

CEE Insights

Fixed Income and Foreign Exchange – July 11, 2008

Croatia: Current account to widen to above 9% of GDP

Czech Republic: EMU slowdown, CZK strength to hit Czech industry

Hungary: CPI inflation slowed to 6.7% y/y in June

Poland: Zloty again overwriting its record highs

Romania: Romanian currency firmed to this year's highest level

Slovakia: Euro conversion rate fixed at ERM-2 central parity

Overview

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Croatia

- 1Q08 GDP growth accelerated to 4.3% y/y
- Current account to widen to above 9% of GDP
- June PPI further accelerated to 9.6% y/y

Czech Republic

- Drop in inflation not likely before autumn
- EMU slowdown, CZK strength to hit Czech industry

Hungary

- CPI inflation slowed to 6.7% y/y in June
- Forint appreciation continued

Poland

- Zloty again overwriting its record highs...
- ...provoking verbal comments from officials
- Spree of macro data scheduled for release next week

Romania

- Trade deficit continued to slow down
- Romanian currency firmed to this year's highest level
- Romania paid maximum yield of 9.75% on 5Y benchmark bonds

Slovakia

- Euro conversion rate fixed at ERM-2 central parity
- Fitch upgraded Slovakia's rating
- Inflation stagnated at 4.6% in June

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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	23.50	0.5%	3.7%	12.9%			
	3Y (yield bp)	4.50	-25	0	19	71	130	41
	10Y (yield bp)	4.90	-18	-31	16	77	131	53
Croatia	EUR/HRK	7.234	0.1%	0.2%	0.9%			
	2Y (yield bp)	5.59	0	-4	28	117	97	140
	9Y (yield bp)	5.80	0	0	26	140	129	135
Hungary	EUR/HUF	231.5	1.0%	6.8%	9.4%			
	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	3.271	1.3%	3.6%	10.1%			
	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	3.577	1.1%	2.7%	0.0%			
Slovakia	EUR/SKK	30.29	-0.1%	0.1%	10.8%			
	3Y (yield bp)	5.11	-9	0	52	60	54	52
	9Y (yield bp)	5.12	-1	17	30	70	42	48
Ukraine	EUR/UAH	7.29	-0.9%	0.8%	1.1%			
	3Y (yield bp)	12.50	-0.5	-0.3	5.0	810	823	361

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

Trading Ideas

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Positions

Currently, there are no trading ideas.

Rationale at inception

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
23	Long EUR/CZK	29/04/2008	19/06/2008	-3.80%

To be included in the trading ideas mailing list, please, mail to rainer.singer@erstebank.at, subject: trading ideas

Forecasts

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Capital markets forecasts

Exchange Rate vs EUR

	CZK Forward		HRK Forward		HUF Forward		PLN Forward		RON Forward		SKK Forward		UAH Forward	
Spot	23.5		7.24		232.0		3.28		3.55		30.3		7.26	
Sep-08	24.7	23.5	7.25	7.25	238.0	233.7	3.40	3.28	3.65	3.60	30.1	30.2	7.39	7.60
Dec-08	25.2	23.5	7.30	7.30	240.0	235.5	3.30	3.30	3.50	3.66	30.1	30.2	7.23	8.01
Mar-09	25.0	23.4	7.25	7.25	235.0	237.2	3.22	3.30	3.60	3.71	-	30.2	6.96	8.27
Jun-09	24.7	23.3	7.22	7.22	235.0	238.9	3.30	3.31	3.58	3.76	-	30.2	6.72	8.42

	Intervention Rate							3m Money Market Rate						
	CZ	HR	HU	PL	RO	SK	UA	CZ Forward	HU Forward	PL Forward	RO Forward	SK Forward	UA Forward	
Spot	3.75	4.85	8.50	6.00	10.0	4.25	12.00	4.14	8.55	6.65	11.83	4.37	15.22	-
Sep-08	4.00	4.50	8.50	6.25	10.0	4.25	12.00	4.09	8.50	6.65	11.50	4.50	14.20	-
Dec-08	4.00	4.25	8.50	6.25	9.50	4.25	12.00	4.14	8.50	6.55	10.00	4.50	13.75	-
Mar-09	4.00	4.00	8.25	6.25	8.50	-	12.00	4.31	8.20	6.35	8.80	5.57	13.25	-
Jun-09	4.00	4.00	8.00	6.00	7.75	-	-	4.30	8.00	6.10	8.05	4.98	13.00	-

	10y Govt. Yield					5y Govt. Yield	3y Govt. Yield
	CZ	HR	HU	PL	SK	RO	UA
Spot	4.89	5.80	8.15	6.50	5.15	10.40	12.5
Sep-08	4.45	5.60	7.90	6.35	5.00	10.00	11.7
Dec-08	4.70	5.50	7.70	6.10	5.00	9.50	11.2
Mar-09	4.80	5.50	7.40	6.05	4.90	8.50	10.5
Jun-09	4.85	5.50	7.00	5.95	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	4.0	4.8
Hungary	3.9	1.3	2.3	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

CPI (%), eoy	2006	2007	2008f	2009f
Czech Republic	2.5	4.9	4.8	2.8
Croatia	2.0	5.8	5.5	3.8
Hungary	6.5	7.4	5.8	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	4.6	3.9
Ukraine	11.6	16.6	19.2	12.0
CEE8 weighted average	4.2	6.6	6.5	4.5

Unemployment (%)	2006	2007	2008f	2009f
Czech Republic	8.1	6.6	6.3	6.1
Croatia	10.5	9.7	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	7.9	7.2

3M rates (average, %)	2006	2007	2008f	2009f
Czech Republic	2.3	3.1	4.1	4.4
Croatia	4.5	5.6	6.3	5.5
Hungary	7.0	7.7	8.4	7.9
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	4.6
Ukraine	13.5	9.6	14.5	12.0
CEE8 weighted average	6.6	6.0	7.8	7.0

C/A (%GDP)	2006	2007	2008f	2009f
Czech Republic	-3.0	-3.2	-3.5	-1.6
Croatia	-7.9	-8.6	-9.7	-9.6
Hungary	-6.0	-5.0	-4.3	-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	-6.7	-7.5
CEE8 weighted average	-5.0	-6.0	-6.7	-6.6

Budget Balance (%GDP)	2006	2007	2008f	2009f
Czech Republic	-2.9	-1.9	-1.8	-2.0
Croatia	-3.0	-2.3	-2.5	-2.8
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	-2.1
CEE8 weighted average	-3.4	-2.3	-2.5	-2.6

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	14-Jul	PPI, m/m, %	0.50	0.50
	15-Jul	Current Account, May, CZK bn.	-2.6	-10
	16-Jul	Retail Sales, %, y/y		4.6%
Croatia	15-Jul	CPI	7.4% y/y	
Hungary	Jul-11	Minutes of the June monetary meeting		
	Jul-17	May Nominal wages	-	10.8% y/y
Poland	15-Jul	Corporate average wages (% y/y)	11.0%	11.0%
	15-Jul	CPI inflation (% y/y)	4.5%	4.5%
	15-Jul	Current account (EUR mn)	-1800	-1679
	18-Jul	Producer prices (% y/y)	2.7%	2.9%
	18-Jul	Industrial output (% y/y)	8.7%	9.6%
Romania		C/A deficit May (FOB-CIF) - EUR mn	1,300	-
Slovakia	Jul-16	June HICP inflation	4.2% y/y	4.2% y/y
Ukraine	14-Jul	June Industrial Production - y/y	7.8%	8.1%
	15-Jul	June GDP - y/y		

*Sources: Bloomberg, Reuters

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast	
Czech Republic		Jul-17	Jul-18	July-17-2009		CZK 5bn		
Hungary		Jul-15	Jul-23	Oct-22-2008	-	HUF 30bn	8.50%	
		Jul-17	Jul-23	June-24-2019	6.50%	HUF 40bn	8.25%	
Poland		Jul-14	Jul-16	2008-Oct-15	-	PLN 0-0.5bn		
		Jul-14	Jul-16	2009-Jul-15	-	PLN 0-1.5bn		
Romania		17-Jul-08	21-Jul-08	3Y	8.00%	RON 700 mn	10.0%	
Slovakia		No auction scheduled						
Ukraine		Jul-14	Jul-16	05-May-10	8.00%		7.70%	
		Jul-14	Jul-16	28-Sep-11	9.50%		7.90%	

Major Markets

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Major markets

ZEW indicator to show further deterioration

Tuesday's release of the ZEW survey is unlikely to brighten the mood on capital markets. It is hard to imagine anything but a deterioration of the sentiment among survey participants. In an environment of tense financial markets, record oil prices and a slowing German economy, the only open question seems the extent of the index fall. We think that the most likely impact of this release will be on the EUR/USD, pushing the relation lower. Other data for next week includes the final inflation rate for EMU countries and Euroland as a whole. The deviation from preliminary figures should be minor, as should the market reaction. Bond markets had a pretty good week and the ZEW should not trigger a counter-movement. We see the main risk for the bond market in a recovery of stock markets, for which the chances have increased, as government support for troubled mortgage financiers Fannie Mae and Freddie Mac has become more likely.

Bernanke testimonies main events next week

The most watched events next week will be Bernanke's monetary policy report to the two committees of the Senate and Congress on Tuesday and Wednesday, respectively. With financial markets remaining under stress and the outlook for consumer spending highly uncertain for the "post tax rebate period", we think that concerns about the economy will get ample space in the prepared statements. At the same time, inflation will of course also be a topic and the chairman must be careful not to paint too bleak a picture of the economy, as this would increase the pressure on the dollar (which we think he wants to avoid). Government support for Freddie Mac and Fannie Mae will likely also be an issue, and the chances are that statements by committee members (election year!!) will stabilize markets. From the macro side, the most watched indicators will be retail sales and consumer prices, also scheduled for Tuesday and Wednesday. For the former, a rather strong figure can be expected, as the second wave of tax rebate checks arrived at households. The market will likely compare the growth rate with the previous month to get an indication if the propensity to spend has changed. Consumer prices were again heavily affected by further energy price increases in June. Core inflation will again be in the spotlight. Markets expect the same monthly rate of increase as in the previous month. We agree, but see the risks tilted to the downside, due to the weak growth of the economy.

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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	4.25	2.00	4.96		2.79		4.42	3.85	1.579	
Sep-08	4.25	2.00	4.60	5.26	2.30	3.29	4.60	4.20	1.55	1.573
Dec-08	4.25	2.00	4.50	5.34	2.30	3.25	4.70	4.40	1.48	1.566
Mar-09	4.25	2.00	4.50	5.53	2.40	3.29	4.60	4.60	1.43	1.559
Jun-09	4.25	2.25	4.50	4.85	2.60	3.40	4.70	4.80	1.38	1.553

Croatia

1Q08 GDP growth accelerated to 4.3% y/y

1Q08 GDP growth met our expectations (ESBe: 4.3% y/y), recording +4.3% y/y and accelerating from the 3.7% y/y recorded in 4Q07. Given the strong base from 2007, the 1Q economic performance has been solid overall. The growth structure offered some surprise. Private consumption was broadly in line with expectations, recording 4.3% y/y and thus maintaining the downward trend seen since 4Q07. After a solid 2007, public consumption hit the brakes, recording just 0.5% y/y growth, thus bringing a slightly lower than expected impetus to growth in 1Q. On the other hand, investment activity surprised on the upside, rising 9.8% y/y. Capital goods imports, mild weather and solid construction activity indices suggested solid 1Q fixed capital formation. On the external balance front, there was little surprise (supported by monthly trade balance figures), as the negative net export contribution widened further, with exports increasing 3.8% y/y, outpaced by imports (+7% y/y). Although the 1Q08 GDP figures were in line with expectations, we decided to revise the FY08 GDP figure to 4%, due to deteriorating expectations for the coming quarters. Private consumption should remain on a downward trajectory in the coming quarters, burdened by rising inflation pressures and moderating credit. Investment activity is also expected to lose momentum, as residential construction will be less supportive, while companies may reassess their investment strategies, given the higher funding costs.

Current account to widen to above 9% of GDP

The 1Q current account deficit amounted to EUR 2,488mn, widening on an annual basis by 23% and coming in slightly above our expectation (EUR 2.4bn). As the trade balance suggested, the pressure came from the merchandise account, as the deficit hit a new high of EUR 2.55bn, thus increasing by 18.2% y/y. Exports recorded only +8.7% y/y in nominal terms, while imports added 13.6% y/y. The service account was practically flat y/y, posting a EUR 100mn surplus. As expected, it failed to have an offsetting effect on the merchandise account deficit increase in 1Q. The income account posted an approx. EUR 260mn deficit (+23.6% y/y), surprising marginally on the upside and confirming pressures on the outflow side, which increased by 13.1% to EUR 590mn. Current transfers confirmed their moderating trend, as the surplus amounted to EUR 224mn, down 9.6% y/y. The financing side offered the expected developments, as FDI inflows - after a strong performance in 1Q07 - halved, recording a EUR 688mn inflow, in line with the expectations that a lower proportion of the C/A deficit would be covered by FDI inflows in 2008.

The 1Q08 C/A figures confirmed a continuing deterioration of the external balance, supporting a widening of the C/A deficit in 2008; currently, we see the C/A deficit in the 9+% of GDP zone. Merchandise account trends are expected to remain negative, as, besides the solid import growth in real terms, the nominal figures should be negatively influenced by the upsurge of energy and food prices. The income account is expected to put additional pressure on the C/A performance. The service account should moderate the pressures to some extent, but fail to offset the rising imbalances on the merchandise account. On the financing side, we expect solid FDI inflows, still significantly below the robust 2007 level. Nevertheless, we do not expect problems on the financing side or more severe pressures on the exchange rate.

June PPI further accelerated to 9.6% y/y

Producer prices showed ongoing strong inflation pressures by adding a robust 1.3% m/m and hitting 9.6% on the annual level. Energy prices (+2.3% m/m) and intermediary goods prices (1.2% m/m) led the way, showing continued strong pressure on the supply side. Next week, all eyes will be on the CPI figures, which are expected to accelerate further, surpassing the 7% threshold, and thus potentially bringing some nervousness to the markets.

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Czech Republic

Drop in inflation not likely before autumn

Data on CPI and industrial production was released this week. CPI rose 0.2% in June, mainly due to the rise in oil prices (diesel at its historical peak, for example) and housing-related prices. A somewhat mixed picture was seen in food prices (some items went up, some went down). The y/y rise of inflation was 6.7%, 0.1pp off the May and April inflation. Prices of goods rose 0.1%, while prices of service rose 0.4%. It is clear that, had it not been for the energy price spike, the decrease of inflation would have been sharper, thanks to the CZK (on a m/m basis, the most substantial decrease was seen in imported goods - cars, motorcycles, mobile phones, cameras). The growth of prices in the service sector might on the other hand be indicative of the existence of demand pressures - the prices of services are not directly influenced by the CZK (only indirectly so, via a slowdown of the economy). After all, the y/y drop of prices is not that large, given the extent to which the currency strengthened (18%). Cars got cheaper by 4%, cameras by 10%. Gradually, tobacco prices should start to reflect the higher January (!) excise tax. The question that remains is when (there are opinions that this might take as long as another five months). In July, prices of natural gas for households will be hiked by RWE (one of the major providers). If this gets compounded by higher oil prices, inflation could again top 7%. A drop in inflation will thus at best be seen in the fall.

EMU slowdown, CZK strength to hit Czech industry

Industrial production rose 3.4% in May. The lower than expected May industrial production could have been influenced by two additional days off. The largest contributions came from the electronics, transportation and machinery segments, while the production of textiles and food products dragged the growth down. What is interesting is the drop in new orders from abroad (with the exception of one month, this has been the case for every month since the beginning of the year), by 6% in May, mainly in the car and machinery segment. Given that these are the drivers of the industry, this does not bode well for the near future. We expect a slowdown of Czech industry, due to the strength of the CZK and the slowdown in the EMU; if the CZK correction proceeds relatively quickly and the EMU slowdown is shallow, industry might still grow at 7% this year. Prolonged CZK strength and/or a deeper slowdown would take industry lower.

Next week, data on retail sales and PPI will be released. Retail sales should slow down again, due to high oil prices (we expect 2.9% y/y), while PPI will move north, for the same reason (0.5% y/y).

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Hungary

CPI inflation slowed to 6.7% y/y in June

The June CPI figures published this morning surprised on the downside. Consumer prices rose just a tiny 0.1% m/m in June. Thus, the 12-month CPI inflation rate slowed to 6.7% (from the 7% published for May). Our expectation was 6.9% y/y, while estimates from market analysts fluctuated in the range of 6.8-7% y/y. The main reason for the positive surprise was that the monthly change in food prices was not estimated very well again, but this time in the opposite direction. After spectacular price increases in this field in the last couple of months, prices of foods dropped by 0.4% m/m in June, as the usual summer decrease in seasonal food prices seems to have started earlier than expected. In addition, the monthly price changes in the fields of clothes and durables were also negative; here, the effect of the stronger forint could have played some role, as well. Prices of services rose 0.2% m/m, also causing a slight positive surprise. As expected, fuel prices rose 2.2% m/m. Although to a lesser extent than the headline figure, the seasonally-adjusted core inflation rate also slowed in June, to 5.8% y/y, from its May level of

5.9% y/y. Despite the lower than expected June CPI figure, we have slightly increased our year-end CPI inflation forecast to 5.8% y/y, based on the already announced administrative price hikes (gas, purchased heating) for the second half of the year.

Budget deficit at 66.8% of latest full-year CF-based forecast at end of June
The Finance Ministry published a budget deficit of HUF 297.2bn for June, which was slightly higher than the ministry's preliminary forecast of HUF 281.2bn. Thus, the budget deficit reached HUF 722bn by the end of June, 66.8% of the Finance Ministry's latest full-year deficit projection.

Forint appreciation continued

The forint has continued its spectacular appreciation process this week, despite the words of the central bank governor. At the beginning of the week, Governor Simor said that it was possible that the firming of the forint was faster than what would be justified by economic fundamentals, which could be seen as a verbal intervention. The exchange rate against the euro, however, still managed to break through the psychologically important level of 230 for a while, then corrected somewhat. In addition, the latest CPI inflation figures do not suggest rate hikes in the near period, which has led to some forint weakening after the release of the data this morning.

We have changed our base rate forecast. We do not expect more increases in the base rate this year, mainly due to the position of the forint. Although we expect some correction to the weaker side in the forint exchange rate in the near future, there are many fundamental reasons behind the expectation that the forint should be able to durably stabilize in a stronger range than earlier, which could support the mid-term inflation goal. We do not expect a rate cut for this year, either, as inflation risks are still rather on the upside.

Next week, the May nominal wage figures should be the most watched (due on Thursday), as these will be the last important fundamental data before the July rate setting meeting. Moreover, this afternoon, the minutes of the June monetary meeting will be released, which could also attract some interest, as the outcome of the June meeting came as a big surprise to the market.

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Poland

Zloty again overwriting its record highs...

The zloty continued its winning streak this week, notching fresh all-time highs on several days. Easily cracking 3.30 EUR/PLN, it approached 3.26 EUR/PLN. As we emphasized last week, there are indeed grounds for the zloty to appreciate in the medium-term horizon. Nevertheless, the pace and magnitude of recent gains seems exaggerated and cannot claim justification in the fundamentals of the economy. Rather, the ultra-bullish sentiment of investors toward the Central European region as a whole is the driver to thank. In the short run, momentum might still push the zloty stronger. However, the longer the exaggeration continues, the deeper the correction that might follow later on. It is hard to guess how long this psychologically-driven appreciation will last. Possible triggers for a correction include the emergence of other good investment opportunities once the picture on major markets brightens and/or visible signs that strong regional currencies are starting to taking their toll on economic growth (however, this could take a longer time to manifest). The zloty appreciation induced a more positive tone on bond and swap markets as well. The risk premium against the Eurozone peers dipped across all maturities. Softer MPC rhetoric and the better mood on major bond markets might have contributed as well.

...provoking verbal comments from officials

The recent stellar performance of the zloty has already prompted some comments from officials. The finance minister speculated that the pre-euro pattern of the Slovak currency might inspire speculators and trigger strong zloty appreciation once in ERM-2, which could result in a need for sizeable interventions. However, the deputy finance minister later said that there are no plans currently from the ministry's side to intervene against the zloty. Such a step is the prerogative of the central bank. Nevertheless, there are no signs of appetite for direct interventions from the central bank. On the contrary, MPC member Halina Wasilewska-Trenkner urged against it, as it is perceived as costly and less efficient. Rather, the central bankers have tried to chill the currency verbally. Hawkish-leaning Dariusz Filar said that if the zloty stays near current levels, the leeway for additional hikes this year would be narrower. The market has failed to react to these comments, as psychological factors, rather than the interest rate differential, are the main determinants of trading at present.

Spree of macro data scheduled for release next week

The macro calendar contains interesting releases next week. The market is psychologically positioned in the direction of zloty appreciation. Hence, we think that the reaction will be asymmetrical with the tendency to ignore worse data and take into account indicators that speak in favor of zloty strength. The releases will start with the current account, where the deficit should widen. We see space for a wider gap than the market (EUR -1,800mn, vs. the EUR -1,550mn consensus), due to the deterioration in the foreign trade picture, where exports will slow (as industrial output signaled), but imports will stay robust, on the back of the high oil bill and domestic demand. Nevertheless, we doubt that the zloty will notice this data. Rather, it will pay attention to the revival in industrial output, which will nevertheless be only technical in nature (the effect of working days). CPI inflation should slightly accelerate, on the back of fuels and tobacco, while wage dynamics will stay in double-digit territory. Normally, this would imply that the central bankers would stay cautious. However, the zloty rally should continue to blunt their rhetoric noticeably.

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Romania

Trade deficit continued to slow down

Exports increased more quickly than imports in January-May and the trade deficit (FOB - CIF) went up by only 10.6% y/y. A year ago, just after Romania's EU accession and the removal of some customs duties, the trade deficit widened by 70% y/y. More mature consumer markets and the RON depreciation during the last 12 months limited the expansion of imports, while the acceleration of exports was determined by the improved supply of the local manufacturing industry. Machinery and transport equipment was the most dynamic sector, accounting for 33.7% of total exports and 37% of imports. In light of the latest available data about the trade deficit and considering the positive developments of net current transfers and the income balance, we might adjust our estimate for the C/A deficit downward in the following months.

Romanian currency firmed to this year's highest level

In the past few weeks, the Romanian currency has positioned on a strong appreciation path, lifted by regional peers (HUF, PLN, CZK), as well as the high interest rate differentials. The local currency started the week in the 3.61 zone and rallied to the 3.52 level on Wednesday, at which point some players decided to cash in their gains, reversing the direction of the EUR/RON pair. In the first three days of the week, the leu appreciated by 2.5% against the euro, but could not keep its earlier gains, and the exchange rate rose to 3.55 on Thursday. The local currency might have been negatively affected by the consensus estimates of local banks

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regarding the monetary policy rate, which is to top out at current levels (10.0%), cooling down expectations among foreign investors of further rate hikes. The liquidity conditions relaxed slightly on the Romanian money market, with short-term interest rates decreasing by around 100 basis points, as the Ministry of the Economy and Finance started to inject liquidity in the market from VAT reimbursements. Therefore, overnight interbank deposits were quoted at 9.5/10.0% bids/asks, while interest rates for one-week deposits fell to 9.7/10.2%.

Romania paid maximum yield of 9.75% on 5Y benchmark bonds

On July 9, the MinFin held an auction for 6-month discounted treasury bills worth RON 800mn. As we had anticipated, the MinFin decided to raise the cut-off rate by 25 basis points to 11.0% (from the 10.75% level paid last month), after the central bank hiked the key rate at the same pace. However, the MinFin drained only a modest amount, RON 194mn, although the overall offer of primary dealers reached RON 1,045mn, as investors increased the yields demanded for placing their liquidities, due to the spark of inflation and restrained liquidity on the global level. The average accepted yield for the 6M T-bills increased to 10.92% per year, from 10.74%. Next week, the MinFin will hold an auction for 3Y benchmark bonds worth RON 700mn. We expect the MinFin to raise the cut-off rate to 10.25% (from 10.0%), due to its increased need for liquidity.

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Slovakia

Euro conversion rate fixed at ERM-2 central parity

The irrevocable conversion rate between the Slovak koruna and the euro was set at 30.1260 EUR/SKK. This matches market expectations, while a more practical 30.0000 EUR/SKK had been seen as the alternative. However, after setting a number of precedents previously, the European authorities chose to follow the standard practice and set the conversion rate at the ERM-2 central parity. The exchange rate will still move until the end of the year, but fluctuations are likely to be mild (similar to the last couple of weeks). The koruna should stay slightly on the weaker side of the ERM-2 central parity, due to the difference in market interest rates and the possible departure of some investors to more lucrative investments (however, the market should ensure that any departure from the forward-implied exchange rate is only mild).

Fitch upgraded Slovakia's rating

After all formal steps on Slovakia's way into the Eurozone were completed, rating agency Fitch upgraded Slovakia's foreign currency rating one notch, from 'A' to 'A+' with a stable outlook, as Eurozone membership should protect Slovakia from currency crises. Slovakia is now rated on par with the Czech Republic and above Hungary (BBB+) and Poland (A-). Thanks to Eurozone membership, Slovakia might also see rating upgrades by other rating agencies.

Inflation stagnated at 4.6% in June

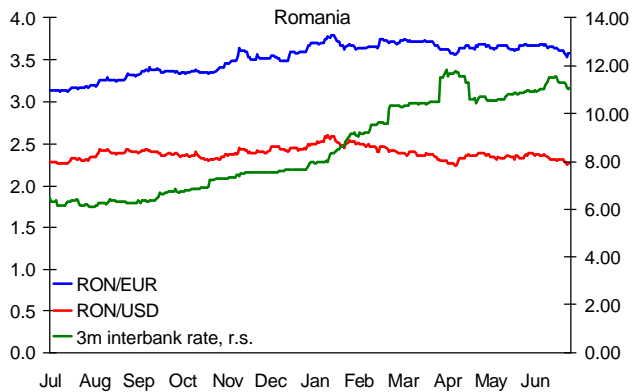
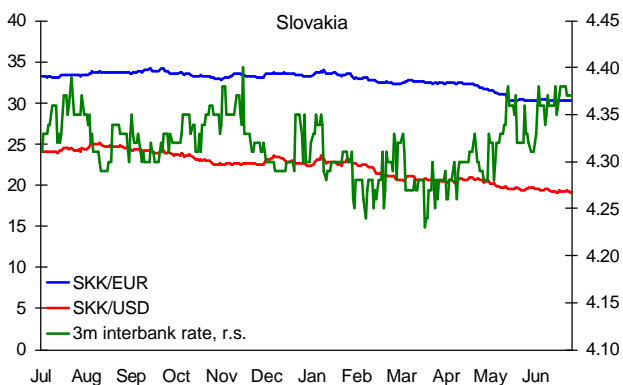
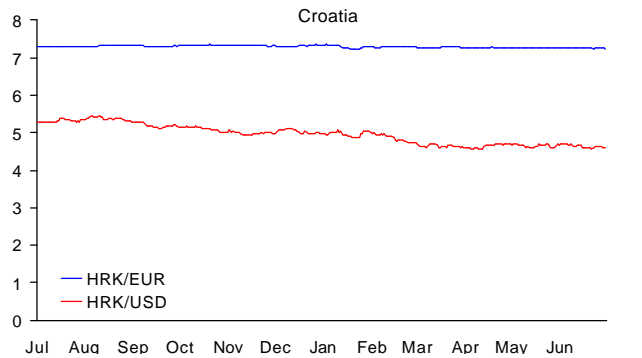
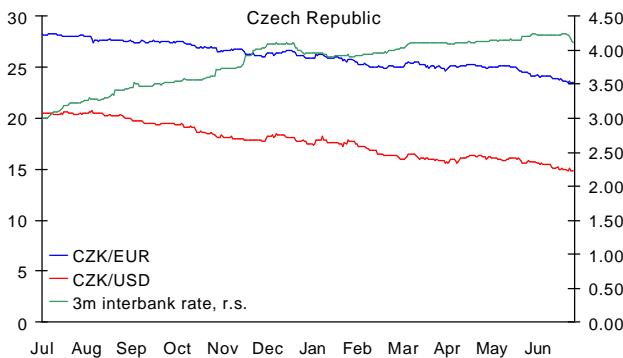
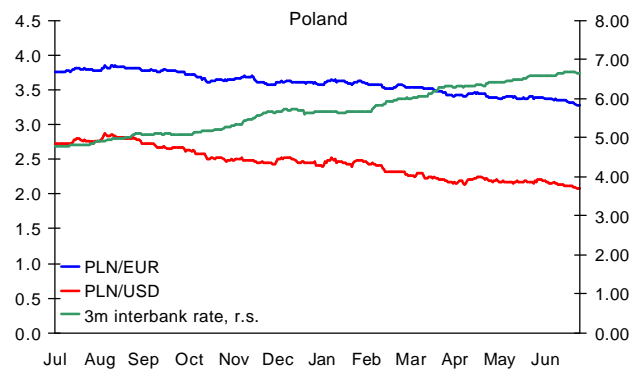
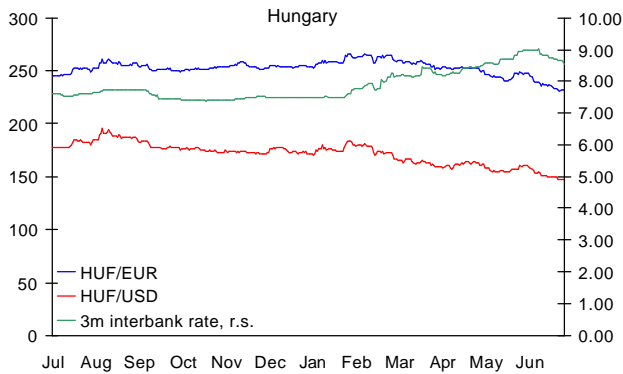
Consumer inflation stayed at 4.6% y/y in June, meeting market expectations. We expected a slightly lower figure of 4.5% y/y. Compared to May, prices increased by 0.4%, fuelled mainly by food and oil prices. Imputed rents also contributed to monthly inflation. Consumer inflation should stay within 4.6-4.9% y/y in the second half of the year, in our view. Among inflation-supportive factors, we see prices of cigarettes and the anticipated increase of energy prices in autumn, while the strong koruna should work as an anti-inflationary tool. At the beginning of 2009, we expect consumer inflation to drop to below 4.5% y/y.

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Appendix Charts

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Exchange rates and interest rates (52 weeks)

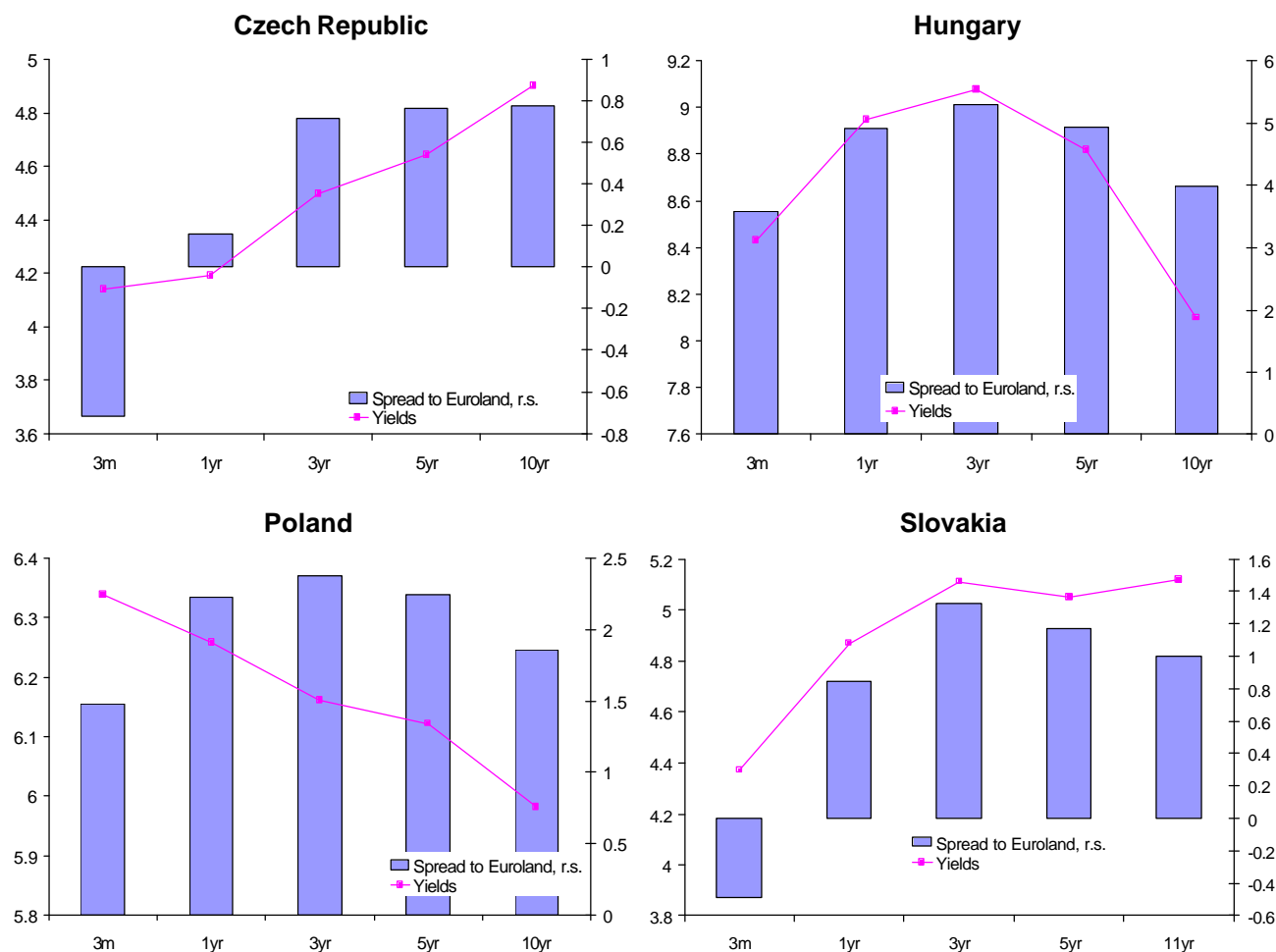


Source: Bloomberg

Appendix Forwards

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Benchmarks



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