February 22, 2008

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** CPI inflation accelerated to 6.2% y/y in January
- **Czech Republic:** Higher inflation to curb consumption
- **Hungary:** Rate setting meeting Monday - outcome uncertain
- **Poland:** Data released this month sparked more hawkish rhetoric from MPC
- **Romania:** Government intends to improve fiscal policy
- **Slovakia:** NBS to keep rates on hold, despite higher inflation

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Overview

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Croatia:

- CPI inflation accelerated to 6.2% y/y in January
- 2008 budget: Deficit to remain unchanged at 2.3% of GDP
- Markets stable

Czech Republic:

- New bank board member named
- Higher inflation to curb consumption

Hungary:

- Rate setting meeting Monday - outcome uncertain
- Volatility remains on market

Poland:

- Both industry and producer prices grew more than expected
- Data released this month sparked more hawkish rhetoric from MPC and more hawkish market
- We still consider March hike more likely

Romania:

- Government intends to improve fiscal policy
- Liquidity conditions improved on Romanian money market
- Romania sold 5Y benchmark bonds with longest maturity this year

Slovakia:

- NBS to keep rates on hold, despite higher inflation
- Koruna hovers near 33 per EUR

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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	25.13	0.5%	4.0%	5.6%			
	3Y (yield bp)	4.01	12	0	-31	54	57	41
	10Y (yield bp)	4.63	3	7	-11	62	57	53
Croatia	EUR/HRK	7.29	-0.4%	0.5%	0.2%			
	3Y (yield bp)	5.90	-1	54	59	244	200	140
	10Y (yield bp)	5.76	-14	14	23	181	176	135
Hungary	EUR/HUF	264.38	-0.9%	-2.8%	-4.2%			
	3Y (yield bp)	8.31	28	82	76	484	398	365
	10Y (yield bp)	7.76	24	51	65	375	326	290
Poland	EUR/PLN	3.56	0.7%	1.7%	1.0%			
	3Y (yield bp)	6.10	26	20	-9	263	239	229
	10Y (yield bp)	5.95	13	51	-2	194	180	176
Romania	EUR/RON	3.65	-0.2%	2.8%	-2.1%			
Slovakia	EUR/SKK	33.02	0.1%	2.2%	1.7%			
	3Y (yield bp)	4.21	-4	-17	-38	73	105	52
	11Y (yield bp)	4.64	1	4	-18	64	77	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. (%)
18	short EURRON	31/12/07	Euribor/ROBID EURRON	4.49 / 7.56 3.60	- 3.67	-1.97%	-1.54%	-10.5%	3.53	2.50%	15.8%

Rationale at inception

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	6.0%
5	long: SKK/CZK	09/11/2005	20/01/2006	1.9%
3	short EUR/SKK	29/09/2005	07/02/2006	3.5%
4	EUR/PLN options	21/10/2005	28/07/2006	-2.7%
6	SKK/CZK long	23/03/2006	30/10/2006	2.2%
7	FRA 9*12 short	28/07/2006	08/11/2006	8bp
8	long HUGB 5y	13/10/2006	29/01/2006	5.7%
9	short CZGB/ long GDBR	09/01/2007	27/02/2007	1.8%
10	long CZK/EUR	27/02/2007	19/03/2007	2.3%
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	-3.1%
17	long 3y HUGB / 3m Pribor	05/12/2007	08/02/2008	-6.8%
20	short EUR/SKK	22/01/2008	13/02/2008	2.9%
19	long USD/CZK	21/01/2008	18/02/2008	-3.6%

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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	25.0		7.28		265		3.58		3.66		33.0		3.75	4.91	7.50	5.25	9.00	4.25
Mar-08	26.0	25.0	7.25	7.25	261	266	3.55	3.58	3.68	3.68	32.6	33.0	3.75	4.50	7.50	5.50	9.50	4.25
Jun-08	26.8	25.0	7.20	7.20	260	269	3.60	3.60	3.65	3.73	32.5	33.0	4.00	4.50	7.50	5.75	9.50	3.75
Sep-08	26.3	25.0	7.25	7.25	256	271	3.55	3.61	3.60	3.78	32.5	33.0	4.00	4.00	7.25	5.75	9.50	3.50
Dec-08	25.9	25.0	7.30	7.30	256	274	3.51	3.63	3.55	3.84	32.5	33.0	4.00	4.00	7.00	5.75	9.00	3.50

	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	3.95		7.50		5.83		10.17		4.27		4.59	5.76	7.75	5.93	4.65	9.70
Mar-08	4.10	4.01	7.50	8.19	5.75	6.03	10.70	10.22	4.25	4.38	4.70	5.80	7.40	5.70	4.65	9.80
Jun-08	4.14	4.05	7.50	8.26	5.95	6.25	10.50	9.34	3.85	4.23	4.60	5.60	7.00	5.60	4.65	9.70
Sep-08	4.09	4.12	7.30	8.24	5.95	6.23	10.20	8.22	3.70	4.01	4.70	5.40	6.60	5.65	4.65	9.10
Dec-08	4.14	3.99	7.00	8.12	5.95	6.16	9.80	7.72	3.70	3.77	4.80	5.30	6.40	5.55	4.70	9.00

Long-term forecasts

GDP growth (%)	2006	2007e	2008f	2009f
Czech Republic	6.4	5.9	4.3	5.4
Croatia	4.8	5.7	4.6	4.8
Hungary	3.9	1.3	2.5	3.2
Poland	6.1	6.5	5.5	5.7
Romania	7.7	5.7	6.1	6.0
Serbia	5.7	7.3	6.3	6.8
Slovakia	8.5	10.3	6.7	5.0
Ukraine	7.1	7.3	6.6	6.0
CEE8 weighted average	**6.3**	**6.0**	**5.2**	**5.4**

CPI (%), eoy	2006	2007e	2008f	2009f
Czech Republic	2.5	5.4	5.4	3.2
Croatia	2.0	5.8	3.1	3.5
Hungary	6.5	7.4	4.5	2.7
Poland	1.4	4.0	3.4	2.7
Romania	4.9	6.6	5.4	4.5
Serbia	6.6	10.1	4.9	5.5
Slovakia	4.2	3.4	3.7	3.9
Ukraine	11.6	16.6	12.8	11.5
CEE8 weighted average	**4.1**	**6.6**	**5.2**	**4.2**

Unemployment (%)	2006	2007e	2008f	2009f
Czech Republic	8.1	6.7	6.3	6.1
Croatia	10.5	9.8	9.4	9.0
Hungary	7.5	7.7	7.6	7.5
Poland	14.9	11.4	9.3	8.0
Romania	5.2	4.1	4.0	3.9
Serbia	20.9	20.0	19.0	18.0
Slovakia	10.4	8.4	7.6	7.4
Ukraine	7.4	6.4	5.4	4.2
CEE8 weighted average	**10.6**	**8.8**	**7.7**	**7.0**

3M rates (average, %)	2006	2007e	2008f	2009f
Czech Republic	2.3	3.0	3.7	4.3
Croatia	4.5	5.6	7.0	5.5
Hungary	7.0	7.7	7.4	6.5
Poland	4.2	4.6	5.8	5.5
Romania	8.8	7.8	9.5	8.0
Serbia	22.1	11.3	11.2	10.0
Slovakia	4.3	4.3	4.0	4.2
Ukraine	13.5	9.8	10.9	10.0
CEE8 weighted average	**6.5**	**6.0**	**6.9**	**6.4**

C/A (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.0	-3.4	-4.0	-3.4
Croatia	-7.8	-8.3	-8.1	-7.9
Hungary	-6.5	-5.2	-4.7	-4.3
Poland	-3.2	-3.7	-5.0	-5.6
Romania	-10.3	-14.3	-15.0	-15.0
Serbia	-11.7	-16.8	-16.0	-16.2
Slovakia	-7.2	-4.8	-3.9	-3.6
Ukraine	-2.9	-4.1	-3.7	-4.2
CEE8 weighted average	**-5.2**	**-6.0**	**-6.5**	**-6.6**

Budget Balance (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-2.9	-1.9	-2.9	-2.7
Croatia	-3.0	-2.3	-2.8	-3.0
Hungary	-9.2	-5.7	-4.0	-3.9
Poland	-3.9	-2.6	-3.2	-2.9
Romania	-1.6	-2.4	-2.7	-2.7
Serbia	0.2	-1.0	-0.5	-0.5
Slovakia	-3.7	-2.5	-2.4	-2.6
Ukraine	-0.7	-2.8	-2.7	-3.0
CEE8 weighted average	**-3.5**	**-2.8**	**-3.0**	**-2.9**

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	No data releases scheduled			
Croatia	28-Feb	Industrial production	0.5% y/y	
	29-Feb	Trade balance	€ -750m	
Hungary	Feb-25	NBH rate-setting meeting	no change (7.50%)	divided: hold/25/50bp hike
	Feb-29	January PPI	2% y/y	2% y/y
	Feb-29	4Q07 Investments	-	-
Poland	Feb-25	Retail sales (% y/y)	14.4%	15.3%
	Feb-25	Unemployment (%)	11.7%	11.7%
	Feb-27	CB rate-setting meeting	no change	no change
	Feb-29	Real GDP 4Q (% y/y)	6.1%	6.0%
Romania	No data releases scheduled			
Slovakia	Feb-26	CB policy rate	no change (4.25%)	no change
	Feb-28	January PPI	0.4% m/m, 3.8% y/y	3.7% y/y
	Feb-29	January HICP inflation	3.1% y/y	

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Feb-27	Mar-03	2011-Apr-11	4.10%	CZK 6bn	-
Hungary		Feb-26	Mar-05	June-04-2008	-	HUF 35bn	8.00%
		Feb-28	Mar-05	Oct-24-2012	6.00%	HUF 75bn	8.30%
Poland		No auction scheduled					
Romania		27-Feb-08	29-Feb-08	1Y	-	RON 100 mn	9.40%
Slovakia		Feb-25	Feb-27	May-12-19	5.3%	-	4.60%

Major Markets

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Major markets

Sentiment indicators and consumer prices

Next week will be loaded with data. After today's release of flash estimates of Reuters PMIs, next week will see the Ifo Index and EU sentiment indicators. Reuters PMIs came in above expectations, showing a better reading in the Service Index. The Ifo Index increased in January. A further improvement would be very surprising, because of the load of negative data released in the meantime. So, stabilization can only be expected as a best case. The same is true for EU sentiment indicators. The inflation rate for Germany should stay unchanged compared to January because of lower price pressure from energy on one side, but still increasing food prices on the other side. M3 will be reported on Wednesday and should stay at an elevated level because of portfolio shifts, but loan growth should have decelerated, on the back of tighter credit conditions. Rising inflation concerns have reduced interest rate cut expectations for Euroland and led to higher yields and a flattening of the curve this week. As inflation data will stay elevated next week, we do not expect a change in direction.

Series of data and Bernanke testimony unlikely to change outlook

Next week will bring release from various parts of the economy. Existing home sales on Monday and new home sales will show the status of the housing market. The best possible outcome in our view is that sales stagnated. A further deterioration - albeit at a slowing pace - seems more likely. Just as interesting will be how inventories of unsold homes and prices developed in January. Two consumer sentiment indices are also to be released next week. The conference board index is scheduled for Tuesday and the Univ. of Michigan index for Friday. It is difficult to see where an improvement could have come from. The most likely outcome is an unchanged to slightly lower number. A hint about current corporate investment activity will come from the durable goods orders on Wednesday, which are expected to have deteriorated in January, after a strong pick-up in December. On Thursday, the second estimate of 4Q GDP will be released, but we expect little to no market impact. Finally, the Fed chairman will give his regular monetary policy reports to the committees of the House of Representatives on Wednesday and the Senate one day later. As the last testimony only took place on the 15th of this month, there is hardly any basis for a new assessment by the Fed. Possibly, the inflationary risks will be more emphasized after the disappointing data released recently. We think that the upcoming data will confirm the poor status of the US economy, which is in line with the market sentiment. Furthermore, it is hard to see why Bernanke's testimony should contain anything new, so we expect bonds and the dollar to remain within recent ranges.

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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	3.00	4.38		3.09		4.00	3.74	1.483	
Mar-08	4.00	2.50	4.20	4.42	2.50	3.06	4.00	3.60	1.48	1.482
Jun-08	3.75	2.50	4.00	4.30	2.60	2.95	4.00	3.80	1.45	1.477
Sep-08	3.50	2.50	3.75	4.25	2.70	2.75	4.30	4.20	1.40	1.471
Dec-08	3.50	2.50	3.70	3.91	2.80	2.80	4.50	4.40	1.35	1.467

Croatia

CPI inflation accelerated to 6.2% y/y in January

January brought a 0.7% m/m pick-up of consumer prices, resulting in a 6.2% y/y rate, thus meeting our expectations (6.1% y/y). As expected, food and beverages prices (+2.1% m/m) contributed heavily to the headline figure. On top of that, housing, water, electricity, gas and other fuel prices rose by 2.4% m/m, due to hikes in some public utilities. On the other hand, clothes and footwear prices declined by 7.5% m/m, due to a seasonal sales effect, thus easing the pressure to some extent. In the coming months, we expect the upward pressure to remain, but a base effect will dampen the yearly figures. In February, the impact from the government agreement with large retailers to cut prices should be visible in the CPI figures. Therefore, some moderation may occur. Towards the year-end, we see the y/y figure moderating to some extent, while, on average, we see inflation at slightly above the 5% threshold. The market reaction to the CPI figures was neutral.

2008 budget: Deficit to remain unchanged at 2.3% of GDP

Some details on the 2008 budget were released to the public this week. According to the budget proposal, the deficit should remain similar to that seen for 2007, hence around 2.3% of GDP. The first figures indicate prudent planning as, on the revenue side, the expected increase is set at approx. 6.5%, which seems reasonable, given the GDP and inflation expectations. The expenditure side was also set tightly, as expenditures should increase by less than 6%, which is only slightly higher than the inflation rate. Therefore, a first look at the budget indicates a more restrictive fiscal stance and lower pressure on foreign debt and inflation. While the revenue side remains realistic, discipline on the expenditure side remains to be seen. In the case that no significant deviations occur, the deficit goal could be within reach.

Markets stable

After the recent pressure on the bond market (triggered by tight liquidity and rising inflation in recent weeks) brought some support to the long end of the curve, yields corrected by approximately 15bps. Further market support has come from the Ministry of Finance decision to refinance maturing debt on foreign markets this year, thereby reducing the supply pressure on the domestic market. The exchange rate slightly depreciated towards 7.28, after the recent appreciation pressure and CNB FX intervention, but nevertheless remained at stronger than expected levels, supported by tight kuna liquidity.

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Czech Republic

New bank board member named

As was the case last week, no data releases were scheduled for this week. The Czech president chose the replacement for Mr. Niedermayer, whose term as a central bank board member expires at the end of February. Ms. Zamrazilova, a long-time analyst with Komercni banka, will replace Mr. Niedermayer; Mr. Hampl, a board member, will become vice governor. For us, this was a surprising nomination, since her name was not among those that circulated in the media. Also, not much is known about her monetary policy stance - she is known to be against speedy euro adoption (a position also held by President Klaus) and has co-authored a few papers with Mr. Tomsik, who is also a member of the board. All in all, given the lack of information, it is premature to say whether the departure of a known hawk and the appointment of Ms. Zamrazilova will shift the balance of powers in the board. However, the current situation is grave enough in that inflation is unusually high and is threatening to feed into inflation expectations. We also expect the CZK to revert back to around 26.80. These two things will in our view be powerful enough to goad the board into action in May and raise the rates by 25bps.

Higher inflation to curb consumption

We have finalized our latest prognosis (the final document will be released next week). The baseline message is the following: higher inflation will curb the growth of real wages and thus real consumption. This will also lower imports; the expected slowdown in the EU will in turn lower exports (and will further depress imports, since lots of exports are import-dependent in the first place). These effects will combine to slow the growth to 4.3% this year. Inflation will remain high throughout the year and will start falling on base effects only towards the end of the year (absent other administrative measures). The unusually high inflation and its visibility will start feeding into inflation expectations, and as the koruna weakens to around 26.8, the board will be pressured into raising the rates in May to 4.00% (this will be the last hike this year). The koruna will weaken towards the end of the first half of the year on the improving macro outlook for the US economy and the subsequent outflow of funds from the quasi-safe haven CZK. Fundamentals will still be inclined towards strengthening of the CZK, even though the trade balance surplus will be slightly lower (at CZK +77bn.) than in 2007.

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Hungary

Rate setting meeting Monday - outcome uncertain

Next week, the most watched event should be the central bank's rate setting meeting on Monday. It has been a long time since market analysts have been so extraordinarily divided on the outcome of the meeting. After dropping the rate cutting option and discussing the option of a rate hike at the January meeting, the likelihood of a rate rise has significantly increased in the last couple of weeks. Hence, analysts' expectations are now divided between no change, a 25bp rate hike and a 50bp rate hike, while markets have priced in aggressive rate hikes within a relatively short time. The simplest and strongest argument for starting a rate hiking process is the expected higher inflation forecasts of the bank's staff for both 2008 and 2009 in the coming February Inflation Report. Inflation has been suffering from different shocks since mid-2006, which basically cannot be handled with monetary policy tools. However, as some council members remarked in January (according to the latest minutes of the monetary council), the effects of the various adverse shocks to CPI may reinforce each other. If the coming inflation forecast for 2009 is closer to 4% y/y than 3% y/y, this would mean that 2009 would be the third year when the CB misses its inflation goal. Thus, the central bank may decide on a rate hike next Monday, in order to preserve the credibility of the monetary policy. We think that, from the fundamental point of view, there is no rate hiking pressure in the economy. Both the January CPI figure and its structure were in line with expectations, continuing to indicate no signs of second-round inflation pressure in the economy. In addition, in the coming Inflation Report, core inflation forecasts for both 2008 and 2009 are expected to be raised to a lesser extent than the headline figures. As for the wage figures, according to the latest statistics published this week, nominal wage increases in the private sector continued to slow down in December. The regular (ex bonuses) wage increase in the private sector was 8.2% y/y in December, after the 8.5% y/y published for November, while the overall wage increase was just 3.2% y/y in the private sector and 4.3% y/y in the overall economy. Last but not least, growth prospects have become even poorer in the mid run, which could have a strong disinflation effect, as well.

On the capital markets, however, rate hiking sentiment is very strong. Thus, the CB could react with a rate hike even next Monday, due to the increased risk premia on Hungarian assets. Depending on the outcome of the Monday meeting, the tone of the monetary council's statement, as well as the Inflation Report, we may have to change our base rate forecasts for the first half of 2008, although we still expect to keep the year-end base rate forecast unchanged at 7%.

Volatility remains on market

The forint continued to show volatile movements during the week. Apart from changes in global risk appetite, speculation regarding CB rate hikes has pushed the forint exchange rate to the weaker side. We expect market sentiment to remain uncertain in the coming days and communications from the central bank after the announcement of the rate decision could be very crucial in handling the current situation.

Apart from the CB rate decision next week, 4Q07 investment figures (due on Friday) should be in focus next week. According to the flash CSO estimate, GDP growth continued to slow in the last quarter of 2007. The contribution of investments to the poor 4Q GDP growth figure should provide some information on the structure of the growth.

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Poland

Both industry and producer prices grew more than expected

Activity in industry delivered a positive surprise at the beginning of this year. Industrial output increased by 10.8% y/y, visibly accelerating its dynamics when taking into account the 6.4% y/y growth seen in December. This was a better outcome than both our estimate and the market consensus (6.6% y/y). Seasonal factors were more or less neutral this time; after eliminating these influences, the growth would have reached 10.6% y/y. Scrutinizing the breakdown, manufacturing (embracing many export-oriented categories) accelerated its dynamics swiftly in January and is the chief factor to thank. Here, radio, television & communication equipment, together with cars and machinery, remain the fastest growing segments. The robust industrial output data signals that the economy is not in trouble, despite worries about the global slowdown. Inflation in the producers' sphere accelerated in January to 2.8% y/y, well above the market consensus of 2.1% y/y, and surpassing our more pessimistic forecast of 2.6% y/y. Although the PPI quickened in January, this was primarily due to a single category (mining), while manufacturing is still performing well and does not present any reason to be concerned about price pressures coming from the producers' sphere.

Data released this month sparked more hawkish rhetoric from MPC and more hawkish market

Information about the macroeconomic development obtained over the previous month led to a more hawkish wind blowing from the central bank and motivated the market to price in greater monetary tightening than previously expected. We suspect that it was primarily the higher than expected inflation reading and faster wages that provoked this. Also, the rebound in industrial output might have eased the growth concerns. Moderate MPC member Andrzej Wojtyna said that there was room for at least one more hike and he emphasized it should be in the near future, as the risk of second-round effects was rising (nevertheless, he said that he could not tell whether it should be at the next meeting). Another moderate, Stanislaw Owsiak, said he did not rule out a hike this month. FRA 3x6 has marched up 40 basis points since the end of January. Also, analysts have become much more hawkish; contrary to the clear 'no-hike' expectation at the beginning of this month, about one third now expect a 25bp rate increase in February. The minutes from the last MPC meeting were also rather hawkish. In particular, the information about the proposed 50bp hike increased the likelihood of a hike coming already in February.

We still consider March hike more likely

Despite the hawks stepping up the pressure in the last few days regarding an as-early-as-possible rate increase, we do not think that the majority of the council members will be willing to deliver a hike just one month after the last move. Rather, they might again prefer to wait for detailed GDP data (to see the development of consumption vs. investments), quarterly labor market data and the revision of weights in the CPI basket, which might alter the already released January inflation number. Hence, we stick to our call for the next hike being delivered only in March and the peak of the hiking cycle standing at 5.75%. Having said that, we acknowledge that this month's decision might be a close call.

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Romania

Government intends to strengthen fiscal policy

The Ministry of Finance plans to reduce the projected deficit of the consolidated state budget for 2008 to around 2.2% of GDP (from 2.7%). The European Commission warned in late January 2008 that Romania might face measures, unless stronger control of government expenditures and a lower budget deficit are implemented. Romania's growing deficit and volatility represent a serious problem, according to the European commissioner for economic and monetary affairs. Romania needs more ambitious budgetary targets so that it does not violate the regulations in the Pact for Stability and Growth, as well as to limit the foreign deficit growth and inflation pressures. In October 2007, the IMF also advised Romania to follow a stricter fiscal policy. The central bank governor recently had a discussion with the government about better coordination between the monetary and fiscal policy, in order to meet the inflation goals and offer RON stability. The central bank significantly tightened monetary policy beginning with 4Q07 by raising the key rate to 9% (+200bp), firming control of the liquidity on the money market and imposing additional restrictions for unhedged borrowers exposed to FX risk. The reaction of the government followed, with a proposal of a set of reforms for public administration, including a freeze on vacant jobs and lower bonuses. Another measure aiming to support the pension hike is the expansion of the calculation base for social insurance contributions. Wage increases in education and health will be lower this year (around 10-11%, according to government statements, as compared to an increase of 12.7% y/y in education and 16.7% y/y in health in 2007). The government also said it would control spending ahead of parliamentary elections. We consider the goals set by the government as challenging, but additional positive implications for reducing household consumption (covered mainly externally) and thus the external imbalance can be expected.

Liquidity conditions improved on Romanian money market

The liquidity conditions have improved lately, after the MinFin started to inject liquidity in the market via pension funds and VAT reimbursements. Therefore, the pressure on the short-term interest rates weakened this week and overnight deposits were traded for 8.0-8.75/9.0-9.8% bids/asks. This week, the central bank has sterilized an overall amount of RON 4.96bn from the money market, while the amount that reached maturity this week stood at RON 4.62bn. The RON had the same evolution as in the previous week and strengthened in the first days of the week, but could not keep the gains and weakened to 3.66 by Friday, amid modest transacted volumes. We expect the volatility of the Romanian forex market to diminish slightly, as there are no important data releases due next week, remaining range-bound in the 3.62-3.69 area.

Romania sold 5Y benchmark bonds with longest maturity this year

The MinFin decided to borrow money at shorter terms this year, due to the current unfavorable financing conditions on the international financial markets and negative perception towards Romania. Therefore, since the beginning of 2008, the MinFin has refused all bids for bonds with maturities longer than three years, as the interest rates demanded by investors exceeded the monetary policy rate (by far). However, on February 21, the MinFin held a 5Y benchmark bond auction for the indicative amount of RON 100mn. The overall offer of the primary dealers reached RON 429mn, but the MinFin accepted only RON 60.5mn at the 9% cut-off rate. The MinFin borrowed from the domestic market for an average yield of 8.97%, issuing 5-year benchmark bonds, the longest maturity this year. Next week, the MinFin will hold an auction for 1Y treasury bonds for the indicative amount of RON 100mn. We believe that investors might be interested in placing their liquidities in treasury bills, as, at the last 1Y T-bill auction, the cut-off rate stood at 9.5%.

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Slovakia

NBS to keep rates on hold, despite higher inflation

After an eventless week, next Tuesday will bring a rate setting meeting. The CB is widely expected to keep rates on hold. At present, the 2W repo rate stands at 4.25%, which is 25bp above the reference rate of the ECB. Even though recent inflation pressures were mostly exogenous (particularly food and oil prices), the CB will be cautious not to cut rates, due to risks of second-round effects. On the other hand, we see a hike as equally unlikely, as it would mean divergence from the ECB rate, especially as cuts are expected in the Eurozone later this year. Please recall that if Slovakia adopts the euro in 2009 as planned, it will also adopt European interest rates (any eventual hike would thus have only a short-lived effect). We think that the CB prefers to keep the reference rate close to the ECB's. Once Slovakia gets a go-ahead to adopt the euro, we expect cuts of Slovak interest rates in May or June to the ECB's level.

Harmonized inflation will also be out next week. Based on the CPI release, the figure should reach 3.1-3.2%, above earlier expectations. Still, the 12M inflation average should stay at 2.0%, well below the required Maastricht limit. A slight pick-up to 2.1-2.2% is expected by March (this data will likely be used for euro evaluation), but the reference limit is due to rise as well.

Koruna hovers near 33 per EUR

On the FX market, the koruna traded near 33 EUR/SKK over the last couple of days and it stood slightly stronger than this mark on Friday. Unless the regional mood worsens significantly, stronger levels might be tested. We see 32.7 EUR/SKK as a crucial resistance level, as it is both the koruna's all-time high and the lower margin of the former (pre-revaluation) ERM-2 band. If the mark is broken, the koruna could see a sharper move to stronger territory.

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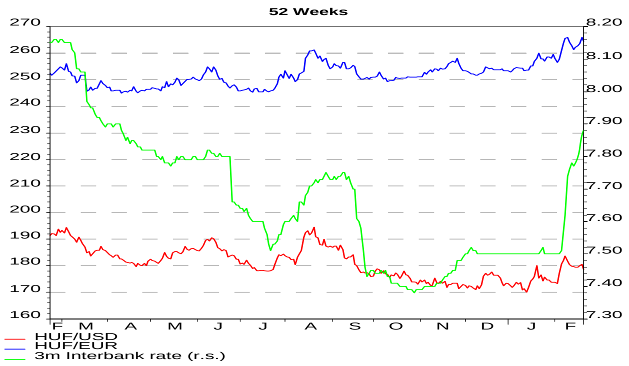
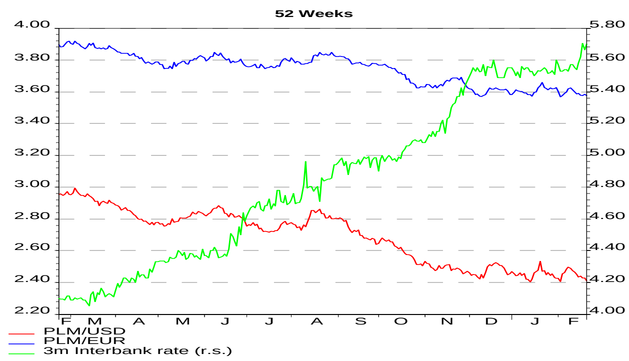
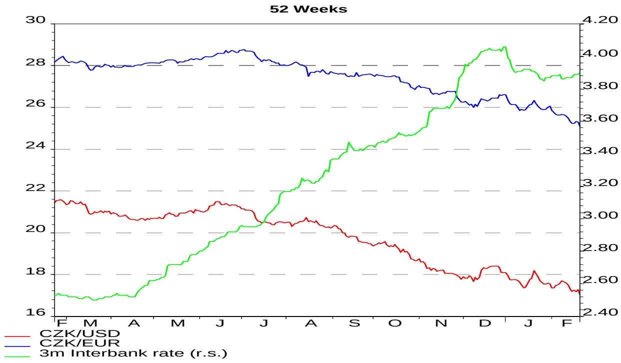
Appendix Charts

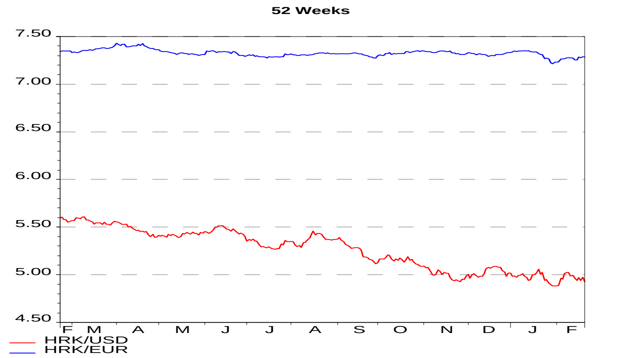
http://global.treasury.erstebank.com

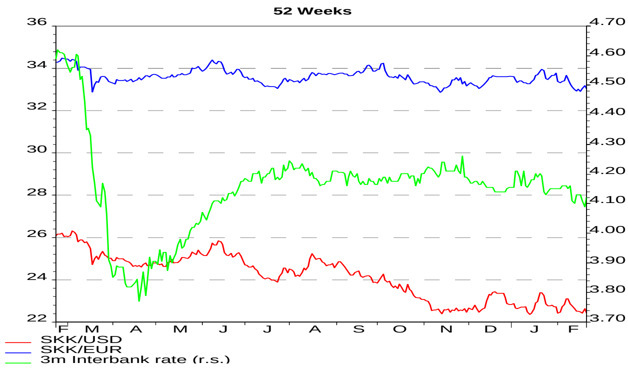
Exchange rates and interest rates (52 weeks)

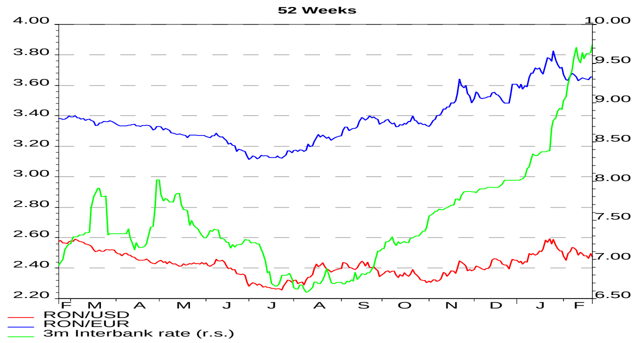








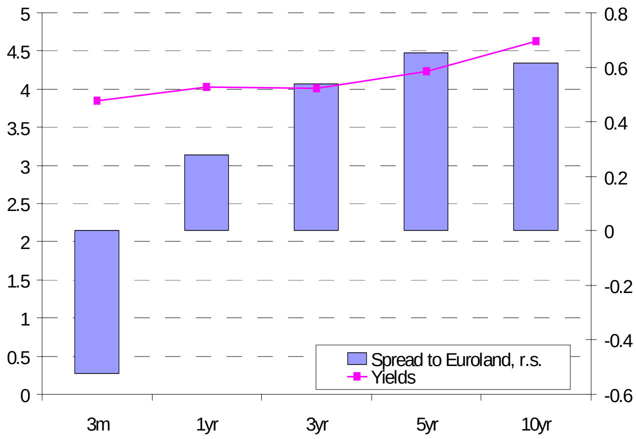




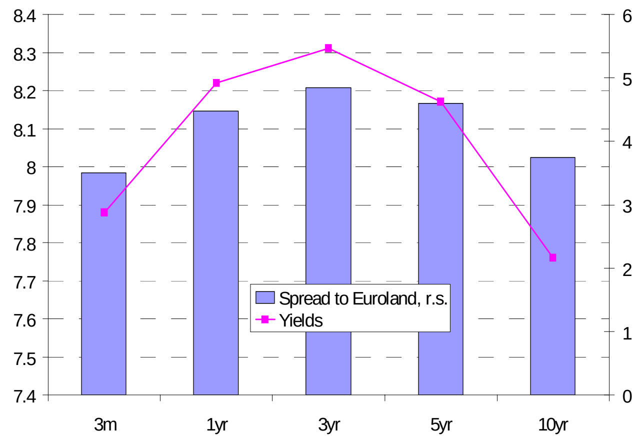
Source: Datastream

Benchmarks

Czech Republic

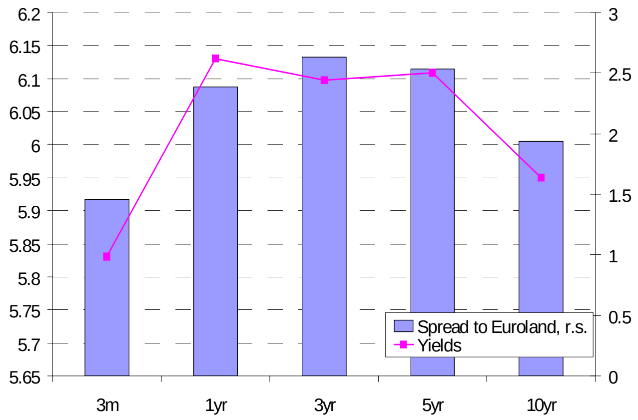


Hungary

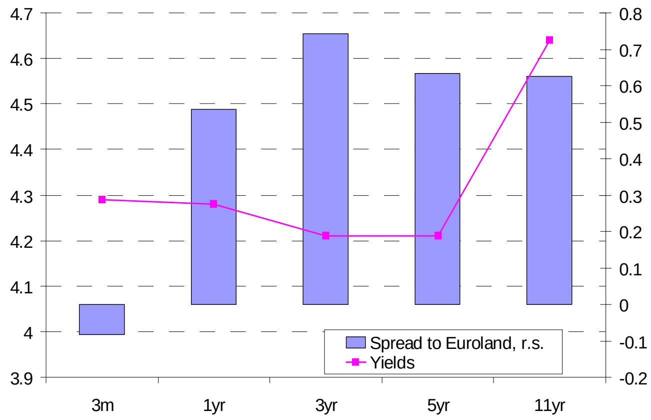


Appendix Forwards

Poland



Slovakia



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