March 7, 2008

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** Financial markets: No significant changes
- **Czech Republic:** FY07: Highest GDP growth since 1993
- **Hungary:** Politics: Referendum on Sunday
- **Poland:** Zloty corrects to weaker territory amid global nervousness
- **Romania:** RON posted slight recovery against euro
- **Slovakia:** Inflation should have stayed flat in February, with food prices main risk

Overview

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Croatia:

- Trade balance: Imports +27.6% y/y, due to energy and capital goods
- Financial markets: No significant changes

Czech Republic:

- FY07: Highest GDP growth since 1993
- January trade balance in surplus
- Real wage growth limited by rising prices in 4Q

Hungary:

- February CPI in focus next week
- GDP rose 1.3% y/y in 2007
- Politics: Referendum on Sunday
- Signs of panic in FI markets

Poland:

- Zloty corrects to weaker territory amid global nervousness…
- …while bonds slide weaker
- Global sentiment remains key driver, investors to also eye inflation data

Romania:

- Economic growth for 2007 exceeded expectations
- Construction remained very brisk in January
- RON posted slight recovery against euro
- Interbank interest rates outpaced monetary policy rate
- Romania paid yield of 9.47% per annum for 3Y benchmark

Slovakia:

- SKK up and down on rating outlook upgrade, CB governor's comments
- Economy grew by 14.3% in 4Q07, supported by cigarette taxes
- Labor market trends still favorable
- Inflation should have stayed flat in February, with food prices main risk

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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	25.09	0.2%	2.5%	5.8%			
	3Y (yield bp)	4.00	-1	0	-31	74	62	41
	10Y (yield bp)	4.60	-3	5	-14	79	70	53
Croatia	EUR/HRK	7.28	0.0%	-0.1%	0.3%			
	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	264.44	-1.6%	-2.0%	-4.3%			
	3Y (yield bp)	9.20	101	125	165	594	460	365
	10Y (yield bp)	8.37	67	82	126	456	370	290
Poland	EUR/PLN	3.56	-1.0%	0.9%	1.2%			
	3Y (yield bp)	6.36	14	62	17	310	239	229
	10Y (yield bp)	6.07	9	82	11	227	179	176
Romania	EUR/RON	3.70	-0.9%	-1.3%	-3.3%			
Slovakia	EUR/SKK	32.68	-0.4%	2.3%	2.7%			
	3Y (yield bp)	4.12	-9	-11	-47	81	88	52
	11Y (yield bp)	4.56	-8	-4	-26	79	70	48

Source: Reuters, Bloomberg (+ means strengthening / - means easing of the exchange rate)

Trading Ideas

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Positions

Currently no open trading idea

Rationale at inception

Currently no open trading idea

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%
18	short EURRON	31/12/2008	28/02/2008	-0.6%

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

Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	25.2		7.28		266		3.57		3.70		32.6		3.75	4.76	7.50	5.50	9.00	4.25
Mar-08	26.0		7.25	7.25	261	267	3.55		3.68	3.71	32.5	32.6	3.75	4.50	7.50	5.75	9.50	4.25
Jun-08	26.8	25.2	7.20	7.20	260	270	3.60	3.58	3.65	3.77	32.5	32.6	4.00	4.50	7.50	5.75	9.50	3.75
Sep-08	26.3	25.1	7.25	7.25	256	273	3.55	3.60	3.60	3.83	32.5	32.6	4.00	4.00	7.25	5.75	9.50	3.50
Dec-08	25.9	25.1	7.30	7.30	256	276	3.51	3.62	3.50	3.89	32.5	32.6	4.00	4.00	7.00	5.75	9.00	3.50

	3m Money Market Rate										10y Govt. Yield					5y Yield
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK	RO
Spot	3.99		8.03		5.95		10.67		4.31		4.60	5.76	8.45	6.11	4.53	9.70
Mar-08	4.10	3.99	8.00	8.35	6.00	6.04	11.00	10.28	4.25	4.30	4.70	5.80	7.70	5.95	4.65	9.80
Jun-08	4.14	4.05	7.60	8.99	5.95	6.40	10.50	9.50	3.85	4.30	4.60	5.60	7.40	5.80	4.65	9.70
Sep-08	4.09	4.12	7.30	9.01	5.95	6.42	10.20	8.40	3.70	4.06	4.70	5.40	6.80	5.80	4.65	9.10
Dec-08	4.14	4.05	7.00	8.93	5.90	6.40	9.80	7.86	3.70	3.79	4.80	5.30	6.50	5.55	4.70	9.00

Long-term forecasts

GDP growth (%)	2006	2007e	2008f	2009f
Czech Republic	6.4	6.6	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	7.9	6.0	6.1	6.0
Serbia	5.7	7.3	6.3	6.8
Slovakia	8.5	10.4	6.7	5.0
Ukraine	7.1	7.3	6.6	6.0
CEE8 weighted average	**6.3**	**6.2**	**5.2**	**5.4**

Unemployment (%)	2006	2007e	2008f	2009f
Czech Republic	8.1	6.6	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**	**8.7**	**7.7**	**7.0**

C/A (%GDP)	2006	2007e	2008f	2009f
Czech Republic	-3.0	-3.2	-3.6	-2.2
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	-10.4	-13.9	-15.0	-15.0
Serbia	-11.7	-16.8	-16.0	-16.2
Slovakia	-7.2	-5.3	-4.5	-4.1
Ukraine	-2.9	-4.1	-3.7	-4.2
CEE8 weighted average	**-5.2**	**-6.0**	**-6.5**	**-6.5**

CPI (%), eoy	2006	2007e	2008f	2009f
Czech Republic	2.5	4.9	5.1	4.2
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**	**6.5**	**5.2**	**4.4**

3M rates (average, %)	2006	2007e	2008f	2009f
Czech Republic	2.3	3.1	4.1	4.4
Croatia	4.5	5.6	7.0	5.5
Hungary	7.0	7.7	7.5	6.5
Poland	4.2	4.6	5.8	5.5
Romania	8.8	7.8	10.3	7.8
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**	**7.1**	**6.3**

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	-2.3	-2.7	-2.7
Serbia	0.2	-1.0	-0.5	-0.5
Slovakia	-3.7	-2.2	-2.1	-2.4
Ukraine	-0.7	-2.8	-2.7	-3.0
CEE8 weighted average	**-3.5**	**-2.7**	**-3.0**	**-2.9**

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Mar-10	CPI February, YoY, %	0.20%	0.30%
	Mar-10	Unemployment, January, %	6.00%	6.00%
	Mar-12	Industrial Output, YoY, %	6.50%	5.10%
	Mar-13	Current Account, January, bn. CZK	-2.0	-0.25
Croatia	Mar-10	PPI	7.3% y/y	
	Mar-12	Retail trade	-0.5% y/y	
	Mar-14	CPI	6.0% y/y	
Hungary	Mar-09	Referendum on co-payments in the healthcare and univ. tuition fees		
	Mar-10	Feb Budget balance	HUF-220bn	-
	Mar-11	Feb CPI	7% y/y	7% y/y
Poland	Mar-13	Current account (EUR mn)	EUR -1100mn	-
	Mar-14	CPI inflation (% y/y)	4.5%	-
Romania		CPI February - y/y	8.2%	8.1%
		Trade deficit FOB-CIF - January (mn EUR)	1,000	-
		Current account deficit - January (mn EUR)	960	-
Slovakia	Mar-13	February CPI inflation	0.2% m/m, 3.8% y/y	3.9% y/y
	Mar-13	January foreign trade balance	SKK -0.8bn	SKK 4.3bn
	Mar-14	February EU-norm inflation	0.2% m/m, 3.2% y/y	3.3% y/y

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Mar-12	Mar-17	2011-Apr-11	4.00%	CZK 7bn	-
Hungary		Mar-10	Mar-12	April-23-2008	-	HUF 40bn	8.30%
		Mar-11	Mar-19	June-18-2008	-	HUF 40bn	8.30%
		Mar-13	Mar-19	June-24-2019	6.50%	HUF 40bn	
Poland		Mar-10	Mar-12	2009-Mar-11	-	PLN 2.0-4.0bn	-
		Mar-12	Mar-14	2037-Apr-25	5.00%	PLN 1.0-2.0bn	-
Romania		12-Mar-08	14-Mar-08	6M	-	RON 500 mn	9.50%
Slovakia		Mar-10	Mar-12	Feb-08-10	-	-	4.05%

Major Markets

Major markets

ECB Council sent hawkish signals

The ECB Council held key interest rates unchanged, as expected. At the following press conference, President Trichet used a quite hawkish wording, sending the euro even higher against the USD. The quarterly ECB Staff growth forecasts were revised downwards to ranges of 1.3% to 2.1% for 2008 and 1.3% to 2.3% for 2009. The inflation forecasts were raised to 2.6% to 3.3% for 2008 - the average of 2.9% being even higher than our expectation of 2.8%. The whole press conference seems to have been dedicated to reducing expectations of interest rate cuts. The market therefore reacted with a flattening of the government yield curve. Nevertheless, the drop in US short-term Treasury yields drove short-term Bund yields lower on Friday. So, risk aversion again took the lead. This can also be seen in the still widening trend within the range of Euro government bonds. Italian government bonds reached a yield uptick of nearly 70 basis points and even French government bonds offer more than 20 basis points. Next week, consumer prices for France and Euroland will be released. We expect an unchanged high inflation rate for Euroland of 3.2%. The main focus will lie on the release of the ZEW, which surprised to the upside in February. The expectation component increased slightly. As the level of the expectation component is still very low, we think stabilization at this level is realistic. An improvement does not seem probable, as the general sentiment in the financial markets is still very anxious. The assessment of the current situation component is expected to decline further.

Important releases ahead, several markets already at extreme levels

The indicators released this week were a mixed bag relative to expectations, but confirmed the continued weakness of the US economy. The extent still seems to be moderate, but of course fears are that it will get worse. An important piece of information in this respect will be today's labor market report. During the week, market expectations shifted from a slight decline of non-farm payrolls to a slight increase. The recent data does not support this change of expectations and we think that the risk for a disappointment is large. Next week will bring important releases towards the end of the week. Retail sales on Thursday are expected to post another minor increase, confirming the slow growth to stagnation scenario for the economy. Friday's consumer price inflation will get more attention than usual, as markets will watch if the previous month's acceleration is continued or was a one-off. The same day, consumer sentiment as measured by the Univ. of Michigan Index should have remained at very low levels during the first weeks of March. While we think that none of the upcoming data will point to a crash scenario for the US economy, concerns about the mid-term outlook will prevail on the markets. Currently, prices on capital markets have been pushed to extremes in a number of fields. The question is how many still want to jump on the bandwagon. In our view, the strong recent movements point to at least a correction ahead.

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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	4.43		2.99		3.76	3.49	1.541	
Mar-08	4.00	2.50	4.20	4.55	2.50	2.93	4.00	3.60	1.48	1.539
Jun-08	3.75	2.50	4.00	4.43	2.60	2.71	4.00	3.80	1.45	1.532
Sep-08	3.50	2.50	3.75	4.38	2.70	2.41	4.30	4.20	1.40	1.525
Dec-08	3.50	2.50	3.70	4.13	2.80	2.42	4.50	4.40	1.35	1.519

Croatia

Trade balance: Imports +27.6% y/y, due to energy and capital goods

The January trade balance figures were rather poor, as exports were easily outpaced by imports (13.8% vs. 27.6% y/y), resulting in a record-low January export-import coverage ratio of 43.8%. Import growth was driven by higher energy imports (+34% y/y) and robust capital goods imports (+58% y/y). Exports, on the other hand, were supported by intermediary (+11% y/y) and capital goods (+41% y/y). Regarding the trade balance outlook for 2008, it remains unchanged, as we continue to expect the trade balance deficit to account for around 25% of GDP. Despite lower consumption spending in 2008, pressure from investment related imports and higher energy prices should continue to burden the trade balance performance.

Financial markets: No significant changes

The last two weeks offered little movement. The exchange rate continued to hover in the 7.26-7.28 band, with pressures balanced on both sides. The improved liquidity slightly eased the pressure on the kuna, but we do not expect movements outside the 7.25-7.30 band in the coming weeks. In the coming months, pressure on the appreciation side should mount, as a number of banks are to increase capital and the government plans to go for a new international Eurobond issue. On top of that, tourist season related FX inflows should also intensify, creating additional appreciation pressures. Turnovers on the bond market remained thin, while yields remained stable. Some positive movement was recorded on the money market, as the liquidity situation is more comfortable now and demand for liquidity at the CNB REPO auction was minor, thus possibly supporting the bond market in the coming period if the present MM situation continues.

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Czech Republic

FY07: Highest GDP growth since 1993

Last week, the most important data released was the final GDP for 4Q and FY07. GDP grew 6.6% in the last quarter of 2007 and 6.5% in FY07, which was the highest growth rate since 1993. This was driven by household consumption, which added almost 3pp to the growth, and by fixed investment (with a contribution of 2.5pp). The most important development in the last quarter was the slowdown in household consumption (which was due to the slowdown in real wages, because of the higher inflation), which was compensated for by one-off effects of higher medical purchases ahead of the planned introduction of fees and higher VAT. As for this year, the slowdown in the EU, the stronger koruna for a longer period (limiting foreign trade) and the decrease in aggregate household consumption (due to lower real wages and cuts in social spending) will all combine to slow the growth to 4.3%.

January trade balance in surplus

Other data last week included the trade balance for January and real wages for 4Q. As for the trade balance, it ended up in a surplus of CZK 12.209bn in January (market: CZK 10.1bn, our estimate: CZK 11.45bn), which was CZK 2.4bn more than in January 2007. The statistical office also slightly revised the trade balance for FY07 to CZK 85bn. This was another example of the January seasonal effect, when a December deficit is followed by a January surplus. The surplus was driven by the same sectors as before - machinery and vehicles. Trade with oil was the main factor working in the opposite direction (due to the higher oil price vis-à-vis 2007 that even the stronger CZK could not offset). The strong CZK thus does not seem to have had much of an impact so far on foreign trade in those sectors that have been driving Czech exports for the last year or so (vehicles, machines, electrical and optical appliances). It remains to be seen, however, what effect the expected slowdown in the EU and strong CZK will have in the period ahead. The trade balance and industrial production are thus to be watched for any effects. All of 2008 should thus see a slightly worse trade balance than in 2007 - we expect approximately CZK 75bn.

Real wage growth limited by rising prices in 4Q

Average wages rose 6.8% in nominal terms in 4Q, reaching CZK 23,435 (and CZK 21,692 for all of 2007, growth of 7.3%). The real growth in 4Q, however, was limited by rising prices - higher food and energy prices shaved some 5pp off the nominal growth in 4Q and brought real grwoth down to 1.9%. This was some 3.4pp less than the average for the first nine months of 2007. Roughly 75% of this is accounted for by higher inflation (and the rest by lower nominal wage growth). Growth of wages was fueled by falling unemployment and the tightening labor market last year (this is also visible in the fact that relatively unskilled jobs posted the highest growth in wages) - unemployment in December 2007 was 1.7pp less than in December 2006. As for 2008, we expect low real wage growth (due to 6% average inflation and relatively mild nominal growth of wages; unions were rather surprised by how high the inflation turned out to be in January) of about 3%. Aggregate income will also not rise as much, since we see rather limited space for a further decrease in unemployment. The impact on consumption will be the most visible.

Next week, the most important data will be CPI, industrial production and unemployment figures. CPI will stay well above 7% (we expect 7.4%) and will still thus constitute a pro-inflationary risk, offset by the stronger than forecast koruna. Industrial production is to be watched for signs of weakening, due to the slowdown in the EU and strong CZK, even though we still expect solid growth of 6.5% (the trade balance does not yet show weakening and there are important lags) and a slowdown only later in the year.

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Hungary

February CPI in focus next week

Next Monday, the preliminary February budget balance will be released. After the small surplus of HUF 33.8bn published for January, the Finance Ministry projected a huge deficit of HUF 219.8bn for the second month of the year. The expected high deficit will basically be due to some one-off items on the expenditure side, usually burdening the first three months of each year. The February CPI inflation figures (due on Tuesday) are expected to attract more attention. We expect 7% y/y, after the 7.1% y/y seen in January. This should again mean a relatively high monthly index (1.1%), based on the accounting for gas, electricity and further administrative services price increases in the statistics. At the same time, uncertainties around food prices still have not disappeared. Apart from the headline figure, the formation of the core inflation and market services inflation could especially be in focus, as these are key factors in the central bank's rate setting policy.

GDP rose 1.3% y/y in 2007

Looking back at this week, the CSO published the breakdown of the 4Q GDP figures this morning. 4Q07 GDP was in line with the flash estimate of 0.8% y/y, while the breakdown of the figure has not brought any big surprises. Household consumption expenditures continued to decrease (by 0.2% y/y), while households' final consumption was down 1.2% y/y, due to further drops in social transfers from the government. It is favorable that the investment figures were at last in positive territory (+2.7% y/y). Finally, in line with the slowdown in industrial output seen in the period, the yearly export growth was just 10.4%, after the 15% published for the third quarter. Import growth also slowed to 9.2% y/y; thus, the gap between exports and imports remained positive, both in 4Q and FY07. As for the outlook, the positive turnaround in the performance of the real economy is very uncertain; a more spectacular revival is only expected in the second half of the year. However, the FY growth seems set to remain below 2.5% y/y.

Politics: Referendum on Sunday

The referendum on the three unpopular fiscal adjustment measures will be held Sunday. The questions are whether to abolish co-payment elements in healthcare (the doctor visit fee and the daily fee at hospitals) and university tuition fees. According to the latest polls, the referendum seems likely to be valid, i.e. 25% of the roughly 8mn eligible voters are expected to vote in the same way. If the referendum passes (with 2mn "yes" votes), this means that these fees will have to be abandoned by January 2009, at the latest. However, as we are talking about a sum of around 0.2% of GDP, the outcome will not jeopardize the ongoing fiscal consolidation process. The second interpretation regarding the referendum is that people are expressing their discontent with the government. This could increase the political noise in the coming days, but we do not expect any direct impact on the markets.

Signs of panic in FI markets

The long-term bond yields jumped to unrealistic levels this week. The Monday announcement of the GDMA (Government Debt Management Agency) on cutting the supply of government bonds with maturity longer than one year improved the sentiment for a while. However, as another wave of global risk aversion swept around the world on Thursday afternoon, the market has shown signs of panic this morning, with extremely wide bid/offer spreads and no trade. In this situation, rumors about an extraordinary meeting of the central bank, GDMA and the Finance Ministry emerged, but this was later denied by the spokeswoman for the central bank. In addition, she said that the bank did not plan to intervene on the FI market. This problem is not related to monetary policy, so we do not expect an emergency rate hike. However, the appearance of the central bank on the buying side of the FI market to restore market sentiment cannot be ruled out, in our view.

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Poland

Zloty corrects to weaker territory amid global nervousness…

The zloty and bonds received a blow from global jitters this week. The rise in global risk aversion and the sell-off on the Polish bond market sparked a correction in the zloty. The unit was whisked from around 3.50 EUR/PLN to as far as above 3.57 EUR/PLN. Looking at the typical seasonal pattern of development (start of dividend season, etc.), we think that further zloty weakening is likely in the coming months to above 3.60 EUR/PLN. However, we retain our bullish medium-term view on the zloty, given the appealing economic picture and hope that the incumbent government sticks to its promises of fiscal prudence and delivers at least partial reforms.

…while bonds slide weaker

Polish bonds suffered losses this week, allegedly on the back of position closures by foreign names, although the move was not as severe as in Hungary (for example). The yield curve rolled upwards by 10-15 basis points w/w, with spreads against Eurozone papers widening by up to 25 basis points. However, swap spreads narrowed on a weekly basis, as a result of which the asset-swap spreads widened visibly. Domestically, mainly hawkish members of the MPC commented, cementing the market view that the tightening cycle will continue. We think that the next hike is indeed likely already this month, but then we expect the central bank to take a break (our core scenario assumes stability of rates until the year-end). However, were the chances of ECB cuts this year to diminish, this would provide further ammunition to the hawks (one of the factors that should prevent a more pronounced tightening cycle in Poland is the desire of the MPC to prevent the zloty from becoming a carry trade currency, which has already been voiced by several central bankers).

Global sentiment remains key driver, investors to also eye inflation data

Developments on majors markets will remain the most important factor affecting Polish assets in the short term. The currency should be at least partially shielded by rate hiking expectations, while the bond market remains more fragile. Apart from events in the world (today's US non-farm payrolls), markets will also watch Polish inflation data next week. We expect the yearly rate to pick up to 4.5% y/y, which is a notch below the estimate of the Finance Ministry (4.6% y/y). The bond market will react sensitively, especially to any upward surprise.

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Romania

Economic growth for 2007 exceeded expectations

The Romanian economy accelerated significantly to 6.6% y/y in 4Q07, resulting in growth of 6% for FY07. The market consensus for 2007 was 5.9%, while we expected around 5.7%. The development shows the significant potential of the Romanian economy - despite the difficult international environment - in terms of real growth (6%). The National Institute of Statistics will present further detailed information about the GDP structure on March 12. Investments in the construction sector increased by around 32% in 4Q, while agriculture delivered negative (but still better than expected) results. Industry was rather modest, as the severe summer drought affected the output of hydropower stations. However, a new nuclear unit started production in late 2007, creating a considerably better outlook for the energy sector in 2008. The mining sector made a poor contribution to the economic growth, following the restructuring process. The growth of manufacturing industry was good, with a focus on high value added sectors that also have good potential for export (means of road transport, radio, TV and communication equipment). Net taxes on products were sustained by the retail sales from December and recovered some losses from the first quarter of 2007. We forecast economic growth of around 6.1% in 2008.

Construction remained very brisk in January

The strong increase of construction work continued in early 2008 (+29.5% y/y in January 2008, compared to +27.2% y/y in the same month of the previous year). The development is appealing, as the investments in the construction sector were the main driver of the economic growth in 2007. Investments in infrastructure kept the pace (+31.5% for civil engineering), while the strong demand for industrial halls, shops, cinemas, offices and administrative spaces resulted in an increase of non-residential building of 27.8%. The high profitability of companies that construct new residential buildings led to a large number of projects; the sector recorded an increase of 22.2% in January. Our estimate indicates an increase of 20-25% in construction work in 2008, with substantial support for real GDP growth.

RON posted slight recovery against euro

After the sharp decline of the leu on Friday, when it tumbled together with its regional peers (on the back of poor international sentiment towards emerging currencies), the RON took a breath of air this week, recovering gradually to the 3.70 zone. The RON started the week in the 3.68 zone and fell to 3.79 in early trading on Monday, losing nearly 3% in several hours. The rally of the euro against the leu seemed to have found some resistance in the 3.79 zone. The RON to strengthened to 3.67 in early trading on Thursday, on the back of better than expected economic growth figures (GDP advanced by 6.0% in real terms in 2007) and a downward revision of the budget deficit to 2.3% (from 2.7%) for 2008. We expect the Romanian forex market to remain highly volatile; bids might range in the 3.68-3.76 zone.

Interbank interest rates outpaced monetary policy rate

The central bank has maintained a tight monetary policy, organizing irregular tender deposit auctions whenever necessary, so that the short-term interest rates do not drop below the key rate. As a consequence of the NBR's restrictive monetary policy, the interbank interest rates outpaced the level of the sterilization rate, as overnight deposits are traded at 9.0-9.3% on the bid side and 9.3-10% on the ask side.

Romania paid yield of 9.47% per annum for 3Y benchmark

In March, the MinFin plans to borrow RON 1.6bn from the local market through 6M and 1Y T-bills and 3Y and 5Y benchmark bonds. On March 6, the MinFin reopened a 3-year benchmark bond issue for an indicative amount of RON 500mn and an 8.0% coupon rate. As we anticipated, the cut-off rate stood at 9.5%, while the average accepted yield increased to 9.47%, from 9.31% at the previous equivalent auction at the beginning of February 2008. The overall offer of the primary dealers reached RON 819mn, but the MinFin accepted only RON 120mn. The next auction will take place on March 12 for 6-month T-bills worth RON 500mn.

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Slovakia

SKK up and down on rating outlook upgrade, CB governor's comments

As the time for the evaluation of euro criteria approaches, the exchange rate has become increasingly sensitive to any euro related comments. Early this week, the koruna surged on the announcement from S&P that it raised Slovakia's rating outlook from stable to positive (sovereign ratings were affirmed at A/A-1). The outlook upgrade reflected the good prospects for Slovakia to join the Eurozone in 2009. The market took the announcement as an opportunity for currency appreciation and the koruna rewrote its all-time high to 32.25 EUR/SKK. However, CB Governor Ivan Sramko later triggered his own currency movement, this time to the weakening side, as he said that the koruna appreciation is not seen as a positive development in an export-oriented economy. It seems that there are two groups within the Bank Board with different opinions on the strength of the conversion rate (this division was also recently highlighted by the PM). Our own view is that the conversion rate will not be too far from the current exchange rate and our baseline forecast is 32.5 EUR/SKK. However, in the short term, any further comments by officials might weigh on the market.

Economy grew by 14.3% in 4Q07, supported by cigarette taxes

The Slovak Statistical Office upped the 4Q07 real GDP estimate to 14.3% y/y (from the flash estimate of 14.1% y/y), putting the full-year GDP growth at 10.4% y/y. Pre-stocking of cigarettes ahead of the January excise tax hike contributed significantly to the growth. Even adjusted for this one-off effect, the economic growth would still have been record-high at 9-10%. Apart from cigarettes, the structure was balanced. Household consumption growth slowed down, in line with our expectations, from the 8.0% seen in 3Q07 to 5.9% y/y, while real wage growth (coming in at 4.5% y/y) was significantly below productivity gains. This will be a positive message for the central bank, confirming its view of contained demand inflationary pressures in the economy. Investment activity remained strong, as fixed investments accelerated from 6.0% in 3Q07 to 8.9% y/y. In 2008, the impact of cigarettes should be seen with the opposite sign and will slow the growth down. We forecast the annual growth at a slower but still solid 6.7%. Apart from the impact of cigarettes, car factories will not increase their production as much as they did in the previous two years.

Labor market trends still favorable

Labor market figures showed improvement in 4Q07. Employment increased by 2.8% y/y. People finding jobs abroad aided the increase (in the last quarter, 185,000 Slovaks worked outside Slovakia), but domestic job creation had a more significantly favorable impact. At the same time, the unemployment rate declined to 10.3% in 4Q07 (the FY07 unemployment rate at 11.0% is the lowest figure since the statistics started to be collected).

Inflation should have stayed flat in February, with food prices main risk

Next week, the most important piece of data is February inflation (CPI is due out on Thursday, HICP on Friday). In the case of CPI, we expect 0.2-0.3% monthly inflation, which would translate into a 3.8-3.9% annual price increase, after 3.8% in January (for HICP, we forecast 3.2-3.3% inflation). Food prices will again draw particular interest, due to the possibility that the excessive food price growth might be more permanent than our baseline scenario assumes. We see this factor as the main upside risk to our inflation forecasts. However, since Slovakia is not the only country experiencing the food price growth phenomenon, this should not significantly affect sustainability discussions during the evaluation of Slovakia's euro preparedness (especially as the Slovak 12M average inflation should be about 1pp below the required limit). The trade balance should also be released on Thursday, but should have little market impact, as the figures are volatile and frequently revised.

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Appendix Charts

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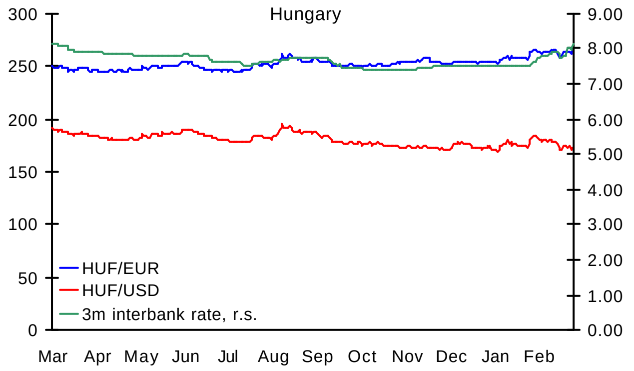
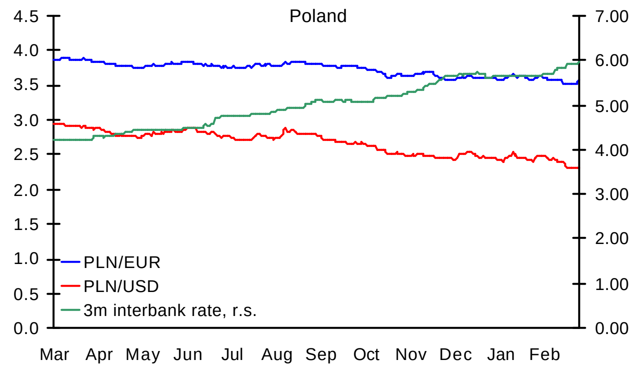
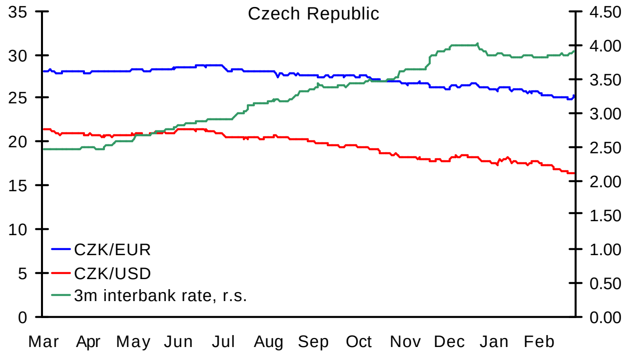
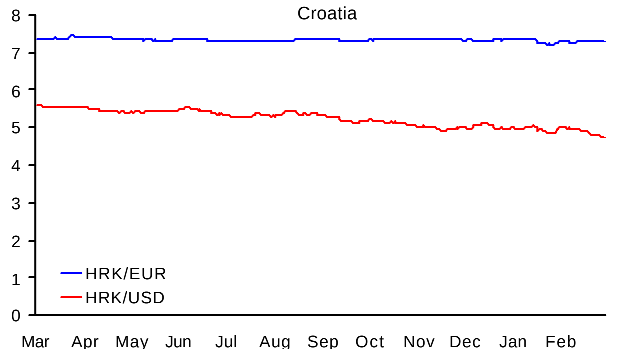
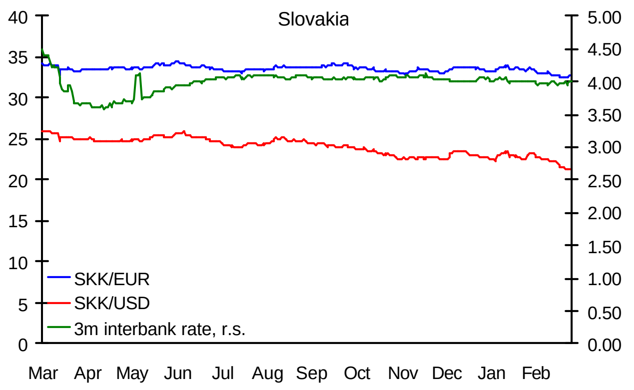
Exchange rates and interest rates (52 weeks)

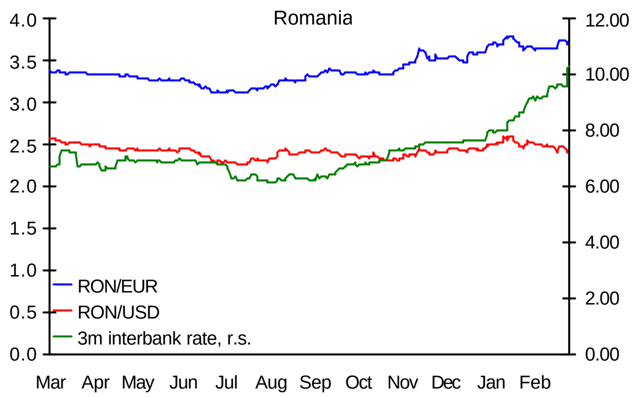






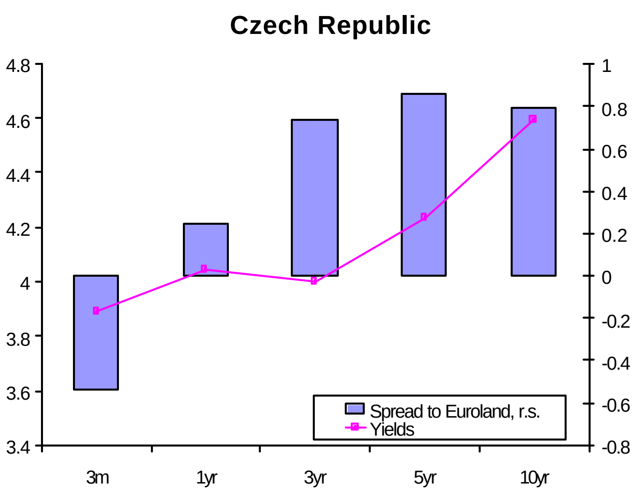


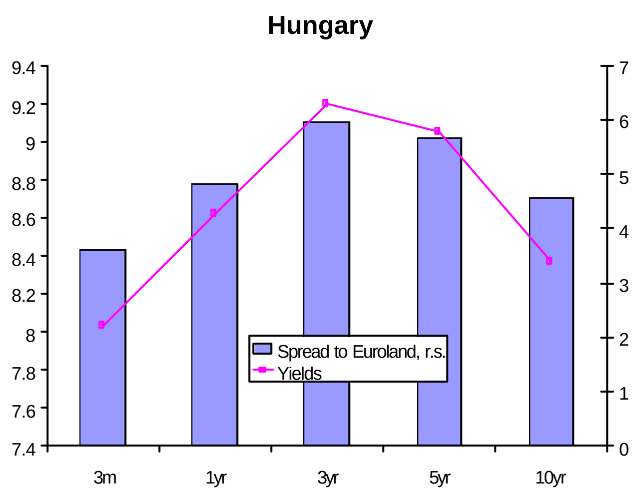




Source: Bloomberg

Benchmarks





Appendix Forwards

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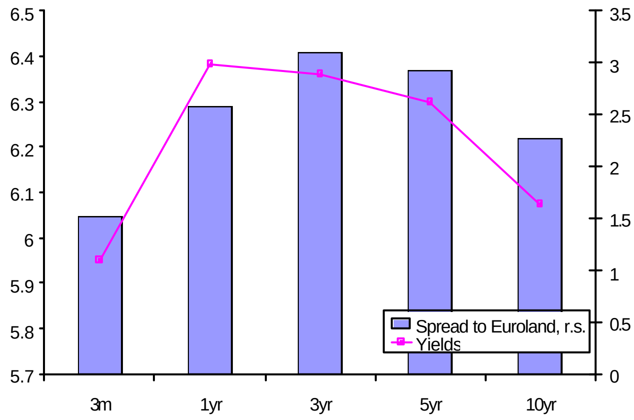
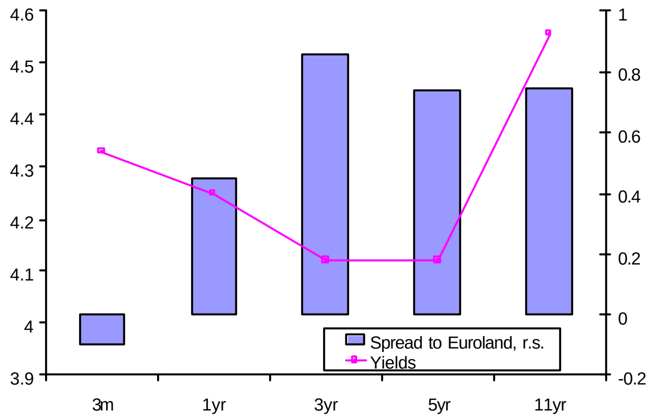
Poland



Slovakia



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