ERSTE GROUP

CEE Insights

Fixed Income and Foreign Exchange – September 12, 2008

Croatia: Kuna heading towards 7.10 HRK/EUR

Czech Republic: CZK pulled stronger by PLN

Hungary: CPI slowed to 6.5% y/y in August

Poland: Prime minister declared 2011 euro target

Romania: Better export performance - key driver of 2Q08 economic growth

Ukraine: New wave of political confrontation

Overview

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Croatia

- PPI eased to 11% y/y in August
- Kuna heading towards 7.10 HRK/EUR

Czech Republic

- CZK pulled stronger by PLN
- GDP growth driven by net exports

Hungary

- CPI slowed to 6.5% y/y in August
- Nominal wages and FOMC meeting in focus next week

Poland

- Prime minister declared 2011 euro target
- Open issues to be solved - legal aspect and ERM II stay
- We stick to our 2013 Eurozone entry date estimate
- Euro story helps zloty

Romania

- Better export performance - key driver of 2Q08 economic growth
- Ministry of Finance rejected all bids at latest 6M T-bill auction

Ukraine

- August CPI at -0.1% m/m, PPI +1.8% m/m
- New wave of political confrontation

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**	24.58	1.0%	-3.6%	8.0%			
	3Y (yield bp)	3.92	1	0	-39	14	43	41
	10Y (yield bp)	4.42	-2	-16	-32	29	68	53
Croatia	**EUR/HRK**	7.109	0.6%	1.4%	2.7%			
	2Y (yield bp)	5.91	2	9	60	173	144	140
	9Y (yield bp)	6.06	4	2	53	203	181	135
Hungary	**EUR/HUF**	240.0	0.7%	-1.5%	5.5%			
	3Y (yield bp)	9.08	6	-88	153	530	644	365
	10Y (yield bp)	8.10	13	-4	99	398	424	290
Poland	**EUR/PLN**	3.393	0.3%	-3.6%	6.1%			
	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**	3.632	-1.5%	-2.7%	-1.5%			
Slovakia	**EUR/SKK**	30.27	0.1%	0.3%	10.9%			
	3Y (yield bp)	4.74	-5	-15	15	73	82	52
	11Y (yield bp)	4.93	0	-3	11	80	69	48
Ukraine	**EUR/UAH**	6.67	1.8%	3.0%	10.5%			
	2Y (yield bp)	13.75	0	0	6	975	941	354

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

Trading Ideas

Positions

#	Position	Date of opening	Instruments	Entry values	Today's values	P/L (%)	P/L incl. carry (%)	P/L p.a.incl. carry (%)	Target values	Target P/L incl. carry	Target P/L p.a. (%)
			3M Robid/3m Euribor	11,25/4,97%							
24	short EUR/RON	05/08/2008	EUR/RON	3.50	3.6077	-2.99%	-2.33%	-22.39%	3.45	3.02%	12.08%
			6M Wibid/6M Euribor	6,36/5,142%							
25	short EUR/PLN	09/09/2008	EUR/PLN	3.47	3.3648	3.13%	3.14%	381.61%	3.28	6.40%	13.21%

Rationale at inception

24) Recently, the Romanian currency has developed a strong rally against the euro, strengthening to the 3.50 zone on back of improved sentiment towards emerging markets and continuous tightening of monetary policy. We consider RON could break the 3.50 threshold and appreciate until the 3.45 zone in the short term, as Romania offers the highest yield in the European Union. We recommend this carry strategy, as it is likely to gain both from substantial interest rate differentials and slight appreciation of the local currency vs. euro.

25) We see only limited space for a further dollar rally. Hence, one of the chief culprits putting pressure on the zloty (and region) should weaken. The economic picture of the Polish economy remains appealing. We agree that the pace of GDP growth will decelerate next year, but Poland will still grow visibly faster than the Eurozone. Also, a catching-up in price levels (compared to the 'old' EU) will materialize partially via the appreciation of the domestic currency. Poland is also the hottest candidate in the Central European region for euro adoption.

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%

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Forecasts

Capital markets forecasts

	Exchange Rate vs EUR													
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	UAH	Forward
Spot	24.5		7.13		238.5		3.37		3.61		30.3		6.69	
Sep-08	24.7		7.15	7.15	238.0	239.0	3.43		3.55	3.63	30.2	30.2	6.82	7.03
Dec-08	25.0	24.5	7.25	7.25	240.0	240.9	3.30	3.38	3.50	3.70	30.1	30.2	6.93	7.32
Mar-09	25.1	24.4	7.25	7.25	235.0	242.5	3.26	3.39	3.60	3.77	-	30.1	7.00	7.52
Jun-09	24.9	24.3	7.22	7.22	235.0	244.2	3.23	3.40	3.58	3.84	-	30.1	6.89	7.75

	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	3.50	4.99	8.50	6.00	10.25	4.25	12.00	3.76		8.58		6.53		13.74		4.17		13.05	-
Sep-08	3.50	5.00	8.50	6.25	10.25	4.25	12.00	3.80		8.50	8.54	6.58		11.60	10.27	4.35	4.25	13.28	-
Dec-08	3.25	4.50	8.50	6.25	10.25	4.25	12.00	3.80	3.44	8.50	8.27	6.45	6.59	10.55	8.60	4.80	4.67	12.75	-
Mar-09	3.25	4.25	8.25	6.25	9.50	-	12.00	3.80	3.45	8.20	8.00	6.37	6.25	9.80	7.77	-	4.80	12.64	-
Jun-09	3.25	4.25	8.00	6.00	9.00	-	12.00	3.80	3.85	8.00	7.78	6.12	5.73	9.30	6.51	-	4.56	12.41	-

	10y Govt. Yield					5y Govt. Yield	2y Govt. Yield
	CZ	HR	HU	PL	SK	RO	UA
Spot	4.40	6.06	7.80	5.79	4.92	10.9	13.8
Sep-08	4.70	5.90	7.70	5.90	5.00	10.8	13.5
Dec-08	4.80	5.70	7.60	5.50	5.00	10.3	12.7
Mar-09	4.85	5.50	7.40	5.50	4.90	9.3	12.8
Jun-09	4.90	5.50	7.00	5.30	5.00	8.8	13.6

Long-term forecasts

GDP growth (%)	2006	2007	2008f	2009f
Czech Republic	6.8	6.6	4.3	4.1
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	8.3	6.0
Serbia	5.7	7.5	6.8	7.0
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**	**5.6**	**5.1**

CPI (%), eoy	2006	2007	2008f	2009f
Czech Republic	2.5	4.9	4.3	2.5
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	9.7	6.0
Slovakia	4.2	3.4	4.8	3.9
Ukraine	11.6	16.6	21.0	12.0
CEE8 weighted average	**4.2**	**6.6**	**6.8**	**4.5**

Unemployment (%)	2006	2007	2008f	2009f
Czech Republic	8.1	6.6	5.5	6.7
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	18.1	17.5	16.8
Slovakia	10.4	8.4	7.3	6.8
Ukraine	7.4	6.9	6.5	6.1
CEE8 weighted average	**10.6**	**8.7**	**7.7**	**7.2**

3M rates (average, %)	2006	2007	2008f	2009f
Czech Republic	2.3	3.1	3.8	3.5
Croatia	4.5	5.6	6.3	5.5
Hungary	7.0	7.7	8.4	7.9
Poland	4.2	4.6	6.3	6.1
Romania	8.8	7.8	11.2	9.0
Serbia	22.1	11.3	15.2	12.8
Slovakia	4.3	4.3	4.4	4.3
Ukraine	13.5	9.6	13.5	12.0
CEE8 weighted average	**6.6**	**6.0**	**7.9**	**7.1**

C/A (%GDP)	2006	2007	2008f	2009f
Czech Republic	-3.1	-2.5	-2.1	-1.8
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	-14.0	-13.6	-12.4
Serbia	-9.8	-13.2	-14.1	-14.8
Slovakia	-7.2	-5.3	-3.7	-3.5
Ukraine	-2.9	-4.2	-6.7	-7.5
CEE8 weighted average	**-5.0**	**-5.8**	**-6.3**	**-6.4**

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	-3.8	-3.5
Poland	-3.8	-2.0	-2.6	-2.7
Romania	-1.6	-2.3	-2.7	-2.7
Serbia	-1.5	-1.9	-1.7	-0.4
Slovakia	-3.6	-2.2	-2.2	-2.4
Ukraine	-0.7	-1.1	-2.0	-2.1
CEE8 weighted average	**-3.5**	**-2.3**	**-2.5**	**-2.5**

Diaries

Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	16-Sep	Retail Sales, July (y/y)	4.0%	5.0
Croatia	15-Sep	CPI (y/y)	7.9%	
	19-Sep	Industrial production (y/y)	1.0%	
Hungary	17-Sep	July Nominal wages	-	-
	19-Sep	Minutes of the CB rate meeting (08/2008)		
Poland	15-Sep	CPI (y/y)	5.2%	5.0%
	15-Sep	Average corporate wages (y/y)	11.5%	11.1%
	16-Sep	MPC meets with government (euro debate?)		
	18-Sep	Producer prices (y/y)	2.1%	2.1%
	18-Sep	Industrial output (y/y)	-0.3%	0.3%
	18-Sep	Minutes of the CB rate meeting (08/2008)		
Romania	No data releases scheduled			
Slovakia	16-Sep	August HICP inflation (y/y)	4.4%	
Ukraine	15-Sep	Retail Trade		

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		17-Sep	22-Sep	2022-Sep-12	4.70%	CZK 6 bn	-
		18-Sep	19-Sep	2009-Jun-19		CZK 5 bn	-
Hungary		16-Sep	24-Sep	2008-Dec-23	-	HUF 40bn	8.60%
		18-Sep	24-Sep	2009-Sep-23	-	HUF 50bn	8.65%
Poland		15-Sep	17-Sep	2009-Mar-18	-	PLN 0-2.0bn	-
		15-Sep	17-Sep	2009-Sep-16	-	PLN 0-2.0bn	-
Romania		18-Sep	22-Sep	3Y	8.00%	RON 350 mn	10.5%
Slovakia		No auction scheduled					
Ukraine		15-Sep	17-Sep	2010-May-05	8.00%		12.00%
		15-Sep	17-Sep	2011-Sep-28	9.50%		12.50%
		15-Sep	17-Sep	2009-May-27	10.70%		12.70%

Major Markets

Major markets

ZEW survey on Tuesday

In an otherwise rather empty calendar, the release of the ZEW survey stands out. On Tuesday, the latest assessment of financial market participants will be made available. While the economic data from Euroland has continued to deteriorate and yet another wave of stress has hit financial markets, the drop of oil prices and the lower euro were supportive. The latter two will only be felt in the period ahead. So, we share the market's expectations for the outcome of the survey: The assessment of the current situation likely have decreased further, while the outlook for the next six months should have improved. Given the current environment, we do not expect too much impact form the ZEW survey on markets. As is the case for the US, news from the financial sector and the performance of stock markets should remain the key determinants.

FOMC should signal stable rates

The retail sales figure for August is still scheduled for release today. Weekly indicators point to a stagnation vs. the previous month. It should be monitored to what extent lower gasoline prices contributed to the overall outcome. Next week will start with industrial production, where a decrease of output is expected. However, taken together with the previous month, the ongoing stagnation of the sector should be confirmed. Tuesday will start with the consumer price index. Alongside the obvious effect of lower oil prices, the core rate will get attention. During the previous two months, core inflation was at elevated levels and another high value might trigger some concerns. Later that day, the FOMC will set key interest rates. Nobody expects any change and the wording of the press release should also point to stable interest rates. It is likely that the drop of oil prices will be mentioned, but the outlook for the economy should be kept gloomy. The data released during the remainder of the week is second-tier, especially in the current environment. Yields will be more affected by the news from the financial sector and the dollar by the oil price.

Rainer Singer, Erste Group, rainer.singer@erstegroup.com

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	4.95		2.82		4.13	3.66	1.410	
Sep-08	4.25	2.00	4.90	5.11	2.70	2.95	4.10	3.90	1.45	1.409
Dec-08	4.25	2.00	4.80	5.31	2.60	3.30	4.00	4.10	1.45	1.402
Mar-09	4.25	2.00	4.60	5.28	2.50	3.08	4.10	4.20	1.45	1.396
Jun-09	4.00	2.00	4.30	5.21	2.50	3.15	4.20	4.30	1.40	1.389

Croatia

PPI eased to 11% y/y in August

The previous weeks offered little in terms of data releases. Producer prices finally showed some signs of moderation, recording a 0.1% decline on the monthly level and thus moderating on the annual level from 12% in July to 11% in August. As expected, the energy price decline (1.5% m/m) was behind the overall moderation of producer prices, while other major components recorded increases, with durables rising 3.9% m/m. On the annual level, pressures from energy prices remain dominant, recording an 18.2% y/y increase, followed by intermediaries, which are growing at a rather robust 12.4% y/y pace. Apart from that, July retail sales were in line with expectations, recording a practically zero y/y real growth rate (-0.1% y/y) and showing a continuation of the weak consumption spending contribution to the overall economic performance in 3Q08.

In the coming week, the most important release is the August CPI, which is likely to be closely monitored by CNB officials. We expect the figure to moderate to below the 8% y/y threshold (July: 8.4% y/y), as the decline of retail gasoline prices and stabilization of food price trends should support CPI moderation. We remain fairly optimistic about the inflation performance and see the July figure as a peak, with the inflation rate on a mild downward trajectory towards the year-end, when the inflation rate should stand around 6%. Still, the upward risks on the supply side remain pronounced. The CNB is likely to closely monitor the upcoming monthly CPI indicators. We see an increased likelihood of further monetary tightening in the case that inflation pressures surge further.

Kuna heading towards 7.10 HRK/EUR

While the bond market witnessed only minor movements and money market conditions have been relatively stable (thus keeping MM rates stable), the spotlight remained on exchange rate developments. Appreciation pressures continued to mount gradually over the last few weeks, moving the exchange rate towards the 7.11-7.12 region in the last few days, steadily approaching the 7.10 level. For the time being, the CNB remains passive, tolerating the advancing kuna and (at present levels) still favoring price stability and tight kuna liquidity management over external competitiveness. With the MOL-INA transaction ahead, we see further pressures that could eventually push the exchange rate down even more in the coming weeks. There is an increased likelihood that the CNB will enter the market at around 7.10. However, the current short-term FX outlook is unclear and increased volatility should not come as a surprise.

Alen Kovac, Erste Bank Croatia, akovac2@erstebank.com

Czech Republic

CZK pulled stronger by PLN

During this past week, the CZK drifted between 24.50 and 24.90. The impulse to strengthen that came at the end of the week was last week's comment from Polish Prime Minister Donald Tusk that Poland will strive to adopt the euro by 2011. This catapulted the zloty and took the koruna along for the ride. We do not think that this will last and expect the CZK to weaken to 25.00-25.20 towards the end of the year. The trigger for further weakening could come from any streak of bad data or the November CNB meeting, at which we expect a 25bps rate cut.

GDP growth driven by net exports

Data this past week included final figures on GDP and industrial production in July. GDP growth in 2Q reached 4.6% (the preliminary CSU estimate was 4.5% y/y; our preliminary estimate was 5% y/y; the market median was 4.9%). First quarter growth was also revised upwards to 5.4%. The structure of the growth did not surprise us - the monthly data had indicated that net exports would drive the 2Q08 growth. Indeed, net exports added some 4p.p. (close to 6p.p. when adjusting for the effect of imports used for consumption); this was due to high export growth (+13.5%), while imports dropped to 8.9%, due to lower consumer demand. Investments as a whole negatively contributed to the growth, which was due to inventories. Fixed investments (mostly housing and machinery) remained solid at 4%. Inventories, however, subtracted 2.2p.p. from the growth. This could indicate fear on the part of companies regarding future demand. Household consumption remained under the influence of high inflation. Even though nominal growth reached 9.4%, most of this was eaten up by higher inflation. Real consumption thus rose by just 3.2%. As for the future, this latter piece of data (alongside industrial production, which was released today as well; see below) suggests that further weakening of growth is likely. Net exports will slow down, with the stronger currency and EMU slowdown taking their toll on demand from abroad. Consumption will accelerate on the back of falling inflation, but this will be offset to some extent by lower employment. Fixed investments will stagnate. Growth next year will thus reach around 4%. The CNB will hence be able to lower rates by another 25bps this year (unless either the koruna or the unions go crazy).

Data on industrial production for July was released last week as well. Industry rose 6.7% y/y (our forecast: 1.9%, market: 6.8%). Even though we expected the higher number of working days to show up (three more days than in 2007), we thought that the effect of falling industrial orders from abroad (four months in a row now) would already be visible in the data. After all, the data from Germany was not good in July. In the end, the working-day effect prevailed. Adjusting for this, the growth would have reached a mere 0.6%, with electronics, optics, machinery and vehicles as the biggest drivers (as has been the case in recent years). In this respect, new orders are interesting. The growth of overall orders was only 0.6%; foreign orders dropped 1% y/y. The biggest drop, however, was in precisely those industries that have been driving industrial production lately - electrical machinery (drop in orders by 23% y/y) and vehicles (-5.6% y/y). It is thus natural to expect the weakness of production to deepen in the future, although when this will show up more in the data is uncertain. For this coming week, only retail sales will be released. We expect the working day effect to push it to 4% y/y. As this is a secondary piece of information, we do not expect any reaction, even if the figure is a surprise.

Martin Lobotka, Ceska sporitelna, mlobotka@csas.cz

Hungary

CPI slowed to 6.5% y/y in August

Consumer prices dropped by 0.3% m/m in August, while the 12-month CPI inflation rate slowed to 6.5% (from the 6.7% published for July). The y/y figure was slightly lower than our expectation of 6.6%. The structure of the monthly index did not really come as a surprise. Due to seasonality, the prices of food and clothes contributed the most to the monthly decline (-1.5% m/m and -3.7% m/m, respectively). In addition, fuel prices dropped by 4.5% last month. As expected, these price-decreasing effects were partly offset by the accounting for the July increase in gas prices (11.6%). The monthly change of prices of durables was also negative (-0.2%), based on the stronger forint exchange rate. Prices of services increased by 0.5% m/m. The seasonally-adjusted core inflation showed a 0.3% m/m increase, while the 12-month core rate also slowed, to 5.8%, from its July level of 6% y/y. As for the short-term outlook, the disinflation process is expected to continue in the coming months, becoming even swifter in the last quarter of the year, as the base effect will be supportive. The sharp increase in food prices was the most important driver of the inflation that started in August last year; it is not expected to be repeated, due to the good harvest. The stronger forint and lower oil prices are also promising concerning the mid-term inflation prospects. The main risk to the success of disinflation remains the same: the formation of nominal wages in the private sector in the near future, as high wage figures could indicate high inflationary expectations among economic players.

As for the other macro releases seen in the last couple of days, both the July industrial output and trade balance figures indicate that deteriorating growth prospects in the Eurozone have started to negatively affect domestic GDP growth prospects. The yearly industrial output figure remained in negative territory (-1.8% y/y), despite the expected slight increase. On the other hand, the July trade balance figure showed a deficit of EUR 238.6mn, after the surpluses seen in the previous months. The figures suggest that 2008 GDP is unlikely to exceed 2.5% y/y, despite the revival of the performance of agriculture.

Nominal wages and FOMC meeting in focus next week

Next week, the most watched domestic macro figure should be the July nominal wages (to be released on Wednesday), as wage developments in the economy significantly affect the monetary policy of the central bank. However, the monetary council is unlikely to change its current "wait and see" mood in the short run. A monetary council member, Gábor Oblath, told Bloomberg this week that the central bank had to see that there was an unequivocal start to disinflation. Thus, no rate reduction should be expected before November or December. However, based on the cautiousness of the council and the overall uncertainties around wage developments, we still expect the first rate cut to be delivered only in 1Q09.

As for the capital markets, the main driver of the forint exchange rate remains US dollar movements on international markets. This week's announcement in Poland on the country's plan for EMU accession has diverted the CEE exchange rates from the dollar's movements just for a while. Thus, the FED FOMC meeting scheduled for Tuesday should attract domestic players' attention, as well.

Orsolya.Nyeste, Erste Bank Hungary, orsolya.nyeste@erstebank.hu

Poland

Prime minister declared 2011 euro target

Like a bolt out of the blue, the PM proclaimed this week that the government's goal is to adopt the common European currency in 2011. The cabinet has profiled itself as euro-friendly right from the beginning, but has been reluctant to commit itself to a concrete date up to now. The market consensus (including us) estimated that Eurozone entry would take place in 2013. Hence, it was not only the abrupt decisiveness that surprised the markets, but also the actual date.

Open issues to be solved - legal aspect and ERM II stay

Purely from the economic point of view, we think that there should not be any major obstacles to meeting the Maastricht criteria on inflation, interest rates, the public finance deficit and debt. Nevertheless, we see two Achilles heels for the 2011 date: the ERM II requirement and legal issues. The first problematic point is the currency criterion, namely the necessity of the zloty to stay in the ERM II regime for at least two years without severe tensions. The central bank said in a statement that the matter (euro adoption date) has not yet been discussed between the government and the central bank. The implicit message of this statement is that the negotiations for ERM II entry have not even started yet. The negotiations will probably last a couple of months. But even assuming ERM II entry at the end of this year (not very likely, in our view), the obligatory two-year stay within ERM II would end at the end of 2010, making entry as of January 1 technically impossible (the process of assessment of whether the country has complied with Maastricht and negotiating the parity is time-consuming). Moreover, dual-pricing should take place six months before euro adoption. The European authorities softened the 'two-year ERM II' condition in the past for some countries (shortening it) and took into account the currency development ahead of ERM II. However, we doubt that this would be the case for Poland, as the currency has not been very stable recently (on the 'weak' side, only 2.25% levels off the parity are considered in compliance with the requirement that the currency should move without severe tensions). All in all, January 1, 2011, is not a feasible date, in our view. Of course, there is no explicit rule that the entry cannot take place on any other day of the year, although no precedent exists in this respect. The second half of 2011 could be viable. However, this date coincides with parliamentary elections. Negotiating about the conversion rate and campaigning for elections at the same time could be a tough task for the cabinet.

The second open question is the legal aspect. The Polish constitution says that the Polish central bank is the only institution that has a mandate to conduct monetary policy and issue money. Lawyers are not united on the issue of whether the Constitution must be amended before euro adoption. If yes, it could prove a very difficult task to manage. Two thirds of MPs are needed to effect a constitutional change. Nevertheless, the euro-skeptic opposition party Law and Justice controls more than one third of seats in Parliament and could easily block it. We think that the government will want to solve this issue before entering ERM II. In any case, the jitters that are likely to surround the potential vote could easily disqualify the zloty from complying with the currency stability requirement or trigger some speculative attacks (please note that, although the official thresholds within ERM II are +/-15%, the clause on 'movements without severe tensions' has often been interpreted as maintaining only a 2.25% boundary on the weaker side).

We stick to our 2013 Eurozone entry date estimate

All in all, we maintain our forecast of euro adoption in 2013 for now. Solutions to legal issues and a clear and credible timetable, supported by both the central bank and the government, would convince us to change it to an earlier date. If this was indeed to materialize, it would imply a stronger zloty for the coming year and lower yields on the middle and long part of the curve. On the other hand, the short end would probably be higher than in our baseline scenario, as the strict Maastricht inflation criterion would somewhat limit the space for rate cuts next year.

Euro story helps zloty

The story around the euro adoption has been the core driver of the zloty this week. The anchor of a concrete euro target date was welcomed positively (also because it carries an implication of a tighter monetary policy) and triggered zloty gains, helping our trading idea on long PLN/short EUR. In the coming week, euro-dollar movement and the ongoing debate around the euro adoption will be the factors influencing the exchange rate. Plenty of interesting macro data is scheduled for release as well. We forecast an above-consensus inflation rate, which, together with double-digit wage dynamics (and despite sluggish industrial output, which will strongly mirror negative working-day effects), should spark talks about the possibility of an interest rate hike in September and likely support the zloty.

Maria Hermanová, Ceska sporitelna, mhermanova@csas.cz

Romania

Better export performance - key driver of 2Q08 economic growth

On Thursday, the Romanian National Institute of Statistics presented detailed information on 2Q08 economic growth. Real GDP went up by a record 9.3% in 2Q08. Although negative, the contribution of net exports to economic growth improved compared to the same period of 2007. Exports increased by 26.9% y/y in real terms in 2Q08, while imports advanced by 24.4% y/y. It seems that significant FDI inflows in manufacturing during the last few years have already begun to produce visible effects. The outlook for the next few quarters is auspicious, as the record agricultural output could boost the export of food products. Actual final consumption stood broadly unchanged (+11.6% y/y), while gross fixed capital formation increased by 30% y/y. A breakdown of the investments in the economy shows a higher share for investments in industry and agriculture and a lower share for investments in trade and services in 1H08, as this latter sector has already reached a certain degree of maturity following its hefty growth rates in recent years. Despite the economic growth being considerably above potential, our base scenario indicates that the central bank will maintain unchanged the key rate at the next monetary policy meeting in September. Considering the forward-looking characteristic of the key rate, the latest statistical data about economic growth was already priced in at the previous monetary policy meeting, when the key rate was raised to 10.25%. In August, the central bank adopted a new set of administrative measures aimed against excessive retail lending that are likely to have stronger effects on aggregate demand compared to a key rate increase. Our new forecast for 2008 real GDP growth currently stands at 8.3%, which might be considered rather conservative.

Ministry of Finance rejected all bids at latest 6M T-bill auction

On September 10, the Ministry of the Economy and Finance held an auction for 6-month discounted treasury bills worth RON 400mn. The interest of investors was quite limited, as the offer of the primary dealers reached only RON 477mn. Investors likely have demanded higher yields than the MEF was willing to pay, probably exceeding the maximum interest rate of 11.24% that was accepted by the MEF at the last similar auction. The EUR/RON passed the 3.60 resistance zone and fell to 3.63 this week. The liquidity conditions continued to restrain this week, as interbank interest rates were quite elevated, outpacing the monetary policy rate (10.25%) by as much as 3-4 percentage points, offering some support to the local currency. Next week, the MEF will reopen a 3Y benchmark bond auction worth RON 350mn for a fixed coupon rate of 8.0% per year. At the last similar auction, the MEF accepted 10.5% per year, but we believe that the MEF will probably reject all bills this time, as the yields demanded by investors will exceed this threshold.

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

Ukraine

August CPI at -0.1% m/m, PPI +1.8% m/m

August was the second month in a row to see a decrease in CPI. The drop again came primarily from the seasonal decline in fruit and vegetable prices. The August PPI figure of +1.8% m/m is the lowest reading this year. The main driver of the slowdown in producer prices was the manufacture of refined petroleum products (-6.2% m/m). Also, for the first time in 2008, there was no increase in the prices of food products, beverages and tobacco. Manufacturers of coke increased prices by 20.1% m/m, with a 10.7% m/m price rise in the chemical industry. Metallurgy had the lowest increase in prices this year of +1.3% m/m. The PPI figures that influence the CPI declined, while those that add to exports increased (except for metallurgy). In September, we expect a slowdown in the growth of output and prices in the metallurgical sector. Nevertheless, until the end of the year, we expect metallurgy prices to increase by 10%. Current price figures reflect the global decline in commodity prices and the good harvest figures. Such figures have given us optimism regarding our year-end CPI forecast, which we have revised to 18.5% from 21%. Fundamentals may allow a further 1% decrease in the CPI outlook, but we add another 1% demand-pull risk premium to our forecast. This "risk premium" is due to political uncertainty amid possible parliamentary elections and the closer presidential election, which often result in an increase in social benefits. We have already seen an increase in social benefits to students and coalminers (UAH 1.14bn by year-end for the latter), while two rises in the minimum wage are planned for this year (the minimum wage, aside from the increase in wages themselves, has a deeper effect; for example, minimum statutory funds requirements for businesses are tied to the minimum wage). Plus, we see the hryvnia falling by the end of the year due to widening of current account deficit. In general, we have seen positive impacts on Ukraine's CPI from global price decreases, which do not seem to have badly affected output prices of industries that are important for the economy.

New wave of political confrontation

September 2 witnessed significant changes to the Ukrainian political system and its future. Parliament adopted changes to laws regarding the Cabinet of Ministers and the Constitutional Court, according to which the president has lost the following rights to influence political and economical processes in Ukraine: block decisions by the Cabinet of Ministers, issue legal acts that are obligatory for execution by the government and decisions by the National Security Council are no longer have to be executed by the government. Parliament also adopted changes that simplify the procedure for impeaching a president. Among the surprises was the majority with which the new changes were adopted - more than 360 out of 450 deputies in Parliament. This is a constitutional majority, which is enough to counter the president's veto. The vote was called by the Block of Yulia Tymoshenko (the current prime minister) and the Party of Regions (the largest opposition party). Some votes came from two small parties and even some deputies from the president's party backed Our Ukraine. On the same day, Our Ukraine voted to exit from the Democratic coalition along with Tymoshenko.

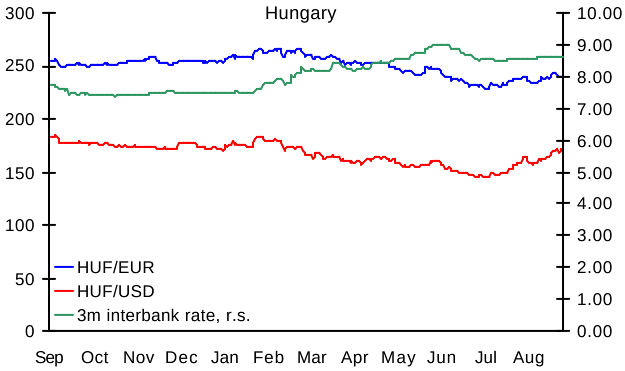
A new coalition and a new center of power may be born, with the two largest political powers in Parliament dominant. The formation of a new government is possible, as are parliamentary elections and the adoption of a new constitution. During the next month, Ukraine is likely to see further important changes to the political system. There could also be changes to foreign policy, as the president has been the main driver of Ukraine's pro-European stance. The market reacted with an increase of Ukrainian Eurobond CDS. The EMBI+ spread widened by 26bp w/w to 325bp, while the EMBI+ Ukraine rose to 594, its highest level since January 2003.

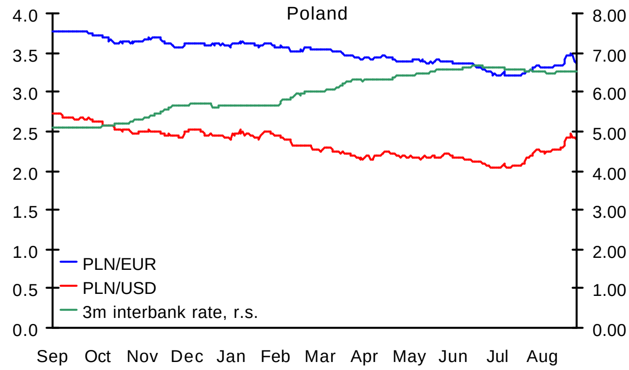
We think that the current situation may be influenced by Russia, which is trying to reverse Ukraine's foreign policy. The president of Ukraine is the leading force in foreign policy, as he has the right to appoint his own foreign policy minister to the Cabinet of Ministers. The current moves may be due to recent events in the Caucasus and the upcoming (October) negotiations on a new Russia-Ukraine strategic agreement, in which main geopolitical and economic relations will be agreed upon. This deal is to replace the existing 10-year deal signed in 1997 (during the time of President Leonid Kuchma). It is hard to predict future political scenarios, but for markets it is important that public opinion is in favor of pro-European economic and democratic models.

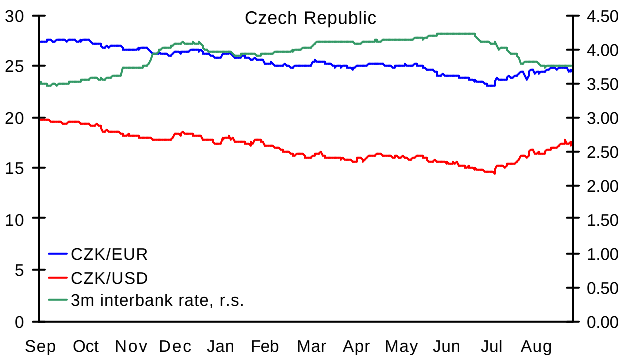
Maryan Zablotskiy, Erste Bank Ukraine, Maryan.Zablotskiy@erstebank.ua

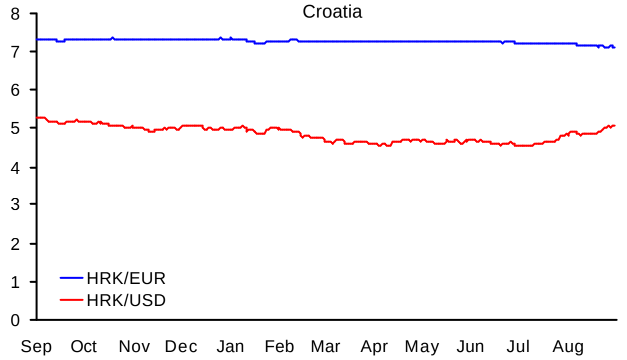
Appendix Charts

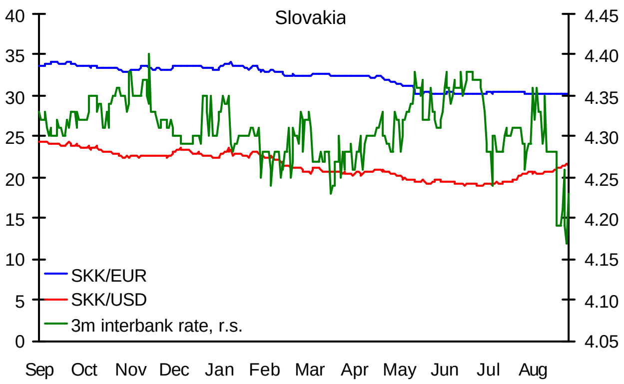
Exchange rates and interest rates (52 weeks)

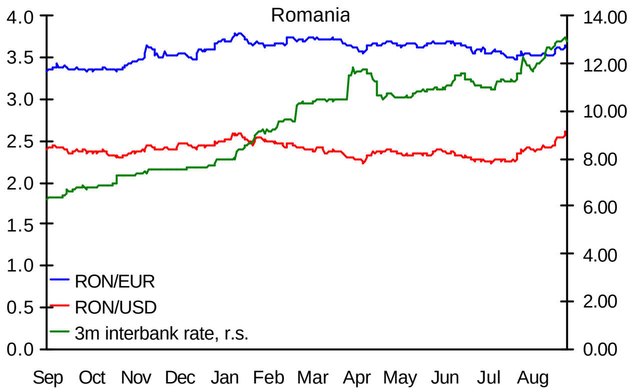


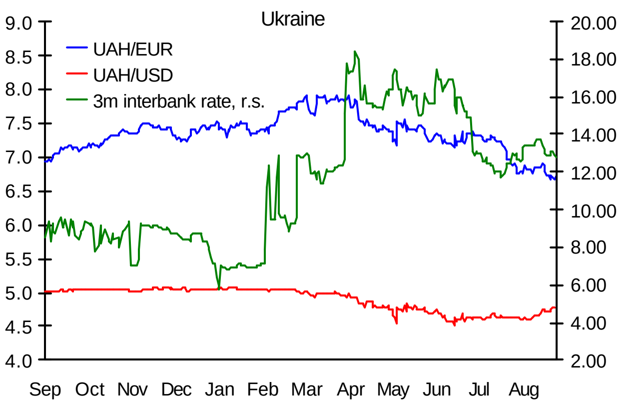








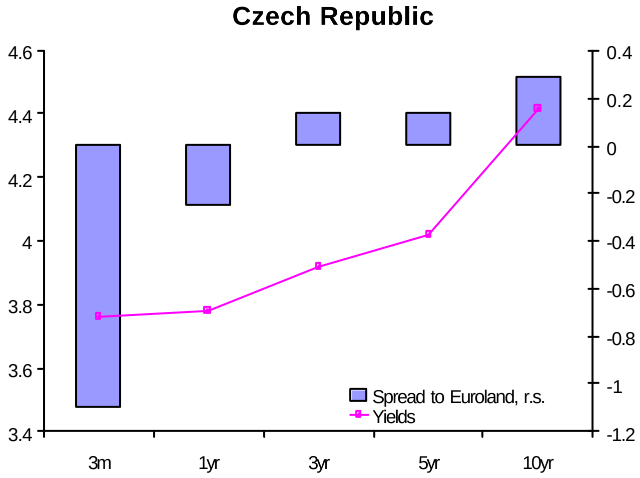


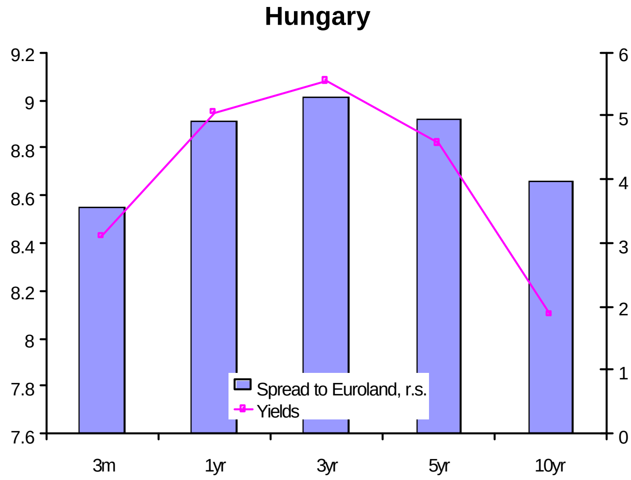


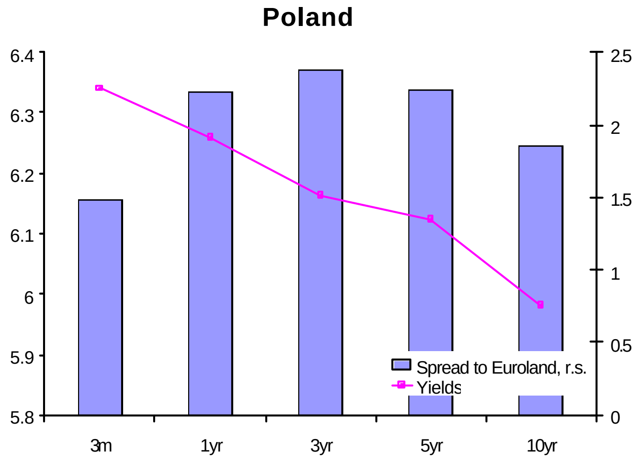
Source: Bloomberg

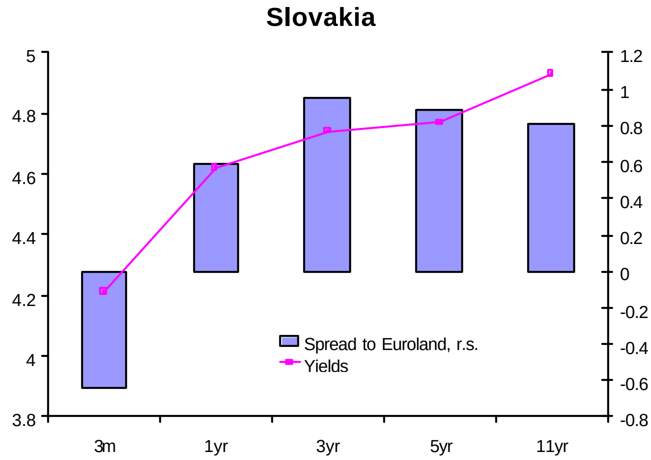
Appendix Forwards

Benchmarks









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Phone +43 (0)5 0100 - ext.

Erste Group Homepage: www.erstegroup.com On Bloomberg please type: ERBK <GO>.

Contacts

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
Macro/Fixed Income Research	
Head: Gudrun Egger (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 33005 - 904
Research, Croatia/Serbia	
Head:Mladen Dodig	+38 1 112200 - 866
Damir Cukman *(Equity)*	+38 5 6237 - 2820
Alen Kovac *(Fixed income)*	+38 5 6237 - 1383
Davor Spoljar *(Equity)*	+38 5 6237 - 2825
Research, Czech Republic	
Head: David Navratil (*Fixed income*)	+420 2 24995 - 439
Petr Bartek *(Real estate)*	+420 2 24995 - 227
Maria Hermanova *(Fixed income)*	+420 2 24995 - 232
Lenka Slamova *(Equity)*	+420 2 24995 - 289
Radim Kramule *(Media)*	+420 2 24995 - 213
Martin Lobotka *(Fixed income)*	+420 2 24995 - 192
Lubos Mokras *(Fixed income)*	+420 2 24995 - 456
Jakub Zidon *(Oil and Gas)*	+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
Gergely Gabler *(Equity)*	+36 1 235 - 5133
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
Melania Hancila *(Fixed income)*	+40 2 1312 6773 - 1028
Cristian Mladin *(Fixed income)*	+40 2 1312 6773 - 1028
Loredana Oancea (*Equity*)	+40 2 1311 - 2754
Eugen Sinca *(Fixed income)*	+40 2 1312 6773 - 1028
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	
Svitlana Bazilevich *(Equity)*	+38 044 593 - 9286
Viktor Stefanyshyn *(Equity)*	+38 044 593 - 1784
Maryan Zablotskyy *(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 - 83121
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
Markus Pistracher	+43 (0)5 0100 - 84100
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
Lukas Linsbichler	+43 (0)5 0100 - 84345
Karin Rauscher	+43 (0)5 0100 - 84112
Michael Schmotz	+43 (0)5 0100 - 84114