher investment (almost +20%) and domestic consumption (+5.2%). This will support the need for further hiking, especially since no slowdown is expected of a magnitude sufficient to remove the risk of high inflation. The step to hike the rates (taken by the MPC on Wednesday) was therefore justified, in our view. The MPC added 25bps to the key rate so that it now stands at 5.00%. This was probably the last hike we will see this year (although strong growth increases the probability of one more in December), but by no means the last hike in Poland during this tightening cycle. The reasoning behind the decision was in line with what we thought - the MPC acknowledged that further wage and inflationary pressures are possible (and thus indicated that this is likely not the last hike to be delivered), but did not elaborate much on the perceived severity of the problem. The tight labor market (as evidenced by the recent rise of aggregate wages by 13.2% and of retail sales by over 19%) and the threat of higher food and fuel prices feeding into the core and pro-cyclical budget next year are factors behind the perception of inflation overshooting the target being more likely than undershooting, in the eyes of the Council.

More hikes to come

The productivity growth (due to high investment activity) and possible Eurozone slowdown will work to lower inflation in the medium term, but not sufficiently so, according to the MPC. Read: still more hikes to come. The governor declined to say whether a 50bps hike was voted on, but another member of the MPC (swing voter Wojtyna) present at the conference said "there are no factors for such a move." It was probably argued that ongoing inflation increases witnessed in the CEE are primarily driven by fuel and food, but at the same time, the Polish economy appears to be the most prone of all of the CEE countries to the feed-through of higher prices (to core). Hungary's growth is anemic this year and thus does not threaten to translate higher prices into higher wages; Slovakia's not-so-tight labor market and intention to adopt the EUR are keeping a lid on wages. The situation in the Czech Republic is closest to that of Poland, but the Czechs are likely to experience a slowdown of consumption, due to reforms. Furthermore, wage demands from unions remain moderate and the effect of the local currency's strengthening are felt more in the smaller Czech economy than in Poland.

The statement overall was hawkish and left no one groping for hints as to what the MPC is likely to do next. After all, a pledge that the "Council will strive to bring inflation down to a level consistent with the central bank's inflation level in the medium term" is pretty straightforward. The MPC acknowledged that, in the coming months, inflation will be above the central October projection and that the bank will be on the lookout for whether the one-off factors ignite second-round effects, as one might reasonably expect in a clearly booming economy. Should that appear to be so, we could see another hike relatively quickly. Our baseline so far calls for another 25bps to be delivered in January and another hike in April (to 5.50 %).

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Romania

RON recovered some of its recent losses against euro

As we expected, the domestic currency rebounded against the euro this week, after an exaggerated decline in early Friday trading to a nearly two-year low. The EUR surged to 3.69 on Friday morning, when a substantial sell order was placed on the market, which pushed the quotes down to the 3.58 zone within several minutes. The initiator of this order remains uncertain, with rumors in the market pointing towards a covered intervention by the central bank, which had declared the day before that large swings of the exchange rate could harm the economy. Therefore, this sudden recovery of the RON, when the sentiment among investors toward Romania was definitely unfavorable, might be attributed to the NBR, which has "reserved the right, without any comment, to conduct adequate policies, even obscure ones, to stabilize the forex market" (according to the governor's statement), as Romania has a managed free-floating forex regime. However, we do not rule out the possibility of an off-shore speculative flow from an investor who decided to get ahead of the NBR and move the EUR/RON downwards. Irrespective of the initiator, we consider this reversion of the EUR/RON as adequate, as the recent sharp losses recorded by the domestic currency had overshot and left macroeconomic fundamentals behind. The domestic currency managed to keep Friday's gains (approximately 2.4%) and started the week in the 3.61 zone. In the first two days of the week, the pair was trading sideways at 3.58-3.62, lacking clear direction. Starting Wednesday, the EUR continued to lose ground against the leu, dropping to the 3.48 zone. Here, the euro found strong support from off-shore players, who decided to close some of their positions, pushing the quotations up to 3.53 in less than an hour. This week, the Romanian currency posted the highest volatility yet this year, as 30-day rolling volatility soared to 10%. We remain confident of the RON's upside potential in the short run, as remittances from Romanians working abroad will begin to offer support for the domestic currency. Therefore, we believe that the EUR/RON will remain range-bound in the 3.45-3.55 zone this week, with risks on the upside if the GDP figures for the third quarter disappoint. However, we assign a low probability to this scenario.

Short tenor interbank interest rates stabilized near policy rate

Starting Monday, interbank interest rates recovered to levels near the monetary policy rate, as a new reserve period has just begun and banks have started to constitute their mandatory reserve requirements. Therefore, short-term deposits were quoted at 7.2/ 7.9% bids/asks the whole week. It seems that the liquidity of the interbank money market has decreased substantially, as the bids submitted at the NBR auction by the banks were rather modest, amounting to RON 2.05bn. This also confirms the scenario of a covered NBR intervention in the local market. Only seven commercial banks placed bids at the 2-week maturity deposit auction of the central bank, which sterilized the whole offer, paying a fixed interest rate of 7.5%. We expect the short-term interest rates to remain stable in the proximity of the monetary policy rate, as the NBR will continue to drain the excess liquidity in the interbank money market, while banks will build up their reserves.

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Slovakia

Coalition crisis inflamed and diffused again

Just when we thought the coalition crisis was over after the no-confidence vote on a parliamentary speaker failed, political tensions were inflamed again with the leader of the coalition party HZDS Vladimir Meciar storming out of the coalition meeting suggesting that PM Robert Fico wants an end to the current government coalition. And, just when we thought that the crisis might be somewhat more serious this time, the very next day, Meciar called for the previous day's events to be forgotten and said that HZDS will support the 2008 state budget and stay in the government coalition 'at least until May' (although with the recent political rows and reconciliations, it is difficult to assess whether another rupture might not cause this vow to be broken). The coalition's staying in place mitigates risks for the EMU entry process. In April or May, Slovakia's euro preparedness should be assessed by the European authorities and, if all goes as expected, it should get the green light to adopt the euro.

GDP growth confirmed at 9.4% in 3Q07

The Slovak Statistical Office confirmed the 3Q07 real GDP growth at 9.4% y/y, in line with the flash estimate. The growth was balanced, driven by both domestic and foreign demand, similarly to the previous quarter. Household consumption growth accelerated to 8.3% y/y, from the 7.8% y/y seen in 2Q07, and outpaced our expectation (the upward surprise was partly due to the downward revision of consumption in 3Q06). The real wage growth of 4.2% y/y was in line with our and market expectations, although in our view, it did not justify such an acceleration of consumption. At the same time, real wage growth was again comfortably covered by productivity increases and does not suggest a rise in demand inflationary pressures. However, the consumption growth supports the central bank's cautious stance on rates.

Investment activity remained strong (fixed investments increased by 6.5% y/y), providing impetus for growth in the coming periods (although the contribution of fixed investments was offset in 3Q07 by the decrease in stock building). Export growth was relatively low (8% y/y), as car factories took a break in summer, but - more importantly - imports increased by just 3% y/y, which allowed net exports to contribute about 5pp to the GDP growth. Looking ahead, we expect strong economic growth in 4Q07 (at around 9%) with a balanced structure. We keep our annual GDP forecast at 8.9%.

Central bank kept interest rates steady

The central bank kept interest rates unchanged, meeting widespread expectations. The 2W repo rate remained at 4.25%, while the O/N rates were kept at 2.25%/5.75%. No proposal to change the interest rates was raised. Slovakia recently faced acceleration of inflation, which speaks in favor of cautiousness. However, the primary reason for the inflation surge was the food price growth; the central bank does not have the tools to influence this phenomenon, which is common to all European countries. Also, we have not seen any significant acceleration of demand pressures. The CB governor repeated that the monetary conditions remain tight, due to the strong koruna.

Since we have recently changed our expectations and anticipate ECB rates staying on hold during this and next year (instead of a hike), this has also affected our forecasts for Slovakia. The key interest rate in the Eurozone should be at 4.0% at the beginning of 2009, when Slovakia's euro adoption is expected. As the current NBS rate is 4.25%, one more 25bp cut by the Slovak central bank would be necessary until the two base rates meet. We expect the central bank to deliver this final cut in 2Q08, once Slovakia's euro adoption is secured. The same timing also applies to when the currently asymmetric corridor of O/N rates around the base rate (2.25/5.75%) could be changed to the ECB's standard of 100bp on both sides.

Koruna responded to volatile politics

The stream of political news also affected the exchange rate development. The koruna lost some ground after the risk of a coalition break-up heightened. However, once the HZDS leader announced that they found an agreement with the PM and that his party would stay in the government, the koruna regained its losses. At the same time, regional sentiment, which has been generally favorable this week, continues to influence the currency development. Summing up, the koruna strengthened from the 33.55 EUR/SKK seen on Monday to about 33.20 EUR/SKK on Friday. We still expect further appreciation in the period ahead. Please note that this week the koruna finished its second year in ERM-2 and Slovakia now formally fulfils the exchange rate criterion.

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Appendix Charts

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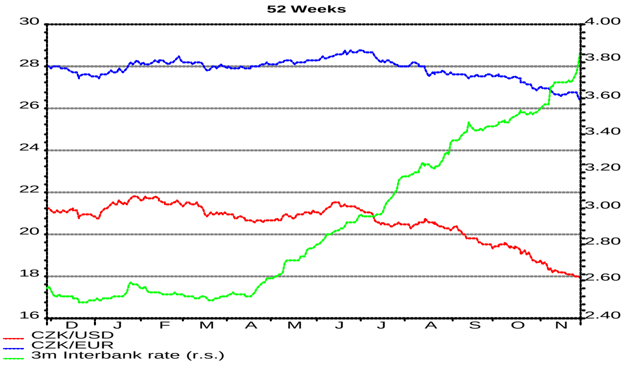
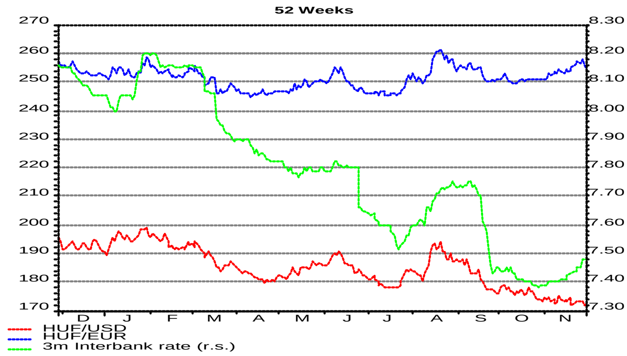
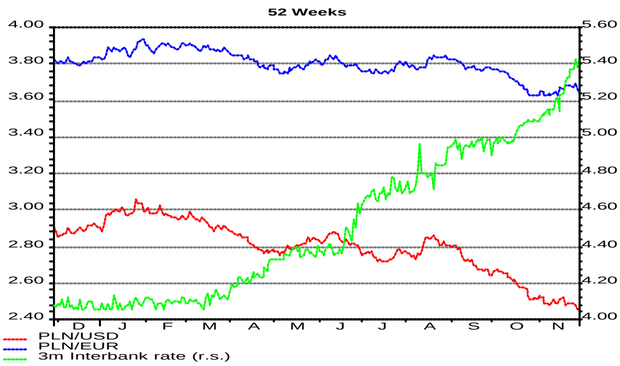
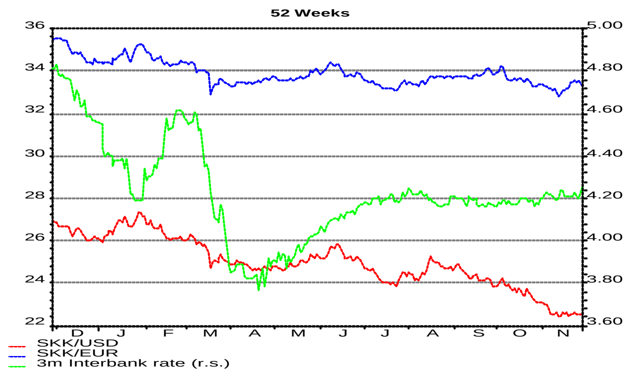
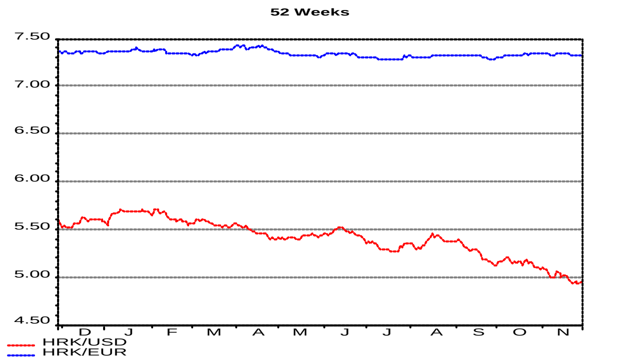
Exchange rates and interest rates (52 weeks)

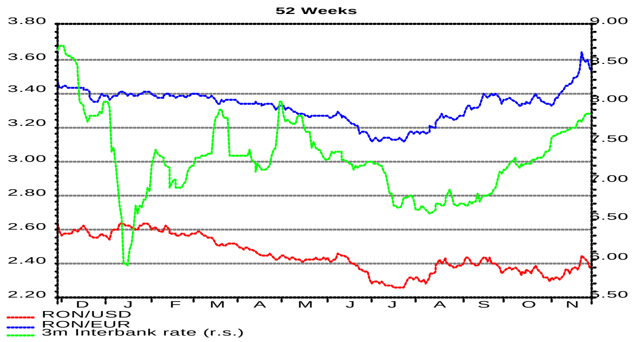








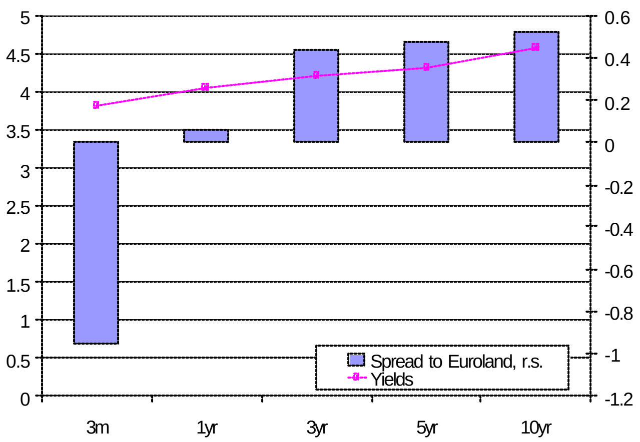




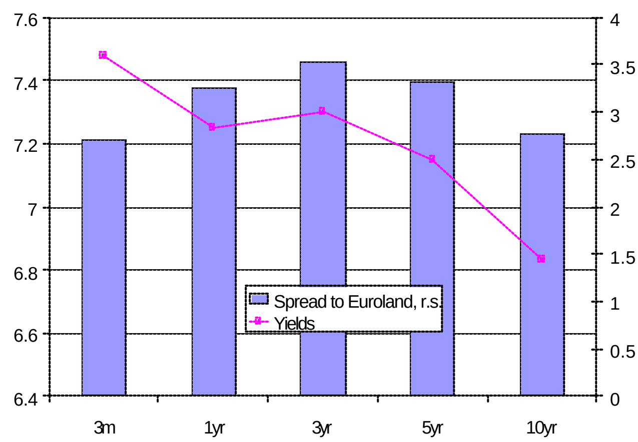
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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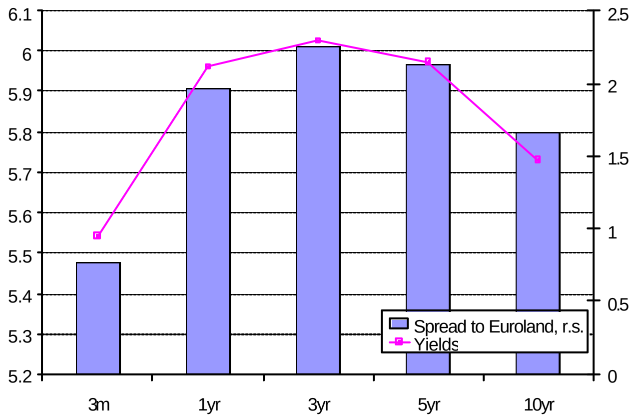
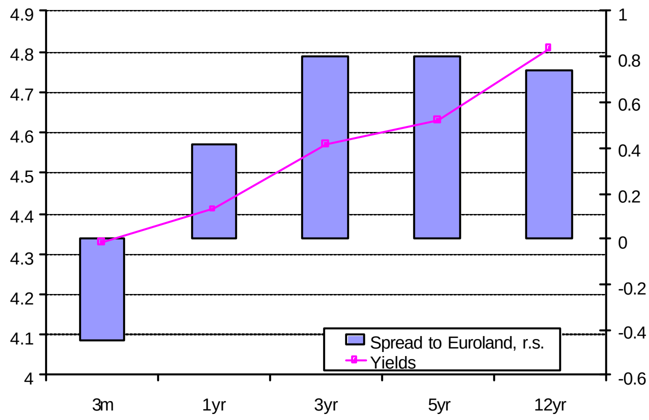
Poland



Slovakia



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