

Fixed Income and Foreign Exchange

CEE Insights

- **Czech Republic:** CZK at new all-time high vs. EUR
- **Hungary:** GDP rose 1.7% y/y in 1Q08
- **Poland:** One more hike likely at next meeting
- **Romania:** Romania issued 5Y benchmark bonds for average yield of 9.45%
- **Slovakia:** Harmonization of Slovak and European rates likely to be done by ECB
- **Ukraine:** Commercial banks' rate for loans to rise

Overview

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Czech Republic:

- CZK at new all-time high vs. EUR
- Slowing EU economy to weigh on Czech economy



Hungary:

- May budget balance and CPI in focus next week
- GDP rose 1.7% y/y in 1Q08
- Forint weakened, bond market again turned to losses



Poland:

- One more hike likely at next meeting



Romania:

- Strong economic growth in 1Q08
- Romanian currency tested 3.60 support zone
- Romania issued 5Y benchmark bonds for average yield of 9.45%



Slovakia:

- Harmonization of Slovak and European rates likely to be done by ECB
- GDP structure: Consumption main driver of strong 1Q growth



Ukraine:

- Tension in orange coalition camp to ease
- Commercial banks' rate for loans to rise, as banks have been under liquidity squeeze

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2008
Czech Republic	EUR/CZK	24.64	1.4%	2.3%	7.7%			
	3Y (yield bp)	4.62	14	0	31	84	76	41
	10Y (yield bp)	5.17	0	45	43	105	82	53
Croatia	EUR/HRK	7.249	0.0%	0.1%	0.7%			
	2Y (yield bp)	5.63	0	-1	32	100	184	140
	9Y (yield bp)	5.80	0	1	26	132	163	135
Hungary	EUR/HUF	243.9	-1.4%	3.3%	3.8%			
	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	3.382	-0.1%	1.6%	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	3.632	0.1%	0.9%	-1.5%			
Slovakia	EUR/SKK	30.35	-0.2%	6.0%	10.6%			
	3Y (yield bp)	4.78	8	34	19	17	60	52
	9Y (yield bp)	4.85	-1	12	3	39	57	48
Ukraine	EUR/UAH	7.40	1.0%	1.0%	-0.4%			
	3Y (yield bp)	13.00	2.5	2.0	5.5	854	716	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. (%)
23	long EUR/CZK	05/05/2008	3M Pribid/3m Euribor EUR/CZK	3,99/4,86 % 25.25	24.59	-2.60%	-2.52%	-28.80%	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	24.6		7.25		245		3.39		3.62		30.4	30.4	7.41	-
Sep-08	25.8	24.5	7.25	7.25	245	249	3.60	3.40	3.65	3.69	30.1	30.3	7.39	7.62
Dec-08	25.9	24.5	7.30	7.30	245	251	3.51	3.41	3.50	3.75	30.1	30.3	7.23	7.90
Mar-09	25.7	24.5	7.25	7.25	240	253	3.45	3.42	3.58	3.80	-	30.2	6.96	8.11
Jun-09	25.5	24.4	7.22	7.22	240	256	3.40	3.43	3.55	3.85	-	-	6.72	8.29

Intervention Rate

3m Money Market Rate

	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	4.20		8.84		6.53		11.30		4.32	4.32	15.60	-
Sep-08	3.75	4.50	8.50	6.25	10.0	4.25	12.00	4.09	4.68	8.50	9.31	6.45	6.78	11.50	7.80	4.40	4.73	14.20	-
Dec-08	4.00	4.25	8.50	6.25	9.50	4.25	12.00	4.14	4.05	8.40	9.22	6.45	6.83	10.00	5.68	4.30	5.32	13.75	-
Mar-09	4.00	4.00	8.25	6.25	8.50	-	12.00	4.31	4.73	8.20	9.10	6.35	6.78	8.80	5.21	-	4.98	13.25	-
Jun-09	4.00	4.00	8.00	6.25	7.75	-	-	4.30	4.74	8.00	8.95	6.25	6.61	8.05	4.75	-	-	13.00	-

10y Govt. Yield

5y Govt. Yield

3y Govt. Yield

	CZ	HR	HU	PL	SK	RO	UA
Spot	5.19	5.80	8.60	6.48	4.85	10.30	13.0
Sep-08	4.70	5.60	7.70	5.90	4.95	9.80	11.0
Dec-08	4.60	5.50	7.30	5.90	5.00	9.50	10.8
Mar-09	4.70	5.50	6.90	5.55	4.90	8.50	10.5
Jun-09	4.80	5.50	6.80	5.45	5.00	7.80	-

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	7.6	6.0
Ukraine	7.1	7.6	6.6	6.0
CEE8 weighted average	6.3	6.2	5.3	5.5

CPI (%), eoy	2006	2007e	2008f	2009f
Czech Republic	2.5	4.9	5.1	4.2
Croatia	2.0	5.8	3.1	3.5
Hungary	6.5	7.4	5.3	3.4
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	6.2	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	7.8	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	7.3	6.8
Ukraine	7.4	6.9	6.5	6.1
CEE8 weighted average	10.6	8.8	7.8	7.2

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	8.3	7.8
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	4.3	4.3
Ukraine	13.5	9.6	14.5	12.0
CEE8 weighted average	6.6	6.0	7.8	6.8

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	-4.6	-4.2
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	-3.7	-3.5
Ukraine	-2.9	-4.2	-5.8	-7.0
CEE8 weighted average	-5.2	-6.0	-6.6	-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	-3.6	-2.2	-2.0	-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	9-Jun	CPI, m/m, %, May	0.3%	0.4%
	9-Jun	Unemployment, %, May	5.00	4.90
	10-Jun	GDP, final, Q1, %	5.60	
	11-Jun	Industrial Output, Yoy, %, April	9.10	8.30
	13-Jun	PPI, m/m, %, May	0.40	0.30
Croatia	13-Jun	CPI	5.8% y/y	
Hungary	10-Jun	May Budget balance	HUF +88.6bn	-
	11-Jun	May CPI	6.7% y/y	6.6% y/y
Poland	13-Jun	CPI, y/y, %, May		4.4%
Romania	9-Jun	Trade balance in April (FOB-CIF) - EUR millior	1,900	-
	11-Jun	CPI in May - y/y	8.3%	
		Current account deficit in April - EUR million	1,840	
Slovakia	9-Jun	April industrial production	13.4% y/y	10.3% y/y
	11-Jun	May CPI	4.6% y/y	4.5% y/y
	11-Jun	May foreign trade	SKK 2.2bn	SKK 3.9bn
Ukraine	6-Jun	May CPI, m/m	1.9%	2.3%
	6-Jun	May PPI, m/m	5.4%	5.0%
	11-Jun	May Industrial Production, y/y	6.9%	7.1%

*Sources: Bloomberg, Reuters

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		6-Jun	13-Jun	Mar-13-2009		CZK 4bn	
Hungary		10-Jun	18-Jun	Sep-17-2008	-	HUF 40bn	
		11-Jun	18-Jun	Nov-19-2008	-	HUF 25bn	
		12-Jun	18-Jun	Jun-03-2009	-	HUF 50bn	
Poland		9-Jun	11-Jun	Jun-2009		PLN 1-2 bn	
Romania		11-Jun	13-Jun	6M	-	RON 800 mn	10.60%
Slovakia		9-Jun	11-Jun	Apr-04-2017	4.20%		4.80%
Ukraine		9-Jun	11-Jun	May-05-2010	8.00%		7.70%
		9-Jun	11-Jun	Sep-28-2011	9.50%		7.90%

Major Markets

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Major markets

ECB to hike in July

Indicator-wise, a rather quiet week lies ahead for Euroland. Still, markets should remain busy digesting the recent ECB Council meeting. While the key rate remained unchanged at 4% (as expected), Trichet rattled markets with his comments. After stating that the Council was in a state of heightened alert, Trichet made things even clearer by saying that a small rate hike at the next meeting was possible, though not certain. A rate hike was already discussed, but the unanimous decision finally was to leave rates unchanged. We think an interest rate hike at the next meeting is a done deal, as a scenario in which the obvious inflation concerns of the Council members would be reduced significantly within only a month is hard to imagine. The only reason why rates were not already hiked was to have time to prepare markets. So, we will adapt our forecasts accordingly. The most interesting question will be how this change of monetary policy plays out on the exchange rate, especially vs. the dollar, in connection with recent Bernanke statements (see below). Some short-term weakening of the dollar is likely, but we do not think that the EUR/USD will touch 1.6.

Important indicators to confirm slow US growth

Before the week closes, markets will get important information about the status of the economy from today's labor market data. We think there is a chance for a slightly better number compared to current market expectations. However, the main message should remain that the labor market is stable at a low level. Next week, the most important indicators will be retail sales on Thursday and CPI on Friday. Retail sales might already be affected by the tax reimbursements. The mailing of these checks started in mid-May. We think that a strong impact is more likely to be seen in June. The effect of a gasoline price increase of almost 10% vs. the previous month also needs to be watched. This already is the bridge to Friday's inflation data, which will of course also be affected by the higher fuel prices. For the core rate, markets expect the usual 0.2% m/m. We see (also as usual) the risk to the downside, as the poor condition of the housing market should affect shelter costs. However, the timing is of course highly uncertain. Interest rate speculation should remain muted, as just this week Fed Chairman Bernanke called the current monetary policy well positioned. In the same speech, he highlighted the attention paid to the effect of any changes in the dollar on inflation. So, any serious dollar weakening might have an impact on interest rate expectations.

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Forecasts (under review)

	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	4.96		2.70		4.43	4.02	1.559	
Sep-08	4.25	2.00	4.60	5.27	2.30	3.27	4.60	4.20	1.47	1.550
Dec. 08	4.25	2.00	4.50	5.50	2.30	3.36	4.70	4.40	1.45	1.542
Mar. 09	4.25	2.00	4.50	5.51	2.30	3.46	4.60	4.60	1.40	1.534
Jun-09	4.25	2.25	4.50	5.04	2.60	3.49	4.70	4.80	1.38	1.527

Czech Republic

CZK at new all-time high vs. EUR

In the past week, the CZK again strengthened to a new high of 24.51 against the EUR, with no apparent news to warrant it. As we said last week, the revaluation of the Slovak parity might have prompted some investors to get into the region. However, what is puzzling is that other currencies did not strengthen. While this is understandable for the HUF, given the country's fundamentals and uncertain euro outlook, for the PLN this makes less sense. As such, the rationale behind the latest wave of strengthening remains unclear. However, pretty much all of the observers (including us) now agree that a CZK correction is overdue. We think that the CZK should (based on fundamentals) strengthen to above 25.50, but the timing is unclear. The CZK thus remains a puzzle.

Slowing EU economy to weigh on Czech economy

The trade balance for April was released. After the y/y fall in exports and imports in March, foreign trade returned to double-digit growth in April. The surplus reached CZK 8.3bn (market expectation: CZK 6.5bn, our forecast: CZK 6.8bn), which was CZK 3.4bn higher than for April 2007. Exports and imports grew at a double-digit growth rate. The greatest contribution came from trade with machinery and vehicles (as usual), where the y/y increase in the surplus was more than CZK 5bn. The deepening of the deficit in trade with mineral oils was in line with expectations, mainly owing to the pricier natural gas (the import of which grew by 83% in value from a year ago). As for the oil, higher prices probably exert a somewhat dampening impact on demand; in value terms, oil imports grew just 2.7%, with the price of oil in CZK 1/3 higher than a year ago. Foreign trade thus did not repeat its disappointing March results, confirming our view that one cannot infer that the trade balance is worsening from the number alone (as some observers were quick to point out after the March data). We do think, though, that the slowing EU economy (May data from the Eurozone was disappointing, hinting at a slowdown after the good 1Q) and strengthening CZK will eventually weigh on the Czech economy - one should see it in the trade balance and industrial production rather quickly.

Next week, a host of data is to be released - CPI and unemployment for May, final GDP data for 1Q and industrial output. By far the most important is the CPI - we expect m/m growth of 0.4%, mainly due to more expensive oil and a slower translation of the strong CZK into prices. This is important for the CNB's next rate setting meeting, even though - with the current strength of the CZK - it is hard to imagine that the CNB would move towards hiking its key rate, even if there is a negative surprise from CPI.

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Hungary

May budget balance and CPI in focus next week

This coming Tuesday, the preliminary May budget balance will be released. After the small deficit of HUF 14.3bn published for April, the Finance Ministry projected a surplus of HUF 88.6bn for May. The May CPI inflation figures (due on Wednesday) now seem to be attracting more attention. We expect 6.7% y/y, after the 6.6% y/y seen in April. May CPI is expected to have been driven by the increase in seasonal foods, fuel and gas prices. Apart from the headline figure, the formation of the core inflation and market services inflation should be in focus, as these are key factors in the central bank's rate setting policy. This week, rate setter Julia Király again warned that the formation of market services inflation could indicate that inflationary expectations have become stuck at high levels, while Governor András Simor said that there were upside risks to the 2010 inflation, as well.

GDP rose 1.7% y/y in 1Q08

Looking back at this week, the CSO published the breakdown of the 1Q08 GDP figures this morning. The 1.7% y/y GDP growth figure published for the first quarter was a bit higher than the flash estimate of 1.6% y/y. The breakdown of the figure was more or less in line with expectations. Household consumption expenditures slightly increased, by

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0.4% y/y in the period, while households' final consumption was down 1.1% y/y. The main driver of the GDP was the growth of exports, accelerating to 13.9% y/y, from the 10.4% y/y published for the fourth quarter of 2007. The growth of imports was 10.2% y/y. As for the outlook, a more spectacular revival of GDP is only expected in the second half of the year. The FY growth is expected to remain in the range of 2-2.5% y/y.

Forint weakened, bond market again turned to losses

The forint preserved its strength for the majority of the week, but started to weaken on Thursday, after the ECB meeting. The reason is that the ECB press conference after the meeting brought a big surprise for markets, by significantly increasing the likelihood of a rate hike, even at the next meeting. As a rate hike in the Eurozone would lower the positive interest rate differential for the Hungarian currency, the forint weakened to a 2-week low against the euro this morning. The bond market reacted even more sharply. After the moderate increases in yields seen in the last couple of days, another 30-40bp jump took place this morning. Events on the bond market are similar to those seen at the beginning of March, with low liquidity and increasing bid-offer spreads. Apart from the unexpectedly hawkish statements coming from the ECB, the above-mentioned comments from the Hungarian central bank's rate setters have deteriorated the market mood as well, suggesting to market participants that the CB will miss its inflation goals for both 2008 and 2009. In addition, structural problems in the domestic bond market have again emerged, as domestic private pension funds tend to continue their bond selling, which seems not to have been offset by buying among foreign players.

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Poland

One more hike likely at next meeting

There were no data releases in the past week. Next week, only CPI is to be released (the expectation is 4.4% in May, after 4.0% in April). This is of crucial importance, now that the Polish economy is racing ahead at full throttle and exogenous inflation shocks threaten to translate into inflation expectations, thereby setting off a wage-inflation spiral. This was one of the things that Governor Skrzypek spoke about on Monday. In an interview with Reuters, Skrzypek said that "the pace of the Polish zloty's appreciation against foreign currencies may be worrying, although the unit's gains help fight inflation." This indicates that the rise of the PLN (6% against the EUR since the beginning of the year) does indeed concern the central bankers and that the monetary tightening may not be as severe as it would have been (given the strength of the Polish economy), had it not been for the PLN's rise. We thus think that there is going to be one more hike to 6.25%, probably at the next meeting.

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Romania

Strong economic growth in 1Q08

Real GDP increased by 8.2% y/y in 1Q08, in line with our expectations (7.8%), but considerably above the market consensus (6.4%). Actual final consumption gained speed, mainly driven by household consumption, while general government consumption remained modest. Gross fixed capital formation was very strong (+33.2%), with an increasing share of agriculture in total investments and lower investments in trade and services. Imports were faster than exports in real terms, resulting in a negative contribution of foreign trade to real GDP growth. The central bank strengthened the monetary policy beginning with 4Q07 by increasing the key rate (+275bp thus far) and firming control over money market liquidity via open market operations. The monetary policy transmission mechanism has a lag of around 2-3 quarters, so the maximum effects of the tighter monetary policy were not visible in early 2008. Given the hefty consumption in 1Q08 and the significant wage hikes in April, we believe that the probability of a further increase of the key rate at the next monetary policy meeting in

June is higher. At the same time, the central bank might take further steps against FX consumer loans through administrative measures. As a result of these figures, we adjusted our estimate for 2008 economic growth upwards to 7%. However, excellent results in agriculture (assuming normal weather conditions) and a further high pace of construction (around 30%) could mean that our base scenario turns out to be rather conservative.

Romanian currency tested 3.60 support zone

The Romanian currency started the week on a strong foot and tested the 3.60 support zone on Monday, after economic growth surprised on the upside. The better than expected data on GDP offered limited support for the local currency, as investors started to build up long positions on EUR/RON in the next few days, lifting the exchange rate to 3.64 towards the end of the week. It seems that the local currency could not maintain the recent gains and reversed its move a little bit. The liquidity conditions on the Romanian money market remained restrictive, as interbank interest rates remained above the monetary policy rate. Therefore, the commercial banks placed no bids at the NBR's regular 1-week tenor deposit auction on Monday. The short-term interbank deposits were traded at 10/10.5% bids/asks during the week. We believe that the EUR/RON pair will continue the upward trend started this week and might test the 3.70 zone, amid the dovish mood of investors regarding emerging markets.

Romania issued 5Y benchmark bonds for average yield of 9.45%

On June 5, the MinFin held an auction for 5Y benchmark bonds worth RON 500mn. The auction stirred the interest of investors, as the offer of primary dealers totaled RON 1.14bn, but the MinFin accepted only RON 215mn. The MinFin decided to pay a maximum yield of 9.5%, while the average yield decreased slightly to 9.45%, from 9.47% previously. The MinFin will hold its next auction on June 13, as it intends to sell 6M discounted T-bills worth RON 800mn. At the previous auction, the highest accepted yield stood at 10.75%, and it is possible that the yields could near 11% at this auction, as the MinFin prefers to attract liquidity for the short term.

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Slovakia

Harmonization of Slovak and European rates likely to be done by ECB

The very hawkish message surprisingly delivered by the ECB also changes our outlook on Slovak interest rates. As the ECB might go up by 25bp already next month, the NBS will not have to cut the rates by 25bp to achieve harmonization with the ECB rates, as we expected before (currently, Slovak interest rates stand at 4.25%, 25bp above ECB rates). By January 2009, when Slovakia enters the Eurozone, the Slovak and ECB rates have to be equal. If the ECB remains highly concerned about the inflation outlook in the second half of the year and delivers more than one 25bp hike, the NBS would likely follow the steps of the ECB shortly thereafter.

GDP structure: Consumption main driver of strong 1Q growth

On the data front, the Slovak Stats Office confirmed 1Q08 real GDP growth at 8.7% y/y last week, at the level of its earlier flash estimate. The economic growth was driven mainly by domestic demand - more specifically, by household consumption and stock building. The growth of household consumption accelerated to 8.4% y/y (from 5.9% y/y in 4Q07), above our expectation of 6% y/y. Higher spending was facilitated by the employment gains (employment increased by 2.8% y/y according to ESA methodology) and real wage growth, which increased by 6.2% y/y, above our and market forecasts at 4%. The structure of wage growth revealed that it was driven mainly by the increase in public sector wages (18% y/y in nominal terms), which were adjusted ahead of last year's schedule (it was July, back in 2007). Hence, for the first time since 2005, real wage growth slightly outpaced productivity growth. Although this is a signal for caution on the central bank side (and even more so in terms of fiscal discipline, with the approaching EMU membership), real wage growth lagged significantly behind productivity

gains in the past two years. Thus, we read the current development as a catching up for the previous periods. This year, we expect the real GDP growth at 7.6% (as compared to the estimate from the Slovak Stats Office of 7.9%), which means a slowdown from the hefty 10.4% seen in 2007. As opposed to the first quarter, the growth structure will likely become more balanced in the coming quarters, i.e. external demand should contribute more significantly to the growth, in our view.

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Ukraine

Tension in orange coalition camp to ease

After the recent war of words between the president and prime minister, which led to a deepening of the crisis in the orange camp, the parties seem to have reached a truce. During this week, the orange coalition members reached a consensus on key issues such as the approval of the presidential nominees for Supreme Court judges, voting on the first draft of the privatization law and the law on the state budget (revenue side). Both parties (BuYT and Our Ukraine) suffered a serious defeat in the city of Kiev's mayoral race, which resulted in the victory of incumbent Mayor Leonid Chernovetskiy (independent candidate).

The coalition parties have learned a lesson from the recent quarrels, as they have been losing the support of voters. The coalition parties now seem to be more open to consensus. The main things to watch in the coming weeks are the approval of the new head of the State Property Fund (SPF), the amendments to the state budget for 2008 (accounting for inflation and UAH revaluation) and the administrative anti-inflationary measures by the government, which were vetoed by the president. On some key issues such as privatization, the position of the president coincides with the position of the opposition Party of the Regions. Both sides support the idea that most of the privatization proceeds should be reinvested in the modernization of the Ukrainian economy, as opposed to increased social spending.

Commercial banks' rate for loans to rise, as banks have been under liquidity squeeze

The central bank (NBU) has released banking statistics for May. The monetary base increased by 0.6% m/m (2.8% in Jan-May 2008). The NBU has significantly increased the refinancing of commercial banks to UAH 16.5bn (UAH 42.3bn in Jan-May 2008), as a result of the NBU's tightening policy. After revaluing the UAH by 4% on May 22, the NBU resumed intervention on the FX market. In May, the NBU's foreign currency reserves increased by USD 954.7mn to USD 34.41bn (six months of imports). Money market rates hovered around 16% in May (3M interest rates).

As a result of the NBU's efforts to curb inflation and policy of monetary tightening, commercial banks' loan rates have increased by more than 300bps. Some of the commercial banks have even stopped issuing new loans to clients. In May, the total amount of loans increased by a mere 0.96% m/m (17% in Jan-May08). The amount of loans to retail clients has seen the smallest increase in more than three years, 0.82% m/m (21% in Jan-May08). Thus the NBU has been successful in curbing credit growth. However, the banks will at first curtail the least profitable segments of the lending business (mortgages), but will continue with consumer lending, which features high profit margins and higher risk. We think that lending growth will not be as high as in 2007 (74%), but will moderate to 35-40%. In Jan07-May08, the total share of deposits at the top 10 banks decreased from 75% to roughly 50%. The smaller banks, desperate for financing, have increased the deposit rates to 18-20% in hryvnia, luring clients from the large banks.

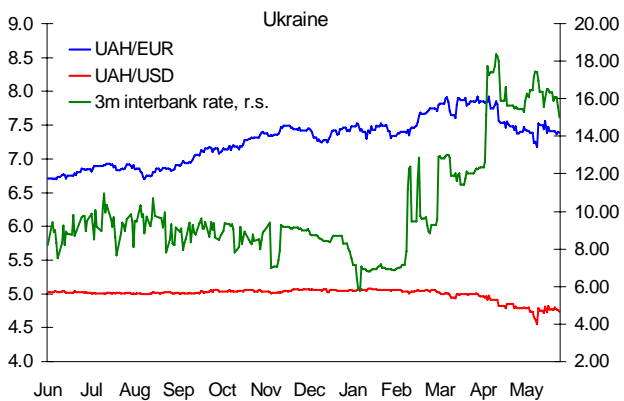
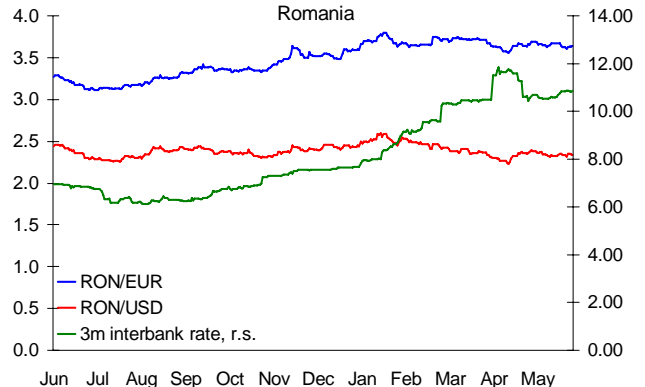
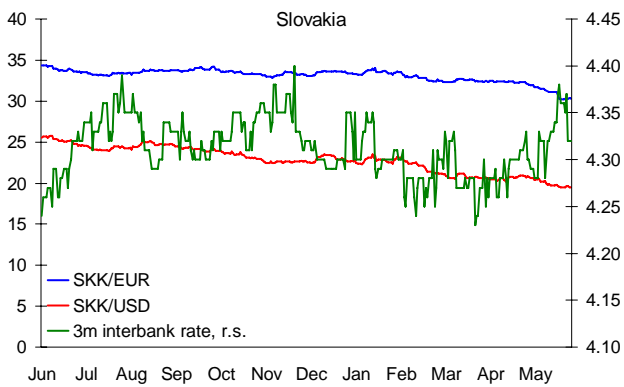
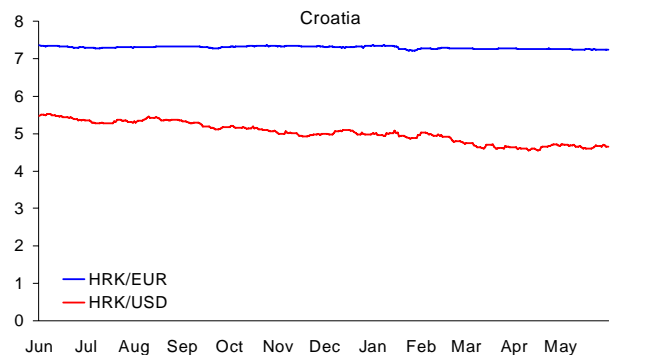
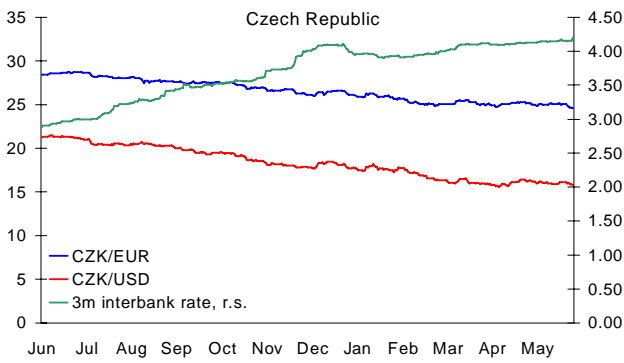
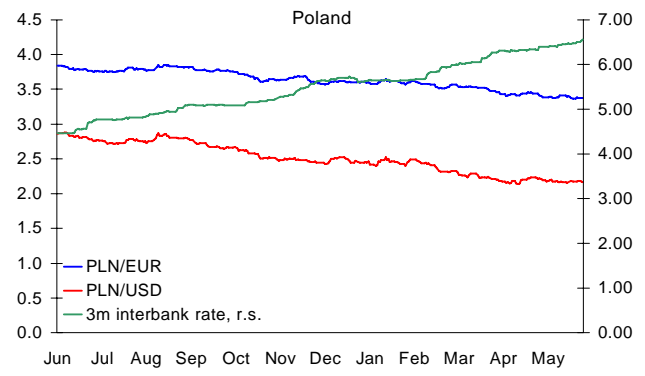
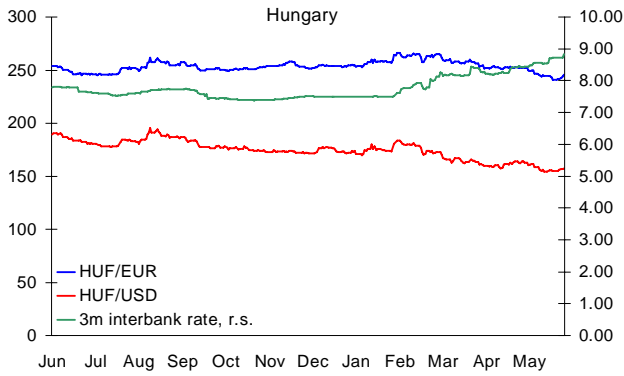
The NBU may be under pressure to loosen its policy as the investments slow, but high inflation (30.2 y/y in April 2008) keeps it from doing so. We expect inflation to moderate in the second half of 2008 and a gradual loosening of the NBU's monetary policy.

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Appendix Charts

<http://global.treasury.erstebank.com>

Exchange rates and interest rates (52 weeks)

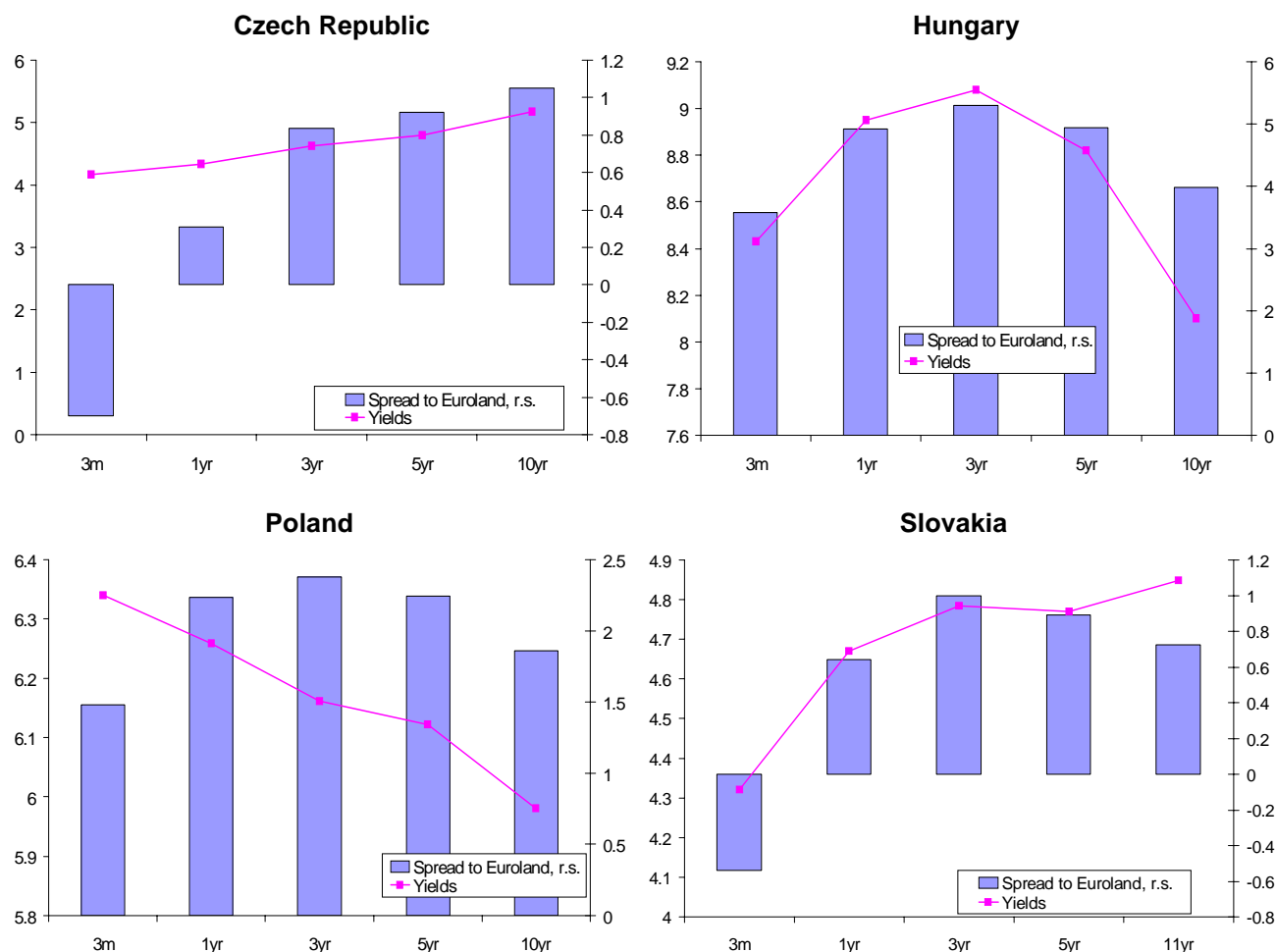


Source: Bloomberg

Appendix Forwards

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Benchmarks



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