CEE Research

April 18, 2008

# Fixed Income and Foreign Exchange

# CEE Insights

- **Croatia:** March CPI inflation down slightly to 5.7% y/y
- **Czech Republic:** 1Q looks to have been stronger than expected
- **Hungary:** Ministry of Finance confirmed 4% of GDP deficit goal for 2008
- **Poland:** Market expectations of April rate hike have weakened
- **Romania:** C/A deficit slowed down significantly in first two months of 2008
- **Slovakia:** Slovakia met nominal inflation criterion, sustainability still uncertain

# Overview

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## Croatia:

- March CPI inflation down slightly to 5.7% y/y
- Bond market in sleep mode, exchange rate in stable band

## Czech Republic:

- 1Q looks to have been stronger than expected
- Retail sales growth solid

## Hungary:

- Strong wage upsurge in February
- Ministry of Finance confirmed 4% of GDP deficit goal for 2008

## Poland:

- Market expectations of April rate hike have weakened
- Deputy FM Gomulka stepped down

## Romania:

- Consolidated budget deficit still in surplus
- Central bank plans to speed up savings
- C/A deficit slowed down significantly in first two months of 2008
- RON tested 3.60 threshold

## Slovakia:

- Slovakia met nominal inflation criterion, sustainability still uncertain
- Fiscal deficit in 2007 well below convergence limit
- Debt agency: Probability of Eurobonds in 2008 declined

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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 | 25.02 | 0.0% | 1.6% | 6.1% | | | |
| | 3Y (yield bp) | 4.17 | 2 | 0 | -15 | 43 | 95 | 41 |
| | 10Y (yield bp) | 4.72 | -1 | 7 | -2 | 65 | 89 | 53 |
| **Croatia** | EUR/HRK | 7.26 | 0.1% | 0.0% | 0.6% | | | |
| | 3Y (yield bp) | 5.66 | -1 | -13 | 35 | 196 | 284 | 140 |
| | 10Y (yield bp) | 5.77 | 0 | -3 | 24 | 170 | 215 | 135 |
| **Hungary** | EUR/HUF | 253.72 | -0.9% | 1.3% | -0.2% | | | |
| | 3Y (yield bp) | 9.08 | -14 | -3 | 153 | 535 | 587 | 365 |
| | 10Y (yield bp) | 7.97 | 1 | -11 | 86 | 389 | 432 | 290 |
| **Poland** | EUR/PLN | 3.43 | 0.1% | 3.0% | 5.1% | | | |
| | 3Y (yield bp) | 6.22 | -7 | -10 | 3 | 248 | 308 | 229 |
| | 10Y (yield bp) | 6.01 | -6 | -11 | 5 | 194 | 226 | 176 |
| **Romania** | EUR/RON | 3.61 | 0.7% | 3.2% | -0.9% | | | |
| **Slovakia** | EUR/SKK | 32.43 | -0.4% | 0.0% | 3.5% | | | |
| | 3Y (yield bp) | 4.38 | 8 | 21 | -21 | 51 | 104 | 52 |
| | 11Y (yield bp) | 4.68 | 6 | 11 | -14 | 59 | 86 | 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. (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | buy EURFRA9x12 | 04/04/08 | EURFRA 9x12 | 4.04 | 4.31 | | | | spread | | |
| 22 | sell SKKFRA9x12 | | SKKFRA 9x12 | 4.22 | 4.35 | | | | 0bp | | |

## Rationale at inception

**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% |
| 21 | Short USD/RON | 02/04/2008 | 10/04/2008 | 3.90% |

***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** | 25.0 | 25.0 | 7.26 | | 254 | | 3.42 | 3.42 | 3.62 | | 32.4 | 32.4 | 3.75 | 4.97 | 8.00 | 5.75 | 9.50 | 4.25 |
| **Jun-08** | 25.1 | 25.0 | 7.20 | 7.20 | 255 | 253 | 3.60 | 3.43 | 3.65 | 3.67 | 32.5 | 32.4 | 3.75 | 4.50 | 8.00 | 6.25 | 9.50 | 3.75 |
| **Sep-08** | 26.1 | 25.0 | 7.25 | 7.25 | 256 | 256 | 3.51 | 3.45 | 3.58 | 3.74 | 32.5 | 32.4 | 4.00 | 4.25 | 8.00 | 6.25 | 9.50 | 3.50 |
| **Dec-08** | 26.4 | 25.0 | 7.30 | 7.30 | 256 | 258 | 3.45 | 3.46 | 3.50 | 3.80 | 32.5 | 32.3 | 4.00 | 4.00 | 7.75 | 6.25 | 9.00 | 3.50 |
| **Mar-09** | 25.9 | 25.0 | 7.25 | 7.25 | 255 | 261 | 3.40 | 3.48 | 3.50 | 3.86 | - | 32.3 | 4.00 | 4.00 | 7.50 | 6.25 | 8.25 | - |

| | 3m Money Market Rate | | | | | | | | | | 10y Govt. Yield | | | | | 5 y Yield |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CZ | Forward | HU | Forward | PL | Forward | RO | Forward | SK | Forward | CZ | HR | HU | PL | SK | |
| **Spot** | 4.09 | | 8.19 | | 6.32 | | 12.1 | | 4.26 | 4.26 | 4.72 | 5.77 | 7.97 | 6.01 | 4.67 | 10.5 |
| **Jun-08** | 4.03 | 4.17 | 8.20 | 8.54 | 6.45 | 6.43 | 10.0 | 9.4 | 3.85 | 4.38 | 4.70 | 5.60 | 7.60 | 5.90 | 4.65 | 10.1 |
| **Sep-08** | 4.06 | 4.05 | 7.80 | 8.57 | 6.45 | 6.43 | 10.0 | 8.2 | 3.70 | 4.37 | 4.60 | 5.40 | 7.00 | 5.90 | 4.65 | 9.6 |
| **Dec-08** | 4.09 | 4.07 | 7.60 | 8.45 | 6.45 | 6.31 | 9.0 | 5.3 | 3.70 | 4.35 | 4.70 | 5.30 | 6.70 | 5.55 | 4.65 | 9.3 |
| **Mar-09** | 4.14 | 3.98 | 7.50 | 8.20 | 6.35 | 6.24 | 8.5 | 5.1 | - | 3.75 | 4.80 | 5.20 | 6.60 | 5.45 | 4.70 | 8.6 |

## Long-term forecasts

| GDP growth (%) | 2006 | 2007e | 2008f | 2009f |
|---|---|---|---|---|
| Czech Republic | 6.4 | 6.6 | 4.3 | 5.4 |
| Croatia | 4.8 | 5.6 | 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 | 4.2 | 4.0 |
| 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 | 10.0 | 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 | -7.9 | -8.6 | -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 | -4.1 | -3.8 |
| 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** | No data releases scheduled | | | |
| **Croatia** | 22-Apr | Industrial production | 4.9% y/y | |
| | 22-Apr | Unemployment rate | 14.4% | |
| **Hungary** | 23-Apr | Retail sales | -3.4% y/y | |
| **Poland** | Apr-18 | PPI, y/y, March | | 3.2% y/y |
| | Apr-22 | Retail Sales,y/y, March | | 20.5% y/y |
| | Apr-22 | Unemployment, March | | 11.3% y/y |
| **Romania** | No data releases scheduled | | | |
| **Slovakia** | No data releases scheduled | | | |

**Sources: Bloomberg, Reuters*

## Auction diary

| Country | Code | Auction-date | Pay-date | Maturity | Cupon | Offer | Forecast |
|---|---|---|---|---|---|---|---|
| **Czech Republic** | | No auction scheduled | | | | | |
| **Hungary** | | Apr-22 | Apr-30 | 30-Jul-08 | | HUF 40mn | |
| | | Apr-24 | Apr-30 | 24-Jun-19 | 6.5% | HUF 40mn | |
| **Poland** | | No auction scheduled | | | | | |
| **Romania** | T-bills | Apr-23 | Apr-25 | 1Y | - | RON 600mn | 9.50% |
| **Slovakia** | | No auction scheduled | | | | | |

# Major Markets

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## Major markets

***Hawkish statements from Axel Weber weigh on market***

Economic data for Euroland was mixed last week, showing a downside surprise in the ZEW Survey and higher than expected inflation. Elsewhere, the growth data was more upbeat, showing still strong growth in China (for example) and slightly better figures for the US. However, the main topic this week was the speech of ECB Council member Axel Weber yesterday, in which he indicated that the Council should assess whether the current interest rates are high enough to secure price stability. As wage agreements go ahead in Germany, the outcome of between 3.5% and 4.5% wage increases over two years still seem tolerable to us, but for the German Bundesbanker, this seems too high. Furthermore, Weber assessed the German growth rate for the first quarter at 0.75% q/q, which would beat the quarterly growth rates of 2007. Yields on two-year bonds increased by 30 basis points and yields on 10-year bonds were up by 20 basis points during the week. An interest rate hike seems very unlikely to occur this year, but of course the chances for interest rate cuts decrease on the back of such statements. Next week, the main focus will be on the Ifo Index and the first readings of the Purchasing Manager Indices. The Ifo has shown three consecutive increases since the beginning of the year, which is normally an indication of an economic upturn. However, there were differences in the two components. The expectation component increased in January and March, but decreased in February. So, for April, a small decline seems the most probable outcome. The even higher euro exchange rate and further lurch in commodity prices do not engender rising optimism. Furthermore, first quarter results from Ambac, Credit Suisse and American Express will gain attention.

***Sentiment improvement mirrored by higher yields***

After a series of slightly better than expected economic data this week, the upcoming indicators from the housing market will be the most watched in the coming days. Existing home sales on Tuesday are expected to show a minor decline, and the same is estimated for new home sales on Thursday. This outcome would add to speculation that the housing market and the economy are building a bottom. On the other side, the recovery of durable goods orders scheduled for Thursday is expected to have been moderate in March. So, the outlook for corporate investment will remain subdued. The final number of the Univ. of Michigan Index, while unlikely to trigger a market reaction, will remind markets of the risks for the further development of consumer spending. Bond markets have reacted relatively strongly to the recent data. Still, this year's yield high (10Y) was not reached, but the upper boundaries of recent trends have gotten pretty close. We think that if the indicators come out as expected, yields will not go up further. Positive surprises could trigger a bond sell-off, also fuelled by technical factors. The dollar continued to slide this week and is vulnerable to further losses, mainly due to the dynamic of the movement, not the upcoming indicators.

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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 | 4.78 | | 2.82 | | 4.08 | 3.74 | 1.587 | |
| **Jun-08** | 4.00 | 2.25 | 4.00 | 4.88 | 2.00 | 2.89 | 4.00 | 3.80 | 1.52 | 1.583 |
| **Sep-08** | 3.75 | 1.75 | 3.75 | 4.70 | 2.10 | 2.90 | 4.30 | 4.20 | 1.47 | 1.576 |
| **Dec-08** | 3.50 | 1.75 | 3.70 | 4.65 | 2.20 | 2.89 | 4.50 | 4.40 | 1.40 | 1.570 |
| **Mar-09** | 3.75 | 2.00 | 4.00 | 4.22 | 2.30 | 3.04 | 4.60 | 4.60 | 1.38 | 1.564 |

## Croatia

***March CPI inflation down slightly to 5.7% y/y***

The March CPI figure showed some easing on the annual level, as the inflation rate moderated by 0.1% to 5.7%. The figure posted a strong 0.6% m/m increase, which was largely expected, while the structure of the pressure offered little surprise. Clothing and footwear prices brought a strong uptick, increasing by 4.3% m/m, after the end of the sales season. Food and beverage prices, after declining in February, showed a slight increase of 0.2% m/m. While CPI has recently been supported by the government action plan to prevent food price increases in the coming months, we expect food prices to continue to create pressure, keeping the CPI figures at an elevated level. Higher gasoline prices also generated pressure in March, as transportation prices increased by 1.3% m/m. The abandonment of retail gasoline price caps and negative trends on global markets are pointing to a more direct transmission channel for higher oil prices into CPI figures, thus having a negative effect on the CPI figures. Also, the announced hikes in regulated prices (gas and electricity) in 2H08 are not supporting significant easing in 2H08. We still expect the y/y figure to fall towards the year-end, due to the strong base effect. However, on average, we continue to anticipate the CPI at above 5% in 2008.

***Bond market in sleep mode, exchange rate in stable band***

In the past few weeks, the domestic bond market has seen little volatility and low turnover, as the majority of investors have been focusing on the turbulent stock exchange movements. Hence, yields on kuna bonds remained stable, after a decline in the preceding weeks. Money market conditions remain supportive, as liquidity is high. Nevertheless, large dividend payouts and higher demand for kuna liquidity as the tourist season approaches could change that. Coupled with the poor real interest rate outlook for much of 2008, the bond market should not have significant support. Nevertheless, we see a lower bond supply than in previous years and CPI moderation towards the year-end as factors that should support the bond market and bring the yields below the 5.5% threshold. The exchange rate continued to perform in a stable manner, staying in the 7.25-7.28 range, with pressure slightly more on the appreciation side. This is where we expect it to remain in the coming months, eventually bringing the exchange rate into the 7.20-7.25 region during the tourist season.

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## Czech Republic

***1Q looks to have been stronger than expected***

No macro data releases are scheduled for next week. In the past week, current account and retail sales figures brought a further indication that 1Q is likely going to be stronger than expected at the end of last year. The current account ended with a surplus of CZK 11.78bn in February, largely in line with our expectation (CZK 10.2bn) and above the market estimate (CZK 5.9bn). This was due to the extraordinary result of the trade balance (in February: CZK 14.3bn), as well as the balance of services and balance of transfers (which included the surplus of CZK 4.4bn EU/CZ transfers). The balance of revenues (comprising dividends and labor income of foreign workers) posted (as usual) a deficit that was covered by foreign investment (amounting to CZK 13.84bn). The current account thus remains a factor for strengthening of the CZK, albeit surely not a decisive one in the current environment. The strong current account reflects the solid foreign trade results, where the CZK does not seem to have had much of an impact as of yet (one hypothesis is that most of the big exporters are hedged, so the strengthening CZK does not affect them). The slowdown in the EU should bring a slowdown of Czech exports. The CZK should have a similar effect eventually, but since it is hard to establish the impact of hedging, this might take a while.

***Retail sales growth solid***

Retail sales kept up the pace in February - while certainly not racing ahead at 20% as in Poland, 6.3% real growth (incl. cars) is still a very solid number (our estimate: 5.0%, market: 4.8%). This indicates that the reform package and higher inflation have not substantially eroded the purchasing power of consumers so far. A significant contribution to the overall growth rate came from the car segment (car sales & repair, up by 8.8%, fuel sales up by 7.1%). This segment has thus been growing continuously for over two years now. Other growth drivers included electronics (the strong CZK spurs sales) and furniture (strong demand for housing persists). Surprisingly strong retail sales is another piece of data that points toward a solid Czech economy (others included the trade balance in a double-digit surplus and industrial production at a double-digit growth rate). Industrial growth, driven by demand from the EU, leads to increases in workers' pay (nominal wages up by 13.1% in February, 12.2% in January), which is naturally reflected in retail sales. If the demand for Czech exports (=industrial production) does not slow down, this year's reform (which lowered the aggregate income of households) might not have as big an impact on the economy as originally estimated. Certainly, the 1Q data appears to indicate stronger than expected growth, making it another argument for the CNB to be on alert.

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## Hungary

***Strong wage upsurge in February***

February wage figures surprised negatively, as, after January's 1.5% y/y decline, gross wages in February posted a robust 13.4% y/y increase. Gross wages in the private sector accelerated to 14.4% y/y, from 9.7% in January, due to bonus payments (mostly in the financial sector). After a 14.6% y/y decline in January, the public sector increased 11.8% y/y (affected by the changed bonus payment scheme in the public sector). The more important wage figures ex-bonus payments rose to the double-digit region, increasing by 10.4% y/y, and thus accelerating from 8.7% y/y in January. This puts pressure on the MPC and increases the risk of a rate hike as soon as at the April meeting.

***Ministry of Finance confirmed 4% of GDP deficit goal for 2008***

According to the MoF figures, the March budget deficit of HUF 326bn came in slightly better than expected (HUF -344bn). Regarding April, the deficit is expected at a minor HUF 13bn, while the 1H08 budget gap is expected to widen to HUF 803bn, or 2.9% of GDP. The MoF confirmed the FY08 expected budget deficit at HUF 1,110bn, or 4% of GDP.

After some gains at the end of last week and the beginning of this week, the forint lost some ground, due to the S&P downgrade rumors. On the other hand, the higher than expected wage figures and risks related to possible rate hikes were supportive of the forint.

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## Poland

***Market expectations of April rate hike have weakened***

Both the average salary and consumer prices were lower than expected. This somewhat weakened the expectations of an April rate hike. We still prefer a scenario of two hikes in the second quarter; thus, we think that an April hike is quite likely. Our stance is supported by several speeches by monetary council members. Noga, Wasilewska-Trenkner and Filar supported further tightening. Noga said that one more rate hike could be enough to stem inflation. He prefers a faster rate hike than a wait-and-see approach. Wasilewska-Trenkner warned that the basis for second-round effects is taking shape. Filar sees a need for an interest rate hike if present macroeconomic trends continue. The NBP must show its inflation fighting resolve, according to Filar. All of the mentioned MPC members are known hawks, so their stance should not be a surprise. Another MPC member, Czekaj, whose vote is considered uncertain and who is regarded as a key swing voter, said that the inflation data is neutral form the point of view of the central bank's monetary policy. He also said that a further deceleration of wage growth could be expected and that slower growth of the Polish economy could make further interest rate increases unnecessary.

***Deputy FM Gomulka stepped down***

Deputy Finance Minister Gomulka resigned. Gomulka was appointed last January to help push through spending cuts. Finance Minister Rostowski said in a statement that he regrets Gomulka's decision. Gomulka said after his resignation that poor cooperation between Prime Minister Tusk and the Finance Ministry may endanger Poland's bid to meet euro-adoption criteria in the timetable outlined by the government in March. Poland should be able to join the pre-adoption exchange rate mechanism next year and drop the zloty in 2012, according to Rostowski. The Economy Ministry said on its website that inflation should quicken in the coming months, due to rising food prices. Inflation should peak in August.

Expectations about further interest rate developments are an important factor for the zloty. However, the currency was driven mainly by regional sentiment this week. The zloty weakened slightly, in step with its regional peers. Next week's retail sales numbers could somewhat reinforce rate hike expectations if they confirm the expected continued strength, thus supporting the zloty. However, the main driver of exchange rate developments should come from main world markets and changes in risk aversion, as in previous weeks.

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## Romania

***Consolidated budget deficit still in surplus***

Romania's consolidated budget deficit was still in surplus in 1Q08. At the end of February, the consolidated budget deficit was 0.2% of GDP, which was maintained at the end of March. The government targets a budget deficit of 2.3% of GDP in 2008. Later this year, it plans to revise its 2008 budget for the second time (most likely in June), but the planned deficit target will likely remain unchanged. As the previous years' experience proved, a large budget deficit occurs at the end of the year. Better performance in tax collection and a tighter budget policy led to a surplus in March. We expect the government to make improvements in infrastructure and build up capacity to spend public funds in an efficient manner.

***Central bank plans to speed up savings***

Recently, central bank officials said that the NBR will change its role in the banking system. Currently, the NBR mainly draws deposits from banks, but the situation will change and the NBR will become a creditor for the banking system. As a result, the interbank market will change gradually from a market with a liquidity surplus into a market with a liquidity deficit. However, in order to perform repo transactions with the NBR, banks need to have a significant portfolio of government securities as collateral for the required loans. So far, the banks' portfolio of government securities is rather low. We could thus see a temporary liquidity squeeze on the inter-bank market. On one hand, this could lead to an increase in interest rates. On the other hand, it could re-launch the savings process, with banks forced to focus more on the local market in order to secure funds.

***C/A deficit slowed down significantly in first two months of 2008***

The C/A deficit reached EUR 2.2bn in January-February, increasing by just 5.6% y/y. This is a sharp decline of the external imbalance and good news for Romania, as the C/A deficit had widened by 66% in 2007. Considering the monthly data for February alone, the C/A deficit went down by 4.2% y/y. The trade balance saw a considerably improved performance during the last few months and February was the third month in a row in which exports grew faster than imports. A strong base effect and the weak RON contributed to an import decline, while the export acceleration was determined by the improved supply of the local manufacturing industry, following significant FDIs in recent years. Retail trade remained high in early 2008 and we believe that the demand was covered more on the domestic side, in line with the decline in imports. The income balance deficit widened by 15.8% y/y. Net current transfers, which include remittances from Romanians working abroad, increased by 3.9%. Total inflows of EUR 1.2bn during the first two months prevented the RON from falling further amid the heavy turbulence on international financial markets. FDIs stood at EUR 1.2bn and covered 55.5% of the C/A deficit, up from the 2007 level (around 42%). We expect even higher FDIs in the coming months, as the government will complete the privatization of the last state-owned companies.

***RON tested 3.60 threshold***

This week, the RON managed to hold on to its earlier gains and again tested the 3.60 psychological zone, which held. The transacted volumes were substantial, but the volatility has decreased as market players could not decide whether to take the pair below the 3.60 support level. This week, the trading has been choppy and the EUR/RON consolidated in the 3.60-3.64 zone. The pressure exerted by the Romanian money market on the pair has eased down this week, as the short-term interest rates (ON, TN) decreased slightly, although the central bank has set up several deposit auctions this week. On Monday, the NBR held its regular 2-week deposit auction, but the interest of the banks was limited, as they placed only RON 6mn with the NBR. In the following days, the central bank organized deposit auctions each day, draining an overall amount of RON 4bn from the interbank market (for maturities shorter than one week). It is likely that short-term interest rates will increase next week, as the beginning of a new reserve period will coincide with the quarterly budget payments and the Easter celebration. Therefore, commercial banks will need a lot of liquidity. The leu might break the 3.60 threshold this week, amid scarce liquidity conditions, if the regional climate is favorable.

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## Slovakia

***Slovakia met nominal inflation criterion, sustainability still uncertain***

March harmonized inflation reached 3.6% on the year, in line with the indication from the earlier-released CPI. The 12M average, to be used for evaluation of the Maastricht criterion, was recorded at 2.2%, well below the reference limit (standing at 3.2%). Hence, Slovakia met the nominal Maastricht inflation criterion. However, the European authorities will also assess the sustainability of price performance, which remains the sole critical point in Slovakia's euro adoption. Speaking in Slovakia's favor is the big buffer below the criterion and possibly the fact that Slovak March inflation was the same as in the Eurozone. Speaking against is the impact of the exchange rate, which helped to reduce inflation in past years, as well as the negative perception of inflation acceleration in Slovenia after that country's euro adoption. Nevertheless, we see a high probability of a favorable assessment overall. Please note that, if sustainability is used as an argument against Slovakia's euro adoption, this would probably preclude EMU entry for other new EU member states as well for a longer time (since this argument could be used against all converging economies).

***Fiscal deficit in 2007 well below convergence limit***

The Slovak Statistical Office released the final 2007 fiscal deficit figure this morning - it reached 2.2% of GDP and was well below the required 3.0% convergence limit. The public debt is only around half of the required maximum of 60% of GDP in Slovakia. The public finance deficit for this year was originally budgeted with a deficit of 2.3% of GDP, but the government later signed an agreement declaring the aim to reduce the deficit further to 2.0% of GDP.

***Debt agency: Probability of Eurobonds in 2008 declined***

According to the head of the state debt agency, Daniel Bytcanek, the probability of a Eurobond issue, which had been planned for this year, has declined, due to the global financial crisis, which widened credit spreads and made new debt more expensive. Earlier, the agency planned to issue Eurobonds worth EUR 1bn, similarly to the previous two years. Our earlier estimate of this year's total gross issuance was around SKK 90-95bn, including Eurobonds and any possible T-bills (the debt agency had a clear preference for bonds in recent years, as it had not held a T-bill auction since late 2005). After the government approved the new fiscal framework with a lower general government deficit in 2008, the issuance could be slightly smaller (some SKK 80 90bn).

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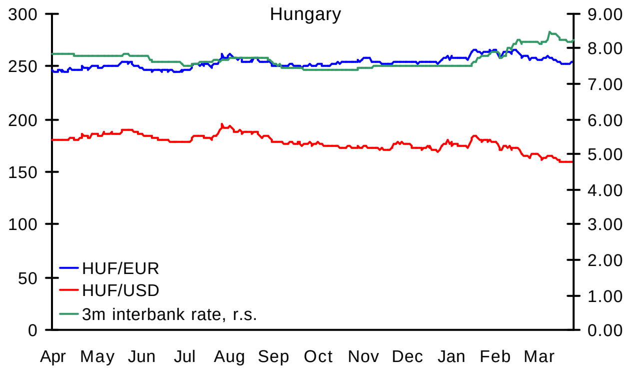
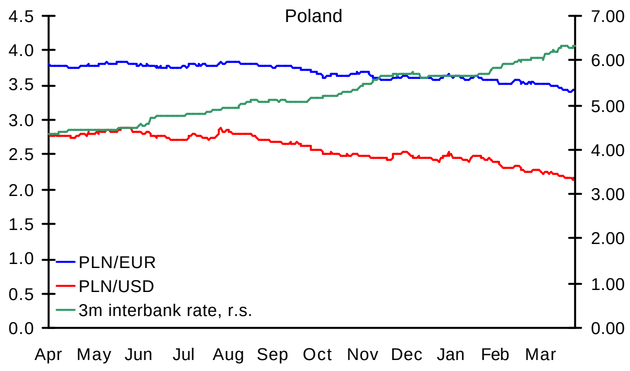
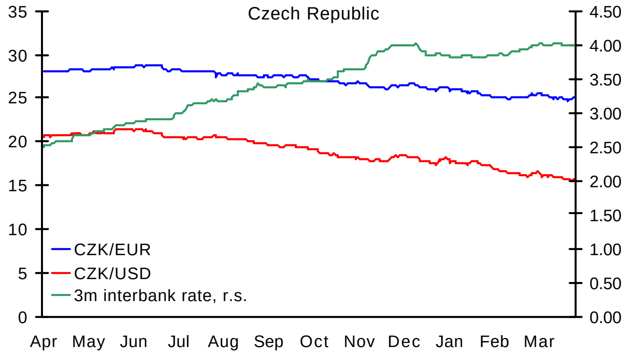
# Appendix Charts

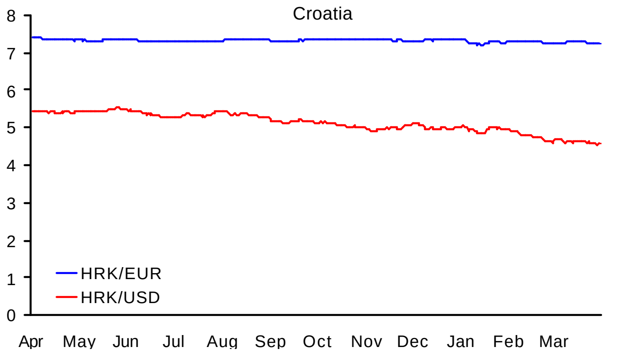
*http://global.treasury.erstebank.com*

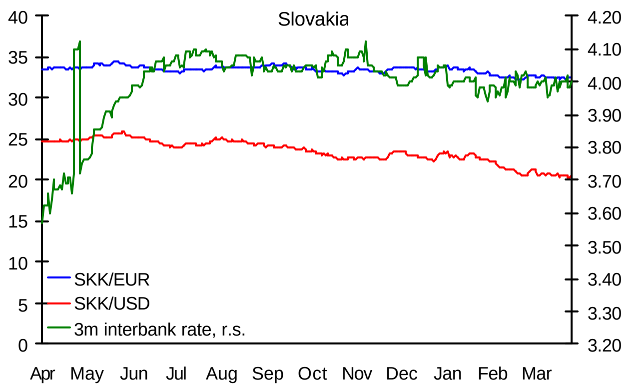
## Exchange rates and interest rates (52 weeks)

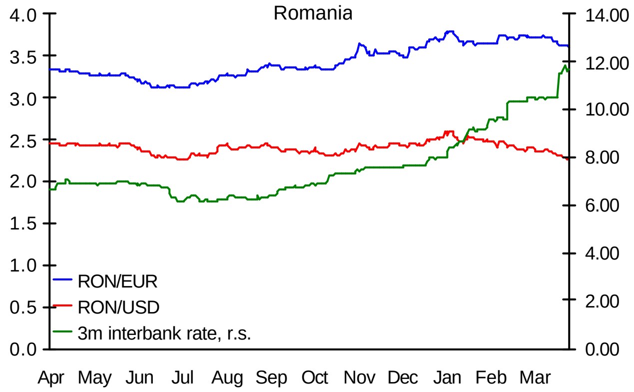



*Source: Bloomberg*

## Benchmarks

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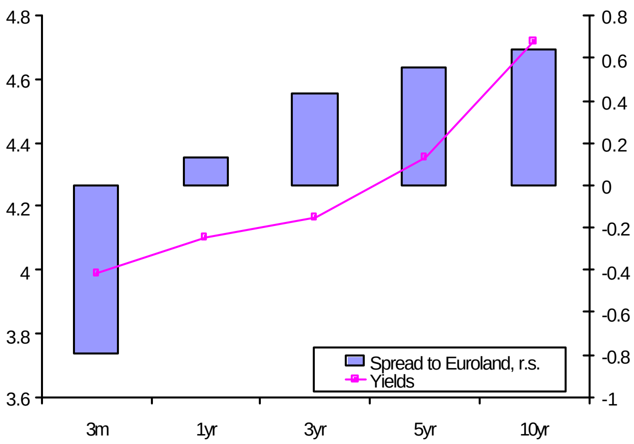
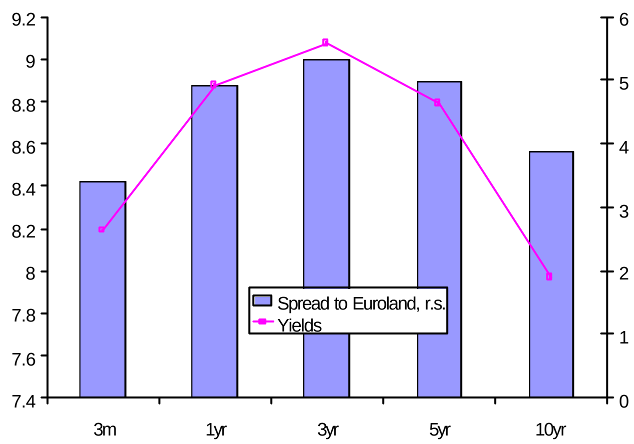
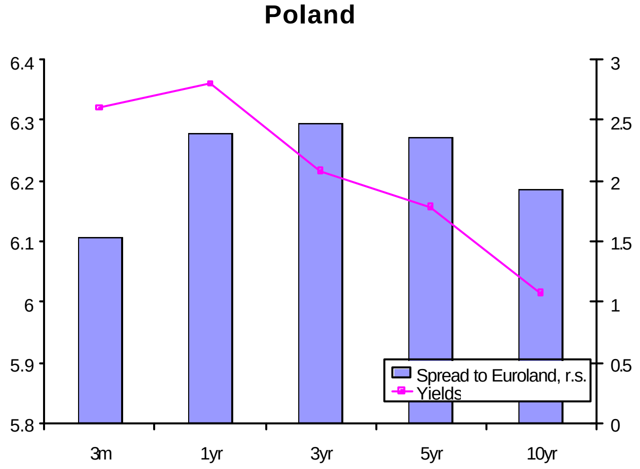


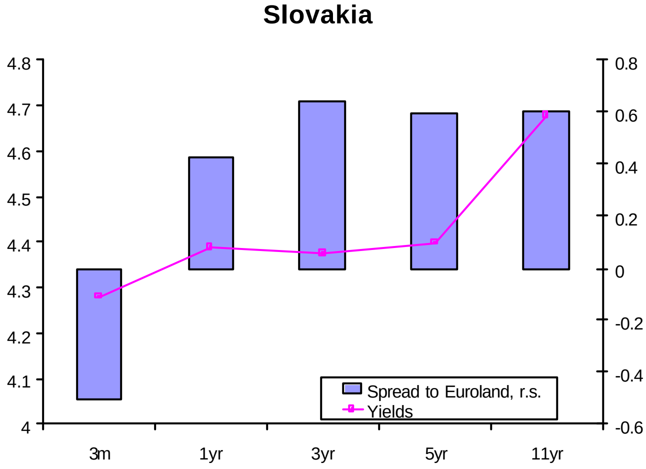

**Hungary**



# Appendix Forwards






**Published by Erste Bank der oesterreichischen Sparkassen AG Börsegasse 14, OE 543 A-1010 Vienna, Austria. Tel. +43 (0)50100-ext.**

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