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CEE: Battling recovery hurdles

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- CEE is making progress in working its way through a variety of growth challenges but amidst constraints. The region is adjusting to slower growth across its trading partners but there is evidence of an improvement in activity.

- Industry growth has improved while credit is bottoming out. External bank deleveraging has eased significantly in the newer EU states. Turkey leads the pack in terms of an acceleration in credit growth while in Russia credit growth is slowing and likely to drag on domestic demand this year. Fiscal policy should be less of a drag on growth going forward given the considerable amount of hard work done over recent years in many countries.

- Inflation pressures vary across CEE. Lower food and energy inflation has eased headline inflation while there should be more disinflation to come for some over the summer months. With much of the required consolidation now behind us, fiscal policy should also prove less problematic for inflation going forward. There are significant differences in core inflation trends, however, with it proving problematic in Russia and Turkey.

- External financing represents the primary risk to the recovery in activity, albeit with significant differentiation across countries. Amidst an expansion of central bank balance sheets in the developed world over the past 3-4 years, the primary driver of emerging market portfolio flows moved beyond a search for value relative to the developed world based on public, bank and external balance sheets and to a search for yield. In part because of this, in CEE ex-Russia net portfolio flows over 2010-12 more than trippled relative to 2005-07 to an average of 2.9% of GDP. At least part of this is now at risk of reversal. In most countries, FX reserve accumulation has failed to keep pace with portfolio inflows, increasing risks to currency stability and financing.

- Against a backdrop of a gradual improvement in activity, mixed inflation pressures and increasing financing risks, monetary policy will take different directions in different countries. In Czech, Hungary and Poland, most of the easing in monetary conditions is behind us while rate hikes remain in the distance. We are still likely to see some modest interest rate cuts in Romania and Russia. Turkey has initiated a tightening cycle while further normalisation lies ahead.

- But there remains a case for building buffers. The inclusion of the newer EU states into banking union has the potential to benefit financial stability, assuming a comprehensive resolution framework is put in place. E(M)U expansion is once again gathering pace with Croatia's EU accession on 1st July and Latvia's likely EMU entry early next year. IMF programmes are becoming increasingly necessary in large twin deficit countries such as Ukraine and Serbia. In Russia and Turkey, identification of an obvious anchor for policy is more difficult and is a source of concern given increasing evidence of more populist policies.

In need of a more convincing recovery

The growth patterns of 2004-07 will not be repeated…

The region is making progress in working its way through a variety of growth challenges but amidst constraints. The years leading up to 2008 were unique in terms of growth. EU integration boosted FDI to manufacturing in the newer EU states and beyond as Germany emerged from a difficult competitiveness adjustment, willing to support its export growth by expanding capacities in CEE. All of this combined with rising commodity prices, which supported Russia and to a lesser extent Ukraine, and ample cheap foreign capital.

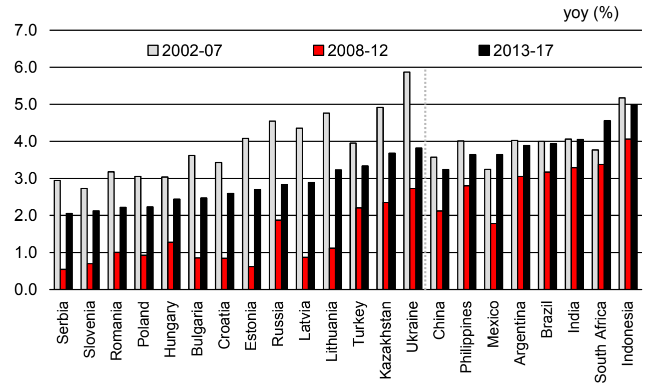
…while the region is currently adjusting to a 'new norm'

As is already clear, there will be considerable difference between this decade and the last, with the region currently in the process of determining a 'new norm'. We have argued for some time that we see a sustained improvement in external demand as central to a cyclical recovery in the region. In the absence of this, domestic demand will continue to struggle.

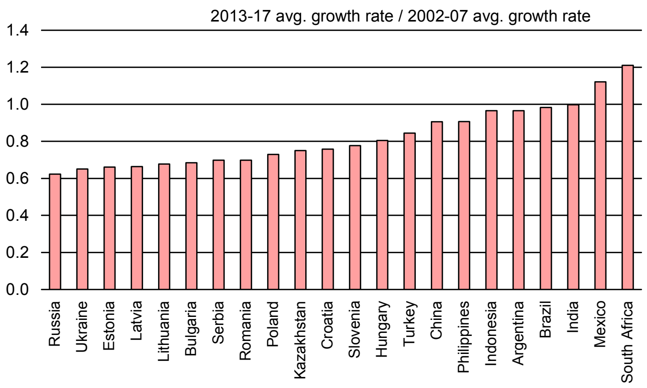
But lower growth in CEE trading partner countries represents a structural impediment that is likely to change only slowly. IMF GDP forecasts to 2017 for CEE's trading partners show growth at between 62% (Russia) and 84% (Turkey) of the rates experienced over 2002-07. In other EM regions (e.g. China, Brazil, India, Mexico) trading partners are forecast to grow at between 91% and 112% of their averages over 2002-07.

CEE COUNTRIES HAVE SEEN THEIR EXPORT PARTNERS MARK DOWN GROWTH MORE THAN OTHER EM REGIONS

GDP growth of trading partners, trade-weighted



GDP growth of trading partners: Future vs. past



Source: IMF, UniCredit Research

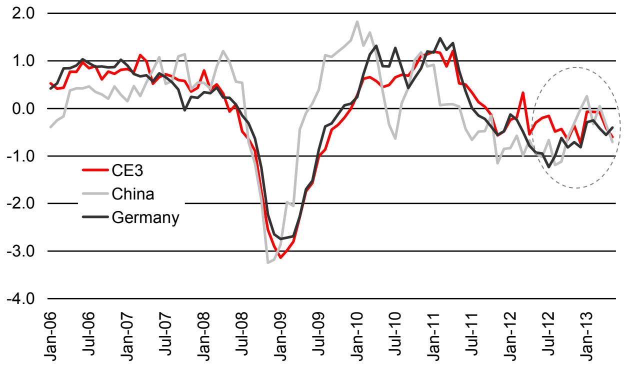
Industry: Doing better but not impressively so

Industry has done better YTD

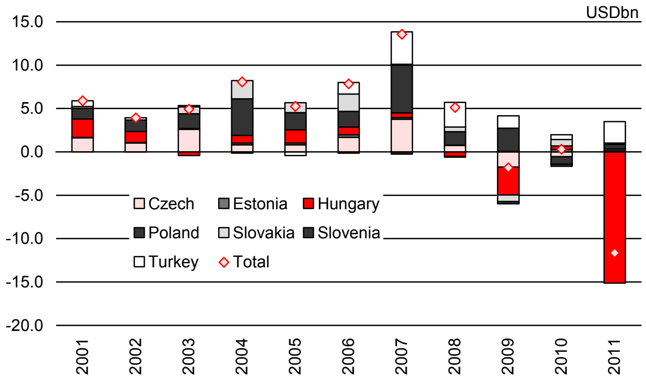
Following a particularly weak Q4 last year, Q1 benefitted from some positive payback. Volatility in vehicle production accounted for some of this, with a weak Q4 followed by a better Q1, though the inverse materialised in Russia. Q2 indicators are mixed but with some bright spots. Averaging the manufacturing PMI data quarter to date, all but Czech have given back Q1 gains and are posting PMIs below where we saw them in Q4 last year. New export orders were down notably in Turkey and Poland, though they rose in Czech Republic. All of the above is in line with a dis-improvement in the manufacturing PMI data in China and Russia in the past few months. In terms of hard data, Turkey, Poland, Hungary, Romania, Russia and Czech Republic are all doing notably between on a 3m/3m SA and annualised basis.

NOT THE RECOVERY WE WERE HOPING FOR

Manufacturing PMIs: CE3, Germany and China



Net FDI to manufacturing in CEE



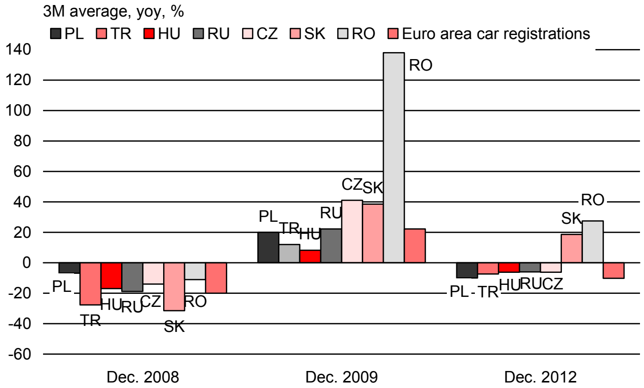
Source: OECD, Markit, UniCredit Research

We expect improvement ahead, but structural constraints mean that it will be gradual

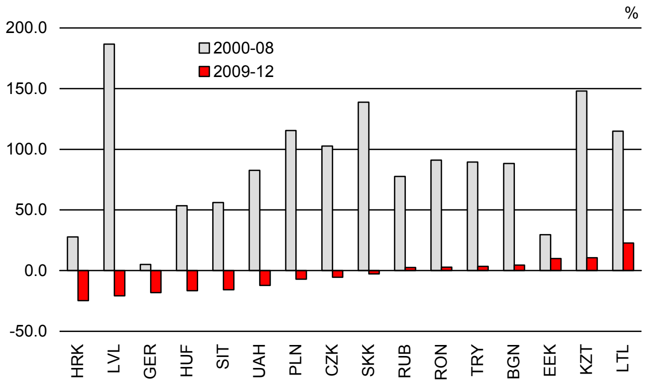
Looking ahead, we continue to expect improvement but this will be gradual and at times volatile. This should be supported by the availability of spare capacities and improving competitiveness, despite a slump in FDI to manufacturing in the region. Demand represents the primary challenge and is translating into a loss in world export shares. For example for many of the vehicle producers in the region, weak European demand is a constraint. In Russia exports are concentrated in the energy sector but the halt to the upward trend in oil prices imposes a price constraint on top of an already existing volume constraint.[1]

CEE'S ABILITY TO EXPORT IS BEING CHALLENGED BY EXPORT SPECIALITIES AND PARTNERS

Car exports in CEE depend on EMU demand



Change in world export shares



Source: OECD, Markit, UniCredit Research

[1] For a much more indepth discussion of industry and export trends across the region, including export partner and production concentration, competitiveness and space capacity trends across CEE countries, please refer to our CEE Navigator of 18 April, *"CEE: The pivotal role of industry and exports"*.

Credit is turning more supportive of GDP...

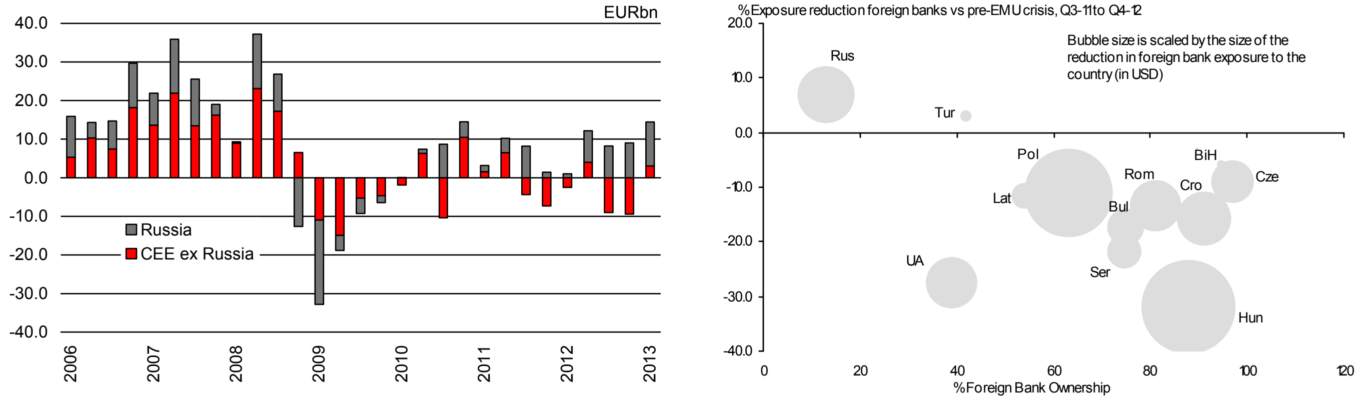
External deleveraging has slowed significantly while in many countries deposit growth comfortably exceeds credit growth, creating some upside for new credit extension, …

Just as in industry, we see improvements in the impact of credit on domestic demand, albeit more gradually than we hoped and with large variation across countries. There are two positives. First, external deleveraging has shown signs of petering out. BIS data for Q4 last year, capturing the exposure of foreign banks to both banks and corporates, indicates that this was the first quarter in six when exposure did not decline. Our own metric, namely the monthly change in external liabilities (fx-adjusted) of banking sectors, points to a similar improvement in Q1. Second, in all of the newer EU states, including Croatia, credit growth is running below deposit growth, opening scope for upside surprise on credit.

…though this is materializing only slowly in the newer EU states

Despite the above, we expect the recovery in credit to be gradual given an NPL overhang and an absence of demand. Within the newer EU states, Bulgaria, Czech, Poland and Lithuania form one group, being the only countries to post positive yoy credit growth, albeit all in low single digits. In Poland the data suggests that we are close to the bottom on credit growth but not there yet. Hungary, Latvia, Romania and Croatia run negative yoy credit growth, though in Hungary and Latvia the pace of contraction in credit is slowing which is supportive of domestic demand. Romania and Croatia are laggards. In Romania the presence of Greek banks, more generally industry-wide consolidation and an NPL overhang, plays a role in external deleveraging. In Croatia the increase in credit to the corporate sector is a positive but retail credit will lag for some time.

EXTERNAL DELEVERAGING HAS EASED BUT FOREIGN OWNERSHIP NO LONGER OFFERS THE CUSHION THAT IT DID



Change in banking sector external liabilities: Q1 saw stabilisation

But foreign ownership has been a disadvantage since the EMU crisis

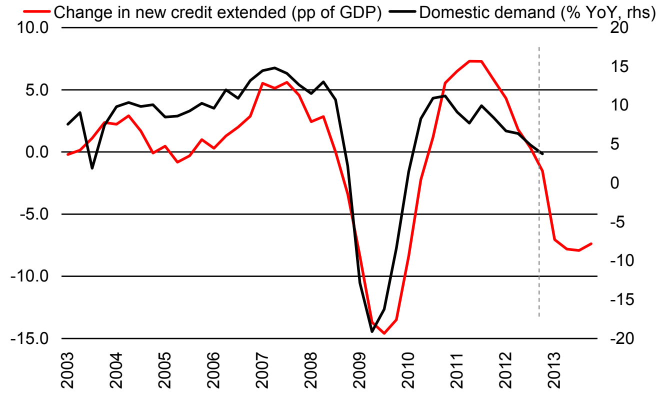
Source: National central banks, BIS, UniCredit Research

In Turkey credit is turning much more supportive of domestic demand while in Russia the opposite applies

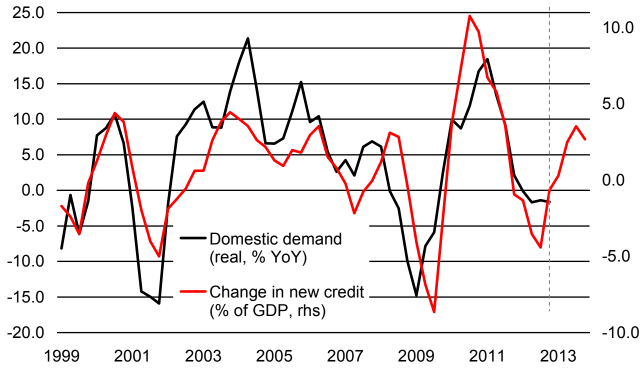
Turkey and Russia are exceptions to the extent that foreign ownership is lower and credit growth stronger. But in terms of the impact that we expect credit to have on domestic demand, it varies. In Turkey we have returned to a period where the pace of new credit extension is accelerating, supporting a recovery in domestic demand. The primary risk is increased reliance on external funding. In contrast in Russia, the credit cycle has turned, with credit growth in yoy terms now easing due to financing and regulatory constraints. Some measures are being taken to ease this downward pressure but acceleration in credit growth this year remains unlikely, with negative implications for domestic demand.

TURKEY AND RUSSIA STAND AT DIFFERENT ENDS OF THE SPECTRUM IN TERMS OF THE CREDIT CYCLE

Russia: Should credit growth remain stable, the change in new credit extension will fall, weighing on domestic demand



Turkey: Assuming credit growth remains stable from here, domestic demand recovers



Source: National central banks & statistics offices, UniCredit Research

...fiscal policy should be less of a drag going forward

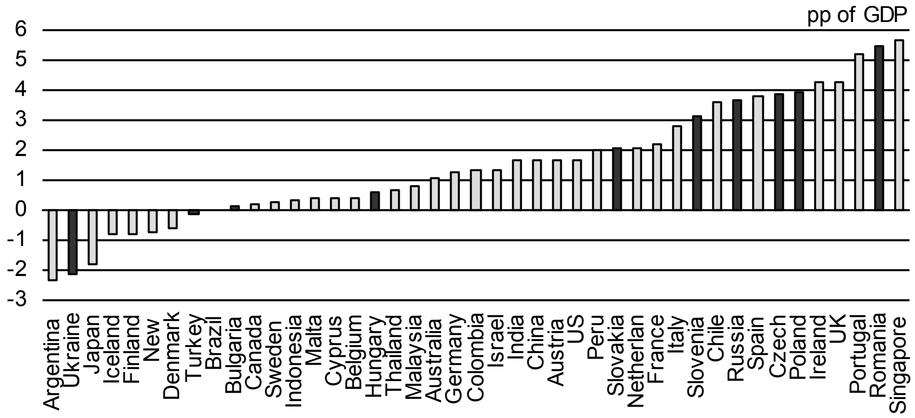
In most countries budget balances are non-problematic

We can add less restrictive fiscal policy to improving industrial production and a more neutral credit environment in a number of countries when forecasting an improvement in activity. Examining changes in structural budget balances since 2009, some of the largest improvements globally are found in the newer EU states, exceeding over 5pp of GDP in Romania and almost 4pp of GDP in Czech and Poland.

In Hungary the change in the structural budget balance is limited since 2009 but if we take 2008 as our starting point, this reached 3.5pp of GDP. This has allowed Czech, Hungary and Romania to bring their structural budget balances within 3% of GDP, in Poland to 3.4% of GDP. Russia's efforts have also been significant at in excess of 3% of GDP while in Turkey there has been no adjustment in the structural budget balance.

SOME OF THE CEE COUNTRIES ARE AMONGST THE WORLD'S 'TOP CONSOLIDATORS'

Structural budget balances: Change between 2009 and 2012



Source: IMF, UniCredit Research

Czech and Poland have announced a slower pace of consolidation going forward while Hungary, Romania, Bulgaria and Latvia are done. The Turkish government is using fiscal policy actively to support activity while the Russian government is also moving in that direction

As a result of the efforts taken to date, in many countries the pace of consolidation will slow from here while others are drawing off fiscal policy to support activity. In Poland and Czech Republic, governments have reacted to weak cyclical growth conditions YTD by announcing a slower pace of consolidation going forward. In Hungary there is some scope to modestly loosen fiscal policy ahead of next year's general election while in Turkey the government is aggressively increasing expenditure. Recent political developments mean that there is a risk that the government increases this further. In Russia headline expenditure growth in real terms stood at 9% and while it has slowed YTD, it remains positive as the government comes under pressure to support economic activity.

In Croatia, Serbia, Slovenia and Ukraine further consolidation is required

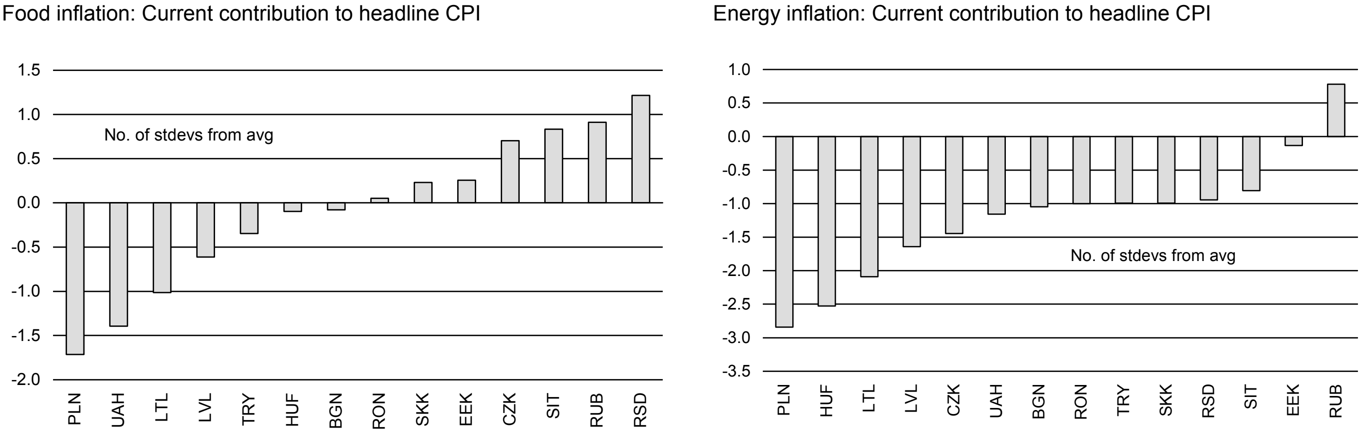
Croatia, Serbia, Slovenia and Ukraine represent the exceptions. Structural budget balances require (further) narrowing in all cases. Commitment is clear in Slovenia, with the government in the process of pushing through its second cut to public sector wages in less than six months. But fiscal performance YTD has been poor in Croatia and Serbia. In Croatia this is due to local elections in May but EU accession in July means that Croatia will be quickly absorbed into the excessive deficit procedure, with some re-statement of fiscal accounts. In Ukraine and Serbia there is an absence of progress on IMF negotiations, with both set to significantly exceed deficit targets this year.

Inflation is non-problematic for some…

Inflation is non-problematic for a number of central banks in the region

Thankfully many central banks in the region do not need to worry about upside inflation pressures, due to a combination of supply and demand side factors. Lower oil prices and reductions in regulated prices, has brought the contribution of energy to headline inflation down significantly. Russia has also announced a slower pace of tariff hikes. Stable, rather than rising, global food prices combined with strong upcoming harvests render food price inflation less problematic. Many countries have pushed through the majority of fiscal consolidation required and as a result tax measures pose less of a risk to inflation going forward.

ENERGY HAS DAMPENED INFLATION EVERYWHERE WHEREAS FOOD HAS HELPED IN SOME COUNTRIES

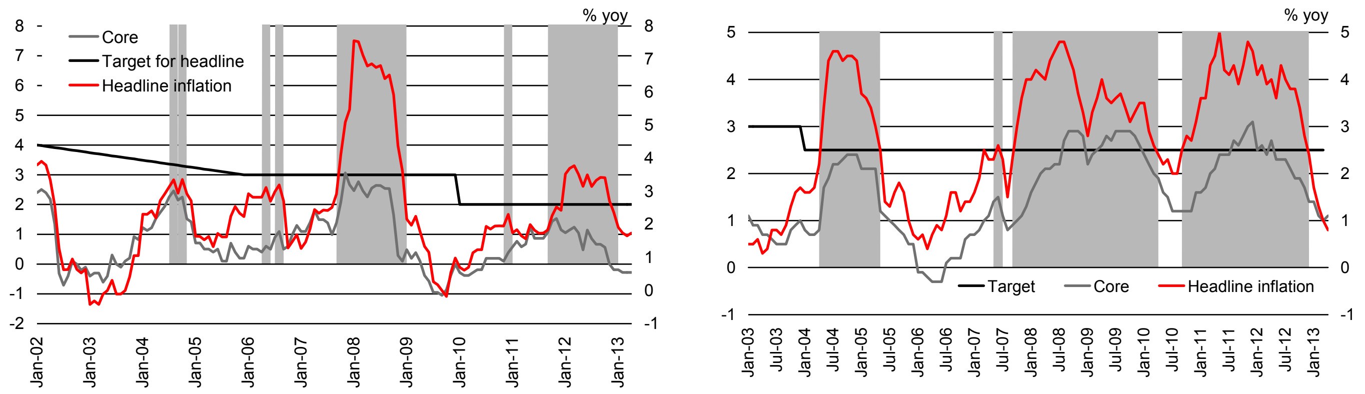


Source: National statistics offices, UniCredit Research

Core inflation is non-problematic in Czech and Poland but above target in Russia and Turkey

That said, there remains significant divergence across the region in terms of the ability of central banks to bring headline inflation in line with target. In Czech Republic and Poland, headline inflation has fallen below target while core inflation is negative. But in Turkey and Russia inflation remains stubbornly above target, so much so that in Russia another upward revision to the inflation target band is under discussion[2].

CZECH AND POLAND HAVE RAPIDLY MOVED FROM A PERIOD OF ABOVE TO BELOW TARGET INFLATION


Czech Republic: Inflation below target, core negative

Poland: From above-target to below-target inflation

Source: National statistics offices, national central banks, UniCredit Research

…but external financing represents the primary risk

Signs of UST yield normalisation puts EM financing at risk

The primary risk to the recovery path is more negative external financing conditions. Recent weeks have provided a glimpse of the risks to emerging markets from a normalisation of US interest rates. The challenges are twofold. The first is reduced global appetite for risk, translating into a more limited inflow of foreign capital and an increased risk of prolonged outflows. The second relates to countries' ability to service this debt at a higher cost in the future.

The increase in short term capital flows to EM since 2009/10 means that this process risks being particularly risky

Two factors mean that this process poses significant risks. First, amidst an expansion of central bank balance sheets in the developed world over the past 3-4 years, the primary driver of emerging market portfolio flows moved beyond a search for value relative to the developed world based on public, banking and external balance sheets and to a search for yield.

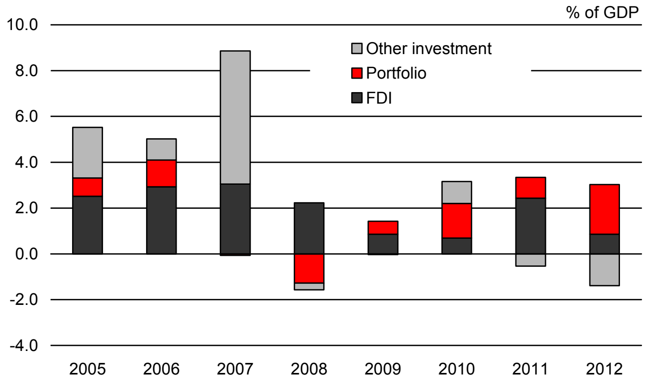
Portfolio flows to CEE ex-Russia have more than trippled relative to 2005-07 to 2.9% of GDP per annum (2010-12)

As the Fed's QE programme moves into its latter stages, this search for yield is weakening. Second, the size of portfolio and other short-term capital flows to EM has been unprecedented, though there is differentiation across countries. In CEE ex-Russia net portfolio flows over 2010-12 more than trippled relative to 2005-07 to an average of 2.9% of GDP per annum while FDI and other investment stood at only 40% (1.8% of GDP) and 27% (0.8% of GDP) of its average over 2005-07. Other investment pre-crisis was to a large extent dominated by financial and non-financial corporates lending to the region, at least some of which was associated with prior FDI inflows. Russia is an outlier to the extent that net capital inflows have been negative since 2008.

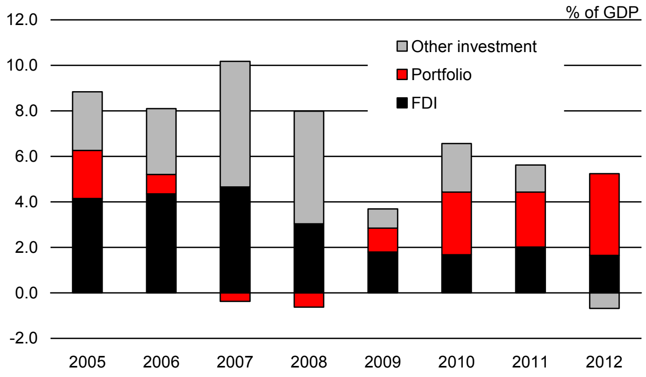
[2] In our CEE Navigator for May, '*CEE: Testing inflation boundaries*', we developed a model for core inflation, drawing off inflation persistence, activity and supply side shock measures as explanatory variables. Layering some assumptions and scenarios for non-core inflation on top of our projections for core inflation, we find that headline inflation in Czech, Hungary and Poland should remain below target through next year while in Turkey and Russia inflation targets are likely to remain out of reach.

A SHIFT FROM LONGER TERM TO SHORTER TERM CAPITAL

CEE: The composition of capital flows



CEE *ex Russia*: The composition of capital flows



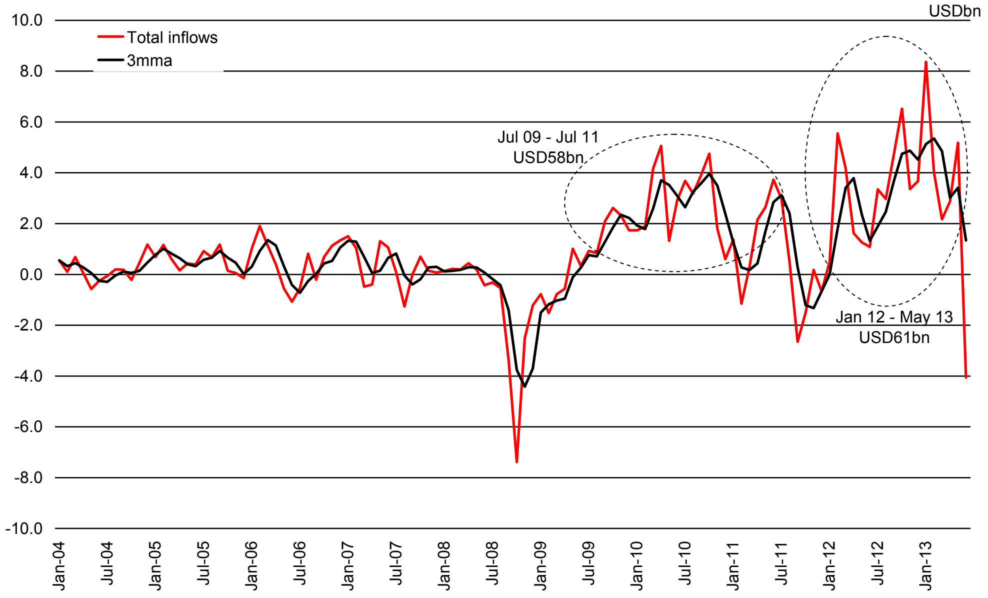
Source: IMF, UniCredit Research

EPFR data re-inforces the record nature of these inflows

This increase in portfolio flows is in part captured by weekly EPFR data. The acceleration of inflows to EM fixed income funds (hard currency, local currency and blend funds) began in ernest in H2-09, reaching a cumulative USD58bn over a 25 month period before the EMU crisis deteriorated. This USD 58bn compares with EM cumulative inflows of USD 19.5bn between Jan-04 and May-08. But the past 17 months have been even more impressive with cumulative inflows over this period accelerating to USD 61bn.

INFLOWS TO EM HAVE ACCELERATED IN TWO STAGES SINCE THE 2008 CRISIS

EPFR data on fixed income funds captures some of the portfolio inflows to EM

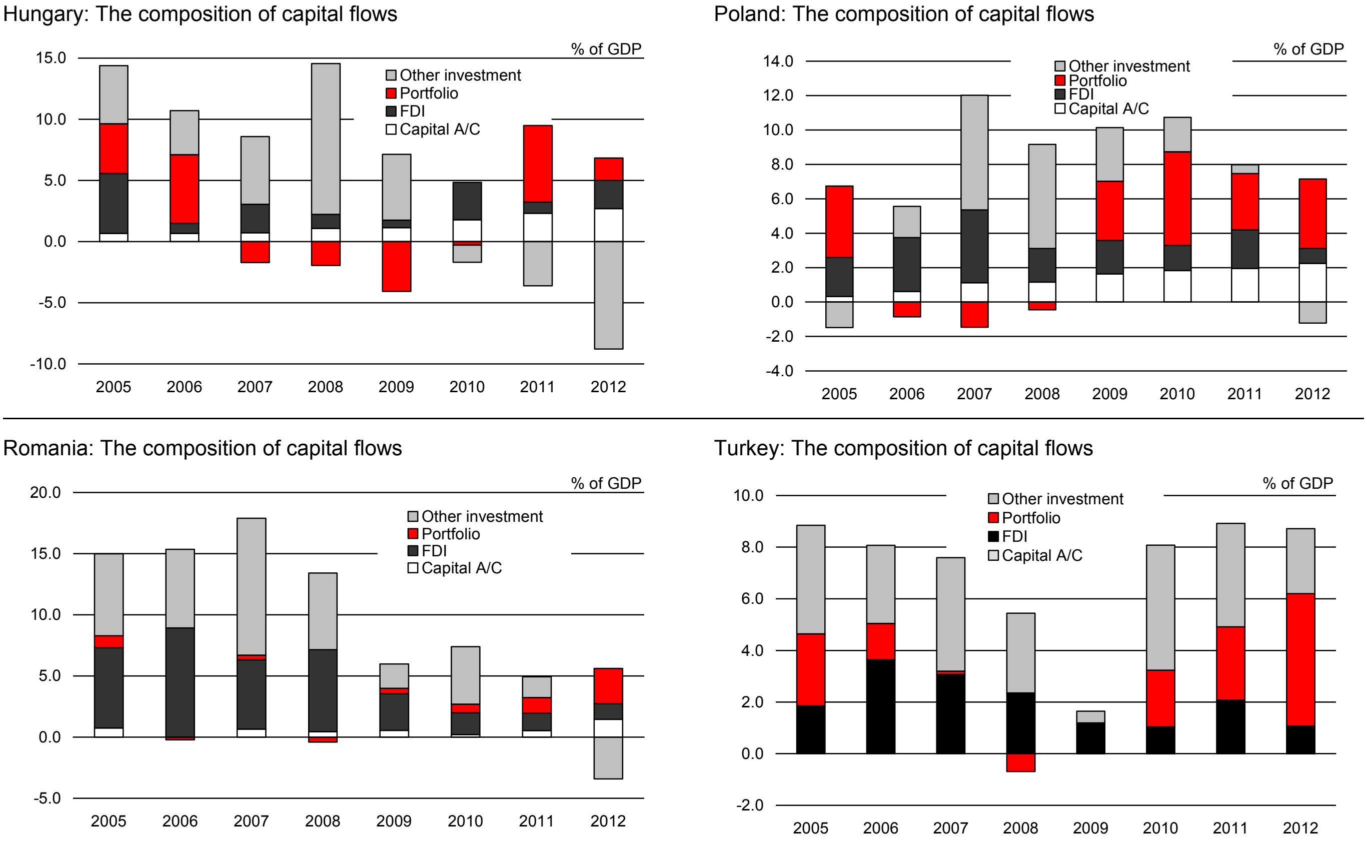


Source: EPFR, UniCredit Research

Turkey and Poland have experienced the largest inflows

Within CEE there is considerable cross-country differentiation. Poland and Turkey top the list as portfolio flows averaged 4.3% and 3.4% of GDP over 2010-12 respectively. In Poland this represents a seven fold increase in portfolio inflows relative to 2005-07, in Turkey an increase of 2.4 times. In Romania and Hungary the amounts are smaller but still significant at 2.6% and 1.6% of GDP over 2010-12 respectively, though in Hungary this is down slightly from what was experienced pre-crisis.

PORTFOLIO FLOWS WERE LARGEST TO POLAND AND TURKEY BUT STILL SIGNIFICANT IN HUNGARY AND ROMANIA



Hungary: The composition of capital flows

Poland: The composition of capital flows

Romania: The composition of capital flows

Turkey: The composition of capital flows

Source: IMF, UniCredit Research

Czech Republic, Croatia and Lithuania also saw signficant increases in net portfolio inflows

An increased reliance on portfolio capital is also notable in Croatia and Lithuania as governments (and corporates in the case of Croatia) financed themselves abroad in the face of wider budget deficits and a downturn in activity. Croatia and Lithuania registered portfolio outflows of 1.0% and 0.8% of GDP on average over 2004-07 but inflows of 2.3% of GDP and 4.2% of GDP over 2010-12 respectively. In Czech Republic portfolio flows shifted by a cumulative 3.3pp of GDP to a positive 1.7% of GDP, reflecting a combination of larger foreign inflows and smaller local outflow.

Some countries are short on FX reserves

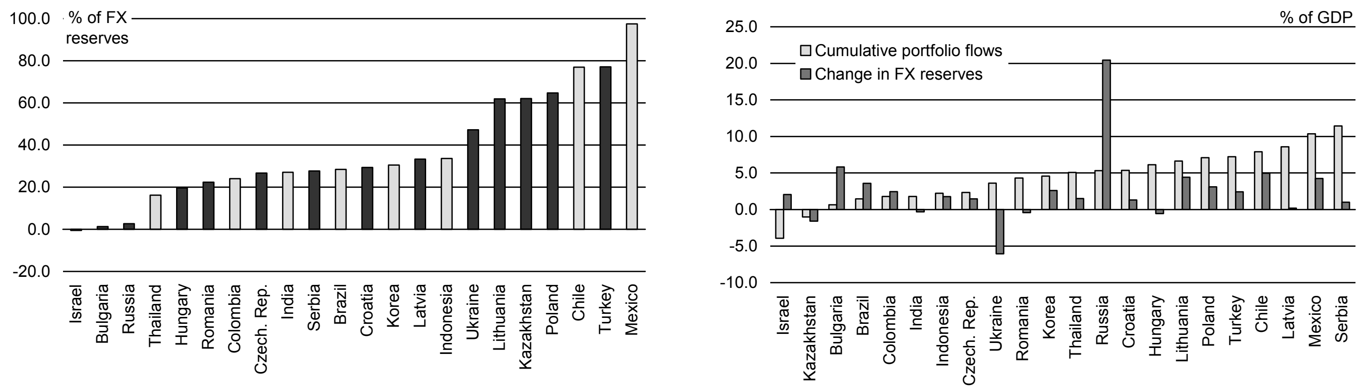
FX reserve accumulation has not kept pace with portfolio inflows

FX reserve accumulation has not kept pace with inflows of portfolio capital. As such the ability of central banks to smooth any adjustment resulting from an outflow of portfolio capital has fallen significantly. It is unrealistic to expect an improvement in FDI or longer term debt-creating flows to fill the gap given the sluggish pace of recovery in Europe and a global trend of cross-border bank deleveraging. We address this via two metrics, namely cumulative portfolio inflows since 2010 relative to the *level* of FX reserves and cumulative portfolio inflows since 2010 relative to the *change* in FX reserves.

FX RESERVE ACCUMULATION HAS NOT KEPT PACE WITH PORTFOLIO INFLOWS

Cumulative portfolio inflows 2010-12

Cumulative portfolio inflows v the change in FX reserves (2010-12)



Source: IMF, UniCredit Research

FX reserve coverage of portfolio inflows to Russia and Bulgaria is high but much lower in Poland and Turkey…

Within CEE cumulative portfolio inflows between 2010 and 2012 vary from less than 5% of FX reserves in Bulgaria and Russia to between 20-30% of FX reserves in Hungary, Romania, Czech Republic, Serbia and Croatia to in excess of 60% of FX reserves in Poland and Turkey. Most central banks have not adopted a policy of reserve accumulation to keep pace with portfolio inflows. Most notably in Turkey total portfolio inflows reached 7.2% of GDP over 2010-12 while FX reserves increased by a much more modest 2.4% of GDP. Poland's FCL is of importance as a cushion. Once included, FX reserve accumulation outpaces portfolio inflows.

Monetary policy will take different paths from here…

Most of the rate cuts in CEE are now behind us while Turkey looks set to tighten further

Within this environment of improving activity, mixed inflation pressures and an increasing need to consider risks to financial stability, monetary policy across the region is no longer a one-way street. We divide countries into 3 groups:

- From the perspective of inflation-targetting credibility, real rates and financial stability, the bias in Poland, Hungary and Czech Republic remains in favour of easier monetary conditions, though most of the work has already been done. Romania will soon join with rate cuts;
- In Russia, there is scope to cut from the perspective of real rates but inflation targets are likely to remain out of reach. This has already delayed rate cuts and should deter central banks from negative real rates;
- In Turkey central bank adherence to its inflation target has been weak while core inflation is likely to remain above the CBT's headline target. Moreover external risk appetite is of more importance than elsewhere. Turkey has already begun to normalise rates but more lies ahead.

…but there is a case to build buffers

The tentative recovery that we are seeing in industry across the region is being put at risk by less favourable external financing conditions

A combination of industry trends, low inflation, a smaller fiscal consolidation burden and signs of a bottoming out in the credit cycle all point to a gradual recovery in activity ahead. But as this materializes, it is being put at risk by the deterioration in external financing conditions that EM is currently experiencing. Of concern is the fact that this represents only the beginning of the normalization in USTs. More comforting is the fact that the US Fed will also be keen to ensure that this process does not become disorderly to the extent that it would put the US recovery at risk. Moreover at this stage the Fed continues to expand its balance sheet. Factors such as Turkey's second upgrade to investment grade will also help to attract capital and potentially in more longer-term forms such as FDI.

Banking union is a potential anchor moving forward as debate on EMU entry gathers pace once again while Ukraine and Serbia are obvious candidates for an IMF programme. Russia and Turkey are missing an obvious anchor

But the case for building buffers is significant. Not only do FX reserves fall short in many countries but political developments in Turkey of late highlight the unfortunate tendency of negative domestic and external developments to co-incide. In Russia and Turkey, identification of an obvious anchor for policy is more difficult and is a source of concern given increasing evidence of more populist policies. There are a number of anchors available to other countries in the region:

- Within the newer EU states, banking union has the potential to boost credibility surrounding financial systems. Much remains to be decided upon and the newer EU states that are outside of EMU must not take a decision immediately but instead are likely to monitor the construction of the resolution framework. Discussion of ECB FX swap lines to the newer EU member states has eased but there remains potential. Meanwhile at least under the SSM construction, the ECB has made extensive efforts to accommodate the concerns of the newer EU states;
- The broader EU anchor is being bolstered, not only by banking union but EU accession in Croatia (July), EMU entry in Latvia (January) and Poland's increasing interest in EMU. In Croatia EU entry will instil much needed fiscal discipline amidst a vacuum in terms of government policy response to weaker budget performance and multi-year recession;
- IMF programmes appear increasingly necessary in Ukraine and Serbia amidst wide twin deficits and an absence of political commitment to consolidation, though Ukraine has the potential to agree to a funding deal with Russia.

In Russia and Turkey, identification of an obvious anchor for policy is more difficult and is a source of concern given increasing evidence of more populist policies.

Countries

Bulgaria (Baa2 stable/BBB stable/BBB- stable)*

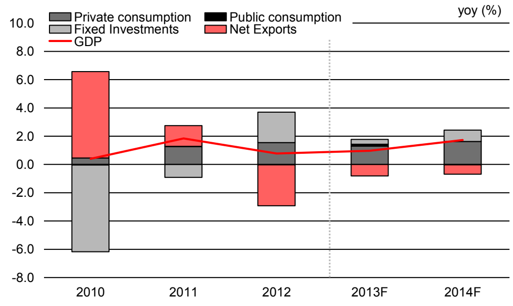
Outlook – GDP growth is likely to be subdued at around 1.0% this and 1.7% next year, which represents a downward revision (from 1.7% and 2.8%) when compared with our forecast three months ago. This mostly reflects the downward revision in our 2013 GDP growth forecast for the euro zone to -0.6%, from -0.1% in March. Perhaps most importantly, we now see private consumption rising more modestly this year, because labor market weakness proved more deeply entrenched than we had thought, which, in turn, suggests that any potential increase in the number of jobs is likely to need more time to materialize. There are no shortcuts to economic recovery and the new government will need to tackle the obstacles for growth and push for absent structural measures, which at a minimum should include education and the profoundly problematic energy sector.

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

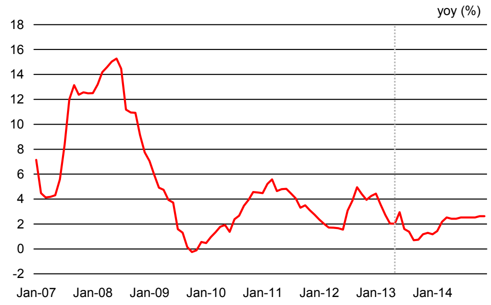
KEY DATES/EVENTS

- 9 August – Number of employees under labor contract for 2Q
- 14 August – Flash estimates for swda real GDP for 2Q
- 22 August – Down payment on 6M bills equivalent to 1% of GDP

GDP GROWTH AND CONTRIBUTION TO GROWTH



INFLATION (CPI) YOY



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	36.1	38.5	39.7	40.9	42.5
Population (mn)	7.5	7.3	7.3	7.2	7.2
GDP per capita (EUR)	4,804	5,255	5,447	5,646	5,906
Real economy yoy (%)					
GDP	0.4	1.8	0.8	1.0	1.7
Private Consumption	0.6	1.7	2.0	1.7	2.1
Fixed Investment	-18.3	-6.5	0.8	2.7	3.4
Public Consumption	-0.5	0.3	-0.4	1.7	-0.5
Exports	14.7	12.3	-0.4	3.6	4.3
Imports	2.4	8.8	3.7	4.3	4.7
Monthly wage, nominal (EUR)	331	351	392	412	435
Unemployment rate (%)	11.4	11.7	12.5	12.7	12.4
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-2.1	-0.5	-2.1	-2.1
Primary balance	-3.3	-1.4	0.3	-1.2	-1.2
Public debt	14.7	15.3	17.6	18.2	23.2
External accounts					
Current account balance (EUR bn)	-0.5	0.0	-0.5	-0.3	-0.8
Current account balance/GDP (%)	-1.5	0.1	-1.3	-0.8	-1.9
Basic balance/GDP (%)	1.2	3.2	1.9	1.9	1.2
Net FDI (EUR bn)	1.0	1.2	1.3	1.1	1.3
Net FDI (% of GDP)	2.7	3.1	3.3	2.7	3.1
Gross foreign debt (EUR bn)	37.0	36.2	37.6	36.9	37.4
Gross foreign debt (% of GDP)	102.7	94.1	94.8	90.2	88.1
FX reserves (EUR bn)	13.0	13.3	15.6	16.0	17.5
Inflation/Monetary/FX					
CPI (pavg)	2.4	4.2	3.0	2.1	2.3
CPI (eop)	4.5	2.8	4.2	1.3	2.6
Central bank reference rate (eop)	0.20	0.22	0.04	0.07	0.12
USD/BGN (eop)	1.5	1.5	1.5	1.4	1.4
EUR/ BGN (eop)	2.0	2.0	2.0	2.0	2.0
USD/ BGN (pavg)	1.5	1.4	1.5	1.5	1.4
EUR/ BGN (pavg)	2.0	2.0	2.0	2.0	2.0

Source: UniCredit Research

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

Recovery remained stuck in low gear

Deceleration in GDP growth in 1Q 2013 was all about private consumption

GFCF has shown clear signs of stabilization in 2012 and in early 2013…

Bulgarian economic growth has been on a slow but persistent downward trend over the last three consecutive years. More precisely, qoq GDP growth has lost momentum from 0.9% on average in 2010 to 0.3% in 2011 and only 0.2% in 2012. What's more, growth has come to a standstill recently after qoq GDP was flat in 4Q2012 and rose only a meager 0.1% in 1Q 2013. But the details of the most recent GDP report were better than the headline number suggests. For a start, it is important to stress that the weakness in 1Q 2013 GDP data came entirely from private consumption. Driven by persistently rising unemployment and weakening wage growth, private consumption shrank on a qoq basis for a third straight quarter. It was also hit by social strains and political paralysis due to the resignation of the CEDB government in February. At the same time, both exports and the very volatile inventories component posted positive qoq growth prints, after contracting in the two preceding quarters. Also on the positive side, revised GDP data showed that the recovery in GFCF was slightly stronger than initially thought, after the latter reported positive qoq growth for a fifth quarter in a row. Improving external competitiveness and robust profitability seem to have prompted Bulgarian companies to boost GFCF by a hefty 2.4% qoq, which also defied expectations for a possible pullback due to concerns over political and social stability in the country.

…but there is no evidence for sustained expansion in investment in the near future

Despite weak growth, we see limited chances of the economy being on the verge of a second recession in four years

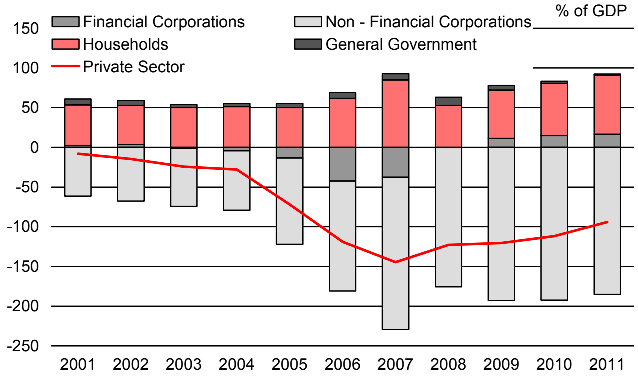
Decisive tackling of labor market problems is also needed for a robust recovery to get under way

We expect the Bulgarian economy to report a gradual improvement as the year progresses. This will be led by exports which are expected to draw support not only from the energy-intensive structure of the economy, which in the context of the falling energy prices generates solid favorable terms-of-trade effects, but also from the ongoing quality improvements which consistently outweigh the losses in cost-competitiveness associated with the income convergence process. Though to a lesser extent, GFCF and government consumption, where fiscal policy is set to become somewhat more growth-friendly in the course of the current year, are also expected to make a positive contribution to growth. But GDP growth is likely to be subdued at around 1.0% this and 1.7% next year, which represents a downward revision (from 1.7% and 2.8%) when compared with our forecast three months ago. This mostly reflects the downward revision in our 2013 GDP growth forecast for the euro zone to -0.6%, from -0.1% in March. And perhaps most importantly, we now see private consumption rising more modestly this year because labor market weakness proved more deeply entrenched than we had thought, which, in turn, suggests that any potential increase in the number of jobs is likely to need more time to materialize.

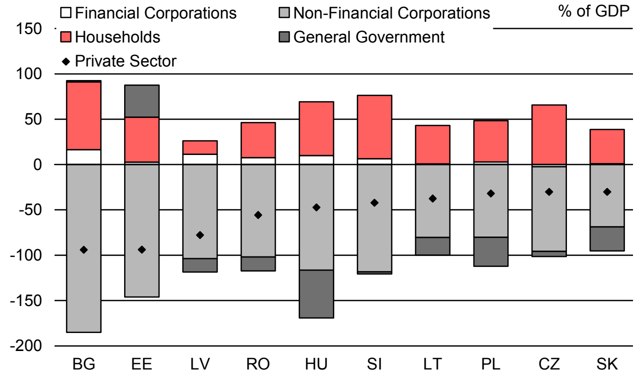
Debt overhang in the corporate sector remains a major drag for the domestic recovery

The ongoing deleveraging process, particularly in the heavily-indebted corporate non-financial sector, remains one of the primary reasons for the frustratingly slow domestic recovery. After peaking in 4Q 2009 at a level which significantly exceeds the CEE average, the loan-to-GDP ratio of the Bulgarian corporate non-financial sector (incl. loans from local banks, leasing, nonresident intercompany loans, and other loans as reported in the gross external debt statistics) has been on a downward trend in both 2010 and 2011, but remained stuck at close to 112% over the last six consecutive quarters, including 1Q 2013.

Bulgaria: net financial assets by sectors



CEE (10): net financial assets by sectors (% of 2011GDP)



Source: Eurostat, UniCredit Research

Sustained corporate sector profitability in both 2011 (8.7%) and 2012 (10%) helped ease the deleveraging pressure

Rising corporate profits and cash, including cash substitutes, have also helped the corporate sector to repair its crisis-hit balance sheet. Apart from flow developments, non-negligible valuation effects, that reflect changes in the stock of underlying assets held by non-residents, and which have been concentrated in 2010 rather than in 2011 and 2012, have additionally contributed to the corporate sector deleveraging process. At the same time, the net asset position of the household sector is moderately positive, while those of the public and banking sectors remain close to balanced. But these proved insufficient to compensate for the large negative net asset balance of the corporate sector, which, in turn, seems to suggest that the deleveraging pressure is likely to remain relatively high in the foreseeable future.

Overlooking private sector debt problems is likely to have aggravated the contraction in output and jobs

Slow financial restructuring creates preconditions for asset stripping by the owners and managers of insolvent companies

Speedy financial restructuring of the distressed companies should be prioritized in order to create conditions for resumption of private-sector led demand

Deleveraging is further impeded by slow and inefficient debt restructuring and insolvency procedures. There are real macro benefits from rapid financial restructuring of bankrupt companies, where decisions need to be taken as to who owns the firm's assets and how the existing stock of debt should be reduced to more sustainable levels, including through conversion of debt into equity and debt write-offs. When only a few companies in an economy are insolvent, the slow and inefficient bankruptcy procedures are associated with little social costs, as there are only few workers and production assets that need to remain idle in anticipation of the financial restructuring. But when many companies are in distress, these social costs can become enormous, thereby prolonging the downturn and making it more severe. Other crisis episodes in history have demonstrated that governments that have taken an active role in the process have succeeded in completing the financial restructuring of a significant part of bankrupt companies within a fairly short period of time of two to three years, while those who have left it unattended suffered disproportionally larger costs. It would be fair to note that Bulgarian authorities have recently undertaken two major steps to improve the existing bankruptcy procedures. First, a 30-day deadline on the payment of invoices was established, along with the introduction of a penalty interest payment which is set by the regulator and is due in case of delay. Second and perhaps more importantly, the option for a company to backdate its insolvency, thus practically leaving some claimants empty-handed, was removed by Parliament on a first reading. But unfortunately these changes, no matter how important they are, fall short of what is actually needed to address the debt overhang problem in the corporate sector.

We see moderate fiscal easing this year as justified at this stage of the economic cycle. What we found somewhat disappointing however is that deficit increase is likely to reflect weaker revenues than above-target capital spending

YTD budget deficit inched marginally higher to 0.4% of GDP in April, from 0.3% one year earlier. But the 2012 fiscal targets now look ambitious, given the weakening growth environment and the need to increase social assistance payments for the most vulnerable. With the tax base at risk of expanding at a slower-than-expected rate, fiscal revenues are likely to fall short; perhaps by an amount equivalent to 1.3% of GDP, according to the newly appointed Finance Minister Petar Chobanov. The weaker growth outlook would adversely affect non-interest spending as well. Social outlays mandated by law, such as unemployment benefits and social assistance payments, are also likely to exceed the target. To address the problems of the most vulnerable, which took central stage during the social protest in February, the new socialist-led government approved an emergency social package for the total amount of BGN 27mn or 0.03% of GDP. This came only two months after the interim government extended BGN 41mn or 0.05% of GDP for practically the same purposes, expanding the scope of some social assistance payments and prolonging the functioning of several programs that provide subsidized employment. Taken together, these factors could leave the budget deficit 1.5-1.6% of GDP more than planned, but when subtracting the so-called emergency reserve which was set at BGN 389mn or 0.5% of GDP the ultimate effect falls to 1.0-1.1% of GDP. Upbeat planning of capital expenditures seems to provide additional room for maneuver, as this year's capital outlays (BGN 4.961bn or 6.2% of GDP) are planned, a hefty 35% above what was actually spent in 2012 (BGN 3.677bn or 4.7% of GDP). As the scope of the likely overall slippage remains far from clear, new Prime Minister Oresharski dismissed speculation of an immediate revision of the budget and pledged to adhere to the existing fiscal plan for as long as possible. We see the 2013 FY deficit at 2.1% of GDP, moderately above both the 1.3% target set by the previous administration and the 1.9% forecast that we made three months ago. This is likely to reflect a combination of modestly weaker fiscal revenues and higher social assistance payments, which will be partially compensated for by moderately below target capital expenditures.

Strategy: MinFin to increase bond supply

A change in the fiscal environment requires the accumulation of higher buffers

Already identified slippages in the budget performance imply that the MinFin will need to prepare for operating in a medium term environment of modestly higher deficits, while also building higher fiscal buffers to offset seasonality in receipts. Due to country-specific factors, this demands a more aggressive domestic issuance policy by debt management.

Elevated levels of liquidity in the financial sector should easily absorb higher domestic issuance and should be able to meet any upticks in GB supply. We see 2013 gross bond supply doubling yoy to 2.9% of GDP, while net issuance expands 5 times to 2.4% of GDP. On the other hand, external issuance will be kept as a main channel for refinancing maturing external debt. Thus, our scenario envisages that the MinFin will resort to this option in a manner repeating the rollover of the Jan-2013 EUR 818mn paper – tapping the external market in the year prior to the maturity date to make sure that sufficient buffers have been acquired in due time. We also envisage a higher rollover ratio as another means of increasing hard currency liquidity (aside from limited EUR-denominated auctions on the primary domestic market).

More growth-friendly fiscal policy will not weigh on the financing cost of the government

Global-wide lax monetary conditions and asset allocation normalization dynamics are an increasing risk the financing cost of the government is unlikely to suffer from the increase in supply and modest softening of fiscal fundamentals. Average weighted yields on the primary market have moved significantly downwards since mid-2012 (YTD average of 2.34% for bonds, compared to a 2012 average of 3.54%) and remained in check despite the short-term political paralysis which the resignation of the CEDB government caused in February.

Author: Nikola Georgiev, Economist and FI/FX Strategist (UniCredit Bulbank);

GOVERNMENT GROSS FINANCING REQUIREMENTS[3]

EUR bn	2011	2012	2013F	2014F
Gross financing requirement	**1.5**	**0.9**	**2.7**	**1.7**
Budget deficit	0.8	0.2	0.9	0.9
Amortization of public debt	0.5	0.5	1.6	0.6
Domestic	0.4	0.4	0.6	0.5
Bonds	0.4	0.4	0.2	0.5
Bills	0	0	0.4	0
External	0.1	0.1	1.0	0.1
WB/EIB/JBIC/Others	0.2	0.2	0.2	0.2
Financing	**0.9**	**1.4**	**1.9**	**2.8**
Domestic borrowing	0.6	0.6	1.6	1.0
Bonds	0.6	0.6	1.2	1.0
Bills	0	0	0.4	0
External borrowing	0.2	0.8	0.4	1.7
Bonds	0	1.0	0	1.3
WB/EIB/JBIC/Others	0.2	-0.2	0.4	0.5
Privatization	0.1	0	0	0
Fiscal reserves change (- = increase)	0.5	-0.6	0.7	-1.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012	2013F	2014F
Gross financing requirement	**16.5**	**16.1**	**16.1**	**15.4**
C/A deficit	0	0.5	0.3	0.8
Amortization of medium to long term debt	5.4	5.5	6.0	5.2
Government/central bank	0.3	0.3	1.2	0.3
Banks	0.8	0.8	0.7	0.8
Corporates	4.3	4.4	4.2	4.1
Short term debt amortization	11.2	10.1	9.7	9.4
Financing	**16.9**	**18.3**	**16.5**	**16.9**
FDI	1.2	1.3	1.1	1.3
Portfolio flows	-0.4	-0.9	-0.6	0.6
Borrowing	5.8	6.4	5.3	6.1
Government/central bank	0.4	0.8	0.4	1.7
Banks	0.8	0.8	0.6	0.6
Corporates	4.7	4.7	4.3	3.8
Short-term	10.1	9.7	9.4	9.0
EU transfers	0.7	1.0	1.1	1.1
Other	-0.6	0.8	0.3	-1.2
Change in FX reserves (- = increase)	0.4	2.2	0.5	1.5

Source: BNB, MF, UniCredit Research

[3] Headline Financing and Financing requirement positions do not add up as the difference is reflected in the Fiscal reserve change position (Government) and Change in FX reserves position (Economy)

Croatia (Ba1 stable/BB+ stable/BBB- negative)*

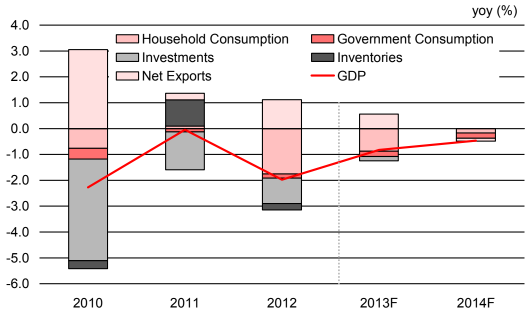
Outlook – Croatia joins the EU on 1 July. However, a lack of decisive reforms and actions to restructure the real sector, especially parts still owned by the state, slow privatization and uncertainty created by continuous changes in the regulatory environment limit the potential benefits of accession and of the expected recovery of EU economies. Therefore, without appropriate economic policy responses for the current domestic economic environment, in 2013 and 2014 we foresee only a mitigation of the recessionary developments.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka d.d.)

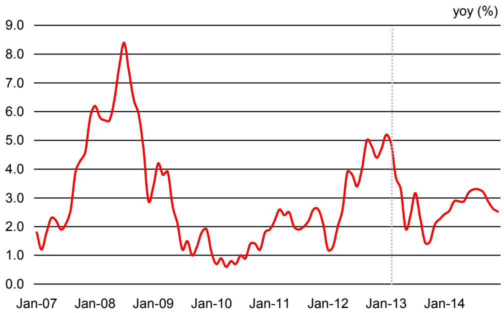
KEY DATES/EVENTS

- 26 June: First results: Labor force survey for 1Q
- 28 June: BoP for 1Q and Foreign debt for 1Q
- 01 July: Croatia joins EU as 28th member state
- 30 August: 2Q GDP flash estimate

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	44.4	44.4	43.9	44.6	46.0
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,060	10,089	10,003	10,181	10,520
Real economy yoy (%)					
GDP	-2.3	0	-2.0	-0.8	-0.5
Private Consumption	-1.3	0.2	-3.0	-1.5	-0.3
Fixed Investment	-15.0	-7.2	-4.6	-0.8	0
Public Consumption	-2.1	-0.3	-0.8	-1.0	-1.0
Exports	4.8	2.0	0.4	1.0	3.0
Imports	-2.8	1.2	-2.1	-0.3	3.2
Monthly wage, nominal (EUR)	1,054	1,049	1,047	1,048	1,071
Unemployment rate (%)	11.8	13.5	15.8	16.5	17.0
Fiscal accounts (% of GDP)					
Budget balance	-5.1	-5.2	-4.1	-4.5	-4.3
Primary balance	-3.0	-2.9	-1.4	-1.7	-1.4
Public debt	42.6	50.0	55.4	58.7	61.7
External accounts					
Current account balance (EUR bn)	-0.5	-0.4	0	-0.1	-0.3
Current account balance/GDP (%)	-1.1	-0.9	0.1	-0.2	-0.7
Basic balance/GDP (%)	-0.1	1.5	2.5	2.1	1.9
Net FDI (EUR bn)	0.4	1.1	1.1	1.0	1.2
Net FDI (% of GDP)	1.0	2.4	2.4	2.3	2.6
Gross foreign debt (EUR bn)	46.5	45.7	44.9	46.1	47.9
Gross foreign debt (% of GDP)	104.6	103.0	102.3	103.3	104.2
FX reserves (EUR bn)	10.7	11.2	11.2	11.8	12.8
Inflation/Monetary/FX					
CPI (pavg)	1.1	2.3	3.4	2.8	2.9
CPI (eop)	1.8	2.1	4.7	2.3	2.5
Central bank reference rate (eop)	-	-	-	-	-
1W money market rate	1.18	1.28	1.39	0.70	0.90
USD/HRK (eop)	5.6	5.7	5.7	5.6	5.4
EUR/HRK (eop)	7.4	7.5	7.6	7.6	7.5
USD/HRK (pavg)	5.5	5.3	5.8	5.7	5.5
EUR/HRK (pavg)	7.3	7.4	7.5	7.6	7.5

Source: UniCredit Research

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

Croatia joins the EU, but without reforms, benefits are small

Following 1Q GDP, we hold our full year forecast at -0.8% yoy

Despite EU accession, seen as an opportunity for the Croatian economy, a lack of structural reforms weighs on the growth outlook

Growth & EU accession: In line with our expectations, the recession which started in 2008 remains persistent despite some indicators suggesting that parts of the economy have reached bottom. This mostly relates to industrial production and construction activity. Industrial production and construction increased around 1% yoy in Q1 2013 after more than four years of decline. However, private consumption continues to suffer from higher unemployment and lower real disposable income. This resulted in a retail sales decline of 4.6% yoy in 1Q despite Easter sales effects. Goods exports fell due to weak competitiveness and weak external demand. New investments are being continuously delayed, especially in the public sector, with uncertainty weighing on private initiatives. The flash estimate for 1Q GDP confirms that there is no turnaround in the economic environment, declining 1.5% yoy, and that more decisive actions in economic policy must be taken to change prevailing trends. The investment climate is suppressed by continuous announcements of regulatory changes, while the lack of decisive reforms, the slow restructuring of the real sector, especially in state-owned companies, and slow privatization limit the potential benefits of EU accession. Therefore, accession on 1 July should not bring visible short-term positive impacts, while risks of remaining in recession in 2014 still prevail. The foreseen recovery of EU economies alone will not be sufficient to drive the Croatian economic recovery, although it should help mitigate unfavorable developments in the domestic economy.

Fiscal policy lacks discipline following disappointing results so far in 2013

Fiscal policy outlook: MoF published preliminary results for 2012 showing general government expenditure at 42.2% of GDP, down 2.1pp from 2011 and considerably more than the 1.0pp required under the fiscal rule. But at least part of this is one-off in nature as a large portion of expenditures related to the shipbuilding industry were transferred to the government. YTD performance has been unimpressive. Expenditure rose 6% yoy in 1Q, with revenues remaining stagnant. A front-loading of expenditure earlier in the year is related to local elections, held in late May, and expenditure growth should moderate from here. EU accession is likely to increase discipline surrounding fiscal policy as Croatia will immediately, as soon as envisaged mechanism it allows, enter the excessive deficit procedure.

Foreign direct investments are absent, although a mild surplus in the current account balance helped alleviate external imbalances

BoP outlook: Improvements in C/A balance last year reflect declining goods imports and growing services incomes (mainly tourism), translating into a surplus of 0.1% of GDP. At the same time, foreign debt declined 1.7% yoy¸ to 102.3% of GDP. However, such achievements were accompanied by lower FDI (-10%). Following 1Q results in foreign trade, with exports declining faster than imports, we see C/A balance return to deficit. Croatia exits the CEFTA which results in losing preferential tariff position for its food and agricultural sectors' exports to this economic area. On the FDI front, net inflows should be driven by smaller investments and retained earnings, but economy is missing investments in export oriented industries.

Access to EU funds can support investment activities and capital inflows, but effects will heavily depend on speed of implementation of EU funded projects

Financial aspects of EU accession: Impact of EU accession can be followed also through flow of funds generated by transfers to EU budget and access to more generous EU funding. Financial envelope envisages transfer up to EUR 267mn to EU budget in 2013. It will be mitigated by cash flow facility in amount of EUR 75mn to reduce impact on government budget and it should, together with advance payments of EU funding for 2013 (30% of allocation), help Croatia keep net recipient position. Allocation commitment for Croatia is set to EUR 800mn through different facilities in 2013 (EUR 450mn from Cohesion policy), but the absorption will heavily depend on speed of implementation of EU funded projects. For an EU financial perspective 2014-2020, annual average allocations of EUR 1.4bn of EU funding are envisaged, spurring public investments, but with effects taking place in 2H of 2014 at earliest.

Without new economic policy actions, the risk of keeping funding conditions in interna-tional markets stable, if not improving, is rising

Credit rating outlook: Croatia has been moved below investment grade by both Moody's and S&P. To maintain the current ratings stance, further efforts are required with reform implementation, fiscal sustainability and financial stability. The breather afforded by relatively favorable borrowing terms in international financial markets should not be a reason for complacency, as the latest short-term movements reveal the vulnerability of current financial conditions for Croatian debtors and issuers.

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

Outlook – The detail of Q1 GDP data was considerably better than the very weak headline print and supports our view of a continued recovery in activity ahead, though a positive full year reading remains out of reach for 2013. Q2 monthly data has already supported such a trend. Fiscal policy should be less of a drag going forward while interest rates look set to remain at record lows for a number of quarters to come. Currency intervention remains an option but is still not our baseline as EUR/CZK has been broadly in line with the CNB's goals. Don't expect a rapid recovery but a gradual improvement should begin to take hold!

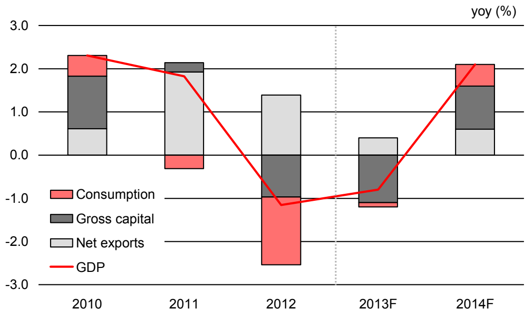
Strategy outlook – While in the very short term 7Y bonds offer the largest premium over bunds, in the longer run we expect the 4Y-8Y segment of the yield curve to steepen.

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

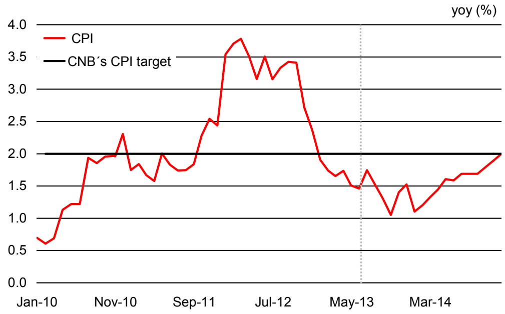
KEY DATES/EVENTS

- CNB policy meetings – Aug 1, Sep 26
- Manufacturing PMI – July1, Aug 1, Sep 2
- 2014 state budget draft – September

GDP: FIXED CAPITAL TO BE THE KEY DRAG IN 2013; A BALANCED GROWTH SEEN IN 2014



CPI: A LENGTHY PERIOD OF BELOW TARGET INFLATION



Source: CZSO, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	149.8	155.4	152.4	150.1	160.6
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	14,241	14,804	14,499	14,258	15,236
Real economy yoy (%)					
GDP	2.3	1.8	-1.2	-0.8	2.1
Private Consumption	0.8	0.5	-2.6	-0.1	1.5
Fixed Investment	0.7	0.4	-2.6	-2.5	2.5
Public Consumption	0.2	-2.7	-1.2	-0.1	0
Exports	15.0	9.6	4.2	1.3	7.0
Imports	14.9	7.0	2.5	1.0	6.8
Monthly wage, nominal (EUR)	944	995	999	984	1,044
Unemployment rate (%)	7.0	6.7	6.8	7.8	7.4
Fiscal accounts (% of GDP)					
Budget balance	-4.8	-3.3	-4.4	-2.9	-3.0
Primary balance	-3.5	-1.9	-3.8	-1.7	-1.5
Public debt	37.8	40.8	45.8	47.9	48.9
External accounts					
Current account balance (EUR bn)	-5.8	-4.2	-3.7	-1.8	-1.8
Current account balance/GDP (%)	-3.9	-2.7	-2.5	-1.2	-1.1
Basic balance/GDP (%)	-1.4	-1.5	2.3	2.2	2.5
Net FDI (EUR bn)	0	0	0	0	0
Net FDI (% of GDP)	2.5	1.2	4.7	3.4	3.6
Gross foreign debt (EUR bn)	70.5	72.8	77.2	80.8	89.8
Gross foreign debt (% of GDP)	47.1	46.8	50.7	53.8	55.9
FX reserves (EUR bn)	31.8	31.1	34.0	34.0	34.0
Inflation/Monetary/FX					
CPI (pavg)	1.5	1.9	3.3	1.6	1.6
CPI (eop)	2.3	2.4	2.4	1.5	2.0
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.75	0.05	0.05	0.50
3M money market rate	1.22	1.17	0.50	0.50	0.95
USD/CZK (eop)	18.8	19.4	19.0	18.9	17.8
EUR/CZK (eop)	25.1	25.8	25.1	25.5	24.5
USD/CZK (pavg)	19.1	17.6	19.6	19.5	18.4
EUR/CZK (pavg)	25.3	24.6	25.1	25.7	25.0

Source: UniCredit Research

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

Not great but also not as bad as it looks

Q1 headline GDP data was weak but the detail was much better

Q1 headline GDP data was particularly weak but the detail was better, signalling improvement across a number of components. GDP in real terms declined by 1.1% qoq, its largest quarterly decline since Q1-09. This translated into a 2.8% yoy slump. That this represented the sixth consecutive quarterly qoq decline in GDP made it even more notable. But detailed data showed much improved private consumption (-0.5% yoy, +1.6% qoq). Gross fixed capital formation rose by a modest 0.4% qoq, following a 5pp decline in the second half of 2012, while exports also rose 0.4% qoq. The key factor behind the deepening recession (from 4Q12's -1.6% yoy) was an inventory rundown, subtracting 0.9pp qoq from GDP (1.1 p.p. yoy). From the production side, all major sectors except for financials saw yoy declines in real gross value added. Nominal GDP dipped 1.0% yoy, the same pace as in 4Q12, as the deterioration in real terms was partially offset by improving terms of foreign trade.

…while there are increasingly positive signals on

There are a number of reasons to believe that the improvement in the detailed data will translate into better headline data ahead. First, severe winter weather delayed the start of seasonal construction activity and slowed other economic activity. Second, the automotive industry – by far the most important manufacturing sector – took a combined hit from a reduction of oversupply across Europe and model upgrades at the local Skoda producer. Third, the scale of inventory adjustment was unprecedented for 1Q and probably left the inventory stock for many companies at minimums. All three factors suggest that improvement should be visible already in 2Q. That the May manufacturing PMI broke above 50 adds to our confidence. Exports also returned to growth in April, posting a 6.4% yoy gain in CZK terms. April (WDA) retail sales have almost ceased to shrink yoy. The early-June flooding seems to be causing some disruption but is unlikely to become a meaningful economic drag.

Although economic activity is set to improve in 2Q13, full-2013 GDP is projected at negative 0.8%

While the recession may be over, the pace of recovery will be modest. Global growth can hardly be expected to generate solid external demand for the Czech economy in the near term, which will not only limit a potential pick-up of exports but in addition make local companies hesitant on capital spending. From a private consumption viewpoint, nominal wage growth is set to stay extremely low (we pencil in a mere 0.7% yoy for 2013), while labor market structural changes may make average pay per employee even weaker (a brighter side of that is a limited rise of unemployment). In the 2013 GDP demand structure, we foresee a marginally positive contribution from net exports, a slightly negative one from household spending, while capital formation will remain more of a drag. Part of the bonuses for 2012 were paid in 4Q12, rather than 1Q13, boosting spending at the beginning of 2013. On balance, full-2013 GDP is expected to decline 0.8%, despite each of the remaining quarters posting growth qoq. We don't change our view of 2014 when growth of 2%+ should be supported by all major demand-side components.

Inflation to remain pretty subdued well into 2014

The weak macro environment means a prolonged period of below-target inflation. Following a sharp drop at the turn of the year, CPI was flat at 1.7% yoy between February and April. Food prices, tax and other administrative changes proved to be the only sources of inflation, with the sluggish economy keeping core inflation negative in yoy terms. Looking ahead, core inflation is likely to start picking up moderately on reviving import prices, driven by CZK weakness earlier this year and, later on, also due to the expected recovery of domestic demand. On the other hand, a drop in natural gas prices in May will dampen regulated price inflation. A planned increase in tobacco prices is of the same size to last year's increase and will not push inflation higher in yoy terms. As a result we see headline CPI at close to 1.5% by end-2013. Early next year, inflation in yoy terms could drop towards 1% as the effect of the VAT hike from this January will fall out of the base. A reduction in pressure on prices of heating and electricity is also a possibility for 2014 due to the recent decline in the price of emission allowances and political intervention in regulated prices. Later in 2014, the reviving economy should support a gradual rise of inflation.

Slowdown in net FDI inflow to be compensated for by improving C/A

1Q13 BoP data highlighted the country's firm external position. The annualised C/A deficit was unchanged from 2012 at a moderate 2.5% of GDP. Looking ahead we see further improvement in the C/A deficit, bringing it to 1.2% of GDP for full-2013. 1Q13 FDI posted similar net inflows as in the same period of last year, but the extraordinary inflow in late 2012 makes it unlikely to repeat the robust full-year outcome in 2013. Importantly, the projected decline in net FDI inflow to 3.4% of GDP in 2013 from 4.7% of GDP in 2012 will still keep the basic balance well in positive territory.

The government intends to terminate fiscal consolidation, with needed repairs after flooding not being the only reason

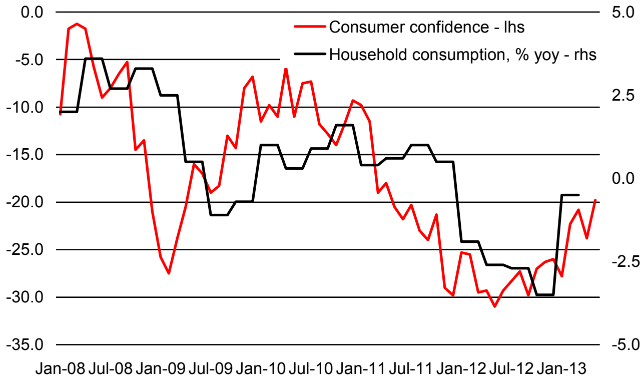
Fiscal policy should no longer drag on GDP growth this year. While the public sector deficit net of one-offs hit 2.5% of GDP in 2012 (against 2011's 3.3% of GDP), the year's deficit is forecast at 2.8%. Moreover the government is said to have set aside CZK 5.3bn for repairs after recent flooding. Much of the spending boost is facilitated by improving VAT collection and would have been triggered even in the absence of floods. However, flooding boosts the chance of extra funds being spent effectively.

Another shift in EUR/CZK forecast and /or another deterioration in GDP outlook would precede a decision on FX intervention by the CNB

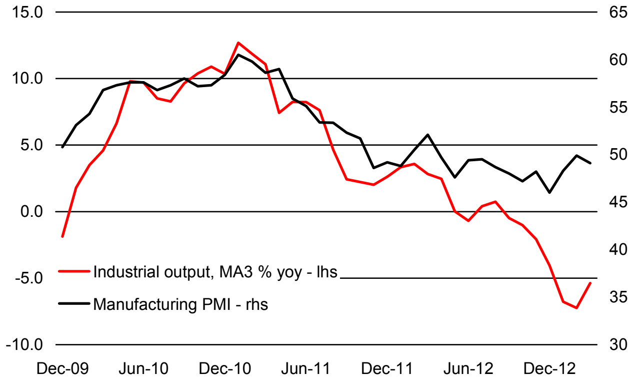
The CNB's May forecasts put GDP growth at -0.5% for 2013 and 1.8% for 2014. It also shifted its average EUR/CZK forecasts 1.2% higher to 25.6 for 2013 and 25.3 for 2014. The inflation outlook, in contrast, remained mostly unchanged. Governor Singer's occasional remarks that intervention may be required in the autumn look consistent with the scenario of a persistent recession but stable currency. We find such a combination possible but not very likely. In any case, we expect another shift in EUR/CZK forecasts and/or another deterioration in the GDP outlook to precede an intervention decision, with the first opportunity for those changes arising in August. All in all, we continue to find interventions unlikely, but the risk of their occurring may still prevent CZK from reverting to appreciation prematurely.

ACTIVITY DATA POINT TO GDP STABILIZATION AT THE START OF 2Q13

The consumer is on the right track…



…while PMI data points to an improvement in industry



Source: Markit, CNB, CZSO, UniCredit Research

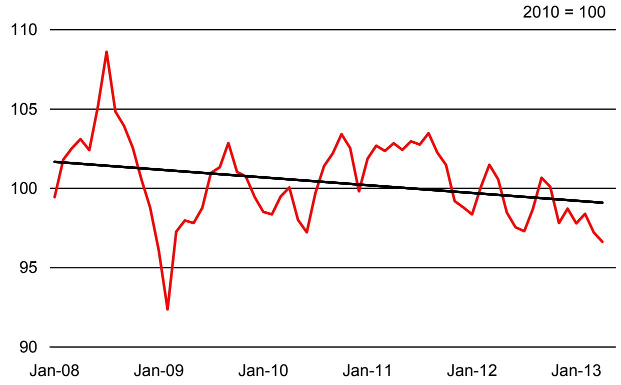
Strategy: More resilient than most

A normalisation of G7 yields created risks for Czech but financing risks are minimal

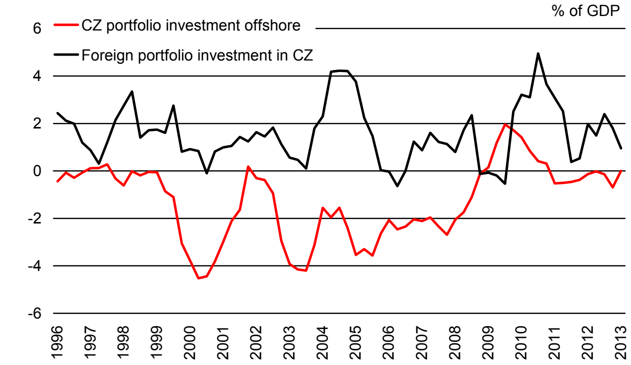
By the end of May, the state had covered 40% of its 2013 assumed borrowing requirements (excluding T-bills). The state treasury's cash reserve was reported at an all-time high of CZK 185bn at the end of 1Q, which may limit its issuance activity going forward. From the demand side, activity of local investors (banking books, building savings schemes, pension funds) will remain stable. Combining all of this with a narrow budget deficit, low public debt and an extended period of low inflation, financing risks in the Czech republic are minimal.

A normalisation of bond yields across the G7 world is more of a risk, particularly if some of the foreign inflows to the domestic fixed income market since 2010 were generated by investors in search of a 'Germany + spread' trade. Unlike pre-2008, these inflows have not been matched by outflows from locals into foreign investments – at times of stress these were returned on-shore but this is not an option this time around. In the very short term, the most interesting curve segment in relative terms appears to be the 7 year where CZK bonds offer an 80-90bp premium over bunds. However, with the short term bond yields anchored by low inflation, easy monetary policy over the medium term and manageable financing needs, we believe that a normalization of bond yields might lead to a bear steepening of the yield curve by 15-40 bp until year-end. The 4Y-8Y segment lies below the medium term inflation target of 2% and looks particularly vulnerable to further corrections.

Real effective FX rate of CZK on the downside since 2008



Portfolio inflows unmatched by outflows support the CZK



Sources: CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**18.8**	**16.2**	**17.6**
Budget deficit	4.0	3.9	3.8
Amortization of public debt	12.7	12.4	13.8
Domestic	12.5	12.3	13.8
Bonds	5.0	4.9	6.2
Bills	7.5	7.4	7.6
External	0.2	0.1	0.1
Change of govt. cash reserve	2.0	-0.1	-0.1
Financing	**18.8**	**16.2**	**17.6**
Domestic borrowing	15.9	15.8	15.5
Bonds	8.4	8.4	8.0
Bills	7.5	7.4	7.6
External borrowing	2.9	0.4	2.0
Bonds	2.7	0.2	2.0
IMF/EU	0	0	0
Other	0.2	0.2	0

MEDIUM AND LONG TERM GROSS EXTERNAL FINANCING REQUIREMENTS (INCL. C/A BALANCE)

EUR bn	2012	2013F	2014F
Gross financing requirement	**7.0**	**10.2**	**9.9**
Banks	0.6	0.8	0.7
Government and central bank	1.9	1.6	3.8
Other sectors	4.5	7.8	5.4
Financing	**7.0**	**10.2**	**9.9**
Banks	0.6	4.6	2.2
Government and central bank	2.8	0	0
Multilateral institutions	0.2	0.7	0.8
Companies	2.3	2.3	1.9
Other investors	1.2	2.5	5.0

Source: UniCredit Research

Hungary (Ba1 negative/BB negative/BB+ stable)*

Outlook – After the exit from the EDP, Hungary needs to focus on changing the structure of fiscal policies in order to boost growth. The current GDP recovery relies on slower destocking and agriculture, while consumption, investment, net exports and manufacturing are still contracting. While the C/A remains in surplus, FDI is weak and bank deleveraging continues. But BOP flows remain HUF supportive, as is the recently adopted funding for growth scheme.

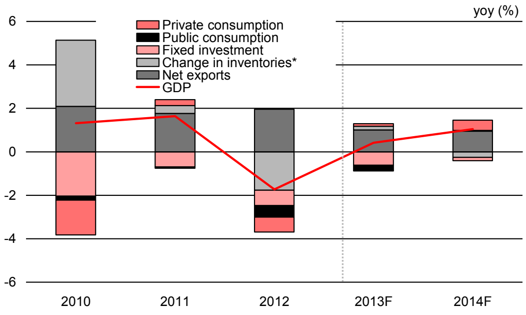
Strategy – The global risk retracement has affected FX bonds more than local currency debt. Going forward, we prefer REPHUN USD 03/21 and REPHUN USD 02/230 over USD HGB 06/22 and HGB 11/23, since FX bonds are more attractive due to the narrowing currency basis, while unhedged positions in local currency bonds are vulnerable to FX volatility.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

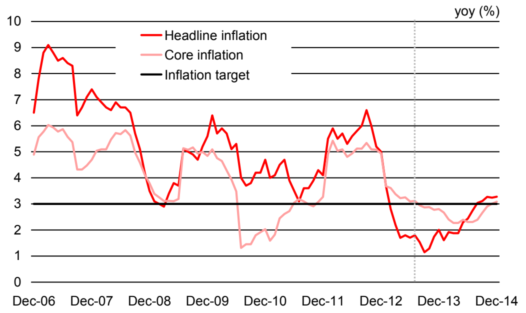
- NBH rate meetings: 25 Jun, 23 Jul, 27 Aug, 24 Sep
- Q2 GDP data: 14 Aug
- Venice Commission ruling on Constitution: 14-15 Jun
- Industrial production: 12 Jul, 14 Aug, 13 Sep

GDP DRIVERS



*Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	97.2	100.5	99.2	101.3	106.6
Population (mn)	10.0	10.0	10.0	10.0	10.0
GDP per capita (EUR)	9,696	10,045	9,923	10,131	10,665
Real economy yoy (%)					
GDP	1.3	1.6	-1.7	0.4	1.0
Private Consumption	-2.7	0.2	-1.3	0.2	0.9
Fixed Investment	-9.7	-5.5	-3.8	-3.4	-0.9
Public Consumption	1.1	-2.4	-2.5	-1.2	0.2
Exports	14.3	8.4	2.0	2.0	3.0
Imports	12.8	6.3	0.1	1.2	2.4
Monthly wage, nominal (EUR)	736	763	771	775	799
Unemployment rate (%)	11.1	10.9	11.0	10.8	10.7
Fiscal accounts (% of GDP)					
Budget balance	-4.2	4.3	-1.9	-2.7	-3.0
Primary balance	-0.7	-2.7	2.0	1.0	0.7
Public debt	82.2	81.6	78.0	78.1	77.1
External accounts					
Current account balance (EUR bn)	1.2	0.9	1.0	1.9	2.1
Current account balance/GDP (%)	1.2	0.9	1.0	1.9	1.9
Basic balance/GDP (%)	3.0	3.8	2.5	4.0	4.0
Net FDI (EUR bn)	1.7	3.0	1.5	2.1	2.2
Net FDI (% of GDP)	1.8	3.0	1.5	2.1	2.1
Gross foreign debt (EUR bn)	138.2	131.7	131.9	126.2	121.9
Gross foreign debt (% of GDP)	142.3	130.9	132.9	124.6	114.4
FX reserves (EUR bn)	32.3	35.1	31.8	31.8	30.7
Inflation/Monetary/FX					
CPI (pavg)	4.9	3.9	5.6	2.2	2.4
CPI (eop)	4.7	4.1	5.0	2.1	3.3
Central bank target	3	3	3	3	3
Central bank reference rate (eop)	5.75	7.00	5.75	3.50	3.50
3M money market rate	5.48	6.10	6.98	4.34	3.55
HUF/USD (eop)	209.6	233.9	220.6	222.2	217.4
HUF/EUR (eop)	278.8	311.1	291.3	300.0	300.0
HUF/USD (pavg)	207.5	199.5	225.0	224.6	217.4
HUF/EUR (pavg)	275.3	279.3	289.3	296.3	295.9

Source: UniCredit Research

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

Need to put growth on a more solid base

Hungary will be out of the EDP on 21 June…

With Hungary out of the excessive deficit procedure on 21 June, the government achieved one of its main goals. The budget deficit was squeezed to just 1.9% of GDP in 2012, but the cost was pushing the economy back into recession. Hence, the other goal of the government – reducing public and external debt to GDP ratios – remains far from being met. Thus, Hungary's situation has improved from a flow perspective, but the country remains highly dependent on risk appetite due to stock imbalances. Though necessary to boost growth, the transition towards more balanced fiscal policies after next year's general elections (expected in April or May) is unlikely, although the government recognizes the toll sectoral taxes are taking on growth.

…and needs to focus on growth, which is narrow-based

Hungary's GDP grew 0.7% qoq in 1Q13, but the economy is still far from a broad-based recovery. On the demand side, only inventories made a positive contribution to quarterly growth due to a slower speed of destocking than before. All other components fell: private consumption by 0.1% qoq, public consumption by 0.7% qoq, and investment by 1.4% qoq. Net exports had a negative contribution to GDP for a second consecutive quarter, due to a faster increase in imports (+3.3% qoq) than exports (+2.7% qoq). On a brighter note, exports recouped the losses from the very disappointing 2H12 and are now at the highest level on record. In contrast, fixed investment fell to the level of 2Q99 and private consumption remains close to the level of 4Q02. On the supply side, value added in all sectors with the exception of agriculture shrank 0.6% qoq in real terms. Manufacturing dropped 1.4% qoq, with the decline accelerating for the past three quarters. This is the sharpest drop since the crisis-hit 1Q09. We still expect a gradual recovery in economic activity due to a better harvest, a smaller fiscal drag and improving foreign demand in 2H13. We forecast growth at 0.4% this year and 1.0% in 2014.

The NBH will use the FGS to boost domestic demand…

…but the expected impact on growth is limited…

Domestic demand remains a drag on growth and its recovery is tied to a recovery of investment and a stabilization of the banking system. The former is unlikely due to the unpredictable tax system and poor growth outlook. The latter has been addressed through the new Funding for Growth Scheme (FGS) announced by the central bank. The FGS aims at stopping the decline of the loan volume by helping SMEs to lend and convert FX loans at preferential interest rates. The program's size (2.5% of GDP) might be extended if it meets healthy demand. At the same time, banks are likely to require state guarantees in order to enter the scheme, since the 2.5pp margin could prove too low to cover the repayment risk (the NPL ratio for SMEs was 19% at the end of March 2013). Updating the NBH estimates with the 50% increase of FGS to HUF 750bn, the maximum impact on GDP growth could be 0.3-0.5pp. The central bank doesn't expect the loan volume to rise due to the FGS, but hopes for a stabilization.

…while a stronger impact is expected on short-term external debt and the currency basis…

Besides the lending scheme, the NBH aims to reduce Hungary's short-term external debt by offering FX swaps for maturities up to two years (or longer if necessary) to banks that wish to repay their short-term FX funding lines. Thus, the short-term external debt of banks will be replaced through longer-term debt, allowing the central bank to reduce its FX reserves while complying with the Guidotti-Greenspan rule. The NBH expects swaps to increase by HUF 1,475bn (EUR 5bn), HUF 325bn from the loan conversion and HUF 1,150bn from the third pillar of the FGS. As a side effect, the structural need of FX will decline in the banking sector and will push the currency basis close to zero. This would be beneficial for the HUF and for FX bonds relative to HGBs. Yet the demand for swaps has been negligible since the FGS was launched.

…but the FGS is unlikely to stop the banking system from deleveraging

The central bank hopes that the banking sector will stop deleveraging and is trying to improve relationships with local banks after slapping them with several rounds of taxes. But bank outflows are far from over: after the foreign liabilities of the banking sector rose by EUR 100mn in 1Q13, a EUR 500mn turnaround vs. 1Q12, April brought outflows of EUR 947mn. The expected consolidation in the banking sector through mergers and acquisitions could further reduce the pace of outflows.

The Financial Stability Report published in May shows that the banking sector is well capitalised: capital represents 196% of minimum requirements under Hungarian regulation and 141% of regulatory capital requirements under the Supervisory Review and Evaluation Process (SREP) methodology. In addition, the banking system enjoys high liquidity buffers, as shown by the outstanding amount of two-week bills (the equivalent of EUR 15.5bn on 5 June). If the NBH manages to reduce the amount of two-week bills by HUF 1.0tn to HUF 3.6tn (as planned), bank outflows are likely to increase. The debt management agency AKK doesn't expect significant switches to T-bills due to longer maturities.

Strong C/A inflows contrast with poor FDI and bank deleveraging…

Meanwhile, commercial flows remain strong and the trade balance improved 15% yoy between January and April 2013, and we expect the current account surplus to increase to 1.9% of GDP this year from 1.0% of GDP in 2012, offsetting poorer FDI. Hungary's fallout with the European Commission over constitutional changes poses a threat to the stability of the BOP due to potential losses of EU fund flows.

…leaving the HUF dependent on portfolio inflows…

…which should be supported by manageable financing needs

With the C/A surplus partly offset by deleveraging, bond flows have a strong impact on the HUF. So far this year, foreign investors reduced their HGB portfolio by HUF 66.3bn (EUR 0.2bn), but 2Q13 brought inflows of HUF 240.8bn (EUR 0.8bn), keeping average EUR-HUF below the 300 threshold. Investors renewed their purchases whenever the pair approached (or exceeded) EUR-HUF 300, leading to a strengthening of the HUF. Sovereign financing needs are approximately EUR 14bn until the end of the year, out of which EUR 9.3bn are T-bonds and T-bills. The government has reserves equivalent to EUR 7.2bn, out of which EUR 1.1bn from the nationalized pension funds (a part of them probably in illiquid assets). Exhausting all reserves would imply that the government needs to roll over 73% - 85% of expiring debt. Local banks are likely to reinvest redemptions, since, from a yield perspective, marketable debt is the only important alternative to two-week bills that doesn't increase risk-weighted assets.

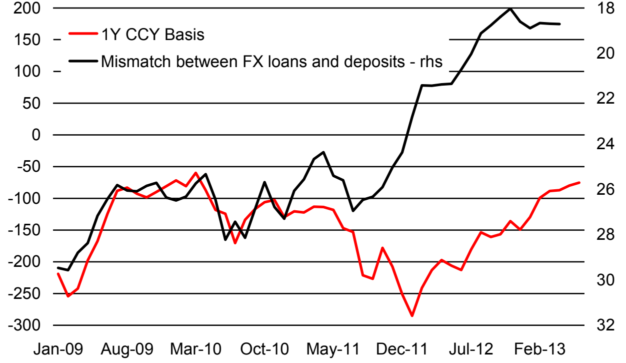
…and further monetary easing

The recent risk appetite correction led to a steepening of the HGB curve, because investors expect the NBH to cut rates further. Inflation fell below the 3% medium-term target and will probably end the year close to 2.1%. With further utilities and energy price cuts in the pipeline, inflation could remain close to 3% in 2014. Low second-round effects from food and energy prices are expected to push core inflation below 3% in 2H13. Weak growth and a tame EUR-HUF will probably support rate cuts to 3.5%.

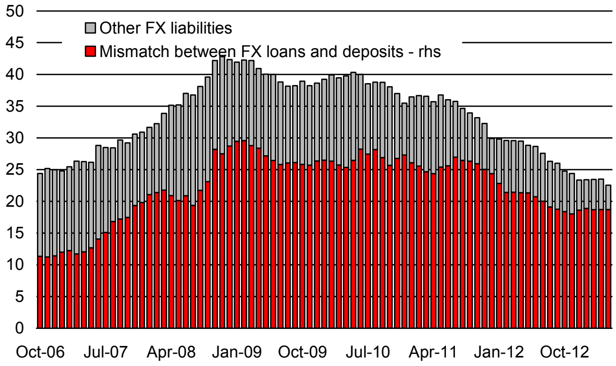
Persistent HUF volatility due to external exposure and political noise

The lower carry will be offset by the closing of the negative currency basis. Adding supportive balance of payments flows, EUR-HUF could dip below 290 absent strong risk aversion. But the HUF is likely to remain volatile due to a strong reliance on foreign funding and political noise before elections. Hence, spikes above EUR-HUF 300 are possible.

The basis should correct due to the lower FX loan-deposit mismatch



…but reducing the FX mismatch might trigger further outflows



Source: National Statistic Office, AKK, NBH, UniCredit Research

REPHUNs to outperform HGBs

In 2013, investors preferred EM local currency assets over hard currency ones

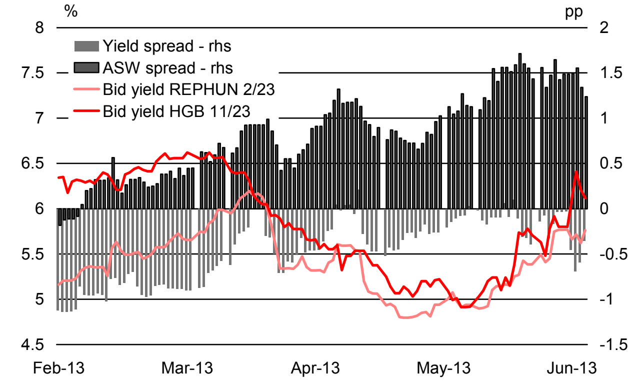
Between 1 Jan and 5 June 2013, investors favoured local over hard currency EM assets (net inflows of USD 15.7bn vs. USD 1.4bn) due to EM currencies outperforming DM ones until mid-May. In comparative terms, EM FX bonds have cheapened vs. local currency bonds, although we need to account for the different investor profiles. Hungary is no exception.

Adding the recent selloff, REPHUNs look cheaper than HGBs…

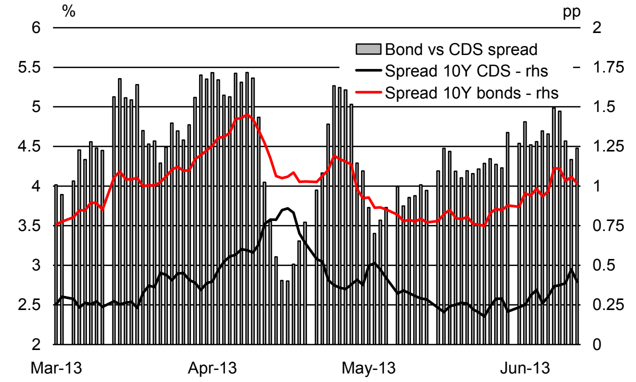
… but a narrower currency basis should help REPHUNs outperform HGBs

HGBs receive support from future rate cuts and foreign investors being slightly underweight, but unhedged positions remain vulnerable to FX volatility amid political noise ahead of elections. A narrowing of the currency basis should also favour REPHUNs over HGBs in relative terms. We prefer REPHUN USD 03/21 and REPHUN USD 02/230 over USD HGB 06/22 and HGB 11/23. We look for a widening of the yield spread by 50bp and a narrowing of the ASW spread by 100bp from 150bp currently, the highest level since October 2011.

Long-term REPHUNs look cheap compared to HGBs…



… and have cheapened compared to bunds



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**17.9**	**21.5**	**18.9**
Budget deficit	1.9	2.7	3.2
Amortization of public debt	16.0	18.8	15.7
Domestic	9.0	10.2	8.6
Bonds	3.4	3.8	4.3
Bills	5.5	6.4	4.3
Other	1.5	2.4	1.3
External	5.6	6.2	5.8
IMF/EU and other loans	3.7	4.8	3.0
Bonds	2.0	1.4	2.8
Financing	**18.9**	**21.5**	**18.9**
Domestic borrowing	17.6	18.3	15.9
Bonds	8.1	11.0	9.5
Bills	9.5	7.3	6.4
External borrowing	0	3.0	3.0
Bonds	0	3.0	3.0
IMF/EU	0	0	0
Pension funds	1.3	0.2	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**31.4**	**26.4**	**27.7**
C/A deficit	-1.0	-1.9	-2.0
Amortisation of medium to long term debt	10.0	11.0	15.1
Government/central bank	3.9	6.9	9.3
Banks	4.5	2.9	3.9
Corporates	1.6	1.2	1.9
Amortisation of short term debt	22.4	17.3	14.6
Government/central bank	7.2	5.6	4.5
Banks	10.9	7.3	6.6
Corporates	4.3	4.5	3.5
Financing	**31.4**	**26.4**	**27.7**
FDI	0.9	1.3	1.3
Equity	1.6	0.8	1.5
Long-term borrowing	3.6	6.7	7.4
Government/central bank	0	3.6	2.5
IMF	0	0	0
Banks	2.4	2.0	3.2
Corporates	1.2	1.1	1.7
Short-term borrowing	18.5	14.6	12.9
Government/central bank	5.0	4.5	4.0
Banks	9.4	6.6	5.8
Corporates	4.1	3.5	3.1
EU transfers	3.5	3.0	3.5
Change in FX reserves (reduction(+)/increase(-))	3.3	0	1.1

Poland (A2 stable/A- stable/A- positive)*

Outlook – The main growth driver in the remainder of 2013 will be net exports, with private consumption contributing only in 2014, and with investments under pressure from the rapid deceleration of EU spending. Inflation is likely to bottom out in June at around 0.6% and rebound towards the lower boundary of inflation target band (1.5%). The MPC is likely to deliver a final rate cut at the beginning of July. The state budget is under pressure from weaker-than-forecast economic growth. With more than 90% of the planned budget deficit reached already in April, the government will amend the 2013 budget bill in June. The newly proposed budget spending rule should be a positive factor in stabilizing long-term public spending.

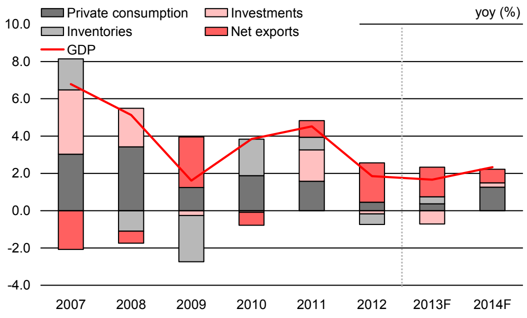
Strategy outlook – We look for a further bear steepening of the POLGB curve, as the easing cycle will probably end in July, followed by a pickup in economic growth and inflation.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

KEY DATES/EVENTS

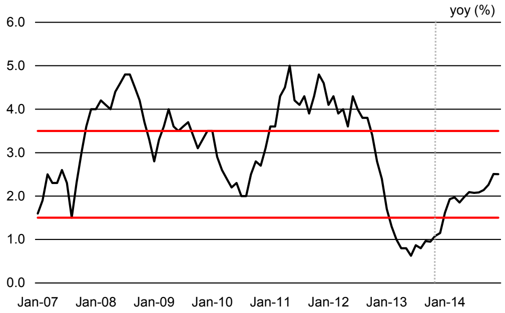
- Cabinet proposes state budget amendment – June
- Cabinet proposes new budget spending rules – June
- MPC decision-making meeting – 2-3 July
- Release of NBP Inflation Projection

GDP DRIVERS



*Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	354.6	370.9	380.3	387.8	413.2
Population (mn)	38.2	38.1	38.1	38.1	38.0
GDP per capita (EUR)	9,283	9,740	9,990	10,190	10,862
Real economy yoy (%)					
GDP	3.8	4.5	1.9	1.7	2.3
Private Consumption	3.2	2.6	0.8	0.6	2.1
Fixed Investment	-0.4	8.5	-0.8	-3.7	1.3
Public Consumption	4.1	-1.7	0.1	0.2	0.6
Exports	12.1	7.7	2.8	2.4	6.5
Imports	13.9	5.4	-1.9	-1.0	5.2
Monthly wage, nominal (EUR)	860	874	890	914	974
Unemployment rate (%)	12.1	12.4	12.8	13.9	13.9
Fiscal accounts (% of GDP)					
Budget balance	-7.9	-5.0	-3.9	-3.9	-3.5
Primary balance	-5.2	-2.3	-1.1	-1.2	-1.0
Public debt	54.8	56.4	55.6	57.6	57.6
External accounts					
Current account balance (EUR bn)	-18.1	-18.0	-13.5	-10.6	-12.9
Current account balance/GDP (%)	-5.1	-4.9	-3.5	-2.7	-3.1
Basic balance/GDP (%)	-2.2	-1.2	-2.9	-0.4	-0.5
Net FDI (EUR bn)	10.5	13.6	2.7	9.0	10.7
Net FDI (% of GDP)	3.0	3.7	0.7	2.3	2.6
Gross foreign debt (EUR bn)	237.4	248.1	276.1	265.3	287.3
Gross foreign debt (% of GDP)	66.9	66.9	72.6	68.4	69.5
FX reserves (EUR bn)	70.0	75.7	82.6	76.4	76.7
Inflation/Monetary/FX					
CPI (pavg)	2.6	4.3	3.7	1.1	2.0
CPI (eop)	3.1	4.6	2.4	1.2	2.4
Central bank target	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp
Central bank reference rate (eop)	3.50	4.50	4.25	2.50	2.50
3M money market rate	3.94	4.54	4.91	2.99	2.64
USD/PLN (eop)	3.0	3.3	3.2	3.1	3.0
EUR/ PLN (eop)	4.0	4.4	4.2	4.1	4.1
USD/ PLN (pavg)	3.0	2.9	3.3	3.2	3.0
EUR/ PLN (pavg)	4.0	4.1	4.2	4.2	4.1

Source: UniCredit Research

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

Economic growth set to accelerate in 2H13

After bottoming out in 1Q13, GDP should accelerate in 2H13, expanding by 1.7% in 2013

Net exports will be the main growth engine this year, supported by sentiment, a German rebound and a weak PLN

GDP growth bottomed out in 1Q13 and will accelerate in the following quarters, with net exports being the main driver. From 2Q12 on, net exports were the biggest contributor to GDP growth, and this situation will continue in 2013. In 1Q13, net exports contributed 1.4pp to the GDP growth of 0.5% yoy – we look for a 1.6pp contribution in 2013, after a 2.1pp contribution last year. Recent dataflow has been supportive for this assumption. First, specialized exporters are declaring increasing external demand and sales margins (NBP quarterly business conditions survey). Second, the German economy, the main trading partner and the recipient of 25% of Poland's exports, has been improving recently (as shown by rising new factory orders, Ifo expectations and industrial output growth), which historically has been a good leading indicator for the Polish industrial output. Third, the early June weakening of the zloty is likely to mean softer levels of domestic currency for at least a few months, and that will additionally boost the price competitiveness of exports while curbing imports.

Private consumption will be a stronger growth driver only in 2014

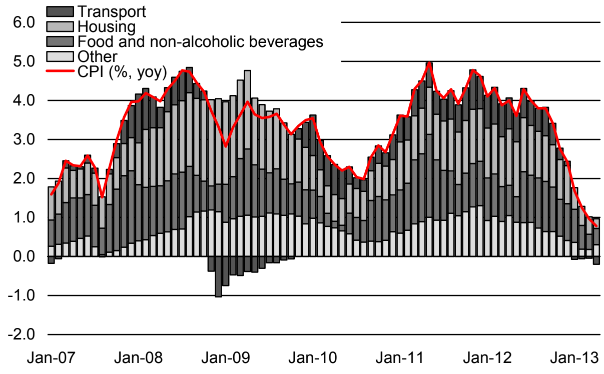
The domestic entrepreneurs find themselves in a relatively new situation – in the past years domestic demand (both private consumption and investment) was strong, whereas since 2Q12 net exports have been driving economic growth. Another factor contributing positively to GDP growth this year will be higher inventories (0.4pp). As the economy starts accelerating, higher levels of inventories will be needed after they were depleted in 2012 (-0.6pp contribution to growth). Private consumption is expected to contribute another 0.4pp to growth, although it remains under pressure from a weak labor market and an increasing savings rate due to positive real interest rates. Private consumption will likely become a stronger engine of growth next year, as labor market conditions improve and the better economic performance increases the propensity to spend.

CPI inflation will bottom out in June at 0.6% yoy

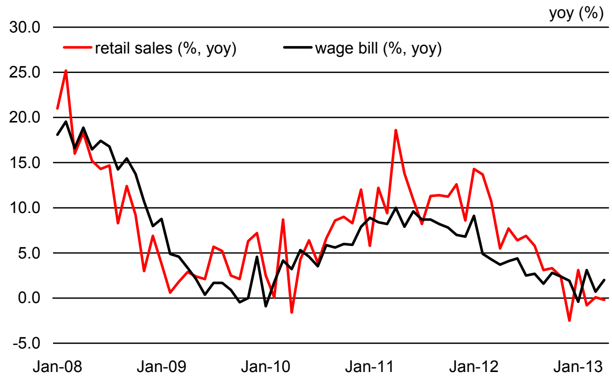
We expect June's inflation reading to represent the trough and expect inflation to rebound to in excess of 1.0% yoy by end-2013, as growth picks up and less-favorable base effects kick in. The inflation outlook remains benign, with net core inflation currently only slightly above 1.0% yoy (1.1-1.2%), and likely to stay there until year-end. Food price inflation has decelerated significantly, from above 5% yoy 12 months ago to less than 2% yoy currently and will probably end 2013 close to this level. We expect CPI inflation to stay below the lower boundary of the inflation target range (1.5%) till year-end, to rise towards 2% in early 2014 and to touch the inflation target of 2.5% in December 2014. Key risks to inflation are global food and energy prices, but sub-potential growth for at least another couple of quarters will contain inflation risks.

DESPITE A WEAKENING LABOUR MARKET CONSUMER CONFIDENCE MAY IMPROVE DUE TO FALLING FOOD AND FUEL PRICES

Lower growth of transport and food prices is the main reason for decline in inflation



The situation on labor market limits growth of retail sales



Source: GUS, UniCredit Research

After a likely 25bp rate cut in July, the MPC will probably keep rates unchanged for a couple of quarters

The July NBP inflation projection will clarify the rate strategy of the MPC

The MPC will likely cut rates again in July, pushing the key rate to 2.50%, and will announce switching to an informal "neutral bias". After the March cut and clear signals from the MPC that it was the end of the easing cycle, the MPC cut again in May (in order to maintain the spread to ECB rates, which were cut a few days earlier) and in June. Statements from many MPC members suggest that the MPC wants to be done with rate cuts "by holidays". July will be an interesting month, since the NBP will also release an updated inflation projection. The previous forecast showed CPI hovering at 1.4% yoy for most of the next three years; the new one will likely show it even lower in the next 1-2 years (due to a lower starting point), and rebounding slightly later on. At the same MPC meeting, we anticipate that the Council will switch to an informal "neutral bias", which would translate to leaving rates unchanged till end-2014 (assuming CPI stays below the 2.5% target and the ECB does not start hiking rates by end-2014).

The fiscal deficit hit 90% of the annual target already in April; budget amendments are expected in June

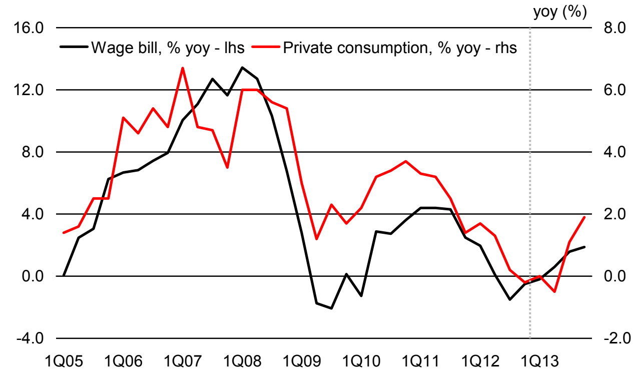
The fiscal situation remains tense, with the budget deficit hitting almost 90% of the annual target already in April. The cabinet announced that it will make an amendment to the budget in June. Weak economic growth and low inflation are taking their toll on tax revenues, with VAT revenues down 12.1% yoy in April, personal income tax revenue down 12.6% yoy and corporate income tax down a whopping 47.8% yoy. In June, the cabinet will release the details of the amendment to the state budget bill. It is likely that the official deficit ceiling for 2013 will be raised to approximately PLN 45bn, which would mean that the general government deficit will stay at 3.9% of GDP this year, flat from the previous year. As the European Commission gave Poland two years to push the deficit towards the target, the fiscal tightening will probably be gradual.

A new budget spending rule will encompass 90% of all public spending, and will be anti-cyclical

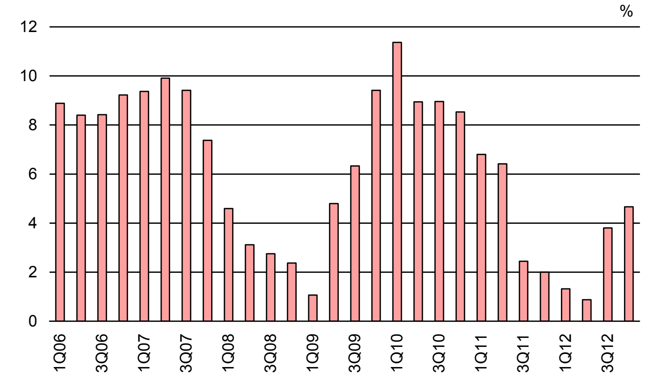
At the same time, Poland has its own internal limit for the debt/GDP ratio and as debt nears 55% of GDP this year, the cabinet may be tempted to "buy some time" with the partial nationalisation of the private pension system (OFE). The details of the analytical work on OFE will be released in the second half of June. Another interesting issue will be the new budget spending rule. The first important feature of the proposed changes is that it will cover most public spending (including social security etc), and not just central government spending, as it is the case now. Second, the rule is intended to be counter-cyclical. It assumes that the spending growth will be related to the pace of GDP growth for the past 8 years. Thanks to that, spending could grow faster than GDP when the economy stagnates and slower than GDP when growth accelerates. The details of the new proposals will be discussed in the coming months, and the government plans to implement the rule from 2014 on.

PRIVATE CONSUMPTION REMAINS SUBDUED DUE TO WEAK SIUATION IN THE LABOR MARKET AND INCREASED SAVING RATE

Real wage bill is set to rebound in the coming quarters, but will still remain under pressure from the weak labor market



Increasing households saving rate dampens consumption



Source: NBP, StatOffice, Ministry of Finance, UniCredit Research

Strategy: POLBGs to stay under pressure, PLN entry opportunities

POLGBs are under pressure from the end of the easing cycle and outflows from EM assets

Domestic T-bonds are expected to remain under pressure for the rest of the year. The expected end of the monetary easing cycle in Poland and the outflows from EM bond funds triggered by higher G7 bond yields have affected domestic fixed income. Local factors, such as the planned budget amendments and signs of recovery in 2H13, are also a negative for bonds. At the same time, approximately 83% of annual financing needs have been covered already, so the debt supply might fall in coming months, reducing the pressure on yields.

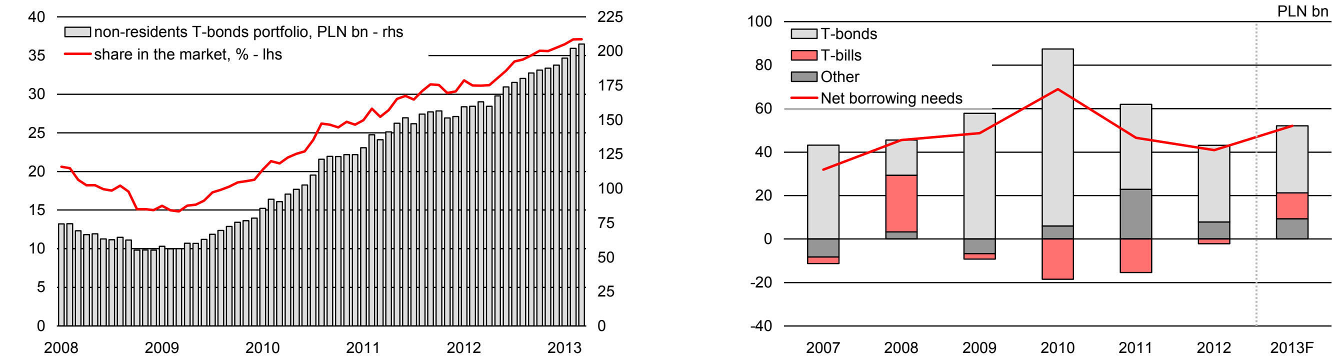
EUR-PLN will likely remain in the 4.25-4.35 range but above 4.3/EUR represents an attractive entry opportunity

EUR-PLN was pushed above 4.30 due to the global risk-off environment and an outflow of capital from EM. We expect the zloty to stay under pressure in the coming weeks, but consider levels above EUR-PLN 4.30 as attractive entry points for going long PLN vs. EUR. An economic rebound in the second half of the year will soothe fears of fiscal slippages and support the PLN. The NBP intervened above 4.30 to strengthen the zloty, and will likely step in above this level in the future. However, given that there is no single FX level that the central bank wants to defend, interventions might be done at various levels above EUR-PLN 4.30. Interventions were efficient in the past, but their effectiveness might be tested if POLGBs are sold in sizeable quantity, given that foreigners hold more than PLN 200bn of zloty T-bonds.

FOREIGN INVESTORS BECAME DOMINANT HOLDERS OF POLGB

Non-residents probably peaked above 200bn PLN of POLGBs

83% of net borrowing requirements for 2013 have been covered



Source: MinFin, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**41.4**	**38.3**	**36.5**
Budget deficit	12.8	13.8	11.2
Amortization of public debt	28.6	24.4	25.3
Domestic	24.6	20.9	21.2
Bonds	21.7	19.5	18.3
Bills	2.9	1.5	2.9
External	4.0	3.5	4.0
IMF/EU	0	0	0
Financing	**41.4**	**38.3**	**36.5**
Domestic borrowing	31.8	30.2	27.9
Bonds	32.5	27.7	27.1
Bills	1.5	3.7	1.7
Other	-2.2	-1.2	-0.9
External borrowing	9.6	8.0	8.6
Bonds	9.3	5.1	6.5
IMF/EU	0	0	0
Other	0.3	2.9	2.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**87.0**	**74.0**	**82.9**
C/A deficit	13.5	10.6	12.9
Amortization of medium to long term debt	18.6	12.6	19.9
Government/central bank	4.0	3.5	4.0
Banks	6.7	2.4	3.3
Corporates	7.9	6.7	12.6
Short term debt amortization	54.9	50.8	50.1
Financing	**87.0**	**74.0**	**82.9**
FDI	3.3	8.0	9.7
Equity	2.4	2.6	2.8
Borrowing	75.9	68.7	68.1
Government/central bank	9.6	8.0	8.6
Banks	17.2	14.9	15.5
Corporates	49.0	45.8	44.0
EU transfers	12.3	11.9	11.8
Other	-6.9	-17.3	-9.6

Source: MinFin, NBP, UniCredit Research

Romania (Baa3 negative/BB+ stable/BBB- stable)*

Outlook – Romania exits the excessive deficit procedure in June, after a successful fiscal adjustment. The country needs to focus now on spurring growth by reducing public sector slack and improving the structure of budget expenditure. Nevertheless, Romania will be one of the best performers in CEE in terms of growth in 2013. The biggest risk to the economy and the RON is bank deleveraging, weighing on lending and future growth potential.

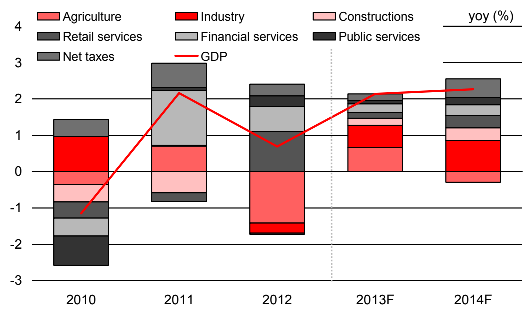
Strategy – If future bond flows will discriminate based on fundamentals and financing needs, Romania is well positioned in CEE. A limited ROMGB rally is possible from here on due to the attractive entry point (both for EUR-RON and yields) and provided that the NBR starts an easing cycle in July.

Authors: Dan Bucşa, Economist (UniCredit Bank London)
Cătălina Molnar, Chief Economist (UniCredit Ţiriac Bank)

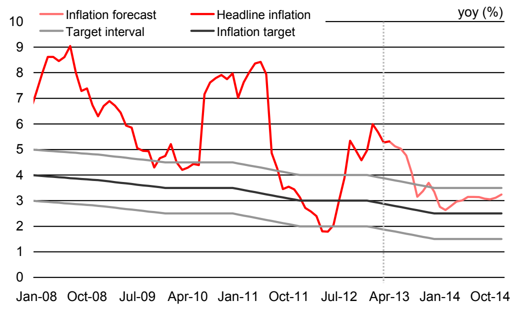
KEY DATES/EVENTS

- 1 July, 5 August, 30 September – NBR rate decisions
- August 2013: 2Q GDP (flash estimates)
- July 2013: talks start on a third IMF agreement

GDP GROWTH RECOVERS GRADUALLY



INFLATION TO MODERATE AT THE END OF 2013



Source UniCredit Research, NBR, CSO

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	124.4	131.4	131.8	143.4	153.9
Population (mn)	21.5	21.4	21.4	20.0	20.0
GDP per capita (EUR)	5,786	6,139	6,161	7,169	7,695
Real economy yoy (%)					
GDP	-1.1	2.2	0.7	2.1	2.3
Private Consumption	0.2	1.1	1.1	1.3	1.2
Fixed Investment	-1.8	7.3	4.9	2.3	5.3
Public Consumption	-13.7	-0.3	2.4	0.9	1.0
Exports	13.2	10.3	-3.0	2.2	3.3
Imports	11.1	10.0	-0.9	1.2	4.0
Monthly wage, nominal (EUR)	334	348	347	370	391
Unemployment rate (%)	7.3	7.4	7.0	6.9	6.7
Fiscal accounts (% of GDP)					
Budget balance	-6.8	-5.6	-2.9	-3.0	-2.5
Primary balance	-5.4	-4.1	-1.1	-1.2	-0.8
Public debt	30.5	34.7	37.8	37.2	36.2
External accounts					
Current account balance (EUR bn)	-5.5	-5.9	-5.2	-4.3	-4.6
Current account balance/GDP (%)	-4.4	-4.5	-3.9	-3.0	-3.0
Basic balance/GDP (%)	-2.6	-3.1	-2.6	-1.6	-1.3
Net FDI (EUR bn)	2.2	1.8	1.7	2.0	2.6
Net FDI (% of GDP)	1.8	1.4	1.3	1.4	1.7
Gross foreign debt (EUR bn)	92.5	98.7	99.2	101.2	105.0
Gross foreign debt (% of GDP)	74.3	75.2	75.2	70.5	68.2
Fx reserves (EUR bn)	32.4	33.2	31.2	30.5	30.5
Inflation/Monetary/FX					
CPI (pavg)	6.1	5.8	3.3	4.6	3.0
CPI (eop)	8.0	3.1	5.0	3.3	3.2
Central bank target	3.5	3.0	3.0	2.5	2.5
Central bank reference rate (eop)	6.25	6.00	5.25	4.50	4.50
1M money market rate (avg)	5.90	5.28	5.22	4.70	4.50
USD/RON (eop)	3.2	3.2	3.4	3.3	3.2
EUR//RON (eop)	4.3	4.3	4.4	4.4	4.4
USD/RON (pavg)	3.2	3.0	3.5	3.3	3.2
EUR/RON (pavg)	4.2	4.2	4.5	4.4	4.4

Source: UniCredit Research

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

Not over the hurdle yet

Exit from EDP caps the successful fiscal adjustment…

Romania's fiscal adjustment helped the country exit the excessive deficit procedure this year, capping four years of budget tightening that weighed on growth and reshaped the local political landscape. Moreover, the second IMF agreement will end in June 2013 and the final assessment due in mid-July will probably be positive. The Romanian government used the extra three months afforded by the Fund to fulfil the final provisions of the agreement: the state sold a 15% stake in Transgaz (the natural gas transporter) prepares to privatise CFR Marfă (the freight transporter) by 21 June and declared the insolvency of Oltchim, a large, loss-making chemical producer. In addition, the government pledged to continue the gradual liberalisation of energy and gas prices. The most problematic provision remains the implementation of professional management (managers chosen from the private sector) at state-owned enterprises (SOEs). The scheme has failed. Some SOEs received competent managers, but most of them have been replaced already, after having tried to implement restructuring programs. Other SOEs received managers reshuffled from other public companies.

…while the second IMF agreement is likely to end with a positive review

Future growth would benefit from a third IMF agreement

In this context, a new precautionary IMF agreement looks necessary, not from a financing or a fiscal point of view, but to continue reforms and increase potential growth. The budget deficit is likely to remain close to 3% of GDP in 2013 and 2014. But the fiscal adjustment squeezed public investment and the co-financing for EU funds more than the wage bill and social security outlays. This affects potential growth in the medium term. Subsidies for loss-making SOEs further reduce the scope of growth-generating state projects like infrastructure works. A third IMF agreement should increase pressure on the Romanian government to privatise or close loss-making SOEs. Selling minority stakes in so-called “strategic” companies (in energy or transportation) could result in better corporate governance and higher tax and dividend revenues for the government.

GDP growth picked up to 0.7%qoq in 1Q13…

Better growth numbers in 1Q13 don't mark a long-term improvement, but reflect revisions to historic data and higher car production. The GDP grew 2.2%yoy and 0.7%qoq in 1Q13, helped by exports on the demand side (+3.9% yoy), industry (+2.6% yoy) and trade and transportation (+3.2% yoy) on the supply side. Other services like IT and support services posted higher growth rates, but they account for just 9% of total value added. Meanwhile, domestic demand remained weak: private consumption fell by 0.2%yoy, while fixed investment fell 0.7%yoy. Inventories subtracted a full 0.5pp from annual growth.

…and the year-end forecast was upgraded to 2.1%...

We expect GDP to grow by 2.1% in 2013 on the back of a good harvest and increasing production at car and electronics manufacturers, both having positive effects on net exports. Although the fiscal drag will decrease substantially, the large share of social security and wages in total budget expenditure means that the likely effect on growth will be a stabilisation of consumption, rather than higher investment. For 2014, the growth forecast of 2.3% relies on a stronger recovery of demand from the euro area. However, there won't be a similar positive supply-side shock as in 2013 because of few large investment projects.

… helped by a good harvest and better net exports

The reliance on exports in 1Q13 coupled with lower imports due to weak domestic demand led to a trade surplus with countries outside the EU and a narrowing deficit with EU partners, resulting in the first current account surplus that Romania has registered since the 1989 regime change. The C/A will probably post a deficit at the end the year because Romania remains a net energy importer, but this could narrow to 3% of GDP from 3.9% of GDP in 2012 and is expected to remain flat in 2014.

Bank deleveraging remains the biggest vulnerability for the economy and the RON…

The C/A turnaround coupled with strong portfolio inflows helped the RON in 1Q13, but EUR-RON failed to break below 4.30 due to sporadic NBR interventions and an acceleration of deleveraging in the banking sector. At EUR 1.2bn in 4M13 and EUR 3bn (2.3% of 2012 GDP) between May 2012 and April 2013, the reduction of the foreign liabilities of the banking system is currently the most worrying vulnerability of the Romanian economy.

…with no meaningful recovery in sight for lending

If in the past banks were increasing FX liabilities at the end of every quarter, in time for NBR reports, there have been six months of continuous outflows since October 2012 (in April the outflows stopped, but it is too early to expect a reversal). In 4Q12, the central bank demanded the revaluation of loan collaterals, resulting in increasing provisions and a RON 2.0bn (EUR 0.45bn) loss for the banking system. The system booked profits of RON 520mn in 1Q13, but the outlook remains dire: the NPL ratio surpassed 19% in March 2013 and is expected to rise further in the absence of new lending. This year, the risk of shrinking credit volumes is high as retail loans fell 1.4%yoy at the end of April (FX-adjusted), while the decline of corporate lending accelerated to -0.7%yoy (FX-adjusted). The cost of funds remains elevated amid high deposit rates and minimum reserve requirements. Absent a money market that could offer a funding alternative, deposit rates are unlikely to fall quickly. Adding regulatory constraints on FX lending, a turnaround in credit extension looks unlikely at the moment.

The NBR should start an easing cycle on 1 July…

In this context, the National Bank of Romania should start a rate cutting cycle at its 1 July meeting. The NBR is the last CEE central bank to react to sub-potential growth due to its focus on RON stability, but governor Isărescu declared after the last rate decision meeting on 2 May that Romania can't opt out of the regional easing cycle, reinforced by the ECB's rate cut to 0.5% that further increased spreads vs. CEE policy rates. Meanwhile, economic data underlines the need for policy easing: GDP growth remains below potential despite picking up recently. The inflation rate is expected to fall inside the target interval (1.5-3.5%) towards year-end, helped by low food and commodity prices. We expect a 75bp easing cycle to be carried out this year. Although there is room for more rate cuts, the NBR has always added a risk premium to real interest rates.

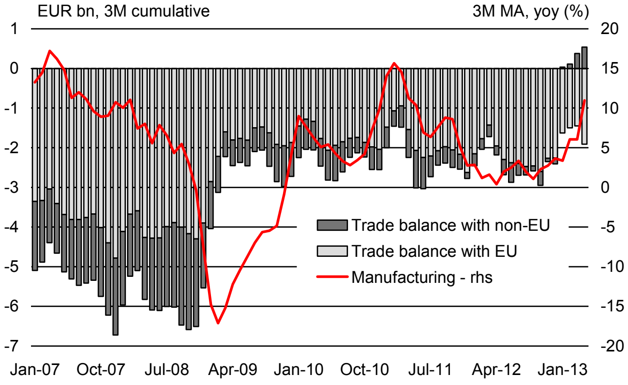
…since it would actually benefit the RON

The central bank's biggest fear is portfolio outflows and the potential short term reaction of the RON. We think that the RON would benefit from rate cuts since bond yields already price in three cuts and would increase if the central bank changes its mind, resulting in further outflows. Meanwhile, we expect EURRON to trade most of the year in the EUR-RON 4.3-4.5 interval, with the central bank intervening to cap volatility, if necessary.

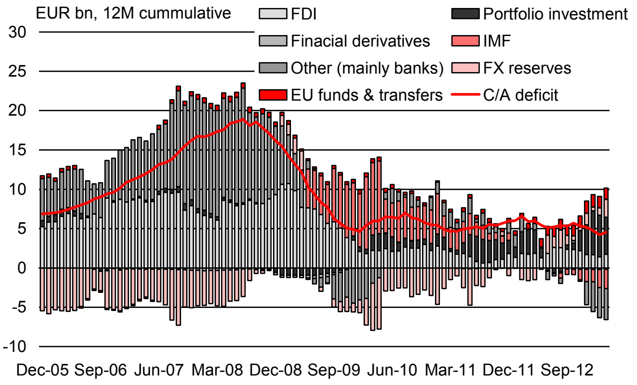
The MinFin has enough reserves to weather a risk-off second half of 2013

After peaking in January, net bond inflows stopped. Foreign investors held 21% of ROMGBs at the end of March and the share probably declined a bit after the May-June sell-off, leaving scope for further purchases. Going forward, ROMGB yields should be supported by better fundamentals and less pressure from new issuance. Benefiting from a relaxed redemption schedule until October, the MinFin is not rushing to issue on the local market. The MinFin covered 50.8% of gross financing needs for 2013 by 5 June. The remaining needs are fully covered by MinFin reserves. Rolling over all domestic redemptions until the end of this year (equivalent to EUR 5.7bn) would leave a financing gap of RON 8.4bn, less than a third of the reserves held by the MinFin at the end of April 2013. If the MinFin decides to return to foreign bond markets in 2H13, then the pressure on reserves will be even lower.

Strong industrial production leads to a narrowing of the trade deficit..



... but portfolio inflows are needed to offset the bank deleveraging



Source: MinFin, NBR, UniCredit Research

Risk appetite and NBR policy to shape RON yields

Romania is well positioned in CEE if investors will discriminate based on fundamentals and financing needs

While the adjustment in risk appetite hits Romania together with other CEE countries, we believe that risk-off episodes will alternate with periods of better risk appetite. However, past large and indiscriminate inflows to all CEE sovereigns are unlikely going forward. In this context, Romania looks better in terms of fundamentals and financing needs than some of its regional peers like Croatia, Hungary, Serbia, Slovenia or Ukraine.

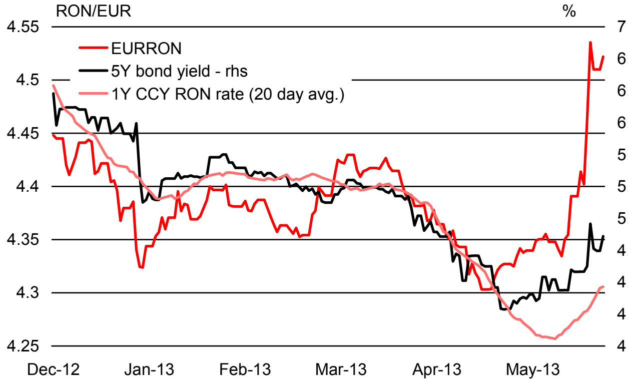
A limited ROMGB rally is possible due to the attractive entry point (both for EUR-RON and yields)

In this environment, we see a potential for limited gains on unhedged ROMGB positions when the RON trades close to EUR-RON 4.5 due to the central bank's bias towards a stable currency. Yield levels above 5.25% (the monetary policy rate in June) for the 5Y-15Y space look attractive if the NBR will deliver at least three rate cuts until the end of the year.

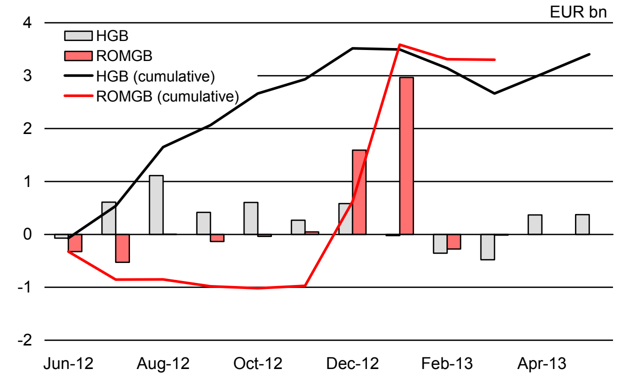
The risk is that the NBR won't start an easing cycle in July

If the NBR balks at an easing cycle, we expect the entire RON yield curve to move up and to steepen further. In this scenario, the MinFin might focus again on short term issuance, relying mostly on local banks to buy the new issues. This could lead to a bear steepening of the curve and, most likely, to pressure on the RON.

We expect EUR-RON to recouple with bond yields and swap rates



ROMGBs inflows have been lower than expected



Source: NBR, MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**15.5**	**16.6**	**15.4**
Budget deficit	3.3	3.9	3.4
Amortisation of public debt	12.2	12.7	12.0
Domestic	10.4	11.3	10.5
Bonds	2.3	4.7	6.0
Bills	7.5	6.1	4.0
Loans	0.6	0.5	0.5
External	1.7	0.5	0.5
IMF/EU	0.1	0.9	1.0
Financing	**20.1**	**16.2**	**15.5**
Domestic borrowing	13.8	13.7	13.0
Bonds	7.3	9.3	8.5
Bills	5.9	3.9	4.0
Loans	0.6	0.5	0.5
External borrowing	6.3	2.5	2.5
Bonds	4.7	2.5	2.5
IMF/EU/WB	1.0	0	0
Other	0.6	0	0

Source: UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**41.1**	**38.0**	**37.7**
C/A deficit	5.2	4.3	4.6
Amortisation of medium to long term debt	13.1	13.4	13.1
Government/central bank	4.1	5.7	5.5
Banks	3.2	2.7	2.0
Corporates	5.8	5.0	5.6
Amortisation of short term debt	22.8	20.3	20.0
Government/central bank	2.0	1.1	1.0
Banks	7.5	5.2	5.0
Corporates	13.3	14.0	14.0
Financing	**41.1**	**38.0**	**37.7**
FDI	1.7	2.0	2.6
Equity	-0.7	0.8	1.0
Borrowing	36.5	32.0	31.1
Government/central bank	8.0	6.5	6.0
Banks	8.3	6.0	6.0
Corporates	20.2	19.5	19.1
EU Funds - capital transfers	1.6	2.5	3.0
FX reserve change(reduction(+)/increase(-))	1.9	0.7	0

Slovakia (A2 negative/A stable/A+ stable)*

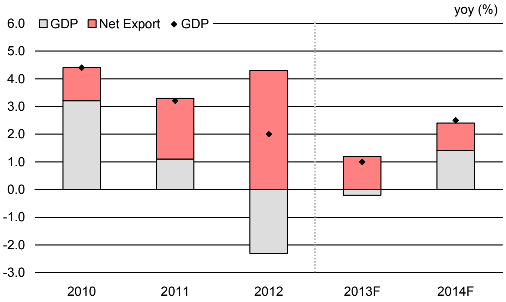
Outlook – The economy is expected to bottom out in the coming quarters, supported by better external demand, mainly in Germany. GDP should be still driven by net exports, while domestic demand remains weak, suppressed by fiscal tightening and low consumer confidence. A rebound of domestic demand is likely only at the turn of 2013 and 2014, following labor market stabilization and a moderate easing in fiscal consolidation. Inflation is subdued, as a result of minimum demand pressure and declining energy prices. The government is on track to narrow the budget deficit below 3% of GDP in 2013 as planned. A record high FT surplus is expected to shrink only with a recovery in domestic demand (2014). The CA should thus remain in surplus at about 3% of GDP.

Author: Ľubomír Koršňák, Chief Economist (UniCredit Bank Slovakia)

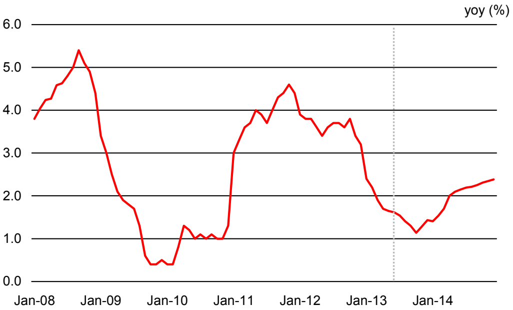
KEY DATES/EVENTS

- 10 Jul, 9 Aug, 10 Sep – Industrial production
- 15 Jul, 12 Aug, 12 Sep – CPI
- 14 Aug – flash GDP
- 4 Sep – GDP and its structure

NET EXPORTS AS A MAIN GROWTH DRIVER OF SLOVAK ECONOMY



INFLATION DECELERATES



Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	65.9	69.1	71.5	72.4	74.9
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12,128	12,725	13,158	13,337	13,791
Real economy yoy (%)					
GDP	4.4	3.2	2.0	1.0	2.5
Private Consumption	-0.8	-0.5	-0.6	-0.7	0.6
Fixed Investment	6.5	14.2	-3.7	2.0	2.9
Public Consumption	1.0	-4.3	-0.6	-1.5	0.0
Exports	16.0	12.7	8.6	3.3	6.8
Imports	14.9	10.1	2.8	2.3	6.6
Monthly wage, nominal (EUR)	769	786	805	821	841
Unemployment rate (%)	14.4	13.5	14.0	14.6	14.5
Fiscal accounts (% of GDP)					
Budget balance	-7.7	-5.1	-4.3	-2.9	-2.6
Primary balance	-6.3	-3.5	-2.5	-1.2	0.2
Public debt	41.1	43.3	52.1	55.2	56.5
External accounts					
Current account balance (EUR bn)	-3.1	0.0	0.0	0.0	0.0
Current account balance/GDP (%)	-3.7	-2.1	2.3	3.0	2.7
Basic balance/GDP (%)	-1.7	0.2	5.4	3.9	4.2
Net FDI (EUR bn)	1.8	0.0	0.0	0.0	0.0
Net FDI (% of GDP)	2.0	2.2	3.1	0.9	1.5
Gross foreign debt (EUR bn)	49.7	52.9	53.8	55.3	57.8
Gross foreign debt (% of GDP)	75.4	76.6	75.2	76.4	77.2
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Inflation/Monetary/FX					
CPI (pavg)	1.0	3.9	3.6	1.6	2.0
CPI (eop)	1.3	4.4	3.2	1.4	2.4
Central bank target	EUR	EUR	EUR	EUR	EUR
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
3M money market rate	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

External Demand Key to Economic Recovery

Government led by Robert Fico remains stable

The government, led by the center-left Smer-SD party of Prime Minister Robert Fico, remains stable. The upcoming presidential election (expected in spring 2014) may bring instability, depending on the choice of candidates. Prime Minister Fico has in our opinion a 50:50 chance of winning. The opposition cannot agree on a common candidate. In case Fico is elected president and leaves the post of PM, the popularity of his Smer-SD party is expected to decline and may mean some instability in the government. However, we do not expect it to lead to early parliamentary elections.

Government to cut public finance deficit below 3% of GDP in 2013

Thanks to a considerable consolidation effort, Slovakia reduced the general government deficit to 4.3% of GDP in 2012 (vs. a budgeted 4.6% of GDP). The government confirmed its objective to reduce the headline deficit below 3% of GDP in 2013, in line with the Excessive Deficit Procedure. The budget for 2013 relies mostly on revenue measures, while the reduction of expenditure is unfortunately concentrated on investment cuts. Tax collection is behind lagging behind target; with VAT particularly problematic. That said, we still see the government on track to meet this year's target.

Public debt ceilings will also trigger further consolidation in the coming years, albeit at a less intensive pace. In 2012, Slovakia increased its ratio of government debt to GDP to 52.1%, exceeding the 50% debt ceiling defined by the Slovak fiscal responsibility law. Based on the law, the Minister of Finance is obliged to submit an open letter to Parliament with a justification for the amount of debt and propose measures on its reduction. Further growth of government debt is expected in the coming years and should peak at the level of 56-57% in 2015. These trends are set to activiate automatic enforcement mechanisms, including a government confidence vote (when the debt ratio exceeds 60% of GDP).

The state has successfully completed several primary auctions of government bonds. Demand, both local and foreign, was particularly strong, mainly in May, narrowing spreads. The spread between 10 year Slovak and German government bonds narrowed to within 100bp . The government, taking advantage of favorable market conditions, has already covered 80% of 2013 financing needs as of May.

Economy continue to grow, driven by net exports

The economy shows recovery reliant on net exports. Domestic demand remains weak, adversely impacted by fiscal austerity measures and persistent low consumer confidence. Export growth remains lacklustre as the weak European car industry takes its toll but the trade balance is nonetheless heading for all-time surpluses amidst weak domestic demand. Structural changes to Slovak manufacturing, concentrated in the automotive sector and aimed at increasing reliance on local suppliers, also plays a role. From the supply side, GDP was supported mostly by services at the beginning of the year while poor weather conditions delayed a stabilisation in construction. Base effects are unflattering for manufacturing. Looking ahead, economic growth should accelerate, supported by stronger external demand. A recovery of domestic demand will materialise only by year-end and through next year. We see GDP growth to be 1.0% in 2013, accelerating to 2.5% in 2014.

Unemployment expected to increase

In line with a gradual recovery in activity, unemployment should peak in the summer-autumn months but continues to rise at this stage. Fortunately labour productivity is improving while the relatively high level of unemployment is preventing wage pressure. After two consecutive years of real wage declines, we could see a negligible increase in 2013, driven by decelerating inflation rather than accelerating nominal wage growth.

Inflation is slowing down

Inflation has slowed significantly, driven by energy price declines and the absence of demand pressure. Food prices remain the only inflation driver and are expected to peak soon. Inflation should remain slightly above 1% for the rest of the year, with some acceleration only at year end due to base effects and a gradually recovery in domestic demand. The downside risk to our forecast comes from regulated prices – the government indicated its intention to increase regulatory pressure, which could lower electricity and gas prices further.

Slovenia (Ba1 negative/A- stable/BBB+ negative)*

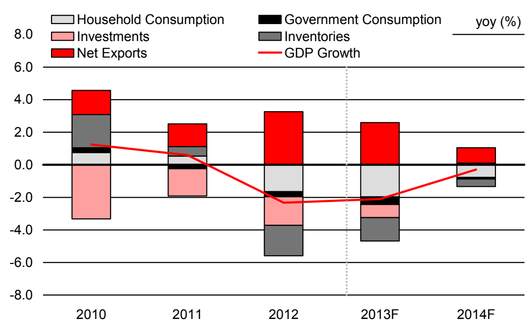
Outlook – Despite discouraging 1Q13 GDP growth numbers, Slovenia has managed to take itself out of the limelight and at least in the near term we see market risks as limited. Speeding up the asset transfers to the BAMC has been a good step forward, though the risks surrounding the banking sector recap requirements remain on the upside. On a more positive note, government funding for this year has already been secured despite the downgrades by both Moody's and Fitch, meaning that the risk of a Troika program is off the table for at least the next 12 months. However, further progress is required in capping budget expenditures as well as in presenting a more ambitious privatization program.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

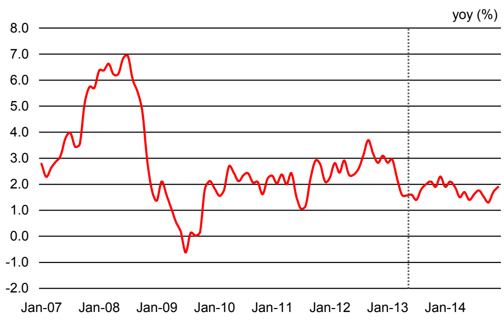
KEY DATES/EVENTS

- 30 Aug – 2Q13 GDP
- 28 Jun, 31 Jul, 30 Aug – Consumer Price Index
- 28 Jun, 31 Jul, 30 Aug – Retail Trade
- 10 Jul, 09 Aug, 10 Sep – Industrial Production

RECESSION TO PERSIST UNTIL END-2014



INFLATION TO SLOWDOWN



Source: Eurostat, NBS, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	35.6	36.2	35.5	35.2	35.5
Population (mn)	2.0	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,381	17,620	17,254	17,091	17,131
Real economy yoy (%)					
GDP	1.2	0.6	-2.3	-2.1	-0.3
Private Consumption	1.3	0.9	-2.9	-3.5	-1.4
Fixed Investment	-13.8	-8.1	-9.3	-4.6	0.6
Public Consumption	1.5	-1.2	-1.6	-2.4	-0.5
Exports	10.1	7.0	0.3	1.5	3.3
Imports	7.9	5.2	-4.3	-2.1	2.4
Monthly wage, nominal (EUR)	1,495	1,525	1,526	1,535	1,553
Unemployment rate (%)	7.3	8.2	8.9	10.3	10.6
Fiscal accounts (% of GDP)					
Budget balance	-5.9	-6.4	-4.0	-8.4	-4.2
Primary balance	-4.3	-4.5	-1.9	-5.9	-1.3
Public debt	38.6	46.9	54.1	67.6	71.3
External accounts					
Current account balance (EUR bn)	-0.2	0.0	0.8	1.3	1.1
Current account balance/GDP (%)	-0.6	0.0	2.3	3.7	3.1
Basic balance/GDP (%)	0.6	1.8	2.8	4.6	4.3
Net FDI (EUR bn)	0.4	0.6	0.2	0.3	0.4
Net FDI (% of GDP)	1.2	1.8	0.5	0.9	1.2
Gross foreign debt (EUR bn)	40.7	40.2	40.8	42.2	42.9
Gross foreign debt (% of GDP)	114.4	111.2	115.1	119.9	121.0
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.1	2.8	2.0	1.7
HICP (eop)	2.2	2.1	3.1	2.3	1.9
EURIBOR 3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: Unicredit Research

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

Double-dip to complicate fiscal and banking recap targets

1Q13 GDP contraction stood at -4.8% yoy, the worst performance since 4Q09…

Slovenia's growth challenge remains a concern as the economy is expected to remain in recession until 2015. In particular, we expect last year's GDP underperformance to be repeated this year as the economy will continue to see a significant weakening of domestic demand. The past 4.8% drop in 1Q13 GDP points in this direction, as domestic demand contracted for the sixth consecutive quarter by a further 7.7% yoy. Not surprisingly, gross fixed capital formation led the decline (-20.7% yoy), due to a large extent to the persistent credit contraction to non-financial corporates (1Q13 drop at -8.3% yoy). Net trade, on the other hand, remained positive, though this time the contraction in import demand was smaller than that seen in previous quarters.

…leading us to revise our GDP growth forecasts down

Against this backdrop, we have lowered our GDP estimates for the forecast horizon. More precisely, we expect the contraction this year to deepen by 2.1% yoy, followed by a mild slowdown of -0.3% yoy in 2014. Worth noting is the drop in private consumption, which will deepen vis-à-vis 2012 on account of: i) the worsening labor market prospects, ii) ongoing contraction in household credit (-2 67% in 1Q13), and iii) the austerity measures introduced in May's reform program. Among other things, the package includes a 2pp hike in the general VAT rate from 20% to 22%, while there is a 1pp increase in the reduced rate to 9.5% (effective as of 1 July 2013). In addition, public sector wages will be cut for the second time in six months, while a property tax will be introduced as early as next year. As for capital investment, it will improve vis-à-vis last year due to the increased absorption of EU funds, though it will still continue to decline given the corporate sector's high deleveraging needs. Slowly but surely, the trade balance will improve, though it will still remain insufficient to offset the overall drop in domestic demand.

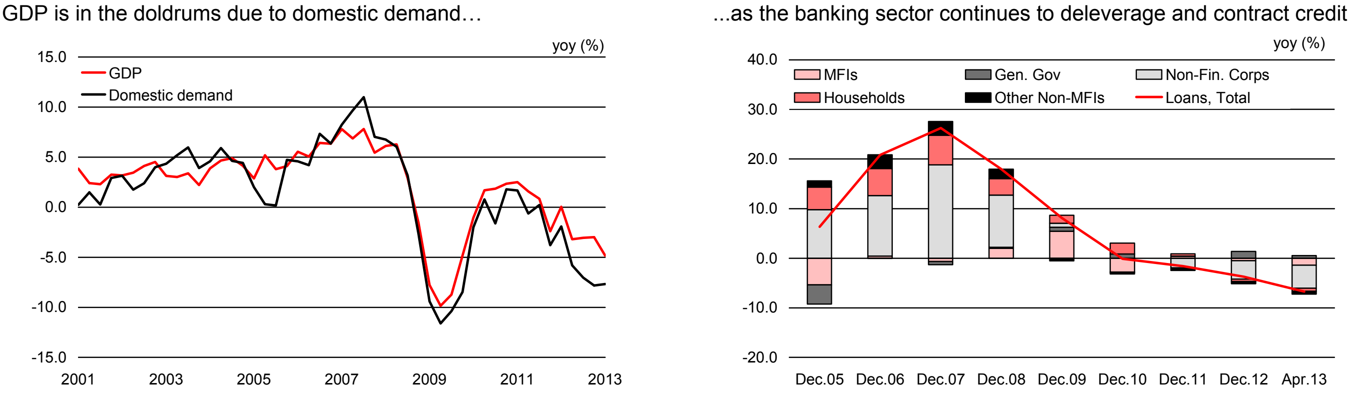
FY13 HICP inflation has been revised down to 2.3%, 0.4pp higher than the euro area average

Inflation continues to slow, with the HICP reading in May decreasing to 1.2% yoy (from 1.5% yoy in April). Component-wise, all basket items showed lower readings, with the biggest retrenchment seen in the prices of clothing and footwear products (-3.1% yoy). For year-end, we see inflation remaining subdued (2013F avg. CPI at 2% yoy) mainly on account of the easing of energy prices and continued slowdown in domestic demand. However, upside risks exist, given the recent lifting of some price controls on public utility services and expected July hikes to the VAT and reduced rates. In addition, there is also the introduction of the property tax next year, which should also contribute to keeping 2014 avg. HICP above the euro area average (1.7% yoy vs. 1.5% yoy respectively)

C/A to remain in surplus on account of the improved net export performance

C/A down in 1Q13, surplus expected for year-end. In 1Q13, the C/A surplus fell to EUR 221.2mn or 2.7% of GDP (from EUR 275.4mn in 4Q12), mainly due to the combined drop in income (EUR 18mn) and net current transfers (EUR 56mn). Funding-wise, portfolio inflows stood at low levels but this will due to the USD 3.5bn Eurobond. FDI continued to decline, with net outflows of EUR 14mn. For year-end, we expect the improved net export performance to increase the C/A surplus by 1.4pp of GDP, with most of the funding coming from portfolio inflows.

DOMESTIC DEMAND REMAINS WEAK DUE TO FISCAL AND CREDIT TIGHTENING



GDP is in the doldrums due to domestic demand…

...as the banking sector continues to deleverage and contract credit

Source: NBS, MinFin, UniCredit Research

Bank recap needs to exceed the EUR 954mn earmarked by the government…

The risks surrounding the banking sector recap needs are tilted to the upside. Following a series of micro stress tests this spring, the government estimated the banking sector's capital deficit at between EUR 954mn (baseline) and EUR 2.4bn (stress). Of these, the government has earmarked EUR 716mn for its three largest domestic banks (NLB, NKBM and Abanka Vipa), although in our view the capital shortfall could exceed this estimate due to the uncertainty on the end point for NPLs and the overall macro environment. Note that already last year NPLs reached 24.6% in the three largest banks, with the ratio of loans migrating from C to D category (i.e. non-performing) being as high as 16% yoy. While it is true that the BAMC will lower the system-wide NPL ratio (expected at 10.4% from 16.9%), there is a risk that the upward trend proves more aggressive than desired. In view of this, the EC recommended last May the need for an independent external adviser to conduct a new system-wide bank asset quality review.

…although efforts are being made to speed up and improve the functioning of the BAMC

BAMC legislation will be modified to encourage a more efficient sell-off of assets. In particular, the deadline for winding down the BAMC will be extended beyond five years and opened to private ownership (currently 100% state owned). This improved operational structure, combined with timely transfers, should increase the ability of the domestic banking sector to attract foreign capital, with NKMB at the top of the government's priority list. That said, our concern remains the speed at which the MinFin will get the BAMC up and running. The aim is to make the first NPL bucket transfer of "claims against clients in bankruptcy procedure" by end-June, with the remaining two buckets (i.e. claims against non-payers insured with real property and claims against restructuring companies) by the end of 3Q13. However, there is the risk that the last bucket transfer could be further delayed, given the complexity of the selection and division of various parts of entities.

The FY13 budget deficit has been revised due to the SOE recaps and limited expenditure cuts

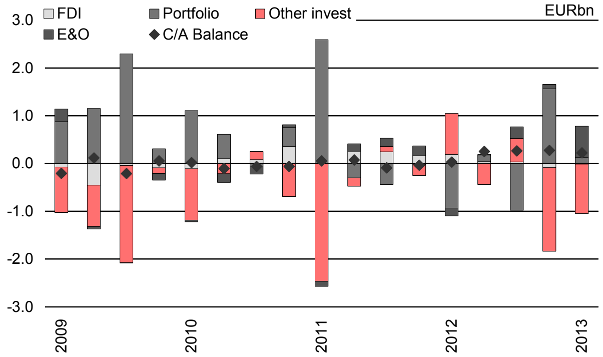
More needs to be done on the fiscal front to bring public finances into balance, as the deficit this year is set to increase to around 8.4% of GDP (vs. a 7.8% target). The revenue measures introduced in May's reform package (hikes in VAT reduced rates, introduction of property tax, suspension of the reduction in the CIT) are certainly welcomed, although they still remain insufficient to overcome the rise in budget expenditures (estimated at 1pp of GDP even after excluding the one-off recaps and incorporating the recent agreement on public sector wage cuts). In view of this and Slovenia's weak macro outlook, the European Commission decided on May 29 to extend the EDP deadline to 2015, with the first package of additional measures expected as soon as 1 October 2013. In addition, the government should also speed-up and enlarge its privatization program, as well as include more attractive corporates such as Triglav and Petrol Group to increase revenue proceeds.

The introduction of the fiscal and referendum rules will enhance fiscal and political stability in the near term

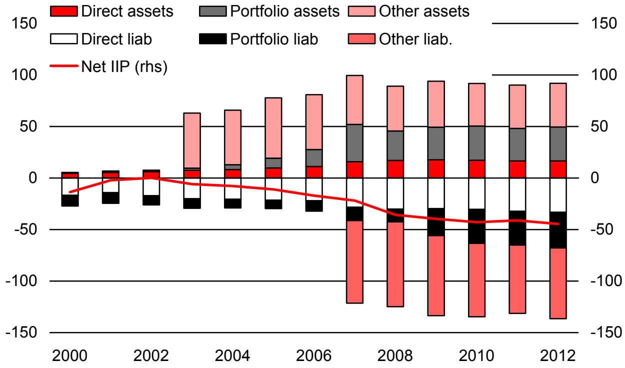
On a more positive note, the fiscal rule and referendum laws were approved by Parliament on May 24. The former includes the zero deficit rule into the Constitution, to come into effect as soon as 2015. The latter, on the other hand, limits the calling of referendums only to initiatives backed by 40,000 voters, while preventing at the same time any calls for legislation dealing with taxes, customs or national security.

EXTERNAL IMBALANCES ARE NOT SEVERE

Portfolio inflows are keeping the C/A funding manageable…



…while Slovenia's negative IIP trend has stabilized



Source: NBS, MinFin, Unicredit Research

Funding secured for 2013

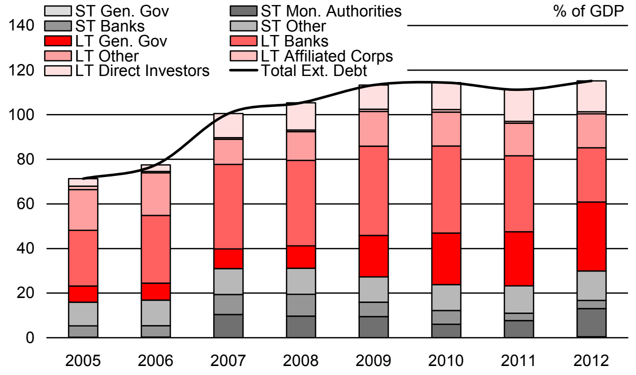
The government has sufficient cash to accommodate further recap needs

May's USD 3.5bn Eurobond has given the government some breathing space as it covers all of its remaining financing needs for the year. These are expected at EUR 2.8bn, after penciling in a remaining budget deficit of EUR 0.68bn (Jan-Apr deficit at EUR 962mn), EUR 0.9bn of debt redemptions, and assumed bank and SOE recapitalization costs of EUR 1.3bn. Note that, should the recap costs be higher than expected (pessimistic scenario at EUR 1.8bn), the government would still be able to accommodate them, as we estimate it has close to EUR 4bn in cash at its disposal (o/w EUR 2.6bn come from May's Eurobond).

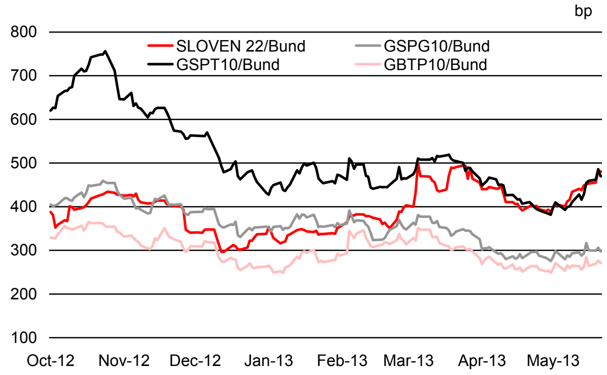
This means the risk of a Troika package in the next 12 months has fallen significantly. The risk of being forced to ELA financing also remains low as it is estimated that Slovenian banks still have sufficient collateral to more than double their current access to Eurosystem facilities. That said, the sovereign is not out of the woods yet as, besides historic-high yields, it still faces large redemptions, the likelihood of early elections and further bank recaps in 1H14.

MARKET CONDITIONS REMAIN A WORRY

Government reliance on LT external debt on a rise…



…with 10yr Slovenian spreads back at Cypriot-crisis levels



Source: NBS, IMF, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**3.3**	**4.8**	**4.5**
Budget deficit	1.4	3.0	1.5
Amortization of public debt	1.9	1.8	3.0
Domestic	1.9	1.8	3.0
Bonds	1.2	0.2	1.8
Bills	0.8	1.7	1.2
External	0	0	0
IMF/EU	0	0	0
Financing	**3.3**	**4.8**	**4.5**
Domestic borrowing	1.5	2.2	3.0
Bonds	0	0	0.5
Bills	1.5	2.2	2.5
External borrowing	1.7	2.6	1.5
Bonds	1.7	2.6	1.5
IMF/EU	0	0	0
Other	0	0	0

Source: MinFin, NBS, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**11.1**	**11.9**	**11.6**
C/A deficit	-0.8	-1.3	-1.1
Amortisation of medium to long term debt	3.5	2.8	2.6
Government	0	0	0
Central Bank	0	0	0
Banks	2.4	1.7	1.5
Corporates	1.1	1.1	1.1
Amortisation of short term debt	8.4	10.4	10.1
Government	0	0	0
Central Bank	2.8	4.5	4.7
Banks	1.2	1.3	1.1
Corporates	4.4	4.6	4.3
Financing	**11.1**	**11.9**	**11.6**
FDI	0.2	0.3	0.4
Medium to long-term borrowing	4.5	3.1	2.0
Government	1.7	2.6	1.5
Central Bank	2.3	0	0
Banks	0.4	0.3	0.3
Corporates	0.2	0.2	0.2
Short-term borrowing	6.0	7.9	8.5
Government	0	0	0
Central Bank	2.8	4.5	4.7
Banks	0.7	0.8	0.8
Corporates	2.5	2.7	3.0
EU Funds	0.5	0.6	0.7

Bosnia Herzegovina (B3 stable/B stable)*

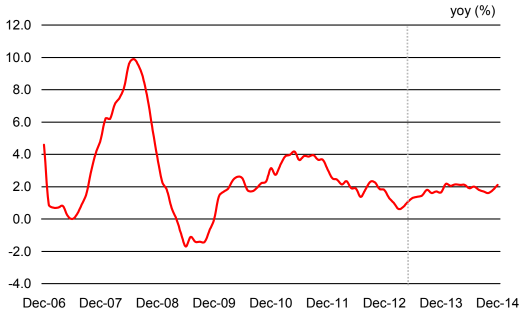
Outlook – Our GDP forecast for 2013 remains unchanged at 0.4% yoy, while for 2014 we revised it down to 0.9% yoy (from 1.2% yoy), as domestic structural reforms need more time to be implemented and global growth became slightly weaker. The domestic economy should recover modestly by the end of year on the back of an improvement in domestic energy, and therefore industrial production. On the other hand, fiscal consolidation will weigh on activity. Furthermore, in line with the SBA program, fiscal consolidation is on track with a focus on structural fiscal reforms, in order to generate medium to long-term sustainability. S&P's confirmed the sovereign rating B with stable outlook at the end of March.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka d.d.)

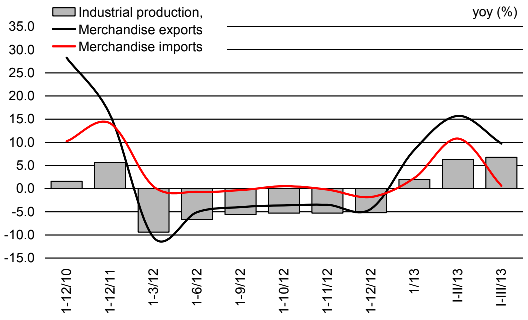
KEY DATES/EVENTS

- July/August GDP for 2012, production approach
- 25 August CPI and Industrial production for June 2013
- 25 August Wages and Unemployment
- 30 September Balance of payments for 1H 2012

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	12.7	13.1	13.3	13.5	13.9
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,296	3,417	3,459	3,520	3,621
Real economy yoy (%)					
GDP	0.7	1.0	-0.9	0.4	0.9
Monthly wage, nominal (EUR)	622	650	660	666	678
Unemployment rate (%)	43.5	44.9	45.5	45.8	45.5
Fiscal accounts (% of GDP)					
Budget balance	-2.5	-1.3	-2.5	-2.3	-1.4
Primary balance	-1.9	-0.5	-1.8	-1.4	-0.4
Public debt	37.1	39.4	41.5	40.1	38.8
External accounts					
Current account balance (EUR bn)	-0.7	-1.2	-1.3	-1.2	-1.1
Current account balance/GDP (%)	-5.7	-9.5	-9.6	-8.9	-8.2
Basic balance/GDP (%)	-4.2	-7.4	-6.4	-5.6	-4.8
Net FDI (EUR bn)	0.2	0.3	0.4	0.4	0.5
Net FDI (% of GDP)	1.5	2.1	3.2	3.3	3.4
Gross foreign debt (EUR bn)	6.6	6.7	6.9	7.0	7.2
Gross foreign debt (% of GDP)	52.4	51.2	51.9	52.2	52.1
FX reserves (EUR bn)	3.3	3.3	3.3	3.3	3.4
Inflation/Monetary/FX					
CPI (pavg)	2.2	3.7	2.1	1.3	2.0
CPI (eop)	3.1	3.1	1.8	1.6	2.1
3M money market rate	0.57	1.18	0.33	0.12	0.38
USD/ BAM (eop)	1.5	1.5	1.5	1.4	1.4
EUR/BAM (eop)	2.0	2.0	2.0	2.0	2.0
USD/ BAM (pavg)	1.5	1.4	1.5	1.5	1.4
EUR/ BAM (pavg)	2.0	2.0	2.0	2.0	2.0

Source: UniCredit Research

[*] Long-term foreign currency credit rating provided by Moody's and S&P respectively

Mild recovery with lower inflation

GDP forecast for 2013 remains unchanged at 0.4% yoy while we revised it down to 0.9% yoy (from 1.2% yoy) for 2014

Our GDP forecast for 2013 remains unchanged at 0.4% yoy, while for 2014 we revised it down to 0.9% yoy (previously 1.2% yoy). The downward revision reflects slower pace and smaller than expected impact of reforms on growth, while a slightly weaker external growth outlook is now envisaged. Readings for 1Q showed an increase in industrial production and goods exports, mostly due to growth of electricity production accompanied by small but overall positive developments in export-oriented manufacturing industry. As a result, industrial production grew by 6.8% yoy, while growth of goods exports reached 9.7% yoy. Unlike developments in the real sector that strongly benefited from the low base effect, weak consumer spending affected merchandise imports, increasing only 0.6% yoy. Fiscal consolidation is proceeding at a faster pace than envisaged earlier. Looking forward, economic trends should be marked by combined effects of dynamics in external demand, as its modest recovery is envisaged by the end of year, but with positive impacts of a lower base moderately fading away. On the other hand, fiscal consolidation and trends in indirect tax revenues will take their toll on public consumption, hindering the domestic demand recovery.

Inflation eased due to methodological changes and the impact of oil prices

Inflation outlook: Domestic and external developments resulted in a further reduction of our inflation forecast to 1.3% (previously 1.8%) for 2013 and to 2% (previously 2.5%) for 2014. Consumer prices in 1Q are largely affected by methodological changes in clothing and footwear, with an annual decline of 11.4%. As a result, overall inflation declined to 0.6% yoy in March. Oil prices on the international market helped maintain fuel prices at approximately the same level as in the previous year. The rise of food and beverage prices of 2.3% therefore was not sufficient to trigger a bigger increase in consumer prices. In the upcoming period, inflation will be determined by the food prices' trend, with the usual spring and autumn adjustments in administered prices. Weak purchasing power and developments in the wage level will help keeping it below the eurozone inflation rate.

The third tranche of SBA is disbursed, the fourth is waiting for a law on privileged pensions to come into force

SBA with the IMF: After adopting a law on privileged pensions, the third tranche (SDR 33.8mn or about EUR 39mn) was disbursed in May with a delay, bringing total disbursements under the program to 40% (SDR 135.3mn or some EUR 156mn). Despite tax revenues undershooting targeted levels due to slow economic growth and low consumer spending, expenditure will be controlled through savings, keeping the deficit within targeted level between 2% and 2.5% of GDP. As the government is set to repay a part of a public debt in 2013 (about 3% of GDP or EUR 400mn), public debt should start falling. Disbursement of the next SBA tranche should be processed as soon as the law of privileged pensions comes into force.

C/A deficit forecast is modestly revised as energy exports, stronger than expected, support overall goods exports trends

Balance of payments outlook: Favourable weather conditions supported electricity exports which increased almost five fold in 1Q. As a result we narrow our C/A deficit forecast for this year to 8.9% of GDP. Last year's deficit stood at 9,6% of GDP. However, with Croatia joining the EU, a common border will become the longest one in the EU. So, from July on, it will demand strong efforts for BH economy to adjust to it, as the key trading partner will exit CEFTA. We therefore see downside risks both for exports and imports in the initial period. On the capital account, downside risks for net FDI inflows (3.3% of GDP) will also rise if implementation of long-term investments in the energy sector will not be accelerated.

S&P confirmed sovereign rating B with stable outlook. Stable sovereign rating is expected to be kept, with no any revision soon

Sovereign rating and political environment: Standard & Poor's confirmed the sovereign rating B with stable outlook in March, noting that the SBA implementation provided economic stability. Developments on the political scene in BH have been marked by disagreements among ruling parties and by a process against the Head of Federation BH, slowing the process of forming a new government for this entity. The stalemate should be resolved in the upcoming period by more intensive relations as 2014 is an election year.

Russia (Baa1 stable/BBB stable/BBB stable)*

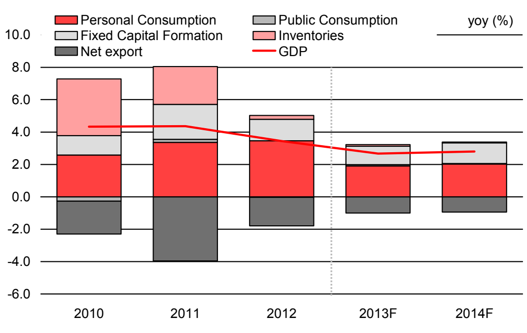
Outlook – Russia’s economy is facing a series of structural hurdles to growth which will take time to overcome. Despite a growth slowdown, the economy is operating at capacity. Last year Russia faced unchanged terms of trade rather than the improvement that is has become accustomed to. This year it is being forced to adjust to a modest disimprovement. New budget rules limit the scope for fiscal policy to support activity. The CBR is likely to continue to ease monetary policy, potentially even changing inflation targets to facilitate this, while the MinFin will also begin to convert at least some of its RUB into FX via the market rather than the CBR, improving domestic RUB liquidity. Moreover base effects will turn more favourable in H2-13. Nevertheless Russia faces a multi year period of structural reform, if it is to enjoy the 5% growth rate targeted by PM Medvedev.

Author: Artem Arkhipov, Head of Macroeconomic Analysis and Research (UniCredit Bank Russia)

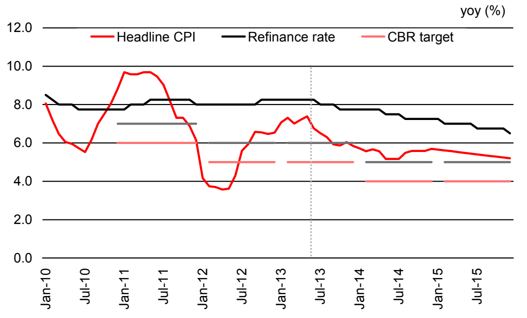
KEY DATES/EVENTS

- 23 June – Elvira Nabiullina becomes the head of the CBR
- June – initiation of the federal budget 2014-2016’ talks
- 5 July – preliminary 2Q balance of payments data
- 16 August – 2Q GDP data
- 18-23 of every month – short-term statistical overview
- 10-15 of every month – CBR decision on rates

DOMESTIC DEMAND WEAKENS



INFLATION ABOVE TARGETED REGION



Source: Federal Statistics Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	1,102.0	1,335.5	1,568.3	1,694.4	1,768.0
Population (mn)	142.9	143.1	142.9	142.7	142.5
GDP per capita (EUR)	7,714	9,336	10,978	11,878	12,411
Real economy yoy (%)					
GDP	4.3	4.3	3.4	2.7	2.8
Private Consumption	5.1	6.4	6.8	3.6	3.8
Fixed Investment	6.2	10.2	6.0	5.0	5.5
Public Consumption	0.7	0.8	-0.2	0.5	0.2
Exports	11.1	0.3	1.4	1.5	1.3
Imports	25.4	20.3	9.5	6.0	5.3
Monthly wage, nominal (EUR)	518	580	675	707	734
Unemployment rate (%)	7.5	6.6	5.3	5.3	5.4
Fiscal accounts (% of GDP)					
Budget balance	-6.6	0.8	0	-0.8	-0.5
Primary balance	-5.8	1.3	0.2	-0.5	-0.2
Public debt	8.3	9.8	10.2	11.0	11.7
External accounts					
Current account balance (EUR bn)	55.9	79.5	63.2	17.8	24.4
Current account balance/GDP (%)	5.1	6.0	4.0	1.1	1.4
Basic balance/GDP (%)	4.2	4.8	3.7	1.6	2.6
Net FDI (EUR bn)	-9.8	-11.8	-4.7	9.9	21.1
Net FDI (% of GDP)	-0.9	-1.2	-0.3	0.6	1.2
Gross foreign debt (EUR bn)	356.3	424.3	485.1	516.9	536.5
Gross foreign debt (% of GDP)	32.3	31.8	30.9	30.5	30.3
FX reserves (EUR bn)	358.2	384.7	407.0	382.1	363.6
Inflation/Monetary/FX					
CPI (pavg)	6.9	8.6	5.1	6.3	5.4
CPI (eop)	8.8	6.1	6.6	5.8	5.7
Central bank inflation target	6 - 7	6 - 7	5 - 6	5 - 6	4 - 5
Central bank reference rate (eop)	5.00	5.25	5.50	5.25	5.00
3M money market rate	4.00	6.60	7.45	6.90	6.25
USD/RUB (eop)	30.7	31.3	30.7	32.0	32.6
EUR/RUB (eop)	40.8	41.7	40.5	43.3	44.9
USD/RUB (pavg)	30.4	29.2	31.0	31.3	32.1
EUR/RUB (pavg)	40.4	40.9	39.9	41.3	43.7

Source: UniCredit Research

[*] Long-term foreign currency credit rating provided by Moody’s, S&P and Fitch respectively

A growth struggle

A variety of factors contribute to Russia' weak growth environment

The first half of 2013 has seen a significant slowdown in growth. Base effects are unflattering, given GDP growth in H1-12 of 4.5%. Capacity constraints play a role as capacity utilization stands close to its pre-crisis highs, investment is sluggish and unemployment is low at 5.6%. In 2012 Russia had to adjust from an environment of consistent terms of trade gains, driven by higher oil prices, to unchanged terms of trade while it is now being forced to adjust to deteriorating terms of trade as oil prices edged lower. Political uncertainty may also be taking its toll, e.g. the resignation of some top officials including ex-Deputy PM Surkov and Moscow Mayor Sobyanin.

Monetary policy has taken some modest measures to date but faces inflation constraints

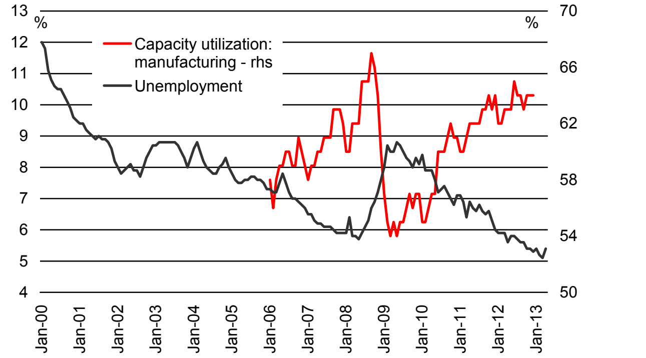
Monetary policy has been adjusted while more is likely to follow. The CBR started its easing cycle in April, which was sooner than expected, and has cut rates on long-term (above 3 months) refinancing operations by 50bp. This impacts almost 25% of total refinancing volumes. On June 23rd Governor Elvira Nabiullina assumes office and will want to take further action to aid activity. On credit, her challenge is twofold. First, corporate credit at 13.6% yoy is considered weak and while much of this is likely related to demand rather than supply, it is correlated with weak investment. Second, retail credit growth at 37% yoy is excessive but slowing. Our credit impulse measure, charting the change in credit growth against domestic demand, suggests considerable downside risks. But the Chairwoman's scope to act is limited by above-target inflation. In May inflation was at a 1.5 year high of 7.4% yoy compared with a target of 5-6%. Next year's target is scheduled to fall to 4-5%. In contrast, as per our 31 May CEE Navigator entitled "CEE: Testing inflation boundaries", we see it difficult for inflation to sustainably fall below 5%. Indeed, in our baseline scenario inflation stays above target. At least one 25bp cut to the repo rate is likely, in part facilitated by slower inflation as summer progresses due to a better harvest, but this in itself will not spur activity significantly.

The government is considering a series of measures to provide the central bank with more scope but these may also generate negative consequences longer term

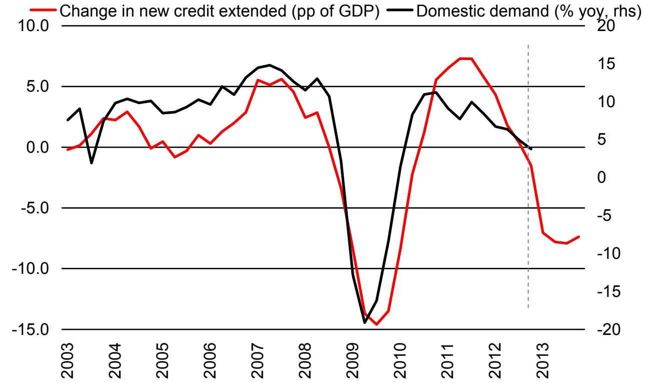
The government is taking action to provide the central bank with more room to act while the CBR also has some policy options available. Our concern is that many come with long term costs. For example there is discussion of an increase in the inflation target, in part because inflation is outside of the CBR's control, but this would come as the second over a 2-3 year period and risks eroding credibility. A change in the central bank's mandate to include growth as well as inflation will also come at a cost to credibility. The government's decision to slow the pace of tariff hikes aids inflation but comes with a fiscal cost. Worried about the pace of retail credit growth, the CBR (now responsible for financial stability and inflation) has initiated a series of regulatory measures (e.g. higher loan loss provisions) but is now considering easing these to maintain retail credit growth higher for longer.

BOTH CAPACITY CONSTRAINTS AND CREDIT LIMIT OUTPUT

Capacity utilisation is close to all time highs, unemployment all time lows



Credit poses downside risks to activity



Source: Rosstat, CBR, UniCredit Research

An agreement between the CBR and Min Fin to convert RUB budget proceeds destined for the reserve fund into FX via the market rather than via the CBR will introduce a structural seller of RUB to the market but introduces new upside risks to inflation and risks discouraging foreign capital into the OFZ market, as well as the local RUB corporate market over time.

Some measures have been taken on the fiscal front to support policy

The government has also taken measures on the fiscal front, bringing short term benefit but delaying the time period required to bring the reserve fund to its target of 7% of GDP. As mentioned above, planned tariff hikes are being delayed. Consolidated budget expenditure is up over 4% in real terms YTD, though this is considerably smaller than the increase around election time this time last year. The government has also decided that privatisation revenues will be re-invested in those companies rather than generating an inflow to the budget. To compensate for the shortfall, the MinFin plans to use the excess oil proceeds that would have otherwise been saved in the Reserve fund. The design of the rule allows for such actions but questions the rule's integrity while delaying accumulation in the reserve fund.

But structural measures to address Russia's growth challenge over the medium to long term are absent

All of the above represents short term gain while risking long term buffers and a higher rate of potential growth. To date the authorities' efforts have done little to address Russia's challenged business model, namely an economy reliant on energy exports but with limited potential to increase volumes at a time when energy prices are stable to declining. Funding for investment is becoming more challenging as domestic capital outflows accelerate and the C/A surplus declines. In Q1 this year it was particularly pronounced as domestic capital outflows exceeded USD 100bn, albeit because of a number of one-offs such as the Rosneft deal, while the C/A surplus edged down to USD28bn. Some renewed borrowing by banks offshore helps to fill the gap while in Q1 support was particularly strong for the opening of the OFZ market to foreigners and strong inflows to EM more broadly.

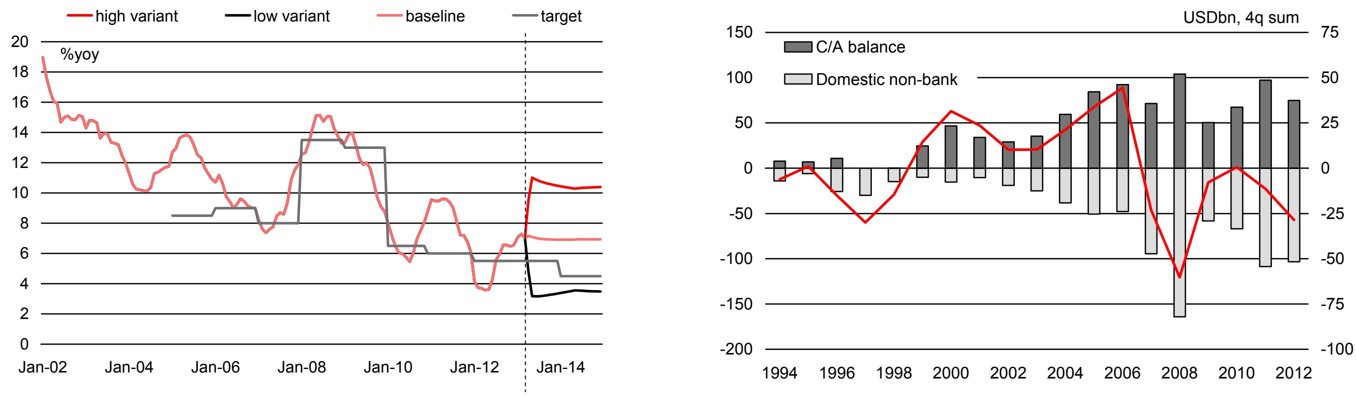
An urgent need to boost private investment

To increase the long-run potential growth of the economy, the government needs measures to boost investment, which has been far too low for too long. Part of this can be direct investment by the state to upgrade the necessary infrastructure (including transport links and telecommunications). However, there are limits to how much the state can do and, importantly, the returns of infrastructure projects tend to be fairly low (due to a mix of corruption and simply not knowing what to spend the money on). Ultimately then, it is crucial that the government provides a more business-friendly environment to stimulate private investment, and to increase spending on education where returns are much higher.

BOTH CAPACITY CONSTRAINTS AND CREDIT LIMIT OUTPUT

The risks to the inflation target are to the upside[4]…

…while Russia reliance on foreign capital has increased



Source: Rosstat, CBR, UniCredit Research

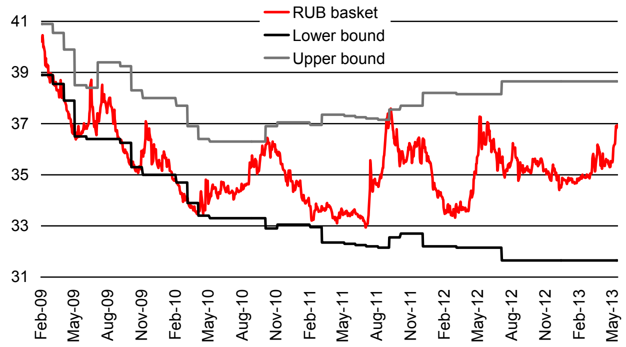
[4] Please note that the inflation projections presented here do not represent our baseline view but are the output of a cross-country inflation model for inflation targetters in CEE, made based on a series of assumptions on FX, oil and food prices. Please see our CEE Navigator for May for further detail.

A sign of more to come?

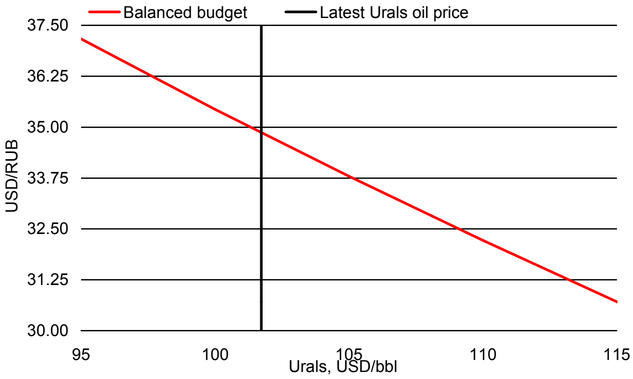
Our bias remains towards RUB depreciation

RUB and OFZ performance since the beginning of the EM sell-off last month is a valuable reminder of vulnerabilities. Russia has been the last emerging market globally to see a return of foreign capital and as such the amounts that the economy has accumulated in recent years relative to variables such as FX reserves are minimal. But this was still not sufficient to offer it protection once EM began to experience outflows. The simultaneous acceleration in domestic capital outflows adds to pressure. At this stage USD/RUB has not moved sufficiently higher to bring the budget into balance. Indeed, as the chart below shows, at the current Urals oil price of 101.7 $/bbl the USD/RUB must rise to around 35 for oil revenues to cover the non-oil budget deficit. Looking ahead some announcement on the sale of MinFin RUB proceeds to the market seems likely, adding a new RUB seller. Meanwhile the authorities themselves have highlighted of late their disappointment with domestic capital outflows. We are not of the view that a sharp RUB depreciation is likely, particularly given Russia's ability to draw off FX reserves, but the case for further gradual depreciation is convincing, should we fail to see a reversal of the current outflows from EM.

The RUB basket remains well within the CBR bounds



For a balanced budget the RUB must depreciate further



Source: Rosstat, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**36.1**	**46.2**	**43.7**
Budget deficit		13.6	8.8
Amortisation of public debt	16.5	18.1	20.8
Domestic	14.8	16.5	19.4
Bonds	14.8	16.5	19.4
Bills	-	-	-
External	1.8	1.6	1.4
Sovereign Fund	19.5	14.5	14.0
Financing	**36.1**	**46.2**	**43.7**
Domestic borrowing	31.0	41.3	39.1
Bonds	31.0	41.3	39.1
Bills	-	-	-
External borrowing	5.1	4.9	4.6
Bonds	5.1	4.9	4.6
Other	-	-	-

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**-3.9**	**39.1**	**32.6**
C/A deficit	-63.2	-17.8	-24.4
Amortisation of debt	47.6	49.1	51.4
Government/central bank	1.8	1.6	1.4
Banks	17.2	18.5	20.0
Corporates	28.6	29.0	30.0
Errors and omissions	11.73	7.84	5.56
Financing	**3.9**	**39.1**	**32.6**
FDI	4.7	12.8	16.2
Equity	-	-	-
Borrowing	63.1	79.0	65.1
Government/central bank	10.0	9.9	4.6
Banks	34.5	31.0	26.7
Corporates	18.6	38.1	33.8
Domestic investments abroad	84.5	27.9	30.2
Officiial reserves change / other	22.2	24.8	18.5

Source: MinFin, NBU, UniCredit Research

Serbia (BB- negative/BB- negative)*

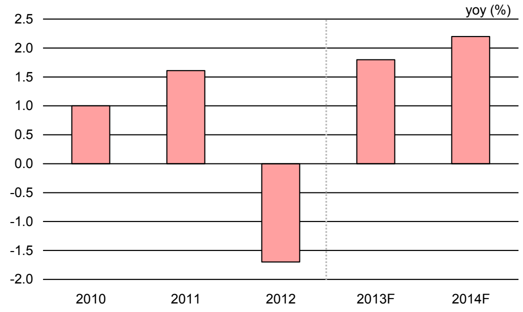
Outlook – The Serbian economy is in a more favorable position than last year amid better GDP growth (1Q13 GDP growth at 1.9% yoy), easing inflation pressures and renewed portfolio and FDI inflows. However challenges remain, particularly on the fiscal front as the deficit is expected to deviate from target by close to 2.1pp of GDP. While it is true the government enjoys a comfortable cash position to accommodate this year's funding needs, there remains a pressing need to address Serbia 's structurally-high twin deficit problem. The possibility of a starting date for EU-membership talks is a positive but an IMF program would provide a much needed anchor for fiscal policy.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

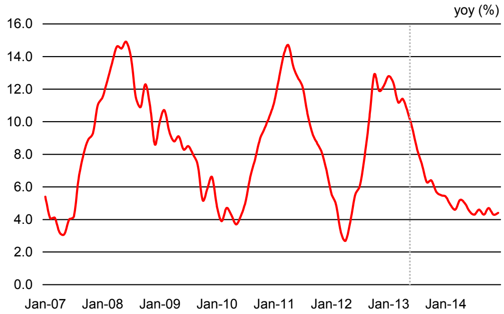
KEY DATES/EVENTS

- 28 Jun, 31 Jul – 1Q13 GDP (final), 2Q13 GDP (prelim)
- 28 Jun, 31 Jul, 30 Aug – Industrial Production
- 28 Jun, 31 Jul, 30 Aug – Retail Trade
- 11 Jul, 08 Aug, 12 Sep – NBS rate decisions
- 12 Jul, 12 Aug, 12 Sep – Consumer Price Index

GDP GROWTH RESUMING IN 2013



INFLATION SET TO PEAK IN 1Q13



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	28.0	31.5	29.9	32.9	34.1
Population (mn)	7.5	7.6	7.6	7.6	7.6
GDP per capita (EUR)	3,735	4,160	3,945	4,319	4,482
Real economy yoy (%)					
GDP	1.0	1.6	-1.7	1.8	2.2
Monthly wage, nominal (EUR)	461	518	508	536	557
Unemployment rate (%)	19.2	23.0	24.0	23.4	23.0
Fiscal accounts (% of GDP)					
Budget balance	-4.7	-4.9	-6.4	-5.8	-4.5
Primary balance	-3.5	-3.5	-4.4	-3.6	-2.1
Public debt	43.4	46.0	59.0	61.3	65.3
External accounts					
Current account balance (EUR bn)	-2.1	-2.9	-3.2	-2.8	-2.8
Current account balance/GDP (%)	-7.4	-9.1	-10.5	-8.5	-8.1
Basic balance/GDP (%)	-4.4	-3.3	-9.8	-5.5	-4.3
Net FDI (EUR bn)	0.9	1.8	0.2	1.0	1.3
Net FDI (% of GDP)	3.1	5.8	0.8	3.0	3.8
Gross foreign debt (EUR bn)	23.8	24.1	25.7	26.6	27.4
Gross foreign debt (% of GDP)	84.9	76.7	85.9	81.0	80.3
FX reserves (EUR bn)	11.7	12.9	12.0	12.2	11.7
Inflation/Monetary/FX					
CPI (pavg)	6.8	11.6	7.3	9.0	4.7
CPI (eop)	10.3	7.0	12.2	5.5	4.4
Central bank target	6%±2%	4.5%±1.5%	4.0%±1.5%	4.0%±1.5%	4.0%±1.5%
Central bank reference rate (eop)	11.50	9.75	11.25	9.75	9.50
BELIBOR 3M	10.72	12.88	11.64	11.48	11.05
USD/RSD (eop)	79.3	78.7	86.1	85.9	86.2
EUR/RSD (eop)	105.5	104.6	113.7	116.0	119.0
USD/RSD (pavg)	77.7	72.8	88.0	86.5	86.3
EUR/RSD (pavg)	103.0	102.0	113.1	114.1	117.5

Source: UniCredit Research

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

Fiscal slippage to complicate IMF deal

Fiat exports are leading the recovery despite weakened domestic demand

The Serbian economy has finally turned the corner after posting its first quarter of GDP growth since late 2011. The preliminary 1Q13 reading, which stood at 1.9% yoy, was mainly attributed to the strong performance of automobile exports (+USD 387.4mn), benefited greatly by Fiat's production of the new 500L model. Total production this year is estimated at 100,000 units, which should add close to 1pp to FY13 GDP growth (expected at 1.8% yoy). Such a positive contribution will also aid industrial production, which YTD has increased by 5.3% yoy. While it is true that this is somewhat flattered by last year's low base effect, we remain confident IP will continue improve until year-end. A strong contribution from agriculture is also expected, though its impact in curbing the current account (particularly from corn) will only be seen by 1Q14 due to the late yields. That said, the ongoing deleveraging and austerity at home will continue to keep domestic demand subdued, with the biggest hit likely to be seen in private consumption. Investment activity, however, is expected to recover due to growing FDI inflows to infrastructure, agriculture and energy (estimated at EUR 1bn this year).

Inflation to decelerate in 2H13 due to easing pressures from food and administered prices

Inflation will ease in 2H13, leaving the door open for further rate cuts. As expected, inflation in May remained high, with headline CPI growth increasing by 9.9% yoy. This mainly responds to the ongoing pressures from food and administered prices, expected to ease from 2H13 onwards as the high base effects from last year dissipate. Domestic demand weakness and lower fuel prices will also help curb headline CPI going forward, expected to converge to the upper level of the NBS' 4±1.5% target tolerance band by year-end. In view of this, we expect the NBS to continue cutting rates, with scope for a minimum of 125bp by end 4Q13. However, this should come alongside a more decisive FX selling policy by the NBS as the past 6 interventions in June (totalling EUR 115mn) have remained insufficient to limit the ongoing (and worrying) depreciation of RSD (2.9% drop since end-May). Note that net FX reserves remain at a comfortable EUR 7.2bn, which should give the NBS enough room of to limit RSD volatility. Soaking up RSD liquidity via increases to reserve requirements could also do the job. Looking ahead, we see the EUR/RSD trading at close to 116/EUR by end-2013, though risks to this estimate are tilted to the upside should Serbia fail to deliver on its fiscal targets and get an IMF deal by autumn.

Budget deficit to deviate from target by 2.1pp of GDP on account of revenue shortfalls

Fiscal slippage remains the biggest concern, as the government already envisages a deficit of between 4.5-5% of GDP this year (vs. an original target of 3.7%). In our view, the deficit this year will come close to 5.8% of GDP (excl. arrears) as budget revenues are expected to deviate further from target (1Q13 drop already at EUR 350mn). Expenditures are also set to increase partly due to i) realized capital expenditures (i.e. construction of Corridor 11 and Zemum-Borca bridge) and ii) increased interest and social protection payments. Securing an IMF deal by autumn will certainly prove challenging as it will require further cuts to public expenditure (new program expected to reduce the deficit by just 0.7% of GDP vs. 1% target). In particular, there is a need to make further adjustments to wage indexations and social contribution rates as public sector wages and pensions remain the highest in the EU. This should also be accompanied by limits to bonus payments, as well as on cuts to subsidies, since these have traditionally been large and non-selective (particularly in the agricultural sector). With this in mind, public debt will continue on an upward path, reaching close to 65% of GDP by end-2015.

Funding needs for this year to be secured via another USD Eurobond issuance

But funding has proved effective, as close to 63% of all financing needs for this year have been covered. Another USD 1.5-2bn Eurobond is expected by end-3Q13, which should more than accommodate the deficit deviation and allow for pre-funding. That said, Serbia remains highly vulnerable to changes in market sentiment as close to 60% of the local bond market is foreign owned. This makes an IMF deal ever more necessary as it would provide an anchor for policy, but for this to happen further efforts to address Serbia 's twin deficit problem will be required.

Turkey (Baa3 stable/BB+ stable/BBB- stable)*

Outlook – Three factors have contributed to a shift in monetary policy to a more hawkish stance in Turkey, namely global risk appetite, a recovery in activity and domestic political developments. Following TRY losses, the CBT has put forward a more decisive strategy to ease market volatility, including a reduction in TRY liquidity and FX auctions while the ROC has also kicked in. The CBT's appetite for TRY losses has limits given the increase in the corporate sector's net open FX position and FX pass-through to inflation. There are limits to the extent to which this strategy can be successful given the large amounts of foreign capital that has entered Turkey in recent years and Turkey's limited stock of FX reserves. Much will depend on the size and pace of outflows of foreign capital from emerging markets.

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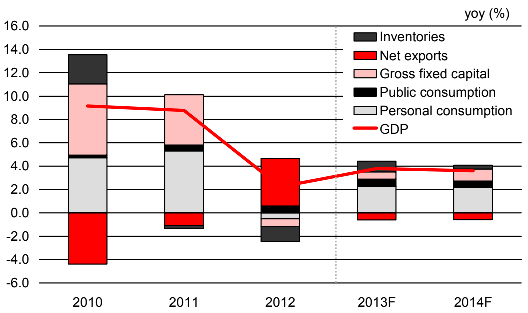
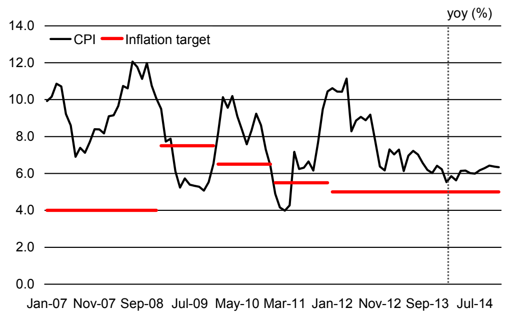
KEY DATES/EVENTS

- 1 Sep – 2Q13 GDP
- 18 Jun, 23 Jul, 20 Aug – Repo Rate Decision
- 3 Jul, 5 Aug, 3 Sep – CPI
- 8 Jul, 12 Jul, 9 Sep – Industrial Production

DOMESTIC DEMAND SLUMPS, LEAVING THE BURDEN ON NET EXPORTS



INFLATION TO EASE ONLY GRADUALLY BUT REMAIN OUT OF TARGET



Source: TurkStat, CBT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	552.4	558.6	611.9	638.2	634.3
Population (mn)	73.0	74.0	74.9	75.8	76.7
GDP per capita (EUR)	7,567	7,553	8,171	8,418	8,269
Real economy yoy (%)					
GDP	9.2	8.8	2.2	3.8	3.6
Private Consumption	6.7	7.7	-0.7	3.4	3.3
Fixed Investment	30.5	18.0	-2.5	2.5	4.2
Public Consumption	2.0	4.7	5.7	6.0	5.0
Exports	3.4	7.9	17.2	3.7	5.0
Imports	20.7	10.7	0.0	5.8	6.9
Monthly wage, nominal (EUR)	796	783	912	972	997
Unemployment rate (%)	11.9	9.8	9.2	9.2	9.2
Fiscal accounts (% of GDP)					
Budget balance	-2.3	-0.4	-1.5	-2.1	-2.9
Primary balance	1.4	2.3	1.3	0.7	-0.4
Public debt	42.4	39.3	36.6	35.8	35.8
External accounts					
Current account balance (EUR bn)	-34.3	-54.0	-37.1	-44.1	-50.0
Current account balance/GDP (%)	-6.2	-9.7	-6.1	-6.9	-7.9
Basic balance/GDP (%)	-5.2	-7.9	-5.0	-5.8	-6.7
Net FDI (EUR bn)	5.7	9.8	6.6	7.0	7.4
Net FDI (% of GDP)	1.0	1.8	1.1	1.1	1.2
Gross foreign debt (EUR bn)	218.5	235.8	255.3	289.5	328.9
Gross foreign debt (% of GDP)	39.5	42.2	41.7	45.4	51.8
FX reserves (EUR bn)	59.2	59.4	74.5	81.3	80.6
Inflation/Monetary/FX					
CPI (pavg)	8.6	6.5	8.9	6.7	6.1
CPI (eop)	6.4	10.4	6.2	6.2	6.3
Central bank target	7.5	6.5	5.5	5	5
Central bank reference rate (eop)	6.50	5.75	5.50	4.50	6.00
3M money market rate	7.5	11.3	5.8	6.75	7
FX/USD (eop)	1.5	1.9	1.8	1.9	2.1
FX/EUR (eop)	2.0	2.5	2.3	2.6	2.8
FX/USD (pavg)	1.5	1.7	1.8	1.9	2.0
FX/EUR (pavg)	2.0	2.3	2.3	2.5	2.7

Source: UniCredit Research

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

Trickier times

The shift in global risk appetite, signs of an unbalanced recovery in economic activity and domestic political developments means that a higher risk premium is being demanded of Turkish assets

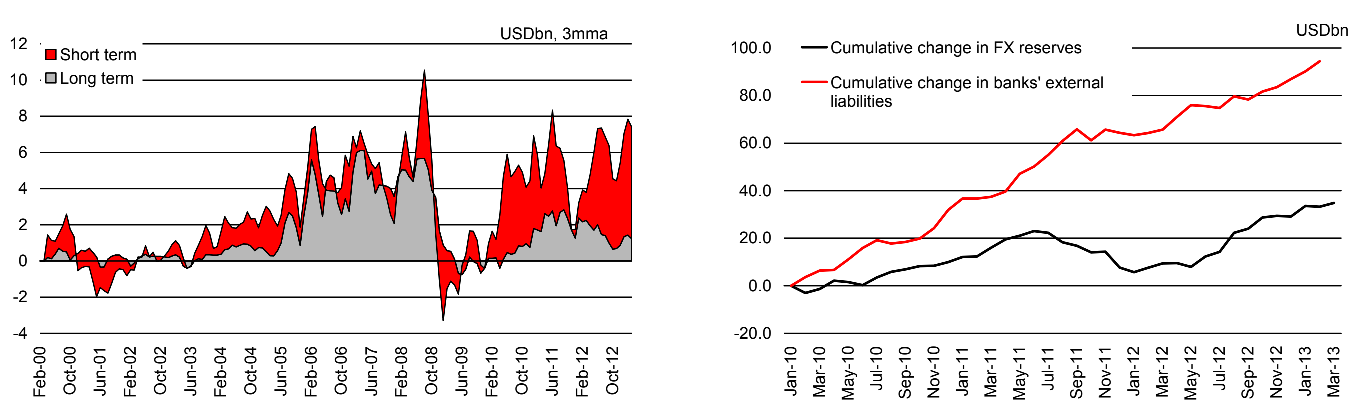
There are three factors generating a significant shift in monetary policy to a more hawkish stance in Turkey, namely global risk appetite, signs of a recovery in activity and domestic political developments:

- The beginning of a normalisation in US interest rates risks being particularly problematic for Turkey given its large C/A deficit and the accumulation of short term external debt over recent years. The C/A deficit on a 12 month basis stood at USD51bn in April, exceeding USD 50bn for the first time since October, in part because in net gold exports. Of the USD 225bn of foreign capital that has entered Turkey since the beginning of 2010, 75% or USD 170bn is short term in nature, e.g. portfolio capital, short term bank and non-bank corporate loans, trade credit and currency and deposits. Weaker global risk appetite means not only a risk of lower inflows at a higher cost but a risk of reversal of past inflows;
- The economy is showing clear signs of an unbalanced recovery in activity. Credit growth, at 28% on a 13 week average, fx-adjusted and annualised basis, is high and accelerating, supporting a rapid recovery in domestic demand. Fiscal policy is particularly expansionary, with current expenditure less interest in real terms up 10.5% yoy in the first 4 months of the year. Following a strong Q1, April saw a further acceleration in import volume growth. Q1 GDP gained 1.6% QoQ. In yoy terms, domestic demand not only contributed positively to GDP but accounted for the full 3.0% increase;
- Following a stable political environment over a multi year period, uncertainty has increased. Early elections remain unlikely and at this stage we do not expect any changes to central positions within AKP but the protests are historical in nature. They represent the first challenge to the PM in a number of years and the first such peaceful protest by a variety of different interest groups in three decades. The protests also increase the potential for more populist fiscal policy ahead.

The CBT has adopted a more hawkish stance

Following a two to three week period of TRY losses, the CBT has put forward a more decisive strategy to ease market volatility. This includes a reduction in TRY liquidity and forex selling auctions, though Governor Basci has signalled that direct FX intervention is unlikely. Simultaneously the ROC (reserve option co-efficient) mechanism also begins to take effect. Since initiation of this policy less than 3 days ago, the CBT has sold USD 250mn, all concentrated in the same day. The Governor noted that via the ROC mechanism banks had withdrawn USD 2bn from FX reserves.

TARGETS ARE BECOMING MORE DIFFICULT TO MEET


Foreign capital flows to Turkey

FX reserves have not kept pace with the increase in bank external liabilities

Source: Turkstat, CBT, UniCredit Research

The combination of the detail of this strategy and its timing (i.e. it has taken over 1 month and a 5% loss on TRY for a more comprehensive CBT reaction) re-inforces our view that the CBT is now willing to facilitate more TRY volatility than over the past 4-6 quarters. That the CBT's actions in taking interest rates higher coincide with statements from Governor Basci signalling further interest rate declines points to a welcome divide between government rhetoric and reality, at least for now.

Higher FX volatility to stay but the CBT still has comfort thresholds

But the CBT's appetite for TRY losses has limits given the increase in the corporate sector's net open FX position in recent years and FX pass-through to inflation. A significant portion of the decline in inflation over the past 12-18 months can be attributed to a much more stable TRY. From a contribution of 3.0pp to inflation in Q1-12, we estimate that FX modestly subtracted from inflation in Q1-13. Recent currency losses mean that this will return to positive. Meanwhile the net open FX position of the non-financial sector stands at USD146bn, up 56% since end-2010 and 267% since end-07. The Bank made clear that TRY has shifted from being over- to under-valued, as the REER stands significantly below 120 while the CBT sees scope for the REER to increase to 122 next year.

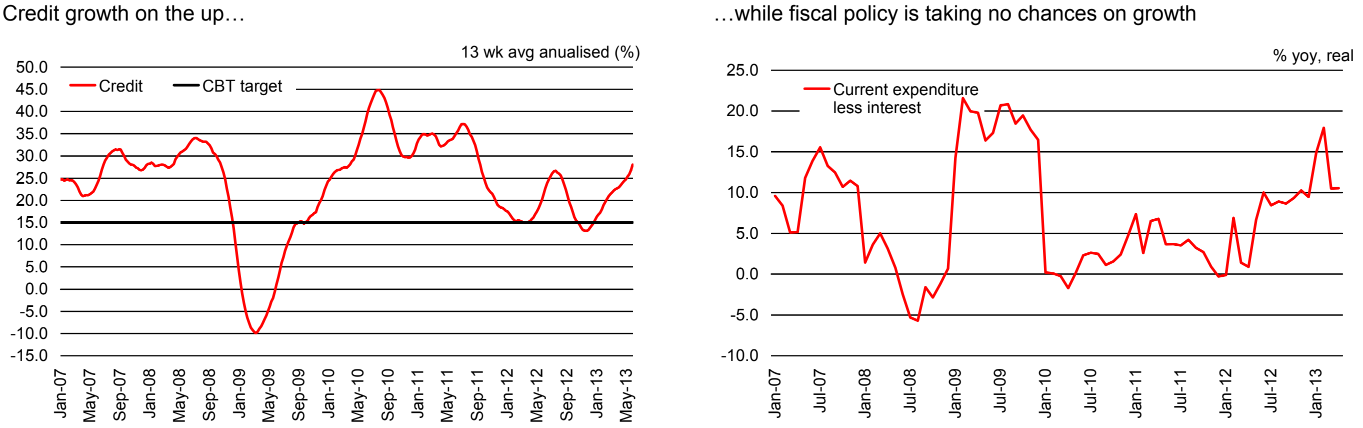
As ever, however, a shortfall of FX reserves is a risk…

There are limits to the extent to which this strategy can be successful given the large amounts of foreign capital that has entered Turkey in recent years and Turkey's limited stock of FX reserves. Compared with USD 225bn of capital inflows since Jan-10, FX reserves are up USD 42bn. The positive is that the USD 32bn in short term inflows to the banking sector have been more than covered by USD 58bn of an increase in bank FX deposits at the CBT, accumulated in no small part via the ROC mechanism. But the CBT's ability to defend other areas of the economy from more persistent outflows is more limited.

…and at some stage may force more aggressive currency losses

As such in a more negative scenario whereby emerging markets continue to experience outflows over a multi month horizon, the CBT's strategy of simultaneously running down FX reserves, absorbing TRY liquidity and increasing interest rates to defend TRY will prove unviable. At this stage, the CBT views these outflows as temporary in nature, i.e. the short term pain of FX reserve losses and higher interest rates justifies the longer term gain in terms of facilitating a continued C/A deficit and protection of GDP growth. More broadly the adjustment higher in interest rates can be considered healthy to the extent that it returns the real interest rate closer to zero at a time when domestic demand is gathering pace once again. But the CBT's finite amount of FX reserves means that as they decline, the probability of success declines. Interest rates can be pushed higher but if this strategy is employed for too long, the long term gains will no longer exceed the short term pain.

PLENTY OF SIGNS OF SUPPORT FOR GDP GROWTH IN TURKEY


Credit growth on the up…

…while fiscal policy is taking no chances on growth

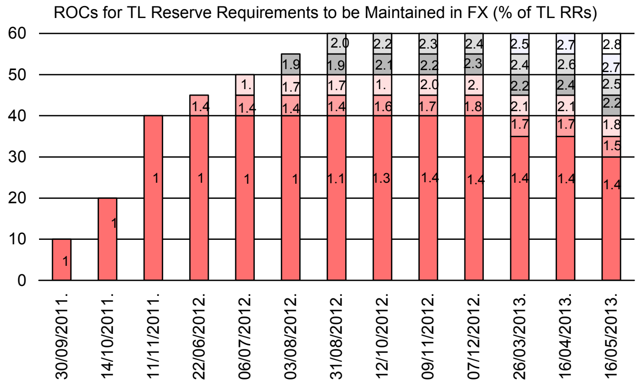
Source: CBT, Turkstat, UniCredit Research

Strategy: Managing financial stability pressures

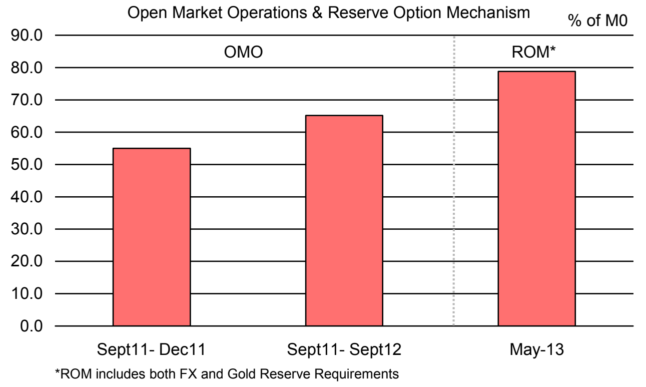
A high beta play on EM flows… structurally we see TRY moving weaker, rates moving higher

Turkey's C/A deficit and the accumulation of short term foreign capital in recent years means that it will remain a high beta play on foreign flows to EM, which will remain determined by the pace of normalisation in USTs. A more dovish Fed in the near term would be of significant benefit to Turkish assets, opening opportunities to initiate tactical short USD positions. That Turkey's ROC mechanism has the ability to absorb almost 80% of M0 means it can also act as a powerful stabilisation mechanism. But structurally we watch for opportunities to initiate payer positions in rates and long USD positions. The moves experienced in recent weeks in both fixed income and TRY are significant but capital outflows from Turkey have the potential to be large. While the two year benchmark has moved over 150bp in yield in a month, this just about brings rates back into positive territory in real terms.

Covering TRY RRRs via FX



OMOs v ROM on FX & gold: Soaking up M0, if necessary



Source: CBT, Treasury, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**57.8**	**67.0**	**76.4**
Budget deficit	9.0	13.4	18.4
Amortisation of public debt	48.8	53.6	58.0
Domestic	34.8	50.2	55.0
Bonds	34.8	50.2	55.0
Bills	0.0	0	0
External	14.0	3.4	3.0
Financing	**57.8**	**67.0**	**76.4**
Domestic borrowing	43.3	57.8	62.2
Bonds	43.3	57.8	62.2
Bills	0	0	0
External borrowing	5.8	5.3	5.7
Bonds	5.4	4.9	5.3
IMF/WB	0.4	0.4	0.4
Other	8.8	3.9	8.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**133.3**	**142.9**	**150.3**
C/A deficit	38.0	42.4	48.5
Amortisation of medium to long term debt	31.1	26.8	25.6
Government/central bank	3.6	2.6	2.0
Banks	7.5	8.6	5.7
Corporates	20.0	15.6	17.9
Short term debt	65.4	73.7	76.2
Government/central bank	6.6	8.8	9.5
Banks	37.1	42.7	43.9
Corporates	21.6	22.2	22.8
Errors & omissions	-1.2	0	0
Financing	**133.3**	**142.9**	**150.3**
FDI	6.8	6.8	7.3
Portfolio	32.5	23.8	18.6
Borrowing medium to long term	32.2	26.6	25.0
Government/central bank	2.2	1.6	1.3
Banks	7.1	9.0	5.4
Corporates	23.0	16.1	18.3
Short term borrowing	80.4	77.8	96.2
Government/central bank	9.7	9.7	10.5
Banks	46.6	44.8	42.9
Corporates	24.2	23.3	42.9
Other	-2.1	7.8	3.2
Reserve accumulation	-16.6	0	0

Source: CBT, Treasury, Bloomberg, Unicredit Research

Ukraine (B3 negative/B negative/B stable)*

Outlook – Ukraine's economy is showing some signs of bottoming out but the government's growth forecast remains far from realistic. Steel prices continue to decline, albeit at a slower pace, monetary conditions are tight while bank deleveraging is ongoing. Ukraine's twin deficits are amongst the widest globally while financing is becoming ever more restrictive. The deterioration in risk appetite and continued declines in FX reserves are considerable risks. The positives are that Ukraine has options, including a choice between an EU free trade agreement and membership of the Eurasian Customs Union. The former increases the potential for an IMF deal, the latter a financing deal from Russia including the pipelines. Despite obvious currency overvaluation, these options mean that FX devaluation is not a done deal.

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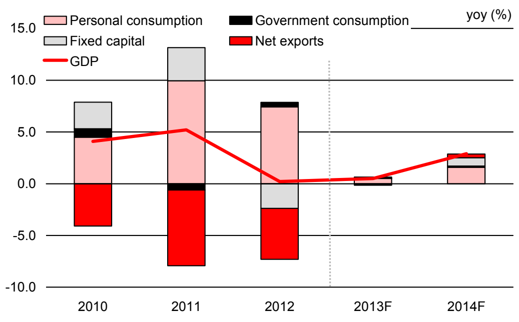
Daniel Vernazza, Economist (UniCredit Bank London)

KEY DATES/EVENTS

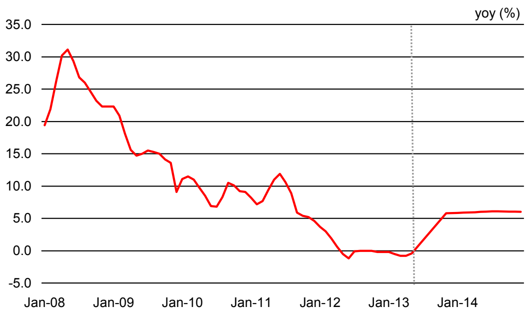
- 5-10 of each month: FX reserve data
- 15-18 of each month: Industrial production data
- 28-29 November – deadline to sign Association Agreement with EU at the Eastern Partnership Summit in Vilnius

GDP GROWTH REMAINS WEAK



Source: Ukraine State Committee Statistics, UniCredit Research

INFLATION AT ZERO BUT SET TO RISE



Source:Ukraine State Committee Statistics; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012	2013F	2014F
GDP (EUR bn)	102.6	117.1	134.2	126.7	126.1
Population (mn)	45.8	45.5	45.3	45.1	44.9
GDP per capita (EUR)	2241	2574	2963	2809	2808
Real economy yoy (%)					
GDP	4.1	5.2	0.2	0.5	3.0
Private Consumption	7.1	15.7	11.7	0.8	2.5
Fixed Investment	3.9	7.1	0.9	0.2	4.5
Public Consumption	4	-3.0	2.2	-0.7	0.6
Exports	3.9	4.3	-7.7	2.0	6.5
Imports	11.3	17.7	1.9	1.7	5.5
Monthly wage, nominal (EUR)	213	237	281	283	290
Unemployment rate (%)	8.4	8.2	8	8.3	8.3
Fiscal accounts (% of GDP)					
Budget balance	-5.8	-2.8	-4.6	-4.8	-4.2
Primary balance	-4.1	-0.8	-2.9	-2.5	-1.8
Public debt	40.5	36.8	41.4	46.9	47.5
External accounts					
Current account balance (EUR bn)	-2.3	-7.8	-11.5	-7.6	-5.9
Current account balance/GDP (%)	-2.2	-6.7	-8.6	-6.0	-4.7
Basic balance/GDP (%)	2.0	-2.1	-4.7	-1.6	-0.6
Net FDI (EUR bn)	4.3	5.4	5.2	5.5	5.1
Net FDI (% of GDP)	4.2	4.6	3.8	4.4	4.0
Gross foreign debt (EUR bn)	88.2	95.5	100.4	104.3	108.1
Gross foreign debt (% of GDP)	86.0	81.5	74.8	82.3	85.8
FX reserves (EUR bn)	25.1	23.3	17.1	16.2	17.7
Inflation/Monetary/FX					
CPI (pavg)	9.4	8.0	0.6	1.9	6.0
CPI (eop)	9.1	4.6	-0.2	5.8	6.0
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	7.75	7.75	7.5	7.5	7.0
UAH/USD (eop)	7.97	8.04	8.05	9.00	9.27
UAH /EUR (eop)	10.60	10.37	10.62	12.15	12.79
UAH /USD (pavg)	7.95	7.99	8.08	8.35	9.14
UAH /EUR (pavg)	10.55	11.12	10.50	11.39	12.47

Source: UniCredit Research

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

Time to address an unviable business model

Ukraine exited technical recession in Q1 but growth will remain subdued

The economy seems to be bottoming out but the government's growth targets remain well out of reach. Ukraine exited recession in the first quarter with GDP growth of 0.6% qoq, although the economy is still 1.1% smaller than it was in 1Q2012 (up from -2.5% yoy in 4Q2012). Net exports played a role but we are unconvinced of the sustainability of this. More specifically gas imports fell USD609mn in 1Q2013 versus 1Q2012. There is anecdotal evidence to suggest that Ukraine reduced gas imports from Russia (which supplies 60% of its gas imports) and instead ran down its gas in storage.

More broadly ever lower steel prices play a role, though at least in yoy terms the pace of decline has eased. Industrial production growth remains negative at -2.2% yoy in April, although this represents an improvement on Q1 (-4.9% yoy). Monetary conditions are extremely tight, with interest rates in real terms amongst the highest globally. Note that YTD inflation is negative in yoy terms while on average 3 month money market rates YTD stand in double digits. Credit growth is in low single digits while external deleveraging continues, albeit at a slower pace than the second half of 2011. There is good news in the fact that this year's harvest looks set to be better, boosting agriculture but the government's 2013 growth target of 3.4% is simply not realistic. We expect GDP growth of 0.5% this year and 3% in 2014.

Ukraine's twin deficits are ever more problematic…

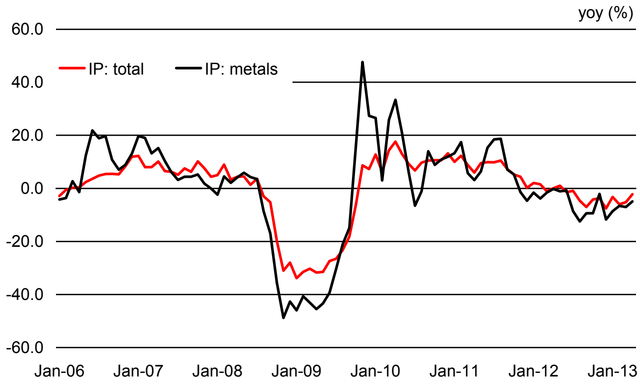
Ukraine's persistent twin deficits and elevated financing requirements are key impediments. Last year saw Ukraine run some of the largest twin deficits globally, with the C/A deficit in excess of 8.0% of GDP and the budget deficit close to 5.0% of GDP. Expenditure growth remains well in excess of revenue growth while the government is still in the midst of IMF repayments. This has forced the government to supplement eurobond issuance with local USD issuance while NBU holdings of domestic government debt continues to increase. As of May this stood at 57.1% of the total domestic debt stock, up from 50% a year earlier. In terms of C/A financing, FDI remains impressively larger than elsewhere in the region but rollover ratios for banks remain well below 1.0.

…with their financing at increasing risk

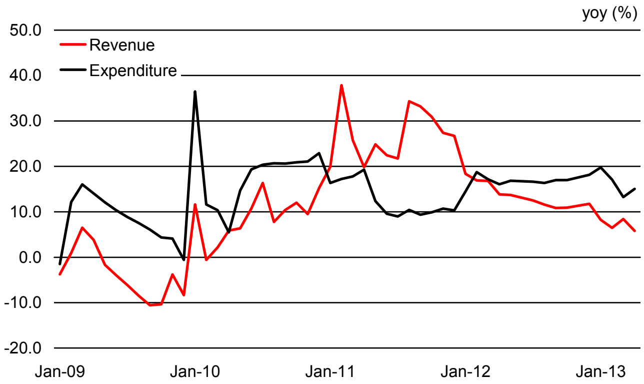
The shift in external risk appetite puts the government's muddle through strategy at risk. To date these deficits have been financed via the issuance of hard currency bonds and a run down of FX reserves. YTD eurobond issuance stands at USD2.25bn. But global risk appetite has deteriorated significantly and will at a minimum increase the cost of external financing for Ukraine. Meanwhile FX reserves fell to USD22.9bn in May, their lowest since Apr-07, down over USD 6.0bn in the past year and over USD13bn from their peak in Feb-11.

WEAK GROWTH COMBINED WITH A WIDE BUDGET DEFICIT

Industrial production may have bottomed



Government spending rises faster than revenue



Source: NBU, national statistics office, UniCredit Research

As a result, FX reserves are equivalent to just over 3 months of imports (compared with a peak of more than 7 months of imports in Q3-10) and only 40% of short term external debt. The Central Bank's rule that forces exporters to exchange 50% of their FX revenue into hryvnia was extended in May for 6 months.

The authorities are edging towards an EU free trade agreement

The authorities hope for continued market financing over the coming months, ahead of the Eastern Partnership summit in Vilnius on 28/29th November. At that stage Ukraine hopes to sign an Association Agreement with the EU which will form a so-called Deep and Comprehensive Free Trade Area (DCFTA) between the EU and Ukraine. This is a bilateral free trade agreement, which removes all visible barriers to trade between Ukraine and the 27 EU member states and has the potential to significantly change Ukraine's business model, with positive implications for market access. The requirements to ensure agreement seem more political than economic. The EU-imposed May deadline for Ukraine to initiate judiciary and electoral reform passed without any meaningful progress. Despite this, the EU has made it clear that Ukraine has 6 months to carry out reforms (including wider-ranging reforms to improve the business climate). The biggest stumbling block is what the EU calls "selective justice". More specifically, the imprisonment of Yulia Tymoschenko in 2011 for abuse of office is deemed by the EU to be (at least in part) politically motivated.

Membership of the Eurasian Customs Union is an alternative

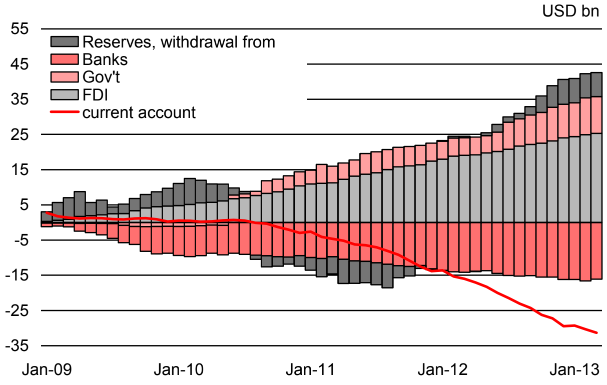
The alternative is membership of the Eurasian Customs Union of Belarus, Kazakhstan and Russia (BKR-CU). In addition to the removal of visible barriers to trade, the union imposes a common external tariff. The distinction is important since the common external tariff of the BKR-CU renders the Association Agreement with the EU mutually exclusive. On 31 May Ukraine signed a memorandum on deepening cooperation with the Eurasian Economic Commission (the oversight body of the Russian-led Customs Union). It gives Ukraine "observer" status to attend meetings without the right to vote.

Financing is the key

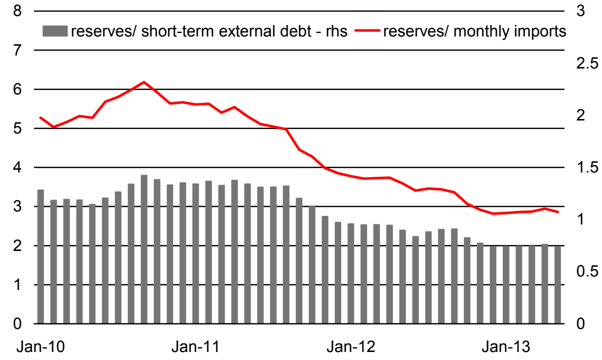
But neither of the above provide significant financing while President Yanukovich is focussed on re-election in early 2015. A renewed improvement in market conditions would help the authorities avoid such a decision but in the absence of this, the options are twofold. The first is an IMF agreement but this will require a move to a more flexible exchange rate, an increase in natural gas tariffs and a lower budget deficit. There has been considerable progress in terms of the technical details of a deal but little to no increase in the domestic authorities willingness to agree to this conditionality. The second is the sale of at least part of the gas pipelines to Russia which comes with much less macro conditionality but risks impairing relations with the EU.

RE-FINANCING EXTERNAL DEBT IS PROBLEMATIC

Banks continue to deleverage, leaving government borrowing and reserves to finance the widening CA deficit



Central Bank reserves remain very low



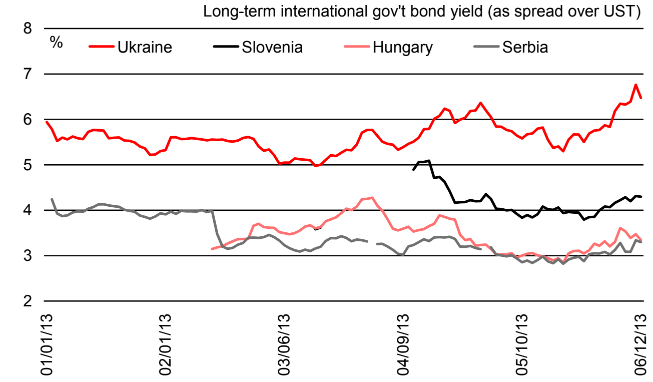
Source: MinFin, NBU, State Treasury, UniCredit Research

Strategy: Hard currency bonds more vulnerable than FX

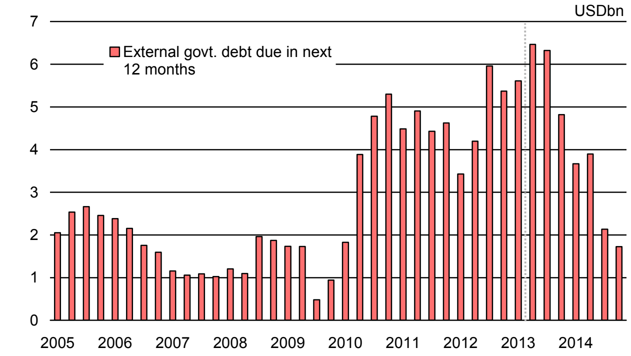
Reluctant to be short UAH, hard currency more vulnerable

Evidence of UAH overvaluation and depreciation pressure is wide-spread, e.g. the low level of FX reserves, large C/A deficit and the sovereign's debt redemption profile. But we remain reluctant to be short UAH given that currency stability takes priority over all other macro objectives for the government while a deal on the pipelines with Russia would likely generate a large one-off FX inflow. Under an IMF deal, UAH depreciation would be larger but could potentially be contained, if accompanied with fiscal consolidation. Domestic demand for FX will remain central to the eventual outcome but at this stage it is limited. In hard currency fixed income space, Ukraine remains a high beta play on risk appetite, given its large funding requirement. If just a matter of price, the authorities are willing to pay a premium to secure funding. The risk of losing market access, irrespective of cost, is non-negligible and will translate into further bond weakness but this must be weighed against the options that Ukraine has, namely the ability to rapidly conclude a deal with both the IMF and Russia.

Ukraine continues to offer a high yield



Sovereign redemption profile remains challenging



Source: Bloomberg, NBU, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**13.6**	**14.5**	**14.1**
Budget deficit (excl Nafto)	3.5	3.5	2.8
Amortisation of public debt	10.0	11.0	11.3
Domestic	5.5	6.1	6.9
Short term	0.7	0.5	0.8
Medium to long term	4.9	5.5	6.1
External	4.5	4.9	4.4
of which IMF	2.5	4.1	2.7
Financing	**13.6**	**14.5**	**14.1**
Domestic borrowing	8.5	8.8	9.0
of which NBU	2.2	3.0	0
Short term	0.5	0.8	1.0
Medium to long term	8.0	8.0	8.0
External borrowing	3.8	4.0	3.5
Bonds	3.8	4.0	3.5
IMF	0	0	0
Other	1.2	1.7	1.6

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**61.5**	**58.0**	**54.0**
C/A deficit	11.5	7.6	5.9
Medium to long term amortisation	17.3	18.6	16.2
Banks	5.5	5.4	4.3
Corporates	7.7	7.5	7.5
Government/central bank	4.1	5.7	4.4
Short term debt amortisation	25.4	25.2	25.2
Banks	4.5	3.2	3.2
Corporates	19.4	21.9	21.9
Government/central bank	1.6	0	0
Other (incl. intercompany lending, capital flight)	7.3	6.7	6.7
Financing	**60.7**	**58.2**	**54.1**
FDI	5.2	5.5	5.0
Portfolio flows	0.5	1.0	1.0
Medium to long term borrowing	21.1	18.2	20.5
Banks	3.3	3.2	3.0
Corporates	13.0	11.0	14.0
Government/central bank	4.8	4.0	3.5
Short term borrowing	24.8	25.2	25.2
Banks	4.2	3.2	3.2
Corporates	19.0	21.9	21.9
Government/central bank	1.6	0	0
Other	2.2	4.3	1.4
Change in reserves	7.0	4.0	1.0

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