

**CEE**

Quarterly

**Economics & FI/FX Research**

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4Q **2011**

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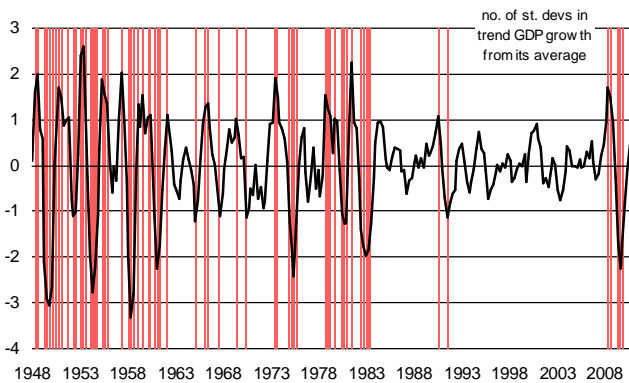
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## CEE: Risk awareness

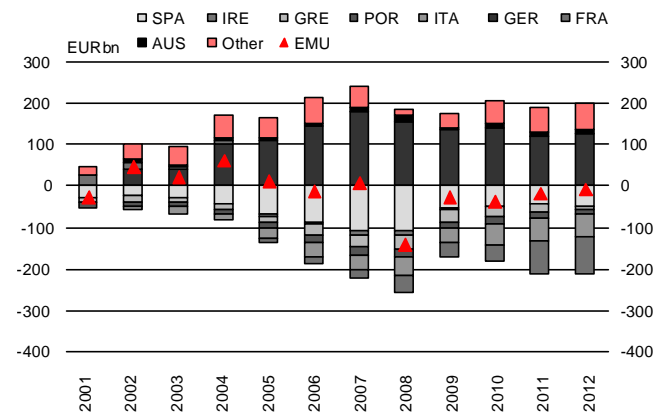
### It was never going to be easy

The past quarter has taught us the perils of post crisis consolidation against a backdrop of elevated debt levels. It is not a smooth path – aftershocks are unavoidable. We believe that what we are seeing currently is a return to a more volatile global macro environment as was evident for a number of decades up until the mid-1980s. This represents an environment whereby GDP in the developed world will no longer display a smooth upward trend but instead gains in GDP will be characterized by pauses and at times mini reversals. Working through the excesses of the past decade and the crisis-related spike in both public and private sector debt is at a minimum a multi-year process. That said against this backdrop there are some clear downside risks and much more limited scope for policy mistakes.

Back to a world of higher macro volatility  
(US, red line signals more than 1 std from average)



EMU is at the beginning of a multi year adjustment (C/A balance)

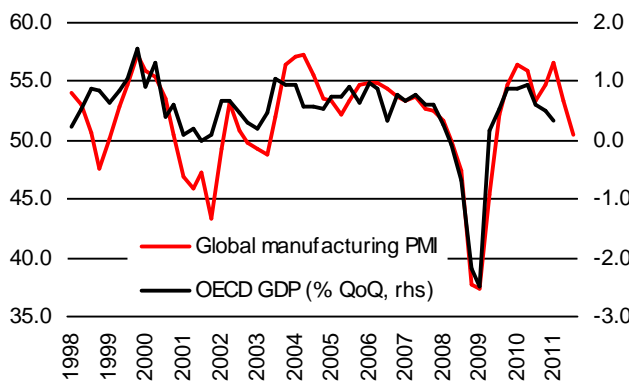


Source: Bloomberg, IMF, Eurostat, UniCredit Research

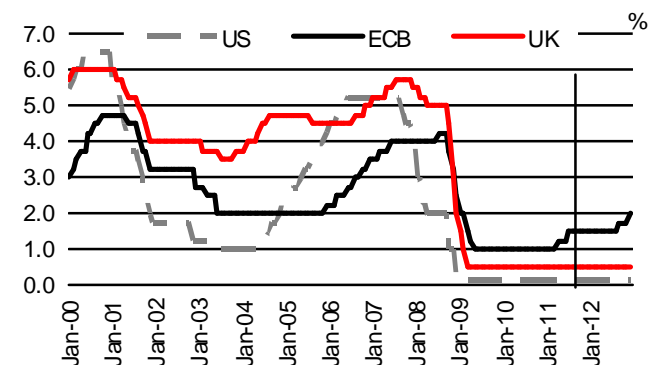
### Marking down 2011 and 2012 growth

The combination of a weak Q2, limited improvement in the macro data quarter to date, the escalation in the EMU crisis and financial market instability has prompted us to reduce our forecasts for growth in both the Euro Area and US for this year and next. We have reduced our forecasts for the US, Euro Area and Germany for this year by 1.0pp, 0.5pp and 0.5pp to 1.5%, 1.6% and 3.0% respectively. The reductions to our 2012 forecast are more significant – we have taken down the US, Euro Area and Germany by 1.2pp, 0.8pp and 0.75pp to 1.5%, 0.9% and 1.0% respectively.

Economic activity is down but not out



A period of extended low policy rates



Source: IMF, Bloomberg, Markit, OECD, UniCredit Research

**Baseline: Slow growth but not recession**

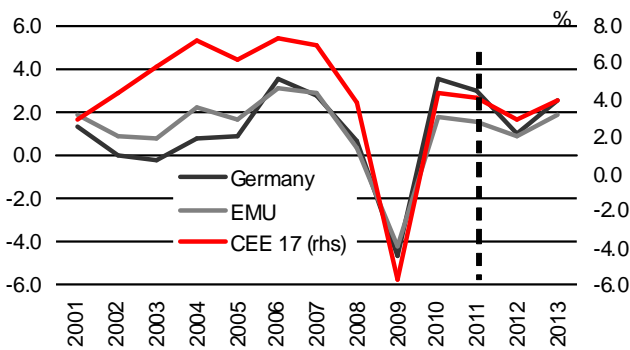
The message from our forecast is one of an extended period of sluggish growth, with risks in both directions. However at this stage there is little in the data to suggest a return to a 2008-style 'sudden stop' scenario while more accommodative monetary policy should also help ease the burden. We now expect the Fed to leave its policy rate on hold until mid-2013, announce an extension to the average maturity profile of its portfolio on 21st September and another round of QE by year-end. While previously we expected the ECB to bring its policy rate to 2.0% by end next year, we now expect the ECB to leave its policy rate on hold until mid next year, before hiking 50bp to 2.0% in 2H12.

**Assessing the collateral damage**

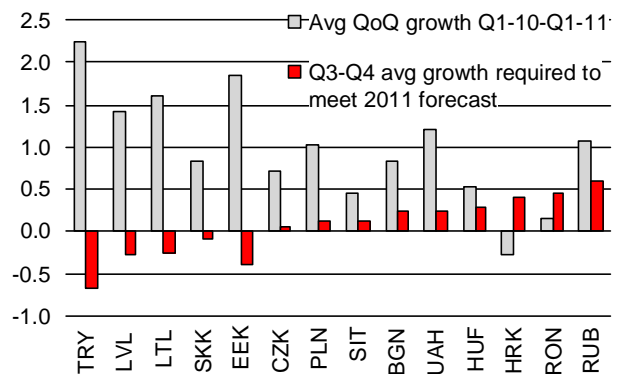
**CEE: We see more moderate GDP growth but do not expect contraction**

The positive news for CEE is that compared with 2008, CEE is not in the eye of the storm. That said, macro trends in CEE remain heavily correlated with those in the developed world, in particular EMU, and some pass-through is inevitable. As a result we have marked down our forecasts for growth in the region for both this year and next by 0.4pp and 0.6pp to 4.1% and 3.3% respectively. For 2013 we forecast GDP at 4.2%, 1.7pp below its pre-crisis long term average. We see risks in both directions to our forecasts.

CEE GDP to move in line with trends in the developed world



Our forecasts assume a sluggish H2 for most



Source: Eurostat, national statistical agencies, UniCredit Research

**A weak Q2...**

Q2 showed clear signs of slowing gains in economic activity in the region, though some held up much better than others. Amongst the weaker economies were Czech, Hungary, Romania, Slovenia, Croatia, Ukraine and Russia where GDP in QoQ terms either flatlined or rose only by a couple of tenths, though in part this reflects payback for a strong 1Q. Other countries surprised us on the upside. For example Turkey posted gains of 1.3% QoQ while Poland posted a robust 1.1% QoQ. The Baltic economies also continued to show strong gains.

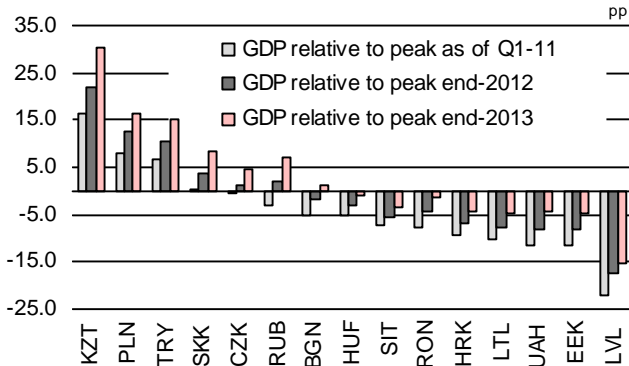
**...followed by a sluggish Q3-Q4...**

The combination of European banking sector woes, continued soft PMI data and downgrades to our forecasts for the developed world means we have penciled in a much softer 2H followed by a gradual recovery over the course of 2012. Our revised forecasts for this year assume that over 2H11 in the vast majority of countries QoQ gains will be at best modest and well below average QoQ growth over the five quarters to 1Q11. Russia, Romania and Croatia represent exceptions but at least in the case of Russia and Romania we see country-specific factors playing a role. In Russia pre-election spending will support domestic demand, we expect oil prices to remain elevated while lower inflation will support real consumer purchasing power. In Romania the impact of last July's 5pp VAT hike has fallen from the base, aiding consumption.

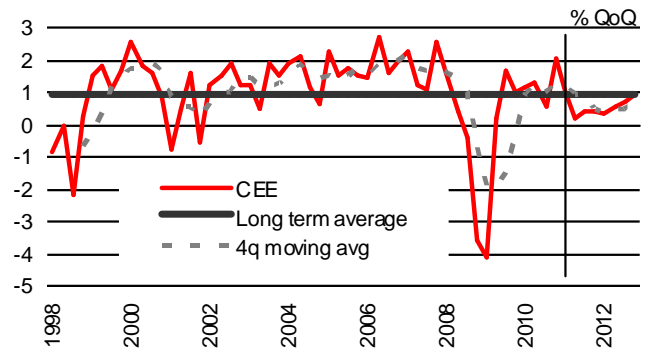
**...and an improving 2012**

This is followed by a gradual recovery next year, with 2H stronger than 1H. Our path is smooth but conservative. It does not incorporate a quarter of contraction but is cautious enough to facilitate a quarter of modest contraction without significant revision to the whole horizon.

By end-2013 GDP will not yet have recovered to its pre-crisis peak in some countries in CEE



Real GDP growth in CEE from here<sup>1</sup>



Source: Eurostat, national statistical agencies, UniCredit Research

**A region of two halves – leaders and laggards**

There is significant differentiation in the extent to which we have marked down our forecasts across the countries in question, though in the vast majority of cases we are now significantly below consensus forecasts. The smallest revisions are concentrated in the oil exporting countries given that we have not adjusted our forecast for oil prices downwards but instead project oil prices at USD 110 per barrel, USD 113 per barrel and USD 122 per barrel on average in 2011, 2012 and 2013 respectively. Assuming our forecasts prove correct, this region will remain one of two halves. The stronger countries will be those that have managed to recover to their pre-crisis GDP levels. This is already the case for Kazakhstan, Poland, Turkey and Slovakia. However even by end-2013 our forecasts indicate that GDP in Hungary, Slovenia, Romania, Croatia, Latvia, Ukraine, Estonia and Lithuania will not have returned to its pre-crisis peak.

**Inventories cannot generate as much of a drag on GDP in 2008/09**

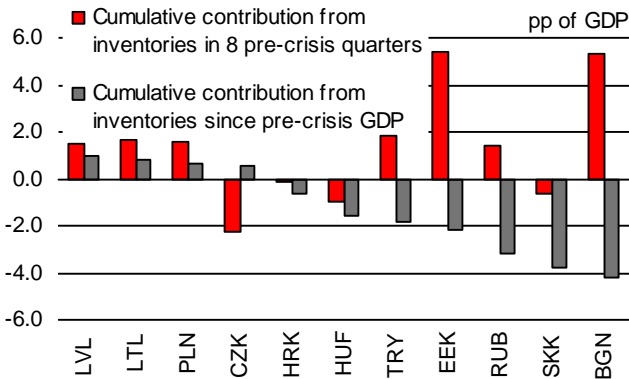
For a number of reasons we are not pushing ahead with a more pronounced downgrading of our growth forecasts despite global financial market turmoil. Firstly both inventories and C/A balances have corrected significantly. As shown below a number of countries in the region entered 2008 having seen inventories account for a decent portion of growth over the preceding quarters. This was most pronounced in Turkey, Estonia and Bulgaria. At this stage inventories on a cumulative basis since the 2008 crisis have acted as a drag on growth in many countries in the region, suggesting more limited risk to GDP this time around.

**Forced closure of C/A deficits much less of a risk**

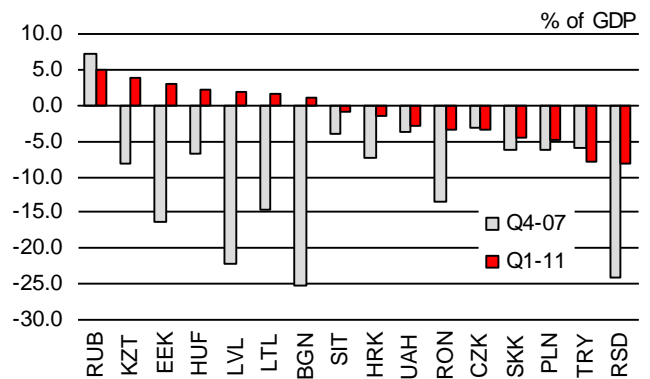
We see a forced C/A balance adjustment as much less of a risk in most countries in the region. Entering 2008, with the exception of a handful of economies, CEE economies were running large and at times double digit C/A deficits. To the extent that their financing translated into a persistent increase in external debt to GDP ratios, they were unsustainable. A halt to global capital flows saw financing of these deficits evaporate almost overnight, forcing rapid adjustment in these deficits and more broadly economic activity. However in the majority of cases countries in the region are now running much narrower C/A deficits, if not at times surpluses. Turkey and Poland represent the exception, an issue we will return to later in this discussion.

<sup>1</sup>Due to limited data availability, our aggregate includes Bulgaria, Czech, Estonia, Hungary, Latvia, Lithuania, Poland, Russia, Slovakia, Slovenia and Turkey.

Inventories are not as big a threat this time around...



...and the difficult period of C/A adjustment is now behind us



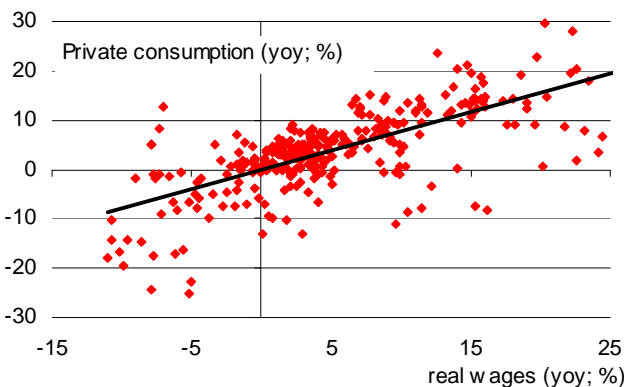
Source: National central banks & statistics agencies, UniCredit Research

### Lower inflation should aid the consumer

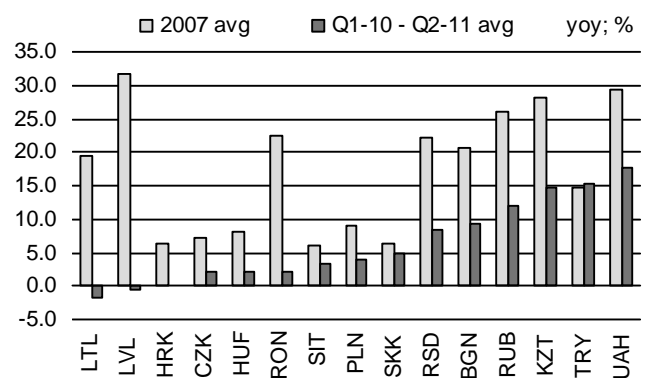
Lower inflation will aid consumers

Declining inflation in the region will support real consumer purchasing power, acting as a buffer against a slump in external demand and boosting what has been to date in a number of countries a very lacklustre consumer. Turkey is the only country in the region where nominal wage growth has recovered to anywhere close to its pre-crisis rates. In many other countries in the region, weak labour markets meant little pressure from employees for nominal wage growth to keep pace with inflation. From sub-4% YoY throughout H1-10, average inflation in the region hit 6.0% in May, further eroding consumer purchasing power. However since May inflation in the region has begun to ease once again, a trend which we expect to remain through Q4 and into Q1 next year, driven by a lower rate of food and energy price inflation.

Real wage growth is the primary driver of consumption...



...but nominal wage growth has not recovered in some countries despite higher inflation



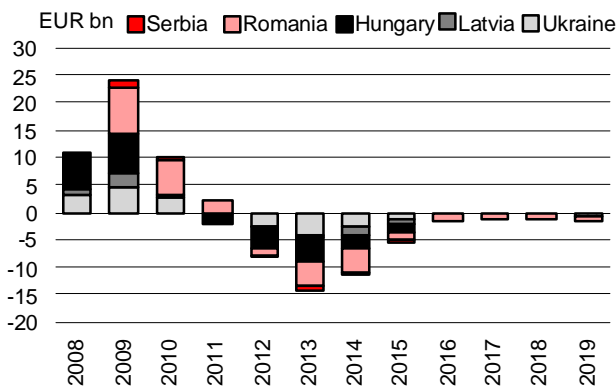
Source: National statistics agencies, UniCredit Research

### Fiscal policy: Pressure to consolidate has moderated in most countries

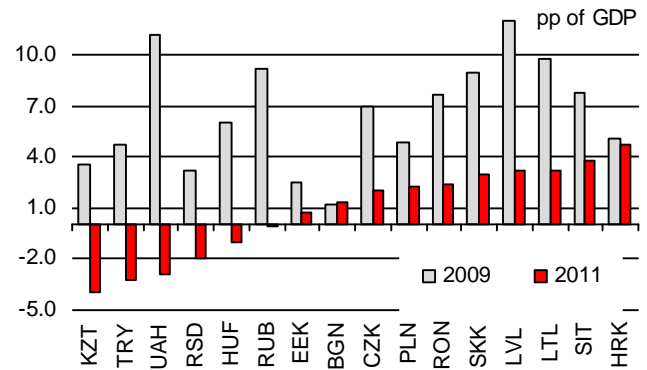
**The IMF is on 'stand by' for some**

The continued presence of the IMF in the region provides a buffer against the implications of a sharp external shock, were it to materialise. At this stage IMF disbursements have come to halt and over the coming year all 5 countries under our coverage with stand-by programmes will begin to repay borrowed funds. Scheduled repayments for next year stand at EUR 8.2bn in total. That said Romania and Serbia have rolled into precautionary programmes with the EU/IMF and have the potential to draw off EUR5bn and EUR1bn of funding if needs be. Latvia's programme rolls off at the end of this year but in the lead up to September's general election government rhetoric on fiscal consolidation has been market friendly. Ukraine and Hungary are in more vulnerable positions to the extent that progress on Ukraine's programme has come to a halt while Hungary has not rolled into a precautionary arrangement. At least in Ukraine's case a new disbursement could be quickly triggered in the event that the government met conditionality, including another round of gas price hikes.

EUR/IMF disbursements & repayments assuming no further drawdowns in the region



Adjustment in primary balance required to stabilise public debt to GDP (positive number signals need for consolidation)



Source: IMF, national statistics agencies & finance ministries, UniCredit Research

**Most have achieved progress on fiscal consolidation**

The vast majority of countries in the region have made progress in reducing budget balances to levels which stabilise public debt to GDP. For example Hungary, Serbia and Ukraine will run budget balances this year that reduce public debt to GDP, in all cases a huge improvement relative to where governments stood in 2009. Most of the new EU countries still need to push through consolidation measures in the region of 1-3pp of GDP to stabilise public debt but our forecasts show significant progress next year, in particular in Latvia, Poland and Slovakia. Two Balkan economies, Slovenia and Croatia, have the most work still to do, even by end-2012.

**Elections may delay but not reverse consolidation measures**

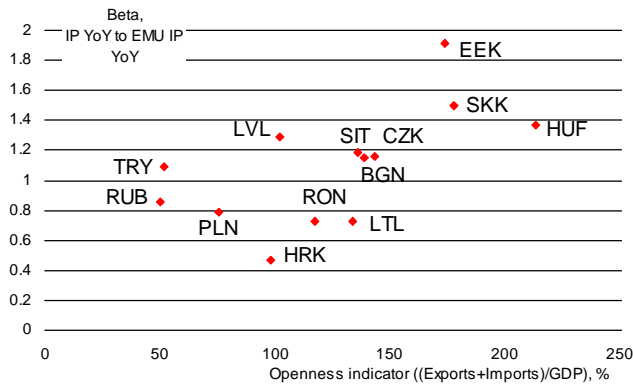
The elections schedule over the coming quarters is busy. Latvia's general election is just behind us while Poland faces a general election in early October. Russia has parliamentary elections scheduled for December, Presidential elections for Q1 next year. Croatia holds a general election early December, Romania late next year and Ukraine and Serbia in Q4 next year. In both Poland and Latvia, we expect election outcomes to solidify commitment to continued consolidation. In Ukraine election prospects have already translated into a delay in reforms while we see similar risks in Romania and Serbia, though Serbia's recent announcement of a new precautionary agreement with the IMF is a clear positive while Romania remains under an IMF anchor. In Croatia should the new government not press ahead with much needed meaningful fiscal consolidation measures, as well as structural reform, the downward risk to ratings (BBB-, negative outlook, by Fitch & Moody's) is significant.

### Monitoring downside risks closely

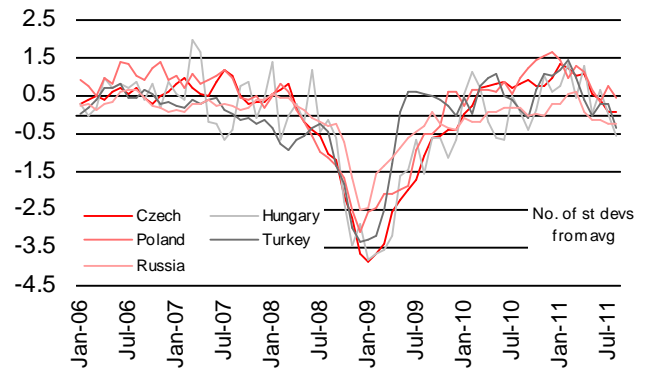
Three inter-related drivers would push our growth forecasts notably lower

We have compiled these forecasts at a time of severe market stress, with the ultimate impact on growth uncertain at the time of writing. To date none of the data available to us shows evidence of a 2008-like collapse in economic activity but should financial markets continue to deteriorate, this would become more of a risk. In assessing this risk, we monitor three key sets of interrelated data.

Some countries more vulnerable to EMU slowdown than others



Manufacturing activity has slowed but not collapsed

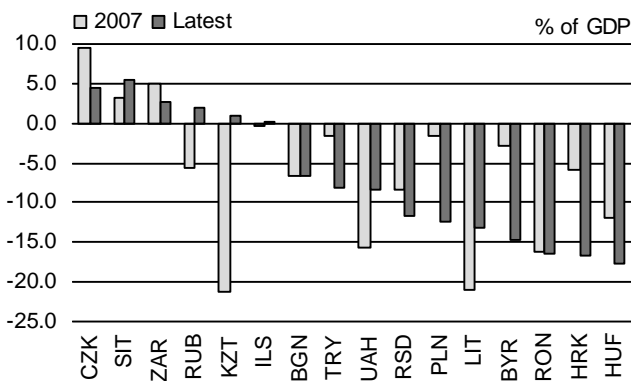


Source: National central banks, ministries of finance & debt management agencies, UniCredit Research

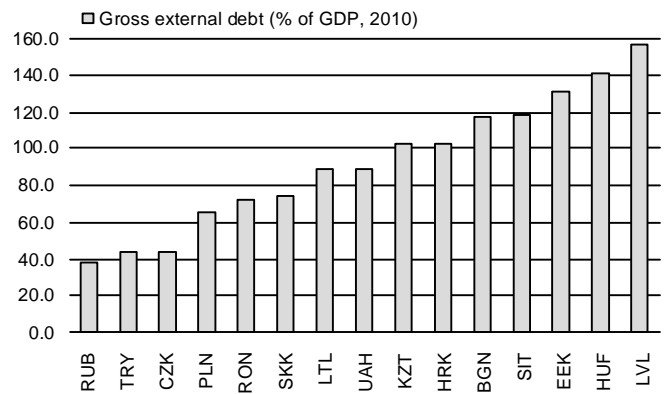
A further decline in external demand would hurt some countries more than others

Another leg downwards in external demand and industrial production would take its toll in particular on countries such as Hungary, Czech Republic, Slovakia and Estonia. As shown above the sensitivity to changes in external demand is highest in these countries while it also represents a key driver of growth for most as domestic demand remains weak. The good news is that to date the manufacturing PMI data shows a sharp decline in economic activity but only to bring it broadly in line with its long term average. Meanwhile the latest available July IP data showed a more constructive picture. For example industrial production in July in Turkey bounced 2.7% MoM, reversing 75% of its losses over the previous 5 months. Industrial production in Romania, Hungary and Czech showed gains of 1.2%, 0.8% and 0.1% MoM SA respectively.

Banking sector reliance on foreign capital varies significantly...



...as does gross external debt

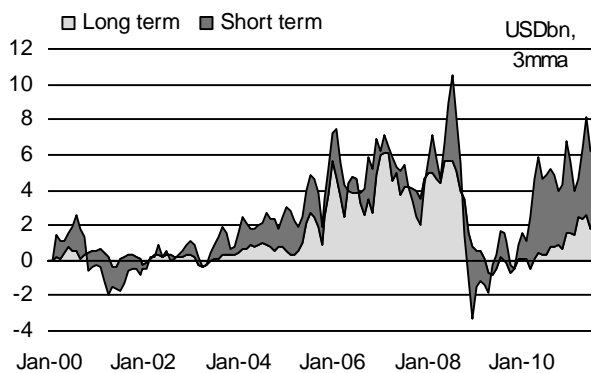


Source: National central banks, UniCredit Research

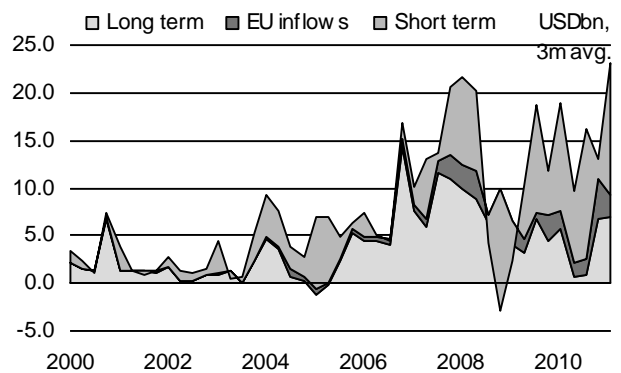
**A collapse in foreign funding for the banking sector would be problematic for some**

Given increased banking sector stress, we monitor banking sector reliance on foreign funding. Since the 2008 crisis some countries have seen large improvement on this front. Both Russia and Kazakhstan have seen the net foreign asset positions of their banking sectors shift from negative to positive. However Hungary, Croatia and Romania have not shown improvement and in some cases disimprovement. Turkey and Poland have also seen deterioration to the tune of 5.2pp and 9.3pp of GDP since end-07 respectively. This divergence in reliance on external capital across the region is relevant not only to banking sectors, but public and private sectors as a whole, with gross external debt varying from less than 40% of GDP at the end of last year in Russia to over 150% of GDP in Latvia. A sudden stop in such flows would force a tightening of C/A balances, limit new credit extension and negatively impact economic activity.

Turkey: A breakdown of capital inflows



Poland: A breakdown of capital inflows



Source: CBT, NBP, UniCredit Research

**A reversal of portfolio inflows would prove problematic for some countries**

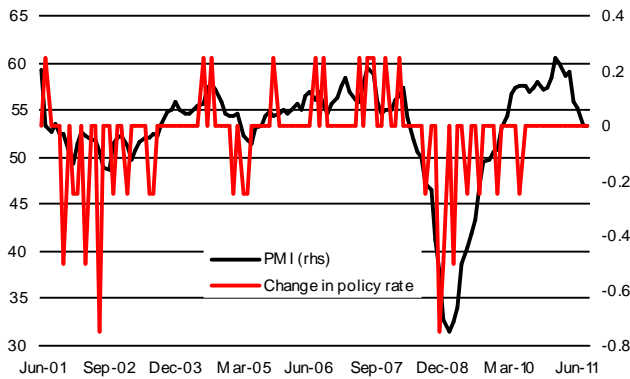
Since the 2008 crisis there has been a sharp shift in the composition of capital flows to the region away from FDI and long term lending to banking sectors and towards portfolio flows and in some cases short term bank borrowing offshore (e.g. Turkey). For example last year, 62% of all capital flows to the region were portfolio in nature. Of the EUR 19.3bn in capital flows to the region in 1Q this year, EUR16.5bn or 86% related to portfolio flows. Poland and Turkey were the first to see a recovery, accounting for almost 65% of these inflows, but towards the end of last year and into this year, portfolio flows to weaker economies in the region such as Hungary and Ukraine also increased. To date there are very limited signs of a sharp withdrawal of capital from the region. The stock of foreign holdings of Hungarian fixed income continues to post new highs while inflows to domestic debt in Turkey have stalled but not declined in any significant manner. EM fixed income funds more broadly continue to see inflows. Nonetheless we continue to monitor these closely given that they are more easily subject to reversal than pre-crisis long term capital inflows. In the event of a sharp reversal, funding of governments and in some cases banking sector would be at risk.

**Central banks: A neutral to easing bias**

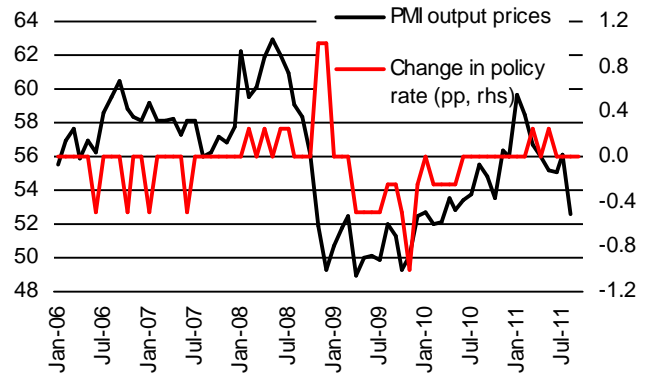
**In the near term risks are weighted towards rate cuts, not hikes**

Against a backdrop of weaker external conditions, easing inflation and a modest recovery in consumption, central banks have stepped away from any tightening of monetary policy. Much more important to determine is which central banks are most likely to leave policy rates on hold from here and which central banks are more likely to cut rates. In most countries in the region, we see central banks on hold for the remainder of this year. This includes Poland, Russia and Romania.

Czech: PMIs suggest that any risk of a near term hike has faded rapidly



Russia: Price pressures have fallen, putting the CBR more at ease



Source: CNB, Markit, CBR, UniCredit Research

**In the near term risks are weighted towards rate cuts, not hikes**

We see Serbia as the most likely country to cut its policy rate further from here, followed by Turkey and Czech, though in the case of Turkey and more so Czech we put that probability below 50%. Even prior to this slump in external demand, Serbia had already initiated a hiking cycle as inflation had begun to ease. The recent announcement on a new IMF agreement, signalling improved commitment to fiscal consolidation, gives the NBS more room to continue on this track. In Turkey we see the CBT as much closer to a rate cut than a rate hike but this will only materialise in the event that the global economy takes another leg downwards. Recent data has pointed to stronger growth and inflation pressures than expected. For the second time in three years the CNB's judgement in Czech of the macro outlook has proved more on the mark than that of the ECB, leaving the CNB comfortable with a policy rate of 0.75%. In the near term any rate move is weighted towards a cut rather than a hike but the negative 75bp spread to the ECB makes an unchanged policy rate most likely.

**Hungary is closest to a hike but still some distance away**

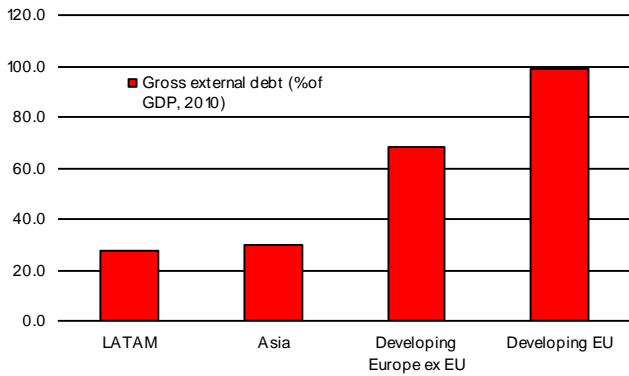
The NBH in Hungary is the central bank closest to a rate hike at this stage but because of financial stability rather than inflation concerns. On inflation the NBH has never been more comfortable. Though on the whole unwelcome, reductions to GDP growth forecasts in Hungary will serve only to re-inforce the NBH's view of well contained inflation pressures. Financial stability is an increased concern however and while more reluctant than at any stage in the past, the NBH has few tools available to it with the exception of a rate hike to stabilise HUF in the case of a continued sell-off. That said, EUR/HUF would need to move rapidly above 300/EUR for this to become a realistic option.

**Stay focussed, be nimble, buy insurance**

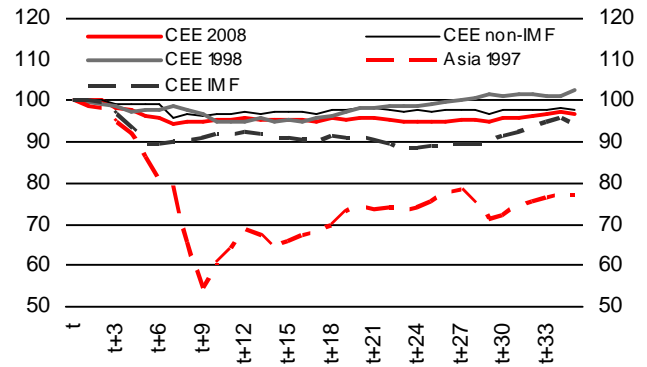
**Policy vigilance is required**

In a world of greater macro volatility, policy mistakes are more likely to cause harm than in the past while insurance in various forms can provide an important cushion to economies at stages over the coming quarters and years. While we believe it important to highlight a variety of efforts taken in the region to set economies on a more sustainable growth path over the last 8-12 quarters, vulnerabilities remain. For example relative to other emerging market regions globally, CEE still remains more heavily indebted to the rest of the world. Relative to currency adjustment seen during the Asia crisis, currencies in CEE have adjusted much less, largely because of concerns about the impact on balance sheets. Moreover at this stage there is little difference in currency adjustment since 2008 on average between those countries that entered IMF programmes and those that did not. This serves only to increase the need for measures to improve competitiveness and growth prospects.

CEE owes more to the rest of the world than LATAM or Asia



FX adjustment in CEE has been much smaller than in Asia during its crisis (t = 3 months prior to beginning of crisis, fx refers to real effective exchange rates)<sup>2</sup>



Source: IMF, BIS, UniCredit Research

**Some central banks need to purchase insurance against sharp outflows of capital**

An examination of central bank ability to defend their currencies/smooth capital outflows relative to 2008 re-inforces the need for such insurance. Below we examine the potential for capital outflows in an extreme scenario whereby we see a repeat of Q4-08/Q1-09. Our estimates work as follows:

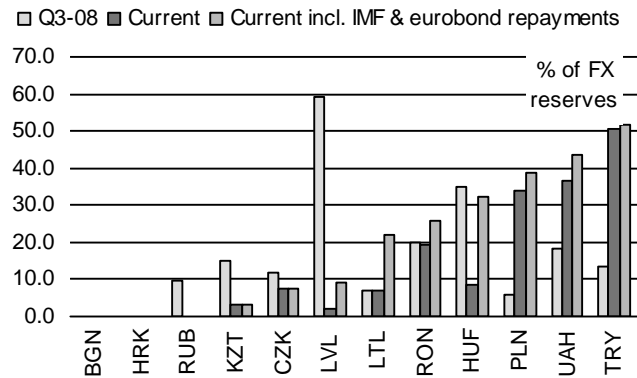
1. We sum portfolio inflows and short term external borrowing (banks, non-bank corporates and governments) between Q1-07 and Q3-08.
2. We then calculate the percentage of these inflows that reversed between 4Q08 and 2Q09, as well as external sovereign debt coming due.
3. We repeat step no. 1 for the period 1Q10 to 2Q11 (though for a number of countries 2Q BoP data is still not available).

From step 2 we apply the same ratio of outflows to inflows as over 4Q08-2Q09. In the event that outflows exceeded 100% of inflows after the 2008 crisis, i.e. all short term borrowing portfolio flows not only fall back to end-06 levels but even further, we capped the outflows at 100%. This is to capture the fact that there has been a more limited time period this time around to accumulate inflows. Finally we add sovereign external debt and IMF repayments coming due until year-end.

According to this metric, Russia, Kazakhstan, Czech and Latvia fare better than was the case in 3Q08, i.e. central banks have more scope to smooth capital outflows via FX reserves. Hungary has seen only modest improvement but remains at the weak end of the spectrum. Romania and Lithuania have also seen deterioration but this is much more pronounced in Poland, Turkey and Ukraine. If central banks in Poland and Turkey were to run down FX reserves to allow all short term capital inflows since the crisis leave the economy, as well as external debt redemptions between now and the end of next year, it would translate into a 39% and 52% decline in FX reserves respectively. Our analysis above does not include cushions such as the Poland's USD30bn FCL from the IMF or the CBT's latest move to allow banks to use FX deposits to cover TRY reserve requirements.

<sup>2</sup>CEE IMF refers to those countries that entered IMF stand-by arrangements in 2008/09, i.e. Hungary, Latvia, Romania, Serbia, Ukraine. CEE non-IMF refers to all CEE countries that did not enter IMF arrangements in 2008/09.

**FX RESERVE COVERAGE OF SHORT TERM CAPITAL INFLOWS & SOVEREIGN REDEMPTIONS**



Source: IMF, national central banks, UniCredit Research

**Greater macro volatility means greater FX volatility but also increased central bank participation in FX markets**

Against such a semi-permanent shift in both macro volatility and capital flows, currency performance will be subject to more volatility while some central banks and governments will be required to be more nimble than in the past. At times this may mean remaining absent from the market for longer than is expected as ammunition cannot be carelessly wasted while some currency volatility may also deter excessive short term inflows. However at other times more aggressive action to stabilise currency performance in both directions may be needed than was the case in the past, e.g. when financial stability begins to be put at risk. This involves absorption of inflows when deemed excessive so that central banks can provide liquidity when there is a rush to the exit. The CBT has already moved in that direction while also trying to improve the composition of capital inflows. Other central banks in the region may well follow.

## Bulgaria (Baa2 stable/BBB stable/BBB- positive)\*

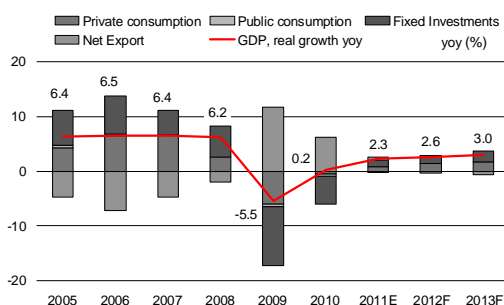
**Outlook** – In line with our projections the Bulgarian recovery lost momentum in 2Q11. With the corporate sector still deleveraging and GDP growth too weak to spur jobs creation, 2012 promises to be another challenging year. Overall, the fundamental problem undermining Bulgarian recovery is the lack of demand on the part of both business and households. From a policy perspective such problems should be addressed with more fiscal and monetary stimulus. But monetary policy is not an option due to the currency board, while fiscal easing looks problematic amid the euro zone sovereign debt crisis. Against this backdrop, policy response, in our view, should concentrate on growth enhancing structural reforms and strengthening the rules to prevent unsound policies.

**Author:** Kristofor Pavlov, Chief Economist for Bulgaria (UniCredit Bulbank)

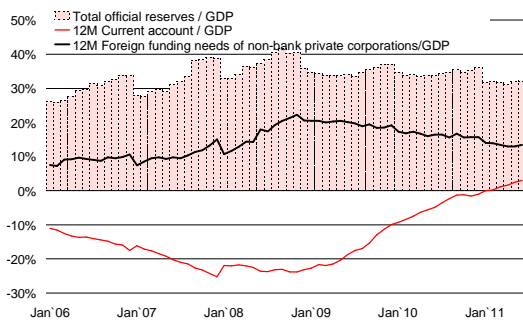
### KEY DATES/EVENTS

- 23 Oct – Presidential and municipal elections
- Oct – XIII annex for construction of Belene nuclear power plant with Russia's Atomstroy export expires
- 15 Nov – Flash estimate of 3Q11 swda GDP figures

### GDP GROWTH AND CONTRIBUTION TO GROWTH



### OFFICIAL RESERVES, CA BALANCE AND 12M FUNDING NEEDS OF NON-BANK PRIVATE CORPORATE SECTOR (JAN 06-JUN 11)



Source: NSI, BNB, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	34.9	36.0	38.4	40.0	42.1
Population (mn)	7.6	7.5	7.4	7.4	7.3
GDP per capita (EUR)	4,618	4,801	5,163	5,425	5,761
<b>Real economy yoy (%)</b>					
GDP	-5.5	0.2	2.3	2.6	3.0
Private Consumption	-7.6	-0.6	1.1	1.9	2.3
Fixed Investment	-17.6	-16.5	6.2	6.7	8.1
Public Consumption	-4.9	-5.0	-2.2	-1.9	0
Exports	-11.2	16.2	7.9	2.5	4.0
Imports	-21.0	4.5	6.3	2.5	4.5
Monthly wage, nominal (EUR)	311	331	351	361	377
Unemployment rate (%)	8.4	11.4	11.3	11.0	10.6
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-0.8	-3.9	-2.8	-2.6	-1.8
Primary balance	0	-3.3	-2.0	-1.8	-0.9
Public debt	15.5	16.7	17.2	20.6	20.1
<b>External accounts</b>					
Current account balance (EUR bn)	-3.5	-0.4	1.2	0.2	-0.8
Current account balance/GDP (%)	-10.0	-1.0	3.0	0.5	-2.0
Basic balance/GDP (%)	-0.3	3.1	4.2	3.2	1.3
Net FDI (EUR bn)	3.4	1.5	0.5	1.1	1.4
Net FDI (% of GDP)	9.7	4.1	1.2	2.7	3.3
Gross foreign debt (EUR bn)	37.7	36.7	35.3	35.2	36.2
Gross foreign debt (% of GDP)	108.0	101.8	92.0	87.9	86.0
FX reserves (EUR bn)	12.9	13.0	13.1	13.7	14.6
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	2.8	2.4	4.3	1.5	2.2
CPI (eop)	0.6	4.5	2.8	1.7	2.4
Central bank reference rate (eop)	0.2	0.2	0.4	1.0	2.9
USD/BGN (eop)	1.37	1.46	1.29	1.36	1.36
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.40	1.47	1.33	1.32	1.32
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Another year of below potential start-stop growth lies ahead

Domestic demand is still far from its credit boosted pre-crisis levels. In 2Q11, individual consumption and GFCF are respectively 7% and 27% below where they were in 3Q08

The elevated gross external financing requirements remain the principal source of weakness

Given the sovereign debt crisis the balance of risks for our baseline scenario is now skewed to the downside

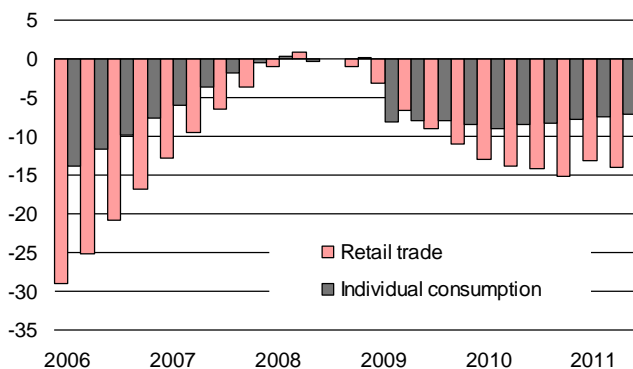
The spike in food and energy prices earlier this year proved temporary and CPI is now on a downward trend

In line with our previous forecast, (see June's Quarterly) GDP growth lost momentum in 2Q11 (up 0.3% qoq and 2.0% yoy). Various factors were at play but the shocks to global food and energy prices, which curbed the purchasing power of household income and undermined net exports, seem to have been the most important ones. Weak foreign capital inflows, as the Greek sovereign debt saga looks far from over, also weighed negatively on GDP growth dynamics in 2Q11. On the positive side, growth showed more evidence of shifting toward a more balanced structure, where domestic demand has a stronger positive contribution to the overall growth dynamics.

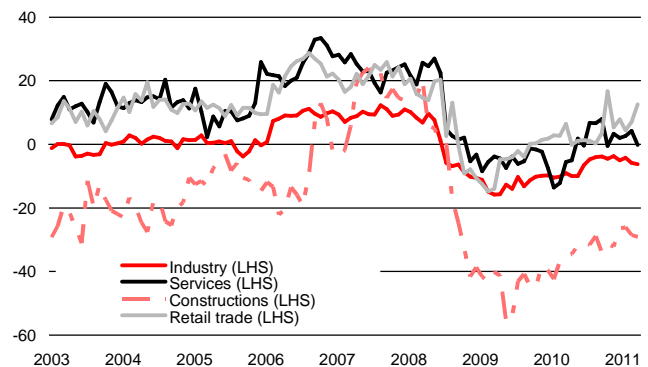
We revised downward our GDP growth projections for this and next year to 2.3% and 2.6% respectively (from 2.8% and 3.3% before). The drags on growth remain considerable. The housing market remains at a stand still. An end to weak capital inflows is still not in sight. The recent worsening of outlook for the economy could well have added to whatever deleveraging the average household or firm might have considered as necessary several months ago. Companies still have little confidence in their own sales and have no enthusiasm to increase capital spending in response. The weak labor market makes households reluctant to put an end to the cash hoarding and increase consumption. And above all, exports are likely to lose pace because not only demand from the euro-zone periphery but also from Germany is set to slow sharply. At the same time, several country specific factors will act in the opposite direction. With the budget deficit target set at 2.5% of GDP this year there will be no need for aggressive fiscal tightening next year. In response, we see the budget deficit target for 2012 only little changed vis-à-vis 2011, thereby ensuring either neutral or a small negative contribution to growth on the part of the public sector. This is in sharp contrast to many CEE countries, which are far from seeing their fiscal consolidation efforts coming to an end anytime soon. The continually improving absorption of EU funds should open up more room for investment in public infrastructure next year. The large gap between contracted (59% of total) and actually disbursed (14%) EU funds suggest that transfers are set to rise markedly. And finally, given the high energy intensity of consumption (Bulgaria uses more than two times extra energy per unit of GDP than the EU average) alleviation of energy prices should provide a stronger positive impulse to Bulgarian recovery than in the rest of the EU region.

Year-on-year CPI receded to 4.4% in July, after peaking at 5.6% in March 2011. This mostly reflects lower food and energy costs as core inflation in July (0.3% yoy) edged down only one notch relative to where it was in March (0.4% yoy). The gap between PPI and CPI also narrowed recently (8.0% in March against 5.0% in July) suggesting that there will be lower pass through effects in the months to come. Inflation expectation, likewise, trended downward. Later this year electricity and heating costs are set to rise moderately, as they follow the global energy prices fluctuations with a considerable time lag. However, this will be more than compensated by easing inflationary pressure in almost all other components of the headline inflation index.

Evolution of retail sales and individual consumption since 3Q08 (3Q08 = 0)



Headline measure of business confidence in industry, services, retail trade and construction (Jun 2003-Jul 2011)



Source: Eurostat, NSI, UniCredit Research

Given the elevated weight of food and energy consumption, we expect Bulgarian headline inflation to exhibit much stronger downward dynamics when compared with other CEE economies

All the above have reinforced our view that when the pass through effect from supply-side shocks to global food and energy prices have come to an end, future inflation will mostly depend on domestic developments and particularly on the pace of labor market recovery. But overall demand conditions will remain weak for the rest of this and next year. Domestic credit is forecast to increase only modestly in 2012. Unemployment is expected to remain stuck at close to the 10% mark while employment will see only a small positive change, if any. Thus, real earnings are set to see only modest gains, suggesting that the labor market will not provide any impetus to inflation next year. Given all of the above, we see eop and avg. CPI next year slowing down to just 1.7% and 1.5% on a yoy basis (from 2.8% eop and 4.3% avg. in 2011).

Given significant degree of fiscal consolidation already achieved this year there will be no need for more fiscal tightening in 2012

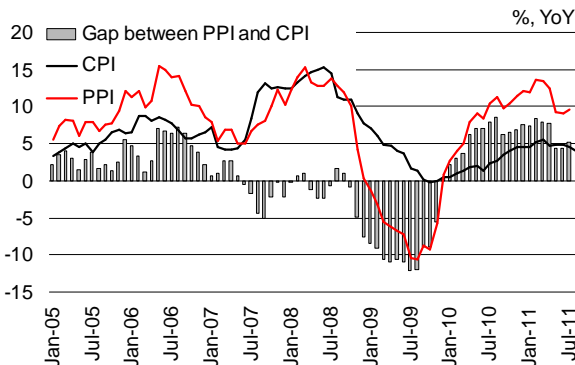
**Strong counter-cyclical fiscal policy during the boom has helped to distance Bulgaria from the fiscal troubles in the eurozone periphery.** The government continued making progress on reducing the budget deficit this year (1.0% of GDP as of July 2011 against 1.7% in 2010) as the effectiveness of its revenue-raising measures improved (tax revenues are 11.2% higher yoy in the seven months to July 2011), while discretionary spending remained well under control (up only 0.6% yoy in the seven months to July 2011). And even though some of the cost cutting seen so far this year looks temporary, as capital spending is set to increase in the run-up to the presidential and municipal elections in October, we see no implementation risk for the budget. Thus, the government is on track to cut its budget deficit below the 3% threshold set by the Stability and Growth Pact this year, which in combination with a public debt to GDP ratio of less than 20%, makes Bulgaria's fiscal metrics one of the most favorable in the entire EU.

Boost in current transfers balance in 2Q11 drew support from improving EU funds absorption

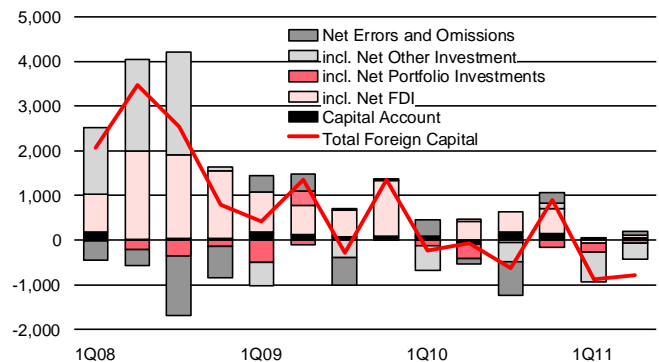
**Positive momentum in C/A dynamics continued in 2Q11 (EUR 310mn surplus) after an almost equally strong reading in 1Q11 (EUR 210mn surplus).** This reflects a combination of a deteriorating merchandise trade balance (EUR 53mn surplus in 1Q11 against EUR 541mn deficit in 2Q11) which was however more than offset by stronger services and the current transfer balance. On the financing side, portfolio and FDI flows disappointed in 2Q11 (EUR 17mn shortfall) though being somewhat less soft than in 1Q11 (EUR 268mn shortfall). Other sources of financing (including net errors & omissions) in 2Q11 (EUR 223mn shortfall) improved relative to 1Q11 (EUR 607mn shortfall) providing further evidence that the pressure on Bulgarian firms and banks to cutback their external liabilities has eased. As a result, EUR 92mn were added to the reserves in 2Q11, following a fall of EUR 665mn in 1Q11. In the context of the fixed exchange rate, the most recent FX reserves data (up EUR 102mn in Jan-Aug this year against EUR 444mn fall one year ago) provided more evidence that the liquidity position of the economy has strengthened. Looking ahead, we see some deterioration in the trade balance as easing global demand will start taking its toll on exports. In 2011 at least, this will be offset to a large degree, as trade will be boosted by a solid rise in tourism and raw agricultural products exports. With net external liabilities at only 4.4% of total assets (EUR 1.8bn) in July (against 8.8% in Dec 2010 and 17.3% at their peak in Nov 2008) the process of bringing banking sector dependence on external funding down to more sustainable levels appears to be over. If deposit volumes continue to exceed lending volumes (which is part of our central scenario for the banking sector) it will come as no surprise if net external liabilities turn positive at some point next year.

Bulgaria's corporate debt is among the EU's highest as a share of GDP.

CPI, PPI and gap (Jan 2005-Jul 2011)



Foreign capital flow, in EUR mn (1Q09-2Q11)



Source: BNB, NSI, UniCredit Research

## Strategy: increased GB issuance, new Eurobond in 2012

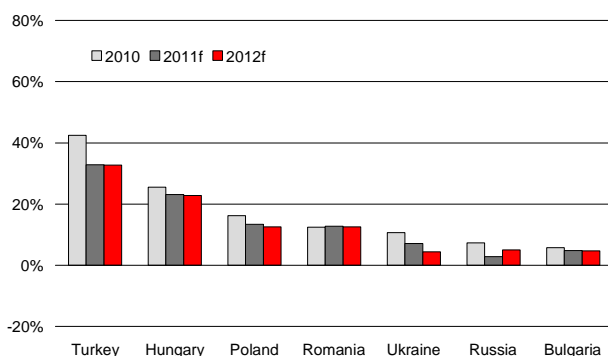
Market conditions dictate increased GB issuance towards the end of 2011

As global economic conditions deteriorate up to the end of 2011 and market volatility makes Eurobond issuance very problematic during the period, we believe the Finance Ministry will have to tap domestic GB markets for its immediate financing needs. **With decreasing room for financing from the fiscal reserve and increased liquidity in the banking sector, GB issuance looks to be the main means of gathering enough funds to plug the budget gap.** We should note that the government is well on its way to reaching the deficit target of 2.5% of GDP at the end of 2011. The healthy fiscal stance of the government allows it to be more conservative and tighten the deficit further, but as economic growth needs this fiscal push and domestic market conditions remain favorable this is not likely to be the case. In our view, domestic GB issuance will be increased from a gross target of BGN 1.050bn to around BGN 1.250bn up to the end of 2011, leaving the Finance Ministry with a fresh goal of selling close to BGN 500mn of medium and long-term papers in 4Q. Already falling yields across the whole length of the yield curve should be further supported by, what is in our view significant room for, a one notch credit rating upgrade from either Moody's or Standard & Poor's during the next 18 months. **Looking ahead, as global economic conditions stabilize in 2012 and some form of final resolution to the Greek sovereign debt crisis is reached, the Finance Ministry is likely to use the first window of opportunity to tap external markets and look for some EUR 1.2-2bn in 2012.**

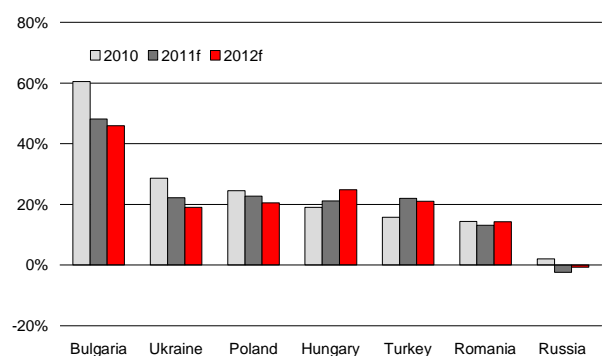
In 2012, the MinFin will use the first window of opportunity to tap external markets

Author: Nikola Georgiev, Economist (+359 2 9269 540)

Gross government financing requirements as % of GDP (2010-2012F)



Gross external financing requirements as % of GDP (2010-2012F)



Source: BNB, MF, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010	2011E	2012F	2013F
<b>Gross financing requirement</b>	<b>2.1</b>	<b>1.8</b>	<b>1.9</b>	<b>2.1</b>
Budget deficit	1.4	1.1	1.0	0.8
Amortization of public debt	0.5	0.5	0.6	1.1
Domestic	0.4	0.3	0.4	0.2
Bonds	0.4	0.3	0.4	0.2
Bills	0	0	0	0
External	0.1	0.2	0.2	0.9
WB/EIB/JBIC/Others	0.2	0.2	0.2	0.2
<b>Financing</b>	<b>1.8</b>	<b>1.8</b>	<b>1.9</b>	<b>2.1</b>
Domestic borrowing	0.8	0.6	0.7	0.6
Bonds	0.8	0.6	0.7	0.6
Bills	0	0	0	0
External borrowing	0.1	0.3	1.7	1.5
Bonds	0	0	1.4	1.2
WB/EIB/JBIC	0.1	0.3	0.3	0.3
Other	0.8	0.9	-0.6	-0.1

Source: UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010	2011E	2012F	2013F
Gross financing requirement	21.8	18.5	18.4	19.6
C/A deficit	0.4	-1.2	-0.2	0.8
Amortization of medium to long term debt	9.1	8.1	8.0	8.2
Government/central bank	0.3	0.4	0.4	1.1
Banks	1.0	0.8	0.6	0.5
Corporates	7.7	6.9	6.9	6.6
Short term debt amortization	12.3	11.5	10.6	10.5
<b>Financing</b>	<b>21.9</b>	<b>18.6</b>	<b>18.9</b>	<b>20.5</b>
FDI	1.5	0.5	1.1	1.4
Portfolio flows	-0.7	-0.3	0.1	0.4
Borrowing	1.6	2.9	2.9	5.2
Government/central bank	0.4	0.3	1.7	1.5
Banks	0.4	1.1	0.8	0.7
Corporates	0.8	1.5	0.4	3.0
Short-term	11.5	10.6	10.5	8.3
Other	8.0	4.9	4.3	5.2

Source: UniCredit Research

## Czech Republic (A1 stable/AA- stable/A+ positive)\*

**Outlook** – Weak export demand is set to slow GDP in 2H11 and 2012, which will delay substantially the anticipated monetary policy tightening. Sluggish growth is not expected to be a major challenge for macroeconomic stability. Government reforms are on-track, as is (though with some risks) fiscal consolidation.

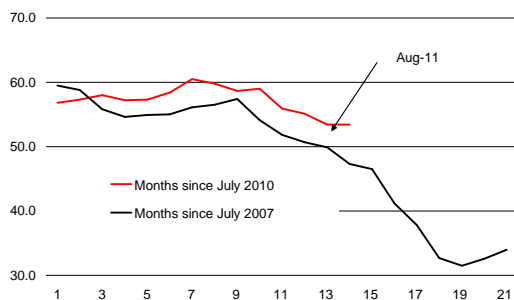
**Strategy outlook** – We expect CZGBs and Czech Eurobonds to continue to benefit from the CEE safe heaven status and relatively decent spread vs. Bunds during 4Q. As Eurobonds are cheaper and more liquid than the FX hedged CZGBs we expect solid demand for the new issue. We maintain our O/W recommendation both in hard currency and local currency papers.

**Authors:** Pavel Sobisek, Chief Economist (UniCredit Bank)  
Patrik Rozumbersky, Economist (UniCredit Bank)

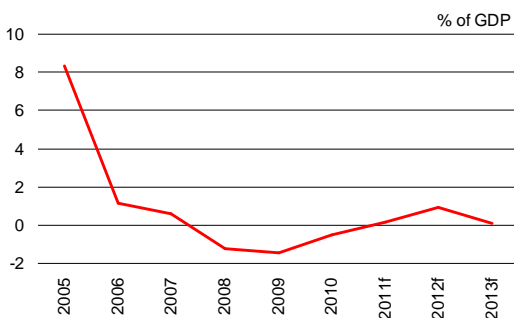
### KEY DATES/EVENTS

- CNB Board meetings – 22 Sep, 3 Nov
- State budget for 2012 – 1<sup>st</sup> reading Oct, final reading Dec
- Manufacturing PMI – 3 Oct, 1 Nov, 1 Dec

### DECLINES IN MANUFACTURING PMI SMALLER THAN IN 2008, CRUNCH TIME YET TO COME



### BASIC BALANCE (NET FDI MINUS C/A) IS SET TO STAY CLOSE TO EQUILIBRIUM



Source: CSO, CNB, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	137.1	145.0	154.1	161.1	171.7
Population (mn)	10.5	10.5	10.6	10.6	10.6
GDP per capita (EUR)	13,069	13,789	14,606	15,226	16,186
<b>Real economy yoy (%)</b>					
GDP	-4.1	2.3	2.0	1.6	3.2
Private Consumption	-0.2	0.1	-0.3	0.5	2.5
Fixed Investment	-7.9	-3.1	2.0	2.5	6.0
Public Consumption	2.6	-0.1	-0.6	0	1.0
Exports	-10.8	18.0	8.5	7.5	10.0
Imports	-10.6	18.0	6.0	7.2	10.5
Monthly wage, nominal (EUR)	883	941	1,001	1,037	1,093
Unemployment rate (%)	8.1	9.0	8.6	8.1	7.4
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-5.9	-4.7	-4.2	-3.5	-2.9
Primary balance	-4.5	-3.3	-2.8	-2.1	-1.5
Public debt	35.3	38.5	42.0	43.8	44.3
<b>External accounts</b>					
Current account balance (EUR bn)	-3.4	-4.6	-3.7	-2.4	-4.2
Current account balance/GDP (%)	-2.5	-3.2	-2.4	-1.5	-2.5
Basic balance/GDP (%)	-0.9	0.4	0.8	1.6	0.9
Net FDI (EUR bn)	2.1	5.1	4.9	5.0	5.8
Net FDI (% of GDP)	1.5	3.5	3.2	3.1	3.4
Gross foreign debt (EUR bn)	61.9	71.4	75.7	80.8	85.8
Gross foreign debt (% of GDP)	45.2	48.8	49.1	49.8	50.0
<b>FX reserves (EUR bn)</b>					
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	1.0	1.5	1.7	2.7	2.5
CPI (eop)	1.0	2.3	1.8	2.7	2.3
Central bank target	3.0	3.0	2.0	2.0	2.0
Central bank reference rate (eop)	1.0	0.8	0.8	1.5	2.5
3M money market rate	1.9	1.1	1.0	1.3	2.2
USD/CZK (eop)	18.5	18.7	16.0	16.7	16.7
EUR/CZK (eop)	26.5	25.1	24.3	24.0	24.0
USD/CZK (pavg)	19.0	19.1	16.5	16.4	16.2
USD/CZK (pavg)	26.5	25.3	24.3	24.2	24.0

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Sluggish growth no challenge to macroeconomic stability

**Net exports account for three-quarters of GDP growth in 2Q**

Real GDP slowed to 0.1% qoq and 2.2% yoy in 2Q on the continued negative input from consumption of both the government and households. Net exports accounted for three-quarters of the yoy growth, with the rest of it attributable to higher gross capital formation. The GDP data was revised down from its flash estimate, suggesting further deceleration towards quarter end. Meanwhile, headwinds from EMU are a concern, although they are not yet blowing the economy into stagnation. On a positive note, August manufacturing PMI remained stable at 53.4, one of the highest levels in Europe. Industrial output as well as exports continued expanding in July. Consistent with UCGs's revised call on Germany, we expect the Czech GDP growth to ease below 2% yoy in 2H11, bringing the FY reading to 2.0%. Exports will slow to low single digit growth yoy, whilst fixed capital formation will be affected by the base effect of last year's solar power generation investments.

**Growth likely to slow to less than 2% in 2H11 on headwinds from eurozone**

For 2012, we have cut all key components on the demand side of GDP, as weaker global demand will translate not only into scarcer export opportunities but also into a deteriorating labor market (affecting household consumption) and slower fixed capital spending. We pencil in 1.6% growth for GDP in 2012, down 1.2%-points from our earlier call. We note, however, that the scenario is marked by considerable uncertainties.

**We have our cut GDP 2012 outlook by 1.2%-points by revising all components**

**Despite economic weakness having little impact on inflation, monetary policy tightening will be subject to considerable delay**

A weaker economy is unlikely to ease inflation substantially, as the latter is more driven by administrative price changes. This applies in particular to the upcoming VAT hike, which is set to add 1%-point to CPI from January 2012. Despite the prospect of a CPI spike, the difficult external environment will delay substantially the anticipated monetary policy tightening. The first sign of a policy shift may arrive as early as September when two hawks in the seven-seat banking board may abandon their tightening bias, allowing the CNB to leave its repo rate on hold in a unanimous vote. With no change in the repo rate foreseen for the remainder of 2011, we expect next year's tightening to correspond to the ECB's plus one additional 25bp rate hike to offset second-round effects of the CPI spike. Taking into account UCG's base scenario on the ECB, the CNB is likely to hike rates three times in 2012, but later rather than earlier in the year.

**EUR/CZK likely to remain locked in a narrow band**

Unlike interest rates, we see no reason to change our predictions on EUR/CZK from 24.3 for end-2011 and 24.0 for end-2012. EUR/CZK has been locked in a narrow band lately, which may have both technical and fundamental aspects. From the technical side, EUR/CZK adjustments have historically been more likely to occur at times of large EUR/USD movements. Fundamentally, the balance of payments basic flows should not ignite currency instability, as the C/A deficit is projected to stay low as is net FDI inflow.

**Key government reforms are set to pass through Parliament; in general, they look business friendly**

The hike of the lower VAT rate from 10% to 14% for 2012 is set to be just one of many policy steps introduced by the government coalition with the aim to stabilize public finances. In comparison with countries more hit by the debt crisis, we see the Czech Republic's reforms as fairly business friendly, preserving flat rates for taxing income, shifting the burden – slightly towards indirect taxation and simplifying some rules for businesses. What goes beyond the goal of short-term fiscal stability is the overhaul of the pension system. The introduction of the voluntary second pillar for financing pensions is a controversial step but its macroeconomic risk is nevertheless strictly limited. Most of the legal norms have passed through the Lower House and are expected to be enforced in 2012 or 2013 as scheduled.

**Government struggles to cut state budget deficit in 2012; underlying macroeconomic assumptions may be of concern**

The government reform efforts are the reason behind the country's (conditional) rating upgrade by S&P to AA-minus. Indeed, without reforms it would not be possible to meet the target of bringing down the 2012 public sector deficit to 3.5% of GDP from this year's estimated 4.2%. The indicated pace of fiscal tightening also seems appropriate for not hurting economic growth too much. What may be of concern, though, are the macroeconomic assumptions behind the budget draft. Our 2012 nominal GDP forecast stands 1.1%-point below that of the finance ministry, which we find consistent with widening the budget shortfall by CZK 20bn (0.5% of GDP).

## Estonia (AA- stable/A+ stable)\*

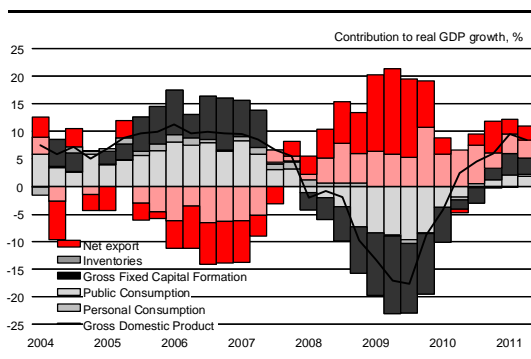
**Outlook** – 2Q11 GDP growth was driven by net exports, fixed investment and recovering domestic demand. Going further, the next export contribution may decrease on the back of a slowdown in international trade but we do not expect a dramatic contraction. Personal consumption growth should strengthen and compensate for net exports. The main challenge remains inflation, which up to now has shown only tentative signs of deceleration. Public finances remain very strong. As a confirmation of this view, S&P upgraded Estonia to AA- – the second highest level in Eastern Europe.

**Author:** Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)

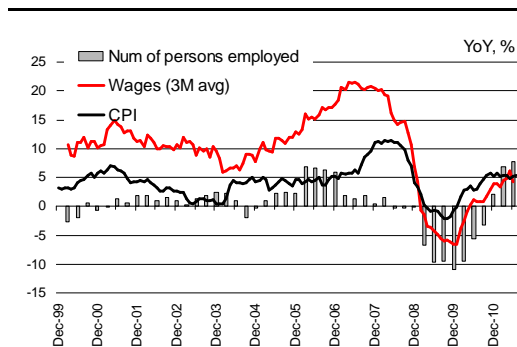
### KEY DATES/EVENTS

- 30 Sep, 31 Oct, 30 Nov – Retail trade
- 11 October – September Trade balance
- 12 December – 3Q GDP (Final)

### NET EXPORTS, GFCF AND PERSONAL CONSUMPTION CONTINUE TO CONTRIBUTE TO THE GROWTH



### ...ALTHOUGH REAL INCOME ONLY STARTS TO CATCH UP WITH RISING INFLATION



Source: Bloomberg, Statistics Estonia, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	13.9	14.5	16.2	17.1	18.2
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	10,343	10,870	12,193	12,856	13,678
<b>Real economy yoy (%)</b>					
GDP	-13.9	3.1	6.9	2.6	3.8
Private Consumption	-18.8	-2.1	5.4	3.8	4.0
Fixed Investment	-32.9	-9.6	15.6	10.7	10.0
Public Consumption	0	-2.0	0.6	0.1	0.9
Exports	-18.7	21.2	32.2	18.8	18.9
Imports	-32.6	20.5	31.5	19.3	19.1
Monthly wage, nominal (EUR)	781	788	820	845	877
Unemployment rate (%)	13.8	16.8	11.6	9.3	8.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-1.7	-0.8	-0.5	0	0.5
Primary balance	-1.4	-0.4	-0.3	0.3	0.9
Public debt	7.2	7.7	7.4	7.0	6.1
<b>External accounts</b>					
Current account balance (EUR bn)	0.6	0.5	-0.2	-0.3	-0.4
Current account balance/GDP (%)	4.5	3.6	-1.3	-1.6	-2.0
Basic balance/GDP (%)	5.3	9.8	6.0	2.1	3.5
Net FDI (EUR bn)	0.1	0.9	1.1	0.7	1.0
Net FDI (% of GDP)	0.7	6.2	7.3	3.7	5.5
Gross foreign debt (EUR bn)	17.3	16.5	17.3	18.0	18.5
Gross foreign debt (% of GDP)	125.5	114.2	105.0	105.8	107.5
FX reserves (EUR bn)	2.3	2.6	2.3	2.5	2.5
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	-0.8	3.9	2.9	2.8	2.6
CPI (eop)	4.9	0.8	2.1	3.1	3.1
Euribor 3M	5.7	4.9	EUR	EUR	EUR
USD/EEK (eop)	10.93	11.69	EUR	EUR	EUR
EUR/EEK (eop)	15.65	15.65	EUR	EUR	EUR
USD/EEK (pavg)	11.22	11.79	EUR	EUR	EUR
EUR/EEK (pavg)	15.65	15.65	EUR	EUR	EUR

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by S&P and Fitch respectively

## Impressing on upside and prudent on potential downside

Impressive GDP growth

Investment and personal consumption are supportive for economic growth

Inflation remains high but still manageable

Domestic demand finds the way up

C/A fluctuates around zero with FDI offsetting banking outflows, trade balance neutral

Public finances are prudent as always

Estonia was rated second highest in Eastern Europe

**Estonian economic growth came in as unprecedented in the region at 8.4% yoy in 2Q11 – the second highest since mid-2007 (the final reading for 1Q increased by 0.5% to 9.5% yoy).**

To some extent the GDP breakdown came in as no surprise, with two thirds of the growth stemming from fixed investment and the net exports. The numbers also confirmed our view that in the coming quarters, domestic demand will support economic growth, helping at least partially compensate for the downturn in international trade. Even in the event of a double dip, Estonia's exports should enjoy relative protection as they are concentrated on specific niche markets (high tech machinery and equipment). In 2008, the relative contraction of Estonian exports was nearly two times less than contraction of imports, resulting in strong contribution to GDP from external trade. Looking forward we note that Estonia's GDP still remains around 10% below the peak – so from a technical standpoint even the latest impressive figures do not exhaust the potential for future growth. We forecast GDP growth of around 7% this year, followed by 2.6% next year, with our forecast for this year implying marginal QoQ growth in Q3 and Q4 this year due to extremely strong results of Q1 and Q2.

**On the negative side, inflation remains the major concern, coming in at above 5% in 2Q11 and showing little sign of slowing down (in June it stood at 4.8% yoy, but in August accelerated back to 5.5% yoy).**

Despite the correction in international energy prices, inflation in Estonia remains high on the back of surging food prices. We expect inflation to ease by the end of the year, although we increase our full-year forecast to around 4.7% with significant upside risks (but not higher than the 5% level, anticipated by Estonia's Ministry of Finance and Central Bank). Inflation is the main danger for our forecast which is based on increasing domestic demand, should it fail to ease, further limiting consumer purchasing power. However, looking at the retail sales figures, we see over 4% yoy growth through most of 2011 (flat yoy in January), accelerating to 6.0% in June, but slowing back to 5.0% in July. Meanwhile the number of people employed has risen sharply by 7.8% yoy in 2Q11 and has a lot of room for upside potential as the number of people employed is still 10% under historical peak.

**BoP looks supportive for the continued recovery** – as we anticipated, the balance is fluctuating around zero. On the financing side, withdrawal of money by international banks calculated on a yearly basis decreased from 11% of GDP in 1Q11 to 7% in 2Q11 – the result of massive deleveraging of the national economy after the pre-crisis credit bubble, supported by the rise in inflow of FDI – from 7.1% to 7.6% of GDP. Portfolio outflows slowed from 1.8% of GDP in 1Q11 (also on a yearly basis) to effectively 0% in 2Q11. We expect FDI to increase further over the remainder of the year and next, as the country is approaching the maximum load of production capacities and will move into renovation of production capacities delayed due to the crisis. Some anecdotal evidence supports our view of this trend.

**Meanwhile, Estonia's government finances remain very prudent** and the Government has demonstrated impressive commitment to managing budget spending and implementing austerity measures, which were widely supported by the public. As a result, in 2010 Estonia was the only EU country to finish the year in surplus and we expect it to run a small deficit this year due to the increase in spending on the back of the improving fiscal situation.

**At the beginning of August S&P announced a two notch upgrade of Estonia to AA-** – the second highest of the new EU countries after Slovenia, which is currently rated at AA. S&P cited solid public finances and strong economic growth as the reasons for the upgrade. Given the strong credit rating improvement we do not expect any further upgrades in the near future, although in our opinion the current relative rating standing in Eastern Europe does not completely reflect the strength of Estonian economy.

## Hungary (Baa3 negative/BBB - negative/BBB - stable)\*

**Outlook** – Significant financial stability concerns coupled with a deteriorating global backdrop and local policy uncertainty mean we see the Hungarian macro to underperform in the coming quarter. We have downgraded our GDP forecast to 1.5% in 2011 and to 1.8% in 2012. Although slower growth without meaningful inflation would justify easier monetary policy we believe the NBH is not planning any rate cut(s) due to increasing financial stability concerns.

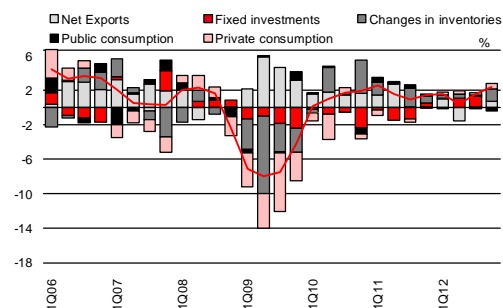
**Strategy** – We recommend reducing Hungarian exposure across all asset classes. In FX we see HUF remaining under pressure and remain long EUR/HUF. In rates we see risk premium as too low at the short end vs. risks Hungary is facing, hence we pay 2y HUF IRS and recommend duration shortening. In credit we recommend selling long end Rephuns.

**Authors:** Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank),  
Istvan Horvath (UniCredit Bank Hungary)

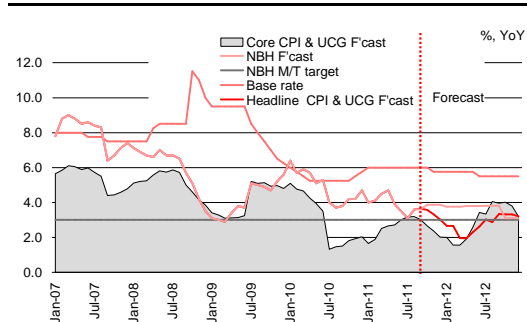
### KEY DATES/EVENTS

- 21 Sep 2011 – NBH – Inflation report 2011/III
- 30 Sep 2011 – 2012 Budget Submission to the Parliament
- 27 Sep 2011 – NBH – Report on Financial Stability
- 19 Sep 2011 – 2012 Final vote on the 2012 Budget

### GDP DRIVERS (CONTRIBUTION TO YOY GROWTH)



### HEADLINE INFLATION TO FALL IN 2012



Source: CSO, NBH, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	92.9	98.5	104.0	110.9	117.9
Population (mn)	10.0	10.0	10.0	10.0	10.0
GDP per capita (EUR)	9,249	9,831	10,391	11,089	11,793
<b>Real economy yoy (%)</b>					
GDP	-6.7	1.2	1.5	1.8	2.5
Private Consumption	-6.8	-2.2	-0.4	0.6	2.2
Fixed Investment	-8.0	-5.6	-2.9	3.2	0.9
Public Consumption	2.2	-0.6	3.7	-1.9	1.1
Exports	-9.6	14.1	7.5	7.8	10.5
Imports	-14.6	12.0	7.1	8.0	10.8
Monthly wage, nominal (EUR)	712	736	780	822	873
Unemployment rate (%)	9.8	11.1	11.0	10.7	8.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-3.9	-4.2	1.0	-2.8	-2.5
Primary balance	0.1	-0.4	-3.9	0.7	0.9
Public debt	78.4	81.0	77.6	67.0	65.0
<b>External accounts</b>					
Current account balance (EUR bn)	0.3	1.8	2.5	3.5	3.7
Current account balance/GDP (%)	0.3	2.0	2.4	3.2	3.2
Basic balance/GDP (%)	1.9	3.9	4.4	7.1	6.1
Net FDI (EUR bn)	1.5	1.8	2.1	4.4	3.5
Net FDI (% of GDP)	1.6	1.8	2.0	4.0	3.0
Gross foreign debt (EUR bn)	136.1	137.3	138.7	129.1	123.0
Gross foreign debt (% of GDP)	141.5	141.1	131.9	117.1	104.3
FX reserves (EUR bn)	30.7	33.0	28.0	24.0	0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	4.2	4.9	3.7	2.8	3.1
CPI (eop)	5.6	4.7	3.0	3.2	3.3
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	6.3	5.8	5.8	5.5	5.5
3M money market rate	8.7	5.5	6.0	5.7	5.8
HUF/USD (eop)	189.1	208.3	176.3	186.8	184.0
EUR/HUF (eop)	270.8	278.8	268.0	269.0	265.0
USD/HUF (pavg)	201.2	207.5	184.3	180.7	179.1
EUR/HUF (pavg)	280.6	275.3	270.9	267.4	265.0

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Weak growth & financial stability vs. policy uncertainty

### Policy uncertainty rises

**During the third quarter the Hungarian government has been sending mixed messages to the market.** Following the private pension fund asset transfers, it announced the purchase of the 21% stake in MOL which pushed the cash-flow based deficit for 2011 to 4.2% of GDP. The government quickly passed a 2011 budget law amendment confirming its commitment to keep the 2011 ESA deficit at 2.8% of GDP. Without the extra revenues from the pension funds the government is actually running a relatively relaxed fiscal policy. At the end of the quarter the government proposed a new plan which allows FX mortgage borrowers (EUR 18bn total stock) to repay their loans at a discounted FX rate with the losses borne by the banks. The estimated loss for the banking sector, with 100% participation rate, is 38% of its capital whilst the potential FX outflow is EUR 18bn. Although the final participation rate will likely be lower this has introduced a considerable uncertainty into the banking sector and the monetary policy outlook. The beginning of 4Q will be driven by newsflow regarding this new proposal.

### As growth already slowed significantly

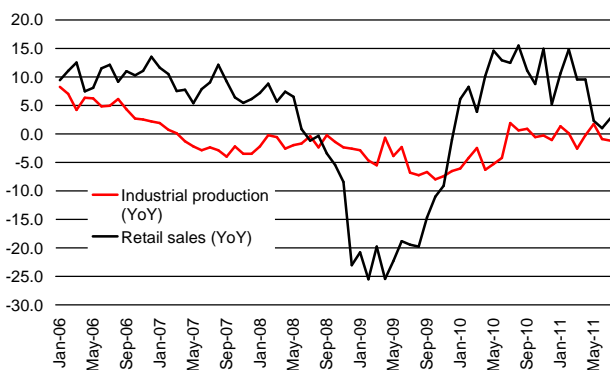
**Weaker economic performance of Hungary's major trade partners – esp. Germany – has taken its toll on the Hungarian economic performance,** as evidenced by the stalled 2Q11 GDP. The flat qoq figure dragged down the yearly performance to 1.5% yoy. Due to the base effect (adverse weather conditions last year) agriculture was up 24% yoy, contributing 0.6%-points to the overall GDP growth. Industrial production rose 5.6% yoy while export oriented manufacturing grew by 6.6% yoy. Gross fixed capital formation was down -8.1% (!), lowering the overall performance by 1.5%-points. The major supportive factor remained net exports with a surplus of HUF 675bn/EUR 2.45bn contributing 2.8%-points to growth. Due to the poor 2Q data and further deterioration in higher frequency indicators (PMI and industrial production) we had to revise down our growth forecast to 1.5% in 2011 and to 1.8% in 2012.

### Which led to some fiscal underperformance

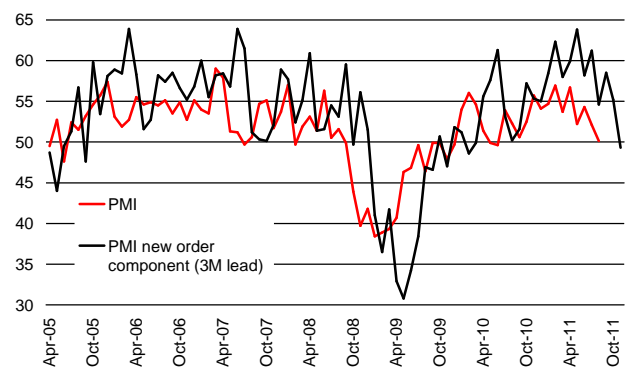
**The lackluster economic performance mirrored in the monthly evolution of the central deficit figures reached HUF 1544.6mn/EUR 5.6bn or 130.4% of the yearly target by August.** Major factors behind the higher deficit are lagging VAT revenues and the ruling of the European Commission on the Hungary's VAT-refunding practice (HUF 250bn/EUR 0.9bn). To the credit of the government it has reacted quickly, revising down its outdated macro forecast and starting to plug the officially announced HUF 100bn/EUR 0.36bn gap (we estimate somewhat higher) by increasing withholding tax, freezing public investment's and purchases and actions to improve tax (VAT) collection.

## ECONOMY IS SLOWING QUICKLY

IndOut slowed in Q3 whilst retails sales never actually recovered



High frequency indicators suggest more slowdown ahead



Source: CSO, UniCredit Research

**Public debt is reduced albeit with rather artificial measures**

**Meanwhile the government reduced public debt to around 73%/GDP. Every effort was put into reducing debt to 73%-ish of GDP by repaying EUR 3bn from unused IMF funds and selling EUR 1bn of the transferred ex-pension fund assets. If all goes to plan, Hungary might end the year with a debt/GDP ratio below the expected EU average of 80%. Meeting the Maastricht debt criteria (3%/GDP) is vital for the country to avoid potential sanctions within the excessive deficit procedure (EDP) as since its EU membership Hungary has never reached this goal. The progress has already been rewarded by Fitch changing the country's outlook to stable, but there is more to do: on top of the HUF 550bn/EUR 2bn adjustment announced in March within the Széll Kálmán plan, an additional HUF 400/EUR 1.4bn cut could be necessary in order to meet the 2.5% debt/GDP in 2012. Despite this, the government is facing repayment needs in 2012. EUR 3.7bn is due to the IMF whilst a EUR 1.4bn Eurobond will mature. This implies next year's external issuance might increase above EUR 4bn (which has been issued) particularly as the absorption capacity of the local sector has been reduced by the pension fund measures.**

**Financial stability concerns were increasing even before the new FX mortgage plan**

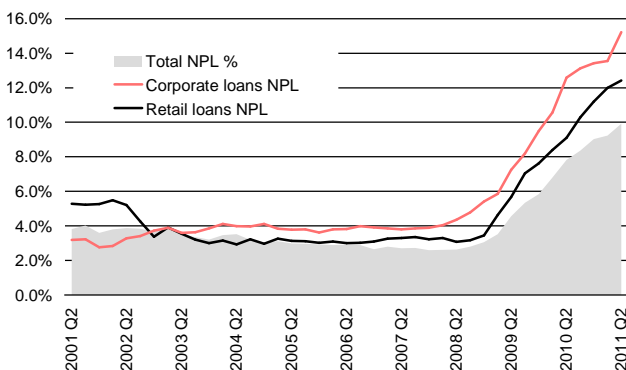
**Financial stability concerns were on the rise even without the new FX mortgage plan:** Domestic banks' foreign currency refinancing need has become obvious as the implied yield of the 3M FX-swaps rose above 200bp early August whilst the sovereign CDS spiked above the 400bp level (something which was mentioned by the NBH previously as a stress level). This spread seems to function as a good indicator of the tight foreign currency liquidity situation. The banking sector has only experienced a similar level of stress in the autumn of 2008. Meanwhile the sharp CHF appreciation in August will likely burden bank balance sheets via higher NPL, which have already reached 10%. As such the banking sector was under significant pressure (and lending growth did not pick up) even before the government announced the new FX mortgage plan. Although full details are not available the maximum loss of the banking sector could reach around 40% of capital. This will undoubtedly lead to a significant restructuring of the sector and will hurt the long term lending outlook (non-resident banks were already reducing exposure to Hungary even before these measures). We should see more details during the last weeks of September.

**This leaves the NBH in a difficult situation**

**Slowing growth, coupled with increasing financing stability concerns and a jump in policy uncertainty leaves the NBH in a very tricky situation.** Our baseline scenario assumes that the bank will not be able to follow the new dovish global trend (we factor in only a 50bp cut until end 2012) as if the FX mortgage plan goes ahead without changes the NBH might be forced to hike rates. Although the presence of the IMF would significantly reduce this risk we think the government needs to radically alter policy. We would also not rule out rating downgrades if financial stability concerns escalate.

**FINANCIAL STABILITY CONCERNS ON THE RISE**

NPL was on the rise even before the Aug spike in CHF/HUF



The balance sheet of the banking sector (EUR bn, June 2011)

Assets		Liabilities	
Total private sector FX loans	38.6	Domestic private sector deposits	45.7
of which		of which	
FX mortgages for consumption	8.3	HUF deposits	35.8
FX mortgages for property purchase	10.0	FX deposits	9.9
Consumption loans	16.3	External liabilities	33.3
Corporate FX loans	14.0	Other	33.5
Total private sector HUF loans	23.1	Own capital	10.6
Loans to financial sector	14.9		
HUF	9.6		
FX	5.3		
Other	46.5		
<b>Total assets</b>	<b>123.1</b>	<b>Total liabilities</b>	<b>123.1</b>

Source: NBH, UniCredit Research

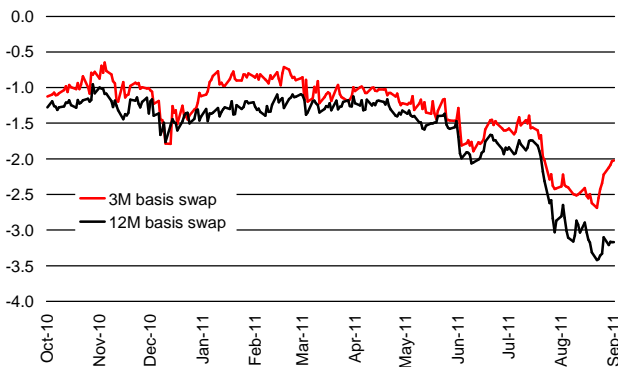
### Strategy: reduce exposure across all asset classes

**FX:** After the SNB EUR/CHF pegging the fate of CHF/HUF became the function of EUR/HUF. As external financing needs are high even without the new FX mortgage plan we think EUR/HUF could break up higher from the current levels. Accordingly, we recommend U/W positioning. In terms of individual trade we see logic in long TRY/HUF.

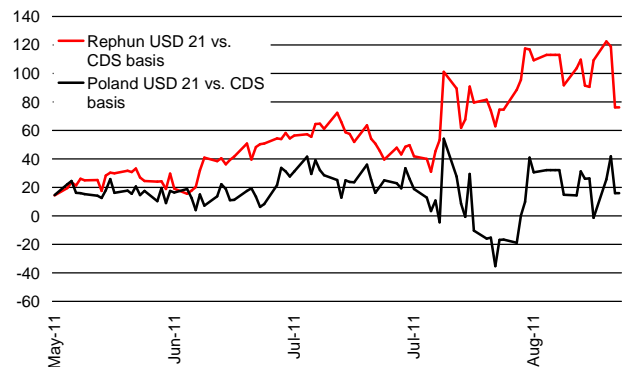
**Rates:** Small risk premium (2y HUF IRS minus policy rate only at 20bp vs. 50/60bp YTD average) coupled with heavy non-resident position (following the pension fund bond cancellation non-resident investors own about 45% of the market, an all time high) and increasing financial stability concerns prompted us to recommend reducing HGB allocation to short despite compelling spreads vs. Bunds. We also recommend paying 2y HUF IRS at current levels. The only constructive position where we still see value is FX hedged t-bills which continue to provide attractive albeit declining carry.

**Credit:** We believe long end Rephuns are expensive (evidenced in the tight spread vs. CDS and vs. regional peers). We hence recommend a general U/W position. In terms of specific bonds we recommend selling Rephun USD 21 versus 10y CDS with a target around 40bp. We also see some logic in switching into Lihun USD 21.

Basis swaps remain at depressed levels



Rephuns looks expensive



Source: Bloomberg, UniCredit Research

#### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>25.2</b>	<b>24.5</b>	<b>25.6</b>
Budget deficit	2.8	3.2	3.0
Amortisation of public debt	22.4	21.4	22.6
Domestic	21.0	17.0	16.1
Bonds	5.0	3.6	3.1
Bills	16.0	13.3	13.0
External	1.3	4.4	6.5
IMF/EU	0	2.0	3.7
<b>Financing</b>	<b>25.2</b>	<b>24.5</b>	<b>25.6</b>
Domestic borrowing	<b>22.5</b>	<b>19.1</b>	<b>19.0</b>
Bonds	7.3	5.1	5.1
Bills	15.2	14.0	13.9
External borrowing	3.0	5.0	6.5
Bonds	1.5	4.1	6.5
IMF/EU	0	0	0
Other	1.5	0.8	0

Source: UniCredit Research

#### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>35.6</b>	<b>36.8</b>	<b>36.2</b>
C/A deficit	-1.8	-2.5	-3.5
Amortisation of medium to long term debt	37.4	39.3	39.7
Intercompany	6.2	6	6.2
Government/central bank	4.7	7.4	9.1
Banks	20	18.5	17.1
Other investment	6.5	7.5	7.4
<b>Financing</b>	<b>35</b>	<b>36.5</b>	<b>35</b>
FDI	1.8	2	4.4
Portfolio flows	0.2	0.1	0.3
Borrowing	0.9	6.4	9.2
Government/central bank	1.1	-3.3	-1.1
Banks	-0.7	6.9	7.2
Corporates	0.5	2.8	3.1
EU transfers	1.8	2	2.1
Other	7.5	7.5	7.5

Source: UniCredit Research

## Latvia (Baa3 positive/BB+ positive/BBB - positive)\*

**Outlook** – GDP growth lags behind other Baltic states but is nonetheless strong. Inflation is of concern, but so far has very limited impact on personal consumption, as it has been offset by nominal wage growth. C/A slid into negative territory, but FDI is picking up. Fiscal consolidation is underway. We expect the government to increase its Eurobond program next year.

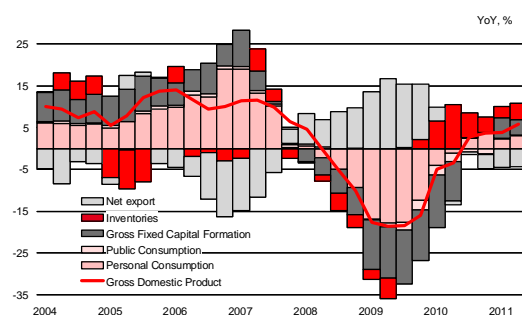
**Strategy outlook** – On the back of increasing supply pressure (in the form of Eurobond issuance) we think Latvian CDS could underperform Lithuania CDS. Accordingly running into the the forthcoming issuance period we see some logic in selling Lithuania vs. buy Latvia CDS at flat spread (main reservation is liquidity).

**Author: Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)**

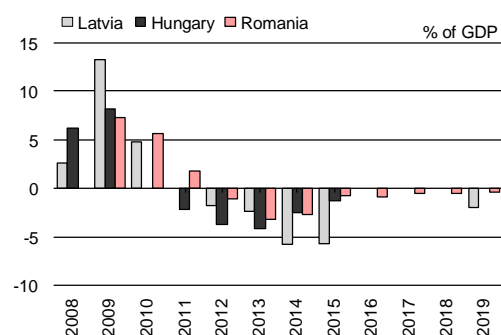
### KEY DATES/EVENTS

- November – Final IMF review under the Stand-By Arrangement
- 9 Nov., 9 Dec – 3Q GDP (prelim., final)
- 2 Dec – 3Q Current Account

### STRUCTURE AND DYNAMICS OF GDP SHARED WITH OTHER BALTIC STATES



### REPAYMENTS TO EU AND IMF ARE PEAKING ONLY IN 2014 AND 2015



Source: Central Statistical Bureau of Latvia, IMF, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	18.5	18.0	19.5	20.6	21.7
Population (mn)	2.3	2.3	2.2	2.2	2.2
GDP per capita (EUR)	8,184	7,989	8,659	9,182	9,644
<b>Real economy joy (%)</b>					
GDP	-17.8	-0.6	5.2	2.6	3.0
Private Consumption	-23.7	-0.2	4.8	2.1	3.2
Fixed Investment	-36.1	-21.7	6.7	5.7	7.0
Public Consumption	-8.9	-11.1	-0.4	1.1	0.9
Exports	-13.3	10.5	14.4	8.1	12.1
Imports	-32.9	7.1	14.7	7.9	13.2
Monthly wage, nominal (EUR)	651	629	656	680	612
Unemployment rate (%)	16.1	14.3	12.5	11.0	12.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance (incl. bank costs)	-7.7	-11.7	-6.2	-2.7	-3.0
Primary balance	-6.2	-9.9	-4.1	-1.9	-2.1
Public debt	32.9	41.6	44.7	45.0	42.7
<b>External accounts</b>					
Current account balance (EUR bn)	1.6	0.6	-0.3	-0.5	-0.6
Current account balance/GDP (%)	8.6	4.9	-1.4	-1.6	-2.0
Basic balance/GDP (%)	9.2	6.3	2.9	2.1	2.8
Net FDI (EUR bn)	0.1	0.2	0.8	0.8	1.0
Net FDI (% of GDP)	0.6	1.4	4.3	3.8	4.8
Gross foreign debt (EUR bn)	28.9	29.8	30.9	32.0	33.0
Gross foreign debt (% of GDP)	156.3	156.8	155.8	154.4	152.4
FX reserves (EUR bn)	5.2	6.9	7.4	7.5	7.4
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	-1.3	2.5	2.8	3.0	2.3
CPI (eop)	3.5	-1.1	3.7	3.2	2.3
RIGIBOR 3M	3.9	1.9	2.5	4.3	4.9
USD/LVL (eop)	0.49	0.53	0.46	0.49	0.49
EUR/LVL (eop)	0.70	0.70	0.70	0.70	0.70
USD/LVL (pavg)	0.50	0.53	0.48	0.47	0.47
EUR/LVL (pavg)	0.70	0.70	0.70	0.70	0.70

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Lagging behind, but catching up

**GDP growth is lagging behind its Baltic peers**

**The 2Q11 GDP reading came in at 5.6% yoy – an impressive result but lagging behind its Baltic peers (9.5% yoy in Estonia and 6.3% in Lithuania).** Looking in detail at the structure of economic growth we see that a significant portion of growth is still coming from the rise in inventories. Overall, we do not expect impressive results for GDP to carry forward into the remainder of 2011 and see the 2H11 growth reverting to the moderate (by Baltic standards) level of 2H10-1Q11 of 3.5-4.0% yoy, bringing yearly result to slightly above 5% yoy. The global downturn should also take its toll, as exports are likely to slow down while personal consumption imports will react more slowly, resulting in a higher negative net export contribution. On the positive side, personal consumption as elsewhere in the region is picking up. If a sharper downturn globally is avoided, the country is very likely to follow the same pattern as Estonia and Lithuania, with the growth model switching to internally driven expansion, based on personal consumption and fixed capital formation. All these trends have had an impact on the numbers – in 2Q11 inventories, GFCF, and personal consumption and contributed 3.9%, 3.6% and 3.0% respectively, while net exports took off 4.3%

**Inflation as everywhere in the Baltics remains elevated due to high energy and food prices**

**Inflation as everywhere in the Baltics remains elevated yoy on the back of high energy and food prices.** Combined with the economic slowdown, this trend may potentially be a burden for personal consumption. However, so far the relative dynamics of inflation and wages works in favor of wages. Inflation in 2011 accelerated from 4.0% yoy in 1Q11 to 4.8% in 2Q11 and remained at approximately the same level in July and August, while wages in 1Q11 and 2Q11 increased by 4.4% and 5.6% respectively. This development was supported by a drop in unemployment, which fell steadily at around 0.5-0.6% per month from 14.4% at the end of 1Q11 to 12.6% at the end of 2Q11 and further to 12.1% in July 2011. The combination of these factors brought about a very strong recovery in retail trade, which surged from 4.4% yoy in January to 9.4% yoy in July. However, the growth was uneven, sometimes falling as low as 3.7% yoy in April, what may signal the underlying fragility of the growth trend. Looking at GFCF we see a similar situation: inspiring but also implying fragility in industry (not sure how these are connected....) behind the strong GFCF readings. Industrial production, which peaked at a 19.13% yoy growth rate in December 2010 (18.8% for the 4Q10), decelerated to 10.5% in 1Q11 to recover to 12.2% in 2Q11, but dipped to 6.86% in July – the slowest yoy recovery rate since March 2010. Capacity utilization in 3Q11 remains the lowest in the region at 68% (70% in Lithuania and 73% in Estonia), below the historical peak of 72.7% in 2Q07.

**C/A is moving into negative territory, financed by accelerating FDI**

**In line with signs of a recovery in domestic demand, the C/A surplus is beginning to edge lower and from a 1Q11 1.3% of GDP surplus slid into a 2% deficit (calculated on a yearly basis) in 2Q11.** On the financing side FDI (calculated on yearly basis) moved up to 4% of GDP in 2Q11, gradually accelerating from 1.5% in 4Q10. Meanwhile outflows of portfolio and other flows accelerated from 0.9% to 3.0% and 1.1% to 2.7% respectively.

**The developments in the general government budget remain positive and we revise our full year budget deficit down to 6.3%**

**The developments in the general government budget remain positive.** Extrapolating from the central government budget deficit to GDP, which has improved to 1.1% in 2Q11 from 1.8% a year ago, we revise our full year budget deficit down to 6.3%. The relative disproportion in 1H11 and full year 2011 comes from the fact that a greater portion of the deficit is generated in 4Q. In 2008 it accounted for 122% of the full year deficit (eradicating the earlier surplus), in 2009 for 42%, in 2010 for 61%. We anticipate no changes in the fiscal policy after this September's general elections. **The IMF program is set to expire in November this year.** The IMF and EU announced an EUR 7.5bn bail-out loan for Latvia in Dec 08, with the program scheduled to expire in 4Q this year (although in 2011 as of September Latvia did not withdraw any of the approved disbursements) and repayments to begin next year – EUR 325 mn in 2012 and EUR 475mn in 2013 to the IMF. Repayments to the EU are scheduled to begin in 2014. Overall, given the forecasted budget deficit for 2012, we expect the government to undertake a EUR 1.5bn Eurobonds issue next year (potentially split into several issues), with maturities ranging from 7 to 9 years.

**We expect the government to come up with EUR 1.5bn Eurobonds issue next year**

## Lithuania (Baa1 stable/BBB stable/BBB positive)\*

**Outlook** – Lithuania is on track to post a strong and sustainable recovery in 2011. Domestic consumption is rising and may be one of the two major growth drivers this year. C/A dynamics with strong FDI flow and credit development look supportive for this trend. Fiscal measures are helping to meet the Government target of a 5% budget deficit, but there's more work to be done. Pre-election risks look limited.

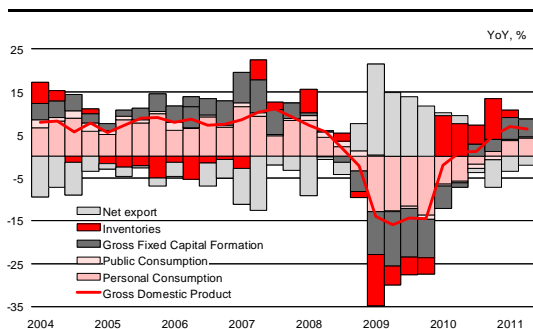
**Strategy outlook** – Lithuanian CDS continues to trade hand in hand with Latvia which we still offers some relative value opportunity. As Latvia is coming back to the market we think Latvian CDS should underperform Lithuanian. Meanwhile Lithuanian cash Eurobonds look relatively expensive vs. regional peers but look cheap vs. CDS.

**Author:** Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)

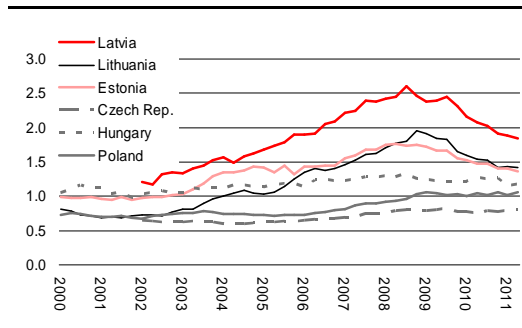
### KEY DATES/EVENTS

- 27 Sep, 27 Oct, 28 Nov – Aug, Sep, Oct retail trade
- 10 Oct, 9 Nov, 9 Dec – Aug, Sep, Oct trade balance
- 28 Oct, 29 Nov – 3Q GDP (prelim., final)

### PERSONAL CONSUMPTION & GFCF DRIVES GROWTH IN 2Q11



### CREDIT SITUATION HISTORICALLY THE HEALTHIEST IN BALTICS (LOAN TO DEPOSIT RATIO)



Source: Statistics Lithuania, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	26.5	27.4	29.9	31.4	33.2
Population (mn)	3.3	3.3	3.3	3.3	3.3
GDP per capita (EUR)	7,939	8,257	9,055	9,564	10,117
<b>Real economy joy (%)</b>					
GDP	-14.7	1.2	5.2	2.7	3.5
Private Consumption	-17.7	-4.1	4.4	3.4	3.4
Fixed Investment	-39.2	-0.3	12.7	10.7	9.5
Public Consumption	-1.9	-3.0	0.9	0.1	0.3
Exports	-12.7	16.3	21.3	17.8	16.4
Imports	-28.4	17.6	22.8	19.0	15.6
Monthly wage, nominal (EUR)	625	600	615	640	650
Unemployment rate (%)	9.5	14.5	12.5	9.0	8.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-7.9	-7.5	-4.2	-3.8	-2.5
Primary balance	-6.7	-4.6	-3.1	-1.2	-1.2
Public debt	29.5	35.0	36.3	38.4	38.8
<b>External accounts</b>					
Current account balance (EUR bn)	1.1	0.3	-0.6	-0.5	-0.7
Current account balance/GDP (%)	4.3	1.6	-2.1	-1.6	-2.0
Basic balance/GDP (%)	4.1	4.3	3.4	3.2	2.5
Net FDI (EUR bn)	0	0.7	1.6	1.5	1.5
Net FDI (% of GDP)	-0.1	2.6	5.5	4.8	4.5
Gross foreign debt (EUR bn)	23.1	22.9	23.6	25.4	25.7
Gross foreign debt (% of GDP)	87.2	83.5	78.8	80.9	77.5
FX reserves (EUR bn)	4.5	4.9	5.2	5.5	0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	4.5	1.1	3.6	2.2	2.2
CPI (eop)	1.3	3.6	2.4	2.4	2.0
VILIBOR 3M	7.1	1.6	1.7	3.1	3.8
USD/LTL (eop)	2.41	2.58	2.27	2.40	0
EUR/LTL (eop)	3.45	3.45	3.45	3.45	0
USD/LTL (pavg)	2.48	2.60	2.35	2.33	0
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	0

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Switching to internally driven growth

**Economy switches to internal sources of growth**

**Growth in Lithuania slowed down from 6.9% in 1Q11 to a still impressive 6.3% in 2Q11.** This reading comes in as the sixth successive positive quarter of yoy GDP figures. The GDP breakdown clearly illustrated that private consumption was the main driver of economic growth – with private consumption generating over half of economic growth. In line with this development, the contribution from net exports remained in negative territory. Another prominent (although anticipated) feature remains the high level of GFCF, contributing slightly under 50% of growth in 2Q11.

**Strong GDP growth in 2011 is evident**

**Full year GDP this year is steadily on the way to posting gains in excess of 5%.** Despite some slowdown in 2Q11 from 1Q11, the main indicators for consumption continue to show strong gains, although in line with the GDP development, slowing in 2Q11. Industrial production in 2Q11 remained steadily above 10% yoy, decreasing to 7.0% in July, the retail trade grew at an average 7.3% yoy in 2Q11 and came in at 7.2% in July. Labor market statistics strengthened and look in 2Q11 even more supportive for domestic demand – gross earnings increased 2.5% yoy in 2Q vs 2.0% in 1Q11, while employment surged by an impressive 4.6% in 2Q11 vs. 1.2% in 1Q11. As we anticipated, inflation is decelerating: having peaked in May at 5.0% yoy, it has gradually slowed down to 4.4% in August and we expect it to decline further to bring the annual reading to under-4% level (which is quite realistic given that it started the year with around-3% readings). This development should also be supportive for personal consumption.

**C/A looks supportive for the GDP dynamics**

**The C/A developments are in line with GDP breakdown dynamics. The BoP balance surplus of 1Q11 was replaced by a 0.6% of GDP deficit in 2Q11 and we expect a modest full year deficit this year in line with progressing internal demand. On the financing side, FDI (calculated on a yearly basis), also as anticipated, posted a recovery from under 1.5% of GDP at end 2010 to 2.2% of GDP in 1Q11 and 3.8% of GDP in 2Q11.** Foreign bank capital withdrawals decelerated from 7.1% of GDP in 4Q10, to 4.4% in 1Q11 and 3.3% in 2Q11. However, it should be noted that Lithuania, of all three Baltic states, historically had the lowest loan to GDP ratio – coming in under 70% at the peak of 2009-2010 vs an above 100% reading in Latvia and Estonia, and quite a low loan to deposit ratio. Volume of loans extended to residents continue to shrink, although at a lower pace yoy, and we may see a breakeven soon as the volume of loans outstanding progressed from contraction of 4.4% at the beginning of the year to only 1.7% in July, supported by a decrease in overdue credit extended.

**Efforts on the fiscal side are bringing results**

**Lithuania has maintained its policy of consolidating the budget deficit and the government may announce a strong result this year. According to Ministry of Finance officials' statements, the full-year 2011 deficit may come in under 5%. The central government balance surplus increased in 2Q11 to 3.1% of GDP vs 2.3% in 1Q11.** Tax revenues grew nearly 15% yoy in 2Q11 – the steepest growth rate since end 2008. The main risk may derive from the general elections in Q4 2012, but given the statements from Lithuanian politicians, populist fiscal policy should be limited.

**We expect the volume of new Eurobond issues to grow to EUR 2bn in 2012**

**We expect Lithuania to tap international markets for approximately EUR 2bn in new issues in 2012,** as it will need to refinance the EUR 1bn bond issue expiring in May and finance the budget deficit for approximately an equal amount. Lithuania in the last few years has shifted borrowing policy towards the longer dated securities, so we expect the new securities to be issued with maturities over seven years.

## Poland (A2 Stable/A- Stable/A- Stable)\*

**Outlook** – H1 GDP growth was strong but is set for slowdown in H2. Following October's general election, we expect the budget deficit to continue to tighten, largely because of EU pressure. Further rate hikes over the coming quarters look unlikely.

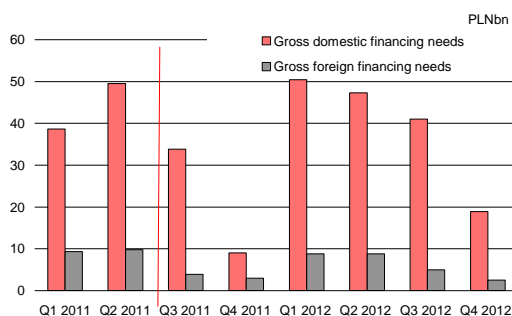
**Strategy outlook** – The sharp divergence between the POLGB and FX market in Q3 should sustain in the coming quarter as most of the non-resident inflows were currency hedged in our view, supply will decline while the POLGB vs. Bund spread remains at a record high. We hence maintain constructive duration exposure. We see PLN appreciating toward the end of the year but for the time being keep our long TRY/PLN as a trade for USD referenced vs. EUR referenced currencies.

**Author:** Marcin Mrowiec, Chief Economist (Bank Pekao)

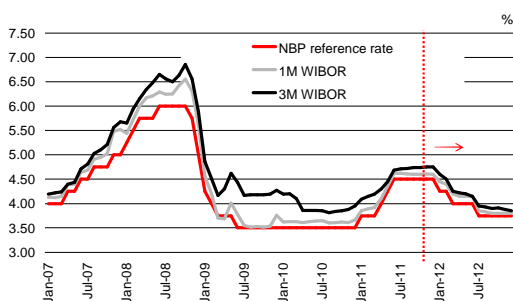
### KEY DATES/EVENTS

- Oct 9<sup>th</sup> – General elections
- Sep 20<sup>th</sup>, Oct. 4-5<sup>th</sup>, 20<sup>th</sup>, Nov 8-9<sup>th</sup>, 15<sup>th</sup> Dec 6-7<sup>th</sup>, 20<sup>th</sup> – NBP MPC meeting
- Nov. 30<sup>th</sup> – 3Q GDP

### FINANCING NEEDS SET TO INCREASE IN 2012



### NBP SET TO CUT RATES IN 2012



Source: IMF, MinFin, Eurostat, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	310.4	354.4	376.2	395.7	431.7
Population (mn)	381.7	382.0	380.8	380.7	380.6
GDP per capita (EUR)	8,134	9,277	9,878	10,394	11,343
<b>Real economy yoy (%)</b>					
GDP	1.6	3.8	4.0	3.1	3.5
Private Consumption	2.1	3.2	3.4	3.1	3.4
Fixed Investment	-1.2	-1.0	8.7	3.4	3.9
Public Consumption	2.0	4.0	1.1	1.9	2.1
Exports	-6.8	10.1	5.9	4.1	4.8
Imports	-12.4	11.6	6.2	4.5	5.0
Monthly wage, nominal (EUR)	767	860	911	987	1,023
Unemployment rate (%)	11.0	12.1	11.8	12.0	11.9
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-7.3	-7.9	-5.8	-3.7	-2.9
Primary balance	-4.8	-5.2	-3.1	-0.9	0
Public debt	50.9	53.6	54.1	54.2	53.9
<b>External accounts</b>					
Current account balance (EUR bn)	-12.2	-15.9	-17.4	-20.2	-19.4
Current account balance/GDP (%)	-3.9	-4.5	-4.6	-5.1	-4.5
Basic balance/GDP (%)	-0.9	-2.6	-2.9	-3.1	-2.6
Net FDI (EUR bn)	9.3	6.7	6.5	8.0	8.0
Net FDI (% of GDP)	3.0	1.9	1.7	2.0	1.9
Gross foreign debt (EUR bn)	194.4	235.4	243.7	240.4	245.6
Gross foreign debt (% of GDP)	59.4	65.9	64.8	60.8	56.9
FX reserves (EUR bn)	55.2	70.0	75.0	77.5	78.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	3.5	2.6	4.1	2.9	2.9
CPI (eop)	3.5	3.1	3.8	3.3	2.5
Central bank target	2.5	2.5	2.5	2.5	2.5
Central bank reference rate (eop)	3.5	3.5	4.5	3.8	4.0
3M money market rate	4.3	3.8	4.5	4.1	4.3
USD/PLN (eop)	2.9	3.0	2.7	2.8	2.7
EUR/PLN (eop)	4.1	4.0	4.1	4.0	3.9
USD/PLN (pavg)	3.1	3.0	2.7	2.8	2.7
EUR/PLN (pavg)	4.3	4.0	4.0	4.1	4.0

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## October general elections – key to future fiscal policy

**GDP to grow 4% this year, with 2H markedly weaker than 1H**

**We have revised downwards GDP growth for 2012 by 0.4%-point to 4.0%**

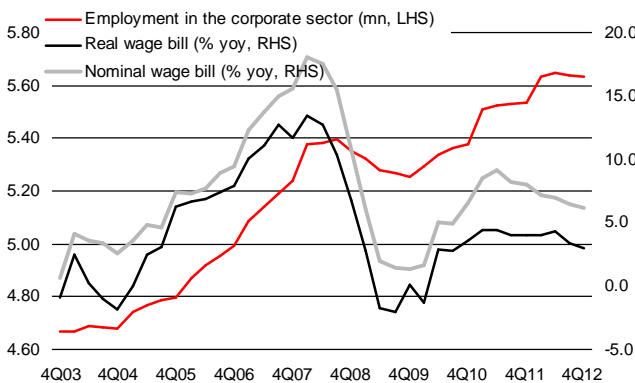
**GDP growth was sound in 2Q but PMI indices point to an economic slowdown in the second half of the year; we look for 3.7% growth in 2H11, after 4.3% in 1H11.** GDP grew 4.3% yoy in 2Q11 vs. growth of 4.4% in 1Q. Individual consumption was up by 3.5% yoy vs. 3.9% in 1Q. Gross fixed capital formation growth accelerated in 2Q to 7.8% from 6.0% a quarter earlier. The increase in domestic demand amounted to 4.3% yoy (4.5% in 1Q), while the contribution from net exports to real GDP growth was neutral (vs. -0.1%-points in 1Q).

**We initially envisaged 4.4% GDP growth for 2011 as a whole, but now revise it down to 4.0% in 2011 and 3.1% in 2012, from 3.9% previously.** Data for 2Q were good but there were signs of a slowdown when analyzing the structure of value added in sectors of the economy. Growth in value added in industry amounted to 4.1% yoy vs. 7.8% a quarter earlier. Industry is a sector that is vulnerable to economic slowdown because of, amongst other things, a high share of fixed costs in total unit costs. Poor performance in the industrial sector has been confirmed by recent readings of PMI indicators. They point to lower growth in industrial production, mainly due to slower inflows of export orders. According to the NBP's survey, the most important barrier in developing economic activity now is high growth in prices of raw materials, which results in lower competitiveness for Polish manufacturers. A worsening economic outlook, lower pressure on capacity utilization and higher costs of acquiring capital (due to the poor performance of the stock market and interest rate hikes) have negatively affected corporate investment activity. A possible worsening of financial results, first in the manufacturing sector and then in other sectors of the economy, is likely to result in lower demand for employees. Recent PMI readings therefore point to a significant slowdown in employment growth in manufacturing, and the uncertain outlook for the labor market will not be supportive of further consumption growth in the medium term. However, on a positive note, the recent weakening of the zloty will help to make Polish exports more competitive abroad, while at the same time rendering imports unattractive – and thus doubly helping domestic manufacturers. This was the factor that contributed to Poland's exceptional performance in 2009, and it should work this time as well; of course, adjusted for the scale of the weakening of the zloty then and now.

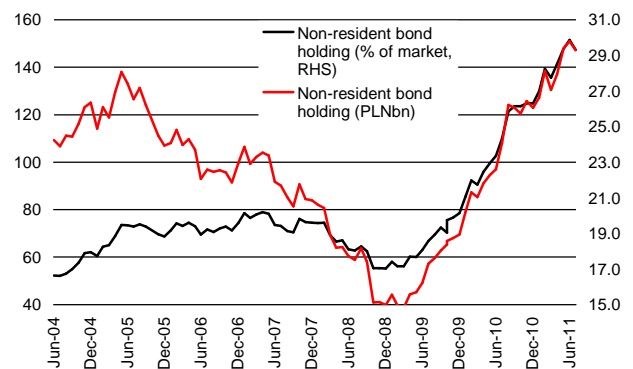
**CPI peaked at 5% in May, it should fall below 4% by year-end, and come close to the MPC central target of 2.5% by mid-2012**

**CPI inflation most likely peaked in May at 5.0%, by end-2011 it should fall below 4.0%, and in 1H12 it will probably approach the MPC's central target of 2.5%.** This year's CPI figures were influenced by the change in the way the statistical office – now measures seasonal prices (another step towards harmonizing domestic inflation methodology with that of Eurostat). As noted by StatOffice officials, this has increased the CPI path so far by around 0.2%-points. Assuming stabilization of food and energy prices, we look for CPI to broadly stabilize by year end, although December will see the first impact of the previous year's high base when CPI should fall below 4.0%, and in the first half of 2012 CPI should approach the MPC's central target of 2.5%.

Wage bill remains moderated



Non-resident bond holdings remain high



Source: GUS, UniCredit Research

**NBP will not hike rates this year; 2012 should see rate cuts, we look for 75bp in total**

**The monetary tightening cycle has probably ended; the market is starting to anticipate rate cuts.** The Monetary Policy Council has raised interest rates by 100bp this year, bringing the reference rate to 4.5%. Inflation pressures eased during summer months, as expected, though CPI still persists above the upper limit of the central bank's target range. According to the NBP's forecasts, inflation is likely to continue to fall in coming months, and due to the worsening economic outlook the MPC will probably not raise interest rates any further this year. In fact, the market expects the first cuts in early 2012. We look for the first rate cut at the beginning of 2012, and believe the Council is likely to ease rates by 75bp in total next year. Currently the MPC members' statements are pretty "balanced", they underline that "it's too early to discuss rate cuts", but we think that they will have to discuss this issue seriously – in the last quarter of this year, as growth is set to decline notably, and as CPI will likely approach the NBP's central target (2.5%) in the first half of 2012.

**October general elections are the key focal point for future economic policy**

**Parliamentary elections are due to take place on 9 October.** Opinion polls suggest that the ruling Civic Platform (PO) will win the elections but will need a coalition partner. The Polish Peasants Party (PSL) remain a plausible choice. Another possible coalition seems to be a PO-SLD alliance. However, opinion polls do not have a track record of being good indicators of final results of the elections (with possible errors exceeding 5%-points), and hence the results of the elections may prove surprising again. This will also be an important juncture for investors, with the main question being to what extent the new Cabinet adheres to the fiscal consolidation path declared by the current government. The stated aim for next year is that the budget deficit will be below 3%, which will be very challenging given the overly optimistic macro assumptions of the current Cabinet – and the looming economic slowdown. The European Commission expressed a view that, after adjusting for optimistic assumptions, the deficit is likely to be around 3.6%. This means that one of the first tasks of a new Finance Minister will be to find fiscal consolidation measures equivalent to 0.7% of GDP, to keep the deficit on track. The key question will be whether the new Cabinet fully realizes the magnitude of the challenges and whether it will be able to proceed on the path of credible fiscal consolidation, while at the same time not harming economic growth. Uncertainty about this may lead to a weakening of the zloty (and to a lesser extent impact the yield curve) in the run up to the 9 October-elections.

**EUR/PLN above 4.30 is an attractive level for exporters; we look for lower levels at year-end and in 2012**

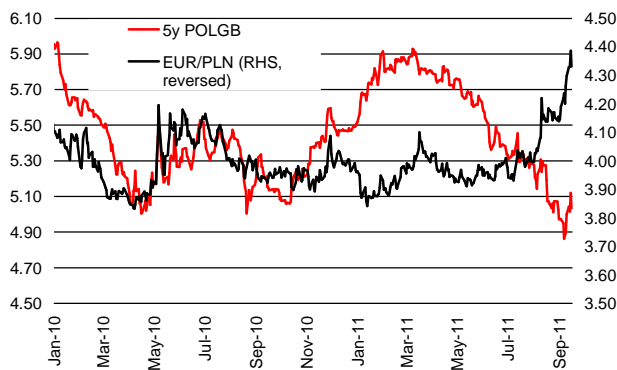
**PLN feels the pressure of increasing global risk aversion.** In the previous issue of this publication we pointed out that positive newsflow was no longer – strengthening the zloty, and that it "remained vulnerable to shifts in global sentiment (and this could drive it weaker near-term)". The expectation of a weaker zloty has materialized – but much more so than we anticipated. However, at this juncture it's important to note factors that will work against further substantial weakening of the zloty. First, as noted above, a weak zloty will stimulate the economy, thus alleviating state budget worries. Second, at current levels the zloty is pretty much undervalued fundamentally. Third, the Cabinet still has sizeable funds to sell in the FX market: in early summer it was declared that EUR 13-14bn of this year's EU funds will be exchanged in the interbank market, and next year another EUR 17-18bn. In addition, should EUR/PLN trend even higher than the current 4.30, the Cabinet might be tempted to use part of the Flexible Credit Line (USD 30bn total) and sell the funds in the market. At this stage this is pure speculation, but shows that the Cabinet has a pretty sizeable amount of "ammunition" to correct the PLN FX rate, should it extend too much. Such an action would be dictated by two key arguments: the first is stabilization of the macro environment (also in the context of CHF-denominated mortgage loans, and their impact on disposable income of burdened borrowers), and the second is that the Cabinet is possibly in favor of a very strong PLN (esp vs EUR) at year-end, when the foreign part of Poland's state debt will be gauged. An excessively weak zloty would push total debt towards the 55% debt/GDP threshold. If exceeded, this would mean very painful adjustments (as envisaged in the Public Finance Act). Therefore, we maintain the view that the zloty will strengthen towards year end, and will likely finish 2011 only slightly above 4.00. Is it possible that as in recent years some of these gains come between Christmas and New Year.

## Strategy: POLGBs should remain resilient to FX weakness

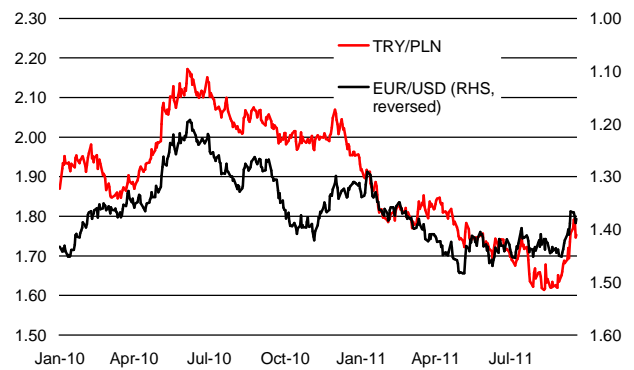
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**Significant divergence between rates and FX during Q3:** Similar to the period in 2008 the performance of PLN and POLGBs significantly diverged in Q3 (see chart 1). This means that FX unhedged POLGB positions has posted losses despite an 80bp yield compression. Given non-resident bond holdings increased further in this period we believe most of this inflow was FX hedged. **Going forward we believe the main question is weather persistent FX weakness will start poisoning the stellar duration performance.** We do not necessary think so given most of the POLGB inflows in 2011 were actually currency hedged (FX hedged as local currency were cheap to hard currency as opposed to several other countries in the region). This plus limited supply in Q4 with record wide spreads vs. Bunds means we think POLGBs will have one more strong quarter and hence keep allocation at overweight. On the curve we see value in the mid to long part where ASW spreads are around 80/90bp. In the same vein we remain U/W in the credit space. **In the pure FX space we see PLN appreciating towards the end of the year** due to likely heavier intervention from the MinFin and maybe even NBP. We see 4.20/EUR as important for the 55% debt to GDP threshold. For the time being we would maintain a long TRY/PLN position which utilizes the downside pressure in EUR/USD. We also recommend a long PLN/HUF as an intra CEE trade.

FX and rates performance diverged significantly in Q3



TRY/PLN versus EUR/USD



Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
<b>Gross financing requirement</b>	<b>48.4</b>	<b>52.7</b>	<b>47.2</b>
Budget deficit	20.2	16.2	17.1
Amortisation of public debt	28.2	36.5	30.1
Domestic	26.7	32.5	26.4
Bonds	20.3	28.3	22.9
Bills	6.3	4.3	3.5
External	1.5	4.0	3.6
IMF/EU	0	0	0
<b>Financing</b>	<b>48.4</b>	<b>54.5</b>	<b>49.0</b>
Domestic borrowing	36.7	44.3	38.5
Bonds	32.2	38.2	33.3
Bills	4.6	6.1	5.2
External borrowing	11.7	10.3	10.5
Bonds	6.3	5.8	5.9
IMF/EU	0	0	0
Other	5.3	4.5	4.6

Source: UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
<b>Gross financing requirement</b>	<b>88.1</b>	<b>88.1</b>	<b>90.1</b>
C/A deficit	17.4	20.2	19.4
Amortisation of medium to long term debt	17.2	14.4	12.9
Government/central bank	5.7	7.0	5.6
Banks	5.1	1.7	3.4
Corporates	6.4	5.6	3.9
Short term debt amortisation	53.5	53.6	57.8
<b>Financing</b>	<b>93.3</b>	<b>93.1</b>	<b>95.1</b>
FDI	6.5	8.0	8.0
Equity	4.3	4.0	4.0
Borrowing	82.1	80.6	83.8
Government/central bank	13.4	15.9	14.5
Banks	32.3	29.3	33.7
Corporates	36.3	35.4	35.6
EU transfers	8.5	8.5	7.3
Other	-8.0	-8.0	-8.0

Source: UniCredit Research

## Romania (Baa3 stable/BB+ stable/BBB- stable)\*

**Outlook** – Domestic demand could drive GDP growth in the second half of 2011, boosted by good crops and a positive base effect, thus offsetting weaker exports and allowing us to maintain our growth forecast of 1.8% yoy for 2011. C/A deficit could be capped at 4%/GDP by feeble capital inflows, despite weakening exports. FDI coverage could remain below 50% at the end of 2011 as privatization plans are hit by lower risk appetite.

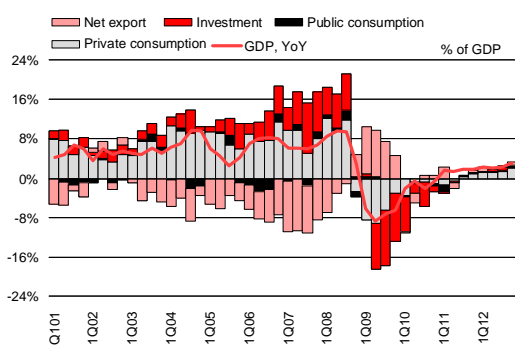
**Strategy** – Romanian assets outperformed their regional peers, which in our view was justified by the significant improvement in external and internal imbalances since 2008 and the anchor provided by the IMF precautionary agreement. From here we would take a cautious stance but among the three asset classes see external debt relatively cheap to local currency debt.

Author: Dan Bucsa, Chief Economist (UniCredit Tiriac Bank)

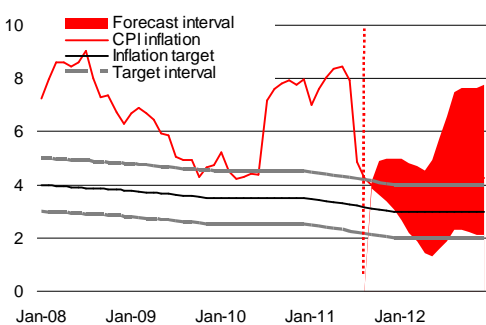
### KEY DATES/EVENTS

- 29 September – NBR rate decision
- 2 November – NBR rate decision
- 4Q Transelectrica privatization

### GDP GROWTH TO FLATTEN



### SHARP DISINFLATION AHEAD



Source UniCredit Research, NBR, CSO

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	117.5	122.0	131.1	141.7	153.5
Population (mn)	21.5	21.5	21.4	21.3	21.2
GDP per capita (EUR)	5,467	5,675	6,116	6,638	7,248
<b>Real economy yoy (%)</b>					
GDP	-7.1	-1.3	1.8	2.5	3.0
Private Consumption	-9.2	-2.0	0	2.2	2.9
Fixed Investment	-25.3	-13.1	-0.5	1.7	3.0
Public Consumption	1.2	-3.2	-2.8	3.9	3.0
Exports	-5.5	13.1	11.5	10.4	8.9
Imports	-20.6	11.6	9.4	8.5	8.5
Monthly wage, nominal (EUR)	326	334	347	377	377
Unemployment rate (%)	6.3	7.6	5.0	4.5	4.3
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-7.3	-6.5	-4.4	-4.5	-4.0
Primary balance	-6.1	-5.1	-3.4	-3.6	-3.2
Public debt	27.4	35.5	48.6	50.0	50.8
<b>External accounts</b>					
Current account balance (EUR bn)	-4.9	-5.2	-5.3	-5.9	-6.1
Current account balance/GDP (%)	-4.2	-4.2	-4.0	-4.1	-4.0
Basic balance/GDP (%)	-1.2	-2.1	-2.1	-1.6	-0.8
Net FDI (EUR bn)	3.6	2.6	2.5	3.5	4.9
Net FDI (% of GDP)	3.0	2.1	1.9	2.5	3.2
Gross foreign debt (EUR bn)	65.7	72.8	78.7	82.4	87.4
Gross foreign debt (% of GDP)	55.9	59.7	60.1	58.2	56.9
FX reserves (EUR bn)	28.3	32.4	30.9	29.2	27.6
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	5.6	6.1	6.3	4.2	4.1
CPI (eop)	4.7	8.0	4.7	4.3	4.0
Central bank target	3.5	3.5	3.0	3.0	3.0
Central bank reference rate (eop)	8.00	6.25	6.25	5.50	5.00
3M money market rate	10.43	6.25	5.50	5.50	5.00
USD/RON (eop)	2.94	3.13	2.88	2.73	2.70
EUR/RON (eop)	4.23	4.28	4.20	4.15	4.05
USD/RON (pavg)	3.05	3.17	3.00	2.79	2.72
EUR/RON (pavg)	4.24	4.21	4.20	4.15	4.10

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Growth driver to switch from foreign to domestic demand

**Growth in 1H11 supported by foreign demand**

In 2Q11, Romania's GDP grew 1.4% yoy in real terms and 0.2% qoq (seasonally adjusted). 1H11 growth was 1.6% yoy, industrial production contributing 2%-points. Market services, net taxes and agriculture added together 0.6%-points. Public services reduced 1H GDP dynamics by 0.7%-points because of fiscal tightening measures, while construction works subtracted another 0.1%-points because of weak demand and scarce financing. The strong industrial output fuelled just exports (+14.2% yoy in 1H11) and inventories (+147.3% yoy in 1H11). Private consumption contracted 1.2% yoy in 1H11 because of lower real revenues (wages declined 7% yoy in real terms during 1H11) and shrinking consumer loans (-8.7% yoy in June 2011, adjusted for inflation). Public consumption was hit by fiscal tightening, falling 7.4% yoy during the first semester. Investment fell 1.7% yoy, the weak demand affecting investment intentions.

**Domestic demand to spur growth in 2H11 and beyond**

**In 2H11, domestic demand will be boosted by good crops and a positive base effect, while external demand will probably weaken (exports to the EU slowed down in July to 5.8% yoy from 25.1% yoy in 1H11).** Preliminary data hint at a very good harvest in 2011 and we forecast a 0.5%-points contribution by agriculture to this year's GDP growth of 1.8%. The positive base effect stems from the comparison with 2H10, when fiscal tightening hit the recovery trend begun in early 2010. We expect GDP to grow 2.5% yoy next year and 3.1% in 2013, relying on two factors: a gradual recovery of the Eurozone economy after an almost flat 2H11 and fiscal stimulus during election year 2012. The former factor could maintain export growth above 10% yoy, while the latter could fuel public consumption (+3.9% yoy expected in 2012). Although private consumption will be hurt by tighter lending standards, revenue-boosting public policies could support growth rates of 2.2% in 2012 and 2.9% in 2013. The forecast for investment growth (+1.7% in 2012, 3% in 2013) is affected by low FDI (2.3% and 3.8% of GDP in 2012 and 2013), low investment appetite in industry and by feeble construction works (2.3% yoy in 2012 and 3.3% yoy in 2013, driven mainly by infrastructure projects).

**C/A adjustment hit by falling external demand, but capped by low, volatile external financing**

**The rapid slowdown of external demand has prompted us to revise upwards our C/A deficit forecast to EUR 5.3 bn in 2011, EUR 5.8 bn in 2012 and EUR 6.1 bn in 2013 (4.0%, 4.1% and 4.0% of GDP from 3.3%, 3.1% and 3.8% respectively).** We forecast exports to grow 11.5% yoy in 2011 (on the back of stellar performance during the first semester), 10.4% yoy in 2012 and 8.9% in 2013, while imports are expected to add 9.4% this year, 8.5% the next and in 2013. Moreover, remittances from Romanians working abroad are still falling (around EUR 3.6bn for the period July 2010-June 2011) and are unlikely to accelerate significantly during the next couple of years because of slow recoveries in Spain and Italy. The main factor capping the trade deficit is weak and volatile external financing (lower FDI and financing from parent banks, higher portfolio investment). The absorption of EU funds picked up, amounting to EUR 0.97bn between January and July 2011, 36% of the money absorbed since 2007.

**The budget deficit target for 2011 is attainable, less so the one for 2012**

**The budget deficit target for 2011 looks safe at 4.4% of GDP, even if the Government decides to frontload some of the 2012 spending in 4Q11.** The seven-month deficit was just 2.1% of GDP. Budget revenues increased 9.4% yoy on higher receipts from consumption taxes and better collection, while expenditure rose just 0.1% yoy, helped by the lower wage bill (-17.8% yoy) and less social assistance expenditure (-2.4% yoy). On the positive side, investment expenditure and co-financing for European projects increased 29% yoy. In 2012, the ambitious budget deficit target of 3% of GDP will be under threat from higher public spending before elections. We see the 2012 budget deficit at 4.5% of GDP and hope that the IMF will hold sway to cap it lower. The push to hold both local and general elections in a single round in November or December 2012 could be beneficial for containing public spending next year.

**The inflation target for 2011 will be missed**

Annual CPI inflation has plummeted from 8.4% in May 2011 to 4.9% in July because last year's VAT hike was excluded and food prices fell sharply across CEE. Pending the scrapping of heating subventions, annual inflation could end 2011 between 4.1% and 4.7%, missing the 3%  $\pm$ 1 pp target. The year-end inflation forecast is 4.3% for 2012 and 4% for 2013.

**Macro-prudential measures to tighten real monetary conditions further**

Despite the better inflation outlook, we still expect the National Bank of Romania to leave its monetary policy rate unchanged at 6.25% in 2011 and to take it gradually to 5.5% by the end of 2012. We currently see a sharp tightening of real monetary conditions in 1H12 stemming from increasing real interest rates, RON appreciation and harder access to consumer financing. If RMC weigh on growth more than expected, the interest cut schedule could be more aggressive. The NBR has drafted a new regulation aimed at reducing risks for both borrowers and lenders. Conservative debt service to income ratios, higher down payments and adverse risk scenarios could slash up to a third of solvent demand.

**Public finances to weigh on RON and interest rates**

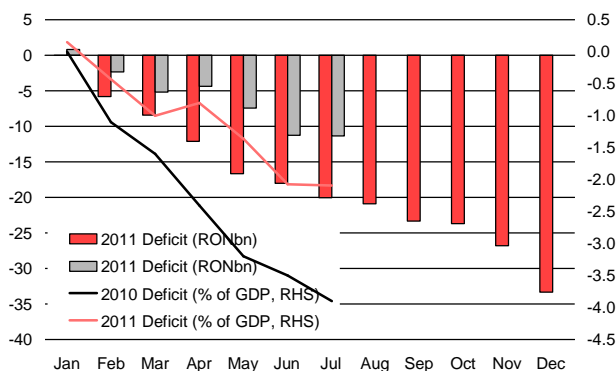
The financing of the budget deficit will probably shape interest rates and exchange rates in 4Q11 and beyond. The treasury yield curve has shifted upward since August, flattening between 6.3% for 6 months and 7.7% for 10 years. We believe that adverse financing conditions have been prompted mainly by lower demand from abroad. Nevertheless, Romanian bills and bonds remain attractive for at least four reasons: **1.** Romania has the highest yields among investment-grade EU countries with the exception of Portugal and Ireland; **2.** Romania's public debt is still around 40% of GDP and its deficit is falling; **3.** disinflation continues, signalling scope for yield reduction and **4.** the FX risk of EUR-funded investment in RON is capped by very low realized EUR/RON volatility. Apart from debt issuance in RON, the Finance Ministry has three additional sources of revenues: privatizations, bond issuance on foreign markets, and tapping IFI money through the current EUR 5.4bn precautionary agreement. The privatization program has been affected by increased risk aversion worldwide. The cost of FX-denominated bonds could increase because of issuance fatigue around Europe and because falling mid-swaps (-1.3 pp between April and September 2011) have been offset by the widening of Romania's CDS spreads (+130bp over the same horizon). From a relative perspective we however see the Romanian Eurobonds as cheaper than the local currency bonds given the ASW in the local market is relatively tight vs. CDS.

**Contagion risk primarily to growth and interest rates and to a lesser extent to the RON**

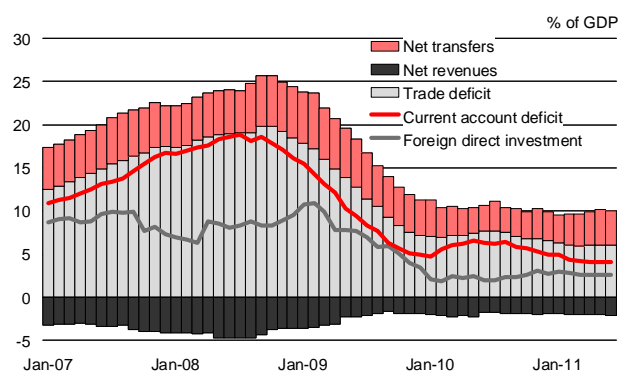
Risks to our economic outlook stem mainly from contagion from current debt and economic woes in the Eurozone. The Romanian economy is already losing pace, while increased risk aversion has affected yields and has driven EUR/RON over 4.2 RON/EUR. Consolidation in the banking system could slow down lending. In the scenario of fund outflows, we see higher risks to interest rates rather than the exchange rate, since the NBR can use its sizeable FX reserves (EUR 32.6bn, 20x larger than average monthly volumes on the local FX market) to curb exchange rate volatility. If foreign funding dries up, the current account could correct more, either through higher local savings or through limited depreciation. In the extreme scenario, Romania could turn again to the IMF, using the current precautionary agreement (the EUR 5.4bn cover completely the C/A deficit).

**TWIN DEFICIT IMPROVES RAPIDLY**

Impressive budget performance YTD



External balance remains supportive



Source: NBR, UniCredit Research

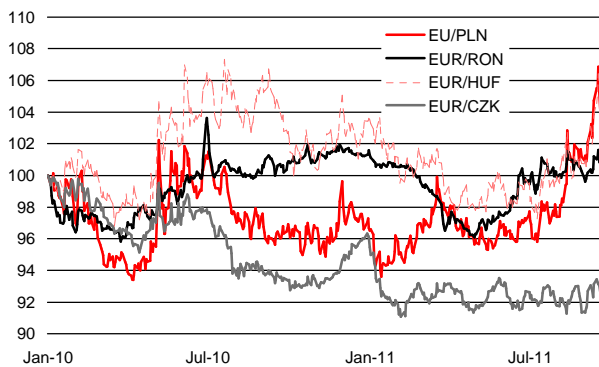
## Strategy: recent outperformance justified; credit looks to be the cheapest asset class from here

**Gyula Toth,**  
**Head of EEMEA FI/FX Strategy**  
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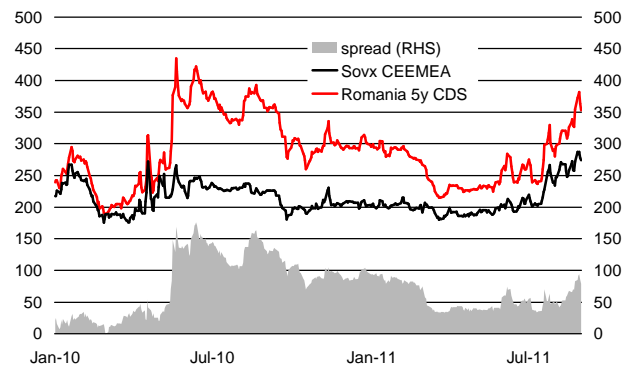
Romanian assets outperformed all of their regional peers during Q3 which in our view was justified by the relatively better fundamental improvement compared to 2008. RON has been the best performing FX and outperformed the PLN by almost 9% QTD. Credit spreads outperformed regional peers with Romanian CDS now trading inside better rated Hungary and Croatia. Meanwhile the lack of non-resident demand and deteriorating banking sector liquidity has pushed RON local rates around 50bp higher but it still looks relatively reasonable vs. CEEMEA peers. From here the MinFin again started to cap long end auction yields at the 7.50% level which could lead to duration shortening.

Overall we believe the recent outperformance is justified by the fact that Romanian imbalances improved the most in relative terms in the region compared to 2008 (see our latest Quarterly for details). From here Romanian assets are unlikely to avoid some contagion from the EMU and hence we recommend M/W allocation in a regional context. Among the three asset classes we see credit to be the most attractive versus FX and local rates.

The RON outperformed regional peers (Jan 2010 = 100)



Romanian credit vs. Sovx CEEMEA



Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011F	2012F	2013F
<b>Gross financing requirement</b>	<b>16.7</b>	<b>22.4</b>	<b>21.6</b>
Budget deficit	5.8	6.4	6.1
Amortization of public debt	10.9	16.0	15.5
Domestic	10.7	15.0	15.3
Bonds	0.8	4.8	6.0
Bills	9.9	10.2	9.2
External	0.2	1.0	0.2
IMF/EU	0.2	2.0	5.1
<b>Financing</b>	<b>19.4</b>	<b>22.6</b>	<b>21.9</b>
Domestic borrowing	15.3	19.6	18.9
Bonds	3.4	7.5	8.4
Bills	11.9	12.1	10.5
External borrowing	4.1	3.0	3.0
Bonds	1.5	3.0	3.0
IMF/EU	2.6	0	0
Other	0	0	0

Source: UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011F	2012F	2013F
<b>Gross financing requirement</b>	<b>20.6</b>	<b>25.0</b>	<b>29.0</b>
C/A deficit	5.3	5.9	6.1
Amortization of medium to long term debt	15.3	19.1	22.9
Government/central bank	2.6	2.8	5.4
Banks	5.6	7.1	7.7
Corporates	7.1	9.2	9.8
<b>Financing</b>	<b>22.3</b>	<b>27.2</b>	<b>31.8</b>
FDI	1.8	3.2	4.3
Equity-	2.0	2.1	3.2
Borrowing	16.7	19.6	21.4
Government/central bank	4.1	3.0	3.0
Banks	5.4	7.2	8.1
Corporates	7.2	9.4	10.3
EU Funds	1.1	1.8	2.3

Source: UniCredit Research

## Slovakia (A1 stable/A+ positive/A+ stable)\*

**Outlook** – Parliament approved a new Labor Code and is likely to adopt further reforms this autumn. The economy posted relatively strong 2Q11 GDP figures, but there are signs of a slow-down, just as we predicted. Dependence on external demand means that the economy will decelerate further in the coming quarters. Longer term, reform measures should enhance the economy's efficiency and flexibility securing a sustainable medium-term growth path.

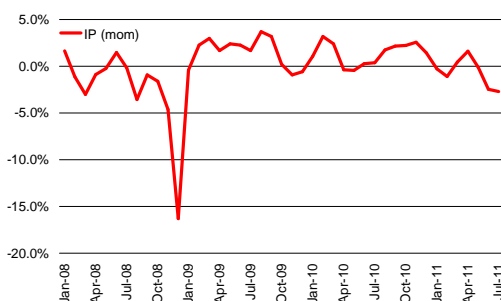
**Strategy outlook:** We believe the locally issued bonds are relatively cheap compared to the Bund curve and even also compared to Czech Eurobonds. We hence see value in buying mid to long dated SLOVGBs at around 150-165bp ASW.

**Author:** Vladimír Zlácký, Chief Economist (UniCredit Bank)

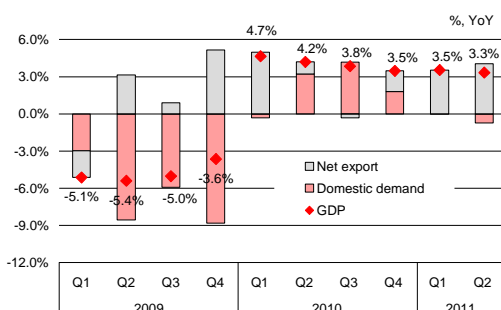
### KEY DATES/EVENTS

- October 10, November 9 and December 8 – Industrial production
- 13 October, 11 November and 13 December – CPI
- 15 November – flash GDP
- 6 December – GDP structure

### INDUSTRIAL PRODUCTION (TREND SA)



### CONTRIBUTIONS TO GDP GROWTH



Source: Statistical Office SR, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	63.1	65.9	69.4	72.6	77.3
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	11,636	12,135	12,772	13,360	14,225
<b>Real economy joy (%)</b>					
GDP	-4.8	4.0	2.9	2.8	4.3
Private Consumption	0.2	-0.3	-0.5	0.8	2.0
Fixed Investment	-31.0	12.9	6.6	5.7	4.9
Public Consumption	5.6	0.1	-5.0	-0.5	0
Exports	-15.9	16.4	9.7	8.4	9.8
Imports	-18.6	14.9	7.6	8.0	8.6
Monthly wage, nominal (EUR)	745	769	792	823	865
Unemployment rate (%)	12.1	14.4	13.1	12.4	11.8
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-8.0	-7.9	-5.1	-4.0	-3.0
Primary balance	-6.5	-6.6	-3.1	-1.9	-0.8
Public debt	35.4	41.0	44.4	44.7	44.1
<b>External accounts</b>					
Current account balance (EUR bn)	-2.3	-2.3	-1.8	-2.0	-1.9
Current account balance/GDP (%)	-3.6	-3.5	-2.7	-2.7	-2.5
Basic balance/GDP (%)	-2.9	-1.9	-1.2	-1.2	-1.1
Net FDI (EUR bn)	0	0.4	0.9	1.4	1.7
Net FDI (% of GDP)	-0.1	0.6	1.3	2.0	2.2
Gross foreign debt (EUR bn)	45.3	49.7	53.6	58.1	62.6
Gross foreign debt (% of GDP)	71.9	75.3	77.3	80.0	81.0
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	1.6	1.0	4.0	3.1	3.4
CPI (eop)	0.5	1.3	4.3	3.3	3.4
ECB	EUR	EUR	EUR	EUR	EUR
3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR/EUR (avg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Reforms progressing, economy slowing down

### New Labor Code becomes effective

**The Government has made progress in its reform efforts.** Parliament approved an amendment to the Labor Code with several improvements leading to greater flexibility of the labor markets (effective 1 September this year). The payroll tax reform simplifying the current system and leading to a lower payroll burden on employees over time, as well as parametric changes to the pension system making it immune to worsening demographics, should be adopted this autumn. Further progress in improvements to the business environment (Project Singapore) as well as in privatization is also expected. However, the success of the reform efforts is dependent on the current government remaining in power. While the recent ruptures within the coalition – such as those related to EFSF upgrade approval – complicate things, our baseline scenario does not assume early elections.

### 2Q11 GDP still strong, but economy slowing down

These reforms would give the economy a much needed boost to growth in the medium-term and secure sustainability. More short-term, **the economy has been showing signs of slowdown** vindicating our previously expressed concerns. Although reported 2Q11 GDP growth (3.3% yoy, 0,9% qoq sa) maintain the flat dynamics from the first quarter, a breakdown of the GDP structure as well as recent industrial production/export performance further accentuate the risks ahead. Regarding the GDP growth structure, net exports made a 4.0%-point contribution to growth in 2Q11 while the contribution of domestic demand was -0.7points. Household consumption and gross capital formation were flat on an annual basis (investments up 6.2% yoy but there was some destocking) while government expenditures contracted by a sharp -4.3% yoy. Despite the positive effect on growth of net exports, export dynamics have already slowed down compared to the first quarter and July export figures testify to the worsening demand for Slovakia's exports. Given the high dependence of growth on external demand as domestic demand continues to be weak, the economy is likely to decelerate in the coming quarters.

### Industry falls for second month in a row

The Slovak industry is highly export-oriented. June and July industrial production figures (- 2.2% and -3.4% mom sa) already clearly show that **the demand for Slovakia's exports is cooling off**. The worst hit sectors in July were consumer electronics, which plummeted 16.0% mom sa, electrical machinery (-9.1%) and refinery (8.1%). We expect a weak industrial production performance in the coming months.

### Downward revision of growth

**We have downwardly revised our growth forecasts for this and next year.** After growing by 3.4% yoy in 1H11, we expect the economy to decelerate in the second half of the year (3Q: 2.9%, 4Q: 2.0%) leading to our full year forecast of 2.9%. Our previous 2011 forecast of 3.1% already incorporated a significant slow-down in the second half of this year. We are also assuming that new production lines at large electronics and car producers will come on stream in 2H11. For 2012, we expect the economy to grow by 2.8% as slightly recovering household consumption should lend some support to the economy hit by lower external demand. Hence, while we expect a sizeable slow-down in the coming quarters we do not expect to see a return to the kind of recession the country experienced in 2008-09.

### Inflation to increase further

**Monthly CPI increased by 0.1% in August meaning that annual inflation rose to 4.0% (from 3.7% yoy in July).** Regulated gas prices went up 7% while food prices (mostly seasonal vegetables and fruit) exerted downward pressure (-0.8% mom) on the price level. August inflation was lower than we expected mostly because the planned increase in the regulated prices of heat did not transpire. We now expect that heating plants will change their prices in September or later, which should lead to a further rise in inflation (the contribution to inflation should be ca. 0.3%-points). Annual inflation will then stabilize for the rest of the year – our end-year CPI forecast is now 4.3% yoy

### S&P may raise Slovakia's rating

**S&P rating agency confirmed Slovakia's rating at A+ but improved its outlook from stable to positive.** The positive outlook reflects the agency's view that the rating will likely be increased if the government delivers on its fiscal consolidation plans, stabilizes its debt and continues its reforms of the labor market and business environment.

## Slovenia (Aa2 stable/AA negative/AA stable)\*

**Outlook** – A deteriorating external environment will adversely impact Slovenia's export oriented economy as the minority government seeks to push through a net EUR 370mn reduction in the budget deficit. The large state-owned share of the banking sector represents another risk, while there is also a very real possibility of early elections should the 5 new proposed ministers not receive parliamentary backing on 20 September.

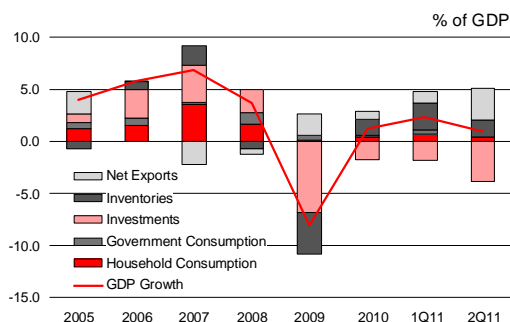
**Strategy outlook** – We recommend reducing Slovenian bond exposure in favor of Slovakian locally issued Eurobonds due to supportive valuation and diverging macro outlook.

**Author:** Goran Šaravanja, Chief Economist (Zagrebačka banka)

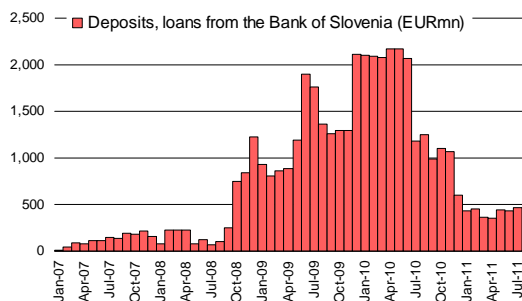
### KEY DATES/EVENTS

- 20 September: confirmation vote on new ministers
- 3Q GDP 30 November
- 6 October, 3 November, 8 December ECB meetings

### GDP REMAINS SLUGGISH



### BANKING SECTOR RELIANCE ON ECB LOW



Source: UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	35	35	37	38	40
Population (mn)	2.0	2.0	2.0	2.0	2.0
GDP per capita (EUR)	17,309	17,293	17,786	18,417	19,180
<b>Real economy joy (%)</b>					
GDP	-8.0	1.4	1.3	1.8	2.2
Private Consumption	-0.6	0	0.7	1.0	2.5
Fixed Investment	-23.3	-8.3	-9.3	1.4	4.5
Public Consumption	2.9	1.5	0.5	-1.0	0
Exports	-17.2	9.5	6.6	5.7	6.5
Imports	-19.6	7.2	5.7	4.9	7.0
Monthly wage, nominal (EUR)	1,439	1,495	1,535	1,580	1,635
Unemployment rate (%)	5.9	7.3	8.2	7.8	7.4
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-6.0	-5.6	-5.8	-4.8	-4.0
Primary balance	-4.7	-4.1	-3.7	-2.5	-2.0
Public debt	35.9	40.7	45.2	48.4	50.3
<b>External accounts</b>					
Current account balance (EUR bn)	-0.5	-0.3	-0.2	-0.7	-0.8
Current account balance/GDP (%)	-1.3	-0.8	-0.5	-1.9	-2.0
Basic balance/GDP (%)	-3.1	0.1	0.9	0.7	1.2
Net FDI (EUR bn)	-0.6	0.3	0.5	1.0	1.3
Net FDI (% of GDP)	-1.8	0.9	1.4	2.6	3.2
Gross foreign debt (EUR bn)	40.3	40.9	44.0	46.0	49.0
Gross foreign debt (% of GDP)	114.1	115.5	120.4	121.2	123.7
FX reserves (EUR bn)	0.7	0.8	0.8	0.7	0.7
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	0.9	1.8	1.9	2.0	2.2
CPI (eop)	1.8	1.9	2.2	1.7	2.4
ECB	EUR	EUR	EUR	EUR	EUR
3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR/EUR (avg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Economy moderating even before summer market turmoil

**GDP slow in 2Q as industrial production and merchandise trade data begin to show signs of moderation**

**Economic growth slowing.** GDP growth in 2Q slowed to 0.9% yoy and to only 0.1% qoq seasonally adjusted. In particular, the pace of contraction in investment spending is accelerating – even after the 10 previous quarters recorded a contraction in investment activity, with the construction industry still the main contributor to this trend. Industrial production is slowing: July revealed an increase of 2% yoy, yet on a mom basis the trend is negative, while export and import growth have both been slowing on a 3M/3M seasonally adjusted basis since February 2011. Unemployment (ILO comparable data) fell in 2Q to 7.8% from 8.5% in 1Q, but at the same time real wage growth moderated in 2Q rising 0.2% yoy in real terms compared to 1.3% yoy in 1Q according to our calculations.

**Current account surplus a pleasant surprise as minimal inflationary pressures reflect weak domestic demand.**

**Inflation remains low, current account in surplus:** In August consumer prices rose 0.9% yoy and we estimate core inflation remains in negative territory. By year-end we see inflation rising to 2.2% yoy on base effects, but the average rate should remain below 2.0% yoy. The current account surplus in Jan-July 11 stood at EUR102.3mn – with June and July the key surplus months - but with merchandise exports expected to moderate in the remainder of the year we expect to post a moderate deficit of 0.5% of GDP, rising to 1.9% of GDP next year, again on the back of weaker external demand. Given the acceleration in the contraction of investment spending however, we would note that the risks to our current account deficit forecast are to the downside – import growth may well slow more quickly than export growth.

**GDP forecast lowered from 2.9% to 1.3%**

**GDP forecast lowered** on deteriorating external environment. Slovenia's economy, with exports and imports of goods and services accounting for an estimated 70% of GDP in 2011, is evidently exposed to slower euro zone growth. We have lowered our GDP forecast for the year to 1.3% yoy and from 2.5% to 1.8% yoy in 2012 as a result of our scenario of slower growth in the euro zone. In addition to an expected reduction of export growth, the current situation in the euro zone could also affect Slovenia via increased cost of funding. Also, the fact the government has large stakes in the main banks in Slovenia presents a risk to the fiscal accounts, as we have mentioned previously. Banking sector reliance on the ECB has increased to EUR464mn at the end of July, a year high for 2011, but still lower than the end 2010 level of EUR602mn.

**Government's plans to rein in budget watered down compared to original plan, but likely to find parliamentary support**

**Government plans spending cuts.** In mid-July the government approved a package of spending cuts in the amount of EUR370mn for this year focusing on capital spending and purchases of other goods and services in an effort to bring the budget deficit down as part of the EU's Excessive Deficit Procedure. Originally the government had planned a EUR455mn reduction in the deficit. Taking the difference between the original and agreed plan and factoring in the impact of our reduced growth forecast we now forecast a consolidated general government budget deficit this year of 5.8% of GDP. We assume the minority government will gather the necessary support for the savings measures (see below) but given the deteriorating external environment would consider our deficit forecast exposed to the risk of widening further.

**Early elections a possibility**

**Early elections a possibility.** As expected the parliament approved the supplementary budget on 16 September, however, the next hurdle for the government will be the confirmation votes of 5 new ministers on 20 September. This vote carries more risk of failing, which would force early elections, most likely in December. In the same week the parliament is due to vote on expanding the size of the European Financial Stability Fund.

**Sovereign rating.** Slowing growth dynamics and the increase in Slovenian banks accessing ECB funds are the main downside risk. The possibility of early elections is not necessarily a negative in the sense that a new political mandate would make it easier to implement reforms. Still low public debt levels mean we remain constructive on the sovereign rating

## Bosnia Herzegovina (B2 negative/B+ negative/not rated)\*

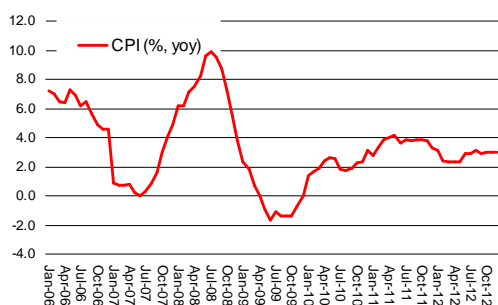
**Outlook** – While we maintain our growth forecast of 1.8% for 2011, the deteriorating external environment has led us to revise our 2012 forecast from 2.5% to 1.5%. The IMF program remains in limbo and while merchandise exports and industrial production have done well in 1H11, they are beginning to slow and can be expected to remain moderate as euro zone growth slows into 2012.

**Author:** Goran Šaravanja, Chief Economist (Zagrebačka banka)

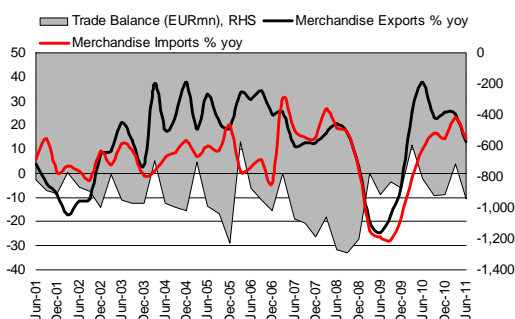
### MACROECONOMIC DATA AND FORECASTS

KEY DATES/EVENTS	
■	25 October: CPI and Industrial production
■	24 November: CPI and Industrial production
■	Late December: 3Q balance of payments

### INFLATION SET TO MODERATE



### MERCHANDISE EXPORT GROWTH SLOWS



Source: Statistical Office, Central Bank of BiH UniCredit Research

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	12.3	12.5	13.2	13.8	14.6
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,194	3,258	3,437	3,585	3,796
<b>Real economy yoy (%)</b>					
GDP	-2.9	0.7	1.8	1.5	3.3
Monthly wage, nominal (EUR)	616	622	650	672	693
Unemployment rate (%)	41.5	42.9	43.3	42.8	42.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-5.7	-4.5	-4.5	-4.0	-3.3
Primary balance	-5.1	-3.7	-3.1	-2.8	-2.2
Public debt	35.4	39.2	41.7	43.9	44.8
<b>External accounts</b>					
Current account balance (EUR bn)	-0.8	-0.7	-0.9	-1.1	-1.4
Current account balance/GDP (%)	-6.2	-5.6	-7.2	-8.3	-9.3
Basic balance/GDP (%)	-4.7	-5.5	-5.2	-4.6	-5.8
Net FDI (EUR bn)	0.2	0	0.3	0.5	0.5
Net FDI (% of GDP)	1.5	0.1	1.9	3.7	3.5
FX reserves (EUR bn)	3.2	3.3	3.2	3.3	3.3
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	-0.4	2.2	3.7	2.8	2.6
CPI (eop)	0	3.1	3.3	3.0	2.4
3M money market rate	0.9	0.6	1.3	2.4	3.3
FX/USD (eop)	1.37	1.46	1.29	1.36	1.36
FX/EUR (eop)	1.96	1.96	1.96	1.96	1.96
FX/USD (pavg)	1.40	1.47	1.33	1.32	1.32
FX/EUR (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Economy performing reasonably well

### Industrial production performing well

**High frequency data suggest GDP forecast on track for 2011.** Industrial production is holding up surprisingly well through to July 2011, expanding at 8.1% yoy in Jan-July. Admittedly, manufacturing production has slowed, rising 7.4% yoy over this period, but mining activity has risen by 23% yoy at the same time to underpin aggregate industrial production growth. This is one of the main reasons we are maintaining our 2011 growth forecast at 1.8%. Unemployment figures in 1H 2011 have remained essentially flat throughout, with the June unemployment rate at 43.1%. Meanwhile real gross wages rose 0.8% yoy in 1H 11 while real net wages have fallen by 1.2% yoy over this period. Combined with moderate loan growth this suggests sluggish domestic demand will continue to characterize the economy. Inflationary pressures are relatively elevated at 3.9% yoy in July, but with agricultural goods' prices somewhat more supportive over the summer we have lowered our 2011 CPI forecast slightly from 4.1% yoy to 3.7% yoy

### Export growth still double digit in 2Q, but down from over 20% yoy in 1Q

**External imbalances widening:** Merchandise exports and imports both continued to expand in 2Q 11, but at a slower pace rising 13% yoy and 14.5% yoy respectively. We nonetheless lower our current account deficit forecast to 7.2% of GDP this year and 8.3% next year from 8.8% and 9.8% respectively. The rationale behind this adjustment is that while export growth will be slower than initially expected, import growth will also slow. Nonetheless, we see the trend of a widening current account deficit continuing.

### Deteriorating international environment main reason for downward revision in 2012 growth to 1.5%

**International environment unsupportive.** The main change to our outlook is related to GDP growth, even though our 2011 forecast remains unchanged at 1.8%. Namely, slower euro zone growth in 2012 is behind our reduced forecast of 1.5% (compared to 2.5% previously). The main ways the worse international environment will impact on growth is through reduced exports as well as a likely reduced net external financing for the banking sector. An additional risk is uncertainty over the IMF program, which has not disbursed funds since 3Q10. At the same time, the inflow of funds of the European Commission and supranational financial institutions is substantially weaker. One notable effect of this has been the reduction in FX reserves by over EUR 100mn at end July to EUR 3.1bn compared to end 2010.

### Federation government to also issue t-bills as IMF disbursements remain on hold

**The Federation will also issue T-bills.** After issuing a 6M t-bill in May, the government of Republika Srpska issued BAM 28.3mn of a 9M t-bill on 20 June at a yield of 3.2% with a bid/cover ratio over 2. The government of the Federation has also decided to issue a total of BAM 90mn in t-bills this year, with BAM 65mn to be issued before the end of September and the remaining BAM 25mn before the end of the year. As the lack of progress on meeting IMF program goals (not helped by the absence of a national level government) has precluded the release of further money from the IMF program, the entity governments have resorted to issuing t-bills in an effort to help finance their activities.

### No progress on forming a national level government in the intervening 3 months

**Still no sign of a national level government.** Although there were hopes that prior to the summer a national level government would be formed, they turned out to be too optimistic. Apart from generating uncertainty which even in a much more benign international environment would be detrimental to investor sentiment, the lack of national level government has also contributed to the ending, for all practical intents and purposes, of the current IMF program. It is due to run to July 2012, but given the delays since the election in implementing reforms, the program will be subject to a review. Ideally, the formation of a national level government would be a catalyst for a new program, which would underpin support for the economy and provide added credibility to the authorities' policy agenda.

**Sovereign rating outlook lowered.** On 28 July Standard and Poor's changed the outlook on Bosnia Herzegovina's sovereign debt from stable to negative, maintaining its B+ rating. With the IMF program in limbo and a government at the national level not in place almost a year after general elections, the probability of a decrease in the sovereign rating has increased.

## Croatia (Baa3 stable/BBB- negative/BBB - negative)\*

**Outlook** – The relatively weak and nascent recovery in growth seen in 2Q is exposed to risk given this summer's global financial market turmoil and sharply reduced EU growth forecasts for 2012. Domestic demand looks set to remain weak while ahead of general elections in December there is uncertainty over the next government's initial economic policy choices.

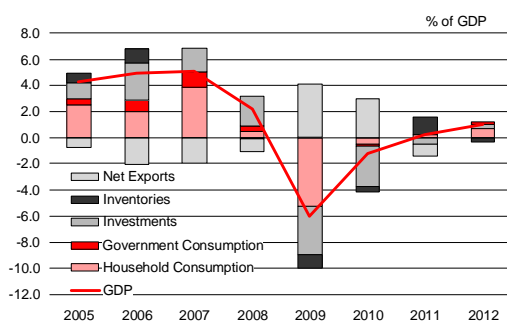
**Strategy outlook** – We remain generally bearish on Croatian markets with EUR/HRK now trading above the 2008/2009 highs whilst Croatia credit underperformed regional peers in 3Q. Due to our bearish multi month outlook we would use the recent regional credit underperformance only tactically in switch trades.

**Author:** Goran Šaravanja, Chief Economist (Zagrebačka banka)

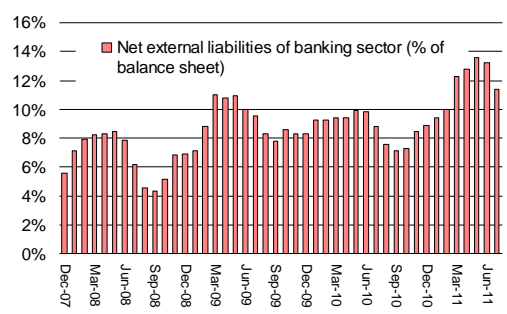
### KEY DATES/EVENTS

- November 25 : 3Q GDP flash estimate
- December: General election to be held (date not confirmed yet, potentially 4 December)

### GDP GROWTH COMPONENTS



### BANKING SECTOR NET EXTERNAL LIABILITIES



Source: IMF, National ministries of finance, Eurostat, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	45.7	45.9	46.3	48.1	50.7
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,310	10,388	10,472	10,897	11,470
<b>Real economy yoy (%)</b>					
GDP	-6.0	-1.2	0.2	1.0	2.0
Private Consumption	-8.5	-0.9	0.4	1.1	2.0
Fixed Investment	-11.8	-11.3	-2.0	1.0	7.0
Public Consumption	0.2	-0.8	0.0	0.0	0.0
Exports	-17.3	6.0	-5.3	3.0	4.5
Imports	-20.4	-1.3	-2.6	2.0	5.2
Monthly wage, nominal (EUR)	1051	1053	1051	1084	1137
Unemployment rate (%)	9.1	11.8	13.0	12.5	11.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-3.9	-4.8	-6.0	-5.0	-4.0
Primary balance	-2.4	-2.9	-2.9	-2.5	-1.8
Public debt	35.2	41.2	49.5	52.8	54.6
<b>External accounts</b>					
Current account balance (EUR bn)	-2.4	-0.5	-0.8	-1.0	-1.4
Current account balance/GDP (%)	-5.2	-1.1	-1.8	-2.0	-2.8
Basic balance/GDP (%)	-2.6	-0.4	-0.7	0.6	0.7
Net FDI (EUR bn)	1.2	0.3	0.5	1.3	1.8
Net FDI (% of GDP)	2.6	0.7	1.1	2.6	3.5
Gross foreign debt (EUR bn)	45.2	46.5	48.0	50.0	53.0
Gross foreign debt (% of GDP)	99.0	101.2	103.8	103.9	104.6
FX reserves (EUR bn)	10.4	10.7	11.0	11.5	12.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	2.4	1.1	2.4	2.5	2.4
CPI (eop)	1.9	1.8	2.9	2.0	2.6
Central bank reference rate (eop)	6.0	6.0	6.0	6.0	6.0
3M money market rate	8.6	1.2	0.8	2.0	2.1
USD/HRK (eop)	5.10	5.51	4.92	5.14	5.13
EUR/HRK (eop)	7.31	7.38	7.48	7.40	7.38
USD/HRK (pavg)	5.26	5.50	5.05	4.99	4.95
EUR/HRK (pavg)	7.34	7.29	7.42	7.38	7.32

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## External environment underlines risks to growth

**Positive 2Q, but even ahead of the impact of August market turmoil signs of renewed economic weakness**

**Weak data despite positive 2Q.** The 2Q GDP flash estimate confirmed expectations driven by high frequency data of a return to growth of 0.8% yoy. Data released so far for 3Q is on the whole positive (industrial production in July up 0.3% seasonally adjusted mom and the peak tourist season was good). However, the 3M MA of underlying merchandise exports (i.e. ex ships and oil) fell 4.4% yoy in July (ahead of the expected impact of global financial market falls on global growth in the remainder of 2011) and import data continue to reflect weak domestic demand. Despite rising producer prices, inflationary pressures remain weak while the prospects for real wage growth remain minimal given high and rising unemployment.

**GDP forecasts lowered as external environment sours and expectations for 2012 are scaled back**

**Growth forecasts revised down on weaker external environment.** Although 2Q11 was positive, in 1H 11 the economy recorded no growth. We reduce our full year 2011 forecast from 1.2% yoy to 0.2% yoy on the back of a deteriorating international environment. Given a much lower statistical carryover and our expectation of slower eurozone growth in 2012 (forecast revised from 1.7% to 1.0% yoy) we now expect growth of only 1% in 2012 (previously 2.5%). The risks to our growth forecasts remain to the downside. The main ways we see the external environment impacting on the Croatian economy are through the credit channel via a reduced aggregate net financing commitment for the sector relative to what could be expected before this summer's escalation of financial market stress (here in particular we note that the net external liability position of the banking sector has increased since December 2010 – from 8.9% of total assets to 11.4% of total assets at the end of July 2011). Put simply the scope for a similar increase in external financing of the banking sector in 2012 is limited given current market conditions. The second potential impact is via lower exports as EU growth slows – this is the main rationale behind our expectation of a rising current account deficit, although we have noted the accompanying decline in merchandise imports, which could still see the deficit narrow this year and next relative to our forecasts. As a positive, we note the recent stabilisation of the CHF: should that continue into 2012, the degree of uncertainty for borrowers in CHF-linked loans will fall, supporting consumption.

**We see a slightly higher budget deficit in 2011 and minimal scope for a looser monetary policy stance**

**Fiscal and monetary policy outlook.** Data for 1H11 support our view of a widening fiscal deficit this year as revenues continue to underperform. We have increased our consolidated general government deficit forecast to 6% of GDP (from 5.7%) on the back of our lower growth forecast. We expect the new government to reduce the fiscal deficit next year, but as we note below uncertainty over the first moves of the next government remains high at present. Since early September the Ministry of Finance has resumed issuing FX-linked t-bills, reversing a policy of running off the existing stock. It has introduced 3M FX-linked t-bills and on 6 September issued a combined EUR132mn in 3 and 12-month tenures. For both local currency and FX-linked t-bills yields have risen by 130-145bps since July and we expect them to remain near current levels through to year end. The resumed issuance of FX-linked t-bills will provide additional support for the currency which we expect to end the year near current levels at 7.48 – we see minimal scope for the central bank to loosen existing monetary conditions in the current global environment.

**Elections expected 4 December amid uncertainty over economic policy in 2012**

**General election expected in early December.** While not yet officially declared as the official date, 4 December is when the election is expected to take place. The need for structural reforms to boost growth and for a policy of generating a primary budget surplus over the course of the next parliament have been well documented yet from today's perspective the outlook for post-election economic policy remains uncertain.

**No change to credit rating, for now**

**Sovereign credit rating outlook.** Ahead of the general election we expect no change in the sovereign rating. The first economic policy choices of the new government will however be the key determinants in respect of credit rating dynamics from then on. With Croatia only one notch above investment grade and on negative outlook by (Fitch and S&P), any delays to fiscal consolidation could prove costly for the sovereign.

## Kazakhstan (Baa2 stable/BBB stable/BBB - positive)\*

**Outlook** – Kazakhstan's real GDP growth is likely to stay above 6% between 2011-2014, provided international demand for commodities does not slump and the current investment weakness can be overcome. Kazakhstan is committed to continue its prudent fiscal policy, which will make it a rare country with a twin C/A and fiscal surplus in the coming years. Tenge appreciation will nevertheless remain moderate as portfolio investment abroad by the National Oil Fund and the authorities' desire to increase the country's competitive position within the Customs Union will limit potential gains.

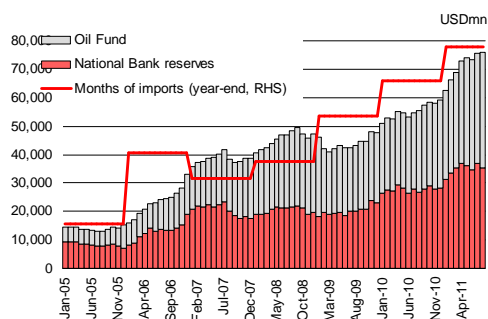
**Strategy outlook** – Following the substantial RUB depreciation we recommend cutting remaining bullish KZT positions as the case for stronger tenge has disappeared.

**Author:** Hans Holzacker, Chief Economist (ATF Bank)

### KEY DATES/EVENTS

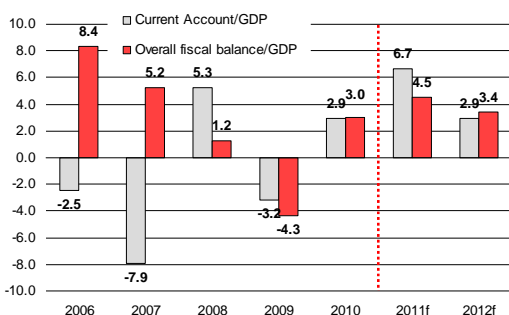
- Adoption of the 2012-14 budget by parliament, October-November
- New agreements on dividing the Kashaganak oil consortium among companies, October-November
- Several laws to be passed, including on investment promotion, energy saving, project finance, October-December

### INTERNATIONAL RESERVES SUFFICIENT FOR 19 MONTHS OF IMPORTS NOW



Source: NBRK, UniCredit Research

### A RARE TWIN SURPLUS COUNTRY



Source: Bloomberg, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	77.3	111.5	120.0	132.7	152.2
Population (mn)	16.2	16.0	16.6	16.8	16.9
GDP per capita (EUR)	4,772	6,953	7,218	7,908	8,989
<b>Real economy yoy (%)</b>					
GDP	1.2	7.3	7.0	6.2	6.8
Private Consumption	-2.8	10.9	6.3	7.1	7.0
Fixed Investment	1.9	3.8	3.1	8.7	11.6
Public Consumption	1.1	2.7	5.1	5.2	5.6
Exports	-6.2	1.9	6.5	7.5	3.6
Imports	-15.9	0.9	16.7	12.9	12.9
Monthly wage, nominal (EUR)	329	397	424	465	528
Unemployment rate (%)	6.6	5.8	5.4	5.2	5.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-4.3	3.0	4.5	3.4	3.1
Primary balance	-3.9	3.4	5.3	4.3	4.1
Public debt	13.9	14.8	16.1	18.6	20.1
<b>External accounts</b>					
Current account balance (EUR bn)	-2.4	3.3	6.7	2.9	2.2
Current account balance/GDP (%)	-3.2	2.9	6.6	2.9	2.1
Basic balance/GDP (%)	8.5	9.5	14.0	9.0	7.5
Net FDI (EUR bn)	9.0	7.4	7.3	6.1	5.3
Net FDI (% of GDP)	11.7	6.6	7.2	6.1	4.9
Gross foreign debt (EUR bn)	75.5	87.7	74.7	69.9	63.8
Gross foreign debt (% of GDP)	97.7	78.6	73.7	70.4	59.4
FX reserves (EUR bn)	15.9	20.8	23.5	25.9	27.7
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	7.3	7.1	8.7	7.0	7.2
CPI (eop)	6.2	7.8	8.6	7.2	7.1
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	7.0	7.0	8.0	7.5	7.5
3M money market rate	9.6	2.0	1.9	3.9	4.9
USD/KZT (eop)	163.6	145.9	145.9	144.4	143.0
EUR/KZT (eop)	234.3	195.2	215.9	219.6	214.5
USD/KZT (pavg)	146.9	147.5	146.0	145.2	143.7
EUR/KZT (pavg)	204.9	195.7	210.2	217.8	217.0

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## A rare twin-surplus, fast growing economy

**GDP grew 7.1% yoy in 1H11, driven by consumption and net exports**

**Strong consumption and hesitant investment.** Kazakhstan saw real GDP growth of 7.1% yoy in 1H11 thanks to strong growth in services of 7.8% yoy and in manufacturing of 8.7% yoy. Mining grew 5.8%, growth in construction and agriculture was at a less impressive 1.7% and 1.5% yoy, financial intermediation contracted 4.7% yoy. Data for real GDP by expenditure are available only for 1Q11: they show high growth in private consumption (7.6% yoy after 10.9% in 2010) and net exports (+2.6%-points of GDP, exports: +6.0%, imports: +6.4% yoy), whereas growth in gross fixed capital formation was only 1.9% yoy. Real incomes per capita increased 5.2% in 1H11, down from 10.2% in 2010. Employment was 0.8% above, official unemployment at 5.3% 0.3%-points below 12 month earlier in July. Constant price retail trade turnover was up by 14.3% yoy as a result. Investment outlays, by contrast, grew a mere 0.1% yoy in Jan-July 2011, despite some bright spots in manufacturing, transportation and telecoms.

**Post-crisis investment growth has remained sluggish**

**The share of investment in nominal GDP has fallen significantly.** Notwithstanding the recent decent growth in consumption, the share of private consumption in GDP is low (45% of nominal GDP in 2010) in line with the low share of wages (34%) and the huge difference of average per capita income and GDP (annual EUR 2,340 vs. EUR 6,953 in 2010). This leaves 55% of GDP for other spending. The share of gross fixed capital formation decreased however from (overheated) 30% in 2007 to 24% in 2010 (15.1% in 1Q11 vs. 17.9% in 1Q10). This is not low by international standards, but given the high wear of Kazakhstan's industrial equipment, the need for upgrading housing, schools etc. and the large investments required for the development of oil fields, more is desirable. The recent weakness in mining investment is related to the stage of field development, but probably also to disputes between the state and the oil companies. Capital formation grew only 1.7%, 1.9% and 3.8% in 2008, 2009 and 2010 in real terms. The main offsetting use of nominal GDP was net exports, largely mirroring commodity prices.

**Current account very positive, but in 2Q11 more than offset by capital outflows**

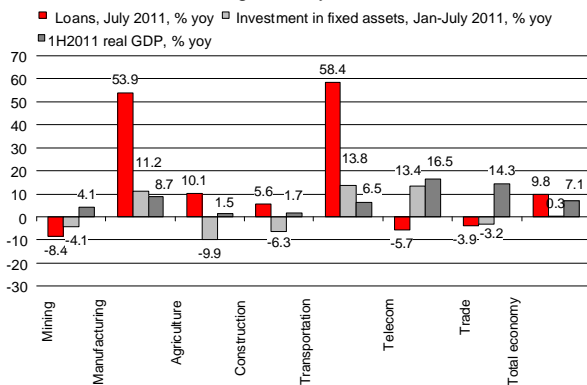
**The C/A surplus widened to USD 7.2bn in 1H11 from USD 4.7bn a year earlier** as exports grew 37% yoy, imports 36% yoy in USD terms. With commodity prices high, **we expect a surplus of 6.7% of GDP for 2011.** The services deficit narrowed to USD 2.5bn from USD 2.8bn, whereas the income deficit increased from USD 8.8bn a year earlier to USD 13.3bn because profits from inward FDI rose from USD 8.1bn to USD 12.0bn. Reserves rose by USD 5.2bn in 1H11. This was however the result of an increase by USD 6.3bn in 1Q and a decrease by USD 1.1bn in 2Q. Despite a C/A surplus of USD 2.8bn and decent inward FDI (USD 3.4bn), the decline in reserves in 2Q was brought about by USD 4.5bn in portfolio investment outflows and USD 1.9bn in outflows of short-term funds. Outflows have continued in 3Q.

**Conservative Oil Fund policy to continue despite very high international reserves**

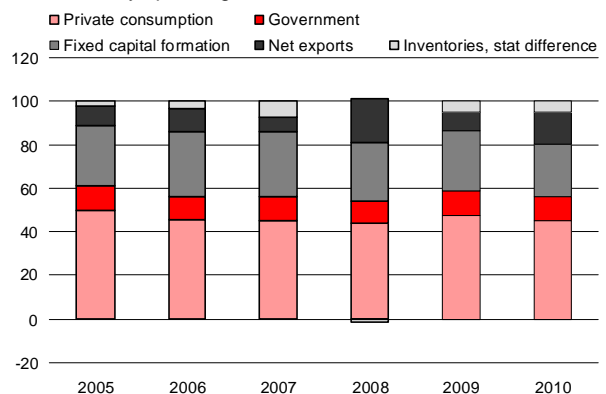
**Kazakhstan intends to keep fiscal (oil) policy tight,** even though the combined net international reserves of the central bank and the foreign assets of the National Oil Fund reached USD 75.8bn by August. This covers 19 months of imports of goods and services, broad money (USD 66bn) by 114%.

### INVESTMENT HAS BEEN WEAK IN 2011, PARTICULARLY IN MINING – ITS SHARE IN GDP HAS FALLEN

Loan, investment and GDP growth by sectors



Nominal GDP by spending, % of GDP



Source: ARKS, UniCredit Research

**We expect an overall fiscal surplus (oil+non-oil) for all 2012-2014**

While praising Kazakhstan for its prudent policy, the IMF advocated in its June country report a more flexible Oil Fund approach, with more funds going to education for example. One could add that pre-crisis plans to lower the corporate tax rate would also be worth discussing again. However, this may not be the right time. In his speech on 1 September President Nazarbayev emphasized that the country has to prepare for new global turbulences. The “Socio-economic forecasts for 2012-2016”, approved by the government on 27 August, project the Oil Fund to reach USD 72.5bn by end 2015, up from USD 40.4bn in August. This translates into an about USD 7-8bn increase per year. With transfers to the budget fixed at KZT 1.2trn (~USD 8bn), roughly one-half of the Oil Fund’s projected revenue will be accumulated and one-half transferred to the budget. The government’s base scenario assumes oil prices of USD 80 per barrel in 2012 and of USD 70 2013-2014; GDP growth is projected to average 7%, in line with the President’s recommendation. We believe that actual oil prices will be higher (av. 2011, 2012, 2013: USD 110, USD 113, USD 122) and Oil Fund revenues as well. The government approved the draft Republican budget for 2012-14, which foresees the gradual reduction of the deficit from 2.6% of GDP next year to 1.3% in 2014. It looks realistic and should keep the overall fiscal balance in surplus over the whole period.

**Authorities fight inflation mostly via (quasi) administrative measures**

**Monetary policy looks more to competitiveness than inflation.** With inflation throughout 2011 above the central bank’s long-standing implicit inflation target of 6%-8%, the central bank should tighten monetary policy and also let the KZT appreciate. The NBK hiked the – mostly symbolic – 1W-Repo rate by 50bp in March and increased the issuance of notes, but the authorities are fighting inflation mostly via (quasi) regulatory measures such as price ceilings on fuels. Food and energy prices are at the core of the inflation problem, not easy money with credit expansion weak as the banking system is still loaded with high NPL ratios. A stronger fx-rate would help. Thanks to NBK interventions – aimed at competitiveness within the Customs Union? – in early 2011 and capital outflows later, little appreciation has taken place despite room in real effective terms. Annual portfolio investment by the Oil Fund of USD 8-10bn in addition to USD 8-13bn in principal repayments due on Kazakhstan’s foreign debt will also reduce appreciation pressures in future. However, not raising the domestic use of Oil Fund resources requires the mobilization of foreign funds for financing the investment needed to keep the country’s GDP growth at the desired 7%. We therefore continue to expect the KZT to appreciate, but we moderate our forecast further to 145.9 to the USD eop 2011 and 144.4 eop 2012.

**We therefore continue to expect the KZT to appreciate, but we moderate our forecast further**

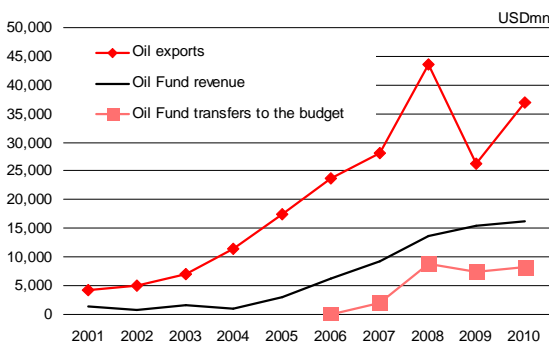
**We expect GDP growth to remain above 6% until 2013**

**We now forecast real GDP growth of 7% for 2011, 6.2% for 2012 and 6.8% for 2013,** considering the 1H11 data and taking into account the determination of the Kazakhstani authorities to achieve the average 7% growth target set by the President. The **main forecast risk** is whether commodity prices and demand hold up and whether Kazakhstan can mobilize sufficient investment to keep growth sustainably high. There is discussion about the political risk associated with the succession of President Nazarbayev and also with the strikes at some oil fields in West-Kazakhstan. However, we do not see unmanageable rifts in the society over the medium term and regard the overall Kazakhstan sovereign risk as low – as does the market, pricing Kazakhstan’s CDSs below those of Poland.

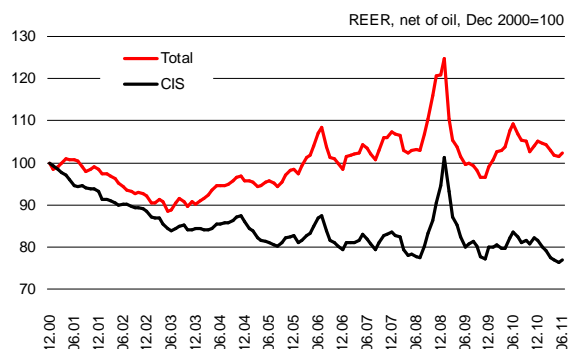
**Main downward risks: commodity prices, lack of investment, some political risk**

**THE OIL FUND’S ACCUMULATION OF FOREIGN ASSETS HAS MODERATED THE REAL APPRECIATION OF THE KZT**

Oil Fund revenues 40% of oil exports, one-half goes to budget



There is some room for real effective appreciation



Source: Ministry of Finance, NBRK, UniCredit Research

## Strategy: Move KZT positioning back to neutral

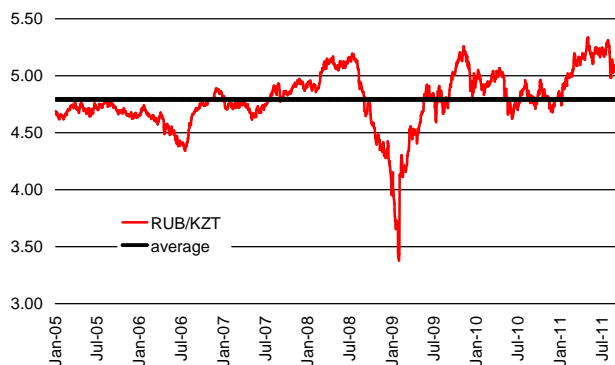
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**FX:** Despite the stellar macroeconomic backdrop we see very limited gains for the KZT in the coming months as the RUB has weakened substantially in the recent weeks pushing the RUB/KZT almost 9% lower from the August peak. The cross is now back to its long term average. Against this backdrop the NBK will have limited appetite to let the tenge appreciate and hence we recommend taking the remaining bullish tenge positions out. The implied NDF yields do not price any meaningful depreciation either (6M NDF only around plus 2%). We think in case the RUB keeps on selling off this topic might come back to the table as was the case in 2008. We are not there and hence our stance on the KZT is neutral at the moment.

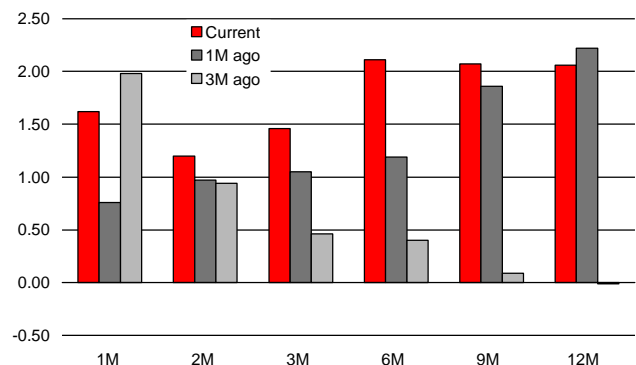
**Rates:** As local rates remain very low we do not see any particular opportunity in the fixed income space either. One asset class in the local currency space which might offer some value is the CPI linked universe. With 3-5y break even inflations in negative territory we believe the CPI linked bonds are fairly cheap at current levels (real yield around 3.5%-4.0%).

### KZT MOVED BACK TO NEUTRAL TERRITORY

RUB/KZT moved back to the long term average



NDF curve is pricing some depreciation (NDF implied yield, %)



Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

KZT bn	2010	2011E	2012F
<b>Gross financing requirement</b>	<b>844.9</b>	<b>902.4</b>	<b>1,078.5</b>
Budget deficit*	554.8	602.4	758.5
Amortisation of public debt	290.1	300.0	320.0
<b>Financing</b>	<b>844.9</b>	<b>902.4</b>	<b>1,078.5</b>
Borrowing (domestic)	882.2**	950.0	1,100.0
Other (change in financial assets)	-37.3	-47.6	-21.5

\*Republican budget ;  
 \*\*Of this, about one-fifth external we estimate

Source: UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

USD bn	2010	2011E	2012F
<b>Gross financing requirement</b>	<b>10.8</b>	<b>1.5</b>	<b>1.6</b>
C/A deficit	-4.3	-11.6	-5.8
Amortisation (loans)	15.1	13.1	7.3
Government/central bank	0.01	3.1	0.4
Banks	6.8	2.2	2.1
Corporates	8.2	7.8	4.8
<b>Financing</b>	<b>10.8</b>	<b>1.5</b>	<b>1.6</b>
FDI (inward net)	9.8	12.7	12.1
Equity	-0.7	0.3	0.5
Borrowing (loans)	14.3	10.9	10.8
Government/central bank	1.5	0	0
Banks	3.3	1.9	1.5
Corporates	9.5	9.0	9.3
Other (outward FDI, portfolio, lending)*	-5.0	-22.4	-21.8

\*Net of USD 12bn in debt forgiveness in 2010

## Russia (Baa1 stable/BBB stable/BBB positive)\*

**Outlook** – A combination of lower inflation, resilient oil prices, more modest potential for capital outflows, expansionary fiscal policy ahead of elections and a better harvest bode well for economic activity in Russia in H2 relative to other economies in the region. That said, Russia's recovery to date has been lacklustre with the crisis of 2008 bringing the economy's structural shortfalls to the forefront. Policy choices following elections will be important in determining Russia's medium to long term growth outlook.

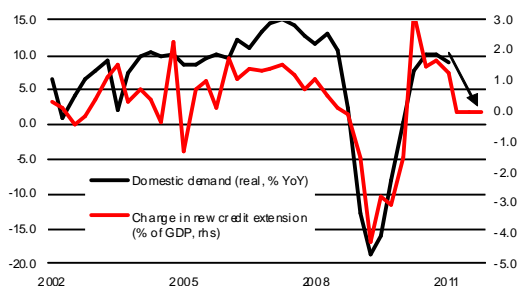
**Strategy outlook** – We recommend keeping a M/W stance on Russia as we believe the economy is better positioned for the volatile environment as it was in 2008. We however believe paying 2y RUB CCS offers good risk reward characteristic at reasonable cost.

**Author:** Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London),  
Kamilla Aleeva, Macroeconomic analyst (UniCredit Bank Moscow)

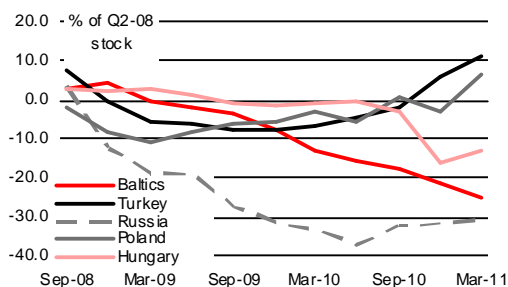
### KEY DATES/EVENTS

- 5-8 of each month – Monthly CPI
- 18-22 of each month – Monthly indicators
- 21-24 Nov – 3Q11 GDP
- Last Fri of each month – CBR rate decision
- Every Wed – weekly OFZ auction (3-7Y and 10Y), avg. RUB 30bn offered

### A HALT TO NEW CREDIT EXTENSION WOULD CAUSE MUCH LESS HARM THIS TIME AROUND



### STOCK OF FOREIGN BANK LENDING TO RUSSIA HAS DECLINED SHARPLY BUT BOTTOMED OUT



Source: Federal Statistical Service, CBR, BIS, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	871.1	1,102.3	1,322.0	1,376.7	1,494.8
Population (mn)	141	141	140	140	139.8
GDP per capita (EUR)	6,165	7,817	9,414	9,829	10,696
<b>Real economy yoy (%)</b>					
GDP	-7.8	4.0	4.0	3.8	4.7
Private Consumption	-4.8	2.7	4.8	5.1	4.0
Fixed Investment	-16.2	6.0	5.0	4.5	6.0
Public Consumption	-0.5	0.7	-0.1	-2.1	3.1
Exports	-4.7	11.1	2.2	4.8	2.7
Imports	-30.4	25.4	7.5	5.9	0.3
Monthly wage, nominal (EUR)	422	518	566	621	679
Unemployment rate (%)	8.3	7.5	7.0	6.5	6.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-12.4	-6.6	-1.8	-4.1	-3.7
Primary balance	-11.6	-5.8	-1.0	-3.2	-2.9
Public debt	7.8	8.3	8.5	9.9	11.3
<b>External accounts</b>					
Current account balance (EUR bn)	35.7	55.9	99.2	40.5	4.8
Current account balance/GDP (%)	4.1	5.1	7.5	2.9	0.3
Basic balance/GDP (%)	3.5	4.2	6.4	2.8	2.3
Net FDI (EUR bn)	-5.5	-9.8	-14.2	-1.9	29.5
Net FDI (% of GDP)	-0.6	-0.9	-1.1	-0.1	2.0
Gross foreign debt (EUR bn)	329.8	356.3	310.4	308.8	313.0
Gross foreign debt (% of GDP)	34.7	33.6	24.2	23.4	21.3
FX reserves (EUR bn)	307.3	358.7	372.7	368.3	364.8
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	11.7	6.9	8.6	7.0	6.4
CPI (eop)	8.8	8.8	7.4	6.9	5.9
Central bank reference rate (eop)	6.0	5.0	5.25	5.5	5.8
3M money market rate	7.5	4.0	5.6	5.9	5.8
USD/RUB (eop)	30.2	30.5	28.4	27.6	29.8
EUR/RUB (eop)	43.1	40.8	42.0	41.9	42.9
USD/RUB (pavg)	31.8	30.3	28.4	27.4	28.2
EUR/RUB (pavg)	44.5	40.4	40.6	41.1	41.8

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Economics: Relative protection from the storm

**Russia's growth outlook has protection on a number of fronts**

The prospects for economic activity in Russia for H2 11 are better than most other countries in the region and it is the only country in CEE where we do not expect QoQ growth in H2 to slow relative to its H1 average. Our conviction on such outperformance is due to a variety of factors.

1. Firstly this year's harvest is set to be much better than in 2010. Agriculture, despite accounting for only 3.4% of GDP, took 0.4pp off GDP last year. H2-11 should see some payback for this.
2. Secondly inflation has eased and is set to decline further, boosting real consumer purchasing power. For the first time since 2009, growth in real disposable income turned negative in H1 but should recover in H2.
3. Thirdly the impact of January's social security hike is fading, with investment already showing signs of recovery. Investment growth accelerated to 7.9% YoY in July versus a contraction of 1.8% YoY in Q1. Next year the government looks set to push through a reduction in social security contributions which should benefit investment growth.
4. Fourthly the banking system has begun to lend once again while improvements in funding of asset growth protect against another sharp halt to new credit extension. From a negative 5.5 % of GDP at end-07, the net foreign asset position of the banking sector now stands at a positive 2.1% of GDP. This leaves the banking sector much more protected to woes in developed Europe than was the case in 2008, with a renewed outflow of capital less likely this time around. Moreover as shown opposite, a sharp halt to new credit extension would have less of a negative impact on domestic demand than was the case in 2008.
5. Lastly fiscal policy is likely to be relaxed ahead of parliamentary elections in December and Presidential elections in Q1 next year. YTD the budget is in surplus, a notable improvement on both 2009 and 2010. Some of this fiscal outperformance is likely to be eroded towards year end given a seasonal increase in expenditures as well as prospects for more populist monetary policy.

With the above factors in mind, we have reduced our forecast for growth this year by a marginal 0.3pp to 4.2% while we maintain our forecast for next year of 3.9%. We assume oil prices in excess of USD110 per barrel throughout our forecast horizon.

**CBR to leave policy rate unchanged but moderate money market volatility**

Against a backdrop whereby domestic demand growth accelerates, external conditions remain volatile and pose clear downside risks while inflation eases notably, we expect the CBR to leave its policy rate on hold at its current 8.25% for the remainder of this year and through most if not all of H1 next year. From 9.6% YoY in May, inflation fell to 8.2% in August, with an easing in food price inflation accounting in full for this decline. However there are also more positive signs on inflation elsewhere. For example both the input and output price components of the PMI index have fallen significantly. Against a sharp increase in the money multiplier, the CBR has brought growth in base money to a halt. In August M0 growth stood at -0.6% YoY, its first negative reading since Oct-09.

That said the CBR has already taken measures to lower volatility in money market rates while tighter liquidity conditions towards year end, generated by an increase in government borrowing and a continued improvement in bank lending are likely to push money market rates closer towards the CBR's reference rate.

**Policy focus post elections will be crucial to Russia's medium to long term outlook**

Looking beyond elections, the government's policy agenda will be crucial to determining Russia's medium to long term growth outlook. Amongst the large emerging market economies globally, Russia's recovery has lagged. Meanwhile the crisis has served only to increase the economy's reliance on oil. From 3.6% of GDP in 2007, the non-oil budget balance widened to 13.9% of GDP in 2009 and narrowed only marginally to 12.8% of GDP last year. YTD has seen modest improvement. Meanwhile the absence of foreign capital inflows post-08 now acts as a cushion but a continuation of this scenario going forward will limit investment and drag on economic activity. On a positive note, capital outflows seem to have eased recently. The government's willingness to push ahead with its privatization programme next year will be a key test. Given delays to sale of a stake in Sberbank, the government's privatisation target for this year of USD10bn will be significantly undershot. Market conditions will be important in determining success next year.

## Serbia (not rated/BB stable/BB- stable)\*

**Outlook** – Growth will be lower than initially expected in 2011 and 2012 as the international environment deteriorates, impacting on export growth. The new IMF deal however offers protection, which should result in exchange rate stability. Weak domestic demand on the other hand will limit import growth and thus the current account deficit while inflationary pressure should continue to moderate leading us to expect a further 75bps in policy rate cuts this year.

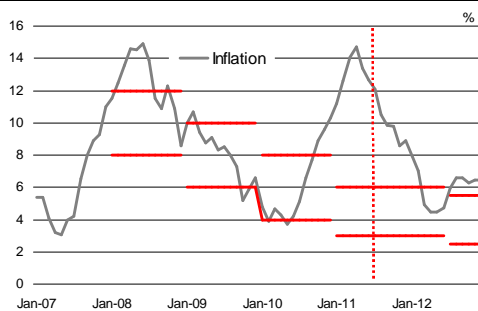
**Strategy outlook** – The agreement with the IMF, better entry levels and falling inflation have the ability to attract foreign investors into the local t-bill market in our view but prefer to wait for the dust to settle down in external markets.

**Author:** Goran Šaravanja, Chief Economist (Zagrebačka banka)

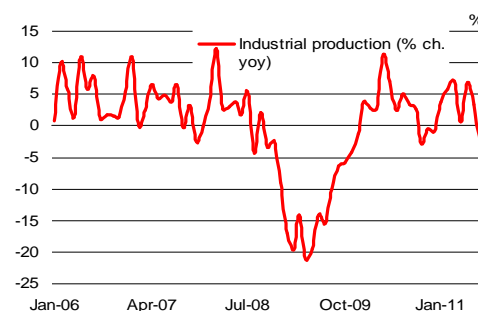
### KEY DATES/EVENTS

- 29 September: IMF Board expected to approve EUR 1bn 18 month precautionary program
- 6 October, 10 November, 8 December NBS Executive Committee meetings, October

### INFLATION OUTLOOK (YOY)



### MERCHANDISE IMPORTS AND EXPORTS



Source: NBS, Statistic Office, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	28.9	28.6	32.5	35.5	38.1
Population (mn)	7.3	7.3	7.3	7.2	7.2
GDP per capita (EUR)	3,943	3,917	4,477	4,905	5,270
<b>Real economy yoy (%)</b>					
GDP	-3.5	1.8	2.0	2.8	3.0
Monthly wage, nominal (EUR)	470.0	462.0	515.1	555.0	588.0
Unemployment rate (%)	16.1	20.0	22.0	21.0	20.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-4.5	-4.7	-4.6	-4.0	-3.5
Primary balance	-3.6	-3.5	-3.1	-2.5	-2.1
Public debt	34.1	42.6	42.2	42.9	43.8
<b>External accounts</b>					
Current account balance (EUR bn)	-2.1	-2.1	-2.2	-2.4	-2.7
Current account balance/GDP (%)	-7.2	-7.3	-6.7	-6.7	-7.0
Basic balance/GDP (%)	-2.5	-4.3	-2.9	-2.5	-1.7
Net FDI (EUR bn)	1.4	0.9	1.3	1.5	2.0
Net FDI (% of GDP)	4.8	3.0	3.8	4.2	5.2
Gross foreign debt (EUR bn)	22.8	23.8	24.0	25.5	28.0
Gross foreign debt (% of GDP)	78.9	83.3	73.8	71.8	73.4
FX reserves (EUR bn)	10.6	10.0	10.5	11.0	11.5
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	8.4	6.3	11.6	6.6	5.8
CPI (eop)	6.6	10.5	9.1	7.0	5.9
Central bank reference rate (eop)	9.5	11.5	10.5	9.5	8.5
3M money market rate	14.5	10.0	12.7	10.8	9.8
FX/USD (eop)	67.0	78.8	68.4	71.5	72.9
FX/EUR (eop)	96.0	105.5	104.0	103.0	105.0
FX/USD (pavg)	67.4	77.4	69.7	69.4	70.3
FX/EUR (pavg)	94.0	102.7	102.5	102.7	104.0

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## New IMF deal offer protection in tougher global environment

Deteriorating external environment most likely to impact Serbia through reduced exports, but weak domestic demand will limit upside risk to current account dynamics

**Manufacturing sector performing well.** The flash estimate for 2Q 11 GDP growth was 2.2% yoy, following growth of 3.0% yoy in 1Q. Industrial production has expanded 3.5% yoy in Jan-July but mom seasonally adjusted figures for both total industrial production and manufacturing in June and July foreshadow a slowdown. Merchandise exports are also exhibiting signs of a slowdown after a very solid start to 2011. In the 3 months to July merchandise exports have grown 11.6% yoy while in Jan-July they have risen 21.6% yoy. Similarly, import growth in the 3 months to July was 11.3% yoy compared to an average growth rate of 16.1% yoy in Jan-July. The deteriorating global environment is most likely to impact on Serbia through slower export growth, which to an extent is already evident even ahead of the impact of the August financial market turmoil on growth. Nonetheless, domestic demand is weak: retail trade turnover was down 14.2% yoy in real terms in 1H 11, unemployment by the ILO standard rose to 22.9% in the April survey compared to 20% in the October 2010 survey and real wage growth is still negative according to our estimates in July. While this has led us to lower our growth forecast for 2011 and 2012 to 2.0% and 2.8% respectively, our current account deficit forecasts reflect a smaller expected deficit (our 2011 import growth forecast was too strong) and we continue to see moderating inflationary pressures, even if we are less sanguine than the central bank.

A further 75bp in policy rate cuts likely in 2011 on lower inflation and new IMF program

**Monetary policy – easing cycle continues:** On 8 September, after a pause of one month, the Executive Committee of the National Bank of Serbia lowered the 2-week repo rate by 50bps to 11.25% as consumer prices continued to fall – from their peak of 13.4% yoy in April, consumer prices have fallen to 10.5% yoy in August. We forecast consumer prices will be 9.1% yoy in December and mainly based on that expect another 75 bps in rate cuts this year by the central bank. Evidently, the external environment, its impact on investor sentiment and how that reflects on the EUR/RSD is one factor which has the potential to complicate matters. We expect a broadly stable EUR/RSD in the remainder of the year given the backstop provided by the new IMF program, forecasting 104 for year end.

New IMF program an important factor for sentiment

**Fiscal policy – IMF deal a welcome development.** With global financial markets febrile, EU accession plans likely delayed (see below), demand for t-bills moderating, growth slowing and the budget deficit widening the announcement of a deal between the Serbian authorities and the IMF on a new EUR 1bn 18 month precautionary program, pending Board approval on 29 September, is a welcome development. Although the program envisages a fiscal deficit of 4.5% of GDP this year (above the initial 4.1% target) and a less pronounced contraction in the deficit next year, this simply reflects the reality of a weaker growth background and approaching general elections. Unsurprisingly, the issue of pension reform has been deferred to the next government. The IMF deal is also a key element of the government's strategy to issue a USD 1bn international bond in 4Q. Market interest in local t-bills has ebbed and flowed this year. Comparing announced issue sizes and actual issuance, we estimate the authorities' financing plan is rough RSD 88bn (approximately EUR850mn) below target so far this year.

EU candidate country status looks less likely...

**EU accession story becomes complicated.** The late August visit of Germany's Chancellor Merkel Belgrade has complicated Serbia's path to achieving candidate country status this year. Chancellor Merkel stated Germany's view that Serbia would have change its Kosovo policy by inter alia dismantling parallel institutions in the north of Kosovo if it wishes to achieve candidate country status. After the visit, president Tadić noted Serbia might not achieve EU candidate country status this year.

...but sovereign rating should remain stable

**Sovereign rating.** A new deal with the IMF is a key positive for Serbia as elections in April/May 2012 come into view and the expectations of achieving candidate country status this year look increasingly unlikely. On balance we see no change in the sovereign rating in the coming 12 months.

## Turkey (Ba2 positive/BB positive/BB+ positive)\*

**Outlook** – After the implementation of the Central Bank of Turkey's (CBT) unorthodox monetary tightening policy and with some push from global volatility, the huge imbalance between Turkey's external and domestic demand started moderating in 2H11. The CBT rapidly shifted to monetary easing at the start of August, in a bid to prevent any excess slump in growth in the year ahead. Despite this change in policy, growth is now expected to slow notably in 2H11 to 2.5%-3.0% contrasting with the 10% yoy growth posted in 1H11 and average at 3.2% for YE 2012. The CAD will see an immediate impact adjustment as of 4Q11, which will become more pronounced in 1H12 and is set to pull down Turkey's CAD/GDP from highs of 9.7% this year to 6.8% by the end of next year.

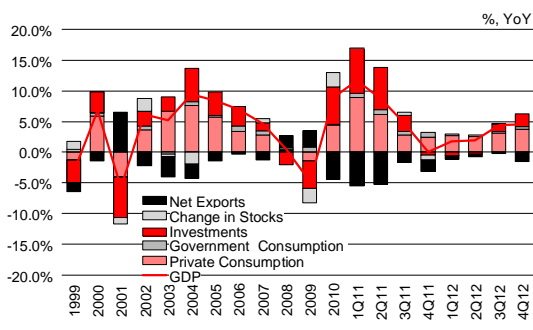
**Strategy** – We upgraded our stance on TRY and recommend long TRY/CEE FX positions, we also increase our credit allocation to O/W and buy 5y Sovx CEEMEA vs. 5y Turkey.

**Author:** Guldem Atabay, Economist (UniCredit Menkul Değerler A.Ş.)

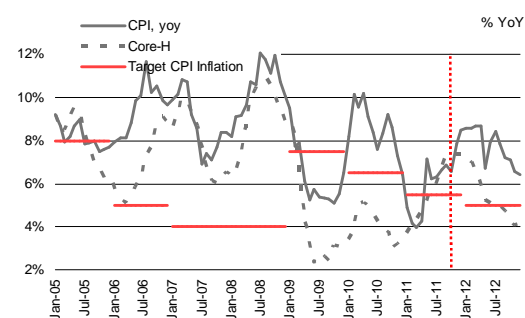
### KEY DATES/EVENTS

- 20 Sep/20 Oct /23 Nov/22Dec: MPC meetings
- 1 Oct: Parliament commences
- 17 Oct: 2012 budget to be submitted; Medium Term Fiscal Plan to be announced
- 26 Oct: Inflation Report-final in 2011

### CONSUMPTION AND INVESTMENT DRIVEN GROWTH TO SLOWDOWN



### HEADLINE AND CORE INFLATION NOW ABOVE THE TARGET



Source: TurkStat, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	444.1	552.6	532.1	551.6	662.4
Population (mn)	71.6	72.9	74.7	75.8	76.8
GDP per capita (EUR)	6,201	7,581	7,125	7,280	8,627
<b>Real economy yoy (%)</b>					
GDP	-4.7	8.9	5.9	3.2	4.3
Private Consumption	-2.3	6.6	6.9	4.1	3.9
Fixed Investment	-19.1	29.9	14.5	2.8	6.5
Public Consumption	7.8	2.0	6.3	2.5	2.5
Exports	-5.0	3.4	9.8	10.0	10.0
Imports	-14.3	20.7	18.8	9.8	9.0
Monthly wage, nominal (EUR)	676	848	792	831	970
Unemployment rate (%)	14.0	11.9	10.0	11.0	11.3
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-5.5	-3.6	-1.8	-1.5	-2.0
Primary balance	0.1	0.9	0.4	1.1	0.7
Public debt	45.5	41.6	39.5	39.0	39.0
<b>External accounts</b>					
Current account balance (EUR bn)	-10.0	-36.5	-47.5	-44.9	0
Current account balance/GDP (%)	-2.3	-6.5	-9.8	-6.8	-6.7
Basic balance/GDP (%)	-1.4	-5.4	-8.6	-5.6	-6.7
Net FDI (EUR bn)	8.4	9.1	12.0	15.0	15.0
Net FDI (% of GDP)	0.9	1.1	1.2	1.2	0
Gross foreign debt (EUR bn)	124.3	144.8	130.7	127.4	149.7
Gross foreign debt (% of GDP)	43.7	39.4	41.0	43.4	43.0
FX reserves (EUR bn)	49.0	60.3	61.0	61.5	72.3
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	6.3	8.6	6.1	7.7	6.1
CPI (eop)	6.5	6.4	8.5	6.4	6.1
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	6.5	6.5	5.8	6.0	6.5
3M money market rate	11.7	7.4	7.9	8.1	8.5
FX/USD (eop)	1.49	1.54	1.69	1.70	1.58
FX/EUR (eop)	2.14	2.06	2.57	2.45	2.27
FX/USD (pavg)	1.55	1.51	1.60	1.68	1.57
FX/EUR (pavg)	2.16	2.00	2.35	2.48	2.32

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Turkey on the verge of a tamer CAD via lower growth

Now it is time to start delivering a new Constitution addressing the Kurdish problem...

...before that the AKP is trying to root out PKK terrorism

Turkey's heightened level of political conflict with Israel is attracting attention

The Greek Cypriots' aspirations to start drilling for natural gas/oil between its and Israel's coast will keep foreign politics on radar screen of investors

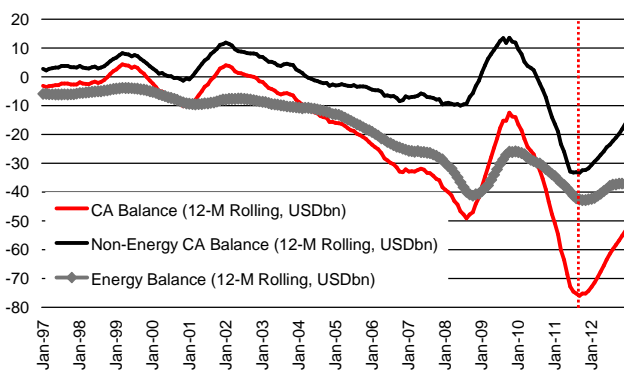
Turkey is not economically immune to the change in sentiment in the global economy

The AKP's dazzling 49.9% support at the mid-year 2011 general election, still reflected in the most recent polls, raises PM Erdogan's ambitions to solve Turkey's long standing Kurdish problem with the start of the new Parliamentary session in October. Competing with Iran and Saudi Arabia to win diplomatic leadership in the greater MENA region, the AKP is well aware that without first putting domestic issues in order, the neighboring contenders can stir domestic politics and weaken Erdogan's regional aspirations. The new Parliament, will be tasked with helping to rewrite Turkey's Constitution to meet the changing social needs of the Turkish society which has enjoyed economic transformation during the past decade. As a result rising PKK terrorism is being met with counter action from the government through the deployment of the military. In fact, ground operations in the Qandil Mountains could soon come on the agenda as Turkey diplomatically is seeking a permanent presence in northern Iraqi roads to block the PKK from infiltrating into Turkey. While trying to root out the PKK for good, the AKP is also engaged in negotiations to meet a feasible set of demands from the Kurdish ranks. Yet, even the 50% support does not guarantee the smooth passage of an AKP tailored Constitution at a potential referendum in 2012, which makes the return of the pro-Kurdish BDP into Parliament by October crucial. The good news is that the AKP's chances of working together with the opposition parties in preparing a new Constitution appear viable, though not guaranteed. In addition, Turkey's heightened level of political conflict with Israel is attracting attention, though naval clashes in the southern Mediterranean look unlikely. Rather, the Greek Cypriots' aspirations to start drilling for natural gas/oil between its and Israel's coasts from as early as 20 September – which is fiercely rejected by Turkey – will keep foreign politics on the radar screen of investors. While Turkey's direct intervention in Syria to topple Esad should not be expected, Turkey could well join the sanctions camp to pressure Esad. In fact, PM Erdogan has initiated efforts to boost economic ties with Egypt, Tunisia and Libya to broaden its peaceful presence in the region.

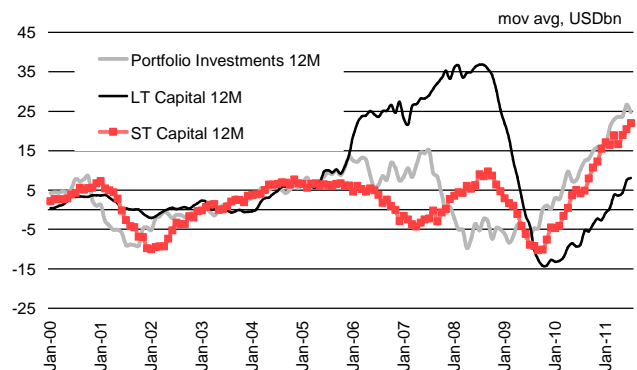
Turkey is not economically immune to the change of sentiment in the global economy as fears of recession rise again and turbulence is exacerbated by the EU sovereign debt problems. The Central Bank of Turkey (CBT) has been trying to engineer a soft landing following GDP gains of an extraordinary 9% last year and 10% growth in 1H11. In the face of a global slowdown, it swiftly shifted its unorthodox monetary policy to easing in early August from tightening since November 2010. For 2H11 we expect Turkey's domestic demand driven GDP gains to slow rapidly, decelerating to 5.9% by end this year and to 3.2% next year as bank and non-bank corporates, especially the latter, will slow their pace of borrowing.

### CBT NOW GEARING TO FACE GLOBAL RECESSION WITH A SWIFT SHIFT TO EASING FROM TIGHTENING

CAD to bottom out and then to start declining...



...as attracting large sums of external financing will become a tough job despite the hefty liquidity available in the markets



Source: CBT, UniCredit Research

Turkey's fiscal balance is positioned to stimulate the economy if needs be.

Turkey's CAD to GDP will ease to 6.8% by the end of next year from 9.7% this year.

Medium Term Fiscal Plan (MTFP) expected in late-September/early-October is important

We maintain our YE 2011 CPI inflation estimate at 8.1% which does not bode well for the 5.5% official inflation target and the 6.9% CPI inflation estimate of the CBT.

The CBT appears set to miss its 2012 inflation target of 5%

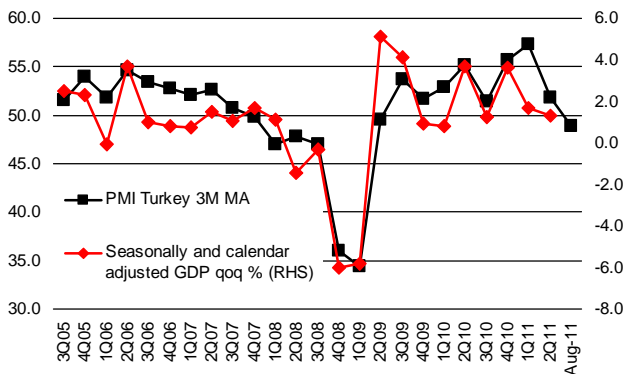
The bank is unlikely to return to 'inflation targeting' soon by its textbook definition

**With GDP growth halving next year and external financing sources more volatile, the adjustment in the CAD will start becoming tangible in 4Q11 and will be more pronounced in 1H12.** Based on an average Brent price of USD 113 next year, we expect the energy bill to decline to USD 37bn at YE 2012 from the 2011 figure of USD 43bn, posting a significant USD 6.0bn decline. As for the non-energy part, our assumed bill is USD 17bn versus our anticipation of USD 31bn at YE 2011. This creates a CAD contraction of approx. USD 20bn due in 2012 as we estimate CAD at USD 54bn at the end of 2012 from USD 74bn at the end of 2011. Thus, Turkey's CAD to GDP will ease to 6.8% by the end of next year from 9.7% this year. Assuming a conservative average GDP growth rate of 4.5% for 2013-2016, we derive an estimated range for Turkey's CAD of 6.0%-7.0%. This is still outside a 'safe' CAD, especially given that there has been at best moderate improvement in the financing of the deficit, and renders the economy open to further adjustment in the future; however, the magnitude of such an adjustment has become more tolerable. The revised Medium Term Fiscal Plan (MTFP) expected in late-September/early-October is of importance to see the official revised three-year fiscal plans and macro outlook given that the upfront sizeable CAD adjustment expected in 2012 is unlikely to be repeated in the years to follow. The authorities are faced with a choice between short term and long term interests – near term fiscal consolidation to help narrow the CAD but potentially threaten further growth or fiscal expansion to support the economy, which could hamper CAD adjustment.

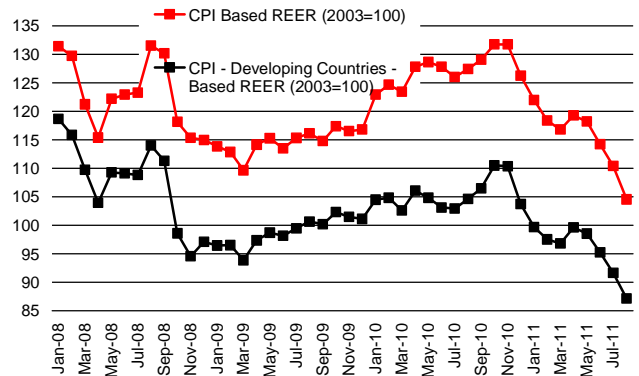
**Core inflation trends suggest that Turkey was not completely immune from the global commodity price spike and circa 20% TRY weakness since November 2010.** Amidst the looming global slowdown the CBT has declared a further easing bias – its realization is dependent on the developments mainly in Europe. In the meantime, the TRY basket (50% EUR+50% USD) seems to have stabilized within a 2.09-2.15 range, gaining ground from a peak of 2.18. Thus, the worst seems to be over for TRY unless the CBT makes another rate cut. This is not part of our baseline scenario, since the expected pass-through calculated at 15%-16% is still sizeable enough to prevent the bank from further cutting rates, though unorthodox measures such as RRR cuts are not ruled out. Given the rising core inflation to a 7.0%-7.5% range, the TRY pass-through and the expected natural gas price hikes in 4Q11, we maintain our YE 2011 CPI inflation estimate at 8.1%, which does not bode well for the 5.5% official inflation target and the 6.9% CPI inflation estimate of the CBT set for this year. In 2012, we expect the rather flattish price of oil, stable TRY and slower growth to stop the surge in the core inflation. The slow GDP growth at 3.3% and the base effect in 4Q12 (i.e. this year's expected natural gas price adjustments) will create opposing forces in favor of slower inflation. Nevertheless, the CBT seems set to miss its 2012 inflation target of 5% as we expect CPI inflation at 6.5% by YE 2012. However, the Bank is unlikely to return to 'inflation targeting' soon by its textbook definition.

**SAERCH FOR YIELD KEEPS INVESTOR ATTENTION IN TURKEY'S BOND MARKET DESPITE THE CURRENCY WEAKNESS**

Turkey PMI



Turkish Currency-CPI based REER



Source: CBT, BRSA, Markit, UniCredit Research

## Strategy: Underperformance to turn into outperformance in FX and credit

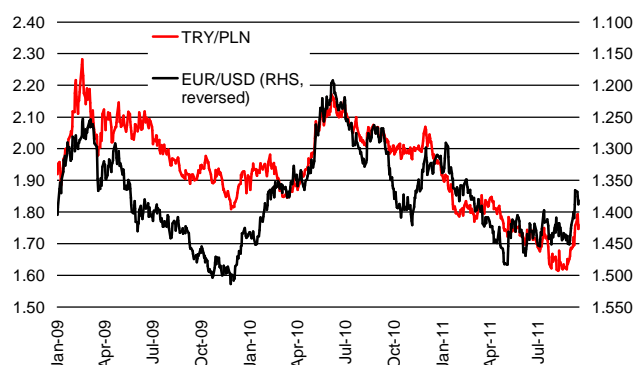
**Gyula Toth,**  
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**FX:** Following the serious TRY underperformance YTD we believe the CBT has all the necessary toolkit (net liquidity provider to the banking sector) and willingness to arrest any further FX depreciation. We think the best way to express this view is via going long TRY versus EUR referenced CEE currencies (we think PLN and HUF) which should also benefit from a potential further downside pressure on EUR/USD. For real money investors we recommend going O/W TRY whilst for leveraged investors we recommend buying TRY vs. equally weighted PLN and HUF.

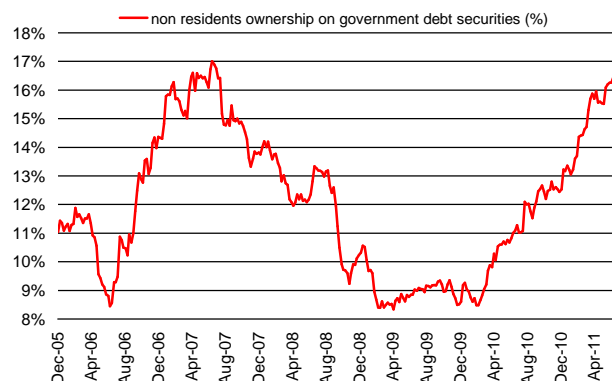
**Rates:** The local bond market has posted strong gains in Q3 as CBT unorthodox policy seems to be justified by the slowing global economy and the curve flattened. We believe TURKGBs have the ability to follow G2 rates lower and hence recommend O/W positioning in the local market (in line with our FX view we recommend this position FX unhedged).

**Credit:** following the significant underperformance of Turkish credit vs. Sovx (Turkey 5y CDS vs. Sovx tightened to almost zero from plus 60bp in 2011) and the U/W positioning of EM bond funds we are upgrading our recommendation to O/W.

TRY/PLN should head higher as EUR/USD moves lower



Non-residents bond holdings close to all time highs as % of market



Source: CBT, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>234.4</b>	<b>177.8</b>	<b>184.0</b>
Budget deficit	39.6	25.0	20.0
Amortization of public debt	194.8	152.8	164.0
Domestic	178.1	135.0	145.0
Bonds	154.9	120.2	129.1
Bills	23.2	14.9	16.0
External	16.7	17.8	19.0
IMF/EU	2.2	2.2	2.1
<b>Financing</b>	<b>194.8</b>	<b>152.8</b>	<b>164.0</b>
Domestic borrowing	159.0	110.0	112.0
Bonds	139.9	101.2	99.7
Bills	19.1	8.8	12.3
External borrowing	14.9	12.5	14.0
Bonds	9.8	7.5	8.0
IMF/EU	0	0	0
Other	5.1	5.0	6.0

Source: UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>-89.0</b>	<b>-115.6</b>	<b>-95.8</b>
C/A deficit	-47.7	-74.4	-53.6
Amortisation of medium to long term debt	-45.9	-49.2	-49.2
Government/central bank	-7.9	-7.2	-7.2
Banks	-6.7	-9.0	-7.0
Corporates	-31.2	-33.0	-35.0
Errors and omissions	4.6	8.0	7.0
<b>Financing</b>	<b>88.9</b>	<b>115.6</b>	<b>95.7</b>
FDI	7.8	8.0	8.0
Equity	19.6	31.6	22.7
Borrowing	37.4	46.0	40.0
Government/central bank	6.2	5.0	5.0
Banks	7.2	8.0	5.0
Corporates	24.0	33.0	30.0
Other (incl. reserve accumulation)	24.0	30.0	25.0

Source: UniCredit Research

## Ukraine (B2 stable/B+ stable/B positive)\*

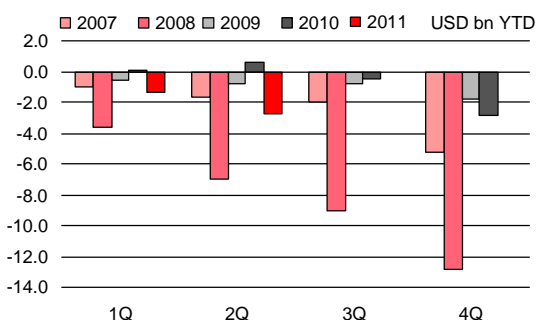
**Outlook** – Growth is performing well, aided in part by strong real wage growth. Capital inflows to the government and non-bank corporate sector have resumed over the past year, more than neutralising continued outflows from the banking sector, but this has been matched by a widening in the C/A deficit. Progress with the IMF programme has stalled and leaves the government facing debt and loan redemptions next year of in excess of USD 6bn. Passage of 1-2 reviews followed by IMF disbursement would significantly ease this burden. We do not see scope for UAH gains before next year's election or the introduction of any significant flexibility on the currency.

Author: Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London)

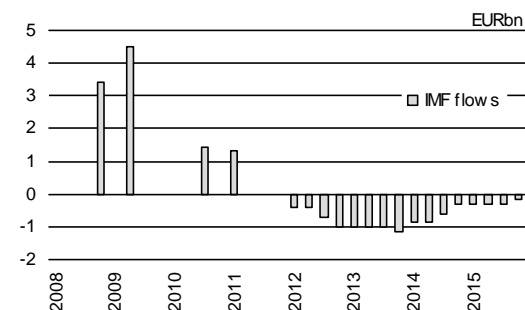
### KEY DATES/EVENTS

- End-Oct – Potential IMF review
- 29-30 Sep – Final Q2 GDP data
- 21-25 Oct – Q3 C/A balance data

### C/A BALANCE WIDENS ONCE AGAIN



### WITHOUT FURTHER DISBURSEMENTS IMF INFLOWS QUICKLY TURN TO OUTFLOWS



Source: NBU, IMF, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	81.2	103.8	93.4	92.4	98.4
Population (mn)	46	45.8	45.5	45.3	44.8
GDP per capita (EUR)	1764	2266	2052	2041	2197
<b>Real economy yoy (%)</b>					
GDP	-14.8	4.2	4.2	3	4.4
Private Consumption	-14.9	7	5	3.5	4
Fixed Investment	-50.5	4.9	12.5	8.6	9
Public Consumption	-2.4	2.7	0.7	0.6	0.6
Exports	-22	4.5	10.7	7.9	10
Imports	-38.9	11.1	13.3	9.5	10
Monthly wage, nominal (EUR)	170	213	228	268	322
Unemployment rate (%)	9	8.4	7.5	6.9	6.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-6.2	-5.7	-4.2	-3.7	-3.2
Primary balance	-5.1	-4.2	-2.3	-1.7	-1.2
Public debt	35	42.2	40.2	38.1	36
<b>External accounts</b>					
Current account balance (EUR bn)	-1.2	-2.3	-4.2	-4.2	-3.9
Current account balance/GDP (%)	-1.5	-2.2	-4.5	-4.5	-4.0
Basic balance/GDP (%)	2.4	2.1	0.4	1.1	1.1
Net FDI (EUR bn)	3.2	4.5	4.6	5.2	5
Net FDI (% of GDP)	3.9	4.3	4.9	5.6	5.1
Gross foreign debt (EUR bn)	72.6	87.7	84.9	83.4	85.3
Gross foreign debt (% of GDP)	89.5	84.5	91.0	90.2	86.7
FX reserves (EUR bn)	17.7	25.1	24.1	22.5	23.3
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	16	9.4	9	8.3	8.25
CPI (eop)	12.3	9.1	8.1	8.5	8
Central bank reference rate (eop)	10.25	7.75	7.75	7.75	7.75
USD/UAH (eop)	8.0	8.0	8.0	8.0	8.0
EUR/UAH (eop)	11.5	10.6	12.2	11.5	11.0
USD/UAH (pavg)	8.1	8.0	8.0	8.0	8.0
EUR/UAH (pavg)	11.3	10.5	11.7	11.8	11.1

Source: UniCredit Research

\* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Ukraine: All about financing

**GDP posted a strong showing in H1, with some risk of a slowdown in H2**

At 4.2% for 2011, our GDP forecasts provides room for a significant slowdown in H2 without further downward revision. YTD GDP has posted gains of 2.7pp. Combined with a positive carryover of 1.0pp from last year, QoQ GDP growth need reach only 0.2% on average over the last two quarters of the year. Private consumption has been the primary contributor YTD, rising 12.7% YoY in Q2, a reflection of strong real wage growth. Nominal wage growth stood at 16.1% YoY in July while inflation reached just over half of that at 8.9% YoY. Looking ahead to next year, we have marked down our GDP forecast to just over 3%. Assuming a carryover over of 0.5pp next year, we view QoQ gains of 0.6% on average per quarter as achievable.

**The government and non-bank corporate sector show a renewal in capital flows...**

Our primary concern at this stage relates to external financing risks. As was the case with others countries that entered into IMF programmes in 2008/09, foreign private sector capital flows returned to Ukraine only towards the end of last year but since then have seen significant improvement. Rollover ratios for medium to long term external debt for the economy as a whole stand a 1.1 YTD. Currently both the government and non-bank private sector are posting rollover ratios in excess of one, though in the case of the government the IMF's February disbursement plays an important roll. Rollover ratios for banking sector medium to long term debt have not shown any improvement at 0.63 for the first 7 months of the year but this is more than compensated for by the government and non-bank corporate sector. At least to a certain extent, these low banking sector rollover ratios reflect an increase in deposits in the system which is improving liquidity and allowing banks to pay down external borrowing. From an average loan to deposit ratio of 2.2 in 2009, July saw a decrease in the loan to deposit ratio to 1.7.

**...facilitating a widening in the C/A deficit**

A renewal of capital inflows has been matched by a widening in the C/A deficit. This combined with higher debt amortisations next year translates into a gross external financing requirement in excess of EUR 40bn compared with EUR 35bn this year. YTD Ukraine has seen its C/A deficit widen by USD 3.6bn from a surplus for the first seven months of last year to a deficit of USD 3.3bn next year. The widening in the deficit is a reflection of a sharp increase in imports (+83% YoY YTD) that been only partially compensated for by a 33.6% gain in exports. Ukraine will struggle to keep its C/A deficit within 4% of GDP this year, though this is still considerably narrower than a deficit of 7.1% of GDP in 2008.

**Gross external financing requirements are on the rise, pushed higher by the government**

Next year the government faces a significant increase in external amortisations. From USD 1.1bn this year, the government must roll USD 6.3bn next year. This is made up of USD 0.6bn, USD 3.4bn and USD 2.0bn in eurobonds, IMF repayments and a VTB loan respectively (assuming this is rolled in December of this year, though recent press reports suggest that USD 1bn may be repaid in December). IMF repayments commence in Q1 at USD 0.6bn and rise to USD 1.4bn by Q4 next year.

**Without progress on IMF conditionality, Ukraine faces a much higher risk of financing shortfalls next year**

Progress with IMF-requested reform would provide an important cushion to the authorities in the face of a sharper slowdown in global capital flows. YTD the budget has performed well, with the deficit for the first 7 months of the year in nominal terms only 23% of what was the case for the same period last year. However this performance is likely to be eroded in the last 3-4 months of the year due to a hike in public sector wages. Meanwhile the absence of gas price hikes means that the target deficit for Naftogaz at 0.4% of GDP could be overshoot by at least 0.6-0.7pp of GDP. Ukraine has made some progress on one key piece of conditionality under the IMF programme, namely pension reform, though the IMF has yet to signal clearly that it is fully compliant with its expectations. However the authorities continue to drag their feet on gas price hikes – gas prices were scheduled to increase by 20% in July, followed by another 10% in August. Parliamentary elections scheduled for next October appear to be taking priority. Were the authorities to push ahead with these reforms and the IMF to disburse in full all delayed payments YTD as well as those scheduled for next year, Ukraine would receive a gross USD 10.1bn, translating into a net receipt of USD 6.7bn, more than covering what is coming due. Such a scenario would also facilitate a more upbeat growth outlook for next year.

**Notes**

**Notes**

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