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For authors see last page

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Regional Scenario

Regional outlook 2008–2009

	Real GDP		Inflation eop.		Interest rate eop.			Exchange rate eop.			Current account/ GDP		Fiscal Balance/ GDP	
	2008	2009	2008	2009	2007	2008	2009	2007	2008	2009	2008	2009	2008	2009
Central Europe														
Czech Rep.	4.3	4.0	5.7	2.8	3.50	4.00	4.00	26.6	25.7	25.5	–3.7	–3.8	–2.3	–2.9
Hungary	2.7	3.3	5.6	3.5	7.50	8.50	7.00	253.4	238.0	232.0	–4.4	–4.1	–3.6	–3.2
Poland	5.2	4.4	4.2	3.8	5.00	6.25	5.75	3.58	3.45	3.53	–4.5	–4.9	–2.5	–2.3
Slovakia	7.7	6.0	4.3	4.4	4.25	4.25	ECB	33.6	30.1	EURO	–4.6	–4.0	–2.0	–1.7
Slovenia	4.4	4.2	6.4	4.6	ECB	ECB	ECB	EURO	EURO	EURO	–5.1	–5.0	–0.3	–0.3
Baltics & SEE														
Estonia	0.1	2.7	8.0	6.0	7.2	5.7	5.1	15.65	15.65	15.65	–11.3	–12.7	–0.7	0.0
Latvia	2.0	1.6	12.0	7.0	6.0	5.5	5.0	0.70	0.70	0.70	–15.5	–13.0	0.1	0.2
Lithuania	4.7	4.4	9.9	5.9	7.2	5.0	4.6	3.45	3.45	3.45	–11.9	–11.2	–0.9	–0.9
Bosnia–H.	5.8	5.0	5.7	4.1	–	–	–	1.96	1.96	1.96	–15.7	–14.2	–0.5	–1.8
Bulgaria	6.0	4.8	8.9	6.8	4.7	5.2	5.0	1.96	1.96	1.96	–20.2	–17.5	3.5	2.5
Croatia	4.0	3.9	5.0	3.2	6.7	5.7	5.3	7.33	7.28	7.28	–9.9	–9.1	–1.4	–1.7
Romania	6.8	5.5	6.8	5.0	7.50	10.00	9.00	3.61	3.58	3.66	–14.2	–13.5	–2.5	–2.9
Serbia	6.2	5.5	10.8	7.7	10.0	17.5	13.0	79.2	78.0	77.5	–16.3	–13.8	–0.6	–0.9
EU Candidates and other Countries														
Kazakhstan	4.6	6.1	10.5	8.8	12.35	7.00	7.50	177.2	175.5	170.8	3.2	0.0	–1.0	–1.0
Russia	7.5	6.6	13.0	11.0	6.82	7.40	7.30	35.9	34.1	32.9	7.0	4.4	7.0	5.0
Turkey	4.2	5.0	11.0	7.1	15.75	16.75	16.25	1.71	1.92	2.01	–6.3	–6.1	–1.8	–1.3
Ukraine	5.8	4.5	20.4	9.0	8.0	8.3	6.8	7.42	7.18	7.28	–8.4	–8.7	–1.4	–3.0

Source: UniCredit Group CEE Research Network.

Global risks testing Central and Eastern European economies

Low economic growth in the US and the eurozone, strong concerns about inflation, high volatility in financial markets and a general repricing of risk are the main characteristics of the global environment.

Q1 GDP growth settled at 2.5 % yoy in the US and at 2.1 % yoy in the eurozone, and expectations point to a further slowdown, with 1.4 % and 1.7 % growth for 2008 as a whole, respectively, and 2.0 % and 1.6 % for 2009. Oil prices have doubled this year as a result of strong demand and clear constraints in terms of supply, and food prices are peaking due to structural rather than temporary factors. With concerns mostly focused on growth, proactive monetary policies have led to rapid declines in interest rates in the US, accompanied by direct fiscal interventions. Other central banks, including the ECB, are more concerned about inflation, reacting to the new environment with higher interest rates. In less than a year, stock markets have lost 30 % of their value in Europe and 15 % in the US. The repricing of risk at the international level is also apparent: CDS spreads have doubled or tripled since July 2007, with several rounds of rebounds.

The region still appears to be resilient …

The usual growth drivers remain constant in CEE, and we continue to forecast an average yearly growth of 4.6 % in Central Europe, 5.1 % in SEE and the Baltics and 6.0 % in broader Europe in the period from 2008 to 2010.

Consumption is fuelled by rising household incomes and declining unemployment, although high inflationary pressure and tighter monetary conditions are resulting in moderation. Moreover, households in the region are now coping with more stretched balance sheets than in the past because they have increasingly been financing their consumption with debt, making them more sensitive to potential shocks.

Even though the cycle peaked from 2006 to 2007 and despite credit tightening, prospects for investment remain relatively positive thanks to fairly robust business activity and a number of infrastructure projects financed by structural funds (in EU member countries) or investment and growth funds (in former CIS countries). Lower growth levels in the eurozone and rising production costs will be reflected in a certain amount of pressure on the export performance of CEE countries. Foreign direct investments (FDI) and M&A deals could also be affected by global uncertainty. However, the CEE region still remains competitive and selected industries might even benefit from decisions by international companies to maximise the return on their past delocalisation strategies. Oil and raw material prices remain supportive for former CIS countries, but there is still the risk that a reversal of the current trend would harm these countries.

… but the international environment reveals long-term weaknesses

It is very clear, however, that vulnerabilities exist. In recent years, most countries in the region have relied on external savings to finance their growth. Rising current account deficits were financed by foreign direct investment, but also by external debt. The banking sector has also played a role, with strong lending growth – one of the main drivers of the retail and investment boom – being financed largely from abroad. In 2007, the region accumulated roughly EUR 100 bn in international debt, while the banking sector almost doubled net access to foreign funding. The repricing of risk at the international level has led to a hike in the cost of such external financing, enhancing the risk of a general tightening of credit conditions. Countries with larger external imbalances and greater dependency on foreign funding are also the ones facing a larger increase in the cost of risk, and are thus more likely to suffer from credit and liquidity tightening. The countries whose banking sector is more dependent on foreign funding are the Baltics, Ukraine, Kazakhstan and Romania. The countries that most need to finance the current account are the Baltics and Southeastern Europe (Serbia, Romania and Bulgaria).

Global inflation problem particularly pressing in CEE

Driven by food and oil price hikes, inflation is a global problem. However, in CEE it seems to be particularly pressing, given the weight of energy and food on households consumption basket. In addition to the international component, CEE countries also face a number of domestic inflation challenges: Remaining market inefficiencies, price liberalisation and simple price convergence towards Western standards are fuelling price increases. Labour market conditions are also not supportive, with unemployment generally in decline and labour scarcity fuelling wage increases. In some countries with very high growth levels, such as Russia and Ukraine, partial bottlenecks, for example, in building materials, are also increasing price pressures.

In addition to these, inflation has been fuelled in some countries by the relatively easy monetary conditions perceived so far, with abundant capital inflows financing strong domestic credit growth. Given the high relevance of foreign credit and exchange rate arrangements in SEE, the Baltics and Ukraine, monetary policy mechanisms have also had quite a limited corrective impact, with only administrative measures proving to be successful in constraining domestic liquidity. In such a scenario, the struggle against inflation will remain a priority, even if finding the proper instruments will be extremely challenging.

Central Europe: generally resilient, with inflation and labour market stretches posing the main challenges

Central European countries (Poland, Hungary, the Czech Republic, Slovakia and Slovenia) are likely to be more resilient to the global context, with the main effects being felt in relation to inflationary pressure and less international and European demand. Tightening policies are on the agenda, while both consumption and investment activities are decelerating but remain lively. It should be noted that the continuing strong pace of growth, combined with inflationary pressure, could generate concerns about asynchronisation with the eurozone in some countries. This may become an issue for Slovakia, which will enter the eurozone at the beginning of 2009 and then adopt an easier monetary policy stance, and for Slovenia, which entered the eurozone in 2007. The other countries are not rushing to adopt the common currency.

Hungary remains the country with the weakest macroeconomic environment in Central Europe and the most sensitive to deterioration in the global environment. Despite a tense political scene, the real economy is slowly crawling out of its slump. The central bank is likely to continue to tighten its stance until the end of the year, which will allow the forint to trade strongly.

Baltics cooling very rapidly, SouthEastern Europe clearly vulnerable

The economic outlook deteriorated quite substantially in the Baltic countries at the beginning of 2008 as a result of rising macroeconomic imbalances, tightening credit conditions and overheated real estate markets, and the adjustment towards slower growth has started. In Estonia and Latvia, the slowdown seems to be proceeding much faster than previously expected, while Lithuania's economy appears to be more resilient at the moment.

The Latvian housing market bubble began to burst in April 2007, largely due to the government's policies on inflation and property speculation. In Riga, apartment prices fell 25 % from the beginning of this year to June. Weak economic growth and higher interest rates are driving the housing market down further. Signs of stagnation in the housing market have also increased in Estonia, after property sales fell by 30 % in Q2. Correction on the Lithuanian real estate market is likely to be milder in the short term because the booming phase started later than in Estonia and Latvia.

With a bursting real estate bubble and tighter lending conditions applied by foreign-owned banks, the Baltic countries are experiencing a clear contraction in capital inflows. As a result, we anticipate further cooling in the pace of economic expansion in Latvia (GDP growth is expected to slow to 2.0 % for the whole year, reaching its lowest point towards the end of 2009). This year, growth is expected to virtually stagnate in Estonia (0.1 % in 2008), while some cooling will also take place in Lithuania (4.7 % growth for the whole year), which, however, will experience a much smoother decline in comparison to the other Baltic states. The cooling of the Baltic economies along with the narrowing of their large current external imbalances – driven by the decrease in the pace of import expansion – are expected to relieve the pressures on the FX markets to a certain degree.

With high current account imbalances, strong dependency of growth on external savings and strong inflationary pressure, SEE countries are facing similar challenges to the Baltic states. The financing of the large current account deficits remains a key issue to monitor: In recent years, a large share of FDI was directed towards the non-tradable sectors (in other words, FDI with less export potential), especially real estate – these financing flows tend to be more volatile and easy to revert. However, while we believe that some moderation in growth should be expected in SEE, based on the booming phase recorded so far, we do not see a hard landing scenario like the one which is now materialising in the Baltics. Firstly, while showing some signs of overheating, the real estate market in SEE is much less inflated than the one in the Baltics, with concerns being limited mostly to specific sub-segments, such as the sea and mountain areas in Bulgaria and specific segments in Bucharest. Secondly, the economic structure in SEE is much more diversified than in the Baltics, and the region still shows a good level of international competitiveness and is able to attract investments in the production sectors – a basis for further improvements in competitiveness. Thirdly, while the SEE countries have also experienced a credit boom, it occurred much earlier in the market development phase. This means that in the case of some tightening or economic slowdown, households might still be less sensitive than those in the Baltics because they have a relatively lower level of indebtedness.

In Bulgaria, we expect some moderation in capital inflows, especially in the overheated holiday-home segment. Sluggish implementation of reforms does not allow for the full compensation of the negative impact that excessive wage growth is having on competitiveness. Labour market shortages and slowing GDP growth in the EU countries are also starting to weigh on growth prospects.

Romania has paid the cost of its imbalances, with a negative turn in the mood of the markets since July 2007 leading to a 20 % depreciation of the currency. The central bank has opted for high interest rates as a strategy for keeping Romanian assets attractive and controlling inflation. Growth prospects remain good, but challenges include a relatively indebted household sector with deteriorating balance sheet positions and an industrial sector that is losing competitive strength.

In Croatia, the central bank's strategy of cooling domestic credit growth while limiting the external indebtedness of local banks and forcing their recapitalisation has proved rather successful. Domestic lending is being squeezed as a result of constraints by fixed targets, while the economic impact of such tightening is relieved by the increasing relevance of cross-border lending.

In the western Balkans, the political scenario is still a source of risk. In Serbia, the political environment remained uncertain for a while before and after the elections in May and turned positive only very recently. In Bosnia-Herzegovina, the domestic political environment is also crucial: The SAA (Stabilization and Association Agreement) with the EU represents a major support for the country, but weaknesses in the political sphere remain.

Broader Europe: Inflation the main issue

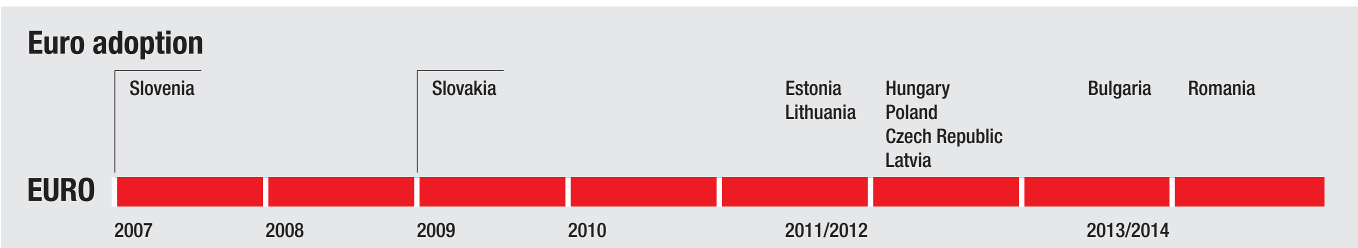
Countries in the rest of Central and Eastern Europe – CIS members and Turkey – are sensitive to the international repricing of risk, but inflation is probably one of the main threats they face.

With record growth already leading to bottlenecks in some areas, Russia is sensitive to high global inflation, particularly with regard to food. The authorities' inflation targets are likely to be missed in 2008 despite monetary tightening. At the same time, Russia is among the countries benefitting from the global environment of high inflation as surging commodity prices boost the incomes of the government, companies and most households. Cross-border capital inflows, including to the banking system, resumed in Q2 2008 despite the global liquidity crisis. We revise our GDP forecast for 2008 from 6.6 % yoy to 7.5 %. Over the coming years, economic prospects will largely depend on the ability to invest sufficiently in order to overcome emerging infrastructure shortages and counter the depletion of aging oilfields.

After a relative boom, with strong optimism regarding future developments, some correction of expectations is now materialising in Ukraine. Tense political debate, soaring inflation and a drastically widening current account deficit have been accompanied by a sharp increase in the cost of risk, leading to a tightening of monetary and liquidity conditions. Investment and credit growth have begun to slow, and we now expect real GDP growth to decline from 7.6 % in 2007 to 5.8 % in 2008 and 4.5 % in 2009. We also admit that Ukraine's outlook has deteriorated and that risk has increased. However, we remain optimistic that Ukraine will be able to keep imbalances at a sustainable level. Its generally sound banking system and lower but still substantial FDI inflows will help to stabilise the country.

The economic environment remains difficult in Kazakhstan. Stalled credit growth, soaring inflation and the bursting of the residential construction bubble are depressing domestic demand, while strong external demand for oil and gas allowed real GDP growth to remain at 6 % yoy in Q1 2008. High commodity prices have supported Kazakhstan's growth and helped it to avoid a severe banking crisis and currency depreciation. The other side of the coin: Should prices fall sharply, Kazakhstan would be hit hard.

The Turkish economy slowed significantly during 2007, which was a very eventful year, dominated by both local elections and global uncertainties. In 2008, fragility is once again mainly related to a perilous political environment: The ruling AKP party, which had a lot of popular support in the 2007 elections, is being challenged by the secular establishment, including the judiciary, the army and academics. The AKP is currently under the threat of a ban by the Constitutional Court (at the time of writing, a decision has not yet been taken). The Turkish economy is also very sensitive to the international environment: Turkey – as an emerging and high-beta country – still remains exposed to financial contagion stemming from abroad more than other CEE countries. The Turkish assets are very liquid and any drastic weakening of the currency due to a change in investor moods translates into higher inflation, while changes in interest rates are often associated with an investment slowdown.



Country	Latest Political Event/Main Achievements	Main issues to be faced
BOSNIA-HERZEGOVINA	▪ In June Bosnia Herzegovina signed the Stabilization and Association Agreement with the EU. ▪ On July 1, an interim trade deal between EU and Bosnia entered in-to force. It will create a free-trade area between Bosnia and EU.	▪ Improving the transparency of the privatization deals. According to an anti-corruption watchdog in 2007 corrupt privatization deals cost Bosnia about EUR 250 mln. ▪ Local elections on October 5, 2008.
BULGARIA	▪ The Government won the fourth and fifth confidence vote (February and April 2008) filed by the opposition that claimed it had failed to fight corruption and had closed ties with the organized crime. ▪ The Socialist-led three-party ruling coalition agreed a Government reshuffle amid Minister of Interior's resignation. ▪ In May, the Bulgarian Government ordered urgent measures to fight European Union fund fraud.	▪ Corruption concerns prompted the European Commission to freeze some EUR 450 million of subsidies and to threaten to suspend another EUR6.8 billion available to Bulgaria until 2013, if Sofia doesn't show progress. ▪ Strong popular disaffection and discontent over the Country's political life. Possible risks of defection by the second ruling partner NMS-II.
CROATIA	▪ The Government temporarily suspended its control of the Fishing and Ecology Protected Zone in order to speed up its accession to the EU. ▪ In April and June 2008, the EU decided to open another four (energy; transport; free movement of workers; social policy and employment) of the 35 policy chapters.	▪ To speed-up the reforms necessary to meet EU accession criteria. Croatia has yet opened negotiations on only 20 chapters. The most contentious issues, such as agriculture and state support to the shipbuilding industry, have been left to last. ▪ Strong popular discontent over inflation and wages.
CZECH REPUBLIC	▪ The Chamber of Deputies approved by 95 votes to 91 a bill raising the pension age gradually to 65 years by 2030. ▪ In July signature of an agreement with the U.S. to host part of a missile-defence system on Czech soil, strong confrontation between the Government and the opposition is expected for the parliamentary ratification.	▪ The weak coalition Government has to face a strong left-wing opposition, especially to approve the needed reforms (pension system, further healthcare reform. ▪ The Czech Constitutional Court's decision about Lisbon Treaty's constitutionality is expected in Sep/Oct.
HUNGARY	▪ After the junior Government coalition partner, the Liberals (SZDSZ), decided to withdraw from the governing coalition leaving the Socialist party to govern in a minority Government, the PM Gyurcsany reshuffled his cabinet.	▪ PM Ferenc Gyurcsany, now leading a minority Government, lacks the backing of both the public and his own party to continue his reform agenda. ▪ The SZDSZ announced that probably it will not vote for 2009 budget law, leaving the minority cabinet unable to discuss the bill in Parliament and increasing the risk of early elections.
ESTONIA/LATVIA	▪ In May Latvian and Lithuanian Parliaments approved the Lisbon Treaty.	
LITHUANIA	▪ In May the Parliament ratified the Lisbon Treaty. ▪ In July the Government dropped its veto on a new partnership agreement between EU and Russia	▪ Parliamentary elections are scheduled for autumn 2008. ▪ To face the widespread corruption.
POLAND	▪ Negotiations continue on deploying elements of a US missile shield on Polish territory. ▪ In May Government approved four-year privatization plan. It will cover more than 700-state owned enterprises.	▪ The Government decided to withdraw Poland's 900 troops from Iraq by the end of 2008. ▪ To push ahead with tax cut and deregulation. ▪ To face further social unrest: Poland's second-largest group of public sector workers, teachers, went on strike demanding pay's rise.
ROMANIA	▪ Local elections were held in June. The Social Democrats have made a strong showing	▪ Parliamentary elections to be held in November 2008.
RUSSIA	▪ In May Medvedev became new Russian President and Putin the new Prime Minister. ▪ In May the bill limiting foreign investments in "strategic" branches of the economy has been ratified. ▪ EU decided to extend the current agreement with Russia to 2008.	▪ The power-sharing between Putin and Medvedev will have to assure the Country political stability and continuity. ▪ Fight against corruption and poverty.
SERBIA	▪ After May Parliamentary elections, in July, the Socialists and the Democratic Party formed the new Government. ▪ On April 30, Serbia and EU signed the Stabilization and Association Agreement.	▪ Kosovo's Serbs decision to set up their own Parliament. ▪ Facing the Kosovo independence's consequences. ▪ Enhancing relations with the EU.
SLOVAKIA	▪ European leaders approved Slovakia's bid to become the euro zone's next member at their Brussels summit in June.	
SLOVENIA		▪ Parliamentary elections to be held on September 21, 2008.
TURKEY	▪ On July 1, AKP closure case opened. ▪ Turkish Constitutional Court decided to overturn a government-led reform allowing students to wear Muslim headscarves at university. ▪ In July 86 people were charged by prosecutors with plotting to overthrow the Government. ▪ The Turkish parliament voted a bill to introduce a Kurdish-language channel on state television in line with a government promise to the Kurdish minority ▪ In June the EU decided to open another two (company law; intellectual property law) of the 35 policy chapters. ▪ In May, Turkish President Abdullah Gul signed into law a long-sought revision of a law criticized by the European Union for limiting free speech in Turkey.	▪ To face Constitutional Court's decision about AKP's ban ▪ To face political uncertainty and slowdown of political reforms, due to the Constitutional case on AKP's ban. ▪ Possible introduction of legal amendments that would rewrite criteria for shutting political parties.
UKRAINE	▪ The Government lost its majority in Parliament after the defection of two coalition deputies, but in July it won a confidence vote. ▪ Starting from May 2008 Ukraine officially became the 152nd member of the World Trade Organization. ▪ In May the Parliament approved a bill increasing President's powers.	▪ Increasing tensions between President Yushchenko and PM Tymoshenko. ▪ Nato decided to reconsider Ukraine's membership in December.

Source: UniCredit Group – Political Studies

Bulgaria

Outlook

GDP growth continued to perform well in the beginning of 2008 and there are a number of signals that it will remain solid in Q2 and Q3. However, we believe that the pace of economic expansion will slow down in Q4 and thereafter. Sluggish implementation of reforms does not allow negative impact that excessive wages growth is having on competitiveness to be fully compensated and Bulgaria starts loosing its attractiveness for international investors. Higher cost of capital and rising risk aversion on the international level are anticipated to bring some deceleration in foreign capital inflows, especially in the overheated holiday home segment. Labour market shortages and slowing GDP growth in the EU countries are also starting to weight on the growth prospects of the Bulgarian economy. At the same time, the strength of disinflationary process expected in the H2 2008 is likely to be limited. The latest hikes in administratively regulated prices will not allow year-end inflation from falling below 8.9 %.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 103
Baa3/Positive	BBB+/Stable	BBB/Negative	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	25.2	28.9	33.8	37.9	42.1
Per capita GDP (EUR)	3,290	3,780	4,450	5,010	5,600
Real GDP, yoy (%)	6.3	6.2	6.0	4.8	5.3
Inflation (CPI), yoy, eop. (%)	6.5	12.5	8.9	6.8	5.7
Inflation (CPI), yoy, avg. (%)	7.3	8.4	11.0	7.2	6.0
Unemployment rate, eop. (%)	9.1	6.9	6.7	6.7	6.4
Exchange rate BGN/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
LEONIA, eop. (%)	3.43	4.68	5.15	4.95	4.80
LEONIA, avg. of the year (%)	2.79	4.03	5.04	5.03	4.85
Current account balance/GDP (%)	–17.8	–21.5	–20.2	–17.5	–14.4
FDI/GDP (%)	23.6	21.1	14.5	11.0	13.5
Budget balance/GDP (%)	3.6	3.5	3.5	2.5	2.7
General government debt/GDP (%)	24.7	19.8	16.6	14.5	13.5
Total external debt/GDP (%)	80.7	97.3	103.0	107.0	113.5

Sources: Central bank, Statistical office, UniCredit Bulbank Economic Research Unit, UniCredit Group CEE Research Network.

Main topics

- The reacceleration of private consumption and a recovery in exports contributed to boost GDP growth to 7.0 % in Q1 2008. Despite promising prospects in Q2 and Q3 2008, we anticipate some slowdown in the pace of economic growth in Q4 and thereafter.
- Inflation increased further in May, but is forecasted to ease moderately over the short run in response to a doubling in agriculture output, in combination with a particularly large base effect in the foods segment. The small difference between headline and core inflation hints that higher food and energy prices are feeding into wages and other goods and services costs, which bodes ill for inflationary prospects in 2009 and thereafter.
- Soaring energy prices reversed the positive trend in the foreign trade balance established in the first 3 months of the year. Nevertheless, our view is that increases in exports of unprocessed agriculture products and new production capacities added in the tradable goods sectors will allow the current account (CA) gap to ease moderately to 20.2 % of GDP towards the end of this year.

GDP growth sustained strong momentum, despite rising vulnerabilities and risks associated with the sub-prime turmoil.

Reacceleration of private consumption and a recovery in exports pushed GDP growth higher in Q1 2008

The growth pattern also experienced some improvement, although generally speaking domestic demand expansion remains overly reliant on imports of international savings. In Q1 2008, real GDP increased 7 % yoy, above the consensus (5.7 %), making Bulgaria's economic growth the third strongest in the EU after Slovakia and Romania. Construction, financial intermediation and real estate were the sectors at the forefront of economic expansion, posting double-digit GVA growth. Output in the agriculture sector continued to disappoint, contracting by 1.6 % in real terms. Following four successive quarters of double-digit output growth, industry reported a real increase of 7.7 % in GVA. In Q1 2008, GDP growth continued to draw support from the process of rapid accumulation of physical capital in the economy.

Investment expenditure, measured by gross fixed capital formation, showed no signs of slackening and continued to account for roughly one-third of total GDP, despite the fact that many companies have started to internalise higher funding cost in the prices of their ongoing projects. The structure of investments, measured by expenditures for acquisition of tangible fixed assets, gradually shifted in favour of tradable goods sectors, which increased to 40 % of the total. The overall picture is still dominated by the service sectors which account for 52 % of total expenditures for acquisition of tangible fixed assets, while investment spending channelled into the booming real estate market and vertically integrated construction and tourism sectors hovered around 20 % of the total. Following a very subdued performance in Q4 2007 (+3.4 %), private consumption grew strongly (+5.7 %) underpinned by the positive effects of introducing a 10 % flat tax rate on personal incomes and in response to the improving situation on the labour market, where unemployment reached an all time low (6.2 %). However, consumption expenditures in the household sector remain vulnerable to negative shifts in sentiment and particularly to the rising inflationary pressure, which will further squeeze real incomes going forward.

Changes in supply side policies have favourably affected output and employment

The decrease in the social security contribution rate and the introduction of a 10 % flat tax on personal incomes reduced the tax wedge in the economy. Now, the companies generate the same take home pay (or salary from the view point of the worker) with a lower gross wage (salary as seen from the employer's perspective). The smaller tax wedge is likewise having a positive effect on the equilibrium level of employment in the economy, which is particularly important as labour market shortages had emerged in a number of industries. In addition, the decision of the authorities to cut the maximum duration of unemployment benefits from 18 to 12 months has increased the attractiveness of work relative to unemployment. This is even more important, given the weak responsiveness of productivity growth to physical capital accumulation, which renders excessive wage growth particularly dangerous for competitiveness. We think that restraining wage growth will be difficult to achieve, given the strong momentum built up over the previous two years and in the context of general elections scheduled for 2009. This reduces the chances for reaching wage agreements that would help to alleviate the pressure on both prices and competitiveness performance.

Economic growth will remain solid in Q2 and most likely in Q3 as well

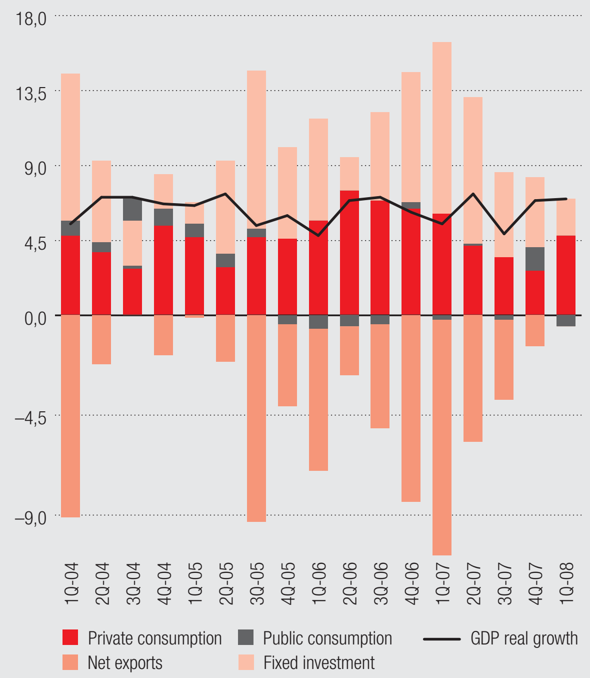
Favourable economic data in April and May suggest that rapid GDP growth will be sustained in Q2 2008. Indications from manufacturing and more generally from the corporate sector remain positive. Output and sales growth in industry are hovering around 8 % with double-digit growth reported in a number of sectors, including manufacturing of metals, construction materials, electrical appliances, and machinery and equipment. Sentiment is following a gradually downward trend, however, starting from a very high level after the surge in expectations in the period ahead of EU accession. Capacity utilisation and new order volumes are close to their highest levels ever, while on the negative

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Real GDP, yoy (%)	7.3	–	–	4.9	–	–	6.9	–	–	7.0	–	–	–
Industrial production, yoy (%)	7.7	14.3	8.4	8.9	11.3	7.4	5	8.2	5.4	–1.1	8.8	–	–
Inflation (CPI), yoy (%)	5.6	8.4	12.0	13.1	12.4	12.6	12.5	12.5	13.2	14.2	14.6	15.0	–
Unemployment (%)	7.42	7.25	7	6.78	6.73	6.62	6.91	7.38	7.26	6.79	6.51	6.19	–
Exchange rate, EUR, eop.	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
LEONIA, avg.	4.01	4.10	4.09	4.24	4.26	4.58	4.68	4.75	4.83	4.85	4.93	4.98	5.06
Export, (EUR) yoy (%)	9.8	15.8	6.6	14.2	22.8	20.8	13.6	28.4	33.1	17.7	33.6	–	–
Import, (EUR) yoy (%)	22.0	20.5	8.4	23.3	21.7	27.2	9.2	18.7	31.9	15.6	37.2	–	–
Trade balance, EUR mn	–558.2	–603.3	–584.7	–607.1	–707.2	–793.5	–801.7	–611.3	–605.4	–579.3	–757.6	–	–
Current account, EUR mn	–299.4	–250.9	–255	–514.3	–691.3	–728.7	–894.2	–744.7	–593.8	–413.7	–679.9	–	–

Sources: Central bank, Statistical office, UniCredit Bulbank Economic Research Unit.

GDP growth and demand side components of GDP growth (yoy real growth in %)



Source: National Statistical office.

side business leaders are increasingly concerned about rising price pressure, weakening domestic demand and growing labour market shortages. The flow of newly announced investments remains abundant. There are only very limited cases where companies are forced to abandon their projects either due to higher cost of capital or lack of sufficient financing. Even so, it is clear that companies are already feeling the pinch as the global financial crisis has generated pressure on the cost of both debt and equity capital. The corporate sector is increasingly turning its attention toward credit extended by local banks in response to the increase in the price of external borrowing and as international lenders' risk appetite has waned. Excessive retail credit growth continues to support consumption expenditures in the household sector. The most recent retail sales data signal that consumption of food has been on a downward trend, but this is more than compensated by double-digit growth in sales of wearing apparel and a rapid increase in purchases of consumer electronics. Our baseline scenario envisages some weakening in private consumption starting in H2 2008, as inflation is squeezing disposable incomes. In addition, GDP in Q3 2008 will draw support from the doubling of the wheat and barley volumes harvested in the agriculture sector, which accounts for roughly one-third of the total output generated in the economy in this particular period of the year.

Mounting signals that some slowdown in economic activity is on the cards

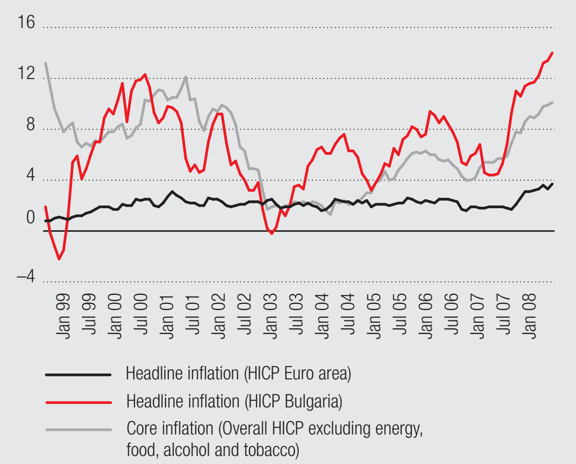
For a start, Bulgaria apparently is losing some of its attractiveness for international investors, as the cost of capital increased quite substantially and sluggish reforms oriented towards improving the business climate have failed to compensate for the negative impact of excessive wage growth on competitiveness. The slowdown in foreign capital inflows is thought to be particularly pronounced in the overheated holiday home segment. During the last two quarters, FDI channelled into the real estate market and the vertically integrated construction and tourism sectors decreased compared with the same period a year ago. Nevertheless, we think that the severity of the downturn in the construction sector will be limited, as cooling construction activity in the field of holiday homes will be compensated by booming investments in infrastructure and supported by the still-high qualitative and quantitative gap in supply in the rest of the country. Secondly, the domestic labour market has tightened rapidly. Despite the fact that labour markets in the EU are, as a whole, still closed for Bulgarian workers there are already acute shortages in many sectors. Things are likely to become even gloomier looking forward, especially when barriers to the free movement of labour are scrapped and local entrepreneurs are forced to pay more to withstand external competition. Thirdly, the knock-on effect which the global financial turmoil is having on GDP growth in the EU and elsewhere in the world is likely to negatively affect demand in the export-oriented sectors of the Bulgarian economy. And finally, international investors are growing more risk averse and have already started to price the higher cost of risk in their projects in Bulgaria. The price of credit extended by the local banking sector also increased, despite the fact that growth of credit channelled to the real economy remains pretty strong indeed. Thus, on balance, our scenario envisages GDP growth in Bulgaria slowing gradually to 6.0 % in 2008 and further to 4.8 % in 2009.

The strength of disinflationary process anticipated in H2 2008 will be rather small

In May, CPI inflation according to the national methodology came in at 15.0 % yoy, its highest level since May 1998. However, underlying prices pressure lost momentum as the month-on-month price increase in May (0.5 %) was the smallest reported in the last five consecutive months. Likewise, HICP increased to 14.0 % yoy, making Bulgaria the country with the second highest inflation among all EU member states. The gap between headline and core harmonised consumer price index (overall HICP excluding energy, food, alcohol and tobacco prices) increased marginally to 3.9 %, compared with 3.4 % and 3.5 % in March and April, respectively. In May, mounting prices pressure was mostly attributable to higher transportation and tobacco prices, while in contrast to the first four months of this year food costs posted a moderate month-on-month decrease (0.4 %). However, energy and transport costs are set to continue their upward trend, as the state regulators approved a series of new hikes of administratively regulated prices. In particular, average electricity tariffs in the household sector were increased by 14 %, while electricity tags for end users linked to the mid and low pressure grid were ticked up by 12.52 % and 16.23 %, respectively. The cost of natural gas increased by 5.16 % to EUR 222 per 1,000 cubic meters (ex VAT), while costs of steam heating energy were raised 13 % on average. Likewise, the state-controlled railway operator raised passenger (9.19 %) and freight prices (8 %) effective from July.

At the moment, the disinflationary efforts of the authorities are based on three policy measures that include: maintaining the MRR rate at 12 %, targeting a surplus in public sector finances of a minimum of

HICP headline and core inflation in Bulgarian and EU headline HICP



Source: National Statistical office.

3 % of projected full-year GDP and 12 % planned job cuts in public administration. However, this policy package has remained unchanged since the autumn of the last year, while at the same time inflation increased from 12.0 % in August 2007 to 15.0 % in May 2008. Furthermore, the small gap between headline and core inflation indicates that soaring food and energy prices are feeding into wages and other goods and services costs increases. Based on these considerations, we believe that in H2 2008, inflation will follow a gradually decelerating trend, which will additionally draw support from the particularly large base effect in the foods segment. However, the latest hikes in the administratively regulated prices, tightening labour market conditions and rising inflationary expectations will not allow year-end inflation to decrease to below 8.9 % yoy.

In the context of deteriorating external conditions, the substantial external financing needs of Bulgarian economy remain an issue to monitor

The CA deficit widened nominally by 15 % in the first four months of this year (EUR 2432 mn) compared to the same period a year ago (EUR 2126 mn). Relative to the size of the economy, however, the CA gap decreased marginally to 7.2 % of projected full-year GDP compared to 7.4 % in the same period of 2007. In April, import growth (37.2 %) exceeded export growth (33.6 %), reversing the trend established in the five previous consecutive months, mostly as higher energy prices swelled the import volumes. In response, the trade balance deteriorated nominally by 16 % yoy, reaching EUR 2554 mn in the period under review (Jan–Apr). Services, transfers and income balances worsened marginally compared to one year earlier. On the financing side, net FDI came in at EUR 821 mn, roughly two-thirds of the level in 2007 (EUR 1403 mn). However, it would be premature to claim that FDI has deteriorated, as what was released are preliminary estimates that are subject to potentially large revisions in the following months. In the first 4 months of 2008, debt-creating financing posted a sizeable yoy increase (42 %), mostly as local commercial banks withdrew some of their foreign assets to finance expansion of their domestic loan portfolios. The end balance between all foreign currency inflows and outflows remains positive. It was roughly twice as large compared to the same period in 2007, allowing BNB reserves to increase by EUR 1010 mn in Jan–Apr. Despite soaring energy prices, we remain optimists with regard to the CA outlook over the medium term. We see the CA gap easing marginally to 20.2 % of GDP in 2008, and further to 17.5 % next year. On the negative side, slow progress in the implementation of reforms aimed at improving business climate, in conjunction with growing unit labour costs will erode competitiveness, likewise bringing about a moderate deceleration of foreign capital inflows.

EU aid for Bulgaria under two more SAPARD programme measures was frozen

Bulgaria risks losing millions of Euros in EU aid due to mounting evidence that corruption has directly affected the agencies responsible for the administration of EU-funded projects. In March, following evidence of serious irregularities in the handling of EU grants, the authorities in Brussels suspended disbursement of most of the financing under PHARE and ISPA programmes. In response, the Bulgarian government dismissed the local head of the executive agency dealing with the administration of the PHARE programme and the Road Agency Director, who ran most of the projects financed under ISPA. The government reshuffles that took place couple of months later, among other things, included nomination of a Deputy Prime Minister who will coordinate activities of all structures of public administration responsible for the handling of EU funds. Likewise, auditing of EU projects was contracted to foreign companies, allegedly due to lack of local firms with satisfactory qualification and expertise. In early July, following an investigation of the EU's antifraud agency OLAF, a total of EUR 94 mn in subsidies allocated to more than 500 already approved projects under the last two remaining measures of SAPARD were frozen. The Commission's decisions triggered resignation of the head of the Agriculture Fund, a local structure operating under the umbrella of the Agricultural Ministry dealing with all EU funds channelled into the sector. At the same time, it appears that Bulgaria's track record in fighting corruption and organised crime remains controversial, despite significant progress made in enacting new legislation. The detailed report that will shape EU's response on the matter is due to be made public on 23 July.

Event	Date	Reading
Report of the European Commission to the European Parliament and the Council on Bulgaria's progress on implementation of accompanying measures following Accession.	23 July 2008	The report is anticipated to cast more light on the possible response EU is going to take to the persistent problems with corruption and slow reform of the judiciary system in Bulgaria.

Czech Republic

Outlook

Following the first sharper deceleration in growth in Q1, the economy is expected to remain on a downtrend for the rest of this year. While household spending should continue to be affected by the inflation spike, the combination of strong crown appreciation and a slowdown in the Eurozone will only be felt in the performance of net exports. Despite the cooling economy, inflation risks have shifted to the upside, opening up some room for yet another interest rate hike before year-end. However, this will be delivered only in the event of a significant CZK/EUR correction, which we are still expecting to occur. On the fiscal policy side, the centre-right government succeeded in pushing through the parliament the first round of a three-step pension reform, which appears necessary for public budget stabilisation over the long term. Nonetheless, lacking a parliamentary majority and facing infighting among the ruling parties, the government will find it increasingly difficult to move forward with fiscal consolidation.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 42
A1/Positive	A/Stable	A+/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	113.5	127.9	152.4	161.5	175.9
Per capita GDP (EUR)	11,050	12,390	14,630	15,400	16,680
Real GDP, yoy (%)	6.8	6.6	4.3	4.0	4.5
Inflation (CPI), yoy, Dec. (%)	1.7	5.4	5.7	2.8	2.8
Inflation (CPI), yoy, avg. (%)	2.5	2.8	6.8	3.5	2.8
Unemployment rate (%)	8.1	6.6	5.4	5.3	5.3
Exchange rate CZK/EUR,eop.	27.50	26.62	25.70	25.50	25.00
Exchange rate CZK/EUR, avg.	28.34	27.76	25.10	25.50	25.20
2-week repo rate, Dec. avg.	2.50	3.50	4.00	4.00	4.00
2-week repo rate, avg. of the year	2.17	2.88	3.76	4.00	4.00
1M Pribor, Dec. avg.	2.52	3.98	4.05	4.05	4.05
1M Pribor, annual avg.	2.22	2.96	3.88	4.05	4.05
Current account balance/GDP (%)	–3.1	–2.5	–3.7	–3.8	–3.6
FDI/GDP (%)	4.2	5.2	5.0	6.3	4.5
Budget balance/GDP (%) (ESA 95)	–2.7	–1.6	–2.3	–2.9	–2.7
Public debt/GDP (%) (ESA 95)	29.4	28.7	28.7	28.0	28.8
Total external debt/GDP (%)	37.1	38.0	38.7	39.0	39.0

Sources: Czech National Bank, Czech Statistical Office, Labour and Social Affairs Ministry, Ministry of Finance, UniCredit Group CEE Research Network.

Main topics

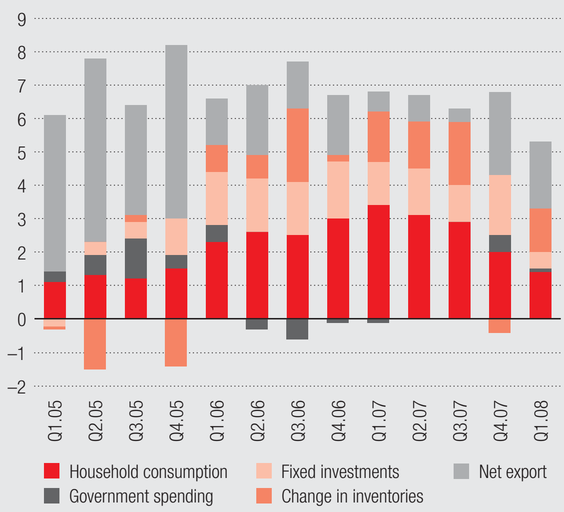
- GDP growth slowed to a 3-year low of 5.2 % yoy in Q1, from 6.6 % yoy in Q4 2007. Private spending was at the heart of this deceleration, with households purchasing power weakened by soaring prices. Given that government spending and fixed investments also lost steam compared to the previous quarter, net exports took over the role of the key growth driver.
- Even though inflation remained elevated and the overall inflationary risks are skewed to the upside, the CNB left interest rates unchanged at its two policy meetings in Q2. The unprecedented appreciation of the Czech crown proved to be the key argument against further monetary tightening. CZK was up a hefty 17 % yoy versus the euro at the end of June, apparently driven by speculative reasons.
- No negative tendencies in this year's state budget developments have been observed so far, with the slight year-on-year deterioration in H1 resulting primarily from one-off capital spending. Importantly, tax collection beat forecasts, leading the Deputy Finance Minister to expect the full-year GFS-based deficit at around CZK 50 bn, well below the planned shortfall of CZK 70.8 bn. For 2009, the government agreed on a further reduction of the deficit to CZK 38.1 bn.

Growth is decelerating, with inflationary pressures still high

Q1 growth hit by weaker consumption

Q1 GDP growth posted the weakest dynamics in more than three years, slowing to an unadjusted rate of 5.2 % yoy, from 6.6 % in the previous year's final quarter. Adjusted for seasonal and calendar impacts, Q1 GDP grew by 5.3 % yoy, 0.1 pct less than shown by the flash estimate from mid-May. A revision for 2005–2007 revealed that GDP growth was cut 0.1 pct to 6.3 % yoy in 2005, and raised by 0.4 pct to 6.8 % yoy and 0.1 pct to 6.6 % in 2006 and 2007, respectively, suggesting that the peak in the economic cycle was already reached in early 2006 and not late last year as outlined previously. As expected, private spending appeared the main reason for the slowdown in Q1, with household purchasing power depressed by the government's fiscal reform efforts and the sharp rise in inflation. Although household expenditures in nominal terms rose at the quickest pace in ten years, their inflation-adjusted growth shrank to the weakest level since Q3 2005. Government spending also suffered a marked pullback from the previous quarter, with the introduction of fees in the healthcare system putting a cap on the sector's expenditures. In addition, growth in fixed investments, affected mainly by a drop in construction investments, surprised on the downside. Nevertheless, the robust stockpiling ensured that total capital expenditures grew even faster than in the previous quarter. The role of economic engine was taken over by foreign demand, which managed to maintain a solid growth rate from Q4 2007, thanks largely to the unprecedented jump in exports of services.

Contribution to adjusted GDP growth (p.p.)



Note: Statistical discrepancies are not considered in the chart.
Source: Statistical Office.

GDP growth to remain on a weakening trend in 2008

We expect the economy to gradually lose steam in the remaining quarters of this year. Whereas capital formation is set to maintain the strong momentum from the previous two years, due to many unfinished investment projects, foreign demand will no longer be able to resist the effects of massive CZK firming and sagging growth in the EU. On the consumption side, slowly declining inflation will not allow households to dramatically increase the real value of their expenditures. Moreover, wage stimulus to private spending is set to ease in the coming quarters, as the Q1 wage rise received an extra boost from a tax-induced shift of bonuses stemming from late 2007. For FY 2008, we now expect GDP growth to reach 4.3 % yoy, with the upward revision from our previous forecast of 4.0 % yoy resulting solely from the faster-than-expected expansion in Q1.

Industrial production set to face a number of challenges

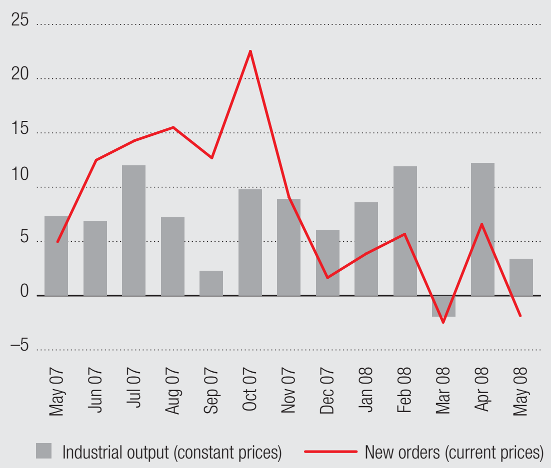
Industrial production growth in the first five months of the year can be characterised as a roller-coaster development. Following a superb start to the year, production slipped 2.1 % yoy in March, the first contraction in five-and-a-half years. While robust growth in April (12.2 % yoy) indicated that the weakness seen in the prior month was primarily caused by one-off factors (high base, Easter, etc.), the soft May reading (3.4 %

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Real GDP, yoy (%)	6.6	–	–	6.4	–	–	6.6	–	–	5.2	–	–	–
Industrial production, yoy (%)	6.9	12.0	7.2	2.3	9.8	8.9	6.0	8.6	11.9	–2.1	12.2	3.4	–
Inflation (CPI), yoy (%)	2.5	2.3	2.4	2.8	4.0	5.0	5.4	7.5	7.5	7.1	6.8	6.8	6.7
Unemployment rate (%)	6.3	6.4	6.4	6.2	5.8	5.6	6.0	6.1	5.9	5.6	5.2	5.0	5.0
Exchange rate/EUR, eop.	28.72	28.04	27.73	27.61	26.97	26.26	26.62	26.07	25.22	25.34	25.21	25.09	23.9
1M Pribor, avg.	2.81	2.90	3.07	3.33	3.35	3.43	3.98	3.70	3.81	3.87	3.89	3.86	3.87
Export, (EUR) yoy (%)	14.7	22.7	17.8	15.8	20.2	17.4	10.5	19.3	24.5	5.8	25.8	12.5	–
Import, (EUR) yoy (%)	14.9	21.1	17.3	12.6	18.2	14.3	9.6	19.3	25.7	9.3	24.2	10.3	–
Trade Balance, EUR mn	285	–54	–16	504	313	437	–89	425	560	307	330	367	–
Current account, EUR mn	–181	–454	–1054	–19	–526	148	–855	297	636	126	–187	–	–

Sources: Czech National Bank, Czech Statistical Office, Labour and Social Affairs Ministry, UniCredit Bank Economic Research.

Industrial output and new orders (yoy growth, in %)



Source: Statistical Office.

yoy) raised concerns that the industry might begin to feel the pinch of a combination of negative shocks. In addition to weaker foreign demand, steeply rising costs of industrial firms pulled by record high oil prices, CZK strength and soaring wage growth seem to have started depressing their output figures. Adding to negative news, jobs growth in May slowed to below 2 % yoy for the first time since late 2006 and May industrial orders lagged behind the level from the same month last year. Furthermore, the key sector driver of past years – production of transport equipment – has seen its output growth losing momentum, with foreign orders for motor vehicles even dropping in the past several months. Going forward, production growth is likely to remain in the black but it will hardly maintain its strong pace from last year. Gradually expiring currency hedges against CZK appreciation concluded by some domestic exporters around mid-2007, along with fading domestic and foreign demand should weigh on the sector's performance in the months ahead. We continue to expect 5 % yoy growth in production this year, down from last year's 9.0 % yoy.

Inflation reluctant to decline with no monetary policy action taken in Q2

The rate of year-on-year inflation continued to drop over Q2, but this process was slower than consensus expectations from the beginning of the year. Not only pressures arose from soaring oil prices, but also a CZK dampening effect on prices is yet to be seen. Fuel costs, housing rents and food prices pulled inflation in the past months, whereas the impact of the January excise tax hike on cigarette prices has not yet been displayed in a substantial way. Looking ahead, we suppose that prices of cigarettes combined with the pass-through of high oil prices into a variety of goods and services might push inflation back to 7 % yoy in the coming months. Additionally, the surprisingly brisk wage growth in Q1 has further underscored the inflation risk. Hence, it now seems highly likely that the decline in inflation towards year-end will be less pronounced than assumed by the CNB. We expect CPI to ease to 5.7 % yoy by December and this year's average inflation to hit 6.8 % yoy, up full a 4 percentage points from last year.

Despite the mounting inflationary pressures, the CNB held interest rates unchanged at its June meeting, with the benchmark 2-week repo remaining at a six-year high of 3.75 %. Similar to the previous two meetings, the vote was 6-1, with board member Hampl being the one who kept advocating a 25-bp hike. The key argument against policy tightening proved to be the rapid CZK appreciation. Governor Tuma said after the meeting that anti-inflation factors are too strong to allow the CNB to raise its rates, although the Board sees the overall risks as slightly pro-inflationary. We do not expect these risks to price stability to ease substantially by early August when the CNB meets again. For this reason, we assume that the most likely outcome is that there will again be no rate change. However, with the ECB having delivered a quarter percentage point hike recently and with fading chances that domestic inflation will quickly drop within the CNB's target, we have shifted the projected timing of the rate hike we are forecasting to the fourth quarter of this year, from Q1 2009. The CNB's current macroeconomic prognosis assumes a sharp drop in yoy CPI by early 2009 and its interest rate trajectory implies an aggressive full-one percentage point cut at a 12M horizon. Nonetheless, most market participants as well as CNB board members do not believe that such a scenario as outlined by the CNB's staff will materialise.

After stabilising at around CZK/EUR 25.0 through May, a new wave of CZK firming started off in early June. This appeared to catch the market by surprise since a vast majority of market participants had bet on a correction that would have brought the crown closer to fundamental developments. Instead, the crown jumped by another 5 % versus the euro during the month, extending its yoy gains against the single currency to 17 %. Apart from a one-off surge to CZK/EUR 23.0 touched in offshore trading in April, the crown hit a new life-time high of CZK/EUR 23.45 at the beginning of July. Accordingly, its deviation from a long-term appreciation trend in real effective terms has further increased to a new record level. Even the CNB's statements that the pace of CZK firming is not in line with labour productivity growth and will hurt economic output did little to knock the currency lower. The exact reason for the latest swing can hardly be identified given that both the domestic political and macroeconomic environment have deteriorated, and the CZK/USD exchange rate, which has tended to be negatively correlated with CZK/EUR in the past months, has retreated from its highs. True, global risk aversion persists, so currencies of a safe haven status continue to benefit. In addition, the crown's strengthening is being put into the context of SKK firming ahead of Slovakia's Eurozone entry, with the intent that CZK will have to face the similar pressure once the Czechs decide on accession. Nevertheless, market analysts almost unanimously agree that at least some temporary cooling is on the cards. Profit-taking, reviving risk appetite on global markets and a weakening domestic economy are mentioned as key arguments. Besides, seasonal outflows of dividends should also help push the crown lower in the coming months. We expect CZK/EUR to consolidate to 25.7 by the year-end, which would still put CZK gains at 3.5 % yoy. Our forecast of CZK/EUR averaging 25.1 in 2008 would even entail a 9.6 % yoy CZK appreciation.

Accumulation of negative shocks to start weighing on trade figures soon

The cumulative January-May trade balance surplus reached CZK 50.5 bn, up marginally from CZK 49.1 bn a year ago, with growth of exports (5.9 % yoy) lagging slightly behind that of imports (6.1 % yoy). The data suggest that the substantial trade balance improvement seen last year is definitely over. On the positive side, however, trade in machinery and cars which is crucial for the evaluation of trends in external demand continued to improve. This indicates that large manufacturing companies have so far been able to face the negative FX developments by making use of hedging operations and by raising output. However, the hedging contracts of many firms expired at mid-year and this together with declining orders from abroad will soon start depressing foreign trade. In addition, the soaring prices of oil and other commodities, which have already been erasing the positive effects from trade in transport and equipment, will also be taking their toll on the trade figures in the months to come. The accumulation of negative shocks forced us to revise sharply downwards our forecast of this year's foreign trade surplus to CZK 65 bn from previous CZK 108 bn.

The current account posted a cumulative CZK 22.4 bn surplus in the first four months of this year, improving markedly from a surplus of CZK 8.3 bn in the same period of 2007. With the trade balance almost flat from last year, the rise in the Jan–Apr surplus was attributable to improvement in the services balance (by CZK 14 bn yoy) and to increased inflows of EU funds, which helped shift current transfers to a CZK 13.5 bn surplus from a 4.6 bn gap a year ago. Higher outflow of dividends, on the other hand, helped inflate the income balance deficit by CZK 18.3 bn yoy. Accelerating profit repatriation, together with the trade balance increasingly suffering from a combination of slowdown in the EU and the appreciation of the CZK, will start to take a toll on the current account in H2. Therefore, we expect this year's C/A deficit to widen to 3.7 % of GDP from 2.5 % last year. The year-to-date financial account saw a net outflow of CZK 36 bn, up by almost CZK 30 bn yoy. Notably, all individual components, including net FDI balance, posted deterioration versus last year. Inflows of FDI in gross terms shrank by CZK 12 bn to CZK 40.4 bn. Importantly for the overall balance of payments, some of the money from EU funds landed also on the capital account, helping boost its year-to-date surplus to CZK 15.9 bn.

State budget doing well, thanks to solid tax collection

The central state budget posted a deficit of CZK 5.65 bn at the end of H1, versus a CZK 1.27 bn surplus a year ago. However, no negative tendencies in state budget developments have been observed so far, with the 12.5 % yoy rise in expenditures resulting primarily from one-off capital spending. January-June revenues were up 11.0 % yoy, bolstered by solid tax collection. Tax and fee revenues rose at a higher-than-expected rate of 8.1 % yoy, mainly driven by corporate taxes, which were up 28.9 % yoy. Admittedly, however, the robust yoy growth in corporate taxes can in part be attributed to their different maturity versus last year when the bulk of these taxes was collected as late as beginning of July. Positively, revenues from social insurance grew by 8.1 % yoy, while social payments from the budget rose by only 1.3 % yoy. Based on satisfactory tax collection in H1, Deputy FinMin Janota estimated that the full-year state budget deficit could be CZK 20 bn lower than the planned gap of CZK 70.8 bn, i.e. even below the latest FinMin forecast from April at CZK 58.3 bn. For 2009, the government approved the deficit to fall to CZK 38.1 bn despite further loosening of the income tax burden. In fact, it decided to cut the payroll social security tax by 1.5 pct to 11 % as of January 2009, instead of lowering the income tax rate for individuals to 12.5 % from 15 % as initially planned. A detailed budget proposal, due in September, as well as the social security tax reduction must still be approved by parliament. Concerning the overall public budgets, FinMin has reiterated its aim to cut the gap from last year's 1.6 % of GDP to 1.5 % this year and keep it flat until 2011 when it should drop further to 1.2 %. However, we are more than sceptical that the cabinet will be able to meet these targets. In addition to fading economic growth, political reasons might also start weighing on the budgets. Lacking a parliamentary majority and facing infighting among the governing parties, the cabinet will find it increasingly difficult to push through further reforms aiming to stabilise the fiscal gap.

Government goes ahead with parametric changes in pension system

The Lower House approved a bill which brings amendments to pensions, such as an increase of the retirement age to 65 years for both men and women by 2030, an increase of the minimum time of paying social insurance and higher penalisation of early retirement. If approved by the Senate, where the government has a comfortable majority, and signed by the President, the bill will be the first step in the cabinet's pension reform plans. Going forward, the government intends to separate pension insurance collection and distribution from the state budget, raise incentives for private savings and most importantly to set up new pension funds making people manage their own savings rather than rely fully on the current "pay-as-you-go" system. However, the future of these plans remains uncertain as the cabinet faces growing resistance from rebellious backbenchers, while efforts to reach a cross-party consensus (including the leftist opposition CSSD and Communists) on the basic pension reform steps have failed. On top of that, the second phase of the healthcare reform, which also includes a plan to turn insurers into for-profit joint stock companies, seems to be in danger as well. Facing pressure from their two junior partners, the right-wing Civic Democrats (ODS) of PM Topolanek have already agreed to soften the previously agreed measures in the healthcare system, allowing the parliament to approve an exemption for babies from paying for doctor visits.

Event	Date	Reading
MPC meeting	Aug 7, Sep 25	MPC decision will show how it balances inflation risks with economic slowdown
Q2 GDP flash	Aug 15	The size of growth should indicate to what extent the economy has been hit by cooling activity in EU, CZK strength and high domestic inflation

Estonia

Outlook

Virtually stalled GDP growth and double-digit inflation have substantially altered the economic climate in Estonia, a country used to double-digit growth rates with moderate inflation in recent years. The contraction in private consumption in early 2008 amidst signs of further cooling, higher lending rates and budget cuts will leave only little room for real GDP growth this year. The sharp adjustments taking place under the surface of the current stagflation environment will, however, provide the preconditions for resurging growth, probably in 2010. Enterprise restructuring and slower price and wage increases will strengthen Estonia's competitiveness. The current account deficit has begun to narrow, which will help to sustain the kroon peg to the euro. Credit growth will resume after some workout period and after the global banking system stress eases. By the turn of the decade, Estonia should return to growth rates above 5 %.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) N.A.
A1/Stable	A/Negative	A/Negative	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	13.2	15.5	16.8	18.5	20.6
Per capita GDP (EUR)	9,840	11,590	12,570	13,880	15,440
Real GDP, yoy (%)	11.2	7.1	0.1	2.7	5.7
Inflation (CPI), yoy, eop. (%)	5.1	9.6	8.0	6.0	4.2
Inflation (CPI), yoy, avg. (%)	4.4	6.6	10.4	6.5	4.9
Unemployment rate LFS (%)	5.9	4.7	5.2	5.4	4.9
Exchange rate EEK/EUR, avg./eop.	15.65	15.65	15.65	15.65	15.65
Interest rate eop. (3m Talibor)	3.85	7.20	5.70	5.10	4.70
Interest rate avg. (3m Talibor)	3.16	4.84	6.45	5.40	4.90
Current account balance/GDP (%)	–15.5	–17.4	–11.3	–12.7	–12.2
FDI/GDP (%)	10.1	11.7	7.1	7.2	7.6
Budget balance/GDP (%)	3.6	2.8	–0.7	0.0	1.5
Public debt/GDP (%)	4.0	2.9	3.2	3.1	2.1
Total external debt/GDP (%)[1]	96.4	110.3	113.7	115.5	118.2

Sources: Ministry of Finance of Estonia, Bank of Estonia, Statistics Estonia, UniCredit Group CEE Research Network.
1) More than one-half is trade credit.

Main topics

- The economic sentiment indicator computed by the Estonian Institute of Economic Research fell to –10.3, the worst reading since 1999. The least optimism was shown by construction enterprises with –26.8, but consumer confidence also dropped to –15.8.
- Real GDP grew a marginal 0.1 % yoy in Q1 2008 as private consumption declined by 0.4 %.
- Consumer prices increased by 11.4 % yoy in June, with food prices rising 18.3 % yoy and housing costs 17.5 %
- Due to the changed economic environment credit quality has deteriorated, although not dramatically. Loans overdue more than 60 days (principal or interest) accounted for 1.4 % of the loan stock as of 31 May, up from 0.4 % in July 2007 when the global liquidity crisis began.
- The current account deficit has begun to narrow substantially. It amounted to EUR 661 mn in Jan–April 2008 compared with EUR 1,043 mn in the same period of 2007.

Testing stagflation

Very weak growth

Real GDP grew a marginal 0.1 % yoy in Q1 2008 as private consumption declined by 0.4 %. Growth in gross fixed capital formation was still up by 5.2 % yoy thanks to companies, but has probably eased further in Q2. They still invested in the re-construction of buildings and in equipment. (At the same time, investments in the acquisition of land decreased by 57 % due to the situation on the real estate market.) Growth in value added decelerated in manufacturing, construction and, particularly strongly, in financial intermediation. Value added decreased in trade, transportation and real estate activities.

Industrial output fell by 0.2 % yoy in Q1 and, judging from the April and May figures, probably more so in Q2. Industries strongly related to the domestic market such as the production of food, furniture and apparel were hit hardest. Retail sales were basically flat in Q1 and probably fell by 1 % in Q2. The weak retail sales contrast with still substantially rising wages. Average monthly gross wages were 19.5 % higher in Q1 than the year before in nominal terms and employment increased by 1.3 % yoy. Obviously slack consumer credit growth and the income distribution – the richer households save – play a role. The recession that started on the real estate market in 2007 has continued in 2008. The number of notarised purchase-sale contracts decreased more than one-third in Q1 compared to Q1 2007. Weak demand and the increase in input prices and labour costs left the (nominal) aggregate profit of enterprises 11.2 % below the levels seen last year in Q1 2008. This will combine with the uncertainty about the future economic development to leave investment weak in the coming quarters.

For 2008 as a whole we now expect only 0.2 % growth in private consumption and 3.3 % growth in fixed investment. With the help of more favourable net exports due to weak imports, real GDP growth will likely remain slightly positive, not higher than 0.1–0.2 %, however.

High inflation

Despite weak domestic demand, inflation remained above 11 % for most of H1 2008 because of hikes in excise duties at the beginning of the year and high global food and fuel prices. Consumer prices grew 11.4 % yoy in June as regulated prices increased by 22.0 % and non-regulated prices by 8.5 %. We expect the base effect to combine with the cooling of the economy and easing global price pressures to slow inflation to 8 % by December. Average annual inflation would be at 10.4 % still in the double digits, however.

A "negative supplementary budget"

The parliament amended the budget law (negative supplementary budget in Estonian parleur) on 19 June. It cut budgeted revenues by EEK 6.1 bn (EUR 0.39 mn) from the original target of EEK 96.3 bn, and expenditures by EEK 3.2 bn (1.2 % of GDP) from EEK 93.6 bn. The decrease was triggered by lower-than-expected collection of taxes, notably social tax and VAT. Current expenditures will be cut by 7 % on average. In addition, about EEK 0.7 bn (of the EEK 3.2 bn) lower allocations to the health insurance fund and the second pillar of the pension system will be made. The negative growth effect will be mitigated by allowing a budget deficit this year.

Slowing credit growth, widening spreads

Loan growth declined to 5.9 % between the end of 2007 and the end of May 2008 from 14.9 % during the same period a year earlier, with corporate loans increasing 5.6 % and retail loans 6.3 %. The increase in corporate deposits was at 0.2 % ytd, almost flat in Dec-May, retail deposits grew by 8.8 %, compared to 11.1 % the year before. Banks' risk aversion has widened interest spreads. Average interest rates for EEK loans increased for companies from 6.57 % p.a. at the end of 2007 to 8.09 % at the end of May, for individuals from 14.79 % p.a. to 19.46 %. At the same time, average interest rates on deposits fell for companies from 6.08 % to 5.64 % and for individuals from 5.01 % to 4.94 %. The 3-month Talibor decreased from 7.30 % to 6.73 % over the same period, and further to 6.67 % in early July, not without some fluctuations however.

Deteriorating credit quality

In line with the changes in the economic environment, the share of overdue loans has increased. Total overdue loans (principal or interest) accounted for 5.8 % of the loan stock as of 31 May, up from 3.2 % in July 2007, with loans overdue more than 60 days increasing from 0.4 % to 1.4 %. Within the latter, overdue company loans increased from 0.1 % to 0.8 %, most significantly among real estate companies, and overdue retail loans from 0.3 % to 0.6 %. These figures are far from being shocking, but prompt banks to extend loans only cautiously.

Sharply narrowing current account deficit

Estonia's current account deficit has begun to improve on declining imports. It narrowed to EUR 661 mn in Jan–April 2008 from EUR 1,043 mn in Jan–April 2007. Imports were 1.9 % lower than the year before in euro terms as exports increased by 8.3 %.

At the same time, FDI proved rather resilient and was at EUR 682 mn, even EUR 40 mn higher than the previous year. However, most of FDI is related to banking, real estate and trade and will weaken given the situation in these sectors. The global liquidity crisis manifested itself mainly by the outflow of EUR 1,079 mn in short-term bank debt. This was however offset by higher long-term inflows (EUR 1,488 mn). The relatively robust long-term capital flows will likely combine with a probably rather flexible reaction of the Estonian economy to re-accelerate economic growth (late) next year.

Event	Date	Reading
Budget 2009	Summer	The governing coalition has to agree on the 2009 budget involving controversial tax issues such as increasing the VAT rate for hotels from 5 to 18 % and a lower income tax rate

Hungary

Outlook

Because of adverse global developments, the recovery will take longer than earlier thought in spite of the fact that the stabilisation program is proceeding apace. There is a good chance that the annual budget deficit for 2008 will decrease to a smaller extent than projected. The Gyurcsány administration, which is governing in minority, will probably seek all means to utilise the surplus for either reducing taxes or buying votes in other ways. Amid such a tense political scene, the issue of next year's budget, which will soon come on the debate agenda, may doom the fate of the ruling government and may bring early elections. In the meantime, the real economy will slowly wriggle out of the slump and will see greater confidence among of foreign investors again. The NBH will likely keep its tightening monetary stance until the end of the year, with the forint trading below 240. No date has been set for euro adoption yet, 2012-2013 is still the most likely timeframe.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 96
A2/Stable	BBB+/Negative	BBB+/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	90.0	101.1	112.7	122.1	129.3
Per capita GDP (EUR)	8,940	10,040	11,210	12,170	12,900
Real GDP, yoy (%)	3.9	1.3	2.7	3.3	4.1
Inflation (CPI), yoy, eop. (%)	6.5	7.4	5.6	3.5	3.1
Inflation (CPI), yoy, avg. (%)	3.9	8.0	6.5	4.0	3.2
Unemployment rate (%)	7.5	7.3	7.7	7.2	7.0
Exchange rate HUF/EUR, eop.	252.3	253.4	238.0	232.0	237.0
Exchange rate HUF/EUR, avg.	264.3	251.3	242.0	238.0	241.0
2-week repo rate, eop.	8.00	7.50	8.50	7.00	6.00
1M Bubor, eop.	8.09	7.51	8.65	7.07	6.08
1M Bubor, avg.	6.80	7.18	8.80	7.60	6.55
Current account balance/GDP (%)	–6.0	-5.0	–4.4	–4.1	–3.8
FDI/GDP (%)	6.0	4.0	3.6	3.8	4.0
Budget balance/GDP (%)	–9.2	–5.5	–3.6	–3.2	–3.0
Public debt/GDP (%)	65.6	66.0	64.0	63.3	61.9
Total external debt/GDP (%)	86.4	97.7	93.7	92.2	89.6

Source: NBH, Statistical Office, Ministry of Finance, UniCredit Group CEE Research Network.

Main topics

- Economic development accelerated to 1.7 % yoy in Q1 partly due to the low base effect. Net export growth, however, contributed 3.7 % to overall GDP growth.
- Prospects for a good agricultural harvest and solid expansion in the manufacturing industry mean that the improvement in net external trade balance is likely to continue.
- There is a widespread debate on how to resolve the problem of structural unemployment and the unfolding low level of activity. The majority of voters oppose social expenditure reforms that may eliminate the notorious budget overspending. The health care reform was rejected by the masses and halted, and has since been reshaped by the ruling socialist party.
- Persistently high inflation, is the main concern as it casts a shadow on the potential private consumption growth.
- The National Bank insists on fighting inflation with interest rate hikes. As a result, the forint strongly appreciated against the euro. The forint is now moving constantly in an exchange rate band well below HUR/EUR 250, where it seems to have stabilised.

Economic growth recovers slowly, with inflation being the main concern

Good external performance drives economic growth...

Compelled to a path of sustainable growth by the convergence programme, the Hungarian economy is showing signs of entering a phase of soft recovery that is, however, endangered by concerns on the international financial and commodities markets. GDP in Q1 2008 expanded by 1.7 % yoy, up from 0.8 % in Q4 2007 and from 1.3 % in 2007 as a whole. Household consumption was still contracting (–1.1 % yoy) especially because social transfers allocated to households – mainly in the form of price subsidies and free services – were down for the fifth consecutive quarter. A reduction of HUF 135 bn in social expenditures is one consequence of the ongoing implementation of the convergence programme. A restrictive budget policy has also influenced both investment activity and public consumption. Investments in the public sector continued to decline (–22 % yoy), though at a slower pace than in Q4 2007, while private investments decreased for the first time since Q4 2006 (–2.7 % yoy), mainly due to the high base effect in some manufacturing industries, especially machinery and rubber. Increasing fixed-capital formation in agriculture (+43 %), hotels and restaurants (+53 %), retail and wholesale trade (+19 %), financial services (+11 %), healthcare (+14 %) and business services (+8 %) were not able to compensate for the investment decline in the manufacturing and public sector.

As orders from the state and municipal authorities represent 20 % of nationwide construction performance, the construction sector has continued to struggle. In Q1 production was down by 19.5 % compared to Q1 2007, and the volume of new orders in April also fell by almost 10 % yoy. Though investments in the manufacturing sectors showed a decline in Q1 2008, industrial production grew by 11.8 % yoy in April. The driver of this performance was still merchandise exports, which expanded by 12.8 %[1] in Q1 in euro terms. Because of weak domestic consumer demand, imports rose by 2.7 % in Q1, more slowly than exports. As a result, the net external trade surplus grew further.

1) According to the external trade statistics, CSO.

....and supports the economic recovery

Still sluggish, consumer demand remains the major obstacle to faster growth. Private consumption is hampered by many factors, among which the shrinking employment base plays a role. The employment rate is low and has even been contracting since August 2007. In March, it was below 50 %, while unemployment is high. Seasonal changes in labour demand will, however, probably push down the unemployment rate in the summer and early fall (to around 7.4 % from the current 7.7 %), but unemployment should climb back to around 7.7 % by the end of the year. Moreover, rising household debt and the amplified debt service that this brings is going to weaken consumer demand as well. By the end of 2007, loans had increased as a share of GDP from 7.91 % in Q1 2002 to 29.1 %. In parallel, interest and principal payments increased from 4.59 % to 13.17 % of disposable income, only 1.31 % lower than the relevant indicator for the US in 2006. On the other side, however, from February on, wages have risen by 1.5–2.5 % faster than the relevant monthly consumer price index and since January, real net wages saw a gain of 8.3 % yoy, with wages rising faster in the public sector than in the private one. This development of course has a positive effect on household consumption. However, wages are expected to keep on rising by as many percentage points faster than the CPI as a combined effect of the developments in employment, net real wages and social transfer decreases, and overall private consumption is expected to grow only by around 0.7 % yoy.

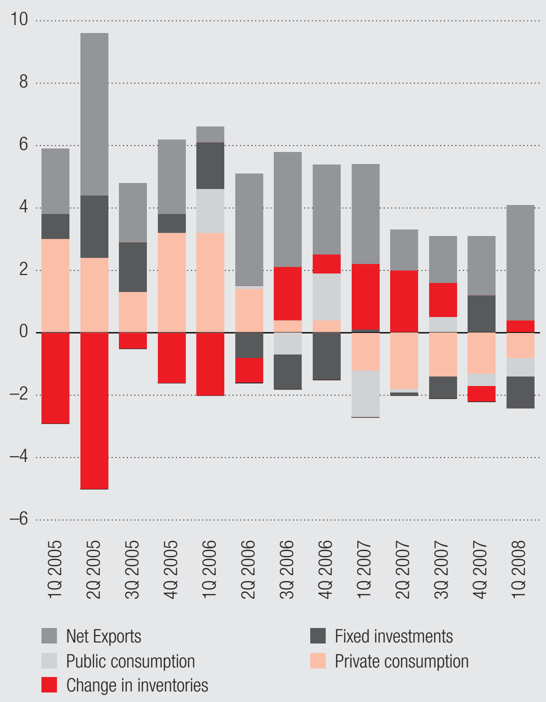
Taking into account high oil and commodities prices, private enterprises may turn out to be less vigorous with their investments than previously thought. However, fading profit margins may inspire large multinational corporations to redirect a larger share of their investments towards CEE countries like Hungary (i.e. Mercedes's decision on a new greenfield plant in Kecskemét). At present, private businesses seem to be carrying on with moderate optimism, and the volume of their expenditures on fixed assets may possibly grow by around 4 % yoy following the 4.5 % expansion in 2007. Both the public and private sectors will

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
GDP real growth, yoy (%)	1.2	–	–	0.9	–	–	0.8	–	–	1.7	–	–	–
Industrial production, yoy (%)	9.0	12.0	9.6	6.5	8.6	5.7	5.3	6.4	13.0	1.9	11.8	2.2	–
Inflation (CPI), yoy (%)	8.6	8.4	8.3	6.4	6.7	7.1	7.4	7.1	6.9	6.7	6.6	7.0	6.7
Unemployment rate (%)	7.0	7.0	7.2	7.2	7.3	7.5	7.7	8.1	8.0	8.0	7.7	7.7	–
Exchange rate HUF/EUR, eop.	245.9	250.7	254.1	250.8	251.1	253.4	253.4	259.5	262.2	259.4	253.4	240.8	237.0
1M Bubor, avg.	7.96	7.74	7.78	7.70	7.50	7.50	7.51	7.50	7.62	7.78	8.05	8.37	8.59
Export, (EUR) yoy (%)	19.3	23.9	19.6	13.0	17.4	8.1	6.4	17.4	18.0	4.2	18.6	6.7	–
Import, (EUR) yoy (%)	14.0	17.2	15.1	7.3	13.5	5.5	7.1	14.1	14.0	2.9	15.3	6.2	–
Trade balance, EUR mn	–150.0	–281.0	–480.8	–245.3	–197.8	–137.2	–307.4	–79.4	157.0	198.9	64.1	47.1	–
Current account, EUR mn[1]	–2,626	–	–	–3,947	–	–	–5,060	–	–	–1,160	–	–	–

Source: NBH, Statistical Office, Ministry of Finance, UniCredit Group CEE Research Network.
1) cumulative.

Contribution of growth components to GDP growth (in %)



Source: CSO

benefit a great deal from the bounty of EU funds that will be provided in the amount of around HUF 500 bn (EUR 2.1 bn) in 2008 and HUF 1000 bn (EUR 4.2 bn) by the end of 2009. All in all, the volume of nationwide investments is expected to grow by around 2.1 % yoy in 2008 following 0.1 % growth one year earlier, and is projected to be good for 0.4 % of annual GDP growth.

In spite of fading global demand, the already good exports growth will certainly improve further over the rest of the year as domestic demand remains weak, and will account for 2.2 % of GDP growth. A strengthening HUF may sow exports somewhat, however. As a result of the combined effects of movements in the detailed individual GDP components, we slightly upped our GDP growth forecasts for the Hungarian economy for the current and next years. The Hungarian economy is now expected to expand by 2.7 % yoy in 2008 (up from 2.4 %). For 2009, GDP should increase by 3.3 % (up from 2.9 %) as personal consumption and fixed capital formation accelerate. Moreover, public consumption should turn to stagnation instead of the current decline. For 2010, GDP growth should further accelerate to 4.1 % yoy (up from 4.0 %).

Budget reform measures need repackaging

The Hungarian stabilisation program seems to have achieved the intended results (basically due to more efficient tax collection and a whitening of the economy), as general government positions in H1 2008 developed in accordance with the preliminary projections. In June, the central government's accounts closed with a deficit of HUF 307.6 bn while extra budgetary funds and social security funds produced a surplus of HUF 8.8 bn and HUF 1.6 bn respectively. The general government's budget deficit excluding municipalities amounted to HUF 722 bn (2.6 % of GDP) in H1, shrinking by 28.1 % yoy. This was a little higher than the recent projections but lower than the earlier ones. Revenue represented 46.8 % of the plan for the year, while expenditures accounted for 48.3 %. This favourable six-month figure is due partly to better tax receipts including VAT, personal income tax and corporate tax, while spending by the central government and other government levels was lower than anticipated as well. As far as the annual projections are concerned, the Ministry of Finance's 2008 target of 4 % will likely also be reached after the better-than-expected 2007 budget deficit (5.5 % of GDP), even though the bulk of EU funding will be disbursed in the second half of the year. Considering the available data for the first six months and the seasonal characteristics of budgetary revenues, our projection of 3.6 % seems feasible as well.

Although the socialist party's minority government is acting resolutely to continue reducing the deficit in line with its commitment to the convergence programme, the uncertainty of the reshaped political environment has become the most critical risk for the long-term budgetary targets and structural reforms. After the 9 March referendum, the socialist party's political support has been entirely undermined, and the reason for the existence of the minority government practically depends on the autumn legislation period and the acceptance of the 2009 budget. There is no doubt that the major radical measures (e.g. renewal of the healthcare and pension system, reorganisation of the education and the public transport companies) have been completely stopped by social resistance, and the government has been forced to revoke its reform plan for the transformation of the medical insurance system as well.

According to experts, the fundamental reform of the tax system is also needed in order to improve international competitiveness, not to mention the cutback in social expenditures. However, two major considerations must be taken into account as they can limit the potential resources and possible surplus revenues in the budget.

The first one is the fragile domestic macroeconomic conditions. As the fiscal tightening package has halted GDP growth and inflation remains high due to the unexpected rise in food and energy prices, the surpluses cannot be used entirely to cut taxes because of the more expensive state debt (a result of the elevated base rate levels and increased government bond yields).

Secondly, as the opposition party Fidesz's support is far stronger than ever, it seems that the minority government is tending to reformulate all the reform steps to make them more palpable. This leads us to presume that the other radical budgetary reforms will also be sacrificed on the altar of excessive spending and regaining political popularity for the 2010 elections.

No room for an early easing of the monetary cycle

While the real economy is slowly crawling out of the recession and the country's internal and external positions are improving, the persistent CPI growth has become the main focus of interest for both the government and the monetary policy makers.

The twelve-month CPI picked up to 7.0 % in May from 6.6 % in April, before dropping back to 6.7 % in June. Inflation-drivers were again the soaring prices of food and oil-dependant goods and services, such as household energy, transportation and catering. Food prices have grown by 14 % yoy. The only hope for some degree of easing in food prices any time soon lies in the agriculture price index that indicated a 2.3 % mom decrease in April, down sharply from the 4.2 % monthly rise in March. Domestic fuel prices have increased by 15.6 % yoy (down by 0.5 % from May) yoy and 2.2 % mom (1.0 % less than in May) and are expected to rise further during the coming months. We now foresee inflation at 6.5 % yoy on average for 2008, and at 5.6 % yoy at year end.

The main problem with the current inflation trend is that it is driven by external factors. This means that any artificial fiscal intervention can serve as an efficient tool to get rid of it. The successive interest rate hikes implemented by the National Bank of Hungary so far this year, which brought the reference rate up to 8.5 % from 7.5 % at the beginning of 2008, can help to curb inflation by strengthening the currency, especially in light of the marginal role that the HUF plays in domestic borrowing. We expect the National Bank to keep a tightening stance this year. The NBH is very unlikely to lower the base rate, unless the HUF strengthens permanently to around 230. In that case we can imagine a base rate of 8.25 %–8.00 % at the end of December. Next year, the NBH is expected to come back to a less restrictive stance as inflation calms down. As far as the exchange rate is concerned, we believe that the forint will float in a range well below 250 against the euro over most of this year, and may end 2008 at around 238. Further appreciation is expected next year, supported by an improvement in the economic environment, while in 2010, uncertainties on the political scene related to the coming elections may push the forint up slightly again.

External financial position improving steadily

The current account showed convincing improvement in the external position. In spite of serious deterioration in terms of trade due to surging oil prices, the external trade surplus of goods and services grew by 94.3 % to EUR 882 mn in Q1. This positive development was impaired by a deterioration in income and current transfers, basically because the heightened cost of debt service accompanied by the extraordinary refinancing requirements following the liquidity crunch this spring burdened the net income on debt. The balance of net inward and outward FDI improved by EUR 152 mn, basically due to higher net inward FDI (+EUR 449 mn), though the decreased volume of net outward FDI also contributed to the better figures by EUR 223 mn. Over the course of 2008, the external trade balance will improve further and the surplus may even creep close to around EUR 4 bn. As the balance of net transfers will grow almost as fast, the current account deficit will decrease just slightly yoy in 2008 and it is likely to sink somewhat below EUR 5 bn. We expect FDI to increase from 3.6 % of GDP in 2008 to 3.8 % in 2009.

Event	Date	Reading
Budget 2009	Q4 2008	It is important to see whether even a minority government is able to go on with the necessary reforms

Latvia

Outlook

The economic outlook has deteriorated quite significantly since the beginning of the year as a result of mounting macroeconomic tensions, tightening credit conditions and an overheated real estate market. Signs that the economy may be heading towards much broader correction have increased following the disappointing performance in Q1 and we anticipate a further cooling in growth, mainly on the back of sagging domestic demand and consumption growth. While this is expected to bring some improvement in the inflationary outlook, it also increases risks that the country may face a period of stagflation. Lowering domestic demand is also expected to bring further improvement in Latvia's external imbalances, with some weakening in FDIs and capital inflows representing an issue to be monitored.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) N. A.
A2/Stable	BBB+/Negative	BBB+/Negative	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	15.9	19.9	23.4	25.9	28.6
Per capita GDP (EUR)	6,928	8,705	10,348	11,472	12,704
Real GDP, yoy (%)	12.2	10.3	2.0	1.6	4.5
Inflation (CPI), yoy, Dec. (%)	6.8	14.1	12.0	7.0	4.5
Inflation (CPI), yoy, avg. (%)	6.5	10.1	15.6	8.8	5.8
Unemployment rate avg. (%)	6.8	6.0	6.2	6.5	6.3
Exchange rate LVL/EUR, eop./avg.	0.703	0.703	0.703	0.703	0.703
Refi rate, eop.	5.00	6.00	5.50	5.00	5.00
Interest rate (3M Rigibor), Dec	4.20	10.75	5.60	5.10	5.05
Interest rate (3M Rigibor), avg.	4.37	8.66	6.35	5.40	5.05
Current account balance/GDP (%)	–22.5	–22.9	–15.5	–13.0	–12.0
FDI/GDP (%)	8.3	8.0	6.2	5.8	5.3
Budget balance/GDP (%)[1 2]	–0.2	–0.04	0.05	0.15	0.50
Public debt/GDP (%)	10.7	9.7	7.8	7.0	6.4
Total external debt/GDP (%)	114.0	134.2	121.8	115.7	112.1

Source: Bank of Latvia, Central Statistical Bureau of Latvia, UniCredit Group CEE Research Network.
Note: 1) Net lending/borrowing under Excessive Deficit Procedure; 2) ESA95.

Main topics

- Real GDP growth eased to a revised 3.3 % yoy in Q1 2008 from 8.1 % in Q4, as lenders start tightening credit, the real estate market continues to falter and the fast growth in prices crimps consumers' buying power. The combination of slower consumer spending and some lowering in capital inflows are likely to bring further cooling in the pace of economic expansion, with GDP forecasted to slow to 2.0 % for the whole year.
- After having been on the rise for 12 consecutive months, CPI inflation dropped marginally to 17.7 % yoy in June from 17.9 % one month earlier, still with pressures coming mainly from rising costs of food, housing, utilities as well as fuel. Although the inflationary outlook has slightly improved, still the risks that the country may be heading toward a period of stagflation have increased.
- Further cooling in the pace of economic expansion is anticipated to bring some significant improvement in Latvian external imbalances, with CA deficit forecasted to slow to around 15.5 % relative to GDP, down from 23 % in 2007.

Risks of stagflation on the rise

A gloomier outlook

The economic outlook has deteriorated quite substantially since the beginning of the year as a result of mounting macroeconomic tensions, tightening credit conditions and an overheated real estate market, and an adjustment towards slower growth has started. In Q1, Latvia's economy expanded by a revised 3.3 %, the slowest pace since 1999, as retail sales and housing prices dropped. Private consumption in the first three months of the year remained pretty weak, although marginally accelerating in comparison with the last quarter of 2007 (up by 2.3 % yoy). Investment activity has also marked some timid recovery, increasing by a real 5.1 % yoy compared to around 2.6 % registered in Q4, influenced by a rise in transport and construction of around 9.6 % and 9 %, respectively. Most of the drop in the pace of economic activity thus resulted from the negative performance of net exports despite a still negative import growth, which suggests that the initial sharp correction in domestic demand has not ended.

Preliminary information on Q2 signals that the economy may slow this year more than previously forecasted. In May, retail sales fell by an annual 5.5 % (unadjusted), representing the biggest decline in more than 6 years, as domestic demand further cooled down. Sales of food products registered the most significant drop due to tightening lending conditions and an eroded consumer purchasing power resulting from skyrocketing prices. The correction in the real estate market goes on with very few signs of stabilization emerging so far.

The bursting of the real estate bubble is affecting the Latvian economy particularly badly, given the less smoother development observed in this segment over the last years compared to the other Baltic states. In Riga, apartment prices fell by around 25 % during the year to June 2008 according to major real estate agencies. The Latvian housing market bubble began to burst in April 2007, largely due to the government's measures to combat inflation and reduce property speculation. Weak economic growth and rising cost of borrowing are pushing the housing market further down.

The combination of slowing consumer spending, lowering capital inflows in connection with tighter lending requirements and some reassessment of risks by large foreign-owned domestic players are likely to bring further cooling in the pace of economic expansion, with GDP forecasted to slow to 2.0 % for the whole year, reaching its bottom towards the end of 2009.

CPI inflation down from the peak

According to the Central Statistical Office, Latvian CPI inflation dropped to 17.7 % yoy in June, down from 17.9 % in May. Inflation had been on the rise for 12 consecutive months, fuelled by rising costs of food, housing, utilities as well as fuel. Although sagging domestic demand and consumption growth are anticipated to foster some improvement in the inflation outlook, still the risk that the country may be heading toward a period of stagflation substantially increased in recent months. Disinflation is expected to regain further strength already from July, gradually slowing down to 12 % towards the end of the year.

After having climbed in the aftermath of sub-primes crisis disruption, tensions in the interbank market have gradually turned to normality, with 3M Rigibor rate remaining quite low in the last four months (in the range of 5.7 to 6.2 per cent) thanks to ample liquidity.

Tightening in fiscal expenditures to keep budget target on track

Lowering domestic demand, rapid wage growth and a cooling real estate market are forcing the government to cut its spending in order to maintain a budget surplus. The Latvian government recently announced it is targeting a surplus of 0.05 % relative to GDP this year to be reached among other things by cutting spending for projects which proved not to promote national development and bring value added. Some amendments to the budget plan for this year might take place during July.

Fast improvement in external imbalances helped by a cooling economy

In April Latvia's CA posted a deficit of 227.1 mn Lats (EUR 0.3 bn), down by almost 18 % yoy on the back of cooling domestic demand resulting from an ongoing tightening in lending conditions. Current account deficit is anticipated to improve faster than expected, to 15.5 % in 2008 and further to 13.0 % in 2009 via strong improvement in the trade balance as import growth remains weak and export is anticipated to perform stronger with producers targeting foreign markets more extensively. On the negative side, FDIs have shown some weakening, going down by 15 % in the first 4M of the year in comparison with the same period of last year to total LVL 0.3bn (EUR 0.5 bn), mainly on the back of lowering equity capital investment, while the inflow of intracompany loans remains robust but is expected to break down considerably in the second half of the year.

Event	Date	Reading
GDP and CA	–	Further cooling in the economy and lowering of external imbalances might help to reduce pressures on the FX market

Lithuania

Outlook

Despite the resilience of the Lithuanian economy in the first quarter of 2008, a slowdown is now imminent, as the Lithuanian economy faces deceleration due to weaker external demand and, even more challenging, an erosion of banks' financing from abroad and capital inflows. The fate of the Lithuanian economy will, however, be rather different from that of the other two Baltic states, at least over the short term. We forecast growth remaining at 4.5–5.0 % in 2008–09. Flagging economic growth will trigger an adjustment in the current account deficit and in inflation, albeit to a lesser extent. Inflation will remain one of the main obstacles, and euro adoption is not yet on the horizon. Parliamentary elections will be held next October, but the political environment is not a major source of risk.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 79
A2/Stable	A–/Negative	A/Negative	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	23.7	28.0	32.7	36.8	40.7
Per capita GDP (EUR)	6,990	8,330	9,730	11,000	12,200
Real GDP, yoy (%)	7.7	8.8	4.7	4.4	5.1
Inflation (CPI), yoy, Dec. (%)	4.5	8.1	9.9	5.9	4.7
Inflation (CPI), yoy, avg. (%)	3.8	5.7	11.3	7.9	5.3
Unemployment rate, LFS (%)	5.6	4.3	5.3	5.8	6.0
Exchange rate LTL/EUR, eop./avg.	3.45	3.45	3.45	3.45	3.45
Interest rate eop. (3m Vilibor)	3.72	7.19	5.00	4.60	4.65
Interest rate avg. (3m Vilibor)	3.11	5.21	5.92	4.80	4.63
Current account balance/GDP (%)	–10.8	–13.7	–11.9	–11.2	–9.8
FDI/GDP (%)	6.1	5.0	4.6	4.5	5.2
Budget balance/GDP (%)	–0.5	–1.2	–0.9	–0.9	–0.7
Public debt/GDP (%)	18.2	17.3	17.5	17.7	17.8

Sources: Ministry of Finance of the Republic of Lithuania, Lietuvos Bankas, Statistics Lithuania, Eurostat, UniCredit Group CEE Research Network.

Main topics

- Growth was quite resilient in Q1 2008, as shown by the final GDP data: the Lithuanian economy grew by 7 % in real terms, considerably better than the other two Baltic states. Unemployment is moving higher from the extremely low levels registered last year.
- Both household consumption and corporate investment accelerated in Q1, with exports and imports also strong. The latest industrial production data were, on the other hand, rather weak (+3.1 % in May).
- Inflation has not stopped accelerating and reached 12.5 % in yoy terms. Interbank rates are again on the rise and are now one point higher than in March.
- In the first four months of the year, the current account deficit was 34 % higher than in the same period of 2007, despite the strong pace of exports. FDI and cross-border financing showed signs of weakness.

Decoupling from the Baltics?

Waiting for slowdown

In Q1 2008, the Lithuanian economy grew by 7 %. Despite representing a significant slowdown compared to the previous two quarters (+8 % in Q4 2007 and 10.8 % in Q3), this figure is certainly a respectable growth rate. Growth drivers for Lithuanian GDP have held up well: the composition of GDP in the first quarter featured an acceleration in both household consumption (+12.2 % from 9.4 %) and corporate investment (+22.4 % from 6.9 %), but was dragged down by the strong pace of imports.

Given the solid performance in Q1, is it possible that will Lithuania be able to "decouple" from the other two Baltic states (and thus avoiding a very significant slowdown)?

On the positive side, country risk has stabilised in recent months, following the peak in February: spreads on 10Y benchmark bonds are now around 100bp. Other signals are positive. Credit growth is still strong, at 35 % yoy (and almost 10 % ytd) and is experiencing only a very mild deceleration, despite the fact that one-fourth of corporate credit is extended to the real estate and construction sectors.

On the negative side, industrial production, which accounts for almost one-fourth of the economy (the highest ratio among the Baltic states), slowed to a mere 3.1 % in May and only energy production looks resilient. Retail sales have also been meagre in recent months. And the real estate market is cooling down tangibly: following average growth of close to 30 % in building permits in the last six years, the slowdown in the first part of 2008 has been very pronounced (–6 % in Q1). Moreover, the share of local currency deposits is dropping in favour of foreign currency, a sign of diminishing confidence in the local currency.

Growth links with the two other Baltic states are rather evident: first, almost 20 % of Lithuanian exports are directed to these markets; second, given the small dimensions of the local economies and their trade openness, the external environment is significantly influencing the growth path of the 3 countries at the same time; third, the three economies have some elements in common, and may be perceived quite uniformly by international investors (i.e. contagion could be a relevant factor), despite exhibiting pertinent structural differences (especially in terms of industrial structure, which is stronger in Lithuania); fourth, the banking sectors of these countries are interlinked due to the major presence of Scandinavian banks.

All in all, given the external and local conditions, we believe Lithuanian growth will be impacted in the next quarters: we forecast 4.7 % GDP growth in 2008, and an even lower rate in 2009, but this is still not the kind of hard landing that we are seeing in Latvia and Estonia. Unemployment, which rose quickly to 5 % in Q1 2008, will remain considerably higher than in 2007.

Inflation surging again

Inflation remains one of the major sources of concern for the Lithuanian economy, in the context of a fixed exchange rate (hence, with clear effects on the country's long-term competitiveness) and aspirations to adopt the single currency as soon as possible.

The CPI increased 0.8 % mom in May, totalling +12.5 % on a yoy basis, the highest level in more than a decade. Food (+18.9 %, with a 26 % weight in the basket) and housing expenses (+17.9 %) were the main drivers. Given the gap with Eurozone inflation, euro adoption in 2010 is no longer within reach. In the meantime, President Adamkus vetoed the law aimed at tying the minimum wage and social benefits to inflation.

Public finances sensitive to slowdown

Both revenues and expenditures grew quickly in Q1 2008 (+24 % and +27 %, respectively). In Q1, the government accumulated a fiscal deficit amounting to 0.2 % of projected GDP for 2008. The plan to balance the budget balance will probably be postponed, according to the authorities. Despite fiscal policy remaining prudent in recent years, we should take into account that Lithuanian public finances are particularly sensitive to the economic cycle, as underlined recently by Moody's, which also cited risks of a rating downgrade.

External adjustment is key

In the first four months of 2008, the current account deficit totalled EUR 1.6 bn, up 34 % on the same period of 2007, despite strong growth in exports. A high current account deficit (13.7 % of GDP in 2007) can only be sustained in symbiosis with capital inflows. And the keen need to finance an elevated current account deficit increases vulnerabilities.

In the first four months, foreign direct investment showed a significant 34 % decrease and covered less than one-fourth of the C/A deficit. Most of this contraction can be attributed to lower funding from international banks to their local daughter banks. The main source of current account financing remains cross border bank lending, which, however, has started to decrease since the beginning of the year: it still financed 41 % of the C/A deficit in the first four months of the year, but fell by 15 % in annual terms. Cross-border lending, representing almost one-fourth of total corporate loans, may experience a slowdown, with clear effects on growth.

We think the current pace of current account expansion (17.7 % of GDP in Q1) is going to halt drastically in the next quarters, with lower imports being the main trigger.

Event	Date	Reading
Q2 GDP	28 July	A slowdown from Q1 is expected (growth between 5 % and 6 % in yoy terms)

Poland

Outlook

The domestic economy continues to experience strong growth, with a 6.1 % increase in GDP in Q1 2008. However, the pace of growth is likely to deteriorate in the coming quarters as a result of the zloty reaching new all-time highs, increasing interest rates and rising inflation, which reduce real purchasing power. Therefore, we stand by our forecast of 5.2 % GDP growth yoy this year and 4.4 % in 2009. The strength of the zloty is becoming a real problem for the domestic economy, and this poses the risk of a more pronounced slowdown in economic growth than anticipated. The current account deficit may also grow more than expected. At the same time, the strong zloty is curbing inflationary pressure, as it acts as a buffer for high commodity prices. Nonetheless, the CPI still remains well above the MPC target range (2.5 % +/–1 p.p.), and in late summer it will likely exceed 5 %. The MPC hiked rates in June. We see a chance for yet another hike of 25 bp in H2 2008.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 73
A2/Stable	A–/Positive	A–/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	272.1	308.7	371.2	391.1	414.1
Per capita GDP (EUR)	7,140	8,100	9,760	10,280	10,880
Real GDP, yoy (%)	6.2	6.6	5.2	4.4	4.7
Inflation (CPI), yoy, Dec. (%)	1.4	4.0	4.2	3.8	2.4
Inflation (CPI), yoy, avg. (%)	1.0	2.5	4.6	4.0	2.9
Unemployment rate (%)	16.2	12.7	10.4	9.0	7.9
Exchange rate PLN/EUR, eop.	3.83	3.58	3.45	3.53	3.50
Exchange rate PLN/EUR, avg.	3.90	3.78	3.44	3.48	3.52
Interest rate (reference), Dec.	4.00	5.00	6.25	5.75	5.25
Interest rate (WIBOR-3M), Dec.	4.20	5.67	6.75	5.90	5.50
Interest rate (WIBOR-3M), ann. avg.	4.21	4.74	6.58	6.15	5.70
Current account balance/GDP (%)	–2.7	–3.7	–4.5	–4.9	–4.4
FDI/GDP (%)	5.5	4.4	3.5	3.6	4.0
Budget balance/GDP (%) (ESA95)[1]	–1.8	–1.8	–2.5	–2.3	–2.3
Public debt/GDP (%) (ESA95)[1]	42.5	45.0	44.0	44.1	43.8
Total external debt/GDP (%)	46.6	48.3	52.0	52.3	52.7

Sources: Central Bank, Central Statistical Office, Bank Pekao Research Division – UniCredit Group CEE Research Network.

1) Pension funds are calculated as part of the public sector up to 2006 and from 2007 related costs are fully included.

Main topics

- GDP growth in Q1 2008 was still at an impressive 6.1% yoy, but we will see a gradual slowdown in the coming quarters, amidst weakening investment activity, less personal consumption and a decrease in external demand.
- Despite significant uncertainty and volatility in global financial markets, the domestic currency continued to strengthen throughout H1 2008 as a whole. PLN/EUR was traded at around 3.60 at the beginning of 2008, and at the end of H1 08 it was around 3.32, in other words, an increase of 8 %. Further appreciation is possible, although it is important to note that the current account is increasing. This poses the risk of a correction, especially later in the year, when the outlook for growth will become less optimistic than it is now.
- Inflation continues to accelerate and is expected to see its peak in August, slightly above 5 % yoy. It should then decelerate towards 4.2 % at the end of 2008. However, the outlook for 2009 is not very optimistic – the CPI is likely to stay at elevated levels due to price increases in the energy sector, as well as continued pressure at the level of net core inflation. We maintain the view that the MPC reference rate is likely to rise to 6.25 %, although risks are clearly skewed to the upside.

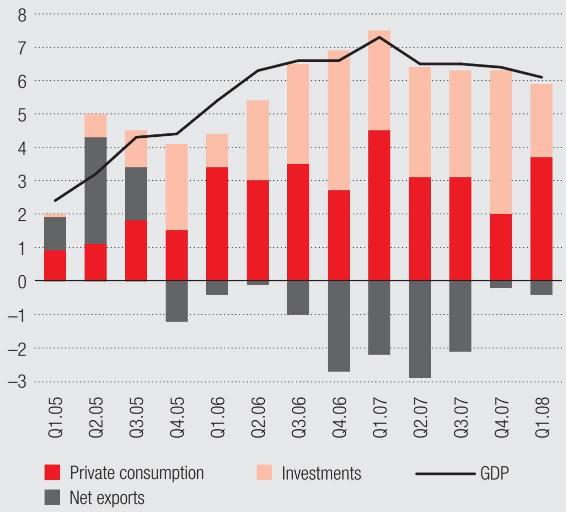
Increasing interest rates, strong zloty and weakening external demand slow the pace of economic growth

Growth dynamics will slow down in the second half of the year

GDP growth in Q1 2008 was still at an impressive 6.1 % yoy, decelerating only slightly in comparison to the previous quarter's 6.4 % yoy, and at 6.3 % yoy, domestic demand slightly exceeded GDP growth. The impact of investment demand on GDP growth was weaker in Q1 2008 (a contribution of 2.2 p.p. vs. 3.0 p.p. in the previous quarter). The same tendency was seen regarding private consumption (a contribution of 3.7 p.p. in Q1 2008 vs. 4.5 p.p. in the previous quarter). The impact of foreign trade on GDP (net exports) remains negative, and in Q1 2008 it was –0.4 p.p. GDP growth is expected to decelerate further in the coming months and to fall below 5 % in the last quarter of 2008. This will slow the pace of GDP growth for the whole year to 5.2 %, vs. the 6.6 % recorded in 2007.

In addition, the financial markets have recently recognised the increasing probability of the Polish economy experiencing weaker growth than previously expected. This has also had a negative impact on the stock market, pushing stock indices to new lows in July 2008. The broad Warsaw Stock Exchange Index (WIG) has already lost more than 40 % since it reached its peak in July 2007.

GDP growth and its key components' contributions (%)



Source: NBP, Bank Pekao – MRO.

GDP growth will decelerate further in 2009

We continue to expect more deceleration in growth in the quarters ahead, as the domestic economy continues to feel the combined impact of higher-than-expected inflation, higher interest rates (pushing up the cost of capital) and the strong zloty (which not only makes exports difficult, but also increases the attractiveness of imports on the domestic market).

Domestic enterprises, in particular, are suffering from this situation, due also to the fact that they are having serious difficulties in hiring new staff (also as a result of substantial labour force emigration). This will feed through into lower investment plans, and will be visible in this year's figures (5.2 % GDP growth). But it will have an even great impact on next year's GDP growth (we are expecting 4.4 % yoy). The year 2010 should see growth pick up again, with stronger production capacity and an increase in demand due to cyclical improvement in the labour market and lower interest rates. The biggest threat to this scenario, however, comes from inflation, which may remain at elevated levels for longer than currently expected.

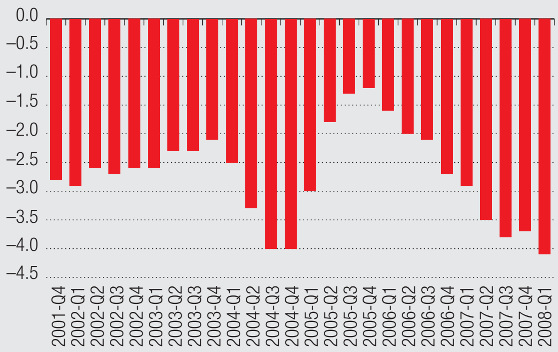
The first signs of an economic slowdown are also visible in employment growth, which was strong in H1 2008, but has recently started to decelerate in the corporate sector. The pace of employment growth will likely fall below 5 % yoy by the end of the year (from almost 6 % yoy at

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Real GDP, yoy (%)	6.5	–	–	6.5	–	–	6.4	–	–	6.1	–	–	–
Industrial production, yoy (%)	5.6	10.4	8.9	5.4	10.8	8.5	6.4	10.7	15.0	1.0	15.1	2.3	–
Inflation (CPI), yoy (%)	2.6	2.3	1.5	2.3	3.0	3.6	4.0	4.0	4.2	4.1	4.0	4.4	4.6
Unemployment rate (%)	12.3	12.1	11.9	11.6	11.3	11.2	11.4	11.7	11.5	11.1	10.5	10.0	–
Exchange Rate/EUR, eop.	3.76	3.79	3.82	3.78	3.63	3.63	3.58	3.63	3.52	3.53	3.46	3.38	3.35
3M Wibor, avg.	4.52	4.78	4.91	5.09	5.13	5.36	5.67	5.64	5.73	6.02	6.29	6.48	6.65
Export, (EUR) yoy (%)	10.7	17.0	14.9	8.2	13.5	13.1	8.7	23.2	30.2	12.0	33.9	12.2	–
Import, (EUR) yoy (%)	20.8	23.3	13.4	13.7	17.7	15.4	15.4	18.7	32.5	13.9	31.8	14.0	–
Trade balance, EUR mn	–1,123	–1,299	–472	–917	–859	–783	–1,645	–535	–840	–1,402	–1,075	–1,240	–
Current account, EUR mn	–1,506	–1,252	–576	–546	–1,183	–67	–2,061	–962	–1,347	–1,738	–1,455	–1,602	–

Sources: Central Bank, Central Statistical Office.

Current account balance (in % of GDP, 12-months cumulative)



Source: NBP, Bank Pekao – MRO.

the beginning of 2008), and only part of this will result from the base effect from the previous year. On the other hand, wage pressures remain strong, with the average wage in the corporate sector expected at around 11 % in 2008 as a whole.

Inflation expected to peak in Q3 2008, but the level of improvement over the coming quarters remains to be seen

The CPI was at 4 % yoy at the beginning of the year, and since then has started to increase. This dynamic was widely anticipated given the increases in regulated and food prices. The CPI is expected to peak in August, at levels slightly above 5 % yoy, and then – supported by a strong statistical base effect – to decline by year-end to 4.2 % yoy in December. For 2009, we have revised our inflation forecasts upwards, taking into account various factors. First of all, regulated prices will continue to increase. Second, the prices of electricity for retail consumers will be freed completely. So far, prices were kept at a relatively low level by the regulator, but, from January 2009 on, regulations will be lifted, and an increase of prices in the order of 20 % to even 50 % is possible. This will have a pronounced effect on CPI figures, but will also diminish a portion of the real purchasing power of households, leaving less funds for consumption, and thus having a negative impact on GDP growth. The National Bank of Poland has also recognised this problem in its most recent inflation projection. The NBP expects energy prices to increase by 9.9 % yoy on average in 2009, and by another 8.4 % yoy in the following year. The NBP also predicts that net core inflation will accelerate, from 2.3 % yoy on average in 2008, to 4.0 % yoy in 2009 and 3.8 % yoy in 2010. Therefore, we now expect the CPI to remain at 4.0 % yoy on average in 2009 (from the previous 2.6 %). Although net core inflation and energy prices are set to accelerate in 2009 in comparison to 2008, and food prices are also likely to increase (besides global considerations, the domestic problem of droughts will play a substantial role), our forecast is still optimistic.

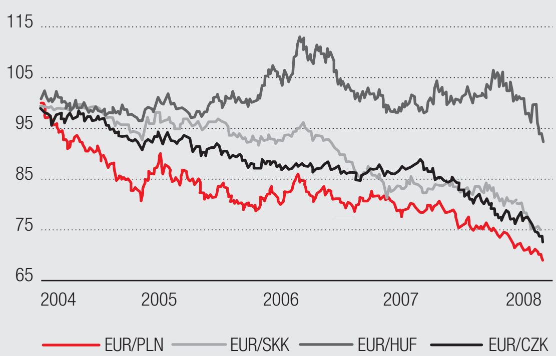
Monetary Policy Council faces tough dilemmas, may continue with hikes

The MPC has already hiked interest rates by 200 bp since the tightening cycle started in 2007, bringing the reference rate to 6.00 % at the end of June. We still expect rates to be lifted to 6.25 % in the third quarter of this year. The probability of such an action increased significantly after the ECB hiked rates at the beginning of July. Nonetheless, the MPC has tough decisions to make. The council realises that most of the increase in CPI is the result of factors that it cannot influence, such as the global rise in food and energy prices, domestic regulated price changes (energy prices, which are set by the national regulator, and municipal service prices, which are regulated by local authorities). Detailed calculations show that only about a third of the increase in the CPI currently results from issues that the MPC can control. Therefore, monetary policy can only influence the second-round effects of the abovementioned price hikes. In addition, the MPC knows that discussing further rate hikes – and their actual implementation – will strengthen the zloty further. The domestic currency has already hit record levels, and may become a serious burden for exports. Finally, the MPC is afraid of increasing the interest rate differential (especially vs. the eurozone) to levels that are too high, in particular because of the effects that this can have on economic growth. On the other hand, inflation pressures still seem likely to last for a while, with a negative impact on wage growth. In order to curb inflation expectations and halt possible second-round effects, the council will continue to increase interest rates in 2008. In 2009, with economic growth slowing down to 4.4 %, the MPC could return to an easy stance. However, considering the worsening scenario in terms of inflation, we now expect the reference rate to decrease by 50 bp – instead of the previous 125 bp – to 5.75 % by Q4 2009.

CA gap continues to widen

The current account deficit widened further in Q1 2008. The deficit amounted to EUR 4.04 bn (vs. a deficit of EUR 3.30 bn in Q4 2007) and accounted for 4.9 % of GDP. It resulted from higher deficits in both income (EUR 2.71 bn in Q1 2008) and trade (EUR 2.77 bn) and a lower surplus in current transfers (EUR 924 mn vs. EUR 1.56 bn on average in 2007). It is worth noting that the growth in both exports and imports remains strong. In Q1 2008, exports increased by 21.3 % yoy, while imports accelerated by 21.1 % yoy. The double-digit export growth rates can still be explained by the increasing role of foreign investors in

CEE-4 Currrencies since entering EU (May '04 = 100)



Source: Central Statistical office, Bank Pekao – MRO.

the Polish export sector, who are relatively less sensitive to increasing wage costs and to the absorption effect caused by soaring domestic demand. Exports accelerated strongly despite the zloty appreciation trend. In the period from January to June, the zloty strengthened by 8 % in relation to the euro (vs. 1.7 % in the same period of 2007) and by 13 % in relation to the US dollar (vs. 3.8 %). On the other hand, the growth of imports is supported by strong retail sales growth (which increased by roughly 20 % yoy on average in Q1 2008) and new car sales (by 29.3 % yoy on average).

The CA figures clearly suggest that both exports and imports have performed well so far. However, in the coming months it will be difficult for both of them to keep annual growth over 20 %. Domestic investment and consumption will continue to drive import growth, which, however, is expected to decelerate, with economic growth slowing down by the end of the year. On the other hand, besides the strong zloty, the slowdown in the eurozone poses the greatest upside risk for exports to decelerate and the CA deficit to widen. Overall, we maintain our stance that the CA gap will widen to 4.5 % of GDP in 2008 and to 4.9 % of GDP in 2009.

Further deterioration in the current account and, in particular, in the trade balance will weaken the zloty in the coming quarters. Therefore, we stand by our previous forecast of the EUR/PLN at 3.45 by the end of 2008, notwithstanding the strong inflows of FDI (in Q1 2008, they amounted to EUR 3.31 bn vs. EUR 3.37 bn on average in 2007), EU funds and remittances from emigrants.

Euro adoption still likely in 2012, but no official declaration yet

When the new cabinet was formed in autumn 2007, there were great hopes that the process of joining ERM II, and then adopting the euro, would be accelerated. This belief was strengthened by statements from both the minister of finance and several MPC members – who emphasised that joining ERM II would be possible by 2009, meaning that Poles would already be paying with euros in 2011. Recently, the rhetoric has changed, and 2009 is no longer mentioned as the year of ERM II adoption. The minister of finance has said that we need to be “well prepared” to enter ERM II, meaning that it would be necessary to lower the budget deficit to 2 % of GDP, which should be possible by 2010. Therefore, 2012 still looks like the most likely date for joining the EMU.

Event	Date	Reading
NBP inflation projection	October 2008	Many MPC members will wait for this document to decide on further medium-term monetary policy
Budget for 2009	November 2008	This will show to what an extent the government is able to pursue its convergence plan.

Romania

Outlook

Despite the deterioration in the international environment and higher cost of risk, the Romanian economy continues to show lively consumption and buoyant investment activity, with particularly strong performance in the construction sector. We expect some deceleration to materialise, but not until the last quarter of this year, arising from the tightening of domestic monetary conditions and the increase in the cost of external funding, which is particularly significant for a country such as Romania, which relies strongly on external savings to finance its growth. The capital market sell-offs and long-lasting currency weakness continue, as uncertainty among investors remains still high. Under these conditions, a tight, well-balanced macro policy mix remains crucial to support a smooth reduction of the current macroeconomic disequilibria.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 138
Baa3/Stable	BBB–/Negative	BBB/Negative	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	97.8	121.4	136.6	158.5	178.7
Per capita GDP (EUR)	4,530	5,640	6,380	7,430	8,430
Real GDP, yoy (%)	7.9	6.0	6.8	5.5	5.0
Inflation (CPI), yoy, eop. (%)	4.9	6.6	6.8	5.0	4.0
Inflation (CPI), yoy, avg. (%)	6.6	4.8	8.2	5.4	4.5
Unemployment rate, avg. (%)	5.4	4.3	4.2	4.2	4.1
Exchange rate RON/EUR, eop.	3.38	3.61	3.58	3.66	3.69
Exchange rate RON/EUR, avg.	3.52	3.33	3.60	3.62	3.67
Policy rate (Dec)[1]	8.75	7.50	10.00	9.00	7.75
1M ROBOR Dec	8.54	8.12	10.42	9.50	8.20
1M ROBOR avg.	8.73	7.85	10.90	9.84	8.85
Current account balance/GDP (%)	–10.4	–14.0	–14.2	–13.5	–12.8
FDI/GDP (%)	8.9	5.9	5.2	4.2	3.6
Consolidated government budget balance/GDP (%)	–1.6	–2.3	–2.5	–2.9	–2.7
Public debt/GDP (%) (ESA 95)	17.4	18.6	17.7	16.7	15.9
Total external debt/GDP (%)[2]	29.2	31.7	32.5	32.6	32.9

Source: Central Bank, Central Statistical Office, UniCredit Tiriac Bank Macroeconomic Research, UniCredit Group CEE Research Network.

Note: 1) CB policy rate is the interest rate applied on 2W (1M till 31 July 2007) commercial bank deposits kept at NBR; 2) Figures exclude short-term external debt.

Main topics

- Romanian GDP expanded at a real rate of 8.2 % yoy in Q1 2008, beating market consensus. Nevertheless, some cooling in the pace of economic expansion is expected in H2 on the back of the delayed impact of tighter monetary conditions and lower purchasing power of households. We still, however, forecast that the large agricultural harvest anticipated for this year will contribute to propping up growth to 6.8 % compared to 6.0 % in 2007.
- Inflation is climbing towards a new three-year peak of 9.5 %, which will likely be reached in July. Although we expect the CB to keep rates on hold at 10 % until the end of the year, other monetary instruments may be used to fight inflation. The base effect will also support some softening in CPI inflation to 6.8 % in the year-end.
- Pressures on the external gap lessened slightly in the first 4 months of 2008, with export growth outperforming import growth. Despite the decline that was seen, the Romanian current account deficit is expected to remain high during the rest of the year, resulting in a full-year gap of 14.2 % of GDP.

Rising economic disequilibria require a tight macro policy mix

2008 election year may bring some surprises

On 1 June, local elections were held for the mayors' seats, and for local and county councils. The results of the ballot showed a neck-and-neck finish for the President Basescu's newly formed Democratic-Liberal Party (DLP) and the left-leaning Social Democratic Party (SDP).

Although DLP was believed to stand the strongest chance of winning the seats, SDP managed to marshal its forces in the last months, despite the corruption scandals that shook the party. DLP received most of votes for the chairmanship of county councils, while SDP ranks first in terms of number of mayors seats and local councils won. More than 30 % of the local councillors will be from SDP, which once again consolidated its hold over much of rural Romania.

In Bucharest, the independent candidate Sorin Oprescu, supported by the leftist SDP won the city hall seat of Bucharest, defeating the Democratic-Liberal Party (DLP) candidate. As regards to the elections for the General Council of the City of Bucharest, the partial results showed that DLP obtained 36 % of the votes cast, SDP 25 % and NLP 13 %.

In terms of overall votes, DLP is slightly ahead compared to its opponent SDP, receiving more than 28 % of votes for the county council and 34 % for the city hall, while SDP gained 27 % of votes for the county councils and around 30 % for the mayors. In third position is the minority ruling party NLP, with 19 % of the votes.

Looking ahead to the parliamentary elections to be held in November, alliances among the political parties might be necessary to form a majority government. SDP was the first party to announce that it had completed a protocol with the Conservative Party (CP). After the dissolution of the D.A Alliance in April last year, the minority party NLP is looking for a new partner and seems more inclined to seek cooperation with the leftist SDP. Its former partner Democratic Party, which meanwhile merged with the Liberal Democratic Party, to form the Democratic Liberal Party (DLP), announced before the elections its intentions to stand alone, but a possible change in attitude cannot be ruled out, as SDP has gained popularity, threatening the position of DLP.

Q1 GDP growth surprised the market on the upside

Real GDP growth accelerated to 8.2 % yoy in Q1, up from 6.6 % in Q4 2007 on the back of lively consumption and booming investments. Beyond the strong growth, however, the soundness of its structure remains questionable, with private consumption representing 85 % of total GDP.

Private consumption accelerated to a record high, up 14.3 % yoy, thus reinforcing concerns about risks of possible economic overheating, which could also generate persistently high inflationary pressures. The fast pace of household consumption continued to be fuelled by strong wage growth (+23 % yoy average growth in Q1) and increases in household loans (+84 % yoy at the end of Q1). Growth was also backed by the record high rise in investment (+33.2 % yoy), mainly oriented towards the new construction (+33.1 % yoy) but also accompanied by strong investment in equipment which accelerated to 35.4 % yoy in Q1. Moreover, the structure of investment among the main sectors of the economy remains well-balanced. Most of the funds were allocated to industry (38.7 %) and trade sectors (23.5 %), which together account for 62 % of total investment. Agriculture also benefited from the buoyant investment activity, accounting for 9.4 % of the total. Despite the better export performance in Q1 (25 % yoy real growth), net exports deteriorated on the back of record increase in imports (up by 35 % yoy).

Large agricultural harvest to support growth, despite weaker external conditions

Romania's accession to the EU, the pro-cyclical fiscal policy spending and credit-driven excess demand are increasingly contributing to the emergence of some capacity constraints.

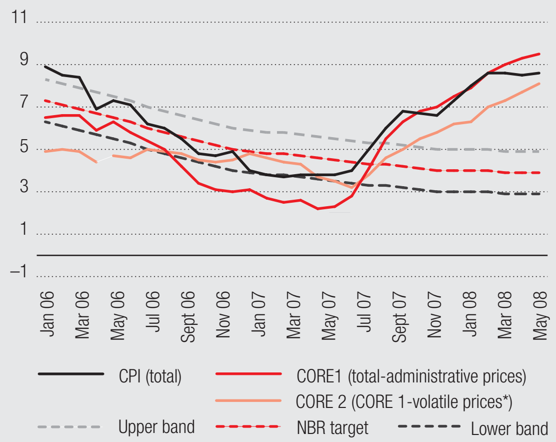
Investment activity is anticipated to continue to expand at very high pace, with some slowing compared to the rate observed in Q1 due to

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Real GDP, yoy (%)[1]	5.9	–	–	5.8	–	–	6.0	–	–	8.2	–	–	–
Industrial production, yoy (%)	5.4	6.3	4.3	6.1	3.6	3.9	–0.1	5.6	4.4	5.7	11.0	–	–
Inflation (CPI), yoy (%)	3.80	3.99	4.96	6.03	6.84	6.67	6.57	7.26	7.97	8.63	8.62	8.46	8.61
Unemployment rate (%)	4.0	3.8	3.9	3.9	4.1	4.2	4.1	4.3	4.3	4.2	3.9	–	–
Exchange rate/EUR, eop.	3.13	3.16	3.27	3.36	3.34	3.50	3.61	3.70	3.73	3.73	3.68	3.62	3.65
1M interbank rate, avg. (%)	7.79	7.25	6.99	7.18	7.65	7.97	8.12	8.61	10.24	10.55	12.04	11.05	11.47
Export (FOB), yoy (%)	9.8	18.8	8.7	12.7	24.9	12.2	15.6	19.8	22.2	2.9	24.3	19.4	–
Import (CIF), yoy (%)	23.4	28.7	20.4	23.7	29.5	23.2	7.9	13.0	16.7	10.7	25.7	8.2	–
Trade Balance, EUR mn	–1,792	–1,803	–1,809	–1,696	–2,208	–2,255	–2,119	–1,414	–1,511	–1,992	–2,092	–1,750	–
Current account, EUR mn[1,2]	–7,357	–8,713	–9,889	–11,192	–12,974	–14,976	–16,950	–1,162	–2,268	–3,557	–4,842	–	–

Sources: Central Bank, Central Statistical Office; Note: 1) Cumulated to end of the period; 2) Reinvested profit included.

CPI inflation and its main contributors (% yoy)



Source: Central Statistical Office, Central Bank.

the higher base effect. Some cooling in construction activity is also expected mainly on the back of the higher cost of funding and slackening foreign demand. The real estate market, especially in the capital, is already showing some signs of stagnation with house price appreciation in some sub-segments even slipping into negative territory since the beginning of the year. Still, despite the fact that some cooling in the real estate boom might be on the cards (especially in Bucharest), the qualitative and quantitative gap in supply and high potential demand is expected to sustain the development of the market in the mid-term. Indeed, a new record-setting transaction occurred at the end of May, boosting market sentiment (a project valued at EUR 340 mn involving the construction of new residential and office units in the northern part of Bucharest was purchased by Deutsche Bank from a local developer). Moreover, a new combined residential, office and commercial real estate project amounting to EUR 1.5 bn has been announced in Brasov, using the location of the former tractor manufacturing plant.

The negative contribution of net exports is projected to weaken considerably, driven by some deceleration in domestic demand for imported food products backed by the expected better agricultural output on the one hand, and improved export capacity on the other hand.

The very good performance of the economy in Q1 together with preliminary indications that growth remained strong in Q2 and the large agricultural harvest expected for this year, support our upward revision of our full-year growth forecast to 6.8 %. Moreover, huge infrastructure projects are expected to be launched starting this year, providing sound sustainability for the construction market and related industries such other non-metallic mineral products and wood products. Along with the planned 600 km in new highways, 180 km railways are also planned to be renovated and 450 km of inland shipping channels to be opened for navigation by 2015, according to the Operational Programme of the Transportation Ministry. The Bucharest-Danube navigable channel project (around EUR 450 mn) is expected to be initiated this year with plans for its completion within three years. Moreover, new airports, harbours and railways stations are slated for renovation.

Strabag, one of the largest investors on the Romanian construction market estimates that business will grow considerably in Romania in the coming years and has already announced its investment plan of around EUR 300 mn.

Inflationary expectations on the rise

Main drivers of CPI increases continue to be the prolonged effect of the supply side shock on food prices, the fuel price hike on the international markets and RON depreciation channelled directly through service prices such as telecommunication.

Inflationary pressures have been further aggravated by increases in administrative prices, which are expected to push the inflation rate towards a new peak of 9.5 % in July. On 1 July, gas prices were adjusted upward by 12.5 %, while the electricity price rose 5.3 %. Moreover, gas distribution companies have already announced their intentions to apply to the energy regulator ANRE for further hikes in natural gas price later on this year.

Excises duties on tobacco were increased by 20 %, but due to the smaller share held by tobacco and cigarettes in the consumer basket, it will result in slightly lower impact on the CPI.

More importantly, new demand-side inflationary pressures with the risk of dangerous wage-prices spiral are already materialising. Although already promised to the trade unions at the beginning of the year, the danger of a new hike of the minimum statutory wage by 10 % to RON 550 (EUR 150) became visible under the current circumstances, even for the government.

The recent developments in CORE2 inflation (excluding administrative and volatile prices), which climbed to 7.7 % yoy in May, provide an indication of some persistence of excess demand.

The fight against inflation became harder due to pressures from various sources. The disinflation process seems to be losing momentum, and we anticipate a less marked slowdown going forward, with inflation to reach a level of 6.8 % by year-end. As a result, we also see lower chances for the central bank to meet its target of 3.5 % next year, with CPI inflation expected to decelerate to 4 % only by 2010.

Monetary policy instruments face new challenges

In line with our expectations, on 26 June, the Romanian Central Bank decided to raise the key policy rate for the sixth time since last November to 10 % from 9.75 %, in order to anchor inflation expectations threatened by the strong growth in consumption and mounting risks of economic overheating. Although we expect the CB to keep on hold rates until the end of the year, further tightening in monetary conditions cannot be ruled out, as the CB stated that it is ready to use the entire array of instruments to counter the stubbornly high inflationary pressures.

Upside risk of looser fiscal performance

The general government budget reached a surplus of 0.2 % of GDP in the first 4M of 2008. The 2008 budget targets a public deficit of 2.3 % of GDP, after the target was lowered in March from the initial 2.7 % of

GDP, to avoid exceeding the Maastricht requirement of a 3 % fiscal deficit in the ESA methodology.

Budget revenues grew sharply by 48 % in the Jan-Apr period, amounting to 12.7 % of GDP. VAT collections made the strongest contribution to the surge in revenues (+81 % yoy in the first 4M of 2008), due to the base effect from lower collections at the beginning of last year, which will vanish in the coming months. At the same time, the expenditures surged by 51 % yoy to 12.4 % of GDP in the first 4M of 2008, maintaining the rapid pace of growth seen in recent months.

July will bring the second budget revision of this year. Although no major modification in the deficit target is expected, the first biannual budget might be launched with the purpose of improving fiscal stability, following the advice of the European Union to implement a medium-term fiscal framework.

While the Ministry of Finance announced its proposal to the government to keep the Fiscal Code unchanged in 2009, the leftist SDP criticised the flat tax rate policy for its undesired social effects. Moreover, SDP wants a new hike of the minimum wage to cover the effects of the soaring prices, a measure supported by DLP as well. As the parliamentary elections are knocking at the door, the question is how long the government will resist to these pressures.

Under these circumstances and given the poor budget planning seen so far, we project a fiscal deficit of 2.5 % of GDP for 2008 and 2.9 % for 2009 by local standards, with some slightly improved outlook compared to our previous forecast.

There is an urgent need for Ministry of Economy and Finance to be more active on the government securities market, which could help to increase the liquidity of the interbank market, offering the necessary investment alternative for the private pension funds.

Following the issue of around RON 9.5 bn in government bonds and treasury notes last year, an announcement at the beginning of this year laid out a plan for an additional RON 11 bn in issuance of government securities in the local market, of which around RON 5 bn has been already sold in the first part of the year. After being absent on the international capital market since 2003, in June Romania launched a 10Y Eurobond, worth EUR 0.75 bn, which was used mainly to refinance the EUR 0.6 bn Eurobond with maturity in June 2008.

External deficit to remain relatively stable, although pressures are fairly high

In the first 4M of 2008, the Romanian C/A deficit widened by 7.5 % yoy to reach EUR 4.8 bn, slowing down from the 11 % yoy registered in Q1 and well below the 66 % yoy increase observed last year. Despite the observed slowdown in the dynamics of external imbalance, the foreign trade gap (FOB/FOB) continued to expand, surging by 14 % yoy since the end of last year.

FDI coverage of the gap has significantly improved, up to the level of 66.5 % from 40 % registered at the end of 2007. FDI reached a record level of EUR 3.2 bn, also including the EUR 0.8 bn payment of ENEL for the takeover of the majority stake and capital increase of the electricity distributor Electrica Muntenia Sud. We believe that Romania will remain an appealing destination, with FDI expected to stabilize around EUR 6.7 bn over the next three years.

The deterioration in the current account deficit is expected to slow significantly compared to last year. Still, Romania remains vulnerable to additional adverse spillover effects resulting from a deteriorated international environment, given the heightened risks of an abrupt slowdown in capital inflows and an upsurge in the cost of refinancing of external debt, aggravated by steeper exchange rate volatility.

Still low absorption of EU funds

According to 2007 Financial Report of The European Commission which appeared in June, Romania used EUR 1.6 bn in EU funds, accounting for 1.32 % of GDP, of which EUR 1.1 bn represented the pre-accession funds and compensation funds. Romania managed to use only EUR 0.4 bn of total EUR 1.28 bn earmarked for 2007 from the structural and cohesion funds and only EUR 24 mn were used from the funds allocated for agriculture, rural development and fisheries in 2007. The Romanian contribution to the European Union Budget was EUR 1.09 bn (0.9 % of GDP). If we take into consideration only the funds earmarked for 2007, excluding the pre-accession fund, Romania was a net contributor to the European Union budget.

Only two months after the European Union approved the National Rural Development Program in February, the local authorities received 1,853 projects worth over EUR 1.1 bn for the total amount of EUR 1.02 bn allocated for agriculture and rural development in 2008. Although the submission deadline is in October, around 340 projects have been already selected with an estimated value of around EUR 170 mn, giving some hope that a higher percentage of the funds allocated for 2008 will be absorbed this year. Most of the projects were submitted for farm modernisation, followed by the investments in the renovation and development of villages and increasing the value added of the farming products.

Event	Date	Reading
Parliamentary election	Nov. 2008	Elections will be held for the first time in an uninominal system
CB Board Meeting	31 July 2008, 25 Sept 2008 30 Oct 2008	CB announced to be ready to use all array of instruments in fight against inflation. We expect policy rate to be kept on hold till the end of the year

Slovakia

Outlook

Euro adoption in 2009 is a done deal. The euro conversion rate was set at an appropriately strong level, corresponding to mid-2009 real equilibrium. This front loading in the exchange rate should decrease inflationary pressures in the future. Despite first minor signals of future worsening of the strong and sound growth picture, a clear deceleration in domestic demand is not expected to occur before 2009. Hand in hand with gradually mounting labour cost pressures, the situation in the labour market still remains satisfactory. The lack of qualified labour force is partly solved by importing workers from abroad. Inflation has sped up, in line with expectations, and is forecast to peak at 5 % over the short run. In 2009, inflation between 4 % and 5 % seems to be the most probable scenario. The monetary stance is expected to follow the ECB's rate decisions from now on.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 40
A1/Stable	A/Positive	A+/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	44.6	54.8	66.1	75.0	81.4
Per capita GDP (EUR)	8,260	10,160	12,250	13,900	15,080
Real GDP, yoy (%)	8.5	10.4	7.7	6.0	5.7
Inflation (CPI), yoy, eop. (%)	4.2	3.4	4.3	4.4	3.5
Inflation (CPI), yoy, avg. (%)	4.5	2.8	4.4	4.5	3.7
Unemployment rate (avg.) (%)	10.4	8.4	7.4	7.0	6.8
Exchange rate SKK/EUR, eop.	34.57	33.60	30.13	EUR	EUR
Exchange rate SKK/EUR, avg.	37.25	33.78	31.24	EUR	EUR
2-week repo rate (Dec)	4.75	4.25	4.25	ECB	ECB
1M Interest rate (Dec BRIBOR – mid)	4.71	4.09	4.31	ECB	ECB
1M Interest rate (avg. BRIBOR – mid)	3.99	4.14	4.14	ECB	ECB
Current account balance/GDP (%)	–7.0	–5.3	–4.6	–4.0	–3.6
FDI/GDP (%)	7.5	3.8	3.8	3.7	3.3
Budget balance/GDP (%)	–3.6	–2.2	–2.0	–1.7	–0.8
Public debt/GDP (%)	30.4	29.4	29.2	28.5	27.1
Total external debt/GDP (%)	50.9	54.7	50.9	49.8	49.2

Source: National bank of Slovakia, Statistical Office of SR, National Labour Office, UniCredit Bank Market Research & Strategy.

Main topics

- Euro adoption in Slovakia in 2009 was officially confirmed, and the conversion rate was set at SKK/EUR 30.1260 – a rate we consider appropriate for the economy
- GDP growth in Q1 was again above expectations – with the first minor signals of future overheating
- Labour market is still sound – with slowly growing cost pressures (partially due to one-off issues), and unemployment continued to fall to historical lows
- Inflation accelerated further, still stoked mainly by food and oil prices, similarly to other EU countries. However, no signs of increasing demand pressures were detected
- After retail sales accelerated significantly in the first 3 months of the year, the second quarter was marked by a significant easing of pressures, thus sending a neutral signal to monetary policy
- The NBS is expected to fully follow the ECB decisions in H2 – a stance slightly too relaxed for the economy considering the practically fixed exchange rate
- The fiscal position keeps improving on the back of brisk economic growth and controlled expenditures

Strong growth with the euro a done deal

GDP growth surprisingly driven by domestic demand

GDP grew 8.7 % yoy in constant prices in Q1, slowing from the record growth of 14.3 % yoy in Q4 2007, but exceeding our original expectations of 7.5 % yoy. Despite this deceleration, Slovakia still recorded the strongest growth among all EU countries again.

Surprisingly, GDP growth was clearly driven by domestic demand, while net exports recorded stagnation in year-on-year terms. The structure of GDP growth was thus less favourable compared to recent quarters and clearly sent a restrictive signal for monetary policy.

Domestic demand was driven mainly by household consumption (accelerating to 8.4 % yoy), while government consumption as well as investments slowed in Q1. Household consumption was stimulated both by rising employment and accelerating real wages. Thus, the increasing purchasing power of households was especially reflected in the dynamic rise in the consumption of durable goods. Although on the basis of previously published information (especially retail sales), we were expecting a stronger contribution of domestic demand to GDP growth, growth driven almost exclusively by domestic demand was a surprise for us.

On the supply side, GDP growth was once again mainly fuelled by manufacturing (especially by increasing production capacities in the automotive industry).

2008–2010 – soft deceleration

Taking into account the stronger-than-expected Q1 figures, we decided to increase our 2008 GDP forecast from 6.9 % yoy to 7.7 % yoy. Compared to the original expectations, the contribution of domestic demand to growth should increase, mainly backed by increasing household consumption driven by vigorous wage growth. On the supply side, automotive and electrical equipment remain as the main driving sectors, still enjoying the support of gradually increasing production capacities.

We do not change the outlook for 2009–2010, forecasting GDP growth of 6.0 % in 2009 and 5.7 % in 2010. The economy should still benefit from past investments and ongoing projects, mainly in automotive and electrical equipment industries, which may also stimulate services over the mid-term horizon. GDP growth thus should be driven mainly by domestic demand in both years, stimulated by elections in 2010 as well as expected dynamic wage growth. However, despite increasing pressure on the consumption of imports, the positive contribution of net exports to GDP growth should persist, backed by expanding production in export-oriented sectors.

Industrial production sustains high performance

Industrial production has shown relatively strong performance, recording annual growth of 7.9 % on average in the first four months of the year. Furthermore, the average figures were negatively influenced by a short-term slowdown in March, due to the Easter effect. Production growth was followed by even higher industrial sales (14.9 % yoy in the same period).

Industrial production is still driven mainly by dynamic yearly growth of manufacturing, but positive growth has also been recorded in mining and quarrying (surprisingly in both the segments of energy materials and construction materials) and electricity, gas and water supply.

Manufacturing growth is still driven mainly by transport equipment, recording 23 % yoy average growth in the first five months of the year. Automotive industry-related sectors, such as machinery (which, however, benefit also from growth of non-automotive parts) and rubber and plastic production, recorded above-average growth as well. Electrical equipment, on the other hand, grew by only 1.2 %, still waiting for a boom in consumer goods production, backed by the announced increase of production capacities the both the Samsung and Sony plants, as well as by opening of a new LCD module plant by Samsung.

On the other side, the strong koruna and increasing wage pressure are leading to a lack of international competitiveness in the leather industry, (which posted a 22.3 % yoy decline in production at the beginning of the year) and partially in the chemical industry. Even if the leather industry was able to fight with cheap Asian competition for a longer period, the destiny of the sector will be most likely similar to that of the textile sector – increasing specialisation and sophistication of production, followed by a significant decline in production.

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Real GDP, yoy (%)	9.3	–	–	9.4	–	–	14.3	–	–	8.7	–	–	–
Industrial production, yoy (%)	11.1	17.1	4.8	11.9	12.6	13.2	6.5	8.7	11.8	1.9	9.8	4.0	–
Inflation (CPI), yoy (%)	2.5	2.3	2.3	2.8	3.3	3.1	3.4	3.8	4.0	4.2	4.3	4.6	–
Unemployment rate (%)	8.3	8.3	8.2	8.3	7.9	7.8	8.0	8.1	7.8	7.6	7.4	7.4	–
Exchange rate/EUR, eop.	33.83	33.54	33.74	33.87	33.36	33.38	33.60	33.67	32.80	32.61	32.24	30.24	30.31
1M BRIBOR mid, avg. (%)	4.12	4.14	4.14	4.16	4.14	4.14	4.09	4.13	4.08	4.07	4.09	4.12	4.12
Export (FOB), yoy (%)	21.0	31.4	15.2	19.6	23.6	24.7	14.9	18.6	28.8	10.1	25.3	–	–
Import (FOB), yoy (%)	22.0	31.3	17.2	8.5	18.8	20.0	14.4	21.8	24.9	10.2	31.5	–	–
Trade Balance, EUR mn	–134	–47	–173	108	22	–139	–347	133	105	–51	–178	–	–
Current account, EUR mn	–576	–555	–140	–108	–439	–423	–308	–33	127	–296	–320	–	–

Source: National Bank of Slovakia (NBS), Statistical Office of SR, National Labour Office, UniCredit Bank Market Research & Strategy.

We expect industrial production to sustain its relatively high dynamics in terms of yoy growth for the rest of 2008 as well, despite an expected modest deceleration. Even despite the currently weaker results, we expect the electrical industry to accelerate again during the year and gradually assume the leading position (in terms of growth) after the automotive industry.

Construction booming again
Construction production is booming again, reaching an average annual growth rate of 13.0 % in the first fourth months of the year. It is driven by both new construction and repairs, mainly in segment of "big construction" (bigger real estate projects). We expect the construction boom to continue in H2 backed by new real estate projects as well as the expected recovery of investment activity in the economy, but also supported by the lower base from last year. Construction production should thus sustain double-digit annual growth for most of 2008. In the following years, the growth of the construction industry could also be significantly supported by infrastructure development supported by PPP projects. However, as some postponement in the preparation for introduction of PPP projects has already been announced, they will most likely take place only in H2 2009 and later.

Sound development on labour market so far
Economic growth is still able to generate new jobs. Employment growth, in the ESA 95 methodology (domestic concept), accelerated to 2.8 % yoy (by 59,900 annually) in Q1, the highest growth since 1995 (the start of the consistent time series). In the domestic economy there were thus 2.2 mn employees. The strong domestic demand for labour was the main driver also for still relatively strong growth of employment in the national concept (reaching 2.8 % yoy as well). The outflow of labour force to abroad has definitely stopped, recording a yearly increase of 0.7 % (1,200 people). Nevertheless, 176,700 people (7.4 % of all the employed ones) are still working abroad. We expect the number of employees working abroad to gradually decline in the coming years mainly as a consequence of expected lack of labour force in some regions of Slovakia and in some professions consequently followed also by increasing wage pressure.

Unemployment continues to decline
Growing employment has resulted in a significant decline in unemployment. However, as expected, the annual decline of unemployment has slowed-down. The unemployment based on Labour office statistics declined to 7.44 % in May, and was 0.89 pp. lower than in the same period of the previous year, while it reached a new historical low of 7.38 % in April. We expect the unemployment rate to continue to decrease to 6.8 % in 2010. This level could be close to the natural level of unemployment, which could be (by our estimate) about 5–6 % in Slovakia. As the growing economy should need new qualified labour force, Slovakia could face labour market problems over the mid-term horizon, potentially leading to higher wage growth pressures.

Wages speeded up driven by one-off effect in public administration
The average monthly gross wage reached SKK 20,443 (EUR 618) in Q1, recording annual growth of 10.4 % – the highest nominal growth since Q4 2004. This means that real wage growth accelerated to 6.2 % yoy and thus exceeded real labour productivity growth of 5.8 % yoy – for the first time in the last 10 quarters. Nevertheless, we do not judge this wage growth as unhealthy. We think, there is still a cushion for future wage growth, as labour productivity has exceeded wage growth for several quarters in a row. Furthermore, Q1 wage growth was also influenced by higher growth in public administration due to movement of wage indexation from July to January. Beside public administration, real estate, business services and mining recorded the quickest wage growth. On the other hand, hotels and restaurants were the only sector to face annual declines in real wages.

We change our outlook for 2008 real wage growth to 5.3 % yoy (from previous 4.8 %) – backed by higher wage growth in public administration in H1. Even despite persisting inflation pressure, we see room for further acceleration of wage growth in Slovakia, mainly in the western part of country and in the quickest growing sectors such as automotive and electrical equipment, where a lack of qualified labour force is expected.

Retail sales return to normal trend
After record growth at the beginning of the year (driven mainly by durable consumer goods), retail sales slowed down in April–May (although increasing by 11.3 % yoy in the first 5 months of 2008). As a consequence, a clearly hawkish signal for monetary policy from the beginning of the year looks now to be more relaxed. The slower growth in retail sales could indicate in fact a relaxation of household consumption, with GDP growth turning out to be more balanced again (between domestic and external demand) in the coming quarters.

Inflation continues to accelerate …
Inflation (CPI – national methodology) continued accelerating and reached 4.6 % yoy as of May. Inflation was stoked mainly by prices of food, fuel and healthcare – hence mainly by external factors, while demand pulled inflation (measured by prices of market services excluding imputed rentals – UniCredit Bank estimate) sped up only slightly to 3.3 % yoy in May – still far behind average price growth. Inflation is thus so far sending mainly neutral signals for monetary policy.

Slovakia safely fulfilled the Maastricht inflation criterion also after the evaluation period (ended as of April 2008) and still keeping a gap of about 1 p.p. Despite the current acceleration, Slovakia is still able to keep its inflation under control reaching EU average in the harmonised methodology over the medium to long term and is recording the lowest inflation among CEE countries. Despite that, over the short run, we expect Slovakia to feel some increased inflationary pressure. Therefore, soon after euro adoption inflation will exceed the Maastricht level, although not as dramatically as in Slovenia, for instance.

… and is expected to accelerate further due to rising oil prices
Two opposing effects should influence inflation in the coming months. Record high oil prices on global markets should fuel growth of prices in transportation and, most likely, lead also to adjustments in regulated prices of heat and gas. On the other hand, the massive strengthening of the koruna in the recent past could soften the price growth, especially in the category of consumer goods. Development of food prices will be also important for price developments at the end of the year. If

expectations of better harvests come true, we can expect declining pressures on food prices, which, along with a higher basis, should lead to some deceleration in year-on-year inflation at the end of 2008. We believe, however, that the effect of increasing oil prices will be stronger than previously expected. Therefore, we have decided to increase the inflation outlook for this and next year: we now expect average inflation to be at 4.4 % in 2008 and to accelerate further to 4.5 % in 2009 – also supported by euro "costs" as rounding or not well functioning FX pass through. With global oil prices shock gradually disappearing, 2010 inflation could stabilise around 3.5 % yoy – driven mainly by services prices convergence.

Koruna reflects incoming euro

The Slovak koruna started Q2 on a positive regional wave. Despite that, the strengthening of the domestic currency was relatively subdued. It was mainly foreign investors who were carefully waiting for the European Commission (EC) forecasts release and convergence report. On a regular basis, the market was overloaded by new statements by politicians and new rumours or leaks of information. At the end of April, the EC released the new forecasts, which supported EMU entry. Consequently, at the beginning of May, both the EC and the ECB released their convergence reports, which did not deny euro adoption in Slovakia (even if, as expected, the ECB cited some doubts about inflation sustainability). The reaction of the market was clearly a strong appreciation of SKK. Supported by several statements by Prime Minister Robert Fico (indicating that Slovakia will prefer conversion rate as strong as possible), SKK broke the historical maximum several times in a row. At the end of May, domestic financial groups started to be active on the market. Koruna broke the level of SKK/EUR 31.0 and trended to the bottom level of the fluctuation range (SKK/EUR 30.1260). Consequently, unusually and surprisingly, the central parity was changed on Wednesday, May 28 (previously it was always done on Friday). The new level of the central parity was set at SKK/EUR 30.1260, i.e. at the bottom level of the original fluctuation range. The new fluctuation range where the koruna exchange rate can move was determined at SKK/EUR 25.6071–34.6449.

Slovakia thereby set a new precedence in the history of ERM-II: it was the first country to revaluate the central parity twice and, at the same time, the new central parity was set at a level at which the exchange rate has never been so far in history. Unusually strong activity of domestic financial groups before the revaluation of parity led to suspicion of information being leaked. It was not officially confirmed at that time, but it is under the investigation of central bank (the final report should be delivered in September).

Euro confirmed, conversion rate to be at SKK/EUR 30.1260

The approval process of EUR adoption took place in May and June in all relevant European institutions, which delivered affirmative statements. The process was finished on July 8, when euro adoption in Slovakia was definitely confirmed. At the same time conversion rate was set at SKK/EUR 30.1260 – the level of central parity. We consider the conversion rate to be very favourable from many aspects. It is important for competitiveness of the economy that the conversion rate was determined close to the expected level of the equilibrium exchange rate in the next years, i.e. it should not significantly endanger domestic exporters. On the other hand, for citizens, the stronger exchange rate could mean moderation of inflation pressures after accession to the Eurozone, and moreover, a level close to the round limit of SKK/EUR 30 will allow easier translation of koruna to euro and thereby also better control of potentially unjustified price growth on the account of EUR introduction.

NBS waiting for ECB call

The Central Bank did not change the key interest rates in H1. The last change (cut of 25 bp) was carried out in April 2007. As the ECB hiked key interest rate for the euro to 4.25 % at the beginning of July, Slovak and Euro rates are balanced now. We expect, the NBS will thus only follow the ECB decisions for the rest of the year. The NBS indirectly suggested this in its latest comments: "with regard to the expected accession to the Eurozone in 2009, the possibility to apply other instruments of monetary policy is already limited."

Favourable state budget development

Despite the surplus reached in first 4 months of this year, the May and June results turned the budget into a cumulative deficit of SKK 4.11 bn. However, government budgetary spending is better than last year in the same period. The expenditure side of the state budget was below the planned average like last year. The revenue side closed H1 at only 44.9 % of planned yearly revenue. The primary difference in the revenue side was in excise taxes and VAT, due to exhaustion of cigarettes' supplies and tobacco purchased last year. However, in the second half of the year the situation with advance stocks creation should repeat due to further hikes in excise taxes in 2009. This effect should stabilise the revenue side again. If the state succeeds in maintaining discipline on expenditure side of the budget, the year-end deficit of the public finance could probably be again below the budgeted level of 2 % of GDP.

Foreign trade almost balanced

Foreign trade showed a surplus of SKK 0.5 bn. in the first four months of the year. The better foreign trade results were driven mainly by dynamic export growth, while it was only partially netted by higher oil prices and investment imports. As global oil price pressure has increased in recent months we have decided to revise our forecast of this year. Foreign trade is now expected to be balanced instead of reaching a surplus. We made a downward revision also in terms of the current account, forecasting a deficit of 4.6 % of GDP for 2008.

Event	Date	Reading
Wage growth	Sep 3	Continual wage growth over the growth of labour productivity could create pressure for fiscal restriction. As it is unlikely considering the upcoming elections (2010), it could create unwished demand-pulled inflation pressure
Consumer prices	Aug 12, Sep 10	Demand pulled inflation to be watched

Slovenia

Outlook

Economic growth was resilient in the first part of the year, but during the quarters ahead the economy will feel some impacts from the global and Eurozone slowdown (the Eurozone accounts for 70 % of Slovenian exports), although not dramatically. Sentiment indicators show some deterioration. Parliamentary elections will be held in September. Slovenia's economy, however, is not exposed to major political or economic risks even if the global outlook does worsen further. All in all, we expect growth to be rather robust, between 4 % and 4.5 %, despite remaining far from the peaks (close to 6 %) of 2006–07. Inflation dynamics are worsening and will remain a source of concern: the inflation gap to the Eurozone will not decline over the short term.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 40
Aa2/Positive	AA/Stable	AA/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	30.5	33.5	37.4	41.1	44.7
Per capita GDP (EUR)	15,170	16,690	18,580	20,400	22,170
Real GDP, yoy (%)	5.7	6.1	4.4	4.2	4.4
Inflation (CPI) yoy, eop. (%)	2.8	5.6	6.4	4.6	3.9
Inflation (CPI) yoy, avg. (%)	2.5	3.6	6.8	5.5	4.3
Unemployment rate, avg. (%)	6.0	4.9	5.0	5.0	4.8
Exchange rate SIT/EUR, eop./avg.	239.6	EUR	EUR	EUR	EUR
Reference rate (ECB)	3.75	4.00	4.25	4.00	4.00
Interest rate (3M interbank rate, eop.)	3.57	4.85	4.65	4.26	4.31
Interest rate (3M interbank rate, avg.)	3.44	4.28	4.68	4.46	4.29
Current account balance/GDP (%)	–2.5	–4.8	–5.1	–5.0	–4.9
FDI/GDP (%)	1.7	3.0	2.8	2.8	3.9
Budget balance/GDP (%)	–1.2	–0.1	–0.3	–0.3	–0.3
Public debt/GDP (%)	27.2	24.1	23.6	23.4	23.3

Source: Bank of Slovenia, SORS, UniCredit Group CEE Research Network.

Main topics

- Parliamentary elections will take place on 21 September, with current Prime Minister Jansa, leader of the centre-right coalition, losing some popularity.
- After a slowdown towards the end of 2007, growth accelerated to 5.4 % in Q1 GDP, from 4.7 % in the previous quarter, driven by investment activity. Construction recorded the best result.
- The rise in prices which started more than a year ago did not slow down in the first half of the year, driven by the rapid growth in commodity prices on the global markets. Inflation reached 7 % in June – the highest rate since the end of 1992.
- Fiscal accounts are on track and the revised budget balance foresees a surplus of 0.2 % of GDP, mostly as a result of higher projected revenues.
- The current account deficit continues to show a widening trend, on the back of merchandise imports growing more than exports. FDI remained robust, increasing 59.7 % yoy in the first four months of the year.

Growth holds, inflation rises, elections in sight

Election in September

On 16 June, President Danilo Turk signed a decree on the 2008 parliamentary elections, setting 21 September as the date. Prime Minister Janez Jansa – leader of the Slovenian Democratic Party, SDS, elected in 2004 – has been facing a growing loss of consensus. The government failed to forge an advantage from the recent higher European visibility, stemming from the European Union presidency, handled in the first half of 2008, and successful euro adoption last year. The ruling Democratic Party is now tied with – or even lagging behind – the opposition Social Democrats. At any rate, however, the country is not exposed to any kind of major political risk.

On the privatisation front, Slovenia will not sell its 75 % stake in the state-owned telecommunications company Telekom Slovenije before the parliamentary elections. There is still a lot of room for future privatisations, because, via investment funds and state-controlled companies, the state still maintains a considerable presence in the banking system, in the telecommunications industry, in the steel industry, logistics and electric power distribution.

Growth resilient in the first quarter

Slovenia is one of the countries which showed an acceleration in economic growth in the first quarter of 2008. Indeed, GDP increased by a robust 5.4 % yoy, compared with 4.7 % in the previous quarter. The main driver of growth remained investment activity (+17.6 %), after a temporary slowdown at the end of 2007. On the supply side, the largest increase in value added was recorded in construction, with a 27.4 % yoy growth, whereas manufacturing increased by a mere 1.9 %, which is considerably lower than in 2007. Over the short term, the pace of growth in the Slovenian economy appears to be dependent on construction activity.

Recent leading indicators show that the economy is not exhibiting any major signs of slowdown, with industrial production increasing 6.9 % yoy in April, driven by rising demand from abroad, especially from outside the European Union.

On the consumers' side, sales of non-food items, growing at an annual rate of 7.6 %, supported retail sales growth of 6 % yoy in May.

Indicators of economic sentiment, however, have been deteriorating in recent months and consumers seem rather pessimistic in all sectors other than retail.

Given the uncertain international environment, we continue to expect slowing growth in the remaining quarters of 2008. High domestic inflation may have some impact on consumption as well. We forecast 4.4 % GDP real growth for 2008 as a whole.

Inflation rising

After slightly falling in May, Slovenian inflation accelerated again in June, reaching 7 % in annual terms, the highest rate since December 1992. The consumer price index has already posted a cumulated increase of 4.1 % year to date, driven by oil, housing, water and electricity prices.

In the latter part of 2008 we can expect some decline in Slovenian inflation, given the high base effect from the last part of 2007. However, taking into account the situation on the commodity markets and the increased probability of some second-round effects on wage growth (7.8 % yoy increase in Q1), we have revised our inflation forecast upwards, from 4.8 % to 6.4 % for year-end.

The persistent price differentials with Eurozone countries is part of the convergence story and will not disappear in the next few years.

Fiscal position showing good results in the first part of this year

On 30 May, the Slovenian National Assembly passed the revised budget for 2008, which envisages a budget surplus of 0.2 % of GDP, given stronger revenue growth and EUR 50 mn in spending cuts. During the first four months of the year, general government revenues showed a robust 10.6 % yoy increase, mainly due to corporate and personal income tax, while expenditures were up 7.9 % in year-on-year terms. Altogether the budget balance registered a surplus of EUR 220 mn in this period. With the expected economic slowdown of the second half of 2008 and the September general election, a surplus will be difficult to achieve, but fiscal accounts will still remain almost balanced this year.

Current account deficit widening

In the first four months of the year, the current account deficit widened to EUR 729 mn, twice the value of the deficit generated in the same period of 2007. The main factor contributing to the increase in the deficit was merchandise trade, with exports growing at a slower pace than imports (9.2 % and 12.5 % yoy respectively).

Foreign direct investment inflows grew significantly in the first part of 2008 (+59.7 % yoy), financing 62 % of the C/A deficit. Most future privatisations will materialise through IPOs (hence, portfolio inflows and not FDI). Bank loans from abroad were less than half in comparison with 2007, but will continue to play a major role in current account financing.

We expect the current account deficit to remain high – around 5 % – in historical terms as import needs, especially capital goods, will remain relevant.

Event	Date	Reading
Q2 GDP Growth	11 Aug	We expect some moderate slowdown following strong performance in Q1
Parliamentary elections	21 Sep	The ruling coalition could lose its majority

Croatia

Outlook

Heading into H2 2008 the Croatian economy is exhibiting signs of an expected slowdown in growth, in line with the more difficult international economic environment. Growth in Croatia is set to reach 4.0 % in 2008 and could be even lower in 2009. Higher commodity prices and the contribution of procyclical fiscal policy to domestic demand are likely to see the current account deficit widen this year and remain high in 2009. If wage developments remain in check, this year's commodity price-induced spike in inflation should, however, moderate next year. The central bank has made clear it sees little reason to ease the current tight monetary policy settings. Completing entry negotiations with the EU in autumn 2009 would provide a major boost to investors' sentiment and will remain the major driver of the reform process in Croatia, even if the Irish "No" to the Lisbon Treaty may influence the country's date of accession to the EU.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 100
Baa3/Positive	BBB/Stable	BBB–/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	34.2	37.5	41.7	45.2	48.6
Per capita GDP (EUR)	7,710	8,450	9,400	10,190	10,950
Real GDP, yoy (%)	4.8	5.6	4.0	3.9	4.3
Inflation (CPI), yoy, Dec. (%)	2.0	5.8	5.0	3.2	2.5
Inflation (CPI) yoy, avg. (%)	3.2	2.9	6.2	3.9	2.7
Unemployment rate, avg. (%)	11.2	9.6	9.1	8.7	8.4
Exchange rate HRK/EUR, eop.	7.35	7.33	7.28	7.28	7.25
Exchange rate HRK/EUR, avg.	7.32	7.34	7.27	7.23	7.20
1w Zibor, avg. of Dec.	3.84	6.70	5.70	5.25	4.75
1w Zibor, avg. of the year	3.28	5.50	4.50	4.00	3.75
Current account balance/GDP (%)	–7.9	–8.6	–9.9	–9.1	–8.8
FDI/GDP (%)	8.0	9.6	7.1	7.3	7.6
Budget balance/GDP (%)[1]	–3.0	–2.3	–1.4	–1.7	–1.9
Public debt/GDP (%)	40.8	38.9	37.4	37.3	37.5
Total external debt/GDP (%)	85.5	89.1	88.7	88.3	88.3

Sources: CNB, CSB, Zagrebacka Banka Research – CEE Research Network; 1) ESA 95 from 2008.

Main topics

- Economic growth in Q1 2008 was 4.3 % yoy, which was slightly below consensus expectations, with private consumption tapering off. The CA deficit in the 12 months to March 2008 widened to 9.6 % of GDP as the merchandise trade deficit continued to rise in Q1 2008.
- Although headline inflation rose to 6.4 % yoy in May 2008 and will have risen further in July (after electricity prices were increased by 20 %), there are still few signs that aggregate wage developments are contributing to inflationary pressures.
- Parliament is expected to approve an adjustment of the government budget over the summer which will see spending increase by HRK 2.5 bn and revenues rise by HRK 2.2 bn. The government, which has moved to reporting its accounts according to the ESA 95 methodology, expects the budget deficit at 1.3 % of GDP, rather than the 2.3 % of GDP which it forecast initially.
- In the wake of the Irish "No" vote on the Lisbon Treaty, EU Enlargement Commissioner Rehn reiterated that Croatia remains in position to close all chapters of the acquis communautaire by autumn 2009. In the meantime, the EU may have enough time to find a way forward with reforms so that Croatia's entry into the EU need not necessarily be delayed.

Slower growth as tightening measures take a toll

Was Q1 the peak for the year in terms of growth?

The economy grew at a rate of 4.3 % yoy in Q1 2008, which was slightly less than the consensus view, but higher than in Q4 2007. Private consumption growth in Q1 was also 4.3 % yoy, marking the fourth straight quarter of slowing consumption growth (down from 7.1 % in Q1 last year). Seasonally adjusted data point to continued deceleration in private consumption. Retail sales growth reflects this, slowing significantly in the first five months of the year to rise only 2.2 % yoy in real terms. The moderate increase in retail sales this year is not too much of a surprise, taking into account that real net wage growth was just 0.2 % yoy in the first four months of the year. The increase in the tax free threshold of HRK 200 from 1 July will support private consumption and real wage growth, but the effect is likely to be only marginal.

Investment activity in Q1 2008 grew a robust 9.8 % yoy, which contributed fully 3 percentage points to the overall growth figure of 4.3 %. Construction activity remains very strong (+13.1 % yoy). Capital goods imports in the first five months of the year rose 14.6 % yoy. On balance, these figures suggest that construction activity is the most important driver of investment growth in Croatia at the moment; but at the same time construction also represents one of the sectors that can be considered more exposed to any further deterioration in international risk aversion. One should also note, however, that construction activity is one of the main beneficiaries of Croatia's EU accession path.

Industrial production data in the first five months of the year revealed an increase in activity of a mere 3.7 % yoy. Although working day effects were more pronounced in March (Easter) and May than usual, seasonally adjusted indicators also point to a slowdown in industrial production activity. In recent months only seasonally adjusted data for energy production has been showing signs of increased production, while for all other major categories the data (seasonally adjusted month on month) has either been stagnating or slightly declining. In addition, imports of intermediate goods have only risen 4.0 % yoy in the first five months of the year, which also suggests less upside potential for industrial production growth.

Employment growth in the first five months of the year was 3.4 % yoy. In May 2008, some 1.535 million people were officially employed, according to the employment data based on the administrative method. According to the International Labour Organisation (ILO) labour force data (for which Q4 2007 is the latest available data point), the unemployment rate in 2007 in Croatia was 9.6 %, the lowest on record. The participation rate last year amounted to only 48.8 % (marginally down from 49.1 % a year earlier). While this last figure points to structural issues ranging from an aging population to rigidities in product and labour markets, the employment data so far for 2008 is positive. Employment growth has slowed slightly compared to last year, but there are no signs of a contraction in employment at the aggregate level.

The slowdown in credit growth may influence economic and investment activity. Credit extension to the private sector continues to slow, as expected given the 12 % credit growth administrative limit imposed by the central bank. In May, credit growth was 10.8 % yoy. Credit to households was up 14.8 % yoy, which represents the thirteenth consecutive month of slowing credit growth to households. In structural terms, Croatia already has the highest level of retail lending to GDP in the entire CEE region, with a ratio higher than 45 % at the end of 2007. Meanwhile, credit growth to enterprises has also been slowing and rose only 5.9 % yoy in May 2008. Cross-border lending however suggests that the corporate sector is not likely to experience a very severe credit squeeze, despite the credit limits imposed by the central bank and the general tightening of international monetary conditions, which are also reflected in an increase in the cost of funding for local banking institutions.

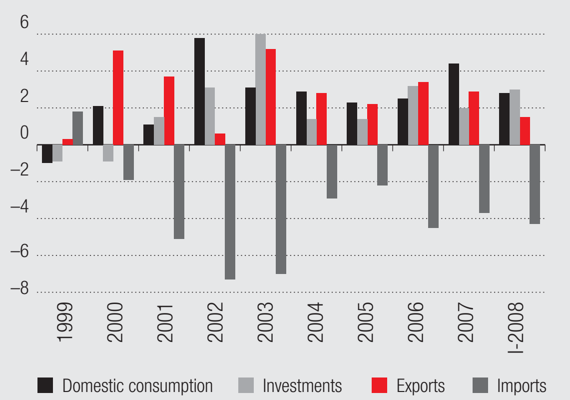
In summary, a few indicators are pointing to slowing growth. Retail sales activity, industrial production data, credit growth in both real and nominal terms as well as imports of merchandise goods, excluding oil, all suggest that domestic demand is slackening. Construction activity data, however, remain strong and the employment data released to date in 2008 suggest the labour market is holding up well, while cross-border lending to the corporate sector reduces the risks of a

Short-term indicators

	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Real GDP, yoy (%)	–	6.6	–	–	5.1	–	–	3.7	–	–	4.3	–	–
Industrial production, yoy (%)	7.7	4.4	8.5	2.8	2.1	5.5	2.5	1.4	6.7	8.1	0.2	6.9	–2.1
Inflation (CPI), yoy (%)	2.2	2.0	2.1	2.6	3.9	4.3	4.6	5.8	6.2	5.8	5.7	5.7	6.4
Unemployment rate (%)	–	9.1	–	–	8.4	–	–	9.7	–	–	–	–	–
Exchange rate, HRK/EUR, eop.	7.31	7.30	7.30	7.32	7.28	7.35	7.31	7.33	7.25	7.27	7.27	7.27	7.26
1W Zibor, avg.	4.7	5.6	7.2	4.5	5.6	7.7	8.3	6.7	7.5	5.4	4.3	4.1	4.6
Export, (FOB) yoy (%)	9.5	19.5	24.6	7.9	7.4	13.0	12.6	–10.9	19.7	9.5	–2.1	10.5	1.3
Import, (CIF) yoy (%)	15.6	1.3	17.7	5.9	6.6	14.0	12.7	6.0	27.4	13.7	4.0	22.7	2.6
Trade Balance, EUR mn	–972	–784	–833	–809	–760	–918	–859	–762	–820	–876	–987	–1,151	–1,007
Current account, EUR mn	–	–1,376	–	–	2,085	–	–	–1,912	–	–	–2,488	–	–

Sources: Official statistics (CNB, CBS), Zagrebacka Banka Research.

Contribution to GDP (p. p.)



Source: CSB

credit squeeze. On balance, we see growth moderating during the remainder of the year and envisage 4.0 % GDP growth this year and even lower (3.9 %) in 2009. We have hence revised downward both numbers (from 4.3 % and 4.2 %, respectively) compared to our previous forecast.

Inflation to peak in July

Following a period of relative stability in Q1, consumer prices rose 6.4 % yoy in May, largely as a result of fuel prices, which were up 5.7 % compared to April. Price hikes for meat and fruit were also relatively steep. The 6.4 % yoy headline inflation figure also featured rises in prices of furniture and household equipment of 0.7 % compared to April, while recreation and culture activities increased 1.0 % mom. In other words, businesses are beginning to pass on the costs of higher input prices to customers.

The high point for consumer price inflation this year will come in July, when the effect of the 20 % increase in electricity prices enters the index. The government has introduced variable tariffs in an effort to take the sting out of the price increase for households. Nonetheless, the headline CPI figure will exceed 7 % in July (we assume the impact of the electricity price increase on the consumer price index will be in the range of 0.4–0.5 percentage points in mom terms). That should represent the peak for consumer prices this year.

Encouragingly, so far there is little evidence that the inflationary pressure generated by higher food and oil prices is feeding through to wage dynamics at the aggregate level. Gross wages in real terms have only risen 1.4 % yoy for the first four months of the year, while at the same time labour productivity in the industrial sector rose of 5.7 % yoy.

Tight monetary policy

Understandably, the Croatian National Bank has made it clear in recent months that it will maintain the current tight monetary policy settings for as long as necessary, given the mounting external imbalances in the economy, the effect of food and oil price rises on inflation and the contribution of fiscal policy to domestic demand.

Credit growth to the private sector is limited to 12 % a year and since the measure was strengthened in the summer last year, growth rates have fallen off accordingly. The macroeconomic benefits of this policy are reflected in slowing non-oil merchandise imports. The public sector is, understandably, not subject to the 12 % credit limit. However, monetary policy continues to provide a subsidy to government borrowing. Short-term borrowing costs for the government are lower than they would otherwise be because the central bank only accepts the Ministry of Finance's Treasury bills as collateral from banks wishing to make use of its reverse repo auctions, contributing to higher demand while at the same time pushing yields lower. At the same time, in recent years the bank has made exemptions to monetary conditions to enable local banks to avoid the high regulatory cost of its measures when providing longer-term financing for the government, which again lowers the cost of borrowing for the government. In May of this year it lowered the foreign assets/foreign liabilities coverage ratio from 32 % to 28.5 % so that local banks could finance EUR 750 mn of government borrowing without having to resort to more expensive external financing sources. Initially, the government had planned to issue a Eurobond in April, but cited worsening market conditions for changing its mind.

To be sure, the central bank has always pointed out the importance of accelerating reforms and curbing public spending to boosting macroeconomic stability and raising the long-run rate of growth. But by softening the impact of its tight monetary policy settings for the government it has been sending a message that tighter credit conditions do not necessarily apply to the public sphere, which in itself reduces the focus of policy makers on pursuing reforms and curbing public spending.

External imbalances widen

The widening in the merchandise trade deficit, which began at the end of last year, continues. The merchandise trade deficit rose by EUR 393 mn in the first quarter of 2008, which was the main reason that the current account deficit rose 23 % yoy in this period. Foreign direct investment covered one-third of the C/A deficit. For the 12 months to March 2008, the current account deficit amounted to 9.6 % of GDP. This year will also see greater profit repatriation from the private sector. As a result, we expect the Q2 income deficit, in particular, to rise this year. If the largest telecommunications company T-HT pays out an extraordinary dividend to shareholders later this year, as is being speculated, the income deficit will widen even further.

A closer look at the merchandise trade deficit reveals that higher oil prices are a major factor. In the first five months of the year, imports of oil have increased over EUR 200 mn or 27.9 % yoy. At the same time, imports of merchandise goods excluding oil have risen only 9.9 % yoy, supporting our view of moderating domestic demand. Q1 2008 tourism revenues were up 17.3 % yoy which partly reflects Easter falling in March this year, but also lends support to anecdotal evidence that another solid tourism season awaits Croatia.

The combination of higher oil prices and our expectations of stronger profit repatriation prompt us to forecast a current account deficit of 9.9 % of GDP this year. While we see foreign direct investment inflows slightly lower this year as banking sector capital increases will not be as large as in 2007, we expect FDI inflows to cover 70 % of the C/A deficit. Although net medium- and long-term credit inflows will be lower than last year, in combination with FDI inflows, they will comfortably cover the C/A deficit. This suggests that the currency will remain stable in the near term.

The currency has remained strong all year, with EUR/HRK trading within a very narrow 7.23–7.28 range since February. The most recent currency intervention by the central bank was on 31 January, reflecting the generally stable conditions. In addition, interbank rates at the beginning of July suggest good interbank liquidity, which has not been the case over the summer in the last few years.

Foreign debt rose EUR 960 mn in Q1 2008, an amount similar to that seen last year. The banking sector increased its exposure abroad by EUR 556 mn over this period, while enterprises increased their foreign indebtedness by EUR 390 mn, just one-half the amount compared to the corresponding period in 2007. The summer months will see a seasonal pause in the accumulation of foreign debt. We estimate the growth of foreign debt will be on the order of EUR 3.5 bn. Given high nominal GDP growth and a strong currency, that would result in foreign indebtedness as a percentage of GDP falling marginally to 88.7 % at the end of this year.

Budget reporting moves to ESA 95 standard

While the economic cycle has ensured that budget deficit figures continue to fall, the Ministry of Finance figures reveal that consolidated general government budget expenditures rose 11.0 % in 2007 (this figure does not include the approximately HRK 3.5 bn spent on the return of pensioner debt last year).

In the first five months of this year central government budget revenues have risen between 10 and 11 %, with profit tax up 20 % while income tax revenues were up 14 % compared to last year. Both these figures reflect last year's strong growth and an increase in employment. At the same time, expenditures are up 4.5 % yoy.

Despite these indications of solid revenue growth in Q1 2008, the government is preparing a budget rebalance, which forecasts increased revenues of HRK 2.2 bn, while expenditures would be increased HRK 2.5 bn. The healthcare sector will receive another HRK 1.2 bn to clear arrears which have built up since October 2007, while the rebalance will also set aside between HRK 500–600 mn for one-off assistance in the face of higher inflation this year.

Yet, the main feature of the budget rebalance is that the government will move to reporting the fiscal position according to the European Union's ESA 95 methodology, rather than the modified accrual method it has used in recent years. That is the reason it is now forecasting a budget deficit of 1.3 % of GDP this year. The main feature of this change is that the government's motorway authority (HAC) will no longer be considered a part of the general government consolidated budget.

In the meantime, the main risk is that with HAC off-budget once again the government, no longer constrained by Maastricht Criteria measures, may well allow the motorway authority to increase its borrowing to finance construction activities. In addition, the possibility of being allowed by the EU to provide the shipyards with another cash injection as part of the restructuring process, presents another risk for a larger budget deficit over the next 18 months.

In summary, fiscal policy remains expansionary, with consolidated general government spending increasing more quickly than nominal GDP growth last year. This year, the government looks set to once more benefit from strong revenue growth which may reduce the budget deficit further. However, just as easily as the economic cycle has contributed in recent years to lower deficits, by provoking slower revenue growth as economic growth slows, it may just as easily contribute to higher budget deficits in future years.

EU accession talks and the effect of the Irish referendum

Rejection of the Lisbon Treaty by Irish voters on 12 June 2008 has complicated the European Union's institutional reform process and, according to the new rotating presidency holder France and other member states, precludes the further enlargement of the European Union (at least formally). This obviously has implications for candidate countries such as Croatia.

However, senior EU officials and leaders of large EU member states, such as Enlargement Commissioner Rehn and French president Sarkozy, have reiterated their support for further enlargement of the EU and sent a clear message to Croatia that it remains in position to complete the acquis communautaire talks in autumn of 2009. Thus, Croatia could complete the technical elements of joining the EU by then. The clear message to Croatia is that the EU in the meantime will work on finding a way to resolve the issues raised by the Irish "No" vote, including the functioning of the Union following the admission of Croatia.

By the time the French presidency of the EU commenced on 1 July 2008 Croatia had opened 18 chapters, and French and Croatian officials expressed the hope the remaining chapters would be opened in the rest of this year. That would be a clear sign – to voters and investors – that Croatia remains on course to complete accession talks by next year.

The key challenges continue to be the legal affairs and competition policy chapters. For the competition policy chapter to be opened, Croatia will have to implement a reform initiative of state-owned shipyards, the details of which have not yet been fully revealed. Shipyards remain one of the biggest loss makers in the economy and its restructuring will be challenging.

Event	Date	Reading
Opening of remaining acquis communautaire chapters	H2 2008	If Croatia succeeds, that will be a very important step to ensuring it completes the technical phase of EU accession talks during 2009

Turkey

Outlook

Despite the difficult environment both at home and abroad, economic performance still held up quite well in the first half of 2008. GDP growth in the first quarter was significantly higher than the market consensus, while worsening inflation seems to have been contained at around 11–12 %. The Turkish lira is still quite strong, but we have only seen a very limited increase in real interest rates. However, given the gloomy global outlook and the extremely tense domestic political environment, no significant improvement in economic conditions can be expected in the short term, with potential fluctuations in financial markets resulting from the flow of international and domestic news. The Constitutional Court's decision regarding the AKP closure case is expected to come within a month or even earlier. This will be the main driver of market reactions and will help to clear up a large amount of uncertainty.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 240
Ba3/Stable	BB–/Negative	BB–/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	419.2	479.5	524.3	598.2	645.8
Per capita GDP (EUR)	5,954	6,791	7,405	8,425	9,070
Real GDP, yoy (%)	6.9	4.5	4.2	5.0	5.5
Inflation (CPI), yoy, eop. (%)	9.7	8.4	11.0	7.1	5.4
Inflation (CPI), yoy, avg. (%)	9.6	8.8	10.6	9.1	6.3
Unemployment rate (%)	9.9	9.9	10.5	10.0	9.5
Exchange rate TRY/EUR, eop.	1.860	1.714	1.924	2.015	2.074
Exchange rate TRY/EUR, avg.	1.809	1.786	1.919	1.969	2.045
Reference rate (O/N, simple), eop.	17.50	15.75	16.75	16.25	14.25
Reference rate, compound yearly avg. (%)	16.9	18.8	17.6	17.9	16.5
Current account balance/GDP (%)	–6.1	–5.8	–6.3	–6.1	–6.3
FDI/GDP (%)	3.8	3.4	2.0	1.6	1.7
Budget balance/GDP (%)	–0.6	–1.6	–1.8	–1.3	–1.3
Primary surplus/GDP(%)	5.4	4.1	3.8	3.7	3.6
Public debt/GDP (%)	48.1	41.3	38.4	35.3	34.0

Source: Central Bank, Turkish Statistical Institution, Yapi Kredi Strategic Planning and Research, UniCredit Group CEE Research Network.

Main topics

- The political situation once again took centre stage. The recently alleged plot against the government involving two retired generals will continue to dominate the political scene.
- GDP growth in the first quarter of 2008 came in at 6.6 %, surprising the market positively. Although we expect some slowdown in growth rates in the quarters ahead, we still maintain our 4.2 % GDP growth forecast for 2008 as a whole.
- Inflation has been increasing very rapidly since March, bringing the annual figures back up to the double-digit level. A 0.36 % decline in the CPI in June brought some relief, although the pressure of rising inflation still continues.
- The current account deficit continued to expand at full speed. The expected slowdown in domestic demand did not materialise in the first quarter. The financing quality of the current account deficit has deteriorated.

Global risks remain, local economic risks are more visible and political risks abound

Waiting for Constitutional Court's decision on AKP

The unexpectedly harsh ruling by the Constitutional Court (CC) with respect to the amendments on the headscarf ban at universities took almost everyone by surprise on 5 June and to a large extent dashed hopes that the CC would not rule in favour of shutting down the AKP nor enact a broad ban of indicted AKP leaders. However, we still believe that a decision not to close the party is very possible. The CC may go for a closure and ban ruling or it may allow the AKP to survive, thinking that forces in favour of the headscarf have been weakened anyway. An outright confrontation is likely to bolster anti-establishment sentiment and lead to heightened uncertainty.

Markets were shaken up again when two retired high-level generals, along with a few other prominent public figures, were arrested on charges of plotting to overthrow the elected government. Regardless of how the case is resolved, conditions in the country are sure to change in an unprecedented way. If the indictment leaves no room for any doubt that these two were indeed involved in plots against the government, they will face life imprisonment. If the indictment turns out to be unfounded and evidence is frightfully inadequate, the AKP will have difficulties in consolidating its power over the state structure.

The intriguing question regarding Turkish markets remains the following: Given current asset prices in Turkey, what is priced in and to what degree? A substantial number of analysts believe that the worst-case scenario of closure and a ban that includes PM Erdogan is indeed priced in, but we believe otherwise. Current asset prices reflect neither a worst-case scenario nor business as usual without a closure or a ban. It is inconceivable that the country will not be thrown into some form of political instability for roughly a year or so if and when a closure/ban ruling is announced. If Erdogan's comeback attempt also becomes impossible, it will further exacerbate the situation. AKP will not take a closure decision lying down and will almost surely appeal to the European Human Rights Court, the decision of which will most likely be in favour of non-closure. How the Constitutional Court reacts in response could set the course of Turkey's EU venture: An adamant attitude towards the European Human Rights Court would be tantamount to a denial of international law overriding local law, a state of affairs which Turkey willingly subjected itself to by signing certain treaties.

Global risks remain, local economic risks are more visible and political risks abound. The current outlook testifies to the correction that the Turkish economy and Turkish institutions have undergone over the last seven years. It does not disrupt the image of fragile equilibrium or the tight rope we will be walking for some time to come, but we have come a long way. Impressive growth performance in Q1 2008 also testifies to the economic transformation that took place here. Whether it can be maintained or not will depend first and foremost on the local political scene and then on the global economic outlook.

First quarter growth surprisingly positive

The 6.6 % GDP growth for Q1 2008 took market participants by surprise (the consensus forecast was at 5 %). Private consumption expenditures rose by 7.3 % following a 4.6 % increase in 2007 and expectations of further easing in 2008. Consumer confidence has been on a steady decline and consumer credit expansion has slowed down, but consumption itself has surprised everyone positively. Thus, there might be a revelation problem on the part of consumers, or numbers are likely to deteriorate soon. We would prefer to believe the former rather than the latter given the less than impressive private consumption growth figures from last year with the exception of Q3.

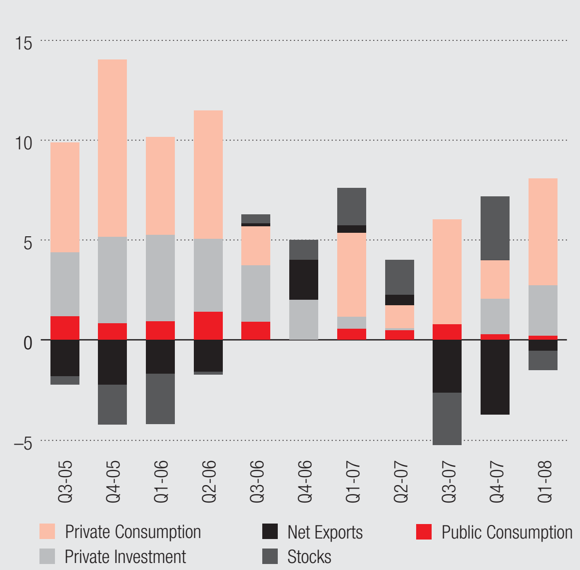
Private investment growth was even more positive at 11.3 % following dismal figures in 2007. Private investment was a crucial driver of impressive growth rates in the period from 2002 to 2006, it suffered a recession in 2007 and it will probably continue to recover in upcoming quarters.

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Real GDP, yoy (%)	4.0	–	–	3.4	–	–	3.4	–	–	6.6	–	–	–
Industrial production, yoy (%)	2.9	4.5	6.3	2.5	8.4	8.1	–1.0	11.4	7.5	2.5	6.3	2.4	–
Inflation (CPI), yoy (%)	8.60	6.90	7.39	7.12	7.70	8.40	8.39	8.17	9.10	9.15	9.66	10.74	10.61
Unemployment rate (%)	8.8	8.8	9.2	9.3	9.7	10.1	10.6	11.3	11.6	10.7	–	–	–
Exchange rate/EUR, eop.	1.767	1.756	1.774	1.717	1.701	1.738	1.714	1.744	1.819	2.074	2.009	1.880	1.934
Reference rate O/N, comp. avg.	19.1	19.1	19.1	18.9	18.5	17.9	17.3	16.9	16.6	16.5	16.5	16.8	17.4
Export (FOB), yoy (%)	8.2	13.8	15.0	4.1	23.2	11.4	0.1	39.8	26.5	8.6	15.8	17.0	–
Import (FOB), yoy (%)	5.9	17.0	10.6	6.5	22.5	13.2	12.3	36.0	23.2	9.5	17.8	13.7	–
Trade Balance, EUR mn	–2,892	–3,566	–3,351	–2,891	–2,995	–2,566	–3,311	–3,119	–2,304	–2,616	–3,090	–3,293	–
Current account, EUR mn	–2,400	–2,388	–2,304	–2,422	–2,664	–2,348	–2,096	–1,214	–1,662	–2,261	–2,218	–3,528	–

Source: The Central Bank, Turkish Statistical Institution, Yapi Kredi Strategic Planning and Research.

Contributions to Growth



Source: Turkish Statistical Institute, Yapi Kredi.

Other good news from the GDP front was the government cutting public expenditures. Final public sector consumption expenditures were up by a mere 4.2 % and quite in line with 2007, but investment expenditures were down by a more sizeable 7.7 %, quite in contrast to the 7.6 % growth in 2007.

Net exports, as expected, made a negative impact on growth, but at -0.5 percentage points the impact was mild in comparison to the figures from the previous two quarters.

From the income method perspective, agriculture, industry and service growth were all impressive at 5.0 %, 7.2 % and 6.4 %, respectively. Construction continues to suffer (with a dismal 2.8 % growth).

All in all, growth rates have not been harmed as much as was feared. Quite the contrary, the transition to a much lower growth scenario should not be too abrupt based on these figures. As a baseline scenario, we predict that growth will remain higher than 4.0 % this year (at 5.0 % in 2009 and 5.5 % in 2010). If political risks clear up going forward and global conditions improve, we may end up with an annual growth rate in the vicinity of the targeted 5 %.

Industrial production weaker

In May, the growth in industrial production slowed, as expected, to 2.4 %. The growth in the manufacturing sector fell from 6.7 % in April to 1.9 % in May. Motor vehicle production was one of the most impressive sectors, with 20.7 % growth and a contribution of 2 percentage points. Other sectors with significant positive contributions were energy, base metals, non-metallic products and food products. Chemical products, textiles and clothing checked the growth in industrial production with strong negative contributions (–0.7, –1.21 and –0.33 contribution points, respectively).

Inflation surprising at the end of the second quarter

Consumer prices fell by 0.36 % in June. As a result, annual inflation dropped from 10.7 % in the previous month to 10.6 %. This outcome stems mainly from a 3.4 % decline in food prices. Starting earlier this year, sales in the clothing sector also had a positive overall impact on the CPI.

There's not much to rejoice about at the moment, though, despite the fact that inflation yoy fell (although only negligibly) at a time when it was expected to rise fairly significantly. Electricity rate hikes will take their toll on inflation in July and will have a delayed (direct and indirect) effect on the upcoming periods. Six of the nine special indices displayed higher inflation levels yoy compared to the previous month. The CBRT's main core inflation reference index has risen steadily from 4.5 % in October 2007 to 6.37 % in June 2008. With the impact of electricity price hikes, we expect the CPI to increase by around 12.5 % in the coming months, before starting to decline in the last quarter of 2008. Under these circumstances, we expect CPI inflation to reach 11 % at the end of the year.

Producer prices were also low in June, with a monthly increase of 0.32 %. However, PPI inflation yoy continued to increase and reached 17.0 %. The surge in international commodity prices continues to affect PPI quite adversely.

Testing times for CBRT

The CBRT increased its policy rate from 15.25 % to 16.25 % in two consecutive meetings in May and June.

According to a CBRT survey, inflation expectations continue to deteriorate. Exchange rate expectations, on the other hand, remained restrained and even declined to a certain degree. The 12-m-ahead projection for YTL/USD at the end of June is significantly lower than it was at the end of April. Thus the increased fragility of inflation expectations is alarming and is due to the division of the projections for the inflation and exchange rates. The CBRT faces the problem that economic indicators indeed do not warrant a rate hike, but the mere deterioration of expectations and the possible exacerbation in the upcoming period call for pre-emptive strikes.

Deterioration in current account deficit has not cut pace

The current account deficit continued to expand at full speed as of May, bringing the cumulative deficit (12-month rolling) to USD 43 billion.

The expected slowdown in domestic demand – which is very evident in the consumer expectations survey, where levels fell to historical lows in June – did not materialise in the first quarter. Hence, robust import growth has continued, except for some deceleration in the import of investment goods. The 37 % growth in imports during the period from January to May stems not only from international commodity price hikes, but also from the strength of exports, which necessitates a high level of imports of intermediate goods. More specifically, the growth in intermediate, capital and consumer goods in the first five months reached 39 %, 25 % and 41 %, respectively, while exports posted a growth of 40 % during this period.

Volume indices reflect a slowdown in imports during the period from March to May. Therefore, we could presume that further weakening of domestic demand in the coming months may decrease imports to some extent. We predict a current account deficit of USD 50 billion at the end of the year, an increase from 5.7 % in 2007 to 6.3 % of the projected GDP.

Financing quality of current account deficit worse

The financing quality of the current account deficit has deteriorated in 2008. This is revealed by the declining share of non-debt financing. FDI inflows (including non-resident purchases of real estate) in the first five months accounted for half of those from last year, amounting to USD 6.1 billion. Big-ticket deals in FDI in the first half of 2008 included the privatisation of the tobacco unit of TEKEL (USD 1.72 bn), the sale of Migros (retail chain store – USD 1.65 bn) and sales in the banking and insurance sectors. In the first half of the year, completed sales approached USD 9 billion. We believe that FDI inflows will decrease to USD 16 billion in 2008 as a whole, which is lower than the previous two years.

On the other hand, there were outflows from portfolios (namely USD 1.1 billion) due to global and local political uncertainties in the first five months. USD 17.8 billion of total capital inflows stemmed from borrowing through loans, by banks and by the corporate sector. Indeed, the corporate sector continues to borrow heavily from abroad (its net borrowing amounted to USD 15 billion). The adversities in the global environment could pose a risk to the availability (and cost) of credit for corporations, especially if we take into account the open positions in terms of foreign currency (corporations borrowing on foreign currency).

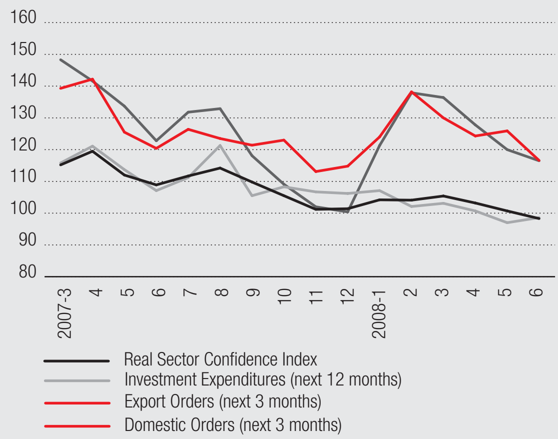
Budget figures on track

Central Administration Budget recorded a primary surplus of YTL 5.1 billion and a budget surplus of YTL 3.4 billion in May. This seems to be a very good result.

The budget realisations are in line with the year-end targets. Tax revenues were up by 8 % in real terms for the initial months of 2008, while non-interest expenditures were quite contained, having increased by only 1.5 % in real terms with respect to the same period in 2007. Nevertheless, one should note the weak non-tax revenues resulting from the slowdown in privatisation and the lack of one-off revenues this year. Major leakages on the expenditures side are again transfers (to social security institutions, the agricultural sector, etc.), which have accelerated in 2008.

In the remainder of 2008, tax collections could decelerate with the slowdown of the economy, and expenditures may start to accelerate in the run-up to early elections. Moreover, the government envisages an increase in expenditures, as outlined in the Medium-term Fiscal Framework, and has reduced the ratio of the public sector primary surplus to 3.5 % of GDP in 2008 (from 4.2 % previously) and further to 2.4 % in 2012. The aim is to channel funds to infrastructure and construction projects, specifically in the underdeveloped southeastern regions. If these investments are carried out as planned, they will not create much concern and would contribute to economic growth accompanied by an increase in employment. Prudent and contained fiscal expenditures that focus on enhancing private sector efficiency and increasing the appeal of investment would be welcome.

Real Sector confidence index[1]



1) New Index starting from 2007
Source: Central bank

Event	Date	Reading
Inflation report	July 28	Central Bank's projections in the context of the future inflation target will be announced.
Constitutional Court's decision about the AKP closure case	Early August	Market expectation is generally in favour of a closure of AKP, but we still believe that a non-closure decision is very possible.

Bosnia and Herzegovina

Outlook

The signing of a Stabilisation and Association Agreement (SAA) with the EU on 16 June after a number of years of effort marks the formalisation of the EU accession process for Bosnia and Herzegovina. The next major political challenge will be to agree on constitutional changes so as to improve the institutional functionality of the state, but this will also take years. Inflationary pressures look set to rise in the remainder of the year, driven in part by higher food and oil prices but also by increasingly expansionary fiscal policy. These will be the most urgent economic policy issues facing the country in the short to medium term. While credit and wage growth remain robust, industrial production data and the widening current account deficit suggest GDP growth this year will be lower than in 2007.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) N. A.
B2/Stable	Not rated	Not rated	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	9.8	10.6	11.9	13.1	14.2
Per capita GDP (EUR)	2,541	2,748	3,102	3,408	3,688
Real GDP, yoy (%)	6.2	6.7	5.8	5.0	5.0
Inflation (CPI), yoy, eop. (%)	4.6	4.9	5.7	4.1	2.8
Inflation (CPI), yoy, avg. (%)	6.1	1.5	7.2	4.9	3.5
Unemployment rate, avg. (%)	44.5	42.9	39.0	38.5	38.0
Exchange rate BAM/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
Current account balance/GDP (%)	–8.4	–13.3	–15.7	–14.2	–13.0
FDI/GDP (%)	5.8	14.0	5.4	5.8	5.7
Budget balance/GDP (%)[1]	2.9	1.3	–0.5	–1.8	–3.0
Public debt/GDP (%)[2]	21.3	18.9	17.7	17.5	17.2

Source: CBBH, BiH Agency for Statistics, Federal Office of Statistics, RS Institute of Statistics, UniCredit Group CEE Research Network.

1) For 2006: not including local government and road authorities. 2) External public debt.

Main topics

- Bosnia has finally formalised its accession plans with the EU after signing an SAA on 16 June with Brussels following a number of years of negotiations. The focus will now shift to attempting to agree on constitutional amendments in an effort to improve institutional effectiveness.
- Rising public expenditures, especially on social welfare in the Federation and on public sector salaries in both entities, have raised concerns about the consolidated budget deficit, which is deteriorating.
- Although higher oil and food prices have contributed to rising inflationary pressures, the sharp increase in public spending since the beginning of 2007 has also played an important part in driving inflation dynamics.
- While higher inflation will eventually have an impact on disposable income, robust domestic demand (and higher oil prices) will see the current account deficit widen to an estimated 15.7 % of GDP this year.
- In recent months, the establishment of the Fiscal Council and the signing of a memorandum on coordination between the central bank and banking sector regulators are encouraging steps which will enhance policy coordination and implementation.

EU accession path formalised as fiscal policy concerns mount

SAA signed
On 16 June 2008, Bosnia and Herzegovina became the final country in Southeastern Europe to sign a Stabilisation and Association Agreement (SAA) with the European Union. By signing the SAA, Bosnia has formalised the accession process with the EU. The next challenge for the country's politicians will be to agree on constitutional amendments, which will take time, but without which it will be difficult for Bosnia's institutions to function more efficiently. Bosnia will hold local elections on October 5.

Economic activity resilient
In April and May, industrial production activity slowed somewhat in the Federation, so that in the first five months of the year the overall index rose 4.5 % yoy. In Republika Srpska, industrial production activity accelerated in April and May to record a growth rate of 7.5 % in the first five months of the year. However, during this period manufacturing sector activity only rose 1.4 % yoy while mining activity rose 24 % yoy and electricity production rose 20.1 % yoy. Construction activity was very strong in the Federation, where it rose 47.4 % yoy from January to April 2008, while in Republika Srpska the rate of growth was 15.4 % for this period.

At the same time, the growth in wages continued to accelerate. In the period from January to April 2008, gross wages rose 7.3 % yoy, with public sector salaries having the greatest impact (in April, gross wages in the education sector rose 41.7 % yoy in nominal terms, while in the social welfare sector wages were up 27.8 % yoy). Credit growth also remains pronounced, rising 29.5 % yoy in May. Credit to households was up 27 % yoy and loan growth to enterprises rose 30.1 % yoy in May. However, the 127 % yoy increase in lending to the public sector in May (to the Federation in particular) to EUR 116 mn points to growing concerns over fiscal policy setting.

Question marks over fiscal policy
Fiscal accounts data released on the central bank website show a surplus for 2007 and Q1 2008, but the fiscal position has worsened. We think the budget might already be in deficit this year (–0.5 % of GDP). The IMF was even more pessimistic recently. It estimates that the consolidated fiscal position of Bosnia will fall to a deficit of 2.0 % of GDP this year (but the IMF estimated a slight deficit already for 2007 as a result of different calculations on last year's budget). And we should consider that this is an environment of strong revenue growth. The most pressing issue is the increasing social welfare and war veterans expenditure mandated by legislative provisions in the Federation. The fiscal position is more tenuous in the Federation, where liquidity issues have arisen in recent months. The establishment of the Fiscal Council with the aim of improving coordination between Bosnia's various levels of government is the first step towards improving the effectiveness and coordination of fiscal policy. Yet, with local elections to be held on 5 October, it is difficult to envisage spending cuts or legislative changes to social welfare policies being implemented in the coming months.

Rising inflation
In May, headline consumer prices rose 8.2 % yoy in Bosnia and were slightly lower at 8.0 % yoy in Republika Srpska. Higher oil and food prices are definitely a factor behind rising inflationary pressures. The improved harvest over the summer should provide some respite in terms of food price rises. However, the contribution of fiscal policy to domestic demand (an increase in expenditure of 4 percentage points last year) remains an important contributor to inflationary dynamics. With anecdotal evidence already suggesting that higher inflation is having a negative impact on disposable income, it would be important to avoid adding to inflationary pressures.

Rising external imbalances
Strong domestic demand and higher oil prices are also influencing the widening of the current account deficit, which we estimate will reach 15.7 % of GDP this year (higher than our previous forecast of 13.8 %). In the first five months of the year, oil imports rose EUR 110 mn compared to the same time last year, an increase of 45.9 % yoy. While high steel and aluminium prices supported solid export growth of 18 % yoy, merchandise imports excluding oil rose 23.4 % yoy in the first five months of 2007. Although the merchandise trade deficit will widen again this year, transfers and service exports will limit the rise in the current account deficit. The two items financed 60 % of the trade deficit last year and will continue to represent a very relevant form of financing in 2007. Last year, FDI inflows covered the entire current account deficit.

The latest data on foreign indebtedness is only for the public sector at the end of 2007. In light of investment into infrastructure projects, which are largely financed by foreign borrowing in the absence of meaningful privatisation revenues, figures for 2008 should reveal a further increase. Foreign exchange reserves amounted to EUR 3.4 bn at the end of last year, or over five months of import cover, implying stability for Bosnia's currency board arrangements.

At the same time, the central bank, which has an advisory role on the Fiscal Council, has signed a memorandum on the coordination of technical issues with entity-level banking sector regulators. We do not, however, see this as foreshadowing the centralisation of banking sector regulation any time in the near future.

Event	Date	Reading
Local elections	5 October	Will be an important gauge of voter sentiment following the signing of the SAA in a country which is rather less centralised than others in the region.

Kazakhstan

Outlook

Stalled credit growth, soaring inflation and the bursting of the residential construction bubble kept domestic demand subdued in H1 2008. By contrast, strong external demand for oil and gas allowed real GDP growth to remain at 6 % yoy in Q1 2008 and growth in industrial production at almost 4 % yoy in January–May. The current account returned to a substantial surplus. This has helped to ease the liquidity squeeze, as large companies began to use their foreign earnings to increase their deposits. In addition, an easing in monetary policy has led to lower interbank rates. High commodity prices have supported growth and helped avoid a severe banking crisis or currency depreciation. The other side of the coin: should prices fall sharply, Kazakhstan would be hit heavily. The National Oil Fund provides some protection however, and if the Kashagan oil field comes on stream in 2013, as recently agreed with the developing consortium, even lower oil prices will leave Kazakhstan with ample export proceeds.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) N. A.
Baa2/Stable	BBB–/Negative	BBB/Negative	EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	64.5	76.1	89.1	114.9	145.8
Per capita GDP (EUR)	4,190	4,890	5,660	7,210	9,150
Real GDP, yoy (%)	10.7	8.7	4.6	6.1	7.8
Inflation (CPI), yoy, Dec (%)	8.4	18.8	10.5	8.8	6.7
Inflation (CPI), yoy, avg. (%)	8.6	10.8	17.0	9.2	7.5
Unemployment rate (%)	7.8	7.6	6.7	6.6	6.4
Exchange rate/EUR, eop.	167.1	177.2	175.5	170.8	166.1
Exchange rate/EUR, avg.	158.3	167.8	182.4	172.8	166.6
Exchange rate/USD eop.	127.0	120.3	121.0	122.0	123.0
1-W repo rate, Dec.	9.0	11.0	10.5	9.5	9.0
KazPrime 3M (Dec)	5.50	12.35	7.00	7.50	7.50
Current Account balance/GDP (%)	–2.4	–6.9	3.2	0.0	–3.3
FDI/GDP (%)	7.7	9.9	6.6	5.9	6.4
Budget balance/GDP (%)[1]	0.7	–0.8	–1.0	–1.0	1.0
Public Debt/GDP (%)	12.0	7.7	9.0	9.7	8.0

1) Including the oil fund.

Sources: NBK, Kazakh Statistical Agency, KASE, UniCredit Group CEE Research Network.

Main topics

- Perception of Kazakh risk has worsened again since May, with 5Y CDS spreads at 230–250 bp in early July. The peak of 287 bp on 17 March 2008 was not reached again however.
- Real GDP growth slowed to a revised 6.0 % yoy in Q1 2008 from 8.7 % in 2007, due to weak domestic demand.
- June brought a further acceleration in inflation to 20.0 % yoy, as food prices surged 29.3 %. The central bank nevertheless reduced its refinancing rate to 10.5 % from 11 %, effective 1 July.
- Loan growth amounted to just 0.001 % from 1 January 2008 through end-May, compared with 28.2 % during the same period in 2007.
- As a result of strong inflows from energy exports and thanks to central bank easing, the 3M-KazPrime interbank rate declined from its peak of over 12 % p.a. in December 2007 to only 7 % in early July.
- A USD 3.9 bn current account surplus in Q1 2008 helped increase fx-reserves, despite net lending reflows from the banking sector of USD 1.6 bn in Q1 2008. Official reserves increased from USD 17.4 bn at end-2007 to USD 19.3 bn by end-March and further to USD 21.4 bn as of 16 June 2008 (3.6 months of imports). The National Oil Fund had an additional USD 24.1 bn in foreign assets as of 16 June.

Oil helps

Political reform

At its Madrid meeting in the autumn of 2007, the OSCE announced that Kazakhstan will chair the organisation in 2010. In a speech on 29 June 2008, President Nazarbaev reportedly outlined some key components of political reform, in part related to Kazakhstan's chairmanship: a) A new parliament structure that will involve at least two parties; the 7 % entry barrier is to be reduced to 4 % (currently "Nur Otan", led by Nursultan Nazarbaev, is the only party represented). b) A beneficial environment for the registration of political parties. c) The electoral process is to be improved. d) Red-tape barriers for the media are to be removed. President Nazarbaev also indicated that he would like to see a more clear-cut division of tasks for politicians and professional civil servants. We expect early parliamentary elections in 2009. Although these reforms are not likely to change the fundamental power structures, they may trigger some progress towards a more liberal and broad-based formation of the nation's political will.

Meagre growth, except for energy

Real GDP growth slowed to a revised 6.0 % yoy in Q1 2008 from 8.7 % in 2007 and growth in industrial production to 3.8 % yoy in Jan-May from 4.5 % in 2007. In May alone, industrial production was up by 5.2 % yoy, however, thanks to energy mining, which grew 9.3 % in May and 6.7 % yoy in Jan–May. Most other industries continued to show weak performance. Manufacturing output remained 0.7 % below the 2007 level in Jan-May, with metallurgy declining by 0.8 % and engineering by 1.1 %. The output of building materials was 22.4 % lower than last year. Retail trade turnover increased by only 2.2 % yoy in real terms in Jan-May, roughly in line with real incomes.

Small and medium enterprises are suffering in particular. This is reflected, and in part caused, by the 0.8 % decline in loans to SMEs between 1 January and 1 June 2008, compared to 39.6 % growth in the same period in 2007. Outstanding loans to construction enterprises even fell by 12.6 %, while they more than doubled during the same period the year before. The government therefore decided to help allocate some KZT 160 bn (USD 1.33 bn) to SMEs via several channels, as Prime Minister Karim Masimov announced.

Inflation at a new high, but monetary policy easing

June brought further acceleration of inflation to 20.0 % yoy, up from 19.5 % in May, as food prices surged by 29.3 %. Prices of non-food goods increased by 11.6 % and prices of services by 15.0 %.

The central bank (NBK) nevertheless reduced its refinancing rate to 10.5 % from 11 %, effective 1 July, and the minimum reserve requirement was cut from 6 % to 5 % for liabilities vis-à-vis residents and from 7 % to 8 % for liabilities vis-à-vis non-residents, effective 29 July. The rate cut runs contrary to the international trend, but the NBK is counting on a decline in the inflation rate in the second half of 2008 due to the base effect, as inflation began to increase only late last year, and measures such as agreements with providers of socially sensitive goods, exports limits on some goods and lower import taxes on some others. The semi-administrative measures could indeed lower inflation close to 10 % by end-2008, (still sufficiently high to cause significant hardship for the poorer slights of the population), not without the danger of distorting some prices and supplies however.

The NBK estimates that the cut in the reserve requirements will free up about KZT 90 bn (EUR 0.5 bn, 1.2 % of outstanding loans) and will help revive the stalled credit growth. Loan growth amounted to just 0.001 % from the beginning of 2008 through end-May. We think that some revival in lending is likely, but this will occur only in late 2008 when the focus of banks shifts again from working out bad loans – particularly bad real estate loans – towards new business.

Budget: low customs revenue offset by oil transfers

Revenues of the state budget, which comprises the central and local governments but not the oil fund, increased by 26.4 % yoy in Jan–May 2008, with expenditures up 27.9 %. This compares with average inflation of 19 % yoy in Jan–May. The operating surplus grew by 11.8 %. However, tax revenues increased by only 17 %, slightly below plan, and customs revenues came in significantly below plan due to weak imports. The shortfall was covered by higher transfers from the Oil Fund. The revised state budget draft for 2008, which takes extra expenditures for banking and construction sector stabilisation into account, targets a deficit of 1.4 % of GDP. For the deficit of the consolidated budget of the republic, the local administrations and the oil fund, we expect a marginal widening to perhaps 1.0 % of GDP in 2008 from 0.8 % of GDP in 2007.

New tax code in 2009

The government has presented an outline for a new tax code. The parliament may consider it in September. The main purpose is to ease the tax burden on business, compensating for it by sharply increasing taxes on mineral users, except for the two dozen largest of them, mainly those at the Tengiz, Kashagan and Karachanak fields. According to media reports, the Finance Ministry wants the corporate income tax rate to drop to 10 % from the current 30 %, while the Ministry of the Economy and Budget Planning favours a more conservative 20 % rate.

Current account in surplus

Thanks to record high oil prices and weak domestic demand, the current account was USD 3.9 bn in surplus in Q1 2008 (6 % of GDP in seasonally adjusted terms according to our calculations), compared with a deficit of USD 0.4 bn in Q1 2007. Exports surged 57 % yoy in USD terms, while imports rose a moderate 12 % yoy. We now expect a current account surplus of 3.2 % of GDP for 2008 as a whole.

Event	Date	Reading
New tax code	Sept. 2008	The parliament will decide about a new tax system.

Russia

Outlook

At record high growth leading already to bottlenecks in some areas Russia is sensitive to high global inflation, particularly with regard to food. The authorities' inflation targets are likely to be missed in 2008 despite monetary tightening. At the same time Russia is among the countries benefitting from the global high inflation environment as the surging commodity prices boost incomes of the government, companies and most of the households. The current account surplus increased in H1 2008 from a year earlier despite strong import demand. New cross border capital inflows, including the influx of capital to the banking system, were observed in Q2 2008 despite the global liquidity crisis. We revise our GDP forecast for 2008 from 6.6 % yoy to 7.5 % and expect growth of 5 %–6 % also in 2009 and 2010. Over the coming years the economic prospects will largely depend on the ability to invest sufficiently to overcome emerging infrastructure shortages and to counter the depletion of aging oilfields.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 148
Baa1/Positive	BBB+/Positive	BBB+/Stable	EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	785	942	1,206	1,505	1,757
Per capita GDP (EUR)	5,520	6,640	8,510	10,650	12,460
Real GDP, yoy (%)	6.7	8.1	7.5	6.6	5.3
Inflation (CPI), yoy, eop. (%)	9.0	11.9	13.0	11.0	8.0
Inflation (CPI), yoy, avg. (%)	9.7	9.0	14.0	11.9	8.6
Unemployment rate (%)	6.7	6.1	5.6	5.1	4.9
Exchange rate RUB/EUR, eop.	34.7	35.9	34.1	32.9	31.7
Exchange rate RUB/EUR, avg.	34.1	35.0	35.0	33.5	32.3
Exchange rate RUB/USD, eop.	26.3	24.6	23.5	23.5	23.5
Exchange rate RUB/USD, avg.	27.1	25.6	24.0	23.5	23.5
Interest rate (3M Mos Prime), eop.	5.89	6.82	7.40	7.30	7.80
Interest rate (3M Mos Prime), avg.	5.07	5.88	6.20	6.50	6.90
Current account balance/GDP (%)	9.6	6.1	7.0	4.4	1.3
FDI/GDP (%)	2.9	4.1	3.7	3.7	3.9
Budget balance/GDP (%)	8.4	6.1	7.0	5.0	3.0
Public debt/GDP (%)	8.2	6.6	6.2	5.9	5.5
Total external debt/GDP (%)	31.4	35.6	37.0	37.7	38.0

Sources: Rosstat, UniCredit Group New Europe Research Network.

Main topics

- On 16 July, Moody's upgraded Russia's government bond ratings and country ceiling for foreign currency deposits to Baa1 from Baa2 with a positive outlook, citing a strong fiscal position and reduced political risk, and said it saw strong economic growth continuing in the medium term.
- GDP grew by notable 8.5 % in Q1 2008 due to the favourable domestic and external environment.
- Investment kept growing at a high pace, fueled by strong domestic demand. It increased by 20.2 % yoy in Q1.
- The surge in global oil prices increased export growth to 27.2 % yoy (in EUR terms) in April and provides additional revenue to the federal budget.
- The Bank of Russia continues to adopt anti-inflation measures such as increasing the obligatory reserve rate and hiking its refinancing rate. As a result, the growth in money supply slowed during the past few months.
- Inflation targets will not be met in 2008. According to Rosstat, CPI growth accelerated to outstanding 15.4 % yoy in May 2008.

High growth, high inflation

Political continuity

After becoming new Russian President on May 2, 2008 Dmitry Medvedev by and large continues the political and economic course of former president Putin's administration. However, Medvedev has softened the tone of foreign policy and declared his intention to foster the development of the civil society. He outlined new political priorities such as strengthening state support for small and medium-sized enterprises, intensifying the fight against corruption and putting higher emphasis on social security. One of the most important political events in the second quarter of 2008 was establishing the president's new administration and the new government. In many ways this was a balancing act between hardliners and liberals. Whereas hardliners support a further strengthening of the role of the state in the economy, liberals advocate increasing the independence of company management and lowering the tax burden.

Growth above 7 % in 2008

In contrast to and despite weak global growth, the Russian economy continues to develop at an impressive pace. According to Rosstat, real GDP grew by 8.5 % yoy in Q1 2008 and the Ministry for Economic Development and Trade estimates a 8.4 % GDP growth for the first five months. Taking into account the very fast growth in H1, we increase our forecast for 2008 GDP growth from 6.6 % yoy to 7.5 % yoy. Private consumption grew by 14.4 % yoy at constant prices in Q1 2008, fixed investment by 19.4 %. Exports were up by 14.4 % yoy, but with imports increasing at 27.3 % yoy even faster, net exports contributed negatively to real GDP growth.

High growth in retail sales, 15.6 % yoy in Jan–May 2008, reflects a continued strong increase in household incomes. Real wages were 14.5 % higher in May 2008 than in May 2007, real disposable income 7.2 %. Adverse inflation expectations play also a role. They prompt households to switch from saving to current consumption.

The strong investment growth was the result of a wave of fixed capital formation in the production sector. We expect this process to continue both this year and next and hike our projection for investment growth in 2008 from 14 % yoy to17 % yoy. High economic growth has kept Russia attractive for foreign investments. According to Rosstat, accumulated foreign investments reached USD 221 bn (48.2 % of which were direct investments) by the end of Q1 2008. Foreign capital inflows in Q1 2008 amounted to USD 17.3 bn, which is however 29.9 % lower than in the same period of 2007. Loans were the biggest part of foreign investment in Q1 and accounted for 47.1 % of the total amount. The largest share went to retail trade, accounting for 31.7 % of total loans, followed by manufacturing with 25 %. Cyprus, the Netherlands, the UK and Germany remained the main investors also in Q1 2008.

Monetary tightening

Despite considerable anti-inflation efforts by the authorities, CPI growth has remained high and amounted to 7.7 % ytd (15.4 % yoy) in May 2008. Food prices grew by 10.2 % ytd. The poorer strata of the population are severely affected by inflation: The cost of the minimal foodstuffs basket increased by 19.6 % since the beginning of the year. The government has therefore decided to raise the minimum labor remuneration from RUB 2,300 to RUB 4,330 as of 1 December 2008. Producer prices grew by 11.5 % since the beginning of 2008. The highest price growth was observed in "electricity, gas and water supply" at 17.6 % ytd, and in manufacturing at 12.2 % ytd.

The inflation target of the authorities of 10.5 % yoy in December 2008 is hardly achievable. We up our forecast further from 12.5 % to 13.0 % in 2008. To counter inflation more decisively, the central bank (CBR) adopted further measures and increased the obligatory reserve ratios for credit organizations from 5.5 % to 7.0 % for debts to foreign credit organizations, from 4.5 % to 5.0 % for ruble obligations to individuals, and from 5.0 % to 5.5 % for other liabilities as of 1 July 2008. On 14 July 2008, the CBR raised its refinancing rate from 10.75 % to 11 %. The refinancing rate is the basic interest rate for all credit and deposit operations performed by the CBR, thus its increase has resulted in similar hikes in other CBR interest rates.Despite these tightening

Short-term indicators

	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
GDP real growth, yoy (%)	7.8	–	–	7.6	–	–	9.5	–	–	8.5	–	–	–
Industrial production, yoy (%)	10.9	7.8	3.8	3.0	6.1	4.7	6.5	4.5	7.5	6.5	9.2	6.7	–
Inflation (CPI), yoy (%)	8.5	8.7	8.6	9.3	10.8	11.4	11.8	12.6	12.7	13.3	14.3	14.7	15.3
Unemployment rate (%)	5.9	5.8	5.7	5.8	5.9	5.9	6.1	5.8	6.6	6.4	6.6	6.4	–
Exchange rate RUB/EUR, eop.	34.7	34.9	35.0	35.3	35.6	36.0	35.9	36.0	36.1	36.8	37.1	36.9	36.8
3M interbank rate (%), avg.	4.8	4.7	5.5	7.3	7.6	7.2	6.8	5.9	6.5	7.5	7.1	6.4	6.1
Export (FOB), yoy (%)	0.84	6.27	3.12	6.34	23.69	23.85	17.15	40.82	28.37	23.59	27.24	–	–
Import (FOB), yoy (%)	19.77	30.48	29.01	17.81	22.24	21.50	13.27	17.06	26.7	14.4	31.9	–	–
Trade balance, EUR mn[1]	46.4	54.0	62.1	70.1	79.1	88.3	97.6	12.8	22.4	32.7	42.6	–	–
Current account, EUR mn[1]	29.0	–	–	38.9	–	–	52.3	–	–	23.5	–	–	69.0

Source: ROSSTAT, Reuters, UniCredit Group CEE Research Network; 1) cumulative.

Krasnoyarsk

As regional expansion has become one of the corner stones of Unicredit Group development in Russia, we think it is useful to give a short overview of some of the most promising Russian regions. We have decided to start from Krasnoyarsk as it is considered one of the most interesting areas for both corporate and retail banking due to its unique geographical position, abundant natural resources and economic potential.

	2005	2006	2007e
Gross Regional Product (GRP), EUR bn	12,505	17,174	20,545
GRP growth, yoy (%)	14.4	12.2	13.0
Industrial growth, yoy (%)	0.8	1.0	4.1
Investment growth, yoy (%)	29.5	27.4	10.2
Export growth, yoy (in EUR terms) (%)	27.6	12.6	22.7
Construction growth, yoy (%)	9.4	6.4	13.6
Retail sales growth, yoy (%)	10.1	9.2	12.4
Average monthly wage, EUR	299	366	452
Loans to private individuals, EUR mn	814	1,392	2,202
Loan to private individuals growth, yoy (%)	78.1	71.0	58.2

Geographic position and population

The Krasnoyarsk kray (region) is situated in Eastern Siberia. The region, whose administrative center is Krasnoyarsk city, occupies almost all the Yenisey river basin. The population of the region is 2.893 mn people, who are concentrated in the south along the Trans-Siberian railroad. The remaining area is nearly uninhabited (average concentration of population is 1.3 people per sq. km). The area of the region is 2,339 thousand sq. km.

Natural resources

Rich natural resources are the key factor for the investment attractiveness of Krasnoyarsk. The region has vast timber resources, which are exploited mainly along the Trans-Siberian railroad. The reserves of industrial timber are estimated at 14.4 bn cubic meters.

An impressive hydroelectric potential of the region is also one of the competitive advantages. The extensive river Yenisey drainage system makes possible the Krasnoyarsk and Sayan hydroelectric power plants, which are among the largest in the world.

The Krasnoyarsk kray is one of the richest Russian territories by mineral resources. The region accumulates about 70 % of all Russian coal reserves. The largest part of the country's nickel, cobalt, platinum and copper is concentrated in Norilsk. Recently, 25 oil and gas fields have been discovered in the region.

The Krasnoyarsk region is one of the most industrially developed regions in Siberia and provides 3.2 % of the industrial output of the country. The main industries are mining, metallurgy, machinery and equipment, food industry, timber and woodworking. The region produces 70 % of Russian copper, 80 % of nickel, more than 90 % of platinum, 28 % of aluminum and 10 % of gold.

Huge investment projects are stimulating government and private investment. Among the largest investment projects are a hydroelectric power plant, an aluminum plant, timber and pulp factories and infrastructure objects such as the construction of railroads, bridges and highways. Planned capital expenditures for these projects are estimated to amount to more than EUR 6.3 bn. Another EUR 5 bn of investments are dedicated to the development of the Vankor oil and gas field with a projected oil output of 22.5 m tons a year.

As a result of economic diversification and the implementation of large-scale investment programs industrial growth accelerated to 4.1 % in 2007. The export base has also been strengthened. The industrial output per capita is one of the highest in Russia (EUR 6,100). Agricultural production is the 5th largest in the Siberian Federal Region (SFR).

The Krasnoyarsk kray has one of the lowest unemployment rates in Russia (2.5 %) and is the leader in fighting inflation. In 2007, inflation was at 9.2 %, the lowest among the 12 territories of the SFR.

All three major international rating agencies have assigned high credit ratings to the region. It is BB+/stable according to Standard&Poor's, BB/stable rating from Fitch and Ba2/stable – from Moody's Investor Service

Small business in progress

All main indicators reflecting SME activities show a rapid development of this segment in the region. The number of SMEs increased by 51.7 % yoy to 15.9 thousand in 2007. They are concentrated in retail trade (48.7 %), construction (13 %), real estate (13 %) and manufacturing (10.8 %). The turnover of SMEs was up by 4.7 % yoy in 2007, reaching the amount of EUR 4.4 bn.

The banking in the region

Growing investment demand and robust economic growth along with fast increasing wages and disposable incomes of the population make the Krasnoyarsk region very attractive for corporate and retail banking. The region is Russia's 11th largest by bank assets. Sberbank and branches of the largest Russian banks are the main players in the regional banking sector. Local banks' assets account for only 14 % of the regional total. The retail banking infrastructure is obviously insufficient. There are only 13 bank offices per 100,000 inhabitants.

measures, the Russian banking sector has not experienced a significant shortage of liquidity however, as banks wound down their assets abroad in Q1 and limited asset outflow in Q2. This combined with renewed dollar purchases by the central bank to decrease the 3 month MosPrime interbank rate from 7.5 % at the beginning of April to 5.9 % as of 1 July 2008.

The CBR has changed the procedure of foreign currency intervention since June 14, 2008: In addition to operations aimed at maintaining the ruble rate against the two-currency basket, the CBR now regularly performs foreign currency interventions based on the specific current situation on the national and external financial markets. This is a step on the road to a gradual transition to inflation targeting. The economic agents should get adapted to higher exchange rate volatility.

Booming industry and construction, but also bottle-necks

According to Rosstat, industrial production increased by 6.9 % yoy in January–May 2008. Thanks to strong investment demand, manufacturing of machinery and transport equipment has become the center of industrial growth since early 2008. Manufacturing of hydraulic tubes and manufacturing of tractors for example grew by a staggering 220 % and 210 % yoy, respectively. Metallurgy also performed well at a 9.8 % yoy growth in January–April 2008.

The construction boom continued also in January–May. The value of construction output 2008 totaled RUB 348bn (approximately EUR 9.42 bn), 24.3 % more than in the same period of 2007. The lack of building materials has, however, become a limiting factor. Production bottlenecks and high raw material prices have begun to cause a deceleration in housing construction growth. New dwellings put into operation numbered 169.5 thousand in January–May, only 6 % more than a year earlier.

The output of mining and quarrying grew by only 0.5 % yoy, and the extraction of oil even contracted by 0.5 % yoy. Several important currently used oilfields are almost at the end of their useful period while new sources are often situated far away from well-developed infrastructure. The mining sector needs huge investment to keep output growth high.

Budget revenue fueled by export growth

According to the Federal Treasury, federal budget revenues amounted to 25.1 % of GDP in the first five months of 2008, 3.8 percentage points more than in 2007. One half of that increase came from higher non-tax revenues from oil and gas export operations and the other 1.9 percentage points from higher tax inflows. The budget income from oil and gas exports equaled 11.2 % of GDP in Jan–April 2008 compared to 8.9 % of GDP a year earlier. The government decided to increase the customs duty for oil exports from USD 398.1 per ton to USD 495.9 per ton from August, which will further increase the oil revenue. The main tax contribution came from value added tax (6.6 % of GDP) and from the tax for the extraction of natural resources (4.2 % of GDP). Federal budget expenditures totaled RUB 2,437 bn or 15.8 % of GDP (according to the estimation of the Ministry for Economic Development and Trade) in January–May 2008, which is 0.9 percentage points higher than in the same period of 2007. Expenditure growth was due to significant increases in national security spending and in transfers to the regional budgets. The general government budget also developed positively in the first four months of 2008. Revenues amounted to RUB 4,684.2 bn or 38.9 % of GDP in Jan–Apr 2008 (compared to 33.6 % in 2007), expenditures to RUB 2,999bn (24 % of GDP), leaving the budget in surplus by RUB 1,685.2 bn or almost 14 % of GDP. As the major contributors to budget revenues, export duties and the tax for natural resource extraction, are likely to further strongly support revenue growth in 2008 we have increased our forecast for the federal budget surplus from 2.5 % to 2.7 % of GDP in 2008.

According to the Ministry of Finance, the amount of Reserve Fund of Russia totaled USD 130.3bn and National Welfare Fund USD 32.85 bn as of July 1, 2008. All oil and gas revenues were used to cover government expenditures since early 2008, neither the Reserve Fund nor the National Welfare Fund received any additional funding since their establishment in February 2008.

Oil prices increase current account surplus

According to CBR estimates, Russian exports increased by 54 % yoy in USD terms in H1 to USD 240 bn, imports by 42 % to USD 135 bn. The trade surplus amounted to USD 105 bn compared with only USD 60 bn in H1 2007, the current account surplus widened to USD 69 bn from USD 37 bn. Growth in export was largely brought about by the surge in global oil and metal prices. The average price for Urals oil almost doubled to 135.8 USD/b in Q2 2008 from 68.2 USD/b the year before. At the same time, exports of crude oil increased by only 68 % and of oil products by 77 % in USD terms. Non-energy exports increased by about 30 % both in Q1 and in Q2. High investment demand and real ruble appreciation kept also import growth high, especially imports of transport equipment, power machinery and cars. Machinery and equipment accounted for 55.5 % of Russian imports in January–April 2008 while the share of food contracted by 3.2 percentage points to 13 % from the same period of 2007. The strong H1 performance prompted us to revise our forecast for the 2008 current account surplus from 5.2 % to 7 % of GDP.

With regard to the financial account of the balance of payments, the resumption of the cross-border financing of the banking sector in Q2 2008 is noteworthy. Whereas the inflows amounted to only USD 4.3 bn in Q1, they increased to USD 21.4 bn in Q2. This is one of the reasons why the increase in foreign exchange reserves accelerated from USD 12 bn in Q1 to USD 65 bn in Q2.

Event/Release	Date	Reading
CPI	04.09.2008	Consumer prices will stay out of control of the government, we expect 0.9% mom growth as of August, 31.

Serbia

Outlook

Now that Serbia has a new government which has declared EU accession as a major goal, Serbia once more has the opportunity to accelerate its path towards joining the EU. The pace of accession will depend first on establishing full co-operation with The Hague Tribunal for war crimes, without which the Stabilisation and Association Agreement and the interim agreement cannot come into force. Inflationary pressures have risen and will remain pronounced this year. Fiscal policy remains loose and if the new government increases pensions 10 % it will be difficult to imagine inflationary pressures easing in the near term. We therefore expect the central bank to continue increasing interest rates for the remainder of the year. The combination of high inflation, rising interest rates and an uncertain international environment should see growth taper off significantly during the remainder of the year.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) N. A.
Not rated	BB–/Negative	BB–/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	24.3	29.1	34.3	40.5	46.0
Per capita GDP (EUR)	3,270	3,940	4,650	5,500	6,250
Real GDP, yoy (%)	5.7	7.5	6.2	5.5	6.2
Inflation (CPI), yoy, eop. (%)	6.6	10.1	10.8	7.7	5.6
Inflation (CPI), yoy, avg. (%)	12.7	6.8	11.9	8.7	6.6
Unemployment rate (%)	20.9	18.8	18.0	17.5	17.0
Exchange rate RSD/EUR, eop.	79.0	79.2	78.0	77.5	77.0
Exchange rate RSD/EUR, avg.	84.1	80.1	80.3	77.8	77.3
2W repo rate, eop.	14.0	10.0	17.5	13.0	10.0
Current account balance/GDP (%)	–9.8	–13.2	–16.3	–13.8	–11.5
FDI/GDP (%)	14.0	5.5	6.8	7.4	7.4
Budget balance/GDP (%)	1.5	1.3	–0.6	–0.9	–1.2
Public debt/GDP (%)	34.1	28.4	23.3	22.0	21.0
Total external debt/GDP (%)	61.3	61.0	61.3	58.5	55.6

Source: NBS, Statistical Office of the Republic of Serbia, UniCredit Group CEE Research Network.

Main topics

- Political stability has improved in Serbia with the election of a government aiming to accelerate the EU accession process. The government comprises two coalitions centred around the Democratic Party and the Socialists. Ethnic minorities are also part of the government.
- Inflation in June rose to 12.1 % yoy and core inflation rose to 10 % yoy, well above the central bank's 3–6 % target. This implies further increases in policy rates by the central bank and perhaps new measures to slow credit growth.
- Solid credit growth and loose fiscal policy have driven domestic demand and thus GDP growth, which surprised on the upside in Q1 2008 coming in at 8.2 % yoy.
- Balance of payments data are in the process of being revised, but in any event higher oil prices and strong domestic demand should see the current account deficit widen to 16.3 % of GDP this year.
- At the same time, the combination of FDI inflows and higher nominal GDP growth should see foreign debt as a percentage of GDP remain stable this year (coming in at 61.3 % of GDP).

New government has an opportunity to accelerate EU accession

New government in place
On 8 July, parliament approved the new Serbian government which is a coalition of the "For a European Serbia" (ZES) bloc, led by the Democratic Party, a coalition built around the Socialists (including the Party of United Pensioners of Serbia; PUPS) and ethnic minorities. The government has a majority of 6 in parliament, but can also count on the support of the Liberal Democrats (13 seats) for legislation and reform initiatives aimed at bringing Serbia closer to the EU. The government faces two main challenges. The first is establishing full co-operation with The Hague Tribunal for war crimes, without which there can be no progress on EU accession. The EU is hopeful that Serbia's new government will succeed in this regard and be constructive on the issue of Kosovo. The Hague Tribunal is expected to deliver its latest judgement on whether Serbia is in full compliance with it in October. We expect the parliament to ratify the Stabilisation and Association Agreement with the EU soon. The second challenge relates to constraining fiscal policy, in part because PUPS is demanding an immediate 10 % increase in pensions.

Very strong Q1 growth
Economic growth in Q1 2008 was a surprisingly strong 8.2 % yoy. The transport, storage and communications sector, a strong performer over the past four years, rose 20.9 % yoy while continued robust credit growth meant the financial intermediation sector recorded a growth rate of 18.9 % yoy in Q1. These were the main sectors driving growth in Serbia. At the same time, construction activity rose only 4.3 % yoy, and the manufacturing sector recorded a growth rate of 3.9 % yoy.

More recent data are also in positive territory. Industrial production rose 3.8 % yoy in May. The industry and manufacturing indices recorded an increase in seasonally adjusted terms as well, after four months of declines, suggesting near-term upside for industrial production.

Credit growth in the first five months of the year points to strong consumer demand. In real terms, credit growth to households rose 33.8 % yoy over this period, despite some moderation in recent months. Lending to enterprises rose 19.7 % yoy over this period, however, to this number one should add cross-border lending, which is not reflected in official credit growth statistics. That investment spending remains resilient is also reflected by the 25.4 % yoy (Jan–May) increase in capital goods imports.

Consumer goods' imports rose 26.5 % yoy over the same period. That said, retail sales turnover data show that since March there has been a marked slowing in activity with average growth of only 2.1 % in the three months to May 2008. At the same time, wage developments have seen net wages rise 20 % yoy in real terms in the first five months of the year with net salaries averaging close to EUR 420 in May. Taking all of the above into account, we expect a smaller contribution to growth from private consumption in the remainder of the year.

Inflation continues to rise …
In June 2008 core inflation rose to 10 % yoy, well above the central bank's 3–6 % target range, and the headline inflation rate stood at 12.1 % yoy. While higher oil and food prices have undoubtedly played a part in these developments, loose fiscal policy, seen mainly in the form of double-digit public sector wage increases prior to the May elections, have also contributed to generating demand pressures. If the new government limits public spending and does not increase pensions 10 % (as demanded by the Pensioner's Party), inflationary pressures will moderate. In response to the approval of a government intending to pursue EU accession, the dinar has strengthened to 79 against the euro and if delayed foreign investments materialise the local currency soon could head lower, which would help combat inflationary pressures. We also believe the National Bank of Serbia will increase interest rates beyond the current 15.75 %. Our forecast is 17.50 %. There is also the possibility of the central bank introducing further measures to tighten credit growth in the second half of the year should the current account deficit deteriorate further.

… as the current account deficit widens
The Serbian authorities are currently in the process of revising their balance of payments data reporting to meet IMF standards. As a result, the historical current account deficits have fallen somewhat, while in 2008 robust domestic demand coupled with higher oil imports on the back of price rises have seen the current account deficit widen 67.8 % yoy. We see the current account deficit approaching EUR 5.6 bn by the end of the year, which amounts to 16.3 % of GDP. At the same time, FDI inflows will largely depend on whether investments delayed by political instability earlier in the year are commenced this year or put back later. We see FDI inflows at 6.8 % of GDP this year. Serbia's foreign exchange reserves in June covered 6 months of imports.

Foreign indebtedness in Serbia actually fell EUR120 mn between the end of last year and April 2008. At the end of 2008, we see foreign indebtedness rising marginally to 61.3 % of GDP. While Serbia continues to access foreign capital for its economic development, robust nominal GDP growth should ensure that, as a percentage of GDP, foreign indebtedness over the short to medium term does not rise too much. Another factor which is likely to limit foreign debt growth as a percentage of GDP over the medium term is Serbia's still extensive privatisation pipeline, which should ensure respectable FDI inflows in the coming years.

Event	Date	Reading
Hague Tribunal opinion on Serbia's co-operation on war crimes	September/ October	If the new government makes enough progress to ensure full co-operation with The Hague Tribunal, then the probability of a positive EC assessment of Serbia in November will rise substantially making significant progress on EU accession achievable.

Ukraine

Outlook

Ukraine continued to experience strong growth in H1 2008. However, it was mainly driven by consumption and accompanied by soaring inflation and a sharply widening current account deficit. Investment and credit growth have begun to slow. This probably indicates a turn of the tide in the Ukrainian economic climate. We expect real GDP growth to decline from 7.6 % in 2007 to 5.8 % in 2008. The CA deficit will further widen in 2009, despite cooling growth, due to hikes in gas import prices. S&P and Fitch lowered their ratings. We also admit that Ukraine's outlook has deteriorated. We remain however optimistic that Ukraine will be able to keep imbalances in sustainable magnitudes. We expect growth to accelerate again in mid-2009, thanks to renewed construction activities, in part related to the Euro 2012, and further fiscal easing in the run-up to the 2010 presidential elections. In full year figures this will however become visible only in 2010 due to a strong statistical base effect in H1 2009.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (JUNE) 377
B1/Positive	B+/Stable	BB–/Stable	EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	84.8	102.6	133.7	166.0	198.9
Per capita GDP (EUR)	1,810	2,200	2,890	3,620	4,370
Real GDP, yoy (%)	7.1	7.6	5.8	4.5	5.6
Inflation (CPI), yoy, Dec. (%)	11.6	16.6	20.4	9.0	7.5
Inflation (CPI), yoy, avg. (%)	9.1	12.8	25.5	10.9	8.1
Unemployment rate (%)	6.8	6.9	6.2	6.0	6.0
Exchange rate UAH/EUR, eop.	6.65	7.42	7.18	7.28	6.89
Exchange rate UAH/EUR, avg.	6.34	6.92	7.56	7.25	7.00
Exchange rate UAH/USD, eop.	5.05	5.05	4.95	5.20	5.10
Current account balance/GDP (%)	–1.5	–4.2	–8.4	–8.7	–9.5
FDI/GDP (%)	5.4	6.6	4.4	3.2	4.7
Budget balance/GDP (%)	–0.7	–1.1	–1.4	–3.0	–3.0
Public debt/GDP (%)	15.0	16.5	18.0	22.2	25.0
Total external debt/GDP (%)	49.8	56.9	52.3	49.6	49.7

Sources: Ukrainian central bank, UkrStat, UniCredit Group New Europe Research Network.

Main topics

- Real GDP expanded by 6.4 % yoy in Jan–May 2008 according to preliminary Ukrstat estimates.
- Consumer price growth peaked at 31.1 % yoy in May as prices of food grew 50.5 %. In June, inflation moderated to 29.3 %.
- Import growth of 45.1 % yoy in USD terms as exports increased by 28.5 % yoy widened the current account deficit to USD 3.6 bn in Q1 2008 or seasonally adjusted 9.3 % of GDP according to our calculations. As a result, official reserves declined during Q1 for the first time since Q1 2006, by USD 150 mn, despite still high inflows of inward FDI (USD 2.5 bn) and loans and deposits (USD 6.9 bn, including USD 2.1 bn to banks).
- The EU relaxed limitations on some Ukrainian imports at the end of May, in particular steel import quotas because of the country's WTO accession on 16 May 2008. Ukraine has also begun to bring customs tariffs in line with the country's commitments.
- On 12 June 2008, S&P downgraded Ukraine's long-term foreign currency rating from "BB–" to "B+", citing "the failure of authorities to put into place adequate policy measures to counter rising inflation in Ukraine's overheating economy". On May 14, Fitch revised Ukraine's sovereign outlook to 'stable' from 'positive'.
- Spreads on 5Y CDS averaged 400 bps in early July compared with 132 bps in June 2007, before the global banking crisis began.

Turn of the tide?

Political uncertainty to continue until 2010

On 6 June 2008, two MPs of the ruling coalition abandoned the governing coalition of the NUNS (Yushchenko) and BYUT (Tymoshenko) parties, leaving the government with the support of only 225 deputies, one short of the majority. However, the constitutional court ruled the provisions of the law "On the status of parliament members" dealing with quitting factions to be unconstitutional. The defections were thus illegal and the government has technically still a majority. On 11 June, a non-confidence vote organized by the Party of the Regions (Yanukovich) failed. Neither the Lytvyn Bloc nor the Communists voted for the dismissal, despite being among the most active critics of the government, obviously because of poor polls and tactical games to gain more from the Party of the Regions. The threat of government dismissal remains looming and new constellations might be seen in autumn. The situation is shaky not only because of the weak backing of the government in parliament but also because of the ongoing rift within the coalition. Disputes include all major topics from fiscal and monetary policy through privatization to energy policy and the constitution. This leaves plenty room for political combinations. Stabilization can be expected only after early parliamentary elections or after the presidential elections due in early 2010.

Booming consumption, weakening investment

Ukraine's economy grew by 6.4 % yoy in Jan–May 2008, according to preliminary UkrStat estimates. Manufacturing and trade were the main driving forces, whereas value-added in construction fell. Real disposable income grew by 17.7 % yoy in Jan–April despite high inflation, real wages by 11.9 %. Industrial output was by 7.5 % higher in H1 than the year before, with the production of transport equipment soaring by 40.8 % yoy. Retail sales increased by impressive 28.8 % yoy in real terms in H1.

Real GDP growth in Q1 was revised to 6.5 % yoy from 6.0 %. Private consumption increased by 20.2 % yoy in Q1, up from 17.4 % yoy in Q4 2007. Gross fixed capital inflation slowed by contrast to 14.7 % from 23.8 % in Q4, which amounts to only a 0.4 qoq increase in seasonally adjusted terms, according to our calculation. Public consumption grew by 1 % yoy, imports of goods and services increased by 20.2 % yoy at constant prices, exports only by 0.9 %. Given the strong growth in early 2008, we revise our GDP forecast for 2008 from 5.4 % to 5.8 %.

Record high Inflation

Consumer price growth peaked at 31.1 % yoy in May 2008. June saw a decline in the inflation rate to 29.3 % yoy, and also in seasonally adjusted mom terms some moderation is visible. However, with further increases in the tariffs for communal and housing services and gas price hikes on the agenda (13 % for households and 12 % for corporate consumers), also the new government forecast of 15.9 % yoy in December 2008 appears far off. We expect now December inflation of some 20 % yoy and average 2008 inflation of 25.5 %.

The monetary paradigm has changed

To reign in inflation and mitigate growth in credit risk, the central bank (NBU) adopted several tightening and regulatory measures. It raised the average weighted interest rate of its refinancing operations stepwise from 8.9 % in September 2007 to 15.6 by June 2008. Reserve requirements for banks on loans (up to 6 months) from non-residents increased from 4 % to 20 % as of July. Even more important: the NBU changed its FX policy fundamentally on 21 May 2008 and appreciated the official exchange by 4.1 % to 4.85 per 1 USD after having it kept at 5.05–5.06 to the dollar for a long time and has altered the FX rate on an almost daily basis since. On 4 July 2008, after some disputes, the NBU Council confirmed for the next 6 months the rate at a parity of 4.85, with a fluctuation band of +/–4 %. Discussions may resurface however in autumn related to discussions about the budget 2009.

Credit growth began to slow

As a result of changed NBU policies and lower refinancing from abroad, banking sector liquidity became scarce in Q2. The overnight KievPrime interbank rate increased to as much as 30 % in April when the NBU abstained from FX purchases in the run-up to its new FX policy. Loan growth halved to average 2.5 % mom in April–June, from 5.0 % in April–June 2007, with growth in corporate loans declining to 2.5 % from 4.4 % and in retail loans to 2.6 % from 6.2 %. Mortgage loans even fell by 0.2 % mom in May while they had increased 5.4 % in May 2007. The increase in deposits declined to average 2.2 % mom in April–June from 3.3 % mom in April–June 2007. Although the liquidity squeeze has eased and the O/N KievPrime fell to slightly above 2 % by mid-July, Q2 was probably the turning point at which banks began to scale down business plans. The expected slow-down in credit growth has arrived.

Fiscal dispute prolonged

On July 7, the cabinet proposed to parliament to amend the 2008 budget law and to increase projected state budget revenues by UAH 25.4 bn and spending by UAH 24.0 bn (including an increase of UAH 10.4 bn in social transfers). This would reduce the budget deficit marginally to UAH 18.7bn or 1.95 % of GDP. On 10 July, President Yushchenko submitted his own amendments. On July 11, parliament rejected both the government's and the president's draft and sent them for perfection to the budget committee. Premier Tymoshenko announced that the government would analyze possibilities of distributing UAH 32 bn of additional expenditures before the budget amendments are adopted. The surplus of the consolidated budget of the central government and the local authorities equalled 3.4 % of GDP in Jan–May, roughly the same as last year, but expenditures were by 0.5 % of GDP lower in 2008 than in 2007. We believe that a way will be found to increase them, resulting in a widening of the consolidated budget deficit to 1.4 % of GDP.

Event	Date	Reading
2009 Budget draft	Autumn	The related debate is likely to further aggravate political tensions.

Annex

Country Ratings – foreign currency long term debt

		Current Rating	Upgrade from	On (date)	Outlook	Date
Bosnia & Herzegovina	Moody's	B2	B3	17-May-06	Stable	24-May-06
	S&P	–	–	–	–	–
	Fitch	–	–	–	–	–
Bulgaria	Moody's	Baa3	Ba1	01-Mar-06	Positive	23-Feb-07
	S&P	BBB+	BBB	26-Oct-06	Stable	26-Nov-07
	Fitch	BBB	BBB–	17-Aug-05	Negative	31-Jan-08
Croatia	Moody's	Baa3	–	–	Positive	18-Jul-07
	S&P	BBB	BBB–	22-Dec-04	Stable	11-Jul-07
	Fitch	BBB–	BB+	28-Jun-01	Stable	28-Aug-07
Czech Republic	Moody's	A1	Baa1	12-Nov-02	Positive	24-May-06
	S&P	A	A–	02-Oct-07	Stable	02-Oct-07
	Fitch	A+	A	04-Mar-08	Stable	04-Mar-08
Estonia	Moody's	A1	Baa1	12-Nov-02	Stable	12-Sep-07
	S&P	A	A–	17-Nov-04	Negative	21-Jan-08
	Fitch	A	A–	07-Jul-04	Negative	31-Jan-08
Hungary	Moody's	A2	A1	22-Dec-06	Stable	22-Dec-06
	S&P	BBB+	A–	15-Jun-06	Negative	14-Mar-08
	Fitch	BBB+	A–	06-Dec-05	Stable	05-Nov-07
Kazakhstan	Moody's	Baa2	–	–	Stable	09-Jun-06
	S&P	BBB–	BBB	08-Oct-07	Negative	29-Apr-08
	Fitch	BBB	BBB–	20-Dec-05	Negative	17-Dec-07
Latvia	Moody's	A2	Baa2	12-Nov-02	Stable	12-Sep-07
	S&P	BBB+	A–	17-May-07	Negative	21-Jan-08
	Fitch	BBB+	A–	17-Aug-07	Negative	31-Jan-08
Lithuania	Moody's	A2	A3	12-Sep-06	Stable	12-Sep-06
	S&P	A–	A	30-Jan-08	Negative	30-Jan-08
	Fitch	A	A–	23-Oct-06	Negative	07-Dec-07
Macedonia	Moody's	–	–	–	–	–
	S&P	–	–	–	Stable	08-May-06
	Fitch	BB+	–	02-Dec-05	Positive	14-Aug-07
Poland	Moody's	A2	Baa1	12-Nov-02	Stable	24-May-06
	S&P	A–	BBB+	29-Mar-07	Positive	21-Feb-08
	Fitch	A–	BBB+	18-Jan-07	Stable	18-Jan-07
Romania	Moody's	Baa3	Ba1	06-Oct-06	Stable	06-Oct-06
	S&P	BBB–	BB+	06-Sep-05	Negative	05-Nov-07
	Fitch	BBB	BBB–	31-Aug-06	Negative	31-Jan-08
Russia	Moody's	Baa1	Baa2	16-Jul-08	Positive	16-Jul-08
	S&P	BBB+	BBB	04-Sep-06	Positive	11-Mar-08
	Fitch	BBB+	BBB	25-Jul-06	Stable	16-Aug-07
Serbia	Moody's	–	–	–	–	–
	S&P	BB–	B+	18-Jul-05	Negative	11-Mar-08
	Fitch	BB–	–	19-May-05	Stable	02-Aug-07
Slovakia	Moody's	A1	A2	17-Oct-06	Stable	17-Oct-06
	S&P	A	A–	19-Dec-05	Positive	03-Mar-08
	Fitch	A+	A	08-Jul-08	Stable	8-Jul-08
Slovenia	Moody's	Aa2	Aa3	26-Jul-06	Positive	29-Jul-06
	S&P	AA	AA–	16-May-06	Stable	02-Mar-07
	Fitch	AA	AA–	12-Jul-06	Stable	16-Oct-07
Turkey	Moody's	Ba3	B1	14-Dec-05	Stable	24-May-06
	S&P	BB–	B+	17-Aug-04	Negative	03-Apr-08
	Fitch	BB–	B+	13-Jan-05	Stable	12-Dec-07
Ukraine	Moody's	B1	B2	10-Nov-03	Positive	10-Nov-06
	S&P	B+	BB–	12-Jun-08	Stable	12-Jun-08
	Fitch	BB–	B+	21-Jan-05	Stable	14-May-08

Ratings' movements since the beginning of 2008: downgrade upgrade

Source: Moody's, S&P's and Fitch's.

Country ceiling ratings scale

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
Moody's	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
S&P's	AAA	AA+	AA	AA–	A+	A	A–	BBB+	BBB	BBB–	BB+	BB	BB–	B+	B	B–	CCC+
Fitch's	AAA	AA+	AA	AA–	A+	A	A–	BBB+	BBB	BBB–	BB+	BB	BB–	B+	B	B–	CCC+

5-Y Credit Default Swaps (USD, bp)

	quarterly – eop.				Latest	Latest YTD
	Q3 2007	Q4 2007	Q1 2008	Q2 2008	10-Jul-08	% change
Bulgaria	30	72	181	159	157	118.8 %
Croatia	30	66	131	95	88	33.4 %
Czech R.	7	16	42	28	28	69.2 %
Hungary	32	49	176	134	121	149.5 %
Kazakhstan	113	203	282	222	224	10.0 %
Latvia	10	138	156	167	200	45.1 %
Poland	14	24	73	51	49	108.5 %
Romania	41	82	204	192	192	133.9 %
Russia	71	88	148	108	110	24.5 %
Serbia	157	227	250	246	245	8.2 %
Slovakia	6	7	17	30	31	87.9 %
Turkey	146	164	167	309	315	88.3 %
Ukraine	135	193	242	378	392	62.0 %

Source: Bloomberg.

Money market interest rates, avg.

	Jun-07	Apr-08	May-08	Jun-08	Jun-07/Jun-08 difference
Bulgaria – 1M Interbank mid	4.33	6.42	6.49	6.60	2.28
Croatia – 1M Zibor mid	5.62	5.36	5.45	5.44	–0.18
Czech Rep – 1M Pribor mid	2.81	3.89	3.87	3.87	1.07
Estonia – 3M Talibor	4.47	5.73	5.81	5.93	1.45
Hungary – 1M Interbank	7.97	8.05	8.35	8.58	0.62
Kazakhstan – 1M Kibor	4.90	7.71	7.87	7.86	2.96
Latvia – 3M Rigibor	6.66	4.97	4.76	5.23	–1.43
Poland – 1M Wibor mid	4.44	6.10	6.19	6.26	1.82
Poland – 3M Wibor mid	4.51	6.29	6.41	6.58	2.07
Romania – 1M Bubor mid	7.00	11.38	10.58	10.98	3.98
Russia – 3M Interbank	4.94	7.17	6.64	6.29	1.35
Slovakia – 1M Bribor mid	4.27	4.23	4.26	4.27	0.00
Slovakia – 3M Bribor mid	4.27	4.28	4.32	4.34	0.08
Turkey – 1M Interbank	17.70	15.58	16.11	17.24	–0.46

Source: Bloomberg.

Exchange rates – ECB methodology

			Exchange rate vs EUR – quarterly eop.				Latest	Latest YTD
	Regime	Target	Q3 2007	Q42007	Q1 2008	Q2 2008	10-Jul-08	% change
Bulgaria	Currency Board	EUR	1.96	1.96	1.96	1.96	1.96	0.0 %
Croatia	Managed Float	Informal peg to EUR	7.27	7.33	7.27	7.24	7.24	–1.3 %
Czech Rep.	Managed Float	Inflation	27.53	26.52	25.23	23.87	23.49	–11.4 %
Estonia	Currency Board	ERM II: central parity at 15.6466 EEK to 1 EUR, +/–15 %	15.647	15.647	15.647	15.647	15.647	0.0 %
Hungary	Managed Float	Central parity at 282.36 to 1 EUR, +/–15 %	250.98	253.04	260.65	235.56	231.23	–8.6 %
Kazakhstan	Free Float	Inflation	171.38	177.17	190.22	189.38	188.64	6.5 %
Latvia	Currency Board	ERMII: central parity at 0.702804 to 1 EUR, +/–15 %	0.705	0.697	0.698	0.705	0.702	0.7 %
Lithuania	Currency Board	ERM II: central parity at 3.4528 to 1 EUR, +/–15 %	3.45	3.45	3.45	3.45	3.45	0.0 %
Poland	Free Float	Inflation	3.77	3.60	3.52	3.36	3.27	–9.2 %
Romania	Managed Float	Inflation (1 new RON = 10,000 ROL)	3.34	3.58	3.73	3.65	3.58	0.0 %
Russia	Managed Float	Control floating, inflation band	35.45	35.94	37.09	36.93	36.87	2.6 %
Serbia	ManagedFloat	Inflation	79.31	78.80	82.43	78.51	78.70	–0.1 %
Slovakia	Managed Float	ERM II: central parity at 30.1260 to 1 EUR	33.89	33.62	32.50	30.21	30.31	–9.8 %
Ukraine	Free Float	USD de facto	7.17	7.36	7.89	7.19	7.29	–0.9 %
Turkey	Free Float	Inflation	1.72	1.71	2.11	1.93	1.93	12.8 %

Source: Bloomberg.

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