May 16, 2008

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** CPI inflation remained flat at 5.7% y/y in April
- **Czech Republic:** Industrial production saw first y/y decrease in 5.5 years
- **Hungary:** Both GDP and CPI met expectations
- **Poland:** Early 2009 too soon for ERM II entry
- **Romania:** Elevated yields offer support to Romanian currency
- **Slovakia:** Koruna surpasses all-time highs, conversion rate seen stronger

Overview

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Croatia:

- CPI inflation remained flat at 5.7% y/y in April
- Retail sales dipped in March to -0.3% y/y in real terms

Czech Republic:

- 1Q GDP growth in line with expectations
- CPI slowed down in April
- Industrial production saw first y/y decrease in 5.5 years

Hungary:

- Both GDP and CPI met expectations
- Forint fluctuating around 250

Poland:

- CPI up in April
- MPC members in wait-and-see mode
- C/A deficit widened
- Early 2009 too soon for ERM II entry, according to Governor Skrzypek

Romania:

- C/A deficit increased by 10.9% y/y in 1Q08
- Elevated yields offer support to Romanian currency
- Romania sold 6M treasury bills for average yield of 10.61%

Slovakia:

- Economy continues in strong growth
- Koruna surpasses all-time highs, conversion rate seen stronger
- Inflation ticked up to 4.3% in April, on back of food prices
- Strong employment growth likely supported consumption

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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	25.05	0.3%	-1.1%	5.9%			
	3Y (yield bp)	4.32	4	0	0	53	58	41
	10Y (yield bp)	4.84	13	18	10	71	76	53
Croatia	EUR/HRK	7.250	0.1%	0.1%	0.7%			
	2Y (yield bp)	5.63	0	-4	32	166	221	140
	9Y (yield bp)	5.80	0	3	26	157	183	135
Hungary	EUR/HUF	249.5	1.2%	1.0%	1.5%			
	3Y (yield bp)	9.08	6	-88	153	530	644	365
	10Y (yield bp)	8.10	13	-4	99	398	424	290
Poland	EUR/PLN	3.395	0.4%	0.5%	6.0%			
	3Y (yield bp)	6.16	-3	-5	-3	238	269	229
	10Y (yield bp)	5.98	-1	-4	1	186	207	176
Romania	EUR/RON	3.660	0.8%	-1.0%	-2.3%			
Slovakia	EUR/SKK	31.63	1.2%	2.1%	6.1%			
	3Y (yield bp)	4.47	5	17	-12	38	71	52
	9Y (yield bp)	4.73	4	9	-9	53	66	48
Ukraine	EUR/UAH	7.41	-0.4%	5.8%	-0.5%			
	3Y (yield bp)	10.70	0.2	1.5	3.2	676	564	361

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. (%)
	05/05/08	3m Pribid/ 3m Euribor	3,99/4,86%			-1.00%	-33.3%	26.2	4.0%	16.0%
23 long EUR/CZK		EUR/CZK	25.25	24.99	-1.03%					

Rationale at inception

23) CZK has been off its fundamental value for some time now (and its current level is also still inconsistent with expectations regarding future rates, as embodied in FRAs, and inflation). On top of that, CZK (thanks to its indirect exposition to US) is a quasi safe-haven in the times when the US economy is going through one of its toughest periods in recent 20 years. We see two possible triggers of correction - dollar turnaround (possibly underway now, also - expected bottom in US rates should stop to damage the greenback) and dividends outflow. Gradually, worse data from region should also start coming in (slowdown in EU will trickle through into CEE).

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%
22	Buy EURFRA, sell SKKFRA	04/04/2008	18/04/2008	26bp

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													
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	UAH	Forward
Spot	25.1		7.25		250		3.40		3.68		31.5	31.5	7.4	-
Jun-08	25.5	25.0	7.22	7.22	255	251	3.60	3.41	3.65	3.69	31.5	31.5	7.4	7.5
Sep-08	26.2	25.0	7.25	7.25	256	253	3.51	3.42	3.58	3.75	31.5	31.5	7.1	7.8
Dec-08	25.9	25.0	7.30	7.30	256	256	3.45	3.43	3.50	3.81	31.5	31.4	6.7	8.0
Mar-09	26.0	24.9	7.25	7.25	255	258	3.40	3.44	3.50	3.86	-	31.4	6.6	8.2

	Intervention Rate							3m Money Market Rate											
	CZ	HR	HU	PL	RO	SK	UA	CZ	Fwd	HU	Fwd	PL	Fwd	RO	Fwd	SK	Fwd	UA	Fwd
Spot	3.75	5.10	8.25	5.75	9.75	4.25	12.00	4.14		8.54		6.41		11.15		4.33	4.33	16.10	-
Jun-08	3.75	4.75	8.50	6.25	9.75	4.00	12.00	4.03	4.20	8.35	8.82	6.45	6.50	10.04	9.79	4.50	4.38	15.25	-
Sep-08	4.00	4.25	8.50	6.25	9.75	3.75	12.00	4.06	4.05	8.20	8.96	6.45	6.57	9.96	8.49	4.30	4.55	14.00	-
Dec-08	4.00	4.00	8.25	6.25	9.50	3.50	12.00	4.09	4.17	8.10	8.88	6.45	6.45	9.50	6.27	4.10	4.49	13.50	-
Mar-09	4.00	4.00	8.00	6.25	8.50	-	-		4.17	7.90	8.72	6.35	6.21	8.70	4.93	-	4.05	13.00	-

	10y Govt. Yield					5y Govt. Yield	3y Govt. Yield
	CZ	HR	HU	PL	SK	RO	UA
Spot	4.82	5.80	8.10	6.14	4.72	10.20	10.7
Jun-08	4.70	5.70	7.90	5.90	4.65	10.10	11
Sep-08	4.60	5.60	7.70	5.90	4.65	9.60	11.2
Dec-08	4.70	5.50	7.20	5.55	4.70	9.30	10.4
Mar-09	4.80	5.40	6.90	5.45	4.80	8.40	-

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	7.6	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	7.8	7.6
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	6.9	6.5	6.1
CEE8 weighted average	**10.6**	**8.8**	**7.9**	**7.2**

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	-7.0
CEE8 weighted average	**-5.2**	**-6.0**	**-6.7**	**-6.8**

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	5.0	3.1
Poland	1.4	4.0	3.4	2.7
Romania	4.9	6.6	6.2	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	19.2	12.0
CEE8 weighted average	**4.2**	**6.6**	**6.1**	**4.5**

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	8.2	7.6
Poland	4.2	4.6	6.3	5.5
Romania	8.8	7.8	10.1	8.0
Serbia	22.1	11.3	11.2	10.0
Slovakia	4.3	4.3	4.0	4.2
Ukraine	13.5	9.6	14.5	12.0
CEE8 weighted average	**6.6**	**6.0**	**7.7**	**6.7**

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	19-May	Retail Sales, % y/y, March	5 % y/y	3.9% y/y
Croatia	20-May	Industrial production	7.3% y/y	
	21-May	Unemployment rate	14.1%	
Hungary	May-16	Minutes of the April monetary meeting	-	-
	May-23	March Retail sales	-2.2% y/y	-2.2% y/y
Poland	19.5.	Average Gross Wage,y/y %,April		11.5%
	21.5.-26.5.	Retail Sales, y/y %, April		19.1%
	21.5.-26.5.	Unemployment , %, April		10.6%
Romania	No data releases scheduled			
Slovakia	No data releases scheduled			
Ukraine	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		May-21	May-26	18/Oct/2012	3,55%	CZK 5bn	4.25%
Hungary		May-20	May-28	Aug-27-2008	-	HUF 40bn	8.50%
		May-22	May-28	Oct-24-2012	6.00%	HUF 50bn	8.90%
Poland		No auction scheduled					
Romania		22-May-08	26-May-08	5Y	8.25%	RON 100 mn	9.40%
Slovakia		No auction scheduled					
Ukraine		19-May	21-May	05-May-10	8.00%		7.70%
		19-May	22-May	28-Sep-11	9.50%		7.90%

Major Markets

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Major markets

Leading indicators to point downwards

GDP data for the first quarter surprised strongly to the upside. However, this robust start to the year will not bode well for the coming quarters. The figures for the second quarter will be depressed by a high basis in the first quarter, as well as a worsening of sentiment. Nevertheless, the market reacted with higher yields in the morning, although 10-year yields dropped back to below 4.2% in the afternoon. Next week, the bond market should get some support from further slight drops in the Ifo Index and the preliminary Purchasing Manager Indices. We expect both components of the Ifo Index - the current assessment and the expectation component - to show lower readings, on the back of a decline in order income and the further rise in commodity prices. On the other hand, the ZEW Survey could show a stable reading or even an increase, as risk aversion decreased significantly, with the effect that the pipeline for corporate bond issues seems to be opening again and yield spreads were quoted lower. The market seems to be building the opinion that the worst of the financial crisis is over.

Hardly any market impact expected from upcoming macro data

For this week, the Univ. of Michigan Index, housing permits and housing starts are still scheduled for release. We expect almost no impact from this data, as it is only to confirm the dire state of consumer sentiment and the construction sector. The releases scheduled for next week are also unlikely to have a lasting impact. The markets might try to do some between-the-lines reading of the FOMC minutes on Wednesday. But, in the end, the message should be confirmed that further cuts cannot be ruled out, but are highly unlikely. Initial jobless claims will give an indication of the status of the labor market as usual on Thursday. Finally, existing home sales will be released on Friday. Sales figures have stabilized during the last few months and inventories have dropped marginally. The upcoming data should be in line with these developments. Several Federal Reserve officials will give speeches; the most promising for any capital markets guidance should be Vice Chairman Kohn's, The Economic Outlook, on Tuesday. Bond markets look vulnerable, as a strong yield increase occurred after this week's retail sales. However, since the coming indicators are pretty much second-tier, we do not expect any breakout of yields from recent bandwidths. The dollar might get some support from Euroland indicators and technicals.

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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	2.00	4.86		2.72		4.21	3.84	1.547	
Jun-08	4.00	2.00	4.50	5.04	2.20	2.93	4.00	3.80	1.52	1.544
Sep-08	3.75	2.00	4.30	4.89	2.30	3.22	4.30	4.20	1.47	1.537
Dec-08	3.50	2.00	4.10	4.91	2.30	3.36	4.50	4.40	1.40	1.530
Mar-09	3.75	2.00	4.10	4.68	2.40	3.35	4.60	4.60	1.38	1.524

Croatia

CPI inflation remained flat at 5.7% y/y in April

April brought a continuation of the intensified inflation pressures, as consumer prices increased by 0.7% m/m, keeping the rate at 5.7% y/y. On the monthly basis, the pressure came from food and beverage prices (+1.1% m/m) and a seasonal increase of clothing and footwear prices, which added 2.8% m/m, while fuel and other energy prices had a neutral effect on the April inflation figures. In the coming months, the pressures should persist, as fuel and food prices should continue to negatively affect the inflation figures. Accompanied by the announced regulated price hikes (gas and electricity) in summer and spillover effects, we see the average inflation rate in 2008 moving towards the 6% region. Our current forecast stands at 5.8%.

Retail sales dipped in March to -0.3% y/y in real terms

After the solid January and February in terms of consumption spending, March brought an unexpected drop from 7.1% y/y in February to -0.3% y/y in March. While the first two months outperformed our expectations, March was well below our estimates, especially given the fact that the Easter holiday moved from April to March this year. Nevertheless, over 1Q, the picture did not deviate from our expectations that consumption's contribution to the growth would be more modest than in 2007, supporting a moderation of GDP growth to the 4-4.5% region in 2008.

In the last few days, the exchange rate strengthened, moving close to 7.25. However, the overall movement has been very gradual, thus not attracting the CNB's attention and falling in line with the mild appreciation pressures towards the beginning of tourist season. The bond market continued in a lethargic mood, offering neither more significant turnovers nor yield curve movements.

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Czech Republic

1Q GDP growth in line with expectations

Last week, the preliminary estimate of 1Q GDP growth was reported. The figure reached 5.4% (after 6.6% in 4Q07). This was roughly in line with the market expectation (at 5.5%) and our estimate (5.6%). The structure of the growth is not known yet, but we suspect the main drivers were still consumption and foreign trade (due to solid expansion abroad; Germany grew twice as fast as expected in 1Q08, while the Eurozone grew at over 2% y/y). Some of the slowdown is only technical - stocking up on medicines in 4Q07 (which added some half a percentage point to the growth in that quarter) might have subtracted something from the growth in this quarter. This, however, remains only a hypothesis and one will need to wait for the final data (due out in June) to confirm this.

CPI slowed down in April

Other important data was also reported last week, including CPI and industrial production. CPI slowed down a bit in April. The y/y growth rate slowed from 7.1% in March to 6.8%, while the m/m growth of prices was 0.4%. The m/m growth was driven primarily by natural gas and heating, as well as food prices (the two previous months saw a drop in prices, but now there was a rise - go figure!). On a y/y basis, food prices and housing related items (heating, gas and rents) drove the inflation. CPI remains uncomfortably high. What is surprising is the relatively slow response of the economy to the strengthening of the CZK (with 10% y/y appreciation of the CZK, we expected a faster decrease of inflation). This might be indicative of the existence of demand pressures in the economy (especially given the strong growth of the Czech economy in 1Q). We expect the inflation to slow down to around 5% towards the end of 2008.

Industrial production saw first y/y decrease in 5.5 years

The slowdown of industrial production that we expected last month materialized in this one. Industrial production experienced its first y/y decrease in 5.5 years. This was partly due to the higher base from the previous years and the different number of working days. Adjusting for these would send the industrial number figure for March into positive territory; the growth in this case would have been 2%. This slowdown was already hinted at by the recent foreign trade data, which turned out surprisingly weak (especially given the strong performance of foreign trade in the first two months of this year). The structure says a lot about the current trends of the Czech economy. A y/y drop was seen in the textile industry and the food, beverage and tobacco industry. On the other hand, the drivers of Czech industry (optics, electronics, vehicles and machinery) still grew (albeit modestly). It remains to be seen whether this already indicates the beginning of a slowdown of the Czech economy (which we previously forecast) or whether this (and March foreign trade data) were one-off factors that are soon to disappear. If further data confirms a slowing economy (due to lower demand from the EU, which was already indicated by the steady decrease of the volume of orders from abroad: January -1.2%, February -1.4%, in March -9%), then 2Q economic activity will be lower. This would then make the overall growth rate for 2008 close to 5%.

As for next week, only the retail sales figure is up for release. We expect growth of around 5%, but no impact on the markets.

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Hungary

Both GDP and CPI met expectations

Some important fundamental data was published this week, but without changing the base picture of the Hungarian economy. According to the CSO's flash estimate, GDP rose 1.6% y/y in the first quarter of 2008 (a bit higher than the consensus), after the 0.8% y/y seen in 4Q07. The picture suggested by the calendar-adjusted figures is gloomier, however. Taking the calendar effect into consideration, the economy grew by just 0.9% y/y in 1Q08, compared to 0.7% y/y in 4Q07. Thus, the adjusted figures did not show as significant an acceleration of growth as the unadjusted figures. Compared to the previous quarter, GDP rose 0.3%. The structure of the growth is not known yet. The breakdown of the figures will be available on June 6. As the most important export market, the higher than expected 1Q GDP growth in Germany suggested that the main driver of economic growth during the first quarter may have still been net exports in Hungary. On the other hand, the poor retail sales figures seen in the first quarter do not indicate the revival of private consumption for the time being.

The 12-month CPI inflation rate slowed slightly to 6.6% (from the 6.7% published for March), in line with expectations. Food prices again surprised negatively (on the upside), rising by 1.4% m/m in April, after a moderate increase of just 0.4% m/m in March. Thus, the relatively low April m/m index (0.4%) was on one hand due to the April abolition of doctor visit fees, which pushed the monthly price index of services into negative territory (-0.2% m/m). On the other hand, fuel prices slightly decreased, by 0.8% in April. It is not too favorable, however, that the seasonally-adjusted core rate accelerated to 5.6% y/y, from its March level of 5.3% y/y. This suggests to us that the central bank will carry out another 25bp rate rise in May, despite the fact that the increase in the core rate can almost totally be explained by the higher inflation of processed food. (The calculation of the core rate excludes only unprocessed food from the headline CPI in Hungary). Please note that, according to the CPI breakdown published by the central bank, the 12-month inflation of market services slowed to 5.4% (from the 6.4% seen in March), while inflation of the exchange rate-led industrial products stagnated at 1.4% y/y.

As for future prospects, 12-month inflation is expected to remain high in May, driven mainly by food and fuel prices, as well as accounting for the April increase in gas prices. A further slowdown should come in the summer months, but CPI is still expected to remain above 6% until September-October. Our year-end inflation forecast is 5% y/y.

Forint fluctuating around 250

On Monday (when domestic markets were closed), the forint strengthened below the psychologically important level of 250 EUR/HUF. The brighter outlook in the US, improving sentiment on major global money and capital markets and increasing risk appetite have played a decisive role in the stronger forint, which fluctuated around this level for the majority of the week. The expected 25bp hike in the base rate in May should mean important fundamental support for the exchange rate in the short run. Thus, the forint is expected to preserve its current strength in the near future.

Next week, the domestic macro calendar is almost empty. Without any important figure, the Thursday bond auction should be in focus for market participants, while in the second half of the week, the approaching monetary meeting (to be held on May 26) should gain greater attention among investors.

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Poland

CPI up in April

CPI rose on a y/y basis in April, in line with expectations. This means a stabilization of the y/y growth of prices. Part of the market considered such a development as the reason for the unchanged rates at the May Monetary Policy Council meeting. Our opinion is that the overall picture of the economy in the monetary policy horizon (especially the development of the output gap and wages) will be more important than the current inflation development. Thus, we do not rule out a rate hike in May, if the growth numbers are still strong and indicate a possible accumulation of inflation pressures.

MPC members in wait-and-see mode

This week, we had more statements from MPC members regarding the possible development of monetary policy. The first came from known dove Pietrewicz, who thinks that the MPC should wait at least until the June inflation projection before a rate hike. According to Pietrewicz, the central bank should refrain from action. The second comment came from known hawk Wasilewska-Trenkner, who stated that the inflation data was good, but that it was too early to draw a conclusion from it. She thinks that the MPC should see more data to decide.

C/A deficit widened

Poland's current account deficit widened to EUR 1.605bn, caused mainly by the wider trade balance deficit. Exports have been negatively affected by the slower growth of the world economy, while the Polish economy has been doing quite well. Also, higher commodity prices (especially oil) have had a negative effect on the trade balance. The worsening structure of the balance of payments could have a negative effect on the zloty. However, it is supported by the good overall economic story and relatively high interest rates for now. We expect a moderate correction of the zloty in the mid-term horizon, caused mainly by changing investor preferences, and not primarily by the worsening balance of payments. However, a weaker trade balance should support such a correction.

Early 2009 too soon for ERM II entry, according to Governor Skrzypek

NBP Governor Skrzypek said that early 2009 entry into the pre-euro exchange rate mechanism ERM II is unlikely. The central bank needs two weeks to do so, once the decision is taken. The central bank will complete a report on the costs and benefits of Poland's Eurozone entry at the end of 2008. Skrzypek said recently that Poland should postpone its Eurozone entry, due to the turbulence on world financial markets. Skrzypek and Finance Minister Rostowski have said it would become clearer in the second half of the year, when Poland should take a significant step towards euro adoption. The time horizon for euro adoption could influence the zloty exchange rate. The sooner Poland adopts the euro, the more pressure on zloty strengthening. The zloty could become a single target for convergence speculation after Slovakia enters the Eurozone, as the Czech Republic has not seen a strong push toward Eurozone entry and Hungary has a string of economic problems that should push back its Eurozone entry.

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Romania

C/A deficit increased by 10.9% y/y in 1Q08

The main determinant of the C/A deficit in 1Q08 was the trade balance deficit. Exports gained speed significantly in January-February, but the March figures were rather disappointing, in line with a slowdown in industrial production. Net current transfers went up by 33% y/y in 1Q08 and mitigated the negative development of the trade balance and income balance. March brought an all-time record in terms of monthly net current transfers. FDIs stood at EUR 1.7bn and covered some 48% of the C/A deficit. We expect higher FDIs in the coming months, following the privatizations of some state-owned companies. The C/A deficit as a % of GDP might remain more stable in 2008. The trade balance could have better results in 2008, as significant FDIs directed towards manufacturing should finally pay off. At the same time, we see some risks from a wider income balance deficit as a result of higher outflows of dividends, interest payments and possible slowdown in remittances inflow.

Elevated yields offer support to Romanian currency

The commercial banks have no interest in placing their liquidities for three months, due to the liquidity shortage on the Romanian money market. Only two commercial banks submitted bids worth a modest RON 21mn at the 3M certificates of deposits auction, demanding yields between 10.64% and 11%. As the offer did not meet the NBR's regulation of 75% of the indicative amount (RON 100mn), the NBR refused all bids. In the regular 1-week deposit auction, the central bank drained RON 2.45bn from the local money market. Only four commercial banks placed bids at the auction for the 9.75% fixed interest rate, denoting an uneven distribution of liquidity in the Romanian banking system. The local currency hit this week's maximum level of 3.64 on Wednesday, after the release of the results of the treasury bill auction, which offered some support to the RON.

Romania sold 6M treasury bills for average yield of 10.61%

On May 14, the MinFin held an auction for 6M discounted treasury bills worth RON 500mn. The overall offer of primary dealers reached RON 806mn, but the MinFin accepted only RON 271mn. This was the first time in the last three months that the MinFin accepted more than half of the initially planned amount. The MinFin decided to pay a maximum yield of 10.75%, while the average yield increased to 10.61%, from 9.49% at the previous auction. Next week, Romania intends to sell 5Y benchmark bonds worth RON 100mn, but we believe that there is little chance that the MinFin will accept any bids, considering the high yields requested by the market players recently. We maintain our view that the MinFin prefers to borrow for the short term, as there are expectations that the disinflation process will resume in the second semester of this year.

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Slovakia

Economy continues in strong growth

Last week's data deluge in Slovakia showed that the economy grew strongly in the first quarter (8.7% y/y), accompanied by gradually increasing inflation, although mainly driven by external factors, such as food prices. Nevertheless, demand-driven inflation pressures remain stable, albeit at higher levels than half a year ago. In March, the production side of the economy slowed down, mainly due to fewer working days than a year ago, while the demand side continued on a strong foot. Going ahead, production will increase back to the levels seen in the beginning of the year, positively affecting foreign trade. Economic growth in 2008 will likely exceed our earlier forecasts and might reach around 7.5% (as compared to our previous forecast of 6.7%).

Koruna surpasses all-time highs, conversion rate seen stronger

The koruna advanced to new all-time highs this week, driven by expectations of a strong conversion rate after top politicians hinted their preference for "as strong an exchange rate as possible." On Friday morning, the exchange rate was 31.49 EUR/SKK. We now expect a stronger final conversion rate than before (in the range of 32.2-32.8 EUR/SKK). The potential for further firming of the koruna will depend on the timing of the expected ERM II central parity revaluation (the conversion rate will be known in July, but, if revaluated, the new ERM II central parity will almost certainly be the level of the conversion rate). There might still be some firming potential for the koruna, unless the revaluation is delivered soon.

Inflation ticked up to 4.3% in April, on back of food prices

Looking at the data in more detail, consumer inflation increased to 4.3% in April, from an annual rate of 4.2% in March, against average market expectations for stagnation at 4.2% and our more optimistic forecast of moderation to 4.1%. On the month, the headline CPI index rose by 0.3%, largely owing to the higher food prices, which continue to pose the main upside risk to our inflation forecasts (we assume that a favorable harvest this year will help to bring the development of food prices back in line with the typical season later in the year). On the other hand, the stronger koruna represents a downside inflationary risk, especially to tradable goods. Harmonized inflation also ticked higher to 3.7% in April, up from 3.6% in March. The figure was slightly above the NBS forecasts, due to food prices, but the food items are out of the scope of the central bank's tools. Closely watched demand inflationary pressures remained rather contained in April. We are still convinced that the NBS will cut interest rates by 25bp in May or June (the call for the May cut would be strengthened if the ERM II central parity was already shifted this month), in order to finish the alignment of the NBS policy rates with the ECB interest rates.

Strong employment growth likely supported consumption

Real GDP growth reached 8.7% y/y in the first quarter of 2008, according to the flash estimate of the Slovak Statistical Office, outpacing our and market expectations (our estimate at 7.0% was on the pessimistic side of the market, which expected, on average, growth of 7.6%, according to an NBS poll, or 8.5%, according to a later-released Reuters poll). The employment growth stood at a strong 2.7% y/y. The Stats Office did not comment on the GDP growth structure; we assume that the growth was driven mostly by domestic demand, but net exports should have contributed positively as well. Given the high employment growth of 2.7% y/y, household consumption might have increased more than we had forecast (6% y/y). The slowdown of the economic growth from 14.3% seen in 4Q07 was expected, due to smaller excise tax intake from cigarettes (caused by the pre-stocking of cigarettes ahead of the January excise tax hike). The underlying growth remained strong and we will revise our full-year GDP forecasts to above 7% (from the previous 6.7% for 2008).

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Appendix Charts

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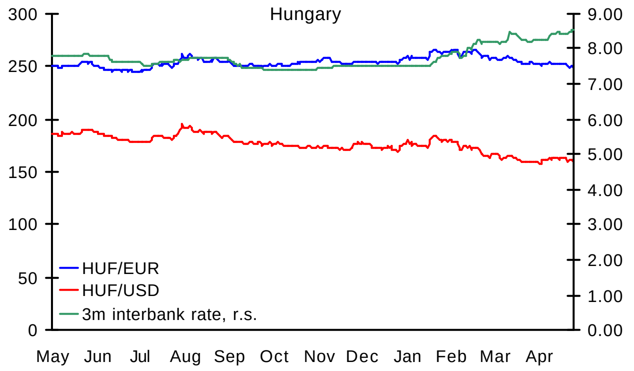
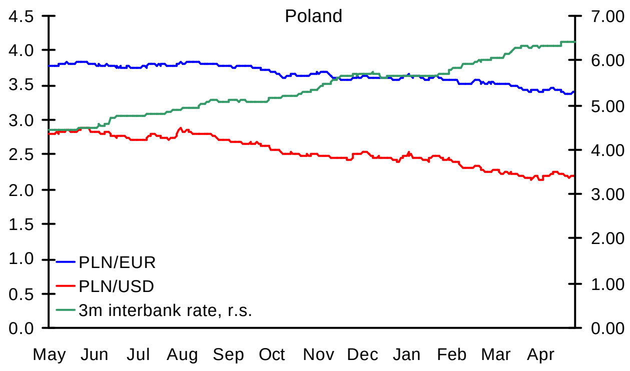
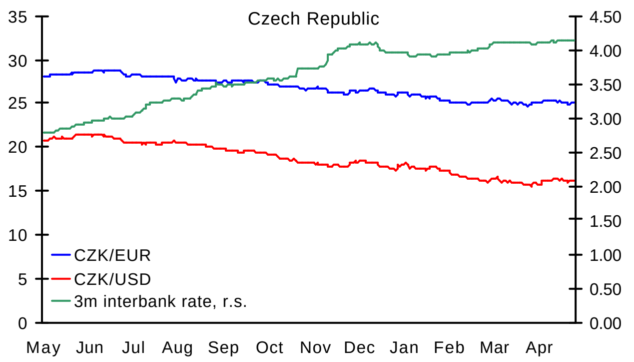
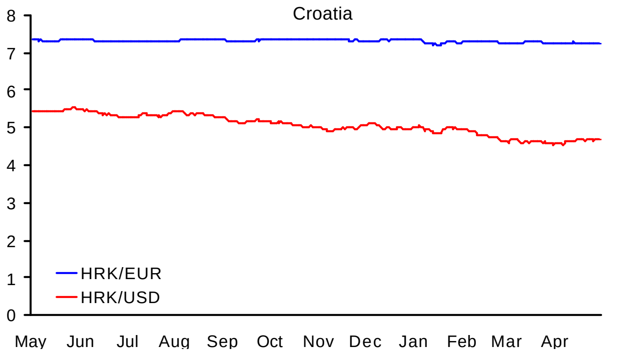
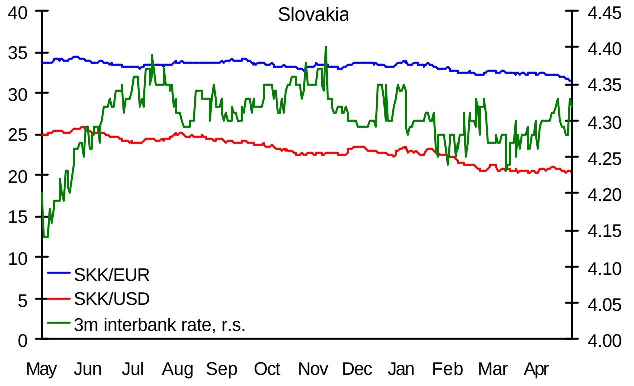
Exchange rates and interest rates (52 weeks)

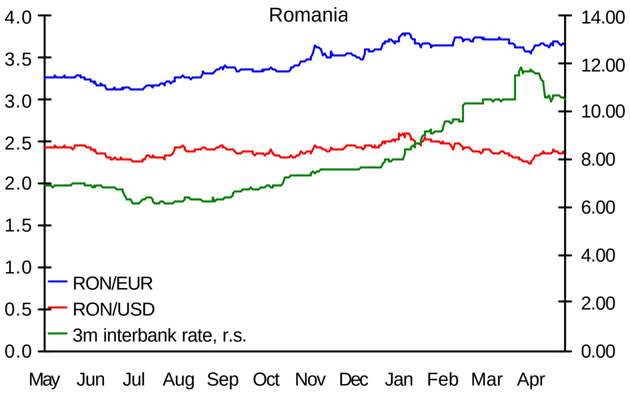


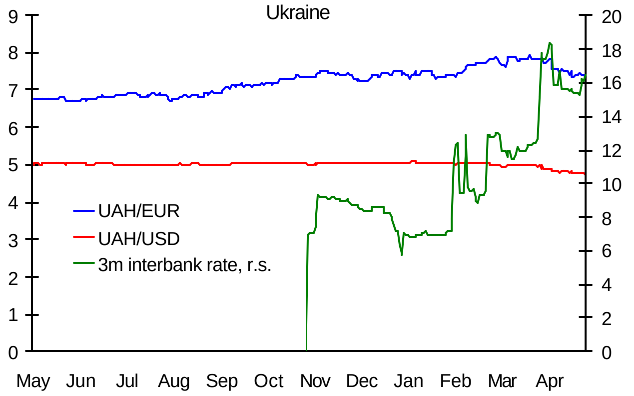












Source: Bloomberg

Appendix Forwards

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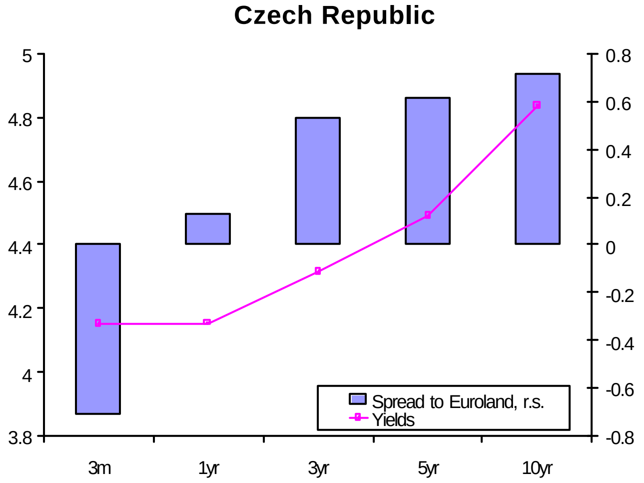
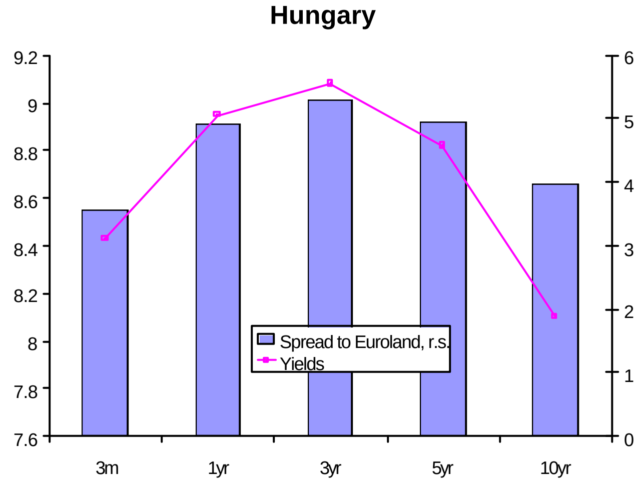
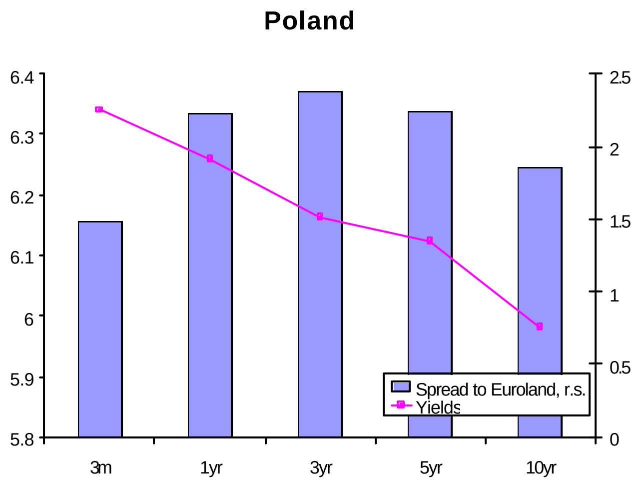
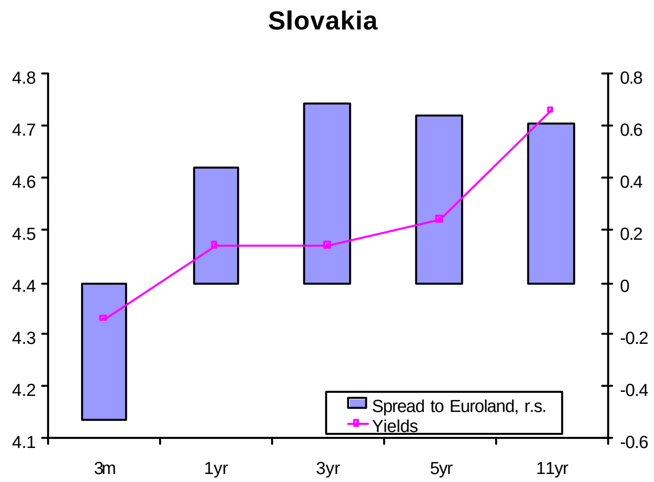
Benchmarks









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