CEE

Quarterly

Economics, FI/FX & Commodities Research
Credit Research
Equity Research
Cross Asset Research

4Q 2013

"Your Leading Banking Partner in Central and Eastern Europe"

Bank Austria Member of UniCredit

HypoVereinsbank Member of UniCredit

UniCredit Bank

UniCredit Bank Banja Luka

UniCredit Bulbank

UniCredit Țiriac Bank

Zagrebačka banka UniCredit Group

Bank Pekao Member of UniCredit

YapıKredi

Contents

Erik F. Nielsen, Global Chief Economist (UniCredit Bank London)
+44 207 826 1765, erik.nielsen@unicredit.eu

Gillian Edgeworth, Head of EEMEA Economics (UniCredit Bank London)
+44 207 826 1772, gillian.edgeworth@unicredit.eu

Artem Arkhipov, Head of Macroeconomic Analysis and Research (UniCredit Bank Russia)
+7 495 258-7258, artem.arkhipov@unicreditgroup.ru

Dan Bucsa, Economist (UniCredit Bank London)
+44 207 826 7954, dan.bucsa@unicredit.eu

Hrvoje Dolenec, Chief Economist, Croatia (Zagrebačka banka d.d.)
+385 1 6006 678, hrvoje.dolenec@unicreditgroup.zaba.hr

Ľubomír Koršňák, Chief Economist, Slovakia (UniCredit Bank Slovakia a. s.)
+421 2 4950 2427, lubomir.korsnak@unicreditgroup.sk

Catalina Molnar, Chief Economist, Romania (UniCredit Tiriac Bank)
+40 21 200 1376, catalina.molnar@unicredit.ro

Marcin Mrowiec, Chief Economist, Poland (Bank Pekao)
+48 22 524 5914, marcin.mrowiec@pekao.com.pl

Carlos Ortiz, Economist (UniCredit Bank London)
+44 207 826 1228, carlos.ortiz@unicreditgroup.eu

Kristofor Pavlov, Chief Economist (UniCredit Bulbank)
+359 2 9269 390, kristofor.pavlov@unicreditgroup.bg

Pavel Sobisek, Chief Economist, Czech Republic (UniCredit Bank Czechia)
+420 955 960-716, pavel.sobisek@unicreditgroup.cz

Daniel Vernazza, Economist (UniCredit Bank London)
+44 207 826-7805, daniel.vernazza@unicredit.eu

Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)
+44 207 826 1808, dmitry.veselov@unicreditgroup.eu

Published on 12 September 2013

V.i.S.d.P.:
Erik F. Nielsen, Global Chief Economist (UniCredit Bank London)
120 London Wall
London
EC2Y 5ET

Imprint:
UniCredit Bank AG
UniCredit Research
Arabellastrasse 12
D-81925 Munich

Supplier identification:
www.research.unicreditgroup.eu

CEE: The trade-off from developed world recovery

Gillian Edgeworth,
Chief EEMEA Economist
(UniCredit Bank London)
+44 207 826-1772
gillian.edgeworth@unicredit.eu

- Our global backdrop contains both positives and negatives for CEE. The overriding positive is the improvement in the growth environment in the US but, more importantly, in EMU. The most prevalent negatives are Fed tapering and the initiation of a normalization in interest rates in many countries across the developed world. This has prompted a partial reversal of the most dominant form of capital to emerging markets in the recent years, namely portfolio flows.
- The benefits of an improving US and European growth environment are already materializing across CEE. Following a particularly weak finish to last year, industry has posted an impressive rebound in some countries. On credit many of the newer EU states are at an inflection point which should see credit turn more supportive of domestic demand. Much of the hard work on fiscal policy has been done and as a result consolidation should act as less of a drag on activity going forward in the newer EU states.
- All of the above adjustment is captured in improved basic balances across the newer EU states in recent years, in contrast with many other emerging markets, while a broader analysis also shows a reduction in external vulnerabilities in a number of countries. Croatia and Slovenia are laggards within this group but face increasing pressure from a number of fronts to address shortfalls.
- Russia and Turkey are at an earlier stage of adjustment. In Russia, years of underinvestment combined with less consistent terms of trade gains limits output and as a result we see GDP growth both this year and next below 2%. An excessive reliance on RUB depreciation over economic diversification risks prolonging the slowdown. In Turkey, a wide C/A deficit and the accumulation of a large amount of short term foreign capital in recent years has pushed it towards a sudden stop. The medicine, namely currency depreciation, slower credit growth and a narrower C/A deficit, is set to translate into a renewed slowdown in growth in the coming quarters.
- Serbia and Ukraine are the two most obvious outliers. Structural impediments cap GDP growth at a low rate, public debt dynamics in both are of concern while the deterioration in the external environment reduces their ability to cover budget and BoP gaps with Eurobond issuance. Ukraine must chose between an EU free trade agreement and IMF deal or accession to a customs union with Russia by end-November. In Serbia a new IMF programme is overdue and should be complemented with progress on EU accession to anchor policy.

A region of many parts

Many of the newer EU states are better positioned to absorb broader emerging market financing pressures this time around….

Having underperformed other emerging markets in 2008/09 and come under renewed pressure due to EMU vulnerabilities in H2-11, there are a number of countries within CEE that are well positioned for a 'good crisis' this time, despite a re-pricing of emerging markets risk. Most of these are concentrated within the EU and include Poland, Czech Republic, Romania and the Baltics. We see higher risks in Hungary but it is still better positioned than in the past. Difficult balance of payments and fiscal adjustments over recent years have been central to reducing vulnerabilities. The probability that banking sectors come under renewed pressure has also fallen. Croatia and Slovenia are outliers and without speedy policy action risk being forced towards IMF/EU financing programmes.

…but Russia and Turkey face more of a growth challenge

But other countries have seen vulnerabilities increase since 2008. The evaporation of portfolio inflows to emerging markets is set to force Turkey, Ukraine and Serbia towards adjustment in the coming quarters. In Russia a lack of diversification away from energy has heightened our concerns that the economy is destined for a multi-year period of sluggish growth.

Balancing better EMU growth against EM capital outflows

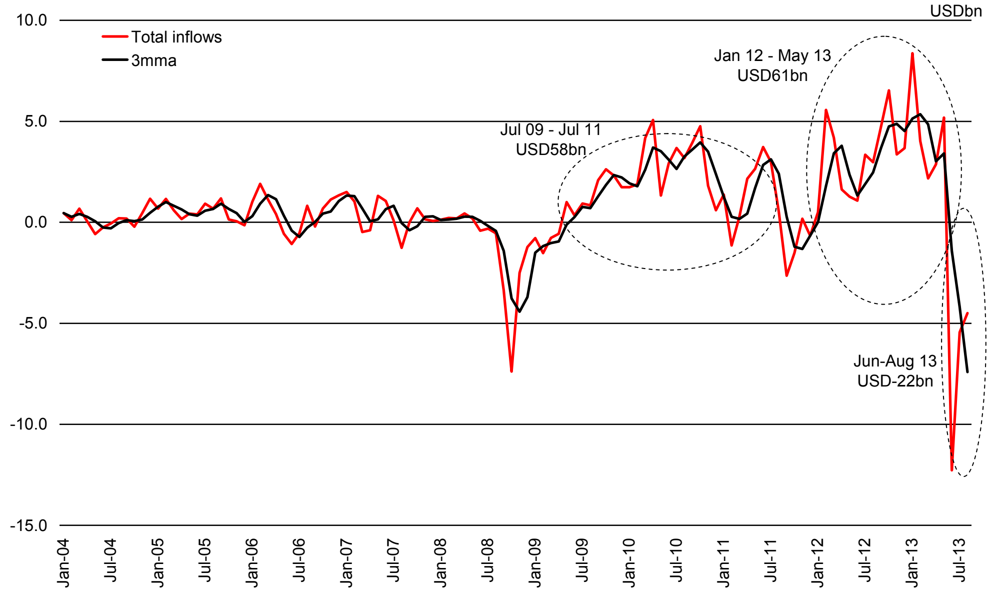
A recovery in activity in the US and EMU is of benefit to CEE but a reversal of portfolio capital from EM represents the primary downside risk

Our global backdrop contains both positives and negatives for CEE. The overriding positive is the improvement in the growth environment in the US but, more importantly, in EMU. The most prevalent negatives are Fed tapering and the initiation of a normalization in interest rates in many countries across the developed world. This has prompted a partial reversal of the most dominant form of capital to emerging markets in recent years, namely portfolio flows.

Looking ahead, we expect the recovery in EMU to continue through the end of this year and next. Moreover while we continue to see UST yields adjusting upwards, the pace of increase should be more gradual from here. We have already, if only for a very brief period, tested 3% on the 10-year while by the time tapering comes to an end towards the middle of next year we see 10-year USTs moving to approximately 3.5%, leaving 130bp of the adjustment since end-April done and another 50bp to go. This is likely to leave us with an EM environment characterized by continued portfolio outflows but at a slower pace. Though only a narrow proxy for flows to EM, EPFR data shows a reversal of all of the USD23bn of inflows seen YTD but we still expect at least some of the USD37.6bn of inflows seen in 2012 to reverse.

RECORD FOREIGN CAPITAL INFLOWS TURN TO OUTFLOWS

Inflows to EM fixed income assets



Source: EPFR, UniCredit Research

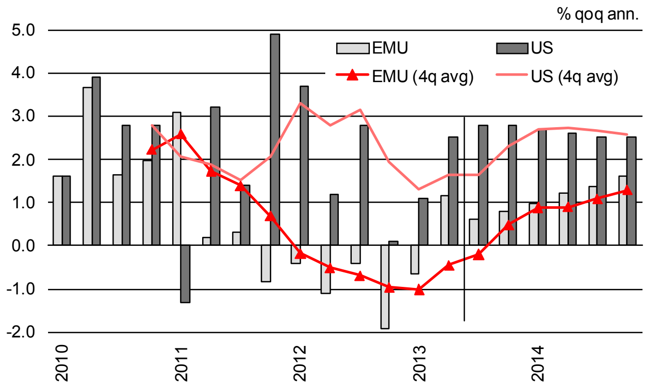
Stronger support from external demand…

Industry is already posting an impressive recovery in a number of countries in the region…

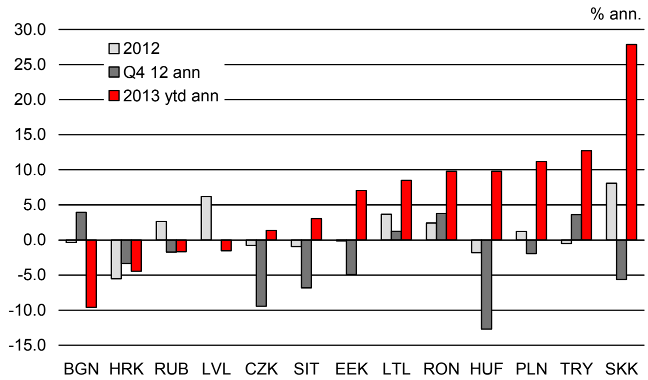
The benefits of an improving US and European growth environment are already materialising across CEE. Following a particularly weak finish to last year, industry has posted an impressive rebound, in particular across Romania, Hungary, Poland and Turkey. In part this reflects payback for a particularly weak finish to 2012 amidst a slump in car production. Hungary and Romania have also benefitted from new car production coming on-line. As a result industry growth should slow over 3Q/4Q but remain positive. Czech is the most obvious laggard, though it is also scheduled to receive a boost from the launch of a new Skoda auto model.

EXTERNAL DEMAND HAS TURNED MUCH MORE SUPPORTIVE OF GROWTH

Stronger US and European GDP performance should continue…



…and is already aiding industry in many CEE economies



Source: Eurostat, BEA, CEE national statistics offices, UniCredit Research

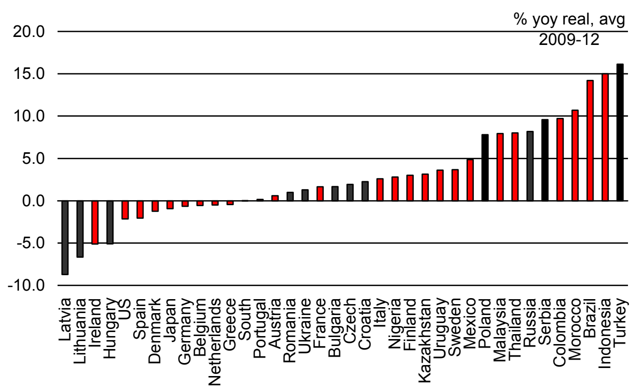
…and credit in some cases

…while credit should be more supportive of domestic demand going forward

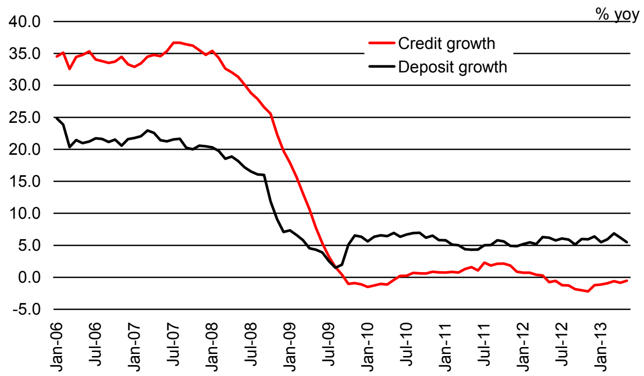
Across the newer EU states, credit poses more of an upside rather than a downside risk to domestic demand at this stage. While credit growth has been strong across many emerging markets in recent years, including Turkey and Russia, the EMU crisis prompted a bout of deleveraging across the newer EU states over late 2011 and 2012. This forced credit growth below deposit growth and domestic demand lower.

LARGE DIVERGENCES IN BANKING TRENDS ACROSS CEE

Credit growth across EM: CEE is both top and bottom of the pack



CEE ex Russia & Turkey: Deposit growth leads credit growth



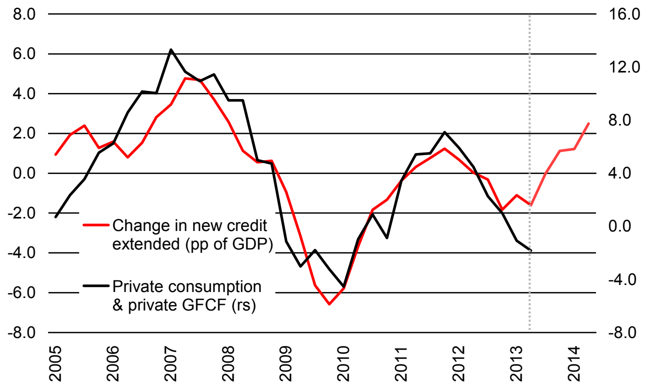
Source: IMF, National central banks, UniCredit Research

But we are at an inflection point in many countries. While uncertainty on the future extent of deleveraging remains, we do not expect its pace to accelerate from here. Moreover stronger nominal GDP growth should correspond with stronger deposit growth. Under our credit impulse framework, we assume that deposit growth and growth in external liabilities remains unchanged from what was experienced YTD and reflected in full in credit growth. This implies an improvement in the rate of new credit extension compared with previous quarters, which is in turn supportive of domestic demand[1].

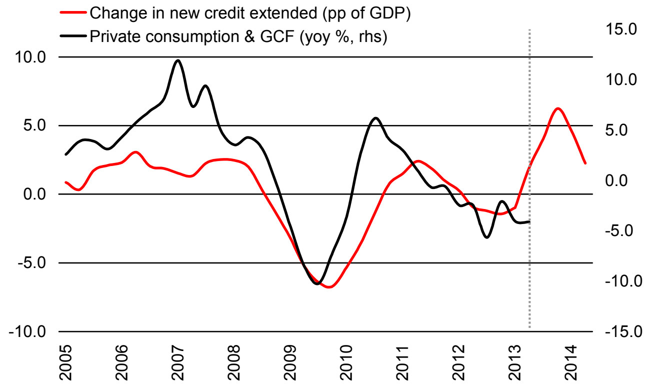
[1]For further discussion please refer to our CEE Navigator of 6th August, "CEE credit and domestic demand: An inflection point".

CREDIT IMPULSES: UPSIDE RISKS TO DOMESTIC DEMAND IN SOME NEWER EU STATES

The risks from credit to domestic demand are to the upside in Poland…



…as well as in Czech Republic



Source: National central banks and statistical agencies, UniCredit Research

Monetary policy to remain accommodative through next year

This should be complemented with low policy rates over the coming quarters. While we do not see further rate cuts in Poland or Czech Republic, we expect their policy rates to remain at record lows until 2015. Meanwhile the monetary policy transmission mechanism in both countries is working well. In Poland lending rates on outstanding loans have fallen 220bp over the past year while in Czech lending rates stand at record lows and continue to decline as the policy rate remains unchanged at 0.05%. We also expect further modest rate cuts in Hungary and Romania.

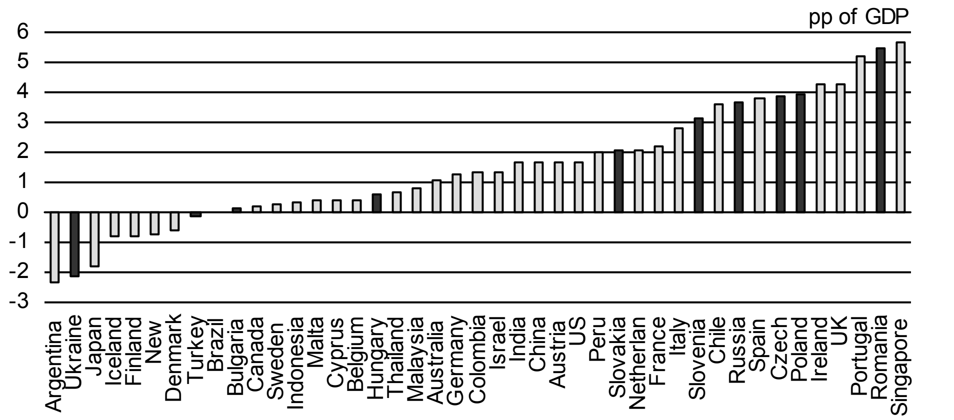
...fiscal policy should be less of a drag going forward

Much of the hard work on fiscal consolidation has already been done

Finally fiscal policy should also prove less of a drag on activity. Some of the newer EU states have been amongst the world's top consolidators since 2009. Hungary also falls into this group if we set the starting point at 2008. But the renewed slowdown in activity towards late last year, combined with efforts taken in recent years, provides governments with more scope to support activity. Poland has already decided to allow automatic stabilisers to work this year as budget performance fell short of target while Bulgaria has also widened its target. Having narrowed the deficit to 1.7% of GDP last year, Hungary will use the space that it has to support activity without breaching the 3% of GDP set down in the EDP this year. Czech Republic plans a modest fiscal stimulus next year.

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

Structural budget balances: Change between 2009 and 2012



Source: IMF, UniCredit Research

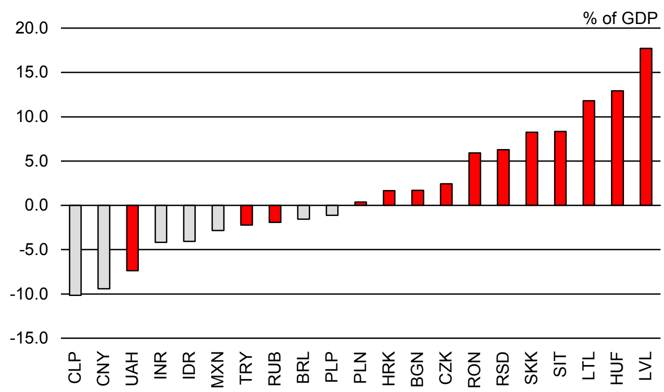
For some the adjustment has been significant…

The adjustments discussed above have helped to reduce external vulnerabilities…

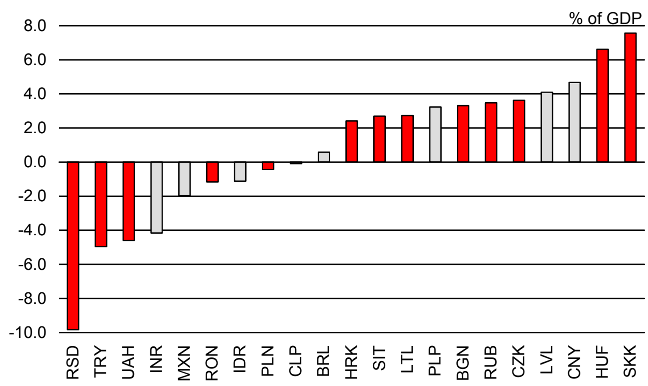
All of the above adjustment is captured in improved basic balances across the newer EU states in recent years, in contrast with many other emerging markets. Summing C/A balances, FDI and EU funds, improvements between 2007 and 2012 are heavily concentrated in the newer EU states relative to EM as a whole. YTD C/A performance has improved even further. For the first time since the fall of communism Romania posted a C/A surplus over the first 7 months of the year while Poland's C/A deficit is 10% of where we stood for the first 7 months of 2012.

THERE HAS BEEN BIG IMPROVEMENTS IN CEE BASIC BALANCES BUT WITH SOME GLARING LAGGARDS

Change in basic balance, 2012 less 2007[2]



Basic balance, 2012



Source: IMF, national central banks, UniCredit Research

[2]In the newer EU states, we include EU funds within the basic balance, as well as FDI and the C/A balance. The change in Serbia refers to the period between 2008 and 2012 rather than 2007 and 2012.

…while some sovereigns have built meaningful buffers

From a financing perspective this helps to reduce vulnerabilities relative to the past. Bank deleveraging remains an uncertainty but some countries find themselves in a position where they are no longer reliant on fresh foreign portfolio capital inflows. A more thorough analysis, examining potential external financing pressures across C/A deficits, foreign holdings of local currency government debt, sovereign Eurobond redemptions, scheduled IMF/EU repayments and maturing private sector external debt, reinforces an improvement in vulnerabilities compared with 2007-12 in Czech Republic, Poland, Bulgaria, Hungary and Lithuania[3].

Poland's USD34bn FCL from the IMF acts as a further buffer. October should see Romania agree to a new precautionary agreement with the IMF/EU (EUR4bn). Focussing on fiscal buffers, Bulgaria is taking action to further increase its cash buffer while Czech Republic has put in place a new system of liquidity management. This is equivalent to more than half of next year's gross financing requirement. Romania can afford to remain completely absent from issuance until year-end. Hungary is the outlier as the debt management agency has reduced the average maturity of issuance by 10 months to 1.38 years on average since May.

The primary risk remains another externally-induced slowdown in activity

Of course, risks remain. Authorities across the region have adjusted to a more realistic rate of potential growth amidst less plentiful FDI to both the tradables and non-tradables sectors and a change to the bank funding model. But even this lower rate of growth is vulnerable to a renewed downturn in external demand. With elections upcoming in a number of countries across the region over the next couple of years (Czech: 4Q this year, Hungary: Q2 next year, Poland: 2015, European parliamentary elections across the EU next May), the willingness to push through another round of difficult fiscal measures would come into question.

…but Slovenia and Croatia lag

EU accession will introduce much needed fiscal discipline in Croatia but competitiveness remains weak

Within the newer EU states, Croatia and Slovenia are exceptions to the rule, having failed to date to push through a critical mass of reform measures. Given the deterioration in the external environment, this increases pressure for progress before these sovereigns return to Eurobond markets to secure funding. This year has seen Croatia's budget performance deteriorate once again while the absence of measures to address the economy's multi-year competitiveness shortfall risks keeping the economy in recession for a 6th consecutive year in 2014. EU accession will help increase fiscal discipline while EU funds should boost investment over time but in itself this will not guarantee a sustainable return to growth.

Slovenia has more to do on banking and fiscal consolidation, with little progress achieved to date on privatisation

Slovenia has made more notable progress, with the release of the bank stress tests scheduled for the end of this month but progress on privatization remains slow. While the sovereign's cash buffer at this stage remains large, bank recapitalizations, hefty redemptions by April next year and the budget deficit means that in the absence of a return to Eurobond markets by Q1 next year, a Troika programme will become an increasing risk.

Russia is at the earlier stages of adjustment…

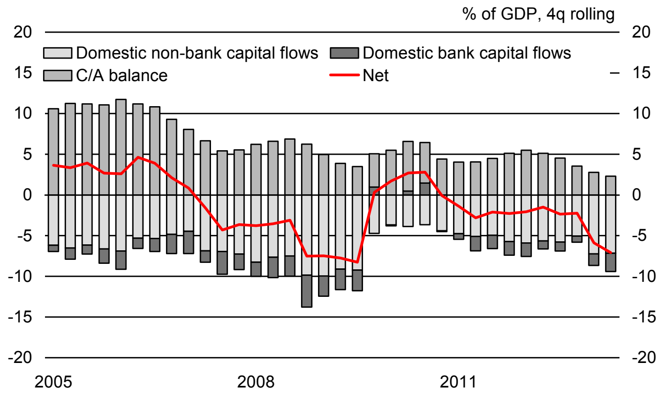
We have substantially reduced our GDP forecasts for Russia…

Russia is at a much earlier stage of adjustment to the 'new norm' than many of the newer EU states. Progress on inflation targeting, currency flexibility, fiscal consolidation and new budget rules all represent important steps forward but in the absence of economic diversification away from oil these measures are not sufficient to generate lasting growth. We have revised our full year growth forecasts for this year and next to 1.7% (prev: 2.7%) and 1.8% (prev: 2.8%) respectively. Given our forecast for a decline in the oil price to USD95pb in 2015, we see GDP contracting by 0.2%.

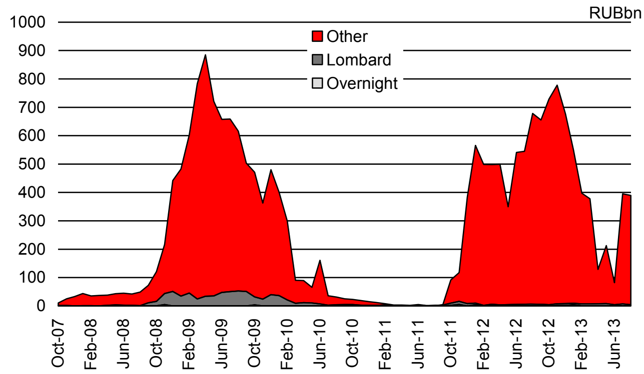
[3]For a cross-country CEE comparison of external vulnerabilities, refer to our Global Theme Series publication of 5th June entitled "CEE: Stress testing external financing shortfalls".

THERE HAS BEEN BIG IMPROVEMENTS IN CEE BASIC BALANCES BUT WITH SOME GLARING LAGGARDS

Dwindling C/A surplus & persistent domestic capital outflows leaves Russia reliant on foreign flows to fill the gap….



….but the CBR may well step in with more lending to boost credit



Source: CBR, UniCredit Research

…amidst an insufficicent diversification of economic activity

The absence of a return of foreign capital to Russia post 2009 means that the economy is not at risk of rapid reversal but the economy's reliance on foreign funding is nonetheless increasing. Russia's C/A surplus and domestic capital outflows sum to an increasingly negative balance, though there were some one-offs in the 1Q data. The end result over recent months has been RUB losses, which helps to protect the budget. The CBR has also acted to foster credit growth via 12 month financing operations. But if persistent, RUB depreciation risks fostering further domestic outflows while discouraging foreign inflows. In such an environment, financing growth becomes even more challenging.

…as is Turkey…

Turkey's C/A deficit and the accumulation of short term capital has made it vulnerable to a sudden stop…

While Russia is being challenged to improve on a weak growth outlook over a multi year period, Turkey is being challenged to address a sudden stop in capital flows. With short term capital flows compensating for a shortfall in FDI and long term external borrowing in recent years, the impact of Fed tapering and a reversal of foreign capital from EM on asset prices has been much more pronounced than elsewhere. Turkey led emerging markets in terms of real credit growth. The CBT's failure to accumulate foreign reserves during the boom exacerbates vulnerabilities[4].

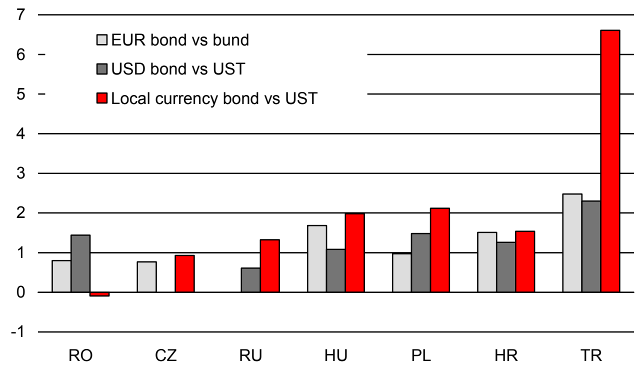
[4]For further discussion of Turkey's external vulnerabilities and their evolution over recent years, please refer to our note from 25th June: "Turkey: Stress testing external financing".

THE CBT HAS LIMITED AMMUNITION TO DEFEND ECONOMY FROM SUDDEN STOP

The CBT's ability to smooth an external adjustment is limited…

% of total reserves net of ROC		% contraction in C/A deficit compared to 2013 baseline						
		10	20	30	40	50	60	70
No. of quarters of reversal of foreign portfolio debt inflows	1	15.0	21.9	28.7	35.6	42.5	49.3	56.2
	2	29.1	36.0	42.8	49.7	56.6	63.4	70.3
	3	41.7	48.6	55.5	62.3	69.2	76.1	82.9
	4	48.5	55.3	62.2	69.1	75.9	82.8	89.7
	5	52.6	59.5	66.3	73.2	80.1	86.9	93.8
	6	60.5	67.3	74.2	81.0	87.9	94.8	101.6
	7	58.2	65.0	71.9	78.8	85.6	92.5	99.4
	8	64.9	71.8	78.6	85.5	92.3	99.2	106.1

…and takes its toll on asset prices (betas, 5 yr yields or closest available, May to date)



Source: CBT Bloomberg, UniCredit Research

…and will force a narrower C/A deficit, a weaker TRY and lower growth in 2014

Given that we do not expect short term flows to emerging markets to resume in large size, we have narrowed our C/A deficit forecast for 2014, reduced our expectations for credit growth and lowered our GDP growth forecast to 2.0% (previous 3.6%). Given local elections next March and Presidential elections next summer, we expect fiscal policy to continue to support activity while stronger external demand will boost exports but private consumption is likely to see a renewed downturn.

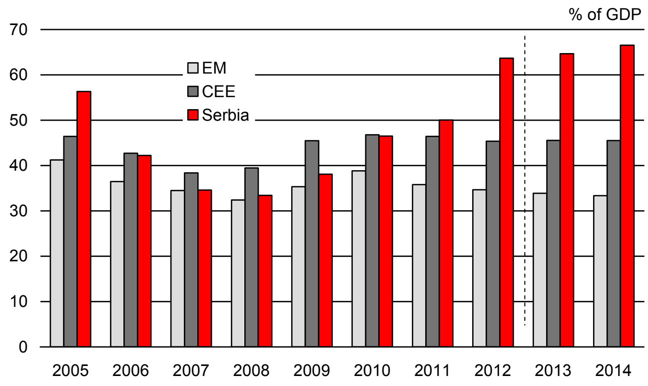
...while for some official sector aid is required

Twin deficits in Ukraine and Serbia are sizeable while growth is unimpressive…

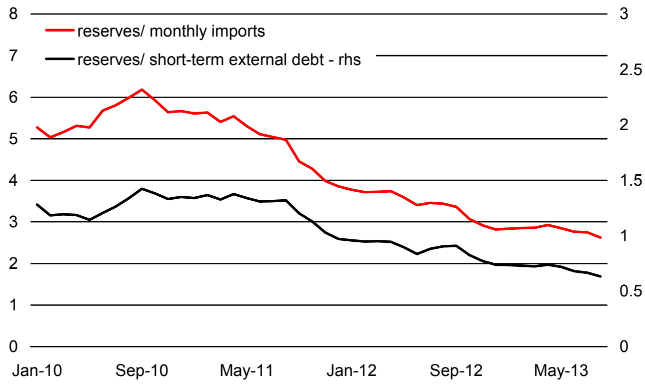
The combination of large twin deficits and the deterioration in the external financing environment risks forcing Ukraine and Serbia towards difficult decisions with multi-year repercussions. In both countries, growth models are being challenged. The steel industry is performing poorly in Ukraine. Serbia has been successful in attracting some foreign investment, including Fiat, but the C/A deficit remains excessive. Agriculture provides a boost to both this year but will subtract from GDP most likely next year. Meanwhile public sector performance threatens macro stability. Ukraine's headline budget deficit is deteriorating but still fails to capture Nafto's increasing shortfall, government guarantees to the public sector and arrears. Serbia has failed to deliver on consoliation plans in the past 12 months. In both countries public debt to GDP remains on an upward trajectory and in Serbia is concerningly above 60% of GDP.

MACRO VULNERABILITIES ARE SUCH THAT EXTERNAL ASSISTANCE MAY BE REQUIRED TO DELIVER STABILITY

Serbia: Public debt to GDP on an uncomfortable upward trend



Ukraine: Foreign reserves at multi-year lows



Source: IMF, NBU, UniCredit Research

Ukraine must choose between the IMF/EU or Russia while in Serbia the combination of an IMF agreement and progress on EU negotiations would provide a much needed anchor to policy

The above macro mix combined with the deterioration in external funding conditions significantly lowers the potential for Ukraine and Serbia to continue to access eurobond markets. In recent years this has been a crucial source of funding to help cover BoP gaps for both. We do not underestimate Ukraine's willingness to continue with its muddle-through strategy but with the EU summit scheduled for the end of November, the authorities will in any case be forced towards a fundamental choice before year-end. An EU free trade agreement will likely be accompanied with an IMF agreement (though not necessarily immediately), some currency flexibility and fiscal consolidation. A deal with Russia should be accompanied by upfront funding, securing the currency peg ahead of Mar-15 Presidential elections but will do little to bolster medium to long term growth prospects. In Serbia any IMF programme will entail a series of difficult fiscal consolidation measures, including reductions in the size of the public sector labour force. Though still approximately a decade away, progress on negotiations on EU accession has the potential to act as an anchor for a series of much needed institutional reforms.

Countries

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

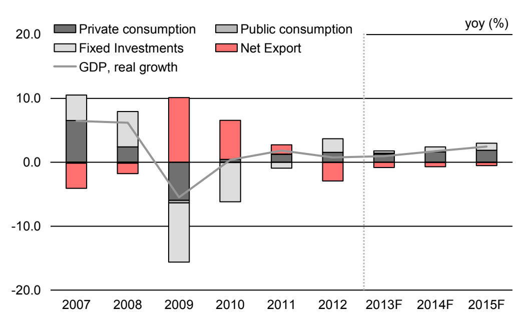
Outlook – Despite slowing GDP growth, we see the chances of the economy sliding into a recession as limited, since the labor market and especially export recovery seem to have strengthened, which in turn should help GDP to gain momentum in the remaining months of 2013 and rise further in 2014. Keeping this in mind, we think that the Bulgarian economy will continue to slowly emerge from a difficult period of adjustment. There is no room for complacency, however, and a shift to a sustained recovery cannot be taken for granted. To strengthen its growth credentials, Bulgarian authorities need to abandon populism in policy making, press ahead with infrastructure improvements, and as a minimum deal with the economic flaws in the health care, the education and the dangerously problematic energy sectors.

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

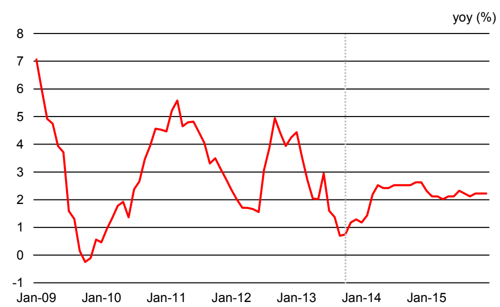
KEY DATES/EVENTS

- 8 November – Number of employees under labor contract for 3Q
- 14 November – Flash estimates for swda real GDP for 3Q
- 31 November – Deadline for presenting the 2014 Budget Law in Parliament

GDP GROWTH AND CONTRIBUTORS TO GROWTH



INFLATION (CPI) YOY



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	38.5	39.7	40.4	41.4	43.2
Population (mn)	7.3	7.3	7.2	7.2	7.2
GDP per capita (EUR)	5,255	5,445	5,572	5,750	6,030
Real economy yoy (%)					
GDP	1.8	0.8	0.5	1.3	2.0
Private Consumption	1.7	2.0	0.1	1.3	1.7
Fixed Investment	-6.5	0.8	0.4	0.9	3.8
Public Consumption	0.3	-0.4	2.8	1.3	0.4
Exports	12.3	-0.4	6.6	6.0	5.4
Imports	8.8	3.7	5.6	5.3	5.0
Monthly wage, nominal (EUR)	351	397	413	431	454
Unemployment rate, avg (%)	11.3	12.3	12.7	12.3	11.3
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-0.5	-2.1	-2.9	-2.8
Primary balance	-1.4	0.3	-1.2	-2.0	-1.9
Public debt	15.3	17.6	17.9	23.2	24.6
External accounts					
Current account balance (EUR bn)	0	-0.5	0.4	0	-1.0
Current account balance/GDP (%)	0.1	-1.3	1.0	0.1	-2.3
Basic balance/GDP (%)	0.4	5.4	-0.2	2.8	1.0
Net FDI (EUR bn)	1.2	1.3	1.2	1.3	1.4
Net FDI (% of GDP)	3.1	3.3	3.0	3.1	3.2
Gross foreign debt (EUR bn)	36.2	37.6	35.5	35.0	34.8
Gross foreign debt (% of GDP)	94.1	94.8	88.0	84.5	80.5
FX reserves (EUR bn)	13.3	15.6	15.5	16.6	17.0
Inflation/Monetary/FX					
CPI (pavg)	4.2	3.0	1.2	1.3	2.2
CPI (eop)	2.8	4.2	-0.6	2.3	2.2
Central bank reference rate (eop)	0.22	0.04	0.04	0.10	0.27
USD/BGN (eop)	1.51	1.48	1.45	1.42	1.46
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.41	1.52	1.49	1.44	1.44
USD/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

Authorities are at risk of focusing on short-term popularity gains at the expense of longer-term real economic costs

Weakening of GDP growth in 2Q13 was attributable to domestic demand and GFCF in particular…

…but a cautious return to growth is expected in 2H13

Looking ahead the Bulgarian economy should display a path of moderate recovery, prompting an improvement of GDP growth from 0.2% yoy in 2Q13 (-0.1% qoq) to 1.3% and 2.0% in 2014 and 2015, respectively. Focusing on 2Q13, following five consecutive quarters of positive qoq readings averaging 1.2%, GFCF unexpectedly shrank by 2.4%, making it the main drag behind the fall in economic activity in 2Q13. Collective and, to a lesser extent, private consumption picked up some of the slack, by rising 0.7% and 0.1% qoq. Export growth increased by another 2.3% qoq in 2Q13, and is now a solid 20.7% above where it was when the adjustment process began five years ago. All this provided additional evidence that domestic demand remains in the doldrums (as private consumption and GFCF are now 4.7% and a hefty 41.1% below their pre-crisis levels in mid-2008) and prompted another downward revision of our GDP growth forecast to 0.5% this and 1.3% next year, from 1% and 1.7%. But slower growth in 2Q13 is unlikely to give way to an outright recession, since the labor market and especially export recovery seem to have strengthened, which should help GDP to gain momentum in the rest of 2013 and rise further in 2014.

Relative to the numbers seen one year ago, some 27 thousand people were back to work in 2Q13, which is the first such increase since mid-2008

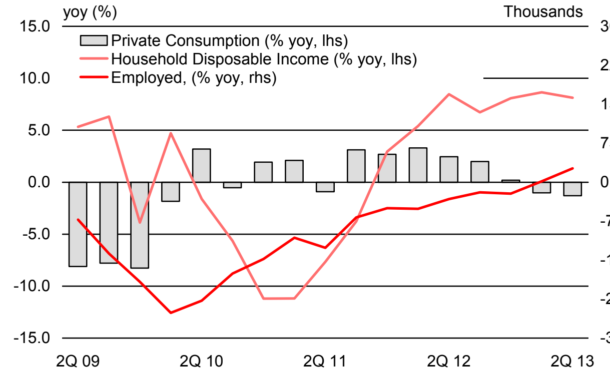
The share of the population that is working or looking for work (a measure known as the participation rate) increased to 53.9% in 2Q13, from 52.8% in 1Q13 and 53.1% on average in 2012

Labor market pain has begun to ease. After peaking at 13% in March, the unemployment rate appears to have leveled off at 12.7% in seasonally adjusted terms over the three months through July. Perhaps even more importantly, the economy has added two thousand jobs in 1Q13 and another 27 thousand in 2Q13 when compared with the same period a year ago, which is very positive, as prior to that the yoy change in the number of jobs has been in negative territory ever since the jobs market crashed in end-2008. Real personal disposable income data also added to the flow of positive headlines after edging higher 8.1% yoy in 2Q13, which was just a notch above the 8% average yoy rise in the preceding four quarters. Various factors were at play, including subdued inflation, lower cost of retail loans and recent pension indexation, which all helped real personal disposable income to rise. Some non-negligible part of the upswing also came from the continuing positive news on wages where, even in the most challenging moments of the adjustment, salaries in some sectors have continued to increase at decent rates. All this helps to explain why, following some softening in the preceding three quarters, personal consumption appears to have stabilized in 2Q13, and is forecasted to contribute positively to GDP growth later this year and further in 2014.

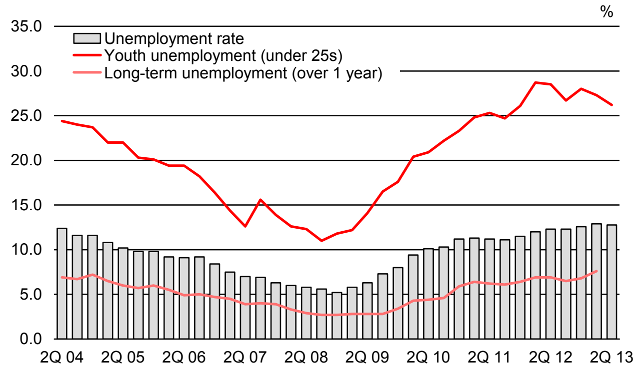
Government's critics expressed concerns that, given widespread VAT fraud in Bulgaria, the new expedient VAT refund regime may include some illegitimate refunds channeled to shadow corporate interests

The government has struggled to generate some positive headlines. It promised more funding to SMEs via the state-run Bulgarian Development Bank and passed legislation to ensure better access of SMEs to public procurement. Some social assistance payments were increased and more funding was made available to the programs aimed at reducing youth unemployment. Given the modest fiscal costs of these measures (not more than 0.1% of GDP for the rest of 2013), they could have been easily accommodated under the existing

Better disposable income and job numbers should help private consumption recovery



Unemployment rate appears to have stabilized recently



Source: NSI, Eurostat, UniCredit Research budget plan. Nevertheless, the government decided to revise this year's budget, including raising the targeted deficit from 1.3% to 2% of GDP. The higher deficit was justified by the need to reduce delayed payments to government suppliers and to speed up VAT tax refunds, including refunds made before the legal deadline. The president vetoed the changes because of the lack of transparency as to the firms which would benefit from the new expedient VAT refunds regime, but Parliament overruled the veto.

In an attempt to boost its popularity, the government has thrown its support behind more populist policies. Among other things, this includes reversing the increases in minimum retirement age and some of the restrictions for early retirement which were enacted by the previous government

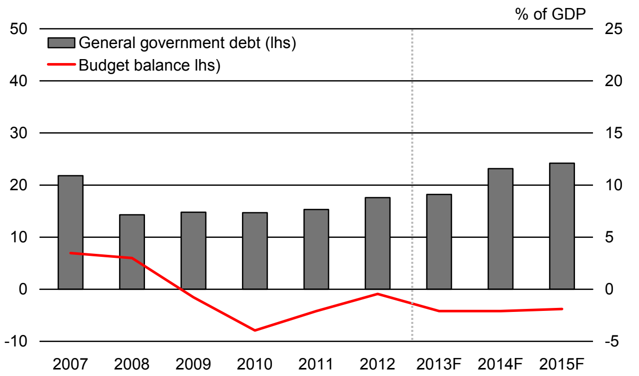
In a much more controversial move, electricity prices for households were cut by 5% in August. Bulgaria has the second lowest household electricity prices in the EU, which prior to this move were increased regularly once annually to accommodate the higher costs for wind and solar power and charges for "brown" energy. If the old methodology was applied, the prices would have increased by some 10%, as the energy sector aggregate "call" was for a 16% rise. Instead, the regulator scrapped most of the costs for green energy, redistributed production quotas to cut the share of the most expensive producers (including mostly wind and solar, but also some coal power plants), and cut the price at which state-owned nuclear and some coal power plants sell electricity to the regulated market. To cover some of the resulting cash shortfall for this year, the government decided to sell free greenhouse gas quotas. But the targeted receipts look overambitious and there is no clarity as to how the shortfall will be funded next year. Also as a negative, the reduced prices for state-owned power plants mean delays in their renovation plans, and perhaps somewhat higher prices for the free market, where the business sector purchases electricity. To make matters worse, the government promised to hike the price of domestically excavated coal, which is used as a primary energy resource in some 40% of the country's installed electricity generation capacities. All this took place against the backdrop of a significant cash flow deficit already existing on the balance sheet of state-owned NEK, which government sources put at EUR 500mn (1.3% of GDP), and deepening overcapacity problems, which could become even more worrisome if the project for building a second nuclear power plant in Belene is restarted. Not surprisingly, questions have been raised about the sustainability of the price cut enacted in August. Shifting these costs to the government is obviously not an option, since it is likely to be criticized by the EU as contradicting state aid rules. Passing on the full amount of these costs to the business sector looks out of the question as well, due to the negative effect it would have on the competitiveness of industry, which still has a long way to go to recoup all the losses it has suffered from the crash in 2008-2009.

The reduction of electricity prices for households was simply wrong and runs the risk to destabilize the already delicate financial position of NEK (a holding company which controls most of the state-owned assets in the energy sector)

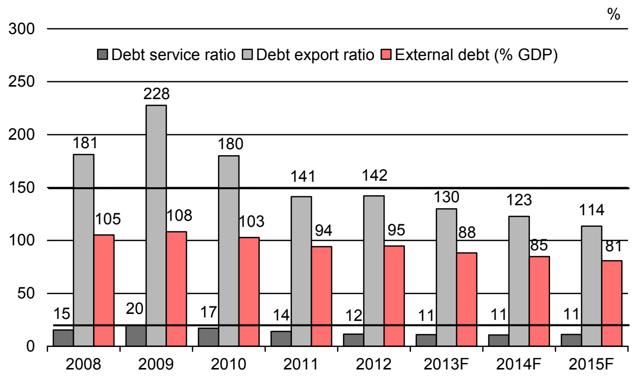
Given Bulgaria's solid fiscal fundamentals and improving external position, the near-term risks arising from the shift toward more populist policies looks modest in scale. But if the government does not soon abandon such populist policies, the medium-term outlook is likely to deteriorate

All this indicates that authorities are at risk of focusing on short-term popularity gains at the expense of longer-term real economic costs. But the shift towards more populist policies has failed to boost the popularity of the government, at least in the first three months since the snap elections in May. A recent poll conducted by Alpha Research found that the approval ratings of the government and the prime minister remained unchanged in August versus May, at 23% and 29%. According to the same poll, however, the negative assessment of the government increased from 28% in May to 47% in August, and for the prime minister from 25% to 44%.

Fiscal fundamentals will remain little changed in 2014 and 2015



Debt sustainability indicators are forecasted to improve



Source: NSI, BNB, MF, UniCredit Research

Strategy: MinFin's focus shifts to shorter maturities

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

Following a revision in the government's macro scenario and recent dynamics in global financial markets, the MinFin has decided to address its financing requirement needs on the domestic bill market. The recently-revised 2013 Budget Law and latest medium-term macro assumptions made by Finance Minister Mr. Petar Chobanov have highlighted an increase in debt issuance to prepare for operating in a medium-term environment of modestly higher deficits, while also building higher fiscal buffers to offset seasonality in revenue receipts.

Global and domestic market dynamics prompt a shift to shorter maturities' issuance

Our initial assumption was that these would be made available via issuance along the whole length of the yield curve in an attempt to increase liquidity in the different GB segments and jump-start the secondary market. Following consultation talks between the debt issuer and primary market dealers, investors have made it clear that they prefer shorter-term paper for liquidity management purposes. Furthermore, the recent adjustment dynamics in the longer end of global GB markets have translated into additional upward pressure on yields on the Bulgarian primary market, prompting the MinFin to cancel a 10½Y benchmark note auction in end-July due to weak demand and potentially higher costs.

The cost for the cheaper funding will come in the form of high concentration of debt due in 2014

The upshot of this is that with all bond redemptions for 2013 already cleared, the MinFin will issue debt in the amount of BGN 1bn in 4Q 2013 (with 9M gross issuance expected to come at just under BGN 2bn), with circa 70% of this in the 1Y segment. High demand and relatively cheap financing (anchored further by disinflationary dynamics in the economy) will come at a cost though, as this will lead to a concentration of domestic debt maturing in 2014 at 27.7% of all outstanding paper (compared to 14.8% in 2013). This should prompt the MinFin to roll over the ST share of the maturing notes, while preparing to tap external markets in a more aggressive manner (to the tune of EUR 1.4bn vs. 2012 issuance of EUR 0.95bn) to secure much needed funding for the rollover of the USD-denominated paper due January 2015. This should lead to a jump in the debt-to-GDP ratio in 2014, providing for an uptick in net issuance, which should be more than enough to increase the government's cash buffers – from the current BGN 1.069bn in July to BGN 2.584bn eop 2014 above the BGN 4.5bn threshold for the fiscal reserve.

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

GOVERNMENT GROSS FINANCING REQUIREMENTS[5]

EUR bn	2012	2013F	2014F	2015F
Gross financing requirement	**0.9**	**2.5**	**2.5**	**2.9**
Budget deficit	0.2	0.8	1.2	1.2
Amortization of public debt	0.5	1.5	1.2	1.5
Domestic	0.4	0.5	1.1	0.6
Bonds	0.4	0.1	0.5	0.1
Bills	0	0.4	0.5	0.5
External	0.1	1.0	0.1	0.9
IMF/EU/Other	0.2	0.2	0.2	0.2
Financing	**0.9**	**2.5**	**2.5**	**2.9**
Domestic borrowing	0.6	1.5	1.8	1.3
Bonds	0.6	0.6	1.3	1.0
Bills	0	0.9	0.5	0.3
External borrowing	0.8	0.4	1.9	0.6
Bonds	1.0	0	1.4	0
WB/EIB/JBIC/Others	-0.1	0.4	0.5	0.6
Privatization	0	0	0	0
Fiscal reserves change (- = increase)	-0.6	0.6	-1.1	1.0

Source: BNB, MF, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F	2015F
Gross financing requirement	**16.1**	**15.5**	**13.6**	**14.7**
C/A deficit	0.5	-0.4	0	1.0
Amortization of medium to long term debt	5.5	6.2	4.9	5.3
Government/central bank	0.3	1.2	0.3	1.0
Banks	0.8	0.8	0.8	0.7
Corporates	4.4	4.2	3.9	3.6
Short term debt amortization	10.1	9.7	8.8	8.4
Financing	**16.1**	**15.5**	**13.6**	**14.7**
FDI	1.3	1.2	1.3	1.4
Portfolio flows	-0.9	-0.6	0.6	0
Borrowing	6.4	5.3	6.1	4.6
Government/central bank	0.8	0.4	1.9	0.6
Banks	0.8	0.7	0.5	0.5
Corporates	4.7	4.2	3.7	3.6
Short-term	9.7	8.8	8.4	8.3
EU transfers	1.0	1.1	1.0	1.2
Other	0.8	-0.4	-2.6	-0.3
Change in FX reserves (- = increase)	-2.2	0.1	-1.1	-0.4

[5] 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+ negative/BBB- negative)*

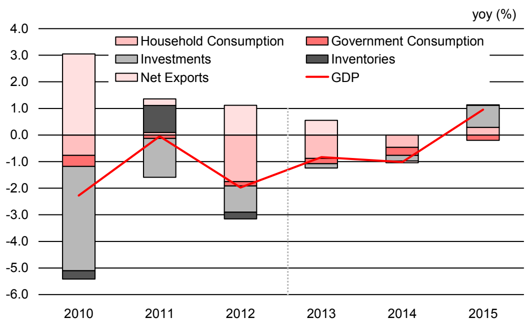
Outlook – Croatia's multi year recession persists and we now see GDP declining by 0.8% in 2013 and 1.0% in 2014. Unaddressed structural weaknesses and fiscal imbalances, tighter (re)financing conditions and a new regulatory environment are all taking their toll. Fiscal consolidation coupled with real sector restructuring have to be accelerated to maximise the benefits from EU accession and finally escape recession. The upcoming budget cycle offers an important reform opportunity, though a supplementary budget will also be required for this year. Activation of the Excessive Deficit Procedure in Q4 will increase pressure on the government to act.

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

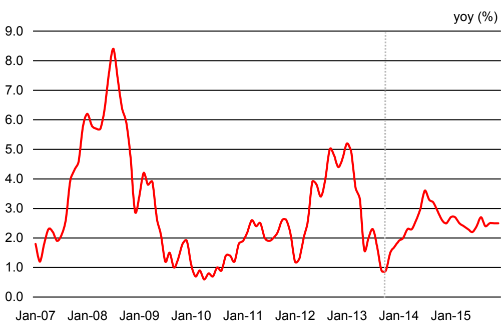
KEY DATES/EVENTS

- 30 September: BoP & foreign debt for 2Q
- 15 October: MinFin submits 2014 draft budget to gov.
- 16 October: Labour force survey for 2Q
- 15 November: Submission of 2014 budget to the parliament
- 29 November: 3Q GDP flash estimate

GDP GROWTH



INFLATION OUTLOOK



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

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	44.4	43.9	44.4	45.5	47.2
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,089	10,003	10,140	10,402	10,830
Real economy yoy (%)					
GDP	0	-2.0	-0.8	-1.0	1.0
Private Consumption	0.2	-3.0	-1.5	-0.8	0.5
Fixed Investment	-7.2	-4.6	-0.8	-1.0	4.0
Public Consumption	-0.3	-0.8	-1.0	-1.5	-1.0
Exports	2.0	0.4	0.1	2.5	3.4
Imports	1.2	-2.1	-1.0	2.6	3.3
Monthly wage, nominal (EUR)	1,049	1,047	1,048	1,060	1,080
Unemployment rate (%)	13.5	15.8	16.5	17.5	16.8
Fiscal accounts (% of GDP)					
Budget balance	-5.2	-4.1	-4.8	-4.3	-3.8
Primary balance	-2.9	-1.4	-1.8	-1.2	-0.7
Public debt	50.0	55.4	60.0	62.9	64.5
External accounts					
Current account balance (EUR bn)	-0.4	0	-0.1	-0.2	-0.3
Current account balance/GDP (%)	-0.9	-0.1	-0.3	-0.4	-0.6
Basic balance/GDP (%)	1.6	2.6	2.2	2.2	2.2
Net FDI (EUR bn)	1.1	1.2	1.1	1.2	1.3
Net FDI (% of GDP)	2.4	2.7	2.5	2.6	2.8
Gross foreign debt (EUR bn)	45.9	44.8	46.0	47.6	49.9
Gross foreign debt (% of GDP)	103.3	102.1	103.5	104.6	105.8
FX reserves (EUR bn)	11.2	11.2	11.8	12.8	13.4
Inflation/Monetary/FX					
CPI (pavg)	2.3	3.4	2.4	2.7	2.5
CPI (eop)	2.1	4.7	1.7	2.5	2.5
Central bank reference rate (eop)	-	-	-	-	-
1W money market rate	1.28	1.39	0.70	0.90	1.30
FX/USD (eop)	5.7	5.7	5.6	5.5	5.6
FX/EUR (eop)	7.5	7.6	7.6	7.6	7.5
FX/USD (pavg)	5.3	5.8	5.7	5.5	5.5
FX/EUR (pavg)	7.4	7.5	7.6	7.5	7.5

Source: UniCredit Research

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

Challenging environment for fiscal policy

The economy is at risk of remaining in recession for a sixth consecutive year next year

Despite a fifth consecutive year of contraction, the case for a sustained recovery in economic activity remains unconvincing. We now forecast full year 2013 and 2014 GDP at -0.8% and -1.0% respectively. GDP declined 0.7% yoy in 2Q. A slowdown in the pace of contraction (-1.5% yoy in 1Q) was aided by government consumption surrounding local and regional elections but will have to be reversed. Over the first half of the year as a whole, GDP fell by 1.1% yoy.

Following poor performance over 1H this year, fiscal consolidation is becoming more and more necessary

Fiscal consolidation is turning increasingly unavoidable. Last year's efforts have been reversed while YTD the deficit is 78% in nominal terms than was the case for the same period last year. Despite the increase of tax collection based on introduction of, so called, fiscal cash registers and consequential growth of VAT revenues (7.5% yoy in 1H), both profit tax revenues and excise duties revenues dropped as a result of long-lasting recessionary environment. Overall government revenues were, therefore, 0.6% lower yoy. The expenditure side of the budget suffers from a lack of reforms, unplanned expenditures to cover the costs of the public health system (1% of GDP) and the impact of local elections on capital expenditures, subsidies and social benefits. Public debt is at risk of reaching 60% of GDP already this year.

The remainder of this year will be occupied with a supplementary budget, entry into the EDP and next year's budget

The remainder of this year will as a result be filled with a supplementary budget to help reign in this year's underperformance, entry into the Excessive Deficit Procedure and budget discussions for next year. Once ESA 95 fiscal data is published, the EDP should act as an anchor given limited patience for fiscal overshoots within the EC. Given that the government is already almost half way through its electoral term, next year's budget also acts as a crucial opportunity to push through some convincing consolidation. Without a transparent adjustment strategy, Croatia risks excluding itself from eurobond markets, particularly given the deterioration in risk appetite across EM. This will see the government further increase its reliance on the banking sector for financing, with related risks to macro stability.

EMU accession does not guarantee a return to growth – more broad-based reform efforts are required

Looking ahead recent EMU accession should benefit activity but in itself does not guarantee recovery and catch-up. A more broad-based reform effort is required at this stage. Croatia's poor competitiveness is captured in a multi-year period of underperformance on exports relative to its peers. In terms of world export market share, Croatia not only underperformed most of its peers over 2000-08 but has also lost more export market share since 2009 than its peers. A multi pronged strategy is required and should include increased work incentives to boost labour force participation and an improved business environment, as well as the above mentioned fiscal consolidation efforts. The Baltics provide examples of successful adjustment under a fixed currency regime outside of EMU, with governments re-elected thereafter, but this was achieved only with some difficult upfront decisions. Cyclically Croatia currently suffers from exit from the CEFTA market, though an EMU recovery should provide some support in 2H.

Current account near balance but FDI has improved

BoP outlook: The C/A continues to post a small deficit, despite declining imports and increases services revenues. Croatia lost its CEFTA membership and as a result preferable customs treatment of its agricultural and food & beverage sectors. Growth in tourism remains limited. There is good news in the fact that there has been some improvement in FDI of late.

2014 budget central to ratings

Rating outlook: S&P downgraded Croatia's rating outlook at the beginning of August to negative, citing fundamental economic constraints, risks of continued weak economic performance and poor budget performance, all of which threaten external funding conditions. The upcoming budget will be important in determining whether or not Croatia can avoid another downgrade.

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

Outlook – A continued recovery in external demand is necessary to help the Czech economy maintain growth in 2H13. For 2014, exports will continue to be a key factor but domestic policies, in particular fiscal easing, will also play a role. The CNB repo rate will stay at technical zero throughout 2014 but FX intervention is now less likely.

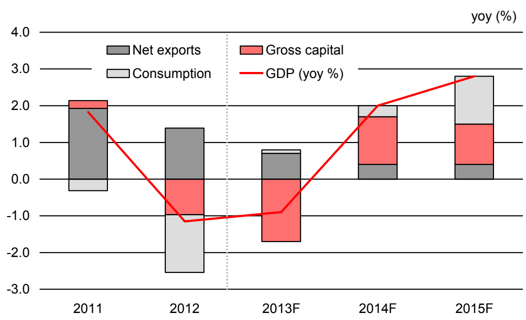
Strategy outlook – With this year's financing needs of the government almost covered to date, urgency to issue new debt is low. This makes CZGB safe instruments relative to peers.

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

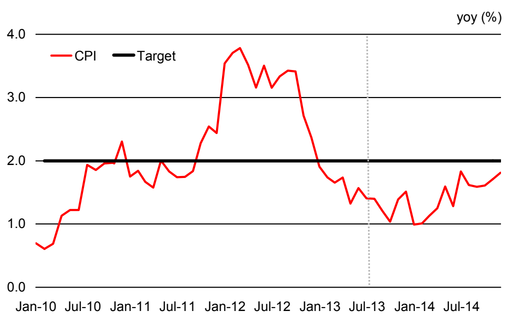
KEY DATES/EVENTS

- General elections – Oct 25-26
- Manufacturing PMI – Oct 1, Nov 1, Dec 2
- CNB policy meetings Sep 26, Nov 7, Dec 17

CAPEX TO BE THE ONLY DRAG ON GDP IN 2013; MORE BALANCED GROWTH TO BE SEEN IN 2014



HEADLINE CPI IS YET TO REACH A TROUGH



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	155.4	152.4	149.6	156.4	168.0
Population (mn)	10.5	10.5	10.5	10.5	10.6
GDP per capita (EUR)	14,804	14,499	14,214	14,839	15,912
Real economy yoy (%)					
GDP	1.8	-1.2	-0.9	2.0	2.8
Private Consumption	0.5	-2.6	0.0	0.7	2.5
Fixed Investment	0.4	-2.6	-4.8	1.6	4.0
Public Consumption	-2.7	-1.2	0.5	0.0	0.5
Exports	9.6	4.2	1.7	5.9	9.0
Imports	7.0	2.5	0.9	6.2	9.8
Monthly wage, nominal (EUR)	995	999	986	1,019	1,086
Unemployment rate (%)	6.7	6.8	7.7	7.8	7.2
Fiscal accounts (% of GDP)					
Budget balance	-3.3	-4.4	-2.5	-2.9	-2.9
Primary balance	-1.9	-2.9	-1.0	-1.3	-1.3
Public debt	40.8	45.8	47.0	48.2	48.9
External accounts					
Current account balance (EUR bn)	-4.2	-3.7	-1.7	-1.6	-1.3
Current account balance/GDP (%)	-2.7	-2.5	-1.1	-1.0	-0.8
Basic balance/GDP (%)	-1.5	2.3	1.7	2.4	2.6
Net FDI (EUR bn)	1.9	7.2	4.3	5.3	5.6
Net FDI (% of GDP)	1.2	4.7	2.9	3.4	3.3
Gross foreign debt (EUR bn)	72.8	77.2	80.2	87.3	95.1
Gross foreign debt (% of GDP)	46.8	50.7	53.6	55.8	56.6
FX reserves (EUR bn)	31.1	34.0	34.0	34.0	34.0
Inflation/Monetary/FX					
CPI (pavg)	1.9	3.3	1.5	1.5	2.2
CPI (eop)	2.4	2.4	1.5	1.8	2.2
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.05	0.05	0.05	1.25
1M money market rate	0.97	0.75	0.30	0.30	0.90
USD/CZK (eop)	19.4	19.0	19.0	18.3	18.3
EUR/CZK (eop)	25.8	25.1	25.7	25.2	24.5
USD/CZK (pavg)	17.6	19.6	19.5	18.7	18.3
EUR/CZK (pavg)	24.6	25.1	25.7	25.5	24.9

Source: UniCredit Research

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

Less pain but still little gain

Recession terminated in 2Q on the back of improved net exports…

On the back of a more constructive outlook for the euro area and easing financial strains within households, we expect the economy continue to post qoq gains, as initiated in Q2. Fiscal policy, still viewed as restrictive, may provide the economy an additional stimuli in 2014. Fixed investment is set to remain the weakest component of demand and will recover only with some delay after the rebound of exports.

…as well as higher private consumption. Gross capital investment was in contrast more of a drag to GDP than in 1Q

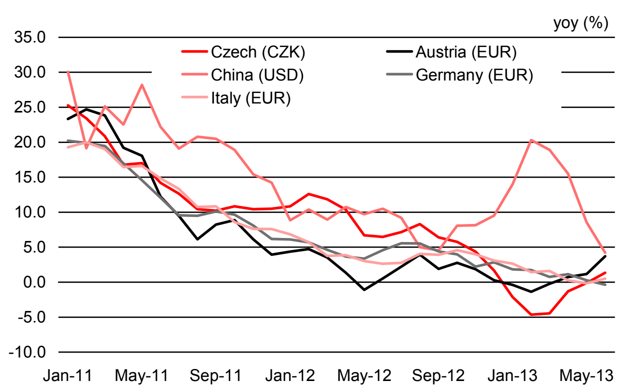
The pick-up of 2Q13 GDP by 0.6% qoq has terminated the longest recession in a 20-year history. GDP contracted for 6 consecutive quarters up to 1Q13. Net exports have started again to add to GDP growth yoy after two quarters of their close-to-zero contributions, though the efficiency of Czech exports has yet to recover from a multi-year weakness (see chart below). Private consumption surprised on the upside with 0.5% yoy real growth. Statistics show that households boosted their spending above all on durable consumer goods. Given that work income ticked up nominally only 0.5% yoy (leaving real income at a negative 1.0% yoy), household savings ratio must have shrunk. While this serves as an indication of easing strain in household sector finances, we see limited scope for growth of private consumption over 2H13. In contrast to spending, investment showed no improvement at all in 2Q. In fact, gross capital investment subtracted a full 3.0 p.p. from GDP and was more of a drag than in 1Q (when its negative input posted 2.2 p.p. of GDP). That said approximately half of this drag is due to inventories, in qoq terms was more positive in Q2 and opens some scope for further upside surprise in the coming quarters.

Firmer July data reflect a positive working-day effect; more evidence needed for judgment on genuine recovery

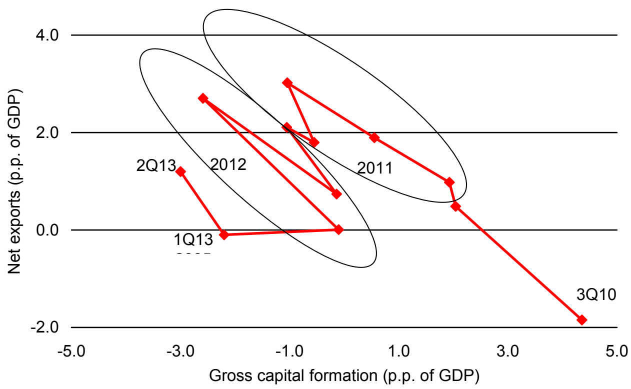
For a time, the GDP upturn was not heralded by short-term activity indicators, but those have since been on a stronger footing. The August manufacturing PMI jumped to 53.9, recording its third above-50 reading in a row. Retail sales picked up to 4.0% yoy and exports in CZK terms resumed growth (3.2% yoy) in July. While such trends are surely welcome, we caution that further evidence will be needed to separate the signs of genuine economic recovery from a strong working-day effect (two days more yoy this July). Looking beyond short-term or seasonal factors, a recovery of external demand is needed to partially help the Czech economy in the remainder of 2013. On the production side, we also see some support from the kick-start of new Skoda Auto models and a good harvest in agriculture. On the other hand, a boost in fixed capital formation will only follow higher exports with some delay. We hence expect for 2H13 a GDP rise by around 0.5% per quarter, which does mean a recovery but hardly a V-shaped one.

EXTERNAL DEMAND: WAITING FOR AN UPTURN

Growth rates of exports: Czech underperformance is over, it had its roots in the exceptionally strong 4Q11-1Q12



GDP components: net exports resumed contributing to growth in 2Q13 but efficiency of exports remained subdued



Source: Datastream, CZSO, UniCredit Research

Fiscal easing may give a moderate boost to GDP in both 2014 and 2015

External demand is assumed to be a decisive factor also in 2014, but domestic factors and policies may play an increasing role then. As to government policies, the early elections to be held on October 25-26 leave a high degree of uncertainty but some fiscal easing will probably follow. We conservatively expect it at 0.5 p.p. of GDP for each of 2014 and 2015 (after the assumed 0.4 p.p. tightening in 2013). The 2014 easing will take the form of higher healthcare spending and perhaps higher wages in the public sector, while a more needed boost in infrastructure investment looks less likely. For 2015, we count on more infrastructure projects coming to a phase of realization.

A drop of inflation will allow private spending to grow in real terms in 2014

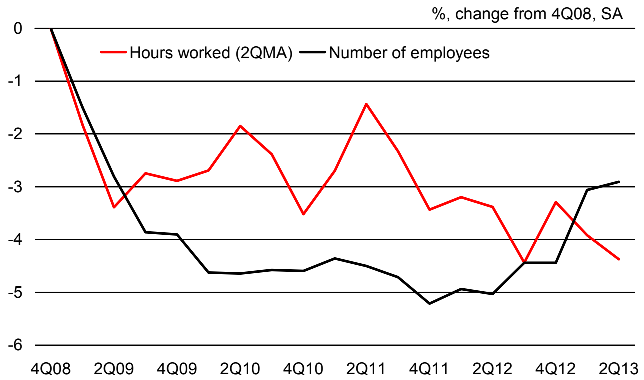
Also importantly, there seems to be less inflation in the pipeline at the start of 2014 compared to 2013. Tax effects from 2013 will mostly fade away, while no new hikes apart from the excise tax on tobacco are set to emerge. A traditional housing price hike may be rather small, as the state has taken steps to lower the regulated part of energy prices. Food prices may react with stabilization following a good 2013 harvest. All in all, headline CPI is seen hitting a trough at around 1% yoy in 1H14 and starting to pick up only from 2H14. The low inflation means that wage increases, even though moderate, will allow real private consumption to gather some momentum (we forecast household consumption to rise by 0.7% yoy in 2014).

No repo rate hike is foreseen until 2015. Chances for an introduction of market interventions by the CNB have sunk below 50%

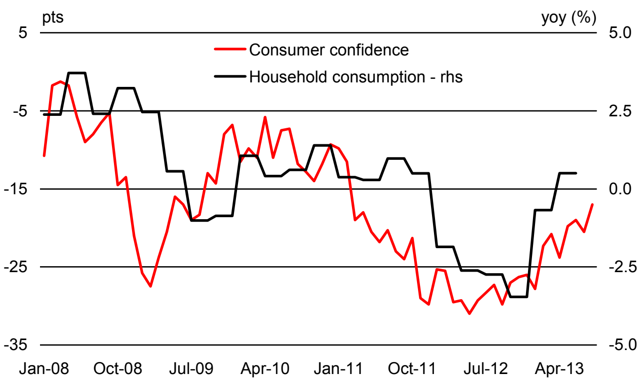
Focussing on CNB policy, we expect the repo rate to remain at a technical zero throughout 2014 before the CNB initiates a trend of interest rate normalisation in 2015. The CNB itself has stated its intention to keep the repo rate low until inflationary risks rise meaningfully. We do not see this before 2015. On the issue of FX interventions, the CNB recently indirectly revealed its goal as its macro model shows a need to ease monetary conditions by an amount roughly equal to 40bp of an interest rate reduction. Given no more scope to cut rates, we estimate that a 1.4% weakening of CZK is required relative to the CNB's baseline of EUR/CZK 25.7 The deviation of monetary conditions from their optimal setting is probably too small to become a trigger for FX interventions on its own. In other words, an additional trigger would be needed to convince a majority of policy makers to move ahead with interventions. With 2Q GDP coming out 0.4 p.p. above the CNB forecast, a poor economic performance may no longer serve the purpose. What's left as a potential trigger hence is a sharp decline of CPI below CNB projections (not particularly likely, in our view) or a CZK appreciation (which looks more conceivable but also more controversial as a trigger). All in all, chances for an introduction of market interventions have, in our view, sunk below 50%, which is also reflected in our EUR/CZK forecasts (on average 25.7 for 2013 and 25.5 for 2014) that are almost identical with the CNB's.

PRIVATE CONSUMPTION: LESS PAIN BUT STILL LITTLE GAIN

More employees work less hours; this doesn't support further improvement in private spending this year



Private consumption has recovered faster than suggested by consumer confidence, firmer confidence is now needed.



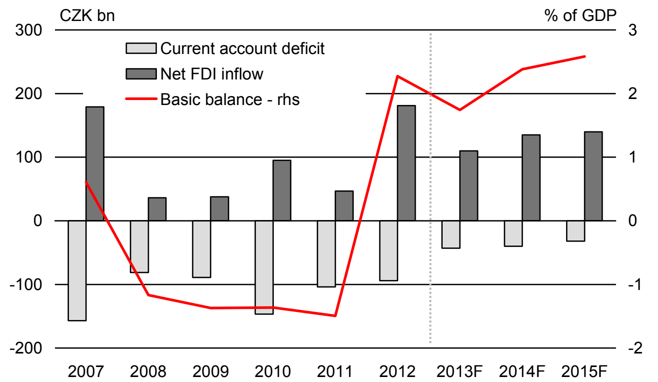
Source: CZSO, UniCredit Research

Strategy: Ample liquidity of the Treasury makes CZGB safe

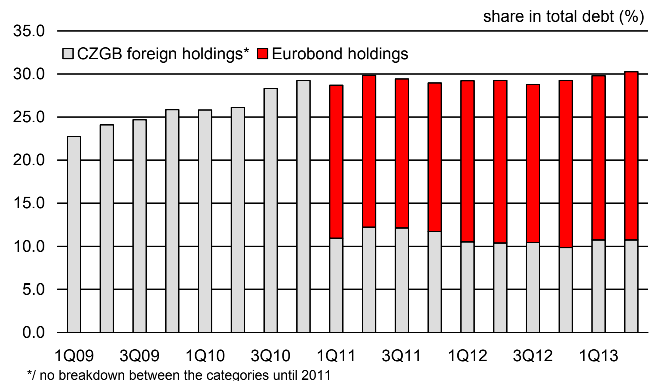
No urgency to place new government debt on the market has turned particularly low

A new system of the government's liquidity management, in place since the start of 2013, has lead to a substantial decline of financing needs. With many public institutions now having their accounts mandatorily with the CNB, the treasury could rely on a new liquidity buffer worth CZK 136bn as of June 30th, 2013. Subsequently, the debt management strategy has been revised, cutting the assumed local bond issuance and reducing the volume of T-bills in circulation. In the same vein, the finance minister of the current caretaker government has indicated that the state will abstain from Eurobond issuance entirely for the remainder of 2013. With the CZGB issuance reaching year-to-date CZK 103bn out of the full-year assumed CZK 109bn to CZK 139bn range, urgency to place new debt on the market by the year-end has turned particularly low. This will put a cap on CZGB yield spreads versus German Bunds as well as on asset-swap spreads. Hence, CZGB are currently seen as safe instruments in relative terms, despite the upcoming early elections and the underlying political noise.

Basic balance is heading for the second year of surplus, outlook for next few years also remains positive



Foreign holders' share of Czech government debt remains around 30%, as Eurobond holding rises at the expense of CZGB



Sources: CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**8.9**	**9.7**	**10.0**
Budget deficit	3.9	3.6	3.2
Amortization of public debt	5.0	6.2	6.8
Domestic	4.6	5.7	6.4
EIB loans	0	0.1	0.1
Other	0.4	0.4	0.4
Financing	**8.9**	**9.7**	**10.0**
Domestic borrowing	4.0	7.8	8.1
Bonds	6.5	7.8	8.1
Bills	-2.5	0	0
External borrowing	0.9	1.9	2.0
Bonds	0.9	1.9	2.0
EIB/IMF	0	0	0
Change of cash reserve	4.0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**10.2**	**9.9**	**5.9**
Banks	0.8	0.7	0.7
Government and central bank	1.6	3.8	1.4
Other sectors	7.8	5.4	3.9
Financing	**10.2**	**9.9**	**5.9**
Banks	4.6	2.2	1.3
Government and central bank	0	0	0
Multilateral institutions	0.7	0.8	0.8
Companies	2.3	1.9	0.7
Other investors	2.5	5.0	3.1

Source: UniCredit Research

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

Outlook – Next spring's general elections will shape public policies. The government will try to spur growth and will need to find additional tax revenues in order to cap the budget deficit. But poor investment and falling export competitiveness will probably keep growth below 2%. Fidesz is very well placed to return to power with a big majority but before that it will cement its chances by cutting energy and gas prices (thus increasing the purchasing power) and by forcing banks to convert FX mortgage loans to HUF. The swap will result in further losses for banks, but will reduce concomitantly the short-term external debt and FX reserves.

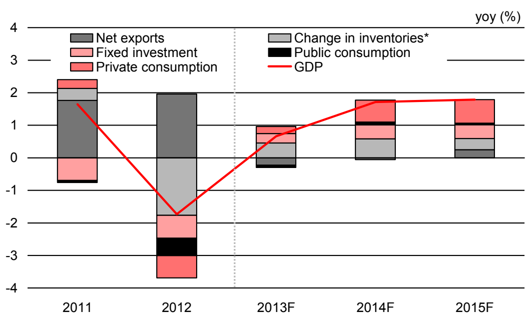
Strategy – Base rate cuts and the absence of local demand for long end bonds should translate into further steepening of the yield curve. We expect the 5Y-1Y spread to steepen another 80bp until the end of the year.

Author: Dan Bucsa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

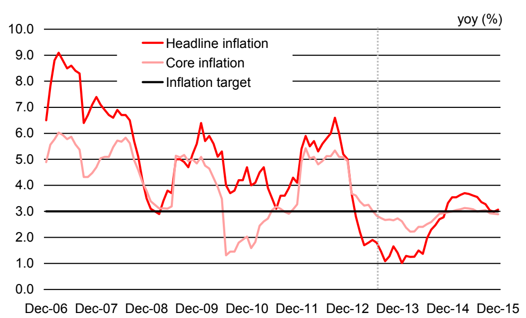
- NBH rate meetings: Sep 24th, Oct 29th, Nov 26th, Dec 17th
- 1 November: government deadline for a deal with banks on converting FX mortgage bonds to HUF
- Q3 GDP data: Nov 14th

GDP DRIVERS



* Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	99.9	97.6	97.8	100.6	103.2
Population (mn)	10.0	10.0	10.0	10.0	10.0
GDP per capita (EUR)	9,975	9,762	9,780	10,066	10,331
Real economy yoy (%)					
GDP	1.6	-1.7	0.7	1.7	1.8
Private Consumption	0.4	-1.9	0.4	1.3	1.4
Fixed Investment	-3.6	-3.8	1.6	2.4	2.3
Public Consumption	-0.3	0.0	-0.3	0.4	0.2
Exports	6.3	2.0	2.4	3.2	3.7
Imports	5.0	0.1	2.9	3.6	3.9
Monthly wage, nominal (EUR)	763	771	772	780	781
Unemployment rate (%)	10.9	11.0	10.8	10.7	10.5
Fiscal accounts (% of GDP)					
Budget balance	4.3	-1.9	-2.7	-3.0	-3.0
Primary balance	-2.7	2.1	1.2	0.9	1.0
Public debt	81.6	79.2	81.6	82.3	80.2
External accounts					
Current account balance (EUR bn)	0.8	1.7	1.8	1.4	1.4
Current account balance/GDP (%)	0.8	1.7	1.8	1.4	1.3
Basic balance/GDP (%)	3.8	3.3	3.0	2.3	3.2
Net FDI (EUR bn)	0.6	1.9	1.2	0.9	2.0
Net FDI (% of GDP)	3.0	1.5	1.2	0.9	1.9
Gross foreign debt (EUR bn)	131.7	131.2	127.3	124.4	119.1
Gross foreign debt (% of GDP)	131.9	134.4	130.2	123.6	115.4
FX reserves (EUR bn)	37.8	33.9	32.5	30.1	31.5
Inflation/Monetary/FX					
CPI (pavg)	3.9	5.7	1.7	1.7	3.2
CPI (eop)	4.1	5.0	1.2	3.2	3.0
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	7.00	5.75	3.50	3.50	4.25
3M money market rate	6.19	6.99	4.37	3.55	4.34
HUF/USD (eop)	233.9	220.6	222.2	221.0	235.1
HUF/EUR (eop)	311.1	291.3	300.0	305.0	315.0
HUF/USD (pavg)	199.5	225.0	226.1	223.0	228.2
HUF/EUR (pavg)	279.3	289.3	298.5	303.5	310.3

Source: UniCredit Research

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

Hungary enters election mode

Elections will shape policies until next spring…

General elections will shape the public agenda and policies ahead of next spring's vote. We expect the government to focus on two major topics: economic growth and voter wellbeing (addressing FX risks and purchasing power).

…with government spending remaining one of the main growth drivers…

The economic recovery in 1H13 had two major drivers: foreign demand (net exports up 2.6% yoy) **and government investment** (+9.0% yoy). Private consumption slumped 0.1% yoy despite three years of efforts to reduce taxes, increase social spending and provide protection against a weaker HUF. On the supply side, agriculture (+12.9% yoy in 1H13) and construction (+5.1% yoy) outperformed industry (-1.6% yoy), trade (-1.7% yoy) and financial services (-1.1% yoy). With external demand recovering only gradually, the government can't singlehandedly revive domestic demand without compromising its fiscal goals. Hence, we expectGDP growth to reach 0.7% in 2013 and to remain below 2% in 2014 (+1.7%) and 2015 (+1.8%).

…leading to further strains on the budget and probably additional ad-hoc taxes…

… and pressure on HUF yields and the overall cost of debt…

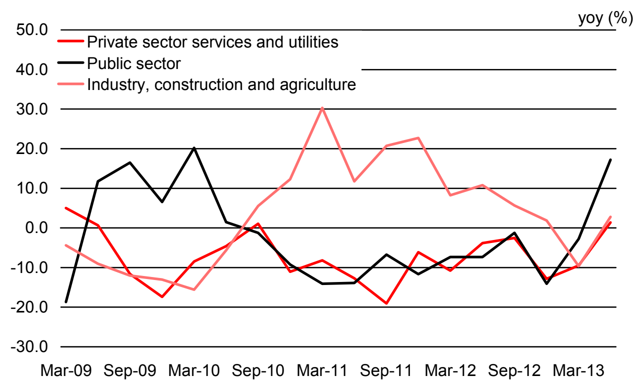
The sub-3% of GDP deficit target remains unsustainable. The public debt exceeds 80% of GDP, translating into an interest cost of about 4% of GDP and forcing a primary surplus of at least 1% of GDP. With social security, wage spending and public investment untouchable before elections, the government needs to tax and borrow even more. Ad-hoc tax packages[6] aimed primarily at the service sector affect results[7] and investment in private sector services[8].

… since gross financing needs are rising…

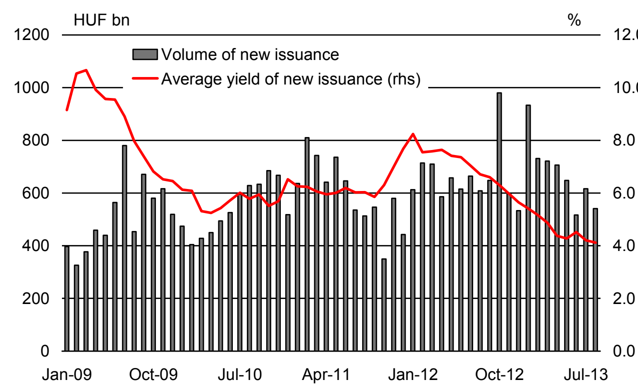
… and the average cost of FX borrowing will exceed the interest paid on the IMF loan

But government borrowing became more problematic since mid-May 2013, when the looming Fed tapering hit EM yields. Hungary faces two major risks going forward: a shorter duration for local debt and higher costs for FX issuance after repaying the IMF loan. The debt management agency AKK responded to the loss of risk appetite by reducing the average maturity of new issuance by 10 months to just 1.38 years, paying 25bp less on average for new HUF issuance in June-August 2013 vs. March-May. Meanwhile, net issuance fell by HUF 115.7bn in June-August vs. March-May and is planned at HUF -297bn (EUR -1.0bn) in September-November. The AKK relies on government reserves of HUF 1.3tn (EUR 4.4bn) which cover more than three months of redemptions. But next year, Hungary's gross financing needs rise to ca. HUF 4.9tn (EUR 15.8bn or 15.5% of GDP). While politically motivated, the repayment in full of the IMF loan leaves the government with two problems: only EUR 1.5bn in FX reserves (30% of the FX financing needs for 2014) and additional costs of approximately 0.05% of GDP if Hungary replaces IMF repayments with a 5Y FX bond issued this autumn.

The government tries to offset the lack of private investment



The AKK sacrifices the volume of issuance in order to cap costs



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

[6] 7 such packages for 2013 after 6 for 2012.

[7] The banking sector lost HUF 49.7bn in 2Q13. One bank turned the entire banking sector to HUF 0.3bn profit in 1H13 by repatriating dividends from its subsidiaries.

[8] Down to 6.7% of GDP (12-month rolling) at the end of June 2013 from 10.5% of GDP four years ago, even when including investment in infrastructure, where the government is very active at the moment.

Deleveraging remains rapid in the banking sector…

While the government fails to curb its financing needs, the private sector deleveraging continues unabated, led by banks. The FX liabilities of the banking sector fell by EUR 6.1bn between August 2012 and July 2013, 12-month outflows remaining above EUR 6bn since the beginning of the year and wiping out completely the positive basic balance (C/A + FDI + EU funds). The gap was EUR 0.4bn between 2Q12 and 1Q13 and was covered by volatile portfolio investment. The bank deleveraging process could decelerate sharply towards EUR 4bn by the end of the year[9], but so will FDI (no big investment projects in the pipeline) and EU fund transfers (due to the temporary freeze of disbursements for 13 out 15 types of funds). Moreover, the government needs to repay next year EUR 2.0bn to the European Commission and EUR 2.6bn in FX bonds and will try to limit running down central bank FX reserves. Hence, the reliance on portfolio investment will continue, weighing on yields and the HUF.

…leaving a BOP gap to be financed through volatile portfolio investment

The government will try to boost its election chances by increasing real wages…

The ruling party Fidesz is well positioned to win an outright majority in the general elections (to be held in the spring) helped by low voter participation, a fractured political left and a nationalistic rhetoric that appeals to the public. Even so, the government will try to improve its re-election chances by increasing the purchasing power and addressing FX risks for indebted households. Since the nominal wage growth will probably fall below 4%yoy in 2014, real wage growth is boosted by falling inflation. One of the most popular measures of 2013 was the electricity and gas price cuts from January, visible in headline inflation and opinion polls. A second cut of 11.1% is expected on 1 November, keeping inflation below 2% until mid-2014. Inflation is expected to exceed the inflation target of 3% in 2015.

…through price cuts…

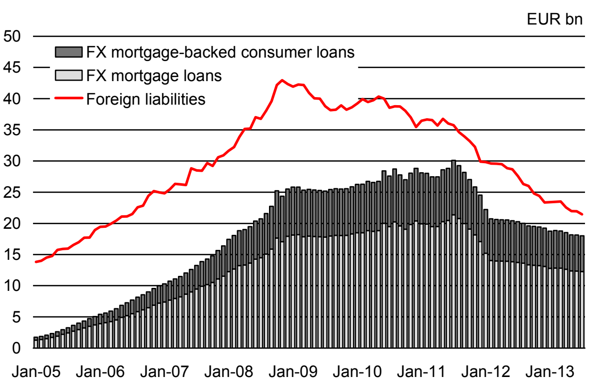
…and by converting mortgage and mortgage-backed FX loans to HUF…

The government is currently negotiating with the Banking Association (BA) the conversion of FX mortgage loans and maybe mortgage-backed consumer loans to HUF, with a solution expected before 1 November. The conversion will probably be covered from FX reserves, but a parallel reduction of the banks' short-term foreign liabilities will ensure a good coverage of short term external debt with FX reserves. The BA might try to extend the bargain in order to reduce its tax burden and address the treatment of NPLs. While the loan conversion won't result in significant new lending, it could reduce the FX mismatch for local banks and improve the chances of recovering some of the overdue loans, offering a lifeline to a battered sector.

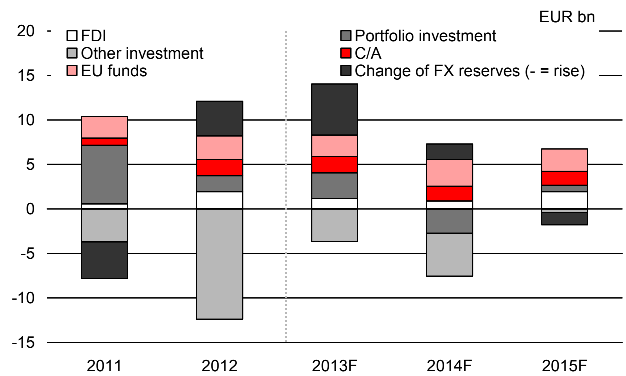
…reducing the social costs of future HUF depreciation

We expect the government to favour a gradual depreciation of the currency once the loan conversion and elections are done. The budget deficit, the net international investment position, the real yield differential and Hungary's share in world exports suggest that the real effective exchange rate of the HUF is currently ca. 10% stronger than it should be.

The foreign liabilities of the banking system continue to fall rapidly



… with a big impact expected in 2014 from FX loan conversion



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

[9] Although the expected conversion of FX mortgage loans to HUF will lead to a one-off spike in outflows from the foreign liabilities of banks, most likely in 2014.

Strategy: More curve steepening

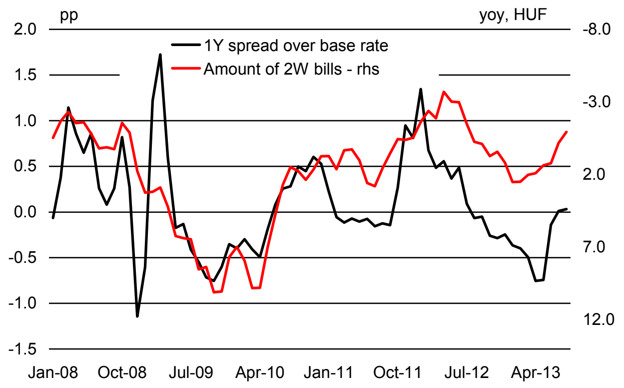
NBH cuts can't anchor yields beyond one year…

…fuelling the rapid steepening of the yield curve…

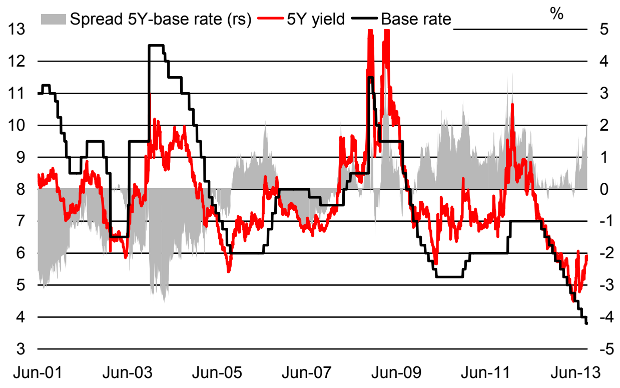
In a low inflation – low growth environment, NBH rate cuts will be driven by risk appetite. We currently expect the end of the easing cycle at 3.5% (currently 3.8%), with risks for more cuts if markets allow. The 5Y-1Y yield spread widened 67bp in August as the last rate cut didn't feed through to the 1Y yield and couldn't stop the 5Y yield (and longer-term ones) from rising further. The end of steepening will come if investors consider HGBs too cheap or the NBH intervenes in the secondary market (an option mentioned by NBH Governor Gyorgy Matolcsy back in March). None of these scenarios is plausible this year.

We expect the 5Y bond yield to move up at least 0.5pp from here, with the 1Y yield falling another 0.3pp for a total steepening of 0.8pp.

The 1Y yield is anchored to the base rate by abundant liquidity



…but the 5Y yield is expected to widen further from here



Source: NBH, AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**21.8**	**20.9**	**20.6**
Budget deficit	2.6	3.0	3.1
Amortization of public debt	19.2	17.9	17.5
Domestic	10.3	10.8	13.4
Bonds	3.8	3.8	5.9
Bills	6.5	7.0	7.5
Other	2.4	2.2	2.0
External	6.5	4.9	2.1
IMF/EU and other loans	5.1	2.2	0.2
Bonds	1.4	2.7	1.9
Financing	**21.8**	**20.9**	**20.6**
Domestic borrowing	18.1	17.9	17.6
Bonds	8.1	7.2	7.9
Bills	10.0	10.7	9.7
External borrowing	3.5	3.0	3.0
Bonds	3.5	3.0	3.0
IMF/EU	0	0	0
Pension funds	0.2	0	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**31.1**	**28.0**	**18.1**
C/A deficit	-1.8	-1.4	-1.3
Amortisation of medium to long term debt	13.1	12.0	7.6
Government/central bank	9.0	6.7	4.1
Banks	2.9	3.2	1.7
Corporates	1.2	2.1	1.8
Amortisation of short term debt	19.9	17.4	11.9
Government/central bank	4.1	4.0	3.8
Banks	11.3	9.6	4.5
Corporates	4.5	3.8	3.6
Financing	**31.1**	**28.0**	**18.1**
FDI	0.7	0.5	1.2
Equity	3.4	-0.4	-0.3
Long-term borrowing	6.4	7.0	5.5
Government/central bank	3.0	2.5	2.5
IMF	0	0	0
Banks	2.3	2.6	1.4
Corporates	1.1	1.9	1.6
Short-term borrowing	16.9	15.4	10.7
Government/central bank	4.0	3.8	3.5
Banks	9.0	8.0	3.7
Corporates	3.8	3.6	3.4
EU transfers	2.4	3.0	2.5
Change in FX reserves (reduction(+)/increase(-))	1.3	2.4	-1.4

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

Outlook – Economic growth is set to accelerate in the remainder of 2013 and early 2014. This trend is already captured in industrial production, retail sales and the PMI. Net exports will remain the principal engine of growth, but there are first signs that domestic demand also improves. Inflation remains below the lower end of the MPC band (1.5%), and we expect the policy rate to remain unchanged until at least till 3Q14. The state budget draft has been revised, with the deficit now expected at PLN 51.6bn, i.e. 16bn higher than initially assumed. However an improving growth environment means that the worst of budget performance should be behind us.

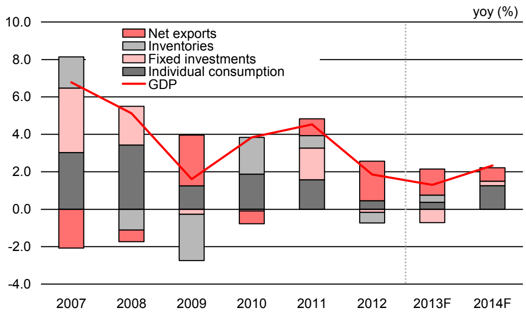
Strategy – POLGBs will remain under pressure, though the majority of the adjustment prompted by higher bund and UST yields should now be done. The zloty should see gains as economic performance improves.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

KEY DATES/EVENTS

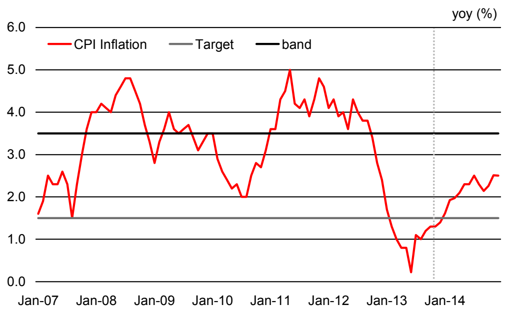
- Cabinet proposes 2014 budget: September
- Cabinet expected to publish full details of proposed changes in pension funds: probably late September/October
- MPC rate-setting meetings: 1-2 Oct, 5-6 Nov, 3-4 Dec

GDP DRIVERS



*adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: StatOffice, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	370.9	381.2	392.6	417.4	448.9
Population (mn)	38.1	38.1	38.1	38.0	38.0
GDP per capita (EUR)	9,740	10,013	10,317	10,973	11,809
Real economy yoy (%)					
GDP	4.5	1.9	1.3	2.3	3.2
Private Consumption	2.6	0.8	0.8	2.1	2.6
Fixed Investment	8.5	-0.8	-3.0	1.0	3.1
Public Consumption	-1.7	0.1	-0.3	0.6	0.5
Exports	7.7	2.8	3.0	6.5	7.5
Imports	5.4	-1.9	0.0	5.2	5.8
Monthly wage, nominal (EUR)	875	890	916	973	1,042
Unemployment rate (%)	12.4	12.8	13.6	13.7	13.3
Fiscal accounts (% of GDP)					
Budget balance	-5.0	-3.9	-4.9	-3.9	-3.0
Primary balance	0.7	1.0	0.8	0.0	0.0
Public debt	56.2	55.6	57.9	51.1	49.1
External accounts					
Current account balance (EUR bn)	-18.0	-13.5	-5.4	-10.9	-15.3
Current account balance/GDP (%)	-4.9	-3.5	-1.4	-2.6	-3.4
Basic balance/GDP (%)	-1.2	-2.9	-1.3	-0.9	-1.2
Net FDI (EUR bn)	13.6	2.7	0.4	7.0	10.0
Net FDI (% of GDP)	3.7	0.7	0.1	1.7	2.2
Gross foreign debt (EUR bn)	248.1	276.1	267.1	289.2	320.2
Gross foreign debt (% of GDP)	66.9	72.4	68.0	69.3	71.3
FX reserves (EUR bn)	75.7	82.6	76.4	76.7	81.3
Inflation/Monetary/FX					
CPI (pavg)	4.3	3.7	1.1	2.3	2.9
CPI (eop)	4.6	2.7	1.4	2.6	2.6
Central bank target	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp
Central bank reference rate (eop)	4.50	4.25	2.50	2.50	3.00
3M money market rate	4.54	4.91	3.06	2.90	3.20
USD/PLN (eop)	3.3	3.1	3.1	2.9	2.9
EUR/PLN (eop)	4.4	4.1	4.1	4.1	3.9
USD/PLN (pavg)	2.9	3.3	3.2	3.0	2.9
EUR/PLN (pavg)	4.1	4.2	4.2	4.1	4.0

Source: UniCredit Research

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

On the road to recovery

After bottoming out in 1Q13, GDP growth should accelerate in the following quarters, expanding by 1.3% in 2013 and 2.3% in2014

The remainder of 2013 and 2014 should see growth accelerating. GDP rose only 0.5% yoy in 1Q13, improved to 0.8% yoy in 2Q13, and we look for 1.6% and 2.1% yoy in 3Q13 and 4Q13, respectively. However, growth will remain externally-driven, with domestic demand expected to accelerate only in 2014. The rebound is suggested by a wide array of data, including leading indicators and 'hard data'. The manufacturing PMI rose to 52.6 in August, its highest level since July 2011, driven mostly by output (56.6) and new orders (55.6). Total new orders outpaced new export orders, signalling a welcome improvement in domestic demand – 2Q13 was the fifth consecutive quarter in which net exports contributed significantly more to growth than domestic demand. Industrial output surged 6.3% yoy in July, the highest level in 18 months, whereas retail sales increased to 4.3% yoy (nominal), the highest reading in 11 months. Strong dataflow from Western European markets (and especially from Germany) bodes well for exports' performance in the coming months.

Economic recovery is signaled both by leading indicators as well as by 'hard data'

An improvement in domestic demand will be necessary to maintain growth momentum and we see the first signs of this

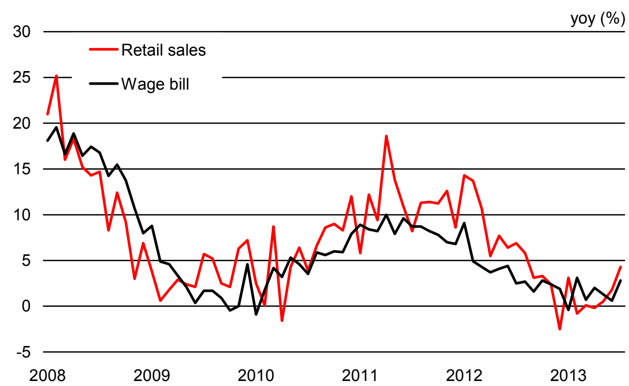
An improvement in domestic demand will be necessary to maintain the growth momentum. Beside the recovery of new orders and retail sales mentioned above, the first signs of improvement in the labour market are emerging – the PMI labour market indicator increased to 50.4 after staying below 50 for almost a year. This is consistent with the positive tendencies seen in the labour market for some time (stabilization of employment in the corporate sector, slight increase of employment in manufacturing), and supports our expectations of an acceleration in wage growth in the coming quarters. The real wage bill decreased in 2H12 and 1Q13 (-0.8% yoy on average), but rose again in 2Q13 (+1.0% yoy). Its growth rate is expected to accelerate towards 2.0% yoy in 2H13 and strengthen further in 1H14. This should be supportive for private consumption going forward (assuming no further increases in the savings ratio). We expect private consumption to recover from -0.2% yoy in 4Q12 and 0.0%yoy in 1Q13 towards 2.0% yoy in 4Q13 and 1H14. Fixed outlays are feeling the pressure from falling investments supported by EU funds (-3.8% yoy in 2Q13; a contraction is expected for 2013), but they should rebound from 2014 on, as new EU funds will be utilized and as the private sector invests more (especially if the accelerated amortization of investments will be introduced as expected). All in all, stronger domestic demand will depend on the stabilization and positive newsflow from Western economies, since sentiment is still fragile and can be easily dampened by any negative news regarding the outlook for the global economy.

CPI inflation is set to increase towards 1.5% yoy by end-2013 and stabilize at 2.5% from mid-2014 onwards

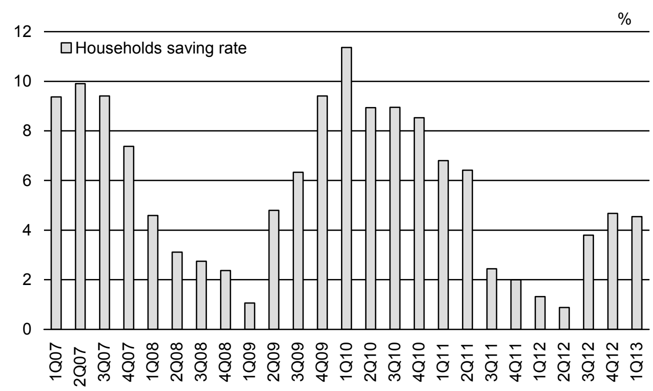
CPI inflation hit bottom in June at 0.2% yoy, spiked to 1.1% yoy in July on the back of garbage collection prices **and is set to increase towards 1.5% at the end of this year and towards the 2.5% MPC target by mid-2014. Thereafter it should stabilize until end-2014.**

AS THE WAGE BILL IMPROVES, CONSUMPTION SHOULD REBOUND WHILE SAVINGS HAVE BEEN REBUILT

The real wage bill should increase faster as the situation on the labour market improves, aiding consumption



The households' saving rate will probably peak soon



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

The MPC is sending clear signals that it wants to keep rates unchanged "for longer". Rates will certainly stay unchanged at least till mid-2014

The MPC finished the 225bp easing cycle in July and announced "a prolonged period of unchanged rates". Statements from MPC members as well as from the NBP President emphasize the need to keep rates unchanged for "*a longer time*", a position supported by a wide consensus in the MPC. Specifically, Belka said that rates will be unchanged at least till year-end. Our baseline scenario assumes that this period will extend till end-2014, in line with unchanged rates at the ECB by then. We expect the MPC to wait for major central banks to start hiking rates before it takes such a step. But much will depend on the pace of economic growth and of inflation, meaning that a first rate hike sometime in 2H14 is possible.

The Cabinet revised the 2013 budget draft, raising the deficit by PLN 16bn, to PLN 51.6bn. However, the situation should improve in the remainder of the year

The fiscal situation remains tense, but should improve as both growth and inflation pick up. The MinFin estimates that at the end of August the budget deficit reached 75% of the (revised) plan. In July, the Cabinet announced a revision of the 2013 budget bill, estimating that budget revenues will be ca. PLN 24bn lower than initially assumed. To counteract this, the Cabinet decided to curb spending by ca. PLN 7.7bn, thus increasing the deficit by ca. PLN 16bn (to PLN 51.6bn). But given the improving growth outlook, we expect this year's deficit to come in at around PLN 50bn. 86% of 2013 borrowing needs were covered by early September and the MinFin will likely start pre-financing for 2014 in late October-November.

The Cabinet will change the rules of functioning of private pension funds. This will have a net positive impact for debt/GDP metrics and borrowing needs

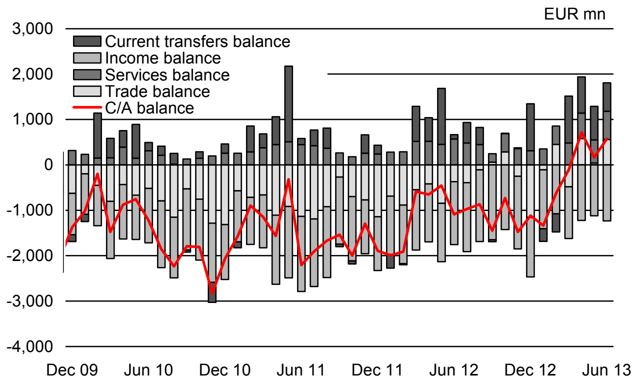
The government will change the functioning of private pension funds (OFE). The T-bonds held by the funds will be transferred to the state-run social security fund and written off, the investment policy of OFE will be liberalized and focused on investments in the real economy (they will be prohibited from investing into T-bonds). Future pension contributions to OFE will be voluntary. For public finance, this means improved debt metrics (debt/GDP declines by 8pp of GDP, debt thresholds to be lowered in unison) and lower debt servicing costs and debt issuance. The MinFin informed that due to the changes in OFE, the gross borrowing needs in 2014 will be PLN 18.9bn lower (amounting to PLN 142bn) and net borrowing needs will be PLN 16.5bn lower (PLN 38bn) than in 2013 (with a comparable deficit).

The C/A deficit will narrow in 2013 to around 1.4% of GDP, the all-time-low

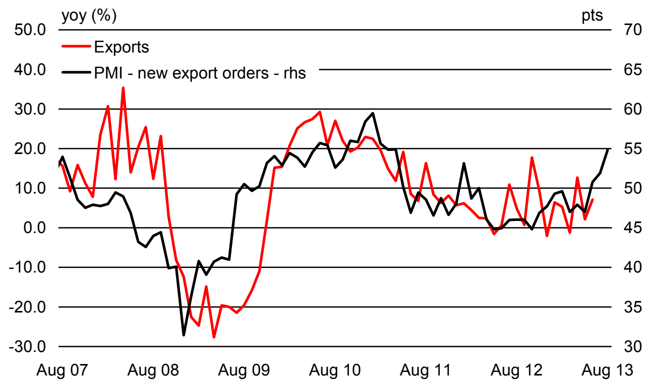
The C/A deficit narrowed sharply in 1H13 helped by a significant improvement of the trade balance. Exports performed well (+5.3% yoy in 1H13), whereas imports were subdued (-1.3% yoy) due to weak domestic demand. In 2H13, we expect that a further moderate recovery in the German economy (Poland's main trade partner) will continue to support Polish exports. At the same time, imports might grow faster, in line with better domestic demand. We expect the 2013 C/A deficit to narrow to 1.4% GDP compared to 3.5% GDP in 2012. This helps to offset a decline in FDI this year (due to large negative reinvested profits) and smaller portfolio investment in 1H13 (EUR 0.3bn vs. EUR 6.3bn in 1H12).

CURRENT ACCOUNT BALANCE SHOULD CONTINUE STRONG PERFORMANCE IN THE COMING MONTHS

The trade balance should remain positive in the coming months



PMI data point to a further increase of exports



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

Strategy: POLBGs to remain under pressure but PLN to rebound

The short end of the curve is well anchored as the policy rate is set to remain on hold for some time, but the long end will still have to weather higher UST/bund yields

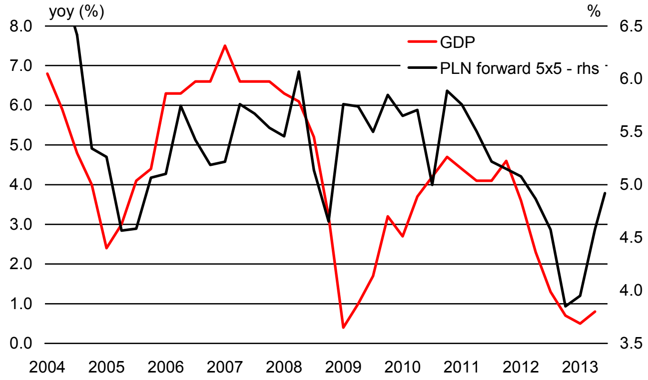
Curve steepening will be a dominant tendency in the coming months, as POLGBs yields will follow Bunds. Although FRAs price in a first hike in 2Q14, we expect flat rates during 2014, taking into account the dovish MPC rhetoric. In such an environment, short-term yields will be anchored, with more volatility in the mid to long part of the curve. Portfolio outflows from EM remain the key external risk factor, while the local newsflow should be neutral. Expected changes in OFEs may be neutralized by an effective issuance policy. The MinFin is expected to cover its financing needs on the local market and through Eurobonds and loans from international institutions.

We expect EUR/PLN to be close to 4.10-4.15 at the end of the year and we feel comfortable with long PLN / short EUR positions above 4.30

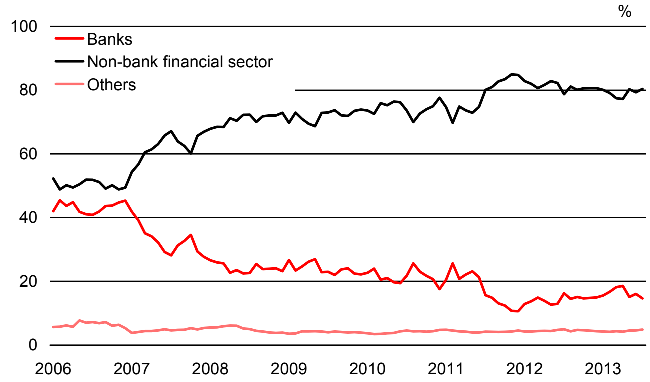
The Polish zloty suffered lately from a poorer risk appetite for EM assets. The expected change in the Fed's policy and unrest in the Middle East played a role. We still see value in the zloty and maintain our last call to go long PLN/ short EUR. The Polish economy will outperform its peers in the coming quarters, which should at least stabilize foreign bond holdings.

FOREIGN INVESTORS BECAME DOMINANT HOLDERS OF POLGBS

Markets discount a faster economic recovery and higher interest rates



Non-bank financial institutions account for 80% of the T-bonds owned by non-resident investors, worth more than PLN 162bn



Source: MinFin, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**41.4**	**39.5**	**35.5**
Budget deficit	12.8	15.0	12.2
Amortization of public debt	28.6	24.4	23.3
Domestic	24.6	20.9	19.3
Bonds	21.7	19.5	18.3
Bills	2.9	1.5	1.0
External	4.0	3.5	4.0
IMF/EU	0	0	0
Financing	**41.4**	**39.5**	**35.5**
Domestic borrowing	31.8	32.6	26.9
Bonds	32.5	29.3	26.6
Bills	1.5	2.4	1.2
Other	-2.2	0.9	-0.9
External borrowing	9.6	6.8	8.6
Bonds	9.3	4.4	6.5
IMF/EU	0	0	0
Other	0.3	2.5	2.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**86.8**	**68.9**	**80.9**
C/A deficit	13.3	5.4	10.9
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	**86.8**	**68.9**	**80.9**
FDI	2.8	1.3	4.0
Equity	2.4	1.2	2.8
Borrowing	75.9	67.5	68.1
Government/central bank	9.6	6.8	8.6
Banks	17.2	14.9	15.5
Corporates	49.0	45.8	44.0
EU transfers	12.3	9.9	11.8
Other	-6.5	-11.0	-5.9

Source: MinFin, NBP, UniCredit Research

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

Outlook – Romania outperforms most CEE countries in terms of growth and fiscal adjustment, but both are unsustainable. The structure of the fiscal adjustment is weighing on domestic demand. Exports, industrial production and agriculture benefit in 2013 from supply shocks that will disappear in 2014, leading to a growth slowdown. The bank deleveraging remains the largest drag on the BOP and the RON, wiping out the entire basic balance surplus and leaving the country reliant on portfolio inflows.

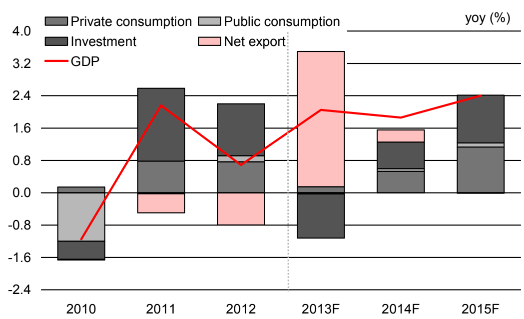
Strategy – The RON is expected to trade range-bound inside the EUR-RON 4.30-4.50 band, occasionally exceeding the upper bound. RON yields up to 3Y are well supported by rate cuts and local demand, but we believe that the longer end of the ROMGB yield curve will steepen.

Authors: Dan Bucşa, Economist (UniCredit Bank London)
Mihai Pătrulescu, Economist (UniCredit Ţiriac Bank)

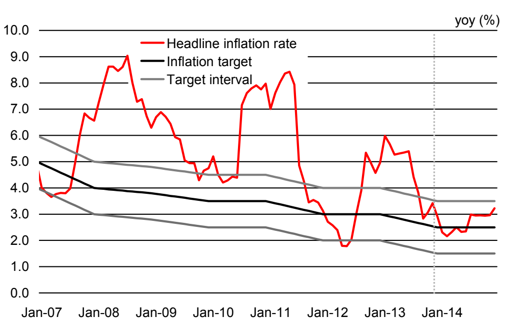
KEY DATES/EVENTS

- September 30th, November 5th – NBR rate decisions
- November 14th: 3Q GDP (flash estimates)
- October 15th: ECOFIN vote on a new IMF-EC precautionary loan for Romania

GDP COMPONENTS



INFLATION OUTLOOK



Source UniCredit Research, NBR, Statistical Office

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	131.4	131.8	142.3	151.9	161.4
Population (mn)	21.4	21.4	20.0	20.0	20.0
GDP per capita (EUR)	6,139	6,161	7,115	7,596	8,068
Real economy yoy (%)					
GDP	2.2	0.7	2.1	1.9	2.4
Private Consumption	1.1	1.1	0.2	0.8	1.6
Fixed Investment	7.3	4.9	-3.9	2.8	4.2
Public Consumption	-0.3	2.4	-0.4	1.0	1.0
Exports	10.3	-3.0	8.0	4.6	5.0
Imports	10.0	-0.9	-0.2	3.8	4.9
Monthly wage, nominal (EUR)	348	347	367	388	408
Unemployment rate (%)	7.4	7.0	7.3	7.2	7.0
Fiscal accounts (% of GDP)					
Budget balance	-5.6	-2.9	-2.7	-2.5	-2.5
Primary balance	-4.1	-1.1	-0.9	-0.7	-0.8
Public debt	34.7	37.8	37.8	36.7	37.0
External accounts					
Current account balance (EUR bn)	-5.9	-5.2	-0.8	-1.7	-2.3
Current account balance/GDP (%)	-4.5	-3.9	-0.6	-1.1	-1.4
Basic balance/GDP (%)	-3.1	-2.6	0.3	-0.1	-0.1
Net FDI (EUR bn)	1.8	1.7	1.2	1.5	2.2
Net FDI (% of GDP)	1.4	1.3	0.8	1.0	1.4
Gross foreign debt (EUR bn)	98.7	99.0	99.0	105.0	116.0
Gross foreign debt (% of GDP)	75.2	75.1	69.6	69.1	71.9
Fx reserves (EUR bn)	33.2	31.2	28.9	28.1	29.0
Inflation/Monetary/FX					
CPI (pavg)	5.8	3.3	4.5	2.9	3.5
CPI (eop)	3.1	5.0	2.9	3.2	3.5
Central bank target	3.0	3.0	2.5	2.5	2.5
Central bank reference rate (eop)	6.00	5.25	4.00	4.00	4.00
3M money market rate	5.28	5.22	4.57	3.92	3.85
USD/RON (eop)	3.25	3.35	3.30	3.20	3.28
EUR//RON (eop)	4.32	4.43	4.45	4.42	4.39
USD/RON (pavg)	3.03	3.46	3.35	3.23	3.23
EUR/RON (pavg)	4.24	4.46	4.43	4.40	4.40

Source: UniCredit Research

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

The growth illusion

Romania is a growth and fiscal outperformer in CEE…

In a regional context, Romania looks like an outperformer: it managed to reduce fiscal and external imbalances and grow faster than most CEE peers. While the country is more stable than before the crisis, it is still a long way from a happy ending.

…but the fiscal adjustment is affecting domestic demand…

…by crowding out public investment…

The fiscal adjustment was done in size, but not in structure. Four years after the first IMF agreement was concluded, the budget deficit has fallen below 3% of GDP and fiscal slippages are less likely. Adding a stable debt to GDP ratio below 40% and a second precautionary IMF-EU loan agreement expected in October 2013, Romania looks well positioned for an (overdue) upgrade to investment from S&P. But the government failed to rein in current expenditure: the public wage bill rose by 16.4% yoy in 7M13 after the public sector wage cuts from 2010 were fully reversed. Goods and services expenses were up 7.4% yoy in 7M13, explained by higher health care outlays and upkeep of the bureaucracy. The deficit remains below 3% of GDP at the cost of crowding out public investment: capital expenditure plummeted 10.4% yoy in 7M13, with EU fund co-financing down 17.8% yoy. Adding poor private sector investment, gross fixed capital formation shrank 4.5% yoy in 1H13. According to the Fiscal Council, the budget revenues fell 6.3% below target in 1H13, leaving no space for cutting social security contributions. The government prefers populist measures such as the VAT cut for bread instead of addressing tax evasion directly and freeing up fiscal space for growth-boosting reforms.

…and weighs on potential growth.

Growth drivers benefit from positive, temporary supply shocks…

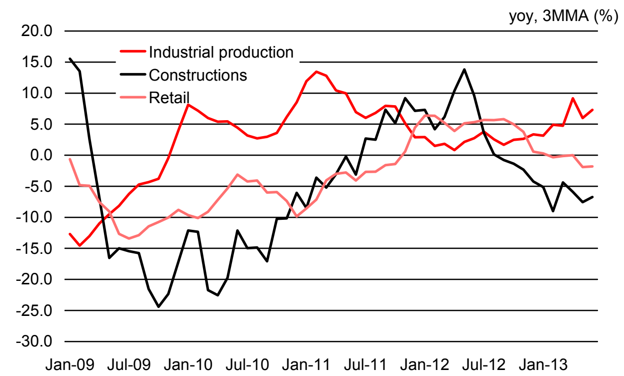
…the 2014 growth forecast being lower than the one for 2013

In this context, **economic growth could remain below potential for several years**. The expected economic growth rate in 2013 is 2.1%, one of the highest in CEE, but is helped by temporary factors and the recovery is not broad-based. Net exports (-19.1% yoy[10] in 1H13) on the demand side and industry (+3.5% yoy) and agriculture (+11.8% yoy) on the supply side were the main growth drivers, but all benefit from supply shocks that are not expected to persist in 2014: new production capacities for the former two and a very good harvest for the latter. Moreover, consumption (flat in 1H13) adds to weak investment in keeping domestic demand in the red (-4.1% yoy in 1H13), despite real wages accelerating to 1.5%yoy. In these circumstances, GDP net of agriculture, electronics and car manufacturing is in danger of falling in 2H13, leading to an expected growth slowdown to 1.9% in 2014 and only a modest rebound to 2.4% in 2015. We expect industry and exports to remain the main growth drivers, while private consumption and fixed investment might recover at a slower pace.

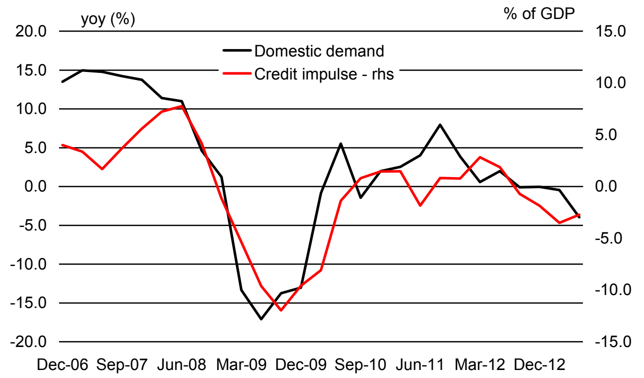
Bank deleveraging remains another drag on domestic demand…

Another drag on growth is the ongoing deleveraging process in the banking sector, whose FX liabilities fell by EUR 2.3bn between August 2012 and July 2013. The pace slowed down from more than EUR 3bn in 2H12-1H13, but the NBR expects it to accelerate again. The banking sector registered a profit of RON 1.1bn in 1H13, almost half of it being due to tax differences after moving from local accounting standards to IFRS.

Domestic demand contracted in 1H13…



…dragged down also by the negative credit impulse



Source: Statistical Office, NBR, UniCredit Research

[10] Negative net exports narrowed 19.1%yoy and 18.8% of GDP in 1H13, subtracting less from GDP and thus contributing to economic growth.

…both retail and corporate lending declining

The NPL ratio rose 4.68pp yoy to 20.93% in July 2013 and the additional provisioning plus the high minimum reserve requirements keep RON lending rates 5.2pp above deposit rates, curbing demand from borrowers. Hence, retail lending fell 1.3%yoy and corporate lending shed 2.9% yoy in July 2013 (both FX-adjusted) and the slowdown continues to accelerate.

We expect further monetary policy rate cuts to 4%...

…but sharper cuts would lower the real rate below the NBR's comfort zone.

The NBR is expected to lower the base rate further, but is unlikely to cut FX MRR from 20% since they temporarily slow down the deleveraging. Although late, the monetary policy easing cycle is welcome and is expected to continue to 4% by the end of this year from 4.50% currently. More aggressive cuts would entail a real interest rate below 1%, a danger zone for the NBR. While inflation is expected to fall below 3% early next year, the disinflation will be temporary, mostly due to lower food prices following the good harvest. Structural rigidities and administered price hikes are expected to push headline inflation to 3.2% at the end of 2014 and 3.5% in 2015, absent strong support from food prices.

The C/A deficit closed in 2013, but is not RON-supportive…

…since the basic balance is offset by bank outflows…

…while portfolio inflows are unlikely to provide the same support to the BOP as in 1H13

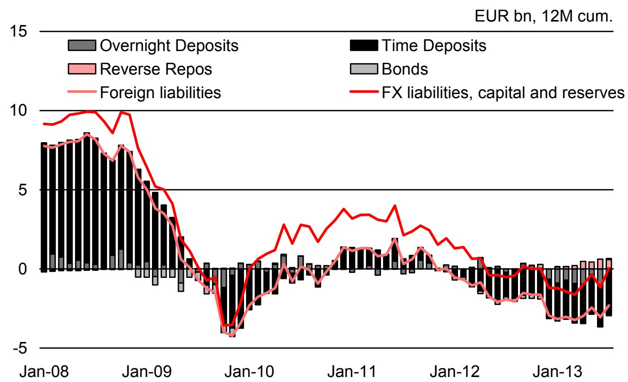
In light of the deleveraging process, the closing of the C/A deficit appears less RON-supportive. On the positive side, the trade balance deficit fell a massive 91%yoy to just EUR 316mn in 1H13, helped by higher exports (+9.5% yoy in 1H13, FOB) and smaller imports (-2.5% yoy FOB). Adding low FDI (EUR 0.6bn in 1H13) and EU fund inflows (EUR 1.7bn in 8M13), the basic balance was 0.9% of GDP in 1H13 vs. banking sector outflows of 1.1% of GDP and IMF repayments of 1.5% of GDP. Next year, a new EU fund programming period starts, but Romania hasn't solved the problems of its faulty absorption framework that led to payments of only 20.1% of the 2007-2013 allocation at the end of August 2013. The easiest way to handle the problem would be to adopt the successful Polish system, rather than trying to implement an original solution. Portfolio inflows were the largest component of the financial account (EUR 3.7bn or 2.6% of GDP in 1H13) amid foreign buying of ROMGBs. But international investors reduced their ROMGB holdings by EUR 875mn in June and the strong buying seen in 1Q13 is unlikely to repeat due to the normalisation of interest rates on developed markets following the expected Fed tapering. Additional flows into ROMGBs will depend on risk appetite for CEE assets and might track Romania's weight in bond indices.

The MinFin is expected to reduce the average maturity of RON issuance…

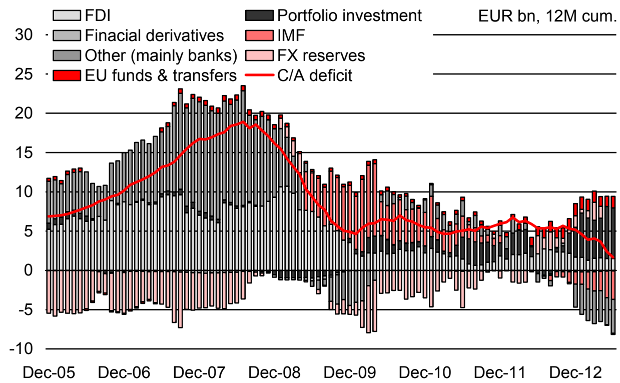
…and to return this autumn to FX debt markets

In these circumstances, **the MinFin could reduce the average maturity of RON borrowing** from 42 months in 8M13 towards the accepted minimum of two years in order to attract demand from duration-weary local banks. Government reserves exceed EUR 6bn, covering the gross financing needs for the rest of 2013. But Romania faces repayments of EUR 4.5bn to the IMF next year and EUR 2.9bn to the IMF and the European Commission in 2015, so the MinFin is expected to issue EUR 1bn on the day we publish this quarterly and at least EUR 2.5bn per year in 2014 and 2015. Even so, the net FX issuance will remain negative, leading to the depletion of FX reserves if EU fund absorption is low.

The FX liabilities of the banking sector shrink at a fast pace…



…driving the steep C/A correction



Source: MinFin, NBR, UniCredit Research

EUR-RON range bound, yield curve to steepen above 3Y

EUR-RON expected to trade inside the 4.30-4.50 range for most of this and next year

EUR-RON continues to trade range-bound, but the reliance on portfolio inflows has kept the pair above EUR-RON 4.40 since June 2013. Seasonal patterns point to a depreciation towards EUR-RON 4.50 by October and a return inside the trading range of EUR-RON 4.30-4.50 by the end of 2013 and for most of the next year.

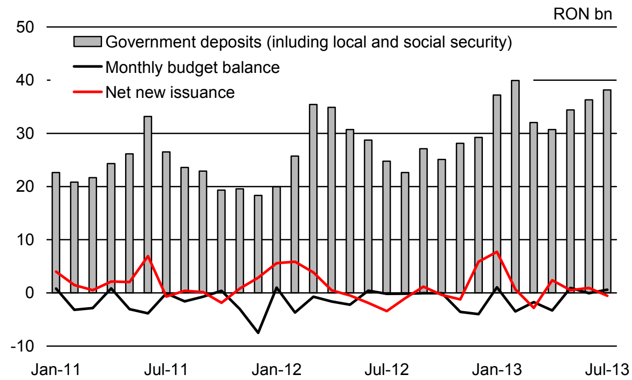
Yields up to 3Y are well anchored by demand and future rate cuts…

Having recovered most of the losses in May and June, ROMGB yields up to 3Y remain well anchored by rate cuts and local demand. Fuarther out the curve, local banks are more reluctant to buy. The private pension system can add approximately EUR 600mn per year in local bonds, but that is just 10% of bonds with maturities above 3Y issued annually.

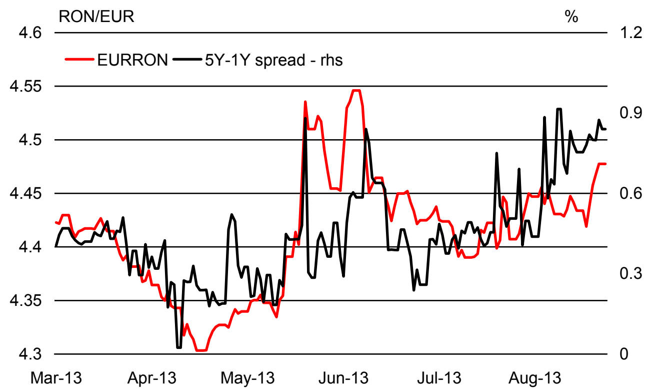
…but the longer end of the curve is expected to steepen

In these conditions, we expect the long end of the RON yield curve to bear-steepen from here. Episodes of risk appetite will provide good entry points in more liquid, short term bonds, especially if EUR-RON is close to the 4.50 threshold.

At the moment, high government deposits cushion the RON…



…but the steeper yield curve could pressure the RON in the future



Source: NBR, MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**16.0**	**15.2**	**13.9**
Budget deficit	3.3	3.2	3.4
Amortisation of public debt	12.7	12.0	10.6
Domestic	11.3	10.5	8.4
Bonds	4.7	6.0	4.6
Bills	6.1	4.0	3.3
Loans	0.5	0.5	0.5
External	0.5	0.5	0.5
IMF/EU	0.9	1.0	1.7
Financing	**16.0**	**15.2**	**13.9**
Domestic borrowing	13.7	12.7	11.3
Bonds	9.3	9.0	7.8
Bills	3.9	3.2	3.0
Loans	0.5	0.5	0.5
External borrowing	2.3	2.5	2.6
Bonds	2.3	2.5	2.6
IMF/EU/WB	0	0	0
Other	0	0	0

Source: UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**34.5**	**34.8**	**33.9**
C/A deficit	0.8	1.7	2.3
Amortisation of medium to long term debt	13.4	13.3	11.8
Government/central bank	5.7	5.5	4.0
Banks	2.7	2.6	2.5
Corporates	5.0	5.2	5.3
Amortisation of short term debt	20.3	19.9	19.8
Government/central bank	1.2	1.1	1.0
Banks	5.2	4.8	4.4
Corporates	13.9	14.0	14.4
Financing	**34.5**	**34.8**	**33.9**
FDI	1.2	1.5	2.2
Equity	0.5	1.3	0.1
Borrowing	28.6	28.6	29.2
Government/central bank	5.1	3.5	3.7
Banks	3.3	4.9	6.9
Corporates	20.2	20.2	18.6
EU Funds - capital transfers	1.9	2.6	3.3
NBR FX reserve change	2.3	0.9	-0.9

Source: UniCredit Research

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

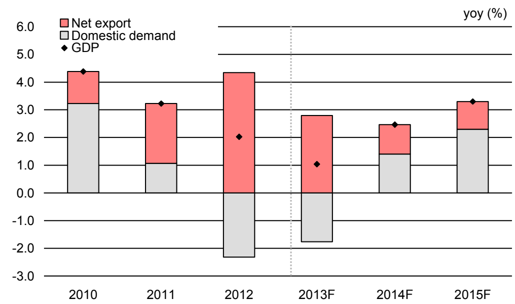
Outlook – Growth is expected to accelerate in the coming quarters, driven by a recovery of external demand, mainly in Germany. Domestic demand remains relatively weak, and will only slowly recover in 2014 following labor market stabilization and an easing of fiscal consolidation. The government proposes to temporarily stop fiscal tightening in 2014, keeping the budget deficit just below 3% of GDP to support economic growth, while consolidation is expected to continue in the next few years as public debt is approaching politically painful triggers set by the Fiscal Responsibility Law. The trade balance continues to move to a new all-time high surplus, driven by declining imports. It is expected to shrink only with a moderate investment recovery in 2014. The CA should thus remain in surplus.

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

KEY DATES/EVENTS

- Oct 9, Nov 11, Dec 10 – Industrial production
- Oct 14, Nov 12, Dec 12 – CPI
- Nov 15 – flash GDP
- Dec 4 – GDP and its structure

NET EXPORTS AS A MAIN GROWTH DRIVER OF SLOVAK ECONOMY



INFLATION DECELERATES

Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	69.1	71.5	73.2	76.1	79.8
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12,725	13,158	13,472	14,012	14,699
Real economy yoy (%)					
GDP	3.2	2.0	1.0	2.5	3.3
Private Consumption	-0.5	-0.6	0.3	0.9	1.5
Fixed Investment	14.2	-3.7	-3.5	2.9	4.8
Public Consumption	-4.3	-0.6	-1.5	0.0	1.5
Exports	12.7	8.6	4.4	5.3	7.1
Imports	10.1	2.8	1.7	4.9	7.0
Monthly wage, nominal (EUR)	786	805	827	852	884
Unemployment rate (%)	13.5	14.0	14.3	14.2	13.9
Fiscal accounts (% of GDP)					
Budget balance	-5.1	-4.3	-3.0	-2.9	-2.6
Primary balance	-3.5	-2.5	-1.1	-1.0	-0.5
Public debt	43.3	52.1	55.1	56.9	56.9
External accounts					
Current account balance (EUR bn)	-1.4	1.6	2.8	2.6	2.4
Current account balance/GDP (%)	-2.1	2.3	3.9	3.4	3.0
Basic balance/GDP (%)	0.2	5.4	4.8	4.9	5.1
Net FDI (EUR bn)	1.5	2.2	0.7	1.1	1.7
Net FDI (% of GDP)	2.2	3.1	0.9	1.5	2.1
Gross foreign debt (EUR bn)	52.9	53.8	55.9	58.7	62.2
Gross foreign debt (% of GDP)	76.6	75.2	76.4	77.2	77.9
Inflation/Monetary/FX					
CPI (pavg)	3.9	3.6	1.6	2.0	2.6
CPI (eop)	4.4	3.2	1.4	2.4	2.8
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 (eop)	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

Private investment held back by government measures

PM Fico has not yet confirmed his candidacy for the president

The Slovak political scene remained calm during the past three months, with the Smer-SD party of Prime Minister Robert Fico having a majority in parliament. Conflicts and disagreements continue among right-wing parties, causing a further disintegration of the already weak opposition. The presidential election is scheduled for spring 2014. While the number of candidates is increasing, the ruling SMER-SD has not yet announced its candidate, keeping speculation about PM Fico's candidacy alive.

Fiscal tightening to end in 2014

The headline government deficit is proposed to increase from 2.9% to 3.0% in 2013 and from 2.4% to 2.9% in 2014. In view of the latest data, it seems that the state budget (as one of the main components of public finance) is on the right track to achieve the target. The expected gradual recovery of economic growth in 2H should be reflected in an increase in tax revenues, although the efficiency of tax collection (especially of VAT) is still very low. In order to improve VAT collection, the Ministry of Finance is launching the National Receipt Lottery starting from September. We consider the introduction of a receipt lottery in Slovakia as an experiment with educational potential, the success of which is hard to predict. In order to improve tax collection, the government should also take systemic steps to eliminate large tax fraud. Despite relatively positive state budget performance, reducing the headline deficit below the targeted 3% of GDP could be at risk as a considerable part of consolidation for this year is planned to come from local governments which are not under the direct influence of the central government. Hence, it cannot be excluded that the government might be forced to adopt additional austerity measures.

Government debt increased due to pre-financing

Public debt increased to 54.9% of GDP in 1Q, coming closer to the next debt ceiling defined by the Slovak fiscal responsibility law which would trigger a further set of automatic enforcement mechanisms, including a wage decrease for members of the government. However, the major part of this debt increase comes from pre-financing. Thanks to favorable market conditions, Slovakia has already covered 90% of its financing needs for this year. As a result, the Debt and Liquidity Management Agency (ARDAL) cancelled the planned primary auctions of government bonds in the summer. The government believes that debt will not exceed 54.7% of GDP in 2013 and 56.9% of GDP in 2014.

Economy continues to grow driven by net exports

The economy continues to expand, rising 0.3% qoq / 0.9% yoy in 2Q. GDP is still being driven mainly by net exports. Domestic demand has been declining, pushed down by falling fixed investment, considerable de-stocking and fiscal tightening. On the other side, household consumption surprisingly recovered in 2Q, showing its first positive yoy gain since 3Q09 – most likely driven by improving consumer confidence and rising real wages. Economic growth is expected to accelerate in the coming quarters, driven by gradually recovering external demand. A recovery of investment is not anticipated earlier than at the beginning of next year, thus restraining domestic demand. On the supply side, GDP was supported mostly by manufacturing, while construction is still weak. We foresee GDP growth to be 1.0% in 2013, accelerating to 2.5% in 2014.

Foreign trade surplus reaches all-time high

Foreign trade recorded an all-time high surplus of 6.5% of GDP, driven mainly by the subdued growth of imports, which are hurt by low investment activity and considerable de-stocking of local companies.

Inflation is slowing down

Growth was driven by a rise in labor productivity, but growth was insufficient to reduce the unemployment rate. Unemployment thus continues to rise and is expected to peak in the autumn months. The relatively high level of unemployment is a brake on wage pressure, which is still lagging behind the labor productivity growth. However, slowing inflation helped to accelerate real wage growth and thus supported household consumption. Consumer inflation continues to slow down, reaching 1.5% yoy in July. As energy prices remain stable, food prices are still the only inflation driver (already peaked). Inflation should remain close to 1.5% for the rest of this year, accelerating to 2.0% in 2014.

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

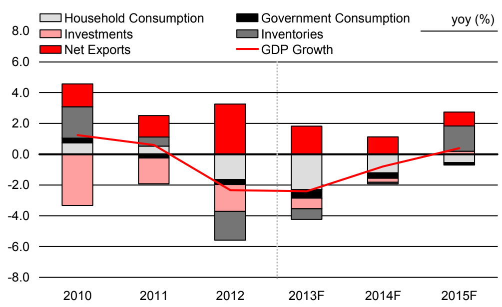
Outlook – The Slovenian economy continues to show no signs of recovery after it posted its seventh consecutive quarter of GDP contraction in 2Q13. As expected, domestic demand remains in the doldrums, leading us to lower our GDP growth estimates throughout the entire forecast horizon. Key to recovery will be the government's progress in cleaning-up its ailing banking sector, currently on hold until the release of Deloitte's and Oliver Wyman's respective asset quality reviews. While we see no risk of EMU assistance in the near term, we view any delay in the banking sector recaps and NPL transfers beyond 1Q14 as a negative. Regaining market credibility is crucial, particularly at a time of scarce EM flows. But for the government to succeed, a much tougher stance on its fiscal consolidation and privatization plans will also have to be adopted.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

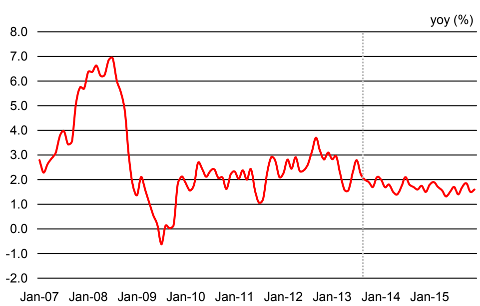
KEY DATES/EVENTS

- 29 Nov – 3Q13 GDP
- 30 Sep, 31 Oct, 30 Nov – Consumer Price Index
- 10 Oct, 08 Nov, 10 Dec – Industrial Production
- 30 Sep, 30 Oct, 29 Nov – Retail Sales
- End-Sept – Results of banking sector's stress tests
- Mid-Oct – First transfer of banks' NPLs to the BAMC

GDP GROWTH RESUMING ONLY IN 2015



INFLATION TO REMAIN STABLE



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	36.2	35.5	35.1	35.2	35.5
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,620	17,254	17,038	16,992	17,144
Real economy yoy (%)					
GDP	0.6	-2.3	-2.4	-0.8	0.4
Private Consumption	0.9	-2.9	-4.1	-2.2	-1.0
Fixed Investment	-8.1	-9.3	-3.9	-1.5	1.1
Public Consumption	-1.2	-1.6	-2.9	-1.8	-0.8
Exports	7.0	0.3	1.4	3.3	4.0
Imports	5.2	-4.3	-1.1	2.1	3.3
Monthly wage, nominal (EUR)	1,525	1,526	1,535	1,553	1,563
Unemployment rate (%)	8.2	8.9	10.8	11.2	10.9
Fiscal accounts (% of GDP)					
Budget balance	-6.4	-4.0	-8.4	-4.2	-3.6
Primary balance	-4.5	-1.9	-5.9	-1.3	-0.8
Public debt	46.9	54.1	66.8	70.9	73.8
External accounts					
Current account balance (EUR bn)	0.1	1.2	1.7	1.8	1.9
Current account balance/GDP (%)	0.4	3.3	4.8	5.1	5.2
Basic balance/GDP (%)	2.2	3.7	3.2	5.5	5.8
Net FDI (EUR bn)	0.6	0.2	-0.6	0.2	0.2
Net FDI (% of GDP)	1.8	0.5	-1.6	0.4	0.6
Gross foreign debt (EUR bn)	40.1	40.8	41.9	42.9	44.3
Gross foreign debt (% of GDP)	110.9	115.2	119.3	122.0	124.7
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.8	2.2	1.7	1.6
HICP (eop)	2.1	3.1	2.1	1.5	1.6
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 respectively

Waiting for the bank stress tests

2Q13 GDP contracted by 1.7% yoy due to a weakening domestic demand

Slovenia's double-dip recession is deepening after its economy contracted for the seventh consecutive quarter in 2Q13. Though less steep than in 1Q13, the economy still fell by 1.7% yoy, attributed once more to weak domestic demand (-3.4% yoy). Component-wise, the biggest fall was recorded in GFCF (-9.5% yoy), though it must be noted that the reduction was not as sharp as in the three previous quarters (3Q12: 21.4% yoy). In part, this can be attributed to the slowdown in destocking (-0.9% yoy vs. -3.7% yoy in 1Q13), even though weak consumption expenditure and tightened credit conditions at home are expected to prolong the decline of inventories into 2014. On the consumption side, public expenditure showed a steep contraction (-3.1% vs. -1.8% in 1Q13), while the decline of private sector consumption slowed down to -2.3% yoy (avg. 3Q12-1Q13 contraction at -4.9% yoy). In contrast, net external demand rose 1.5% yoy, slightly slower than in 1Q13 (2.9% yoy) on account of a smaller decline of imports (-0.1% yoy vs. -2.3% yoy in 1Q13).

Net external demand will limit the contraction next year, with recovery expected by 2015

Against this backdrop, we have lowered our FY13 GDP growth forecast to -2.4% yoy. The downward revision, from a previous -2.1% yoy, mainly responds to a steeper contraction in private consumption, impacted by the ongoing contraction in household credit (-2.78% in 2Q13) and further labour market weakness. The new set of austerity measures envisaged for October will also take their toll on public consumption, expected to bottom out next year, to reverse this year's budget deficit deviation. As for capital investment, the contraction will be less pronounced than in 2012 (FY13 at -3.9% yoy), although it will still make a negative contribution to GDP next year due to the ongoing deleveraging phase of the economy. Note, however, that much of the adjustment has already taken place, with fixed investments in 2Q13 already at 4Q98 levels (vs. 2009 levels in the eurozone). This explains why we believe the worst of the contraction is over, with growth in fixed investment already envisaged for 2015. As for net external demand, it will continue to make a positive contribution to growth throughout the entire 2013-15 period, thanks mostly to the slow but steady recovery in the eurozone. That said, the economic recovery will remain sluggish, with growth only expected to resume by 2015.

Further budget cuts will be needed to bring public finances into balance…

Fiscal consolidation remains a concern, as the budget deficit this year is expected to widen to around 8.4% of GDP (vs. the government forecast of 7.9% of GDP). This mainly comes as a by-product of the banking sector and SOE recap one-offs, expected to add approx. 4% of GDP to this year's deficit. Note also that the state budget deficit continues to balloon, with the January-July deficit figure already at EUR 1.21bn (vs. FY13 target of EUR 1.5bn). In our view, the revenue enhancing measures introduced in May's reform package are a positive, a new package in still needed (expected by late September). Going forward, we expect the deficit to narrow to 4.2% of GDP next year, even though we still believe the budget cuts will remain insufficient to meet the MinFin's 3% target. Keeping this in mind, public debt will continue spiraling upwards, and is expected at close to 74% of GDP by 2015.

Speeding-up the banking “clean-up process” is key to avoid EMU assistance

Key at this stage is the speed at which the government cleans up its banking sector and proceeds with privatization. The results of Deloitte and Oliver Wyman’s stress tests have been postponed to end-September for NLB, with October now being the deadline for the first batch of its NPL transfers to the BAMC. By December, the final details of the whole banking sector recap needs, expected by the NBS to top EUR 1.5bn, and the selling timeline of Telekom Slovenije should also be known. Of key importance to us is to have the 3 NPL-bucket transfers to the BAMC completed by 1Q14. While it is true the government is still in a comfortable cash position (ca. EUR 4bn), note that it still faces a challenging debt redemption profile (EUR 3.4bn to end-2014, o/w EUR 1.6bn in April) and a politically difficult period ahead (i.e. no-confidence vote scheduled for 1Q14). This funding is sufficient to cover redemptions to next April, SOE recaps and EUR1.5bn of bank recaps but little else. This further increases the pressure on the government to demonstrate progress as it attempts to re-access Eurobond markets at a time of outflows from EM.

Bosnia and Herzegovina (B3 stable/B stable/not rated)*

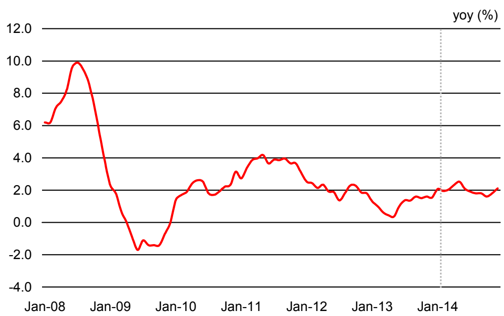
Outlook – We raise our GDP growth forecast for 2013 to 0.6% yoy (from 0.4% yoy), while leaving the forecast for 2014 unchanged at 0.9% yoy. We see that improvements in the external environment have a beneficial effect on domestic industrial production and exports, while domestic demand is still being constrained. High unemployment with declining real income limits private consumption, putting the recovery in a slow-growth mode, below potential. The reform process and EU integration process face a challenging time prior to the autumn 2014 general election. Therefore, compliance with the SBA requirements is becoming of outmost importance, considering debt repayments to the IMF in 2014.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

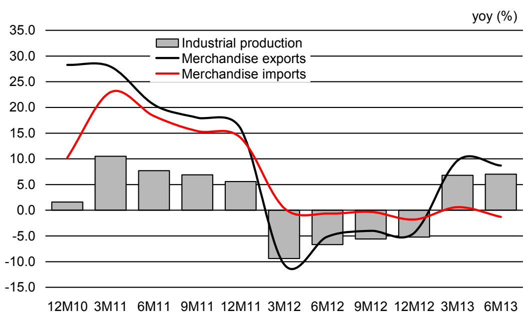
KEY DATES/EVENTS

- 25 October CPI and Industrial Production
- 26 November Unemployment and Wages
- 24 December Wages and Unemployment
- December Balance of payments 3Q 2013

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	13.1	13.1	13.4	13.7	14.3
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,419	3,419	3,482	3,584	3,734
Real economy yoy (%)					
GDP	1.0	-1.1	0.6	0.9	1.7
Monthly wage, nominal (EUR)	650	660	663	675	692
Unemployment rate (%)	43.3	44.1	44.6	44.3	44.0
Fiscal accounts (% of GDP)					
Budget balance	-1.3	-2.1	-2.3	-1.5	-1.0
Primary balance	-0.5	-1.3	-1.2	-0.6	-0.2
Public debt	40.4	42.1	41.9	41.2	40.0
External accounts					
Current account balance (EUR bn)	-1.2	-1.3	-1.2	-1.1	-1.3
Current account balance/GDP (%)	-9.5	-9.6	-8.8	-8.2	-8.0
Basic balance/GDP (%)	-7.4	-6.0	-5.5	-4.7	-4.4
Net FDI (EUR bn)	0.3	0.5	0.4	0.5	0.5
Net FDI (% of GDP)	2.1	3.5	3.4	3.5	3.6
Gross foreign debt (EUR bn)	6.7	6.9	7.0	7.2	7.4
Gross foreign debt (% of GDP)	51.2	52.5	52.3	52.1	51.5
FX reserves (EUR bn)	3.3	3.3	3.3	3.4	3.4
Inflation/Monetary/FX					
CPI (pavg)	3.7	2.1	1.2	2.0	2.5
CPI (eop)	3.1	1.8	1.5	2.1	2.7
3M money market rate	1.18	0.33	0.12	0.38	0.80
USD/ BAM (eop)	1.5	1.5	1.4	1.4	1.5
EUR/BAM (eop)	2.0	2.0	2.0	2.0	2.0
USD/ BAM (pavg)	1.4	1.5	1.5	1.4	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, S&P and Fitch respectively

Recovery in a slow-growth mode

GDP growth forecast for 2013 mildly raised, while left unchanged for 2014

Our GDP forecast for 2013 has been revised upward to 0.6% yoy (previously 0.4% yoy), while the forecast for 2014 remains unchanged at 0.9% yoy. Key rationale for this revision lies in the stronger impact of increased merchandise exports in 1H (8.7% yoy), while further improvements in external demand are expected. This benefitted industrial production, growing nicely in 1H (7%). Although growth in exports and industry is driven dominantly by energy production, it should remain supportive in the remainder of the year. On the other hand, weak domestic demand produced lower merchandise imports by 1.3% yoy, while weakening growth in lending activities (1.2% YTD in July) confirmed weak domestic credit demand. High unemployment with declining real wages will constrain consumer spending and the domestic contribution to economic growth in 2013/2014. A return to higher growth requires implementation of deep structural reforms connected with the labor market. Weak domestic demand reflected in suppressed merchandise imports in 1H will contribute to the slightly improved, but still high C/A deficit.

SBA on track – almost half of the funds under the program drawn down, next tranche should be disbursed during September

SBA agreement: the June disbursement of SDR 33.82mn (EUR 39mn) raised total withdrawn funds under the current program to SDR 169.1mn (EUR 194.4mn), roughly 50% of the program allocation. Reading the IMF staff observations, progress in the implementation of reforms has been achieved, specifically related to the strengthening of tax administration and overall public financial management. The fourth staff review of the IMF is planned for September. The expected positive assessment should result in a new tranche of SDR 42.3mn (EUR 48mn), increasing total disbursements to 62.5% of the program. Sticking to the arrangement and complying with the requirements are particularly important considering the fact that the repayment obligations to the IMF amount to SDR 151.1mn (EUR 173mn) in 2014.

Minimal inflation levels should be behind us; the trend should accelerate modestly on the back of food and administrative prices

Inflation outlook: As expected the inflation reached a multi-year low in April and May, rising 1% yoy in June. Slightly lower rates in the first six months have resulted in a slight downward revision in the outlook for the current year to 1.2% yoy. A modest rise of consumer prices is expected in the autumn, driven by food prices and winter tariffs for electricity prices. Next year should bring a return to moderate inflation levels slightly above eurozone levels, as a result of external influences and a convergence path in administrative services and food prices.

Despite lower indirect tax revenues, fiscal deficit remains sustainable

Fiscal Outlook: Fiscal adjustments on the expenditure side in accordance with released official data for the previous year resulted in a lower fiscal deficit, 2.1% of GDP. Despite the improved fiscal discipline, this year should result in a modestly higher fiscal deficit (2.3% of GDP), primarily as a consequence of the decline in net revenues from indirect taxes. Rising government debt, resulting from loans from supranational financial institutions and commercial banks, was unplanned. It leads us to the conclusion that the IMF requirement for a significant long-term decline in public debt to 30% of GDP by 2017 will be very hard to achieve, even though (on the back of debt repayments in 2013 and 2014 – planned up to 3.6% of GDP or EUR 500mn) we see a modest decline of public debt to close to 41% of GDP.

Sovereign rating remains stable, political disagreements continue to affect the reform dynamics

Sovereign rating and political environment. The sovereign rating was kept stable by both Moody's (B3, stable) and S&P (B, stable). Political developments continue to be marked by disagreements among leading parties; therefore, the progress report of the European Commission can hardly be expected to have a positive tone. However, the upcoming meeting with the EU Commissioner for Enlargement at the very beginning of October should bring some new momentum to the pace of the reform process. However, the current deadlock in negotiations on changes in the legal environment bring the chances of B&H submitting an application for EU candidate status by the end of this year to virtually zero. The reform process and EU integration process will face a challenging time in 2014, as the approaching autumn general election won't help the implementation of reforms.

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

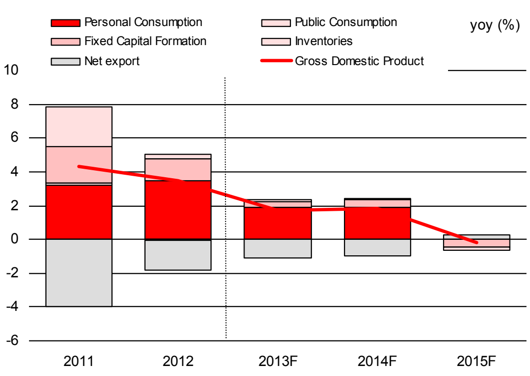
Outlook – The economy is experiencing a structural slowdown, caused in part by years of under investment. The economy should avoid recession due to robust retail sales, but even this may start to wane as the CBR looks to reign in household credit growth. Rather than take the necessary measures to improve the business climate, the government will likely pursue short term stimulus measures at the expense of long-run growth. Among these, we see the government drawing on the National Well-being Fund to finance additional public spending. So far the CBR has refused to bow to pressure to cut its interest rates, but we think it will eventually cut rates later this year.

Authors: Artem Arkhipov, Head of Macroeconomic Analysis and Research (UniCredit Bank Russia), Anna Bogdyukevich, Economist, (UniCredit Bank Russia)

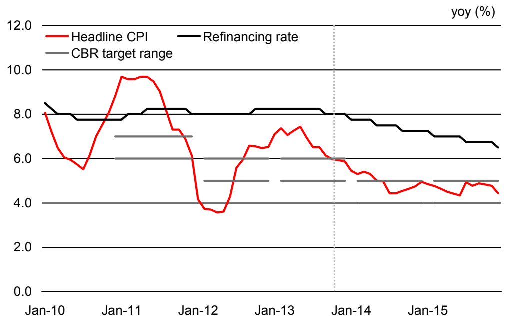
KEY DATES/EVENTS

- 13 September – the CBR decides rates
- September – discussion of the federal budget 2014-2016
- October – annual release of the monetary policy priorities for the medium term (2014-2016)
- 18-23 of every month – short-term statistical overview
- 10-15 of every month – CBR decision on rates

DOMESTIC DEMAND WEAKENS



INFLATION ABOVE TARGET FOR NOW



MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	1,336	1,568	1,604	1,632	1,598
Population (mn)	143.1	142.9	142.7	142.5	142.3
GDP per capita (EUR)	9,336	10,978	11,247	11,455	11,233
Real economy yoy (%)					
GDP	4.3	3.4	1.7	1.8	-0.2
Private Consumption	6.4	6.8	3.6	3.5	0
Fixed Investment	10.2	6.0	1.5	2.0	-2.0
Public Consumption	0.8	-0.2	0	0.2	0.2
Exports	0.3	1.4	1.3	1.3	-2.0
Imports	20.3	9.5	6.0	5.3	-3.3
Monthly wage, nominal (EUR)	580	675	697	713	701
Unemployment rate (%)	6.6	5.3	5.4	5.5	6.4
Fiscal accounts (% of GDP)					
Budget balance	0.8	0	-0.7	-0.7	-1.5
Primary balance	1.3	0.2	-0.4	-0.3	-1.0
Public debt	9.8	10.2	11.7	12.8	14.2
External accounts					
Current account balance (EUR bn)	79.5	63.2	33.2	11.3	-8.2
Current account balance/GDP (%)	6.0	4.0	2.1	0.7	-0.5
Basic balance/GDP (%)	5.3	3.5	2.1	0.7	-0.6
Net FDI (EUR bn)	-11.8	-4.7	-39.1	-2.2	1.3
Net FDI (% of GDP)	-1.2	-0.3	-2.4	-0.1	0.1
Gross foreign debt (EUR bn)	424.3	485.1	536.2	560.5	585.0
Gross foreign debt (% of GDP)	31.8	30.9	33.4	34.3	36.6
FX reserves (EUR bn)	384.7	407.3	376.6	362.7	353.9
Inflation/Monetary/FX					
CPI (pavg)	8.6	5.1	6.7	4.9	4.7
CPI (eop)	6.1	6.6	5.9	5.0	4.4
Central bank inflation target	6 - 7	5 - 6	5 - 6	4 – 5	4 - 5
Central bank reference rate (eop)	5.25	5.50	5.25	4.75	4.25
3M money market rate	6.60	7.45	6.75	5.75	6.00
FX/USD (eop)	32.2	31.1	32.6	34.1	36.8
FX/EUR (eop)	41.7	40.5	44.0	47.1	49.4
FX/USD (pavg)	29.3	31.0	32.0	33.0	35.2
FX/EUR (pavg)	40.9	39.9	42.3	44.9	47.9

Source: Federal Statistical Service, CBR, UniCredit Researc

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

A Structural Slowdown

Russia is experiencing a structural slowdown

The economy has been slowing down since 4Q11 and in the second quarter of this year GDP growth was just 1.2% yoy. The weakness is largely structural. Indeed, the supply-side struggles amid falling investment from an already low level and industrial output that is flat YTD despite high employment. Meanwhile, the demand side is relatively strong with retail sales up 4.3% yoy in July (driven by wage growth of 13.5% yoy and household credit growth in excess of 30% yoy). Consequently capacity utilization rates are high. Looking ahead we see the CBR taking measures to slow excessive household credit growth, which will further wane on economic growth. One cannot simply put supply weakness down to external factors - in the last 3 months oil prices have risen but we expect oil prices to fall in 2014 and 2015. Consequently, we have lowered our forecast for GDP growth to 1.7% this year (previously 2.7%) and 1.8% next year (previously 2.8%).

Russia is in danger of watering down its fiscal and nominal anchors

Russia has a choice between a combination of near term gain and long-term pain or long-term gain in return for short-term pain. Russia's current macroeconomic policy mix of (transitioning to) inflation-targetting on the monetary policy side and a fiscal rule that saves excess oil revenues provides the necessary anchors for stable long-term growth in a country that is heavily specialised in oil and gas and has a recent history of high and volatile inflation. However, both of these anchors are in danger of being weakened to provide a short-term stimulus to the economy.

The Well-being Fund is likely to be tapped

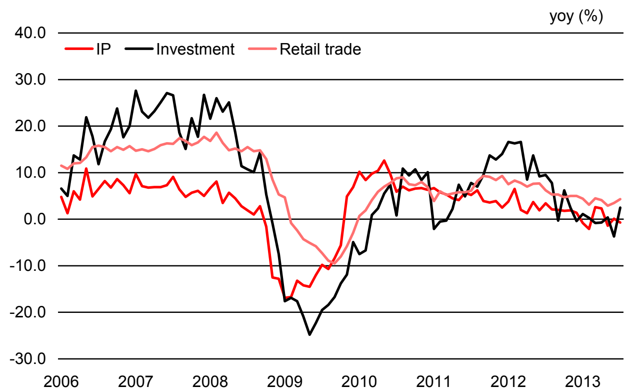
Indeed, the government will shortly present a draft of the new budget for 2014-2016. It is likely that a part of investment spending will be financed from the National Well-Being Fund (up to RUB 450bn). This is formally in line with the fiscal rule (which relates to the Reserve Fund) but risks representing the start of a slippery slope. Given the importance of this buffer, generating a reasonable return on such funding is crucial. Note that YTD budget performance has been weak, with the seasonal H1 surplus having halved relative to H1-12, capturing in part stagnant revenue.

The CBR may widen its inflation target range

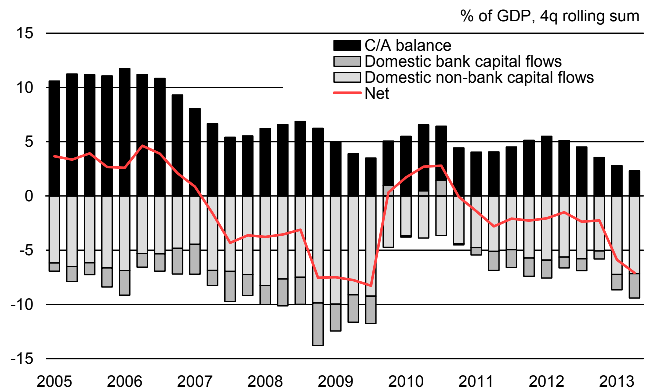
In late October, the CBR will provide its annual update on future monetary policy for 2014-2016, including any deviation from its commitment to inflation targeting and a freely-floating RUB by 2015. While we do not expect any major changes, the CBR may give itself more flexibility in meeting its inflation target by widening the target range (i.e. 4.5% +/-1.5% rather than 4-5%). Moreover, there is pressure on the CBR to assign a weight to economic activity over and above its effect on inflation (in late July the State Duma changed the CBR's remit to include creating conditions for economic growth, although price stability remains the primary goal).

LOW INVESTMENT AND DOMESTIC CAPITAL OUTFLOWS ARE A SYMPTOM OF THE UNFAVOURABLE BUSINESS CLIMATE

Industrial production and investment struggle



Domestic capital outflows rise while the C/A surplus falls



Source: Rosstat, CBR, UniCredit Research

The CBR has so far resisted pressure to cut rates…

The CBR Chairwoman, Elvira Nabiullina, who took office on 24 June, has so far resisted pressure to cut the CBR's key rates. Nabiullina has said that the economic downturn is not cyclical and, therefore, monetary policy can do little to stimulate economic activity. We largely agree with this and, although financial conditions are considerably tighter for SME's than the CBR's key rates suggest, cutting rates is an extremely blunt instrument to solve this. For example, funding for lending schemes, reducing lenders' administrative costs and making it easier for lenders to recover collateral would be, among other measures, much more effective. Moreover, inflation was running at 6.5% in August (unchanged from July's reading) which is above the CBR's 5-6% target. Although inflation is widely expected to fall towards the upper-end of the target range by year-end, the target itself is lowered to 4-5% next year and this seems almost impossible for the CBR to hit with both inflation expectations and core inflation hovering around 5.5%. In addition, inflation is not entirely under the CBR's control – roughly a quarter of inflation is determined by regulated prices and tariffs. The government currently considers delaying a tariff hike until 2015, which will have a clear anti-inflationary impact.

…but has taken other measures to support credit

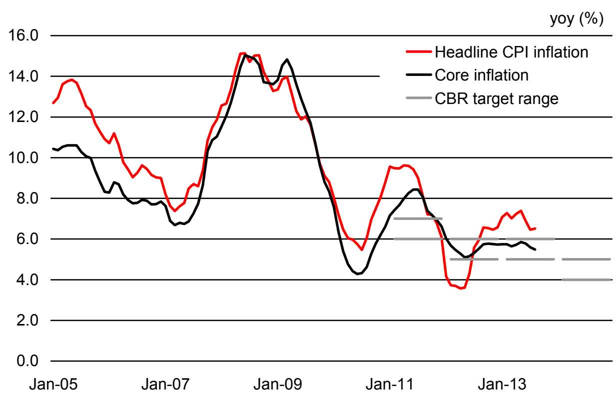
To facilitate lower interest rates on lending to corporates, the CBR has been trying to improve the functioning of the transmission mechanism and tighten regulation of the banking system. At its July meeting the CBR introduced a new instrument that offers 12-month floating rate refinancing to banks collateralized by non-marketable assets. We expect that, while the key short-term repo rates will be closely linked to inflation developments, the price of longer-term instruments might decrease to stimulate investment. In our view, the auction repo rate will be cut once in the remainder of 2013 by 25bp to 5.25%. The refinancing rate and other rates (including for 1 year MTROs) could be cut by 50-75 bp in the next quarters.

Medium to long term, financing investment is a challenge

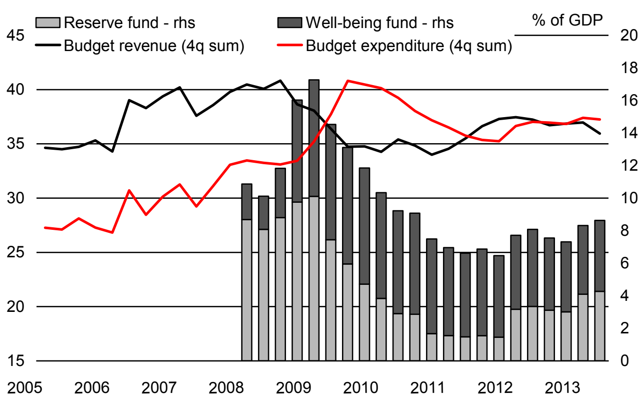
All of the above should provide some short term support to activity but is not sufficient to ensure adequate financing for much needed investment over the medium to long term. Summing Russia's dwindling C/A surplus (USD 32bn over H1-13, down 42% from H1-12) and domestic capital outflows, the balance has been negative since the beginning of 2011. While there were some one-offs in Q1's release, the balance still continues to deteriorate. In contrast with 2008, the risk to Russia from a reversal of foreign capital flows is limited, given that it is one of the few large emerging markets globally to not see any large return of foreign capital. But this negative balance means that it either needs to attract new foreign capital (which brings its own risks) or it needs to increase domestic investment.

THE CBR WILL FIND IT HARD TO MEET NEXT YEAR'S TARGET, WHILE THE GOVERNMENT BUDGET DETERIORATES

The persistent component of inflation lies above next year's target



Budget revenue has stagnated while spending rises



Source: Rosstat, CBR, UniCredit Research

Strategy: Currency weakness erodes returns

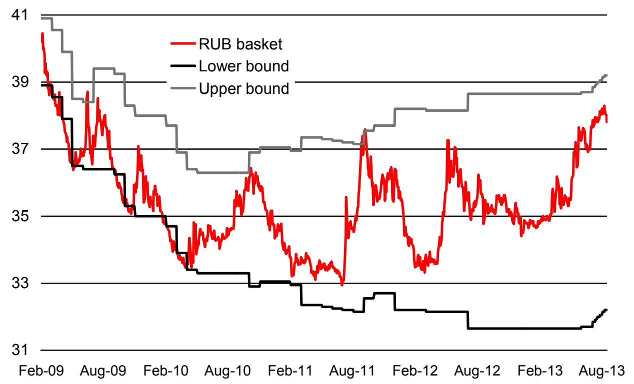
RUB weakness appears to be increasingly viewed as an adjustment mechanism, though we do not exclude better performance to year-end on the back of favourable seasonal C/A patterns

RUB performance in recent months captures this capital flow shortfall. The regulator has shifted the corridor eight times since the beginning of August while daily interventions by the CBR in forex increased from USD 200mn in July to USD 300-400mn in August. This is despite an increase in oil prices over this period. In reaction the MinFin has delayed plans to convert RUB into USD for the Reserve Fund but beyond this the authorities have not expressed a strong opposition to RUB weakness. Instead it appears to be increasingly viewed as a preferred adjustment mechanism to more difficult structural reforms.

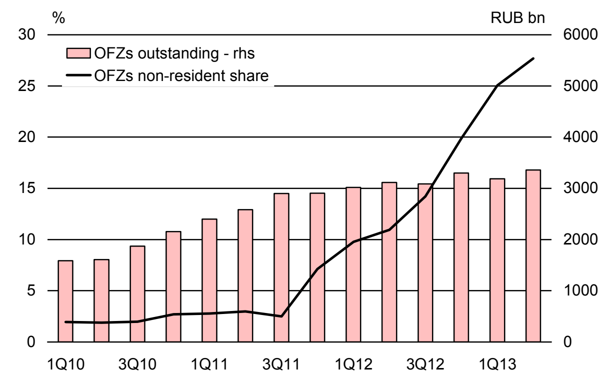
Poor RUB performance and already elevated foreign holdings imply a slower inflow to OFZs going forward

Foreign holdings of OFZ bonds have already increased to approximately 28% of the total, implying that a further surge in inflows is unlikely. Moreover the MinFin has already expressed some discomfort with the rapid increase. Instead we expect foreign holdings from here to increase in line with issuance while demand from the domestic banking system should also remain solid, if only because of a need for collateral.

The RUB has traded near the upper end of the CBR's trading band



The non-resident share of OFZs has risen sharply



Source: Rosstat, CBR, Bloomberg; UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**39.5**	**35.4**	**51.6**
Budget deficit	11.2	11.4	24.0
Amortisation of public debt	19.6	15.7	20.5
Domestic	18.1	14.8	18.2
Bonds	18.1	14.8	18.2
Bills	0	0	0
External	1.6	0.9	2.3
Sovereign Fund	8.7	8.2	7.1
Financing	**41.4**	**32.4**	**51.6**
Domestic borrowing	28.7	21.7	33.0
Bonds	28.7	21.7	33.0
Bills	0	0	0
External borrowing	5.4	5.0	8.8
Bonds	5.4	5.0	8.8
Other	7.4	5.7	9.8

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**26.1**	**41.7**	**62.5**
C/A deficit	-33.2	-11.3	8.2
Amortisation of debt	52.1	47.4	50.1
Government/central bank	1.6	0.9	2.3
Banks	21.5	18.0	22.0
Corporates	29.0	28.5	25.8
Errors and omissions	7.2	5.6	4.2
Financing	**26.1**	**41.7**	**62.5**
FDI	-39.1	-2.2	1.3
Equity	0	0	0
Borrowing	130.9	92.4	81.1
Government/central bank	5.4	5.0	8.8
Banks	38.5	32.4	28.0
Corporates	87.0	55.0	44.3
Domestic investments abroad	-35.0	-34.5	-11.1
Officiial reserves change / other	-30.7	-13.9	-8.8

Source: Rosstat, CBR, UniCredit Research

Serbia (B1 stable/BB- negative/BB- negative)*

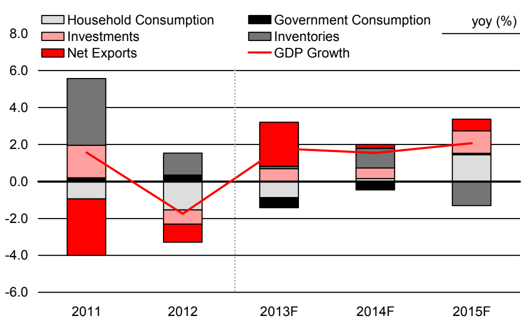
Outlook – The Serbian economy is facing a challenging period ahead. The economy has emerged from recession but continues to run some of the widest twin deficits globally. Public debt remains on an upward trajectory amidst a budget overshoot again this year, while the sovereign needs to return to the Eurobond market to secure close to EUR 2bn in funding. Set against a backdrop of deterioration in emerging market financing conditions and the risk of early elections next year, the authorities are at risk of struggling to restore market confidence. Key from here will be the government's determination to secure an IMF deal in the coming months, as this would not only reassure investors but also help unlock close to EUR 500mn in World Bank and Russian loans. But for it to be successful, a much tougher stance on fiscal consolidation and privatizations will have to be adopted.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

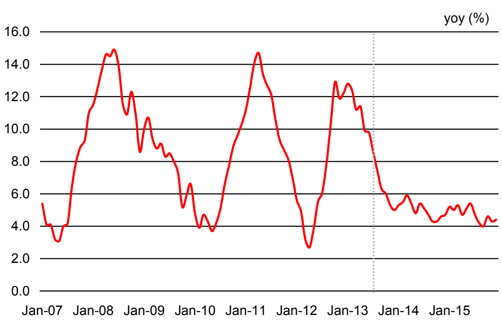
KEY DATES/EVENTS

- 30 Sep – 2Q13 GDP (final), 3Q13 GDP (prelim)
- 20 Sep, 21 Oct, 20 Nov – Current Account Balance
- 11 Oct, 12 Nov, 12 Dec – Consumer Price Index
- 30 Sep, 31 Oct, 29 Nov – Retail Sales
- 30 Sep, 31 Oct, 29 Nov – Industrial Production

RECESSION TO PERSIST IN 2013



CPI SET TO MODERATE



Source: NBS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	31.5	29.9	32.8	33.9	35.1
Population (mn)	7.6	7.6	7.6	7.6	7.6
GDP per capita (EUR)	4,160	3,945	4,309	4,452	4,607
Real economy yoy (%)					
GDP	1.6	-1.7	1.8	1.5	2.1
Private Consumption	-1.1	-1.9	-1.1	0.2	1.9
Fixed Investment	8.4	-3.4	3.2	2.6	5.4
Public Consumption	-0.1	1.8	-2.6	-2.3	0.4
Exports	3.4	4.5	11.6	6.6	6.1
Imports	7.0	2.3	3.6	4.0	3.2
Monthly wage, nominal (EUR)	518	508	535	556	556
Unemployment rate (%)	23.0	23.9	24.0	23.0	22.3
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-6.4	-6.5	-4.6	-3.5
Primary balance	-3.5	-4.4	-4.2	-2.1	-0.8
Public debt	46.0	59.0	60.4	63.0	64.4
External accounts					
Current account balance (EUR bn)	-2.9	-3.2	-2.3	-1.7	-1.5
Current account balance/GDP (%)	-9.1	-10.5	-7.0	-5.0	-4.3
Basic balance/GDP (%)	-3.3	-9.8	-4.0	-1.2	-0.7
Net FDI (EUR bn)	1.8	0.2	1.0	1.3	1.3
Net FDI (% of GDP)	5.8	0.8	3.1	3.8	3.6
Gross foreign debt (EUR bn)	24.1	25.7	27.4	27.2	27.6
Gross foreign debt (% of GDP)	76.7	85.9	83.5	80.3	78.7
FX reserves (EUR bn)	12.9	12.0	11.4	10.3	9.7
Inflation/Monetary/FX					
CPI (pavg)	11.6	7.3	8.8	5.0	4.7
CPI (eop)	7.0	12.2	5.0	4.7	4.4
Central bank target	4.5±1.5%	4.5±1.5%	4.5±1.5%	4.5±1.5%	4.5±1.5%
Central bank reference rate (eop)	9.75	11.25	10.25	9.50	10.00
BELIBOR 3M	12.88	11.64	10.58	9.95	10.88
USD/RSD (eop)	78.7	86.1	85.9	86.2	91.8
EUR/RSD (eop)	104.6	113.7	116.0	119.0	123.0
USD/RSD (pavg)	72.8	88.0	86.6	86.5	89.3
EUR/RSD (pavg)	102.0	113.1	114.3	117.8	121.5

Source: Unicredit Research

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

A difficult period ahead

FY13 GDP growth will pick-up to 1.8% yoy due strong net export performance; Trend growth to be reached in 2015 as domestic demand recovers.

Serbia's recovery is well on track, with GDP growth being supported by a strong export pick-up this year and a recovered domestic demand by 2015. Based on preliminary data, 2Q13 GDP grew by 0.7% yoy, down from 2.1% yoy in 1Q13. While details on the growth composition will be given on September 30, we believe much of the slowdown was caused by a further weakening of domestic consumption, already down by 7.6% since 2012. In our view, such a negative trend will persist until year-end, with the biggest hit likely to be seen in public expenditure (2013F drop at 2.6% yoy). That said, we still maintain our forecast that the economy will grow this year by 1.8%, with net exports expected to add close to 2.3pp to GDP on account of Fiat and better agricultural yields. For 2014, however, we expect their contribution to be flat. Adding austerity-driven public expenditure cuts, the economy should slow to 1.5% yoy. By then, both private consumption and investment will have recovered, but they will have a strong impact on growth only in 2015 (2015F at 2.1% yoy).

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

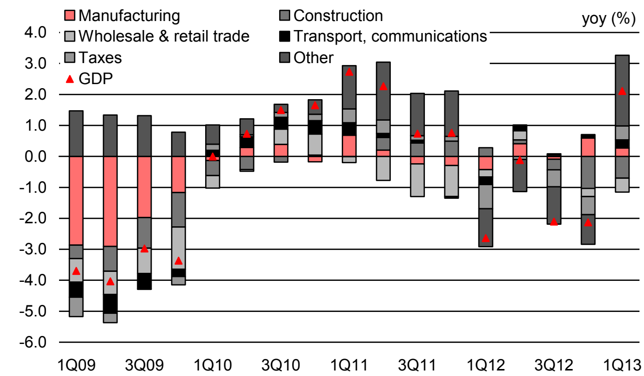
Easing inflationary pressures in 2H13 also point to looser monetary conditions. Inflation eased to 8.6% yoy in July. While still above target, the reading is nonetheless at a 12-month low, with the YTD slowdown at 4.2pp. Food prices had the biggest disinflationary impact, contracting 4.2% vs. June to 9.2% yoy. Looking ahead, the rise in oil prices could slow down disinflation, but it should not prevent headline CPI converging towards the NBS's 4±1.5% tolerance band by year-end. This should encourage the NBS to cut rates further, though its decision to keep the policy rate unchanged for a third consecutive month in September suggests it remains concerned with renewed episodes of dinar volatility. The IMF's call for monetary policy restraint until fiscal consolidation takes hold may also have played a role. That said, we expect a 75bp easing cycle to start in October.

C/A to improve on account of Fiat exports; external debt to increase due to higher market borrowing

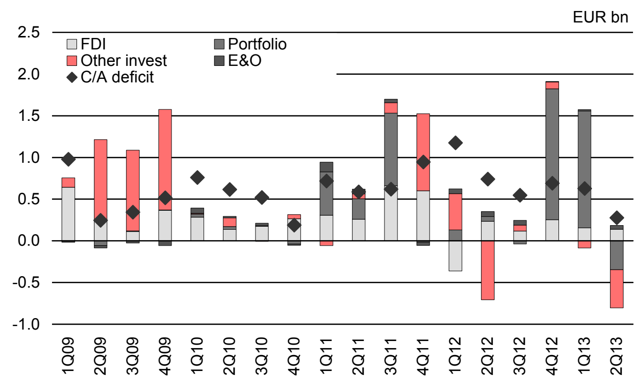
External vulnerabilities remain a concern. Serbia's C/A deficit last year was the largest in the region at 10.5% of GDP, while FDI collapsed to just EUR 0.2bn (or 0.7% of GDP). This year, the C/A will improve following Fiat's strong export push, but will remain unsustainably high (2013F at -7% of GDP). Meanwhile, external debt has risen by close to 30pp of GDP since 2008, with the latest 1Q13 reading standing at 89.7% of GDP. National savings and investment are also the lowest in the region at 8% and 19% of GDP respectively, while the non-bank corporate sector continues to pay down external debt. On a more positive note, short-term debt has declined significantly in the past five years, from a peak of EUR 2.1bn in 2008 to just EUR 0.5bn in 2012. In addition, private sector external debt rollover requirements this year have declined to 10.9% of GDP (from 15.6% in 2012), well below those in other countries like Bulgaria (28.3%) or Slovenia (24.7%).

DESPITE THE RECOVERY, FUNDING SERBIA'S LARGE C/A DEFICIT WILL PROVE CHALLENGING

Economic activity is slowly catching-up…



…but C/A funding remains too dependent on portfolio inflows



Source: National Bank of Serbia, MinFin, UniCredit Research

The government reshuffle does not lessen the risk of early elections next year

On the political front, the government reshuffle was approved by Parliament on September 2. 11 ministers were replaced, three of whom were part of the former coalition partner United Regions of Serbia (URS). In addition, the Ministry of Finance and Economy was split into two separated ministries. It remains to be seen how effective the newly-appointed economic (Sasa Radulovic) and finance (Lazar Krstic) ministers will be in implementing the badly-needed economic reforms. They remain 'outsiders' to the Serbian political scene. The lasting viability of the reshuffled government is likely to be short lived as Vucic's Progressive Party (SNS) could surely attempt to cash in on its rise in popularity by calling for early elections next year (SNS popular support at 41.4% vs. 13.1% for the SPS). We do not expect any early election until EU accession negotiations start in early 2014.

July's rebalanced budget remains insufficient to prevent the deficit increasing to 6.5% of GDP this year

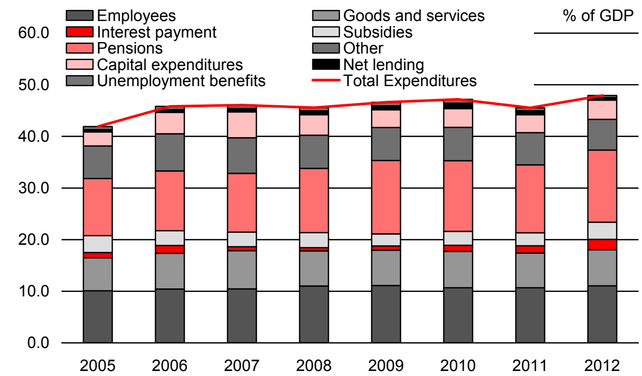
On the fiscal front, further effort is required. The target was already raised to 4.7% of GDP last July (from 3.3% of GDP). The annual revenue target was lowered by 9% to EUR 7.6bn, with most of the decline attributed to lower corporate income tax (-31.6%) and non-tax revenues (-18.9%). Current expenditures were reduced by 1.5%. But the deficit this year is expected to widen to around 6.5% of GDP. In particular, we see continued risks to the government's revenue projections on account of: **i.** the country's weakening domestic demand prospects, **ii.** the higher VAT refunds to exporters, and **iii.** the rise in tax evasion. At the same time, expenditures are also set to increase partly due to: **i.** realized capital expenditures, and **ii.** increased interest and subsidy payments beyond the 2.0% and 1.8% growth rates penciled in the revised budget. Additional fiscal risks also stem from the planned issuance of guarantees and payment of arrears, expected at close to 0.7% of GDP this year. The deficit should start reversing next year, as the government will have to undertake severe budget cuts to secure an IMF agreement and fiscal consolidation.

Further expenditure cuts are required to keep public debt under control

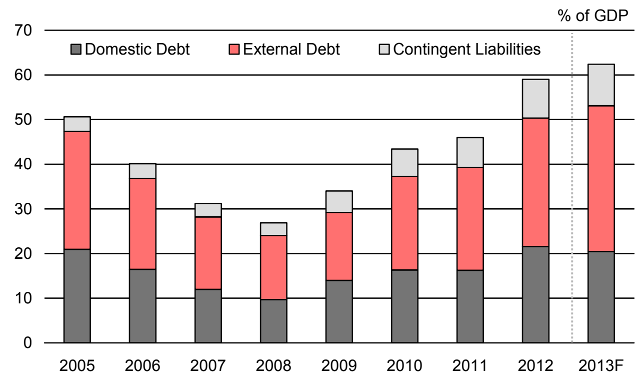
Public debt will remain on an upward trajectory, set to reach close to 65% of GDP this year. It has more than doubled since 2008. Moreover, reliance on foreign market funding has also risen considerably, increasing debt-servicing costs and dependence on market conditions. An IMF deal would certainly help reverse this tendency. This is particularly necessary for public sector wages and pensions, currently at EU-highs (ca. 25% of GDP). Progress in the restructuring of 179 of its former SOEs will also help on this front (cost at EUR 0.75bn/annum), though we remain skeptical that it will be accomplished by 1H14.

FISCAL CONSOLIDATION SHOULD BECOME THE GOVERNMENT'S TOP PRIORITY

Public expenditure levels are at all-time highs…



…increasing the sovereign's reliance on foreign funding



Source: NBS, MinFin, UniCredit Research

Eurobond issuance expected in 4Q13

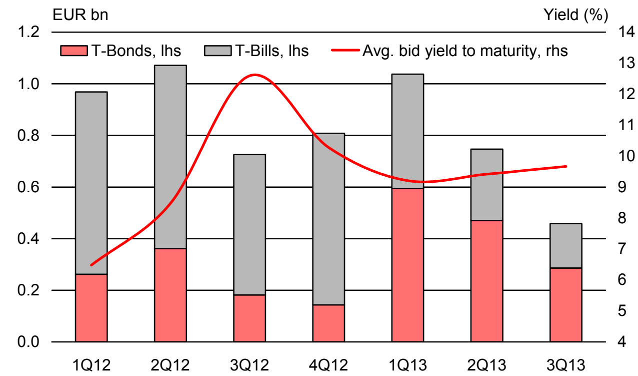
Serbia's cash position remains insufficient to cover this year's remaining funding needs

Serbia's funding challenge remains acute, as only 65% of this year's funding needs have been covered. These are estimated at EUR 5.9bn, after penciling in a FY13 budget deficit of EUR 2.1bn (6.5% of GDP), EUR 0.23bn in guarantees (0.7% of GDP) and EUR 3.6bn in domestic and external debt repayments. Our figure exceeds that of the MinFin (EUR 5.4bn), as the latter is based on a budget deficit estimate of just 4.7% of GDP. With EUR 2.1bn still to finance, and only EUR 0.8bn in cash reserves, it becomes evident that another USD Eurobond issuance will be required before year-end, with October being the most plausible date. While it is true that Serbia could increase its reliance on 'friendly' countries like Russia for cheaper funding, it would nonetheless still be insufficient to cover the funding gap in full.

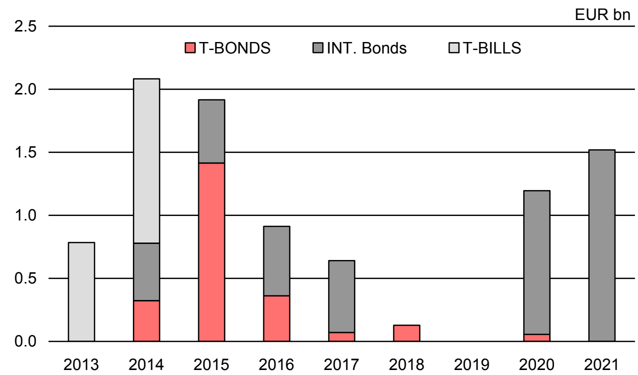
But securing funding will not be an easy task, particularly when portfolio inflows into EM are reversing. Even more, market borrowing is becoming increasingly expensive, with 10-year yields already at 6.8%. Reaching an agreement with the IMF in the near term remains crucial, also triggering the disbursement of EUR 200mn in World Bank loans.

MARKET CONDITIONS REMAIN A CONCERN

Yields on domestic debt continue at elevated levels



Debt redemption profile as of September 2013



Source: NBS, IMF, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**5.9**	**5.0**	**4.7**
Budget deficit	2.1	1.6	1.2
Amortization of public debt	3.8	3.5	3.5
Domestic	2.9	1.8	2.4
Bonds	0.0	0.5	1.6
Bills	2.9	1.3	0.8
External	0.6	1.4	0.9
Other	0.251	0.2	0.2
Financing	**5.9**	**5.0**	**4.7**
Domestic borrowing	3.1	2.0	3.2
Bonds	1.7	0.8	1.7
Bills	1.4	1.2	1.5
External borrowing	2.8	3.0	1.5
Bonds	2.2	1.0	1.0
IMF/EU	0.0	1.5	0
Other	0.6	0.5	0.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**6.8**	**7.8**	**5.8**
C/A deficit	2.3	1.7	1.5
Amortization of medium to long term debt	4.2	5.7	3.9
Government/Central Bank	0.6	1.4	0.6
IMF	0.2	1.0	0.1
Other	0.4	0.5	0.5
Banks	0.5	0.4	0.4
Corporates	2.5	2.4	2.2
Amortization of short term debt	0.4	0.4	0.4
Government/Central Bank	0.0	0.0	0.0
Banks	0.3	0.3	0.3
Corporates	0.1	0.1	0.1
Financing	**7.1**	**7.8**	**5.8**
FDI	1.0	1.3	1.3
Equity	0.0	0.0	0.0
Borrowing	5.5	5.7	4.3
Government/Central Bank	2.8	3.0	1.5
IMF	0.0	1.5	0.0
Bonds	2.2	1.0	1.0
Other	0.6	0.5	0.5
Banks	0.2	0.4	0.5
Corporates	2.5	2.3	2.3
Change of reserves (+ = decline)	0.6	0.8	0.2

Source: MinFin, NBS, UniCredit Research

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

Outlook – The Turkish economy is undergoing a fundamental shift, triggered by much less favourable external financing conditions. Determining a sustainable C/A balance going forward is a tricky task but adjustment at this stage is unavoidable. The economy is showing signs of adjustment but this is only the beginning of what is likely to be a multi-quarter process. The tail risks remain significant at this stage. This leaves us marking down our growth forecasts for next year as well as narrowing our C/A deficit projection. We see little scope for monetary policy to ease the slowdown heading into 2014.

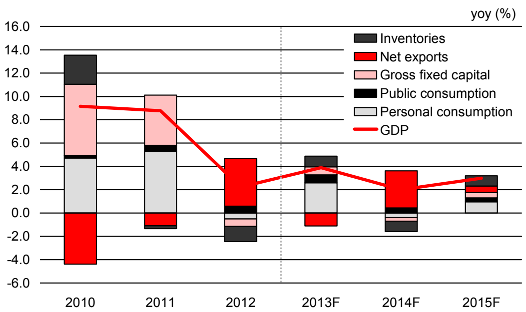
Strategy – We continue to expect the TRY basket to depreciate further. Domestic fixed income has adjusted to capture inflation risks but not an increase in external financing stresses.

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

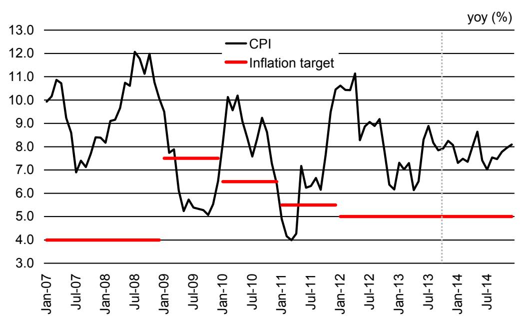
KEY DATES/EVENTS

- 10 Dec – 3Q13 GDP
- 17 Sep, 23 Oct, 19 Nov – Repo Rate Decision
- 3 Oct, 4 Nov, 3 Dec – CPI
- 8 Oct, 8 Nov, 9 Dec – Industrial Production

DOMESTIC DEMAND RECOVERY BEING PUT TO TEST ONCE AGAIN



INFLATION TARGET OUT OF REACH



Source: TurkStat, CBT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	558.6	611.9	617.4	574.3	608.5
Population (mn)	74.0	74.9	75.8	76.7	77.6
GDP per capita (EUR)	7,553	8,171	8,143	7,487	7,841
Real economy yoy (%)					
GDP	8.8	2.2	3.9	2.0	3.0
Private Consumption	7.7	-0.7	3.9	-0.6	1.5
Fixed Investment	18.0	-2.5	2.8	-1.2	1.9
Public Consumption	4.7	5.7	6.5	4.0	3.0
Exports	7.9	17.2	4.1	9.2	7.0
Imports	10.7	0	8.0	-2.3	5.4
Monthly wage, nominal (EUR)	788	922	940	900	982
Unemployment rate (%)	9.8	9.2	9.5	9.5	9.3
Fiscal accounts (% of GDP)					
Budget balance	-0.4	-1.5	-1.5	-3.5	-3.5
Primary balance	2.3	1.3	1.0	-1.2	-1.0
Public debt	39.3	36.6	36.5	37.1	38.1
External accounts					
Current account balance (EUR bn)	-34.3	-54.0	-37.1	-43.6	0
Current account balance/GDP (%)	-6.2	-9.7	-6.1	-7.1	-7.9
Basic balance/GDP (%)	-5.2	-7.9	-5.0	-5.8	-6.2
Net FDI (EUR bn)	5.7	9.8	6.6	7.7	15.0
Net FDI (% of GDP)	1.0	1.8	1.1	1.2	1.7
Gross foreign debt (EUR bn)	218.5	235.8	255.3	288.4	302.5
Gross foreign debt (% of GDP)	39.1	38.5	41.4	50.2	49.7
FX reserves (EUR bn)	59.2	59.4	74.5	67.3	62.6
Inflation/Monetary/FX					
CPI (pavg)	6.5	8.9	7.4	6.7	6.3
CPI (eop)	10.4	6.2	7.3	6.6	6.5
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	5.75	5.50	4.50	6.00	7.50
3M money market rate	8.55	7.69	6.27	6.88	7.15
USD/TRY (eop)	1.9	1.8	2.2	2.2	1.8
EUR/TRY (eop)	2.5	2.3	3.0	3.0	2.4
USD/TRY (pavg)	1.7	1.8	1.9	2.2	1.8
EUR/TRY (pavg)	2.3	2.3	2.6	3.0	2.4

Source: UniCredit Research

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

Determining turning points

The change in the external environment is forcing a structural shift in the Turkish economy

The Turkish economy is undergoing a fundamental shift, triggered by much less favourable external financing conditions. Turkey's Achilles heel has long been its C/A deficit but a shift in the financing of this deficit over recent years away from long term capital flows (FDI, long term bank and non-bank corporate lending) and towards short term capital flows (largely portfolio flows and short term foreign bank borrowing) has further added to this vulnerability. These short term flows have represented the majority of C/A deficit financing since 2010 but have now ground to a halt as part of a broader shift in short term flows to emerging markets. Meanwhile over the 12 months to June Turkey's C/A deficit stood at 6.5% of GDP, 0.6pp of GDP wider than 6 months prior, attributable largely to deterioration in the gold balance.

A C/A deficit adjustment is unavoidable

Determining a sustainable C/A balance going forward is tricky but adjustment at this stage is unavoidable. To ensure a stable gross external debt ratio and stable currency, Turkey can run a C/A deficit of between 4-5% of GDP but this does not take account of financing. Long term financing is currently running at only 1.4% of GDP (USD 11.2bn) on a 12 month basis, 2.5% of GDP (USD 20.1bn) on average since Jan-11. Assuming no further short term inflows and an improvement in long term inflows in line with their average since Jan-11, this suggests that Turkey needs to more than half its C/A deficit. Should past short term inflows reverse, the required adjustment will be even larger given the CBT's limited stock pile of foreign reserves.

TRY losses to date and slower credit growth will lower imports while exports should remain well supported…

The economy is beginning to adjust via a number of channels. First TRY depreciation, even if involuntary, is a tool used by Turkey every 2-3 years to aid required C/A adjustment. Since May the TRY basket has lost almost 15%. Second, credit is finally beginning to slow. As per the CBT's preferred metric, credit growth on a 13 week, SA and annualized, moving average basis has slowed to 35.7%, down from a peak of 37.7%. Interest rates on commercial loans have increased over 300bp since end-April. Third, currency losses and slower credit should lower imports while exports should remain supported by a stronger EMU and, to a lesser extent, US. Note that over the first 7 months of the year industrial output rose 6.1%. Over the first 7 months of last year, industrial outflow rose by a much more modest 0.2%.

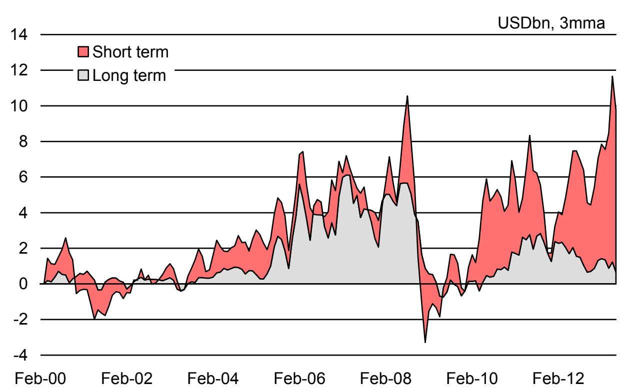
…but there remains more to be done

But this represents only the beginning of a multi-quarter adjustment while the tail risks remain significant:

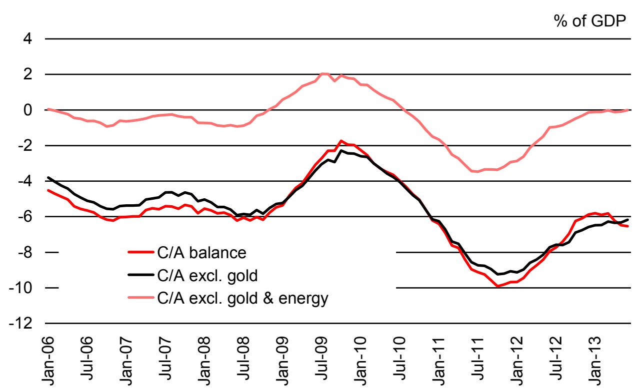
- Relative to past bouts of TRY losses, TRY depreciation since May is not significant. In mid-06 the TRY basket adjusted more than 30%, post Lehman's more than 40% and between the end of 2010 and the end of 2011 more than 30%;

TURKEY'S EXTERNAL ACCOUNTS ARE ITS PRIMARY CHALLENGE

A shift from long term to short term capital flows



The C/A deficit has improved but remains wide at this stage



Source: Turkstat, CBT, UniCredit Research

- Credit has much further to adjust given that credit growth stands at almost double deposit growth while external funding is unlikely to be as ample as in the past;
- Foreign holdings of domestic government debt have fallen only marginally. Data to 30 August show foreign positioning in domestic debt has declined by USD 3.4bn from its peak but holdings are still up USD 6.1bn YTD, USD 33.4bn since end-11 and USD 62.8bn since end-10. Turkey's second investment grade plays some role here but we are concerned that the speed of the sell-off prevented any reduction in positioning. Moreover we cannot rely on a rapid rebound to inflows this time around, in contrast with the first half of 2012.

The CBT is taking a more realistic approach

The CBT has adopted a more timid approach of late compared to June-July. While July saw the central bank put USD 5.15bn in FX through the market via intervention (sufficient to cover the C/A deficit in full), over the month to 5 September this fell to USD 2.1bn. We view this as an acknowledgement that current pressures risks being much more than temporary while the CBT's FX reserve pile does not facilitate persistent aggressive TRY defence. Developments in Syria also seem to play a role – at times when foreign action turns less likely, the CBT seems to feel that it gets more 'bang for its buck' from FX intervention. Looking ahead the ROM provides valuable protection to the banking sector while changes in ROM coefficients and reserve requirements on FX deposits are also possible in an effort to provide the economy with more FX. But we still do not exclude rate hikes, even if the CBT has been more reluctant this time than in the past, given the net open FX position of the non-bank corporate sector. This widened from a negative USD 72bn at end-08 to USD 146bn by 2Q this year.

A narrower C/A deficit means slower than desired growth…

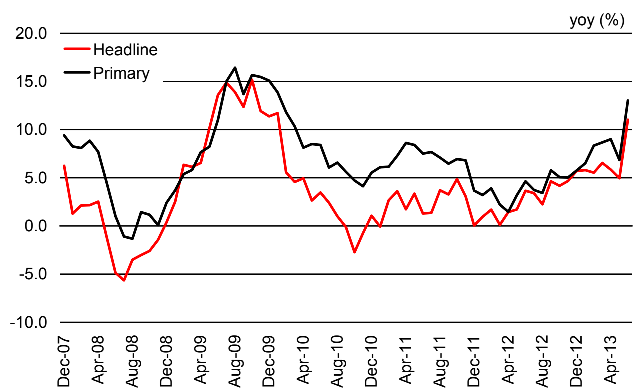
This leaves us marking down our growth forecasts for next year as well as narrowing our C/A deficit projection. Exports and government consumption, as well as positive carryover from this year, will help. As per the Q2 GDP release, government consumption rose 7.4% yoy. With the government heading into local elections in March and Presidential elections in the summer (with some potential to bring forward general elections from 2015), we expect continued support from fiscal policy. As ever inventories can be volatile in Turkey but pose some upside risks to GDP. But the 4.0% floated by the government ahead of its release of its medium term programme next month remains out of reach, in our view, due to an inevitable slowdown in private consumption and investment over at least Q4 this year and Q1 next year.

…with little scope for monetary policy to ease the downturn

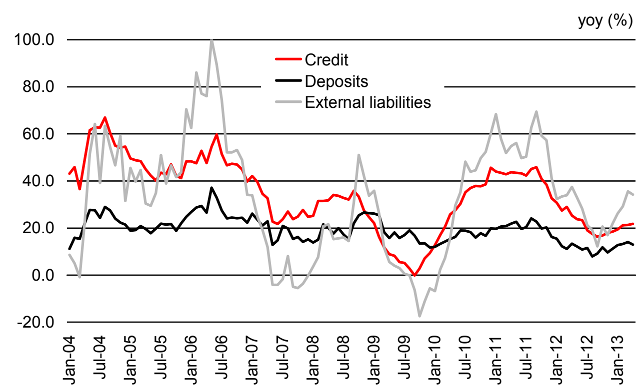
We see little scope for monetary policy to ease the slowdown heading into 2014. The CBT already revised upwards its year end inflation projection at end-July to 6.2% but the increase in oil prices and further TRY losses means that another increase is unavoidable.

GOVERNMENT SUPPORT FOR ACTIVITY WILL REMAIN BUT CREDIT GROWTH LOOKS SET TO SLOW SHARPLY

The government is supporting activity…



…but funding will constrain credit growth going forward



Source: CBT, Turkstat, UniCredit Research

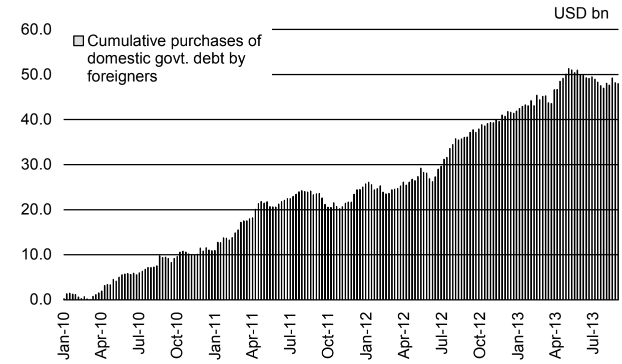
Strategy: To early to call a turnaround

We see further weakness in the TRY basket ahead, before stabilization, while risks remain weighted towards higher rates

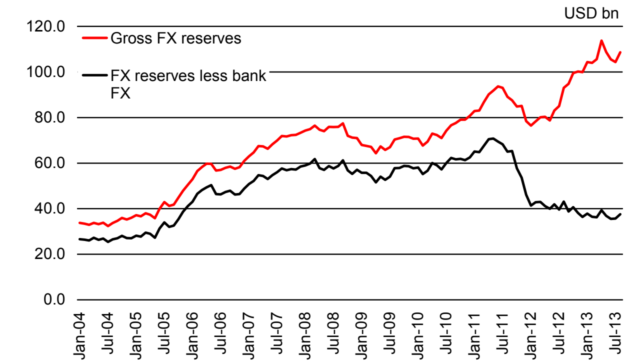
The C/A adjustment remains in its early stages and tail risks are still significant. While the CBT sees TRY as undervalued currently, C/A financing remains problematic. This is unlikely to change rapidly. We do not exclude an announcement by the IMF and some central banks in the developed world in terms of credit lines for large emerging markets under pressure but Turkey did not benefit from Fed action in early 2009 (Singapore, Korea, Mexico and Brazil received swap lines) and we assume that this will remain the case this time around. With CBT foreign reserves limited relative to the size of financing requirements, we continue to expect the TRY basket to move higher. Domestic fixed income has adjusted to capture inflation risks much more realistically compared with Q2 while the normalization in USTs from here should be more gradual than what was experienced in recent months. But the minimal reduction in foreign holdings of domestic government debt and the risk that the CBT is forced to hike interest rates to defend against a more disorderly TRY move remains. With all of this in mind, we remain on the sidelines in local currency government bonds, waiting for a better entry opportunity.

FOREIGN INFLOWS TO DOMESTIC DEBT ALLOWED THE BANKS TO SHIFT FOCUS

Foreign holdings of domestic debt have barely corrected…



…while the CBT has limited ammunition for outright interventions



Source: CBT, Treasury, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**57.8**	**56.4**	**78.1**
Budget deficit	9.0	9.4	20.3
Amortisation of public debt	48.8	47.0	57.8
Domestic	34.8	44.0	55.0
Bonds	34.8	44.0	55.0
Bills	0	0	0
External	14.0	3.0	2.8
Financing	**57.8**	**56.4**	**78.1**
Domestic borrowing	43.3	50.7	70.0
Bonds	43.3	50.7	70.0
Bills	0	0	0
External borrowing	5.8	4.5	4.4
Bonds	5.4	4.1	4.0
IMF/WB	0.4	0.4	0.4
Other	8.8	1.1	3.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F
Gross financing requirement	**130.1**	**143.6**	**116.5**
C/A deficit	37.1	43.6	27.0
Amortisation of medium to long term debt	30.3	27.8	21.0
Government/central bank	3.5	2.7	2.1
Banks	7.3	8.9	7.7
Corporates	19.6	16.2	11.2
Short term debt	63.8	76.5	68.6
Government/central bank	6.5	9.2	9.8
Banks	36.2	44.3	38.2
Corporates	21.1	23.0	20.6
Errors & omissions	-1.1	-4.3	0
Financing	**130.1**	**152.7**	**116.5**
FDI	6.6	7.7	9.7
Portfolio	31.7	7.6	7.3
Borrowing medium to long term	31.5	38.6	27.8
Government/central bank	2.1	4.5	4.4
Banks	6.9	11.4	7.7
Corporates	22.5	22.7	15.8
Short term borrowing	78.5	83.6	69.5
Government/central bank	9.4	10.1	10.8
Banks	45.5	49.2	38.2
Corporates	23.6	24.2	20.6
Other	-2.0	6.1	2.1
Reserve accumulation	-16.2	9.1	0

Source: CBT, Treasury, Bloomberg, UniCredit Research

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

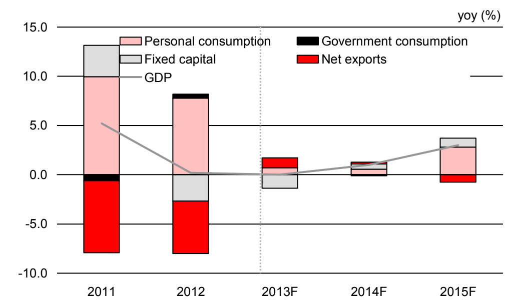
Outlook – The deterioration in the external environment has negative implications for Ukraine at a time when both its external and fiscal accounts are already under considerable pressure. We do not underestimate the authorities' willingness to persist with its 'go it alone' strategy but believe that in an environment of outflows from EM Ukraine will not be able to secure sufficient market financing over the coming quarters. We see an IMF deal by mid next year as the most likely outcome. This should be accompanied by the signing of the Association Agreement with the EU in November, bringing long term gains but providing little in the way of short-term financing. Both combined will result in fiscal consolidation and currency depreciation. The alternative, which we do not exclude, is a deal with Russia which would provide support for the currency peg for longer but little to no boost to the growth outlook. Meanwhile, the economy will continue to be weak amidst macroeconomic mismanagement, weak external demand and further tensions with Russia.

Author: Daniel Vernazza, Economist (UniCredit Bank London)

KEY DATES/EVENTS

- 5-10th of each month: FX reserve data
- 15-18th of each month: Industrial production data
- 28-29th November – deadline to sign the Association Agreement with EU
- 29th March 2015 Presidential elections

GDP GROWTH WILL BE SLOW TO RECOVER



Source: State Statistics Service of Ukraine, UniCredit Research

INFLATION SHOULD RISE IN 2014

Source: State Statistics Service of Ukraine, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	117.1	135.6	132.0	129.4	130.7
Population (mn)	45.6	45.5	45.4	45.3	45.2
GDP per capita (EUR)	2568	2979	2907	2857	2891
Real economy yoy (%)					
GDP	5.2	0.2	0	1.0	3.0
Private Consumption	15.7	11.7	1.0	0.8	4.0
Fixed Investment	7.1	0.9	0	3.0	4.5
Public Consumption	-3.0	2.2	0	-0.5	0
Exports	4.3	-7.7	-5.0	5.0	5.5
Imports	17.7	1.9	-6.0	4.0	6.0
Monthly wage, nominal (EUR)	237	292	294	296	318
Unemployment rate (%)	8.2	7.8	7.9	7.9	7.6
Fiscal accounts (% of GDP)					
Budget balance	-2.8	-4.6	-5.3	-4.4	-4.0
Primary balance	-0.8	-2.9	-3.0	-2.0	-1.6
Public debt	36.8	37.4	42.3	45.6	47.2
External accounts					
Current account balance (EUR bn)	-7.4	-11.5	-7.6	-5.9	-5.1
Current account balance/GDP (%)	-6.3	-8.5	-5.7	-4.5	-3.9
Basic balance/GDP (%)	-2.0	-4.7	-2.6	-1.1	-0.3
Net FDI (EUR bn)	5.0	5.2	4.2	4.4	4.8
Net FDI (% of GDP)	4.3	3.8	3.2	3.4	3.7
Gross foreign debt (EUR bn)	97.4	102.3	106.2	110.1	109.6
Gross foreign debt (% of GDP)	83.2	75.5	80.5	85.1	83.9
FX reserves (EUR bn)	23.4	17.2	14.4	15.9	18.7
Inflation/Monetary/FX					
CPI (pavg)	8.0	0.6	0.8	6.2	4.9
CPI (eop)	4.6	-0.2	3.8	5.8	4.5
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	7.75	7.50	6.50	7.00	7.00
3M money market rate (Dec avg)	21.9	24.4	12.0	15.0	8.0
USD/UAH (eop)	8.04	8.05	8.20	9.02	9.47
EUR/UAH (eop)	10.37	10.62	11.07	12.45	12.69
USD/UAH (pavg)	7.99	8.08	8.14	8.61	9.25
EUR/UAH (pavg)	11.12	10.39	10.76	11.76	12.57

Source: UniCredit Researc

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

Turning West?

Macro mismanagement continues to drag on the economy

After exiting technical recession in the first quarter of 2013, the Ukrainian economy contracted a seasonally-adjusted 0.5% qoq in the second quarter (-1.3% yoy). In the last three months the situation has deteriorated due to a sharp decline in industrial production, a trade war with Russia and EM capital outflows. Consequently, we have downgraded our GDP growth forecast to 0% (previously 0.5%) this year and 1% (previously 3%) next year:

The public deficit has widened

- Ukraine has one of the largest twin deficits in the world and the public sector deficit is widening. Ukraine's fiscal gap over Jan-July was USD 4.2bn, which is almost twice as wide as over the same period in 2012. The MinFin forecasts a deficit of 3% of GDP for next year; however this is overly optimistic since it includes USD 2.1bn from privatization of state assets (YTD it has only managed to raise UAH 0.02bn, 8.8% of planned) and is based on unrealistic growth assumptions. Further, we remain concerned that government guarantees are not fully reflected in the public accounts, most notably the state-owned Naftogas, which posted a loss in 1H13 that was more than twice as large as that in 1H12. The sovereign's cash balance is at a multi-year low while the NBU now holds 59% of government bonds (mid-2012: 48%).

Ukraine runs a large C/A deficit

- The current account deficit in the first half of this year was 6.3% of GDP, down from 7.3% in the same period last year. Comparing trade in 1H with the same period in 2012, exports are down 8.7% while imports have fallen a heavier 14.5%. The latter is largely due to a fall in gas imports (-36%), as well as weak domestic demand. We do not see the reduction in gas imports as sustainable, as indicated by low levels of gas in storage.

Industrial production has shrunk

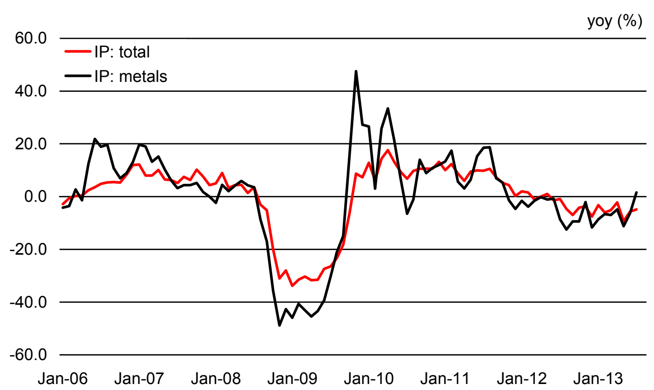
- Industrial production has taken a turn for the worst and was down 4.9% yoy in July, which followed a particularly sharp 9.3% yoy contraction in May. Steel production, which is Ukraine's main export, has contracted (steel exports are down over 12% yoy YTD) as world steel prices have at best stagnated. Russia's ban on Ukrainian imports will no doubt have a negative effect on August industrial production and in the future as further agression from Russia is likely.

Foreign reserves are running low

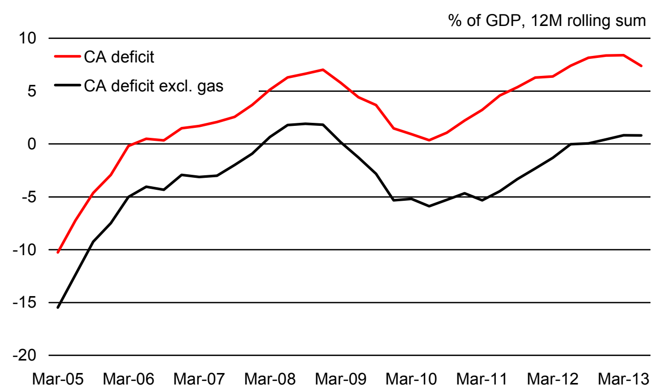
- Foreign reserves have fallen from USD 31.8bn at the start of 2012 to USD 24.5bn at the start of this year, and to USD 21.7bn in August and now cover less than 3-months of imports. Capital controls gather pace: there's a daily restriction on the amount of FX locals can purchase and exporters are forced to convert 50% of revenue into UAH.

INDUSTRIAL PRODUCTION HAS FALLEN FURTHER AND THE CURRENT ACCOUNT DEFICIT IS LARGE

Industrial production has contracted further



Ukraine runs a large current account deficit



Source: NBU, national statistics office, UniCredit Research

Financing becomes ever more problematic

In our country note "Ukraine: No easy options" published on 1 August 2013, we summed up the FX payments that the state must pay between now and the Presidential election on 29 March 2015. IMF repayments total USD 1.6bn for the remainder of 2013, USD 3.6bn in 2014 and USD 1.5bn in 2015. Notably, a funding squeeze comes in the second quarter of next year when, in addition to an IMF payment of USD 1.2bn, both a USD 1bn Eurobond and a USD 1bn VTB loan expire (see chart). In our country note we presented 3 scenarios for access to hard-currency funding: benign, optimistic and adverse. Even in our optimistic scenario reserves fall, while in our benign scenario reserves fall to below USD 15bn at the time of the 2015 Presidential election.

Ukraine must choose between the IMF/EU or Russia

Ukraine has so far been able to maintain its go-it-alone strategy but both the EU's November summit and the change in external financing conditions means that this strategy is under increasing pressure. The state must choose between signing an Association Agreement with the EU on 28-29 November (which includes a free trade pact) and joining the Russian-led Eurasian Customs Union with Russia, Belarus and Kazakhstan. Both the EU and Russia have made it clear that the two are mutually exclusive. In return for joining the Eurasian Customs Union, Russia has offered Ukraine cheaper natural gas and has warned of stricter border controls if it signs the accord with the EU. The Ukrainian government has been trying to delay making a decision, saying that it would like to sign both the EU agreement and join the Russian-led customs union. The opinion polls suggest the Ukrainian population is equally split between EU and Russian integration.

We see Ukraine signing the EU accord, but this is unlikely to bring in FX in a timely manner

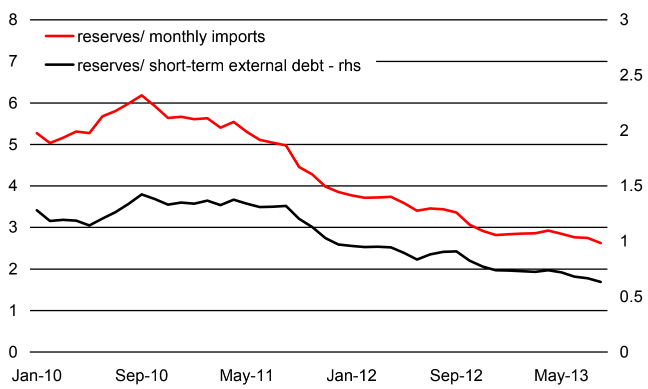
We think Ukraine will sign the accord with the EU in November since **1.** both the government and opposition support it and have said they will enact the judicial, electoral and trade reforms requested by the EU, and **2.** while little progress has been made so far in passing the reforms, various EU leaders have spoken of the need to sign and the EU has recently softened its tone on the conditions (in response to Russian aggression). But this in itself is unlikely to be sufficient to secure consistent market access to stabilize foreign reserves and will have to be complemented with an IMF agreement, prompting fiscal consolidation and currency flexibility.

An IMF deal seems most likely and, although the politics are not conducive, we think the government will have to make concessions

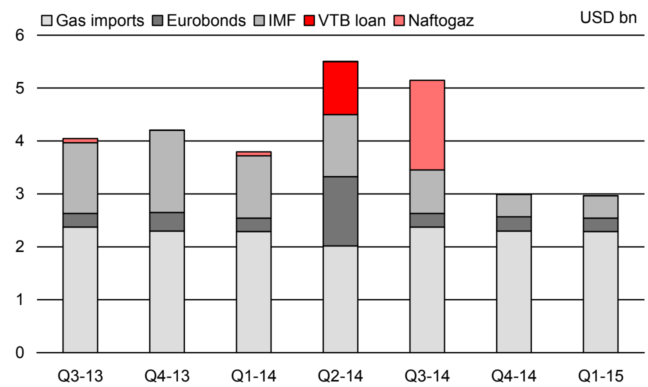
That said, we do not exclude the alternative, namely a deal with Russia. The difference in macro implications between the two deals is significant. A deal with Russia would provide the President with much more upfront financing, securing the currency peg for longer and delaying fiscal consolidation, including gas price hikes. Longer term, however, it risks leaving Ukraine with a much lower rate of potential growth.

FOREIGN RESERVES FALL FURTHER WHILE FX PAYMENTS DUE IN THE COMING QUARTERS ARE LARGE

Foreign reserves cover less than 3-months of imports



Ukraine's FX payments due before the 2015 Presidential election



Source: NBU, IMF, Bloomberg, UniCredit Research

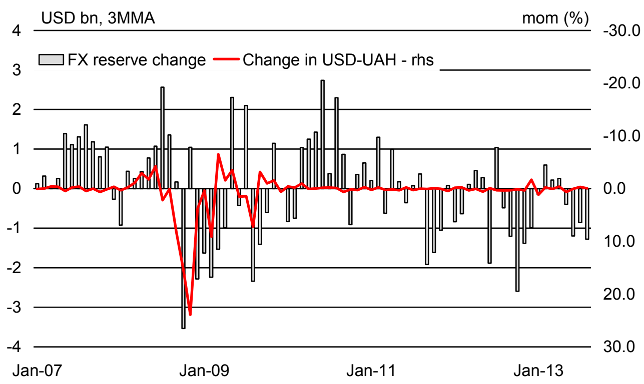
Strategy: Too soon to enter longs

The UAH will depreciate on an IMF deal

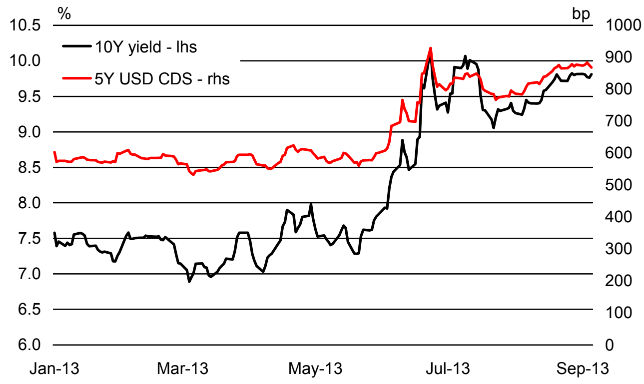
We see little upside to long positions in Ukrainian bonds in the near term. Any decision on an IMF deal will materialize only after a further increase in market stress while if for some reason Ukraine manages to secure sufficient market financing, new issuance will in any case provide an entry window to the market.

- In our most likely scenario, the government agrees to the conditions of an IMF deal but this may not materialize before mid-2014. This, combined with an IMF/EU deal, would be a clear signal to initiate a long bond position. We suggest entering local currency positions only after at least some initial steps towards currency flexibility.
- If the government agrees to a deal with Russia, it should secure the UAH peg for at least another year, depending on the detail of the deal. Short-dated bonds should also benefit given an improved government cash cushion but curve steepening is likely unavoidable.

Ukraine has so far been able to defend its USD/UAH peg



Ukraine's 10Y government bond yield is close to 10%



Source: Bloomberg, NBU, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**15.4**	**15.1**	**13.3**
Budget deficit (excl Nafto)	4.4	3.1	2.6
Amortisation of public debt	11.1	12.0	10.7
Domestic	6.3	7.1	7.9
Short term	0.6	0.8	1.0
Medium to long term	5.7	6.3	6.9
External	4.8	4.9	2.7
of which IMF	3.1	2.6	1.1
Financing	**15.4**	**15.1**	**13.3**
Domestic borrowing	10.8	9.0	9.0
of which NBU	3.2	0	0
Short term	0.8	1.0	1.0
Medium to long term	10.0	8.0	8.0
External borrowing	2.3	4.6	6.1
Bonds	2.3	2.0	3.5
IMF	0	2.6	2.6
Other	2.4	1.5	-1.8

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**60.1**	**56.6**	**52.8**
C/A deficit	7.6	5.9	5.1
Medium to long term amortisation	19.7	17.8	14.7
Banks	5.7	4.5	3.6
Corporates	8.4	8.4	8.4
Government/central bank	5.7	4.9	2.7
Short term debt amortisation	25.2	25.2	25.2
Banks	3.2	3.2	3.2
Corporates	21.9	21.9	21.9
Government/central bank	0	0	0
Other (incl. intercompany lending, capital flight	7.7	7.7	7.7
Financing	**60.1**	**56.6**	**52.8**
FDI	4.2	4.4	4.8
Portfolio flows	0	0.2	1.0
Medium to long term borrowing	16.5	19.2	23.6
Banks	3.2	3.2	6.1
Corporates	11.0	14.0	14.0
Government/central bank	2.3	2	3.5
Short term borrowing	25.2	25.2	25.2
Banks	3.2	3.2	3.2
Corporates	21.9	21.9	21.9
Government/central bank	0	0	0
Other	11.6	9.1	0.9
Change in reserves	2.7	-1.5	-2.7

Notes

Notes

Disclaimer

Our recommendations are based on information obtained from, or are based upon public information sources that we consider to be reliable but for the completeness and accuracy of which we assume no liability. All estimates and opinions included in the report represent the independent judgment of the analysts as of the date of the issue. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice.
This analysis is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as an advertisement thereof. The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Changes in rates of exchange may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither UniCredit Bank, UniCredit Bank London, UniCredit Bank Milan, UniCredit Bank Vienna, UniCredit Bulbank, Zagrebačka banka, UniCredit Bank Czechia, Bank Pekao, UniCredit Russia, UniCredit Slovakia, UniCredit Tiriac, ATF Bank nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This analysis is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

Responsibility for the content of this publication lies with:
a) UniCredit Bank AG (UniCredit Bank), Am Tucherpark 16, 80538 Munich, Germany, (also responsible for the distribution pursuant to §34b WpHG). The company belongs to UniCredit Group. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom.
Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Services Authority (FSA), 25 The North Colonnade, Canary Wharf, London E14 5HS, United Kingdom. Details about the extent of our regulation by the Financial Services Authority are available from us on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank Milan), Via Tommaso Grossi 10, 20121 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.
Regulatory authority: “Bank of Italy”, Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank Vienna), Julius-Tandler-Platz 3, 1090 Vienna, Austria
Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria
Regulatory authority: Financial Supervision Commission (FSC), 33 Shar Planina str.,1303 Sofia, Bulgaria

f) Zagrebačka banka d.d., Trg bana Jelačića 10, HR-10000 Zagreb, Croatia
Regulatory authority: Croatian Agency for Supervision of Financial Services, Miramarska 24B, 10000 Zagreb, Croatia

g) UniCredit Bank Czech Republic (UniCredit Bank Czechia), Na Príkope 858/20, CZ-11121 Prague, Czech Republic
Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic

h) Bank Pekao, ul. Grzybowska 53/57, PL-00-950 Warsaw, Poland
Regulatory authority: Polish Financial Supervision Authority, Plac Powstańców Warszawy 1, 00-950 Warsaw, Poland

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya emb. 9, RF-19034 Moscow, Russia
Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Slovakia a.s. (UniCredit Slovakia), Šancova 1/A, SK-813 33 Bratislava, Slovakia
Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Tiriac Bank (UniCredit Tiriac), Bucharest 1F Expozitiei Boulevard, RO-012101 Bucharest 1, Romania
Regulatory authority: National Bank of Romania, 25 Lipscani Street, RO-030031, 3rd District, Bucharest, Romania

POTENTIAL CONFLICTS OF INTEREST
UniCredit Bank AG acts as a Specialist or Primary Dealer in government bonds issued by the Italian, Portuguese and Greek Treasury. Main tasks of the Specialist are to participate with continuity and efficiency to the governments' securities auctions, to contribute to the efficiency of the secondary market through market making activity and quoting requirements and to contribute to the management of public debt and to the debt issuance policy choices, also through advisory and research activities.

ANALYST DECLARATION
The author’s remuneration has not been, and will not be, geared to the recommendations or views expressed in this study, neither directly nor indirectly.

ORGANIZATIONAL AND ADMINISTRATIVE ARRANGEMENTS TO AVOID AND PREVENT CONFLICTS OF INTEREST
To prevent or remedy conflicts of interest, UniCredit Bank, UniCredit Bank London, UniCredit Bank Milan, UniCredit Bank Vienna, UniCredit Bulbank, Zagrebačka banka, UniCredit Bank Czechia, Bank Pekao, UniCredit Russia, UniCredit Slovakia, UniCredit Tiriac, and ATF Bank have established the organizational arrangements required from a legal and supervisory aspect, adherence to which is monitored by its compliance department. Conflicts of interest arising are managed by legal and physical and non-physical barriers (collectively referred to as “Chinese Walls”) designed to restrict the flow of information between one area/department of UniCredit Bank, UniCredit Bank London, UniCredit Bank Milan, UniCredit Bank Vienna, UniCredit Bulbank, Zagrebačka banka, UniCredit Bank Czechia, Bank Pekao, UniCredit Russia, UniCredit Slovakia, UniCredit Tiriac, ATF Bank and another. In particular, Investment Banking units, including corporate finance, capital market activities, financial advisory and other capital raising activities, are segregated by physical and non-physical boundaries from Markets Units, as well as the research department. In the case of equities execution by UniCredit Bank AG Milan Branch, other than as a matter of client facilitation or delta hedging of OTC and listed derivative positions, there is no proprietary trading. Disclosure of publicly available conflicts of interest and other material interests is made in the research. Analysts are supervised and managed on a day-to-day basis by line managers who do not have responsibility for Investment Banking activities, including corporate finance activities, or other activities other than the sale of securities to clients.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

Notice to Australian investors
This publication is intended for wholesale clients in Australia subject to the following:
UniCredit Bank AG and its branches do not hold an Australian Financial Services licence but are exempt from the requirement to hold a licence under the Act in respect of the financial services to wholesale clients. UniCredit Bank AG and its branches are regulated by BaFin under German laws, which differ from Australian laws. This document is only for distribution to wholesale clients as defined in Section 761G of the Corporations Act. UniCredit Bank AG and its branches are not Authorised Deposit Taking Institutions under the Banking Act 1959 and are not authorised to conduct a banking business in Australia.

Notice to Austrian investors
This document does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any securities and neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever.
This document is confidential and is being supplied to you solely for your information and may not be reproduced, redistributed or passed on to any other person or published, in whole or part, for any purpose.

Notice to Czech investors
This report is intended for clients of UniCredit Bank, UniCredit Bank London, UniCredit Bank Milan, UniCredit Bank Vienna, UniCredit Bulbank, Zagrebačka banka, UniCredit Bank Czechia, Bank Pekao, UniCredit Russia, UniCredit Slovakia, UniCredit Tiriac, ATF Bank in the Czech Republic and may not be used or relied upon by any other person for any purpose.

Notice to Italian investors
This document is not for distribution to retail clients as defined in article 26, paragraph 1(e) of Regulation n. 16190 approved by CONSOB on October 29, 2007.
In the case of a short note, we invite the investors to read the related company report that can be found on UniCredit Research website **www.research.unicreditgroup.eu.**

Notice to Japanese investors
This document does not constitute or form part of any offer for sale or subscription for or solicitation of any offer to buy or subscribe for any securities and neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever.

Notice to Polish investors
This document is intended solely for professional clients as defined in Art. 3 39b of the Trading in Financial Instruments Act of 29 July 2005.The publisher and distributor of the recommendation certifies that it has acted with due care and diligence in preparing the recommendation, however, assumes no liability for its completeness and accuracy.

Notice to Russian investors
As far as we are aware, not all of the financial instruments referred to in this analysis have been registered under the federal law of the Russian Federation "On the Securities Market" dated 22 April 1996, as amended (the "Law"), and are not being offered, sold, delivered or advertised in the Russian Federation. This analysis is intended for qualified investors, as defined by the Law, and shall not be distributed or disseminated to a general public and to any person, who is not a qualified investor.

Notice to Turkish investors
Investment information, comments and recommendations stated herein are not within the scope of investment advisory activities. Investment advisory services are provided in accordance with a contract of engagement on investment advisory services concluded with brokerage houses, portfolio management companies, non-deposit banks and the clients. Comments and recommendations stated herein rely on the individual opinions of the ones providing these comments and recommendations. These opinions may not suit your financial status, risk and return preferences. For this reason, to make an investment decision by relying solely on the information stated here may not result in consequences that meet your expectations.

Notice to UK investors
This communication is directed only at clients of UniCredit Bank, UniCredit Bank London, UniCredit Bank Milan, UniCredit Bank Vienna, UniCredit Bulbank, Zagrebačka banka, UniCredit Bank Czechia, Bank Pekao, UniCredit Russia, UniCredit Slovakia, UniCredit Tiriac, or ATF Bank who (i) have professional experience in matters relating to investments or (ii) are persons falling within Article 49(2)(a) to (d) ("high net worth companies, unincorporated associations, etc.") of the United Kingdom Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 or (iii) to whom it may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This communication must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this communication relates is available only to relevant persons and will be engaged in only with relevant persons.

Notice to U.S. investors
This report is being furnished to U.S. recipients in reliance on Rule 15a-6 ("Rule 15a-6") under the U.S. Securities Exchange Act of 1934, as amended. Each U.S. recipient of this report represents and agrees, by virtue of its acceptance thereof, that it is such a "major U.S. institutional investor" (as such term is defined in Rule 15a-6) and that it understands the risks involved in executing transactions in such securities. Any U.S. recipient of this report that wishes to discuss or receive additional information regarding any security or issuer mentioned herein, or engage in any transaction to purchase or sell or solicit or offer the purchase or sale of such securities, should contact a registered representative of UniCredit Capital Markets, LLC.
Any transaction by U.S. persons (other than a registered U.S. broker-dealer or bank acting in a broker-dealer capacity) must be effected with or through UniCredit Capital Markets.
The securities referred to in this report may not be registered under the U.S. Securities Act of 1933, as amended, and the issuer of such securities may not be subject to U.S. reporting and/or other requirements. Available information regarding the issuers of such securities may be limited, and such issuers may not be subject to the same auditing and reporting standards as U.S. issuers.
The information contained in this report is intended solely for certain "major U.S. institutional investors" and may not be used or relied upon by any other person for any purpose. Such information is provided for informational purposes only and does not constitute a solicitation to buy or an offer to sell any securities under the Securities Act of 1933, as amended, or under any other U.S. federal or state securities laws, rules or regulations. The investment opportunities discussed in this report may be unsuitable for certain investors depending on their specific investment objectives, risk tolerance and financial position. In jurisdictions where UniCredit Capital Markets is not registered or licensed to trade in securities, commodities or other financial products, transactions may be executed only in accordance with applicable law and legislation, which may vary from jurisdiction to jurisdiction and which may require that a transaction be made in accordance with applicable exemptions from registration or licensing requirements.
The information in this publication is based on carefully selected sources believed to be reliable, but UniCredit Capital Markets does not make any representation with respect to its completeness or accuracy. All opinions expressed herein reflect the author's judgment at the original time of publication, without regard to the date on which you may receive such information, and are subject to change without notice.
UniCredit Capital Markets may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. These publications reflect the different assumptions, views and analytical methods of the analysts who prepared them. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is provided in relation to future performance.
UniCredit Capital Markets and any company affiliated with it may, with respect to any securities discussed herein: (a) take a long or short position and buy or sell such securities; (b) act as investment and/or commercial bankers for issuers of such securities; (c) act as market makers for such securities; (d) serve on the board of any issuer of such securities; and (e) act as paid consultant or advisor to any issuer.
The information contained herein may include forward-looking statements within the meaning of U.S. federal securities laws that are subject to risks and uncertainties. Factors that could cause a company's actual results and financial condition to differ from expectations include, without limitation: political uncertainty, changes in general economic conditions that adversely affect the level of demand for the company's products or services, changes in foreign exchange markets, changes in international and domestic financial markets and in the competitive environment, and other factors relating to the foregoing. All forward-looking statements contained in this report are qualified in their entirety by this cautionary statement

This document may not be distributed in Canada.

Banking network

UniCredit Group CEE banking network – Headquarters

Azerbaijan

Yapi Kredi Azerbaijan
Yasamal District, Jafar Jabbarlı Str., 32/12,
AZ 1065, Baku/Azerbaijan
Phone +994 12 497 77 95
E-mail: info@yapikredi.com.az
www.yapikredi.com.az/

Bosnia and Herzegovina

UniCredit Bank
Kardinala Stepinca b.b.,
BH-88000 Mostar
Phone: +387 36 312112
E-mail: info@unicreditgroup.ba
www.unicreditbank.ba

UniCredit Bank Banja Luka
Marije Bursac 7,
BH-78000 Banja Luka
Phone: +387 80 051 051
E-mail: info-bl@unicreditgroup.ba
www.unicreditbank-bl.ba

Bulgaria

UniCredit Bulbank
Sveta Nedelya Sq. 7,
BG-1000 Sofia
Phone: +359 70 01 84 84
www.unicreditbulbank.bg

Croatia

Zagrebačka banka
Paromlinska 2
HR-10000 Zagreb
Phone: +385 1 6104 169
Email: zaba@unicreditgroup.zaba.hr
www.zaba.hr

Czech Republic

UniCredit Bank
Na Poikopi 20
CZ-113 80 - Prague 1
Phone: +420 221 112 111
E-mail: info@unicreditgroup.cz
www.unicreditbank.cz

Hungary

UniCredit Bank
Szabadság square 5-6,
H-1054 Budapest,
Phone: +36 1 301 12 71
E-mail: info@unicreditbank.hu
www.unicreditbank.hu

Kyrgyzstan

JSC "UniCredit Bank"
493, Jibek Jolu. Ave.
720070 Bishkek, Kyrgyzstan
Phone: + 996 312 37 670047
E-mail: bank@unicreditbank.kg
www.unicreditbank.kg

Macedonia

Bank Austria Representative Office
Ulica Makedonija br. 53/4
MK-1000 Skopje
Phone: +389 2 215 130
E-mail: bisera.strezoska@unicreditgroup.mk

Montenegro

Bank Austria Representative Office
Hercegovacka 13
ME-81000 Podgorica
Phone: +382 20 66 77 40
E-mail: milan.djordjevic@unicreditgroup.mk

Poland

Bank Pekao
ul. Grzybowska 53/57,
PL-00-950 Warsaw
Phone: +48 22 656-0000
www.pekao.com.pl

Romania

UniCredit Tiriac Bank
Bd. Expozitiei Nr. 1F,
RO-012101 Bucharest 1,
Phone: +40 21 200 2000
E-Mail: office@unicredit.ro
www.unicredit-tiriac.ro

Russia

UniCredit Bank
Prechistenskaya emb. 9,
RF-119034 Moscow
Phone: +7 495 258 7258
Email: unicredit@unicreditgroup.ru
www.unicreditbank.ru

Serbia

UniCredit Bank
Rajiceva 27-29,
RS-11000 Belgrade
Phone: +381 11 3204 500
E-mail: office@unicreditgroup.rs
www.unicreditbank.rs

Slovakia

UniCredit Bank
Sǎncova 1/A,
SK-813 33 Bratislava
Phone: +421 2 4950 1111
www.unicreditbank.sk

Slovenia

UniCredit Bank
Šmartinska cesta 140,
SI-1000 Ljubljana
Phone: +386 1 5876 600
E-mail: info@unicreditgroup.si
www.unicreditbank.si

Turkey

Yapı Kredi
Yapı Kredi Plaza D Blok, Levent,
TR-34330 Istanbul
Phone: +90 212 339 70 00
www.yapikredi.com.tr

Ukraine

UniCredit Bank
D. Galytrskogo Str. 14.,
UA-43016 Lutsk
Phone: +380 332 776210
E-mail: info@unicredit.com.ua
www.unicreditbank.com.ua

PJSC Ukrsotsbank
29 Kovpaka St.,
UA-03150 Kiev
Phone: +380 44 230 32 99
E-mail: info@ukrsotsbank.com
www.unicredit.com.ua

Contacts for entering into a business relationship with UniCredit's corporate banking network

Austrian contact

Bank Austria

Cross Border Business Mangement
E-mail: business_development@unicreditgroup.at

German contact

UniCredit Bank AG

Ulrich Burghardt
Phone: +49 89 378 27472
E-mail: ulrich.burghardt@unicredit.de
(Czech Republic, Slovakia, Slovenia, Turkey, Hungary)

Shetong Jiang
Phone: +49 89 378 24366
E-mail: shetong.jiang@unicredit.de
(Baltics, Russia)

Steffen Reiser
Phone: +49 89 378 25639
E-mail: steffen.reiser@unicredit.de
(Austria, Bulgaria, Romania, Poland)

Peter Ulbrich
Phone: +49 89 378 25282
E-mail: peter.ulbrich@unicredit.de
(Bosnia and Herzegovina, Croatia, Serbia)

Italian contact

UniCredit Corporate Banking

Stefano Coceancigh
Phone: +39 0422 1637 836
E-mail: CBBM-CIB@unicredit.eu

Marino Inio
Tel: +39 02 886216 72
E-mail: marino.inio@unicredit.eu

International contact

Azerbaijan

Sinan AGIRBAS
Phone: +994 12 497 7095
E-mail: sinan.agirbas@yapikredi.com.az

Bosnia and Herzegovina

UniCredit Bank d.d.
Ilvana LOKVANČIĆ
Phone: +387 33 49 16 56
E-mail: ilvana.lokvancic@unicreditgroup.ba

UniCredit Bank a.d. Banja Luka
Boris Dragic
Phone: +387 51 243 320;
E-mail: boris.dragic@unicreditgroup.ba

Bulgaria

Aldo Andredoni
Phone: +359 2 923 2560
E-mail: aldo.andredoni@unicreditgroup.bg

Croatia

Zoran Ferber
Phone: +385 1 6305 437
E-mail: zoran.ferber@unicreditgroup.zaba.hr

Czech Republic

Miroslav Hrabal
Phone: +420 955 961 108
E-mail: miroslav.hrabal@unicreditgroup.cz

Hungary

Paolo Garlanda
Phone: +36 1 301 1207
E-mail: paolo.garlanda@unicreditgroup.hu

Macedonia

Milan Djordjevic
Phone: +389 70 267 034
E-mail: Milan.Djordjevic@unicreditgroup.mk

Montenegro

Milan Djordjevic
Phone: +389 70 267 034
E-mail: Milan.Djordjevic@unicreditgroup.mk

Poland

Robert Randak
Phone: +48 22 524 8957
E-mail: robert.randak@pekao.com.pl

Romania

Christine Tomasin
Phone: +40 21 200 1768
E-mail: christine.tomasin2@unicredit.ro

Russia

Inna Maryasina
Phone: +7 495 544 5352
E-mail: inna.maryasina@unicreditgroup.ru

Serbia

Zoran Jevtovic
Phone: +381 11 3204 533
E-mail: zoran.jevtovic@unicreditgroup.rs

Slovakia

Massimiliano Giuliani
Phone: +421 2 4950 2373
E-mail:massimiliano.giuliani@unicreditgroup.sk

Slovenia

Branka Cic
Phone: +386 1 5876 512
E-mail: branka.cic@unicreditgroup.si

Turkey

Esra Omuzluoglu
Phone: +90 212 339 7592
E-mail: esra.omuzluoglu@yapikredi.com.tr

Ukraine

Roberto Poliak
Phone: +380 44 529 0583
E-mail: roberto.poliak@unicredit.ua

UniCredit Research*

Michael Baptista
Global Head of CIB Research
+44 207 826-1328
michael.baptista@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
+49 89 378-13952
ingo.heimig@unicredit.de

Economics & FI/FX Research

Erik F. Nielsen, Global Chief Economist
+44 207 826 1765
erik.nielsen@unicredit.eu

Economics & Commodity Research

European Economics

Marco Valli, Chief Eurozone Economist
+39 02 8862-8688
marco.valli@unicredit.eu

Dr. Andreas Rees, Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Stefan Bruckbauer, Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco, Economist
+39 02 8862-2079
tullia.bucco@unicredit.eu

Chiara Corsa, Economist
+39 02 8862-2209
chiara.corsa@unicredit.eu

Dr. Loredana Federico, Economist
+39 02 8862-3180
loredana.federico@unicredit.eu

Alexander Koch, CFA
+49 89 378-13013
alexander.koch1@unicredit.de

Chiara Silvestre, Economist
chiara.silvestre@unicredit.eu

US Economics

Dr. Harm Bandholz, CFA, Chief US Economist
+1 212 672-5957
harm.bandholz@unicredit.eu

China Economics

Nikolaus Keis, Economist
+49 89 378-12560
nikolaus.keis@unicredit.de

Commodity Research

Kathrin Goretzki, Economist
+49 89 378-15368
kathrin.goretzki@unicredit.de

Jochen Hitzfeld, Economist
+49 89 378-18709
jochen.hitzfeld@unicredit.de

EEMEA Economics & FI/FX Strategy

Gillian Edgeworth, Chief EEMEA Economist
+44 207 826-1772
gillian.edgeworth@unicredit.eu

Artem Arkhipov, Head, Macroeconomic Analysis and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Anca Maria Aron, Economist, Romania
+40 21 200-1377
anca.aron@unicredit.ro

Dan Bucşa, Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Hrvoje Dolenec, Chief Economist, Croatia
+385 1 6006 678
hrvoje.dolenec@unicreditgroup.zaba.hr

Ľubomír Koršňák, Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Catalina Molnar, Chief Economist, Romania
+40 21 200-1376
catalina.molnar@unicredit.ro

Marcin Mrowiec, Chief Economist, Poland
+48 22 656-0678
marcin.mrowiec@pekao.com.pl

Carlos Ortiz, Economist, EEMEA
+44 207 826-1228
carlos.ortiz@unicredit.eu

Mihai Patrulescu, Senior Economist, Romania
+40 21 200-1378
mihai.patrulescu@unicredit.ro

Kristofor Pavlov, Chief Economist, Bulgaria
+359 2 9269-390
kristofor.pavlov@unicreditgroup.bg

Pavel Sobisek, Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

Daniel Vernazza, Ph.D., Economist, EEMEA
+44 207 826-7805
daniel.vernazza@unicredit.eu

Dmitry Veselov, Ph.D., Economist, EEMEA
+44 207 826-1808
dmitry.veselov@unicredit.eu

Global FI Strategy

Michael Rottmann, Head, FI Strategy
+49 89 378-15121
michael.rottmann1@unicredit.de

Dr. Luca Cazzulani, Deputy Head, FI Strategy
+39 02 8862-0640
luca.cazzulani@unicredit.eu

Chiara Cremonesi, FI Strategy
+44 20 7826-1771
chiara.cremonesi@unicredit.eu

Elia Lattuga, FI Strategy
+39 02 8862-2027
elia.lattuga@unicredit.eu

Kornelius Purps, FI Strategy
+49 89 378-12753
kornelius.purps@unicredit.de

Herbert Stocker, Technical Analysis
+49 89 378-14305
herbert.stocker@unicredit.de

Global FX Strategy

Dr. Vasileios Gkionakis, Global Head, FX Strategy
+44 207 826-7951
vasileios.gkionakis@unicredit.eu

Armin Mekelburg, FX Strategy
+49 89 378-14307
armin.mekelburg@unicredit.de

Roberto Mialich, FX Strategy
+39 02 8862-0658
roberto.mialich@unicredit.eu

Publication Address

UniCredit Research
Corporate & Investment Banking
UniCredit Bank AG
Arabellastrasse 12
D-81925 Munich
Tel. +49 89 378-18927

Bloomberg
UCCR

Internet
www.research.unicreditgroup.eu

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank), UniCredit Bank AG London Branch (UniCredit Bank London), UniCredit Bank AG Milan Branch (UniCredit Bank Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank Vienna), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic (UniCredit Bank Czechia), Bank Pekao, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Slovakia a.s. (UniCredit Slovakia), UniCredit Tiriac Bank (UniCredit Tiriac).