CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** Central bank unlikely to match quick inflation with quick hikes

- **Hungary:** Issue planning for 2008

- **Poland:** Rhetoric of central bankers confirms that another hike is in pipeline

- **Romania:** Ministry of Economy and Finance issued debt calendar for 1Q08

- **Slovakia:** 2007 cash deficit positively surprised, strengthened chances for euro

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Overview

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Czech Republic:

- Central bank unlikely to match quick inflation with quick hikes
- January CPI eagerly awaited

Hungary:

- C/A deficit amounted to EUR 1.390bn in 3Q07
- Issue planning for 2008
- Forint tracking US capital markets

Poland:

- MPC refrained from delivering Christmas surprise
- Rhetoric of central bankers confirms that another hike is in pipeline
- No macro data on schedule for next week

Romania:

- Ministry of Economy and Finance issued debt calendar for 1Q08
- Romanian currency failed to strengthen on back of foreign remittances

Slovakia:

- 2007 cash deficit positively surprised, strengthened chances for euro
- December inflation to slightly increase
- We remain optimistic on koruna

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2008
Czech Republic	EUR/CZK	26.19	1.6%	0.6%	1.4%			
	3Y (yield bp)	4.28	-9	0	-3	40	46	41
	10Y (yield bp)	4.66	-12	9	-8	46	55	53
Croatia	EUR/HRK	7.35	-0.3%	-0.2%	-0.6%			
	3Y (yield bp)	5.33	1	1	2	152	149	140
	10Y (yield bp)	5.53	-3	5	0	140	136	135
Hungary	EUR/HUF	253.24	0.2%	-0.1%	0.0%			
	3Y (yield bp)	7.55	n.a.	24	0	367	358	365
	10Y (yield bp)	7.11	n.a.	27	0	292	281	290
Poland	EUR/PLN	3.60	0.4%	0.4%	0.1%			
	3Y (yield bp)	6.17	3	5	-2	229	239	229
	10Y (yield bp)	5.95	4	27	-1	176	180	176
Romania	EUR/RON	3.60	-1.5%	-0.9%	-0.6%			
Slovakia	EUR/SKK	33.45	0.5%	-0.4%	0.3%			
	3Y (yield bp)	4.54	4	-2	5	67	81	46
	11Y (yield bp)	4.77	-5	-3	-5	59	72	37

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. (%)
16	long USD/CZK	29/11/07	6m Libid/ 6m Pribor USD/CZK	4,91/3,99% 17.93	 17.80	 -0.71%	-0.6%	-6.3%	19.7	9.3%	18.7%
17	long HUGB 3Y CZK 6M CZK/HUF	05/12/2007	3Y HU GB 6,25 6M Pribor	97.42 4.04 9.63	96.81 9.70	-0.11% 0.01	0.33%	0.0%	98.95 4 9.41	5.1%	10.10%
18	Euribor/ROBID short EURRON	31/12/07	Euribor/ROBID EURRON	4.49 / 7.56 3.60	- 3.59	0.22%	0.26%	23.1%	3.53	2.50%	15.80%

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.

18) We consider that a EUR/RON exchange rate of 3.6 is a good level to sell. We expect RON to trade around 3.53 in two months time and therefore we recommend closing the position by the end of February. We see RON appreciating slightly as compared to the level reported as the central bank is likely to tighten monetary policy in an attempt to mitigate pressures on inflation. So, the interest rate differential will widen, not only for the RON but also for some other regional currencies, stirring up the sentiment for the whole region.

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%

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

Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	26.2		7.33		254		3.61		3.60		33.4		3.50	3.50	7.50	5.00	7.50	4.25
Mar-08	27.0	26.1	7.30	7.30	255	256	3.55	3.61	3.53	3.63	32.6	33.4	3.75	3.50	7.50	5.50	8.50	4.25
Jun-08	27.1	26.1	7.20	7.20	255	258	3.60	3.62	3.50	3.66	32.5	33.4	3.75	3.50	7.25	5.75	8.50	4.00
Sep-08	26.5	26.1	7.25	7.25	256	259	3.55	3.64	3.45	3.70	32.5	33.3	3.75	3.50	7.00	5.75	8.50	4.00
Dec-08	26.4	26.1	7.30	7.30	256	261	3.51	3.66	3.40	3.73	32.5	33.3	3.75	3.50	6.75	5.75	8.00	4.25

	3m Money Market Rate										10y Govt. Yield					5y Yield
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK	RO
Spot	3.99		7.50		5.62		8.38		4.35		4.64	5.53	7.15	5.94	4.72	7.60
Mar-08	3.95	4.02	7.45	7.42	5.70	5.62	8.70	8.52	4.30	4.40	4.90	5.30	6.70	5.85	4.70	7.50
Jun-08	3.97	4.07	7.20	7.33	5.95	6.28	8.70	8.34	4.15	4.43	4.80	5.20	6.50	5.78	4.80	7.50
Sep-08	4.10	4.06	6.90	7.20	5.95	6.28	8.70	6.31	4.15	4.47	4.80	5.20	6.30	5.72	4.80	7.50
Dec-08	4.10	4.05	6.75	7.06	5.95	6.09	8.20	5.23	4.35	4.64	4.80	5.30	5.90	5.65	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	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

Budget Balance (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.3	-1.9	-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	Jan-9	CPI inflation		5.2%
	Jan-9	Unemployment	6.1%	6.0%
	Jan-11	Trade balance	CZK 4.7bn	CZK 7.5bn
Croatia	7-Jan	PPI	5.7%y/y	
Hungary	Jan-04	Minutes of Dec 17 monetary meeting	-	-
	Jan-08	Dec Budget balance	-	-
	Jan-09	Nov Trade balance	-	-
	Jan-09	Nov Industrial output	7.8% y/y	-
Poland		No important data releases scheduled		
Romania		CPI December 07 - y/y (%)	6.7	6,4
		Trade balance (Nov 2007) - EUR mn	2,200	-
Slovakia	Jan-10	November industrial production	17.0% y/y	-
	Jan-11	December CPI inflation	0.3% m/m, 3.4% y/y	3.3% y/y
	Jan-11	November trade balance	SKK -1.6bn	SKK -2.4bn

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Jan-09	Jan-14	2017-Apr-11	4.00%	CZK 7 bn.	4,68%
Hungary		Jan-08	Jan-16	April-16-2008	-	HUF 35bn	7.45%
		Jan-09	Jan-16	July-30-2008	-	HUF 20bn	7.40%
		Jan-10	Jan-16	Dec-17-2008	-	HUF 40bn	7.40%
Poland		Jan-09	Jan-11	2022-Sept-23	5.75%	PLN 1-2.5bn	
Romania		09-Jan-08	11-Jan-08	6M		RON 1 billion	8.0%
Slovakia			No auction scheduled				

Major Markets

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Major markets

ECB on hold for while

The ECB Council is expected to keep interest rates on hold at the meeting next week. We also expect President Trichet to signal a longer-term hold position. The latest economic data was mixed, with some leading indicators pointing in the direction of a more pronounced cooling of the economy than the ECB Staff Projections forecast. On the other hand, the inflation figures were also reported above expectations and risks for longer-term inflation pressure still point to the upside. Data releases will comprise Euroland sentiment indicators, industrial production figures for Euroland and Germany, as well as new orders for Germany. Reuters Purchasing Manager Indices released this week showed a stable reading compared to November, but Consumer Confidence Indicators went down further in most countries. Euroland sentiment indicators should mirror that and should show a further drop in consumer confidence and - at best - a stable reading in business confidence. Industrial orders for Germany are expected to drop after the strong figure for the previous month and on the back of the lower sentiment indicators. Industrial production should increase, as energy production should have picked up in November.

Labor market data and Bernanke speech to set tone

After important data this week (the labor market report is still to come today), barely any important macro indicators are scheduled for next week. After the ISM already disappointed market expectations, the labor market data will likely do the same, deteriorating more strongly than the markets expect. A speech by Vice Chairman Kohn is also scheduled for today. However, the speech by Fed Chairman Bernanke on Thursday will be of greater importance, the more so given that the title will be Financial Markets, the Economic Outlook, and Monetary Policy. Whether there will be any hints is of course anybody's guess. However, we think that the Fed should be content with the markets' expectations of another rate cut at the end of January, considering the still tense situation on money markets and the recent soft macro data. The macro indicators that could get some attention next week include pending home sales on Tuesday and the trade balance on Friday. All in all, we expect today's labor market data to set the (friendly) tone for bond markets, at least until Bernanke's speech on Thursday. At the current level, the dollar seems immune to poor US economic data, as worries about a global economic slowdown have increased.

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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	4.64		4.65		4.18	3.90	1.471	
Mar-08	4.00	4.00	4.35	7.70	4.70	4.30	4.30	4.20	1.43	1.472
Jun-08	4.00	4.00	4.15	4.60	4.30	3.70	4.60	4.50	1.38	1.471
Sep-08	4.00	4.00	4.15	4.00	4.20	3.40	4.70	4.60	1.35	1.468
Dec-08	4.25	4.00	4.35	4.00	4.20	3.43	4.70	4.60	1.35	1.465

Czech Republic

Central bank unlikely to match quick inflation with quick hikes

Let's start the new year with a look back. My favorite Magnificent Seven from the Czech National Bank decided to leaves rates unchanged in December. We were ambivalent, but slightly skewed toward a hike (alongside two board members, but against five for stability), due to the quick acceleration of inflation. However, reading the minutes shows that the board is leaning towards the opinion that the acceleration of food and oil prices, which drove inflation in recent months, is a one-off effect and that inflation will decelerate during the year. They are also afraid of the strong CZK. The rhetoric confirms our opinion that the board will not follow the inflation with fast hikes; we still hold our call of 25-50bps for this year.

January CPI eagerly awaited

What about the timing? Starting this year, the CNB will hold only eight meetings. The first is February 2 (followed by March 26, May 7, June 26, August 7, September 25, November 6 and December 17). The most keenly awaited figure is January CPI, which will show how the higher VAT is transmitted into final prices. I think that the effect will be lower, as, in recent months, food prices grew by a higher pace than abroad, which could mean that retailers partly incorporated the higher VAT into prices in advance. CPI will be released February 8, one day after the meeting. However, the weekly surveys will indicate their behavior. The next factor will be the CZK. According to our estimates, the CZK is now overvalued. Therefore, we expect a gradual shift towards 27 per euro in 1H, which will pave the way for a hike in 1Q/2Q.

Good news from the MinFin: The budget finished the year with a deficit of CZK 40.4bn (ESA95), which means 1.9% of GDP. With expectations at 3-4%, this seems good. The reasons are higher growth and lower unemployment than the budget anticipated. For this year, the budget assumes 2.95%, and the MinFin is in an optimistic mood, as they think it could be lower once again. Looking at their macro assumption, this could be the case, as they forecasted 3.8% inflation. In our view, this is a substantial underestimation, as we see 5.7% inflation for this year. Moreover, the reform package cancels the automatic valorization scheme. This means higher revenues, but not necessarily higher spending.

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Hungary

The most important events of the previous weeks (albeit without any market reaction) proved to be the publication of the 3Q C/A balance by the NBH and its issue planning for 2008 by the Government Debt Management Agency.

C/A deficit amounted to EUR 1.390bn in 3Q07

As for the C/A balance, the deficit amounted to EUR 1.390bn in July-September, taking the cumulative C/A deficit for the first three quarters of last year to EUR 3.999bn. The four-quarter rolling C/A deficit stands at 5.4% of GDP, after the 5.5% of GDP seen in 2Q07, which should not be seen as a big change. This is due to the fact that while the trade balance continued to improve in the period, this improvement was practically offset by the further deterioration on the "Incomes" balance. The trade surplus was EUR 204mn in 3Q07, raising the four-quarter rolling trade surplus to 0.9% of GDP, from just 0.3% of GDP seen at the end of June. However, the deficit on the "Incomes" remained enormous, amounting to EUR 1.774bn, EUR 221mn higher than in the same period of 2006. On the financing side of the balance, non-debt-creating financing remained negative, as inward and outward non-debt capital transactions showed a net outflow of EUR 475mn in the July-September period. It was favorable, however, that the FDI inflow to Hungary amounted to EUR 2.32bn, although 68% of it was reinvested earnings.

Issue planning for 2008

According to the issue plan of GDMA, both the gross and net financing needs of the state are expected to drop this year. Thus, the total gross issuance will be HUF 6,846bn in 2008, within which the gross forint-denominated issuance will be HUF 6,294bn, down from the HUF 6,750bn in 2007. At the same time, the gross FX issuance will increase to around EUR 2.2bn (after EUR 1.2bn in 2007), due to more repayment obligations. As for the net issuance, the most important thing is that the net forint-denominated government paper issuance will decrease to HUF 580bn in 2008, from HUF 931bn last year. This drop in the net forint-denominated issuance is basically due to the termination of 6-month T-bills after July 2008. However, the net issuance of forint government papers with a longer maturity than one year will remain practically unchanged (around HUF 1,004bn).

Forint tracking US capital markets

Calm trading with low turnover characterized the FX and FI markets during the last few days of 2007, which has not changed during this short week. Neither the 3Q C/A deficit nor the state's financing plans for 2008 were able to cause any market reaction. Furthermore, instead of domestic figures and events, investors are concentrating on global market processes, especially US macro figures, the FED rate outlook and the development of the dollar.

In the short run, domestic markets are expected to continue to track US capital markets. Trading should remain trendless, at least until the publication of December CPI figures, due on January 15. Next week, only second-tier (from the market's point of view) fundamental figures will be released, among which the budget balance figures should gain the most attention. The latest official projection for the CF-based budget deficit for December 2007 is HUF 13.7bn (meaning HUF 1,353bn for FY07). However, a positive surprise could come again (the monthly balance may have been in surplus), as the finance minister said this week that, due to higher than expected corporate and personal income tax revenues pouring into the budget last month, the 2007 ESA-based deficit was seen below 6% of GDP. (Remember that the 2007 ESA-deficit forecast was cut to 6% of GDP from 6.2% of GDP in the middle of December, when the above-mentioned CF-based forecasts were announced).

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Poland

MPC refrained from delivering Christmas surprise

After delivering four hikes during 2007, the Polish central bank remained faithful to the tradition of not altering the monetary policy setting in the final month of the year and kept the reference rate at 5.0% in December. Nevertheless, the statement clearly hints that the MPC remains tuned to a hawkish note and it will not be long before another increase in rates is seen. The statement points out that inflation is higher than projected in the latest prognosis, economic growth is set to hover above the potential rate, fiscal policy will act pro-cyclically and further intensification of wage pressures is possible. All in all, the probability of inflation overshooting the target in the medium term (which is the horizon that the central bank looks at) is still higher than the probability of inflation ending below the target. So, why did the central bank opt to leave the rates unchanged? The bank needs to see more data and analyze the inflation outlook more properly. A more comprehensive assessment of the inflation outlook will be provided this month with a fresh quarterly inflation report. Some central bankers might have also preferred to take a break following a hike in November and prevent the appearance of falling into panic. They might still have the situation of the post-EU entry period in their memories, when a series of brisk hikes in reaction to an inflation uptick (largely driven by external factors, such as food price increases) later led to significant disinflation and the inflation rate falling well below the tolerance band. Thus, the majority of the council may prefer to keep the pace of hiking at 2-3-month intervals. Importantly, however, the situation is a bit different now than in 2004, as the economy is currently operating above its potential and labor markets are suffering from tightness. Hence, the probability that undesirable second-round effects of higher food and oil prices will emerge is greater. We therefore think that the central bank will continue its campaign of monetary policy tightening, with the next hike expected as early as this month and the key rate reaching 5.75% by the middle of 2008.

Rhetoric of central bankers confirms that another hike is in pipeline

Interviews with members of the central bank's monetary policy board support our scenario of another hike coming already this month. The hawkish camp is traditionally very clear. Halina Wasilewska-Trenkner said there was a very high probability of a January interest rate rise. Professor Filar expressed concerns that, without a move in rates, net inflation could reach 2.5-3.0% by the end of this year and he views the scenario of the key rate rising to 6.0% (preferably in 1H08) as justified. Also, the moderate members of the council have hinted that the scales are tipping towards further rate increases, although they have not been as specific on the proper timing.

No macro data on schedule for next week

Next week's calendar is empty from the viewpoint of important local macro data releases. The Polish markets will thus remain under the influence of regional and global events. It will be interesting to watch what strategy the global players adopt towards the region for this year, once the trading escapes from the post-holiday lull. We think that unless fears of a US recession intensify further, the zloty is likely to come under appreciation pressure in the coming weeks. Government bonds did not start the new year very successfully. The spreads against the Eurozone widened by 20-25 points across the curve. One of the impulses was the auction of government bonds, which was scheduled (not very fortunately) for the first trading day of this year; the ministry failed to sell the intended volume. Markets took this as a sign of weakening interest among investors. The second event that knocked bonds lower was the flash estimate from the Finance Ministry for price development in December. It expects inflation to have moved further away from the central bank's tolerance band, increasing by 0.4pp to as far as 4.0%.

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Romania

Ministry of Economy and Finance issued debt calendar for 1Q08

The Ministry of Economy and Finance plans to issue debt instruments on the local market worth RON 4bn in the first quarter of 2008, according to a press release on January 3, 2008. Two thirds of the total debt plan of the ministry consists of short tender treasuries, as the MinFin hopes that the yields demanded by investors for purchasing Romanian government securities will gradually decrease, as inflation eases in the last part of 2008. The MinFin intends to attract the largest part of the total debt plan for the first quarter in January, as it is possible that the yields might increase further in the coming months, due to the recent rebound of inflationary pressures. Therefore, the MinFin is to issue government securities worth RON 3bn in January in 6-month, 1-year and 10-year tenders, each amounting to one billion lei. According to the minister of finance, Romania intends to borrow RON 11bn from the local market in 2008, increasing its debt plan from RON 9.5bn in 2007. Also, Romania wants to issue its first Eurobond since 2003 in February 2008 worth at least EUR 500mn in a 10-year tender, as it hopes that investors will be demanding lower yields. We believe that the MinFin will prefer to borrow for short terms, counting on investors to ask for lower risk premiums after the turbulence on global financial markets has calmed down. The first debt issuance is to be held on January 9 for the indicative amount of RON 1bn in 6-month treasury bills. We believe that the accepted yields could average around 8.0% per year, as the MinFin closely mirrors the monetary policy rate, which we expect to be raised by at least 50 basis points on January 7 (to 8.0%).

Romanian currency failed to strengthen on back of foreign remittances

The Romanian currency finished the year in the 3.61 zone, slightly above our expectations, as the current inflows were not able to offer support for the currency. Although the remittances from Romanians working abroad continued at a high level, they did not manage to offset the strong purchases of hard currency for import needs. In 2007, the RON depreciated by 6.8% y/y in nominal terms compared to the euro. However, when considering the average exchange rate, the RON strengthened by 5.3% against the euro, due to the sharp rise in the first half of the year stirred up by Romania's recent accession to the European Union. When compared to the American dollar, the Romanian currency managed to gain 4.3% y/y during 2007, as the greenback was strongly hit by the American sub-prime mortgage market crisis. In the last quarter of 2007, the Romanian currency started to be affected by the country's large external shortfall, which was strongly punished by investors amid the global risk aversion environment (triggered by the liquidity shortage). We believe that the Romanian currency might recover slightly in January compared to the end of 2007, as the National Bank might hike the key rate by at least 50 basis points to 8.0%, which might whet the appetite of investors for the RON. The government debt securities issuance scheduled for January worth RON 3bn may also offer some support for the Romanian currency.

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Slovakia

2007 cash deficit positively surprised, strengthened chances for euro

This week, the 2007 cash budget was released, with a lower than projected deficit at SKK 23.5bn, vs. the SKK 38.4bn planned in the budget (i.e. it was lower by 0.8% of GDP). This creates a buffer should the other parts of broader public finances (such as social insurance and municipalities) come in worse than expected. The public finance deficit will be known only later in the year, but it is very likely that the deficit will fall within the required 3% of GDP.

December inflation to slightly increase

Next week will bring a set of new data, December inflation being the most interesting. Annual inflation will likely jump to 3.4%, up from November's 3.1%; that is a notch above market expectations. For the month, we expect CPI to increase by 0.3%, due to more expensive services, fuel and food. Industrial production and foreign trade, both to be released next week, should show a strong reading (we expect +17% y/y), due to exports by the car and electronics industries. These should offset the impact of stronger pre-Christmas imports.

We remain optimistic on koruna

During the holidays, the koruna traded within 33.45-33.70 EUR/SKK and moved to the stronger side of the range as the new year opened. The unit booked an annual gain of 2.5% in 2007, less than the nearly 9% seen a year ago (please recall the heavy interventions by the central bank against the koruna back in spring 2007, coupled with interest rate cuts and under-acceptance of liquidity in repo tenders, which halted the koruna surge). We see the koruna slightly stronger in the weeks ahead and still expect one more shift in the ERM2 central parity (some time in 1Q08) to around 32.5-33.0 EUR/SKK, which should also be the level of the euro conversion rate. We see only a small probability of the exchange rate being fixed at the current parity, i.e. at 35.44 EUR/SKK.

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Appendix Charts

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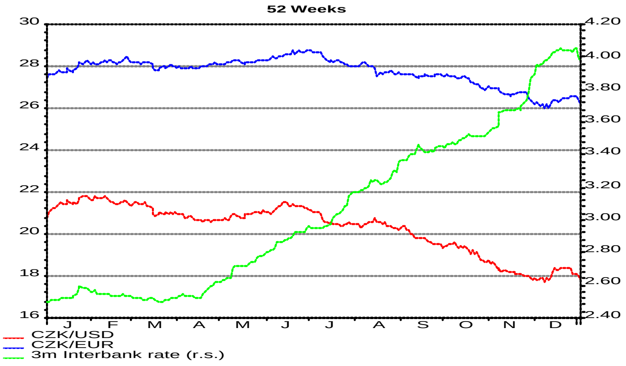
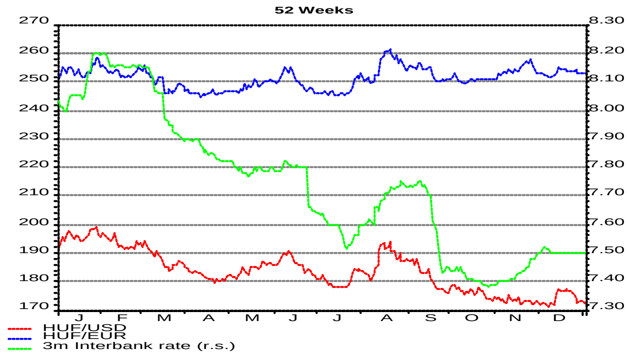
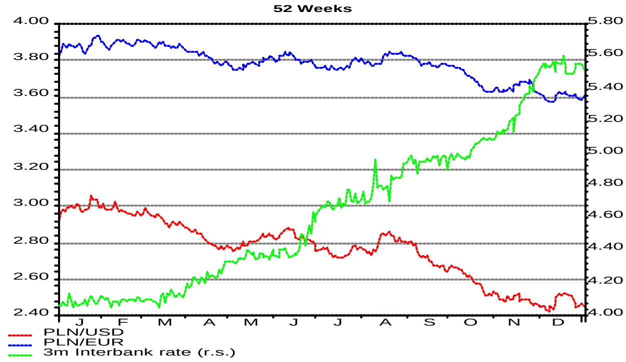
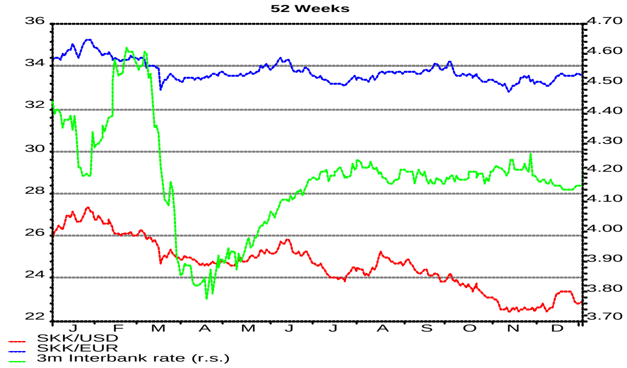
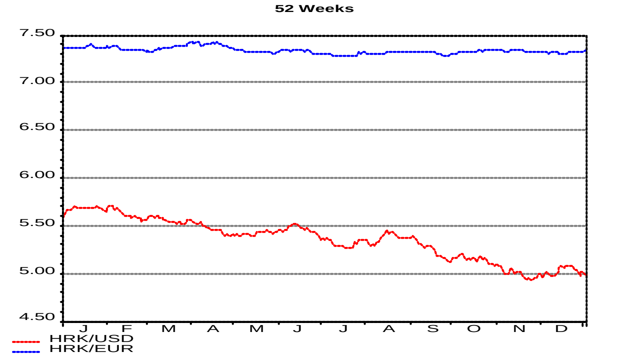
Exchange rates and interest rates (52 weeks)

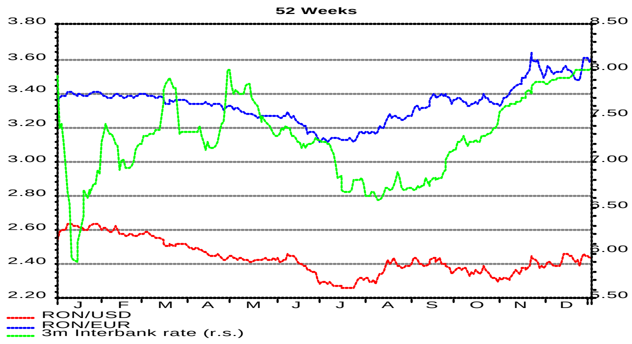








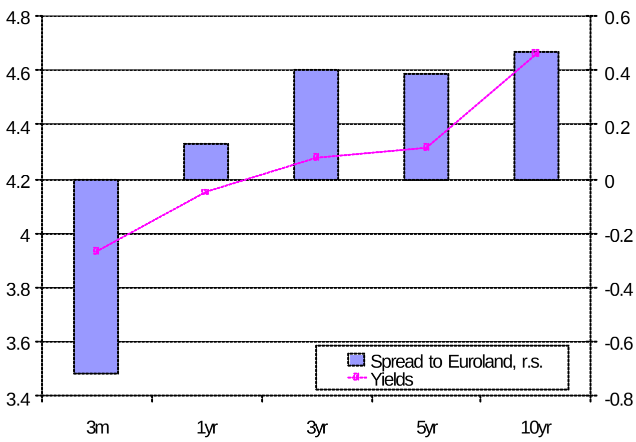




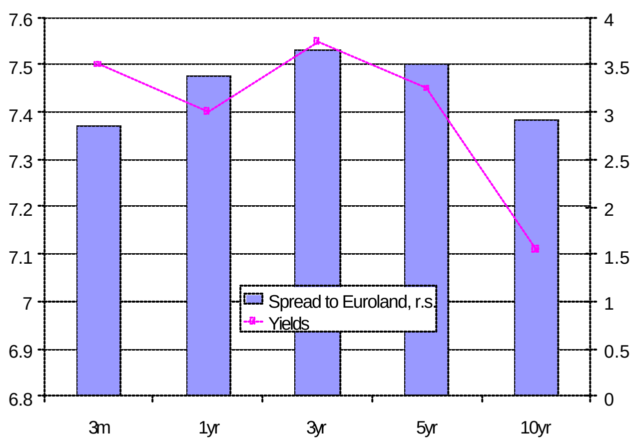
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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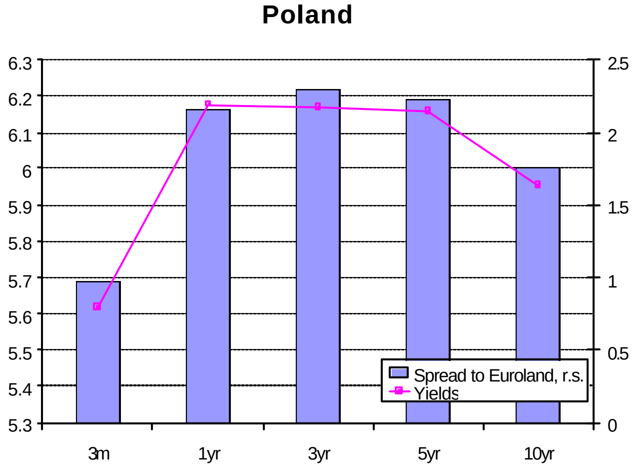

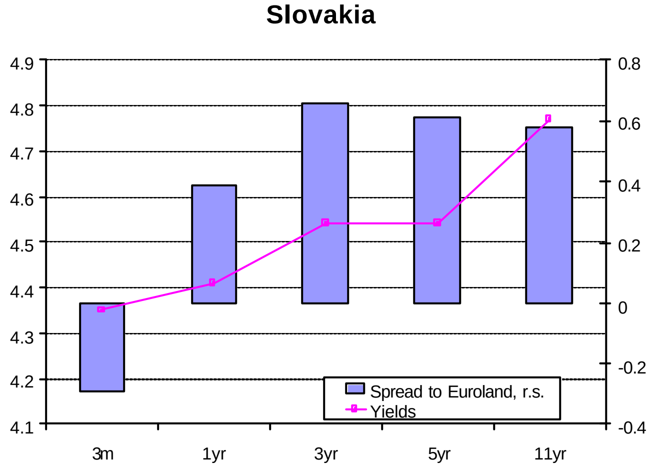

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