CEE Research

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Fixed Income and Foreign Exchange

CEE Insights

- **Croatia:** PPI skyrocketed to 8.7% y/y in May
- **Czech Republic:** CZK and interest rate mismatch
- **Hungary:** CPI accelerated to 7% y/y in May
- **Poland:** Central bankers signal possibility of rate hike
- **Romania:** Romania issued 10Y Eurobonds after break of five years
- **Slovakia:** Inflation increased to 4.6% in May, mainly due to food prices

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Overview

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Croatia:

- PPI skyrocketed to 8.7% y/y in May
- 4Q LFS unemployment rate at 9.7%

Czech Republic:

- Koruna is shooting star…
- …meaning impetus for CZK?
- …or risk aversion?
- CZK and interest rate mismatch

Hungary:

- CPI accelerated to 7% y/y in May
- Budget processes on track in May
- Forint in range of 245-250

Poland:

- Cabinet greenlights 2009 budget draft
- Central bankers signal possibility of rate hike
- Data spree scheduled for next seven days

Romania:

- European funds to sustain economic growth in coming years
- Romanian currency tested 3.70 resistance zone
- Romania issued 10Y Eurobonds after break of five years

Slovakia:

- Inflation increased to 4.6% in May, mainly due to food prices
- Some slowdown in inflation towards year-end could be seen
- Industrial production accelerated in April
- Foreign trade in deficit, due partly to investment imports

Rainer Singer (Co-Head CEE FI Research) rainer.singer@erstebank.at
Juraj Kotian (Co-Head CEE FI Research) juraj.kotian@erstebank.at

Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland current	- 1m	02/01/2008
Czech Republic	EUR/CZK	24.17	1.9%	3.1%	9.8%			
	3Y (yield bp)	4.86	23	0	54	107	75	41
	10Y (yield bp)	5.27	10	56	53	115	81	53
Croatia	EUR/HRK	7.248	0.0%	0.1%	0.7%			
	2Y (yield bp)	5.63	0	0	32	107	191	140
	9Y (yield bp)	5.80	0	0	26	119	178	135
Hungary	EUR/HUF	246.8	-1.2%	1.0%	2.6%			
	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	3.397	-0.4%	-0.4%	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	3.668	-1.0%	-0.4%	-2.5%			
Slovakia	EUR/SKK	30.34	0.0%	4.5%	10.6%			
	3Y (yield bp)	5.09	31	75	50	34	62	52
	9Y (yield bp)	4.95	10	33	13	34	61	48
Ukraine	EUR/UAH	7.28	1.7%	1.9%	1.2%			
	3Y (yield bp)	11.00	-2.0	0.5	3.5	638	670	361

Source: Reuters, Bloomberg (+ means strengthening / - means easing of the exchange rate)

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	24.20	-4.17%	-4.08%	-38.16%	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	24.2		7.25		248		3.40		3.67		30.3		7.34	-
Sep-08	25.8	24.2	7.25	7.25	245	251	3.40	3.41	3.65	3.74	30.1	30.2	7.39	7.53
Dec-08	25.9	24.2	7.30	7.30	245	253	3.35	3.42	3.50	3.79	30.1	30.2	7.23	7.81
Mar-09	25.7	24.1	7.25	7.25	240	255	3.28	3.43	3.58	3.85	-	30.2	6.96	8.01
Jun-09	25.5	24.1	7.22	7.22	240	258	3.35	3.44	3.55	3.90	-	30.1	6.72	8.19

	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	4.23		8.98		6.59		11.44		4.32		15.89	-
Sep-08	4.00	4.50	8.75	6.25	10.0	4.25	12.00	4.09	4.57	8.70	9.34	6.45	6.80	11.50	7.93	4.50	4.60	14.20	-
Dec-08	4.00	4.25	8.75	6.25	9.50	4.25	12.00	4.14	4.05	8.65	9.29	6.45	6.84	10.00	5.78	4.50	4.76	13.75	-
Mar-09	4.00	4.00	8.50	6.25	8.50	-	12.00	4.31	4.73	8.40	9.23	6.35	6.82	8.80	5.27	-	5.39	13.25	-
Jun-09	4.00	4.00	8.00	6.00	7.75	-	-	4.30	4.66	8.00	9.03	6.10	6.69	8.05	4.80	-	5.35	13.00	-

	10y Govt. Yield					5y Govt. Yield	3y Govt. Yield
	CZ	HR	HU	PL	SK	RO	UA
Spot	5.27	5.80	8.60	6.45	4.99	10.20	11.0
Sep-08	4.45	5.60	7.90	6.35	4.95	9.80	11.0
Dec-08	4.70	5.50	7.40	6.15	5.00	9.50	10.8
Mar-09	4.80	5.50	6.90	5.90	4.90	8.50	10.5
Jun-09	4.85	5.50	6.80	5.75	4.90	7.80	10.2

Long-term forecasts

GDP growth (%)	2006	2007	2008f	2009f
Czech Republic	6.4	6.5	4.9	4.5
Croatia	4.8	5.6	4.6	4.8
Hungary	3.9	1.3	2.2	3.2
Poland	6.2	6.6	5.5	5.3
Romania	7.9	6.0	7.0	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	**6.4**	**6.2**	**5.5**	**5.2**

Unemployment (%)	2006	2007	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**

C/A (%GDP)	2006	2007	2008f	2009f
Czech Republic	-3.0	-3.2	-3.5	-1.6
Croatia	-7.9	-8.6	-8.1	-7.9
Hungary	-6.1	-5.0	-4.5	-4.2
Poland	-2.7	-3.7	-5.0	-5.6
Romania	-10.4	-13.9	-14.2	-14.1
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	**-5.0**	**-6.0**	**-6.5**	**-6.5**

CPI (%), eoy	2006	2007	2008f	2009f
Czech Republic	2.5	4.9	4.8	2.8
Croatia	2.0	5.8	3.1	3.5
Hungary	6.5	7.4	5.6	3.6
Poland	1.4	4.0	3.8	3.1
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**	**6.3**	**4.5**

3M rates (average, %)	2006	2007	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	8.4	8.0
Poland	4.2	4.6	6.2	6.1
Romania	8.8	7.8	11.0	7.9
Serbia	22.1	11.3	11.2	10.0
Slovakia	4.3	4.3	4.4	4.4
Ukraine	13.5	9.6	14.5	12.0
CEE8 weighted average	**6.6**	**6.0**	**7.9**	**7.0**

Budget Balance (%GDP)	2006	2007	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	-3.8	-2.0	-2.6	-2.7
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	**-3.4**	**-2.3**	**-2.6**	**-2.8**

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	17-Jun	Current account (CZK bn), Apr	-6.0	-12.6
	18-Jun	Retail sales (% y/y), Apr	6.0%	5.8%
Croatia	19-Jun	Industrial Production	2% y/y	
	20-Jun	Unemployment rate	13.1%	
Hungary	Jun-13	Minutes of the May 26 monetary meeting		
	Jun-19	April Nominal wages	-	9% y/y
Poland	Jun-16	Corporate average wages (% y/y), May	-	11.5%
	Jun-17	Current account (EUR mn), Apr	-	-1407
	Jun-18	Producer prices (% y/y), May	-	2.5%
	Jun-18	Industrial output (% y/y), May		7.6%
	Jun-20	Net core inflation (% y/y), May	-	3.3%
Romania	No data releases scheduled			
Slovakia	Jun-16	May HICP	4.0-4.1% y/y	3.9%
Ukraine	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Jun-18	Jun-23	Apr-11-2011	4.10%	CZK 7bn	
Hungary		Jun-17	Jun-25	Sept-24-2008	-	HUF 30bn	
		Jun-19	Jun-25	April-22-2011	6.75%	HUF 70bn	
Poland		Jun-16	Jun-18	Sept-17-2008	-	PLN 1.0-2.0bn	
		Jun-16	Jun-18	June-17-2009	-	PLN 1.0-2.0bn	
Romania		Jun-20	Jun-24	5Y	8.25%	RON 500 mn	9.50%
Slovakia		No auction scheduled					
Ukraine		No auction scheduled					

Major markets

ECB Council members cooling market fears of strong interest rate hikes

President Trichet's comments at the press conference drove short-term interest rates sharply higher and led to an inversion of the government curve. Comments by other ECB Council members this week seemed to be aimed at calming down fears of strong interest rate hikes to come. Therefore, the curve could end the week flat, but nevertheless at drastically higher yields for longer-term maturities. The 10-year German Bund yield increased by 20 basis points and the 2-year German Bund yield stayed unchanged compared to last Friday. As the Bund Future is already near the strong support level of 110, we expect a consolidation of the longer-term maturities during the coming days. The government bond market should also get some support from the correction on the stock market and the rising risk aversion. Next week, consumer prices for Euroland in May (Monday) will be released and will get more attention than usually, as inflation fears are on the rise. The most important factor will be the development of core inflation. The ZEW Survey due on Tuesday is expected to show a further decrease in the expectation component.

US interest rate expectations surge

Yet another week with market-provoking comments from the Fed chairman comes to a close. Bernanke made some hawkish statements that were interpreted by markets as signals for a rate hike, even before the end of summer. We disagree, and rather see these comments as intended to support the dollar vs. the euro, after previous clear indications of an ECB hike soon. Just a week earlier, Bernanke said that monetary policy was well positioned to promote price stability. The market is currently betting on three rate hikes before the end of the year. Recently released retail sales, which got a boost from the tax rebates, contributed to this development. Today's consumer prices could fuel interest rate speculations further, but we think the market consensus is the most likely outcome, with risks on the downside. The next week will only bring second-tier data, with indicators from the housing market on Monday, Tuesday and Wednesday. Industrial production is also scheduled for Tuesday; it is likely to have stagnated in May. While the coming data will remind markets of the weak status of the economy, it will probably not shift interest rate expectations. However, some technical consolidation on the bond market could be seen. For the dollar, the G8 meeting this weekend poses some risks, but we do not expect any new statements. Bernanke will speak on Monday. The topic, "Challenges for Health-Care Reform", does not point to any hints on monetary policy, but Bernanke has surprised markets twice during the last two weeks.

Veronika Lammer, veronika.lammer@erstebank.at
Rainer Singer, rainer.singer@erstebank.at

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		2.78		4.64	4.23	1.533	
Sep-08	4.25	2.00	4.60	5.27	2.30	3.51	4.60	4.20	1.55	1.525
Dec-08	4.25	2.00	4.50	5.51	2.30	3.74	4.70	4.40	1.48	1.519
Mar-09	4.25	2.00	4.50	5.60	2.40	3.93	4.60	4.60	1.43	1.514
Jun-09	4.25	2.25	4.50	5.22	2.60	4.12	4.70	4.80	1.38	1.509

Croatia

PPI skyrocketed to 8.7% y/y in May

Producer prices surprised on the negative side, accelerating by a robust 1.3% m/m in May and hitting the highest level seen since early 2001. Energy and intermediary goods prices continue to contribute substantially to the overall PPI performance, as the energy component added a robust 2.9% m/m. The pressure is likely to continue in the coming months, putting additional strain on consumer prices as well. Given the persistent inflationary environment, the government decided to adjust the announced electricity hike, aiming to avoid a negative effect on disposable income among lower income groups. Nevertheless, we see pressures mounting, as food and energy prices will undoubtedly continue to push ahead strongly, bringing the y/y CPI rate to the 7% region in the coming months.

Among the recent monthly indicators, retail trade figures showed the expected continuation of the sluggish trend, recording +7% y/y in nominal terms and just +0.5% y/y in real terms. Thus, after the surprisingly good performance in the first two months, March (-0.3% y/y in real terms) and April brought the retail trade figures to the expected region, as inflationary pressures are biting deeply and, coupled with credit activity moderation, consumption spending is losing momentum (thereby contributing to GDP performance to a much lower extent than in 2007).

4Q LFS unemployment rate at 9.7%

The 4Q labor force survey unemployment rate came in at 9.7%, in line with our expectation (9.8%). This shows the ongoing favorable development of the labor market, as the unemployment rate has declined by 0.8pp since the end of 2006. However, some old weaknesses remained, as the activity rate stayed under 50%, continuing to show that a large proportion of the working-age population has little incentive to actively seek a job. In the course of 2008, we expect a continuation of the solid labor market performance and an additional decline of the unemployment rate (by 0.3-0.5pp), based on solid official monthly administrative unemployment rate developments and still solid investment activity, which should support the job creation process.

The exchange rate remained stable at around 7.25, with slightly more pronounced appreciation pressure. This came as no surprise, given the beginning of the peak tourist season. For quite some time, the bond market has failed to offer significant movement, recording no yield changes and low turnovers.

Alen Kovac, akovac2@erstebank.com

Czech Republic

Koruna is shooting star…

The EUR/CZK is at a new all-time high and the market expects CNB hikes in response to inflation. How does this match up? The CZK is approaching 24 EUR/CZK and technical analysis shows further room for appreciation. We have argued that the koruna is overvalued in terms of domestic fundamentals. However, the market is going against us. On a 12M basis, the CZK is the top currency in the world, with a gain of almost 18%. The PLN is in second place, followed by the SKK, both of which have strengthened by approximately 13%.

…meaning impetus for CZK?

The SKK provides one explanation for the strong CZK. The development of the Slovak currency shows that there is greater catch-up potential among CEE currencies than was thought before. According to this line of thought, the CZK could reach 20 EUR/CZK, erasing the lower Czech price level compared to productivity (due to space limitations, I will not go into details on this right now; we will release our analysis on this topic in a special report in a few days). There is an obvious contradiction here. In the paragraph above, I noted that our view is that the CZK is overvalued. Then, I stated that an argument exists that the CZK is undervalued. One view is based on the long-term gap, which indicates potential for a stronger CZK. The second view is based on the normal development. This gap has been here for several years without a significant reduction. This normal view is based on balance of payments flows, like the trade balance, dividends and interest rates, which indicate the koruna at close to 26 per euro.

…or risk aversion?

I assign a higher probability to the second explanation. Let's call the CZK a safe haven. Although the Czech economy is slowing down, it is still seeing excellent growth. There is high inflation (indeed, the highest in the last 10 years), which is driving interest rates up, skewing the interest rate differential towards the CZK. The story is not only about domestic fundamentals, but also fundamentals relative to other countries. Particularly in this high-risk-aversion environment, the pure interest rate differential is not the main driver, but rather the expected volatility. We underestimated the length of the high risk aversion and the short memory of the market.

CZK and interest rate mismatch

Why the short memory? The reason is that the Czech Republic is still a small, open economy with all of the pros and cons that entails. I would keep in mind the sensitivity of the economy to foreign exchange developments. Our simulations show that 3% appreciation decreases inflation by 1pp (with a lag, of course). Moreover, monetary conditions have tightened through FX, which will also slow the economy (again with a lag). Thus, a lower-inflation environment is in the pipeline. We still expect interest rate hikes to 4% this year (+25bps); for end-2009, we anticipate rates at 4.25%. The expected CZK correction is consistent with this scenario. However, we see increasing expectations regarding the interest rate, as the market has priced in 75bps in hikes within six months (with the current CZK appreciation). In our view, these priced-in hikes are not consistent with this pace of appreciation. We therefore recommend shorting the Czech short-end yield curve, long EMU money market. Either the CZK will correct and the CNB will hike to what is already priced in (gains from CZK depreciation), or the market will correct its expectations regarding the CNB (widening spread).

David Navratil, dnavratil@csas.cz

Hungary

CPI accelerated to 7% y/y in May

Consumer prices rose 1.1% m/m in May, accelerating the 12-month CPI inflation rate to 7% (from the 6.6% published for April). Our expectation was 6.7% y/y, while analyst estimates fluctuated in the range of 6.6-6.8% y/y. Thus, the actual figures came as a big negative surprise. We did not estimate well the monthly increase in food prices, which was 1.9% in May (our estimate: 1.5% m/m). Prices of services surprised on the upside as well, rising by 0.6% m/m. Other drivers burdened the May CPI index, more or less in line with expectations. The 3.2% m/m increase in fuel prices and the accounting for the April increase in gas prices (7% on average) both added 0.2-0.2pps to the headline CPI. Apart from "non-core" items, it is not favorable that the seasonally-adjusted core inflation showed a 0.5% m/m increase, while the 12-month core rate further accelerated to 5.9% (from its April level of 5.6% y/y). All in all, the figures have significantly increased the likelihood of another rate hike at the June monetary meeting. The higher than expected May inflation figures should push the inflation path upwards for the remainder of the year. Thus, we had to increase our year-end CPI inflation forecast to 5.6% y/y, from the earlier 5.3% y/y.

Budget processes on track in May

According to the Finance Ministry's preliminary figures, the budget surplus amounted to HUF 97.6bn in May, exceeding the ministry's preliminary forecast of a surplus of HUF 88.6bn. Thus, the deficit for the first five months of the year decreased to HUF 424.8bn, 38.9% of the latest full-year projection.

Forint in range of 245-250

The forint has showed volatile movements during the week, but managed to preserve its strength in the range of 245-250 EUR/HUF. Intensifying rate hike expectations mean important fundamental support for the exchange rate. The situation has hardly improved on the bond market, however. Although no further rises in long-term bond yields have been observed this week, they seem to have become stuck at irrationally high levels, mainly due to the lack of demand. On the other hand, short-term yields are pricing in much higher rate hikes than would make sense. As a response to the current problems on the bond market, it cannot be ruled out that the Debt Management Agency (ÁKK) could decrease the supply of forint-denominated papers and shift somewhat to currency-based financing for the remainder of the year.

Next week, April nominal wage figures (due on Thursday) should be in focus for market participants, as the last important fundamental figures before the June monetary meeting. Fuelled by the high core inflation and series of comments from rate setters, however, another 25bp rate hike seems certain on June 23.

Orsolya.Nyeste, orsolya.nyeste@erstebank.hu

Poland

Cabinet greenlights 2009 budget draft

The Polish government gave a preliminary nod to the 2009 budget outline. Now, consultations with unions will follow and the cabinet will grant final approval of the budget at the end of September, before handing it over to Parliament. The draft foresees the central budget ending up in a deficit of PLN 18.2bn next year. This seems to be a significant step ahead in fiscal consolidation, taking into account the shortfall of PLN 27.1bn planned for 2008. However, the fiscal developments have been better than expected so far this year, with the booming economy the main factor to thank. Hence, the actual 2008 shortfall could be much lower (around PLN 18-24bn, according to Finance Ministry officials), and the reduction in the deficit will not be as huge next year as it looks at first sight. The projections already comprise the cost of planned tax changes, which the finance minister estimates at around PLN 7bn. These concern personal income taxes, with the current progressive system (tax rates of 19%, 30% and 40%) to be simplified (only two rates of 18% and 32%, with most Poles falling into the lower category). All in all, public finances should stay under control next year, with the overall public finance deficit staying safely below the Maastricht threshold of 3%.

Central bankers signal possibility of rate hike

Interviews with MPC members published this week have hinted that the scales might tip towards an interest rate hike in June (in our view). A hawkish leaning central banker, Dariusz Filar, was quoted as saying that the bank will need to hike interest rates once or twice in order to maneuver inflation back to the target. Moreover, swing voter Jan Czekaj confirmed that the robust economy and wage dynamics represent threats to inflation and did not rule out another rate hike. We think that, with the new inflation prognosis in hand, the central bank will have enough ammunition to raise the rates at this month's meeting. Given the tight labor market, positive output gap and existing inflation pressures, we think that at least two hikes are still on the cards this year, with rates peaking at 6.25%.

Data spree scheduled for next seven days

The market will monitor a rich set of data releases in the coming days. For bonds, inflation and corporate wages are of key importance. The former is expected to increase, primarily on the back of gas price rises and a spike in oil prices. For the sake of the rate outlook, the structure will be scrutinized to identify the extent to which robust demand transfers into price pressures. We think that the markets will be more sensitive to a downward surprise in both indicators, as the opposite development (and monetary policy tightening in the months ahead) is already incorporated into the prices.

Maria Hermanová, MHermanova@csas.cz

Romania

European funds to sustain economic growth in coming years

The total value of projects that will be financed in the near future through European funds exceeds EUR 1bn. This value includes community assistance, local financing from the state budget and applicants' own contributions. The European funds will be received under three operational programs: the Human Resources Development Operational Program (106 projects approved so far), the Operational Program Environment (six projects) and Regional Operational Program (11 projects). Romania could receive EUR 19.7bn from EU structural funds during 2007-13. The absorption capacity remains a problem, as only EUR 440mn was used in 2007, with an absorption rate of 21.7%. The EU funds could generate 15-20% additional GDP growth by 2015. We thus estimate economic growth rates of at least 5.5-6% in the coming years, with civil engineering work and services receiving substantial support from European funds.

Romanian currency tested 3.70 resistance zone

As we had anticipated, the RON approached the 3.70 level at the beginning of the week, on the back of bearish sentiment among investors towards emerging markets. The euro rally was triggered by worse than expected US unemployment data, record oil prices and local corporate demand from unhedged borrowers. However, the euro could not maintain the recent gains and the pair reversed back to the 3.67 zone. The traded volumes were substantial, but the volatility diminished in the past week. The liquidity conditions have eased slightly on the Romanian money market in the last part of the current reserve period. The central bank held its regular 1-week deposit auction on Monday, draining RON 450mn from the local money market at the fixed interest rate of 9.75%. Only two commercial banks placed bids at the NBR auction, as banks prefer to keep the liquidity at their disposal. Therefore, overnight interest rates decreased gradually during the week, especially as the banks have already constituted a large part of their mandatory reserve requirements. Overnight interbank interest rates fell from 9.75/10.25% bids/asks at the beginning of the week to 9.3/9.8% towards the end of the week.

Romania issued 10Y Eurobonds after break of five years

On June 11, Romania sold 10-year Eurobonds for a fixed coupon rate of 6.5% per annum. Romania attracted EUR 750mn from the international markets. The issue was over-subscribed, as the overall offer reached EUR 1.3bn. The issue was lunched with a 6.70% yield, 170 bps over mid-swaps. On the same day, the MinFin held another auction, this time on the local primary market, for 6M discounted treasury bills worth RON 800mn. The auction drew limited attention on the Romanian market, as it was over-subscribed by just RON 200mn (EUR 998mn). The average yield increased to 10.74% (from 9.61% previously). The MinFin will hold its next auction on June 19, as it intends to sell 3Y benchmark bonds worth RON 500mn. At the previous auction, the highest accepted yield stood at 10%. It is possible that yields will top out at this level for the time being, as the MinFin prefers to attract liquidity for shorter terms.

Melania Hancila, melania.hancila@bcr.ro
Eugen Sinca, eugen.sinca@bcr.ro

Slovakia

Inflation increased to 4.6% in May, mainly due to food prices

The consumer price index increased by 0.3% m/m in May, putting headline annual inflation at 4.6%, up from 4.3% in April. The figure was in line with our expectations, while the market (on average) expected a slightly lower figure of 4.5% y/y. May inflation was driven mainly by food prices, which increased by 1.1% on the month, due to more expensive vegetables (up 9.2% m/m). The increase in vegetable prices is a seasonal phenomenon, and we expect them to decline again from July. Aside from food, prices of fuels increased by 2.5% m/m in May and prices of heating also went up by 0.9% m/m. Harmonized inflation, to be released next Monday, will likely reach 4.0-4.1% y/y, in line with our pre-CPI forecasts. The 12-month HICP average should increase to 2.6%, up from the 2.4% seen in April (but will remain below the Maastricht limit). Demand inflationary pressures stayed unchanged in May, according to our measure of demand-driven inflation (CPI ex regulated prices, taxes, food, fuel and imputed rents), at April's level of 2.2% y/y, after the gradual increase in past months (from 1.6% in December).

Some slowdown in inflation towards year-end could be seen

In the coming months, we expect some deceleration of demand inflation, facilitated by the strong koruna. Headline inflation should fluctuate around the May level over summer, before gradually declining to around 4% by the year end. The main risk to our forecasts is oil prices, which might prompt the gas distributor and heating companies to demand an increase in their prices for households before the year end. As for monetary policy, the increasing chances that the ECB will hike interest rates by 25bp to 4.25% already in July imply that the NBS can wait and keep rates on hold (currently, Slovak key interest rates stand 25bp above the key ECB rate).

Industrial production accelerated in April

Industrial production picked up in April (as expected) to an annual growth rate of 9.7%, from the 2.0% seen in March. Easter holidays shrank the number of working days in March this year, while last year's Easter (in April) made a favorable base for annual production growth in April 2008. The key contributing sector - the automotive sector - increased production by a hefty 43% y/y, after growing by an average 60% last year. In the months ahead, we expect industrial production to continue with solid growth of around 8-12%.

Foreign trade in deficit, due partly to investment imports

Despite the revival of growth in export-oriented industrial sectors, merchandise foreign trade posted a deficit of SKK 5.7bn in April, coming in well below our and market expectations (surpluses of SKK 2.2bn and SKK 3.9bn, respectively). The growth of both exports and imports was strong, at 21% and 27% y/y, respectively. The structure is not known yet, but, given the significant surprise, the Stats Office hinted that investments in the automotive and electronics industries (which would be positive for the economy, despite causing a temporary deficit in trade) also stood behind the exceptionally high import growth. The Stats Office also revised the trade surplus for the first three months down by SKK 4bn. The 12-month cumulative trade balance hence reached a deficit of 1.4% of GDP, as compared to the revised 1.0% seen in March.

Mária Valachyová, valachyova.maria@slsp.sk

Appendix Charts

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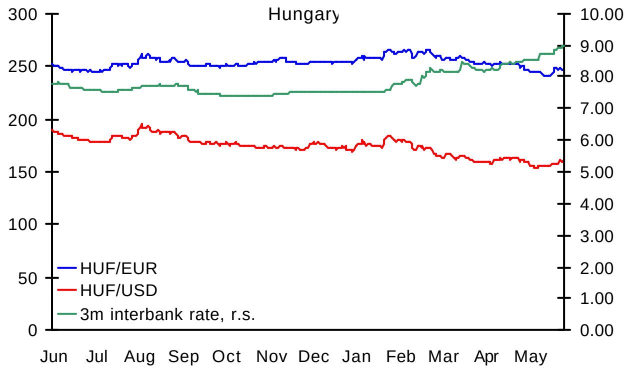
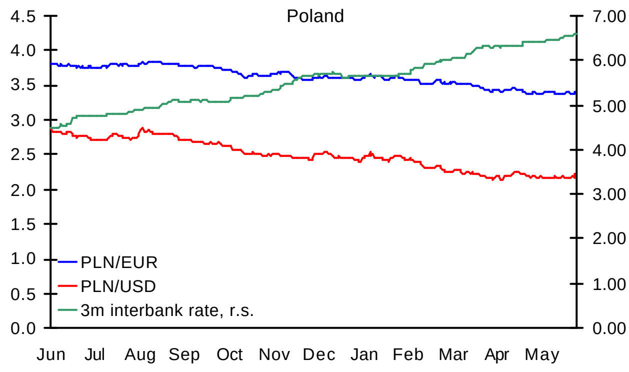
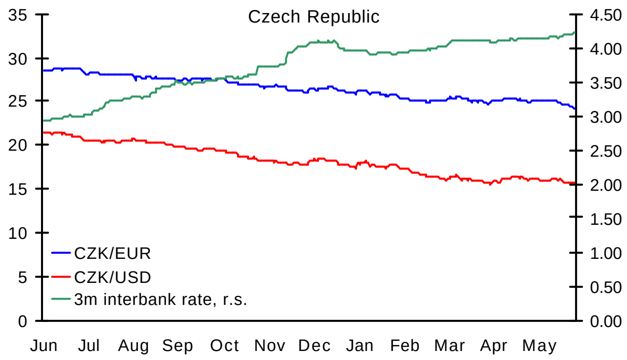
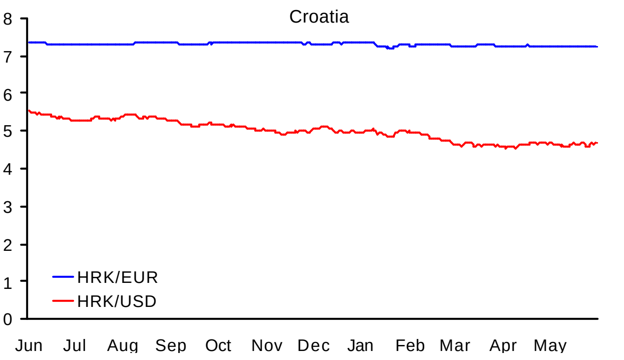
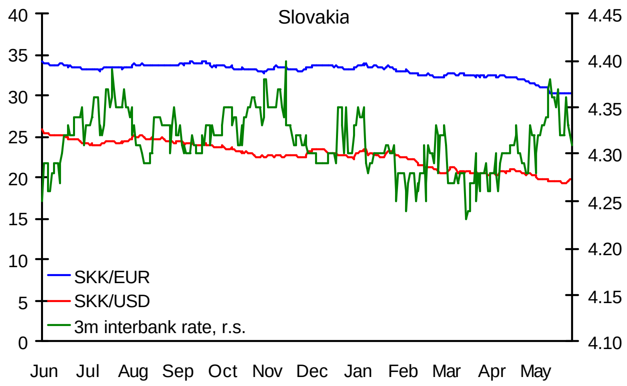
Exchange rates and interest rates (52 weeks)

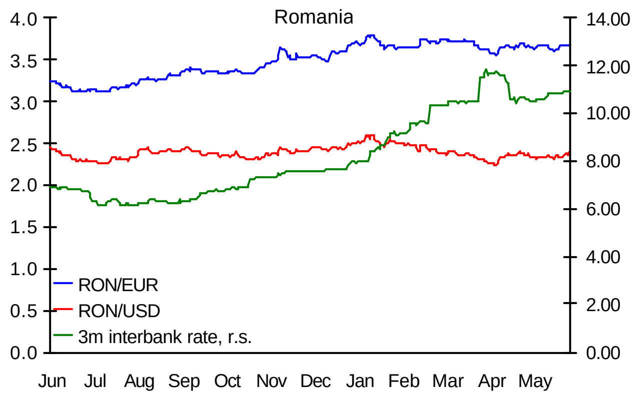


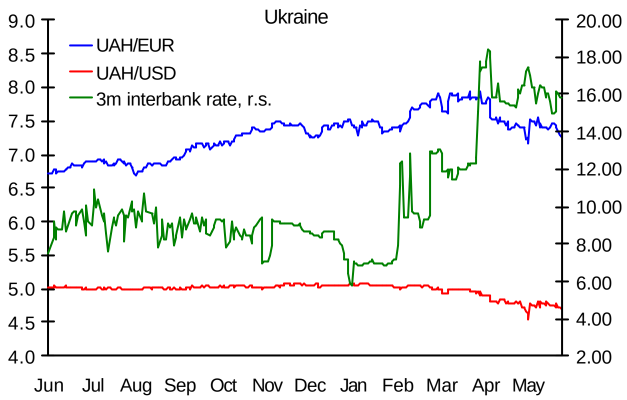












Source: Bloomberg

Appendix Forwards

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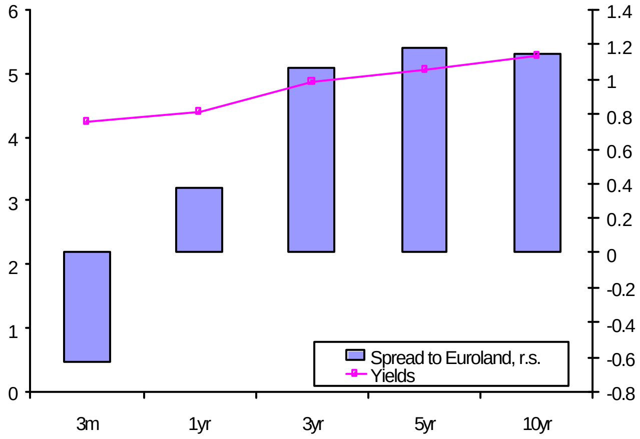
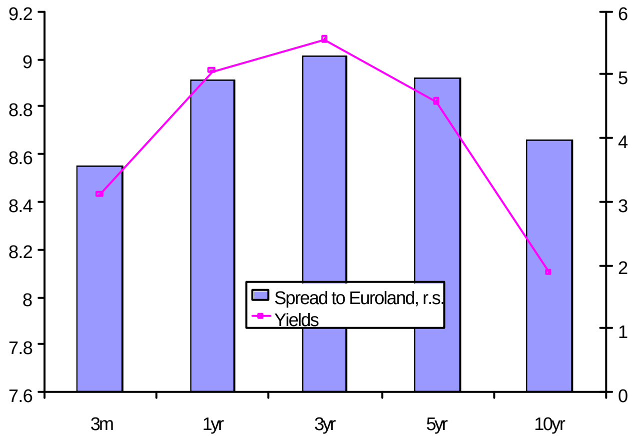
Benchmarks

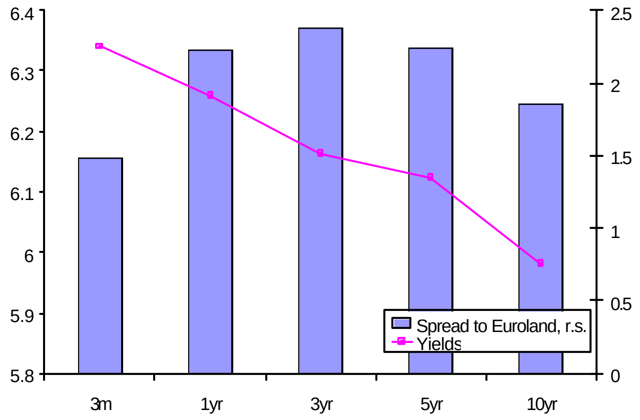
Czech Republic



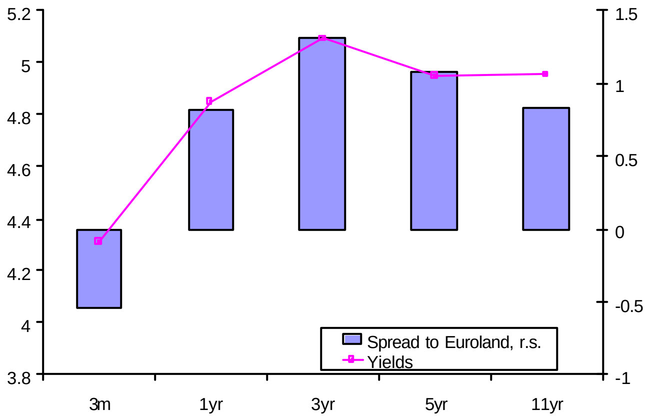
Hungary



Poland



Slovakia



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Contacts

http://global.treasury.erstebank.com

Group Research

Head of Group Research	
Friedrich Mostböck, CEFA	+43 (0)5 0100 - 11902
CEE Equity Research	
Co-Head: Günther Artner, CFA	+43 (0)5 0100 - 11523
Co-Head: Henning Eßkuchen	+43 (0)5 0100 - 19634
Günter Hohberger *(Banks)*	+43 (0)5 0100 - 17354
Franz Hörl, CFA *(Steel, Construction)*	+43 (0)5 0100 - 18506
Gernot Jany, CFA *(Banks, Real Estate)*	+43 (0)5 0100 - 11903
Daniel Lion *(IT)*	+43 (0)5 0100 - 17420
Martina Valenta, MBA *(Transp., Paper)*	+43 (0)5 0100 - 11913
Christoph Schultes, CIIA *(Ins., Util.)*	+43 (0)5 0100 - 16314
Vera Sutedja, CFA *(Telecom)*	+43 (0)5 0100 - 11905
Thomas Unger *(Telecom)*	+43 (0)5 0100 - 17344
Vladimira Urbankova *(Pharma)*	+43 (0)5 0100 - 17343
Gerald Walek, CFA *(Machinery)*	+43 (0)5 0100 - 16360
International Equities	
Hans Engel *(Market strategist)*	+43 (0)5 0100 - 19835
Ronald Stöferle *(Asia)*	+43 (0)5 0100 - 11723
Jürgen Rene Ulamec, CEFA *(Europe)*	+43 (0)5 0100 - 16574
Macro/Fixed Income Research	
Head: Veronika Lammer (*Euroland*)	+43 (0)5 0100 - 11909
Alihan Karadagoglu (*Corporates*)	+43 (0)5 0100 - 19633
Rainer Singer (*US*)	+43 (0)5 0100 - 11185
Elena Statelov, CIIA (*Corporates*)	+43 (0)5 0100 - 19641
Mildred Hager (SW, Japan)	+43 (0)5 0100 - 17331
Macro/Fixed Income Research CEE	
Co-Head CEE: Juraj Kotian *(Macro/FI)*	+43 (0)5 0100 - 17357
Co-Head CEE: Rainer Singer *(Macro/FI)*	+43 (0)5 0100 - 11185
Editor Research CEE	
Brett Aarons	+420 2 24995 - 904
Research, Croatia/Serbia	
Head:Mladen Dodig	+38 1 112200 - 866
Damir Cukman *(Equity)*	+38 5 6237 - 2820
Ivan Gojnic *(Equity)*	+38 1 112200 - 852
Alen Kovac *(Fixed income)*	+38 5 6237 - 1383
Uros Mladenovic *(Equity)*	+38 1 112200 - 872
Davor Spoljar *(Equity)*	+38 5 6237 - 2825
Research, Czech Republic	
Head: David Navratil (*Fixed income*)	+420 2 24995 - 439
Petr Bartek *(Equity)*	+420 2 24995 - 227
Maria Hermanova *(Fixed income)*	+420 2 24995 - 232
Lenka Slamova *(Equity)*	+420 2 24995 - 289
Radim Kramule *(Equity)*	+420 2 24995 - 213
Martin Lobotka *(Fixed income)*	+420 2 24995 - 192
Lubos Mokras *(Fixed income)*	+420 2 24995 - 456
Jakub Zidon *(Equity)*	+420 2 24995 - 340
Research, Hungary	
Head: József Miró *(Equity)*	+36 1 235 - 5131
Zoltan Arokszallasi *(Equity)*	+36 1 235 - 5135
Mihaly Tatar *(Equity)*	+36 1 235 - 5134
Orsolya Nyeste (*Fixed income*)	+36 1 373 - 2830
Research, Poland	
Head: Artur Iwanski *(Equity)*	+48 2 23306 - 253
Magda Jagodzinska *(Equity)*	+48 2 23306 - 250
Marcelina Hawryluk *(Equity)*	+48 2 23306 - 255
Tomasz Kasowicz *(Equity)*	+48 2 23306 - 251
Piotr Lopaciuk *(Equity)*	+48 2 23306 - 252
Marek Czachor *(Equity)*	+48 2 23306 - 254
Research, Romania	
Head: Lucian Claudiu Anghel	+40 2 1312 - 6773
Mihai Caruntu (*Equity*)	+40 2 1311 - 2754
Dumitru Dulgheru *(Fixed income)*	+40 2 1312 6773 - 1028
Cristian Mladin *(Fixed income)*	+40 2 1312 6773 - 1028
Loredana Oancea (*Equity*)	+40 2 1311 - 2754
Raluca Ungureanu (*Equity*)	+40 2 1311 - 2754
Research, Slovakia	
Head: Juraj Barta *(Fixed income)*	+42 1 25957 - 4166
Michal Musak *(Fixed income)*	+42 1 25957 - 4512
Maria Valachyova *(Fixed income)*	+42 1 25957 - 4185
Research, Ukraine	
Viktor Stefanyshyn *(Fixed income)*	+38 044 593 - 1784
Roman Oliynyk *(Fixed income)*	+38 044 593 - 9188

Institutional Sales

Head of Sales Equities & Derivatives	
Michal Rizek	+44 207 623 - 4154
Brigitte Zeitlberger-Schmid	+43 (0)5 0100 - 83123
Equity Sales Vienna XETRA & CEE	
Hind Al Jassani	+43 (0)5 0100 - 83111
Werner Fuerst	+43 (0)5 0100 - 83114
Josef Kerekes	+43 (0)5 0100 - 83125
Cormac Lyden	+43 (0)5 0100 - 83127
Stefan Raidl	+43 (0)5 0100 - 83113
Simone Rentschler	+43 (0)5 0100 - 83124
Sales Derivatives	
Christian Luig	+43 (0)5 0100 - 83181
Manuel Kessler	+43 (0)5 0100 - 83182
Sabine Kircher	+43 (0)5 0100 - 83161
Christian Klikovich	+43 (0)5 0100 - 83162
Armin Pfingstl	+43 (0)5 0100 - 83171
Roman Rafeiner	+43 (0)5 0100 - 83172
Equity Sales, London	
Dieter Benesch	+44 207 623 - 4154
Tatyana Dachyshyn	+44 207 623 - 4154
Jarek Dudko, CFA	+44 207 623 - 4154
Federica Gessi-Castelli	+44 207 623 - 4154
Declan Wooloughan	+44 207 623 - 4154
Sales, Croatia	
Zeljka Kajkut *(Equity)*	+38 5 6237 - 2811
Damir Eror *(Equity)*	+38 5 6237 - 2813
Sales, Czech Republic	
Michal Brezna (*Equity*)	+420 2 24995 - 523
Ondrej Cech *(Fixed income)*	+420 2 24995 - 577
Michal Rizek	+420 2 24995 - 537
Jiri Smehlik (*Equity*)	+420 2 24995 - 510
Pavel Zdichynec *(Fixed income)*	+420 2 24995 - 590
Sales, Hungary	
Gregor Glatzer (*Equity*)	+36 1 235 - 5144
Krisztián Kandik (*Equity*)	+36 1 235 - 5140
Istvan Kovacs (*Fixed income*)	+36 1 235 - 5846
Sales, Poland	
Head: Andrzej Tabor	+48 2 23306 - 203
Pawel Czuprynski *(Equity)*	+48 2 23306 - 212
Lukasz Mitan *(Equity)*	+48 2 23306 - 213
Jacek Krysinski *(Equity)*	+48 2 23306 - 218
Sales, Slovakia	
Head: Dusan Svitek	+42 1 25050 - 5620
Rado Stopiak *(Derivatives)*	+42 1 25050 - 5601
Andrea Slesarova *(Client sales)*	+42 1 25050 - 5629

Treasury - Erste Bank Vienna

Sales Retail & Sparkassen	
Head: Manfred Neuwirth	+43 (0)5 0100 - 84250
Equity Retail Sales	
Head: Kurt Gerhold	+43 (0)5 0100 - 84232
Domestic Sales Fixed Income	
Head: Thomas Schaufler	+43 (0)5 0100 - 84225
Treasury Domestic Sales	
Head: Gottfried Huscava	+43 (0)5 0100 - 84130
Corporate Desk	
Head: Leopold Sokolicek	+43 (0)5 0100 - 84601
Alexandra Blach	+43 (0)5 0100 - 84141
Roman Friesacher	+43 (0)5 0100 - 84143
Helmut Kirchner	+43 (0)5 0100 - 84144
Christian Skopek	+43 (0)5 0100 - 84146
Fixed Income Institutional Desk	
Head: Thomas Almen	+43 (0)5 0100 - 84323
Martina Fux	+43 (0)5 0100 - 84113
Michael Konczer	+43 (0)5 0100 - 84121
Ingo Lusch	+43 (0)5 0100 - 84111
Ulrich Inhofner	+43 (0)5 0100 - 84324
Karin Rauscher	+43 (0)5 0100 - 84112
Michael Schmotz	+43 (0)5 0100 - 84114