May 30, 2008

Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** MoF to postpone international bond issue
- **Czech Republic:** CZK boosted by SKK news
- **Hungary:** Base rate raised to 8.50% on Monday
- **Poland:** Rates unchanged, but hike likely to come next month
- **Romania:** Romania plans to build new nuclear plant
- **Slovakia:** ERM-2 central parity revalued at 30.13 EUR/SKK

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Overview

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Croatia:

- 2008 budget performance above-plan so far
- MoF to postpone international bond issue

Czech Republic:

- 1Q average wage and trade balance figures to be released next week
- CZK boosted by SKK news

Hungary:

- Base rate raised to 8.50% on Monday
- Investments dropped by 4.8% y/y in 1Q
- Industrial output and 1Q GDP breakdown in focus next week

Poland:

- Rates unchanged, but hike likely to come next month

Romania:

- Romanian currency strengthening as risk aversion weakens
- Romania issued 1Y T-bills for average yield of 10.66%
- Romania plans to build new nuclear plant
- 1Q economic growth figures to be released next week

Slovakia:

- ERM-2 central parity revalued at 30.13 EUR/SKK
- Conversion rate seen as close to parity
- Central bank kept rates unchanged
- Government passed cigarette excise tax hike

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland current	Spreads vs. Euroland - 1m	Spreads vs. Euroland 02/01/2008
Czech Republic	EUR/CZK	24.98	0.6%	1.1%	6.3%			
	3Y (yield bp)	4.48	15	0	17	69	74	41
	10Y (yield bp)	5.17	25	38	44	105	90	53
Croatia	EUR/HRK	7.253	-0.1%	0.2%	0.7%			
	2Y (yield bp)	5.63	0	-2	32	132	187	140
	9Y (yield bp)	5.80	0	1	26	137	164	135
Hungary	EUR/HUF	240.5	1.9%	5.3%	5.3%			
	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	3.379	1.0%	2.4%	6.5%			
	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	3.638	0.9%	1.0%	-1.7%			
Slovakia	EUR/SKK	30.27	2.8%	6.5%	10.9%			
	3Y (yield bp)	4.70	17	25	11	34	66	52
	9Y (yield bp)	4.86	8	12	4	41	59	48
Ukraine	EUR/UAH	7.47	0.6%	-0.1%	-1.4%			
	3Y (yield bp)	10.50	-0.7	-0.5	3.0	621	722	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	P/L (%)	P/L incl. carry (%)	P/L p.a.incl. carry (%)	Target values	Target P/L incl. carry	Target P/L p.a. (%)
			3M Pribid/3m Euribor	3,99/4,86 %							
23	long EUR/CZK	05/05/2008	EUR/CZK	25.25	25.13	-0.49%	-0.43%	-6.28%	26.2	4.00%	16.00%

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

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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		241		3.38		3.65		30.3		7.52	-
Jun-08	25.4	25.1	7.22	7.22	243	242	3.60	3.38	3.65	3.70	30.1	30.3	7.30	7.53
Sep-08	26.2	25.1	7.25	7.25	245	244	3.51	3.40	3.58	3.76	30.1	30.2	7.13	7.86
Dec-08	25.9	25.0	7.30	7.30	245	247	3.45	3.41	3.50	3.81	30.1	30.2	6.72	8.04
Mar-09	25.7	25.0	7.25	7.25	240	249	3.40	3.42	3.50	3.87	-	30.2	6.62	8.22

	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	4.99	8.50	5.75	9.75	4.25	12.00	4.16		8.71		6.47		11.35		4.38		16.50	-
Jun-08	3.75	4.75	8.50	6.25	9.75	4.00	12.00	4.03	4.22	8.50	8.80	6.45	6.56	10.04	9.84	4.45	4.40	15.25	-
Sep-08	4.00	4.25	8.50	6.25	9.75	4.00	12.00	4.06	4.05	8.50	8.79	6.45	6.62	9.96	8.59	4.40	4.51	14.00	-
Dec-08	4.00	4.00	8.50	6.25	9.50	4.00	12.00	4.09	4.13	8.40	8.69	6.45	6.51	9.50	6.41	4.30	4.74	13.50	-
Mar-09	4.00	4.00	8.25	6.25	8.50	-	-	4.14	4.27	8.00	8.52	6.35	6.32	8.70	5.05	-	4.44	13.00	-

	10y Govt. Yield					5y Govt. Yield	3y Govt. Yield
	CZ	HR	HU	PL	SK	RO	UA
Spot	5.17	5.80	8.05	6.29	4.87	10.75	10.5
Jun-08	4.70	5.70	7.90	5.90	4.90	10.10	11.2
Sep-08	4.60	5.60	7.70	5.90	4.95	9.60	11.0
Dec-08	4.70	5.50	7.30	5.55	4.75	9.30	10.4
Mar-09	4.80	5.40	6.90	5.45	4.90	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	2.6.	Average real wage, %,Q1 yoy		
	6.6.	Trade balance, April, CZK bn.	6.80	
Croatia	5-Jun	Retail trade	0% y/y	
	6-Jun	PPI	7.6% y/y	
Hungary	Jun-05	April Industrial production	-	-
	Jun-06	April Trade balance	-	-
	Jun-06	1Q08 GDP breakdown	1.6% y/y	1.6% y/y
Poland	No data releases scheduled			
Romania	02-Jun-08	1Q 2008 real GDP growth	7.8%	6.4%
	06-Jun-08	Construction works, April, y/y	30.0%	-
	06-Jun-08	Retail trade, April, y/y	16.0%	-
	06-Jun-08	Industrial production, April, y/y	5.0%	-
Slovakia	Jun-03	1Q08 GDP	8.7%	8.7%
	Jun-03	Real wage growth	3.9%	4.0%
Ukraine	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		June-04	June-09	Sep-12-2022	4.7%	6	
Hungary		Jun-02	Jun-04	July-16-2008	-	HUF 40bn	8.50%
		Jun-03	Jun-11	Sept-10-2008	-	HUF 40bn	8.65%
		Jun-05	Jun-11	June-24-2019	6.50%	HUF 40bn	8.10%
Poland		No auction scheduled					
Romania		No auction scheduled					
Slovakia		No auction scheduled					
Ukraine		2-Jun	4-Jun	05-May-10	8.00%		7.70%
		2-Jun	4-Jun	28-Sep-11	9.50%		7.90%

Major markets

ECB Council meeting to confirm hawkish stance

The euro government bond markets suffered massive losses this week, on the back of higher than expected inflation data for May and hawkish rhetoric from the central banks. Next week's ECB meeting will not help to turn the market around, as the new economic and inflation forecasts will not bode well for the ECB interest rate outlook. Inflation will be revised upwards strongly for this year and maybe also for next year, while the growth outlook should be held stable for this year and revised slightly downwards for next year. On the back of the still high inflation outlook for next year, the wording of the press conference could easily even become more hawkish, although a rate hike seems very unlikely as long as the central banks still have to support liquidity on the money markets. However, the release of German factory orders and industrial production could show some weakening and help to stabilize the yield level of 10-year German government bonds at around 4.4% in the short term. Over the coming weeks, it seems that the market is going to test the latest low in the bund future at 110, raising the yield level to approx 4.7%.

ISM and labor market data to shape expectations

As always, the new month will start with important releases from the US economy. On Monday, the ISM Index can be expected to post yet another reading slightly below 50, confirming the stagnation of US manufacturing. On Wednesday, the volatile ISM index from the non-manufacturing sector should at most have a temporary market impact. The week will close with what is likely to be the most watched monthly indicator - the labor market report. Markets expect jobs to have been shed in May at a slightly higher rate than in the previous month. We think the risk is tilted to a slightly better number. Overall, though, the message should be confirmed - that the US labor market is weak, but stable. Fed Chairman Bernanke is giving speeches on Tuesday and Wednesday. Both will concern the economy, so the markets' attention seems warranted. This week saw quite a substantial increase of yields (unexpected) and a firming of the dollar (expected). While the most obvious explanation for the greenback's firming is a movement towards the other end of the trading range (1.52) after the EUR/USD failed to overcome the 1.58 mark, the behavior of the bond market is more difficult to explain. Ever-rising oil prices have of course increased inflationary risks, but the recent retrenchment only had a minor impact on yields. The data did not improve the economic outlook to a significant extent, in our view. Thus, a lot of positive expectations for the economy are already included in the current yield level and the chance for disappointment definitely exists.

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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		2.68		4.40	4.04	1.550	
Jun-08	4.00	2.00	4.50	5.00	2.20	2.83	4.00	3.80	1.52	1.547
Sep-08	3.75	2.00	4.30	4.96	2.30	3.15	4.30	4.20	1.47	1.540
Dec-08	3.50	2.00	4.10	5.09	2.30	3.38	4.50	4.40	1.40	1.533
Mar-09	3.75	2.00	4.10	5.03	2.40	3.52	4.60	4.60	1.38	1.527

Croatia

2008 budget performance above-plan so far

According to a release from the MoF, budget revenues have performed well in the first five months, growing between 10% and 11% y/y, according to preliminary figures. As the budget was planned based on revenue growth of slightly below 7% y/y, higher revenues should give the government additional maneuvering space to carry out a budget rebalance in June or July and to try to dampen inflation pressures. The government could increase non-taxable personal income from HRK 1,600 to HRK 1,800 starting from July 1 and use an additional HRK 500-600mn (approximately 0.2% of GDP) to counteract inflation pressures (although no exact measures have been presented yet). Also, the MoF should release final 2007 budget figures soon. However, the MoF methodology is to change and the budget figures will be reported according to ESA 95 methodology. As the MoF announced, this will mean a downward revision of the 2007 budget deficit from 2.3% of GDP to 1.6%, although the final figures should be monitored for further details.

MoF to postpone international bond issue

Although the MoF announced earlier this year that it would return to international markets to meet its refinancing requirements, the global turbulence and greater degree of uncertainty changed the situation, prompting the MoF to go with credit from domestic banks in the amount of EUR 760mn. For this purpose, the CNB lowered the amount of liquid FX assets that banks must hold for all FX or FX-linked liabilities from 32% to 28.5%, thereby freeing needed liquidity and not lowering the banks' credit potential. Details about issuance towards the year-end are not known yet. Thus, it remains to be seen whether there will be any bond issues - either domestic or foreign - this year.

The FX market remained stable and the kuna continued to hover around 7.25, with slightly more pronounced pressure on the appreciation side. Meanwhile, pure kuna bonds performed flat in terms of yields and turnovers and spreads declined by 20-30bps, due to movements on the benchmark market.

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Czech Republic

1Q average wage and trade balance figures to be released next week

The Czech Republic did not see any data releases this past week. As for the coming week, the 1Q average wages and trade balance are set for release. As for the average wages, we expect the growth to be commensurate with that seen in 4Q07 (1.9% in real terms), mainly owing to the fact that inflation was high in the first quarter, thus sapping the growth of nominal wages (which was rather quick, especially in industry). The trade balance, also up for release next week, should reflect higher oil prices; we expect a surplus of CZK 6.8bn.

CZK boosted by SKK news

The CZK first weakened to around 25.20 this past week, then strengthened again once Slovakia sent speculators the gift of a revalued central parity. We think the coming week will be positive for CEE currencies, as sentiment should remain relatively good. The weaker trade balance might then shake investors' beliefs about the immunity of the CEE region to the slowdown abroad, sending the CZK lower.

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Hungary

Base rate raised to 8.50% on Monday

On Monday, the central bank hiked the base rate by 25bp to 8.50%, in line with the market consensus. The statement of the Council, however, proved to be more hawkish than expected by not suggesting at all that the current rate hiking cycle would come to an end sooner or later. Instead, by saying that "that there is significant upside risks in the time horizon relevant to monetary policy" and "the Monetary Council continues to see a need to maintain tight monetary conditions and is ready to take the necessary steps if the inflation target comes under threat", they kept the door open for the continuation of rate hikes at the coming monetary meetings. At the press conference, Governor Simor maintained his hawkish tone, by putting more emphasis on the possible danger of higher inflationary expectations and higher than expected private sector wage outflow. The base rate hike was in line with the increase in the central bank's inflation forecasts. For 2008, the bank's staff expects average inflation of 6.3% y/y (5.9% y/y was published in the February Report). However, it should have been more decisive that the 2009 average inflation forecast was raised to 4.2% y/y, up from the 3.6% y/y projected in February. According to the latest CB projections, inflation will slow to the mid-term target only in 2010, as it projects 3% y/y average CPI inflation for this year.

As for the base rate outlook, our view is that the central bank has managed to restore its credibility by strongly expressing its commitment to the inflation target with the rate hikes carried out in the recent period. Although more rate hikes cannot be ruled out (partly depending on the data on inflation and wage growth next month), our base forecast is that the current small rate hiking cycle will come to a halt, especially if the forint is able to preserve its current strength against the euro for a longer period. Later on in the week, Monetary Council member Júlia Király indicated that maintaining tight monetary conditions does not necessarily mean a further rate hike, if the exchange rate-led disinflation is guaranteed.

Investments dropped by 4.8% y/y in 1Q

This morning, the CSO published disappointing investment figures for the first quarter. According to the preliminary figures, investments dropped by 4.8% y/y in 1Q08. Compared to the previous quarter, the decline in investment activity was 1%. The data does not suggest a spectacular revival of GDP growth in the near term. The 9.8% y/y drop in the processing industry shows that confidence seems to have remained low in the corporate sector, which is not encouraging in terms of future growth prospects. At the same time, investments in the construction industry finally moved into positive territory, increasing by 4.5% y/y in the January-March period.

Industrial output and 1Q GDP breakdown in focus next week

After some correction, the forint continued its appreciation process this week, driven by another rate hike by the central bank and the positive regional mood, stemming from the revaluation of the koruna's central parity in Slovakia. As we indicated last week, the high interest rate differential and Hungary's decreasing financing needs are the most important fundamental support for the stronger exchange rate. The forint is expected to try to break through the strong end of the old band (240 EUR/HUF) in the near period, provided that the international market environment remains supportive.

Among the data harvest next week, the April industrial output figures and the breakdown of the 1Q GDP figures will be in focus. The former is important because the performance of domestic industry strongly depends on the extent to which the economy slows in 2Q in the Eurozone. As for the structure of GDP, the above-mentioned investment figures were disappointing; thus, exports should be watched closely, as they are supposed to have been behind the economy's growth.

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Poland

Rates unchanged, but hike likely to come next month

The Polish central bank held its monthly rate setting meeting last week. Rates were kept unchanged, but the statement afterwards was pretty hawkish and indicated that there will not be much of an opposition to another hike from within. See for yourselves: "The council does not rule out that bringing inflation back to the target in the medium term may require further monetary policy tightening." The MPC also added that it "sees a probability of sustained wage and inflation pressures", but that "it needs to see the next consumer price inflation projection and more data in order to judge the outlook better." Topping this off, the MPC "sees inflation above 3.5% in the short term and the risk of second-round effects due to fuel, food and regulated items' price increases." The subsequent comments from the more hawkish-leaning bankers (Slawinski, Filar, Noga, Wasilewska-Trenkner), as well as the data released last week regarding unemployment and retail sales, further suggested that it is very likely indeed that rates will go up next month.

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Romania

Romanian currency strengthening as risk aversion weakens

The Romanian currency gained 1.4% since the beginning of the week, rallying to 3.62 in early Friday trading. This week, liquidity has been restrained on the Romanian money market, as a new reserve period has just started and the commercial banks are building up their reserves with the NBR. Short-term deposits (ON, TN, SW) are traded for 10/ 10.5% interest rates, outpacing the level of the key rate (9.75%), while, for longer maturities, interest rates range between 10.7%-11.5% bids/asks. The NBR's regular Monday 1-week deposit auction did not draw the attention of commercial banks, as only one bank placed an offer worth RON 75mn for the 9.75% fixed interest rate. Given the recent appreciation of Romanian Leu in the last two days, we believe that the local currency could break the 3.60 support zone next week, especially if the GDP figures for the first quarter surprise on the upside.

Romania issued 1Y T-bills for average yield of 10.66%

On May 28, the MinFin held an auction for 1Y treasury bills worth RON 200mn. The overall offer of primary dealers reached RON 485mn, but the MinFin accepted the initially announced amount of RON 200mn. The MinFin decided to pay a maximum yield of 10.75%, while the average yield increased to 10.66%, above the 10.22% yield paid at the previous auction. The MinFin has not released the debt calendar for June yet. Since the beginning of the year, Romania has issued state debt instruments worth RON 1.5bn, attracting RON 640mn during May. We think that the yields could increase further in the coming months, as Romania will have to borrow at least RON 12bn from the local primary market in 2008 and the liquidity squeeze does not seem to be easing.

Romania plans to build new nuclear plant

Romania intends to construct a new nuclear plant with capacity between 2,000 and 2,400 megawatts, to become fully operational by 2020. A database of potential locations is already available, due to an intensive search carried out in the past. Romania currently has a nuclear power station in Cernavoda with two units, while two more reactors will be built in the near future through a partnership between state and private companies. The second reactor at Cernavoda started production in late 2007 and the share of nuclear power energy in Romania's total resources of electric energy increased to 17% in 1Q08, compared to 9.4% in the same period of 2007. Romania is comfortable in terms of electric energy resources, as 98.8% of its total electricity is domestically produced. However, given the recent increases in oil prices on international markets and the considerable share of thermal electric energy, more resources should be used in the future, including wind energy.

1Q economic growth figures to be released next week

The Romanian National Institute of Statistics will publish 1Q08 real GDP growth on Monday. Our forecast is 7.8% y/y, above the market consensus. Our estimate relies on the very good development of the construction sector in 1Q08 (+32.2% y/y), with a balanced distribution among residential buildings, non-residential buildings and civil engineering works. Improved VAT collection for the consolidated state budget should also provide a strong support for the economic growth. According to the preliminary data, trade and services remained vigorous, despite the tighter monetary policy implemented by the central bank at the beginning of 4Q07. The transmission mechanism of monetary policy implies a lag of around 2-3 quarters, so the maximum effects of the stronger monetary policy should be more visible in 2H08. After a good start in 2008, industry delivered rather disappointing results in March. The contribution of agriculture to the economic growth is traditionally insignificant in the first quarter, as its share in nominal GDP is below 3% in January-March. However, better results for domestic agriculture (compared to the severe drought in 2007) could boost economic growth, especially as agriculture's share in nominal GDP increases to around 7% in the later quarters of the year

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Slovakia

ERM-2 central parity revalued at 30.13 EUR/SKK

The ERM-2 central parity was revalued effectively from Thursday morning at 30.1260 EUR/SKK, which was the bottom margin of the previous ERM-2 band and more than 20% from the initial ERM-2 central parity at 38.455 EUR/SKK set in November 2005 (parity was revalued twice). Lacking transparency, the central parity was moved - unusually - during the workweek (instead of on Friday). Also, contrary to our and most other expectations, the level was set off-market (and there were not many reasons to rush, since the spot exchange rate was clearly converging towards the ERM-2 bottom boundary anyway). Apart from being off-market, the level is not such a surprise, given the evident political preferences for a strong conversion rate and the recent disappearance of the Slovak CB's objections (heard in the past). The new parity is unlikely to be seen as the current equilibrium exchange rate by the CB. However, some voices argued that future development should be incorporated into the conversion rate, as it will be fixed forever.

Conversion rate seen as close to parity

According to a Reuters poll, the new central parity at 30.1260 EUR/SKK is viewed as the most likely level of the final conversion rate; we agree with this. Still, since Slovakia set the precedent in about every possible aspect, we cannot rule out that the conversion rate could be even stronger, as it will be purely a political decision (this could be either a mild tempering to an easy-to-calculate exchange rate of 30.0000 EUR/SKK or a more significant move). Indeed, PM Robert Fico said that the 'central parity has nothing to do with the conversion rate'. Nonetheless, since the market anticipates that the conversion rate will match the current ERM-2 parity, the koruna is unlikely to depart too much from the current levels unless new comments from politicians prompt thoughts of an off-parity conversion rate. Today, the koruna was traded at 30.25 EUR/SKK, keeping the forward exchange rate for the beginning of 2009 near 30.13 EUR/SKK.

Central bank kept rates unchanged

The central bank kept interest rates unchanged this week, meeting market expectations. The key policy rate stays at 4.25%, 25bp above the ECB rate. While we originally expected the NBS to align its rates with the ECB soon after the 2009 euro adoption was confirmed, last week's comments from CB Governor Ivan Sramko against imminent harmonization indicated a 'no change' outcome. However, we still regard the early harmonization of policy rates as the more likely scenario (i.e. within the next two or three months). After that, we expect the NBS to follow the steps of the ECB, which is increasingly likely to keep rates flat this year. Hence, it would mean only one 25bp rate cut by the NBS to 4.0% by year-end. Since market rates in the Eurozone are significantly above the base rate (3M EURIBOR at 4.85% vs. the base ECB rate at 4.00%), Slovak market interest rates may indeed increase by year-end, despite the NBS rate going down.

Government passed cigarette excise tax hike

The government approved an excise tax hike on cigarettes, which should bring Slovak excise taxes in line with EU requirements. The provision, which still needs parliamentary approval, should add about 0.3pp to HICP inflation next year (0.2pp to CPI). In the past, excise tax hikes also led to massive pre-stocking (this year, it was worth about eight months of consumption) and will thus probably influence the timing of the tax intake and nominal and real GDP (excise taxes add to GDP).

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Appendix Charts

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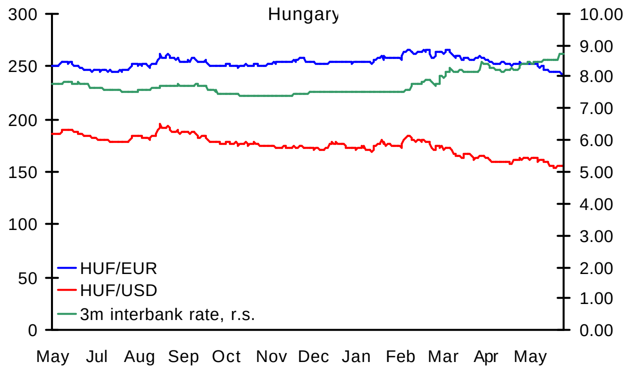
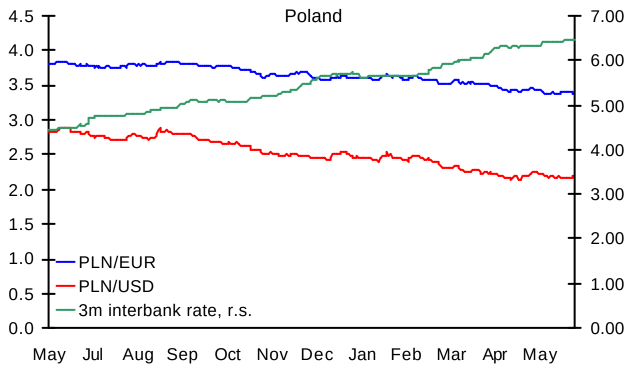
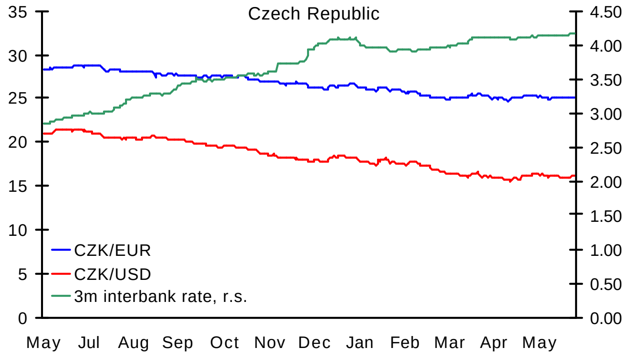
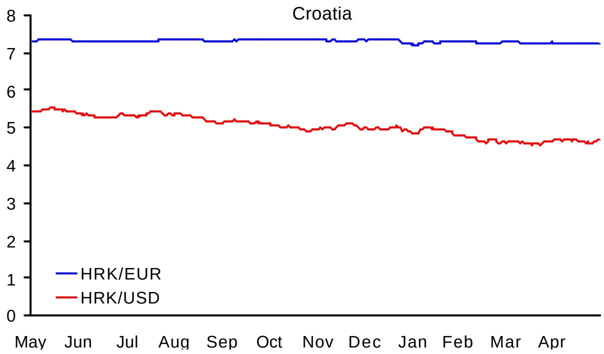
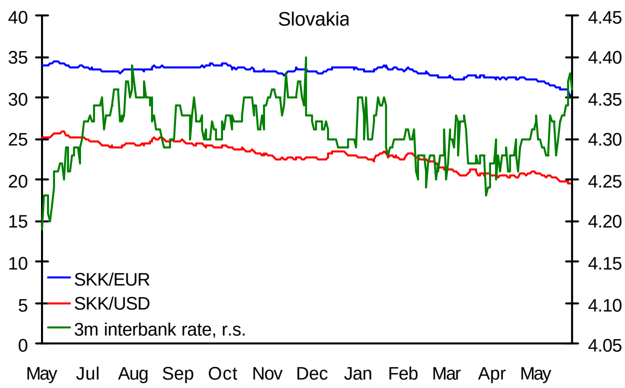
Exchange rates and interest rates (52 weeks)

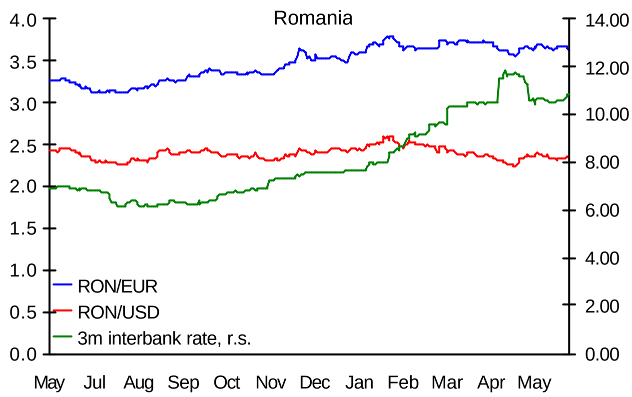


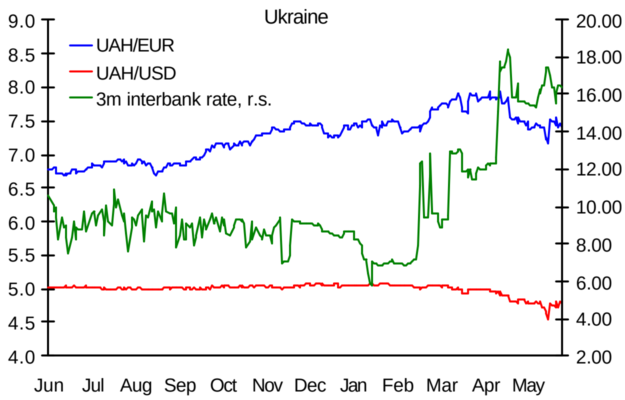












Source: Bloomberg

Appendix Forwards

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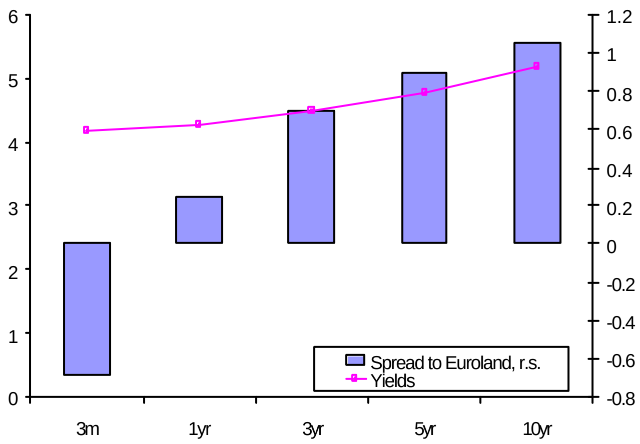
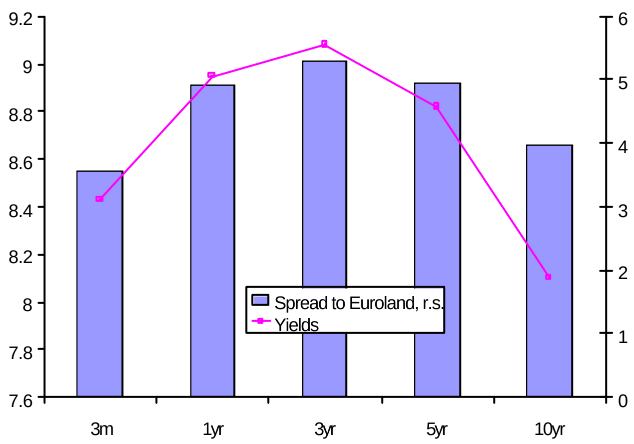
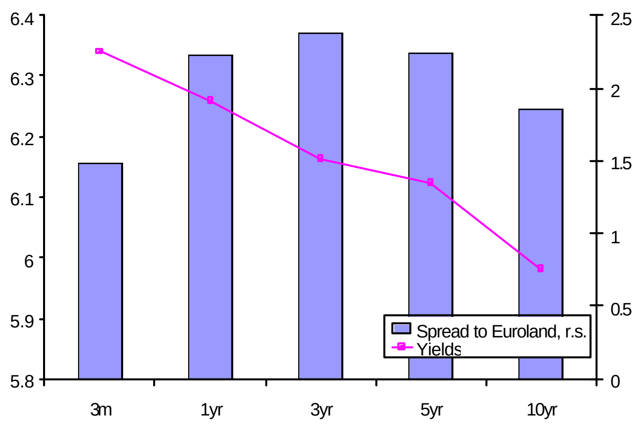
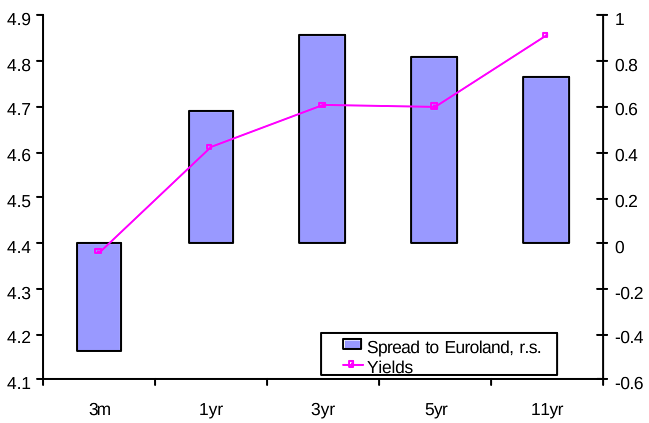
Benchmarks









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