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4Q **2009**



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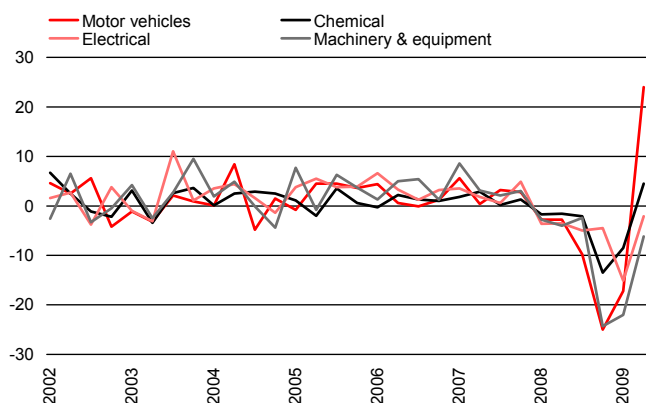
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Emerging Europe: Relief, not euphoria

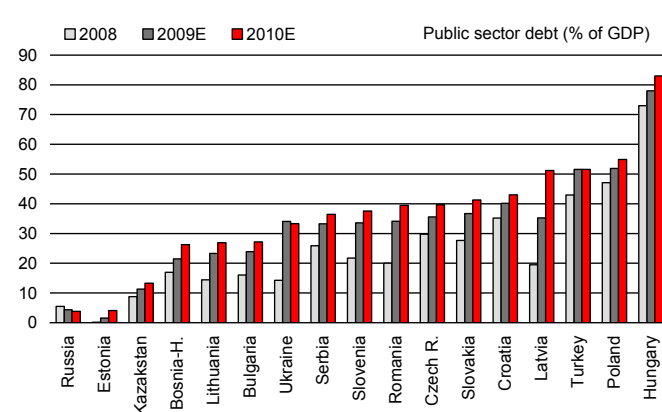
- **On the back of the healthier than anticipated rebound in global growth we have marginally raised our broad CEE17 growth forecast to 1.4% (by 0.3pp) in 2010. The modest size of the revision signals that we feel more confident about the economic recovery in EME, but certainly not euphoric, as headwinds at both the global and local level will limit the pace of recovery going forward.**
- **The global economy** is rebounding faster than anticipated, driven by a robust recovery in global trade. Germany has also surprised on the upside, and the rapid improvement in the euro zone should quickly transmit to CEE. The more open economies (Czech Republic, Hungary, Slovakia) are best positioned, but Poland for now remains the outperformer.
- **CEE vulnerabilities** have shifted from external to fiscal balances, as the growth contraction has narrowed C/A gaps and widened fiscal deficits, including in Poland and Turkey. Hungary and to some extent Romania are bucking this trend, with a prudent fiscal stance in the context of IMF-supported programs. Political ramifications of these adjustments have, however, been evidenced by the recent collapse of the Romanian government.
- **Key macro forecast highlights:** **1.** Although Poland is outperforming at the moment we believe this reflects the late cycle nature of its economy, and expect this to turn into underperformance in 2010-2011. We hence increased our 2009 GDP forecast but slightly reduced 2011, **2.** We expect the Turkish economy to significantly outperform the region in 2010 and see GDP growing at 3.2%, **3.** Despite the recent surge in oil prices we expect the Russian economy to only grow by 1.3% in 2010 due to weak domestic demand, **4.** We expect Hungary, the Baltic Countries, Bulgaria, Croatia and Serbia to remain in recession in 2010.
- **FI/FX market outlook:** We expect the likely appreciation pressure on CEE currencies to translate into sustained low levels of short-end rates and we see scope for ongoing underperformance of CEE FX vs. other asset classes. As such we only expect the PLN to meaningfully appreciate by the end of the year given undervaluation and expected privatization flows.

IMPROVEMENT IN GLOBAL TRADE IS POSITIVE BUT VULNERABILITIES SHIFTED FROM THE EXTERNAL TO THE FISCAL SIDE

Global trade driving the recovery (German foreign new orders)



CEE vulnerabilities shifting from the external to the fiscal side



Source: UniCredit Research

Global recovery underway, with strong short-term momentum

The global economy is currently enjoying a robust and broad-based rebound, but momentum will weaken in 2010

The recent round of 2Q GDP releases has confirmed that the global economy has rebounded sooner and faster than markets had been anticipating. The evidence in terms of hard data suggests that this recovery is genuine, and in coming months will probably continue to look V-shaped, fueling market optimism. In the euro zone, economic activity contracted a mere 0.2% on a quarterly basis, much less than expected, thanks to upside surprises in France and in Germany, where quarterly growth has already returned to positive territory. In the US, 2Q GDP showed a 0.7% annualized contraction, while the UK was the only developed economy to disappoint, showing a 0.8% qoq decline. In Asia, the main emerging economies grew by an average annualized rate of more than 10%, and even sluggish Japan rebounded by a solid 0.9% qoq. The resilience of Latin America, especially Brazil, has also surprised on the upside.

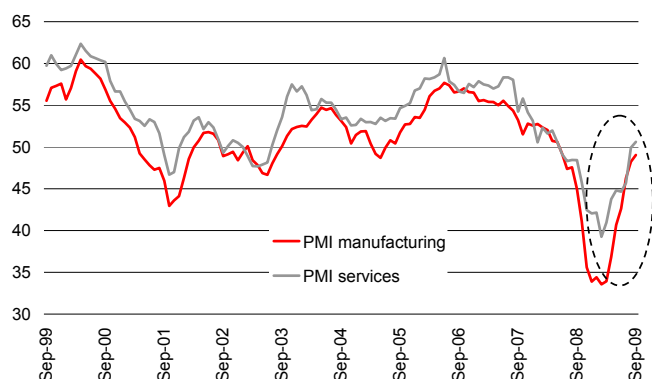
While policy stimulus has played a key role, it is global trade that has become the main engine of the recovery: the acceleration in economic activity has started most decisively in Asia, and its robust pace has helped turn net exports into an important contributor to growth – together of course with the ongoing contraction in imports.

The positive momentum of data surprises is likely to continue until the end of the year and possibly into early 2010, pushed by three main drivers: 1. global trade will continue to provide support; 2. the inventory cycle is only now kicking in with gusto, and will start showing up in the GDP growth data beginning in 3Q (inventories subtracted as much as 0.7pp from euro zone growth in 1Q and 2Q); and 3. already enacted policy stimulus will continue to come on line and propel the economy.

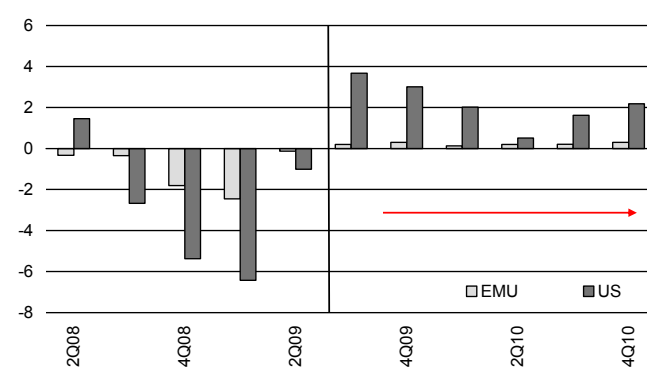
However, growth momentum is fated to fade into 2010 especially in the developed economies. Even though supportive policies will remain in place, policymakers will not provide fresh stimulus as the economy improves, and the policy impulse will therefore abate. Private sector demand should take up the baton, but both investment and consumption face important headwinds: 1. consumption will be held back by rising unemployment; and 2. investment will be restrained by historically low levels of capacity utilization and the already high levels of leverage by corporates.

HEALTHY RECOVERY IN THE EURO ZONE UNDER WAY BUT WE EXPECT ANOTHER SLOWDOWN IN 2Q10

Healthy recovery in the euro zone



Recovery underway, but momentum will weaken in 2010



Source: Markit, UniCredit Research

CEE to benefit from global recovery, but concerns persist on fiscal imbalances and lending

The faster pick-up in the euro zone will gradually support a recovery in CEE activity

The sharp pick-up in euro zone sentiment indicators is already reflected in better CEE business sentiment – CEE should benefit very soon from the strong German recovery.

This will primarily support countries with more open economies (Czech Republic, Hungary, Slovakia). Besides net exports, a further contribution to growth should come from a turnaround in the inventory cycle: the sharp recession registered throughout the region in 1Q and 2Q included an unprecedented rapid downward adjustment in inventories – which now bodes well for near-term recovery prospects. **Poland remains the outperformer in terms of growth.** The country has successfully avoided recession, and is poised for growth of 1.5% this year, as private consumption has remained resilient in the face of rising unemployment. This outperformance, however, in part reflects a late-cycle phenomenon: we expect investment and consumption to struggle, restraining the acceleration of growth to rates well below potential in 2010-11.

Sentiment indicators failed to improve in the service sector, however, which suggest that domestic demand is set to remain weak in the coming quarters:

1. CEE retail sales correlate highly with credit, and hence household demand will remain weak where the banking sector relied heavily on external financing, and is currently reducing its loan to deposit ratios by moderating lending. The winners here are Turkey and Poland, where loan to deposit ratios are below 100%; and which are therefore less vulnerable to deleveraging in the banking sector.

2. Investment will remain extremely soft given that significant spare capacity gives firms leeway to increase production and delay new investment until they have greater confidence in the recovery.

This implies that after a deep recession, the structure of CEE growth is changing in favor of net exports. This has already helped to drive a fast and significant reduction in external current account imbalances, which were the region's Achilles' Heel – external financing risks are therefore declining quickly. Turkey, where the adjustment has been helped significantly by lower energy prices, is a case in point: we project the C/A deficit to narrow to 1.5% this year from nearly 6% last year.

In some countries, however, fiscal imbalances are becoming a concern. In Kazakhstan and Russia falling commodity prices and lower revenues are pushing deficits wider – although the low level of total public sector debt (Russia: 4.4% of GDP estimated for end of 2009) (Kazakhstan: 11.3% of GDP estimated for end of 2009) is a supportive factor. Within CEE, Hungary is the strong performer on this front: in the context of its IMF program, it is running a tight fiscal policy to balance the fact that it has the highest debt ratio in the region (79% of GDP estimated for end of 2009). In contrast, fiscal deficits are widening rapidly in Poland and Turkey.

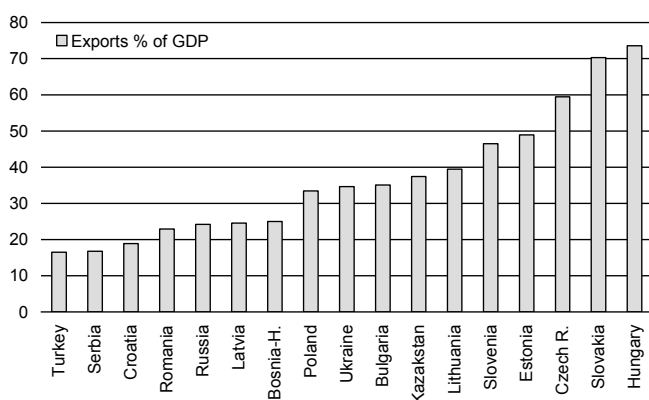
Just as in the euro zone, there is concern that a contraction in lending could hamper the recovery in the EEMEA region. In the euro zone, this concern has been clearly articulated by the ECB: the worry is that as non-performing loans rise due to the recession, their adverse impact on banks' balance sheets will trigger another round of deleveraging via a contraction in lending. Given the strong inter-relation between the banking system in the euro zone and in EEMEA, this credit squeeze would then most likely manifest itself across the whole European region. This concern needs to be taken seriously, as some lending markets have already come under stress, notably in Romania.

However, conditions in the banking sector are improving: 1. banks' profitability has increased recently, with support coming also from the recovery in asset prices, which has led the IMF to lower its estimate of total financial sector losses; 2. the improvement in the growth outlook reduces the downside risks to the NPL forecasts; and 3. some banks have already begun to strengthen their capital positions, thereby putting themselves on a stronger footing to sustain credit growth. Within the euro zone, there are some encouraging signs of ongoing normalization in financial markets, including a much reduced demand for liquidity at the ECB's Long Term Refinancing Operation on 29 September.

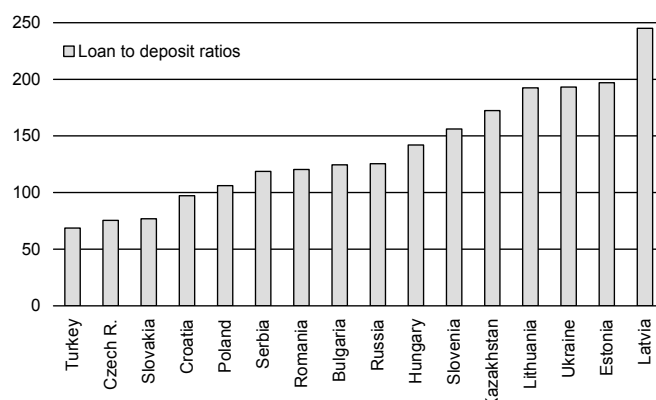
Bottomline: the growth outlook for the EEMEA region has improved – even though the region remains in a more vulnerable position than Emerging Asia and Latin America – and vulnerabilities have now shifted from the external to the fiscal side. With the recovery getting underway, rate cutting cycles are coming to an end: Turkey, Hungary and Russia are the only countries where we expect further rate cuts before year-end. It is too early, however, to start betting on a turn in the monetary policy cycle. With growth outlooks still uncertain and more dependent on exports, and hence competitiveness, central banks will remain wary of fuelling currency strength and will maintain a dovish bias for longer than markets expect. Even in the cases of the Czech Republic and Poland, where central banks have signaled the end of the easing cycles, markets are in our view too aggressive in pricing future hikes (see below).

MORE OPEN ECONOMIES SET TO BENEFIT THE MOST BUT LENDING WILL REMAIN SOFT IN SOME COUNTRIES

More open economies set to capitalize on recovery in global trade...



Lower banking sector leverage = lower risk to lending levels



Source: Fitch, UniCredit Research

FI/FX market strategy

Following a stellar second quarter when EEMEA/USD was up by 13.5%, EEMEA FX started to decouple from other asset classes in 3Q09. Our EEMEA/USD basket closed only 3.8% higher vs. a near 15% jump in SPX and the average 100bp spread tightening in their own 5y sovereign CDS. The divergence is even bigger when measured vs. the EUR given the general USD weakness observed in the last quarter. Moreover EEMEA FX has also underperformed the local rates market. This decoupling trend is even more spectacular considering the significant improvements in the region's current account balances during the third quarter. We attribute these developments to the following two factors:

1. **As domestic demand is still very weak and net exports have taken the lead in GDP growth central banks have become less tolerant toward stronger currencies** particularly given painful competitiveness gains at the end of last year. This is evidenced by ongoing rate cuts in Turkey (150bp in 3Q), the restart of the easing cycle in Hungary (200bp in 3Q vs. no change in 2Q) and the 150bp rate cuts together with increased intervention efforts by the Central Bank of Russia. The strength of this factor is also evidenced by the fact that the two best performing currencies in the CEE region were PLN and CZK where CenBanks hinted that they are finished with rate cuts (for now) and yield curves started pricing rate hikes (forward rate agreements indicate around 80bp rate hikes from both central banks over the next 12M).
2. **Non-resident holding data suggest that non-resident real money positioning is still relatively light in the local markets.** This indicates that the rally in local markets was mostly driven by local participants. For instance the non-resident ownership of HGBs has failed to increase since the end of July, non-resident ownership of TURKGBs was up by 8% but a significant part of this was driven by valuation effects. And finally we believe that inflows into dedicated euro zone convergence funds have not been remarkable in the last quarter.

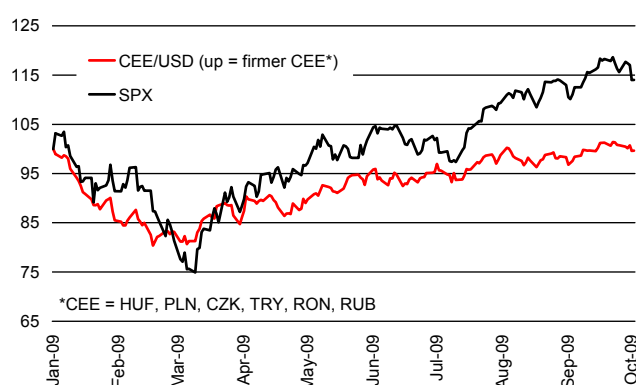
Looking ahead we expect the external balance improvement to put further appreciation pressure on FX, which CenBanks will continue to resist. On top of a temporary inventory driven deterioration we expect CEE current accounts to continue delivering positive surprises as household demand is still very weak (lower wages, soft lending growth) vs. a somewhat improved outlook for exports. We believe that the associated FX appreciation pressure is still unwelcome and CenBanks will continue to resist it with low rates and interventions. Against this backdrop although both Poland and the Czech Republic signaled the end of their easing cycles we think that no imminent rate hikes are on their agenda. On the other hand, we expect Hungary (further 50bp by year end), Turkey (at least further 50bp by year end) and Russia (further 100bp by year end) to continue the easing cycle in the next quarter. We believe this trend will continue to support the short end of the yield curves and we are particularly positive about Russia (as CBR tries to draw a line under the basket), Czech Republic and Poland (where the curves are pricing rate hikes). Additionally we see scope for further downside in TRY and HUF short end.

While external financing risks have been broadly addressed, focus will remain on fiscal policies with associated pressure on the long end of the curves. This can be best assessed, in our view, through ASW spread developments and on the shape of the yield curves. According to our estimates, although the level of Polish and Czech long end yields are relatively high, only the Turkish yield curve includes a fair amount of risk premium while the other curves have steepened on the back of falling short ends and steeper EUR yield curve. We think that risk premium vs. fiscal risks will continue to hang over the long ends of the curves vs. the short ends in Poland, the Czech Republic and potentially in Russia in the coming quarter.

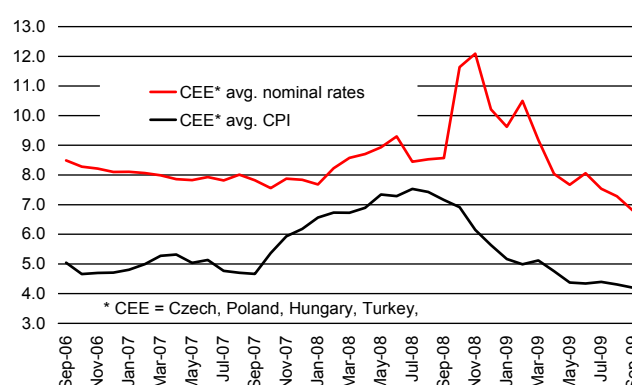
Bottom line: Overall, we expect that the likely appreciation pressure on CEE currencies will translate into a sustained low level of short end rates and we see scope for ongoing underperformance of CEE FX vs. other asset classes. As such, we only expect the PLN to meaningfully appreciate by the end of the year given undervaluation and expected privatization flows. In the bond markets we expect the long ends to continue underperforming short ends where the curve does not price sufficient fiscal related risk premium (Poland, Czech Republic and Russia).

CEE FX DECOUPLED FROM IMPROVING RISK APPETITE

CEE FX decouples from SPX in 3Q...



as CEE CenBanks accelerated rate cuts



Source: UniCredit Research

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Bulgaria



Outlook

We expect the downturn to deepen in 3Q09 but see some scope for an inventory driven recovery after this period. Given the limited ability of local policymakers to loosen fiscal and monetary policy we believe that the worst is not over yet for Bulgaria and we expect GDP to contract in 2010 by 2.5%, which appears to be in line with the recent IMF forecast but circa 2% below market consensus.

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Long-term foreign currency credit rating	Moody's Baa3 stable	S&P BBB negative	Fitch BBB- negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	28.9	34.1	32.9	31.8	32.9
Population (mn)	7.6	7.6	7.6	7.5	7.5
GDP per capita (EUR)	3,782	4,485	4,341	4,225	4,396
GDP (constant prices yoy %)	6.2	6.0	-6.3	-2.5	2.0
Private Consumption, real, yoy (%)	5.1	4.5	-7.5	-5.3	-2.1
Fixed Investment, real, yoy (%)	21.7	20.4	-22.4	-15.7	-5.0
Public Consumption, real, yoy (%)	3.4	-1.4	-1.2	2.0	1.5
Exports, real, yoy (%)	5.2	2.9	-15.8	-3.8	5.0
Imports, real, yoy (%)	9.9	4.9	-23.4	-11.2	-2.8
CPI (average, yoy %)	8.4	12.4	2.6	-0.6	1.5
Central bank reference rate	4.58	5.77	2.15	3.30	4.80
Monthly wage, nominal (EUR)	220	268	252	237	234
Unemployment rate (%)	6.9	6.3	9.5	12.9	13.5
Budget balance/GDP (%)	3.5	3.0	-0.3	-1.8	-1.8
Current account balance (EUR bn)	-7.3	-8.6	-4.1	-2.9	-2.3
Current account balance/GDP (%)	-25.1	-25.3	-12.4	-9.1	-6.9
Net FDI (EUR bn)	8.3	5.7	2.7	2.1	2.1
FDI % GDP	28.7	16.7	8.3	6.5	6.5
Gross foreign debt (EUR bn)	29.0	36.7	35.6	34.9	35.3
Gross foreign debt (% of GDP)	100.2	107.7	108.5	109.8	107.1
FX reserves (EUR bn)	11.9	12.7	11.2	10.0	10.1
(Cur.Acc-FDI)/GDP (%)	3.5	-8.6	-4.1	-2.6	-0.4
FX reserves/Gross foreign debt (%)	41.2	34.6	31.4	28.6	28.7
Exchange rate to USD eop	1.34	1.40	1.33	1.32	1.42
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD AVG	1.43	1.33	1.39	1.30	1.38
Exchange rate to EUR AVG	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Strong commitment of the new administration to cut corruption and press ahead with other structural measures
- Significant potential to support growth by improving EU funds absorption

WEAKNESSES

- Large private sector funding gap
- Lack of exchange rate flexibility
- Limited room for fiscal and monetary policy expansion

Recovery is around the corner, but the worst is not over

Economy will hit the bottom in 2H09, as recession in industrial sector spills over into services sectors

GDP continued to contract to 4.9% yoy in 2Q09 from 3.5% yoy in 1Q09, with gross fixed investments and private consumption being the main drags. Activity indicators reported positive mom readings in July and August, but remain close to the -20% mark on a yoy basis. Retail sales dipped to fresh lows, as the downturn stimulated a move from consumption and borrowing towards savings and debt consolidation. Forward-looking indicators are not far from their lowest levels ever; signaling the worst is not over and output contraction is likely to have sharpened in 3Q09. Rebalancing of the labor market advanced at an encouraging pace in 1Q09 but lost momentum in 2Q09, partly due to the lack of effort to scale back jobs and wages in the public sector ahead of the general election in June. In August, CPI receded to just 1.3% yoy from 11.2% yoy one year ago, after headline inflation posted negative mom readings in the last four consecutive months. In 2Q09, housing prices lost 9.7% of their value qoq and were 24.2% down from their peak in 3Q08. Credit growth has come to a near-halt, as banks are under pressure to cutback external borrowing and growth of domestically attracted deposits lost momentum to just 0.9% yoy in August. On the positive side, the unwinding of the C/A gap has progressed at a faster than expected pace causing a pronounced improvement in the external position of the country.

Stronger than expected external balance improvement is under way

Rising job losses, falling housing prices and anemic credit growth will take their toll on consumer spending

We expect output in the manufacturing sector to stabilize in 1H10, as inventories start to be rebuilt and the growth prospects in the euro zone are less bleak, in our view. Despite the signs that manufacturing may turn the corner soon, there are several second-round-crisis effects which are now hitting the economy. The combination of rising job losses, falling housing prices and anemic credit growth will keep GDP growth negative next year. We expect the recession to be technically over at the end of 2010 or in early 2011, but at the same time the origins of the downturn does not augur for a strong rebound. In our view, self-sustainable recovery will not be possible without a normalization of lending growth and stabilization of the housing market. In addition, more time will be needed to steer the economy towards a more sustainable growth pattern, shifting production resources from overheated domestic-demand-oriented sectors to higher-value-added export driven industries.

Bumpy and protracted recovery lies ahead...

Despite difficult environment the new government seems to have restored fiscal discipline

The anti-crisis measures implemented by the previous government were too-short-term and lacked the focus to match the severity of the downturn. Following the general elections we have seen a pronounced shift toward more prudent policies. The new administration adopted a more decisive stance against corruption, which remains the Achilles heel of the economy, and embarked on aggressive cost cutting as it became clear that the lack of fiscal policy adjustment during the first seven months of the year could lead to a huge budget deficit in 2009. The authorities are now committed to downsizing public administration, bringing wage growth in line with productivity, linking pension growth to budget performance and shifting the financing of public investments at the expense of higher EU funds absorption and external borrowing. To help the recession-battered private sector the government will speed up VAT refunds, cut the social security contribution rate, reduce the number of license regimes and streamline the public procurement process.

Strong reform agenda reduces the pain from the downturn and helps bring end to recession

The policy approach seems to be the right one. Given the limited room for fiscal and monetary policy expansion under the fixed exchange rate regime, attention has shifted toward pressing ahead with the structural measures needed to improve competitiveness in the medium-to-long term, while at the same time boosting the absorption of EU aid which should provide the necessary stimulus for domestic demand in the short-run.

We see low risk of a sovereign ratings downgrade

The combination of re-established fiscal discipline and the strong commitment of the new administration to cutback corruption and press ahead with structural measures is a big plus for Bulgaria's sovereign ratings. In addition, in contrast to other emerging markets with pegged currencies, Bulgaria has better reserves metrics and exhibits less painful economic adjustment dynamics.

Czech Republic



Outlook

We have increased our 2010 GDP forecast to 1.4%, due to a somewhat better export outlook and an expected rebuild of inventories, domestic demand is to remain weak, however. Against this backdrop we do not think that the CNB will tolerate a much stronger CZK and only expect a 25bp rate hike at the end-2010 while forecast EUR/CZK at 26.00 in both years.

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Long-term foreign currency credit rating	Moody's A1 stable	S&P A stable	Fitch A+ stable
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	127.3	148.1	137.7	144.3	155.2
Population (mn)	10.3	10.4	10.5	10.5	10.6
GDP per capita (EUR)	12,336	14,198	13,127	13,683	14,642
GDP (constant prices yoy %)	6.1	2.7	-4.2	1.4	3.5
Private Consumption, real, yoy (%)	4.9	3.4	1.1	-0.6	3.0
Fixed Investment, real, yoy (%)	10.8	-1.1	-8.0	-2.5	4.0
Public Consumption, real, yoy (%)	0.7	1.6	2.6	0	2.0
Exports, real, yoy (%)	15.0	6.6	-10.2	6.0	9.0
Imports, real, yoy (%)	14.3	5.0	-10.0	5.9	8.5
CPI (average, yoy %)	2.8	6.3	1.1	2.2	2.1
Central bank reference rate	3.50	2.25	1.25	1.50	3.25
Monthly wage, nominal (EUR)	755	910	879	907	971
Unemployment rate (%)	6.6	5.5	8.1	9.6	9.4
Budget balance/GDP (%)	-0.6	-1.5	-7.0	-5.0	-4.6
Current account balance (EUR bn)	-4.1	-4.6	-2.0	-3.1	-4.1
Current account balance/GDP (%)	-3.2	-3.1	-1.5	-2.1	-2.7
Net FDI (EUR bn)	7.6	7.3	4.0	4.2	5.5
FDI % GDP	6.0	4.9	2.9	2.9	3.5
Gross foreign debt (EUR bn)	51.6	57.8	64.2	67.3	74.0
Gross foreign debt (% of GDP)	38.9	42.1	45.8	46.6	46.7
FX reserves (EUR bn)	23.7	26.6	28.0	29.0	29.0
(Cur.Acc-FDI)/GDP (%)	2.8	1.9	1.4	0.8	0.9
FX reserves/Gross foreign debt (%)	45.9	46.0	43.6	43.1	39.2
Exchange rate to USD eop	18.19	19.21	17.69	17.57	18.12
Exchange rate to EUR eop	26.52	26.80	26.00	26.00	25.00
Exchange rate to USD AVG	20.25	16.97	18.79	17.22	17.96
Exchange rate to EUR AVG	27.75	24.96	26.50	26.00	25.50

Source: UniCredit Research

STRENGTHS

- External financing at comfortable levels
- Flexible monetary policy
- Low vulnerability of financial sector

WEAKNESSES

- Austerity package to hit private consumption
- End of car subsidies in W. Europe to drag on auto industry
- Interim government lacking political mandate

GDP growth: exports and inventories to drive recovery

2Q GDP structure barely changed from 1Q, with inventories remaining the most depressing component

GDP grew by a mere 0.1% qoq in 2Q, ending 6 months of recession, but its yoy contraction still gained momentum to 5.5% from 1Q's 4.5%. The deepening of yoy decline resulted almost solely from a sharp reduction of inventories which wiped off 4.4pp from 2Q GDP. Retaining a similar dynamic to 1Q, fixed capital formation was down 7.2% yoy while private consumption rose 1.6% yoy, which implies that households have redirected their spending from investment to consumer goods. Finally, net exports continued to improve on the previous quarters, although their contribution to GDP was still negative (-0.7pp). The trend of falling inflation has remained intact with headline CPI dropping to a mere but still positive 0.2% yoy in August. Prices of food and transportation costs have been particularly compressed but both with the signs of bottoming out. Importantly, the country's external position has kept firm despite sharply slowing net FDI inflow. This is thanks to improving foreign trade and shrinking outflow of dividends which have brightened the picture on the C/A front.

Net exports and inventories to drive the economic rebound from 2H09

We believe the recession in yoy terms peaked in 2Q. Even though the first month of 3Q brought little signs of a rebound in the activity data, leading indicators combined with a favorable base effect paint a somewhat rosier picture for August onwards. We expect the upturn in GDP to be led by a rally in stock-building and a better export performance. That said, fixed capital formation is projected to remain depressed and the positive growth in private consumption should gradually evaporate. On balance, we have made few changes to the outlook for the GDP dynamic in 2H09, but a weaker than expected outcome in 1H has led us to revise the full-2009 GDP forecast down to -4.2% from -3.2%. By contrast, we have lifted the GDP growth forecast for 2010 from 0.7% to 1.4% in reaction to improved prospects for Germany (could be even higher without the austerity package). Hence, foreign demand is set to become the engine of GDP growth, propping up both exports and inventories, while domestic capital and household spending will hardly make any contribution to the recovery.

Austerity package to prevent public sector deficit from bursting

Our GDP and public sector deficit forecasts take into account the government austerity package recently approved by parliament. We estimate that the underlying fiscal restriction will slash next year's public sector deficit to 5% of GDP from 7% of GDP if there is no policy change scenario. Unlike its negative impact on GDP growth worth roughly 0.8pp in 2010, the package implies a stronger expansion for 2011, with our prediction for 3.5% GDP growth looking appropriate.

Risk of a November rate cut increasing, our baseline remains unchanged rates until end 2010

Although the August interest rate cut was not repeated in September, the recent appreciation pressure on CZK and dovish comments from the CNB suggests that the risk of a November rate cut is increasing. From a broader perspective our baseline scenario, however, remains that no more rate cuts will arrive in this cycle as inflation is approaching its bottom and economic activity is apparently behind the turning point. Given a parliamentary "yes" to a bolder fiscal restriction, we assume that the CNB will put off the start of a tightening cycle until late 2010. Importantly, planned hikes in VAT and excise taxes, which are supposed to add around 1%- point to the headline inflation next year, should not influence the CNB's decision making. We expect the repo rate at 1.50% at end-2010.

Period with the interim government in power extended after an early election plan scrapped

Political uncertainty increased sharply after the Constitutional Court scrapped a law allowing an early election to be held on 9-10 Oct. The chance of an election taking place before the year-end were then killed by the leftist parties, leaving the responsibility for the preparation of the 2010 budget to the interim government of PM Fischer. The austerity package supported by both main left and right-wing parties has given Fischer's cabinet wide political backing and has raised the likelihood it will stay on until the end of regular term in May 2010.

CZK will lack extra fundamental support to resume the firming trend next year

CZK has extended its rally against the euro by another 3% over the last three months taking little notice of the increasing tension on the political scene. However, we doubt that CZK will be able to keep these gains, forecasting its retreat to EUR/CZK 26.0 which is viewed as the level more consistent with CZK's long-term trend.

Estonia



Outlook

Estonia's economy has contracted very sharply since the credit crunch and, as a result, we continue to believe that plans to introduce the euro as early as in 2011 are very ambitious and are unlikely to happen. Nevertheless, we will keep a close eye on fiscal developments, which are also expected to influence the ratings outlook.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	WR negative	A- negative	BBB+ negative

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	15.6	16.1	13.1	11.5	10.4
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,644	12,001	9,813	8,584	7,815
GDP (constant prices yoy %)	6.3	-3.5	-15.3	-3.8	5.1
Private Consumption, real, yoy (%)	7.9	-4.6	-16.2	-5.2	2.3
Fixed Investment, real, yoy (%)	4.8	-11.5	-29.2	-3.2	1.2
Public Consumption, real, yoy (%)	3.9	4.1	-4.7	-4.1	0.6
Exports, real, yoy (%)	0	-0.7	-12.3	-1.8	4.3
Imports, real, yoy (%)	4.2	-8.7	-23.9	-2.6	0.5
CPI (average, yoy %)	6.6	10.4	-0.1	-1.4	1.7
Monthly wage, nominal (EUR)	725	819	776	709	584
Unemployment rate (%)	4.7	5.5	13.5	15.4	15.1
Budget balance/GDP (%)	2.7	-2.9	-4.0	-4.4	-4.7
Current account balance (EUR bn)	-2.8	-1.5	0.1	0.2	0.4
Current account balance/GDP (%)	-18.1	-9.4	1.0	1.9	3.8
Net FDI (EUR bn)	0.8	0.6	0.1	0.2	0.2
FDI % GDP	5.3	3.7	0.6	1.5	2.0
Gross foreign debt (EUR bn)	17.2	19.1	16.5	15.8	14.1
Gross foreign debt (% of GDP)	112.4	118.5	125.6	138.3	135.7
FX reserves (EUR bn)	2.2	2.8	2.3	2.0	2.2
(Cur.Acc-FDI)/GDP (%)	-12.5	-5.7	1.6	3.3	5.7
FX reserves/Gross foreign debt (%)	13.0	14.7	14.0	12.6	15.6

Source: UniCredit Research

STRENGTHS

- Political determination to introduce the EUR
- Rapidly unwinding external imbalances
- Significant spare capacity

WEAKNESSES

- Difficulties to meet the 3% budget deficit criterion
- High FX leverage in domestic private sector
- Risk of contagion in case of Lat devaluation

