January 11, 2008

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** Politics: Negotiations over, new government formed
- **Czech Republic:** Inflation sprint
- **Hungary:** December CPI and November wage figures in focus next week
- **Poland:** Next week's calendar packed with data
- **Romania:** Central bank maintaining tight monetary conditions
- **Slovakia:** December inflation picked up to 3.4%, as expected

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Overview

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Croatia:

- Politics: Negotiations over, new government formed
- GDP slightly below expectations
- C/A brought no surprise
- Exchange rate hovering around 7.35

Czech Republic:

- Inflation sprint
- No demand-driven pressures visible

Hungary:

- Budget balance showed surplus in December
- Lower than expected industrial output growth in November
- December CPI and November wage figures in focus next week

Poland:

- FI and FX markets had relatively successful week
- Next week's calendar packed with data

Romania:

- Budget returns to deficit
- Trade deficit continued to slow down at end of November
- RON tested two-year low against euro
- Central bank maintaining tight monetary conditions

Slovakia:

- December inflation picked up to 3.4%, as expected...
- ...while trade balance disappointed
- Net bond issuance in 2007 should be similar to 2006

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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	25.93	1.0%	0.3%	2.4%			
	3Y (yield bp)	4.17	-11	0	-14	36	32	41
	10Y (yield bp)	4.60	-5	-11	-14	51	47	53
Croatia	EUR/HRK	7.35	0.0%	-0.3%	-0.6%			
	3Y (yield bp)	5.30	-3	9	-1	154	120	140
	10Y (yield bp)	5.54	1	8	1	148	123	135
Hungary	EUR/HUF	253.38	-0.1%	-0.5%	-0.1%			
	3Y (yield bp)	7.38	-17	9	-17	357	335	365
	10Y (yield bp)	6.99	-12	16	-12	290	259	290
Poland	EUR/PLN	3.58	0.4%	-0.3%	0.5%			
	3Y (yield bp)	6.01	-16	-6	-18	220	213	229
	10Y (yield bp)	5.84	-11	16	-12	176	160	176
Romania	EUR/RON	3.66	-1.7%	-3.9%	-2.3%			
Slovakia	EUR/SKK	33.30	0.5%	-0.5%	0.8%			
	3Y (yield bp)	4.51	-5	-10	-8	65	64	52
	11Y (yield bp)	4.73	-4	-5	-9	62	49	48

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	17.53	-2.23%	-2.1%	-18.0%	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	97.22 9.79	0.43% 0.02	1.74%	0.2%	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	- 3.67	-1.86%	-1.77%	-58.1%	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%

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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	25.9		7.35		254		3.58		3.68		33.2		3.50	3.50	7.50	5.00	8.00	4.25
Mar-08	27.0	25.9	7.30	7.30	255	255	3.55	3.59	3.62	3.68	32.6	33.2	3.75	3.50	7.50	5.50	8.50	4.25
Jun-08	27.1	25.9	7.20	7.20	255	257	3.60	3.60	3.56	3.75	32.5	33.2	3.75	3.50	7.25	5.75	8.50	4.00
Sep-08	26.5	25.8	7.25	7.25	256	259	3.55	3.62	3.55	3.79	32.5	33.2	4.00	3.50	7.00	5.75	8.50	4.00
Dec-08	26.4	25.9	7.30	7.30	256	260	3.51	3.63	3.47	3.83	32.5	33.1	4.00	3.50	6.75	5.75	8.00	4.25

	3m Money Market Rate										10y Govt. Yield					5y Govt. Yield
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK	RO
Spot	3.96		7.50		5.66		8.64		4.30		4.59	5.54	6.95	5.84	4.69	7.70
Mar-08	3.95	4.09	7.45	7.31	5.70	5.97	8.70	8.53	4.30	4.37	4.90	5.30	6.70	5.88	4.70	8.30
Jun-08	3.97	11.28	7.20	7.13	5.95	6.13	8.70	8.35	4.15	4.36	4.80	5.20	6.50	5.85	4.80	8.50
Sep-08	4.10	4.16	6.90	7.00	5.95	6.13	8.70	6.36	4.15	4.36	4.80	5.20	6.30	5.82	4.80	8.30
Dec-08	4.10	4.08	6.75	6.86	5.95	6.23	8.20	5.29	4.35	4.62	4.80	5.30	5.90	5.80	4.80	8.10

Long-term forecasts

GDP growth (%)	2006	2007e	2008f	2009f
Czech Republic	6.4	5.9	4.3	5.4
Croatia	4.8	6.1	4.9	4.9
Hungary	3.9	1.6	2.5	3.5
Poland	6.2	6.6	5.5	5.8
Romania	7.7	5.7	6.1	6.0
Slovakia	8.5	9.0	7.2	5.3

C/A (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.0	-3.4	-4.0	-3.4
Croatia	-7.8	-8.2	-7.7	-7.8
Hungary	-6.5	-5.2	-4.6	-4.2
Poland	-3.2	-3.8	-4.5	-4.9
Romania	-10.3	-13.7	-14.7	-14.7
Slovakia	-7.2	-3.8	-3.6	-3.3

CPI (%), eoy	2006	2007e	2008f	2009f
Czech Republic	2.5	4.0	5.1	3.2
Croatia	2.0	4.0	3.3	3.5
Hungary	6.5	7.2	4.1	2.5
Poland	1.4	4.0	3.4	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	-2.9	-2.7
Croatia	-3.0	-2.6	-3.0	-3.0
Hungary	-9.2	-5.7	-4.0	-3.9
Poland	-3.9	-3.0	-3.4	-3.1
Romania	-1.6	-2.4	-2.7	-2.7
Slovakia	-3.3	-2.5	-2.4	-2.6

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Jan-15	PPI, December (y/y, %)		5.7%
	Jan-16	Industrial output (Nov,y/y %)		8.6%
	Jan-18	CA, November CZK bn.		-7.8bn
Croatia	15-Jan	CPI	5.1% y/y	
Hungary	Jan-11	Minutes of Dec 17 monetary meeting	-	-
	Jan-15	Dec CPI inflation	7.2% y/y	7.3% y/y
	Jan-17	Nov Nominal wages	-	8.9% y/y
Poland	Jan-15	CPI inflation (% y/y)	4.0%	4.0%
	Jan-16	Current account (EUR mn)	-1160	-1040
	Jan-16	Average corporate wage (% y/y)	11.5%	10.8%
	Jan-18	PPI (% y/y)	3.1%	2.9%
	Jan-18	Industrial output (% y/y)	9.8%	8.6%
Romania		Current account deficit Nov 07 - EURmn	1,700	-
Slovakia	Jan-16	December EU-norm inflation	0.3% m/m, 2.5% y/y	2.4% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Jan-17	Jan-18	Jan-16-2009		CZK 5 bn.	
Hungary		Jan-14	Jan-16	Feb-27-2008	-	HUF 30bn	7.35%
		Jan-15	Jan-23	April-23-2008	-	HUF 35bn	7.35%
		Jan-17	Jan-23	Oct-24-2012	6.00%	HUF 75bn	7.30%
Poland		No auction scheduled					
Romania		17-Jan-08	21-Jan-08	11-Jun-17	6.75%	1000mn	7.8%
Slovakia		Jan-14	Jan-16	Feb-08-10	-	-	4.45%

Major Markets

Major markets

ECB on hold well into second half of 2008

The ECB Council kept the key interest rate unchanged at the January meeting (as was widely expected), at 4%. In the following press conference, President Trichet again pointed out the upward risks to inflation. However, at the same time, the outlook for the economy was described a bit more cautiously. Taken together, the wording was still hawkish, on the back of very high inflation and high wage demands by the German unions. We expect rates to stay unchanged well into the second half of the year, as lower growth will prevent the Council from hiking, although inflation should moderate only slowly. This week's data for Germany came out mixed, showing high order intake in November, but a significant drop in retail sales. Next week, the ZEW expectations index should decline further, on the back of a rising risk of a recession in the US; over the next few months, this index should stabilize. In contrast, the current assessment index is still at a high level and therefore will trend down for several months to come. Euroland data will comprise industrial production, consumer prices and the trade balance. Industrial production figures will be down and consumer prices should meet the flash estimate of 3.1%. On Friday, the Bank Lending Survey for 4Q will be released. During the press conference, Mr. Trichet gave an indication that there was an additional tightening in credit standards. Support for government bonds could come from the release of annual reports from Merrill Lynch and Citigroup next week. For both banks, further significant write-downs are expected by the market.

Fed's concerns about economy are increasing

The most important releases next week will be retail sales on Tuesday and consumer price inflation on Wednesday. After the recent speech by Fed Chairman Bernanke, the focus will definitely be more on risks for economic growth than on inflation. While Bernanke emphasized that the Fed would monitor the development of inflation expectations closely, the much larger concerns about economic growth was in our view pretty clearly the main message. The upcoming retail sales figures will not ease these concerns, likely posting only very low growth. If they show an outright decline vs. the previous month, it will fuel expectations of a 50bp rate cut at the next FOMC meeting at the end of the month. Inflation numbers should hardly have any impact on the markets - even if they surprise on the upside, this would only be seen by the market as temporary, due to the subdued outlook for the economy. Overall, we expect bond markets to remain well supported. The upside for yields should be limited, while new lows could be tested. For the dollar to post new lows, retail sales would have to be considerably below expectations. We think it more likely that the EUR/USD will remain within recent ranges, as concerns about the Euroland economy are increasing on the market.

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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	4.60		4.51		4.16	3.86	1.472	
Mar-08	4.00	3.75	4.35	4.69	4.30	4.08	4.30	4.20	1.43	1.475
Jun-08	4.00	3.75	4.15	4.58	4.00	3.53	4.60	4.50	1.38	1.473
Sep-08	4.00	3.75	4.15	4.51	4.00	3.26	4.70	4.60	1.35	1.469
Dec-08	4.25	3.75	4.35	3.97	4.00	3.21	4.70	4.60	1.35	1.465

Croatia

Politics: Negotiations over, new government formed

After a month and a half of negotiations, an agreement between CDU and the HSS&HSLS coalition was finally reached. In exchange for their support, PM Sanader had to offer two ministerial posts (agriculture and tourism) to HSS and a deputy PM position (one of four) to HSLS. Also, one deputy PM position was given to the Independent Democratic Serbian Party (SDSS), thus ensuring Sanader the support of an additional three MPs. An assembly of the new Parliament is scheduled for today and in the coming days the new government should be given majority support and inaugurated. Hence, political developments confirmed the post-election speculation that CDU is closer to forming a new government. We now have to wait and see the first steps taken by the new government. As far as fiscal matters are concerned, the PM recently stated that commitment toward further consolidation of the deficit would remain. More details on that should be known when the budget proposal for 2008 is published.

GDP slightly below expectations

The 3Q GDP figures posted a 5.1% increase, slightly below our expectations. Nevertheless, domestic demand remained strong, supported by the ongoing solid consumption momentum. Hence, private consumption increased by 6.2% y/y in real terms, as expected following the monthly frequency retail trade figures. Fixed capital formation was in line with expectations, as we anticipated that investment activity would continue to moderate (as seen in 2Q), supported by construction activity indices and the likely slowdown of public investment activity prior to the elections. On the other hand, the elections were supportive of public consumption, which recorded a 4.4% y/y increase, confirming the accelerating trend from recent quarters. The change in inventories had a more negative effect on the overall performance than was seen last year, which to some extent lowered the overall GDP growth rate. Exports recorded solid 7.3% y/y growth, confirming the good tourist season results and trade balance figures. Imports followed closely, increasing 7.0% y/y - hence, the usual 3Q positive net export contribution increased only marginally. For the FY07 GDP figure, we continue to expect close to 6% y/y, with some moderation in the last quarter.

C/A brought no surprise

The 3Q current account surplus remained virtually unchanged with respect to 3Q06 and amounted to EUR 2,097mn (-0.1% y/y). On the other hand, the current account deficit for the first nine months of 2007 reached EUR 1,303mn, increasing 13.1% y/y, and the overall 3Q figures are supportive of our C/A deficit forecast of slightly above 8% of GDP. The merchandise account figures came as no surprise, given the trade balance figures. 3Q07 exports increased 10.7% y/y (EUR 2,326mn). The 3Q service account posted good results, as the 3Q surplus increased 4.7% y/y, reaching EUR 4,327mn. In absolute terms, the increase of the service account surplus offset approximately 82% of the increase of the merchandise account deficit, a considerably higher proportion than a year before. The income account deficit was 8.1% lower y/y in 3Q, which confirmed the moderating trend on the income account; in the first nine months, the deficit declined 5.2% (EUR 1,009mn), due primarily to strong inflows (which increased 52.4% y/y). On the other hand, the current transfers surplus also continued to moderate. Hence, the 3Q surplus was 3.9% lower, while the surplus in the first nine months declined 9.7% y/y (EUR 779mn). Therefore, we leave our C/A deficit forecast for 2007 unchanged at 8.2% of GDP.

Exchange rate hovering around 7.35

After the appreciation pressures at the end of December and the CNB's FX intervention, the beginning of January brought the expected stabilization and mild depreciation pressure. With the end of December and higher demand for cash on one hand and high MM rates on the other, there was pressure on the exchange rate. The beginning of January saw significantly improved system liquidity, which triggered some moderation on the MM and alleviated the exchange rate pressures. Therefore, in January, we have seen the exchange rate hovering around 7.35, with a greater likelihood of the HRK moving slightly above that level. The bond market was calm during the past few weeks, with no significant yield changes, and we see it remaining stable - at least as long as the money market outlook is so unclear regarding interest rate developments.

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Czech Republic

Inflation sprint

Czech inflation quickened to 5.4% y/y in December (from 5.0% in November 2007), pushing the CPI 1.5pp above the estimate of the CNB in its October 2007 prognosis. Based on the weekly surveys, our expectation was growth of just 5.0% in December. As for the factors behind the inflation, they are pretty much the same as in the previous 2-3 months - prices of foodstuffs (everything made from wheat, eggs, milk and cheese has posted double-digit growth rates) and oil products (gasoline +12%), as well as tobacco products and alcohol. The global growth of food and fuel prices could be ascribed to the rapidly growing China, making this a rather exogenous shock to the Czech economy.

No demand-driven pressures visible

Of course, it is true that the growth of food prices has been higher in the Czech Republic than in certain other countries (in Germany, food prices rose by 0.7% m/m, while Czech food prices grew at more than twice that pace), which might be due to the anticipation of the VAT law coming into force as of January 1. Of utmost importance in this regard will be January inflation, which will hint at whether most of the price hikes seen in the last months of 2007 were indeed due to retailers raising prices in advance of the higher VAT, or whether more is to come.

As for the prices that posted a decrease in December, classic items such as electronics and household appliances (dollar slide) were visible, alongside a few food items (notably, potatoes at -37.4%). Generally, no demand-driven pressures are visible whatsoever, which is also what we expect for this year - demand-driven pressures will remain subdued, mainly due to lower real wages.

As for the monetary policy impact, this is still cost-driven inflation, although it significantly exceeds the expectation of the CNB. As such, it surely constitutes a strong pro-inflationary factor. Concern for the impact of high inflation numbers on the economy (which has grown accustomed to low inflation) will surely be voiced by the board members when they next convene for a rate setting meeting at the beginning of February. This, plus the expected weakening of the CZK in 1H08 and the new prognosis in January, will work in favor of a hike in February. Working in the opposite direction will be the fear of a slowdown in the EU and the still strong koruna, which might not weaken sufficiently before February. As for the CPI figure in and of itself, it surely points toward a hike. As for the CZK, it strengthened to a new high.

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Hungary

Budget balance showed surplus in December

The December budget balance figures leaked out on Monday afternoon, before the official publication due on Tuesday. Although the Finance Ministry did not comment on the leaked figures, they proved to be in line with the official ones. Hence, instead of a small deficit of HUF 13.7bn predicted earlier, the CF-based budget balance showed a surplus of HUF 48bn in December, taking the cumulative CF-based budget deficit (without local councils) for FY07 to HUF 1,291.3bn. This could mean an ESA-based deficit of around 5.6-5.7% of GDP. (The official ESA figures will be available in spring.)

As the 2007 ESA-deficit could have been more than 1pp lower than the original plan (6.8% of GDP), this clearly shows that, after the serious budget overshoots that characterized the previous years, budget processes were absolutely on track in 2007. As for the outlook, reaching the budget goal of a further deficit reduction to 4% of GDP in 2008 could be more or less automatic, as the structure of revenues will not show any significant changes this year, while some one-off items will disappear from the expenditure side. And, last but not least, a further deficit reduction will again be supported by the higher inflation. The 2008 budget law was planned with an average inflation rate of just 4.8% y/y, while the actual inflation figure is expected to be 5.5-5.6% y/y in 2008.

Lower than expected industrial output growth in November

Both the adjusted and unadjusted figures showed an increase of just 5.5% y/y in industrial output in November, remaining below expectations. Output rose 0.1% on the monthly level. At the same time, the CSO published a higher than expected trade surplus of EUR 70.1mn for November, but with a slowdown (to 7.9% y/y) in the export growth (the 2007 January-November average growth in exports was still 16.5% y/y). The figures were not too encouraging in terms of the GDP outlook, taking into consideration the fact that industrial export is the only source of economic growth at present.

December CPI and November wage figures in focus next week

Neither the FX nor the FI markets showed any reaction to the above macro figures. Forint movements have remained volatile, driven by risk appetite factors. Toward the end of the week, sentiment improved somewhat in slow trade, due largely to the US rate outlook.

Next week, the most influential figure should be the November CPI inflation (published Tuesday morning). After the 7.1% published for November, the 12-month index should have stood at 7.2% in the last month of 2007. The monthly price pressure seems to have slightly mitigated in December - after sharp increases characterized the previous months. However, the base effect from the previous year is unsupportive; thus, further acceleration in the yearly index could have taken place in December 2007. November wage figures are due on Thursday. None of these figures are expected to change the short-term base rate outlook. The central bank is very likely to keep the base rate on hold this month.

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Poland

FI and FX markets had relatively successful week

This week was poor in terms of macro data releases, with market participants mainly keeping their eyes on major markets. Government officials issued some statements regarding euro adoption plans, which hinted that the issue will not be as hot as the market previously thought and the attitude of the government might be more lackluster than it appeared. The finance minister asserted that Poland should adopt the euro, although it must not rush to do so, and should rather ensure that the economy is well prepared. He also refused to pinpoint a target date and only said it would be before 2016. This is a slight shift from the earlier attitudes of quick EMU entry. The past week was relatively favorable for both the zloty and bonds. The exchange rate drifted slowly southward, briefly dipping below 3.58 EUR/PLN in the second half of the week. Bonds appreciated on the good news regarding the favorable budget development (as a result of which the Finance Ministry again cancelled a T-bill auction) and the courageous privatization plans of the new cabinet. The volume of sold state property should be at least double the projections made by the previous government (i.e. at least PLN 4.6bn). This would of course lower the issuance needs (the question is how the government distributes the savings between foreign and domestic papers). All in all, the spreads on the Polish curve against the Eurozone were compressed by about 10 basis points across the curve this week.

The coming week will see a plethora of macro data releases. From the viewpoint of monetary policy, inflation and wage data will be crucial. We agree with the forecast of the

Next week's calendar packed with data

Finance Ministry that the inflation will creep further upwards by 0.4pp and reach 4.0% in December 2007, on the back of fuels and food. This is already half of a percentage point above the tolerance band of the central bank. The bond market will be especially sensitive to a higher than expected number, which might nudge yields upwards along the curve. Too robust corporate wage data would have a similar effect, due to worries about a future spillover of strong disposable income into the inflation numbers. We expect only hikes by 75bp this year (to 5.75%), while the market already prices in tightening to at least 6.0%. However, we think that the market is unlikely to revise its view unless it sees hard data about inflation development at the beginning of this year and is convinced that the price development is not spinning out of control.

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Romania

Budget returns to deficit

By the end of November, the general consolidated budget registered a RON 4.43bn deficit (EUR 1.3bn), or 1.14% of GDP. Budget revenues amounted to EUR 33.4bn, while expenditures totaled EUR 34.7bn. The budget had a 0.12% surplus until October. Following the experience of previous years, the general consolidated budget returned to a deficit in the last few months, when the government, in the absence of great infrastructure projects, chose to spend significant amounts on current expenses (especially personnel expenses and goods and services). Capital expenses were only 3.2% of GDP (RON 12.34bn). The budget deficit for 2007 was set at 2.4% of GDP (according to Romanian standards), but ministry officials have repeatedly said that the shortfall would come in at a much smaller figure. For 2008, we expect a consolidated budget deficit of around 2.7% of GDP (according to Romanian standards).

Trade deficit continued to slow down at end of November

Exports increased by 13% between January and November 2007, while imports saw a 26.6% expansion in the same period, thus leading to an FOB-CIF trade deficit of EUR 19.4bn, close to our estimate. The trade deficit widened by 52%, down from 54% at the end of the first ten months. Imports doubled in early 2007, following the removal of some customs duties, but lost speed significantly after that. The base effect also explains the downward trend of the trade deficit. The EU was again the major commercial partner, accounting for 72% of Romania's total exports and 71% of imports. We estimate an FOB-CIF trade deficit of around EUR 22.4 before end-2007 (+50% compared to the previous year).

RON tested two-year low against euro

The domestic currency tested a two-year low against the euro on January 10, on the back of speculative trades aimed at pushing the National Bank to further tighten the monetary policy. The local forex market was characterized by high volatility and substantial transacted volumes, especially on Wednesday and Thursday, when the leu lost nearly 2.5% vs. the euro. Starting Wednesday, the RON biased on a clear downward path against the euro, decoupling from its regional peers, mostly due to domestic selling orders - speculating on the tightness of the local forex market. Therefore, the RON weakened to 3.69 from the 3.60 zone within two trading sessions. In late trading on Thursday, the leu recovered some of the earlier losses, closing the forex session in the 3.66 area, due to a surprise deposit auction by the National Bank, which drained the entire surplus in the money market. We expect volatility to maintain high next week as well, with the currency trading range-bound in the 3.60-3.69 area.

Central bank maintaining tight monetary conditions

In line with our expectations, the board of the National Bank of Romania decided to hike the monetary policy rate by 50bp (to 8.0%) on January 7, due to the sharp rebound of inflationary pressures in the past few months. Furthermore, the NBR committed to firm management of money market liquidity and has proven its intentions this week. On the same day as the monetary policy meeting, the NBR surprised the market and decided to enforce the new key rate at the usual Monday deposit auction. The CD auction did not stir interest among the commercial banks, as the market players expect further hikes of the key rate and prefer to place their liquidities on shorter tenors, for a more adequate management of liquidity. Immediately after canceling the 3M CD auction, the NBR announced a deposit auction at a 4-day tender, which fully managed to draw the interest of the market, as 17 banks took part. The central bank sterilized the whole sum, amounting to a record RON 8bn, as the market is flooded with liquidity from the Ministry of the Economy and Finance, which spent large amounts from the state budget in December. We believe that the NBR is committed to anchoring inflation near the upper limit of the target band and will continue to drain the entire liquidity in the money market in the coming months via its open market operations.

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Slovakia

December inflation picked up to 3.4%, as expected...

December CPI inflation was in line with our forecasts at 0.3% m/m and 3.4% y/y, delivering an increase from the 3.1% seen in November. The market expected inflation a notch lower at 3.3%. The structure brought no surprises. The monthly increase owed to higher prices of food, fuels and imputed rents. After this figure, we are sticking with our earlier December HICP estimate at 2.5% y/y. We expect the 12-month HICP average at around 2.0-2.1% at the time of the euro preparedness evaluation (in spring 2008), well below the reference limit (expected closer to 3%). With regards to monetary policy, the CB will likely remain cautious. The increase in inflation is mostly driven by global factors (food and fuels), which are beyond the scope of central bank policy. However, the CB will watch for risks stemming from the secondary impacts of more expensive food and fuels on the CPI basket.

...while trade balance disappointed

November foreign trade ended in a deficit of SKK 7.7bn, short of our and market expectations (an SKK 1.6bn shortfall), due in particular to lower than expected exports. A possible disappointment was first hinted at by Thursday's industrial production (13.2% y/y, which grew more slowly than expected in November), due to the slowdown of auto production growth (which, however, still grew by a hefty 40% y/y). The trade balance will very likely end in the red again in December (due to elevated imports). However, the full-year figure will be much better than a year ago. We expect the deficit at around 0.8% of GDP for 2007 (compared to the 4.5% seen in 2006). This year, the trade shortfall should also remain mild, amounting to no more than 1% of GDP.

Net bond issuance in 2007 should be similar to 2006

This year's T-bond auction calendar kicks off on Monday, as the debt agency is to sell a 2Y zerobond. This year, we expect net supply to be around the same as last year, but since the total volume of redeemed bonds is lower than in 2007, the issuance should also be lower. Our expectation is around SKK 90-95bn in new government bonds. One Eurobond issue worth EUR 1bn is planned, while the remainder of about SKK 60bn should be in domestic currency (compared to SKK 72bn in 2007). As was the case in 2007, the acceptance might be skewed more toward the first half of the year. Overall, the impact on spreads should be neutral.

On the FX market, the koruna encountered slight appreciation this week, strengthening from 33.37 EUR/SKK on Monday to 33.25 EUR/SKK on Friday. We foresee further appreciation in the period ahead to below 33.0 EUR/SKK.

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Appendix Charts

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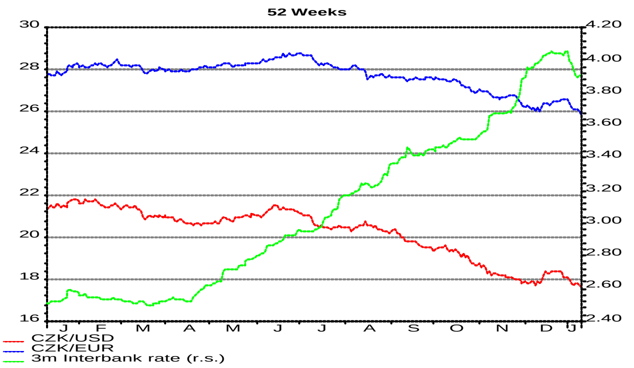
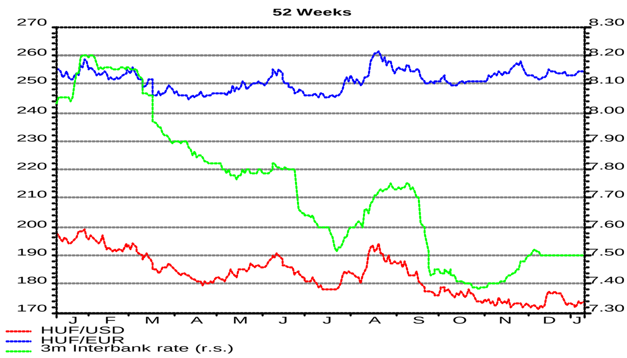
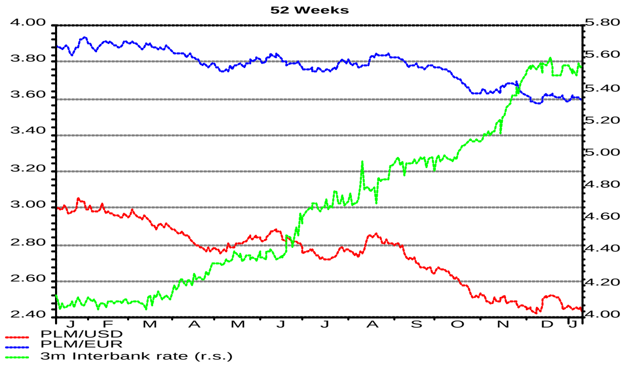
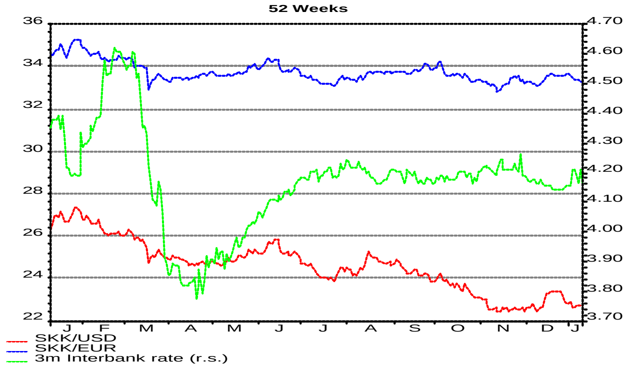
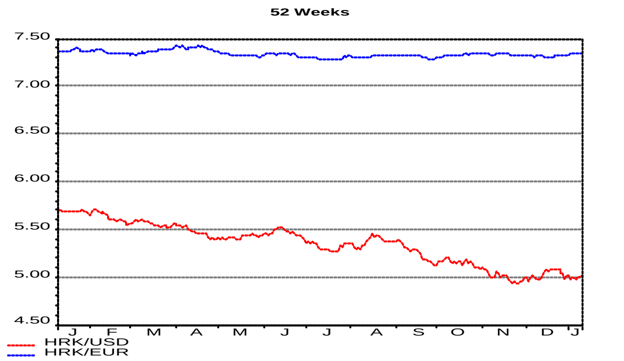
Exchange rates and interest rates (52 weeks)

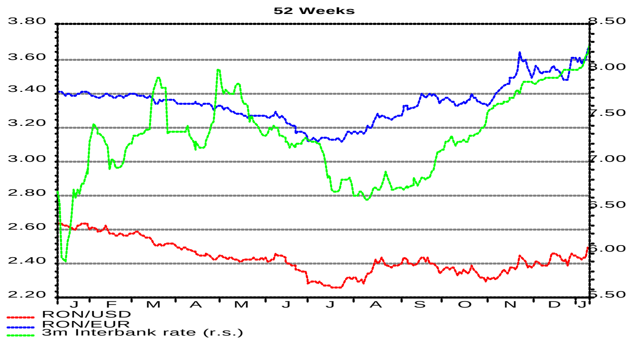








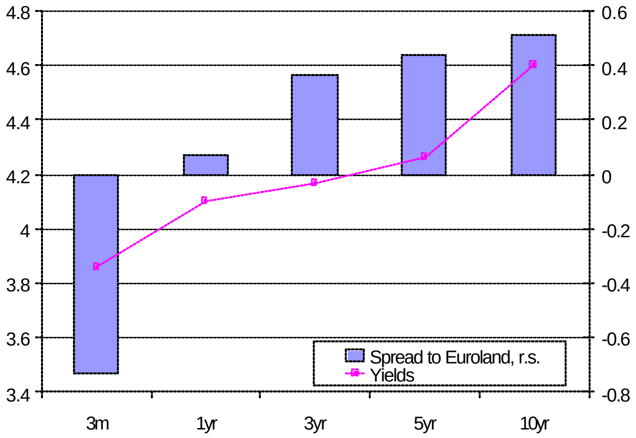




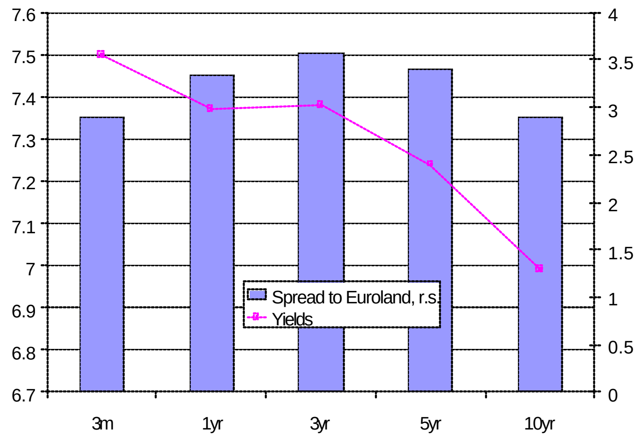
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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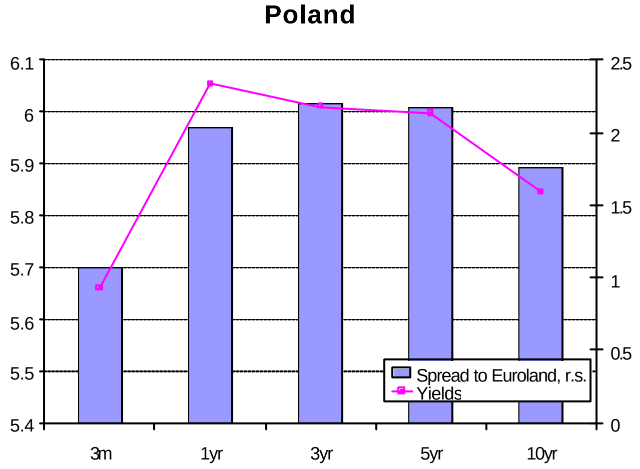

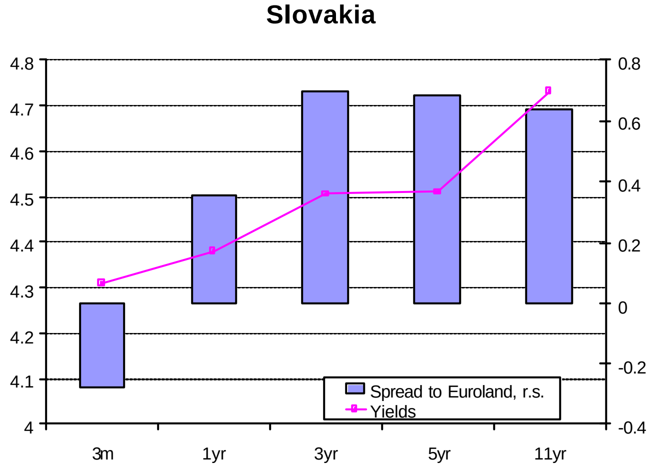

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