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**3Q**  
**2011**

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Published 17 June 2011

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## CEE: A bumpier path forward

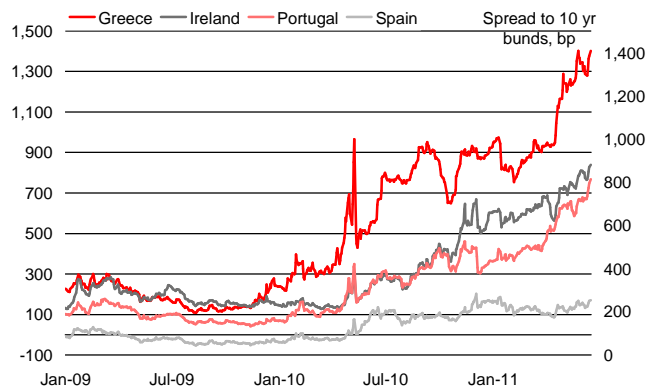
**Adding a variety of different uncertainties to the global mix...**

As we enter 3Q, the global economy faces more uncertainty than it has for a number of quarters. Most recent high frequency indicators have shifted downwards, though from a high level. The EMU crisis has seen a further escalation as Greece continues to disappoint in terms of reform implementation. At the time of writing discussion was underway on the potential for EMU member states to put considerably more funding on the table, prompting a re-consideration of EMU's approach to private sector 'burden sharing', with yet another EU weekend summit approaching. In the US policy makers have yet to reach agreement on the increase to the debt threshold while more importantly reaching agreement on a viable set of fiscal consolidation policies remains out of reach. From China, the world's growth engine, the housing market and credit shows signs of slowdown, as do exports, while the PBOC continues to tighten while Middle East tensions rumble on.

April/May sees a correction in global manufacturing PMIs...



...while periphery spreads show no signs of easing

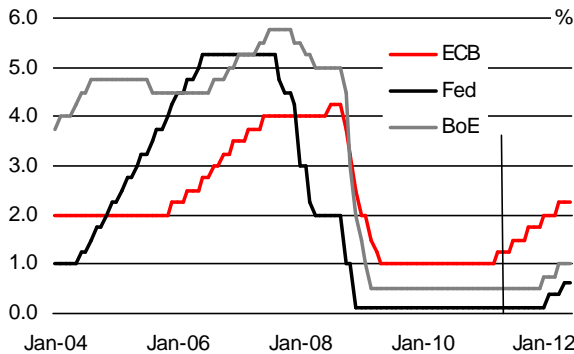


Source: Bloomberg, Markit, UniCredit Research

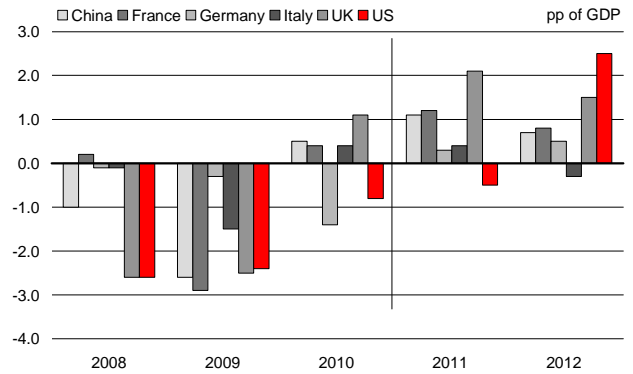
**...at a time when policy accommodation is being reduced....**

This is all happening at a time when monetary and fiscal policy in the US and Europe is turning less supportive. The end of this month sees the Fed's QE2 policy come to a finish while we believe that we would need to see a significant deterioration in activity indicators from here before the central bank steps in with QE3. In EMU the ECB seems on course for its second rate hike in July while we expect a total of 50bp in rate hikes between now and year end. Simultaneously fiscal policy is expected to turn more contractionary both this year and next, with a variety of countries (China, France, India and the US) forecast to see a cumulative shift in their cyclically adjusted primary balance of approximately 2pp, with the UK to see a shift of over 3pp.

Policy rates to edge higher but remain below historical averages



Change in cyclically adjusted budget balances – from fiscal expansion to contraction



Source: IMF, Bloomberg, UniCredit Research

...means a continued but softer recovery for now

The above does not deter us from our view that the global economy will continue to post gains each quarter over 2Q-4Q this year however. It does translate into a scenario whereby 2Q is softer than originally expected, with some spillover risks to 3Q. For example we have marked down our expectations for 2Q GDP growth in the US from an annualized 2.5% to 2%. The risks to our EMU forecast for 2Q of 2.0% annualized are also on the downside. That said with the data available to hand at this stage, we remain optimistic that a double dip scenario will be avoided.

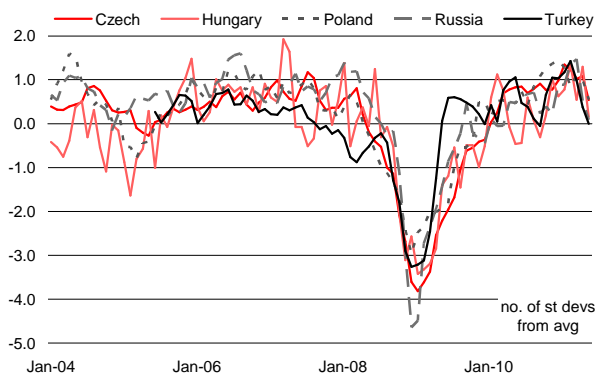
### A strong 1Q, a softer but still positive 2Q/3Q

CEE joins the global slowdown

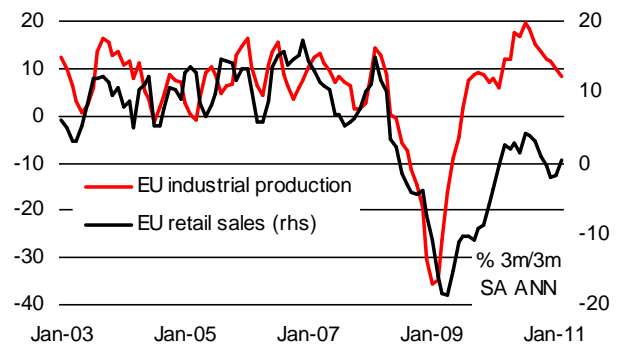
As we enter 3Q, the most pressing issue is the ability of CEE to withstand this global slowdown, even if only temporary in nature. That CEE is synchronized with global developments is not in doubt. To date the most obvious sign of a slowdown in economic activity in the region is seen in the manufacturing PMI data. Over the three months to May, the manufacturing PMI indices have fallen between a cumulative 1.2 points in Poland to a much larger 7.9 points in Turkey. There are also some signs of a dis-improvement in consumer confidence in some of the new EU countries, as well as in Russia.

That said, the PMI move has been sufficient to bring the PMIs back in line with their long term averages, i.e. levels still consistent with gains in industry but more in line with long term averages than the more elevated growth rates that have been experienced in recent quarters. Current PMI readings do not imply a contraction in industrial production.

CEE manufacturing PMIs slip back towards average



Different contributions from components of GDP



Source: Markit, Eurostat, UniCredit Research

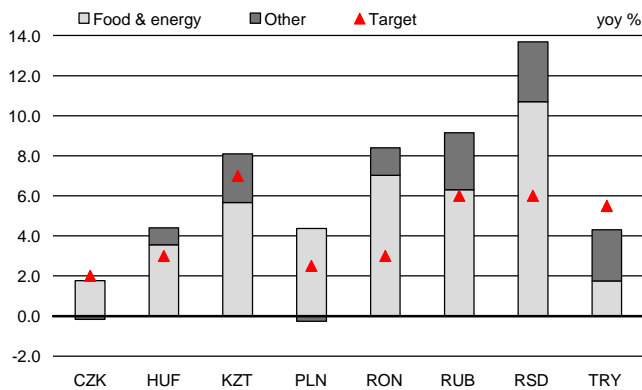
**Domestic demand can help fill the gap**

Meanwhile domestic demand has the potential to act as a form of 'automatic stabiliser' over the next couple of quarters in an environment where this global slowdown does not deteriorate significantly further. To date the recovery in domestic demand has been lackluster in many countries in the region. Turkey is the most obvious exception, followed by Poland, Kazakhstan and Ukraine. As shown above latest IP readings put industrial production gains at close to double digits on a 3m/3m SA and annualized basis for the new EU countries. Meanwhile retail sales struggle to post any gains. Russia is another example of a country where gains in private consumption showed clear signs of slowdown in 4Q last year, a trend that continued into 1Q.

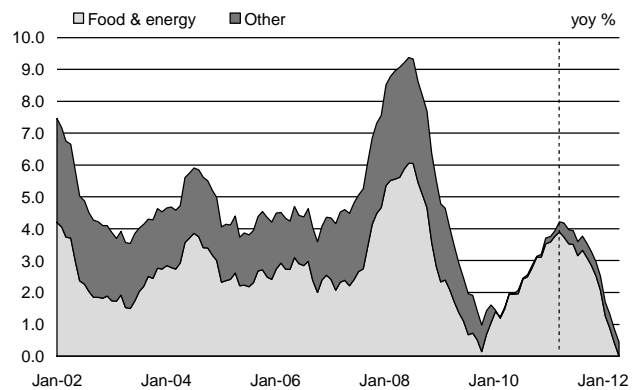
**To date it has been constrained by higher inflation...**

We attribute this weak domestic demand performance to date at least in part to a combination of a supply-side spike in inflation combined with a weak recovery in labour markets. The inflation spike reflects higher global energy prices over the past year in the region, feed-through from higher global food prices and poor harvests in a number of countries last year. Averaging inflation across CEE<sup>1</sup>, it stood at 5.5% in April. We estimate that 4.3pp of that increase in inflation indices in the past 12 months is down to food and energy – these two components account on average for 47% of inflation baskets across the region. The remaining 53% of the basket added only 1.2pp. Within the EU countries in our coverage, inflation stood at 4.2% yoy of which 3.9pp was due to food and energy prices. These two components on average account for 43% of HICP baskets. The remaining 57% of inflation in the EU countries in our coverage added only 0.3pp to HICP in the 12 months to April. With data available since Jan-02, never before have the 'core' elements of the inflation basket contributed so little to HICP gains as they have over the past 12 months.

Food & energy price increases absorb central bank 'inflation allowances'



Inflation 12 months forward assuming unchanged food & energy prices in the EU countries in CEE



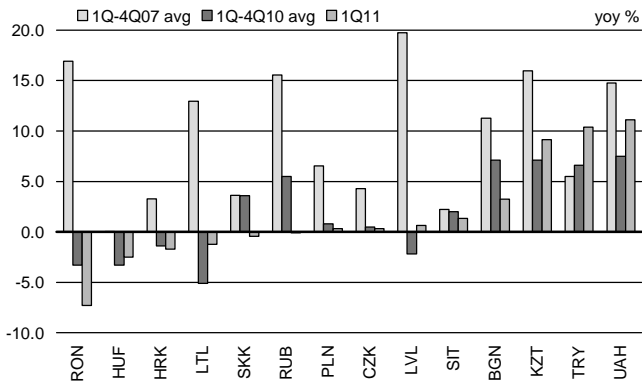
Source: Eurostat, national central banks, national statistical offices, UniCredit Research

**...limiting real wage growth**

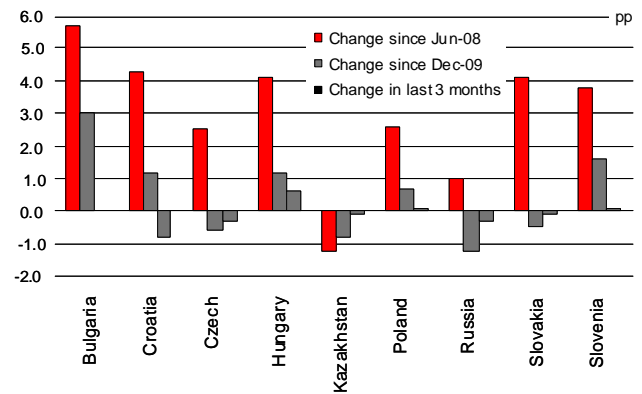
Such acceleration in inflation has reduced consumer purchasing power. In 1Q real wage growth in Romania, Hungary, Croatia, Lithuania, Slovakia and Russia was negative in yoy terms. In Poland, Czech and Latvia real wage growth was less than 1% yoy. Kazakhstan, Turkey and Ukraine buck the trend, posting wage growth which is close to or in double digits. In turn private consumption in a number of countries remains well below its pre-crisis peak. Drawing off available 1Q GDP data, private consumption saw its third quarterly qoq decline in 4 quarters in Hungary and Romania and its second quarterly qoq decline in 4 quarters in Czech. Retail sales in volume terms in Russia over the first 4 months of the year showed gains of 2.5%, compared with gains of 3.7% for the same period last year.

<sup>1</sup> CEE includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Croatia, Kazakhstan, Russia, Serbia, Turkey and Ukraine.

Real wage growth remains negative or close to negative in many countries



In most countries unemployment is well above its pre-crisis lows and is declining only slowly, if at all

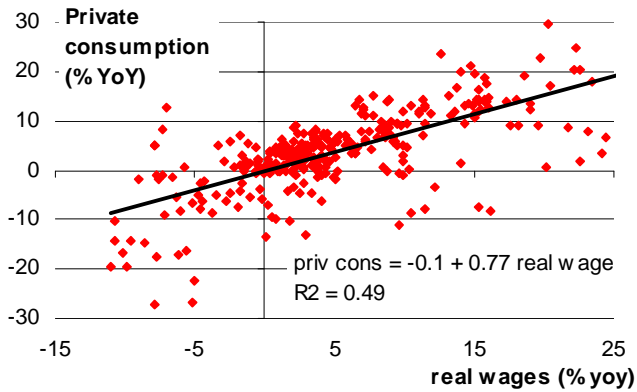


Source: Eurostat, national statistical offices, UniCredit Research

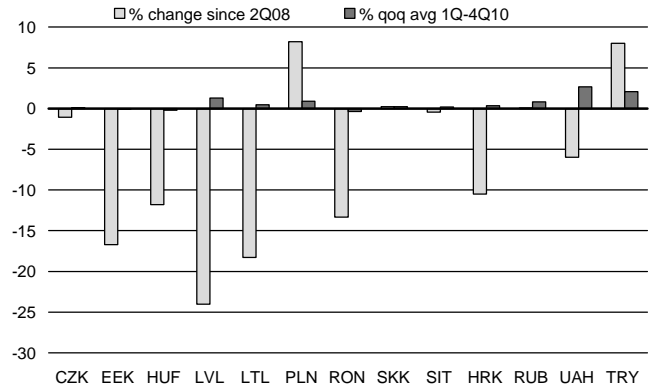
**Inflation to stabilize over summer and decline sharply from there**

Looking ahead we see a decline in inflation which should help to boost real consumer purchasing power and support domestic demand. For example should we assume that food and energy prices remain unchanged from here for the next 12 months, inflation will remain close to current levels for much of 3Q but over 4Q this year and 1Q next year will show much more significant declines. On average across the region such a scenario would see inflation ease to below 2% by April next year. Repeating the same exercise for the countries in our group within the EU, inflation is projected to decline to below 1% yoy by April next year. Of course assuming that food and energy prices do not rise for the next 12 months may prove ambitious but that increases over the coming 12 months are not as large as over the previous 12 months is less ambitious in our view. That Romania does not face another 5pp hike to VAT this July (adding 4.4pp to CPI) or that Poland does not plan to hike VAT 1pp again next January also helps. In an environment whereby external demand growth moderates, rather than contracts, lower inflation should facilitate higher real wage growth and see domestic demand prove more supportive of economic activity going forward. Turkey represents the exception on this front, where inflation is on an upward rather than downward trend, though this has the potential to play an important role in helping the CBT moderate consumption pressures. With this in mind we see growth in the region broadly in line with last year at 4.2%, though it should be more uniform across the region with each country posting positive gains for the first year in 4.

Real wage growth is a key driver of private consumption gains (INCLUDE R2)



Private consumption in CEE: Any recovery remains modest at this stage



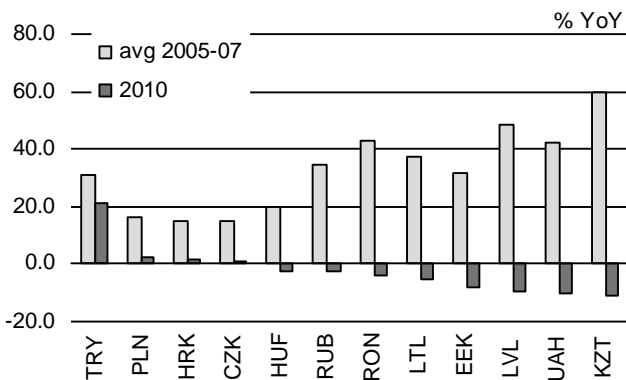
Source: Eurostat, national statistical offices, UniCredit Research

### Credit in most cases remains constrained

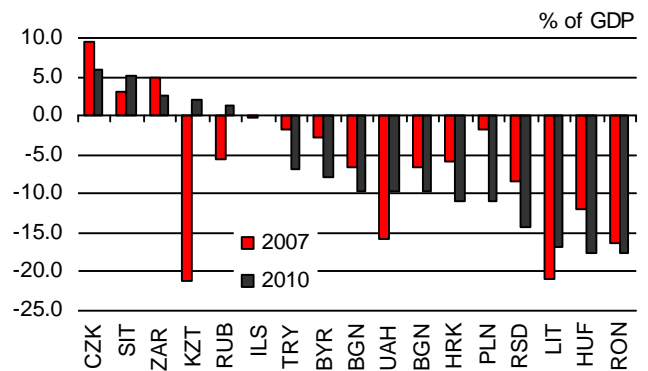
Banking sectors also differentiate the strong from the weak

Banking sector performance across the region also has a role to play in differentiating the recovery in domestic demand. We see both a structural and cyclical element to this. As shown below Turkey was the only country in the region to see a rebound in credit growth last year. Hungary, Russia, Romania, the Baltics, Ukraine and Kazakhstan saw continued negative real credit growth. To the extent that credit growth tends to be cyclical in nature and many of the economies in the region suffered a more prolonged downturn than in other EM regions, a more gradual recovery in credit is to be expected.

Credit growth in real terms – still to show recovery in most countries



Now and then: Change in net foreign asset position of banking sector



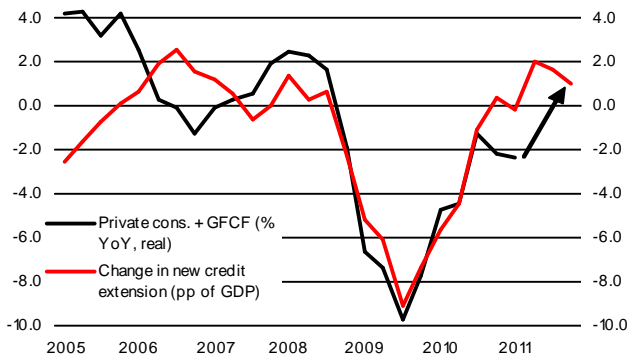
Source: Eurostat, national central banks, UniCredit Research

Reliance on new credit has eased in some countries

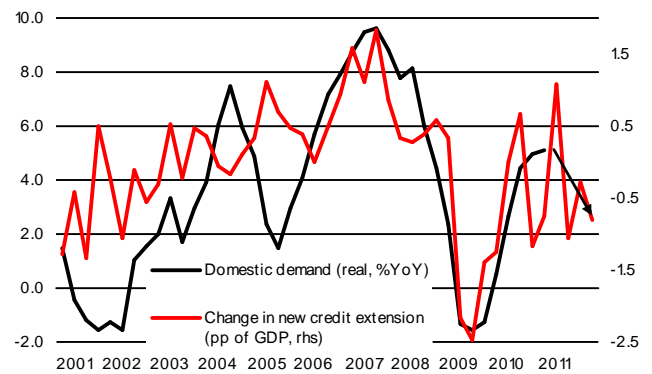
Indeed in the event of a more risk adverse global environment that feeds into more of a sudden stop in capital flows and credit extension, many countries in the region should suffer much less from a domestic credit perspective than was the case in late 2008. Below we include estimates for our credit impact indicator against GDP assuming zero new credit extension between over 2Q-4Q this year (at the time of writing we have credit data available until end-April for most countries). Our credit impact indicator measures the amount of new credit extended in the current period relative to the previous period as a percent of GDP, rather than credit growth (the change in the stock of credit) and moves in line with changes in

domestic demand. In this environment Hungary looks well protected, in part because at this stage credit continues to contract on a monthly basis in Hungary – a shift to a flat credit stock would represent an improvement and be supportive of domestic demand. In Russia and Poland, domestic demand growth would slump but remain positive, in contrast with late-08/early-09. Given the pace of credit growth in Turkey over recent quarters, a sudden stop there would be most detrimental to economic activity, forcing a double digit contraction in domestic demand similar to what the economy experienced in 2009.

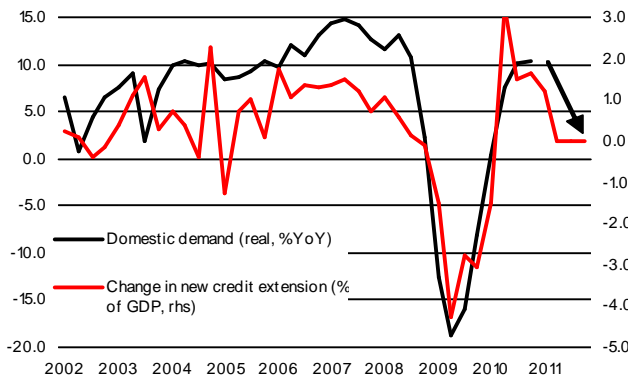
Credit impact indicator: Hungary assuming zero credit extension over 2Q-4Q this year



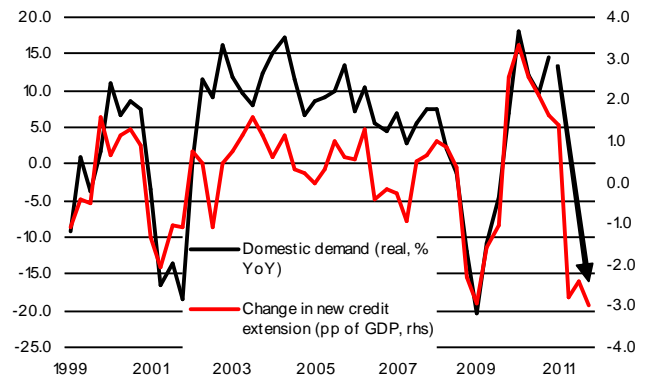
Credit impact indicator: Poland assuming zero credit extension over 2Q-4Q this year



Credit impact indicator: Russia assuming zero credit extension over 2Q-4Q this year



Credit impact indicator: Turkey assuming zero credit extension over 2Q-4Q this year



Source: National central banks & statistical agencies, UniCredit Research

**Banking sectors play a role in differentiating weak from strong**

From a broader perspective, differing degrees of reliance on external funding potentially also playing a role. The net foreign asset position of the banking sectors in the region varied significantly as we entered the downturn. For example in Czech the net foreign asset position of the banking sector stood at a positive 9.5% of GDP at end-07 while at the other extreme Latvia posted a negative net foreign asset position for the banking sector of 47% of GDP. Banking sectors in Hungary, Lithuania, Romania, Kazakhstan and Ukraine all posted negative net foreign asset positions which stood in double digits as a percent of GDP at end-07. In Poland and Turkey the net foreign asset position of banking sectors stood at less than 2% of GDP. Since the crisis the largest improvements have been seen in Kazakhstan and Russia, which have more back into positive positions. Latvia, Lithuania and Ukraine have seen a narrowing of the net foreign asset position of their banking sectors. In contrast deterioration is largest in Turkey, Poland, Hungary, Serbia and Belarus.

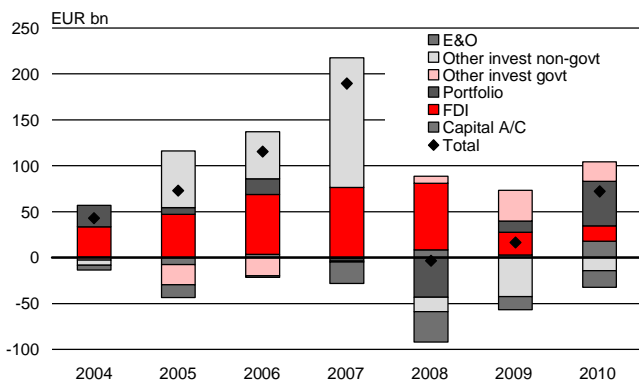
## CEE is no longer enjoys the protection of 'under ownership'

**More and more countries in the region experience in capital inflows**

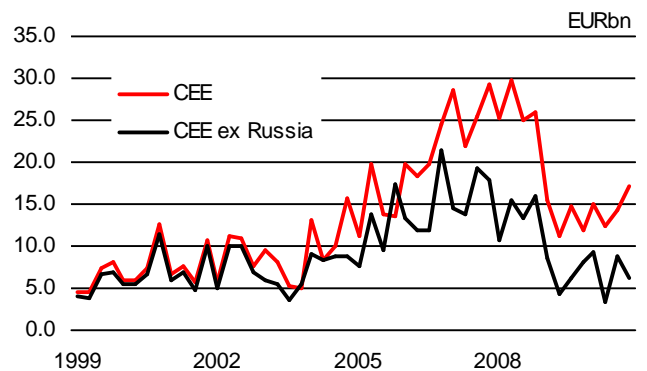
Up until end-2010 the recovery in capital flows to the region was unbalanced both in terms of the make up of the inflows and their destination. For example 2010 was CEE's strongest year in three in terms of capital inflows. From EUR 16.6bn in total inflows in 2009, capital to the region last year reached EUR 72.3bn. However EUR 48.2bn of these inflows were portfolio in nature, with Poland accounting for EUR 20.2bn of the total inflow, Turkey EUR 12.4bn. Entering 2011, this capital flows picture means that with the exception of Turkey and Poland, should the world experience a sharp pull-back in risk appetite and in turn capital outflows, the majority of CEE economies should be well protected.

A shift in capital flows across the region since the start of the year means that this is no longer the case. Hungary is the most obvious example, with inflows to the domestic fixed income market of EUR 3.3bn YTD, as well as large external issuance. Portfolio investment to Romania over Jan-Feb reached EUR 0.4bn compared with EUR 1.1bn for the entirety of last year. In Serbia net portfolio inflows reached EUR 334.6bn over Jan-Feb, compared with EUR 27.5mn for the same period last year.

Net capital inflows to CEE have recovered but are dominated by portfolio flows



Inward FDI to the region shows little signs of recovery except for Russia



Source: BIS, national central banks, UniCredit Research

**FDI and bank inflows have yet to see a meaningful recovery**

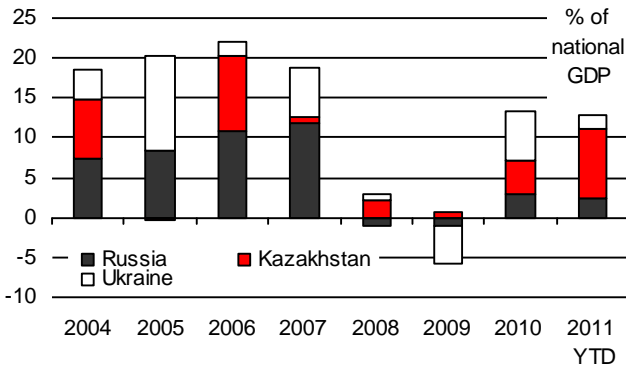
In contrast with the recovery in portfolio flows to the region, FDI flows lag. Having peaked at EUR 76.3bn in 2007, FDI flows last year reached EUR 16.5bn. Foreign bank lending to entities in the CEE region also remains muted, though it is moving in the right direction. Just as was the case with portfolio flows up until early this year, there is large differentiation within the region in terms of foreign bank flows. Turkey began to see a recovery already in 1Q10 while the Baltics, even up to 4Q last year, continue to see a decline in foreign bank exposure. Data released YTD suggests that this trend persists. This divergence between portfolio flows and more medium to long term FDI and bank/non-bank borrowing is unlikely to persist indefinitely. Policy decisions on both the monetary and fiscal side will be important in determining in which direction the 'convergence' occurs.

## Divergence within CIS

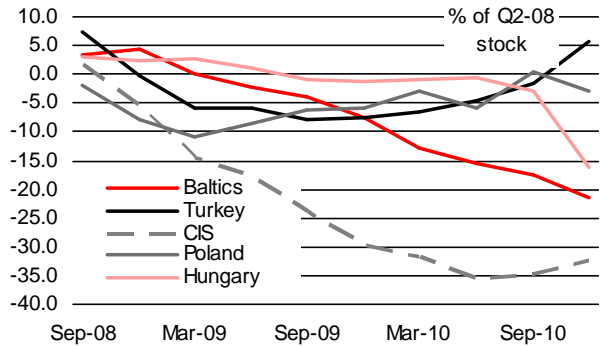
**Banking sector outflows in CIS were largest**

Examining trends in CIS in more detail, Russia lags Kazakhstan and Ukraine in terms of a renewal of capital inflows. Most uniform across the region up until the end of last year was the decline in foreign bank exposure in CIS which was much more pronounced than elsewhere in the region. Relative to its peak, foreign bank exposure to CIS had fallen by over 35% by the middle of last year and now appears to have reached bottom (in line with shifts in net foreign asset positions discussed above).

Reserve accumulation pre and post crisis: Russia lags, Kazakhstan rebounds much quicker



Foreign banks appear to have finally finished running down their exposure to CIS



Source: National central banks, UniCredit Research

**Kazakhstan now leads Russia in terms of reserve accumulation**

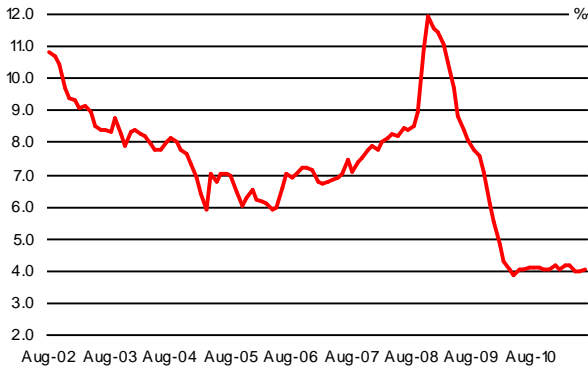
Since last year all three central banks have once again begun FX reserve accumulation. However the pace of reserve accumulation is more sizeable and consistent in Kazakhstan than it is in Russia, in contrast with pre-crisis trends. Given the degree of improvement in the banking sector's net foreign asset position in both countries, a continued recovery in inflows seems likely. Central to the full picture in Russia will be the willingness of locals to retain capital domestically. Meanwhile in Kazakhstan the authorities remain stubborn in terms of KZT gains, despite renewed capital inflows and underperformance relative to RUB – it appears that a period of continued if not larger inflows for longer is needed before the NBK opts for a path of gradual appreciation. In Ukraine the authorities welcome the capital inflows in the absence of progress with the IMF but there remains reluctance to introduce more currency flexibility, at least for now.

**Low interest rates to be normalised only gradually**

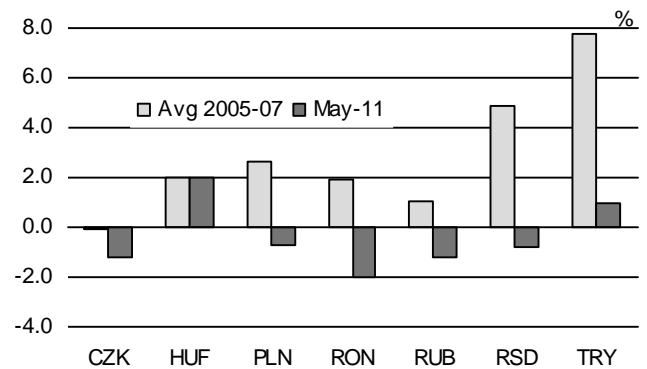
**Monetary policy: An absence of urgency**

Against a backdrop of weakening external demand, a gradual recovery in domestic demand and favourable base effects which should lower inflation over the coming quarters, any tightening in monetary policy from here in the region should be gradual in nature. Nominal interest rates on average across the region remain at record lows while many countries are running negative real interest rates. Czech Republic is likely to stand 75p below the ECB effective early July. That said economic activity indicators do not pressure central banks to act rapidly. We see Russia, having tightened policy via reserve requirements and interest rate hikes YTD, as close to finished. Serbia surprised us at its last meeting by already beginning to reverse a series of aggressive interest rate hikes in anticipation of a decline in inflation over the coming quarters. From a domestic demand and inflation perspective, Kazakhstan has scope to tighten monetary conditions but has opted instead for regulatory measures to control price pressures.

CEE interest rates (3m money market rates) remain at record lows



Real interest rates in most countries are negative & well below pre-crisis norms



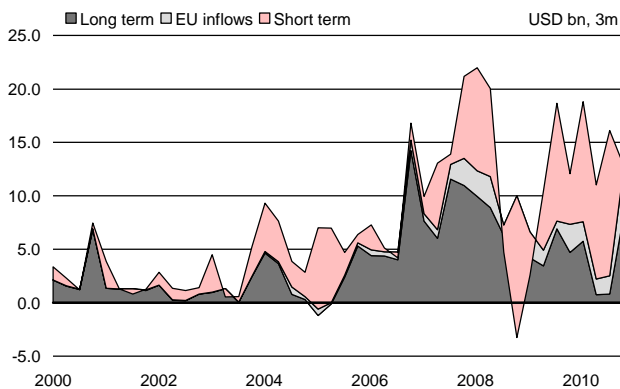
Source: National central banks & statistical agencies, UniCredit Research

**Poland and Turkey need to balance inflation against financial stability concerns**

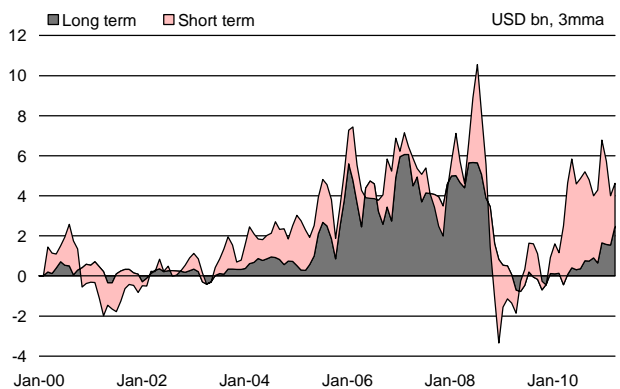
In terms of monetary policy we place Poland and Turkey in a separate group to the rest of the region due to the large amount of short term capital inflows that the two countries have experienced and the financial stability risks related with these inflows. In both countries there has been a clear shift in financing of C/A deficits since the crisis from long term to short term capital inflows. In Poland the government is welcoming of these inflows given the crucial role they play in financing the budget deficit. In part to counteract an excessively loose fiscal policy, in part to support PLN, in part to contain inflation, the NBP has acted aggressively YTD as it has hiked interest rates 100bp. Concerned about what they see as 'excessive FX volatility', the authorities have also confirmed the sale of up to EUR 15bn in EU proceeds this year on market.

In Turkey the CBT has placed more emphasis on the financial stability risks associated with these inflows, prompting a policy of rate cuts and reserve requirement hikes. A gradual decline in short term capital inflows, in part because of an end to QE2, should as we draw closer to the end of the year gradually see the CBT revert back towards a more 'orthodox' monetary policy, including the initiation of a gradual rate hiking cycle. In the event of market stress, banking sector reliance on CBT funding gives it more control over its currency than is the case in Poland. The recent shift from USD 50mn to USD 40mn in daily FX purchases suggests that the CBT sees less scope for TRY losses from here.

Poland: Breaking foreign inflows into short v long term



Turkey: Breaking foreign inflows into short v long term



Source: National central banks, UniCredit Research

## Fiscal performance has the potential to prove decisive

Fiscal policy continues to play an important role in the region with a busier election schedule ahead:

**In Turkey & Poland, fiscal consolidation should ease C/A pressures**

1. In **Turkey and Poland** further fiscal consolidation efforts would help narrow C/A deficits and reduce reliance on short term capital inflows. Fiscal performance YTD in both countries has shown improvement. Turkey is particularly impressive with the budget deficit YTD only 3% of what it was for the first five months of this year. The announcement of a fiscal package in Turkey to narrow the deficit further would have at a minimum a positive headline impact, though it seems more likely that the government continues with a more 'covert' strategy of outperformance relative to targets. In Poland passage of next year's budget prior to the summer parliament recess and October's general election would send a strong signal of commitment to the consolidation path set down in the Convergence Programme;

**In Hungary & Ukraine, complacency is the primary risk**

2. In **Hungary and Ukraine**, focus over the next couple of quarters will be on government ability to deliver on reform agendas. The obvious risk is that easy market access fosters complacency. In Ukraine, the absence of progress on pension reform and gas tariff hikes prior to the Rada's summer recess would be a clear negative to the extent that the government is even less likely to push ahead post the summer period given next year's parliamentary elections. In Hungary the budget debate for next year scheduled for 4Q represents the most important measure of government commitment and will likely prove the key domestic determinant of assets prices between now and year end.

**In Romania we monitor privatisations, in Croatia & Slovenia government ability to tackle budget pressures**

3. In **Romania** we focus on structural measures rather than deficit performance. Progress on key privatizations and improved use of structural funds, as per the precautionary IMF programme, would support government financing, the balance of payments and overall growth prospects. In **Croatia** following a 4Q general election, pressure is likely to rapidly build on the government to tackle the budget deficit. In **Slovenia** we monitor the tailrisk of further bank recap costs for the government as it struggles to compensate for the fiscal cost of the failed pension reform. Failure to progress would risk putting these countries more in the headlines.

## Gauging the risks from a more negative EMU periphery scenario

**An escalation in the periphery requires monitoring**

We conclude by gauging the risks of a more negative scenario for the region, namely a further significant deterioration within the EMU periphery. Our base case includes the assumption that upon concluding the current review, the IMF and EU disburse to Greece to cover bond redemptions over the coming months, as well as put sufficient financing on the table to cover the sovereign's needs over 2012-13 and potentially into 2014. In a more negative scenario whereby prolonged uncertainty on the political front in Greece and/or EMU translates into instability of the deposit base in Greece and other periphery economies as well as threatening funding for the Greek sovereign, the risks to the banking sector in Europe and the recovery in economic activity would increase in a much more pronounced fashion. We identify 3 key channels via which this would impact CEE, namely risk appetite, banks linkages and trade linkages.

### 1. Global risk appetite:

Should the EMU periphery story translate into an outflow of capital from the EM universe, we see Kazakhstan (13.3% of GDP), Croatia (9.2% of GDP), Slovenia (12.6% of GDP), Poland (6.6% of GDP) and Hungary (7.1% of GDP) as the most likely candidates for an outflow of capital, at least to the extent that as a percent of GDP these countries have seen the largest inflows since the start of last year. In terms of absolute volumes, inflows have been largest in Poland, Turkey and Hungary.

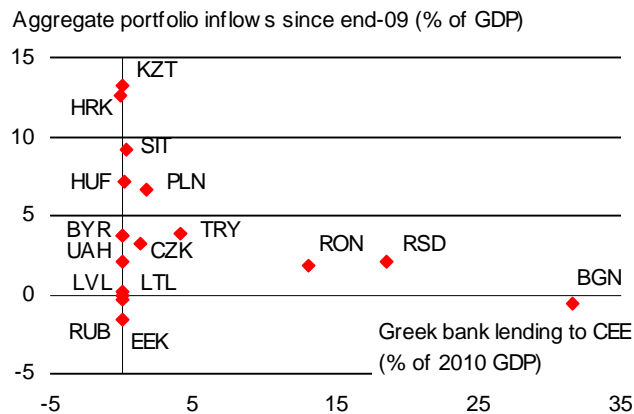
**2. Bank linkages:**

On this front it is the Balkan economies which are most at risk, with Bulgaria most vulnerable. Greek banks have lent over 31% of Bulgarian GDP to Bulgarian entities, as per BIS data. Bulgaria has seen its exposure increase by 12pp of GDP since end-08. In Serbia and Romania it stands at 18.5% and 13.1% of national GDP respectively. Turkey stands in fourth position at 4.2% of Turkish GDP. Over the last 4-5 quarters, trends in this exposure differ across countries. For example it has fallen from its peak in Bulgaria and Romania but increased, at least up until 4Q last year, in Serbia and Turkey.

**3. Trade linkages:**

On this front the vast majority of countries enjoy protection. 15.1% of all CEE exports last year were destined for Germany – only 3.3% of all CEE exports went to the EMU periphery (Greece, Ireland, Portugal, Spain). At least to date, strong growth in Germany has been able to more than compensate for a slump in external demand from elsewhere. In terms of outliers, Bulgaria is the only country in our group which exports more to the periphery, primarily Greece, than it does to Germany.

**SOME COUNTRIES MORE AT RISK DUE TO BANK EXPOSURE, OTHERS DUE TO ACCUMULATION OF PORTFOLIO INFLOWS**



Source: National central banks, BIS, UniCredit Research

**Some comfort cushions to hand**

In the event of a further deterioration in the EMU periphery situation, at least parts of CEE will increasingly suffer. That said there are some comfort cushions to hand to soften the impact. Romania's precautionary IMF agreement means that its Vienna Initiative agreement remains in place, keeping a careful watch on the activities of foreign banks. In the event of a significant increase in pressure in Serbia, the authorities have the option of reaching a quick agreement with the IMF on a precautionary agreement – as per Romania, this would facilitate the reinstatement of its Vienna agreement. Other countries such as Turkey are currently struggling with excess capital inflows rather than outflows – as a result any return of funds to Greece could well be compensated for from elsewhere. Finally the EBRD has put in place a funding facility for banks within CEE that face re-capitalisation needs which cannot be met by parent banks. Put together this should offer the region more stability than would otherwise be the case. More broadly it should help keep the CEE region on track for further, albeit bumpier gains in economic activity over the remainder of 2011.

**Countries**

## Bulgaria (Baa3 positive / BBB stable / BBB- positive)\*

**Outlook** – Domestic recovery is still facing headwinds while external conditions are likely to take a turn for the worse. This combination suggests that economic growth will lose some steam throughout the rest of 2011. Next year though, we expect real GDP growth to accelerate to 3.3% yoy, from 2.8% in 2011. Falling inflation and a gradually improving labor market should ensure that household recovery faces fewer obstacles, while investment is likely to draw support from improving EU funds absorption and a more permanent resolution of the Greek sovereign debt crisis, which arguably weighs on foreign capital inflow channeled toward the entire Balkans region at the moment.

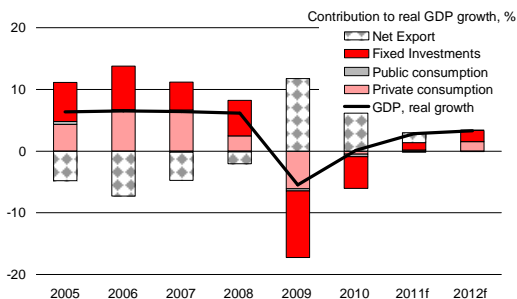
**Strategy** – We do not think that Bulgarian credit spreads can tighten from the current levels as it is already inside Romania whilst the economy is still facing challenges.

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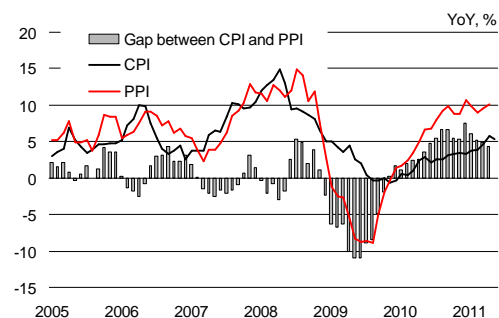
### KEY DATES/EVENTS

- July – New contract with Russia’s Atomstroyexport re. construction of a second nuclear power plant in Belene
- July – Final vote in Parliament on indexation of minimum pension
- 12 Aug – Flash estimate of 2Q11 swda GDP numbers

### GDP GROWTH AND CONTRIBUTION TO GROWTH



### CPI, PPI AND GAP (JAN 2005 – APR 2011)



Source: UniCredit Research, National Statistical Institute

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011E	2012F
GDP (EUR bn)	35.4	34.9	36.0	38.9	41.1
Population (mn)	7.6	7.6	7.5	7.4	7.4
GDP per capita (EUR)	4,658	4,618	4,801	5,226	5,575
<b>Real economy yoy (%)</b>					
GDP	6.2	-5.5	0.2	2.8	3.3
Private Consumption	3.0	-7.6	-0.6	0.2	2.1
Fixed Investment	21.9	-17.6	-16.5	4.0	7.2
Public Consumption	-1.5	-4.9	-5.0	-2.6	-1.1
Exports	3.0	-11.2	16.2	7.5	5.0
Imports	4.2	-21.0	4.5	4.5	4.5
Monthly wage, nominal (EUR)	279	311	331	357	380
Unemployment rate (%)	5.3	8.6	10.1	10.1	9.7
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	3.0	-0.8	-3.9	-2.8	-2.6
Primary balance	3.7	0.0	-3.3	-2.0	-1.7
Public debt	15.5	15.5	16.7	17.6	18.8
<b>External accounts</b>					
Current account balance (EUR bn)	-8.2	-3.5	-0.4	-0.2	-1.1
Current account balance/GDP (%)	-23.1	-10.0	-1.0	-0.5	-2.7
Basic balance/GDP (%)	-5.6	-0.3	3.1	3.7	2.3
Net FDI (EUR bn)	6.2	3.4	1.5	1.6	2.1
Net FDI (% of GDP)	17.5	9.7	4.1	4.2	5.0
Gross foreign debt (EUR bn)	37.2	37.7	36.7	36.3	37.2
Gross foreign debt (% of GDP)	104.9	108.0	101.8	93.3	90.6
FX reserves (EUR bn)	12.7	12.9	13.0	13.2	14.3
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	12.4	2.8	2.4	5.0	2.4
CPI (eop)	7.8	0.6	4.5	4.0	2.7
Central bank reference rate (eop)	4.1	0.2	0.2	0.3	1.0
BGN/USD (eop)	1.40	1.36	1.46	1.26	1.36
BGN/EUR (eop)	1.96	1.96	1.96	1.96	1.96
BGN/USD (pavg)	1.33	1.40	1.47	1.33	1.32
BGN/EUR (pavg)	1.96	1.96	1.96	1.96	1.96

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

## Bulgaria: Recovery to be tested in 2H 2011

Export and industry remain in the forefront of Bulgarian recovery...

...with domestic demand recovery lagging behind

Decelerating industrial output represents the strongest signs so far that the Bulgarian economic recovery is about to lose some steam in the coming months

Inflation is expected to take a backseat soon

Fiscal metrics have continued to improve, after decision to frontload fiscal consolidation in order to address rising fears about Greek debt restructuring and its reverberation over the Balkan region

No major shift in BOP trends so far this year.

Foreign funding needs of the non-bank private corporations remain high, with total foreign liabilities maturing over the next 12M (excl intercompany loans) at 17% of GDP in March 2011

In 1Q11, Bulgaria's GDP edged up a notch qoq to 0.6%, from 0.5% in 4Q10. The recovery remains over-reliant on exports, while breakdown data suggest that there are only tentative signs of stabilization in domestic demand components. Individual consumption was down 0.1% qoq in 1Q11, after adding a meager 0.3% in 4Q10, but is still 8.5% lower relative to its pre-crisis level. Moderation in the speed of household consumption recovery arguably reflects higher inflation and a weak labor market, which has made households more cautious about their spending decisions. After a 7.9% qoq surge in 4Q10, GFCF was up just 0.9% in 1Q11, bringing its volume 42% below where it was when the crisis began. Various factors were at play, but weak foreign capital inflow seems to be the key, as deepening Greek economic troubles cast a shadow over the flow of capital channeled toward the entire Balkans region. On the positive side, export posted a solid 4.6% qoq gain (18.8% higher than its pre-crisis level), while import was down 1% (7.9% below its pre-crisis benchmark). Looking ahead, we see qoq growth dynamic losing some steam this year as the boost from export and upturn in inventories is set to fade. At the same time, policy makers have only limited room for maneuver. Credit conditions remain tight due to the pro-cyclical nature of the currency board arrangement; while front loaded fiscal consolidation looks the right policy response to the Greek sovereign debt crisis. Next year we expect moderate acceleration of GDP growth to 3.3% yoy.

**Annual average CPI increased to 3.7% in April**, from 2.4% in December 2010. At the same time, the significant gap between PPI and CPI suggests that there must be some pass through effect in the months to come. After peaking in February and March, inflation expectations have also declined recently. Recent developments have reinforced our view that, although headline inflation will continue to rise in the coming months, and is expected to peak at 6.2% yoy in June, it is likely to recede thereafter to 4.0% yoy and 5.0% avg in December 2011. Later on, inflation is likely to depend more on domestic market developments and particularly on the pace of labor market recovery. We expect the combination of sluggish domestic demand recovery and high unemployment to keep inflationary pressures subdued during the whole of 2012 (eop 2.7% and avg 2.4%).

**The budget is running a deficit equivalent to 0.7% of GDP for the first 4M** of the current year compared with more than twice that shortfall one year ago (1.8% of GDP). This reflects a blend of a solid 11% yoy increase in tax revenues and 3.5% fall in fiscal spending. Some of the cost reductions seen so far this year look temporary though, as capital spending and subsidies are likely to rise in the run-up to the municipal and presidential elections scheduled for October. We continue to see fiscal policy in Bulgaria as too tight for this stage of the cycle. There is some room for policy easing, in our view, provided that a permanent resolution to the Greek debt crisis is found and Bulgarian authorities are able to convince the market that such a move would not place the sustainability of public finances at risk.

**There are no indications for recovery in the portfolio and FDI flows to Bulgaria so far in 2011**, in contrast with the rest of the CEE region. We see some scope for recovery later this year though, similar to the dynamics seen in 2009 and 2010, while also noting that FDI and portfolio investment data are usually subject to potentially large scale upward revisions. Stabilization of capital flows will also draw support from privatization efforts this year, which should culminate in the sale of a major tobacco processing company in September, and floating one-third of the shares of electricity generation utilities on the local stock market. Instead, there is some positive momentum in the C/A dynamics so far in 2011. C/A turned positive for the first 3M of the current year for the first time since the start of the transition (EUR 253mn or 0.6% of GDP), mostly thanks to a constantly improving trade balance. It should be noted though that export also drew support from some temporary factors, such as the re-export of cars and other consumer durables which due to weak household sector recovery were difficult to sell on the local market. Looking ahead to the rest of the year we expect some deterioration (to 0.5% of GDP deficit), as higher energy and food costs should put some negative pressure on the foreign trade balance.

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

**Outlook** – Although the recent high frequency indicators confirm a material slowdown, they remain far from recessionary territory. On the back of the higher GDP forecast for the key trading partner Germany we have revised up slightly our 2011 GDP forecast to 2.3% yoy but due to the lack of meaningful demand pressure we see inflation remaining close to the 2% yoy target. Against this backdrop, we expect the CNB to hike rates just 50bp by year end.

**Strategy outlook** – As the CZGB curve remains relatively steep whilst the CNB will likely push forward some rate hikes we see the curve flattening and CZGBs potentially outperforming, we hence increase our duration recommendation to long. We are neutral on CZK.

**Authors:**

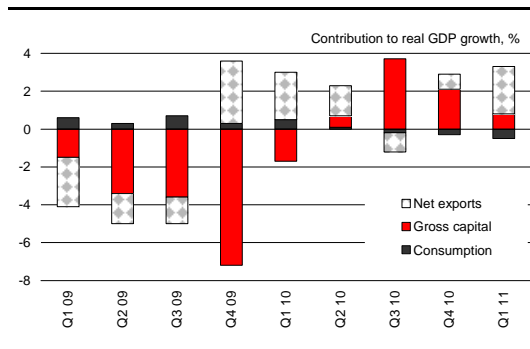
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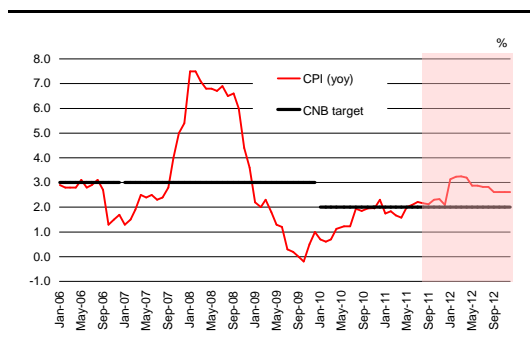
**KEY DATES/EVENTS**

- 23 June, 4 August – CNB Board meetings
- June/July – Vote on key reform laws in Parliament
- Early July – Government to hold confidence vote

**NET EXPORTS BECOMING THE MAIN GROWTH DRIVER**



**CPI JUST ON THE CNB TARGET, MAY MOVE ABOVE SOON**



Source: CSO, CNB, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	147.9	137.2	145.0	154.1	163.6
Population (mn)	10,430	10,491	10,517	10,550	10,579
GDP per capita (EUR)	14,181	13,081	13,789	14,603	15,462
<b>Real economy yoy (%)</b>					
GDP	2.5	-4.1	2.3	2.3	2.8
Private Consumption	3.6	-0.2	0.1	0.3	2.0
Fixed Investment	-1.5	-7.9	-3.1	2.5	4.5
Public Consumption	1.1	2.6	-0.1	-0.5	0.0
Exports	6.0	-10.8	18.0	12.5	9.0
Imports	4.7	-10.6	18.0	10.2	9.0
Monthly wage, nominal (EUR)	906	888	941	1,002	1,055
Unemployment rate (%)	5.5	8.1	9.0	8.5	7.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-2.1	-5.8	-4.7	-4.2	-3.5
Primary balance	-1.6	-4.5	-3.3	-2.8	-2.1
Public debt	30.0	35.3	38.5	41.8	43.2
<b>External accounts</b>					
Current account balance (EUR bn)	-0.9	-4.3	-5.5	-4.8	-6.0
Current account balance/GDP (%)	-0.6	-3.2	-3.8	-3.1	-3.6
Basic balance/GDP (%)	0.4	-2.1	-1.2	-0.7	-1.1
Net FDI (EUR bn)	4.4	2.1	5.1	4.7	5.6
Net FDI (% of GDP)	3.0	1.5	3.5	3.1	3.4
Gross foreign debt (EUR bn)	59.7	61.9	71.4	75.7	80.8
Gross foreign debt (% of GDP)	43.6	45.2	48.8	48.9	49.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	6.3	1.0	1.5	2.0	2.9
CPI (eop)	3.6	1.0	2.3	2.1	2.6
Central bank target	3.0	3.0	2.0	2.0	2.0
Central bank reference rate (eop)	2.3	1.0	0.75	1.25	2.25
3M money market rate	3.8	1.9	1.1	1.1	1.9
CZK/USD (eop)	19.21	18.39	18.74	15.68	16.67
CZK/EUR (eop)	26.80	26.35	25.05	24.30	24.00
CZK/USD (pavg)	16.97	18.96	19.06	16.60	16.35
CZK/EUR (pavg)	24.96	26.43	25.28	24.40	24.20

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

## External demand to continue driving growth

GDP maintains its previous yoy dynamic in 1Q, pulled by external demand

**1Q real and seasonally adjusted GDP added 0.9% qoq**, putting the yoy expansion at 2.8%, a notch above the 4Q's reading. The main driving force of yoy growth on the demand side was net exports with a contribution of 2.5pp. Private and government consumption shrank 0.5% yoy and 1.3% yoy respectively, combined subtracting 0.5pp from GDP growth. Fixed capital formation advanced 3.8% yoy, while the inventory change was flat with respect to GDP growth. Manufacturing was again the major growth pillar on the supply side.

Economic activity loses momentum at the start of 2Q

**Recent indicators** – industrial output, manufacturing PMI, foreign trade – have surprised on the downside, raising speculation that the assumed slowdown in economic activity could even surpass expectations. Nonetheless, the underlying trends allow us to remain optimistic. Export sales and new manufacturing orders continued to rise at a solid pace in April. May's manufacturing PMI, despite dropping sharply on the previous month, was far from contraction territory and even above its long-term average.

With austerity to bite on the domestic demand side, 2011 GDP growth will continue to be led by foreign demand

**Our assumption that the economic slowdown will be moderate** rather than sharp from 2Q, coupled with solid 1Q growth and UniCredit's higher call for Germany's 2011 GDP expansion allowed us to upgrade our 2011 Czech GDP forecast to 2.3% from 2.0%. We left the proportion between the contribution of domestic and foreign demand to this year's growth almost unchanged from three months ago, with the latter contributing the overwhelming part of the increment. On the domestic demand side, we see potential for slightly faster growth of fixed capital formation and a smaller drop in government spending, while household consumption is set to post a milder rise given its contraction in 1Q. Household spending will not gain momentum nor domestic demand take over the role of the main growth driver until 2012, in our view. We have revised down our 2012 GDP growth forecast slightly to 2.8% from 3.0%, due to a higher base formed by the 2011 upgrade.

Inflation is set to stay slightly above 2% in 2011, but no demand pressures on the horizon

**After remaining below the CNB's 2% inflation target in the first four months of the year, CPI hit the target in May**, after a surprisingly strong boost from surging food prices. Importantly, however, the absence of demand-driven pressures has persisted. Going forward, we expect food price rises to continue for several months which, together with the secondary impacts of the recent oil price spike, will keep inflation above but not far from 2% until year-end. At the beginning of 2012, CPI is set jump above 3% but mainly due to the VAT rate hike as the assumed recovery of domestic demand will not be evident until later.

We expect the first interest rate hike late 3Q, a bit earlier than the CNB forecasts

**Compared to the CNB's prediction, we expect stronger GDP growth as well as weaker CZK**, with the latter resulting in part from the CNB's inaction as regards interest rates. With the ECB committing itself to a further rate hike in July, the negative interest rate spread of CZK vs. EUR is set to widen to as much as 75bp. We, therefore, see the risk of a CZK drop rather than the imminent inflation threat as a reason for the CNB to begin tightening sooner rather than later. On the other hand, we are aware of the fact that one of the CNB's arguments against the early start of a tightening cycle has been the Eurozone's debt crisis, an issue which is unlikely to disappear any time soon. On balance, we believe that the first 25bp hike will be in September, roughly one-and-a-half months earlier than the CNB itself has forecast. Against our previous view, we have reduced the total number of CNB's quarter-point steps this year from three to two.

The first package of government reform bills approved in the first reading

**The lower house of parliament has given a preliminary approval to the first package of government reform bills** (a rise in the lower VAT rate; elimination of a cap on the retirement age and an increase of the differential between high and low pensions; a reduction of state subsidies of private savings in building societies; amendment on public procurement). Whether the reform legislation will win the lower house's support in the following two readings is uncertain, as the junior coalition partner threatens to leave the cabinet unless its demands for changes in ministerial posts are met. We believe in our baseline scenario that the government will maintain its three-party format and thus manage to push through its reform package.

## Estonia (A stable / A stable / not rated)\*

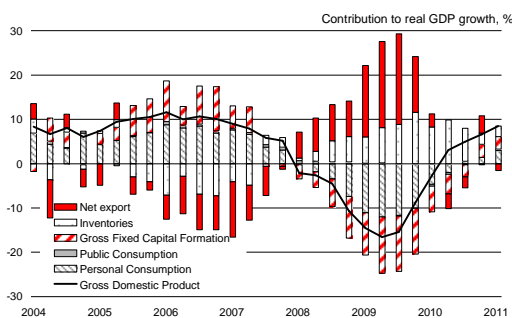
**Outlook** – We continue to maintain a positive view on the country as the pace of economic recovery outperforms its peers. Combined with prudent fiscal policy and ongoing commitment to pursue a nearly-balanced budget, we see scope for positive economic development driven by growing exports, FDIs and recovering domestic demand.

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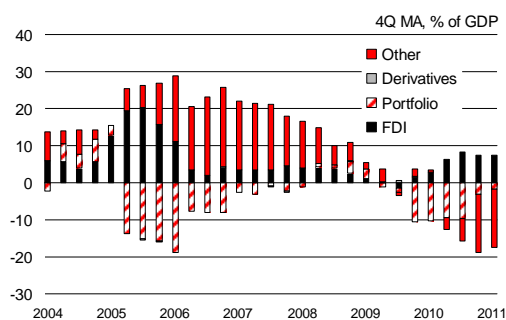
### KEY DATES/EVENTS

- August-September 2011: Presidential elections
- 7 July, 4 August, 8 September: ECB Governing Council meeting

### FIXED INVESTMENT BEGINS TO MAKE MORE OF A CONTRIBUTION TO ECONOMIC ACTIVITY



### ...IN LINE WITH GROWING FDI



Source: Bloomberg, Statistics Estonia, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	16.1	13.9	14.5	15.7	16.9
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,993	10,344	10,878	11,825	12,698
<b>Real economy yoy (%)</b>					
GDP	-5.1	-13.9	3.0	4.5	4.3
Private Consumption	-5.6	-18.8	-2.1	4.2	5.9
Fixed Investment	-15.0	-32.9	-9.6	16.5	14.1
Public Consumption	3.8	0	-2.0	1.7	1.7
Exports	0.4	-18.7	21.2	23.9	18.7
Imports	-7.0	-32.6	21.6	25.3	19.3
Monthly wage, nominal (EUR)	820	782	788	820	845
Unemployment rate (%)	5.5	13.8	16.8	11.0	7.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-2.8	-1.7	-0.8	-1.7	-2.3
Primary balance	-2.6	-1.4	-0.4	-1.3	-1.9
Public debt	4.6	7.2	7.7	8.8	10.5
<b>External accounts</b>					
Current account balance (EUR bn)	-1.6	0.6	0.5	-0.2	-0.4
Current account balance/GDP (%)	-9.7	4.5	3.6	-1.3	-2.2
Basic balance/GDP (%)	-7.1	5.2	11.1	3.1	0.5
Net FDI (EUR bn)	0.4	0.1	0.9	0.5	0.5
Net FDI (% of GDP)	2.6	0.7	6.2	4.4	2.7
Gross foreign debt (EUR bn)	19.0	17.4	16.6	17.3	18.0
Gross foreign debt (% of GDP)	118.2	125.5	114.2	109.9	106.9
FX reserves (EUR bn)	2.6	2.6	2.1	2.3	2.5
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	10.4	-0.1	3.0	3.9	2.8
CPI (eop)	4.3	-0.8	3.9	2.7	2.8
Euribor 3M (since 2010)	5.7	4.9	0.8	2.10	3.05
USD/EEK (eop)	11.21	10.92	10.94	0.64	0.69
EUR/EEK (eop)	15.65	15.65	15.65	1.00	1.00
USD/EEK (pavg)	10.64	11.22	11.66	0.68	0.67
EUR/EEK (pavg)	15.65	15.65	15.65	1.00	1.00

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

## Surprising on the upside

### GDP growth is impressive

**GDP in 1Q11 grew by 8.5% yoy in real terms – once again the fastest pace of all three Baltic States. In absolute terms we can see the pace of recovery pushing GDP up to the level of end-2008 but remaining approximately 10.5% under the record-high 1Q in 2007.** 1Q11 on the production side was attributable mostly, as in previous quarters, to manufacturing and construction, the former highlighting the strong connection with the Nordic economies and production of hi-tech equipment. On the expenditure side, the positive news is due to fixed capital formation and personal consumption, each adding around 3% to GDP growth, followed by inventories accumulation, which contributed a notch under 2.5% to GDP. Exports, which grew 39% yoy in real terms, did not add much to the GDP, as this surge was offset by the equivalent rise in imports.

### Investment and personal consumption should support economic activity from here

Looking forward, we expect growth from re-stocking to show signs of exhaustion. As in other Baltic States we should see an increase in fixed investment which is already evident in the last GDP reading, though we are wary that capacity utilization remains well below the historical maximum. We see some potential for gross fixed capital formation growth on the back of investments undertaken by some enterprises in the transport and infrastructure sector, as well as the revitalization of small business. Household consumption is showing signs of rebound, a trend which impressive given the extent to which inflation has recently limited gains in real purchasing power. Nominal wages grew 4.5% in 1Q, not even covering inflation which came in at 5.2% yoy for the same period. Helping to neutralise this, unemployment has declined sharply to 14.1% from 19.8% in 1Q10.

### Inflation is bottoming down

**Inflation remains high but should ease from here.** HICP rose 5.4% yoy over the 12 months to April. Food and energy accounted for 4.3pp of this increase, with the remainder of the basket (57%) adding only 1.1pp. Over the summer months inflation is likely to remain elevated but towards end-3Q and into 4Q should be to ease, at least in part due to favourable base effects. Given continued expected declines in unemployment and stable if not increasingly nominal wage growth, we should see further gains in consumption ahead.

### Public finances are prudent as always

**Public finances as always remain very prudent** – and the good news here is the absence of major news. At the end of April the Government approved the State Budget Strategy for the next four years, which effectively follows up on the previously successful course of limited spending and hard tax policy which has brought Estonia EMU accession. The Ministry expects the budget to run with a small deficit until 2012 inclusive – and in line with the extremely conservative policies it would only then signal for the reduction of the tax burden – a sustainable policy which has proved effective so far – as witnessed by the high GDP growth figures and sustainable budget. We forecast this year's budget deficit within 2% of GDP, with public debt to remain below 10% of GDP.

### C/A is moving into negative territory as domestic demands is recovering

**As a sign of continuing recovery in domestic demand, the C/A slipped slightly into deficit – the first negative 1Q number since 1Q09, driven by higher imports.** In 1Q11 exports of goods and services rose 41.5% yoy, while imports rose by almost 44%. For the full year period we expect the C/A to register its first deficit in three years but this should be fully compensated for by FDI. Meanwhile the banking sector continues to capital outflows.

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

**Outlook** – Ongoing tensions in bank lending means only easing inflation pressure can support the domestic consumption. As net exports are now providing more than 50% of GDP growth we see some downside risk to headline GDP growth in the second half of the year. The favorable base effect in food and energy prices and basically non-existent underlying inflation pressure means further FX appreciation could translate into rate cuts despite higher EUR rates.

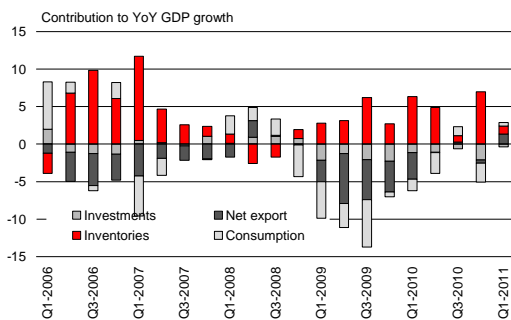
**Strategy outlook** – We do not see much value in the HUF at current levels as likely appreciation pressure could translate into a more dovish NBH. We recommend U/W HUF and long PLN/HUF positions. For HGBs we stay mod long due to cheap valuation on a global level. We stay overweight external bond market on completed YTD funding plan and also as credit lagged the rally in LC bonds.

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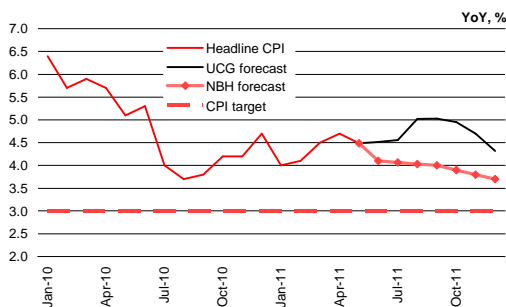
### KEY DATES/EVENTS

- 22 June – Inflation report 2011/II;
- 1 July – Report on Széll Kálmán – plan progress;
- 15 July – NBH quarterly report;
- July 2011 – 1H central budget deficit development

### NET EXPORT THE MAIN GROWTH DRIVER CONSUMPTION DRAG EASES



### CPI WILL START TO SLOW MEANINGFULLY IN 4Q



Source: UniCredit Research, CSO, NBH

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	106.5	92.9	98.5	105.8	112.3
Population (mn)	10,050.0	10,040.0	10,020.0	10,010.0	10,002.0
GDP per capita (EUR)	10,600.4	9,249.2	9,830.5	10,573.6	11,227.8
<b>Real economy yoy (%)</b>					
GDP	0.8	-6.7	1.2	2.8	3.5
Private Consumption	0.6	-6.8	-2.2	0.0	1.8
Fixed Investment	2.9	-8.0	-5.6	3.4	5.2
Public Consumption	0.2	2.2	-0.6	2.0	-1.6
Exports	5.7	-9.6	14.1	11.4	15.0
Imports	5.8	-14.6	12.0	11.2	14.3
Monthly wage, nominal (EUR)	791.7	712.2	736.0	769.2	811.7
Unemployment rate (%)	7.8	9.8	11.1	10.8	9.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-3.4	-3.9	-4.2	0.6	-1.0
Primary balance	-1.6	-4.5	-3.3	-2.8	-2.1
Public debt	72.3	78.4	81.0	75.5	67.0
<b>External accounts</b>					
Current account balance (EUR bn)	-7.7	0.3	1.8	4.3	0.3
Current account balance/GDP (%)	-7.3	0.3	2.1	4.0	0.8
Basic balance/GDP (%)	-4.4	-0.2	2.7	5.2	3.1
Net FDI (EUR bn)	5.1	1.5	1.2	2.1	4.4
Net FDI (% of GDP)	4.8	1.6	1.2	2.0	3.9
Gross foreign debt (EUR bn)	123.5	136.1	136.9	133.6	128.1
Gross foreign debt (% of GDP)	122.3	141.5	140.7	124.8	113.5
FX reserves (EUR bn)	24.0	30.7	33.0	28.0	24.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	6.1	4.2	4.9	3.9	2.6
CPI (eop)	3.5	5.6	4.7	3.2	2.9
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	10.0	6.25	5.75	6.0	6.0
3M money market rate	10.6	6.4	5.6	6.1	5.5
HUF/USD (eop)	190.27	188.26	208.00	174.19	187.50
HUF/EUR (eop)	265.49	269.80	278.01	270.00	270.00
HUF/USD (pavg)	171.09	201.00	207.55	184.05	182.43
HUF/EUR (pavg)	251.66	280.28	275.33	270.55	270.00

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

## Weak domestic demand coupled with easing CPI pressure

Successful long-term placement on the capital markets for Hungary

In spite of increased tensions in the Eurozone and around the world, Hungarian assets performed well and closed a relatively solid quarter. Following the announcement of the fiscal reform program (Kalman Szell plan) the risk premium of the country fell sharply (5Y CDS tightening below the 250bp level). Investors rushed to cut underweighted positions of Hungarian assets, HGB foreign holdings increased to just HUF 33bn off the all time high of HUF 3,499bn. This quarter the country successfully tapped the Eurobond market, selling USD 4.25bn Eurobond in two tranches, completing the longest ever debt issue in CEE (USD 1.25bn of 30 year bonds). Soon afterwards, the remaining eurobond issuance for 2011 was completed, providing comfortable cover for the 2011 foreign debt reimbursements. Furthermore, the Hungarian Development Bank managed its EUR 500mn bond sale at reasonable pricing in May.

No major surprises in the convergence program

The stream of domestic newsflow again centered around fiscal issues, as Hungary submitted its new convergence program to the EU. The program sets ambitious goals for the government to ensure sustainable public finances. Besides the concrete measures announced (e.g. almost 30% cut in drug subsidies) a public debt ratio ceiling has been introduced in the new constitution. Due to the one-off nature of several revenue items (bank tax, pension assets) in this year's budget, the monthly deficit figures have already exceeded the full year target in March. Considering the back-loaded revenues from the pension reform and the permanent HUF 250 expenditure cut, we believe the 2011 deficit target will be met with significant swings in the monthly balances. Increasing tensions show that discussions may last longer than planned with the different unions putting pressure on the government to meet the pre-set deadlines in the fiscal plan.

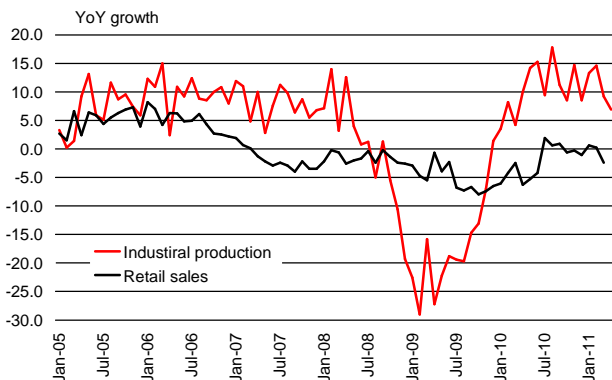
A public debt ceiling introduced. This year's deficit target already reached, but Y/E target shall be met

Apart from the potential delays during the negotiations certain goals have been met, such as the agreement with the banks on easing conditions for FX-loan takers. Although the agreement between the banks and government about fixing the CHF/HUF rate at the 180 level might ease the burden on households in the near term we believe the net impact on GDP growth will be relatively small whilst we put the total maximum cost of the scheme at around HUF30/50bn per annum. We believe high NPL and ongoing uncertainty about of the future of the bank tax will continue to constrain bank lending which is also evidenced in renewed foreign outflow from the banking sector. In Jan/April external banking sector liabilities declined by EUR 1.2bn after a EUR 5.1bn outflow in 2010. In our view the lack of meaningful lending will continue to constrain domestic demand whilst the recent export and industrial production data are already showing signs of a slowdown in line with the global trends.

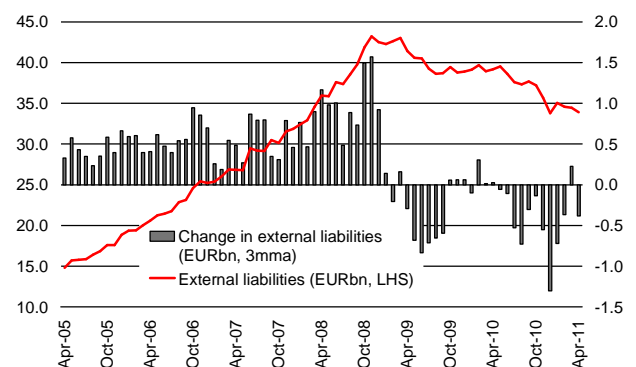
The package for FX-loan takers is likely to have contained effect on the budget

### DOMESTIC DEMAND IS STILL CONSTRAINED BY LACK OF LENDING

Retail sales remained poor in 1Q while IndOut started to slow



As banking sector continues losing external funding



Source: NBH, CSO, UniCredit Research

The engine of growth remained unchanged: net export

Domestic demand is showing some signs of improvement despite lack of lending

The trade surplus is offsetting outflows from the banking sector...

...whilst the portfolio flows we have seen in 1H will likely stay

Potential appreciation pressure on the HUF coupled with easing inflation pressure could lead to rate cuts in 2H despite higher EUR rates

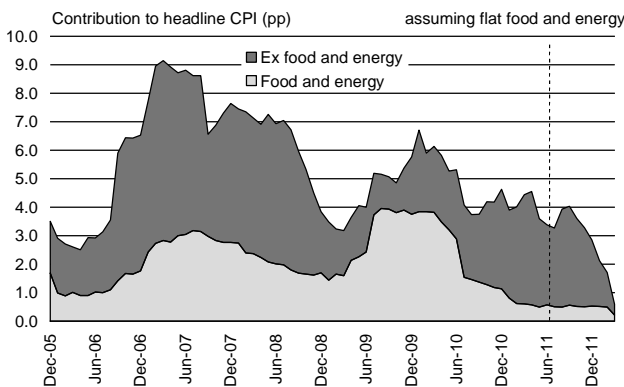
The real economy bucked the adverse conditions and posted the fastest growth in yoy terms since 4Q06 at 2.5% yoy. The seasonally adjusted qoq growth accelerated to 0.7% from 0.5% whilst the drag from domestic demand also eased somewhat (private consumption down 0.3% qoq after negative 1.1% and gross fixed capital formation down only 0.1% qoq after a drop of 1.8% qoq). With private consumption we believe the PIT cut also played a one off role. Looking ahead we believe easing inflation pressure (on the back of a favorable base effect from food and energy prices) should support further improvement in household demand despite still poor lending dynamics and the high savings rate. As net export contributed more than 50% of 1Q GDP growth (1.3pp in 1Q) we see some downside risk from this side on slowing global growth evidenced in the recent PMI indicators both in Hungary and in the key export partner Germany.

Although external banking sector liabilities have started to decline (EUR 1.2bn outflow in Jan/Apr) again, we believe the higher than expected trade surplus (Jan/Apr showed EUR 2.5bn surplus, 2.5%/GDP) is offsetting this by a wide margin. Looking ahead we believe somewhat slower export growth coupled with slowly improving domestic demand will likely see the trade surplus gradually narrowing in 2H but we do not believe it will return to deficit any time soon. Although the LC bond market has seen EUR 3.7bn inflow YTD we believe this was only enough to put allocations back to around market weight in non resident portfolios. Accordingly, unless we see a significant deterioration of risk appetite this portfolio inflow will likely stay in the market. This backdrop coupled with around EUR 2.0bn per annum EU inflows will provide further support for the HUF over the coming months, in our view.

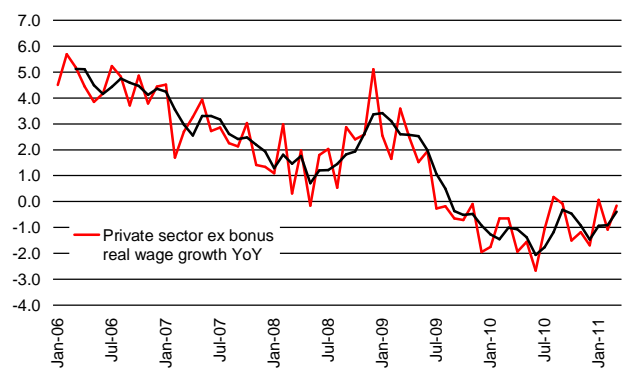
The appreciation pressure on the currency coupled with easing inflation pressure might push the NBH toward an easing bias despite the forthcoming hike by the ECB. In terms of inflation outlook, we expect the headline inflation to ease from the current levels of 3.9% yoy to around 3.5% yoy by the end of the year whilst the 3% target could be met around early 2012. We note that our ex-food, ex-energy measure is currently running at just 0.6%yoy, which is the lowest since early 2006 whilst the food and energy component is at 4.0%yoy which in itself is 100bp above the NBH mid-term target. Our baseline scenario assumes unchanged rates until the end of the year but if the favorable base effect on food and energy prices is met by a sudden appreciation of the currency we do not rule out some rate cuts in 4Q11. The new MPC has so far maintained the neutral bias despite earlier fears that the pro government majority might push through instant rate cuts but we think in the above scenario the rate cuts could easily win the necessary majority.

**INFLATION SHOULD START SUPPORTING THE CONSUMER**

Headline CPI should improve from here on base effects...



...which should ease some pressure on the consumer



Source: CSO, UniCredit Research

## Strategy: mod O/W credit, mod long duration in HGBs and long PLN/HUF

**We do not see much value in HUF from the current levels**

**FX:** We believe further appreciation pressure on the HUF is unlikely to be welcomed by the NBH given **1)** increasing signs of global slowdown and **2)** the recent bank government agreement ensures that CHF/HUF upside pressure will not put a burden on household disposable income in the near term. **3)** recent CPI data surprised on the downside. Accordingly we see the HUF underperforming and stay U/W. For leveraged investors we recommend long PLN/HUF at current levels (target 70.0, stop: 66.00)

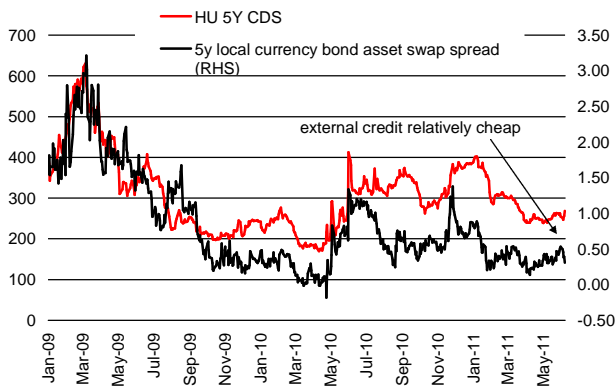
**We are neutral on HGB duration**

**Rates:** we recommend moderately long duration in HGBs: HGB yields are still relatively high compared to the inflation outlook and compared to nominal GDP growth. Although big part of the technical positioning driven rally is probably behind us and the AKK is in a comfortable position when it comes to issuance. We would not go to the longest maturities as we see the 2014/D and 2017/B papers as relatively cheap to the curve.

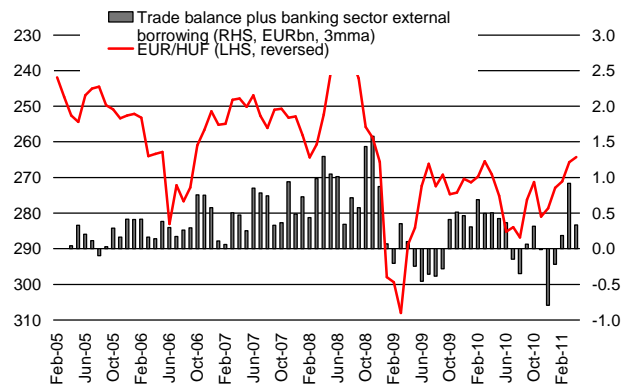
**Credit should tighten from here**

**Credit:** we believe external credit markets still offer value on directional basis as they lagged the bond market rally (see chart) whilst Hungary is the only country in the region which has fully completed its external borrowing needs for this year. We also see room for further rating improvements after the recent move by Fitch.

Credit market relatively cheap vs. local currency bonds



Flows turned more HUF supportive recently



Source: Bloomberg, NBH, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010	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	0.0	2.0	3.7
<b>Financing</b>	<b>25.2</b>	<b>24.5</b>	<b>25.6</b>
Domestic borrowing	22.5	19.1	19.0
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	0.0	0.0
Other	1.5	0.8	0.0

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>18.7</b>	<b>22.3</b>	<b>27.9</b>
C/A deficit	-2.1	-4	-0.8
Amortisation of medium to long term debt	16	20.2	22.1
Government/central bank	5.4	7.8	8.4
Banks	8.1	8.7	9.6
Corporates	2.5	3.7	4.1
Short term debt amortisation	4.8	6.1	6.6
<b>Financing</b>	<b>15.9</b>	<b>23.6</b>	<b>28.5</b>
FDI	0.6	1.3	2.6
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
Short term	4.9	6.3	6.8
EU transfers	1.8	2	2.1
Other	7.5	7.5	7.5

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

**Outlook** – GDP is on an upward path, having finally bottomed out, though the recovery lags other Baltic states. To date the upturn is reliant on external demand but we expect domestic demand to play more of a role in future. The C/A surplus has peaked and over the coming quarters is likely to edge back into negative territory. Fiscal consolidation remains the primary challenge for the domestic authorities.

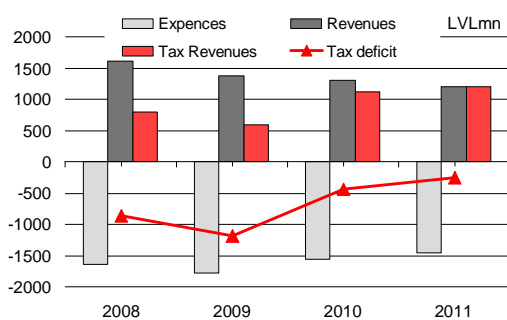
**Strategy outlook** – We believe Latvian credit can maintain the bullish momentum as the economy is through the major rebalancing. Although issuance just started we believe the relative size is relatively small for the USD market. We nevertheless see Lithuania credit outperforming Latvia due to less supply. We are mod O/W Latvia.

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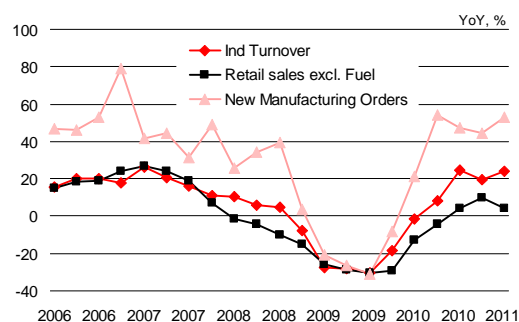
### KEY DATES/EVENTS

- September – General elections
- November – Final IMF review under the Stand-By Arrangement

### TAX REVENUES ARE RECOVERING



### INDUSTRY AND RETAIL INDICATORS ARE RECOVERING, BUT UNEVENLY



Source: Bloomberg, Central Statistical Bureau of Latvia, UniCredit Research, IMF, European Commission

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	22.9	18.5	18.0	19.4	20.7
Population (mn)	2.3	2.3	2.3	2.2	2.2
GDP per capita (EUR)	10,082	8,184	7,996	8,631	9,248
<b>Real economy yoy (%)</b>					
GDP	-4.1	-17.8	-0.5	3.8	3.5
Private Consumption	-5.6	-23.7	-0.2	3.0	2.1
Fixed Investment	-13.7	-36.1	-21.7	6.7	8.9
Public Consumption	1.8	-8.9	-11.1	-0.4	1.5
Exports	0.9	-13.3	10.5	11.1	8.7
Imports	-11.1	-32.9	7.1	12.0	9.9
Monthly wage, nominal (EUR)	678	651	629	656	680
Unemployment rate (%)	7.1	16.1	14.3	12.5	11.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance (incl. bank costs)	-7.5	-7.7	-11.7	-6.8	-2.3
Primary balance	-6.9	-6.2	-9.9	-4.7	0.0
Public debt	17.1	32.9	41.6	45.4	44.8
<b>External accounts</b>					
Current account balance (EUR bn)	-3.0	1.6	0.6	-0.3	-0.5
Current account balance/GDP (%)	-13.1	8.6	4.9	-1.4	-2.2
Basic balance/GDP (%)	-10.0	9.2	6.3	2.2	1.7
Net FDI (EUR bn)	0.7	0.1	0.2	0.7	0.8
Net FDI (% of GDP)	3.0	0.6	1.4	3.6	3.9
Gross foreign debt (EUR bn)	29.6	28.9	29.8	30.9	32.0
Gross foreign debt (% of GDP)	129.2	156.3	165.2	159.3	154.4
FX reserves (EUR bn)	5.8	5.2	6.9	7.4	7.9
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	15.4	3.5	-1.1	3.7	3.2
CPI (eop)	13.6	-1.3	2.5	2.8	3.0
RIGIBOR 3M	6.00	4.00	3.50	2.30	3.20
USD/LVL (eop)	0.51	0.49	0.53	0.47	0.48
EUR/LVL (eop)	0.71	0.71	0.71	0.71	0.71
USD/LVL (pavg)	0.48	0.51	0.53	0.48	0.47
EUR/LVL (pavg)	0.71	0.71	0.71	0.71	0.71

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

## Economic recovery but turbulent politics

Though lagging its Baltic peers, GDP is showing firm gains

**The Latvian economy has seen 5 consecutive quarters of positive qoq growth, but GDP still remains 22.5pp below its peak.** At the trough, GDP was 25.5pp below its high. 1Q GDP came in at 3.4% yoy (0.7% qoq). Over much of 2010 the recovery was heavily reliant on external demand and industry. In 1Q export growth remained strong, with goods and services exports in nominal terms showing gains of 30% yoy. However, imports have begun to accelerate rapidly, in part due to higher commodity prices, rising 31.7% yoy in 1Q. We saw a large surge in gross fixed capital formation. On a yoy basis investment grew 28.4% yoy, contributing nearly 4pp to GDP growth in 1Q11. Household consumption grew 3.6% yoy, despite negative real wage growth as declining unemployment acted as a support. At 16.6% in 1Q, unemployment is down almost 4pp from 1Q10 but still significantly above the 6% level of 2008.

Inflation remains high but we expect it to moderate in the mid-term

**Inflation at 5.0% yoy in May should be close to a peak.** Not surprisingly, the biggest upward pressure in 1Q11 came from food and housing, electricity and fuel. According to our estimates, food and energy account for in excess of 80% of the increase in CPI over the past 12 months. It appears that global food prices have at least reached a temporary peak while world oil prices have corrected 10% since April. We forecast a decline in inflation to below 3.0% by year-end. Such a decline in inflation combined with continued employment gains and a further recovery in investment should see domestic demand remain an important driver of economic activity from here.

C/A: From large surplus to small deficit

**In line with signs of a recovery in domestic demand, the C/A surplus is beginning to edge lower.** From a peak of 10.6% of GDP over the 4 quarters to 1Q10, the C/A surplus for the 4 quarters to 1Q11 stood at 2.0% of GDP. In nominal terms the C/A surplus in 1Q was only 21% of the surplus posted in 1Q10. From here we expect the C/A to slip back into modest deficit. Examining capital flows to Latvia, we are seeing a strong recovery in FDI but outflows of portfolio capital. Foreign banks also continue to run down their exposure, representing a persistent outflow of capital.

Focus remains on the budget

**Narrowing the budget deficit remains the biggest challenge for the country.** The efforts of the government to tighten fiscal policy are starting to show in the numbers, though this is not visible at first sight. The baseline deficit in four months of 2011 increased by 14% but this is due to a delay in the drawdown of EU structural funds until the latter half of the year. Excluding this impact, government revenue rose by 8% yoy in January-April of 2011. Government expenditure is down 5.5% in nominal terms over the first 4 months of the year. For the full year we anticipate budget deficit of 6.8% of GDP, though we monitor for risks of pre-election spending. The IMF targets the general budget to be at 6.4% of GDP in 2011.

Returning to external markets

In the beginning of June the government returned to the Eurobond market for the first time since March 2008 with a USD 500mn issue. The most recent IMF program documents put external borrowing needs for the government this year at in excess of EUR 350mn, though this assumes that Latvia continues to draw off IMF funds while the government has said that it will not draw further funds from the IMF and EU. The IMF and EU announced an EUR 7.5bn bail-out loan for Latvia in Dec-08, with the program scheduled to roll off 4Q this year and repayments to begin next year – EUR 325mn in 2012 and EUR 475mn in 2013 to IMF. Repayments to the EU are scheduled to begin in 2014.

A general election in September is a focus point

The political environment has taken a turn for the worst though it is encouraging that S&P's commented that the dissolution of Parliament would have no effect on Latvia's rating provided the new Government sticks to the fiscal commitments. S&P currently rates Latvia BB+ with a positive outlook. A general election is scheduled for September. Assuming the current government is re-elected Latvia should remain on track for an upgrade in 4Q. Thereafter focus will shift to whether or not the government re-engages with the IMF.

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

**Outlook** – The economy continues to recover. Exports remain the main driver of the growth, but internal consumption is starting to catch up. We expect the FDI inflow to push up the fixed capital formation in the country. Ratings momentum remains positive

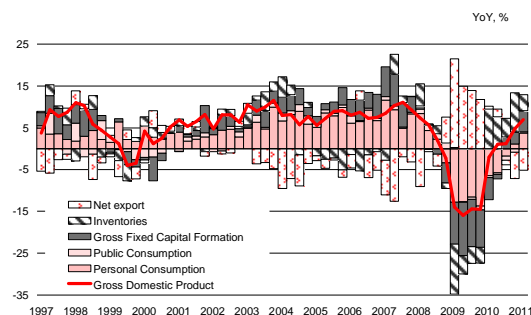
**Strategy outlook** – We believe the positive ratings momentum to support further credit spread tightening whilst the lack of new Eurobond issuance should see Lithuania outperforming Latvia. We are OW in cash credit. We also see some logic in selling Lithuania CDS versus Latvia CDS at flat spreads.

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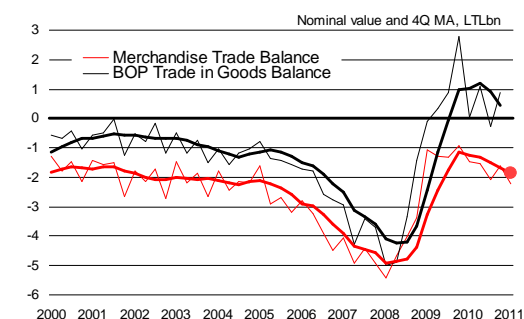
### KEY DATES/EVENTS

- Autumn, 2011 – Paliament decides on nuclear power-plant construction in Lithuania
- 2012 – Parliament elections

### GDP STRUCTURE IS DEVELOPING TOWARDS SUSTAINABLE GROWTH



### SLOWDOWN IN INTERNATIONAL TRADE TO BE EXPECTED



Source: Statistics Lithuania, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	32.3	26.5	27.4	29.2	30.7
Population (mn)	3.4	3.3	3.3	3.3	3.3
GDP per capita (EUR)	9,615	7,939	8,257	8,837	9,360
<b>Real economy yoy (%)</b>					
GDP	2.8	-14.7	1.3	5.1	3.2
Private Consumption	3.8	-17.7	-4.1	3.8	3.5
Fixed Investment	-6.9	-39.2	-0.3	5.5	5.3
Public Consumption	7.3	-1.9	-3.0	0.9	1.0
Exports	11.6	-12.7	16.3	20.3	9.7
Imports	10.3	-28.4	17.6	21.0	10.1
Monthly wage, nominal (EUR)	654	625	600	615	635
Unemployment rate (%)	4.8	9.5	14.5	9.5	7.3
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-2.6	-7.9	-7.5	-4.8	-3.7
Primary balance	-1.9	-6.7	-4.6	-2.6	-1.1
Public debt	15.6	29.5	35.0	37.7	40.0
<b>External accounts</b>					
Current account balance (EUR bn)	-4.2	1.1	0.3	-0.6	-0.9
Current account balance/GDP (%)	-13.1	4.3	1.6	-2.1	-3.0
Basic balance/GDP (%)	-9.5	4.1	4.3	0.5	0.6
Net FDI (EUR bn)	1.2	0.0	0.7	0.8	1.1
Net FDI (% of GDP)	3.6	-0.1	2.6	2.6	3.6
Gross foreign debt (EUR bn)	23.0	23.1	22.9	23.7	24.5
Gross foreign debt (% of GDP)	71.3	87.2	83.5	81.4	79.6
FX reserves (EUR bn)	4.6	4.5	4.9	5.2	5.5
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	11.0	4.5	1.1	2.6	2.2
CPI (eop)	8.5	1.3	3.6	2.4	2.4
VILIBOR 3M	9.20	4.54	1.56	1.90	2.75
USD/LTL (eop)	2.55	2.37	2.61	2.30	2.33
EUR/LTL (eop)	3.45	3.45	3.45	3.45	3.45
USD/LTL (pavg)	2.35	2.48	2.60	2.34	2.30
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	3.45

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

## More evidence of strong recovery

**Economy grows at an impressive speed**

**The Lithuanian economy demonstrated an impressive pace of recovery in 1Q11 with GDP expanding 6.9% yoy.** This is the fifth successive positive quarter of yoy GDP figures. The most recent data shows a shift from a reliance on net exports to a more broad based recovery incorporating domestic demand. Household consumption contributed over 3.5pp to the yoy GDP increase, while fixed investment posted gains of 38.3% yoy more than compensating for a slowdown in the inventory cycle. The recovery in fixed investment is in line with strong gains in FDI.

**A strong 2011 for GDP**

**Full year GDP this year has the potential to post gains in excess of 5%.** A strong finish to last year translates into a positive carryover of 1.8pp while 1Q posted a robust 3.5% qoq. The main exporters, faced by capacity utilization constraints, will aim to expand their production capacity. The formal capacity utilization indicator is rapidly recovering and nearing its historical peak. Household consumption should also play a role, aided by easing inflation and in turn improved real wage growth. Inflation stood at 5.0% yoy in May due to rising energy and food prices. We expect both to peak over the summer and inflation to decline from there. At 12.5% in April the unemployment rate is down 2.6pp over the past year. .

**C/A account is approaching break even on recovering imports...**

**The C/A balance surplus in 2010 narrowed to 1.4% of GDP, decreasing by two-thirds compared to 2009 and is likely to post a modest full year deficit this year.** This trend is in line with the recovery in domestic demand that is underway. Indeed over the first 4 months of this year the C/A slipped into deficit. FDI is showing recovery however and show compensate for this. Foreign banks continues to run down their exposure but at a slow pace than previously. In line with this trend, credit growth appears close to bottoming out. High levels of external indebtedness remain a concern, though less so than elsewhere in the Baltics. Gross external debt finished last year in excess of 80% of GDP but should be on a downward trajectory from here.

**Fiscals start to improve – the structure of income looks healthy as tax revenues increase**

**Efforts to consolidate the budget deficit are bringing results in Lithuania.** Tax revenues grew in 1Q11 approximately 17% from 1Q10, which coupled with the reduction of expenditure, reduced the baseline deficit by over 19%. However, there's still more room for improvement – significant amount of reforms need to be carried out in the fiscal area to hit the Government goal of 3% budget deficit by 2013. This year the government targets a deficit of 5.3% of GDP compared with 7.5% of GDP last year. We expect public debt to rise to 47.7% by the end of this year. Fiscal efforts will not only be important in terms of stabilizing public debt but will also help to avoid a crowding out of the private sector as it recovers and increasingly attempts to access foreign capital from here.

**We expect rating upgrades to follow shortly**

**Fitch has upgraded its outlook for Lithuania to positive.** In the press release Fitch refers to "strengthening public finances, strong economic recovery and increasing stabilization in the financial sector." We expect a rating upgrade to follow in the next quarter.

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

**Outlook** – We remain positive on the outlook for GDP growth this year. CPI inflation is set to peak in 2Q, easing later during the year. The MPC has already delivered 100bp of rate hikes. Our baseline scenario would assume either no further hikes, or one more hike. Markets and rating agencies look for further public finance consolidation steps after the October elections.

**Strategy outlook** – We see EUR/PLN in a relatively tight range (3.85/4.00) during 3Q with limited appreciation bias. As the NBP finished the tightening cycle for now we expect short ends to pull in somewhat but we only play it tactically. Wide ASW at the mid to long end part of the POLGB curve still offers some tactical value in our view. We remain U/W on credit.

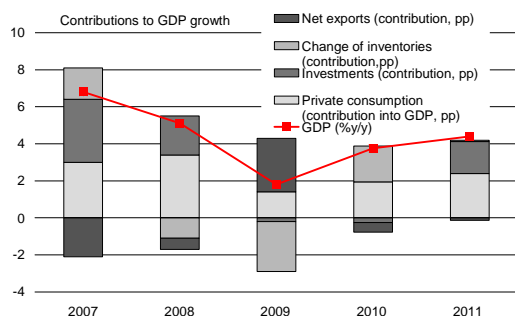
**Author: Marcin Mrowiec, Chief Economist (Bank Pekao)**

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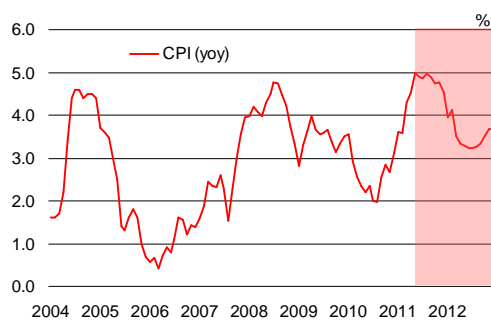
### KEY DATES/EVENTS

- NBP rate decisions: 6<sup>th</sup> July, 7<sup>th</sup> September
- October: General election
- Inflation report: July, November

### HOUSEHOLD DEMAND AND INVESTMENTS ARE STILL THE MAIN DRIVER OF GROWTH



### CPI SHOULD EASE FROM THE CURRENT LEVELS



Source: GUS, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	361.9	310.4	354.3	381.5	417.0
Population (mn)	38.1	38.2	38.1	38.1	38.1
GDP per capita (EUR)	9,490.8	8,132.4	9,301.8	10,023.2	10,958.1
<b>Real economy yoy (%)</b>					
GDP	5.1	1.7	3.8	4.4	3.5
Private Consumption	5.7	2.1	3.2	4.0	3.7
Fixed Investment	9.6	-1.1	-1.2	8.8	4.5
Public Consumption	7.4	2.0	4.0	1.9	2.0
Exports	7.1	-6.8	11.5	8.8	9.6
Imports	8.0	-12.4	4.3	10.9	9.1
Monthly wage, nominal (EUR)	905.1	766.5	859.9	911.3	986.9
Unemployment rate (%)	10.0	11.0	12.1	11.8	10.8
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-3.7	-7.3	-7.9	-5.8	-3.7
Primary balance	-1.5	-4.6	-5.0	-2.6	-1.4
Public debt	47.1	50.9	53.6	54.1	54.0
<b>External accounts</b>					
Current account balance (EUR bn)	-17.4	-6.7	-12.0	-15.6	-17.4
Current account balance/GDP (%)	-4.8	-2.1	-3.4	-4.1	-4.3
Basic balance/GDP (%)	-2.0	1.0	-1.3	-1.5	-1.5
Net FDI (EUR bn)	10.1	9.9	7.3	10.0	11.0
Net FDI (% of GDP)	2.8	3.2	2.1	2.6	2.7
Gross foreign debt (EUR bn)	174.3	195.0	233.7	240.0	250.0
Gross foreign debt (% of GDP)	57.1	59.6	65.4	62.9	60.0
FX reserves (EUR bn)	44.1	55.2	70.0	81.0	91.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	4.2	3.5	2.6	4.4	3.1
CPI (eop)	3.3	3.5	3.1	4.4	3.3
Central bank target	2.5	2.5	2.5	2.5	2.5
Central bank reference rate (eop)	5.0	3.5	3.5	4.75	4.25
3M money market rate	5.6	4.3	3.9	4.6	4.6
USD/PLN(eop)	2.97	2.86	2.96	2.52	2.64
EUR/PLN (eop)	4.15	4.10	3.96	3.90	3.80
USD/PLN (pavg)	2.39	3.10	3.01	2.72	2.64
EUR/PLN (pavg)	3.52	4.33	3.99	4.00	3.90

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

## Solid growth, stable monetary & improving fiscal policy

**GDP to grow above 4% this year, with domestic demand getting stronger**

**We remain positive on the outlook for GDP growth this year, with domestic demand playing a more important role in 2H.** The recently released data for 1Q11 confirmed strong private consumption (3.9% yoy is a notch weaker than in the previous quarter but households had to digest a 1pp VAT hike as well as real wage growth which stood at only 0.3% yoy). Investments accelerated to 6% yoy. The labor market should continue to perform strongly: the number of employed in the corporate sector continues to grow at circa 4% yoy and we expect this pace of growth to be maintained this year. In the last quarterly we expressed an expectation that wages should accelerate from 2Q onwards – and this is starting to materialize, with an April reading of 5.9% yoy. We expect further acceleration in the coming months, and that (combined with inflation easing) will mean a higher real wage bill, and hence stronger private consumption (we revised our private consumption forecast to 4.0% from 3.6% previously, which offsets investments' downward revision to 8.8% yoy). Therefore, GDP growth is bound to be more driven by domestic consumption, rather than net exports or inventory rebuilding. The labor market is set to be supported by strong pressure on wages in the state-owned enterprises (which are likely to be at least partially satisfied prior to general elections in October), reduced labor supply.

**EU funds will be an important boost to economic growth, especially in 2011, less so in 2012**

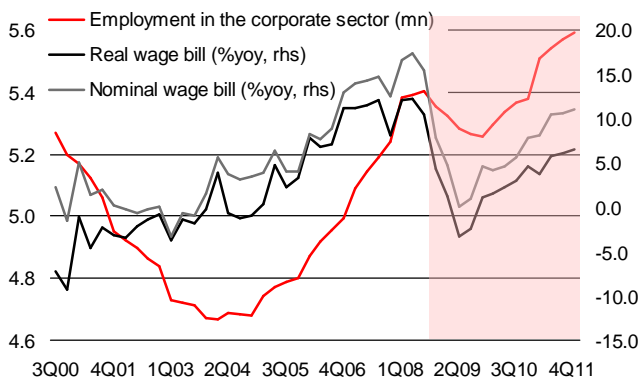
**This year's GDP growth is also set to be supported by EU investments.** The government plans that the sum total of EU funds and domestic contribution that will be spent in 2011 will exceed PLN 70bn (vs PLN 42bn in the previous year and circa PLN 20bn two years ago). This is an additional source of financing for GDP this year, on top of internal resources of the economy. The recent report from NIK (Supreme Audit Office) noted numerous delays in EURO-2012 related investments (which may partially explain the slight disappointment in 1Q investment data), and catching up for the lost time will be one of the aims of the government, accelerating public, infrastructure investment wherever possible in the remainder of the year.

**CPI is bound to top out in 2Q, and ease towards 4.0% in end-2011**

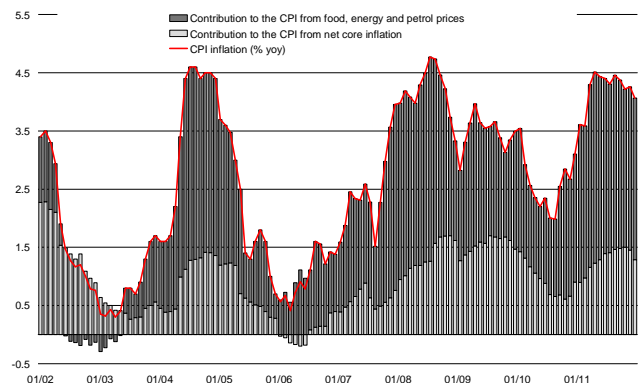
**CPI inflation is set to see its top in 2Q, easing later during the year.** From 3.1% in December, CPI inflation rose to 5.0% in May. However, we do stick to our baseline scenario that from the top in 2Q it should ease, towards 4.4% at year-end. This scenario assumes stabilization of food and energy prices in the second half of the year. However, declines in PMI inflation expectations, PPI already topping out in March make this scenario realistic. One should also keep in mind that surprisingly high inflation was impacted by implementation by the domestic statistical office of the EC regulation concerning the treatment of seasonal products in consumer price indices.

### STRONGER GROWTH, STRONGER LABOUR MARKETS, HIGHER INFLATION

Labour market is recovering



As inflation is still at elevated levels



Source: GUS, UniCredit Research

**After hiking rates by 100bp this year, the NBP signaled entering wait-and-see mode**

**The MPC has already delivered 100bp of rate hikes this year**, bringing the reference rate to 4.5%, and the NBP Governor has now signaled entering “wait and see” mode. He did not rule out further tightening, “should the outlook for inflation coming back to MPC target deteriorate”, but it is clear that the bulk of tightening is already over. The risk factors for the second half of the year include global food and energy prices. However, given the CPI at twice the MPC target in May (and high probability of CPI staying in 4.5-4.9% range in 3Q, we’d look for one more hike this year, with risk scenario for two more hikes in case second-round effects are visible in 2H11

**The deficit should narrow, though more fiscal consolidation is expected post-elections**

**Markets and rating agencies look for further public finance consolidation steps after the October elections.** As Poland’s public finance deficit increased significantly in recent years (reaching almost 8% in 2010), and debt/GDP started approaching 55% (which is very important from the point of view of the domestic Public Finance Act, triggering painful adjustment if broken), the government introduced steps aimed at curbing deficits. These included increases of VAT (by 1pp from Jan’11), a freeze of PIT rates, lower spending on activation of the unemployed, changes in the pension systems and other steps, which, according to government calculations, are to reduce the deficit by almost 2.5% GDP in 2011 and by 2.15% in 2012.

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

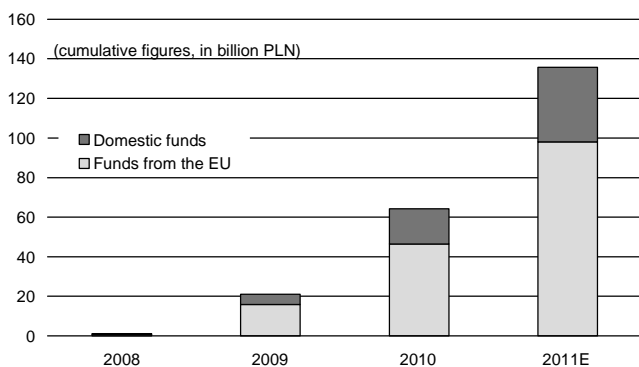
**Opinion polls suggest that the ruling Civic Platform (PO) will win the upcoming general elections** but it will have to form a coalition. PO leaders suggest that the most welcome option would be re-creation of the current setup, with the PSL as junior coalition partners. Another likely combination would be PO in coalition with the left-wing SLD. The key economic challenge will be continuation of the fiscal consolidation path while simultaneously absorbing EU funds. Rating agencies emphasize the need to adhere to deficit reduction.

**A bumpy ride for PLN – watch end-June C/A revisions**

**Despite of the announced exchange of EUR 13-14bn of EU funds this year (and another EUR 17-18bn next year) in the FX market**, the exchange rate hardly changed. In the near term focus will centre on the end-June revision of foreign trade data, aimed at reducing the scale of errors and omissions (currently at almost 4% of GDP). The key question is how much will be added to the C/A deficit. The NBP suggested the 12M cumulative C/A gap will be increased by circa 1pp, towards 5% GDP. However, we maintain our end-2011 forecast of 3.90 for EUR/PLN, as economic data is to remain supportive, and the government is likely to exchange most of the funds close to year-end to push the zloty stronger to ensure no breach of the 55% debt/GDP threshold.

**USE OF EU FUNDS HELPS GROWTH BUT ALSO CONTRIBUTES TO WEAKER FISCAL PERFORMANCE**

The structure of project financing in 2007-2013



Foreigners increased their holdings of domestic bonds significantly



Source: European Commission, Ministry of Finance, UniCredit Research

**Strategy: long PLN/HUF, neutral duration in POLGB, U/W credit**

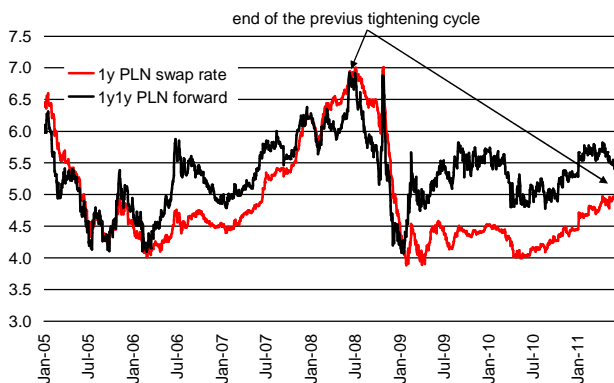
**FX** – The near term outlook will be determined by the 1) end June current account revision and 2) privatization flows. Although the MinFin/NBP indicated that they are converting EUR13/15bn on the market it had only limited impact on the PLN so far potentially because of lack of actual transactions which should intensify toward the end of the year. Following the diverging CPI trends between Poland and Hungary we see value in going long PLN/HUF (target 70.0 and stop loss at 66.00). On the same vein we would remain mod O/W in PLN.

**Rates** – we recommend switching from longer dated POLGBs into the mid part of the curve following the May CPI release and likely new hawkish turn from the NBP. Although we do not think the NBP will hike rates aggressively it is possible that the curve will price back some rate hike. We also do not see long end POLGB nominal yields as that attractive vs. the current inflation outlook.

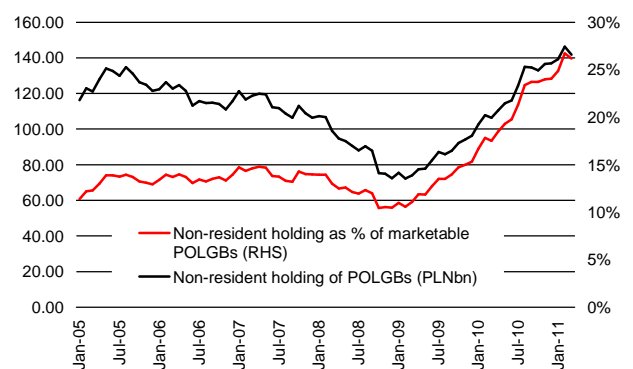
**Credit** – We do not see much value at current 150/160bp spreads given still heavy issuance pipeline (we estimate another USD2/3bn till year end) and still wide budget deficit. We stay U/W. .

**PLN FORWARD ALREADY PULLED IN WHILST NON-RESIDENT POSITIONING REMAINS HIGH**

PLN forward is still a bit above where the last tightening cycle ended



Non-resident positioning is still high in POLGB market



Source: MinFin, Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>57.3</b>	<b>50.9</b>	<b>52.5</b>
Budget deficit	28.0	22.7	16.2
Amortisation of public debt	29.3	28.2	36.3
Domestic	27.1	26.7	32.8
Bonds	15.2	20.3	28.9
Bills	11.9	6.3	3.8
External	2.2	1.5	3.6
IMF/EU	0	0	0
<b>Financing</b>	<b>57.3</b>	<b>50.9</b>	<b>52.5</b>
Domestic borrowing	44.9	38.5	40.7
Bonds	39.1	32.1	34.1
Bills	5.9	6.4	6.6
External borrowing	12.4	12.4	11.8
Bonds	6.8	7.1	6.3
IMF/EU	0	0	0
Other	5.6	5.3	5.5

**GROSS EXTERNAL FINANCING REQUIREMENTS**

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>86.8</b>	<b>86.4</b>	<b>85.4</b>
C/A deficit	12.0	15.6	17.4
Amortisation of medium to long term debt	23.3	17.3	14.4
Government/central bank	8.2	5.7	7.1
Banks	5.2	5.1	1.7
Corporates	9.9	6.4	5.6
Short term debt amortisation	51.5	53.5	53.6
<b>Financing</b>	<b>94.2</b>	<b>92.1</b>	<b>89.9</b>
FDI	7.4	10.0	11.0
Equity	4.8	4.5	4.7
Borrowing	88.4	83.4	80.9
Government/central bank	19.4	14.7	16.2
Banks	30.2	32.3	29.3
Corporates	38.7	36.3	35.4
EU transfers	6.9	7.4	6.5
Other	-13.2	-13.2	-13.2

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

**Outlook** – The economy is likely to show positive GDP growth of around 1.8%yoy this year mostly on the back of good export performance. Meanwhile domestic demand remains relatively weak which in turn is improving the C/A deficit further to around 3.3%/GDP. FDI coverage remains relatively high at around 75% with several privatization projects playing a major role.

**Strategy** – We remain positive on all Romanian asset classes (FX, rates and credit) due to significant improvement in the fundamental backdrop particularly in relative terms vs. other CEE countries. We recommend selling EUR/RON at current levels, buying mid to long term ROMGBs and keeping Romanian Eurobonds O/W. We also recommend selling 5y Romania CDS vs. buying 5y Turkey CDS. The key risk is potential spillover from Greece.

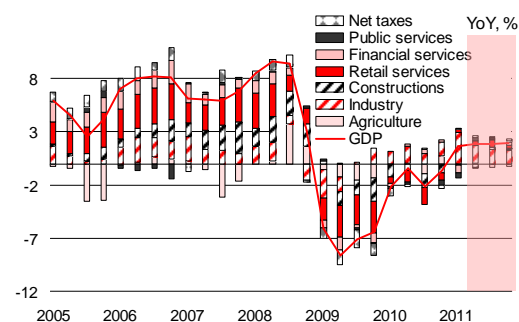
**Author: Dan Bucsa, Chief Economist (UniCredit Tiriac Bank)**

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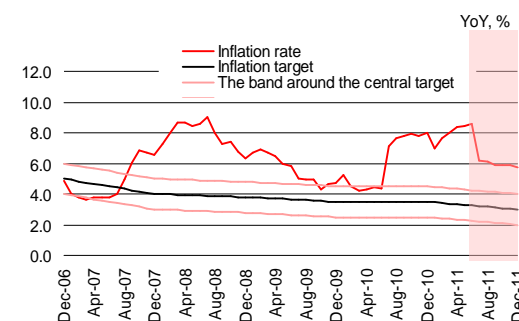
### KEY DATES/EVENTS

- 29 June – NBR rate decision
- 3 Aug – NBR rate decision
- June/July Petrom privatization

### GDP GROWTH TO REMAIN POSITIVE IN 2011



### CPI TO REMAIN ABOVE NBR TARGET



Source NBR, CSO, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	136.9	115.9	122.0	130.7	142.4
Population (mn)	21.5	21.5	21.4	21.3	21.2
GDP per capita (EUR)	6,359.5	5,392.9	5,692.2	6,120.3	6,703.8
<b>Real economy yoy (%)</b>					
GDP	7.1	-7.1	-1.3	1.8	3.3
Private Consumption	8.4	-9.2	-2.0	0.5	2.9
Fixed Investment	19.3	-25.3	-13.1	0.5	4.5
Public Consumption	3.7	1.2	-3.2	-3.9	4.0
Exports	19.4	-5.5	13.1	17.3	13.5
Imports	17.5	-20.6	11.6	13.6	11.0
Monthly wage, nominal (EUR)	347.2	326.0	334.1	347.4	377.8
Unemployment rate (%)	4.0	6.3	7.6	5.0	4.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-4.9	-7.4	-6.5	-4.4	-4.5
Primary balance	-4.2	-6.2	-5.1	-4.1	-4.0
Public debt	20.0	27.8	35.5	40.6	43.0
<b>External accounts</b>					
Current account balance (EUR bn)	-16.2	-4.9	-5.2	-4.3	-4.4
Current account balance/GDP (%)	-11.8	-4.2	-4.2	-3.3	-3.1
Basic balance/GDP (%)	-5.0	-1.2	-2.1	-1.8	-1.1
Net FDI (EUR bn)	9.3	3.6	2.6	3.2	4.4
Net FDI (% of GDP)	6.8	3.1	2.1	2.4	3.1
Gross foreign debt (EUR bn)	72.4	81.2	93.4	100.9	106.1
Gross foreign debt (% of GDP)	52.8	70.0	76.6	77.2	74.5
FX reserves (EUR bn)	26.2	28.3	32.4	32.5	31.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	7.9	5.6	6.1	7.1	4.6
CPI (eop)	6.3	4.7	8.0	5.9	4.0
Central bank target	3.8	3.5	3.5	3.0	3.0
Central bank reference rate (eop)	10.3	8.0	6.3	6.3	5.5
3M money market rate	13.0	11.7	5.9	4.6	4.4
RON/USD (eop)	2.89	2.95	3.20	2.68	2.85
RON/EUR (eop)	4.03	4.23	4.28	4.15	4.10
RON/USD (pavg)	2.50	3.04	3.17	2.84	2.78
RON/EUR (pavg)	3.68	4.24	4.21	4.17	4.11

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

## Higher-than-expected growth over-reliant on foreign demand

**GDP grew 0.7% qoq in 1Q11**, after barely rising in 4Q10 (+0.1% qoq on seasonally-adjusted data). A breakdown of growth shows industry (+3.0% qoq) and exports (+10.6% qoq) as the main drivers, backed by strong foreign demand. At the same time, services (0.0% qoq) and construction (-0.2% qoq) – on the supply side – and consumption (-0.8% qoq) and investment (-2.0% qoq) – on the demand side – are still shrinking, signaling weak domestic demand. We expect a moderation of foreign demand coupled with a gradual recovery of services and domestic demand, boosted by corporate lending and increased public spending in view of the election year 2012. At the same time, real revenue growth is unlikely to turn positive before 4Q11 and consumer lending could decline further, curbing consumption (+0.5% yoy in 2011) and retail sales. Our central forecast for 2011 is 1.8% growth (close to the previous forecast of 1.7%), while the forecast range is -0.4% to 2.8% yoy. The GDP growth rate expected for 2012 has been cut to 3.3% from 3.6% previously.

**Disappointing FDI to be supplemented by privatizations**

**Foreign direct investment could amount to just EUR 3.2bn in 2011 and EUR 4.4bn in 2012**, including EUR 0.6bn and EUR 0.8bn respectively from privatization proceedings. Other investment flows shrunk 61% yoy in 1Q11 to EUR 1.44bn (excluding IMF money, inflows net of FDI fell 57.1% yoy to EUR 0.54bn). The biggest inflows came from foreign companies granting long-term loans to local subsidiaries (EUR 0.78bn in 1Q11). Despite improved investor sentiment (as reflected by falling CDS spreads and investment inflows in CEE), portfolio investment inflows in Romania have been tepid at best (EUR 0.45bn in 1Q11, 65.9% less than in 1Q10), curtailed by the local capital market being illiquid and underdeveloped in terms of size and products.

**C/A adjustment to lose speed if stronger RON persists**

**The current account deficit could fall in 2011** from 2010 (EUR 4.3bn or 3.3% of GDP vs. EUR 5.2bn or 4.2% of GDP). The growth rate of exports could moderate to 17.3% yoy in 2011 from 39.4% yoy in 1Q11 on softer economic growth in the EU during 2H11. Imports are primarily driven by exports (with a high content of imported goods) and fuel consumption, the forecast growth rate being 13.6% yoy in 2011. Growth rates for exports and imports could moderate to 13.5% yoy and 11% yoy respectively in 2012, taking the current account deficit to EUR 4.4bn or 3.1% of GDP.

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

**The budget deficit target of 4.4% of GDP looks attainable in 2011.** The 5-month deficit was 1.2% of GDP, but public expenditure rises seasonally towards year-end. Romania concluded a second, precautionary agreement with the IMF in March 2011 and will probably fulfill all its provisions in 2011. The Government's main propositions aimed at slashing public waste regard: private management for big state companies, privatizing loss-making companies such as CFR Marfa, reducing administration by consolidating the existing 42 counties into 8 regions. The Government plans to sell stakes in public companies (oil, electricity, natural gas) in order to finance its investment projects. We expect the 2012 deficit target of 3% of GDP to be missed because of populist spending before elections (our deficit forecast is 4.5% of GDP), despite IMF monitoring. If the budget deficit falls towards the Maastricht threshold, Romania's sovereign ratings could go up a notch to investment grade in 2H12. We attach a probability below 50% to the event.

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

**Romania's inflation rate remains the highest in the EU**, reaching 8.4% yoy at the end of May 2011. Headline inflation is expected to climb to 8.6% yoy in June before falling close to 6.2% yoy at the end of July, when the effect of the VAT hike in July 2010 is eliminated. We expect CPI inflation to end 2011 at 5.9% yoy (forecast interval 4.6%-6.9%), missing the year-end target of 3% (+/- 1pp). The main explanations for the high inflation rate are: **1)** high past inflation (48.3% annual average between 1991 and 2000), **2)** big weight of food in the consumer basket (37.45%), **3)** fast-rising food prices, **4)** gradual liberalization of administered prices (scraping heating subventions could add 0.5-0.6 pp to inflation in 2011, according to the IMF mission in Romania), **5)** high inflation expectations (the highest since May 2001 in the European Commission survey), feeding into downward price rigidity and offsetting downward

pressures from shrinking demand (-11.2% yoy in 2009 and -4% yoy in 2010). Our end-2012 central inflation forecast of 4% could be threatened by disappointing crops worldwide in 2011, a new spike in oil prices and generous public spending during election year 2012.

**NBR to focus on alternative instruments**

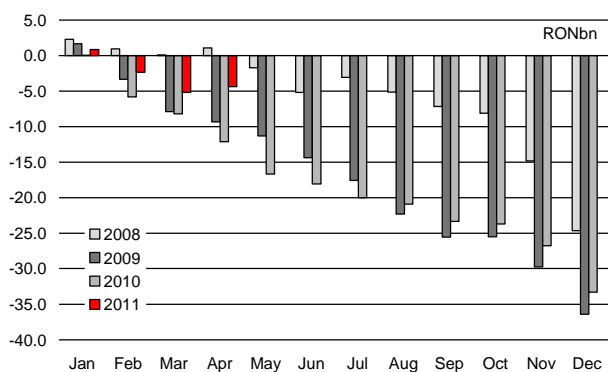
**Faced with high inflation and slow economic recovery, the National Bank of Romania is likely to leave the monetary policy rate unchanged at least until 1Q12**, favoring money market liquidity and RON nominal appreciation as policy instruments. The money market remains shallow, liquid maturities running up to 3 months. Structural excess liquidity has driven short term deposit rates close to the deposit facility without managing to lengthen maturities. The FX swaps market is more liquid, with maturities extending towards one year. We expect ROBOR 3M to dip towards 5% by year-end on excess liquidity characteristic of all pre-electoral periods in Romania. Subsequent decreases in 2012 could be limited by inflation and by cautious monetary policy moves.

**Treasury yields helped by MM liquidity**

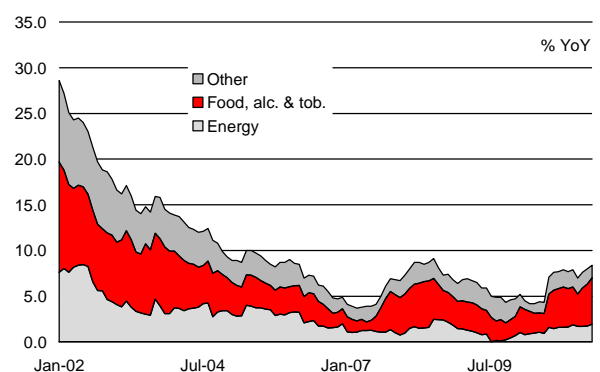
**MM liquidity weighs onto treasury yields, regardless of maturity.** The MinFin has favored RON T-notes maturing in 6 months or one year in order to keep yields below 7%. The result is an average maturity of around 8 months for Romania's public debt, the shortest in the EU. The yield curve is flat, 3-5Y yields being capped at 7.4%. The MinFin has restarted its multi-year EMTN program by issuing 5Y eurobonds worth EUR 1.5bn at 5.3%, 29bp over mid swaps and 5Y CDS. 5Y CDS spreads have fallen towards 230bp in May 2011 on better investor assessments, but tighter liquidity conditions in the Eurozone have offset lower risk. We still expect the bulk of treasuries to be issued locally. Rollovers and interest payments amount to EUR 10.7bn in 2011 and EUR 13.3bn in 2012 (as of 14 June 2011). Deficit financing and IMF repayments (the Government's share) will amount to EUR 6bn in 2011 and EUR 8.2bn in 2012.

**Alongside Bulgaria, Romania is the EU country with one of the largest presence of Greek banks** (approx. 15% of bank assets). Greek subsidiaries had an aggregate solvency ratio of 15.7% at the end of March 2011, above the banking system's average of 14.75% (according to NBR Deputy Governor Georgescu) and the NBR has repeatedly stressed the soundness of all Romanian banks with Greek shareholders. Local subsidiaries of Greek banks accounted for 25% of their groups' profits in 2010. Any contagion risks are likely to affect the whole Romanian banking sector, since the public doesn't differentiate among ownership and the bank crisis at the end of the '90s is still vividly remembered.

Impressive budget performance YTD



Inflation is mostly driven by food and energy



Source: UniCredit Research

### Strategy: stay structurally bullish in all asset classes

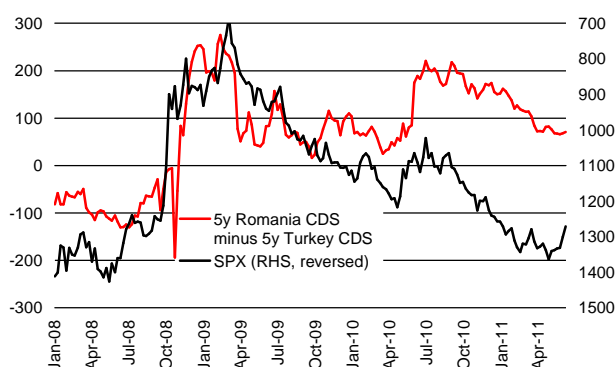
**FX:** The recent spike in EUR/RON was driven by a number of factors including speculation that the Petrom privatization will be delayed (expected inflow from that deal is around EUR 600mn which is 50% of the Jan-Apr C/A deficit). Moreover Romania has some proximity to Greece given those banks relatively high share of the Romanian banking sector. We believe the government and the NBR has the necessary firepower to stop the depreciation in case the currency comes under too much pressure (government just completed an EUR 1.5bn Eurobond issuance). Accordingly we are using the current weakness to add to the positions.

**Rates:** We use the current weakness to re-enter the Romanian local currency bond market. Romania is among the countries which did most of the progress in terms of correcting its macro imbalances and we prefer remaining currency unhedged long this local currency market. Following the recent drop in short end yields we prefer mid to long end maturity for better risk premium: We hence recommend long duration in ROMGB market.

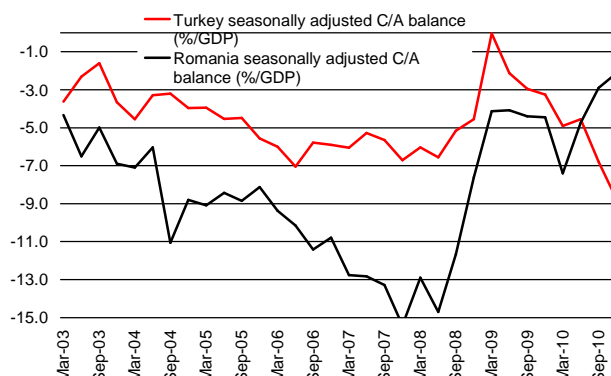
**Credit:** Romanian credit spreads still do not price the fundamental improvement since the 2008 crisis properly and we believe they can outperform regional peers. We also recommend sell 5Y Romania CDS versus buying 5Y Turkey CDS.

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Romania minus Turkey 5y CDS



A tale of two economies



Source: Bloomberg, UniCredit Research

#### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>15.2</b>	<b>16.7</b>	<b>17.9</b>
Budget deficit	7.9	5.7	6.4
Amortization of public debt	7.3	11.0	11.5
Domestic	7.2	10.7	10.6
Bonds	2.0	2.7	4.4
Bills	5.2	8.0	6.2
External	0.1	0.2	0.9
IMF/EU	0.1	0.1	0.9
<b>Financing</b>	<b>15.2</b>	<b>17.5</b>	<b>18.7</b>
Domestic borrowing	10.9	14.5	16.2
Bonds	2.6	6.8	7.4
Bills	8.3	7.7	8.8
External borrowing	4.3	3.0	2.5
Bonds	1.0	1.5	2.5
IMF/EU	3.3	1.5	0
Other	0	0	0

#### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>17.6</b>	<b>17.1</b>	<b>20.2</b>
C/A deficit	5.2	4.3	4.4
Amortization of medium to long term debt	12.4	12.8	15.8
Government/central bank	2.4	3.0	5.3
Banks	0.4	2.8	0.7
Corporates	9.6	7.0	9.8
<b>Financing</b>	<b>18.0</b>	<b>17.3</b>	<b>20.6</b>
FDI	2.6	3.2	4.4
Equity-	1.1	1.7	2.1
Borrowing	14.3	12.4	14.1
Government/central bank	8.2	3.9	2.5
Banks	1.6	3.3	3.8
Corporates	4.5	5.2	7.8

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

**Outlook** – The economy grew 3.5% yoy in 1Q11 but the sole growth driver was external demand. Additional risks to domestic and foreign demand for 2011 have been identified suggesting that risks to growth this year are increasingly shifting to the downside. The government prepared several reforms, which should bolster the economy's competitiveness and spur the much needed FDI inflow. The growth model from the past decade was based on strong FDI inflow – lackluster recent new FDI raises concerns about the medium-term growth trend.

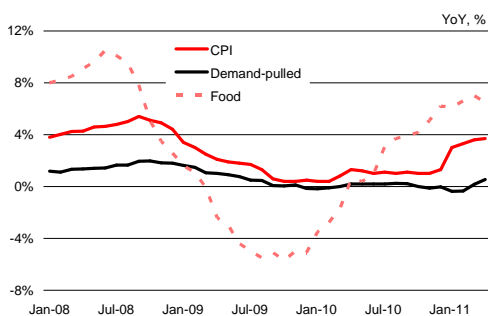
**Strategy** – We will keep a close eye on the developments around pension fund investment regulations, which if changed could see a potential significant demand (EUR 4bn in pension assets) toward longer dated assets.

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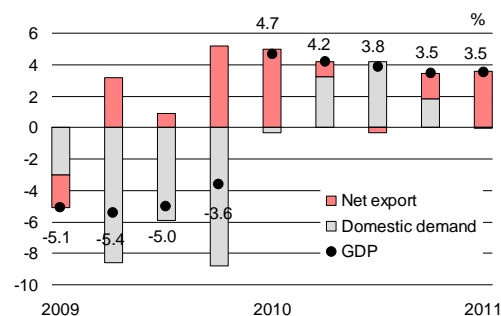
### KEY DATES/EVENTS

- 8 July, 9 August and 8 September – Industrial production
- 12 July, 12 August and 12 September – CPI
- 16 August – flash GDP
- 6 September – GDP structure

### INFLATION STARTING TO ACCELERATE, DRIVEN BY FOOD AND OIL PRICES



### CONTRIBUTIONS TO GDP GROWTH



Source: Statistical Office SR, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	64.6	63.1	65.9	69.6	73.9
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	11,939.3	11,636.5	12,135.0	12,820.8	13,607.9
<b>Real economy yoy (%)</b>					
GDP	5.8	-4.8	4.0	3.1	3.9
Private Consumption	6.1	0.2	-0.3	-0.3	1.0
Fixed Investment	4.7	-31.0	12.9	6.0	5.7
Public Consumption	6.1	5.6	0.1	-5.0	-0.5
Exports	3.1	-15.9	16.4	9.0	8.1
Imports	3.1	-18.6	14.9	6.7	7.1
Monthly wage, nominal (EUR)	723.0	744.5	769.0	792.1	830.8
Unemployment rate (%)	9.6	12.1	14.4	13.5	12.6
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-2.1	-8.0	-7.9	-4.8	-3.5
Primary balance	-0.8	-6.5	-6.6	-2.8	-1.4
Public debt	27.8	35.4	41.0	44.4	44.7
<b>External accounts</b>					
Current account balance/GDP (%)	-6.6	-3.6	-3.5	-3.5	-3.5
Basic balance/GDP (%)	-1.7	-3.6	-2.9	-2.1	-1.6
Net FDI (% of GDP)	5.0	-0.1	0.6	1.3	2.0
Gross foreign debt (EUR bn)	37.7	45.3	49.7	52.4	54.0
Gross foreign debt (% of GDP)	58.5	71.9	75.3	75.3	73.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	4.6	1.6	1.0	3.8	3.5
CPI (eop)	4.4	0.5	1.3	4.0	3.3
Central bank target	2.0	-	-	-	-
Central bank reference rate (eop)	2.5	EUR	EUR	EUR	EUR
3M money market rate	3.9	EUR	EUR	EUR	EUR
FX/USD (eop)	21.59	21.02	22.54	19.44	20.92
FX/EUR (eop)	30.13	30.13	30.13	30.13	30.13
FX/USD (pavg)	21.27	21.60	22.71	20.49	20.36
FX/EUR (pavg)	31.29	30.13	30.13	30.13	30.13

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

## Risks to growth shift to the downside

### Several reforms prepared

**The Government has drafted several reform packages**, which have yet to be approved by Parliament. Probably the most contentious is the payroll tax reform that seeks to simplify the system and gradually decrease the payroll burden on employees. However, the reform gets rid of several special treatments for the self-employed entrepreneurs effectively increasing the tax burden on a substantial share of them. Changes in the labor code have been prepared by the Social Affairs Ministry, but they are unlikely to mean revolutionary improvements on the labor market. Finally, the Economy Ministry has prepared a Project Singapore for implementation – a complex program with many practical measures which should lead to the improvement of the business environment over the next 2-3 years.

### Weak domestic demand in 1Q11

**Slovakia's 1Q11 GDP came in at 3.5% yoy and 1.0% qoq sa.** External demand was the key growth driver contributing with a full 3.5pp to growth whilst the domestic demand's contribution was zero (it declined 0.2% yoy). Export growth (15.8% yoy) significantly outpaced import growth (11.3% yoy). The only component of domestic demand that showed some growth was gross capital formation – but it has been rather disappointing (up 2.2% yoy) to date. As we forecast, real wages declined 0.4% yoy in 1Q11 thus hurting the consumer who is clearly not showing signs of recovery (add high unemployment, 13.9% in 1Q11, to the unpleasant real wage development).

### Industry the main driver of 1Q11 GDP growth

**Industry continued to be the driving force** behind the economic growth in the first quarter. Value-added in industry in 1Q11 grew 21.7% yoy mostly fuelled by external demand. Germany as the main trading partner of Slovakia is generating a strong demand for Slovakia's exports – during the first two months Slovakia's exports to Germany increased by almost 40%. However, with expected growth slowdown in Germany we foresee that the demand for Slovakia's exports will lose some momentum in the coming quarters. Given that growth in Slovakia currently depends on external demand this poses a risk for the growth outlook for the rest of the year.

### Risks to the growth shifting to the downside

**Going forward, we conjecture that there are further risks to domestic demand** this year. First, inflation is likely to continue rising in the course of the year (substantial hikes in household gas prices and railway fares have been pre-announced) reducing real household income. Second, two major rating agencies expressed concerns about the government's ability to meet the 2011 fiscal targets increasing the likelihood of additional fiscal measures by the government with negative impact on domestic demand. For the moment, we stick to our end-year forecast of 3.1% yoy growth in 2011 but note that the risks to the forecast are increasingly shifting to the downside.

### Weak FDI inflow erodes the growth outlook

**We have revised our growth outlook for 2012** and lowered the expected growth rate to 3.9% (down from 4.5%) mainly because we have revised downward household consumption growth. More fundamentally, the Slovak economy was able to generate near-miracle growth rates in the past decade due to the incoming FDI. Since the crisis, the inflow of new direct investment has dried up - after registering a decline in 2009 (-0.1% GDP) only meager growth in 2010 (0.6%GDP) was reported while the average during the high-growth period of 2000-2008 was 6.4% GDP.

### Further upside risks to the inflation identified

**As for the inflation outlook for the year**, we noted considerable upside risks as substantial gas price hikes for households and railway fare increases have been indicated. This could negate any possible positive base effect of food price developments in the second half of the year.

### Sovereign rating outlook

**Two major rating agencies** – Fitch and Moody's – **confirmed Slovakia's rating at A+**. However, they have expressed concerns about the government's ability to meet 2011 fiscal targets and indicated that the rating could come under pressure should there be a slippage on the fiscal consolidation effort.

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

**Outlook** – Industrial production and merchandise export growth remain solid, but net exports look set to be a drag on growth this year while gross fixed capital expenditure in particular will remain weak reflecting high corporate indebtedness. After the defeat of pension reform at a referendum in early June, the government is seeking to cut spending by EUR455mn (1.2% of GDP) this year to meet 2013 budget targets.

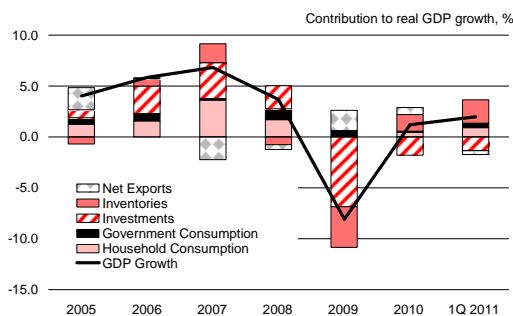
**Strategy**– Although the failed referendum might pose some upside risks to the fiscal outlook we believe the relatively low level of public sector debt (45%) and well known nature of government guarantees toward the banking sector (13%) should limit the recent underperformance of Slovenian bonds.

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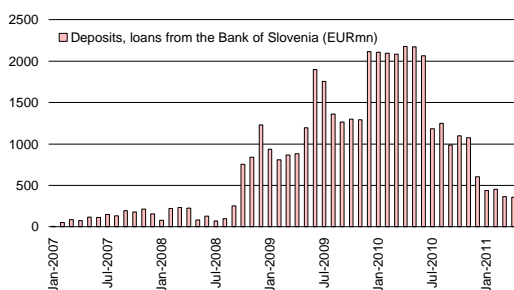
### KEY DATES/EVENTS

- 7 July, 4 August, 8 September: ECB Governing Council meeting
- July: expected tabling of EUR455mn spending cuts to parliament

### CONTRIBUTION TO GDP GROWTH



### BANKING SECTOR RELIANCE ON ECB EASES



Source: Statistic Office, BoS, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	37.3	35.3	36.0	37.5	39.5
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	18,455.4	17,302.5	17,565.4	18,240.8	19,161.0
<b>Real economy yoy (%)</b>					
GDP	3.7	-8.1	1.2	1.9	2.4
Private Consumption	3.5	-1.9	0.5	1.8	2.5
Fixed Investment	8.5	-21.6	-6.7	-2.5	3.5
Public Consumption	6.2	3.0	0.8	0.8	0.5
Exports	3.3	-17.7	7.8	8.7	5.5
Imports	3.8	-19.7	6.6	9.5	6.0
Monthly wage, nominal (EUR)	1,391	1,439	1,495	1,535	1,592
Unemployment rate (%)	4.5	5.9	7.3	7.8	7.0
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-1.8	-6.0	-5.6	-5.4	-4.0
Primary balance	0.5	-4.7	-4.0	-3.3	-2.3
Public debt	22.6	35.9	40.0	43.8	45.6
<b>External accounts</b>					
Current account balance (EUR bn)	-2.5	-0.5	-0.4	-0.8	-1.4
Current account balance/GDP (%)	-6.7	-1.5	-1.2	-2.2	-3.6
Basic balance/GDP (%)	-5.7	-3.0	0.2	-0.9	-1.1
Net FDI (EUR bn)	0.4	-0.5	0.5	0.5	1.0
Net FDI (% of GDP)	1.0	-1.5	1.4	1.3	2.5
Gross foreign debt (EUR bn)	39.2	40.3	40.9	44.0	47.0
Gross foreign debt (% of GDP)	105.2	114.1	113.7	117.4	119.1
FX reserves (EUR bn)	0.7	0.7	0.8	0.8	0.7
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	5.7	0.9	1.8	2.3	2.9
CPI (eop)	2.1	1.8	1.9	3.3	2.7
Central bank target	about 2%	about 2%	about 2%	about 2%	about 2%
Central bank reference rate (eop)	2.5	1.0	1.0	1.75	2.75
3M money market rate	4.6	1.2	0.8	1.5	2.6

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

## Risks coming into focus as pension reform is defeated

**Industrial production data a plus while unemployment and investment data point the other way**

**Manufacturing sector performing well.** In 1Q11 GDP grew 2.0% yoy reflecting relatively strong household consumption and inventory building. Net exports were a drag on growth for the second consecutive quarter while gross fixed capital formation remained in deep recession (contracting 6.1% yoy) reflecting the indebted nature of Slovenian corporates. Industrial production continued to perform well expanding 8% yoy in 1Q11 with seasonally adjusted mom data point to further expansion. Unemployment data for 1Q11 revealed an increase to 8.5% from 7.8% in the previous quarter while gross wages rose 3.1% yoy overall in 1Q and 7.5% yoy in the manufacturing sector pointing to another year of positive real wage growth. For the year as a whole we have lowered our GDP forecast for the year to 1.9% yoy reflecting continued weakness in gross fixed capital formation, public spending cuts and our expectation that net exports will act as a drag on growth this year.

**GDP forecast lowered from 2.6% to 1.9%**

**Inflation remains low in early 2011 given food and oil price dynamics**

**Inflation remains low, external imbalances:** In May consumer prices rose 2.2% yoy and by year-end we see inflation above 3% yoy, but the average rate should remain below 2.5% yoy, noting core inflation remains low. Examining the banking sector and external accounts, banking sector reliance on ECB funds has contracted sharply since May 2010 when banks accessed almost EUR 2.2bn – at the end of March the banking sector had accessed EUR 365mn in central bank funds. The current account deficit in 1Q11 rose 55% yoy to EUR 166mn as the goods and services balance deteriorated reflecting stronger import growth. That said Slovenia has undergone a sharp C/A adjustment (from a deficit of 6.7% of GDP in 2008 to 1.2% of GDP last year. This year's widening deficit, on the back of a wider trade balance, should prove manageable. With gross external debt at 113.7% of GDP at the end of last year, the economy remains heavily indebted from an external perspective like many of its peers.

**Government's plans to rein in budget deficit after referendum rebuke**

**Government plans spending cuts.** In response to a resounding referendum defeat for pension reform which sought to increase the retirement age to 65, alter the pension indexation formula amongst other things and generate recurrent savings of EUR 300mn per annum, the government is seeking to implement a series of savings measures to shave EUR455mn (1.2% of GDP) off public spending this year. The aim is to bring the fiscal deficit down in line with the Excessive Deficit Procedure and below 3% of GDP in 2013. Factoring into account the planned reduction in government spending this year we forecast a consolidated government budget deficit of 5.4% of GDP for this year. The main risk to fiscal settings are banking sector exposures (over EUR2bn in banking sector loans guaranteed by the government mature in 2012 and the potential need for further recapitalizations which we estimate may amount to a further 0.7pp of GDP). The cost to budget of these recapitalizations however, will be lower if the main banks fund part of the capital increases through assets sales. How Slovenia's main bank fare at this year's European stress tests will provide guidance on potential exposures.

**Referendum defeat weakens government**

**Referendum defeat weakens government.** In addition to pension reform, two more legislative initiatives were defeated at a referendum in early June further limiting the government's room to maneuver. A new pension reform proposal cannot be tabled until 12 months has passed from the referendum, meaning that genuine longer term reform initiatives are unlikely to be enacted until after general elections due in 2H12.

**Sovereign rating.** We do not expect a downgrade in the next 12M. The rejection of pension reform at referendum was not a surprise, although it does point to difficulties in getting reforms in place and reduces the scope to boost m-t growth potential much above current growth rates. The biggest plus for Slovenia is that public debt is low – the government is aiming to limit public debt to 45% of GDP and government guarantees to a further 13% of GDP in the m-t and that most of the contingent liabilities related to the banking sector are known. The reduced reliance of the banking sector on ECB liquidity is another plus in terms of the sovereign rating.

## Belarus (B2 negative / B negative / not rated)\*



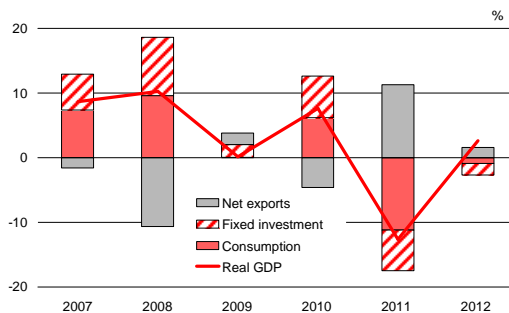
**Outlook** – Belarus is likely to see a few turbulent quarters, as growth contracts and inflation accelerates. The flipside of this ought to be a correction of the C/A which will narrow the financing gap. Following the 70% devaluation seen in May the USDBYR is now trading at 5000 but even at these rates the market is not clearing, implying that a further correction might be needed. CenBank FX reserves have now stabilized at USD3.6bn, and we expect to see some increases in the months ahead as funds from EurAsEc come through and big ticket privatization deals are finalized. We also see increasing potential for an IMF program being put in place, following the request by the government, although risks are to the downside.

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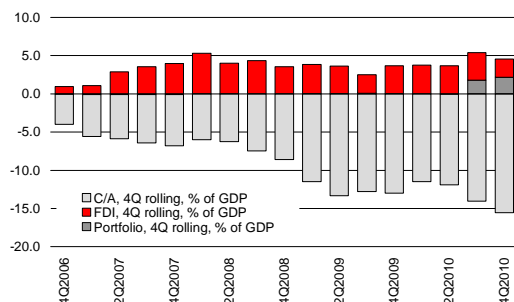
### KEY DATES/EVENTS

- Potential for an IMF agreement in late summer/early autumn
- Big ticket privatization deals in 2H2011
- Further liberalization on the FX market

### NET EXPORTS WILL SUPPORT ACTIVITY IN 2011



### UNSUSTAINABLE BOP WILL CORRECT IN 2011



Source: UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	41.3	35.1	41.2	25.1	26.1
Population (mn)	9.7	9.6	9.6	9.6	9.5
GDP per capita (EUR)	4,266	3,645	4,298	2,629	2,747
<b>Real economy yoy (%)</b>					
GDP	10.3	0.2	7.6	-12.6	2.6
Private Consumption	16.6	0.1	10.3	-15.9	0.7
Fixed Investment	23.6	5.0	15.1	-15.1	-4.7
Public Consumption	0.3	-0.1	0.9	-15.1	-10.2
Exports	5.9	-13.1	15.9	-5.2	7.3
Imports	19.1	-13.2	18.8	-23.3	4.6
Monthly wage, nominal (EUR)	282	256	313	202	220
Unemployment rate (%)	1.0	0.9	0.8	1.6	1.1
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	0.7	0.4	-2.4	-1.0	-1.0
Public debt	6.1	16.1	17.7	35.7	40.6
<b>External accounts</b>					
Current account balance (EUR bn)	-3.7	-4.5	-6.4	-2.2	-1.4
Current account balance/GDP (%)	-9.1	-12.7	-15.4	-8.6	-5.3
Basic balance/GDP (%)	-5.3	-9.2	-13.0	1.7	5.3
Net FDI (EUR bn)	1.5	1.2	1.0	2.6	2.8
Net FDI (% of GDP)	3.7	3.5	2.4	10.3	10.6
Gross foreign debt (EUR bn)	15.2	22.1	28.5	31.3	31.3
Gross foreign debt (% of GDP)	26.3	43.8	51.7	80.3	83.1
FX reserves (EUR bn)	2.2	3.9	3.8	6.4	8.6
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	14.8	12.9	7.7	30.5	21.9
CPI (eop)	13.4	9.9	10.0	39.8	10.8
Central bank reference rate (eop)	12.0	13.50	10.50	40.00	12.00
FX/USD (eop)	2,136	2,793	2,979	4,808	5,000
FX/EUR (eop)	2,200	2,863	3,000	5,500	5,200
FX/USD (pavg)	3,143	3,895	3,951	7,068	7,400
FX/EUR (pavg)	3,070	4,103	4,010	8,525	7,488

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

## Economics: Waiting for the liberalization drive

**Following a decade of robust growth Belarus growth model is in trouble**

In the past decade Belarus has posted robust real rates of growth, with GDP increasing on average by 7% over 1998-2010. However, following May's 70% devaluation the situation is less sanguine, and we are expecting to see a significant correction in 2011, with our estimates suggesting a 12% yoy contraction in real GDP. Domestic demand is to bear the brunt of this with consumption and investment estimated to fall by 16% yoy and 15% yoy. Beyond the immediate concerns, it remains to be seen what measures the authorities put into place in the coming months – so far we have seen a stop-and-go reaction which has hindered the restoration of trust amongst the population. Our preferred scenario would be one where an IMF program is agreed over the summer months (the IMF has mulled a 3Y program, with our estimates suggesting that a 600%-800% of the country's quota could be assigned, implying a USD 3.8-5.0bn program). An IMF program would also go a long way to build investor sentiment and support the BoP adjustment, as well as give the CenBank ammunition to support FX. The risks of no program are significant, something that is underlined by the tight start of June IMF statement.

**Accelerating inflation a result of the 70% devaluation in USDBYR**

Inflation came in at 32.7% yoy in May, and a further rise is anticipated when BYR devaluation is fully priced in. Our estimates suggest that inflation will be at least 40% yoy at year end. In the meantime the biggest risk, in our view, is related to any potential loosening of fiscal policy – authorities are mulling increasing pensions and wages of state-employees to compensate for the recent price increases. This in our view would only add fuel to the fire, and bring the country into a cycle of rising inflation and potentially numerous multi-step devaluations. This, however, is set against robust fiscal performance with the YTD budget surplus running at BYR1bn in 4M11 vs. a BYR1.3bn deficit seen in the same period last year. The government has a good track of being able to maintain a surplus when necessary – a budget surplus was sustained both in 2008/2009 as part of the previous IMF stand-by agreement. Current plans suggest that the government will be running a 1.5% of GDP deficit in 2011, although the IMF has recommended running a balanced budget.

**Fiscal performance solid YTD but risks are present around further moves**

**C/A deficit only to correct by 50% given that share of intermediate goods is high**

The flipside of the ongoing correction in growth and FX ought to be a correction on the C/A, which stood at an unsustainable 16% of GDP at the end of 2010, and continued to rise in the first three months of the year. However, following the FX shortage that materialized on the local market in March, we are already seeing a moderation in import growth with April numbers slowing to 50% yoy from 73% yoy growth in March. By the same token the BYR devaluation has supported exports, which jumped 80% yoy both both in March and April. For the full year we expect to see the C/A deficit narrowing by some 50%, which would bring it down to USD3.4bn in nominal terms from USD8.5bn at the end of 2010 (this would still amount to 8.6% of GDP deficit). A greater improvement, in our view, is constrained by the structure of the trade balance, where 74% of imports are intermediate goods.

**NBRB FX reserves have stabilised and ought to start rising on FX receipts, but FX market still has difficulties clearing**

Following a large contraction at the start of the year NBRB FX reserves have stabilized at USD 3.6bn in June covering close to 1 M of imports. We anticipate some improvement in 2H11 as the first USD800mn tranche from the EurAsEc fund comes through in June. Belarus has also signed an agreement with China for a USD1bn loan for industrial and infrastructure projects. And there have been reports that USD1bn will come from Uralkali as a 6M prepayment for BelarusKali products in the coming weeks. Moreover, we see potential for an IMF program to be signed over the summer, and the country receiving a total of USD 1.5bn in 2011 (without a program the pace of privatization will need to be quicker). A combination of these funds together with a potential USD 4bn from privatizations ought to help cover the USD 4.5bn financing gap. We expect to see some big ticket privatization deals in 2H11 (there is market speculation that a 50% stake in Beltranzgas will be sold to Gazprom for USD 2.5bn and 50% of BelarusKali could be sold for USD 15bn). In terms of FX, following the 70% devaluation the market is not fully clearing at USDBYR5000, implying that further weakening of the BYR could be needed should no FX come to the market.

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

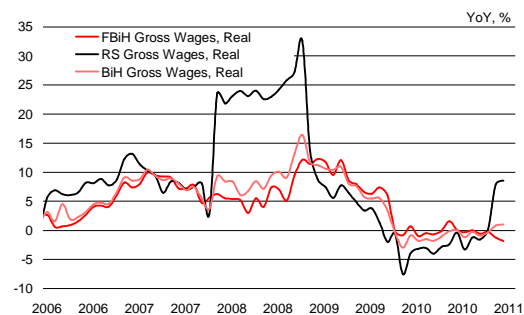
**Outlook** – The economy continues to recover with industrial production expanding and inflationary pressures rising. Despite solid export growth the current account deficit will widen significantly this year as a result of imports of oil, intermediate goods and energy. The political impasse which has characterized the country since last October's elections should soon be resolved boosting confidence and allowing the implementation of the IMF program and the EU accession process to resume.

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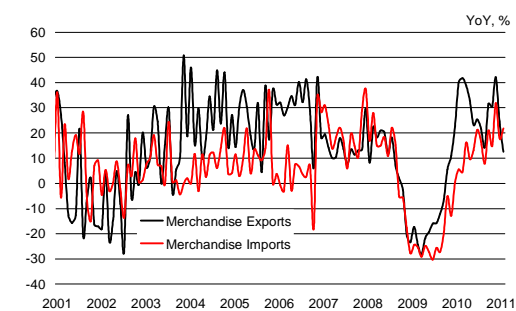
### KEY DATES/EVENTS

- Late July: preliminary 2010 GDP estimate
- 25 August: CPI release for July

### DIVERGING WAGE TRENDS IN THE ENTITIES



### MERCHANDISE EXPORT GROWTH STILL STRONG



Source: Statistic Office, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	12.6	12.3	12.6	13.3	14.1
Population (mn)	3.9	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,282.6	3,194.4	3,279.8	3,473.3	3,667.8
<b>Real economy yoy (%)</b>					
GDP	5.4	-2.9	0.5	1.8	2.5
Private Consumption					
Fixed Investment					
Public Consumption					
Exports					
Imports					
Monthly wage, nominal (EUR)	568	616	622	650	675
Unemployment rate (%)	40.3	41.5	42.9	43.3	42.8
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-4.0	-5.7	-4.5	-4.2	-3.7
Primary balance	-3.1	-5.1	-3.7	-2.8	-1.0
Public debt	30.8	35.4	39.0	41.0	42.5
<b>External accounts</b>					
Current account balance (EUR bn)	-1.8	-0.8	-0.7	-1.2	-1.4
Current account balance/GDP (%)	-14.2	-6.2	-5.5	-8.7	-9.6
Basic balance/GDP (%)	-9.3	-4.7	-5.4	-6.8	-6.0
Net FDI (EUR bn)	0.6	0.2	0.0	0.3	0.5
Net FDI (% of GDP)	5.0	1.5	0.1	1.9	3.6
Gross foreign debt (EUR bn)	0.0	0.0	0.0	0.0	0.0
Gross foreign debt (% of GDP)	0.0	0.0	0.0	0.0	0.0
FX reserves (EUR bn)	3.2	3.2	3.3	3.2	3.3
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	7.4	-0.4	2.2	4.1	3.1
CPI (eop)	3.2	0.0	3.1	4.2	3.0
Central bank target	n.a.	n.a.	n.a.	n.a.	n.a.
Central bank reference rate (eop)					
3M money market rate	4.3	0.9	0.6	1.3	2.4
USD/BAM (eop)	1.40	1.36	1.46	1.26	1.36
EUR/BAM (eop)	1.96	1.96	1.96	1.96	1.96
USD/BAM (pavg)	1.33	1.40	1.47	1.33	1.32
EUR/BAM (pavg)	1.96	1.96	1.96	1.96	1.96

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

## Political deadlock nearing resolution

**Economic recovery driven by solid industrial production growth as divergent wage growth dynamics between Republika Srpska and the Federation begin to emerge**

**Industrial production is growing but at a slower pace.** During the first four months of 2011 industrial production continued to improve solidly rising 8.5% yoy, with manufacturing activity recording growth of 10.6% yoy over this period. In contrast, insufficient expansion of new production export capacity and base effects were reflected in the slowing of industrial output in April, which recorded growth of only 3.2% yoy. An interesting development in Bosnia Herzegovina is the divergence of gross wage dynamics with data from Republika Srpska for Jan-April revealing nominal wage growth of 9.4% yoy over this period (approximately 5.5% yoy in real terms) while in the Federation during 1Q real gross wages fell approximately 1% yoy. The smallest increases in wages in Republika Srpska were in the public sector (4.4%-6.9% yoy) with the construction, mining and transport sectors all recording double digit nominal gross wage growth in the first 4 months of the year. This implies stronger imports as well as the potential for wage growth dynamics, if sustained, to outpace productivity gains, adversely impacting the competitiveness of enterprises in Republika Srpska.

**Current account deficit widens as production related imports surge**

**External imbalances widening.** Merchandise exports and imports both continued to expand in 1Q11 rising 24.5% yoy and 23.0% yoy respectively largely reflecting the pick up in industrial activity and higher energy and intermediate goods' prices. While we expect both growth rates to moderate in the remainder of the year partly because of base effects and partly because of a softer international environment heading into summer, these dynamics clearly point to a widening of the current account deficit in 2011. At the same time, FX reserves have fallen by EUR 170mn in April compares to end 2010, but once a national level government is formed and the IMF resumes tranche disbursement FX reserves should recover.

**Inflation and current account deficit forecasts increased**

**Inflation forecast revised up.** We have again revised up our year-end inflation forecast to exceed 4% yoy to reflect the impact of higher oil, energy and food prices. In addition to strong growth in food and transport prices of 6.4% yoy and 7.2% yoy respectively in the first four months of this year, wage dynamics in Republika Srpska (accounting for approximately one thirds of Bosnia's GDP) are also a factor which might require closer monitoring from an inflation perspective. As a result of the trends in merchandise exports and imports, we forecast a widening of the current account deficit to 8.7% of GDP from 5.5% last year.

**Inaugural t-bill auction held in Republika Srpska in May**

**Inaugural t-bill auction held.** May 11 saw Bosnia Herzegovina's first ever t-bill auction with the Ministry of Finance in Republika Srpska issuing BAM 36mn in 6M paper at a yield of 2.5% on a solid bid cover ratio of 2.8. One further issue is planned this year to bring issuance up to BAM 65mn for the year. Whether the Federation follows suit remains to be seen. Nonetheless, it is encouraging to see the beginnings of a domestic short-term government debt market forming.

**Post election negotiations have progressed in recent months**

**Post election negotiations nearing an end.** Since our last update the parliaments in the Federation and at national level have been constituted and currently negotiations are under way on the formation of an executive government at national level. We are increasingly confident a national level government could be in place prior to the summer vacations. This would unblock the country's long-term EU accession path and enable the active completion of the current stand-by agreement with the IMF.

**No change in sovereign rating expected.** In mid-May Moody's revised its outlook for Bosnia Herzegovina to negative from stable citing an inability of the various political forces to form a national government. With the formation of a national level government now more likely immediate concerns about political stability in the country should dissipate.

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

**Outlook** – The imminent completion of EU accession talks will be supportive for sentiment as the latest data point to the beginnings of a recovery in GDP growth following a weak 1Q. Government spending has been lowered in 1Q, but the adverse impact on revenues from the recession underline the need to continue working on lowering the budget deficit and implementing structural reforms to boost sustainable economic growth rates.

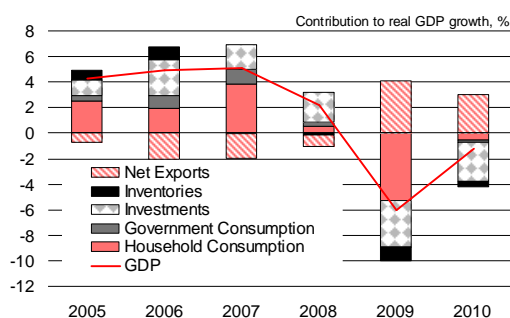
**Strategy outlook** – Although Croatia's imbalances are well known we believe the positive sentiment surrounding the EU election will protect the credit from significantly widening from here. We nevertheless see better value in Romanian and to lesser extent Hungarian credit than in case of Croatia.

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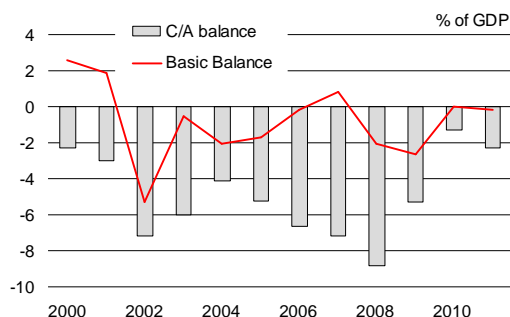
### KEY DATES/EVENTS

- Late June/early July: formal completion of EU accession talks
- 31 August: 2Q 11 Flash GDP estimate
- 30 September: 2Q balance of payments data

### SHIFT IN GDP GROWTH CONTRIBUTIONS...



### ...REFLECTED IN CURRENT ACCOUNT TRENDS



Source: IMF, National ministry of finance, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	47.8	45.7	45.9	47.0	49.8
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,771.1	10,310.5	10,390.4	10,645.4	11,275.2
<b>Real economy yoy (%)</b>					
GDP	2.2	-6.0	-1.2	1.2	2.5
Private Consumption	0.8	-8.5	-0.9	1.1	2.5
Fixed Investment	8.2	-11.8	-11.3	3.5	6.5
Public Consumption	1.9	0.2	-0.8	0.0	0.0
Exports	2.2	-17.3	6.0	5.1	6.0
Imports	3.3	-20.4	-1.3	4.8	6.5
Monthly wage, nominal (EUR)	1,044	1,051	1,053	1,054	1,095
Unemployment rate (%)	8.4	9.1	11.8	11.5	10.9
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-1.4	-3.9	-4.8	-5.7	-4.7
Primary balance	0.4	-2.4	-2.9	-2.7	-2.2
Public debt	29.0	35.2	41.2	48.6	50.9
<b>External accounts</b>					
Current account balance (EUR bn)	-4.2	-2.4	-0.6	-1.1	-1.4
Current account balance/GDP (%)	-8.8	-5.3	-1.3	-2.3	-2.9
Basic balance/GDP (%)	-2.0	-2.6	0.0	-0.2	1.1
Net FDI (EUR bn)	3.2	1.2	0.6	1.0	2.0
Net FDI (% of GDP)	6.8	2.6	1.3	2.1	4.0
Gross foreign debt (EUR bn)	40.7	45.2	46.4	48.5	51.0
Gross foreign debt (% of GDP)	85.2	99.0	101.2	103.1	102.4
FX reserves (EUR bn)	9.1	10.4	10.7	11.0	11.5
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	6.1	2.4	1.1	2.8	2.7
CPI (eop)	2.9	1.9	1.8	3.5	2.3
Central bank target	n.a.	n.a.	n.a.	n.a.	n.a.
Central bank reference rate (eop)	6.0	6.0	6.0	6.0	6.0
3M money market rate	6.8	8.6	1.2	0.8	2.0
USD/HRK (eop)	5.29	5.09	5.52	4.81	5.13
EUR/HRK (eop)	7.37	7.30	7.38	7.45	7.38
USD/HRK (pavg)	4.91	5.26	5.49	5.03	4.97
EUR/HRK (pavg)	7.22	7.34	7.29	7.40	7.35

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

## Spring ushers in better data as July 2013 EU entry date set

High frequency data from early 2Q paint more positive picture

**Better data in 2Q11.** The flash estimate for 1Q11 GDP growth revealed a contraction of 0.9% yoy and on a seasonally adjusted qoq basis GDP growth was -0.8%. High frequency data in 2Q11 point to an improvement with industrial production in April finally recording growth (0.2% yoy) and retail sales up 3.7% yoy. Although the manufacturing sector is down 1.7% yoy in Jan-April, sub-sectors such as machinery and equipment are up 46.5% yoy and basic metals 2.2% yoy over this period with the upshot of higher employment in these and similar sub-sectors. While we expect industrial production to remain flat this year, clearly there are sectors which have recovered and are growing. This is also being reflected in merchandise export growth which rose 7.3% yoy in Jan-April, even as the softer international environment is impacting adversely on growth rates.

Growth and current account forecasts lowered

**Forecasts point to a weak recovery.** Following a weak 1Q 11 GDP print we have revised our full year growth forecast to 1.2% yoy from 1.6% yoy. Croatia's economy is adjusting to a new, lower equilibrium with household sector deleveraging set to continue. Unemployment remains high and by March 2011 real gross wages had fallen 5% compared to their December 2008 peak. We also see this as the beginning of a necessary adjustment process which will have to be sustained to boost overall competitiveness. We expect investment activity to pick up after the completion of EU accession talks and once general elections, expected at the end of the year, are out of the way but the recovery in private consumption will be more modest. Continued low import growth should see the current account widen to only 2.3% of GDP. Meanwhile minimal scope to boost public spending and a stable currency should see inflation average 2.8% despite higher food and energy prices.

Government cuts spending but revenue weakness underlines impact of recession on fiscal position

**Fiscal policy: recession takes it toll on revenues.** Last year's consolidated general government deficit came in at a less than expected 4.8% of GDP, and even including the motorways authority and the repayment of pensioner debt amounted to 5.3% of GDP by our estimates. In 1Q11 the government has managed to cut spending by 3.7% yoy with subsidies down 18% yoy and other assistance (railways and motorways authorities) down almost 15% yoy. Nonetheless, revenue growth is down over 4% yoy in 1Q11. Compared to 1Q08, when the abolished solidarity tax on wages (abolished in late 2010) was also not in force, revenues are down 12% reflecting the impact of the recession on revenues. During 2Q11 the government assumed HRK 11.3bn in guarantees provided in the past to shipyards into public debt paving the way for their privatization thus removing a major source of subsidy spending in the future. We see the fiscal deficit at 5.7% of GDP this year (with a 0.5pp contribution from the motorways authority and the repayment of pensioner debt – the main difference between our forecast and the government's view) while public debt will rise to 48.6% of GDP (over 60% including government guarantees).

EU accession talks to close in late June/early July

**EU accession talks expected to be completed imminently.** The European Commission on 10 June recommended member states conclude EU accession talks with Croatia and set a target date of 1 July 2013 for the country's accession. This will open up many more sectors of the economy to competition and provide competitive enterprises improved access to the single market. These dynamic effects on growth in the medium term will be positive as will access to a potential 3%-4% of GDP per annum in structural funds. Lastly, the credibility of macroeconomic policy will also benefit from the greater focus the EU is now placing on monitoring fiscal policy as it responds to its own eurozone crisis.

No change to credit rating, for now

**Sovereign credit rating outlook.** We expect no change to current rating before the elections and the formation of a new government. While EU accession is priced into the rating, the risk in terms of sovereign ratings remains fiscal policy and the slow growth environment. The key will be for the new government to present a credible plan to lower the fiscal deficit over the life of the next parliament and embark on a braver structural reform agenda.

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

**Outlook** – While high income growth has fuelled consumption and thus GDP growth, investment has remained fairly weak in early 2011. This contrasts with the government's large development programs and we assume stronger readings later this year. However, until this materializes and given some signs of economic slowing globally and in Kazakhstan, we slightly reduce our real GDP forecast for 2011 to 6.5% from 6.8%. We see inflation only somewhat above the central bank's 6%-8% implicit target corridor.

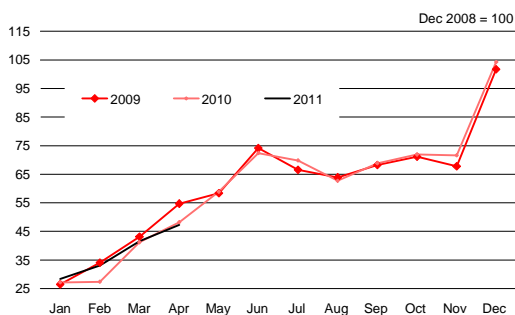
**Strategy outlook** – As the resistance against KZT appreciation is stronger than previously expected, we recommend closing short USD/KZT positions at current levels.

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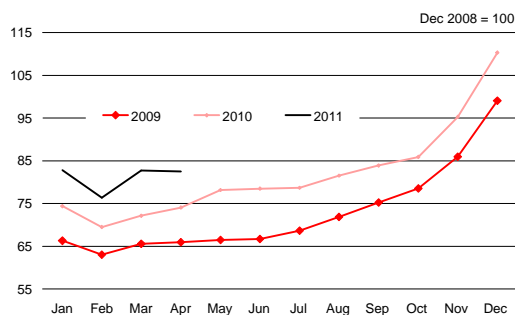
### KEY DATES/EVENTS

- 3Q11 – Resumption of NBRKs intervention against the KZT
- 3-4Q11 – Measures by the authorities to ease banks' poor asset quality problem
- 4Q11 – Ownership changes in the large oil consortia, "Peoples IPO"

### INVESTMENTS ARE BELOW THEIR 2009 LEVELS



### RETAIL SALES IMPROVING



Source: UniCredit Research, CSO, NBK

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	89.8	77.3	109.9	125.4	141.2
Population (mn)	15.7	16.2	16.0	16.2	16.3
GDP per capita (EUR)	5,728.7	4,771.8	6,856.3	7,750.5	8,650
<b>Real economy joy (%)</b>					
GDP	3.3	1.2	7.0	6.5	5.9
Private Consumption	3.8	-2.8	10.9	6.6	6.2
Fixed Investment	1.7	1.9	3.8	7.1	8.1
Public Consumption	5.5	1.1	2.7	4.3	5.8
Exports	0.8	-6.2	1.9	10.4	7.0
Imports	-11.5	-15.9	0.9	15.9	13.2
Monthly wage, nominal (EUR)	343.1	329.0	397.4	420.2	477.6
Unemployment rate (%)	6.6	6.6	5.8	5.4	5.3
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	1.2	-4.3	3.1	3.5	3.0
Primary balance	1.6	-3.9	3.5	4.6	4.2
Public debt	8.8	13.9	15.0	17.8	20.3
<b>External accounts</b>					
Current account balance (EUR bn)	4.7	-2.4	3.3	6.0	1.8
Current account balance/GDP (%)	5.3	-3.2	3.0	4.8	1.3
Basic balance/GDP (%)	16.3	8.5	9.7	10.5	6.3
Net FDI (EUR bn)	9.9	9.0	7.4	7.2	7.1
Net FDI (% of GDP)	11.0	11.7	6.7	5.7	5.0
Gross foreign debt (EUR bn)	79.9	75.5	87.7	88.3	92.5
Gross foreign debt (% of GDP)	88.9	97.7	79.7	70.4	65.5
FX reserves (EUR bn)	14.8	15.9	20.8	24.8	27.2
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	17.2	7.3	7.1	8.8	6.8
CPI (eop)	9.5	6.2	7.8	8.5	7.1
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	10.5	7.0	7.0	8.0	7.5
3M money market rate	8.9	9.6	2.0	2.2	6.2
USD/KZT (eop)	120.88	148.36	147.37	143.00	135.80
EUR/KZT (eop)	168.66	212.61	196.97	221.65	195.55
USD/KZT (pavg)	120.32	147.5	147.35	145.2	140.9
EUR/KZT (pavg)	176.98	205.89	195.49	213.6	210.8

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

## Solid growth, but investment lags

**We continue to see solid growth in Kazakhstan with some signs of slowing**

**Industrial output up 5.8% yoy in Jan-May.** Mining increased 4.0% yoy (with oil production up 2.4% yoy), manufacturing 8.7%. This is somewhat less than the 10.0% in 2010; seasonal adjustment also indicates some slowing. 1Q11 real GDP growth accelerated to 6.6% yoy (1.6% qoqsa) from 5.9% yoy (+1.5% qoqsa) in 4Q10, but predominantly thanks to trade and telecoms, which grew more than 14% yoy, reflecting higher consumption. Manufacturing continued its recovery (+8% yoy) while financial intermediation contracted by 1.9%. Value added in mining and construction grew below average in real terms, 5.0% yoy and 3.1% yoy respectively.

**Growth predominantly consumption driven**

**Post-crisis growth has been less export-led in real terms than we previously assumed** and a lot more consumption driven, FY2010 GDP by use figures now available suggest. Exports of goods and services were only 1.9% higher in real terms in 2010 than in 2009 and tons of oil exported increased only 0.3% yoy (to 67.5mn), though oil exports rose 41% in USD terms. Private consumption by contrast grew by an impressive 10.9% yoy. Gross fixed capital formation increased 3.8%. Early 2011 data point to continued strong consumption growth: Constant price retail sales were up 11.7% yoy in Jan-May thanks to decent income growth made possible by large terms of trade gains. Nominal wages were 16.2% higher than the year before in Jan-April, real wages 7.2% yoy.

**Investment in manufacturing up strongly, while investment in the oil-gas sector was weak in early 2011**

**Investment in fixed assets**, which we see as a main driver of growth over the coming years, not least thanks to the government's large industrialization and infrastructure plans, has been disappointing so far. After +12.6% yoy in Jan-Feb due to a low base, investment outlays fell 0.8% yoy in real terms in March-April 2011. Investment in manufacturing was up 25.7% yoy in January-April, but investment in the industry as a whole grew only 0.8%, indicating weak investment in the oil-gas sector.

**We expect inflation to only slightly overshoot the central bank's implicit 6%-8% target**

**Inflation stood at 8.3% yoy in May**, down from 8.4% yoy in April as food price inflation eased. The money base grew 13.0% YTD to April vs 8.2% a year earlier as bank reserves held with the central bank continued to increase. M3 growth slowed nevertheless to 5.5% from 7.0%. Sluggish credit growth still adversely affects the money multiplier, leading the authorities to attribute monetary policy little weight for fighting inflation. Only some sectors such as manufacturing and transportation have begun to borrow a bit more decisively. Bank loans increased 1.2% mom in April, 2.3% yoy. Corporate loans were up 3.3%, retail loans down 0.2% yoy. Fighting inflation thus relies on non-monetary measures such as subsidized food and fuels. Fiscal policy has remained prudent as consolidated budget tax revenues increased 45.9% yoy in Jan-Apr and the surplus amounted to about 10% of GDP.

**Credit growth has remained sluggish, some increase in manufacturing and transportation**

**KZT appreciation pressures persist as the C/A balance is in surplus**

**The C/A surplus widened to USD 4.8bn in 1Q11 from USD 2.8bn in 1Q10.** Exports grew 35.9% yoy to USD 18.5bn. Imports totaled USD 7.4bn vs USD 5.6bn a year earlier. Though obviously not a lot invested in production assets, net inward FDI held up well at USD 3.2bn. While Oil Fund foreign assets rose by USD 2bn to USD 38.1bn in May, net international reserves of the central bank fell for the first time in six months and decreased by USD 969mn to USD 35.5bn, in part nominally because of a weaker EUR (we estimate about one-third of reserves are in EUR) in part because of debt repayments and one-off BoP outflows. We expect renewed reserve increases later this year as the central bank resumes intervening against the KZT (it purchased about USD 6.6bn in Jan-April) on a much smaller scale though with principal debt repayments due amounting to a significant USD 5.7bn in 2H11.

**We reduce our 2011 forecasts for real GDP growth from 6.8% to 6.5%, for December inflation from 9.8% to 8.5% and revise our fx-rate prognosis from 140 to the USD eop 2011 to 143**

Because of signs of slowing output growth both globally and in Kazakhstan, sluggish investment YTD, and persistently high NPL ratios that limit bank lending in particular to individuals and SMEs we slightly reduce our real GDP forecast from 6.8% in 2011 to 6.5%. December 2011 inflation we see at 8.5% now thanks to more contained food price increases vs 9.8% previously. Resistance against KZT appreciation is stronger than we assumed. **We therefore revise our USD/KZT forecast from 140 to the USD eop 2011 to 143.**

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

**Outlook** – Russia has lagged its peers in terms of a recovery in economic activity but stronger domestic demand and favourable base effects from agriculture over H2-11 should help partially close the gap from here, though we continue to see the CBT's inflation target as out of reach. Capital flows remain lackluster, with reserve accumulation lagging other countries in the region. From here higher money market rates should discourage domestic capital outflows and help balance a deterioration in the trade balance.

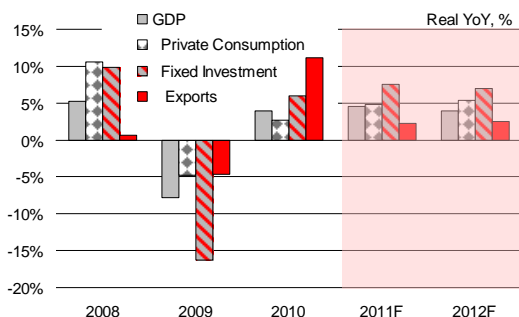
**Strategy outlook** – We believe the cleanest trade is to position for higher local rates and we recommend paying 2y RUB ccs rates for a potential 150bp move north. In similar vein we move our RUB allocation to mod U/W. In credit we believe it could outperform regional peer and keep mod O/W.

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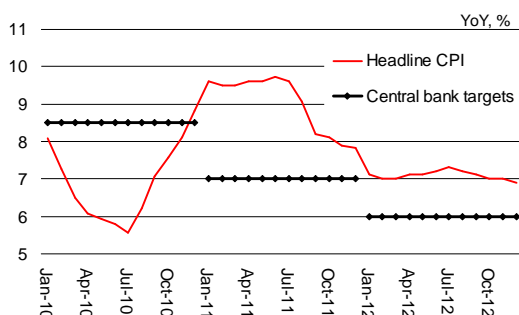
### KEY DATES/EVENTS

- 5th-8th of each month – Monthly CPI
- 18th-22th of each month – Monthly indicators
- 18-23-Aug- 2Q 2011 GDP
- Last Fri of each month - CBR rate decision
- Every Wed - weekly OFZ auction (3-7Y and 10Y), avg RUB40bn offered

### DOMESTIC DEMAND SHOULD OVERTAKE EXPORTS AS KEY GROWTH DRIVER



### INFLATION IS LIKELY TO REMAIN ABOVE OFFICIAL TARGETS



Source: Federal Statistical Service, CBR, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	1,132.2	871.1	1,102.3	1,305.9	1,389.9
Population (mn)	141.6	141.3	141.0	140.4	140.1
GDP per capita (EUR)	7,995.8	6,164.7	7,817.5	9,299.1	9,922.7
<b>Real economy yoy (%)</b>					
GDP	5.2	-7.8	4.0	4.5	3.9
Private Consumption	10.6	-4.8	2.7	4.8	5.5
Fixed Investment	9.9	-16.2	6.0	7.5	7.0
Public Consumption	3.4	-0.5	0.7	-2.8	0.5
Exports	0.6	-4.7	11.1	2.2	2.5
Imports	14.8	-30.4	25.4	7.6	5.9
Monthly wage, nominal (EUR)	471.0	422.0	518.3	558.6	621.5
Unemployment rate (%)	6.3	8.3	7.5	7.0	6.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	4.9	-12.4	-6.6	-2.1	-4.3
Primary balance	5.5	-11.6	-6.8	-2.4	-4.0
Public debt	5.5	7.8	8.3	8.4	9.9
<b>External accounts</b>					
Current account balance (EUR bn)	77.7	35.7	55.9	92.0	40.8
Current account balance/GDP (%)	6.9	4.1	5.1	7.0	2.9
Basic balance/GDP (%)	11.0	6.8	7.0	8.3	4.5
Net FDI (EUR bn)	51.0	26.3	24.8	20.2	24.8
Net FDI (% of GDP)	4.5	3.0	2.2	1.5	1.8
Gross foreign debt (EUR bn)	340.8	329.8	356.3	296.4	326.0
Gross foreign debt (% of GDP)	35.6	34.7	34.3	22.5	23.7
FX reserves (EUR bn)	302.9	307.3	358.7	398.7	423.7
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	14.1	11.7	6.9	9.0	7.1
CPI (eop)	13.3	8.8	8.8	7.8	6.9
Central bank target	0.0	0.0	8.5	7.0	6.0
Central bank reference rate (eop)	13.0	8.75	7.75	8.25	8.25
3M money market rate	9.8	13.8	4.4	5.0	5.9
USD/RUB (eop)	30.53	30.04	30.54	27.66	28.38
EUR/RUB (eop)	42.59	43.04	40.81	42.87	40.87
USD/RUB (pavg)	24.78	31.65	30.35	27.98	27.40
EUR/RUB (pavg)	36.46	44.13	40.27	41.13	40.55

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

## Economics: A laggard, for how long?

We cut our inflation forecast from 8.4% yoy to 7.8% yoy in 2011 eop, taking into account weaker than expected inflationary trends of 2Q11. It marks strong disinflation in 3Q11, which we expect to be supported by the arrival of new crop from July-August on top of a very strong high base effect, which alone will take off about 1-1.5pp off the current 9.7% yoy headline rate. However, even apart from that core inflationary pressures are likely to start easing from Summer onwards as well, and we can claim that this is a result of an effective shift to inflation targeting by the Central Bank.

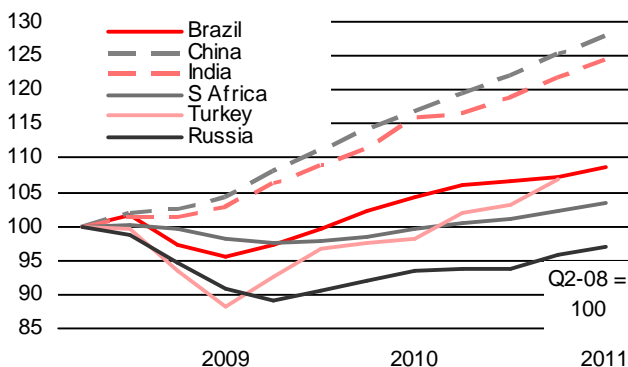
Nevertheless, the 7.8% yoy forecast is still above the government 7.5% yoy target for the year let alone quite optimistic CBR forecast of 7%, which the CBR officials kept reiterating in 2Q11. Moreover, such seasonal disinflationary impact of a new crop could be a least partly offset by the reintroduced import duties of key food items (removed last year specifically to contain inflation) and removal of grain export ban from July. Both of these factors directly endanger CBR inflation targets for the year and are likely to extend monetary policy tightening cycle by another 25bps hike in June or July, even despite apparent signs of a disinflation.

In fact, there is another food-related risk to this inflation outlook arising from the E.Coli outbreak in Europe, which already has triggered introduction of complete ban on vegetable imports from Europe. This is already mentioned as among important inflationary risks by CBR officials, but we expect that such a ban is likely to be temporary in nature, which should limit its adverse impact.

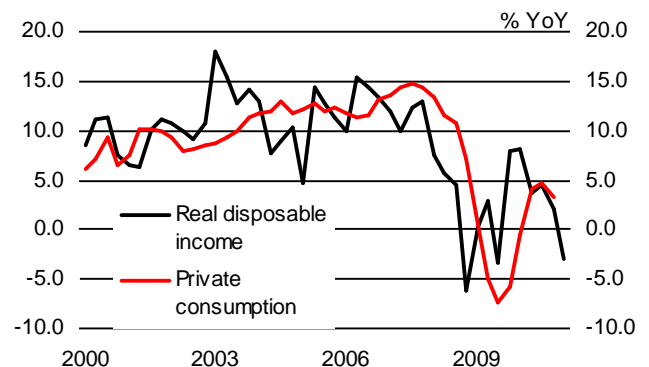
Largely as a result of such consistent anti-inflationary policy by the CBR and the government, domestic money market is likely to remain pressured by the lack of fresh liquidity inflows from the budget or from the Central Bank interventions. With lack of any major remaining excesses of liquidity the short term money market rates are likely to finally diverge from the floor set by the CBR depo rates (3.5% presently) and start to move closer to the ceiling set by CBR repo rates (5.5% presently). As a result, the tightening moves are likely to be increasingly more concentrated on liquidity provisioning rates, rather than depo rates as before.

### GDP RECOVERY REMAINS LACKLUSTRE

GDP gains lag peers



Higher inflation dents consumer purchasing power and an already lacklustre recovery in private consumption



Source: CBR, Federal Statistical Service, UniCredit Research

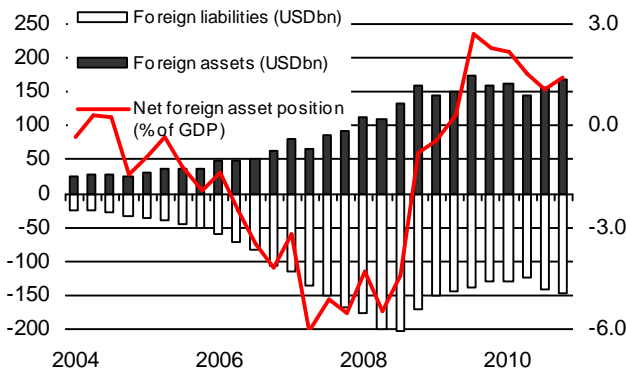
Rising money market rates should start to build a case for an easing and potentially reversing capital outflow from Russia, which should give considerable support to the RUB in 2H11. The unit is likely to start to pressure from the erosion of fundamental support in the form of shrinking trade surplus. Thus, the stabilization of oil prices in 2Q11 on top of the likely continued, albeit slowed, expansion of imports should bring trade surplus down sharply from its multi-year peaks in March-April, triggering sharp qoq contraction of current account surplus in 2H11. This is expected to push the RUB down to our RUB34.5/basket forecast for 2011 eop, which we keep unchanged.

The broader economy is likely to start recovering from the adverse impact of social security tax hike starting from 2011. Given the nature of the tax, most of it is paid in the first few months of the year and the tax payout starts to fall with each subsequent month. In 2011, such adverse effect was the strongest in 1Q11 due to some 9pp tax hike, which seemed to have diverted corporate resources away from productive activity and triggered sharp deceleration of real wage and particularly the investment demand. As the adverse impact of taxation should start to fade, domestic demand is also likely to resume robust expansion in 3Q11 onwards, pushing the economy up robust 4.5% in 2011.

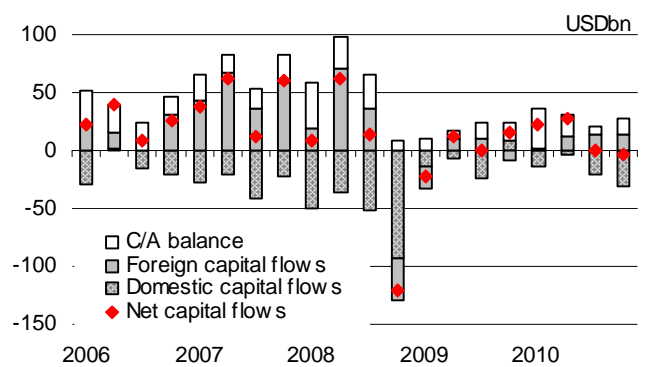
Record high annual oil prices give a strong boost to budget revenues pressuring federal budget deficit down to just above 1% of GDP or close to RUB600bn, most of which will arise in the last few months of the year. We think that the deficit of such limited size is feasible to finance on domestic market, with no major pressures on liquidity conditions. Thus, we note that FinMin presently continues to have substantial leverage against pricing pressure on its OFZ placements in the form of persistent substantial resources in the Reserve fund. This, we think, is likely to prevent any major increase of the longer end of RUB curve.

**AN ABSENCE OF CAPITAL: LOCALS TAKE FUNDS OFFSHORE WHILE THE BANKING SYSTEM REPAYS FOREIGN DEBT**

Banking sector has shifted from foreign debtor to foreign creditor



The capital flows picture remains lackluster



Source: CBR, Federal Statistical Service, UniCredit Research

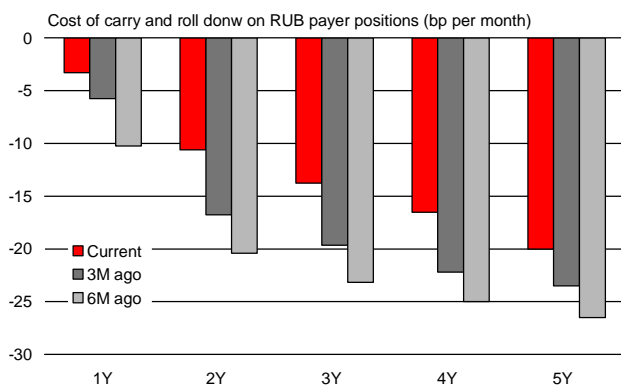
## Strategy: position for higher rates and less stellar RUB performance

**FX:** We believe as the RUB is losing some fundamental support (via shrinking trade surplus and ongoing private sector capital outflows) it will unlikely to repeat the stellar performance we have seen in H1. We hence move our RUB allocation to mod U/W.

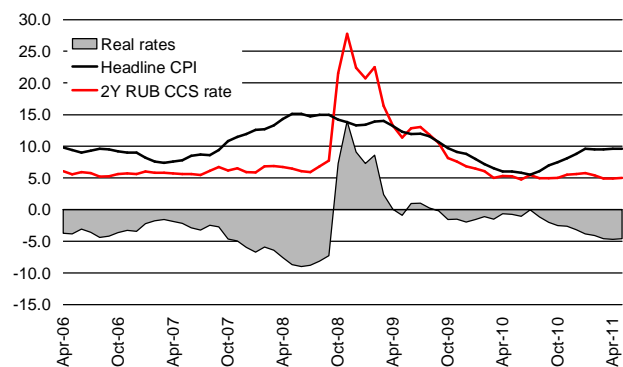
**Rates:** we think RUB rates are still too low versus the inflation outlook whilst if capital outflow intensifies we can imagine a similar spike in rates as in 2008. Russia also performs poorly on our fundamental FX scorecard mostly on the back of a significant deterioration of the fiscal balance and significant REER appreciation observed in the last 2 years. We also think that even if the global slowdown story does not materialize RUB rates should go higher due to deep negative real interest rates. Paying RUB rates has been an expensive exercise during 2010 but following the recent increase in 3M Mosprime rates (+50bp since mid April) we think the cost has declined significantly. At the moment the cost of carry and roll down has cheapened the most on the short end of the curve and we recommend paying 2y RUB CCS rates at current levels of 4.96%. We set a target of 6.50% and stop loss at 4.40% (all time low).

**Credit:** We do not see particular value in outright Russian credit exposure but we think it could outperform several regional peers (most importantly Turkey). We hence would remain mod O/W.

Paying RUB rates is now relatively cheap vs. 3m and 6m ago



RUB rates are low vs. inflation



Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>80.9</b>	<b>37.0</b>	<b>70.6</b>
Budget deficit	72.3	27.1	59.2
Amortisation of public debt	8.6	9.9	11.4
Domestic	8.6	9.9	11.4
Bonds	8.6	9.9	11.4
Bills	0	0	0
External	0	0	0
IMF/EU	0	0	0
<b>Financing</b>	<b>25.4</b>	<b>36.7</b>	<b>56.8</b>
Domestic borrowing	21.2	34.6	50.0
Bonds	21.2	34.6	50.0
Bills	0	0	0
External borrowing	4.1	2.1	6.8
Bonds	4.1	2.1	6.8
IMF/EU	0	0	0
Other	0	0	0

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>22.5</b>	<b>-31.5</b>	<b>-10.6</b>
C/A deficit	-55.9	-92.0	-40.8
Amortisation of medium to long term debt	78.4	60.5	30.2
Government/central bank	2.1	3	1.9
Banks	24.2	21.8	5.4
Corporates	52.1	35.7	22.9
<b>Financing</b>	<b>73.9</b>	<b>57.3</b>	<b>48.8</b>
FDI	24.8	20.2	24.8
Equity	0	0	0
Borrowing	68.3	67.1	44
Government/central bank	4	2.1	3
Banks	23	25	11
Corporates	41.3	40	30
Other	-19.2	-30	-20

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

**Outlook** – We maintain our growth forecast of 2.7% but up our inflation and current account deficit forecasts. Despite the beginnings of a loosening monetary policy cycle in June, we expect EUR/RSD near current levels at year-end as t-bill yields continue to attract inflows. We also see EU candidate country status for Serbia as far likelier following the arrest of Ratko Mladić.

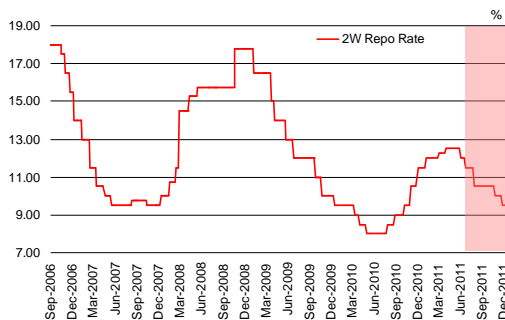
**Strategy** – We believe the strong investor optimism regarding the local currency t-bill market will ease somewhat as the NBS is trying to draw a line under the EUR/RSD. Proximity regarding the Greek debt crisis is also factor to consider. We would stay on the sidelines at the moment with the t/bills till we have more clarity in terms of what the NBS would like to achieve.

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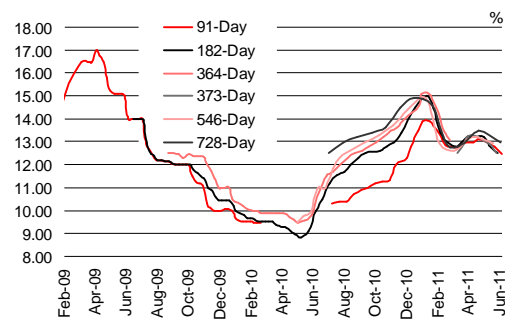
### KEY DATES/EVENTS

- 7 July: NBS Meeting
- 11 August: NBS Meeting
- 8 September: NBS Meeting

### NBS COMMENCES EASING CYCLE...



### ...AS STRONG INTERNATIONAL DEMAND SEES T-BILL YIELDS FALL



Source: NBS, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	32.7	28.9	28.6	33.5	37.3
Population (mn)	7.4	7.3	7.3	7.3	7.2
GDP per capita (EUR)	4,443.5	3,942.7	3,917.1	4,607.4	5,150.4
<b>Real economy yoy (%)</b>					
GDP	3.8	-3.5	1.8	2.7	3.5
Private Consumption	0.0	0.0	0.0	0.0	0.0
Fixed Investment	0.0	0.0	0.0	0.0	0.0
Public Consumption	0.0	0.0	0.0	0.0	0.0
Exports	0.0	0.0	0.0	0.0	0.0
Imports	0.0	0.0	0.0	0.0	0.0
Monthly wage, nominal (EUR)	560.5	470.0	462.0	525.7	574.3
Unemployment rate (%)	13.7	16.1	20.0	19.5	18.8
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-2.6	-4.5	-4.7	-4.5	-3.9
Primary balance	-2.0	-3.6	-3.5	-3.0	-2.4
Public debt	26.9	34.1	42.6	40.9	40.8
<b>External accounts</b>					
Current account balance (EUR bn)	-7.1	-2.1	-2.1	-2.8	-2.9
Current account balance/GDP (%)	-21.6	-7.2	-7.3	-8.3	-7.8
Basic balance/GDP (%)	-16.0	-2.5	-4.3	-2.3	-2.4
Net FDI (EUR bn)	1.8	1.4	0.9	2.0	2.0
Net FDI (% of GDP)	5.6	4.8	3.0	6.0	5.4
Gross foreign debt (EUR bn)	21.8	22.8	23.8	26.0	29.0
Gross foreign debt (% of GDP)	66.7	78.9	83.3	77.7	77.8
FX reserves (EUR bn)	8.2	10.6	10.0	10.5	11.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	11.7	8.4	6.3	12.5	7.9
CPI (eop)	8.6	6.6	10.5	10.6	7.8
Central bank target	10%	8%	6%	4.5%	4.0%
Central bank reference rate (eop)	17.8	9.5	11.5	9.5	8.5
3M money market rate	15.5	14.5	10.0	11.3	10.0
USD/RSD (eop)	64.34	67.11	79.40	64.52	71.53
EUR/RSD (eop)	89.78	96.17	106.12	100.00	103.00
USD/RSD (pavg)	55.40	67.45	77.73	68.71	68.58
EUR/RSD (pavg)	81.49	94.05	103.12	101.00	101.50

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

## Mladic arrest boosts EU accession hopes

Industrial production growth shows signs of slowing, but export growth remains strong

**Manufacturing sector performing well.** The flash estimate for 1Q11 GDP growth was 3.0% yoy. Industrial production has increased 4.5% yoy in Jan-April, however, in line with a softer international environment in 2Q11 mom seasonally adjusted figures since March point to a slow down. Merchandise exports, meanwhile, continue to expand strongly, rising 30.9% yoy in Jan-April but with imports up 21.1% yoy the merchandise trade deficit is widening. The upshot is that intermediate goods, energy and capital goods imports make up over 2/3 of total imports. This, however, does imply that the current account deficit will deepen this year to 8.3% of GDP from 7.3% of GDP last year.

Inflation has peaked for this year. High carry on Serbian t-bills likely to underpin EUR/RSD this year, although investor sentiment does bear watching

**Monetary policy – easing cycle begins.** At its June meeting the central bank lowered policy rates 50bps to 12.00%, with governor Šoškić signaling a few days later the commencement of an easing cycle given expected favorable food price movements, more stable inflation expectations and the passing of the peak in headline CPI (May CPI was 13.4% yoy compared to 14.7% yoy in April). Nonetheless, we have increased our end of year inflation forecast to 10.6% yoy as a result of significant increases in inflation so far this year. We now look for a further 250bps in rate cuts this year to 9.50% at year-end. More difficult to judge is the EUR/RSD. The central bank however purchased EUR 40mn over 20 days from 19 May as part of its policy of smoothing excessive RSD gains as the EUR/RSD reached 97, but the governor's dovish rate comments and, more importantly, the decision by the Treasury to stop issuing FX-linked t-bills saw the EUR/RSD rise to 100 in mid-June. While we note that lower yields on t-bills implied from expected rates cuts at the margin should reduce portfolio inflows. Nonetheless, those portfolio inflows should largely sustain given the associated high carry, limiting potential depreciation pressures. We therefore forecast EUR/RSD near current levels at year-end. The main source of risk for the EUR/RSD is Serbia's high external debt financing requirements especially if the brakes come off fiscal policy settings as elections approach.

New IMF program an important factor for sentiment in the absence of large privatization inflows

**Fiscal policy – IMF deal will add credibility.** Higher inflation has boosted fiscal revenues during 1Q and the government has used this windfall to finance higher salaries and pensions (to a formula agreed with the IMF, rather than approving much higher union demands) and by boosting subsidies and support programs. Nonetheless, with no new IMF program in place until after the summer and tax revenue growth slowing, the risk is increasing that the 4.1% of GDP deficit target will be breached. With the flagship privatization of Telekom Srbija having failed the government is also increasing public debt issuance and plans to issue a Eurobond between September and November. Solid nominal GDP growth and a strengthening RSD will mean public debt as a percentage of GDP should rise only moderately this year, but with 2007-09 GDP growth rates revised down to the effort of reducing 2009 nominal GDP by EUR 1bn and with the final revision likely to be greater, maintaining public debt below 45% of GDP as required by law may prove a challenge in the m-t. Most importantly, the authorities are working on a new deal with the IMF which envisages an 18-month USD 1bn Stand-by agreement being put in place, probably from September onwards. This will be a key plank for maintaining investor confidence in Serbia's macroeconomic policies.

Transfer of main Hague Tribunal fugitive has greatly increased chances of attaining EU candidate country status this year

**Path to EU candidate country status opened.** The arrest and transfer of Ratko Mladic, the wartime Bosnian Serb general, at the end of May to The Hague Tribunal has opened the way for the Serbia to achieve its goal of EU candidate country status by the end of the year. This would also be a boost for the government approaching a general election in 2Q12.

Government aiming for EU candidate country status by the end of 2011

**Sovereign rating.** Given general elections are less than 12 months away and expectations Serbia will achieve EU candidate country status towards the end of 2011 are essentially priced in, we would not expect further movements in the sovereign rating for now.

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

**Outlook** – As Turkey continues to post strong gains in economic activity, the CBT has shifted policy to address its concerns about the C/A deficit and rapid credit growth. Via hikes to reserve requirements, the CBT hopes to contain the amount and price of new credit extended while rate cuts should deter s-t inflows. Aggressive rate hikes over the next 1-2 quarters seem unlikely, though we expect some move by year end.

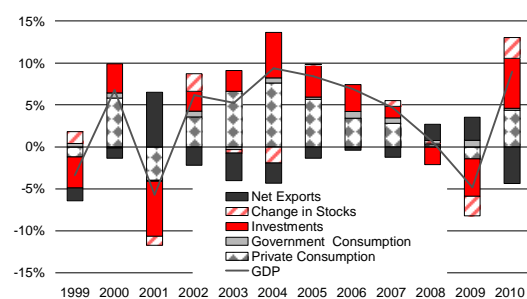
**Strategy** – We believe the balance of risk around TRY is becoming more symmetrical and we increase our TRY allocation to mod U/W from U/W. In local rates the curve should flatten both under the positive and negative scenario and we receive 2y/10y TRY spread at current levels targeting a 180bp move south. We stay U/W Turkish external credit and recommend buying 5Y Turkey CDS vs. 5Y Romania CDS.

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

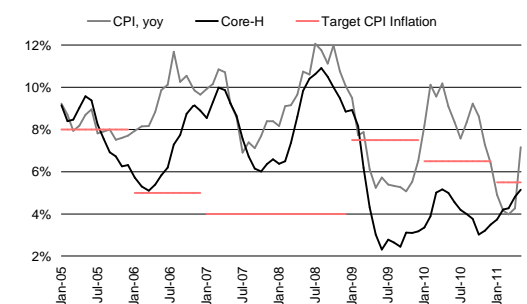
### KEY DATES/EVENTS

- June 23 – CBT rate decision
- July 21 – CBT rate decision
- Aug 23 – CBT rate decision

### CONSUMPTION AND INVESTMENT DRIVEN GROWTH



### HEADLINE CPI IS ABOVE THE TARGET, CORE NOT YET



Source: Statistic Office, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	505.1	444.1	552.6	532.1	551.6
Population (mn)	71.5	72.6	72.9	74.7	75.8
GDP per capita (EUR)	7,062.0	6,120.0	7,580.8	7,124.5	7,280.1
<b>Real economy yoy (%)</b>					
GDP	0.7	-4.7	8.9	5.8	4.1
Private Consumption	0.5	-2.2	5.9	5.0	3.3
Fixed Investment	-8.2	-19.1	29.9	17.0	6.9
Public Consumption	1.7	7.8	2.0	6.9	2.5
Exports	2.7	-5.3	3.4	10.3	10.0
Imports	-4.2	-14.3	20.7	17.3	9.0
Monthly wage, nominal (EUR)	734.4	634.1	295.0	275.2	282.5
Unemployment rate (%)	11.0	14.0	11.9	10.5	10.5
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-1.8	-5.5	-3.6	-2.2	-1.5
Primary balance	3.5	0.1	0.9	0.4	1.1
Public debt	40.7	47.1	41.6	39.8	39.0
<b>External accounts</b>					
Current account balance (EUR bn)	-28.2	-10.0	-36.5	-47.5	-44.9
Current account balance/GDP (%)	-5.6	-2.3	-6.6	-8.9	-8.1
Basic balance/GDP (%)	-3.2	-1.3	-5.5	-6.5	-6.5
Net FDI (EUR bn)	12.3	4.1	6.0	6.4	6.9
Net FDI (% of GDP)	2.4	0.9	1.1	1.2	1.2
Gross foreign debt (EUR bn)	188.6	192.9	219.3	223.6	237.2
Gross foreign debt (% of GDP)	37.8	43.6	40.0	38.5	39.0
FX reserves (EUR bn)	50.2	49.3	53.3	54.6	52.7
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	10.5	6.3	8.6	6.2	7.8
CPI (eop)	10.1	6.5	6.4	8.1	7.3
Central bank target	4.0	7.5	6.5	5.5	5.0
Central bank reference rate (eop)	15.0	6.5	6.5	7.75	7.75
3M money market rate	17.3	9.7	7.3	7.4	8.2
USD/TRY (eop)	1.54	1.49	1.54	1.66	1.70
EUR/TRY (eop)	2.15	2.14	2.06	2.57	2.45
USD/TRY (pavg)	1.30	1.55	1.51	1.60	1.68
EUR/TRY (pavg)	1.91	2.16	2.00	2.35	2.48

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

## CAD and inflation to get worse before they get better

The general election is over but politics remains high on the agenda, maintaining a risk that the government does not take the necessary fiscal measures

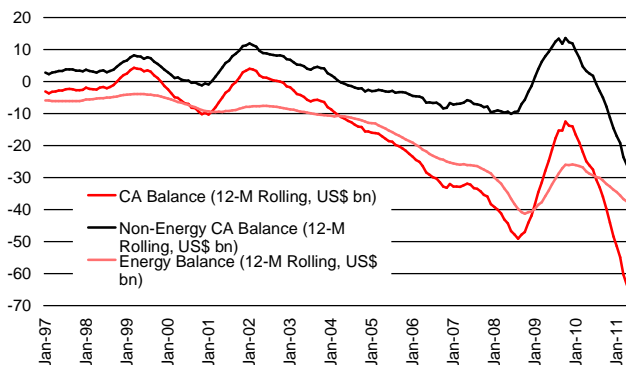
The AKP's landslide victory that gave its leader Erdogan a third consecutive term in office with a clear majority of 49.9% is seen as an indicator of continuing stability in Turkey. This is especially true as the lower than expected number of seats could force the AKP to seek the support of the now stronger opposition pro-Kurdish BDP and center-left CHP parties in its push for a new Constitution. The AKP's third term will not be easy. It will be important to reach a balanced, civilized discourse with other political parties to address the key issues domestically and abroad. The economy needs measures to address the rising CAD problem while the AKP's "zero-problem" foreign policy is being challenged by regional uprisings, especially in neighboring Syria, the AKP's strong ally. Meanwhile markets await the announcement of fiscal measures to the CBT combat Turkey's ever widening C/A deficit. With a new Constitution and a solution to the Kurdish question on the table, there is a clear risk that the political agenda is likely to dominate over economic requirements. With a possible referendum on the constitution in 2012; local elections and perhaps a presidential election in 2014 with Erdogan as the contender, a meaningful restraint on public spending might not be feasible for the government.

Inflation is set to be volatile but in general on the increase from here

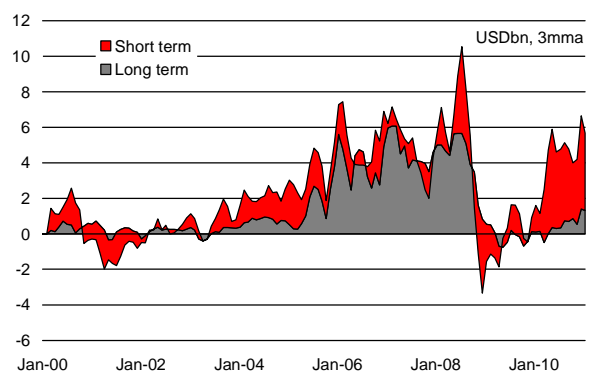
While in many economies the spike in energy and food prices combined with a poor harvest hurts the inflation rate, Turkey's experience has been the opposite until very recently. Thanks to the base year effect created by last year's administrative price increases and fluctuations in food prices, from 6.4% at year end 2010 CPI dived to historic lows of 4.0% by the end of 1Q11. However, while other countries are just entering a phase of slowing inflation, Turkey has seen its inflation rate jump to 7.2% in May. The favorable base year effect is fully phased out as of 2Q11 and the jump in inflation has roots in the rise in the goods sector prices due cost-push pressures. The services sector prices mostly remain tame for the time being allowing some more months for the CBT before resorting to more orthodox monetary policy applications. Nevertheless versus its 5.5% official CPI target in 2Q11 the bank has shifted its end of year estimate to 6.9% from 5.9% set in 1Q11. In 3Q11, Turkey's CPI inflation will be highly volatile and range bound (6.3% to 7.3%), while heading to 8.1% by 11YE. Thus, as the CBT is likely to refrain from changing the policy rate during 3Q11, it is very likely for the bank to work in harmony with the BRSA in imposing further unorthodox monetary policy measures to deal with the still booming loan growth in the Turkish banking sector.

### CBT WANTS TO AVOID ABRUPT ADJUSTMENT IN EXTERNAL ACCOUNTS BY TACKLING THE ISSUE NOW RATHER THAN LATER

C/A deficit moves to record level at rapid pace...



...financed by large amounts of short term capital inflows



Source: CBT, UniCredit Research

Since introduction of their unorthodox monetary policy, a series of external developments have moved against the CBT

Further tightening ahead, though initially via reserve requirements rather than the policy rate

**Following 9.0% in 2010, domestic demand is to yield a further 8%-9% GDP growth in 1Q11.**

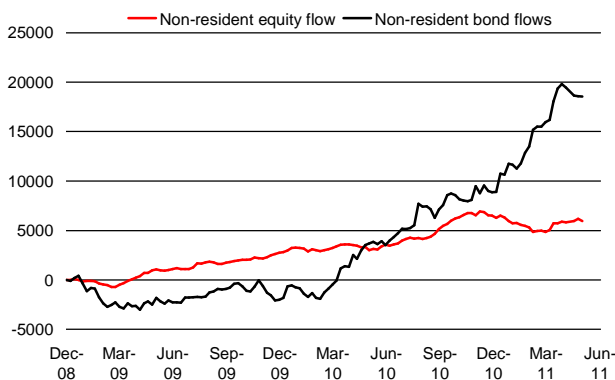
Again in contrast to many of its peers, Turkey is seeing relatively weak external demand while private sector consumption and investments are driving growth. We forecast GDP growth at 5.8% this year. Perhaps motivated by the election countdown the government no doubt is adding a significant amount of fiscal stimulus to the economy – 1.6pp of GDP this year following 1.9% last year. Thus, combined with the CBT's tighter monetary policy stance via unorthodox tools, the months following the mid-June election become critical. The market is looking for a tighter fiscal policy: either through some selective tax hikes and/or spending reductions in areas that stimulate demand. But, there is a heavy election calendar in the pipeline for the next few years. Thus, as political competition hots-up, the AKP government is unlikely to deliver the necessary withdrawal of fiscal stimulus, which we estimate at 2%-3% of GDP. Windfall gains from the tax amnesty is likely to help in terms of enabling a strong recovery in budget deficit but does not represent the needed tightening of the fiscal stance or a meaningful scaling back of expenditure. Turkey's main macro challenge is the rapidly rising CAD to GDP ratio, which we estimate will reach circa 9.0% by end 2011. While the price of oil is playing a large part in the huge imbalance, it is domestic demand that sustains the CAD.

**This structural fragility and the global backdrop has left Turkey dependent on short-term capital flows and portfolio flows**

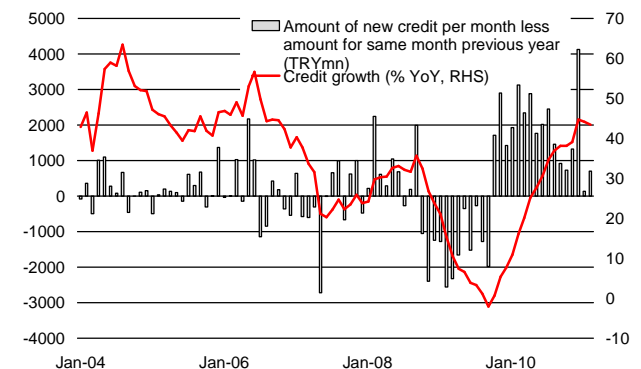
while the share of FDI in funding the CAD will be below 20% this year. Given the strength of growth and a healthy financial sector Turkey managed to attract a good portion of capital flows; especially with the real sector rollover ratio once again extending beyond 100% and the attractiveness of the Turkish banks enabling them to borrow easily from abroad. As for the portfolio flows, these were robust in most of 1H11 but more recently they have started to dry up on fears of a rising CAD. We believe investors would welcome any additional measures from the CBT and especially from the government through a tighter fiscal policy in terms of taming domestic demand. Since last November, the CBT has been trying to push away speculative flows and attract long-term flows. However, given the current economic fragility regarding the level of the CAD, avoiding hard landing scenarios would necessitate both CBT and government action of a more tangible and direct coordinated tightening. The BRSA is likely to step in summer months and join the CBT in trying to cool down domestic demand through imposing loan/value ratio increases for the housing loans, limiting credit card installment payments and perhaps escalating premiums on deposit insurances. We still plug in a mild 50bps rate hike in 4Q11, if not in late 3Q11. In the meantime, realization of a QE3, would be the worst case scenario for Turkey perhaps triggering further rate cuts and carrying the CAD to GDP ratio swiftly to double-digits.

**CREDIT GRWOTH REMAINS ELEVATED WHILE NON-RESIDENT INFLOWS INTO BOND MARKET SUSTAINS**

Non-resident bond holdings still up YTD (USDbn)



Credit growth remains elevated at this stage



Source: CBT, Eurostat, UniCredit Research

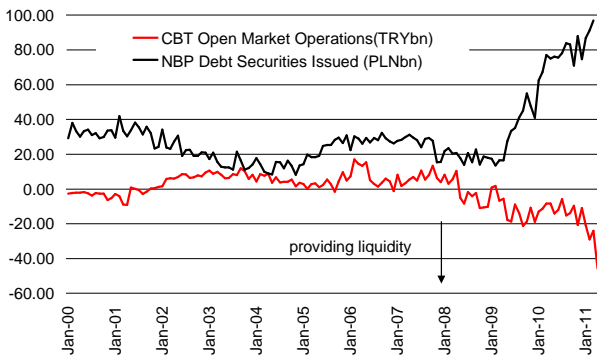
### Strategy: flatter curve, stabilizing TRY and U/W credit

**FX:** We think the CBT has the necessary toolkit to arrest any abrupt TRY weakness from the current levels. Specifically the CBT now provides more than TRY 50bn (4%/GDP) in repo funding to the banking sector whilst it still purchases USD 40mn per day in FX auctions. Following the recent inflation release and comments from the Governor we are not too far from the comfort zone in TRY vs. the basket (around 1.95) in our view. We do not think that the CBT would want to drive back the lira to Nov 2010 levels but do think that the risk reward is now more balanced on TRY longs against an environment where the bearish TRY view is a consensus. Accordingly, we are moving our TRY allocation to moderately U/W from full U/W.

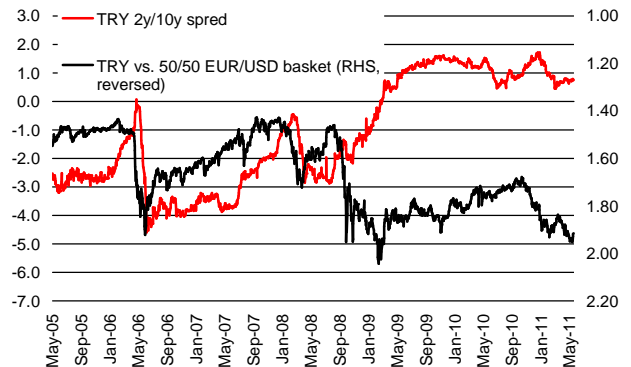
**Rates:** In local rates we recommend receiving 2Y/10Y TRY ccs spread at 80bp and target a move to around negative 100bp, as we believe the curve should flatten under both the positive and negative outcomes of the Turkish policy experiment. Namely, if the policy does not work and TRY comes under pressure with spiking inflation, the CBT will have to limit liquidity and hike policy rates pushing short end rates higher. As the policy mix requires a tighter fiscal policy to be successful this should be supportive for longer dated yields on the back of less supply. We hence do not think that the recent TRY curve steepening will sustain during 3Q and add a flattener position (receive 2Y/10Y TRY cross currency swaps).

**Credit:** We believe the Turkish credit market does not price the challenges properly and we recommend U/W in cash. In CDS we recommend buying 5Y Turkey versus selling 5y Romania.

The Turkish banking sector is more dependent on liquidity



TRY curve looks too steep



Source: CBT, UniCredit Research

#### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>234.4</b>	<b>175.1</b>	<b>181.0</b>
Budget deficit	39.6	25.0	20.0
Amortization of public debt	194.8	150.1	161.0
Domestic	178.1	135.0	145.0
Bonds	154.9	120.2	129.1
Bills	23.2	14.9	16.0
External	16.7	15.1	16.0
<b>Financing</b>	<b>234.4</b>	<b>175.5</b>	<b>181.0</b>
Non-market sources	38.5	35.0	38.0
Domestic borrowing	181.0	128.0	129.0
Bonds	160.0	117.8	114.8
Bills	21.0	10.2	14.2
External borrowing	14.9	12.5	14.0
Bonds	9.8	7.5	8.0
IMF/EU	0.0	0.0	0.0
Other	5.1	5.0	6.0

#### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
<b>Gross financing requirement</b>	<b>86.9</b>	<b>117.1</b>	<b>115.6</b>
C/A deficit	48.4	69.4	67.2
Amortisation of medium to long term debt	45.7	46.7	46.4
Government/central bank	7.9	7.7	7.4
Banks	6.7	9.0	9.0
Corporates	31.0	30.0	30.0
Errors and omissions	5.6	8.0	7.0
<b>Financing</b>	<b>88.5</b>	<b>117.8</b>	<b>114.9</b>
FDI	7.3	10.0	10.0
Equity	19.6	33.1	30.5
Borrowing	37.6	49.7	49.4
Government/central bank	6.2	7.7	7.4
Banks	7.2	9.0	9.0
Corporates	24.2	33.0	33.0
Other (incl. reserve accumulation)	24.0	25.0	25.0

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

**Outlook** – Robust real wage growth is supporting the recovery in consumption, while the renewed drive for borrowing by corporates and preparation for EURO 2012 provides impetus for a recovery in investment. We see domestic led factors playing a more important role in the structure of growth in the coming quarters. The government needs to be careful about avoiding fiscal slippage, as it has been slow to implement pension reform and tariff hikes.

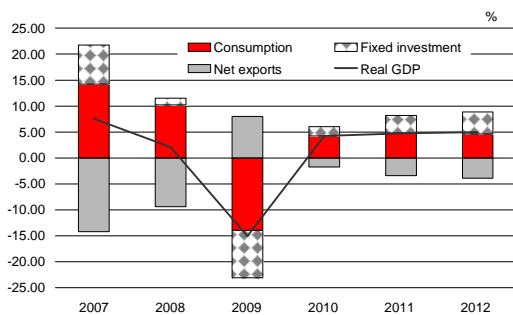
**Strategy outlook** – We continue to favor the UAH, on the back of robust levels of FX reserves and favorable developments on the BoP. On the Eurobond side we switch our focus to medium-to-long end bonds on better yield pick-up. Potential for volatility on the short-end of the curve given the risks around further IMF reform is another factor for the switch.

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### KEY DATES/EVENTS

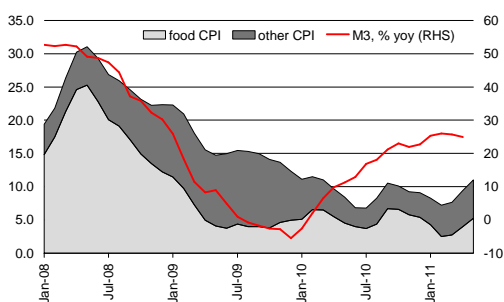
- Aug-Sept 2011 – Potential next IMF disbursement
- June 2012 – UEFA EURO 2012 football cup
- October 2012 – Parliamentary elections

### WITNESSING DOMESTIC DEMAND-LED GROWTH



Source: Ukraine State Committee Statistics, UniCredit Research

### NOT ONLY FOOD RISING IN PRICE



Source: Ukraine State Committee Statistics; UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	123.4	81.3	103.8	113.7	142.7
Population (mn)	46.2	46.0	45.8	45.5	45.3
GDP per capita (EUR)	2,671	1,768	2,267	2,497	3,152
<b>Real economy yoy (%)</b>					
GDP	2.1	-15.1	4.2	4.7	5.0
Private Consumption	11.6	-14.2	4.5	5.2	5.0
Fixed Investment	4.2	-46.2	8.5	15.0	17.0
Public Consumption	-0.4	-8.8	1.5	0.7	0.9
Exports	6.7	-25.6	10.0	10.0	11.0
Imports	17.5	-38.6	13.0	13.7	14.2
Monthly wage, nominal (EUR)	235	170	213	228	284
Unemployment rate (%)	6.4	9.0	8.4	7.5	6.9
<b>Fiscal accounts (% of GDP)</b>					
Budget balance	-1.3	-11.3	-6.2	-3.5	-2.5
Primary balance	-2.6	-5.1	-3.7	-2.0	-1.0
Public debt	13.7	35.0	42.2	42.0	36.7
<b>External accounts</b>					
Current account balance (EUR bn)	-9.4	-1.2	-1.9	-3.2	-4.5
Current account balance/GDP (%)	-7.6	-1.5	-1.8	-2.8	-3.2
Basic balance/GDP (%)	-1.7	2.5	2.5	2.0	1.7
Net FDI (EUR bn)	7.3	3.2	4.5	5.5	6.9
Net FDI (% of GDP)	5.9	4.0	4.3	4.9	4.9
Gross foreign debt (EUR bn)	75.1	72.6	87.8	87.2	105.1
Gross foreign debt (% of GDP)	60.8	89.3	84.6	76.6	73.6
FX reserves (EUR bn)	19.9	18.5	25.9	29.7	36.0
<b>Inflation/Monetary/FX</b>					
CPI (pavg)	25.2	16.0	9.4	10.2	9.6
CPI (eop)	22.3	12.3	9.1	10.5	9.0
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	12.00	10.25	7.75	8.00	8.00
3M money market rate	14.8	18.0	7.2	5.8	5.5
UAH/USD (eop)	7.81	8.01	7.97	7.75	7.40
UAH/EUR (eop)	10.90	11.48	10.66	12.01	10.66
UAH/USD (pavg)	5.24	8.06	7.95	7.89	7.58
UAH/EUR (pavg)	7.70	11.24	10.55	11.61	11.33

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

## Economics: Complacency is the concern

**Domestic demand playing a more important role in growth**

**GDP growth accelerated 2.9% qoq in 1Q11** vs. the 1% qoq growth seen in 4Q10, bringing headline growth to 5.2% yoy. We expect domestic demand to start playing a more important role in the structure of growth both in 2011 and 2012. High frequency data show real wage performance staying consistently above 10% yoy since May 2010. We ascribe the steady increase to the post crisis recovery but also to some reduction of the grey sector of the economy. The rise in incomes is also reflected in the robust growth rates seen in the retail sector, with turnover up 34% yoy in April 2011 and 26% yoy in 1Q11. Other indicators also suggest that Ukrainians are more willing to spend. For example sales of new cars rose 45% yoy in May, with consumers opting to upgrade (Russian VAZ-Lada lost its four decade long dominant position to Hyundai). For now we expect further household spending, but should tariffs for utilities be hiked in 2H11 there could be some headwind to the robust activity.

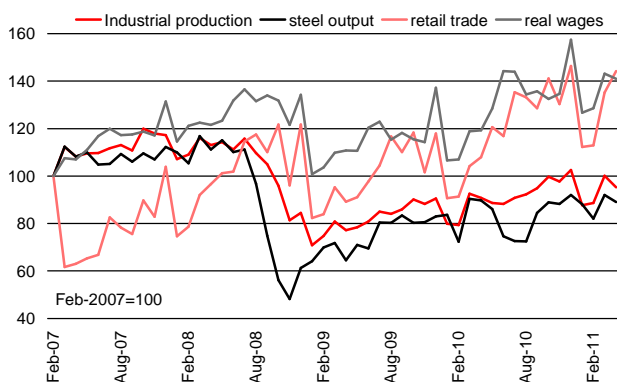
**Corporates tap lending, as households continue to deleverage**

**Household lending is improving only gradually**, from -13.1% yoy in December to +8.2% yoy in April. Total lending has seen more robust rates of recovery, at 8% yoy in April vs. 1.3% yoy seen in December. For now we are seeing most of the demand coming through from the corporate lending segment, up by 15.6% yoy in April, which bodes well for future growth in investment. Bank funding is not a problem, as we continue to see sustained and significant growth in deposits – so should there be demand for loans, banks could easily satisfy them. Re-accelerating bank lending has also been one of the stated priorities of the NBU. The finalization of the banking sector reorganization ought to facilitate this, as well as the fact that NPLs have now peaked and are expected to start declining in 2H11.

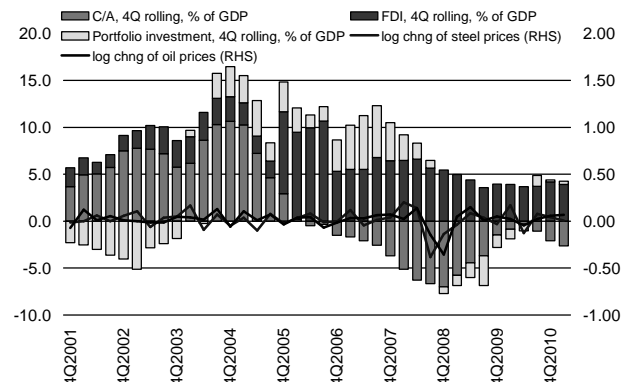
**Investment growth to remain robust on EURO2012 preparations**

**We expect to see further robust growth in investment** (at 12% yoy in 2H10). Base effects have continued to support performance in 1H11 and momentum has been building. Construction is seeing a recovery, on the back of EURO2012 preparations, with the volume of fulfilled building works up by 55% yoy in April after 37% yoy in 1Q (NBU's economic activity index also shows that construction was up by 6.8% YTD in 1Q11 after a 48.2% fall in 2009 and 5.4% fall in 2010, suggesting that the sector is coming out of the doldrums of the previous years). In terms of industrial production, April saw a softer patch of data coming in at 4.9% yoy (which still remains highly correlated to steel production, which has seen growth moderate). The softer data on this front reflects potential headwinds from softer global growth in the coming months. This in our view ought to be offset by higher growth in Germany (since our last publication the forecast has been increased by 1% for 2011 and 0.3% for 2012 to 3.5% yoy and 2.0% yoy respectively). On the back of that we maintain our growth outlook of 4.7% yoy for 2011 and 5% for 2012.

Wage recovery bodes well for domestic demand



BoP back to surplus, but commodity influence large



Source: Bloomberg, NBU, State Committee Statistics, UniCredit Research

**Budget performance OK, but more needs to be done to achieve eop target**

**In nominal terms, budget performance in 4M2011 is in line with that seen in 4M2010**, posting a deficit of UAH2.5bn (which is a mere 5% of the expected UAH 46bn deficit for 2011). Traditionally spending accelerates in 2H implying plenty of room for deterioration, but one supportive factor is the better revenue performance related to the new tax code. However, when one looks at the 12M rolling average, the improvement has been slow with the deficit oscillating around 5% of GDP. On a more positive note we continue to witness an improvement in the government's cash levels at the Treasury and NBU accounts, especially when compared to the 2010 lows. Key to future budget performance in our view is the government's willingness to hike tariffs and implement pension reform. Without some degree of reform fiscal slippage is very real, and would make the 3.5%/GDP deficit target difficult to attain.

**IMF stipulated reforms have the potential to be implemented before we enter the Oct-2012 parliamentary election cycle**

**We expect to have clarity on IMF stipulated reforms** before Rada goes into summer recess in mid-July. We place a 60% probability on the government coming to an agreement with the IMF and receiving the next disbursement in August. The latter would necessitate the passing of the pension reform, as well as some move on the issue of raising gas prices for the population. Should no reforms be passed this summer the chance of the IMF program being off-track for the rest of 2011 increases, given that MPs would already start thinking about the October 2012 parliamentary elections after coming back in September (especially so, given that the Party of the Regions popularity has been on the decline).

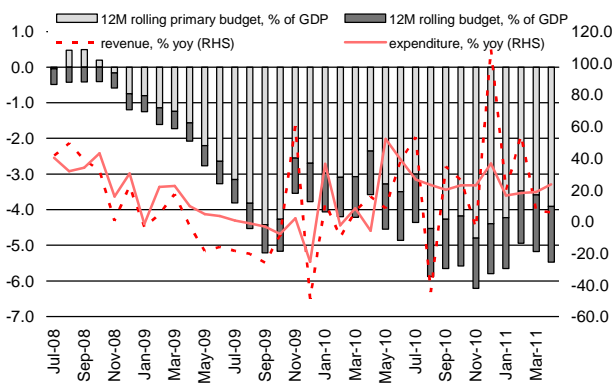
**C/A deficit growing but offset by FDI and other capital inflows**

**We continue to witness favorable developments on the BoP** (a surplus of USD 2.1bn in 4M11 vs. USD 0.6bn in 4M10). That, coupled with access to external markets compensates for lack of IMF funds. Ukrainian corporates have tapped the Eurobond market worth USD 3bn YTD vs. USD 2.5bn in 2010, while the sovereign has also issued USD 2.75bn worth of bonds YTD, with the June 06/2016 issue seeing good international demand. On the other hand, the C/A deficit is growing, up to USD 1.6bn in 4M11, with higher gas prices remaining a drag on the economy, although by the same token these are to a large degree offset by a pick-up in metals and agricultural exports.

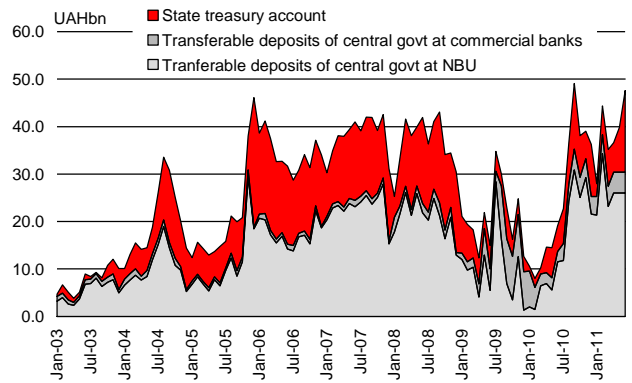
**NBU has sufficient FX reserves, and is looking more closely at the inflation prints**

**Should no disbursements come through from the IMF in 2011**, our calculations show that NBU FX reserves would remain at levels seen at the start of the year (USD 35bn). That would imply some USD 3bn decrease from current levels, given the need towards continuous intervention on behalf of the NBU to keep the UAH stable. Given these risks we believe that the NBU will continue its current policy of keeping the UAH stable for now. Comments from Governor Arbuzov suggest that more FX flexibility is only likely once the forwards and futures contracts markets are operating. A stronger UAH would fit into the more hawkish statements from the NBU on inflation, which came in at 11% yoy in May – a result of a less benign base effect and some reacceleration of food price pressures.

Govt deficit improving slowly, more is needed to achieve eop target



Government cash levels back to pre-crisis levels, and rising



Source: MinFin, NBU, State Treasury, UniCredit Research

## Strategy: go long, but differentiate

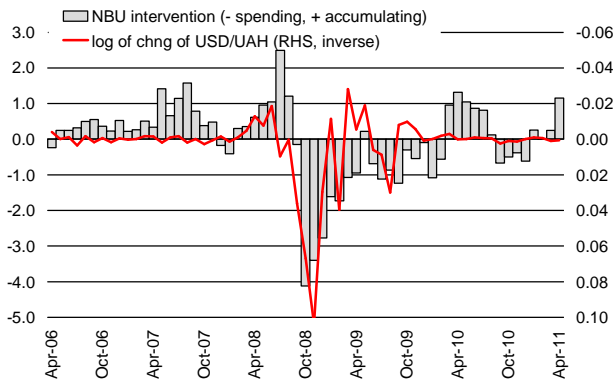
### NDF market continues to price in depreciation

#### Forward UAH rates, bid

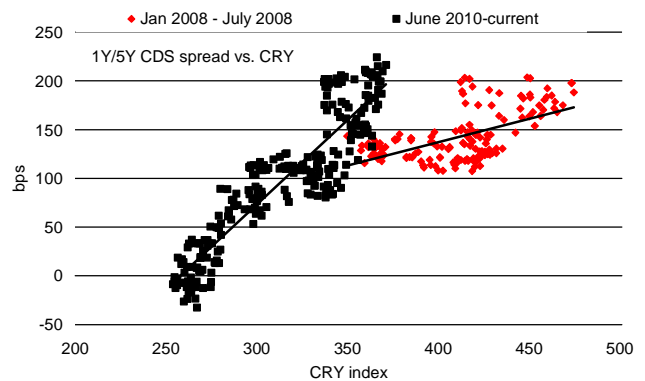
Current	7.99
1M	8.02
3M	8.09
6M	8.25
9M	8.39
12M	8.55
18M	8.80
2Y	9.11

The NDF market still prices in too much devaluation and we **continue to favor being short USD/UAH through longer dated NDF's**. NBU FX reserves are at a comfortable level (USD 38bn in May), and could carry on growing should the IMF tranches come through in the coming months exerting additional pressure on the UAH (should no money come through, we would expect the UAH to remain stable, although traditional pressures on the UAH could materialize in September – a result of "harvest money" being converted into FX). In terms of credit, we have continued to see further steepening of the credit curve, which has been chiefly a result of tightening on the short end (we expect further contraction). Progress on the 5Y CDS segment is, in our view, dependent on progress with the IMF. However, the **steepening on the curve is now much more reactive to commodity price rises** (which was not the case in 2008), implying that further normalization will also be related to commodity price movements. In terms of **Eurobonds, we switch from short-end bonds to more longer term maturities (5-10Y)** as these now offer more yield pick-up, besides there could be more volatility on the short-end in reaction to any negative news on further IMF cooperation.

### NBU continues to exert control over FX market



### CDS spread has become more reactive to commodity prices



Source: Bloomberg, NBU, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>11.1</b>	<b>8.1</b>	<b>6.3</b>
Budget deficit	6.2	3.7	3.5
Amortization of public debt	4.9	4.3	2.8
Domestic	2.4	2.3	2.2
External	2.5	2.0	0.6
<b>Financing</b>	<b>11.1</b>	<b>8.1</b>	<b>6.3</b>
Domestic borrowing	5.1	5.7	4.5
External borrowing	5.9	2.4	1.9
Bonds	2.8	1.8	1.0
IFI	1.7	0.6	0.8
Other (VTB loan)	1.5	0	0

### GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F
<b>Gross financing requirement</b>	<b>29.7</b>	<b>25.2</b>	<b>27.1</b>
C/A deficit	1.9	3.2	4.5
Government/central bank	2.5	2.0	0.6
Amortization of medium to long term debt	11.5	8.4	9.6
Banks	4.3	3.2	3.7
Corporates	7.1	5.2	5.9
Short term debt amortization	8.8	7.4	8.0
<b>Financing</b>	<b>33.2</b>	<b>28.7</b>	<b>29.5</b>
FDI	4.3	5.5	6.9
Portfolio flows	3.7	2.6	3.5
Borrowing	17.2	14.1	12.4
Government/central bank	2.8	1.8	1.0
IMF	2.6	3.9	1.6
Banks	2.9	2.3	2.8
- Corporates	8.9	6.1	6.9
Short-term	7.7	5.3	5.9
Other	0.3	1.2	0.8

**Notes**

**Notes**

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