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Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** Inflation hydra
- **Hungary:** CPI should have stood at 6.9% y/y in November
- **Poland:** Consensus among MPC members on need for hikes
- **Romania:** RON closely mirrored its regional peers
- **Slovakia:** Almunia appraised Slovak efforts to adopt euro

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Overview

Czech Republic:

- CZK in heaven
- Inflation hydra
- Christmas gift for bond traders
- Czech GDP growth still at 6%, but should slow down next year

Hungary:

- CPI should have stood at 6.9% y/y in November
- November budget deficit lower than expected
- GDP rose just 0.9% y/y in 3Q07

Poland:

- Government plans should mean lower bond supply next year
- Consensus among MPC members on need for hikes

Romania:

- Infrastructure construction set record for year in October
- Capital goods up strongly in October
- RON closely mirrored its regional peers
- Short tenor interbank interest rates eased down slightly, but stayed above 7%
- MinFin rejected all bids in 3Y benchmark bond auction

Slovakia:

- Parliament passed next year's budget
- Almunia appraised Slovak efforts to adopt euro
- Industrial production outpaced expectations
- Inflation to decline in November

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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	26.15	0.5%	3.0%	5.6%			
	3Y (yield bp)	4.16	-5	0	95	38	8	-66
	10Y (yield bp)	4.57	-2	1	86	49	38	-23
Croatia	EUR/HRK	7.32	-0.1%	0.3%	0.4%			
	3Y (yield bp)	5.21	-20	57	67	138	60	66
	10Y (yield bp)	5.45	-4	27	n/a	134	99	n/a
Hungary	EUR/HUF	252.16	0.8%	0.1%	-0.3%			
	3Y (yield bp)	7.32	2	29	-23	355	301	368
	10Y (yield bp)	6.81	-2	21	62	273	242	276
Poland	EUR/PLN	3.58	1.4%	1.3%	7.0%			
	3Y (yield bp)	6.03	0	28	138	225	173	78
	10Y (yield bp)	5.78	5	21	60	170	145	124
Romania	EUR/RON	3.52	0.4%	-4.1%	-3.9%			
Slovakia	EUR/SKK	33.24	0.4%	-0.2%	3.7%			
	3Y (yield bp)	4.54	-3	3	16	67	50	50
	12Y (yield bp)	4.76	-5	-6	45	64	64	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. (%)
16	long USD/CZK	29/11/07	6m Libid/ 6m Pribor	4,91/3,99%			-0.2%	-9.3%	19.7	9.3%	18.7%
			USD/CZK	17.93	17.89	-0.22%					
17	long HUGB 3Y	05/12/2007	3Y HU GB 6,25	97.42	97.26	-0.14%	-0.03%	-0.1%	98.95	5.1%	10.10%
	CZK 6M		6M Pribor	4.04					4		
	CZK/HUF			9.63	9.64	0.00			9.41		

Rationale at inception

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.

17) Due to the jitters around the sub-prime crisis, sentiment on international markets turned for the worse and risk premiums increased. As Hungary's exposure to changes in global risk appetite is still seen as high, the forint weakened, while long-term bond yields jumped significantly in November, based on the increase in global risk premiums. We think that Hungarian government bonds have become attractive at their current level. Thus, there is potential for bond investors to cautiously enter the market (even at the auction scheduled for today). The target for six months is 6.75% HUF GB 3Y.

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%
12	Short EUR/SKK	04/06/2007	04/12/2007	1.6%

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Forecasts

http://global.treasury.erstebank.com

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	26.2		7.32		252		3.59		3.52		33.2		3.50	3.50	7.50	5.00	7.50	4.25
Dec-07	27.0	26.1	7.35	7.35	253	253	3.60	3.59	3.50	3.53	32.5	33.2	3.50	3.50	7.50	5.00	7.50	4.25
Mar-08	27.2	26.1	7.30	7.30	255	255	3.55	3.59	3.45	3.56	32.4	33.1	3.50	3.50	8.00	5.25	8.00	4.25
Jun-08	27.1	26.1	7.25	7.25	255	256	3.60	3.61	3.40	3.59	32.5	33.1	3.50	3.50	8.00	5.50	8.00	4.00
Sep-08	26.5	26.0	7.25	7.25	256	258	3.55	3.62	3.35	3.63	32.5	33.1	3.50	3.50	8.00	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	4.01		7.51		5.63		8.23		4.32		4.60	5.45	6.81	5.77	4.68	8.25
Dec-07	3.30	4.01	7.40	7.49	5.25	5.65	7.80	8.27	4.30	4.33	4.55	5.40	6.70	5.70	4.70	7.40
Mar-08	3.40	4.03	7.20	7.30	5.60	6.03	8.20	7.99	4.30	4.39	4.80	5.20	6.50	5.65	4.80	7.50
Jun-08	3.55	4.03	6.95	7.13	5.70	6.13	8.20	7.83	4.15	4.40	4.90	5.20	6.40	5.60	4.80	7.50
Sep-08	3.60	4.10	6.70	6.98	5.70	5.97	8.20	5.69	4.15	4.47	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

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

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

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-10	CPI (%,y/y), November	4.50	4.50
	Dec-10	Unemployment, November, %	5.70	5.70
	Dec-11	Industrial output, October, %	2	6.3
	Dec-12	Current Account, October, CZK bn.	-22.00	-16.20
	Dec-14	PPI %	5.00	5.00
Croatia	14-Dec	CPI	4.2% y/y	
Hungary	Dec-11	CPI November	6.9% y/y	7.2% y/y
Poland	Dec-13	CPI (%,y/y), November		3.5
Romania	10-Dec	Trade balance (FOB-CIF) October	EUR 1.8 billion	
	11-Dec	CPI November (y/y)	6.3%	5.9%
	14-Dec	Current account October	EUR 1.4 billion	
Slovakia	Dec-11	November CPI	3.1% y/y	3.0% y/y
	Dec-12	October foreign trade	SKK -0.6bn	SKK -1.0bn
	Dec-14	November HICP	2.2% y/y	2.2% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Dec-13	Dec-14	Mar-03-2008		CZK 5 bn.	
Hungary		Dec-11	Dec-19	March-19-2008	-	HUF 25bn	7.40%
		Dec-12	Dec-19	June-04-2008	-	HUF 20bn	7.35%
		Dec-13	Dec-12	Dec-17-2008	-	HUF 25bn	7.30%
Poland		No auction scheduled					
Romania		Dec-12	14-Dec-07	1Y		RON 300 million	7.30%
Slovakia		10-Dec-07	12-Dec-07	11-Feb-14	4.9%		4.6%

Major markets

Trichet reiterated ECB stance

This week's ECB meeting brought the expected outcome. Rates were left unchanged, but inflationary risks were again highlighted. It seems that concerns about possible effects of the slowing US economy and the turmoil on financial markets on the Euroland economy, as well as the fact that inflation is still contained to a few areas, are keeping the ECB from hiking further. It was reiterated that no second-round effects of increased commodity prices on inflation was the key assumption for leaving rates unchanged. The uncertainty about external effects on the Euroland economy will prevail for some time, so we expect the next ECB hike only in the later part of next year. The only important release next week will be the ZEW survey, which is scheduled for Tuesday. In the volatile market situation, the sentiment of financial market participants is difficult to assess. In total, the negative and positive changes vs. the previous month should have offset each other, pointing to a little-changed index value. As in the US, the determining factor for bond markets will be how the risk coming from the financial sector is perceived. We expect at most a slight increase of yields in the week ahead.

FOMC decision on assessment of financial markets' condition

The week ahead is full of important events. Today, the labor market report for November is scheduled. Job creation will very likely slow down, but this should be seen in the context of the strong growth reported for the previous month. So, even if employment growth slows down to half the previous rate, this should not unsettle markets. Monday will bring pending home sales, an early indicator of home sales. Tuesday will bring the most watched event of the week, the FOMC interest rate decision. The renewed strong increase of tension on money markets will lead to a cut of at least 25bp, as recent comments have indicated a highly concerned Fed. Even a cut of 50bp cannot be ruled out, depending on the informal information received from the banking sector. Any rate cut would be due exclusively to financial markets, as the recent economic indicators would not require such a step. Thursday will bring retail sales numbers for November. A solid increase can be expected, as data from the Thanksgiving weekend points to a good start of Christmas shopping. Finally, consumer price inflation and industrial production are scheduled for the last day of the week. In the current environment, the market impact should be limited, especially as the numbers are likely to confirm expectations for monetary policy. The decisive question for next week will be if the recent measures introduced by the US government to reduce foreclosures and the monetary policy action will suffice to restore some confidence among financial institutions. At best, any recovery would proceed slowly, in our view. The dollar could strengthen somewhat.

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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	4.88		5.15		4.13	4.01	1.464	
Dec-07	4.00	4.25	4.35	4.95	4.70	5.09	4.30	4.20	1.43	4.464
Mar-08	4.00	4.00	4.15	4.70	4.30	4.51	4.60	4.50	1.38	1.465
Jun-08	4.00	4.00	4.15	4.57	4.20	3.94	4.70	4.60	1.35	1.464
Sep-08	4.00	4.00	4.35	4.43	4.20	3.73	4.70	4.60	1.35	1.463

Czech Republic

CZK in heaven

The CZK has moved closer to 26 EUR/CZK. The reasons? Hedge funds' efforts to drift profits before end-year (this year, they are more motivated to compensate for losses connected with the sub-prime crisis), low Christmas liquidity, and fear of further Fed cuts. And, last but not least: the CNB hike. What next? Higher volatility and inflation (see below) could move the CZK to even stronger levels. If the CZK follows the usual seasonal pattern, it will appreciate to just below 26 EUR/CZK. However, this seems like a lot only if you compare it with the 1H07 level, which was influenced by carry trades. Nevertheless, as we expect further nervousness about developments in the US, we expect a trend reversal for the CZK and a return to a more fundamentally-based level. For 1H08, we see EUR/CZK 27-27.3. This is also supported by seasonal analysis. How to play it? Short CZK, long USD, SKK and RON.

Inflation hydra

The inflation hydra has awakened. This can be seen immediately from the latest inflation development. A figure starting with four is something that we have not seen for a long time. Moreover, it will get worse. For November, we expect acceleration from 4% to 4.5% (the risks are skewed upward); the figure will be released on Monday. The beginning of next year will push inflation towards 6%. Regular readers know that inflation has been pushed largely by supply-side factors (oil, food and regulated prices + tax hikes). Demand inflation, which is most sensitive to interest rates, is compressed below 2%. This is the reason why we do not expect drastic CNB rates hikes (next hike in April, end-2008 rates at 3.75-4.0%). However, as the market will see figures starting with four, five, maybe even six, they can start to price-in more hikes than will be delivered in the end. This could move the CZK to stronger levels and/or increase the short end of the yield curve.

Christmas gift for bond traders

The MinFin released its emission strategy for next year, which is consistent with the budget approved this week (deficit: CZK 71bn). The government will need CZK 180bn, of which CZK 15bn will be a loan from the EIB, allowing the MinFin to continue lowering the debt financed by T-bills (CZK 0-20bn). For next year, we expect EUR 1-1.5bn in Eurobond emissions. For the domestic market, we expect approx. CZK 130bn to be placed with CZK 90bn maturing. This means an increase of net emissions by approx. CZK 37bn (this year: approx CZK 100bn). Looking at demand from domestic financial institutions, we expect an increase of the loans to deposits ratio. This will partly reduce the downward pressure on the CZGB/GECU spreads.

Czech GDP growth still at 6%, but should slow down next year

If you have seen our short note on GDP growth, skip this part. The 3Q GDP growth was at 6% y/y (Erste: 5.8%, market: 5.8%), with 2Q revised from 6% y/y to 6.3% y/y. The main driver is domestic demand - consumption (5.6% y/y) and investment (5.7% y/y). The net export contribution was down 1pp from the level seen in the last two years. This year's consumption acceleration has been due to higher social spending, the fast unemployment decrease and real wage acceleration. Investment has been supported by building construction - forward buying, as the VAT will increase next year (this effect will also influence the 4Q07 figures). This year, the economy will maintain 6% y/y growth. However, the economy will slow next year, due to the negative effect of the approved reform package (consumption will be hurt the most, as the pace will fall close to 3.5% y/y). This figure does not change our view on the CZK or rates.

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Hungary

CPI should have stood at 6.9% y/y in November

Next week, the most influential figure should be the November CPI inflation (published on Tuesday morning). After the 6.7% published for October, the 12-month index should have stood at 6.9% in the eleventh month of the year. The monthly index could again have been relatively high - I expect 0.4%. While sharp monthly increases in food prices - which characterized the previous months - may have somewhat mitigated, the sharp rise in fuel prices seen in November could have been the main driver.

November budget deficit lower than expected

Following the traditions of the previous months, the November monthly budget deficit proved to be somewhat lower than predicted earlier by the Finance Ministry. Despite the ministry's forecast of HUF 172.2bn, the actual deficit was HUF 142.4bn in November, taking the cumulative budget deficit for the first eleven months of the year to HUF 1339.4bn, 90.4% of the ministry's latest full-year CF deficit projection. Budget processes are on track this year and the 2007 ESA deficit should stand at 6% of GDP, a bit lower than the government expectation of 6.2% of GDP (also indicated in the latest Convergence Program).

GDP rose just 0.9% y/y in 3Q07

The CSO revised down the 3Q GDP growth to 0.9% y/y, from the preliminary 1% y/y. The breakdown of the figure has not brought big surprises, reinforcing earlier suspicions that the further GDP downturn in the period was again due to sluggish domestic demand. Household consumption expenditures decreased by 0.8% y/y, while households' final consumption was down 2% y/y, due to drops in social transfers from the government. At the same time, government consumption expenditures also decreased by 3.8% y/y. Investment figures were revised upwards (to -1.8% y/y from the -2.5%y/y published last week). However, it is hard to asses this fact positively, as they are still in negative territory. And, last but not least, it is not too favorable that, although exports increased by an impressive level of 14.9% y/y, imports rose by 14.6% y/y as well. Thus, the gap between exports and imports narrowed further to just 0.3%. For FY07, I expect 1.5-1.7% y/y GDP growth, which seems unlikely to approach 3% y/y in 2008.

The forint has appreciated further, based on increasing risk appetite on international markets. In the short run, investors should focus on the minutes of the November 26 monetary meeting, which is due this afternoon. Next week, the November CPI figures should be watched closely, although they are unlikely to change the Hungarian base rate outlook in the short term. The outcome of the Fed rate setting meeting could be crucial for domestic markets, while in the second half of the week, the approaching meeting of the NBH (Dec. 17) should gain increasing attention. This month, the rate setting meeting is scheduled earlier than the publication of monthly wage statistics (Dec. 19).

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Poland

Government plans should mean lower bond supply next year

Last week saw no macroeconomic data releases. Two of the events worth mentioning were the statements from three central bankers and the further addition to the new government's privatization plans. As for the latter, the government added its 4% stake in Bank Pekao to the assets it intends to sell in 2008, doubling the PLN 2.3bn planned by the previous, conservative government. The government also said it is considering floating more shares in PKO Bank Polski. All in all, these plans would mean a lower supply of bonds next year.

Consensus among MPC members on need for hikes

Skrzypek, Noga and Wojtyna were among those who made statements concerning the inflation outlook (as the data on November inflation is to be released next week) and future monetary policy. There appears to be a consensus among the MPC members on the need for further hikes to contain inflation. However, while Noga said (pretty unconditionally) that two or three more hikes are needed by mid-2008, Governor Skrzypek remarked that responding to supply-side shocks should not be the MPC's business and that the MPC should instead stay on the lookout for a rise of inflation expectations. However, he declined to elaborate on how severe he thinks the problem is or could get. On the other hand, Wojtyna - one of the key voters on the MPC - did, saying that they can "no longer assume that the food prices would not cause secondary effects across the economy" and that a "hike in December cannot be ruled out." While the only time the MPC hiked in December was back in 1998, he admitted that the "decision must be made on merit." Our baseline calls for another hike to be delivered only in January (from the macro viewpoint, one month does not make much of a difference), but there is a substantial risk that the hike could be delivered as early as this month. This risk was heightened by the faster than expected growth of the Polish economy in 3Q and the rather volatile zloty (a far cry from the CZK since the middle of the year), and could get another boost if the inflation data next week surprises negatively (the expectation is 3.5% y/y, compared to the October rise of 3.0%).

As for next week, the crucial data will be the release of the CPI - a surprisingly negative figure might be another blow to Polish bonds, which have already lost most of the value gained in the immediate aftermath of the Polish elections. The trade balance should not move the markets much.

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Romania

Infrastructure construction set record for year in October

Construction work increased by 35.5% y/y in October, mainly supported by civil engineering (+46.1% y/y). Non-residential building increased by 38% y/y, while residential building slowed to 17.8% y/y. The very high increase of construction activity has been constant since the beginning of 2007 and Romania now has one of the most dynamic construction sectors in the EU. The high demand for residential buildings and the need for infrastructure improvements were at the core of this development. The very high growth rate of civil engineering in October can be partly explained by the increased capital expenditures recorded in the consolidated state budget in October (+0.5pp of GDP in a single month). New construction work currently takes first place among total investments in the economy, with their share exceeding that of equipment. Considering the modern technologies used by construction companies, we believe that the cold winter weather will have only a slightly negative impact in the next few months. We estimate an increase in the rate of construction activity of around 30% for end-2007.

Capital goods up strongly in October

Industrial production went up by 5.9% y/y in October, on the back of capital goods, which grew by 23% y/y. At the same time, durables gained speed in October (+18.1% m/m), putting the y/y increase at 5.6%. Energy declined by 1.7% y/y, following the summer drought. We estimate that industrial production will rise by 6.4% in 2007. For next year, we see strong support from new international players that might begin production in areas like IT&C and the car industry.

RON closely mirrored its regional peers

During the week, the Romanian currency was strongly correlated with its regional peers, leaving behind the domestic economic data releases for the construction and industry sectors, which proved that the economy is still growing at a fast pace. The RON strengthened slightly on Friday to 3.49, on the back of better than expected economic growth, as Romania's GDP increased by 5.7% y/y in 3Q07. The RON started the week in the 3.50 zone, but could not keep its earlier gains and underwent a depreciating trend, due to increased risk aversion among off-shore investors toward emerging markets. This might have also been caused by the fact that the central bank had published its foreign currency reserves data, which did not offer support to the rumors that the NBR had intervened indirectly in the domestic forex market in late November. Therefore, even a modest selling order had a strong impact on the market (psychological effect). Romania's international reserves increased by EUR 230mn in November, while they are growing by EUR 400-500mn per month, on average. The RON started to recover on Thursday, amid the more favorable sentiment among investors towards emerging markets, which still offer a positive yield differential compared to mature markets. We remain confident in the RON's upside potential in December, as remittances from Romanians working abroad will begin to offer support for the currency. Therefore, we expect the RON to trade sideways in the 3.48-3.55 zone this week, with a slight upside potential.

Short tenor interbank interest rates eased down slightly, but stayed above 7%

The short-term interbank interest rates eased down slightly this week, as commercial banks preferred to keep a large part of their liquidities at their disposal, rather than placing them at the NBR. Therefore, interest rates decreased by 20 basis points compared to last week's levels, being quoted in the 7.1/7.8 zone, but stayed near the monetary policy rate, as a new reserve period has just begun and banks have started to constitute their mandatory reserve requirements. We expect the short-term interest rates to remain stable around the monetary policy rate, as the NBR will continue to drain excess liquidity in the interbank money market, while banks will build up their reserves.

MinFin rejected all bids in 3Y benchmark bond auction

The Ministry of the Economy and Finance again rejected the offers of primary dealers at its debt auctions. The primary dealers had submitted RON 800mn for the 3-year benchmark bond auction on December 6, while the indicative amount of the MinFin stood at RON 600mn. It is likely that the yields demanded by investors substantially exceeded the price the MinFin was willing to pay to borrow from the domestic market. In December, another two auctions for government debt instruments with 1Y and 10Y maturities are scheduled. We believe that the MinFin will prefer to borrow for a shorter term, as it expects borrowing costs to decrease in the medium term. Therefore, it is likely to drain some liquidity at the one-year treasury bill auction on December 12.

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Slovakia

Parliament passed next year's budget

Last week, the Slovak Parliament passed the 2008 budget; the motion was attached to the confidence vote on the government. The broader fiscal deficit is budgeted at 2.3% of GDP, down from this year's ceiling of 2.9% of GDP (although this year's deficit will likely be lower, between 2.5% and 2.7% of GDP, depending on whether the debt of the highway company is included in the public finances or not).

Almunia appraised Slovak efforts to adopt euro

During the week, the Slovak delegation led by PM Robert Fico discussed the prospects of Slovakia to introduce the euro in Brussels. After discussion, EU Commissioner for Monetary Affairs Joaquin Almunia appraised the efforts made so far by Slovakia, but stressed that the criteria have to be met in spring. Fico said that he sees the chance of euro adoption in 2009 as very high (with inflation sustainability being the biggest issue for possible discussion). We assess the probability at 70-80%.

Industrial production outpaced expectations

October industrial production outpaced market and our expectations, rising by 17.4% y/y (expectations were around 13%). Again, production of cars was the main driver, while production of electronics and optical devices strengthened its contribution significantly (to 5.9pp, while the car sector contributed 7.4pp to the growth). The figures imply that foreign trade might be balanced or in surplus in October (we expected a deficit of SKK 0.7bn before).

Inflation to decline in November

The koruna has moved within the 33.12-33.36 EUR/SKK corridor since Monday, trading at 33.20 on Friday morning. The regional mood remained positive during the week, while we expect further gains in the coming weeks alongside improving global risk appetite. On the data front, we will see November inflation on Tuesday, which should slightly decelerate on an annual basis (CPI to 3.1%, from 3.3% the previous month, and HICP to 2.2%, from 2.4% in October). The monthly gain in prices (by 0.3%) should be due to higher prices of food, services and imputed rents.

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Appendix Charts

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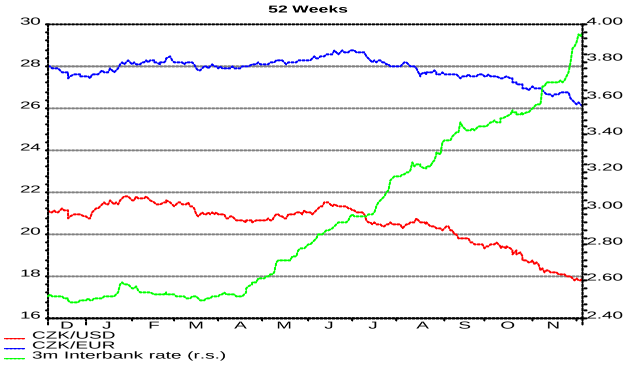
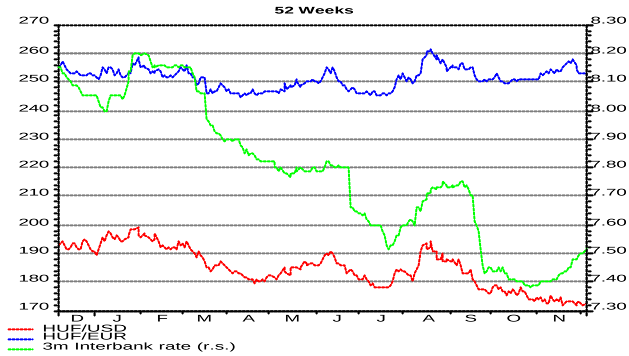
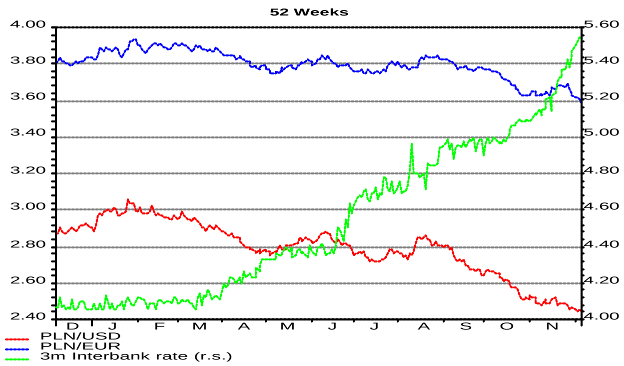
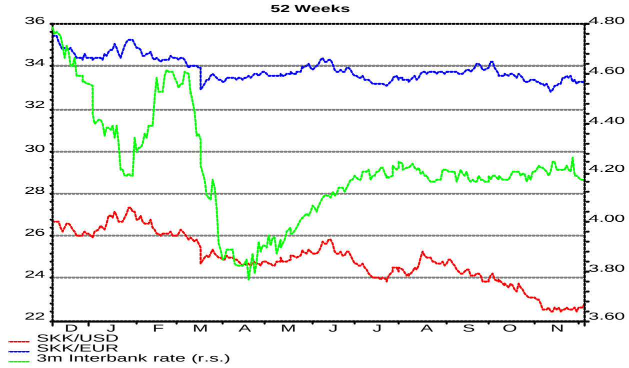
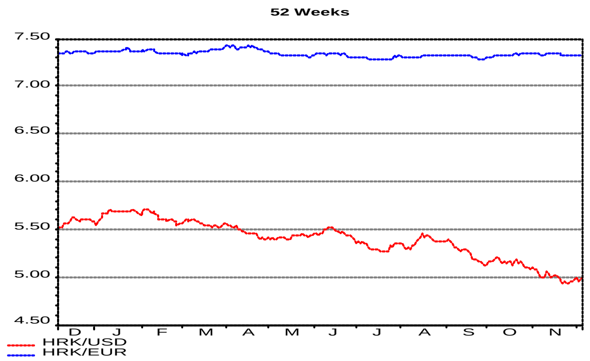
Exchange rates and interest rates (52 weeks)

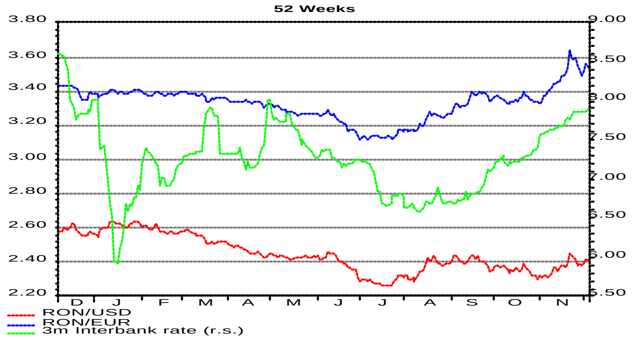








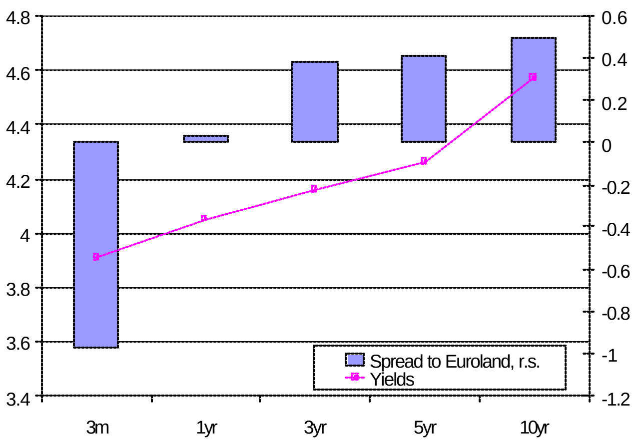




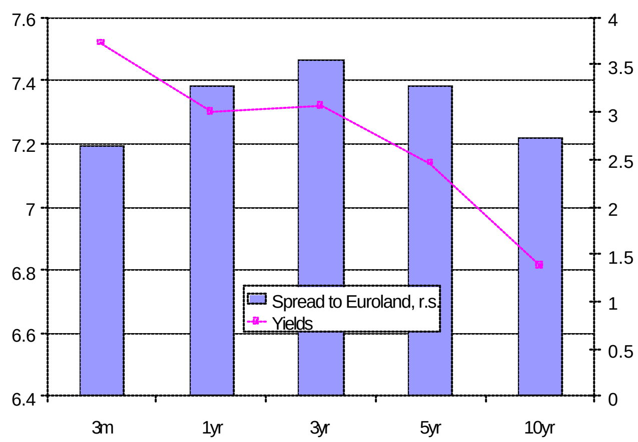
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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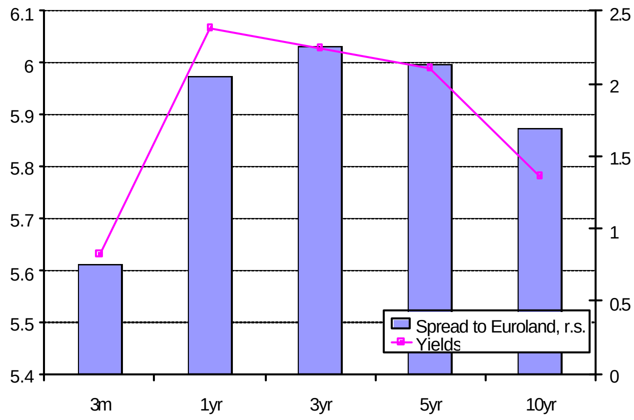
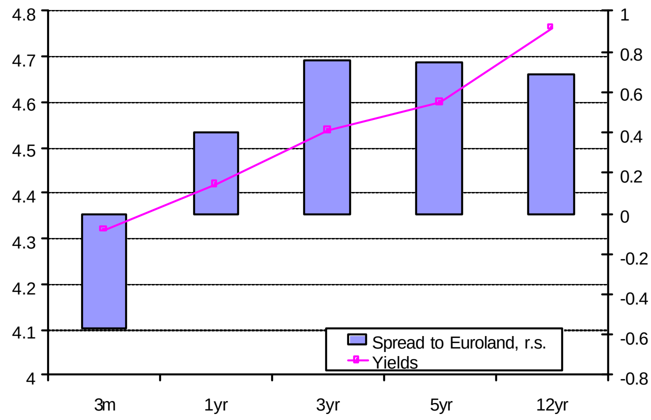
Poland



Slovakia



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