CEE Research

December 13, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** Elections: still no government
- **Czech Republic:** We call for unchanged rates after CNB meeting
- **Hungary:** No rate cut expected on Monday
- **Poland:** Outcome of upcoming rate decision a close call
- **Romania:** Romanian currency stayed relatively stable
- **Slovakia:** Inflation slowed down in November

The research team at ERSTE BANK wishes you a Merry Christmas and a Prosperous New Year 2008

The next CEE Insights will be published on January 4, 2008

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Overview

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Croatia:

- Elections: still no government
- CNB: monetary policy for 2008 accepted
- Exchange rate surprised on the upside

Czech Republic:

- Risks are high, but we call for unchanged rates after CNB meeting
- Inflation risks make a hike possible next week…
- …the strong koruna though tilts the probability to no change

Hungary:

- CPI inflation stood at 7.1% y/y in November
- No rate cut expected on Monday
- GDMA issue plan and 3Q C/A balance figures in focus at the end the year

Poland:

- Outcome of upcoming rate decision a close call

Romania:

- Trade deficit slowed down at 54.1% y/y after the first ten months
- Romanian currency stayed relatively stable
- Romanian money market liquidity has diminished

Slovakia:

- Inflation slowed down in November
- Foreign trade in surplus again
- Central bank to keep rates on hold
- Koruna stayed shy of 33 SKK/EUR

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Wednesday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland: current	- 1m	02/01/2007
Czech Republic	EUR/CZK	26.08	0.5%	2.2%	5.9%			
	3Y (yield bp)	4.29	14	0	108	26	31	-66
	10Y (yield bp)	4.74	19	14	104	44	51	-23
Croatia	EUR/HRK	7.32	0.1%	0.4%	0.4%			
	3Y (yield bp)	5.30	4	49	76	130	89	66
	10Y (yield bp)	5.43	-6	25	n/a	115	108	n/a
Hungary	EUR/HUF	252.63	-0.2%	0.6%	-0.5%			
	3Y (yield bp)	7.34	0	18	-21	331	326	368
	10Y (yield bp)	6.85	0	20	64	254	255	276
Poland	EUR/PLN	3.57	0.4%	1.9%	7.3%			
	3Y (yield bp)	6.08	5	26	143	205	193	78
	10Y (yield bp)	5.85	10	20	68	155	153	124
Romania	EUR/RON	3.52	0.4%	-2.0%	-3.8%			
Slovakia	EUR/SKK	33.12	0.2%	-0.4%	4.1%			
	3Y (yield bp)	4.55	-1	5	17	48	62	50
	12Y (yield bp)	4.78	0	-2	47	45	72	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. (%)
		29/11/07	6m Libid/ 6m Pribor	4,91/3,99%			-0.5%	-12.4%	19.7	9.3%	18.7%
16	long USD/CZK		USD/CZK	17.93	17.83	-0.51%					
	long HUGB 3Y	05/12/2007	3Y HU GB 6,25	97.42	97.21	-0.09%	-0.17%	-0.1%	98.95		
17	CZK 6M		6M Pribor	4.04					4	5.1%	10.10%
	CZK/HUF			9.63	9.63	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

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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	26.1		7.32		252		3.57		3.52		33.1		3.50	3.50	7.50	5.00	7.50	4.25
Dec-07	27.0		7.35	7.35	253	252	3.60		3.50	3.53	32.5	33.1	3.50	3.50	7.50	5.00	7.50	4.25
Mar-08	27.2	26.0	7.30	7.30	255	254	3.55	3.58	3.45	3.56	32.4	33.1	3.50	3.50	7.25	5.25	8.00	4.25
Jun-08	27.1	26.0	7.25	7.25	255	256	3.60	3.59	3.40	3.59	32.5	33.0	3.50	3.50	7.00	5.50	8.00	4.00
Sep-08	26.5	26.0	7.25	7.25	256	257	3.55	3.60	3.35	3.63	32.5	33.0	3.50	3.50	6.75	5.50	8.00	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	4.04		7.50		5.64		8.28		4.32		4.76	5.45	6.85	5.85	4.69	7.90
Dec-07	3.30		7.45	7.49	5.60		7.80	8.25	4.30	4.33	4.55	5.40	6.70	5.70	4.70	7.40
Mar-08	3.40	4.15	7.30	7.35	5.60	6.11	8.20	8.00	4.30	4.42	4.80	5.20	6.50	5.65	4.80	7.50
Jun-08	3.55	4.17	7.00	7.18	5.70	6.20	8.20	7.84	4.15	4.45	4.90	5.20	6.40	5.60	4.80	7.50
Sep-08	3.60	4.17	6.80	7.02	5.70	6.04	8.20	5.73	4.15	4.51	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	7.2	4.1	2.4
Poland	1.4	3.4	3.0	2.7
Romania	4.9	6.7	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-17	Retail Sales (%,y/y), October		6.00
	Dec-19	CNB rate-setting meeting	3.50%	3.50%
Croatia	20-Dec	Unemployment rate	14.6%	
	21-Dec	Industrial production	5% y/y	
Hungary	Dec-17	NBH rate-setting meeting	no change (7.50%)	no change (7.50%)
	Dec-19	October Nominal wages	-	-
	Dec-21	October Retail sales	-3.4% y/y	-
	Dec-29	3Q07 C/A balance	EUR -1.2bn	-
Poland	Dec-17	Avg. Gross Wage, November,y/y%		11.2%
	Dec-19	MPC rate-setting meeting	5.0%	5.0%
	Dec-19	PPI, y/y, %		2.8
Romania		No data releases scheduled		
Slovakia	Dec-18	CB policy rate	no change (4.25%)	no change

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Dec-20	Dec-21	Sep-19-2008		CZK 5 bn.	
Hungary		Dec-18	Dec-27	March-26-2008	-	HUF 25bn	7.45%
		Dec-20	Dec-27	Oct-24-2012	6.00%	HUF 45bn	7.05%
		Dec-20	Dec-27	Feb-24-2017	6.75%	HUF 40bn	6.80%
Poland		No auction scheduled					
Romania		20-Dec-07	24-Dec-07	10Y	6.75%		7.3%
Slovakia		No auction scheduled					

Major Markets

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Major markets

IFO Index to be released next week

The only relevant data scheduled for Euroland next week is the IFO index on Wednesday. So far the financial market turmoil and concerns about the future course of the US economy have had barely any affect on this indicator from the real economy. Should this continue in December as well, this would support a decoupling scenario for the Euroland economy. In the end though, with all the global-scale risks on the horizon and the approach of the Christmas holiday and yearend, any stronger market reaction seems unlikely.

Financial markets in Fed's focus

This week the Fed lowered the target rate as expected by 25bp to 4.25%. The wording in the press release points to another rate cut ahead unless the situation on the interbank market calms down by the end of January, which seems unlikely in our view. The focus of the US-Fed is currently on the money markets. The recent announcement to add more liquidity in the weeks ahead through term funds must be seen in this context, but so far has only received a muted reaction from markets. In this environment interest rate expectations will hardly be shaped by macro indicators. Nonetheless, the current status of the economy will of course be of interest. Retail sales released today are likely to be positive, as the Thanksgiving weekend seems to have brought good revenues for retailers and gasoline prices increased in November. Consumer inflation, released tomorrow, should have remained steady, excluding the effects of energy prices. Next week will only bring second tier releases, the most important of which will be housing starts on Tuesday. Also, final 3Q GDP data is scheduled for Thursday and the final Univ. of Michigan Index for December on Friday.

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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	4.25	4.95		5.06		4.29	4.09	1.469	
Dec-07	4.00	4.25	4.80	5.03	4.90	5.12	4.30	4.20	1.45	1.469
Mar-08	4.00	4.00	4.35	4.79	4.70	4.67	4.30	4.20	1.43	1.470
Jun-08	4.00	4.00	4.15	4.70	4.30	4.04	4.60	4.50	1.38	1.469
Sep-08	4.00	4.00	1.15	4.59	4.20	3.80	4.70	4.60	1.35	1.467

Croatia

Elections: still no government

We are in the third post-election week and still no agreement regarding the government has been reached. Negotiations between the CDU and HSS&HSLS coalition have been in progress for some time now and besides the usual word that negotiations are going well, not much information has been issued to the public. One of the main topics has been the activation of the fishery zone in the Adriatic see (supposed to be activated by 1st January 2008): HSS&HSLS demanded that the issue should not be delayed and the CDU is leaning more to reaching some kind of compromise as it does not want to endanger EU talks. Despite this, negotiations are likely to be in the final phase and an agreement could be reached by the end of the week. At the moment, the CDU forming a new government seems a more probable outcome, while the SDP's chances would increase in the case of negotiations between CDU and HSS&HSLS coalition stalling.

CNB: monetary policy for 2008 accepted

At the December CNB Council meeting, the announced monetary measures for 2008 were confirmed. This means that the monetary policy stance in 2008 would remain tight and directed towards the slowing down of credit growth. The CNB, therefore, only fine-tuned existing regulations, leaving the allowed credit growth at 1% pm (12% pa) and penalising the excess credit growth more harshly (banks are obliged to purchase CNB bills in the amount of 75% of excess credit, previously 50%). Expectations remain the same and we continue to expect tighter monetary conditions in 2008 and an additional slowdown of credit.

Exchange rate surprised on the upside

In the past two weeks, the kuna came under some appreciation pressures, which pushed the exchange rate to around the 7.32 level, which is slightly stronger than expected. The kuna was supported by tight MM conditions, which was further boosted by Christmas spending and higher demand for kuna liquidity. The banks would also not want to see any significant depreciation of the exchange rate due to the high proportion of FX-linked assets affecting credit growth limits. Therefore, we foresee the exchange rate at around the 7.35 level towards the year-end. The bond market recovered to some degree in the past two weeks. After some time the CNB accepted a large proportion of the bids and the CNB repo rate stabilized at around 4%. Stabilisation and further recovery would depend on MM conditions and the CNB's stance towards reverse REPO auctions.

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Czech Republic

Risks are high, but we call for unchanged rates after CNB meeting

As for the Czech Republic, the major event of the week is the rate-setting meeting of the Czech National Bank. Our baseline calls for no change in rates even though there is a significant risk of a hike in December.

First, our quantitative model - based on fundamentals we view as important for the CNB decision-making process - assigns a probability of close to 80% to the scenario of a hike in December. It is a model though so one needs to take it cum grano salis as it has never really experienced inflation of 5% as an input and thus might be overdoing it a bit.

Inflation risks make a hike possible next week…

So, what does this all mean in plain English and intuitive economics? The situation for the central bank is at least as puzzling as it was a month ago - and quite possibly even more so. Headline inflation is substantially higher than what the CNB had forecast in its latest prognosis (the forecast error widened to 1.1% in November) and it may not be as easy for the CNB to dismiss this as a short-term cost factor that requires no response. A strong argument in this direction is that the food and fuel rises, coupled with the VAT hike as of January, 1st, might be just the trigger threatening to set off the buildup in inflationary expectations in an economy operating above the potential that the Board had hoped would not materialise. This is a similar situation to that seen in Poland.

…the strong koruna though tilts the probability to no change

And is there anything that could prevent the bank from hiking next week? There is the strong Koruna and the possibility of further strengthening as witnessed after the previous decision in November. Secondly, even though it is true that the next rate-setting meeting will be on February, 7th and the Board will not have final CPI data for January, it will still have weekly surveys that might give an indication of whether the food price increases witnessed recently (October and November 2007) were partly driven by food stores increasing the prices in an anticipation of the VAT rise from January 2008. Thirdly, as liquidity hopefully returns to the markets in January, the koruna might start to weaken on its usual seasonality. Finally, the Bank will have a new prognosis at the beginning of February (the CNB will be down to 8 meetings a year next year) and thus will see the impact of the changes to the inflation outlook.

So, clearly, the situation is somewhat confusing, and a tough call for the CNB to make. As for the more tangible data, October retail sales are due next week where we expect growth of 7.5% providing evidence of the strong consumer demand However, demand as such is not a top priority as the demand inflation is well below.

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Hungary

CPI inflation stood at 7.1% y/y in November

Consumer prices nudged up 0.6% m/m in November, while the 12-month inflation rate accelerated further to 7.1% (from 6.7% published for October). Food prices and fuel prices were again to blame for the acceleration of the yearly index, rising by 1.4 m/m, and 3.3% m/m, respectively. Apart from these drivers, other items did not show any significant changes on a monthly basis and so far do not indicate strong price pressure in the other sectors. The seasonally adjusted core inflation increased 0.5% m/m, thus the 12-month core CPI rate slightly increased to 4.6%, from 4.4% in October. Following the publication of the November figures we had to increase the forecast for the December inflation index to 7.2% y/y, while the 2007 annual average rate should reach 8%.

No rate cut expected on Monday

Next week, the most watched event is likely to be the central bank's rate-setting meeting on Monday. Taking into consideration the poor short-term inflation outlook, uncertainties around food and fuel prices as well as around wage deals, no rate change is expected at the last meeting of the year. The November CPI figures mentioned are not likely to change the current cautious stance of the monetary policy either. As for the rate outlook, even though at the beginning of the week, another member of council Gábor Oblath also mentioned a rate hike as an option (if the faster pace of wage growth indicates increasing inflationary expectations), we do not think that a rate hike is a likely scenario. The next rate step, therefore, could be a rate reduction, but such a step is not expected before February-March 2008.

In the current climate, it is no wonder that the central bank is communicating very strongly against excessive wage hikes in the private sector. On Wednesday, the bank released a statement which contained that the bank's management had met both the trade unions' and employers' side of the National Interest Reconciliation Council (OÉT). At these meetings there was some discussion on the role of wage formation in fighting against inflation. On Monday, trade unions decreased their previous wage hike demand of 10% to 9%, while employers widened the range of their recommendation to 4.5-6.0% from the previous 5%. The debate is scheduled to continue this Friday.

GDMA issue plan and 3Q C/A balance figures in focus at the end the year

Apart from the central bank meeting and the possible outcome of wage deals, the most important events of the last working days of the year are as follows. The final vote on the 2008 budget law in Parliament will be on December 17. Three days later, the Government Debt Management (GDMA) will hold a press conference on its issue planning for 2008, which may cause some movements in bond yields, depending on the planned structure of debt financing. And last but not least, the central bank will publish 3Q C/A balance figures on December 29. The deficit is set to come in at about EUR 1.2bn for the July-September period, which could take the cumulative C/A deficit for the first three quarters of 2007 to EUR 4.087bn. However, because of the timing of publication, this should not influence the markets at all. Subdued activity and dry liquidity on both FX and FI markets should characterize the days ahead.

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Poland

Outcome of upcoming rate decision a close call

Next week, the major event is the rate-setting meeting of the MPC. Our baseline calls for no change and the hike to be delivered only in January (25bps). However, the risk is that the MPC, accused by some analysts and observers of having fallen behind the curve and having to chase inflation, might succumb and hike as early as December even though this would be the first time since December 1998 it has done so. We would associate probability of around 30% with this scenario, the rationale for this being the threat of higher headline feeding through to inflation expectations, a threat more pronounced given the rapid gains in aggregate wage bills (another piece of data to be released next week, the market expectation of which is a hefty 11.2 % y/y in real terms) and the economy operating above potential. We think Poland is in need of two more hikes in the first half of 2008 and the MPC is almost certainly under a lot of pressure to hike as early as possible. Whereas the hawks in the MPC have been saying for some time now that inflation is a threat, the Council as a whole now appears to have converged on the idea of there being a need for further hike(s) with only the timing becoming an issue.

There appears to be a dividing line between the Czech Republic and Poland on the one hand and Slovakia and Hungary on the other as far as inflation and its outlook is concerned. The Czech Republic and Poland are operating above potential with tight labour markets, and such economies are always susceptible to shocks inflating price levels and to the subsequent buildup in expectations.

Two pieces of data could provide a hint of what the Council might do in December. At the time of writing there was no final data on CPI for November, but the expectation was 3.5% (as against 3% and 2.3% in two months before November). Any negative surprise would surely act as a stimulus for the Council to consider hiking as early as next week's meeting, as would the surprise in aggregate wages bill, also to be released next week.

As for the markets, all eyes will be on the MPC - hiking might be viewed by some players as an admission of late response and could send bonds lower on the threat that runaway inflation will erode their value.

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Romania

Trade deficit slowed down at 54.1% y/y after the first ten months

The slower pace of the trade deficit at the end of October (as compared to 67.1% y/y in 1H and 57.8% y/y at the end of September) was determined by a deceleration of imports.

In early-2007, after Romania's accession to the EU, the trade deficit dynamic was heavily influenced by very high imports, due to the removal of certain customs duties. However, imports lost pace considerably after that. EU accounted for 72% of exports and 71% of Romania's imports. We estimate that the trade deficit will slow down further, following the RON's depreciation from November. For the coming year, on the exports side we see strong potential for cars, electronics and a recovery of mineral fuels.

Romanian currency stayed relatively stable

The domestic currency found some stability in the 3.52 area in recent days, amid thin volumes. Volatility has also calmed down substantially this week, as quotes moved within a tight range between 3.51-3.53 levels. It seems that off-shore players have refrained from taking positions on the Romanian forex market lately, as the year-end approaches and as they await the outcome of the NBR's monetary policy rate due on January 7. The market has built up expectations for a hike of the key rate by at least 25 basis points, but we expect the NBR to increase rates by 50 basis points up to 8.0% in January. The leu traded sideways in the first part of the week, ranging in the 3.51-3.53 zone. Volumes transacted were quite modest, mainly for commercial purposes, while remittances from Romanians working abroad were not sufficient to offer strong support for the leu.

The RON might strengthen slightly in the latter part of December, sustained by remittances from Romanians working abroad, finishing the year in the 3.45 zone.

Romanian money market liquidity has diminished

The liquidity of the Romanian money market has diminished lately, as local players probably prefer to keep more funds at their disposal for the year-end payments. Therefore, the short-term interest rates increased slightly in recent days up to 7.5/8.0% bids/asks, although RON 2.05bn entered the market from the NBR. On Monday, the Central Bank held its regular 2-week deposit auction for the fixed monetary policy rate of 7.5%. The offer of the commercial banks has totalled RON 1.6bn, as only six banks had submitted bids at the NBR's open market operation. As we had already got used to in recent months, the Central Bank has drained the entire liquidity surplus of the commercial banks. On Friday, the NBR will hold its regular monthly auction for selling 3-month maturity deposit certificates, but we expect limited interest from the banks for this auction, as the market anticipates the increase of the policy rate in January. Also, for the same reason, the commercial banks might lose interest in the NBR's depo auctions once the new reserve period has got under way, preferring to keep higher reserves at the NBR.

We expect the short-term interest rates to stay relatively stable in the proximity of the monetary policy rate until the end of the year, as the NBR will continue to drain the excess liquidity in the interbank money market, while banks build up their reserves.

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Slovakia

Inflation slowed down in November

Consumer inflation slowed down from 3.3% in October to 3.1% y/y in November, matching our expectations. The monthly increase of 0.5% was driven by food prices and prices of services. The release sends a message of caution to the central bank, as CPI adjusted for food, fuels and imputed rents - which is our proxy for demand pressures - increased by 0.3pp to November's 1.8% y/y. However, CB Governor Ivan Sramko dismissed fears of demand-led inflation on Wednesday, suggesting that the CB does not see any significant pressures from the demand side. In the coming months, we expect CPI inflation to increase slightly to 3.4-3.5%.

November HICP (to be released on Friday) could reach 2.3% y/y versus our pre-CPI forecast at 2.2%. The Maastricht criterion should be still fulfilled with a substantial reserve in spring. We expect 12M HICP average at 2.0-2.1% in spring 2008, when evaluation of euro preparedness takes place, which should be 0.5-0.8pp below the reference limit.

Foreign trade in surplus again

The Statistical Office also released October foreign trade data. The balance ended in a surplus of SKK 2.5bn compared to expectations of a deficit at about SKK 1bn. The positive surprise is owed to stronger exports, particularly in the car and electronics industries (judging by industrial production data). However, the positive surprise from the headline figure was overshadowed by downward revisions of the YTD data. Nevertheless, this is still a significant improvement compared to a year ago.

Central bank to keep rates on hold

Next week will bring the central bank's final meeting of this year. The Bank Board is widely expected to keep rates unchanged, as it has done on each occasion this year since April. We expect the central bank to retain its no touch policy and wait for ECB moves. That means also keeping Slovak rates on hold in 1Q08.

Koruna stayed shy of 33 SKK/EUR

This week, the koruna came close to 33 SKK/EUR after a month but has so far stayed shy of crossing this threshold. We expect appreciation of the koruna in the weeks ahead, while the regional trading mood will be important for near-term development. Speaking about the koruna, Bank Board member Peter Ševcovic admitted that the second revaluation of ERM-2 central parity is a possibility (although he added that such discussions are premature). We reiterate our long-held view that we expect the central parity to be revaluated again at the beginning of next year and the euro conversion rate is likely to be set later at this new central parity.

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Appendix Charts

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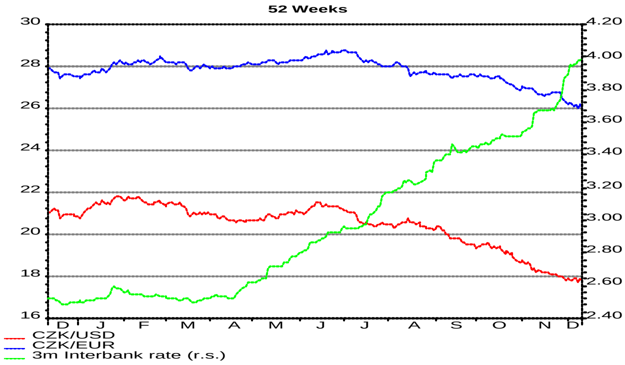
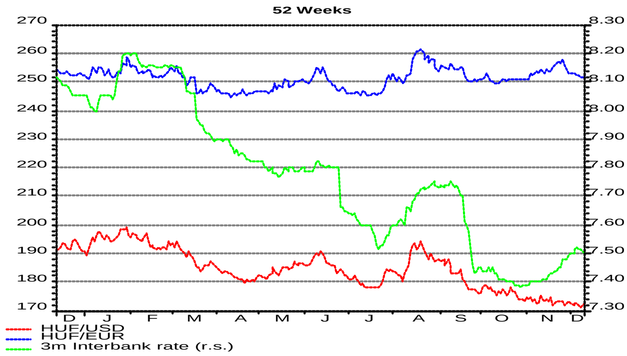
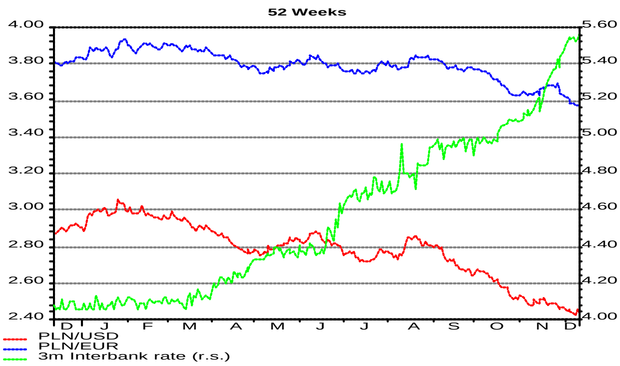
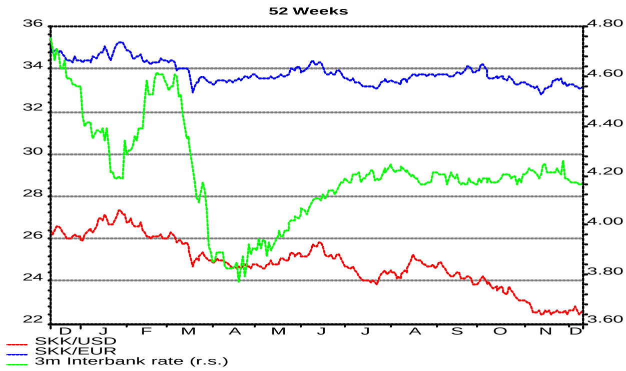
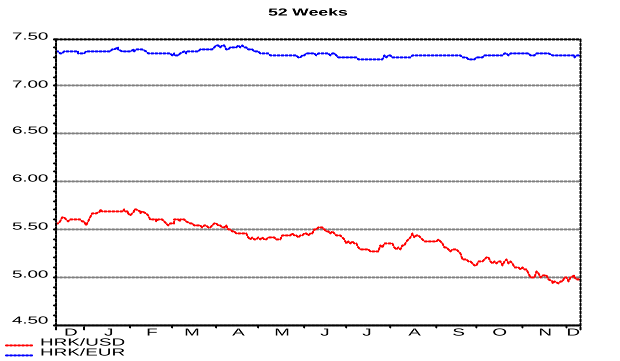
Exchange rates and interest rates (52 weeks)

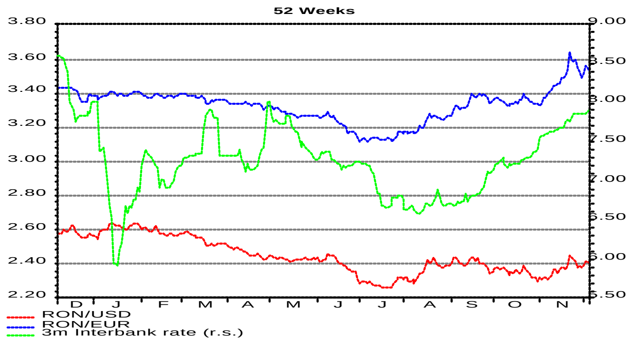








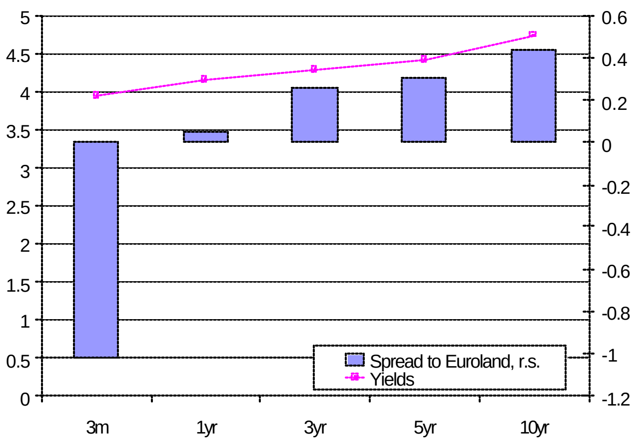




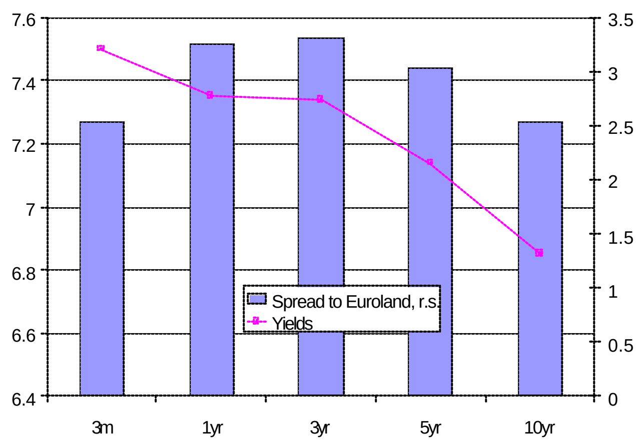
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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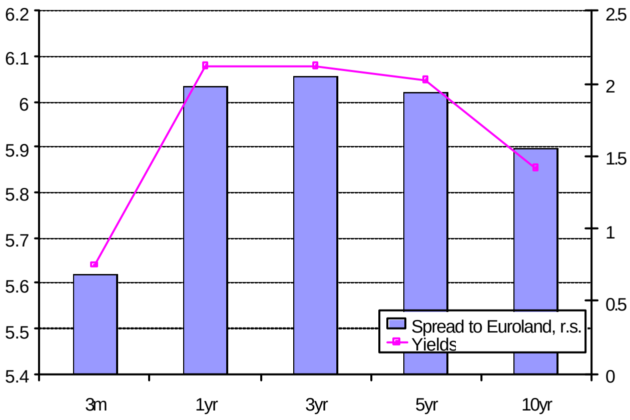
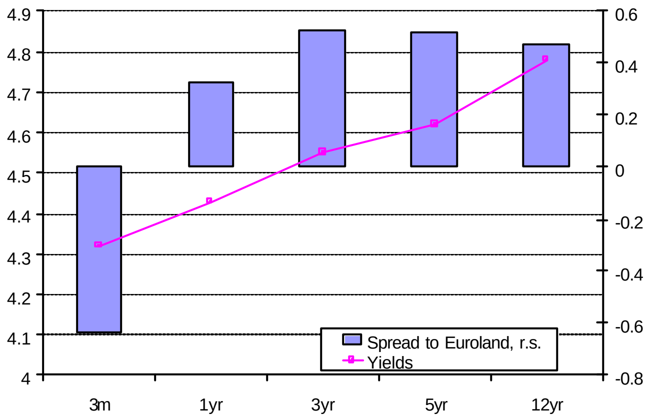
Poland



Slovakia



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