CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** 2007 current account deficit widened to 8.6% of GDP
- **Czech Republic:** CNB will need to hike rates one more time this year
- **Hungary:** Politics: Minority government could come, low likelihood of early elections
- **Poland:** We anticipate interest rate peak at 6.25% in 2Q
- **Romania:** Romania sold 3Y benchmark bonds at 10% yield
- **Slovakia:** March inflation likely last piece for Maastricht 12M average

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Overview

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Croatia:

- Economy moderated in 4Q07, overall 2007 GDP growth at 5.6% y/y
- 2007 current account deficit widened to 8.6% of GDP
- Exchange rate eased slightly after Easter holidays; bond yields down slightly

Czech Republic:

- CEZ hedging not as influential on FX rates as claimed
- Strong CZK to curb industrial growth
- CNB will need to hike rates one more time this year

Hungary:

- Central bank hiked base rate by 50bp to 8.0%
- Politics: Minority government could come, low likelihood of early elections
- March CPI figures in focus next week

Poland:

- We anticipate interest rate peak at 6.25% in 2Q
- Two MPC hawks support further growth of rates

Romania:

- RON positioned on appreciating trend
- Romania sold 3Y benchmark bonds at 10% yield
- Industrial production expected to grow in February

Slovakia:

- March inflation likely last piece for Maastricht 12M average

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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	24.94	1.4%	0.0%	6.4%			
	3Y (yield bp)	4.33	8	0	2	75	80	41
	10Y (yield bp)	4.87	12	32	14	89	75	53
Croatia	EUR/HRK	7.28	-0.2%	0.0%	0.3%			
	3Y (yield bp)	5.80	-6	-7	49	230	257	140
	10Y (yield bp)	5.78	-5	-2	25	179	200	135
Hungary	EUR/HUF	257.28	-0.3%	2.9%	-1.6%			
	3Y (yield bp)	9.56	24	36	201	598	603	365
	10Y (yield bp)	8.10	-5	-27	99	412	456	290
Poland	EUR/PLN	3.48	1.4%	1.7%	3.6%			
	3Y (yield bp)	6.29	9	7	10	271	304	229
	10Y (yield bp)	6.07	12	-27	10	209	214	176
Romania	EUR/RON	3.71	0.0%	0.4%	-3.7%			
Slovakia	EUR/SKK	32.40	0.5%	0.0%	3.6%			
	3Y (yield bp)	4.32	4	18	-27	62	88	52
	11Y (yield bp)	4.64	2	7	-18	65	70	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. (%)
21	short USDRON	02/04/08	1M USD Libor/ROBID EURRON	2.70 / 10.38 2.38	- 2.36	0.71%	0.75%	135.2%	2.30	4.08%	58.4%
22	buy EURFRA9x12 sell SKKFRA9x12	04/04/08	EURFRA 9x12 SKKFRA 9x12	4.04 4.22	4.04 4.22				spread 0bp		

Rationale at inception

21) We see the current exchange rate of 2.38 as a appropriate level to open a short position on USD/RON, as we consider that the local currency has good perspectives to further appreciate against the greenback in the next month as:

The Central Bank proved to be determined to conduct a restrictive monetary policy, making use of all its instruments, so that the disinflation process resumes in a sustainable manner.

The sentiment of foreign investors towards Romania might see a slight improvement in the second quarter of the year, on back of better than expected macroeconomic data. We expect that the interest rate differential will further widen between the dollar and euro.

22) The spread between Slovak and Eurozone FRA 9x12 has widened recently, creating an opportunity for profit if one believes that Slovakia adopts the euro in January 2009, as we do. Upon euro adoption, Slovakia will share money market with the Eurozone. Hence, interest rates will be equal in January 2009 at the latest.

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%

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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	24.9		7.27		258		3.48		3.71		32.4		3.75	4.93	8.00	5.75	9.50	4.25
Jun-08	25.1	24.9	7.20	7.20	258	260	3.60	3.49	3.65	3.77	32.5	32.3	3.75	4.50	8.00	6.25	9.50	3.75
Sep-08	26.1	24.9	7.25	7.25	256	263	3.51	3.50	3.60	3.82	32.5	32.3	4.00	4.25	8.00	6.25	9.50	3.50
Dec-08	26.4	24.9	7.30	7.30	256	266	3.45	3.52	3.50	3.88	32.5	32.3	4.00	4.00	7.75	6.25	9.00	3.50
Mar-09	25.9	24.9	7.25	7.25	255	269	3.40	3.54	3.50	3.94	-	32.3	4.00	4.00	7.50	6.25	8.25	-

	3m Money Market Rate										10y Govt. Yield					5y Yield
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK	RO
Spot	4.11		8.40		6.23		10.95		4.24		4.87	5.78	8.10	6.07	4.62	10.02
Jun-08	4.03	4.17	8.20	8.85	6.45	6.43	10.50	9.47	3.85	4.35	4.70	5.60	7.60	5.90	4.65	10.10
Sep-08	4.06	4.05	7.80	8.88	6.45	6.51	10.10	7.93	3.70	4.33	4.60	5.40	7.00	5.90	4.65	9.60
Dec-08	4.09	4.11	7.60	8.77	6.45	6.42	9.50	5.11	3.70	4.25	4.70	5.30	6.70	5.55	4.65	9.30
Mar-09	4.14	4.05	7.50	8.56	6.35	6.10	8.50	4.99	-	3.63	4.80	5.20	6.60	5.45	4.70	8.55

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	2.2	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**

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	4.8	3.1
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	15.2	12.0
CEE8 weighted average	**4.2**	**6.6**	**5.5**	**4.5**

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	7.2	7.1	6.7
CEE8 weighted average	**10.6**	**8.8**	**7.9**	**7.3**

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	8.0	7.1
Poland	4.2	4.6	6.3	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	**6.6**	**6.0**	**7.3**	**6.4**

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	-6.1	-5.0	-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	-4.2	-5.8	-5.6
CEE8 weighted average	**-5.2**	**-6.0**	**-6.7**	**-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	-5.5	-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	-1.1	-2.0	-3.0
CEE8 weighted average	**-3.5**	**-2.5**	**-2.9**	**-2.9**

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	Apr-07	Trade Balance, February, bn. CZK	14.9	12.8
	Apr-08	CPI, March, % YoY	0.2%	0.1%
	Apr-08	Unemployment, March, %	5.6%	5.7%
	Apr-11	Industrial Output, Feb, % YoY	2.6%	8.0%
Croatia	Apr-8	Retail trade	3.5% y/y	
	Apr-8	PPI	7.2% y/y	
Hungary	Apr-08	Feb Trade balance	EUR -60mn	EUR -50mn
	Apr-08	Feb Industrial output	6% y/y	5.2% y/y
	Apr-08	March Budget balance	HUF-344bn	-
	Apr-11	March CPI inflation	6.9% y/y	6.7% y/y
Poland	Apr-07	Current Account, Q4, mil. EUR		-3350.0
	Apr-11-15	Current Account, Feb, mil.EUR		-1249.0
Romania	11April	Industrial production - y/y	5.1	-
	11 April	Trade deficit FOB-CIF - February (EUR mn)	1,400	-
Slovakia	Apr-08	February industrial production	8.0% y/y	10.0% y/y
	Apr-11	March CPI	4.2% y/y	4.1% y/y
	Apr-11	February foreign trade	SKK -0.2bn	SKK 1.5bn

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Apr-10	Apr-10	2009-Apr-04		CZK 4bn	-
Hungary		Apr-07	Apr-16	May-21-2008	-	HUF 40bn	8.60%
		Apr-08	Apr-16	July-16-2008	-	HUF 40bn	8.60%
		Apr-10	Apr-16	Oct-24-2012	6.00%	HUF 50bn	9.30%
Poland		Apr-09	Apr-11	2017-Oct-25	5.25%	PLN 1.5-3.0bn	-
Romania		09-Apr-08	11-Apr-08	6M	-	RON 600 mn	10.50%
Slovakia		No auction scheduled					

Major markets

Hawkish ECB press conference expected

The recent hawkish comments from ECB Council members do not bode well for the coming press conference. The further increase in Euroland inflation to 3.5% in March and the ongoing wage negotiations, as well as the good performance on the stock markets and a stabilization on the credit markets, are the background for next week's ECB Council meeting. However, the money market still seems to be under stress, as money market rates increased again and Euribor rates were quoted above 4.7% for maturities longer than three months. We therefore expect Mr. Trichet to again point out the readiness to act, but on the other hand to confirm that the actual interest rate level is adequate to secure price stability in the medium term. An interest rate hike seems very unlikely in the current situation, but of course the probability of interest rate cuts has decreased over the last few weeks. Our core scenario still entails rate cuts of 50bp in the middle of the year. Economic data next week will contain industrial production figures for Germany and France. Although there could be small setbacks on the monthly basis, the industrial sector seems to be doing well in both countries. Trade data will gain special attention, as there are still fears of a broad-based cooling in the export sector.

Today's labor market report will shape economic expectations

The release calendar for next week is virtually empty. Only on Thursday, the trade balance and weekly initial jobless claims are scheduled. The latter should get some attention, as of course the labor market is seen as the indicator of the length and depth of the economic downturn in the US. However, more extensive information in this respect will of course come from today's labor market report for March, which will shape economic expectations during the upcoming week. Markets are in our view too optimistic, expecting fewer jobs to be shed than in the previous month. We see a significant risk of a further deterioration. However, the markets' reaction would definitely be stronger if the actual numbers surprise on the upside, as expectations for the economy are still very subdued. This assessment was supported by Fed Chairman Bernanke this week: "…GDP will not grow much, if at all over the first half of 2008 and could even contract slightly." However, Bernanke added that he expected some strengthening in the second half of the year. The Fed chairman will also give speeches next week (Wednesday and Thursday), but the topics do not point to any new indications for capital markets. So, while economic expectations will remain muted, the assumed slow improvement on financial markets should work in the opposite direction, speaking in favor of a continued sideways movement of US yields and EUR/USD.

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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	2.25	4.74		2.73		3.98	3.57	1.572	
Jun-08	4.00	2.25	4.00	4.75	2.00	2.70	4.00	3.80	1.52	1.566
Sep-08	3.75	1.75	3.75	4.65	2.10	2.55	4.30	4.20	1.47	1.558
Dec-08	3.50	1.75	3.70	4.59	2.20	2.55	4.50	4.40	1.40	1.551
Mar-09	3.75	2.00	4.00	3.76	2.30	2.70	4.60	4.60	1.38	1.546

Croatia

Economy moderated in 4Q07, overall 2007 GDP growth at 5.6% y/y

The 4Q GDP figures confirmed the expected slowdown in the last quarter of 2007, posting 3.7% y/y, thus slightly underperforming our expectations (+4.1% y/y). On the annual level, GDP rose by 5.6% y/y, only a notch below the expected 5.7% y/y and confirming the overall strong growth momentum in 2007, resulting in the highest growth rate since 2002. Domestic demand continued to boost economic performance, but fell with respect to the previous quarters. Private consumption, despite the deteriorating monthly indicators' performance, maintained a rather robust pace (+5.0% y/y), supporting the GDP growth strongly. Public consumption recorded a 3.7% y/y increase, hence moderating slightly with respect to 3Q, but still confirming the expansion trend that was evident throughout 2007. Fixed capital formation slowed further in 4Q, recording 4% y/y growth. The drop in investment activity was expected, due to lower construction sector activity and slower credit growth in 2H08. Net export trends remained negative, as exports grew only 2.1% y/y in real terms, while imports maintained a stable growth rate of 6.0% y/y. Expectations for 2008 remain unchanged; we continue to expect a slowdown of economic activity, due to weaker domestic demand, which is burdened by lower purchasing power, tight monetary conditions and unfavorable capital market developments. External demand is not expected to have a strong offsetting effect. Hence, we continue to see 2008 GDP growth in the region around 4.5%

2007 current account deficit widened to 8.6% of GDP

The 4Q current account figures came in broadly in line with expectations, posting a slightly higher than expected deficit of EUR 1.89bn. As one could have expected, the merchandise account continued to burden the current account performance. Thus, given the higher energy prices and EU slowdown, the widening of the merchandise account deficit in 4Q07 (by 21.4% y/y) came as no surprise. The service account finished in positive territory, recording a 14.7% y/y higher surplus of EUR 370mn. The income and current transfer accounts also presented no surprise; only current transfers surprised slightly on the upside, recording a 9.3% y/y higher surplus. The FY07 current account figures showed further deterioration and a widening of the current account deficit to 8.6% of GDP. Thus, the C/A widening trend extended to three years in a row. In nominal terms, the current account deficit surpassed the EUR 3bn threshold, amounting to EUR 3.2bn, up 19.1% y/y. The story remains well known - the merchandise account continues to widen, reaching EUR 9.4bn (+13.1% y/y), while the service sector continues to offset a proportion of the increasing imbalance on the merchandise account (56% of the merchandise account deficit increase has been covered by the increase in the service account surplus). The income account deficit showed signs of stabilization. Thus, the stagnating current transfer surplus managed to cover roughly 92% of the income deficit. In 2007, the financing side showed somewhat more favorable trends than in 2006. FDI inflows were robust, reaching EUR 3.6bn, up 32% y/y. Thus, strong FDI inflows (9.7% of GDP) comfortably covered the current account deficit (8.6% of GDP). Hence, the need for debt-creating financing was significantly lower. Still, as the majority of FDI was likely linked to the financial sector and was regulatory-driven, in the long run, maintaining the current FDI inflow level is not likely, again shifting the pressure onto debt-creating financing. For 2008, we continue to expect a C/A deficit slightly above 8% of GDP, but with an eventual mild narrowing of the imbalance. The export performance should have support from the EU's economic performance and deteriorating competitiveness. Pressure from the import side should ease to some extent, due to lower consumption spending. Nevertheless, capital goods and energy imports should work in the other direction. Some upside risk also comes from the tourism sector's performance - the uncertainty related to Euro 2008 competition negatively affecting the tourist season - and higher profit repatriation as a consequence of the unstable global environment.

Exchange rate eased slightly after Easter holidays; bond yields down slightly

After the Easter holidays, exchange rate pressures shifted to the depreciation side, moving the exchange rate from 7.25 to around 7.27, which was largely anticipated, as demand for kuna liquidity and tourist related FX inflows decline, thus easing the pressure. In the coming weeks, we see the exchange rate in the 7.25-7.30 range, with no clear trend in either direction. On the other hand, bond yields slightly declined in recent days (5-10bps), supported by improved liquidity and stable MM conditions (in line with our expectations). We continue to see room for some yield decline throughout the year, driven by lower supply and a decline in the inflation rate towards the year-end, but still remaining sensitive to short-term liquidity shocks.

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Czech Republic

CEZ hedging not as influential on FX rates as claimed

No macro data was released during this past week. News on the massive hedging operation carried out by CEZ broke, with some newspapers claiming it was the decisive factor behind last year's strengthening of the CZK. Our view is that, while it may have contributed somewhat (it did generate some additional demand), it certainly was not the major driving force. Daily average turnover on the EURCZK market was (according to the latest CNB data from October 2007) approximately USD 677mn, while CEZ said its hedging amounted to CZK 70bn (which is some USD 4bn, give or take).

Strong CZK to curb industrial growth

As for next week, three pieces of data are to be released. The first is the trade balance; we expect a continuation of strong exports and for the balance to remain in a double-digit surplus. The trade balance is to some extent a lag indicator, since goods are exported that were contracted for before. Industrial output is more forward-looking in this respect. We thus expect the strong koruna to curb industrial growth (and for exports to slow down later in the year, on the stronger CZK and slowing demand) - our expectation is around 3% in February.

CNB will need to hike rates one more time this year

The most important data release next week is inflation for March 2008. We expect the high inflation to stick with us in March as well (our expectation is 7.4%). This would bring the 1Q average to approximately 7.5%, some 0.7pp above the CNB expectation. This would be a major pro-inflationary factor for the Banking Board (in April, inflation should remain high - not only due to base effects, but also to further price increases - gas from RWE, for example). We thus think that the CNB will need to hike the rates one more time this year, as soon as the CZK - which is now overvalued - weakens.

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Hungary

Central bank hiked base rate by 50bp to 8.0%

The central bank hiked the base rate by 50bp to 8.0% on Monday. According to the statement of the monetary council, the risk of inflation sitting permanently higher than 3% and the increase in the risk premium required on forint assets made it necessary to hike the base rate. Among the inflationary shocks, the council explicitly mentioned the rise in producer energy prices and wage costs, which may have a more lasting, second-round inflationary impact. They said that the council was ready to take the necessary steps to reach the 2009 inflation goal. At the press conference, Governor Simor said that the bank had discussed three options: holding rates, a 25bp rate rise and a 50bp rate rise, but the council voted with a convincing majority for the 50bp increase. He added that the monetary council's opinion on inflation had changed over the past month and the base rate hike reflected the changed risk assessment of the council. As for the future rate prospects, we do not expect more rate hikes and, instead of two cautious rate reductions in 2H, we now see room for just one 25bp rate cut at the end of the year, assuming an improving global market environment and a convincing slowdown in the 12-month inflation rate by that time. We must note, however, that the risks are on the upside. Based on the above-mentioned comments (which point to a more hawkish stance on the council) and the fact that the difference between the central bank's base rate and market yields is still seen as high, a further increase in the base rate cannot be ruled out in the coming months.

Politics: Minority government could come, low likelihood of early elections

On Monday, Prime Minister Ferenc Gyurcsany sacked Health Minister Ágnes Horváth. Earlier, Gyurcsany said that the coalition partners - the Socialist Party (MSZP) and the Liberal Democrats (SZDSZ) - should rethink the coalition agreement and choose a new health minister. However, the junior coalition party - which has been dissatisfied with the speed of the (structural) reforms for a while - took another stance. They rejected the request of the PM to stay in the coalition and said that they would quit from April 30. They added, however, that they would support all decisions that serve the interest of structural reforms and reaching the goals of the Convergence Program. As the SZDSZ is not planning to quit until April 30, an agreement between the MSZP and SZDSZ cannot be ruled out in the coming month. (Rumors have it that the SZDSZ is not of one mind on the issue). The likelihood of early elections is very low, mainly because of the low popularity of the governing parties. Thus, a minority government seems the most likely scenario now (from May 1). In this case, the Socialists would be four seats short of a majority in the Parliament. (The SZDSZ has 20, while the Socialists have 190 seats). As the SZDSZ is planning to support the government from the "outside" on certain issues, a Socialist-led minority government should be able to collect enough votes for decisions. A minority government is still less stable, however, which of course could cause uncertainties on capital markets from time to time.

March CPI figures in focus next week

The forint - which was able to preserve its relative strength in the second half of March - reacted negatively to the coalition crisis, but this was only short-lived. The improving global market mood and increasing risk appetite have made political events less important to markets. In addition, the exchange rate was strongly supported by the higher than expected central bank base rate hike and hawkish comments from the monetary council. Among the data to be reported next week, the March CPI inflation should be the most watched (Friday). We expect the 12-month rate to remain at 6.9%. The expected still high monthly increase may have been driven by food, fuel and the usual seasonal increase in clothing prices.

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Poland

We anticipate interest rate peak at 6.25% in 2Q

The voices from the central bank remained essentially the same this week as they were after the last MPC meeting - further, albeit limited, growth of interest rates is likely. We accordingly updated our projection for interest rate development. We now expect a peak at 6.25%. This level should be reached already in the second quarter. Our expectation is supported mainly by the combination of faster than expected wage growth and a continuation of the positive output gap, as well as hawkish rhetoric from MPC members.

Two MPC hawks support further growth of rates

Hawkish voices continued to sound from the MPC this week. According to hawkish MPC members Filar and Noga, CPI should peak in August, followed by a decline. Inflation was expected to peak already in the second quarter. However, a delay in the expected natural gas price hike put off the expectations. The main reason for the expected decline of inflation after August is the predicted drop in food inflation, due to a base effect. According to Filar, inflation should breach the Maastricht euro-adoption criteria. The main question for monetary policy is if wage growth is also receding. Both Noga and Filar support further growth of interest rates. Another MPC member, Wasilewska-Trenkner, also supported an interest hike as early as this month. She said that the current inflation spike is a consequence of the very accommodative monetary policy 1-1.5 years ago.

Next week is without any major expected events, aside from the 10-year bond auction. The zloty should be influenced mainly by regional behavior and implicitly by majors. Next week's calendar is also rather empty on major markets, so we can expect a rather calm period, unless there is another wave of financial market trouble.

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Romania

RON positioned on appreciating trend

This week, the local currency positioned on an appreciating trend against the euro, as the RON found support in the large positive yield differentials. The high yields offered by the Romanian money market managed to calm investors' worries, compensating for a possible depreciation. Gradually, the sentiment on the Romanian currency improved, thanks to central bank's tight monetary policy, and off-shore players started to open some short positions on EUR/RON. The domestic currency started the week on a weak foot, trading at 3.73 at the beginning of the week, on the back of negative news about some European banks' write-downs. The euro sell-off came mainly from foreign players, who were attracted by the high yields offered by the RON, betting on a liquidity squeeze around the Orthodox Easter holiday, when banks badly needed money to finance the high demand for consumer credit. We expect the RON to strengthen further next week, breaking through the 3.70 support level, as money market liquidity is likely to be restrained, with short-term deposits traded at double-digit interest rates. This week, interbank interest rates remained above the key rate, traded for 9.5/10.0% bids/asks.

Romania sold 3Y benchmark bonds at 10% yield

On April 3, the MinFin reopened a 3-year benchmark bond issue at an indicative amount of RON 500mn. The offer of primary dealers totaled RON 698mn, but the MinFin accepted only RON 179mn. The average accepted yield rose to 9.80%, from 9.47% at the previous 3Y benchmark bond auction on March 6. The maximum accepted rate reached 10.0%, 50bps higher than the cut-off rate in the previous auction. This is the first time that the MinFin agreed to pay higher yields than the level of the monetary policy rate. This fact indicates that Romania badly needs financing to cover the budgetary expenses projected for 2008, including the development of infrastructure. The next MinFin auction will be held on April 11 for the sale of 6-month treasury bills worth RON 600mn. We expect the MinFin to pay even higher yields than previously, with the cut-off rate standing at around 10.5%, as the MinFin prefers to attract financing on shorter terms, due to expectations that interest rates will decrease in the medium term.

Industrial production expected to grow in February

The National Institute of Statistics will release industrial production data for February next week. Our forecast indicates an increase of about 5.1% y/y. According to company managers polled by the central bank, industrial output is expected to grow further, as well as the volume of new orders. External orders could play an important role in the development of industrial production during the next period. Means of road transport, metallurgy, metallic construction and metal products, manufacturing of electrical and optical equipment will be the key drivers of industrial production, according to managers' expectations. Further investments are expected in industry, while construction might face a slight decline on a m/m basis, due to unfavorable weather conditions.

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Slovakia

March inflation likely last piece for Maastricht 12M average

In contrast with this week, the coming one will be rich in new data. On Tuesday, February industrial production kicks off the data deluge; growth of around 10% y/y is expected, while the car and machine building sectors will be the drivers, in our view. On Wednesday, retail sales will show a strong reading for the second month running. Eurostat already published the growth (in slightly different methodology) at a strong 16.6% y/y, after 15.6% in January. The most interesting figure of the week will be March CPI inflation (due on Friday), which will increase to an annual 4.2% (from 4.0% in February), in our view, supported by higher heating prices. The national inflation will indicate the level of harmonized inflation (to be released on April 14), which will likely be the final piece for the 12M average used for the convergence criterion evaluation. We expect harmonized inflation at 3.5% y/y in March (up from 3.4% in April), which would put the 12M average at 2.2%. That will be safely below the Maastricht limit, which stood at 3.1% in February and might move up a notch to 3.2% in March. The debate about the sustainability of inflation in Slovakia will surely follow, but as inflation there is comfortably below the required limit, a negative stance towards euro adoption is unlikely.

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Appendix Charts

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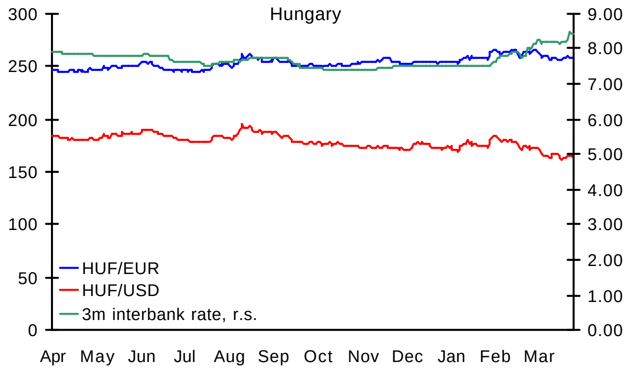
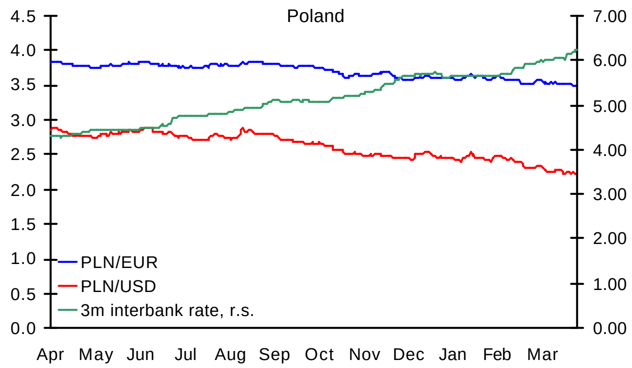
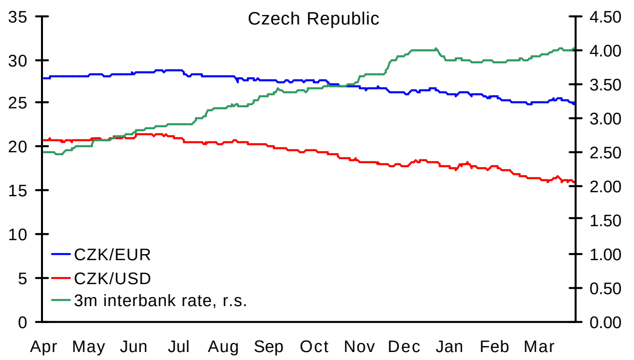
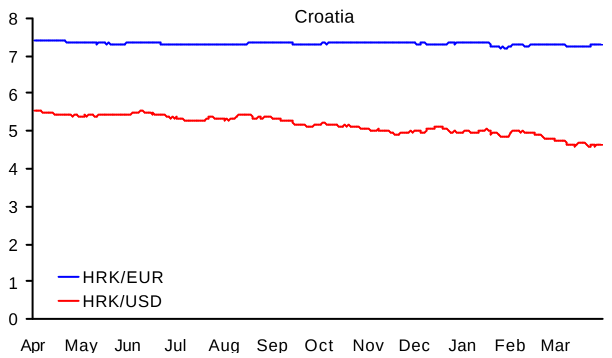
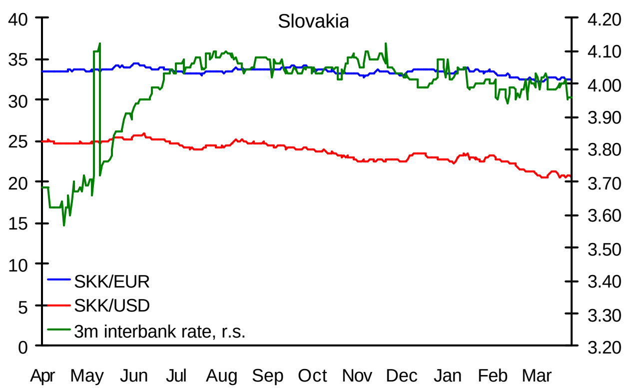
Exchange rates and interest rates (52 weeks)

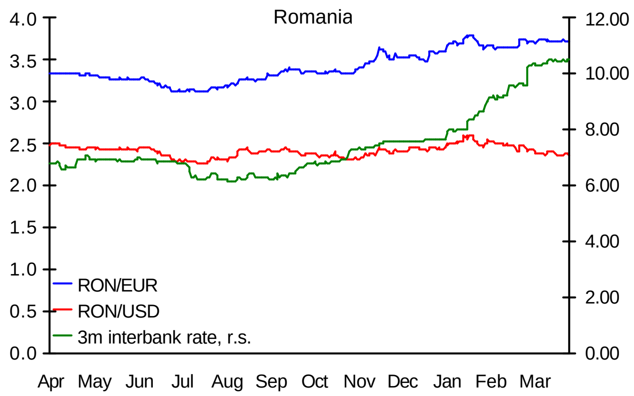






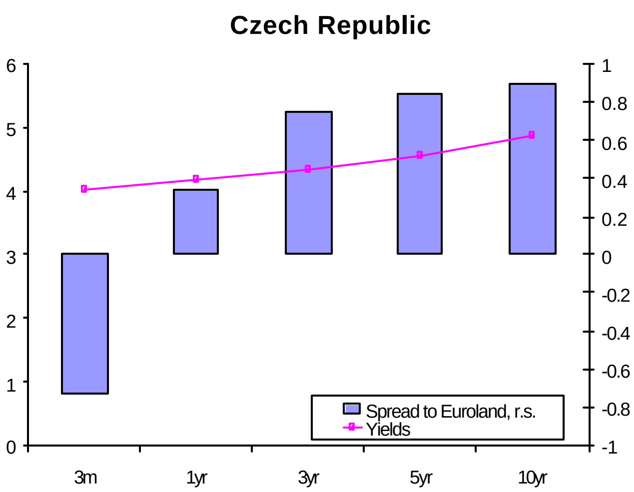


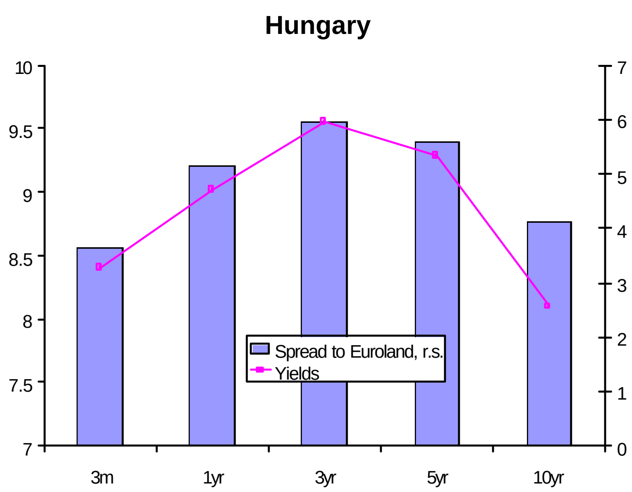




Source: Bloomberg

Benchmarks





Appendix Forwards

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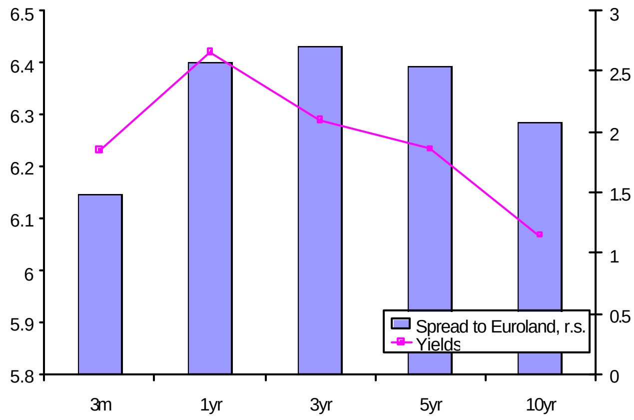
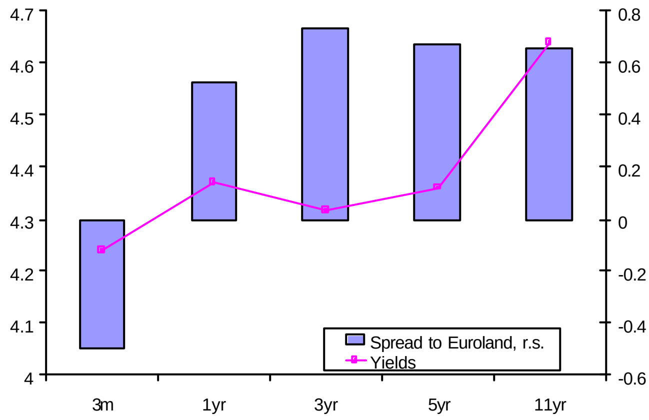
Poland



Slovakia



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