CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** December CPI rocketed to 5.8% y/y
- **Czech Republic:** February CNB meeting could be close
- **Hungary:** Forint searching for direction
- **Poland:** January hike still very likely
- **Romania:** Interbank interest rate started to reflect hike of policy rate
- **Slovakia:** CB governor hinted at stronger conversion rate

Overview

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Croatia:

- December CPI rocketed to 5.8% y/y
- Bond market lost support, exchange rate firmed

Czech Republic:

- November witnessed big leap in food prices
- February CNB meeting could be close
- New CZK high set against EUR

Hungary:

- NBH kept base rate on hold (7.50%)
- Forint searching for direction

Poland:

- Past week's data on soft side; might take wind out of hawks' sails…
- …but January hike still very likely
- US cut enabled correction of zloty; next week's hike should not move markets
- Personnel changes at central bank might hurt its credibility

Romania:

- Government plans to end large privatization process in 2008
- EUR/RON encountered resistance in 3.79 zone
- Interbank interest rate started to reflect hike of policy rate
- MoF sold 1-year T-bills for 9.5% yield

Slovakia:

- CB governor hinted at stronger conversion rate…
- …and boosted koruna exchange rate
- MinFin: 2007 public finance deficit likely below 2.5% of GDP

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland current	Spreads vs. Euroland - 1m	Spreads vs. Euroland 02/01/2008
Czech Republic	EUR/CZK	25.88	1.1%	2.5%	2.6%			
	3Y (yield bp)	4.04	-11	0	-27	47	30	41
	10Y (yield bp)	4.56	-3	-21	-18	56	47	53
Croatia	EUR/HRK	7.27	1.0%	0.6%	0.5%			
	3Y (yield bp)	5.78	44	45	47	230	133	140
	10Y (yield bp)	5.83	25	26	30	187	127	135
Hungary	EUR/HUF	257.40	-0.8%	-1.4%	-1.6%			
	3Y (yield bp)	7.49	10	-2	-6	392	347	365
	10Y (yield bp)	7.25	21	14	14	325	281	290
Poland	EUR/PLN	3.61	-0.1%	-0.2%	-0.3%			
	3Y (yield bp)	5.85	-9	-30	-34	228	211	229
	10Y (yield bp)	5.79	-5	14	-18	179	161	176
Romania	EUR/RON	3.76	-2.2%	-7.4%	-4.9%			
Slovakia	EUR/SKK	33.50	0.5%	0.3%	0.2%			
	3Y (yield bp)	4.28	-14	-35	-31	62	58	52
	11Y (yield bp)	4.60	-4	-19	-22	57	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. (%)
17	long HUGB 3Y CZK 6M CZK/HUF	05/12/2007	3Y HU GB 6,25 6M Pribor	97.42 4.04 9.63	97.04 9.96	0.48% 0.03	3.33%	0.2%	98.95 4 9.41	5.1%	10.10%
18	short EURRON	31/12/07	Euribor/ROBID EURRON	4.49 / 7.56 3.60	- 3.83	-5.88%	-5.68%	-81.8%	3.53	2.50%	15.80%
19	Long USDCZK	21/01/08	US-Libor/Pribor USDCZK	3,7/3,99 17.925	 17.60	-1.84%	1.87%	168.5%	19.50	8.80%	17.8%
20	short EURSKK	22/01/08	4m Bribid/Euribor EURSKK	4,08/4,38 33.96	 33.51	1.35%	1.35%	162.3%	33.00	2.80%	8.5%

Rationale at inception

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.

19) We see the US narrowly avoiding the recession (albeit with massive assistance from Fed) and the economy will start to pick up on real estate market being through its trough. Later phase of the business cycle will then appear in Europe. CZK got off the fundamentally justified level over last couple of months, becoming one of the fastest appreciating currencies in the world. Based on the fundamentals and seasonality, we expect weakening of CZK towards 27.00 against EUR in first half 2008.

20) The recent negative mood on the regional markets brought the koruna closer to 34 EUR/SKK. While there is a possibility of a further short-term weakening, we see current levels as attractive to open long koruna positions, as we expect the euro conversion rate to be set within 32.5-33.0 SKK/EUR. Taking a more conservative approach, our target is 33.0 EUR/SKK with a recommended 4M time horizon.

Trading Ideas

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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%
16	long USD/CZK	29/11/2007	14/01/2008	-3.10%

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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		7.32		257		3.61		3.77		33.5		3.50	3.50	7.50	5.00	8.00	4.25
Mar-08	27.0	25.9	7.30	7.30	255	259	3.55	3.62	3.68	3.80	32.6	33.4	3.75	3.50	7.50	5.50	9.00	4.25
Jun-08	27.1	25.9	7.20	7.20	255	261	3.60	3.63	3.65	3.85	32.5	33.4	3.75	3.50	7.25	5.75	9.50	4.00
Sep-08	26.5	25.9	7.25	7.25	256	263	3.55	3.65	3.55	3.90	32.5	33.4	3.75	3.50	7.00	5.75	9.50	4.00
Dec-08	26.4	25.9	7.30	7.30	256	265	3.51	3.67	3.50	3.94	32.5	33.4	3.75	3.50	6.75	5.75	9.00	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	3.91		7.50		5.65		9.09		4.28		4.56	5.83	7.20	5.77	4.58	9.10
Mar-08	3.95	3.95	7.45	7.46	5.70	5.86	9.30	9.99	4.30	4.46	4.71	5.50	6.80	5.86	4.65	9.70
Jun-08	3.97	4.05	7.20	7.28	5.95	5.89	9.80	8.88	4.15	4.29	4.65	5.50	6.60	5.81	4.70	9.50
Sep-08	4.10	3.96	6.90	7.15	5.95	5.88	9.60	7.26	4.15	4.20	4.65	5.40	6.30	5.76	4.80	9.30
Dec-08	4.10	3.97	6.75	7.02	5.95	5.67	9.10	7.06	4.20	4.52	4.64	5.30	6.00	5.70	4.80	9.00

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	-14.1	-14.7	-14.7
Slovakia	-7.2	-4.2	-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	7.4	4.2	2.5
Poland	1.4	4.0	3.4	2.7
Romania	4.9	6.6	5.4	4.5
Slovakia	4.2	3.4	3.5	3.5

Budget Balance (%GDP)	**2006**	**2007e**	**2008f**	**2009f**
Czech Republic	-2.9	-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	No data releases scheduled			
Croatia	31-Jan	Trade balance	€ -775mn	
Hungary	Jan-30	December PPI	1.7% y/y	
Poland	Jan-28-31	Real GDP (4Q, % y/y)	6.3%	6.0%
	Jan-30	CB rate-setting meeting	5.25%	5.25%
Romania	No data releases scheduled			
Slovakia	Jan-28	December PPI	2.8% y/y	3.0% y/y
	Jan-29	NBS monetary meeting	4.25% (on hold)	4.25% (on hold)

Sources: Bloomberg, Reuters

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		No auction scheduled					
Hungary		Jan-29	Feb-06	May-07-2008	-	HUF 20bn	7.45%
		Jan-31	Feb-06	June-24-2019	6.50%	HUF 55bn	7.15%
Poland		No auction scheduled					
Romania		No auction scheduled					
Slovakia		Jan-28	Jan-30	Feb-11-14	4.9%		4.35%

Major markets

Turnaround in business sentiment?

Euro government bond markets saw hefty declines at the end of the week, on the back of a rebound on stock markets, hawkish statements by some ECB Council members and a stabilization in business confidence indices. The most prominent business sentiment index - the Ifo-Index - managed to increase slightly, driven by an improvement of the expectation index. French business sentiment showed an unchanged reading, while the Italian figure declined. Italy seems to have been hit harder than Germany or France by the strong euro and the cooling of the US economy. Part of the worsening of the sentiment could stem from the unclear political situation. The hawks on the ECB Council (like Trichet and Weber) were supported by these figures in their assessment of still imminent inflation risks. So, the probability of interest rate cuts has decreased and the yield curve flattened significantly. Next week's inflation data for Germany should show a drop of about 0.5% in the yearly rate, as the hike in VAT last year should bring about a negative base effect. This will feed through to the flash estimate of the HICP to a lesser extent, so we expect 3% (after 3.1% in December). Euroland sentiment indicators are expected to show a slight improvement in sentiment in the industry sector, a worsening in the services sector and a further worsening in consumer confidence. M3 is expected to stay very high at above 12%. German labor market data is expected to remain robust.

Next week full of important data

After the surprising intermediate rate cut by the FOMC, another rate cut can be expected at the regular meeting on Wednesday. The outlook given in the accompanying press release was so bleak, that we expect another 50bp cut after the 75bp delivered this week. It is hard to imagine that the press release will change significantly after only a week has passed. However, the week will start off with new home sales, which should confirm the dire status of the housing market. On the same day as the FOMC rate decision - but earlier in the day - the first estimate of 4Q GDP growth will be released. Given the recession fears, this figure could get more attention than usual. We are in agreement with the market in expecting low, but clearly positive growth. Finally, the week will end with two important indicators released on Friday. First, the labor market report is scheduled. Here, alongside the non-farm payrolls, the unemployment rate should get a lot of attention, as the market will want to see if the sudden increase from the previous month has continued, which the market currently does not expect. One and a half hours later, the ISM index will be the next indicator to heat up or cool recession fears. The market expects an unchanged figure, indicating a not deepening contraction (at least). We see the risk for this outcome on the downside. As there are so many important events scheduled for next week, and the markets are highly nervous, the next developments are difficult to predict. We think that the markets will give more weight to indicators surprising on the downside. The environment is still perceived to be full of downside risks for the economy and any positive surprise will not be able to change this assessment.

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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	4.39		3.31		4.01	3.67	1.472	
Mar-08	4.00	2.50	4.35	4.41	2.50	3.28	4.00	3.60	1.48	1.469
Jun-08	4.00	2.50	4.15	4.30	2.60	3.04	4.20	3.80	1.45	1.465
Sep-08	4.00	2.50	4.15	3.75	2.70	3.88	4.40	4.20	1.40	1.461
Dec-08	4.00	2.50	4.15	3.79	2.80	2.87	4.60	4.40	1.35	1.457

Croatia

December CPI rocketed to 5.8% y/y

The December CPI figures confirmed the upward trend from the preceding months, but surprised on the upside, as a 1.2% m/m increase was recorded. As expected, food and non-alcoholic beverage prices (+2.9% m/m) contributed the most to the price increase. Additional pressure came from the prices of housing, water, energy and other fuels (+1.7% m/m). Following the recent pressure and low base effect from 4Q06, the y/y rate rocketed to 5.8%. 1H08 should definitely bring a continuation of the pressure and the y/y rates are expected in the 5-6.5% range. The higher CPI figures also boosted extensive public debate and prompted increased nervousness. The new government and the CNB therefore announced that they will fight hard against rising inflation. For now, the government has postponed hikes of gas and electricity prices to calm the situation somewhat. The CNB governor again stressed the bank's dedication to a stable exchange rate and suggested that the CNB would continue to fine-tune system liquidity and MM interest rates, in order to support the exchange rate, while working to moderate credit demand and lower demand pressures. Hence, inflation is again a hot topic that could prevail throughout the year. As it is largely supply-side driven, the CNB has few options. The direction that fiscal policy takes should be seen in the coming weeks, when the proposal for the 2008 budget should be finished.

Bond market lost support, exchange rate firmed

Last week witnessed significant market movement, as the higher inflation figures and CNB announcements had a negative impact on the bond market. For some time, the bond market sustained the pressures stemming from the MM quite well and yields increased only slightly. Nevertheless, this week brought a correction of approximately 30-40bps and the mid and long end of the kuna yield curve is now in the 5.75-5.85 range and spreads range from 190bps to 230bps. On the other hand, the FX market brought significant kuna strengthening, as it moved from 7.34 to 7.27 in a short period without triggering CNB FX intervention. Strengthening was triggered with the anticipation that kuna liquidity would remain tight throughout 2008, alongside an absence of FX interventions, as the CNB is reluctant to inject fresh kuna liquidity into the system. The exchange rate outlook remains unchanged at the moment, in keeping with our expectations. In any case, it will depend on the CNB's stance towards FX interventions.

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Czech Republic

November witnessed big leap in food prices

Next week, there are no data releases scheduled. Last week, only retail sales for November came out. The prices of food were largely behind the deceleration from real 9.4% y/y in October to 5.9% y/y. This is quite understandable, given that November saw the biggest month-on-month increase in food prices (in November, food prices grew by 4% m/m). This probably led to the real y/y 2.3 % drop of retail sales in food stores. The cumulative growth of food prices itself over last three months of 2008 was 5 pp higher than the corresponding rate of growth in Germany. Our hypothesis is that this "excessive" price increase reflects the higher VAT from January of this year having come ahead of time. If that proves true, January inflation could well be less than what would have been the case if the full inclusion of higher VAT was only carried out in a one-off manner in January. For this year, we expect the reforms to slow consumption growth to 3%, from 7% last year.

February meeting could be close

Two more bankers joined the recent discussion on rates - Mr. Singer and Mr. Tomsik. These days, it is hard to find a banker willing to state loud and clear their intentions for the next meeting at the beginning of February (this is understandable, as no new inflation prognosis is available to them yet), and these two men are no exception. Both of them said, yes, current inflation is indeed high, but only due to administrative shocks or cost factors (or both). However, they both see inflation as coming down again at the horizon at which they look when setting the policy. Mr. Tomsik also indicated that he is sympathetic to Mr. Hampl's view that the rates are either close to their peak or have already peaked. At the same time, they both said that the bank cannot allow expectations to get out of control. All in all, with only Mr. Niedermayer firmly in favor of a hike, the February meeting could be very close.

New CZK high set against EUR

The CZK posted yet another record against the EUR (25.795). It is a bit of a mystery why the CZK is performing this well, given the dire outlook for the US economy and how far the koruna is from its fundamental level. One of the hypotheses is that the CZK, with its strong macro background and reputation as an ever-strengthening currency, is indeed a CEE safe haven (the CEE region is relatively well positioned to weather a slowdown in the US, at least in the short run). Nonetheless, it is our belief that the misalignment between the fundamental and market values is not sustainable and that we will eventually see a correction towards 27.00.

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Hungary

NBH kept base rate on hold (7.50%)

At its Monday meeting, the Monetary Council kept the base rate on hold. The decision did not come as a surprise; expectations for the outcome of the meeting were unanimous. Thus, the base rate has been standing at 7.50% for four consecutive months now. The statement of the Council said that uncertainties around global risk appetite factors on capital markets, as well as around domestic inflationary expectations, were the main reasons for the decision. The bank's picture of inflation has practically not changed. According to them, inflation should slow down to close to 3% y/y in 2009, but significant risks are still seen on the upside. At the press conference the governor said, however, that the bank even discussed the option of a 25bp rate hike, but they ended up not voting on it. As the fundamental picture has not changed since the December rate setting meeting, I think that the tremendous turbulence on global markets seen in the first half of the week could have played an important role in the emergence of the hike option. My view is that such a step is unlikely, unless the forint weakens to above 265-270 for a longer period. However, the dropping of the discussion on a rate reduction - which characterized the previous months - suggests that the Council has become even more hawkish. As for the expected rate path, the mid-term inflation outlook should make cautious rate reductions possible later this year. Both the latest retail sales figure (a 4.2% y/y drop in November, again larger than expected) and the formation of the core inflation do not suggest strong demand pull inflation pressure in the economy. However, strong price pressure from administrative prices (not affected by monetary policy) should keep inflation high in the first months of the year. Summarizing the above, the central bank is expected to wait for the publication of inflation and wage figures for the first months of the year to have a clearer picture of possible second-round effects, which makes any rate cut unlikely before May-June.

Forint searching for direction

Due to the turbulence on capital markets and the fall of share prices globally, the forint weakened to above 260 HUF against the euro in the first half of the week, in nervous and volatile trading. Please note, however, that the weakening of the forint has not surpassed the magnitude seen with other regional currencies, as the country's vulnerability has decreased, due to the improvement in the economic balance situation seen in the last year and a half. The extraordinary 50bp rate reduction in the US has supported the forint as well, with the exchange rate strengthening below 260 EUR/EUR in the second half of the week.

Next week, the domestic macro calendar is again practically empty. The December industrial PPI figures are not expected to attract investors' attention. Instead, the FED rate setting meeting and statement from the bank on future economic and rate prospects in the US should also be in focus in Hungary. Apart from global events, the newly-issued 10-year (2019/A) bond auction on Thursday should be interesting. Bond markets could capitalize somewhat on the improving global sentiment, but no significant changes are expected in the short run.

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Poland

Past week's data on soft side; might take wind out of hawks' sails …

The macro releases of the last seven days could serve as ammunition for the doves, rather than for the hawkish camp. (i) Activity in industry disappointed, slumping as low as 6.2% y/y (from the 8.5% y/y seen in November). Seasonal influences cannot be blamed this time. If they were eliminated, the growth would have been even lower at 5.3% y/y. The category of manufacturing, which comprises many export-oriented categories, was the main culprit. Still, industry grew more rapidly in the fourth quarter than in the third. (ii) Contrary to the consumer sphere, producer inflation does not suffer from acceleration. PPI slipped by 0.5% m/m in December. Its annual dynamics stayed unchanged at 2.5% y/y. Hence, there are no signs of price pressures coming from the producer sphere at the moment. (iii) Retail sales grew by a mere 12.4% y/y, which was down from the 19.2% y/y witnessed in November and even below our pessimistic forecast. The slump in food sales might reflect the sensitivity of households to the uptick in their prices.

…but January hike still very likely

The weaker activity in December, coupled with fears of a US recession, might fuel greater cautiousness at the MPC with regards to further monetary policy tightening. However, we still view a hike in January as a very probable scenario. To begin with, despite slower industry and retail, the actual spot inflation is well above the tolerance band and should grow further at the beginning of this year. The structure of the December figure pointed to growing prices across the board, including services categories. Moreover, it is still likely that the slowdown in the activity data and wages seen in December will turn out to be merely a one-off. Last but not least, market expectations are firmly anchored on a 25bp hike in January. All analysts polled expect such an outcome, guided by statements from central bankers. Hence, a hike in January might also be a question of credible communication. Looking forward, macro releases in February will be crucial in shaping the interest rate outlook. January inflation and wage development are important for policy makers. They will also look for clues regarding the sustainability of a December slowdown in activity. For the time being, we stick to our scenario of rates going up by 75bp this year (to 5.75%).

US cut enabled correction of zloty; next week's hike should not move markets

The decision of the FED to cut interest rates had a stabilizing impact on Polish markets. Amid the more conducive attitude of investors towards the region, the zloty firmed back to around 3.61 EUR/PLN. The threshold of 3.60 is the next resistance level to be conquered. However, we judge that the current recovery is still fragile and is contingent upon a more optimistic view on major markets, which could turn around quickly. Of course, the outlook for the US and world economy and the sentiment on international financial markets remain keys for the short-term zloty development. In light of the soft domestic data and fears of a US recession, investors scaled back their expectations regarding the expected monetary policy tightening in Poland, which supports the short end of the curve. Next week's hike is already included in the prices and should thus not act as a market mover. That said, an 'unchanged' verdict would be a surprise and could trigger a rally on the short end of the curve.

Personnel changes at central bank might hurt its credibility

Respected Deputy Governor Jerzy Pruski resigned this week. The reasons he cited included criticism of research conducted at the bank (underestimation of inflation forecasts) and a disagreement with the organizational and personnel changes undertaken by the governor and management board. Less than one month ago, another deputy governor, Rybinski, decided to leave his post. Last year, the head of the research department resigned. The pace of changes at top central bank posts might start to be worrying for market participants. None of the deputy governors were MPC members. Hence, their departure has no implications for the monetary policy outlook. Still, their resignation prompted two MPC members to express their worries and criticize the governor.

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Romania

Government plans to end large privatization process in 2008

The Romanian privatization agency said that it wants to sell its participations in 283 state companies by the end of this year for a total sum of around EUR 0.43bn. We estimate total FDIs falling slightly from EUR 7.2bn in 2007 to EUR 7bn in 2008, based primarily on investments made by long-term investors already present on the Romanian market. Foreign companies put in very good financial performances in 2007. Consequently, we saw an important outflow of dividends in the income balance. At the same time, new greenfield projects could arrive in Romania. More international players in areas like electronics and the automotive industry are expected to open production facilities in Romania or upgrade old ones, considering the attractive labor costs, highly skilled labor force in engineering and the strategic location, allowing easy access to Russia, the Middle East, the Balkans and CEE. Salaries increased at double-digit rates during the last few years, and their convergence process towards EU standards seems faster than other indicators. Despite that, Romania still has a considerable competitive advantage against other states from the region and productivity remains high compared to average labor costs. According to our estimates, labor costs could increase further by 60%, given constant labor productivity, in order to reach the average CEE level.

EUR/RON encountered resistance in 3.79 zone

The domestic currency posted a slight recovery in the last days of this week, as Romanian central bankers threw a lifeline to the leu, stating that the recent depreciation was an overshoot. However, the rebound of the RON was short-lived, as it started the week in the 3.70 area. The risk aversion of global investors increased substantially, on worries regarding a recession in the US, which could affect most economies. Therefore, stock exchanges worldwide suffered steep losses and investors unwounded carry trades. The RON mirrored its regional peers and touched a fresh 3-year low against the euro on Tuesday, dipping to the 3.79 zone. The traded volumes were consistent and the intraday volatility remained high. After the Federal Reserve reduced the policy rate by 75bp to 3.5%, emerging currencies gained ground against the major currencies. The central bank and the MoF supported the leu with intense sterilization auctions, soaking up the entire excess in the money market, which increased interest rates to above the current monetary policy rate. We believe that the EUR/RON will not break the 3.8 resistance zone next week, especially as the NBR has given plenty of signals that they would increase the key rate by at least 50bp at the next monetary policy meeting (February 4).

Interbank interest rate started to reflect hike of policy rate

The NBR intensified the control over money market liquidity, setting up open-market operations whenever excess liquidity occurred. Starting this week, the NBR organized two deposit auctions in a single day, as it realized that daily auctions are insufficient to soak up all of the liquidity in the Romanian money market. Therefore, the central bank drained RON 7.22bn from the interbank market this week, paying a fixed interest rate of 8.0%. The intensification of the open market operations had an immediate impact on the money market, as the overnight interest rates dropped to 7/7.8% on Tuesday and Wednesday. However, starting Thursday, ON interest rates outpaced the monetary policy rate, trading for 8.5/9.1% bids/asks. We expect that the short-term interest rates will remain in the 8.5/9% zone next week, due to the NBR's firm control of money market liquidity.

MoF sold 1-year T-bills for 9.5% yield

The MoF sold one-year treasury bills on January 23, paying an average yield of 9.29% per annum. As we had anticipated, the MoF preferred to finance its immediate expenses through short-term debt instruments, to the detriment of medium- and long-term instruments. The MoF relies on investors lowering the risk premiums demanded in Romania as domestic macroeconomic indicators improve and the global liquidity squeeze eases. It seems that the MoF needs financing, as it drained RON 1,285mn from the money market through a 5-day tender deposit, accepting all submitted bids at the 8.0% cut-off rate.

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Slovakia

CB governor hinted at stronger conversion rate…

Central bank Governor Ivan Sramko said on Thursday that the conversion rate to the euro should reflect economic fundamentals. He added that if the current global financial crisis deepens, the gap between the equilibrium and market exchange rate may widen. This is a strong indication that the central bank prefers a stronger conversion rate than the current ERM-2 central parity at 35.4424 EUR/SKK (and stronger than the then-spot exchange rate, which was at 33.85 EUR/SKK before Sramko's comments). Please recall that when the central parity was revalued in March 2007, the CB said that it was close to where it saw the equilibrium exchange rate. Since then, the equilibrium exchange rate has appreciated and we think the CB might see it within 32.5-33.0 EUR/SKK in 2Q08. The conversion rate should be officially set at the beginning of July, but there is a possibility that the central bank will revalue the ERM-2 central parity ahead of this date and this level will later serve as the conversion rate.

…and boosted koruna exchange rate

The comment, seen as a verbal intervention by the NBS, was positive news for the koruna. Although the majority of the market expected the conversion rate to be set at a stronger level than the current ERM-2 central parity, recent comments by PM Robert Fico that he did not expect another ERM-2 central parity revaluation brought some doubts that the conversion rate might be set at the current parity (although he did not comment on where the final conversion rate would be). On the contrary, Governor Sramko's comments reduced these doubts. As a consequence, the koruna strengthened from Thursday's 33.85 EUR/SKK to below 33.40 EUR/SKK on Friday.

Due to the expected firming of the koruna, we opened a trading idea during the week, when the SKK was near 34.0 per EUR (with a targeted 33.0 EUR/SKK level). Sramko's words prompted the koruna to travel more than half of the way to the target. The time horizon was four months, as, in May, it should already be known whether Slovakia was positively assessment to adopt the euro. If the ERM-2 central parity is not revalued by then (which would be a clear indication of the final conversion rate), the markets are likely to attempt to push the koruna stronger after a positive assessment, in order to influence the process of setting the conversion rate (and get a more favorable fixed exchange rate once the euro is adopted).

MinFin: 2007 public finance deficit likely below 2.5% of GDP

Deputy Finance Minister Frantisek Palko said that the preliminary data suggests that the broad public finance deficit will likely be below 2.5% of GDP for 2007 (the relevant year for euro evaluation). The figure includes costs of pension reform, but does not include the debt of the national highway company (the latter should not exceed 0.2pp of GDP and Eurostat has not ruled yet whether it should be included in the public finances). The ministry is still waiting for data from municipalities, which is part of the broader public finance. The final figure could be known by the end of February; it should be comfortably below the required Maastricht limit of 3.0% of GDP.

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Appendix Charts

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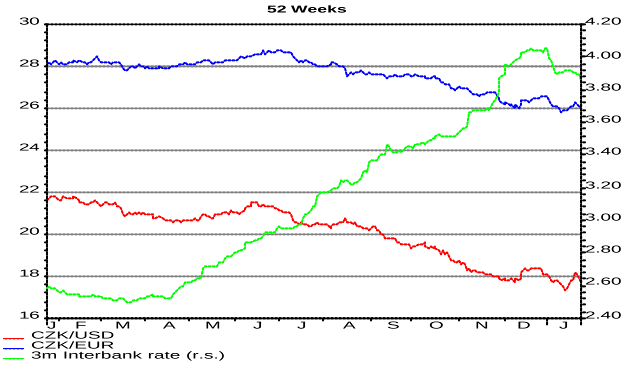
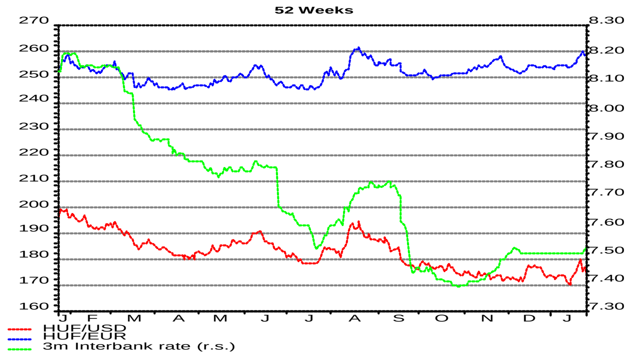
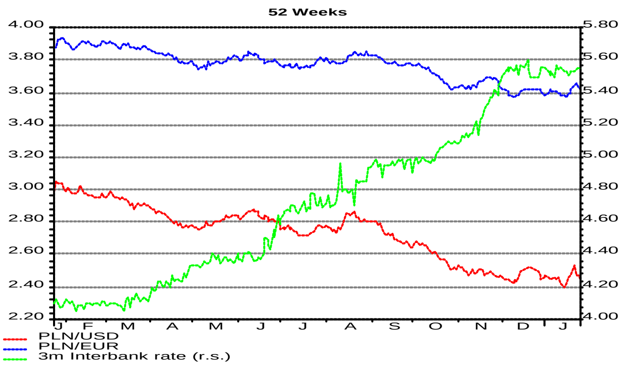
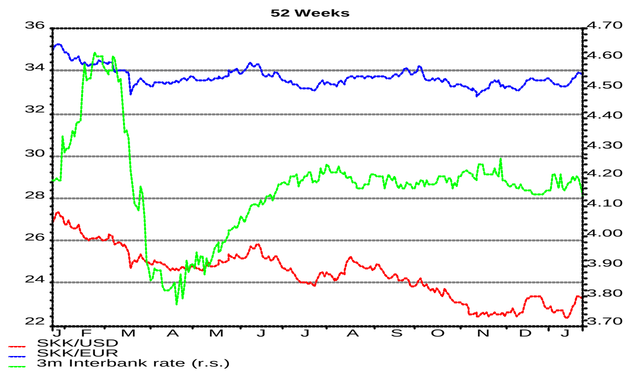
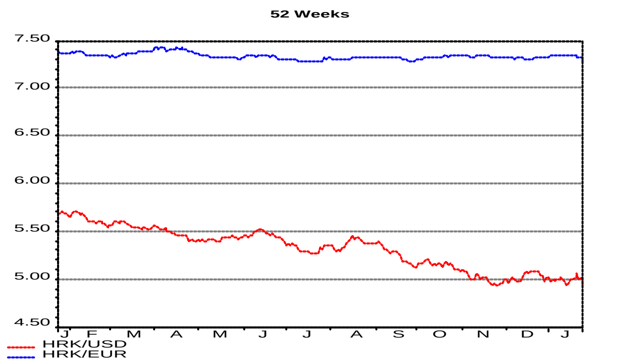
Exchange rates and interest rates (52 weeks)

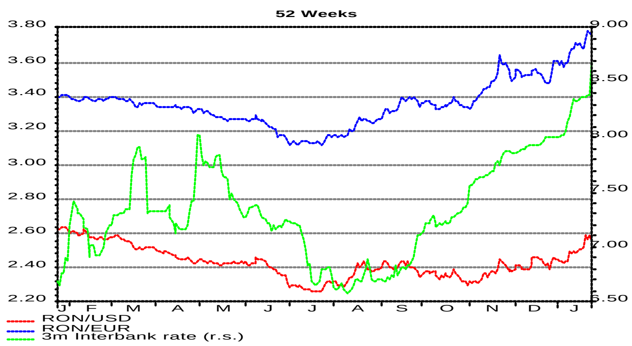








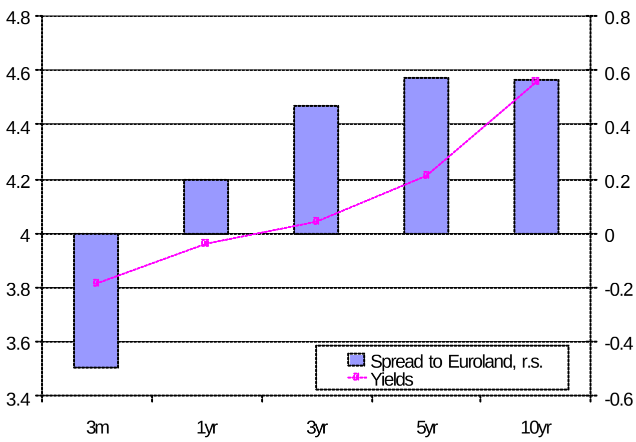




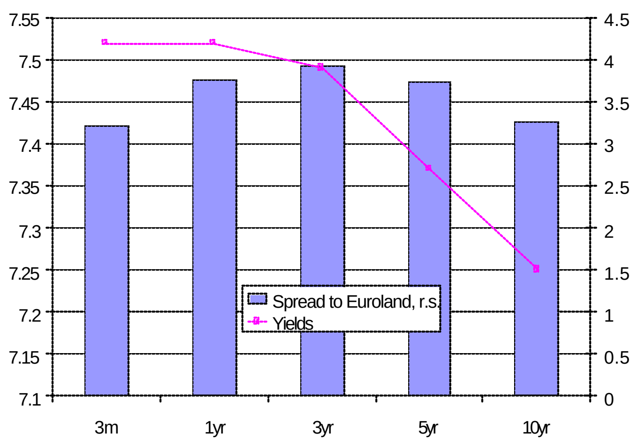
Source: Datastream

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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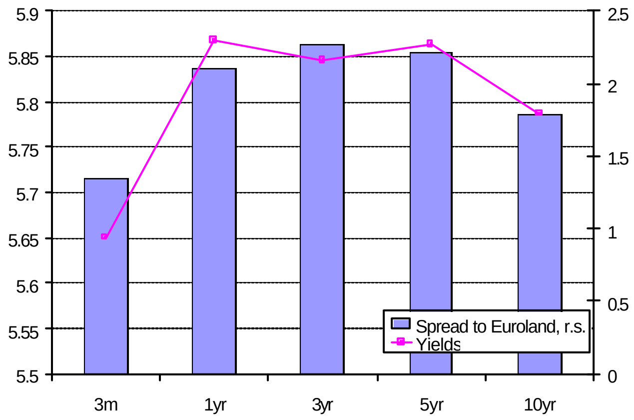
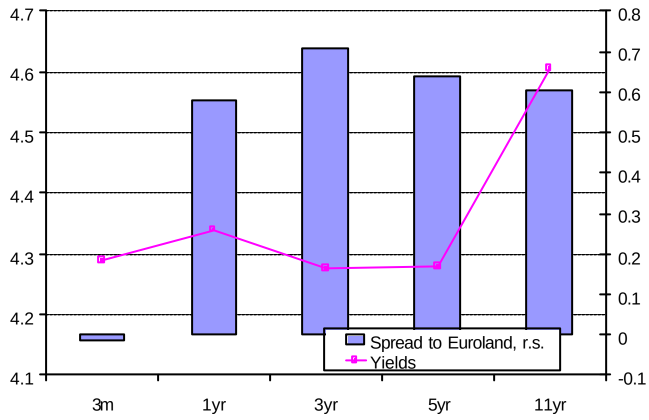
Poland



Slovakia



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